Bank of Albania

MONETARY POLICY REPORT
2012 Q4

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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 supporting the financial stability are some of the benefits provided by an economic environment characterized by stable prices. This stability is the greatest contribution of the central bank to sustain a stable and long-term economic growth.

In line with its approved Monetary Policy Document 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 premia.

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

The Monetary Policy Report for the fourth quarter of 2012 refers to the Monetary Policy Statement of the Bank of Albania for the second half of 2012, approved by the Supervisory Council of the Bank of Albania on 30 January 2013. The economic analysis in this Report is based on the latest available statistical data as at 18 January 2013.

I. FOREWORD BY THE GOVERNOR

The Albanian economy improved slightly in the second half of 2012, driven by a fuller reflection of monetary stimulus and improved external economic and financial environment. However, the economic activity remains below potential and the growth sources appear unstable. The growth of output is not reflected in lower overall uncertainties, which contain private investments and consumption, and lead to downward credit demand and supply. The banking system maintains sound and liquid balance sheets but remains highly prudent in terms of financing long-term investments. These tendencies will condition the economic developments over the period ahead.

Inflationary pressures were low during the last quarters. Reflecting also the Bank of Albania's prudential monetary policy, inflation remained within its target in 2012. Consumer prices rose 2.4% annually, while annual inflation rate averaged 2%. The inflation rate increased progressively during the first three quarters and fell slightly in the fourth quarter.

Inflation volatility was mainly driven by food prices, which were subject to international market developments and performance of domestic production. The effect of other basket goods' prices on inflation was low and slightly volatile. Regulated or administered price inflation was insignificant, while higher prices for consumer goods, oil and primary commodities in the global market did not yield higher inflation in the Albanian economy.

From the macroeconomic viewpoint, all inflation determinants contributed to keeping it low. The incomplete utilisation of productive capacities was associated with businesses' low demand for labour, hence exerting no pressure for higher wages and labour costs. In addition, the weak demand for goods and services reduced businesses' ability to determine final product prices and led to low profit margins. On the other hand, the low rise in global prices and stable exchange rate contributed to containing import prices. Expectations for low inflation in the medium run were reflected in stable costs, prices and interest rates in medium and long-term contracts concluded in the labour market, consumer goods and financial instruments.

According to data from INSTAT, the Albanian economy grew by 2.7% in 2012 Q3 and similar growth rates are also expected for Q4. Growth was driven by services, industry and agriculture sectors, while the construction sector continues to contract.

The performance of aggregate demand components during Q3 and Q4 confirms, to a great extent, the previous periods' trends. External demand was the main driver of economic growth in Albania. Net export deficit narrowed in Q3 mainly due to higher exports of goods and services. The data on Q4 provide evidence for the continuation of this trend. In October and November, exports grew by 14.3%, while imports fell by 5% on a year earlier. As a consequence, trade deficit dropped by 15.5%, y-o-y. On the other hand, domestic demand remained sluggish due to lack of fiscal stimulus and poor performance of consumption and private investments.

Indirect available data show improved consumption in Q3 but low private investments due to incomplete utilisation of productive capacities, uncertainties about the future and tighter lending standards. Fiscal indicators have reflected the overall performance of the economy and the consolidating fiscal policy pursued in 2012. Budget revenue and spending registered slow increase, while budget deficit contracted. Fiscal revenue for the first 11 months of the year increased by 2.0% annually, reflecting the low contribution of related taxable component. Public spending increased by 0.9% annually, reflecting, to a large extent, the negative growth rates of capital spending. As a result, budget deficit dropped 8%, y-o-y.

The last quarter of 2012 evidenced a better pass-through of monetary stimulus into the financial markets. It also showed better anchoring of interbank rates and their lower volatility. The Bank of Albania has pursued an accommodative monetary policy during the last three years. Monetary stimulus has increased progressively during this period, bringing the key interest rate to record low and relaxing the liquidity pressures in the interbank market.

However, the pass-through of easing monetary policy effects into the economy has been contained by the higher perceived risk premium and altered behaviour of financial market agents and the real economy. Over the first half of the year, the Albanian primary market faced structural changes arising from the enforcement of new austerity measures by the European supervisory authorities. This led to relatively high yield rates, despite the easing monetary policy and lower short-term interest rates in the money market. The normalisation of the primary market in the second half of the year was reflected in progressively falling yields over this period. This tendency seems to have also been passed through into the cost of lek-denominated credit to the private sector, though at lower intensity due to the risk premium reflected in private agents' loan price. Overall, the contained public sector borrowing in the domestic money market, the expanded base of investors in Government securities and the stable risk premium in the economy provide room for better functioning of transmission channels in the future. The Bank of Albania, therefore, believes that long-term public debt sustainability and contained public borrowing in the domestic money market help enhance the efficiency of monetary policy and boost lending to the private sector of the economy.

The growth rates of monetary indicators decelerated in the second half of the year, signalling low monetary inflation pressures on the economy. In October and November, money supply growth averaged 5.9% annually, driven primarily by developments in the external sector of the economy. Demand for money from domestic economic agents was low. The higher households' participation in public debt securities was reflected in lower financing of this sector by the banking system. Business and household demand for borrowing decelerated markedly as a reflection of the low demand for consumption and investment. In addition, banks continued to maintain a more cautious approach to lending, applying tight standards in response to the perceived uncertainties at sector and economy level. Consequently, lending to the economy recorded an annual growth of 4% in November. The growth of lending to the economy was triggered by the increase in lek loans by 18%, while foreign currency loans fell by 3.2%. Credit growth continues to be driven by the higher business loans, while consumer and mortgage loans appeared rather low.

The so-far economic activity performance and projections for 2013 support the outlook for positive economic growth close to the previous year's figure. External demand is expected to maintain its positive contribution to Albania's economic growth, although it is expected to be lower due to unfavourable developments in Albania's trading partners and the relatively low diversification of Albanian exports. Private demand is also expected to be positive, taking advantage of the higher monetary stimulus and use of domestic savings. The public sector is also expected to provide positive stimulus to economic growth. Despite the positive growth, economic activity in Albania is expected to remain below its potential and demand-side inflationary pressures are expected to remain low during the current year. The Bank of Albania considers that after four quarters, with a 90% probability, annual inflation will fluctuate within a band of 0.8%-3.8%. The low annual inflation rates and forecast for their continuation over the monetary policy-relevant horizon call for maintaining and strengthening the stimulating monetary policy over the next four quarters.

Considering the information summarised above, the Supervisory Council of the Bank of Albania decided to lower the key interest rate by 0.25 percentage points to 3.75%[1]. This decision aims to create appropriate monetary conditions to meet the medium-term inflation target. The easing of monetary conditions keeps the short-term financial market rates low, hence boosting the activity and lowering the related liquidity trading premia. By lowering the cost of financing, the Bank of Albania aims to increase consumer loans and investments in the economy. This transmission mechanism boosts aggregate demand and, under the current circumstances, creates more appropriate conditions for meeting the medium-term inflation target.

[1] *Bank of Albania Supervisory Coucil's decision No.08, of 30 January 2013.*

II. EXTERNAL ECONOMY

Global economy continued to record moderate growth rates in 2012. Its performance was not uniform across the regions and there were factors of uncertainty prevailing in the economies. Euro area's economy in particular registered negative growth rates in Q3 and the outlook for the period ahead does not show positive signals. Global inflation rates showed a declining trend over the past months, mainly due to the performance of oil and energy prices. Inflationary pressures were contained both in the short and medium-term period. Financial markets underwent declining interest rates and a lower perceived risk. Central banks kept their monetary policy stance unchanged and reaffirmed their commitment to stabilizing the markets.

II.1 ECONOMIC GROWTH AND INFLATION

Global economy showed low growth, despite remaining in positive territory. Tensions in financial markets and euro zone's two-year-old debt crisis constrained economic performance and fuelled uncertainty about the medium-term outlook. Governments and private agents' little room for expansion due to their frail accounts position hampered the recovery of consumption and investment.

Inflation showed a downward trend in Q4, owing mainly to the performance of energy prices. After registering a temporary rise in mid-2012, energy prices maintained a declining path in the following months of the year. Inflationary pressures were contained in most economies, reflecting the lower contribution of primary commodity and energy prices and abating demand-side pressures.

Table 1 Selected macroeconomic indicators

Countries	GDP change	Unemployment rate		Inflation rate	
	2012 Q3/2012 Q2	2012 Q3/2011 Q3	November 2012	December 2012/ November 2012	December 2012/ December 2011
United States	0.7	2.5	7.8[1]	-0.3	1.7
Euro area	-0.1	-0.6	11.8	0.4	2.2
Germany	0.2	0.9	5.4	0.9	2.0
France	0.2	0.1	10.5	0.4	1.5
United Kingdom	1.0	-0.1	7.8[2]	0.5	2.7
Japan	-0.9	0.2	4.1	-0.2[3]	-0.4[3]

Source: ECB, Fed, Eurostat and respective statistical institutes.

[1] December 2012.

[2] July-September 2012.

[3] November 2012.

Business and consumer confidence indices and the overall purchase index of the last months of the year showed positive figures, above agents' expectations, hence providing evidence for an improved global economic growth in the last quarter.

EURO AREA ECONOMY

According to data published by Eurostat, euro area's GDP contracted in 2012 Q3. Negative growth rates were registered both q-o-q (-0.1%) and y-o-y (-0.6%). This performance was mostly driven by lower consumption, investment and poor net exports. The latest indices, such a retail sales index, new car registrations, industrial production and non-residential fixed investment, albeit more stable than in 2012 Q3, suggest poor consumption and growth in Q4. The gradual improvement of external demand and recovery of consumption and manufacturing industries are expected to provide modest contribution to GDP in the future. ECB's last year projections and EC's half-yearly projections for growth in 2012 and 2013 were revised down, hence shifting the economy's return to positive territory in the second half of 2013 and recovery in 2014. Inflation was downward and its annual rates averaged 2.3% in 2012 Q4 compared to 2.5% in Q3. Medium-term inflation expectations were anchored around ECB's target. Inflationary pressures were contained against a background of low pressures from the economy and falling energy prices. Unemployment rate continued to increase to 11.8% in November, from 11.7% in October and 10.6% a year earlier.

UNITED STATES ECONOMY

United States economy grew 2.6% in 2012 Q3, driven mainly by government spending, which registered a positive quarterly growth rate after two years of negative growth. The higher private spending, exports and private investment were other driving factors of economic growth. The decline in non-residential investment and increase in imports provided negative contribution. Annual inflation decreased to 1.7% in December.

Indirect data on Q4 suggest moderate growth owing to climate-related concerns in North-eastern states during November, uncertainties about fiscal policies in December and expectations for lower government spending impulse. On the other hand, house prices and sales went up, industrial production maintained a rising tendency and unemployment remained steady at 7.8% in December. The economy is projected to maintain a similar path in the quarters ahead and register a moderate growth of about 2.0%[2] in 2013.

[2] *IMF, October 2012.*

ECONOMIES IN THE REGION[3]

The Italian economy remained in recession in Q3, registering an annual change of -2.4%. Consumer spending and investments contracted significantly, hence overshadowing the positive effect of net exports. The Italian economy is expected to continue to contract in 2013, but at a more subdued pace. Annual inflation marked 2.6% in December, similar to a month earlier. Unemployment maintained the recent months' rising trend, reaching 11.1% in November.

The Greek economy continued to deteriorate in 2012 Q3, contracting 7.2% y-o-y. Investment and consumer spending remained subdued. According to EC, the Greek economy is expected to contract 4.2% in 2013. Annual inflation marked 0.3% in December, slightly lower than a month earlier, while unemployment maintained the recent years' rising trend, reaching 26.8% in October.

Turkey's GDP slowed its annual growth rates to 1.6% in 2012 Q3, driven by the sharp decline in investment and poor consumer spending. This performance was slightly offset by the increase in government spending, while the contribution of foreign trade was almost neutral. Preliminary data suggest an increase in consumer spending in 2012 Q4, while GDP growth is forecast to range between 2.5%-3.0% in 2013. Annual inflation decreased to 6.8% in December, while unemployment rate rose to 8.8% in Q4.

After contracting for two consecutive quarters, FYROM's GDP grew 0.2% on an annualised bases, in 2012 Q3. Positive performance of investment and lower imports seem to have offset the poor performance of consumer spending, industrial production and exports. GDP is forecast to grow about 1.7% in 2013. Inflation picked up slightly to 4.7% in December, while unemployment fell to 30.6% in Q3.

Short-term indirect data suggest that Kosovo's growth rates are slightly lower. The IMF projects real GDP to grow 3.8% in 2012 and 4.1% in 2013. Kosovo's growth has been driven by remittances and government investments. Inflation increased to 3.7% in December, marking higher rates than in the previous quarter.

[3] *Growth projections for Italy, Greece, Turkey and FYROM in 2013 have been obtained from DG Ecfin, European Commission, Autumn 2012.*

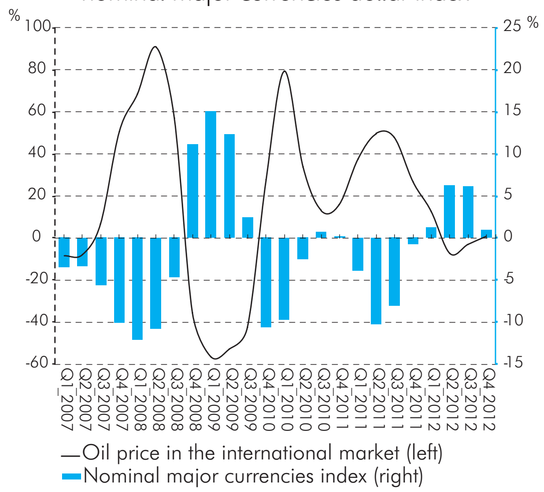
Table 2 Economic figures for countries in the region

Countries	GDP change	Annual inflation	Unemployment rate
	2012 Q3/2011 Q3	December 2012	October 2012
Italy	-2.4	2.6	11.1[1]
Greece	-7.2	0.3	26.8
FYROM	0.2	4.7	30.6[2]
Serbia	-2.5	12.2	22.4
Croatia	-1.9	4.7	20.4[1]
Turkey	1.6	6.2	9.1
Kosovo	4.5 (2011)	3.7	:
Albania	2.7	2.5	13.3[2]

Source: Respective statistical institutes, IMF, EcFin, Eurostat.
[1] November 2012.
[2] 2012 Q3.
: Unavailable data.

II.2 PRIMARY COMMODITY PRICES

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

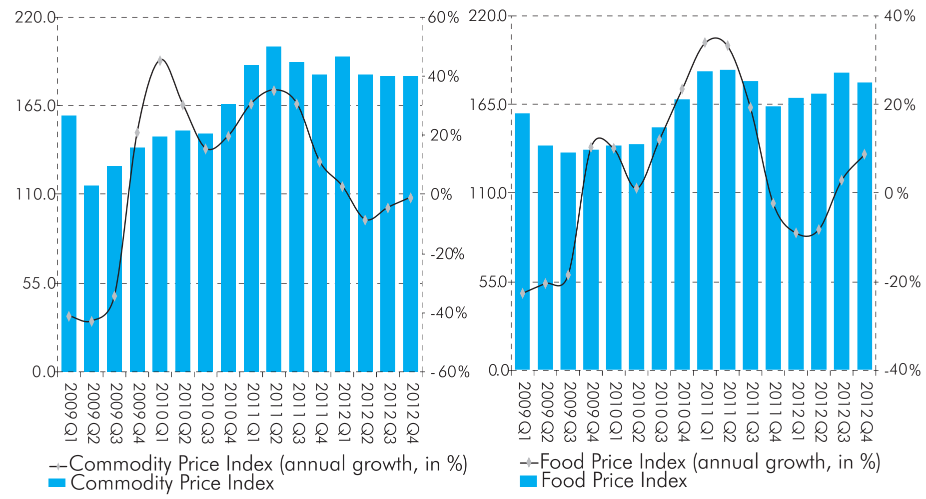


Source: Fed, EIA.

Average oil price per barrel in the international market rose by 0.6% on an annualized basis in 2012 Q4. According to the Brent Index, the price of a barrel of oil reached an average of USD 110.1, or 0.43% higher than in Q3. Geo-political tensions in the Middle East and production-related concerns in the North Sea restrained oil supply during October-December. On the other hand, the higher production in North America and Russia drove global supply higher in the last quarter of 2012. Demand for oil grew higher due to the low temperatures and higher consumption in the Chinese transportation sector.

EIA (Energy Information Administration) expects global demand for oil to grow by an average of 1 million barrels per day in 2013, driven by the economic growth of China, India and USA, and the recovery of euro area countries. However, the higher growth of oil supply resulting from the surge in oil production capacity in North America and Iraq is expected to lower its price in the months ahead.

Chart 2 Global prices by primary commodities



Source: IMF.

Commodity Price Index[4] narrowed by nearly 1.2% in 2012 Q4, though at lower annual rates. Within this Index, Food Price Index rose 8.7% on average, reflecting mainly the low comparative base of 2011 Q4, as a consequence of the euro area crisis escalation and contraction in the Chinese aggregate demand.

The rising tendency of grain prices since 2012 Q3 is expected to continue until the end of 2013 Q2, to be later followed by their fall in the second half of the year and in 2014[5]. This dynamic reflects the more buoyant crop prospects than in the previous season and a more contained increase in ethanol production. Wheat exporting countries are expected to reduce the trading volume due to high reserves of importing countries and contracted demand for wheat destined for food.

Metal prices are expected to rise moderately in 2013, in line with the projections for bolstered global demand following the measures to boost the European, Chinese and U.S. economies. While the trading price of metals like iron and nickel is expected to be 1.2% and 2.6% higher than in 2012, the price of copper is expected to fall due to a lower demand and higher use of its substitutes. Despite the uncertainties affecting the future performance of supply and demand for commodities, the improvement of global growth is expected to provide substantial contribution to the stability of primary commodity markets during 2013.

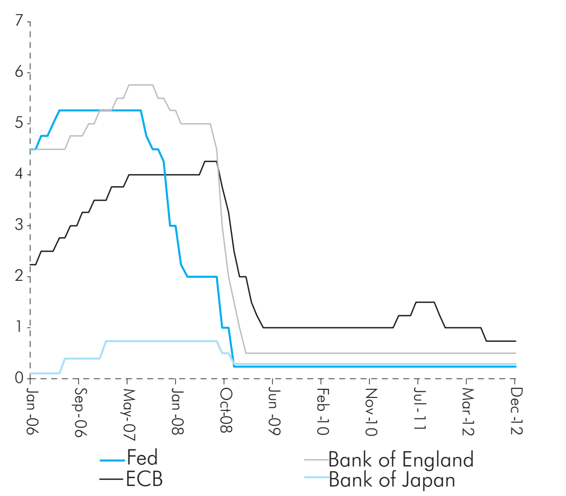
[4] Commodity Price Index is measured as the weighted average price of 51 primary commodities classified into three groups: energy, industrial goods (mainly metals) and foods. This index is published by the IMF on a monthly basis.

[5] FAO, Food Outlook, November 2012.

II.3 MONETARY POLICY AND FINANCIAL MARKETS

The major central banks kept their key policy rates unchanged: European Central Bank at 0.75%, Federal Reserve at 0-0.25%, Bank of England at 0.5%, and Bank of Japan at 0-0.1%.

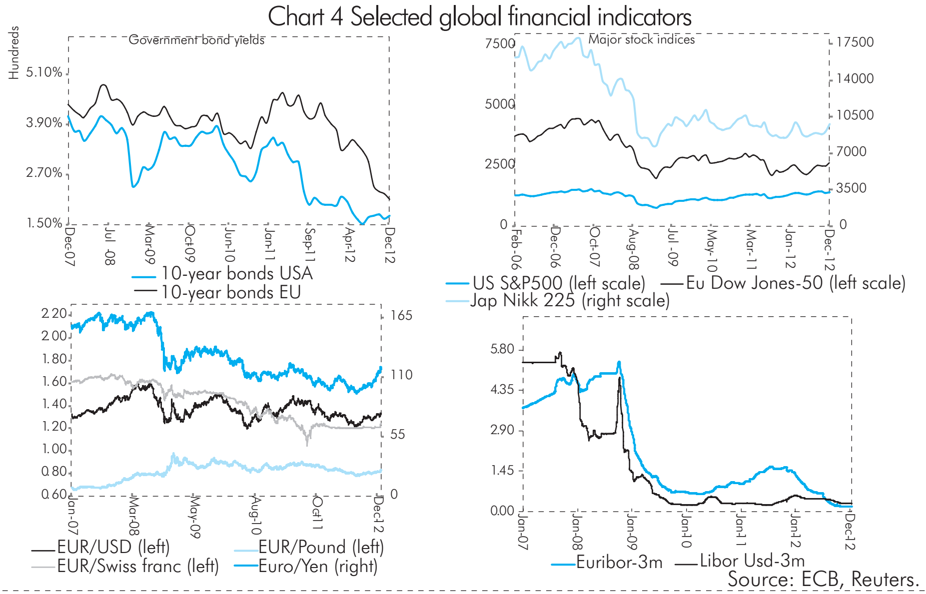
Chart 3 Key interest rates



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

Yields of bonds and other debt instruments in the financial markets generally maintained a falling tendency in the recent months. This trend was maintained by all securities, despite agencies' ratings. The spreads between euro area and German bond yields declined in the past weeks, mainly due to ECB and EC's decisions to solve the sovereign debt crisis. ECB President's December speech and position on this topic contributed positively to improving trust in all market players, hence leading to lower risk premia. In U.S. financial markets, bond yields rose slightly during this period, reflecting mainly the better-than-expected figures of several economic and financial indicators. In the major U.S., European and Japanese stock markets, the indicators have generally maintained a rising tendency as a reflection of the improved financial agents' confidence.

Chart 4 Selected global financial indicators



Source: ECB, Reuters.

In the euro area money markets, the ask rates continued to drop, reflecting the ample liquidity provided by the ECB over the period. The 3, 6 and 12-month Euribor rates stood at 0.19%, 0.32% and 0.55%, respectively, in December, registering an average fall[6] of 0.14 percentage points from September. The 3-month U.S. dollar Libor rate fell to 0.31%, from 0.39%.

[6] *They fell by 0.06, 0.16 and 0.19 percentage points, respectively.*

In the foreign exchange markets, the euro appreciated against major currencies (U.S. dollar, British pound and Chinese renminbi) in Q4. On average, the euro appreciated 3.7% against the U.S. dollar from Q3. In December, it was traded at USD 1.3119, 2.3% higher than in November and 0.5% lower than in December 2011.

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

In the second half of 2012, annual inflation fluctuated within a narrow band (2.4%-2.8%), maintaining a declining tendency from the third (2.7%) to the fourth quarter (2.4%). This performance was driven by the mitigation of supply-side factors, while domestic demand continued to exert weak inflationary pressures. This environment was supported by a stable exchange rate in the medium term. The observance of the inflation targets has contributed to anchoring medium-term inflation expectations.

Inflation forecast shows that it will manifest a similar tendency as in 2012, owing mainly to a persistent negative output gap in 2013. However, against a background of heightened uncertainties in the economies of the region and beyond, domestic and external supply-side shocks may raise inflation volatility.

III.1 CONSUMER PRICES, TARGET AND MONETARY POLICY

Annual inflation averaged 2.6% in the second half of 2012, or 0.3 percentage points lower than in the same period in 2011. In 2012 Q4, annual inflation was 2.4%, compared to 2.7% in Q3. It maintained a decelerating trend throughout the last three months of the year. The lower annual inflation rate reflected the higher fall of seasonal agricultural product prices compared to their historical average, mainly in October and November. As expected for this period of the year, inflation fluctuated in December and marked a higher monthly rate compared to the previous two months. The monthly inflation rate was almost similar to the forecast, hence making no "surprise" effects[7] to annual inflation. In the absence of supply-side shocks[8], the dampening inflationary pressures originating from aggregate demand gave rise to moderate and mildly volatile inflation rates. The above-mentioned developments are also reflected in the stable 12-month average inflation[9], core and non-traded inflation of the CPI basket of goods and services.

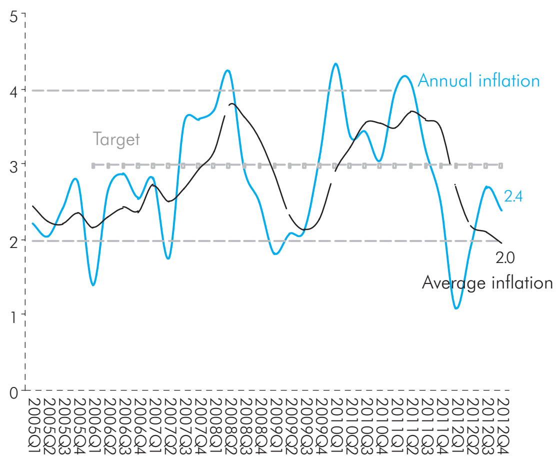
[7] *Annual inflation in December 2011 marked 1.7%, being considered an unusual rate in the inflation series.*

[8] *These effects are usually caused by the rise in prices of particular goods (as has been the case with regulated prices – electrical energy, water billing etc.) and deviations from the historical seasonal performance of inflation rates in the time series due to an increase or decrease in domestic agricultural production.*

[9] *Average 12-month inflation stood at 2.0%, hence below the lower bound of the target tolerance band for medium-term inflation.*

Macroeconomic developments in Albania, particularly during this year, were conditioned by the curbing global economic growth. Albania's economy grew below its potential in the first nine months of the year. Financial constraints, both foreign and domestic, and the cautious spending behaviour due to the high uncertainty about growth, contributed to shrinking private investment. Consumer demand and fiscal stimulus were also lower than in the past years. Under these circumstances, monetary policy has aimed at revitalizing the overall economic activity. The Bank of Albania pursued an accommodative monetary policy during 2012, by providing room for boosting aggregate demand and a more balanced economic activity and inflation. Considering that inflation, forecasts and economic agents' expectations remain within the tolerance band, signals for the continuous slowdown of domestic demand motivated the injection of monetary stimulus.

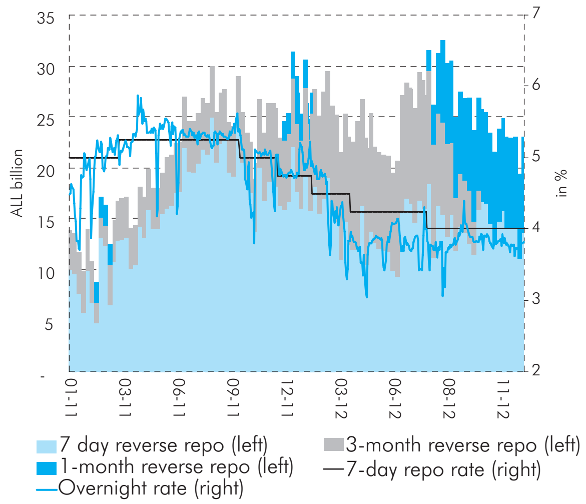
Chart 5 Annual inflation (in %)



Source: INSTAT and Bank of Albania.

The Bank of Albania took consecutive decisions to cut the key interest rate to record lows. During September 2011-July 2012, the central bank lowered the key interest rate by 125 basis points, to 4.00%. The latter was maintained until the end of the year. The accommodating monetary conditions were transmitted more rapidly into the interbank market, while the structural changes in the markets during the first half of the year slowed down the transmission of signals into the cost of credit to the economy. As expected by the Bank of Albania, these obstacles began to moderate in the second half of the year. Taking into account a better pass-through of previous decisions in line with the lags in monetary policy action, and the balanced risks associated with the inflation forecast, the key interest rate was kept unchanged in Q4.

Chart 6 Bank of Albania liquidity-providing operations in the open market



Source: Bank of Albania.

The Bank of Albania continued to supply the banking system with liquidity, enabling minimized volatility of interbank rates and their steering toward the key interest rate.

III.2 INFLATION BY ITEM

Q4's inflation continued to be determined by the fluctuating food prices. 'Processed foods' and 'Unprocessed foods' accounted for about 70% of inflation. The other items continued to provide low contribution to headline inflation. The lower 'Housing' inflation rate in September was also maintained in the last quarter of 2012, hence contributing to a lower inflation rate.

During the same quarter, 'Unprocessed foods' made the highest contribution to inflation rate. The gradual price rise in this item's goods during July-September was curbed in October. Its contribution fell to 1.0 percentage points in Q4, from 1.3 percentage points in Q3. The main factor behind this move in prices is the satisfaction of domestic demand for these goods by the increasing domestic supply.

Table 3 Annual contribution of key items to annual inflation (in percentage points)

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4
1. Processed foods (pp)	1.4	2.2	2.5	2.2	1.6	0.7	0.4	0.4	0.6
Bread and grains (pp)	0.4	0.7	1.0	0.8	0.5	0.2	0.0	0.0	0.0
Alcohol and tobacco (pp)	0.2	0.5	0.4	0.4	0.4	0.1	0.1	0.1	0.2
2. Unprocessed foods (pp)	0.5	0.6	0.5	0.0	-0.1	-0.6	0.5	1.3	1.0
Fruit	0.1	0.2	0.4	0.2	0.3	0.3	0.3	0.5	0.5
Vegetables	-0.7	0.1	-0.4	-0.6	-0.7	-1.2	-0.1	0.7	0.2
3. Services (pp)	0.0	0.0	0.0	0.1	0.0	0.0	0.2	0.2	0.2
4. Regulated prices (pp)	0.9	0.4	0.3	0.1	0.0	0.1	0.1	0.1	0.1
Fuels and energy (pp)	0.4	0.2	0.3	0.2	0.1	0.0	0.0	0.0	0.0
5. Housing (pp)	0.1	0.2	0.3	0.3	0.3	0.3	0.2	0.0	-0.2
6. Non-food consumer goods	0.2	0.6	0.5	0.4	0.6	0.6	0.4	0.5	0.5
7. Durable consumer goods (pp)	0.0	0.0	0.1	0.1	0.1	0.0	0.1	0.2	0.2
Consumer Price Index (y-o-y, %)	3.1	4.0	4.1	3.2	2.5	1.1	1.9	2.7	2.4

Source: INSTAT and Bank of Albania.

'Processed foods' increased their contribution to 0.6 percentage points in 2012 Q4, from 0.4 percentage points in summer. The higher inflation over the past months is attributed to price rise in 'Alcoholic beverages' as a reflection of new fiscal adjustments. However, this item's annual inflation remains lower than in the previous year[10] due to the steady global prices for these goods and the stable exchange rate.

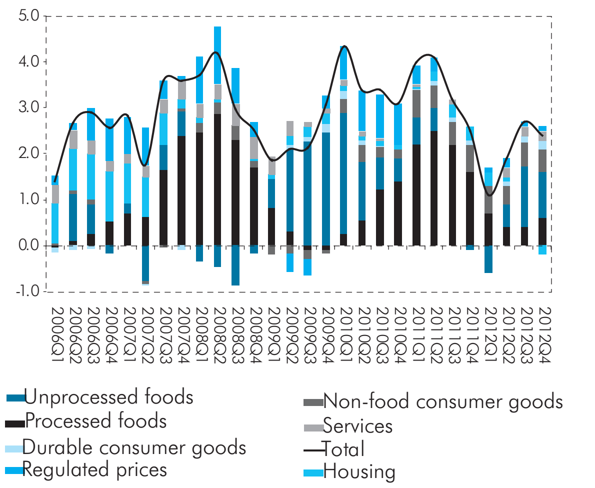
'Regulated prices' continued to provide low contribution to headline inflation rate, down to 0.1 percentage points in the second half of the year. In the absence of a new rise in electrical energy and drinking water prices, this item's contribution is expected to remain low in the first half of 2013.

[10] *In 2011, it stood at 6.7%, while in October 2012, it marked 2.1%.*

The contribution of 'Non-food consumer goods' to headline inflation was similar to the previous quarter (0.5 percentage points). There were, however, frequent fluctuations in prices over the quarter, particularly in 'Miscellaneous goods and services, which derived from the fluctuations in motor vehicle insurance prices[11]. There have also been positive developments in fuel prices, which fell in the last quarter of 2012.

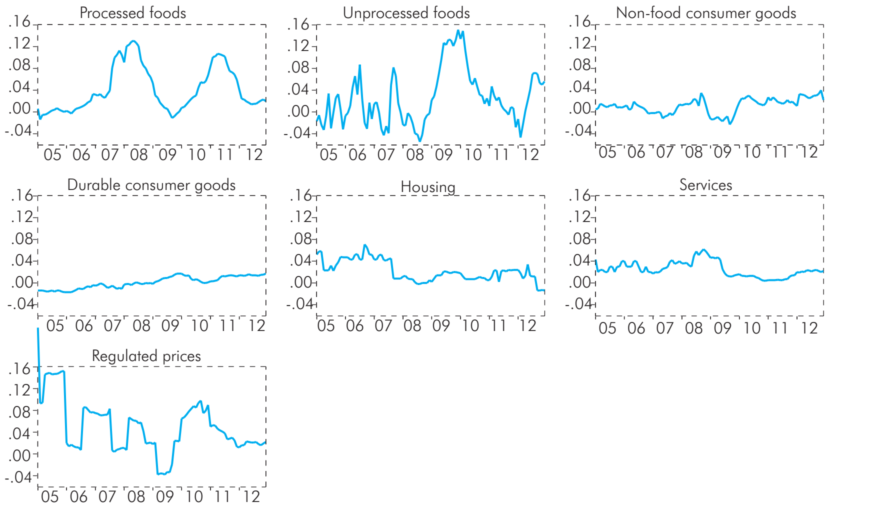
The other items having a low share made a total contribution of 0.3 percentage points to headline inflation. 'Housing' in particular registered falling prices. Hence, its contribution to headline inflation remained negative, from 0.1 percentage points in summer to -0.2 percentage points in the last four months of the year.

Chart 7 Contribution of main items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania's estimates.

Chart 8 Annual inflation by items of goods and services (in %)



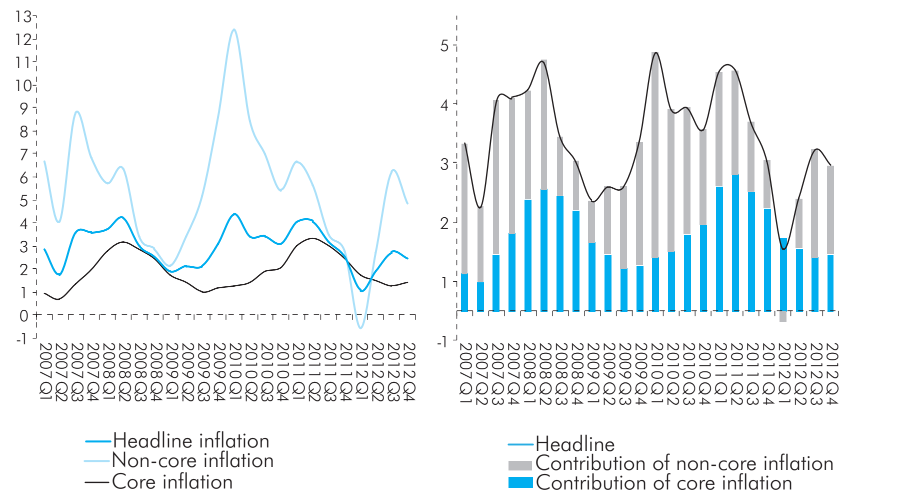
Source: INSTAT and Bank of Albania.

III.3 MAIN INFLATION TRENDS

Annual core inflation[12] was about 1.3% in the second half of 2012, remaining close to record lows[13]. Long-term inflationary pressures on Albania's economy accounted for about 36% of the semi-annual headline inflation. This contribution increased from Q3 (34%) to Q4 (39%), as the stable core inflation was followed by a reduced non-core inflation. The latter accounted for the rest of headline inflation. Non-core inflation reached 4.8% in Q4, from 6.8% in Q3.

[11] In November, these tariffs rose by 23%, while in December, they fell by 31%.
[12] The simple average of both measurements, permanent exclusion and trimmed mean.
[13] Core inflation stood at 1.3% and 1.4% in Q3 and Q4.

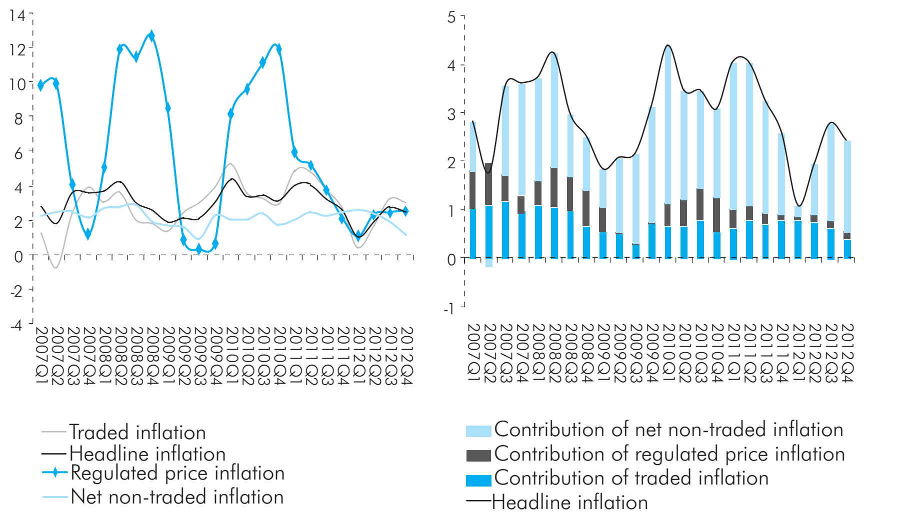
Chart 9 Annual core and non-core inflation (left) and respective contributions (right)



Source: INSTAT and Bank of Albania.

The second half of 2012 continued to see low and falling inflation rates in the non-traded goods and services in the CPI basket. In addition, traded inflation showed relatively low volatility compared to its historical trend. Annual traded inflation stood at 3.1%, gradually decreasing from Q3 (3.2%) to Q4 (3%). This performance was driven by the curbing rise in prices of primary commodities, mainly oil, and the stable annual appreciation of the Albanian lek against the euro. Traded inflation contributed by about 76% to headline inflation in the second half of the year, or 1.9 percentage points[14].

Chart 10 Annual inflation by sector (left) and respective contributions (right)



Source: INSTAT and Bank of Albania.

[14] In Q3 and Q4, it contributed by 74% and 77%, respectively.

Net annual non-traded inflation[15] stood at 1.6% in the second half of 2012, marking a minimum rate of 1.2% in Q4. The reduction was driven by the shock on rental price index in September, whose effect remained almost unchanged until the end of 2012[16]. Consequently, the average annual contribution of net non-traded inflation to headline inflation for the second half of 2012 is estimated at about 19% or 0.5 percentage points, falling considerably in Q4[17]. The rest of inflation was formed from developments in major regulated prices, whose impact on domestic inflation remained low and comparable to the first half of 2012.

Developments in the main inflation components show that the curbing inflationary pressures on the economy during the second half of 2012, and particularly in Q4, owed to the weak domestic demand pressures and the lower impact of various supply-side shocks.

[15] *This inflation mainly refers to prices of services in the CPI basket and excludes regulated prices' effects (water, electrical energy and hospital services).*

[16] *This sub-item accounts for a significant share in the CPI basket (10.7%) and the sub-basket of net non-traded inflation (32.9%).*

[17] *In 2012 Q3 and Q4, the contribution of net non-traded inflation to headline inflation was estimated at 23% and 15%, respectively.*

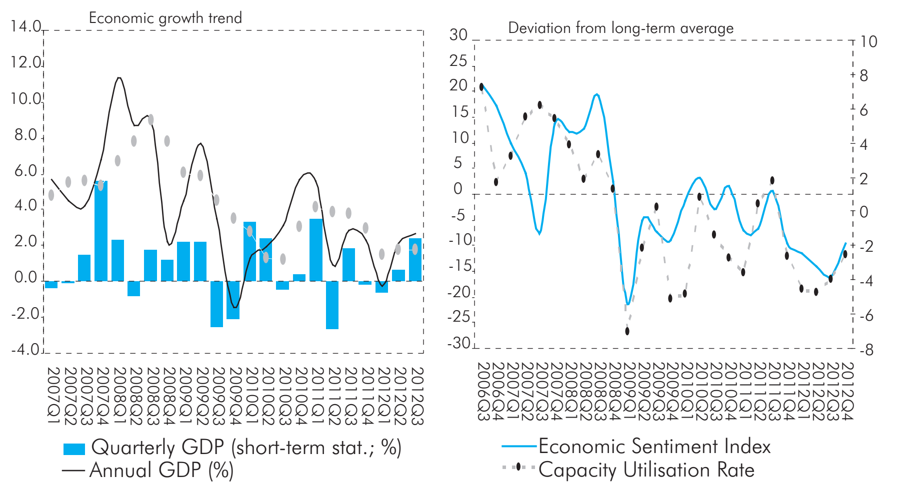
IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

During the second half of 2012, the Albanian economy saw slow growth in output and employment, and curbing inflationary pressures. According to data made available by INSTAT, Albania's economic activity improved in Q3, registering an annual growth of 2.7%. There was a more balanced improvement of aggregate demand, supported by both domestic and external demand. Despite the short-term fluctuations, growth remains below its potential, hence generating weak inflationary pressures. Against a background of a stable exchange rate, pressures from imported prices were contained. CPI inflation was low throughout the year and inflation expectations were anchored close to the target. Economic and monetary analysis shows that inflationary pressures will be moderate over the monetary policy-relevant horizon.

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Economic activity and aggregate demand grew faster in Q3. After registering low growth of 1.0% in the first half of the year, annual GDP growth picked up to 2.7% in Q3. The growth of aggregate demand was fuelled by the positive contribution of external demand and added contribution of domestic demand. Despite the difficult economic situation facing Albania's major trading partners, exports continued to pick up in Q3. In terms of domestic demand components, the absent fiscal stimulus was balanced by a better performance of private domestic demand, in line with the improved consumer confidence and lending compared to the previous quarter.

Chart 11 GDP (left) and Economic Sentiment Index (right)



Source: INSTAT and Bank of Albania.

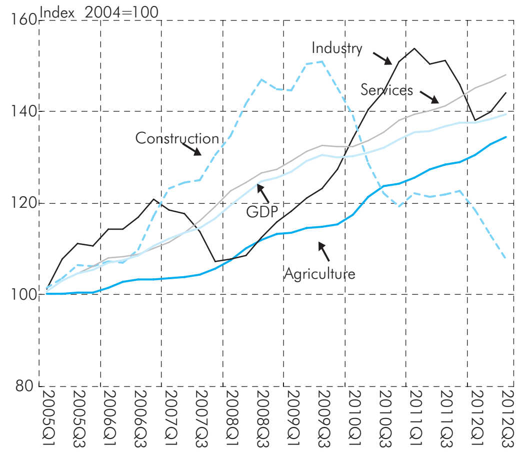
Available information[18] signals slow growth dynamics of economic activity in Q4. Private consumption was low due to sluggish economy and perceived uncertainty about the future. In addition, private investment remained low owing to the incomplete utilisation of production capacities, uncertainties about domestic and external demand, and tighter lending standards from the financial sector.

IV.1.1 OUTPUT BY SECTOR

GDP accelerated its annual and quarterly annual growth rate to 2.7% and 2.4%, respectively, in Q3. The services sector remains the main driver of economic growth for this period. Its value added was about 4.5% higher than in the same period in 2011, translating into a contribution of 2.5 percentage points to domestic GDP. On the other hand, value added in the production sector was about 0.7% higher than in 2011 Q3. The recovery of industrial activity and the stable agricultural sector were dimmed by the continued contraction of the construction sector, providing a total contribution of 0.2 percentage points to economic growth.

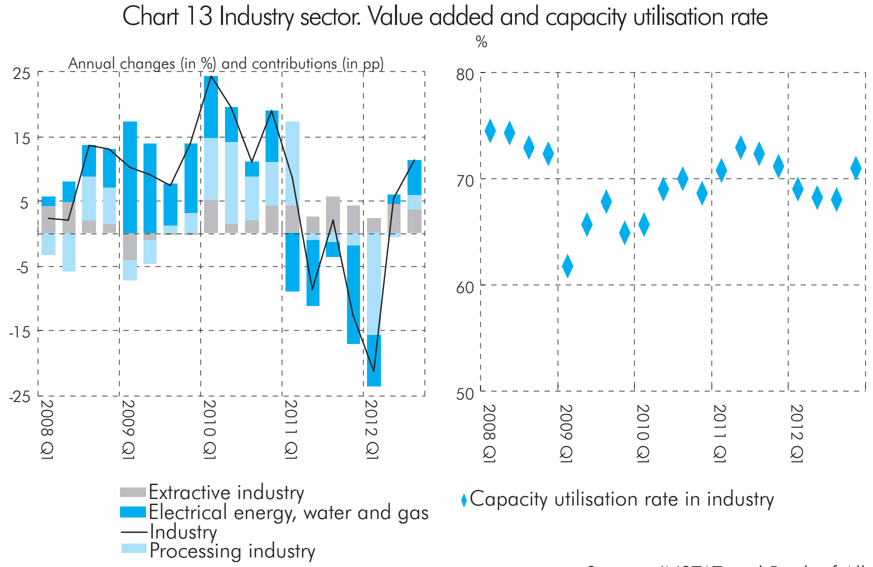
The improved Economic Sentiment Index in Q4 signals recovered economic activity during this period. Confidence indicators by sector suggest continued decline in construction, slight increase in industry and more accelerated growth in services.

Chart 12 GDP and output by sector*



Source: INSTAT and Bank of Albania's estimates.
*Note: The index is constructed based on GDP series at basic prices in total and by sector, as annual moving sums.

Chart 13 Industry sector. Value added and capacity utilisation rate



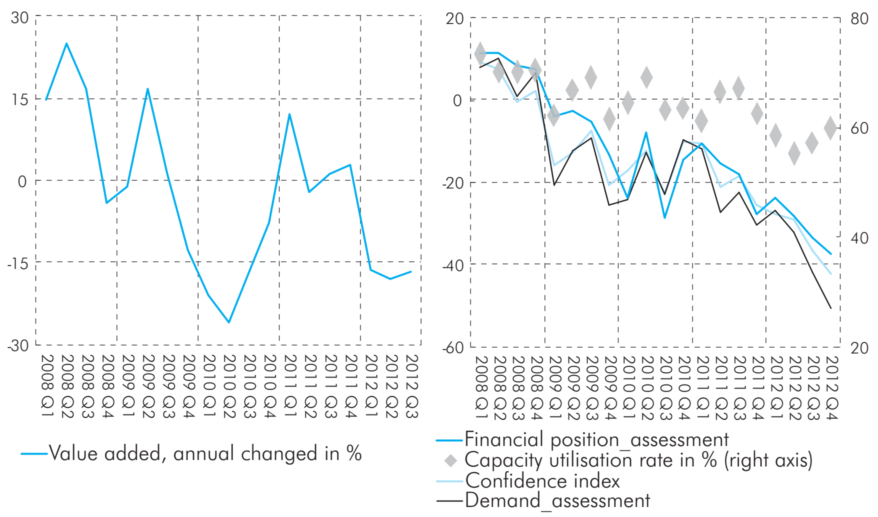
Source: INSTAT and Bank of Albania.

[18] In order to make an assessment of the economic performance in Q4, we analyse the value of imports and exports of goods, lending to the economy, fiscal indicators as at November, and qualitative indicators obtained from the confidence survey for the quarter under review.

Value added in industry sector registered a high annual growth of 11.4% in Q3, hence discontinuing the average fall of 7.8% in the first half of the year. This sector contributed by 1.2 percentage points to annual GDP growth. The accelerated increase in industry was largely triggered by 'Electrical energy, water and gas', whose value added was about 55.2% higher on an annualized basis. This sub-branch increased for the second consecutive quarter, reflecting primarily the higher production of electrical energy[19]. According to the latest data on electrical energy, the latter's domestic production slowed its annual growth rates to 1.4% during October and November. Extractive industry continued to grow in Q3, though at lower rates than a quarter earlier. More specifically, value added in this branch registered an annual growth of 23.1%, slightly above the historical average growth rate of 22.5%. This growth is largely attributed to the activity in the sub-branch of "Extraction of energy products". A similar positive performance was also manifested by processing industry, whose share in total industrial activity averages 75%. Value added in processing industry recorded a low annual growth of 3%, about 4.3 percentage points below the historical average rate.

Partial quantitative data on Q4, industrial exports in October and November, and survey figures on industry[20] signal a slightly improved activity in the industry sector during the quarter under review.

Chart 14 Construction sector. Value added and survey figures



Source: INSTAT and Bank of Albania.

[19] According to the Albanian Power Corporation, the production of electrical energy in 2012 Q3 registered an annual growth of 49.5%.

[20] In 2012 Q4, demand, production, overall business situation and capacity utilisation rate stand higher than a quarter earlier.

In 2012 Q3, value added in the construction sector maintained the contracting trend begun since early this year. It fell 16.5% annually, hence making a negative contribution of 2 percentage points to annual GDP. The shrinking dynamics of the construction sector reflects the sluggish demand for investment in residential buildings and public sector's falling contribution[21] to construction, at a time when the number of construction permits has also been low. Preliminary[22] and survey data continue to signal a negative performance of the construction sector in Q4. Based on the annual increase in capital spending in October and November, public sector's impact on construction grew higher in Q4.

[21] *Government's capital spending is used as a proxy to estimate public sector's contribution to construction.*

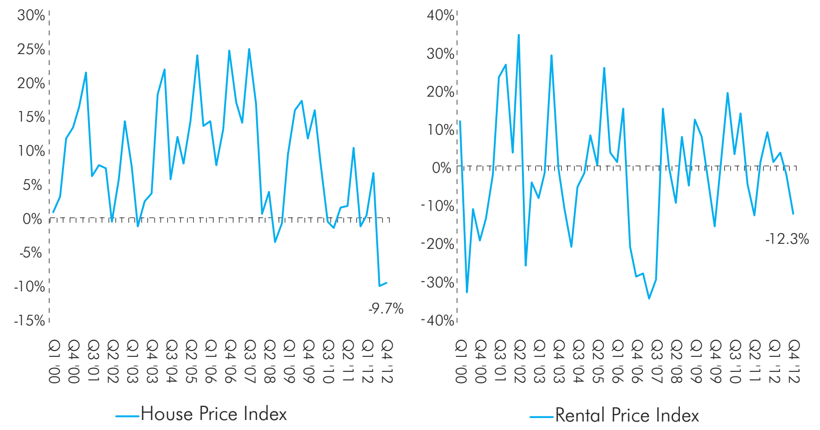
[22] *The number of granted construction permits, which generally signals the dynamics of construction in the quarters ahead, remained at minimum levels in the first three quarters of 2012. 18, 18 and 37 construction permits were granted in Q1, Q2 and Q3, respectively, considerably lower than the historical average number of 478 construction permits.*

*Box 1 House and rental prices in Tirana during 2012 Q4**

House price index fell for the second consecutive quarter in Q4, by about 9.7% y-o-y. Deflated with CPI, there was an annual real change of -11.9% in Q4.

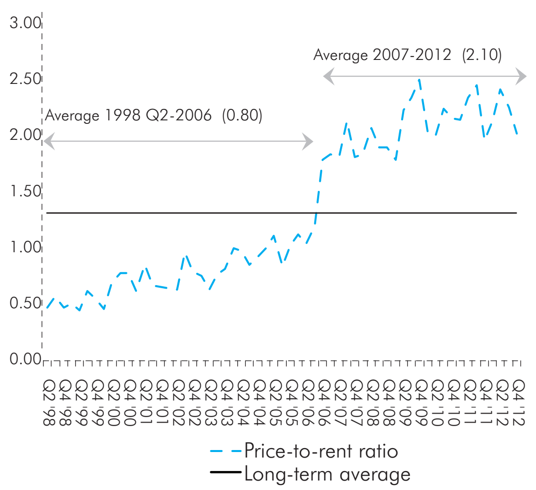
Rental Price Index for Tirana recorded sharp fall by about 12.3% in annual nominal terms, hence confirming the trend begun since Q3. In annual real terms, rental price index fell by about 14.5%.

Chart 15 House Price Index and Rental Price Index (annual change in %)



Source: Bank of Albania.

Chart 16 Price-to-rent ratio



Source: Bank of Albania.

Based on indirect data, the performance of the House Price Index was largely driven by demand-side factors. Consumer confidence remains low and their actual and expected financial situation is reported to be negative. On the other hand, the stagnating employment and curbing growth rate of available income contributed adversely to demand for residential properties. In addition, lending standards applied to households for house purchase were tight in 2012, which is confirmed by the negative data on this type of loan.

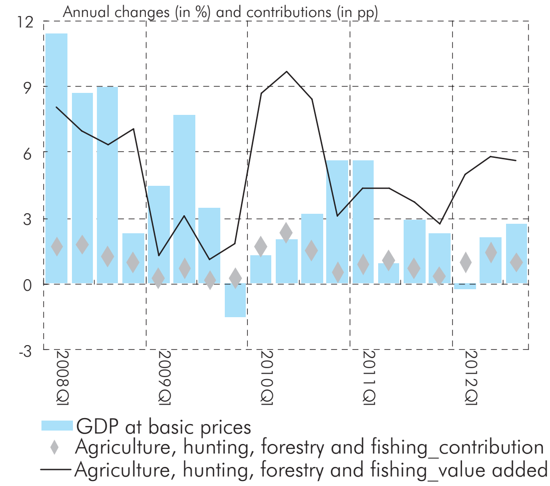
Price-to-rent ratio stabilized at an average of 2.21 in 2012. After increasing in Q1 and Q2, it fell in the following two quarters due to a sharper decline in house prices than in rental prices during the period under review. Price-to-rent ratio, albeit downward, remains above its historical trend.

** House and rental price indices are built only for Tirana.*

Agriculture, hunting, forestry and fishing contributed by 1 percentage point to annual GDP growth in Q3. The annual growth rate of value added in these activities was slightly lower than a quarter earlier, about 5.6%. However, agriculture has manifested above the 3.8% historical average growth in the first three quarters of 2012.

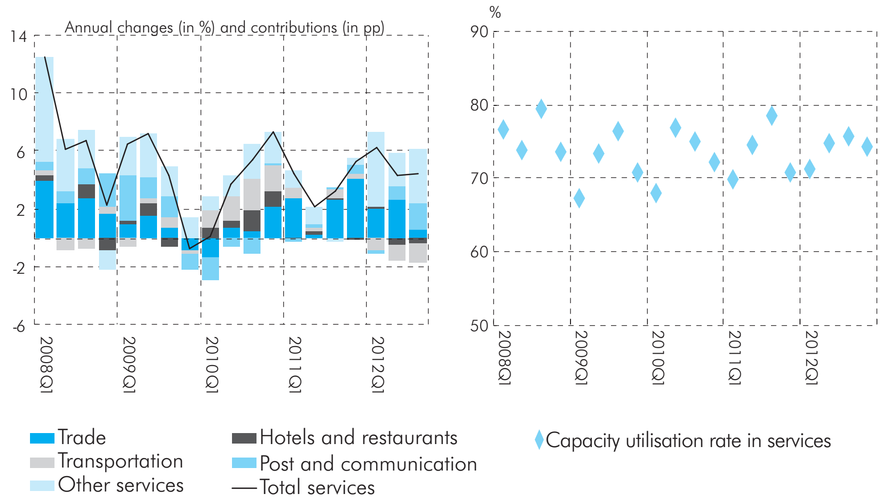
During Q3, value added in the services sector rose 4.5% annually, comparable to the previous quarter but slightly below the average annual growth rate of 5.5%. 'Other services'[23], 'Post and communication' and 'Trade' contributed positively to annual growth of value added in the services sector, by 3.7, 1.8 and 0.7 percentage points, respectively. By contrast, the contributions of 'Transportation' and 'Hotels and restaurants' reduced the value added of total services by 1.3 and 0.4 percentage points, respectively.

Chart 17 Agriculture, hunting, forestry and fishing



Source: INSTAT and Bank of Albania's estimates.

Chart 18 Services sector. Value added and capacity utilisation rate



Source: INSTAT and Bank of Albania.

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

During the quarter under review, value added in 'Other services' was about 9.1% higher than in the same quarter in 2011. The higher growth rate[24] attributes, to a large extent, to the dynamics in the sub-branches of 'Real estate, leasing and business-related services' and 'Monetary and financial intermediation'. The high annual growth of value added in 'Post and communication' by 21.6% in Q3, compared to 11% in Q2, was primarily driven by the sub-branch of communication[25].

Trading activities reduced their annual growth rates of value added to 2.0%, from 8.9% a quarter earlier. The performance of value added in trading, which remains even lower than the 5.0% historical average annual growth rate, reflects, to a large extent, the comparative base effect[26]. The analysis of trade sub-branches based on the turnover volume identifies the higher annual growth rate of wholesale trade.

On the other hand, transportation services continued to shrink in Q3. Its value added was about 11.5% lower than in the same period in 2011. The negative performance of transportation seems to have been triggered by the annual decline in the turnover volume generated by auxiliary transportation services and travel agencies[27]. In addition, the annual growth of 'Hotels and restaurants' fell for the second consecutive quarter. Its value added was about 6.1% lower than in the same period in 2011.

Surveys suggest improved services in 2012 Q4 compared to Q3. Despite the slightly lower capacity utilisation rate, confidence, demand and financial situation appear higher for this quarter.

IV.1.2 AGGREGATE DEMAND COMPONENTS

Aggregate demand picked up in Q3, driven by the positive contribution of net exports and the recovery of domestic private demand. New economic information on aggregate demand shows that it continued to grow in Q4 as well. Judging from the performance of trade in goods during October and November, external demand continued to make a positive contribution to economic growth. On the other hand, domestic demand remained sluggish.

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[24] A higher annual growth rate compared to the annualized rate of about 5.3% a quarter earlier and the historical average annual rate of about 5.4%.

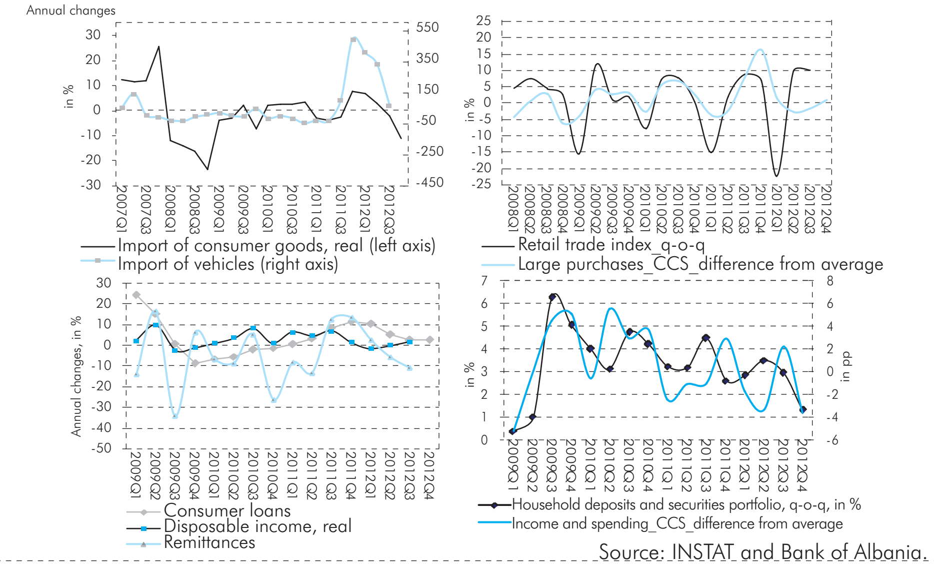
[25] More specifically, the turnover by volume in communication services grew 19.0% compared to the same quarter in 2011, considerably higher than the historical average annual growth rate of 7.4%.

[26] In 2011 Q3, value added in trading activities adjusted for seasonality registered a high quarterly growth rate of 8.0% (the historical average of quarterly changes in value added adjusted for seasonality during the third quarters stands at around 1.5%).

[27] The turnover volume of auxiliary transportation services registered an annual fall by 13.5%, while the same index for travel agencies fell by 26.6%.

Private consumption made a positive contribution to aggregate demand in Q3. Available data provide evidence for higher consumption of services and durable goods, in line with the improved consumer confidence and higher consumer loans. This performance may have also been triggered by the accommodative fiscal measures for the purchase of motor vehicles.

Chart 19 Indirect private consumption data and financing resources



Source: INSTAT and Bank of Albania.

Recovery of the positive rates of private consumption is evidenced by the return of the annual dynamics of retail trade index to positive territory, and a better performance of the services sector in Q3. Retail trade index increased 0.2% y-o-y, compared to the 4.7% fall in the first half of 2012. The import of vehicles continued to increase in Q3. Consumer survey data confirm the increasing trend of purchasing large goods during the quarter under review.

Despite the short-term developments in private consumption dynamics, its performance was sluggish during 2012. The perceived uncertainty about the future, stagnating employment and falling remittances have contributed to subdued consumer demand. On the other hand, uncertainty about the outlook materialized into higher savings in the form of deposits and securities.

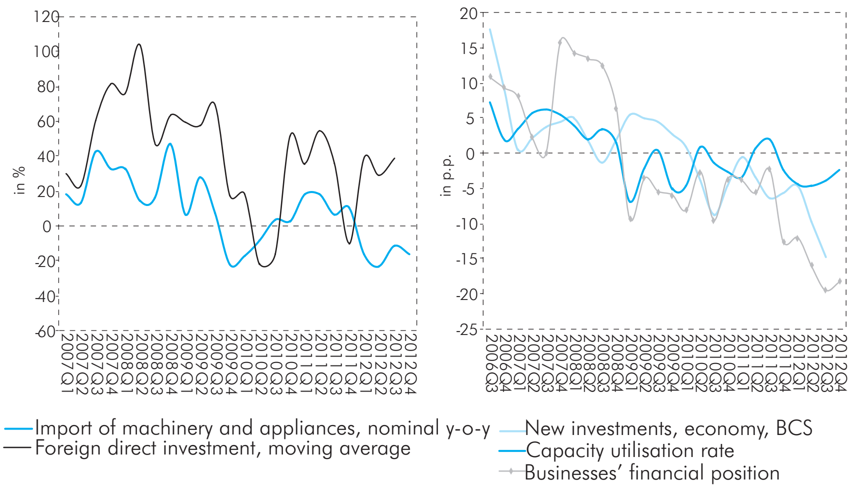
The most recent quantitative and qualitative data obtained from surveys for 2012 Q4 suggest low consumer spending. The import of consumer goods fell 11% in real terms. Consumer confidence also fell in Q4, despite the slightly higher balance of large purchases. Indirect data on financing resources show higher support to private consumption from the increase in personal income in Q4[28].

Private investments were low during the first nine months of 2012. Their low increase continues to be driven by the sluggish domestic and external demand, low capacity utilisation rate, businesses' worsened financial situation[29] and tight lending standards[30].

[28] *Tax on personal income increased in October and November by about 9% y-o-y.*
[29] *Business Confidence Survey.*
[30] *Bank Lending Survey.*

The import of machinery and appliances, which hint at the perform ance of investment in the economy, continued to fall in Q3, although at lower rates than in the first two quarters of 2012. Foreign direct investment increased 4.9% in real annual terms.

Chart 20 Proxies for private investment



Source: INSTAT and Bank of Albania.

Partial data on Q4 show an unfavourable setting for the recovery of growth rates in private investment. The improved business confidence (industry and services), the positive growth rate of investment loans and the doubling number of construction permits in Q3 suggest higher private investment in the economy. On the other hand, data on the import of machinery and appliances in October and November show further deepening of the annual decline rate in Q4. Based on bank lending survey, the standards applied to business loans for investment purposes tightened further in Q4. Business confidence survey shows that their expectations for future investment remain on the downside.

IV.1.3 EXTERNAL DEMAND AND FOREIGN TRADE

The most recent data show that the deficit in net real exports[31] narrowed in annual terms, in 2012 Q3, due to an increase in real exports by about 2.5% in annual terms. The developments in real imports and exports of goods and services materialized into a positive contribution to aggregate demand over the period under review.

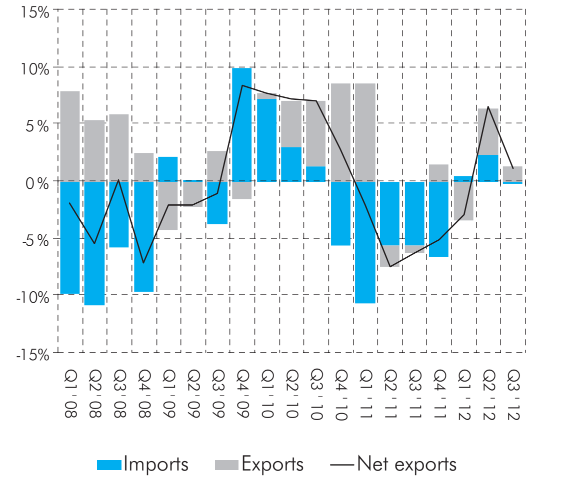
[31] *To switch from nominal to real terms of imports and exports of goods, we use the Unit Value Index, as published by INSTAT, while for imports and exports of services, we use the Consumer Price Index of services, as measured by the Bank of Albania.*

Growth in net real exports in Q3 seems to have also been triggered by the slightly higher real depreciation pressures on the domestic currency, as shown by the REER[32] performance. Lek's real-term depreciation by 0.8% in Q3 helped narrow the net real export balance by about 3.5% y-o-y.

TRADE IN GOODS

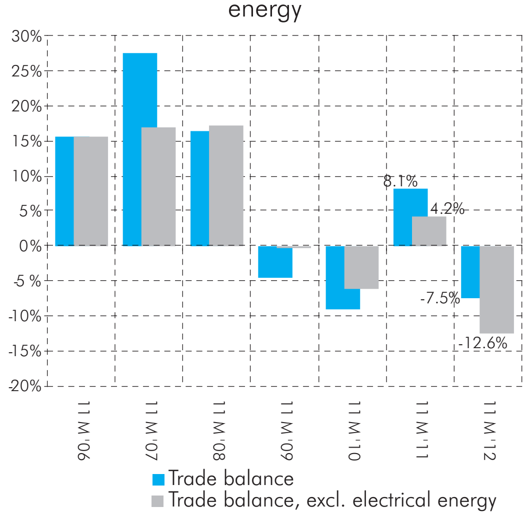
Data on Albania's international trade in goods during January to November 2012 show a narrowing trade deficit by nearly 7.5% in annual nominal terms. The accelerated increase in exports in the previous two years[33] moderated markedly to about 8.7% in the first 11 months of 2012. During this period, imports fell by about 1.5% y-o-y. As in the previous two years, trading flows of electrical energy remain a significant factor in Albania's trade balance. Excluding this effect, trade deficit narrowed by about 12.6% compared to a year earlier.

Chart 21 Contribution of net exports to real GDP (in percentage points)



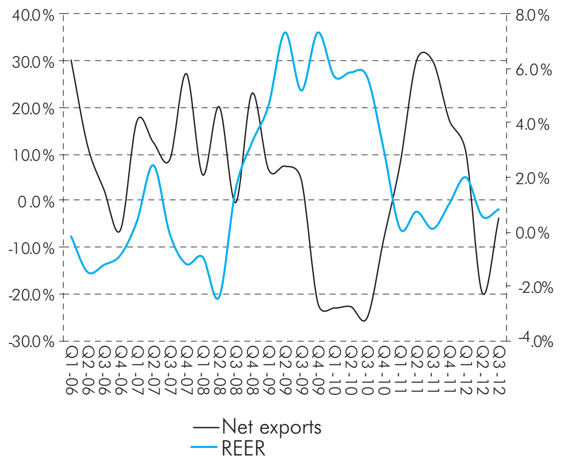
Source: Bank of Albania.

Chart 23 Trade deficit including/excluding electrical energy



Source: International Trade Statistics, Bank of Albania.

Chart 22 Annual change in net real exports (left) and REER (%; right)



Source: Bank of Albania.

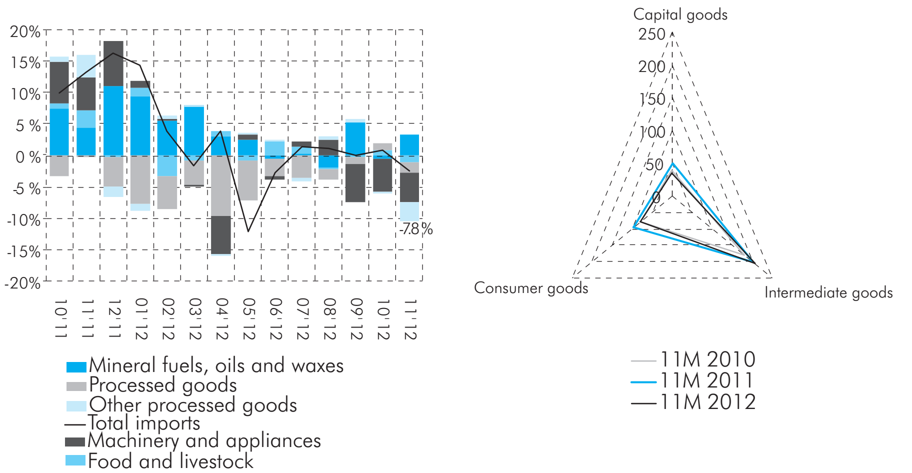
Trade exchanges in the first 11 months of 2012 increased slightly by about 1.2% y-o-y. Import coverage ratio by exports was about 40.5% during the period under review, or about 3.8 percentage points higher than in the same period in 2011.

[32] *The Real Effective Exchange Rate (REER) is measured as a geometric weighted average of domestic prices, compared to trading partners' prices and the NEER. A decline in the index implies a real appreciation, while its increase implies a real depreciation of the domestic currency.*

[33] *Exports increased by about 58.1% y-o-y during the first 11 months of 2010, and by about 19.9% in the same period in 2011.*

Imports value has maintained a stable declining trend since the early months of the year, being about 1.5% lower y-o-y during January-November 2012. Broken down by final use in the economy, there is a clear orientation toward imports of intermediate goods[34]. The latter registered an annual decline by about 0.1% over the period under review. Import of capital goods recorded sharper decline, primarily due to lower imports of capital goods, excluding vehicles, narrowing by about 14.2% y-o-y. On the other hand, import of consumer goods manifested a positive performance, albeit at lower rates than in the same period in 2011.

Chart 24 Contribution to total imports by item, in percentage points (left); import orientation by final use in economy, in EUR million (right)



Source: Bank of Albania.

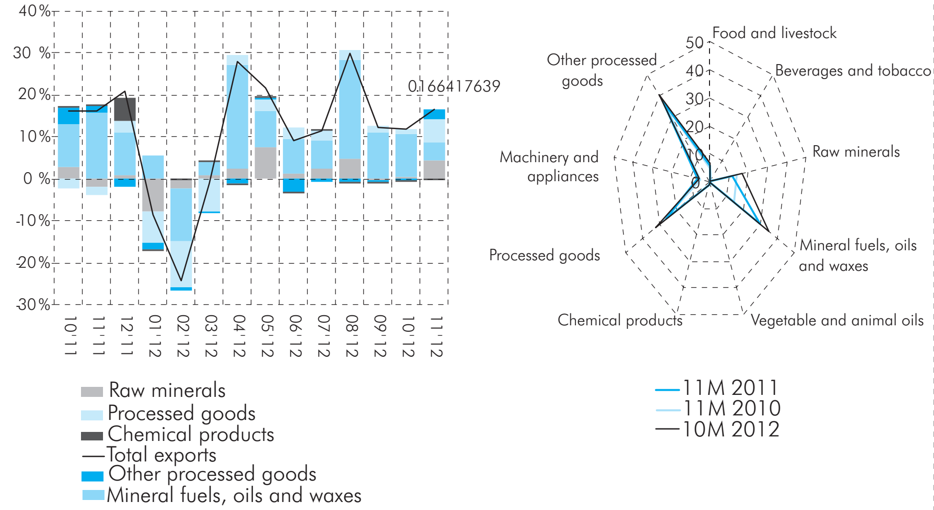
Exports registered satisfactory growth rates in the first 11 months of 2012, albeit more moderate than in the previous two years. The low export increase was primarily due to the macroeconomic conditions facing Albania's trading partners.

The increase in exports by about 8.7% y-o-y was largely triggered by the export of 'Mineral fuels, oils and waxes', and more specifically by the export of crude oil. The lower export of cast-iron and steel by about 10.0% y-o-y gave rise to a negative performance of exports of 'Processed goods'[35]. Other processed goods, which have the main share in total exports and include re-exported products, provided an adverse contribution to total exports.

[34] This item includes: raw and processed food and beverages for the industry, processed and unprocessed industrial products, mineral fuels, crude and processed oils and waxes, capital goods, spare parts and accessories.

[35] The main exported products under this item are base processed metals of steel, cast-iron, copper and aluminium.

Chart 25 Contribution to total exports by item, in percentage points (left); export orientation, in EUR million (right)



Source: Bank of Albania.

Albania's trade activity, as measured by the flow of trade exchanges (imports and exports) increased slightly during January-November 2012. Trade exchanges mostly remain EU-oriented, accounting for about 65.8% of Albania's total trade activity. Trade flows with CEFTA member states[36] increased by about 2.1% y-o-y over the period under review. On the other hand, trade exchanges with other trading partners, such as China, Turkey and Russia, increased.

[36] *Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia and Kosovo. Not included countries joining EU in 2007. Source: www.ceftatradeportal.com*

*Box 2 Balance of Payments Highlights**

*The latest data on the balance of payments are as at 2012 Q3. Albania's net current account position registered a deficit of EUR 671.1 million during this period, down by about 12.8% from the same period in 2011. Current account deficit was estimated at 9.2% of nominal GDP ** or 1.9 percentage points lower than in 2011 Q3. Similarly to 2011, current account dynamics for the first nine months of 2012 was broadly triggered by the trade balance and services account. The combined improvement of their net position, compared to the corresponding period of a year earlier, contributed significantly to narrowing the current account deficit.*

Table 4 Balance of Payments indicators

	Q3 '11	Q4 '11	Q1 '12	Q3 '12	Q3 '12	9M '11	9M '12
Current account (in EUR million)	-244.1	-352.1	-253.1	-219.9	-198.1	-769.9	-671.1
YOY	1.80%	-1.20%	19.40%	-29.90%	-18.80%	16.30%	-12.80%
/ GDP	-10.20%	-15.20%	-11.80%	-8.60%	-7.70%	11.10%	9.20%
Trade balance	-593.1	-658.6	-465.3	-475.5	-540.5	-1,583.00	-1,481.40
Exports, f.o.b.	344.1	360	325.8	394.2	402.5	1,045.50	1,122.50
Imports, f.o.b.	-937.2	-1,018.60	-791.2	-869.7	-943	-2,628.50	-2,603.90
Balance of services	116.7	41.2	8.5	26.2	132.6	93.4	167.3
Credit	629.8	428.5	293.8	381.1	578.1	1,318.90	1,253.00
Debit	-513.1	-387.3	-285.4	-354.9	-445.4	-1,225.40	-1,085.70
Travel - net	82.9	28.4	4.3	6.2	119.7	19.5	130.2
Balance of income	14.1	14.5	-1.9	-10.2	20.8	33.1	8.7
Credit	77.5	67.5	59.7	60.9	74.9	202	195.5
Debit	-63.3	-53	-61.6	-71.1	-54.1	-169	-186.8
FDI income - net	-22	-7.9	-30.2	-30.1	-18.7	-48.2	-79
Current transfers	218.2	250.8	205.7	239.7	188.9	686.6	634.2
Credit	245.6	279.1	242.3	279.6	227.3	771.2	749.2
Debit	-27.5	-28.3	-36.7	-39.9	-38.4	-84.7	-115
Remittances - net	153.8	188.7	159.5	178.6	138.9	499.2	477
Capital and financial (in EUR million)	227.6	277.1	258.3	172.2	176.8	649.9	607.4
YOY	29.10%	-32.60%	12.20%	-10.30%	-22.30%	40.90%	-6.50%
/ GDP	9.50%	11.80%	12.10%	6.70%	7.00%	7.00%	8.40%
Capital account	6.5	27.8	12.9	43	9.8	57.1	65.8
Financial account	221.1	249.3	245.4	129.2	167	592.8	541.6
A. Liabilities	413.3	390.7	307.5	268.6	375.9	860.9	951.9
FDI	160.1	289.7	201.8	178.3	171.2	457.2	551.4
Portfolio investment	11.1	11.4	14.3	13.2	14.9	28.4	42.4
Other investments	242.1	89.6	91.3	77.1	189.8	375.3	358.2
Borrowing	110.2	39.2	41.5	30.8	27.2	181.4	99.5
Currency and deposits	137.2	54.1	73	44.6	149.9	191.7	267.5
B. Assets	-192.3	-141.3	-62	-139.4	-208.9	-268.1	-410.3
FDI	-3.9	-19.8	-2.6	0	-7.3	-10.4	-9.9
Portfolio investment	-57.1	14.4	-61	9.9	-26.4	-103.1	-77.5
Other investments	-131.2	-135.9	1.5	-149.3	-175.2	-154.6	-322.9
Currency and deposits	-114.8	-94.3	-11	-137.6	-173.8	-79.9	-322.4
Credit (for commercial financing)	-34.5	-57	9.7	0.6	-1.7	-62.6	8.6
Errors and omissions	72.9	68.8	-2	55.2	111	97.6	164.1
Reserve assets	-56.4	6.2	-3.2	-7.5	-89.7	22.4	0

Services account surplus widened by about 79.0% during the first nine months of 2012, compared to the corresponding period a year earlier, hence contributing significantly to narrowing the current account deficit. The widening surplus in this account was primarily triggered by the marked improvement in net income from travel services. The net balance of the income account resulted in a surplus of EUR 8.7 million over the same period, down by about 73.6% y-o-y. The orientation of *developments in this account was mainly driven by the falling compensation of employees by about 21.6% y-o-y. The net deficit on investment income provided its impact in the same direction, widening by about 5.2% compared to the same period in 2011. Current transfers account surplus, an important financial resource for the current account deficit, narrowed by about 7.6% y-o-y, primarily due to the decrease in other current transfers' items. Remittances, the main sub-item in this account, maintained the downward trend begun since 2010.*

CAPITAL AND FINANCIAL ACCOUNT

Capital and financial flows (net) registered a positive balance of EUR 607.4 million in the first nine months of 2012. This account's surplus was about 6.5% lower than in the same period in 2011, and it is estimated at about 8.3% of nominal GDP. Currently, capital and financial account surplus managed to finance about 90.5% of the resulting current account deficit. Foreign direct investment inflows increased by about 20.6% y-o-y. Net portfolio investments were EUR -11.5 million, recording a more moderate increase in our assets invested abroad compared to the same period in 2011. Net other investments account, broadly influenced by higher resident assets invested in foreign economies, registered a net flow of EUR 35.2 million in 2012 Q3. The decline in residents' borrowing flow and the increase in currency and deposits of the Albanian banking system in foreign economies led to respectively lower liabilities on non-residents and higher assets of the Albanian economy invested abroad.

As at end-period, international reserve stock was about EUR 2,024.3 million, sufficient to cover 4.5 months of imports of goods and services.

* *The latest data on the balance of payments are as at 2012 Q3.*
** *Nominal GDP for 2003-10 as published by INSTAT. Bank of Albania's Monetary Policy Department projections for 2011 and 2012.*

IV.1.4 FISCAL INDICATORS AND FISCAL POLICY[37]

The Albanian Government pursued a consolidating fiscal policy during the first 11 months, materialized into annual contraction of budget deficit and fiscal stimulus. Low increase in fiscal revenues and controlled budget deficit were reflected in the low increase in public spending, and particularly in capital spending.

The consolidating fiscal policy relied broadly on the reduction of budget spending, and mainly capital ones. The latter also determined the path of total budget spending over the course of the year, despite their more moderate share compared to current spending.

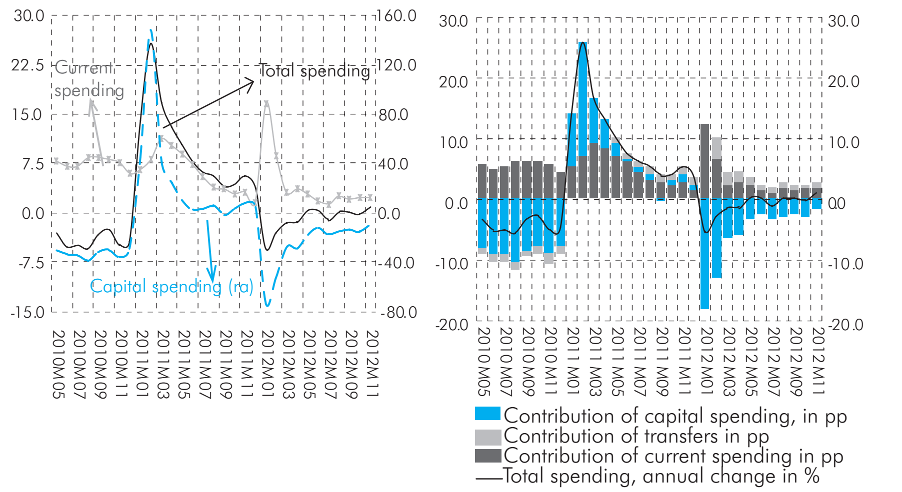
Budget spending amounted to about EUR 336.8 billion during January-November 2012, or about 0.9% higher in annual nominal terms[38]. The

[37] *Available fiscal data as at 18 January 2013 refer to January-November 2012.*
[38] *Excluding lending to KESH amounting to ALL 2 billion, classified under budget spending, the annual change in total spending for the 11-month period would be 0.26%.*

short-term component of budget spending registered an annual increase of 2.4%, maintaining an almost similar growth profile to the previous period. On the other hand, capital spending was about 9.8% lower than in 2011. The negative growth rate of capital spending improved at the end of the 11-month period, due to a relatively high level of this type of spending carried out only in November.

Within budget spending items, social security, personnel, and unemployment and economic benefit expenditures recorded stable growth during January-November 2012. In annual nominal terms, they increased by 5.5%, 2.8% and 7.7%, respectively, contributing positively to increasing current spending by 2.0, 0.6 and 0.5 percentage points.

Chart 26 Annual change in budget spending, in % (left) and respective contributions of current and capital spending in pp (right) *



*Transfers shown in budget spending chart include only lending to KESH.
Source: Ministry of Finance.

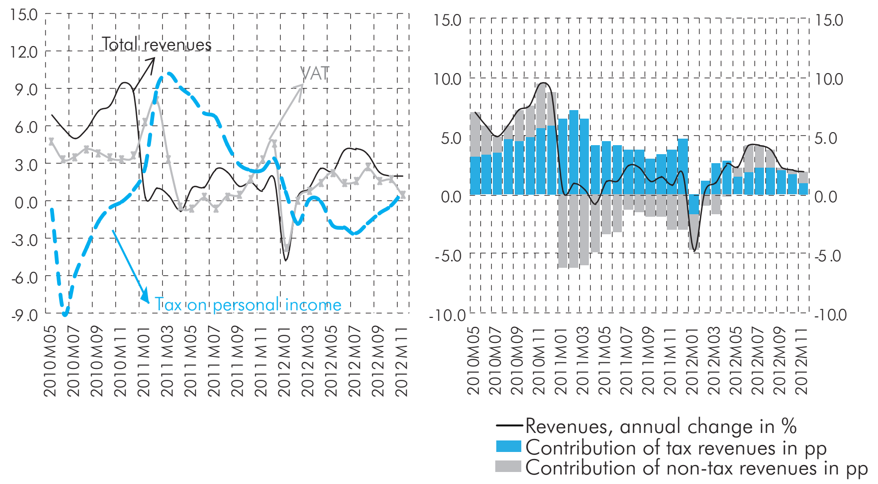
Public sector's contribution to aggregate demand took different directions over the quarters. Its impact, expressed as the total between Government final consumption and gross fixed capital formation, was negative in Q1 and Q3. In Q2, economic growth was driven by both Government final consumption and gross fixed capital formation, albeit moderately. The public sector is expected to generate a positive contribution to economic growth in 2012 Q4 due to, among others, one-off expenditure[39]. The total effect of public spending on real economic growth in 2012 is yet to be assessed based on the intensity of their increase in December.

[39] *Economic terminology defines one-off expenditure as temporary spending with no continuous effect on a country's fiscal position. The social and cultural activities organized on the occasion of Albania's 100th Anniversary of Independence are believed to have increased budget spending in 2012 Q4, a portion of which was authorized under the Council of Ministers' decisions.*

Despite the new fiscal measures[40], budget revenues increased at low rates during the 11-month period, in response to the sluggish growth during this financial year. They totalled ALL 301.6 billion, up by about 2% in annual nominal terms. The increase in fiscal revenues was mainly driven by the collection of non-tax revenue, which accounted for about 60% of the increase in total revenues for this period.

On the other hand, tax revenues contributed by about 0.9 percentage points to the annual nominal increase in budget revenues. The main revenue sub-items, which indirectly reflect the performance of economic activity in Albania, saw low growth rates or lower than a year earlier. VAT revenues, which have the highest share in total revenues (about 36%), saw modest annual nominal growth by 0.5%[41]. Adjusted for reimbursements effect, VAT revenues registered an annual increase of about 1.8%[42]. VAT collected on import value for the first 11 months of 2012 increased by about 1.6% in annual nominal terms, similar to the increase in consumer goods import for the same reference period. On the other hand, after improving in Q3, the growth rate of VAT collected from the tax administration returned to negative territory in October and November. The negative growth rates of collected VAT were mainly triggered by the VAT on production, construction and transportation sectors, suggesting sluggish economic activity in these sectors over the course of the year.

Chart 27 Annual change in revenues, in %, (left) and contributions of key items to revenue increase, in pp (right)



Source: Ministry of Finance.

[40] The new fiscal measures are elaborated further in the paragraph describing the performance of national tax; however, the approval of the circulation tax on petrol from 5 lek in 2011 Q4 to 7 lek as from January 2012 is the change providing the highest impact on the collection of revenue during this period. This tax was first introduced in 2011 Q4.

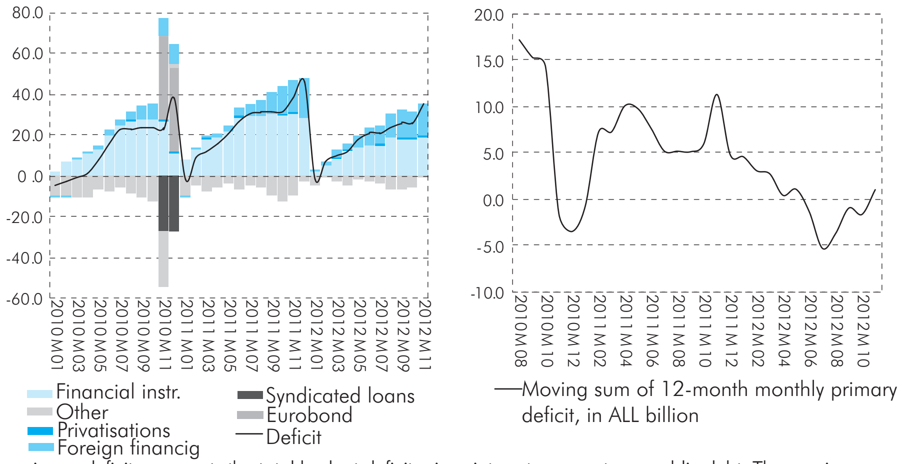
[41] In the absence of fiscal measures that shrink the VAT-paying base or reduce the applied VAT rate, and against a background of a stable domestic currency, the low increase in VAT revenues suggests poor consumption in 2012.

[42] The higher VAT growth rate in gross terms versus the growth rate in net terms owes mainly to the performance of exports, which increased by about 8.7% y-o-y.

During the 11-month period, profit and excise tax revenues were 16%[43] and 8% lower in annual nominal terms, transmitting similar signals to VAT related to economic growth in 2012. For the same stated period, personal income tax revenues increased by about 0.8% in annual nominal terms, following their contraction for seven consecutive months. The lower annual revenues collected from this item during 2012 owe primarily to the performance of the sub-item of 'Sale of immovable property', which reflected the previous year's fiscal measures relating to asset revaluation[44]. In the meantime, the other sub-items with the highest share in this item, tax on public and private sector wages, saw moderate growth rates compared to a year earlier.

National tax provided the main contribution to increase in revenues during January-November 2012, by about 2.6 percentage points, hence offsetting the negative effect of other tax items (profit, excise and local government taxes). The positive performance of this item mostly reflects the changes in fiscal measures related to: circulation tax on petrol, annual tax on vehicles, minerals resource rent tax, higher carbon tax, and the latest amendment to the excise law, which classifies a category of goods subject to excise under national taxes[45].

Chart 28 Budget deficit and financing instruments, in ALL billion (left) and moving sum of primary deficit*, in ALL billion (right)



*The primary deficit represents the total budget deficit minus interest payments on public debt. The moving sum of the primary deficit is constructed taking into consideration the monthly primary deficit for a 12-month period.

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

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[43] All the sectors of the economy have reported lower profits from the previous year (Fiscal Report, October 2012).

[44] In April 2011, the Albanian Parliament approved the fiscal amnesty law, which, among others, included the revaluation of assets. Consequently, revenues collected from the sale of immovable property as at end-October 2011 are about ALL 1 billion higher than in the same period in 2012.

[45] The new fiscal measures related to national taxes consisted in the following legal basis: (1) Council of Ministers' Decision No. 201 dated 21 March 2012, On some amendments to Decision No. 7, dated 4 January 2012 of the Council of Ministers "On establishing the procedures and required documentation for the collection of minerals resource rent tax"; (2) Law No. 61 dated 24 May 2012 "On excises", which excludes packaging of glass and plastics from being subject to excise; (3) Law No. 83/2012 dated 13 September 2012 "On some amendments to Law No. 9975 "On national tax"; (4) Law No. 10458 dated 21 July 2011 "On some amendments to National Tax Law".

Despite the sluggish growth in 2012, budget deficit narrowed by about 8% as at end-November.

The issue of securities in the domestic market was the main source of budget deficit financing. Domestic borrowing through the issue of securities of all maturities financed nearly 54% of total budget deficit for January-November 2012. Broken down by security holders, individuals financed a considerable portion of the budget deficit[46]. Commercial banks restructured their security portfolios during 2012 by maturing the short-term securities, while increasing the amount of long-term ones. This approach of market players has been in line with the Government's borrowing policy, which has aimed at increasing the share of long-term domestic debt instruments.

The behaviour of the main market players toward the Government's borrowing policy materialized into the slight decrease by 0.1 percentage point (from end-2011) of the weighted average interest rate on Government's domestic debt during the first 9 months of 2012[47]. Since domestic debt represents the largest portion of public debt (56% as at end-Q3), the lower average interest rate reduces the cost of public debt service in the future.

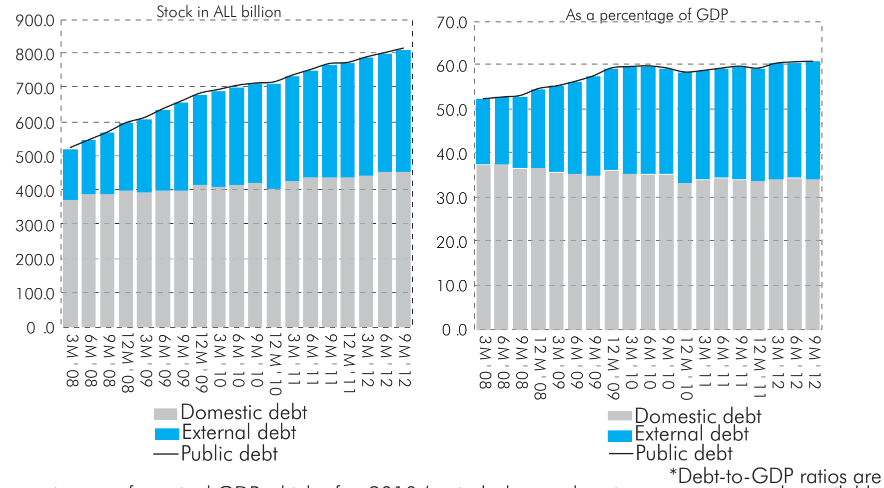
As at end-2012 Q3, public debt stock amounted to about ALL 813.8 billion[48], accounting for about 60.9% of GDP. Public debt increased by about 1.6 percentage points from end-2011, with 70% accounting for the increase in external debt stock. In terms of GDP, it was estimated at about 26.8% at end-Q3, compared to 25.7% at end-2011. The more deteriorated public debt dynamics owes partly to the difference between real economic growth and real interest rate paid on public debt. On the other hand, the fiscal policy pursued during this period (as shown by the primary balance performance) seems to have affected the public debt dynamics positively, but not sufficiently to offset the deteriorating effect arising from the unfavourable economic conditions during this period.

[46] Individuals' security portfolio in lek T-bills increased by about ALL 9.5 billion from end-2011, which accounts for about 51% of total domestic borrowing for the 11-month period of 2012. The new investment policy launched by Raiffeisen Bank during 2012 restructured the bond holders, shifting ALL 12.4 billion from Raiffeisen Bank's portfolio in favour of individuals. Considering both types of securities, for the 11-month period, individuals financed about 66% of total budget deficit through their participation in T-bill auctions and purchase of bonds through "Prestigj" Fund from the Raiffeisen Bank.

[47] According to Ministry of Finance's publication "Debt figures on the first 9 months of 2012".

[48] Domestic debt according to Ministry of Finance's publication "Debt figures on the first 9-month period of 2012", while external debt refers to external sector statistics publication on 2012 Q3, according to Bank of Albania's Statistics Department.

Chart 29 Public debt in ALL billion (left) and as a percentage of GDP (right)*



*Debt-to-GDP ratios are built on estimates of nominal GDP, which after 2010 (period when such estimates are not made available by INSTAT) has been built taking into consideration the real economic growth and CPI. Ratios for 2012 Q3 represent the debt stock resulting at end-Q3 as a percentage of annual nominal GDP (2011 Q4-2012 Q3).

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

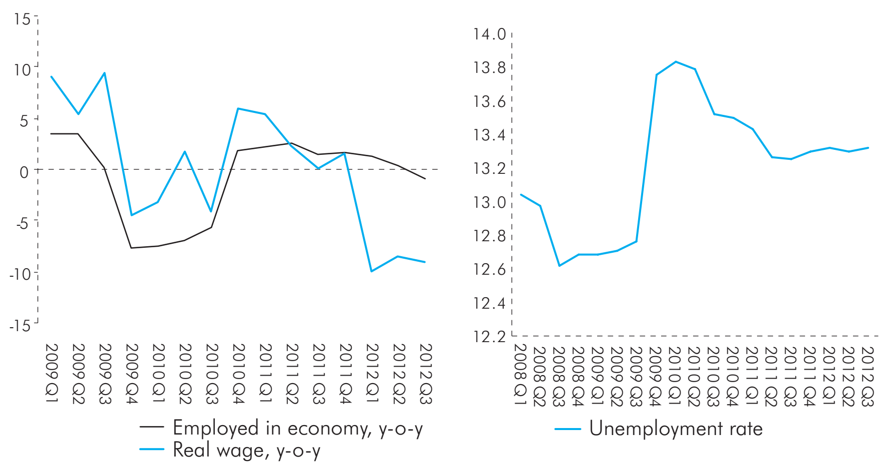
IV.2 LABOUR MARKET, WAGES AND COSTS

The labour market was characterised by a modest increase in employment, with the unemployment rate stabilising at above 13%. The demand-to-supply ratio led to lower wages and other labour costs, implying low inflationary pressures on consumer prices.

LABOUR MARKET

The labour market conditions remained unchanged, in line with the low economic performance and ongoing uncertainty about future developments in Albania and abroad. Unemployment rate remained similar to end-2011 levels, fluctuating around 13.3%. Employment rose modestly by 0.3% in the first three quarters. Wages dropped both in real and nominal terms.

Chart 30 Quantitative labour market figures

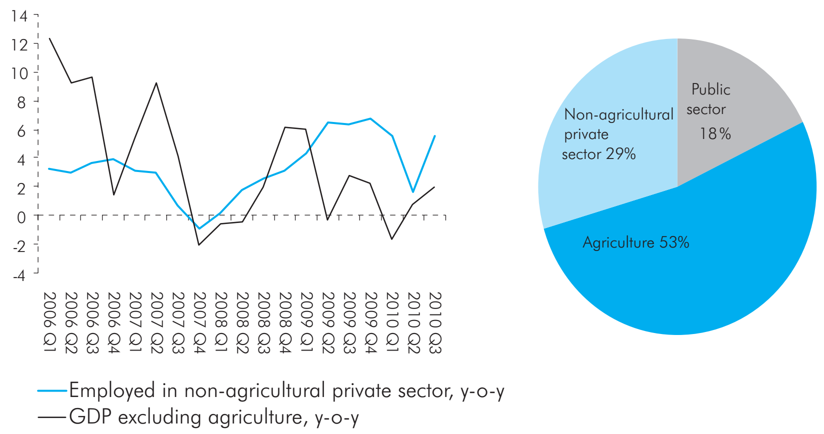


Source: INSTAT, Labour Force Balance, Short-term Statistics.

EMPLOYMENT

The latest data on the labour market developments over 2012 Q3 are based on the Labour Force Survey[49] for 2010. According to this survey results, employment in the non-agricultural private sector increased by 5.6% y-o-y, while that in the agricultural private sector decreased by 4.2%. The contraction in the latter, together with the 0.36% decrease in the public sector employment, resulted in a negative annual and quarterly dynamics of total employment by about 0.8% and 1.2%, respectively.

Chart 31 Quantitative labour market figures



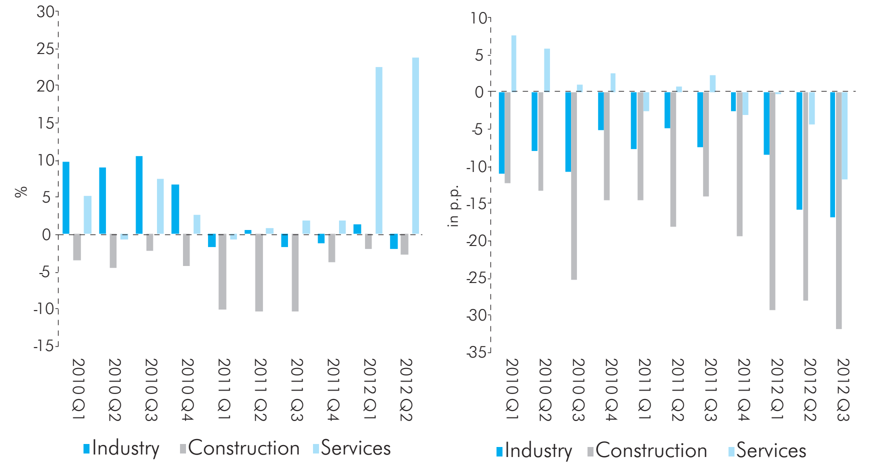
Source: INSTAT, Ministry of Labour, Social Affairs and Equal Opportunities (MLSAEO).

The short-term statistics analysing the distribution of employment in the non-agricultural private sector by branches show that services marked the highest increase (by 17.8%) in 2012 Q3. In line with the production sector[50] activity, the related employment index marked negative growth. It also dropped by 2.3% in industry and by 8.2% in construction.

[49] *Since 2007, employment in the agricultural private sector has been estimated by means of a household-based Labour Force Survey (LFS), conducted annually by INSTAT. From 2010 Q3 to 2012 Q2, the average number of persons employed in this sector has been constant (about 506,664 persons), based on the 2009 LFS results. Initial results of the LFS published on 31 October 2012 by INSTAT showed a lower employment level in the agricultural private sector (about 485,408 persons), a figure used to evidence persons employed in 2012 Q3. As a result, employment in the agricultural private sector, which contributed negatively by 2.3 percentage points to the annual performance of total employment in 2012 Q3, is expected to contribute to the next three quarters.*

[50] *Excluding agriculture.*

Chart 32 Annual increase in employment index by main sectors (left); Employment in economy (right)



Source: INSTAT, Bank of Albania.

Unemployment rate continued to fluctuate around 13.3% in 2012 Q3. Compared to the first two quarters, it edged up slightly, mainly due to the lower labour force. Long-term unemployment rate performed similarly, standing at 8.2%. In 2012 Q4, businesses were less pessimistic about their employment prospects than a quarter earlier.

Box 3 Structural changes in the labour market[I]

When employment does not respond to output growth, the analysis should focus on structural changes in the labour market to see whether job relocations explain employment developments. Groshen and Potter (2003)[II] *define structural changes in the labour market as permanent shifts in the distribution of workers throughout the economy. According to the authors, materialisation of structural changes is likely to affect the sluggishness in the labour market to such an extent that needs further research. They emphasise that recessions mix cyclical and structural adjustments. Groshen and Potter note that cyclical adjustments are reversible responses to lulls in demand, while structural adjustments transform a firm or industry by relocating workers and capital. Change in the number of jobs is cyclical, if job loss/creation during recession is translated into job loss/creation during recovery. By contrast, job adjustment is structural, if job loss/creation in an industry continues during the recovery period.*

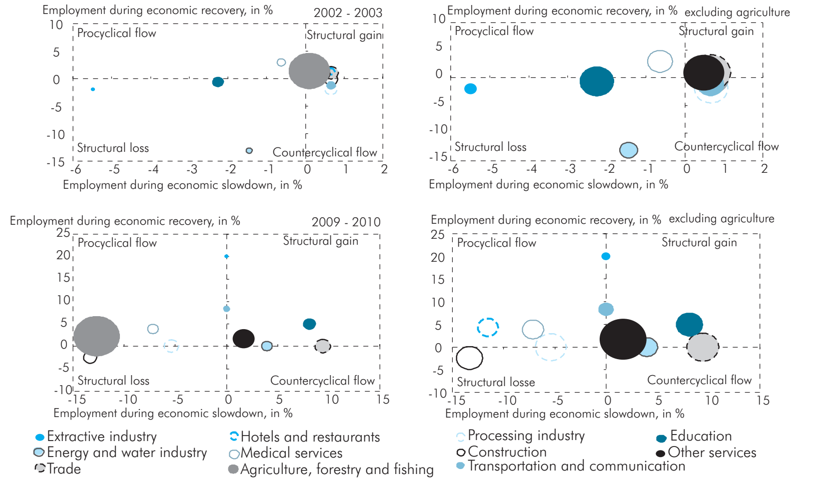
The method pursued by Groshen and Potter is a proxy for assessing[III] *employment in Albania. The annual performance of employment by branches of economy*[IV] *is examined for two periods: – 2002 (growth slowdown) – 2003 (growth recovery); 2009 (growth slowdown) – 2010 (growth recovery), and is shown in chart 1. This chart is divided into four quadrants; the horizontal axis measures the annual performance of employment during the economic slowdown, while the vertical axis measures the annual change of employment during the economic recovery. The size of each cycle reflects the share of employment by branches of the economy, measured at the recovery period. Given that the employed in the Albanian agriculture sector*[V] *share the major part in total employment and that they still have accuracy issues, developments in employment are shown graphically including and excluding agriculture. The position of each branch of the economy in the chart shows whether the change in employment has been structural or cyclical.*

The branches of the economy, which marked employment growth during both periods - growth slowdown and economic recovery -, were: Agriculture, Trade, Hotels and restaurants, Other services (for 2002 – 2003) and Education, Other services (for 2009 – 2010). If a branch of the economy records increase in employment during both opposite phases of the business cycle, it grows structurally, as shown by the structural gains quadrant of the chart. By contrast, the branches of Extractive industry, Electricity, gas and water, Education (for 2002 – 2003) and Construction (for 2009 – 2010) recorded decreased employment during the economic slowdown and recovery. The ongoing contraction of employment in a certain branch during the economic slowdown and expansion indicates that this branch has declined structurally.

On the other hand, medical services (in 2002) and agriculture, transportation and communication, and medical services (in 2009) recorded decreased employment. In the following years, 2003 and 2010, when the economy expanded at a higher rate, employment in those branches increased again. Graphically, the above branches are positioned in the procyclical job flows quadrant: economic slowdown is associated with contracted employment and economic recovery is associated with increased employment.

The calculation of total employment share by branches included, respectively in 2 cyclical quadrants and in 2 structural quadrants as shown in chart 2, further clarifies the evidence on the employment trend, in terms of cyclical swings or structural changes[VI]*. The economic slowdown in 2002 has been substantially materialised into structural changes in employment (including and excluding agriculture). By contrast, during the 2009 economic slowdown, the major part of employment is allocated*

Chart 33 Changes in employment during 2002-2003 and 2009-2010, including agriculture (left) and excluding agriculture (right)

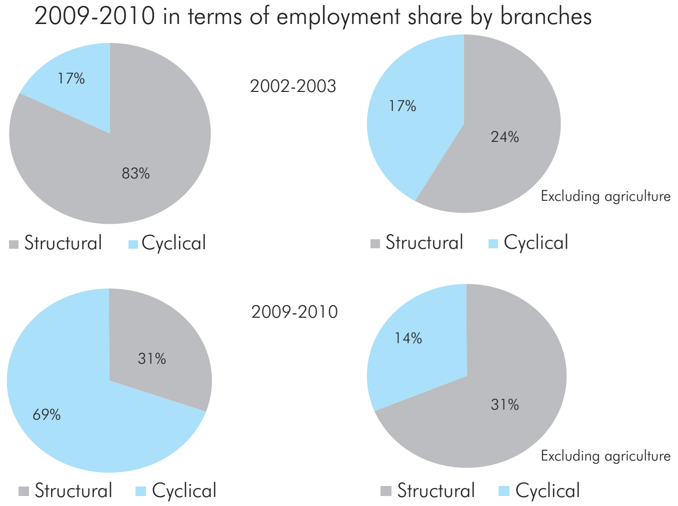


Source: INSTAT and author's calculations.

to those branches of the economy that underwent cyclical changes. However, it is worth noting that abstracting from the share of the employed in the agriculture sector overturns the conclusions.

More concretely, compared to 2002, the greatest structural change occurred in 2009 when about 31% of the employed were in those branches of the economy that underwent relatively higher structural changes.

Chart 34 Structural and cyclical changes in employment in 2002-2003 and 2009-2010 in terms of employment share by branches



Source: INSTAT and author's calculations.

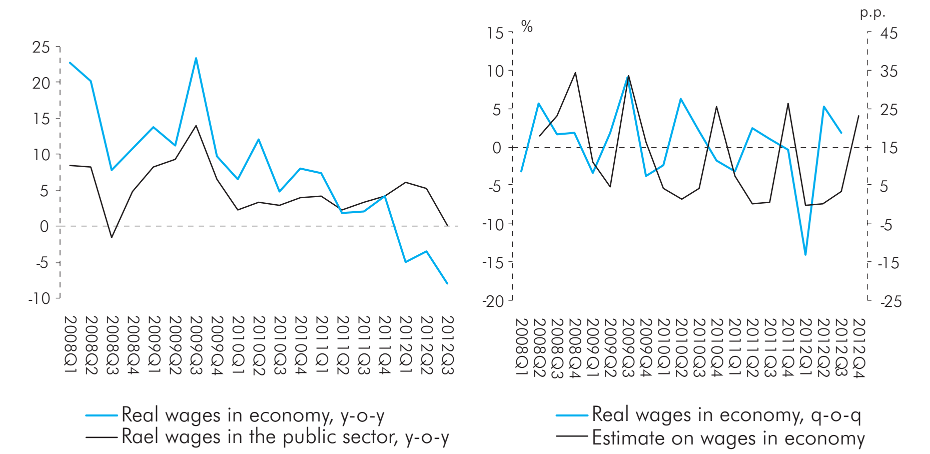
However, conclusions resulting from the application of an approach similar to the one pursued by Groshen and Potter should be considered cautiously, as the branches of the economy respond unevenly to macroeconomic conditions.[VII] As a result, the highest response of some branches[VIII] may inaccurately identify a sectoral shock as a source of shocks to the economy (which does not cause any long-term change in employment).

[I] This is a study in process by Iris Metani, Monetary Policy Department, Bank of Albania.
[II] Grochen, Erica L., and Simon Potter. 2003. "Has structural change contributed to a jobless recovery?" Current Issues in Economic and Finance. Federal Reserve Bank of New York. Volume 9, No. 8. August.
[III] For the years 2000-2011, employment is analysed during growth slowdown and recovery periods identified by the annual GDP at current prices.
[IV] The data on employment are disclosed annually by INSTAT for 11 branches of the economy according to Nomenclature of Economic Activities. This nomenclature (NACE Rev1) serves as a basis for classifying the economic activity of enterprises and the distribution of employees among branches of economy. The branches are as follows: A, B (Agriculture, forestry and fishing); C (Extractive industry); D (Processing industry); E (Energy and water supply industry); F (Construction); G (Trade); H (Hotels and restaurants); I (Transportation and communication; M (Education); N (Medical service); J, K, L, O, P, Q (Other).
[V] They are assessed through surveys.
[VI] The chart is constructed using the sum of shares of the employed in the branches of the economy included respectively in the 2 quadrants that reflect the structural and cyclical changes, by generating the share of employment affected by structural changes and the one affected by cyclical changes. Shares included in the calculations belong to the economic recovery year.
[VII] Based on the research by Abraham, Katherine, and Lawrence F. Katz. 1986. "Cyclical unemployment: sectoral shifts or aggregate disturbances?" Journal of Political Economy 94(3), pp. 507 – 522.
[VIII] For example, construction and processing industry may be affected negatively and to a greater extent, if aggregate demand falls.

WAGES AND LABOUR COSTS

In Q3, average wage in economy continued the downward trend that had started since Q1, albeit at a lower rate. The low demand for labour during 2012 was followed by decreased wages. Based on short-term statistics, average wage index in economy recorded an annual decline of 5.6% during this quarter. Deflated by consumer price index, real wage recorded an annual fall of 8.07%. The lower wage in the economy[51] while the number of employed in the non-agricultural private sector has increased, shows that the labour market adjustment to domestic economic conditions may have occurred mainly through wage reduction.

Chart 35 Wages in the economy and in the public sector (left); related estimates (right)



Source: INSTAT and Bank of Albania.

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

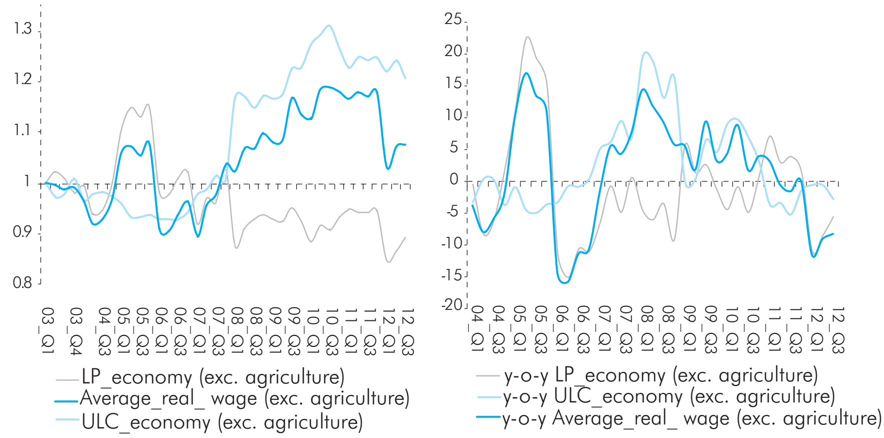
The annual dynamics of wages was uneven across all sectors. The services sector recorded decreased wage and expanded employment, while the industry sector registered increased wage. At the same time, wage in the construction sector maintained its downward trend.

Average wage in the public sector continued to increase, recording an average annual growth of 7.6%. In real terms, this growth was 4.7%. Businesses expect wages in economy to increase in 2012 Q4.

LABOUR PRODUCTIVITY AND UNIT LABOUR COST

In Q3, labour productivity (LP) continued to record negative but lower annual rates (-5.5%). This development owes to contained growth rates of employment index, versus modest growth rates of value added in the non-agricultural economic activity. Unit labour cost (ULC) in the non-agricultural sector continued to record annual decline during this period (-2.8%). The negative dynamics deepened further due to a more pronounced drop in the average real wage than in LP. The performance of this indicator suggests that the inflationary pressures stemming from the labour cost have been and remain weak.

Chart 36 LP, ULC and average real wage (left); annual changes (right)*



*The measures refer to LP and ULC of the economy, excluding agriculture. The estimates use value-added data (seasonally adjusted - INSTAT, GDP, 2012 Q3), and short-term statistics for employment and wages (INSTAT, Short-term statistics, 2012 Q3). 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 Q3). For comparison purposes, the indicators are re-based on the value of each indicator in 2003 Q1.

Source: INSTAT and Bank of Albania.

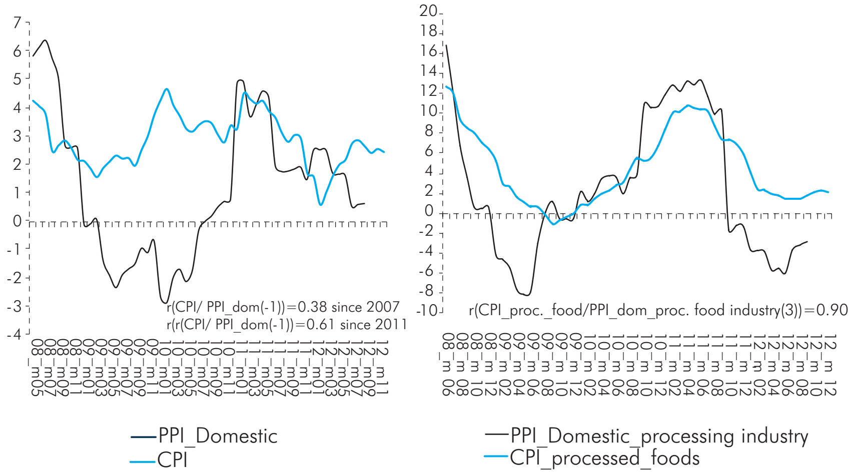
INDUSTRIAL PRODUCER PRICES

In 2012 Q3, industrial producer prices for goods destined for the domestic market sharpened the slowing annual dynamics of the first half of the year. The annual change in Producer Price Index (domestic PPI) was 0.6%, from 2% in the first half. This development confirms expectations for downward industrial producer price pressures on consumer prices in 2012 Q4[52].

[52] *Domestic PPI of respective sub-branches - oil extraction and oil refinery, and food industry - are taken into account. According to estimates, the annual changes in the domestic PPI of these sub-branches are significantly correlated to annual inflation of respective sub-items (CPI_ fuels and CPI_ processed foods).*

Producer prices in food processing industry continued to fall in Q2 (-3.2% annually). The contained falling rates compared to those of the first half of the year (-4.7%) reflect a completely cancelled out effect of the previous year's high comparative base. The contained decline in processing costs for foods destined for the domestic market until end-September affected the annual inflation trend of this category over the next quarter[53].

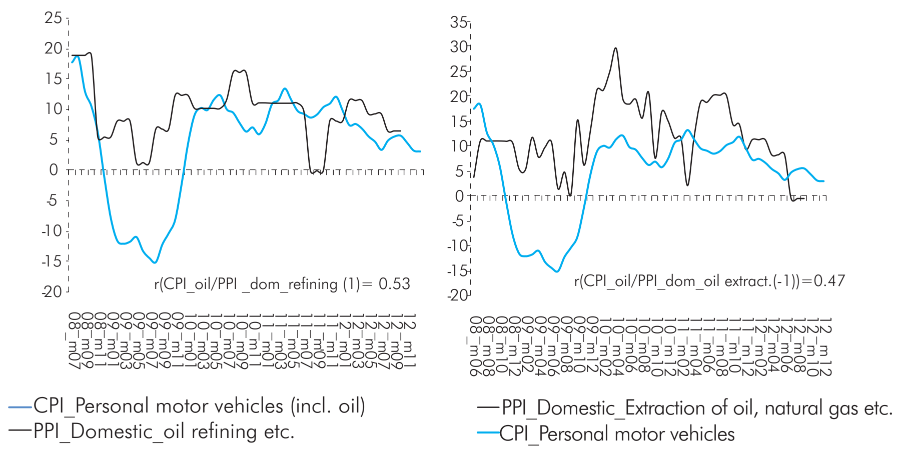
Chart 37 Annual changes: CPI (processed foods) and PPI-domestic (total and food industry)



Source: INSTAT and Bank of Albania.

Producer prices in oil extractive sub-branch dropped by 0.4% annually, while processing costs in oil refining sub-branch were refrained to 6.5% from 9.3% in the first half of the year. The above developments and the international oil prices were partially transmitted to the downtrend of inflation in the respective CPI sub-item during October-December 2012. This performance attests to weakening inflationary pressures from producer costs of this commodity on consumption and economic activity.

Chart 38 Annual changes: CPI and PPI-domestic (for oil); linear correlation



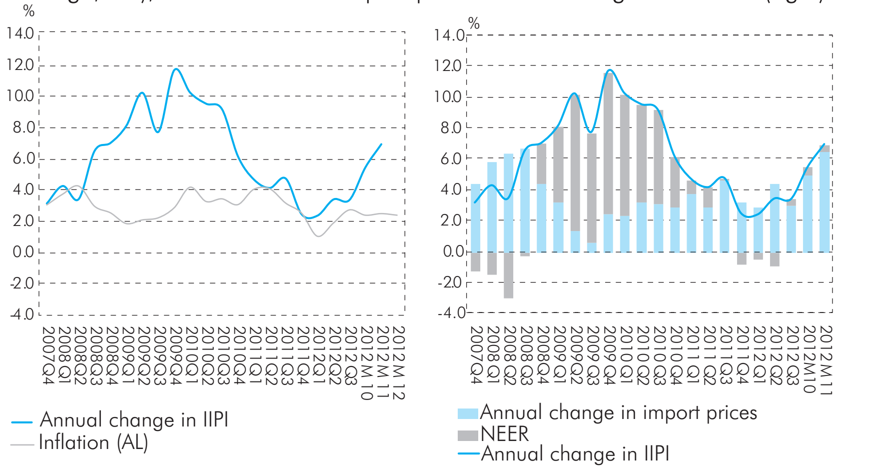
Source: INSTAT and Bank of Albania.

53 Annual inflation of processed foods averaged 1.6% and 2.1% in Q3 and Q4, respectively.

IV.3 IMPORTED INFLATIONARY PRESSURES

In the last five months of the year, imported inflationary pressures index[54] was highly volatile (from 1.5% in July to 6.9% in November). Compared to the first half of the year, this indicator is 1.6 percentage points higher. Its performance attested to added inflationary pressures, particularly during October-November, up by 6.2% annually. This development reflected primarily the import price dynamics, which registered an annual growth of 2.9% in Q3 and 5.7% in October-November. Over the period under review, the lek's stability in terms of the NEER index during the second half of the year seems to have played a controlling role in passing through the import price rise effect on the domestic headline inflation.

Chart 39 Imported inflationary pressures index (IIPI) and domestic inflation (annual change, left); contributions of import prices and exchange rate to IIPI (right)



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

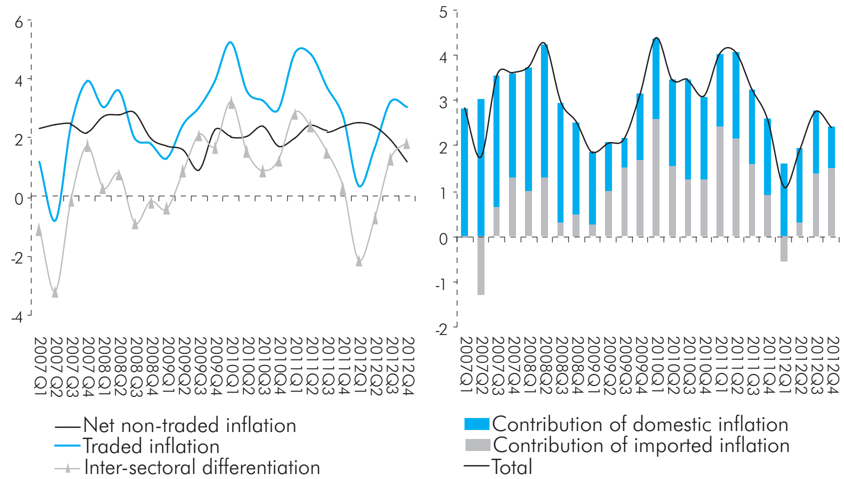
Signals from import prices, domestic foreign exchange market and decreased non-tradeable inflation were partially passed on to the behaviour of the inter-sectoral differentiation of inflation in the second half of 2012, which averaged 1.6 percentage points[55]. Its positive value shows that the inflation of goods was generally higher than that of services in the economy in the second half of 2012. Its expansion owes to the 3% traded inflation rate versus a higher reduction in net non-traded inflation throughout the last two quarters. The contribution of imported inflation to headline inflation was almost similar in both quarters (1.4 percentage points in Q3 and 1.5 percentage points

[54] *This is a proxy for imported inflationary pressures. Imported inflation is measured as the weighted average of 21 countries' CPIs, using their import share based on latest foreign trade data, and adding the NEER for the respective month. Imported inflationary pressures appear to impact on inflation with a 1-3 month(s) lag. Besides the signalling values, assessments based on this indicator should be considered carefully because: CPIs of importing countries do not necessarily perform in line with Export Unit Value index (EUVI) of these countries toward Albania; Importing countries' CPIs also reflect the fiscal measures, which do not necessarily affect EUVIs; the import structure is not the same as that of the Albanian CPI basket. This mismatch should be taken into account when the index is compared to our inflation and to inter-sectoral differentiation of inflation. The latter quantifies the contribution of external inflationary pressures to headline inflation.*

[55] *From 1.3 to 1.9 percentage points, respectively in Q3 and Q4.*

in Q4), while that of domestic inflation was 1.3 and 0.9 percentage points, respectively. The above developments show that the decrease in inflation from 2012 Q3 to Q4 was triggered by restrained domestic inflationary pressures in the economy, favoured by the appreciation of the euro/lek exchange rate and the steady pass-through of import price pressures to headline inflation.

Chart 40 Inter-sectoral differentiation of inflation (left) and respective contributions (right)

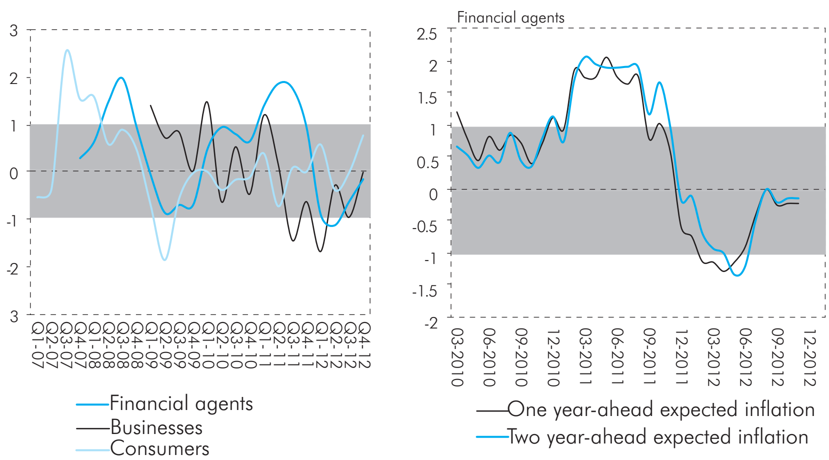


Source: INSTAT and Bank of Albania.

IV.4 INFLATION EXPECTATIONS[56]

The 2012 Q4 survey results show that economic agents' one-year ahead inflation expectations have risen for all groups. The rise was similar for consumers, businesses and financial agents (+0.2 percentage points, respectively). However, the index that quantifies the anchoring shows that expectations of financial agents and businesses have remained anchored, while those of consumers have shifted down by 1 standard deviation from

Chart 41 Anchoring of inflation expectations by different economic agents



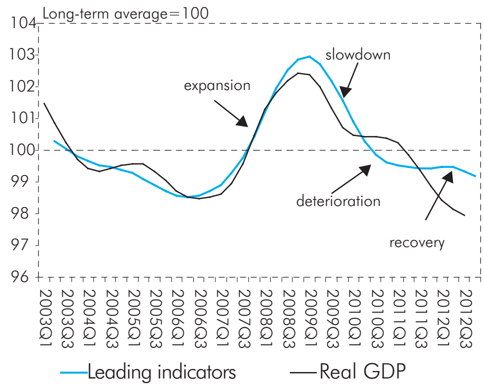
Source: Financial agents survey, Bank of Albania.

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

their long-term average. The financial agents' survey results show that the two-year ahead inflation expectations continue to be better anchored than one-year ahead ones.

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

Chart 42 Cyclical component of GDP and leading indicator's deviation from long-term average



*Composite leading indicator summarises information from several real economy, financial sector and fiscal sector indicators and qualitative data from confidence surveys, which in time have displayed predicting characteristics of economic activity.
Source: Bank of Albania and INSTAT.

The economy grew slowly in 2012, characterised by the presence of a negative output gap, which continued to condition the weak increase in capital and labour market prices. On the other hand, imported inflationary pressures showed an upward trend in 2012 H2. However, they were subdued against the backdrop of a stable exchange rate. In an economic environment with weak demand-side pressures and anchored inflationary pressures, inflation settled at low rates throughout the year.

Economic growth in the period ahead will be driven by global economic developments, fiscal policy nature and revival of output growth. Economic outlook for 2013 remains weak. It will be supported by net exports, albeit to a lower degree, reflecting the pessimistic forecasts for the global economic activity. Domestic demand will remain weak due to low consumer and business confidence, restricted financing sources and further slowdown of foreign demand. Potential growth in economy will also be slowing due to still high unemployment, low level of investments in recent years and negative productivity growth rates. Given the current developments and future trends, and in the absence of any unexpected shocks beyond the monetary policy scope, the CPI inflation is likely to be low but within Bank of Albania's target band. This assessment is based on the ongoing negative output gap and economic agents' anchored inflation expectations. Concluding, the Bank of Albania expects the inflationary pressures to remain weak in the medium run.

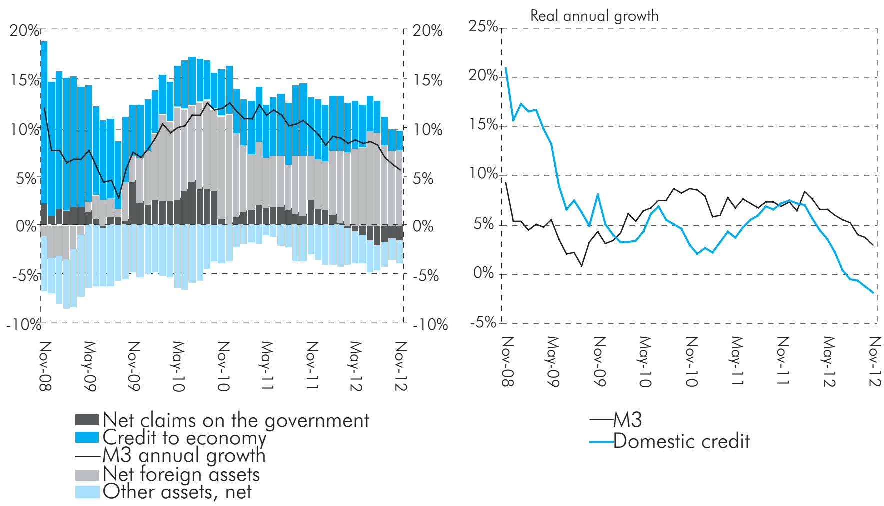
V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Fourth-quarter monetary developments[57] confirm lower money supply growth. Broad money growth is mainly supported by the foreign exchange component and the external sector of the economy. Despite the good liquidity situation in the banking system, the low contribution of domestic credit to economy to broad money expansion reflects the private economic agents' downward demand for money and the public sector's financing (outside the banking sector). Monetary indicators remain in line with real-economy developments, while monetary pressures on inflation remain subdued.

V.1 MONETARY INDICATORS

Broad money, M3, pursued a slowing trend, registering an average annual growth of 5.9% in October-November, from 7.8% in Q3. Its dynamics reflected economic agents' low demand for monetary assets. The contribution of domestic credit to M3 annual growth slowed down to an average of 0.5 percentage points, from 1.4 percentage points in Q3. Developments in lending to the private sector reflected the weak economic activity, economic agents' uncertainties about the future and banks' prudential approach to lending in the presence of rapidly increasing non-performing loans. Money creation in economy was supported mainly by the external sector's foreign currency flows. The contribution of net foreign assets to M3 aggregate growth was 7.6 percentage points on average in October-November.

Chart 43 Contribution of money demand components; domestic credit and M3

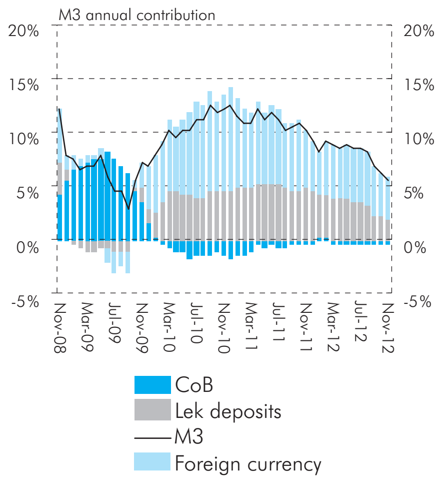


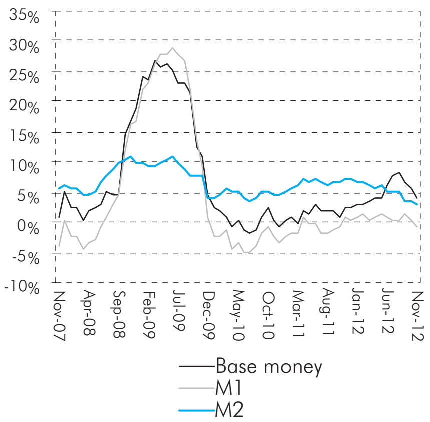
Source: Bank of Albania.

[57] The latest monetary data refer to November 2012.

The national currency monetary aggregate, M2, registered an annual growth rate of 3.2% on average for October-November, from 4.5% in 2012 Q3. Its slowing trend was driven by the lower government borrowing from the banking system. In the meantime, its expansion was supported by the increase in ALL-denominated lending to the private sector. The liquid money aggregate, M1, fell by 1% annually, attesting to economic agents' downward demand for liquid assets over this period. Reserve money or base money, also slowed down its growth rate to 4.9%, from 7.5% in the previous quarter.

Chart 44 Contribution of money supply components; other monetary aggregates



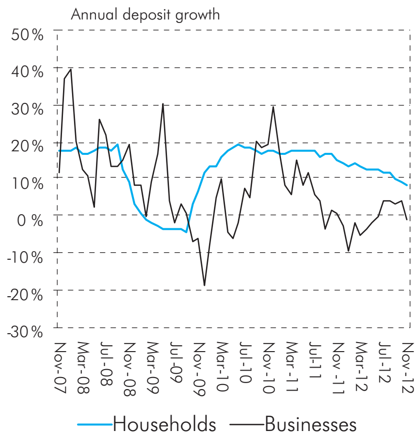


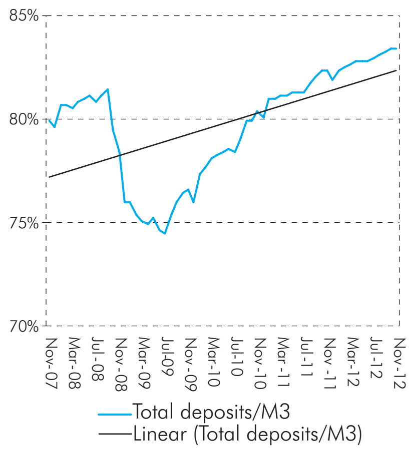
Source: Bank of Albania.

DEPOSITS

Total deposit stock as at end-November was about 6.9% higher than a year earlier. Total deposit to broad money ratio peaked at about 83.3% at end-November, hitting a record high. Deposit growth was continuously supported by the foreign currency component throughout the year owing to net foreign currency flows, which were concentrated mainly in summer. However, in

Chart 45 Deposits by economic agents and deposit to broad money ratio



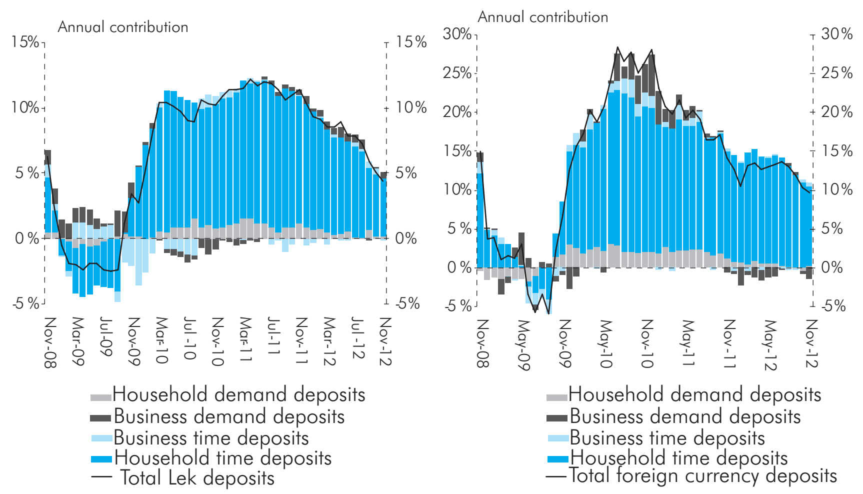


Source: Bank of Albania.

October-November, deposits performed sluggishly and the total deposit stock remained almost unchanged from September.

Fourth-quarter deposit structure by currency showed a better performance of lek-denominated deposits, supported by a larger creation of money in the national currency. In absolute value, lek-denominated deposits grew by ALL 4.8 billion during this period. In annual terms, their growth averaged 4.7%, or about 2 percentage points less than in the previous quarter. Lek-denominated deposit growth was mainly driven by households' time deposits, hence reconfirming their propensity to save. Lek-denominated deposit growth during this period offset the contraction of foreign currency deposit stock that was concentrated mainly in November. Despite its slowdown, the annual growth of foreign currency deposits remained higher than that of lek-denominated deposits. Foreign currency deposits registered an average annual growth of about 10% in October-November, from 12.8% in 2012 Q3. Compared to end-Q3, the foreign currency deposit stock contracted by about ALL 4.9 billion. This performance was mainly driven by business deposits, which dropped during this period. Developments in foreign currency business deposits during this period appear to have supported the growth of imports in certain sectors of the economy.

Chart 46 Contributions of lek and foreign currency deposits by economic agent



Source: Bank of Albania.

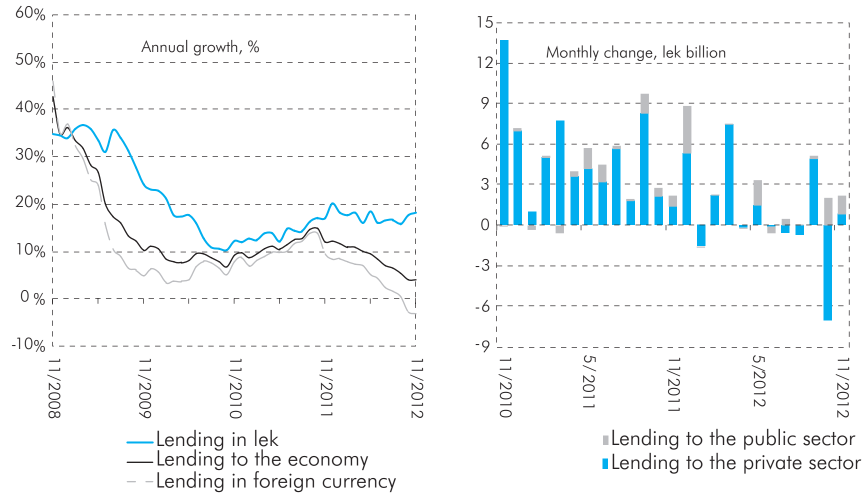
Time deposit structure reveals a higher contribution of time deposits to total deposit stock, particularly in the national currency. Growth of lek-denominated time deposits, in the form of household and business deposit growth, offset the contraction in foreign currency time deposits. Time deposits as at end-November accounted for 81.5% of total deposit stock.

LOANS[58]

Lending to the economy performed poorly in 2012, especially after the first quarter. After increasing slightly in 2012 Q2 and Q3, lending shrank significantly in October and recorded a low positive flow in November. These developments led to a sharp deceleration of its annual growth in 2012. In October and November, annual credit growth was 4.0%, from 5.5% as at end-Q3 and 12.2% as at end-2011.

Lower lending to the economy owes to bank lending-related demand and supply factors. Credit demand by the private sector remained low, reflecting the slowing economic activity in the country and economic agents' uncertainties about the future. On the other hand, banks increased their prudence in terms of lending, reflecting it in further tightening of lending standards on business loans and their more selective approach to lending to projects and clients.

Chart 47 Lending to the economy



Source: Bank of Albania.

Besides the low credit demand by the private sector, October and November showed advance repayments of business loans, mostly in foreign currency. Such a phenomenon, which was more noticeable in October, has affected credit performance significantly.

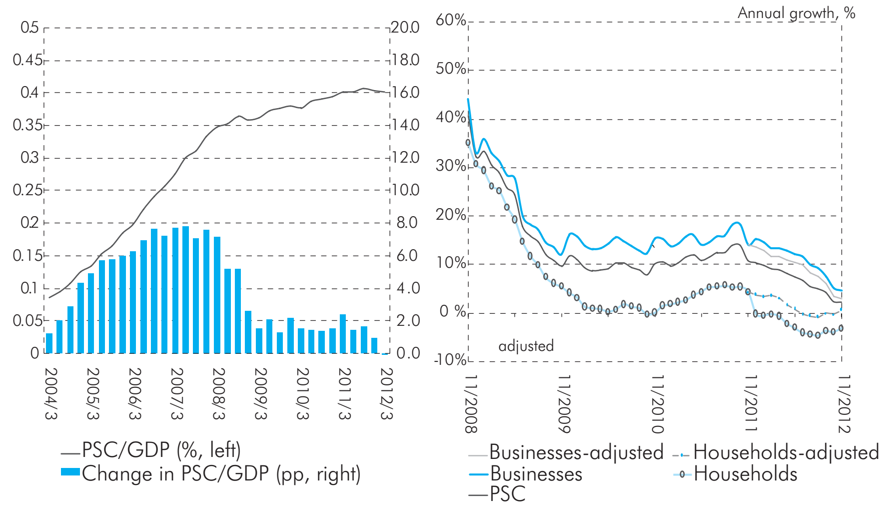
During the last two months, credit growth was influenced by public enterprises' demand for borrowing. Lending to public enterprises increased by about ALL 3.5 billion but it did not offset the decline in lending to the private sector.

In October and November, the economy's demand for borrowing remained oriented toward the national currency. Lek-denominated credit accelerated its annual growth rates, registering 18.1% in November, from 15.8% at end-Q3. Foreign currency credit contracted during both months, as a result of advance repayment of foreign currency liabilities by both private and public sectors. As at end-November, its portfolio was 3.2% lower than a year earlier.

[58] This analysis is based on monetary data. Analysis of lending by purpose of use and by sector of economy is excluded. Lending by purpose of use and by sector of economy excludes accrued interests and includes public enterprises.

The low credit demand and advance repayments in October slowed the annual growth rate of lending to the private sector further. In November, it dropped to 2.3%, from 4.2% at end-Q3 and 10.4% at end-2011. Its low growth in 2012 was also reflected in the impulse of credit to economic activity. Lending to the private sector as a percentage of GDP started to fall in 2012 Q2, reaching at end-Q3 the level seen a year earlier (40.1%).

Chart 48 Private sector credit as a percentage of GDP and its annual growth



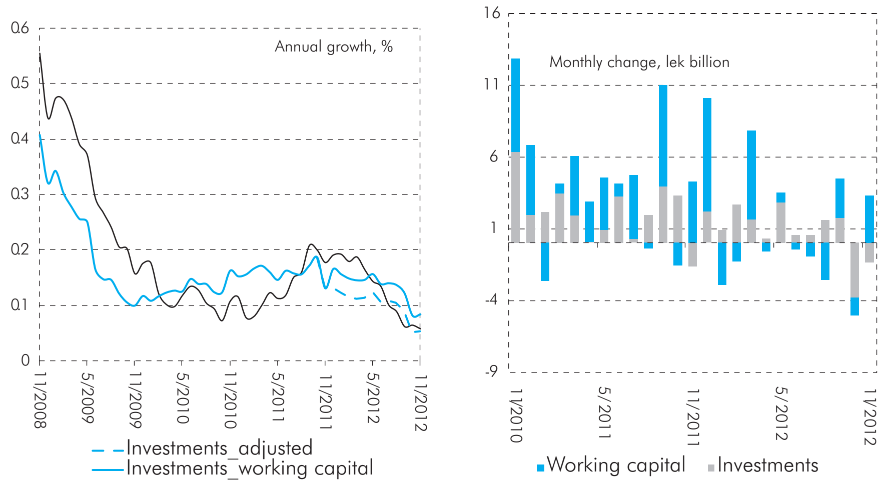
Source: Bank of Albania.

Credit to private enterprises performed poorly in October and November. After increasing slightly in Q2 and Q3, it shrank significantly in October and remained almost unchanged in November. In annual terms, the growth of credit to private enterprises maintained the previous months' slowing trend, dropping to 4.6%[59] at end-November, from 7.6% and 15.3% at the end of the previous quarter and end-2011, respectively.

By purpose of use, the performance of business loans in October and November reflected mainly the contraction in investment loans over both months. This portfolio dropped by about ALL 5 billion in October-November due to advance repayment of several large loans. Consequently, the annual growth of investment loans slowed significantly in both months, registering 8.4% on average, or 4.0 percentage points less than as at end-Q3.

[59] *In December 2011, a reporting bank's loan portfolio was reclassified by purpose of use. The reclassification led to the reduction of the household mortgage loan stock by ALL 5.77 billion and increase by the same amount of the business investment loan stock in December. Due to this reclassification, the annual changes of business loans for December 2011-November 2012 shifted up by 1.7 percentage points on average, while those of investment loan portfolio shifted up by 3.2 percentage points on average.*

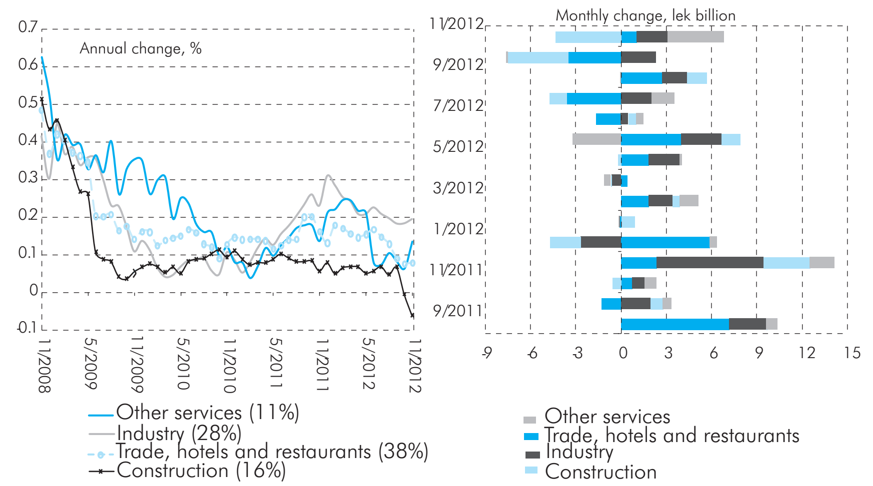
Chart 49 Business loans by purpose of use*



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

Working capital loans performed poorly in 2012 compared to the previous years, characterized by low or negative monthly flows. During October-November, outstanding working capital loans increased in response to demand for short-term financing by public enterprises. Their annual growth continued to slow over both months but at lower rates than in the first three quarters of the year. As at end-November, they stood at 5.8%, from 6.2% and 19.1%, respectively, at end-Q3 and end-2011.

Chart 50 Business loans by sectors of economy



Source: Bank of Albania.

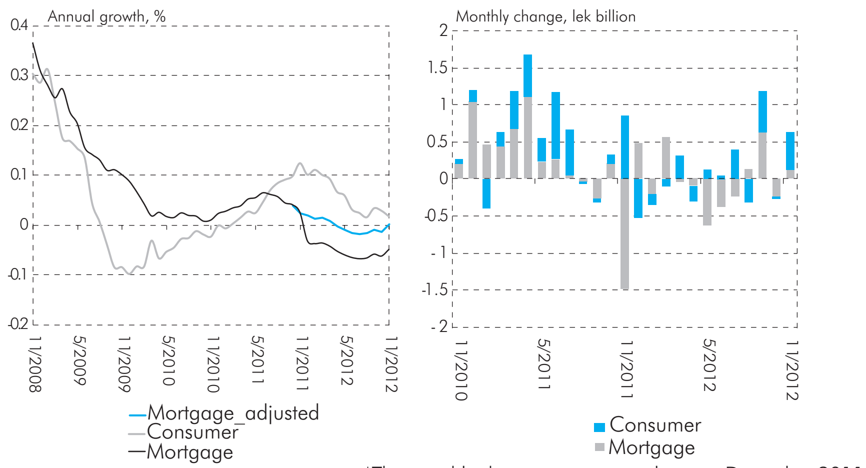
The distribution of business loans by sectors of economy was in line with their economic performance in 2012. In October and November 2012, lending financed mainly the activity of public enterprises of the industry sector (energy branch) and other services (immovable property)[60], while lending

[60] *The positive performance of this type of lending in November was influenced by the loan portfolio reclassification from lending to construction to lending to immovable property management sector.*

to trade and construction sectors dropped. In annual terms, the growth of credit to industry and to other services improved, marking 19.5% and 13.4%, respectively at end-November. The annual growth of credit to trade slowed down, registering 7.8% in November, while bank financing to construction was 6.3% lower than a year earlier.

Credit to households continued to contract annually, albeit at lower rates than in Q3. After reaching a record low of -4.6%[61] in August, the annual change of household credit stood at -3.2% as at end-November. Household credit demand was low, despite the banks' efforts through promotional campaigns, particularly for mortgage loans. Lack of households' response is related to their reluctance to spend, invest and engage in long-term financial commitments, hence reflecting their elevated uncertainty about the future and the poor performance of disposable income.

Chart 51 Household loan by purpose of use*



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

By purpose of use, mortgage loans showed a poorer performance than consumer loans. After the low increase in 2012 Q3, their portfolio fell again in October-November. In annual terms, they continued to contract but at lower rates on a year earlier. As at end-November, mortgage loans were 5.0% lower than a year earlier.

After remaining unchanged in 2012 H1, consumer loans registered positive flows in 2012 H2. Bank advances accounted for the major share in the increase in consumer loans, while loans for the purchase of non-durable goods fell. In annual terms, the growth rate of consumer loans remained low in October and November, within the 1.5%-2.5% band, similar to 2012 Q3.

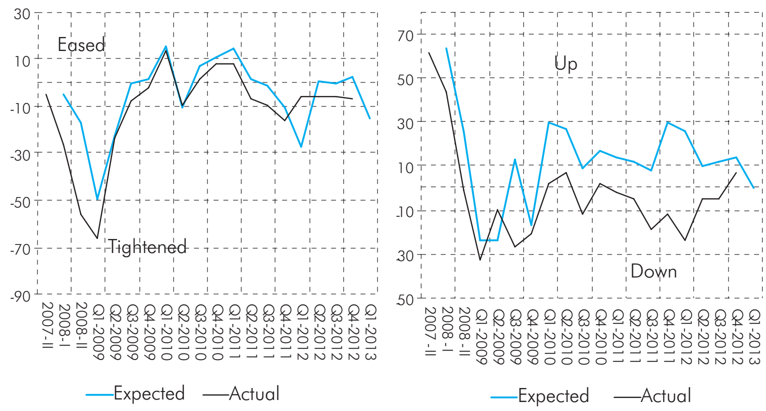
[61] *The effect of loan portfolio reclassification materialised into the decline of the annual growth rates of household loans by about 3.8 percentage points in December 2011-November 2012. The effect of this reclassification on mortgage loans is the reduction of their annual growth by an average of 5.1 percentage points during this period.*

*Box 4 Bank Lending Survey for 2012 Q4**

The results of the lending survey indicated that business lending standards continued to tighten, while household lending standards remained unchanged in 2012 Q4. Lending standards tightened for both loans to small and medium-sized enterprises and loans to large enterprises. By purpose of use, lending standards tightened on investment loans and working capital loans. Lending standards on home purchase loans and consumer loans have remained unchanged since 2012 Q1.

The main factors contributing to the tightening of business lending standards in 2012 Q4 were: specific sector-related concerns, non-performing loans situation and the macroeconomic setting. The main factors contributing to the tightening of household lending standards were: non-performing loans situation, households' financial situation and real-estate market developments.

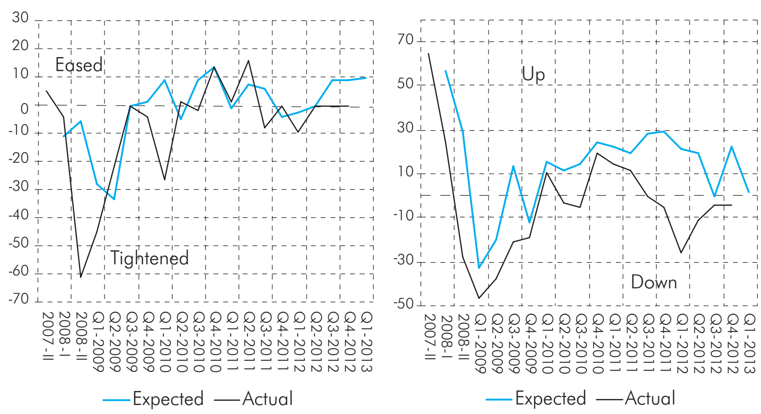
Chart 52 Lending standards and the demand for business loans (net balance)



Source: Bank lending survey for 2012 Q4.

Conditions through which banks applied their tight lending policy on business loans were: higher collateral requirements in relation to loan size, wider average margin and wider margin on risky loans. For households, the tight lending policy was applied by lowering the loan size and increasing the collateral requirement.

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



Source: Bank lending survey for 2012 Q4.

Business demand for loans increased significantly in 2012 Q4, particularly influenced by the demand of small and medium-sized enterprises for loans. Net demand for household loans remained negative during this quarter due to the lower demand for home purchase loans.

Business lending standards are expected to tighten further by purpose of use and business size in 2013 Q1. Household lending standards are expected to ease further, for both home purchase and consumer loans. Business demand for loans is expected to fall, while household demand is expected to improve slightly in 2013 Q1.

* *The survey conducted in December 2012 covers bank lending developments in 2012 Q4 and banks' expectations for lending in 2013 Q1. For a more detailed analysis of Bank Lending Survey Results visit www.bankofalbania.org, under publications.*

V.2 FINANCIAL MARKETS

Financial markets have maintained the positive notes of improved liquidity situation and the declining trend of interest rates, reflecting, as expected, a fuller transmission of monetary policy signals. In particular, yields on public debt instruments fell markedly, a signal that seems to have also been transmitted, albeit slowly, to private sector lending cost. On the other hand, the higher prudence by the banks, in some cases dictated by their parent banks' constraints, affected the non-easing of lending standards, including the private sector lending cost. The likely improved confidence in the domestic and international markets would impact on a fuller transmission of monetary stimulus received during this period.

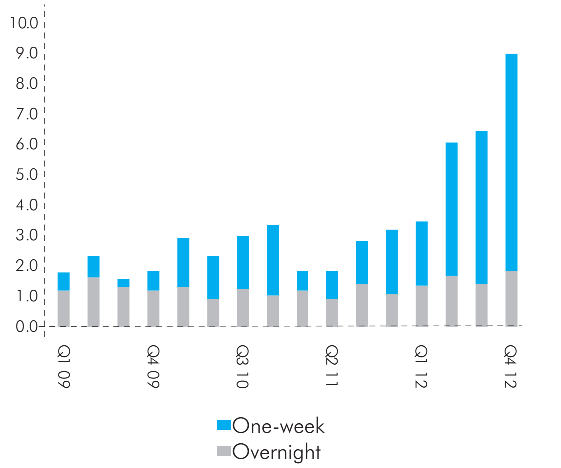
INTERBANK MARKET

Interbank rates have generally maintained a downward tendency during this quarter, which was more pronounced in December. Interest rate decline was noticeable in one-week maturity, while overnight rates were almost similar to previous quarter's levels and remained below the central bank's key interest rate. Banks continued to increase their trading volume in this market and the overall liquidity level was satisfactory. A more active use of this market by banks kept the interest rate on transactions low, hence contributing positively to reducing the liquidity risk premia. The profile of transactions during this quarter did not change, confirming the larger share of one-week maturity transactions as compared to overnight ones.

The Bank of Albania continued to conduct regular open market operations by injecting liquidity of 7-day and 1-month maturity. The liquidity injected into the system was slightly lower than in the previous periods, while the auction yield was close to the key interest rate.

The higher trading volume during this period owes to the expanding volume in both maturities used most frequently by banks, while being also positively

Chart 54 Average quarterly volume of interbank transactions (in ALL billion)

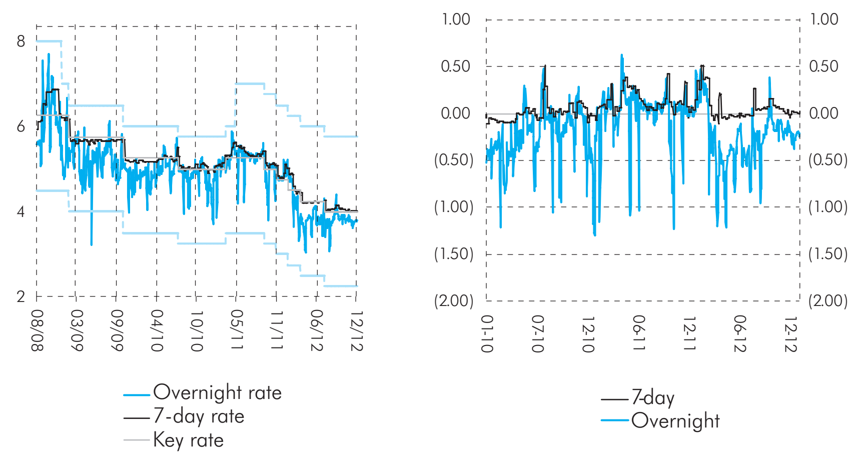


Source: Bank of Albania.

influenced by the use of other maturities (other than overnight or 7-day ones). The average volume of overnight transactions increased by ALL 0.4 billion to ALL 1.82 billion, while that of 7-day transactions increased by ALL 2.12 billion to ALL 7.12 billion. This quarter also saw a higher frequency of 2-3 day transactions.

The spread between overnight rate in the money market and key rate narrowed during this quarter[62] while overall, pointing to a lower volatility[63] than in the previous quarter. In Q4, overnight rate averaged 3.82%, or 0.02 percentage points higher than in Q3, while the 7-day rate dropped to 4.05%, from 4.12%.

Chart 55 Interbank rates (left) and spread between them and the key interest rate (right)



Source: Bank of Albania.

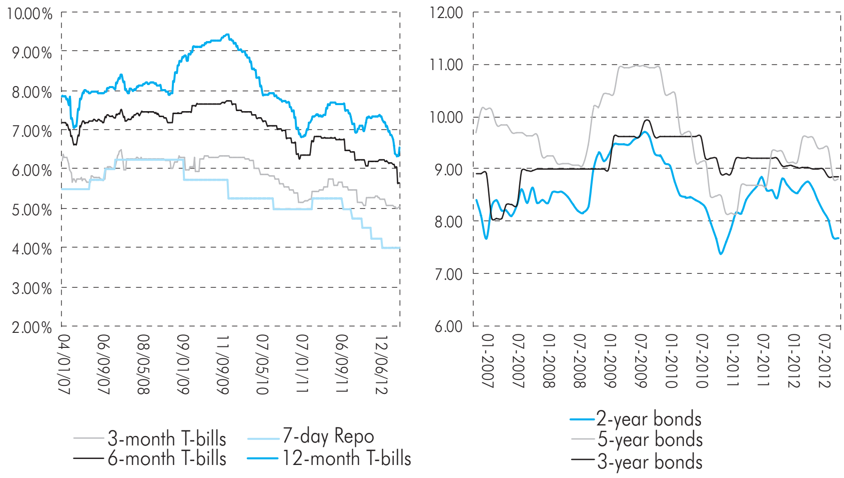
PRIMARY MARKET

The decline in government security yields that had started in Q3 continued in Q4. Yield decline was gradual and for all maturities. It reflected the low pressures from the public sector's demand for borrowing, the stabilised structure of market participants and the decreased risk premia perceived by agents, which, as expected, enabled a better transmission of easing monetary conditions to this segment.

[62] *The spread between the overnight rate and the key rate averaged 18 basis points in Q4, compared to 32 basis points in Q3.*

[63] *Overnight rate standard deviation in the interbank market was 0.0663 in Q4, from 0.2316 in Q3.*

Chart 56 Primary market yields



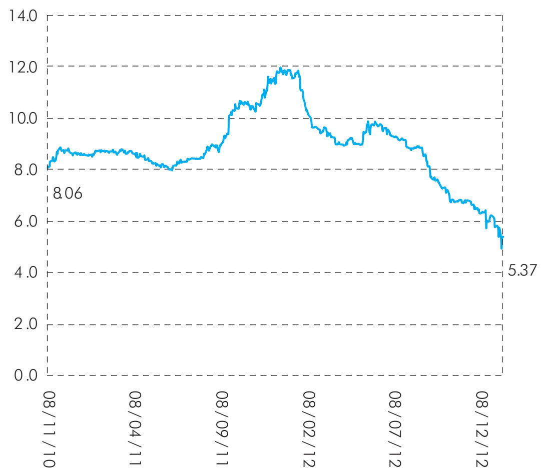
Source: Bank of Albania.

On average, 12-month yield fell to 6.49% in Q4, from 7.13% in Q3. It fell gradually until the second half of December, driven also by the lower short-term security issues. In December's last auction, the higher demand for T-bill financing was followed by a higher 12-month yield, to 6.55%, from 6.35% in the previous auction.

The Government was mostly financed through long-term instruments (bonds). Yields on these instruments dropped, reflecting the overall trend and the lower risk premia. The 2-year yield dropped to 7.68% in December, from 8.20% in September, while the 3-year one dropped to 8.84% in October, from 9.00% in July. Similarly, the ask premium on 5-year bonds at a variable interest rate dropped to 2.04 percentage points in November, from 2.08 percentage points in the previous auction held three months ago.

At end-November, the Moody's reaffirmed Albania's B1 rating of government security investments, which was first made in June 2007. The performance of the Eurobond yield quotations in the interbank market points to a lower perceived risk of international investors over 2012 H2.

Chart 57 Eurobond yield issued by the Albanian government in the international market

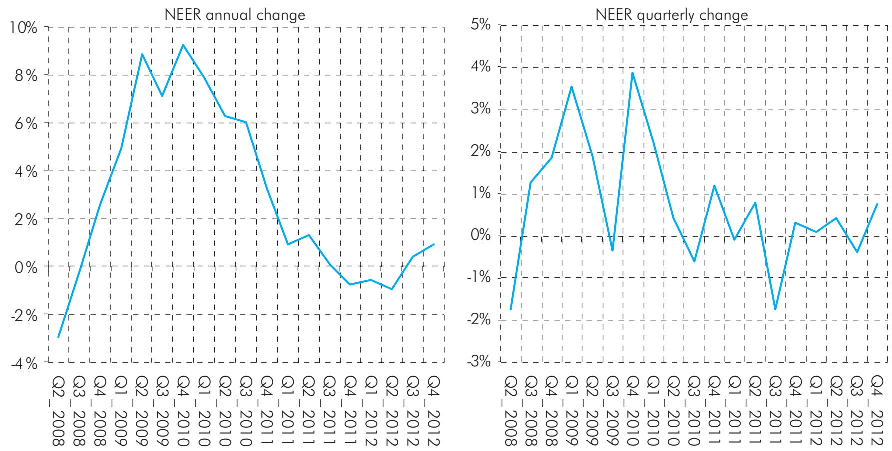


Source: Bloomberg, last quotation, 18 January 2013.

EXCHANGE RATE

The lek's nominal effective exchange rate (NEER) was characterised by a slight depreciation volatility in 2012 H2. After the lek's moderate appreciation in 2012 H1, the NEER marked an annual change of 0.42% and 0.89% in Q3 and Q4, respectively. The depreciation rates are also confirmed by the quarterly NEER analysis. In Q4, the lek depreciated by 0.75%, in line with this indicator's seasonal behaviour. The trajectory of the NEER values seems to combine the trade deficit narrowing during October-November and the appreciation of the U.S. dollar against the major currencies in foreign exchange markets, bringing about the appreciation of the latter against the lek, in annual terms.

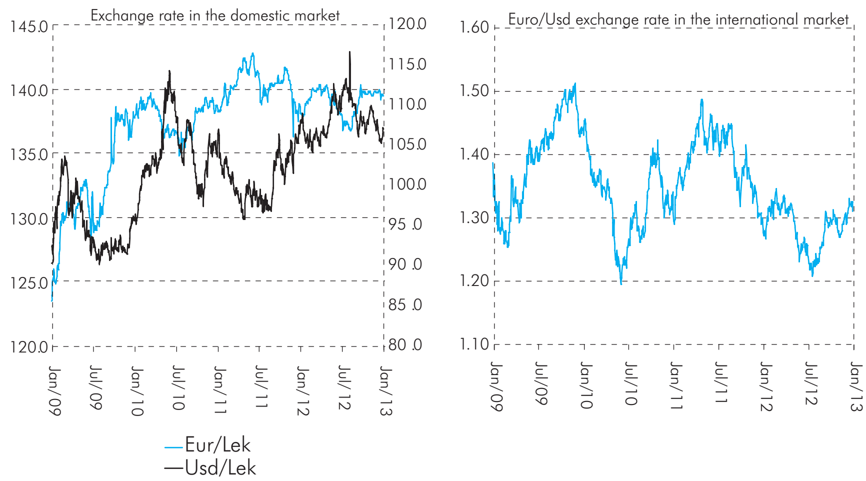
Chart 58 Lek's annual and quarterly changes in NEER terms



Source: Bank of Albania.

Individual developments in the three major currencies in the foreign exchange market show the depreciation of the lek against the U.S. dollar (3.7%) and its mild appreciation against the euro (0.2%) in 2012 Q4, compared to 2011 Q4. On the other hand, in quarterly terms, the lek lost ground against the euro by 1.3%, while gaining ground against the U.S. dollar by about 2.4%, hence reflecting the foreign currency dynamics in the international markets[64].

Chart 59 Daily EUR/ALL, USD/ALL and EUR/USD



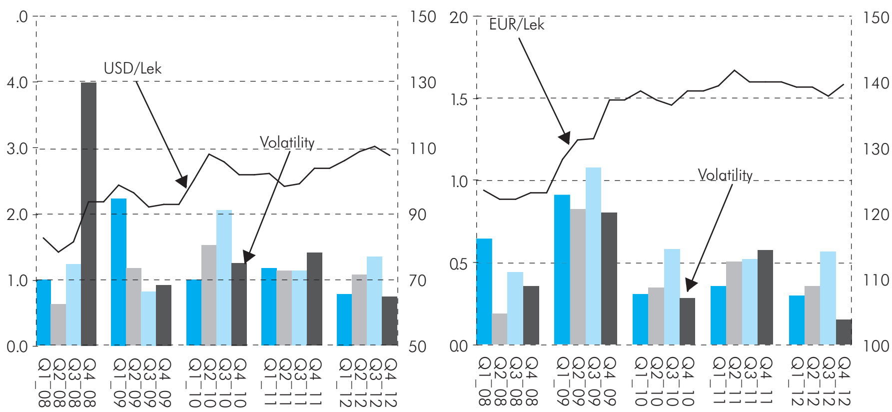
Source: Bank of Albania.

[64] *Based on Major Currencies Index, Federal Reserve for Q4. The positions of the U.S. dollar against major foreign currencies are weaker (1.2%), compared to the previous quarter's average.*

The euro's appreciation against the lek, which had started since end-September, continued in Q4, with one euro exchanging for 139.72 lek on average, hence confirming the lek's stability in Q4. The negative import growth associated with less foreign currency inflows, typically in winter, may be regarded as key factors affecting the euro/lek stability. In addition, the positive performance of the euro against the U.S. dollar[65], triggered by the spread between the key rates applied by the ECB and the Federal Reserve, seems to have been passed on to the domestic foreign exchange market.

The above developments are also confirmed by the volatility indicator that has reflected the lowest value in the last four years for both ratios - euro/lek and usd/lek.

Chart 60 USD/ALL and EUR/ALL quarterly volatility

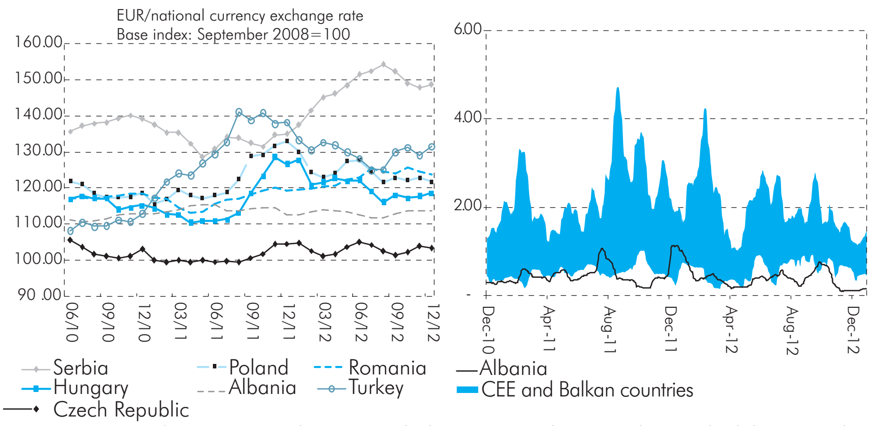


Source: Bank of Albania.

In a regional context, the lek's exchange rate against the euro continues to be the steadier. In quarterly terms, except for Serbia and Poland, the currencies of other countries depreciated in Q4. The lek's volatility stands at the lower limit of the range of values showing the euro/national currency volatility for the countries in the region.

[65] *Compared to the previous quarter, the U.S. dollar depreciated against the euro by 3.4% in 2012 Q4.*

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



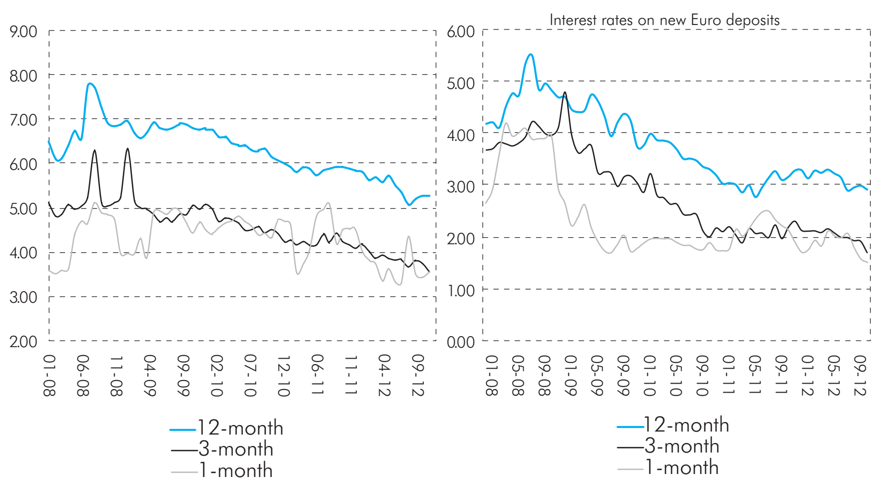
*The euro/national currency volatility is measured as a 30-day standard deviation. The peak and trough volatility levels in each period represent the maximum and minimum standard deviation of selected exchange rates. The selected countries include Poland, Czech Republic, Hungary, Romania, Turkey and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

Source: Bank of Albania's estimates.

INTEREST RATES ON NEW DEPOSITS AND LOANS[66]

New deposit interest rates dropped on average terms over October-November (4.54% in November, from 4.73% in September). Deposit interest rate drops were applied mainly by banks with a larger share in the market, while the smaller banks maintained relatively higher rates, aiming to improve the competitive position and attract domestic savings. During summer, the interest rates for the short-term maturity (1-month) rose sharply, hence affecting the average value, while those of a 12-month maturity dropped. In October-November, the short-term interest rates were close to rates seen in 2012 H1, while those of a 12-month maturity were upward, 5.25% in November, from 5.19% in September. However, it appears that the upward trend of this maturity is influenced by the temporary effect of new placements with small banks. Preliminary data evidence that the decrease in interest rates (mainly on above 1-month deposits) continued after November.

Chart 62 Interest rates on new lek (left) and euro (right) deposits

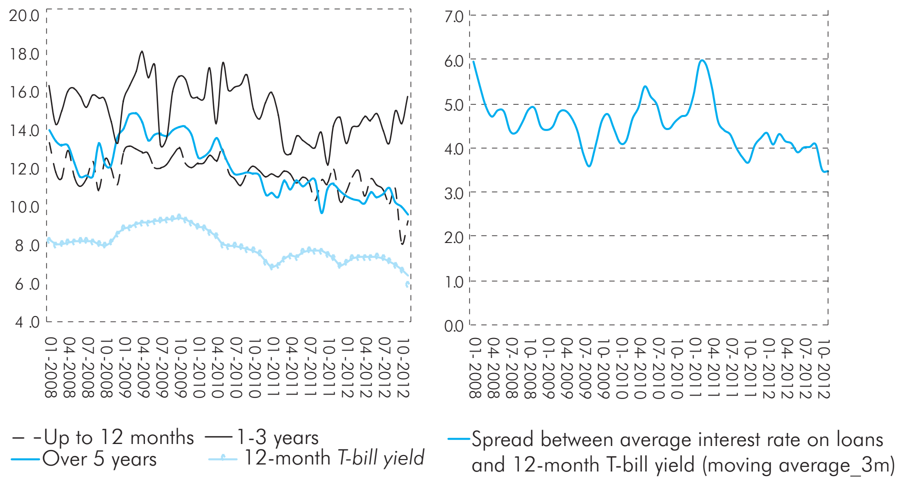


Source: Bank of Albania.

[66] The latest official data on deposit and loan interest rates are as of November 2012.

New euro deposit rates have shown a clearer downtrend for almost all maturities since Q3. In November, the weighted average interest rate on these deposits fell to 2.22%, from 2.49% in September and 2.51% in June. Euro deposit interest rates were relatively high until end-Q3, compared to their performance in the European market. It seems that their level over the last two months (October-November) came closer to new deposit rates applied in the euro area[67]. In addition, this period showed lower drop of euro-denominated time deposits in the domestic banking system.

Chart 63 Interest rates on new lek loans



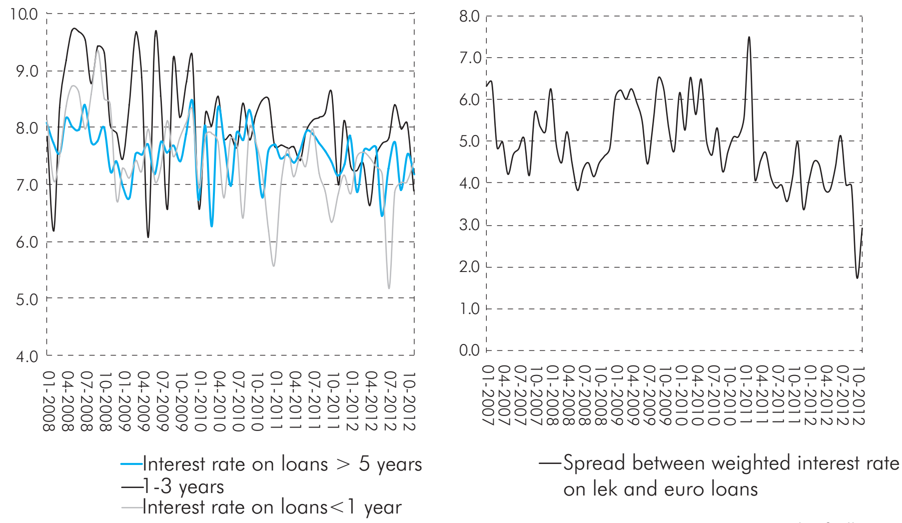
Source: Bank of Albania.

The cost of ALL lending to the private sector was lower in October-November, compared to 2012 Q3. However, we should emphasize that banks' tightening of the lending standards did not favour the easing of lending costs. Moreover, during this period, the interest rates were significantly affected by the share of credit to public enterprises, whose risk is qualified as lower. Albeit slowly, the lek loan interest rates followed the downtrend of government security yields they are indexed to. The spreads between both indicators fell slightly in 2012 H2.

Short-term interest rates (up to 1 year) fell on average to 8.64% in October-November, from 10.68% in Q3. The significantly lower value over this period owes partly to the effect of a large loan with a relatively lower rate extended to public sector. Interest rates on long-term loans also fell, while those on medium-term loans increased (15.02%, from 14.07%).

[67] *Interest rate on new euro-denominated time deposits of a 12-month maturity was 2.93% in November. Over the same period, the interest rate on households' new time deposits of a 12-month maturity was 2.73% in the euro area. A year earlier, these figures were 3.17% and 2.78%, respectively.*

Chart 64 Interest rates on new euro loans



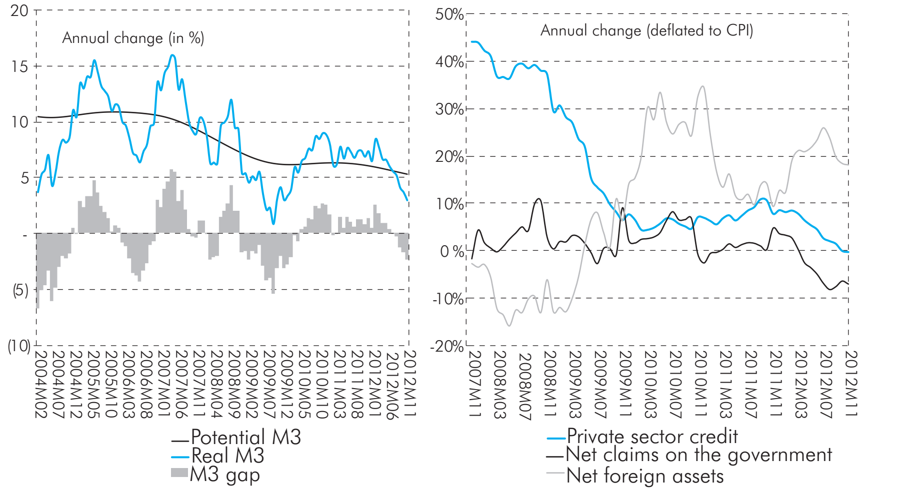
Source: Bank of Albania.

The spread between lek and euro intermediation cost has narrowed since 2011 H2. This effect was more pronounced in October-November, when interest rates on lek and euro ones, on average, moved in opposite directions. The latter fluctuated around a broad band, despite the decreasing interest rates on euro-denominated deposits or on deposits in the European market. Their performance has reflected the characteristics of lending in euro and the reduced euro loan portfolio in 2012.

V.3 ASSESSMENT OF FINANCIAL INFLATIONARY PRESSURES

Real monetary expansion in 2012 H2 slowed down and positioned below its potential growth, in line with the country's economic activity. This tendency has been driven by the real-term contraction in domestic credit, reflecting the weakening demand for monetary assets by both public and private sectors compared to a year earlier. Financial markets in 2012 H2 were tranquil, with subdued pressures from liquidity and risk premia. The spread between the 12-month and 3-month yield was below its historical trend. This performance confirms that financial agents do not factor a higher inflation into financial instruments prices. At the same time, pressures from the foreign exchange market were contained and below their historical average. Overall, the financial sector is characterised by a stable macro-financial environment with subdued inflationary pressures.

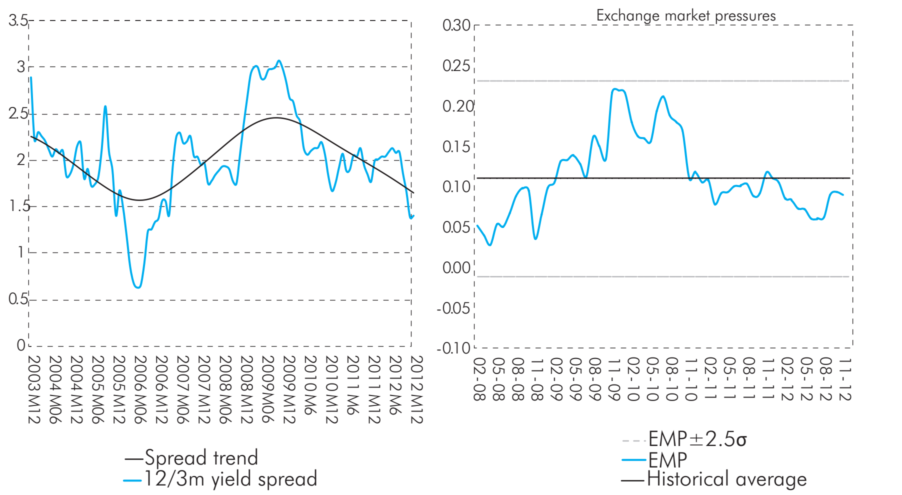
Chart 65 Money gap and domestic credit*



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

Source: Bank of Albania.

Chart 66 Yield spread and exchange market pressure



Source: Bank of Albania.

VI. OUTLOOK FOR THE ALBANIAN ECONOMY IN 2013

The Albanian economy is expected to improve gradually over the next two years, but its performance will be subject to added risks related primarily to economic growth. The key trends expected in the medium-term horizon include the gradual narrowing of the negative output gap, maintenance of inflation close to Bank of Albania's target, ongoing gradual adjustment of the current account deficit, and maintenance of a stable financial environment. In support of these developments in the financial system, alongside further consolidation of balance sheets, a further increase in financial intermediation is projected, albeit at a lower rate than its historical average.

For 2013, economic growth is expected to remain below its potential, though it will benefit from the maintenance of the monetary stimulus and a higher fiscal stimulus.

Consumption and private investments are expected to contribute positively to economic growth. In terms of financial soundness, both Albanian consumers and businesses, in aggregate, have sound balance sheets, thanks to increased households' savings, avoidance of major disorders in employment indicators, and business flexibility in controlling related costs. Increasing financial savings and preserving the labour force are positive grounds to maintain the growth potential in the medium term. However, during 2013, private consumption will remain under the negative impact of a higher risk perception in income realisation, slow recovery in financial intermediation, and uncertain inflows from non-residents.

In the short term, the so-far decline in the labour productivity is an obstacle for a rapid translation of output growth into higher employment and consumption. The high risk perception and low financial intermediation will continue to affect private investments. The restructuring of the economy toward industrial activities and other productive activities requires reallocating financial funds in the economy and is another driver to the low paces of lending and investment. Recession in our trading partner countries will continue to condition the growth of exports. Their performance during the last two years has been supported by the real exchange rate depreciation and temporary supply-side factors. Despite the uncertainty and concerns about maintaining a high export growth rate, the tendency to replace imports with domestic product is expected to make a positive contribution to trade deficit adjustment and economic growth.

According to expenditure projection, the public sector is expected to provide a direct positive contribution in 2013, but risk perception and financial market response will condition the magnitude of further pass-through of this stimulus. The provision of monetary stimulus in a longer time horizon is limited by the need for further fiscal consolidation. Adopting a fiscal rule that reconfirms the public sector's commitment to maintaining public debt sustainability would help reduce the risk premia in the economy and create more room for increasing long-term private investments.

The financial sector is expected to gradually recover its growth rates in the medium-term horizon, in line with the expected performance of aggregate demand. The banking system's good liquidity situation, the steady accumulation of private savings and the good level of capitalisation will boost lending to economy. However, the lending rates are expected to remain low in 2013, with a slight improvement compared to 2012. The tightening of lending standards reflects a higher risk in the economy and across the sectors, thus making the monetary stimulus pass-through more challenging. However, the tendency to lend in the national currency is a steady phenomenon, in response to private agents' more realistic assessment of exchange rate risk. The restructuring of lending, though likely to hinder its rapid growth in the short term, is viewed as a necessity to enhance the effectiveness of monetary policy action and increase our financial system's resilience in a longer-term horizon. Taking into account the relatively weak lending rates, the higher fiscal deficit financing and lower inflows from abroad, the growth of deposits is expected to continue in the short-term at paces similar to those of 2012. For 2014, credit growth is expected to provide higher contribution to deposit growth. Broad money aggregate growth will also remain in line with real sector developments, without exerting any inflationary pressures.

Given the real, monetary and external sector developments, the two-year ahead inflation forecast remains in line with Bank of Albania's target, though at the lower bound of the tolerance band. Under these conditions and in the absence of fluctuations in inflation expectations, the monetary policy is expected to maintain its stimulating nature in 2013. This will be reflected in the maintenance of the key interest rate at low levels and ongoing supply of the banking system with liquidity. It will provide room for lowering the interest rates for all financial instruments in lek, hence supporting the growth of consumption and investments in Albania.