Bank of Albania

MONETARY POLICY REPORT

2018/IV

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C O N T E N T

BOXES

TABLES

CHARTS

INTRODUCTION

The primary objective of monetary policy in Albania is to achieve and maintain price stability. In quantitative terms, it is defined as maintaining inflation close to the 3% target.

By achieving 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.

Our monetary policy is always forward looking.

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

The economic and monetary analysis in this report is based on the statistical and qualitative data available as at 17 December 2018.

1. FOREWORD BY THE GOVERNOR

Economic activity in Albania expanded in 2018 H2, although the available information sustaining this assessment is partial and indirect. Economic growth is reflected in better utilisation of production capacities, as shown in an increase in employment, decrease in the unemployment rate and build-up of domestic inflationary pressures.

This performance has been overall in line with our previous expectations and does not bring about significant changes to our projections. Among other things, it evidences the positive impact of the accommodative monetary policy of the Bank of Albania and suggests that the current stance of this policy is adequate for both ensuring economic growth rates in line with the production capacity of the country and guaranteeing the convergence of inflation toward the target within 2020.

From a sectorial perspective, expansion of economic activity appears to reflect, mainly, growth in industrial production and services. Nonetheless, available data show that the growth pace of electricity production has been slowing down in the third quarter, suggesting a slight deceleration of the economic growth rate for 2018 H2.

From the perspective of aggregate demand, expansion of consumption and private investments and growth in Albanian exports appeared to have continued to underpin economic growth. Conversely, fiscal policy consolidation in the third quarter and most of the fourth quarter has been stronger than expected, leading to a slower-than-projected contribution to economic growth by public expenditure.

In balance, the overall context of economic and financial developments in Albania remains positive.

The Albanian economy continued to benefit from the positive performance of our main trading partner, the euro area, from improvement in the financial balances of households and firms, and from the fiscal consolidation, which has reduced the risk premia in domestic financial markets.

In parallel to these factors, economic activity expanded, supported by the accommodative monetary policy of the Bank of Albania. The monetary policy has been transmitted through the low policy rate, the continuous injection of liquidity into the domestic financial market, the forward guidance instrument, and selective interventions in the foreign exchange market during the summer period.

Our monetary stimulus has created a liquid financial environment with low interest rates, and has mitigated the effect of appreciation pressures on the exchange rate. Low interest rates have supported the expansion of credit: excluding the effect of the exchange rate and the lost loan write off, credit to the private sector increased by 4.9% and 4.5% in the third quarter and in the first two months of the fourth quarter, respectively. Low interest rates have also helped in restructuring loans, easing the debt servicing costs and improving the financial system stability. The NPL ratio dropped to 12.7% in November, illustrating a continuous improvement in the soundness of the banking sector. Lastly, temporary intervention in the foreign exchange markets has reduced misbalances in the supply and demand for foreign currency, calming the foreign exchange market and reducing exchange rate deviations from the levels suggested by fundamental factors.

The growth of credit, the easing of borrowers' financial burden, and reduction of exchange rate volatilities have promoted consumption, investments, economic growth and employment gains, thus creating premises for the return of inflation to target in the medium-term horizon.

Inflation stood at 1.8% in November, downward from the level registered in the third quarter and in October. In line with our previous expectations, this fall reflects a downward effect from the appreciation of the exchange rate on imported inflation. Our analyses suggest that this effect is expected to be transitory and will not affect the convergence of inflation to the target in medium term.

The update of projections in accordance with the baseline scenario confirmed our previous expectations for the return of the economy to equilibrium in the second half of the next year and of inflation to target in 2020. This performance is expected to be supported by the positive performance of the euro area and other trading and financial partners, the stimulating monetary and financial environment in Albania and the calming of exchange rate appreciation pressures.

In parallel, the Bank of Albania deemed that the balance of risks remains tilted to the downside. These risks are related to both potential shocks from the external environment, and the speed at which the business climate and lending in Albania have improved.

Judging on the above, the Bank of Albania deems that the current monetary policy stance remains adequate. Maintaining the direction and intensity of the monetary stimulus boosts aggregate demand growth, contributing to the growth of employment and build-up of domestic inflationary pressures.

In line with the baseline scenario, and based on the available information, the increase in the policy rate will not resume before the second quarter of 2019.

Moreover, the Bank of Albania will continue to monitor the performance of the exchange rate and stands ready to use the instruments available to it, to prevent the appreciation of the exchange rate at levels that jeopardise the convergence to the inflation target.

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

The economic and financial developments in the Albanian economy are positive, as shown by the acceleration trend of the economic growth pace, the broad base of factors underpinning economic growth, and the improvement of labour market indicators. Domestic inflationary pressures have built up as a result of an increase in the utilisation of production capacities. On the other hand, external inflationary pressures remain low, as a result of the appreciation of lek's exchange rate against the euro.

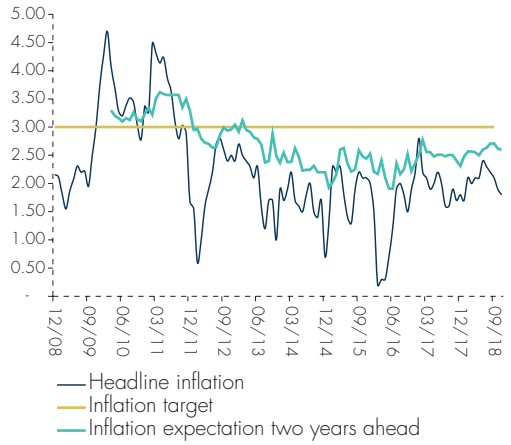
Macroeconomic projections show that the continued expansion of aggregate demand will boost the utilisation of production capacities of the economy, building up internal inflationary pressures. Inflation forecasts suggest it will rise gradually, to converge to our 3% target, by 2020. The monetary policy should maintain the accommodative stance over the medium term, but the monetary stimulus is expected to tone down the intensity, in line with the upward inflation prospect. The balance of risks remains tilted to the downside in the medium-term horizon.

New economic and financial information confirms the positive trend in the Albanian economy. Economic activity has been improving, underpinned by the good financing conditions, increase in foreign direct investments, and positive developments in the external environment. The cyclical improvement of the economy has boosted participation in the labour force, increased employment, and decreased unemployment. Reflecting the monetary policy of the Bank of Albania, financial markets have been calm, liquid, with low interest rates, thus providing adequate financing conditions for Albanian firms and households. In response to these developments, the domestic inflationary pressures have been trending upward.

Average annual inflation stood at 2.2% in the third quarter and 1.8% in October and November. The rise of inflation in the third quarter was driven by the price increase in services and by the pass-through of the oil price rise in international markets. In the following, the slow rise in agriculture products determined the slowdown in inflation.

From the macroeconomic perspective, the performance of inflation was better supported by the domestic inflationary pressures, while external pressures remain low. Core inflation and domestic inflation added their contribution to the formation of headline inflation. The build-up of domestic inflationary pressures reflects improvement of the economic activity, increase in the utilisation of production capacities, and a better anchoring of inflation expectations.

Chart 1 Inflation, inflation expectations and target



Source: INSTAT, Bank of Albania

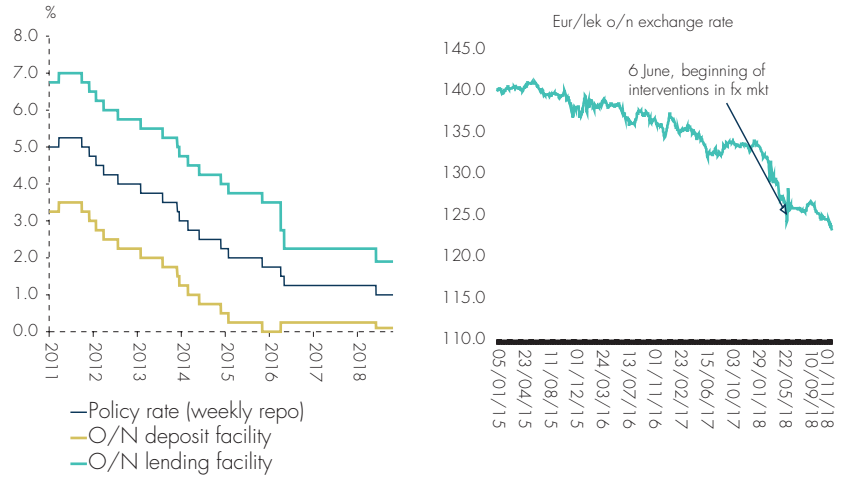
According to INSTAT data, the Gross Domestic Product grew by 4.3% in annual terms in the second quarter, from 4.5% in the first quarter. From a sectorial perspective, economic activity expanded supported, mainly, by the services and the industry sectors, while the construction sector recorded a decline. The production of electrical energy continued to provide a significant contribution, by 1.8 percentage points, to economic growth. From the aggregate demand perspective, economic growth was supported by the domestic demand, mainly in response to the improvement in household consumption, whereas investments slowed down. International trade supported economic growth in terms of increase in both exports of goods and tourism. Data on economic growth rates for the third and fourth quarter are partial. They suggest a slower pace of economic growth; its main drivers are expected to be private consumption and investments.

Growth of aggregate demand has been accompanied by an increase in the utilisation of production capacities, illustrated in the improvement of labour market indicators. The unemployment rate fell to 12.2% in 2018 Q3. Notwithstanding the constant improvement of labour market indicators, wages continue to rise at a slow pace. Core inflation has shown an upward trend; yet, it remains below its historical average testifying to an economy that still operates below its potential. Financial agents' medium-term inflation expectations have been trending upward and currently stand at 2.6%.

External inflationary pressures continue to provide low contribution to inflation. In trading partners, inflation rose in the third quarter mainly attributable to energy prices, and is driven by the sharp rise in oil prices. The fall in oil prices in October and November appears to have subsequently slowed down inflation in these countries. Moreover, the exchange rate appreciated from a year earlier, preventing the pass-through of external inflationary pressures to the Albanian economy. The effect of this factor is expected to be present for a few quarters ahead.

Economic and financial developments were sustained, among other things, by the monetary policy of the Bank of Albania. The monetary stimulus has been transmitted by maintaining the policy rate at 1.0%, supplying the market with liquidity and selectively intervening in the domestic foreign exchange market, in the summer months. The use of this non-conventional and temporary instrument resulted as effective in containing the rapid appreciation of the exchange rate, calming the foreign exchange market and mitigating its negative effect on achieving the inflation target.

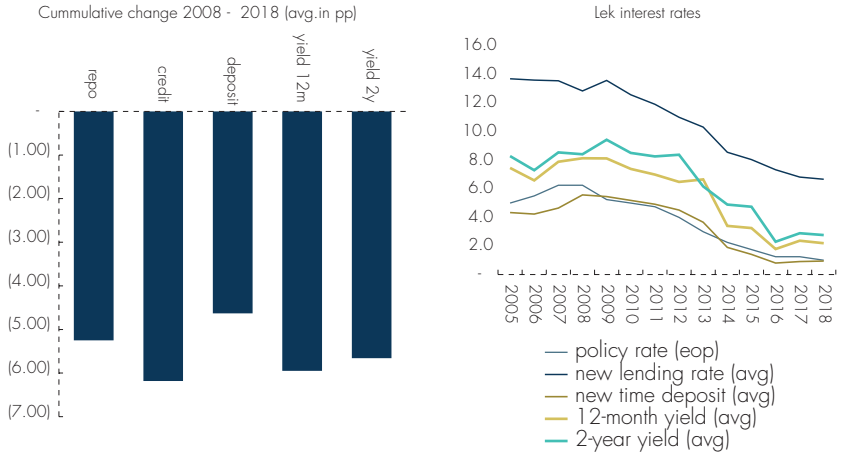
Chart 2 Policy rate (left) and daily EUR/ALL exchange rate (right)



Source: INSTAT, Bank of Albania

Domestic financial markets have reacted to the lowering of the policy rate, reflecting it in lower interest rates in the interbank and the primary markets. Interest rates on lek credit remain at low historical levels across all the segments of loan products. They have encouraged continuous growth of crediting in lek, rendering it as the main contributor to the growth of credit to the private sector over the last five years. At the end of November, lek credit accounted for around 50.7% of total credit, or 1.5 percentage points higher than in the previous year.

Chart 3 Monetary policy pass-through to financial markets



Source: Bank of Albania

The growth of credit to the private sector remains sluggish, as a result of the performance of loans to enterprises. The supply-demand analysis for this segment suggests a conservative approach by banks - expressed in tight credit standards - and low credit demand. Enterprises' investments have been financed

mainly by enterprises' own income. On the other hand, the standards of credit to households show easing trends, supporting the satisfactory expansion of credit to this segment. The Bank of Albania expects the credit supply will improve, since the reduction of credit risk increases the capacity of banks to be more proactive in lending[1].

The accommodative monetary policy has created preconditions for the convergence of inflation to target. Due to the lowering of interest rates and reduction of risk premia in financial markets, and recently the deceleration of the sharp exchange rate appreciation, the real monetary conditions are accommodative. They support the growth of internal demand and build-up of inflationary pressures.

Expectations for economic developments are positive. The economy is expected to continue to perform on an upward trajectory, supported by the favourable financial conditions, confidence of economic agents, and improvement of the external environment. Over the medium-term horizon, growth of aggregate demand is expected to increase the utilisation of producing capacities close to their optimum levels, toning up domestic inflationary pressures.

According to Bank of Albania projections, the average annual inflation will be around 2.1% for 2018 and will return to target within 2020.

Updated analyses and projections in this report suggest that the risks surrounding our forecasts remain tilted to the downside over the medium-term horizon. They are related to duration, impact and transmission channels of the effects from the exchange rate appreciation on inflation, 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 convergence of inflation to target.

[1] *The ratio of non-performing loans fell to 12.7% in November, from 14.3% a year earlier, and 20.4% two years earlier, and points to diminishing credit risk.*

3. EXTERNAL ECONOMIC ENVIRONMENT

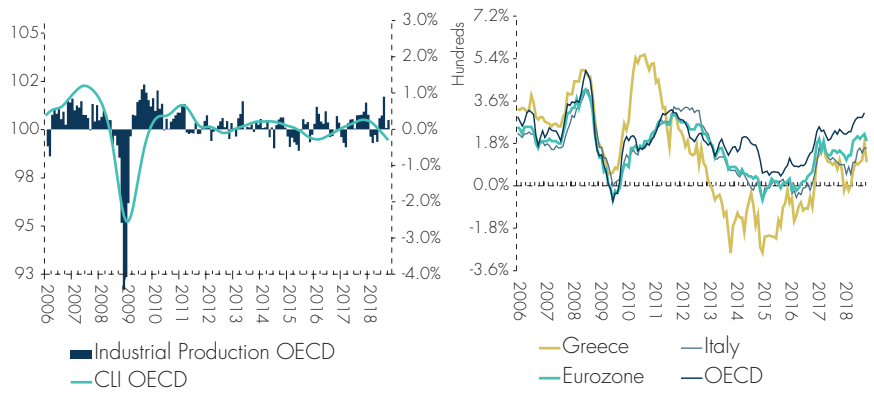
The global economy continued to grow in the third and fourth quarters. Economic growth appears faster in the US and in emerging economies, but slowed down in the euro area. Tensions arising from protectionist measures and trade tariffs introduced by the United States are risks that may affect the overall economic climate in the future.

Inflation rates increased in the third quarter to decrease again, as a result of changes in oil prices. Medium-term inflationary pressures remain moderate, reflected in low core inflation rates. The monetary policies of major central banks signal they will start moving toward the normalisation of interest rates, but at varied speed. Divergences in the intensity of economic developments and expectations about the monetary policy direction in advanced economies have increased the risk for higher volatility in financial markets.

3.1. GLOBAL ECONOMY

Economic activity in the major advanced economies slowed down in the third quarter and lead indicators suggest a reduction in economic growth also in the fourth quarter. The GDP growth in OECD member states fell for the fourth consecutive quarter, to 2.4% from 2.5% in the second quarter and 2.6% in the first quarter, as a result of a decline in trade activity and investments. The US is an exception from the trend, where the fiscal stimulus has supported the accelerated growth pace. The inflation rate has increased, drive by energy

Chart 4 Composite Leading Indicator (CLI) of GDP and Industrial Production* in the main countries** (left) and inflation in main countries (right)



*Industrial production is a monthly change, while CLI long-term is 100.
**OECD countries and Brazil, China, Russia, India and South Africa.
Source: OECD, (Organisation for Economic Co-operation and Development).

prices[2]. Unemployment has dropped to even lower levels than before the pre-crisis period and pressure from wages has increased, but they have not yet been transmitted to a sustainable increase in core inflation.

The tightening of monetary conditions - especially in the US, uncertainties surrounding trade relations with China and financial tensions in emerging economies have increased uncertainties. This is reflected in economic sentiment indicators, which recorded a decline in the fourth quarter.

US ECONOMY

The US economy grew at a fast pace in 2018 Q3, maintaining the improving trend from the previous quarters. Economic growth was driven by consumer spending, non-residential investments and central government expenditures. On the other hand, local government expenditures and residential investments slowed down the growth pace. Net exports, dictated by tensions over trade agreements, contributed negatively, driven by both the decrease in exports and the increase in imports. The domestic economy has benefited from a long period of the accommodative monetary policy and fiscal stimuli, which have been translated into improved balance sheets for firms and higher disposable income. Unemployment continues to register among the lowest rates in the last decades. The positive trend of the economy is expected to continue in the period ahead, but trade tensions, the gradual tightening of the monetary policy and the reduction of the effect of the fiscal stimuli may lead to slower economic growth.

Annual inflation, after the downward trajectory in the first half of the year, took a slight upturn in October, mainly owing to fuel prices. Meanwhile, the core inflation rate recorded a slight slowdown, approaching the Fed target.

Table 1 Selected macroeconomic indicators

Countries	GDP change T3-2018		Unemployment rate (%)	Annual inflation rate
	Quarterly	Annual	October -2018	November 2018
USA	0.9	3.0	3.7	2.2
Euro area	0.2	1.6	8.1	2.0
Germany	-0.2	1.2	3.3	2.4
France	0.4	1.4	9.1	2.2
United Kingdom	0.6	1.35	4.1	2.3

Source: Eurostat, respective statistical institutes.

EURO AREA ECONOMIES

The euro area economy continued to grow in the third quarter, albeit at a slower pace. In this quarter, the GDP resulted in 1.7% growth, from 2.1% in the previous quarter. During the first half of the year, the contribution from external demand diminished, which continued to make negative contribution

[2] *Annual inflation of OECD countries is 3.1% in October, from 2.9% in the third quarter.*

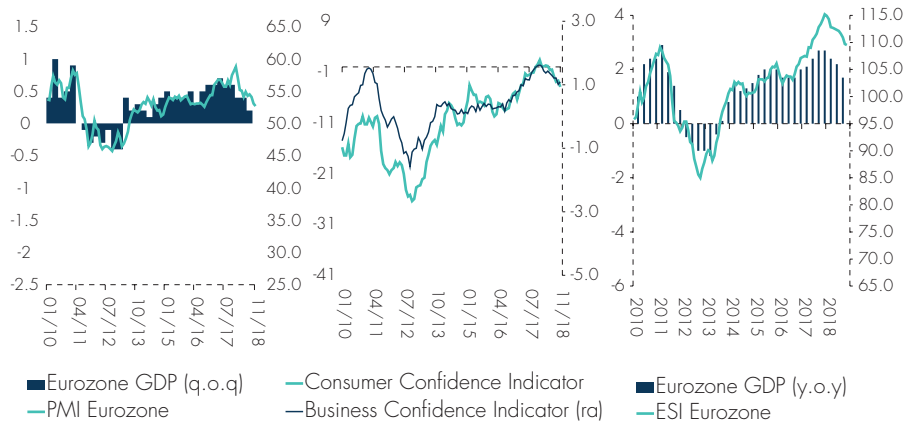
to economic growth in this quarter as well. Economic growth was supported mainly by the positive contribution of consumer spending and investments. Leading indicators of economic developments and confidence indicators suggest economic growth will continue in the last quarter, but at a slower pace than in the previous quarters.

After two months of growth, annual inflation fell in November, at 2.0%. This move is a result of the fall in energy prices, which remain the main contributor to the formation of inflation. Core inflation remains low and stable inflationary pressures are assessed as contained.

The economies of Albania's two main trading partners, **Italy** and **Greece**, performed at a dissimilar pace in the third quarter of the year. The slowdown in Italy's economic activity was dictated mostly by the deceleration in consumer spending and domestic demand in general. External demand was among the factors making positive contribution. Preliminary data from retail trade and confidence surveys point to similar developments in the country's economic activity in the last quarter. Uncertainties surrounding the upcoming fiscal budget and a slower economic performance of the euro area are expected to be decelerating factors for Italy's economic growth in the period ahead. The economy of Greece picked up speed in the third quarter. A preliminary analysis suggests a positive contribution from government expenditures, while consumer spending and net exports have not changed their contribution to GDP. Economic activity in Greece is expected to continue following an upward trajectory, driven by the recovery of consumption and positive developments in investments.

In Italy, annual inflation hit the year's record high in November, at 1.7%, owing to the performance of energy and related products. In Greece, annual inflation returned to the average rate for the year, standing at 1.0% in November (from

Chart 5 Euro area, composite output index (PMI) and quarterly GDP (left), confidence survey indicators (middle) and the economic sentiment indicator (ESI) and annual GDP (right)



Source: Markit, Eurostat, EC.

1.8% in the previous month). In both countries, core inflation ranges low, suggesting subdued inflationary pressures.

REGIONAL ECONOMIES[3]

The economies of regional countries continue to grow steadily in the third quarter. Growth was supported by domestic demand, with consumer spending accounting for the largest share in spending in the economies of our region. The labour market improved as well, with the unemployment rate falling - in the case of Serbia to its historical low. The positive economic performance is being transmitted slowly to prices in the region. Domestic inflationary pressures remain subdued and the inflation rate is related closely to energy and food prices.

In line with expectations, the annual economic growth in **Turkey** slowed down significantly in the third quarter of 2018 (to 1.6%, from 5.3% in the second quarter) and is expected to turn negative in the fourth quarter. The depreciation of the Turkish lira and the sharp increase of interest rates are reflected in less private consumption and investments. The contraction in the construction sector made the main contribution to the slowdown. The exchange rate has recovered somewhat from the depreciation by 47% recorded in August; yet, the effects of the exchange rate crisis will continue to be present in the upcoming year as well. The economy of **Kosovo** grew at 4.2% in the first half of 2018, driven mainly by investments in the transport infrastructure. Private spending and government expenditure have also contributed to the expansion of economic activity at a faster pace.

Economic activity in **Serbia** saw high growth rates, beyond projections. The economy grew at 4.5% in the first nine months of 2018, compared to the same period in the previous year. The pace of economic growth slowed in the third quarter, albeit remaining above expectations. Economic growth was supported mainly by investments, which increased at two-digit figures, and consumer spending. The latter have benefited from improvements in employment indicators. After some difficult quarters, the economy of **Macedonia** continued to grow at a fast pace in the third quarter, as a result of the expansion in exports, public consumption and private consumption. Private investments continued to shrink, reflecting the uncertainty in the wake of the tense political situation in the first half of the year.

Annual inflation rates in the region showed lower values in October and November, after a rise in the summer months. The performance of inflation was dictated to a large extent by fuel, energy and food prices. Inflation expectations remain low across the region. Turkey is an exception to the trend with the inflation rate, albeit downward in the last two months, retaining two-digit values, dictated by the exchange rate.

[3] *The main trading partners outside the European Union (Kosovo, Macedonia, Serbia, Turkey).*

Table 2 Economic indicators for countries in the region

Countries	Annual change of GDP		Annual inflation	Unemployment rate
	2018 Q2	Q3-2018	November 2018	2018 Q3
Italy	1.2	0.7	1.7	10.6
Greece	1.7	2.2	1.0	18.6
Macedonia	3.0	3.0	1.2	20.8
Serbia	4.9	3.8	2.2*	11.3
Turkey	5.3	1.6	21.6	11.1
Kosovo/1	3.5	4.7	2.1	29.4**
Albania/1	4.5	4.3	1.8	12.9**

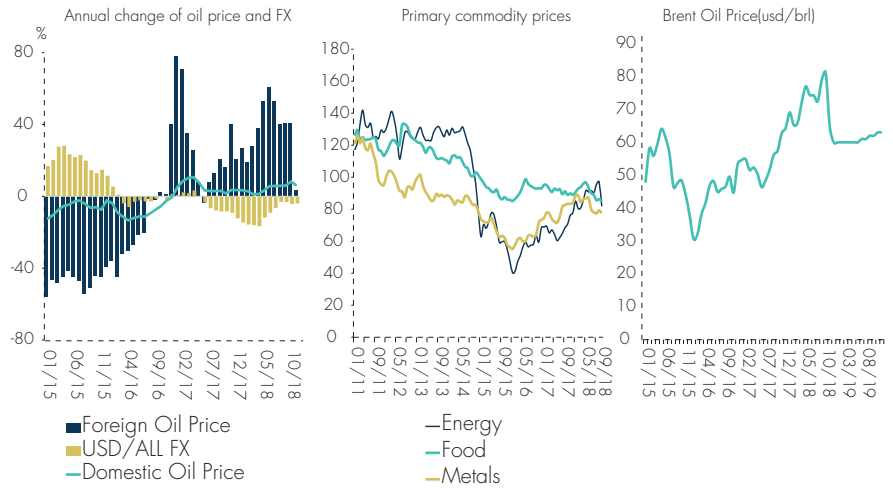
Source: Respective statistical institutes.
Note: 1/ Data on economic growth for Kosovo and Albania refer to the first and second quarters of 2018.
**October 2018; **2018 Q2.*

3.2. COMMODITY PRICES IN GLOBAL MARKETS

The main commodity indices showed dissimilar performance in the third quarter. The index of energy prices (including also fuels) registered high values, whereas the indices of food prices and metal prices pursued a downward trajectory. The prices of energy products changed their direction in November. The index of energy prices slowed down the annual growth rate to 7% in November, from 42% on average in the May-October period.

Geopolitical tensions in the Middle East area, the main oil producing region, coupled with smaller supplies from countries in the American continent, drove oil prices and fuel prices up in international markets in the third quarter. In September, the Brent crude oil price in international markets hit $78.9/barrel, spiking up by 40.5% in annual terms. Brent crude oil price average fell to $65/barrel in November. The markets' concerns about the possibility of a higher supply than demand in the next year have pushed down the prices of this product in international markets. The latest forecasts by relevant institutions

Chart 6 Oil prices in international and domestic markets



Source: INSTAT, staff calculations; WB indices; EIA forecasts.

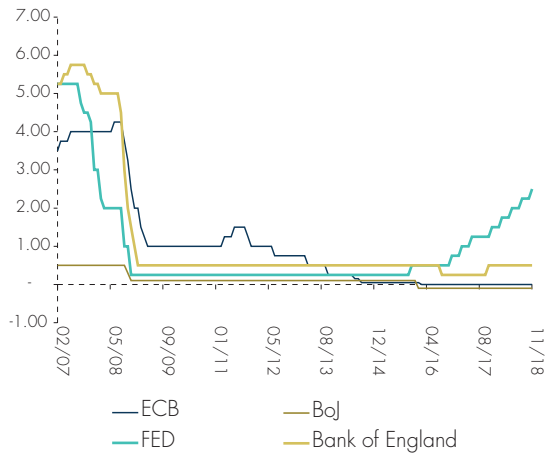
that survey the energy market suggest that the oil price will hover around the current levels in the quarters ahead to rise slightly at the end of 2019[4].

Indices of food and metal prices continued to record negative growth rates in the fourth quarter. The metal prices deepened their annual contraction in November (to 7% from 5% in October). Expectations for reduced need for metals in countries where industrial production accounts for a significant share of the economy, produced lower demand, which, coupled with the tariffs imposed by the USA on imports, has shifted prices of metals in international markets down. Food prices record lower values, driven by the low demand and latest tariffs imposed by the US on the imports of certain foods from China.

3.3. FINANCIAL MARKETS

As expected, in its September meeting, the Fed raised the target range for the federal funds rate by 0.25 percentage point, to 2.0 - 2.25%. In August, the Bank of England also raised the Bank Rate (policy rate) by 0.25 percentage point to 0.75%, as a result of strong positive developments in the labour market. Other major central banks have kept the respective policy rates unchanged: ECB's policy rate remains at 0.0% and the policy rate of the Bank of Japan stands at -0.1%. The monetary conditions are tightening as central banks are withdrawing the monetary stimulus created through low interest rates or quantitative easing. The Fed has announced that it will raise the policy rate, which has triggered the withdrawal of capital flows from emerging economies and has caused fluctuations in the financial markets of these countries. The European Central Bank has said that it will end the bond-buying programme at the end of this year.

Chart 7 Policy rates of major central banks



Source: Central Banks (ECB, FED, BoJ, BoE

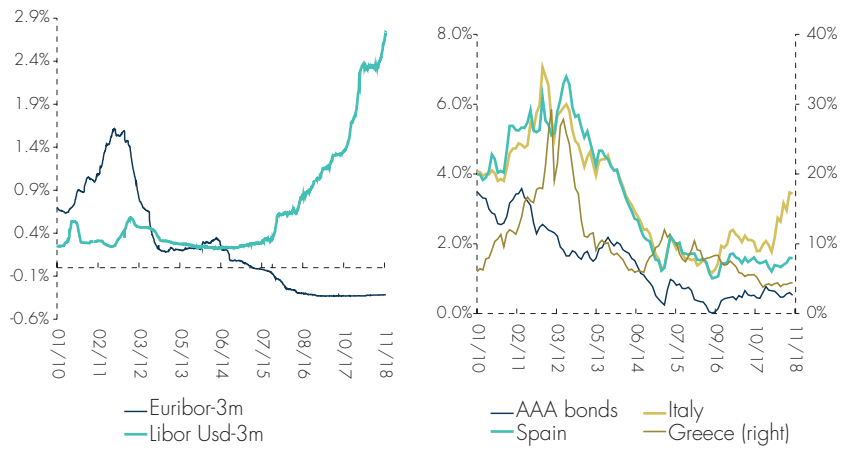
In capital markets, the yields on government securities in advanced economies showed an upward trend in the third and fourth quarters. These yields in the US and the UK were determined mainly by the good performance of the economy and agents' positive expectations. In the euro area, yields were determined by uncertainties subsequent to the rating of Italy's securities. This performance has caused the spread between securities of countries that need fiscal consolidation and German bonds to expand in this period. Yields on corporate bonds in the euro area markets edged up slightly in these months; yet, they remain below the values registered before the ECB's asset purchase programme of private sector securities. In the euro area money market, interest rates on short-term instruments

[4] *Forecasts by the U.S. Energy Information Administration: "Short-term energy outlook", December 2018.*

have not changed, in line with ECB's monetary policy communication. They remain at negative levels.

The euro depreciated against the US dollar, reflecting the differences in the monetary policy in these two economies. In the meantime, the euro appreciated against the currencies of many advanced and emerging economies. On average, the euro depreciated 2.35% against the US dollar in the third quarter, from the second quarter. In November, the euro was traded for 1,137 US dollar, or 3.2% lower than in the previous year.

Chart 8 Selected global financial indicators



Source: Bloomberg, Reuters and Eurostat.

4. FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

In 2018 Q4, financial markets are characterized by higher liquidity, lower interest rates and contained risks. The issue of the Eurobond in international markets contributed to the fall of government's demand for financing, while the improved liquidity conditions contributed to the fall of yields. Meanwhile, the interest rates on loans and deposits remained low. The Albanian lek appreciated against the euro and depreciated against the US dollar in the foreign exchange market.

Developments in credit portfolio show the growth pace slowed down, driven by both the low loan demand from enterprises, and the tightened lending standards to this segment. Loans to households lead the growth of credit to the private sector, mainly supported by mortgage loans. By currency, the higher growth of lek loans supported the further shift of the portfolio towards a more balanced currency structure.

The sluggish demand for money from public and private economic agents continues to condition a weak monetary expansion and does not signal any change of monetary pressures on inflation.

4.1. FINANCIAL MARKET DEVELOPMENTS

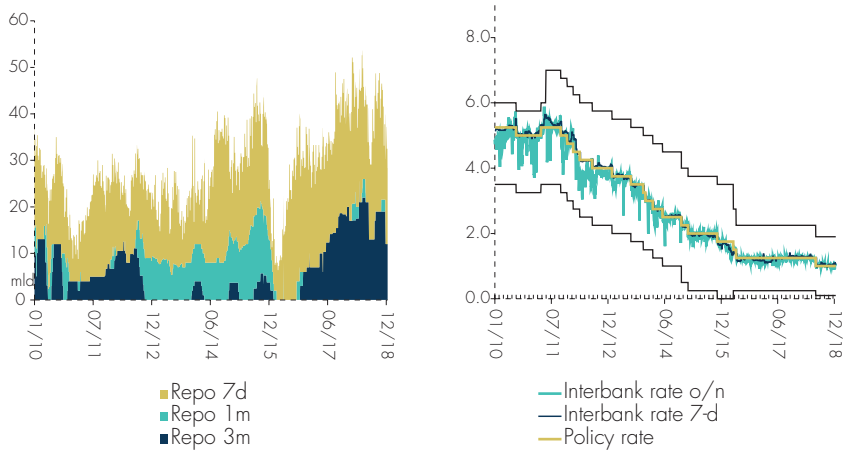
INTERBANK MARKET

The interbank rates hovered near the policy rate in 2018 Q3 and in October and November. The spread of interbank rates with the policy rate remains at the minimum level. Liquidity conditions improved and supported this performance of the interest rates. The average traded volume contracted compared to 2018 Q3, as a result of the decrease in the weekly transactions. Overnight and one-week maturities remain the most employed ones; in addition, the 2-, 3- or 30-days transactions have been also used. The volatility indicators[5] stand close to the previous quarter values, remaining at low levels.

The Bank of Albania continued to supply liquidity through its main instrument, the one-week repo. In addition the injections through the three-month maturity repo agreements increased as well. The average injected amount was lower than in the previous quarter, whilst interest rates in the auctions were close to the policy rate.

[5] *The standard deviation of the overnight interbank rates was 0.02 in October and November, from 0.04 in 2018 Q3.*

Chart 9 Bank of Albania open market operations and interbank rates



Source: Bank of Albania

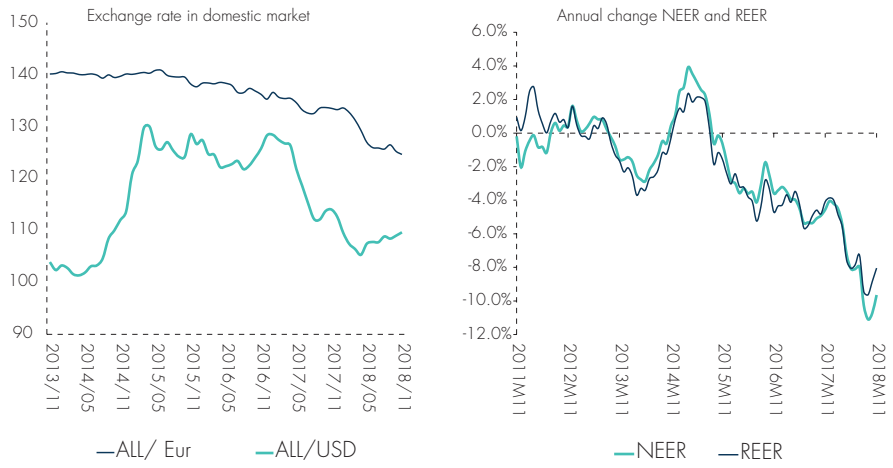
DOMESTIC FOREIGN EXCHANGE MARKET

Lek continues to appreciate against foreign currencies, compared to a year earlier. Data from the external sector show high foreign currency flows in Albania during the nine-month period of 2018, supporting the appreciation trend of the foreign exchange rate. In parallel, the exchange rate was subject to shocks, which accelerated the appreciation of lek, especially in the second quarter, when the change in the behaviour of financial agents led to a misbalancing of the foreign currency supply-demand relations[6]. These shocks accelerated the appreciation trend of the lek, diverging from the levels suggested by fundamental factors and necessitating the intervention of the Bank of Albania in the foreign exchange market. The temporary intervention of the Bank of Albania in the foreign exchange market has reduced misbalances in the supply and demand for foreign currency, calmed the functioning of the foreign currency market and decelerated the rapid appreciation of the lek.

The EUR/ALL rate was stable in the third quarter, but it resumed the appreciating trend in the fourth quarter. In October and November, one euro was traded on average for ALL 124.9, appreciating 0.9% compared to the third quarter. This performance appears to reflect both euro depreciation in international markets and the presence of a high supply in euro. The Bank of Albania was almost not present at all in the market during this period. One euro was exchanged at around 6.5% less into lek compared to the previous year. Data for December show that lek appreciated against euro, averaging EUR/ALL 123.6 in line with its seasonal behaviour of the end of year.

[6] *A detailed analysis is found in the Monetary Policy Report III, August 2018.*

Chart 10 Developments in the foreign exchange market



Source: Bank of Albania

The ALL/USD performance reflected the EUR/USD performance in international markets. The good performance of the US economy, and signals for a faster interest rate normalisation by Fed, against the slowdown of European economies, supported the strengthening of US dollar. Lek depreciated against US dollar in October and November, similarly to the third quarter. Thus, one US dollar was traded on average at 109 lek, or 0.9% higher than in the third quarter. In annual terms, lek's appreciation against the US dollar fell at 3.8%, from the 4.1% average in 2018 Q3. Data for December show that Albanian lek appreciated against US dollar on average at ALL/USD 108.8.

The performance of exchange rate composed indices of Albanian lek to the main currencies of trading partners shows the appreciation of the Albanian lek in the fourth quarter similar to the third quarter. During this period, according to the nominal effective exchange rate (NEER)[7], Albanian lek appreciated on average 9.9% y-o-y, or around 3.6 p.p. higher than the average in 2018 H1. Meanwhile, the Albanian lek appreciation by the Real Effective Exchange Rate (REER) index recorded and average annual contraction of 8.4%, from 8.8% in the third quarter. The strong appreciation of Albanian lek against the currencies basket, after July, was broadly affected by its appreciation against Turkish lira, by reflecting the strong depreciation of this currency in the international markets.

[7] *The Nominal Effective Exchange Rate (NEER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market weights. For the purpose of calculating the lira/lek and the renminbi/lek rates, the exchange of the Turkish lira and the Chinese renminbi against the US dollar remain the official reference rates. The Real Effective Exchange Rate (REER) is calculated similarly to the nominal one, but it considers the domestic inflation and that in the trading partners.*

BOX 1: THE EFFECT OF INTERVENTIONS IN THE FOREIGN EXCHANGE MARKET[8]

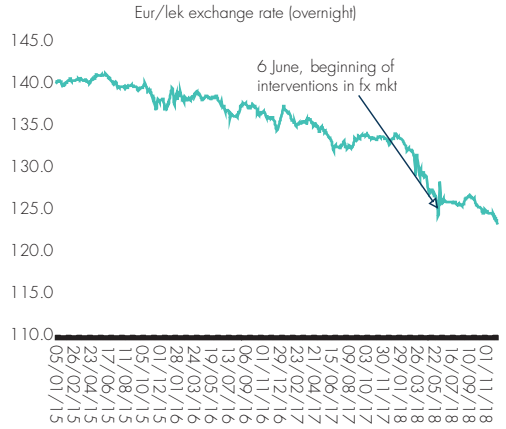
In the meeting on 6 June, the Supervisory Council of the Bank of Albania approved the use of interventions in the domestic foreign exchange market as an instrument of the monetary policy. In strategic terms, interventions aimed at avoiding the materialisation of potential negative effects from the strong appreciation of the exchange rate on inflation in the medium term. In operational terms, they aimed at establishing the premises for a more normal activity in the domestic foreign exchange market. The judgement on the effectiveness of interventions takes account of these objectives. Based on the available information, we deem that the initial premises for achieving the first objective appear positive. Nevertheless, a complete assessment to measure the level at which this objective has been achieved would request still some time. On the other hand, interventions in the foreign exchange market have addressed the goals related with the operational objective.

From the operational perspective, the presence of the Bank of Albania in the foreign exchange market, aimed at calming down the behaviour of financial agents and their expectations for the further appreciation of the exchange rate, reducing the uncertainty in the foreign exchange market, and encouraging banks to have a more proactive role in absorbing the outstanding supply in this market. The following analysis shows that Bank of Albania succeeded in ensuring a normal functioning of the foreign exchange market.

The first indicator considered is the spread of the EUR/ALL quoted price - the spread of euro buying and selling prices - where its increase represented heightened uncertainty in the foreign exchange market. This spread peaked in June, and then decreased returning to normality. The decrease in uncertainty is noted both in the considerable narrowing of the allocation of the quoted spread and in the lowering of its average level in the third and fourth quarters. This performance shows calmer behaviour of financial operators in foreign exchange market.

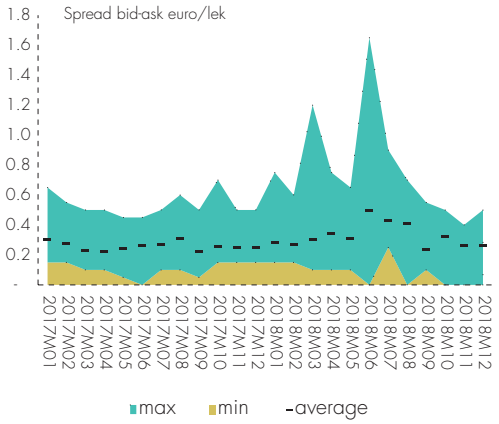
Also, the Bank of Albania encouraged banks to undertake a more proactive role in absorbing shocks of the foreign exchange market, determining a normal performance of the exchange rate even in the case of its absence. The foreign exchange position of commercial banks shows that they

Chart 11 Euro/lek daily exchange rate*



*Data as at the end of November 2018.
Source: Bank of Albania

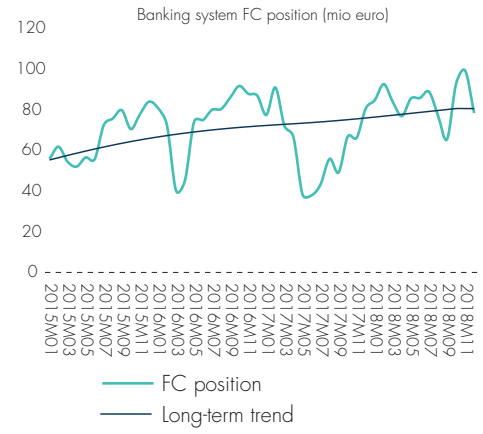
Chart 12 Price spread of EUR/ALL quoted exchange rate by the commercial banks (in lek)



Source: Bank of Albania

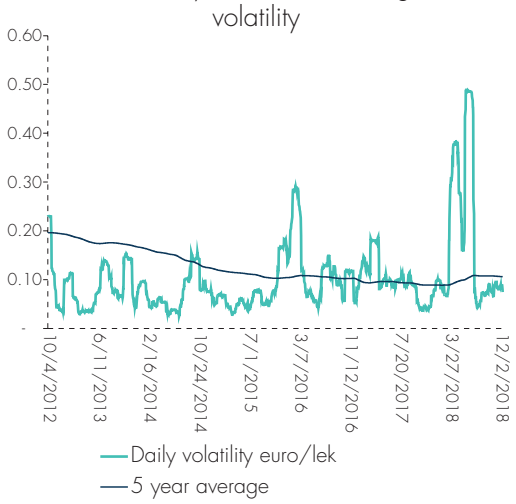
[8] *Box "Exchange rate developments in 2018 H1" in the Monetary Policy Report 2018/III provides more information on the decision to intervene in the foreign exchange market. It also addresses concerns on the functioning of the domestic foreign exchange market.*

Chart 13 Open foreign exchange position of the banking system (in eur mln- deviation from the trend and seasonality)



Source: Bank of Albania

Chart 14 Daily EUR/ALL exchange rate volatility



Source: Bank of Albania

accumulated foreign currency in their balance sheet, during 2018 Q3 - showing prudence in complying with the regulatory framework. This indicator shows that unlike previously, banks changed their behaviour and assumed long positions in the market, becoming more active in their intermediating role in the foreign exchange market. The resumption of their behaviour in accordance with the seasonality has contributed to calming the pressures on the appreciation of Albanian lek in the foreign exchange market.

The daily volatility of the exchange rate is another indicator showing the increased uncertainty in the foreign exchange market. In June, standard deviation of daily volatilities peaked almost 4.6 times more than the average of the last five years. The continuous presence of the Bank of Albania in the domestic foreign exchange market contributed to the considerable contraction and the return of this indicator to normality. Due to both the subdued uncertainty and the more active role of banks in determining the price of the Albanian against the euro, the daily volatility of the EUR/ALL contracted even in the period when the Bank of Albania was not present in market. In fourth quarter, the Bank of Albania as almost not present at all in the foreign exchange market.

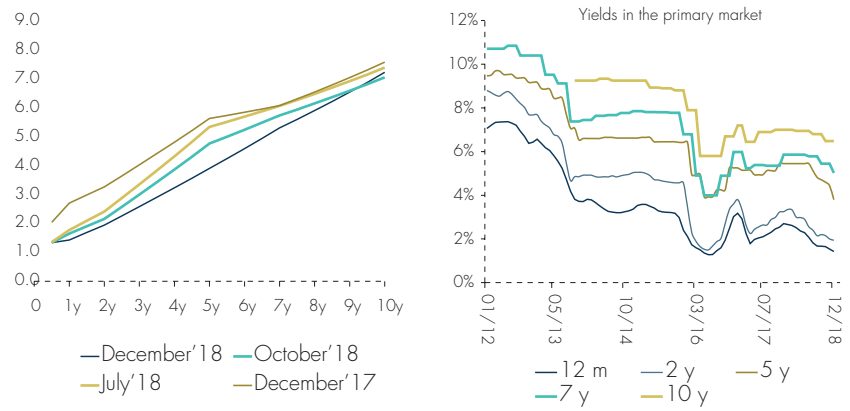
As the improvement in the above indicators shows, interventions of the Bank of Albania in foreign exchange market have rectified the short-term disorders, which were noted in 2018 Q2. Also, through the slowdown of the exchange rate appreciation, the exchange rate risk on inflation was mitigated.

PRIMARY MARKET

In the primary market of government debt's instruments, **Treasury bill** and **bond** yields continued to trend downward throughout 2018 Q3 and in the last months. The fall of yields was present across all instruments; excluding September, it maintained the strength in the second half of year. In December auctions, yields continued to decline. In the absence of pressures from government's supply, the high competitive demand of banks determined the performance of yields, pushing them down. The issue of the government's Eurobond at the beginning of October provided the latter with the possibility to lower its demand for financing in the domestic market.

The average yield of 12-month T-bills fell to 1.43% in December, from 2.7% and 2.1% at the beginning of the year and in June, respectively. Bond yields showed similar performance to T-bills, but the decrease of the asked premia was stronger, particularly in the medium term. The 2, 5, 7 and 10-year bond yields during the recent auctions were 1.94%, 3.80%, 5.02% and 6.48%, respectively, from 2.40%, 5.13%, 5.45% and 6.80% in July. The yield curve was slightly less steep. The bid/cover ratio of debt securities auction in these months increased[9], affirming a more competitive behaviour of banks.

Chart 15 Yields in the primary market*



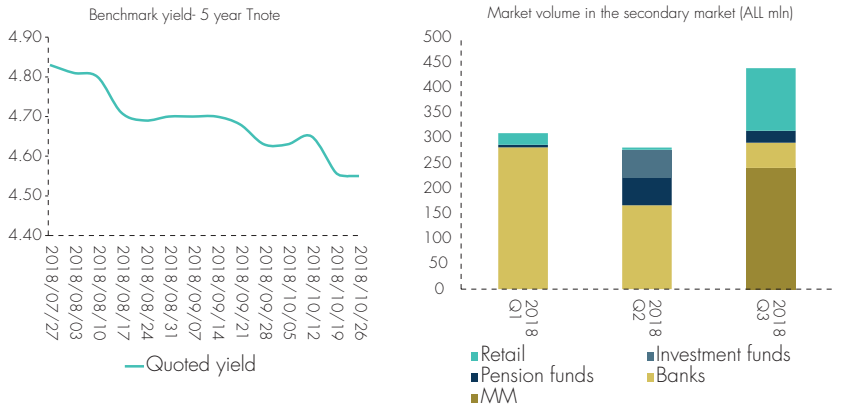
*The chart includes the auctions conducted till 18 December 2018.
Source: Bank of Albania

[9] *Bid/cover ratio for both T-bill and bond auctions held from July to November was 1.54, from 1.23 in 2018 H1.*

BOX 2: ISSUE OF THE FIVE-YEAR BENCHMARK BOND

In the framework of the last initiative of the Government and the Bank of Albania to develop the domestic financial markets, the issue of the five-year benchmark security started in July as a pilot project. This project aims at developing the securities' secondary market. Through the development of securities' secondary market, it is aimed to increase the liquidity of government's long-term securities, to determine a rather efficient price of securities, and to establish a benchmark rate for interconnecting financial instruments in the market. The daily quotation of this security yield, by market makers, increases transparency and makes available real-time information on the price of a "non-risk" financial instrument. This is required to determine the interest rates of long-term financial instruments. The performance in the first three months of this project shows that it has provided the first positive results, regarding both the traded volume and the increase in market participants. The benchmark yield, which is quoted every day by market maker banks, has been falling.

Chart 16 Yield and the quoted volumes in the secondary market of the five-year benchmark security*



*MM, in the right chart, refers to banks selected as market developers.
Source: Bank of Albania

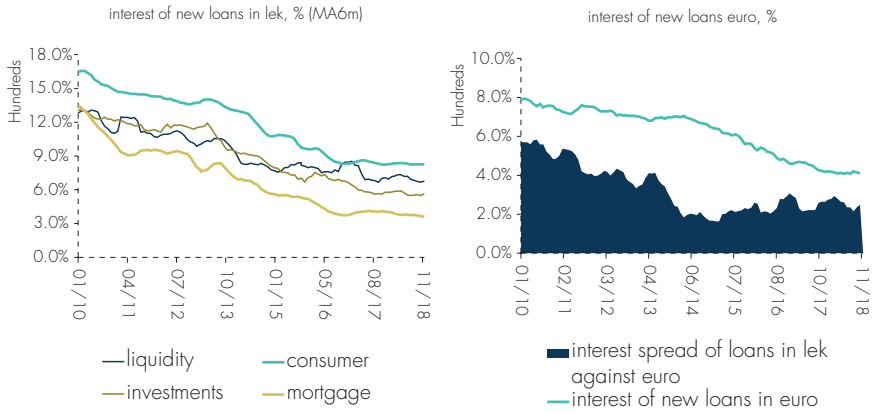
4.2. DEPOSIT AND CREDIT INTEREST RATES AND FINANCING CONDITIONS

The interest rates on new deposits in lek are low. The 6.5% average interest rate on **new loans in lek**, in October and November, was close to the average values of the third quarter (6.8%). Interest rates on loans with medium-term maturity were up, while they slightly fell on loans with short-and long-term maturity. Nevertheless, interest rates on loans are slightly lower compared with 2018 H1. Analysis by customer shows that interest rates on lek loans decreased more for enterprises, while for households they decreased only marginally. Interest rates on loans to enterprises decreased for both liquidity and investment purposes. Regarding loans to households, interest rates decreased in particular on mortgage loans[10]; meanwhile, interest rates on consumer loans

[10] *Interest rates on mortgage loans in lek, in October and November was 3.44%, from 3.6% in 2018 Q3 and 3.8% in 2018 H1.*

were volatile. The average interest spread on lek loans against euro loans was slightly up in these two months, mainly due to the higher contraction of interest rates on loans in euro than in the domestic currency. Interest rates spread of loans between the two currencies by client show increase for enterprises, and decrease for households, particularly on mortgage loans.

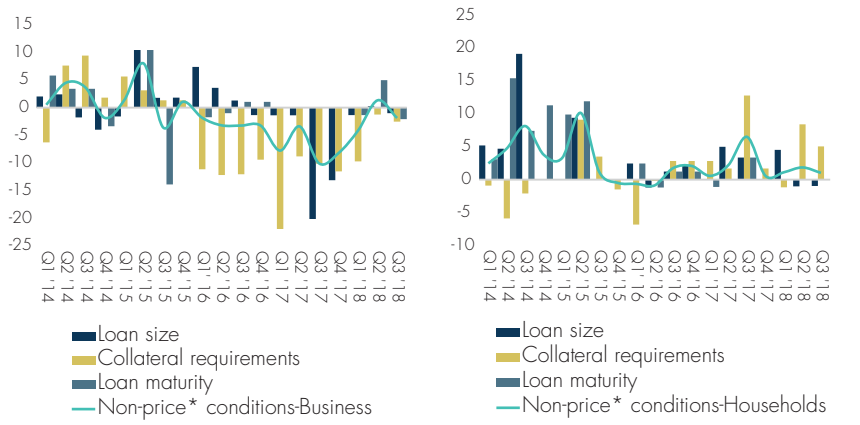
Chart 17 Interest rates on new loans in lek, six-month moving average



Source: Bank of Albania

The average interest rate on new euro loans in these two months decreased from 2018 Q3 and 2018 H1. The average interest rate in this period was 3.9% from 4.2% in the previous quarter. The fall in interest rates showed their decrease on loans to enterprises for both liquidity and investment purposes. Meanwhile, the interest rates on euro loans to households increased for both consumer and mortgage loans.

Chart 18 Non-price credit terms and conditions to enterprises (left) and to households (right), net responses balance

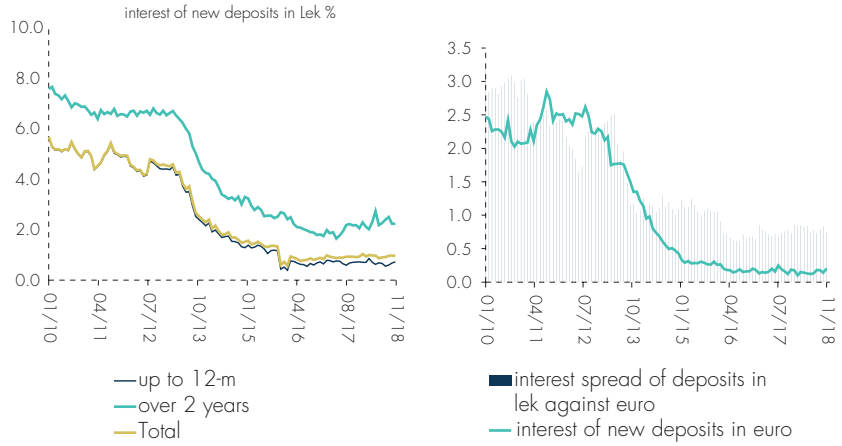


* arithmetic mean of respective components' net balances.
Source: Bank Lending Survey, Bank of Albania.

Bank lending survey[11] results show that banks slightly tightened the non-price terms and conditions for enterprises and eased them for households in 2018 Q3. Unlike a quarter earlier, non-price terms and conditions for enterprises were tightened, through both the decrease of loan maturity and the higher collateral requirements. Also, the change of the margin on riskier loans was tightened, by affirming that banks' policies on lending to enterprises remained tightened in 2018 Q3.

Banks implement a more favourable approach for loans to households. The average of non-price terms and conditions appears slightly on the positive side by reflecting the easing of collateral requirements by banks compared to the previous quarter, while banks slightly tightened the credit size. In parallel, price terms and conditions to households remain almost unchanged from the previous quarter. Nevertheless, bank lending policies on loans to households remain on the easing side.

Chart 19 Interest rates on new deposits in lek and euro



Source: Bank of Albania

Average interest rate on **new time deposits in lek** was 0.9% in 2018 Q3 and 0.97% in October and November. Within maturities, interest rates on maturities up to one year have increased slightly, while interest rates on 2 to 5 years have not changed. Interest rates on **new time deposits in euro** were around 0.17%, while their level over 2018 was around 0.10%-0.20%.

4.3. CREDIT TO THE PRIVATE SECTOR[12]

Credit activity continued to show moderate growth rates in 2018 Q3, and in October and November. Credit performance over this period reflected the

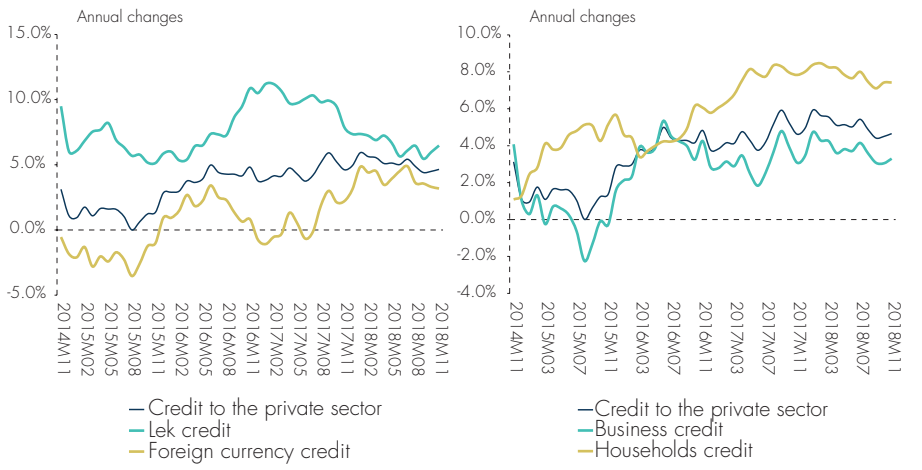
[11] *The Bank Lending Survey is performed four times each a year with commercial banks. The latest available data refers to 2018 Q3.*

[12] *Credit data are adjusted for written off loans and exchange rate movements.*

sluggish monthly performance of loans to enterprises. Banks reported[13] that the enterprises' loan demand was lower from the previous quarter, whereas terms and conditions remained tight. On the other side, loans to households continued to show stable growth and provide the main contribution to the expansion of the credit portfolio. Nevertheless, loans to enterprises, sharing 66% of total credit, dominate the credit portfolio. At the end of September, credit to the private sector, as a ratio to GDP, is assessed at around 35.3%, unchanged from the end of previous quarter.

Outstanding credit to the private sector showed slow annual growth rates at 0.9%, in October and November. Adjusted for the appreciation of the domestic currency against main foreign currencies, this rate fluctuated around 4.5%[14] from 4.9% in 2018 Q3. In absolute terms, the stock of credit to the private sector increased by around ALL 4.3 billion from the end of September.

Chart 20 Credit to the private sector by currency and economic agent



Source: Bank of Albania

Developments by currency evidence a stable growth of the portfolio in lek (6.2% y.o.y.). Notwithstanding the slowdown of this portfolio's growth rates compared to 2018 H1, it continues to provide the main contribution to the expansion of credit to the private sector. On the other hand, foreign currency loans decelerated the growth pace, at around 3.2%, adjusted for the effect of the exchange rate appreciation. The performance of this portfolio is characterised by a more volatile demand, particularly in the segment of enterprises.

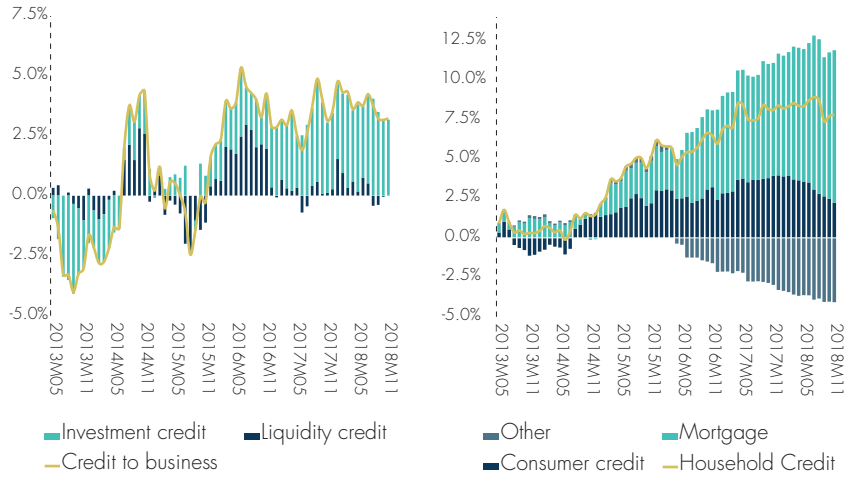
Loans to enterprises slowed down the growth rate at 3.2%, reflecting the slowdown of growth rates in loans for investment at 5.6%, from 6.4% in 2018 Q3. Nevertheless, the growth of loans for investment fully supported

[13] *For more details, see Bank Lending Survey 2018 Q3, at: https://www.bankofalbania.org/Monetary_Policy/Surveys_11282/Bank_Lending_Survey/*

[14] *Credit analysis in this report shows figures adjusted for written off loans and exchange rate movements.*

the annual expansion of loans to enterprises. The good performance of this portfolio in the last two years has affected the shift of the structure towards loans for investment, which accounts for 57% of loans to enterprises in November. Loans for liquidity continue to remain weak, affected also by the good situation of enterprises' liquidities, as noted by the growth of enterprises' deposits over 2018.

Chart 21 Lending by purpose of use



Source: Bank of Albania

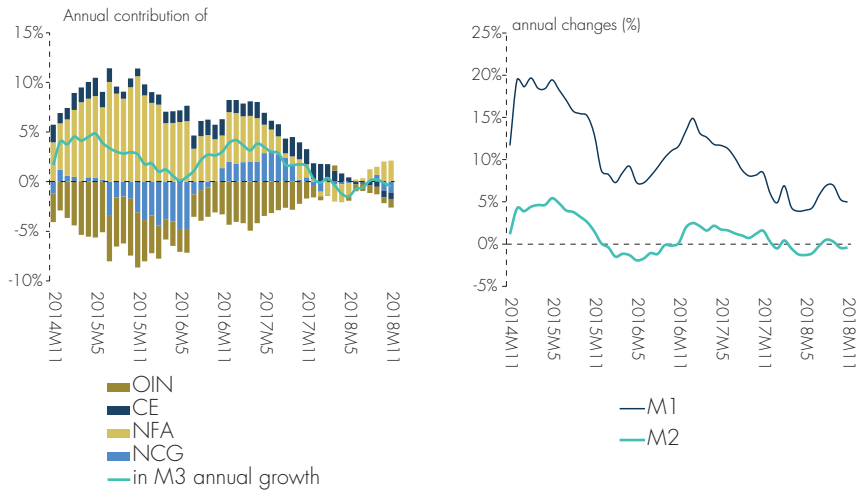
In October and November, loans to households showed similar annual growth with the third quarter, at around 7.8%. Notwithstanding this rate is lower than in 2018 H1, loans to households provided the highest contribution to the expansion of credit to the private sector in annual terms. From a longer-term perspective, this performance is related to the eased credit conditions to this segment, supported also by the continuing increase of the demand. The demand is reported to have been increased also in 2018 Q3, for both consumer and house purchase loans. Both consumer and house purchase portfolios recorded an equal growth rate by around 7.8% on average, in October and November. Compared to 2018 H1, the growth dynamics of these portfolios appear on opposite directions. Thus, house purchase loans improved the growth pace, while consumer loans decelerated the growth pace.

4.4. DEPOSITS AND MONEY SUPPLY IN THE ECONOMY

Money supply in economy was weak over 2018. The average annual rate of the M3 aggregate overall appears in negative territory, recording -0.5% annual rate in November, similar to the average of January - October period. The performance of this indicator reflects, on the one hand, the statistical effect of the domestic currency appreciation against both the euro and the US dollar and the structural changes of holding the money - deposits shifting to higher

than two years maturities[15] throughout the year, on the other. Adjusted for both factors, the broad money shows an average growth rate around 2%. Conversely, the low creation of money in the economy reflects the still weak financing of the private sector with monetary assets from the banking system. Also, the domestic currency, i.e. the M2 aggregate, recorded contracting annual rates over the year. In November, this indicator fell by 0.4% y.o.y, similar to the average recorded over the January - October period. The liquid money, i.e. M1 aggregate, expanded on average by around 5.3% in annual terms, (5% in November), reflecting the preference of economic agents for liquid monetary assets. The ratio of currency outside banks against the M2 aggregate was 37.2% at the end of November, around 1.3 percentage points higher than at the end of the previous year.

Chart 22 Monetary Indicators



Source: Bank of Albania

Deposits' stock in the banking system expanded by around 1.1%[16] in annual average terms during the period January-November 2018. The increase in deposits is supported by both the growth of deposits in lek (1.3%), and in foreign currency (0.9%). According to respective developments, deposits slowed down the annual growth pace in November, both in lek and foreign currency deposits.

In terms of maturity structure, the performance of deposits continued to show partial shift to liquid instruments, but the main shifts are noted towards deposits over two years, particularly in the domestic currency. This trend continued in November. Thus, deposits with under two-year maturity were reduced by around ALL 24 billion over the January-November period. Meanwhile, demand

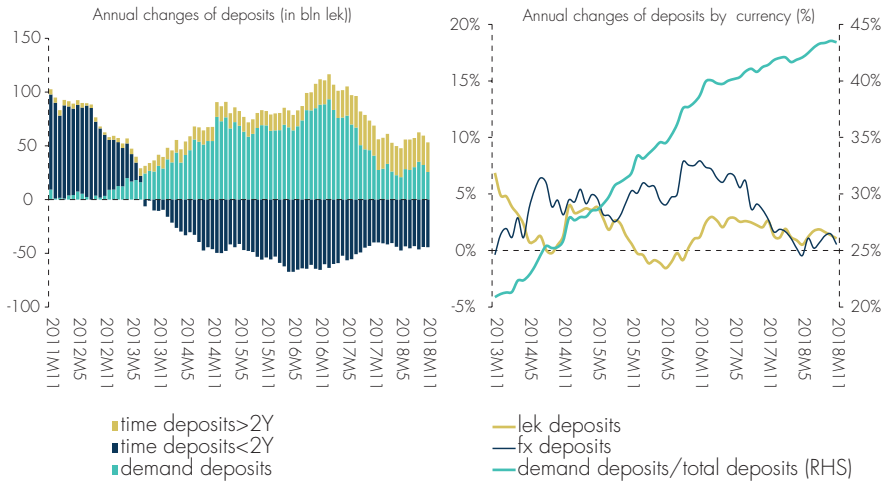
[15] *According to the implemented statistical methodology, deposits over two years are not included in calculating the monetary aggregates.*

[16] *Adjusted for the exchange rate appreciation, their average annual growth rate fluctuates at around 4%.*

deposits and time deposits with over two-year maturity in lek grew by around ALL 3 billion and 20 billion, respectively. On the other hand, deposits in foreign currency grew both in demand deposits and time deposits with under and over two-year maturity.

Deposits performance, according to economic agents, shows that deposits grew faster for enterprises than for households. This trend continued in November, when enterprises' deposits, notwithstanding the slowdown, grew at around 2.6%. The expansion of enterprises' deposits is mainly in the form of deposits in foreign currency. Meanwhile, the stock of households' deposits at the end of December was around 0.8% higher than a year earlier.

Chart 23 Deposits in the banking system



Source: Bank of Albania

5. INFLATION AND ECONOMIC GROWTH

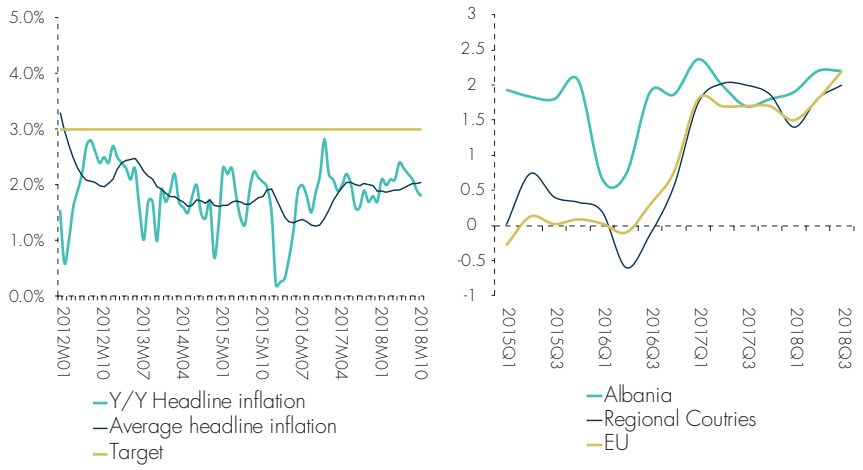
Average inflation was 2.2% in 2018 Q3 and 1.8% in October and November. Over the year, inflation was supported by domestic inflationary pressures, which were upward, driven by the cyclical improvement of the economy. On the other hand, the continuous appreciation of the domestic currency reduced the external inflationary pressures.

The cyclical improvement of the economy was affected by the acceleration of economic growth, at 4.4% in 2018 H1. The favourable financing conditions, the positive expectations for the outlook, the improvement of the financial situation, the growth of electricity production and tourism activity were the main factors for the recovery of aggregate demand. These developments are followed by the increase in employment and wages and decrease in the unemployment rate. As these dynamics are assessed to continue, the return of inflation to target in the medium-term horizon is fully achievable.

5.1. INFLATION

Annual inflation averaged 2.2% in 2018 Q3, standing at the same level as in 2018 Q2. Inflation trended downward in October and November, at 1.9% and 1.8%, respectively. Food items, especially unprocessed-food items, continued to be the main contributors to the formation and fluctuations of inflation over the period July - November 2018. In the same period, for basket categories, with less volatile prices, inflation showed more gradual increase than in the previous

Chart 24 Annual inflation and target (left).
Inflation in regional and EU countries (right)



Source: INSTAT, www.tradingseconomics.com and Bank of Albania calculations.

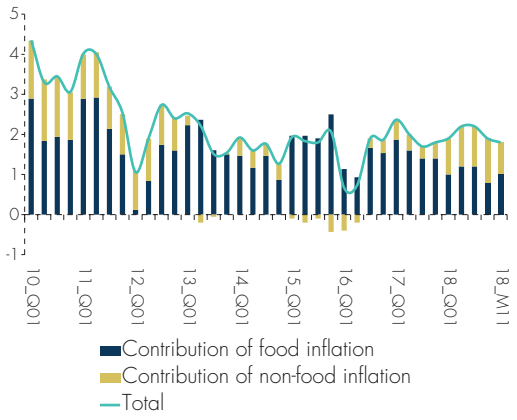
months of the year. Import prices increased higher in the period under review, but the exchange rate appreciation weakens its transmission.

Unprocessed foods were characterised by downward contribution to inflation, over the July – November period. It also determined the reduction of headline inflation compared to 2018 Q2.[17] In October and November, the contribution of this category fell by around 0.3 percentage point compared to the third quarter. Developments in the prices of this category are explained in the light of the supply growth in both quarterly and annual terms, affected by the favourable weather conditions. Foreign trade data show that imports of fruits and vegetables increased, especially in October, accompanied with downward prices.

In 2018 Q3 and in the two next months, **Processed Foods** maintained the positive low contribution of 0.2 percentage point. The sub-category "Bread and grains", from August 2018 registers negative annual rates of inflation.

Non-food consumer goods provided the same contribution (0.3 percentage point) to headline inflation over the July - October period. Oil prices increased in these four months, albeit this category maintained almost the same contribution due to the fall of prices in some other sub-categories (for example: clothing and footwear, etc.). In November, the contribution of this category was lower than in the previous month (-0.1 percentage point). Oil prices in international markets fell during this month. At the same time, the fall of prices was reflected also in the domestic market of fuels.

Chart 25 Contributions by food and non-food categories to inflation rate, in p.p.



Source: INSTAT and Bank of Albania calculations.

The prices of more stable components of inflation, mainly including prices of services and durable consumer goods, provided a higher contribution to headline inflation, in the period under review. Within the category "**Services**", the price of imputed rent maintained the upward trend noted since the beginning of the year. Thus, the contribution of "housing- rent" stood at 0.5 percentage point in October. The contribution of imputed rent slightly fell in November, the first one noted since the beginning of the year. This development reflected the start of setting off the base effect, because the increase of prices in this category started in November 2017.

The inflation of "hotels, bars and restaurants" trended upward in July and August. This trend had been absent in this period in the last two years. Prices of services "Package tours" showed a double-digit increase of inflation in these two months[18], by slightly

[17] *Inflation in June was 2.4%, meanwhile in November this rate reduced at 1.8%.*

[18] *Inflation of services "Package tours", were 12.2% and 14.7%, respectively in July and August. Their share in CPI basket is around 0.84%.*

affecting the growth of contribution of services. Their prices fell as usually by the end of the summer season. Nevertheless, the fall was more pronounced in the group of transport services in November, driving the contribution of "services" down by 0.1 percentage point.

The category of goods at "**Regulated prices**" continues to contribute positively to headline inflation since January 2018 (0.2 percentage point), due to the increase of water price in Tirana.

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

	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Avg. Oct-Nov. 18
Processed food	-0.4	0.1	0.4	0.6	0.6	0.5	0.2	0.0	0.1	0.2	0.2	0.2
Bread and grains	-0.2	-0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Alcohol and tobacco	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Unprocessed foods	1.5	0.9	1.2	0.9	1.3	1.1	1.2	1.3	0.9	1.1	1.0	0.7
Fruits	0.7	0.6	0.4	0.2	0.3	0.3	0.5	0.6	0.6	0.1	0.0	-0.1
Vegetables	0.8	0.3	0.8	0.6	0.9	0.7	0.7	0.6	0.2	0.9	0.9	0.7
Services	-0.1	0.0	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Goods with regulated prices	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2
Water supply	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2
Housing lease	-0.2	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.3	0.4	0.4	0.4
Non-food consumer goods	-0.3	-0.3	-0.1	0.1	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.2
Fuel	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2
Long-term consumer goods	0.1	0.1	0.1	0.1	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Consumer Price Index (annual change, %)	0.7	0.7	1.9	1.9	2.4	2.0	1.7	1.8	1.9	2.2	2.2	1.8

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

5.2. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

In the second quarter, economic growth was 4.3%, slightly lower than the 4.5% growth recorded in the first quarter. Even in the second quarter, growth was generated, to a large extent, by the industry sector, driven by the strong expansion in energy production. The services sector showed added contribution, whereas the effect from the construction sector is assessed to be on the down side.

The analysis of aggregate demand components shows that economic growth continued to be sustained by domestic demand, led by the final consumption of the population. The component of investments is accounted to have sustained economic growth to a lesser extent than in the previous quarter. Net exports had a minimum impact on economic growth over this quarter.

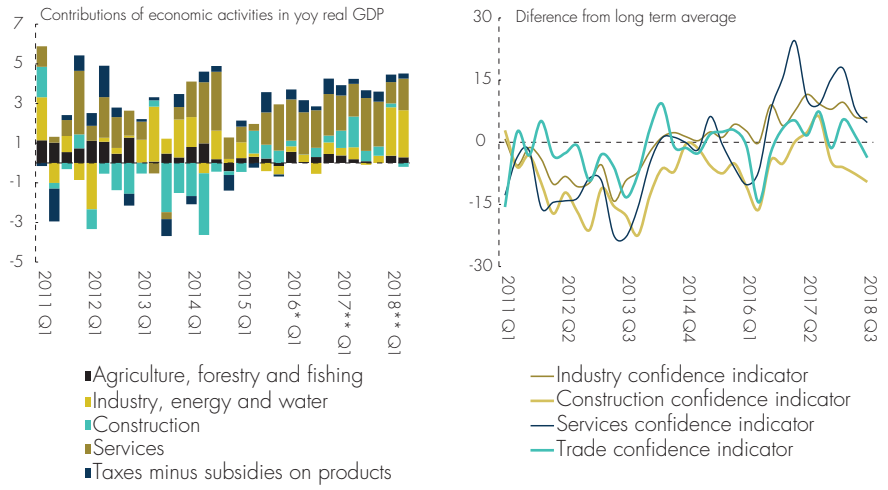
According to information obtained from quantitative lead indicators, positive developments in the electrical energy branch continued in the third quarter as well. In relation to aggregate demand, consumption remains the main contributor to economic growth. Domestic demand is expected to continue to support economic growth even in the last quarter of this year.

5.2.1. GROSS DOMESTIC PRODUCT BY SECTOR[19]

The rate of economic growth recorded in the second quarter continues to be attributed to the performance of the **production sector**. Notwithstanding the slower increase in production's value added, 5.8% from 7.5% in the previous quarter, the production sector contributed by around 2.5 percentage points to GDP growth. The activity in industry, energy and water continued to dictate the sector's dynamics and its contribution to the annual GDP is around 2.4 percentage points, unchanged from the previous quarter. The 67.4% expansion in the value added of the electrical energy continued to determine considerably the positive dynamics of the industry and economic growth in general. The contribution of the branch of electrical energy to the real GDP growth is 1.8 percentage points in the second quarter, similar to the previous quarter (1.9 percentage points).

The deceleration of the upward dynamics in the production sector is attributable mainly to the contraction of the value added in construction, and the slightly slower growth in "agriculture, forestry and fishery". The activity in construction contributed negatively to the annual GDP, by 0.2 percentage point. In the meantime, the activity in agriculture, forestry and fishery made slightly lower contribution to economic growth (at 0.3 from 0.4 percentage point in the previous quarter). The services sector interrupted the deceleration performance, adding its contribution to economic growth over this quarter (1.6 from 1.1 percentage points in the first quarter).

Chart 26 Gross domestic product by output and confidence indicators

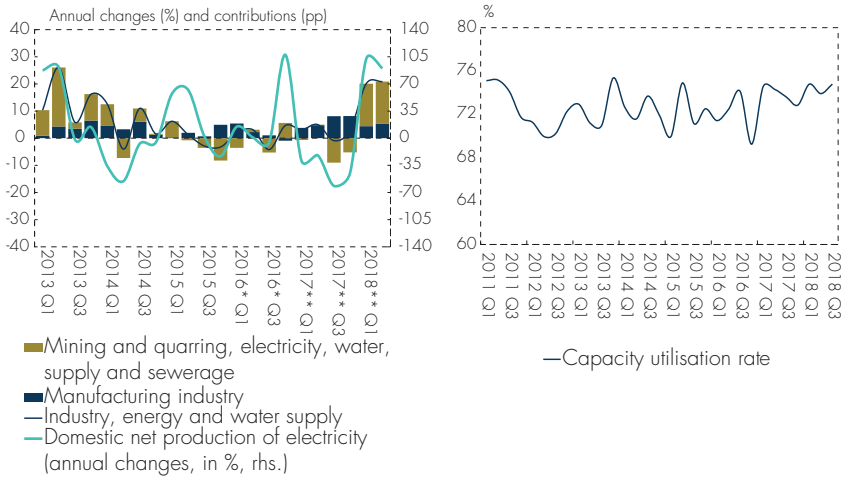


Source: INSTAT and Bank of Albania. *Semi-final data. ** A preliminary estimate.

[19] *Gross Domestic Product and Gross Value Added by sector are treated in terms of real annual changes. The analysis is based on the latest GDP data according to the output method for 2018 Q2, published by INSTAT on 26 September 2018. The differences between the sectors' growth rates of this publication and those analysed in the Monetary Policy Report 2018/III are the result of the revision of the series.*

The value added of the industry, energy and water sector recorded 20.9% annual growth in the second quarter, slightly higher than in the previous quarter. This performance reflected mainly the positive developments in electrical energy branch. The expansion of electrical energy production continued at a fast paces also in the second quarter, providing a considerable contribution to the upward growth trend of this branch.[20] In addition, the dynamics in the annual growth of processing industry branch picked up speed, to 11.2% from 9.9% in the previous quarter.[21] Yet, its contribution to the expansion of the sector, around 5.4 percentage points, remains lower than the contribution by the electrical energy branch. In the meantime, the value added by the extractive industry branch continued to contract in annual terms, by 4.0%, thus contributing to the down side of the sector's performance, by 0.8 percentage point.[22]

Chart 27 Contribution of branches to value added in "Industry, energy and water", and the capacity utilisation rate in industry



Source: INSTAT and Bank of Albania. *Semi-final data. ** A preliminary estimate.

The **industry sector** is expected to pursue an upward trend in the third quarter as well. The assessment is sustained by the upward trend in the electrical energy production, the increase in the volume of net sales in the industry and

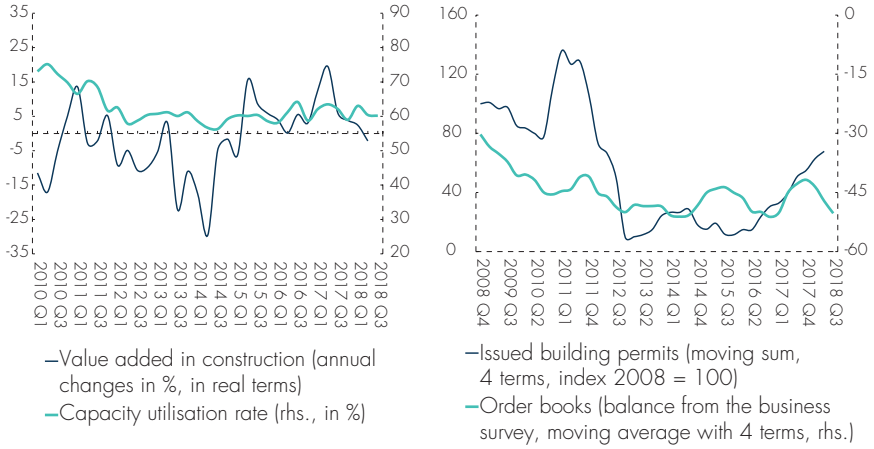
[20] *The electrical energy branch contributed by 15.7 percentage points to the annual growth of the industry sector, from 16.1 percentage points in the previous quarter. According to quarterly data on electrical energy balance, published by INSTAT, the net domestic output of electrical energy in the second quarter maintained the high annual pace, at around 90.1% from 102.3% in the previous quarter. The volume of net sales showed similar dynamics for the branch "Electrical energy, gas, steam and air conditioning", increasing, in annual terms, by 38.2% in the second quarter from 49.2% in the previous quarter. Meanwhile, the volume of production output for this branch speeded up the annual upward trend to 52.3% from 43.8% in the previous quarter.*

[21] *Among the sub-branches of the processing industry, the textile, clothing, leather and footwear industries, as well as industries related to metal products and base metals continue to support to a large extent the performance of the processing industry, as demonstrated by the upward dynamics of the exports of products from these industries.*

[22] *A largely exports-oriented industry, the annual decrease in the value of exports of some of the main non-energy products related to the extractive industry is assessed to have contributed to the down trend of the performance of the branch.*

the expansion of exports of some products related to the respective activities in the industry, as well as the higher capacity utilisation rate in this sector.

Chart 28 Valued added and capacity utilisation rate in construction



—Value added in construction (annual changes in %, in real terms)
—Capacity utilisation rate (rhs., in %)

—Issued building permits (moving sum, 4 terms, index 2008 = 100)
—Order books (balance from the business survey, moving average with 4 terms, rhs.)

Source: INSTAT, Bank of Albania

The construction sector deepened the slowdown trend, showing negative dynamics in the third quarter. Value added of the construction sector fell by 2.2%, in annual terms, following the increase by 2.4% in the previous quarter[23]. The performance of the construction sector was assessed to have been dictated mainly by the lower level of public investments, mainly due to the high comparative base of a year earlier. This is also illustrated by the annual growth in the volume of engineering works.[24] In the meantime, the increase in the foreign direct investment inflows, albeit at a slower pace, and the continued expansion of the realised investments for new constructions is assessed to have sustained the performance of the construction sector. Regarding other indirect quantitative indicators related to construction, the proxy of approved construction permits decreased in annual terms for the category engineering works. Conversely, this indicator increased for residential and other constructions.[25]

Our assessments suggest an improvement in the performance of the construction sector in the third quarter. This is signalled by the increase in the volume of

[23] *The shrinkage in the construction sector is assessed to have reflected to a large extent also the higher comparative base a year earlier. In 2017 Q2, the value added in construction expanded by 19.5% in annual terms, the highest value over the period 2009 - 2017. Nonetheless, in line with these performances were also the signals from the annual contraction of the output volume in construction and nets sales in this volume, by 3.0% and 4.9%, respectively.*

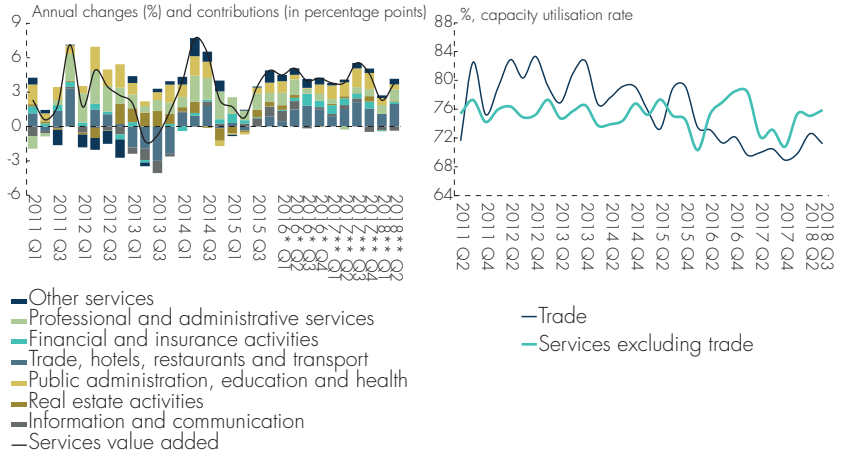
[24] *According to the proxy of the construction permit by type of client, the category of engineering works is performed to a larger extent by state clients.*

[25] *The number of construction permits granted in total for new buildings in the second quarter was 270 from 221 permits approved in the previous quarter. This number continued, reflecting mainly the increase in the number of construction permits granted for residential buildings. Yet, their number is still below the historical average. Of the permits approved in the second quarter, around 180 are permits for residential buildings, and 90 for other purposes (such as hotels, office buildings, commercial, industrial buildings and others).*

production output and of net sales in this sector, by the gradual increase in the number of construction permits approved for new buildings and by the assessments for a contribution to the upward trend of the public component. In the meantime, the downtrend in the confidence indicator and in the capacity utilisation rate in construction signal for moderate growth in this sector in the third quarter.

The **services sector** interrupted the slowdown in the second quarter, recording 3.8% annual growth of its value added, from 2.3% in the previous quarter. This performance is above the historical average of the sector and is attributed mostly to the branch "Trade, transport, accommodation and food services". The value added of this branch increased to 5.7% from 3.5% in the previous quarter, which was translated into 2.0 percentage points contribution to the sector's growth. Developments by branch reflected mainly the faster growth related to accommodation and food services. Also the branches of "Professional activities and administrative services", "Other services" and "Financial and insurance activities" accelerated the annual growth pace in terms of value added, contributing 1.0, 0.5, and 0.2 percentage point, respectively, to the performance of services. The contribution from "Public administration, education and health" to the sector's performance accounts for around 0.5 percentage point, slightly lower than in the first quarter. The contribution of real estate to the sector's growth remains low, around 0.1 percentage point. In the meantime, "Information and communication" continued to contribute to the performance of services on the down side, by -0.4 percentage point.

Chart 29 Contribution of branches and capacity utilization rates in the services sector



Source: INSTAT and Bank of Albania. *Semi-final data. ** A preliminary estimate.

The services sector is assessed to have continued the positive dynamic in the third quarter as well. Such performance is corroborated by signals from the increase in the aggregated indicator of the capacity utilisation rate in services. Nonetheless, the lower confidence in this sector and the higher comparative

base from a year earlier[26], limit the speeding up of the estimated growth in services, in the third quarter.

5.2.2. AGGREGATE DEMAND

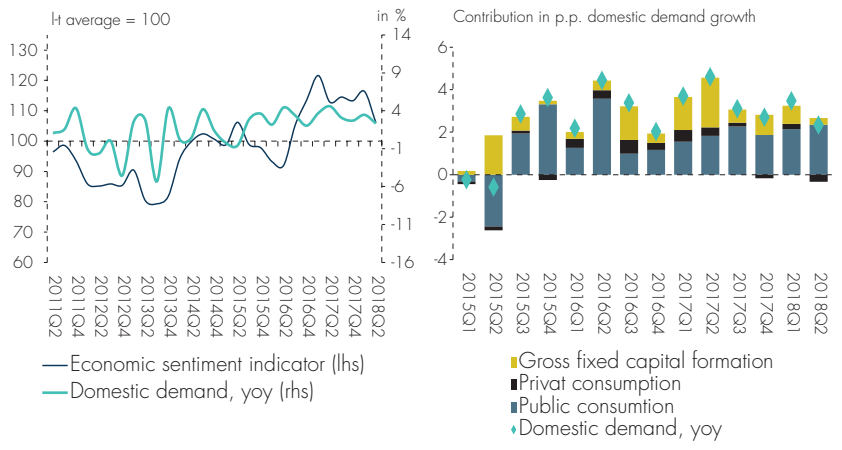
In 2018 Q2, aggregate demand reflected growth rates similar to those recorded in 2018 Q1. On the side of domestic demand, the population consumption provided the main contribution, while investments provided low positive contribution. Net exports' contribution was slightly positive, whereas public consumption's contribution was negative.

Information obtained from indirect indicators suggests lower economic growth for 2018 Q3. The expected expansion of the population consumption is assessed to remain the main contributor. Moreover, net exports are expected to provide a positive contribution, and investments to provide positive, but low, contribution as well. According to signals from lead indicators for the fourth quarter, consumption and investments are assessed to remain the main contributors to economic growth.

Domestic demand expanded by 2.4% in annual terms in 2018 Q2, slackening from the previous quarter (3.3%). The deceleration of growth rates is related to the reduction of the impact from investments and a negative contribution by public consumption. By contrast, the population consumption recorded faster growth than in 2018 Q1.

Leading and indirect indicators suggest domestic demand will continue to grow in the third and fourth quarters, in similar terms to the previous quarter. Population consumption is expected to provide the main contribution, and capital formation is expected to provide a relatively lower positive contribution.

Chart 30 Economic sentiment indicator and structure of domestic demand



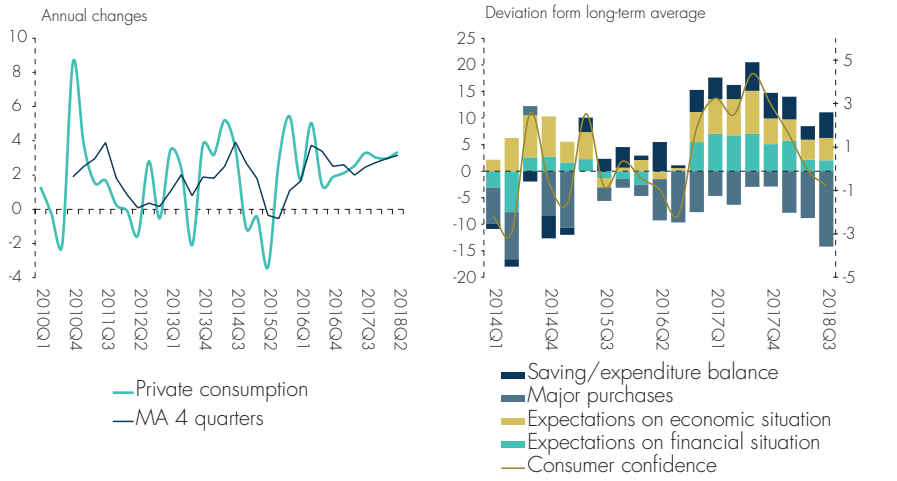
Source: INSTAT, Bank of Albania

[26] *The annual growth in the value added of the services sector was higher in the third quarter from the previous year, at around 5.6%.*

PRIVATE CONSUMPTION

Private consumption expanded by 3.3% in annual terms in the second quarter, slightly higher than in the previous quarter (3%). For two years, private consumption has been the main contributor to aggregate demand growth. Judging on indirect indicators that provide more detailed information on the categories of consumption, its growth was supported by added contribution from expenditures for services and non-durable goods[27]. On the other hand, survey indicators and quantitative indicators from the retail trade index suggest that consumption for durable goods has slowed down. Based on the consumer confidence survey, the balance of major purchases has fallen and remains below the historical average, whereas the other balances of the consumer confidence continue to remain above the historical average. The growth in private consumption was driven by the increase in employment, remittances, and loans to households in the second quarter. It was also favoured by the low interest rates.

Chart 31 Private consumption and consumer confidence



Source: INSTAT, Bank of Albania

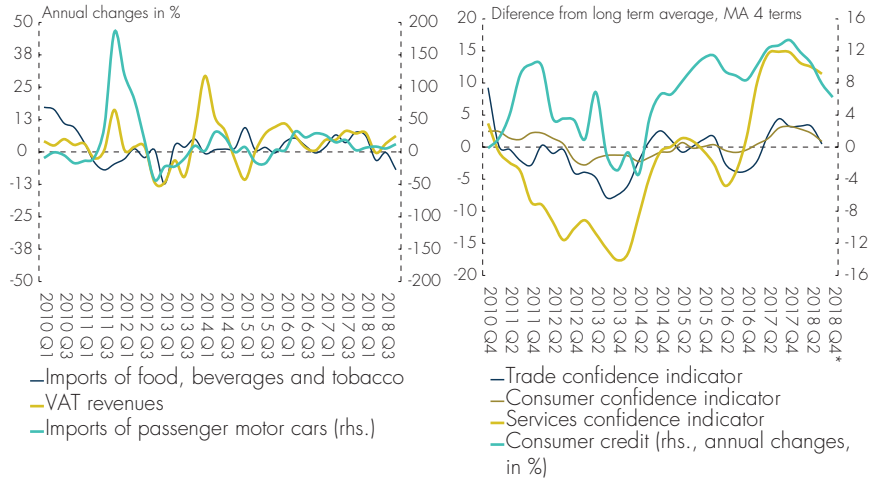
For the third quarter, private consumption is expected to post similar growth rates to the first two quarters of the year. This is in line with the positive signals from the increase in VAT revenues and in the volume of sales in retail trade. The positive performance of employment and higher remittances supports the assessment for higher consumer spending. Other short-term indicators, such as imports of vehicles and consumer credit, despite the slowdown shown in the third quarter, remain on the upward trend.[28] In the meantime, the consumer confidence is downward in the quarter under review, mainly due to the decline in the balance of major purchases. The other component balances of this indicator remain above the historic average. Available data on private consumption in the fourth quarter are

[27] *Based on disaggregated indicators of the retail trade index and the value added in the services sector, excluding trade.*

[28] *The more contained growth for the two indicators is driven to a large extent by the higher comparative base from the previous year.*

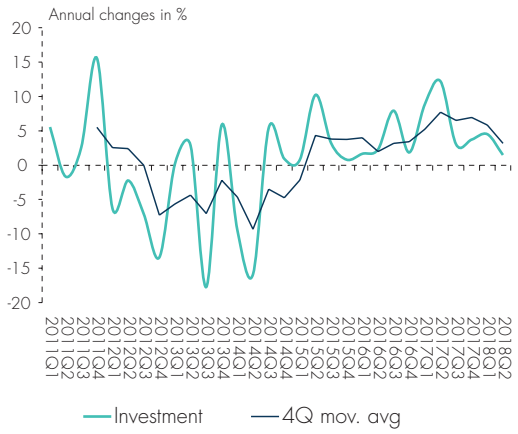
partial and address developments over October and November. The increase in VAT revenues over October - November and in imports of vehicles in October at a higher annual pace than in the third quarter signals that consumption at the end of year will continue to trend up. On the other hand, the decline in the imports of food, beverages and tobacco over October - November and the further slowdown in consumer credit in November suggest that the increase in private consumption in the last quarter of the year is expected to remain unchanged from the previous periods of the year.

Chart 32 Quantitative (left chart) and qualitative (right chart) indirect indicators on private consumption



Source: INSTAT, Bank of Albania

Chart 33 Gross fixed capital formation, annual change



Source: INSTAT

INVESTMENTS

Investments registered around 1.5% annual growth in 2018 Q2, from 4.5% in the previous quarter. The upward contribution of this component to aggregate demand declined at 0.4 percentage point, from 1.0 percentage point in the previous quarter. The slower performance of total investments in the economy was affected by both the public and the private components.

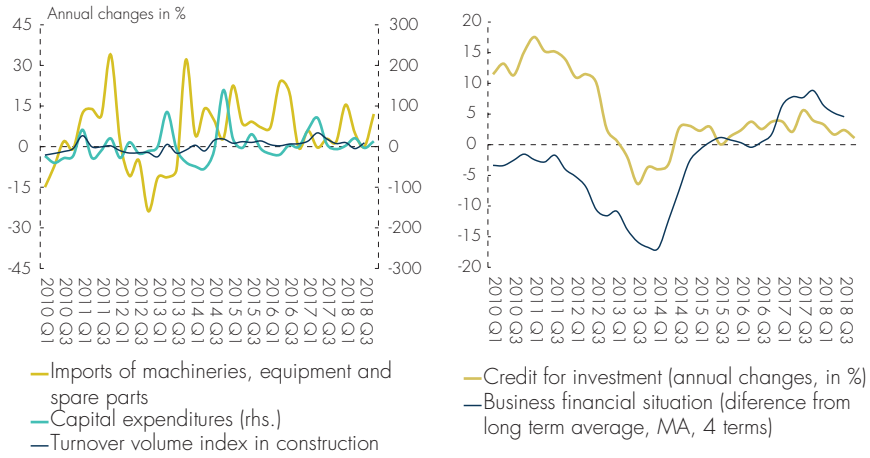
The increase of private investments in 2018 Q2 is assessed to have reflected mainly the increase of the non-construction component, as suggested by the performance of the imports of "Machinery, equipment, spare parts".[29] The component of construction-related investments results to have curbed the growth rates. This performance was signalled by the value added and imports of materials used in this sector. The performance of this indicator

[29] *The share of this component of investments increased at a slower annual rate, around 4.9% in 2018 Q2, after the increase of 15.5% in the previous quarter.*

is assessed as reflecting to a certain degree the high comparative base with a year earlier[30]. The improvement of consumer demand and eased financing conditions continue to support private investment in the economy.

Indirect indicators signal that investments are expected to grow slowly throughout 2018 Q3, similar to the previous quarter. This reflects somewhat the performance of non-construction investments, as suggested by the import of machinery, equipment and spare parts[31], the decrease of foreign direct investments inflows in 2018 Q3 and the downward trend of enterprises' financial situation. Meanwhile, growth of net sales in volume in construction and of credit for investment purposes signal that investments will continue to trend upward. Investments are expected to improve their upward dynamic in 2018 Q4. This trajectory is in line with the annual growth of imports of machinery, equipment and spare parts, and of government's capital expenditure over the October-November period. Meanwhile, according to other data such as loans for investment, its slower growth during November may limit the investment growth rate expected for 2018 Q4.

Chart 34 Short-term indicators for investments



Source: INSTAT, Bank of Albania

PUBLIC SECTOR DEMAND AND FISCAL POLICY[32]

The fiscal policy continued to consolidate even more pronouncedly in October, mainly due to a higher accumulation of budget revenues. The fiscal balance continues to be positive, around ALL 1.5 billion, generating, at the same time, a negative fiscal impulse of 1.5 pp of GDP[33].

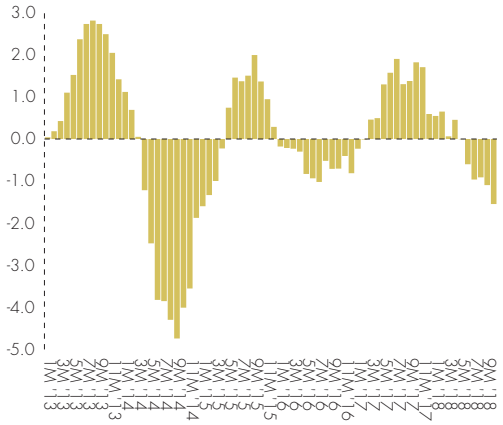
[30] *In the second quarter a year earlier, the annual growth of value added in construction resulted significantly higher, at around 19.5%.*

[31] *This indicator slowed down its annual growth rate from 4.9% in 2018 Q2 to 0.0% in 2018 Q3.*

[32] *The fiscal data published by MoFE are preliminary and subject for future review.*

[33] *The fiscal impulse is proxied by the change of the ratio of the primary balance against GDP, from a year earlier, considering the cumulative primary balance of 12 months.*

Chart 35 Orientation of fiscal policy, proxied by the change in the primary deficit

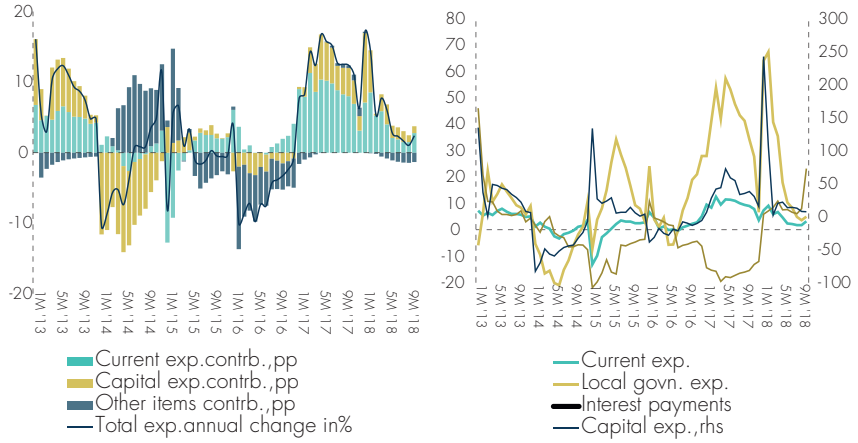


Source: Ministry of Finance and Economy, INSTAT, and Bank of Albania staff calculations.

Budget expenditures in the first 10 months of 2018 accelerated the annual growth rate at 2.4%, from 1% in the first 9 months. Total expenditures increased in this period mainly due to the expansion of interest (contributing 1.6 pp) and capital expenditures (contributing 1 pp). The budget expenditure growth trajectory during this year also partially reflects the lack of expenditures in the form of support for the energy sector.

Budget revenues continued to follow an improving growth trajectory from the end of 2018 H1. For the first 10 months of the year, total revenues registered around 3.8% growth in annual terms. The highest contribution to the increase of total revenues came from social insurance (1.6 pp), VAT (1.1 pp), and tax on personal income (1.1 pp). VAT revenues showed

Chart 36 Expenditures by contribution from main categories (left) and annual changes of main items (right) 2013 1M - 2018 10M

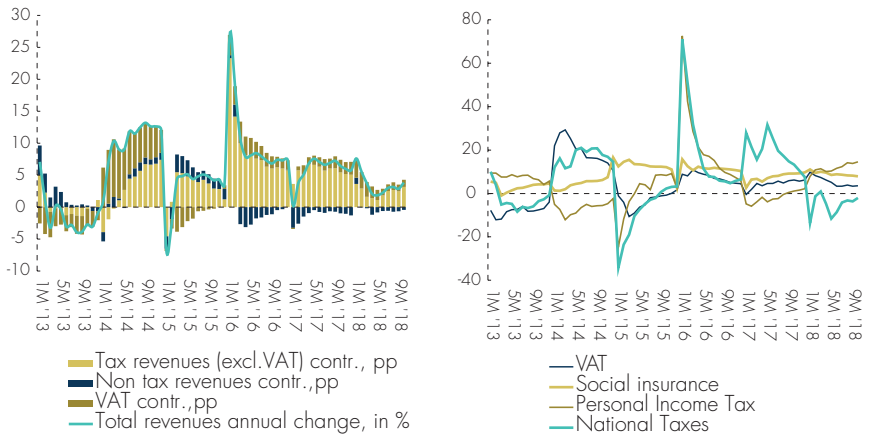


Source: Ministry of Finance and Economy

an improved dynamic after 2018 H1. This performance partially reflects the curbing of the negative impact from the appreciation of the domestic currency against the euro, on the one hand, and the improved dynamic of VAT collected from the production of goods and provisions of services in Albania, on the other.

The performance of VAT revenues in the last three months may be interpreted as a combination of positive signals for consumption, as well as an increase in business formal registration. The latter, in addition to the improvement of labour market indicators, is also supported by the improved growth rates of tax on personal income, as well as of social insurance.

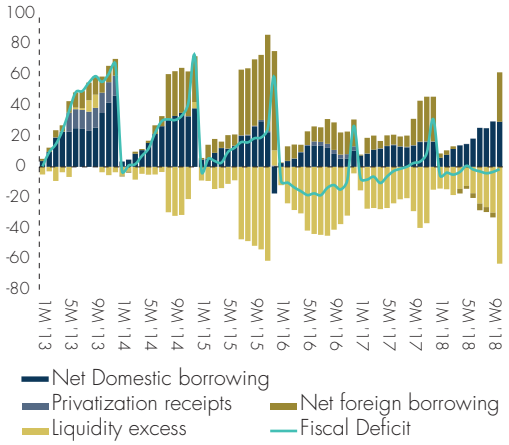
Chart 37 Revenues by contribution of main categories (left) and annual changes of main tax items (right) 2013 1M - 2018 10M



Source: Ministry of Finance and Economy

Budget balance resulted with a surplus of around ALL 1.5 billion at the end of October. The domestic borrowing was maintained at around ALL 29.4 billion (the same level of the first nine months of the year and almost the same of that planned for the whole year). On the other hand, with the issue of the EUR 500 million Eurobond, the level of foreign borrowing increased at ALL 32.1 billion in October[34]. Owing to the positive values of the fiscal balance, on one hand, and the expansion of government borrowing in the foreign market, on the other, the government liquidity surplus increased by around ALL 33.3 billion just for October this year. The government surplus liquidity created during the first 10 months of this year is around ALL 63.1 billion.

Chart 38 Deficit funding instruments, in ALL bln, 2013 1M - 2018 10M



Source: Ministry of Finance and Economy

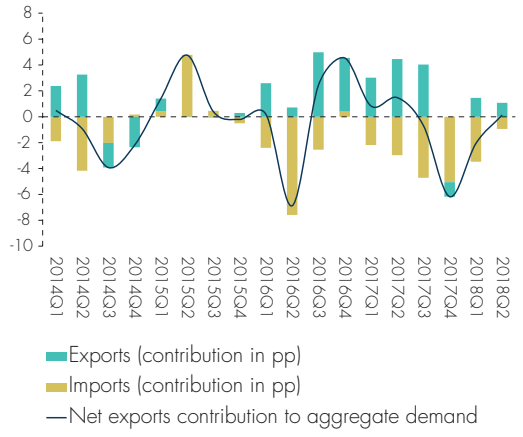
EXTERNAL DEMAND AND FOREIGN TRADE

The trade deficit in goods and services contracted in real annual terms during 2018 Q2 (0.7%)[35]. This development was determined mainly by the annual growth of exports by around 3.9% and, in particular, the growth of exports of goods by around 16.7%. On the other hand, exports of services decreased by around 0.2% in annual terms. Imports registered 2.0% real annual growth. The

[34] *EUR 200 million were used for the partial repayment of the Eurobond maturing in 2020.*

[35] *The trade deficit in nominal terms is different from that in real terms. While the deficit in real terms contracted only by 0.7%, in nominal terms it contracted by 17.2%. The difference is related with the distinctions between the deflators of exports and imports. The export deflators are assessed as positive and relatively high, for both goods and services, which signals an increase of the respective prices in annual terms. On the other hand, imports show negative deflators, which indicate a decrease of import prices in annual terms.*

Chart 39 Contribution of net exports to aggregate demand (in percentage points)

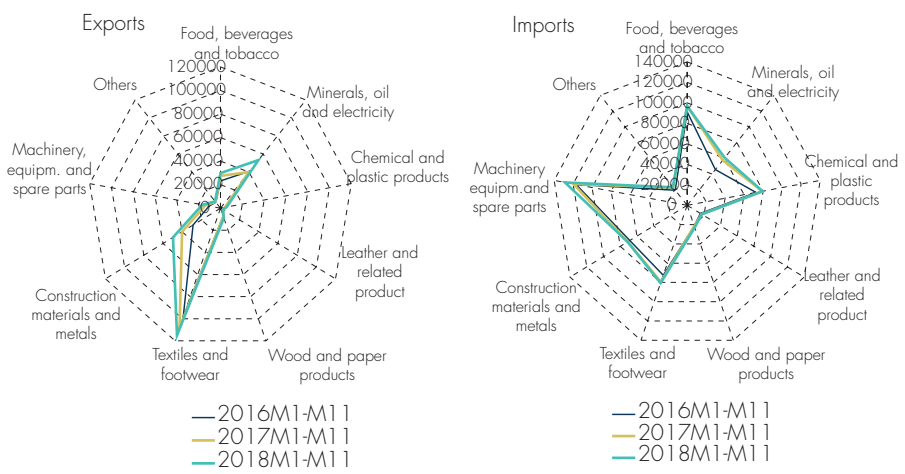


Source: INSTAT, Bank of Albania

main contribution came from the increase by 2.7% of imports of goods. In parallel, imports of services expanded by 0.6% compared with the previous year.

Regarding 2018 Q3, the trade deficit in goods was contracted at 7.0% in nominal annual terms. The performance was defined mainly by the increase of exports of services, by around 9.2% in annual terms, being lower, compared with 2018 Q1 and Q2 (the annual growth of export of goods registered 18.9% and 17.9%, respectively). The increase of exports is closely related with the categories "Minerals, fuel and electricity", driven mainly by the export of electricity (the impact of electricity in the growth of exports is assessed as lower than in 2018 H1). Positive contributions also resulted from "Fuel" and "Construction materials and metals". In 2018 Q3, imports also decreased, by around 0.1% in annual terms. The main downward contribution came from the category "Minerals, fuel and electricity", due to a decrease of imports of electricity.

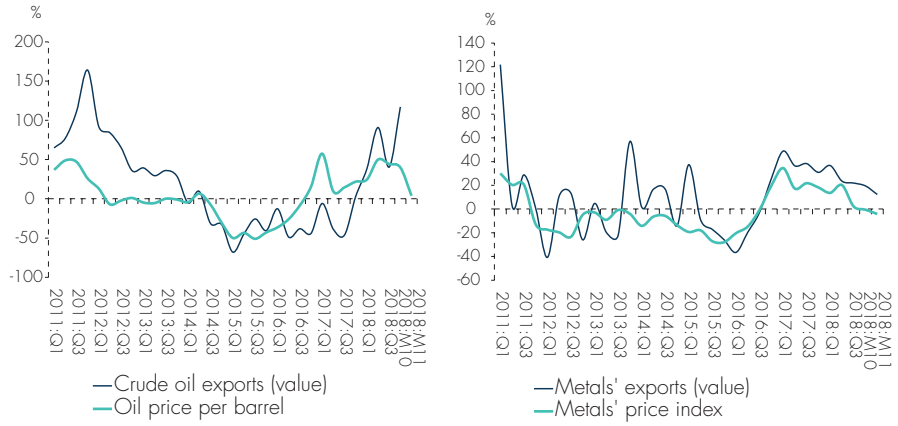
Chart 40 Import and export by category (in ALL million)



Source: INSTAT

External trade data for 2018 Q4 cover October and November. Statistics show the trade deficit in goods narrowed by around 8.2% in annual terms. As in 2018 Q3, the performance is mainly defined by the increase of exports by around 13.9%. In this period as well, the growth of exports was mainly dictated by the category "Minerals, fuel and electricity" and more concretely by the increase of the export of "Fuel". Positive contribution also resulted from the categories "Textile and clothing" and "Construction materials and metals".

Chart 41 Annual Dated Brent oil prices, domestic oil export (left), metal prices index and domestic metal export (right)



Source: INSTAT, IMF, EIA, London Metal Exchange, Marketindex, Cameco.

During the same period, the import of goods expanded by around 1.7%. The positive contributions are related with the categories "Machinery, equipment, spare parts" and "Minerals, fuels, electricity".

By 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, electricity and metals has contributed to the increase of the share of partners like Spain, Kosovo and Switzerland.

BOX 3: BALANCE OF PAYMENTS 2018 Q3

The net position of the current account recorded a deficit of EUR 146.4 million in 2018 Q3, expanding by around 2.6%, annually. It was assessed at 4.5% of nominal GDP, around 0.4 percentage point lower than in the same quarter of the previous year. This dynamic was determined mainly by the expansion of primary income outflows related with direct investments. The sub-account of services has also had an impact in the same direction, registering a decrease in annual terms of the respective surplus. This is related with the faster expansion of imports (compared with exports), due to travel services outflows.

The sub-categories of secondary income and goods contributed to the narrowing of the current deficit. In the case of the former, the phenomenon is related with the growth, in annual terms, of remittances inflows, but mainly by other personal transfers. Income inflows of the public sector have also had an impact in the same direction. Regarding the sub-account of goods, the relevant deficit contracted by around 1.8% in annual terms, driven mainly by the fast expansion of exports (by around 27.9%). Imports increased more moderately (4.0%). Overall, the trade deficit of goods and services narrowed by around 3.5%, in annual terms.

In the financial account, net direct investment inflows decreased by 21.1% in annual terms. Regarding the financing of the current deficit by flow profile, non-debt-creating flows made the main contribution. Reserve assets increased by around EUR 154.8 million.

Table 4 Balance of payments indicators (in EUR million)

	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3
Current account (in EUR mln)	**-157.5**	**-255.8**	**-142.8**	**-309.9**	**-170.7**	**-176.3**	**-146.4**
y.o.y (%)	-20.4	-11.1	-3.9	74.5	8.4	-31.1	2.6
/GDP (%)	-6.1	-8.4	-4.9	-10.2	-6.1	-5.2	-4.5
Goods and services	**-311.7**	**-486.7**	**-373.8**	**-570.2**	**-360.1**	**-428.9**	**-360.7**
y.o.y (%)	-22.7	-12.3	-9.0	30.5	15.5	-11.9	-3.5
Exports, f.o.b.	773.4	894.2	1110.0	875.6	840.0	1022.1	1238.8
y.o.y (%)	27.1	24.7	19.8	2.2	8.6	14.3	11.6
Imports, f.o.b.	1085.1	1380.9	1483.8	1445.8	1200.1	1451.0	1599.6
y.o.y (%)	7.2	8.5	10.9	11.7	10.6	5.1	7.8
Net Travel	75.6	80.1	180.9	109.6	77.6	83.5	197.1
Primary income	**-14.7**	**17.4**	**18.8**	**7.1**	**-13.4**	**13.7**	**-18.4**
Credit	79.6	122.9	106.6	98.4	73.5	125.4	96.1
Debit	94.3	105.5	87.8	91.2	86.8	111.7	114.6
Net income from Direct Investments	-62.2	-81.8	-50.6	-46.4	-61.7	-89.1	-87.0
Secondary income	**169.0**	**213.4**	**212.2**	**253.1**	**202.8**	**238.9**	**232.8**
Credit	198.3	242.2	236.7	284.7	224.4	260.5	253.9
Debit	29.3	28.7	24.5	31.6	21.6	21.6	21.2
Net Remittances	135.1	162.7	165.8	172.1	148.6	181.7	170.0
y.o.y (%)	-0.5	5.7	3.9	4.1	10.0	11.7	2.6
Capital account	**23.8**	**25.3**	**30.4**	**42.9**	**18.3**	**21.2**	**22.9**
Net Borrowing/Lending	**-133.7**	**-230.6**	**-112.3**	**-267.1**	**-152.4**	**-155.1**	**-123.5**
Financial account	**-295.9**	**-206.4**	**-222.3**	**-205.4**	**-287.9**	**-200.0**	**-11.1**
y.o.y (%)	112.7	-22.7	144.2	72.0	-2.7	-3.1	-95.0
/GDP (%)	-11.4	-6.7	-7.7	-6.8	-10.2	-5.9	-0.3
Direct investments	**-206.4**	**-225.9**	**-340.2**	**-221.3**	**-291.0**	**-222.6**	**-268.5**
y.o.y (%)	63.3	-10.0	12.5	-13.8	40.9	-1.5	-21.1
Portfolio investments	**-137.5**	**-21.6**	**31.2**	**27.9**	**3.5**	**110.6**	**13.1**
Financial derivatives	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Other investments	**39.4**	**117.3**	**49.1**	**-227.3**	**142.0**	**-173.2**	**89.5**
Reserve assets	**8.6**	**-76.2**	**37.6**	**215.4**	**-142.4**	**85.1**	**154.8**
Errors and omissions	**-162.2**	**24.2**	**-110.0**	**61.7**	**-135.5**	**-45.0**	**112.4**

Source: Bank of Albania, INSTAT and staff's estimates.

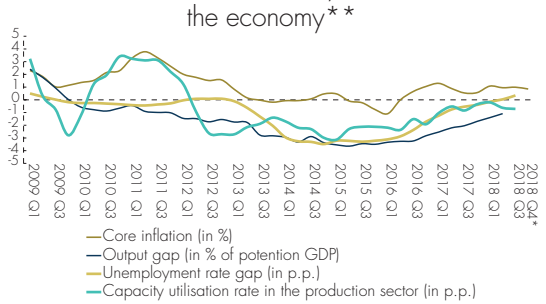
5.3. CYCLICAL SITUATION OF THE ECONOMY AND INFLATIONARY PRESSURES

The update of indicators on the cyclical situation does not change the assessment that the output gap has continued to narrow, although it remains in negative territory. The improvement of the cyclical position of the economy is assessed to have contributed to the gradual build-up of domestic inflationary pressures. The continuation of the use of the factors of production toward an optimal level is expected to increase these pressures further. Meanwhile, the appreciation of the exchange rate continued to impede the complete transmission of imported inflationary pressures.

As the cyclical situation of the economy continues to improve and the effects from the exchange rate diminish, inflation is expected to return to target in the medium-term.

The analysis of available data is in line with our assessment that the negative output gap is continuing to narrow. The main labour market indicators in 2018 Q3 continue to give positive signals in terms of higher use of the labour factor. In addition, the capacity utilisation rate by enterprises in 2018 Q3, despite short-term fluctuations, signals a more intensive use of production capacities in the economy.

Chart 42 Indicators of the cyclical situation of the economy**



* Core inflation for 2018 Q4 is the average of annual rate for October and November.
** The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilisation rate gap is assessed as a deviation of the current value from the relevant historical average, for each of the Business Confidence Survey sectors. After, the gaps of the sectors are weighted as in the economic sentiment indicator, and finally is applied the method of the four terms moving average. The unemployment rate gap is assessed as an average of unemployment gaps according to three methods, which assess the equilibrium or structural level of unemployment (NAIRU or NAWRU). The unemployment rate gap is stated as the difference of equilibrium unemployment rate to actual unemployment rate and then the method of the four terms moving average is applied.

Source: INSTAT and estimations of the Bank of Albania.

Despite the improving trend of cyclical conditions, the presence of spare capacities in the economy conditions the strengthening of domestic inflationary pressures. At the same time, the appreciation of the exchange rate has limited the increase in imported inflation. The continuation of aggregate demand growth, the further decline of spare capacities and the curbing of the exchange rate appreciation are expected to be reflected in increased inflationary pressures, contributing to the return of inflation to target in the medium-term.

Labour market developments continued the positive trend in 2018 Q3, as well. Employment increased by 2.3% in annual terms, from 3.3% in the previous quarter.[36] The positive dynamics of employment was mainly supported by the services and industry sectors. At the same time, the participation rate of the labour force continued to grow, standing at 59.4%. Employment growth remains the main contributor to reducing the unemployment rate in the economy.[37] The

[36] *The analysis of employment and unemployment is based on the data of the "Quarterly Labour Force Survey", and it refers to the indicators for those 15 years and older.*

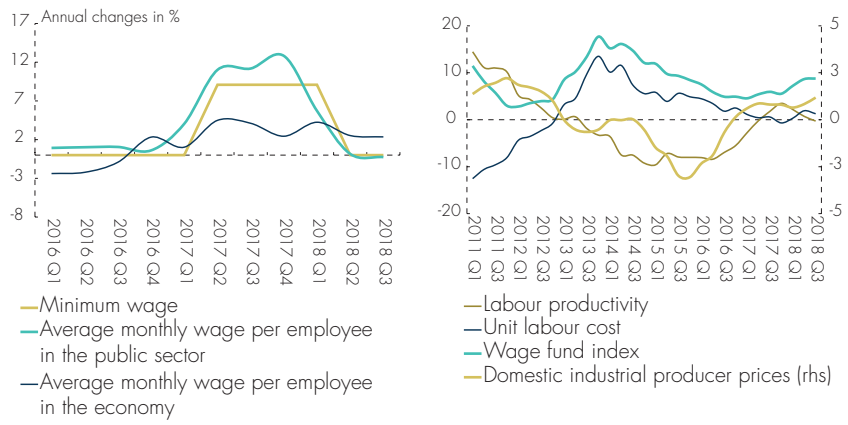
[37] *In examining the factors that drive the formation of the unemployment rate are analysed the performance of employment, on the demand side, and the participation rate in the working and population by working age, on the employment supply side.*

unemployment rate, around 12.2% in 2018 Q3, resulted lower than in the previous quarter (by 0.2 percentage point), as well as in the previous year (by 1.4 percentage points). These developments are assessed to have contributed to the higher use of the labour factor.

The **capacity utilisation rate** registered around 72.4% in 2018 Q3. This rate was higher than in the previous quarter by 0.3 percentage point, as well as in the same period a year earlier, by 1.4 percentage points. This indicator suggests a gradual reduction of spare capacities in the economy.

The **unit labour cost**[38] continued to follow the upward trend in 2018 Q3 as well, albeit at a more moderate pace. Thus, the indicator increased by 1.3% in annual terms, compared to 1.9% in the previous quarter. This performance of the unit labour cost continues to be attributed to the upward trend - albeit at a slow pace - of the average real wage proxy for the activities covered by short-term statistics.[39] According to the data of the average monthly wage for an employee in the country, this indicator registered an annual growth similar to the

Chart 43 Average wage indicators (left) and annual flattened average changes of productivity, labour cost and output (right) *



*Four-terms moving averages were applied on annual changes of indicators, to mitigate relevant fluctuations.
Source: INSTAT and estimations of the Bank of Albania.

38 *Proxy indicators of labour productivity and unit labour costs and average wage by short-term statistics are calculated by the Bank of Albania using the total series of Short-Term Statistics (SHTS, INSTAT, 2018 Q3). 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 in real terms and refer to the four-terms moving average of the annual changes of the indicator.*

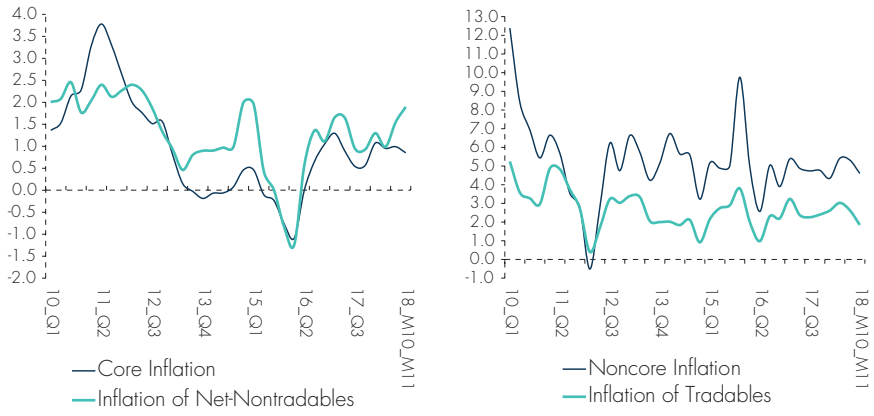
39 *Short-term statistics cover the activities of "Industry" (05 – 33), "Electricity" (35), "Water supply, sanitation and waste management"(36 – 39), "Construction" (41, 42, 43), "Wholesale and retail trade, repair of vehicles and motorcycles" (45), "Wholesale trade, apart vehicles and motorcycles" (46), "Transport and storage, including postal and courier activities" (49 – 53), "Accommodation and catering services only hotels" (55.1), "Information and communication"(58, 61, 62), "Architecture and engineering activities" (71) and "Travel agencies"(79).*

previous quarter (around 2.4%, from 2.5% in the previous quarter).[40] Deflated with inflation, the increase of the average monthly wage for an employee is assessed at around 0.2%, from 0.3% in the previous quarter.

Data on **other output costs** show a slightly higher increase in 2018 Q3. More concretely, industrial producer prices registered 2.8% annual increase, following the 2.4% increase in the previous quarter. This performance reflected mainly the faster rise of export prices, compared with the increase of domestic industrial producer prices.

The continuation of the cyclical improvement is being translated into a higher sensitivity of long-term and domestic components of inflation. In 2018 Q3, **core inflation** and **non-tradable inflation** of CPI basket items were 1.0% and 1.5%, respectively. Meanwhile, in October and November, the average core inflation was 0.9% and non-tradable inflation was 1.9%. The transmission of the upward pressures from the narrowing of the output gap materialized in steadier contributions from the long-term and domestic components of headline inflation. The resilience of these components to the downward effects of the exchange rate appreciation has increased. These impacts are assessed to have been transmitted to headline inflation more by its short-term components. Thus, **non-core** and **tradable inflation** of the CPI basket items registered lower

Chart 44 Long-term inflation expectations (left) and short-term expectations (right)



Source: INSTAT and estimations of the Bank of Albania.

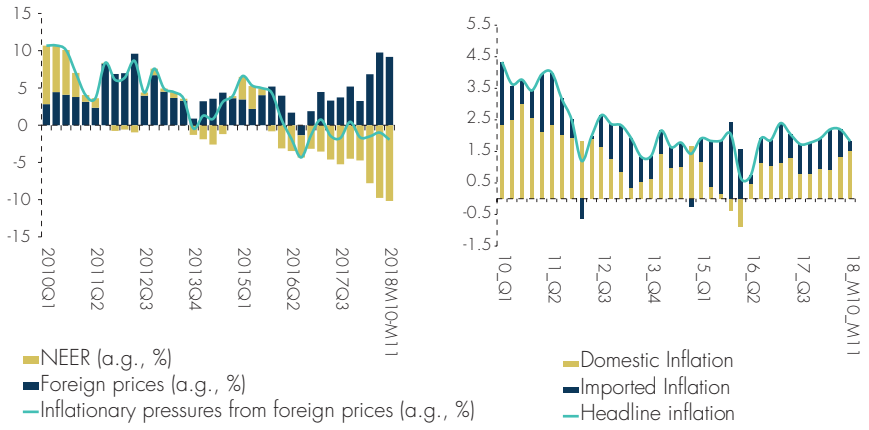
[40] *On 11 June 2018, INSTAT published for the first time quarterly data on the average monthly wage per paid employee. The published data series starts since 2015 Q1. This indicator refers to the gross average wage and is based on the payroll information declared at the General Directorate of Taxation. It includes all the economic activities, both in the public and the private sectors, for all paid employees working in Albania, including foreign residents as well. The dynamic of this indicator in 2018 Q2 reflected, to some extent, the mitigation of the positive impact from the increase of the minimum and average wage in the public sector in the previous year. More concretely, the minimum official wage increased from ALL 22.000 to ALL 24.000 in 2017 Q2. This increase was 9.1% in annual terms. Its upward impact on the average wage in the economy as a result of the comparison with a lower base is assessed to have diminished in 2018 Q2.*

levels than a quarter earlier, at 5.3% and 2.6%, respectively. In October-November 2018, the rates registered 4.4% and 1.8%, respectively, continuing the decline.

Over 2018 Q3, the **imported inflationary pressure index** (IIPI)[41] contracted on average by 1.0% in annual terms. In this quarter, foreign prices and the exchange rate had opposite impact, but at almost the same magnitude. Thus, the appreciation of the nominal effective exchange rate in annual terms registered 9.8%, while the annual expansion of "Import Price Index" (IPI)[42] was around 9.0%. The impact of the exchange rate on the imported inflationary pressure index dominated and this index declined in annual terms, remaining in negative territory for a long time.

Developments in October-November are similar to those of 2018 Q3; with opposite symmetry between import prices and the NEER. The "Import Price Index" increased by around 8.4% and the NEER appreciated 10.2%. Thus, IIPI declined by 1.9% in annual terms, due to the dominance of the exchange

Chart 45 IIPI and contributions of its components (left); contributions of imported inflation and domestic inflation to annual headline inflation (right)



Source: INSTAT and estimations of the Bank of Albania.

rate effect.

Similar developments are also confirmed by the decomposition of headline into imported and domestic inflation. During 2018 Q3, imported inflationary pressures contributed less to headline inflation (0.9 percentage point). Their

[41] *It is a proxy on imported inflationary pressures, which aggregates in one single indicator the information from import price indices (IPI), with the information from the developments in the in nominal effective exchange rate (NEER). IIPI is calculated as the annual growth of IPI and NEER for the respective period. IIPI is assessed to affect domestic inflation approximately after a 5 months' time lag.*

[42] *It is a proxy of imported inflation pressures, comparable to tradable goods sector inflation of Albania's CPI basket. The import price index is based on the values of: the inflation of "Food, beverages, tobacco" for the 18 main countries; and the inflation of "Items" (i.e., not only foods) for Bulgaria, Germany, Greece, Italy and Turkey.*

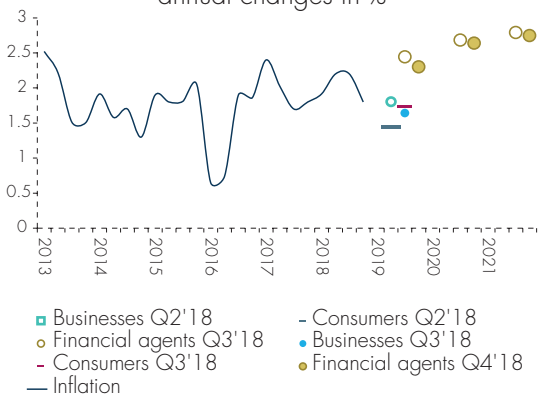
contribution declined even further in October-November 2018 (0.3 percentage point). This development, against the backdrop of increasing import prices, suggests a more complete transmission of the effects of the appreciation of the domestic currency to headline inflation, through the channel of the imported one. During the same period, domestic inflationary pressures have ensured compensating upward contributions. The contribution of domestic inflation reached 1.3 percentage points in 2018 Q3 and 1.5 percentage points in October. Although it is not totally isolated from the behaviour of the exchange rate, it seems that it is assimilating better the pressures added by the cyclical improvement.

INFLATION EXPECTATIONS[43]

Based on the latest data from the financial agents survey, short-term inflation expectations have been revised downward by 0.1 percentage point in 2018 Q4. Medium-term expectations have not changed in this quarter, compared with 2018 Q3.

During 2018 Q3, the expectations of different agents of the economy were revised in different directions. Short-term consumer expectations and financial agents' expectations, for all three time horizons under review, were revised upwards. Short-term business expectations were revised downwards in this quarter.

Chart 46 Inflation expectations, annual changes in %*



*) Financial agents' expectations for 2018 Q4 are approximated from the arithmetic average of the values of October and November 2018.
Source: INSTAT and Bank of Albania.

[43] *The analysis on inflationary expectations is based on the results of the business and consumer confidence survey, as well as on the financial agents' expectations survey. The first two groups declare their inflation expectations after one year.*