

Bank of Albania

# QUARTERLY MONETARY POLICY REPORT

November 2015

Data from this publication may be used, provided the source is acknowledged.

Published by:

Bank of Albania, Sheshi "Skënderbej", Nr.1, Tirana, Albania

Tel.: + 355 4 2419301/2/3; + 355 4 2419401/2/3

Fax: + 355 4 2419408

E-mail: [public@bankofalbania.org](mailto:public@bankofalbania.org)

[www.bankofalbania.org](http://www.bankofalbania.org)

Printed in: 270 copies

# C O N T E N T S

1.	OBJECTIVE	7
2.	FOREWORD BY THE GOVERNOR	8
3.	PRICE STABILITY AND BANK OF ALBANIA'S MONETARY POLICY	11
4.	FINANCIAL MARKETS AND MONETARY INDICATORS	14
4.1.	Financial Market Developments	14
4.2.	Interest rates on deposits and financing conditions in the economy	17
4.3.	Lending to the economy	20
4.4.	Monetary Indicators	25
5.	INFLATION AND ECONOMIC GROWTH	28
5.1.	External economic environment	28
5.2.	Gross Domestic Product and aggregate demand	33
5.3.	Cyclical economic situation	50
5.4.	Inflation performance	50

B O X E S

Box 1	Bank Lending Survey 2015 Q3	19
Box 2	Cleaning the balance sheet	21
Box 3	Measures to boost lending	23
Box 4	House market prices	37
Box 5	Measuring the economic uncertainty and the relation to consumption and investments	42
Box 6	Balance of Payments Developments in 2015 Q2.	48

T A B L E S

4. Financial markets and monetary indicators		14
Table 1.	Annual credit change by economic agents, currency and purpose (in %)	21
5. Inflation and economic growth		
Table 2.	Selected macroeconomic indicators	29
Table 3.	Economic figures for countries in the region	30
Table 4.	Balance of payments indicator.	49
Table 5.	Main categories contribution in annual inflation (in percentage points).	51

# C H A R T S

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

Chart 1. Interest rates in the economy.	12
Chart 2. Inflation, key rate and target (left). Output gap and core inflation (right).	12

## 4. Financial markets and monetary indicators

Chart 3. Bank of Albania open market operations (left) and interbank rates (right).	15
Chart 4. Yields on public debt securities in the primary market.	15
Chart 5. Annual changes of the nominal and real exchange rate index, EUR/ALL and USD/ALL.	16
Chart 6. New deposit interest rates	17
Chart 7. Interest rates on new loans	18
Chart 8. Standards and demand for business loans.	19
Chart 9. Standards and demand for households loans.	19
Chart 10. Credit by economic agent and currency	22
Chart 11. Lending by purpose of use	23
Chart 12. Monetary Indicators	26
Chart 13. Deposits	26

## 5. Inflation and economic growth

Chart 14. Composite output index and quarterly GDP (left) and business and consumer confidence indicators and economic sentiment (right)	29
Chart 15. Annual changes in commodity prices	31
Chart 16. Key interest rates of selected central banks	32
Chart 17. Selected financial indicators in international markets	32
Chart 18. Annual and quarterly GDP.	33
Chart 19. Gross Domestic Product by output and confidence indicators	34
Chart 20. Contribution by branch to value added in industry and capacity utilisation rate	35
Chart 21. Valued added and capacity utilisation rate in construction	36
Chart 22. House Price Index and Price-to-rent index	37
Chart 23. Indicator from construction confidence survey (left) and lending survey (right)	37
Chart 24. Contributions by branches and capacity utilisation rate in services.	38
Chart 25. The structure of aggregate demand (contributions in annual change of GDP) and ESI (long-term average = 100)	39
Chart 26. Private consumption and confidence in the trade sector	40
Chart 27. Indirect indicators on private consumer spending in Q3.	40
Chart 28. Gross fixed capital formation, annual change	41
Chart 29. Short-term indicators of private investments in Q2 and Q3	41
Chart 30. Economic Uncertainty Indicator (EUI) of businesses and annual growth of investments, left chart and TPE of consumers and annual growth - private consumption, right chart	43
Chart 31. EUI of businesses and annual growth of investments, left chart and EUI of consumers and annual growth - private consumption, right chart	43
Chart 32. Orientation of the fiscal policy, proxied by the change of the primary deficit.	44
Chart 33. Annual change of expenditure's total and the major items (left) Contribution of the major components of expenditure on total expenditure (right)	45
Chart 34. Annual change of the main items of revenue (left), and annual revenue change by the main items contributions (right).	46
Chart 35. The cumulative deficit / GDP (left) and its financing instruments, in ALL billion (right).	46
Chart 36. The contribution of net exports in the aggregate demand (in percentage points).	47
Chart 37. Orientation of imports and exports by category (in ALL million)	47
Chart 38. Cyclical economic indicators	50
Chart 39. Contributions by categories of food and non-food in total annual inflation.	51
Chart 40. Long-term trends of inflation (left) and short-term inflation (right).	52
Chart 41. Hammered annual average changes in productivity, labour costs and production	52
Chart 42. IPI and its components' contributions (left); imported and domestic inflation contribution in the annual total.	53
Chart 43. Inflationary expectations of various economic agents.	54



## 1. OBJECTIVE

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

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

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

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

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

*The Monetary Policy Report for the third quarter of 2015 was adopted by the Supervisory Council Decision No. 79, dated 04.11.2015. The economic, financial and monetary analysis in this report is based on the latest data available as at 23 October 2015.*

## 2. FOREWORD BY THE GOVERNOR

The Albanian economy continues in the positive trajectory. However, aggregate demand, output and employment stand below their potential and medium-term pressures on inflation remain weak.

New economic and financial information has been in line with our projections, but economic growth and credit performance resulted on their down side. The external environment appears still challenging and domestic resources for economic growth appear as not yet consolidated. Moreover, the rapid rise in inflation over the recent months seems to be largely due to the short-term supply-side shocks.

The expected monetary and economic developments maintain a similar profile to that in our previous forecasts. In the medium-term horizon, the Bank of Albania expect inflation to return gradually to target, corroborated by the progressive improvement of economic growth. However, unlike previous forecasts, current projections suggest that the return of the economy to equilibrium and of inflation to target will require a somewhat longer time. Also, these projections suggest the need for stepping up the monetary stimulus in the economy, to bolster further domestic demand and strengthen further the credit channel.

In accordance with these projections, considering this report, the Supervisory Council of the Bank of Albania lowered the key interest rate, by 0.25 percentage points, down to 1.75%.

***Inflation is expected to rise progressively in the medium-term horizon.***

In the third quarter, inflation averaged 1.8%. This rate was similar to that of the previous quarter, but inflation recorded significant fluctuations during the period. For the most part, these fluctuations were triggered by food prices.

The slow rise in inflation reflects unutilised production capacities, the downward trend of international prices, and moderate inflation expectations. Therefore, core inflation remains at low levels.

The analysis of available information suggests that, in the short term, low inflationary pressures will persist. Average inflation is expected to range around 2% for 2015, and 2.2% for 2016. In the medium term, inflation is expected to rise and return to Bank of Albania's 3% target, by the first quarter of 2018.



***The gradual recovery of the economy will be the main factor contributing to the return of inflation to target.***

Economic activity registered 2.5% in the second quarter, being close to our forecasts. Economic growth was driven by investments and improvement in the balance of trade exchanges with abroad. Conversely, private consumption fell, due to households' stronger inclination to save. Available data suggest that the Albanian economy will register similar growth rates in the second half of 2015. Economic activity in this period will expand driven mostly by the growth in investments and improvements in the trade balance.

The Albanian economy is expected to further improve in the medium term. Economic activity is expected to accelerate driven by the easing of financing standards, reduction of uncertainties, and improvement of the external economy. Economic growth will be financed by the use of accumulated private sector savings and foreign capital inflows. Also, the economic activity will expand due to the increasing support with bank loans in the second half of the forecast horizon.

***A new monetary impulse will support better consumption, investments and lending.***

Financial markets are liquid and their activity is steady. The banking system was able to weather well the challenges arising from the financial turbulence in Greece. However, financial agents continue to show low risk appetite and willingness to finance long-term projects.

The accommodative monetary policy implemented by the Bank of Albania has driven the interest rates on loans to the historic minimum and boosted credit demand. In response, the lek credit portfolio continued to show positive performance; the annual growth rate of this portfolio stood at 5.2% in August, and its share in total loans rose to 41%.

Lending, however, remains sluggish, especially as regards business loans and foreign currency loans. The annual growth of the credit portfolio reduced to around 1% in August. The reduction was dictated by the low business demand for financing and tightened conditions of banks supply for loans. Moreover, the payment of arrears by the public sector has offered an alternative source of liquidity and financing for businesses, introducing an additional temporary effect on the decline of credit demand.

The analyses and forecasts in this report illustrate the need for stepping up the monetary stimulus in the economy and maintaining it for a longer time than our previous assessments. Based on these considerations, the Bank of Albania deems that the monetary policy stance will remain accommodative throughout 2016. Also, the swift implementation of the agreed plan of measures for preventing and resolving non-performing loans is a major priority for reducing the perceived credit risk in Albania.

***Steady and long-term economic growth should be sustained by the continuation and deepening of structural reforms.***

The Bank of Albania deems that the monetary stimulus provides the time necessary for conducting structural reforms and mitigates the costs of the reforms on the economy. However, it may not provide for long-term economic growth and should not be considered as a substitute for the reforms.

Therefore, the Bank of Albania iterates the need for continuing and accelerating structural reforms. These reforms should aim at sustainably improving the business climate, boosting the productivity and competitiveness of the Albanian economy, promoting domestic and foreign investments, and enhancing the economic and financial stability in Albania.

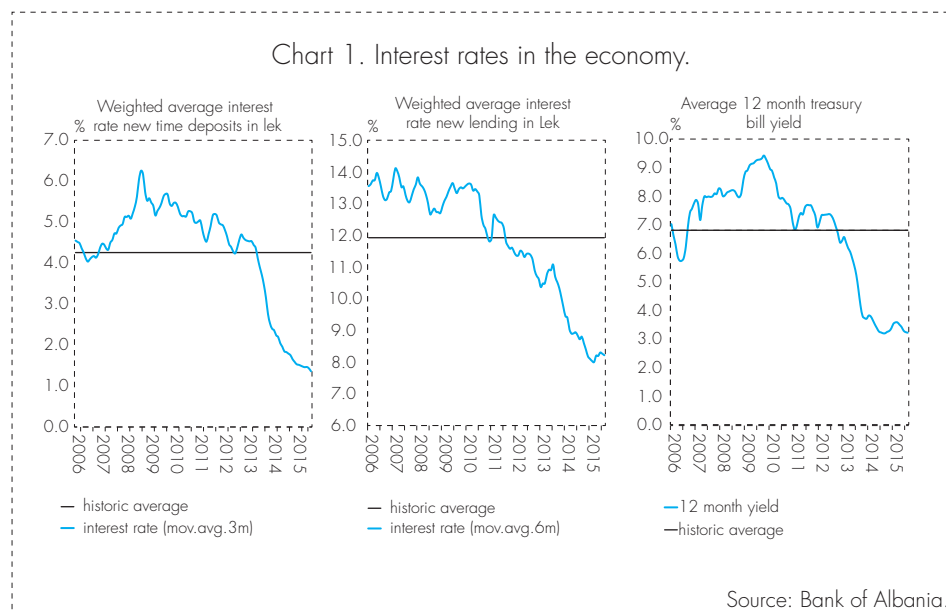
### 3. PRICE STABILITY AND BANK OF ALBANIA'S MONETARY POLICY

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

*The return of economic activity to its potential parameters would create the right conditions for the sustainable return of inflation to target. Achieving these objectives requires a stimulating monetary policy stance for some quarters ahead.*

The monetary policy remained accommodative, in accordance with the commitment of the Bank of Albania to maintain low interest rates for some quarters. Following the last cut in January, the key interest rate stood at the 2.0% minimum historic level. During this period, the Bank of Albania has continued to inject liquidity in the market through refinancing operations in the banking system, providing another channel for easing monetary conditions. To strengthen the accommodative monetary policy stance, the Bank of Albania has constantly communicated its commitment for maintaining the key rate at low levels, until the sustainable return of inflation to target. This form of communication has helped reduce uncertainties in the economy and better transmit the monetary policy to financial markets.

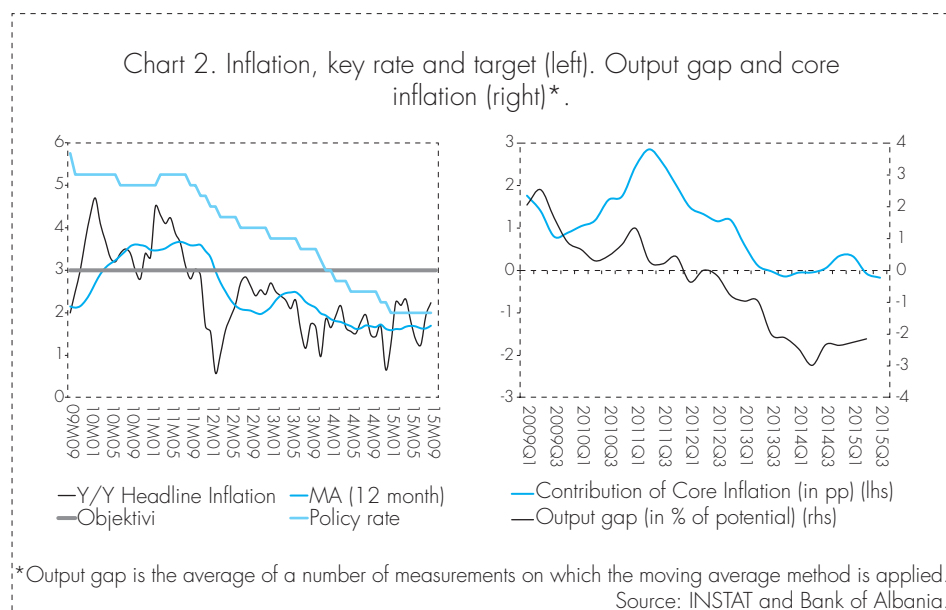
The monetary policy was reflected in financial markets albeit perceived risk premiums remain high and the appetite for loans remains low. The monetary policy easing has been followed by the fall to all-time low levels of borrowing interest rates in the national currency. In response, lek lending continues to grow, whereas the portfolio of foreign currency lending has been downward. In addition, yields on government securities are at minimum historic rates, facilitating the public and private debt servicing. Lastly, interest rates on deposits stand at their lowest levels, encouraging thus the growth in private consumption.



While costs of financing in the economy are favourable, the credit growth appears sluggish and the Albanian businesses and consumers have not been willing or able to avail themselves of these rates. This situation is dictated by risk premiums perceived by economic and financial agents at home, still problematic developments in Albania's main trading partners, and still conservative policies by the European banking system.

Economic activity at home continues to operate below its potential and domestic long-term inflationary pressures are weak. On the other hand, global markets are characterised by moderate inflation rates for raw materials and finished goods.

In Q3, inflation averaged 1.8%, almost unchanged from the previous quarter and in line with Bank of Albania's forecast. It saw an apparent fall in July, to



return to higher rates during August-September. Inflation fluctuated due to short-term supply-side factors, related mainly to food prices volatility. In the presence of a sluggish and below potential economic activity, core inflation remains low.

The Albanian economy grew 2.5% in Q2, driven by the rise in investments and improvement of the balance of trade with trading partners. Economic growth, during the period, resulted on the down side of our forecasts, illustrating the fragile aggregate demand and economic growth.

Latest economic and financial developments have not changed significantly the direction, dynamics and intensity of the expected developments. Economic growth is expected to gain strength in 2016 and beyond. Its composition is expected to be more balanced, sustained by both domestic and foreign demand. Domestic demand is expected to benefit from the low interest rates, the improvement of financing conditions, the reduction of uncertainties and the increase in the propensity for consumption. The growth in the domestic private demand is expected to generate adequate economic activity to absorb the spare production capacities, despite the consolidating fiscal policy and many uncertainties about economic growth in trading partners. The negative output gap is expected to gradually close in the following year, shifting to positive direction by the beginning of 2017.

However, the still sluggish performance of the economy and of the financial markets in Europe, uncertainties of economic agents at home and persisting problems characterising credit growth have led to a slight downward revision of expected economic pace for 2016. Consequently, our projections for the return of the economy to equilibrium and of the inflation to target have been prolonged slightly in time.

Compared to our projections in the previous quarter, in the new projections, the negative output gap will be closed later, as a result of expectations for slower economic growth over 2016 H1. The slower cyclical improvement of the economic is assessed to be accompanied with the return of inflation to target at the beginning of 2018. In the short-term horizon of four quarters ahead, inflation is expected to average around 2.3%.

The above projections are conditioned by and take into account a higher monetary stimulus in the economy in the short-term period. Moreover, the return of the economy to equilibrium and of the inflation to target will require maintaining a stimulating monetary policy throughout the medium-term forecast horizon. The intensity of the monetary stimulus will not weaken during 2016. Based on the available information, the Bank of Albania deems that the upward cycle of interest rates will not start before 2017.

## 4. FINANCIAL MARKETS AND MONETARY INDICATORS

*The financial markets continue to be characterised by a good liquidity situation. Developments in Greece did not cause shocks or consequences in the Albanian financial market, whereas interest rates in the market fell further in response to the accommodative monetary policy. The exchange rate has been overall stable, seeing an appreciation trend in September.*

*During July-August, lending was sluggish, albeit the easing of financing conditions. Lending continued to be affected by both low credit demand and banks' conservative lending policies. The expansion of monetary assets remains low and does not signal for high inflationary pressures in short and medium terms. The Bank of Albania expects a similar situation to continue in the rest of the year.*

*On the other hand, interest rates are expected to remain at low historic level, supporting credit demand. Moreover, the expected improvement of the financing conditions in response to the reduction of the perceived credit risk will boost banks' willingness to lend. Lending is expected to result weak until the end of 2015. It is expected to recover during 2016 and beyond, and better sustain the improvement of economic activity in the medium term.*

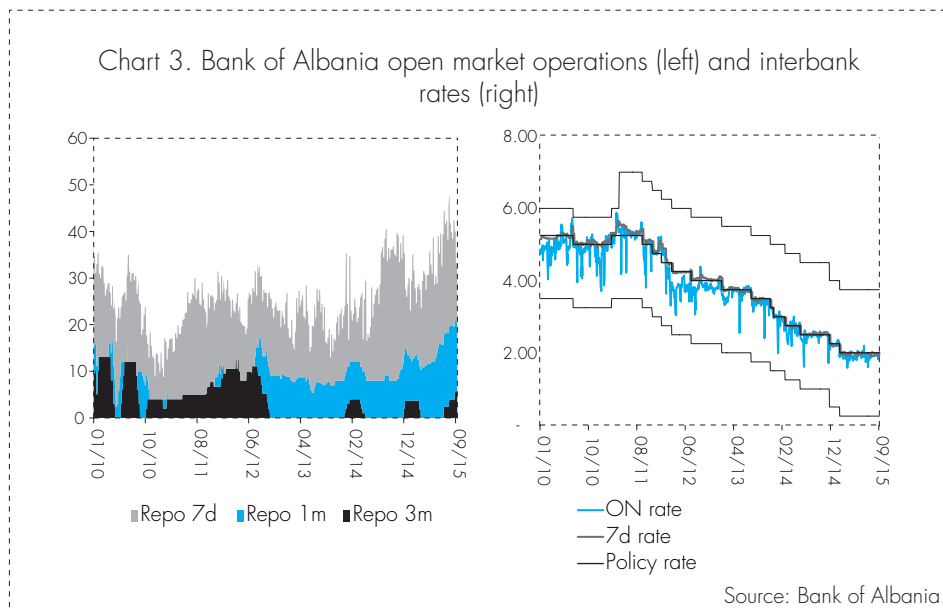
### 4.1. FINANCIAL MARKET DEVELOPMENTS

#### *Interbank Market*

The interbank rates remained unchanged from the previous quarter, whereas the traded volume fell slightly in the third quarter.<sup>1</sup> Banks maintained the short-term approach to this market, with transactions' maturity concentrated mainly in the one day and one week segments. Interest rates remained positioned below the key rate, whereas the volatility indicators did not show difference from the previous quarter.<sup>2</sup> The overnight 1.93% rate resulted almost the same as the one in Q2 (1.92%). For the one-week maturity, the interest fell by 0.04 percentage points, falling to the same value as that for the overnight rate. The Bank of Albania continued liquidity injection operations in the system, through the 1-week repo, and 1 and 3-month reverse repos. The amount injected in this period was higher than in the previous quarter. It reflected not only the banks' needs, but also Bank of Albania's policy to reduce the liquidity in the system, from the unclear situation in Greece during June-July.

<sup>1</sup> The total volume was ALL 6.8 billion from ALL 7.5 billion in Q2.

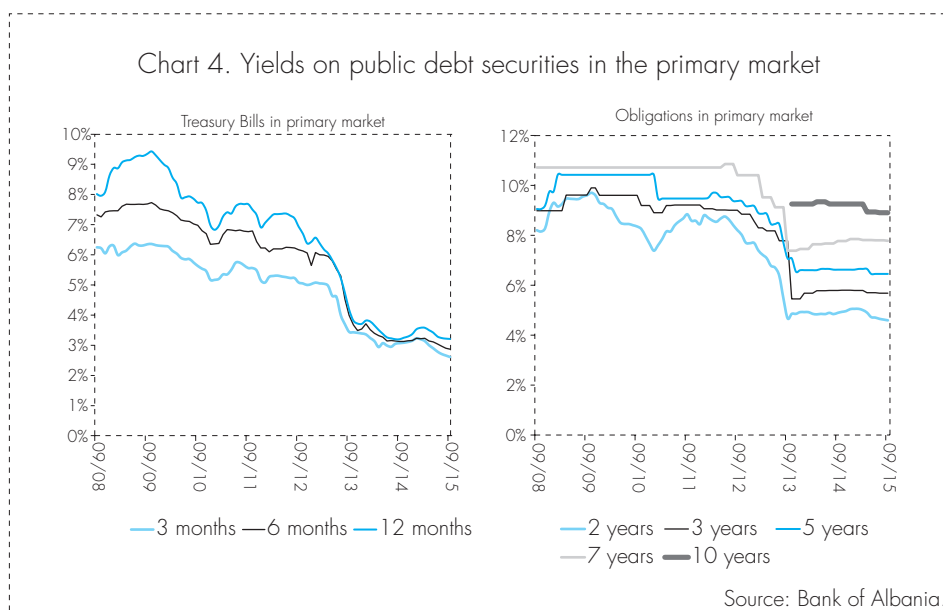
<sup>2</sup> In Q3, the standard deviation of the overnight interbank rate was 0.0841 from 0.0842 in Q2.



Notwithstanding the improvements in recent years, the interbank market continues to have a low share in banking system assets. Banks show low willingness to use this segment for trading and securing funds.<sup>3</sup>

### Primary Market

Except for the short-term segment, yields on government securities changed slightly from those in Q2. They remained steady due to the ample liquidity in the market, and the balance of between demand and supply for funds. At the same time, the participation in lek bond auctions was lower, whereas participation in euro instruments was higher<sup>4</sup>.



<sup>3</sup> The borrowing volume in the interbank market is calculated to be around 1.0% of total banking system assets.

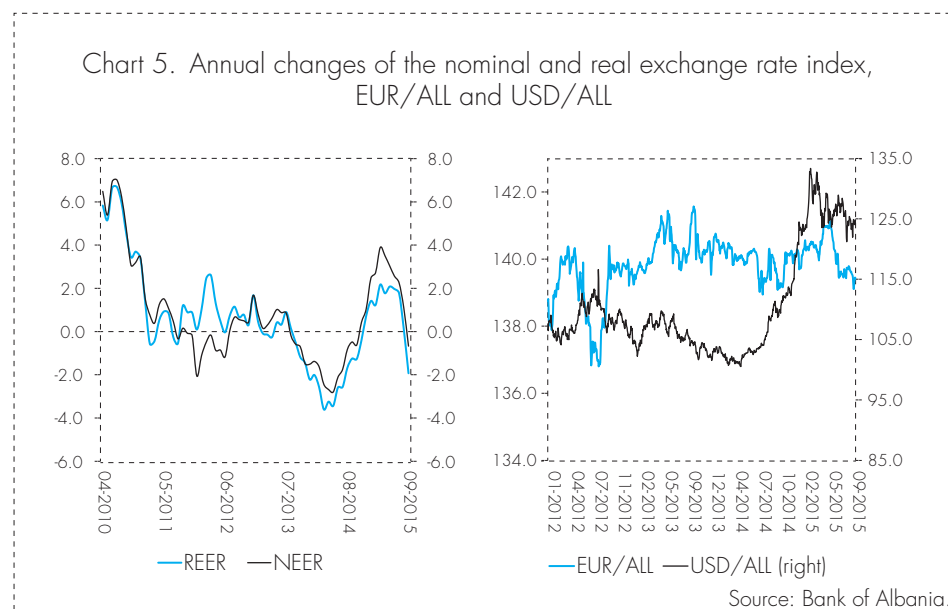
<sup>4</sup> In accordance with the calendar of issues, at the end of July, T-bills were issued in euro, and at the end of August, 2-year bonds were issued in euro.

Yields on 3 and 6-month T-bills continued to fall in Q3 (2.60% and 2.87% respectively in September auctions), driven down by lower issues for these maturities. The 12-month yields decelerated the fall and have been standing around 3.21% since mid-August. In bond auctions, the 10-year yield stood at 8.90% in July, from 8.93% in the previous auction in April. In August, the 5-year yield remained unchanged at 6.45%. The 2-year yield has declined gradually, settling at 4.59% at the end of September, or 11 basis points less from end of Q2. Also, auctions for variable rate bonds showed lower margins (5 and 10-year margins stood at 2.51% and 3.15%, down 2 and 3 basis points, respectively from previous auctions).

During the quarter, auctions for euro securities were also held, with demand being visibly higher for longer-term instruments. In July, the auction for the 12-month instruments was not met and the yield recorded 2.26% from 2.34% at the end of 2014. In August, an auction for the 2-year bond was organised; demand for it was almost double to the auctioned amount.<sup>5</sup> In September, this auction was reorganised, resulting again in over demand.

### Currency market

The national currency slowed down the depreciation trend in Q3. According to the Nominal Effective Exchange Rate (NEER)<sup>6</sup>, the Albanian lek depreciated slightly by 0.9% in annual terms. After the slowdown of depreciating trends in July and August, the national currency marked a turning point in September, appreciating 0.7%. The behaviour was conditioned by both the stability of EUR/ALL rate and the implied appreciation of the Albanian lek against the



<sup>5</sup> Households participation in this auction was considerable, accounting for around 43% of the granted amount.

<sup>6</sup> The NEER is measured against the currencies of Albania's five main trading partners, namely Italy, Greece, Germany, Turkey and China. An increase in NEER implies depreciation of the lek.

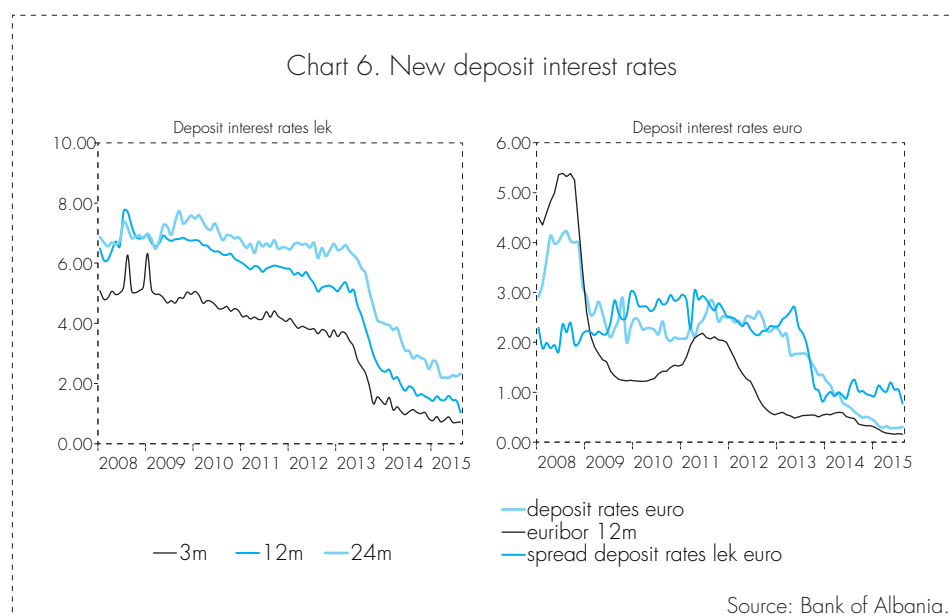


Turkish lira<sup>7</sup>. The appreciation of the Albanian lek in real terms resulted even higher than in nominal terms (1.9%, y-o-y). In almost all Albania's trading partners, inflation stood below the rates it registered in Albania.

The EUR/ALL exchange rate averaged 139.7 in Q3, or 0.1% than in the previous year. In quarterly terms, the lek appreciated modestly by 0.5%, reflecting the seasonality. The national currency continued to depreciate against the US dollar, although at more moderate rates, as a result also of the base effect. The depreciation in annual terms resulted 19.1%, while against Q2, the Albanian lek appreciated 1.2% against the US dollar.

#### 4.2. INTEREST RATES ON DEPOSITS AND FINANCING CONDITIONS IN THE ECONOMY<sup>8</sup>

The banking system's financing costs fell further during Q3. **Interest rates on lek deposits** fell in July-August. Interest rates on longer-term deposits (over one year) were volatile and trended slightly up in recent months. Conversely, interest rates on 1-12 month deposits, which account for the major share in term deposits, fell gradually month after month. Interest rates on euro deposits were volatile, but, in quarterly terms, they were unchanged from the previous period. The spread with those applied in euro area banks remained unchanged as well.

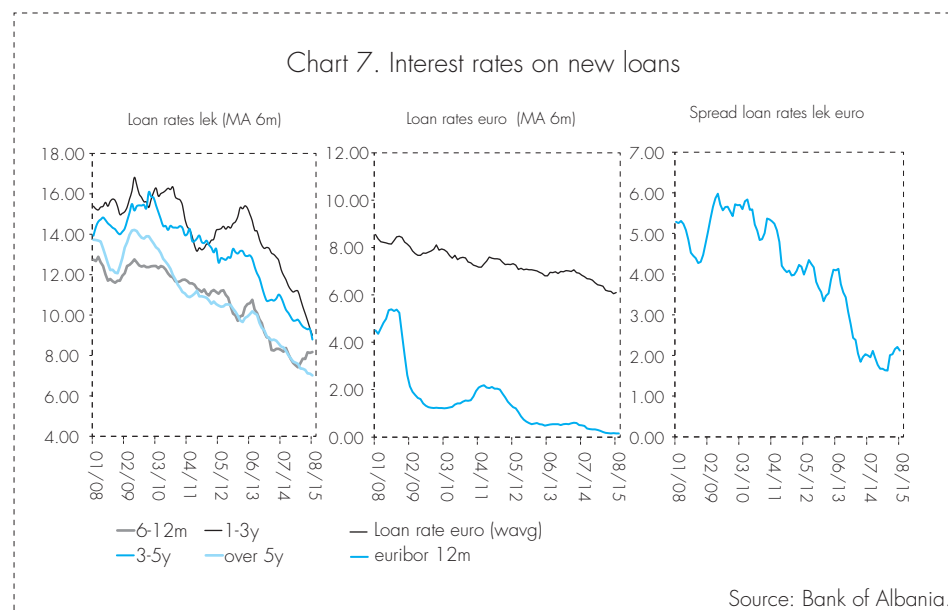


<sup>7</sup> When calculating TRY/ALL exchange rate, the official TRY/USD rate is used. The Turkish lira depreciated 32%, in annual terms, against the US dollar. Against the Albanian lek, it depreciated 14.6% on average. As a result, the Albanian lek appreciated 1.6% y-o-y against the Turkish lira, contributing to the performance of the national currency in nominal and real terms, despite the 10 share of our trade activity with Turkey.

<sup>8</sup> The latest official data related to interest rates on new loans and deposits are as of August 2015.

In parallel to the reduction of banking sector financing costs, the economy's financing cost has been downward. **Interest rates on lek loans** were volatile, but they confirmed the upward trend noted in previous months. The average weighted interest rate on new lek loans stood at 7.81% during July - August from 8.30% in 2015 H1. The lowering of interest rates on loans for investment and working capital contributed most to this performance. At the same time, interest rates on consumer credit fell, sustaining the growth of lending for this category. The reduction was driven by short and medium-term interest rates, whereas the long-term ones - over 5 years - were up compared to the previous quarter. New loans continue to be granted mainly for financing liquidity for businesses, and remains concentrated in a few banks.

Interest rates on euro loans rose, especially in August. Rates on new euro loans appeared volatile, being exposed to rates applied by certain banks and their share in the total. The average interest rate on euro loans stood at 6.20% in this period, from 5.97% in the previous quarter. The growth is dedicated mainly to the effect of a bank, while its exclusion from the analysis shows a more steady performance of interest rates. Interest margins on euro loans to euribor rates stood approximately at the same level in these months.



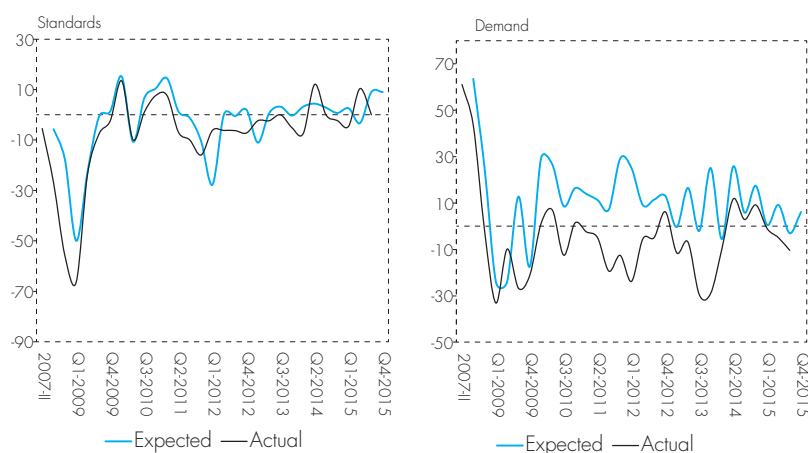
According to the bank lending survey, banks expect to apply lower interest rates in Q4, on both lek and euro loans, thus contributing to the easing of financing conditions.

### BOX 1 BANK LENDING SURVEY 2015 Q3

Standards of lending to businesses remained unchanged, whereas those to households continued the easing trend during Q3. For businesses, credit standards remained unchanged both for working capital and for investments purposes. For households, standards eased for both consumer loans and for house purchase loans.

Banks continue to be more optimistic for the loan to households, for Q4. Thus, they expect easing of standards, for both house purchase loan and for consumer loan and increase in demand. For businesses, banks expect eased standards, but at a slower pace than expectations for loans to households. Banks expect increased demand from small and medium-sized enterprises, but a decline in demand from larger enterprises.

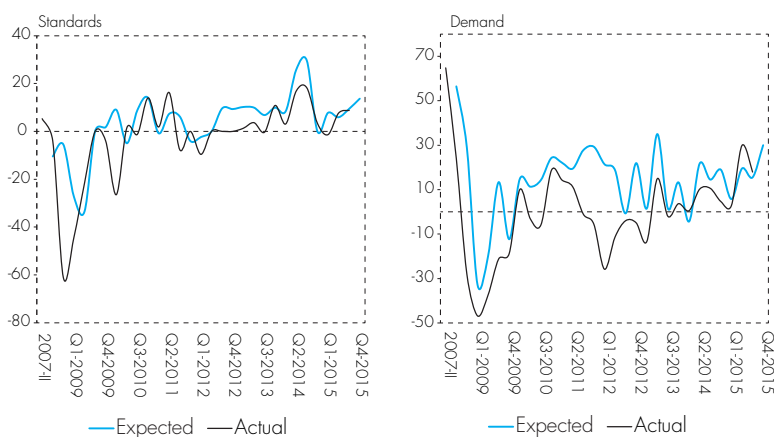
Chart 8. Standards and demand for business loans



Source: Bank of Albania.

The impact of different factors on lending standards was similar to the previous quarter. The main factors contributing to easing are the decisions of the Bank of Albania and the level of competition. Conversely, the NPL situation, the macroeconomic situation and financial position of households continued to contribute to the tightening of lending standards.

Chart 9. Standards and demand for households loans



Source: Bank of Albania.

*The main criterion with which banks applied an easing policy, for both businesses and households, was the narrowing of the average margin of credit. All the conditions on credit for households in Q3 contributed to the implementation of an easing lending policy. For businesses, the expansion of the margin for the risk loan and the lowering of maturity contributed to the tightening of standards.*

*Businesses loan demand continued the downward trend, whereas households loan demand marked lower rates in Q3. The latter has seen positive developments over the past two years.*

### 4.3. LENDING TO THE ECONOMY

Developments over the third quarter evidence a sluggish performance of lending in July and August, when the credit portfolio remained unchanged from June. Lending in summer is generally sluggish, but the weakness of credit noted during this period goes beyond the seasonal effect. The performance seems to be affected by both businesses weak demand for financing and tightened supply-side conditions. The incomplete utilisation of production capacities reduces demand for investments, whereas the use of alternative financing sources, mainly of businesses<sup>9</sup>, reduces the credit demand even further. From the supply side, the high credit risk and uncertainties for the future remain decelerating factors in banks' lending policies.

The following analysis of the credit portfolio is based on monetary data adjusted for loans off the balance sheet. The annual growth rate of lending to the private sector slowed down to 0.7% in August, against 2.4% it recorded in June. The slowdown reflected fully the reduction of the credit portfolio to businesses. The steady positive performance of credit to households continued during the period, driven by the higher demand for financing and ample offers from the banks for this segment.

<sup>9</sup> According to monetary data, during 2015 business deposits averaged ALL 25 billion higher than the average for 2009-2013. This performance is thought to have reflected the payment of government arrears.

## BOX 2 CLEANING THE BALANCE SHEET

The credit portfolio in 2015 was driven by the process of writing off from the balance sheet the loans categorised as loss for three or more years, pursuant to the Regulation of the Bank of Albania that entered into force in January of the current year\*. These loans have reduced the value of banks' loan portfolio in the balance sheet. Until August, due to this process, the loan portfolio was reduced to around ALL 13 billion. According to published data, the private sector credit in August 2015 stands significantly lower than the picture showed in the analysis. The following table presents a summary of published and analysed data, which exclude the effect of the written off loans from banks' balance sheet.

Table 1. Annual credit change by economic agents, currency and purpose (in %)

Adjusted monetary statistics	Private sector credit	ALL	FX	Businesses	Households	Liquidity credit	Investment credit	Consumer credit	House purchase credit
2014	2.0%	6.0%	-0.4%	2.4%	1.2%	1.5%	3.2%	6.5%	-0.2%
2015 Q1	2.5%	6.8%	-0.2%	1.9%	4.0%	1.8%	1.9%	6.3%	1.3%
2015 Q2	2.4%	6.4%	-0.1%	1.6%	4.3%	0.8%	2.4%	8.0%	2.3%
2015 M7	2.3%	5.9%	-0.1%	1.1%	5.0%	-1.7%	3.9%	10.7%	2.2%
2015 M8	0.7%	5.2%	-2.2%	-1.1%	5.2%	-3.1%	0.8%	11.6%	2.1%

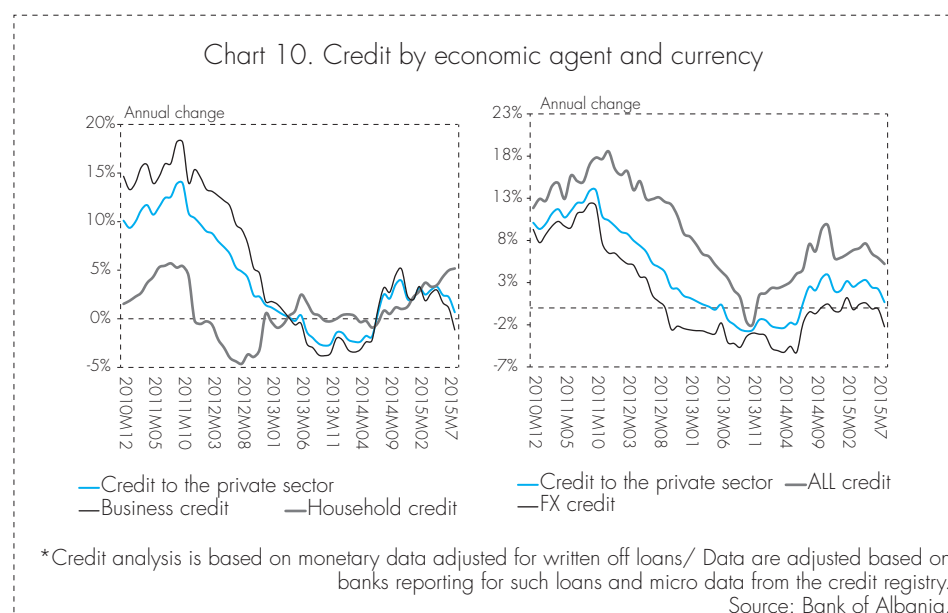
  

Published monetary statistics	Private sector credit	ALL	FX	Businesses	Households	Liquidity credit	Investment credit	Consumer credit	House purchase credit
2014	2.0%	6.0%	-0.4%	2.4%	1.2%	1.5%	3.2%	6.5%	-0.2%
2015 Q1	1.9%	6.2%	-0.7%	1.3%	3.6%	1.6%	1.0%	5.9%	0.8%
2015 Q2	0.3%	5.3%	-2.9%	-0.6%	2.5%	-0.8%	-0.4%	6.3%	0.4%
2015 M7	-0.2%	4.6%	-3.3%	-1.5%	2.9%	-3.7%	0.8%	8.4%	0.1%
2015 M8	-1.7%	3.9%	-5.3%	-3.7%	3.1%	-5.1%	-2.2%	9.2%	0.0%

The write off has affected various levels of the credit portfolio by economic agents and purpose of use. The businesses portfolio saw the largest write off in 2015. Therefore, in monetary statistics the annual reduction of the businesses credit portfolio is significantly higher than that in the analyses. In the meantime, the positive dynamics of the households credit portfolio has hidden the negative effect from the write off of loans from the balance sheet. By currency, the write off has affected most foreign currency credit, mainly that denominated in euro. By monetary statistics, the contraction of the foreign currency credit portfolio is visibly deteriorated from the analysed level. In the meantime, the positive dynamics of the lek credit has hidden to some extent the negative effect from this process. By purpose of use, the credit write off seems to have affected most credit for investments, and less credit for liquidity purposes. In credit to households, mortgage credit seems to have seen the highest write off, whereas consumer credit was the least affected of all portfolios.

In conclusion, we would highlight that for monetary policy purposes, the credit analysis in this report and in those that will follow will exclude written off loans, because they remain monetary assets used by economic agents. Moreover, the adjustment of data for off-balance loans helps understand the real developments in lending.

\* Pursuant to the regulation on the credit risk management.

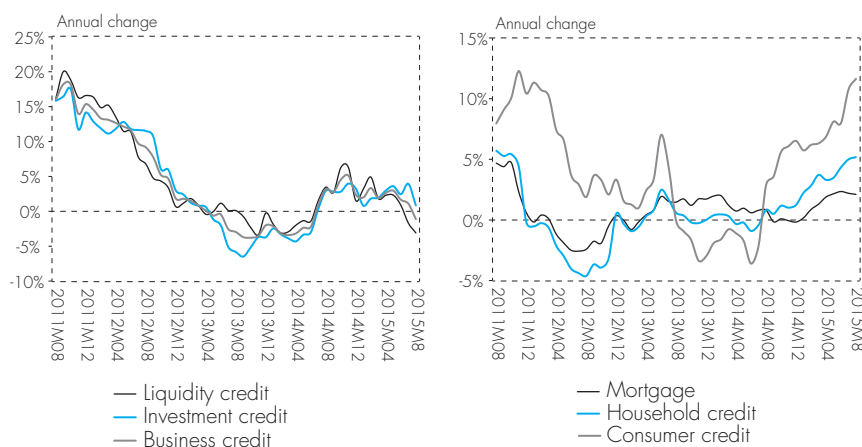


Private sector credit expanded driven by the growth in lek credit. This portfolio posted 5.2% annual growth in August, whereas the foreign currency credit portfolio shrank 2.2% compared to the previous year. The narrowing of the interest rates on lek and euro loans, and the more appropriate perception and price of the exchange rate risk, have stimulated the shift of demand for financing towards the national currency. Moreover, the shift was supported also by the concentration of demand on the consumer credit segment, which is mainly denominated in lek. At the end of August, the ratio of lek credit to total credit stood at 40.8%, or 1.3 percentage points higher than in December 2014.

The weak performance of lending has reflected businesses low credit demand, still-tight lending standards for this segment, and the liquidity generated by the payment of arrears. The annual change in the businesses credit portfolio stood at -1.1%, against the 1.6% growth in June. This performance was driven by a weaker performance of lending for liquidity, which shrank 3.1% in annual terms (+0.8% in June). In the meantime, credit for investments showed deceleration of the annual growth rate to 0.8% (2.4% in June). The payment of government arrears to businesses in the last two years has injected liquidity for businesses and has, therefore, reduced their demand for financing, especially for the short-term credit.

The households credit portfolio expanded driven by the consumer credit, which is growing at around 11.6% in annual terms (in August). In annual terms, mortgage loans stood at 2.1%. Although banks have eased significantly lending terms for mortgage loans, households demand for this product remains sluggish, dictated by uncertainties and households' low risk appetite.

Chart 11. Lending by purpose of use



Source: Bank of Albania.

In the near future, the businesses demand for loans will continue to reflect the limited needs for investment - against the backdrop of unutilised production capacities - and reluctance to undertake risk. In the meantime, the still-conservative lending policies will also condition the low credit levels. Bank lending to businesses is expected to remain selective, and concentrated in a few banks. In the long term, the improvement of financial conditions in the euro area is expected to ease bank lending policies; the perceived credit risk is expected to decrease, in response to the plan of measures for reducing non-performing loans; and, efforts for formalising the economy are expected to enhance businesses transparency and efficiency of the distribution of funds in the economy. These developments are expected to create a more solid basis for the growth of credit in the economy.

### BOX 3 MEASURES TO BOOST LENDING\*

*In the recent years, lending performance has been sluggish, driven by both supply and demand-side factors. The analysis of bank lending standards shows that they remained overall tight. In parallel, credit demand by the private sector has been low. These phenomena have been present in Central Eastern and Southeast European (CESEE) countries, determining thus a weak performance of lending. To address these issues, the CESEE countries have taken a series of measures for the recovery of lending. This box presents an overview of the measures the Bank of Albania has taken with a view to boosting lending in Albania.*

*In recent years, credit demand has reflected the economic slowdown and, subsequently, investment contraction, against the backdrop of unutilised production capacities, determining the fall in the need for financing. To address the sluggish credit demand, the Bank of Albania has lowered the key interest rate by 4.25 percentage points against the rate in 2008. The lowering would ease the credit costs*

and better support the financing of low-return projects. Following the accommodative monetary policy, the interest rate on lek loans fell by 4.4 percentage points for the same-stated period. Despite the significant drop in the cost, credit demand and its growth rates remain low. This fact illustrates that credit demand, albeit its cost, is affected by other factors such as: business uncertainties or use of own funds.

Credit supply is assessed as tightened in the long term. The tightening of supply by banks is expressed in the higher collateral requirements, lower maturity term, and lower credit amount, etc. The banks credit supply is dictated by liquidity-related issues, banks capital level and cost, parent group policies, and credit risk. Thus, our analyses find that these factors have had the following effects in Albania:

- In recent years, banks have had good liquidity and capital levels; therefore, these factors have not restricted lending directly.
- The rising of capital costs in international markets after 2008, has contributed to the lowering of banks willingness to lend.
- The lowering of banking group willingness to undertake risk was reflected in the tightening of the group's policies. In particular, after the Greek crisis in 2011, the introduction of new rules by the European Banking Authority contributed to the further tightening of these policies, with a direct impact on the lowering of credit supply in the countries of the region.
- The higher credit risk, as shown by the high ratio of non-performing loans to total loans, is the main concern for banks. In addition to the deterioration of the credit performance, banks have also faced legal difficulties in the process of non-performing loan management, especially with regard to collateral execution.

To address the rise in the capital costs, in 2013, the Bank of Albania compiled a package of countercyclical measures. Among the most important ones was the application of lower capital requirements for bank, which would increase the credit portfolio by 4-10% in annual terms. Other measures consisted in the changes to the regulatory treatment of restructured loans, in terms of the reduction of both the cost and the period during which these loans were accounted as cost for the bank. These measures are shall be in force until the end of 2015.

To address the high ratio of non-performing loans and credit risk, the Bank of Albania has undertaken a series of initiatives, in cooperation with other public and international institutions, as follows:

In cooperation with the Ministry of Finance, in April 2014, the treatment of non-performing loans for tax purposes was revised, thus alleviating the tax burden on banks. The change removed the legal barriers for writing off non-performing loans. In accordance with this change, the Bank of Albania made a regulatory amendment to require banks to write off loans categorised as loss for three or more years. The decision entered into force in January 2015.

In cooperation with the FinSAC of the World Bank, in May 2014, the Bank of Albania undertook the initiative for the restructuring of larger borrowers. The initiative aimed at restructuring larger borrowers in all banks in which they were exposed, in order to coordinate the efforts and find a common solution.

While the insofar measures have produces some effects and are expected to contribute to the further reduction of the non-performing loans ratio, the level of non-performing loans remains high. To address this issue, in July 2015, the Bank of Albania, in cooperation with other government units, drafted a national plan for reducing non-performing loans. This action plan is based on legal and regulatory



amendments, aimed at resolving issues pertaining to non-performing loans and collateral execution. In concrete terms, this plan consists of:

- Legal amendments initiated by the Ministry of Justice, Ministry of Finance, Ministry of Economy and their relevant institutions on drafting a new law on bankruptcy, amendments to the law on immovable property registration, amendments to the law on securing charges, and clarification of the interaction between the Law on Tax Procedures and other provisions on obligatory execution.
- Regulatory amendments initiated by the Bank of Albania as follows: prolonging the timeframe for the package of macroprudential measures to boost lending; revision of the timeframe for holding in the balance sheet the immovable properties collected under the collateral execution; finding solutions for larger borrowers in the system; improvement of the regulatory framework for the sale of non-performing loans; improvement of data in the credit registry and support of financial analyses for granting loans based on tax statements starting from 2018.

The package of measures is expected to mitigate the credit risk and bolster banks risk appetite. Together with the improvement of financing conditions and reduction of the risk perception in euro area markets, this will contribute to the gradual easing of the credit supply. The improvement of supply and lending standards will indirectly boost credit demand, and sustain the recovery of lending in the long term.

\* By Erjona Suljoti, Monetary Policy Department and Gerond Ziu, Supervision Department.

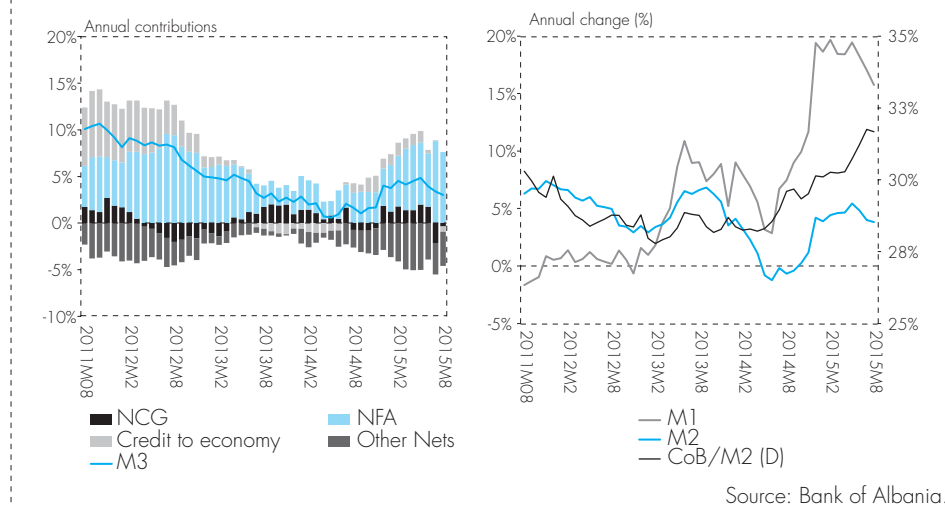
#### 4.4. MONETARY INDICATORS

Expansion of the money stock slowed down in July and August. The broad money, M3 aggregate, posted 3% annual growth in August, compared with 3.9% in June. Money creation in the economy continues to rely on the foreign currency component, which contributed 7.6 percentage points to M3 expansion, in annual terms. In the meantime, the growth rates for monetary aggregates decelerated due to the slowdown in lending to the economy and the low demand by the public sector.

The M2 aggregate in lek slowed down its growth to 3.8% in August, against the 4.8% at the end of the first half of the year. The ratio of currency outside banks to M2 aggregate rose to 31.7% in August, reflecting the added seasonal demand for liquid assets during the summer months. At the same time, in July and August, households investments in government securities continued to grow. Taking into account this shift, the ratio of currency outside banks to financial assets in lek<sup>10</sup> resulted 25.9%, standing close to the average in the last five years.

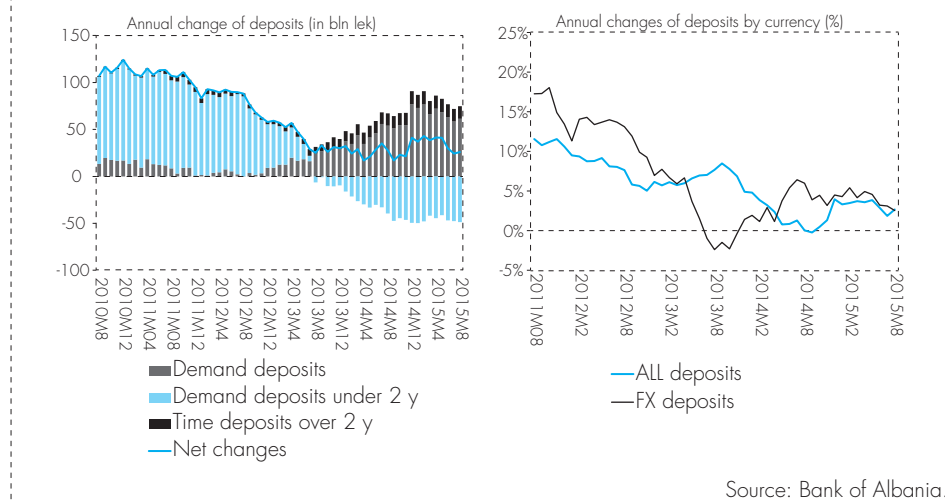
<sup>10</sup> Financial assets in lek include the M2 aggregate, lek deposits with over two years term to maturity, and lek investments in securities.

Chart 12. Monetary Indicators



Total banking system deposits<sup>11</sup> as of end-August stood at about 2.6% higher than a year earlier. The annual performance of deposits shows slowdown of growth rates, both for lek deposits (annual growth 2.7%) and foreign currency ones (annual growth 2.5%). In absolute terms, the stock of deposits in July and August expanded by ALL 7.4 billion, driven fully by the expansion of foreign currency deposits. This performance has reflected the seasonal foreign currency inflows during the summer months, and the return to the system of deposits withdrawn in June due to the psychological effects of the Greek crisis.

Chart 13. Deposits



<sup>11</sup> The analysis of deposits includes deposits with over two years term to maturity, which are not included in the calculation of the M3 broad money aggregate.

By maturity, deposit with less than two years term to maturity continued to shift towards demand deposits or deposits with over two years term to maturity. By economic agents, in July and August, in addition to the growth in households deposits, businesses deposits performed well. In addition to the seasonal effect of tourism, the good performance relates to the entry into the system of the payment of arrears by the public sector.

For the remainder of the year, the money supply in the economy is expected to grow at rates similar to the current ones. The sluggish lending during this period also is envisaged to decelerate the expansion of monetary aggregates. The low interest rates will drive the shift of savings towards deposits with over two years term to maturity and investments in securities. The expected monetary development are not expected to originate inflationary pressures in the short and medium term.

## 5. INFLATION AND ECONOMIC GROWTH

*Annual inflation averaged 1.8% in 2015 Q3, trending up during the last two months. The demand-side pressures are reflected in low core inflation levels, while supply-side shocks are reflected in fluctuations of unprocessed food prices.*

*Albania's economy continued to recover at a slow pace in 2015 H1, and we expect the pace to continue in 2015 H2. The Albanian economy grew 2.5% in the second quarter, driven by the rise in investments and improvement of the balance of trade exchanges with abroad. On the other hand, private consumption continued to shrink, mainly reflecting the strengthening of consumers' propensity to save. The improvement in economic growth in the years to come is expected to be driven by the reduction on the accumulated savings of private sector, the improvement of financing conditions reflecting the accommodative monetary policy, the improvement of economic agents' confidence and by the increase of the demand in the exporting markets. The Negative output gap is expected to gradually close during 2016, shifting to the positive direction at the beginning of 2017.*

*We assess that the inflationary pressures will remain low in the short run, conditioned by the negative output gap, the low rates of commodity prices and of inflation in partner markets. The impact of these factors is expected to decrease and inflation is forecasted to return to the Bank of Albania's target at the beginning of 2018.*

### 5.1. EXTERNAL ECONOMIC ENVIRONMENT

#### 5.1.1. GLOBAL ECONOMY

Global economy continues to expand gradually and at a different pace across the regions. Economic activity in advanced economies is driven by the low oil prices, the improved financing conditions, the improved labour markets and the decrease of the effects related to fiscal consolidation. Meanwhile, developing economies are reflecting a slow economic growth and an increased uncertainty. The international environment is reflecting the deceleration of the Chinese economy, by factoring it into the forecasts for a lower growth of global economy. The decrease in the indicators of the demand for raw materials and of global trade has affected the performance of the economies in developing countries. The macroeconomic balances and their structural problems drove to the increased stress in the economic activity. Inflationary pressures remain low, due to low energy and commodity prices.

Table 2. Selected macroeconomic indicators

Countries	GDP change				Unemployment rate August 2015	Inflation rate	
	Quarterly		Annual			September 2015 August 2015	September 2015 September 2014
	2015 Q1	2015 Q2	2015 Q1	2015 Q2			
USA	0.2	0.9	2.9	2.7	5.1 <sup>1</sup>	0.1	0.2
Euro area	0.5	0.4	1.2	1.5	11.0	0.2	-0.1
Germany	0.3	0.4	1.1	1.6	4.5	-0.3	-0.2
France	0.7	0.0	0.9	1.0	10.8	-0.4	0.1
United Kingdom	0.4	0.7	2.9	2.6	5.4 <sup>2</sup>	-0.1	-0.1

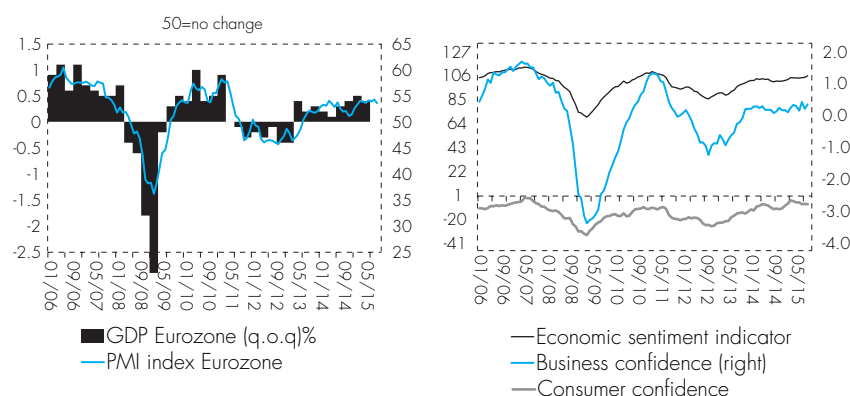
Source: ECB, Fed, Eurostat and respective statistical institutes.

<sup>1</sup> September; <sup>2</sup> June-August 2015.

### Euro area economy

In 2015 Q2, the euro area economy grew by 1.5% annually and 0.4% quarterly, from 1.2% and 0.5%, respectively, in 2015 Q1. The growth was driven by the positive contribution of consumption and net exports, while investments were down. The leading indicators for the euro area GDP growth in the last two months confirm its positive trend, albeit remaining surrounded by uncertainty factors. The business and consumers' confidence indicators performed in opposite directions in the third quarter. Businesses showed positive expectations, while consumers reduced their expectations. The PMI index<sup>12</sup> for euro area production suggests an economic growth in the third quarter at a similar pace with the previous one. The forecasts published recently revised GDP down for 2015 and 2016<sup>13</sup>. The forecasts reflected the latest

Chart 14. Composite output index and quarterly GDP (left) and business and consumer confidence indicators and economic sentiment (right)



Source: Markit, Eurostat, EC.

<sup>12</sup> The PMI indices (Purchasing Managers Index) are economic indicators derived from the survey conducted on a large group of businesses, which are representatives of producing sector of a country. The PMI index is based on five indicators: production levels, new orders, supplier deliveries, inventories, and employment levels. The value index higher than 50% shows increase or expansion, while the values below 50% show the opposite. The PMI index is one of the fastest indicators of economic growth as the answers of businesses' managers are obligatory based on real data and not on opinions. The main producers of this index are "Markit Group" which conducts surveys in more than 30 countries and "ISM" in USA.

<sup>13</sup> ECB staff macroeconomic projection, September 2015.

non-positive data in some developing economies. In the last months, inflation returned to negative territory (September -0.1%) and expectations for the next months were revised down, driven by the low prices in oil and commodities.

### *United States economy*

The US economy continued to expand in 2015 Q2, reflecting high annual growth rates. This development is mainly driven by the increase in consumer spending, non-residential investments, local government spending and the increase in exports. The rise in imports and the slowdown of federal government spending drove the economic growth to the opposite direction. Unemployment continued to stay at low rates, while inflation was slightly positive. The data of higher frequency suggest a steady growth in the second half of the year. Economic environment at home is deemed to impose a possible increase of the interest rate by Federal Reserve within the end of year.

### *Economies in the region*

The economy of Italy recoded a positive growth in 2015 Q2, by accelerating the growth pace. Growth was driven by the consumer spending and public and private investments. Increase in imports exceeded that in exports, by exerting pressure on the economic activity slowdown. The more frequent data, as industrial production and confidence indices suggest a positive economic growth in the third quarter of year as well.

The economy of Greece showed a positive economic growth in the second quarter. The low comparative base led to an increase in consumer and government spending, which are accompanied by the rapid shrinking of imports, and have positively affected the annual economic growth. Investments contracted fast. The fragile political situation and the negotiations on debt restructuring that stopped banking activity for a long period during the third quarter are expected to have negatively affected the economic development of the country.

The economy of Turkey consolidated the economic growth in 2015 Q2. The growth was driven by the increase in consumer spending, private investments and government spending. Changes in inventories, the contraction in exports and increase in imports, contributed to the slowdown of the economic growth. Indirect data show a positive and more moderate growth in 2015 Q3.

*Table 3. Economic figures for countries in the region*

Countries	GDP change 2015 Q2/2014 Q2	Annual inflation September 2015	Unemployment rate August 2015
Italy	0.7	0.2	11.9
Greece	1.6	-0.8	24.6 <sup>1</sup>
Macedonia	2.6	-0.2	26.8 <sup>1</sup>
Serbia	1.0	1.4	17.9 <sup>1</sup>
Croatia	1.4	-0.5	15.5
Turkey	3.8	8.0	9.8 <sup>3</sup>
Kosovo	0.2 <sup>2</sup>	-1.2	35.3 <sup>4</sup>
Albania	2.5	2.2	17.3 <sup>1</sup>

1- Value for 2015 Q2; 2- Value for 2015 Q1; 3- Value for July 2015; 4- Value for 2014.

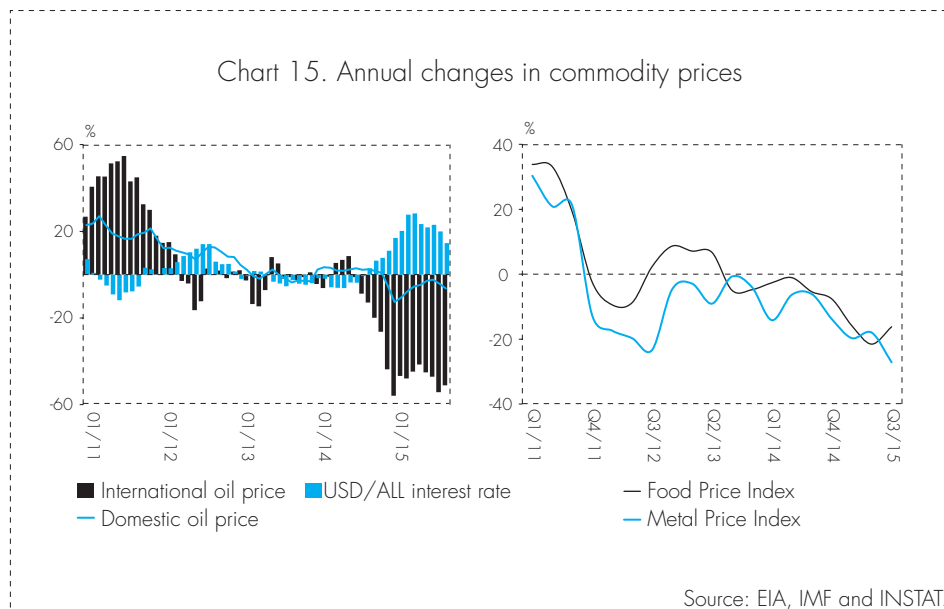
The economy of Macedonia slowed somewhat the growth pace in 2015 Q2, attributable to the contraction in annual terms of private investments. Economic growth was driven by the performance in consumer spending, public investments and spending and the upward contribution of net exports. Data from industrial production show a slight slowdown in 2015 Q3.

Economy of Kosovo slowed down the growth pace in 2015 Q1, after a quick growth in the previous year. Consumer spending increased in positive terms, while government spending contracted. The fast increase in exports overshadowed the increase in imports. Indirect data show a weak performance of industrial production and an improvement in mining during the third quarter of year.

### *Commodity prices in global markets*

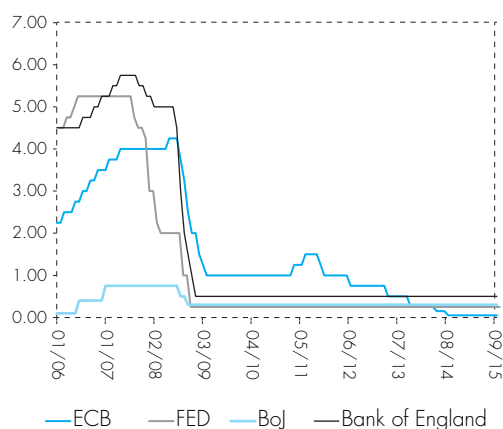
Commodity prices in global markets continued to fall in the third quarter. Energy and metal prices recorded the most considerable drop due to the most substantial fall, due to the drop of the demand in China.

According to the European Brent Index, oil price in global markets averaged USD 50/barrel, the half of the price compared with the previous year, mainly driven by the excess supply in the market and the economic slowdown in China. The same trend was reflected in the domestic market, where oil price fell, particularly in August and September. Oil price is expected not to exceed USD 60/ barrel in 2016, while USA investments in this sector decelerated.



In annual terms, IMF index for food prices lost around 16.3% of its value during this quarter. The lack of supply-side pressures and appreciation of the US dollar dictated the downward performance of this indicator. Under the pressure of the economic developments in China and the weakening of demand, metal

Chart 16. Key interest rates of selected central banks



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

prices contracted by 27.0% compared with the same period in the previous year.

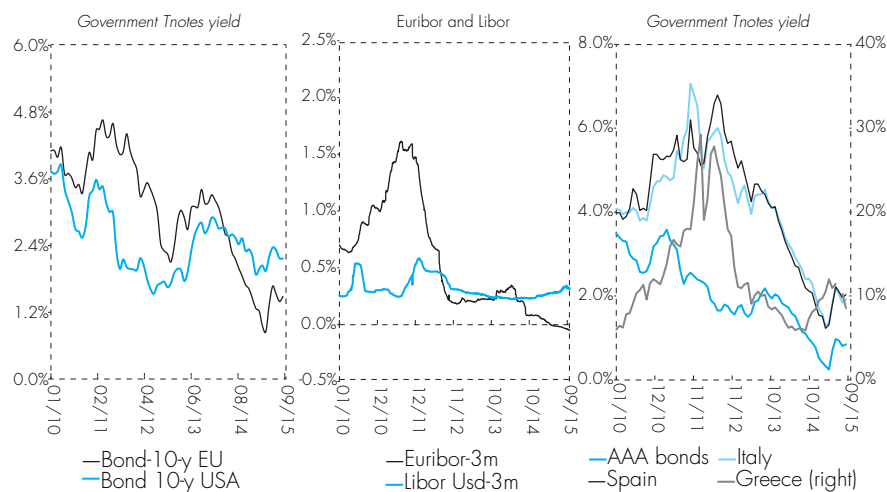
### 5.1.2. GLOBAL FINANCIAL MARKETS

The major central banks kept their key interest rates unchanged, respectively, the European Central Bank at 0.05%, the Federal Reserve at 0.15%, the Bank of England at 0.5% and the Bank of Japan at 0-0.1%.

In euro area money markets, Euribor rates continue to fall, reflecting the ECB's liquidity easing policy. Libor rates for the US dollar remained unchanged from the previous quarter. In capital markets, bond yields performed down affected by agents' expectation on the economic developments. They have postponed

the reversing of the monetary policy direction of the main central banks. Except of two intervals, at the beginning of July and in the middle of August, respectively related to the conclusion of the agreement with Greece and the developments in China, yields have performed down.

Chart 17. Selected financial indicators in international markets



Source: Bloomberg, Reuters and Eurostat.

In Q3, the euro appreciated against the US dollar and other major currencies. The analysis on the performance of euro against US dollar shows that the latter is recovering its depreciation since the beginning of the ECB's quantitative easing program in January of this year. In average bilateral terms, in September, 1 euro was traded at 1.1221 US dollar, appreciating 2.0% from July. In quarterly terms, the euro appreciated 0.6% against the US dollar.



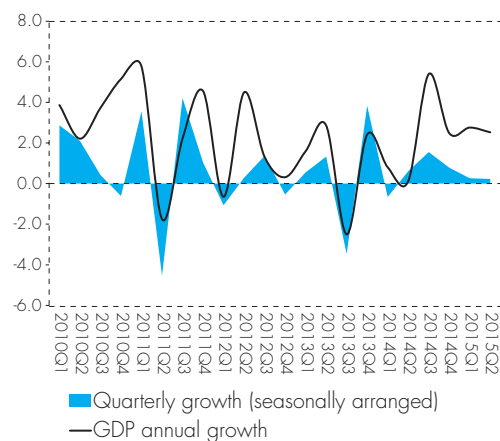
## 5.2. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

According to INSTAT data, the Albanian economy grew 2.5% annually in 2015 Q2. This growth rate is on the down side of our expectations. Expansion of economic activity continued to be driven by the increase in investments and the continuous improvement of trade exchanges with abroad, while the fall in private consumption and agriculture affected negatively the growth rate.

In balance, available information for 2015 Q3 suggests that positive growth rates will continue. In 2015 H2, the economic growth is expected to maintain a similar pace and profile to 2015 H1. The new information leaves unchanged the forecast for a higher growth from the previous year, but shifted on the down side the balance of risks surrounding it.

The Gross Domestic Product rose 2.5% and 0.2%, in annual and quarterly terms, respectively<sup>14</sup>. These growth rates show a slight slowdown, from the values recorded in the first quarter. Construction produced around 78% of the economic growth; while increase in services slowed down and agricultural output fell. From the demand side, investments and net exports provided the main contribution to the economic expansion. Private consumption did not support the domestic demand. It contracted for the third successive quarter. The increased propensity to save due to the higher uncertainty are assessed to have affected the fall in consumer spending<sup>15</sup>. The rise in external demand for Albanian services and the fall in their imports narrowed the real net exports deficit. This item provided positive contribution to the growth of economic activity. The other domestic demand item, public administration consumption, is assessed to have not contributed to the economic growth in this quarter.

Chart 18. Annual and quarterly GDP.



Source: INSTAT and Bank of Albania.

In balance, available information for Q3 shows that the positive growth rates will continue.<sup>16</sup> Similar to the first half of year, the economic growth in the second half is expected to be mainly supported by the domestic demand, driven by investments. On the other side, the vulnerable demand in euro area and the commodities' low prices in international markets, are expected to decelerate the increase in Albanian exports.

<sup>14</sup> On 5 October 2015, INSTAT published the data on the GDP from the production side and aggregate demand side, until 2015 Q2. Data for 2013 are semi-final, those for 2014 are preliminary and for 2015 a first publication being subject to future revision.

<sup>15</sup> For more information, see Box 5 "Measurement of economic uncertainty and the connection to consumption and investments".

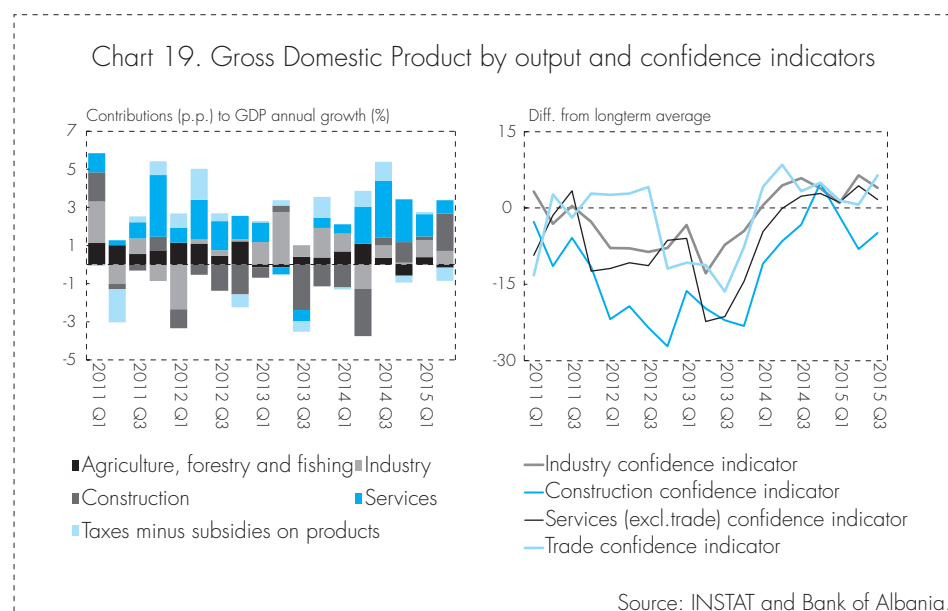
<sup>16</sup> Economic analysis and the assessments of aggregate demand for Q3 are based on updated fiscal indicators, external trade, credit and deposits until August and confidence indicators for 2015 Q3.

In our previous assessments, the implementation of austerity measures in Greece was expected to reduce the economic growth in the second half of the year. The early elections in Greece postponed the implementation time of these measures. While our assessments remain available, their effectiveness period is postponed, in line with the start of their implementation. Also, by based on the factual insofar performance of exports to Greece, the main transmission channel remittances may extend in the first half of 2016.

Risks balance surrounding this assessment stands on the down side. They reflect the uncertainties concerning the outlook for economic and financial developments in the euro area and in Albania.

### 5.2.1. OUTPUT BY SECTOR

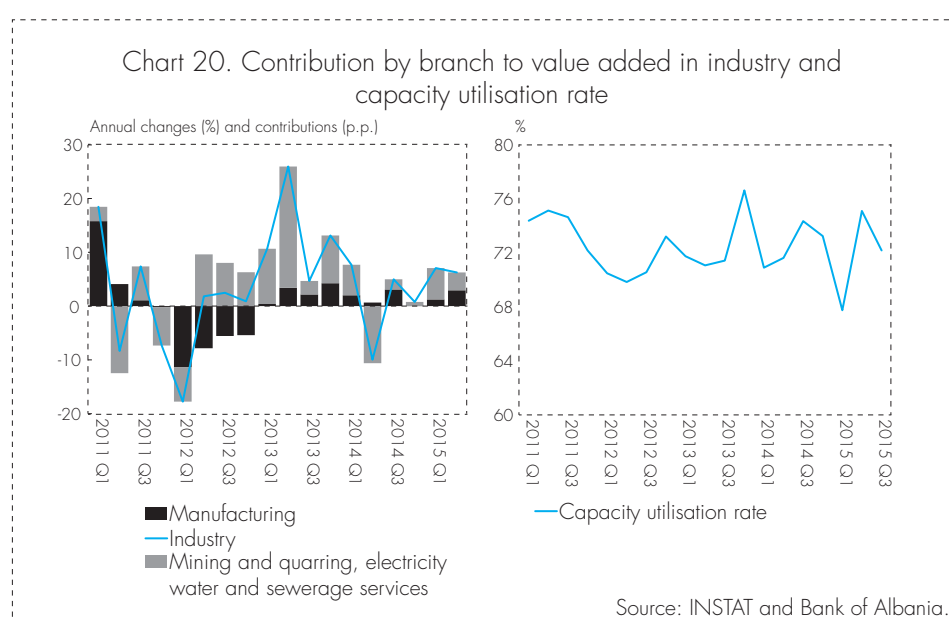
Real GDP grew 2.5% in 2015 Q2, from 2.8% in the previous quarter. Manufacturing provided the highest contribution to the economic growth by 2.5 percentage points. The activity in manufacturing was largely affected by the increase in the value added in construction, around 2.0 percentage points. Industrial activities contributed by 0.7 percentage points to GDP growth. The value added by agriculture, forestry and fishing fell annually 0.8%<sup>17</sup>, by lowering 0.2 percentage points the contribution of manufacturing to economy. In the meantime, services continued to decelerate for the third successive quarter, contributing by 0.7 percentage points to GDP growth rate. The net taxes on products<sup>18</sup> provided a negative contribution to the annual GDP growth, around 0.7 percentage points.



<sup>17</sup> Data on value added in agriculture, forestry and fishing show a slight increase in the sector, 0.3% in 2015 H1, still not reflecting the positive results deriving from the improved agricultural infrastructure, better financial support from the banking system, and facilitating government policies

<sup>18</sup> Net taxes series is calculated as the difference of taxes on products with the subsidies on products.

The value added in industry expanded by 6.3% in the 2015 Q2, slightly lower than the annual growth of 7.1% in 2015 Q1. The improved performance of processing industry branch implied a positive contribution of 3.0 percentage points to the annual growth of the sector. Other industries grouping the value added from “extractive industry, electricity, water supply and waste treatment” slowed down the annual growth to 5.6%, from 9.1% in the previous quarter. The output index data show the continuation of the contraction in extractive industry production and positive dynamics in “Electricity, gas, steam and air conditioning supply” and “Collection water supply and waste treatment”<sup>19</sup>. The lower level of business confidence index in industry and capacity utilization rate suggest decelerated trends in industry in the third quarter.



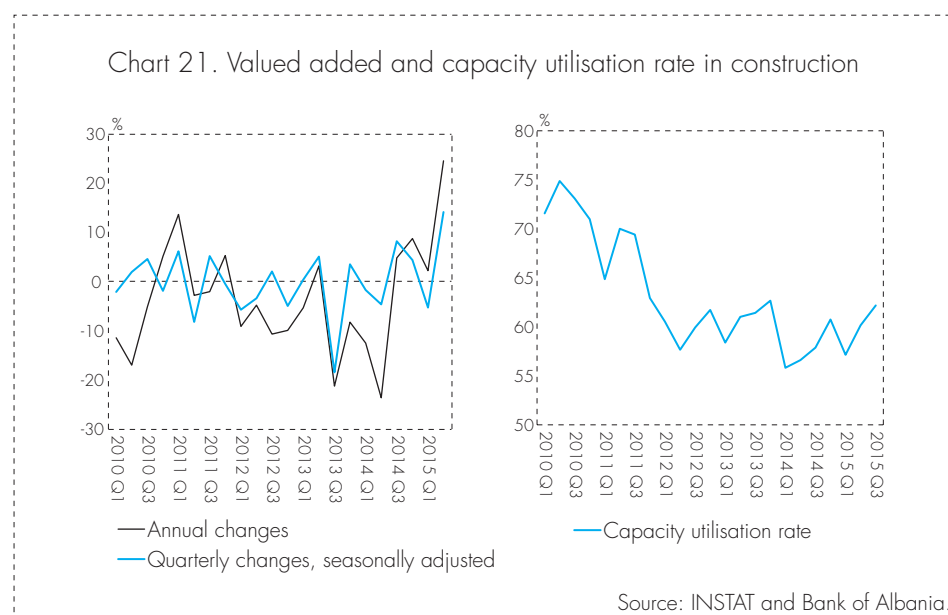
The performance of Construction boosted considerably in 2015 Q2. The value added from construction expanded 24.5%, by strengthening the improved trend of the annual performance. This dynamic was reflected by the higher increased of turnover figure in volume, 11.8%, and by the output volume index in construction, 22.7%, in annual terms. In the view of the approximated value of building permits<sup>20</sup>, the good performance of the sector has mainly reflected the increase in new non-residential constructions and of reconstructions<sup>21</sup>,

<sup>19</sup> In 2015 Q2, extractive industry index fell annually 18.9%, after the contraction of 26.3% in the previous quarter. While, output of “Electricity, gas, steam and air conditioning supply” and “Collection, water supply and residuals processing” slowed down, up by 10.2% and 20.2%, respectively.

<sup>20</sup> Data on building permits and types of construction are published in quarterly statistical bulletins of INSTAT.

<sup>21</sup> In 2015 Q2, the value of building permits shows higher annual increase of new buildings mainly for buildings related to industrial and trade activities, and of engineering works related to water supply, electricity and telecommunication lines, as well as for the category of works in roads and highways.

encouraged by both, private and public sectors.<sup>22</sup> Indicators from surveys<sup>23</sup> provide positive signals related to the expected developments in construction during 2015 Q3.



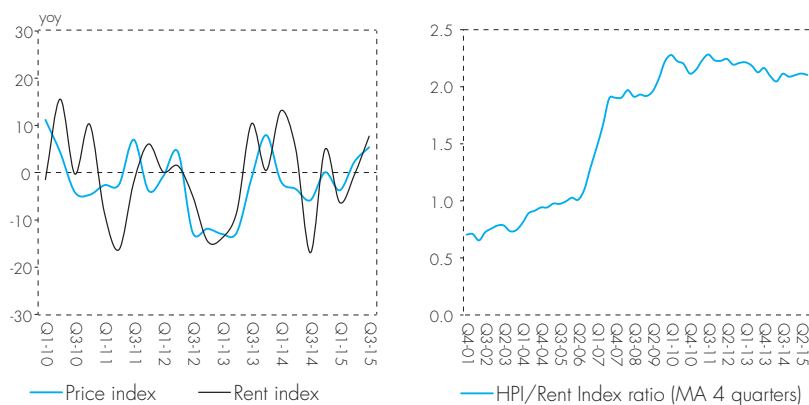
<sup>22</sup> Around 57% of the approximate value of building permits for the second quarter was attributable to private clients, whereas 46% to the public client. Also, the realisation of infrastructural projects supported by the Regional Development Fund suggests a continuation of public investments.

<sup>23</sup> In 2015 Q3, businesses operating in construction assess the demand, output and the capacity utilisation rate as upward. Nevertheless, the performance of the indicators remains below the respective historical averages.

## BOX 4 HOUSE MARKET PRICES\*

House Price Index increased 5.4% y-o-y in 2015 Q3, after the increase by 2.3% in the previous quarter. Rental Price Index rose 7.7% in this quarter. The similar short-term fluctuations in indices have contributed to maintaining a steady ratio over the last five years.

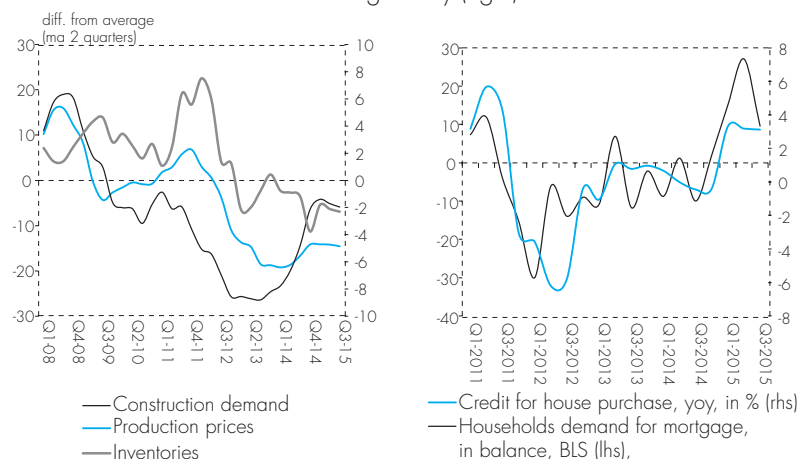
Chart 22. House Price Index and Price-to-rent index



Source: Bank of Albania.

Developments in the real estate market prices over the third quarter are characterised by the boosting of the demand and the recovery of supply for houses. According to the construction confidence survey, the demand in construction improved. The same trend is confirmed by the bank lending survey. According to this survey, banks report an increase in households' demand for mortgage loan (albeit lower from the second quarter of year).

Chart 23. Indicator from construction confidence survey (left) and lending survey (right)

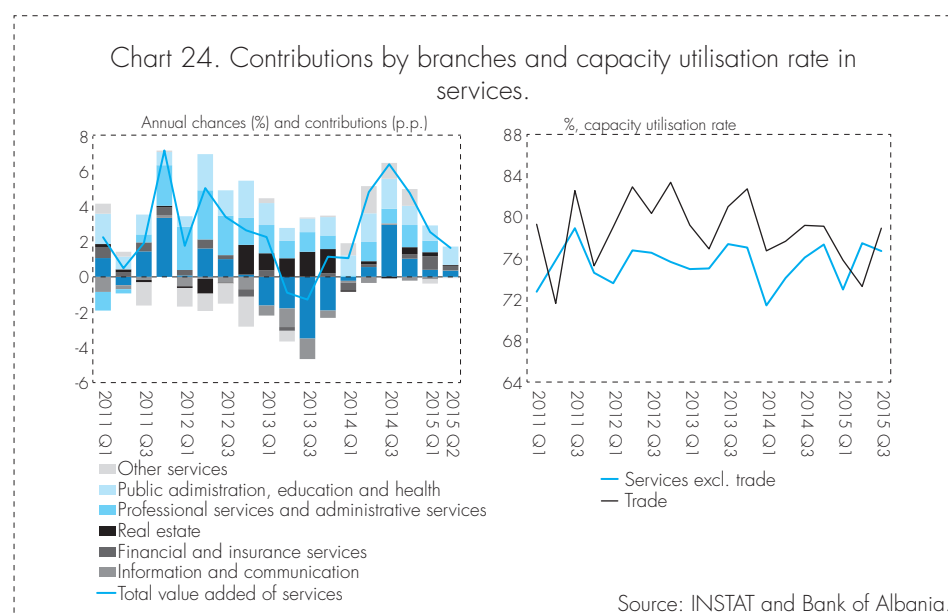


Source: Bank of Albania.

Output prices measured through business survey are reported as slightly lower in the third quarter, and inventories' balance with a slight falling trend.

\* The analysis of house and rental prices is based on respective information only for Tirana.

Activity in the services sector continued the slowdown trend started in the fourth quarter of 2014. Value added by services to economy rose 1.7% in the second quarter. This annual rate was lower than the annual expansion of 2.6% in the first quarter of 2015, and from the historical annual growth rate of 2.7%. The limitation of growth pace was mainly determined by the contraction of value added in services related to professional activities and administrative services<sup>24</sup>. The activity in public administration, education and health contributed by around 1.0 percentage point to the increase in the sector. Branches of "Trade, hotels and restaurants and transport"<sup>25</sup> and of "Financial activities and insurance" increased the value added in services by 0.4 and 0.3 percentage points, respectively. The improved performance of survey data for the confidence indicators, mainly in trading activity and for the capacity utilisation rates, suggests a positive dynamic of the sector in the third quarter.



## 5.2.2. AGGREGATE DEMAND

Aggregate demand growth in Q2 was formed by the positive contribution of gross formation of fixed capital and the net external demand. Private and public spending for goods and services continued to provide negative contribution to the formation of aggregate demand.

<sup>24</sup> By the Albanian Classification of Economic Activities (NVE Rev. 2) this branch includes "professional, scientific and technical activities" (section M) and "Supporting administrative services" (N session). Data of short-term statistics suggest a slowdown of the growth pace of the turnover figure for the services supplied by the travel agencies, tour operators and other travel services, part of session N, in the second quarter.

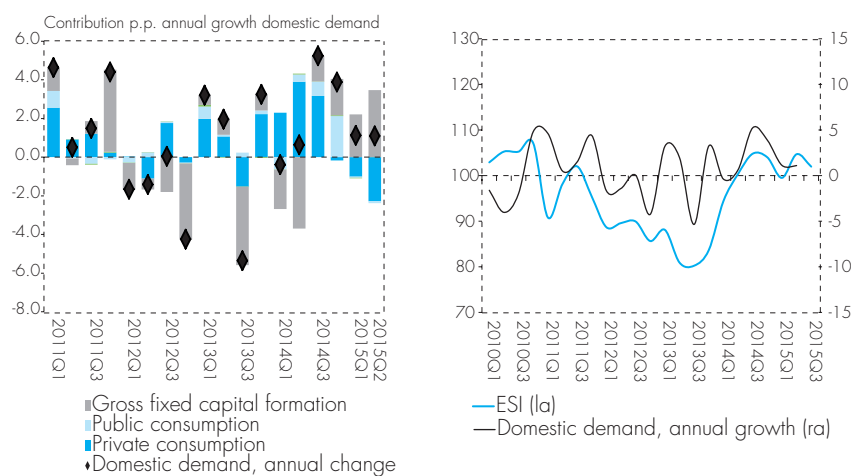
<sup>25</sup> Referring to the data of turnover figure in volume, hotel activities recorded the highest growth compared with the activity performance in the branches of trade, transport and storage. In more concrete terms, the turnover figure of hotels grew annually 14.0% in Q2, after the annual fall 3.2% in the first quarter.

Related to the third quarter, indirect quantitative data and business survey suggest that the aggregate demand will grow, being simultaneously affected the improvement in the balance of trade exchanges and domestic demand. The latter is expected to mainly be based on the continuous expansion of investments, while private consumption is expected to remain weak.

The domestic demand expanded by the same pace as in the previous quarter, 1.1%. The increase in domestic demand was positively affected by the rise in the component of fixed capital formation. Nevertheless, this contribution was decreased attributable to the further contraction of final private and public consumption in this quarter.

Other economic indicators that are available earlier than national accounts, and data from confidence survey, suggest a slow growth of the domestic demand in the third quarter of year. The Economic Sentiment Indicator (ESI) fell by 2.7 points in the third quarter, albeit it continues to remain above the long-term average. This indicator was characterised by a higher volatility over the last four quarters.

Chart 25. The structure of aggregate demand (contributions in annual change of GDP) and ESI (long-term average = 100)

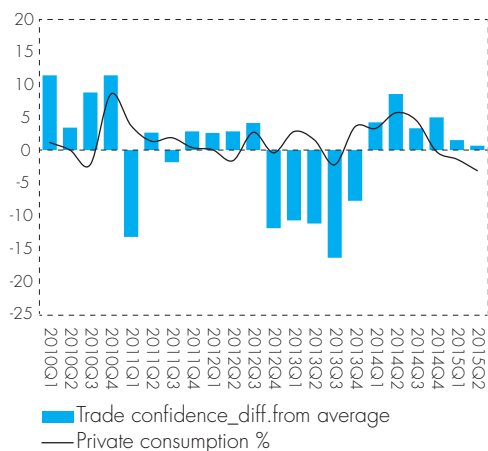


Source: INSTAT and Bank of Albania.

Private consumption fell 3.2% in the second quarter, by providing a negative contribution to the aggregate demand for the third consecutive quarter. Analysis of consumption indicators based on indirect quantitative indicators, shows a continuing down trend of spending for durable goods in the second quarter<sup>26</sup>. Retail Trade Index for long-term goods and import of vehicles fell annually in

<sup>26</sup> In theory, in periods characterised by the increase in uncertainty level, households do reduce the expenses for long-term goods, for example: home appliances, furniture, vehicles, etc.

Chart 26. Private consumption and confidence in the trade sector



Source: INSTAT and Bank of Albania.

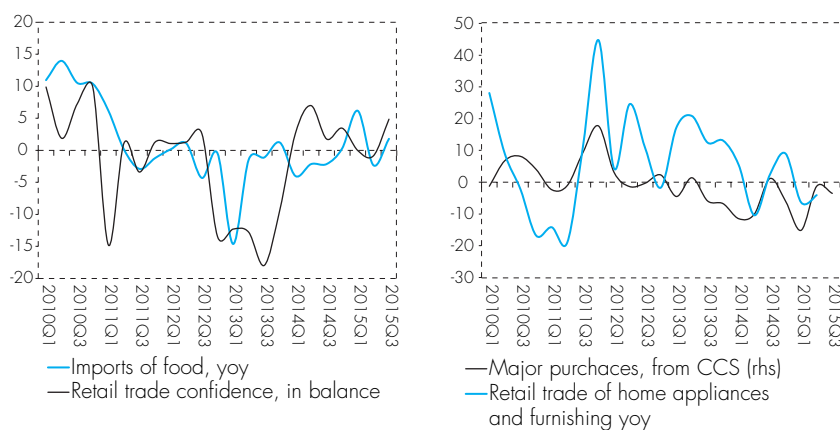
this quarter<sup>27</sup>. The increase in consumer spending for short-term goods and services was lower than in the previous quarter.<sup>28</sup>

Sources of financing private consumption increased in this quarter, but the uncertainty assessed at still high, has affected the channelling of a considerable part of income to savings.<sup>29</sup> The increase in wages fund index<sup>30</sup> and remittances inflows supported the increase of disposable income. Also, the increase in consumer credit accelerated in the second quarter and lending standards to households eased.

Related to the third quarter, the partial available data signal a continuation of the weak consumption. It is expected to be more evident in the reduction of expenses for long-term consumption appliances and

for services, and less in expenses for non-durable goods. The balance of large purchases from the consumer survey and the Services Confidence Indicator fell in the third quarter. Import of food items and trade confidence indicator were up in this quarter.

Chart 27. Indirect indicators on private consumer spending in Q3.



\*The increase in the import of food items in Q3 is proxied by the annual average growth in July and August 2015.

Source: INSTAT and Bank of Albania.

<sup>27</sup> The index of retail sub-item "Various households' appliances, furniture and other household appliances" fell annually 4.1% and the import of passenger's vehicles fell annually 15.4% in the second quarter.

<sup>28</sup> Based on the disaggregated data of the gross domestic product, according to output method and the Retail Trade Index.

<sup>29</sup> For more information, see Box 5 "Measurement of economic uncertainty and the connection to consumption and investments".

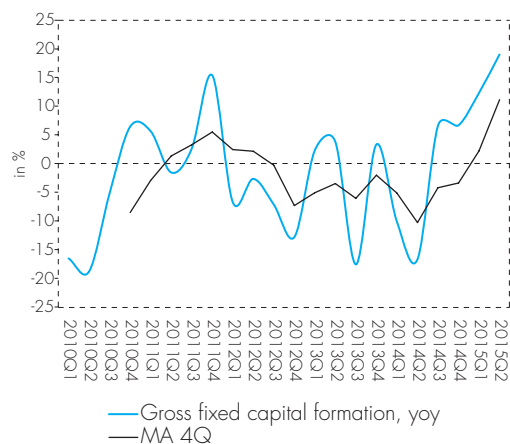
<sup>30</sup> It refers to the Wages Fund Index for the total of activities reported by the short-term statistics questionnaires until the third quarter of 2015 by INSTAT. In more concrete terms, the index recorded an annual growth of 7.6% in 2015 Q2, after the annual expansion of 9.4% in the previous quarter. The Wages Fund Index is part of economic indicators of short-term statistic of economic enterprises published by INSTAT. It is a proxy index of wages fund performance in the surveyed unit.



Investments surged 19% in Q2, being one of the main contributors to the formation of the aggregate demand in Albania. The increase of this item benefited from the inflow of foreign direct investments and the growth in public capital spending relate to infrastructure in Q2<sup>31</sup>. Investments in constructions, with the highest share in total investments, provided the main contribution to the growth<sup>32</sup>. Investments in machineries and equipment, also were up, based on the increase of their import, 8.6% in Q2<sup>33</sup>.

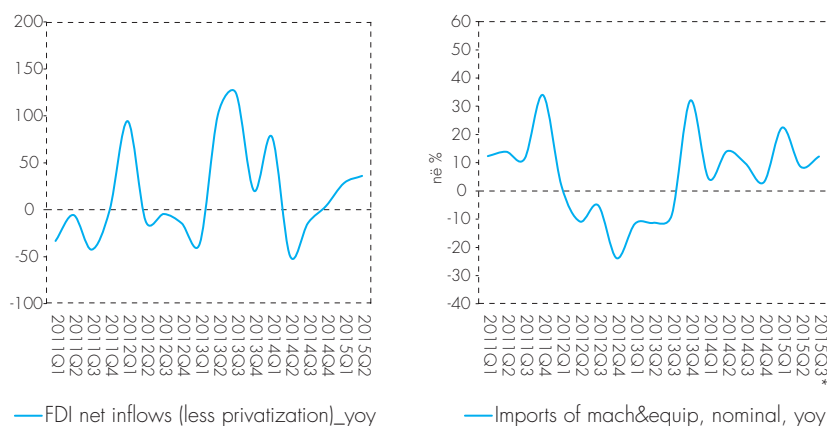
Investments are expected to continue to provide positive contribution in the third quarter. The increase in construction confidence indicator and in the balance of new investments signals that investments in construction will continue. The expected contribution of investments in machinery and equipment also is positive. Preliminary data for the third quarter reflect an average growth 12.2% in the import of machinery and equipment. Also, the growth of public investments in the third quarter is expected to have supported the gross fixed capital formation.

Chart 28. Gross fixed capital formation, annual change



Source: INSTAT.

Chart 29. Short-term indicators of private investments in Q2 and Q3



\*The increase in Q3 is proxied by the annual average growth in July and August 2015.

Source: INSTAT and Bank of Albania.

<sup>31</sup> Local authority capital expenditure increased considerably in 2015 Q2.

<sup>32</sup> The value added in construction was up 24.5% in Q2 and the value of building permits doubled in this quarter, compared with the previous year.

<sup>33</sup> Based on the structure of gross fixed capital formation in 2013, investments in construction share 75%, in machinery and equipment 12%, in transport vehicles 6%, in mining research 3% and agriculture 4%. Investments in computer software and databases have a share almost 0% in gross fixed capital formation.

#### BOX 5 MEASURING THE ECONOMIC UNCERTAINTY AND THE RELATION TO CONSUMPTION AND INVESTMENTS\*.

One of the reasons, the economists provide regarding the slow recovery of euro area and USA economies after the crisis of 2008, is the high level of uncertainty<sup>1)</sup>. Uncertain for the future, the businesses stopped investing and employing, while consumers postponed their purchases. In Albania, one of the global crisis transmission channels was the fluctuation in economic agents' confidence and the deceleration of economic growth.

The earliest definition for uncertainty considers the latter as the impossibility to forecast the occurrence of definite events. When faced with high uncertainty, businesses hesitate to invest because frequently investments are costly to reverse<sup>2)</sup>. Similarly, consumers postpone consumption and increase savings.

Economic uncertainty may not be measured directly as the other indicators: inflation or output. Nevertheless, indicators that approximate the uncertainty in economy by using other measures may be constructed, for example: fluctuation in securities prices, confidence surveys indicators, flexibility in the forecasts of professional forecasters, media monitoring of the group of words that contain uncertainty<sup>3)</sup>, etc. Following is presented a measure of economic uncertainty in Albania, by using detailed data from businesses and consumers' surveys.

**Uncertainty indicator from heterogeneous expectations (EUI\_expectations)** is calculated for businesses and consumers. If businesses and consumers, in a definite period, have more or less similar expectations for the future (the responses of the questions are focused on one of the alternatives of the response), the degree of uncertainty is considered as low, and vice versa. EUI quantifies the dispersion degree of responses among various alternatives of the question, through the construction of Theil Index<sup>4)</sup>:

$Th = 1 / [N * (\ln(N)) * \sum_{i=1}^N [x_i * \ln(x_i / N)]$ , where  $x_i$  is the part of responses of one alternative and  $N$  is the number of the alternatives of the question's responses.

Theil index takes values from 0 to 1. If responses are dispersed equally in all the alternatives of the question, the index receives the lowest value and shows high uncertainty. The index is equal to 1 if all agents have chosen only one alternative. In this case the uncertainty is at minimum levels. To ease the analysis and interpretation of uncertainty indicator  $EUI\_expectations = 1 - Th$ , is calculated. In this case, the values of uncertainty indicator fell in the interval (0-1), while 1(one) shows the maximum of uncertainty.

**The Indicator of Uncertainty of Forecast Error (EUI\_forecast)** is constructed only for businesses and measures their error in one quarter, by comparing the forecast indicator to the factual performance in the next quarter. The methodology to carry out confidence survey, which is based on the survey of a fixed businesses sample in time, provides this type of comparison. The forecast error of businesses is analysed based on the question for the output<sup>5)</sup>. In more concrete terms, the response to the question in quarter  $t$ , "what will be the performance of output in your company in the next quarter?", is compared to the response provided by the same business in the quarter  $t+1$ , "what was the performance of output in your company during the previous quarter?". The forecast error is coded similarly by the methodology implemented by Bachman et al (2012). For example, if the business chooses the same alternative in both quarters, then its forecast in quarter  $t$  is correct or the

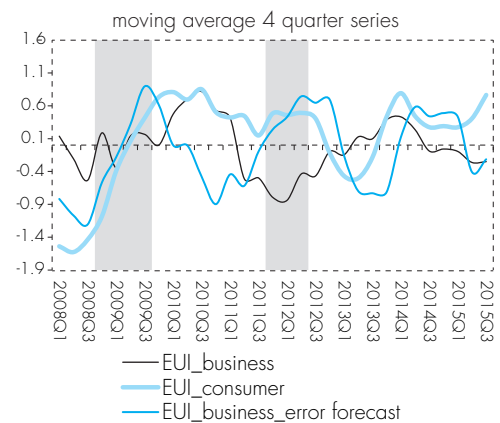
forecast error is 0, notwithstanding it may have chosen the positive, negative or neutral alternative<sup>6)</sup>. If the response of the question in quarter  $t+1$  is different from the forecast in the previous quarter, the following coding possibilities are presented:

Expectations in $t$ for $t+1$ / Assessment in $t$	Increased	Equal	Decreased
Will increase	0	-1	-2
Will remain equal	+1	0	-1
Will decrease	+2	+1	0

A series of "errors" is received for each business in each quarter to survey  $t$ . Standard deviation of this series constitutes the indicator of economic uncertainty measured from forecast error,  $EUI_{part} = \text{dev.std}(\text{forecast error})$ .

Chart 30 shows the indicators of uncertainty for businesses, constructed in both ways, from forecast error and dispersion of expectations, and the indicator of uncertainty of consumers measured according to the second method. Grey colour identifies the periods after the global crisis of 2008 and after the euro area financial crisis of 2011. The three indicators of uncertainty increased over both periods, but they are more synchronised in the first one. The indicator of consumers' uncertainty continues to remain high after 2008, according to its historical average. Its level fell for the first time after a four-year period below long-term average in 2013. Meanwhile, the indicators of businesses' uncertainty showed a more pronounced cyclical behaviour and higher fluctuation. During the last year, the uncertainty as perceived by businesses and consumers is different: the indicator of consumers' uncertainty trended upward, while the indicators of businesses' uncertainty stood below their long-term average.

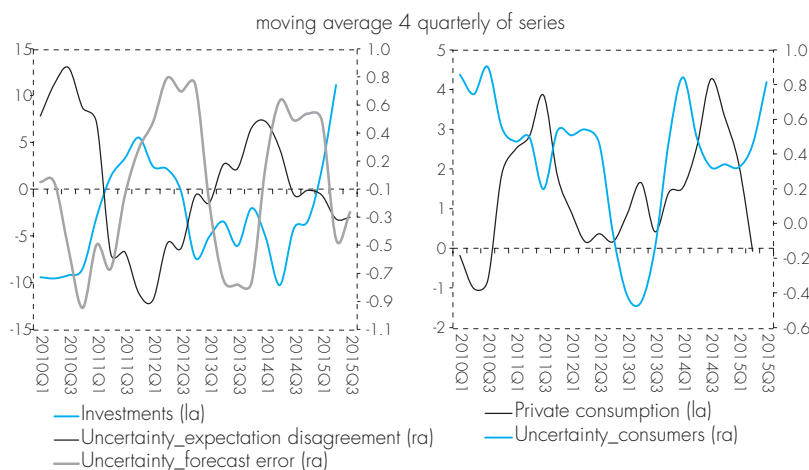
Chart 30. Economic Uncertainty Indicator (EUI) of businesses and annual growth of investments, left chart and TPE of consumers and annual growth - private consumption, right chart



Source: Bank of Albania.

Chart 31 shows the indicators of uncertainty of businesses and the annual performance of investments in economy (left chart), and the indicator of consumers' uncertainty to the performance of private consumption (right chart). The chart suggests that the uncertainty indicators are counter-cyclical. In the periods when the uncertainty

Chart 31. EUI of businesses and annual growth of investments, left chart and EUI of consumers and annual growth - private consumption, right chart



Source: INSTAT and Bank of Albania.

is down, the economic aggregates are up, and vice versa. This is in line with the economic theory, according to which the uncertainty indicators are negatively related to the economic growth over the business cycle. During 2015, the environment characterised by low uncertainty levels of businesses has sustained the growth of investments in economy. In contrast, the increasing trend of uncertainty of consumers is reflected in the fall of private consumption. The increase of uncertainty has affected in particular the consumption of long-term goods, which has an elastic demand and may be postponed, while households expect for the situation to be clearer.

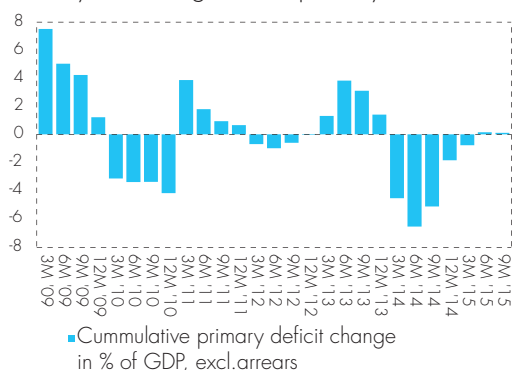
Notes:

\* By Ermelinda Kristo, Monetary Policy Department.

- 1) Bloom, N, Kohse, M., Terrones, M. 2013: "Held back by uncertainty", Finance and Development, March.
- 2) Bernanke, B, 1980: "Irreversibility, uncertainty and cyclical investment", NBER, working paper No.502, July 1980.
- 3) Some articles where various uncertainty indicators are used: Baker and Bloom 2013: "Does uncertainty reduce growth? Using disasters as natural experiments", NBER working paper No.19475; Bloom, N. 2014: "Fluctuations in Uncertainty", Journal of Economic Perspectives, Volume 28, No.2, pg153-176; Bloom, N 2009: "The impact of uncertainty shocks", Econometrica, Vol. 77, No.3; Niemira, M. 1996: "Measuring consumer uncertainty"; Kose and Terrone, 2012: "How does uncertainty affect economic performance?", World economic outlook, October 2012, pg. 69.
- 4) At the beginning, the Theil index is used to measure economic inequality. In the working paper by Balta, N, Fernandez, I and Ruscher, E, 2013: "Assessing the impact of uncertainty on consumption and investment", this index configures uncertainty from the harmonised businesses and consumers' confidence surveys organised the European Commission.
- 5) The reports on the output of around 400 businesses in industry and construction sectors are compared every quarter.
- 6) The reports of the businesses' questions on the output are broken in three categories: increased; has not changed, and decreased.

### 5.2.3. PUBLIC SECTOR DEMAND AND FISCAL POLICY

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



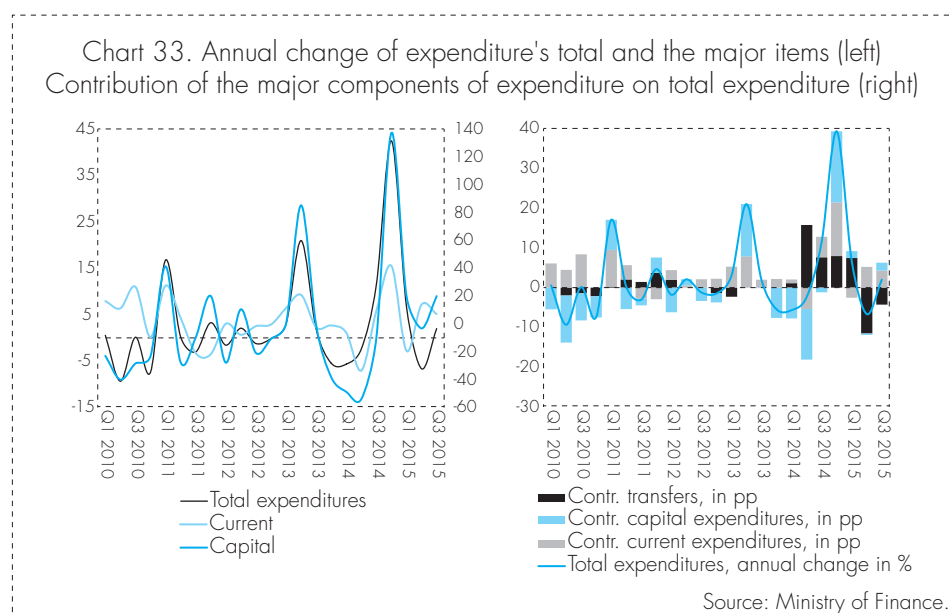
\*Fiscal stimulus is proxied by changes of quarterly cumulative primary deficit against GDP, compared with the previous year. The positive changes in these reports show a positive fiscal stimulus, while negative differences signal fiscal consolidation.  
Source: Ministry of Finance, INSTAT, Bank of Albania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

Fiscal stimulus resulted almost neutral during the first nine months of the year. Primary balance returned to the positive territory in 2015 Q3. Revenues collection increased in annual terms, while expenses remained almost unchanged from the previous year.

Compared with the previous year, budget expenditures increased by 0.1% in the first nine months of the year, reaching ALL 297.6 billion. Current expenditures, in annual terms, increased by 3.3%, driven by the increase in operating and local government expenses. Debt servicing expenditures contracted, following the trend of this year. Capital expenditures increased to 10.4% compared with the previous year, reaching ALL 33 billion in the first nine months of the year. Payment of arrears contracted by

41.7% in annual terms, driving down the growth in total expenditure as a result of the high comparative base on a year earlier.<sup>34</sup>

Total expenditures are distributed almost evenly across the quarters, while capital expenditures were concentrated mainly in Q2 and Q3. Payment of arrears is concentrated in 2015 H1, with almost half of them in Q1.



In Q3, expenses rose by 2% compared with the same quarter a year earlier. Current and capital expenses increased respectively by 5.1% and 20% in annual terms, while early settlement of liabilities recorded a stronger contraction.

Budget revenues were realized at approximately ALL 279 billion for the first nine months of the year, increasing 4.6% in annual terms. The increase is mainly driven by the good performance of "Income tax"<sup>35</sup>, "Social and health insurance contributions"<sup>36</sup> and "Personal income tax", which grew 13.6%, 12.4% and 7.3%, respectively. "Value Added Tax" contracted by 1.4%, in annual terms, but has followed an improvement trajectory. After several months of positive performance, excise tax revenues slowed the pace of annual growth, at 0.8%. "Non-tax revenues" increased by 30.6% in annual terms<sup>37</sup>, contributing by 1.2 percentage points to total revenue growth.

<sup>34</sup> Up to September about 75% of arrears planned for the entire year are paid. About 37% consist in arrears for infrastructure works, while around 35% consists in tax arrears.

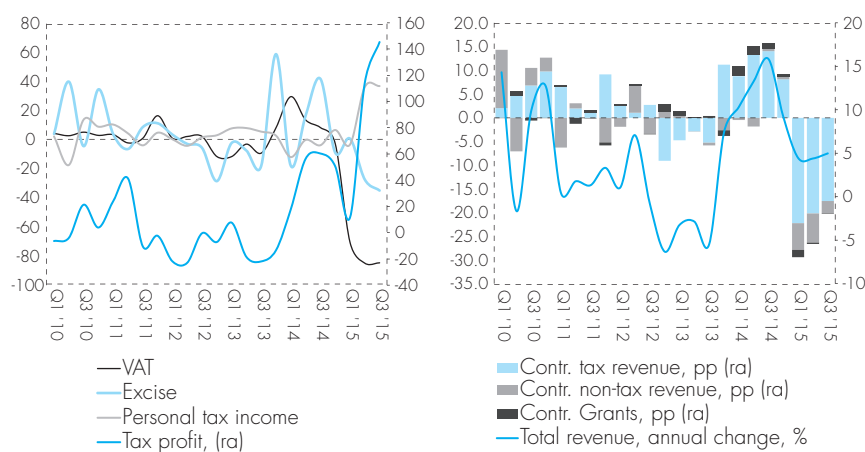
<sup>35</sup> After legal amendments, since 1 January 1 2015, the tax rate on profit from the deposits in the banking system rose to 1.5% from 10%.

<sup>36</sup> On 1 January, the Decree of the Minister of Finance No.23, 9.12.2014 entered into force "For the collection of compulsory contributions to social and health insurance" which stipulates the increase of the minimum wage on which the contributions, for those declared as self-employed and unpaid family workers who work and live with the self-employed, are calculated. This rise, along with the increase of the effectiveness of tax administration, has led to the increase in revenues from health and social insurance contributions.

<sup>37</sup> The non-tax revenues have reflected the rapid growth of the income from budgetary institutions, reflecting the sale of licenses for the provision of 4G service from mobile operators.

The revenues recorded an annual growth by 5% in 2015 Q3. This growth is driven by the revenues from “value added tax”, “personal income tax”, “national taxes” and “social and health insurance contributions”, whereas the negative performance of “profit tax” and “excises” contributed to the opposite direction.

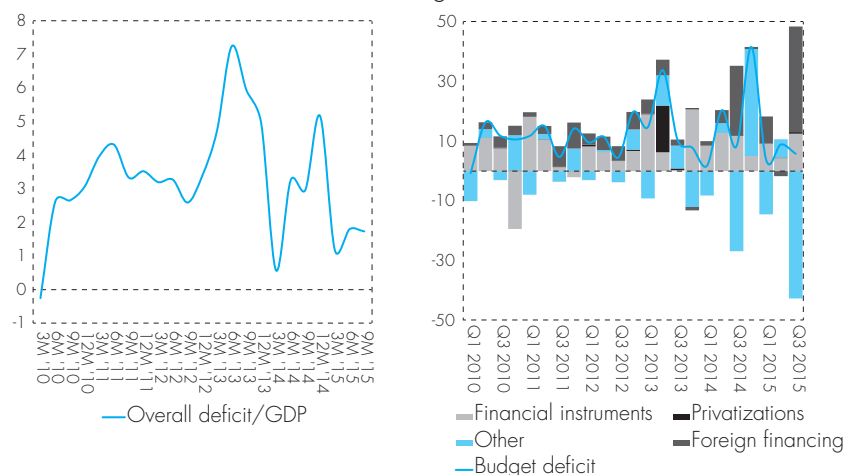
Chart 34. Annual change of the main items of revenue (left), and annual revenue change by the main items contributions (right).



Source: Ministry of Finance.

The budget deficit reached ALL 18.5 billion in the first nine months of the year, decreasing with around 39.5% year over year. It is mainly financed by foreign sources. Domestic borrowing reached ALL 26.1 billion in the first nine months of the year. The deficit resulted in ALL 5.8 billion for Q3, about 30.6% lower compared with the same quarter a year earlier.

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



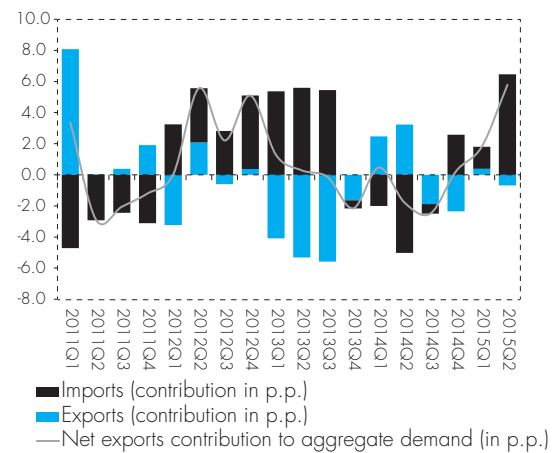
Source: Ministry of Finance, INSTAT, staff assessments.

## 5.2.4. FOREIGN DEMAND AND FOREIGN TRADE

Real trade deficit in goods and services narrowed in 2015 Q2. The annual reduction of the deficit by 23.2% indicates an acceleration of the trend started in the previous quarter. The performance of net exports is estimated to have made a positive contribution to the annual performance of aggregate demand, up from the previous quarter. Annual decline of real imports of goods and services had a substantial impact. Given the developments in 2015 Q2, our projections for the deficit of net exports in 2015 are revised upwards.

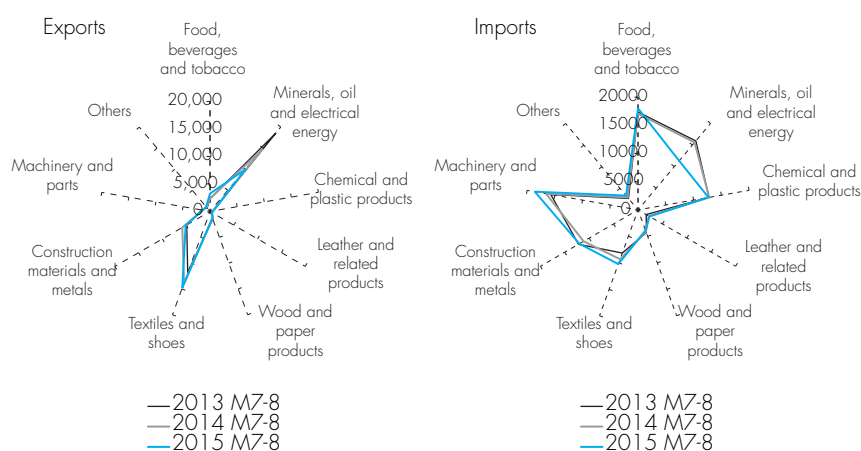
Data on the performance of net exports in 2015 Q3 include only the trade component in goods for July-August. The trade deficit in goods for these two months grew by 8.5% in annual terms, dictated by the decline in annual exports.

Chart 36. The contribution of net exports in the aggregate demand (in percentage points).



Source: INSTAT.

Chart 37. Orientation of imports and exports by category (in ALL million)



Source: INSTAT.

The value of exports in goods decreased by about 8.8% in annual term. The decline in exports in "Minerals, fuels and electricity" gave the main contribution to this performance. Within this category, the reduction of oil exports by approximately 34% compared with the previous year had the greatest impact. On the other hand, electricity exports showed positive growth rates. In terms of unfavourable price tendencies in international commodity metal markets, export in "Construction materials and metals" decreased both in value and in volume. On the other hand, exports in "Food, drinks and tobacco" resulted about 38.6% higher these two months, compared with the same period a year earlier. Exports in "Textile and footwear" increased by about 6.8% in annual



terms, giving the highest contribution to the positive performance. However, the combined contribution of these two categories was not sufficient to offset the negative effects by the two above-mentioned categories.

Imports increased by approximately 0.7% compared to the same period a year earlier. The dynamic of imports was broadly determined by the increase in: "Machinery, equipment and spare parts", "Textile and footwear" and "Food, drinks and tobacco". Positive trends of the first two categories are closely related to the performance of gross fixed capital formation in 2015 Q3 and the expected performance of the re-exporting textile industry. On the other hand, increased imports of the latter category indicates a higher domestic demand for consumer goods. Imports in "Minerals, fuels and electricity" displayed a downward tendency. The reduction of imported electricity and of imported oil in value contributed negatively.

According to the geographical orientation, exports continue to be directed towards Italy, Kosovo, Spain and Germany. Meanwhile, the origin of imported products appears more diverse, where EU countries hold the major historic share against the total imports (62% this year).

#### BOX 6: BALANCE OF PAYMENTS DEVELOPMENTS IN 2015 Q2.

*The net position of the current account recorded a deficit of 181.3 million Euro in 2015 Q2. For the second consecutive quarter, the current deficit followed a narrowing trend by about 42.9%, in annual terms. It was estimated by 6.7% against nominal GDP. According to the component items of the current account, the improvement in net exports and higher secondary revenues compared with the same quarter a year earlier contributed to the narrowing direction. Imports of goods and services decreased by 10.6% and exports fell by 1.9%, in annual terms. The balance of secondary income account continued the expansion trend that began in 2014 Q2. In annual terms, they grew by about 19.7%. The main sub-item of this category, the remittances' inflows from emigrants stood approximately 17.6 % higher in annual terms. Primary income deficit continued the deepening trend for the sixth consecutive quarter. The latter contributed to the expansion on the annual performance of the current account deficit. In structural terms, as measured by the national gap between savings and investments, the private sector played a major role in the formation of the current deficit.*

*Net inflows in the capital account recorded a value of 21.3 million euro. Net foreign inflows in the financial account decreased by 18.6% in annual terms and financed 96.9% of the current account deficit. Net foreign direct investment expanded by about 39.7% in annual terms. On the other hand, other net investments were estimated at a positive net margin by about EUR 72.6 million, mainly influenced by the increase in domestic funds invested abroad. On the contrary, net portfolio investments declined by about 75.2 million euro. In the allocation of funding of the current deficit according to debt creating and non-debt creating flows, a more*



significant support to the second form of financing is noticed. The overall balance of payments resulted in the expansion of foreign currency reserve assets of EUR 111.8 million. At the end of June, the stock of foreign exchange reserves was EUR 2.4 billion. This level was sufficient to cover 5.3 months of goods' import and services and 192% of short-term external debt.

The overall balance of payments resulted in the expansion of foreign reserve assets by EUR 16.2 million. In June 2015, the stock of foreign exchange reserve was about EUR 2.38 billion. This level was sufficient to cover 6.3 months of goods' import and services and 161.7% of short-term external debt.

Table 4. Balance of payments indicator.

	Q1 '14	Q2 '14	Q3 '14	Q4 '14	Q1 '15	Q2 '15
Current account (in million euro)	-271.5	-341.0	-313.2	-377.5	-242.0	-181.3
In annual terms (%)	21.3	19.5	64.0	12.0	-16.8	-42.9
/ GDP (%)	-11.7	-12.8	-12.6	-14.5	-10.6	-6.7
Goods and services	-396.2	-473.3	-462.8	-536.0	-374.6	-366.9
Exports, f.o.b.	608.8	752.0	838.8	757.1	591.8	699.1
Imports, f.o.b.	1005.0	1225.3	1301.6	1293.1	966.4	1066.0
Net travels	-21.8	10.6	32.0	66.0	43.6	76.4
Primary revenues	-20.6	-43.3	-48.7	-47.0	-48.2	-24.6
Loan	28.7	25.7	28.3	27.8	27.2	24.7
Debit	49.3	69.1	77.0	74.8	75.4	49.3
Net FDI incomes	-30.4	-47.1	-56.2	-38.6	-50.7	-28.3
Secondary revenues	145.3	175.6	198.3	205.4	180.7	210.2
Loan	172.6	204.4	230.6	244.1	211.9	243.3
Debit	27.3	28.8	32.3	38.8	31.2	33.0
Net migrant remittance	118.2	137.5	165.1	171.0	141.8	161.7
Capital account	22.5	22.4	20.7	21.1	26.0	21.3
Net borrowing/ Net lending	-249.0	-318.7	-292.5	-356.4	-216.1	-160.0
Financial account	-199.1	-214.5	-206.1	-285.9	-194.9	-175.8
In annual terms (%)	57.2	-18.3	190.7	26.5	-19.8	-18.6
/ GDP (%)	-8.6	-8.0	-8.3	-10.9	-8.6	-6.5
Direct investments	-168.0	-150.4	-253.4	-229.4	-278.3	-189.3
Investment portfolio	14.5	14.0	-12.4	104.7	-82.9	-75.2
Finance derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other investments	-5.2	-100.6	-94.2	-122.2	54.5	72.6
Reserve assets	-40.3	22.5	154.0	-38.9	111.8	16.2
Errors and omissions	49.9	104.2	86.4	70.5	21.2	-15.8
Net borrowing/ Net lending	-249.0	-318.7	-292.5	-356.4	-216.1	-160.0

Source: Bank of Albania

### 5.3. CYCLICAL ECONOMIC SITUATION

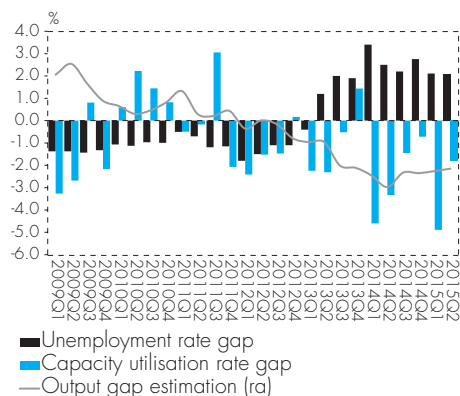
Economic activity continues to increase, but production capacity utilization remains below potential. Inflationary pressures from the real economy have been and are expected to remain low in the short term. The expected cyclic improvement of the economy in the years ahead is estimated to contribute to the closure of the negative output gap and the return of inflation to target by early 2018.

Inflation pressures from the domestic economy are low, reflecting weak consumer demand and utilization of production capacities below potential. Labour market continues to be characterized by low dynamics, where the employment increase is balanced by the increase in the labour participation rate. Therefore, the unemployment rate remained 17.3% 2015 Q2. Also, capacity utilization

rate, as reported in businesses confidence surveys, remains below the historical average. Besides these indicators, our estimates for the size of the output gap shows that it continues to be negative, exerting weak pressures on the increase of costs in domestic economy.

In our assessment, the fastest growth of the economy, expected in the years ahead, will reduce the size of spare capacities in the labour and capital markets. The negative output gap is foreseen to close gradually during 2016 and the economy growth to approach its potential in early 2017. Cyclical economic improvement is expected to be accompanied with pressures to gradually increase production costs and consumer prices. Inflation is expected to approach the target by early 2018.

Chart 38. Cyclical economic indicators



\*Output gap is the average of several measurements, on which the method of moving average is applied. Gap capacity utilization rate and the unemployment rate is calculated as a deviation of the current value against the historical average.  
Source: INSTAT and Bank of Albania.

### 5.4. INFLATION PERFORMANCE

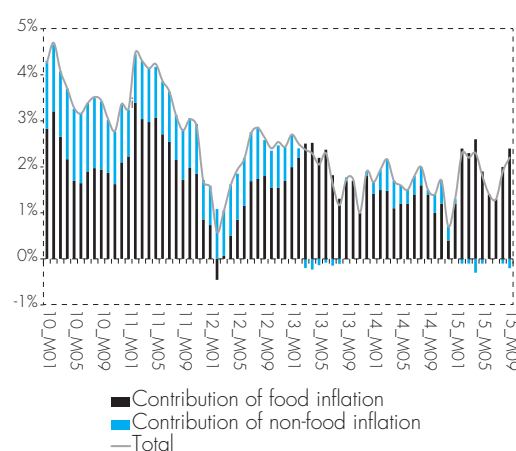
Developments in food prices, in particular of unprocessed ones, have determined the major part of the inflation rate during January-September 2015. In Q3, foods have contributed more than the value of the headline inflation. This contribution is mitigated by the negative impact of the "Consumer non-food goods". Disinflationary effects, which shifted the inflation curve downward in May/June, were cancelled out completely in the last two months of the quarter, reinforcing the assessment that the effects of price falling in the above period were temporary.

Price fluctuation of daily use foods has been significant this year, driving their monthly inflation to diverge from the seasonal average in many cases. This characteristic was more obvious during 2015 Q3. Having experienced a

sudden increase in Q1, the contribution of food prices began to be significantly reduced by half in July compared to April, 2015<sup>38</sup>. In the last two months, the contribution of this category experienced an increase again, returning to Q1 levels<sup>39</sup>.

“Non-food consumer goods” maintained a negative contribution to headline inflation rate, 0.2 percentage points to. Inflation performance of this category was affected by the annual decline/fall in fuel prices, after several months of increase. The contribution of “Goods at regulated prices” item was 0.1 percentage points in the formation of headline inflation, remaining at its average over the course of one year. Overall, other categories with a lower share continue to provide a low contribution to the annual inflation rate.

Chart 39. Contributions by categories of food and non-food in total annual inflation.



Source: INSTAT and Bank of Albania calculations.

Table 5. Main categories contribution in annual inflation (in percentage points).

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

Source: INSTAT and Bank of Albania.

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

#### 5.4.1. LONG-TERM INFLATION COMPONENTS

Developments in the long-term and domestic inflation continued to reflect the weak pressures from demand-side factors, cost of labour and production in the economy during 2015 Q3. Core<sup>40</sup> and non-tradable CPI inflation<sup>41</sup> resulted around -0.2% and 0.01%, respectively, lower than in the previous quarter and significantly below the last decade average.

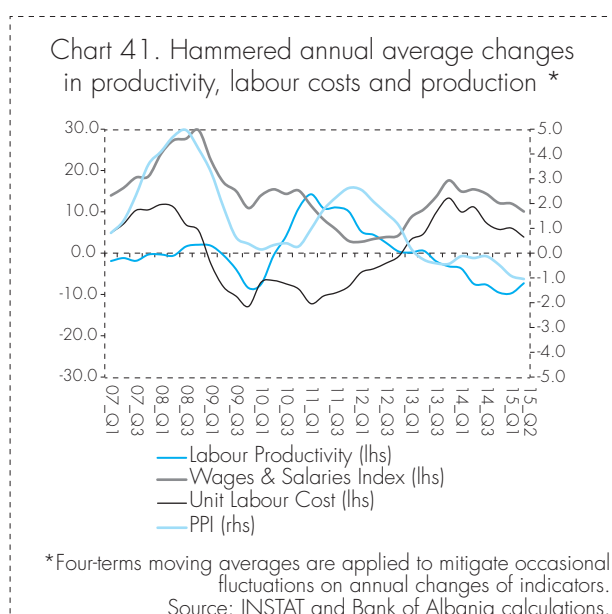
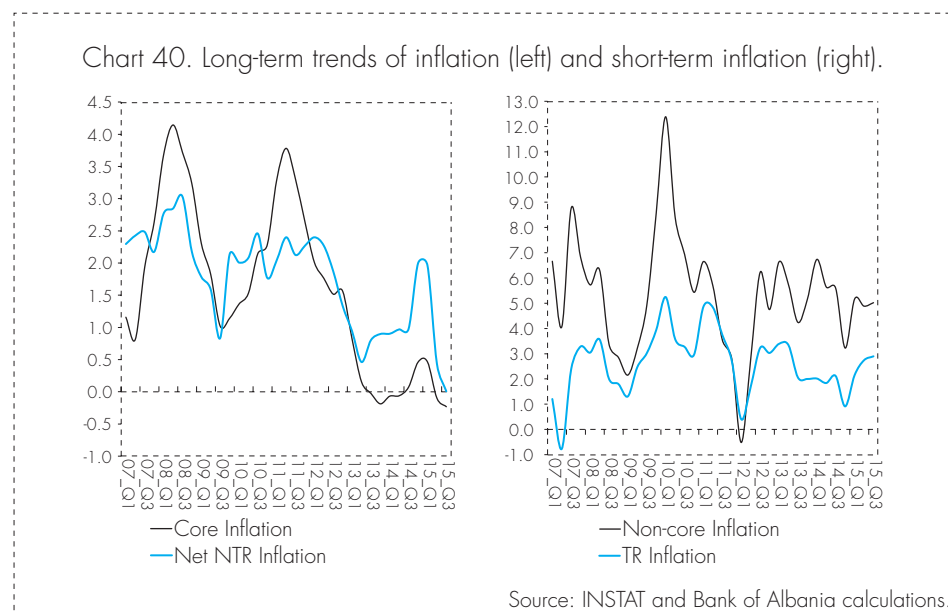
<sup>38</sup> The contribution of this category was reduced in half in the middle of 2015, from 2.3 percentage points in April to 1.2 percentage points in July.

<sup>39</sup> In September, the contribution of this category stood at 2.2 percentage points.

<sup>40</sup> Measured by the permanent exclusion method.

<sup>41</sup> The non-tradable and tradable inflation refer to the CPI changes of the respective sub-baskets, where the non-tradable consist mainly of goods and services, while the tradable one consists of only goods.

The action of short-term factors of supply-side was reflected in the fluctuation of value of non-core annual inflation and tradable goods of CPI basket during the quarter. On average terms they were around 5.02% and 2.90%, respectively, approaching the respective averages for the period 2005-2015.



The low values of the headline, domestic and core inflation in this quarter were dictated by low inflationary pressures in the economy, generated by the presence of the negative output gap.

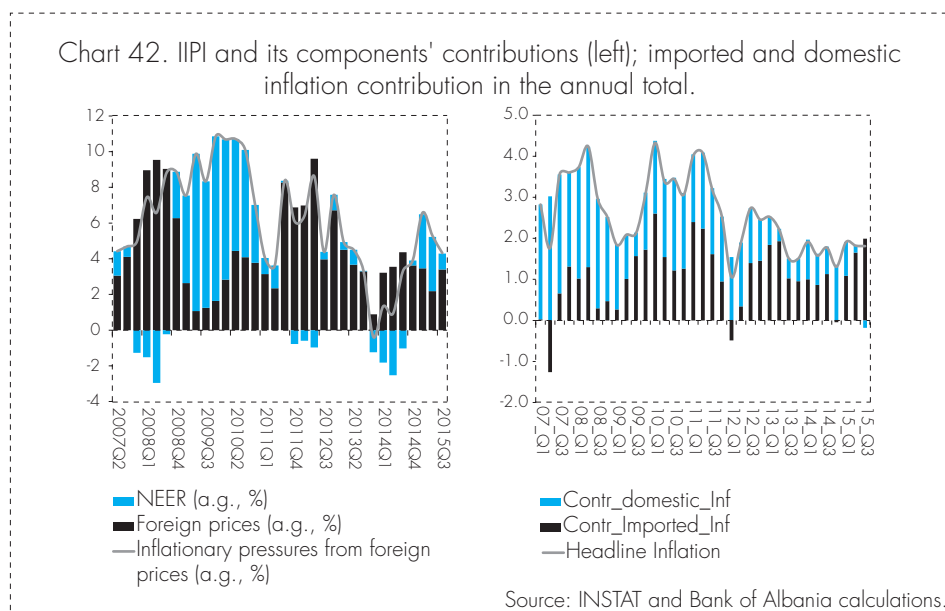
### *Wages, productivity and labour and production costs<sup>42</sup>*

The annual growth rates in labour costs slowed during 2015 Q2 (3.9%). This slowdown reflected the curbing of the downward trend of labour productivity indicator and the slow growth of wages fund index. For the same period, the annual rate of the industrial producer price index (PPI) recorded a decline almost identical to that of the previous quarter (-1%). Developments in these indicators suggest a continuation of weak inflationary pressures from the wage and production costs side.

<sup>42</sup> Proxy indicators of labour productivity and labour costs per unit of output are calculated by the Bank of Albania using the total series Short Term Statistics (SHTS, INSTAT, T2'2015). Their calculations consist of the index of employees paid, turnover and total wage fund for the total of the activities covered by the survey SHTS.

### 5.4.2. IMPORTED INFLATION

Imported inflation is assessed as the main contributor to the headline annual inflation value as the domestic one remains with a negligible negative contribution in this quarter. The assessment bears statistical effects of the comparative base, expected to be present in the following quarter as well.



Similar to the previous quarter, the index that approximates the expected inflationary pressures originating from trading partners, (IIPi<sup>43</sup>), slowed the pace of annual growth. The data for 2015 Q3 show the continuation of the low inflation rates in European Union countries. "Foreign prices" indicator<sup>44</sup>, which, in annual terms, expanded by 3.4% (1.2 percentage points higher than in Q2), was supported by inflation rates in Serbia and Turkey. On the contrary, a slight depreciation of the lek in terms of NEER index (by 0.9% in annual terms) had a peripheral contribution to the transmission of foreign inflationary pressures to Albania.

### 5.4.3. EXPECTATIONS FOR INFLATION<sup>45</sup>

Inflationary expectations have remained below the target of 3% and their long-term average. Different agents' expectations for inflation have fluctuated

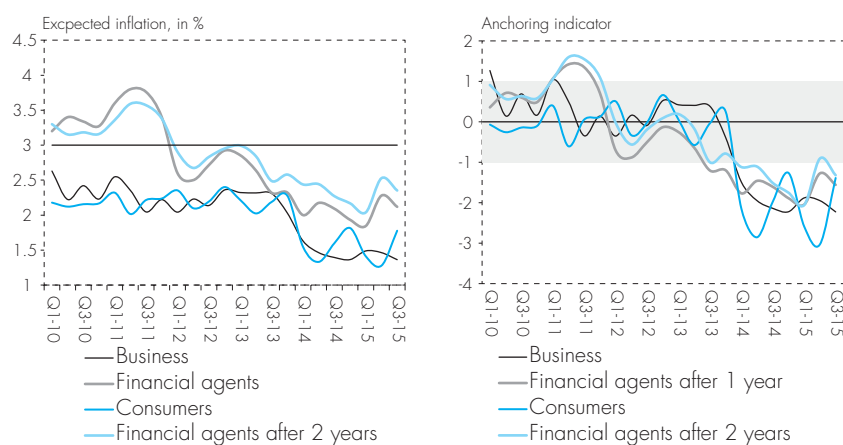
<sup>43</sup> IIPi is calculated as the annual growth of foreign prices NEER index for the respective month. Foreign inflationary pressures are assessed to affect the inflation with a delay of 1-3 months.

<sup>44</sup> It is a proxy indicator of foreign inflationary pressures, comparable with the inflation of the marketable sector of the national CPI basket goods. Foreign price index is based on values of: the inflation of: "Food, drinks and tobacco" for 18 main countries; and the inflation of: "Goods" (ie, not just foods) for Bulgaria, Germany, Greece, Italy and Turkey. Some goods have recorded an annual growth of prices, whilst the share of imports has also increased with the respective states. This has affected the indicator ultimate value (above mentioned CPI weighted average with the monthly share of their imports).

<sup>45</sup> Inflationary expectations' analysis is based on the results of the business and customer confidence survey with a quarterly frequency as well as in the surveillance of financial agents' expectations, with monthly frequency.

in different directions based on quantitative measurement collected from the surveys during Q3. Consumers revised upward the one year ahead inflation expectations. The inflation rate they expect is 0.5 percentage points higher than the expected rate for Q2. On the contrary, financial agents' expectations, the most adaptive among other agents, have declined, reflecting the reduction of the official inflation during Q2. One year ahead, business expectations for inflation fell slightly from the previous quarter (by -0.1 percentage points) and stand at the lowest level compared with the expectations level of other agents.

Chart 43. Inflationary expectations of various economic agents.



Source: Bank of Albania.

Inflation expectations of various economic agents during the past two years have remained below their long-term average. As the slight deviation of the level of expectations from the long term average shows<sup>46</sup>, the degree of anchoring of consumers' expectations improved in Q3.

<sup>46</sup> The degree of anchoring is quantified as the change of the expectations' level from their long-term average which is different for various economic agents.