Bank of Albania

MONETARY POLICY REPORT

MAY 2015

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OBJECTIVE

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

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 that are expected to affect the performance of consumer prices in Albania.

The Monetary Policy Report for the first quarter of 2015 was adopted by the Supervisory Council Decision No 28, dated 6.5.2015. The economic analysis in this Report is based on the latest available data as of 27 April 2015.

1. FOREWORD BY THE GOVERNOR

Recent economic and financial developments resulted overall in line with our expectations. Economic growth accelerated during 2014 and provisional data suggest that the trend will persist in 2015. In line with our baseline scenario, the improvement of domestic demand is reflected in the progressive growth of economic activity and a gradual, yet fragile, consolidation of long-term inflationary pressures.

Due to supply-side shocks in the first quarter, inflation rates resulted higher than we expected. These shocks gave rise to the need to revise slightly downward the expected economic growth for 2015. Their effect, however, is expected to be transitory. Such developments have not affected our assessments for the medium-term performance of economic activity and inflation. Economic growth is expected to improve gradually during this time horizon driven, at its initial stage, by the growth of domestic demand. The Albanian economy is projected to approach its potential during 2016, which would create adequate premises for the return of inflation to target over the medium-term policy-relevant horizon. The expected trajectories will require maintaining the accommodative stance of the monetary policy in the period ahead.

* * *

Annual inflation averaged 1.9% in the first quarter of 2015, standing higher than the previous quarter and our projections. Core inflation, which measures longer-term trends of price performance, continued to trend up in this quarter. However, the rapid increase in inflation in the first quarter was mostly due to the rise in food prices, which rose beyond their seasonal behaviour. In the Bank of Albania's assessment, this development reflected the reduction in the supply of fresh food items as a result of floods in January and February 2015. As such, it is expected to have a temporary effect on consumer prices. On the other hand, the fall in global oil prices gave negative contribution to this quarter's inflation, although it was offset in part by the appreciation of the US dollar against the Albanian lek. Prices of other CPI items were steady and had little impact on headline inflation.

Long-term inflationary pressures from the demand side are picking up; however, they remain subdued. While economic activity continues to improve, spare production capacities in the Albanian economy remain. The incomplete utilisation of the labour market and firms' production capacity keeps the economic activity below its potential and inflation below Bank of Albania's target.

According to INSTAT data, the annual growth of value added was 1.9% in 2014, against 1.4% in the previous year. By sector, economic growth was driven by the growth of production in services and agriculture and, to a lesser extent, industry. From the expenditure side, economic growth reflected largely the recovery of domestic private demand and a positive contribution by public spending in the last quarter. By contrast, foreign demand has been sluggish and economic activity with abroad did not give any positive impulse to economic growth.

Based on available information, the Bank of Albania estimates that the positive growth rates continued in the first quarter of 2015. Economic growth for this period is assessed to have slowed down temporarily, because of damages caused by floods on the agricultural sector and reduction of oil production, in response to the sluggish conjunctures in global markets.

Yet, economic growth for 2015 is projected to be higher than in the previous year. Economic growth is expected to be driven by the strengthening of private consumption and investments, as well as the stimulating monetary conditions and increased risk appetite in financial markets. In addition, the budget and fiscal plans for 2015 envisage a lower intensity of fiscal consolidation, which is being already noticed in the budget indicators for the first quarter of the year. Lastly, the Albanian economy is expected to capitalise on the more positive outlook in main trading partners. Although the latter is estimated to be insufficient to make a direct positive contribution to economic growth in 2015, the more favourable economic and financial climate in trading partners helps foster the confidence of economic agents at home, improves foreign financing terms and tends to boost foreign direct investments. This situation is expected to continue in the years ahead, but with an increasingly greater contribution of Albanian exports to economic growth. The expected improvements in economic activity will contribute to gradually reducing the negative output gap, until its closing in the next year.

The latest available information and our new economic projections do not change the expected medium-term trajectory of inflation. In line with the improvement of the economy, inflation is expected to rise gradually during 2015 and beyond. Four quarters ahead, inflation is expected to average around 2.2%, and return to target in the medium term. It is expected to be driven also by the increase in inflation in the euro area and the rise of inflation expectations at home.

The balance of risks to the inflation projections remains on the down side. In particular, the slower recovery of the economy, the stronger drop in global prices, and the further decline in inflation expectations may lead to lower inflation rates.

The actual and expected performance of the Albanian economy requires the pursuit of an accommodative monetary policy. In line with our forward

guidance for keeping the interest rates low, the Bank of Albania lowered the key interest rate by 0.25 percentage points in January, down to 2.0%. The accommodative monetary policy has aimed and succeeded to lower the cost of financing the economy, as well as to support the growth of demand and return of inflation to target. Its transmission to lower interest rates has resulted adequate, but its reflection in credit growth is slower.

Credit expansion is low, although the banking system is well capitalised and liquidity and profitability indicators stand at adequate levels. The sluggish credit performance reflects the weak credit demand and the banks' conservative approach. The model of budget deficit financing during this year is expected to ease the terms of lending to the private sector. The shift of public borrowing from the domestic to the foreign market will create premises for further lowering of interest rates and ampler credit supply for the economy. Also, the expected addressing of non-performing loans through a comprehensive national platform would relieve banks' balance sheets and improve their approach to lending. These developments are expected to materialise in better lending terms during the current year and a better transmission of the insofar monetary stimuli to economic growth. In the future, the improvement of confidence and of the financial situation in the private sector is expected to be reflected in the strengthening of credit demand.

* * *

To conclude, the Bank of Albania finds that the performance of the economy is overall in line with expectations. Economic growth is expected to gradually improve in the years ahead, which would create adequate premises for the return of inflation to target over the policy-relevant horizon.

The strengthening of aggregate demand will be the main driver of economic growth in the short and medium-term period. In the long term, the Bank of Albania emphasises the need for deeper structural reforms, as a pivotal instrument for generating sustainable economic growth. Structural reforms should aim at increasing the productivity of the Albanian economy and expanding the markets for our products. This will be realised, among others, through establishing a modern development infrastructure, creating a favourable business climate, and continuous investment on human resources capacity building.

Based on conclusions of the analysis presented in this report, the Bank of Albania deems that the current monetary conditions are consistent with the achievement of the price stability objective. Consistent with our baseline scenario and economic projections, as well as with a view to attending to the negative balance of risks, the Bank of Albania judges that the monetary policy will remain accommodative for some quarters ahead.

2. PRICE STABILITY AND BANK OF ALBANIA'S TARGET

The annual inflation rate trended up during the first quarter of 2015, averaging 1.9%. The rise in inflation was faster than estimated, driven mainly by supply-side factors related to food prices. However, the upward trend of inflation reflected also the intensification of long-term inflationary pressures, as shown by the upward trend of core inflation. Medium-term inflation projections suggest it will gradually, but progressive, increase in the quarters ahead.

Low inflationary pressures required strengthening the accommodative policy stance. In January 2015, the Bank of Albania lowered the key interest rate to 2.0% and continued to supply the banking market with all the required liquidity. Maintaining eased monetary conditions would contribute to the recovery of demand and to inflation approaching the medium-term target.

2.1. INFLATION HIGHLIGHTS

Inflation rates and target
Annual inflation averaged 1.9% in 2015 Q1, standing higher than in the previous quarter, but still below the target. The performance of inflation was determined mainly by the price increase in some unprocessed food items. In the same-stated quarter, the oil prices continued to be evidently lower than in the previous year.

Economic activity recorded positive growth rates in 2014 H2, driven mainly by the increase in private spending and public investments. The implementation of an accommodative monetary policy and the fiscal stimulus in 2014 Q4 drove domestic demand up. The improved economic growth has narrowed the negative output gap, but did not close it. Consequently, inflationary pressures generated by the aggregate demand remain weak and below their historic intensity.

Chart 1. Annual rate and inflation target (in%)*
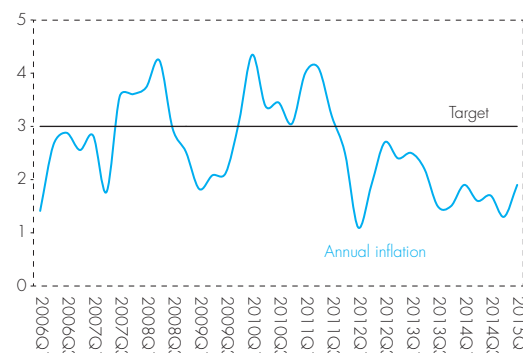
*Until 2014, Bank of Albania's target was set at 3.0%, with a +/-1.0% tolerance band. Following the revision of the Monetary Policy Document in 2015, the tolerance band was removed, keeping a punctual target, at 3.0%. For more details, see the "Monetary Policy Documents" www.bankofalbania.org.
Source: INSTAT and Bank of Albania.

Chart 2. Output gap and contribution of core inflation*

■ Core inflation contribution (pp)
■ Output gap_MA(4) (% of potential)
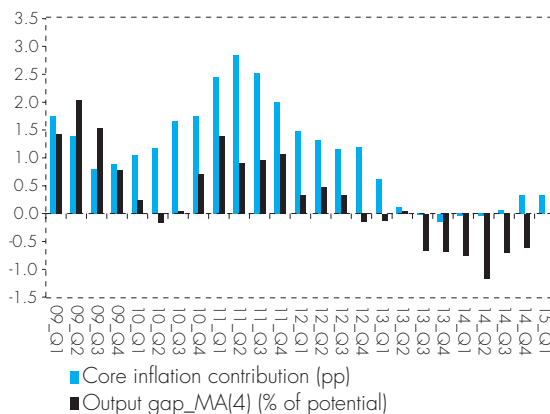
*The assessed series of the output gap are flattened applying the four-terms moving average [MA(4)].
Source: Bank of Albania calculations, INSTAT.

In addition to the contribution from demand-side factors, which resulted with slightly added intensity in this quarter, supply-side factors played an important role in inflation fluctuations. Adverse weather conditions contributed to the temporary decrease of the unprocessed food items supply in the domestic market and to the increase of transportation costs. Due to the action of these factors the respective prices rose higher and faster than expected, diverging from the seasonal behaviour. The effect of these factors is expected to extend throughout the current year, to be cancelled out at the beginning of the next year. However projections for constant improvement of economic activity suggest that demand-side pressures on inflation will be upward. In line with the intensity of the expected improvement of economic activity, inflation is expected to return to target in the medium term.

Inflation and monetary policy transmission

The overall economic setting, characterised by low inflationary pressures and below-potential economic growth, has dictated the implementation of an accommodative monetary policy. The Bank of Albania lowered the key interest rate by 0.25 percentage point, to 2.0% in January. As part of the monetary policy instruments, it continued to verbally signal the public on the continuation of the accommodative monetary policy in the quarters ahead. At the same time, monetary operations consisted in liquidity injection for up to one-month term for the banking system. Demand for liquidity has been normal and was reflected in low levels and moderate volatility of overnight rates in the interbank market. By contrast, yields on government securities continued to increase in the first quarter. This move is deemed as temporary, given that the increase in yields was caused mainly by the increase in financing the budget deficit. Interest rates on lek credit increased slightly in January-February, reflecting the seasonal behaviour of credit and economic activity. The accommodative monetary policy and the expected decrease in public sector borrowing in domestic financial markets will be accompanied by further lowering of credit interest rates during 2015.

Chart 3. Response of interest rate across various segments to key interest rate cut (right)

Repo -3.25pp

Key rate
Average deposit interest rate
yield 12m
Average credit interest rate (MA 6m)
yield 24m
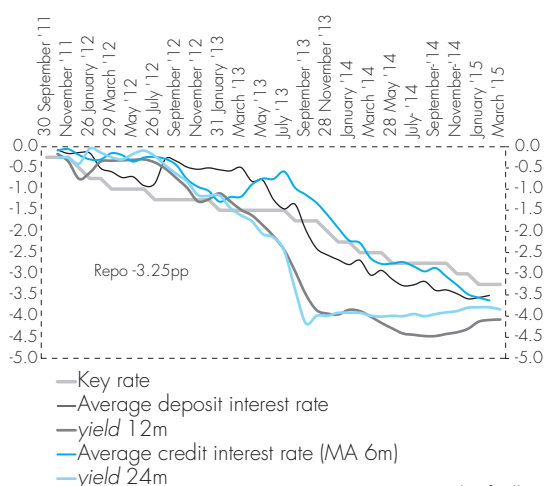
Source: Bank of Albania.

Overall, the trend of interest rates in financial market segments has been downward, responding to the accommodative monetary policy implemented by the Bank of Albania since 2011. Interest rates on lek lending to the private sector have been significantly down, especially during 2014. The spread between interest rates on lek and euro loans narrowed significantly. These trends have been more evident in the business segment, which received the highest share of the lek credit. However, the expansion of credit activity continues to be hindered by businesses reluctance to engage in long-term investments and banking system's low risk appetite.

The accommodative monetary policy stance of the Bank of Albania will continue to stimulate the economic activity by easing financing costs, contributing at the same time to anchoring for inflation expectations and its return to the 3.0% target in the medium term.

2.2 INFLATION BY CATEGORY

Food items were the main contributors to the level and profile of inflation during 2015 Q1. The category of 'unprocessed foods' formed almost 90% of annual inflation, increasing its contribution by 1 percentage point compared to the previous quarter. The additional 0.9 percentage point from the 'vegetables' sub-group made the main contribution to this increase. Most of the additional contribution from this category is attributable to its higher inflation during the first two months of the year. Especially in February, when floods reached the peak of their intensity, monthly inflation was verified at 10.2% in the group of unprocessed foods.[1] The category of 'processed foods' contributed 0.3 percentage point to the formation of annual headline inflation. The effect of the new excise taxes contributed to the increase of respective prices, but less than in the previous year.

The other categories resulted mainly in negative annual inflation, reducing the headline inflation by 0.1 percentage point. Thus, the category of 'non-food consumer goods' continued to contribute to the reduction side (-0.4 percentage point), due to the annual fall in fuel prices.[2]

The category of goods at 'administered prices' contributed only 0.1 percentage point to inflation formation, in the first quarter. In March, the effect of the application of the new scheme of electrical energy billing was also reflected in the calculation of the CPI. This scheme is estimated to have contributed to reducing headline inflation by around 0.1 percentage point in March. This reduction is expected to be carried forward in the value of headline inflation throughout the current year, until the cancelling out of this effect.

Chart 4. Contribution by food and non-food categories to annual headline inflation

■ Contribution of "Food"
■ Contribution of "Non-food" — Total
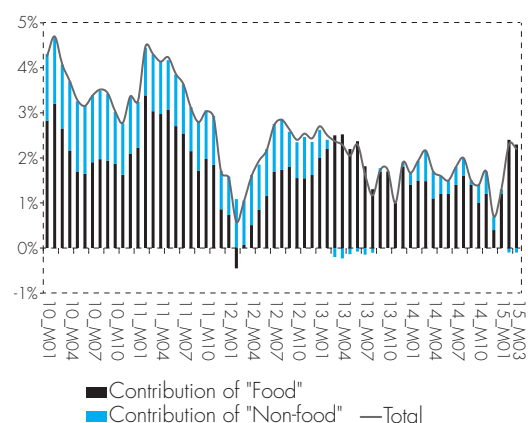
Source: INSTAT and Bank of Albania calculations.

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[1]   Around 5 percentage points higher than the average in the last five years.
[2]   The annual increase in fuel prices, decelerated in Q1. That was because, in monthly terms, during February-March 2015, inflation shifted from negative to positive rates.

Table 1 Contribution of key items to annual inflation

	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1
Processed foods (pp)	0.5	0.3	0.1	-0.1	-0.1	-0.2	-0.1	0.2	0.3
Bread and grains (pp)*	0.1	0.1	0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0
Alcohol and tobacco (pp)	0.1	0.2	0.1	0.1	0.3	0.3	0.3	0.3	0.3
Unprocessed foods (pp)	1.7	2.0	1.5	1.5	1.6	1.3	1.5	0.8	1.7
Fruit (pp)	0.3	0.4	0.8	0.5	0.7	0.7	0.2	0.4	0.5
Vegetables (pp)	1.2	1.5	0.5	1.1	0.9	0.6	1.2	0.2	1.1
Services (pp)	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1
Regulated prices (pp)	0.1	0.1	0.1	0.0	0.0	0.0	-0.1	0.1	0.1
Fuels and energy (pp)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Housing (pp)	-0.1	-0.1	0.0	0.3	0.3	0.2	0.1	0.1	0.1
Non-food consumer goods	0.0	-0.3	-0.4	-0.2	0.2	0.2	0.2	0.0	-0.4
Durable consumer goods (pp)	0.1	0.1	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0
Consumer Price Index (y-o-y, %)	2.5	2.2	1.5	1.5	1.9	1.6	1.7	1.3	1.9

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

Chart 5. Annual inflation by items of goods and services (in %)

Source: INSTAT and Bank of Albania.

BOX 1 TRANSFORMATIONS IN INFLATION'S SEASONAL PATTERN: IMPLICATIONS FOR ANALYSIS AND FORECASTING.[3]

The presence of seasonality in inflation's time series is a common phenomenon in advanced and emerging economies. Regular intra-annual variability of prices for some goods and services, in certain periods or months and for some consecutive years, create the seasonal inflation's profile. Some of the factors driving the seasonal behaviour are: seasonality in agricultural production; seasonality in demand and consumer behaviour, etc. (Kaminski et. al., 2014). Knowing the trend of seasonal price behaviour is important for the monetary policy, both for appropriate interpretation of new information and enhancing the forecasting accuracy.

Monthly performance of consumer prices in Albania evidently shows the seasonal

[3]   By Evelina Çeliku, Monetary Policy Department.

pattern. At the 'micro' level of the CPI basket, seasonal factors have resulted statistically significant especially for the 'unprocessed food items' inflation series. However, inflation developments in Albania, in the region, and beyond have indicated that their intensity may change over time (Sahn, 1989; Reardon, 1997; Dorward et. al. 2004). The performance of headline inflation and 'foods' group in various economies has strengthened the conviction of economists that the seasonality has changed over the past five years.[4] Transformations in seasonality are caused by factors such as: "surprise" weather events; marketing policies; differences in transaction and transport costs; changes in market structure and their integration; financial limitations; degree of investments and intensification methods in agriculture; customs agreements.[5] The latter have affected the activity of imports and exports of fresh agricultural products and, consequently, their prices. Due to the combination of the effects of some of the above-listed factors, in the case of Albania, the seasonal pattern has changed.

The following assessments indicate that the intensity of seasonal factors according to certain periods has been modified: seasonality has shifted in time; in particular months, the direction of their effects has changed.

Table 2 Evaluation results for seasonal factors during M2:2003-M3:2015

Months	Seasonal factors under two sub-periods and for the whole period			
	M2:2003-M2:2008 Sub-period I	M3:2008 -M3:2015 Sub-period II	M2:03 -M3:2015 Total period	Significant changes for the seasonal factor
1	0.14	4.43	2.86	Factor strengthening (+) ***
2	2.77	8.18	6.02	Factor strengthening (+) ***
3	-0.46	0.63	0.53	Non-seasonality
4	-1.24	-3.73	-2.70	Factor strengthening (-) (**)
5	-9.37	-8.40	-8.82	High seasonality and no change in direction
6	-8.77	-6.66	-7.70	High seasonality and no change in direction
7	-6.14	-5.72	-5.91	High seasonality and no change in direction
8	-1.58	0.72	-0.05	Non-seasonality
9	1.06	2.17	1.88	Slight seasonality and no change in direction
10	-0.19	-0.18	-0.38	Non-seasonality
11	3.73	-1.66	0.43	Change of direction ***
12	20.05	10.23	13.83	Weakening of the factor (+) ***

Source: INSTAT and author's estimates; (***) and (**) statistical significance for 5% and 10% critical level of probability, respectively.

The strongest deviations from the average seasonality are noted in the months of January and February, when the seasonal factor increased the intensity over the years; the months of December in recent years, with a minimum seasonality in 2014; and the months of November, when, during last years, the historical direction of the seasonal factor has changed from positive to negative. The seasonality for December and November has diminished significantly over time.

This behaviour identifies some similarities of the seasonal inflation pattern between Albania and a selected panel of countries, mainly in the months of November and December. At the same time, the average monthly inflation for the seasonal food items in Albania has been several times higher than in the respective countries.

[4] http://www.imf.org/external/np/seminars/eng/2014/food/
[5] http://www.imf.org/external/np/seminars/eng/2014/food/pdf/Kaminski.pdf

Chart 6. Monthly inflation of seasonal food items and average of the season for M2:2003-M3:2015

— Seasonal average

Source: INSTAT and author's calculations; Eurostat: (HICP, 2005 = 100%) - monthly data (index) [prc_hicp_midx].
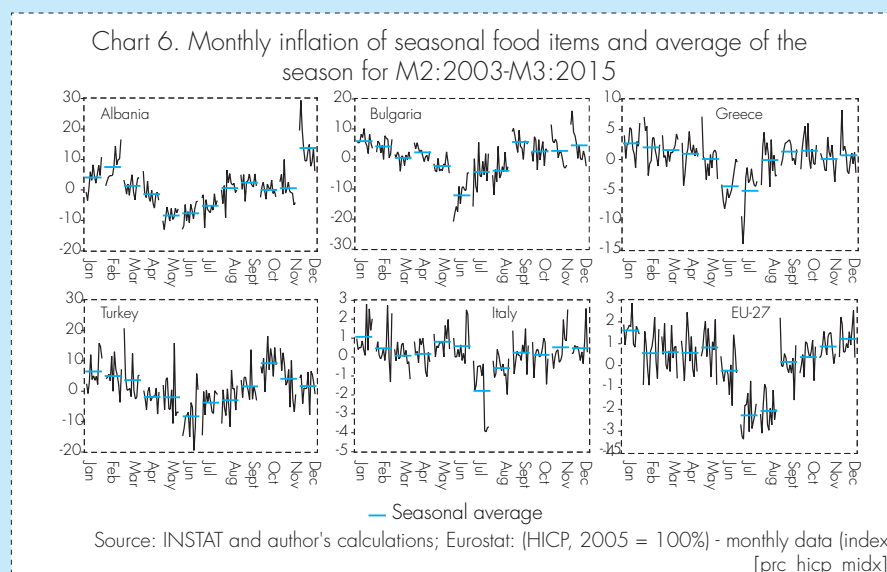
Another reason that emphasises the change of the seasonal pattern in the Albanian case consists of the significant share of these products in the current CPI basket[6]. Because of this, the corresponding contribution to headline inflation might result considerable, even for not-so-significant changes of the seasonality factors.

Table 3 Average weights in the CPI/HICP** baskets, for two food categories, with highly seasonal prices

Fresh seasonal foods	Average 2003-2007	Average 2008-2015	Unprocessed foods	Average 2003-2007	Average 2008-2015
EU-27	3.6	3.7	EU-27	7.3	7.3
Bulgaria	6.3	4.3	Bulgaria	12.1	8.9
Greece	5.0	4.8	Greece	8.9	8.8
Croatia	6.1	5.4	Croatia	13.7	11.7
Italy	4.3	4.4	Italy	8.1	8.4
Romania	7.3	7.0	Romania	16.5	16.1
Turkey	7.9	7.3	Turkey	12.3	11.6
Albania	11.3	10.4	Albania	21.9	19.3

Source: INSTAT and author's calculations; Eurostat: [HICP - Item weights [prc_hicp_inw] – Item weights in the *Harmonised Index of Consumer Prices (HICP).

The average weight of foods with high seasonality in prices is around 2.6-2.8 times higher in Albania than in EU countries. A relatively considerable weight, combined with unpredicted events in the seasonality of prices, increases decision-makers uncertainties in interpreting expected inflation volatility within the year. This uncertainty would be mitigated with a more accurate understanding and assessment of seasonality.

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[6] *The CPI basket, December 2007.*

3. MACROECONOMIC DEVELOPMENTS

The Albanian economy is recovering gradually, in line with our expectations and projections. Economic growth in 2014 Q4 resulted in 2.4%, bringing the annual growth to 1.9%. The accommodative monetary policy, the reduced consolidating nature of fiscal policy in 2014 H2 and the improved confidence in the economy drove aggregate demand up. In our assessment, economic growth for 2015 will accelerate, maintaining, in general, the trends noted in 2014.

In spite of the economic recovery, inflationary pressures remain weak and the inflation rate stands below the target of the Bank of Albania. Annual inflation averaged 1.9% in 2015 Q1. The return of inflation to target continues to be impaired by both demand and supply-side factors. First, in the long term, aggregate demand is not managing to completely absorb production capacities in the economy, keeping production costs and profit margins low. Second, in the short term, the fall in commodity prices and inflation rates in trading partners contributed directly to the fall in imported prices and indirectly to it, through lower costs for imported inputs. Third, economic agents' expectations for low inflation rates have reinforced the weak inflationary pressures.

Overall, the action of these factors is expected to remain present in the quarters ahead. Economic growth is expected to pick up and production capacities in the economy to be more fully utilised. Against this backdrop, inflation is expected to rise gradually, converging to the objective in the medium term. The Bank of Albania deems that risks surrounding this projection remain on the down side. They relate mostly to the uncertainty about the outlook in the euro area, and domestic cyclical and structural factors that hinder the sustainable growth of private demand.

Maintaining macroeconomic policies on the stimulating side is necessary for the return of the economy to equilibrium and of inflation to target.

3.1 EXTERNAL ECONOMIC ENVIRONMENT

3.1.1 ECONOMIC GROWTH AND MAIN MACROECONOMIC BALANCES

The global economy[7] has shown positive performance in the first three months of the year, continuing its gradual recovery. The dynamics of provisional

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[7] The paragraph refers mainly to the latest economic bulletin of the ECB, March 2015 and the PMI analysis of the GDP by Markit, 7 April 2015 (JPMorgan Global All-Industry Output Index, OECD CLI).

and indirect indicators in 2015 Q1 suggest that the global economy will grow faster. It will be driven mainly by the expected growth in advanced economies. The fall in oil and energy prices is expected to contribute to the further growth in advanced economies. The rise in unemployment rates in these countries decelerated, in addition to improvement in the business and consumer confidence. Inflationary pressures have fallen significantly, as a result of the downward commodity prices, mainly energy prices. Projections point to an upward trend of the GDP in 2015. These projections are, however, surrounded by risks, whose balance weighs more on the down side. Developments that support this assessment relate to geopolitical tensions in Eastern Europe (Russia, Ukraine) and the different speed of growth between countries and regions.

Table 4 Selected macroeconomic indicators

Countries	GDP change		Unemployment rate	Inflation rate	
	Q4-14/ Q3-14	Q4-14/ Q4-13	February-15	March-15 February-15	March-15 March-14
USA	1.0	2.4	5.51	0.2	-0.1
Euro area	0.3	0.9	11.3	1.1	-0.1
Germany	0.7	1.5	4.8	0.5	0.1
France	0.1	0.2	10.6	0.7	0.0
United Kingdom	0.5	2.7	5.6	0.2	0.0

Source: ECB, Fed, Eurostat and respective statistical institutes.
1 March 2015.

Euro area economy

In 2014 Q4, economic growth in the euro area was 0.3% and 0.9% in quarterly and annual terms, respectively.[8] Compared to 2014 Q3, the euro area economy is stronger. Broken down by item, the analysis shows that domestic consumption will continue to grow and will make positive contribution to GDP formation. The categories of investments and exports have made less or neutral contribution to growth. By country, growth was more prominent in Germany, Spain and Portugal, modest in France and contracted in Italy. Latest leading indicators show that the performance of GDP for the euro area in the first quarter appears more recovered, reflecting the effect of the quantitative easing by the ECB in this year.[9] Preliminary and indirect assessments on sales, new orders and industrial production suggest stronger economic growth in 2015 Q1 and overall strengthening of economic activity throughout 2015. Business and consumer confidence indicators performed in the same direction, showing more optimism. Inflation rates remained low and in small negative values during the last months. Latest projections[10] for the euro area place inflation at 0% for 2015 and rising for 2016.

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[8]   *Second estimate for the fourth quarter of 2014, (Eurostat, 6 mars 2015).*
[9]   *The decision was made by the Governing Council of the ECB in January 2015 and the implementation started in March 2015.*
[10] *ECB staff macroeconomic projections for the euro area March 2015,5 Mars 2015.*

United States economy

The US economy continued to grow in 2014 Q4, following its positive trend throughout the year. Economic activity was driven by the increase in consumer spending, exports, residential investments and local government spending. The fall in central government spending and increase in imports contributed to the opposite direction. Unemployment continued to decrease, and annual inflation in March resulted 0%, after two months with negative values. Provisional data from 2015 Q1 suggest that consumer spending will increase, driven by higher disposable income as a result of the fall in oil prices. Exports are expected to fall, in response to the appreciation of the US dollar against other currencies.

Regional economies

Italy's economy remained in recession even in 2014 Q4. The economic activity contracted determined by the negative dynamics of industrial and agricultural production; services, on the other hand, increased slightly. On the spending side, the negative performance of investments and consumer spending continued, whereas net exports made positive contribution. Data from 2015 Q1 are unclear. The increased trade activity is accompanied by the increase in the confidence indices, as well as by the increase in unemployment and decrease in industrial production.

The growth of the Greek economy slowed down in 2014 Q4. The fall in investments, capital expenditure and domestic consumption owes mostly to the effect of the low comparative base. Government spending was lower than in the same quarter in the previous year. The economy is expected to have performed in similar terms in 2015 Q1, amid an unclear political climate and ongoing negotiations between the government and its creditors.

Turkey accelerated the economic activity pace in 2014 Q4, as a result of the improvement in the domestic demand. Consumer spending and increase in inventories were the main drivers to economic growth, whereas exports contributed negatively. Private and public investments resulted in decelerated growth pace, thus slowing down the country's economic performance. In 2015 Q1, data on retail trade, net exports and capacity utilisation signal a more decelerated economic activity than in 2014 Q4.

The annual economic growth in Kosovo in the first three quarters of 2014 is assessed[11] at around 0.1%. In response to the contraction of domestic consumption, net exports and government spending increased. Latest data on foreign trade point to the expansion of the trade deficit in the first two months of 2015. The number of unemployed persons increased in 2014 Q4. Inflation rates have been trending downward since October 2014, moving to negative territory in the last three months. In March, inflation posted -0.4%, being lower than in February. The pace of growth in loans and deposits in the first two months of 2015 did not change, whilst average interest rates on deposits

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[11] *These are provisional data based on the periodic report of the European Commission 'EU Candidate and Potential Candidate Countries' Economic Quarterly (CCEQ), April 2015.*

fell. The average interest rate on loans did not change, leading thus to the expansion of the spread between the two parameters.

The pace of economic activity growth in FYROM slowed down in 2014 Q4, after three quarters of rapid growth. This performance reflected the deceleration in investments. The positive effect from the increase in exports was offset, in part, by the acceleration of imports. Economic activity was sustained by industrial production and construction. Data for the first months of 2015 suggest that the growth of economic activity will decelerate in the first quarter.

Table 5 Economic indicators for countries in the region

Countries	GDP change Q4:14/Q4:13	Annual inflation March-14	Unemployment rate February-14
Italy	-0.5	0.0	12.7
Greece	1.3	-1.9	26.11
FYROM	2.7	-0.3	27.61
Serbia	-1.8	1.9	16.81
Croatia	0.4	0.0	18.5
Turkey	2.6	7.6	11.33
Kosovo	1.42	-0.4	30.04
Albania	2.4	2.2	18.01

1- Value for 2014 Q4; 2- Value for 2014 T3; 3- Value for January 2015; 4- Value for 2013.

3.1.2 RAW MATERIAL AND COMMODITY PRICES

Commodity prices fell considerably in annual terms during 2015 Q1. According to the European Brent index, the oil price fell almost by a half, year on year. A barrel was traded on average for USD 54/barrel, or 30% cheaper than in the past quarter. This performance is attributable mainly to the slow growth of demand, against the constant growth of production. During this quarter, the fall in oil prices and appreciation of the US dollar in international markets has added downward pressures on goods traded in the US dollar.

Commodity prices fell by 35.4% in annual terms and 19.1% in quarterly terms. The index of food prices followed along the same lines contracting at the end of the period by 23.0% in annual terms. The high growth pace of the supply and the weak demand were key factors determining these developments.

Oil prices are expected to fluctuate around USD 55 and 63.5/barrel in 2015 H1 and 2015 H2, respectively[12], and increasing during 2016 (USD 75/barrel). In the meantime, the trajectory of average

Chart 7. Annual change in comodity prices (in %)

—Oil prices   —Food prices

Source: IMF, EIA.

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[12] *According to U.S Energy Information Agency (EIA). Data referring to the EIA monthly report, April 2015.*

commodity prices is expected to trend down until Q3, to record a seasonal increase at the end of it.[13]

3.1.3 MONETARY POLICY AND INTEREST RATES

The major central banks kept the key interest rates unchanged, as follows: ECB at 0.05%, Federal Reserve at 0.15%, Bank of England at 0.5%, and Bank of Japan at 0-0.1%.

Euribor rates in euro area money markets fell further in this quarter, whereas Libor rates remained unchanged. ECB's quantitative easing was the main factor contributing to this behaviour. The EONIA rate in the euro interbank market has been fluctuating in negative territory since December 2014.

In euro area capital markets, bond yields reflected the effects of the quantitative easing programme by the ECB, registering a further drop. This trend is also reflected in the yields of corporate securities, contributing to the downward cost of their financing. However, the bond yield of countries with fiscal consolidation duties (Italy, Portugal, and Spain) are affected by uncertainties related to the solution of the situation in Greece. These yields appeared volatile; however, their fall decelerated in March. In the foreign exchange markets, the euro depreciated, in quarterly terms, against the U.S. dollar (9.9%) and

Chart 8. Key interest rates of major central banks
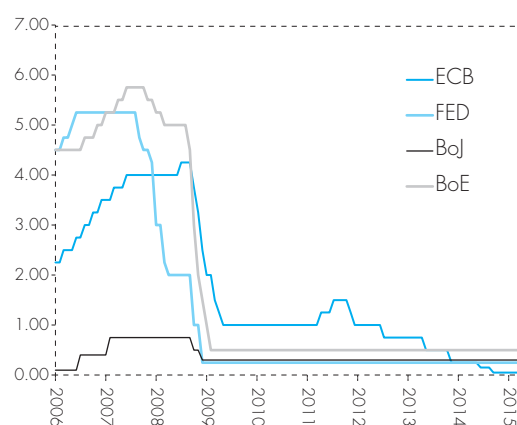
Source: Central banks (ECB, Fed, BoJ and BoE).

Chart 9. Selected financial indicators in international markets
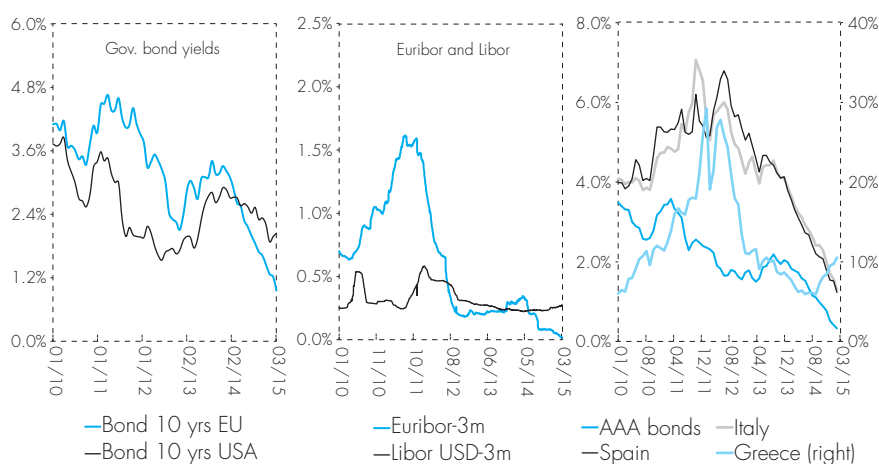
Source: Bloomberg, Reuters.

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[13] *According to IMF estimates (April 2015)*

Chinese renminbi (8.6%), British pound (5.8%), and Japanese yen (6.0%). In bilateral average terms, in March, one euro was traded at USD 1,084, depreciating 4.5% from a month earlier, and 21.6% from the previous year.

3.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The Albanian economy grew 2.4% in 2014 Q4, driven mainly by public investments and was reflected in the expansion of services and construction sectors. On the other hand, private demand slowed down and foreign demand reduced the growth of the economy in this quarter.

Overall, new economic information has revised down our assessments for economic growth in 2015. The damages caused to the agricultural sector by floods in the south of the country and problems related to the oil sector are expected to be reflected in lower growth of the Albanian economy in 2015 Q1. However, the effect of these shocks is expected to be temporary and offset in the future by the improvement in private demand, financing conditions and trading partner economies. Economic growth for 2015 is estimated to be higher than in the previous year, although the balance of risks remains on the down side.

In line with our previous assessments, economic growth and economic activity for 2014 improved, registering 1.9% annual growth. Economic activity expanded unevenly throughout the quarters, driven by temporary factors and statistical effects of the comparative base.[14] After contracting 0.2% in Q2, the value added in the economy picked up 3.9% and 2.4%[15], in Q3 and Q4, respectively. In spite of the volatility, the economic stood on a clearly upward trend in the second half of the year.[16]

Stimulating monetary conditions, enhanced confidence of economic agents and improved private sector liquidity have boosted domestic demand. On the other hand, foreign demand has been weak. The last quarter of 2014 was characterised by lower private consumption and higher contribution by the public sector to economic growth. The payment of past-due electricity bills and the fall in consumer confidence dictated consumer behaviour in this period. On the other hand, high investments in infrastructure added the contribution of the public sector and construction to economic growth, at year end.

In balance, the available information for 2015 Q1 showed that the positive growth rate continued, but at a slower pace from 2014 Q4.[17] Damages on agriculture and livestock from the floods and the weakness in the oil sector

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[14] These factors have been analysed in previous Quarterly Monetary Policy Reports.
[15] Publication of national accounts for 2013 drove to revisions of the quarterly series of the value added to the economy.
[16] Quarterly growth rates have been progressively up by around 0.8 and 1.1% in this period.
[17] Economic analysis and the assessments of aggregate demand for Q1 are based on the updated fiscal indicators, the external trade, credit and deposits until November and confidence indicators for 2015 Q1.

Chart 10. GDP and annual dynamics of aggregate demand components

—GVA (%, annual)
—GVA (MA, Q4)

—Private domestic demand (%)
—Net exports (%)
—Public sector demand (%)
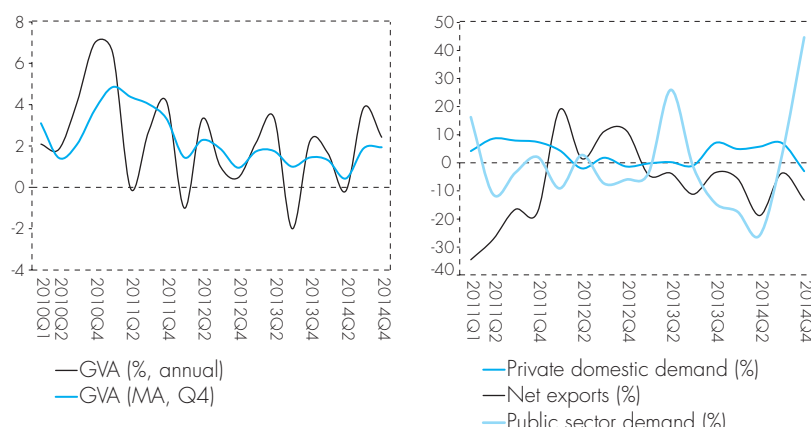
Source: INSTAT and Bank of Albania.

are estimated to slow the growth rates down. On the other hand, private sector expenditures are expected to benefit from low interest and inflation rates, increase in employment and continuation of payment of Government arrears. The fiscal policy is expected to pursue the planned consolidation trajectory, with limited space for expanding public sector's contribution to economic growth. On the other hand, such policy helps reduce risk premiums and expand space for financing the private sector.

Economic agents confidence stands at pre-crisis levels, pointing to a positive moment in the economy. Together with the improvement of confidence and risk appetite in the economy, stimulating monetary conditions will help strengthen private consumption and investments. Foreign demand is envisaged to increase its contribution in line with the recovery of trading partner economies. The economy is expected to grow progressively in the years ahead, but the balance of risks to this projection remains on the down side. Economic growth will continue to be conditioned by the spare capacities in the capital and labour markets, recovery of risk appetite in financial markets and need to adjust balance sheets in certain sectors of the economy.

3.2.1 SECTORAL OUTPUT[18]

Although to a lesser extent, the increase in value added in the economy during 2014 Q4 continued to be driven mainly by the services sector. The services

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[18] *INSTAT published the data on the real gross value added by economic activity for 2014 Q4 on 3 April 2015. As INSTAT does not make quarterly assessments of taxes and subsidies on products in real terms, the performance of production by sector throughout the quarters is analysed only for the gross value added, and not in terms of the gross domestic product. The published data are revised to a larger extent for 2014. Thus, in April's publication, the annual growth of value added in the first three months was 1.6%, -0.2% and 3.9%, respectively. In the meantime, in the previous publication they were 1.4%, -0.4% and 3.3%, respectively. We must note that data revision is a periodic process related to enriching and updating information.*

sector contributed 1.3 percentage points to total economic growth in this period.[19] Manufacturing sector decelerated and lessened its contribution to economic growth - from 1.9 to 1.1 percentage points - in 2014 Q4. This reflected the contraction of agricultural production and slowdown of industrial activity. Meanwhile, construction was the branch of the economy contributing most to the annual growth of value added.

Chart 11. Contribution by sector to value added and confidence indicators

GVA annual growth (%) and contribution by sector (p.p.)

Diff. from long-term average

Other services
Post and telecommunication
Trade, hotels and restaurants
Agriculture, hunting and forestry
GVA in economy
Industry
Transport
Construction

Confidence in industry
Confidence in services
Confidence in construction
Confidence in trade
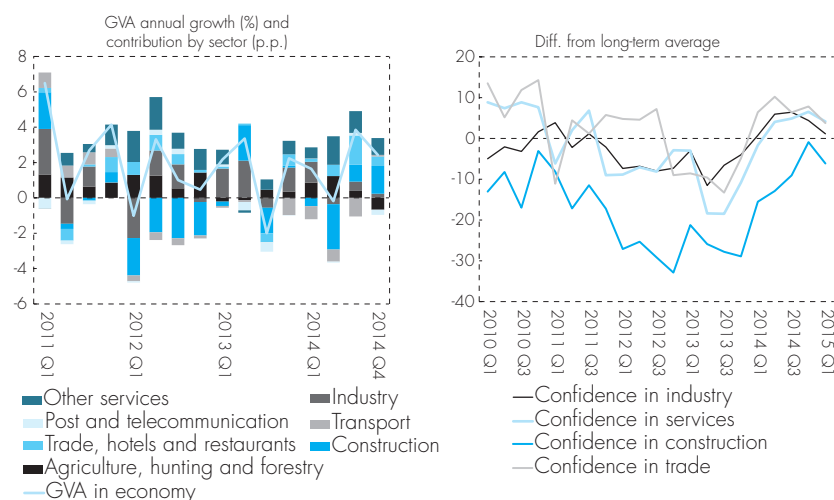
Source: INSTAT and Bank of Albania.

Economic Sentiment Indicator (ESI) fell by 4.6 points in 2015 Q1. This performance of the ESI suggests moderation of the pace of expansion of economic activity during this period. However, the level of confidence stands close to the historic long-term average.

Chart 12. Valued added and capacity utilisation rate in construction

Annual change   Quarterly change

Capacity utilisation rate
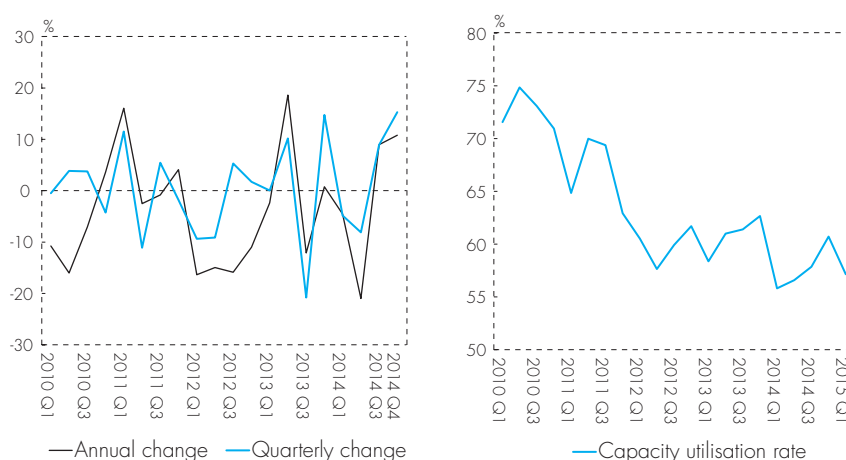
Source: INSTAT and Bank of Albania.

[19] *Against 2.0 percentage points in the previouas quarter.*

The positive performance of the construction sector helped expand the value added in the economy by 1.6 percentage points in 2014 Q4. The value added from construction expanded 10.8% in this quarter, continuing the positive rate (9.0%) recorded in 2014 Q3. The positive dynamics of the value added from this sector in the second half of the year is related to: approval of a large number of building permits, mainly in the third quarter[20]; improvement of liquidity in the sector due to the payment of Government arrears[21]; and increase in infrastructure and transport construction works.[22]

The capacity utilisation rate in 2015 Q1 is assessed as being higher, year on year, suggesting that developments in construction will remain positive, but at lower annual rates than in the previous quarter. The continuation of public investment projects is expected to contribute positively to the construction sector's performance in 2015 H1.[23]

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[20] *Number of approved building permits was 58, 39, 122 and 51 in the four quarters of 2014. The ESI remains below the average number of permits granted over time. Data on building permits and types of construction are published in quarterly statistical bulletins of INSTAT.*

[21] *Government arrears to businesses that had carried out public works in infrastructure (construction and renovation of roads, schools, etc) continued to be paid in November and December 2014. As a result, the payment of arrears is deemed to have played a positive role in construction activity in Q4.*

[22] *The approximate number of building permits recorded the highest growth compared to the previous year, for engineering works, mainly in the field of transport, such as roads and highways. In the last quarter, the realisation of other engineering works such as water supply networks, electrical energy and telecommunication, complex buildings in industrial compounds, and other works increased as well. The Regional Development Fund provided positive contribution to the realisation of projects, by funding projects related to the improvement of roads and facades.*

[23] *Referring to the Decision of the Regional Development Committee No. 14, dated 23.9.2014 "Amendment to Decision No. 13, dated 6.8.2014, of the Regional Development Committee "On the allocation of the fund for local infrastructure, part of the Regional Development Fund" and allocation of the fund for the local infrastructure, part of the Regional Development Fund", and Notes to the draft-law "On the budget for 2015), October 2014.*

BOX 2 HOUSE MARKET PRICES*

House and rental price indices fell 3.7% and 6.3%, respectively, in real terms in 2015 Q1. Despite short-term fluctuations, their trend has been on the down side in recent years, affected by the weak consumer demand. Presently, the house price index stands 20.6% and the rental price index stands 16.2% lower than in 2010.

The historic correlation between the two indices is expressed in the price-to-rent ratio. The similar dynamics of house and rental prices in the recent years is translated in almost constant ratio of the respective indices**. The value of this ratio is unchanged from the previous year.

Chart 13. House Price Index and price-to-rent index
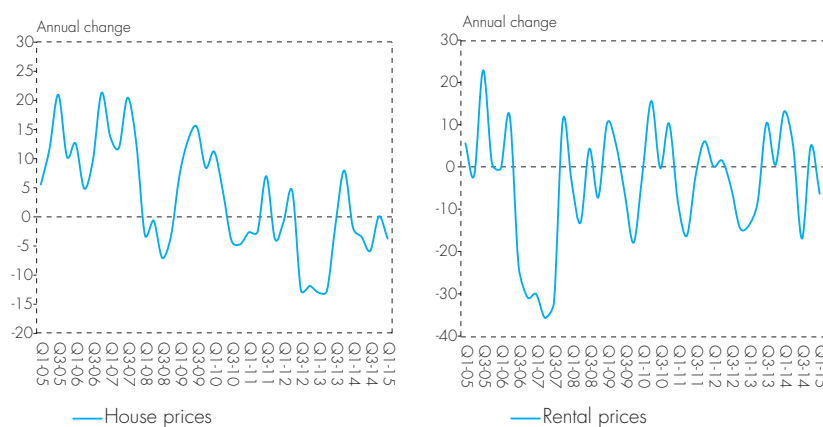
Source: Bank of Albania.

The house market is characterised by the recovery of both consumer demand and supply, in the past year.

Based on data from the confidence survey in this sector, notwithstanding the growth of demand in construction and the gradual reduction of inventories, businesses have been more contained in increasing the producer price. This is reflected in part in the downward final prices, measured through the house price index***.

Chart 14. Price-to-rent ratio and qualitative indicators from the confidence survey in construction.
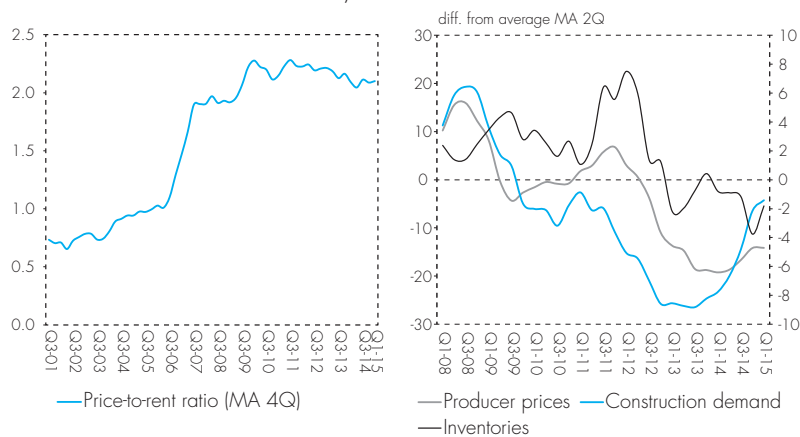
Source: Bank of Albania.

The industrial sector continued to show slow growth in 2014 Q4. After the 3.4% annual growth recorded in 2014 Q3, the added value from the industrial activity rose 1.6% in the quarter under review. This sector is estimated to have contributed 0.2 percentage point to the annual value added in the economy.

Chart 15. Contribution by branch to value added and capacity utilisation rate in industry

Source: Bank of Albania.
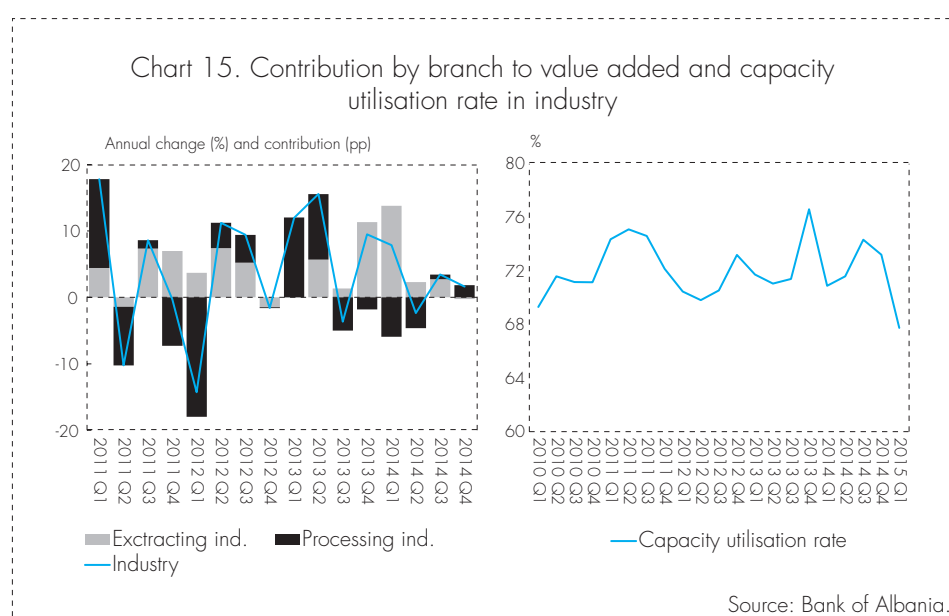
A detailed analysis of the sector shows that the branch of processing industry contributed positively 1.8 percentage points to the growth of industrial production, driven mostly by the improvement in developments related to production and distribution of electrical energy[24]. Conversely, in 2014 Q4 the value added in the extractive industry fell 0.5% in annual terms, reducing industrial production by 0.2 percentage point. This reflected mainly the fall in the sub-branch of energy mineral extraction. The deterioration of the industry survey indicators in 2015 Q1 defers the potential recovery of the sector.[25]

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[24] The value added from production and distribution of electrical energy contributed positively 0.2 percentage point to annual growth of economic activity after a negative contribution on average 0.6 percentage point for five consecutive quarters.

[25] We must note that the branch of production and distribution of electrical energy is estimated to continue to contribute positively to the growth of activity both in the short term, due to abundant rainfall in the first quarter, and in the long term due to the structural reformation of the sector, reflecting the enhanced efficiency in the functioning and management of the system (for example, the Decision of the Energy Regulatory Entity No. 1, dated 2. 2 2015 "On the approval of the agreement between KESH sh.a. and OST on selling and buying electrical energy to cover technical losses in the transmission system for 2015", published in the Official Journal No. 21.)

Chart 16 Value added in agriculture, hunting and forestry, and its contribution to economy

Contribution in pp (ra)
Annual change, in per cent
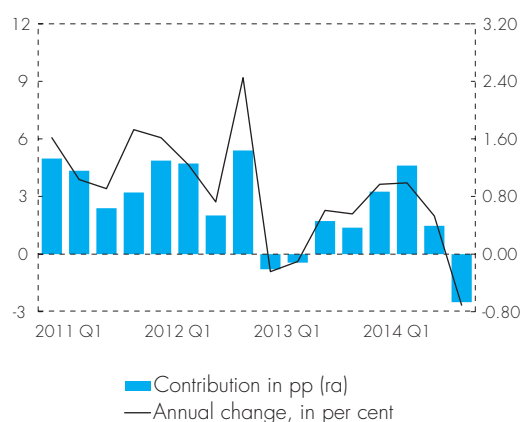
Source: INSTAT.

In 2014 Q4, the value added from agriculture, hunting and forestry contracted 2.7% in annual terms, against 2.0% annual growth in the previous quarter. The contribution of these activities to the economy is estimated as negative, at 0.7 percentage point, in the quarter under review. Though in 2014 agricultural production performed better than in 2013, it remains below the 6.2% average growth rate for the period 2010 – 2012. The partial damage of agricultural production is assessed to materialise as a negative shock on the performance of the agricultural sector in 2015 Q1.

Services sector continued to generate annual growth of the value added, by 2.5% at end of 2014 Q4. This growth rate was lower from the annual expansion 3.8% of the previous quarter, nevertheless remaining above the average annual growth rate of 2.2%. Positive developments reflected the increase of value added by other services[26] and trade. Their contribution to economic growth was 1.0 and 0.5 percentage point, respectively. However, both, 'other services' and 'trade' resulted slower at the end of year[27].

Within the sector, the annual fall of added value in 'post and communication' branch led to a fall of the value added in economy by 0.3 percentage point[28].

Chart 17 Contribution by branch to value added in services and capacity utilisation rates in services

Annual changes (%) and contributions (pp)

%, Capacity utilisation rate

Trade, hotels and restaurants   Transport
Post and telecommunication   Other services
Total services

Services excl. trade
Trade
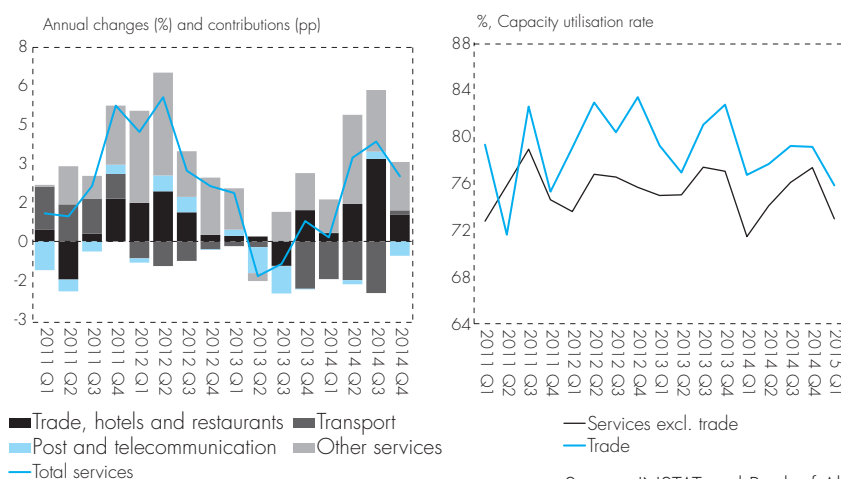
Source: INSTAT and Bank of Albania.

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[26] The other collective, social and personal services determined at a larger extent the positive performance of this branch.

[27] Annual fall of value added by services in education affected considerably the slowdown of other services. In trade activities, retail trade increased at a slower pace in the fourth quarter.

[28] The turnover index volume reveals that the negative dynamic was driven by the performance of communication sub branch of communication.

While, the negative effect of shock in the activity of air transport[29] in the previous year, is almost subdued in the fourth quarter of 2014. Transport recorded a slight increase of 3.0%, providing a small contribution (0.1 percentage point) in the total annual increase of value added. The fall of the confidence survey index in this activity, signals its slowdown in the first quarter of 2015.

3.2.2 AGGREGATE DEMAND

Aggregate demand grew in 2014 Q4, mainly as a result of the increased domestic demand. The domestic demand was sustained by the increase of confidence in economy, the low interest rates, and the increase of employment, the eased monetary conditions and the growth of public investments. Foreign demand was weak and the increase in imports determined the negative contribution of net exports.

Our assessments show that domestic demand supported the economic growth in 2015 Q1, while the contribution of foreign demand remained negative. The prior quantitative and indirect data suggest that investments were the main contributor to the growth of the private domestic demand, while the contribution provided by family consumption was low. Indicators from business and consumer confidence surveys confirm these developments.

Private consumption decelerated in the fourth quarter of year, after the progressive increase in the three first quarters. Retail trade indicator slowed down the growth pace at 4.1% in the fourth quarter, after the average increase in the first nine-month period of the year. The payment of arrears of electricity bills and the fall of confidence highlighted the hesitating behaviour of consumers to carry out expenses in this period. That was mainly reflected in the decrease of services for consumption and of major purchases. On the other hand, the improved employment indicators, the increase in remittances and consumer loans supported the consumer demand.

Chart 18 Private sector demand, y-o-y, and ESI (long-term average=100)

— ESI (la)   — Private sector demand (ra)

Source: INSTAT and Bank of Albania.

Confidence indicators signal a low consumption during the first quarter of 2015. Confidence Index in business branches and trade fell by four percentage points. Consumer confidence index fell below the long-term average in this period. On the other hand, the available quantitative information from imported goods for consumption purposes and loans to households is positive.

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[29]   *The exit from the market of the Albanian airline company Belleair in 2013 Q4.*

Chart 19 Indirect data on private consumption

CII_diff. from average
Retail index

Imports of "food, beverages and tobacco", yoy, real
CCI_diff. from average (ra)

Source: INSTAT and Bank of Albania.
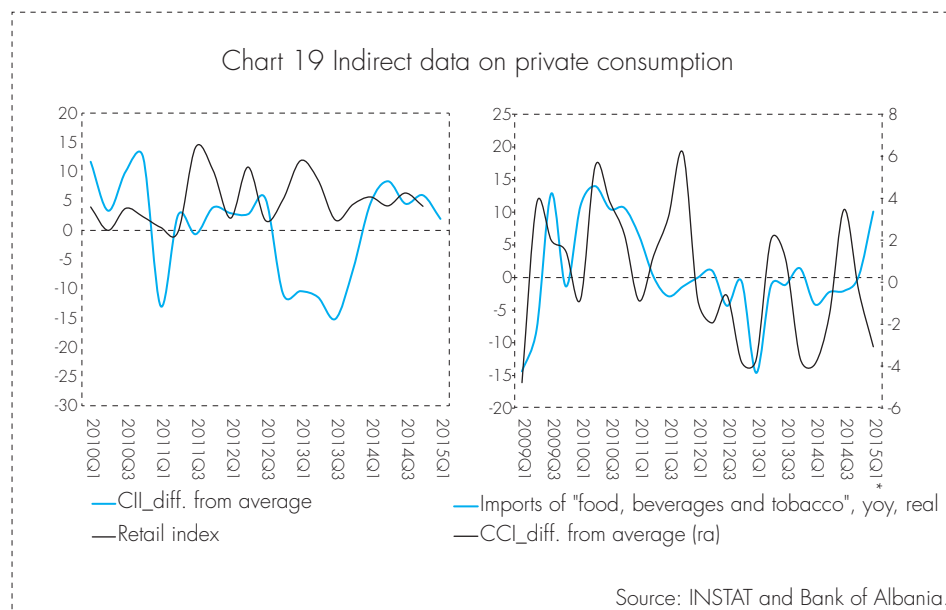
Private investments grew in 2014 Q4, supported by an improved business climate in this period and the positive flows of foreign direct investments. The increased credit for investments, the higher capacity utilisation rate and the improved businesses' financial situation in the fourth quarter, drove to a growth of investments in this period.

The increase in the import of machineries and equipment during the two first months, suggests a positive contribution of this component, during 2015 Q1 as well. Notwithstanding, businesses reported, overall, a capacity utilisation rate lower than in the previous quarter, investments' balance increased in this quarter, particularly in services[30].

Chart 20 Proxies for private investments

diff. from average

FDI inflows excl.privatisations, yoy (la)
Imports of "machineries and equipment", nominal, yoy

Capacity utilisation rate (MA 2Q)
Business financial situation (MA 2Q)

Source: INSTAT and Bank of Albania.
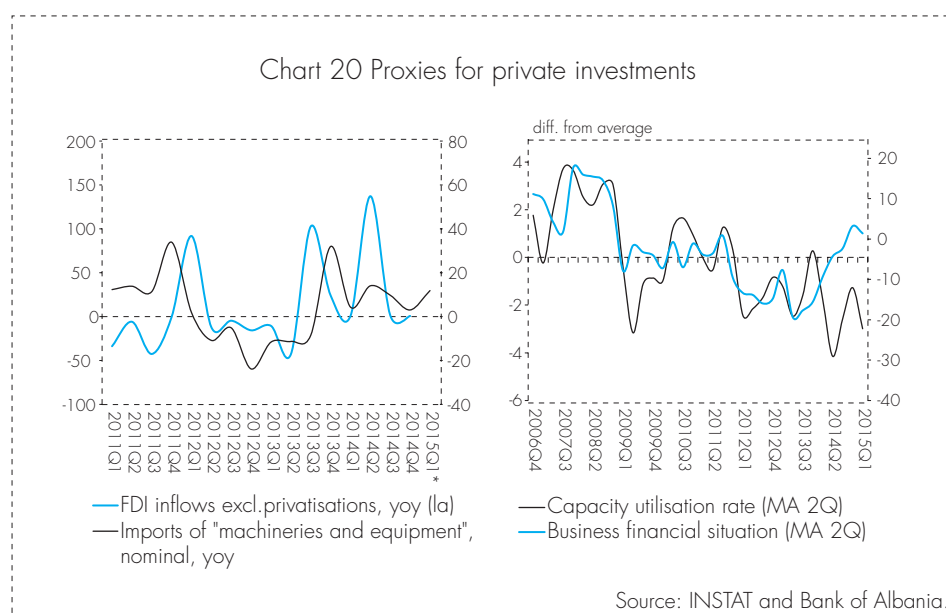
[30] Based on the businesses confidence survey results

Fiscal indicators and fiscal policy

Fiscal policy showed simulating in 2015 Q1, as in the previous quarter. The increased expenditure, whose effect exceeded the increased revenues, drove to this development. However, this approach was attributable to the effects of the lower comparative base and the payment of arrears by the Government.

Budget expenditure grew annually in the first three months of the year, mainly due to the payment of arrears. Their effect was strengthened by the rapid increase of capital expenditure[31]. In 2015 Q1, expenditures stood at ALL 90.5 billion, about 5.9% higher than in the previous year. Current expenditure, accounting for the main part of public expenditure, shrank by about 2.8% from the same period a year earlier. Capital expenditure recorded and annual growth of 11.9%. Capital expenditure contributed by 1 percentage point to the annual growth of total expenditure. The payment of arrears in the three-month period was ALL 7.4 billion, and were realised at 78% of the quantity planned for this period. Excluding the payment of arrears, the budget expenditure in the first quarter of the year amounted to ALL 83 billion, or 1.5 % lower than in the previous year[32].

Chart 21 Orientation of fiscal policy, proxied by the change in the primary deficit*

■ Δ Primary deficit excl. arrears (PD/GDPt-PD/GDPt-1)
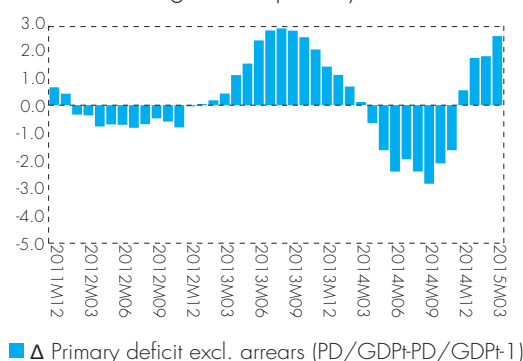
*The fiscal stimulus is proxied by changes in the ratio of primary deficit for a 12-month period to the GDP, compared to a year earlier. Each value in the chart reflects the change in the last 12 calendar months, compared to the previous 12 months. Positive changes in these ratios show a positive fiscal stimulus, whereas negative differences signal for fiscal consolidation.
Source: Ministry of Finance, INSTAT and Bank of Albania calculations.

Chart 22 Annual change in total quarterly expenditure by contribution of main items (left) and annual change in main expenditure items (right)

■ Current expenditures contributions, in pp (ra)
■ Other expenditures contributions, in pp (ra)
— Total expenditures, annual change, in %
■ Capital expenditures contributions, in pp (ra)

— Current expenditures
— Social securities
— Interest payments
— Capital expenditures (ra)
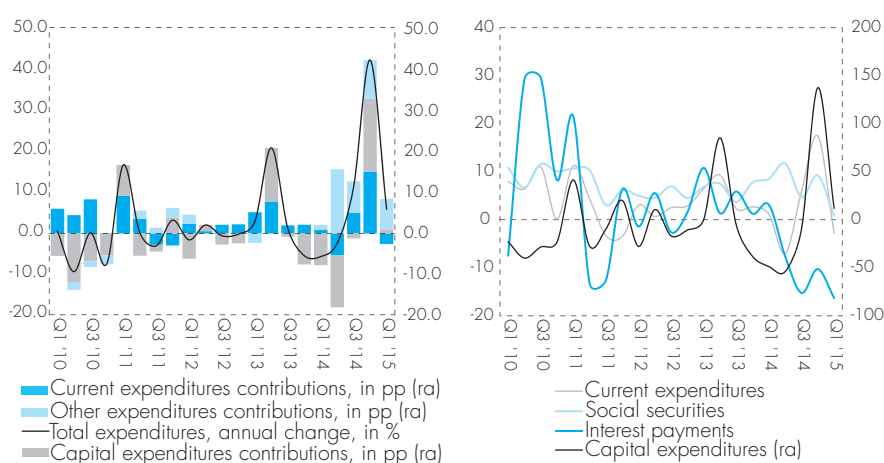
Source: Ministry of Finance.

Budget revenues amounted to around ALL 86.6.7 billion, or 3.6% higher than in the same period a year earlier. Total revenues plan was almost realised for

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[31]   This part of the year reflects also the statistical effect of the comparative base.
[32]   Until March, about 64% of payments consists in the payment of arrears in infrastructure.

this period.[33] In the first three months of year, tax revenues shrank by 1.3% from the previous year. This performance reflected the fall in the revenues collected from the "Value added tax", which accounts for the main part of this item. The latter contracted by 9% in annual terms. Revenues from profit tax and excise increased rapidly, recording an annual growth of about 37.6% and 19.1%[34], respectively. Revenues from personal income tax fell by about 5% in annual terms. "Non-tax" revenues[35] and health and insurance contributions provided positive impact. They were up by 12.4% in annual terms[36].
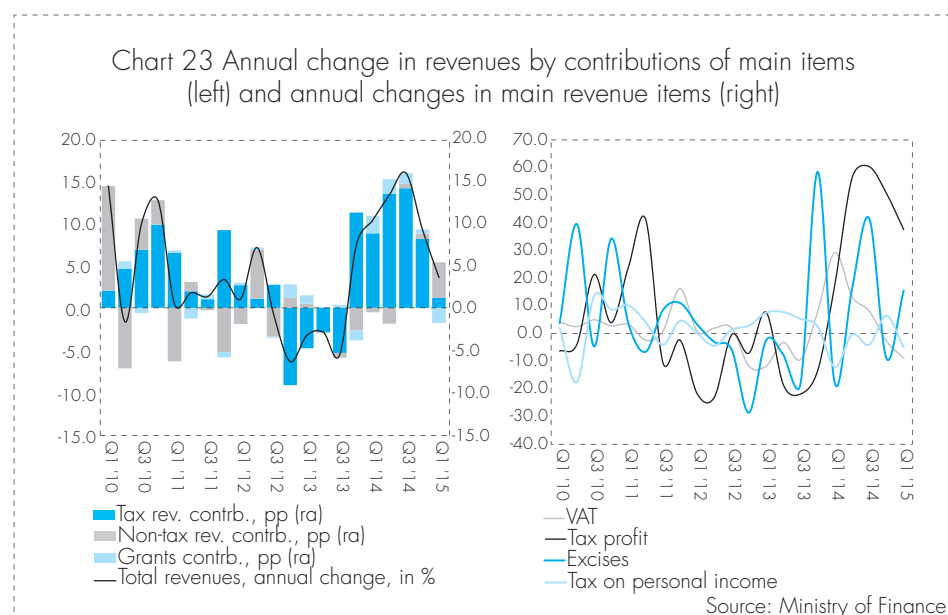

Chart 23 Annual change in revenues by contributions of main items (left) and annual changes in main revenue items (right)

Tax rev. contrb., pp (ra)
Non-tax rev. contrb., pp (ra)
Grants contrb., pp (ra)
Total revenues, annual change, in %

VAT
Tax profit
Excises
Tax on personal income

Source: Ministry of Finance.

Budget deficit in the first quarter of year stood at ALL 3.9 million, about 115.1% higher than the same period a year earlier. This development does not only reflect the low comparative base effect, also the rather volatile nature of this indicator in the first months of year. Budget deficit was financed through foreign resources, mainly the IMF's loan disbursement. Along with the foreign resources, the Government's demand for financing in the domestic market increased. On the other hand, the situation of the Government's accounts at the Bank of Albania was up, showing that the gross borrowing of the Government was higher than its needs to finance deficit.

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[33] In January - March 2015, total revenues were realised at 98.1% of the planned budget quantity of 2015.

[34] Excise revenues reflects the base effect of the previous year. In 2014 started the application of increased tax on imported goods from excise. Because businesses had anticipated this phenomenon at end-2013, excise revenues stood at low rates in 2014 Q1.

[35] Non-tax revenues reflected the rapid increase of revenues from budget institutions. They increased by 138.1% from the first quarter in the previous year.

[36] The Guideline of the Ministry of Finance, No. 23, dated 09.01.2014 "On the collection of obligatory health and social insurance contribution" entered into force on 1st January. This guideline lays down the raise of minimum wage upon which are calculated the obligations for the declaration of the self-employed persons and of the persons not employed of the family that work and live with the self-employed person. This increase led to the surge of revenues from health and social insurance contributions.

Chart 24 12-month moving sum of deficit (left) and its financing instruments, in ALL billion (right)

—Overall deficit/GDP

Financial instruments
Eurobond
Foreign financing
—Overall budget deficit

Privatisations
Syndicated loan
Other

Source: Ministry of Finance, INSTAT and Bank of Albania's staff calculations.
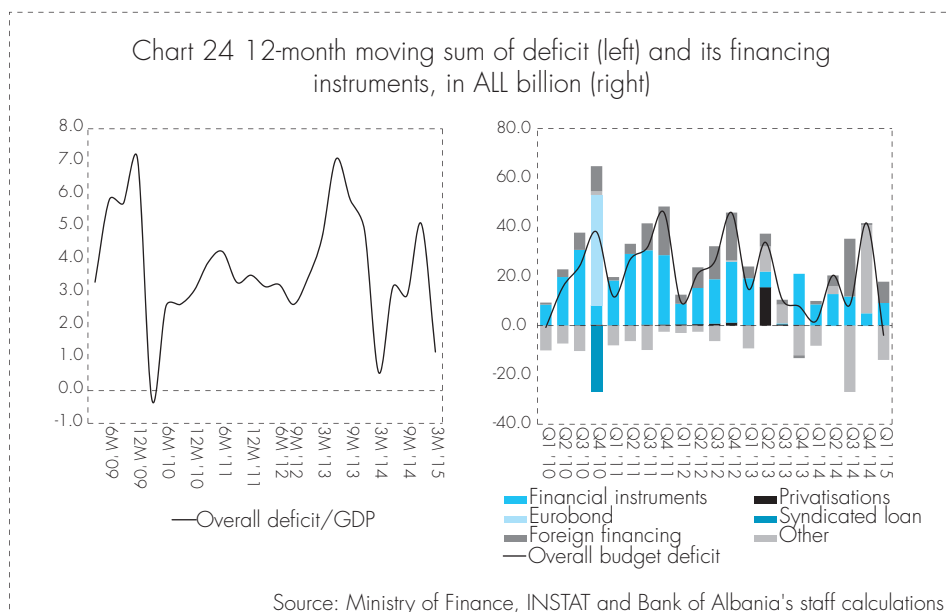
External demand and external trade

Real trade deficit in goods and services continued to expand in 2014 Q4. Its annual expansion was around 4.2% during this quarter, while trade deficit expansion for 2014 stood at 7.8%. In terms of impact on the economy, the performance is assessed to have given a negative contribution by 1.0 percentage point to the annual change of aggregate demand. The annual fall of real exports of goods provided a considerable impact. Throughout 2014, our assessments show a negative contribution of real net exports to the economic growth by around 1.7 percentage points. For 2015, our projections suggest for a continuing negative contribution of foreign sector to the increase of aggregate demand, at a close degree with the previous year.

The latest data on net exports for the first quarter of the year include only trade in goods for January and February. Trade deficit in goods in these two months widened by around 6.9% in annual terms, driven by the fall in exports (-6.8%), compared to a slight lowering of goods imports (-0.2%). Trade activity during the period points to a reduction by around 2.4% of trade flows, compared to the same months in the previous year. The coverage ratio of imports by exports was at 48.1%, or around 3.4 percentage points lower than in the previous year.

During January and February 2015, the value of export of goods decreased, mainly due to the negative contribution of the annual fall in exports in the category "minerals, oil and electrical energy" (-40%). The trend of oil price per barrel in the

Chart 25 Contribution of net exports to aggregate demand (in percentage points)

Exports (contrb. in p.p.)
Imports (contrb. in p.p.)
—Real net exports/agregate demand (contrb. in p.p.)

Source: INSTAT and Bank of Albania.

Chart 26 Import and export orientation by item (in ALL million)
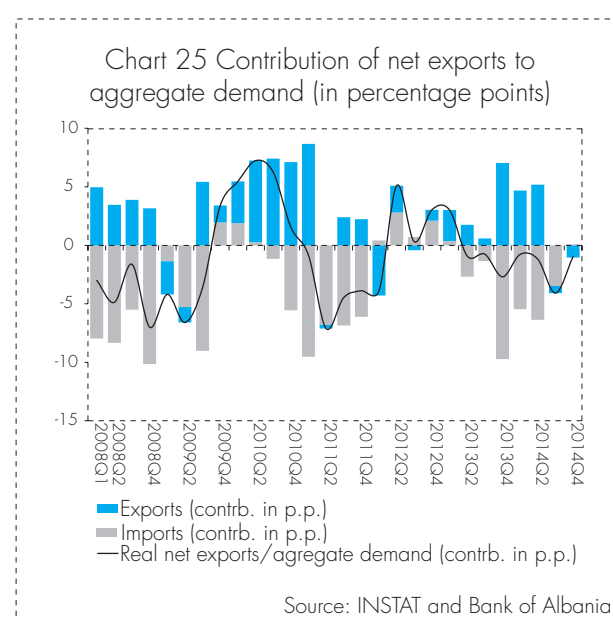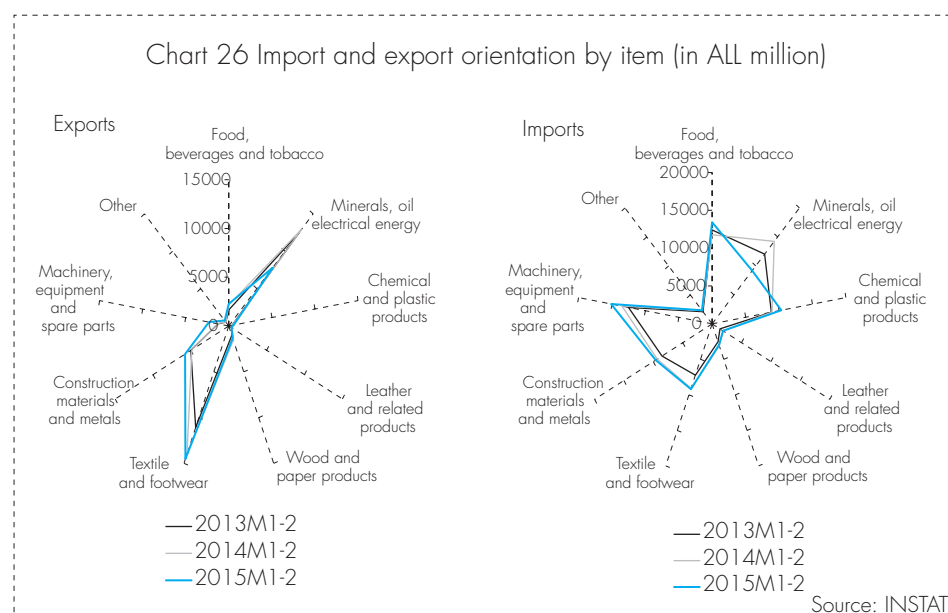
international market[37] contributed to the fall in the value of exports of this product by 67% in annual terms. The export in products under "construction materials and metals" and "machinery, equipment and spare parts" increased at accelerated paces during these two months. This performance was supported by the higher amount in the export of basic goods of metal and by the rise in cast-iron and steel price in international markets. The widened exports of products in the category "food, beverages and tobacco" provided another important positive contribution. Nevertheless, the increasing pace in the two first months of 2015 was lower than those recorded during 2014.The export of re-exporting industries products resulted with an annual slowdown during January and February. The slowdown of imports of intermediary products that are used in re-exporting industry, during the end of 2014 and in the start of the current year, do not suggest an acceleration of exports in the category "textile and footwear" during the upcoming period[38].

The fall in imports of goods in value during January and February was mainly driven by the negative dynamic of import of goods under "Minerals, oil and electrical energy" (around -35.5%). Within this item, the lower level of imports of electrical energy provided the main impact. The annual growth pace of goods which are directly related to the production in textile industry of re-exporting character slowed down considerably (1.4%), compared to the same period of the previous year (25.5%). The imports of "Machinery, equipment and spare parts" expanded by around 11.9% in annual terms. Imports in "construction materials and metals" performed similarly. The performance of both stated categories is closely related to the positive tendencies of private investments performance in Albania for the first quarter of year.

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[37] Price of oil per barrel in international market during January and February fell in annual terms by around 51.2% (EIA, April 2015). The average price per barrel for the Albanian oil fell by around 45.6% (INSTAT and calculations of the Bank of Albania).

[38] Statistical assessments suggest the presence of a positive correlation with a time lag (four months), between the export of re-exports, with the imports of materials used for production in these industries (re-exports).

The exporting activity for Albania continues towards the markets of Italy, Kosovo, Turkey, Spain, Greece and China. The origin of imports remains diverse, with the EU countries having the major share in the total during the two first months of 2015 (56%).

BOX 3 BALANCE OF PAYMENTS DEVELOPMENTS DURING 2014 Q4

Albania's net current account balance recorded a deficit of EUR 377.5 million in 2014 Q4, maintaining an upward trend for the fifth consecutive quarter. During the quarter under review, current account deficit increased around 12%, in annual terms, and was estimated at 14.5% of nominal GDP. For the whole 2014, this deficit was estimated at around 12.9% of nominal GDP, increasing by around 25.7% from 2013. By item of the current account for the quarter under review, the deterioration of the deficit in net exports and primary income contributed to the expansion side. Meanwhile, secondary income surplus increased at an accelerated pace, on an annual level, providing contribution to the narrowing of the annual current account deficit.

In this quarter, the external demand did not help maintain the uptrend in the exports of goods and services. Also, imports of goods and services trended downward, but the pace of decline was more moderate than that of exports. The balance of the primary income account remained in negative territory for the fifth consecutive quarter, deepening further the registered deficit compared to the last quarter of 2013. On the other hand, during this quarter, secondary income registered around 12.9% increase, especially the annual growth of remittances by around 22.1%.

Net inflows in the capital account increased to EUR 21.1 million, from EUR 18.2 million in 2014 Q4. Net flows in the financial account increased by around 26.5% annually, financing 5.7% of the current account deficit. Net foreign direct investments decreased slightly by around 0.8%, in annual terms*. On the other hand, other net investments registered reduced assets owned abroad by around EUR 122.2 million, due to the fall in assets in the form of currencies and deposits. However, the latter were somewhat offset by an increase of around EUR 104.7 million of assets in the form of portfolio investments owned by residents.

Table 6 Balance of Payments indicators

	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
Current account (in EUR million)	-191.0	-337.0	-271.5	-341.0	-313.2	-377.5
y-o-y (%)	-22.9	63.7	21.3	19.5	64.0	12.0
/ GDP (%)	-8.2	-13.4	-11.7	-12.8	-12.6	-14.5
Goods and services	-395.4	-518.9	-396.2	-473.3	-462.8	-536.0
Exports, f.o.b.	861.3	808.7	608.8	752.0	838.8	757.1
Imports, f.o.b.	1256.8	1327.6	1005.0	1225.3	1301.6	1293.1
Travel - net	26.1	34.0	-21.8	10.6	32.0	66.0
Primary income	22.2	0.0	-20.6	-43.3	-48.7	-47.0
Credit	40.2	33.4	28.7	25.7	28.3	27.8
Debit	18.0	33.4	49.3	69.1	77.0	74.8
Net FDI income	6.2	6.9	-30.4	-47.1	-56.2	-38.6
Secondary income	182.3	181.9	145.3	175.6	198.3	205.4
Credit	216.5	213.5	172.6	204.4	230.6	244.1
Debit	34.2	31.6	27.3	28.8	32.3	38.8
Net remittances	152.5	140.1	118.2	137.5	165.1	171.0

y-o-y (%)	8.3	-28.6	-2.8	6.1	8.3	22.1
/GDP	6.5	5.6	5.1	5.1	6.6	6.5
Capital account	15.0	18.2	22.5	22.4	20.7	21.1
Net borrowing/net lending	-175.9	-318.8	-249.0	-318.7	-292.5	-356.4
Financial account	-70.9	-226.1	-199.1	-214.5	-206.1	-285.9
y-o-y (%)	78.4	-16.2	57.2	-18.3	190.7	26.5
/ GDP (%)	-3.0	-9.0	-8.6	-8.0	-8.3	-10.9
Direct investments	-307.0	-231.2	-168.0	-150.4	-253.4	-229.4
y-o-y (%)	145.2	22.2	46.7	-44.4	-17.4	-0.8
Portfolio investments	6.2	-18.1	14.5	14.0	-12.4	104.7
Financial derivatives	0.0	-2.4	0.0	0.0	0.0	0.0
Other investments	195.4	18.6	-5.2	-100.6	-94.2	-122.2
Reserve assets	34.5	7.1	-40.3	22.5	154.0	-38.9
Current deficit financing (Financial account)	37.1	67.1	73.3	62.9	65.8	75.7
Errors and omissions	105.1	92.7	49.9	104.2	86.4	70.5
Net borrowing/net lending	-175.9	-318.8	-249.0	-318.7	-292.5	-356.4

Source: Bank of Albania.

The overall balance of payments recorded decreased foreign reserve assets by about EUR 38.9 million. At the end of December, the stock of the foreign currency reserve was around EUR 2.19 billion, sufficient to cover 5.5 months of imports of goods and services and 181% of the short-term foreign debt.
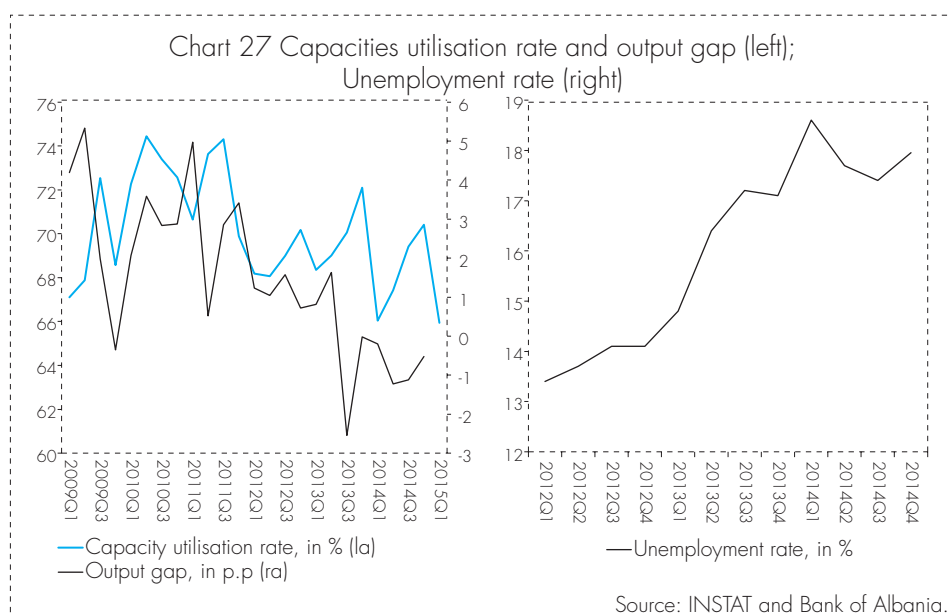
* Estimation of foreign direct investments of quarterly frequency during the year is based on the data that are taken by banks and are not included in the information on borrowing/ lending in the foreign direct investment relationship in Albania. This information is provided only by the annual survey of Foreign Direct Investments (FDI) at the enterprises, which is published in September of the successive year. Due to the data taken from this survey, FDIs values are reviewed for each quarter. Thus, FDIs value for each quarter of 2014 shall be reviewed after the FDIs survey for 2014.

3.3 CYCLICAL POSITION OF THE ECONOMY, WAGES, LABOUR COSTS AND INFLATION TRENDS

Inflationary pressures from the real economy remain weak, maintaining inflation below the Bank of Albania's target even during 2015 Q1. The fall in the indicator of capacities utilisation rate and the still high unemployment rate show unused resources of capital and labour in economy, by transmitting weak pressures for the rise of wages and production costs.

Albanian economy continued to be characterised by the presence of a negative output gap, despite the higher growth in 2014. Labour market indicators are in line with this assessment. Unemployment rate increased at 18% as at end-2014. Surveys data shows a fall in the utilisation rate of production capacities for businesses in 2015 Q1.

Our assessments and projections suggest that the gradual recovery of the domestic aggregate demand will drive to an increase of production capacities

Chart 27 Capacities utilisation rate and output gap (left);
Unemployment rate (right)

Capacity utilisation rate, in % (la)
Output gap, in p.p (ra)

Unemployment rate, in %

Source: INSTAT and Bank of Albania.

in economy, by narrowing the negative output gap, during the current year towards its closure in the next year. In line with the time lag of the transmission of impulses from the real economy in the formation of prices, inflationary pressures are expected to increase gradually to turn inflation to target in the medium-term horizon.

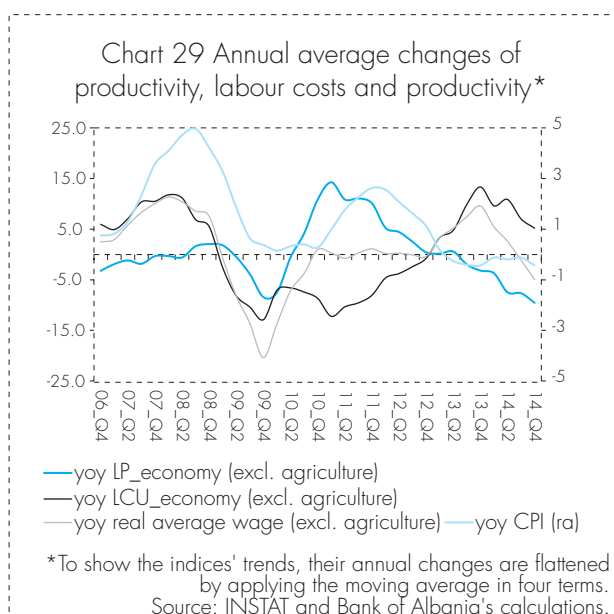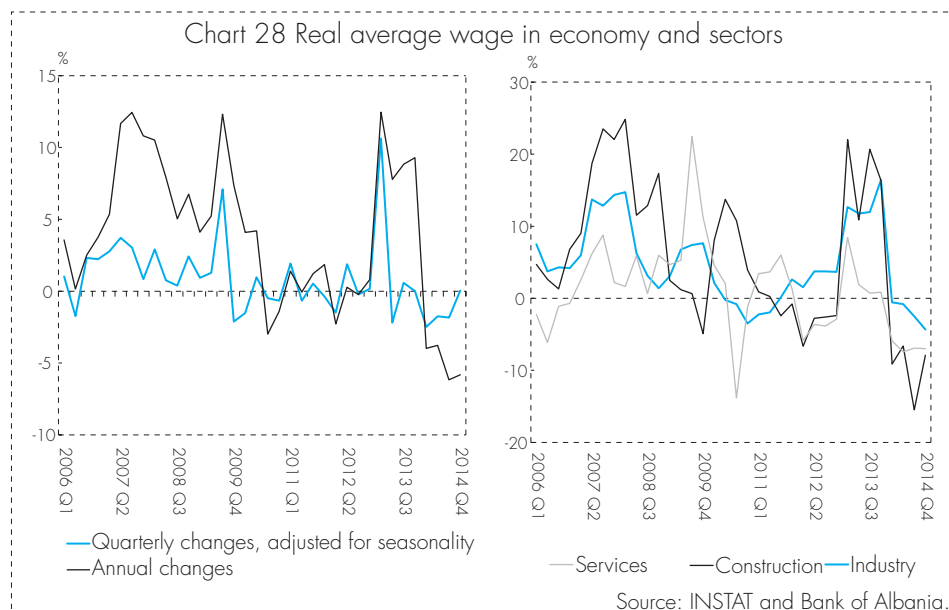### Productivity, wages and labour costs[39]

The proxy index of average wage recorded an annual fall in 2014 Q4. This fall was 4.6% and 5.8%, respectively, in nominal and real terms.[40] On the other hand, the slight quarterly increase of adjusted indicator for seasonality may signal the interruption of the down trend of wages. Also, confidence survey data signal more positive developments of wages in 2015 Q1.

On the other hand, labour productivity (LP) index in non-agricultural activity recorded a more negative dynamic (-9.5%) than the average real wage, during 2014 Q4. Hence, the indicator of the cost of labour per unit of output (CLU) resulted with a slowdown of the annual growth (5.2%). The annual change

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[39] Indicators of average wage, labour productivity and unit labour costs are proxies calculated by the Bank of Albania, based on data of short-term statistics 2014 Q4 (INSTAT). They include: employment index, turnover and wages fund, for non-agricultural activity. The average wage index is calculated as the ratio of wages fund index to employment index, (excluding agricultural sector and the self-employed persons). In real terms, the average wage index is deflated by CPI.

[40] Since 2014 Q1, statistics where the calculation of this index is base changed methodologically. These changes consists in: the implementation of the reviewed nomenclature of economic assets NACE Rev.2, the updating of representative shares in accordance with chain link method and the updating of the reference period. In 27 June 2014, INSTAT announced the implementation of NACE Rev. 2 on the reporting of economic activities, as part of statistics of businesses activity. The shift from NACE Rev 1.1 to NACE Rev 2 took place in the framework of obligations that INSTAT has versus EUROSTAT, to provide full alignment of Albanian statistics with European statistics. The implementation of NACE Rev. 2 took place under the legal act approved with Government Decision No. 320 on 28 May 2014.

of Industrial Producer Price Index (IPPI) recorded a gradual deepening of the negative pace (-0.4%).

Chart 28 Real average wage in economy and sectors

Source: INSTAT and Bank of Albania.

Chart 29 Annual average changes of productivity, labour costs and productivity*

*To show the indices' trends, their annual changes are flattened by applying the moving average in four terms.
Source: INSTAT and Bank of Albania's calculations.

The performance of the above indices shows the presence of weak inflationary pressures from wages and producing costs in non-agricultural sectors of economy.
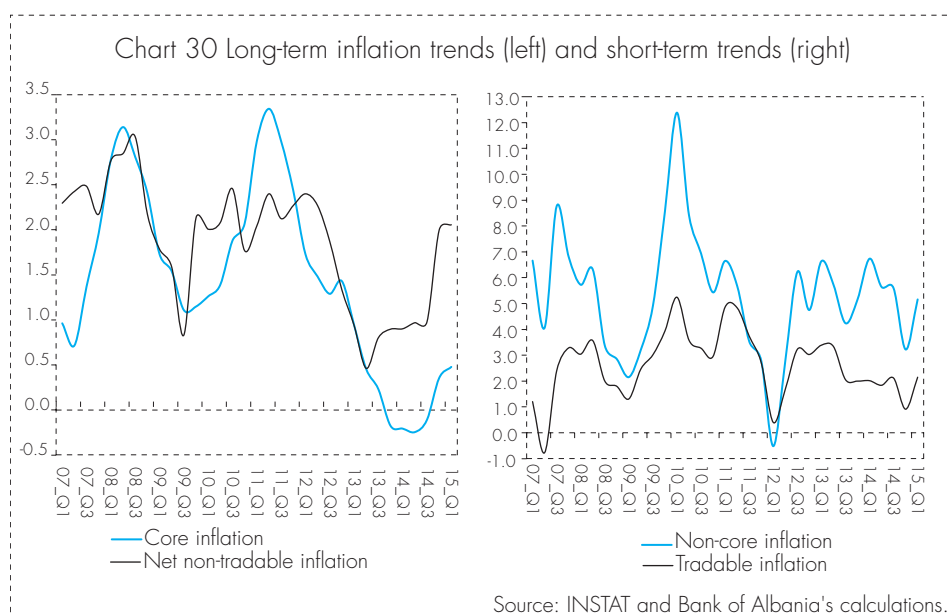
Main inflation trends

In 2015 Q1, core inflation and inflation of the non-tradable sector of the CPI were 0.5% and 2.1%,[41] respectively, slightly higher than in the previous quarter. By representing the long-term and internal origin of inflation's trends, the performance of these indicators points to the rising demand-side inflationary pressures. Core inflation contributed by 0.33 percentage point (or 17.5%) to the formation of headline inflation. Hence, headline inflation for the quarter under review was mostly determined by the increase of its short-term components. The annual non-core and tradable inflation rates resulted 5.2% and 2.2%, respectively.

The above assessments show that the long-term inflationary pressures are trending up. Nevertheless, in line with our expectations, this increase will be gradual, with a stable return of inflation to the target in the medium-term horizon.

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[41] *Core inflation is the simple average of two measurements: with permanent exclusion of the same items of the basket; with reduced average of 30% of items, symmetrically in both extremes of monthly contributions of main items and sub-items of CPI basket. Non-tradable inflation, refers to the change of CPI of a sub-basket, that consists mainly in services but also its certain goods.*

Chart 30 Long-term inflation trends (left) and short-term trends (right)

Source: INSTAT and Bank of Albania's calculations.

3.4 IMPORT PRICES AND IMPORTED INFLATION

Foreign inflationary pressures were upward over 2015 Q1. "Foreign prices" index[42] recorded an annual growth of 4.2%. The double-figure inflation of Turkey and Russia drove to this performance, against the deflationary pressures generated from main European partner countries. The annual depreciation of the domestic currency in terms of NEER index (around 30%), particularly in March, increased the presence of foreign inflationary pressures in Albania. As

Chart 31 IIPI and contributions of its components (left). Contributions of imported inflation and domestic inflation to annual headline inflation (right)

Source: Bank of Albania.

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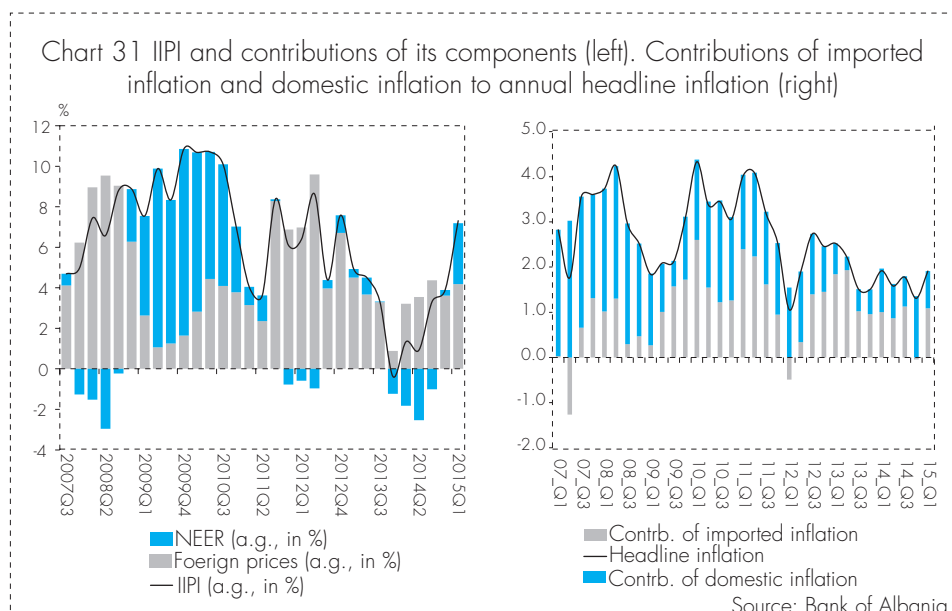
[42] It is a proxy of imported inflation pressures, comparable to tradable inflation of Albania's CPI basket. Import Price Index is based on the inflation rates of "Food, beverages and tobacco" for 18 major countries, and "Goods" (i.e., not only "Food") of Bulgaria, Germany, Greece, Italy and Turkey.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

a result of the above-stated developments, Imported Inflationary Pressures Index (IIPI) [43] recorded 7.3% annual increase, higher 3.4 percentage points than in the previous quarter.

Imported inflation provided positive contribution to the formation of headline inflation. Annual contribution of imported inflation was estimated at around 1.08 percentage points (or 56%) of headline inflation. This contribution reflected the fluctuations in the food and core goods' prices in both international and domestic markets, accompanied by the weakening of lek against US dollar. The rest of inflation was formed by the domestic inflation.

Chart 32 Inflation expectations of different economic agents

— Businesses   — Financial agents
— Consumers   — Financial agents_after 2 years
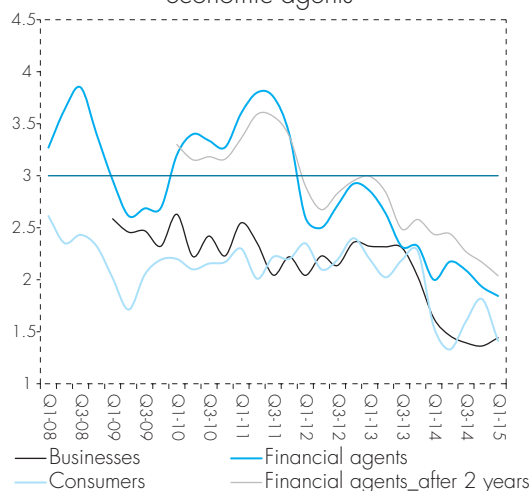
Source: Bank of Albania.

3.5 INFLATION EXPECTATIONS[44]

Inflationary expectations measured under the surveys at economy agents, overall, maintained the downward trend in 2015 Q1. Currently they stand in values below the inflation target. Medium-term expectations are closer to 3%[45]. In 2015 Q1, consumers revised downward by 0.4 percentage point their expectations (after the increase of 0.5 percentage point in 2014 H2). Financial agents' expectations fell by 0.1 percentage point[46].

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[43] 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.

[44] The analysis on inflation expectations is based on the results of the quarterly businesses and households survey and the monthly financial agents expectations survey.

[45] Based on the monthly data taken from the surveys of financial agents' expectations.

[46] Businesses and consumers' expectations are measured through confidence surveys.

4. FINANCIAL MARKETS DEVELOPMENTS AND MONETARY INDICATORS

Financial markets were characterised by a high liquidity, low interest rates and a weak exchange rate during the first months of 2015. The expansion of money supply stood at levels similar to end-2014. This expansion was supported by the foreign currency component and the financing of public sector. The high demand from public sector was materialised in a slight increase of yields in the securities market. Private sector provided a lower contribution to the monetary expansion compared to 2014 Q4.

Financing costs remain low and favourable for the recovery of credit. However, private sector's demand for financing remains weak. In parallel, banks' supply for financing remains tight, albeit portfolio quality is improving. On the other hand, the low interest rates of deposits drove consumers to move savings to financial market's segments of high rates of return.
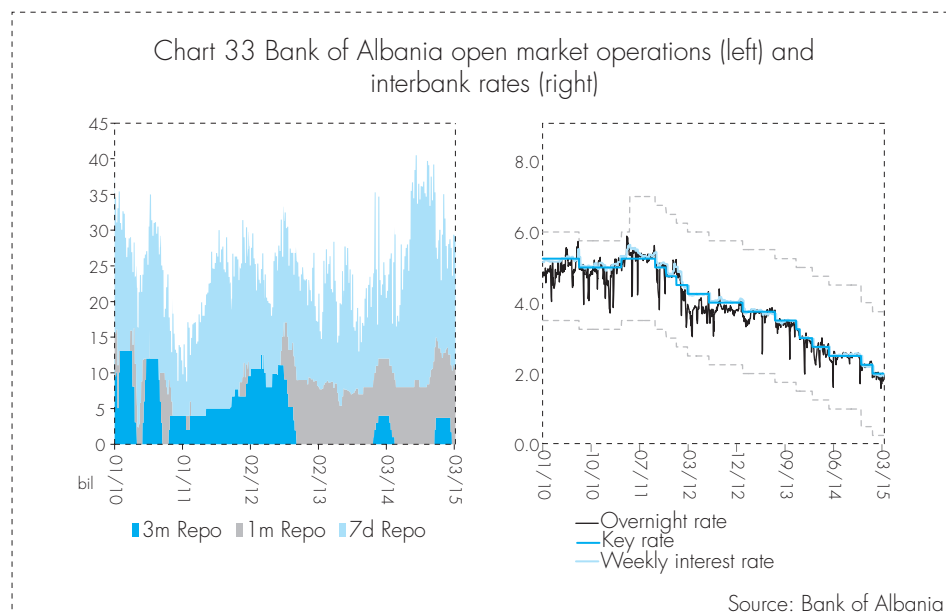
4.1 FINANCIAL MARKET DEVELOPMENTS

Interbank Market

Interest rates in interbank market trended down during the first months of 2015, favoured by the good liquidity situation and the eased monetary policy. The Bank of Albania continued to conduct regular open market operations, injecting liquidity of one-week maturity and applying reverse repurchase agreements of one month maturity. The liquidity injected into the system was less than in the previous quarter, while the auctions yield was continuously close to the key interest rate.

The cut of key interest rate at end of January 2015, was immediately reflected in the interbank market. Daily interest rates fluctuated mainly below the key interest rate[47] and the volatility indicators for the quarter show their stable performance[48]. In 2015 Q1, the overnight interest rate averaged 2.02%, or 0.36 percentage point lower than in the previous quarter, whereas the seven-day rate dropped to 2.05%, from 2.40% three months earlier.

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[47] *The spread between the overnight rate and the key rate was 9 basis points, from 6 basis points in the previous quarter.*

[48] *In Q1, the standard deviation of the overnight interbank rate was 0.194, from 0.174 in the previous quarter.*

Chart 33 Bank of Albania open market operations (left) and interbank rates (right)

■3m Repo ■1m Repo ■7d Repo

——Overnight rate
——Key rate
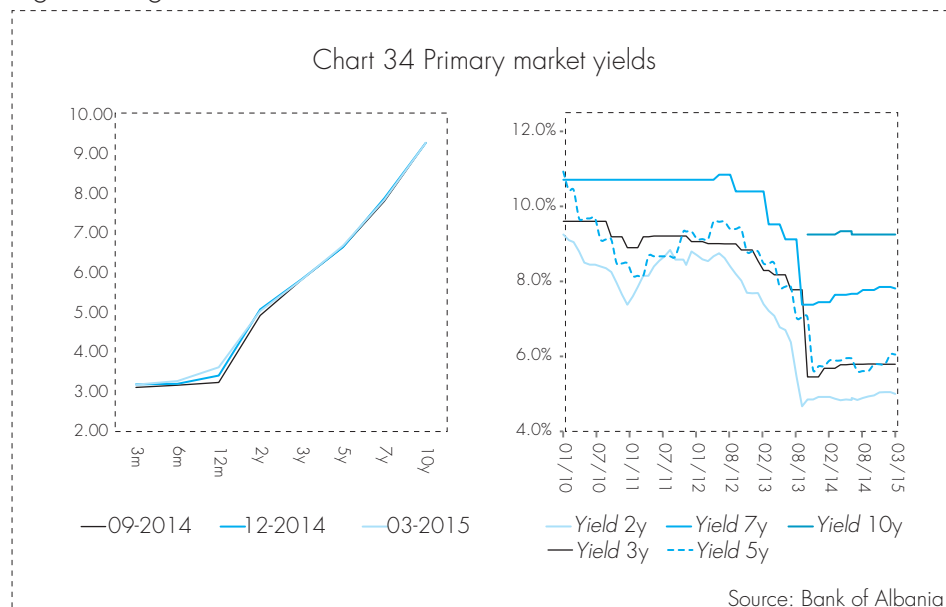——Weekly interest rate

Source: Bank of Albania.

Notwithstanding the trading volume slightly shrank during this period, it stood close to the averages of the last quarters. Transactions' profile continued to favour the one-week transactions. Daily and one-week transactions stood at ALL 6.3 and 2.2 billion, respectively, from ALL 6.8 and 1.9 billion a quarter earlier.

Primary market government security yields
Yields applied on short and long-term instruments showed a slight increasing trend, during the first quarter. Overall, yields values in this quarter were higher than their values at the end of the previous quarter, by not reflecting the cut of key interest rate in January. The increase of Government demand for financing and the tighter supply of banking system, exerted increasing pressures on the yields. Albeit, this trend changed direction at the end of the period.

Participation in the announced auctions for short and long-term instruments was high, driving to overloaded auctions as well.

Chart 34 Primary market yields

——09-2014 ——12-2014 ——03-2015

——Yield 2y ——Yield 7y ——Yield 10y
——Yield 3y ---Yield 5y

Source: Bank of Albania.

The 12-month yield stood at 3.57% at end-March, from 3.45% at end-December. The 3- and 6-month applied yields stood at 3.06% and 3.23%, from 3.22% and 3.16% at end of year. Market agents showed less interest in other floating-rate bonds, by not exerting pressures for any cut of their margins.

End of the quarter and the start of April marked the returning of yields downward trend for all maturities. The shift of Government demand for internal financing to external financing is expected to exert falling pressures of the yields applied on the Government's securities. On 10 April, Standard & Poor's confirmed the B/B evaluation for Albania, predicting that the country's debts will have a positive performance during this year, in terms of the fiscal consolidation and debt reduction.

Exchange rate

In 2015 Q1, the Albanian lek was characterised by upward depreciating pressures, under the impact of mainly external factors. The NEER[49]index, showed a lek depreciation of 3.0% in annual terms, the highest value since November 2010. The depreciation stood at 1.8% compared to the previous quarter. The continuous strengthening of U.S. dollar in the financial market provided the main contribution to this performance. Owning to the lack of inflationary pressures in eruo area trading partners and the increase of annual inflation in Albania, the Albanian lek depreciated only by 1.6% in real annual terms. In line with the above developments, the exchange market pressure index[50] was up, albeit standing below its historical average.

Chart 35 Annual change in NEER, Exchange Market Pressure Index and bilateral exchange rate

Source: Bank of Albania.

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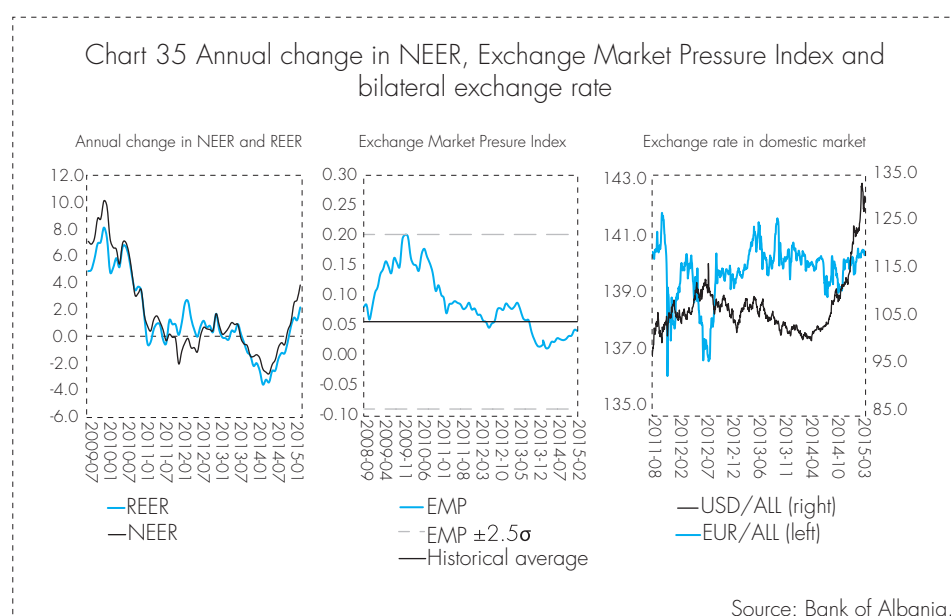
[49] Nominal Effective Exchange Rate is measured against the currencies of Albania's five main trading partners, namely Italy, Greece, Germany, Turkey and China. An increase in NEER implies the lek's depreciation.

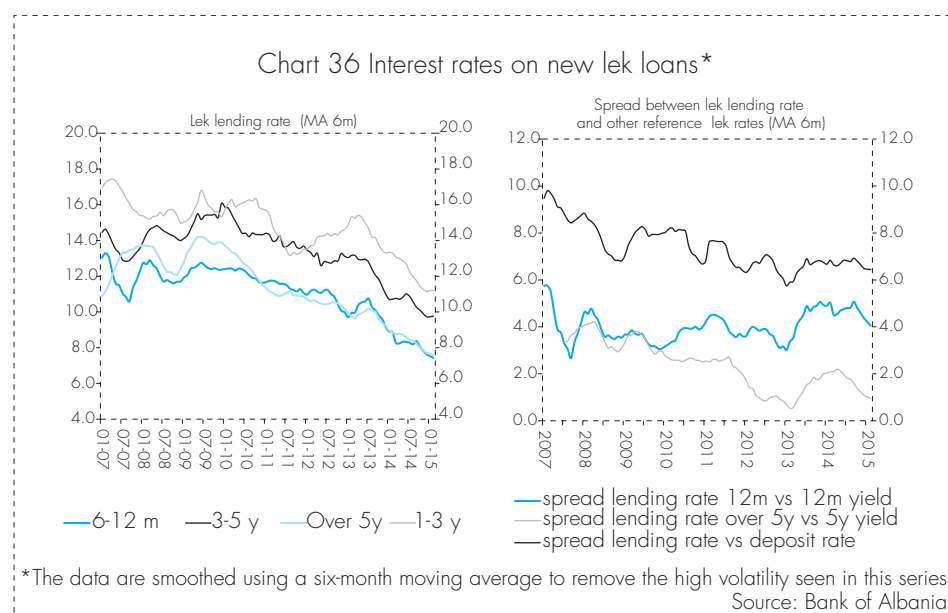[50] Exchange Market Pressure Index is calculated as a linear combination of annual change in foreign exchange reserve, and NEER Index in percent and the differential index of ALL deposits interest rates against USD and Euro deposits in line with the shares they have in the balance sheets of the commercial banks. Shares in this index are calculated as reverse distribution of monthly series of each component.

In 2015 Q1, the average EUR/ALL exchange rate stood at ALL 140.2, implying an appreciation of 0.1% in annual terms and a depreciation of 0.4% in quarterly terms. EUR/ALL exchange rate fluctuated within a narrowed band during this quarter, of ALL 139.6-140.6, being traded at higher rates in February and March. In this period, the demand for foreign currency increased, driven by both public and private agents of the market. In front of this dynamic, foreign currency supply showed more weak.

In line with the developments in international exchange markets[51], for the eighth successive quarter, U.S. dollar continued to appreciate notably against the domestic currency, both in annual (21.6%) and quarterly terms (11.4%). In this period, one U.S. dollar averaged ALL 124.6, recording a new historical value of the past 12 years.

Deposit interest rates and terms of financing[52]
Interest rates on lek deposits increased slightly in January - February. The interest rate on lek deposits averaged 1.56% in February, from 1.48% in December. The increase in interest rates on lek deposits extended across all main maturities. Interest rates applied on euro deposits continued to fall, reaching at minimum levels, comparable to Euribor interest rates. In February, interest rates applied on euro deposits averaged 0.33%, from 0.47% in December 2014. The spread between time deposits in lek and time deposits in euro expanded, thus constituting a sustainable factor to the domestic currency.

Chart 36 Interest rates on new lek loans*

*The data are smoothed using a six-month moving average to remove the high volatility seen in this series.
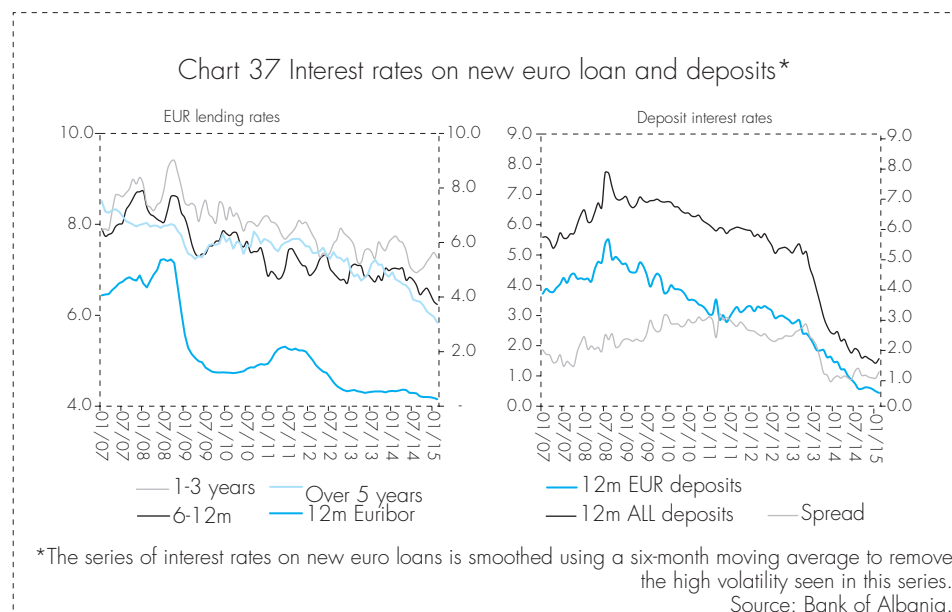Source: Bank of Albania.

Interest rates applied to new lek loans increased in January, while they decreased again in February, but without falling at the rates of December. The weighted average interest rate for this segment was 8.02% in February, from 7.75% in December. Commonly, first quarter is characterised by a more sluggish lending

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[51] In March, according to Nominal Index published by FED, U.S. dollar appreciated against the other main currencies basket, by 18% since August 2014.
[52] The latest official data on new deposit and loan rates are as of February 2015.

activity compared to the previous quarter. That is reflected in the increase of loan interest rates. The lending activity survey for the first quarter shows the tightening of lending standards. Banks reported tight lending standards owing to the financial situation of businesses and households, or specific problems facing the business sector environment. The accommodative monetary policy supported the easing of lending standards. Banks' expectations for 2015 Q2 are for a decrease of interest rates applied on lek loans.

Chart 37 Interest rates on new euro loan and deposits*

EUR lending rates

Deposit interest rates

- 1-3 years
- 6-12m
- Over 5 years
- 12m Euribor

- 12m EUR deposits
- 12m ALL deposits
- Spread

*The series of interest rates on new euro loans is smoothed using a six-month moving average to remove the high volatility seen in this series.
Source: Bank of Albania.

At the beginning of this year, the increase of interest rates was more pronounced for consumer loan and for the loan granted for liquidity to businesses. Interest applied to long-term loans, granted for real estate to households and business, continued to decline. The falling trend of interests applied to lek loans was reflected in narrowed spreads from reference indices - yields- and the interest rates applied to Euro loans, fluctuating around 6.3% in January - February, from 6.4% in the previous quarter. Banks applied lower interest rates to loans granted to households, while they resist cutting them for the loans granted to businesses.

BOX 4 SUMMARY OF BANK LENDING SURVEY RESULTS

Bank lending survey results in 2015 Q1 showed tightening of lending standards applied by banks to businesses and households.

Lending standards applied to businesses were tightened for the second successive quarter, mainly due to the tightening of lending standards applied to large enterprises. Concerning households, banks reported a slight tightening of standards for both, home purchase and consumer loan.

The performance of bank lending standards was negatively affected by factors relating to the financial situation of households and businesses, non-performing loans and specific problems facing the business sector environment. Competition in the banking system and Bank of Albania's policies drove the easing of lending standards.
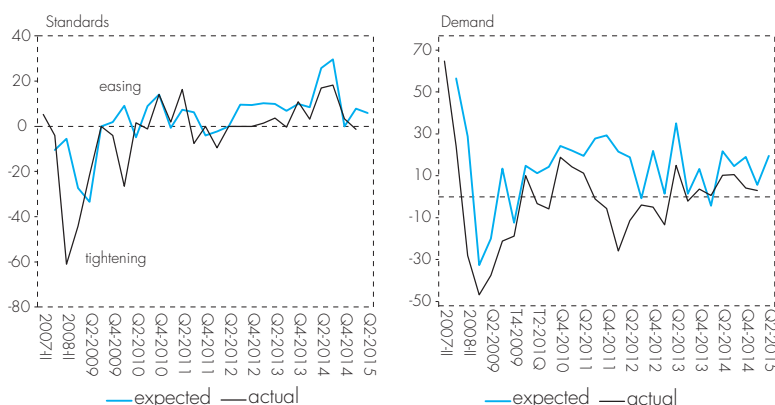
Chart 38 Businesses' lending standards and demand for loans (net balance)
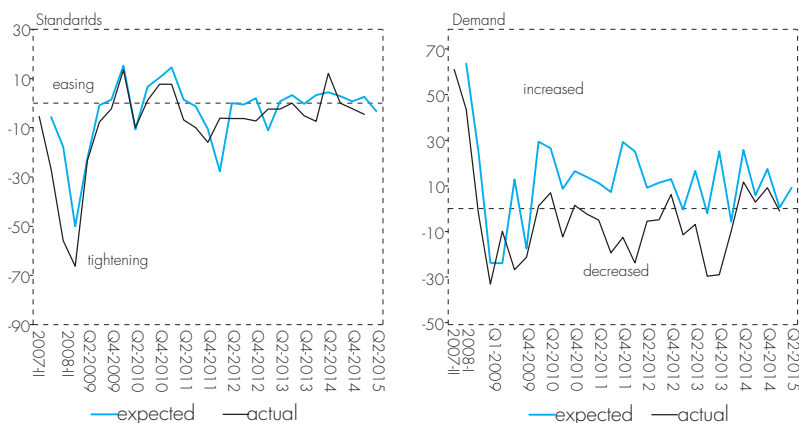
Source: Bank Lending Survey, Bank of Albania.

The main terms and conditions that banks used to apply the tightening policy on businesses were by widening the margin on risky loans, and reducing the size of loan.

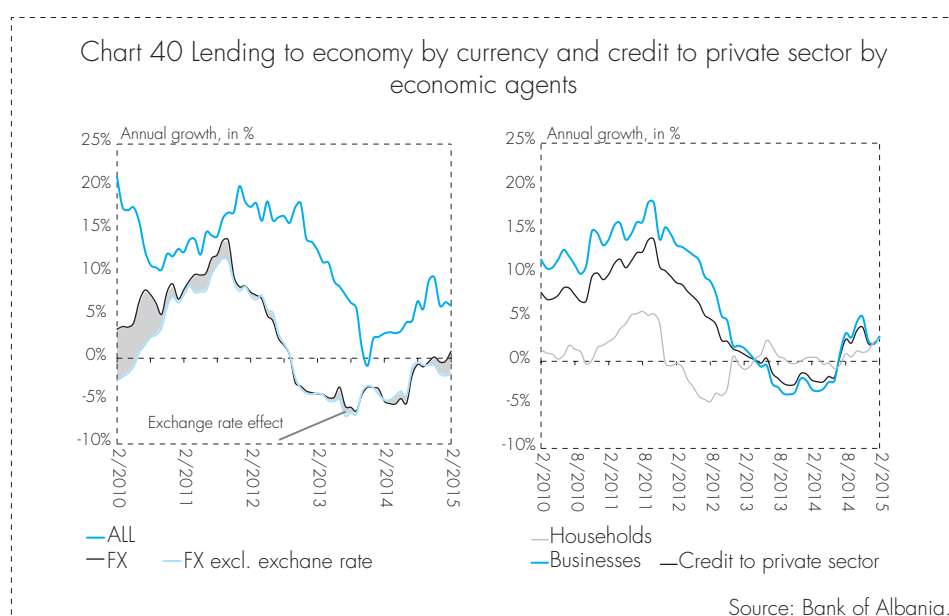Chart 39 Households' lending standards and demand for loans (net balance)

Source: Bank Lending Survey, Bank of Albania.

Demand for loan, during the first quarter of 2015, was assessed down for businesses and at a lower increase compared to the previous quarter for households. Related to business, mainly small and medium-sized enterprises lowered the demand for loan. The slowdown of the demand for loan from households reflects the slowdown of the demand for consumer loan. Banks' experts expect an easing of lending standards applied to households, but a tightening of these standards applied to businesses. On the other hand, businesses and households are expected to increase the demand for loan.

4.2 LENDING [53]

Lending to the economy was weak in the first two months of 2015. Monthly flows were negative and annual growth maintained the level of the end of previous year. The slowdown of lending to businesses drove to these developments. Lending to households showed recovery signals. The increase in lending in lek and the shrinkage of lending in foreign currency was a positive and stable development, driving to an increased influence of the monetary policy decision-making in economy.
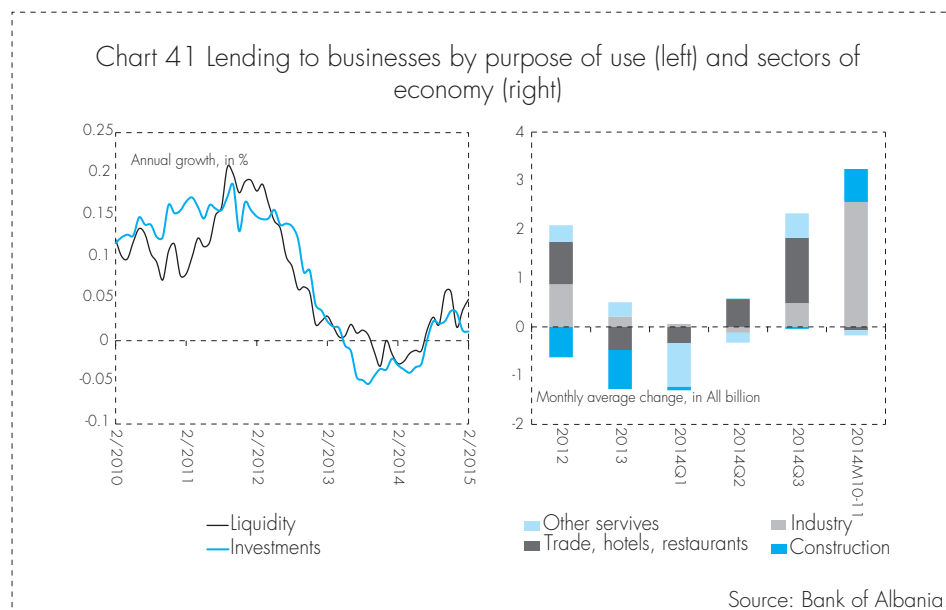
In a more extended point of view, the stable recovery of lending is contained by economic agents' risk aversion. This attitude is reflected through a still conservative approach of banks to lending, particularly for businesses, and an anaemic credit demand.

Chart 40 Lending to economy by currency and credit to private sector by economic agents

Source: Bank of Albania.

Lending to economy shrank by around ALL 3.3 billion in January and February, by maintaining the approach concluded at the beginning of the past two years. In February, the annual nominal growth of credit stood at 3%. Annual credit growth, excluding the exchange rate effect, stood close to the levels noted at the end of last year[54]. Lending in lek continued to grow, and its rates in January and February averaged 6.3%. On the other hand, the annual contraction of lending in foreign currency deepened further in January and February, averagely 1.9%, excluding the exchange rate effect.

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[53] For a detailed analysis on lending activity, see: "Tendencies in lending - 2015 Q1" on www.bankofalbania.org.

[54] The effect of exchange rate on credit performance was particularly considerable in February. Credit, excluding the exchange rate effect, contracted by around ALL 7 billion in January and February. Annual growth rate of credit averaged 1.4% in January and February, equal to December 2014.

Chart 41 Lending to businesses by purpose of use (left) and sectors of economy (right)

Source: Bank of Albania.

Lending to businesses, the main driver of the growth of lending to the private sector in the previous year, appeared sluggish during the two first months of 2015. It registered a negative flow in almost all its segments, mostly in the loan for investments in foreign currency. Annual growth of lending to businesses stood at 2.8% in February, higher than at end of 2014. However, excluding the exchange rate effect, it slowed down in January and February[55]. Conservative approach of banks and the weak financing demand were more notable for businesses than households, particularly in investment loans. Annual growth of investment loans slowed down at 1.1%. Liquidity loans performed better, increasing annually 5.0%. By sectors of economy, the negative flow in these two months was concentrated in construction, trade, hotels and restaurants.

Chart 42 Lending to households by purpose of use
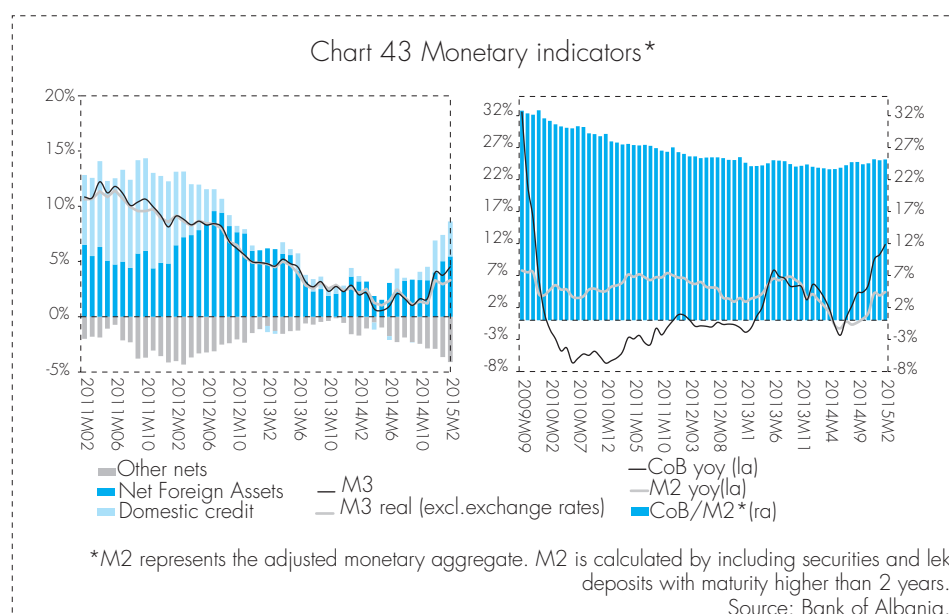

Source: Bank of Albania.

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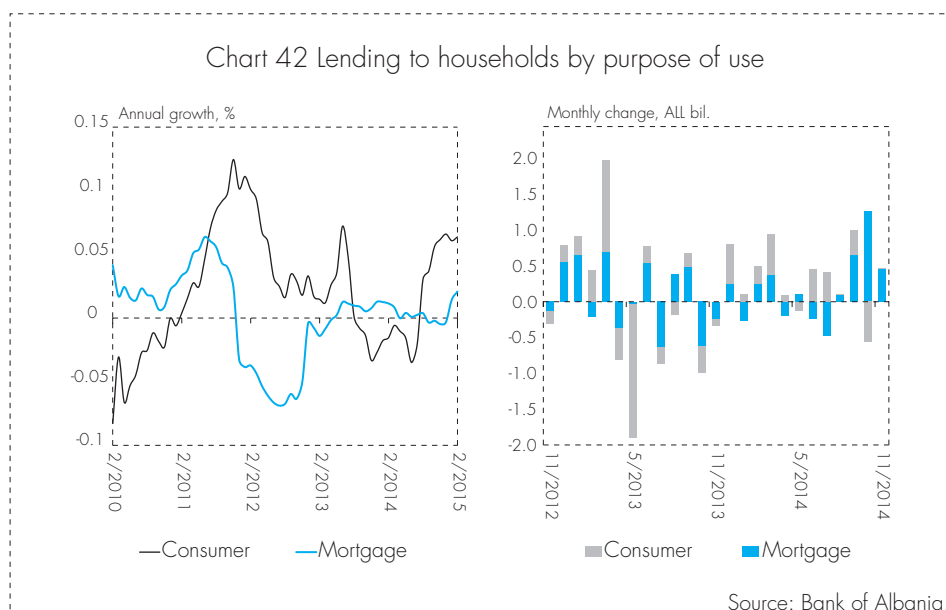
[55] Lending to businesses, excluding the exchange rate effect, shrank by about ALL 7.8 billion during January and February. Its annual growth slowed down to 0.6 in February, from 1.2% in December 2014.

Lending to households performed well in January and February, by strengthening the recovery signals noted at the end of 2014. Bank financing to households grew by about ALL one billion, and its annual growth improved to 2.6%, from 1.2% in December 2014. These developments show a reaction of households' demand for loan to the gradual easing of lending standards applied to this segment in the last two years. Mortgage loan recorded positive flow in these two months. It returned to the positive rates of annual growth, pointing at 2.1% in February. Consumer loan shrank in these two months, but it continued to grew at annual rates comparable to those of the last quarter in previous year, averaging 6.2%.

4.3 MONETARY INDICATORS

Annual growth of monetary aggregates was slightly higher compared to the end of 2014. M3 broad money aggregate grew by 4.5% in February. On asset side, the increase of foreign currency component (5.7 percentage points) supported the growth of M3 aggregate. Also, Lek depreciation against the two main currencies, provided positive impact to the growth of M3 aggregate. Annual growth of M3 aggregate, excluding the exchange rate fluctuations, showed at the same rate with December 2014[56]. Government's demand was high and financed by both, banks and households. This performance exerted pressures on the interest rates in the primary market as well. The demand of private sector for financing was weak and its contribution to the creation of money of 1.4 percentage points stood at lower rates, compared to 2014 Q4.

Chart 43 Monetary indicators*

Other nets
Net Foreign Assets
Domestic credit
— M3
— M3 real (excl.exchange rates)
—CoB yoy (la)
—M2 yoy(la)
CoB/M2*(ra)

*M2 represents the adjusted monetary aggregate. M2 is calculated by including securities and lek deposits with maturity higher than 2 years.
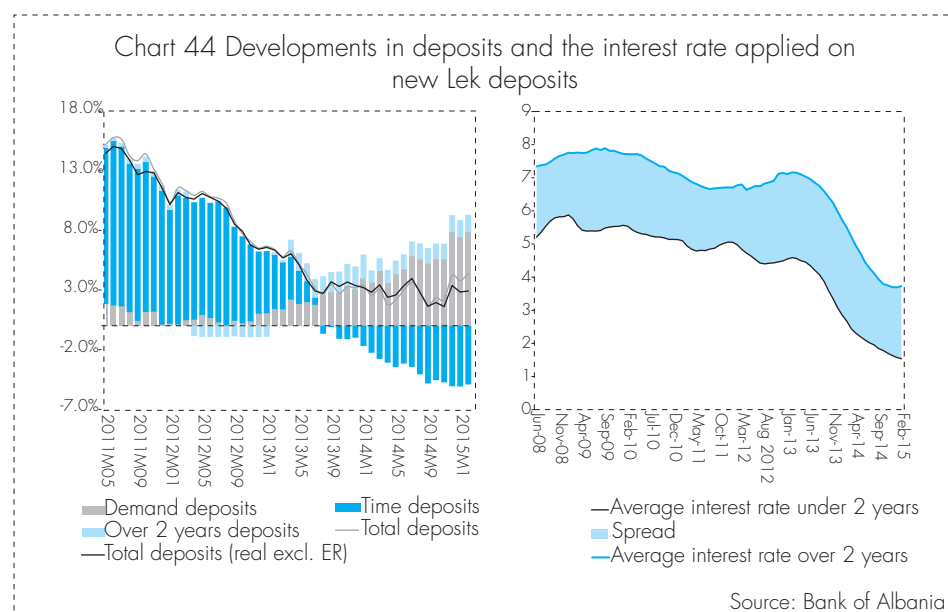Source: Bank of Albania.

M2 aggregate in lek maintained the annual increasing pace of 4.4%, affected mostly by its liquid component. The ratio of currency outside banks to M2 grew

[56] Adjusted for the purpose of exchange rate effect, the M3 growth was 3.3% in February, as in December 2014.

at 30.3%, supported by the increase of Currency outside Banks (11.9% y-o-y) and the shift of lek savings to non-liquid instruments, which are not included in M2. Considering this shift, the currency outside ratio to M2 aggregate is estimated as stable, at the four last years level.

Time deposits with a maturity of less than two years, increased by 3% from a year earlier, by reflecting the growth of households' deposits and demand deposits. Notwithstanding the positive developments in annual terms, their monthly performance in the first two months of the year was weak. These deposits were reduced by ALL 2.5 billion from December, shifting to time deposits with a maturity of above two years. Total deposits of the system improved in annual terms, to 4.4%.

Annual growth of lek deposits stood at 1.5% in February, from 2.1% in December. The Albanian Lek deposits, after the rapid growth in December, shrank in the two first months of 2015, due to the withdrawal of deposits from businesses and state-owned enterprises. Households' deposits increased slightly. By time structure, these deposits continued to shift from time deposits to demand deposits and deposits with maturity above two years. The shift to time deposits with maturity above two years was more notable for lek deposits compared to foreign currency deposits. This fact is supported by the spread of interests rates for these instruments.

Chart 44 Developments in deposits and the interest rate applied on new Lek deposits

Demand deposits
Over 2 years deposits
Total deposits (real excl. ER)
Time deposits
Total deposits
Average interest rate under 2 years
Spread
Average interest rate over 2 years

Source: Bank of Albania.

Adjusted from the fluctuations in the exchange rate, the annual growth of foreign currency deposits slowed down at 1.4%, from 1.9% in December 2014. Developments in foreign currency deposits were attributable to the low creation of money in foreign currency and the low interest rates applied for Euro and U.S. dollar.