

FOREWORD BY THE GOVERNOR

The new information analysed in this Report has resulted overall in line with our expectations. Economic growth continued to slow down in the second quarter, in line with the performance observed in the previous quarter, while inflation remained low, undershooting the target in the third quarter.

This performance was dictated mainly by temporary supply-side shocks. As such, it does not change significantly our expectations on economic developments in the medium term.

In our baseline scenario we forecast that the economic growth pace will be improving in the next two years, enabling inflation to converge to target within this time horizon. Against this backdrop, the current monetary policy stance is assessed as adequate.

In the third quarter, inflation averaged 1.4%, close to the values recorded in the previous quarter. The downward contribution of both non-food consumer goods and housing services on inflation was offset by the higher inflation of items in the category of services and durable consumer goods.

From the macroeconomic perspective, inflation has reflected the build-up of domestic inflationary pressures, and the fall of inflation rates in trading partner countries. Looking ahead, the Bank of Albania deems that the increase in wages and production costs, coupled with the stabilisation of the exchange rate, will create premises for inflation to gradually converge to target.

According to INSTAT data, the Albanian economy grew by 2.3% in the second quarter of 2019. Growth was driven by the expansion of public and private consumption, while net exports and investments were down.

Similar to the first quarter, the slowdown in the growth pace reflects the reduction in production and exports of electrical energy, the transitional effects of the gambling shutdown and the entry into the final stage of works in a large energy project. These effects will continue to be present in the second half of the year. Thus, the economic growth pace in this period is expected to be comparable with that of the first half of year, but to accelerate in the next two years.

The economic activity expanded in the second quarter, reflecting the low cost for financing consumption and investment, the improved balance sheets of economic agents, and the increased revenues from tourism. The combination



of monetary stimulus with fiscal consolidation and the strengthening of banking sector's soundness have provided a favourable environment for growth.

In particular, the domestic financial environment appears stimulating, in response to the monetary policy stance implemented by the Bank of Albania. The exchange rate appears relatively stabilised: the ALL/EUR exchange rate is closer to the equilibrium, while its fluctuations are dictated by seasonal factors. Risk premia in financial markets are low, and liquidity conditions appropriate. Interest rates on loans, deposits and government's securities are close to minimum levels, thus bolstering credit growth and stimulating higher consumption and investments.

Credit to private sector grew 7.5% on average in the third quarter. The acceleration of growth is attributable to both the expansion of demand and the improvement of bank credit supply. The latter reflects the on-going improvement of credit environment and the balance sheet of the banking sector, as shown by the drop of the non-performing loans ratio to 10.6%, as well as the increase of competition in the system, following the finalisation of consolidation in the banking sector. Regarding its composition, credit growth picked up on the back of a broad base, in terms of: currency structure; beneficiaries; and its destination. This is another encouraging signal suggesting an expansion of credit in the future.

The fiscal policy continues to maintain a consolidatory trend, but its intensity has been lower. This development reflects a faster increase of public expenditures vis-a-vis revenues, although budget deficit remains at low levels. The Bank of Albania continues to highlight the importance of strengthening public finances' soundness, through maintaining the focus on budget deficit control and furthering reforms to improve public finance management. The further expansion of aggregate demand has enabled a continuous increase of employment and decrease of the unemployment rate. The unemployment rate stood at 11.5% in the second quarter, recording a historical minimum level of this indicator. The increase of labour demand has created the premises for the rise of wages and production costs. According to INSTAT data, the average wage in the economy was up by 4.5% in the second quarter, continuing the positive trend started since 2017.

The Bank of Albania deems that economic growth will remain in positive territory in the medium term ensuring an increasingly fuller utilisation of production capacities. Projections in our baseline scenario suggest that the Albanian economy will return to equilibrium in the next year, creating premises for faster increase in wages and domestic production costs. Coupled with the expected stabilisation of the nominal exchange rate, they will help inflation converge to target in the second half of 2021.

Our baseline macroeconomic forecast scenario confirms the adequacy of the current monetary policy stance. This scenario predicts that the expansionary



monetary policy trend will be kept in the medium term. The intensity of the monetary stimulus is expected to be reduced in accordance to and conditional with the forecasts of a steady inflation increase towards its target. The normalization of the monetary policy will be gradual and –in any case – it is not expected to start before the second quarter of 2020.

In parallel with the developments expected in the baseline scenario, the Bank of Albania notes that downward risks to the forecasts remain present. These risks arise from both the external environment, with the Euroarea economy showing slowdown constantly, and the domestic environment, with the political tension continuing to induce uncertainties and potential shocks to the exchange rate may shift it farther away from the equilibrium. The materialization of these shocks would hinder and/or slow down the inflation's return to target, creating the premises for an increase of the monetary stimulus.

