QUARTERLY MONETARY POLICY REPORT

2022/II
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INTRODUCTION

The main objective of the BoA’s monetary policy is to achieve and maintain price stability. Price stability implies reaching low rates with positive inflation, and maintaining these for a relatively long period. In quantitative terms, the Bank of Albania has defined price stability as maintaining a 3.0% annual inflation rate of consumer prices in the medium term. By preserving price stability, the Bank of Albania helps establish a sustainable monetary environment and assists Albanian households and enterprises in planning their own consumption and investments.

The Supervisory Council of the Bank of Albania holds 8 meetings each year to decide on monetary policy, aimed at achieving the price stability objective. The Supervisory Council sets the key interest rate. Changes in the key interest rate affect, with a time lag, other interest rates in the financial market, for example, yields on government’s securities and the interest rates on loans. These changes drive increase or decrease in the demand for goods and services through a chain known as the “transmission mechanism”. Changes in the demand for goods and services bring about increases or decreases in the prices of these goods and services.

Transmission mechanism encompasses various channels through which prices may change, for example: the exchange rate channel; the inflationary expectations channel; and the foreign assets channel. The Bank of Albania has constructed models to forecast changes in all elements which affect prices and to inflation for up to three years. When forecasts show a dominance of low inflationary pressures, which may drive inflation below the 3.0% target, this is a signal that the monetary policy should be accommodative - interest rates should stay at low levels. The opposite also is valuable. However, drafting a monetary policy is not a mechanical process. The monetary policy decision-making considers the reasons that cause the deviation of inflation from target and the time needed to economy to react against the changes in the interest rates.

The Supervisory Council makes decisions on the monetary policy based on a variety of information, including estimations regarding economic developments, forecasts in relation to inflation, the performance of financial markets, risks and uncertainties surrounding forecasts. The Monetary Policy Report - which is the main component of the monetary policy - includes these considerations and assessments on this information. With the aim of communicating its monetary policy in a transparent manner, the Bank of Albania regularly publishes this Report and makes it available to citizens.

The Monetary Policy Report is published on a quarterly basis. This Report is compiled by the Monetary Policy Department at the Bank of Albania and it is adopted by the Supervisory Council. The current report contains data as at 21 April 2022. The supervisory council reviewed and adopted this Report at its meeting on 4 May 2022.

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1 Monetary Policy Documents delineates the monetary policy framework at the Bank of Albania. This Document is available at: https://www.bankofalbania.org/Monetary_Policy/Objective_and_strategy/Monetary_Policy_Document.html
FOREWORD BY THE GOVERNOR

The Albanian economy recovered swiftly and thoroughly in 2021. The expansion in the demand for goods and services drove to the growth of output, wages and employment, and to the improvement of the financial balances of both enterprises and households. In parallel, inflation increased steadily in the last year, by gradually shifting close to our 3% target.

Overall, Albanian economy carried over the positive development momentum into early 2022.

Nevertheless, the military attack of Russia on Ukraine has unfolded a new economic and geopolitical reality. In economic background, the sanctions imposed on Russia and the global trade headwinds have driven to a sharp rise in prices, and the aggressive response of central banks in terms of tightening the monetary policy stance. At the same time, the heightened uncertainty, the curtailed purchasing power and the increased debt servicing costs, have curbed the economic growth.

Albania, as a small open economy, is not an exception from these global trends.

The analyse and forecast of these factors, as well as the identification of a more adequate monetary policy stance, lies at the heart of this report.

Our analyses suggest that the surging global prices will continue to generate high inflation rates in the following period. The combination of external supply shock with the sound domestic demand is expected to keep consumer price inflation close to the current levels in the course of 2022. Further, inflation is expected to gradually decrease in 2023, and converge to the target at the end of 2024.

This forecast takes into account the supply shock fading in the next year and a gradual normalization of monetary policy in the medium term.

Against this backdrop, the Albanian economy is expected to grow during 2022. This forecast takes into account the positive momentum the Albanian economy entered the 2022, the overall monetary and financial stability in Albania, as well as the continuous lending for consumption and investment. The increase in both demand and output are expected to maintain the positive trend of employment and help to wages rise.
However, the economic growth pace is expected to be notably lower than in the previous year and lower than our forecasts at the beginning of year, in reflection of the base effect fading and the assessment of the shock impact originating from international markets.

Based on these assessments, the Supervisory Council decided to keep the monetary policy stance unchanged. After the increase of policy rate in March, the Supervisory Council deems that this stance provides an adequate balance between the risks for accelerated inflation with the decelerated economic growth.

In the light of the new information, the monetary policy stance will be regularly assessed in the future. In any case, the Bank of Albania will take all the measures to accomplish our 3% inflation target in the medium term.
1. INFLATION AND MONETARY POLICY STANCE

In the meeting of 4 May 2022, the Supervisory Council of the Bank of Albania decided to keep the policy rate unchanged, at 1%, and to re-affirm its attention on the heightened inflationary pressures and the willingness to react in a timely manner against them. The Supervisory Council deems that the current monetary policy stimulus is adequate to meet inflation target in the medium term.

Forecasts show that inflation will remain elevated in 2022, to trend downwards during 2023. This forecast is based on the gradual normalisation of the monetary policy and the expected reduction of the current inflationary pressures from the supply-side. The Council emphasises that the monetary policy normalisation will be a gradual process and led by the updated assessments of the Bank of Albania on the performance of both economy and inflation.

The Russia - Ukraine war is negatively affecting the global economy through rising prices, supply headwinds and heightened uncertainty. So far, this war has provided its most notable impact on commodity prices, which have reached new multi-years peaks, in reflection of the important role of Russia and Ukraine as producers of fuels, wheat and vegetable oils. The European economy is particularly affected, as it considerably depends on the import of these goods. Inflation in the euro area jumped to 7.5% in March, after the upward trend started in the previous year. The upsurge in prices is pushing up both the living costs for families and the production cost for firms. In addition, the increased uncertainty is an additional factor with a negative impact on the growth of the demand. As a result, forecasts on global economic growth for the next two years have been revised downwards, while inflation forecasts have been revised upwards. Most central banks have accelerated their plans for the monetary policy normalization.

The level of economic activity in Albania continues to generate rising inflationary pressures, which were accelerated by the war in Ukraine. Inflation rose to 4.4% in the first quarter, jumping from 3.7% in January to 5.7% in March. A rapid increase was observed in food and oil prices, mainly affected by the sharp rise in these prices in global markets.

Pressures on soaring prices are expanding while rising energy costs are being transmitted to prices in other sectors. Meanwhile, the increase in the demand, employment and wages continue to exert steady upward pressures on prices. In parallel, expectations of economic agents for inflation have edged up, signalling that supply shocks could leave long-term strains in inflation if are not addressed.
The outbreak of Russia-Ukraine war found the Albanian economy in improved economic and financial parameters. According to INSTAT, the economic activity grew by 8.5% during 2021, exceeding both the pre-pandemic and the pre-earthquake levels. This growth reflected the expansion of consumption, investment and exports. The improved confidence, the recovered partner economies and the macroeconomic stimuli, particularly robust over the last two years, have underpinned this growth. The available information suggests that the positive growth momentum has been also maintained over the first two months of 2022.

Our assessments suggest that inflationary pressures are broad-based. In reflection, the labour market shows increased employment and wages and a decreased unemployment rate to 11.4%, at the end of 2021, by illustrating stable pressures from the aggregate demand. In particular, data for the fourth quarter reveal the rapid growth in employment and the acceleration in wages, which increased by 8.4% in economy level and 10.2% in the private sector.

Factors underpinning the economic growth are relatively robust, but the war in Ukraine will affect negatively the Albanian economy. Although our direct exposure to countries involved in the war is relatively low, the consequences will be felt through rising prices in international markets, lower growth of trading partners, and tighter global financial conditions. Updated forecasts for our economy indicate higher inflation rates and slower economic growth compared to our assessments in the previous monetary policy report.

Despite this shock, the Albanian economy is projected to continue to grow in the course of 2022 and in the medium term. The increase in consumption, investment and exports is expected to dictate the growth in activity. The low interest rates financial environment, the relatively good balance sheets of private sector and the growth of partner economies, will be supportive factors in this regard. On the other hand, the contribution of public sector to the economic growth is expected to reduce, in line with the fiscal policy returning towards its consolidation.

Inflation is projected to accelerate in 2022, and declining during 2023. Both domestic factors - rise in demand, employment and wages - and external factors - high international prices - are expected to boost inflationary pressures in the short run. Further, under the assumption of finding a solution to the war, tensions in international markets are expected to calm down by easing the inflationary pressures. The latter is projected to return to target, starting in early 2024. Expectations of international markets for a longer time with high levels of inflation have postponed the moment of inflation return to target compared to the previous forecasts.

Uncertainties about the future are high, amid upside risks to inflation and downside risks to economic growth. Short-term risks are concentrated around
the war in Ukraine, while in the domestic environment the risks stem from the potential second-round effects of high inflation.

The Supervisory Council deems that addressing the risks to inflation and its steady convergence to the 3% target requires the gradual normalization of monetary policy. The updated assessments of the Bank of Albania on the performance of economy and inflation will lead this process.

Currently, financing conditions remain favourable while bank credit remains a stable financing source to the economy. Interest rates on government securities have followed the increase of the policy rate, while interest rates on loans and deposits continue to fluctuate at low levels. The exchange rate appears stable. Alongside these factors, the good banking sector’s soundness and the increasing demand has supported the steady growth of credit. In March, banks have increased the credit volume to private sector by 12.8% ².

After raising the key interest rate to 1.0% in March, the Supervisory Council decided to keep it unchanged at its May meeting. Currently, the key interest rate has returned to its pre-pandemic level. The key interest rate is expected to remain below its neutral level in the medium term, a level that corresponds to an economy with full employment and an inflation to target. Consequently, interest rates on lek financial products will continue to remain at stimulating levels, by boosting investments and spending.

On the other hand, the Supervisory Council remains attentive to the development of the situation in Ukraine and the transmission of foreign shocks in the Albanian economy. The Supervisory Council is ready to react, if they will jeopardise the price stability objective in the medium term.

² This rate is calculated for the credit being adjusted for the foreign exchange rate and loan write-offs.
Box 1 Supply shocks and the impact on inflationary expectations

The positive supply shock on prices is experienced in case of costs increase, due to the rise in raw material prices, higher labour costs per unit, increase of taxes; and increase in transport costs. Overall, these shocks are transitory, unless they affect the economic agents’ expectations for inflation in the future and do not translated into wages or contracts indexing. In an inflation targeting regime, in cases of positive supply shocks, monetary policy faces, in the short run, movements in opposite directions of the two constituent elements of the monetary policy response’s function.

The above view changes when supply shocks are extended in time, de-anchor the inflationary expectations, and through them, capture the medium-term impact on prices. In this case, the initial supply shock could create an inflationary spiral, where persistent demands for increase of wages generate a spillover effect in costs and final prices in the economy, and passes within the timeframe of monetary policy action. Thus, the need to anchor inflationary expectations is primary important to avoid the secondary effects of supply shocks. In addition, the control over inflationary expectations turns more difficult once they are more adaptable, as being assessed to be in Albania.

To illustrate the profile of monetary policy reaction conditioned by various-forms of shocks on prices, we have conducted some empirical exercises by employing the Medium-Term Projection Model (MPM), to generate the macroeconomic projections and inform the decision making at the Bank of Albania. Results show the need for a rapid and highly intensive policy reaction when supply shocks affect the de-anchoring of inflationary exactions and jeopardise the creation of inflationary spirals. At the same time, monetary policy response should be prudent in preserving the sustained economic growth and controlling the inflationary pressures.

The rapid increase of inflation in Albania, in 2021 Q4 and 2022 Q1, reflects a combination of supply shocks, with a gradual build-up of inflationary pressures from the domestic demand.

a) Impact of Russian invasion of Ukraine on final prices in Albania

In the previous year, global industry recovery stalled amid the supply headwinds (delays, high costs of transport), driving to a shortage of production in view of an increased demand for goods. This mismatch was reflected in the upswing in prices since the second half of 2021. Particularly, prices of commodities, like energy, wheat and metals, showed a rapid increase due to the geopolitical configurations and the policies speeding up the take-up of renewable energy. Consequently, the in euro area - our main trade partner - inflation rate jumped to 5.0% in December 2021. This swift upsurge in prices was transmitted to our inflation as well. The main pressures stemmed from the prices of energy and foods. Initially, the increase in commodity prices was considered temporary and was expected to fade within 2022.
The Russia-Ukraine war and the turmoil it has brought about, in both geopolitical and economical view, have turned around the judgement on inflation. Russia and Ukraine are important suppliers of metals, energy resources and food commodities in the international market. Uncertainties over supply shortages in these items have led to another increase in their prices, which is transmitted to production costs and has passed through to final consumer prices. Uncertainties over the evolution of the war and the reformatting of raw material suppliers are fuelling expectations for high inflation rates.

b) Economy in equilibrium and domestic inflationary pressures

The positive supply shocks to final prices in our country coincided with a domestic economy close to its equilibrium, after a period characterized by rapid growth and a gradual approach to medium-term trends of macroeconomic indicators (see the chapter “Inflation determinants” below).

The sustained growth of consumption expenditure, the expansion of private investments supported by low interest rates and risk premia, the positive impulse in the economy of fiscal policy and the foreign demand in constant expansion, have contributed to an improvement in the cyclical position of the economy. As a result, domestic inflationary pressures have strengthened and core inflation has accelerated to around 3.2% in the first quarter of 2022, from averagely 1.7% during 2021. As a result, positive extended supply shocks increase the risk of de-anchoring expectations and creating inflationary spirals.

c) Monetary policy implications

Economic history in Albania shows that shocks, which shift inflationary expectations, are more harmful in terms of the impact on final prices and economic growth. As such, they require a stronger monetary policy response. A de-anchoring of inflation expectations can derive as a result of strong and prolonged supply shocks, which affect expectations for the future inflation profile and are reflected today in wages and prices. This shock can be reinforced by the lack of monetary policy response or by its inappropriate reaction.
A delayed monetary policy response could bring about a high profile of inflationary expectations for a longer period of time, and a lack of response today would imply the need for a much stronger response in a second time. On the contrary, a hasty reaction of monetary policy can damage the economic performance and bring negative consequences on the well-being of the population.

To illustrate a theoretical monetary policy response, a shock to aggregate demand, a short-term supply shock and a de-anchoring of inflation expectations after one year was simulated, using the Medium-Term Forecast Model (MPM). The size of the shocks is the same in each scenario, to make the results comparable. The latter represent the deviation of annual inflation from the Bank of Albania’s target and the monetary policy response for 4 years.

The simulation results show that the upward shift of inflation expectations after 1 year requires a stronger monetary policy response compared to other scenarios. Higher expectations would affect prices today, due to demand for higher wages and other production costs, and exerts pressure on enterprises’ profit margins. To avoid an inflationary spiral in a second time, monetary policy must react strongly and promptly. In the conditions of a positive shock to the demand, the monetary policy response factors both the expansion of the demand and the increase of the inflation.

Transmission to final prices is smoother, and the size of the monetary policy response more contained. In the short-term supply-shock scenario, the inflation deviation is similar in the first instance to the demand shock, but as the shock is transitory, its impact on headline inflation remains low and disappears rapidly.

Taking into account all the above considerations in the monetary policy-making process and in the light of the risk of rising inflationary expectations, the Bank of Albania has started to react gradually. It raised the key rate by 0.50 percentage point, bringing it to 1.0% on March 23, 2022. The interest rate level remains low and stimulating for the economy. Meanwhile, unfolding the sustainability of the factors that have led to shifts in supply and demand remains essential for the next decision-making.


IV A discussion of the inflationary pressures nature in 2021-2022 is provided at : Box 3 High inflation in Albania, transitory or permanent?”, Quarterly Monetary Policy Report 2021/IV.
2. EXTERNAL ECONOMIC ENVIRONMENT

The outbreak of the war in Ukraine and the sanctions imposed by most advanced countries on Russia, in the first quarter of 2022, have significantly weigh on the external economic environment. The considerable share of these two countries in the world export of food, oil, gas, energy and metals have fuelled prices of these goods soaring in world stock exchanges. Meanwhile, sanctions imposed on Russia have strengthened the headwinds related to distribution chains, by building up increasing pressure on consumer prices. Inflation rates remain at the highest levels in recent decades, and central banks have begun to withdraw monetary stimulus. The intensity and duration of this war are expected to affect the economic performance in the future.

2.1. ECONOMIC GROWTH

The global economy was on a recovery path and Omicron wave had a short-lived impact. At the end of 2021, most advanced countries lifted the pandemic-related restrictions, and the opening up of economies was accompanied by rising consumer spending. The outbreak of the war in late February and the imposition of sanctions on Russia caused a further and significant increasing energy and food prices in global markets. It also strengthened the headwinds in the trade sector and distribution chains, coupled with heightened uncertainty about the future. These factors are expected to have reduced the consumer spending and business investment, and have amplified the headwinds in global trade since March. On the other hand, the emergence of COVID-19 cases in China, and quarantine measures taken by national authorities, along with rising energy prices, have contributed to the emergence of new headwinds in the production chains.

Main financial institutions have revised the global growth outlook downwards. The countries directly involved in the conflict will suffer the war consequences. These countries will experience a recession, while economic growth in other countries will decelerate. The rise in prices will continue throughout the current year, keeping inflation rates

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The new IMF projections for April have revised by -0.8 percentage points the global economic growth of 2022. Economic growth is projected at 3.6% from 6.1% in 2021.
above the targeting levels of central banks. The downside-risks to the forecasts depends derive from the evolution of the conflict, the tightening of monetary conditions, as well as the resurgence of new COVID-19 variants are.

**EURO AREA ECONOMY**

The euro area economy grew in the final quarter of 2021, but at a slower pace than in the previous quarters. Government spending and investment supported the growth of aggregate demand, while consumer spending and net exports curtailed the growth. Preliminary data of the first quarter suggest a slowed economic activity, which has continued to suffer the consequences from surging prices, supply chain disruptions, and the consequences of the Russia - Ukraine war. The increased uncertainty for the future is reflected in the worsened confidence of businesses and consumers, notwithstanding the continuous improvement in labour market. The unemployment rate has continued to be on a downward trajectory started in 2021, to stand at 6.8. % in February. Inflation has trended upwards, hitting 7.5% in March. This is the highest rate in some decades, and considerably above the ECB’s target. The increased prices of energy and food have affected the rising trend of inflation, coupled with the increasing trend of core inflation, by showing the presence of inflationary pressures in economy.

The ECB points to a more moderate economic growth during 2022, by suffering the impact of the war in Ukraine and the surging energy and commodity prices. Notwithstanding the expected slowdown, the economic growth will remain positive. Inflation is expected to record high rates in the course of 2022 and to pursue a downward trajectory towards the ECB’s target of 2.0% in the next year.

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4 *Eurosystem staff macroeconomic projections, March 2022.*
Economic activity in the region has grown at positive rates in the fourth quarter of 2021, but the growth pace has slowed down. Consumer spending has underpinned the economic grow across all regional countries. The performance of investment has been positive in Serbia and North Macedonia, while it has slowed down significantly in Kosovo. Government spending has slowed and the difficult situation in the distribution chains has slowed down net exports. The war in Ukraine has affected the performance of the regional economies in the first quarter due to the high energy and food prices.

Inflation rates have followed an upward trajectory, recording the highest values in the last decade across all countries. The upsurge in the prices of energy and food has been the main contributor to the increase in inflation, although core inflation has also increased, reflecting the built-up inflationary pressures from demand. The situation in international markets with higher prices is expected to affect the inflation rate during the current year.

<table>
<thead>
<tr>
<th>Country</th>
<th>Annual change of GDP</th>
<th>Annual inflation</th>
<th>Unemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2021 Q3</td>
<td>2021 Q4</td>
<td>March 2022</td>
</tr>
<tr>
<td>Italy</td>
<td>3.9</td>
<td>6.2</td>
<td>6.8</td>
</tr>
<tr>
<td>Greece</td>
<td>11.4</td>
<td>7.7</td>
<td>8.0</td>
</tr>
<tr>
<td>North Macedonia</td>
<td>3.0</td>
<td>2.3</td>
<td>8.8</td>
</tr>
<tr>
<td>Serbia</td>
<td>7.7</td>
<td>7.0</td>
<td>9.1</td>
</tr>
<tr>
<td>Kosovo</td>
<td>14.5</td>
<td>6.4</td>
<td>10.0</td>
</tr>
<tr>
<td>Albania</td>
<td>7.0</td>
<td>5.5</td>
<td>5.7</td>
</tr>
</tbody>
</table>

Source: Respective statistical institutes.
*February 2022, †2021 Q1.

Commodity prices in global markets continued to increase at high rates in the first quarter of 2022, affected also by the outbreak of the war in Ukraine. The war-torn region is a major exporter of grain, oil, fertilizers, metals, petrol and gas. Uncertainties about the quantity of these goods offered in the future, as well as the sanctions imposed on Russian products, were immediately transmitted to the market. The price of Brent crude oil averaged $117.3 / barrel in March, up about 80% from the same period a year earlier. Its upward trend is expected to peak during the current year, to follow a slightly falling trajectory in the next year. Forecasts for future price developments are closely linked the evolution of the war in Ukraine and the tightening of sanctions imposed on Russia. In the domestic market, the increase in oil prices in the global market has been transmitted to higher fuel prices in the consumer price index.

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Also, the situation in other commodity markets has recorded similar behaviour. While at the end of last year there was a moderation of high growth rates, the situation was reversed in the first quarter of this year. The annual increase of the food price index was 37.5% in annual terms in March, that of metals around 28.2% and of energy 101.6%. Electrical energy price has reached 285 Euro/MWWh in the Hungarian Power Exchange (HUPX)\(^7\), more than four times higher than in the same period in the previous year.

### 2.3. GLOBAL FINANCIAL MARKETS

Rising inflation and expectations for the withdrawal of monetary stimulus have led to a tightening of financial conditions in international markets. Financial markets have fluctuated under: the pressure of news on the aggravation of the war in Ukraine, the continuing upsurge in commodity prices, heightened uncertainty on the future performance of economies, and central bank communications to react to high inflation interest rates.

Central banks have balanced the risk of inflation with the risk of a significant slowdown in economic growth, with the former appearing to be more dominant. The evolution of the war and supply headwinds is expected to keep inflation high for longer. In response to this perspective, some central banks have reacted towards reducing the monetary stimulus. The intensity of the reaction is different depending on the cyclical position of the respective economy.

The Fed raised its key interest rate by 0.25% in March (to 0.50%), while announcing further successive increases. The Bank of England raised the key

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\(^7\) The World Bank Energy Index includes prices for oil, gas and coal.

\(^8\) Hungarian Power Exchange (HUPX), energy price at base profile.
interest rate for the second time to 0.75% in March, while the ECB announced the end of net asset purchases faster than it had previously communicated, taking a step towards tightening monetary conditions. Despite these movements, interest rates remain quite low and stimulating for these economies. In countries where inflation rates have reached double-digits value even as a result of an accelerated economic cycle, central banks have shown more aggressive in their response.

Central banks have reduced the monetary stimulus. Uncertainties about the price effects on economic growth are high and condition the forward-guidance of monetary policy. Inflation inching up and assumptions that monetary policy may be tightened have led to the increase of short-term yields. Interest rates on public debt securities have risen, especially in the short-term segments, which have factored in the tightening policies of central banks. The increase in interest rates in the long-term segments has been more restrained reflecting the uncertainties on the effect that this price increase will have on economic growth. Indicators in corporate financing segments, including stock indices fluctuated reflecting the uncertainty over private sector income in the second half of the year. However, the indicators of these markets remain more positive compared to the pandemic outbreak period.

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9 Central banks in Czech Republic, Hungary and Poland have accelerated the increase of the respective interest rates, in response to the higher inflationary pressures from the labour market.
3. FINANCIAL MARKETS AND LENDING CONDITIONS

The financial market in Albania has appeared relatively stable. The increase of policy rate has been fully transmitted to the interbank market and the current primary market auctions of government securities. Interest rates on credit continued to fluctuate at low levels, whereas banks are paying additional attention to loans’ applications. Following the shock experienced by the foreign exchange market, the lek has appreciated slightly against the euro, of this period of year.

The financing of private sector has continued at a high pace. Banks have particularly expanded the foreign currency intermediation, both to meet funding demand and to collect liquidity in foreign currency. The up-to-now developments in banks’ balance sheets confirm that although monetary policy started to normalise, the financial conditions will remain accommodative in the medium term.

3.1. DOMESTIC FINANCIAL MARKET\(^{10}\)

The first quarter of 2022 is characterised by low interest rate volatility and a calm liquidity situation. The increase of policy rate at the end of March was immediately and fully reflected on the interest rates applied in the interbank market. The lack of liquidity pressures has helped interest rates to mainly fluctuate below the policy rate, whereas their difference with the policy rate remains at minimal levels. The Bank of Albania continued to conduct regular open market operations by injecting liquidity of 7-day and 3-month maturity.

The liquidity required by banks during this quarter has been lower than at the end of the previous year, increasing only in March. Since the end of February, auctions have returned to fixed amount form and competitive prices. This change has neither affected their overall performance, nor the monetary policy signal transmission in the market.

\(^{10}\) The following analysis is based on the data available up to 21 April.
Overall, the foreign exchange market has been calm, characterised by normal trading parameters during the first quarter of the year, except for a short-lived episode of uncertainty at the beginning of March. The euro/lek exchange rate averaged 121.92 lek/euro in the first three months of the year, remaining close to the average level of the fourth quarter of the previous year. During the first three weeks of April, the euro/lek exchange rate fluctuated at an average of 121.1 lek/euro, with a slight appreciation of lek, which is in line with its seasonal behaviour. The lek appreciated against the euro by around 1.6% compared to the average of April 2021.
The depreciation of the lek against the US dollar, in reflection of the latter’s appreciation in the international market since the second half of the previous year, continued also in the first months of this year. The usd/lek exchange rate averaged 111.1 lek/usd in the first three weeks of April, from 106.8 lek/usd in December. This ratio is about 7.9% higher compared to the previous year.

Yields on T-bills and bonds in the primary market have shown an upward trajectory, reflecting the changes of policy rate and, coupled with the expectations for high inflation. If at the beginning of 2022, yields on government securities fluctuated at stable levels, starting from the first week of March, they have recorded consecutive hikes. Initially, changes in the upward trend have been minimal. Later they also reflected the policy rate change, in some securities, and beyond the gradual and expected transmission of this change. This trend in yields was mainly dictated by banks’ behaviour in the primary market auctions. Their perception for inflation pushing up further has driven to a postponed part of the demand to invest in government securities, and higher yields required from these investments. The increasing pressures on yields have been partially balanced by the good liquidity situation of the government.

In detail, at the beginning of April: yield on 12-month T-bill was 2.2%, up by 0.60 p.p. from January; the 10-year yield on bonds increased by 0.65 p.p.; while 2-year yield recorded a hike comparable to the policy rate. In future auctions, the monetary policy signals are expected to extend also to other maturities in the primary market. These developments have been materialised in a higher yield curve. The curve has slightly shifted upwards due to a more pronounced increase of primes in the long-term segment.

In April, the Ministry of Finance and Economy issued a bond with 2 years maturity in euro. Its yield was 2.2%, up by 0.3 p.p. compared to the yield of bond issued two years ago.
3.2. LENDING CONDITIONS

The Russia-Ukraine war found the banking system in Albania with sound parameters, able to withstand another possible shock. The uncertainties induced by this conflict do not seem to have had a tangible impact on banks’ availability to credit the economy, although they have become more attentive in this regards. The interest rate continues to fluctuate at low levels, recording a marginal increase in certain segments or specific banks.

The average interest rate on new loans to enterprises in ALL stood at 5.8% in 2022 Q1, marginally up compared to the previous quarter and the average of last year. This increase was recorded in the segment of loans larger than ALL 140 million and is particularly noticeable in loans used to finance liquidity needs. On the other hand, the cost of financing investment projects of enterprises remains stable and at low levels.

The first quarter of year was characterised by higher interest rates for households in the segment of consumer credit. It recorded on average 9.1%, from 7.9% in the previous quarter. Data analysis shows that the increase of interest rates on consumer credit is evident in some banks of the system. On the other hand, mortgage loans continue to be granted with low interest rates, at 3.6% on average, remaining close to the average levels of the previous year.

In the first quarter of 2022, interest rates on new loans to enterprises in euro recorded a slight increase, at 4.9%, compared to the stable average of 4.5% in the previous year. The increase during this month was manifested on loans larger than EUR 250 000, mainly on those used to cover liquidity needs. For households, the interest rates have remained broadly close to the average levels in the previous quarter and in 2021.
Box 2 Credit supply conditions and demand for loans in 2022 Q1*

Commercial banks showed more prudence in lending to firms in the 2022 Q1. Uncertainties’ intensification due to higher prices in international and domestic markets drove banks to be somewhat more conservative - compared to the previous quarter - in determining credit standards, terms and conditions, as well as in accepting loan demand mainly from medium-sized and small enterprises. The more prudential lending policies have been fragmented, not just regarding the size of enterprises - only for small and medium-sized enterprises, since risk for the future is perceived to strengthen the vulnerable position of this segment - also regarding loan’s purpose of use - only for investment loans, since according to banks, the complexity of the macroeconomic situation and its prospect require the formulation of more stable investment plans.

The tightening of lending standards for small and medium-sized enterprises was succeeded by a tightening in terms and conditions on loans, which was manifested in high margins for both riskier and average loans. In addition to price components, banks applied higher commissions and loan covenants to enterprises during this quarter. The loan rejection ratio to the total of applications of enterprises was up.

In contrast to enterprises, banks applied eased lending policies to households, facilitating both the credit standards as well as the lending terms and conditions on loans. At the same time, the loan rejection ratio for households fell during the first quarter. This type of approach was dictated by the pressure of the banking system competitiveness.

Loan demand is reported high from all economic agents, for the fourth consecutive quarter. Enterprises expressed a higher demand for loans from the banking system, in order to finance inventories and working capital, as well as planned investments. On the other hand, households demand for financing, particularly house purchases, was up.

* The analysis is based on Bank Lending Survey, conducted on quarterly bases and is published at: www.bankofalbania.org/
3.3. CREDIT TO THE PRIVATE SECTOR\textsuperscript{12}

Banks have continued to finance the private sector at a high pace also in the first quarter of 2022. In March, the annual growth of credit to private sector was 12.8%, or 2 p.p. higher than at the end of the previous year. The expansion of credit portfolio was observed across all categories, but it is more pronounced in lending in foreign currency and credit to households. This expansion was underpinned both by the improvement of banks’ balance sheets, as well as the increased demand for financing these segments. As a ratio to GDP, credit to the private sector reached at 38.5%, remaining at an upward trajectory throughout the previous year.

The developments of lending by currency show an acceleration of credit in foreign currency, at 16.3%. The increase of credit in foreign currency reflects the heightened demand by both enterprises for working capital and households for house purchases. On the other hand, lending in lek has shown a slower growth rate, at 9.6%, compared to 10.1% in December 2021. At the end of the first quarter, the share of credit in lek is slightly higher than that in foreign currency, accounting for 51% of credit to the private sector.

Credit to enterprises continued to increase at a high pace, at around 10.8%, a rate similar to the average growth in 2021 Q4. Loans for meeting liquidity needs seem to have accelerated the growth rates, compensating the deceleration noticed in loans for investment purposes. This performance reflects the higher demand of enterprises for working capital, given the upsurge in prices in international markets and the uncertainty on providing certain commodities.

\textsuperscript{12} Credit analysis is based on the new set of data prepared by the Statistics Department, in line with the ECB methodology on “real” credit flows, which excludes both the effect of exchange rates and written-off loans of balance sheets. Given the methodological changes, the actual values are higher than growth rates analysed heretofore. Despite the changes, both sets show the same performance of lending over time.
Credit to households increased at a high pace in 2022 Q1, by 16.3%, supported mainly by lending to finance house purchases. The price performance of apartments and the higher demand for housing and investment have contributed to the positive outlook of this portfolio. Also, consumer credit has maintained similar growth rates, as in the last quarter of the previous year.

Chart 10

Deposits continued to grow, supported mainly by the foreign currency component

Deposits continued to grow, supported by both households and enterprises

Notes: Growth of total deposits, including over 2-year deposits, decomposed by currency.
Source: Bank of Albania.

Notes: Growth of total deposits by agents, including over 2-year deposits, decomposed by economic agents and currency.
Source: Bank of Albania.

Deposits in the banking system continued to expand with a high pace. In 2022 Q1, private sector’s deposits grew by 10.8%, a rate similar to the one of 2021. The higher growth pace of foreign currency deposits, at 18.2% from 16% in 2021, has compensated by the slower expansion rates of deposits in lek (at 5.4%, from 7.1% in 2021).

According to economic agents, households’ deposits grew by 7.9%, while enterprises’ deposits continue to be characterised by double-digit growth rates.

Developments in the structure of deposits by maturity show that time deposits grew at a steady pace by around 3%, while demand deposits trended downwards. This trend is mainly due to households’ higher interest for time deposits. At the end of the first quarter, demand deposits accounted for 56% of total deposits, remaining at the same ratio from the previous quarter.

The banking system operates with a steady deposit base, which has enabled it to maintain a minimum financing cost of the lending activity. Interests on new deposits in the first quarter have recorded a marginal drop compared to the previous quarter and the average of the previous year.

The average interest on new time deposits in lek was 0.64%, from 0.70% in the previous quarter, reflecting the lower rates on time deposits for over a year. The average interest on new time deposits in euro was 0.17% in this quarter, slightly down compared with the previous quarter, but remaining close to the average of the previous year.
4. ECONOMIC GROWTH

In the first quarter of 2022, the economic developments in Albania were framed in the context of high uncertainties and increased prices in foreign economies, due to the Russia-Ukraine war. The Albanian economy is in a recovery cycle, mainly driven by the domestic demand. The Gross Domestic Product (GDP) grew by 5.5% in 2021 Q4, supported by the increase in consumption and investment. On the other hand, net exports provided a negative contribution, where the import of electrical energy gave an important impact.

The rapid increase of costs and inflation, as well as the higher uncertainties due to the conflict in Ukraine, is expected to put a break on consumption spending and production in some of the following sectors. The available data shows that the economic activity has slowed down in 2022 Q1. However, the war is not expected to affect long-term stability and macroeconomic indicators, while the Albanian economy is expected to record positive growth rates over the course of the next two years.

4.1. GROSS DOMESTIC PRODUCT

The GDP expanded by 5.5% in annual terms, during 2021 Q4. The expansion of economic activity was broadly based, where both the production and services sector have contributed by 2.1 p.p., respectively, to the growth of GDP (Chart 11, left).

Economic growth recorded 8.5% throughout 2021, from a 3.5% contraction of economy in 2020. Currently, the level of economic activity stands at 4.8% above both the pre-pandemic and pre-earthquake levels, showing that the negative effects of this shock have been overcome.

<table>
<thead>
<tr>
<th>Economic growth slowed down compared to the previous quarter, affected also by the evaporation of base effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production components appear over the pre-earthquake and pre-pandemic levels</td>
</tr>
</tbody>
</table>

Notes: The value added of the economic sectors adjusted seasonally and turned into an index based on the 2019 Q3. Source: Bank of Albania.
The increase in the value added of the production sector accelerated to 5.7%, from 3.0% in 2021 Q3. This performance reflects the high level of construction activity, which contributed by 1.8 p.p. to economic growth in 2021 Q4, from 0.5 p.p. in 2021 Q3. On the other hand, the contribution of the industry branch fell to zero, mainly due to the negative impact of the electricity production. Last, activities in agriculture, forest and fishing have returned to the upward trend, but their contribution to economic growth remains quite low, at around 0.3 percentage point.

The increase in value added of the services sector decelerated to 4.0% in 2021 Q4, from 9.5% in 2021 Q3. The deceleration effects mainly stemmed from the branch of “Trade, transport, accommodation and food services” and the branch of “Accommodation”, reflecting the lower growth in the export of tourism services compared to the third quarter of the year. On the other hand, the branch of real estate recorded a higher growth.

Economic growth in Albania is expected to slow down during the first quarter of 2022, due to the war in Ukraine. Supply chain disruptions, the geographical re-orientation of the trade activity, and the rapid upsurge in prices are expected to affect the domestic economic activity through both direct and indirect channels. The upswing in prices is expected to directly impact the domestic purchasing power, by decelerating demand for goods and services. In addition, the economy will be indirectly affected as demand in the main trading partners of the EU will slow down, and prices in the economy will push up.

4.2. AGGREGATE DEMAND

The growth of aggregate demand slowed down at the end of 2021, due to the expansion of trade deficit. Meanwhile, domestic demand increased at an accelerated pace due to faster investment growth.

Based on the data in the Balance of Payments for 2021 Q4.
Domestic demand rose by 8.0% in annual terms, in 2021 Q4, from 5.2% in the previous quarter. Population consumption had the main contribution to its annual growth, while the higher growth of investments has accelerated domestic demand. Public consumption reflected a growth of 6.8%, compared to 6.3% in the third quarter.

Private consumption increased at a slower pace compared to the previous quarter. The growth of public consumption in the fourth quarter is supported by higher employment income, favourable financing conditions, and the improved confidence following the pandemic shock. The annual growth of 5.3%, in the fourth quarter, was driven by the increase of consumer spending in all the components of private consumption.\(^4\) (Chart 13, right). The index of retail trade for food items accelerated in the fourth quarter, compared to the previous quarter, while the index of trade for long-term items and spending for services had a slower growth in this quarter.

Private consumption is expected to continue inching up in 2022 Q1. The increase in the import of food items and confidence indicator in services and trade have both registered the same values as the fourth quarter (Chart 14, left). The data from the consumer confidence survey signal that consumers have been prudent, given an environment with increased uncertainty (Chart 13, left). The data of the survey suggest that in the first quarter large purchases will fall and savings are expected to increase (Chart 14, right).

\(^4\) The analysis on the components of private consumption is based on indirect data from the retail trade index, import of goods, and GDP measured using the production method.
Total investments in economy grew by 16% in the fourth quarter, providing the main contribution to the increase of aggregate demand (Chart 15). The improved confidence of enterprises, above the historical average, the gradual improved demand, and the eased financial conditions have supported the conduction of investments. Both the private and the public components provided large contributions to the growth of investments, however the private component had the largest impact.

Survey indicators suggest that investments will continue to grow in the first quarter of the year, as well. The financial situation and the current capacity utilisation rate of enterprises stand above the historical average, respectively (Chart 16, left).
Quantitative indicators on external trade suggest growth in both categories: investments in construction and investments in machinery and equipment.

The contribution of net exports shifted in negative territory in 2021 Q4 (Chart 17). Trade deficit in goods and services expanded by 45.0%, in response to the rapid growth of imports by 32.8%. The latter was driven by both the increase in the import of goods (32.9%), where import of electricity was the main contributor, as well as the rise in the import of services (32.5%).

Export of goods and services also recorded a high growth of 24.4%, but insufficient to offset the impact of higher imports. The growth of exports appears to have slowed down compared to the previous quarter, when they expanded by 63.3%. The sluggish tourist activity coupled by the lower growth rate of goods export contributed to this performance. Exports of electricity contributed negatively in the growth of exports during this period.

The trade deficit in goods contracted by 6.6% in 2022 Q1, due to the stronger exporting effect. Developments in the trade of goods continued to reflect mainly the upsurge in prices in international markets. This factor has played a decisive role in the nominal increase of imports, which, in terms of trade volume, have remained almost at the levels of the previous year. The impact of the prices surge in international markets has also dominated the growth of exports, but the latter have increased in terms of volume as well.

Rising international prices for oil and industrial metals have determined the increase in exports of goods

The growth in imports was affected by the surge in international oil prices and construction materials

Chart 17
The contribution of net exports was negative in 2021 Q4, due to the acceleration of imports

Chart 18
Rising international prices for oil and industrial metals have determined the increase in exports of goods

The growth in imports was affected by the surge in international oil prices and construction materials

Notes: Contribution of imports and exports in economic growth.
Source: INSTAT and estimations of the Bank of Albania.
In 2022 Q1, export of goods grew by 49.6%, in annual terms (Chart 18, left). Categories “Construction materials and metals” and “Minerals, fuels and electrical energy” provided the main contributions in this growth. For both categories, the increase has mainly reflected the effect of rising prices of relevant products in international markets, especially in the case of fuels and industrial metals. Other categories of exports have also made positive contributions, albeit to a lesser extent compared to the above categories.

Imports of goods, in 2022 Q1, grew by 27.9%, annually (Chart 18, right). Even in this case, the categories “Minerals, fuels, electricity” and “Construction materials and metals” provided the main contributions to the growth. In the case of fuels and energy, the increase is attributed only to the increase in prices, while imports related to the construction sector in the country increased, both in terms of prices and volumes. Other categories of imports have also made positive contributions, which have maintained the contributing values of the end of 2021.

In terms of major trading partners, the growth of exports in this quarter was led by Italy, Germany and Kosovo, while Turkey, Saudi Arabia and Italy contributed more to the growth of imports.

Fiscal policy for 2022 is designed to maintain a rate similar to a year ago. The annual deficit in 2022 is planned at around 4.9% of GDP, or around 0.4 percentage point higher than the level realised for 2021.

In 2022 Q1, the fiscal impulse became negative, estimated at around -4 percentage points of GDP. The high values of the primary surplus of the first quarter were determined mainly by the strong growth of revenues, and partly by the temporary suspension of a part of public investments. With the reduction of high volatility of metal prices in international markets, public investments are
expected to return to their seasonality and meet the annual plan target, recently revised to levels similar to the target for 2021.\(^\text{15}\)

The budget balance reached a surplus of ALL 22.2 billion in the first quarter, the highest ever recorded within a quarter. The high level of budget surplus of this quarter reflected, on the one hand, the positive dynamics of revenues - reflecting to some extent the rapid growth of foreign and domestic prices - and on the other hand the slowdown of public investment, compared to the previous year. In terms of GDP, the fiscal surplus in the first quarter was estimated at around 4.9%.

In the first quarter, domestic borrowing was planned to be increased by about ALL 1.8 billion. However, in the March auctions, there was a reluctance of banks to meet the amount announced for issuance by the government. This has reduced the government securities portfolio in the first quarter by ALL 1.8 billion. Banks reduced their exposure against the government by about ALL 5.2 billion, which was partially amortized by the more active participation of other non-bank financial institutions in government securities auctions.

Net external borrowing\(^\text{16}\) amounted to about ALL -1 billion in the first quarter. Considering the effect of domestic and external borrowing, by about ALL -3 billion, the high values of the budget surplus have been converted into an increase in government liquidity, by about ALL 19.5 billion.

\(^{15}\) With the review of the 2022 budget with a normative act in March 2022, the initial plan of total expenditures increased by ALL 10 billion. Meanwhile, the capital expenditure plan was reduced by ALL 10 billion, to a total of ALL 129.5 billion for 2022, including the ALL 20 billion fund for reconstruction. This level of the plan was similar to the actual value for 2021, of ALL 128 billion. With the review of the plan for 2022, the plan on deficit remained unchanged at ALL 100.9 billion (as a result of the upward revision of revenues by ALL 10 billion).

\(^{16}\) New external borrowing, deducting foreign debt principal payments.
In the first quarter, **budget expenditure** amounted around ALL 117 billion, or 1% lower than in the same period in the previous year. Expenditure slowdown in this quarter is attributed to the decline in capital expenditures. The latter, including the reconstruction fund, were about ALL 7.6 billion, almost half of the level recorded in the same period of the previous year. The rapid rise in prices of metals and raw materials in world markets, coupled with the increased uncertainty about the future as a result of the Russia-Ukraine war\(^{17}\), seem to have been among the main factors holding back public investment in the first quarter\(^{18}\).

Current expenditure amounted to around ALL 104.1 million, around 2.5% higher than the same period in the previous year. Their increase was achieved mainly due to higher expenditures on the pension scheme and domestic debt interest rates. Also, in the first quarter, the government allocated a fund of ALL 5.4 billion in the form of loans to the energy sector, to partially mitigate the financial balance of OSHEE, as a result of not fully reflecting the increase in energy prices in foreign markets to end user. This form of support was further amplified by the budget review - increasing the energy sector loan plan to ALL 28 billion, from the originally planned at ALL 8 billion. In the first quarter, it contributed to the annual growth of total expenditure by 4.4 percentage points.

**Chart 21**

Expenditures were slow ... ... as a result public investment contraction

---

Budget revenues in the first quarter amounted to ALL 1.39 billion, up by 27% in annual terms. VAT revenues made the largest contribution to revenue increase, by about 12.7 p.p. The high impulse of this item in revenue growth is largely explained by the upward trajectory of commodity prices in foreign markets. Other tax items - profit tax, local government revenues, national taxes and those from social insurance- have also had a positive impact on revenue growth, signalling positive developments in the production of goods and services in the country, and in the labour market.

\(^{17}\) These are two of the countries with the highest metal exports in Europe.

\(^{18}\) The plan for 2022 Q1 was about ALL 11.2 billion.
Quarterly Monetary Policy Report, 2022/II

Notes: Composition of revenue growth by quarters.
Source: Ministry of Finance and Economy.

... where the high role of VAT revenues stands out

Notes: Annual growth in % of main tax items, by quarter
Source: Ministry of Finance and Economy.
5. INFLATION, PRICES AND COSTS IN THE ECONOMY

Annual inflation averaged 4.4% in 2022 Q1, from 3.1% in the previous quarter. It stood at 5.7% in March, recording one of its highest historical values.

The increase in the inflation rate has reflected, for the most part, foreign inflationary pressures, as a result of the significant increase in import prices, especially of raw materials and foods in international markets. Domestic inflationary pressures have also increased, reflecting the recovery of demand, employment growth, wages and inflation expectations. Based on the current trends and their determinants, inflation is expected to remain relatively high in 2022 and further decrease during 2023.

5.1. CONSUMPTION PRICES

Annual inflation averaged 4.4% in 2022 Q1, standing 1.3 percentage point higher compared the previous quarter. Inflation followed an upward trend during the quarter, which peaked in March, recording a historically high rate.

Inflation in Albania followed the upward trajectory that started at the end of last year, due to strong pressures from supply factors, which resulted mainly from the increase in global prices of energy goods, raw materials and raw food items. These developments directly and indirectly affected almost all production chains and the supply chain of the market, causing an overall increase of prices. On the other hand, the global conjuncture of electricity prices was reflected in higher energy prices for large businesses, and consequently in increased costs and prices for domestic production. In parallel, economic agents revised upwards their inflation expectations.

Inflation increased in other countries in the region and the EU as well (Chart 23, right). Global commodity and energy prices, due to the pandemic and recently the geopolitical situation caused by the war in Ukraine, are causing a rapid increase of inflationary pressures as a result of strong imbalances between supply and demand for industrial commodities and food items. In most economies, inflation is higher than the target of central banks, and in some of them it has reached the highest historical levels.
Annual inflation in Albania continued on the upward trajectory, due to strong pressures coming from global supply factors. The pandemic and recently the geopolitical situation are causing unpredictable rise of inflation.

From the point of view of the basket structure on which inflation is measured, the increase in prices is observed in the group of processed foods and that of energy goods, including oil, which marked an increase in contributions this quarter (Table 2).

The category of energy goods was influenced by the increase in prices of oil and gas products in the global market. The prices of the latter increased in the domestic market, especially starting from the end of February. The contribution of this category to headline inflation was around 0.4 percentage point higher than in the previous quarter, or 22% of total (Chart 24, right). The increase in the contribution from "Unprocessed food" was observed in the first two months of the quarter, while in March, prices in this category had less of an impact on the inflation rate. The rise in prices in the category of processed foods peaked in March, forming about 40% of inflation. The prices of other more stable components of inflation, including services, housing and durable consumer goods, also contributed the same amount to inflation as in the previous quarter. However, the prices of some services increased, especially influenced by the upsurge in the prices of energy goods.

### Table 2 Contribution of key items to annual inflation (p.p.) *

<table>
<thead>
<tr>
<th></th>
<th>Q1 ’20</th>
<th>Q2 ’20</th>
<th>Q3 ’20</th>
<th>Q4 ’20</th>
<th>Q1 ’21</th>
<th>Q2 ’21</th>
<th>Q3 ’21</th>
<th>Q4 ’21</th>
<th>Q1 ’22</th>
<th>Inf. Q1 ’22(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processed food</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.6</td>
<td>0.4</td>
<td>0.6</td>
<td>0.9</td>
<td>1.4</td>
<td>6.6</td>
</tr>
<tr>
<td>Bread and grains</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.4</td>
<td>9.5</td>
</tr>
<tr>
<td>Unprocessed food</td>
<td>0.8</td>
<td>1.2</td>
<td>0.8</td>
<td>1.0</td>
<td>0.3</td>
<td>0.9</td>
<td>1.0</td>
<td>1.0</td>
<td>1.5</td>
<td>7.8</td>
</tr>
<tr>
<td>Fruits</td>
<td>0.7</td>
<td>0.7</td>
<td>0.5</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
<td>0.2</td>
<td>6.4</td>
</tr>
<tr>
<td>Vegetables</td>
<td>0.2</td>
<td>0.4</td>
<td>0.2</td>
<td>0.6</td>
<td>0.0</td>
<td>0.6</td>
<td>0.8</td>
<td>0.4</td>
<td>0.9</td>
<td>14.6</td>
</tr>
<tr>
<td>Services</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>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Goods with regulated prices</td>
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<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>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Housing lease</td>
<td>0.2</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.0</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Non-food consumer goods</td>
<td>0.0</td>
<td>-0.2</td>
<td>-0.2</td>
<td>-0.4</td>
<td>-0.3</td>
<td>0.1</td>
<td>0.3</td>
<td>0.6</td>
<td>1.0</td>
<td>7.6</td>
</tr>
<tr>
<td>Fuel</td>
<td>0.0</td>
<td>-0.3</td>
<td>-0.3</td>
<td>-0.4</td>
<td>-0.3</td>
<td>0.0</td>
<td>0.2</td>
<td>0.4</td>
<td>0.7</td>
<td>27.2</td>
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<tr>
<td>Durable consumer goods</td>
<td>0.1</td>
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<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>0.1</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>1.6</td>
<td>1.9</td>
<td>1.4</td>
<td>1.6</td>
<td>0.9</td>
<td>1.8</td>
<td>2.4</td>
<td>3.1</td>
<td>4.4</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania’s calculations.
* The table presents the contributions to inflation by constituent categories and some of their main items. The table also shows the average value of inflation in 2022 Q1.

Inflation increase was also reflected in the upward trend of core inflation, or various measures of inflation, which exclude the effect of more volatile goods (Chart 24, right).

**Chart 24**
Its performance reflected rising inflation in food and energy goods price.

Various measures of net inflation have shown an upward trend

Source: INSTAT and estimations of the Bank of Albania.

5.2. DETERMINANTS OF INFLATION

The increase in inflation was influenced by the components most exposed to developments in foreign markets. Domestic and core inflation components carried intensified inflationary pressures as a result of the second round effects from commodity prices to those of consumer goods and services. Consequently, the increase in contributions to the formation of headline inflation in the first quarter resulted in a broad base, where imported inflation is estimated to be predominant (Chart 25).

**Chart 25**
Core and non-core contributions appear balanced in the first quarter of the year, with more significant increase from the non-core component

The intensity of imported inflationary pressures was higher in the first quarter, leading to the acceleration of headline inflation

Source: INSTAT and estimations of the Bank of Albania.
With the outbreak of the Russia-Ukraine war, the uncertainties in international markets over the supply of commodity materials and food items also materialized in rapidly rising prices in the domestic market. Imported inflation, as well as core and domestic inflation, showed an upward trend. Similarly, electricity fees at market prices for some large businesses are estimated to have been transmitted to the final prices of consumer goods and services during the quarter under review. As a result, core inflation was 3.2% in average annual terms, trending upward during the quarter. Processed food gave a significant contribution to this growth - part of the sub-basket of measuring core inflation. Net core inflation - without the impact of the prices of these food items - was 1.5% this quarter (Chart 26). Its growth trajectory was faster in March (1.8%) compared to the value of the previous two months (1.3%). This shows that the share of services and housing were affected by cost increases, and has been transmitted through price-setting channels, up to the respective final consumption prices.

The most volatile components of inflation also recorded rapid growth. In particular, imported inflation reflected the expansion of foreign prices and the increased costs of accompanying services of imported goods. Imported inflation recorded increasing and double-digit values, to an average of 11.1%, and non-core inflation was around 6.9% in the first quarter.

**Cyclical position.** Our assessments suggest that cyclical position of the economy has been improving. This improvement is especially noticeable in the higher employment growth and in the significant acceleration of the wage growth rate in 2021 Q4. Wages in the private sector increased by 10.2%, accelerating the upward trend observed throughout 2021. In parallel, output prices have increased.

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19. The reviewed weight of the core inflation measurement sub-basket for 2022 is 68.3% compared to 71% during 2021. The usual measurement of core inflation also includes some subgroups of processed foods (including “bread and corn”), which have demonstrated relatively stable inflation over the years.

20. Net core inflation is an alternative measure of core inflation that excludes processed food subgroups from its usual measurement. Measured in such way, the net core inflation takes into account about 44% of the CPI basket.
The capacity utilisation rate in the economy continued to remain above the long-term average in 2022 Q1. It was about 76.6%, slightly below the last level of the previous year. Businesses that are in the services and trade sectors report a lower capacity utilization rate, while businesses in the industry and construction sectors report a higher rate.

Employment and unemployment. Employment continued to grow in 2021 Q4, at an accelerated rate of 2.7%, from 0.7% in the third quarter. The industry and services sectors continue to lead to employment growth, while the agricultural sector continues to reduce labour demand.

Employment growth impacted on the decline of unemployment rate to 11.4% in the end of 2021 from 11.8% in the end of 2020. Also, other labour market indicators such as labour force participation and inactivity have improved (Chart 28).

Wages and labour costs. The average gross monthly wage for a full-time employee in 2021 Q4 expanded by 8.4% in nominal terms and 5.3% in real terms, adjusted for inflation (Chart 29). This rate is significantly accelerated compared to the third quarter, when the index increase was 6.9%. In particular, the 10.2% wage increase in the private sector with broad-based contributions from all branches of the economy stands out.

Other output costs are characterized by further acceleration of growth rates during the fourth quarter of the previous year. The industrial production prices increased by 5.6%, from 4.3% in the third quarter of the year. Domestic market prices expanded by 4.0%, from 3.3% in the previous quarter, while production prices for exports increased by 14.0%, from 7.1%. Finally, production costs in the construction sector increased by 3.1%, from 2.2% in the previous quarter.

Imported inflation. The Imported Inflationary Pressures Index (IPI) expanded by 16.8% in annual terms, during January-February 2022, a significant acceleration compared to 2021 Q4 (Chart 30). Sharp growth of foreign prices (25.2%) continues

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21 This indicator refers to the gross monthly average wage received per employee and is based on the payroll data declared at the General Directorate of Taxation (INSTAT 2021 Q3).

22 IPI is calculated as the annual growth of foreign price index and the NEER index for the respective month. Correlative analysis of relevant indicators with various time lags shows that IPI affects inflation component imported from 3-5 months.
to lead the performance of this indicator. Exchange rate appreciation - albeit stronger than at the end of last year - has failed to offset rising prices abroad.

The expansion of IPI is in line with the increase of the contribution of imported inflation to the formation of headline inflation during 2022 Q1. This contribution reached 57.0%, up by 11 percentage points compared to the previous quarter (Chart 25, right).

Inflation expectations. All measurements from surveys for inflation expectations in the future have increased in 2022 Q1, above the 3.0% target. Consumer expectations recorded the highest historical level of 7.3%, while their level has remained significantly above the relevant historical average, starting from the second half of the previous year (Chart 31, left).

Expectations of businesses and financial agents have increased above the target, but remain below the official inflation rate in the first quarter. Enterprises expect that one-year-ahead inflation will be 3.3%, up by 0.9 percentage point than expectations for the fourth quarter. Financial agents have also revised upwards the expected future inflation (Chart 31, right). They expect one-year-ahead inflation to be 3.5%, or 0.8 percentage points higher than the expectations of the previous quarter. Expected inflation after two and three years is 3.3% and 3.4%, (up by 0.4 and 0.4 percentage point, respectively, from the expectations of the previous quarter).

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.

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23 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.
Box 3 The reasons behind the increase of consumer expectations regarding inflation

During the recent months, all measurements of inflation expectations from surveys have increased, staying above the 3% target. Consumer expectations are in particular high, compared to the expectations of other agents, as well as to its historical average. Measurements of consumer expectations for inflation for longer than one year time horizons are lacking, but similar measurements for businesses and financial agents show that long-term expectations are still anchored near the 3% target. The purpose of this information box is to identify in more detail the growing trend of consumer expectations by different groups, as well as to compare them with other EU countries and the region.

The upward trend of Albanian consumers’ expectations for future prices is in line with those of consumers in the European Union and the countries of the region (Chart 1). The trajectory of inflation expectations has been growing sharply after the first months of the pandemic. The same trend is observed in the countries of the region, where consumer expectations for future inflation have increased mainly in Serbia, Montenegro, and to a lesser extent in Northern Macedonia (Chart 1, right). Previous estimates on the series of consumer expectations in Albania for short-term inflation have identified their adaptive nature to the previously published inflation values. Consumers’ perceptions and expectations for inflation are more sensitive to fluctuations in food prices, demonstrating a higher positive correlation with the latter. The impact of the pandemic on goods distribution chains and, more recently, the aftermath of the war in Ukraine have significantly increased commodity prices and uncertainties in the relevant markets, leading to a rapid rise in consumer inflation expectations.

More detailed data from the Consumer Confidence Survey shed light on the behaviour of consumer inflation expectations, divided by average income level, employment level, gender and level of education (Chart 2). The upward trend of expectations is observed in all categories, but their level is higher for some groups of consumers. The results show that expectations are generally higher for lower-income households, whose expenditures are more food-oriented (Chart 2, top left). According to employment, inflation expectations have remained higher for the unemployed throughout their measurement history, although this change...
has faded slightly during the recent years (Chart 2, top right). Meanwhile, the change in the trend of inflation expectations between the genders appeared only during the pandemic, where women generally expect higher prices than men (Chart 2, bottom right). The pandemic evidenced changes in expected prices even among respondents with different levels of education, where expectations are higher for individuals in the lower categories of education (Chart 2, bottom left).

Concluding, the upward trend of consumer expectations for inflation is a phenomenon observed in all countries, influenced mainly by global factors. Inflation expectations in Albania in recent quarters have increased more for the unemployed, and for households with lower income and lower level of education.

1 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.
2 The Confidence Surveys are conducted by all EU member states and candidate countries, according to the same methodology harmonized by the European Commission.
3 https://www.bankofalbania.org/Publications/Are_Inflation_Expectations_in_Albania_Rational_Empirical_Evidence_from_Surveys_Data_.html.
5 The linear correlation analysis shows that the correlation of price expectations is stronger with the inflation of unprocessed foods.