FOREWORD BY THE GOVERNOR

The new information shows economic growth slowed down in the first half of the year and average inflation declined in the second quarter. The Bank of Albania expected these developments to trend in this direction, but the slowdown in the pace of growth resulted higher than our expectations.

Analysis of available information suggests that this dynamic reflects, to a large extent, supply-side shocks, whose effect is expected to be short lived. The Bank of Albania continues to expect the pace of growth to improve in the medium term. This improvement will contribute to the return of the economy to equilibrium and of inflation to target within this time horizon.

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Average annual inflation stood at 1.4%, against 1.6% registered in the previous quarter. From the perspective of basket composition, the decline in inflation reflected a decline in food inflation, a phenomenon that is present also in our trading partners’ economies. From the perspective of macroeconomic factors, the decline in inflation reflected the decline in imported inflation.

On a longer-term horizon, the low and undershooting inflation reflects a persisting insufficient level of domestic inflationary pressures - dictated by the still-incomplete utilisation of production capacities - and low pressures from imported inflation, dictated, to a large extent, by the still-appreciating exchange rate. The decelerating effect of these factors is expected to gradually fade over the next two years. The positive performance of the labour market and firms’ assessment for higher utilisation of production capacities support this expectation.

According to INSTAT data, the Albanian economy grew by 2.2% in the first quarter. This development reflects a significant slowdown in the pace of growth, compared to both the previous quarter and the same quarter in the previous year. The slowdown is mainly attributable to a drop in electrical energy production, due to unfavourable weather conditions. This factor had a negative effect of 1.6 percentage points on economic growth in the first quarter. Although not at the same intensity, the effect of this factor is expected to remain present during the rest of the year.

On the other hand, the main components of aggregate demand - consumption and private investments - continued to grow, the balance of external trade
worsened, also a result of the decline in electrical energy production, whereas the fiscal policy was on the consolidating side in the first quarter and on the easing side in the second quarter.

While not favoured by the tense political climate, consumption and private investments expanded in response to higher disposable income, the need to expand production capacities and favourable financing conditions.

The accommodative monetary policy has created a financial environment with low interest rates, and reduced risk premia, hence fuelling growth of credit, consumption and investments.

Interest rates on credit remained near historically low levels in the second quarter, enabling a further improvement of lending. The improvement is noted both in the acceleration of credit growth at 6.8%, and expansion of the base of this growth. Constant reduction of non-performing loans, the consolidation process in the banking sector, and the upward trend of demand have created premises for increasing lending in the future.

The exchange rate has shown slight appreciation trends over the summer months. In our judgment, this is a result of the seasonal increase in foreign currency inflows. The annual appreciation rate, however, has been on the decline and the decelerating effect that it generates on the economy and inflation is diminishing.

In line with these trends, the Bank of Albania deems that economic growth will remain in positive territory in the medium term, underpinned by favourable financing conditions and improved balance sheets of private agents. The drop in electrical energy production will lead to a temporary slowdown of growth during 2019. In our assessment, the volatility in electrical energy production does not have an impact on medium and long-term trends of economic growth or production costs. Therefore, they do not affect our assessment on the cyclical position of Albania.

The Albanian economy is expected to return to equilibrium in the next year, creating premises for faster increase in wages and domestic production costs. Inflation is expected to converge to target in the second half of 2021, underpinned also by the expected stabilisation of the nominal exchange rate. Compared to previous projections, supply side-effects and added uncertainties in the economy have pushed back the momentum for the expected return of inflation to target.

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Baseline scenario projections confirm the current monetary policy stance is adequate and evidences the need for a more accommodative stance of the monetary policy in the medium term. This scenario foresees that the normalisation of the monetary policy will start only in the presence of the consolidation of
positive development trends and the sustainable build-up of inflationary pressures. In accordance with these developments, the normalisation of the monetary policy stance is not expected to start earlier than the second quarter of 2020.

In parallel with the expected developments in accordance with the baseline scenario, the Bank of Albania evidences that the number of downside risks has risen and their probability has increased. These risks arise from both the external environment, with the euro area economy showing continuous slowdown, and the domestic environment, with political tension continuing to induce uncertainties and unexpected shocks to the exchange rate may shift it farther away from the equilibrium. The materialisation of these risks could prevent the convergence of inflation to our target, and require a response action by the Bank of Albania toward further easing the monetary policy stance.