Bank of Albania

MONETARY POLICY REPORT

2019/1

THE REPORT REFERS TO BANK OF ALBANIA’S MONETARY POLICY STATEMENT FOR 2018 H2, APPROVED BY THE SUPERVISORY COUNCIL, DECISION NO. 5, DATED 06.02.2019
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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.

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

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

The economic and monetary analysis in this report is based on the latest statistical and qualitative data, available as at 28 January 2019.
The new economic and monetary information suggests that the Albanian economy continues on a positive development trend. Aggregate demand continued to grow in the second half of the previous year, resulting in an increase in production, employment growth and improvement of main economic and financial balances.

Our monetary policy continues to support growth, by providing a financial environment with low interest rates, and decelerating appreciating pressures on the exchange rate.

The Bank of Albania deems that the new information is broadly in line with our expectations.

Inflation registered a slight decline in the last quarter of 2018. Average inflation declined to 1.8% in the fourth quarter, from 2.2% in the previous quarter. The decline reflected temporary supply-side shocks and a fuller transmission of the decelerating effect arising from the exchange rate appreciation on inflation. This effect will remain present over the first half of 2019; it is, however, expected to wear off in the following period.

The Bank of Albania deems that the domestic medium-term and long-term inflationary pressures are gaining strength, as illustrated by the core inflation. Irrespective of the fluctuations, this indicator shows a gradual trend of convergence toward the equilibrium. Such performance is dictated by the further improvement of the cyclical position of the country, as reflected in both the downward trend in the unemployment rate, and the improvement of the capacity utilisation rate.

According to INSTAT data, the Albanian economy grew by 4.45% in the third quarter of the previous year. Growth was fuelled by the further expansion of private consumption, investments and exports, as well as the annual growth of electricity production. It was reflected in the expansion of activity in industry, services and construction. Available data suggest that the economy continued to grow in the fourth quarter as well, although at a slower pace than in the previous quarters. Our analyses suggest that this slowdown reflects a lower contribution from electricity production, while it is expected to be temporary.

Our medium-term projections have not changed significantly. The current trends of economic development and their underlying economic and financial factors hint that the economy will trend upward and inflationary pressures will build up in the period ahead.
While uncertainties and risks persist, the external environment appears overall favourable for economic growth at home. The upward demand from the global economy continues to favour growth for Albanian exports, and financing costs remain relatively low.

In parallel, the domestic policy mix remains stimulating.

As a result of the accommodative monetary policy stance, interest rates on deposits, credits and government securities remain at historical low levels. Similarly, the situation of liquidity in financial markets has been improving and risk premiums have been trending down. The exchange rate appeared stable in January, due to a better balancing of demand and supply for foreign currency, and to the response of the Bank of Albania. Additionally, the banking sector continues to be characterised by good liquidity, capital and profitability levels, while the balance sheets continue to improve. In particular, the ratio of non-performing loans dropped to 11.1% at the end of 2018, illustrating the sustainable progress marked in this regard.

In response, credit to the private sector showed signs of recovery, although the reported downward stock continues to reflect the effects arising from the cleaning of balance sheets from both non-performing loans and the effect of the exchange rate. Excluding these two effects, credit to the private sector recorded 5.9% annual growth at the end of 2018. Credit growth continues to be faster for credit denominated in lek and that for consumer loans. Meanwhile, loans to enterprises grew rapidly in December, regardless of the conservative policies that banks apply to this segment.

Fiscal policy continued the consolidation trend. Fiscal data suggest that budget deficit decreased to 1.6% of the GDP at the end of 2018, standing 0.4 percentage point lower than planned. In line with it, the direct fiscal stimulus to the economy was lower than previously anticipated. On the other hand, the reduction of total public sector borrowing and the reliance on foreign markets for financing a major part of it, over the past year, have broadened the space for crediting to the private sector.

In accordance with these trends, the Bank of Albania deems that the Albanian economy will continue to grow in the next three years. The expansion in aggregate demand will contribute to further employment growth, creating the premises for rising wages and domestic inflation. In parallel, the slowdown in the exchange rate appreciation will subdue disinflationary pressures arising from it. In accordance with this scenario of developments, inflation is expected to converge to our target in the second half of 2020.

In parallel to the expected positive developments according to the baseline scenario, the Supervisory Council finds that the balance of risks remains tilted to the down side. In particular, the external environment, the exchange rate and the pace of credit growth may tilt inflation to the down side of our expectations.
Judging on these factors, the Bank of Albania considers the current accommodative path of the monetary policy as adequate. The monetary policy will remain accommodative in the medium-term horizon, although the intensity of the stimulus will be adjusted to the speed and the sustainability of the economic activity improvement.

The Bank of Albania emphasises that structural reforms need to continue, as the best instrument for boosting sustainable and long-term growth in Albania.
1. PRICE STABILITY AND BANK OF ALBANIA’S MONETARY POLICY

The new information obtained in 2018 Q4 was broadly in line with our expectations, although economic growth in 2018 Q3 was somewhat higher and inflation in 2018 Q4 somewhat lower.

In 2018 H2, the Bank of Albania maintained the intensity of the monetary stimulus, aiming to provide a boost for stimulating economic activity and the return of inflation to target. The monetary stimulus has supported the expansion of consumption and of investments, the growth of employment and rising wages, as well as the gradual build-up of domestic inflationary pressures. On the other hand, the exchange rate appreciation eased foreign inflationary pressures.

Expectations for the outlook are positive. The Bank of Albania expects the aggregate demand and the economy to growth further, which will increase the utilisation of productive capacities and domestic inflationary pressures. In parallel, the exchange rate is expected to be more stable and disinflationary pressures from its appreciation are expected to diminish. Inflation is expected to converge to our 3% target, by 2020.

In line with this forecasting scenario, the monetary policy is expected to maintain the accommodation path in the medium-term, but the intensity of the monetary stimulus will start to diminish.

However, the medium-term horizon continues to be dominated by risks titled to the down side. Consequently, the monetary policy normalisation will be prudent and conditional on new information.

The new economic and financial information taken in analysis is positive. Aggregate demand, output and employment have been upward. The accommodative monetary policy of the Bank of Albania has brought low interest rates across the spectrum of financial instruments in lek and has helped to ease appreciation pressures on the exchange rate, providing adequate financing conditions for Albanian enterprises and households. By stimulating the aggregate demand, increasing employment and wages, the accommodative monetary policy has contributed to the build-up of domestic inflationary pressures.

The average inflation rate resulted 1.8% in 2018 Q4 and 2.0% for 2018. It slowed down over the last few months, driven by the decline of oil price in international markets and of food prices in the domestic market. Inflation fell
more pronouncedly in December, due to the decline of rental prices, as a result of base effects. The prices of other basket items have been more stable.

Inflation, during 2018, was supported by the improvement of the economic activity, fuller utilisation of productive capacities, and better anchoring of inflation expectations. On the other hand, the appreciation of the exchange rate has eased foreign inflationary pressures. This factor, coupled with the decline of inflation in trading partner countries, has led to the reduction of the imported inflation for consumer basket items. The negative impact of the exchange rate appreciation is estimated at around 0.2 percentage point, on average, during 2018. In line with the relevant time lag of the pass-through on prices, the effect of the exchange rate is expected to peak during 2019 and wear off afterwards.

According to INSTAT data, the Gross Domestic Product grew 4.5% in 2018 Q3, against 4.5% in 2018 H1. Growth profile remained broadly unchanged and economic growth reflected the continued expansion of consumption, investments and exports. It was helped by the high output of electrical energy, due to favourable hydrological conditions. Preliminary data suggest economic growth continued in the last quarter of 2018.

The growth of economic activity has contributed to better utilisation of productive capacities and build-up of domestic inflationary pressures. Employment growth has absorbed a significant part of the labour market’s spare capacities, pushing the unemployment rate down, at 12.2% in 2018 Q3. In addition, enterprises report a higher capacity utilisation rate in the production sector of the economy. In parallel, the medium-term inflation expectations of financial agents remain at 2.7%. In response to these developments, wages, other production costs and core inflation have been upward, but the pace remains slow and volatile.

The positive performance of the economy is supported, among other things, by the accommodative monetary policy. The policy rate was lowered by 0.25 percentage point in June 2018, down at the historical minimum level of 1.0%. In parallel, the Bank of Albania continued to supply the banking system with the required liquidity through open market interventions. In addition, the Bank of Albania undertook an extraordinary and temporary programme of interventions in the domestic foreign exchange market, in order to curb the appreciation pace of the exchange rate, against a backdrop that jeopardized achieving the inflation target. The pace of the exchange rate appreciation has slowed down, and its performance is closer to its seasonal behaviour. Consequently, the exchange rate risk to achieving the inflation target has been mitigated.
The accommodative monetary conditions have favoured the growth of credit in lek and the decrease in the cost of debt servicing. Interest rates in lek remain at the lower historical levels across all financial market segments. The yields in the securities’ primary market decreased further in 2018 Q4, after the issue of the Eurobond 2025 and the decrease of the government’s demand for domestic funding.

The growth of lek credit has sustained the growth of domestic demand. In December, lek credit accounted for 48.4% of total credit, or 1.3 percentage points higher than in the previous year. Banks support households with loans on a steady basis, while their approach to enterprises is more conservative.

The Bank of Albania assesses that the reduction of credit risk, the decrease of non-performing loans¹ and sound banking system indicators should be accompanied by a more active approach by banks to lending.

Our economic forecasts for the outlook remain positive. The Albanian economy is expected to continue the cyclical improvement over the next years, underpinned by low interest rates, economic agents’ confidence and expansion of foreign demand. Inflation is forecasted to average around 1.8% in 2019, slowing down somewhat from 2018 in response to a more complete transmission of the exchange rate appreciation to inflation. Furthermore, the expected return of the economy to potential will increase the inflationary domestic pressures, thus enabling the return of inflation to target within 2020.

The accommodative monetary policy has created adequate financial conditions for the convergence of inflation to target. Through the decrease of

¹ The ratio of non-performing loans to total loans dropped at 11.1% in December 2018 from 13.2% a year earlier.
the interest rates and risk premiums in financial markets, and recently through the deceleration of the strong exchange rate appreciation, the monetary conditions are adequate to support domestic demand growth and inflationary pressures build-up.

Fulfilling medium-term forecasts requires maintaining an accommodative monetary policy in the medium-term. However, in line with the expectations for stronger inflationary pressures and the gradual return of inflation to target, the intensity of the monetary stimulus is expected to diminish gradually.

The medium-term balance of risks remains tilted to the down side. Down-side risk factors are related to uncertainties surrounding economic and financial developments in our trading partners, the duration and impact of the exchange rate appreciation on inflation, as well as the speed of credit recovery.

For these reasons, the normalisation of the monetary policy will be cautious, aiming to guarantee adequate monetary conditions for a stable convergence of inflation to target.
2. EXTERNAL ECONOMIC ENVIRONMENT

The global economy slowed down growth rates in 2018 H2. Growth was faster in the US, but it has slowed down in the euro area and the Asian countries. The balance of risks shifted to the down side, mainly related with tensions over trade tariffs applied by the US and the expectations for economic slowdown in the euro area.

Inflation rates decreased mainly due to the oil prices in the global market, whereas long-term inflationary pressures remained sluggish. Of the main central banks, the Federal Reserve has started normalising the monetary policy, while the ECB is expected to start normalisation later. Financial markets experienced stability in the last quarter of the year, with decreasing yields and lower volatility.

The risks to a slowdown in economic growth and prices in the euro area, our main trading partner, have increased. The downward revised expectations in this region are a factor of uncertainty over the impact of the external environment on the Albanian economy and the performance of imports prices.

2.1. GLOBAL ECONOMY

The global economy continued to grow in 2018 Q3, but leading and global trade indicators slowed down. Negotiations on trade tariffs between the US and China, as well as the eventual Brexit deal, weigh on the growth pace and dynamics of global GDP. Growth rates were uneven amongst advanced economies, with growth in the US inching up but decreasing in the euro area. The latest leading economic performance indicators showed that many of these economies continued to register growth in the last quarter as well, but at a more contained pace. In developing countries, including China, the growth of economic activity was slower in 2018 Q3.

The inflation rate decreased in the last months, reflecting the drop in oil and energy prices. Core inflation remains low. Central banks expect inflation will rise slowly over the year. Global financial conditions remain favourable overall, although lately they tightened slightly in the developing economies.

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2 In the December projections, for 2019, the ECB revised down the expectation for economic growth, at 1.7% from 1.8% in the previous projections, and at 1.6% from 1.7% for inflation.
3 Data from CPB Netherlands Bureau for Economic Policy Analysis and ECB, December 2018.
4 The Global Composite Output PMI and Global Manufacturing PMI, Markit, October, November, and December 2018.
5 Annual inflation of OECD countries decreased at 2.7% in November, from 2.9% in the third quarter.
The US economy improved in 2018 Q3, as well. Growth was driven by domestic factors such as consumer spending, non-resident investments and central government spending. The tense situation of trade relations with China was reflected in the negative contribution of net exports. Throughout the year, the economy has benefited from the central bank’s monetary stimulus, which, along with fiscal incentives, helped companies improve balance sheets and increased households’ disposable income. Unemployment at the end of the year marked the lowest levels in several decades. The positive momentum of the economy is expected to continue in this year, but at lower growth rates. The slowdown may be caused by the diminishing monetary and fiscal stimuli and the increasing uncertainty surrounding foreign trade and domestic political
tensions, which caused the shutdown of several segments of the government for over a month\(^6\).

Annual inflation followed a downward trajectory in 2018 H2. The inflation rate decreased at 1.9% in December, mainly driven by fuel prices. Meanwhile, the core inflation remained near Fed’s 2.0% target.

**EURO AREA ECONOMIES**

The economy of the euro area slowed down the growth pace in 2018 Q3. Economic growth was driven by domestic demand, with consumer spending and investment as main boosters of such growth. Tensions in international trade relations, the uncertainty surrounding the Brexit process hindered the economic activity. Higher frequency indirect indicators suggest the same trend continued during 2018 Q4 as well, with positive, but slower economic growth rates. The weaker performance of the larger economies in the EU has also increased uncertainties in financial markets. In November, unemployment continued to show positive developments, for the first time in a decade falling below 8%. However, the performance of the labour market was uneven across the euro area.

Annual inflation declined for the second month in a row in December, at 1.6%. This decline reflects a slower increase in energy prices, which remain the main contributor to the formation of inflation. Core inflation remains low, as inflationary pressures remain stable and contained.

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\(^6\) Due to authorities’ disagreement on fiscal budget, from 22 December to 25 January, several public institutions were shut down.
The economies of Albania’s two main trading partners, Italy and Greece, showed different growth paces in the third quarter. Economic activity in Italy slowed down as consumer spending and overall domestic demand decelerated. Foreign demand, on the other hand, had a positive impact on the economic activity. Preliminary data suggest a similar trend in the last quarter of the year. Italy’s economy is expected to remain sluggish this year, suffering the weakest performance in the euro area.

The economic growth in Greece accelerated in 2018 Q3. This trend has been driven by the faster growth of government spending and the steady contribution of consumer spending and exports. The economic activity is expected to have expanded in the last quarter of the year as a result of improved domestic consumption and investments.

Annual inflation in Italy decreased in December, after a constant performance in the past two quarters. The annual inflation rate declined as a result of the decrease of energy and food prices. In Greece, the annual inflation rate decreased for the second month consecutively, driven by the decrease of energy, food and rental prices. In both countries, core inflation ranges low, suggesting subdued inflationary pressures.

**Regional Economies**

The economic activity of the region continued to record positive growth in 2018 Q3. The positive performance was driven mainly by domestic demand and in particular by consumer spending. The labour market registered different trends among the countries. The positive dynamics of the economy have been transmitted only marginally to the price level. Domestic inflationary pressures are low, while headline inflation is determined mainly by the performance of energy prices.

As expected, the economic activity in Turkey slowed down in 2018 Q3 and is expected to contract in Q4. The depreciation of the domestic currency and the strong increase of the interest rate afterwards curbed the performance of consumption and investments. The economy of Kosovo slowed down its growth pace in 2018 Q3, but continues to grow fast. The slowdown was driven by the strong contraction of government spending, while consumer spending, investments and net exports contributed positively to growth. The economy of Serbia grew rapidly in 2018 Q3 driven by the double-digit growth of investments and the improvement of consumer spending. The economy of Macedonia registered a positive growth rate in 2018 Q3, consolidating the economic activity in the country after a difficult period. Economic growth is driven by domestic and foreign demand, while private investments contracted due to uncertainties surrounding the tense political situation in the first half of the year.

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The main trading partners outside the European Union (Kosovo, Macedonia, Serbia, Turkey).
The annual inflation rates in the region slowed down in 2018 Q4, driven by the performance of energy and food prices. Turkey is an exemption, registering a double-digit inflation throughout the year, although trending downwards in the last two months of the year. Inflation expectations remain low across the region.

Table 1. Economic indicators for countries in the region

<table>
<thead>
<tr>
<th>Countries</th>
<th>Annual change of GDP</th>
<th>Annual inflation</th>
<th>Unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2018 Q2</td>
<td>2018 Q3</td>
<td>December 2018</td>
</tr>
<tr>
<td>Italy</td>
<td>1.2</td>
<td>0.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Greece</td>
<td>1.7</td>
<td>2.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Macedonia</td>
<td>3.0</td>
<td>3.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Serbia</td>
<td>4.9</td>
<td>3.8</td>
<td>2.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.3</td>
<td>1.6</td>
<td>20.3</td>
</tr>
<tr>
<td>Kosovo</td>
<td>4.7</td>
<td>3.4</td>
<td>2.9</td>
</tr>
<tr>
<td>Albania</td>
<td>4.2</td>
<td>4.5</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: Respective statistical institutes.
*November 2018; **October 2018.

2.2. COMMODITY PRICES IN GLOBAL MARKETS

The main indices of commodity prices trended downward in the last quarter. The energy prices index (including fuel) registered high values in October, but slowed down significantly in November and registered a negative growth in December. Metal and food price indices continued to contract in annual terms, a trend noted during most of 2018 H2.

Concerns on a high supply, and afterwards contraction of demand, due to the slowdown of global economic growth, significantly curbed the oil price in November. This trend was also followed by the exit of Qatar from OPEC, hence being no longer subject to output limitations OPEC imposes on member countries. The Brent oil price in international markets registered USD 57.4/barrel

Chart 6 Oil prices in international and domestic markets

Source: INSTAT, staff calculations; WB indices.
in December, or around 10% lower than in the same month a year earlier. The latest forecasts by relevant institutions that survey the energy market suggest that the oil price will follow a slightly upward trajectory this year.\(^8\)

Indices of food and metal prices continued to record negative growth rates in the fourth quarter. Expectations for lower economic growth in the countries with high industrial output, and consequently for a lower demand, together with tariffs applied by the US on metal imports have contributed to the decrease of prices in international markets. Food prices recorded lower values, driven by lower demand and the latest trade tariffs imposed by the US on the imports of certain foods from China.

### 2.3. FINANCIAL MARKETS

As expected, the Fed increased the target range rate by 0.25 percentage point to 2.25% to 2.50% in the December meeting. This was the fourth time that the Fed increased the interest rate during 2018. Other major central banks have kept the respective policy rates unchanged: the ECB kept the policy rate unchanged at 0.0%; the Bank of England at 0.75% and the Bank of Japan at -0.1%. As stated, the ECB ended the asset purchase programme in December, while it did not change the communication to maintain the policy interest rate unchanged. The economic data in the euro area resulted weaker than the expectations of the central bank.

In capital markets, the yields on government securities in advanced economies showed a downward trend in December. Government yields in the euro area were driven mainly by economic indicators, which have resulted lower than the expectations of financial agents. The spread between securities of countries that need fiscal consolidation and those of Germany reduced slightly in this period, after agreements for fiscal consolidation were reached with Italy. Yields on corporate bonds also decreased and remain below the values registered before the ECB’s asset purchase programme of private sector securities. In accordance with ECB’s monetary policy communication, interest rates on money market short-term instruments have not changed. They remain at negative levels.

The euro depreciated against the US dollar, reflecting the differential in economic growth and monetary policy in these two economies. Also, the euro depreciated against many other currencies of major and developing countries. On average, the euro depreciated 1.9% against the

US dollar in the fourth quarter from the third quarter. In December, the euro was traded for 1,138 US dollar, or 3.8% lower than in the previous year.

Source: Bloomberg, Reuters and Eurostat.
3. FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

Financial markets continue to be characterized by high liquidity, low interest rates and contained risks. The issue of the Eurobond in international markets and the reduction of domestic debt contributed to the improvement of banks liquidity, dictating the decrease of yields across all maturities. 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 the lending portfolio indicate its growth pace picked up in 2018 Q4, driven by a somewhat higher demand of enterprises for lending. Credit to households continues to register a stable growth helped by the improvement in the labour market, the increase of consumption and a more positive approach of banks’ funding policies for this segment. However, the growth rates of credit to the private sector remain low. Non-performing loans write off from banks’ balance sheets and the consolidation of the banking system are expected to contribute to a stable growth of lending in the future.

The low demand for money from public and private economic agents continues to condition a weak monetary expansion.

3.1. FINANCIAL MARKET DEVELOPMENTS

INTERBANK MARKET
Interest rates in the interbank market fluctuated close to the policy rate. The spread between interbank rates and the policy rate remains at the minimum level. This trend was supported by improved liquidity conditions in the market. The average traded volume in the interbank market contracted compared to 2018 Q3, as a result of the decrease in the weekly exchanges. Overnight and one-week maturities remain the most used ones, in addition the 2, 3 or 30-days transactions have been also used. The volatility indicators9 appear 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 amount injected in this period was smaller than in 2018 Q3, whereas interest rates in auctions stood close to the policy rate.

9 The standard deviation of the daily interest rates in the interbank market in 2018 Q4 was 0.04, from 0.03 in 2018 Q3.
DOMESTIC FOREIGN EXCHANGE MARKET

In 2018 Q4, one euro was traded on average at ALL 124.5, or 1.2% lower than in the previous quarter. This trend reflected mainly the seasonal impact that characterizes the end-year period, and particularly December, when, due to the holidays, the foreign currency supply increases. Also, data from the external sector indicate higher foreign currency inflows from exports in 2018 Q4. Reflecting the improvement of the efficiency in the foreign exchange market and the diminishing of the exchange rate risk on inflation, the Bank of Albania has barely been present in the foreign exchange market. Daily fluctuations of the exchange rate were close to minimum levels and the bid-ask spread for the euro normalised in 2018 Q4. Compared with 2017 Q4, one euro was 6.8% cheaper on average.

Source: Bank of Albania.

Chart 9 Bank of Albania open market operations and interbank rates

Chart 10 Developments in the foreign exchange market

Source: Bank of Albania.

Bank of Albania
The USD/ALL exchange rate registered a different behaviour from the EUR/ALL rate. In 2018 Q4, one US dollar was traded on average at ALL 109, or 0.6% higher than in the third quarter. The appreciation of the US dollar in the domestic market reflected its appreciation against the euro in international markets in 2018 Q4. The better performance of the US economy, the normalisation of the Federal Reserve’s monetary policy as well as expectations for its further appreciation seems to have driven the appreciation of the US dollar during this quarter. However, in annual terms, the US dollar continues to be depreciated against the lek, by 3.9% on average, compared with 2017 Q4.

The above developments have determined the performance of lek’s exchange rate against currencies’ basket of Albania’s main trading partners. The composite index of the nominal exchange rate NEER registered on average 93, or around 0.8% less than 2018 Q3. In real terms, the expansion of the spread of domestic inflation against that of partner countries has defined a slight depreciation of the average level of the REER, at 0.4% in quarterly terms. The annual changes of the two indicators confirm a stronger appreciation than in 2018 Q3, also reflecting the depreciation crisis of the Turkish lira in international markets.

**BOX 1: EXCHANGE RATE AND DETERMINING FACTORS**

Lek has registered a clear appreciating trend against the euro in the domestic financial market starting from end-year 2015. The appreciation trend was relatively slow until 2017, but it accelerated significantly during 2018.

The appreciation of the exchange rate has been the focus of Bank of Albania’s analyses, which have consistently sought to identify its underlying factors, distinguishing between fundamental factors that bring the exchange rate in new equilibrium levels, and specific and short-term foreign exchange market factors, which cause a deviation of the exchange rate from equilibrium levels. Such identification allows for a further assessment of the impact from the exchange rate appreciation on the economy and inflation. On their basis, the Bank of Albania formulates its response. This Box summarises briefly the conclusions of our analyses.

From the medium and long-term point of view, the appreciation of the exchange rate is in line with the economic theory and macroeconomic factors. Hence, the appreciation trend of the exchange rate reflects the improvement of the foreign position of the economy and a higher interest to invest in saving instruments denominated in lek, in the domestic financial market.

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10 In 2018 Q4, one US dollar was traded on average at EUR 1.14, or 1.8% higher than in the third quarter.

11 The nominal effective exchange rate (NEER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market weights. For the purpose of calculating the lira/lek and the renminbi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renminbi against the US dollar. The real effective exchange rate (REER) is calculated similarly to the nominal, but it considers the domestic inflation and those in the trading partners, as well.
The improvement of the foreign position of the economy is illustrated by:

- the stable and continuous narrowing of the balance of foreign trade exchanges, mainly reflecting the rapid expansion of Albanian exports;
- high foreign currency inflows in Albania, mainly in the form of foreign direct investments, as well as in the form of remittances (Chart 11).

Likewise, low interest rates on foreign currency have increased the interest to save in lek, in the form of both deposits and government securities (Chart 12).

In accordance with the free exchange rate regime applied in Albania, the structural growth of foreign currency supply has defined the appreciating trend of the domestic currency. Exchange rate analyses and forecast models indicate that the performance of the exchange rate during 2015-2017 has not deviated largely from levels suggested by macroeconomic factors.
From the short-term point of view, the appreciation of the exchange rate was stronger than the improvement of the above-mentioned factors. In our assessment, the appreciation of the exchange rate reflected specific developments in the domestic foreign exchange market related with the conversion of capital from some banks of the system, the disbursement and conversion of a large EBRD loan, as well as the creation of expectations for further lek appreciation. These expectations were accompanied with a change of behaviour among economic operators, leading to a high but temporary imbalance in the foreign currency demand and supply. The above factors brought a rapid appreciation of the exchange rate during 2018, and a deviation from the level suggested by macroeconomic factors (Chart 13).

In the absence of fundamental changes in the economy, these deviations of the exchange rate diminish the intensity of inflationary pressures and give rise to implications for the monetary policy stance. Transmission channels of the fluctuation of the exchange rate in the economy are included in the forecasting models of the Bank of Albania.¹ These forecasts showed that the continuation of rapid appreciation of the exchange rate would jeopardise achieving the inflation target in the medium term. As such, it necessitated the reaction of the Bank of Albania, which materialised in the form of lowering the policy rate in June and of extraordinary-but-temporary interventions in the domestic foreign exchange market. This managed to stabilise the performance of the exchange rate and created the premises for a normal functioning of this market. Current assessments suggest that exchange rate risks on inflation target have diminished.

¹ See Box No 2 in this Report: “Exchange rate and impact on the economy”.  

### PRIMARY MARKET

T-bills and bond yields in the primary market continued to decrease in the last quarter. Yields decreased across all instruments and continued at the same pace in the second half of the year, save September. Yields continued to decrease in January auctions. The lower government demand for funding was the main factor determining the yields performance in this period. The issue of the Eurobond at the beginning of October provided the Government with the possibility to decrease its demand for financing in the domestic market. The performance of yields was determined by the competitive bid of banks, which was high and pushed them down.

The average yield on 12-month T-bills fell to 1.40% in December, from 2.7% and 1.67% at the beginning of the year and in September, respectively.
The bid-to-cover ratio of debt securities auctions in these months increased\textsuperscript{12}, thus adding downward pressures on asked yields and confirming a more competitive behaviour of banks.

Bonds yields showed a similar performance to T-bills, but the decrease of the asked premia was stronger, particularly in the medium term. The 2, 5 and 7-year bond yields in the December auctions were 1.94%, 3.80%, 5.02% respectively, from 2.20%, 4.70%, and 5.45% in September. In the auctions of January 2019, the yields on the 2 and 10- year bonds yields decreased further, down to 1.92% and 5.85% from 1.94% and 6.48% at the most recent respective auctions. The gradient of the yield curve was slightly flattened.

\textbf{FINANCING TO THE PUBLIC SECTOR}

The budget deficit for 2018 was about ALL 26.5 billion. Domestic financing, through issuing of securities in the domestic market, and foreign financing amounted to ALL 19.7 billion and ALL 33.1 billion, respectively. Foreign borrowing materialized mainly in the issuance of the 7-year Eurobond at the amount of EUR 500 million. Borrowing beyond the amount needed to finance the deficit led to a high surplus of government liquidity.

Borrowing in the domestic securities market was ALL 10.3 billion less than the level planned at the beginning of the year for financing the deficit during this budget year.\textsuperscript{13} The reduction of domestic borrowing concentrated most in the

\textsuperscript{12} Since October, the bid-to-cover ratio for both T-bills and bonds auctions has been 1.63, form 1.40 in the third quarter and 1.26 for the first half of the year.

\textsuperscript{13} Borrowing in the domestic market was reduced in accordance with the government borrowing schedule following the issuance of the Eurobond, which partially replaced borrowing in the domestic market by about ALL 10.2 billion, and partially replaced the early repayment of the Eurobond maturing in November 2020, by about EUR 200 million.
last quarter of the year\textsuperscript{14}, upon the full maturation of some of the securities, whose maturities ranged from six months to five years. By analogy, the stock of government securities, issued until the end of 2018, decreased by the end of the nine-month period.

The structure of government securities holders did not show significant change from the end of the nine-month period, despite the decline in stocks compared to this period. The main development in this regard over the last quarter consisted in a slight shift of the holders of these securities, by 0.8 percentage point, from commercial banks to households and other non-bank institutions. According to data for the end of 2018, households owned about 24.5\% of the total government securities portfolio, down by 0.7 percentage point from the end of the previous year. The behaviour of the households has reflected, with a time lag, the most significant interest rate cut in the primary securities market since 2016 H2.\textsuperscript{15}

Despite developments in the last quarter, commercial banks remain the largest funders of government’s domestic debt, holding about 57.9\% of total issued securities, or 0.1 percentage point less compared to the previous year. In a period of time longer than one year, the structure of government securities holders shows a higher polarization, manifested in an increasing share of the securities portfolio owned by commercial banks.\textsuperscript{16}

\textsuperscript{14}At the end of September, domestic borrowing was ALL 29.5 billion.

\textsuperscript{15}At the end of 2015, households owned 27.1\% of total government securities issued in the domestic market.

\textsuperscript{16}Commercial banks, during a 3-year period, increased their share in total securities by about 1.7 percentage points.
3.2. DEPOSIT AND CREDIT INTEREST RATES AND FINANCING CONDITIONS

The average interest rate on new loans in lek in the last quarter was similar to that in the third quarter (6.6%). Compared to the first half of this year, interest rates on loans are slightly lower. Interest rates on loans have been increasing for short-term and long-term maturities, and decreased slightly for the medium-term maturity. The analysis by consumer shows that, compared with the first half of the year, interest rates decreased further for enterprises; for households the decrease was marginal. The decline in loans to enterprises has mainly reflected their performance in the category of loans for liquidity. Regarding loans to households, interest rates decreased in particular on mortgage loans; meanwhile, interest rates on consumer loans showed a volatile performance.

The average spread of the interest rates on lek loans to euro loans was slightly up during these three months, mainly due to the higher contraction of interest rate in euro than in the domestic currency. The spread of interest rates on loans denominated in both currencies, by client, shows they increased for enterprises, and contracted for households, particularly on mortgage loans.

The average interest rate on new loans in euro during these three months (4.1%) decreased slightly compared to the third quarter. Within the quarter, the dynamics of interest rates showed their upward performance mainly in the long-term maturity. Compared to the previous quarter, the fall in interest rates reflected the decrease of 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.

17 Interest rate on mortgage loans in lek, in the fourth quarter was 3.5%, from 3.6% in 2018 Q3 and 3.8% in 2018 H1.
In 2018 Q4, non-price terms and conditions on new loans to enterprises, based on the perceptions of commercial banks\(^\text{18}\), remained almost unchanged from the previous quarter. The increase in the size of the loan contributed to the easing of non-price terms and conditions for loans, offsetting the contraction effect stemming from the conditionality of the credit agreements approved for enterprises in the fourth quarter. Other non-price elements of terms and conditions for loans to enterprises were reported as unchanged.

For households, terms and conditions that are not directly related to the loan price, in 2018 Q4, were somewhat more moderate, due to lower collateral requirements for new loans to households in this quarter. Other non-pricing

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\(^{18}\) For more information refer to the publication of the Bank Lending Survey: https://www.bankofalbania.org/Politika_Monetare/Vrojtimet/Vrojtimi_iAktivitetitKreditues/
terms and conditions such as maturity, commissions, size, or the conditions arising from the loan agreement are the same as a quarter earlier, according to the perception of commercial banks.

The average interest rate on new time deposits in lek continued to fluctuate close to the values of the previous quarter, at 0.93% in the last quarter. Their monthly performance indicates that the average interest rate followed a downward trend in these months, down to 0.85% in December. This decrease is mainly due to over one year maturities. Interests for new time deposits in euro, in this quarter, did not change from the previous quarter’s average (0.16%). Their level has fluctuated around 0.10% - 0.20%, since January 2018.

3.3. CREDIT TO THE PRIVATE SECTOR

Lending activity, in 2018 Q4, appears moderate but steady. The stock of private sector credit to GDP is assessed at around 35.2%, similar to 35.3% registered at the end of third quarter. Excluding the effect of write offs from bank balance sheets and the exchange rate effect, annual growth of credit to the private sector is on average 5.0% in the fourth quarter, about 0.1 percentage point higher than in the previous quarter.19 The expansion of this portfolio in the last quarter is largely supported by the growth of credit to enterprises, particularly in December.20 Despite the positive developments noted in December, the performance of credit to the private sector continues to be driven by a sluggish demand for loans from enterprises, as well as by banks’ still-tight credit policies.

Chart 19 Lending by currency and economic agent

![Chart](chart.png)

Source: Bank of Albania.

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19 Credit analysis is reported with adjusted data for loan write offs from banks’ balance sheets and for the exchange rate effect. Excluding only the effect of loan write offs, the balance of credit to the private sector increased on average by 1.3% year on year in the fourth quarter.

20 In December, the loan portfolio was significantly affected by loan write offs from banks’ balance sheets. In this month, the write-offs amounted to almost the same level as the total of written off loans for the period January-November 2018.
The ratio of non-performing loans declined further in 2018 Q4. At the end of December, it decreased to 11.1%, from 12.9% at the end of the third quarter. The decline in non-performing loans, in addition to the improvement of the economic activity, reflects the banks’ commitment to complying with the plan of measures for reducing non-performing loans.

The annual growth of the credit portfolio in lek was 6.8% in the fourth quarter. The positive performance of this portfolio reflects the steady growth in the households segment, who borrow mainly in the domestic currency. Developments in the portfolio of foreign currency loans carry out the statistical effect of exchange rate appreciation. Adjusted for this effect, foreign currency lending recorded about 3.7% average annual growth.

The portfolio of loans to enterprises recorded around 3.8% average annual growth, registering a high growth in December. This performance is supported by the growing demand for loans in this segment. According to the bank lending survey in the fourth quarter of the year, the demand for financing from enterprises was reported higher than in the previous quarter. This demand was largely channelled into the credit for investment segment, affecting the growth of this portfolio by about 6%, y-o-y, in the fourth quarter of the year. The portfolio of loans for liquidity purposes appears more volatile. Its performance reflects the unstable demand from enterprises for this product, depending on short-term funding needs and their capabilities to fulfil these needs with their own funds. Outstanding loans for liquidity purposes increased by about 1.3%, on average, in the fourth quarter of the year.

The portfolio of loans to households increased by 7.6% in average annual terms, maintaining similar growth rates with a quarter earlier. The continued easing of lending standards and stable credit demand in this segment continued
to support its expansion. Lending to households is mainly focused on financing for house purchase purposes, with this portfolio increasing in the last quarter by about 7.3%, year on year. Consumer credit also increased, recording about 8.3% an annual growth. The relatively fast growth rate of this portfolio is an indicator of the small size of this portfolio, which accounts for only about 31% of the total loan portfolio for households.

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

The expansion of monetary supply in the economy continued to be weak in 2018 Q4. The broad money indicator, M3 aggregate, shrank by 0.3% in average annual terms. These developments continue to be dictated by the still-low level of currency creation in the economy on the side of assets in the balance sheet of banks, and the shift in the structure of money holdings toward longer-term instruments on the liabilities side. Adjusted for deposits with over two year maturity, as well as for the statistical effect of exchange rate appreciation, the annual growth rate of the M3 aggregate fluctuates around 3%.

Performance of aggregate M2 in lek, shows annual changes in negative territory, recording a decrease in surplus by 0.6% on average, y-o-y, in the last quarter of the year. Afterwards, the liquidity indicator slowed down to 4.7%, y-o-y, on average, over the same period. The ratio of currency outside banks to M2 was at 37.6% in December, down from 37.2% at the end of the third quarter of the year. This performance reflects the seasonal trend of this indicator during this period, where the demand for keeping the monetary assets in a liquid form grows during the end-of-year holiday season.
The stock of deposits in the banking system increased by about ALL 7 billion in 2018 Q4, or 1.1% in annual average terms. Developments by currency show an annual growth of deposits in lek by an average of 1% and deposits in foreign currency by 1.2%. Their growth is mainly concentrated in December, reflecting the seasonal effect of high foreign currency inflows during this period. This has affected the largest increase in absolute terms of households’ deposits during this month. Deposits from enterprises continued to increase in the last quarter, but their performance is relatively volatile.

The time structure of deposits continues to reflect shifting in two directions: on the one hand, towards demand deposits and, on the other hand, on deposits with maturity with over two years. At the end of December, demand deposits accounted for about 44% of the total stock, while those with a maturity over two years accounted for about 11.8%.

21 Adjusted for the statistical effect of the exchange rate appreciation, the annual rate of foreign currency deposits stands at around 8% on average, for the fourth quarter.
4. INFLATION AND ECONOMIC GROWTH

Average annual inflation was 1.8% in the fourth quarter, down compared to the third quarter. Average inflation for 2018 was 2%, similar to 2017.

The upward contribution of the cyclical improvement of the economy to the formation of inflation has been curbed by the disinflationary pressures generated by the appreciation of the domestic currency and the decline in inflation in trading partner countries.

Economic growth of the first nine months amounted to about 4.3%, accelerating to 4.5% in the third quarter. The expansion of economic activity was supported by the positive performance of domestic demand: population consumption and investments. The recovery of domestic demand is helped by adequate financing conditions, improved financial balances and the confidence indicator above its historical average. These developments are reflected in the continuation of the positive employment performance, the reduction of the unemployment rate and in the increase of wages. These dynamics are expected to continue in the future, enabling the return of inflation to target within a medium-term horizon.

4.1. INFLATION

Average inflation in 2018 Q4 was 1.8%, standing 0.4 percentage point lower than in the third quarter. The inflation rate reflected the declining contribution from almost all major categories. Specifically, in November and December,
groups of non-food basket items decreased: rent, fuels and other goods. On the other hand, in December, the contribution of "Unprocessed Foods" partly offset the decline of the contribution of the above categories, but without reversing the downward trend in prices during this quarter. Pressures from foreign prices continue to remain subdued, affected not only by exchange rate appreciation, but also by falling prices in the euro area and in countries in the region.

"Unprocessed foods" was characterised by upward contribution to the inflation rate, during October-December. However, the low inflation rate recorded in October and November determined also the reduction of its contribution to headline inflation. In December, this category was characterized by high inflation rates contributing by 1.2 percentage points, or forming around 70% of headline inflation. This contribution is driven almost entirely by the high inflation from the sub-category of vegetables.

"Processed foods" was characterized by downward annual inflation rates. In this year, the inflation of these products has been stable in low positive values (below 1%), but in December it slowed down considerably. The most significant drop in the contribution during December (by -0.1 percentage point) was noted in "Bread and grains", which since August has been contributing to inflation slowdown.

"Non-food consumer goods" contributed on average by 0.2 percentage points to fourth quarter inflation, contributing less than in the previous quarter. This performance has reflected the fall in foreign oil prices in foreign markets, illustrated in the domestic fuel market for the third consecutive month.

The contribution of "Housing-Rent" reduced during November-December, following gradual increases since the end of 2017. In December declined sharply, reducing the contribution of this category by 0.1 percentage point compared to the previous quarter. This has mainly come as a result of the base effect caused by the increase in domestic rental prices in the last two months of the previous year, whilst the index did not experience the continuation of the gradual growth. The prices of other more stable components of inflation, including mainly the prices of services, durable consumer goods and those at regulated prices, contributed similarly to the previous quarter (about 0.3 percentage point).
Table 2 Contribution of key items to annual inflation (p.p.)*

<table>
<thead>
<tr>
<th></th>
<th>Q1 16</th>
<th>Q2 16</th>
<th>Q3 16</th>
<th>Q4 16</th>
<th>Q1 17</th>
<th>Q2 17</th>
<th>Q3 17</th>
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<th>Q2 18</th>
<th>Q3 18</th>
<th>Q4 18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processed food</td>
<td>-0.4</td>
<td>0.1</td>
<td>0.4</td>
<td>0.6</td>
<td>0.6</td>
<td>0.5</td>
<td>0.2</td>
<td>0.0</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Bread and grains</td>
<td>-0.2</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Alcohol and tobacco</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
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<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Unprocessed foods</td>
<td>1.5</td>
<td>0.9</td>
<td>1.2</td>
<td>0.9</td>
<td>1.3</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
<td>0.9</td>
<td>1.1</td>
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<td>0.9</td>
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<td>Fruits</td>
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<td>0.3</td>
<td>0.3</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
<td>0.1</td>
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<td>Vegetables</td>
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<td>Services</td>
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<td>Goods with regulated prices</td>
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<tr>
<td>Housing lease</td>
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<td>0.0</td>
<td>0.0</td>
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<td>0.2</td>
<td>0.2</td>
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</tr>
<tr>
<td>Non-food consumer goods</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.2</td>
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<tr>
<td>Fuel</td>
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<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
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<tr>
<td>Long-term consumer goods</td>
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<td>0.0</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0.0</td>
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<td>0.0</td>
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</tr>
<tr>
<td>Consumer Price Index (annual change, %)</td>
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<td>0.7</td>
<td>1.9</td>
<td>1.9</td>
<td>2.4</td>
<td>2.0</td>
<td>1.7</td>
<td>1.8</td>
<td>1.9</td>
<td>2.2</td>
<td>2.2</td>
<td>1.8</td>
</tr>
</tbody>
</table>

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

4.2. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Economic growth was 4.5% in 2018 Q3, showing a more positive dynamics compared to the first two quarters of the year. For the first nine months of 2018, real GDP growth was 4.3%, about 0.5 percentage point upward from the previous year. The growth rate of the quarter was supported largely by the production sector. Its contribution continued to reflect mostly the expansion of electricity production and, to a lesser extent, the increase in construction activity. The services sector also gave a positive contribution to economic growth, reflecting mainly the developments of the accommodation and food services branch.

In the third quarter, economic growth continued to be driven by domestic demand, with the main contribution by the final population consumption and investments. Meanwhile, the component of net exports affected the economic growth downward, as a result of the stronger effect of increasing imports. Public consumption also gave a negative contribution, albeit at a small extent.

The analysis of the available data for the fourth quarter suggests that economic growth will continue to be supported by private consumption and investments. The contribution of the public consumption is assessed as almost negligible; meanwhile, reflecting the faster increase of imports, net exports are expected to have a negative contribution on economic growth in the fourth quarter.
4.2.1. GROSS DOMESTIC PRODUCT BY SECTOR\textsuperscript{22}

Economic growth in 2018 Q3 continues to be attributed to developments in the production sector. Its contribution to economic growth is estimated at about 2.5 percentage points, the same as in the previous quarter. Despite the slowdown in industry, energy and water, these activities continued to shape the performance of the production sector at a large extent, contributing by 1.7 percentage points to the economic growth of the quarter. This performance continues to reflect the impact of the strong expansion of the added value of the electricity branch. Its contribution by 1.3 percentage points to annual GDP growth, among other things, has also carried out the effect of the low comparative base of the previous year. This contribution remains lower than the in the first two quarters of the year, 1.9 and 1.8 percentage points, respectively.

Meanwhile, the faster growth rate of the value added of the production sector, to 6.5% from 5.9% a quarter earlier, was mainly determined mainly by the improvement in construction activity and to a lesser extent by the continuous increase in agriculture, forestry and fisheries. Their contribution to economic growth was 0.5 and 0.3 percentage point, respectively. The service sector also gave a slightly higher contribution to the annual GDP growth, about 1.6 percentage points from 1.4 percentage points a quarter earlier. The impact of the net taxes component on GDP growth was higher in the third quarter compared to the previous one (0.4 against 0.2 percentage points).

\textsuperscript{22} GDP and GVA by sector are analysed in terms of real annual changes. The analysis is based on the latest GDP data according to the output method for 2018 Q3, published by INSTAT on 28 December 2018. The differences between the sectors’ growth rates in this publication and those analysed in the Monetary Policy Report 2018/IV result from the series’ review. However, the publication of new quarterly GDP data for Q3 according to the output method does not reflect significant economic growth reviews. Specifically, the annual growth rate is revised down 0.1 percentage point in 2017 Q3, revised up 0.1 percentage point in Q4 of this year, and at the same extent, but downward, for the first two quarters of 2018.
The industry, energy and water sector slowed down the upward trend in the third quarter. Value added in this sector increased by 15.4% in annual terms, compared to 20.8% in the previous quarter. This sector’s dynamic remains significantly above the historical growth average, mainly driven by the strong expansion of electricity production, similar to the first half of the year. In spite of the continuous increase in value added of electricity, the contribution of this branch to the sector’s performance was relatively lower. Meanwhile, the processing industry branch decelerated the annual growth rates significantly. Its value added grew by 4.5% y-o-y, from 10.4% in the previous quarter, reflected in a decrease of the contribution on the sector’s performance, at 2.8 percentage points from 5.0 percentage points in the previous quarter. The performance of quarrying improved. Even though this branch contributed by 0.8 percentage point to the annual growth of the sector, this contribution remains lower compared to the contribution given by the other branches.

The industry sector is expected to pursue a positive but decelerating pace in 2018 Q4, driven mainly by the electricity production branch. Meanwhile, the increase of exports of certain products related to industrial activities, and greater

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**Chart 26: Contribution of branches to value added in “Industry, energy and water”, and the capacity utilisation rate in industry**

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

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23 The contribution of the electricity sector to the annual growth of the industry, energy and water sector in the third quarter is estimated at about 11.6 from 15.6 percentage points in the previous quarter. Value added of this branch continued its upward trend, expanding to 79.1%, in annual terms, after increasing by 67.2% in the second quarter. The net domestic electricity production performed the same. According to the quarterly data of the electricity balance published by INSTAT, this production expanded by 289.7% in the third quarter compared to 90.1% in the second quarter.

24 This performance reflects to some extent the comparison with a higher base a year ago when the branch of processing industry recorded an annual growth of 16.0%, about 2.5 times higher than its historical growth average. According to sub-branches, the dynamics of the processing industry reflected mainly the decline in the contributions of textile, clothing, leather and footwear industries, as well as industries of metallic and metal-based products, as evidenced by the slower growth of exports of these industries’ products.

25 Being a largely export-oriented industry, the annual increase of exports of some of the main energy products related to it, is assessed to have contributed positively to the performance of the branch.
utilization of production capacities in industry signal that the sector’s dynamics will remain positive. However, the lower level of confidence in industry, albeit above its historical average, suggests a more contained growth of the sector in the fourth quarter.

Construction performed better in 2018 Q3. The added value in construction recorded 5.4% annual growth, after contracting slightly in the previous quarter.\(^{26}\) This dynamics is estimated to have been driven by the continuation of new constructions and the realization of renovation works. Meanwhile, the lower level of public investments is estimated to have pushed the performance of the construction sector on the down side for the second consecutive quarter, as reflected by the decline in the volume of engineering works.\(^{27}\) Also, the decline of foreign direct investment inflows is another development, imposing limitations on the upward performance of the construction sector in the quarter under review.

The growth rate in the construction sector continued to increase in the fourth quarter. The expected positive developments in the sector are confirmed by the continuing upward trend in the number of permits approved for new buildings\(^{28}\).

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26 In line with this dynamics was the performance of the volume of production index and net sales index in construction, which increased by 12.0% and 9.5% respectively, after the contraction by 3.0% and 4.9% respectively.

27 The comparison with a higher base a year earlier, affects at a certain extent the decline of the estimated public component, similar to the previous quarters. 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.

28 The number of building permits granted in total for new buildings in the third quarter was 343 from 270 the second quarter. This number continued to increase, reflecting mainly the increase in the number of building permits granted for other buildings. However, the total number of issued building permits is still below the historical average. Around 215 from the permits issued in Q3 are for residential buildings, and 128 for other purposes (such as hotels, office buildings, commercial, industrial buildings and others).
the support from the estimated growth of public component, the higher utilization rate of production capacities and improved confidence. However, the level of confidence in construction, still below its historical average, suggests a continuation of moderate growth rates of the sector in the fourth quarter.

In 2018 Q3, the services sector generated a value added of 3.2% higher than in the same period a year earlier. This rate is slightly below the growth rate recorded in the previous quarter, but remains close to the historical average of the sector’s performance. The “Trade, Transport, Accommodation and Food Service” branch continues to lead the performance of services, contributing by 2.2 percentage points to the sector’s performance. The added value of this branch accelerated the annual growth rate to 5.9%, mainly driven by the activity related to accommodation and food service. Meanwhile, the slower growth dynamics of “Professional activities and Administrative services” and “Public Administration, Education and Health” were reflected in lower contribution to annual growth of the sector compared to the previous quarter, 0.7 and 0.2 percentage point, respectively. The rapid slowdown of “other services” was translated into a negligible contribution of this branch to total service performance. Meanwhile, the value added of “Real Estate” and “Financial and Insurance Activities” accelerated the growth pace, but their contributions to the services sector remained low, about 0.2 percentage point each. Services related to “Information and Communication” continue to contribute negatively to the sector performance by 0.4 percentage point, which is more moderate compared with the previous quarter.

Our estimates suggest that the services sector will continue to grow at a slow pace in 2018 Q4. This performance is in line with the lower level of confidence in the sector and the capacity utilization rate for services below the historical average of the indicator.
4.2.2. AGGREGATE DEMAND

In 2018 Q3, aggregate demand reflected high growth rates. “The population consumption” and “Gross fixed capital formation” provided the main contribution to this growth. Meanwhile, “public consumption” and “net exports” provided a negative contribution to the expansion of aggregate demand.

Information obtained from indirect indicators suggests growth of aggregate demand was slower in 2018 Q4. The expected expansion of the population consumption is assessed to remain the main contributor, followed by investments. Net exports are expected to provide a negative contribution to growth.

Domestic demand expanded by 3.5% in annual terms in 2018 Q3, gathering speed from the previous quarter (2.5%). Growth rates accelerated mainly due to the performance of population consumption. In parallel, the annual growth rate of gross fixed capital formation accelerated as well. On the other hand, public consumption shrank in real annual terms.

Leading and indirect indicators suggest domestic demand will continue to grow in 2018 Q4. Population consumption and gross fixed capital formation are expected to provide the main contribution to this performance.

HOUSEHOLD CONSUMPTION

The growth pace of private consumption accelerated at 3.8% in 2018 Q3, after recording 3.2% growth in 2018 H1. Positive developments in the labour market, as reflected in the increase of employment and wages, has driven the growth cycle of private consumption over the last three years. The low inflation rates and remittances flow supported the disposable income of households. Consumer credit continued also to finance consumer spending. Indirect quantitative data show that consumption growth in the last quarters was mostly
reflected in the increase of expenditures for non-durable consumer goods (short-term), and less for durable goods (long-term). Data on added value show that services consumption increased in 2018 Q3, at a similar pace to 2018 H1. Indicators from the consumer confidence survey support the signals obtained from the quantitative data. The aggregated confidence indicator decreased mainly due to the decline in the balance of major purchases.

Indirect data suggest that private consumption will remain the main contributor to the growth of aggregate demand in 2018 Q4. The increase in both VAT revenues and consumer credit suggest consumption will continue to grow in this quarter. Consumer confidence improved slightly in 2018 Q4.

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29 The disaggregate data from the retail trade, show that the increase in indices of “Computer appliances” and “electro-home appliances, furniture, etc”, slowed down, mainly in 2018 Q2 and Q3.
INVESTMENTS
Total investments grew by 5.4% in 2018 Q3, contributing by 1.3 percentage points to the expansion of aggregate demand. Based on indirect assessments, the growth in this component was mainly supported by private investments, whereas the public component provided a negative contribution in this quarter\(^{30}\). The good performance of value added in construction and of import of construction materials suggests that investments related with construction have provided the main contribution to the growth of private investments over the third quarter. The second largest component of private investments, machinery and equipment, provided a low contribution based on the import data for this item.

The increase in the import of machineries, equipment and construction materials, in 2018 Q4, suggest private investments will continue to grow in this quarter. Also, the increasing use of current production capacities stimulates more investments from enterprises. The capacity utilisation rate in industry and construction rose by 1.6 percentage points in 2018 Q4. Our assessments suggest public component will also provide a positive contribution during the fourth quarter.

PUBLIC SECTOR DEMAND AND FISCAL POLICY\(^ {31}\)
Fiscal policy was set on a consolidation trend throughout the major part of 2018, driven by both developments in income and the sluggish performance

\(^{30}\) INSTAT does not publish investment data divided into public and private component.

\(^{31}\) The fiscal data published by MoFE are preliminary and subject for future review.
of budget expenditures. As at end 2018, budget deficit was estimated at around ALL 26.5 billion, or around 1.6% of GDP, from the forecasted ALL 32.4 billion or 2.0% of GDP. Primary deficit narrowed by 0.6 percentage point of GDP over 2018, beyond the projected level. From a broader perspective, this development implies added savings of the Government and negative fiscal impulse.

The largest part of the deficit was realised in December; meanwhile, until November, the budget deficit amounted to only 0.1% of GDP. The expansion of deficit by ALL 25.3 billion in the last month drove to a rather high concentration of expenditures in December.

**Chart 34 Orientation of fiscal policy**

*The orientation of fiscal policy is proxied by changes in the ratio of primary cumulative deficit for a 12-month period to the GDP, compared to a year earlier.

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

Budget expenditures grew faster in the last quarter compared to the previous period of the year. They grew 8% in annual terms, compared with the average 1.3% in the first three quarters of the year. The profile of expenditure during the last quarter was different from the previous quarter, being broadly based on the increase of capital and interest expenditures. Both items contributed by 4.9 and 2.1 percentage points, respectively, to the growth of total expenditure during the last three months of the year. The performance of expenditure in the last quarter of the year suggests a higher presence of the public component in the formation of aggregate demand, mainly in the form of gross fixed capital formation.

In 2018, expenditures were realised at ALL 475.9 billion, around 3.1% higher from the previous year, but around 3.7% below the level planned in this year. Taking into account the structure of expenditure and the dynamics of some of items, capital expenditure, social insurances, and those for the payment of

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32 The comparison with the Normative Act for the budget 2018, approved in December 2018, which sets out that the annual plan on expenditure was revised at ALL 494.2 billion, from ALL 497.1 billion at the beginning of the year, also in the normative act approved in July 2018.
interests on debt taken in previous years provided the highest contribution to the increase of expenditure. On the other hand, the absence of fiscal transfers, which are neither part of current nor capital expenditures continued to be a decelerating factor on the pace of expenditure growth during this year.\(^{33}\)

In 2018, capital expenditure showed stable growth pace, standing at around 14.5% as at the end of 2018. The growth in public investments was a strong stimulus to the expansion of production capacities in the economy.

Revenues, like expenditure, showed an improved growth dynamic in the last three months, compared to the rest of the year. The annual growth rate was 8.9% in 2018 Q4, and was largely (around 64%) formed by the increase

\(^{33}\) If eliminating this effect, the annual growth of expenditure for 2018 would be 5.4%.
in profit tax, the local government and income from national taxes. VAT revenues increased at a faster pace in October and November, attributable to the positive contribution from VAT collected on the production of goods and services in Albania.\footnote{The detailed data in the tax and customs reports are available for November. Till the end of July the collected VAT from taxes provided a negative contribution on total reported VAT.}

In 2018, revenues registered ALL 449.4 billion, around 4.4% higher than in the previous year, but around 2.7% below the planned level for this fiscal year\footnote{According to the normative act for the budget 2018, revised in December 2018, the plan on revenues was ALL 461.9 billion.}. Personal income tax, social insurances and VAT revenues provided the main contribution to the growth over the year (mainly due to the share of the last two items in total revenues). From the macroeconomic perspective, fiscal developments related to revenues suggest both private consumption and investments increased in the last quarter. Also, the positive performance in some specific items of revenues signals a further improvement of labour market indicators, and increase of the domestic production of goods and services.

**EXTERNAL DEMAND AND FOREIGN TRADE**

The trade deficit in goods and services expanded by 6.7% in real annual terms in 2018 Q3. The 4.1% annual growth of imports was the main determinant in this development. The fast growth of the import of services by 10.4% in real terms, broadly determined their performance. In parallel, the import of goods was up by 0.5% in annual terms. In the case of exports, the annual total growth is calculated at 1.5%. The increase in the export of goods by around 16.2% provided the main contribution in this regard. Meanwhile, the real export of services contracted by around 1.4%.

The trade deficit in nominal terms performed differently from that in real terms. The trade deficit in real terms expanded, while in nominal terms, the deficit narrowed by around 8.5%. The divergence is related with the distinction 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.

Data on exports and imports of goods for 2018 include statistics for the fourth quarter of the year. The trade deficit in goods contracted by around 5.3% in annual terms, mainly owing to the increase in the export of goods. In parallel, a growth in imports was reported as well.
The export of goods expanded by around 9.3%, in annual terms, in 2018 Q4, almost similar to the rate reported in the third quarter. The growth of exports was mainly dictated by the categories: “Minerals, fuel and electricity”; “Construction materials and metals”; “Textiles and footwear”; and “Machinery, equipment and spare parts”.

Imports expanded by around 0.8% in annual terms during 2018 Q4, unlike in the previous quarter, when imports fell in annual terms at 0.1%. The categories “Machinery, equipment and spare parts” and “Construction materials and metals” contributed to the expansion side.
By geography, the countries of the European Union, and particularly Italy, remain our main trading partners for both exports and imports. In 2018 Q4 a relative decrease of shares of some partners to which are exported goods related to fuels and electrical energy, like Switzerland and Spain, is noted.

Regarding foreign trade in 2018, trade deficit narrowed by around 6.3%, mainly due to the rapid growth of exports (around 13.7%). The high increase in the exports of “Minerals, fuel and electricity”, particularly in 2018 H1, was the determinant factor in this regard. “Construction materials and metals” and “Textiles and footwear” also provided supporting contribution.

Imports registered 2.4% annual growth, notably lower from 8.1% registered in the previous year. The growth was broadly driven by “Machinery, equipment and spare parts”, while the other categories provided rather low contributions.

4.3. CYCLICAL SITUATION OF THE ECONOMY AND INFLATIONARY PRESSURES

Economic activity affirmed our assessments that the narrowing trend of the negative output gap continued in 2018 H2. Signals from the labour and capital markets suggest improvement of the cyclical situation. Nevertheless, the materialisation of these trends in increasing the inflationary pressures is still uncompleted, in the presence also of the depreciating behaviour of the exchange rate.

Both the more complete use of production factors and the expectations for a more stable exchange rate are expected to exercise upward inflationary pressures. The accumulation of the latter is assessed to generate a stronger impulse for the return of inflation to target in the medium term.

The update of our assessments with the recent information shows that the expansion of economy is approaching its potential level. Also, the signals from other indicators of the cyclical situation are in

* 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 then is applied the method of the four terms moving average. The chart shows the resulted gap for the production sector. Services sectors are excluded due to the presence of many short-term fluctuations. 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.

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Source: INSTAT and Bank of Albania estimations.
line with it, such as: the capacity utilisation rate gap and unemployment rate gap. The capacity utilisation rate, aggregated for the economy in 2018 Q4, suggests a relatively high level of the utilisation of capacities. Meanwhile, the signals from the labour market till the third quarter are more positive regarding the use of the labour factor.

Notwithstanding the improvements recorded in the labour and capital markets, the domestic inflationary pressures strengthened slowly. The positioning of the economy below its potential and the exchange rate appreciation continue to limit the build-up of inflationary pressures. A more optimal use of the production factors, supported by the growth of aggregate demand and the reduction of the exchange rate appreciating trend, are expected to establish the conditions for the return of inflation to target in the medium term.

Results of the Business Confidence Survey for the fourth quarter suggest the capacities utilisation rate in the economy is at around 71.0%, standing 1.8 percentage points higher than in the same quarter of the previous year. Notwithstanding the indicator remains below its historical average, the capacities utilisation rate trends upwards, mainly driven by the producing sectors of the economy.

**Labour market** developments were positive in 2018 Q3 as well. Employment in economy reduced the increasing dynamic, at 2.3%, after the 3.3% increase in the previous quarter.\(^{36}\) The employment growth was mainly supported by services and industry. Also, the indicator of the participation in labour force, which continues to be upward, standing at 59.4%, provided positive signals. The growth of employment is followed by the further fall of the unemployment rate. Unemployment was 12.2% in 2018 Q3, down by 0.2 percentage

\(^{36}\) 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.
point in quarterly terms, and by 1.4 percentage points in annual terms. These developments suggest a more intensive use of the labour factor.

The unit labour cost\(^{37}\) 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.\(^{38}\) According to the data of the average monthly wage for an employee\(^{39}\) in the country, this indicator registered an annual growth similar to the previous quarter, both in nominal and real terms\(^{40}\), by 2.4% and 0.2%, respectively.

Data on other output costs show a slightly higher increase in 2018 Q3. The 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.

Core inflation and net non-tradable inflation were 0.7% and 1.6%, in annual terms, respectively. Both components did not remain isolated against the exchange rate appreciation. The reducing effect of the appreciation behaviour of the exchange rate on core inflation is assessed higher during the months of 2018 Q4. The more complete effect of comparative base of the rent index was superposed to this effect for the same period in the previous year. Notwithstanding these developments, both the short-term and domestic components continued to provide positive contribution, though low, in the formation of headline inflation.

The lowest rate of headline inflation in this quarter was also affected by the slowdown of its short-term components. Non-core and tradable inflation of the CPI basket items were 4.7% and 2%, respectively. Notwithstanding that inflationary pressures from cyclical improvement are assessed as upward, they

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\(^{37}\) 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.


\(^{39}\) 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.

\(^{40}\) Deflated for the annual inflation in the respective quarter.
continued to contain the appreciation of the exchange rate. Its impact was more intensive through the inflation of short-term components.

Over 2018 Q4, the imported inflationary pressure index (IIPI)\(^{41}\) contracted on average by 1.4% in annual terms. Also in this quarter, foreign prices and the exchange rate had opposite dynamics, but at almost the same magnitude. The appreciation of the nominal effective exchange rate (NEER) in annual...
terms registered 10.2% against the expansion of “Import Price Index” (IPI)\textsuperscript{42} by around 8.8%. These developments have kept the annual change of the overall index in negative territory for almost two years.

Assessments from the decomposition of headline into imported and domestic inflation converge with the information from IPI. In 2018 Q4, imported inflation reduced its contribution by around 0.4 percentage point compared with the previous quarter, or by around 12% less in the formation of the headline inflation. This development, given the almost similar imported price pressures, suggests a more complete transmission of the domestic currency appreciation’s effects, through the channel of imported inflation to headline inflation. Notwithstanding the monthly dynamic, in 2018 Q4, the domestic inflationary pressures remain similar with 2018 Q3, providing a contribution of around 1.3 percentage points in the formation of the headline inflation. In relative terms, they resulted more substantial for the formation of headline inflation in the fourth quarter (around 72.2%).

\textbf{BOX 2: EXCHANGE RATE AND ITS IMPACT ON ECONOMY}

This box provides a summary of BoA’s assessments about the impact of the exchange rate on the cyclical position of the economy and on inflation. The implications of the exchange rate performance for the economy depend on the nature of factors causing an appreciation or depreciation of the exchange rate, and, consequently, from the deviation of this rate from its equilibrium level.\textsuperscript{1} The analysis in this box focuses on the appreciation of the real exchange rate, as a specific development in 2018.

The appreciation of the exchange rate may reflect an improvement of its structural determinants related with the growth of productivity, the improvement of external economy balances, and increase of domestic demand and reduction of structural vulnerabilities of the economy. In this case, economic agents do expect the appreciation, and they take it into account in their decisions for consumptions and investments. This appreciation of the real exchange rate has no effect on economic growth and inflation. When the appreciation reflects temporary phenomena, which do not reflect structural changes in the economy or in the long-term trend of the exchange rate, it has adverse implications for inflation in the short run.

The appreciation of the exchange rate beyond its long-term trend affects the Albanian economy through a range of channels. The main channels are:

- Competitiveness, which implies that an appreciation of the real exchange rate expands the trade deficit. This channel has a negative impact on output gap;

\textsuperscript{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.
Economic agents’ financial balance. The appreciation of the real exchange rate reduces the cost of debt service in euro for unhedged borrowers from the exchange rate fluctuations and provides them more free funds for consumption and investments. This channel has a positive impact on economy.

Interest rates gap in euro. The real interest rates of loans in euro trend downwards due to the appreciation of the exchange rate, the decrease of risk premia on loans in euro. This channel provides a positive impulse in economy.

Prices. The appreciation of the real exchange rate decreases inflationary pressures from import prices and through the output gap (combination of the above channels of impact).

The decomposition of the contribution of factors which are affected by the exchange rate shows that the appreciation has contributed to the expansion of the trade deficit over 2018. Nevertheless, this effect is partially offset by the positive impact of the low real interest rates on euro loans, and partially by the higher purchasing power of borrowers unhedged against exchange rate fluctuations. In balance, the effect of the real exchange rate appreciation beyond its long-term trend in the economic growth is marginally negative.

The appreciation of the real exchange rate beyond its long-term trend has contributed also to the reduction of inflation during 2018. On average, the effect of the exchange rate is assessed to have caused inflation deviation from the target, by around 0.2 percentage point; however, this effect had an upward trend throughout the quarters of the year, in line with the time lag of the monetary policy transmission mechanism. The effect from the improvement in the cyclical position has generated a lower contribution to the deviation of inflation from the target. The decelerating effect on inflation from the real exchange rate is expected to be present even during the first quarters of 2019, but this effect is expected to be downward after the second quarter.

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1 See Box No 1 in this Report: “Exchange rate and determinant factors”.
INFLATION EXPECTATIONS\textsuperscript{43}

Both enterprises and consumers’ expectations were revised upwards by 0.1 and 0.2 percentage point, respectively, in 2018 Q4. Notwithstanding this development, their level remains below the long-term average. Conversely, financial agents’ expectations were revised downwards in the same quarter. Based on the survey of financial agents, inflation expectations reduced on average by 0.1 percentage point for the three time horizons they were asked. Financial agents expect inflation to be 2.7% three years ahead.

\textsuperscript{43} The analysis on inflation 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 one year ahead.