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

MONETARY POLICY REPORT 2012 Q3

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OBJECTIVE

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

In line with its approved 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 target for inflation aims at anchoring economic agents' expectations and reducing the risk premium.*

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

The Monetary Policy Report for the third quarter of 2012 was approved by the Supervisory Council of the Bank of Albania on 31 October 2012. The economic analysis in this Report is based on the latest available statistical data as at 18 October 2012.

I. FOREWORD BY THE GOVERNOR

As a consequence of a difficult economic situation in the world and particularly in the euro area, the Albanian economy faced a challenging global environment over the first three quarters of 2012. Domestically and externally generated supply shocks determined the economic growth profile and continued to test Albania's macroeconomic and financial foundations. During that period, the Albanian economy experienced slow foreign demand growth, increased risk premia in financial markets and tendencies of some financial market agents to reduce their exposure to the Albanian economy. Those developments were also reflected in low levels of consumption and investments. Together with the decreased fiscal stimulus in 2012, they resulted in a weak aggregate demand and low economic growth over the first three quarters of the year.

Despite the negative impact on economic growth rate, Albania's financial and macroeconomic stability was preserved. In the face of demand volatility and supply concerns, inflation remained low and on track, reflecting, inter alia, the well-anchored expectations around the 3% target. Sustainable fiscal balances, improved external position, sound real and financial sector balance sheets in the economy further enhanced Albania's economic and financial stability over that period.

Consumer Price Index (CPI) annual inflation rate increased gradually along the year, settling at 2.7% in the third quarter. Third-quarter annual inflation rate was mostly formed by a higher contribution from unprocessed food and non-food consumer prices. On the other hand, prices of other basket items were steady or slightly volatile. The economic and monetary analysis confirms the presence of weak demand-driven inflationary pressures. Due to real sector developments, the price rise for the domestically produced output was on track. These tendencies were reflected in a downtrend of core inflation and low non-tradable inflation of the CPI basket. Developments in consumer prices continued to reflect low pressures from other cost elements. In particular, low import prices against relative exchange rate stability transmitted low pressures from imported inflation.

Following the economic contraction of the first quarter, the Albanian economy grew at an annualised rate of 2.0% in the second. Agriculture, industry and some branches of the services sector have generated the economic growth, while construction sector's contribution has fallen sharply.

In terms of aggregate demand, foreign demand has broadly supported the second quarter economic growth, while domestic demand has remained sluggish. Consumer spending, though higher than in the first quarter, has not returned to past-year growth rates. The perceived uncertainty, sluggish labour market and slowed available income continue to affect the performance of this domestic demand component. Private investments also remain low due to a low final demand for their products, available spare capacities and relatively tight credit standards.

In particular, during the first half of 2012, the low level of private investments has reflected households' low demand for housing.

Public spending and fiscal stimulus were also weak, reflecting the consolidating fiscal policy and observing the fiscal restrictions required by law. Fiscal consolidation, based mostly on spending cuts, is illustrated through a downward budget deficit trend over this period. Budget deficit resulted about ALL 25.7 billion during the first three quarters of the year, down by about 19%, y-o-y. As at September, the realised expenditures were down by 0.2%, while budget revenues were up by 2.3% on a year earlier.

The data on external sector developments reveal that Albania's external position has improved significantly. The value of exports increased 6.7%, y-o-y, in the first eight months, reflecting the moderate foreign demand and the global market prices. Over that period, imports contracted 0.9%, y-o-y. These developments have led to an annualised contraction of the trade deficit by 5.4% as at August, hence influencing positively the aggregate demand growth. Also, the sharply decreased current account deficit over the second quarter is a positive signal for the long-term stability of this indicator and assists in stabilizing the demand for and supply of foreign currency in the domestic market.

Monetary sector developments confirm low inflationary pressures in the economy. The growth of monetary assets slowed over the third quarter, reflecting the reduced domestic demand for money. The public sector's prudential stance has led to slowing demand for monetary assets, particularly from the banking sector. On the other hand, the sluggish economic activity and available spare capacities appear to have restricted the private agents' demand for monetary assets. Private sector credit increased by 5%, y-o-y, in August, following the slowing trajectory having started since the second half of 2011. Performance over the recent months shows that banks are more active in lek intermediation and less in foreign currency one. This highlight is due to banks' willingness to invest funds in lek and economic agents' raised awareness of foreign currency credit risk.

About lending-related concerns, we would emphasise that the weak credit performance owes mostly to economic agents' low demand for monetary assets. Also, the bank credit supply appears somewhat tight. The banking system remains prudent in selecting the funding projects due to diminished loan portfolio quality and uncertainties about the outlook for the future. Banks have maintained tight credit standards, appearing rather selective in assessing business plans and meeting the loan demand. Overall, the Bank of Albania assesses that creating a positive climate would help revive lending and meet the loan demand. The Albanian banking system remains well-capitalised, liquid and capable of meeting the economy's needs for credit. However, within the parameters of financial prudence, it should be forward-looking in its decision-making and more flexible about funding the Albanian business.

Financial market yields trended down in the third quarter, associated with low liquidity pressures and reflecting the Bank of Albania's easing monetary policy. An increase in the interbank market activity suggests a more efficient deployment of this market, a good premise for the development of the overall monetary market in Albania. During that period, the easing monetary policy signals for lower government security yields were better transmitted. This transmission was supported by completion of structural movements in the banking system and reduced government demand for funding. Deposit interest rates continued to fall, but as already reflected by the high deposit growth over that quarter, they did not restrain the growth of savings at the banking system. The mitigation of financial costs was not fully transmitted to private sector credit during July-August. In particular, additional costs sought by banks to extend the new credit are still constrained, in response to their perceived uncertainty and response mechanism to reduce credit risk.

Against the backdrop of slow current and expected economic developments, aggregate demand and inflation, the monetary policy deepened its stimulating nature in the third quarter. As at end-July, the key interest rate was lowered by 0.25 percentage points, down to its historical low of 4.0%. That was the fifth consecutive key interest rate cut since September 2011. Parallel to that, the Bank of Albania continued to supply the banking system with the requested liquidity through its variable liquidity-providing operations.

The outlook for inflationary pressures suggests that they remain low. Our analyses and projections conclude that the economic activity will remain below potential, exerting downward pressures on inflation. At the same time, the supply pressures appear contained. Based on current performance of inflation-determining factors and their outlook, inflation as at 12 months ahead is expected to fluctuate around 1.2% – 3.4%, with a 90% probability. The expected inflation and economic outlook imply the maintaining of a stimulating monetary policy for the period ahead. The Bank of Albania remains heedful to future developments and new information, and stands ready to intervene timely and duly to meet its legal mission.

II. EXTERNAL ECONOMY

The global economic recovery has been delayed. After a promising start in 2012 Q1, the economic growth rates waned in the next months. In 2012 Q2, the growth slowed in many advanced economies and moderated in developing and emerging economies. Survey results and preliminary indicators show that the fragile economic growth will continue in the third quarter, to strengthen slightly in the fourth one. International financial markets continued to reflect instability, though political decisions and mechanisms adopted recently by main organisations have reduced the uncertainties. Global inflation rates have fallen over the past months, mainly due to decline in primary commodity prices.

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

Following the recovery in the first quarter, the global economic growth slowed in the second. Contraction in the domestic consumption is the main factor affecting economic developments in many countries. Revival of financial market tensions has heightened the uncertainties surrounding the medium-term outlook and affected significantly the global aggregate demand. The sluggish labour market and the need to consolidate the public and private sector balance sheets have lowered the expectations for a quick recovery. Emerging economies have displayed a better economic performance, though the above concerns have been reflected in weaker growth in many of those countries. Inflationary pressures have eased in many economies, reflecting the downward contribution of primary commodity prices over 2012 H1 and the weakening demand pressures.

Global outlook is surrounded by many uncertainties. Preliminary indicators and economic agents' forecasts support the idea that this poor performance will continue in 2012 H2, particularly in the euro area.

Table 1 Selected macroeconomic indicators

	GDP change		Unemployment rate	Inflation rate	
Countries	2012 Q2/ 2012 Q1	2012 Q2/ 2011 Q2	August 2012	September 2012 August 2012	September 2012/ September 2011
United States	0.4	2.2	7.8	0.6	2.0
Euro area	-0.2	-0.4	11.4	0.7	2.6
Germany	0.3	1.0	5.5	0.0	2.1
France	0.0	0.3	10.6	-0.3	2.2
United Kingdom	-0.7	-0.8	7.9[1]	0.4	2.2
Japan	0.3	3.6	4.1	-0.3[2]	-0.4[2]

Source: ECB, Fed, Eurostat and respective statistical institutes.
[1] June-August 2012.
[2] August 2012.

EURO AREA ECONOMY

The euro area economy contracted in 2012 Q2. Negative growth rates were registered q-o-q (-0.2%) and y-o-y (-0.5%). Data published recently by Eurostat show that the euro area economy continues to suffer from a weakening domestic demand, sluggish labour market, modest business credit growth and fragile financial markets. The positive contribution of net exports did not mitigate the negative impact of the above items. Unemployment rate also increased in August (11.4%), attesting to the ongoing difficult labour market conditions in this region. Third-quarter inflation[1] fell slightly to 2.5%. The dynamics of long-term inflation trend depicts contained inflationary pressures.

Indirect and preliminary data[2] for July and August provide clear signals about third-quarter economic performance, though ECB's experts show that the current trajectory will persist for the remainder of the year. Expectations for positive growth have shifted to year 2013.

UNITED STATES ECONOMY

In 2012 Q2, the US economy continued to slow, growing at an annualised rate of 2.2%. Growth in Q2 has been affected largely by expanded consumer spending and less by increased exports and private investments. On the other hand, government spending and import growth have negatively affected the growth. In September, the unemployment rate dropped to 7.8%, reaching the lowest level in the last four years. Annual inflation edged up slightly, settling at 2.0% in September.

Indirect and preliminary data give unclear signals for the next period; the business confidence index continues to display low values, whereas the housing market and consumer confidence index give positive signals. These

[1] In this case, the simple average of annual inflation for the three months of the quarter is calculated.
[2] Such indicators as retail sales, industrial output, matriculation of vehicles and fixed investments (other than construction).

data suggest that the growth continued to slow even in 2012 Q3. The Federal Reserve (Fed) has launched a third round of quantitative easing (QE3), which allows the Fed to buy $40 billion per month of mortgage-backed securities, with no maximum amount or time limit.

BRIC ECONOMIES

BRIC economies, which grew rapidly over the previous periods, slowed in 2012 Q2.

Brazil's economy has expanded by only 0.5% y-o-y, broadly reflecting the significantly decreased exports in consequence of a low global demand for Brazilian output. Also, other components of aggregate demand slowed their growth rates over that quarter. The Brazilian government has carried out a stimulating package, which is expected to provide positive outcomes over the next quarters.

In Russia, the economic activity remained within a positive but lower than expected range. In 2012 Q2, the Russian economy grew by 4.1%, y-o-y, thanks to increase in investments and industrial output. Construction sector contracted. After 19 years of negotiations, Russia joined the World Trade Organisation. This event is expected to promote foreign direct investments (FDIs) and competitiveness, and improve domestic demand. Concerns about a rising inflation made the Central Bank of Russia raise its key interest rate by 0.25 percentage points in July.

The economic activity of India continued to slow its annual growth rate to 4.2% in 2012 Q2. Unfavourable weather conditions caused difficulties in the agriculture sector, which is the main source of income in rural areas. On the other hand, capital investments suffered from low crediting. High inflation rates prevented the central bank from easing the monetary policy.

China's economy experienced economic slowing for the seventh consecutive quarter. The annualised economic growth was about 7.4% in Q3. The difficult economic situation in the United States and in the euro area - China's main trading partners - has restrained its exports. Domestic demand has also performed poorly. Despite the public authorities' efforts to maintain high economic growth[3], the main financial institutions have revised down their earlier economic growth outlook for 2012 and 2013.

[3] *Since November 2011, the Central Bank of China has lowered banks' required reserve three times, while the government has adopted a number of stimulating packages, including major infrastructural projects.*

Table 2 Selected macroeconomic indicators for BRIC economies

Countries	Annual GDP change		Annual inflation	
	2012 Q1	2012 Q2	2012 Q3	September 2012
Brazil	0.7	0.5	5.2	5.3
Russia	4.6	4.1	3.8[1]	5.9[3]
India	5.3	4.2	10.1[1]	10.3[3]
China	7.6[1]	7.4[2]	1.9	1.9

Source: OECD, respective statistical institutes.
[1] The data for 2012 Q2.
[2] The data for 2012 Q3.
[3] The data for August 2012.

ECONOMIES IN THE REGION

Turkey's annual growth slowed to 2.9% in 2012 Q2. Though the industrial output was upward, investments, consumer spending and construction have deteriorated significantly. Italy's economy continued its recession, contracting by 2.6%, y-o-y. Net exports have positively influenced, while consumer spending and construction sector have continued their negative performance. Third-quarter indirect data depict that the economic activity will continue to contract but at more moderate rates than in the previous quarters. Greek economy continued its economic recession in 2012 Q2, down by 6.5%, y-o-y. The reduced government spending and conditions of aid packages led to decline in consumer spending, public and private investments. At aggregate level, investments fell by 19% y-o-y, adversely affected by the uncertainty about the future. Macedonia's economy continued to contract, down by an annualised rate of 0.9% in 2012 Q2. Industrial output and construction sector dropped, eclipsing the increase in consumer spending.

Table 3 Economic indicators for countries in the region

Countries	GDP change	Annual inflation	Unemployment rate
	2012 Q2/2011 Q2	September 2012	August 2012
Italy	-2.6	3.6	10.7
Greece	-6.5	1.6	24.4[2]
Macedonia	-0.9	5.3	31.2[1]
Serbia	-0.8	10.3	26.1[1]
Croatia	-2.2	5.0	17.7[3]
Turkey	2.9	8.3	10.4
Kosovo	4.5[(2011)]	4.1	:
Albania	2.0	2.6	13.3[1]

Source: Respective statistical institutes, IMF, EcoFin, Eurostat.
[1]2012 Q2; [2]June 2012; [3]August 2012;
: Unavailable data.

II.2 PRIMARY COMMODITY PRICES

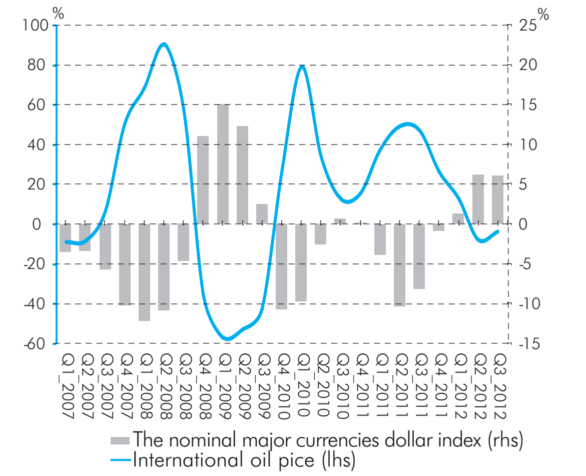
International oil price continued to fall in the third quarter, though at a smaller amplitude than in the second. *Brent* - the European index - depicts that a barrel of oil was traded at USD 109.6 on average, down by 3.3%, y-o-y[4]. Compared to the previous quarter, oil price rose 1.1%, broadly reflecting the performance of the global oil supply. The economic and financial sanctions on Iran, the North Sea production problems and severe weather conditions in the Gulf of Mexico, especially during July to August, are the main factors affecting the oil price performance over the quarter.

Based on *Ice Brent Crude Index (FUT)*, this product quotations depict a slightly downtrend of the price expected for the coming months. This expectation reflects analysts' assessments of a weakened global oil demand and an increased supply from Saudi Arabia in the coming months.

Primary commodity prices continued the downtrend having started since 2011 H2. Commodity Price Index slowed the annual decline to 4.6% in Q3, from 8.7% in Q2. Fuel Price Index performed similarly, down by 1.2% on average. In quarterly terms, Commodity Price Index and Fuel Price Index appeared relatively unchanged.

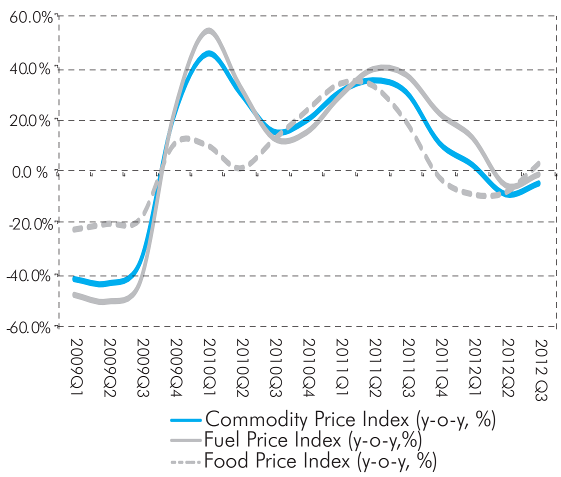
The severe drought over this year and the use of crops to derive methanol, particularly in the United States, affected the growth of the Food Price Index by 2.9% y-o-y. Compared to Q2, the same index has expanded 7.7%, transmitting the sharp increase in this index over July[5]. Over the next months, the Food Price Index did not reflect any significant volatility, assimilating the contraction in the supply for these products in July's prices. Concerns about global growth, re-dimensioning of the global demand and concerns about indebtedness in several euro area economies affected the performance of international commodity prices.

Chart 1 Annual change in international oil price and the nominal major currencies dollar index



Source: Fed, EIA.

Chart 2 Price indices by primary commodity and their annual change



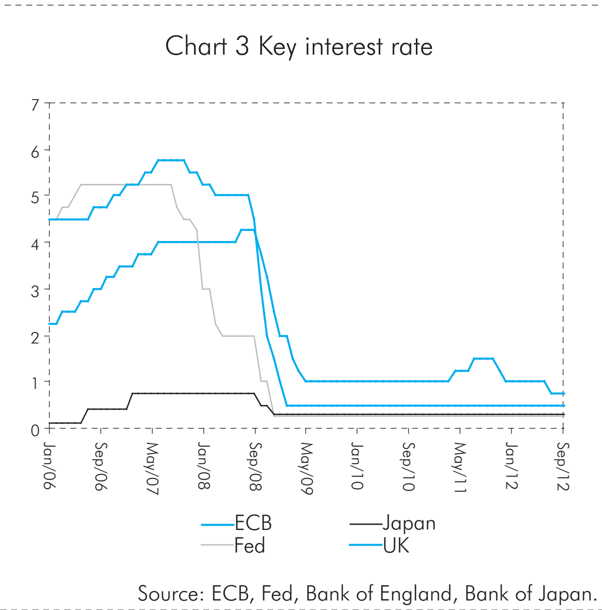
Source: IMF.

II.3 INTEREST RATE DECISIONS AND FINANCIAL MARKETS

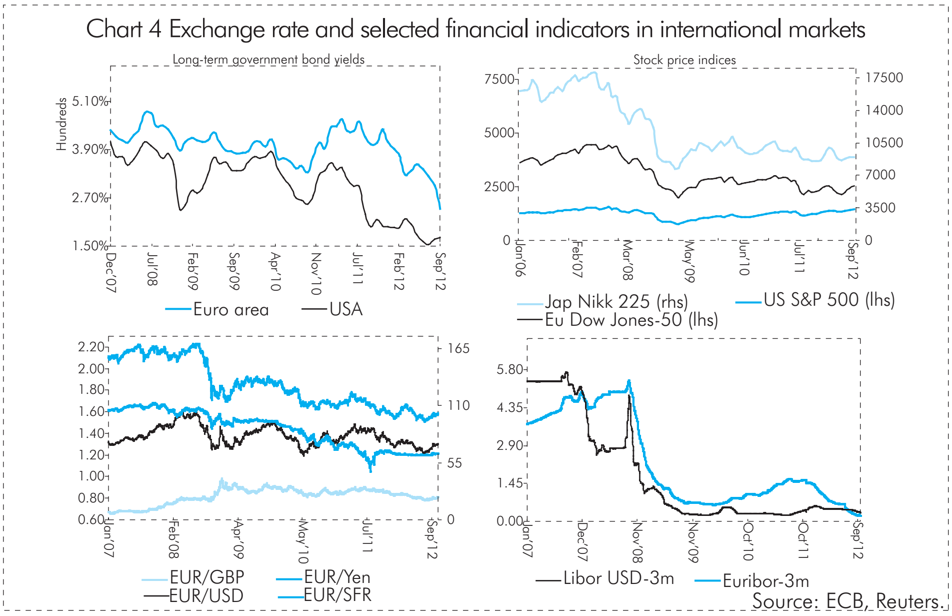
The European Central Bank decided to lower the key interest rate at start-July by 25 basis points, to 0.75%. The other central banks maintained their key interest rates unchanged: Federal Reserve at 0-0.25%, Bank of England at 0.5% and Bank of Japan at 0-0.1%.

[4] *In Q2, the oil price dropped by 7.6% on a year earlier.*

[5] *The Food Price Index surged in July, up by 9.4% on a monthly basis as a consequence of the severe drought and reduced crops, particularly in the United States.*



During Q3, financial market yields trended down, though specific segments and issuers reflected difficulties and upward risk premia. The euro area debt crisis remains one of the main concerns of market agents and investors. On the other hand, decisions taken by the ECB and other main financial institutions, and the establishment of several automatic mechanisms to reduce risk and maintain the euro's soundness have provided their fruits, leading to lower sovereign debt yields for many euro area countries. With the key interest rate close to zero, the major central banks have focused their action on 'non-conventional' monetary policy instruments, renewing or extending their maturity terms. The effect of such operations has led to further yield cut over this period. In the euro area money markets, the ask yields continued to drop, reflecting the key interest rate cut at the beginning of July and the ample liquidity provided by the ECB over that period. In major stock markets of the United States, indicators have generally performed positively and the overall trend has been upward. Financial agents' behaviour has been substantially influenced by the European Central Bank's policy actions to resolve the debt crisis. Higher-than-expected outturns for a considerable number of business categories supported the upward stock trend over that period.



Euribor rates of one, three, six, and twelve-month maturity continued to fall. In September, they marked 0.12%, 0.25%, 0.48% and 0.74%, respectively, down by 0.37 percentage points on average[6], from June. The three-month

[6] *The decline was respectively 0.16, 0.41, 0.45 and 0.48 percentage points.*

Libor rate for the US dollar fell slightly to 0.35% over that period. In foreign exchange markets, during Q3, the euro appreciated slightly against the main currencies (the US dollar, Yuan, Japanese yen, Swiss franc), though in quarterly terms, it has lost ground. In September, one euro was exchanged for 1.2856 US dollars, up by 3.7% from August, though in annual terms it is down by 6.6%.

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

The annual inflation rate averaged 2.7% in 2012 Q3, slightly higher than in the previous two quarters and close to Bank of Albania's forecasts. Food price behaviour determined this development. Estimates show that the seasonal factor for agricultural commodity prices reflected a varied deviation from the historical one. Overall, inflation volatility was driven by short-term supply factors in Q3 and by certain developments in house prices over the last month. Demand inflationary pressures remained weak despite the easing monetary policy.

Baseline scenarios of inflation and GDP projections over the monetary policy-relevant horizon suggest the presence of subdued inflationary pressures, against the backdrop of a continued negative output gap and a non-rising trend of inflation expectations and external pressures of the economy.

III.1 CONSUMER PRICES, TARGET MEETING AND MONETARY POLICY

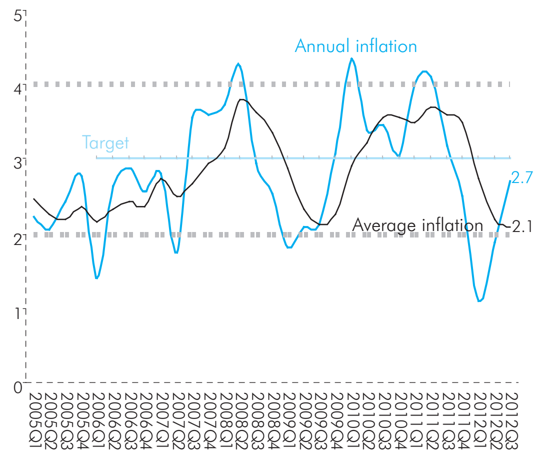
Annual inflation averaged 2.7% in 2012 Q3, attesting to projections for an upward trend over that period. Annual inflation rate averaged 2.1%[7] over the past four quarters, being comparable to that of Q2 and 1.5 percentage points lower than in the same period a year earlier.

The quarterly CPI change reached -0.7%, as much as half of the decline registered a year earlier. Monthly developments over the quarter under review reflected a dampening effect of the seasonal decline in unprocessed food prices. This phenomenon was inherited from certain inflation rates as at end-2011 and start-2012. A characteristic of this quarter is the negative inflation of the leasing sub-item in September of this year, a factor pulling down this month's headline inflation by 0.2 percentage points. If the rental price index had remained similar to that of August, the third-quarter inflation would have been close to 2.8%. Leasing remains a separate signal from the historical performance of this series. During the same quarter, the statistical effect of the high comparison base of processed food prices cancelled out, cleansing the pace of relevant price rise from this non-economic factor.

[7] *An indicator that smoothes considerably the short-term volatility of the series, providing an assessment of the trend along the year.*

The downtrend of core inflation and the relative stability of net non-tradable inflation along the first three quarters of the year reflect the developments of the real sector of the economy against the backdrop of a weak demand. The performance of current inflation rate, continuation of below-historical capacity utilization rate and availability of low labour and producer costs in the economy have all anchored market agents' inflationary expectations in the medium term. Improvement in the external sector indicators in the first eight months of the year, along with the one-year exchange rate stability, have led to waning external price pressures.

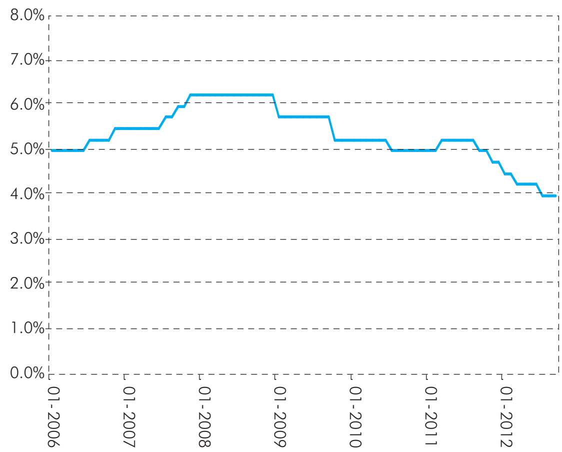
Chart 5 Annual inflation (in %)



Source: INSTAT and Bank of Albania.

The actual performance of Albania's economic activity and the analysis of the balance of inflationary risks support the estimates and projections for below-potential economic growth in the medium term. The meeting of the public debt sustainability targets has conditioned the consolidating stance of the fiscal policy and its low contribution to economic growth. Private investments and consumption have maintained low levels due to uncertainties about future developments in Albania and abroad. On the other hand, the difficult international situation is expected to affect the foreign demand, hence diminishing its contribution to Albania's growth. At the same time, these developments are translated into a controlled balance of inflationary pressures, determining a slow increase in future consumer prices. Taking these factors into account, the Bank of Albania continued to preserve the stimulating monetary policy in Q3. As at end-July, the Bank of Albania lowered the key interest rate by 0.25 percentage points to its historical low of 4.00%. It is the fifth key interest rate lowering since September 2011. The latest decision aims to create appropriate monetary conditions to meet the medium-term inflation target. Also, in the absence of a fiscal stimulus, the easing monetary policy provides the necessary support for boosting aggregate demand.

Chart 6 Key interest rate (in %)

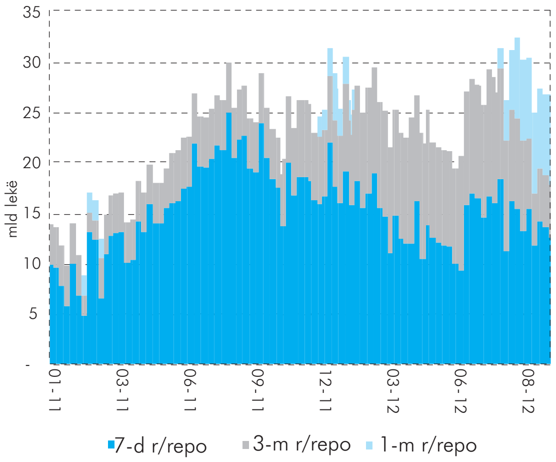


Source: Bank of Albania.

In order to boost demand and meet the inflation target, the Bank of Albania continued to provide the banking system with the necessary liquidity, hence minimising the volatility of inter-bank rates and orienting them toward the key interest rate.

The easing monetary policy is assessed to have been more fully transmitted to the interbank and primary markets during July-September 2012. The

Chart 7 Bank of Albania's liquidity-providing operations in the open market



Source: Bank of Albania.

accumulated effects of this decision are expected to be more clearly transmitted to the banks' intermediation activity, supporting the economic activity and consumption in the medium term.

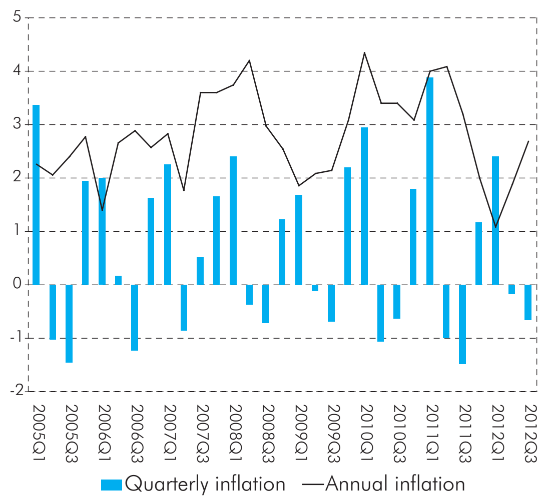
Due to a medium-term outlook for balanced risks to price stability, the monetary conditions are expected to contribute to narrowing the negative output gap that has been created since end-2009. The balance of risks to inflation and economic growth remain subject to uncertainties surrounding the financial markets and primary commodity prices in the region and beyond.

III.2 INFLATION BY SECTOR

Average annual inflation of 2.7%[8] in Q3 was mostly accounted for by increased contribution (67%) of 'Unprocessed foods' and 'Non-food consumer goods'. Other items accounting for a significant share in the inflation rate, such as 'Administered prices' and 'Processed foods', did not change their contribution to headline inflation over the quarter.

'Unprocessed foods' inflation increased persistently[9] over the past five months, reflecting a different performance from late 2011 and early 2012. Over the quarter under review, this item's annual inflation rate (7.1%), increased by almost 10 percentage points compared to December 2011- March 2012 period average. The seasonal effect of 'Unprocessed foods' item - which shifted the inflation curve down by some percentage points, particularly in 2012 Q1 - provided no contribution during summer. The swings of the seasonal constituent of this item's inflation put additional inflationary pressures on the supply side. That behaviour was materialised into an additional contribution by 1.2 percentage points from the main fruit and vegetables sub-items (accounting for 45%) to headline inflation.

Chart 8 Annual and quarterly inflation (in %)



Source: INSTAT and Bank of Albania.

Non-food consumer goods continued to make a higher contribution (0.5 percentage points) compared to historical average. Despite the partially waning effect of fuel price rise due to circulation tax applied in September 2012, this item accounted for

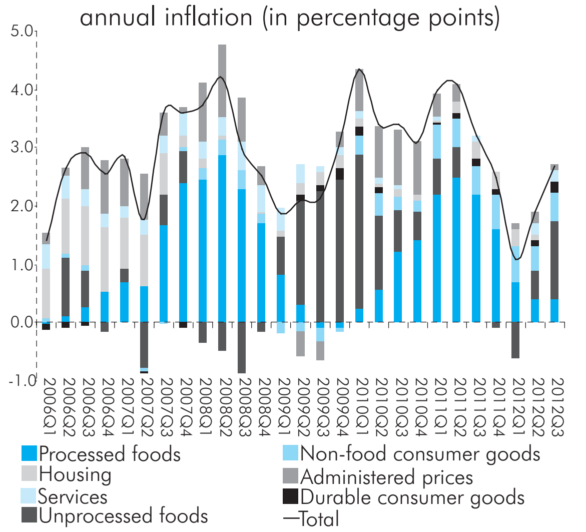
[8] *A year earlier, the average annual inflation rate was 3.2%*

[9] *This item's inflation increased from 0.2 % in April to 7.2 % and 7.0% in August and September 2012.*

a considerable part of headline inflation. Together with the high prices of fuels in international markets, the national currency's depreciation against the US dollar strengthened the increase in related prices during August and September.

Processed food prices resulted almost similar to those in the previous quarter due to this item's stable prices internationally and the exchange rate stability. A year earlier, this item's annual inflation was 8.8%, dropping to 1.6% over the quarter under review. As a consequence, its contribution to headline inflation dropped to 0.4 percentage point over the quarter. In September, prices picked up and this item's contribution to inflation increased due to higher prices for tobacco, and oils and fats sub-item.

Chart 9 Contribution of main inflation items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania calculations.

The annual change in the index of administered price goods and services over the quarter under review reached a low level due to the waning effect of the price rise for several related goods and services.

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

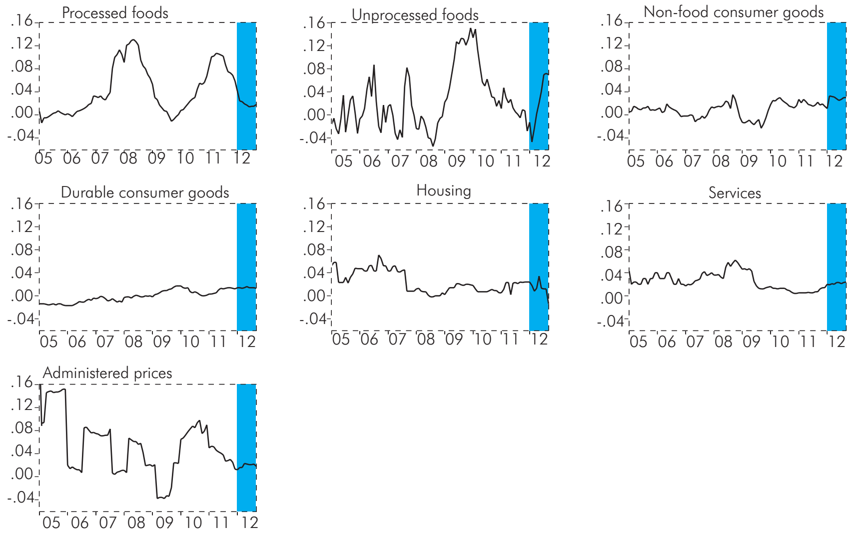
	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3
1. Processed foods (pp)	1.1	1.4	2.2	2.5	2.2	1.6	0.7	0.4	0.4
Bread and grains (pp)	0.1	0.4	0.7	1.0	0.8	0.5	0.2	0.0	0.0
Alcohol and tobacco (pp)	0.2	0.2	0.5	0.4	0.4	0.4	0.1	0.1	0.1
2. Unprocessed foods (pp)	0.9	0.5	0.6	0.5	0.0	-0.1	-0.6	0.5	1.3
Fruit	0.3	0.1	0.2	0.4	0.2	0.3	0.3	0.3	0.5
Vegetables	0.1	-0.7	0.1	-0.4	-0.6	-0.7	-1.2	-0.1	0.7
3. Services (pp)	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.2	0.2
4. Administered prices (pp)	1.0	0.9	0.4	0.3	0.1	0.0	0.1	0.1	0.1
Fuels and energy (pp)	0.4	0.4	0.2	0.3	0.2	0.1	0.0	0.0	0.0
5. Housing (pp)	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.2	0.0
6. Non-food consumer goods	0.3	0.2	0.6	0.5	0.4	0.6	0.6	0.4	0.5
7. Durable consumer goods (pp)	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.1	0.2
Consumer Price Index (y-o-y, %)	3.4	3.1	4.0	4.1	3.2	2.5	1.1	1.9	2.7

Source: INSTAT and Bank of Albania.

The other items continue to maintain low contribution to headline inflation. However, the leasing sub-item, which accounts for a significant share in the CPI basket (10.7%), highlighted a new development in September 2012. The monthly and annual decline by 2.3% and 1.5%, respectively, over this month affected the volatility and reduction of the headline inflation. This has made the 'Housing' item contribute to reducing the headline inflation rate by 0.2 percentage points. The behaviour of inflation and the contribution of leasing sub-item constitute a below-historical average of the series following 2003.

III.3 MAIN INFLATION TRENDS

Chart 10 Annual inflation by item of goods and services (in %)

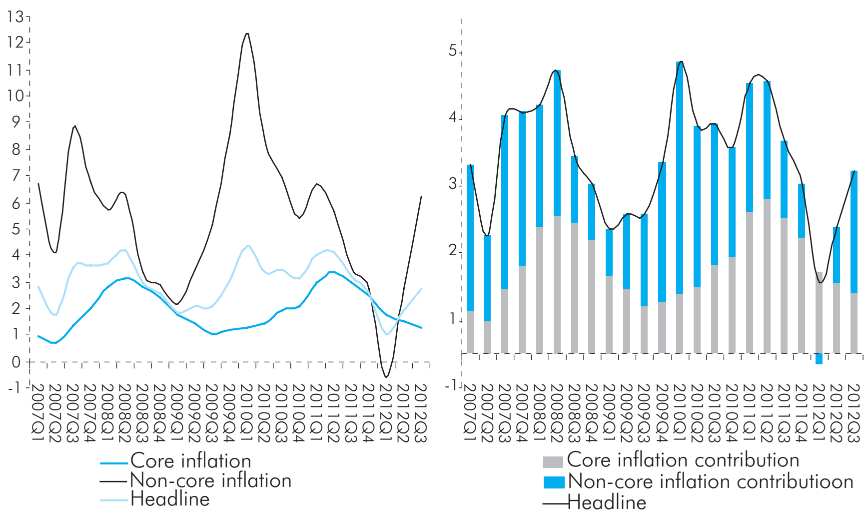


Source: INSTAT and Bank of Albania.

Annual core inflation[10] continued to trend down in 2012 Q3, reaching a low historical rate of 1.3%. Confirming the behaviour having started since Q2, core inflation fell gradually during the quarter under review, against the average increase in headline inflation. This profile was determined by the increase in non-core inflation in Q3 due to the upward dynamics of the seasonal agricultural output prices. In 2012 Q3, the core and non-core inflation rates accounted for 34% and 66%, respectively, of the annual headline inflation.

In 2012 Q3, developments in the tradable sector of the CPI basket continued to determine the performance of inflation. During the period under review, this sector's annual inflation resulted 3.2%, from 1.7% in Q2. Its rate has broadly reflected the intensity of external inflationary pressures and

Chart 11 Annual core and non-core inflation rates (left); respective contribution (right)



Source: INSTAT and Bank of Albania.

[10] The simple average of both measurements, permanent exclusion and trimmed mean. In 2012 Q3, they were 1.1% and 1.5%, respectively.

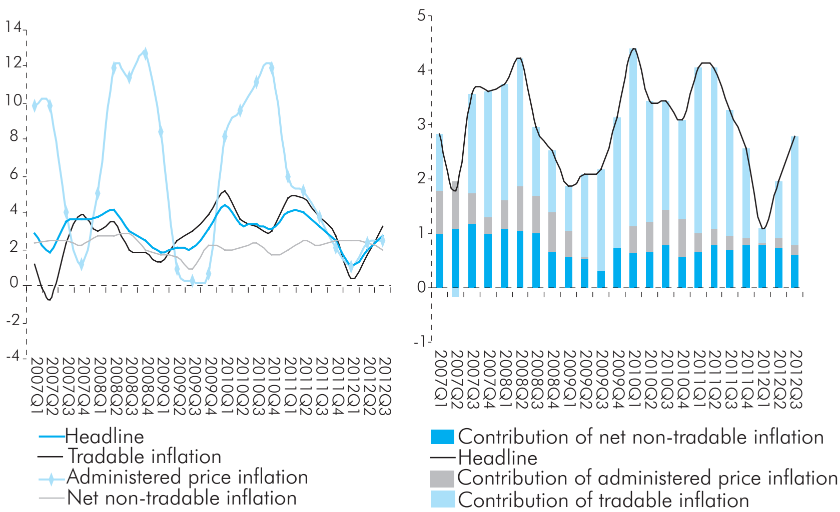
the exchange rate developments, particularly against the US dollar. These factors slightly increased this sector's inflation in Q3 due to the low share of fuels in the CPI basket and the non-dominant share of the US dollar in foreign trade. On the other hand, the lek's appreciation against the euro has eased the inflation volatility in most sub-basket constituents, on which the tradable inflation is calculated. The tradable inflation was stable during Q3, contributing by 72% (1.9 percentage points) to the formation of headline inflation, being comparable to the previous year's figure but significantly higher than the previous quarter's.

Over the same quarter, annual net non-tradable inflation[11], mainly of services of the CPI basket, resulted 1.9%, being lower than the previous quarters' figure and also below its historical average (2.2%). This reduction was driven by its low rate in September (1.3%) due to decline in rental prices[12]. The annual contribution of net non-tradable inflation to headline inflation was 22% (0.6 percentage points) in Q3. Developments in the main administered prices, whose impact on domestic inflation stood at historical lows, have determined the rest of the inflation rate.

Above developments show that added inflationary pressures on the economy are determined by short-term domestic and foreign supply shocks, while permanent and domestic pressures have decreased.

Box 1 Prices in Albania against prices in the European Union

Chart 12 Annual inflation by sectors (left); respective contribution (right)



Source: INSTAT and Bank of Albania.

Since mid-2000s, the Eurostat (Institute of European Statistics) has published the results of a price level survey for each member state and candidate country against the EU-

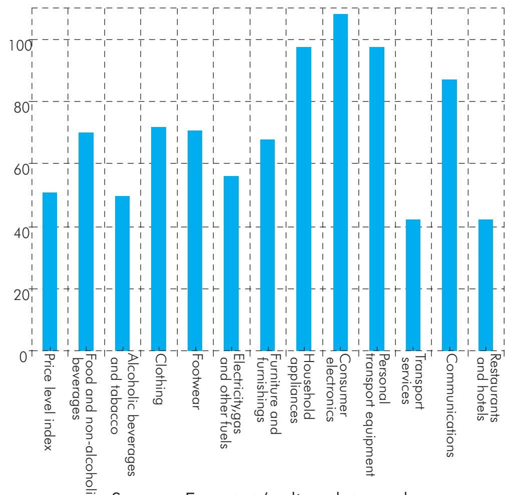
[11] *This inflation is adjusted for the effect of administered prices (bills of water, electricity and hospitalisation services).*

[12] *This sub-item accounts for a significant share in the CPI basket (10.7%) and even more in the sub-basket of the net non-tradable inflation (32.9%). If the September's rental index had remained similar to that of the previous month, the net non-tradable inflation would have marked 2.1% for this month and 2.2% for the third quarter of 2012.*

27 countries adhering to the European Union. In June 2012, the latest results[13] were published on price volatility of the CPI goods and services for 2011. The survey results suggest that Albania's price level accounts for about 50% of the price level for the EU-27 countries. Among the most important groups of the price level index, that of "Food and non-alcoholic beverages" in Albania accounts for about 70% of the EU average, while those of fuels, electricity, transport services, alcoholic beverages and tobacco are slightly above the 50% price average. The lowest price level is found in services (restaurants and hotels) accounting for almost 40% of the average, whereas prices of consumer electronics, household appliances, purchase of personal transport vehicles are higher, being equal to or higher than the average prices in EU member countries.

The survey results over the past four years also show that the general price level has not undergone any significant changes against the European average[14]. This phenomenon is explained by the fact that the most important basket item: 'Food and non-alcoholic beverages'[15] has also marginally fluctuated around the European average[16]. Decline is marked particularly in 'Clothing' item (from 90% in 2008 to 72% in 2011), 'Alcoholic beverages and tobacco' (from 57% to 50%), 'Consumer electronics' (from 122% to 108%), 'Transport services' (from 55% to 42%) and 'Communication' (from 94% to 87%). Increase is marked in 'Household appliances' (from 88% to 98%) and 'Fuels and energy' (from 55% to 56%).

Chart 13 Price level index for several groups of the CPI against the EU-27 average =100 (in %)



Source: Eurostat (online data code:prc_ppp_ind).

In general, the latest survey ranks Albania the last but one in less expensive countries in the euro area. In more details, compared to countries of the region and of the East Europe, the price level in Albania for both main basket groups - 'Food and non-alcoholic beverages' and 'Fuels and energy'[17] is higher than in some of these countries. For the first group, Albania's price level - accounting for 70% of the EU average - exceeds that of Macedonia, Bulgaria, Romania and Poland. For the second group, Albania's 55% price level is higher than in Montenegro, Romania, Serbia and equal to that of Bulgaria. The same phenomenon[18] is highlighted in the groups of 'Household appliances and consumer electronics' and 'Purchase of transport vehicles', where the price level is the highest in all the

13 http://epp.eurostat.ec.europa.eu/

14 The price level fluctuates within the 50-53% range of the average price level for EU member countries. However, this level fell from 53% in 2008 to 51% in 2011.

15 This group accounts for about 39% of total goods and services composing the inflation basket.

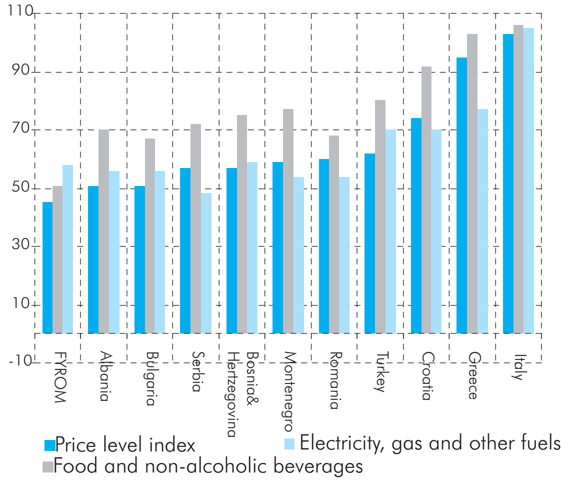
16 Over the past four years, it has fluctuated around 70%.

17 These two groups account for about 50% of the CPI basket.

18 The comparison of these commodity groups may be extended to all the surveyed countries (37 altogether).

surveyed countries (37)[19]. Well below the EU average are the prices of 'Transport services' and 'Restaurants and hotels', which are the lowest on average in all the countries adhering or intending accession to the European Union[20].

Chart 14 Overall price level and the price level of two groups of the CPI against the EU-27=100 average in some countries of the region (in %)



Source: Eurostat (online data code: prc_ppp_ind).

19 Respectively, 98% and 108% for the group 'Household appliances and consumer electronics' and 98% for 'Purchase of transport vehicles'.

20 The prices in both groups - 'Transport services' and 'Restaurants and hotels' are about 58% below the average EU prices.

IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

Macroeconomic developments in 2012 H1 reflected on the one hand the macroeconomic stability and improved risk premia and on the other, the low economic activity, weak aggregate demand and weak inflationary pressures from the real and monetary sectors. Following the first-quarter contraction, the Albanian economy turned to positive economic growth, with a 2.0% annual GDP growth. The improved aggregate demand was primarily sustained by foreign demand, while domestic consumption and investments remained low. Despite the improvement, the economic growth remains low and insufficient to fully utilize the productive capacity of the economy. The domestic economic conditions have determined the weak increase in prices of the production factors in Albania.

Contained inflationary pressures were passed on by the external economy, affected by the national currency's stability and the low inflationary pressures on partner countries. Consumer price inflation rate settled within the Bank of Albania's target band, in the presence of anchored inflationary expectations.

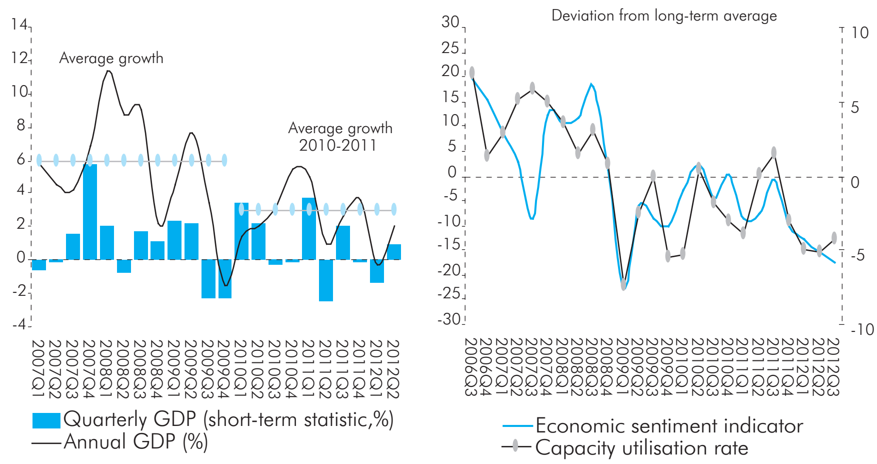
Forecasts and assessments of the medium-term outlook depict positive economic growth of the Albanian economy. However, the economic activity will remain below potential, conditioning low inflationary pressures along the monetary policy horizon.

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The economic activity and aggregate demand improved in Q2, following the contraction in Q1. Upon the waning effect of temporary factors on the output of some sectors, GDP grew at an annualised rate of 2.04% in Q2. The value added was generated mainly by the services sector, while the production sector contributed negatively, albeit lesser than in Q1.

On the demand side, positive net exports accounted for the largest share in the economic growth for the quarter. Alongside the increased exports of goods and services, the narrowing of net export deficit was mostly driven by the annual decline in imports, reflecting the sluggish domestic demand. Private investments and consumption maintained low levels due to the heightened uncertainty, relatively tight financing conditions and less room for fiscal stimulus.

Chart 15 GDP (annual and quarterly change, left); economic sentiment indicator, capacity utilisation rate (right)



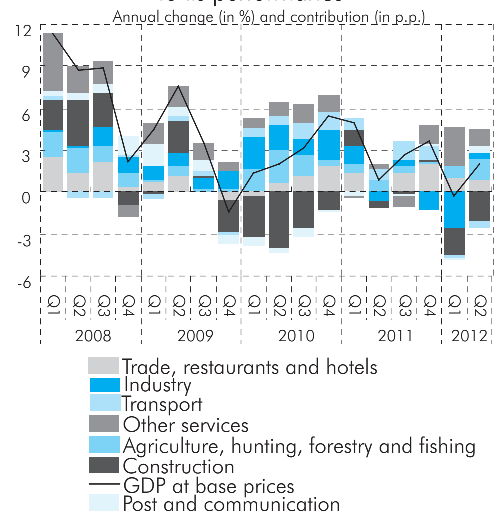
Source: INSTAT and Bank of Albania.

Preliminary estimates on the remainder of the year suggest persistence of low economic growth, against the backdrop of a highly uncertain environment. Exports will continue to sustain the economic growth, but their expansion is expected to be lower, reflecting the difficult economic environment in our trading partners. On the other hand, domestic demand is expected to maintain low levels due to the tendency to save and the reluctance to invest. Monetary conditions are eased and the complete materialisation of monetary policy effects will create a more stimulating environment for consumption and private investments.

IV.4.1.1 SECTORAL OUTPUT

In Q2, GDP expanded by 2% in annual terms and 0.9% in quarterly terms. Agriculture and other services[21] were key drivers to third-quarter economic growth, contributing by 1.4 and 1.3 percentage points, respectively. Overall, the production sector affected negatively the GDP growth (by 0.1 percentage point), while the services sector expanded it by 2.1 percentage points. Low confidence indices on overall economy suggest that the domestic activity will continue to grow at a low rate in Q3.

Chart 16 GDP and sectoral contributions to its performance

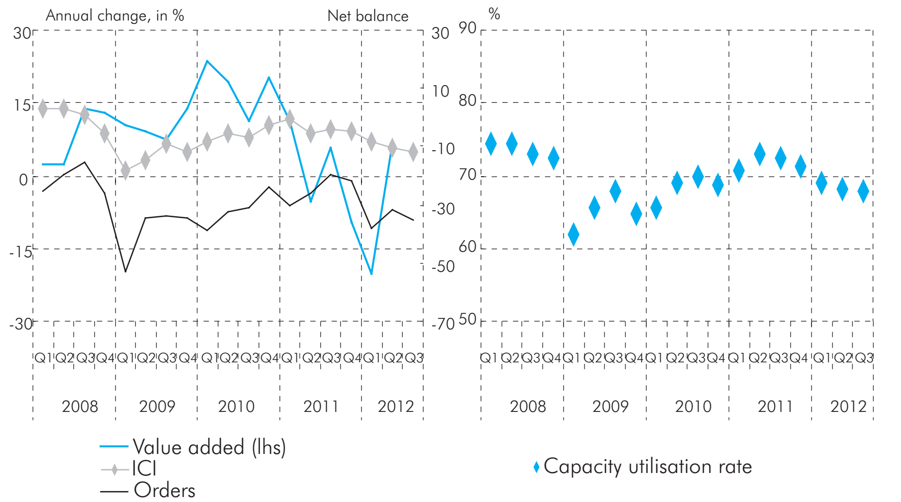


Source: INSTAT and Bank of Albania calculations.

[21] '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.

In 2012 Q2, the industrial sector interrupted the decline posted in the previous two quarters, mainly due to expansion in main industrial exports. The industry value added increased by 6.4% y-o-y, being slightly higher than the historical average (5.9%). This positive tendency was broadly influenced by extractive industry, which contributed by 4.67 percentage points to expanding the industrial output. 'Processing industry' and 'Electricity, gas and water' have made positive low contributions, by 0.96 and 0.81 percentage points, respectively.

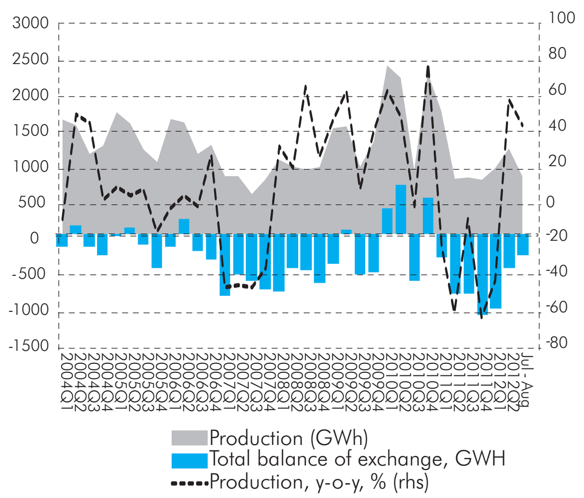
Chart 17 Industrial sector. Value added, confidence indices, orders index and capacity utilization rate



Source: INSTAT and Bank of Albania.

Extractive industry value added was about 32.5% higher than in Q2, compared to a year earlier. 'Extraction of energy products' continued to make the highest contribution to expanding the value added from the extractive industry. The processing industry contraction that started in Q1 did not continue in Q2, reflecting the higher positive impact from activities of metal processing metallurgy. However, the annual growth of the processing industry's value added by 1.3% remains low, broadly reflecting the deepening of the decline in the textile and leather industry. Also, after the contraction over five consecutive quarters, the value added of 'Electricity, gas and water' increased by 7.5% y-o-y in Q2. In line with the improved electricity balance in Q2, its domestic production increased in July-August, by 41% on a year earlier. The improved production over these months has been reflected in increased exports, though the exchange balance remains negative.

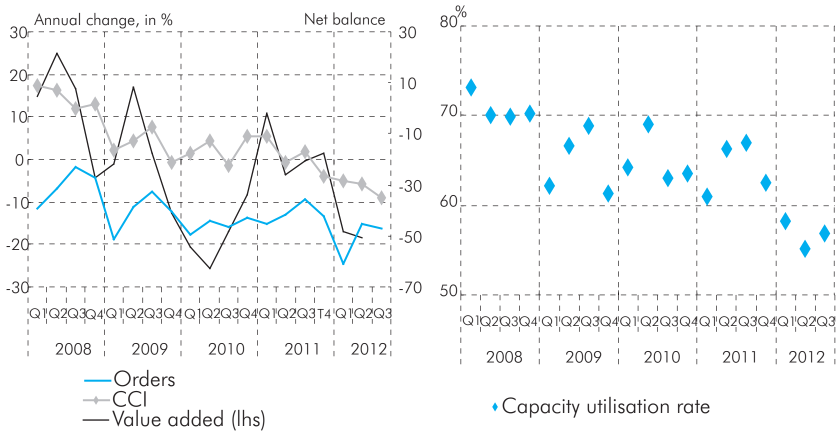
Chart 18 Main energy balance indicators



Source: Albanian Power Corporation and experts' calculations.

Alongside the positive developments in electric energy sector, the annual growth rate of industrial exports in July and August support the expansion of the value added from the industrial sector even for Q3. The survey indicators for Q3 provide opposite signals about the industrial sector performance. Though at low rates, the confidence index, orders, demand and capacity utilization rate in businesses operating in this sector fell slightly.

Chart 19 Construction sector. Value added, confidence index, orders index and capacity utilisation rate



Source: INSTAT and Bank of Albania.

Construction sector output continued to fall in Q2, without supporting this quarter's growth. The value added by this sector deepened the annual decline to 18.4%, after the contraction by 17.1% in Q1. In terms of contributions, the contraction in construction reduced the growth by 2.1 percentage points. The decline of the capacity utilization rate to historically lows and the decrease in the demand indicator, as shown by the businesses confidence survey, remain the factors affecting negatively the performance of the construction sector.

The decline in the construction confidence index in Q3 signals the persistence of negative developments, in line with the minimum historical level of construction permits granted[22] over 2012 H1[23]. Though the orders indicator for Q2 and the capacity utilization rate for Q3 appear slightly better, their improvement is regarded as low to positively offset the construction sector output.

[22] *Generally, this indicator precedes developments in the construction sector.*
[23] *Source: Quarterly Statistical Bulletin.*

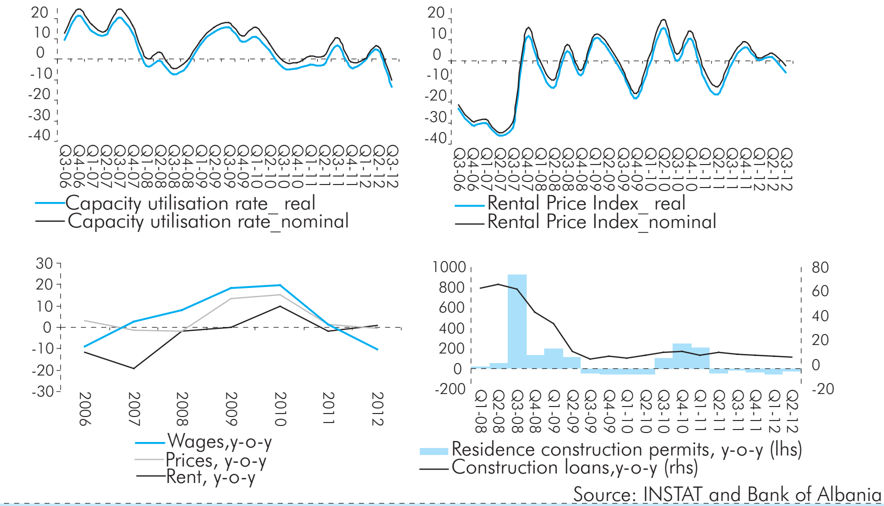
Box 2 House prices in 2012 Q3

House price index[24] fell by a double-digit in 2012 Q3. Its annual nominal change was -10.2% and deflated to consumer price index, the real annual change was -13.2% over this quarter.

Positive growth rates have characterised the Rental Price Index since 2011 Q3. After increasing by 2.3% in the first half of this year, the rental price index fell by 2.2% in the quarter under review. Adjusted for inflation, the rental price index fell by 5.5% in real terms.

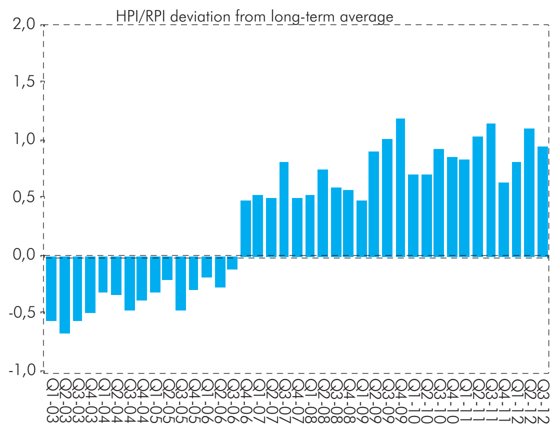
House prices in Q3 were more influenced by demand factors than by supply ones. The slowing house purchase demand is influenced by low consumer confidence on future outlook, lower disposable income, still high unemployment rate and tight credit standards. On the supply side, indirect quantitative and qualitative data obtained from surveys support the assessment for a missing supply of new houses. Also, new credit standards to construction sector continue to tighten.

Chart 20 House Price Index (HPI) and Rental Price Index (RPI), and indirect supply and demand figures



Source: INSTAT and Bank of Albania.

Chart 21 HPI and RPI



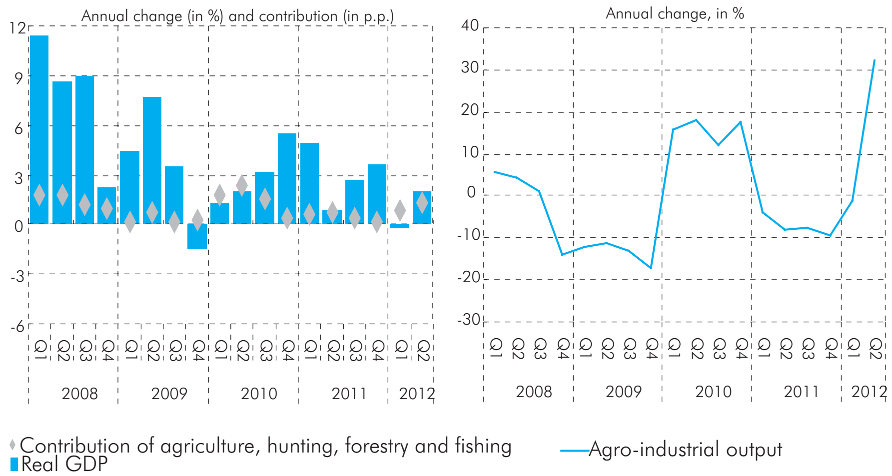
Source: Bank of Albania.

House price performance shows that selling prices remain high compared to rental prices, as revealed by the analysis of the price-to-rent ratio. This ratio slowed down slightly in Q3, albeit remaining above its long-term average. The quarterly dynamics highlights decline in house and rental prices over the quarter. The most pronounced decline in house prices compared to rental prices is reflected in the reduced price-to-rent ratio by 0.16 percentage points compared to the previous quarter.

[24] *The house price and rental price indices are built only for Tirana.*

Agricultural output improved in Q2, compared to the long-term average of annual growth (3.7%) and to first-quarter annual growth (4.5%). The value added from agriculture, hunting, forestry and fishing grew by 5.6% y-o-y. The highly increased agro-industrial output index supports the assessment for a positive performance of agriculture. Based on data from the Ministry of Agriculture, Food and Consumer Protection, the projected agricultural output for 2012 is higher than in 2011.

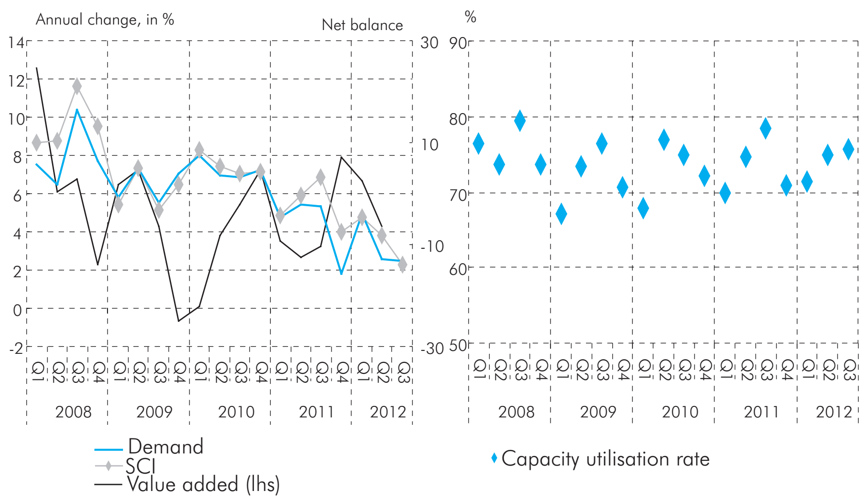
Chart 22 Agriculture, hunting, forestry and fishing sector. Sectoral contribution to annual GDP and the agro-industrial output



Source: INSTAT, MAFCP and Bank of Albania.

The value added from the services sector continued to slow its annual growth rate to 4.3% in Q2, after expanding by 6.6% in Q1. The lower expansion of the value added from the services sector reflected the contraction in the branches of transport, restaurants and hotels, and the slow growth in other services.

Chart 23 Services sector. Value added, confidence index, demand and capacity utilisation rate



Source: INSTAT and Bank of Albania.

The value added from 'Transport' was 7% lower in annual terms in Q2, deepening the decline having started since year-start. Disaggregated data on transport attest to negative developments pertaining to air transport, travel and tourism agencies[25]. Activities of 'Restaurants and hotels' also marked an annual decline of their value added to the economy, by 5.9%, after performing positively over the past two years. The value added by 'Other services' decelerated significantly the annual growth rate, from 11.2% in Q1 to 5.6% in Q2. However, this growth rate fluctuated around the historical average of other services growth, by 5.3%. The performance of this branch was mainly affected by the slow dynamics in real estate, leasing and business-related services.

Trading activities accelerated their annual growth rate to 7.6% in Q2. As a result, their contribution to total services increased to 2.2 percentage points. Referring to sales data and the volume turnover index, the improved trading output has broadly reflected the good performance of retail trade. Post and communication branch posted positive growth, by 9.9% compared to its historical average. Indirect quantitative data of the turnover index show that communication sub-branch expanded at higher paces than the post one, hence determining the performance of post and communication[26].

In Q3, the survey results indicate decline in the services confidence index. However, the almost unchanged level of the demand reported by businesses and the increased capacity utilization rate signal a positive performance of this sector in Q3.

4.1.2 AGGREGATE DEMAND CONSTITUENTS

Available data on aggregate demand show that its improvement in 2012 Q2 was primarily driven by a better performance of exports against a weak domestic demand. The added contribution of net exports is assessed to have offset the low contribution of domestic demand, resulting in the 2.0% economic growth. During the year, economic agents have reinforced their propensity to save and their reluctance to invest, materialising their perception for an uncertain economic environment. Also, fiscal policy remains oriented toward fiscal consolidation in view of the long-term public debt sustainability. On the other hand, monetary conditions are assessed as easing and their full pass-through to economic agents would be translated into an added demand for the economy.

Private consumption growth was weak during 2012 Q2. Based on indirect data, decline in the consumption of daily consumer goods and in hotel and restaurant services[27] is offset by a higher consumption of

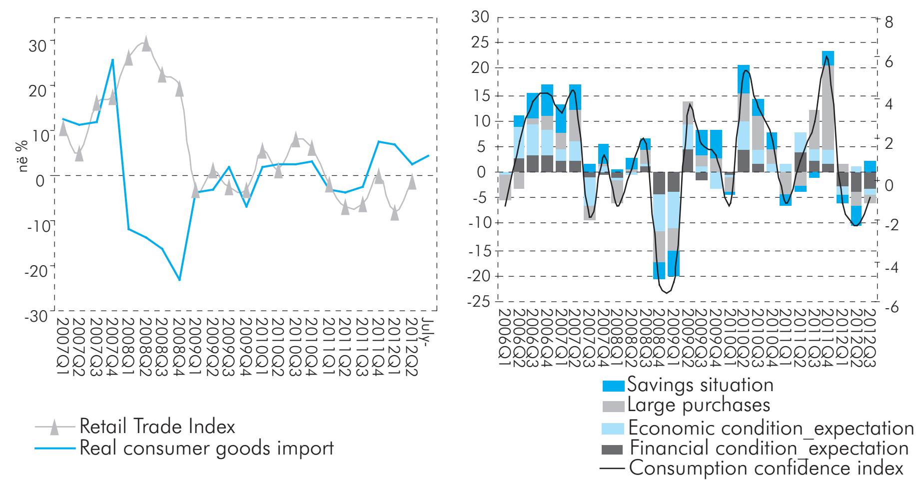
[25] *In 2012 Q2, the volume turnover index continued to contract by 26.7% in the air transport branch and by 14.8% in travel and tourism activities.*

[26] *The turnover index of the post sub-branch increased by 2.7%, y-o-y (compared to the historical average of 13.5%) in 2012 Q2, while the turnover index for communication increased by 9.9%, y-o-y (compared to the annual historical average of 7.4%).*

[27] *The annual decline in the volume index of 'Miscellaneous items, particularly foods, beverages and tobacco', and of 'Miscellaneous items, mainly non-food at unspecialised trading units' in the retail trade index and the value added from 'Restaurants and hotels' to GDP for 2012 Q2.*

other services[28] and durable goods. Overall, retail trade volume index fell by 1.2% y-o-y, in Q2, less than the 8.3% decline in Q1. By main constituent groups, expenditures for household appliances and for purchasing/maintaining vehicles increased in 2012 Q2. The upward trend of consumer spending for vehicles, having started since 2011 Q3, was associated with the increase in their imports; the number of imported vehicles saw a fourfold increase in 2012 Q2, compared to the same quarter a year earlier[29]. Import of consumer goods is another quantitative indicator that proxies the overall household expenditures. In Q2, these goods recorded a real annual growth by 2.7%.

Chart 24 Proxies for private consumption



Source: INSTAT and Bank of Albania.

Consumer demand financing channels improved slightly in Q2, as suggested by the increase, though low, in the available income index. However, this additional income has been channelled toward savings in the form of government securities and deposits. In terms of liabilities, household consumer loans maintained positive growth rates even in Q2, supporting the purchase of durable goods.

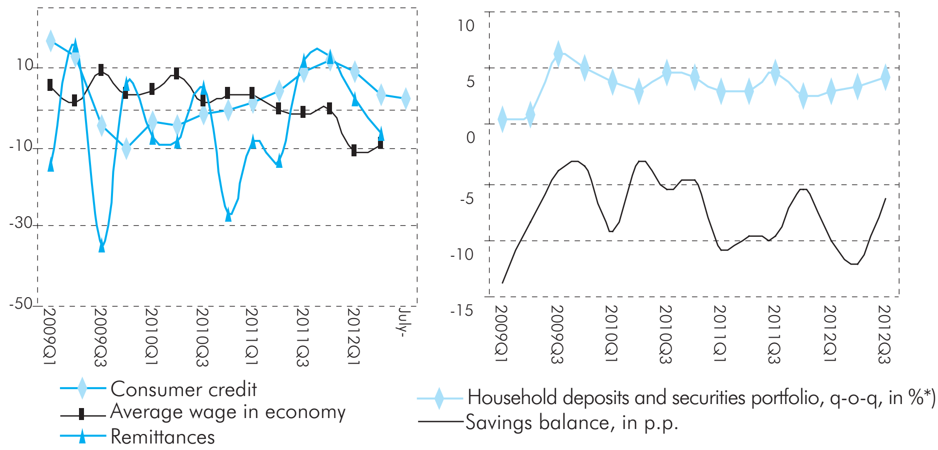
The latest data for Q3 show increased consumer spending. Import of consumer goods increased in real terms by 4.5% in July-August. The improved consumer confidence in Q3 by about 1.3 percentage points appears to have led to higher consumption.

Indirect data do not support the recovery of private investment level in the economy over 2012 Q2. The poor performance of this aggregate demand component reflects the continuing decline in business confidence and the uncertainty about the future demand. Imports of machinery and equipment - an indirect proxy for private investments - marked a 7.5% real decline in Q2.

28 *Real annual growth by 3.9% of the services sector's value added (excluding restaurants and hotels) in 2012 Q2.*

29 *Increase in the number of imported vehicles partly reflects the fiscal measures effect.*

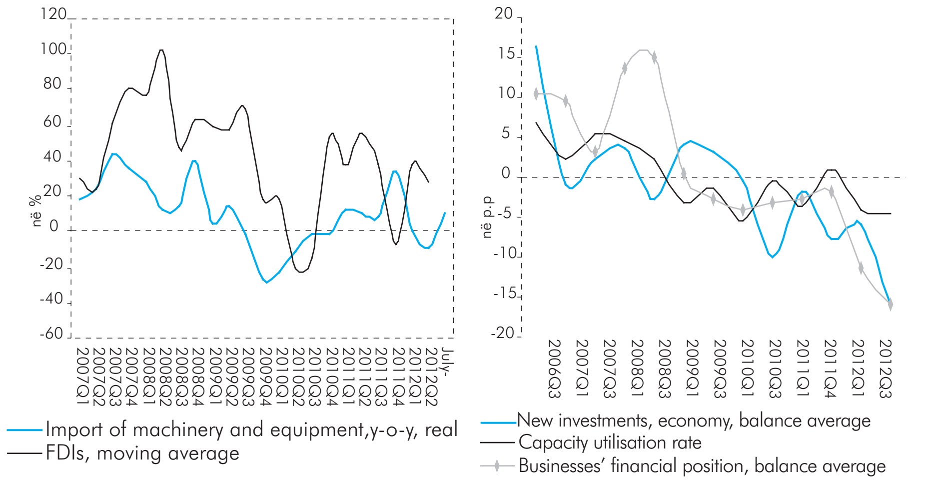
Chart 25 Proxies for private consumption financing



Source: INSTAT and Bank of Albania.
*) The third quarter is proxied only by the data for July and August 2012.

The reduced number of approved construction permits indicates lesser investments in the construction sector. The recovery of investments in this sector is negatively affected by the persistently deteriorated business confidence and by the steady decline in new orders/demand in this sector. Foreign direct investments dropped by 14.2% in Q2, after the annual growth in the previous two quarters. Bank loans financed private investments in Q2, though at slow paces.

Chart 26 Proxies for private investment



Source: INSTAT and Bank of Albania.

The 9.7% real annual growth of import of machinery and equipment for July and August and the 0.8 percentage points increase in the capacity utilization rate in Q3 signal a slight recovery of private investments over this period. On the other hand, qualitative indicators from business surveys show a more pessimistic perception compared to other quantitative indicators. New investments carried out by businesses and their financial soundness indicators continued their downtrend in Q3.

Surveys suggest a negative contribution to aggregate demand from reduced inventories in Q3. The survey conducted during this quarter suggests that the balance of inventories fell by almost 2 percentage points, also influenced by negative expectations of new orders for 2012 Q4.

Box.3 Change in consumer behaviour - an indicator of household financial soundness

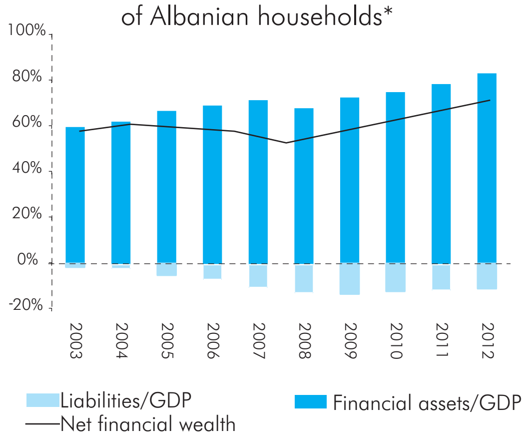
Our periodic analyses have pointed out a downward consumption in recent years, reflecting domestic and external economic developments. The changed consumer behaviour over this period is also reflected in the household financial soundness indicator. The gap between assets and liabilities measures the household financial soundness. In Albania's case, financial assets include households' deposits with the banking system, investments in T-bills and other financial assets held in the form of any currencies outside banks. In other Central and Eastern European countries, because of higher financial market developments, other financial assets such as stock investments, pension funds, joint funds and other securities are also included. Financial assets are an important source of households' income, hence ensuring gains in the form of dividends, pensions and various paid off interest rates. Financial liabilities are basically composed of households' bank loans granted for consumption and for real estate purchase, comparable to countries in the region.

Financial wealth is an important source of economic property of households[30] playing the role of a stabiliser at times of crisis and economic downturns. Due to uncertainties about the economic outlook, as pinpointed by the recent global financial crisis, the customer behaviour is guided by the tendency to save more and spend less. Such a behaviour affects their financial asset to liability ratio, and hence their expanded financial wealth.

The following chart shows that Albania is characterised by a high ratio of households' net financial wealth to GDP. After a downtrend highlighted in 2006, the dynamics of development over time shows an uptrend during the 2008 post-crisis period. Upon spread of the global crisis effects to the country, economic agents paid attention to improving their financial balance sheets. This tendency is explained mainly with the increase in their financial assets, which attests to a changed consumer behaviour, oriented mainly toward savings and being reluctant to spend.

Lesser than the growth of financial assets, the decline in financial liabilities to GDP on the supply side reflects the tight credit conditions in the framework of loan portfolio quality deterioration and prudential behaviour by the banking sector in lending to households during that period. On the other hand, household loan demand remains low due to the labour market developments, heightened uncertainty and pessimistic perception of the future.

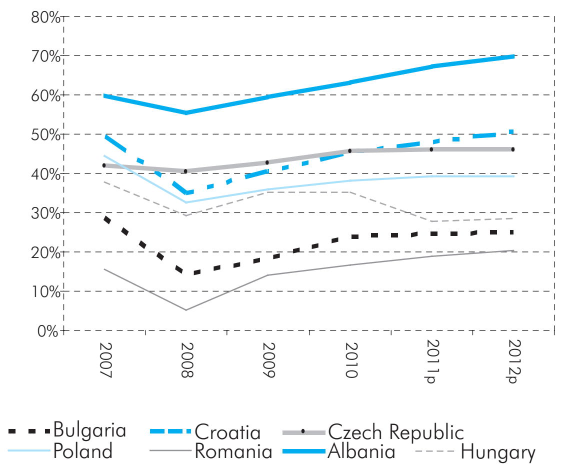
Chart 27 Assets, liabilities and net financial wealth of Albanian households*



*Data for 2012 are forecasts as at end-2012.
Source: Unicredit Group and Bank of Albania.

[30] Economic wealth is a broader concept including the financial property, real estate such as land, residential homes, etc.

Chart 28 Net financial wealth of households in Albania and in the region



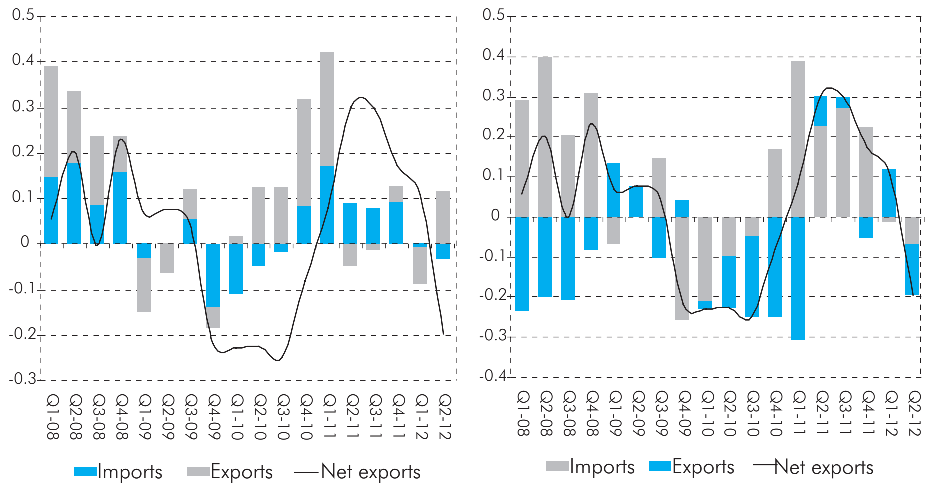
Source: Unicredit Group and Bank of Albania.

However, this phenomenon is not merely an Albanian phenomenon. Based on a report by Unicredit, it is clear that after the initial shock from the 2008 financial crisis, the same trend is noted even in other countries of the region, such as Bulgaria, Romania, Croatia and the Czech Republic. This behaviour is expected, since as in Albania, economic agents tend to regulate their financial balances over the crisis and post-crisis period, being reluctant to spend for consumption and highly inclined to save. The same downtrend is marked in financial liabilities of most countries in the region, confirming low paces of lending to households of these countries as well. The high value of financial wealth compared to countries in the region indicates a low usage of the financial leverage by Albanian households.

IV.1.3 FOREIGN DEMAND AND FOREIGN TRADE

Second-quarter economic growth was formed mainly by the positive contribution of real net exports[31]. Despite the unfavourable foreign environment, the real growth of exports of goods and services was 11.7% in Q2. By contrast, real imports of goods and services contracted 4.8% y-o-y, reflecting the weak domestic demand. Consequently, the net export deficit in nominal and real terms narrowed compared to 2011 Q2, hence contributing

Chart 29 Growth rate of exports, imports and real net exports (in %, left); their contribution to increasing the real net exports (in pp, right)

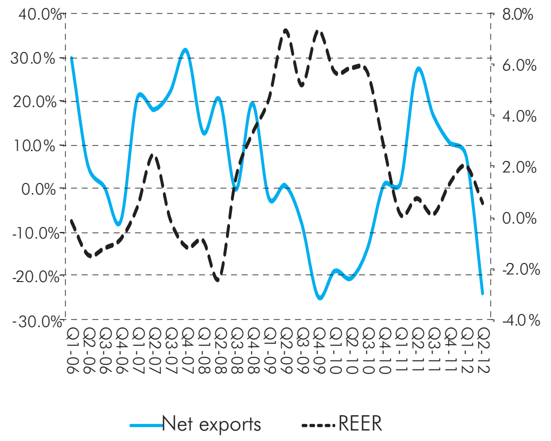


Source: Bank of Albania and INSTAT.

[31] *Unit Value Index published by INSTAT is used to measure the switching from nominal to real terms for goods imports and exports. Consumer Price Index of the services item calculated by the Bank of Albania is used for services imports and exports.*

positively to aggregate demand growth. The real export growth was broadly influenced by goods export growth (24.3%), mainly by the 'Fuels and energy' group. On the other hand, foreign demand for domestic services was low, resulting in decline in real services export (-2.1%). Domestic demand for import goods and services contracted in real terms for both goods (-2.3%) and services (-10.9%).

Chart 30 Annual change in net exports (lhs) and REER index (%; rhs)

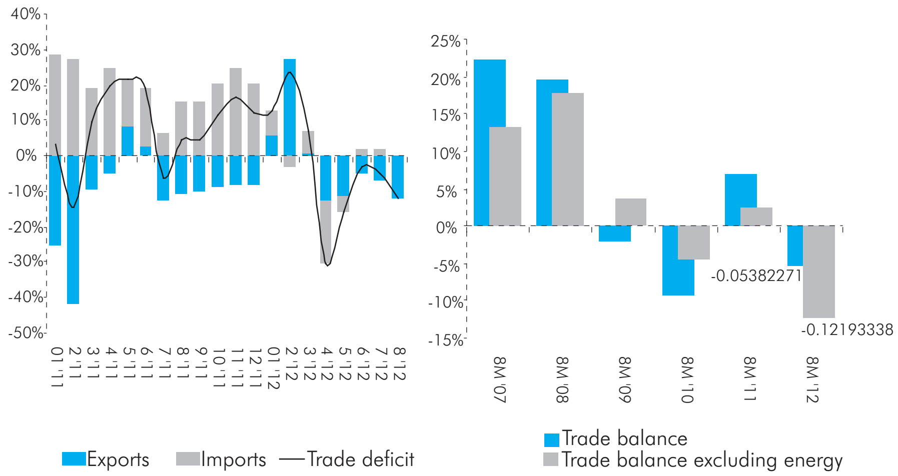


Source: Bank of Albania.

Growth in real net exports in Q2 seems to have also been supported by the lower real depreciation pressures on the national currency, as shown by the real effective exchange rate (REER) performance[32]. The real-term lek's depreciation by 2.0% in Q1 supported the improved balance of real net exports. For Q2, lek depreciated by 0.6% in REER terms.

Partial data on Q3 show an ongoing positive performance of goods export and signs of recovery of the domestic demand for import goods. The value of goods export increased by 19.4% on average in July-August and the value of imports increased slightly by 0.5% on average for the same period. In consequence, the trade deficit narrowed by about 8.9% on a year earlier. The import coverage ratio was 39.5%, about 6.3 percentage points higher than in the same period a year earlier. Albania's trade activity, measured by trade exchanges with the trading partners, grew by 5.2%, y-o-y.

Chart 31 Contribution of imports and exports to annual trade deficit (lhs) and the trade balance (annual change in %, rhs)

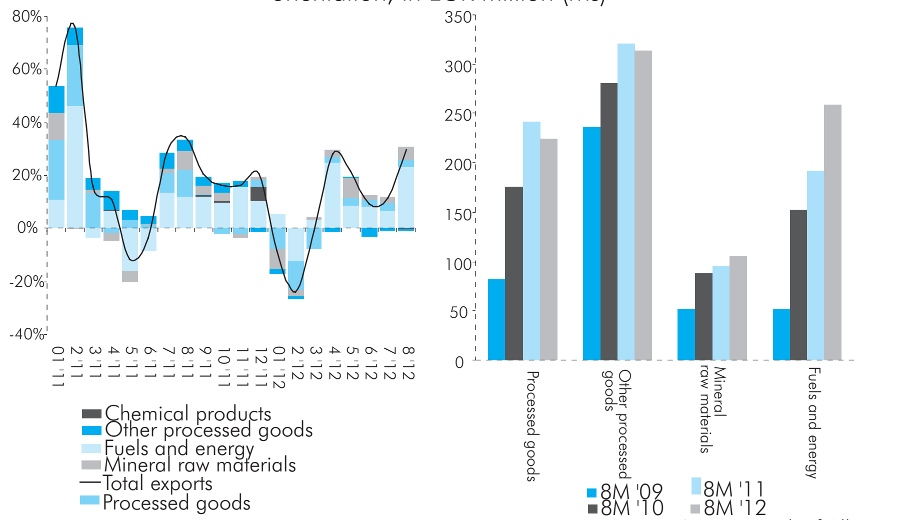


Source: Bank of Albania.

[32] *The REER is measured as a geometric weighted average of domestic prices, compared to trading partners' prices and NEER indicator. A decline in the index implies a real appreciation, whereas an increase in it implies a real depreciation of the national currency.*

Continuing the uptrend having started since April, the value of exports hit record highs by 29.8% in August. The main contribution to export growth during this month was made by 'Fuels and energy', by about 23.4 percentage points. Within this group, a substantial contribution was made by crude oil export, which accounts for about 33.7% of total exports. Exports of 'Processed goods'[33] and 'Raw materials, minerals' performed positively, up by 11.3% and 29.6%, y-o-y. On the other hand, 'Other processed goods', including textile and re-exporting products maintained the downtrend even during August.

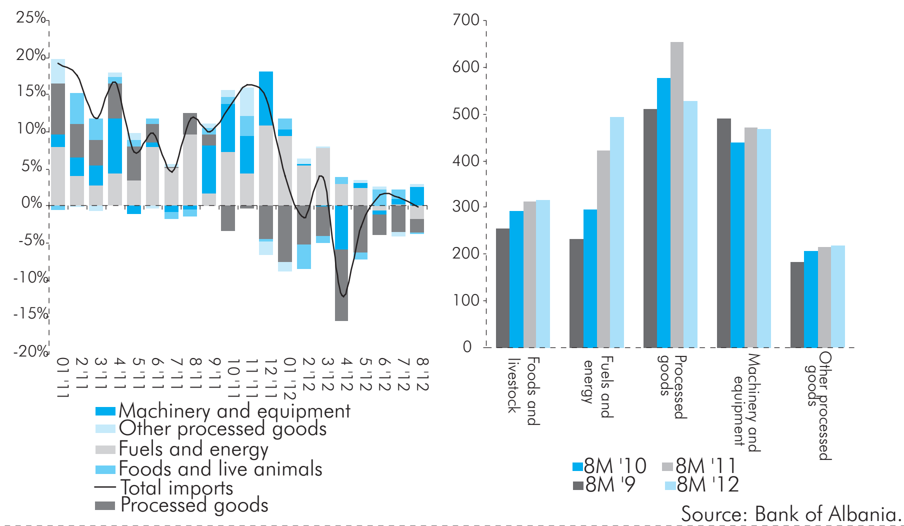
Chart 32 Items' contribution to total exports in percentage points (lhs); export orientation, in EUR million (rhs)



Source: Bank of Albania.

The value of imports in August fell slightly by 0.1%. Excluding electric energy imports, total imports increased by 1.4% y-o-y. Import of goods included in 'Machinery and equipment' made the main contribution by 2.6 percentage points to expanding total imports. On the other hand, imports of 'Processed goods' continued to trend down, contributing by about 1.7 percentage points to the decline in total imports.

Chart 33 Items' contribution to total imports, in percentage points (lhs); import orientation, in EUR million (rhs)



Source: Bank of Albania.

33 The main exported products of this item are base processed metals of steel, cast iron, iron and copper.

Trade exchanges continue to be concentrated in EU countries, accounting for about 65.8% of the trade activity during the first eight months of 2012. During January-August, the value of exports to EU countries expanded by 13.8%, y-o-y. Italy and Spain are the main EU member states, to which our exports increased over the period under review. On the other hand, exports to countries such as China, Switzerland and Turkey fell, marking a 3.9% negative contribution in cumulative terms in the eight-month period. CEFTA member countries have contributed only 0.3%. Decline in imports from EU and CEFTA member countries, respectively by about 4.4% and 1.3%, broadly influenced the decline in import value for the eight-month period. Imports from China, Switzerland, Turkey and the United States increased during the above period, providing a positive contribution to total imports to Albania.

Box 4 Balance of Payments developments in 2012 Q2

In 2012 Q2, foreign assets increased by about EUR 7.5 million in the overall balance of payments. Net current account position registered a deficit of EUR 196.6 million. In annual terms, the current account deficit narrowed by about 37.3%, accounting for 7.7% of nominal GDP[34] or 5.3 percentage points lower than the figure for 2011 Q2.

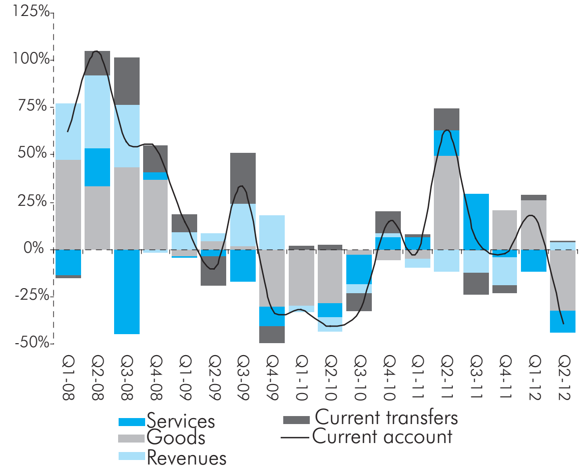
Table 5 Main Balance of Payments indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2
Current account (in EUR million)	-313.8	-244.1	-352.1	-249.3	-196.6
y-o-y	58.7%	1.8%	-1.2%	17.6%	-37.3%
/ GDP	-13.0%	-10.2%	-15.0%	-11.7%	-7.7%
Trade Balance	-581.4	-593.1	-658.6	-465.3	-475.8
Exports, f.o.b.	330.8	344.1	360.0	325.8	394.2
Imports f.o.b.	-912.2	-937.2	-1,018.6	-791.2	-870.0
Balance of services	-6.2	116.7	41.2	8.4	28.8
Credit	376.8	629.8	428.5	293.8	383.7
Debit	-383.0	-513.1	-387.3	-285.4	-354.9
Travel - net	-19.9	82.9	28.4	4.3	6.2
Balance of income	13.7	14.1	14.5	-10.5	-6.6
Credit	67.4	77.5	67.5	59.9	62.5
Debit	-53.7	-63.3	-53.0	-70.4	-69.1
Net FDI income	-10.2	-22.0	-7.9	-38.7	-22.9
Current transfers	260.2	218.2	250.8	218.1	257.0
Credit	287.6	245.6	279.1	241.5	299.8
Debit	-27.4	-27.5	-28.3	-39.5	-42.8
Net remittances	190.4	153.8	188.7	159.5	178.6
Capital and financial account (in EUR million)	192.0	227.6	277.1	254.4	171.3
y-o-y	2.4%	29.1%	-32.6%	10.4%	-10.7%
/ GDP	7.9%	9.5%	11.8%	11.9%	6.7%
Capital account	31.5	6.5	27.8	12.9	44.7
Financial account	160.5	221.1	249.3	241.5	126.7
A. Liabilities	283.0	413.3	390.7	304.0	269.7
FDI	212.5	160.1	289.7	200.3	182.2
Portfolio investment	11.1	11.1	11.4	14.4	13.2
Other investments	59.4	242.1	89.6	89.3	74.3
B. Assets	-122.5	-192.3	-141.3	-62.5	-143.1
FDI	-1.7	-3.9	-19.8	-3.4	-7.7
Portfolio investment	-26.2	-57.1	14.4	-61.0	8.4
Other investments	-94.6	-131.2	-135.9	1.8	-143.7
Errors and omissions	120.1	72.9	68.8	-1.9	32.8
Reserve assets	1.7	-56.4	6.2	-3.2	-7.5

Source: Bank of Albania.

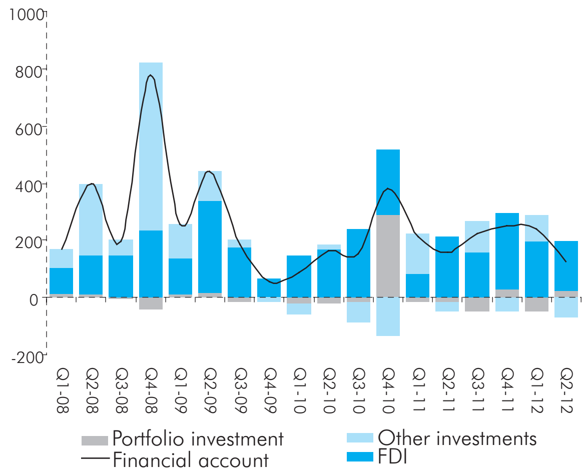
[34] *Nominal GDP for 2003-2010 is the one published by INSTAT. For 2011, the data for the nominal GDP is based on real GDP and on inflation rate.*

Chart 34 Items' contribution to current account deficit (in pp)



Source: Bank of Albania.

Chart 35 Capital and financial account (net flow, in EUR million)



Source: Bank of Albania.

Current account dynamics during this quarter was broadly influenced by the performance of trade balance and services account. The combined improvement of their net position, compared to the same period of a year earlier, contributed significantly to narrowing the current deficit. Narrowing of goods trade deficit by about 18.2% y-o-y, and the services account surplus have led to narrowing of net export deficit by about 23.9%, y-o-y. Net balance of income account resulted in a deficit of EUR 6.6 million, mainly due to increased outflows of foreign direct investment income. Current transfer account surplus narrowed by about 1.2% y-o-y. Net transfers from emigrants - the main sub-item of this account - fell by 6.2% y-o-y. Their ratio to trade deficit is estimated at 37.5%, or about 4.8 percentage points lower than the financing ratio for the same period in 2011.

Net capital and financial flows registered a positive balance of EUR 171.3 million in 2012 Q2. This account's surplus was about 10.7% lower than in the same period of 2011 and accounted for about 6.7% of GDP. Currently, the capital and financial account surplus managed to finance about 87.1% of the resultant current account deficit. Inflow of foreign direct investments fell by about 14.3% y-o-y. Net portfolio investments registered EUR 21.6 million in 2012 Q2, marking a shift to surplus, from the deficit marked in the same period of 2011. The annualised change in net portfolio investments was due to less portfolio investments of residents in non-resident economies.

Net other investments account, broadly influenced by higher claims of residents on non-residents, posted a deficit of EUR 69.4 million in 2012 Q2. The decline in borrowing flow and the increase in currencies and deposits of the domestic banking system in foreign economies led to higher assets of the domestic economy.

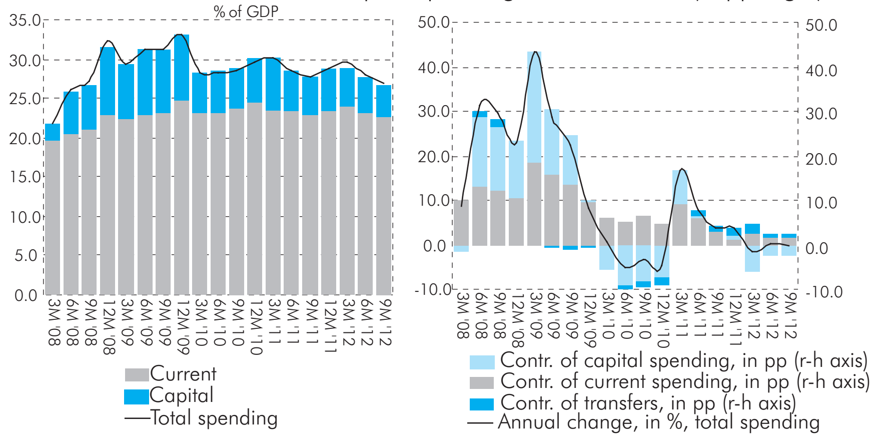
Foreign reserve stock at the end of the period was EUR 1,930.93 million. This level was sufficient to cover 4.5 months of import of goods and services.

IV.1.4 FISCAL INDICATORS AND FISCAL POLICY

Fiscal policy oriented toward a fiscal consolidation process, materializing into a downward trajectory of budget deficit in the first three quarters of 2012. As at end-Q3, fiscal consolidation process was mainly based on cuts in budget spending. Their decrease was driven by the lower capital spending, hence translating into lower contribution of public investment to the growth of aggregate demand. On the other hand, the low annual growth rates of budget revenues suggest a more fragile economic environment compared to a year earlier.

Fiscal policy materialized in lower spending compared to a year earlier being conditioned by the available fiscal room. More specifically, as at end-Q3, total spending amounted to about ALL 270.6 billion, down by 0.2% in nominal annual terms[35]. Spending accounted for about 26.9% of GDP, the lowest percentage in the last five years. Current and capital spending accounted for 22.7% and 4% of GDP.

Chart 36 Cumulative budget spending* (current and capital) as a percentage of GDP (in %, left) and annual percentage change in budget spending and the respective contributions of current and capital spending and transfers** (in pp, right)



*Cumulative within the budget year timeframe. For instance, the ratio of spending for the first six-month period was constructed as budget spending for January-June as a percentage of GDP for the same period.
**Transfers include 'Lending to KESH' and 'Loan repayment by KESH'.
Source: Ministry of Finance, INSTAT and BoA's MPD estimates.

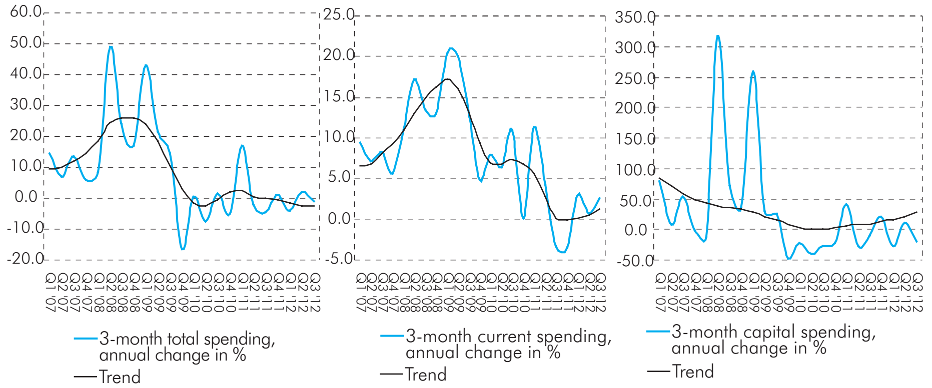
As at end-September, current spending amounted to ALL 228.4 billion, about 2% higher in nominal annual terms. The higher growth rates of current spending over the present year have been mainly driven by the higher spending on social insurance. Other spending items, such as social and personnel spending, provided a positive, albeit modest, contribution to the increase in current spending during Q3. In the meantime, the impact of spending on local government and subsidies on total current spending was opposite but similar in size to the above two items.

As at end-Q3, capital spending amounted to ALL 40.2 billion, down by about 15% from the same period in 2011. Their financing has altered compared to early 2012, with the share of foreign resources showing progressive growth.

Concerning the distribution of budget spending over the quarters, Q2 saw the highest level of spending, while Q1 and Q3 saw almost similar levels of spending. This approach of spending distribution is dissimilar to its historical performance, where Q1 holds the lowest share of total spending[36]. Capital spending determined the direction of the change in total spending over the three quarters, despite its low share in total spending (about 15%).

[35] *Excluding lending to KESH, total spending for the nine-month period is 0.9% lower y-o-y.*
[36] *Excluding 2011, when 33% of spending actualized for the first three quarters was made in Q1.*

Chart 37 Annual change of quarterly spending* in % by main items (charts from left-right: total spending, current spending and capital spending) and their respective trends, 2007 Q1 - 2012 Q3**.

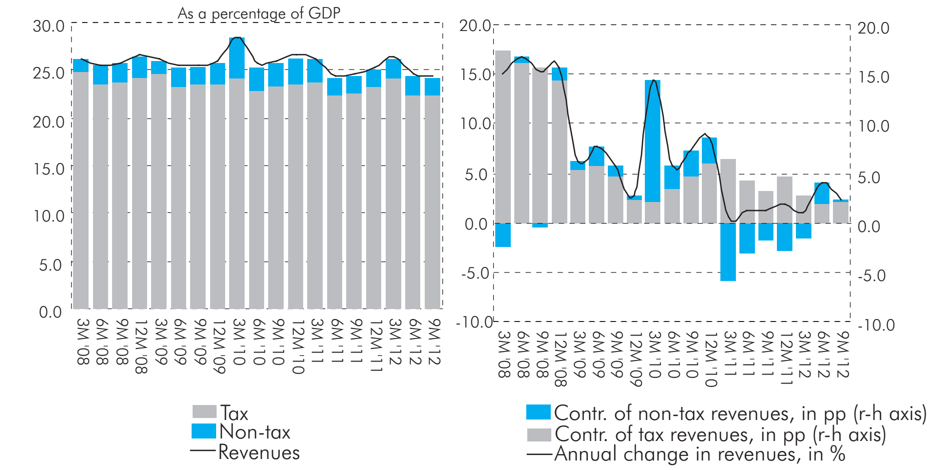


*Total spending excludes 'Net lending to KESH'.
**The annual change trend of each item of spending/revenues shown in the charts is derived using the Tramo/Seats adjustment method.
Source: Ministry of Finance and BoA's staff estimates.

Budget revenues amounted to about ALL 244.9 billion in the first three quarters, about 2.3% higher in nominal annual terms. The growth rate of revenues slowed compared to end-H1 due to the lower non-tax revenues. As in 2012 H1, tax revenues continued to increase at low rates despite the tax policy being similar to a year earlier[37].

As at end-Q3, total revenues accounted for about 24.4% of GDP, 0.9 percentage points below the last five year's average. Tax revenues accounted for about 22.4% of GDP or 0.7 percentage points below the last five year's average. On the other hand, non-tax revenues and grants were estimated at 1.8% and 0.2% of GDP.

Chart 38 Tax and non-tax revenues as a percentage of GDP (left) and annual change in total revenues and contribution of two main items in pp (right), 2008 Q1 - 2012 Q3



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

37 *Worth noting are the following two changes in the fiscal package effective during this budget year: (i) some amendments to Law 'On national taxes'; and (ii) approval of the new Law 'On excises' in the framework of the approximation of Albania's tax legislation with the EU Directives and Regulations.*

For the period under review, tax revenues amounted to ALL 225.2 billion, about 2.4% higher than a year earlier and contributing by 2.2 percentage points to the increase in total revenues. The latter owes to the developments in national taxes[38], which, unlike their historical performance, registered very high annual growth rates (49%). The performance of national tax revenues primarily attributes to fiscal measures aiming to increase the circulation tax for fuels, change the minerals resource rent tax and the shift of glass and plastic packaging item from goods subject to excise to goods subject to national tax[39].

VAT revenues, which have the main share in total revenues (about 35%) and, at the same time, are a proxy for the performance of domestic consumption, continued to register slow annual growth rates by about 1.6%. Their slow performance reflects a lower imports value compared to a year earlier[40]; relative exchange rate stability[41]; improved output of domestic goods and services from 2012 H1[42], increase in exports[43], and the effects of specific adjustments related to the payment method of the VAT on capital goods import.

Profit tax, personal income tax, excises and local government revenues were lower than in the previous year, thus providing a negative contribution (by 1.1, 0.1, 0.3 and 0.2 percentage points, respectively) to the increase in total budget revenues. The negative growth rates of personal income tax are a combination of the decrease in income tax on property sale from a year earlier[44] and the more moderate annual growth rates of tax on wage income, both in the public and private sector.

The growth rates of tax items closely related to the performance of Albania's economic activity, such as VAT revenues, excises, profit tax and personal income tax, were below their long-term average. In the absence of fiscal measures that may alter the tax rate, the taxation mode or the taxpayer base,

[38] *Over the period under review, national taxes contributed by about 3.0 percentage points to the increase by 2.3% in total revenues.*

[39] *As of 1 January, the circulation tax is set at 7 leks/liter from 5 leks/liter in September 2011. According to the latest amendments (Council of Ministers Decision No. 201, dated 21 March 2012), the minerals resource rent tax is set based on the market value of minerals according to a list of reference values based on the technological norms approved by an ad hoc commission. The new excise law, which became effective in August 2012, in addition to eliminating the item of packaging, unlike the previous law, introduced a wider range of energy products and alcoholic beverages (by detailing them further according to intervals based on the alcohol percentage).*

[40] *Imports value for the first eight months contracted by about 0.9% y-o-y.*

[41] *For the first three quarters of 2012, NEER recorded an annual change of -0.38%.*

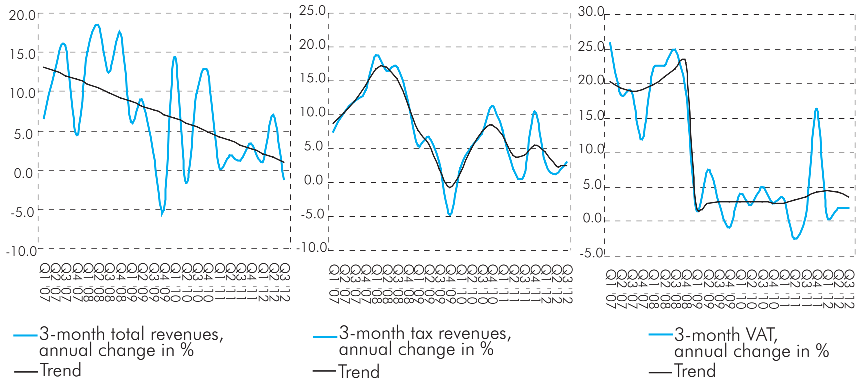
[42] *Starting from February 2010 (period from which data has been made available) to July 2012, VAT collected on taxes contributed negatively to the increase in total VAT. By contrast, as at end-Q3, VAT collected on the output of domestic goods and services contributed positively by 0.3 percentage points to total VAT collected over the same stated period. According to the latest data on sectoral VAT, the improved VAT seems to attribute to the improved activity in the sectors of trade and services.*

[43] *Exports value for the first eight months increased by about 6.7% y-o-y. Consequently, VAT refund was higher than a year earlier, yielding an annual growth rate of net VAT of about 0.7 percentage points lower than gross VAT.*

[44] *This development reflects the base effect resulting from the high revenues collected in 2011 from the reassessment of assets following the entry into force of the Law 'On partial forgiveness of tax and customs duties'.*

their weak performance reflects, among others, the sluggish economic activity over this budget year.

Chart 39 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 Q3

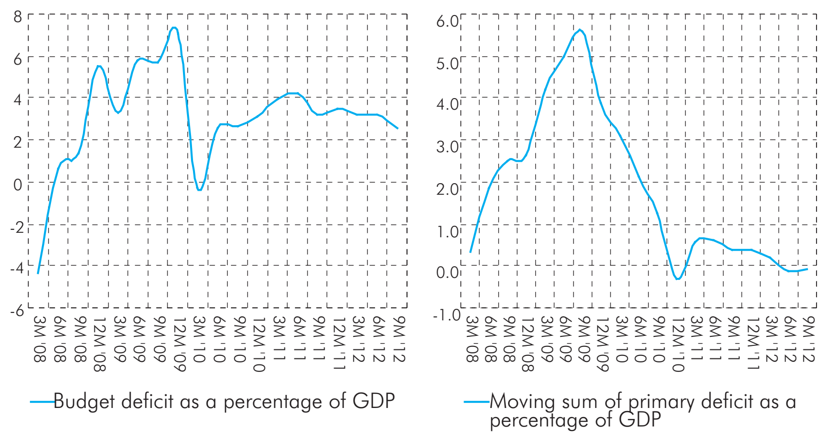


Source: Ministry of Finance and BoA's staff estimates.

The growth profile of tax revenues over the quarters is almost similar, with a slight improvement in Q3. On the other hand, developments in non-tax revenues - in addition to the high volatility shown over the quarters - determined the direction of the change in total revenues in Q2 and Q3.

As at end-Q3, budget deficit amounted to about ALL 25.7 billion, accounting for about 2.6% of GDP. Expressed in quantitative terms, fiscal consolidation reduced the budget deficit by 0.7 percentage points compared to a year earlier. The downward trajectory of the budget deficit pursued since February this year has primarily reflected the developments in budget spending. As at end-Q3, budget deficit was about 19% lower than a year earlier.

Chart 40 Budget deficit as a percentage of GDP (left) and primary deficit as a percentage of GDP (right)*, 2008 Q1 - 2012 Q3



*The right chart is constructed taking into account the moving sum of the 3-month primary deficit (including 4 quarters) as a percentage of cumulative GDP per quarter.

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

The approach to budget deficit financing appears to be within its traditional framework, with domestic borrowing instruments playing the greatest role. The issue of government securities accounted for about 70% of total budget deficit financing[45]. Concerning the classification of domestic borrowing by maturity, long-term instruments dominated versus short-term ones. Bidders' demand in the primary securities market, which was mostly concentrated in some of the instruments (12-month T-bills and 3, 5 and 7-year bonds), seems to have determined the Government's borrowing policy over the period under review. More specifically, the increase in domestic borrowing consisted in 12-month T-bills and 3, 5 and 7-year bonds, while lowering, albeit not to the same degree, the share of financing through short-term instruments such as 3 and 6-month T-bills.

The increase in long-term securities' portfolio is a positive factor in view of lowering debt refinancing risk, contributing at the same time to a more improved debt settlement profile. On the other hand, the improved primary balance, noted particularly in the last two quarters, contributes positively to the public debt dynamics in the period ahead. However, in addition to the developments in the primary balance, public debt is affected by the performance of interest rates paid on public debt, real economic growth, different public guarantees and exchange rate developments.

Table 6 Key fiscal indicators

	2012 Q3		Annual change, in %		
	ALL billion	% of GDP	2010 Q3	2011 Q3	2012 Q3
Total revenues	244.9	24.4	7.2	1.2	2.3
Tax and customs	173.7	17.3	5.7	2.7	2.6
VAT	86.1	8.6	3.9	0.5	1.6
Profit tax	12.7	1.3	2.2	16.9	-16.6
Excises	28.4	2.8	10.4	1.7	-2.6
Personal income	20.3	2.0	-1.6	2.9	-0.9
National tax	21.6	2.2	36.6	7.2	49.1
Local government	8.8	0.9	-8.8	5.9	-4.4
Social security contributions	42.7	4.2	5.4	5.8	2.7
Non-tax	17.6	1.7	34.6	-19.6	0.8
Grants	2.1	0.2	9.2	-10.3	3.2
Total spending	270.6	26.9	-3.3	3.9	-0.2
Current spending	228.4	22.7	8.5	3.6	2.0
Personnel	50.8	5.0	5.1	3.7	2.5
Interest payments	29.0	2.9	17.3	-4.0	0.6
Operating and maintenance	23.7	2.4	12.8	3.8	-1.9
Social security	88.1	8.8	9.7	7.7	5.5
Local government	19.4	1.9	-8.3	-4.2	-6.6
Capital spending	40.2	4.0	-31.9	-1.5	-15.0
Lending to KESH	2.0	0.2	…	…	…
Budget deficit	25.7	2.6	-50.7	30.7	-18.8

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

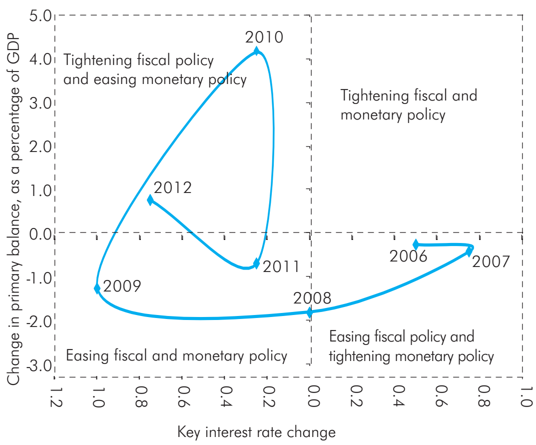
[45] *As at end-Q3, Government's liquidity position, which has a (-) sign in deficit financing, accounted for about 24% of the budget deficit.*

Box 5 Macroeconomic Policy Response during 2006-2012

The global crisis, considered by many economists to be the worst financial crisis since the 1930s, required the joint intervention of monetary and fiscal authorities with a view to recovering aggregate demand and supporting the financial sector. In many cases, these measures went beyond the conventional framework of each of these policies' actions, bringing about the deterioration of fiscal positions, and considerable expansion of central bank balance sheets[46]. Fiscal authorities injected massive stimulus, reflecting in turn in considerably deteriorated fiscal positions. In the meantime, the monetary authority employed a wider range of indirect instruments with a view to recovering domestic economic activity. Central banks' measures included, among others, the cut of policy interest rates to historical lows and their maintenance for prolonged periods; temporary or permanent lending and quantitative facilities; interventions in the foreign exchange market; purchase of private long-term securities, and other measures beyond the conventional framework of instruments used[47].

This Box seeks to provide an overview of the fiscal and monetary policy response in the pre-crisis period, during the crisis and until 2012. Concerning the monetary authority instruments, it only takes into consideration the key interest rate change in percentage points compared to a year earlier. This change reflects the monetary policy nature, which in the following charts will be positioned on the tightening side for each right-side move along the horizontal axis and vice versa. The nature of fiscal policy will be illustrated through the changes in the primary balance-to-GDP ratio compared to a year earlier. This Box considers fiscal policy as easing when the primary balance[48] expressed as a percentage of GDP deteriorates (moves down along the vertical axis), and the opposite, tightening when the primary balance improves. In order to compare the combination of both policies before and during the global crisis, we consider the euro area countries (EU-17)[49] as they represent Albania's major trading partner with abroad.

Chart 41 Combination of fiscal and monetary policy in the case of Albania



Source: Ministry of Finance, INSTAT, Bank of Albania.

A comparative analysis of Albania and euro area countries shows that the monetary policy was tightening during 2006-07 with a view to maintaining price stability[50]. In the meantime, for the same period, Albania's fiscal policy was easing, thus opposite to euro area's approach. During 2008-09, monetary policy was significantly eased in the euro area, combined with a similarly eased fiscal policy, in response to the financial and economic crisis that swept across these countries. Over the same period, fiscal policy in Albania was expansionary due to the higher capital spending during the period[51]. A year later, the consolidating fiscal policy, which lowered the budget

46 Cotarreli C. and Vinals J. (2009) 'A strategy for renormalizing fiscal and monetary policies in advanced economies', IMF SPN/09/22.

47 For more information, refer to IMF (2010) 'Central banking lessons from the crisis', pages 10-12.

48 Primary balance = Budget balance + Interest payments.

49 EU-17: Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, The Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

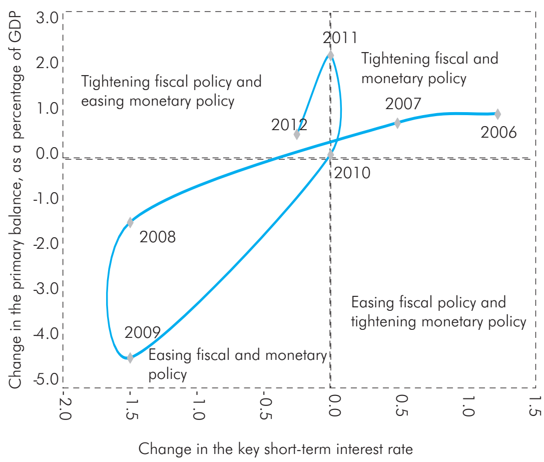
50 In 2007, the rise in basic food prices required the intervention of monetary authorities in order to keep inflation in check.

51 In 2008 and 2009, budget deficit as a percentage of GDP was 5.5% and 7.0%, respectively, reflecting primarily the increase in capital spending to an average of 8.5% of GDP from 5.4% during 2004-07.

deficit as a percent of GDP by about 3.9 percentage points compared to a year earlier, combined with a stimulating monetary policy that had begun since 2009.

The response of macroeconomic policies in Albania in 2012 was similar to the one in the euro area. Monetary policy was stimulating in 2012, both in Albania and the euro area. It seems that the deterioration of fiscal positions in the euro area countries, reflected in the increase of net public debt to about 73.4% of GDP for 2012 from 68% in 2011[52], conditioned the room for fiscal policy action, placing the latter on the consolidation side. The deterioration of fiscal positions in the euro area is assessed to be a consequence of the combination of the European Economic Recovery Plan[53] with the structural reforms, and the operation of automatic stabilizers in response to the economic slowdown in these countries. Albania's public debt has also increased. As at end-2011, it was close to the threshold of 60% of GDP as stipulated by the organic budget law.

Chart 42 Combination of fiscal and monetary policy in EU-17



Source: Eurostat, IMF WEO October 2012, and the Bank of Albania.

52 According to IMF's assessments and projections in WEO, October 2012.
53 http://europa.eu/rapid/press-release_MEMO-08-735_en.htm

IV.2 LABOUR MARKET, WAGES AND COSTS

The low economic activity in the recent years was followed by slow employment growth and an unemployment rate rising above 13%. Despite the structural factors affecting the high unemployment rate, the current labour market conditions generate low inflationary pressures. Wages and other producer costs fell during 2012 H1.

Labour Market

The labour market remained sluggish in 2012 H1, being in line with the previous three years' trends. The slackening of the labour market was more pronounced in Q2. Employment slowed the annual growth to 0.4% in Q2 from 1.4% in Q1. In absolute terms, this growth is translated into 3,750 people. This modest increase owes to the low demand from the private non-agricultural sector (1.6%) and the lower public sector demand for labour (-0.2%). Employment in the agricultural sector remained unchanged at 506,664 people. Labour force increased slightly by about 0.4% due to a higher increase in the number of unemployed people (0.7%) compared to the number of employed people (0.4%).

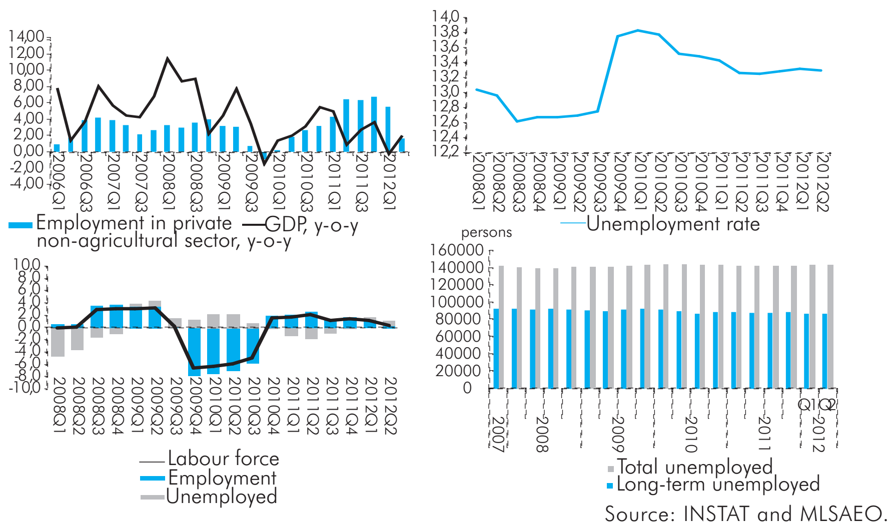
Table 7 Labour force figures

Annual changes in %	2010	2011	2012 T1	2012 T2
Labour force	1.7	1.5	1.3	0.4
Total employed	2.0	1.7	1.4	0.4
Employed in the public sector	-0.2	-0.6	-0.5	-0.2
Employed in the private agricultural sector	2.1	0.0	0.0	0.0
Employed in the private non-agricultural sector	3.1	6.7	5.5	1.6
Total registered unemployed	-0.2	-0.1	0.4	0.7
Unemployment rate	13.49	13.29	13.32	13.30

Source: INSTAT.

As a reflection of developments in labour market supply and demand, unemployment rate has since 2009 fluctuated above 13% and settled at 13.3% in 2012 Q2. Data from the MLSAEO[54] show that long-term unemployment remained high in Q2, thus evidencing one of the protracted structural concerns of the labour market. People seeking a job for more than a year accounted for about 60% of total unemployed people in Q2, down by about 4 percentage points from the average of 64% in 2007 Q4.

Chart 43 Quantitative labour market figures



Source: INSTAT and MLSAEO.

Based on Q3 survey results, businesses continue to remain pessimistic in their expectations for employment for the remainder of 2012.

Wages and Labour Costs

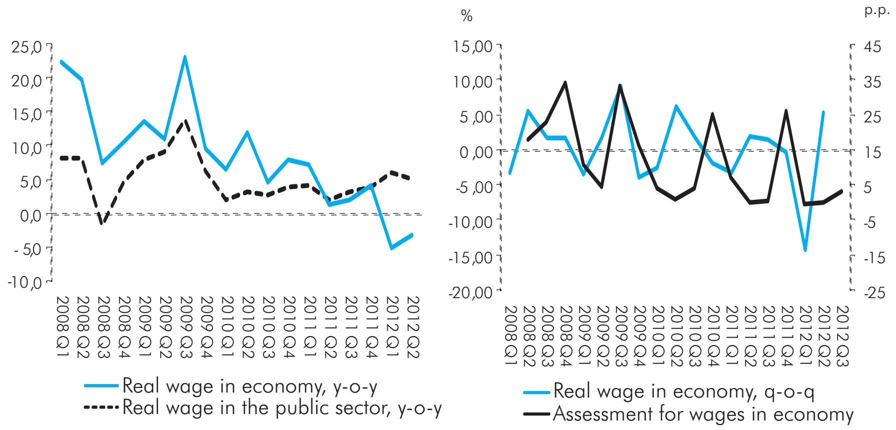
Labour market developments reflected in the slowing trend of wages in the last two years. During 2012 H1, average wage index in economy[55] recorded

[54] *Ministry of Labour, Social Affairs and Equal Opportunities.*

[55] *Wage index in the economy, also referred to as 'average wage', is measured as the ratio of wages fund index to the number of employed people index. Source: INSTAT 'Short-term statistics', excluding 'Agriculture'. The data frequency is quarterly.*

negative growth rates. After registering a double-digit fall in Q1, it slowed its annual contraction in Q2 to -7.1% in nominal terms and -8.4% in real terms. The quarterly dynamics shows that average wage rose by about 5% from Q1. By sector, wages in the production sector rose by 3.3% in nominal terms and 1.93% in real terms. Wages in the services sector fell by 11.7% and 12.9%, respectively, in nominal and real terms. Within this sector, wages in trade and transportation fell significantly. Unlike the private sector, average monthly wage in the public sector maintained an upward trend. In 2012 Q2, average wage in the public sector rose by 7.3% in nominal terms and 5.3% in real terms.

Chart 44 Wages and related assessments in the economy



Source: INSTAT and Bank of Albania.

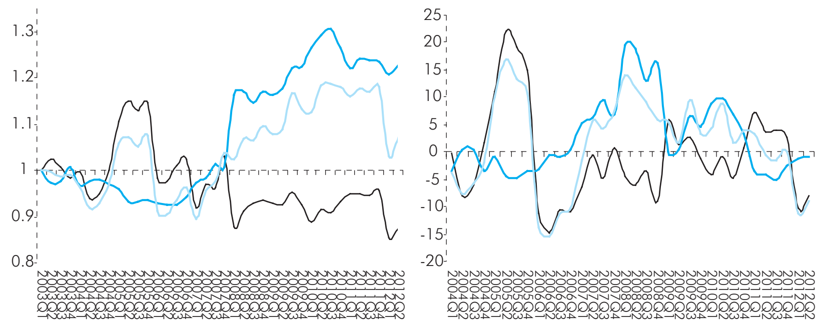
Following the rise in minimum wage in the economy in July 2012, the wage index is expected to increase in Q3. This expectation is also confirmed by business assessments of wages in Q3 and their expectations for the further rise in wages in Q4.

- Other Labour Costs

Developments in economic activity, labour market and wages in non-agricultural sectors during 2012 H1 materialized in a volatile labour productivity (LP) indicator. After the growth rates in 2011, its dynamics registered an annual decline in 2012 Q1 (-10%) and Q2 (-8%). Its performance was driven by the increase in the employment index at faster rates than the value added of domestic non-agricultural economic activity. This performance is an indication of the lower efficiency in the use of the labour factor during the production process by the relevant businesses. LP's negative rates do not signal any 'heating' of economic activity in the future – an important premise that would ensure low domestic inflationary pressures in the medium run.

Labour Cost per Unit of Output Index (LCUOI) in the non-agricultural sector continued to register negative annual rates in 2012 H1. The negative dynamics curbed slightly from Q1 (-1.2%) to the second (-0.9%) due to developments in LP and average real wage. The figures show that the fall in real wages in both quarters was more pronounced than the fall in LP. This performance, in addition to LP developments, shows that there have not been any labour cost-side inflationary pressures originating from the domestic economy.

Chart 45 LP, LCUOI and average real wage (left); annual changes (right)*



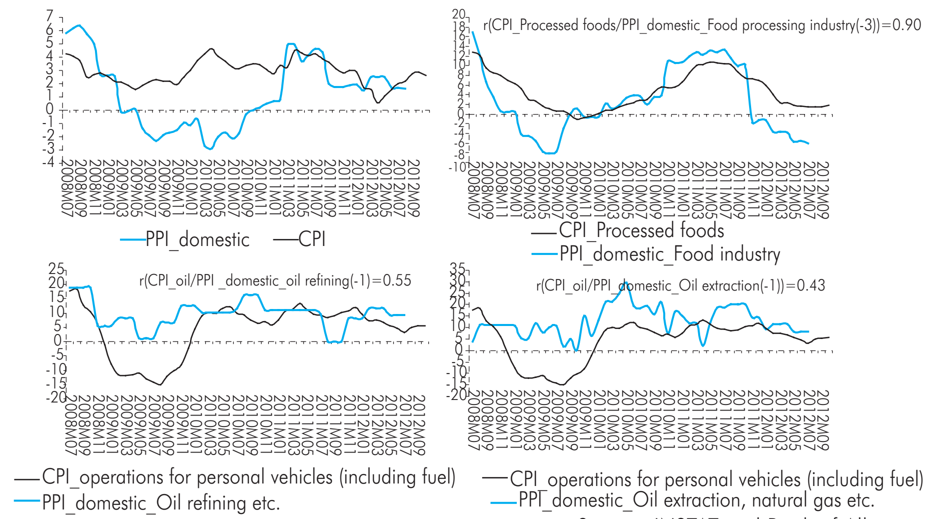
*The measures refer to LP and LCUOI of the economy, excluding agriculture. The estimates use value added data (seasonally adjusted - INSTAT, GDP, 2012 Q2), and short-term statistics for employment and wages (INSTAT, Short-term statistics, 2012 Q2). Short-term statistics exclude agriculture, therefore the value added is considered excluding agriculture. Average real wage index is derived after deflating it to the seasonally adjusted CPI (2012 Q2). For comparison purposes, the indicators are rebased on the value of each indicator in 2003 Q1.
Source: Bank of Albania's estimates.

The above performance of these indicators does not create an environment that may generate second-round effects from the labour costs in the economy. There is little likelihood of the emergence of an inflationary spiral from wages to inflation expectations in the medium run. This assessment is confirmed by the anchored inflation expectations in medium and long terms.

- Industrial Producer Prices

As at end-June 2012, industrial producer prices of goods destined for the domestic market did not transmit added pressures on consumer prices in Q3. In Q2, Producer Price Index (domestic_PPI) fell by 0.6% q-o-q and rose by 1.7% y-o-y. Despite this increase, annual PPI inflation stands 2.7 percentage points below the same period in 2011. With reference to the industrial production sub-branches – whose domestic PPI fluctuations are more correlated to the respective sub-items' CPI –, it results that oil extraction and refining operated at higher producer prices in 2012 Q2 than a year earlier, by 8.3% and 9.3%, respectively. These developments in production and processing industry exerted added inflationary pressures on 'Operations for personal transportation vehicles' during July-December 2012.

Chart 46 Annual changes: CPI and PPI for domestic productions; linear correlations



Source: INSTAT and Bank of Albania.

In Q2, producer prices in food processing industry registered an annual fall by 5.7%, hence relatively deeper than in Q1. Part of this fall owes to the previous year's high comparative base effect. These developments have kept the annual inflation low in 'Processed foods' during July-September[56]. This performance continues to confirm the lag at which the significant fluctuations in producer prices are transmitted to the consumer prices of processed foods.

IV.3 IMPORTED INFLATION

Based on the dynamics of imported inflation in the recent months, the inflationary pressures deriving from the external economy were generally low in the domestic market; however, showing an increasing tendency in August 2012[57]. The analysis of inflationary pressures deriving from the external economy uses two indicators. While imported inflation[58] helps assess the overall inflationary pressures originating from outside the Albanian economy, intersectoral inflation differentiation seeks to quantify the extent of their materialization in domestic inflation.

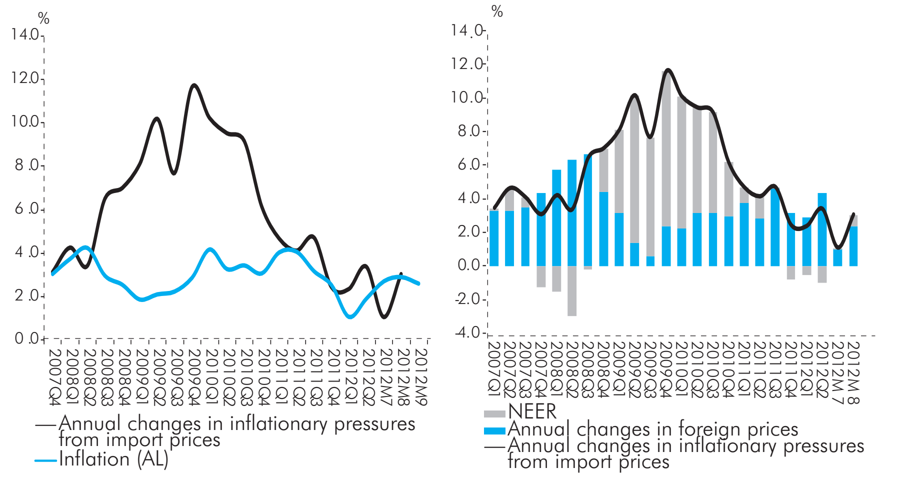
Imported inflation was volatile in the first eight months, registering the lowest rate of 0.9% in February and the highest of 4.5% in April. The inflationary pressures originating from outside the domestic economy increased by nearly 2.9% in H1, while increasing by an average of 2.1% during July and August. This development reflected mainly the performance of 'Import prices', which for the same time interval increased by 1.7% y-o-y. In addition to the price rise in Albania's main trading partners, the slight depreciation of the lek in terms of the NEER index during July-August seems to have played a complementary role in passing through the rise in import prices to domestic inflation.

[56] *Annual inflation of processed foods averaged 1.7% and 1.6% in Q2 and Q3, respectively.*

[57] *The inflationary pressures originating from outside do not exert immediate effect on the domestic market. There is a lag of a few months until they start to impact. In September, there was an increasing presence of inflationary pressures.*

[58] *Imported inflation is measured as the weighted average of 21 countries' CPIs, using their import share based on foreign trade data, and adding the NEER for the respective month.*

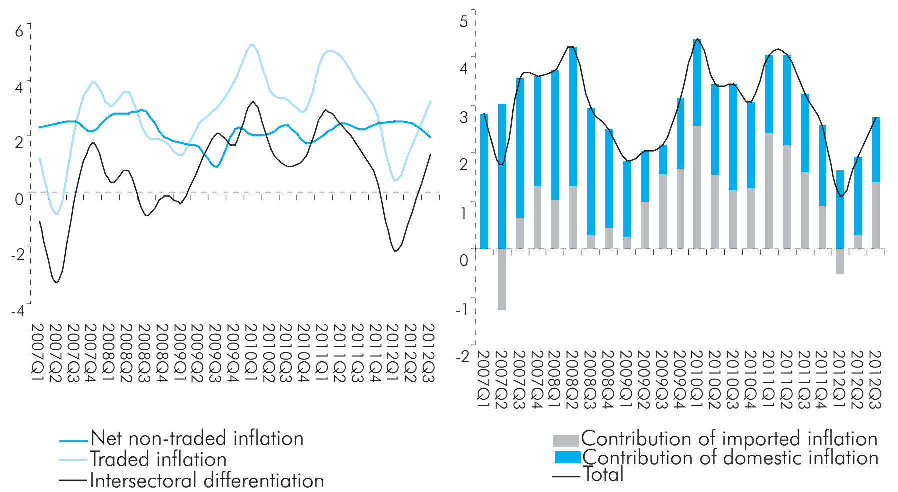
Chart 47 Inflationary pressures from import prices and domestic inflation (left, annual change) and contribution of import prices and exchange rate (right)



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

Intersectoral inflation differentiation shows added contribution of imported inflation to headline inflation in 2012 Q3. It resulted positive and evidenced that developments in commodity prices during the quarter under review generated higher inflation than those in services' prices. Imported inflationary pressures showed higher intensity during 2012 Q3 also due to the waning effect of the previous year's high comparative base. They contributed to the increase of inflation by about 1.3 percentage points, forming about 48%. Almost the other half of inflation was formed from the domestic pressures in the economy, which remained relatively stable. The balancing of the contribution structure of domestic and external inflationary pressures was favoured by the prolonged appreciation behaviour of the euro/lek exchange rate.

Chart 48 Intersectoral differentiation and respective contributions (right)

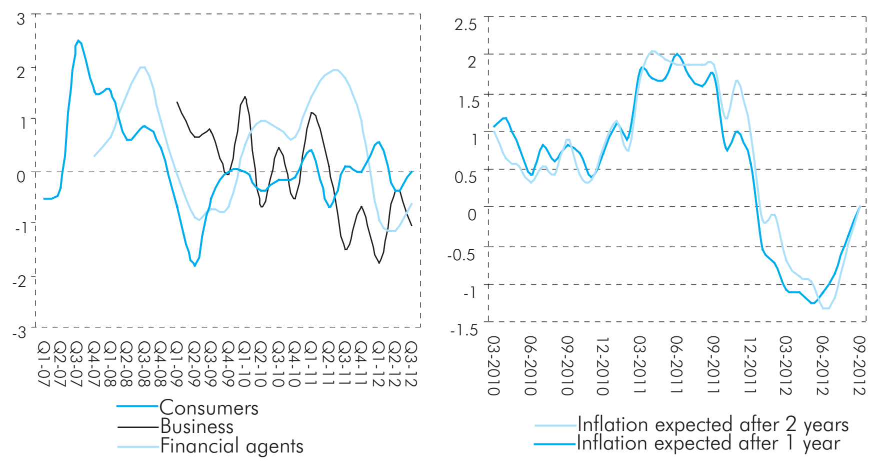


Source: INSTAT and Bank of Albania.

IV.4 INFLATION EXPECTATIONS[59]

Inflation expectations were better anchored in 2012 Q3 than in H1. The record low official inflation registered in Q1 provided a temporary downward effect on economic agents' expectations. The index quantifying the anchoring of short-term expectations[60] has been increasing and approaching 0, thus indicating low inflationary pressures from the three major economic agents. Medium-term inflation expectations, which measure the more stable shocks, are anchored better than in the previous quarter[61]. The anchoring of expectations, particularly of medium-term ones, provides evidence for financial agents' confidence in the capacity of monetary policy to maintain price stability.

Chart 49 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

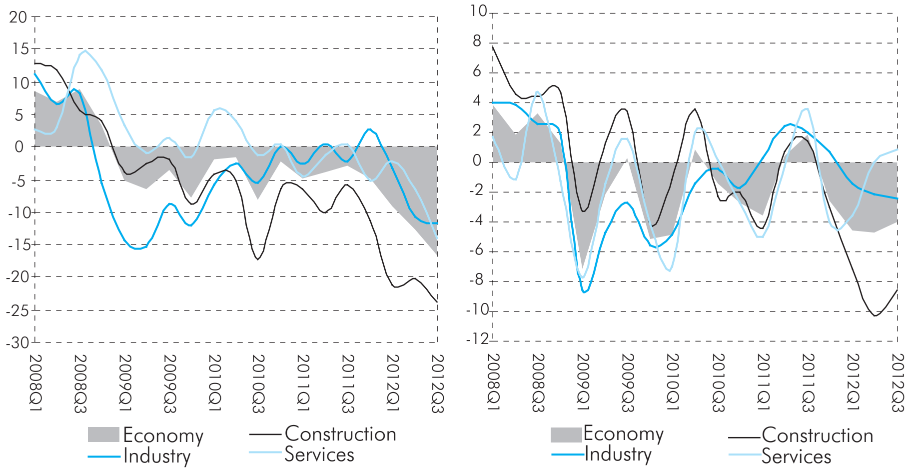
Developments in real economy during 2012 H1 show continued below-potential economic activity, sluggish aggregate demand and weak demand-side inflationary pressures. After registering a decline in Q1, the Albanian economy returned to positive growth rates. It, however, remains low and unbalanced, driven primarily by foreign demand while domestic demand remains weak. The current economic conditions materialized in low pressures stemming from capital and labour costs in the domestic market. Pressures originating from the external economy were more present in Q3. They, however, remain under control due to a stable exchange rate for almost one year. In line with the forecast, annual inflation followed a rising trajectory over the first three quarters of 2012, standing at 2.7% at end-Q3.

59 The Bank of Albania measures economic agents' inflation expectations through business and consumer confidence surveys and financial agents' expectations survey.

60 This index shows how many standard deviations away is the expected inflation rate from the historical average of the expectations' time series.

61 Medium-term expectations are measured only for the financial agents.

Chart 50 Capacity utilization rate in economy (deviation from average, left) and assessment for employment (deviation from average, right)



Source: Bank of Albania and INSTAT.

The partial information available for Q3 and the following period shows that the Albanian economy will perform below its potential. Against a background of low demand, the rise in prices is expected to be low. On the other hand, forecasts for raw material prices in the international markets and the exchange rate show their relatively stable performance, implying an external environment characterized by controlled inflationary pressures. The inflationary expectations are well-anchored, thus facilitating the monetary policy efficiency in the event of temporary supply-side shocks. Concluding, the Bank of Albania expects the inflationary pressures to remain weak in the medium run.

V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

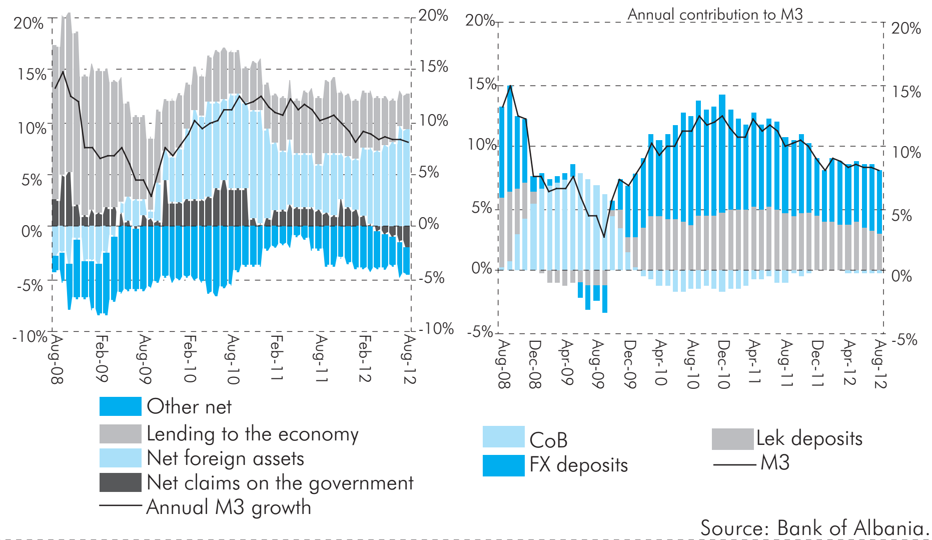
Monetary assets in economy maintained stable growth rates during the first eight months of 2012. Broad money growth was mainly in the form of net foreign assets in response to the high seasonal inflows during summer. The contribution of lending to the private and public sector was downward from a quarter earlier. Despite the good liquidity situation in the banking system, the low private economic agents' demand for monetary assets, the uncertainties about the outlook and the tight lending standards continue to generate low credit growth rate in the economy. The consolidating fiscal policy and budget deficit financing from non-bank institutions reflected in an adverse public sector contribution to the creation of monetary assets in the economy. The monetary developments so far confirm the presence of low monetary-related inflationary pressures.

V.1 MONETARY INDICATORS

Broad money aggregate, M3, was stable during July and August, registering an average annual growth of 8.3%. Broad money growth rates reflect the low economic agents' demand for money and the good performance of the foreign currency component. Against a background of weak economic activity, uncertainties about the outlook and the still tight bank lending standards, the contribution of private sector lending to the creation of monetary assets by about 3.3 percentage points was lower than in Q2. In addition, public sector's contribution to the annual growth of broad money was negative by 2 percentage points, reflecting the consolidating fiscal policy and public sector's financing from outside the banking system. On the other hand, the high foreign inflows characterizing the summer months reflected positive developments in the external sector, contributing by 9.4 percentage points to broad money growth.

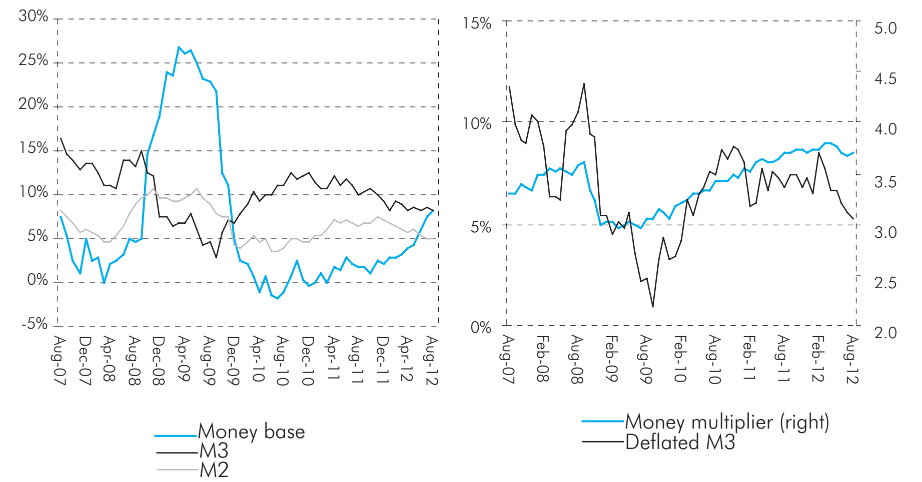
The low creation of money denominated in the domestic currency reflected in the slower annual growth rates of M2 aggregate, which grew by about 5% in July and August, compared to the average of 5.6% in Q2. The slow annual dynamics owes to the lower financing of the Government with banking system monetary assets and the good performance of lek-denominated credit. In addition, the liquid money aggregate, M1, followed a decelerating trajectory, mainly owing to the low demand for liquid money.

Chart 51 Contribution of money demand and supply components



Source: Bank of Albania.

Chart 52 Annual performance of monetary aggregates and money multiplier

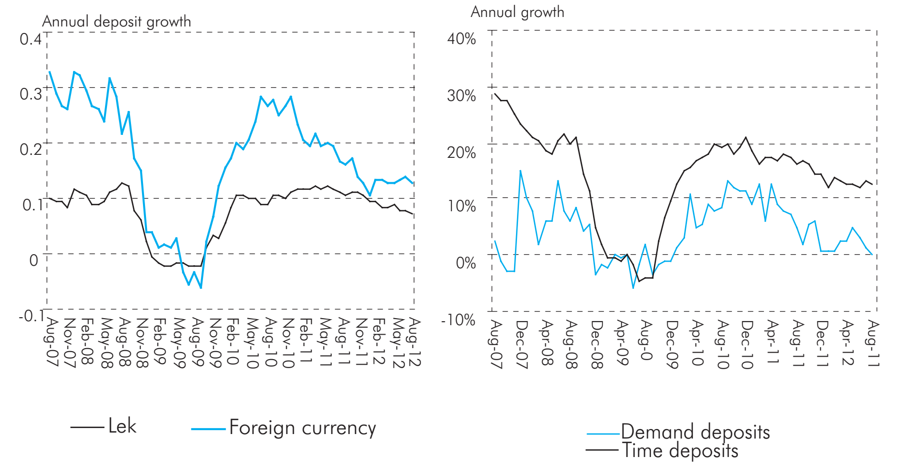


Source: Bank of Albania.

DEPOSITS

Total deposit stock grew at an average annual rate of 10.3% in July and August compared to 10.6% in Q2, or by about ALL 25 billion in monthly terms. Their performance reflected mostly the high foreign inflows during summer, which mainly concentrated in August. Foreign currency deposits grew by about 13.4% y-o-y. Their monthly growth by about ALL 27 billion in July and August offset entirely the slight contraction of lek deposits during this period. The low creation of money in domestic currency was also reflected in the annual increase of lek deposits by about 7.5% during July and August, compared to 8.5% in the previous quarter. The continuous deposit growth increased the deposit-to-M3 ratio to 83.1% from 81.8% at end-2011.

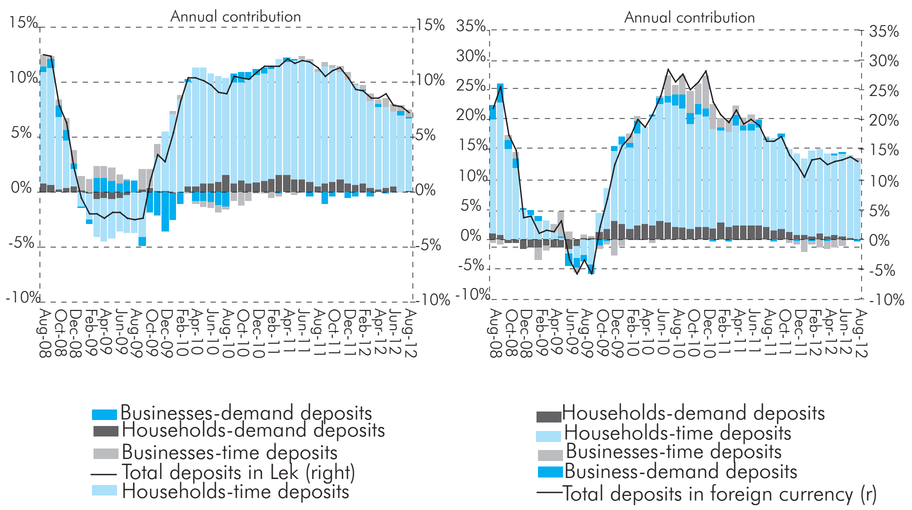
Chart 53 Annual deposits by currency and maturity



Source: Bank of Albania.

Household time deposits in lek contracted during July and August, with the contraction being sharper in August. In parallel, household investments in T-bills and bonds in the primary market grew higher during this period. Time deposits in foreign currency provided the major contribution to total deposit growth. Business deposits registered positive growth being also driven by the positive performance of exports over the period.

Chart 54 Lek and foreign currency deposits by economic agent

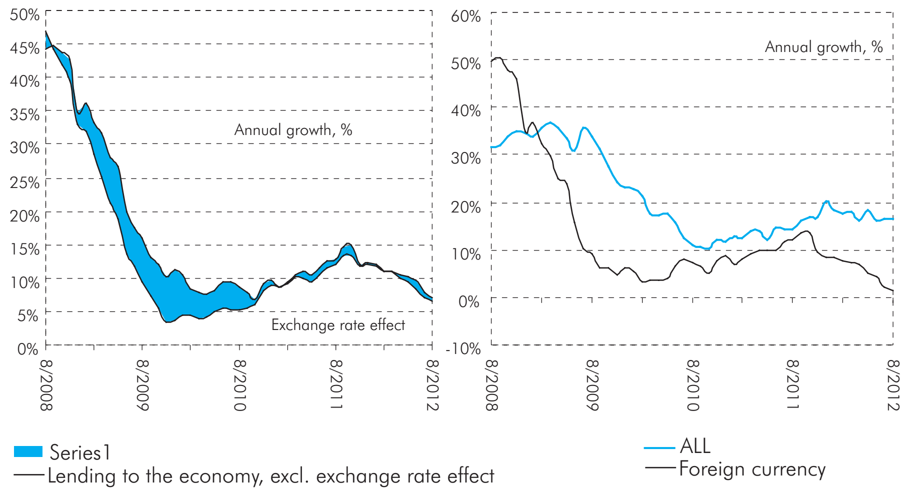


Source: Bank of Albania.

LOANS[62]

Lending to the economy showed poor performance in July and August, being manifested in its further annual growth deceleration. As at end-August, the annual growth of loans slowed to 6.5%, compared to 8.3% and 10.9% at end-Q2 and Q1. The performance of lending to the economy mainly reflects the low demand of domestic economy for goods, services and investments, and the little use of financial leverage by economic agents. Lending also continues to be affected by the cautious bank approach. Lending standards remain tight, despite their easing for certain market segments in short time periods.

Chart 55 Lending to the economy by currency



Source: Bank of Albania.

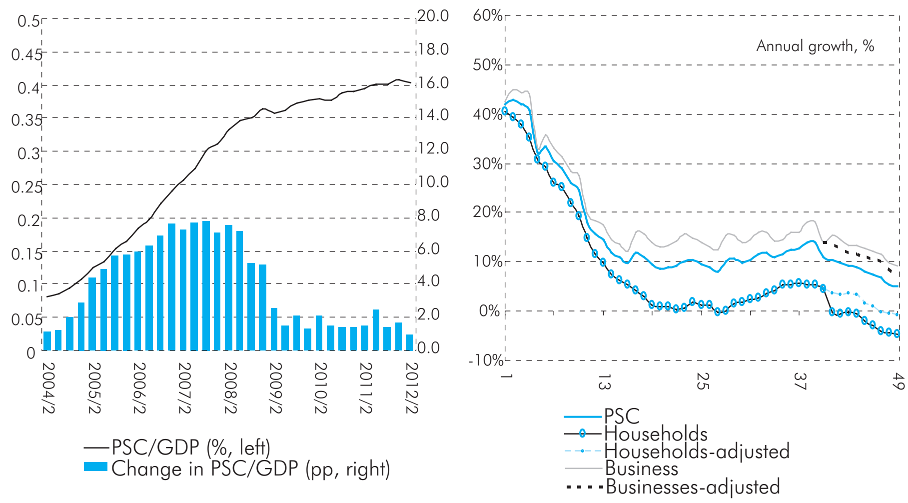
Lending in lek maintained high annual growth rates. In July and August, it grew 16.5%. Outstanding loans in lek increased by about ALL 2 billion; however, it did not offset the reduction of the foreign currency loan portfolio by about ALL 2.7 billion. The continuous contraction of foreign currency lending in the last five months reflected in the pronounced deceleration in its annual growth. As at end-August, the annual growth of foreign currency lending slowed to 1.5%, compared to 4.3% and 7.3% at end-Q2 and Q1. In addition to the continuous tendency of households to reduce their foreign currency liabilities, the sluggish performance of foreign currency lending was also determined considerably by the settlement of businesses' current foreign currency liabilities.

The annual growth of lending to the private sector maintained the decelerating trend of the previous months. In August, it settled at about 5.0%, down by 5.4 percentage points from end-2011. The continuous deceleration in the growth rates of lending over the current year was also

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

reflected in the lower credit impulse to economic activity. Private sector credit-to-GDP ratio stood at 40.4% in Q2, registering an annual change by 0.9 percentage points.

Chart 56 Private sector credit to GDP and its annual growth



Source: Bank of Albania.

Lending to private enterprises in July and August was comparably lower than in 2012 H1. After recording low growth in Q2, outstanding business loans contracted in July and August. As at end-August, its growth rate slowed to 9.2%[63] y-o-y, compared to 11.7% and 13.3% at end-Q2 and Q1.

The deceleration in business loans owes to the poor historical performance of working capital loans. After registering low positive net flows in Q1 and remaining almost unchanged in Q2, this portfolio contracted in July and August. This performance was reflected in the sharp slowdown of its annual growth rates, which at end-August stood at 8.9%, from 19.1% at end-2011.

Investment loans registered positive, albeit low, net flows, in July and August. Its annual growth slowed though to a lower degree compared to the other types of loans. As at end-August, it stood at 13.7%[64], standing close to the growth in Q2.

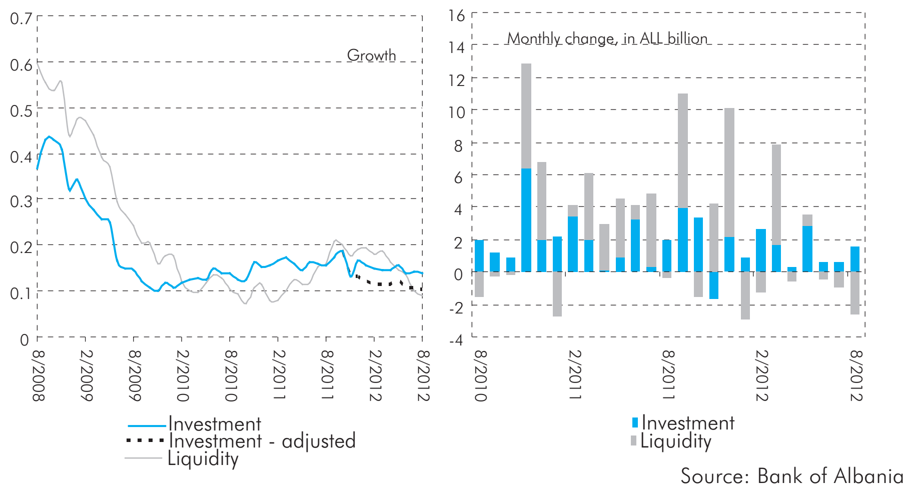
Businesses increasing borrowing from the banking sector during July and August mainly pertained to industry and other branches of services. Lending to trade, hotels and restaurants, and construction contracted. Y-o-y, as at end-August, the slowdown was more pronounced in the annual growth of lending to other services[65] (10.3%), industry (19.7%) and trade, hotels and

[63] *In December 2011, the loan portfolio of one of the reporting banks was reclassified by purpose of use. It 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. Due to this reclassification, the annual change of business loans point to a positive shift by an average of 1.7 percentage points.*

[64] *The reclassification of investment loans increased their annual change during December 2011-August 2012 by about 3.3 percentage points.*

[65] *Other services include lending to social services, financial intermediation, education, health, etc.*

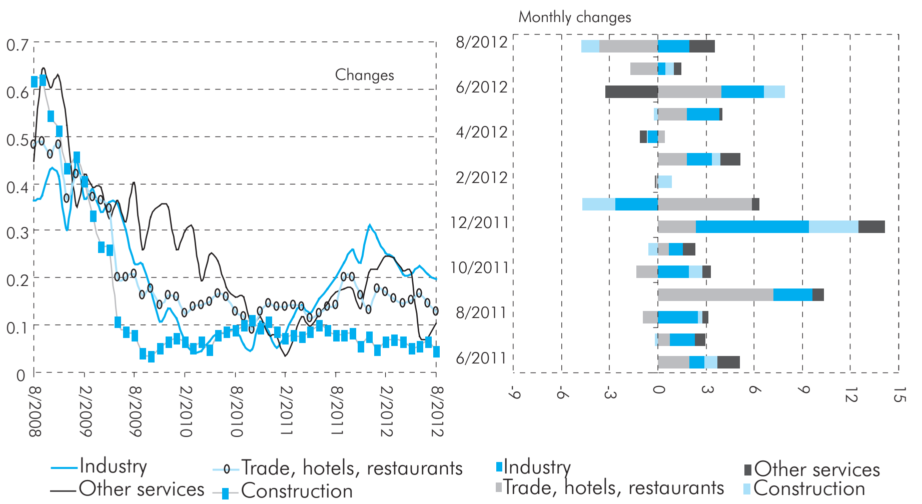
Chart 57 Business loans by purpose of use



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

restaurants (12.8%). The growth of lending to the construction sector stood at 4.6%, down by about 1 percentage points from end-Q2.

Chart 58 Business loans by sectors of economy

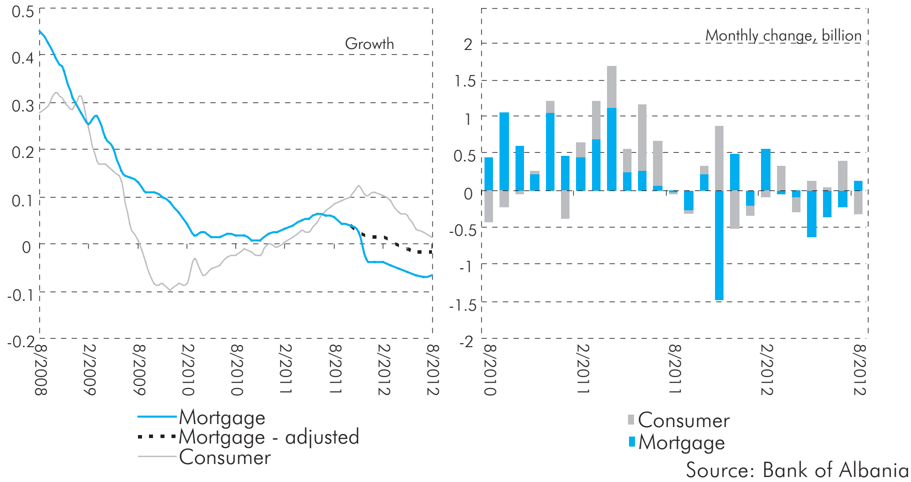


Source: Bank of Albania.

Lending to households deepened its annual contraction. As at end-August, outstanding household loans were 4.6%[66] lower than a year earlier. Although the lending standards applied to households were less tight than to businesses, lending to households suffers the lack of demand for loans, particularly of long-term maturity, more. This provides evidence for greater uncertainty in consumer behaviour.

[66] *Loan portfolio reclassification reduced the annual growth rate of household loans during December 2011-August 2012 by about 3.8 percentage points. Adjusting for this effect, the annual change in household loans slowed until May and moved into negative territory in the later months.*

Chart 59 Household loans by purpose of use



Source: Bank of Albania

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

Mortgage loans showed poorer performance than consumer loans. The first continued to contract by 6.7% y-o-y[67] in August, almost by as much as at end-Q2. Beyond their volatility, the monthly changes kept the consumer loan portfolio almost unchanged from end-2011 levels. The annual growth of consumer loans slowed further to 1.6% in August.

Box 6 Summary of Bank Lending Survey Results for 2012 Q3[68]

The lending standards applied to business loans during 2012 Q3 remained unchanged from Q1 and Q2. Banks tightened lending to businesses by size (SMEs and corporates) and purpose (working capital and investment) to the same extent. For the second consecutive quarter, banks kept the lending standards applied to consumers unchanged, both for house purchase and consumption purposes.

The main factors contributing to the tightening of business lending standards include specific business sector-related concerns, non-performing loan situation and the overall macroeconomic situation. Capital adequacy has also contributed to the tightening of lending standards in the last two quarters. The main factors contributing to the tightening of household lending standards include households' financial situation, non-performing loans and the housing market, while liquidity and competition contributed to their easing.

[68] *The survey conducted in September 2012 covers the developments in bank lending during 2012 Q3 and banks' expectations for lending in 2012 Q4. You can find a detailed analysis of Bank Lending Survey Results on www.bankofalbania.org, under Publications.*

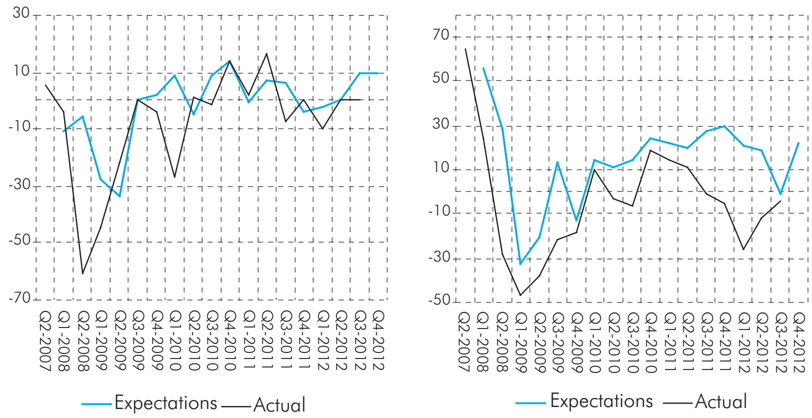
[67] *Loan portfolio reclassification reduced the annual change in mortgage loans during December 2011-August 2012 by an average of 5.1 percentage points. Adjusting for this effect, the annual growth of mortgage loans slowed significantly until March and moved into negative territory in the later months.*

Chart 60 Business lending standards and demand for loans (net balance)

Source: Bank Lending Survey, Bank of Albania.

The change in terms and conditions for the approval of new loans in Q3 reflected the tightening of business lending standards. The terms and conditions for household loans remained almost unchanged. Banks' tight lending policy was mainly applied to businesses through wider average margin, higher commissions, lower loan amount, higher collateral coverage and shorter loan maturity.

Chart 61 Household lending standards and demand for loans (net balance)



Source: Bank Lending Survey, Bank of Albania.

According to bank experts, net demand for loans fell during Q3 both from businesses and households, albeit at a lower rate than in Q2.

Banks' expectations for 2012 Q4 appear more optimistic. Lending standards are expected to ease and demand is expected to grow, both for businesses and households. Expectations improved compared to both expectations a quarter earlier and the assessment of the current situation in Q3.

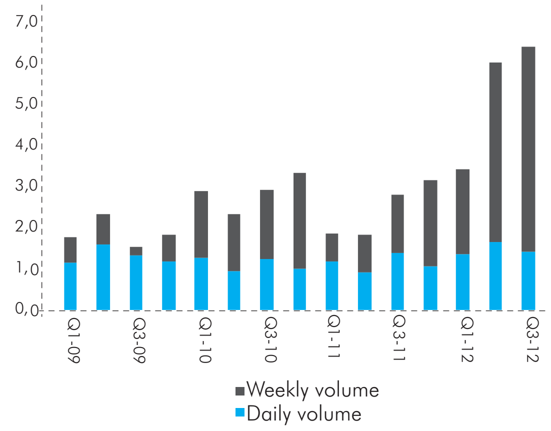
V.2 FINANCIAL MARKETS

Financial markets were liquid and interest rates were downward in 2012 Q3. Bank trading volume in the interbank market increased and the maturities diversified, thus suggesting its more efficient management by the market participants. Yields on public debt instruments, whose premiums increased markedly a quarter earlier, decreased in the primary market. The latter's restructuring facilitated the transmission of monetary policy signals and is expected to reflect in other related segments. Average interest rates on lek loans were lower in Q3. The transmission of easing signals into this market remains, however, weak and the lending standards remain tight.

INTERBANK MARKET

One-week interbank rates dropped slightly while overnight rates showed a rising tendency in Q3. Bank trading volume increased and transactions extended to other maturities rarely used in the previous periods. The overall liquidity level was higher, thus creating favourable conditions to improve the interbank market agents' activity and favouring the increase in free funds' trading. At the end of July, the Bank of Albania cut the key interest rate by 0.25 percentage points to 4.00%. In line with the monetary policy signal, interbank rates dropped further in August. Interest rates were generally downward in the first two months of Q3 for both maturities used by banks. In September, interest rates in the money market increased. The volume of borrowing in the interbank market increased progressively over the months. In addition to the positive seasonal effect, its performance reflected a more active bank approach to this segment in order to meet the short-term needs for liquidity. One-week maturity continues to have the main share in total transaction volume, while worth noting is also the increase in the number of transactions with a maturity different from overnight or one-week.

Chart 62 Average quarterly transaction volume in the interbank market for overnight and one-week maturity (in ALL billion)



Source: Bank of Albania.

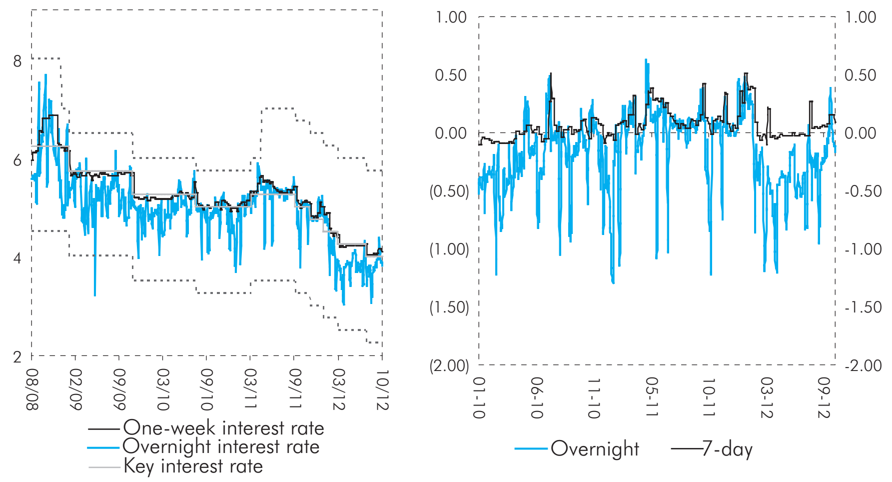
The Bank of Albania continued to conduct regular open market operations by injecting liquidity of one-week maturity. The liquidity injected into the system was slightly higher than in the previous periods. The central bank also employed reverse repos of 1- and 3-month maturity.

Overnight rates mainly dropped in July and August. On the other hand, they were continuously below the Bank of Albania's key policy rate. Overall, they showed similar fluctuation[69] to the previous quarter, while the spread between the overnight interest rate in the money market and the key

[69] The standard deviation of the overnight interbank rate was 0.231 in Q3 compared to 0.226 in Q1.

interest rate has narrowed[70]. In Q3, overnight interest rate averaged 3.80%, 0.02 percentage points higher than in Q2. One-week interest rate dropped to 4.13% from 4.24%. The average volume of overnight transactions fell by ALL 0.23 billion to ALL 1.42 billion, while that of one-week transactions increased by ALL 0.61 billion to ALL 5.00 billion. The trading volume totalled ALL 7.97 billion in Q3, reflecting the increase in weekly and monthly borrowing and the presence of some 2 or 3-day transactions.

Chart 63 Interbank market rates (left) and spread between them and the key rate (right)



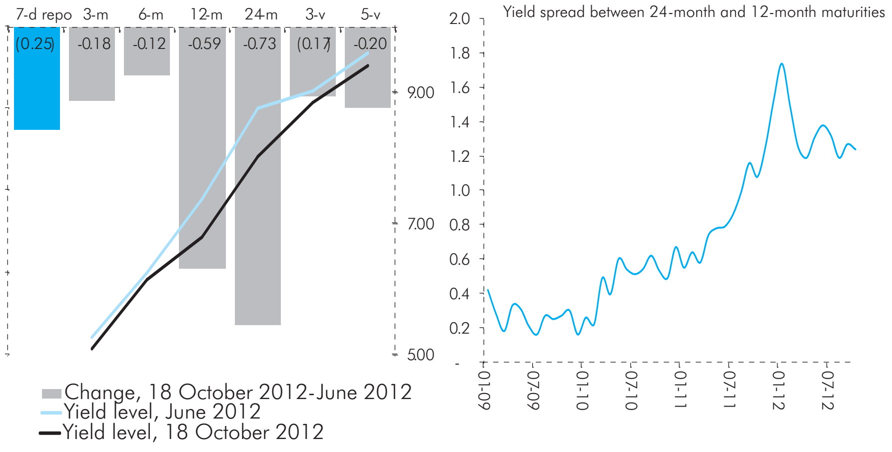
Source: Bank of Albania.

PRIMARY MARKET

The third quarter of 2012 marked a turning point in the yield performance. Starting in end-July, they maintained a continuous falling trend for all maturities. This performance attributed to the structural adjustment of banks' positions and the low government demand for borrowing in the market, which facilitated the transmission of the stimulating monetary policy into the primary market in Q3. The key interest rate cut in the Bank of Albania's Supervisory Council meeting of 25 July reflected instantly in the following 12-month T-bill auctions. Yields' correction in Q3 was more evident in instruments with a maturity of longer than one year, whose premiums had increased considerably a quarter earlier. The consolidating fiscal policy trend seems to have lowered agents' perceived risk. The easier conditions in the government securities' investment market are expected to be channelled into other investment segments as well, since this market is often used as a reference.

70 *The spread between the overnight rate and the key rate averaged 32 basis points in Q3 compared to 47 basis points in Q2.*

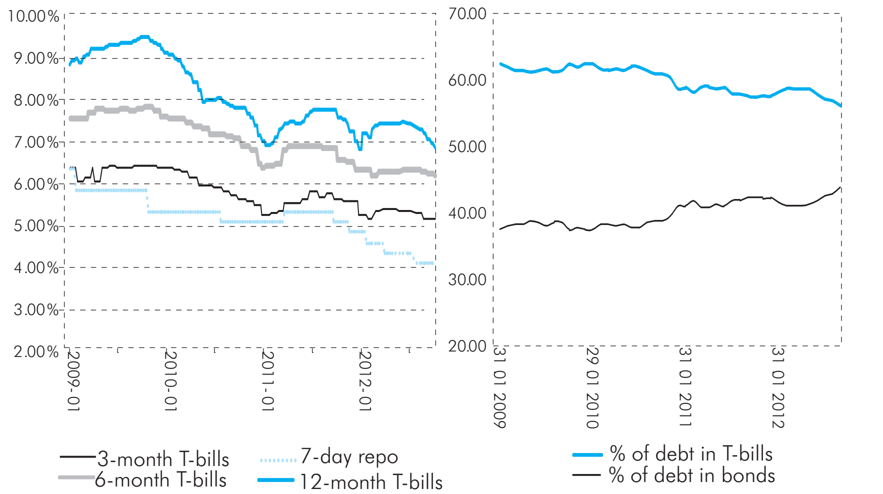
Chart 64 Change in yields and their level (left) and spread between maturities (right)



Source: Bank of Albania.

Average 12-month T-bill yield dropped to 6.78% in the second week of October, down by 0.59 percentage points from June[71]. The ratio between demand to invest in this instrument and the amount of T-bills to be auctioned was relatively high (1.51 in Q3 from 1.11 in Q2). Auctions of instruments with other maturities showed a similar trend, confirming the low liquidity pressures that supported the drop in yields. In addition, the considerably higher participation of individuals in investing in government securities (from 14.1% in early 2012 to 19.1% in September) facilitated the operation of the primary market and the improvement of indicators.

Chart 65 Government security yields in the primary market (left) and domestic debt maturity structure (right)



Source: Bank of Albania.

[71] The latest data on primary market developments are as of 18 October 2012.

In Q3, the Government was financed through long-term instruments (bonds). In October, 2-year bond yields dropped to 8.02% from the relatively high figure of 8.75% at end-Q2. The ask premium on longer-term instruments dropped along the same line. In May, the variable rate 5-year bond dropped to 2.08 percentage points in August from 2.25 percentage points in May.

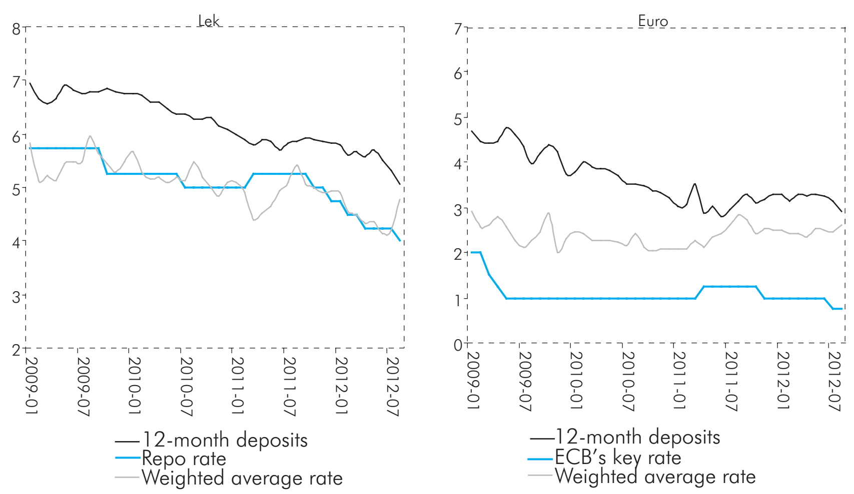
Two auctions for the issue of new euro-denominated T-bills were held in July and August. Despite being a new instrument, participation in auctions was quite satisfactory, being considered an alternative mean of investing households' savings in foreign currency. It is also worth noting that the issue of this instrument did not generate any pressures in the foreign exchange market.

INTEREST RATES ON NEW DEPOSITS AND LOANS[72]

Interest rates on deposits generally maintained a downward tendency, both in lek and foreign currency. The latter are ever-increasingly converging toward the deposit rates applied in the euro area, albeit still remaining slightly higher. The drop in lek deposit rates followed the monetary conditions easing signals and the lower borrowing cost in the interbank market. The weighted average interest rate on 12-month deposits (which have the main share in total deposits) dropped to 5.06% in August or 0.44 percentage points below June. The interest rate on 1-month deposits was relatively high in August, at 4.33% compared to 3.31% in June, which, however, seems to have been driven by the short-term offers during summer.

Euro deposit rates dropped during the quarter similar to their performance in the international markets. Average interest rate on 12-month euro deposits was 3.03% in July and August, down by 0.24 percentage points from Q2. Despite the lower interest rate, new euro deposits increased considerably during summer.

Chart 66 Interest rates on new lek (left) and euro (right) deposits



Source: Bank of Albania.

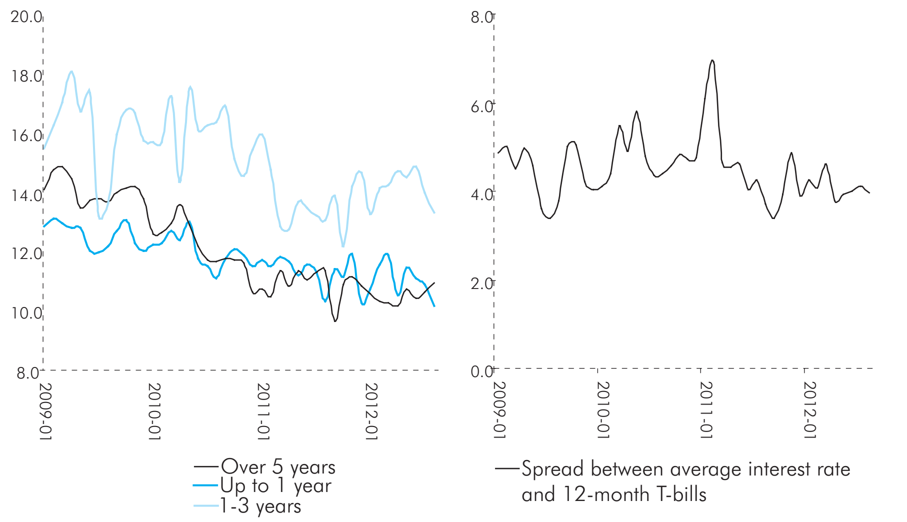
72 *The latest official data on deposit and loan interest rates are as of August 2012.*

Lending in domestic currency remains tight, being also expressed in the maintenance of spreads between loan rates and the reference rates[73]. Loan rate performance was conditioned by the fall of demand for loans, added bank prudence and the impact of the share of preferential bank clients at a time when new credit flows are low.

Interest rates on lek loans showed dissimilar trends by maturities in Q3. Short-term (up to one year) interest rates dropped on average to 10.53% in July and August from 11.15% in Q2, while long-term (over five years) ones rose to 10.79% from 10.60%. This performance also reflects the structure of new loans, which sees a dominating position of short-term business loans for working capital purposes and increasing risk premiums for long-term projects.

Lek loan rates were also conditioned by the level of government security yields they are indexed to.

Chart 67 Interest rates on new lek loans

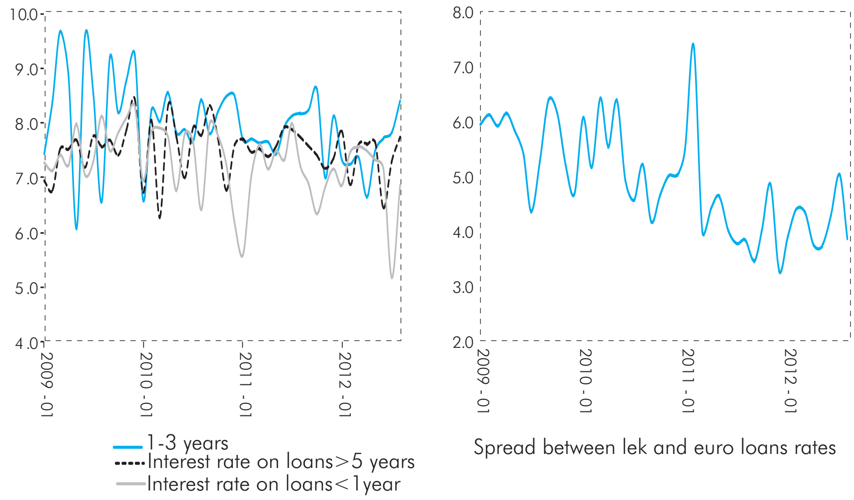


Source: Bank of Albania.

Despite the sharp drop in reference rates in the international market, interest rates on euro loans in the domestic market responded sluggishly and reflected higher margins for all maturities in this segment. In addition, the growth rate of lending in euro slowed considerably and the interest rates have been markedly influenced by certain loans, hence showing volatility. Consequently, the spread between lek and euro loan rates has been narrowing. In August, it pointed to 3.94 percentage points from an average of 4.29 percentage points in early 2012.

[73] *Bank Lending Survey for 2012 Q3.*

Chart 68 Interest rates on new euro loans

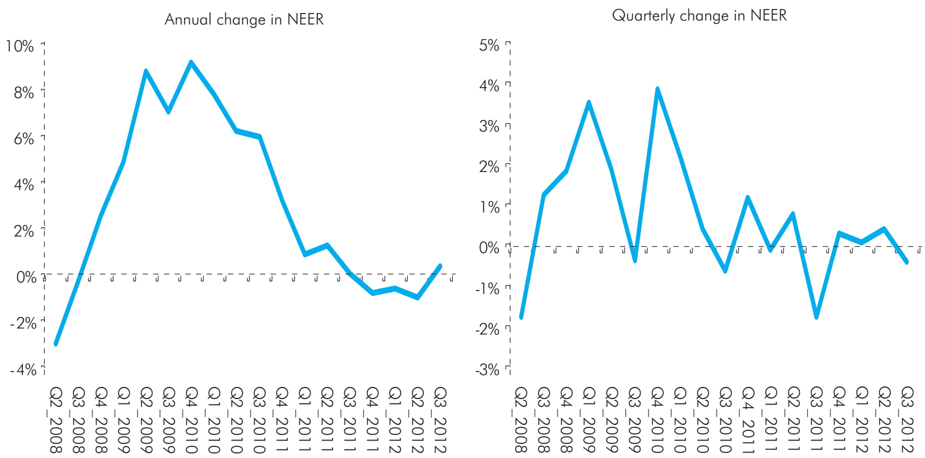


Source: Bank of Albania.

Exchange rate

The nominal effective exchange rate remained relatively stable in 2012 Q3. After appreciating slightly in H1, the annual changes in lek's NEER[74] remained almost unchanged during the period under review (up by only 0.4% y-o-y and down by about 0.4% q-o-q). The stable NEER seems to combine lek's appreciation against the euro and its depreciation against the U.S. dollar in the international markets. The narrowing net export deficit and the improved services account[75], along with the foreign inflows characterizing July and August, continued to contribute to the strengthening of lek's position against the euro.

Chart 69 Lek's annual and quarterly changes in NEER terms



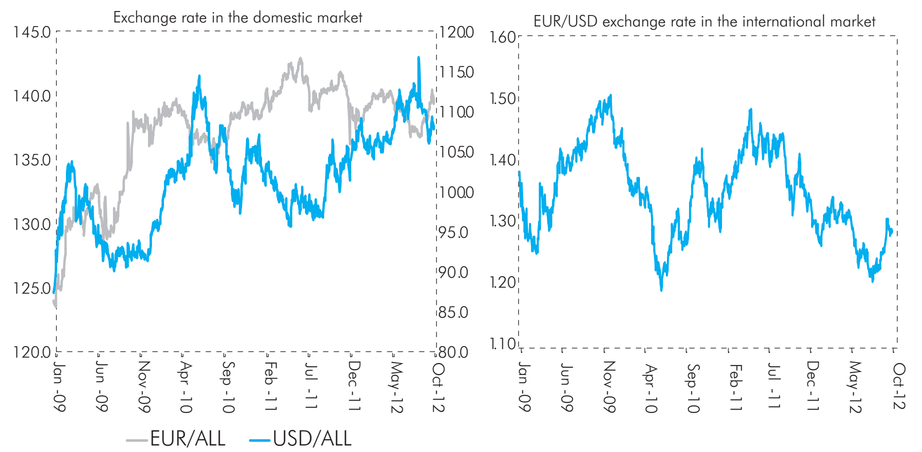
Source: Bank of Albania.

74 NEER - Nominal Effective Exchange Rate, as measured against the currencies of Albania's main trading partners, namely Italy, Greece, Germany, Turkey and China. Higher NEER implies the depreciation of lek.

75 The latest data refer to the balance of payments for 2012 Q2.

Individual developments in the three major currencies in the foreign exchange market show the significant depreciation of the lek against the U.S. dollar (11.3%) and its appreciation against the euro (1.6%) in Q3 compared to the same period in 2011. A similar dynamics is also reflected in quarterly terms. The lek appreciated slightly against the euro by about 1.0% from the past quarter's average, while losing ground against the U.S. dollar by nearly 1.6%.

Chart 70 Daily EUR/ALL, USD/ALL and EUR/USD

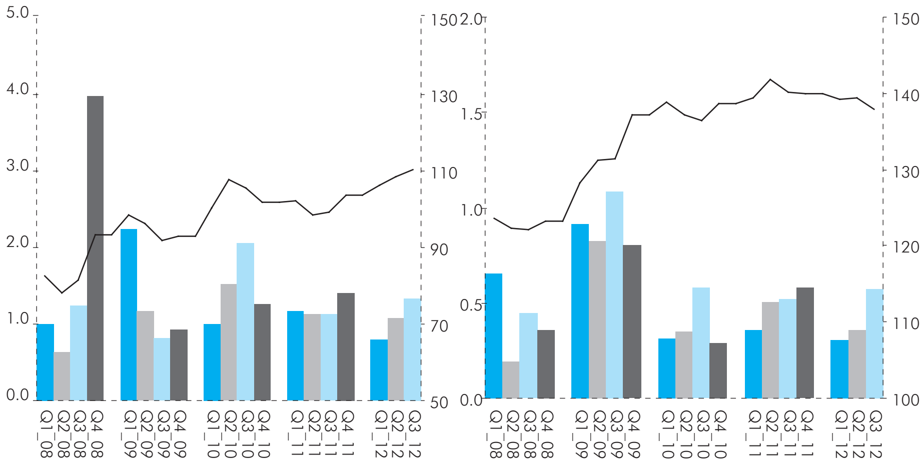


Source: Bank of Albania.

The economic and financial uncertainties facing some euro area countries and their effects on the dynamics of euro/U.S. dollar exchange rate were also passed through to the domestic foreign exchange market. Summer's seasonal effect peaked in the exchange of the euro against the lek for 136.8, the lowest in the last two years. The end of summer was associated with the depreciation of the lek against the major currencies traded in Albania. At the end of the first week of September, one euro exchanged for ALL 138.0. It rose continuously until the last but one day of the month when one euro exchanged for ALL 140.4 driven also by the high demand at end-Q3 and the expectations for the short-term depreciation of the lek during this period. Euro's appreciation was coupled with the increase in market agents' supply with foreign currency, thus favouring the Albanian lek in early October.

The above mentioned developments are also confirmed by euro's volatility against lek, which appeared higher than in Q2.

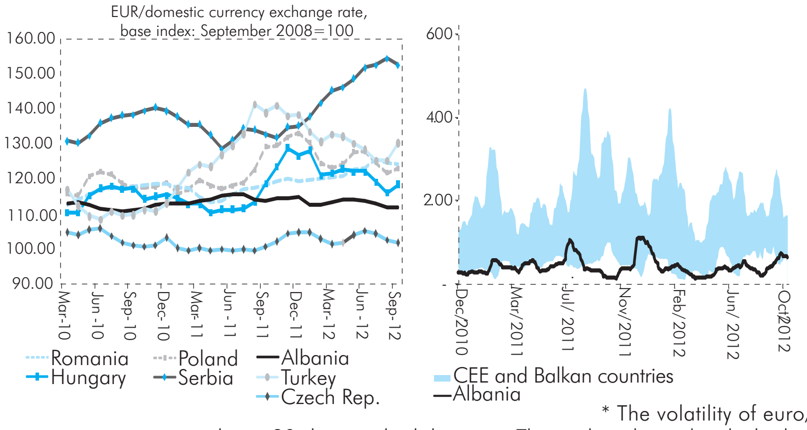
Chart 71 USD/ALL and EUR/ALL quarterly volatility



Source: Bank of Albania.

In a regional context, lek's exchange rate against the euro appears far more stable than that of CEE and Balkan countries' domestic currencies. In quarterly terms, except for Serbia and Romania, the currencies of other CEE and Balkan countries appreciated against the euro in the recent months. In the chart, lek's volatility stands in the lower limit of the range of values showing the euro/domestic currency volatility.

Chart 72 Euro/lek exchange rate (base month: October 2008) and volatility compared to CEE and Balkan countries' domestic currencies*

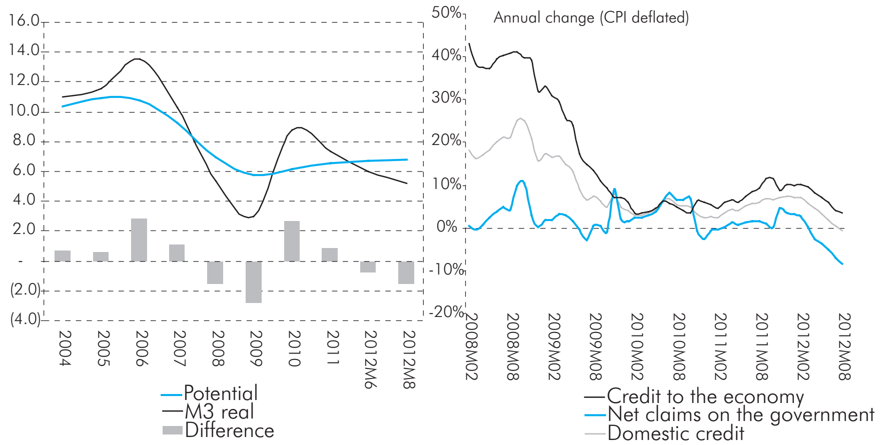


* The volatility of euro/domestic currency is measured as a 30-day standard deviation. The peak and trough volatility levels in each period represent the maximum and minimum standard deviation of selected exchange rates. The selected countries include Poland, Czech Republic, Hungary, Romania, Turkey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

V.3 ASSESSMENT OF FINANCIAL INFLATIONARY PRESSURES

Monetary developments as at August 2012 provide evidence for the considerable deceleration in M3's annual real growth rate to 5.2% from 7.7% and 6% in Q1 and Q2. On the one hand, this deceleration has reflected the placement of household savings with the securities market, hence giving rise to a lower growth of lek deposits in the system, and on the other hand, it has reflected the low domestic economy demand for money and the positive developments in the foreign currency component. The latter shows increased household wealth, which may potentially be used in the future to boost consumption. In the short run, its impact on inflation is, however, low. Domestic credit - a monetary indicator directly related to economic agents' demand for money - contracted in real terms by 0.5% in August compared to a year earlier. The contraction of domestic credit in real terms is a rather new phenomenon driven by the low fiscal sector financing by banks and the sluggish bank lending.

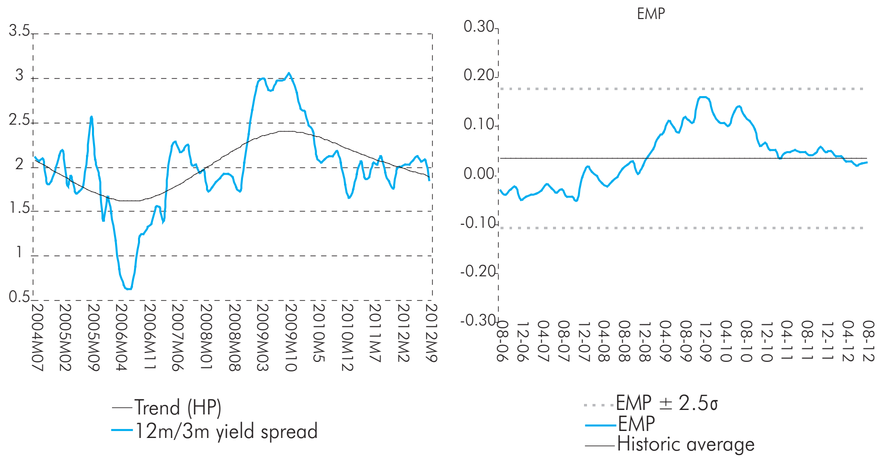
Chart 73 Money gap and domestic credit*



*Money gap is measured as the difference between real M3 growth and its potential level generated through HP-filter.
Source: Bank of Albania.

The spread between 12-month and 3-month yield fell close to historical lows, evidencing that financial market developments show low materialization of inflationary pressures in financial product prices. The foreign exchange market also appears relaxed and does not signal any inflationary pressures on consumer prices. A stable foreign exchange market contributes to further safeguarding Albania's financial stability and eventually maintain price stability in the medium run.

Chart 74 Yield spread and exchange market pressure



Source: Bank of Albania.