THE REPORT REFERS TO BANK OF ALBANIA’S MONETARY POLICY STATEMENT FOR 2018 H1, APPROVED BY THE SUPERVISORY COUNCIL’S DECISION NO.56, DATED 01.08.2018
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INTRODUCTION

The primary objective of monetary policy in Albania is to achieve and maintain price stability, which, in quantitative terms, is defined as maintaining inflation at around 3%.

Through the achievement of this objective, the monetary policy promotes a stable and long-term growth of the Albanian economy, contributes to safeguarding financial stability and supports the welfare of the Albanian citizens.

The monetary policy is always forward looking.

In accordance with the principles defined in the Monetary Policy Document, the Bank of Albania implements a consistent, balanced, prudent, and transparent monetary policy.

The report refers to Bank of Albania’s Monetary Policy statement for 2018 H1, Approved by the Supervisory Council’s Decision No.56, dated 01.08.2018.

The economic and monetary analysis in this report is based on the statistical and qualitative data available as at 20 July 2018.
The Albanian economy continued to pursue a positive development trend in the first half of 2018. Economic activity has been proceeding along an upward growth path, enabling thus the expansion of employment, increase in wages, improvement of firms’ financial situation, and gradual build-up of inflationary pressures.

These developments have been underpinned by the improvement in the external environment, the improvement of confidence in the economy, the favourable financial conditions, dictated by our accommodative monetary policy, and positive supply-side shocks.

Our expectations for the outlook remain positive. Yet, their materialisation requires maintaining the accommodative monetary policy stance, while the balance of risks remains skewed to the downside.

Average inflation registered 2.2% in the second quarter, upward from 1.9% registered in the first quarter. In particular, inflation hit 2.4% in June. The balance of inflationary pressures continues to be formed by a gradual build-up trend of domestic pressures and short-term fluctuations in the prices of specific items in the consumption basket.

The pickup in inflation in the second quarter reflected the resultant effect of two shocks in opposite directions. On the one hand, the rise in oil prices in international markets led, in turn, to higher production costs and had an upward impact on inflation. On the other hand, the appreciation of the exchange rate decelerated the pass-through of foreign inflationary pressures to the domestic market. The effect of the first factor was more intensive in the second quarter, but this effect is expected to be shorter in time.

Our projections suggest that inflation will converge toward our target within 2020. This projection takes into account the positive dynamics of economic growth and our expectations for the return of the economy to equilibrium in the first half of the next year. Also, it is based on the assessment that disinflationary pressures from the appreciation of the exchange rate will remain transitory.

These judgments are corroborated by economic and monetary data of the first half of the year.

The Albanian economy grew 4.45% in the first quarter, and indirect data suggest positive growth rates will continue in the second quarter. The acceleration
of the economic growth pace in the first quarter reflected the rapid growth in electricity production, in response to favourable weather conditions. In the longer term, the expansion of economic activity was supported by the pickup in private consumption and investments, whereas the deficit of external trade expanded and the fiscal policy continued on the consolidating trend. Indirect data suggest that these development trends have been carried forward into the second quarter.

The economic activity expanded, while employment improved and the unemployment rate fell to 12.5%. This is the lowest historical level of unemployment registered in Albania and suggests an increasingly fuller utilisation of production capacities in Albania. In response to it, the INSTAT reports that the average real wage increased by 2.3% in the first quarter, a positive premise for the gradual build-up of domestic inflationary pressures.

The domestic financial market remains calm and liquid, but appreciation pressures of the Albanian lek remain present in the foreign exchange segment. The recent monetary policy measures - lowering the policy rate to 1.0% and intervention in the domestic foreign exchange market, with a view to preventing the rapid appreciation of the exchange rate - have proven to be effective.

The interest rates for the Albanian lek have been downward in the second quarter. Interest rates on loans, deposits and securities denominated in lek are currently at minimum levels. Credit to the private sector registered 5% average growth in the second quarter, with a more balanced contribution to growth between lek and foreign currency credit.

Overall, credit growth is in line with the moderate improvement of credit demand. However, the bank lending survey suggests that credit standards and loan terms and conditions applied by the banking sector remain conservative. The Bank of Albania finds that the diminishing of the credit risk and the steady improvement of balance sheets - as illustrated by the drop to 13.27% of the non-performing loans ratio - should be better reflected in the lending policies of the banking sector.

After the rapid appreciation of the exchange rate in the April - May period, the intervention of the Bank of Albania succeeded in calming the functioning of the domestic foreign exchange market and decelerated the appreciation of the exchange rate. Our analyses, however, suggest that the demand-supply ratio in the domestic foreign exchange market remains misbalanced, in part due to the high seasonal flows. In addition, the rapid and further appreciation of the exchange rate would impair the convergence of inflation towards our target in the medium term.

Judging on the above, the Bank of Albania deems that the current monetary policy stance remains adequate.
Maintaining an expansionary monetary policy stance in the medium term will serve to boost aggregate demand, contributing thus to employment gains, higher wages, and build-up of domestic inflationary pressures. The monetary stimulus is consistent with the fiscal policy consolidation and remains a necessary precondition for the convergence of inflation to our target within 2020. In accordance with projections of the baseline scenario, and based on the available information, the normalisation of interest rates in the domestic financial market will not resume before the second quarter of 2019.
1. PRICE STABILITY AND BANK OF ALBANIA’S MONETARY POLICY

The Albanian economy remains on a positive development trajectory, as illustrated by the accelerating trend of the economic growth pace, the broad base of factors underpinning economic growth and improvement of labour market indicators. Domestic inflationary pressures have built up as a result of fuller utilisation of production capacities. On the other hand, the appreciation of lek’s exchange rate against the euro went well beyond its trend, stalling the rise in inflation and shifting downward the balance of risks in the short term. This development required revising the monetary policy stance on the easing side, with a view to achieving the medium-term inflation target.

The Bank of Albania increased the monetary stimulus in June, by lowering the policy rate and approving a programme of interventions in the foreign exchange market. These decisions were aimed at preventing the materialisation of the negative effects of a strong and rapid appreciation of the exchange rate on the achievement of the inflation target and on other economic indicators. Through the reduction of costs of funding and deceleration of the exchange rate, the monetary easing has been now transmitted to the financial markets. Financial conditions remain accommodative and consistent with the return of inflation to target within 2020.

The Albanian economy is set on a positive development trajectory. Aggregate demand and output have been upward, driven by low interest rates, more optimistic expectations by economic agents, and positive developments abroad. As a result of the economic activity expansion, the financial situation of enterprises improved, employment and wages increased, hence supporting the increase in consumption of Albanian households. The gradual convergence of the economy toward its potential has been accompanied by a build-up of domestic inflationary pressures. In response to it, the inflation rate ticked up in the second quarter, although it continues to remain below the Bank’s target.

The real sector marked a positive performance in the first half of the year, standing on the upper side of our expectations, while the exchange rate showed strong appreciation. Our analyses suggest that the positive development trends will continue, whereas the deviations from the trend have been a result of supply-side temporary factors.

Economic activity in continued to improve in 2018 Q1. INSTAT data show that the Gross Domestic Product grew by 4.45% in 2018 Q1, from 3.80% in 2017. Economic activity expansion was supported by all aggregate demand components, primarily consumption and investments. The growth in aggregate
demand has triggered the output growth in all the main sectors of the economy. In addition, economic growth in the first quarter was stimulated by supply-side specific factors. The weather conditions favoured the increase in electricity production, which provided a high contribution, 1.9 percentage points, to annual growth. The positive performance is expected to recur in the second quarter of the year. Leading indicators of the GDP growth in 2018 Q2 suggest a similar growth pace to the first quarter.

Annual inflation trended upward in 2018 Q2, driven mostly by short-term components. In this period, the average inflation rate stood at 2.2%, from 1.9% in the previous quarter. Inflation rose mostly in June, when its rate recorded 2.4%. The rise is largely attributable to short-term and supply-side factors, related mainly to the increase in food and oil prices. In particular, the rise in oil prices is assessed to have provided a positive impulse to the rise in inflation, through both the direct effect and its transmission to producer prices and related services.

The update of our forecasts suggests that domestic inflationary pressures are upward; however, they are insufficient to guarantee the return of inflation to target in the short term. Albeit improving, economic activity in Albania remains below its potential and aggregate demand continues to be insufficient to ensure full employment. The cyclical position of the economy is reflected in still low values of core inflation.

Likewise, the appreciation of the exchange rate has contributed to toning down inflationary pressures. In the past two years, the exchange rate has gone through an appreciating trend, reflecting the structural improvements of the Albanian economy. The Albanian lek appreciated, on average, by 2.3% against the euro, in 2017. This appreciation accelerated to around 6.4%, just in the first half of 2018. The appreciation was more distinct especially in May and the first week of June when the Albanian lek appreciated by around 3.4% vis-à-vis the euro over a five-week span.

According to our estimates, the appreciation of the exchange rate went beyond the trend dictated by structural factors. The appreciation reflected a strong consensus of expectations on the further appreciation of the exchange rate in the period ahead, leading also to the change of behaviour of economic agents and forex market operators, resulting thus in a misbalancing of supply-demand for foreign currency. Subsequently, through the modification of

1 In April and May, annual inflation stood at 2.1%.
2 For more on the impact of oil price on inflation, refer to the box 4 “Direct and indirect impacts of fuel prices on inflation”.
3 Box 1 ‘On the exchange rate performance in 2018 H1’, in the following sections.
behaviour, expectations had a self-fulfilling effect in the short term, leading to the appreciation of the exchange rate and facing the risk of creating negative spirals with potential negative effects on the financial market, economy and inflation. A more detailed analysis on the underlying factors for the appreciation of the exchange rate is given in the Box ‘On the exchange rate performance in 2018 H1’, in the following sections.

In particular, the exchange rate appreciation shifted down the expected trajectory of inflation in the medium term and the risk of the presence of negative inflation rates in this time horizon. This reaction required, therefore, a monetary policy response, to avoid the above-stated risk and realign monetary conditions with the medium-term inflation target.

Against this backdrop, the Bank of Albania revised the monetary policy stance in June, lowering the policy rate and approving a programme of interventions in the foreign exchange market. The policy rate was lowered by 0.25 percentage point to 1.0%, a new historical low. In parallel, interest rates on standing facilities were lowered to 0.1% for the overnight deposit and 1.9% for the overnight lending facility.

Similarly, based on the limited space for further lowering the policy rate, and judging on the origin of shocks to inflation, the Bank of Albania decided to use foreign exchange market operations as an instrument of the monetary policy. In strategic terms, the use of this instrument was aimed at preventing the materialisation of potential negative effects from the rapid exchange rate appreciation on achieving the inflation target. In operational terms, the instrument was aimed at decelerating the rapid exchange rate appreciation and creating the premises for a more normal trading activity in the domestic foreign exchange market. This instrument will continue to be used until risks from foreign exchange activity - affecting the return of inflation to target - have passed.
Monetary accommodation is expected to be transmitted to the economy through the reduction of the costs of funding and deceleration of the rapid appreciation of the exchange rate. Domestic financial markets have reacted quickly to the lowering of the policy rate, reflecting it in lower interest rates in the interbank and the primary markets.

The interest rates on loans in lek remain at low historical levels, contributing to the expansion of the credit portfolio in lek. Credit in lek remains the most preferred financing instrument and is the main driver to the expansion of credit to the private sector. At the end of June, lek credit accounted for around 46.5% of credit to residents, 1.5 percentage points higher than in the previous year.

However, credit growth remains slow. Albeit increasing, credit demand remains sluggish, whereas banks continue to apply tight credit conditions, especially in the enterprises segment. Although credit risk has been downward, as shown by the constant drop in the ratio of non-performing loans, banks remain conservative in their approach toward credit to the private sector.

The accommodative monetary policy stance has created preconditions for the return of inflation to target. The monetary policy has lowered the interest rates and the risk premia in financial markets and has decelerated the appreciation trend of the exchange rate, thus contributing to boosting the economic activity, through eased financing conditions.

The Albanian economy is expected to remain on a positive economic growth trajectory. The growth of aggregate demand is expected to increase the utilisation of production capacities close to their optimum levels, adding domestic inflationary pressures. On the other hand, the negative effect of the exchange rate on inflation is expected to remain present for some quarters ahead, in accordance with the duration and intensity of the shock and in line with the time lag and the strength of its pass-through to prices.

According to Bank of Albania projections, the average annual inflation will be around 2.0% during 2018 and will return to target within 2020. Compared to the previous round, the convergence of inflation to our target is projected to be somewhat slower, reflecting the impact of the exchange rate.

The updated analyses and projections in this report suggest that in the medium-term horizon, the risks surrounding our forecasts remain on the down side. They are related to the duration, impact and transmission channels of the exchange rate appreciation on inflation, the speed of bank credit recovery, and uncertainties in the external environment.

The monetary policy will maintain the accommodative stance over the medium-term horizon, to support economic growth and the return of inflation to target.
2. EXTERNAL ECONOMIC ENVIRONMENT

The global economy slowed down the growth pace in 2018 Q1, as a result of the slowdown in some of the advanced economies. Tensions arising from the protectionist measures and trade tariffs introduced by the United States and the implications with its main trading partners may affect the overall economic climate and dynamics. The outlook for the second half of the year, however, remains favourable and leading indicators for the second quarter suggest a gradual return to the rates noted at the end of the previous year.

Inflation rates picked up in May and June as a result of rising oil prices. Medium-term inflationary pressures remain moderate. Financial markets are liquid with low interest rates and risk premiums, reflecting expansionary monetary policies by the major central banks.

2.1. GLOBAL ECONOMY

Economic activity in the major advanced economies slowed down in 2018 Q1 (especially in Europe and Japan), but the outlook remains overall favourable. Indirect and leading indicators of the global economic growth for the second quarter suggest growth will strengthen in major advanced economies driven by the constant growth of employment and households’ disposable income. While downward from the maximum levels marked at the end of the previous year,

Chart 3 Composite Leading Indicator (CLI) of GDP and Industrial Output in the main countries (left) and inflation in main countries and trading partners (right)

* Industrial output is a quarterly moving average of the monthly change, while CLI longterm trend is 100. Main countries are OECD countries plus Brazil, China, Russia, India and South Africa.

Source: Markit, OECD, Eurostat.

4 The global composite output PMI and Global manufacturing PMI, Markit, May and June 2018.
5 The Composite Leading Indicator (OECD), January - May 2018.
the main confidence indicators\(^6\) support the expansion of production during this period. Inflation registered higher readings in recent months, but inflationary pressures remain moderate, as its core component ranges in low levels. The rising prices of oil and energy products are expected to affect headline inflation in the months ahead.

**UNITED STATES ECONOMY**

The US economy improved in 2018 Q1, recording higher annual growth rates than in the previous quarter (2.8% from 2.6%). Economic growth has been driven primarily by domestic demand, with the improvement of consumer spending and non-residential investment. This performance has reflected fiscal easing measures by the government in 2018, which envisage lower tax rates both for enterprises and households. Government expenditures slowed down the growth pace, together with residential investments. These two indicators, together with the expansion of imports, have shifted economic growth to the downside. Indirect indicators for the period suggest that economic growth will perform in similar terms in the second quarter. The fiscal stimulus and improvements in the labour market are expected to support economic growth, while tensions related to trade barriers are expected to contribute negatively to external demand. Labour market indicators are adequate: unemployment is low and employment has been rising. Annual inflation has pursued an upward trajectory, hitting 2.9% in June, thanks to the rise in fuel prices. The inflation rate has been overshooting the US Federal Reserve’s target, since the beginning of the year. The latter is set on a tightening trajectory of the monetary policy.

**Table 1 Selected macroeconomic indicators**

<table>
<thead>
<tr>
<th>Countries</th>
<th>GDP change Q1-2018</th>
<th>Unemployment rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Quarterly</td>
<td>Annual</td>
</tr>
<tr>
<td>USA</td>
<td>0.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Euro area</td>
<td>0.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Germany</td>
<td>0.3</td>
<td>2.3</td>
</tr>
<tr>
<td>France</td>
<td>0.2</td>
<td>2.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.1</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Eurostat, respective statistical institutes.

*The value for June 2018

**EURO AREA ECONOMY**

Adverse weather conditions and political developments\(^7\) have contributed to slower growth pace of the euro area economy in the first quarter. Growth was driven by investments and consumer spending. The latter have slowed down. The contribution from external demand has been almost neutral, with exports and imports slowing down the growth pace. The labour market continues to improve, with the unemployment rate recording the lowest levels since the 2008 economic and financial crisis.

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\(^6\) Business Climate Indicator (BCI) and Economic Sentiment Indicator (ESI) for the EU and Markit Global Business Outlook, June 2018.

\(^7\) The parliamentary elections in Italy in March resulted in no immediate consensus for forming a government. The new government was formed only on 1 June.
Indirect indicators for the period ahead suggest that the steady growth in the euro area economy will continue. Although lower than at the year-start, leading indicators stand on the expansionary side of economic growth. The decrease in unemployment and increase in income support the expansion of private consumption, while the favourable financing conditions and the stable demand support investments. Yet, due to uncertainties surrounding trade agreements with the US, risks to the outlook are mounting. Expectations for 2018 GDP growth have been revised down, compared to expectations at the beginning of the year\(^8\).

Inflation has inched up, to 1.9% and 2.0% in May and June, standing close to the central bank target. These rates, however, have been supported by price rise in energy products, whose effect is expected to wane over the next year. Core inflation remains low and stable (at around 1.0%), leading the ECB to extend the accommodative monetary policy stance in the euro area.

The economies of Albania’s two main trading partners, Italy and Greece, performed in two opposite directions in the first quarter. Economic activity in Italy slowed down the growth pace, mainly as a result of deceleration of consumer spending and import growth. The increase in total investments contributed to the opposite direction. The growth forecast for Italy has been marked down. The economy is expected to grow at a slower pace in the period ahead, due to uncertainties surrounding economic activity in the euro area, where trade barriers that may be imposed by the US on automobile imports would hit the Italian industry. The economy of Greece accelerated the pace of growth in the first quarter. The main drivers of growth were the strong increase in investments,

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\(^8\) New IMF forecasts for advanced economies show that, in 2018, growth in the euro area economy will be 2.2%, from 2.4% forecasted in April. (World Economic Outlook Update, July 2018).
together with net exports. The performance of consumer spending was slack, with negative growth rates. The positive momentum in the Greek economy is expected to persist in the quarters ahead. The annual inflation rates inched up in both countries, pursuing an upward trajectory within the months of the quarter. In June, annual inflation readings were 1.4% in Italy and 1% in Greece, lifted by oil and energy prices.

**REGIONAL ECONOMIES**

The economies of the countries of the region, excluding Macedonia, improved in the first quarter, amid political stability and less clouded outlook. While growth drivers vary among the countries, investments have supported economic growth across the region. Unemployment remains high in the region, trending downward though, except for Serbia. In the next quarters, the situation is expected to improve in the countries of the region, aided by macroeconomic stability and positive expectations in their trading partners. Inflationary pressures are building up and inflation rates are set on an upward trajectory.

The economy of **Turkey** developed at a rapid pace in the first quarter, as a result of higher consumer spending and investments. The economy benefited from some government measures to boost lending to the economy through state guarantees and fiscal incentives. Meanwhile, the contraction of net exports contributed to the decelerating side. The economy of **Kosovo** accelerated the growth pace in the first quarter, driven primarily by investments, mainly by the government. The growth in net exports contributed positively to the total growth of the economy, whereas consumer spending has slowed down for the second quarter in a row. Economic activity in **Serbia** improved in the first quarter, continuing the upward trajectory started a few quarters earlier. Economic growth has been supported by private consumption and investments, whereas net exports exerted a drag on growth. The economy of **Macedonia** ticked up at minimum rates in the first quarter, supported mainly by external demand and private consumption. The lacklustre growth is attributable to the significant drop in public investments. Infrastructure projects could not be realised due to the political crisis the country experienced in the previous year. The outlook for economic growth in the quarters ahead is positive. It is underpinned by the pickup in private consumption and recovery of public investments.

Inflation rates showed an upward trend in June, in most of the countries of the region, excluding Kosovo and Macedonia. They were affected mainly by higher food and fuel prices, which have been transmitted to headline inflation. Yet, medium-term inflationary pressures remain low across the region, with the exemption of Turkey.

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9 Main trading partners, non-EU member countries.
10 Consensus Forecast, June 2018.
Table 2 Economic indicators for countries in the region

<table>
<thead>
<tr>
<th>Countries</th>
<th>Annual change of GDP Q1-2018</th>
<th>Annual inflation June-2018</th>
<th>Unemployment rate 2018 Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>1.4</td>
<td>1.4</td>
<td>10.7*</td>
</tr>
<tr>
<td>Greece</td>
<td>2.3</td>
<td>1.0</td>
<td>20.2**</td>
</tr>
<tr>
<td>Macedonia</td>
<td>0.1</td>
<td>1.4</td>
<td>21.6</td>
</tr>
<tr>
<td>Serbia</td>
<td>4.6</td>
<td>2.3</td>
<td>14.8</td>
</tr>
<tr>
<td>Turkey</td>
<td>7.4</td>
<td>15.4</td>
<td>9.6**</td>
</tr>
<tr>
<td>Kosovo</td>
<td>3.5</td>
<td>0.8</td>
<td>26.5</td>
</tr>
<tr>
<td>Albania</td>
<td>4.5</td>
<td>2.4</td>
<td>12.5</td>
</tr>
</tbody>
</table>

Source: Respective statistical institutes.
Note: *May 2018; **April 2018;

2.2. COMMODITY PRICES IN GLOBAL MARKETS

In the second quarter, the oil prices increased significantly in international markets. The Brent price spiked by around 50% in this quarter, from a year earlier, and around 15% from the year start. The oil price hiked in May, approaching the 80 USD/barrel price. The hike was driven by the prospect of reduction of oil production by Iran following confirmation of US sanctions, and the declining capacity in Venezuela. At the same time, the growth of economic activity has contributed to demand growth. In June, OPEC countries agreed to raise oil production quota, correcting its price in the marketplace. Authorities, however, indicate prices are likely to decline over the next two years, supported by the expectations for increased US production.

The increase in oil and energy product prices has lifted inflation in advanced and emerging market economies in May and June. It is also reflected in the rising oil prices in the domestic market and a higher contribution to inflation during this period.
The food prices index continued to rise marginally in the second quarter. It has increased around 3% since the start of the year. Weather conditions in some cereal-producing countries have triggered expectations for diminishing agriculture supply, hence lifting food prices. They are expected to rise slowly in the future, but trade tensions among main suppliers in this market have added uncertainties about food prices in the periods ahead.

Metal prices continued the two-digit rise, in annual terms, hitting a record high in the last six years. The rise stalled in June, when uncertainties surrounding trade tensions between the US and China were reflected in expectations for deceleration of demand for metal raw materials. Also, the fall in output indices in advanced economies led to a revision of expectations for a slowdown of the economy and metal prices are expected to remain broadly unchanged until the end of the year.

2.3. FINANCIAL MARKETS

Monetary conditions dictated by central banks of major economies remain accommodative. The monetary policy trend in the future is toward normalisation. As expected, in its meeting on 13 June, the Fed decided to raise the target range for the federal funds rate by 0.25 percentage point, to 1.75-2%. It declared that it will continue to gradually raise the rate in the future. Other major central banks have kept the respective policy rates unchanged in the second quarter. Thus, the ECB rate remains 0.0%, the BoE rate remains 0.5% and the BoJ rate remains -0.1%. The European Central Bank extended the accommodative monetary policy stance, stating that it expects them to remain at their present levels at least through the summer of 2019, and confirmed it will end the open market asset purchase programme at the end of 2018.

Interest rates in the euro area money market did not change in the second quarter. They continued to be low. In euro area capital markets, the yields on government securities showed volatility and different performance on both sides. The concern related to the impact of inward-looking policies and trade tariffs has driven investors to purchase debt securities from countries perceived as safer and with maximum rating by rating agencies. This move has affected
the ask premiums in the financial market widening the spread of the countries against the German bonds. Nonetheless, financial conditions in the market (euro area) and sovereign risk premiums remain low and supportive of the economy.

In May-June, the euro depreciated against the US dollar and some other major currencies (British pound, Japanese yen, and Chinese renminbi). After starting the year with an appreciation trend, since March, the euro has lost ground to the US dollar. In June, one euro was traded on average to 1.168 US dollar, depreciating by 4.9% from April and 4.3% from the start of the year.
3. FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

The second quarter was characterised by a rapid appreciation of lek’s exchange rate, which was accompanied by heightened volatility and uncertainty in the forex market. The creation of one-sided expectations for the appreciation of the exchange rate was accompanied by a change in the behaviour of economic agents and financial market operators, resulting in the rapid appreciation of the Albanian lek and hazarding the achievement of the inflation target in the medium term. To prevent potential negative effects, the Bank of Albania eased further the monetary conditions and undertook a programme of intervention in the foreign exchange market. In the following, the developments in the foreign exchange market have been calm, and the lowering of the policy rate has been transmitted to all short-term segments of the financial market.

Lending continued to grow at a contained pace, reflecting banks’ tightening lending policies toward enterprises. Credit demand was higher both from enterprises and households, in response to stimulating monetary conditions, improvement of the domestic economic activity, and positive outlook for the economy.

The shift in the preference for keeping the money in non-liquid financial instruments continues to determine a low monetary expansion.

3.1. FINANCIAL MARKET DEVELOPMENTS

INTERBANK MARKET

The interbank market continued to be characterised by low interest rates and minimum spread vis-à-vis the policy rate in Q2. The interest rates asked by banks for fund trading amongst them have resulted close to the policy rate, while volatility indicators registered low levels. This performance was supported also by the improvement of banks liquidity position. The latest change in the policy rate passed through immediately to interest rates applied by banks in the money market. The average traded volume inched up slightly compared to Q1, as a result of the expansion of exchanges in longer than overnight maturities. However, the profile of interbank transactions remains in favour of overnight and one-week maturities.

\[11\] In 2018 Q2, the exchange rate performance contributed largely to the monetary data reporting in lek. To prevent this effect, the monetary analysis has been based on the real dynamics of monetary indicators.
The Bank of Albania continued its liquidity injection operations in the system by employing its main instrument - the one-week repo. In addition, three-month maturities have been also used. The amount injected in this quarter was smaller than in the previous quarter, whereas the interest rates in the auctions stood close to the policy rate.

**DOMESTIC FOREIGN EXCHANGE MARKET**

The second quarter was characterised by a rapid appreciation of the domestic currency, mainly against the euro. This appreciation peaked in May and at the beginning of June. The appreciation of lek against the euro was a resulting effect of the foreign currency supply and change in the behaviour of economic agents and financial intermediators, in response to expectations formed for a further appreciation of the exchange rate in the future. Due to the persistence...
and magnitude of this shock, the Bank of Albania intervened to prevent the rapid appreciation and the pass through of its negative effects on inflation. In this regard, in addition to money market interventions, the Bank of Albania was present in the foreign exchange market in June, on the side of foreign currency purchasing. The exchange rate has since stabilised, standing at 125.9 lek for one euro in this period.

In 2018 Q2, one euro was traded at ALL 127.4 on average, or 3.9% cheaper than in the previous quarter. In annual terms, the lek appreciated on average 5.2% against 2.5% in 2018 Q1. The appreciation of the lek against the euro during this period was accompanied by higher volatility in the foreign exchange market12 and increased uncertainty, measured as the spread between the ask and bid price of the European currency. The spread peaked in the first week of June, at ALL 1.6 on average, against ALL 0.5 in normal periods. Following the presence of the Bank of Albania in the foreign exchange market, the spread in the quoting of ask and bid prices of the euro in banks returned to normality.

In parallel to the euro, the Albanian lek appreciated slightly also against the US dollar. Thus, one US dollar was traded on average at ALL 106.5 in Q2, from ALL 107.3 in the previous quarter. In annual terms, the US dollar cost, on average, 12.6% less than in the same period in the previous year.

As a result of these developments, the nominal effective exchange rate13 appreciated on average 7.8% in annual terms in Q2, from 4.7% in the previous quarter. The real exchange rate against currencies of the trading basket ranged around similar values, in the presence of inflation differences that are largely unchanged at home from those of the region.

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12 In Q2, the standard deviation of daily changes in the exchange rate euro/lek recorded 0.34 on average against the 0.14 average in the last ten years.

13 The nominal effective exchange rate (NEER/REER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market weights. For the purpose of calculating the lira/lek and the renminbi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renminbi against the US dollar. The real effective exchange rate (REER) is calculated similarly to the nominal, but it considers the domestic inflation and those in the trading partners, as well.
Box 1: Exchange Rate Developments in 2018 H1

The lek exchange rate was characterized by a strong appreciating trend during 2018 H1. Given the importance of this indicator on financial markets and real economy indicators, the Bank of Albania paid particular attention to the analysis of the underlying factors of such behaviour. In particular, the analysis focused on if, or to what extent, this appreciation was determined by fundamental factors and if, or to what extent, it was determined by temporary shocks that lead to deviations from medium and long-term trends.

Answering these questions is of utmost importance for defining the Bank of Albania’s response. In the first case, i.e. exchange rate fluctuations are in line with the fundamental factors, appreciation does not lead to economic or financial imbalances. As such, it does not provoke any response by the Bank of Albania. In the second case, i.e. exchange rate fluctuates in response to temporary factors, the appreciation of exchange rate would signal a deviation from the fundamentals. If these deviations last, they can negatively affect aggregate demand and inflation over the policy-relevant horizon. As such, they should be subject to the monetary policy response.

The information presented in previous reports\(^1\) suggests that:

- The appreciation of the exchange rate during 2015-2017 is dictated mainly by fundamental factors and during this period the exchange rate did not have large deviations from its equilibrium.
- On the other hand, the appreciation of the exchange rate in the first two quarters of 2018, besides the fundamental factors, is largely a result of other factors. The main causes of this appreciation appear to be specific developments in the foreign exchange market, which have induced a change in some of the agents’ behaviour, producing a temporary imbalance of supply and demand.

The following section provides a more detailed analysis of the developments in the foreign exchange market during 2018 H1.

Long-term trend and fundamental factors

The lek exchange rate has shown a continuous appreciating trend, since mid-2015. This trend is based on structural improvements in the economy in the form of a steady narrowing of the current account deficit; high level of foreign direct investments, as well as the increase of confidence in institutions and products of the Albanian financial market. These developments have supported the gradual appreciation of the exchange rate.

\(^1\) Annual Report 2017, Information Box 3: “Exchange Rate appreciation” -Determining Factors and Implications"
More than a reflection of the fundamental factors, the rapid appreciation of the rate in the first two quarters of 2018 seems to be dictated by strong short-term shocks. These shocks appear to have originated in the foreign exchange market and have steered the exchange rate away from its long-term equilibrium. When estimating the performance of the exchange rate risk premium, it is noted that during 2015-2017, pressures from premiums against the nominal exchange rate did not increase and, consequently, the appreciating trend was driven by fundamental factors. The assessment changes for 2018, when during the second quarter, the fx risk premium suffered a negative shock, mainly in the form of a temporary risk premium, which led to the acceleration of the appreciation of the exchange rate at the beginning of this year beyond fundamentals.

In support of this argument, the following section presents a more detailed analysis of developments in the foreign exchange market during 2018 H1.
Short-term developments in the foreign exchange market

The performance analysis of the foreign exchange market during 2018 H1 focuses on three key moments: (i) trading volume; (ii) behaviour of main operators in the foreign exchange market; and (iii) indicators of uncertainty and volatility.

Theoretically, transactions in the domestic foreign exchange market (seen as the total volume of transactions by banks and foreign exchange bureaus) are a function of the trade of goods and international services and exchanges for financial reasons. The available data suggest that, in Albania, the volume of transactions in the domestic foreign exchange market is mostly determined by the volume of international trade transactions. As shown in Chart 14, the correlation of these two indicators is high.

However, 2018 data suggest that the volume of transactions in the domestic foreign exchange market is lower than the one dictated by international trade transactions. This mismatch suggests that real-economy sector operators may have changed their behaviour. Taking into account that – in balance – international trade of goods constitutes a net source of demand for foreign currency in the domestic foreign exchange market, this change in behaviour may suggest that unilateral expectations for further appreciation of exchange rate have dictated the deferment of demand for foreign currency and have contributed to the appreciation of exchange rate.

The second moment relates to the behaviour of main foreign exchange market operators: commercial banks. Within regulatory limits, commercial banks hold an open foreign exchange position (the spread between assets and liabilities denominated in foreign currency). Historically, this position has served to mitigate temporary demand and supply surpluses and to minimize their impact on the market. A temporary or seasonal supply surplus led to an increase in the open position in foreign currency purchases by banks, not resulting in appreciation of the exchange rate. On the contrary, a temporary or seasonal demand surplus led to a fall in the foreign currency purchase position by banks, not resulting in exchange rate depreciation.

Chart 16 shows the fluctuations of banks’ foreign exchange positions over the years. More specifically, the chart shows the deviations of the current foreign exchange position from the level dictated by trend and seasonality. Despite the shock in the foreign exchange market being the strongest of the last decade (after
in conclusion, an important indicator of uncertainty in the domestic foreign exchange market is the performance of the bid-ask spread. This performance is reflected in Chart 17. It shows a rapid expansion of the spread during the last months of the second quarter, which reflects the increased uncertainty in the foreign exchange market and the unwillingness of banks to position themselves in the market.

All three above-mentioned moments serve as evidence of the change in the behaviour of economic agents and foreign exchange market operators, suggesting that the rapid strengthening of the exchange rate:

− Has happened in the presence of relatively low volumes of trading in the domestic foreign exchange market;
− Is facilitated by banks’ reluctance to play their mitigating role; and;
− Is accompanied by heightened uncertainty in the foreign exchange market.

PRIMARY MARKET

Treasury bills and bonds yields have strengthened the downward trend that began at the end of 2018 Q1. Since February, the 12-month T-bill yields continued to decline in each auction. In the presence of low pressures of government’s supply with securities, the performance of yields is determined by the competitive demand of banks, which has been high. The decrease in yields was higher for the one-year maturity and more restrained for longer maturities, not affecting the gradient of the yield curve in the long-term segment.

The average yield of 12-month T-bills fell to 2.07% in June, from 2.37% in April. In the last auction\(^ {15}\) organized for this instrument, the yield was 1.87%, reflecting the lowering of the policy rate at the beginning of June. The two-year bond yield was 2.40% at the last auction, from 3.0% in March. The 5-, 7- and 10-year bond yields decreased as well during the recent relevant auctions\(^ {16}\), confirming thus the overall downward trend during this period. The banks’ demand in the primary market\(^ {17}\) was high and rising, thus strengthening the downward pressures on the yields of these instruments.

\(^{15}\) The auction was held on 4 July 2018.

\(^{16}\) The 5-7-and-10-year bond yields were respectively 5.30%, 5.78% and 6.80% in the recent auctions during this quarter compared to 5.45%, 5.86% and 6.95% in the first quarter.

\(^{17}\) The bid/cover indicator was above 1 (1.3).
3.2. DEPOSIT AND CREDIT INTEREST RATES AND FINANCING CONDITIONS

The interest rates on new deposits in lek averaged 0.93% in 2018 Q2, at levels close to the previous quarter (0.99%). The interest rates on deposits with up to 1-year maturity, which have the main share in time deposits, fell slightly. Meanwhile, the average interest on deposits with up to one-year maturity was volatile and has increased compared to the previous quarter. All deposits with these maturities offered higher interest rates in comparison with the previous year. The interest rates on new deposits in euro were close to the average level of 2018 Q1, standing at 0.13%.

Although the cost of bank funds remained unchanged, interest rates of credit in lek followed a downward trend in 2018 Q2. The average interest rate for the new lek loans to the private sector was 6.0%, standing below the average of the first quarter (7.3%). Credit interests declined more for enterprises and less for the households segment (mainly for consumption). Interest rates on loans for investments have been steadily declining in the enterprises segment, while interest rates for liquidity are characterized by frequent fluctuations. Interest rates on mortgage loans have not changed during the second quarter, standing around 3.8%. 

*The chart includes auctions conducted as at 20 July 2018. Source: Bank of Albania*
The spread between the average interest rate in lek and that in euro decreased this quarter, mainly as a result of the decrease of loans’ interest rates in the domestic currency. The average interest rate on new euro loans to the private sector increased slightly in 2018 Q2. This interest rate was 4.2% in 2018 Q2, from 4.0% in 2018 Q1. By purpose of use, interest rates in euro increased for loans to enterprises, mainly in those for liquidity, and decreased for loans to households.

Based on the banks’ opinion, gathered through the bank lending survey for 2018 Q2, banks have kept broadly unchanged the non-price standards of loans to enterprises and eased standards of loans to households. Thus, unlike a quarter earlier, banks did not change their collateral requirements and maximum

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**Chart 19 Interest rates on new deposits**

**Chart 20 Interest rates on new loans (in %, 6-months moving average)**
maturities of loans to enterprises, while they slightly tightened the requirements for loans size. Banks report a tightening of lending policies to enterprises, which reflect the costs of the funds, bank’s capital and liquidity positions, their perception on risk exposure as well as their risk appetite. On the other hand, banks eased their lending standards to households during this quarter. The generally more positive approach of banks toward households is reflected by the eased collateral requirements for credit coverage. The other standards of these loans remained similar to the standards of the previous quarter.

3.3. CREDIT TO THE PRIVATE SECTOR

Credit activity grew moderately in 2018 Q2, similar to the end of 2017. Private sector credit to GDP ratio is estimated at about 35.5%, or 0.7 percentage point less compared to the previous quarter. Adjusted for the appreciation of the domestic currency against the main currencies, present during most of the second quarter of this year, the average annual growth rate of credit to the private sector fluctuated around 5%, from 5.6% in the previous quarter.

Credit developments, in terms of currency, confirm higher growth of credit in lek compared to credit in foreign currency. Despite this, the credit portfolio in lek recorded a lower growth rate in the second quarter (6.3%) compared to the first quarter (7.0%). This slowdown partially reflects the impact of lower lending to enterprises, which peaked in the second quarter of the previous year. The performance of credit in foreign currency carries to a large extent the impact of the exchange rate. Excluding this impact, lending in foreign currency increased on average around 4%, from 4.5% in 2018 Q1.

Credit data are adjusted for written of loans and the movements of exchange rate.
Credit expansion to the private sector reflects the good performance of loans to households. Credit to this segment increased annually on average by around 8%. The continuous ease of standards for credit to households, in line with the increasing demand in this segment, has broadly supported this portfolio expansion. At the same time, positive developments in the labour market and the perception of the housing market developments are among the main factors that stimulate the demand for loans to households. These developments were reflected in the annual growth of credit for house purchase by 6.8% and consumer credit by 12% on average in 2018 Q2.

Loans to enterprises slowed down its growth rate to 3.5%, in 2018 Q2. It appears volatile, both in terms of short-term monthly developments and annual
terms, due to unsteady developments in the liquidity loan portfolio (2.6%). This portfolio is generally characterized by large fluctuations, depending on the short-term financing needs of enterprises. Investment loans (4.3%) performed better and they largely support the growth of credit to enterprises.

### 3.4. FINANCING OF THE PUBLIC SECTOR

The budget balance at the end of the first half of the year was positive by ALL 2.3 million, down compared to the first quarter. The additional internal borrowing over this period was around ALL 18.4 billion, of which 85% was realized with long-term instruments. Net foreign borrowing in 2018 H1 decreased by about ALL 3.7 billion, as a result of the higher repayments over the last three months.

![Chart 24 Budget deficit and its financing instruments, in ALL billion (cumulative) and main holders of government’s domestic debt](chart24)

The structure of government securities holders remains almost the same, with the largest share by commercial banks at around 56%. However, this ratio has fallen by about 1 percentage point since the end of 2017, offset by an increase of the same extent of the share of securities held by other non-financial institutions. The share of households in the total government securities stock was the same as in the first quarter of the year, around 26%.

### 3.5. DEPOSITS AND MONEY SUPPLY IN THE ECONOMY

Broad money in the economy continued to expand at moderate rates in 2018 Q2. Adjusted for the exchange rate, the annual growth of the M3 aggregate fluctuated around 2%, further declining from the previous quarter. On the banking system’s asset side, money creation in the economy is supported by
the expansion of the net foreign assets of the banking system, which bear the main effect from the appreciation of the domestic currency. On the other hand, the performance of the money supply continues to be conditioned by the scarce financing of the government with domestic monetary assets. The contribution of credit to the private sector to the growth of monetary stock remains at moderate levels, reflecting thus a still sluggish lending activity. Monetary stock constrains, on the banking system liabilities side, continue to reflect the structural changes of the shift of deposits towards maturities above two years.

The indicator of domestic currency, the M2 aggregate, continues to shrink annually. It has deepened its annual shrinkage to 1.2% on average in 2018 Q2. One the one hand, the performance of this indicator reflects the low creation of money in lek, and on the other hand, the partial change in the form of household’s savings: from deposits with maturity up to two-year and to deposits with over two-years maturity, and, to a greater extent, in government securities investments. Adjusted for this effect, the annual rate of M2 aggregate rose by 1.5%, y-o-y. The aggregate of liquid money, M1, slowed down its growth rates to 4.1% in average annual terms. Currency outside banks at the end of June accounts for about 35.8% of the M2 aggregate, or about 27.3% of the adjusted M2 aggregate.\(^{19}\)

Deposits in the banking system continue to show an annual growth trend, but at a slowing pace. Their ratio to GDP is estimated at about 68.1%, from 69.6% at the end of the first quarter. Adjusted for the exchange rate appreciation, the stock of total deposits expanded by 1.7%, y-o-y, on average in 2018 Q2. Their slowdown is conditioned by the performance of deposits in lek (0.9%) and deposits in foreign currency (2.4%), although the rates of deposits in foreign currency continues to grow faster than for deposits in lek. The increase

\(^{19}\) This indicator also takes into account investments in government securities and deposits over two years.
of deposits in lek reflects the above-mentioned developments in the shifting of household’s savings outside the banking system. In order to benefit from the higher interest rates, households have invested around ALL 7.3 billion in government securities in the first half of the year, while their deposits in lek reduced by about ALL 2.7 billion. The expansion of foreign currency deposits is supported by deposits of households as well as by deposits of enterprises. They are mainly in the form of demand deposits.

As a result of low interest rates, the time structure of deposits has shifted further toward the liquid component. Demand deposits accounts for around 42.5% of the total stock of deposits in the banking system. Also, economic agents that invest in long-term have shifted their savings in deposits with two-years and longer maturities, especially domestic currency deposits. At the end of June, deposits with over two-year maturity accounted for about 10.6% of the total stock.
4. INFLATION AND ECONOMIC GROWTH

Average inflation increased from 1.9% in the first quarter to 2.2% in the second quarter. The increase of inflation was a result of the increase in prices in the categories of fuel, rent and food. From the macroeconomic point of view, the cyclical improvement of the economy is reflected in a slight and gradual increase of domestic inflationary pressures, but these pressures are not yet sufficient for the return of inflation to target. Furthermore, the appreciation of the exchange rate has led to curbing the pass through of foreign inflationary pressures into the domestic market. This phenomenon is expected to continue for several quarters.

Economic growth accelerated in 2018 Q1, reaching 4.45%, due to the significant contribution from "electricity production". Economic activity is mainly supported by private consumption and gross capital formation, reflecting favourable financing conditions, positive expectations for outlook, and improved financial situation.

The growth of aggregate demand is associated with increase of employment and wages and decline of unemployment. These dynamics are expected to further continue in the medium-term horizon.

4.1. INFLATION

Annual inflation averaged 2.2% in 2018 Q2, standing 0.3 percentage point higher compared to 2018 Q1. The increase in inflation for 2018 Q2
reflected the rise in oil and fuel inflation as well as the higher inflation of the “Unprocessed food” group. The supply shock in these commodities resulted in a higher monthly inflation rate compared to seasonal developments, generating thus upward headline inflation. The appreciation of the exchange rate continued to weaken the general inflationary pressures, albeit the pressures from foreign prices were at a higher level during this quarter.

“Unprocessed foods” contributed by around 1.1 percentage points to inflation, forming around 50% of headline inflation of the quarter. On the other hand, the category “Processed food” marked a modest increase in contribution only in June, but remained unchanged quarterly.

The prices of more stable inflation components contributed almost at the same level to the inflation rate of this quarter. Compared to the previous year, the contribution of this segment of the basket to headline inflation is more notable: its contribution accounted for 26% of headline inflation compared to just 5% in the previous year. Inflation in services continues to be largely formed by the contribution of imputed rent (this basket item contributes 64% to service inflation in June and averaged 74% in 2018 H1).

The contribution of the category of “Non-food consumer goods” remained unchanged in this quarter, but developments in oil prices, especially in June, had a direct and indirect effect on prices of this month and throughout the second quarter. Inflation of “Fuel” was 5.6% in June, compared to 3.2% and 2.5% respectively in May and in 2018 Q1. The increase of prices in the global market contributed to their growth in the domestic market.

The category of “Regulated prices” goods continues to contribute positively and constantly during 2018 by 0.2 percentage point to headline inflation.

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20 In this part of the consumer basket we have included services (along with housing-rent category) and some of the subcategories “Non-food consumer goods” such as clothing footwear, home appliances, etc.

21 The contribution of fuel price to inflation, passes through a direct channel (according to the share that the fuel takes up in the consumer basket) as well as through the indirect channel. This channel includes production costs in the economy; an increase in the cost of fuel is transmitted in the final price of goods and services. It is estimated that this contribution is indirect and can outweigh the direct impact.
4.2. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND PERFORMANCE

According to INSTAT, economic growth in the first quarter was 4.45% from 3.63% in the previous quarter. The acceleration of economic growth was largely supported by the industrial sector, whose higher contribution reflected the increase of electricity output. The growth of the services sector continued to slow down, and its contribution to economic growth in this quarter declined. Regarding demand components, economic growth is largely attributed to the final household consumption, whilst investment contribution remained broadly unchanged from the previous quarter and the expansion of net export deficit slowed down.

Preliminary quantitative and qualitative indicators suggest that the positive effect of “Electricity” on economic growth will continue in the second quarter. However, estimates show that this effect will be more moderate and temporary. The expansion of the economy in the second quarter is expected to be characterized by a similar profile to that of the beginning of the year.

4.2.1. GROSS DOMESTIC PRODUCT BY SECTOR\textsuperscript{22}

Economic growth in 2018 Q1 is attributable to the expansion of the manufacturing sector. The sector’s value added grew by 7.4%, compared 2.1% in the previous quarter, translated into a contribution of 3.0 percentage points. Performance of GDP and gross value added by sector is analysed in terms of real annual changes. The analysis is based on the latest GDP data according to the output method for 2018 Q1 published by INSTAT on 29 June 2018. The differences between the sectors’ growth rates of this publication and those analysed in the Monetary Policy 2018 /II are a result of the series review. The real economic growth over the first three quarters of 2017 was revised down by 0.1 percentage point for each quarter and revised up by 0.3 percentage point in 2017 Q4.

<table>
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<th>Table 3 Contribution of key items to annual inflation (p.p.)*</th>
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Source: INSTAT and Bank of Albania.

* The table shows some of the main groups of items.
points to GDP growth. This dynamic was largely influenced by the expansion of the value added of industry, energy and water supply, which contributed by 2.4 percentage points to the annual GDP growth. In particular, the increase by 66.4% of the value added of electricity contributed by 1.9 percentage points to economic growth.

Activities related to agriculture, forestry and fishery increased their contribution to economic growth by 0.4 percentage point, after the almost absent impact over the previous two quarters. Meanwhile, activity in construction continued to slow down, giving a low contribution of 0.2 percentage point to the annual GDP growth. The services sector continued the decelerating trend. Its contribution to economic growth is estimated at 1.1 percentage points, from 2.3 percentage points in the previous quarter. In conclusion, the net taxes component contributed by 0.4 percentage points to the annual growth rate of GDP.

The value added of the industry, energy and water supply sector was 19.9% higher than the same period a year earlier, mainly driven by developments in the electricity sector. Electricity production expanded by about 102%, in annual terms, giving a significant positive contribution to the branch’s performance.23 The processing industry reached an annual growth of 9.5% of value added, translated into a contribution of 4.3 percentage points to the expansion of the

23 The electricity branch contributed by 16.1 percentage points to the annual growth rate of industry, energy and water. According to the quarterly data of electricity balance, published by INSTAT, the annual growth of net domestic electricity production in the first quarter of this year is 102%, among the highest levels for 2012-2018 Q1, after the increase of 108% in 2016 Q4. Also, other indicators such as the index of the production volume and the index of net sales in volume for “Electricity, gas, steam and air conditioning”, recorded significant growth in the first quarter, respectively by 50.3% and 49.2%.

sector. However, its dynamics this quarter was slower than that in 2017. Quarrying contributed by 0.7 percentage point to the downward trend of the sector’s performance, although the annual contraction of 3.7% of its value added was more moderate than in the previous quarter.

The industry, energy and water supply sector is estimated to remain on the upside in the second quarter. This is confirmed by the continuation of the upward trend of some groups of exports of products related to these industries. Meanwhile, the confidence indicator and the capacity utilization rate in industry, although still above their historical averages, declined during the second quarter, signalling that the sector’s growth in this quarter is expected to be more moderate.

The construction sector slowed its growth trend for the third consecutive quarter. The value added in construction increased by 2.1% in annual terms in the first quarter of this year, after the increase by 3.8% in the previous quarter. The positive dynamics in the construction sector was supported by both the higher level of public investments and the higher inflows of foreign direct investments. However, the slower growth of investments realized for new constructions

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24 Among subsidiaries involved in the processing industry, it continues to rely largely on textile, clothing, leather and footwear industries, as well as metal and metal-based industries, exports of which continued to grow in nominal terms.

25 As a largely export-oriented industry, the growth in exports of some of the main products related to it is estimated to have affected the branch performance on the upward trend, curbing to some extent the shrinking trend.

26 The slower growth of the construction sector in the first quarter is estimated to have been affected to some extent by the higher cooperative base of the previous year. More specifically, in 2017 Q1, added value in construction expanded with high annual growth rate by about 12.6%, after an average growth of about 3.2% in 2016. However, the slowdown of growth rates in the construction sector is also confirmed by the annual performance of the volume of construction production, which increased by 6.0% from 7.5% in the previous quarter. Meanwhile, the dynamics of the Net Volume Sales Index in this sector has slightly improved, increasing by 9.9% from 7.5% in the previous quarter.
is estimated to have determined the sector’s downward trend. Among other indirect quantitative indicators, the proxy of approved building permits for the category of construction for residential purposes declined compared to the same period in the previous year. Meanwhile, this indicator grew annually for the categories of other construction and engineering works.\footnote{Regarding building permits in total for new construction, their number in the first quarter was 221 from 211 permits in the previous quarter. This number of permits continues to remain below its historical average albeit its increase. In the permits granted during the first quarter about 127 are permits for residential buildings, about 94 are permits for other buildings (such as hotels, office buildings, industrial buildings and others).}

Developments in the construction sector are estimated to remain positive during 2018 Q2. In the same line are the signals obtained by the gradual increase of the number of building permits approved for new construction and the positive contribution estimated by the public sector. However, base effects from the previous year\footnote{In the second quarter, a year earlier, the annual growth of added value in construction resulted to be considerably high at around 19.5\%}, and the decline in the confidence indicator and the capacity utilisation rate in construction, limit somewhat the estimates for the growth rate of the sector in 2018 Q2.
BOX 2: HOUSE PRICES

The Housing Price Index, in nominal terms, did not change significantly during 2018 Q2. In real terms, deflated by the consumer price index, the housing price index in this quarter declined by 2.5%. In the meantime, Rental Price Index declined by 7.6% in 2018 Q2. The price to rent index ratio is stable around the historical average of the last ten years (right Chart).\textsuperscript{2}

I The analysis of house price and rent is based on data only on prices and rents in the city of Tirana.

II The performance of this ratio summarizes into a single indicator the overall dynamic of the house market price and is used as a signal of “bubbles” in the house prices.

The value added of the services sector increased 2.3% in annual terms, lower than the 4.6% increase registered the previous quarter, as well as the 3.2% historical average of the sector. The contributions of almost all the main branches of the sector resulted lower than the previous quarter. Among the services items, ‘Trade, transport, accommodation and food services’ continues to contribute most to growth, by 1.2 percentage points.\textsuperscript{29} Meanwhile, ‘Public administration, education and healthcare’ and ‘Other services’ also showed slower growth dynamics and contributed by 0.6 and 0.2 percentage point, respectively, to the increase of services. Meanwhile, the value added of ‘Professional activities and administrative services’ accelerated its growth only slightly, contributing by 0.7 percentage point to the performance of the sector. Services related with ‘Real estate’ gave a negligible contribution to the growth of the sector, following the 0.5 percentage point contribution in the previous quarter. Regarding ‘Information and communication’ and ‘Financial

\textsuperscript{29} This branch has also the largest share among services activities, by around 33% in real terms in 2017.
and insurance activities’, their value added decreased from the same period in the previous year. These branches contributed to the performance of the sector on the down side by 0.2 and 0.1 percentage point, respectively.

The services sector is assessed to remain on the upward side in 2018 Q2. This dynamic is signalled also by the increase of the capacity utilisation rate in services and trade. However, the lower level of the confidence indicators in services, although still above historical averages, suggests that the growth of the sector in 2018 Q2 is expected to be contained.

### 4.2.2. AGGREGATE DEMAND

The aggregate demand registered accelerated growth rates during 2018 Q1. This dynamic was driven by the gradual growing trend of households consumption, the increase of public consumption and the slowdown of the expansion of the net exports deficit. Meanwhile, the contribution of investments resulted similar to that of 2017 Q4.

Information by indirect indicators shows a continuation of economic growth in 2018 Q2. Overall, it is expected a higher contribution by the consumption of households, but a lower one by investments. Regarding net exports, the negative contribution is expected to be narrower.

Domestic demand grew 3.5% in annual terms in 2018 Q1, recording a higher rate than in the previous quarter. The acceleration of growth is related with the positive contribution by the households consumption and the increase of public consumption. Meanwhile, the contribution of investments was almost the same as in 2017 Q4, while the negative contribution of net exports was more
moderate. Leading and indirect indicators signal that domestic demand will continue to grow in 2018 Q2. Households consumption is expected to make a higher contribution, while the contribution of capital formation is expected to slow down.

Chart 34 Economic sentiment indicator and structure of domestic demand

PRIVATE CONSUMPTION

Growth in domestic demand continued to be driven by private consumption in 2018 Q1. The annual growth rate of private consumption registered 3%, thus giving a 62% contribution to the formation of domestic demand. This rate remains higher than the 2.7% average increase in 2017. Starting since 2016 Q4, private consumption has registered a slight but steady upward trend. Its increase is supported by the gradual expansion of employment and compensation of employees, the improvement of confidence, as well as by the increase of consumer credit and eased financial conditions.

Chart 35 Private consumption and consumer confidence

Source: INSTAT and Bank of Albania.
Indirect indicators available for 2018 Q2 suggest private consumption will continue to grow. Indicators from surveys show an overall steady upward cycle of consumption. Consumer confidence and the confidence in the trade sector indicator have remained above their long-term averages during the last two years. Other quantitative data that point to an increase of private consumption in 2018 Q2 include the increase of VAT revenues and the increase of the import of food items. The increase of employment and compensation of employees are expected to support consumer spending. They are supported also by consumer credit, which has continued to increase in 2018 Q2.

**INVESTMENTS**

The performance of aggregate investments in the economy was positive in 2018 Q1. They grew by 5.4%, near the historical average of the last two years. According to the assessments, investments grew both from the public sector and from the gross capital formation of enterprises. Based on indirect indicators, private investments increased in 2018 Q1 supported by a higher contribution of investments in machinery and equipment. The factors that continue to support the increase of private investments by enterprises are: the increase of confidence in the economy, where the confidence index is above its average; the improvement of the production capacity utilisation; as well as the increase of the final consumer demand for goods and services.

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30 Quarterly national accounts published by INSTAT do not break down aggregate investments into private and public investments.

31 Imports of machinery and equipment in 2018 Q1 accelerated at 15.5% compared with the 1.8% increase in the previous quarter.
Indirect indicators for 2018 Q2 suggest growth of aggregate investments will continue, but with lower rates than in 2018 Q1. The expectations for a slow growth of investments are supported by quantitative indirect indicators: the assessment on public capital investments, disaggregated data from the imports of machinery and equipment, as well as loans for investment purposes.

PUBLIC SECTOR DEMAND AND FISCAL POLICY
The consolidating fiscal policy pursued during 2018 H1 materialised in a negative direct fiscal impulse, assessed at around 0.6% of GDP. Despite the negative direct contribution to the increase of aggregate demand, the consolidating fiscal policy, which is also materialised in positive values of the budget balance, has an overall positive impact on the economic activity, through the decrease of risk premiums in the economy and the increases of space for funding in the private sector. In terms of profile, 2018 Q2 is characterized by...
a higher intensity of fiscal consolidation, as a result of the impact of the high comparative basis of the previous years.

Budget expenditures realized in 2018 Q2 remained at the same level of those in 2017 Q2. For this reason, the annual growth rate of expenditures for the half-year period decreased at 2.4% from 5.3% at the end of 2018 Q1. The slowdown of the annual growth rate of expenditures is attributed mainly to expenditures for the local government, which contracted in 2018 Q2 by around 8.4% in annual terms. The trajectory of expenditures for the local government during this year is affected to a large extent by the development of the previous year.

A negative impact, but to a lesser extent, on the performance of aggregate expenditures in this quarter came from expenditures in the form of compensations and subsidies, as well as expenditures for the personnel.

On the other side, capital expenditures saw an annual growth by around 17.1% in 2018 Q2, from 2.3% in the previous quarter. Operational expenditures and those for interest payments of domestic debt were also upward. The latter, after a negative contribution to expenditures for a relatively long period of time (2014-2017), contributed positively to the expenditure performance in 2018, although to a lesser extent (around 0.5 p.p.). The positive contribution of expenditure for interests on debt in 2018 H1 is explained by the relatively higher interest rates on 12-month T-bills in January-June 2017\(^{32}\) (2.4% in average) compared with January-June 2016 (1.6% in average).

Budget revenues saw a slow annual increase by around 0.8% in 2018 Q2, the lowest rate registered for this period since 2013. The slowdown in the increase

\[^{32}\text{The issues of January-June 2017 mature in the same period the next year. On the maturity date are also the interest payments for this instrument.}\]
is attributed partially to lower revenues from national taxes\textsuperscript{33}; non-tax revenues and grants; excises; as well as VAT\textsuperscript{34}. The annual growth rate of revenues for 2018 H1 was 2.2%, from 3.7% at the end of 2018 Q1. The slowdown of the annual growth of revenues, among others, is also partially related with the negative impact of the appreciation of the exchange rate on revenues related with the imports of goods in Albania (such as excises, VAT, and custom duties).

FOR\textsc{EIGN DEMAND AND EXTERNAL TRADE}

Real trade deficit in goods and services expanded by 13.7% in 2018 Q1. The main determinant in this development was the annual growth of imports by around 8.2% and in particular of goods by around 6.5%. In the same direction, the import of services increased by 12.4% in annual real terms. In the case of exports, the annual real growth registered 5.0%. The contribution for this growth came from the increase in the export of goods by 16.4%. In parallel, exports of services expanded by 1.5% compared with the previous year.

The data of 2018 Q2 include only the statistics of exports and imports of goods for this period. The

\textsuperscript{33} Revenues from national taxes, where are included taxes such as for packaging, the annual vehicle circulation tax, mining rent tax, etc., during 2018 carried a high basic effect compared with the previous year. This came as a consequence of the classification of revenues from the reassessment of assets to this category of revenue after the legal measures that allows natural and legal persons to reassess real estates at 2% and 3% of the taxable basis, respectively, from the 1.5% defined by the existing law, up to May 2017.

\textsuperscript{34} In order, their contribution to aggregate revenue for 2018 Q2 was: -1.7 p.p. from national taxes; -1.1 p.p. from non-tax revenues and grants; -0.7 from excises; and -0.1 from VAT.
trade deficit in goods narrowed by around 12.8% in annual terms in this period, affected by the rapid increase of exports. On the other hand, the increase of imports has been low.

The value of the export of goods expanded by around 17.8%, in annual terms, in 2018 Q2, a similar rate with the previous quarter (the growth registered 18.9%). Significant contributions continued to come from ‘Minerals, fuels, electricity’, mainly as consequence of the high growth of the exports of energy and oil. At the same time, a high increase was noted in the categories ‘Textiles and footwear’ and ‘Construction materials and metals’ with other categories providing positive impact as well.
Imports increases 0.6% in annual terms during 2018 Q2, significantly slower compared with previous quarter (9.7%). The main impact in the growth came from the categories ‘Machinery, equipment, spare parts’ and ‘Minerals, fuels, electricity’. However, the categories ‘Construction materials and metals’ and ‘Food, beverages, tobacco’ registered falling contributions.

By trading partner country, the countries of the European Union, and particularly Italy, remain our main trading partners for both exports and imports. The increase of exports of fuels and energy affected the increase of the share of partners like Spain, Serbia and Switzerland.

**BOX 3: BALANCE OF PAYMENTS DEVELOPMENTS 2018 Q1**

The net position of the current account resulted in EUR 164.6 million deficit in 2018 Q1, expanding by around 11.0% in annual terms. It was assessed at 5.8% of nominal GDP, about 0.1 percentage point higher than in the same quarter a year earlier. The deepening of the current account was defined mainly by the trade deficit and in particular by that of goods. The secondary income was the only sub-account that had an opposite effect, driven by the increase of remittances and other income.

Goods and services’ exports increased by around 8.6%, annually, affected mainly by the expansion in annual terms of services exports by 20.6%. Meanwhile, the export of goods also increased by 5.0%, annually. Overall import expanded by around 10.1% in annual terms, with the main contribution from the growth in the import of goods, up by around 8.4% compared with the previous year. The import of services also registered a rapid growth, at 14.3%. As a result of these developments, the overall trade deficit of goods and services expanded by 13.8% in annual terms, mainly attributable to the expansion of the goods account deficit by around 4.6%. At the same time, the positive surplus of the services account has narrowed by 5.7% in annual terms. Regarding the income accounts, a high increase in the secondary income surplus was also noted, driven by a higher increase of remittances and other income. In the case of primary income, the negative surplus registered expansion, mainly owing to the sub-account of income from investment.

Net direct investments inflows expanded by 47.0%, in annual terms, determined by the performance of investments in the energy sector. Net direct investments inflows registered EUR 290.7 million or 177% of the current deficit. Non-debt-creating flows (from the capital account and direct investments) gave the main contribution to funding the current account deficit and, in parallel, a decrease of debt-creating flows (portfolio investments and other investments) was noted. Reserve assets decreased by EUR 142.4 million, also due to the reduction of excess foreign currency reserves by commercial banks deposited at the Bank of Albania. The errors and omissions also showed high outflows values (around EUR 142.0 million).
4.3. CYCLICAL SITUATION OF THE ECONOMY AND INFLATIONARY PRESSURES

Aggregate demand growth improved the cyclical position of the economy, reflecting a better utilisation of production capacities. This dynamic is particularly evident in the labour market, where the increase in employment was accompanied by a decrease in unemployment and an increase of wages. In turn, it provided positive signals and premises for domestic inflationary pressures build-up. On the other hand, the appreciation of the exchange rate has curbed the pass through of foreign inflationary pressures to the Albanian economy.

The appreciation of the exchange rate and the domestic inflationary pressures - still insufficient - suggest that the return of inflation to our target remains a medium-term projection.
As the effect of the shocks on the exchange rate ends and the cyclical position of the economy improves further in this period, inflation will gradually converge towards our target.

The analysis of the macroeconomic environment suggests that the Albanian economy is converging gradually towards its potential. The dynamics shown in the labour market in 2018 Q1 signal a more intensive use of the labour factor, reflected in the trend towards the closure of the negative unemployment rate gap. The capacity utilisation rate in the economy, despite short-term fluctuations, is pursuing an upward trajectory and the gap with its long-term average has narrowed. These developments are transmitted to a build-up in domestic inflationary pressures.

While the cyclical position of the economy has improved, the economic activity has not reached the potential level and the domestic inflationary pressures are still insufficient for the return of inflation to target. Also, the appreciation of the exchange rate has curbed the foreign inflationary pressures and has affected negatively both the core and the imported inflation. The expected improvement of aggregate demand, the more complete capacity utilisation and the curbing of the exchange rate are expected to contribute to the strengthening of inflationary pressures and the return of inflation to target in the medium term.

The labour market continued to improve during 2018 Q1. The number of employed in the economy increased 4.9% in annual terms, compared to 4.3% in the previous quarter.\(^\text{35}\) The annual growth of employment is supported by almost all the main economic activities. However, it is mostly attributed to the services and industry sectors. The unemployment rate decreased at 12.5% in 2018 Q1, accelerating the decline both in quarterly terms (by 0.9 percentage point) and in annual terms (by 1.7 percentage points). It remained almost near its equilibrium level. The decrease of unemployment rate in 2018 Q1 is attributed mainly to the increase of employment.\(^\text{36}\)

The capacity utilisation rate in the economy during 2018 Q2 was almost at the same level as in 2018 Q1. This rate averaged around 72.2% from 72.3% in the previous quarter, standing 1.3 percentage points higher than in the

\(^{35}\) The analysis of employment and unemployment is based on the data of the quarterly Labour Force Survey, and it refers to the indicators for those 15 years old and up. The number of employed with quarterly frequency from the Labour Force Survey has been published since 2012 Q1. The aggregated series does not show seasonality, and as a consequence quarterly changes are calculated on the non-adjusted for seasonality series.

\(^{36}\) In examining the factors that drive the formation of the unemployment rate are analysed the performance of employment, on the demand side, and the participation rate in the working and population by working age, on the employment offer demand.
same period in the previous year. The performance of this indicator signals the higher utilisation of spare capacities in the economy.

The unit labour costs showed a slight increase in 2018 Q1. This indicator is assessed to have increased 0.4% in annual terms. It reflects mainly the faster growth of the average real wage for activities covered by short-term statistics, against the labour productivity performance. According to the new data published by INSTAT, the average monthly wage for an employee paid in the country registered an annual growth by 4.2% in nominal terms, after the 2.4% growth recorded in the previous quarter. Deflated with inflation, this indicator increased by 2.3%, from 0.7% in the previous quarter. The rise of the minimal wage had also an impact on the dynamic of the annual growth of the average wage per employee in Albania. Notwithstanding the added impulse by the employment growth and by the continued decrease of the unemployment rate, the transmitted pressures for wage growth in the economy remain subdued.

The dynamic of other production costs resulted sluggish in 2018 Q1. Industrial producer prices increased by 1.0% compared with the previous year, lower than the 2.0% increase registered in the previous quarter. The increase of these prices for products in the domestic market followed the same decelerating trend, but registering even lower growth rates (0.7% in 2018 Q1 from 0.9% in the previous quarter). Meanwhile, production costs in the construction sector registered a slightly higher increase in 2018 Q1, around 0.5% from 0.4% in 2017 Q4.

*Proxy indicators of labour productivity and labour costs per unit of output and average wage by short-term statistics are calculated by the Bank of Albania using the total series Short Term Statistics (SHTS, INSTAT, 2018 Q1). Their calculation includes: the index of paid employees, the net sales volume and total wage fund for the total of activities covered by the survey of SHTS. The reported growth rates are referred to the four terms moving average of the annual changes of the indicator. The difference of the growth rates in this Report with the previous Monetary Policy Report reflects the reviewing process of the series by INSTAT.


On 11 June 2018, INSTAT published for the first time quarterly data on the average monthly wage per employee with wage in country. The published data series starts since 2015 Q1. This indicator refers to the gross average monthly wage and the source the wages list at the General Directorate of Taxation. In it are included all the economic activities, both in the public and private sector, for all paid employees that work in Albania. The minimum official wage increased from ALL 22.000 to ALL 24.000 in 2017 Q2. This growth in annual terms is around 9.1% and its upward impact on the average wage in the economy as a result of the comparison with a lower base is expected to end in 2018 Q2.

Construction cost index for apartments includes prices of building materials, labour force and other capital expenditures used for the construction of a typical building of 8-10 floors.
The continuation of the closing of the output gap is assessed to have materialized partially in the performance of long-term and domestic inflation during 2018 Q2, but with a lower intensity than in the previous quarter. Core inflation and non-tradable inflation of the CPI basket in this period were 0.95% and 1.0%, respectively. The upward trend of core and net non-tradable inflation has slowed down due to the appreciation, in effective nominal terms, of the domestic currency. According to our estimates, in the first and the second quarters, core inflation decreased by 0.17 and 0.21 percentage point, respectively, due to the exchange rate.

The increase of headline inflation, mainly in June, was affected by the acceleration of its short-term components. These components - non-core and tradable goods inflation - resulted at 5.4% and 3.0%, respectively. The appreciation of the exchange rate has affected the performance of these inflation components as well. Assessments show that the negative effect of the exchange rate on non-core and tradable inflation is around 0.3 and 0.4 percentage point, respectively, in 2018 Q2.

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The assessments on the impact of NEER on the components of inflation take into account the historical developments after 2010 and are conducted with (short-term) inflation models that are linear and assume a symmetrical response of inflation to explanatory factors. In fact, the behaviour of inflation, particularly against the fluctuation of the components rate and foreign prices is asymmetrical: against increases and depreciation the response is transmitted faster and more intensively while being slower and weaker against decreases and appreciation. However, according to assessment, prolonged appreciation, in the conditions of negative gap and low foreign prices, has accumulated asymmetry for decline of inflationary pressures and has strengthened the adaptive expectations and the persistence for low inflation (study “Factors of low inflation in Albania”, January 2018).
The **Imported Inflationary Pressures Index** (IIPI)\(^{43}\) suggests low inflationary pressures from abroad, due to the appreciation of the exchange rate. The “Foreign Prices Index” (FPI)\(^{44}\), which assesses the impact of the increase of prices in trading partner countries on inflationary pressures, expanded in 2018 Q2 (7.1% in annual average terms). On the other hand, the appreciation of the nominal effective exchange rate (7.8% in average in the same period) curbed the spillover of the increase of prices of foreign economies, thus contributing to the low values of the overall IIPI.

![Chart 48 IIPI and its components' contributions (left). Contribution of imported and domestic inflation to the annual total (right)](chart)

Source: INSTAT and Bank of Albania estimations.

However, the rise in oil prices in foreign markets is reflected in the increased contribution of imported inflation to headline inflation. The contribution of imported inflation to headline inflation was around 1.28 percentage points in 2018 Q2 from 0.97 in the previous quarter. The pressures added by commodities price rise in foreign markets would have been higher in the absence of the impact from the exchange rate appreciation in the domestic foreign exchange market.

\(^{43}\) It is a proxy on imported inflationary pressures, which aggregates in one single indicator the information from foreign price indices (FPI), with the information from the developments in the in nominal effective exchange rate (NEER). IIPI is calculated as the annual growth of FPI and the NEER for the respective period. IIPI is assessed to affect domestic inflation approximately after a 5 months’ time lag.

\(^{44}\) It is a proxy of imported inflation pressures, comparable to tradable goods sector inflation of Albania’s CPI basket. The foreign price index is based on the values of: the inflation of “Food, beverages, tobacco” for the 18 main countries; and inflation of “Goods” (i.e. not only foods) for Bulgaria, Germany, Greece, Italy and Turkey.
This Box presents a quantitative assessment on the direct and indirect effects of the increase of fuel prices on annual inflation in 2018 H1. Annual inflation of fuel increased from 2.5% in 2018 Q1 to 3.3% in Q2, reaching a one-year historical high in June (5.6%).

The direct channel implies the transmission of the fuel price increase to headline inflation through its impact on the relevant sub-group of the CPI basket. Its share in the basket, which has been constantly revised up, is currently estimated by INSTAT at around 3.14% and is related to the use of fuel by consumers for personal vehicles. However, the impact of fuel prices on headline inflation is also materialized through indirect channels related to the production and services costs. Fuel constitutes an important part of input purchases for certain categories. Hence, the increase of costs due to the increase of fuel prices may be reflected in the final prices of goods and services in the market.

Assessment results

In the following charts the direct and indirect contributions of the impact of fuel prices to annual inflation during 2018 H1 (left Chart) and the annual inflation decomposed by total contribution by the increase of fuel prices and other contributions are presented.
According to these assessments, fuel prices and consumption have played a significant role in the formation of inflation. The contribution of fuel prices increased significantly in June 2018, tripling compared to the average of the February-May period (0.2 percentage point). Meanwhile, the contributions from other sources of formation of headline inflation in February-June have remained relatively constant (around 1.8 percentage points on average). The appreciation of the domestic currency against the US dollar (14% in average in annual terms during January-June 2018) has reduced the intensity of the transmission of the rise in international fuel prices to headline inflation by both channels combined.

Given the importance of fuels on inflationary developments, the movements and the impact of the respective prices should be monitored on a continuous basis in the interest of the accuracy of the analysis, forecasting and monetary policy decision making.

* Prepared by Enian Çela, Monetary Policy Department.

http://www.instat.gov.al/al/temat/ekonomi-dhe-financ%C3%AB/tabela-e-burimi-p%C3%ABaldorimeve-dhe-input-output. For generating the assessment, we have assumed that the structure of the economy has not changed significantly from that suggested in the last input-output tables.

**INFLATION EXPECTATIONS**

Based on direct measurements through economic agents’ surveys, the expectations for short-term inflation have been revised in different directions in 2018 Q2. Business expectations on inflation after one year continued to increase by 0.2 percentage point, following the 0.1 percentage point increase in 2018 Q1. However, the expectations of consumers on inflation one year ahead were revised downwards, 0.3 percentage point lower than the previous quarter. Financial agents did not change their expectations on all three

45 The analysis on inflationary expectations is based on the results of the business and consumer confidence surveys, as well as on the financial agents’ expectations survey.
forecasted horizons. Their expectations for inflation after three years continued to register the highest level of expectations and the closest to inflation’s target.

Chart 50 Business and consumers’ expectations (left chart), and financial agents’ expectations (right chart), on inflation, annual change in %

Source: INSTAT and Bank of Albania.