

Bank of Albania

QUARTERLY MONETARY POLICY REPORT

February 2016

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POLICY STATEMENT OF THE BANK OF ALBANIA FOR THE SECOND HALF OF 2015,
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C O N T E N T S

OBJECTIVE	7
1. FOREWORD BY THE GOVERNOR	9
2. EXTERNAL ECONOMIC ENVIRONMENT	12
2.1. <i>Global Economy</i>	12
2.2. <i>Global financial markets</i>	15
3. PRICE STABILITY AND BANK OF ALBANIA'S MONETARY POLICY	17
4. FINANCIAL MARKETS AND MONETARY INDICATORS	20
4.1. <i>Financial Market Developments</i>	20
4.2. <i>Interest rates on deposits and financing conditions in the economy</i>	24
4.3. <i>Lending to the economy</i>	27
4.4. <i>Monetary indicators</i>	29
5. INFLATION AND ECONOMIC GROWTH	32
5.1. <i>Inflation performance</i>	32
5.2. <i>Gross domestic production and aggregate demand performance</i>	34
5.3. <i>Cyclical economic situation and internal inflationary pressures</i>	48
5.4. <i>Imported Inflation</i>	50
5.5. <i>Inflation expectations</i>	51

B O X E S

Box 1	<i>The Albanian Eurobond and its impact in the Albanian financial market</i>	22
Box 2	<i>Bank Lending Survey 2015 Q4</i>	26
Box 3	<i>Price performance in the housing market</i>	39
Box 4	<i>Balance of Payments Developments in 2015 Q3</i>	47

T A B L E S

<i>2. External economic environment</i>		
Table 1.	<i>Selected macroeconomic indicators</i>	12
Table 2.	<i>Economic indicators for countries in the region</i>	14
<i>5. Inflation and economic growth</i>		
Table 3.	<i>The main contribution of annual inflation</i>	33
Table 4.	<i>Balance of Payments indicators</i>	48

C H A R T S

2. External economic environment

Chart 1. Composite output index and quarterly GDP and business and consumer confidence indicators and economic sentiment	13
Chart 2. Annual changes in commodity prices	15
Chart 3. Key interest rates of selected central banks	16
Chart 4. Selected financial indicators in international markets	16

3. Price Stability and Bank of Albania's Monetary Policy

Chart 5. Inflation, key rate and target	17
Chart 6. Interest rates in the economy	18

4. Financial markets and monetary indicators

Chart 7. Bank of Albania open market operations and interbank rates.	20
Chart 8. Government security yields in the primary market	21
Chart 9. Albanian Eurobond compared to similar instruments of regional economies	22
Chart 10. Annual changes of the nominal and real exchange rate index, EUR/ALL and USD/ALL	24
Chart 11. New deposit interest rates	25
Chart 12. Interest rates on new loans	25
Chart 13. Standards and demand for business loans	26
Chart 14. Standards and demand for households loans	26
Chart 15. Loans by economic agents and currency	27
Chart 16. Lending by purpose of use	28
Chart 17. Monetary indicators	29
Chart 18. Deposits' performance in the banking system	30

5. Inflation and economic growth

Chart 19. Food and Non-food contributions in the total annual inflation	33
Chart 20. Annual and quarterly performance of GDP	34
Chart 21. Gross domestic product by production and the confidence indicators	36
Chart 22. Contributions of branches and capacity utilization rates in the service sector	36
Chart 23. The contributions of branches in the performance of value added in industry and capacity utilization rates	37
Chart 24. Branches contributions in the performance of value added in construction and capacity utilization rates	38
Chart 25. Price and Apartments Rent Index and their ratio	39
Chart 26. Indicators from lending survey	39
Chart 27. The structure of aggregate demand and ESI	40
Chart 28. Private consumption and confidence in the trade sector	41
Chart 29. Indirect indicators on private consumer spending	41
Chart 30. Performance of investments, annual changes	42
Chart 31. Short-term indicators for private investments	42
Chart 32. Orientation of fiscal policy, proxied by the change in the primary deficit	43
Chart 33. Contribution of the major components of expenditure on total expenditure, and annual change of expenditure's total and the major items	43
Chart 34. Annual change in budget revenues by contributions of main items and annual changes in main revenue items	44
Chart 35. Cumulative deficit/GDP and financing instruments	45
Chart 36. Contribution of net exports to real GDP	45
Chart 37. Import and export orientation by item	45
Chart 38. The performance of oil price in the Brent market, export of domestic oil, metals index price and of domestic metals export	46
Chart 39. Economy cycle indicators	49
Chart 40. Long-term inflation trends and short-term trends	49
Chart 41. Hammered annual average changes in productivity, labour costs and production	50

Chart 42. <i>IIP and contributions of its components; contributions of imported inflation and domestic inflation to annual headline inflation</i>	51
Chart 43. <i>Inflation expectations from different economic agents</i>	51

OBJECTIVE

Bank of Albania's primary objective is to achieve and maintain price stability.

Promoting long-term investments, maintaining the purchasing power of money, enhancing the efficiency of fund allocation in the economy and safeguarding the financial stability are some of the benefits provided by an economic environment characterized by stable prices.

Stability is the greatest contribution by the central bank to sustain a steady and long-term economic growth.

In line with its approved Monetary Policy Document, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0% in the medium term. The announcement of the quantitative target for inflation aims at anchoring economic agents' expectations and reducing the risk premiums.

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

The Monetary Policy Report February 2016 refers to the Monetary Policy Statement of the Bank of Albania for the second half of 2015, adopted by the Supervisory Council Decision No 4, dated 3.02.2016. The economic, financial and monetary analysis in this report is based on the latest data available as at 22 January 2016.

1. FOREWORD BY THE GOVERNOR

New data for the third and fourth quarters show that economic activity in Albania is moving along a positive trajectory. Our analyses and forecasts suggest that the Albanian economy will continue to see positive growth rates in the next three years. Economic activity is expected to return to equilibrium in the first quarter of 2017 and inflation is expected to return to target in the second quarter of 2018.

These forecasts have not changed our previous assessments. The direction and intensity of expected developments reflects: (i) actual dynamics of the Albanian economy; ii) expected improvement of the external environment; and (iii) maintaining the accommodative monetary policy stance over the forecast horizon. Let me now briefly explain these factors.

During the second half of 2015, the economy performed on the up side of our expectations. As a result, the expected economic growth rate for the year was revised slightly up. Based on the current trends, the Bank of Albania expects economic growth to accelerate somewhat in 2016. In the meantime, inflation is expected to average around 2% in this period.

According to INSTAT data, the Albanian economy posted 2.98% growth in the third quarter, driven mainly by the increase in investments and recovery of the activity in the services sector. Indirect data for the fourth quarter suggest that growth remained in positive territory. Analysing the available information, the Bank of Albania deems that private investments will continue to grow, fuelled by high levels of foreign direct investments, improvement of firms' financial situation, due to payment of arrears, and easing of financing conditions by the banking sector. Also, households' consumption has seen growth whereas its determining factors - employment, wages and consumer confidence - showed improvement. On the other hand, Albanian exports are suffering from the sluggish performance in Albania's trading partners and unfavourable conjuncture in international markets. In addition, public spending fell during 2015, reflecting the strong fiscal consolidation by the public sector.

Inflation rose slightly during the fourth quarter, averaging 2.1%. Inflation went through a progressive rising trend in the second half of the year, reflecting in part the improvement of economic activity and the transitional effects of the low comparative base against the previous year. However, in line with our previous statements, inflation remains below Bank of Albania's target. This performance illustrates the fact that employment and the capacity utilisation rate

remain below their potential. It also highlights the need for an accommodative monetary policy stance in the medium term.

The unfavourable situation in Albania's trading partners and international markets has not contributed to the economic activity in Albania in the second half of 2015. Developments in Greece, low oil and commodity prices, and frequent fluctuations in the financial markets have led to low demand for Albanian exports and did not encourage credit growth. While monitoring actual economic trends and international institutions' projections, the Bank of Albania judges that the external environment will strengthen in the medium-term horizon, and increasingly support economic growth in Albania.

Moreover, economic growth over this period is expected to be driven by the improvement of financing conditions and the progressive credit recovery. This expectation reflects a combination of a series of underlying factors.

- First, the strong accommodative monetary policy stance has brought interest rates in financial markets to historic minimum levels. The Bank of Albania deems that these rates will remain below the historic average over the next two years.
- Second, the issue of the euro bond led to the reduction of public borrowing in domestic financial markets. This has brought interest rates down - even beyond signals given by the monetary policy - thus contributing to the increase of the monetary policy stimulus in the economy. In accordance with the medium-term budget plan, the Bank of Albania deems that the effect of this factor will be also present over the next two years.
- Third, the implementation of the plan of actions for reducing non-performing loans will contribute to the easing of credit standards and the increase in bank credit supply.

All these factors are expected to better support consumption and private investments, in the medium-term horizon. In line with them, the Bank of Albania deems that economic growth will further improve in the medium-term horizon, fed initially by the domestic demand and later by the steady growth of exports. This growth will help in the gradual return of inflation to the 3% target.

In Bank of Albania's judgment, the actual monetary conditions are adequate for achieving the inflation target within a medium-term horizon. Based on this judgement, with the approval of this Statement, the Supervisory Council decided to keep the key interest rate unchanged at 1.75%. The Bank of Albania deems that the materialisation of our projections, and the presence of risks that may shock economic activity, require implementing a prudent monetary policy. This policy should pay particular attention not to damage the stable

economic growth and the perspective of achieving our inflation target. Based on available information, the Bank of Albania judges that the intensity of the monetary stimulus will not decrease in 2016, and that monetary conditions will remain stimulating over two years ahead.

Lastly, the Bank of Albania iterates the need for continuing and accelerating the structural reforms. These reforms are the only instruments to place the economy on a faster growth track, as well as a principal tool to bolster Albania's economic and financial stability.

2. EXTERNAL ECONOMIC ENVIRONMENT

The external economic environment remains sluggish and inflationary pressures are low. While the activity in advanced economies improved slightly, growth rates are inadequate to contribute to the rapid expansion of external demand for Albanian products. Low commodity prices in international markets contributed to maintaining low inflationary pressures from abroad.

2.1. GLOBAL ECONOMY

The global economy continued the path of growth in the last quarter of 2015. The economic activity toned up in advanced economies, but remained sluggish and saw slow growth rates in emerging economies. In advanced economies, growth was driven by financing conditions, improving labour markets, and receding fiscal consolidation. On their side, emerging economies are experiencing slowdown in economic activity and increase in uncertainties, driven by low commodity and oil prices for a prolonged period of time. The deceleration of the Chinese economy has generated some uncertainties both among market agents and in forecasts for 2016. Indicators of demand for raw materials and of global trade for emerging economies appeared to be modest in the last months, thus adding uncertainties surrounding economic activity. Inflationary pressures remain subdued, due to the prolonged decline in energy and commodity prices.

Table 1. Selected macroeconomic indicators

Countries	GDP change				Unemployment rate	Inflation rate	
	Quarterly		Annual			Nov. 2015	Dec. 2015
	2015 Q2	2015 Q3	2015 Q2	2015 Q3	Nov. 2015		Nov. 2015
USA	1.0	0.5	2.7	2.2	5.0 ¹	-0.1	0.7
Euro area	0.4	0.3	1.5	1.6	10.5	0.2	-0.1
Germany	0.4	0.3	1.6	1.7	4.5	-0.1	0.3
France	0.0	0.3	1.1	1.2	10.1	0.2	0.2
United Kingdom	0.7	0.5	2.4	2.3	5.2 ²	0.0	0.1

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

¹December; ²Interval August - October 2015.

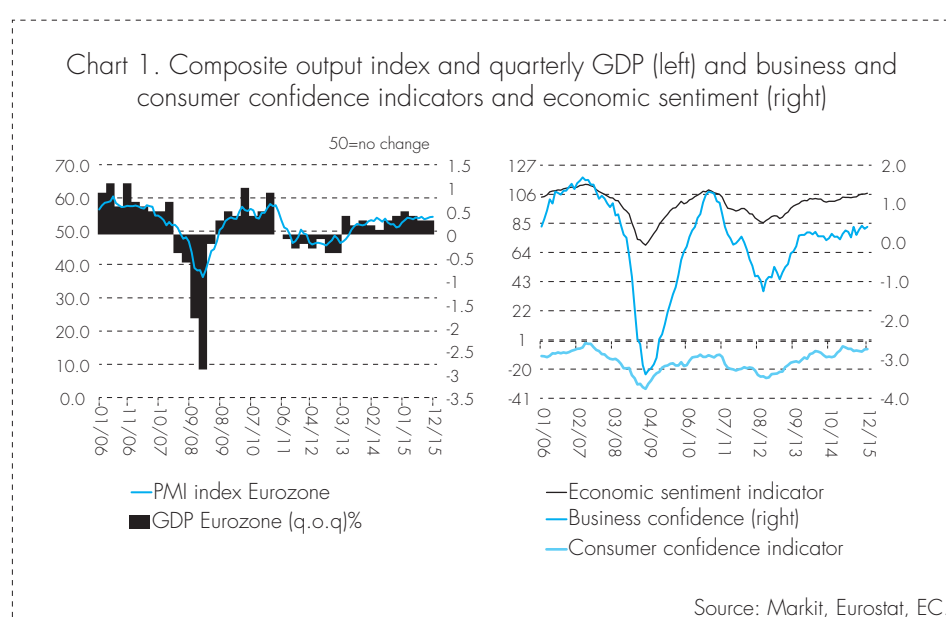
EURO AREA ECONOMY

In 2015 Q3, the economy continued to grow in the euro area, albeit at a slower pace compared to the previous quarter. The GDP growth rate resulted in 0.3% in quarterly terms, and in 1.6% in annual terms. Compared to a year earlier, the pace of growth intensified¹. Growth was driven by the positive contribution by consumption and investments, which offset the contraction in net exports.

¹ The annual growth rate was 1.6% in Q3, from 1.5% and 1.2%, respectively, in Q2 and Q1.

The business and consumers' confidence indicators in the last quarter performed positively. The PMI² output indices suggest that the economy continued to grow at a similar pace to the third quarter. The outlook for 2016 confirms the consolidation of economic activity, while risks relate mainly to geopolitical tensions and the potential weakening of emerging economies, which may weaken European exports towards these regions.

The accommodative policy of the ECB and purchase programmes have succeeded in supporting economic activity, but the overall weakness in commodity markets and their prices have contributed to low inflation rates throughout this period. Euro area inflation ranged low and stood below the ECB's target, in the recent months. Inflation projections for 2016³ were revised down, reflecting the persisting low oil and commodity prices.



UNITED STATES ECONOMY

The US economy continued to grow in 2015 Q3, but the pace slowed somewhat down. Economic activity was mainly driven by consumer spending, private investments and local government expenditure. By contrast, shrinking of central government expenditure has driven economic growth down. Also, net exports contributed negatively, reflecting the combined effect of the deceleration in exports

² The Purchasing Managers Index (PMI) indices are economic indicators derived from the survey conducted on a large group of businesses, which are representatives of producing sector of a country. The PMI index is based on five indicators: production levels, new orders, supplier deliveries, inventories, and employment levels. The value higher than 50% of index show increase or expansion, while the values below 50% show the opposite. The PMI index is one of the fastest indicators of economic growth as the answers of businesses' managers are obligatory based on real data and not on opinions. The main producers of this index are "Markit Group" which conducts surveys in more than 30 countries and "ISM" in USA.

³ The December 2015 Eurosystem staff macroeconomic projections for the euro area, 3 December 2015.

and increase in imports. Indirect data suggest an acceleration of economic growth in the last quarter of the year. Unemployment stood low in the fourth quarter, whereas inflation trended up at the end of the year. Against this backdrop, the Fed decided to raise the key interest rate in December, as anticipated.

ECONOMIES IN THE REGION

The economy of **Italy** accelerated the pace of growth in 2015 Q3. Economic activity improved thanks to the increase in consumer and government spending and investments. Imports grew faster than exports, hence the negative contribution of net exports. Preliminary high-frequency data point to positive growth in 2015 Q4, sustained by industrial production and improved confidence indices. Conversely, the performance in consumption, labour market and construction suggest that growth will be somewhat lower than in the previous quarter.

The economy of **Greece** contracted in 2015 Q3 due to the strong contraction in investments and exports. By contrast, the increase in consumer spending mitigated the negative performance of the economy. In this quarter, the Greek economy suffered also from the freezing of banking activities for a limited period, as a result of negotiations on debt restructuring with international creditors, and the domestic fragile political situation.

Economic activity in **Turkey** grew faster than in the third quarter. Government and consumer spending were the main drivers of growth. Imports reduced faster than exports, thus making positive contribution to economic activity. During this period, investments shrank, contributing therefore negatively to economic growth.

The economy of **Macedonia** accelerated the pace of growth in 2015 Q3. The positive performance reflects the rapid increase in government expenditure, investments and consumer spending. The positive performance was decelerated by the growth of imports and slowdown of exports growth.

Economic activity in **Kosovo** improved in 2015 Q2. The positive performance is attributable to the increase in consumer spending and investments. Conversely, government expenditure and imports growth contributed on the opposite direction in economic growth.

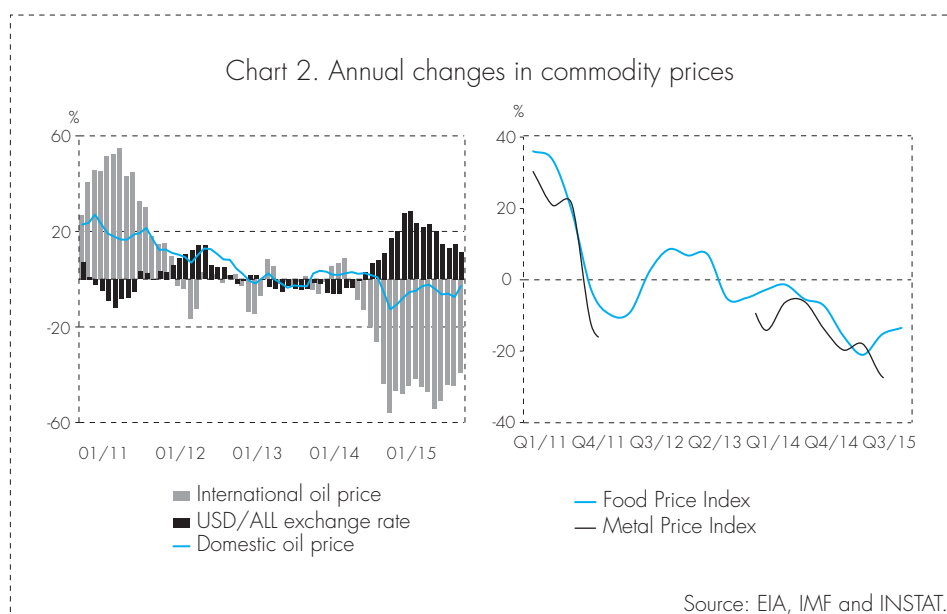
Table 2. Economic indicators for countries in the region

Countries	GDP change	Annual inflation	Unemployment rate
	2015 Q3/2014 Q3	December 2015	November 2015
Italy	0.8	0.1	11.3
Greece	-1.1	-0.2	24.5 ²
Macedonia	3.5	-0.3	25.5 ³
Serbia	2.2	1.5	17.3 ³
Croatia	2.7	-0.6	16.6
Turkey	4.0	8.8	10.5 ²
Kosovo	3.4 ¹	-0.1	35.3 ⁴
Albania	3.0	2.0	17.5 ³

¹- Value for 2015 Q2; ²- Value for October 2015; ³- Value for 2015 Q3; ⁴- Value for 2014.

COMMODITY PRICES IN GLOBAL MARKETS

Commodity prices continued the downward spiral for the sixth consecutive quarter. In the European market, the Brent oil price fell to USD 43.6 per barrel in the fourth quarter, or 43% lower than in the same period in the previous year. The supply for this product exceeded demand, reflecting mainly the lifting of sanctions for Iranian exports and accommodative policies of OPEC countries. On the other hand, irrespective of the low prices, demand for oil remained sluggish, driven by the slowdown in the global economy and warmer weather for the period. In the domestic market in the last quarter, the oil price fell both in annual and quarterly terms. Expectations for 2016 dictate the oil price averaging USD 40 per barrel, whereas supply is assessed to be ample until the end of the year.



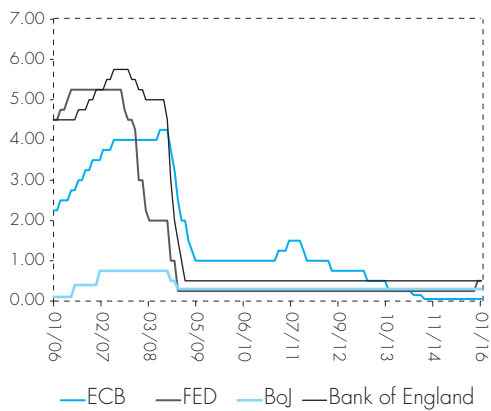
A similar trend was noted in the food and metal markets. Food prices shrank 13.5% in annual terms, in line with the ample supply and appreciation of the US dollar, especially against the currencies of emerging markets.

The slowdown of economic activity in China and the high level of reserves contributed to the further reduction of metal prices, 28% in annual terms. The drop in metal prices is expected to continue.

2.2. GLOBAL FINANCIAL MARKETS

In December, the Fed decided to raise the key interest rate by 0.25 percentage points, to 0.5%. Other central banks left the key interest rates unchanged, ECB at 0.05%, Bank of England at 0.5% and Bank of Japan at 0-0.1%.

Chart 3. Key interest rates of selected central banks

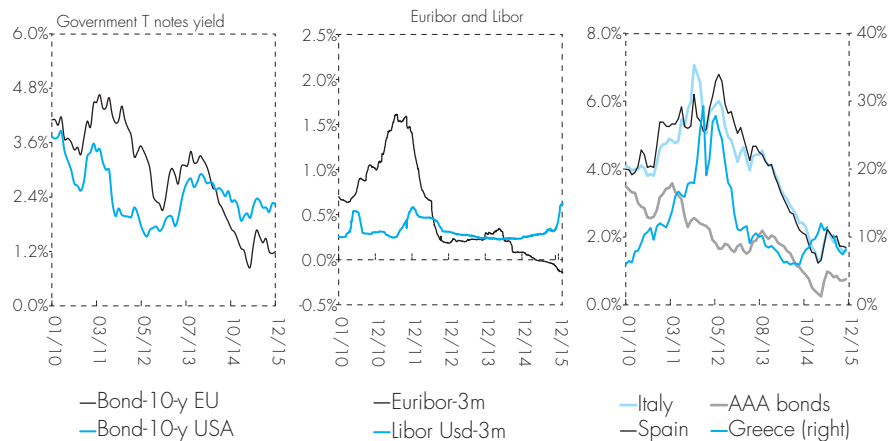


Source: Respective banks (ECB, Fed, BoJ and BoE).

In euro area money markets, Euribor rates continue to fall, reflecting the ECB’s accommodative policy. Libor rates for the US dollar were slightly up from the previous quarter. In capital markets, yields on government bonds showed a downtrend, due to effects from the securities purchase programme by the ECB and agents perceptions on economic developments. The latter have contributed to the deterrent of the expectation for the reversal of the monetary policy direction by the main central banks. The raise in the key interest rate by Fed in December was reflected calmly in financial markets. The private sector securities’ yields were driven by the developments in China and markets in emerging economies in general. During the end of December and beginning of January, the yields performed upward.

In Q4, the euro depreciated against the US dollar and many other major currencies. The analysis of the performance of the euro against the US dollar shows that it is reflecting the opposite direction of the monetary policy of these markets. In average quarterly terms, the euro depreciated 1.53% against the US dollar. In December, one euro was exchanged for 1,088 US dollars, on average.

Chart 4. Selected financial indicators in international markets



Source: Bloomberg, Reuters and Eurostat.

3. PRICE STABILITY AND BANK OF ALBANIA'S MONETARY POLICY

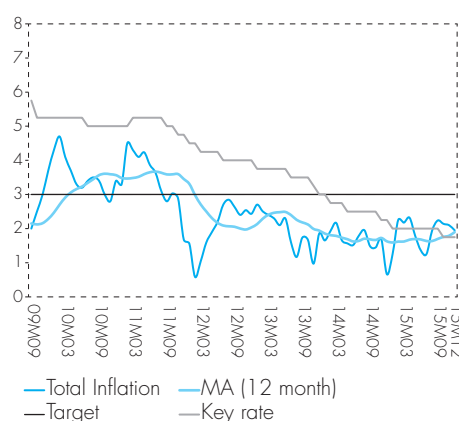
The monetary policy of the Bank of Albania is designed and implemented in light of the price stability objective. The cyclical weakness of the economy and low inflationary pressures dictated the implementation of a stimulating monetary policy over the recent years. This policy aims at: (i) lowering the costs of lending to the economy and boosting growth through the promotion of consumption and investments; (ii) improving the flow of money of economic agents, releasing financial funds that may be also used to increase consumption and investments; and (iii) keeping anchored economic agents' inflation expectations. Moreover, the accommodative monetary policy stance stimulates the improvement of the trade balance, providing another instrument for boosting aggregate demand. Aggregate demand growth and return of the economy to equilibrium is a precondition for the return of inflation to target.

In November, Bank of Albania's Supervisory Council lowered the key interest rate by 0.25 percentage points to 1.75%, a new historic minimum. To achieve the target, based on the available information, the Bank of Albania deems that the monetary policy will maintain the accommodative stance throughout 2016 as well.

New data point to inflation rising slower in Q4 and the economy growing faster in Q3 than our expectations. The Albanian economy grew around 2.98% in Q3, resulting above the upper bound of Bank of Albania projections. It reflected better than expected positive developments in construction and services and increase in final consumption by the public. In 2015 Q4, average inflation was 2.1%, slightly up from the previous quarter, but below Bank of Albania's forecast. Inflation did not fluctuate notably during this quarter. It continued to be driven by the increase in unprocessed food prices.

While the economic activity improved in Albania in the first three quarters of 2015, the Albanian economy continues to grow below its potential. The increase in employment, capital and improvement of productivity have not succeeded yet to provide sufficient impulse for steady medium-term growth. Domestic inflationary pressures remain weak and continue to materialise in low core inflation rates, as a result of slow growth in labour and production costs. In the meantime, development in raw material and core food prices in international markets continue to produce low inflationary pressures, weakened further by the appreciation of the national currency.

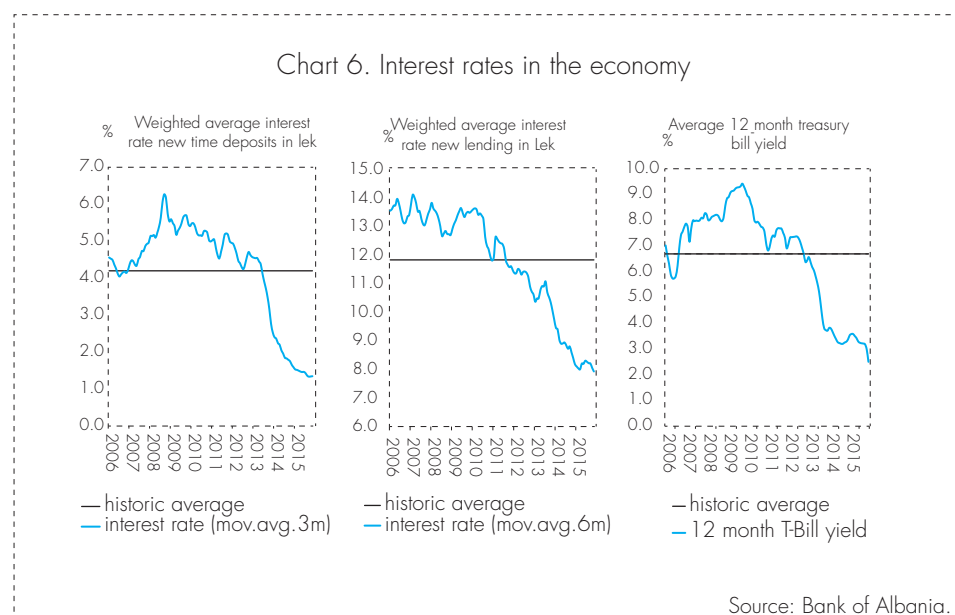
Chart 5. Inflation, key rate and target



Source: INSTAT and Bank of Albania.

The monetary policy of the Bank of Albania remained accommodative in the fourth quarter, in line with the performance of inflation below the target, the cyclical weakness of the economy and Bank of Albania’s commitment to keep low interest rates for some quarters ahead. The Supervisory Council of the Bank of Albania lowered the key interest rate by 0.25 percentage points in November. Following this decision, the key interest rate dropped to 1.75%, a new historical low. The decision was based on assessments for low inflationary pressures in the medium-term horizon. Our monetary operations consisted in injecting liquidity up to three months term, contributing to the transmission of the monetary policy. Moreover, the Bank of Albania has used the monetary policy forward guidance as a supplementary instrument for the easing of monetary conditions. It has stated publicly that it will maintain low interest rates until a firm return of inflation to target. This form of communication serves to mitigating uncertainties in financial markets and increase the effectiveness of traditional instruments.

Monetary policy easing has been followed by lowering of interest rates in instruments denominated in the national currency. In response to low interest rates, lek credit increased and led the growth of credit to the private sector. The credit portfolio in lek expanded, thus increasing its share in the total credit portfolio to the private sector, from 28% in 2008 to 43% in 2015. The yields of government securities fell to new historic low, due to the easing of the monetary policy stance and lowering of the domestic debt. The drop in yields suggests a further drop in interest rates on credits, which are indexed in accordance with the yields. Lastly, interest rates on deposits stand at their lowest levels, hence boosting private consumption.



The insofar performance of the economy shows it is moving towards a steadier growth trend. Domestic demand has been and is expected to be the main driver of growth, supported by low interest and inflation rates, strengthening

of financing sources and improvement of economic agents confidence. The growth demand by the private sector is expected to offset the low contribution expected by the public and external sectors.

With the prolongation of the forecast horizon, economic growth is expected to be more dynamic and more balanced. Higher growth rates are expected to be translated to higher utilisation of capacities in the economy, and the eventual return to potential during 2017. The cyclical improvement of the economy is expected to be associated with pressures for the gradual rise in producer costs and consumer prices, and inflation is expected to return to target in the first half of 2018.

Compared to projections for the previous quarter, expected developments have not changed significantly their medium-term trend and dynamics. In the short term, inflation forecasts are revised slightly down, mainly due to the revision of commodity prices and inflation in trading partner countries. Inflation is expected to average 2.0%, four quarters ahead.

The stable return of inflation to target will require implementing an accommodative monetary policy in the period ahead. Based on the available information, the Bank of Albania deems that the upward cycle of interest rates will not start before 2017.

4. FINANCIAL MARKETS AND MONETARY INDICATORS

The accommodative monetary policy has contributed to creating favourable conditions in financial markets. The latter have been liquid and have quoted low interest rates. In the fourth quarter, yields of government securities dropped markedly, due to the lowering of the interest rate and reduction of domestic borrowing by the government, following the issue of the Eurobond. This trend is expected to continue in the first half of 2016 and reflected in interest rates for other financing instruments in the economy.

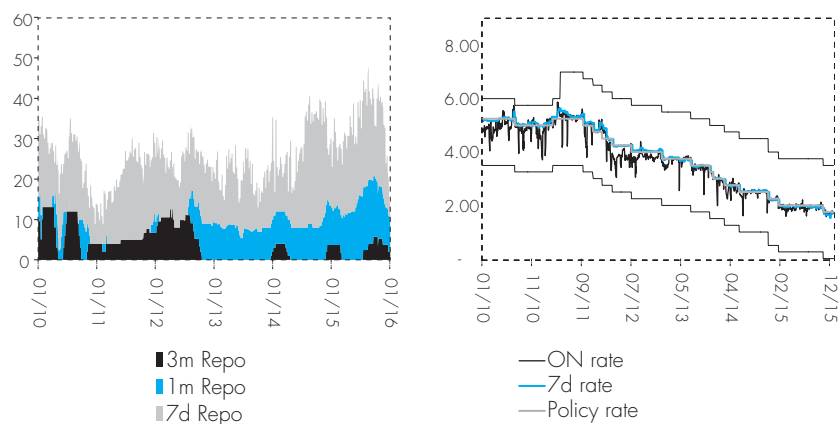
Despite the easing of monetary and financial conditions, private sector credit remains sluggish due to both demand and supply-side factors. In line with expectations for economic activity improvement, lending is expected to improve gradually, but higher, in 2016 and afterwards. At the same time, the expansion of monetary assets is low and does not signal for high inflationary pressures in the short and medium term.

4.1. FINANCIAL MARKET DEVELOPMENTS

INTERBANK MARKET

Interest rates in the interbank market fell in the last quarter. Liquidity conditions in the market improved significantly, due to government's lower borrowing in the domestic market following the Eurobond issue in November.⁴ The Bank of Albania injected less liquidity than in previous periods and the ask rate by the system was close to the key rate. The main employed instrument was the seven-day reverse repo, followed by the one and three-month agreements.

Chart 7. Bank of Albania open market operations and interbank rates



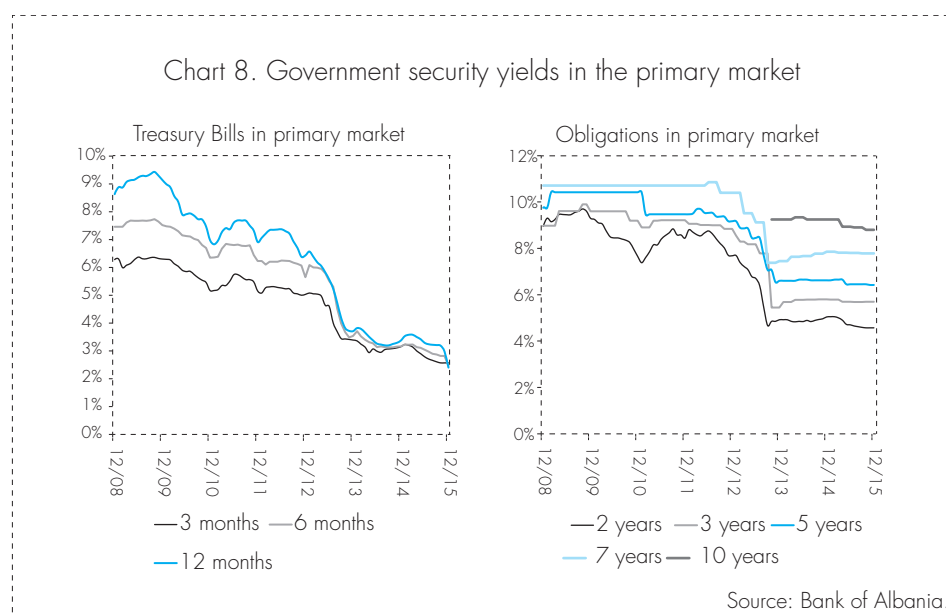
Source: Bank of Albania.

⁴ A more detailed information on the governments Eurobond issue is given in the box "The Albanian Eurobond and its implications".

The accommodative monetary policy stance has favoured the decline of interest rates. The lowering of the key interest rate in November was reflected immediately on interest rates for interbank transactions in the subsequent period. Overnight rates resulted close and often below the key rate. In Q4, The overnight rate averaged 1.81% or 0.12 percentage points lower than in Q3, while the 7-day rate dropped to 1.75%, from 1.93%. The volume of trade by banks in Q4 remained unchanged from Q3. The overnight maturity averaged ALL 1.86 billion from ALL 1.97 billion, whereas for the 7-day maturity it averaged ALL 6.7 billion.

PRIMARY MARKET

Yields on securities trended down in the fourth quarter, both for the short and the long-term segment. In the short-term segment, the yield fell more markedly for the 12-month instrument, which fell to 2.26% minimum in the auction at the year end⁵. In November, the 12-month yield fell 0.21 percentage points on average, reflecting the transmission of the lowering of the key interest rate by the Bank of Albania. In December, it fell again 0.57 percentage points, driven by the reduction of domestic debt. With the issue of the Eurobond and shift of deficit financing from domestic to external resources, in December certain securities were repaid before reaching maturity, whereas some others matured.



In long-term instruments, the yield fell more markedly for the fixed 7-year⁶ instrument, which descended to 6.79% in December, from 7.78% in September. Two-year bond auctions were not organised in November-December. The yield for this instrument descended to 3.45% in January, or 1.12 percentage points

⁵ The drop in this rate continued in the first auction in 2016, when the 12-month yield reached 2.21%.

⁶ The auction for variable-rate maturities did not take place.

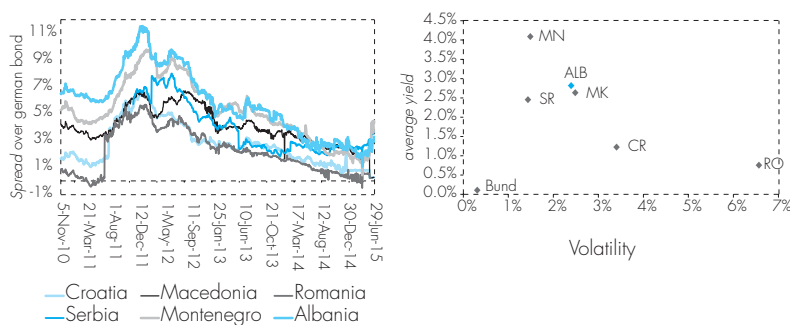
down from October. Participation in auctions for these instruments has been high, especially in the second half of the fourth quarter. The small need for domestically financing the budget deficit according to the 2016 budget, and the accommodative monetary policy point to low yields also in the months ahead.

BOX 1 THE ALBANIAN EUROBOND AND ITS IMPACT IN THE ALBANIAN FINANCIAL MARKET ⁱ

The issue of Eurobonds to tap in capital from international markets is a widely-used practice in emerging economies. The Eurobond as a financial instrument has a number of advantages. First, this transaction facilitates the attraction of foreign currency funds addressing temporary misbalances in the demand and supply for foreign currency and relieving the pressure on domestic financial markets. Second, the risk of roll over is diminished due to the extension of the debt maturity, given that Eurobonds are generally long-term instruments. Third, more space is created for credit to the private sector due to the reduction of domestic borrowing. Lastly, the presence of a country in international markets creates a reference rate for banks in relation to foreign currency borrowing. In addition to advantages, the Eurobond bears some risks, such as exposure of an economy to volatility in international foreign currency markets. The Quantitative Easingⁱⁱ by the European Central Bank (ECB) has lowered significantly the yields on European governments' bonds, rendering investors to look for instruments with higher return rates. In this context, Eurobonds of the countries in our region have been pretty attractive investment instruments.

On 4 November 2010, Albania sold its debut Eurobond, thus officially entered financial markets, and raised EUR 300 million for a five-year term and coupon rate 7.5%. The Albanian Eurobondⁱⁱⁱ was asked by financial institution with a long-standing investment profile such as banks, investment funds and insurance companies, including 25 countries. The trend of the spread between the yield of Albanian Eurobond and that of the German government used as benchmark was similar to the spread of similar instruments of neighbouring countries, although it has stood generally above that of other countries^{iv}. During the global financial crisis at the end of 2011, the spreads expanded followed by a gradual narrowing until mid-2015, when the Greek crisis stirred the financial markets, thus raising the perceived risk level for its neighbouring countries, such as Albania, Montenegro, Serbia and

Chart 9. Albanian Eurobond compared to similar instruments of regional economies



Note: In the right chart, the jump in the curb of the Romanian and Croatian spread in 2011 owes to the issue of the second Eurobond by these countries at that moment, and for each country a weighted yield was calculated with the two Eurobonds they had in the market during the period. The curbs interrupt at the end of June 2015 because during the second half of the year most of the instruments under review mature.

Source: Bloomberg.

Macedonia. In terms of annual volatility^v, the Albanian Eurobond has performed similar to the Macedonian one, as the yield and volatility performed similarly.

On 5 November 2015, the Government of Albania issued the second Eurobond for EUR 450 million. The instrument is issued for a five-year maturity and the coupon rate is 5.75%. Most of the funds was used to pay the EUR 300 million Eurobond issued in 2010. The remaining EUR 150 million will be used to reduce the domestic debt. The instrument was ranked as B1 by Moody's and B+ by Standard and Poor's. After the payment of the Eurobond and compliance with limitations on the level of financing and increase of the public debt in the Law on the Budget 2015, some opportunities were considered for the management of the liquidity situation in the domestic market until the end of the year. On 19 November, the Ministry of Finance published the new calendar of issues/maturities for the remainder of 2015, announcing the reduction of domestic financing by around ALL 46 billion^{vi}. On 4 November, the Bank of Albania lowered the key interest rate by 0.25 percentage points; consequently, the cost of money in domestic financial markets was also lowered. The monetary policy easing, coupled with the issue of the Eurobond and lowering of domestic financing, generated downward pressures on the yields for all maturities at the end of the year. These developments, together with the change in the supply/demand for liquidity in the market will continue to dictate low yields in 2016. The budget deficit is planned at ALL 34.4 billion for 2016, or around 34% lower than in 2015. This level of the deficit is estimated at around 2.2% of GDP, representing a reduction of 1.4 percentage points from the level of 2015.

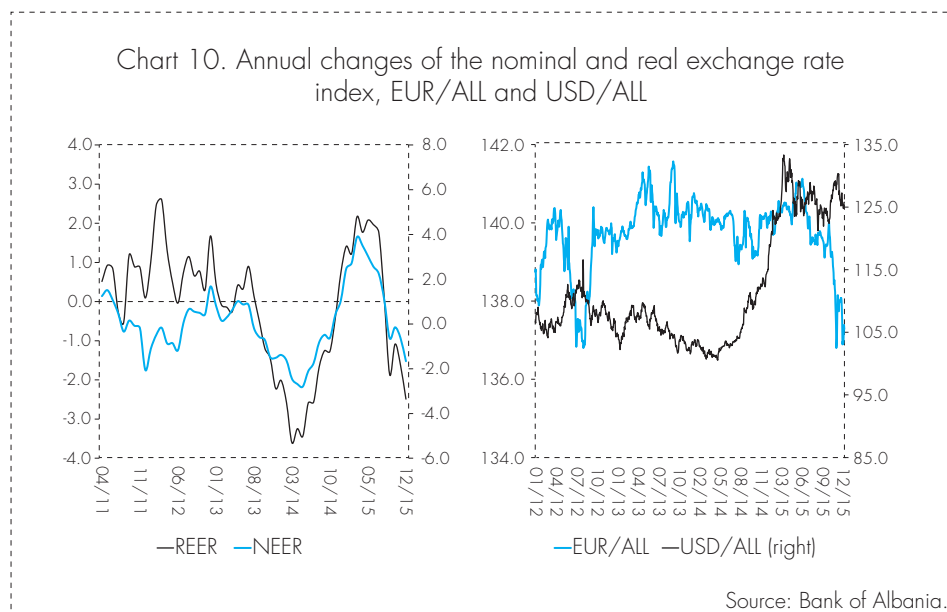
Notes

- i By E. Leka, Monetary Policy Department, in cooperation with D. Duro, Monetary Operations Department and E. Maci, Monetary Policy Department.
- ii Since March 2015, the ECB started to purchase public debt instruments of EU countries, injecting around EUR 60 billion in financial markets every month and announced that this practice would continue at least until March 2017.
- iii In relation to the quality, the instrument was ranked as B1 by Moody's and B+ by Standard and Poor's.
- iv The instruments taken into consideration in this analysis are selected based on the similar duration with the Albanian Eurobond.
- v Annual volatility is calculated as the standard deviation of daily yields for the period under review (Fabozzi, 2009).
- vi The reduction was achieved through buyback transactions (ALL 22.8 billion) and the maturity of securities whose maturity date was until the end of the year (ALL 23.9 billion).

FOREIGN CURRENCY MARKET

The domestic currency continued to appreciate against the currency basket of the five main trading partner countries in the last quarter. The Nominal Effective Exchange Rate (NEER)⁷ shows that the Albanian lek appreciated in both quarterly and annual terms, by 0.9% and 0.8%, respectively. In this regard, the appreciation of the lek against the euro was more notable. Considering the increasing difference between domestic inflation and euro area inflation, the appreciation of the lek in real terms was even higher (1.7% yoy).

⁷ The NEER is measured against the currencies of Albania's five main trading partners, namely Italy, Greece, Germany, Turkey and China. An increase in NEER implies depreciation of the lek.



The EUR/ALL exchange rate followed along a downtrend, averaging 138.5 lek. Lek's appreciation in quarterly terms resulted at the same intensity as in the previous quarter (0.9%). In addition to the seasonal effect of December, the issue of the Eurobond and the early repayment of T-bills in euro are assessed to have impacted the growth of foreign currency supply. Coupled with the decline in imports, this supply supported the appreciation of lek in annual terms (0.9%).

The lek continued to depreciate against the US dollar, both in annual terms (13.0%) and in quarterly terms (0.7%). These developments are in line with the appreciation of the US dollar in international markets, as a result of Fed's interest rate raise in December.

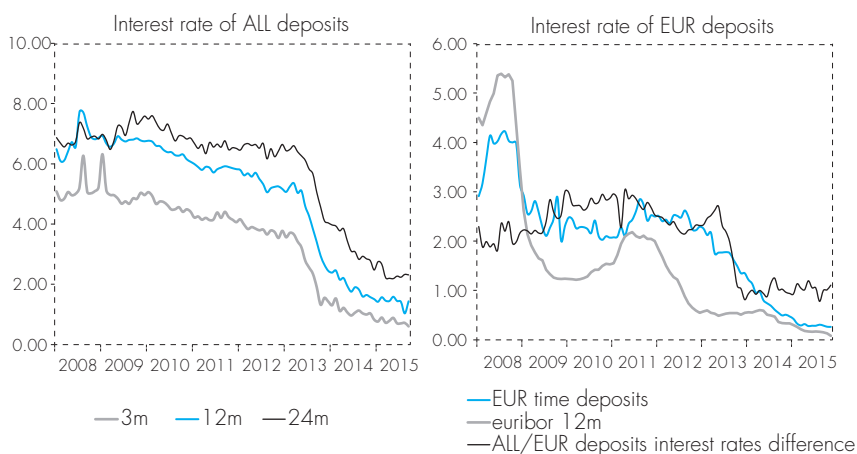
4.2. INTEREST RATES ON DEPOSITS AND FINANCING CONDITIONS IN THE ECONOMY⁸

Average interest on new lek deposits did not change significantly in October-November. The interest rates fell slightly for short-term maturities (1 and 3 months), and trended up for long long-term maturities (over one year). Interest rates on euro deposits experienced a similar situation.

Credit interest rates for the private sector were downward in October-November. Interest rates on the new lek credit confirmed the downward trend noted in previous months. The average weighted interest rate on new lek credit stood at 7.68% during October - November 2015 from 7.93% in Q3. The decrease was driven by both short and long-term interest rates, whereas the medium-term ones increased slightly compared to the previous quarter. New loans continue to be granted mainly for financing liquidity for businesses, and

⁸ The latest official data related to interest rates on loans and new deposits are as of November 2015.

Chart 11. New deposit interest rates

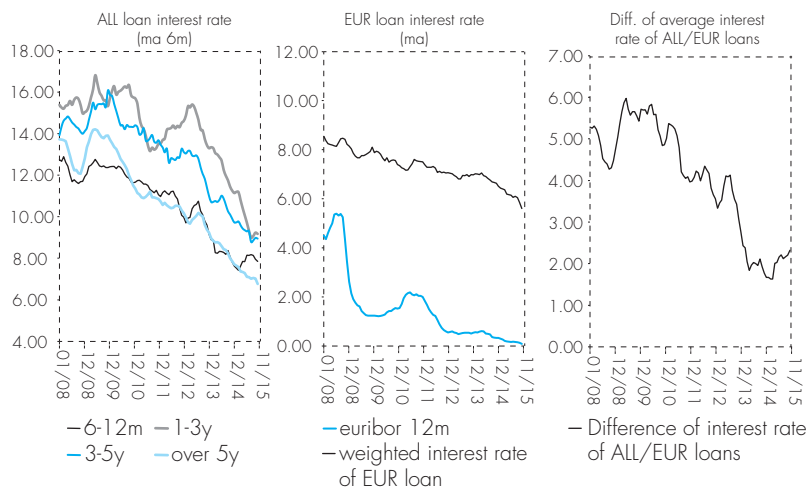


Source: Bank of Albania.

remains concentrated in a few banks. By purpose of use, credits for investment and working capital contributed most to the decrease in interest rates. Interest rates for consumer credit increased slightly in these two months. The decrease in lek credit in these months is reflected in the narrowing of the lek intermediation margin. The spread between the credit and deposits interest rate stood at 7.4 percentage points in October-November, from 7.8 percentage points in the first quarter.

The interest rate on new euro credit fell, especially in November. The average interest rate stood at 4.7% in this period, from 6.1% in the previous quarter. This rate was driven by the fall in long-term interest rates, mainly due to the behaviour of one bank. The analysis, excluding these items, shows a more stable performance of interest rates, although falling interest rates for the euro credit. The downward euro interest rates have been present for both businesses and households credit.

Chart 12. Interest rates on new loans



Source: Bank of Albania.

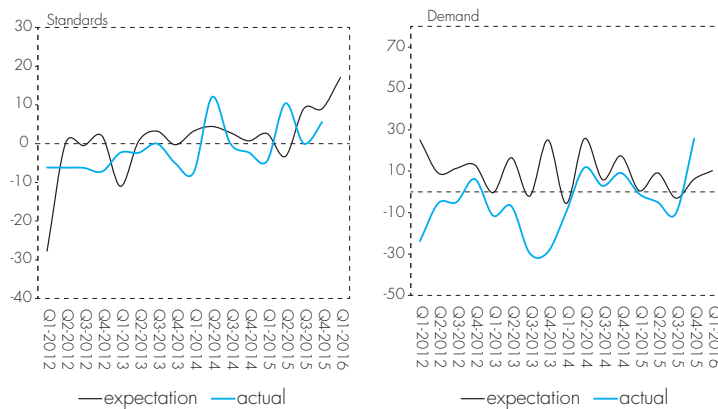
The fall in credit interest rates for October - November corroborate banks trend to ease credit standards in the fourth quarter. Bank lending survey for the period suggests that this approach will continue in the first quarter of 2016.

BOX 2 BANK LENDING SURVEY 2015 Q4

Bank lending survey results show easing of credit standards for businesses and continuation of credit standards for households in 2015 Q4. Credit standards for businesses were easier for small and medium-sized enterprises. Banks continued to ease the credit standards to households for house purchase, and consumer credit.

The main **factors** contributing to the easing of bank credit standards for both enterprises and households were: competition in the banking system, Bank of Albania's decisions and developments in the real estate market.

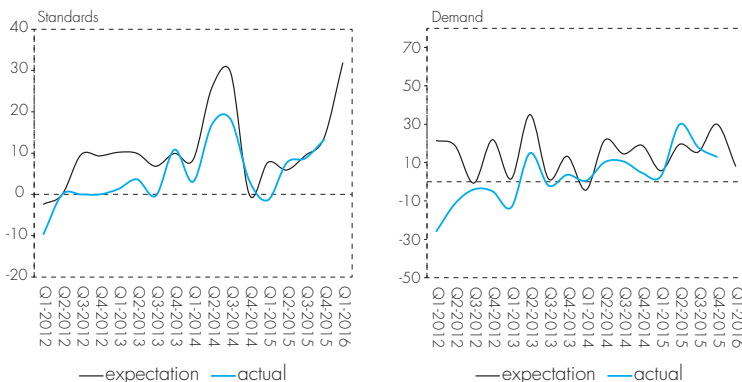
Chart 13. Standards and demand for business loans



Source: Bank of Albania.

Banks implemented an accommodative lending policy through **terms and conditions** related to credit price. In more concrete terms, banks reported a narrowing of the average margin and lowering of commissions in the fourth quarter.

Chart 14. Standards and demand for households loans



Source: Bank of Albania.

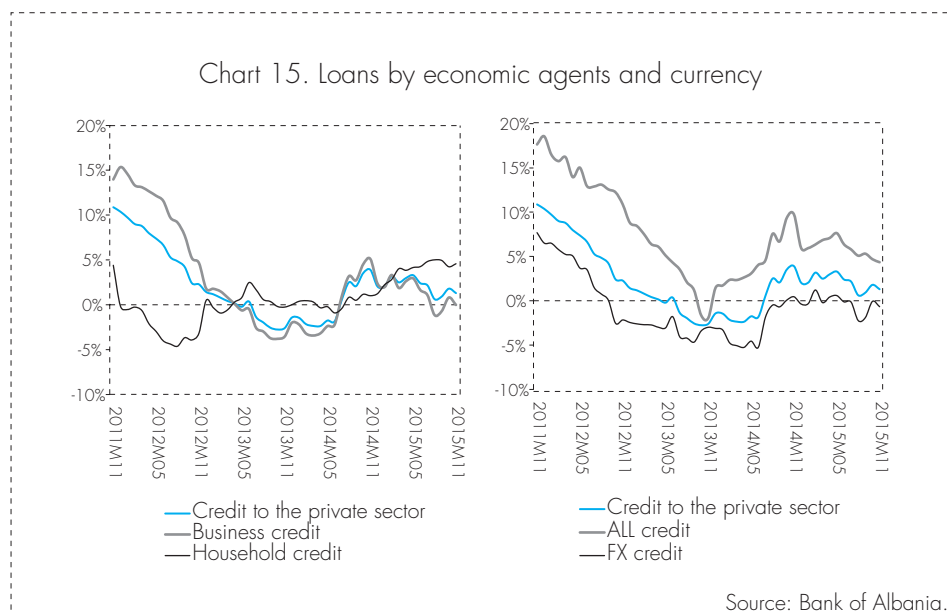
According to banks' reporting, enterprises and households credit **demand** increased in 2015 Q4. The enterprises credit demand was mainly driven by the demand of small and medium-sized enterprises. Households demand increased higher for house purchase loans and showed a slower expansion for the consumer credit.

Banks **expect** credit standards applied to both consumers and enterprises to continue easing during 2016 Q1. Businesses expect higher easing trend for the credit to small and medium-sized enterprises and somewhat lower for credit to larger corporates. Similarly, banks expect credit demand of small and medium-sized enterprises to grow in the first quarter of 2016. Related to households, banks state that credit standards will continue to ease for house purchase and consumer credits. Households' credit demand is expected to record a slower increase.

4.3. LENDING TO THE ECONOMY

Loan performance has continued to appear sluggish in the last quarter⁹, reflecting both the demand and the supply-side problems. In terms of incomplete utilization of production capacities, business demand for financing remains weak. Also, despite the easing of credit conditions, credit is still reported as tight, in several segments.

For the private sector, in October-November the credit portfolio expanded by an average of 1.6% yoy, compared with the 1.2% in the previous quarter¹⁰. In absolute terms, the outstanding credit for the private sector increased by about ALL 5 billion from September, thus partly reflecting the seasonal effect of Q4.

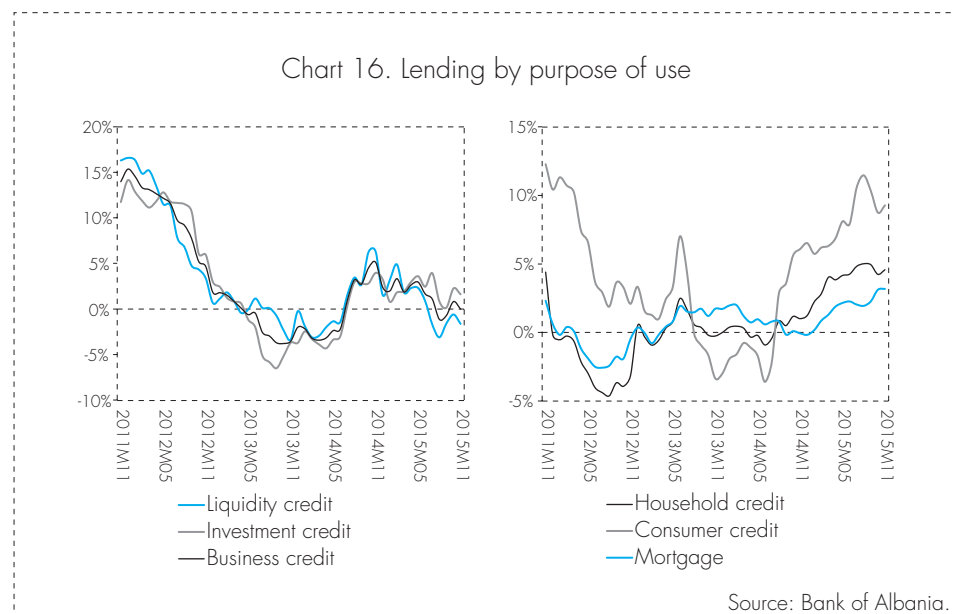


⁹ The latest monetary data for Q4, include October and November.

¹⁰ Credit analysis is based on monetary data adjusted for written off loans. The total of written off loans, in 2015, is ALL 27 billion.

All loans increased by 4.5% on average during October-November, slowing down compared with the 5.4% registered in the previous quarter. Meanwhile, declining rates of the outstanding loan in foreign currency have eased during this period, thus reducing to 0.4% yoy. From a longer-term perspective, continued tightening of the interest rate between EUR and ALL as well as the economic agents' awareness of exposure to exchange risks, have impacted the orientation of credit toward domestic currency.

Developments according to economic agents indicate that the credit for the private sector continued to be supported by the steady growth of the household s' loan portfolio. The expansion of this portfolio reflects the growing demand for funding, eased credit conditions for several consecutive quarters, and competitive promotions in the market for this segment. The concentration of credit in the households segment, records a high growth of credit for consumption purposes, although with a slower pace in the last quarter (9%). Meanwhile, developments in the balance of mortgage loans show a low but steady increase of this portfolio. In the last two months this portfolio shows a rapid growth, thanks to the presence of the banks' ample offers for this product during this period.

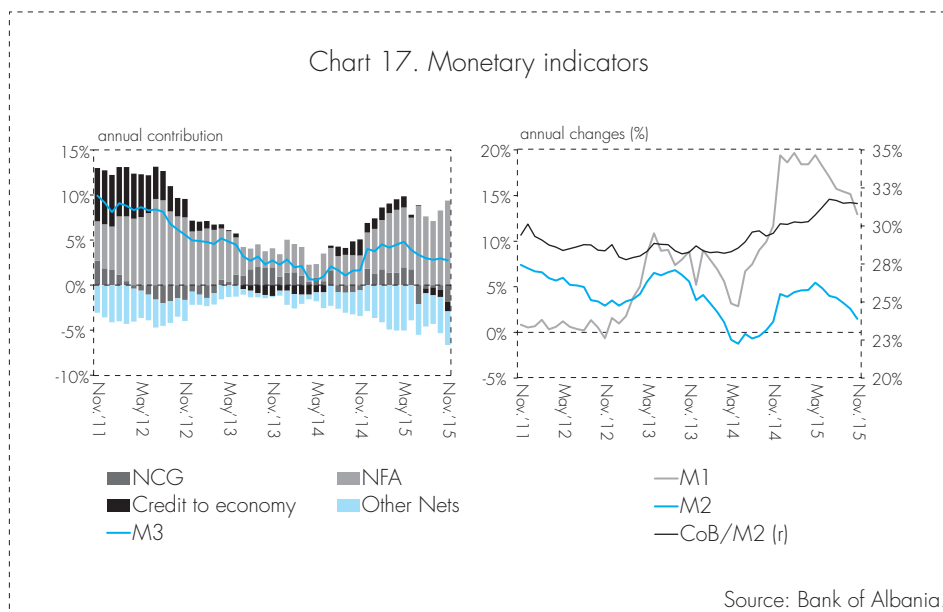


The sluggish credit performance reflects the poor performance of the business loan portfolio. The weak demand for funding and credit conditions, reported as tightened for large businesses, continue to be among the most prominent factors for October-November. The weak performance of business credit reflects the shrinking of the loan portfolio for liquidity by 1.1% on average in October-November. On the contrary, expansion of credit for investment purposes remains positive, but low - increasing by 1.6% at the end of the period.

4.4. MONETARY INDICATORS

Expansion of the broad money was moderate in October-November, following the slowing trend displayed in 2015 H2. The M3 aggregate posted an average of 2.9% annual growth, compared with 3.1% of the previous quarter. Expansion of the broad money continues to rely largely on the foreign component, which has given an average contribution of about 8.8 percentage points during this period. Meanwhile, the slowdown in the money supply reflected the poor performance of the domestic demand for funding both from the private and public sector.

The M2 aggregate in lek also slowed down the growth rates. This slowdown was more pronounced at the end of October-November, when the growth rate stood at 2%. The government financing shifting from the domestic to the external borrowing, has led to the low creation of lek. At the same time, although positive in annual terms, credit to the private sector in domestic currency, remains low. The M1 aggregate, the indicator of liquid money, has also followed a slowing trajectory, marking an average annual growth rate of 14.1% in October-November. The ratio of currency outside banks against the M2 aggregate has remained stable, at 31.5%, unchanged from the end of the previous quarter.



Deposits in the banking system¹¹ marked an average annual growth of 2.8% in October-November. In absolute terms, the total stock of deposits is about ALL 2.1 billion higher than at the end of September. Currency developments identify a shrinkage of about ALL 3.1 billion of lek deposits. This shrinkage is fully offset by the expansion of foreign currency deposits by ALL 5.2 billion. This performance reflects similar deposits' behaviour according to the economic

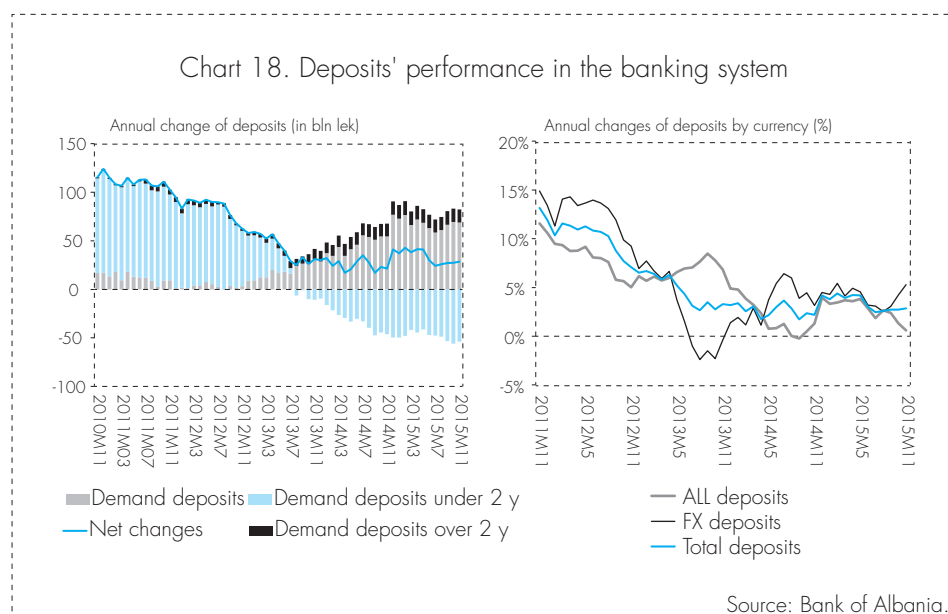
¹¹ Deposits' analysis includes deposits with maturity of over two years, which are not included in the calculation of M3 broad money.

agents, whereby deposits of households and businesses in the domestic currency declined and their foreign currency stock expanded.

The households deposits in domestic currency declined mainly concentrated in October, when simultaneously households investments in government securities in the domestic currency increased¹². The shifting of the savings from deposits in the banking system to government securities affects mainly the stock of deposits in domestic currency, since the presence of alternative saving instruments outside the banking system is even bigger for this currency. Meanwhile, the expansion of the foreign currency stock has taken the form of business' deposits.

The time structure of the deposits points out further shifting towards more liquid instruments. Thus, savings in the banking system during this period identify a shifting from time deposits toward demand deposits, and, to a lesser extent, toward deposits with a maturity of over two years. Deposits' total stock decreased by about ALL 7 billion, while demand deposits increased by ALL 9.1 billion despite the tendency for a partial shift towards deposits with higher maturities. The ratio of demand deposits to total inventory increased to 31.9% in November, from 31.1% at the end of the previous quarter.

In terms of low interest rates, partial shifting of households' savings towards higher maturity instruments in the banking system or towards other financial instruments outside the banking system reflects the demand of the most favourable rates of interest from them.



Money supply is expected to grow faster in 2016. This growth will mainly reflect the higher lending to the economy and the projections for high currency flows from abroad. The improvement of the private sector credit is in line with

¹² Investment increase in government securities for January-November 2015 is ALL 19 billion.

the projections for economic activity growth in Albania and the improvement of the bank credit supply. Easing monetary policy, competition in the banking market and improved credit standards, are expected to have a positive impact on further boosting the economy lending in the year ahead. Inflationary pressures from monetary developments are expected to be contained in short and medium term.

5. INFLATION AND ECONOMIC GROWTH

Annual inflation fluctuated around 1.9% in 2015, trending upward during the last quarter. Slow growth of inflation reflects the presence of the negative output gap, the low prices of raw materials of imported inflation as well as stable inflation expectations.

Economic activity has been improving. According to INSTAT, economic growth resulted 2.98% for Q3 and it is estimated at 2.7% for the first nine months of the year. The service and construction sectors are the main drivers of growth in production. On the demand side, economic growth is sustained by the expansion of investments and the improvement of the balance of foreign exchange. Consumption of public administration continues to be weak, thus reducing growth for the third consecutive quarter.

Higher growth rates have not been able to absorb the spare capacity in the economy and the economic activity remains below the potential. A similar trend is expected to persist even in 2016. Thus, inflationary pressures from the domestic economy will continue to be weak, together with the low prices of commodities and low inflation rates in the trading partner markets. The impact of these factors is expected to curb as the situation in the Albanian economy and foreign markets improves. In such conditions, the transmission of the monetary stimulus toward the economic growth will be more complete, ensuring the return of inflation to the target of the Bank of Albania in 2018 H1.

5.1 .INFLATION PERFORMANCE

Annual inflation resulted 1.9% in 2015 H2. It rose to 2.1% in Q4 from 1.8% in Q3. The increase of the annual inflation rate, reflected higher increase in seasonal agricultural products' prices, mainly in the first two months of the quarter. The inflation of goods and services, in December was high. Weak inflationary pressures from aggregate demand, in absence of supply shocks resulted in moderate values with low inflation volatility in Q4.

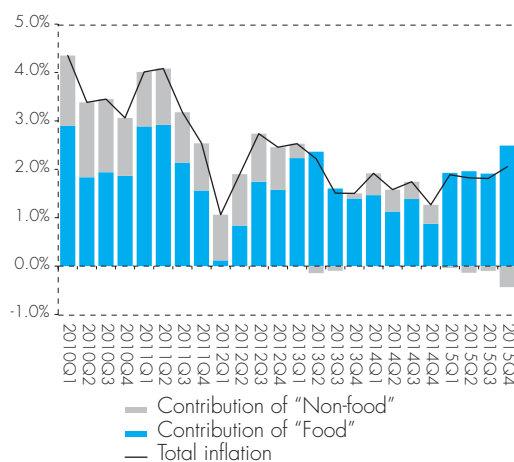
In terms of the components of the basket, the price of unprocessed foods determined the inflation growth during Q4. This category has been on a rise of its inflation and its contribution to the total inflation rate. On the other hand, the contribution of inflation from processed foods has dropped. Non-food price fluctuations have also had a negative resultant effect on the formation of headline inflation. More specifically, this downward effect is influenced largely by the decrease in oil prices and the in rent prices for this quarter.

"Unprocessed foods" contributed 2.6 percentage points to headline inflation in this quarter, or 0.8 percentage point higher than in the previous year. Imbalances of supply and demand for products of this category, caused

significant price fluctuations, especially in October and November. Similarly to the past three years, the increase of the demand due to the end-of-the-year holidays exerted no significant additional pressure on prices. Despite the developments of December, this category recorded an average annual inflation of 11.7% during this quarter. Such value had not been recorded since the first months of 2010. What contributed mostly to this increase is the growth of vegetable prices, with an additional contribution of 0.8 percentage points to headline inflation.

The “Processed foods” made a lower contribution to headline inflation compared with the previous quarter. Notably, the decline of tobacco and grains prices is an element that contributed to the decline of inflation. “Non-food consumer goods” deepened the negative contribution to the total inflation rate. Inflation performance of this category is affected by the annual decline in fuel prices which recorded the lowest levels in 2015. “Rent” prices marked a decline again after a period of calmness and resumed to contribute negatively to the headline inflation (-0.2 pp). This trend was in accordance with the consumer expectations for house and rent prices. Other categories provide a total negligible contribution to the overall inflation rate.

Chart 19. Food and Non-food contributions in the total annual inflation



Source: INSTAT and Bank of Albania calculations.

Table 3. The main contribution of annual inflation (in p.p)

	Q4:13	Q1:14	Q2:14	Q3:14	Q4:14	Q1:15	Q2:15	Q3:15	Q4:14
Processed food	-0.1	-0.1	-0.2	-0.1	0.2	0.3	0.2	0.1	0.0
Bread and grains	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.1
Alcohol and tobacco (pp)	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Unprocessed foods (pp)	1.5	1.6	1.3	1.5	0.8	1.7	1.8	1.8	2.6
Fruits (pp)	0.5	0.7	0.7	0.2	0.4	0.5	0.8	0.8	0.9
Vegetables (pp)	1.1	0.9	0.6	1.2	0.2	1.1	0.9	0.9	1.7
Services (pp)	0.1	0.1	0.1	0.1	0.2	0.1	0.0	0.0	0.0
Goods with adjusted prices (pp)	0.0	0.0	0.0	-0.1	0.1	0.1	0.1	0.1	0.0
Fuels and energy (pp)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1
Accommodation (pp)	0.3	0.3	0.2	0.1	0.1	0.1	-0.1	0.0	-0.2
Non-food consumer goods	-0.2	0.2	0.2	0.2	0.0	-0.4	-0.2	-0.2	-0.3
Durable consumer goods (pp)	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Consumer price index (y/y %)	1.5	1.9	1.6	1.7	1.3	1.9	1.8	1.8	2.1

Source: INSTAT and Bank of Albania.

* The table shows some of the main groups of categories.

From the macroeconomic perspective the slow increase of inflation has reflected the slow growth of aggregate demand, the low prices of goods in international markets and the shift of inflation expectations below the target of the Bank of Albania. Economic activity in the Albania continues to grow below its potential, in other words, the economy continues to have unutilised production capacity. This exerts low pressure for the increase of wages and production costs, translated into slower price rise. At the same time, the commodity prices and

key trading partners conjunctures suggest that the pressure they transmit to the prices of the products sold in Albania are low. Finally, the current performance of inflation has driven market agents' inflation expectations below the target of the Bank of Albania.

5.2. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND PERFORMANCE

According to INSTAT, the Albanian economy recorded an annual growth of 2.98% in 2015 Q3. Economic activity exceeded our expectations due to a sudden positive turn of the services sector and consumer spending. The other components of demand, and other sectors of the economy, showed no significant changes from their trends and our expectations. Investments¹³ maintained a positive contribution, while foreign demand and consumption of public administration continued to contribute negatively. Construction was the main contributor to the growth of the manufacturing sector, whilst the industrial production slowed down and agriculture production shrank.

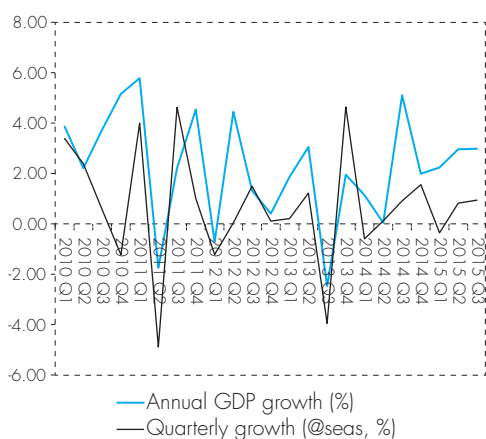
The economic growth resulted 2.7% for the first nine months of the year, and the information for Q4 confirms our estimates for a higher economic growth compared with 2015. The economy is expected to be even more dynamic in 2016 taking advantage of the low interest rates, of the rising confidence in the economy and of the funding sources improvement.

The gross domestic product rose by 2.98% and 0.9%, respectively in annual and quarterly terms¹⁴ in Q3. The annual growth rate stood very close to the

previous quarter (2.96%), but the quarterly dynamics showed a clear growth trend. The services sector produced about 57% of the increase, interrupting the slowing trend of recent quarters. The growth of the manufacturing sector was supported by the significant expansion of construction, while industrial production slowed down and agriculture production shrank.

The analysis of the demand components shows that the economic growth has continued to be supported by the domestic demand. The domestic demand growth had a broader basis this quarter. It reflected the expansion of investments and private consumption, while the consumption of public administration continued to contract. Foreign demand had a negative contribution, mainly reflecting its contraction

Chart 20. Annual and quarterly performance of GDP



Source: INSTAT and Bank of Albania.

¹³ The term refers to the "Gross fixed capital formation", component of GDP by expenditure.

¹⁴ On 11 January 2016, INSTAT published the GDP data by production and aggregate demand components until 2015 Q3. The data for 2013 remained semi final, for 2014 preliminary and data for 2015 a first publication, and as such will be again a subject to review in the future.

for the exports of goods, while the demand for the exports of services has increased. On the other hand, the contribution of net exports to growth was positive due to the decline in imports of goods and services.

In balance, the information for Q4 shows positive economic growth rates continue.¹⁵ The economic growth is expected to be higher in 2015 compared with last year and it's expected to improve even further. Domestic demand, supported by the low interest rates and the improvement of the confidence in the economy, is expected to be the main contributor to growth. On the other hand, expectations for a slow recovery of partner economies as well as for low commodity prices, discourage the expectations for a positive contribution of net exports in short term. In a longer time horizon, economic growth is expected to be more broad-based and consolidated on an upward trend.

5.2.1. PRODUCTION BY SECTOR¹⁶

In the third quarter, the economic growth was supported to a greater extent by the services sector, unlike during H1.¹⁷ This sector contributed by 1.7 percentage points to the annual GDP growth, thus reflecting an improvement of the activity across all the branches of services, except for "other services" and "Financial and Insurance Activities". Despite the shrinkage of the value added to the two above mentioned branches, their contribution resulted negative.

Value added in the **services sector** grew by 3.6% in 2015 Q3. After the slowing trend initiated in 2014 Q4, the performance of the service sector has improved, standing above its historical average of 2.6%. The analysis of the value-added of the sector by branches shows that services associated with the professional activities and the administrative services¹⁸, as well as the public administration, health and education branch,¹⁹ contributed largely to the growth of the sector, respectively with 1.1 percentage points. Also, the branches of "Real Estate", "Trade, hotels and restaurants and transport"²⁰ and "Information

¹⁵ The economic analysis and the evaluation of the aggregate demand for Q4 are based on the indicators of : updated fiscal, foreign trade, credit and deposit up to November and the indicators of 2015 Q4.

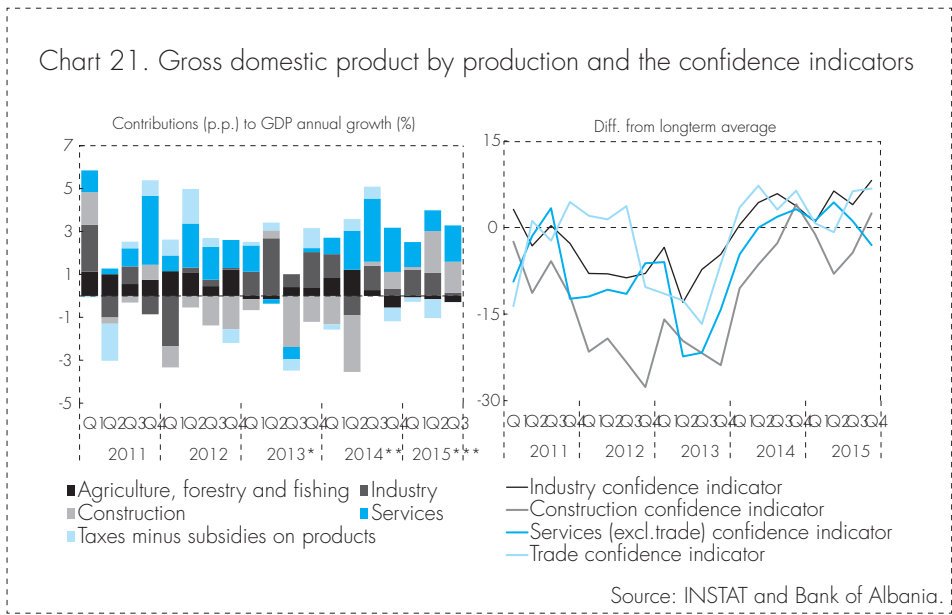
¹⁶ Within the framework of the series' review process, the publication of the annual national accounts of 11 December, as well as the enriching of the information is reflected on the differences between the economy growth rates and its sectors of this publication and of those analysed in the previous quarter report on Monetary Policy.

¹⁷ The performance of GDP and gross value added, is analysed in real terms of their annual changes.

¹⁸ According to the statistical classification of the economic activities in this sector are included: "Professional, scientific and technical activities" (Section M) and "Administrative and support services" (Section N) Short-term statistical data suggest an improvement of the annual turnover growth in volume in Q3 of architecture and engineering activities, part of M section, and of services provided by the travel agencies, tour operators, and other travel services, part of the N section.

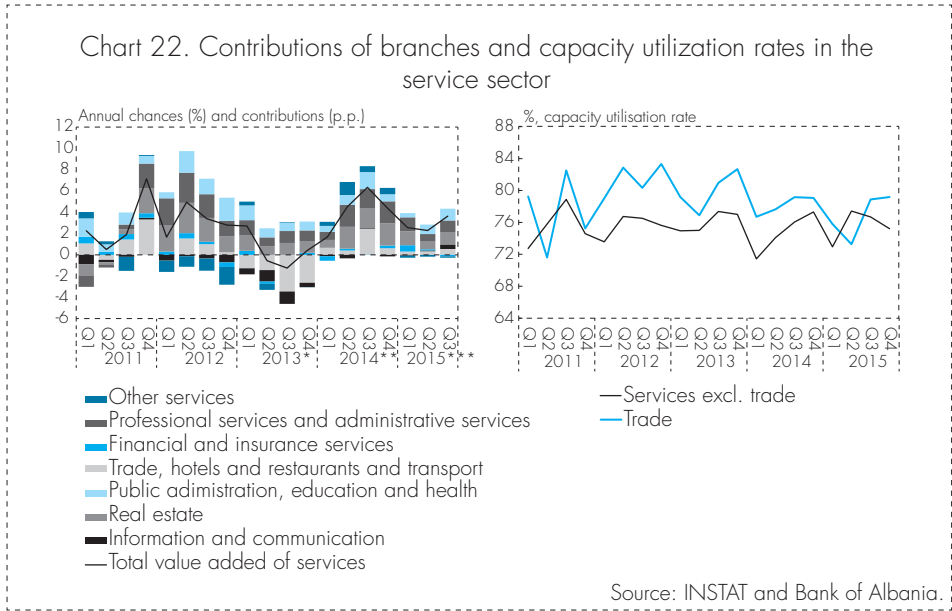
¹⁹ Regarding the public component of this branch, the budgetary data expenditures show an increase of expenditures incurred in the health field.

²⁰ Details on the turnover indicate an acceleration of the annual growth for the hotels activity by 23.9% in Q3 compared with 14.0% in the previous quarter. Also, retail recorded the highest growth in Q3 by 7.8%, after the fluctuation of 3.4% in H1.



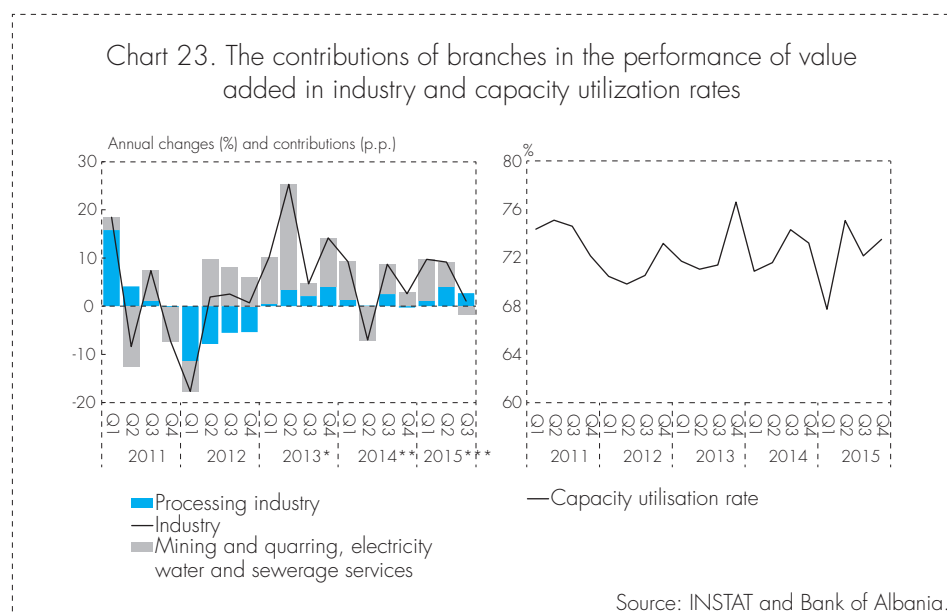
and communication”, displayed a better performance, contributing by 0.7, 0.6 and 0.4 percentage point, respectively.

The slight improvement of the confidence and the capacity utilization rate in trade indicate that the service activity is expected to expand in 2015 Q4. On the other hand, the lower level of the confidence indicator and the capacity utilization rate in services suggest the possibility of a limited increase in the last quarter of the year.



The **manufacturing sector** reduced its positive impact on the economic growth by 1.3 percentage points compared with 2.9 percentage points in the previous quarter. The high increase of the value added of construction contributed to the

economic growth by 1.5 percentage points. On the other hand, agriculture, forestry and fishery continued to contribute negatively by 0.3 percentage points whilst industrial activity significantly reduced its contribution at 0.1 percentage points. In terms of the calculated tax contributions²¹, Q3 data showed that this component had a neutral impact on the growth of GDP.



Activity in the **industrial sector** significantly slowed down its performance in 2015 Q3. Value added by sector recorded an annual growth of 1.1%, a rate lower than the growth of 9.1% in Q2 and below its historic average rate of 7.4%. The dynamics was mainly driven by strong, negative developments in the “Mining and quarrying, Energy, Water and waste treatment”²². These industries contributed with -1.6 percentage points to the annual performance of the sector, while in H1 their contribution fluctuated at 6.9 percentage points. Referring to the data of the production volume index, “Electricity, gas, steam and air conditioning” had the biggest decline among industrial activities.²³. Meanwhile, the performance of the processing industry branch, was positive and supported the growth of the sector by 2.7 percentage points.

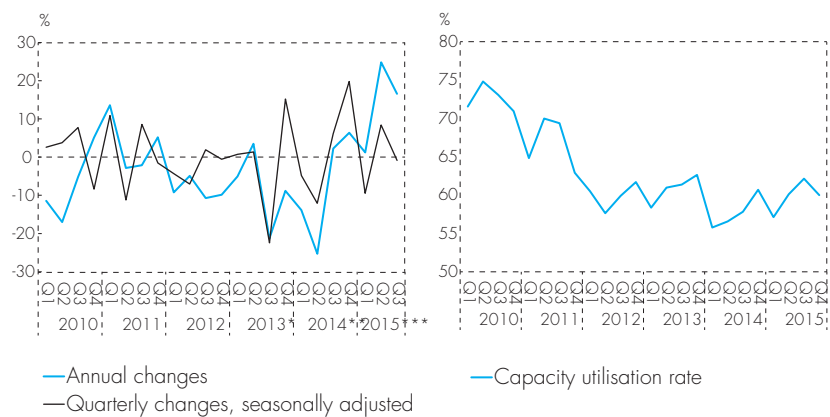
Regarding the expected developments in industry, survey indicators show positive signals for the industrial activity, reflected in the highest level of the confidence indicator, on the slight increase of the capacity utilization rate and on the orders. The growth of industry sector is estimated to be comparable to that of the previous quarter.

²¹ Net tax series is calculated as the difference between the taxes on products and the subsidies on products.

²² According to the statistical classification of economic activities, NACE Rev. 2, branches involved belong to the sections : “ B, D and E”

²³ Production index of the “Electricity, gas, steam and air conditioning” branch, shrank by 27.9% in Q3, after the high annual expansion recorded in the first two quarters approximately by 34.6%. Production marked an annual decline also for these branches: “Collection, water supply and waste treatment” and “extractive industry” with 3.3% and 27.1%.

Chart 24. Branches contributions in the performance of value added in construction and capacity utilization rates



Source: INSTAT and Bank of Albania.

Construction sector performance continued its upward trend for the fifth consecutive quarter. After increasing by 24.8% in Q2, the value added of construction marked a high annual increase by 16.5%, during 2015 Q3. Construction activity seems to have retained the high reviving of Q2, although the positive developments of value added of the sector, continue to remain above the average historical growth. This slowdown trend is also evidenced by the annual performance of the turnover volume and the volume of production, increased by 10.7% and 14.5%.²⁴ Approximated value statistics of the building permits²⁵ resulted lower in Q3, but they continued to be focused in new non-residential buildings and engineering works²⁶.

Confidence indicators upward trend, suggest that the construction sector developments will remain positive in Q4. However, businesses have not increased their current capacity utilization rates, limited to an extend by insufficient demand²⁷. This may signal a slowdown of construction growth rates at the end of 2015.

²⁴ The index of turnover and production volume increased respectively by 11.8% and 22.7% in the second quarter.

²⁵ Details of building permits and construction types quarterly statistical bulletin published on the INSTAT.

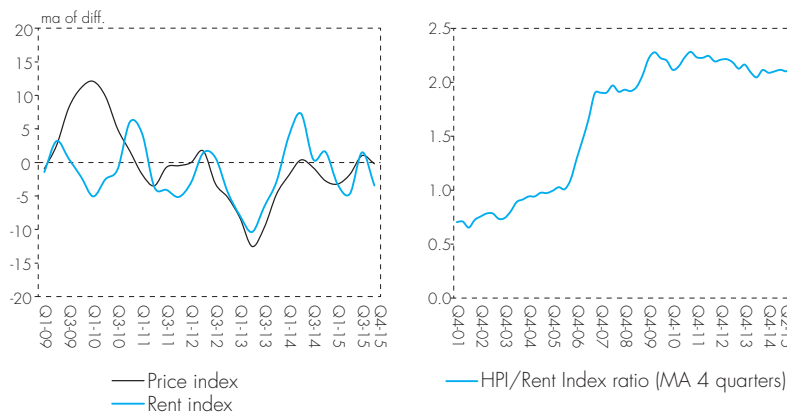
²⁶ In 2015 Q3, the index of turnover and production volume increased respectively by 10.7% annually and 14.5% after annual expansion rates by 11.8% and 22.7% resulting in the second quarter. Meanwhile, around 60% of the approximate value of building permits for Q3 is carried out by private clients, while 40% belongs to the public client. Also, the capital expenditures carried out by the government, both central and local suggest a support of the construction activity from the public sector. The Fund continuation of the public infrastructure projects has had a positive role for the Regions' Development.

²⁷ In 2015 Q4, according to the data, the number of construction businesses that identified the insufficient demand as being the main limiting factor in the utilization of production capacity, increased significantly.

BOX 3: PRICE PERFORMANCE IN THE HOUSING MARKET²⁸

House Price Index fell by 4.8% in Q4 after it increased by 2.3% and 5.4% in the previous two quarters. House rent index recorded similar fluctuations. After an increase by 7.7% in Q3, rent index registered an annual decline of 14.8% in Q4. The downward of rent index compared to the price index was reflected by a slight increase in the price/rent ratio in Q4.

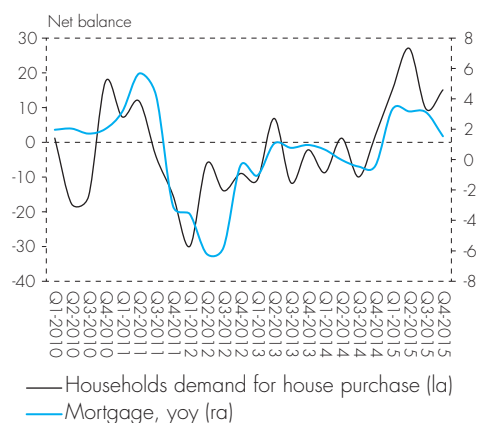
Chart 25. Price and Apartments Rent Index and their ratio



Source: Bank of Albania.

Price performance of housing market in 2015 is generally affected by the revival of the estimated demand for housing loans, as data from the confidence and lending activity signal. From businesses perspective, the construction sector reports a slow growth of demand over 2015. From banks' perspective household demand for loans for house purchase is significantly higher this year. Also, based on bank's opinion, the recovery of the real estate market has served as a factor that has helped in easing lending standards.

Chart 26. Indicators from lending survey



Source: INSTAT and Bank of Albania.

²⁸ Price and house rent analysis is based solely on the information available for the price and rents in Tirana.

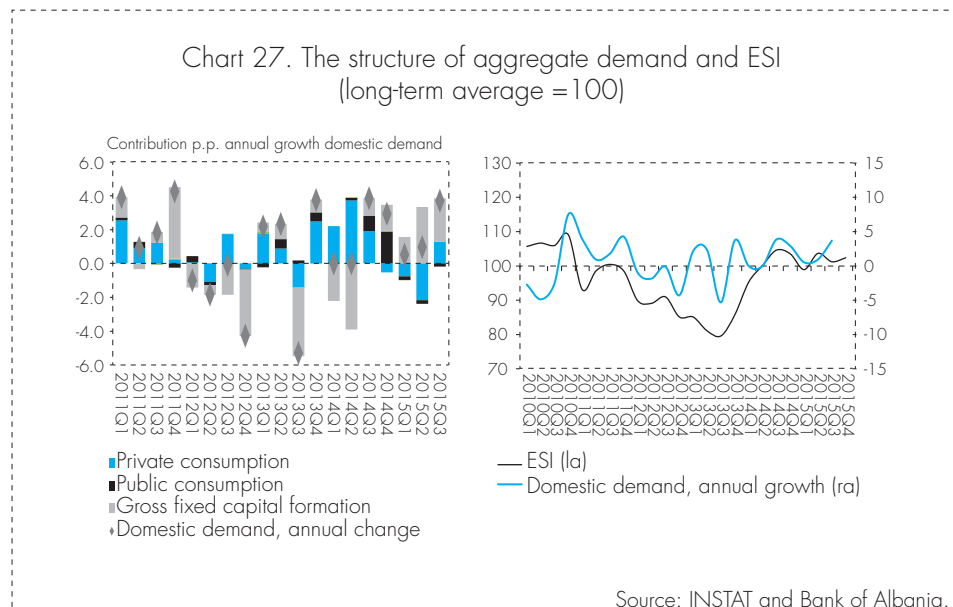
5.2.2. AGGREGATE DEMAND

The increase of aggregate demand in the third quarter was mainly driven by the growth in investments and net exports. Private consumption, also, provided a positive contribution, while public consumption a slight negative contribution.

The recovery of aggregate demand is expected to continue in the fourth quarter, signalled by the improved confidence in businesses and households. Hence, the positive contribution from the domestic demand is expected to offset the expected fall of the contribution from net exports in the fourth quarter.

Domestic demand accelerated in the third quarter mainly supported by the private demand in economy. Investments, which defined the growth of aggregate demand during 2015, contributed by 70% on the increase of the domestic demand, during the third quarter. Meanwhile, private consumption affected positively the domestic demand, after the negative contribution for three successive quarters. On the other hand, public consumption continued to provide small negative contribution, as in the two previous quarters.

Domestic demand continued to grow at a slower pace in the fourth quarter. Its components are expected to maintain the same direction, albeit at a lower degree from the previous quarter. The Economic Sentiment Indicator (ESI) increased slightly, while the indicators that approximate the economic uncertainty of businesses and consumers fell in the fourth quarter.



Private consumption increase of 1.9% sustained the recovery of the domestic demand in the third quarter. The positive developments in the labour market²⁹ and the eased credit standards are assessed to have provided positive contribution

²⁹ Slight increase of wages fund and in the number of employed persons.

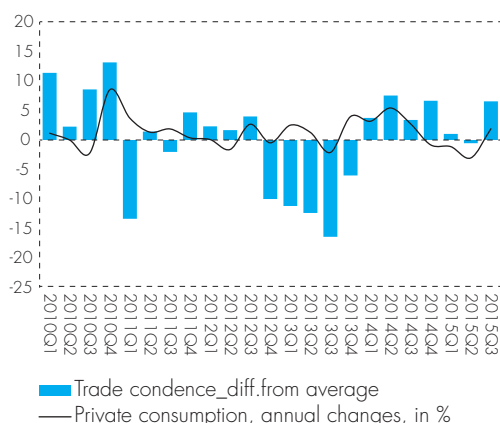
to the performance of consumer spending in the third quarter. Nevertheless, various sources of financing the private consumption did not record a uniform increase, while consumers' uncertainty remains at an average rate. This was reflected on the continued high inclination of consumers to save in the third quarter.

In a more disaggregated division, private consumption increased for long-term durable goods³⁰, after a negative dynamic of some successive quarters. Consumer spending for large purchases decreased from some successive quarters.

Consumer spending for services recovered during the third quarter, while spending for daily non-durable goods continued trending up.

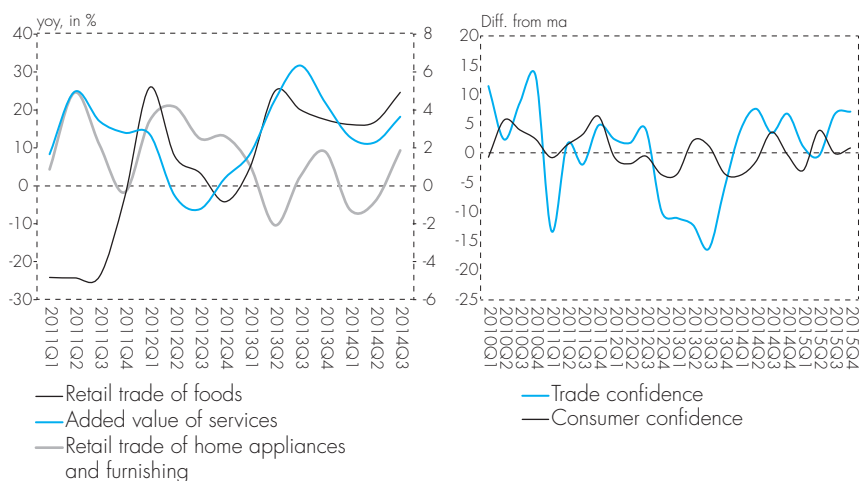
In balance, indirect quantitative data and surveys data show a slow growth in private consumption in the fourth quarter, while consumer's uncertainty decreased. The growth in VAT income and consumer credit and the improved confidence in trade and of consumers signal the increase. On the other hand, the import of food items fell in the first two months of the fourth quarter³¹. Consumers continued to save in the last quarter of 2015.

Chart 28. Private consumption and confidence in the trade sector



Source: INSTAT and Bank of Albania.

Chart 29. Indirect indicators on private consumer spending

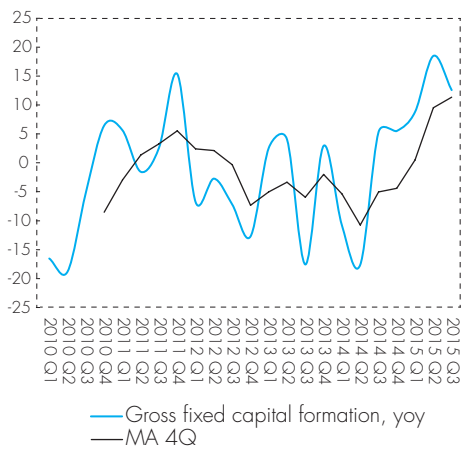


Source: INSTAT and Bank of Albania.

³⁰ The analysis for the division of consumer spending by the purpose of use is based on the disaggregated data by the Retail Trade Index and the GDP data calculated according to the output method.

³¹ The falling trend in the import of food items was noted during 2015, Survey data have signalled the effect of replacement of imports' goods with the domestic products.

Chart 30. Performance of investments, annual changes



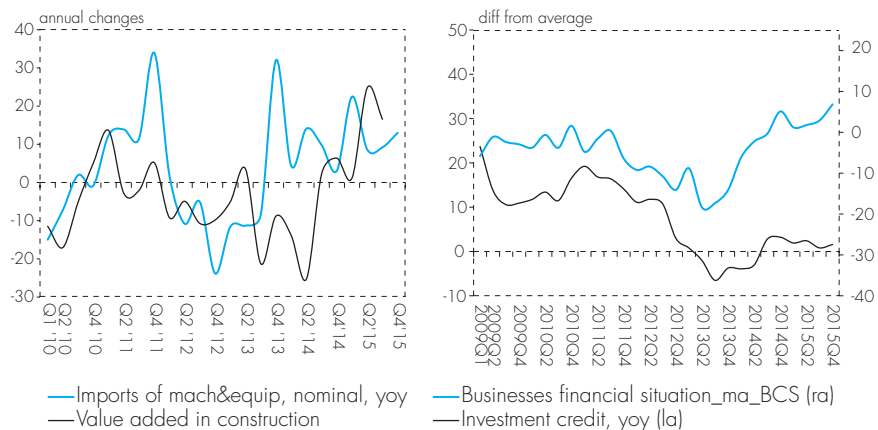
Source: INSTAT.

Investments continued to grow in the third quarter, by providing the main contribution to the formation of the domestic demand. Their increase was driven by the improved confidence, mainly in construction, the increase in capital public spending and the eased credit standards. Based on GDP data according to the spending method³², investments in construction continued to support the growth of this item over the third quarter. In addition, the increase of 9.2% in the import of machineries and equipment in the third quarter shows the positive contribution provided by this item.

Indirect quantitative and qualitative data from surveys support the assessments on the growth of investments in the fourth quarter as well. The improved credit standards³³, further improvement of confidence,

in particular in construction as well as the improved financial situation of businesses contributed to investments in the fourth quarter³⁴. The increased import of machineries and equipment of 13% in the period October-November are the quantitative data, which reveal the positive contribution of investments in the aggregate demand in the fourth quarter. Also, lending for investment purposes recorded small positive changes during the fourth quarter (October - November).

Chart 31. Short-term indicators for private investments



Source: INSTAT and Bank of Albania.

³² The added value in construction increased 16.5% in the third quarter. Investments in this sector share around 75% of the gross formation of fix capital.

³³ Based on the Lending Survey Results, 2015 Q4.

³⁴ Based on the Business confidence Survey Results, the balance of the question on the financial position continued to trend up in the fourth quarter. Also, based on this survey, "financial restrictions" constituted a lower hampering factor to businesses for the utilisation of their capacities, in the fourth quarter.

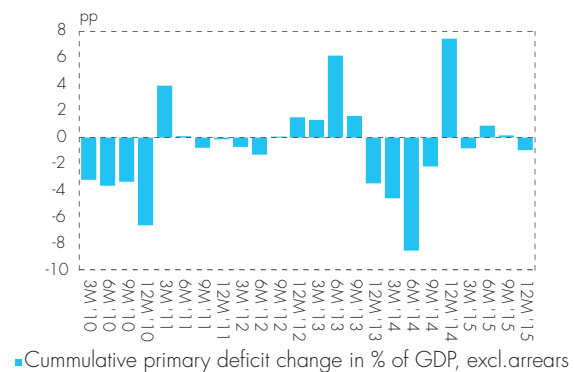
PUBLIC SECTOR DEMAND AND FISCAL POLICY

Fiscal stimulus was negative in 2015, thus showing the consolidated fiscal policy of this year. This stimulus was positive in the second and fourth quarters, and negative in the two other quarters. Revenues recorded a positive growth during the year, accounting for 26.2% of GDP. Expenditures decreased at 29.8% of GDP. The speed of fiscal consolidation, over the year, was higher than planned in the budget.

Budget expenditures reached ALL 430.6 billion in 2015, shrinking by 1.9%, from a year earlier. Current expenditures, in annual terms, increased by around 1.9%, driven by the operating expenses, personnel expenses and local government expenses. Debt servicing expenditures contracted, along with other expenditures item. Capital expenditures were ALL 59.4 billion, or around 1.8% lower than in the previous year. They provided an impact of around 0.25 percentage point, on the annual growth of Government's total expenditures. The payment of arrears provided the main contribution to the decrease of total expenditures, by around 49% in annual terms, as a result of the high comparative base on a year earlier³⁵.

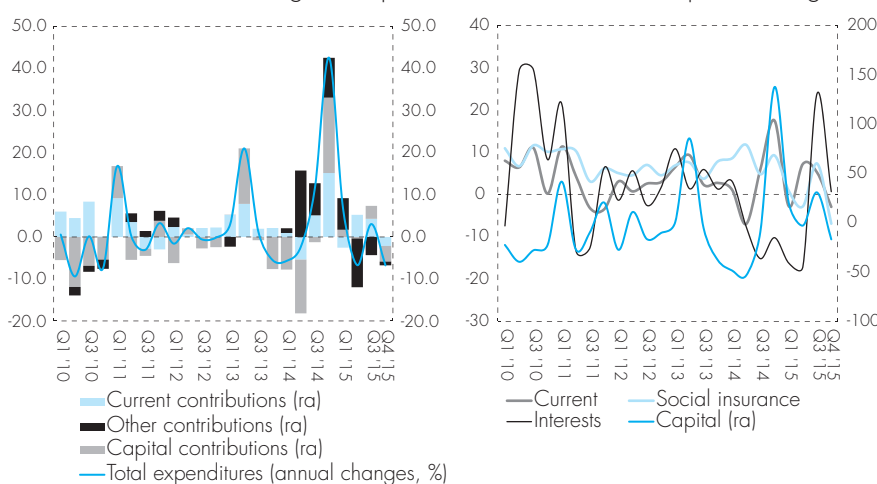
Total expenditures are distributed almost evenly across the quarters, while capital expenditures were concentrated in the second half of the year, mainly in the last quarter. The major part of accumulated obligation, around 73% of year's total, was paid during the first half of the year.

Chart 32. Orientation of fiscal policy, proxied by the change in the primary deficit*



*Fiscal stimulus is proxied by changes of quarterly cumulative primary deficit against GDP, compared with the previous year. Positive changes in these ratios show a positive fiscal stimulus, while negative differences signal fiscal consolidation. Source: Ministry of Finance, INSTAT and Bank of Albania calculations.

Chart 33. Contribution of the major components of expenditure on total expenditure (left), and annual change of expenditure's total and the major items (right)



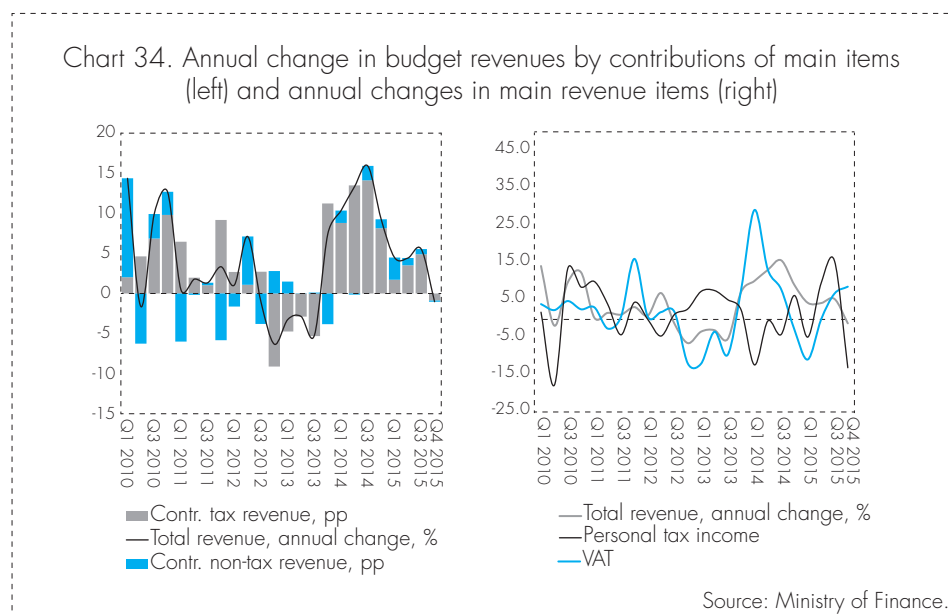
Source: Ministry of Finance.

³⁵ The arrears are fully paid in compliance with the plan of the Ministry of Finance.

In the fourth quarter, expenses shrank by 6.7% in annual terms, as a result of the high comparative base on a year earlier. Current and capital expenses decreased by 1.3% and 17.1%, respectively, while the payment of arrears contracted strongly.

Budget revenues resulted around ALL 378.5 billion at the end of 2015, or around 3.2% higher, from the previous year. Income tax” and “Social and Health insurance contributions” provided the higher contribution to this growth. Revenues from “Value Added Tax”, accounting for around 33% of total revenues, increased by 1.4% in annual terms, improving in the fourth quarter, after a weak performance in the first half of year. Excise tax revenues were lower than a year earlier, recording a low realisation in the second half of year. “Non-tax revenues” increased by 30.6% in annual terms³⁶, with a higher concentration in the two first quarters of the year.

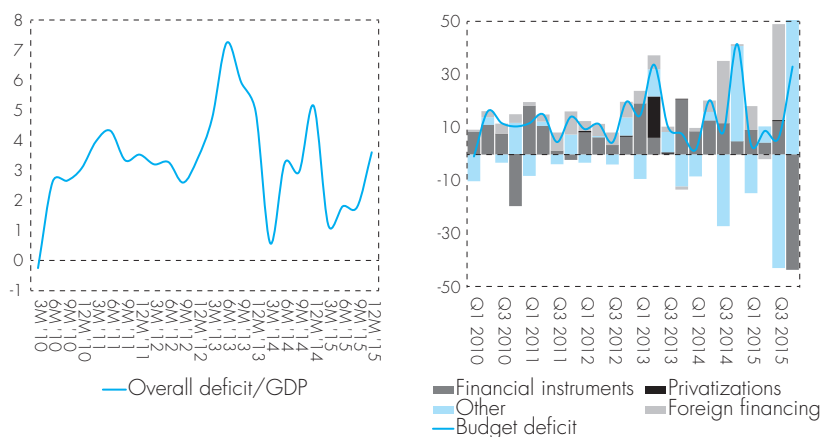
In 2015 Q4, revenues contracted 1% in annual terms. The positive contribution of the revenues from “Value Added Tax” and “Income Tax” was offset by the contraction in “Personal Income Tax”, “Social and Health Insurance Contributions” and in “Excises”. The two last items suffer the effect of the high comparative base to a year earlier.



Budget deficit stood at ALL 52.1 billion at the end of the year, estimated at around 3.6% of GDP. This performance constitutes a strong narrowing, by around 27.7% in annual terms. Budget deficit was mainly financed through foreign sources, including a guaranteed loan from the World Bank (PBG) and a part of Eurobond funds, which was issued in the fourth quarter of 2015. Domestic financing was negative, implying the foreign financing sources were used to reduce the public debt in the domestic market.

³⁶ Non-tax revenues reflected the sharp growth from budget institutions, which reveal the sale of license for supplying the 4G service by one of the mobile telephone operators.

Chart 35. Cumulative deficit/GDP (left) and financing instruments (in ALL billion, right)

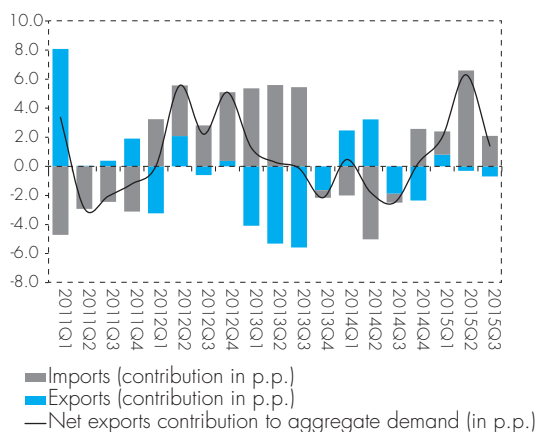


Source: Ministry of Finance, INSTAT and Bank of Albania's staff calculations.

EXTERNAL DEMAND AND EXTERNAL TRADE

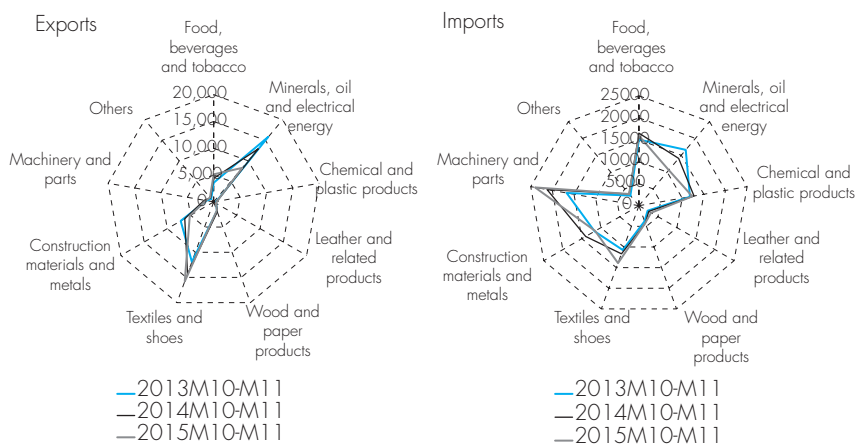
Real trade deficit in goods and services narrowed in 2015 Q3. Nevertheless, the annual reduction of the deficit by 8.7% indicates a slowdown of the corrective trend from the two previous quarters. The performance of net exports, as a whole, is estimated to have provided a positive contribution to the annual growth of aggregate demand, albeit somewhat lower than the contribution in the previous quarter. Annual decline of real imports of goods and services provided the main impact on this performance.

Chart 36. Contribution of net exports to real GDP (in percentage points)



Source: INSTAT.

Chart 37. Import and export orientation by item (in ALL million)

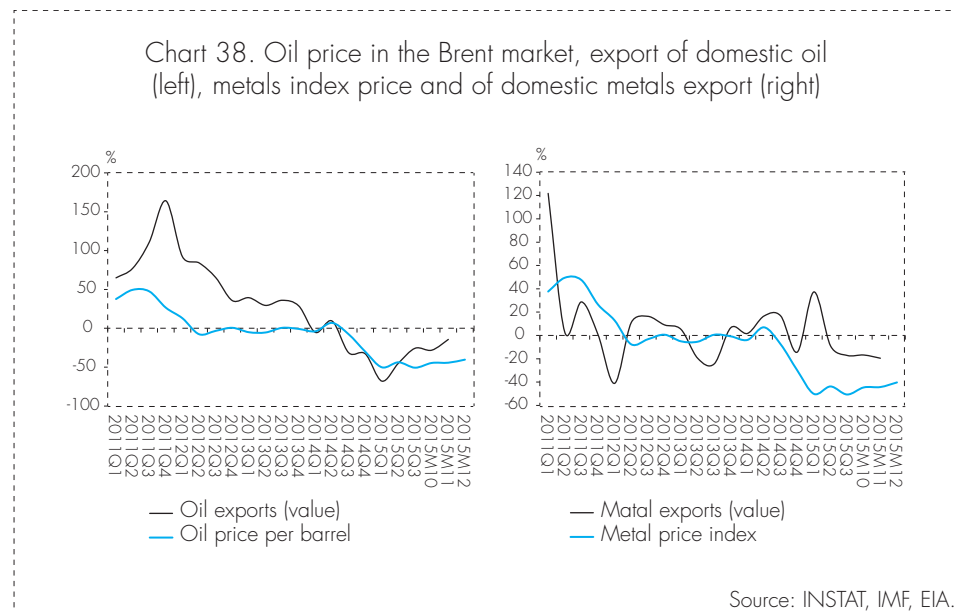


Source: INSTAT.

Given the results of net exports' contribution to the aggregate demand in 2015 Q3, our projections on their impact during 2015 are revised slightly down.

The data on net exports for 2015 Q4 include only trade in goods for October and November. The trade deficit in goods for these two months expanded by around 4.6% in annual terms, dictated by the fast decline in exports.

The value of export of goods was reduced by around 9.2% annually. The decline in "Minerals, fuels and electricity" and in "Construction materials and metals" provided the main contribution to this performance. The continuing fall in oil and raw materials prices in the international markets conditioned the fall in the export value of both items. Thus, oil export in terms of value decreased by around 22.5% in annual level, while basic metals' export by 18.1%. On the other hand, export of products included in "Textiles and footwear" recorded an accelerated growth pace. If during the first three quarters of year, re-exporting textile industry expanded averagely by 2.7% in annual level, whereas in the last two months, the expansion of this export averaged about 10% compared to the previous year. Although this category of export products provided a considerable contribution to total annual performance, the category "Food, beverages and tobacco" provided the highest contribution. In this regard, the export of agricultural products and of fishing processed goods played the main role. During the two months under review, the export of these products was 16.3% higher from the same months in the previous year.



Import was down by around 1.4% in October and November, compared to the same period a year earlier. Dynamic of imports was broadly determined by the decrease in imports of products in the categories "Minerals, oil and electrical energy" and "Construction materials and metals". Similar to the performance of export, international conjuncture of price impacted the performance in terms of value of these products. Also, electrical energy imports was 3% lower on an

annual level. On the other hand, import in "Machinery, equipment and spare parts" and in "Textiles and footwear", expanded averagely 13% and 19.2%, respectively, in annual level. The performances of both categories signal an expectation for a positive performance of investments in Albania and a positive activity of re-exporting textiles industry for the fourth quarter. Meanwhile, import of category "Food, beverages and tobacco" decreased by 3.6% in annual level. Overall, for these two months, the profile of goods import from Albania reveals an expansion in the import of capital goods and a decrease in the import of consumer goods and of intermediate goods.

By country, exports continue to be directed towards Italy, Kosovo, Spain, Greece and Malta. The origin of imported products appears more diverse, where EU countries hold the main share against the total imports (averagely 62% during October and November).

BOX 4: BALANCE OF PAYMENTS DEVELOPMENTS IN 2015 Q3

The net position of the current account recorded a deficit of EUR 325.6 million in 2015 Q3. Unlike the two previous quarters, the current account deficit expanded by around 10% in annual level. It was estimated at 12.5% of nominal GDP, around 0.7 percentage point higher, compared to the same quarter in the previous year. By item of the current account, the worsened trade deficit in goods and services and the reduced secondary income flow contributed to the expanding direction. Exports of goods and services decreased by around 3.4%, and imports fell by around 1.8%, in annual terms. The net balance of secondary income account reduced by 13.2%, in annual level, affected by the shock in Greek economy, when the Government decided to impose capital controls and limits on the daily withdrawals from banks. The sub item "remittances" was the main driver of this performance. After an increasing trend of five successive quarters, remittances inflows fell by 18% in annual terms. Primary income deficit narrowed during this quarter, thus contributing to the narrowing on the annual performance of the current account deficit. In structural terms, as measured by the national gap between savings and investments, the private sector played a major role in the formation of the current deficit. The accelerated growth in private investments provided the main contribution to the deepening of the current deficit in annual level.

Net inflows in the capital account amounted EUR 45.6 million, around EUR 25 million higher compared to the same quarter in the previous year. Net position in the financial account, shows a reduction in the country's assets by around 39.3% in annual level. Net inflows in the capital and financial account accounted for 48.2% of the current account deficit. While, the main part of current deficit financing is included in "Errors and omissions" item. Net foreign direct investments decreased by around 4.6%, in annual terms. Other net investments were estimated at an increase of liabilities by around EUR 180 million, mainly due to the rise in liabilities in the form of central government debt. Net assets owned in the form of investments of portfolio decreased by around EUR 12.7 million. Division of the current deficit financing according to debt creating and non-debt creating flows reveals a more pronounced support for the second type of financing. Nevertheless, during this quarter, the form of funding according to debt creating flows expanded by around 3.6 percentage points against GDP, compared to the same quarter in the previous year.

The overall balance of payments resulted in increased foreign reserve assets by EUR 312.5 million. At the end of September, the stock of foreign exchange reserve was around EUR 2.69 billion. This level was sufficient to cover 6.1 months of goods' import and services and 183.5% of short-term external debt.

Table 4. Balance of Payments indicators

	Q2 '14	Q3 '14	Q4 '14	Q1 '15	Q2 '15	Q3 '15
Current account (in million euro)	-341	-313.2	-377.5	-239.9	-170.5	-325.6
yoy (%)	7.8	55.5	13.9	-17.6	-46.3	10
/ PBB-së (%)	-12	-11.8	-14.5	-10.6	-6.2	-12.5
Goods and services	-479.5	-470.2	-540.8	-376.8	-360.3	-474.6
yoy (%)	5.8	18.9	4.3	-6.2	-24.9	0.9
Exports, f.o.b.	712.7	803.7	720	589.6	705.7	776
yoy (%)	14.1	-3.6	-7	2.2	-1	-3.4
Imports, f.o.b	1192.3	1273.9	1260.8	966.4	1066	1250.6
yoy (%)	10.6	3.7	-2.5	-1.2	-10.6	-1.8
Net travels	10.6	32	66	43.6	76.4	64.5
Primary revenues	-13.7	-24.1	-47.1	-43.8	-20.5	-23.1
Loan	28.9	34.7	30.5	27.2	24.7	30.3
Debit	42.6	58.8	77.6	71.1	45.2	53.4
Net FDI incomes	-17.5	-31.6	-38.7	-46.4	-24.1	-28.7
Secondary revenues	175.6	198.3	205.4	180.7	210.2	172.1
Loan	204.4	230.6	244.1	211.9	243.3	214.7
Debit	28.8	32.3	38.8	31.2	33	42.6
Net migrant remittance	137.5	165.1	171	141.8	161.7	135.4
yoy (%)	6.1	8.3	22.1	19.9	17.6	-18
Capital account	22.4	20.7	21.1	26	21.3	45.6
Net borrowing/ Net lending	-295.3	-275.3	-361.3	-213.9	-149.2	-280
Financial account	-215.8	-183.2	-292.5	-187.4	-184.8	-111.2
yoy (%)	-22	131.5	17.5	-22.9	-14.4	-39.3
/ GDP (%)	-8.2	-7.3	-11.1	-8.3	-6.8	-4.3
Direct investments	-135.5	-242.3	-222.8	-273.9	-200.5	-231
yoy (%)	-49.9	-21.1	-3.6	29.8	47.9	-4.6
Investment portfolio	14.3	-12	105.1	-79.1	-71.3	-12.7
Finance derivatives	0	0	0	0	0	0
Other investments	-117.1	-83	-135.9	53.7	70.8	-179.9
Reserve assets	22.5	154	-38.9	111.8	16.2	312.5
Errors and omissions	79.5	92	68.9	26.5	-35.6	168.8
Net borrowing/ Net lending	-295.3	-275.3	-361.3	-213.9	-149.2	-280

Source: Bank of Albania.

5.3. CYCLICAL ECONOMIC SITUATION AND INTERNAL INFLATIONARY PRESSURES

Our assessments for the output gap show that the economy continues to be characterised by spare capacities in the labour and capital market. Notwithstanding the higher growth pace during 2015, the aggregate demand remains insufficient for the return of the economy to potential.

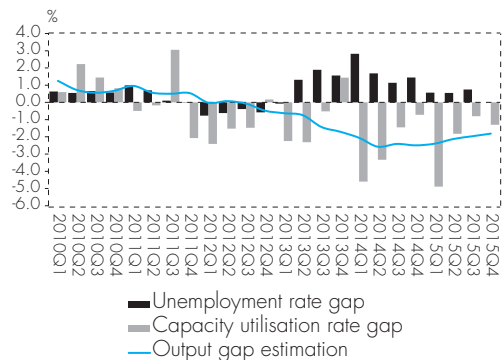
Labour market indicators signal spare capacities in this market and weak pressures for the rise of wages. Unemployment rate stood at 17.5% in 2015 Q3, slightly up from the first half of year. Employment rate increased, albeit

it failed to absorb the increase in the labour force participation rate. Also, capacity utilization rate, as reported in businesses confidence surveys, remains below the historical average. In sectorial light, capacity utilisation rate remains low in the sector of construction and of services.

The negative output gap exerted weak inflationary pressures. Both the long-term trend and the domestically originated inflation were down during 2015 Q4. Core inflation³⁷ and the CPI non-core tradable inflation³⁸ converged around the same value (-0.8%).

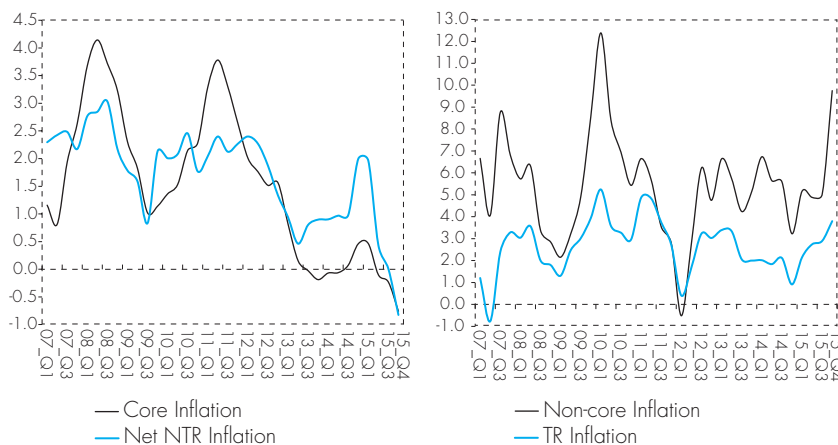
At the same time, short-term factors on the supply side continue to be present. Non-core annual inflation

Chart 39. Economy cycle indicators*



*Output gap is the average of a number of measurements on which the moving average method is applied. The gap of capacity utilisation rate and of unemployment rate is respectively calculated as a deviation of the current value from the average historical one and against the estimated balance rate of unemployment.
Source: INSTAT and Bank of Albania calculations.

Chart 40. Long-term inflation trends (left) and short-term trends (right)



Source: INSTAT and Bank of Albania's calculations.

and the inflation of the non-tradable goods of the CPI basket were 9.8% and 3.8%, respectively. Their increased values, compared to the previous quarter and the previous year, are mainly related to the expected statistical effect of the rather low comparative base. Excluding this effect, the respective inflation rates and headline inflation would be lower.

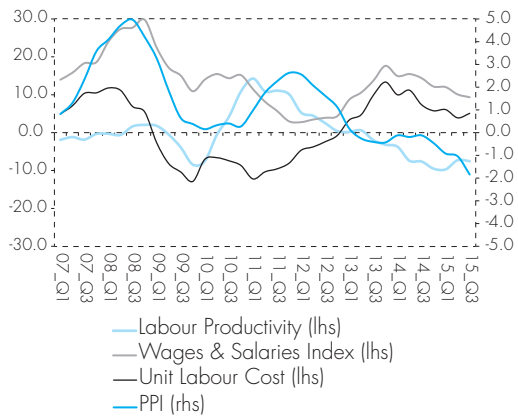
The stable growth of aggregate demand is expected to increase the use of producing capacities of economy. The economy is expected to gradually grow by approaching to the potential at the beginning of 2017. The cyclical improvement of the economy is expected to be associated with pressures for the

³⁷ Measured upon the method of permanent exclusion.

³⁸ Non-tradable inflation and tradable inflation refer to the change of CPI of relevant sub-baskets, where non-tradable sub-basket consists mainly in services and good, while the tradable sub-basket consist only in goods.

gradual rise in producer costs and consumer prices, and inflation is expected to return to target in the first half of 2018.

Chart 41. Hammered annual average changes in productivity, labour costs and production*



*Four-terms moving averages are applied to mitigate occasional fluctuations on annual changes of indicators.
Source: INSTAT and Bank of Albania calculations.

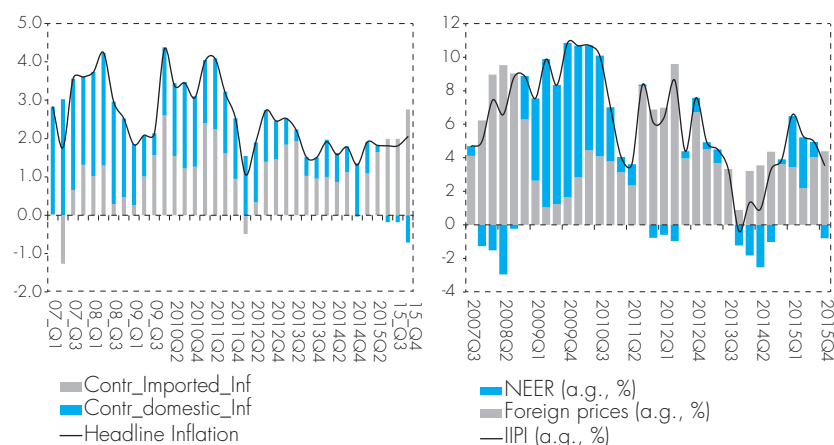
WAGES, PRODUCTIVITY AND LABOUR AND PRODUCTION COSTS³⁹

Unemployment rate beyond its optimum level continues to determine slow growth of wages and production costs. Labour cost indicator recorded an annual increase of 5.1% in 2015 Q3. This value is relatively higher from the previous quarter, but lower from the same period a year earlier. This development was driven by the continuing fall in labour productivity, while the wages fund index increased compared to the previous quarter. For the same period, the annual change of the industrial producer price index (PPI) deepened the fall, both in total and for the production destined to the domestic market.

5.4. IMPORTED INFLATION

Imported inflation is assessed as the main contributor to the headline annual inflation value, while the domestic one provided a relatively higher negative contribution than in the previous quarter⁴⁰. Nevertheless, imported inflation is

Chart 42. IIPi and contributions of its components (left); contributions of imported inflation and domestic inflation to annual headline inflation (right)



Source: INSTAT and Bank of Albania's calculations.

³⁹ Proxy indicators of labour productivity and labour costs per unit of output are calculated by the Bank of Albania using the total series Short Term Statistics (SHTS, INSTAT, 2015 Q2). Their calculations consist of the index of employees paid, turnover and total wage fund for the total of the activities covered by the survey SHTS.

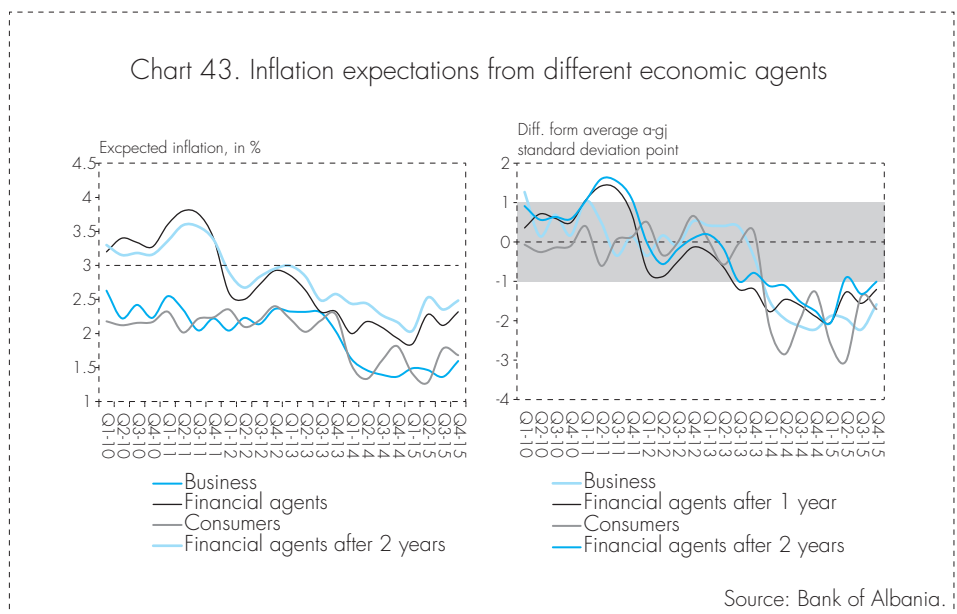
⁴⁰ Domestic inflation encompasses also the contribution of some items of adjusted prices. Their inflation fell further in this quarter, -1.2%.

lower than its history, owing to the low prices in commodities, basic foods in international markets and appreciation of the exchange rate. The pronounced increase of the imported inflation's contribution during 2015 H2 was mainly driven by the effect of the low comparative base.

In the fourth quarter, the index that approximates the expected inflationary pressures originating from trading partners (IIPI⁴¹), continued to trend downward. This quarter was characterised by low inflationary pressures in European Union countries, while countries, such as Turkey, Brazil and Russia experienced two-digit inflation rates. In reflection of these developments, "Foreign prices" indicator⁴², increased by 4.4% in annual terms, somewhat higher than in the third quarter. Meanwhile, lek appreciation in terms of NEER index, by 0.8% on an annual base, appears to have hampered the complete transmission of foreign inflationary pressures in Albania.

5.5. INFLATION EXPECTATIONS⁴³

Fiscal agents and businesses revised upward the inflation expectations, from the fourth quarter. Consumers lowered somewhat their expectations for inflation one year ahead, compared to the previous quarter. Overall, economic agents' expectations for inflation remain at low levels and below the Bank of Albania's target, 3.0%.



⁴¹ IIPI is calculated as the annual increase in Import Price Index and NEER index for the respective month. Imported inflation pressures impact inflation with a 1-3 month lag.

⁴² It is a proxy of imported inflation pressures, comparable to tradable inflation of Albania's CPI basket. Import Price Index is based on the inflation rates of "Food, beverages and tobacco" for 18 major countries, and "Goods" (i.e., not only "Food") of Bulgaria, Germany, Greece, Italy and Turkey. Some goods marked annual price rise, while the import share with respective countries has increased. This has led to considerably increase in the final value of the indicator (weighted average of above-mentioned CPIs with their monthly import shares).

⁴³ The analysis on inflation expectations is based on the results of the quarterly businesses and consumers' survey and the monthly financial agents' expectations survey.

Inflationary expectations of financial agents, compared to their historical position, continue to be well-anchored and have the lowest deviation from their long-term average. Consumers and businesses' expectations stand considerably (more than the standard deviation) below the respective historical average.