Bank of Albania

MONETARY POLICY REPORT
2012 Q2

*This Report refers to the Monetary Policy Statement of the Bank of Albania on the first half of 2012, approved by the Supervisory Council's Decision No. 46, dated 25.07.2012.

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

www.bankofalbania.org

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OBJECTIVE

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.

The Monetary Policy Report for the second quarter of 2012 refers to the Bank of Albania Monetary Policy Statement for the first half of 2012, approved by the Supervisory Council of the Bank of Albania on 25 July 2012. The economic analysis in this Report is based on the latest available statistical data as at 18 July 2012.

I. FOREWORD BY THE GOVERNOR

During the first half of 2012, the Albanian economy continued to maintain the parameters of macroeconomic and financial stability, against an increasingly challenging global context. Consumer price inflation, budget deficit and public debt indicators, balance of payments and financial situation of the banking system were stable. In particular, the Albanian financial sector remains well-capitalised, liquid and able to conduct its intermediation role. During this period, the Albanian economy experienced some shocks on the supply side, with structural movements in the domestic financial markets, and a slowed domestic and foreign demand. These developments drove the fall in GDP in the first quarter of 2012 and hampered the implementation of stabilising policies on the aggregate demand. As tensions may be reduced in the second half of 2012, the Albanian economy is expected to record positive growth rates.

Average annual inflation marked 1.9% in the second quarter of 2012, increasing 0.8 percentage points compared to the first quarter of 2012. The gradual rise in consumer prices has mainly reflected the increase in unprocessed food prices, whereas prices of processed foods and those of non-food consumer goods lowered their contribution to inflation during the second quarter of 2012. The other categories in consumer prices basket showed a serene performance, and were characterised by low inflation rates.

Within the macroeconomic context, consumer prices continue to reflect weak inflationary pressures, both on the supply and demand sides. On the demand side, the presence of free capacities in using the production factors is reflected in the control of costs in economy and in declining pressures on inflation. On the supply side, the slowdown of imported inflationary pressures, decrease in oil and primary commodity prices, steady administered prices, low inflationary expectations and minimal second-round effects did not generate inflationary pressures. Consumer price inflation remains at low rates and is expected to remain so in the period ahead. These assessments conditioned the retaining of the stimulating nature of monetary policy during the second quarter of 2012. The key rate stood at the lowest historical level, providing eased monetary conditions in order to meet our inflation target and support Albania's economic activity. The Bank of Albania has also continued to inject sufficient liquidity demanded by the banking system, against an expanded collateral base and at adequate maturity terms.

According to recent data from INSTAT, the Albanian economy recorded an annual fall of 0.2% in the first quarter of 2012. Industry contracted 19.3%, y-o-y, mainly due to the significant decrease in electrical energy output.

Construction also decreased its activity in real terms, by 17.6%, thus providing a negative contribution to the GDP. By contrast, services contributed positively to the economic activity, pointing to an annual growth of 6.0%. Agricultural sector grew 4.5%, y-o-y during this period, providing a positive contribution to GDP growth.

Estimates on the aggregate demand in the first quarter of 2012 suggest a continuing weak domestic demand. The consolidating fiscal policy determined the lack of fiscal stimulus in this period and a downturn in public sector's demand for goods and services. Private consumption remains sluggish, thus reflecting the prudent consumer behaviour and the increasing tendency to save. Private investments also remained low. Given the free production capacities, Albanian businesses found less room to increase their investments in machinery, equipment, and production, while the demand for residential buildings remains weak. At the same time, foreign demand was sluggish in the second quarter of 2012, owing to the problems in the euro area and in our main trading partners. The weak foreign demand, and the problems in electrical energy production, imposed the slow increase in the Albanian exports.

Data on economy for the second quarter of 2012 are incomplete. Indirect data signal a weak recovery of the economy in this period. Their analysis supports the estimation for a continuing sluggish aggregate demand, especially of the domestic demand. On the production side, in the second quarter of 2012, economic sectors are expected to maintain the dynamics showed in the first quarter of 2012.

Fiscal developments in the second quarter of 2012 were in line with those observed in the first quarter, characterised by the consolidated fiscal policy and its inclination to maintain budget deficit and public debt targets. This behaviour is reflected in the contraction of budget expenses by 2.5%, in the first half of 2012. Furthermore, fiscal revenues increased by 3.7% during this period, continuing to show a slow dynamic of their taxing component. The performance of public expenditure and revenues in the first half of 2012 is materialised in the significant contraction of budget deficit in annual terms, at 37.7%. This deficit was ALL 16.8 billion in monetary value, and is estimated at 2.6% of the GDP.

Data on developments in the external sector of the economy reveal a contracted trade exchange in the first five months of 2012. Value of exports marked a low annual growth of 1.3% in this period, reflecting the moderation of foreign demand and price developments in global markets. In this period, imports shrank by 2.0% in annual terms. These developments resulted in a decreased trade deficit in the first five months of the year by an annualised rate of 4.2%. Developments in foreign trade in this period were determined mostly by electrical energy trade exchanges. Excluding this effect, the growth in exports would be higher and the contraction in imports deeper, resulting in a contracted trade deficit, at 18.1%.

The performance of monetary indicators was in line with the developments in the real economy and our analyses show contained monetary pressures on inflation. The annual growth of M3 was 8.7% in May, maintaining the average rates of the previous months of the current year. The growth paces of money supply slowed down compared to a year earlier, reflecting the lower demand of economic agents for money. The consolidated fiscal position was coupled with a decrease in public sector borrowing, while the private agents of economy reflected a low demand for financing. Lending to the private sector rose by 7.5% in May, pursuing the slowing trend, which has started since the end of 2011. Along with the low demand of businesses and households, its performance reflects the selective and prudent behaviour of banks in lending.

Regarding lending problems, the Bank of Albania deems that banking system's balance sheets are sound, sufficiently liquid, and well capitalised to comply with the economy's demand for monetary assets. The positive position of its balance sheets triggered the lending growth during the past years, while many countries in our region experienced contraction of lending. The banking system has reviewed and tightened the lending standards during the last years; however, this behaviour to enhance the financial discipline of the economy is welcomed and will positively support the long-term growth of Albania. On the other side, credit performance is increasingly experiencing the lack of demand, which is triggered by the consumers and businesses' reluctance to spend and invest. Notwithstanding the cyclical situation of Albania's economy, the Bank of Albania deems that the perspectives on medium and long-term development remain positive. This is also reflected in the interest of foreign investors to increase their exposure to the Albanian economy. In particular, economy sectors related to exports, tourism and agriculture – the latter serving to the domestic and regional markets – provide unused potentials for development. The Bank of Albania deems that, within the sound business' logic parameters, there is room for the Albanian entrepreneurs and consumers to pursue a more active approach toward the growth of investments and consumption.

Financial markets showed low interest rate fluctuation and operated under sufficient liquidity terms in the second quarter of 2012. The transmission of reduced rates is also observable in lek deposits market, followed by normal growth pace of deposits. By contrast, government security yields increased in the primary market, particularly the long-term yields. This performance has reflected the repositioning of some agents in this market and the demand for financing in this period, without implying a shift of inflationary expectations. At the beginning of July, ratios improved and borrowing costs reduced in the primary market. The second quarter also transmitted signals on eased interest rates on lek credits from banks. Nevertheless, credit-lending paces remain low and mainly designated for short-term use, leading to fluctuating interest rates.

The entry of new financial intermediaries, specialised in channelling the public savings to government securities, was a positive development, as we analyse the financial markets standing for the first half of year. Along

with the increased public interest in government securities, this development enhances the depth of our financial system, improves the liquidity, enhances its risk management capability, limits the interest rates fluctuation, increases the Albanian public debt sustainability and exerts pressures to reduce the financing cost of the public sector.

Verified performance of economic activity at home and the information filtered from indirect indicators have shifted downward our baseline projections for the economic performance for the rest of year. This shift reflects the materialisation of some risks around the previous baseline projections, being expected and factorised in our scenarios. The domestic economy is expected to slow down during the rest of year, being conditioned by the weakening of domestic and foreign demand. Given the consolidated fiscal behaviour and the slowed foreign demand, the performance of the private domestic demand will determine the economic activity growth. However, its two components, consumption and investments, have not shown any recovery signals so far.

Expected developments at home and abroad result in a contained balance of inflationary pressures, determining a slow increase in consumer prices in the future. The growth of demand below the potential of the economy in the upcoming period will continue to exercise low inflationary pressures. At the same time, the pressures generated by demand-side factors appear contained. Based on the insofar developments of the determinant factors of inflation and the projections for their performance in the future, with 90% probability, inflation will range within 1.0% – 3.3% band after 12 months. The expected developments in economy and inflation imply that the simulating nature of the monetary policy will be retained during the period ahead. The Bank of Albania remains heedful to future developments and new information, ready to respond in the appropriate time and extent in order to comply with its legal mission.

II. EXTERNAL ECONOMY

The landscape of economic developments shows that the global economy grew at slower rates in the second quarter of 2012, with disparities among various countries and zones. In advanced economies, structural weaknesses, tensions in the capital markets of the euro area related to the sovereign debt and the need to consolidate the balance sheets in the public and private sector rendered economic recovery more difficult. Emerging economies performed better, although the above-listed problems contributed to lower growth pace in many of these countries. Inflationary pressures were more contained in most economies, reflecting declining contribution of energy products and cooling down of demand-side pressures.

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

In the second quarter, the global economy was characterised by sluggish growth rates. According to preliminary and indirect indicators, the global economic activity is growing at slower rates and the disparities among various zones continue to be evident. The rising tensions in financial markets added the uncertainties for the medium run and conditioned a considerable part of the aggregate demand, worldwide. Emerging economies resumed their positive performance that had started a year earlier, although their growth is more moderate. In advanced economies, the performance was conditioned by the evolution of the debt crisis that has also hit other countries of the euro area, adding to economic agents' uncertainties. The fragile situation in the labour market and the need to consolidate balance sheets in the private and public sectors have decelerated the economic recovery, slackening the expectations for a rapid recovery. In the last months, inflation remained relatively low in advanced economies and recorded modest decline in emerging economies, reflecting mainly the reduction of energy and commodity prices.

Table 1 Selected macroeconomic indicators

	GDP change		Unemployment	Inflation	
Countries	2012 Q1/ 2011 Q4	2012 Q1/ 2011 Q1	June-12	June 2012/ May 2012	June 2012/ June 2011
USA	0.5	2.1	8.2	-0.3[1]	1.7[1]
Euro area	0.0	0.0	11.1[1]	-0.1	2.4
Germany	0.5	1.2	5.5[1]	-0.1	1.7
France	0.0	0.3	10.0[2]	0.0	1.9
United Kingdom	-0.2	0.0	8.2[2]	-0.1[1]	2.8[1]
Japan	1.0	4.1	4.41	-0.3[1]	0.2[1]

Source: ECB, Fed and respective statistics institutes.
[1] May 2012.
[2] January-March 2012.

EURO AREA ECONOMY

Data released from the Eurostat show that, in 2012 Q1, the euro area GDP did not grow. The euro area economy continues to suffer from weak domestic demand, unfavourable performance of the labour market, modest growth of business loans, and fragile situation of financial markets. A detailed analysis reveals that the positive contribution of the external demand has been offset by the contraction of consumption and inventories. In country specific terms, the good performance of Germany, Austria and Finland has compensated the contraction in the economies of Italy, Spain and other euro area countries. For the second quarter, preliminary and indirect data suggest the continuation of sluggish consumption and investments. Foreign demand and certain specific sectors of the industry are expected to provide modest contribution to GDP. The debt crisis effect on the real sector, fiscal consolidation and the increase in unemployment are the main factors determining economic growth rates in the euro area in 2012. Inflationary pressures were contained and, in June 2012, annual inflation stood at 2.4%, unchanged from May. Unemployment rate reached another record high in May, settling at 11.1%.

US ECONOMY

The US economy continued to expand moderately. According to BEA's third estimate of real GDP, it grew at the annualised rate of 1.9% in 2012 Q1. During this quarter, growth was driven mainly by exports and private spending and consumption. Given the decline of income, they were financed by cutting personal savings. While manufacturing and consumer spending continued to grow, difficulties in the labour market and ongoing uncertainties in global financial markets raised a number of concerns over the recovery speed of the US economy. Preliminary data and indirect indicators support the idea that, in the second quarter, growth will be more moderate than in the first quarter. Inflationary pressures were downward and, in May 2012, annual inflation was 1.7%. The unemployment rate was 8.2% in June, unchanged from a month earlier.

BRIC ECONOMIES

Latest data suggest that, in the first months of 2012, BRIC economies continued to grow, though more moderately. Brazil's GDP grew 0.8% y-o-y in 2012 Q1. The services and industry sectors provided positive contribution, up about 1.6% and 0.1%, respectively. Conversely, the agricultural sector shrank significantly by 8.5%, y-o-y. The effects of the fiscal package are considered to stimulate the economy over the second half of the year, increasing the investments in the public and private sectors. Recent data show that during 2012 Q1, Russia's GDP grew 4.9%, y-o-y. Demand for investment and real wages increased, contributing positively to economic growth. Moreover, boosted government spending in the context of presidential elections in March 2012 contributed to GDP's positive growth. In 2012 Q1, the Indian economy grew 5.3%. The depreciation of the national currency and high inflation rates dictated the moderation of India's growth rates. However, in the last month, the national currency appreciated against the US dollar. In 2012 Q1, the Chinese economy, which has the highest growth rates among the BRIC countries, grew 8.1%, y-o-y.

Table 2 Selected macroeconomic indicators for BRIC countries

Countries	Annual GDP change			Annual Inflation	
	2011 Q4	2011	2012 Q1	2011	June 2012
Brazil	1.4	2.7	0.8	6.6	4.9
Russia	3.5	4.3	4.9	8.5	3.6
India	6.1	7.0	5.3	9.1	7.6[1]
China	8.9	9.2	8.1	5.4	2.2

Source: IMF, OECD, respective statistics institutes. [1] May 2012.

ECONOMIES OF THE REGION

Latest data from the economies of the region reveal that, during 2012 Q1, the respective economies shrank. The real GDP growth contracted further in Croatia and turned negative in FYROM and Serbia. In some countries, this performance is considered to be temporary, as in addition to the effects of the worsening economic situation in EU countries, it reflects the considerable influence of weather conditions on production and exports. In Turkey, economic growth was about 3.2% in 2012 Q1. Net exports triggered positive contribution to growth while domestic demand contracted during this period. The Italian economy shrank for the third consecutive quarter. In 2012 Q1, consumption and investments fell while net exports contributed positively. In June, unemployment reached 10.1%. Projections show that the Italian economy will continue to slow down throughout 2012 also owing to government measures for fiscal consolidation. Pressures from preconditions about the aid package and uncertainties about the future contracted the Greek economy further. Subdued loan levels and reduced real wages and pensions withered the disposable income and subsequently slackened the demand. Serbia's economy was affected negatively by decline in net exports, consumption and investment. Latest data on FYROM's economy reveal that during 2012 Q1, the economy contracted about 1.4%, mainly due to investments falling by about 19%, y-o-y. The high base effect is another significant contributing factor.

Table 3 Selected economic indicators for countries of the region

Countries	GDP change	Annual inflation	Unemployment rate
	2012 Q1/2011 Q1	June 2012	March 2012
Italy	-1.4	3.3	10.8[2]
Greece	-6.5	1.3	22.6
FYROM	-1.4	2.1	31.6
Serbia	-1.3	5.5	25.5[4]
Croatia	-1.3	3.9[1]	13.9
Turkey	3.2	8.3	10.4
Kosovo	3.8[3]	1.1	:
Albania	-0.2	2.2	13.3

Source: Respective statistics institutes, IMF, EcoFin, EuroStat.

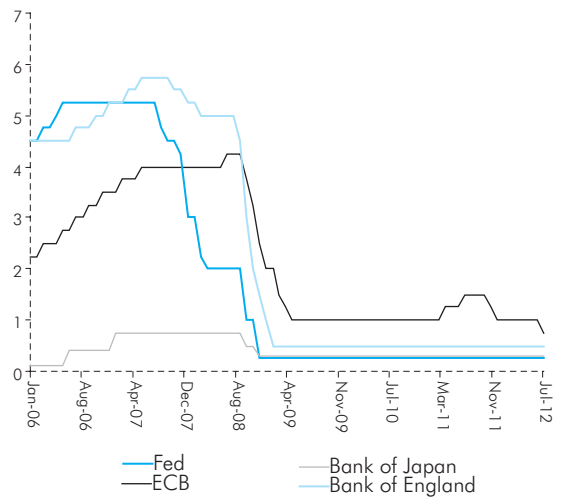
[1] *May 2012;*
[2] *June 2012;*
[3] *IMF's projections, WEO April 2012;*
[4] *2011; : Unavailable data.*

II.2 INTEREST RATE DECISIONS AND FINANCIAL MARKETS

At the beginning of July, the European Central Bank decided to cut the key interest rate by 25 basis points, taking it down to 0.75%. Other central banks kept their key interest rates steady: Federal Reserve at 0-0.25%, Bank of England at 0.5% and Bank of Japan at 0-0.1%.

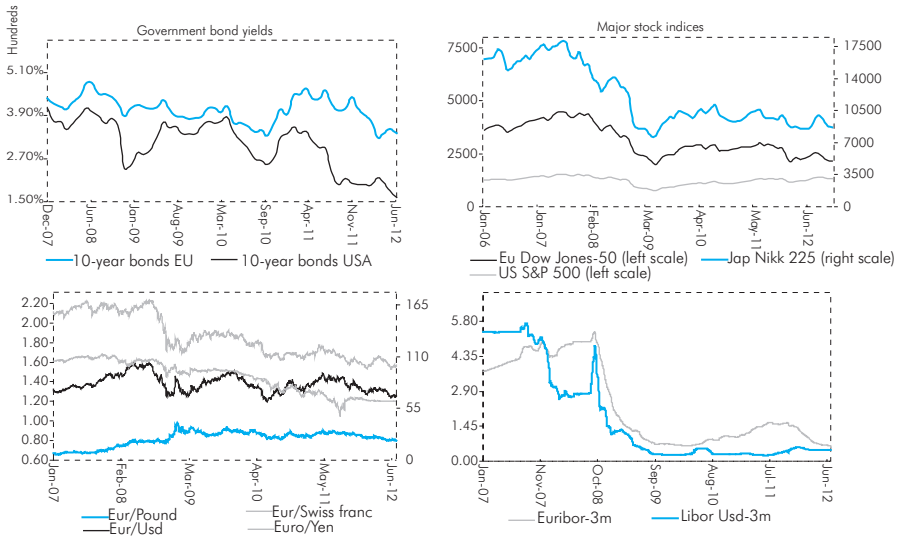
In the second quarter, financial markets showed downward trend and high volatility. Interest rates in certain segments of the market were also conditioned by developments in the solution to the debt crisis in euro area countries. Thus, the period following official meetings of world leaders were characterised by normalisation of interest rates and enhanced confidence of market agents. The ECB and other central banks eased the policy so as to calm financial markets and encourage banking activity. Re-emerging tensions in the financial markets related to the sovereign debt of Greece and difficulties of Spain affected the performance of debt securities of many institutions and states perceived by the markets as exposed to these risks. The bond yields spread between the euro area countries and Germany expanded during this quarter, although the respective values stand below those of November 2011 or other more tense periods. In the money market, ask rates continued to reduce during this period owing to liquidity excess provided by the ECB. In US financial markets, bond yields went down, reflecting mainly the effects of higher demand and the downward revision of financial agents' expectations for the medium-term economic performance. The above-mentioned factors about the euro area and the not-so-positive results of a considerable number of business categories are reflected also in the major stock markets in the US, Europe and Japan, recording downward values during this period.

Chart 1 Key interest rates



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

Chart 2 Exchange rate and selected financial indices in international markets



Source: ECB, Reuters.

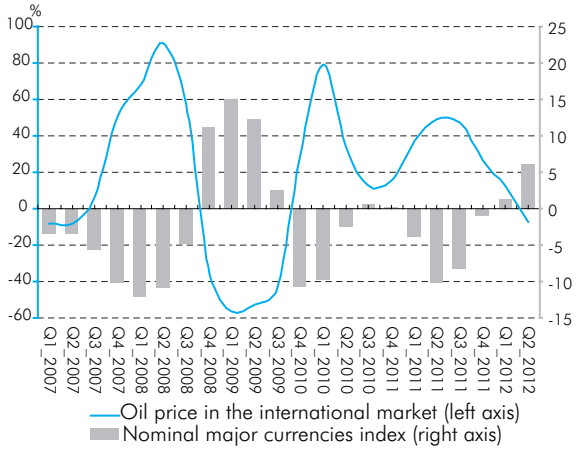
In the second quarter, Euribor rates with a maturity of 1, 3, 6 and 12 months continued to fall in the money market. In June, they stood at 0.38%, 0.66%, 0.93% and 1.22% respectively, recording a monthly fall[1] of 0.15 pp from March. The three-month Libor rate for the US dollar was steady at 0.47% during this period. In foreign exchange markets, starting from the end of March, the euro depreciated against most major currencies (Japanese yen, GB pound, Swiss franc). It lost ground against the US dollar during these months depreciating 2.1% from the previous quarter, q-o-q. On average, in June, the euro was exchanged for 1.25 US dollars or 0.3% less than in March and -12.9% from a year earlier.

II.3 OIL AND PRIMARY COMMODITY PRICES

In this quarter, oil price in international markets was downward. Year-start concerns related to the uncertainty arising from geo-political tensions in the Middle East were gradually subdued and replaced by downward pressures, which were present for a number of months and driven by the sluggish demand worldwide. The feeble performance of advanced economies and the impact on the world economy led economic agents to revise down their expectations for a rapid recovery of the global economy. This was one of the main factors that triggered the oil price downtrend. Other supplementary factors, such as the appreciation trend of the US dollar against some of the major currencies during these months and the presence of a high and stable oil supply from some countries within and outside the OPEC, provided their contribution in this regard. On average, in the second quarter, oil price fell by 7.6% y-o-y and 8.5% q-o-q. In June, the price per barrel was USD 95, falling below USD 100 after one year. From the quotations of this product in future contracts in the major markets, the expected price level for the period ahead shows a downward trend reflecting the agents' concern for the effects of the crisis in many euro area countries and its impact on the fall of global demand for oil.

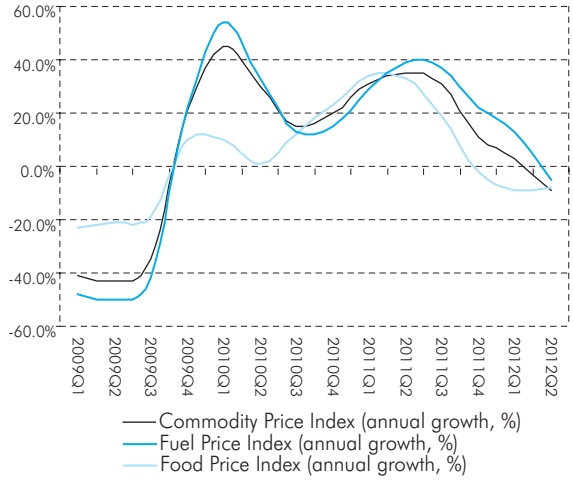
[1] *Respectively 0.9, 0.20, 0.23 and 0.28 percentage points.*

Chart 3 Oil price annual change and nominal major currencies dollar index



Source: Fed, EIA.

Chart 4 Annual change of prices by commodity



Source: IMF.

Primary commodity prices continued their downtrend that had started in second half of 2011. In this quarter, the Commodity Price Index fell 8.7%, y-o-y. The Food Price Index and the Fuel Price Index followed along similar lines, falling 8.3% and 5.3%, respectively. In quarterly terms, the Commodity Price Index, Fuel Price Index and Food Price Index fell 5.5%, 7.3% and 0.9%, respectively. Concerns about the global growth and a re-dimensioning of the global demand especially in the USA and China, as well as the concerns over sovereign debt in the euro area appear to have affected the commodity prices in international markets.

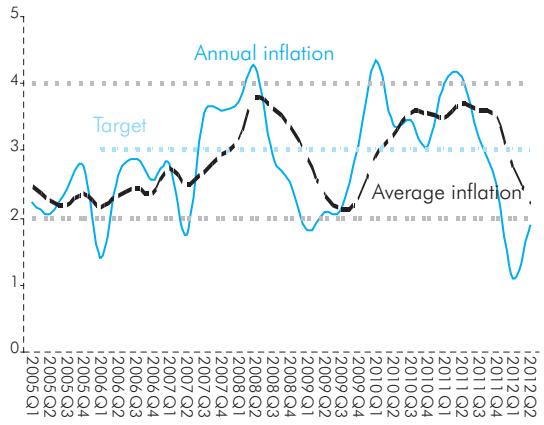
III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

In 2012 H1, annual inflation reached its historic low, but recovered gradually throughout the quarters: from 1.1% in Q1 to 1.9% in Q2. Overall, inflation was conditioned by developments in food prices, which rose more moderately than a year earlier. Inflation rates for 2012 H1 were driven by the presence of the high comparison base of last year, a statistical effect that weakened in the second quarter. Weak pressures from both the demand and supply contributed to the formation of downward inflationary expectations by market agents. These factors are supported by stable developments in the national currency, with an appreciation trend, creating a low-risk environment for inflation in the economy.

III.1 CONSUMER PRICES, INFLATION TARGET AND MONETARY POLICY

In 2012 Q2, annual inflation was 1.9% or 0.8 percentage points higher than the record low of 2012 Q1. In line with the seasonal behaviour, on average terms, quarterly inflation fell (-0.5%), but it was smaller than the average of the second quarters of the period 2007-2011 (-0.7%)[2]. In addition, the rise in rental prices (mainly in the first two months of the quarter), medicines and the continuation of water price rise are the main factors driving inflation up during this quarter. Annual inflation rate during this quarter continued to be affected by the statistical effect of the high comparison base.

Chart 5 Annual inflation (in %)



Source: INSTAT and Bank of Albania.

Signals for the deceleration of inflationary pressures in the long term are also confirmed by developments in the core inflation and the non-tradable sector of the CPI basket of goods and services during 2012 H1. This development is reflected also in consumer, business and financial market experts' expectations for inflation, which are reduced gradually.

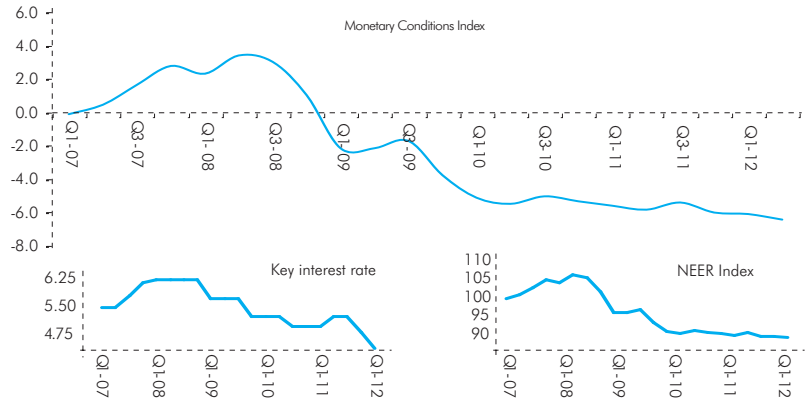
Low inflationary pressures from the supply side and below-potential growth of demand, as reflected in the dynamics of wages and labour costs, weak materialisation of second-round effects, downtrend of inflationary expectations of economic agents and steady appreciation of the national currency continued to contribute to the formation of low inflation.

[2] *A year ago, this rate reached the unusual level of -0.9%.*

Despite the relatively higher rate of 2012 Q2, the average trend of annual inflation[3] was downward at the end of the period (2.2%), mostly driven by the low inflation of the current months. The easing monetary policy persisted in H1 and was conditioned by medium-term projections for inflation ranging around the target and for below-potential economic growth. These projections were also supported by the assessments for capacity utilisation below the average production capacities, weak pressures from labour costs and production, as well as relatively anchored inflationary expectations of market agents. Under these conditions, monetary policy decision-making aimed at recovering economic activity in general. The key rate cut by 0.25 percentage points at the end of March was coupled with the continuation of liquidity injection in the second quarter. More concrete actions are expected from the financial and real sectors towards boosting private consumption and investments.

Liquidity by the Bank of Albania was injected through one-week and three-month variable rate reverse repurchase agreements. Interest rates in these transactions were close to the key rate with minimum volatility. During the second quarter, interest rates dropped and volume increased significantly in transactions in the interbank market. The easing of borrowing costs in this market was reflected in lower rates for lek-denominated deposits during April-May. Furthermore, the transmission of monetary policy signals was slow in the primary market of government securities. This market responded to the monetary easing that had started in 2011 Q4. However, at the start of 2012, the yields showed an upward trend, due to changes in the market participation structure, as a result of new regulations by international authorities and the increase in public sector's demand for funds. They were steady during the second quarter and did not signal increase in inflation expectations by financial agents. Since yields are used as a reference to determine the price of lek-denominated loans, their performance did not support the easing of lending standards to the private sector. The response of lending activity to monetary conditions easing remains delayed while uncertainty is relatively high and demand for loans is concentrated in short-term needs for liquidity.

Chart 6 Monetary Conditions Index (MCI)*

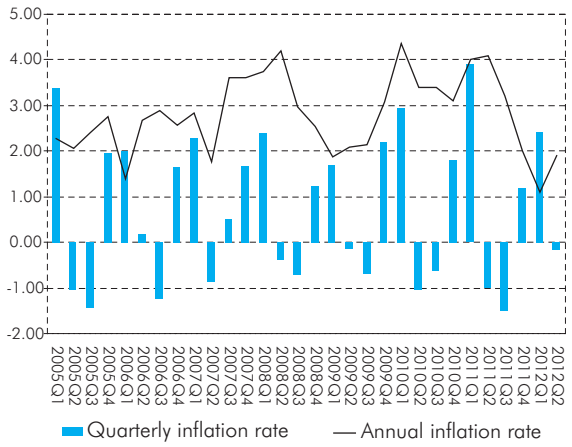


*The MCI is constructed using the performance of the key interest rate and the nominal effective exchange rate. In this series, an increase in the NEER implies exchange rate appreciation. In the MCI, an increase in this index implies tightening of monetary conditions and vice-versa.
Source: Bank of Albania.

[3] *Measured as a moving average (12 terms), which eliminates in part the short-term fluctuations.*

Although recent projections by the Bank of Albania for inflation envisage a gradual increase of inflation, its rates are not expected to exceed the medium-term target. Likewise, projections for economic growth continue to support a below-potential growth until the end of 2012. These projections have factorised a steady exchange rate and the absence of unexpected shocks from the external supply. Hence, the balance of risks to inflation in the upcoming quarters will be contained.

Chart 7 Annual and quarterly inflation (in %)



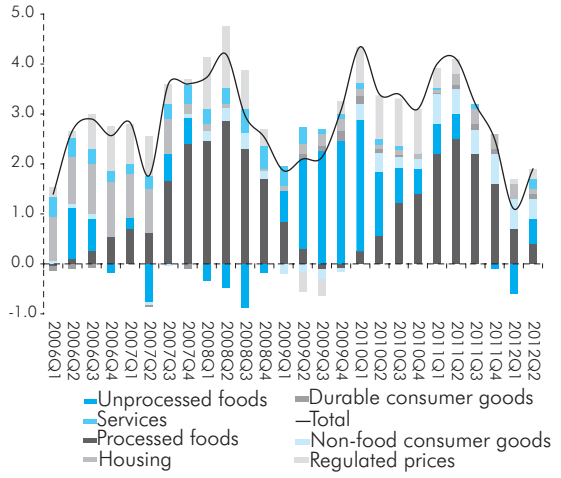
Source: INSTAT and Bank of Albania.

III.2 INFLATION BY ITEMS

During this quarter, inflation of goods and services by item was characterised by rising inflation of unprocessed foods for daily use.

Annual headline inflation, in this quarter, was 1.9%[4] and was formed, for the most part, by the contribution of "Foods" and "Non-food consumer goods" (about 70%). In particular, inflation of "Unprocessed foods" was on the upward side, while "Non food consumer goods" and "Processed foods" continued to be on the downward side. In June (for the first time since November 2011), the positive and rising contribution of the first item returned the inflation rate above the lower limit of the Bank of Albania's inflation target band.

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



Source: INSTAT and Bank of Albania's calculations.

Prices of "Unprocessed foods" declined further, which is normal for this period of the year. However, this seasonal behaviour was less intense than a year earlier. The annual inflation rate for this item recorded higher positive values (2.1%) from a quarter earlier (-2.8%), and a year earlier (2.0%). This item's inflation is mainly driven by prices of fruit and vegetables, which registered lower values (on average -2.5% in monthly terms); however, they did not reach the very low values of the corresponding period a year earlier (on average -4.5% in monthly terms). During the months of the second quarter, the price rising seasonal behaviour for these items shifted the inflation trajectory by some percentage points to the upward trend. While a quarter earlier, this category contributed negatively to headline inflation (on average -0.6 percentage points), during this quarter the contribution returned to positive values (on average +0.5).

[4] *A year earlier, the average annual inflation rate was 4.1%.*

Prices of "Processed foods" were lower than a quarter earlier. Annual inflation a year ago was 10.6%, while this value was down to 1.7% during this quarter. Consequently, its contribution to headline inflation fell from 2.5 percentage points, a year earlier, to 0.4 percentage points, in this quarter. The contribution fell further in this quarter because the effect of immediate price rise of grain in international markets, which had started in August 2010, was fully eliminated. The contribution of the sub-item "Bread and grains" is now considered insignificant compared to the 1 percentage point it posted in July 2011. An important factor in the inflation of this category was the exchange rate stability (since most of these goods are imported).

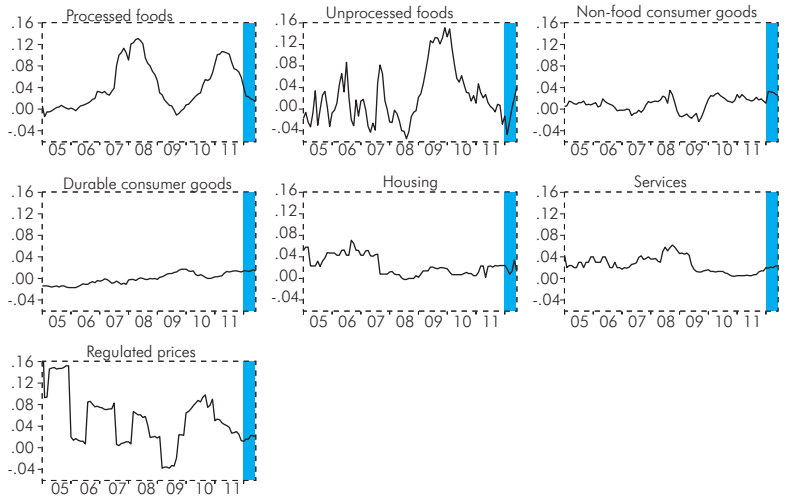
During this quarter, the contribution of "Non-food consumer goods" was lower as a result of lower oil price both in global and domestic markets. This item's inflation was also down from 2012 Q1, but continues to be amongst the highest of the last five years (2.8%) with a significant contribution to the formation of the headline inflation (0.4 percentage points).

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

	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11	Q2-11	Q3-11	Q4-11	Q1-12	Q2-12
1. Processed foods (pp)	0.3	0.6	1.1	1.4	2.2	2.5	2.2	1.6	0.7	0.4
Bread and grains (pp)	-0.2	-0.1	0.1	0.4	0.7	1.0	0.8	0.5	0.2	0.0
Alcohol and tobacco (pp)	0.1	0.2	0.2	0.2	0.5	0.4	0.4	0.4	0.1	0.1
2. Unprocessed foods (pp)	2.6	1.3	0.9	0.5	0.6	0.5	0.0	-0.1	-0.6	0.5
Fruit (pp)	0.2	0.1	0.3	0.1	0.2	0.4	0.2	0.3	0.3	0.3
Vegetables (pp)	2.0	1.5	0.1	-0.7	0.1	-0.4	-0.6	-0.7	-1.2	-0.1
3. Services (pp)	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.2
4. Administered prices (pp)	0.7	0.9	1.0	0.9	0.4	0.3	0.1	0.0	0.1	0.1
Fuels and energy (pp)	0.4	0.4	0.4	0.4	0.2	0.3	0.2	0.1	0.0	0.0
5. Housing (pp)	0.1	0.1	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.2
6. Non-food consumer goods	0.3	0.4	0.3	0.2	0.6	0.5	0.4	0.6	0.6	0.4
7. Durable consumer goods (pp)	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.1
Consumer Price Index (y-o-y, %)	4.3	3.4	3.4	3.1	4.0	4.1	3.2	2.5	1.1	1.9

Source: INSTAT and Bank of Albania.

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



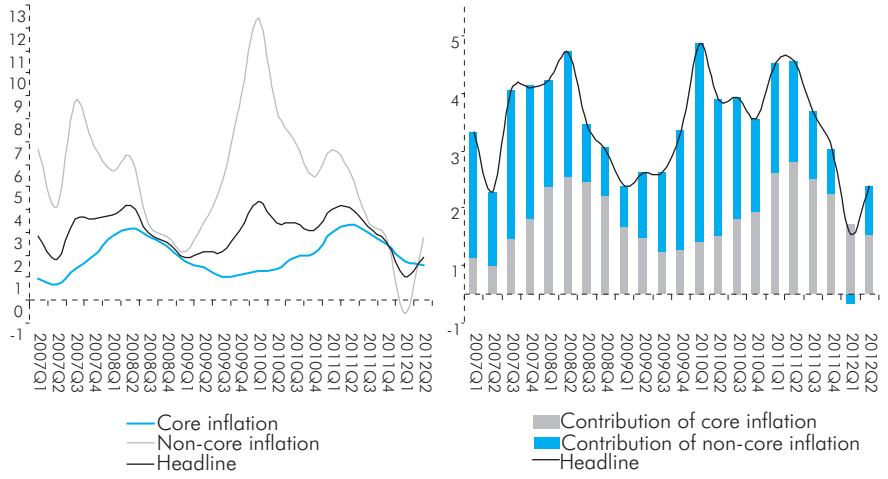
Source: INSTAT and Bank of Albania.

The contribution of "Administered prices" to headline inflation formation was 0.1 percentage points, remaining at its average in the one-year period. Other items with a smaller significance, overall, continue to provide low contribution to annual inflation. "Services" prices rose slightly in June, which corresponds to the beginning of the tourism season.

III.3 MAIN INFLATION TRENDS

Annual core inflation[5] stood at 1.6% in 2012 H1, or at half the rate of the corresponding period a year earlier. In the first and second quarters of the current year, core inflation was 1.8% and 1.5%, respectively. While in 2012 Q1 core inflation was 0.7 percentage points above the headline inflation, during 2012 Q2 it fell gradually below headline inflation[6]. The increase in headline inflation against the gradual reduction of inflation's core component show that added inflationary pressures were caused, for the most part, by the increase in the values of inflation's short-term or non-core component. In Q1, non-core inflation was -0.6% and in Q2 it stood at 2.7%[7]. Despite the developments in non-core inflation, both non-core and core inflation were some percentage points lower than a year earlier. The downtrend of core inflation was determined mainly by the elimination of the grain price rise effect during the last year and deceleration of the rise in the prices of some processed foods. The minimum contribution of administered prices and excise goods helped discontinue further increase in non-core inflation. During 2012 Q2, the core and non-core components formed 60% and 40% of the headline inflation, respectively. The appreciation of the national currency in nominal effective terms during the last nine months has further supported the flattening of overall inflationary pressures on Albania's economy.

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



Source: INSTAT and Bank of Albania.

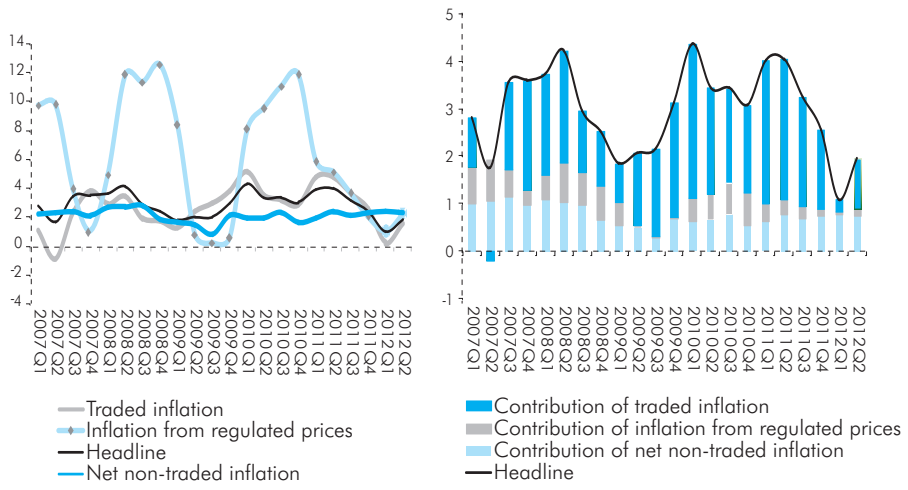
[5] *Average of two measurements, permanent exclusion and trimmed mean, 1.9% and 1.2%, respectively.*

[6] *Annual core inflation was: 1.57%; 1.54% and 1.45%, respectively by month - very gradual deceleration.*

[7] *Annual non-core inflation was: 1.6%; 2.7% and 3.8%, respectively by month - relatively rapid increase.*

The analysis of inflation formation by origin of inflationary pressures shows that during 2012 H1 headline inflation was determined by price volatility in the tradable sector of the CPI basket and steady prices in the non-tradable sector. For the period under review, inflation of tradable goods sector was 1.1%, ranging from 0.4% to 1.7% respectively in the first and second quarter. Despite this increase, it stood clearly below the respective rates of a year earlier, reflecting also the effect of the high comparison base. Nonetheless, its effect has been falling throughout the months of the second quarter, which is also shown in the gradual increase of tradable inflation[8]. Annual and quarterly fall of basic food prices and fuels in global markets is coupled with the appreciation of the national currency. These two trends supported the slowdown of price rise of processed foods at home, y-o-y, contributing to historic low tradable goods inflation. In the second quarter, it contributed by about 53.9% (1.05 percentage points) to the formation of headline inflation.

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



Source: INSTAT and Bank of Albania.

Net annual inflation of the non-tradable sector[9] was steady during 2012 H1, standing close to 2.5% throughout the two quarters. In the second quarter, this sector's inflation fell slightly, settling in June close to this series' average of the last five years[10]. This sector contributed by about 38.4% (0.75 percentage points) to headline inflation. The rest of inflation rate was determined by the minimum impact of regulated prices.

During the first two quarters, core and net non-tradable inflation confirmed the presence of weakening pressures on the demand side. Short-term fluctuations and those generated by the external economy were more reduced than in 2011 H1. The trend was rising from the first quarter to the second one, due to the mitigated effect of the high comparison base. This framework is

[8] *Tradable annual inflation was: 1.1%; 1.7% and 2.2%, respectively by month.*

[9] *This inflation is cleaned from the effects of regulated prices (water and electric energy bills and hospitalisation services).*

[10] *Non-tradable annual inflation, net, was: 2.53%; 2.45% and 2.24%, respectively by month - gradual reduction.*

significantly driven by the appreciation of the national currency against major foreign currencies during October 2011 – June 2012.

IV. MACROECONOMIC HIGHLIGHTS AND IMPACT ON INFLATION

In 2012 Q1, for the first time since 2009, the Albanian economy posted an annual decline by about 0.2% of the GDP. In addition to lower aggregate demand, the economy contracted also due to relatively big and temporary supply-side shocks on production of certain sectors of the economy. The partial utilisation of production capacities in the economy continues to condition the low rise in wages and other production costs, transmitting weak inflationary pressures. On the other hand, the stable exchange rate mitigated the external inflationary pressures during the first five months of the year. In 2012 H1, consumer price inflation stood at low levels, reflecting low pressures from the internal and external costs as well as anchored inflation expectations.

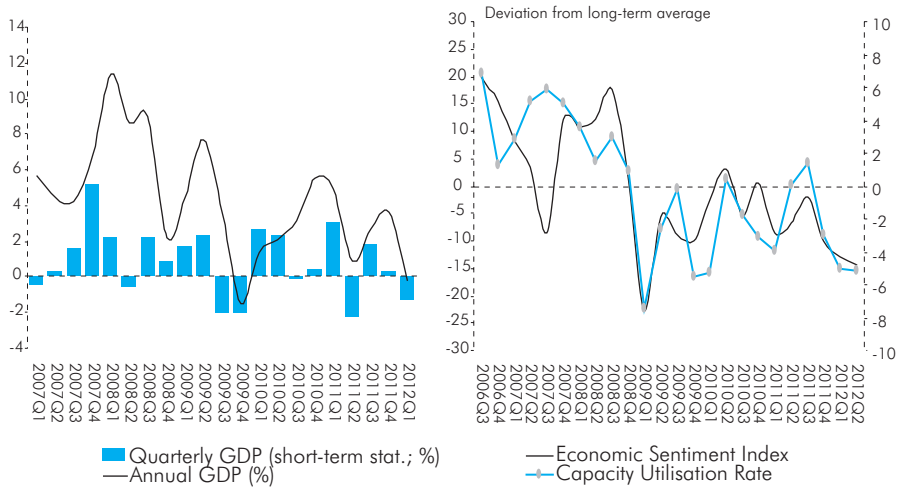
Overall, the new statistical information sustains the projection and estimation that the Albanian economy will continue to be characterised by unused capacities in the medium run. Under these conditions and in the presence of anchored inflation expectations, pressures on inflation are assessed to be low over the policy-relevant horizon.

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Economic activity shrank 0.2% in 2012 Q1. The annual GDP rate fell by about 3.9 percentage points from 2011 Q4. This performance reflected, inter alia, the impact of temporary weather-related factors on the production of certain sectors of the economy and the especially high uncertainty about the international developments. The sectoral analysis of the economy shows higher negative contribution from the production sector and the continued positive contribution from the services sector.

For the period under review, all aggregate demand components are assessed to have contributed less to economic growth. The strained situation of the European economy and the sluggish domestic demand are materialised in the downward nominal value of exports and the deceleration of imports. There was little fiscal room to boost economic growth, resulting in downward contribution of the public sector to the growth of aggregate demand. On the other hand, consumers and businesses continued to be cautious about spending and investing.

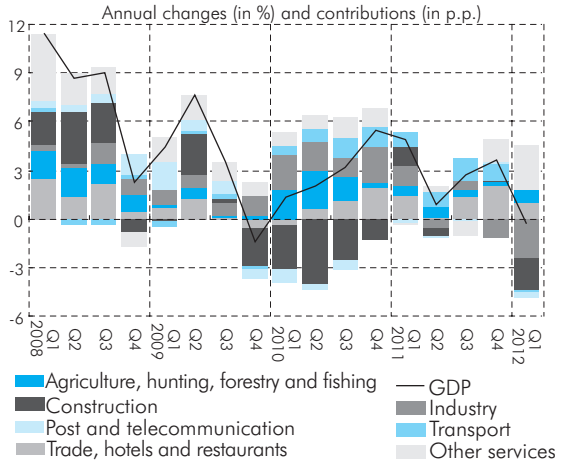
Chart 12 GDP annual and quarterly change (left); Economic Sentiment Index and capacity utilisation rate (right)



Source: INSTAT and Bank of Albania.

The available statistical information[11] for 2012 Q2 supports the assessment for below-potential growth rates. Despite tensions in the euro area, exports[12] added their contribution to economic growth during April and May. On the other hand, the fiscal sector had a tightening impact on domestic demand during the period under review. Under these conditions, the private domestic demand has been the main driver of economic growth. Improvement of economic agents' confidence in future developments at home and abroad will enable them to benefit more from stimulating monetary conditions, increasing their demand for consumption.

Chart 13 GDP and sector contribution to annual GDP



Source: INSTAT and Bank of Albania.

IV.1.1 OUTPUT BY SECTOR

GDP fell 0.2% in 2012 Q1 following the 3.7% growth in the previous quarter, y-o-y. By economic activity, industry branches (excluding the extractive industry), construction, transport, post and communications performed negatively. Conversely, the GDP generated by the services sector in total, which accounts for about 59.5% of the output for Q1, grew 6.0%, y-o-y. The value added by this sector recorded a more contained growth than the 7.9% rate in 2011 Q4.

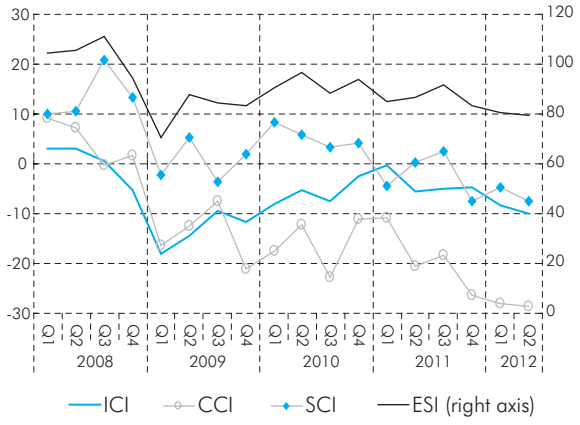
[11] *Credit to the economy, fiscal indicators and imports decelerated during this period. Qualitative indicators of the economic sentiment and capacity utilisation rate run along the same lines with Q1.*

[12] *Total exports surged, on average, about 24.5%, y-o-y, during these two months.*

Survey data suggest absence of improving trends for 2012 Q2 compared to 2012 Q1. The economic sentiment index dropped 1.3 points compared with 2012 Q1, standing 20.7 points below the long-term average. Economic activity deteriorated across all the sectors of the economy, based on the signals from the decline in confidence indicators in industry, construction and services[13].

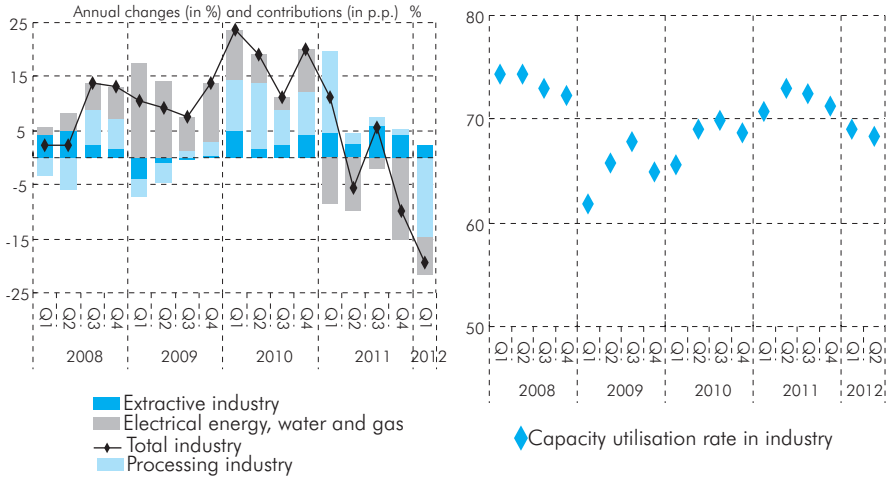
In 2012 Q1, the industrial output contributed negatively to the annual GDP by 2.4 annual percentage points. This performance combined the reduced value added of "Electricity, gas and water supply", the pronounced contraction of processing industry, and the decelerated expansion rate of the extractive industry. More specifically, the value added of the industry sector deepened its annual downswing by 19.3% from 9.7% in 2011 Q4.

Chart 14 Economic Sentiment Index (long-term average = 100), industry, construction and services confidence indices (in balance, seasonally adjusted)



Source: INSTAT and Bank of Albania.

Chart 15 Industrial sector, value added and contributions by sub-branches (left); capacity utilisation rate (right)

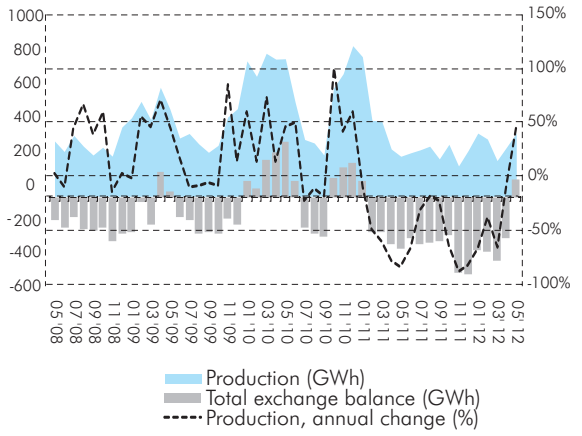


Source: INSTAT and Bank of Albania.

During 2012 Q1, "Electricity, gas and water supply" contributed negatively by 7.0 percentage points to the generation of the value added in industry. The balance of the main indicators of the electric energy at home continued to worsen compared to the preceding year. These negative developments materialised in the pronounced annual decline of domestic output by 46.6%, the significant increase in import, and the lack of electric energy export. Recent data on the electric energy balance for April-May appear more improved, reflecting the domestic output increase, the exports significant upsurge and absence of electric energy imports. During these months, electricity production in Albania hiked by about 29%, y-o-y.

[13] *Services confidence index does not include the branch of trade.*

Chart 16 Main energy balance indicators

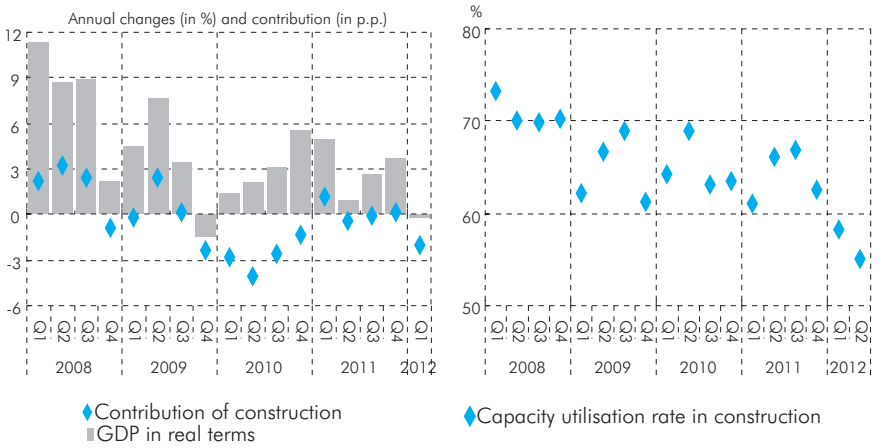


Source: Albanian Power Corporation and experts' calculations.

Processing industry, after a decelerating trend during the last three quarters of 2011, contracted by 20.5%, y-o-y, in 2012 Q1. The value added of this branch declined reflecting the performance of the value added across all the categories of the processing industries, excluding the sub-branches of "Manufacturing of other foods" and "Manufacturing of machinery and equipment", which contributed positively. The extractive industry's value added was 18.3% higher than a year earlier. However, the expansion of the value added was slower than in 2011, affected broadly by activities pertaining to "Extraction of non-energy products". The annual decline of industrial exports in 2012 Q1 and of cumulative income from the VAT of the production sector during the first four months of 2012 suggest a weakening of foreign and domestic demand in the industrial sector. Survey indicators signal that the negative performance of the industrial sector will continue in 2012 Q2. This trend is reflected in the decline of the confidence index, business demand, financial situation and capacity utilisation rate in the industrial sector.

The construction sector's value added fell 17.6% in 2012 Q1, following the modest increase by 1.4% in 2011 Q4, hence confirming its fragility. The contraction of this sector lowered the GDP by 2.0 percentage points. The lower contribution by the public sector, unfavourable weather conditions during the year start, and the presence of the base effect determined the performance of the construction sector[14]. This sector continues to suffer from private sector's low demand. Survey data reveal the continued downward trend of the construction sector in 2012 Q2. On a quarter earlier, the confidence index, business demand, and the capacity utilisation rate in this sector remain on the contracting side.

Chart 17 Construction sector. Contribution to annual GDP (left); capacity utilisation rate (right)



Source: INSTAT and Bank of Albania.

[14] *Value added in the construction sector increased, y-o-y, by 10.8% in 2011 Q1.*

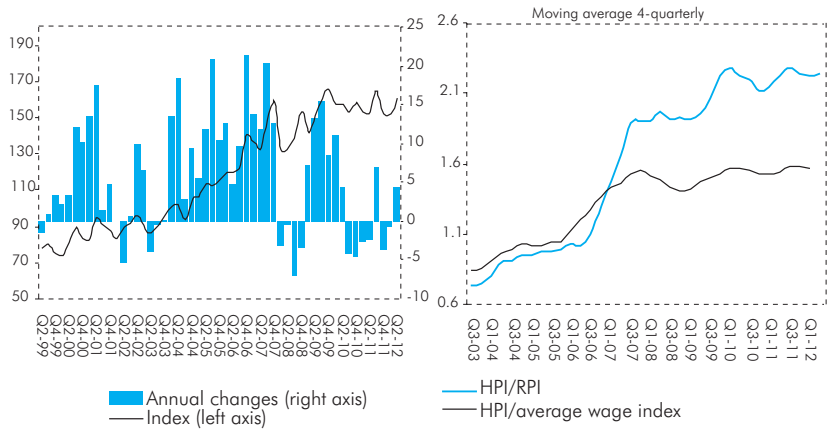
Box 1 House Price Index and Rental Price Index in Tirana, 2012 Q2

House Price Index (HPI) for Tirana increased 4.4% in real terms in 2012 Q2, discontinuing the downward trend. During the previous two quarters, the HPI had declined y-o-y. Indirect indicators continue to point to weak purchasing demand and the reduction of construction permits in 2011 Q4 suggests decelerated supply for new houses.*

Rental Price Index increased 1.5%, y-o-y. This development is in line with the positive annual changes registered during the previous two quarters.

House indices increased during 2012 H1. Price-to-rent ratio increased by 0.2 and 0.3 points q-o-q, respectively, in the first and second quarters of 2012, offsetting its quarterly decline by 0.5 points in the fourth quarter of 2011. Actually, this ratio stands 0.1 points below the maximum level registered in 2009 Q4.

Chart 18 Annual change of the price index and HPI/RPI and HPI/average wage ratio

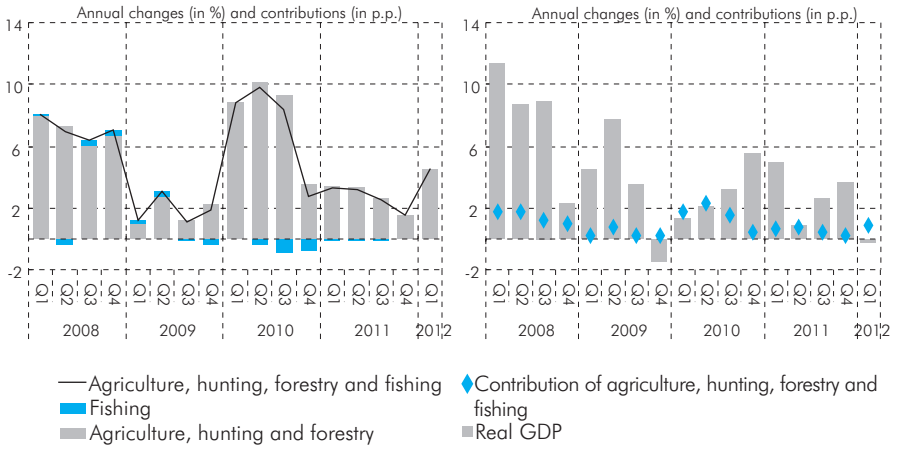


Source: Bank of Albania.

* *The house price index is constructed on the basis of announcements at "Çelësi" newspaper, from 1998. It includes information only for Tirana city area.*

The higher positive contribution to the GDP by the production sector was generated by agriculture, hunting, forestry and fishing. The value added of these activities expanded 4.5% during Q1, contributing positively to the domestic production by 0.8 percentage points. Partial data[15], such as higher sales, increased number of economic entities and investments in agro-industry, support the assessment for a positive performance of agriculture in Q1.

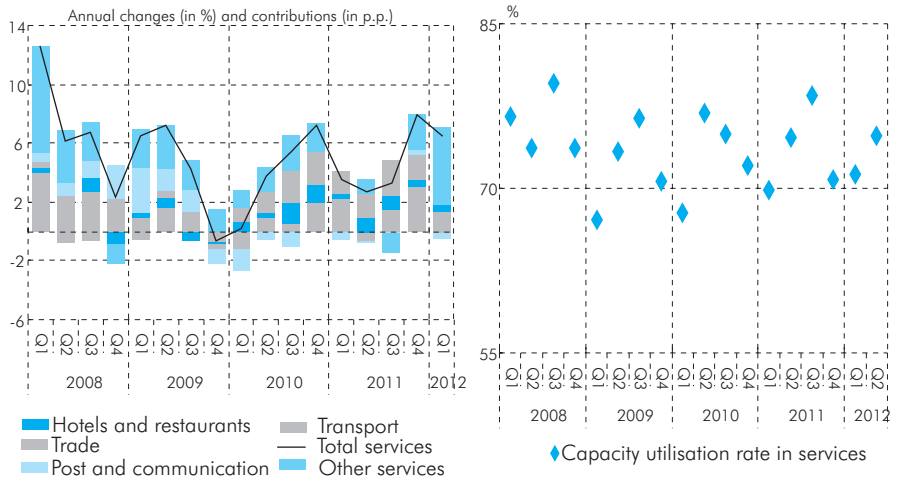
Chart 19 Agriculture, hunting, forestry and fishing; value added and contributions by sub-branches (left); sectoral contribution to annual GDP (right)



Source: INSTAT and Bank of Albania.

Services sector remains the main contributor to economic growth, with about 3.4 percentage points in 2012 Q1, mainly driven by the dynamics of activities included under "Other services"[16]. The value added of services expanded 6.5% in total. This growth rate remains above the long-term average of 5.6%, but is lower than the annual growth of 7.9% recorded a quarter earlier.

Chart 20 Services sector. Value added and contributions by sub-branches (left); capacity utilisation rate (right)



Source: INSTAT and Bank of Albania.

[15] *Data on agro-industry are taken from the Ministry of Agriculture, Food and Consumer Protection.*

[16] *Other services include: financial and monetary intermediation; real estate, leasing and business-related activities; public administration, protection, social security; education; healthcare and other social activities; other collective, social and individual services.*

The contribution of "Other services" to GDP, by about 2.8 percentage points, is the highest across branches during 2012 Q1. The value added in the economy from other services increased y-o-y by 11.1%, standing 6.0 percentage points higher than the average long-term rate of expansion. Activities related to immovable property, leasing and services to businesses continue to be the main contributors (by 9.3 percentage points) to the annual increase of value added of other services.

Among services, the annual expansion of trade by 5.0% was translated into positive contribution by 0.7 percentage points to economic growth. Transport's annual fall was 1.7% in terms of value added, following a positive performance during 2010-2011. Post and communications services did not manage to maintain the upward trend of the previous quarter and contracted 4.8%. The negative contribution of transport and post and communications branches subdued the GDP by 0.4 percentage points. Although the confidence index and the estimated business demand in the services sector lowered in 2012 Q2, the increase in the capacity utilisation rate signals improvement of this sector from the first quarter.

IV.1.2 AGGREGATE DEMAND COMPONENTS

In 2012 Q1, aggregate demand contracted reflecting less favourable conditions for its growth and the especially high uncertainty about international developments. Economic activity slowdown abroad, especially in the euro area, drove the nominal values of Albanian exports down during 2012 Q1. Uncertainties about macroeconomic developments continued to condition the private sector's prudent approach to consumption and investments. The sluggish private consumption was triggered also by the low increase in income and lack of dynamism in the labour market. Against a sluggish consumer demand and a low capacity utilisation rate, businesses reduced their investments. On the other hand, fiscal agent's approach to keeping with budget deficit targets will continue to limit the fiscal stimulus and domestic demand in the short run.

Available data on private consumption during 2012 Q1 point to slow increase. The sluggish dynamic of consumer spending was triggered by the lower consumption in both services and goods[17]. Consumer goods imports in real terms, a quantitative indicator of private consumption in the economy, increased 6.9% in 2012 Q1, compared to 7.6% in 2011 Q4. Private consumption slowdown suggests lower income from the VAT (-0.3% in real annual terms).

Data on financing resources of private consumption during 2012 Q1 are only partially available. Wage, which is the steadiest component of consumer income, has dropped in real terms since 2011 Q2. The downtrend of income from personal income tax signals further drop in wages during 2012 H1[18].

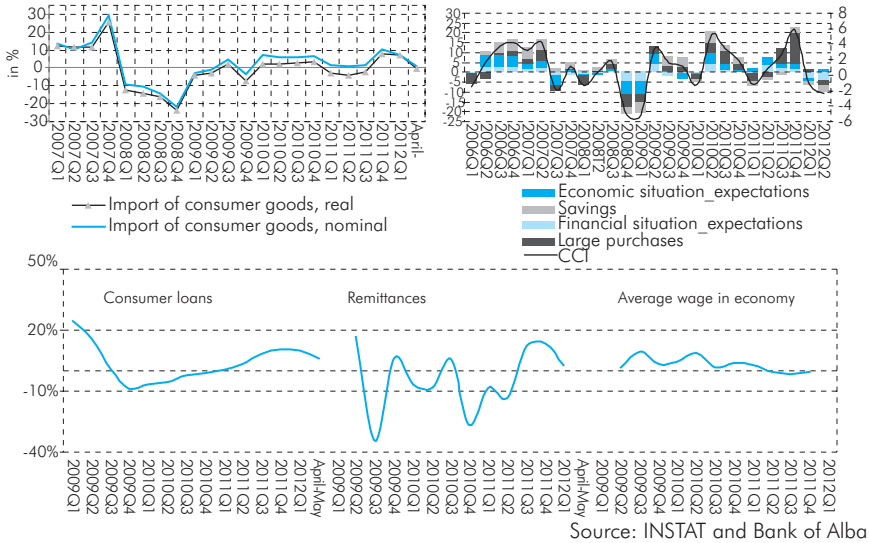
[17] *Value added of trade and services increased at slower rates in 2012 Q1, compared to the previous quarter.*

[18] *Personal income tax was up 0.1% in 2012 Q1 and down 4.4% in 2012 Q2.*

Other financing resources such as consumer credit and remittance inflows continued to support consumption during 2012 Q1. In addition, the exchange rate stability has mitigated the cost of import prices. The steady increase of households' term deposits and their portfolio expansion to include bonds testifies a cautious behaviour of consumers to spending.

Latest indirect data on private consumption signal its further slowdown during 2012 Q2. This is suggested by quantitative and qualitative indicators from surveys. Consumer goods imports fell 0.2% in real annual terms in April-May, while income from VAT increased only 0.1% in 2012 Q2. The decline in the consumer confidence indicator during 2012 Q2 was driven mainly by the lower balance for large purchases (5.4 percentage points, standing at 3 percentage points below its long-term average).

Chart 21 Private consumption and its financing indicators



Source: INSTAT and Bank of Albania.

According to indicators that proxy the performance of private investments in the economy, their contribution to economic growth in 2012 Q1 was negative. The poor performance of private investments was affected by businesses perception for downward demand[19], low capacity utilisation rates (on average 5 percentage points below the historic average) and still-tightened lending standards[20]. Imports of machinery and equipment, which proxy the performance of private investments, increased 1.5% in nominal annual terms during 2012 Q1. This indicator had increased 33.2%, y-o-y, in 2011 Q4.

Qualitative data from business confidence surveys support the downward trend of private investments and businesses inclination to invest mostly in technological equipment and much less in new structures. According to the data from confidence surveys, investments did not fall uniformly across the sectors. In the services sector, investments fell less than the more deteriorated approach of the industry and construction sectors to new investments.

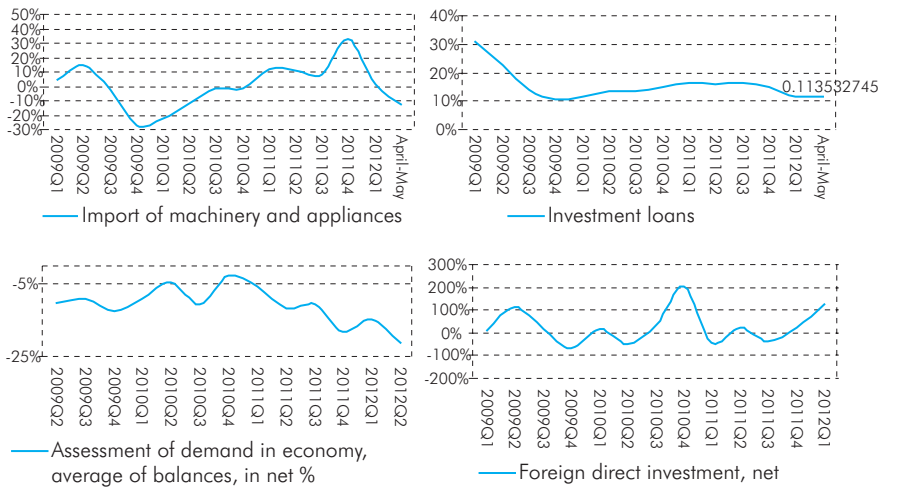
[19] *The balance of businesses evaluation of demand for their products has decreased over the last two years, as shown by results from business confidence surveys.*

[20] *According to the lending survey, banks have tightened lending standards starting from 2011 Q3.*

Domestic private investments in the economy continued to be supported by the positive upward rates of lending for investments, although at lower paces than in the previous two years.

Foreign direct investments were satisfactory during 2012 Q1. Their increase, by doubling FDI value from 2011 Q1, has reflected the base effect of the decline of a year earlier.

Chart 22 Private investments, annual change



Source: INSTAT and Bank of Albania.

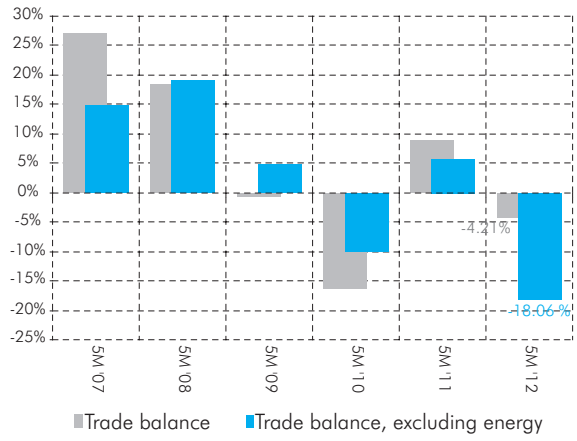
Partial data for 2012 Q2 suggest that the contraction of private investments in the economy continued, while the capacity utilisation rate stood below its historic average and business expectations about demand were downward. Import of machineries and appliances' annual fall averaged 12.7% in nominal terms in April and May. Confidence indicators for industry, construction and services deteriorated in 2012 Q2.

IV.1.3 EXTERNAL DEMAND AND FOREIGN TRADE

During the first five months of 2012, the trade deficit narrowed by about 4.2%, y-o-y. Trade flows of electric energy contributed substantially to the trade deficit during this period. Excluding this category, the trade deficit for the first five months of 2012 narrowed by about -18.1%, y-o-y.

Exports in value were up 1.3% y-o-y during the first five months of 2012, whereas imports of goods in value shrank about 2%. Excluding the effect of the electric energy, exports surged about 10.2%, whereas imports fell about 7.5%, y-o-y. This performance of foreign trade was reflected in trade

Chart 23 Trade balance (annual change in percent)



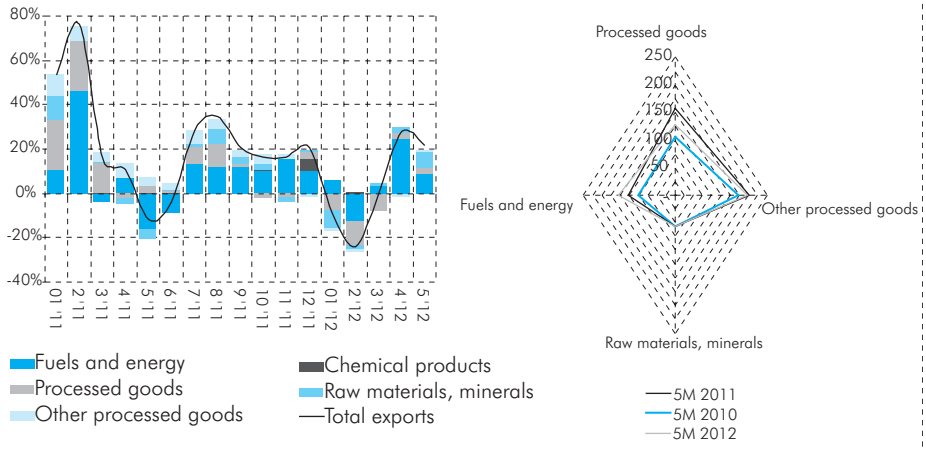
Source: Bank of Albania.

activity in Albania narrowing by about 1.1%. The imports coverage ratio for the first five months of 2012 was 40.8% or about 1.35 percentage points higher than in the corresponding period a year earlier.

In May 2012, the trade deficit narrowed by about 15.8% in nominal annual terms. Excluding electric energy flows, the trade deficit for May 2012 narrowed 17.8%, y-o-y. The narrowing of the trade deficit in the two main categories of foreign trade, i.e. "Raw materials, minerals" and "Processed goods", was the main determinant for total trade deficit narrowing in May 2012. During the first five months of 2012, the trade deficit was driven mainly by the performance of "Fuels and energy" and "Processed goods".

After decreasing in 2012 Q1, total exports increased substantially in April and May 2012. During the last month, the trend of total exports was driven mainly by exports in "Fuels and energy". Crude oil exports within this category accounted for about 22% of total exports for May 2012, continuing the substantial positive contribution. Export of goods under "Raw materials, minerals" and "Processed goods" contributed positively, although their prices have been downward in the international markets[21].

Chart 24 Contribution by item to total exports in percentage points (left); orientation of exports in EUR million (right)



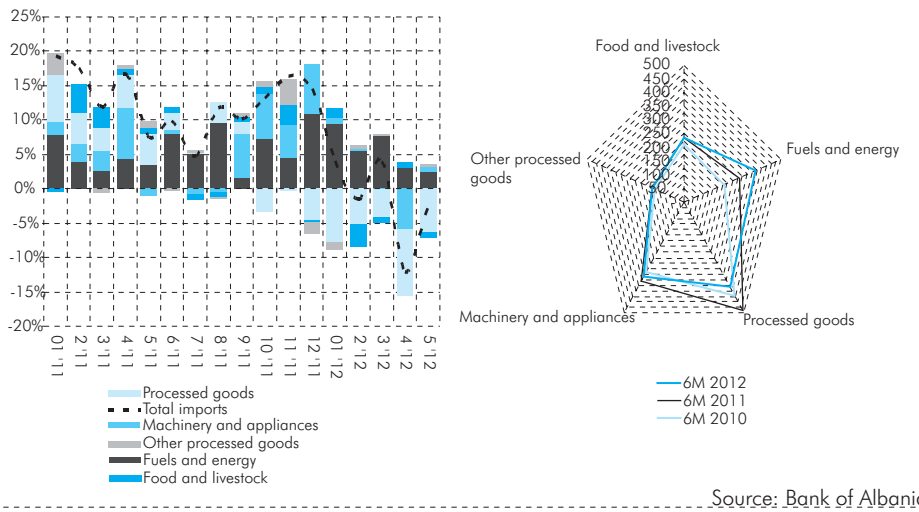
Source: Bank of Albania.

A significant contributor, "Other processed goods", increased slightly during May 2012, reversing the downward trend during December 2011-April 2012. The difficult macroeconomic situation in our trading partner countries will continue to condition the performance of this category.

Total imports fell 2.8% in May 2012. Excluding imports of electric energy during the month under review, total imports fell about 3.5%, y-o-y.

[21] *Based on the Metal Price Index, published monthly by the IMF. In May 2012, this index fell by about 19.3%, y-o-y.*

Chart 25 Contribution by item to total imports in percentage points (left); orientation of imports in EUR million (right)



Source: Bank of Albania.

The decline of imports of goods under "Processed goods", mainly the sub-item "Cast iron and steel" and "Articles of cast iron and steel", was the main contributor to the decline in total imports in May 2012. Imports of "Fuels and energy" showed a slight positive contribution to the increase in total imports. Within this category, the import of crude and processed oil as well as that of electric energy accounted for about 10.2% and 5.3% of total imports, respectively.

By purpose of use in the economy, during the first five months of 2012, imports of "Capital goods" and "Intermediate goods" dropped 15.7% and 1.7%, respectively, whereas imports of "Consumer goods" surged 4.7% , y-o-y. In May 2012, imports of goods included in the two main items "Capital goods" and "Intermediate goods" fell. Imports of goods included in "Capital goods" continued the downward trend for the fifth consecutive month, with the contribution by the drop of imports of the "Capital goods (excluding transport equipment)". The decline in imports of industrial equipment has contributed substantially to the imports of "Intermediate goods". Import of goods included in "Consumer goods" surged 7.7% during May 2012.

As measured by the trade exchange flows, Albania's trade activity showed a slight increase by about 3.5% during 2012. The imports coverage ratio was 43.6%. By geography of trading partners, trade flows continue to be concentrated towards EU countries. During the first five months of 2012, they fell about 0.4%, y-o-y. A substantial contribution to this drop was given by the trade exchanges in April 2012, when trade outflows towards the EU dropped 8.4%, y-o-y. During May 2012, trade outflows towards the EU recovered by 2%. On the other hand, during the first five months of 2012, trade activity with CEFTA countries fell by about 0.7%, y-o-y. In May 2012, trade flows subsided by -11.1%, y-o-y.

*Box 2 Balance of Payments Highlights**

In 2012 Q1, the overall balance of payments registered an increase by about EUR 0.9 million of foreign assets. In this quarter, the current account deficit amounted to EUR 259.2 million, expanding by about 17.4% compared with the corresponding period of a year earlier.

Table 5 Key balance of payments indicators

	Q1 '11	Q2 '11	Q3 '11	Q4 '11	Q1'12
Current account (Eur millions)	-220.9	-321.9	-253.9	-348.7	-259.2
y-o-y	-1.7%	62.8%	5.9%	-2.1%	17.4%
/ GDP	10.4%	13.3%	10.6%	14.9%	12.1%
Trade balance	-408.5	-581.4	-593.1	-658.6	-465.3
Exports, f.o.b.	370.6	330.8	344.1	360.0	325.8
Imports, f.o.b.	-779.1	-912.2	-937.2	-1,018.6	-791.2
Balance of services	-17.0	-6.2	116.7	41.2	8.4
Credit	312.3	376.8	629.8	428.5	293.8
Debit	-329.3	-383.0	-513.1	-387.3	-285.4
Net-travel services	-43.5	-19.9	82.9	28.4	4.3
Balance of income	-3.6	5.6	4.3	17.9	-4.3
Credit	47.5	58.6	66.6	58.9	59.7
Debit	-51.0	-52.9	-62.3	-41.0	-63.9
Net FDI income	-15.0	-9.5	-21.0	-7.1	-37.1
Current transfers	208.2	260.2	218.2	250.8	202.0
Credit	238.0	287.6	245.6	279.1	241.5
Debit	-29.8	-27.4	-27.5	-28.3	-39.5
Net remittances	155.0	190.4	153.8	188.7	159.5
Capital and financial acc. (eur mil.)	242.9	199.8	222.7	255.8	269.1
y-o-y	149.1%	6.6%	26.3%	-37.7%	10.8%
/ GDP	11.5%	8.2%	9.3%	10.9%	12.6%
Capital account	19.1	31.5	6.5	27.8	12.9
Financial account	223.9	168.3	216.2	228.0	256.2
A. Liabilities	164.0	287.3	408.2	381.9	294.6
FDIs	83.3	212.2	158.4	288.1	185.9
Portfolio investments	0.2	5.2	5.2	5.4	5.4
Other investments	80.5	70.0	244.7	88.5	103.3
B. Assets	59.9	-119.0	-192.1	-153.9	-38.4
FDIs	-4.7	-1.7	-3.9	-19.8	-4.1
Portfolio investments	-6.6	-37.7	-54.5	0.4	-50.0
Other investments	71.2	-79.6	-133.6	-134.5	15.7
Errors and omissions	-99.2	120.4	87.6	86.7	-9.0
Reserve assets	77.1	1.7	-56.4	6.2	-0.9

Source: Bank of Albania.

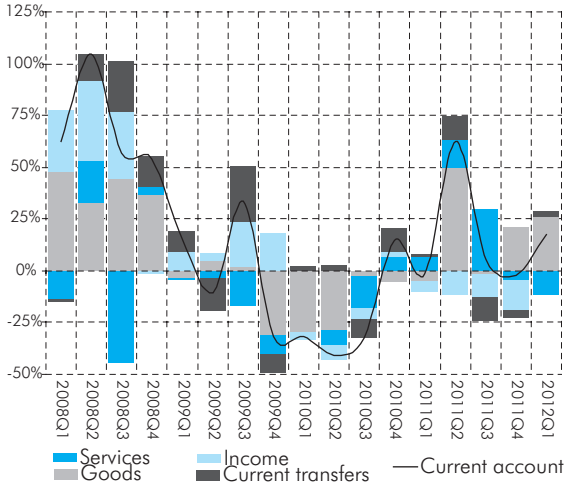
*The current account deficit during this period was about 12.1% of nominal GDP**, up by about 1.7 percentage points from a year earlier. This performance was conditioned significantly by net exports, which expanded about 7.4%, y-o-y.*

OTHER ITEMS OF THE CURRENT ACCOUNT

During 2012 Q1, the net balance of services account resulted in EUR 8.4 million surplus. The y-o-y improvement of the balance of this account was determined by the increase in net foreign currency inflows in the travel services, whereas other business services and transport provided an increasingly negative contribution.

Net balance of the income account posted a deficit of EUR 4.3 million determined by the increase in outflows of investment income. Outflows of income from net foreign direct investments amounted to EUR 40.4 million in 2012 Q1, from EUR 21.3 million in 2011 Q1. Though at a lower annualised level, income from employees' compensation contributed positively to the total income account.

Chart 26 Contribution to current account deficit by item (in percentage points)



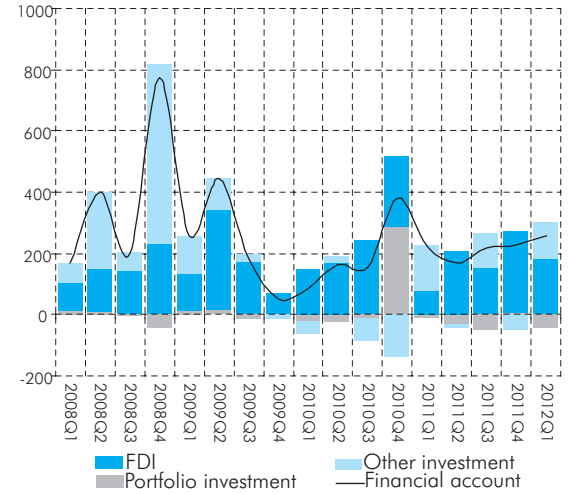
Source: Bank of Albania.

Net balance of the current transfers account resulted in EUR 202 million in surplus in 2012 Q1, down by about 3%, y-o-y. The main sub-item of this account, net remittances, improved slightly by about 3%, y-o-y, during 2012 Q1. The trade deficit financing from net remittances was 34.3% during 2011 Q4, which is 3.5 percentage points lower than in the corresponding period a year earlier.

CAPITAL AND FINANCIAL ACCOUNT

Net financial and capital account flows recorded a positive balance of EUR 269.1 million during 2012 Q1, financing the entire current account deficit registered during this period. Relative to the same period a year earlier, capital and financial flows surged 10.8%, accounting for about 12.6% of the nominal GDP. The main contributors to the capital and financial account were the financial flows, which hiked 14.4%, y-o-y, reaching 12% of the GDP, that is about 1.4 percentage points higher than a year earlier. Liabilities of residents to non-residents increased substantially, y-o-y.

Chart 27 Capital and financial account (net flows, in EUR million)



Source: Bank of Albania.

In 2012 Q1, net foreign direct investments (inflows–outflows) totalled about EUR 181.8 million, against EUR 78.6 million in 2011 Q1. In the major part, this change owes to the base effect of the 2011 Q1, which registered capital outflows in the form of other capital. Inflows posted substantial increase in 2012 Q1. FDI inflows in the form of property securities (shares) and profit re-investment amounted to about EUR 188.6 million, up by about 27.5%, y-o-y. Moreover, the first quarter of 2012 registered a small capital outflow in the form of other capital of about EUR 2.7 million. The contribution of privatisation receipts to FDI increase remains modest, reaching EUR 4.2 million in 2012 Q1.

Net portfolio investments posted EUR -44.6 million during 2012 Q1, considerably up from the corresponding period a year earlier. The annualised change in the net portfolio investments owes to higher residents' portfolio investments in non-resident economies in property securities (shares) and debt securities.

Net other investments account posted a surplus of EUR 119 million during 2012 Q1, mainly driven by higher liabilities of residents to non-residents. The increase in borrowing flows, as well as in currency and deposits of the foreign banking system in Albania, led to higher liabilities of the domestic economy by about EUR 103.3 million. On the asset side, in 2012 Q1, domestic claims on foreign economies decreased by about EUR 15.7 million. The decline of our assets invested abroad was due to fewer credits granted to finance trade.

Foreign reserve assets increased by about EUR 1 million at the end of 2012 Q1. The foreign reserve stock at the end of this period was about EUR 1,888.8 million, sufficient to cover 4.3 months of import of goods and services.

* *Latest data on the balance of payments are from 2012 Q1.*
* *Regarding the nominal GDP, for the period 2003-2010, the series published by INSTAT is used. For 2011, projections by Bank of Albania's Monetary Policy Department are used.*

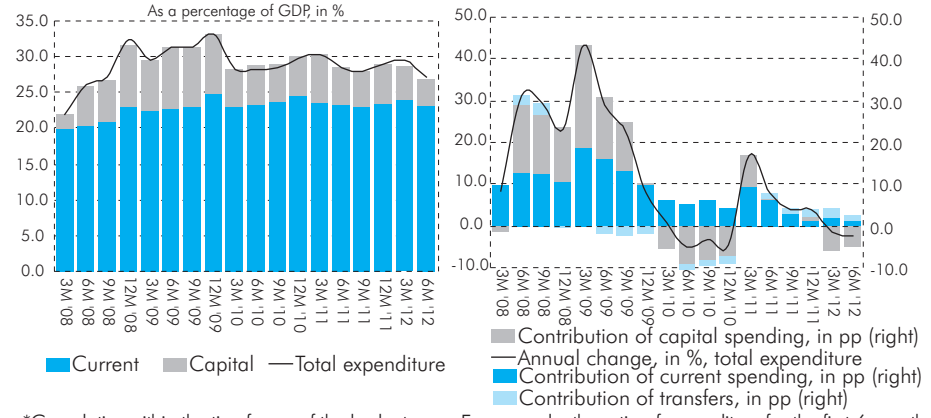
IV.1.4 FISCAL INDICATORS AND FISCAL POLICY[22]

The fiscal policy pursued in the first half of 2012 was in line with the budget plan. It oriented towards a fiscal consolidation process, expressed in a downward trajectory of the budget deficit. The available fiscal room for 2012 conditions a similar trend of fiscal policy to the first half of the year. In addition, fiscal consolidation process determined an adverse contribution of the public sector to aggregate demand growth in the first half of the year, being, for the most part, expressed in the form of lower gross fixed capital formation. The items approximating the final consumption of the government show figures almost similar to the previous year, suggesting an absent contribution of this component to aggregate demand growth. On the other hand, budget revenue-side fiscal developments suggest sluggish economic activity in Albania during the first half of 2012.

Budget expenditure amounted to about ALL 177.7 billion in the first half of 2012, down by about 2.5% in nominal annual terms[23]. The lower total expenditure attribute to the annual nominal contraction of capital spending by about 27% in the first half of the year, providing in turn a negative contribution by 4.9 percentage points to the annual change of total expenditure. By contrast, over the period under review, current expenditure increased by about 1.6% y-o-y, mainly due to the higher spending on social security. On the other hand, the higher spending on personnel, public debt interest payments, the higher operating expenditure and social welfare spending compared to the previous year have offset the negative effect of local government expenditure and subsidies on total current spending.

[22] *The fiscal data on the first half of 2012 are preliminary and may be subject to revision.*
[23] *Excluding lending to KESH (classified as an item in budget expenditure), the annual change in public spending for the first half of 2012 is -3.5%.*

Chart 28 Cumulative budget expenditure* (current and capital) as a percentage of GDP, in % (left), and annual change of budget expenditure in % and the respective contributions of current and capital spending and other transfers**, in pp (right)

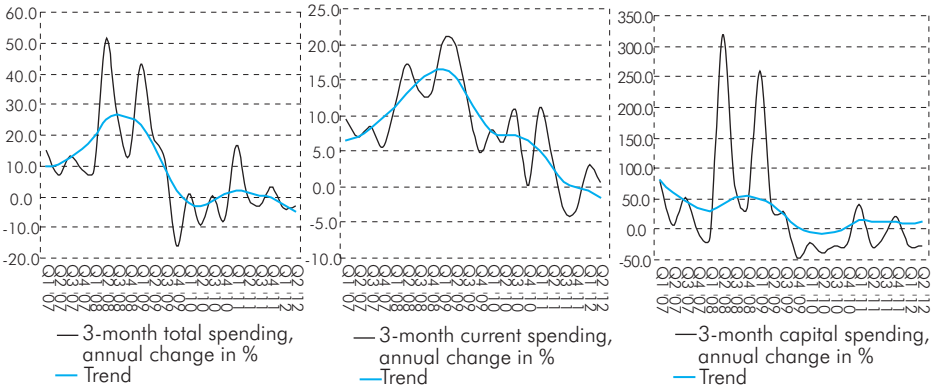


*Cumulative within the timeframe of the budget year. For example, the ratio of expenditure for the first 6-month period has been constructed as budget expenditure for January-June as a percentage of GDP for the same period.
**"Other transfers" includes "lending to KESH" and "capital transfers".
Source: Ministry of Finance, INSTAT and BoA's staff estimates.

As a percentage of GDP, total expenditures were estimated at about 27.3% in the first half of 2012, the lowest since 2008. This performance of total budget expenditure-to-GDP ratio owes mainly to capital spending, which were estimated at about 3.7% of GDP in the first half of 2012 or 1.9 percentage points below the average of 2008-12.

Budget expenditures displayed a similar dynamics in the first and second quarter of 2012. More specifically, public spending[24] contracted by 3.8% and 3.3% y-o-y in the first and second quarter, reflecting an almost similar intensity of capital spending over the first two quarters. Current spending, on the other hand, did not display a uniform distribution, recording higher annual growth rates in the first quarter rather than in the second one.

Chart 29 Annual change in % of quarterly expenditures by main items (charts from left-right: total spending, current spending and capital spending) and their respective trends during 2007 Q1-2012 Q2*



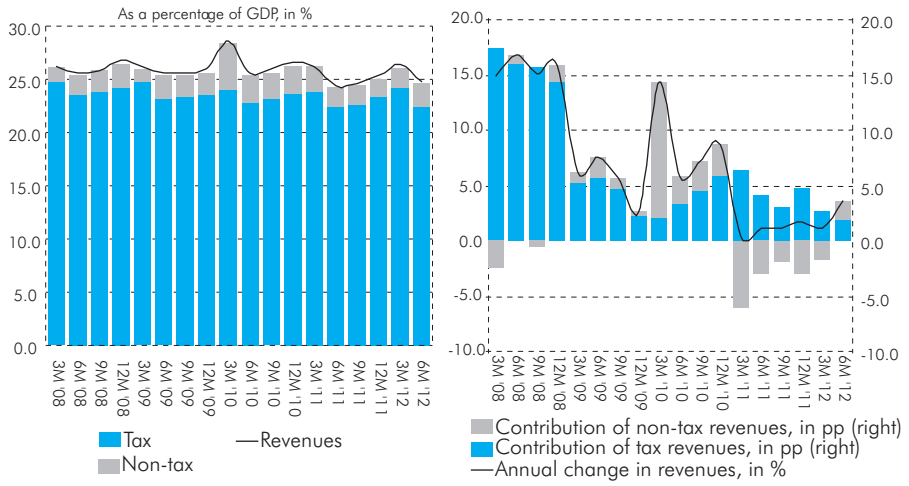
*The annual change trend of each item of expenditure/revenues shown in the charts is derived using the Tramo/Seats adjustment method
Source: Ministry of Finance and BoA's staff estimates.

[24] *Total spending excludes the loan of ALL 2.0 billion to KESH as it is classified under budget spending.*

Budget revenues amounted to about ALL 160.9 billion in the first half of 2012, about 3.7% times higher y-o-y. The acceleration of the growth rate of budget revenues at the end of the first half of 2012 to 3.7% from 1.1% at the end of the first quarter owed to the positive contribution of non-tax revenues (by about 1.8 percentage points[25]). On the other hand, tax revenues (tax and customs, social security and local government revenues) collected in the first half of 2012 increased by about 2.0% compared to the same period in 2011. National income tax recorded the highest increase in tax revenues, accounting for about 83% of the increase in total revenues. Unlike its historical performance, this item has contributed markedly to total budget revenues over the current year, reflecting primarily the effect of fiscal measures related to the national tax[26].

In addition to the national income tax, VAT and social security revenues were the only items contributing positively to the increase in total revenues (by 0.5 and 0.7 percentage points, respectively). VAT revenues, which have the main share in total revenues (about 34% in the first half of 2012), increased at low rates (by about 1.4%) in nominal annual terms. VAT revenues are closely linked to the import value, exchange rate, production of goods and services at home, exports and specific adjustments in the VAT payment method for the import of capital goods. Available data[27] show that the sluggish performance of VAT revenues owes primarily to the lower import value[28], signalling at the same time the presence of low consumption over the period under review.

Chart 30 Tax and non-tax revenues as a percentage of GDP (left) and annual change of total revenues and contribution of two main items in pp (right), 2008 Q1-2012 Q2



Source: Ministry of Finance, INSTAT and BoA's staff estimates.

[25] *As at the end of the first quarter, non-tax revenues contributed negatively by about 1.6 percentage points to total revenues. The high increase in non-tax revenues in the second quarter of 2012 owes partly to the classification of a part of privatization receipts under non-tax revenues.*

[26] *These measures consisted in changes related to the circulation tax for petrol and gasoline, environmental tax and minerals resource rent tax.*

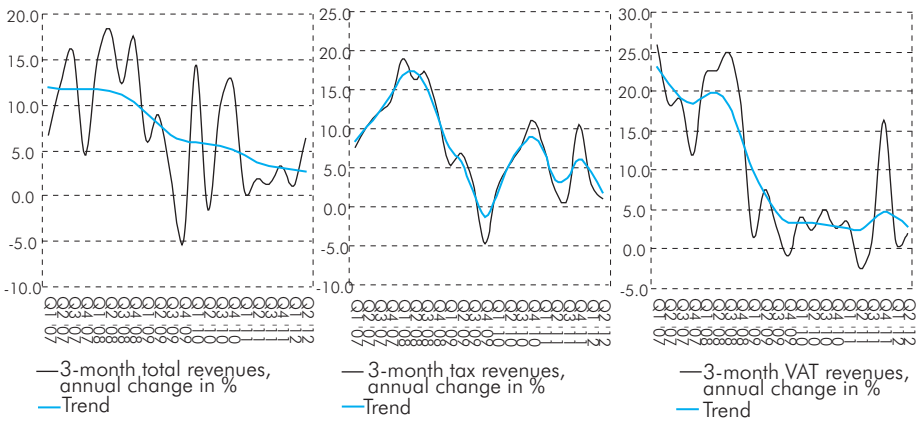
[27] *Imports and exports, VAT from taxation and customs, VAT refunds for the first five months of the year and the exchange rate for the first half of 2012.*

[28] *The value of imports contracted by about 2% y-o-y in the first five months of 2012. For the same period, exports increased by about 1.3%.*

Profit tax, personal income tax, excises and local government revenues were lower than in the previous year, thus providing a negative contribution to the increase in total budget revenues.

As a percentage of GDP, during the first half of 2012, total revenues were estimated at about 24.7% or 0.5 percentage points below the average of the same period during 2008-12. The deviation from the recent years' average owes to the lower ratio of tax revenues (about 22.4% of GDP compared to the average of 22.9% during 2008-12).

Chart 31 Annual change in % of quarterly revenues by main items (from left-right: total revenues, tax revenues and VAT revenues) and their respective trends, 2007 Q1-2012 Q1



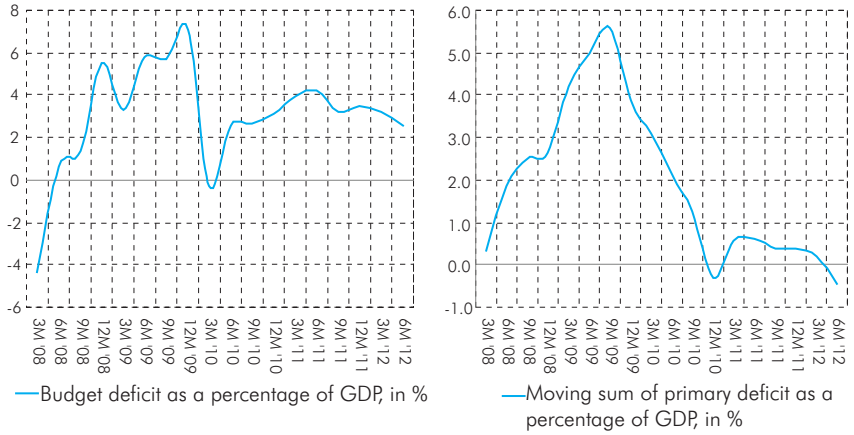
Source: Ministry of Finance and BoA's staff estimates.

With respect to the distribution of budget revenues by quarters, they were higher in the second quarter compared to the first one, mainly in the form of non-tax revenues. The growth rates of tax revenues, particularly VAT revenues, were below their long-term trends in both the first and second quarter. Being closely linked to the performance of economic activity and recording rates below their long-term average, the sluggish performance of tax items (VAT revenues, excises, tax on profit, personal income tax), in the absence of fiscal measures that may change the tax rate, the taxation mode or the taxpaying base, suggests the effect of automatic stabilizers on the economy.

As at the end of the first half of 2012, budget deficit amounted to about ALL 16.8 billion, accounting for about 2.6% of GDP. The developments in budget expenditure particularly yielded a budget deficit of about 37.7% lower in nominal annual terms. Total budget deficit financing in the first half of 2012 was mainly based on the issue of Government securities, while foreign resources accounted for about 24%. Concerning the division of domestic borrowing by maturity, long-term instruments dominated over short-term ones. Bidders' demand in the primary securities market segmented into some instruments (12-month T-bills, 5 and 7-year bonds) seems to have determined government's borrowing policy over the period under review. In this context, the increase in government securities portfolio was concentrated in 12-month T-bills and 3, 5 and 7-year bonds, lowering, albeit not to the same extent, the share of financing through 3 and 6-month T-bills and 2-year bonds.

The orientation of domestic borrowing towards longer instruments, while gradually maturing short-term instruments, favours the domestic debt settlement profile and, at the same time, contributes to reducing the risk of debt refinancing.

Chart 32 Budget deficit as a percentage of GDP (left) and primary deficit as a percentage of GDP (right)*



*The right chart is constructed taking into account the moving sum of the 3-month primary deficit (including four quarters) as a percentage of cumulative GDP per quarter.
Source: Ministry of Finance, INSTAT and BoA's staff estimates.

The developments in total budget deficit during the first half of 2012 reflected in a primary surplus of 0.4% of GDP. As a result of the fiscal consolidation process during the first half of 2012, the primary surplus suggests, among others, the improved fiscal position.

Table 6 Key fiscal indicators

	2012 H1		Annual change, in %		
	ALL billion	% of GDP	2010 H1	2011 H1	2012 H1
Total revenues	160.9	24.7	5.8	1.1	3.7
Tax and customs	110.9	17.0	4.4	4.6	2.0
VAT	54.7	8.4	3.3	0.3	1.4
Tax on profit	8.8	1.3	-5.4	31.0	-22.3
Excises	17.1	2.6	22.4	-2.5	-0.4
Tax on personal income	13.1	2.0	-8.9	7.1	-2.1
National income tax	14.3	2.2	22.9	17.8	49.3
Local government	6.4	1.0	-7.7	6.5	-5.0
Social security contributions	28.8	4.4	4.2	4.8	3.9
Non-tax	13.9	2.1	23.1	-26.9	27.4
Grants	0.9	0.1	54.9	-39.1	-19.9
Total expenditure	177.7	27.3	-5.11	7.71	-2.4
Current expenditure	151.5	23.3	7.1	7.4	1.6
Personnel	33.7	5.2	7.6	3.4	2.4
Interest payments	20.0	3.1	11.5	0.7	2.2
Operating and maintenance	16.5	2.5	10.6	3.9	3.3
Social security	56.3	8.6	8.6	10.5	4.4
Local government	13.1	2.0	-6.4	4.0	-11.0
Capital spending	24.2	3.7	-33.6	2.5	-26.9
Lending to KESH	2.0	0.3	..	..	...
Budget deficit	16.8	2.6	-52.9	72.5	-37.7

Source: Ministry of Finance, INSTAT and Monetary Policy Department's estimates.

IV.2 LABOUR MARKET, WAGES AND COSTS

Unemployment rate has remained above 13% over the last two years, conditioning thus the dynamics of nominal wage rise in the economy. The sluggish wage rise eased the inflationary pressures in terms of demand and unit labour costs. Businesses reported a weaker increase in employment in the second quarter of 2012.

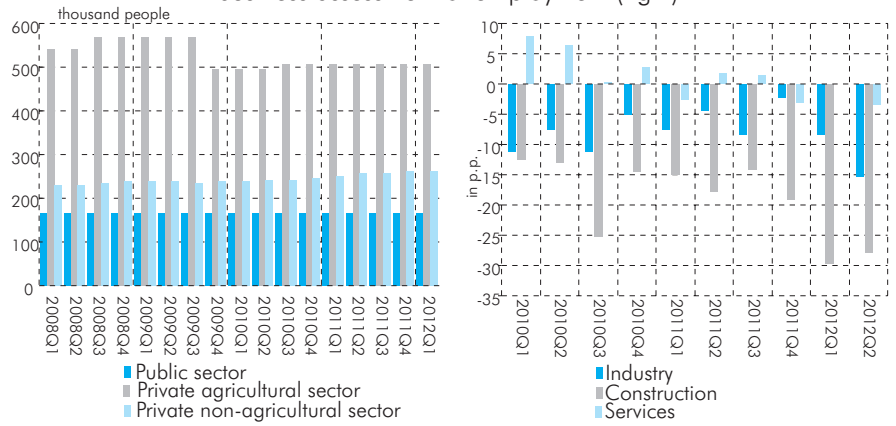
LABOUR MARKET

The latest available data show stable labour market conditions in the first quarter of 2012. Employment continued to pursue a rising trend in the quarter under review, while unemployment rate remained similar to 2011 at 13.3%.

According to INSTAT, the average number of employed people in the economy increased, albeit at lower rates than in the previous quarter. This indicator increased slightly by 0.1% quarter-on-quarter and by 1.4% year-on-year. The performance of employment continued to be driven by the annual increase of employment in the private non-agricultural sector by 5.5%, while employment in the public sector continued to pursue a declining trend.

Labour force grew higher than employment due to the slight increase in the average number of unemployed people.

Chart 33 Average number of employed people by sectors of economy* (left); business assessment of employment (right)



*The average number of employed people in the private agricultural sector is estimated through the Labour Force Survey. Since the latest estimation dates back to the 2009 Labour Force Survey, which was carried out in the third quarter of 2010, their number has not changed in the last quarters.

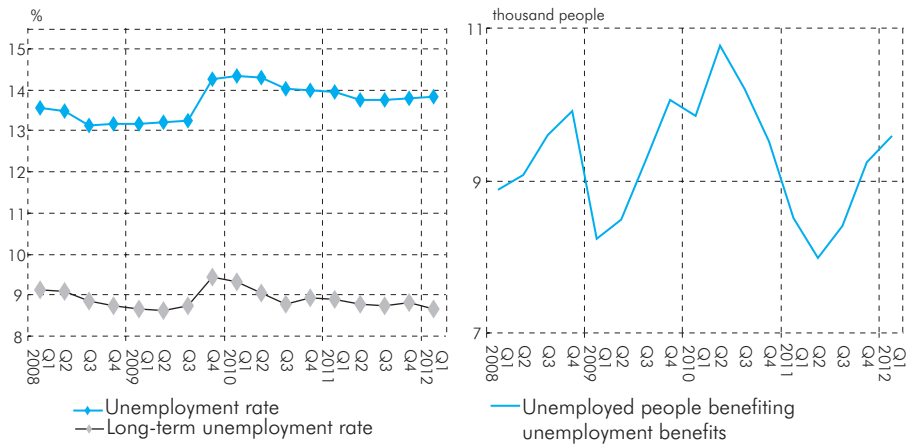
Source: INSTAT and Bank of Albania.

Businesses report that demand for labour, mainly from the sector of industry, fell in the second quarter of 2012. The deterioration in manufacturing industry and the sluggish demand seems to have pushed businesses to lower fixed costs, thereby reducing the level of employment.

A more elaborate analysis of the structure of unemployment obtained from data made available by the Ministry of Labour, Social Affairs and Equal Opportunities signals non-positive developments in the labour market. The

data show relatively high long-term unemployment rates. This performance can have negative effects on potential growth if it persists over a long period of time and if concentrated in certain labour market segments requiring constant update of work-related skills. The higher number of beneficiaries of unemployment benefits[29] is another signal of the non-positive developments in the labour market, despite their low share in the average number of unemployed people (about 6.7% in the first quarter of 2012).

Chart 34 Unemployment rate and long-term unemployment rate (left); average number of unemployed people benefiting unemployment benefits (right)



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

WAGES AND LABOUR COSTS

There are partial data on the performance of wages in the economy in the first quarter of 2012[30]. Average monthly wage in the public sector accelerated the annual growth rate to 7.3% in nominal terms and to 6.2% in real terms. The lower real wage in the economy[31] over the last three quarters of 2011, at a time when the number of employed people in the economy increased, shows that the adjustment of the labour market to the conditions the Albanian economy is operating in may have mainly materialized through the reduction of the real wage. The slight increase in unemployment, among others, may have exerted pressure over the reduction of wages. Worth noting is that the further increase in the number of long-term unemployed people may exert downward pressure[32].

[29] *All people benefiting unemployment benefits according to the Law No. 7703, dated 11 May 1993 "On Social Security in the Republic of Albania", Article 53.*

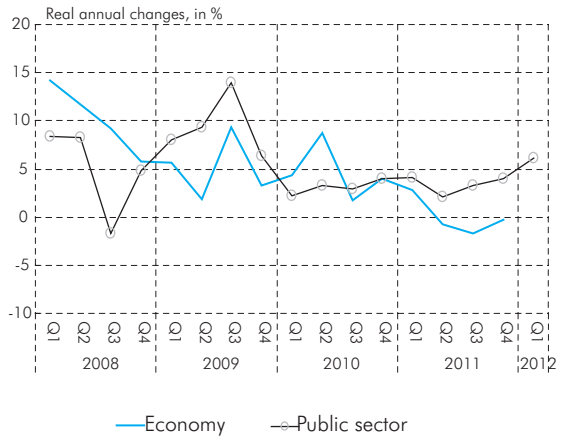
[30] *You can find a more detailed analysis of the performance of average wage in the economy in the Quarterly Monetary Policy Report for the first quarter of 2012.*

[31] *Wage index in the economy, referred to as "average wage" is measured as the ratio of wages fund index to employment index. Source: INSTAT, "Short-term Statistics", excluding "Agriculture". The data frequency is quarterly.*

[32] *Long-term unemployed people have lower employment opportunities than other unemployed people in the labour market. Being unemployed for a long period of time causes them to lose their ability to effectively apply for a job, hence generating lower pressures on the rise of wages.*

Businesses state that wages in economy rose in the second quarter of 2012 compared to the previous one. In line with the rise in minimum wage, businesses expert further rise in wages in the third quarter of 2012.

Chart 35 Average wage in economy and the public sector



Source: INSTAT and Bank of Albania.

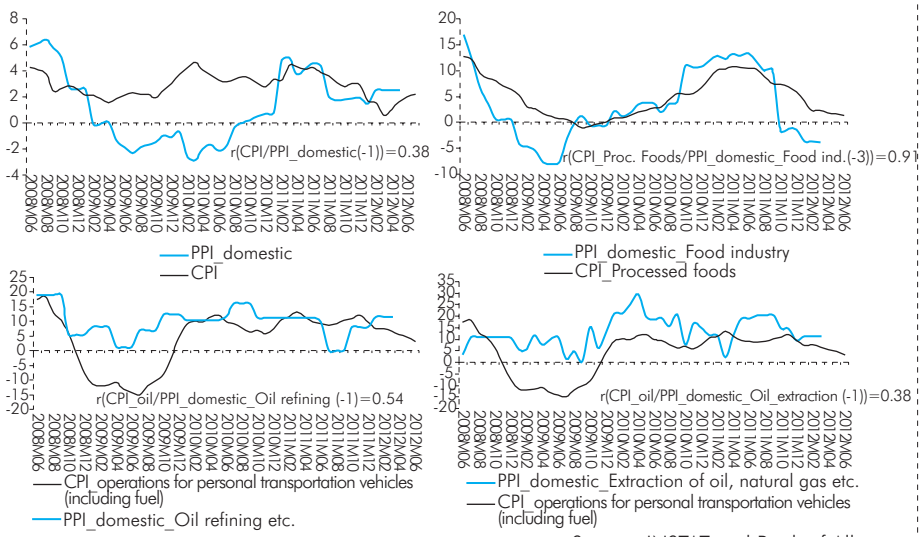
PRODUCER PRICES

Based on the Producer Price Index (PPI), during the first quarter of 2012, industry operated at higher producer prices compared to the previous quarter. The PPI rose by 2.5% y-o-y, still remaining about 0.5 percentage points below the annual figure of the same period in 2011. This performance owes mostly to the annual rise in extractive and petroleum refining industries.

The performance of PPI in individual industries for products destined for the domestic market is, to a certain extent, explained by the performance of inflation in certain items. Overall, producer prices for domestic goods rose by 2.5%, y-o-y, or 2 percentage points lower than the previous year's rise. The PPI in the sub-branches of oil extracting and refining rose by about 11.5%, exerting added inflationary pressures from the producer prices on the inflation of the respective sub-item during the first months of 2012.

Producer prices in the food industry performed on the opposite side, deepening the annual descending dynamics during the first quarter of 2012 (-3.7%). These developments contributed to curbing the inflation rates of processed foods further during April-June 2012[33].

Chart 36 Annual changes of domestic CPIs and PPIs and respective linear correlations



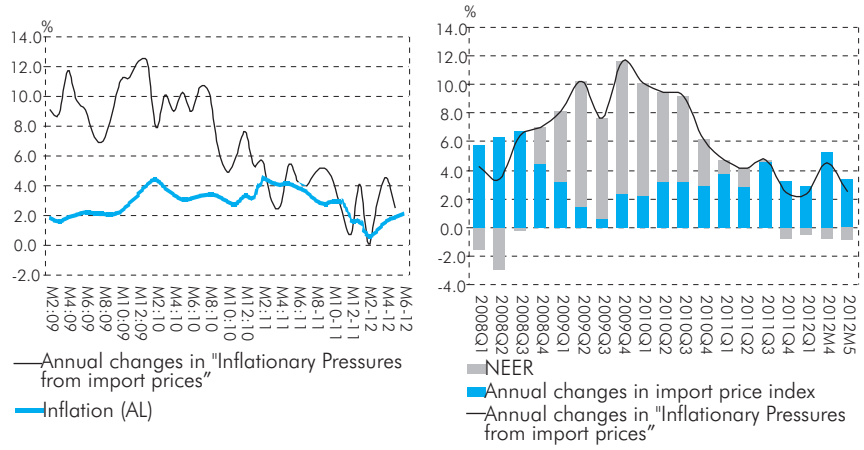
Source: INSTAT and Bank of Albania.

[33] *Empirical estimates show that fluctuations from producer prices in food industry for products destined for the domestic market are passed through, in the same direction and to a relatively high extent, to the consumer prices of the respective item with a 3-month lag.*

IV.3 IMPORTED INFLATION

The inflationary pressures stemming from the external economy on domestic prices were generally low during the first five months of 2012. Import Price Index[34] showed high volatility during this period, recording the lowest rate of 0.9% in February and the highest of 4.5% in April. In May, imported inflation decreased by about 2 percentage points from the previous month to 2.5%. This volatility was mostly determined by the monthly CPI developments in Albania's main trading partners. Import Price Index rose by 3.4% in May, down by about 1.9 percentage points from the previous month. Beyond these temporary fluctuations, the annual dynamics of imported inflation has maintained a decelerating pace, mainly due to the appreciation tendency of the exchange rate. During the period under review, lek appreciated by an average of 0.65% in nominal terms. This factor plays a key role in the extent of the transmission of inflationary pressures originating from outside Albania.

Chart 37 Inflationary pressures from import prices and domestic inflation (left, annual change) and contribution of import prices and exchange rate (left)

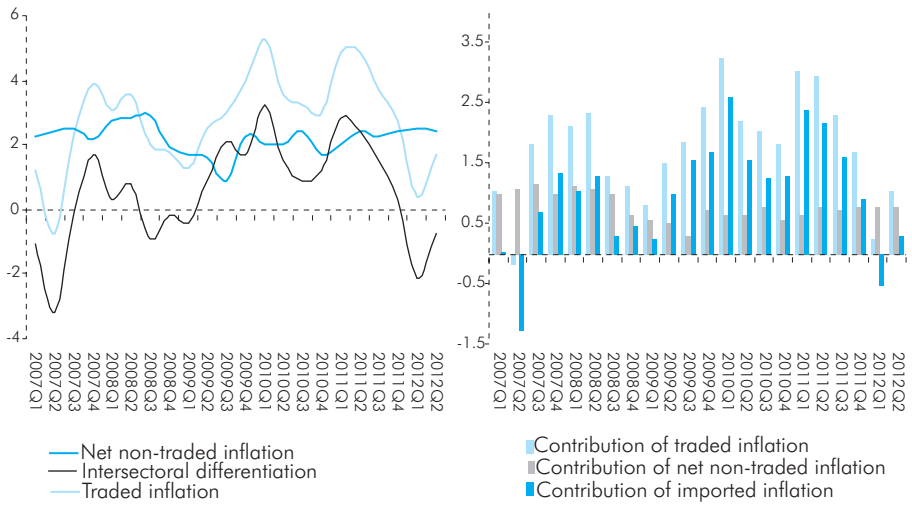


Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat.

Intersectoral differentiation of inflation marked negative rates, narrowing from -2.2 percentage points in the first quarter to -0.72 percentage points in the second. This performance reflected the two opposite moves of intersectoral inflation – increase in annual traded inflation and slight decrease in net non-traded inflation. Hence, a higher impact of imported inflation on headline inflation was signalled in the second quarter of 2012. This conclusion is also confirmed by the difference between the contributions of each sector, which shifted direction from negative in the first quarter to slightly positive in the second quarter of 2012. After lowering headline inflation in the early months of 2012, imported inflation contributed to increasing headline inflation by 0.3 percentage points (16%) in the second quarter of 2012. Domestic inflation formed 1.6 percentage points (84%) of headline inflation.

[34] *Import Price Index is measured as the weighted average of the consumer price indices of 21 countries, using their import share based on foreign trade data and adding the NEER index value for the respective month.*

Chart 38 Intersectoral differentiation of inflation and its contribution



Source: INSTAT and Bank of Albania.

IV.4 INFLATION EXPECTATIONS[35]

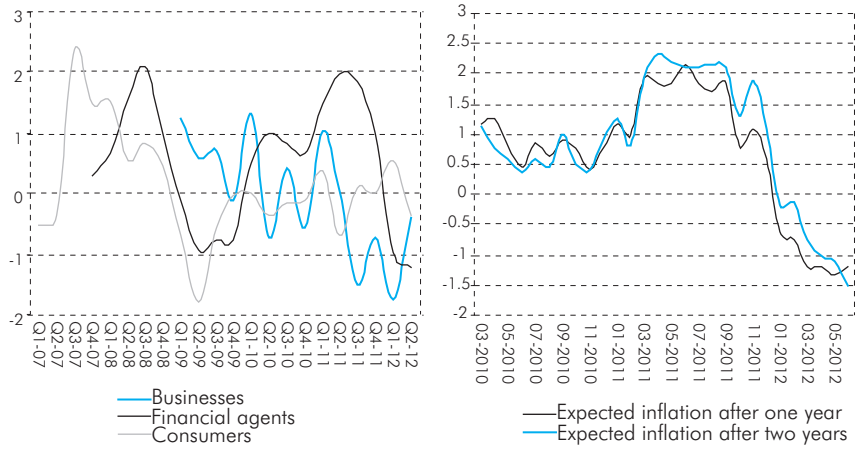
The inflation expectations of different economic agents were low during the first half of 2012 and close to the lower limit of the Bank of Albania's target range for maintaining price stability. Expectations anchoring index[36], which shows how many standard deviations away is their current level from the long-term average, provides evidence for low inflation pressures from the behaviour of inflation expectations. Although the expected inflation rate is below the Bank of Albania's point inflation target (2.3% from 2% in the first quarter of 2012), business inflation expectations rose in the second quarter of 2012. On the other hand, consumers and financial agents revised their expectations for future inflation down (by -0.3 and -0.1 percentage points, respectively). Expectations anchoring index provides evidence for a better anchoring of consumer and business expectations (the index stands close to 0) than of financial agents. The index for the latter stands about 1 standard deviation below 0. The latter shows the perfect anchoring of expectations.

More detailed data obtained from the monthly financial agents' survey show that the medium-term inflation expectations (expected inflation rate after two years) are better anchored than short-term inflation expectations (expected inflation rate after one year).

[35] *The Bank of Albania measures economic agents' inflation expectations through business and consumer confidence surveys and financial agents' expectations survey.*

[36] *This index is used to quantify the anchoring of expectations and is estimated by deducting the long-term average or the numerical inflation target of 3% from the expectations' series level and dividing it with the respective standard deviation.*

Chart 39 Anchoring of inflation expectations from different economic agents

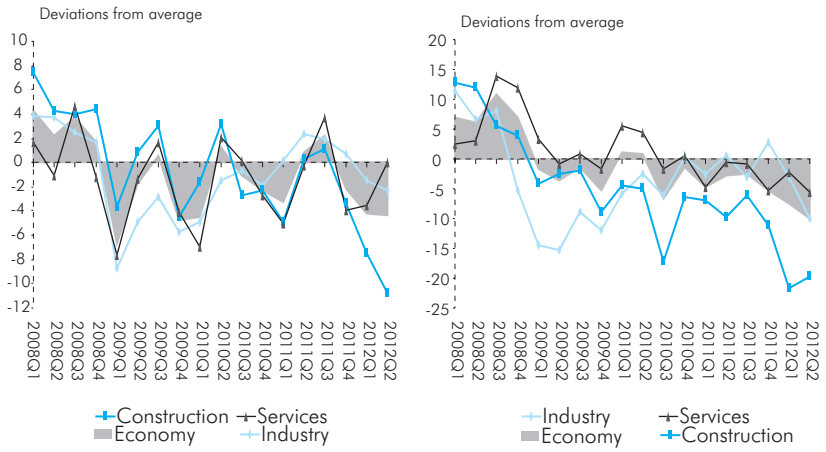


Source: Consumer and Business Confidence Surveys and Financial Agents' Survey, Bank of Albania.

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

Inflationary pressures from the real economy remain weak against a background of low demand, stable domestic currency and anchored expectations. Annual inflation marked low rates during the first half of 2012. In the first and second quarter of the present year, it marked 1.1% and 1.9%. Economic activity declined by about 0.2% in the first quarter. Although the decline in the economic performance in the beginning of 2012 reflects, among others, temporary factors as well, the Albanian economy has been growing below its potential in the last three years. The growth of aggregate demand remains insufficient to fully utilize the capacities in the economy, thereby resulting in an unemployment rate of above 13% and a low capital utilization

Chart 40 Capacity utilization rate in economy (deviation from average, left-hand chart) and assessments for employment (deviation from average, right-hand chart)



Source: Bank of Albania and INSTAT.

rate in production. Against this setting, the costs of the factors of production have recorded low growth rates and have not encouraged the formation of cost-price inflation spirals. On the other hand, the stable exchange rate has smoothed out the external inflationary pressures, which were highly volatile during the first months of the current year.

The new statistical information flow on the second quarter of 2012 shows that the Albanian economy will continue to be characterized by unused capacities. Capacity utilization rate for the economy has dropped by 4.6 percentage points from its historical average and demand for labour fell in the second quarter. The inflationary pressures from the real economy will remain contained in the period ahead, as a reflection of the economic conditions, the outlook for stable primary commodity prices in the international markets and anchored inflation expectations.

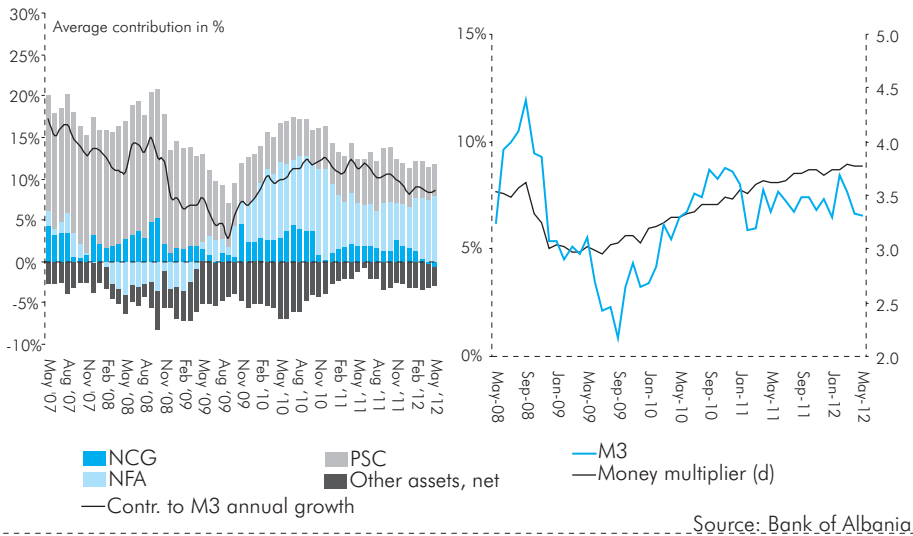
V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Money growth slowed down in the first half of 2012 compared to 2011, in response to the weaker demand for money from the economic agents at home. The foreign currency component contributed to the growth of money and somehow offset the lower contribution of domestic credit. The distinctly decelerated growth rates of domestic credit were driven by both the contraction of government financing from the banking sector and the consecutive deceleration of the loan portfolio growth rates. Against a background of sluggish economic activity and spare capacities, private sector demand for financing was low. In addition, the loan portfolio was also impacted by the heightened uncertainty about the future and the added bank prudence in terms of lending. Developments in financial markets show a good liquidity position of the banking system and low pressures over the interbank rates. Financial agents' inflationary expectations are anchored around the Bank of Albania's target. Overall, monetary and financial developments confirm the absence of inflationary pressures over consumer prices at home in the medium run.

V.1 MONETARY INDICATORS

Broad money, M3, grew by an average of 8.6% y-o-y in the first half of 2012[37]. The annual money growth rate has been slowing down in response to the lower demand for monetary assets from the real sector of the economy. In real terms, money growth has been stable at an average of 7.2%. The growth

Chart 41 Contribution of money demand components, money multiplier and M3



Source: Bank of Albania.

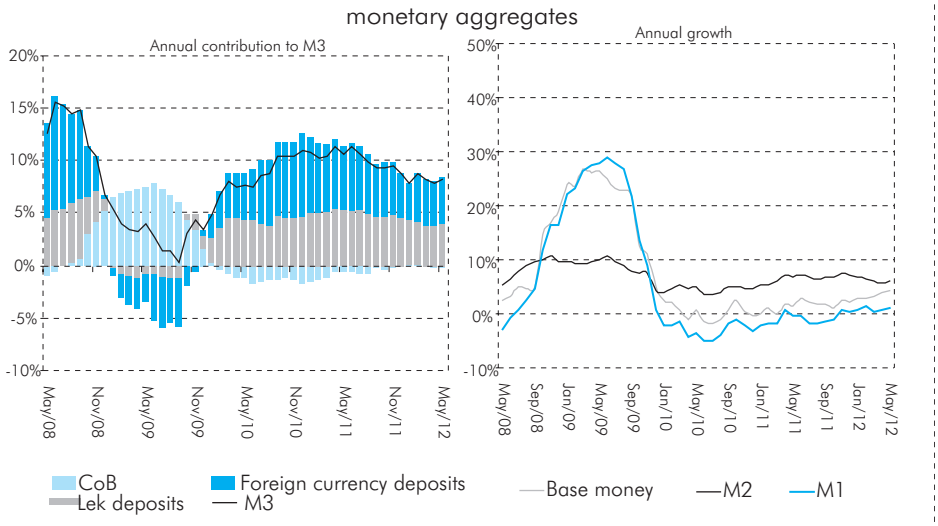
[37] *The latest monetary data refer to May 2012.*

of base money in the economy continues to be widely driven by the external sector's foreign currency flows. Real demand for money displayed a downward tendency, with fiscal agents manifesting a more cautious behaviour and the private sector showing a more moderate demand for monetary assets. In real terms, domestic credit grew by an average of 5.6% y-o-y in the first half of 2012, compared to 6.4% in the second half of 2011.

The annual growth of monetary aggregate in lek, M2, slowed down slightly to 6.2% y-o-y. The lower banking system participation in budget deficit financing was also reflected in its contribution to the growth of monetary assets in the second quarter of 2012. The growth of M2 aggregate during this period was driven by the positive growth rates of lending to the economy in lek.

The liquid indicator of money, M1, increased slightly during the first half of 2012, by an average of 0.8% y-o-y. This performance was driven by the downward demand of economic agents for cash compared to the previous year, which was somehow offset by the increase in lek-denominated demand deposits over the same stated period.

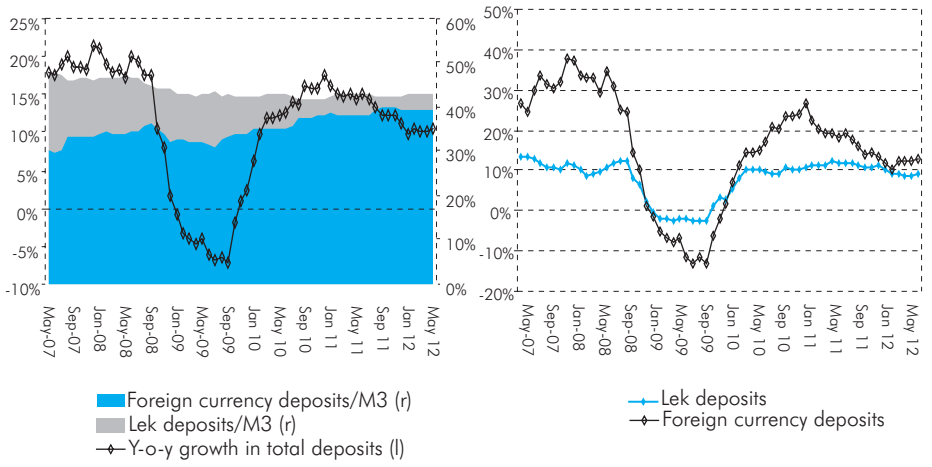
Chart 42 Contribution of money supply components and annual increase of monetary aggregates



Source: Bank of Albania.

Banking system deposits maintained stable growth rates in the first half of 2012. On average, they grew by 10.3% y-o-y, compared to about 11% at end-2011. The growth of the deposit stock was driven by households' tendency to save and the creation of money from lending. This has also been reflected in the total deposit-to-broad money, M3, ratio, which in May rose to 82.8% from 81.8% at end-2011.

Chart 43 Total deposits to M3 and annual performance of deposits by currency

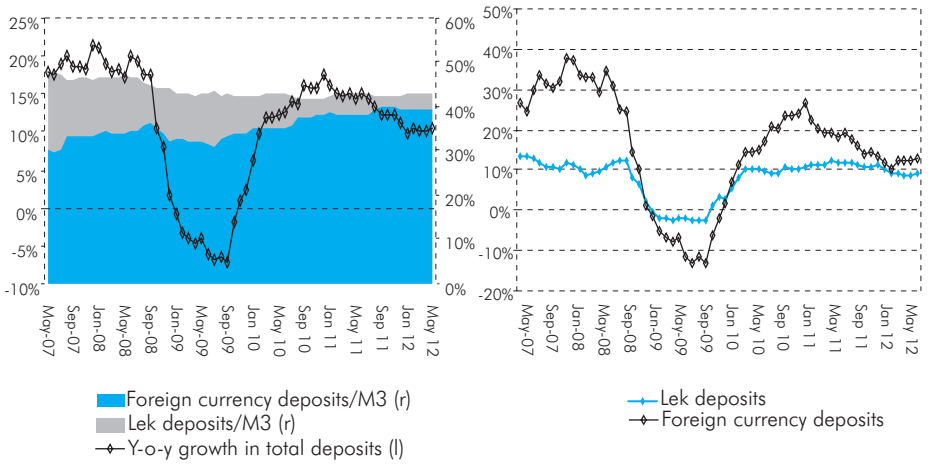


Source: Bank of Albania.

Broken down by currency, lek-denominated deposits grew by about 9% y-o-y, compared to 11% in the second half of 2011. This slowdown was driven by the moderate public sector demand for monetary assets, coupled with the shift of its financing outside the banking system in the first half of 2012. The annual growth rate of foreign currency-denominated deposits seems to have also maintained a downward trend. In the first half of 2012, they grew by about 12% y-o-y. Foreign currency deposits-to-M3 ratio stands at 39.5%, similar to end-2011.

Household deposits account for the major share of total deposit stock growth. Broken down by maturity, household time deposits showed stable growth throughout the first half of the year. Business deposits were more volatile and their stock, particularly business time deposits, showed a declining tendency throughout the period.

Chart 43 Total deposits to M3 and annual performance of deposits by currency



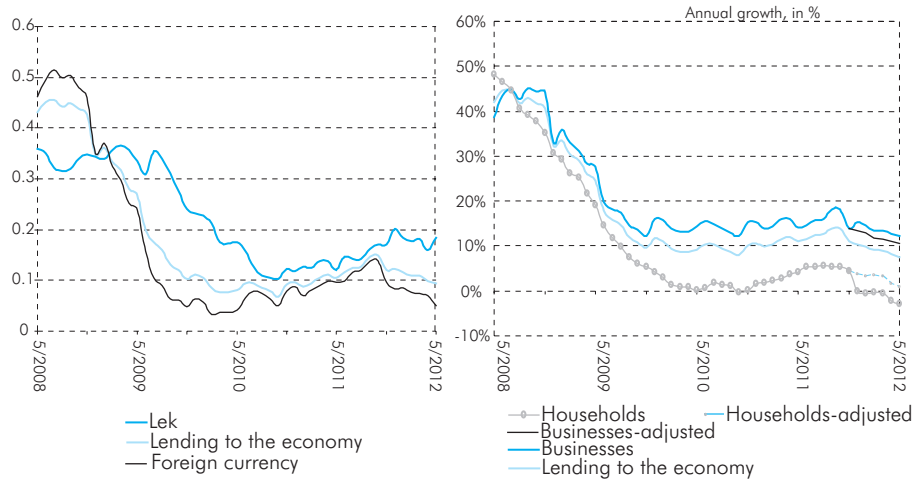
Source: Bank of Albania.

LENDING TO THE ECONOMY[38]

Lending to the economy continued to slow down further in the second quarter of 2012. Its annual growth rate dropped to 9.9% and 9.4% in April and May, compared to 10.9% at the end of the first quarter of the current year. After remaining almost unchanged in April, outstanding credit grew by about ALL 3.4 billion in May, out of which ALL 1.9 billion were lek lending to public enterprises.

The growth of the loan portfolio during April and May was entirely driven by the growth of lek-denominated loans. In May, lek-denominated loan portfolio recorded an annual change of 18.3%. Foreign currency-denominated loans contracted during these two months due to the continued settlement of foreign currency-denominated household loans and the low business demand for investment. At the end of May, this portfolio recorded an annual change of 5.0%, compared to 7.3% at the end of the first quarter.

Chart 45 Lending to the economy by currency and private sector credit by customer



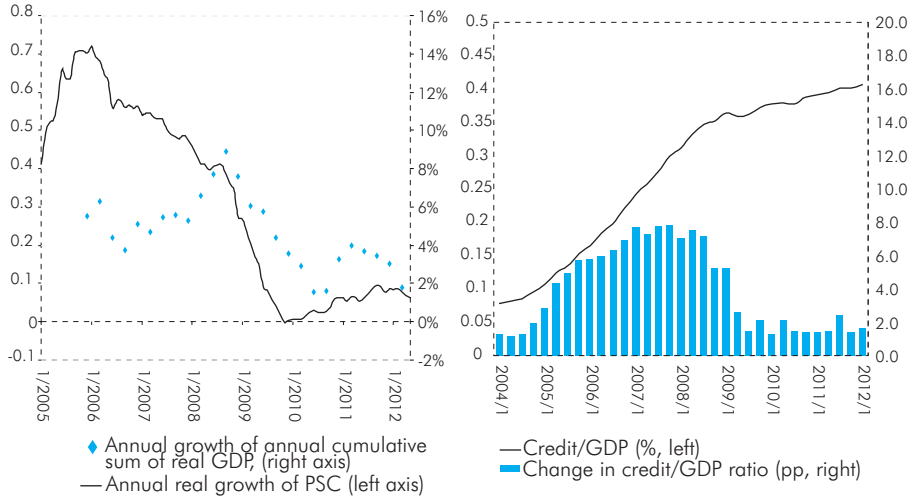
Source: Bank of Albania.

The growth of private sector credit in the first five months of 2012, and particularly during March-April, was considerably lower than in the previous years. In line with the developments in real economy, the slowdown in private sector credit reflects primarily the low economic agents' demand for credit. In addition, banks continue to pursue a cautious approach to lending, being reflected in the tight lending standards or their further tightening for specific market segments.

The annual change in private sector credit dropped to 7.5% at the end of May, compared to 9.0% at the end of the first quarter. Despite the deceleration noted over the current year, private sector credit continues to provide a positive impulse to the growth of economic activity. Updated economic growth figures show that private sector credit-to-GDP ratio was estimated at 40.7% at the end of the first quarter of 2012, recording an annual change of 1.6 percentage points.

[38] *This analysis is based on monetary data, excluding the analysis of loans by purpose of use and sectors of economy, which uses data that do not include accrued interests and covers public enterprises.*

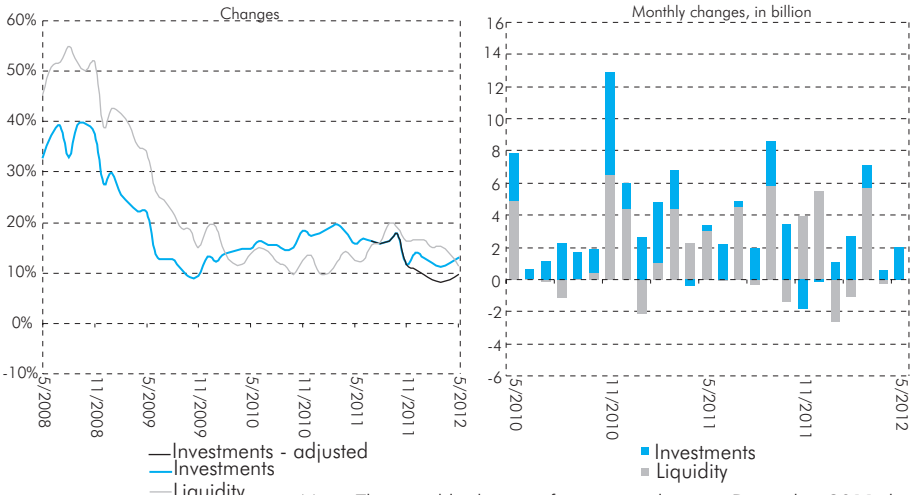
Chart 46 Private sector credit and GDP



Note: Real credit growth excludes the effect of the exchange rate and inflation.
Source: Bank of Albania.

The annual growth rates of credit to private enterprises reduced during April and May to 12.2%[39] or about 1 percentage point below the end of first quarter's figure. Private enterprises' demand for credit was low, particularly for investment purposes, due to the low capacity utilization. In May, the annual growth of investment loans grew to 15.7%[40] due to the higher lending to public enterprises for investment purposes. On the other hand, similar to the first quarter of 2012, the growth of working capital loans was low during April and May. The annual growth of this portfolio slowed down significantly to 14.4% in May, compared to 18.8% at the end of the first quarter.

Chart 47 Business loans by purpose of use



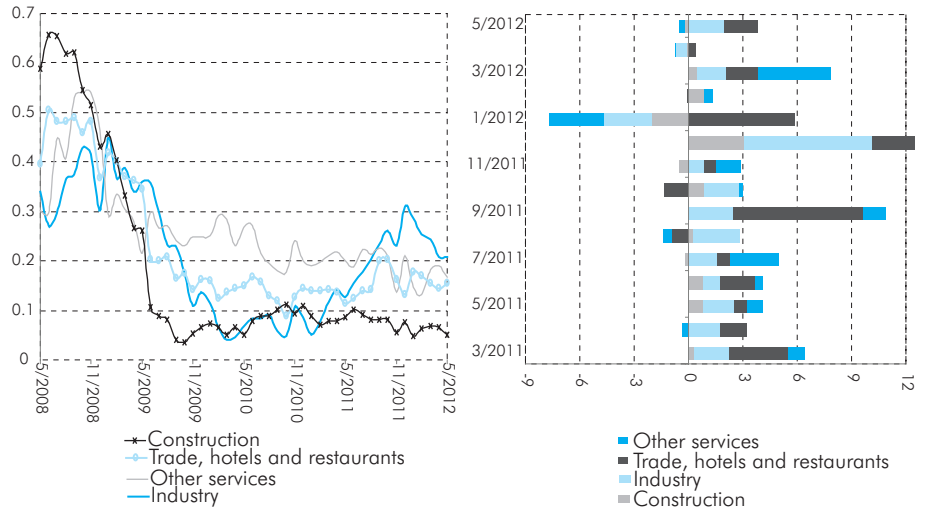
Note: The monthly change of investment loans in December 2011 does not include the increase arising from the reclassification.
Source: Bank of Albania.

[39] *In December 2011, the loan portfolio of one of the reporting banks was reclassified by purpose of use. The reclassification led to the reduction of the household mortgage loan stock by ALL 5.77 billion and the increase by the same amount of the business investment loan stock in December. As a result of this reclassification, the annual changes of business loans point to a positive shift by an average of 1.7 percentage points.*

[40] *The reclassification of investment loans increased their annual change by about 3.4 percentage points during December 2011-May 2012.*

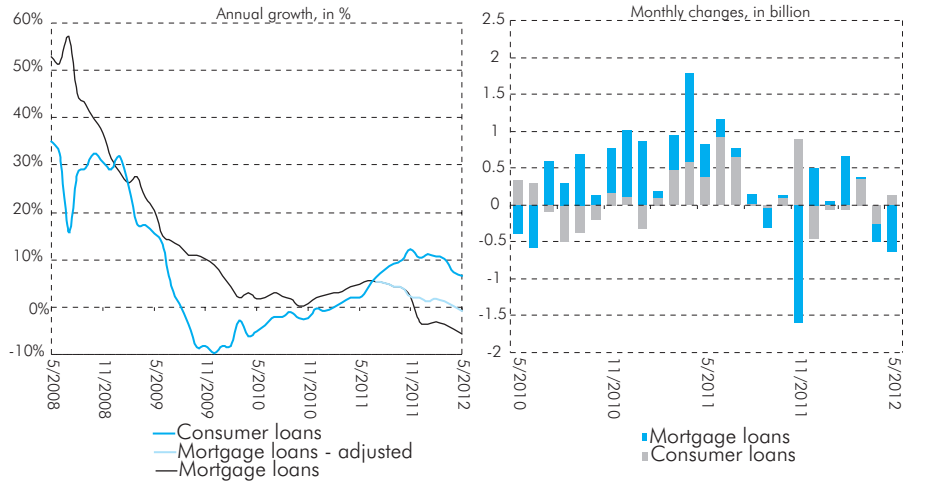
Broken down by sectors of economy, during April and May, the banking sector lent to trade, hotels and restaurants, and industry. This was reflected in the slight improvement of the annual growth of credit to trade (15.4%) and the maintenance of a similar annual growth rate of credit to industry (20.8%). Outstanding credit to construction-related businesses and other services contracted slightly over these two months. Their annual growth rates fell to 5.0% and 16.7%, respectively.

Chart 48 Business loans by sectors of economy



Source: Bank of Albania.

Chart 49 Household loans by purpose of use



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

Credit to households contracted during April and May. Households' approach continues to be largely determined by the uncertainties over the financial outlook. This has, in turn, led them towards saving and pursuing a cautious approach to consumption, particularly to long-term consumption and its financing through bank loans. The annual change of bank lending to households was -2.1% and -3.0% in April and May, compared to -0.6% at the end of the first quarter of 2012[41].

The developments in household loans have reflected the sluggish performance of mortgage loans noted since mid-2011. The annual change of this portfolio was -6.1% in May compared to -4.3% at the end of the first quarter of 2012[42]. Consumer loans also performed sluggishly during the first five months of 2012, decelerating their annual growth rate significantly. Beyond the monthly volatility, outstanding consumer loans at end-May remained almost unchanged from end-2011. In May, consumer loans increased by 6.0% y-o-y, down by 3.3 percentage points from the end of the first quarter of 2012.

[41] *The loan portfolio reclassification effect materialized in the reduction of the annual growth rates of household loans by about 3.8 percentage points during December 2011-May 2012. Adjusting for this effect, the annual growth of household loans remains positive, albeit lower and close to zero.*

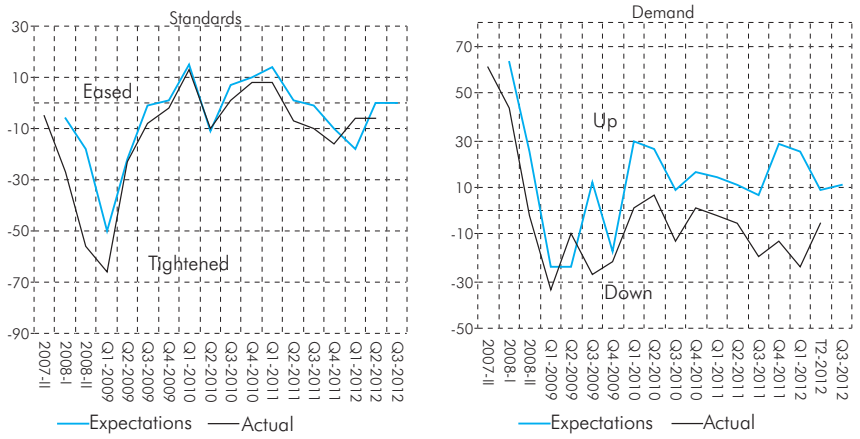
[42] *The loan portfolio reclassification effect on mortgage loans led to the reduction of their annual change during December 2011-May 2012 by on average 5.1 percentage points. Adjusting for this effect, the annual growth of mortgage loans, after slowing down significantly until March, fell into a negative territory in April and May.*

*Box 3 Bank Lending Survey for the Second Quarter of 2012**

Bank lending survey results show that the lending standards applied to businesses tightened slightly in the second quarter of 2012, while those applied to households remained unchanged. The latter remained unchanged both for mortgage and consumer loans. Business lending standards were mainly tightened on loans to small and medium-sized enterprises and, by purpose of use, mainly on loans for investment purpose. Banks kept the standards on lending to large enterprises and for working capital almost unchanged.

Specific business sector-related concerns, non-performing loans situation and the overall macroeconomic setting were the main factors contributing to the tightening of business lending standards. Concerning households, the factors contributing to the tightening of the lending standards were non-performing loans, households' financial situation and developments in the housing market. The liquidity situation and Bank of Albania's decisions contributed to easing the lending standards on both businesses and households, while competition contributed to easing only the lending standards applied to households.

Chart 50 Lending standards and business demand for credit (net balance)



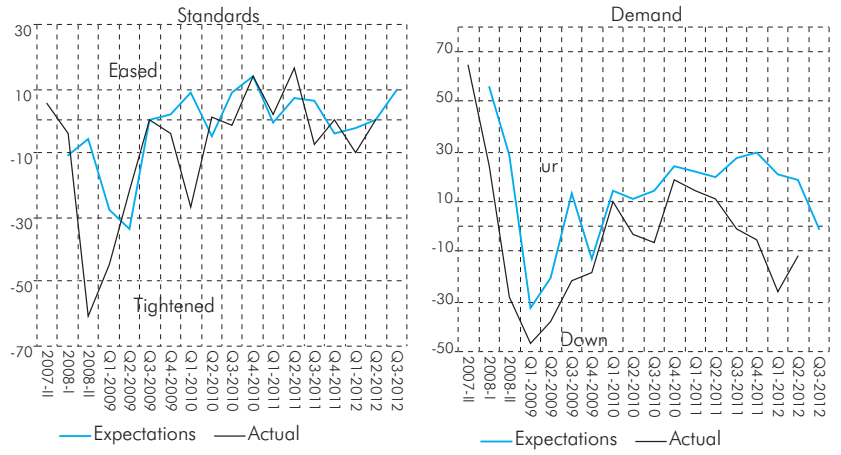
Source: Bank Lending Survey, Bank of Albania.

Banks' tight lending policy continued to be mainly applied through collateral requirements, both for businesses and households. During the second quarter of 2012, the wider average margin applied to reference rates increased its tightening impact.

Net demand for credit continued to fall in the second quarter of 2012, albeit to a lower degree, both for businesses and households. Demand from small and medium-sized enterprises and demand for investment and consumer loans recorded a net negative balance.

Banks' expectations for the lending standards in the third quarter of 2012 are more optimistic than their assessments of the lending standards applied in the second quarter of the present year. Banks do not expect further tightening of the lending standards applied to businesses in the third quarter, while they expect easing of the lending standards applied to households.

Chart 51 Lending standards and household demand for credit (net balance)



Source: Bank Lending Survey, Bank of Albania.

* *The survey conducted in June 2012 covers the developments in bank lending during the second quarter of 2012 and banks' expectations for lending in the third quarter of 2012. You can find a detailed analysis of Bank Lending Survey results for the second quarter of 2012 on www.bankofalbania.org, under Publications.*

V.2 FINANCIAL MARKETS

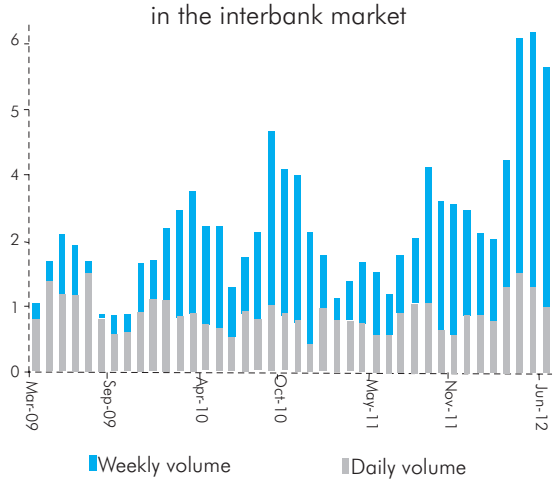
INTERBANK MARKET

During the second quarter of 2012, the bank trading volume increased in the interbank market, while the interbank rates decreased. Total liquidity level was higher, thereby facilitating interbank market agents' activity and favouring the increase in the trading of available funds between them. The decrease in interbank rates affected both maturities (overnight and 7-day) used by banks and was more pronounced in the first two months of the second quarter. The profile of transactions has not changed, confirming banks' preference for 1-week maturity trading.

At the end of March, the Bank of Albania cut the key interest rate by 0.25 percentage points. Interbank market response was immediate and in line with the key interest rate cut. Over the following months, interbank rates stood 30-50 percentage points below the key interest rate. The Bank of Albania continued to conduct regular open market operations by injecting liquidity of 7-day and 3-month maturity. The amount of liquidity injected through reverse repos over this period was slightly lower than in the previous quarter, while the interest rate in these auctions was close to the key interest rate.

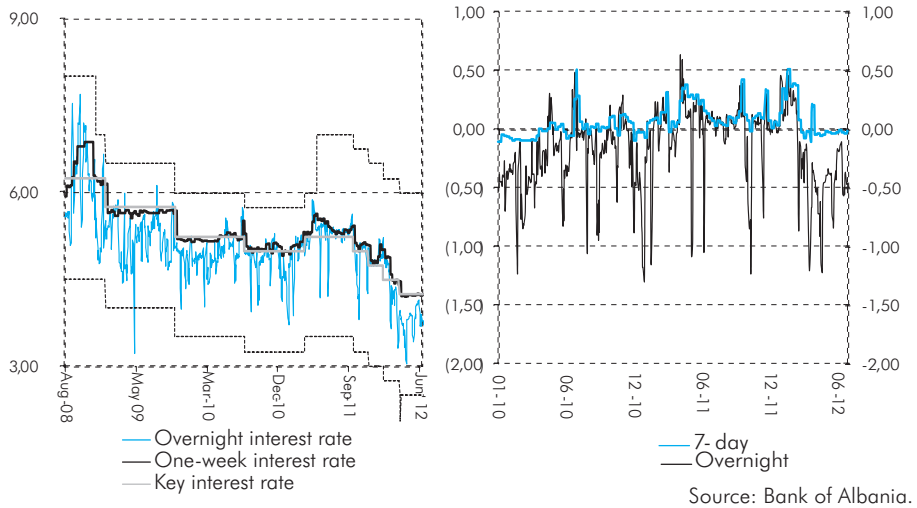
On average, overnight interbank rate dropped to 3.78% in the second quarter from 4.43% in the previous quarter, while 7-day interbank rate stood at 4.22% from 4.62%. Overnight interbank rates mainly decreased in April and May. Overall, they were less volatile[43] than in the previous quarter, while the spread between the overnight interest rate in the money market and the key interest rate increased slightly[44]. The average volume of overnight transactions grew by ALL 0.29 billion to ALL 1.66 billion, while that of 7-day maturity transactions grew by ALL 2.40 billion to ALL 4.35 billion. The trading volume totalled ALL 6.62 billion in the second quarter, reflecting the increase in one-week and overnight borrowing, and the presence of some monthly transactions.

Chart 52 Average monthly transaction volume in the interbank market



Source: Bank of Albania.

Chart 53 Interbank market rates (left) and spread between them and the key interest rate (right)



Source: Bank of Albania.

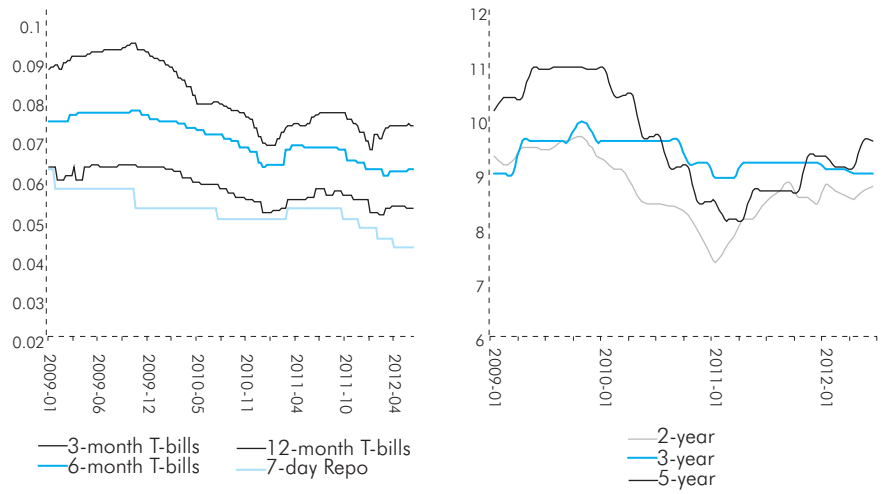
PRIMARY MARKET

The decrease in interbank market rates did not channel into the primary market in the second quarter. Government security yields have remained relatively high since the first quarter of 2012, although the primary market has been liquid. Their performance was impacted by the market repositioning of participant entities and the continued demand for financing through securities in the domestic market. Budget deficit was mainly financed through long-term instruments, reflecting in higher premium on this maturity.

[43] *The standard deviation of the overnight interbank rate was 0.226 in the second quarter of 2012, compared to 0.505 in the first quarter.*

[44] *The spread between the overnight interest rate and the key interest rate was on average 47 basis points in the second quarter, compared to 36 basis points in the first quarter of 2012.*

Chart 54 Primary market yields



Source: Bank of Albania.

After peaking (7.39%) in early June, 12-month yield dropped to 7.36% at end-June, compared to 7.33% at end-March, while 3-month yield dropped to 5.26% from 5.30%. Demand for T-bill financing has been falling in the last two months and the liquidity provided thereupon has been sufficient, hence exerting no added pressures over T-bill yields.

On the other hand, the higher issue of long-term instruments was coupled with higher premium and wider yield spreads between the maturities. The frequency of T-bill issues is low, hence supporting the performance of yields in this segment. 2-year yield stood at 8.75% in June's auction or 0.19 percentage points higher than in March. Along the same line, the ask margin on 5-year bond yield stood at 2.25 percentage points in May, compared to 2.08 percentage points in the previous auction in February. The auctions for the issue of 7-year bonds of fixed (10.85%) and variable rate (margin of 3.45 percentage points) were held in June. The previous auctions for this instrument dated back in 2008.

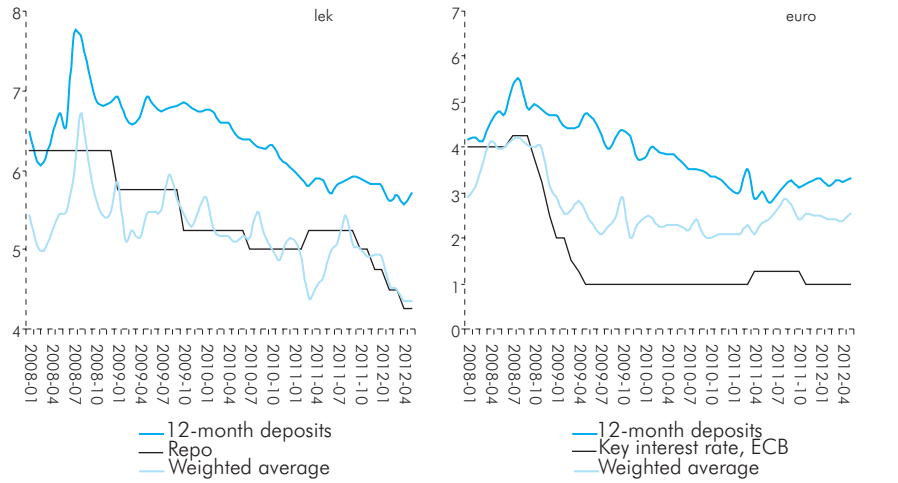
INTEREST RATES ON NEW DEPOSITS AND LOANS

Interest rates on new lek-denominated deposits generally showed a downward tendency in the second quarter of 2012, being in line with the interbank rates. This tendency was somehow slower due to individual banks' policies to keep and gain the deposit market share by attracting customer savings. Interest rates decreased for all maturities. The average interest rate on new lek-denominated deposits dropped to 4.35% during April and May, compared to 4.65% in the first quarter. In addition, lek-denominated time deposits continued to grow at relatively buoyant and stable rates.

Interest rates on new euro-denominated deposits were quite similar to the first quarter of 2012, despite the decrease of euro interest rates in the international markets. In April and May, the weighted average interest rate

on euro-denominated deposits was 2.44%, compared to 2.45% in the first quarter. In May, interest rates on euro-denominated deposits of up to 1 year maturity increased slightly. The difference between lek deposit rate and euro deposit rate has narrowed starting from the second half of 2011; however, this has not been reflected in the shift of deposits.

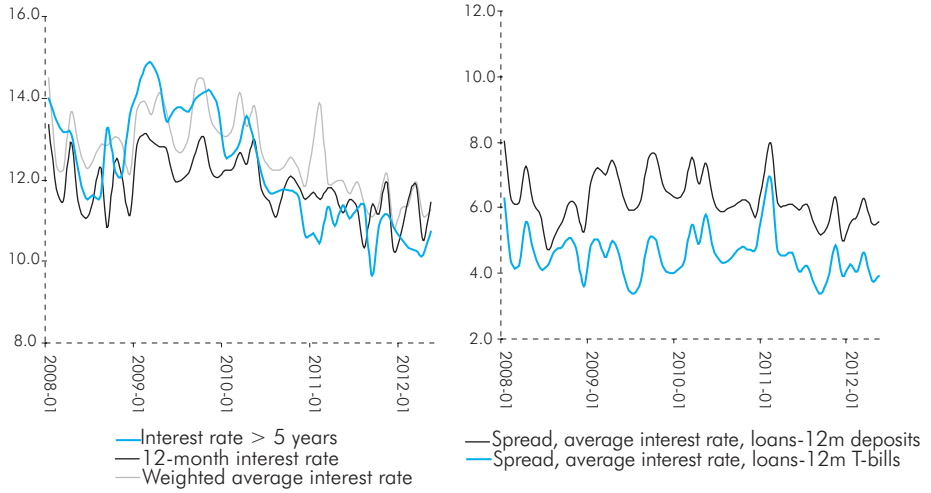
Chart 55 Interest rates on new lek (left) and euro deposits (right)



Source: Bank of Albania.

The sluggish lending activity and the risks associated with lending provided their impact on the price of new loans to the private sector. Against a background of low credit growth rates, the performance of loan rates was dominated by certain offers to individual clients.

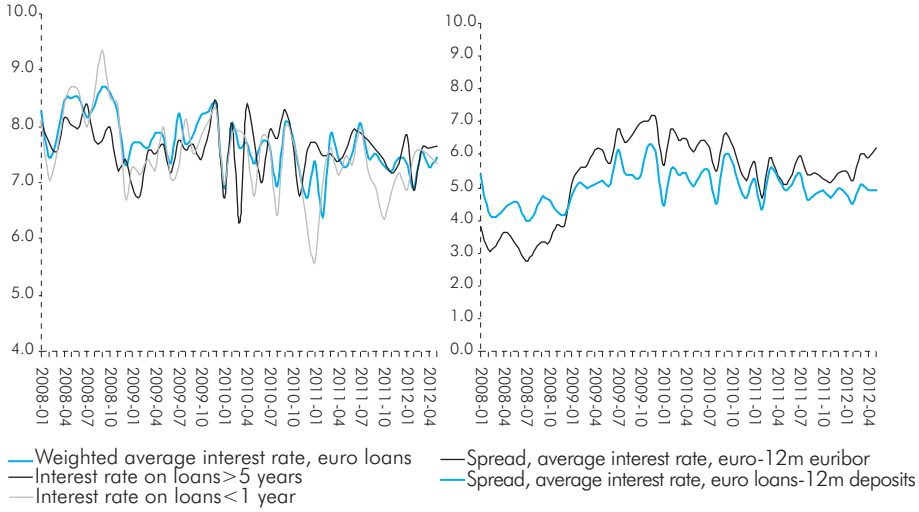
Chart 56 Interest rates on new lek loans



Source: Bank of Albania.

In April and May, interest rates on lek-denominated loans were signalled to have reduced, expressed in the slight decrease of margins compared to the reference rates they are parameterized with. On the other hand, the latter (most commonly the 12-month yield) were relatively high, hence providing no contribution to the further decrease of interest rates on lek-denominated loans. Average lek loan rate dropped to 11.20% in April and May, compared to 11.55% in the first quarter of 2012. Its performance was mostly determined by short-term business loans (of up to 1-year maturity) for working capital purposes. The downward trend of interest rates on long-term lek loans persisted in the period under review.

Chart 57 Interest rates on new euro loans



Source: Bank of Albania.

The interest rate on new euro-denominated loans increased for almost all maturity terms, to an average of 7.37% in April and May from 7.25% in the first quarter of 2012. This move has reflected the maintenance of the intermediation margins in this currency, the enhanced uncertainty, the cautious behaviour of banks related to foreign currency lending and the fall of demand for medium and long-term loans. The difference between lek and euro loan rates narrowed down further in the last two months to an average of 3.83 percentage points, compared to 4.30 percentage points in the first quarter of 2012 and 4.50 percentage points in 2011.

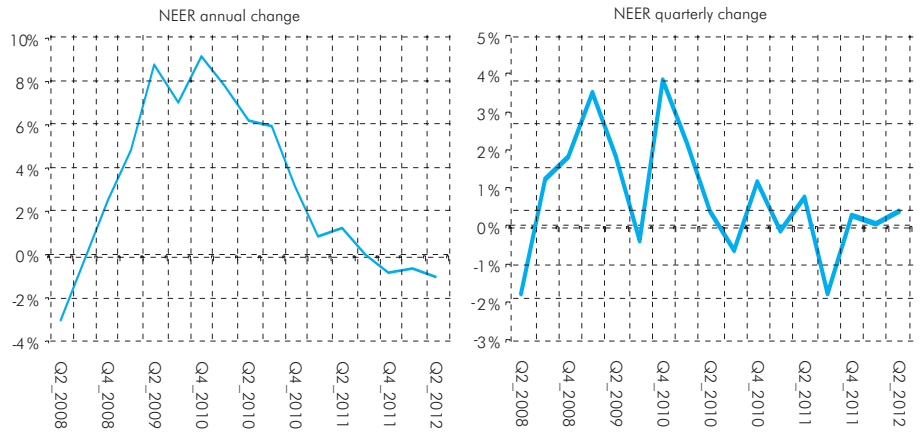
EXCHANGE RATE

The nominal effective exchange rate continued to show a slight appreciation trend in the second quarter of 2012. The performance of the NEER index[45] shows the decrease of exchange rates in annual terms (-1.0%) and their stability in monthly terms (0.4%). The NEER index dynamics has generally reflected lek's appreciation against the euro. Developments in Albania's trade exchanges with abroad have favoured the strengthening of lek's position against the

[45] *NEER – Nominal Effective Exchange Rate, measured against the currencies of Albania's five main trading partners: Italy, Greece, Germany, Turkey and China. An increase in NEER implies lek's depreciation.*

euro. The lower imports in the last two months, coupled with the recovery of exports, seem to have contributed to the mitigation of depreciation pressures, hence keeping the Albanian lek relatively stable over the period under review. In addition, in light of the current crisis developments in the euro area, euro's depreciation against the major currencies in the international markets has strengthened the US dollar and heightened agents' uncertainty about the euro, thereby impacting on the NEER's appreciation.

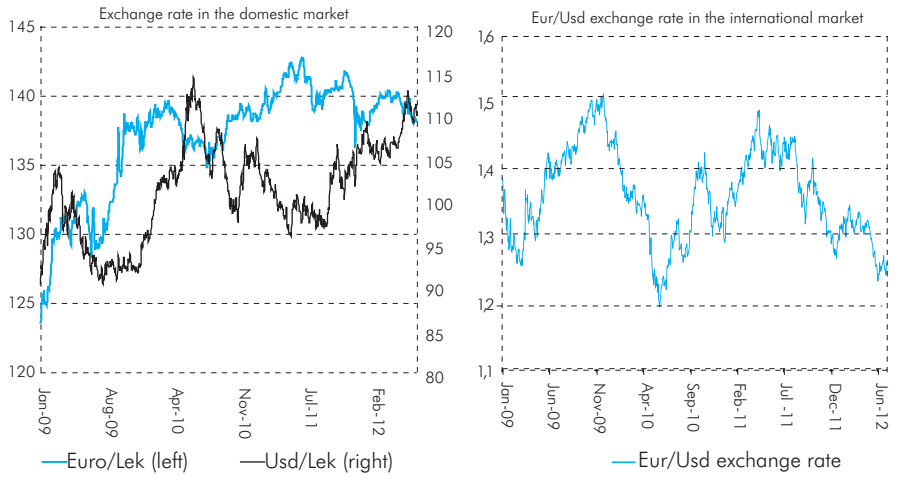
Chart 58 Lek's annual and quarterly changes in nominal effective terms (NEER)



Source: Bank of Albania.

The abovementioned developments are also confirmed by the Exchange Market Pressure Index, which appeared to be stable in the second quarter of 2012, stabilizing around its historical average.

Chart 59 Daily euro/lek, US dollar/lek and euro/US dollar

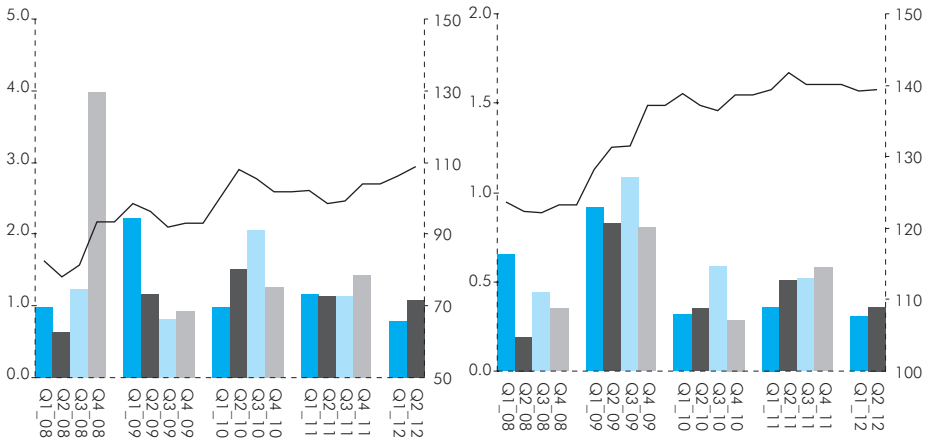


Source: Bank of Albania.

A more detailed analysis of the major currencies in the foreign exchange market during the second quarter of 2012 shows the depreciation of the Albanian lek against the US dollar (10.4%) and its appreciation against the euro (1.72%), compared to the same period in 2011. On the other hand, in quarterly terms, lek was stable both against the US dollar (depreciating by an average of 0.02%) and the euro (0.00%).

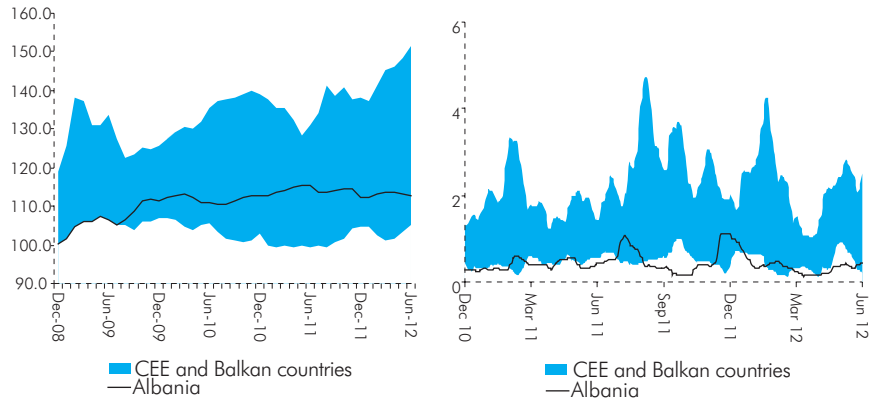
Euro/US dollar exchange rate dynamics in the international market was reflected in the domestic market with the euro/lek exchange rate often pursuing a similar tendency as the euro/US dollar exchange rate. Euro's volatility against the lek in the second quarter of 2012 remained similar to the previous quarter. US dollar's exchange rate against the lek was more volatile and in line with US dollar's performance in the international markets.

Chart 60 US dollar/lek and euro/lek exchange rate volatility in quarterly terms



Source: Bank of Albania.

Chart 61 Euro/lek exchange rate (base month: October 2008) and volatility compared to CEE and Balkan countries' local currencies*



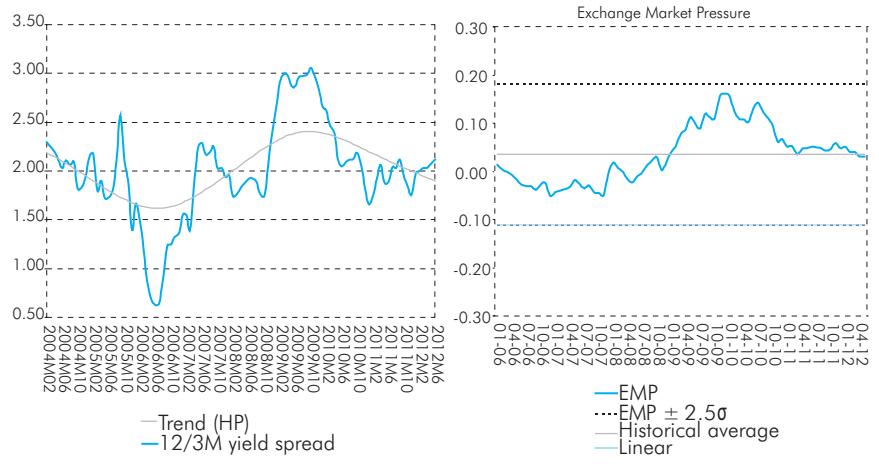
*The volatility of euro/local currency is measured as a 30-day standard deviation. The peak and trough volatility levels in each period represent the maximum and minimum standard deviation of selected exchange rates. The selected countries are Poland, Czech Republic, Hungary, Romania, Turkey and Serbia.
Source: Bank of Albania's estimates.

In a regional context, lek's exchange rate against the euro was considerably more stable than that of CEE and Balkan countries' local currencies. Except for Hungary and Turkey, the local currencies of other CEE and Balkan countries depreciated against the euro during the recent months. Chart 61 shows that lek's volatility stands in the lower limit of the range of values showing the euro/local currency volatility.

V.3 ASSESSMENT OF FINANCIAL-RELATED INFLATIONARY PRESSURES

Monetary assets grew by an average of 7.2% y-o-y[46] in the first half of 2012, which is similar to the previous year. In May, real domestic credit grew by 3.2% y-o-y, hitting one of its lowest historical levels. This deceleration reflected the sluggish private sector demand for investment loans and banks' lower participation in public sector's financing. The balancing of money supply with the moderate money demand transmits signals for contained monetary pressures on consumer prices in the medium run. Almost close to zero money gap[47] corroborates the lack of monetary pressures on inflation.

Chart 63 Financial market pressures



Source: Bank of Albania.

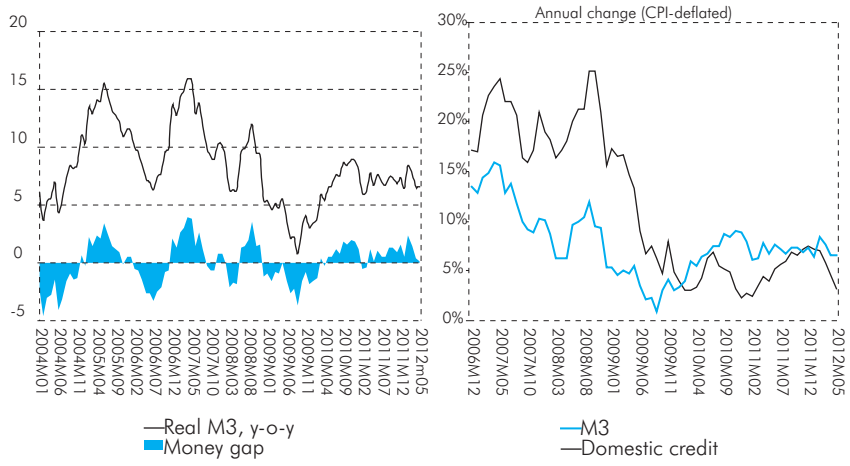
Financial market developments signal a stable performance and in line with the first quarter of 2012. Money and deposit markets show that banks have a good liquidity position, while the interest rate performance has been in line with the monetary policy signals. The further transmission of these signals into the lending channels appears sluggish, owing mainly to the heightened uncertainty about the future and the perceived credit risk. Moreover, the shift of government financing from short to long-term instruments gave rise to a higher difference between 12-month and 3-month yields. In addition, in the

[46] *Considering the CPI volatility.*

[47] *Money gap is measured as the difference between the real M3 aggregate growth and its potential level generated through statistical methods, HP Filter (average of some λ).*

absence of pressures on the Albanian lek and due to the performance of hard currencies in the international markets, the Albanian foreign exchange market was relaxed.

Chart 62 Monetary-related inflationary pressures and real money indicators



Source: Bank of Albania.

Overall, the financial indicators provide evidence for a good liquidity level in the banking system, lack of pressures on market rates and a relaxed foreign exchange market in line with the demand and supply of foreign currency. These indicators do not signal any rising inflationary pressures.

VI. OUTLOOK FOR THE ALBANIAN ECONOMY IN THE SECOND HALF OF 2012

The latest data on the real and financial sector of the economy confirm that despite being generally within the parameters of stability, the Albanian economy is seriously facing the challenge of growth over the current year. Economic growth fell into negative territory in the first quarter of 2012, being, to a large extent, driven by the unfavourable weather conditions or other supply-side shocks. It, however, also signalled the sluggish domestic and foreign demand, driven by the challenging domestic and external environment, which is characterized by heightened uncertainty hampering consumption and investment, and a highly cautious banking system behaviour towards lending to production-related activities in the economy. This environment will continue to accompany and affect the development of the Albanian economy in the medium run. On the other hand, the main stability parameters related to the cost of living, Albania's fiscal and financial sustainability, and the external balances of the economy appear stable and under control.

The Albanian economy is expected to grow at positive rates for the remainder of the year. Based on the highly negative outlook for economic growth in Albania's trading partners, foreign demand is expected to provide modest contribution to economic growth. However, our assessments show that, excluding the effect of global demand, during the recent years, Albanian exports have benefited from the higher competitiveness in terms of quality and cost, and a better geographical distribution. In addition, if we exclude exchanges in electrical energy, Albania's trade deficit – one of the major structural concerns of the Albanian economy – has shown a downward tendency. If the latter persists, re-orienting consumption towards domestic production, while boosting economic growth, reduces the risk premium for the economy and pushes the entry of foreign capital. Domestic demand is expected to continue to be affected by some persistent factors related to the tendency to save and the uncertainty about investments, which are difficult to recover in the short run. However, for the remainder of the year, financial conditions are expected to ease and the monetary policy effects on the real sector are expected to be better transmitted, hence allowing for a more stimulating environment for increasing consumption and investment at home. First, after the structural adjustments related to government debt, financial markets are expected to improve the circulation of liquidity and alleviate the pressures on the primary market rates. Second, the pressures exerted by the foreign regulatory authorities on the banking system are expected to have come to an end following the fulfilment of the regulatory standards on a group level in June 2012. Meeting the group's objective will allow these banks to focus better on lending to the economy and creating more appropriate products for their customers. Third, in compliance with the expenditure plan

and the budget deficit performance, the public sector is expected to provide higher contribution to economic growth in the second half of 2012.

Inflation forecast indicates a 90% probability that it will fluctuate around 1-3.3% over a four-quarter period, driven by the negative output gap, anchoring of inflation expectations and expectations for a relatively low imported inflation. Monetary pressures on inflation are also expected to be weak due to the slow growth of monetary aggregates.

Despite the persistent negative output gap over time, Albania's economic development potential remains high. The Bank of Albania notes that there are positive development perspectives for the Albanian economy. They are based on the labour market productivity and flexibility, human capital enhancement, relatively low utilization of financial leverage in the economy, and the enhanced attractiveness of the Albanian economy as a business and investment destination for foreign capital. These competitive advantages, however, need to be further stimulated. First, the structural reform of the economy should strengthen further. It should rely on a broad political and social consensus towards the vision of the Albanian economy development in the next decade, towards the most effective growth model that fulfils this vision best and towards concrete initiatives that need to be undertaken. These reforms should also take into account the new global and regional market context, as well as the enhanced competitiveness of emerging economies in terms of attracting foreign capital and new market penetration. Second, reliable macroeconomic policies, anchored in clear and consistent rules and based on measurable macroeconomic stability objectives will remain a precondition for a stable and long-term growth. The adequacy of the latter was one of the positive factors that kept Albania's sovereign debt rating unchanged in June 2012.