Bank of Albania

QUARTERLY MONETARY POLICY REPORT

2020/II
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INTRODUCTION

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

In achieving this objective, the monetary policy sustains the stable and long-term growth of the Albanian economy, promotes financial stability and supports improvement in the overall welfare of 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 statistical and qualitative data available as at 24 April 2020.
The analysis of the economic and financial situation of Albania, the discussions of the possible development scenarios in the future, and the identification of the reaction strategy of the monetary policy were dominated by the current and expected impact of the Covid-19 pandemic on Albania.

The health emergency caused by the spread of Covid-19 pandemic and the measures taken by the public authorities to control it, in Albania and globally, posed challenges to: the economic and financial stability of the country; the soundness of enterprises and households’ finances; and the sustainability of the economic growth of Albania, both in the medium and long term.

The available information shows that Covid-19 pandemic will have a strong impact on all the economic and financial indicators of Albania.

Social distancing measures together with the heightened uncertainty have driven to an overall slowdown in almost all components of the aggregate demand: the export of goods and services; family consumption; and investments. In parallel, the temporary closure of some production and service activities triggered a further fall of output. This twofold shock, demand and supply, will be reflected in the downturn of the economic activity during 2020. Further, the drop in production is expected to trigger a fall of employment, increase of unemployment, decrease of household income and financial difficulties to firms.

The medium and long-term dynamics of economic development, in Albania, and globally, will depend on the duration of the pandemic.

In the positive scenario, a gradual reduction of social distancing measures during the second quarter, the economic activity - in Albania-, is expected to peak the slowdown in the second quarter, to continue to remain in negative territory in the next two quarters, and return to positive growth in 2021. This scenario forecasts a relatively stable inflation rate during 2020, and gradually converges to the target in the next two years. In this scenario, pandemic will have makeable traces, but transitional ones, on the economy and finances of the country. Above all, it will not affect the economic and financial equilibriums and the medium and long-term trends of the growth.

On the other hand, a potential extension of pandemic, beyond the third quarter, implies also a proportionally higher negative impact on the economic and financial situation of Albania.
financial indicators of the country.

The primary objective of public policies and of the public sector reaction should be to take measures for dealing with the emergency, and the establishment of premises for a rather rapid recovery of economic growth in the future. This will require, first, the safeguarding of monetary and financial stability of Albania; and second, the containment of damages on the production capacities of the country.

In this context, the fiscal policy has a primary role in tackling the situation. The allocation of necessary funds to deal with the health emergency, the social aid for families in need, and the fiscal measures to improve the liquidity situation of firms, are necessary measures to address the situation. The increase of public debt is an acceptable cost for maintaining the economic and financial equilibriums of the country.

The private business should be: flexible in adopting the new business models; prudential in managing the liquidity situation; and far-sighted in distributing fairly the costs, for keeping both the production and service chain functional.

On its side, the Bank of Albania has taken a complete package of measures to address the situation.

- The easing of monetary policy stance implemented by the Bank of Albania, through the cut of the policy rate to 0.5%, and the unlimited supply with liquidity to the banking system; by promoting the smooth operation of the financial markets; and by enabling the increase of the volume and decrease of credit cost to private sector.
- The presentation of easing measures in the field of banking regulation has encouraged the temporary postponing of the credit payment, with one quarter, hence improving the liquidity situation of enterprises and households and their chances to endure this situation.
- In parallel, we have facilitated the operational cost of electronic payment system, by responding to the increasing needs for this type of activity, and we have taken care for the normal supply of economy with cash.

The Bank of Albania has taken the needed timely measures. In their response, the financial markets continue to conduct their activity within the limits of normality, notwithstanding the upward demand of public sector for funds and the heightened uncertainty about the economic and financial future of the country.

Judging on the projections of the scenario for a quick end of the pandemic, the current monetary policy stance will remain accommodative throughout the forecast horizon. The uncertainty surrounding the forecasts for this time is considerably high. This uncertainty shows a relatively high probability that the future developments result on the downside of our expectations. In particular,
the downside risks arise from:

- The possible extension of pandemic beyond the second quarter.
- Creation of problems in monetary policy transmission mechanism, in the form of: increased interest rates and financing costs to private sector; worsened credit supply; strong fluctuations of the other financial indicators.

The materialisation of these risks might dictate a further easing of the monetary policy stance. In line with our contingency plans, this easing may take the form of non-conventional instruments, always in compliance with the reality and needs of the Albanian financial market and the legal framework that regulates the activity of the Bank of Albania.
Covid-19 is expected to severely hit both global and Albanian economies. Its swift spread and the severe social distancing measures will lead to a fall in both demand and output and increase of unemployment. Income of households and enterprises will decline, causing financial difficulties for a part of them and being accompanied, potentially, with longer negative impacts on consumption and investments.

Like in other countries, the economic activity in Albania is expected to shrink and unemployment to increase in the short run. With the end of health emergency, the economic activity is expected to be gradually improving. The time and speed of the economy recovery will depend, firstly, on the evolution of pandemic, and the end of the confinement measures. Also, the time and speed of the economy recovery will depend on: its impact on the monetary and financial stability of Albania; its impact on the enterprises’ soundness; and the reaction of economic agents after the end of the pandemic.

In the view of this situation, public authorities in Albania have increased the macroeconomic stimuli. In compliance with its legal mandate and framework, the Bank of Albania has undertaken a package of measures to: increase the volume and reduce cost of credit; increase liquidity injected in the banking system; and strengthen the financial stability at home. These measures complement the fiscal stimulus and together aim at mitigate the economic costs of pandemic, restrict the shock spread, and establish the premises for a swift recovery of the economy. Nevertheless, the situation remains dynamic, and the downside risks are dominant.

The Bank of Albania will continuously monitor the implications of pandemic spread in the economy, the performance of financial markets and the effectiveness of its measures. The Bank of Albania is willingness to use all the instruments available to mitigate the effects of this crisis.

Covid-19 pandemic is plunging the global economy into a deep and unprecedented recession. Pandemic spread and the measures undertaken to restrain it have had strong negative impacts on the economic activity and employment. The first effects were felt in markets, where prices index in capital market dropped considerably, risk premia were up, the functioning of some market segments became difficult and the commodity prices, particularly oil price, were down.
The IMF latest forecasts\(^1\) show the global economy is projected to contract by 3.0%, while the euro area economy by 7.5% in 2020. In particular, Italy and Greece, our main trading partners, are expected to suffer the sharpest contraction of the economy, by 9% and 10%, respectively. Overall, the forecasts of specialised institutions converge to a strong negative projection of Covid-19 in the first half of 2020, and an improvement of the global economic activity starting from 2021. Nevertheless risks remain on the downside and the uncertainty is high.

Against this shock, authorities worldwide have undertaking aggressively simulating policies. The introduced fiscal, monetary and financial packages vary from one country to another, both in size and employed instruments. Nevertheless, essentially, they aim at supporting households and firms to tackle the crisis and minimise the long-term costs in their economies.

Covid-19 pandemic will have a strong negative impact on the Albanian economy in 2020. This shock is the second successive one in the time frame of the last six month, after the earthquake of 26 November 2019. This earthquake was assessed to have caused economic damages and losses amounting to 7.5% of GDP\(^2\).

Social distancing, within the country and abroad, drove to a simultaneous drop of output (because of the temporary suspension of economic activities), demand (because of social, voluntary or mandatory social distancing), and in the income of households and firms (because of the fall in sales and increase of unemployment). Furthermore, the uncertainty about the duration of pandemic is expected to trigger hesitation to consume and invest, while the fall in foreign trade is expected to strongly hit the Albanian exports, particularly tourism.

The drop of output and aggregate demand will be reflected in a considerable economic downturn in the first half of year. Further, the performance will depend on the degree and speed of economic and social life normalisation in Albania, and in our trading partners.

Pandemic is expected to have a neutral impact on inflation in the short run. The domestic inflationary pressures are expected to trend downwards: the effect of downward demand is expected to be stronger than the supply’s one. In contrary, the external inflationary pressures are expected to be upwards, as the depreciating trends of the exchange rate are expected to offset the fall of inflation in our trading partners. Nevertheless, uncertainties in this assessment are high. They mainly relate with the impact of the simultaneous fall in both demand and supply on inflation, and with the performance of external inflationary pressures.

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\(^1\) The forecasts are taken from World Economic Outlook, April 2020.

\(^2\) See https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/albania_post-disaster_recovery_a_v9.0.pdf
The severe shock of the economy demanded for an immediate and extraordinary reaction of economic policies. A set of easing fiscal, monetary and financial packages are undertaken to minimise the costs of the shock on households, firms and on the Albanian financial system. In addition to the increase of expenses for the health system to fight COVID-19, fiscal packages aim at mitigating the economic and social costs to families in needs, and to provide liquidity to firms. The first objective is addressed through the implementation of the compensation scheme to cover a part of wages. The second objective is addressed through the extension of the payment of taxes, and through providing public guarantee for bank credits.

In line with its legal framework, the Bank of Albania has undertaken a package of measures to: increase the volume and reduce costs of credit; guarantee the necessary liquidity injected to the banking system, and support the financial stability. These measures consist in:

- **Reduction of the policy rate from 1.0% to 0.5%, on 25 March 2020.** In parallel, the overnight facilities corridor narrowed through the reduction of the overnight lending facility, at 0.9%. This measure aims at reducing the cost of new loans and reducing the existing loans servicing cost. In this way it eases the budget of households and firms, providing them with time and space to face the shock.

- **Increase of liquidity injection in the banking system**, through the adoption of operational strategy of the single price/variable amount auctions for the one-week liquidity injection. This strategy supports the smooth functioning of the financial market and the monetary policy transmission mechanism.

- **Encouraging the extension with one quarter of the loan payments for borrowers who are in temporary difficulties due to the pandemic.** This measure aims at addressing the temporary liquidity difficulties that economic units are experiencing.

- **Suspension, up to June 2020, of the dividend allocation by banks for the years 2019 and 2020, to further strengthen banks’ capital and their ability to finance economy;**

- **Removal of commissions charged on the transfers in national currency for on-line services, staring from 10 April 2020, to ease the conduction of electronic payments during the period of social distancing.**

The measures undertaken by the Bank of Albania to support economy and financial system complements the fiscal measures, which have and will have a primary role in addressing the situation. Together, they aim at minimising the economic costs triggered by pandemic, restricting the spread of shock, and creating the premises for a swift recovery of the economy after the pandemic is ended.
Once the pandemic risk is overcome and the social distancing measures will be mitigated, the economic activity is expected to recover. After the contraction in 2020, the economic activity is expected to pursue an upward trend in the next years.

The speed of economy recovery will depend on the scale of fulfilment of some preconditions.

- **First, safeguarding the monetary and financial stability of Albania.**
  The Albanian economy entered in this crisis with sound balance sheets of the banking sector, improved liquidity situation of enterprises and households, and improving indicators of public debt and foreign debt stability.
  The Bank of Albania deems that the relatively sound financial situation of the country prior to pandemic shock, and the safeguarding of the monetary and financial stability during the pandemic, enable a rapid recovery in the next period.

- **Second, containment of the damage on affected firms and sectors, and on the potential output of the country.** In this regard, the preservation of firms’ liquidity conditions is crucial, through both fiscal support and bank loans.
  We deem that the Albanian firms have space to face a shock which is limited in time, through: the increase of flexibility in production processes; the control of costs; and a rather fair breakdown of shock costs in the production and trade chain.

- **Third, safeguarding the stability of banking sector and its ability to supply economy with payment and credit instruments.** Both banking and financial systems have a key role in financing the private and public sectors as well as for the monetary policy pass through in the economy.
  We deem that the banking system is solid, with sound parameters of liquidity, capitalisation and profitability. Banks enjoy a solid position to carry out their functions as custodians of Albanians’ savings and intermediators of funds.

- **Fourth, swift recovery of global economic activity.** The increase of external demand for Albanian goods and services has a crucial role for the stable and long-term growth of the country.
  The Bank of Albania deems that the equal origin of the shock in Albania and in our trading partners implies that the exit from this shock will be relatively synchronised.

The recovery of aggregate demand is expected to be accompanied with the increase of employment, absorption of free capacities in economy and increase of inflation. The speed of inflation return to target will depend of the strength of economic recovery. Nevertheless, the uncertainty surrounding economic developments in the future is considerably high and downside risks remain dominant.
An optimist scenario assumes that the containment measures would be removed within the second quarter. Under this scenario economy would recover rapidly, providing for a positive economic growth in 2021, and the convergence of inflation to target within 2 years horizon. This scenario does not demand for considerable changes from the current stance of the economic policies.

In the more negative scenarios, restrictions will extend in time and the economic recovery will delay and slowdown. In this scenario, the drop of the economic activity, employment and revenue would be deeper by demanding for a higher fiscal and monetary stimulus.

The Bank of Albania will carefully monitor the implications of pandemic spread in the economy and in the monetary policy pass through, as well as it will analyse the effectiveness of its measures. The Bank of Albania is willingness to use all the instruments available to mitigate the effects of this crisis in the economy.

**BOX 1 RESPONSE OF PUBLIC AUTHORITIES TO COVID-19 PANDEMIC**

The COVID-19 pandemic is inflicting high and rising human costs worldwide, and the necessary protection measures are severely impacting economic activity. The economic activity has suffered the shock caused from the problems in the output chains, the lower demand for goods and services and the negative expectations for the future. This situation has created the premises for a global recession. The major part of countries forecast to undergo a sharp contraction of the economic activity during this year. International institutions deem that the established situation will cause much worse consequences than the global financial crises of 2008.

In these circumstances, public authorities in the major part of the world were obliged to intervene to mitigate the effects of the pandemic. These stimuli are of fiscal nature, and further of the monetary and macroprudential nature.

The fiscal measures are the most rapid and efficient way in supporting the economic activity. The fiscal policy allows targeted interventions, which provide for a channelled support to heavily affected sectors and to firms and households in difficulties. Fiscal measures implemented globally have varied from direct transfers of cash to households to whom it was impossible to carry out their profession or to be paid during pandemic, to the extension of the deadline for the payment of taxes, the removal of taxes or their reduction to sectors facing difficulties, the supply of government guaranties to lend firms facing temporary liquidity difficulties, etc. These measures provide an immediate help to the affected agents, and consequently are effective and indispensable to confine the impact of the crisis.

On the other hand, monetary policy needs a somewhat longer period, some quarters, to pass through across markets. The current conditions, globally, with low interest rates, provide for only a restricted space of action through the main employed instrument, the policy interest rate. The central banks which have had the space to reduce the policy rate did use this possibility. Anyway,
the economic activity situation needs additional measures, where banks have undertaken a set of other measures, like: the supply of long-term liquidity; asset purchase programme (QE) through the purchasing of commercial banks’ assets, corporate and government bonds. Also, some of them have applied the reduction of the mandatory reserve and have encouraged commercial banks to offer the extension of loans payments to households and firms being affected by the crisis.

Among macroprudential measures, the most implemented ones were the reduction to commercial banks of the obligation to hold capital buffers and the encouragement for restructuring and extension of the loan payments.

Also in Albania, the situation created by coronavirus outbreak and the restrictive measures to restrict movement and the closure of businesses arose the need for helping measures by the authorities. Fiscal policies undertaken in Albania have consisted in some aid packages to households and businesses.

In more concrete terms, the Government:
- granted a fund of ALL 6.5 billion to the employees and businesses that have closed their activity for the purposes of the undertaken containment measures;
- granted ALL 2 billion as a humanitarian aid, in food and clothes, to the vulnerable groups of the society;
- approved an aid package amounting ALL 7 billion, which provides the payment of salaries to: the employees in firms which have closed their activity; the employees who lost their jobs; and the employees in accommodative structures;
- allocated a fund amounting ALL 26.5 billion, or 1.7% of GDP, as a guarantee to firms applying for a loan to the banking system in order to handle the payment of salaries to their employees;
- extended the payments and the tax on profit to small and large entities up to the end of 2020;
- cancelled the obligation of the rent payment for April and May to small and medium-sized enterprises.

The Bank of Albania undertook a set of measures to guarantee ample liquidity in financial markets and to ease lending, by supporting the financial stability.

In March 2020, the Bank of Albania:
- reduced the policy rate by 50 basis points, to 0.50% the lowest historical level;
- narrowed the corridor for lending facilities, with the interest rate for the overnight lending facility and the overnight deposit facility, at 0.10% and 0.90%, respectively;
- adopted the operational strategy of the unlimited injection of liquidity in the system, through the conduction of single price-variable amount auctions for the weekly injection of liquidity;
- reduced to zero the cost of digital transfers, providing to clients the possibility not to go physically to banks’ subsidiaries;
- stopped banks to allocate the dividend for the years 2019 and 2020, in order to realise capital and encourage lending;
- called for the postponing of loan payments for households and enterprises being affected by the crisis, and undertook the temporary regulatory easing which favours its implementation.
### Table 1  Measures taken by government in selected countries

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<thead>
<tr>
<th>Country</th>
<th>Fiscal</th>
<th>Monetary and macroprudential</th>
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<tbody>
<tr>
<td></td>
<td>Cash transfers</td>
<td>Purchase of government securities</td>
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<td></td>
<td>Employment support</td>
<td>Liquidity supply</td>
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<td></td>
<td>Credit guarantees</td>
<td>Required reserve</td>
</tr>
<tr>
<td></td>
<td>Extension of tax payments</td>
<td>Credit moratorium</td>
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<tr>
<td></td>
<td>Policy rate</td>
<td>Capital conservation buffer</td>
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<tr>
<td>U.S.</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Euro area</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Czech Republic</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Romania</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Poland</td>
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<td>Hungary</td>
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<td>Serbia</td>
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<td>Croatia</td>
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<tr>
<td>Kosovo</td>
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<tr>
<td>North Macedonia</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>Albania</td>
<td>✔</td>
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</table>

Source: IMF.

Nevertheless the spread and effects of pandemic on the economy remain dynamic, unclear regarding the duration and size of these developing effects. Public authorities, while monitoring these developments, are willingness to take other measures and/or review the modalities of active measures, depending on them. Also, the Bank of Albania is continuously monitoring the situation and is willingness to employ every available instrument to support the economy and the financial system.
2. EXTERNAL ECONOMIC ENVIRONMENT

After a relatively positive period in the last quarter of previous year, global economy has experienced a sharp contraction in 2020 Q1. The spread of Covid-19 pandemic has disrupted the global economic activity. The restrictions on national and international mobility of people, disruptions of output chain, drop of the demand and the uncertainty about the future, have created a heavy economic environment, beyond the level of the 2008 global financial crisis. Expectations on the economic growth in 2020 remain negative for the major part of global economies. Expectations appear more negative in advanced economies compared with developing economies. The global economic activity is expected to record a rapid recovery of the growth in the next year, but risks remain on the downside.

Pandemic spread brought about a sharp fall in the main commodities prices, particularly in energy prices in international markets. Inflation rates declined in March. They are expected to remain low in the next quarters.

Financial markets are suffering the economic uncertainty. They have shown fall in the value of capital markets and movement of funds to more secured financial instruments, like long-term government bonds, bringing about a drop in yields.

Central banks and governments across the major part of countries have undertaken many easing monetary and fiscal measures to mitigate the impact of the pandemic and to safeguard the monetary and financial equilibriums.

2.1 GLOBAL ECONOMY

COVID-19 pandemic has dramatically affected global economic activity in the first quarter of year. The appearance of the virus in China, its rapid spread across the world, with a huge number of deaths, the quarantine measures and mobility restrictions, triggered large disorders in the global economic activity. This situation has created problems in the production chain, stoppage of consumption and investments, turmoil in financial markets and a fall of confidence. The first signals in labour market show a sharp increase of unemployment and problems with the financial soundness of businesses across all affected countries.

The spread of pandemic brought about a simultaneous drop in the demand and supply for goods and services, but the contraction of the demand for consumption items appears more rapid than that of output. This situation drove
to a reduction of inflationary pressures. This effect is expected to extend in the current year and in 2021. Fiscal and monetary authorities have taken various easing monetary and fiscal measures, to mitigate the strengthening of the crisis shock and establish the conditions to overcome the created situation.

Although, Covid-19 spread curve have peaked in the major part of large economies, the restrictions are still applicable in many of them. This situation has heightened the uncertainty about the future. The shock of this year is expected to be higher than that of the Global Financial crisis in 2008. IMF forecasts show that around 90% of countries in the world will experience a contraction of their activity in 2020. This contraction is forecasted to be sharper in advanced countries, and somewhat more faded in developing economies. Nevertheless, these forecasts are surrounded by high uncertainty related to the duration and intensity of the pandemic impact on the economy. For this reason downside risks remain dominant.

Financing conditions continue to be favourable for borrowers, as the major central banks have affirmed the monetary policy easing. The more optimistic expectations about the economic growth, being favoured also by the eased policy orientation of central banks have positively affected the performance of equity market and have favoured the moderate recovery of long-term yields.

![Composite Leading Indicator of GDP (left) and inflation (right) in major countries*](chart1)

**US Economy**

The economic activity in the US showed positive signs in the two first months of the year, but the outbreak of Covid-19 in March changed the situation. The implementation of social distancing measures drove to the contraction of consumer spending and suspension of production. The uncertainty about the future affected equity markets, which experienced a sharp fall in March. The
unemployment rate picked up sharply in March, by around 0.8 percentage point. Preliminary data show that this phenomenon is expected to deepen in April. Annual inflation rate recorded a slowdown in March, mostly affected by the prices in energy.

The US Federal Government and Federal Reserve (Fed) undertook a set of measures to contain the effect of pandemic. The Federal Government announced a fiscal easing package, including direct transfers for every citizen, while Fed cut the interest rate, restarted the quantitative easing program and launched a full range of programs aiming to increase liquidity in the financial system and to support the flow of credit to businesses.

**EURO AREA ECONOMY**

After a slowed growth in 2019 Q4, the economy in euro area was strongly hit by the spread of Covid-19 in the first quarter of 2020. Some of the largest economies in the European Union, like Italy and Spain, were among the first countries affected by pandemic in the period February - March. Then the pandemic spread very quickly across all euro area countries. The containment measures taken to restrict the movement of citizens brought to a halt consumption and production at home, while problems in industry production chain drove to the contraction of output. Annual inflation rate recorded a slowdown in March, mostly affected by the price in energy.

The European Central Bank, governments in European members and the European Commission has in place a set of easing fiscal and monetary measures, to minimise the negative impacts of pandemic spread and to create a foundation to support the economy in the second half of the year. Financial institutions forecast a contraction of the economy in euro area, across all its members, in the current year. Further, under the assumption the pandemic will...
The economies of Albania’s two main trading partners, Italy and Greece, are suffering a hard economic situation. Italy was the first spot of Covid-19 spread and suffered large human deaths. The restrictions on mobility undertaken at the beginning of March are still applicable. Preliminary data and available forecasts suggest that the Italian economy will contract considerably in the current year, by suffering the consequences of the economic activity stoppage. Greece also undertook restrictions to businesses and citizens since March 2020. This situation, in addition to the lack of income from tourism during the year, is expected to affect the sharp contraction of the economic growth in 2020. Inflation slowed down in both countries, while unemployment data for March are still unavailable.

**REGIONAL ECONOMIES**

Regional countries recorded positive growth trends in the fourth quarter of previous year, in terms of output growth and in terms of the direction of movement of economic balances. Nevertheless, regional economies will suffer the consequences stemming from Covid-19 spread, with the reduction of the domestic demand and the fall of the external demand for goods and services. In particular, as small open economies, the fall in foreign currency flows -due to the drop in exports, the disruption of foreign investments, and the slowdown of remittances- may trigger problems in the balance of payments.

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3 The main trading partners outside the European Union (Kosovo, North Macedonia, Serbia, Turkey).
Economy of Kosovo accelerated the growth pace in 2019 Q4, supported by the strong increase of government spending and the expansion in investments, consumer spending, and in the exports. In the same time horizon, the growth of the economic activity in Serbia was supported by the strong increase of investments, improvement of consumer and government spending. Economic growth in North Macedonia was supported by the positive performance of consumer and government spending, and the strong increase of investments, while the slowdown of imports affected negatively the growth pace. The economy of Turkey accelerated considerably the growth pace in the last quarter of 2019. This performance was fuelled by the increase of consumer and government spending and the sharp contraction of imports.

Table 2 Economic indicators for countries in the region

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<tr>
<th></th>
<th>Annual change of GDP</th>
<th>Annual inflation</th>
<th>Unemployment rate</th>
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<td></td>
<td>2019 Q4</td>
<td>March 2020</td>
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<tr>
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<td>Turkey</td>
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<td>11.8</td>
<td>13.8**</td>
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<tr>
<td>Albania</td>
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<td>11.2</td>
</tr>
</tbody>
</table>

Source: Respective statistical institutes.

2.2 COMMODITY PRICES IN GLOBAL MARKETS

Prices of main commodities fell considerably in March, after the upward performance in the last two quarters. Covid-19 spread and the lockdown of the economic activity in the major part of the world have brought global demand to a halt and are extracting a sizable toll on the markets of commodities and energy. Also, the uncertainty surrounding the future has restrained investments and hit the demand for metals. Meanwhile the food price index recorded a slight increase in annual terms, but by slowing down the growth pace compared with the previous period. Energy price index registered a sharp annual contraction (-47.4%). The metal price index recorded a double-figure annual contraction in March.
The Brent oil price averaged USD 62.5/barrel in March, recording a sharp annual contraction of -41.6%. This impact reflects the disagreements in discussions among OPEC+ countries, which due to the failure to find a consensus regarding the quantity of gross produced oil, started a war of prices among them, with Saudi Arabia which reduced drastically the oil prices. This situation, in addition to the fall of the global demand for oil, is expected to affect the keeping of the gross oil at low levels in the next period.

2.3 GLOBAL FINANCIAL MARKETS

In response to the economic shock, Fed and the Bank of England reduced by 1.50 and 0.50 percentage points, respectively, the key interest rates in their meetings of March. Meanwhile, the ECB and the Bank of Japan maintained the interest rate on the main refinancing operations, unchanged, at 0 and -0.1%, respectively.

In global financial markets, the yields on government securities were considerably volatile. Overall, they have trended downwards since January, related to the positive trends of global economy development prior to the spread of pandemic. The spread of Covid-19 changed this trend: on one side, the yield of countries being perceived as stable from the fiscal side experienced an increase of the demand and decrease of yields; on the other side, yield on securities of countries with fiscal consolidation needs...
performed at the opposite direction. However, the actions of the main central banks (ECB, Fed, etc.) have helped to decrease and mitigate tensions created in markets. Interest rates on money market short-term instruments in euro area further decreased, in line with ECB’s monetary policy communication. They remain at negative levels.

Euro continued to depreciate against US dollar in the first three months of 2020. This trend has mainly reflected the differential in the monetary policy stance followed by these two economies. In the first quarter, the euro was traded for 1,138 US dollar, depreciating by 0.4% from the previous quarter and 2.9% lower from the previous year.
The activity of financial markets in Albania continues to be within the limits of normality, although the indicators of uncertainty, risk and volatility are upward. The stress, with which the real economy is faced, due to the pandemic, has not yet affected the financial market operations.

Before the situation caused by Covid-19, the performance of financial markets was calm, characterised by normal activity volumes, low interest rates and contained risk premiums. Monetary and financial conditions were adequate for boosting economic growth and for the return of inflation to target.

With pandemic spreading, the foreign Exchange market experienced a strong but short-lived shock in March. Meanwhile, other market segments are relatively calm. Yields on securities increased, mainly on the short-and-medium term segment. Interest rates on loans and deposits continued to fluctuate around their lowest levels, but banks are being more prudent when granting loans.

The extension of shock or the increase of its intensity would create premises for increased fluctuation in financial markets. As the country’s monetary authority, the Bank of Albania will remain attentive to react in a timely manner and with the right instruments, to mitigate them.

3.1 FINANCIAL MARKETS

Interest rates in the interbank market remained low in the first quarter of this year, while volatility indicators appear at minimal levels. The latest decline in the policy rate was immediately reflected in the interest rates of money market. The interest rates spread of the interbank market with the policy rate remains at minimum level. The financial market seems to have absorbed increased pressures on liquidity, supporting the stability of interest rates. One and seven-day maturities continue to dominate the transactions profile of banks, where the share of volumes is in favour of the latter.

The Bank of Albania continued to conduct regular open market operations by injecting liquidity of one-week maturity. In addition, inverse agreements with a 3-month maturity have been used. The amount of liquidity injected in this period was the same to the amount injected in the previous quarter, whereas interest rates in auctions stood close to the policy rate.
The Bank of Albania changed the form of the auction used for liquidity injection, switching to liquidity injection operations at fixed and unlimited price. In recent auctions, banks’ demand for funds increased.

**DOMESTIC FOREIGN EXCHANGE MARKET**

The Albanian Lek appeared relatively stable against foreign currencies in the first two months of the year and the first half of March. The euro/lek exchange rate averaged at ALL 122.4, close to the average level of December. The annual appreciation of lek in this period was about 1.9%, slightly higher than the appreciation observed at the end of the previous year.

With Coronavirus Covid-19 spreading, the foreign exchange market experienced a strong and unusual shock in the last ten days of March. Driven by the uncertainty of market agents, trade volumes reduced, margins between quotations for currency purchase and sale expanded, lek depreciated sharply and exchange rate volatility increased. By the end of March, lek depreciated about 6.6% against euro. The euro/lek exchange rate increased from 122.89 to 131.06 in less than two weeks. Regardless of its strength, this shock was short-lived. In April, the foreign exchange market gradually normalised, quotations’ spreads are narrowing, volatility decreased, and lek regained about 80% of its lost value at the end of March. Moreover, there are no market positions in purchase or sale by market actors, nor one-sided expectations on the short-term exchange rate perspective. The current exchange rate, 125 eur / lek, is close to the average level of April in the previous year.
Similar shocks, as a result of the spread of Covid-19 pandemic, were observed in all countries of the region that use free floating exchange rate regimes (Czech Republic, Hungary, and Poland). The foreign exchange market of each of these countries reacted similarly, regardless the fact that the size and the duration of the shock is not the same. In particular, the depreciation rate of the respective currencies depends on the profile of the external sector of each country’s economy. Countries with high levels of foreign portfolio investment have suffered the immediate withdrawal of capitals from investors as the result of Covid-19 spread. Meanwhile, the economy of exporting countries is damaged due to the temporary cessation of production and trade in the framework of restrictive measures to prevent the spread of the virus.
The USD/ALL rate was stable in January, close to the levels of December, about 110.0 ALL/USD. Afterwards, the value of the US dollar has been relatively volatile, reflecting its fluctuations in the world (national) market.

In average terms, in February and in the first 18 days of March, the US dollar was 111.9 ALL/USD and 109.7 ALL/USD, respectively. The performance of the US dollar in the country also reflected the shock on the foreign exchange market at the end of March; the USD/ALL rate increased to 118.8 ALL/USD, with lek depreciating by 8.2%. During the second 10-days of April, it fluctuated around 115.3 ALL/USD or about 4.3% higher compared to the previous year.

In nominal effective terms the performance of lek in the first quarter of this year slightly appreciated compared to the last quarter of the previous year, by 0.4%. The effective annual appreciation of lek increased this quarter, to 2.8% from 1.7% in the previous quarter, reflecting at the same extent the appreciation of lek against euro and the Turkish lira. Similar performance was shown by the effective real exchange rate; the real annual appreciation was 2.2% in the first quarter, from 1.0% in the last quarter of the previous year.

**PRIMARY MARKET**

T-Bills and bond yields in the primary market trended upward. The 12-month bond yield slightly increased in the majority of the auctions over the past two months.

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*The nominal effective exchange rate (NEER) is calculated against the currencies of Albania’s 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 renmibi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renmibi 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 bid-to-cover ratio in government debt securities auctions was downward during the recent months\(^5\). In early April, the government issued a 2-year bond in euro, and the yield has increased since the last issuance of this instrument\(^6\). Bond yields followed the same trend as the 12-month bonds, showing an upward trend that has been strengthening in March and April. This increase was more pronounced in the short- and medium-maturity.

The increase in yields reflected the government’s increased demand for financing as a result of fiscal measures taken to prevent the spread of Covid-19. Meanwhile, the reduction of the policy rate by the Bank of Albania had a greater impact on curbing the upward trend of yields rather than reducing them.

![Chart 10 Yields in the primary market*](image)

*The chart includes auctions conducted as at 24 April 2019. Source: Bank of Albania.

### 3.2 Deposit and Credit Interest Rates and Financing Conditions

The average interest rate on new loans in lek in the first quarter (6.2%) was close to the level of the last quarter of the previous year (6.3%), but slightly lower compared to the previous year. The monthly dynamics show that loan interest rates increased in March - after decreasing in January and February - mainly for short-term maturity to enterprises and for mortgage loans to households. In a broader time-horizon, loan interest rates followed a downward trend since the last year, mainly driven by the interest rates of loans to enterprises. Decrease of credit interest rates to enterprises has mainly reflected the performance in the liquidity loans category. This category showed a downward trend during this period. Interest rates of loans to investments are also downward, albeit more contained. Regarding loans to households, interest rates decreased in

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\(^5\) The bid/cover ratio for T-bill and bond auctions realised in this period was 1.2 from 1.5 in the last quarter of the year, and 1.7 in the same period of the previous year.

\(^6\) The yield on the 2-year bond in euro was 1.96%, from 0.80% in the last auction, in August 2017.
particular on mortgage loans\(^7\), meanwhile interest rates to finance consumer loans showed a volatile performance. The differential of the interest rates of loans in lek to loans in euro loans has been narrowing, mainly reflecting the decrease in the interest rates of loans in lek.

![Chart 11 Interest rate on new loans in lek and euro, 6-month moving average](image)

The average interest rate on new loans in euro during this quarter (4.1%) was close to that of the previous quarter (4.2%) and the average of 2019. During the quarter, interest rates showed an upward dynamics in January and March. The analysis by customer shows that interest rates slightly decreased for businesses, for both, liquidity and investment. Regarding loans to households, the increase of interest rates to mortgage loans was offset by the decline of interest rates to consumer financing.

![Chart 12 Interest rates on new deposits in lek and euro](image)

\(^7\) The average interest rate on mortgage loans in lek in 2020 Q1 and in 2019 was 3.5%, while in 2018 it was 3.7%.
Average interest rate on new time deposits in lek continued to hover around minimal values. The average interest rate was 0.75% this quarter, roughly the same as the values in the last three quarters. By maturities, the performance of interest rates of over one-year-maturity appears more volatile. Interest on new time deposits in euro continued to record minimal values and continued to further decrease this quarter, at 0.11% from 0.14% in the last quarter of last year. This decline was affected by interests with over 1 year maturity.

**NON-PRICE TERMS AND CONDITIONS OF LOANS TO ENTERPRISES AND HOUSEHOLDS**

Banks’ terms and conditions of new loans to enterprises remained unchanged during 2020 Q1. Loans price related terms and conditions appear to offset non-price terms and conditions, which are more tightened compared to the previous quarter. Thus, reflecting the uncertainty caused by the Covid-19 pandemic, banks reduced the size of loans to enterprises, added new terms and conditions to loan agreements, and reduced the maximum loan maturity to enterprises in 2020 Q1. The only factor to have had a positive impact on lending conditions is the reduction of commissions applied to loans.

The overall terms and conditions of loans to individuals were tightened in the first quarter of the year, based on two of the factors that complement the set of non-price elements of loan. Thus, the increase in commissions along with the reduction of the size of loan determined the tightening of the overall terms and conditions of loans to households, while the other factors remained the same as in the previous quarter.

The Covid-19 pandemic and the measures taken to control its spread will affect the Albanian market and financial sector. Measuring the reaction and the resistance rate from the shock from the financial sector offers ample interest, for two important reasons.

Firstly, given the speed of information processing and the high frequency of trading, the performance of the financial market provides preliminary information of the possible effects of the shock on the economy.

Secondly, the financial system can mitigate or boost shocks in the real sector of the economy. A sound financial system helps cope with the shock, through liquidity support, as well as through covering a part of the shock’s financial bill. In contrast, a weak financial system can enhance shocks, through the withdrawal of liquidity and funds from the real sector.

Although there are no previous experiences of a crisis of this magnitude, presented below are the implications that the situation created by Covid-19 may have on key financial indicators.

(1) Increase of yields of government securities and other interest rates
Revenues slowdown and fiscal measures for coping with the situation imply the increase of need to borrow in the domestic market. This applies pressure on yields to rise, a phenomenon that was observed in the recent auctions in the primary market, and may be followed by increase of other interest rates. Thus, increase of government’s demand for financing can put pressure to reduce financing the private sector, through a mechanism, namely crowding out (or exclusionary effect).

Based on the government budget review (March-April 2020), the majority of the new financing needs for supporting the economy in the face of the pandemics are expected to be covered by the international market, through both, soft
loans and grants from international institutions, as well as the issuance of a Eurobond. As a result, the pressure on yields in the domestic market is expected to be contained and the access of the private sector to loans will remain open.

However, the impact of increased borrowing of government in the domestic financial markets as well as the liquidity performance of the banking sector, remain crucial for the monetary policy transmission mechanism. For this reason, the Bank of Albania will be monitoring the situation, ready to intervene with its instruments, to avoid any issues in the monetary policy transmission mechanism.

(2) Fluctuations in the foreign exchange market
The spread of Covid-19 pandemic in Albania shocked the foreign exchange market during its first days, which however, turned out to be short-term. This shock, similar in all countries of the region that implement a free floating exchange rate regime, is evidence of the immediate reflection of uncertainties and major events such as the current situation, in the financial markets.

In view of the future, in the absence of unforeseen shocks, the exchange rate risks appear relatively balanced. The economic crises caused by Covid-19, hit both the demand and supply of goods and services in the economy. This is expected to be reflected in the simultaneous reduction of demand and supply for foreign exchange. The net effect of the exchange rate will depend on the significant dominance of one over the other.

The Bank of Albania has implemented and will maintain a free floating exchange rate regime. In this context, the exchange rate will continue to be freely determined in the market, in line with the demand and supply ratio of foreign exchange. The free floating exchange rate offers an automatic mechanism for dealing with shocks in the foreign sector of the economy, thus enabling flexibility in pursuing a monetary policy aimed at mitigating internal shocks. However, the Bank of Albania will remain aware against exchange rate fluctuation, aiming to avoid rapid, large and unfavourable fluctuations, which do not reflect the foundations of the Albanian economy and which may have negative consequences on the country’s monetary and financial stability.

(3) Lending performance
Lending to the economy is a key function of banks, as well as the main channel through which they affect the activity of the economy. The immediate cessation of economic activity has caused liquidity problems in some enterprises and has been accompanied by increase of unemployment; consequently it has affected the ability of bank customers to repay loans. To address this struggle, since the beginning of the pandemic, the Bank of Albania decided to postpone the payment of loan instalment to enterprises and households in difficulty due to the situation, with at least three months.

However, further extension of pandemic prevention measures will lead to the further deterioration of real sector balance sheets, increased credit risk and may lead to a decrease in lending appetite from the banking sector. Likewise, the big consequences that Covid-19 pandemic had on the international economies and markets, may lead to a tightening of lending policies dictated by parent banks to some foreign capital banks in Albania. The results of the bank lending survey show that the increase in uncertainty has contributed to the strong decline in credit demand as well as the tightening of standards.
The current measures taken by the government for the provisioning of a state guarantee and preferential interest rates for lending to enterprises are necessary instruments to mitigate the risk and to encourage banks’ willingness to lend. The escalation toward the negative direction of the situation may require their further expansion.

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The continuous structural improvements during the recent years in our banking and financial sector have strengthened the soundness parameters and increased resilience to shocks. So far, the effect of the pandemics on Albanian financial markets has been tangible, but low and bearable thanks to the measures taken. However, the Bank of Albania will continue to monitor the performance of financial markets and monetary indicators, aiming to respond in a timely manner and with the appropriate instruments, in the interest of meeting its price stability objective and in the interest of promoting financial stability in the country.

FINANCING TO PUBLIC SECTOR

The fiscal deficit in 2020 Q1 was about ALL 2.2 billion. Its financing was carried out through the issuance of government securities in the domestic market. During the first three months of the year, borrowing in the government securities market increased by about ALL 3.7 billion in treasury bills and ALL 7 billion in bonds. This borrowing enabled the increase of government liquidity by about ALL 4.9 billion and the reduction of net foreign borrowing by ALL 3 billion, in the first quarter of the year.

The borrowing structure in the securities primary market was similar to that of the last year. Commercial banks continued to finance most of the fiscal deficit from domestic sources (about 93%). The total portfolio of government
securities owned by commercial banks was about 59% at the end of 2020 Q1. Households did not expand their portfolio into government securities, maintaining more or less the same stock as at the end of the previous year. The structure of the primary market seems to be consolidated from the strategy pursued by the government since July 2018. Its main aim is the market’s development for benchmark securities, which intends to serve as a stimulus for the development of the secondary market in the future.

### 3.3 CREDIT TO THE PRIVATE SECTOR

Lending activity slowdown its growth rates in the first quarter of the year, increasing averagely by 7% compared to 7.8% in the previous quarter. In line with the performance of the economic activity, this slowdown reflected the lending contraction in March, which lowered the annual growth rate of credit to 6.4%. At the end 2020 Q1 the credit ratio for the private sector to GDP increased by 38.1%, about 1.4 pp higher than the level at the end of 2019.¹⁰

The slowdown of lending in March was observed in all categories, but it was more pronounced in the portfolio of loans denominated in foreign currency in and loans to households. The slowdown in growth rates has mostly reflected a strong decline in demand, especially in the segment of households. In this

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⁸ Since the beginning of the issue of the benchmark bond, in July 2018, government borrowing increased mostly due to this type of instruments. For 2018, they were 5-year bonds, whereas in 2019, 3-year bonds were also added.

⁹ As a result of the situation created by the COVID-19 pandemic, on the last day of March, lek depreciated by 6.5% against the two main currencies, the euro and the usd, compared to the end of February. In order to analyse the real developments of March, the credit and other monetary indicators that are analysed below are adjusted for this effect. As before, credit data are also adjusted for loan write offs.

¹⁰ The significant increase in the ratio of credit and deposits against GDP at the end of 2020 Q1 reflects the projections for contraction of economic activity in this quarter, as well as the significant effect that the depreciation of the exchange rate showed at the end of the March.
survey, banks stated that they have tightened the standards, which is expected to be more obvious in the second quarter of the year. However, from a longer-term point of view, it is noted that low interest rates and favourable financial conditions have consistently supported lending in lek, pointing to a more balanced foreign currency structure of the loans portfolio.

After increasing by 7.7% for the first two months of the year, loan portfolio to enterprises slowed down its annual growth rate at 6.2% in March. This slowdown has reflected lower credit growth rates for liquidity (2.4%). On the other hand, loan to investments maintained high growth rates of 9.3%. March developments indicate that monthly contraction of loan portfolio to enterprises has been mainly in liquidity loans, a decline which is partially offset by the use of enterprises’ deposits in banks.

Loan to households followed a positive trajectory until February 2020, when the annual rate of this portfolio increased by 8%. In March, this portfolio shrank and its annual rate slowed at 6.8%. However, the growth of this portfolio during the first quarter remains similar to that of end-2019. Measures taken to prevent pandemics appear to have contributed to the slowdown of annual growth rates, of both home purchase loans (6.9%) and consumer loans (6.7%). Based on the results of lending activity, the slowdown in credit growth rates of loans to households reflected the significant decline in loans demand from households and the tightening of their standards. The decline in demand and supply for loans from households reflected the increased uncertainties about developments in the real estate and labour market, decline in consumer confidence, and low willingness of banks to accept risk.
3.4 MONEY AND DEPOSITS IN THE ECONOMY

Monetary supply in the economy is stable. M3 aggregate registered an average annual growth of 4.4%\(^{11}\) during the first quarter. On the assets’ side, money creation in the economy is driven by funding in monetary assets, mainly in domestic currency, of the private and public sector. The public sector has supported the expansion of the money indicator in lek, aggregate M2, which recorded an average annual growth of 3.9%. On the passives’ side the structure of the monetary measure reflects the partial shift towards long-term instruments, i.e. deposits with over-2 year maturity (which are not included in the calculation of monetary aggregates)\(^{12}\), and the increase in the share of demand deposits and current accounts. Thus, the liquid aggregate, M1, marked an acceleration of growth rates by an average of 9.4% in the first quarter.

The performance of this indicator was most affected by the increase of the amount of currency outside banks, especially in March. The demand increase for liquid assets is in line with the increase of short-term consumption during the situation created by Covid-19. The ratio of the amount of currency outside banks to M2 aggregate was 38.3%\(^{13}\) in March, similar to the ratio recorded at the end of the previous year.

The total stock of deposits in the banking system expanded averagely by 3.9% during the first quarter of the year\(^{14}\). As a ratio against GDP, deposits at the end of March are estimated at 73.6%, about 2.8 percentage points higher compared to the end of the year. Performance by currency confirms the steady increase of deposits in lek, averagely by 5.4% in the first quarter. In absolute terms, they increased by about ALL 10 billion, mainly from households’ deposits. Foreign currency deposits registered an average annual growth of 3.1%. Their stock shrank compared to the end of the year, a decrease concentrated in March. This performance partly reflects the reduction of enterprises’ deposits, which, in the face of the situation created by Covid-19, used their funds to finance the activity. The contraction has also affected the households’ deposits in foreign currency, in February and March. The time structure of deposits has continued to shift towards the liquid component, where the ratio of demand deposits to total stock is 47.8%. Deposits with over-two-year maturity increased in January and February, but remaining unchanged in March. At the end of the quarter, they constituted around 13.4% of the total stock of deposits.

\(^{11}\) In nominal terms, the M3 aggregate increased by 6.8%, influenced by exchange rate fluctuations as a result of market uncertainties related to the global Covid-19 pandemic.

\(^{12}\) Adjusted for deposits with over-two-year maturity, the growth of the M3 aggregate in the first quarter of the year results is 6%.

\(^{13}\) The ratio of currency outside banks to the adjusted M3 indicator for deposits with over-two-year maturity and investments in government securities registers a lower level, at 27.5%.

\(^{14}\) In nominal terms, deposits increased at 6.4%, reflecting the effect of the depreciation of the exchange rate during this period and at the same time the structure of deposits in the banking system, where 50% of their stock consists of deposits in foreign currency, mainly in euro.
Chart 18 Monetary Indicators

Source: Bank of Albania
The Albanian economy has been in a positive development trend during the recent years, despite the fluctuations in the growth rate caused by various shocks of demand and supply. This positive trend is reflected in the trend of employment growth and decrease of unemployment rate, increase of capacity utilization rate of businesses, increase of wages and income for Albanian households, the gradual strengthening of domestic inflationary pressures, as well as in the improvement of the sustainability indicators of external debt and public debt. The positive dynamics of the economy was supported by the stimulating monetary environment and has been fuelled by the upward lending of the banking sector.

However, the Albanian economy experienced two strong shocks, during a short period of time- the last two quarters. The earthquake that struck Albania on 26 November 2019 was followed by the spread of Covid-19 in March and by the coercive measures taken by the public authorities to curb its spread.

The still emerging pandemic has faced the economic activity with a difficult challenge. In the short term, this challenge will be accompanied by a significant decline of economic activity, increase of unemployment, as well as financial difficulties for Albanian enterprises and households. In response to that, public authorities have taken several monetary and fiscal easing measures, to help and cope with the current situation.

Assuming that the pandemic will be under control within a reasonable time horizon, its impact on economic indicators and inflation will be temporary. In this case, the positive outlook for the country’s development in the medium and long term would not be damaged. Prolonging the effect of coercive measures will increase more than proportionally the impact of pandemics on the economy.

The duration and intensity of the health emergency generates increased uncertainties on macroeconomic projections.

However, economic, monetary and fiscal policies must remain accommodative in the short-and-medium term.
4.1 INFLATION

Average inflation of the first quarter was 1.6%, standing 0.3 percentage point higher compared to the previous quarter. Inflation had an upward trend, recording 1.5% in January, 1.2% in February and 2.1% in March. Increase of inflation in March had a defining role in the average inflation this quarter. This increase was influenced by the unusual situation in the goods and services markets, as a result of measures taken in the context of the fight against the spread of pandemics.

Inflation growth in March was mainly determined by the increase of food products’ price, which accounted for 85% of the headline inflation rate. Commodity prices in foreign markets, and in particular oil prices, as well as inflation in EU countries, fell sharply. However, weak inflationary pressures from import prices failed to be transmitted to domestic prices, due to the blocking of the activity of many sectors of the economy. The fuels sub-category was the only one that experienced decrease of inflation, as a result of the fall in the oil price across the global market. However, the rise of prices was not reflected in the prices of other goods, especially services.

According to the basket categories, the prices of “Unprocessed Foods” were main contributors to the inflation of the first quarter of the year. This behaviour was accentuated in March, when the monthly inflation if this category recorded a rate of 3.7%. Consequently, the annual contribution of this category reached 1.4 percentage points, from 0.6 and 0.5 pp in January and February, respectively. The increase in this category was driven to a considerable extent by the effect of the measures taken against the pandemics, which not only caused imbalances between supply and demand for these products, but also increased the difficulty of trading them.
The category “Processed foods” experienced upward rates of annual inflation. Its inflation contributed by 0.1 pp higher to the headline inflation compared to the previous quarter. The most significant growth happened in the sub-categories “bread and cereals”, “milk, cheese and eggs” and “sugar, etc.”

The category “Non-food consumer goods” contributed with declining values in March compared to the other two months of the quarter (-0.1 percentage points). This performance reflected the significant drop in oil prices in foreign markets, which also affected the domestic fuel market, but to a lesser extent than abroad.

The prices of other more stable components of inflation, where are included the prices of services, housing and durable consumer goods also had a lower contribution to the inflation rate compared with the previous quarter (0.4 from 0.2 percentage point). The increase in contribution came entirely from the ‘housing-rent’ category, by 0.2 percentage points. The category “services” has contributed slightly to headline inflation, as in the previous quarter. Durable consumer goods have continued to contribute positively to headline inflation; however this impact has been almost negligible as well (0.1 p.p.).

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

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<td>Processed food</td>
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<td>0.4</td>
</tr>
<tr>
<td>Bread and grains</td>
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<td>1.3</td>
<td>0.9</td>
<td>1.1</td>
<td>1.0</td>
<td>0.9</td>
<td>1.3</td>
<td>0.8</td>
<td>0.7</td>
<td>0.8</td>
<td>0.8</td>
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<tr>
<td>Fruits</td>
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<td>0.3</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
<td>0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.3</td>
<td>0.0</td>
<td>0.1</td>
<td>0.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Vegetables</td>
<td>0.9</td>
<td>0.7</td>
<td>0.7</td>
<td>0.6</td>
<td>0.2</td>
<td>0.9</td>
<td>0.9</td>
<td>1.5</td>
<td>1.5</td>
<td>0.8</td>
<td>0.6</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Services</td>
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<td>0.2</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>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Goods with regulated prices</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
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<td>0.0</td>
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</tr>
<tr>
<td>Water supply</td>
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<td>0.2</td>
<td>0.2</td>
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<td>0.0</td>
<td>0.0</td>
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</tr>
<tr>
<td>Housing lease</td>
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<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.3</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.0</td>
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</tr>
<tr>
<td>Non-food consumer goods</td>
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<td>0.2</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.2</td>
<td>0.1</td>
<td>0.0</td>
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</tr>
<tr>
<td>Fuel</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Durable consumer goods</td>
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<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>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Consumer Price Index (annual change, %)</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>
<td>1.6</td>
<td>1.4</td>
<td>1.3</td>
<td>1.3</td>
<td>1.6</td>
</tr>
</tbody>
</table>

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

15 The prices of some of these goods and services, due to the inability to gather data, have not been updated for March. Their indices are the same as those of February.
4.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The positive development trend was hit hard by the earthquake that struck Albania on 26 November and the Covid-19 pandemic.

In the short-term horizon, Covid-19 is expected to negatively impact all components of aggregate demand: household consumption, investment and exports, being only partially offset by government spending. Covid-19 is also expected to negatively impact almost all sectors of the economy. However, the negative impact will be more concentrated in the manufacturing sectors oriented toward export and the service sector enterprises directly affected by the social distancing measures. On the contrary, the agricultural sector, construction and certain sub-sectors of the services sector are expected to be affected less. This situation will be accompanied by decrease of employment, increase of unemployment, and financial difficulties for enterprises and households.

In the medium-and-long-term, the dynamics of aggregate demand, production and economic growth will depend on the speed of normalization of the situation after the end of pandemics and the effects it will have on the economic and financial stability of the country, on the soundness of the Albanian enterprises and households, as well as on the recovery speed of foreign demand.

In our baseline scenario, we assume that the situation will gradually normalize after the second quarter; economic activity in Albania is expected to increase gradually over the next two years. However, uncertainties concerning this projection are high.

4.2.1 GROSS DOMESTIC PRODUCT BY SECTOR

The information available from the indicators of the real economy does not yet fully reflect the developments in the economy related to the situation created by the spread of pandemics in March 2020. The decline of the confidence and of the capacity utilization rate in the manufacturing sectors, as well as lower consumer confidence during the first quarter, suggest that the pandemics will significantly halt the economic activity.

To help prevent the spread of Covid-19, several activities of the service sector, mainly related to the retail trade of non-food items, bars, restaurants, commercial centres, art and leisure/entertainment and personal care, were

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16 Performance of GDP and gross value added by sector is analysed in terms of real annual changes. The analysis relies on the latest GDP data according to the output method for 2019 Q4, published by INSTAT on 27 March 2020. The differences between the sectors’ growth rates of this publication and those analysed in the Monetary Policy Report 2020/I are the result of the series’ review.

17 According to the order of the Minister of Health and Social Protection, No. 193, dated 20.3.2020, from 20th of April, a part of the enterprises, such as the retail sales of non-food items, were allowed to open their activity. Bar-restaurants, entertainment, personal care and commercial centres continue to remain closed.
closed in March 2020. Also, despite the government support through two financial packages\textsuperscript{18} easing of monetary policy and other measures taken by the Bank of Albania, consumer spending, those of a discretionary nature in particular\textsuperscript{19}, and investments are expected to decrease.

This impact will affect both, supply and demand. In terms of supply, the limitation of production and service activities will be accompanied by a decline in certain categories of goods and services available in the market. In terms of demand, the contraction of consumer spending, of private and public investments, and of foreign demand, will lead to an overall decline of production in all sectors of the economy.

The economic activity in 2019 Q4 decreased by 0.2%, after increasing by 3.0% during the first nine months of the year. Contraction of the manufacturing sector, gave a negative contribution by 0.8 percentage point to the economic growth, while the slower growth of the services sector gave a lower contribution by about 0.3 percentage point from 2.4 percentage points in the previous quarter, upward. The net tax component also contributed by 0.3 percentage point compared to 0.6 percentage point in the previous quarter.

The decrease in the value added of producing activities by 2.3% in the fourth quarter is mainly attributed to the contraction of the construction sector. This sector negatively affected GDP, by 1.7 percentage points, deepening the downward trend of the previous two quarters. Developments in construction

\textsuperscript{18} The first financial package, according to DCM No. 254, dated 27.3.2020 “On the determination of procedures, documentation and the measure of receiving financial assistance for employees in business entities with annual income up to 14 million ALL, economic assistance and payment of income from unemployment during the period of natural disaster, declared as consequence of COVID-19”. The second financial package according to DCM No. 305, dated 16.4.2020 “On determination of procedures, documentation and amount of financial assistance for current employees and for dismissed employees due to Covid-19”.

\textsuperscript{19} Consumer spending on non-basic goods and services (travel, entertainment, luxury goods), with income remaining after meeting other necessary expenses.
continued to reflect the gradual completion of the Trans Adriatic Pipeline (TAP) project and the lower level of new constructions, as a result of blocking the issuance of building permits in three districts of the country\(^{20}\). Also, value added in agriculture, forestry and fishing also decreased, contributing by -0.2 percentage point to the GDP performance this quarter. Meanwhile, the improved performance in the industry, energy and water sector, with a contribution of about 1.1 percentage point to the annual dynamics of GDP, was insufficient to offset the negative developments in construction and agriculture. The increase by 8.8% of added value in industry, energy and water was mainly due to the increased electricity output.\(^{21}\) This branch supported the upward performance of the economic growth by 0.5 percentage point. The annual dynamics in the mining and quarrying and processing industry despite the slowdown, remained positive, influenced also by the performance of exports.\(^{22}\) They contributed to the economic performance by 0.3 and 0.2 pp, respectively.

The services sector significantly slowed down in the fourth quarter, generating an added value of 0.6% higher in annual terms. This dynamic is mainly attributed to the contraction of “Professional activities and administrative services”, which contributed -0.5 percentage point to the economy.\(^{23}\) The branch "Art, entertainment, leisure and other services’ activities" continued its downward impact by -0.4 percentage point. Meanwhile, “Trade, Transport, Accommodation and Food Services”\(^{24}\) reduced its positive contribution to the economic performance, to 0.4 percentage point from 1.1 percentage points in the previous quarter. The slower growth of the branch mainly reflects the lower positive effect from accommodation and food service. “Financial and insurance activities” and “Public Administration, Education and Health” contributed to a lesser extent (0.2 percentage points each), whilst “Real Estate” increased its impact at 0.4 percentage points.

In balance, despite the high uncertainty regarding the impact of the shock caused by the Covid-19, the volume of economic activity is expected to show a decline this quarter. Moreover, the fall in production will be reflected in the decrease of employment and temporary liquidity problems for enterprises, as well decrease of Albanian households’ income.

\(^{20}\) After the earthquake of 26 November 2019, the Territorial Development Agency blocked the issuance of new building permits in Tirana, Durres and Lezha. The number of building permits issued for new buildings during the fourth quarter was 196, 45.6% lower than in the same period of the previous year. The indicator fell by 44.0% for residential buildings and by 49.1% for other buildings.

\(^{21}\) The branch “Electricity, gas, steam and air conditioning” increased its production volume by 10.9% in the fourth quarter. The Net domestic production of electric power according to the preliminary data of the electricity balance increased as well.

\(^{22}\) The slowdown in the quarrying industry largely reflects the performance of “salt, sulphurs, oxides, lime and cement” exports, while exports of “Mineral fuel, mineral oil and their distillation products” have supported the positive developments. The slow growth of the processing industry continued to be affected by the decrease in the production of textile, clothing, leather, footwear and metallic products.

\(^{23}\) It mainly reflects the contraction in architectural and engineering activities, whose net sales according to shortterm statistics recorded a sharp annual fall by 32.4% in the fourth quarter.

\(^{24}\) Net sales in volume of “Hotels” and “Bar – restaurants”, recorded a slower increase during the fourth quarter.
BOX 3 A METHODOLOGY FOR ASSESSING THE IMPACT OF SHOCKS IN ECONOMY

The Albanian and global economy are facing the crisis caused by COVID-19. The rapid spread of the pandemic in global terms has prompted restrictive measures by the governments of almost all countries. Strong measures have also been implemented in the case of Albania, declaring the state of natural disaster. Restrictions on the movement of people and the closure of certain economic activities have caused shocks both in terms of demand and supply.

The Bank of Albania is monitoring carefully the performance of the real sector of the economy, in order for monetary decision-making to help as efficiently as possible in minimizing losses in the economy.

This Box aims to illustrate, in a concise and simple way, the economic impact that would have on the Albanian economy a potential impact on the side of demand or supply. In this context, this exercise does not reflect the expectations and forecasts of the Bank of Albania, which are based on realistic assumption on the intensity and duration of the shock, but provides an assessment mechanism on potential shock scenarios.

The assessment in based on the functioning of the Albanian economy according to the structural connections quantified by input-output tables*.

First, we will present the impact on the economy of a decline of aggregate demand, assumed at 10% over one year timeframe, and evenly distributed across all its components.

From the point of view of aggregate demand, we have assumed that the 10% decline affects all components simultaneously and uniformly: households’ consumption, investments and exports. The contraction of aggregate demand is reflected partially in the decline of GDP and partially in the decline of imports. The resulting impact of these three shocks is a decline by 13.5% of imports and a decline by 6.9% of GDP. At the same time, employment would decrease by around 8.3%, while the unemployment rate would increase by 7.4 percentage points**. Table 4 presents the disaggregated and total assessments on the decline of imports, the decline of employment and the increase of unemployment.

In this case as well, the highest impact is related with the decline of private consumption, followed by exports and investments.

Table 4 Impact on imports, employment and unemployment rate

<table>
<thead>
<tr>
<th></th>
<th>Impact on GDP (%)</th>
<th>Impact on imports (%)</th>
<th>Impact on employment (%)</th>
<th>Impact on unemployment (p.p.)</th>
<th>Unemployment rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumption</td>
<td>-4.0</td>
<td>-7.4</td>
<td>-5.5</td>
<td>+4.9</td>
<td>16.1</td>
</tr>
<tr>
<td>Investments</td>
<td>-1.1</td>
<td>-2.5</td>
<td>-0.9</td>
<td>+0.8</td>
<td>11.9</td>
</tr>
<tr>
<td>Exports</td>
<td>-1.8</td>
<td>-3.6</td>
<td>-1.9</td>
<td>+1.7</td>
<td>12.9</td>
</tr>
<tr>
<td>Total</td>
<td>-6.9</td>
<td>-13.5</td>
<td>-8.3</td>
<td>+7.4</td>
<td>18.6</td>
</tr>
</tbody>
</table>

Source: INSTAT and authors’ calculations.

This methodology also enables a disaggregation of the impact of the decline of demand by sectors of the economy. Staying within the same hypothetical situation, the impact of a 10% decline of private consumption will generate a 4.0% loss in the Gross Domestic Product, concentrated on the sectors of “Agriculture”, “Manufacturing industry” and “Real estate”. Also, a hypothetical
The decline of 10% of investments would generate a 1.1% loss of GDP, concentrated mainly in the “Construction” sector. Meanwhile, a hypothetical decline of 10% of exports would have a negative impact of around 1.8% of GDP, with a relatively broader distribution in the economy. These results are summarized in Chart 1.

This methodology also enables an approximate assessment of the impact on the economy of the fiscal measures to cope with the situation. Again, in a hypothetical situation where public consumption increases by 10%, which materialises in an increase of available income and private consumption, the positive impact on the economy would be around 0.5% of GDP, with a positive impact on employment of 0.7% and a decrease of unemployment rate of around 0.7 percentage points.

Following, we will present the assessment where the shock affects only on the side of supply. We emphasize that the methodology allows a two-way assessment of the sides of the shock, but the results must be analysed as separate and must not be aggregated. Again, we have a hypothetical situation where output declines by 10% in all sectors of the economy. The sectors are interconnected due to intermediate consumption. For this reason, the following assessments disaggregated by sector should be considered as individual shock and as such, cannot be aggregated. The results of these assessments are presented in Table 5.

Table 5: Impact on GDP, employment, unemployment rate, for a decrease in sectoral output of 10% (by sector)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Impact on GDP (%)</th>
<th>Impact on employment (%)</th>
<th>Impact on unemployment (p.p.)</th>
<th>Unemployment rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>-2.1</td>
<td>-4.3</td>
<td>+3.9</td>
<td>15.0</td>
</tr>
<tr>
<td>Extracting industry</td>
<td>-0.4</td>
<td>-0.1</td>
<td>+0.1</td>
<td>11.3</td>
</tr>
<tr>
<td>Processing industry</td>
<td>-1.0</td>
<td>-1.1</td>
<td>+1.0</td>
<td>12.2</td>
</tr>
<tr>
<td>Construction</td>
<td>-1.7</td>
<td>-1.3</td>
<td>+1.1</td>
<td>12.3</td>
</tr>
<tr>
<td>Trade and transport</td>
<td>-1.5</td>
<td>-1.5</td>
<td>+1.3</td>
<td>12.5</td>
</tr>
<tr>
<td>Accommodation, hotel, catering</td>
<td>-0.2</td>
<td>-0.4</td>
<td>+0.4</td>
<td>11.5</td>
</tr>
<tr>
<td>Information and communication</td>
<td>-0.9</td>
<td>-0.5</td>
<td>+0.5</td>
<td>11.6</td>
</tr>
<tr>
<td>Real estate</td>
<td>-0.7</td>
<td>-0.1</td>
<td>+0.1</td>
<td>11.2</td>
</tr>
<tr>
<td>Other services</td>
<td>-2.3</td>
<td>-2.4</td>
<td>+2.2</td>
<td>13.3</td>
</tr>
</tbody>
</table>

Source: INSTAT and authors’ calculations.
According to assessment, the highest impact in terms of GDP is related with the decline of output in the sector of “Agriculture, followed by “Construction” and “Trade and transport”. The impact of the group “Other services” is high due to the involvement of several sectors. The ranking of the sectors is almost the same in the case of the impact of employment and unemployment rate as well.

In conclusion, let us also underline some of the limitations of the methodology and assumptions;

- First, impacts are distributed uniformly, to simply illustrate the meaning of this assessment. However, the impact in the case of demand components depends on the sectoral structure of each component and dimensions of the sectors of the economy. The same is also true for the impact conditions on the side of output. Thus, keeping in mind that the sector of “Agriculture” accounts for a significant share in terms of private consumption, gross value added and employment, the economic impact that characterises this sector is higher compared with the others as well. The results of the assessment may be significantly different in terms of total, as well as in terms of distribution, if shocks are not uniform.

- Second, the assessments represent direct impacts related with respective shocks. They do not include second round indirect impacts related with the decrease of demand or output beyond the time frame of the original shock. Thus, future consumption may be affected by the decrease of available income in the current period. Also, future output may be affected by the decrease of investments in this moment. If we add these effects, the impact of shocks would be even higher.

- Finally, the assessments are based on an assumed magnitude of original shocks. If the magnitude of the shock would be higher or lower, the economic impacts also would be higher or lower.

* More about the methodology can be found in the material “Analysis and structural developments of the Albanian economy: approach according to Social Accountability Matrices”, written by Çela, Metani and Çeliku, BoA (December, 2019). https://www.bankofalbania.org/Botime/Botime_Kerkimore/Materialet_studimore/Analiza_dhe_zhvillimet_strukturore_te_ekonomise_shqiptare_perqasje_sipas_Matriceve_te_Kontabilitetit_Social.html

** The assessments are based on labour market data from the Labour Force Survey. For the detailed distribution of employment by economic activity, the data are supplemented also with the structure of employment by administrative data.

4.2.2 AGGREGATE DEMAND

Aggregate demand in Albania has experienced two consecutive shocks in the last two quarters. The earthquake of 26 November was accompanied with a decline of investments and slowdown of consumption, driving economic growth in negative territory in this period. Furthermore, the spread of the pandemic and the introduction of social distancing measures are assessed to have generated a further decline of aggregate demand in the first and second quarter.

The duration of this negative trend will depend on the duration of the pandemic and the measures taken by public authorities for its control.
In a longer-term horizon, the Bank of Albania assesses that maintaining the sustainability of enterprises and households’ balance sheets, as well as the accommodative monetary and financial environment, will create premises for growth recovery.

Domestic demand contracted by 1.8%, contrary to the average growth of 3% registered in the first 9-months of the year. The contraction was defined by the annual decline of investments by 12.1% and slow increase of the consumption of the population (1.6% against 3.8%). Meanwhile, the public consumption growth registered 2.6%.

Leading and indirect indicators suggest that the weak performance of domestic demand will continue in 2020 Q1 as well. Both consumption and investments are assessed to show a weak annual growth.

**PRIVATE CONSUMPTION**

Private consumption growth slowed at 1.6% in 2019 Q4, after the average growth of 3.8% during the first 9-months. The weakening of private consumption in this quarter was affected by the decline in confidence and the increase in uncertainty, after the shock of the earthquake at the end of the year. Consumer reluctance to spend appeared more in the categories of services and the purchase of long-term consumer goods, judging on available indirect indicators. Based on these indirect indicators, short-term consumer goods have continued to give the same contribution to the performance of total consumption during 2019 Q4.
The spread of the COVID-19 virus in Europe in the first months of 2020 and the measures taken in the beginning of March in Albania to minimize it, are expected to have a negative impact on private consumption during 2020 Q1. The assessment of the magnitude of this negative impact on consumption is accompanied with much uncertainty. Partial quantitative data available for the first months of 2020 as well as data from surveys indicate a dynamic of private consumption at low levels. However, available data during these months do not yet fully reflect the developments related with the measures taken to prevent the spread of the COVID-19 pandemic as well as the increase of uncertainty. Looking beyond the period of the spread of the epidemic, the recovery of private consumption is expected to be supported by the fiscal stimulus, low interest rates and the improvement of confidence.

**INVESTMENTS**

Investments expanded their decline in 2019 Q4 at -12.1%, after registering a slight decline in the previous two quarters, affected mainly by the contraction of investments in construction. Judging by the measurement of GDP on the side of output, it is assessed that investments in construction have registered the weakest performances of the last years in 2019 Q4: the value added in construction decreased by 14.8%, the lowest value since 2014 Q2. Meanwhile, investments in machinery and equipment registered a decrease during all four quarters of 2019, judging by indirect data of capital goods import. Public investments are also assessed registering a slight decline in 2019 Q4.

Quantitative indirect indicators from surveys for 2020 Q1 as well have not yet fully reflected the impact that measures against the spread of the virus have
had on investments in the economy. Their impact in the decision of enterprises to invest will be inevitable. The recovery of the growth rates of investments will depend on the duration of confinement measures and the recovery of consumer demand for goods and services. Indirect assessments indicated that the public component of investments will also give a downwards contribution during 2020 H1.

PUBLIC SECTOR DEMAND AND FISCAL POLICY

Fiscal policy has taken an easing stance in 2020 Q1, in an attempt to mitigate the consequence of the spread of COVID-19 in Albania. Fiscal mitigation in this period was a combination of lower revenue from taxes and expenditure increase.

Overall fiscal policy for 2020 is expected to be accommodative, in the form of direct support for certain sectors of the economy, or for the most vulnerable strata of the population, in order to mitigate the negative impacts from COVID-19 pandemic.

In addition to easing measures reflected in two consecutive reviews of the budget for 2020, the fiscal stimulus is planned to be also supported by the fund of ALL 20 billion allocated for the reconstruction of housing damaged by the earthquake of November 2019. The deficit planned for 2020 is ALL 68.7, assessed at around 4.0% of GDP, from 1.9% for 2019.

The fiscal impulse, which approximates the impact of discretionary fiscal policy on aggregate demand, at the end of 2020 Q1 was assessed at around 0.8 percentage point of GDP. This level represents the highest value after an almost 4 year cycle of consolidation of public finances. The impulse will continue to be high in the other quarters of 2020 as well, reflecting the easing measures declared in support of the sectors that are suffering the most financially and economically the consequences of COVID-19. Also, these measures aim to mitigate the negative impact on personal income due to the increase of unemployed because of the pandemic, or in support with additional financial sources for that part of the population that is granted social allowance.

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26 Until 17 April, the budget plan for 2020 is revised twice through two normative acts in order to reflect in figures the measures taken by the government to cope with the consequences of COVID-19 on the economy. The first normative act projected an increase of specific expenditure to cope with the consequences of COVID-19 of around ALL 12 billion. The second normative act approved on 17 April added other 9 billion to the expenses destined to face the consequences of COVID-19, bringing the total amount to ALL 19 billion, or 3.4% of total expenditure planned for 2020.
Budget expenditure in 2020 Q1 increased by around 2.3% in annual terms. The increase of expenditure was supported by the expansion of expenses in the form of social allowance, as well as by the increase of capital expenditure compared with the same period in the previous year. On the other hand, expenditure for local government, as well as that for interest payments on debt was lower than in the previous year, contributing by around -1.9 and -0.5 percentage points, respectively on the increase of total expenditure.

Capital expenditure in 2020 Q1 expanded by around 23.9%, somewhat reflecting a comparison impact with the low base in the previous year.

Revenue in 2020 Q1 contracted by around 3.8% in annual terms. Revenue
contraction in this quarter is driven by the strong decline of revenue from taxes in March\(^{27}\). Revenue contraction concentrated mostly on revenue from tax on profit, revenue on personal income and that from local taxes, which contribute by 2.4, 0.8 and 0.8 percentage points, respectively, to the decline registered for total revenues in 2020 Q1.

The unprecedented situation caused by the COVID-19 epidemics and the partial closure of economic activities in the entire country has had its first impacts on fiscal indicators. Thus, revenues from VAT for March were around ALL 8.9 billion, the lowest nominal level registered in this month since 2015. In addition, revenues from VAT decreased by ALL 2.5 billion from the level registered in February, a performance contrary to cycle that this budget item shows, which in the first quarter of the year is expected to register the highest monthly value in March. Also, revenues from local taxes in March almost halved from those in the previous month, an atypical behaviour for March.

The deterioration of revenue from taxes, in addition to the negative signals they transmit on the expected performance of the economic activity and consumption in 2020 Q1, also somewhat carry the impacts of easing measures taken by the fiscal authority. One of them is related with the performance of the tax on profit, which is the item with the highest negative contribution on the performance of total revenue in 2020 Q1. Thus, the Decision of the government on 26 March to postpone to the end of the year the prepayments of the tax on profit belonging to the first and second quarter for small enterprises\(^{28}\) seems to have been reflected on the annual decline of revenue from tax on profit by around 22% in 2020 Q1.

\(^{27}\) Until the end of February revenues were around 3.4% higher than in the previous year.

\(^{28}\) Enterprises with annual circulation up to ALL 14 million per year.
4.2.3 EXTERNAL DEMAND AND FOREIGN TRADE

The trade deficit in goods and services contracted in real annual terms by 16.5% during 2019 Q4. The main driver has been the rapid increase of export of services (by around 16.1%). Meanwhile, export of goods continued to be characterized by a decline in annual terms (7.6%). For the same quarter, imports decreased by 0.8%, driven by the decline of import of goods (3.2%). On the other hand, imports of services expanded by 5.0% compared with the previous year.

Data on the performance of foreign trade of goods for 2020 Q1, report a decline both in exports and imports. The drivers have been the developments of March, when tightening measures due to the pandemic started as well. Exports of goods declined by around 9.0% in annual terms during 2020 Q1. In March, the annual decline of exports registered 36.2%. The decline had a broad base. Particularly, it stands out the negative performance of the category “Textiles and footwear”, which is related directly with the critical situation in Italy. The category “Minerals, fuel and energy” also gave negative contributions. During the first two months of the year, the performance in this category was positive, which was related with the performance of the export of fuel. But in March, the trend reversed both due to the demand that stopped immediately and due to the rapid decline of prices. Also, the strong decline of the export of “quarrying” towards China added even more to the negative contribution from this category.

Similar developments characterized the category of “Construction material and metals” as well. During the first two months of the year, the exports of this category expanded by around 5.4% in annual terms, whereas in March they declined by around 50.4%.

Imports reflected similar developments to exports. During the first two months of the year, the annual growth of imports was quite low (1.7%) due to the impact of strong energy growth from the previous year. In March, annual decline accelerated at 25.4% and negative impacts derive from a broad base. Particularly high were the annual declines for the categories “Machinery” and “Construction material and metals”, which signal a weak performance of investments.
Due to a strong impact from imports, the overall trade deficit declined by around 8.0% during 2020 Q1 and 14.9% in March. Since the import intensity is overall higher compared with the exports, if similar conditions to March will repeat in the future, the tightening of trade deficit may characterize the coming quarters as well.

By geographic orientation, the decline of exports and imports has affected almost all partners. In the case of exports, the considerable contraction has characterized the exports towards Italy, Kosovo, Greece and China. In the case of imports, neighbouring Italy resulted as the most affected, followed by Greece, China and Turkey.
BOX 4 BALANCE OF PAYMENTS DEVELOPMENTS DURING 2019 Q4

The net position of the current account recorded a deficit of EUR 346.5 million in 2019 Q4, narrowing by around 6.9% in annual level. It was assessed at 10.1% of nominal GDP, or around 0.9 percentage point lower than in the same quarter of the previous year. The main driver in this dynamic was the expansion of surplus of the services account. Exports of services increased by 12.8% driven by the performance of “travel services”. On the other hand, exports of goods decreased by 10.1% compared with the previous year. Total imports increased by 1.2%, driven by the increase of imports of services by 6.9%. On the other hand, import of goods decline in annual terms by 1.3%.

“Primary income” account was characterised by a negative surplus of EUR 48.9 million, from the positive surplus of EUR 6.3 million registered in the previous year. This was due to the increase in income outflows related to “direct investment”. Regarding the secondary income, a positive surplus of 15.2 % was recorded in annual terms. In this regard, net remittances grew annually by 7.5%.

The financial account was characterized by an annual contraction of net liabilities by 44.7%. Direct investments net flow contracted by around 1.9%, while direct investments liabilities expanded by 2.1% in annual terms. The balance of payments was characterized by a decrease in reserve assets by about EUR 73.0 million in 2019 Q4. The reserve is sufficient to cover 6.5 months of imports of goods and services or 164% of short-term external debt.

The balance of payments reports an inflow of “errors and omissions” at EUR 170.4 million.

Table 6 Balance of Payments indicators

<table>
<thead>
<tr>
<th>Current account (in EUR million)</th>
<th>2018 Q2</th>
<th>2018 Q3</th>
<th>2018 Q4</th>
<th>2019 Q1</th>
<th>2019 Q2</th>
<th>2019 Q3</th>
<th>2019 Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>y-o-y (%)</td>
<td>-169.4</td>
<td>-146.4</td>
<td>-372.2</td>
<td>-247.8</td>
<td>-283.1</td>
<td>-163.9</td>
<td>-346.5</td>
</tr>
<tr>
<td>/GDP (%)</td>
<td>-3.2%</td>
<td>2.5%</td>
<td>20.1%</td>
<td>3.9%</td>
<td>6.7%</td>
<td>12.0%</td>
<td>-6.9%</td>
</tr>
<tr>
<td>Goods and services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>-3.4%</td>
<td>-3.8%</td>
<td>-11.0%</td>
<td>-8.0%</td>
<td>-7.8%</td>
<td>-4.7%</td>
<td>-10.1%</td>
</tr>
<tr>
<td>Exports, f.o.b.</td>
<td>-427.2</td>
<td>-359.7</td>
<td>-614.8</td>
<td>-403.7</td>
<td>-519.0</td>
<td>-327.8</td>
<td>-549.9</td>
</tr>
<tr>
<td>Imports, f.o.b.</td>
<td>-1038.2</td>
<td>-1344.8</td>
<td>-1586.6</td>
<td>-170.4</td>
<td>-223.2</td>
<td>-266.3</td>
<td>-250.0</td>
</tr>
<tr>
<td>Primary income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>2.7%</td>
<td>8.4%</td>
<td>8.8%</td>
<td>5.1%</td>
<td>3.3%</td>
<td>8.4%</td>
<td>6.7%</td>
</tr>
<tr>
<td>Credit</td>
<td>-123.6</td>
<td>-94.0</td>
<td>-105.0</td>
<td>-76.0</td>
<td>-129.7</td>
<td>-106.0</td>
<td>-108.2</td>
</tr>
<tr>
<td>Debit</td>
<td>103.8</td>
<td>111.0</td>
<td>98.7</td>
<td>111.2</td>
<td>142.3</td>
<td>148.9</td>
<td>157.0</td>
</tr>
<tr>
<td>Net income from Direct investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>11.7%</td>
<td>2.6%</td>
<td>-1.7%</td>
<td>1.0%</td>
<td>1.9%</td>
<td>8.6%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Secondary income</td>
<td>238.0</td>
<td>230.4</td>
<td>236.4</td>
<td>191.2</td>
<td>248.5</td>
<td>256.0</td>
<td>272.3</td>
</tr>
<tr>
<td>Credit</td>
<td>260.9</td>
<td>254.8</td>
<td>265.2</td>
<td>220.1</td>
<td>274.2</td>
<td>280.8</td>
<td>294.8</td>
</tr>
<tr>
<td>Debit</td>
<td>22.9</td>
<td>24.4</td>
<td>28.8</td>
<td>28.9</td>
<td>25.7</td>
<td>24.7</td>
<td>26.1</td>
</tr>
<tr>
<td>Net Remittances</td>
<td>-181.7</td>
<td>-170.0</td>
<td>-162.9</td>
<td>-150.2</td>
<td>-185.2</td>
<td>-184.6</td>
<td>-181.9</td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>11.7%</td>
<td>2.6%</td>
<td>-1.7%</td>
<td>1.0%</td>
<td>1.9%</td>
<td>8.6%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Capital account</td>
<td>21.2</td>
<td>22.9</td>
<td>41.6</td>
<td>12.9</td>
<td>12.3</td>
<td>19.7</td>
<td>26.2</td>
</tr>
<tr>
<td>Net borrowing/net lending</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>-148.2</td>
<td>-123.5</td>
<td>-330.6</td>
<td>-229.9</td>
<td>-270.8</td>
<td>-144.2</td>
<td>-320.3</td>
</tr>
<tr>
<td>Financial account</td>
<td>-198.0</td>
<td>-169.0</td>
<td>-271.0</td>
<td>-373.2</td>
<td>-355.4</td>
<td>-19.0</td>
<td>-149.8</td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>-4.1%</td>
<td>-92.4%</td>
<td>32.0%</td>
<td>30.9%</td>
<td>79.5%</td>
<td>12.3%</td>
<td>-44.7%</td>
</tr>
<tr>
<td>Direct investments</td>
<td>-218.2</td>
<td>-268.7</td>
<td>-244.9</td>
<td>-264.7</td>
<td>-230.2</td>
<td>-266.3</td>
<td>-250.0</td>
</tr>
<tr>
<td>Portfolio investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>y-o-y (%)</td>
<td>-3.4%</td>
<td>-21.0%</td>
<td>10.7%</td>
<td>-1.9%</td>
<td>5.5%</td>
<td>0.9%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Financial derivatives</td>
<td>108.3</td>
<td>31.3</td>
<td>203.0</td>
<td>-0.2</td>
<td>-82.4</td>
<td>93.4</td>
<td>129.8</td>
</tr>
<tr>
<td>Other investments</td>
<td>-173.3</td>
<td>83.9</td>
<td>-96.9</td>
<td>-17.6</td>
<td>0.9</td>
<td>44.2</td>
<td>43.4</td>
</tr>
<tr>
<td>Reserve assets</td>
<td>-105.5</td>
<td>154.8</td>
<td>273.9</td>
<td>70.7</td>
<td>43.6</td>
<td>109.7</td>
<td>73.0</td>
</tr>
<tr>
<td>Errors and omissions</td>
<td>-49.8</td>
<td>-71.0</td>
<td>59.7</td>
<td>143.3</td>
<td>84.0</td>
<td>125.5</td>
<td>170.4</td>
</tr>
</tbody>
</table>
| Source: Bank of Albania, INSTAT and staff’s estimates.
4.3 CYCLICAL SITUATION OF THE ECONOMY AND INFLATIONARY PRESSURES

The earthquake of 26 November 2019 and the COVID-19 pandemic have been strong shocks, which increased uncertainty in assessing the current situation and forecasting future developments.

Aggregate demand and supply registered a decline, but our assessments indicated that demand shocks will be dominant, expanding the negative output gap and weakening medium-term pressures on inflation. On the other hand, the depreciation of the exchange rate exerts pressure on growth of import items prices and commodity costs, compensating the downward trends of inflation in partner countries as well.

The balance of inflationary pressures in the medium-term will depend on the duration of the shock and the degree of the interaction of the two above-mentioned channels in defining prices in the economy. The baseline scenario of the Bank of Albania is that of a short-term shock, which will maintain inflation low in 2020, but will not prevent its return to target in the next year. However, unlike previous forecasts, the return of inflation to target is expected to reflect a higher contribution from the exchange rate and a lower contribution from internal inflationary pressures.

Despite the slight increase of core inflation in 2020 Q1, uncertainties have been present in this quarter and are expected to increase in the coming months. They will accompany the process of inflationary pressures formation.

Despite the positive trends so far, the decline of capacity utilisation rate in manufacturing businesses during 2020 Q1 as well as the slowdown of the positive dynamics of the labour market in the previous quarter, signal a slowdown of internal inflationary pressures, at least in the short-term.

The capacity utilisation rate in the economy resulted 74.5% in 2020 Q1, remaining near the value of the previous quarter (+0.3 percentage point).

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29 Available information still does not reflect the impacts of COVID-19 in these markets, since the epidemic hit Albania in 9 March 2020.
30 Hendeku i prodhimit është mesatare e disa matjeve mbi të cilën aplikohet metoda e mesatares lëvizëse. Hendeku i normës së shfrytëzimit të kapaciteteve llogaritet si devijim i vlerës aktuale nga mesatarja përkatëse historike, dhe më pas zbatohet metodë e mesatares lëvizëse. Hendeku i shkallës së papunësisë vlerësohet si diferencë e shkallës ekuilibër me shkallën faktike të papunësisë sipas 3 metodave, të cilat vlerësojnë normën ekualbardhë të papunësisë (NAIRU dhe NAWRU). Hendeku i papunësisë shprehet si differencë e shkallës ekualbardhë me shkallën faktike të papunësisë dhe më pas zbatohet metodë e mesatares lëvizëse.
The indicator continues to stay above its historic average, by 0.9 percentage point. However, short-term signals indicate that enterprises have decreased the production capacity utilisation by 0.4 percentage point, compared with the previous year.

The basic indicators of the labour market, employment and unemployment rate, continued to reflect the positive developments of 2019 Q4. Employment increased by 3.1% in annual terms, from 3.3% in the previous quarter. The activity in “Trade, transport, hotels, business and administrative services”, was the main contributor to the annual growth of employment. Meanwhile, unemployment rate resulted 11.2% in 2019 Q4, 1.1 percentage points lower compared with the previous year and 0.2 percentage point lower compared with 2019 Q3. This decline is mainly attributed to the lower number of unemployed. As a result, labour force registered a quarterly decline by 0.2% and was reflected in a participation rate that is almost the same as in the previous quarter (at 69.7% from 69.8%).

Chart 33 Salary indicators in Albania (left); labour costs and their decomposition (right)

Source: INSTAT and estimations of the Bank of Albania.

The analysis of employment and unemployment is based on the “Quarterly Labour Force Survey” (QLFS), and refers to indicators for those 15 years and older. Participation in the labour force represents the group 15 - 64 years old, to prevent the impact from retired persons (according to the explanatory note of INSTAT in the QLFS for 2019 Q4).

The examinations of the factors that affect the unemployment rate suggest that the quarterly downward trend of the indicator was mainly driven by the developments in labour supply. On the side of labour supply, are analysed the participation degree and the working age population, while on the side of labour demand is analysed the employment performance.

Labour force is calculated as the sum of employed with unemployed. In 2019 Q4, the quarterly decline of unemployed resulted higher that the quarterly increase of employment, generating a decline of labour force compared with the previous quarter.
The gross monthly average salary for a paid employee slowed down growth in 2019 Q4. The indicator registered an annual growth of 2.2%, following the 3.7% growth in the previous quarter. Deflated by annual inflation, the increase of the average salary was 0.9% from 2.3% in the previous quarter. The slower dynamic of average salary reflected the mitigated growth of nominal salary in the government sector, by 0.9% from 5.6% in the previous quarter (0.4% from 4.2%, respectively, in real terms). Meanwhile, the average salary in the public sector continued to slightly accelerate growth at 3.1% in nominal terms and 1.8% in real terms. This dynamic mainly reflected the performance of salary in the services activities of information and communication and those of financial and insurance.

Unit labour costs continued the upward trend in 2019 Q4, resulting 2.5% higher in annual terms. The acceleration of the growth rate was driven mainly by labour productivity. The decline of labour productivity could not compensate the increase of real salary for activities covered by short-term statistics, transmitting an increase of labour costs. Regarding other production costs, their performance, albeit at a slower pace, continued to decline. Industrial output process decreased by 1.1%, mainly driven by the lower prices of export output, concentrated in the mining and quarrying industry. Meanwhile, industrial output prices for products in the domestic market decline in annual terms by 0.4%. Referring to the Construction Cost Index (CCI), output costs in this sector resulted 0.1% lower in annual terms.

From a longer-term prospective, the increase of labour costs and output prices by the domestic economy is slow and remains below historic averages. The operation of the economy under potential is mirrored in mitigated inflationary pressures. On the other hand, the lower appreciation of the domestic currency as well as specific developments in the market of rent and housing after the earthquake, have increased moderately long-term and internal inflation pressures in January-February 2020. Meanwhile, respective assessments for March were affected significantly by the situation created by COVID-19. Part of services in the sub-basket of above-mentioned components of inflation were closed, other were curbed down, thus affecting the assessment of the indexes of the respective prices. Core and net non-tradable items inflation registered 1.2% and 1.3%, respectively in 2020 Q1. This values resulted relatively higher compared with both the previous quarter as well as with the values from the same period in the previously year. Meanwhile, in terms of contributions to headline inflation, the behaviour of these components continued to appear stable.

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34 This indicator refers to the gross monthly average wage received by an employee and is based on the payroll information declared at the General Directorate of Taxation. This wage consists of the base salary, additions to the salary for management positions, additions for years of work, additions for work hardships, and other additions related to titles, degrees and bonuses. It includes all the economic activities, both in the public and the private sectors, for all paid employees working in Albania, as well as foreign residents.

35 Proxy indicators of labour productivity, output unit labour costs and average salary by activities covered by short-term statistics are calculated by the Bank of Albania (SHTS, INSTAT, 2019 Q4). Their calculation includes: the index of paid employees, net sales volume and salary fund for activities covered by surveys. The reported growth rates are in real terms and refer to the four-terms moving average of the annual changes of the indicator.
In addition to the stability in contribution of the above-mentioned components, short-term component fluctuated significantly over this quarter. Non-core inflation registered an average value of 2.5%. It reached 4% in March, after the very low value of 1.5% in February. This increase reflected an unbalance between demand and supply in good markets, mainly in those of food, due to the sudden increase of demand for them. For the same reason, the inflation of tradable items of the basket has similar behaviour. It fluctuated upward from February to March, from 1.3 to 2.8%, respectively. In average terms, this indicator registered the same value as in the previous quarter, 2%.

Over January-February 2020, the imported inflationary pressure index (IIPI)36, expanded on average by 1.6% in annual terms. It continued to reflect the contrary dynamics of foreign prices and exchange rate. Hence, if the appreciation of the Nominal Effective Exchange Rate (NEER) in annual terms registered 3.0%, the Import Price Index (IPI)37, expanded by around 4.6%, exceeding the impact of NEER.

In terms of IPI components, imported inflation registered strong fluctuations over the months of 2020 Q1. It continued to contribute positively, but to a more limited extent than in the previous quarter. This component registered a significant increase in March, following the increase of foreign prices in January-February. In average terms for the quarter under review, imported inflation contributed by around 40% in the formation of total inflation. The exchange

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

37 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.
rate continued to exert curbing down pressures in imported inflation. The other component, domestic inflation contributed with around 8 percentage points more than in the previous quarter, showing stability throughout the quarter.

The weakening of the economy, generated by COVID-19, will be accompanied by a temporary decline of employment and increase of unemployment. The impact on employment is expected to be concentrated in the services sector, due to the limitation in the exercise of activity from the measures taken to prevent the spread of COVID-19. The deterioration of conditions in this market is also signalled by the expectations of enterprises for decline of employment during 2020 Q2, as well as by the expectations of consumers for increase of the number of unemployed during 2020 (Confidence Surveys). The materialisation of the shock from the pandemic in decline of employment and increase of the unemployment rate is expected to expand the free capacities of the labour market. The government’s financial support packages have aimed to fulfil only part of loss income of those employed in the affected sectors of the economy and to somewhat mitigate the risk of losing jobs. Despite the above-mentioned support and the efforts of the private sector to adapt to entirely new conditions, the probability that the pressure on salaries and inflation will shift downwards in the following period is considered significant.

**INFLATION EXPECTATIONS**

Measurements from surveys by various economic agents indicated that expectations on inflation have been revised upwards for businesses and consumers, during 2020 Q1. Whereas, they have remained overall unchanged for financial agents. Expected inflation after a year by consumers,

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38 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.
after decreasing at 3.8% in 2019 Q4, increased at 4.2% in 2020 Q1. Expectations of enterprises show a lower quarterly volatility. The current level for inflation after a year is 2.5%, after registering 2.3% in the two previous quarters.

Just like businesses’ expectations, financial agents’ expectations as well register values below inflation target. Their expectations for the three time horizons are almost at the same level of 2019 Q4. Financial agents expect an upward trend of inflation in the medium-term horizon.

> Chart 36 One-year-ahead inflation expectations, businesses and consumers (left) and financial agents, according to three horizons (right), annual change in %

Starting from 2019 Q1, inflationary expectations of businesses and consumers are reported by measuring through direct quantitative questions rather than intervals. This question has been addressed to businesses and consumers starting from 2016 Q2. The extension of this series back in time is done by using the values of the old question with intervals. The change in the form of the question, from interval values to open quantitative points, has caused an increase of volatility in the series. Time series of businesses and consumers’ inflation expectations, with both measurement ways, in addition to an explanation on how they are built, are published at the Bank of Albania’s website.