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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 of 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 inflation target 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 the Monetary Policy Report quarterly. 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 contribute to consumer prices in Albania.

FOREWORD BY THE GOVERNOR

The information analysed in this quarterly monetary policy report has resulted overall in line with the expectations of the Bank of Albania. New economic and financial data show economic growth accelerated and main macroeconomic balances improved during the end of 2016 and beginning of 2017.

***

Inflation has been upward in the first quarter of 2017, averaging 2.4%. This performance was determined by the rise of foods and oil prices. The prices of other basket items did not change significantly, and continued to provide low positive contribution.

From the macroeconomic perspective, inflation’s uptrend is underpinned by the improvement of economic activity and more complete utilisation of production capacities, the upward prices in global markets, and the better anchoring of inflation expectations.

The effect of these factors is expected to persist in the periods ahead. Inflation is forecasted to average around 2.3% for 2017 and to rise further toward the target - during the next year.

According to INSTAT data, the pace of economic growth improved in the last quarter of the previous year. The Gross Domestic Product increased by 4.0% in this quarter, taking economic growth annual rate for 2016 at 3.5%. The services and construction sectors made the largest contribution to economic activity; meanwhile, industry and agriculture grew at positive, but lower, rates.

In terms of aggregate demand, economic growth reflected the expansion of domestic and external demand for goods and services. Private consumption and investments increased, driven by the low interest rates, expansion of employment, improvement of confidence, and high FDI inflows. In parallel, economic growth in the fourth quarter benefited from the increased activity in tourism and the recovery of growth rates in the exports of goods.

Indirect available data suggest that these trends continued in the first quarter of 2017.

Fiscal data for the first quarter point to fiscal consolidation slowing down materialised in budget surplus 33.2% lower than in the same period in the previous year. Budget expenditure for this quarter increased 10.3% in annual terms, against the 4.3% increase in income. The budget plan for 2017 suggest added contribution by the fiscal policy to aggregate demand growth, but the
Bank of Albania continues to draw the attention on the need for a more even distribution of expenditure and budget deficit throughout the year.

The analysis of the available information reveals the positive role of our monetary policy. Financial markets continue to be characterised by low interest rates on both deposits and loans. The rise in yields on government securities at the end of the year resulted to be a temporary development and was not transmitted to other segments of the financial market. The stimulating monetary conditions have favoured the growth of credit and reduction of debt servicing costs; they have, therefore, supported the recovery of private consumption and investments, and have established the preconditions for the return of inflation to target.

The monetary policy has supported in particular the growth of credit in the domestic currency, albeit the total credit growth remains sluggish. As at end-March, credit to the private sector was 3.3% higher than a year earlier. During the last twelve months, lek credit expanded by 10.2%, whereas foreign currency credit reduced by 1.5%. By sector, credit expansion was concentrated in the segment of loans to households, whereas loans to enterprises appears sluggish, driven both by the weak demand from enterprises and the tight supply by the banking sector.

Judging on the current economic and financial trends, as well as the relevant underlying factors, the Bank of Albania deems that the cyclical improvement of the economy will continue in the medium-term horizon. According to the baseline scenario, in this time horizon, we expect economic activity to grow further, driven by the recovery of domestic demand and improvement of the external environment. The growth in economic activity is expected by accompanied by the absorption of spare production capacities, both in the labour and capital markets. The return of the economy to equilibrium will establish adequate preconditions for the stable return of inflation to target within 2018.

The Bank of Albania deems that the realisation of these projections requires maintaining the actual macroeconomic policy mix and continuing with structural reforms.

Fiscal policy is expected and should continue to maintain a consolidation stance in the medium term. This policy stance lowers risk premiums, increases space for credit to the private sector and fosters the country’s capacities for withstanding shocks in the future.

Based on the available information, the monetary policy will remain accommodative during the medium-term period. This policy stance ensures the necessary stimulus for boosting economic activity and for the return of inflation to target.
In the medium-term horizon the Bank of Albania expects a progressive improvement of credit demand. The increasing demand should be matched by increased credit supply. In this context, the reduction down to 17.4% of non-performing loans ratio in March is an encouraging development, but it should be accompanied by continuation of the implementation of initiatives for improving the credit environment and more active lending policies by banks. In this context, it is necessary to continue the structural reforms with regard to improving the business climate, enhancing the efficiency and expanding the production potential of Albania.
1. PRICE STABILITY AND BANK OF ALBANIA’S MONETARY POLICY

The monetary policy of the Bank of Albania is formulated and implemented in light of the primary objective: achieving and maintaining price stability. In response to the low inflationary pressures from the slow economic growth after the financial crisis, the Bank of Albania has implemented an accommodative monetary policy. The policy rate was lowered gradually and currently stands at the minimum historic level of 1.25%. Also, monetary policy communication has aimed at guaranteeing market agents that the low policy rates will be maintained for some periods. Through these instruments, the accommodative monetary policy was crucial for boosting the private domestic demand, strengthening the economic growth and shifting inflation on a converging trajectory toward the target.

Economic activity performed positively and we expect this trend to continue in the medium term. Monetary stimulus is assessed as sufficient to support the growth of the economy to equilibrium and the return of inflation to target within 2018. Nevertheless, the balance of risks for the materialisation of these expectations has shifted to the downside. In this view, the monetary policy stance will remain accommodative, but the intensity of the monetary stimulus will be adapted to the needs for maintaining the macroeconomic balances.

Economic and financial developments in Albania are positive and confirm the growing trend of the Albanian economy. INSTAT data show economic activity accelerated, employment expanded in 2016 Q4, and inflation increased in 2017 Q1. Annual inflation averaged 2.4% during the period. From the composition aspect, the increase is attributable mainly to the increase of food and oil prices. Also, it reflected the statistical effect of comparison with the low level recorded a year earlier (0.7%). From the macroeconomic aspect, inflation’s uptrend reflects the higher use of production capacities in the economy, elevated inflationary pressures from foreign markets and better anchoring of inflationary expectations.

Economic activity accelerated in 2016 Q4 and the gross domestic product (GDP) increased by 4%, in annual level. Economic growth for the whole year in 2016 was 3.5%, higher from the previous years. The expansion of the domestic demand and higher income from tourism supported the upward cycle of the economy. Private consumption and investments are supported by low interest rates, improvement of confidence in economy and high levels of foreign direct investments. Also, economic developments in the external environment were positive, supporting the growth of exports. This development was more evident at the end of 2016. Available data show that these trends continued in 2017 Q1.
The accommodative monetary policy implemented by the Bank of Albania provided an adequate monetary environment for the increase of demand, inflation and of inflationary expectations. The monetary policy stance is expressed through the monetary policy rate, kept at 1.25%, and through the forward guidance. Also, the Bank of Albania continued to supply the needed liquidity to the banking market, contributing to the intermediation activity and the stability of interest rates in the money market.

Financial markets reflected the accommodative monetary policy and were characterised by low interest rates. Yields increased temporarily in 2016 Q4 to pursue a downward trajectory in 2017 Q1, in reflection of the improvement in the demand/supply ratio and of the unchanged fiscal and monetary policies. Also, interest rates to borrowers are at the lowest historical levels and have supported the credit demand. Credit growth was more notable to households, to whom the “non-price” standards were eased. On the other hand, “non-price” standards to enterprises remained tight. Credit to enterprises was sluggish, owing to low demand, tight supply, high credit risk and ample liquidity of enterprises.

The low interest rates in lek shifted lending toward the domestic currency. The share of this portfolio has been trending up, accounting for about 43.7% of credit to the private sector in February, from 40.6% in the previous year. Credit in lek expanded by 10.9%, in the first two months of the year, offsetting the negative performance of credit in foreign currency. The growth of lending in the domestic currency provides more space for the monetary stimulus pass through in economy, and reduces the euroisation risks to the financial stability.

The monetary policy stance will remain accommodative in the medium-term horizon. It implies maintaining interest rates below the equilibrium ones.
This stance is in line with the medium-term forecasts of the Bank of Albania, which suggest that economic growth will continue at a similar pace to 2016. Monetary conditions are eased and favour the growth in private investments and consumer spending. Also, the expected expansion of exports will underpin economic growth in 2017 as well. On the other hand, the medium-term budget plans suggest the continuation of fiscal consolidation would decrease fiscal vulnerabilities.

Higher utilisation of production capacities and rising employment contributed to the increase of domestic inflationary pressures. Also, pressures from imported prices are upward, although part of them has been mitigated by the exchange rate appreciation. Inflation is forecasted to average 2.3% in 2017, from 1.3% in the previous year. Due to the improvement of economy and the gradual closure of the negative output gap, inflation is expected to gradually increase toward the target within 2018.

Risks balance surrounding the baseline scenario is assessed as downward in the short run. On the positive side, a faster improvement than expected of economic agents’ expectations and external trade may shift economic growth and inflation to a higher trajectory than our forecasts. On the negative side, the uncertainty from the political situation at home may be reflected in a contraction of both consumption and investments in economy. In the medium term, downside risks remain more dominant, mainly related to the uncertainties in the external environment and the speed of credit recovery. The confirmation of our medium-term expectations and relevant risk balance suggest that the current monetary policy stance is adequate.
2. EXTERNAL ECONOMIC ENVIRONMENT

The external economic and financial environment improved. Economic activity expectations on its performance are positive. Nevertheless, risks remain on the downside, related to the political situation in some European Union countries and the geopolitical tensions. The effects of these risks may also affect the small regional economies, which have been growing at a steady pace. Their economic growth is expected to improve during 2017, mainly driven by the domestic demand. Inflation rates were up in the first quarter, mainly reflecting short-term impacts and statistical effects from higher commodity prices. Domestic inflationary pressures remain low. The financial markets have factorised the improvement of economies in major countries’ economies and the reduction of risk premia.

2.1. GLOBAL ECONOMY

Economic indicators show a gradual consolidation of the global economy over 2017 Q1. The global composite output economy index and GDP preliminary indicators picked up in the first quarter, affirming the positive performance of the economic activity. Monetary and fiscal policies in some major countries had a stimulating stance, thus supporting the economy. Inflation was up in 2017 Q1, albeit inflationary pressures, overall, remained low, reflected in the low core inflation. Uncertainties surrounding economic policies prospect and the political instability in certain regions and countries remain risk factors.

Chart 2: Composite Leading Indicator (CLI) of GDP and Industrial Production in main countries* (left) and inflation in main countries (right)

Source: OECD, (Organisation for Economic Co-operation and Development).

*Industrial production is a monthly change, while CLI long-term is 100.
OECD countries and Brazil, China, Russia, India and South Africa

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United States economy

The US economy improved steadily, but at a slower pace. Economy expanded by 2.0% in 2016 Q4, from 3.5% a quarter earlier. The weak public and private investments were offset by the increased private consumption. Preliminary indicators show economic activity slowed down its pace in 2017 Q1. Sales slowed down and employment in March was lower than expected. On the other hand, confidence indicators are at high levels and wages’ data are positive. The Composite Leading Indicator of production, which anticipates economic activity, is also upward in this quarter.

Economic activity is expected to accelerate over 2017, driven by consumption and expectations for a simulating fiscal policy in the next quarter. The improvement of financial agents and enterprises’ sentiment provide the grounds for the materialisation of these expectations. The Federal Reserve raised the key interest rate, continuing with the tightening cycle of the monetary policy. Although, headline inflation was on an upward trajectory, overshooting the Fed’s target, the core inflation increased at a moderate pace. This led Fed to announce that it will tolerate inflation over 2.0% and avoid the risk for an early tightening of monetary conditions.

Table 1 Selected macroeconomic indicators

<table>
<thead>
<tr>
<th>Countries</th>
<th>GDP change 2016 Q4</th>
<th>Unemployment rate*</th>
<th>Annual inflation rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Quarterly</td>
<td>Annual 12/2016 03/2017</td>
<td>Q4/2016 Q1/2017</td>
</tr>
<tr>
<td>USA</td>
<td>0.5</td>
<td>2.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Euro area</td>
<td>0.5</td>
<td>1.8</td>
<td>9.6</td>
</tr>
<tr>
<td>Germany</td>
<td>0.4</td>
<td>1.8</td>
<td>3.9</td>
</tr>
<tr>
<td>France</td>
<td>0.4</td>
<td>1.1</td>
<td>10.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.7</td>
<td>1.9</td>
<td>4.8</td>
</tr>
</tbody>
</table>

Source: Eurostat, respective statistical institutes.
*Employment data in euro area countries and EU members are as at February 2017.

Euro area economy

Euro area economy maintained the positive performance in 2016 Q4. Recovery of consumption is continuously strengthening economic activity, while public investments are providing positive contribution. Higher consumer spending reflected the improvement of labour market and the more favourable lending standards, due to the easing of the monetary policy. Leading indicators in 2017 Q1 show economic growth continued at a similar pace to 2016. Inflation continued to rise in the first months of the year, thus eliminating the risk on a possible disinflationary spiral. Nevertheless, the rise during this period was attributable mainly to the prices of fresh agricultural products and the high change of oil prices from a year earlier, while core inflation continues to be low. Economic growth in the euro area is expected to be positive and stable in the period ahead. Risks surrounding these expectations remain high, mainly
related to the uncertainty of the political situation in some large countries of European Union, and its main regional partners.

Economies of trading partners of Albania, Italy and Greece, showed different dynamics of economic development. In Italy, the economy continued to grow in 2016 Q4. Economic recovery in 2016 H2 benefited from the increase of investments and consumption. Dynamics in GDP leading indicators show economic growth will continue at the same pace in 2017 Q1. Meanwhile, the Greek economy contracted considerably in 2016 Q4, reflecting the reduction of investments and of consumer spending. The outlook is surrounded by uncertainties created by the possible problems regarding the management of sovereign debt. Like other euro area countries, inflation trended upward in both Italy and Greece in the 2017 Q1.

Regional economies

Economic growth of main trading partners in the Balkan region strengthened over 2016, mainly underpinned by investments and private consumption, and less by exports (Serbia and Macedonia). Turkey is an exception of this trend. Its economy slowed considerably down due to the internal political tensions. The economic prospect for regional partner countries is positive for 2017. Economic growth is expected to be driven mainly by the domestic demand, while risks arise from developments in large economies and the internal political tensions (Macedonia, Turkey). Inflation rates were up in all the countries. Higher prices of foods and primary commodities in international markets are the main factors driving inflation up.

2 Main trading partners in the Balkans, non-EU members.
The pace of economic activity was uneven across all countries. Serbia recorded faster growth, at 2.8% in 2016, from 0.8% a year earlier. Economic growth in 2016 Q4 was supported by the considerable expansion of exports and by public and private consumption. Preliminary data for 2017 Q1 show a steady expansion of the economic activity. The economy in Macedonia grew at a slower pace in 2016, at 2.8%, from 3.5% in the previous year, due to the fall in investments. The political crisis in Macedonia seems to have affected the business climate. In 2016 Q4, the contraction in investments deepened further the negative contribution. On the other hand, the expansion in consumer spending and exports provided positive contribution. Economic growth in Kosovo came mainly from the expansion of investments and private spending. Net exports provided negative contribution due to the high increase of imports in response to the increased consumption and high investments. This profile of the economic activity is expected to be maintained in the current year. The economy of Turkey grew 2.9% in 2016, considerably lower than 6.1% in the previous year. After the negative annual growth in 2016 Q3, the fourth quarter recorded positive growth at 3.5%, driven by consumption and investments (public and private). Data for 2017 Q1 are positive, and show similar growth pace to 2016. Consumer and business confidence indicators stabilised at higher levels from the end of the previous year.

### Table 2 Economic figures for countries in the region

<table>
<thead>
<tr>
<th>Countries</th>
<th>Annual change of GDP 2016 Q3</th>
<th>Annual change of GDP 2016 Q4</th>
<th>Annual change of GDP 2017 Q1</th>
<th>Annual change of GDP 2016 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>1.0</td>
<td>1.0</td>
<td>1.3</td>
<td>11.5†</td>
</tr>
<tr>
<td>Greece</td>
<td>2.0</td>
<td>-1.1</td>
<td>1.4</td>
<td>23.5*</td>
</tr>
<tr>
<td>Macedonia</td>
<td>2.0</td>
<td>2.4</td>
<td>0.5</td>
<td>23.1</td>
</tr>
<tr>
<td>Serbia</td>
<td>2.8</td>
<td>2.5</td>
<td>3.1</td>
<td>13.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>-1.3</td>
<td>3.5</td>
<td>10.2</td>
<td>12.4</td>
</tr>
<tr>
<td>Kosovo</td>
<td>3.8</td>
<td>3.0</td>
<td>1.6</td>
<td>27.5</td>
</tr>
<tr>
<td>Albania</td>
<td>3.1</td>
<td>4.0</td>
<td>2.4</td>
<td>14.2</td>
</tr>
</tbody>
</table>

Source: Respective statistical institutes.
Note: *January 2017; †February 2017.

Inflation rates in the region trended up in 2017 Q1. Inflation in Macedonia shifted to a positive territory, while in Serbia it entered within the target band of the central bank. This acceleration is considered to be temporary, as it reflects the supply-side factors related to the high prices of foods due to the bad weather conditions in the first months of the year. Core inflation remains low. In Turkey, inflation recorded two-digit value, overshooting considerably the 5.0% target of the central bank, reflecting the high prices of foods and the delayed effect of the Turkish lira depreciation.

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3 Parliamentary elections took place in December 2016, after being postponed several times during the year. After the election results, there was no agreement on the creation of the Government. This situation led the country into a political crisis.
2.2. PRIMARY COMMODITY PRICES IN GLOBAL MARKETS

Commodity prices continued to increase in the first quarter, following the recovery of global economic activity. The main index of primary commodity prices increased by 6%, from the previous quarter, and 35% from the previous year. Oil prices had the strongest increase, among the commodities groups. Their prices hiked in January and February, reflecting the market confidence in the Agreement among OPEC countries and non-OPEC countries on the reduction of oil production in 2017 H1. Brent oil price ranged at 54-57 USD a barrel, recording around 70% annual increase. Oil prices were considerably volatile in March and April. Market optimism ended in March, with the growth of production in the USA and the doubts that OPEC agreement would not be sufficient to provide pressures on oil prices. It led to the fall of prices in this month. Nevertheless, due to heightened geopolitical tensions and the declarations by the authorities to respect the agreement, the price rose again in April, standing close to year start levels.

Metal prices increased as well, in response to the perspective for the increase of investments in emerging market economies, decrease of output capacities in some mines and a simulating fiscal policy in the USA. Food prices increased less, and performed differently within the groups. Cereal prices reflected the expectations for lower production and higher consumption, recording a moderate increase.

Prices of oil products and for many metals are expected to maintain the current levels till the end of 2017. For many food items, prices are expected to rise due to adverse weather conditions⁴.

⁴ World Economic Outlook, IMF, April 2017.
2.3. FINANCIAL MARKETS

Federal Open Market Committee (FOMEC) of Fed, in the meeting of March, raised the key interest rate by 0.25 percentage point, to 0.75% - 1.00%. The other major central banks kept their key interest rates unchanged, respectively: the European Central Bank at 0.0%, the Bank of England at 0.25% and the Bank of Japan at -0.10%.

Conditions in financial markets eased in 2017 Q1. Stock indices in advanced economies were upward. The spread of yields for highest-rated securities with those rated lower by the rating agencies narrowed. The increase of demand for these securities shows an improvement of market agents’ confidence. Capital inflows into emerging market economies turned positive and the currencies of these countries showed an overall appreciation.

Interest rates on money market instruments in the euro area did not change, remaining at low levels. Interests quoted in the US dollar increased, reflecting the change in the Fed monetary policy. Long-term interest rates in euro were up, by mainly reflecting the improvement of economic conditions, and an increase of sovereign risk premia. The euro depreciated against the US dollar and some of the major currencies, during these three months. In average terms, the euro depreciated by 1.3% against the US dollar, compared with the previous quarter.
3. FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

Financial markets were calm in 2017 Q1, amid low risk premia and good liquidity levels. Yields on Government securities returned to the downward trend, in addition to the improvement of the bid-to-cover ratio. Their fluctuations were not transmitted to the other segments of the market and the interest rates are close to their minimum values. The accommodative monetary policy implemented by the Bank of Albania is reflected in the decrease of financing costs to the private sector. Developments in credit confirm the shift of the portfolio towards credit in lek, whose growth was offset by the contraction of credit in foreign currency. The increase of total credit portfolio continues to be slow, affecting the pace of monetary expansion. Hence, inflationary pressures of monetary nature remain low for the medium-term period.

3.1. FINANCIAL MARKET DEVELOPMENTS

Interbank Market

Interbank market continued to be characterised by low interest rates over 2017 Q1. The volume traded by banks was similar to that at the end of 2016. Interests for the exchange of funds among banks continued to fluctuate close to the monetary policy rate and the indicators of their fluctuation has maintained low levels. Liquidity in the market was satisfactory, supporting this performance of interest rates. One and seven-day maturities continue to dominate the transactions profile, where the share of volumes is in favour of the latter. In addition to these maturities, the 2 and 3-day transactions increased. The Bank of Albania has continued to provide liquidity through its main instrument,
the one-week repo, and through repo agreements with one and three-month maturity. The injected amount was slightly lower than in the previous quarter.

**Domestic foreign exchange market**

The domestic currency continued to show an appreciating behaviour, both in effective and bilateral terms, during 2017 Q1. The annual change of the nominal effective exchange rate\(^5\) was -3.5% in 2017 Q1, from -3.2% in the previous quarter and over 2016. The deepening of the effective appreciation in this period mainly reflected the considerable appreciation of lek against the Turkish lira, whose value fell considerably against the US dollar. The performance in real terms\(^6\) was steady. The real effective exchange rate (REER) appreciated on average 4.0% in 2017 Q1. This pace was similar to the one in the previous quarter. The strengthening of nominal appreciation was balanced by the narrowing of spread of inflation at home with that in European partner countries.

Lek’s appreciating trend against euro was present also in 2017 Q1. While euro/lek exchange rate reversed the seasonal appreciation of December, it increased at 136.6 in January, fell at 135.6 in February, and at 135.4 in March. In annual terms the increase in lek value against the euro averaged 1.8%, similar to the pace at the end of 2016. Overall, euro/lek exchange rate reflected the higher supply than the demand of the domestic economy for euro. This phenomenon was particularly noted in 2016 H2, when the domestic economy experienced an acceleration of exports and a slowdown of imports, and increased tourism inflows, remittances and foreign financing related to

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\(^5\) The Nominal Effective Exchange Rate (NEER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market weights. For the purpose of calculating the lira/lek and the renminbi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renminbi against the US dollar.

\(^6\) The Real Effective Exchange rate (REER) is calculated similarly to the nominal, but it considers the domestic inflation and those in the trading partners, as well.
large investments projects. Developments in April show euro/lek exchange rate fluctuate close to the average levels of March.

Lek again showed appreciating trends against the US dollar during 2017 Q1. In January the US dollar/lek exchange rate stood close to the average level of December, at 128.4, but fell at 127.4 in February, and further at 126.7 in March. In annual terms, lek continues to depreciate against the US dollar, 1.6% on average. The observed developments in US dollar/lek exchange rate, overall, are in line with the performance of the green currency in the international market.

**Primary Market**

T-bill and bond yields decreased in the primary market of government debt instruments. Yields took a turn at the end of January, ending the upward trajectory that was dominant in 2016 H2. The decrease of yields reflected the improvement of the bid-to-cover ratio. The demand for financing from the government was higher in 2017 Q1, but banking system participation and supply in auctions has been up, triggering downward trends in yields. Yields fell across the entire spectrum of maturities, but at different intensity. The reduction was stronger for 12 and 24-month maturities. Thus, the yields’ curve shifted down and its slope increased compared with the beginning of the year.

At the beginning of April, the 12-month yield was 1.79%, from 3.22% in January. The yield on the 2-year bonds (issued on regular monthly basis) reduced at 2.25% in the April auction, from 3.80% in January. In the 5 and 7-year bond auctions, (quarterly issues), the yields stood at 5.15%, 5.24% and 6.45%, respectively, from 5.25%, 5.98% and 7.20% in the previous respective auctions. The demand to buy bonds increased 2017Q1, affirming the increase of banks’ interest on these investment instruments.

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**Bid/cover ratio for the auctions held in January, February and March for bonds was 1.66, from 0.98 in the last quarter.**

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3.2. DEPOSIT AND CREDIT INTEREST RATES AND FINANCING STANDARDS

Interest rates on new deposits in lek, in January maintained comparable levels to the previous quarter, at 0.83%, meanwhile they increased in February, at 0.98%. Interest rates on 6, 12 and 24-month deposits increased more notably. The detailed analysis shows that the increase of deposits interests in February is not at a broad base. It reflects the behaviour of two banks of the system. Excluding both banks from the calculation, the average interest rate on deposits is close to the one in 2016 H2. Interest rates on new deposits in euro were close to the average level of 2016 Q4, at 0.16%.

In terms of financial intermediation, the financing cost of the banking activity remains at low historic levels. Interest rate on deposits in lek stands at its minimum values, reflecting the accommodative monetary policy and the good liquidity situation in the banking system. Given the improved balance sheets of banks and the progressive growth of economic activity, the reduction of the banking system’s financing costs is translated into lower financing rates to the private sector.

Interest rates on new credit in lek have performed downward in 2017 Q1. The interest rate averaged 7.36%, from 7.75% in 2016 Q4. Credit interest rates did not perform equally across all segments in January and February. Interest rates on loans to private enterprises decreased, while interest rates on loans to households increased. The interest rate on loans to enterprises averaged 7.33%, from 8.03% in 2016 Q4. In the segment of enterprises, the interest rates decreased for liquidity and increased for investments. Interest

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8 The latest official data related to interest rates on loans and new deposits are as at February 2017.
9 The average of Q4 is calculated by excluding a loan granted to a public company at a preferential interest rate in December.
rates on loans to households increased across all segments, both for consumer and mortgage loans. The volatility of yields is not translated into a volatility of interest rates on loans, but their increase in the last months of the previous year has exercised pressures on the increase of interest rates on long-term loans in general, and on loans to households in particular.

The average interest rate on new credit in euro was slightly down in 2017 Q1. It averaged 4.62%, from 4.71% in the previous quarter. Overall, both, enterprises and households benefited from the lowering of interest rates on credit in euro. Regarding enterprises, interest rates fell on loans for liquidity, and continue to be at minimum levels for investments. Households benefited lower interest rates on mortgage loans, while the interest rates on consumer loans increased. The spread of the average rate of credit in lek against that in
Euro decreased during these two months due to the higher fall of interest rates on credit in lek. This spread is slightly above the average of the previous year.

In 2017 Q1, bank lending survey results show credit standards tightened on loans to enterprises, for the fourth consecutive quarter. Lending standards were tightened on loans for investments and liquidity, mainly through the increased collateral requirements, and, at a lesser extent, through decreasing the credit size. Meanwhile, lending standards to households continued to ease on both consumer and mortgage loans. The eased approach of banks to this segment is materialised through decreasing the collateral requirements and the improvement of instalment-to-income ratio.

### 3.3. CREDIT TO THE PRIVATE SECTOR

Lending increased at a moderate but steady pace during the last two years. Credit to the private sector increased on average by 2.9% in January and February, after increasing by 3.3% in the previous quarter. On monthly terms, outstanding credit to the private sector shrank in January, and slightly increased in February, resulting in ALL 1.9 billion less compared to the end of 2016. Sluggish lending reflects the still-tight supply of the banking sector to the enterprises segment. Meanwhile, it grew mainly driven by credit to households, reflecting a more stable demand, as well as more eased supply-side standards. The ratio of outstanding credit to the private sector to GDP is estimated at 37%, as at the end of February.

By currency, credit in ALL has fully supported the expansion of credit to the private sector, offsetting the decrease of credit stock in foreign currency. The decline of the financing cost in ALL, banks’ lending policies, combined with the...
awareness of economic agents for risk exposures to exchange rate, materialized in the growth of lending in lek. Outstanding loans accounted for about 43.7% of credit to the private sector in February, compared to 40.6% in the same period of the previous year. Credit portfolio in lek accelerated the annual growth to 10.9%, whilst credit portfolio in foreign currency averaged 2.5% lower than the previous year. The appreciating trend of the domestic currency against the main currencies, the US dollar and the euro, has contributed to deepening this contraction. Cleaned from this effect, the annual reduction in the foreign currency loan portfolio is more mitigated.

By customer, credit expansion is supported by the growth of credit to households. Credit to households grew steadily at almost same rates as a quarter earlier. It has benefited from the continued easing of credit standards for households, combined with their increasing demand for bank financing. In annual average terms, outstanding loans for households increased by 5.3% in January-February. This portfolio expanded supported by both the good performance of consumer credit and mortgage loans. The outstanding loan for house purchase purposes showed higher annual growth than in the previous quarter (4.5% versus 3.7%). Meanwhile, consumer credit slowed down its growth by 0.4 percentage point, down to 9.9% for the same-stated period. Monthly changes of the total credit stock to households increased by ALL 0.3 billion from the end of the previous year.

Credit to enterprises continued to show sluggish and unsteady growth. This portfolio slowed down the annual growth to about 1.8% in January-February, compared to 2.4% in the previous quarter. Changes in outstanding credit to enterprises in monthly terms show a decline by about ALL 2.2 billion from the end of the previous year. The performance of credit to enterprises is conditioned by the still tight supply for this segment, focused on large enterprises. On the
other hand, credit demand is also unsteady and segmented. By purpose of use, credit for investments has increased steadily over time (3.6%). Conversely, credit for liquidity (-0.3%) is characterized by higher volatility reflecting the short-term maturity of this portfolio, as well as the good liquidity situation of enterprises.

3.4. FINANCING TO PUBLIC SECTOR

Government borrowing was oriented towards long-term instruments in 2017 Q1, supporting thus the extension of the domestic debt maturity. Borrowing in the domestic market has been diversified in terms of both instruments and currency, and is distributed in accordance with the securities issuance calendar.

At the end of March, domestic debt was ALL 11.2 billion and was formed mostly (around 90%) from the long-term instruments. About 48% of the increase in the domestic debt stock by the end of December 2016 was a result of the issuance of two year Euro-Bonds. The rest is formed from the 7 and 10-year bonds as well as from treasury bills, offsetting thus the reduction of the 3-year bond portfolio by around ALL 1.1 billion.

Regarding the stakeholders in the securities market, the role of the banking system remains dominant. As at the end of March, banks owned about 58% of the government securities portfolio, compared to 57% a year earlier. Also, the presence of households in this market increased: at the end of March, households held about 25% of the debt securities stock.

3.5. THE PERFORMANCE OF DEPOSITS AND CURRENCY IN THE ECONOMY

The money supply in the economy expanded in January-February. The broad money indicator, M3 aggregate, increased by 3.9% in annual average terms, compared to 3.2% in the previous quarter. Net foreign assets of the banking system continued to provide the main contribution to the expansion of the monetary stock. The latter is also supported by the positive contribution of the public sector, where net claims on government partly reflect the statistical effect of their decrease a year earlier. Credit contribution to the economy in the expansion of broad money is positive, but on average lower than in the

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11 Based on the bank lending surveys, for more information: https://www.bankofalbania.org/web/Vrjtimi_i_aktivitetit_kreditues_5311_1.php
previous quarter. Money aggregate in lek, M2, shows expansion of money in the domestic currency, recording an average annual growth rate of 2.3% in January-February, from 0.6% a quarter earlier. The increased activity in the domestic currency is highly driven by the concentration of lending in the domestic currency and government financing in lek. The indicator of the narrow money, M1 aggregate, recorded an annual growth of 14%. The upward trend of this indicator mainly reflects the preference of economic agents to keep deposits in liquid form. After the seasonal growth at the end of the year, the currency outside banks shows a reduction of stock in January-February, in line with expectations.

Deposits in the banking sector\(^\text{12}\) expanded on average by 4.8% in annual terms in January-February, compared to 4.5% in the previous quarter. The total stock of deposits to GDP is estimated at 72.8%, at the end of February. Deposits grew supported by the good performance of foreign currency deposits (6.8%), as well as the improvement of growth of deposits in lek. Short-term developments show a decrease of the deposit stock from the previous year [by ALL 5.6 billion], driven by the reduction of deposits in lek during this period, affected by the shifting of savings to alternative financial instruments, such as government securities. Meanwhile, deposits in foreign currency increased moderately (ALL 0.2 billion) which, cleared from the effects of domestic currency appreciation over this period, are slightly higher.

\(^{12}\) Deposits’ analysis includes also deposits with over two-year maturity, which are not part of the M3 aggregate calculation.
Developments in terms of the time structure show that reduction of deposits stock during January-February has mainly affected demand deposits (ALL 3.9 billion), and less time deposits. However, in long-term, the time structure still indicates the preference of economic agents for liquid monetary assets.

At the end of February, demand deposits in the banking sector accounted for 39.8% of the total stock.
4. INFLATION AND ECONOMIC GROWTH

The average annual inflation was 2.4% in 2017 Q1, confirming thus the Bank of Albania assessments for its upward trend during this period. This growth reflected elevated domestic inflationary pressures as a result of the improved aggregate demand and cyclical position of the economy, increase of foreign pressures and better anchoring of inflation expectations. In our view, the impact of these factors will continue in the quarters ahead.

The economic growth of the fourth quarter, accelerated to 4% as expected. Aggregate demand grew supported by the positive contribution of its components, mostly by exports. On the production side the services sector and the construction activity were main contributors to the expansion of economic activity. Available data for the first quarter of the year suggest these trends continue.

Albanian economy is expected to grow steadily over the period ahead, thus more completely activating production capacities in the economy. The approach of the economy to equilibrium will be accompanied by the increase in inflationary pressures and the return of inflation to target within 2018.

4.1. INFLATION

Average annual inflation was 2.4% in 2017 Q1, standing 0.5 percentage point higher compared to the previous quarter. Inflation rose mainly from the increase of food prices, which formed around 80% of the total inflation rate. Also, oil prices continued to be significantly higher than a year earlier. During the first quarter of the year, inflation rates reflected also the base effect of...
comparison, with the lowest level recorded in the previous year (0.7%). The inflation upward trend during this year is in line with our previous forecast.

During the first quarter, inflation showed a downward trend, falling from 2.8% in January to 2.1% in March. This performance was determined by the slowdown of the contribution from “Unprocessed foods”. Annual inflation of this category was 10.1% in January, contributing by 1.7 percentage points to headline inflation. Food prices increased in January driven by both increase in foreign markets and the adverse weather conditions in Albania. As the weather effects ended, inflation of this category scored lower values. Its contribution to headline inflation fell to 1.0 percentage points, in February and March.

Processed foods contributed at the same extent as in the previous quarter to headline inflation, by 0.6 percentage point. This development reflects the upward trend of food prices in international markets.

Inflation and contribution increased in the non-food products category as well. The positive contribution of this category was a result of the rise in oil prices in the country, reflecting its growth in international markets, the rise in gas price, and low comparative base of the previous year. Despite not causing significant changes in the values of quarterly contribution, inflation from “housing” increasing in March as a result of the increase in the rental index. Other basket categories retained almost the same contribution to headline inflation.

Table 3 Contribution of key categories to annual inflation (p.p.)*.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Processed foods [p.p.]</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.0</td>
<td>0.4</td>
<td>0.1</td>
<td>0.4</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Bread and grains [p.p.]</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.2</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Alcohol and tobacco [p.p.]</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Unprocessed food [p.p.]</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
<td>2.6</td>
<td>1.5</td>
<td>0.9</td>
<td>1.2</td>
<td>0.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Fruits [p.p.]</td>
<td>0.5</td>
<td>0.8</td>
<td>0.8</td>
<td>0.9</td>
<td>0.7</td>
<td>0.6</td>
<td>0.4</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Vegetables [p.p.]</td>
<td>1.1</td>
<td>0.9</td>
<td>0.9</td>
<td>1.7</td>
<td>0.8</td>
<td>0.3</td>
<td>0.8</td>
<td>0.6</td>
<td>0.9</td>
</tr>
<tr>
<td>Services [p.p.]</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Goods with regulated prices [pp]</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Fuels and energy [p.p.]</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Housing [pp]</td>
<td>0.1</td>
<td>-0.1</td>
<td>0.0</td>
<td>-0.2</td>
<td>-0.2</td>
<td>-0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Non-food consumer goods</td>
<td>-0.4</td>
<td>0.2</td>
<td>-0.2</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.1</td>
<td>-0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Durable goods [pp]</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Consumer Price Index (annual change, %)</td>
<td>1.9</td>
<td>1.8</td>
<td>1.8</td>
<td>2.1</td>
<td>0.7</td>
<td>0.7</td>
<td>1.9</td>
<td>1.9</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania.
* The table presents some of the main items.

As mentioned before, the rapid growth of inflation is mainly driven by supply-side factors. Demand-side inflationary pressures, albeit upward, remain contained.
The positive growth of the economy and employment, narrowed but could not eliminate the gap between actual and potential output. Also, the appreciation of the exchange rate has curbed pressures from the imported commodity prices (oil, basic food, grains, etc.). On the other hand, better anchoring of inflation expectations creates conditions for a steady increase in inflation.

**BOX 1: HARMONIZED INDEX OF CONSUMER PRICES VS. CONSUMER PRICE INDEX: TWO DIFFERENT INDICATORS**

This box shares some detailed information about the Harmonised Index of Consumer Prices, its purpose of use and differences with the Consumer Price Index, particularly in the case of Albania.

The Consumer Price Index (CPI) is widely known by the public as the indicator used to calculate inflation. In Albania, it has been measured and published by INSTAT. The CPI has been published monthly since January 1992. CPI is calculated at national level and is among the most important macroeconomic indicators. The methodologies used to calculate CPI have been perfected, aiming at harmonizing the methods and measurement techniques in accordance with the conditions in the respective countries. Basically, the application of statistical methodologies ensures the quality of the calculation process of consumer prices and inflation. Despite the standardization of methodologies, the differences between CPIs and inflation rates related to the characteristics of different economies cannot be eliminated. This makes the cross-country comparison of indicators difficult, at the level of member states and EU candidate countries.

In order to help draft the policies and to better compare with the other countries, in coordination with Eurostat, measures have been taken to create a joint methodological basis of the member states for constructing and using the HICP, according to the European Council Regulation, No 2494/95, dated 23 October 1995. Euro area inflation is measured on the basis of HICP. The term “harmonized” underlines the fact that all EU countries apply the same methodology in measuring the respective indicator.

In the framework of convergence, Albania, as an EU candidate country is obliged to calculate and publish the “HICP”. Since February 2017, INSTAT has started to publish this new consumer price index, on monthly basis. The aim is not to have two different measurements of headline inflation, but for each of them to calculate the performance of consumer prices in the economy, depending on the purpose they are created for, as follows:

- Inflation calculated by the CPI serves to measure the performance of consumer prices and to formulate policies and economic and social strategies of different countries. More specifically, in Albania, the main objective of monetary policy is to achieve and maintain price stability. In numerical terms, the Bank of Albania’s target is to have an annual increase of consumer prices, as measured by the CPI, about 3% in the medium term.\(^\text{iii}\)
- Inflation calculated under the HICP is used exclusively for the comparison of inflation rates, by member state and EU candidate countries;
Differences between the CPI and the HICP in Albania are:

- Items of respective baskets in Albania. The CPI contains 332 items; The HICP contains 331 items (imputed rent is not an element of the basket).
- Expenditure coverage and source of their measurement. CPI covers only the expenditures of households incurred within the territory of the country. The main source of data for expenditures (“weights”) is the household budget survey (HBS); HICP covers all the expenses incurred within the territory of Albania by Albanian households, as well as expenditure of resident and non-resident visitors. The main source of data for expenditures (“weights”) are the national accounts “Household final monetary consumption expenditure (HFMCE).
- Structure of the respective baskets. The largest differences between the two baskets belong to the group: “Accommodation (rental); “Water, fuel and energy”; “Health”, “Education” and “Hotels, Restaurants and Cafés”. In the first group, the difference starts from the construction of these indices. In the case of CPI, the item “imputed rent” is included with a significant share, whilst in the construction of HICP this item is not part of the basket. In the other groups, the differences are verified after conducting the two surveys that are the basis for creating these two indicators: 2015 Household Budget Survey for CPIs and Household Final Monetary Consumption Expenditure, for the second indicator.

Due to the main changes, mentioned above, the two indicators cannot provide the same numerical information, and, above all, they cannot be used for the same analysis and decision-making purposes.

Analysis between the values of the two indicators

The comparison of two series of headline inflation shows that the group: “Food and non-alcoholic beverages” gave the main contribution to the annual change of CPI and HICP, respectively at 75% and 83% in 2017 Q1.

Table 4 Contribution by group to the annual change for 2017 Q1, according to CPI and HICP.

<table>
<thead>
<tr>
<th>Classification by COICOP</th>
<th>Contribution of groups in the annual change in the CPI (pp)</th>
<th>Contribution of groups in annual change HICP (pp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>01. Food and non-alcoholic beverages</td>
<td>1.78</td>
<td>3.17</td>
</tr>
<tr>
<td>02. Alcoholic beverages and tobacco</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>03. Clothes and footwear</td>
<td>-0.01</td>
<td>0.00</td>
</tr>
<tr>
<td>04. Accommodation (rental), water, oil and energy</td>
<td>0.14</td>
<td>0.10</td>
</tr>
<tr>
<td>05. Furniture, equipment, and house maintenance</td>
<td>-0.01</td>
<td>-0.03</td>
</tr>
<tr>
<td>06. Health</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>07. Transport</td>
<td>0.20</td>
<td>0.22</td>
</tr>
<tr>
<td>08. Communication</td>
<td>0.00</td>
<td>0.01</td>
</tr>
<tr>
<td>09. Entertainment and culture</td>
<td>0.08</td>
<td>0.07</td>
</tr>
<tr>
<td>10. Educational service</td>
<td>0.02</td>
<td>0.03</td>
</tr>
<tr>
<td>11. Hotel, restaurants and cafés</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>12. Goods and various services</td>
<td>0.15</td>
<td>0.18</td>
</tr>
<tr>
<td>Total</td>
<td>2.38</td>
<td>3.82</td>
</tr>
</tbody>
</table>

Source: INSTAT.
Contribution differences from one indicator to another are related to the fact that the composition of weights within the group: “Food and non-alcoholic beverages” is different from one indicator to another. Thus, within this group, the sub-group “Fruits-Vegetable” has a larger share in the HICP basket (12.84% of the total basket), compared to that of CPI (8.44% of the total). Due to this difference, contribution of this group to the total is equal to 2.5 percentage points in the case of HICP indicator and 1.2 percentage points in the case of CPI. Small differences in contributions are also noted in other groups but not in the size of change in the above mentioned case. In conclusion, the sub-group “Fruits-Vegetable” created 1.3 percentage points or more than 80% of the total inflation change measured by the two indicators (3.84% versus 2.38%).

By Gent Hashorva, Monetary Policy Department.


II https://www.bankofalbania.org/web/Dokumenti_i_Politikes_Monetare_7190_1.php


4.2. GROSS DOMESTIC PRODUCTION AND THE PERFORMANCE OF AGGREGATE DEMAND

According to INSTAT data, Gross Domestic Product (GDP) resulted with a real annual growth of 4.0% in 2016 Q4. By sector, the services and construction sectors gave the main contribution to this growth; the industry and agricultural sectors contributed positively as well. In terms of aggregate demand, all its component, consumption, private and public investments and net exports contributed to its growth during this period. Domestic demand is estimated to have benefited from the eased monetary conditions, confidence improvement, employment increase and inflows of foreign direct investments.

4.2.1. PRODUCTION BY SECTORS

Value-added data by economic activities shows that GDP growth in 2016 Q4 continued to be attributed mainly to the performance of the services sector. Similar to the previous quarter, the increase in value added of services was translated into a contribution of 2.0 percentage points to the annual GDP growth. Contribution of the production sector rose to 1.6 percentage points from 0.6 percentage point in the previous quarter. The fastest growth dynamics of the production sector reflected the continuation of the positive performance of the construction activity and the improvement of industrial activity, which

13 Performance of GDP and gross value added by sector is analysed in terms of real annual changes. The analysis is based on the latest GDP data according to the output method for 2016 Q4, published by INSTAT on 3 April 2017. The differences between the sectors’ growth rates of this publication and those analysed in the previous quarterly report of the Monetary Policy are a result of the series review.
contributed respectively by 0.9 and 0.6 percentage points to economic growth. Meanwhile, the growth of forestry, agricultural and fishing activities gave a slight positive contribution (+0.1 percentage point) to GDP. Contribution of net taxes to GDP continued to gradually decrease, resulting in about 0.3 and 0.5 percentage point from 0.4 percentage point in the previous two quarters.\textsuperscript{14}

The value added of the services sector continued to grow in the last quarter of the year (by 4.0%), albeit at lower rates than in the first three quarters (respectively by 5.2%, 6.1% and 4.3%). The sector’s performance remains above the historical average of 3.1% with the main contributor “Trade, hotels and restaurants and transport” (+1.9 percentage points). This branch mainly reflected the positive developments of the trade activity\textsuperscript{15}.

The “Public administration, education and health” branch, accelerated the annual growth rate from 0.2% in the third quarter to 2.4% in the fourth quarter. Its contribution to the added value of services is estimated at 0.6 percentage point. On the other hand, the value added of activities related to “Other services” “Financial and insurance activities” and “Professional Activities and administrative services” slowed down the growth, contributing respectively by 0.5, 0.4 and 0.3 percentage point to the annual growth of the sector. The “Information and communication” branch showed a positive dynamics, but its contribution to the growth of value added of the sectors remains low, (+0.3 percentage point). Meanwhile, the “Real Estate” generated an added value slightly lower compared to the same period a year earlier (about 0.2%)

\textsuperscript{14} The net tax component was once again largely determined by the item of tax on products, contribution of which is estimated at about 0.3 percentage points for the annual GDP growth.

\textsuperscript{15} According to the short term statistics data for 2016 Q4, the wholesale trade activity is among the branches which contributed to the increase of the turnover volume indicator for service businesses.
Chart 21 Contributions of branches and capacity utilization rates in the services sector

Source: INSTAT and Bank of Albania.

Signals from confidence indicators and capacity utilization rates in service activities suggest positive developments in this sector in 2017 Q1.

Chart 22 Value added in construction and capacity utilization rate

Source: INSTAT and Bank of Albania.

Developments in the construction sector remained positive in 2016 Q4. However, the annual growth rate of value added of the sector by 6.8% was lower than the 8.1% recorded in the previous quarter. The increase of the construction category, relating to engineering works, the continuation of the Trans-Adriatic Pipeline project, and the expansion of foreign direct investments

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The volume index data of production in construction signalled this performance, thus reflecting a slowdown of the indicator growth from 7.9 in 2016 Q3, to 6.6% in the quarter under review.

The engineering works had a positive impact on the performance of the production volume index data in construction.
inflows contributed positively to the performance of construction. Leading indicators of the number and approximate value of construction permits are increasing in all the main categories of construction in the fourth quarter18.

Increase of confidence indicator and capacity utilisation rate in construction shows positive signals regarding this sector’s performance in 2017 Q1. Also, the granting of a larger number of construction permits, increase of imports value for groups of goods related to construction activity and support from the public component19 suggest for a continuation of the positive dynamics in the construction sector, even beyond the first quarter.

The performance of the industry sector was positive. This was reflected in the improvement of the value added, which increased annually by 5.1% in 2016 Q4, after contracting by 3.1% in the previous quarter. The positive developments of the industrial activity were determined by the contribution on the up side, of “Quarrying, energy, water and waste treatment” (+7.9 percentage points). The value added of this branch expanded by 15.6%, a rate above the historical average by about 7.5%. Improvement of the activity in this branch reflected, on

18 During the fourth quarter, the approximate value of construction permits was higher compared to the same period a year ago for residential buildings, other buildings and engineering works. Also, the number of construction permits granted was 147 out of 145 permits approved a quarter earlier, and significantly higher than the permits granted a year ago.

19 Preliminary data of March show a rise in central government capital expenditures during 2017 Q1.
the one hand, the expansion of electricity production\textsuperscript{20}, and on the other hand, the curbing of the contraction of quarrying industry\textsuperscript{21}. Meanwhile, "Processing Industry" was characterized by negative developments, contributing by about -2.7 percentage points to the performance of the industrial sector. After the slowdown of the positive trend of three-quarters, the value added of the processing industry marked an annual decline of 6.0\%\textsuperscript{22}.

Improvement of the confidence indicator and increase of the capacity utilization rate in the industry suggest that the dynamics of this sector continues to be positive during the first quarter of this year. These signals are also confirmed by the strong expansion of some exports groups of industrial products\textsuperscript{23} in the first quarter.

### 4.2.2. AGGREGATE DEMAND

Aggregate demand continued to expand during 2016 Q4, supported by both domestic and foreign demand. Population consumption, the gross fixed capital formation and net exports provided the main contribution in this regard. The information from the indirect indicators suggests the same growth profile of aggregate demand during 2017 Q1.

Domestic demand expanded by 3.2\% in 2016 Q4. As in the previous quarters, the main contributions were from population consumption and capital formation. Also, public consumption has provided slight positive contributions. About capital formation, the positive contributions are related with private investments.

Leading and indirect indicators signal that domestic demand will continue to increase during the first quarter of 2017. Population consumption and private investments are expected to continue to support this trend. Also, public consumption signals positive contributions.

\textsuperscript{20} Production volume index data show an annual increase by 68\% of the index for the "Electricity, gas, steam and air conditioning" index in 2016 Q4. This rate is significantly higher than the average growth of 23.4\% recorded in the first three quarters of the year. Also, electricity balance data for 2016 H2 show an increase of net domestic electricity production by 45.7\% compared to the previous year, following the 8.2\% increase in 2016 H1.

\textsuperscript{21} The production volume index for the quarrying industry continued to be lower than in the previous year, about 20.3\%, but this trend is more mitigated compared to the 39.3\% decline in the previous quarter. Also, foreign trade data for this mostly export-oriented industry record high increase of exports in value for the "Ores, dies and ash", curbing of the downward trend for the group "Mineral fuels, mineral oils and products for their distillation" and continuation of the downward trend for the group "Salts, sulphur, oxides, lime and cement".

\textsuperscript{22} Exports of textile industry products, clothing, leather and footwear, industry with the highest share in the processing industry continue the positive dynamics but decelerating. This signals a support of a lesser extent of the processing industry from these activities in 2016 Q4.

\textsuperscript{23} In the first quarter of this year, exports in value for "Ores, dies and ash", "Salt, sulphur, oxides, lime and cement" and "Mineral fuels, mineral oils and distillation products" recorded high annual growth rates.
Private consumption grew by 2.5% during the fourth quarter, at the same pace of its annual average during 2016. This component was the main contributor to the increase of aggregate demand during 2016. It was positively affected by the increased confidence, the eased financial conditions, the increased employment and the increased available income. Other indirect indicators, in addition to the information from national accounts, suggest that private consumption registered growth in all its three main categories: consumption goods, durable goods, and services.  

Private consumption is assessed to have continued to increase during the first quarter of 2017 as well, judging by the short-term data published earlier than the national accounts. The imports of vehicle and food items, and the value added tax expanded in the first quarter. Consumer credit continued the upward trend and the confidence indicators for the services and trade sectors continue the upward cycle.

Investments grew at a slower pace in the fourth quarter, affected by the slower growth of investments in machinery and equipment as well as in construction. Investments in this quarter increased by 5.7%, and contributed by 22% in the expansion of aggregate demand. The improvements of the financial situation, the increase of the capacity utilisation rate, the increase of construction permits and the improvement of businesses’ confidence in the economy remain the

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24 Quarterly national accounts do not publish results for disaggregated consumption by composing categories. The indirect indicators assessed for the trend of the composing categories are the increase of food and durable goods retail trade indicators, increased vehicle imports and increased added value of the services sector.  

25 Judging from machinery and equipment imports and the added value in the construction sector.
underlying factors of investments’ growth. Business financing sources were supported by the growth of foreign direct investments and the expansion of credit in the fourth quarter.

Other quantitative and qualitative indicators in the confidence surveys signal the continuation of the upward cycle of investments during the first quarter of 2017. Positive signals come mainly from the increase of the capacity utilisation rate, the improvement of the financial situation of businesses and the increase of machinery and equipment imports. Also, credit for investment registered positive annual changes in January and February 2017.
Prices in the housing market

House Price and Rent Indices have registered divergent developments during the first quarter of 2017. Thus, the rent index continued to trend up in the third quarter. It increased by 6.3% in annual real terms. House Price Index, after the increase by 4% in the last quarter of 2016, returned to the decreasing trend in the first quarter of 2017. This index fell by 5.9% in real terms. The different dynamic of the two indices drove to a decrease of the price to rent ratio during the first quarter of 2017.

Public sector demand and fiscal policy

The 2017 budget plan suggests an almost neutral fiscal position, mainly thanks to the strong correction of public finances during 2016. During this year, it is planned to achieve a deficit of 2% of GDP, from 1.8% assessed for 2016. Fiscal policy for 2017 is assessed to support economic growth through the short-term and long-term instruments. The expected growth of government final consumption, driven mainly by the increase of the wages fund for public administration employees, as well as by the projected increase of public investment spending, is assessed to generate an added contribution to the growth of domestic demand during 2017.
The nature of fiscal policy, expressed in quantitative terms, is factorized in a positive fiscal impulse of 0.3% of GDP until the end of the first quarter. Its main part is assessed to have been generated by the upward dynamic of budget expenditure.

During the first quarter of the year, budget expenditures continued their growing trend started in the third quarter of the previous year. They amounted to around ALL 91.9 billion in the first three months of the year, around 10.3% higher in annual nominal terms. Local government spending, unlike historical behaviour, continue to lead the growth of total spending over three quarters. During the first quarter, the increase of this item represented around 37% of total spending growth. Other items that supported the expenditure during this quarter were...
social security and capital spending, by 5.5 and 2.6 percentage points, respectively. Debt interest spending impacted on the opposite side, by partially reducing the increase of total spending (-1.8 percentage points).

Developments in expenditure items suggest that the government final consumption, as well as the formation of gross public fixed capital, is expected to affect positively the growth of aggregate demand during 2017 Q1.

Revenues for the first three months of the year were about ALL 100.8 billion or around 4.3% higher than the same period of the previous year. The main tax items that formed the growth of the total were the revenues from the local government\textsuperscript{32}, VAT, social insurance and national taxes. By contrast, non-tax revenues as well as grants provided a negative contribution to the growth of total revenues, by around 2.3 percentage points.

The dynamic of specific revenue items gives positive signals for consumption, as well as suggest improved conditions in the employment market during the first quarter of 2017.

Budget balance during the first quarter resulted positive, around ALL 8.9 billion, or 33.2% lower compared to the same period the previous year. Notwithstanding these positive values, government borrowing continued to increase both in the domestic and external markets (ALL 11.2 billion), (around ALL 8.7 billion), respectively, resulting in high levels of government liquidity.

\textsuperscript{32} Revenues from the local government continue to support stably the growth of total revenues for four quarters consecutively.
Foreign demand and foreign trade

Trade deficit in goods and services during 2016 Q4 narrowed around 21.7% in real terms. The main driver of this development has been the annual increase of services export by 12.9%. Also, the export of goods registered a high annual growth as well (25.9%), reversing the negative dynamic that characterized the previous quarters. On the other hand, imports decreased by 0.5%, affected mainly by the decline of the import of goods (-0.4%). Also, the import of services declined by 0.6% in real annual terms.

Data on exports and imports of goods' performance for 2017 include statistics for the first quarter. Trade deficit in goods recorded an annual expansion of 1.3% during this period, mainly affected by the increased imports.

Export of goods in value expanded by around 15.7%, in annual terms, during the first quarter of 2017. The increase in exports of categories: “Construction material and metals”, “Minerals, fuel, electricity”, and “Textiles and footwear” provided the main contribution to this performance.

In the first category, exports' growth is oriented toward Albania’s main partner, Italy, as well as toward some neighbour countries (Kosovo, Montenegro, Macedonia, Greece and Bulgaria) which generally have had low shares. Exports also increased towards other more distant partners, thus expanding the number of countries were these products are exported. Taking into account that
these are recent developments for this category (concentrated mainly in March 2017), it is still not clear if they are temporary or constitute a long-term situation.

In the category “Mineral and fuel”, the main contribution is related to the high and growing exports of ore, mainly toward China\(^3\). The drive of the domestic producers to export is related with the considerable increase of the prices offered by the partners during this period. Also, the positive contributions of fuel export of have continued during this quarter as well, at a similar pace to the positive performance started during the last two months of 2016. Regarding “Textiles and footwear”, the performance has continued to be stable, as in the previous quarters. Lastly, the positive contributions of the category “Food, beverages, tobacco” have resulted rather low, unlike the developments of 2016.

Import increased by around 7.5%, in annual terms. This activity was concentrated mainly in March. The main positive contributions came from the categories “Chemical and plastic products”, “Machinery, equipment, spare parts” and “Textile and footwear”. Imports from the category “Machinery, equipment, spare parts” have returned to contribute positively, after the decline registered during the previous quarter. Also, the imports of the category “Minerals, fuel, electricity” have shown positive contributions in increasing imports, for the first time after a long period.

According to geographical orientation, the countries of the European Union and, especially Italy, remain Albania’s main partners in trade exchanges. The share of China has grown during the last months, as a consequence of the high growth of exports of minerals. On the other hand, we observe a higher diversity in the partners of the exports of fuel. To traditional partners like Italy and Spain have been added other destinations (Kosovo, Serbia and Germany).

\(^3\) This development has been recorded since November 2016.
Box 2: Balance of Payments 2016 Q4

The net position of the current account in Albania recorded a deficit of EUR 240.3 million in 2016 Q4, narrowing by around 39.6% in annual level. It was assessed at 8.3% of nominal GDP, or about 6.4 percentage points lower than in the same quarter of the previous year. According to the component items of the current account, the improvements related with all the sub-accounts, and especially services and goods, contributed to the narrowing side.

Exports of goods and services expanded by 19.9%, whilst imports increased by around 11.1%, in annual terms. The positive net balance of the secondary income expanded by 11.6% in annual level. Remittances and public sector provided the main contribution to this performance. Remittance inflows expanded by 7.9% in annual terms, continuing the trend showed in the previous quarter. Meanwhile, primary income deficit narrowed by around EUR 6.4 million in annual terms. In structural terms, as measured by the national gap between savings and investments, the private savings were the determinant factor in defining the narrowing of the current deficit.

The overall balance of payments resulted with increased assets of reserves of around EUR 153.3 million. At the end of 2016 Q4, the stock of foreign exchange reserves was around EUR 2.94 billion, sufficient to cover 7.2 months of import of goods and services and 165% of the short-term gross external debt.

Table 5: Balance of Payments indicators (in EUR million)

<table>
<thead>
<tr>
<th></th>
<th>'15 Q2</th>
<th>'15 Q3</th>
<th>'15 Q4</th>
<th>'16 Q1</th>
<th>'16 Q2</th>
<th>'16 Q3</th>
<th>'16 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account (in EUR million)</td>
<td>-163.2</td>
<td>-312.7</td>
<td>-397.7</td>
<td>-223.8</td>
<td>-359.6</td>
<td>-206.1</td>
<td>-240.3</td>
</tr>
<tr>
<td>YoY (%)</td>
<td>-48.6</td>
<td>5.7</td>
<td>4.0</td>
<td>-3.1</td>
<td>120.3</td>
<td>-34.1</td>
<td>-39.6</td>
</tr>
<tr>
<td>/GDP (%)</td>
<td>-6.0</td>
<td>-1.2</td>
<td>-1.4</td>
<td>-9.4</td>
<td>-12.9</td>
<td>-7.7</td>
<td>-8.3</td>
</tr>
<tr>
<td>Goods and services</td>
<td>-360.6</td>
<td>-476.3</td>
<td>-564.5</td>
<td>-403.3</td>
<td>-555.1</td>
<td>-410.9</td>
<td>-436.9</td>
</tr>
<tr>
<td>YoY (%)</td>
<td>-24.8</td>
<td>1.3</td>
<td>4.4</td>
<td>8.2</td>
<td>54.0</td>
<td>-13.7</td>
<td>-22.6</td>
</tr>
<tr>
<td>Exports, f.o.b.</td>
<td>705.9</td>
<td>785.0</td>
<td>714.7</td>
<td>608.5</td>
<td>717.2</td>
<td>926.8</td>
<td>857.0</td>
</tr>
<tr>
<td>YoY (%)</td>
<td>-1.0</td>
<td>-2.3</td>
<td>-0.7</td>
<td>2.5</td>
<td>1.6</td>
<td>18.1</td>
<td>19.9</td>
</tr>
<tr>
<td>Imports, f.o.b.</td>
<td>1066.5</td>
<td>1261.4</td>
<td>1279.1</td>
<td>1011.9</td>
<td>1272.3</td>
<td>1337.6</td>
<td>1293.8</td>
</tr>
<tr>
<td>YoY (%)</td>
<td>-10.5</td>
<td>-1.0</td>
<td>1.5</td>
<td>4.7</td>
<td>19.3</td>
<td>6.0</td>
<td>1.1</td>
</tr>
<tr>
<td>Net Trips</td>
<td>76.4</td>
<td>64.5</td>
<td>51.6</td>
<td>67.3</td>
<td>72.8</td>
<td>153.1</td>
<td>95.7</td>
</tr>
<tr>
<td>Primary income</td>
<td>-12.9</td>
<td>-12.8</td>
<td>-34.2</td>
<td>10.4</td>
<td>-21.3</td>
<td>-5.5</td>
<td>-27.8</td>
</tr>
<tr>
<td>Credit</td>
<td>34.5</td>
<td>40.0</td>
<td>43.9</td>
<td>50.8</td>
<td>38.1</td>
<td>42.5</td>
<td>45.7</td>
</tr>
<tr>
<td>Debit</td>
<td>47.4</td>
<td>52.8</td>
<td>78.1</td>
<td>40.3</td>
<td>59.4</td>
<td>48.0</td>
<td>73.5</td>
</tr>
<tr>
<td>Net income from Direct Investments</td>
<td>-26.4</td>
<td>-27.7</td>
<td>-31.7</td>
<td>-3.8</td>
<td>-30.5</td>
<td>-21.3</td>
<td>-29.8</td>
</tr>
<tr>
<td>Secondary income</td>
<td>210.2</td>
<td>176.4</td>
<td>201.0</td>
<td>169.1</td>
<td>216.8</td>
<td>210.3</td>
<td>224.4</td>
</tr>
<tr>
<td>Credit</td>
<td>243.3</td>
<td>219.1</td>
<td>247.2</td>
<td>205.0</td>
<td>250.1</td>
<td>250.7</td>
<td>255.4</td>
</tr>
<tr>
<td>Debit</td>
<td>33.0</td>
<td>42.6</td>
<td>46.2</td>
<td>35.9</td>
<td>33.2</td>
<td>40.5</td>
<td>31.0</td>
</tr>
<tr>
<td>Net Remittances</td>
<td>161.7</td>
<td>139.7</td>
<td>153.9</td>
<td>135.7</td>
<td>153.8</td>
<td>159.6</td>
<td>165.4</td>
</tr>
<tr>
<td>YoY (%)</td>
<td>17.6</td>
<td>-15.4</td>
<td>-10.0</td>
<td>-4.2</td>
<td>-4.8</td>
<td>14.2</td>
<td>7.4</td>
</tr>
<tr>
<td>Capital account</td>
<td>21.3</td>
<td>45.6</td>
<td>32.8</td>
<td>6.6</td>
<td>7.2</td>
<td>3.1</td>
<td>49.4</td>
</tr>
<tr>
<td>Net Borrowing/Net lending</td>
<td>-141.9</td>
<td>-267.1</td>
<td>-364.8</td>
<td>-217.3</td>
<td>-352.4</td>
<td>-203.1</td>
<td>-190.9</td>
</tr>
<tr>
<td>Financial account</td>
<td>-177.1</td>
<td>-126.6</td>
<td>-243.3</td>
<td>-170.5</td>
<td>-255.2</td>
<td>-90.0</td>
<td>-149.2</td>
</tr>
<tr>
<td>YoY (%)</td>
<td>-17.9</td>
<td>-30.9</td>
<td>-16.8</td>
<td>4.3</td>
<td>44.1</td>
<td>-28.9</td>
<td>-38.7</td>
</tr>
<tr>
<td>/GDP (%)</td>
<td>-6.5</td>
<td>-4.9</td>
<td>-9.0</td>
<td>-7.1</td>
<td>-9.1</td>
<td>-3.3</td>
<td>-5.1</td>
</tr>
<tr>
<td>Direct investments</td>
<td>-196.5</td>
<td>248.1</td>
<td>-120.0</td>
<td>-148.1</td>
<td>-233.6</td>
<td>-295.8</td>
<td>-280.9</td>
</tr>
</tbody>
</table>
4.3. CYCLICAL SITUATION OF THE ECONOMY AND DOMESTIC INFLATIONARY PRESSURES

The latest data confirm the assessments of the Bank of Albania on the gradual improvement of the cyclical position of the economy, suggesting also the narrowing of the negative output gap. Developments in capital and labour markets show that the economy is continuing to utilize spare capacities. In the conditions of using at more optimum levels the production factors, the economy will tend to converge toward the potential, thus bringing to an end the negative output gap in medium-term. This trend is expected to transmit elevated pressures on wages, other production costs and core inflation. As a consequence, the improvement of the cyclical situation in the economy is assessed to support the return of inflation to target within 2018.

The latest data on capital and labour markets suggest for a gradual reduction of spare capacities in the economy, and the continuation of the narrowing trend of the negative output gap. The capacity utilisation rate in economy was around 74.6% in 2017 Q1, about 3.0 percentage points higher than in the previous period. 

* Output gap is the average of a number of measurements on which the moving average method is applied. The capacity utilization rate gap and the unemployment rate is calculated as the deviation of the actual value of the respective historical averages.

Source: INSTAT and Bank of Albania.

![Chart 36 Economy cycle indicators](chart.png)

Starting from 2017 Q1, the capacity utilisation rate indicator will be analysed adjusted for seasonality and weighted (for more information related to the process of weighting of survey data refer to the methodology published on the web of the Bank of Albania: [https://www.bankofalbania.org/web/pub/metodologjia_e_vrojtimeve_te_harmonizuara_te_besimit_shq.pdf](https://www.bankofalbania.org/web/pub/metodologjia_e_vrojtimeve_te_harmonizuara_te_besimit_shq.pdf))
previous quarter, and 4.8 percentage points higher than in the same period a year earlier. This development shifted this indicator above the historical average, by about 0.9 percentage point.

The tendencies shown in the labour market continued to be positive in 2016 Q4. Indicators filtered by quarterly labour forces surveys show that employment in the economy increased by 5.5% in annual terms, at a slower pace than in the previous two quarters. The annual growth of employment by economic activity resulted 4.5% in the agricultural sector, 5.1% in the industrial sector and 7.4% in the services sector. The services sector remains the main contributor to employment’s annual growth. Meanwhile, employment resulted lower by 1.4%, from the level of the previous quarter. The quarterly dynamic of the employees is mainly attributable to the contraction of employment in the agricultural sector.

The unemployment rate decreased by 0.6 percentage point during 2016 Q4, remaining at 14.2%. The quarterly dynamic shifted the unemployment rate about 3.1 percentage points lower than the level of the same period in the previous year, and around 0.5 percentage point lower than the average unemployment rate during the period 2007-2015. As a consequence, the negative unemployment gap is assessed to have continued its trend toward narrowing, signalling inflationary pressures on the growing side originated in wage performance.

The unit labour costs indicator is assessed upward in annual terms (3.3%) in 2016 Q4, slightly lower than in the previous quarter. Labour productivity performance continues to fluctuate in negative territory, but with a more mitigated annual pace. This dynamic is affected by the slightly higher level of volume turnover and the expansion at a slower pace of employment. The real average wage in the activities covered by short-term statistics continued its improving trend. Also, the other costs in the producing process, like the prices of industrial production recorded a slight annual increase (0.9%).

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35 The analysis of employment and unemployment is based on the data of the “Quarterly Labour Force Survey”, and it refers to the indicators for those 15 years and older.

36 Employment with quarterly frequency from the labour force survey has been published since 2012 Q1. The aggregated series does not show seasonality, and as a consequence quarterly changes are calculated on the non-adjusted for seasonality series.

37 Meanwhile, employment by age results to have registered a higher decrease for the group 30-64 years old, which represents 78% of the employees 15 years and older.

38 Assessed as the margin of balance unemployment rate with factual unemployment rate.

39 The proxy indicators of labour productivity and labour costs per unit of output, are calculated by the Bank of Albania, using the total series of short-term statistics (SASH, INSTAT, 2016 Q4). Their calculation includes: the index of the paid employees, the turnover volume and total wage fund for the activities covered by the survey of SASH.
after the negative pace followed since 2013. Production costs in construction continued to increase, but at low annual rates (0.4%).

The gradual improvement of the cyclical position of economy continued to be reflected in the upward trend of long-term and domestic components of inflation. Core inflation and non-tradable inflation of CPI basket were 1.3% and 1.7%, respectively, in the first quarter of 2017, remaining at higher levels from the previous quarter. Short-term components of inflation recorded higher growth rates in January, reflecting the supply-side shocks from the difficult weather conditions. Non-core inflation and tradable inflation of the CPI basket resulted 5.4% and 3.2%, respectively, in 2017 Q1, remaining at a higher level than in the previous quarter.

Gradual upward trends and positive contribution of core and domestic inflation in the formation of headline inflation is expected to continue during 2017, reflecting the narrowing trend of the negative output gap.

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40 Construction cost index for houses includes prices of building materials, labour force and other capital expenditures used for the construction of a typical building of 8-10 floors.
4.4. IMPORTED INFLATION

Imported inflation is assessed to have contributed by 1.2 percentage points to the headline inflation in 2017 Q1. Its increase is in line with the performance of the “foreign prices” index\textsuperscript{41}. This indicator increased by 4.3% in annual average terms during the period January-February 2017. Positive contributions have come from almost all the partners involved\textsuperscript{42}. On the other hand, the effective nominal exchange rate appreciation, by 3.3% in average in the same period, has continued to curb the transmission of these effects in the overall index. As a consequence, the Inflationary Imported Pressures Index (IIPI)\textsuperscript{43} expanded on average by 0.8% during the first two months of 2017.

In the same quarter, domestic inflation contributed by around 1.2 percentage points, increasing its determining role in the formation of headline inflation.

\textsuperscript{41} It is a proxy of imported inflation pressures, comparable to tradable goods sector inflation of Albania’s CPI basket. Foreign price index is based on the values of: the inflation of “Food, drinks and tobacco” for 18 main countries; and inflation of “items” (i.e., not only foods) for Bulgaria, Germany, Greece, Italy and Turkey. Some of the goods marked annual price growth, while imports share of the respective states increased. This caused the index final value (the weighted average of aforementioned CPI with their imports monthly shares) to significantly increase.

\textsuperscript{42} Neighbour countries, EU partners and those more distant geographically.

\textsuperscript{43} IIPI is calculated as the annual growth of foreign price index and the NEER index for the respective month. Inflationary pressures of foreign origin are assessed to affect the domestic inflation with a 5 month time lag.
4.5. INFLATION EXPECTATIONS

Enterprises and consumers’ expectations on inflation did not change during 2017 Q1 (around 1.5%). On the other hand, the financial agents have revised them upward, for the third consecutive quarter for all the horizons. One year-ahead inflation stood at 2.5% (around 0.4 percentage point higher from the previous quarter). Expected inflation after two and three years is 2.6% and 2.7%, respectively, up by 0.3 and 0.2 percentage point, respectively, compared with the expectations in 2016 Q4.

In addition to the presence of an adaptive behaviour with the published inflation values, it results that the expectations, particularly medium and long-term ones, have approached closer to the Bank of Albania’s inflation target.

The analysis on inflationary expectations is based on the results of the business and consumer confidence surveys, as well as on the financial agents’ expectations survey.