THE REPORT REFERS TO BANK OF ALBANIA’S MONETARY POLICY STATEMENT FOR 2019 H2, APPROVED BY THE SUPERVISORY COUNCIL, DECISION NO. 4, DATED 5.2.2020
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INTRODUCTION

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

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 January 2020.
The new information analysed in this Report suggests that the economic activity in Albania was hit by the earthquake of November 26th, 2019, but this shock has not compromised the medium-and long-term trend of development. The consequences of the earthquake are expected to have a slowdown resultant effect on both the economic growth and inflation. However, this slowdown is expected to be temporary and concentrated during 2020.

The updating of our baseline scenario suggests that the growth pace will accelerate in the medium term. This acceleration is expected to bring the economy to equilibrium and inflation to target by 2021. Based on these considerations, the Supervisory Council deemed that the current monetary stimulus remains adequate.

The Supervisory Council concludes that downside risks have increased. Their materialisation might dictate a further easing of the monetary policy stance.

The conclusions of this Report are detailed following.

In the fourth quarter, inflation averaged 1.3%, down from the previous quarter, and remaining below our target of 3%. The decline in the inflation rate reflected the slower increase of food prices. This phenomenon is particularly present in December. While, prices of other basket items recorded less fluctuations.

From the macro-economic perspective, low inflation rates and the undershooting of the target reflect a still insufficient growth in wages and production costs in the economy, low inflation rates in our trading partners and the residual effect from the exchange rate appreciation in 2018. The decelerating effect of these factors will be gradually reduced in the medium term.

According to INSTAT data, the Albanian economy recorded an annual growth of 3.8% in the third quarter, accelerating from the first half of year, and in the upper side of our expectations. In sectoral terms, this acceleration was driven by the positive tourist season and the reduction of the negative effect originating from the fall in production of electrical energy. In terms of aggregate demand, it reflected the faster growth of consumption and exports, while private investments were down.
The expansion of aggregate demand is combined with the gradual improvement of the country’s cyclical position in the last four years. In response to these trends, the unemployment rate stood at 11.4% in the third quarter, the historical lowest rate recorded in Albania, while the average wage recorded an annual growth of 3.7%.

Nevertheless, the rise of wages and production costs remains insufficient for inflation to converge to target, by showing that the Albanian economy is still far of the fuller utilisation of its production capacities.

The information available on the economic developments in the fourth quarter is incomplete. Analysis of preliminary data suggests that the earthquake of November 26th, 2019, had a negative impact on the economic growth pace. This effect is expected to continue in 2020 as well. The damages to firms’ sites, the increase of uncertainty and the re-orientation of expenditures to repair the damages, are expected materialise in the slowdown of the production in the affected sectors, including tourism. On the other side, the re-construction process is expected to provide a positive effect on the growth, but not simultaneously with the negative shocks, and not sufficiently strong to compensate their effects.

Judging on the available information and global experience, the Bank of Albania deems that the earthquake has not damaged the medium-term and long-term basis of the country growth and development.

The reconstruction process and the normalisation of the situation will help to regenerate the production capacities and a faster expansion of the aggregate demand in 2021 and further. The rise in employment and wages will support the expansion of family consumption; the rise of utilisation of production capacities will increase the demand for investments; while Albanian exports will continue to benefit from the development of tourism sector.

In parallel, the overall financial environment appears favourable. The financial markets are relatively calm, financing costs are low, while the exchange rate appears more stable. Our accommodative monetary policy stance, the restructuring of banking sector and the improvement of its balance sheet have boosted a more rapid credit growth. The credit portfolio grew by 7.8% on average in the fourth quarter, driven by the expansion of credit to enterprises and of credit in lek. The structure of credit growth provides encouraging signals, both on its impact on economic growth and on credit portfolio quality in the long term. At the same time, non-performing loans ratio dropped at 8.4% in December, by reflecting the concrete measures implemented by the Bank of Albania for their reduction and the improvement of both economic environment and financial situation of borrowers.

Looking ahead, the Bank of Albania deems that the earthquake effect on the economy is expected to concentrate during 2020. Both the economic growth and average inflation in 2020 are expected to be comparable with the rates
recorded during 2019. On the other side, overcoming the consequences of the earthquake is expected to pave the way for a more rapid growth of economy and inflation in the period ahead.

Our baseline projection, compared with the previous round, shows a notable shift to the down side for 2020, but it maintains the same trajectories for 2021 and on. These forecasts are surrounded by a heightened level of uncertainty, linked primarily to the inability of precisely forecasting the impact of the earthquake on the economic growth. Also, the balance of risks around the central forecast is tilted to the down side.

Judging on these projections, the Bank of Albania deems that the current monetary policy stance remains adequate. The fulfilment of our objective - price stability - would require maintaining the accommodative stance of the monetary policy in the medium term.

The risks to the down side remain present. These risks arise from both the external environment, with the euro area economy improvement still remaining fragile, and the domestic environment. In particular, the potential risks with possible adverse impact are:

- A stronger intensity of the earthquake negative effects on the economy performance over 2020 and on. In particular, this scenario might be materialised if the psychological aspects of the earthquake exceed its material impact on the economy.
- The delay in the reconstruction programme or a higher support from domestic financing sources.

Addressing the factors that can lead to these risks materialise is in the remit of the central and local governments. However, if they do materialise, the monetary policy stance would need to be revised on the easing side.

Finally, the Bank of Albania emphasises the need for further accelerating the structural reforms, as the best instrument for improving sustainable and long-term growth in Albania, and maintaining the focus of the economic policies on the long-term stability of the country.
The new information analysed in this report points to a complex dynamics in the second half of the previous year and makes the forecast for the short-term trends of the country’s development difficult. On one hand, the performance of both economic activity and labour market in the third quarter, as well as monetary developments in the fourth quarter have been positive. On the other hand, the low inflation in the fourth quarter; the earthquake of 26th November 2019; and the worsening of confidence indicators, suggest a possible slowdown in this period, and – potentially – also in the forthcoming quarters.

Available data show that the Albanian economy continued to improve the cyclical position until the third quarter. In line with this performance, the domestic medium-term inflationary pressures continued to increase, although they remain insufficient for the convergence of inflation to target. In parallel, imported inflation continues to remain low, in response to developments in international markets and the appreciation of the exchange rate during the previous quarters.

Financial markets are calm, characterised by low interest rates, ample liquidity and increased stability of the exchange rate. Both the increase of the demand and the improvement of bank credit supply were accompanied by a better transmission of monetary stimulus and an upward trend of credit to private sector.

In the short run, the consequences from the earthquake are expected to feed into the slowdown of the economic activity, but they will not affect the expected economic trends in the medium term. The update of our medium-term forecasts suggests inflation will converge to target within 2021, albeit the downside risks remain dominant.

In accordance with these projections, the current stance of the monetary policy remains adequate. Bank of Albania will continue to assess on on-going basis the adequacy of this stance and the intensity of monetary stimulus, always aiming at the convergence of inflation to target within the medium-term time horizon.

The new analysed information shows a positive performance of economy in the third quarter. According to INSTAT data, the Albanian economy grew 3.8% in this period, compared with 2.5% in the first half of 2019. The higher pace of economic growth was mainly driven by the good tourist season, the growth
of industrial production and the fading out of the negative effect from the lower electricity output. Also, labour market continued to improve in the third quarter, driving the unemployment rate at the historical minimum level of 11.4%.

Annual inflation averaged 1.3% in the fourth quarter, down from the previous quarter. Inflation reduction, in this quarter, was attributable to the fall in prices of rents and oil. On the other hand, processed food prices have increased, while prices of other items in consumer basket maintained low positive contributions to inflation.

The slow increase of costs in the domestic economy and the weak pressures from external environment affected the low inflation. The rise in wages and production costs is still insufficient for inflation to converge to target. In turn, core inflation stands at low levels. Also, imported inflation remains at low levels reflecting the low prices in international markets and the appreciation of the exchange rate.

Financing conditions and lending have maintained the improving trend at the end of year. This performance reflects the accommodative stance of the monetary policy. Financial conditions for firms and households continue to be characterised by low interest rates and reduced risk premia. Also, the annual appreciation of the exchange rate has been trending downward, lessening its tightening effect on financing conditions.

The favourable financing conditions have supported the expansion of credit portfolio to private sector. Adjusted for loan write offs and the exchange rate, this portfolio recorded 7.5%, annual growth, in December. Credit growth to private sector was supported by the higher financing to enterprises. Credit in the domestic currency has accelerated in the last quarter, thus helping the better balancing of credit portfolio. The ratio of loans in lek to total loans to the private sector increased at 48.7%.

The new economic and financial information suggests that both medium-term and long-term trends of development remain positive. Nevertheless, the short-term perspective of economic and financial developments shall be considerably determined by the consequences of November 26th earthquake.

The earthquake impact on the macroeconomic indicators is foreseen to be negative, in the short run. Its effects may be transmitted into the economy through a possible reduction in: consumption; private investments; tourism and other economic activities, in the affected areas. On the other side, the re-construction programme will give a positive impulse to construction sector.

The slowdown of the growth pace is expected to reduce the inflationary pressures in the short run. In line with this forecast, inflation is projected to hover around the average 1.6% in 2020, lower than our previous projections.
In the medium term, economic growth pace is expected to accelerate, by increasing the inflationary pressures. The re-construction programme to recover the stock of lost capital will give a positive impulse to construction sector, by supporting the faster growth of economy. The return of economy to equilibrium will be accompanied by the increasingly utilisation of production capacities and a faster rise in wages and production costs. In accordance with these forecasts, inflation is expected to converge to the target in the second half of 2021.

Forecasts in the baseline scenario require maintaining the accommodative stance of the monetary policy in the medium term. Monetary stimulus is necessary to support the growth of aggregate demand and build up domestic inflationary pressures.

The macroeconomic forecasts in this Report are updated in the context of an increased uncertainty. Albeit the medium-term development perspectives of the Albanian economy are stable, the economic performance in the short run remains subject to the degree of materialisation of the earthquake consequences in the macroeconomic indicators. The impulse generated from the re-construction programme is particularly important to the medium-term dynamic of both aggregate demand and production. The size and structure of financing, as well as the timely allocation of expenditures for re-construction may have significant effect on the performance of both production and inflation.

Bank of Albania will continuously aim at adjusting the monetary stimulus to the new macroeconomic data. In the event this information suggests a slower performance of both economy and inflation compared to our current projections, Bank of Albania is willing to undertake a further easing of the monetary policy stance.
BOX 1 ASSESSMENT OF THE EFFECT OF EARTHQUAKE ON THE ECONOMY AND PRICES

The earthquake that hit Albania on November 26th, 2019, caused many damages in residential and trading buildings, disruption of economic activities and increased the uncertainty. The ability to assess and forecast the size and extent of these effects is limited, due to the lack of such episodes in the close past. The international evidence suggests that in event of natural disasters, the economic activity pursues a V-trajectory: at the first moments, the disruption of economic activity and capital damage drive to production loss, but evolving, the expenses to recover the lost capital boost the economy.

This Box aims at presenting a prior assessment on the possible impacts of the earthquake on the economy in the short and medium term, and the expected transmission channels of them*. These assessments are based on preliminary available data, which, as such are subject of a high uncertainty.

Our analyses evidences that short-term effects of the earthquake are expected to be negative on both economic growth and inflation. With the extension of time horizon, the positive effect of re-construction are expected to be dominant, and to support the growth of economy and inflation at a faster pace. In the medium term, the earthquake effect on the economy will depend on, among others, the volume and form of re-construction process financing, and the extension in time of its allocation.

Based on the available information so far, we assess that the degree on which these potential impacts will materialise is expected to be low. Each of the above stated points is addressed following:

Possible transmission channels of the earthquake consequences

Durrësi was the district most hit by the earthquake. According to INSTAT, this district generates around 10% of Albania Gross Domestic Product, it accommodates around 10.1% of the population of the country, and it employs around 9.1% of employed persons in economy. Statistics about Durrësi show that around 7.9% of active enterprises in Albania conduct their activity in this district. During 2018, Durrësi was visited by around 9.1% of residents who travelled for either personal or business purposes in Albania. These statistics illustrates the economic importance of this region and suggest that the economic consequences of the earthquake will be felt on country level.

The potential transmission channels of the earthquake consequences may be:

- Increase of uncertainty among Albanian households and businesses. The earthquake seems to worsen the perception of Albanian households and enterprises, who may hesitate in conducting expenditures and investments. Uncertainty indicators, calculated from the confidence survey of economic agents, show the increase of uncertainty during the last months;
- Reduction of tourist activity. Tourism in this district may be reduced due to the damage of respective structures and the psychological effect of both national and international visitors. Damages of firms across other sectors, in addition to tourism, remain a transmission channel;
- Growth of investments for recovering the lost capital stock. Through this channel, the high levels of private and public expenditures - boost the economy- which relate to the re-construction of the damaged capacities.
Assessment of the effect of earthquake on the economy and prices

In the current stage, it is difficult making precise assessments on the extent of materialisation and duration of the earthquake effect on economy and prices, through the above-mentioned channels. Our preliminary analyses and assessments show that its short-term effect will be negative. Summarising:

- The earthquake consequences may reduce the economic growth by 0.3-0.6 percentage points during 2020. This effect combines the reduction in tourism revenues and the deceleration of consumers’ spending given the heightened uncertainty. The effect from reduction of expenditures for consumption is expected to be lower compared with the reduction in tourism. The shock in confidence and uncertainty are expected to reduce over time and consumers are expected to return to their consumption model. In January, the economic sentiment indicator maintained the level of the previous month. On the other side, the positive stimulus which will be injected into economy from the reconstruction activity of the damaged objects is expected to balance the negative effect of the earthquake. Considering the necessary time for the collection of funds and the compilation of logistic plans for action, this effect is expected to cover the calendar year unevenly. For that reason, the positive impact from reconstruction, albeit cushioning the negative effects of the earthquake, fails to fully counterbalance the latter.

- The earthquake shock may reduce inflation by 0.2 - 0.3 percentage points during 2020. The growth of aggregate demand at a low pace, during the current year, would be accompanied with weak pressures for the rise of wages, other production costs and consumption prices in economy. In the analysis of the earthquake effect on inflation, it is important to assess its impact on the production capacities of the economy, and consequently, on the size of output gap.

The reduction of short-term effect of the earthquake is expected to be accompanied with the recovery of the economic growth rates in the medium-term horizon. First, the key factors that support economic growth have not changed considerably. This judgement is based on the low impact on: capital stock and the production base of economy; financial sector balance sheet; and the simulating financial environment. Second, re-construction activity is expected to provide a crucial stimulus to the economy beyond the short-term horizon. Construction sector is expected to accelerate by providing positive chained effects on other related sectors. Third, the recovery of capital stock enables its replacement with new and improved capital, by boosting economic growth in the long term.

* Box 2 summarises the analysis and assessments of the Bank of Albania about the potential impacts of earthquake on the financial sector.
2. EXTERNAL ECONOMIC ENVIRONMENT

The global economy has showed signs of improvement in 2019 H2, after the slowdown trend it pursed in the first half of year. Advanced countries are expected to grow at a more moderate pace in 2020. The emerging countries are expected to increase faster compared to the previous year, albeit, the recovery of the high growth rates will be slow. Expectations on the economic growth are surrounded by downside uncertainties, originating from the increase of geopolitical tensions and the structural problems in the manufacturing sector in some countries.¹.

Inflation rates have started to show a slight increase, mainly affected by the increase in energy price at the end of year. Inflationary pressures continue to be contained, although in some countries the unemployment rates record the lowest historical values.

Major central banks continue to pursue an accommodative monetary policy. Financial markets continue to appear calm and financial conditions remain favourable.

2.1 GLOBAL ECONOMY

The global economy improved in 2019 H2, albeit the growth pace remain slow. The trade disagreements between USA and China appear close to a solution and the indicators on global economy have started to expand again. Nevertheless, the outlook for the global economic growth appears unsecured, within the context where geopolitical tensions are rising. Risks to the global economic growth remain on the downside.

In 2019 Q3, GDP in Japan, China and India recorded slower growth rates, while USA, euro area and many advanced countries recorded slightly higher growth rates. The leading indicators on economic growth (PMI²) and OECD confidence indicators suggest a moderate growth pace in the fourth quarter. Inflation rates increased, at the end of year, affected by the rise in oil price, but the long-term inflationary pressures appear down.

¹ IMF forecasts, World Economic Outlook, January 2020.
² PMI is the composite output index, constructed from the information available from survey and serves as preliminary indicator on economic growth. This index is published by the Markit on a monthly basis.
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.

**United States economy**

In 2019 Q3, the economic growth pace in USA pursued the slowdown trend started since the beginning of 2019. Consumer spending have continued to support the economic growth, but their increase pace have slowed down. Also, government spending, residential investments and net exports have positively affected the growth, while non-residential investments provided an opposite impact. The positive news about the reduced US-China trade tensions affected the increase of foreign trade. The inflation rate trended upward in 2019 Q4, driven by the energy prices. Core inflation did not change standing close to the target of Federal Reserve. Unemployment rate continued to record low values, unchanged at 3.5% in November and December.

In the United States, growth is expected to be sluggish in 2020. Consumer spending will continue to provide a positive contribution, while the reduced fiscal stimulus will effect on the downside the economic growth.
**Euro area economy**

In 2019 Q3, the economic growth in the euro area showed equal rates with the previous quarter. Economic activity recorded the same pace with the second quarter, both in annual and quarterly terms, 1.2% and 0.2%, respectively. GDP growth was underpinned by the increase of consumer and government spending and the increase of investments. On the opposite, the contribution of net exports to economic growth remained negative. By sector, the economic growth was supported by services sector, while industrial production provided a negative contribution to the growth. The analysis by country shows the positive developments in France, Spain and Germany (the latter shrunk a quarter earlier).

Data available suggest the GDP growth in euro area will continue at a moderate pace in the fourth quarter. Preliminary indicators of economic developments (PMI) increased these months; nevertheless remaining below the averages recorded when the economic growth was strong. The weakness is mainly noted in industrial sector, whose production continues to be below the expected levels. The recent projections\(^3\) of the European Central Bank have revised down the economic growth for 2020.

In the last quarter, inflation remained unchanged and below the ECB’s target. The updated forecast of ECB experts assess that inflation will continue to be contained in the next two years.

In **Italy**, economic activity grew at a positive, but low, pace. Economic growth was fuelled by consumer spending and investments, while net exports provided a decelerating impact on the economic growth, by reflecting the faster increase of imports. Although slowing down, economic activity in **Greece**, recorded

\(^3\) *Eurosystem staff macroeconomic projections, December 2019.*
a higher positive growth than the European region. This growth was mainly supported by investments and net exports, while the slowdown of private consumption and the contraction of public consumption decelerated the aggregate growth of the economy. Unemployment rate in both countries stands above the Euro area average, with marginal changes per month. Inflation picked up more rapidly in both countries in December, but it continues to recode lower rates than ECB’s target.

**REGIONAL ECONOMIES**

In 2019 Q3, the regional economies showed higher growth, compared to 2019 Q2. They mainly benefited from higher consumer spending and investments, which account for the main share of aggregate demand. Unemployment rates trended downward across the regional countries. The economic growth across the regional countries will maintain the similar pace in the fourth quarter as well. Risks on the expectations for the economic outlook of the regional countries are set on the downside and mostly relate to the slowdown in the euro area, the main trading partner of the regional countries.

The economy of Kosovo accelerated the growth in 2019 Q3, supported by the strong increase of government spending and the expansion of consumer spending. The slowdown in investments and net exports has negatively impacted the economic growth. In 2019 Q3, economic growth in Serbia was supported at a broader base. The strong increase of investments is accompanied by the improvement of both consumer and government spending and by the acceleration of net exports. Economic growth in North Macedonia was underpinned by the positive performance of both government and consumer spending and the strong increase of investments. The slowdown of exports has impacted negatively the pace of aggregate growth. Economy of Turkey returned to the annual positive growth in 2019 Q3, after three quarters of economic contraction. The increase of consumer and government spending fuelled this growth. The contraction in investments and the weak performance of net exports affected negatively the economic growth.

<table>
<thead>
<tr>
<th>Table 1 Economic indicators for countries in the region</th>
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<tbody>
<tr>
<td>Annual change of GDP</td>
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<td>-----------------------</td>
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<tr>
<td><strong>2019 Q3</strong></td>
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<tr>
<td>Italy</td>
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<tr>
<td>Greece</td>
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<td>North Macedonia</td>
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<td>Serbia</td>
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<td>Turkey</td>
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<td>Kosovo</td>
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<td>Albania</td>
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</table>

Source: Respective statistical institutes.

*November 2019; **October 2019.

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The main trading partners outside the European Union (Kosovo, North Macedonia, Serbia, Turkey).
In December 2019, inflation rates picked up in all countries, except of Kosovo. The items of “Transport” and “Food and non-alcoholic beverages” remain the determinant factors of inflation in the region.

2.2 COMMODITY PRICES IN GLOBAL MARKETS

The main indices of commodity prices trended upward in 2019 Q4. The annual increase of indices shifted gradually from negative values to positive ones at the end of year. The Food Price Index drove to the acceleration of the annual growth pace by around 7% in December, mainly affected by the increase in the prices of cereals. The Metal Price Index recorded one-figure positive increase in December, for the first time since the middle of 2018. The performance of this index is affected by the positive news on US-China trade deal.

In December, Brent oil price averaged 67.3$/barrel, up around 17.3% annually, from -2.4% a month earlier. The geopolitical tensions in Middle East - which are expected to decelerate the crude oil supply-, affected the increase of this item price. According to market forecasts oil prices will decline in the next months.

2.3 FINANCIAL MARKETS

At the end of October, Fed cut, for the third time this year, the federal funds target range, by 25 basis points, down to 1.50%-1.75%. The ECB maintained the interest rate on the main refinancing operations unchanged, while it confirmed the expansion of the Asset Purchase Programme. The policy rate of the Bank of England stands at 0.75%, while that of the Bank of Japan stands at -0.1%.

The yields on government securities in advanced economies showed a slight upward trend during these months. The heightening of expectations on a US-China trade deal and the eased monetary policies implemented by central banks have favoured the shift of investors’ interest, from bonds to equities market, which coupled with the more optimistic assessments on the economic growth outlook is reflected on a slight growth of long-term yields.

The spread between securities of countries that need fiscal consolidation against German Bonds overall remained unchanged during this period. Yields on corporate bonds in the euro area markets also edged slightly down during these months affected by the ECB’s asset purchase programme of private sector securities. In the euro area money market, interest rates on short-term instruments remain at negative levels.

The Euro reduced the depreciation against US dollar during 2019 Q4, hovering at levels almost similar with the previous quarter. In December, the euro was traded for 1.11 US dollars, appreciating 0.6% on average, compared to the previous three months. In annual terms, the euro depreciated 2.4% from the previous year.
The financial market in 2019 Q4 was characterized by decreasing risk premiums, low interest rates and favourable liquidity conditions. Yields on government securities were downward this quarter, driven by the banks’ high demand to invest in them. Banking financing costs remained low for households and enterprises, reflecting low risk premiums and increase of the banking sector efficiency following the consolidation process. Currency risk indicators in the foreign exchange market appeared to be within normal parameters.

Favourable financial conditions and structural improvements of the banking sector supported the expansion of lending activity, especially lending in lek, which recorded high growth rates in the fourth quarter. These positive developments are also reflected in the monetary expansion in the economy and expansion of other monetary indicators. The financial situation so far does not signal for increased risks in the post-earthquake financial activity in the economy.

3.1 FINANCIAL MARKETS

Interbank Market

Interbank rates hovered near the policy rate in 2019 Q4, in line with the operational objective of monetary policy. The liquidity of the banking system was at adequate levels for the monetary policy transmission, thus not being a stress factor in the money market. The interests applied on two main maturities used for daily and weekly fund exchanges recorded a decrease in the marginal rates this quarter, and continued to maintain minimal spread against the policy rate. Their volatility was also low, close to values noted in the previous quarters of the year. Trading volumes slightly decreased compared to the previous quarters, as a result of the reduction of transactions in both maturities. Overnight and one-week maturities remain the most employed ones; in addition, the 2-, 3-days transactions have been also used.

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The standard deviation of the overnight interbank rates in the fourth quarter of the year was 0.06, from 0.05 and 0.06, respectively in the two previous quarters.
The Bank of Albania continued to supply liquidity to the banking system through its main instrument, the one-week repo, and through the three-month maturity injections. As a result of the decrease in the liquidity deficit, the injected amount was lower than in the third quarter of the year, mainly in injections with one-week maturity. In the meantime, interest rates in auctions have always been close to the policy rate.

**DOMESTIC FOREIGN EXCHANGE MARKET**

The domestic currency (lek) depreciated in 2019 Q4, following the appreciation in the two previous quarters, which coincided with a good tourist season. The average exchange rate was 122.7 lek/euro in this quarter, with a lek depreciation of 0.9% compared to the previous quarter. Lek continues its appreciation against the euro, compared to the previous year, although at a lesser extent. Lek appreciation slowed down considerably, dropping at 1.4% in the last quarter of the year, from 3.4% in the two previous quarters, and from 5.9% in the first quarter of the year.

Concerning the shorter-term horizon, December was characterized by the appreciation of lek against euro by 0.5%, in line with its seasonal behaviour. Euro/Lek exchange rate hovered around the average of 122.0 lek/ euro in the first three weeks of January, with no significant change from the average level in December. Overall, the euro trading in the foreign exchange market during the recent months has been calm; Risk indicators appeared at optimum levels7 and in the market, no slanted expectations have been noted on either

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7 Bid-ask spreads in the euro / lek exchange rate and volatility indicators have been low and within their normal values.
the appreciation or the depreciation of the Lek⁸. The performance of these indicators shows the normalization of agents’ expectations in the market and the lack of speculations regarding the future performance of the exchange rate.

The performance of the US dollar in the domestic market reflected its appreciation in the international foreign exchange market, further reinforced by the depreciation of lek against euro. The USD/ALL rate averaged 110.8 lek/usd in the fourth quarter, with a lek depreciation of 1.4% compared to the third quarter, and 1.6% compared to the previous year. In the first weeks of January, the US dollar was traded at values close to those registered in December.

The exchange rate appreciation/depreciation ratio is calculated as the ratio of the number of days when the lek is depreciated against the number of days when the lek is depreciated, over a moving time horizon of 250 days. The value of this indicator near 1 indicates an equal number of cases of appreciation and depreciation. If this indicator is significantly and persistently above 1, there are one-sided pressures for appreciation in the market and vice versa.
In nominal effective terms, lek depreciated by 0.7% in the fourth quarter against the third quarter of the year, reflecting its depreciation against all currencies of the main trading partner countries, except for the Turkish lira. The effective annual appreciation of lek continued to narrow, falling to 1.7% in this quarter, from 3.1% in the previous quarter. The real effective exchange rate has shown a similar trajectory to the nominal. The annual appreciation of the exchange rate was 1.0% in the fourth quarter, from 2.5% in the third quarter.

**PRIMARY MARKET**

T-Bills and bond yields in the primary market trended downward in 2019 Q4. The performance of yields mainly reflected the behaviour of banks and their competitive bids. Given the lack of pressures from government’s supply, the banks’ demand was higher and drove to their decrease. The average yield of 12-month T-bills fell to 1.7% in December, from 2.3% and 2.1% in September and October, respectively. Similar to the previous quarter, banks have confirmed their interest in government debt securities, thus keeping the bid-to-cover ratio always high, especially in the long-term segments. During this quarter, yields declined along the whole curve and as a consequence its slope remained roughly the same as in October. However, compared to the previous year, the yield curve has been flattening, mainly as a result of the decrease of premiums in long-term maturities, which are more preferred by the banks.

The downward trend in yields was somewhat curbed at the end of December and in the first auctions of 2020; bond yields did not change, while bond premiums registered marginal growth. In the last auction in January, the 12-month bond yield was 1.76%, being roughly the same as the average in December. Similarly, bond yields declined in the last three months, but in the recent auctions they registered marginal growth. Thus, the yield on the 2-year and 10-year bonds was 2.25% and 5.29%, respectively, in January from 2.16% and 5.20%, respectively, in the previous auctions held in December and October.

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9. 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 lira/lek and yuan/lek rates, the official reference rates remain those of the Turkish lira and the Chinese yuan 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.

10. The bid/cover ratio for T-bill auctions realised in the period October-December was 1.3. This ratio for bond auctions is 1.6 for this period.
FINANCING TO PUBLIC SECTOR

By the end of the 11-month period, budget deficit totalled around ALL 10.6 billion, from ALL 0.9 billion in the same period in the previous year. Deficit financing sources during 2019 were domestic, the use of which beyond the budget deficit has led to the reduction of government external debt by about ALL 10.4 billion by the end of the 11-month period.

The budget deficit in October and November expanded by about ALL 7.2 billion. Its financing came through borrowing in the primary market for government securities (84%), as well as the use of liquidity created throughout the year, thus staying in line with the approach implemented during the first 9 months. Domestic borrowing during these two months increased by ALL 6.1 billion, which consisted entirely of long-term debt denominated in lek.

*Values above the horizontal axis in this chart imply Fiscal deficit; values below zero imply Fiscal surplus.

Source: Ministry of Finance and Economy, Bank of Albania.
In the fourth quarter, the borrowing structure in the primary securities’ market was similar to that of the two previous quarters. Thus, similar to the two previous quarters, commercial banks continued to play the primary role in financing the fiscal deficit in the domestic market (at around 87%). This structure of the primary market seems to reflect at the largest extend, 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.

In the last quarter of 2019, non-bank financial institutions continued to show interest in expanding their securities portfolio, and this interest continued during the rest of the year. Meanwhile, unlike the first three quarters, the participation of households in the primary securities market was more active, and it was finalized with an increase by 1.4% of their existing portfolio by the end of September 2019.

### 3.2 DEPOSIT AND CREDIT INTEREST RATES AND FINANCING CONDITIONS

Interest rates on new loans to the private sector continued to hover near their lowest levels, both for lek and euro loans. Their level indicates lower cost of financing in lek to the private sector since after the first quarter of the year. The lower interest rates reflect a reduction in risk premiums and a more positive approach of banks toward lending, driven also by increased competition following the consolidation process in the banking system.

![Chart 11 Interest rates on new loans in lek and euro](chart)

Note: Interest rates and the spread between them are presented as a 6-month moving average.

The average interest rate on new loans in lek was 6.3% in 2019 Q4, remaining the same as the two previous quarters’ average. The interest rate of loans to

11 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.
enterprises was stable at 6.1%, reflecting slightly lower interest rates rate for liquidity financing loans and a marginal increase of loans rate for investment financing. Households continued to receive mortgage loans at low interest rate, whilst interest rates on consumer loans increased in this quarter.

Average interest rate for new loans in euro to the private sector was 4.2% in the fourth quarter, slightly up compared to the previous quarter (4.0), but remaining near the average level of the last two years. The growth of this quarter is mainly driven by the increase in the rates of loans for investments granted to enterprises, while interest rates on loans for liquidity to enterprises and to households changed to a negligible extent. The spread between interest rates on lek and euro loans remains at low levels of about 2.0 percentage points for enterprises, 3.0 percentage points for households and almost zero for mortgage loans\(^{12}\).

Non-price terms and conditions of loans to enterprises and households

Banks’ terms and conditions of loans to enterprises remained unchanged during the last quarter of the year. The increase in loan size compared to the previous quarter was offset by the higher conditionality set out in the respective loans to enterprises agreements.

The general terms and conditions of loans to households did not change in the last quarter of the year. Thus, commissions, loan size, collateral requirement in relation to the loan received, and terms of the loan agreement, as well as the maximum loan maturity remained the same as in the previous quarter.

The financing costs for the banking activity through deposits remain low, thus supporting low interest rates on loans. The average interest rate on new time deposits in lek stands at 0.76% in 2019 Q4, close to the levels of the two

\(^{12}\) The values are the average for 2019.
previous quarters and slightly below the average of the previous year. Interest rates on time deposits of up to one year, which make up the majority of time deposits have been stable, while rates for deposits with higher maturities have been downward for several quarters. The average interest rate on new time deposits in euro was 0.14% in this quarter, close to its average in the last two years. The spread between the interest rate on Lek and Euro deposits is minimal, by 0.7 percentage point during 2019.

Chart 13 The interest rate on lek and euro deposits

Source: Bank of Albania.

BOX 2 POTENTIAL IMPLICATIONS OF THE EARTHQUAKE ON THE FINANCIAL MARKET

In addition to Box 1, the following section addresses the potential impact that the earthquake implications or the measures taken to address them may have on the financial market. A significant amount of financial indicators are measured and reported at a periodic frequency compared with other economic data, and as such they provide preliminary signals on what is happening in the economy. After the Earthquake, the Bank of Albania kept these indicators under special monitoring, in order to identify potential signs of stress in the financial market. So far, no tangible impact of the earthquake has been identified in the market. From the previous year’s experience, or even from that of the other countries, shocks of this nature can be manifested in the market in three main directions: (1) in the volatility in yields and in other interest rates, (2) the volatility of the foreign exchange market, and (3) the lending performance. More specifically, these implications are discussed below.

(1) Volatility in yields and other interest rates

Interest rate volatility may increase due to the uncertainties of economic agents and/or increased government borrowing in the domestic market to finance measures to address earthquake-related damages. So far, there is no evidence of increased volatility or uncertainty in the financial market segments. The addition to the government deficit for 2020, planned after the earthquake, is
about ALL 10 billion, of which about ALL 7 billion is projected to be financed through increased borrowing in the domestic market. This amount remains within the historical funding rates, and is considered affordable by the money market, without causing shocks to the yields performance. In the government securities auctions conducted post-earthquake, yields have fluctuated in a narrow range, with no real upward trend.

(2) Volatility in the foreign exchange market

During the two months following the earthquake, the exchange rate has fluctuated roughly in line with its seasonal year-end behaviour. Foreign currency trading was conducted within normal risk parameters and no signs of stress were detected in the volatility indicators.

The potential impacts on the exchange rate performance in the current year are twofold and the risks are balanced. On the one hand, with the depreciating effect on the value of the lek lies the scenario of possible reductions of revenues from the tourism. The impacts of the earthquake were more pronounced in the coast area of Durres and as a result the tourism activity might be weaker this year, since the reception capacity has reduced and there is need for reconstruction. Also the foreign tourists might feel discouraged to visit Durres after such event. On the other hand, an increase of inflows in the form of remittances or foreign aid and donations is also possible, in support of the families affected by the earthquake. The impact on the exchange rate will be a result of the action of these two factors.

(3) Lending performance

Lending to the economy has been steadily improving over the last year, reflecting the growth of loans to enterprises and the stable performance of loans to households. The potential impact on the continuity of loan growth may result in two scenarios: On the one hand, the slowdown of the economic activity in sectors affected by the earthquake and the increase of the uncertainties of households, enterprises or even the banks themselves may induce a slowdown of loan growth. Bank of Albania deems that even if this happens, it would be temporary, as will the consequences of the earthquake in the real economy be. On the other hand, the need for restructuring and replacement of physical capital may be associated with increase of loan demand. The balance between these two scenarios will also depend on the risks-weighting by banks and their approach to lending.

To sum it all up, based on the information available to date, we deem that the materialization of earthquake-related risks is expected to be limited in the financial market. However, all indicators are under constant monitoring, in order to timely detect and address the issues.
3.3 CREDIT TO THE PRIVATE SECTOR

The growth rates of banks’ financing to the private sector improved in the fourth quarter, averagely at 7.8% or 0.3 percentage point higher compared to the previous quarter. Credit to GDP ratio also increased, reaching 36.5% or 1.2 percentage points higher compared to the previous year. Positive developments in the lending activity were supported by the easing of credit supply and the structural improvements that have taken place in the banking sector during 2019. Meanwhile, demand for loans is not stable yet - after rising for two consecutive quarters, it decreased in the last quarter, impacted by both enterprises and households. Based on the banks’ opinion, the performance in the last quarter was also affected by the post-earthquake situation. From a longer point of view, the dynamics of loans portfolio point to a more balanced structure of the portfolio of loans by currency and a higher contribution of loans to enterprises regarding portfolio expansion.

The improvement of lending activity was supported by funding in domestic currency, which contributed by 4.8 percentage points to the annual growth of credit to the private sector in the fourth quarter. The contribution increase of loans in lek offset the lower contribution of loans in foreign currency, which slowed down the growth rates at year-end. The high growth rates of banks’ lending in lek, by 10.1%, are supported by low interest rates, by banks’ favourable policies for financing in lek as well as by higher awareness of public on the risk of the exposure of exchange rate in borrowing. This positive dynamic has led to a more balanced structure of the loan portfolio. Loans in lek accounted for 48.7% of loans to the private sector in December 2019, 10 percentage points higher than the weight of this credit five years ago.

Source: Bank of Albania

13 Credit data are based on monetary statistics and are adjusted for the effect of written-off loans and exchange rate movements.

14 For more, click here https://www.bankofalbania.org/Monetary_Policy/Surveys_11282/Bank_Lending_Survey/.
The main contributor to this increase, during 2019, is the loan to enterprises, unlike the lending dynamics of the last three years. Loans to both households and enterprises improved in the last quarter of the year. The portfolio of loans to households increased by 7.5%, from 6.9% in the previous quarter. The expansion the growth pace of loans to households, in the last quarter, has benefited not only from the higher contribution of loans for house purchase, but also from consumer loans. The annual growth pace for each portfolio improved to 7% and 7.7%, respectively. Meanwhile, growth pace of loans to enterprises is slightly higher than in 2019 Q3, of 8% on average (7.8% in 2019 Q3). Unlike the previous quarter, it is noticed that the growth of loans to enterprises in the fourth quarter is determined by the expansion loans for investments. This portfolio grew by an average of 9.2% compared to the previous year, or about 4 percentage points higher than in the third quarter. The improvement of lending to investments has offset the weaker performance of loans for liquidity, which slowed down its growth pace to 6.5% against 11.1% in the previous quarter.

### 3.4 MONEY AND DEPOSITS IN THE ECONOMY

Monetary supply in the last quarter of the year accelerated its growth pace. The broad money indicator, M3 aggregate, registered an annual growth of 4.3% on average during this period, 0.7 percentage point higher compared to the third quarter. The creation of money in the economy is supported by the financing of the private and public sector by the banking system. On the liabilities side of the banking system, the money structure continues to be affected by the shift of household savings to deposits with maturities of over two years.
which are not included in the calculation of M3. The aggregate in lek, M2, improved the growth rates to 3.5% on average over this period, against the 2.7% in the third quarter of the year. Expansion of the monetary supply was widely supported by the steady performance of loans in domestic currency and by government funding. Money supply M1, shows an acceleration of the annual growth rate at 9.6% or 1.2 percentage point higher compared to the previous quarter. This indicator has mainly taken the form of demand deposits, reflecting at the same time the increased demand of economic agents’ for cash, at the end of the year. Meanwhile, the ratio of the latter to aggregate in lek, M2, stands at relatively similar levels as in the previous quarter, around 38.3%.

The growth pace of deposits in the banking system improved in the last quarter. Total deposits are estimated at around 70.4% as a ratio to GDP at the end of the year. Deposits’ stock recorded an average annual growth by 5.7% in the fourth quarter, compared to 4.7% a quarter earlier. This performance was mainly supported by the rapid expansion of deposits in foreign currency by about 6.5% in annual terms, compared to 5.7% a quarter earlier. The growth rates of deposits in lek improved to 4.9%, up by 1.3 percentage points from the third quarter. In terms of the time structure of deposits, the latter in the banking system continues to shift toward two maturities, mainly in the form of demand deposits, as well as time deposits with maturity above two year. As at the end of the period, demand deposits accounted for around 47% of the total stock, whereas those whose maturity term is longer than two years accounted for around 13.4% of the total stock.
Households’ deposits account for over 80% of the deposit stock in the banking system. About 60% of them are held in time instruments, reflecting their investment in a longer-term form of savings. On the other hand, enterprises hold over 90% of their deposits as liquid holdings (cash), depending on their seasonal activity and needs.
4. INFLATION AND ECONOMIC GROWTH

Inflation averaged 1.3% in 2019 Q4, resulting 0.1 percentage point lower than in the previous quarter. The performance of inflation reflected the slow increase of wages and domestic production costs, the low inflation in our trading partners and the lagged effect of exchange rate appreciation during 2018. The positive rates of economic growth and employment have mitigated the negative output gap, but have not eliminated it, thus supporting the assessment that the demand-side inflationary pressures remain insufficient for the convergence of inflation to target.

Economic growth accelerated in 2019 Q3 reaching at 3.8%, underpinned by both domestic and external demand. In particular, the consumption of population provided a significant contribution followed by net exports.

The return of the economy to potential is expected to continue, but at a more mitigated pace, driven by the negative impacts expected from the earthquake of 26th November 2019. Given this factor, the low inflation environment and inflation expectations, headline inflation’s convergence to target may require a longer time. Meanwhile the return of inflation to target is expected to be supported by the stronger materialisation of the impacts from the rise of wages and costs in the economy.

4.1 INFLATION

In 2019, the average inflation was 1.4%. Throughout the year inflation registered low levels, failing to respond adequately to the relatively positive developments of economic activity and domestic demand. Although the negative output gap continued to narrow down, the weak performance of import prices, the appreciating of the exchange rate and the presence of base effects have kept inflation values below those of the previous year.

The average inflation registered a low level in the last quarter of 2019 (1.3%). Inflation in this quarter was affected by the developments in December (1.1%). The seasonal impact of inflationary effect from the category “Unprocessed food” had a lower intensity than in the previous years\(^\text{16}\). The other categories continue to have a low impact on headline inflation, as in most of the year.

\(^{16}\) Monthly inflation of the category “Unprocessed food” in December resulted at 5.0% against 6.2% in the previous year.
The slow increase of prices in the last quarter has continued to be affected by the contained pressures generated by the domestic economy. Commodity prices in foreign markets, as well as inflation in EU and regional countries returned to increasing values at the end of 2019. Nevertheless, the relatively long period of appreciation of the domestic currency has kept the pressures from import prices low.

The structure shows that the volatility of food prices accounted for 85% of this quarter’s inflation. The contribution of prices in the category “Unprocessed food” continues to be significant within this group of goods, accounting for around 60% of headline inflation. In the first two months of the quarter this category registered an increase in terms of inflation and contributions. Meanwhile, in December, the value of the contribution of particular sub-items within this category was dominated by “vegetables” which drove to the decrease of contribution by 0.3 percentage point\(^\text{17}\). Favourable climatic conditions, the increase of greenhouse output, weak pressures from production costs due to lower fuel prices and the increase of competition in agricultural produce markets are factors that have driven the slowdown of inflation in the respective category.

In the category “Processed food” the result of slight fluctuations of the prices of groups composing it was almost the same as in the previous quarter (0.3 percentage point). Within this category, prices of the sub-category “bread and cereals” have increased, while the contribution of the sub-category “tobacco” has resulted downwards in December.

\(^{17}\) In December the contribution of this category decreased from 0.9 to 0.6 percentage point, driving the decline of headline inflation rate as well.
The “Non-food consumer goods” contributed with low positive values to this quarter’s inflation, a lower contribution compared with the previous quarter. This performance has reflected inflation and the negative contribution of fuel due to: the downwards trend of oil prices in foreign markets by the end of the year; the appreciation of the domestic currency; and the impact of the high comparative base of the previous year.

The prices of other more stable components of inflation, which includes the prices of services, housing and durable consumer goods also, had a lower contribution to the inflation rate compared with the previous quarter (0.2 from 0.3 percentage point). The category “housing-rent” registered a stronger base impact compared with the previous quarter, decreasing its contribution by 0.1 percentage point. 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.).
Annual change in the index of “Goods and services at regulated prices” over this year reached a low level due to the diminishing impact from the increase of water price rise in the previous year (-0.2 percentage point). This behaviour was noted during this quarter as well, where the relevant category maintained its low, almost negligible, annual contribution to headline inflation.

### 4.2 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

In 2019 Q3, economic growth resulted at 3.8%, faster than the 2.5% growth in the first half of the year. The expansion of the economic activity continued to be determined largely by the services sector, mainly with increased contribution from tourism and continued trade support. Also, the decline of the downward impact of low electricity output and the increase of the value added in industry were reflected in positive contributions for economic growth. Meanwhile, construction activity continued to show a slight downward dynamic similar with the previous quarter.

The increase of aggregate demand in 2019 Q3 continued to be largely driven by domestic demand, with private consumption being the main contributor. Net exports, supported mainly by services exports, also had a positive impact. Public consumption contributed slightly upwards, while the impact of investments, albeit to a small extent, remained negative.

The update of macroeconomic developments with data obtained by indirect and qualitative indicators, given the materialisation of the negative impacts from the earthquake of 26th November 2019, suggests a more moderated economic growth in 2019 Q4.

#### 4.2.1 GROSS DOMESTIC PRODUCT BY SECTOR

In 2019 Q3, the economic growth is mainly attributed to the services sector, by around 66%, whose contribution is calculated at 2.5 percentage points. The production sector also improved its performance and contributed as well to the acceleration of economic growth. The value added of the production sector increased by 1.9% and its contribution to economic growth resulted at 0.7 percentage point. The improved dynamic of production mainly reflected the diminishing downward impact of electricity. After negative contribution, averaging 1.3 percentage points during 2019 H1, the impact of energy in economic growth resulted negligible, during 2019 Q3.

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18 Gross Domestic Product and Gross Value Added by sector are treated in terms of real annual changes. The analysis relies on the latest GDP data from output method for 2019 Q3, published by INSTAT on 24 December 2019. The differences between the sectors’ growth rates of this publication and those analysed in the Monetary Policy Report 2019/IV are the result of the series’ review.
Mining and quarrying and the manufacturing industry continued to support the annual growth of GDP as well, by 0.4 and 0.2 percentage point, respectively. The value added in agriculture, forestry and fishing decelerated, contributing to the annual growth of GDP by only 0.1 percentage point. Meanwhile construction, largely affected by the incoming completion phase of the Trans-Adriatic Pipeline (TAP) project, contributed negatively by 0.1 percentage point, as in the previous quarter. The net tax component provided a contribution of around 0.6 percentage point to economic growth, from 0.5 percentage point in the previous quarter.

The industry, energy and water supply sector improved its performance in 2019 Q3, registering a growth of value added by 5.8%. After the contraction in 2019 H1, the dynamic of the sector reflected mainly the diminishing of the negative impact of the low electricity output, and to a lesser extent the expansion of mining and quarrying industry. The mining and quarrying branch, with a contribution of 3.2 percentage points, formed around 54.9% of the annual growth of the sector. Manufacturing industry supported as well the performance of the sector by 2.0 percentage points, albeit at a slower growth of value added at 3.6%, compared with 5.4% in the previous quarter. The slower growth performance of manufacturing industry is attributed mainly to the slowdown of the negative dynamic showed by the branch of “Electricity, gas, steam and air conditioning” is also confirmed by the net volume sales, which increased by 3.3% after a contraction of 12.6% in the previous quarter. Net domestic output of electricity during 2019 Q3, continued to be lower than the same period in the previous year by 27.3%, a rate that was lower than the strong contraction in 2019 H1. This dynamic continues to bear the impact of a higher comparative base with the previous year, where for the first three quarters of 2018 the net domestic output volume of electricity expanded on average by 120.1% in annual terms.

Increase in value of exports of the group “Salt, sulphurs, oxides, lime and cement” and the increase in volume of exports of the group “Mineral fuel, mineral oil and their distillation products” related with the mining and quarrying industry are assessed to have affected positively the performance of this branch of industry.
downward impact of textile, clothing, leather and footwear output as well as to metal products manufacturing, which is also evidenced by the contraction of the exports of products related with them. Meanwhile, other activities included in manufacturing industry contributed positively to the performance of the branch.

The growth of industry, energy and water supply sector is assessed to continue in 2019 Q4, albeit at a slower pace. The higher utilisation of production capacities, the confidence level above the historical average and the declining impact from the high comparative base of the previous year, suggest for a continuation of the positive dynamic of the sector. However, the quarterly fall of confidence and of some groups of product exports related with industrial activities give mitigating signals of the upward trend of the sector for 2019 Q4.
The construction sector continued to decline in 2019 Q3. As in the previous quarter, the negative developments in the construction sector are closely related to the Trans-Adriatic Pipeline (TAP) project entering its final stage. The annual decline of value added in construction, affected largely by the high comparative base with the previous year\textsuperscript{21}, resulted around 1.1%, comparable with the decrease of 1.6% in the previous quarter. The contraction of the output volume in construction is assessed to have been driven by the lower level realised in new constructions and reconstructions\textsuperscript{22}. Meanwhile, the engineering category registered an increase, affecting positively the performance of the sector, in line with the assessed contribution of the public component. The increase of foreign direct investments inflows as well, albeit at a slower pace than in 2019 Q2, is assessed to have supported the sector’s upward performance.

The performance of the construction sector is expected to improve slightly in 2019 Q4. The increase of the capacity utilisation rate and the higher number of construction permits granted during the first three quarter of 2019\textsuperscript{23} suggest for a relatively better performance of the construction sector in 2019 Q4. However, the decline of the confidence indicator, the downward impact of the completion of most of the TAP project implementation, and the assessed negative impact by the public component, remain restricting factors for the expected improvement of the sector.

The services sector registered a faster upward dynamics in 2019 Q3. The value added of the sector expanded by 5.0%, after the annual growth of 4.3% in the previous quarter. The branch “Trade, transport, accommodation and food service” continued to generate the main upward impact, contributing by 2.5 percentage points in the performance of the services sector. Developments in it reflected largely the contribution of activities related with accommodation and food service\textsuperscript{24}, while trade activity continued to support the performance of the sector to the same extent as in the previous quarter. The branches “Professional activities and administrative services”\textsuperscript{25} and “Public administration, education

\textsuperscript{21} In 2018 Q3, value added in construction registered also the highest annual growth of the year, around 6.5%.
\textsuperscript{22} These two categories are also affected by the higher comparative base with the previous year, when they also registered a strong expansion of the respective output volume.
\textsuperscript{23} The number of construction permits granted in total for new buildings in 2019 Q3 was 293, from 310 permits granted in 2019 Q2. In total, the number of building permits granted in the first three quarters of 2019 remains higher than in the previous year, and mainly for residential buildings. The projected value of construction permits for new residential buildings also increased compared to the previous year.
\textsuperscript{24} According to the volume of net sales index the branch “Hotels” registered a rapid upward performance in 2019 Q3 by 22.5% from 7.0% in the previous quarter. The volume of net sales generated by the activity of “Bar - restaurants” also continued to increase by 5.4% from 4.1% in the previous quarter. The number of foreign nationals also increased during 2019 Q3, albeit at a slower pace compared with the previous quarter (by 5.8% from 16.0%). The main impact by purpose of travel continues to be attributed to the increase of the number of individuals travelling for personal purposes in the category “Vacation, visit to relatives, etc.”
\textsuperscript{25} The improvement of the performance of value added of Professional activities and administrative services is attributed mainly to the increase of the volume of net sale of architectural and engineering activities, after two consecutive quarters of contraction.
and healthcare increased their positive impact on the growth of the services sector as well, contributing by 1.3 and 1.4 percentage points, respectively.

Meanwhile, services related to “Real estate” and “Financial and insurance activities” supported the performance of the sector by 0.6 percentage point each, slightly lower than the previous quarter. The impact of the branch “Information and communication” on the sector also weakened compared with the previous quarter, reflecting an almost negligible contribution in the annual performance of services. The branch “Art, entertainment, recreation and other services’ activities” continued its downward impact by 1.3 percentage points, mainly reflecting the closure of gambling activity.

The upward dynamic of the services sector is assessed slower in 2019 Q4. This expected performance of services is in line with the fall in both confidence and the capacity utilisation rate of the sector.

**4.2.2 AGGREGATE DEMAND**

Economic growth is supported by both domestic and foreign demand in 2019 Q3. The increase of domestic demand is driven by the acceleration of consumption, while the positive contribution from foreign demand is related with the rapid growth of services’ exports. On the other hand, “investments” generated negative contributions.

Data from indirect indicators signal that economic growth in 2019 Q4 is expected to be slower. The domestic demand, with main impacts from population consumption, will determine this growth. Also, investments are expected to provide positive contributions.

26 Regarding the budget expenditure data by functional classification, the main upward impact in this branch is related to healthcare expenditure.
Domestic demand expanded by 2.5% in annual terms in 2019 Q3, a higher rate compared with 2019 H1 (2.3%). The annual dynamic was defined by population consumption, with positive contributions from public consumption as well. On the other hand, investments decreased compared with the previous year.

Leading and indirect indicators suggest domestic demand will continue to grow in 2019 Q4, but at a slower pace. Private consumption is expected to deliver the main impact, followed by investments.

**Private consumption**

Private consumption increased by 3.9% in 2019 Q3, around 1.2 percentage points higher than during 2019 H1. This component provided the main contribution to the expansion of domestic demand and in the economic growth of 2019 Q3. The increase of private consumption was affected by the increase of expenditures in the services sector (based on value added data from output). The contribution of the two other components of private consumption, short-term and durable consumer goods, is assessed to have remained unchanged compared with 2019 Q2, based on indirect data from retail trade index.

In terms of factors that support the growth of private consumption, both the performance of income from employment, and the increase of the number of employed, have driven consumer spending. This is reflected in an improvement of the economic sentiment indicator in 2019 Q3. Also, consumer and services sector confidence indicators remained above their historical averages over 2019 Q3 as well. The increase of remittances’ inflow in Albania continued to support private consumption funding during 2019 Q3. Financial conditions also continued to drive the acceleration of consumption and its contribution to the expansion of aggregate demand.
Available partial data for 2019 Q4 suggest a continuation of the increase of households’ consumption for short-term consumer goods and services. This assessment is based on quantitative data on the performance of food imports, movements of citizens in Albania and the increase of consumer credit. The performance of household expenditures for durable goods, a component that is even more sensible to the confidence environment, is harder to evaluate for the last quarter of the year, based on the available partial data.

The decline of confidence may have an impact particularly on the consumption of durable good purchases, which has an elastic demand that may be delayed over time while households wait that the situation is clearer.
Investments

In 2019 Q3, investments deepened the annual fall, 1.9%, with a negative contribution to economic growth of -0.4\(^{28}\) percentage point. Indirect assessments show that private investments determined the downward dynamic of investments. The latter, based on indirect data from 2019 Q3\(^{29}\), was affected by both investments in construction and investments in machinery and equipment.

The factors affecting private investments remained supportive during 2019 Q3 as well, but their decrease has reflected the continuation of the shock from the final stage of the investment in the Trans-Adriatic Pipeline (TAP) project. Meanwhile, the positive impact factor for private investments are: increase of the capacity utilisation rate in the production sector; acceleration of consumer demand for goods and services; continuation of the impact of eased financial conditions. The growth of foreign investments also resulted in positive territory serving as funding source for new investments.

Indirect assessments indicate that the contribution from public investments was low, but positive during 2019 Q2 and Q3.

Indirect indicators suggest an improvement of investment dynamic in 2019 Q4, supported by private investments. The component of public investments is assessed to give a negative contribution in the last quarter of the year.
Public sector demand and fiscal policy

Fiscal policy has shown consolidating features for most 2019, illustrated by the positive values of primary balance. However, the weakening of the intensity of fiscal consolidation, particularly in October-November of this year, has increased the positive impact of fiscal policy on aggregate demand growth.

Fiscal impulse, which proxies the impact of fiscal policy on economic growth, by the end of 11-month period was estimated at around 0.9 percentage point of GDP, from 0.2 percentage point at the end of September.

Budget deficit was around ALL 10.6 billion, at the end of the 11-month period, estimated at around 0.6% of GDP, higher by 0.4 percentage point from the end of 9-month. Primary balance continues to be positive, at around 1.4% of GDP.

Budget expenditures, in October and November, increased by around 2.1% in annual terms, at a slower pace than the average 6.4% registered for the first three quarters of the year. The slowdown in the growth pace of expenditures, in these two months, was defined by lower expenses for domestic and foreign debt interests. The performance of interest payments on foreign debt is related this the cycle of interest payments on Eurobonds issued in global markets. On the other hand, the decline of expenditures for domestic debt interests is due to the continuous decrease of the interest rates of government securities issued in the domestic market.

* The orientation of fiscal policy is proxied by changes in the ratio of primary cumulative deficit for a 12-month period to the GDP, compared to a year earlier. Negative changes, i.e. the values of this indicator under zero show that the fiscal position has improved, which indirectly indicates negative values of fiscal impulse in the economy.

* The analysis on fiscal indicators is based on data published as of 23 January 2020, including the more recent reporting for 11-month 2019 period. As such, they still do not reflect potential impacts due to the earthquake of 26th November 2019.
Capital expenditures registered an annual contraction by around 2.4% in October and November as well, albeit at a slower pace than the average registered in the other three quarters of the year. The contraction impact (0.4 percentage point) of this category on total expenditure, during these two months, was compensated by the 2.7 percentage points positive contribution of current expenditures. From the current expenditure components, expenses for special funds and those for local government continued to drive growth in this quarter as well, thus keeping the profile of total expenditure growth almost similar to the previous quarter.

The performance of the budget expenditure items suggests that the fiscal sector will continue to support aggregate demand growth in the fourth quarter, mainly in the form of an additional impulse from public consumption.

For the first 11 months of 2019, expenditures were around ALL 431.6 billion, or 5.6% higher in nominal annual terms. Current expenditures, for the same period, expanded by 7.2%, while capital expenditures contracted by around 3.7%, compared with the previous year.

Revenues in October and November contracted by around 1.3% in annual terms, unlike the behaviour shown in the first three quarters of the year. Revenues from VAT, grants, local taxation and tax on earnings, over the last two months, had a negative impact on revenues performance. The VAT revenue item has shown a dynamic almost similar to the first three quarters, registering a decline of around 5.9% in annual terms, in October and November. Adjusted for the impact of reimbursements this decline results somewhat more mitigated, at around 4.3%.
Regarding the 11-month period, revenues amounted to around ALL 421.1 billion, or 3.2% higher than in the previous year. The increase of the total, during 2019, is supported mainly by tax revenues on personal income, which accounted for around 72% of the growth of total revenues, despite the modest share of 11% that this component has on total revenues. VAT, which is the item with the largest share in revenues (30%), has declined throughout 2019. The annual contraction at the end of 11-month was 4.7%. Lower revenues from VAT, compared with the previous year, are due to the combination of several factors\(^{31}\).

**External demand and foreign trade**

Real trade deficit in goods and services contracted by 19.1% in 2019 Q3. This performance is in contrast with 2019 H1, where the deficit expanded by 9.6%. The main driver of this development has been the rapid increase of export of services (by around 13.0%). On the other hand, export of goods continued to be characterized by a decline in annual terms (2.4%). For the same quarter, imports expanded by 3.6%, driven mainly by the annual increase in export of goods (3.6%). Imports of services were also characterized by an increase (3.6%).

\(^{31}\) First, during 2019 the amount of VAT reimbursed has been higher than in the previous year. Adjusted for this impact the contraction of VAT for the 11-month would be 1.2%. Second, for 2019 were envisioned some relieve in the form of exemptions or reductions of VAT, supported by specific sectors of the economy, such as agriculture, agrotourism and pharmaceuticals. The impact of these measures is hard to assess. However, the curbing impact that this year’s fiscal relieves may have provided are in line with the dynamic of VAT collected on the output of goods and services in Albania. At the end of the 11-month period, domestic VAT made a negative contribution of 5.2 percentage points to the contraction of total VAT of 4.7%.
Data on the performance of external trade of goods, in 2019 Q4, show a slight narrowing of the trade deficit in annual terms (around 1.5%). Both exports and imports have contracted compared with the previous year, but the effect of imports has been higher.

The exports of goods in value declined by about 6.7% in annual level during 2019 Q4, a faster rate compared with the previous quarter (0.9%). Categories “Textile and footwear” and “Construction materials and metals” have generated the main impacts on this dynamic. The unfavourable external demand situation, the declining deflators\footnote{Due to international prices as well as the performance of the exchange rate.} and the relatively high comparative base of the previous year, were factors that have affected negatively the performance of exports, particularly in October. Electricity trade continued to remain a significant factor\footnote{Particularly in October, affecting the performance of 2019 Q4.} in the dynamic of exports, but with lower impacts compared with the previous quarters.
Imports of goods decreased by 3.8% during 2019 Q4. The downward import performance has been defined by the categories “Construction materials and metals” and “Minerals, fuel, electricity”. Overall, the dynamic of the other categories as well has been negative or quite sluggish.

By geography, the countries of the European Union, and particularly Italy, remain our main trading partners for both exports and imports. Over 2019 Q4, the relative share of Italy declined due to the poor performance of “Textile and footwear” exports.

**BOX 3 BALANCE OF PAYMENTS DEVELOPMENTS IN 2019 Q3**

Net current account position recorded a deficit of EUR 161.2 million in 2019 Q3, expanding by around 10.1%, annually. It stood at 4.6% of nominal GDP, around 0.1 percentage point higher than the same quarter a year earlier. A key driver in this dynamic was the expansion of the trade deficit in goods. This performance was determined by the growth of imports by around 7.6%. In the case of exports of goods, a significant decline of around 3.9% in annual terms has been verified, a rate that is more mitigated compared with 2019 Q2. Regarding services, the positive surplus expanded in annual terms mainly due to the increase in exports (by around 11.3%). The performance was mainly driven by the rapid increase of “travel services” exports. In parallel, it was observed an increase of import of services as well (by around 7.6%), also driven by travel services.

The “Primary income” account was characterized by a negative surplus, up around EUR 22.9 million from the previous year. This was due to the increase in income outflows related to “direct investments”. Regarding the secondary income, a positive surplus of 10.9 % was recorded in annual terms. In this regard, net remittances grew annually by 8.6%. The financial account was characterized by an annual contraction of net liabilities by 8.8%. Direct investments net flows contracted by around 1.9%, while only the liabilities of direct investments expanded by 1.4% in annual terms. The balance of payments was characterized by an increase in reserve assets by around EUR 109.7 million in 2019 Q3. The reserve is sufficient to cover 6.7 months of imports of goods and services or 160% of short-term external debt.

The balance of payments reports an inflow of “errors and omissions” at EUR 126.0 million.
Table 3 Balance of Payments indicators.

<table>
<thead>
<tr>
<th></th>
<th>2018 Q1</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>
</tr>
</thead>
<tbody>
<tr>
<td>Current account (in EUR million)</td>
<td>-178.4</td>
<td>-169.4</td>
<td>-146.4</td>
<td>-372.2</td>
<td>-245.2</td>
<td>-280.4</td>
<td>-161.2</td>
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<tr>
<td>Yoy (%)</td>
<td>13.3</td>
<td>-33.8</td>
<td>2.5</td>
<td>20.1</td>
<td>37.4</td>
<td>65.5</td>
<td>10.1</td>
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<tr>
<td>/GDP (%)</td>
<td>6.3</td>
<td>-5.0</td>
<td>-4.5</td>
<td>-11.0</td>
<td>-8.0</td>
<td>-7.8</td>
<td>-4.6</td>
</tr>
<tr>
<td>Goods and services</td>
<td>-358.3</td>
<td>-427.2</td>
<td>-359.7</td>
<td>-614.8</td>
<td>-403.7</td>
<td>-518.9</td>
<td>-376.8</td>
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<tr>
<td>Yoy (%)</td>
<td>14.9</td>
<td>-12.2</td>
<td>-3.8</td>
<td>7.8</td>
<td>12.7</td>
<td>21.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Exports, f.o.b.</td>
<td>841.8</td>
<td>1024.0</td>
<td>1240.4</td>
<td>952.8</td>
<td>885.2</td>
<td>1058.2</td>
<td>1345.0</td>
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<tr>
<td>Yoy (%)</td>
<td>8.8</td>
<td>14.5</td>
<td>11.7</td>
<td>8.8</td>
<td>5.2</td>
<td>3.3</td>
<td>8.4</td>
</tr>
<tr>
<td>Imports, f.o.b.</td>
<td>1200.1</td>
<td>1451.2</td>
<td>1600.1</td>
<td>1567.6</td>
<td>1288.9</td>
<td>1577.1</td>
<td>1721.8</td>
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<tr>
<td>Yoy (%)</td>
<td>10.6</td>
<td>5.1</td>
<td>7.8</td>
<td>8.4</td>
<td>7.4</td>
<td>8.7</td>
<td>7.6</td>
</tr>
<tr>
<td>Net Travel</td>
<td>77.6</td>
<td>83.5</td>
<td>197.1</td>
<td>72.1</td>
<td>75.9</td>
<td>81.5</td>
<td>254.9</td>
</tr>
<tr>
<td>Primary income</td>
<td>-22.8</td>
<td>19.8</td>
<td>-17.1</td>
<td>6.3</td>
<td>-32.7</td>
<td>-10.0</td>
<td>-39.9</td>
</tr>
<tr>
<td>Credit</td>
<td>70.3</td>
<td>123.6</td>
<td>94.0</td>
<td>105.0</td>
<td>78.7</td>
<td>132.5</td>
<td>108.7</td>
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<tr>
<td>Debit</td>
<td>93.1</td>
<td>103.8</td>
<td>111.0</td>
<td>98.7</td>
<td>111.4</td>
<td>142.5</td>
<td>148.6</td>
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<tr>
<td>Net income from Direct Investments</td>
<td>-69.4</td>
<td>-81.2</td>
<td>-83.9</td>
<td>-48.1</td>
<td>-74.6</td>
<td>-111.2</td>
<td>-110.2</td>
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<td>Secondary income</td>
<td>202.7</td>
<td>238.0</td>
<td>230.4</td>
<td>236.4</td>
<td>191.2</td>
<td>248.6</td>
<td>255.6</td>
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<td>Credit</td>
<td>224.5</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>
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<td>Debit</td>
<td>21.7</td>
<td>22.9</td>
<td>24.4</td>
<td>28.8</td>
<td>29.8</td>
<td>25.6</td>
<td>25.2</td>
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<tr>
<td>Net Remittances</td>
<td>148.6</td>
<td>181.7</td>
<td>170.0</td>
<td>169.2</td>
<td>150.2</td>
<td>185.2</td>
<td>184.6</td>
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<tr>
<td>Yoy (%)</td>
<td>10.0</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>
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<tr>
<td>Capital account</td>
<td>18.3</td>
<td>21.2</td>
<td>22.9</td>
<td>41.6</td>
<td>17.9</td>
<td>12.3</td>
<td>19.7</td>
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<tr>
<td>Net borrowing/net lending</td>
<td>-160.1</td>
<td>-148.2</td>
<td>-123.5</td>
<td>-330.6</td>
<td>-227.3</td>
<td>-268.0</td>
<td>-141.5</td>
</tr>
<tr>
<td>Yoy (%)</td>
<td>-3.6</td>
<td>-4.1</td>
<td>-92.4</td>
<td>32.0</td>
<td>30.1</td>
<td>78.4</td>
<td>-8.8</td>
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<tr>
<td>/GDP (%)</td>
<td>-10.1</td>
<td>-5.9</td>
<td>-0.5</td>
<td>-8.0</td>
<td>-12.1</td>
<td>-9.8</td>
<td>-0.4</td>
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<td>Direct investments</td>
<td>-290.3</td>
<td>-218.2</td>
<td>-268.7</td>
<td>-244.9</td>
<td>-287.2</td>
<td>-227.5</td>
<td>-263.6</td>
</tr>
<tr>
<td>Yoy (%)</td>
<td>40.6</td>
<td>-3.4</td>
<td>-21.0</td>
<td>10.7</td>
<td>-1.1</td>
<td>4.3</td>
<td>-1.9</td>
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<td>Portfolio investments</td>
<td>5.5</td>
<td>108.3</td>
<td>13.1</td>
<td>-203.0</td>
<td>-0.2</td>
<td>-82.4</td>
<td>90.8</td>
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<tr>
<td>Financial derivatives</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>
</tr>
<tr>
<td>Other investments</td>
<td>142.0</td>
<td>-173.3</td>
<td>83.9</td>
<td>96.9</td>
<td>-12.9</td>
<td>0.4</td>
<td>47.6</td>
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<tr>
<td>Reserve assets</td>
<td>-142.4</td>
<td>85.1</td>
<td>154.8</td>
<td>273.9</td>
<td>-70.7</td>
<td>-43.6</td>
<td>109.7</td>
</tr>
<tr>
<td>Errors and omissions</td>
<td>-125.1</td>
<td>-49.8</td>
<td>106.5</td>
<td>59.7</td>
<td>-143.8</td>
<td>-85.1</td>
<td>126.0</td>
</tr>
</tbody>
</table>

Source: Bank of Albania, INSTAT and staff’s estimates.

4.3 CYCLICAL SITUATION OF THE ECONOMY AND INFLATIONARY PRESSURES

The indirect indicators of the cyclical situation, the unemployment rate and capacity utilisation rate gap show a gradual shift towards equilibrium. However, domestic inflationary pressures sourced by rising wages and production costs remain still insufficient to generate the return of inflation to target. This has been reflected also on the performance of core inflation during 2019 Q4. In parallel, the appreciation of the exchange rate during previous quarters and the slow growth of inflation in partner countries have generated a slow increase of imported inflation.

In the medium-term, the continued upward trend of the economy and of the capacity utilisation rate, as well as higher stability of the exchange rate, are expected to bring about faster economic growth and a more stable price base.
The improvement of the cyclical position of the economy is estimated to have continued in 2019 Q3 as well. The utilisation rate of output factors has increased, but the economy is still below potential. As a result, inflationary pressures from the real economy are still insufficient for inflation to converge to target.

The capacity utilisation rate in economy stood at around 74.0% in 2019 Q4, a level similar to the rate in the previous quarter. However, the indicator remains 2.1 percentage points higher than in the same period in the previous year, and 0.4 percentage point higher than the historical average.

Developments in labour market resulted positive during 2019 Q3 as well. Employment in the economy increased by 3.3% in annual terms, a comparable rate to the 3.4% registered in the previous quarter.34 The upward dynamic of employment continued to be attributed mainly to the activities in the services sector and to lesser extent to industrial activity. This increase continued to affect the further growth of employment and the decline of the unemployment rate. This indicator declined at 11.4% in 2019 Q3, down by 0.8 percentage point compared with the same period in the previous year, and registering the lowest historical level.

The gross monthly average salary per employee registered an annual increase of 3.7% in 2019 Q3, continuing the upward trend of 2019 H1.36 In real terms, the monthly average wage increased by 2.3%, from 3.1% in the previous quarter. The slower performance of the average wage has reflected the more mitigated growth of the average wage in the private sector, at 2.6% in nominal terms, or 1.2% in real terms. Meanwhile, the average wage in the public sector continued to accelerate the annual growth rate, at 5.6% in nominal terms and 4.2% in real terms.

34 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 Q3).

35 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, including foreign residents.

36 The performance of wages during the year was affected by the increase of the minimum wage and the increase of wages for various categories of the public sector. The monthly minimum wage for employees nationwide increased from ALL 24,000 to ALL 26,000 in 2019 Q1, or by 8.3% in annual terms.
The Unit Labour Cost\(^{37}\) followed an upward trend in 2019 Q3, up by 1.5% in annual terms from 1.2% increase in Q1. The performance of this indicator continues to be largely determined by the relatively rapid growth of real wage versus labour productivity for the activities covered by the respective statistics.\(^{38}\)

Meanwhile, other production costs showed a downward dynamic in 2019 Q3. The prices of industrial output registered an annual decline of 1.6% affected mainly by export output prices. These developments are attributed largely to the contraction of prices in the mining and quarrying branch. Meanwhile, industrial output prices for products in the domestic market decreased by 0.4% in 2019 Q3 while production costs in the construction sector\(^{39}\) were almost the same as in the previous year.

The gradual narrowing of the negative production gap and the more contained appreciation of the exchange rate affected the upward trajectory of core inflation during 2019 H2. This indicator registered 0.9% in this period, compared with the average of 0.6% in 2019 H1.

However, on a longer time horizon, long-term and domestic inflation fluctuated around low levels in 2019. In average annual terms, core inflation and net non-tradable inflation resulted 0.7% and 1%, respectively. They stood 0.1 and 0.4 percentage point lower than the respective averages in the previous year. This development reflected partially the impact of the comparative base due to

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\(^{37}\) Proxy indicators of labour productivity and unit labour costs and average wage by short-term statistics are calculated by the Bank of Albania using the total series of Short-Term Statistics (SHTS, INSTAT, 2019 Q3). Their calculation includes: the index of paid employees, the net sales volume and total wage fund for the total of activities covered by the survey of SHTS. The reported growth rates are in real terms and refer to the four-terms moving average of the annual changes of the indicator.

\(^{38}\) For activities covered by the Short-Term Statistics, see the respective methodology (INSTAT).

\(^{39}\) Construction cost index for apartments includes prices of building materials, labour force and other capital expenditures used for the construction of a typical building of 8-10 floors.
the increase of inflation in the category of housing during 2018 and partially the more complete transmission on costs of the exchange rate appreciation.

In addition to the developments of the above components, inflation performance during 2019 Q4 was affected also by the performance of short-term components. Non-core inflation stood at 2.4%, slightly lower than in the previous quarter while basket tradable inflation was around 2%. This value reflects the particularly low inflation of non-processed food during December.

In the first two months of 2019 Q4, the imported inflationary pressure index (IIP)[40] contracted on average by 0.5% in annual terms. Import prices and the exchange rate dynamics continued in opposite directions. The appreciation of the nominal effective exchange rate (NEER) in annual terms registered 1.6%, while the expansion of “Import Price Index” (IPI)[41] expanded by around 1.1%.

[40] 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). IIP is calculated as the annual growth of IPI and NEER for the respective period. IIP is assessed to affect domestic inflation approximately after a 2 months’ time lag.

[41] 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.
The increase of IIPI in the first three quarters of 2019 materialised in an increased contribution of imported inflation in 2019 Q4 (0.8 percentage point). Despite this development, the relevant contribution in average terms for 2019 remained lower than that from domestic inflation, standing at 48% and 52%, respectively. Imported inflation showed high volatility during the last months of 2019. However, curbing pressures from the exchange rate are assessed to have trended downwards during 2019 H2.

**Inflation expectations**

Measurements other than inflation expectations surveys during 2019 Q4 remain overall at levels similar to the previous quarter. Their level continues to stay higher than official inflation in the last quarters. More specifically, in 2019 Q4 consumers expect that one-year-ahead inflation will be 3.8%, down by 0.2 percentage point from the previous quarter.

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42 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.

43 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.
Businesses and financial agents expect that one-year-ahead inflation after a year will be 2.3% and 1.8%, respectively, the same values as in the previous quarter. The expectations of financial agents also remained unchanged for two and three-year-ahead inflation, at 2.1% and 2.4%, respectively.