Bank of Albania

QUARTERLY MONETARY POLICY REPORT

2021/III

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C O N T E N T S

INTRODUCTION[1]

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

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

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

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

The Monetary Policy Report is published on a quarterly basis. The Monetary Policy Department at the Bank of Albania compiles this Report. The current report contains data up to 22 July 2021. The Supervisory Council reviewed and adopted this Report at its meeting on 4 August 2021.

[1] *Monetary Policy Document delineates the monetary policy framework at the Bank of Albania. This Document is available at: lhttps://www.bankofalbania.org/Monetary_Policy/Objective_and_strategy/*

FORWARD BY THE GOVERNOR

The Albanian economy showed recovery signs during the first half of the year.

The information analysed in the report indicate that the economic recovery is gaining traction. The gross domestic product grew by 5.5% during 2021 Q1, a rate which went beyond our expectations. The available data analysis suggests a further acceleration of the growth rate in the next quarters.

Furthermore, the recovery is supported by a wide range of factors and is present in almost all the sectors of the economy. Relaxation of containment measures thanks to the vaccination process; the increased business and consumer's confidence; the improvement to the economies of our trading partners, as well as the supportive monetary and fiscal policies have fuelled the expansion in consumption, private and public investments, and exports. This performance has been beneficial to both the production and service sectors, providing more breathing room for enterprises and establishing the premises for higher employment and increase of wages in the future.

In particular, the accommodative monetary policy stance has created an environment with low financing costs, adequate lending conditions, and a relatively stable exchange rate. This financial environment has enabled a stable growth of lending to the private sector, assessed at around 7.7% in the second quarter.

Given these positive trends, our economic growth projections in 2021 have been revised upwards and our expectations of inflation converging to target in 2022 have been strengthened.

Nevertheless, according to the Bank of Albania, inflation continues to undershoot the target, while employment is still below the pre-pandemic level. Also, the Bank of Albania deems that the stable recovery of the economy should remain anchored to adequate financing conditions throughout the medium-term horizon, and downside risks, particularly those related to the pandemic and restrictions imposed by it, remain present.

Against this backdrop, the Supervisory Council assessed that the current monetary policy stance is adequate for underpinning both the further economic recovery and inflation converge to target. In this view, the Supervisory Council decided to keep the policy rate unchanged, at 0.5%. Maintaining the adequate financing conditions will bolster consumption and investments, which in turn will drive increase employment and wages increase and inflation gradually converge to the target.

In the future as well, our monetary policy will provide the appropriate support for the rebound of economy, considering it is a necessary preliminary condition for the return of inflation to target.

1. INFLATION AND MONETARY POLICY STANCE

After reviewing the Monetary Policy Report, the Supervisory Council decided to keep the policy rate unchanged, at 0.50%, and to affirm its willingness to maintain the accommodative policy stance in the medium term. The Supervisory Council has assessed that the current monetary conditions are adequate for boosting a stable economic growth, which establishes the necessary preconditions for inflation to return to 3.0% target, within the medium-term horizon.

External environment continues to recover its economic activity, providing more support for the Albanian economy. The improved economic situation reflects the increasing vaccination of citizens and the easing of restrictions, higher optimism of households and enterprises, as well as the continuous support with stimulating economic policies. On the other hand, medium-term inflationary pressures remain low, partially due to the weak rise in wages, and partially due to the appreciation of euro against the US dollar. In the medium-term, they are expected to increase in parallel with the full recovery of the economic activity. Forecasts on the European economy are positive, but new variants of the virus present uncertainties and risks for the future.

The Albanian economy is showing a clear recovery trend, at an even higher pace than expected. After going into the positive territory in the last quarter of the previous year, economic growth accelerated at 5.5% in 2021 Q1. In terms of the demand, economic growth was driven by higher consumption and investments, both private and public ones, and the increase in exports. In terms of sectors, the increase of economic activity reflected the simultaneous expansion of production and service sectors, with an additional positive impact by the electrical energy sector. Indirect data show a faster recovery rates during the second quarter.

In 2021 Q2, annual inflation rose to 1.8%, remaining notably above the 0.9% level of the previous quarter. The increase of inflation mainly reflected the higher food and oil prices, while the prices of other items in the consumer basket did not change significantly. Food prices remain a source of inflation volatility, whereas core inflation – which excludes prices that tend to fluctuate – was stable, around 1.4%. Inflation is expected to hover around the current levels in the following months, recording an average close to 1.8% in 2021.

Although upward, the improvement of the determining factors for the upsurge of inflation remains insufficient for its return to target. The labour market has

still not recovered from the pandemic effects and continues to be characterised by low employment levels, a relatively high level of unemployment – which increased at 11.9% in the first quarter – and weak rise of wages. Also, inflationary pressures in partner economies, although upwards, remain contained in the presence of the exchange rate appreciation. In parallel, the expectations of economic agents on inflation remain below our objective.

Forecasts of the Bank of Albania show that the Albanian economy will set on an upward trajectory during the following years. After last year's recession, the economy is expected to grow relatively fast during 2021. The increase in the scale of vaccinations, the high level of optimism of households and enterprises and the more positive external environment have established the premises for the acceleration of households' consumption, exports of goods and services and an upswing in private investments. The fiscal stimulus will continue to provide a positive contribution to the economic growth during this year, consisting in the expansion of current and capital public expenditure. In parallel with it and for a longer period of time, monetary stimulus will contribute to preserve the favourable financing conditions of domestic demand. Its increase is expected to boost sales, income and strengthen enterprises' balance sheets, enabling the latter to increase employment demand and offer higher wages. The rise in wages will exert pressure on the increase of production costs and consumer prices, whose upsurge will be also supported by the rapid increase of inflation in the external environment. Our forecasts show that inflation will return to target within 2022.

The Bank of Albania assesses that risks regarding this forecast are balanced. On the upside, the increase of economic activity may exceed our expectations, if the epidemiological situation improves more rapidly or the trajectory of fiscal consolidation in the medium-term is smoother. On the downside, the intensification of the pandemic continues to be a source of risk given the spread of new variants or a slower recovery in consumption, due to a more prudential approach of Albanian households.

The Supervisory Council deems that the current monetary conditions are appropriate for the stable growth of the economy and inflation. The stimulating monetary policy has continued to be transmitted in favourable financing conditions and upward bank credit. Financial markets appear calm and liquid. They are characterised by low levels of inflation and a stable exchange rate, which reflects the demand and supply ratios in the market. In parallel with them, lending to private sector continues to grow relatively fast and the volume of credit to the private sector increased on average by 7.7%[2] in the second quarter. Credit growth has mostly funded the increase in investments for both enterprises and households, mainly for real estate. Financing in ALL has maintained a high growth pace, by pursuing the improving trend of the last years. Thanks to this dynamic, credit structure appears more balanced, where the share of credit portfolio in ALL to total is over 50%.

[2] *This rate is calculated for the credit being adjusted for the foreign exchange rate and loan write-offs.*

Pursuant to these forecasts, the Supervisory Council assesses that the monetary policy will continue to be accommodative throughout the medium-term horizon. This means that the policy rate and, consequently, financial market rates will be below their equilibrium levels in the medium-term horizon. For this reason, in the meeting of 4 August 2021, the Supervisory Council decided to maintain the policy rate unchanged, at 0.50%, and the overnight deposit and overnight lending rates at 0.1% and 0.9%, respectively.

The Bank of Albania will cautiously monitor the economic developments and will continuously maintain adequate monetary conditions to support both the economy and inflation converging towards our 3% target.

2. EXTERNAL ENVIRONMENT

Prospects for the world economy have improved in the second quarter. The preliminary data suggest a sharp expansion of the economic activity, particularly in the services sector and across advanced economies. The vaccination campaigns, the easing of containment measures and continuing monetary and fiscal stimuli have strengthened the confidence among investors and consumers. Risks to economic growth are more balanced. The higher demand has driven to an increase in commodity and consumer prices. The main central banks posit that the increase of inflation is temporary and monetary stimulus will remain present in order to strengthen long-term inflationary pressures. The financial conditions in international markets are accommodative.

2.1. ECONOMIC GROWTH

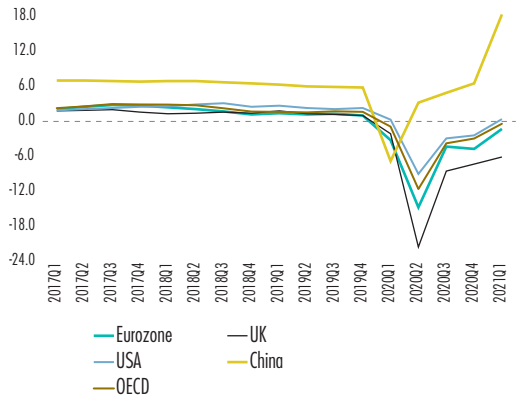
The global economic activity is recovering, but the performance of the economy across the countries is uneven. The pace of economic growth in 2021 Q1 picked up in the US and China, while it slowed down in the Euro area and the UK. Indirect data in the second quarter suggest that the improvement of the economic activity has continued at a faster pace. The economic recovery is mainly observed in the sectors of production and commodities trade, which have surpassed the volume of the pre-pandemic period. The services sector continues to remain below the pre-pandemic levels, but has a better outlook after the removal of restrictions.

The growth pace is heterogeneous across the countries, since the performance of the economy remains restricted by the scale of the pandemic spread in individual regions. The progress of vaccination roll out has improved the performance of economic indicators in some advanced economies, while the challenging epidemiological situation in some emerging countries has contained the pace of economic improvement in the second quarter.

The recovery of global economy is broadly underpinned by the fiscal packages and the accommodative monetary policies of the main central banks. Economic activity is expected to pick up at a faster pace in the second half of the year and

Chart 1

The economic growth has improved, but remains below the average pre-pandemic levels



Notes: Annual growth of GDP.
Source: OECD.

in 2022, but this growth is surrounded by uncertainties related to the pandemic evolution and progress of vaccinations.

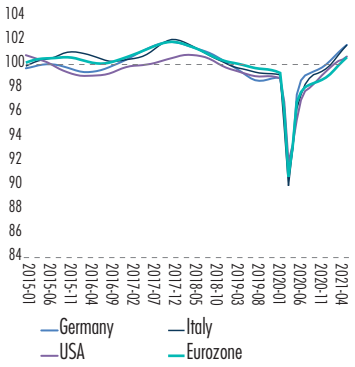
EURO AREA ECONOMY

Compared with the previous year, the euro area economy contracted by 1.3% in the first quarter of 2021. Economic activity slowed down due to a new wave of COVID-19 infections and tougher restrictions on movement. These paralysed the services sector and economic growth was supported by the production sector. The negative impact by private consumption was mitigated by the positive contribution of investments and exports. The services sector was restored in the preceding months due to the acceleration of vaccination, putting hospitalisation under control, and the removal of some restrictions. The preliminary indicators of production activity and services have reached high historical values and suggest a strong growth of the European economy during the second quarter. Confidence indicators are at high levels, expecting an increase in consumption and investments. New forecasts indicate a higher economic growth of the euro area in 2021-2022, at around 4.5%[3].

Consumer price inflation rose to 1.9% in June, from 0.9% in the beginning of the year. This increase was largely driven by higher prices of energy and food in international markets. After going up in the beginning of the year, core inflation declined at low levels, recording 0.9% in June. The rise of inflation is assessed to be transitory, as the factors that might exercise long-term sustainable pressures on its increase are considered weak by the central bank. The European Central Bank (ECB) forecasts that the inflation rate will remain high in the second half of the year and will decrease in 2022.

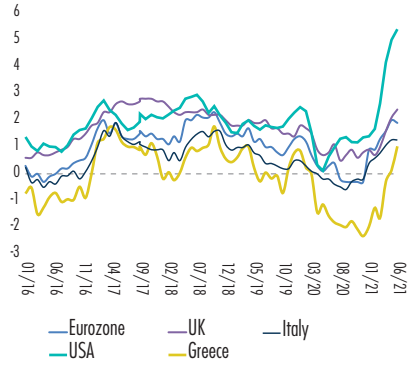
Chart 2

The economic activity in the euro area has accelerated in 2021 Q2



Notes: Preliminary composite indicator of the economic cycle, which shows fluctuations around the potential level of the economy. Index where the long-term average = 100.
Source: OECD.

Inflation rates have considerably increased due to higher commodities prices



Notes: Annual inflation rate.
Source: OECD.

[3] *Consensus Forecast, July 2021.*

REGIONAL ECONOMIES[4]

Across the regional countries the economic activity has improved and consumer prices have gone up. The vaccination roll-out and removal of restrictions in these countries, as well, have restored all the sectors of the economy. In 2021 Q1, economic growth was positive for all the countries of the region, with the exception of North Macedonia. Both private consumption- supported by the increase of confidence - and investments - supported by public spending- have improved. North Macedonia stands apart as fiscal policy is following a consolidating stance and public investments have contracted. Private consumption remains weak, reflecting the uncertainties related to the performance of the pandemic in the country. Indirect data suggest that economic activity in the region will improve in the second quarter, although it will not reach the pre-pandemic levels. The positive performance of the euro area, with which the economic activity of the region is tightly connected to, is expected to increase external demand and contribute positively to its economic performance.

Inflation rates have increased, reflecting the rise in the prices of oil and food. However, pressures on price increase by the domestic demand and the labour market, remain weak.

Table 1. Economic indicator for countries in the region

	Annual change of GDP		Annual inflation		Unemployment
	2020 Q4	2021 Q1	2021 Q1	2021 Q2	2021 Q1
North Macedonia	-0.7	-1.9	2.0	2.8	16.0
Serbia	-1.1	1.7	1.4	3.2	12.8
Kosovo	0.8	5.6	0.6	2.1	27.0*
Albania	2.4	5.5	1.0	1.8	11.9

Source: Respective statistical institutes.
**Q4 2020.*

2.2. COMMODITY PRICES IN GLOBAL MARKETS

Commodity prices in global markets have continued to increase, reflecting the recovery of the global economy, difficulties in the supply chains and the base effects from the decrease of prices a year earlier. Oil price has exceeded the pre-pandemic level, while prices of metals and food have reached historical levels among the last years. The increase of metal prices triggers positive effects in the export of the domestic metal, which accounts a significant share in total exports.

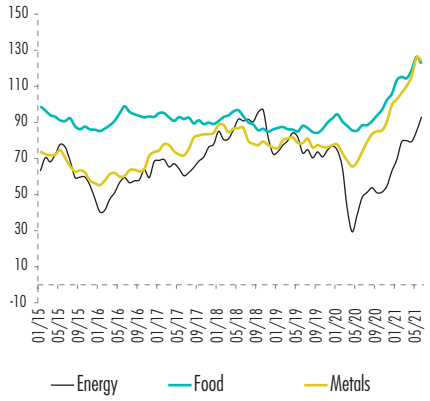
The price of Brent oil was 81% higher than in the previous year and 15% higher than in January 2020, quoting at around 73 USD a barrel in June. The rise in the price of oil was driven by the increase of the demand in the context of the positive expectations in the global economy. Restrictions in production due to reduced OPEC+ quotas since 2020, have contributed to the same

[4] *Main trading partners outside the European Union (Kosovo, North Macedonia, Serbia).*

trend. Although OPEC may review production quotas, the increasing demand is expected to keep the price of oil at the current levels until the end of the year[5].

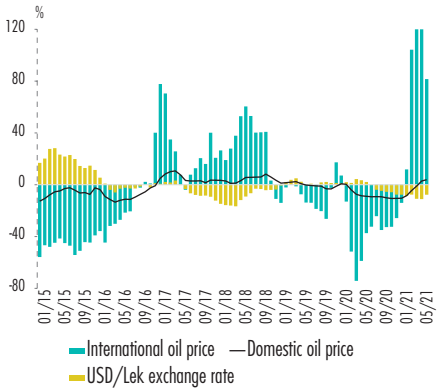
Chart 3

Main indices have pursued the upward path



Source: World Bank

Oil prices in Albania have reacted at a lower level and with a time lag to fluctuations in prices in global markets



Notes: Annual indices changes. Oil price in Albania is approximated to the changes of oil price index in the CPI
Source: Instat and BoA staff calculations

The expansion of the economic activity has triggered a significant growth in the demand for metals. The metal price index increased by 69% in June, compared with the previous year. The rise in the price of metals was driven by a supply restriction from several main mines. The price of agriculture products have also increased continuously since the middle of the past year. The index of food prices increased by 39% in June, from the previous year. At the presence of a high demand, food prices were affected by lower harvest, supply-side problems and an increase in the cost of international transport, as well as grain export restrictions embarked on by Russia. As supply restrictions are eased, the pressures from increasing prices of metals and food are expected to stabilise.

2.3. GLOBAL FINANCIAL MARKETS

Financial conditions have eased, in the view of the improved economic outlook of advanced countries and the maintenance of the accommodative monetary policy stance by the main central banks. After the growth in May, due to the expectations on the increase of inflation, yields on sovereign bonds in the USA and the Euro area, fell again close to the pre-pandemic levels. The FED and ECB deemed the increase of inflation during this period as temporary and affirmed the accommodative monetary policy stance, driving to the medium-term adjustment of inflation. Some central banks in the world have assessed that the rise of inflation may cause the increase of inflationary expectations and have started to act in order to tighten monetary stimulus[6].

[5] *US Energy Information Administration, Short term energy outlook, July 2021.*

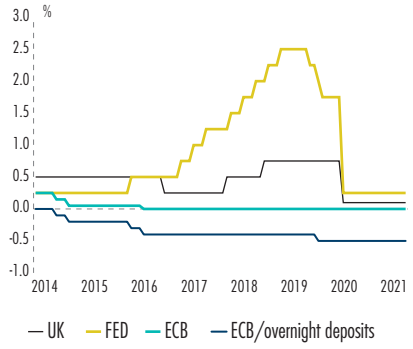
[6] *A panel of 104 central banks: 93 banks decreased the key interest rate during 2020. During 2021, 8 banks have continued to decrease the key interest rate, while 19 banks have increased it (data up to 22 July, Central bank news).*

Investors' sentiment in the euro area remains positive, supported by the expected economic recovery, higher revenues of enterprises and accommodative monetary and fiscal policies. In real terms, negative yields help to finance the private and public sector for the continuing rebound of the economy. The improvement of the investors' sentiment has driven to an increase in stock indexes, where some of them are hitting up historical levels.

The ECB has affirmed to maintain the accommodative monetary policy stance to supporting the economic activity and preserving price stability. Short- and medium-term expectations factorised in the interest rates of future contracts, confirm a contained performance of premia. Whereas, the support with liquidity from central banks has maintained short-term interest rates at low levels.

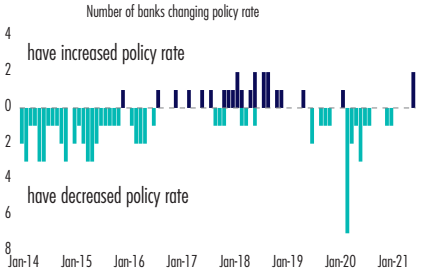
Chart 4

Interest rates by main central banks are expected to remain at low levels for several periods



Notes: Key interest rates for large central banks with impact on international markets
Source: Central banks.

Some banks have started to tighten monetary policy



Notes: The number of banks that have made changes to the key interest rates. These are the main banks and some European banks close to the region that target inflation (ECB, FED, BA, Bank of Albania, Bank of Czech Republic, Bank of Poland, Bank of Hungary, Bank of Romania, Bank of Serbia). The Bank of Hungary and the Bank of Czech Republic increased the key interest rate in June.
Source: Central banks.

3. FINANCIAL MARKETS AND LENDING CONDITIONS

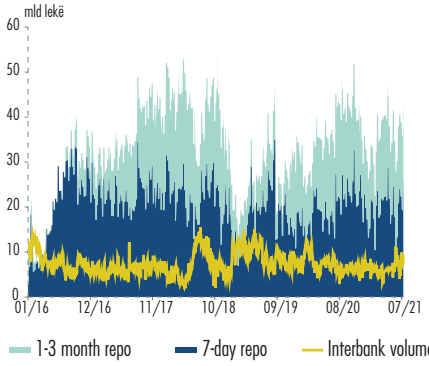
Developments in the financial market reflect an environment with contained risk premia and low interest rates. The foreign exchange market was calm, characterised by a slight appreciation of lek when traded against foreign currencies. The accommodative monetary policy and sound balance sheets of banks are transmitted in favourable lending conditions for the private sector, supporting its requirements for financing during this cycle of the economic recovery. As a result, credit and deposits of the sector have improved, confirming the positive trajectory in line with the positive macroeconomic perspective in Albania.

3.1. DOMESTIC FINANCIAL MARKET

Interest rates in the interbank market remain anchored close to the policy rate[7], confirming the low risk premia of liquidity and supporting the monetary policy transmission mechanism. They have slightly decreased from the previous quarter and have maintained low volatility. This landscape reflects both the stable balance sheets of banks, and the Bank of Albania's operational policy of liquidity provisioning. The Bank of Albania has continued the operations of liquidity injection in the system, through its main instrument of one-week repo. In addition, three-month repo has been also used. The injected amount in this

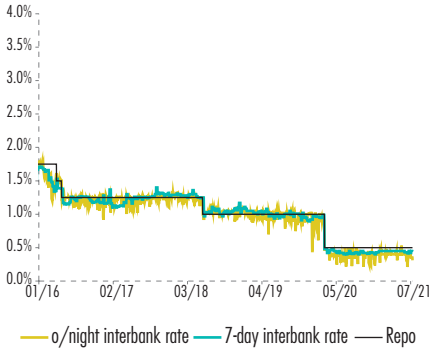
Chart 5

The liquidity situation of banks has remained calm in the course of the second quarter



Note: Daily performance of liquidity supplied by the Bank of Albania through one-week and 1-3 month repo and traded volume by banks in the money market.
Source: Bank of Albania.

Interest rates in the interbank market remain anchored close to the policy rate



Note: Data show the daily performance of interest rates in the interbank market.
Source: Bank of Albania.

[7] *In 2021 Q2, the standard deviations of the overnight and weekly interbank rates were 0.04 and 0.01, respectively, from 0.03 and 0.001 in 2021 Q1.*

quarter was slightly higher than in the first quarter of 2021[8], but the ratio of weekly injections to long-term injections (up to three months) has remained almost unchanged.

During the second quarter of 2021, the foreign exchange rate was characterised by a low volatility and calm trading conditions of foreign currencies. Lek continued the slight appreciation against the euro that started since March, while fluctuations against the US dollar were two-sided, but maintaining the average of the first quarter of the year.

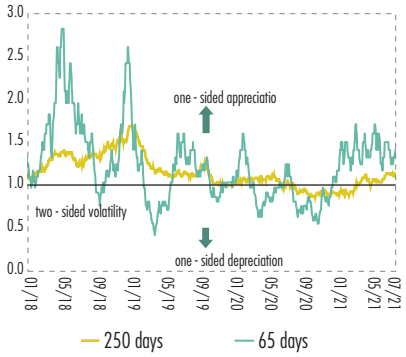
The **euro/lek** exchange rate fell around the 122.8 lek/euro, on average, in the first three weeks of July, from 123.3 lek/euro average in March. The appreciation of lek during this period is in line with its seasonal behaviour, but it was gradual and moderate compared to the previous years[9]. The restrictions on movement, as part of the measures to contain the spread of the pandemic, continue to condition a weaker tourism compared with the preceding years, and thus, resulting in lower currency flows from this sector. Stress indicators for the euro/lek exchange rate – volatility, quotation spreads, the appreciation/depreciation bias[10] - remain at normal levels. In particular, although the short-term volatilities of the euro/lek exchange were on the appreciating side of lek, the appreciation/depreciation bias, calculated in a longer-term horizon, results

Chart 6

Lek has appreciated against the euro and has remained unchanged on average against the US dollar

Note: Data show the daily performance of ALL exchange rates against Euro and US dollar
Source: Bank of Albania.

Short-term volatilities on the appreciating side of the euro/lek exchange rate have not affected the balance of position of economic agents in the market over the longer-term horizon



Note: Data show the exchange rate appreciation/depreciation ratio. For more look at footnote 10.
Source: Bank of Albania.

[8] *The injected amount of liquidity averaged ALL 37 billion in 2021 Q2, from ALL 33 billion in 2021 Q1, up for both weekly repo and for those with one month and three-month maturities.*

[9] *In the April-July period during 2015-2019 (2020 is excluded from calculations, as an unusual year), lek had an average monthly appreciation of 0.4%. I the April-July period of this year, the average monthly appreciation of lek was 0.2%.*

[10] *The exchange rate appreciation/depreciation ratio is calculated as the ratio of the number of days when the exchange rate is appreciated against the number of days when the exchange rate is depreciated, over a moving time horizon that may vary, e.g. 22 days (one calendar month) up to of 250 days (one calendar year). The value of this indicator near 1 indicates an equal number of cases of appreciation and depreciation and it shows that there are no one-sided pressures for appreciation or depreciation. If the value of this indicator is above 1 (below 1), then in the market there are signals for one-sided expectations for exchange rate appreciation (depreciation).*

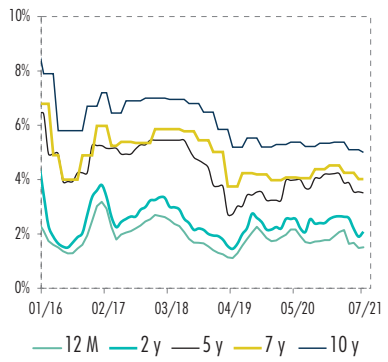
close to the equilibrium value, by showing balanced positions of economic agents in the market. In 2021 Q2, Lek appreciated against euro by 1.2% on average, compared with the previous year.

After the appreciation of lek against the US dollar in the first three months of the year, lek has pursued a slightly appreciating track in April and May, to depreciate once again in June and July. Despite this volatility, the performance of the US dollar against the euro in the international market, on average, the US dollar/lek exchange rate is stable during this year; it recorded 102.4 lek/USD in April – July, remaining close to the level recorded in the first quarter of the year. The annual appreciation of lek against the US dollar, after culminating at 11.0% in April and May, has come down at 4.6% in July.

Yields on T-bills and bonds in the primary market have shown a downward performance since April, reflecting a better balance between the market supply and Government's demand for financing. The drop in yields was general, but was more pronounced in the medium-term segment, by flattening the convex of the curve noted since 2020 Q4. Compared with the previous year, yields on securities in the primary market are positioned 0.2 pp, on average, lower along the curve, while its slope has remained almost the same. In details, yields of 12-month T-bills dropped to 1.5%, from 2.0% at the end of March. Yields on bonds have followed the same direction, decreasing by 0.3 pp on average, from the values recorded in the previous quarter. The performance of yields over these months has reflected the competitive behaviour of banks within a context where the financial market has easily absorbed the dynamics of the Government's demand for funds. Meanwhile, the interest of the banking system to invest in debt securities in long-term segments has confirmed the contained risk premia and inflation during this period. The coverage ratio of debt securities auctions in these months has increased[11], affirming banks' pressures for premia discounts.

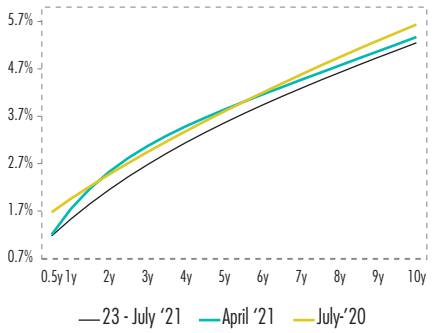
Chart 7

Yields in primary market are downward since April



Note: Data show the interest rates (monthly average) on public T-bills and bonds issued in the primary market.
Source: Bank of Albania.

Yields curve has flattened again in the medium-term segment and has shifted downwards compared to the previous year



Note: Data show the interest rates (monthly average) on Government debt securities by various maturities calculated according to Nelson Siegel model.
Source: Bank of Albania.

[11] *The bid/cover ratio on T-bills and bonds auctions organised since April recorded 1.7, from 1.4 in the third quarter.*

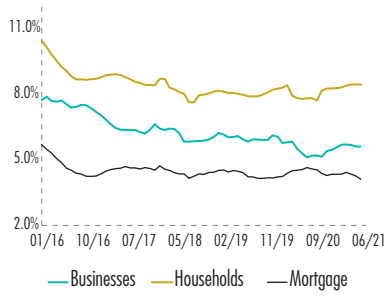
3.2. LENDING CONDITIONS

The sound balance sheets of banks and the low premia of liquidity and credit risk, coupled with the recovery of the economy, **have helped transmit the monetary stimuli to the interest rates of loans**. They have continued to fluctuate at low levels, confirming overall favourable conditions for investments and consumption.

The average interest on new loans to enterprises in the second quarter recorded 5.4%, from 5.8% and 5.6% in the two previous quarters. Analysis by size of credit disbursed shows that interests have slightly fallen on loans up to ALL 35 million (loans mainly granted to the small enterprises segment), while interests on loans over ALL 35 million are more stable, fluctuating close to the levels of previous quarters.

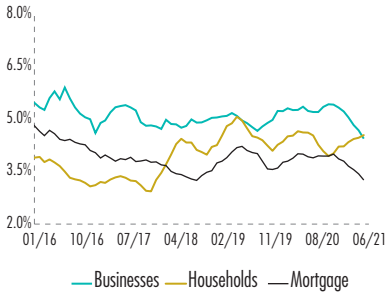
Chart 8

Interest rates on loans in lek decreased for loans to enterprises and for mortgage loans to households



Note: The data indicate the monthly interest rates of new loans in lek in %, 6-months moving average.
Source: Bank of Albania.

Interest rates in euro remain unchanged from the first quarter and below last year's average



Note: The data indicate the monthly interest rates of new loans in euro in %, 6-months moving average.
Source: Bank of Albania.

The interest rate on loans to households have decreased, reflecting the decrease of the interest on mortgage loans at 3.5%, from 4.5% that lasted for over one year. The interest rate on consumer loans recorded 8.4% in this quarter, maintaining its stability since 2020.

Interests on new loans in euro to enterprises were on average 4.5% in 2021 Q2, close to the level of 2021 Q1 and simultaneously below the 5.4 % average in the previous year. Within the intervals, interests slightly increased for loans up to ALL 35 million, while interests on loans over ALL 140 million contracted, in these three months. For households, interest rates on consumer loans in euro decreased, while on mortgage loans remain unchanged.

Interest rates on deposits in lek fluctuated close to their lowest levels, reflecting the continuous increase of deposits and the lack of pressures in financing the

intermediary activity of banks. The average interest rate on new time deposits in lek was 0.69% in 2021 Q2, from 0.66% in the previous quarter, with a marginal growth for both maturities (up to one year and over one year).

BOX 1:

Supply conditions and demand for loans in 2021 Q2[1]

Loan supply to enterprises eased in 2021 Q2, after a period of contraction for five consecutive quarters. The easing of containment measures imposed to curtail the spread of Covid-19 and the improvement in the balances of macroeconomic and financial indicator from the previous quarters, have triggered banks to perceive a lower credit risk. These factors put together have driven banks to ease standards on loans to enterprises across all the categories. Small- and medium-sized enterprises have benefited more from the easing of credit standards.

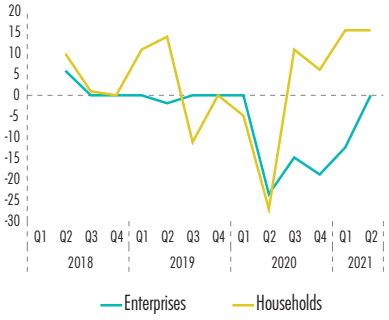
Terms and conditions on loans to enterprises remain unchanged in the second quarter, after a continuous contraction in the previous year. The pressure from competition in the banking system and the improvement of indicators related to risk perception have made banks more tolerant in approving the terms and conditions of new loans to enterprises during this quarter, compared with the previous ones.

Chart 1 Box 1

Credit standards continued to be tightened for enterprises and eased for households

Values on the chart are calculated as net percentage. Positive values indicate easing of credit standards, whereas negative values indicate their tightening
Source: Bank of Albania.

The terms and conditions of lending remained tightened for enterprises and accommodative for households



Values on the chart are calculated as net percentage. Positive values indicate easing of terms and conditions and vice versa.
Source: Bank of Albania.

The indicators that assess the conditions of loans to households continued to improve in the second quarter as well. Hence, credit standards were positive in this quarter, driven by the higher competition in the banking system, as well as the improvement of borrower's creditworthiness, particularly in the segment of consumer credit. In response to the lower risk perceived by the market, banks have appointed lower margins and have extended the maturity and the size of new loans (especially consumer loans) approved in this quarter, by easing thus the terms and conditions for households.

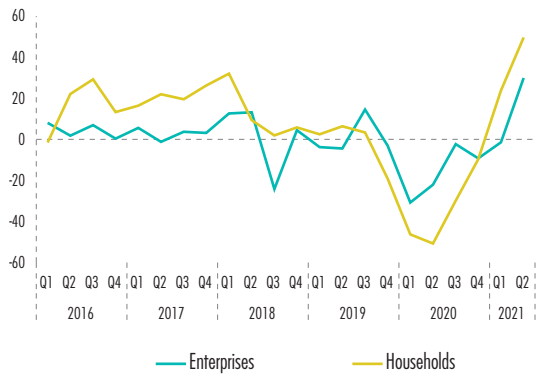
Balance of loan demand from enterprises was positive in this quarter, following the negative values recorded for six consecutive quarters. The added demand on loans from all enterprise sizes was as a result of the additional requirements for financing investments and liquidity, in reflecting the improvement of the macroeconomic and financial environment in Albania.

Loan demand from both households and enterprises was higher in 2021 Q2. Higher financing needs, in particular for house purchase, underpinned by a more consolidated framework of macroeconomic factors, have determined the rapid increase of loan demand from households in this quarter.

[1] *The analysis is based on Bank Lending Survey, conducted on quarterly bases and is published at : www.bankofalbania.org/*

Chart 2 Box 1

Loan demand was perceived as improving in 2021 Q1



Values on the chart are calculated as net percentage. Positive values show increase of credit demand, while negative values show its decrease.
Source: Bank of Albania.

3.3. CREDIT TO THE PRIVATE SECTOR[12]

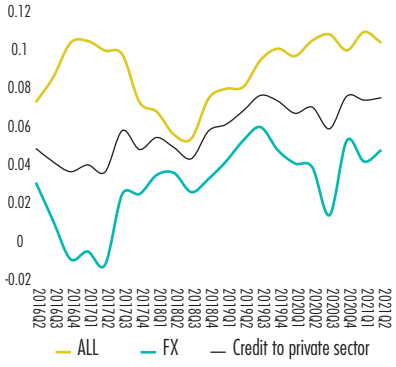
Credit to the private sector has maintained the positive growth trajectory during 2021 Q2, where the annual growth rate of credit portfolio, 7.7% on average, is slightly higher than in 2021 Q1. Furthermore, in quarterly terms, the expansion of portfolio by ALL 15 billion reflected the seasonal improvement in 2021 Q2, by returning to the growth pace of the pre-pandemic period. The return of the economy to normality after the removal of restrictions and the vaccination roll-out, higher public sector activity, and the improvement of credit supply are the main factors that have supported this performance.

However, in contrast with 2021 Q1, the increase in lending was mainly supported by **household financing**. The credit portfolio for this segment increased by 8.7%, on average, compared to the previous year, up by 2.6 pp than in the first quarter. Loans for house purchases gave the main contribution to this improvement. The annual growth of this portfolio was 11.1% or 2.7 percentage points compared to the first quarter, confirming the positive trajectory started in the previous year. The upward trend of real estate prices coupled with the favourable financing conditions, were accompanied by both a higher demand for financing property purchases through banks and a more accommodative approach of the latter regarding this segment. In addition, consumer credit has shown a stable improvement since last autumn, recording an average annual expansion of around 5.4% in 2021 Q2.

[12] *In order to analyse the real developments of ongoing loans, credit data have excluded the effect of exchange rates and write-off loans of balance sheet.*

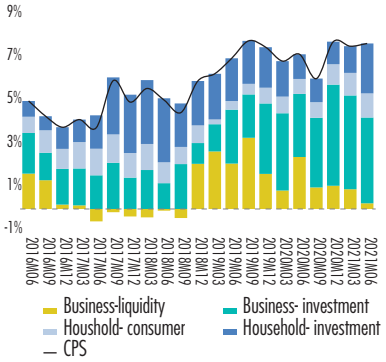
Chart 9

The increase of credit to the private sector remains stable both in Lek and foreign currency



Notes: The data indicate the annual changes (in %) of lending by currency.
Source: Bank of Albania.

The increase of credit in 2021 Q2 is supported by lending to households mainly for house purchases



Notes: The data indicates lending to the private sector by purpose of use.
Source: Bank of Albania.

Credit to enterprises, with an annual growth of 7.1% continues to be supported by high growth rates of credit for investments. The 11.6% growth rate of this credit appears stable and in line with the recovery of economic activity and stronger confidence. It has somewhat balanced the slowdown in the growth rate of loans for liquidity. This slowdown has mainly reflected the decline in demand of enterprises for liquidity – related with the increase of the turnout volume in the economy and payments rendered by the government.

In 2021 Q2, the expansion of credit is supported in almost the same degree by both lending in **lek** and in **foreign currency**. However, the annual growth of loans in lek by 11% is clearly higher than that of foreign currency by 4.5%. The expansion of the lending activity in the domestic currency is supported by the accommodative monetary policy and a more prudential approach to the exchange rate – in particular as regards loans to households. As a ratio of the total credit, loans in lek account for 50.1% in June.

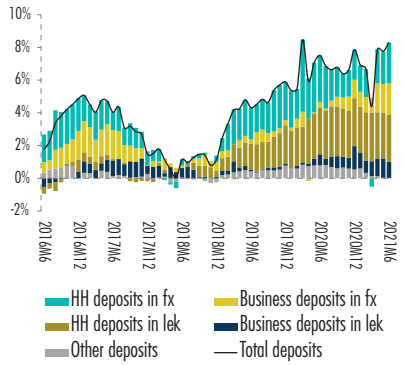
The stock of deposits in the banking system has continued to expand at an accelerated pace in 2021 Q2. The annual growth rate was close to the average value of 8%, or 2 percentage points higher than in the previous quarter. The increase of deposits during this period was broadly driven by deposits in lek (8.3% annual growth), providing a contribution of around 4.2 percentage points on average to the growth of the total stock. Deposits in lek also recorded a growth (7.6%) with an annual contribution of around 3.8 percentage points.

At the end of June, the total stock of deposits expanded by around ALL 30 billion, from March. Enterprises characterised by an overall volatile behaviour compared to households, have recorded a considerable expansion of deposits – with over ALL 13 billion – in particular in May and June. Furthermore, this performance is related to government payments for refunding VAT in arrears,

as well as public sector spending. Household's deposits continue to have the main contribution to the expansion of deposits in the banking system, recording a growth of around ALL 18 billion during this period.

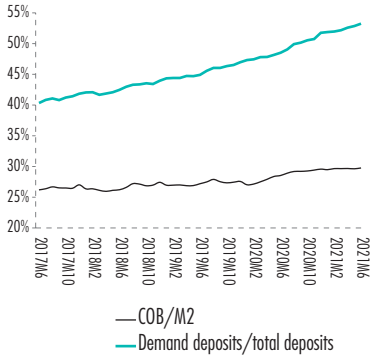
Chart 10

The main contribution continues to come from the expansion of households' deposits



Note: The data represent the annual contribution in % of deposits by currency and economic agents.
Source: Bank of Albania.

The time structure of deposits continues to shift towards the liquid component



The money indicator in lek, M2, is corrected for demand deposits with 2 years maturity and government securities.
Source: Bank of Albania.

In terms of the time structure, the expansion of deposits for enterprises is mainly in the form of current accounts and demand deposits. Households' deposits, which have a longer maturity, given the low interest rates, continue to shift towards demand deposits in both lek and foreign currency. Demand deposits and current accounts in the banking system accounted for over 53% of the total stock of deposits at the end of June. The monetary liquid component, or the currency outside banks was also upwards during this period, reflecting the higher demand for liquid monetary instruments. Currency outside banks ratio to the M2 aggregate increased by 29.8%, from 29.6% at the end of March.

4. ECONOMIC GROWTH

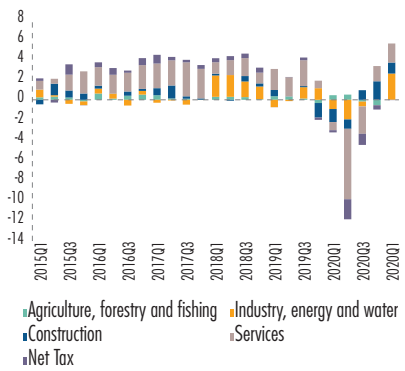
The GDP growth accelerated to 5.5% in 2021 Q1, although the performance of services suffered from the movement restrictions of international travellers. The growth is driven by the domestic demand and mainly the strong expansion of investments. Meanwhile, exports showed a slight increase, by discontinuing interruptin the downward trend that characterised the entire 2020. Indirect indicators suggest a further intensification of the growth rates during 2021 Q2. The acceleration of vaccination roll-out, alongside the lower intensity of infections, has triggered an easing of the restriction measures domestically. At the same time, some restrictions on international movement have been lifted, becoming thus a supportive factor to the economic recovery.

4.1. GROSS DOMESTIC PRODUCT

GDP further accelerated its recovery dynamic in 2021 Q1. Economic growth was 5.5%, from 2.4% in 2020 Q4. This growth was broadly-based, where the production sector gave the main contribution (3.7 percentage points), supported also by the services sector (1.9 percentage points) (Chart 11, right).

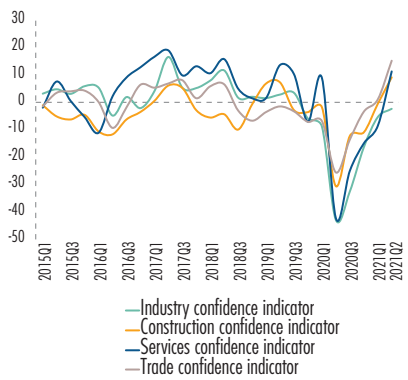
Chart 11

Production and services activity supported the economic growth in 2021 Q1



Source: INSTAT and Bank of Albania.

Economic sentiment indicator improved significantly



Source: Bank of Albania.

The expansion of the **production sector** accelerated to around 9.6% in 2021 Q1, compared to 3.5% in the previous quarter. The branch of electrical energy and the construction activity gave the main contribution to the economic growth,

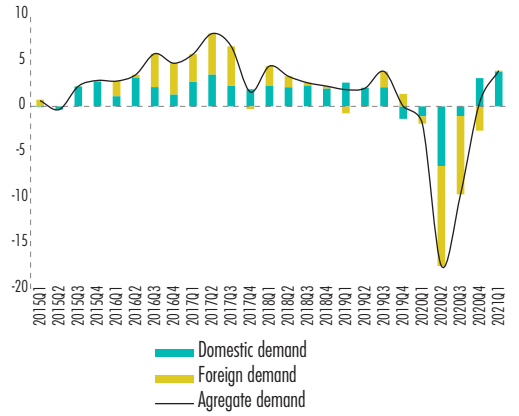
by 1.7 pp and 1.1 pp, respectively. Expansion in construction is assessed to have reflected a higher volume in the three main categories: *new constructions*, *reconstructions*, and *engineering work*. The contribution of the *manufacturing industry*[13] was 0.7 percentage point, accelerating from the previous quarter. In contrast to the previous quarters, the effects of mining were in the upward trend. Whereas, activities in agriculture, forests and fishing had an almost insignificant contribution.

The added value of the **services sector** increased by 3.9% in the first quarter, accelerating from the previous quarter (at 2.9% growth rate). *"Public administration, health and education"* had the main impact followed by *"Real estate"*. The other services subcategories also reflected an increase in annual terms, except for *"Trade, transport, accommodation and food services"*, which continued to remain on the downward trend. This performance was affected by the branch of *"Accommodation"*, which was limited from restrictions related to international travel.

Economic growth is assessed to have accelerated in 2021 Q2[14]. This period is characterised by the expansion of the vaccination process and the significant easing of the containment measures due to the rapid decrease of new COVID-19 cases, encouraging the positive dynamics of the economic activity in Albania. This assessment is confirmed by the indirect quantitative indicators, as well as the increase in exports & imports, the movement of citizens and fiscal statistics. The sharp rise in construction permits supported also by the reconstruction effect, suggest the continuation of positive developments in this sector. In addition, the broad-based improved confidence indicator and the lower uncertainty indicator (Chart 11, right; Chart 13, left) support the assessment on the accelerated growth in 2021 Q2.

Chart 12

Domestic demand has contributed almost entirely by itself to the annual expansion of aggregate demand in 2021 Q1



Notes: Domestic and foreign contribution to the annual growth of aggregate demand.
Source: INSTAT and estimations of the Bank of Albania.

4.2. AGGREGATE DEMAND

The growth of aggregate demand accelerated during 2021 Q1. The positive contribution is almost entirely related to the domestic demand. Foreign demand recorded low positive contributions, after the negative values throughout 2020.

Domestic demand grew by 4.8% in annual terms in 2021 Q1, from 4.0% in the previous quarter. The annual growth of "investments" by 21.1% provided the main contribution in this regard. This performance

[13] *The more improved performance of manufacturing industry is assessed to have been supported mainly by the growth of exports related to the output of metal products.*

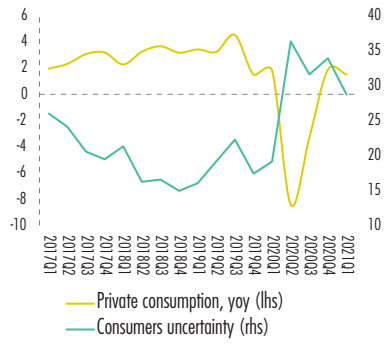
[14] *The performance of economic activity in this quarter is expected to be affected by the strongest statistical effect. In 2021 Q2, GDP recorded the deepest contraction of 11.3%.*

has significantly accelerated compared to the previous quarters. At the same time, the increase of "population consumption" (1.5%) has slightly slowed down compared to the previous quarter (1.9%). "Public consumption" also provided positive contributions, increasing by 5.2% in annual terms.

Private consumption gave a positive contribution to the expansion of aggregate demand for the second quarter in a row. However, the trend of consumers to spend remains contained and below the pre-pandemic level. Households have increased their spending for services and non-food items, reflecting the decrease of uncertainty[15] (Chart 13, right). The increase of credit to households, wages and remittances have financed the growth of private consumption in the first quarter. Consumer trust has gradually improved and has supported spending. Nonetheless, the level of this indicator still remains below the pre-pandemic level, evidencing the fragility in the recovery of private consumption.

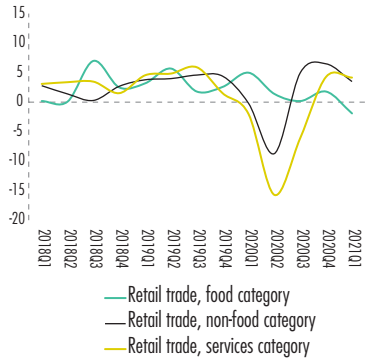
Chart 13

Private consumption continued to grow, but at a slower pace in 2021 Q1



Note: The consumer uncertainty indicator is measured from the Consumer Confidence Indicator and is expressed in net balance in p.p
Source: INSTAT and Bank of Albania.

The growth of consumer spending for services and non-food items slowed down



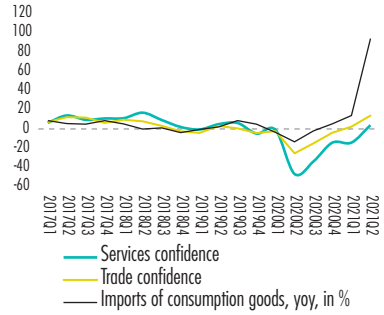
Notes: All indicators are stated in annual changes.
Source: INSTAT and Bank of Albania.

Based on the data available in the second quarter, private consumption continued the upward trend. Both the import of goods for consumption (Chart 14, left) and automobile import increased sharply in the second quarter. Data from consumer survey show an increase of confidence in the sectors of trade and services, suggesting an increase in consumer demand for goods and services. More detailed data from consumer survey suggest that consumers' behaviour will remain cautious. The performance of major purchases indicator has gradually improved during the year, but the assessment of consumers on savings continues to have an upward trend (Chart 14, right).

[15] *The analysis of family spending by various categories of consumption is based on the indicators of Retail Trade Index and GDP measurements by output.*

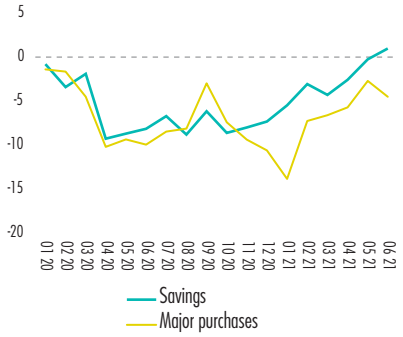
Chart 14

The growth in the import of goods for consumption and the improvement of confidence in the sectors of trade and services give positive signals for private consumption in 2021 Q2



Notes: The Import of consumer goods is the annual change and the confidence indicators are balance averages in p.p.
Source: INSTAT and Bank of Albania.

Consumers' trend to save is assessed as more uniform than the one for large purchases in 2021 Q2

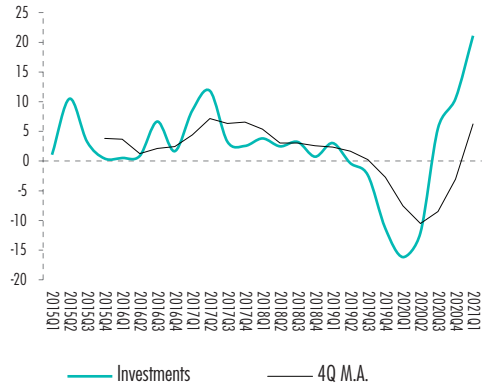


Note: The indicators are based on the Consumer Confidence Survey and are expressed in the balance in p.p.
Source: INSTAT and Bank of Albania.

Total investments in economy were the main contributor to the expansion of aggregate demand in the first quarter. After increasing by 10.5% in 2020 Q4, the growth rate of investments doubled in this quarter. Our assessments show that the private component provided the main contribution to the increase of total investments. Public investments also gave a positive albeit lower contribution. The positive performance is observed by both investments for construction and for machinery and equipment. Value added in construction increased by 16.9% in the first quarter and the import of machinery and equipment grew by 36.1%.

Chart 15

Total investments in economy accelerated the growth in 2021 Q1

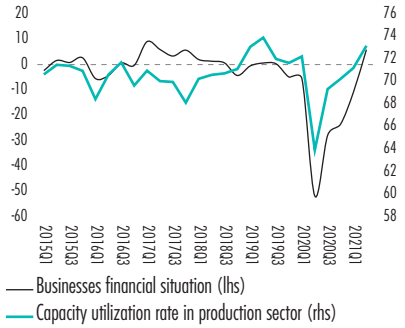


Source: INSTAT and Bank of Albania.

The positive trend in investments is expected to continue in the second quarter. Data from confidence surveys show that enterprises have increased the capacity utilisation rate of production over the pre-pandemic level (Chart 16, left). Data on both investments for machinery and equipment and for materials used in the construction sector, suggest a growth in investments for these two categories in the second quarter (Chart 16, right).

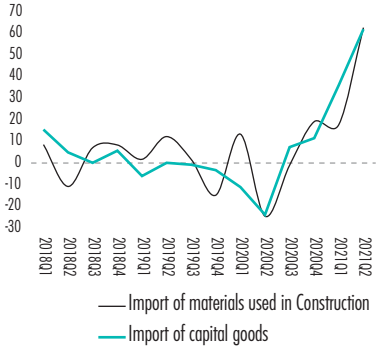
Chart 16

The capacity utilisation rate and the enterprises' financial situation recovered the pre-pandemic levels in the second quarter



Notes: Enterprises' financial situation is a balances' weighted average by sector from confidence surveys. The capacity utilisation rate is in percent of full capacity.
Source: INSTAT and Bank of Albania.

Import indicators suggest an increase of construction investments and investments in machinery and equipment in the second quarter



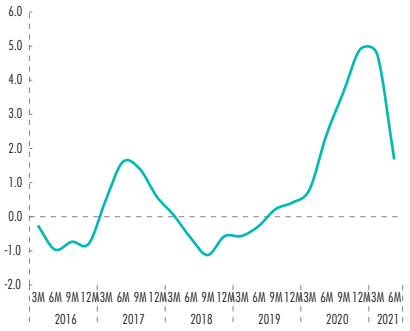
SNotes: Indicators are annual changes in percentage.
Source: INSTAT and Bank of Albania.

In the current year, fiscal policy is projected to be accommodative, in support of the healthcare system, oriented towards the reconstruction of infrastructure damaged from the earthquake of 2019, as well as for increasing public investments. Fiscal policy is expected to support the economy at a larger degree from the one forecasted at the beginning of the year. The deficit plan for 2021 was revised by around 0.4 percentage point in June, by assigning a budget deficit equal to the one in 2020, at 6.9% of GDP. In nominal value, the deficit increased to ALL 120.5 billion, from ALL 108.7 billion planned initially.

The increase of spending in the first six months of the year, together with the impact of easing fiscal measures in the second half of 2020, have created a fiscal impulse of around 1.7 percentage points of GDP. The smoothening of the curve that approximates the impact of fiscal policy on the economy in the 2021 Q2 besides the rapid increase of income, reflect the base effect of the previous year as well, where direct transfers of households culminated in the second quarter.

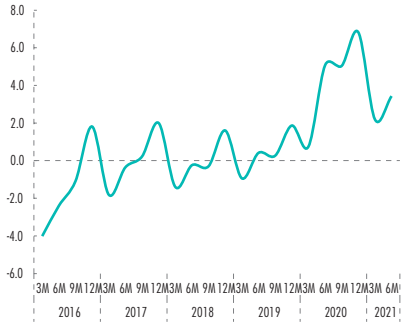
Chart 17

Fiscal policy remained easing



Notes: Change of the primary balance ratio for 12 months to GDP, from the previous year. Positive values of this indicator show that fiscal policy has been easing, while negative values that it has been consolidating.
Source: Ministry of Finance and Economy and calculations of MPD.

The budget deficit was higher than its seasonal behaviour



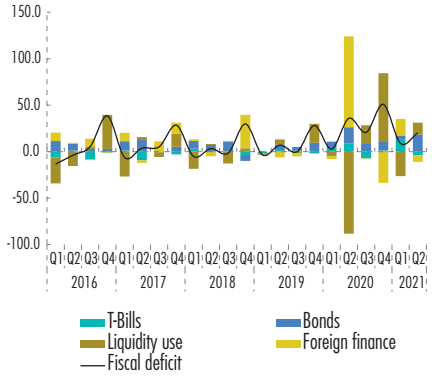
Notes: Budget deficit to GDP. Calculations are based on quarterly fluctuations. Positive values indicate a budget deficit, while negative values a surplus.
Source: Ministry of Finance and Economy.

In 2021, the easing features of fiscal policy were more pronounced in the second quarter, with the fastest activation of spending on the healthcare system and on public infrastructure for the reconstruction fund.

At the end of the first six months, **budget deficit** increased to ALL 29.1 billion, from ALL 8.8 billion in the previous quarter. In terms of GDP the deficit in 2021 H1 was assessed at around 3.4%, or 1.6 percentage points below the level of the previous year. The lower annual deficit is entirely attributed to the rapid increase of income (2 p.p.), which has neutralised the impact of the expansion of spending (0.4 p.p.).

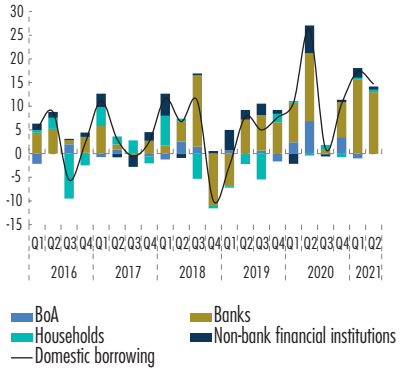
Chart 18

The deficit was financed by the issuance of securities and use of liquidity



Notes: Budget deficit by quarters and it financing, in ALL billion
Source: Ministry of Finance and Economy.

Banks carried the main share in financing with domestic sources



Notes: Government borrowing in debt securities, by buyers, in ALL billion, by quarters
Source: Ministry of Finance and Economy.

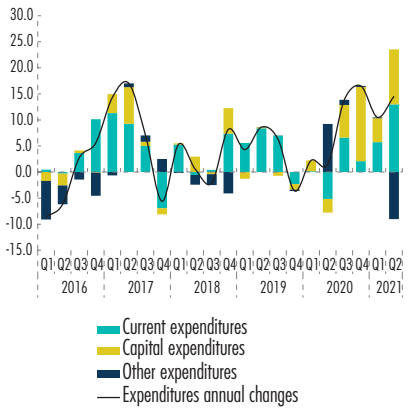
In 2021 Q2, the budget deficit expanded by ALL 20.3 billion, financed through increasing issuances in long-term instruments and using liquidity surpluses accumulated in the previous quarter. Liquidity surpluses were used for servicing foreign debt. Additions to long-term issuances in the domestic market compensated the lower issuances in T-bills as well. The main purchasers remain commercial banks, which own around 60% of the portfolio of government securities issued in the domestic market until the end of June.

Budget expenditure amounted to ALL 145.2 billion in the second quarter, or around 14.5% higher than in the same quarter of last year. The growth of expenditure was driven by all expense items, compensating also the negative effect of 9 percentage points from indirect transfers conducted in previous year. Expenses for investments, the reconstruction fund, and healthcare expenses provided the main share in the growth of expenditure. Expenses for public investments were ALL 22.4 billion in the second quarter, or around 33% higher in annual terms.

In 2021 H1, budget expenditure amounted to ALL 263.4 billion, or 12.7% higher than in the previous year. The profile of growth of budget expenditure remained unchanged in the first six-months from the second quarter. The reconstruction fund, public investments and expenditure on social and health insurances provided the highest contribution to the total growth.

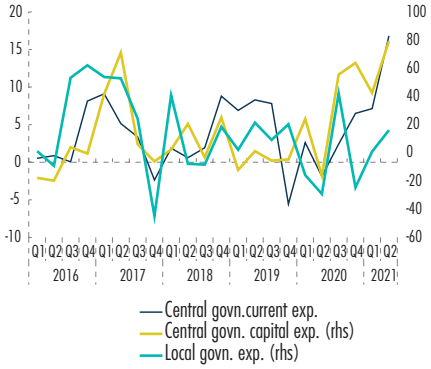
Chart 19

Expenditure continued to increase rapidly



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

The increase in expenditure was driven mainly by the reconstruction fund and investments



Notes: Annual growth in % of main expenditure items, by Quarters.
Source: Ministry of Finance and Economy.

Public expenditure related to the purchase of goods and services, as well as infrastructure, has increased at a high pace in the second quarter, suggesting a positive impact of the public component on the expansion of aggregate demand. The direct presence of the public sector on economic growth, in the form of public consumption, is assessed to be significant in 2021 Q3.

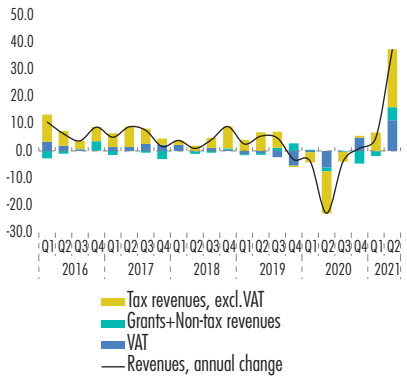
Budget revenues were around ALL 125 billion in the second quarter, or 37.4% higher than in the same period last year. The rapid growth of revenues contains the base effect at a large scale, since 2020 Q2 marked the culmination of movement restrictions in the framework of the containment measures for preventing the pandemic. VAT revenues provided the highest contribution to the total growth in the second quarter. The revenues added by this group reflect largely the rapid increase of commodities prices in international markets (Chart 3).

In the first six months of 2021, budget revenues recorded around ALL 234.3 billion, or 20.1% higher in annual terms. The highest contribution to the total growth was provided by VAT revenues (5.2 pp), social insurances[16] (3.6 pp) and revenues from national taxes (2.4 pp). In addition to the base effect, the performance of revenues was positive during the year. The level of revenues in 2021 H1 exceeded that of 2019 by around 3.6%, supported by all tax items except revenues from company profits and personal income.

[16] *The growth in social insurances is related, among others, also to the increase of minimum wage, which increases automatically the maximum limit on which social security contributions are calculated.*

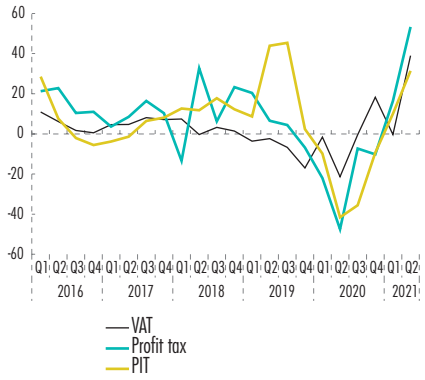
Chart 20

Revenues increased at a rapid pace in 2021 Q2...



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

...affected by all tax components.



Notes: Annual growth in % of main tax items, by quarters.
Source: Ministry of Finance and Economy.

Developments in terms of budget revenues, alongside the effects of fiscal measures[17] or the increase of prices in international markets, signal the improvement of consumption, economic activity and of labour market indicators during 2021 Q2, as well.

BOX 2: FISCAL POSITION STABILITY: THE LEVEL OF PUBLIC DEBT AND ITS FINANCING STRUCTURE

The challenges faced by economies due to the pandemic brought to attention once again the decisive role of a stable fiscal position in withstanding shocks. As they were tackling an unprecedented situation, governments in many countries undertook high fiscal stimuli, which aimed to allocate funds for withstanding the health emergency as well as provide the necessary financial support to specific sectors of the economy. The size and speed of providing the stimuli and their effectivity had a high correlation with the scale of soundness of public finances in the pre-pandemic period.

In almost all the countries, the supportive fiscal packages brought about the rapid increase of public debt. Given the emergency and the indispensability of the fiscal stimuli, which was implemented globally, and the accommodation provided by the expansionary monetary policies, international rating agencies did not adjust the assessments on credit ratings for the sovereign debt. Also, the cost of debt financing in national and international markets remained at low levels or declined further. However, this assessment factors in the judgement of agencies and financial markets that public authorities will turn their attention towards the sustainability of debt once the pandemic is over.

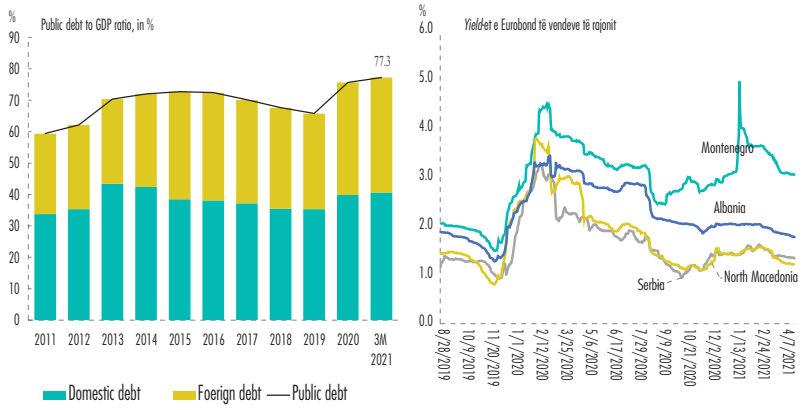
Being on the same track as the rest of the world, the Albanian Government became involved in creating fiscal stimuli in order to mitigate the consequences

[17] *One of the fiscal measures that is expected to bring a considerable growth in revenues is the increase of minimum wage from January 2021. This measure, in addition to the growth of revenues from personal income tax, increases the amount of social insurances as well.*

of the pandemic. In addition to the pandemic, the earthquake at the end of 2019 pressured the public debt with extra costs. As regards the supportive measures undertaken by the government and the applicability of automatic stabilizers, the ratio of public debt to GDP reached 77.3% at the end of 2021 Q1, from 65.8% at the end of 2019 (Chart 1, left). Meanwhile, the costs of financing the Albanian public debt in local and international markets (Chart 1, right) did not increase and the rating degree remained unchanged (Standard and Poor's: B+/Stable and Moody's: B1/Stable).

Chart 1 Box 2

The performance of public debt in Albania and its financing costs in international markets



Source: Bank of Albania.

Once the pandemic is over, countries are expected to give priority to consolidating fiscal policies, which will help to put debt on a stable track. The medium-term fiscal projections suggest that the fiscal policy in Albania will return to a consolidated cycle after 2021. The Bank of Albania has adopted the accommodative fiscal policy for the past two years, in order to minimise the negative effects of the pandemic on the Albanian economy. At the same time, the Bank of Albania has emphasized that going back to fiscal consolidation, once the pandemic is over, is a necessary precondition to guarantee the stability of public finances in the long-term horizon.

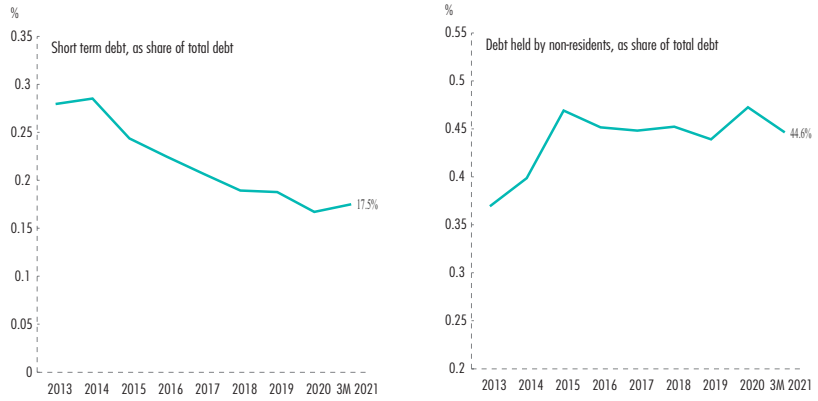
In parallel with the debt level, the analysis on the sustainability of fiscal policy and its degree of exposure to shocks, shall take into account also the structure of financing said debt. In particular, three potential risks that characterise the structure of debt financing are: the refinancing risk, interest rate risk and exchange rate risk. Below we will present in short the performance of these risks in Albania.

The re-financing risk refers to hypothetical situations where a government might not find potential buyers for its debt. This indicator itself is a direct function of government's needs for borrowing during a specific time period, usually one calendar year, and the origin or structure of the owners of its debt. In the case of Albania, the re-financing risk has been downward during the last years. Hence, the ratio of short-term debt to total debt has progressively decreased across time, from 29% in 2014 to 18% in 2020 Q1 (Chart 2, right). This signifies that - during one year – there is a lesser need for the government to be present in the financial market in order to finance debt and – as a result – it is

exposed less towards potential financial market turbulences. On the other hand, although the share of debt held by non-residents, who theoretically show lower interest on the local market than residents, is relatively high, this indicator has been comparatively stable across time (Chart 2, left).

Chart 2 Box 2

The share of short-term debt (right) and the share of debt held by non-residents (left) to total debt



Source: Bank of Albania. *Source: Bank of Albania.*

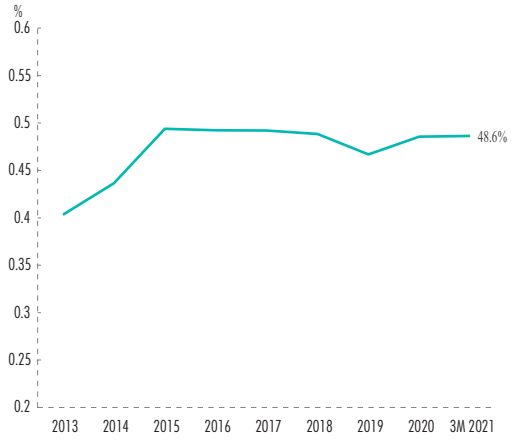
Interest rate risk refers to the volatility that may be experienced by the level and cost of servicing debt, as a result of financial market fluctuations or the nature of instruments used for its financing. In Albania, the interest rate risk has been downward during the last years. Beyond the increase of maturity and the depth of domestic financial markets, extending debt maturity and progressively reducing the share of debt instruments with changing interest, have mitigated the interest rate risk and have improved the assessment framework of debt servicing cost in the future.

Lastly, the exchange rate risk refers to the volatility that might be experienced by the level and cost of debt servicing, as a result of exchange rate fluctuations. This risk is particularly relevant for countries that utilize the international financial markets to cover borrowing needs, through issuing debt instruments dominated by currencies different from the domestic one. In Albania, the share of debt in foreign currency has increased during the past years (Chart 3). This growth reflects at a large scale the awareness on the negative impact of accessing local financial markets in order to withstand the large financing needs of the budget, as a result of the costs of reconstruction of earthquake damages and the pandemic. However, managing this risk requires constant attention in the future.

In this regards, the commitment to put debt in a downward trajectory in the future shall be accompanied by a constant watchfulness in order to improve the risks related with its structure.

Chart 3 Box 2

Foreign currency denominated debt, as share of total debt



Source: Bank of Albania.

Net exports contributed negatively to the growth in 2021 Q1. The trade deficit in goods and services expanded by 25.0%, driven by the rapid growth of imports by 7.6%. Import of goods has been decisive as it increased by 18.8% in response to the recovery of domestic demand. In parallel, the expansion of foreign demand is reflected in a 33.2% increase of "export of goods" (Chart 21).

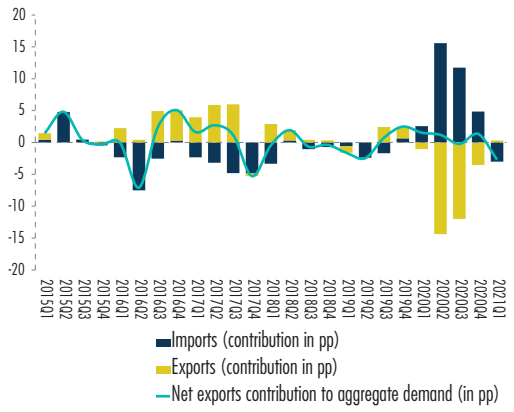
In contrast with goods, the recovery in the flow of services is not verified yet. Annual changes remain negative, but rates are lower compared to the previous months. "Export of services" declined by 17.8%, whereas "import of services" fell by 9.4%. In both cases the reason is related to the flow of "travel services" (tourism). Barriers in the movement of citizens continue to be a hindering factor.

Developments on foreign trade of goods show a significant growth in annual terms, in both exports and imports in 2021 Q2. The continuation of the upward trend since the previous quarters and the fact that values have increased considerably as compared also to the same period in 2019, indicate the recovery of foreign trade of goods in general. The annual growth rate of exports has been higher than imports, but the higher share of imports in the trade balance has driven deficit to expand by 29.7% in this quarter. In addition to the above-mentioned developments, the positive dynamic is also related to the base statistical effect in 2020 Q2.

In 2021 Q2, exports of goods grew by 69.2% in annual terms (Chart 22, left). This growth was mostly dictated by the categories "Minerals, fuels, electricity" and "Construction materials and metals", with the latter led by the industrial metals subcategory. The

Chart 21

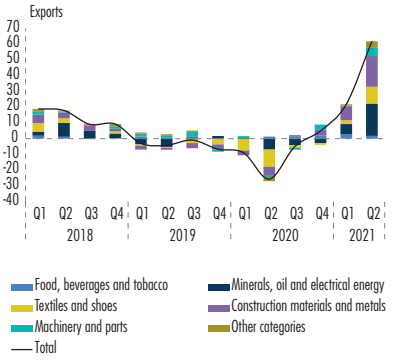
The increase of imports has caused the negative contribution of net exports to the growth in 2021 Q1



Notes: Contribution of imports and exports in economic growth.
Source: INSTAT and estimations of the Bank of Albania.

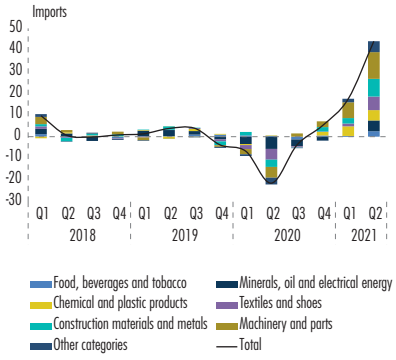
Chart 22

The increase of exports is related mainly to the categories of fuels and industrial metals



Note: Contribute of main categories in the goods market, in percentage points.
Source: INSTAT and Bank of Albania calculations.

The increase of imports is broadly-based, led by construction goods



Note: Contribute of main categories in the goods market, in percentage points.
Source: INSTAT and Bank of Albania calculations.

category "Textile and shoes" gave an important positive contribution in annual terms, but it remains below the 2019 levels.

Imports of goods grew by 44.1% in annual terms (Chart 22, right). Contributions were broadly-based, but were led by the categories of "Machinery, equipment and spare parts" and "Construction materials and metals", whose goods are related mainly to the construction sector. Like exports, the category of "Textile and clothing" remains below the 2019 levels, despite the annual growth, because some imports are used as raw materials in the domestic textile industry. The category "Minerals, fuels and electricity" remains below the 2019 levels as well. In this case, the reason is the import of electricity, which has declined due to higher domestic production.

Regarding the main trade partners, Italy, Kosovo and Spain contributed the most in the annual growth of exports. In the case of imports, Italy, Turkey and Germany have driven their increase in annual terms.

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

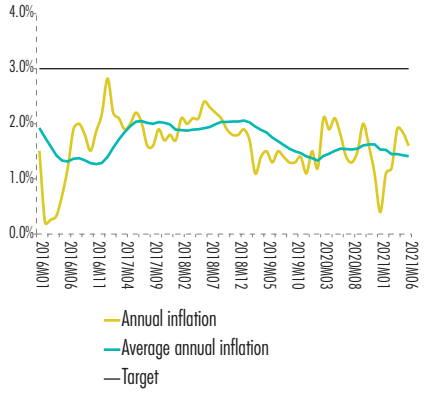
The average inflation resulted 1.8% in 2021 Q2, up by 0.9 percentage point compared with the previous quarter. This increase reflected the presence of temporary supply shocks and the gradual diminishing of the decelerating effect from the fall of oil prices in the previous year. Overall inflationary pressures are expected to strengthen in the medium-term, reflecting the improvement of demand and the cyclical position of the economy. Also, the continuing upward trend of prices in foreign markets will increase imported inflationary pressures.

5.1. CONSUMER PRICES

Annual inflation resulted 1.8% in 2021 Q2. The average value was around 0.9 percentage point higher compared with 2021 Q1, tightening the negative inflation gap (Chart 23, left). The acceleration of inflation during the second quarter reflected mainly the increase in the contribution of unprocessed foods (+0.6 percentage point). The increase of prices for these goods was stronger in April, while in June they registered the usual seasonal contraction. Then, the mitigation of the reducing impact of oil and shelter prices (rent), generated positive contributions (+0.2 percentage point) to the formation of headline inflation. The transmission of the significant increase of inflation in both regional and EU countries, mainly due to the increase of oil and food prices, has triggered external inflationary pressures (Chart 23, right). However, external inflationary pressures are assessed as contained. Overall, pressures from domestic supply-

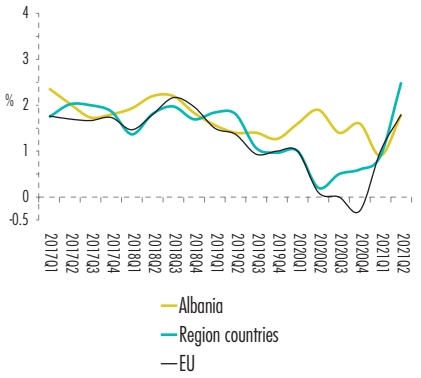
Chart 23

The negative gap of inflation has tightened



Source: INSTAT and Bank of Albania calculations.

Inflation accelerated in the countries of EU and of the region, due to the upwards trend of oil prices



Source: Bank of Albania and Trading Economics database.

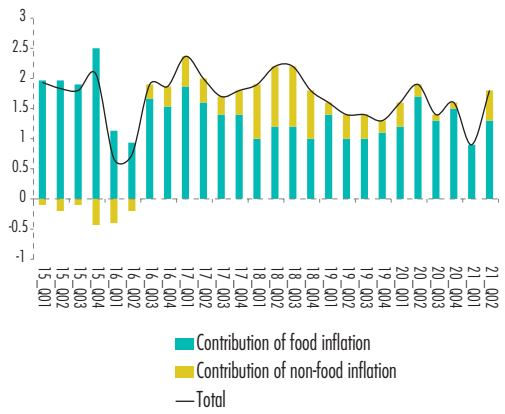
side factors showed upwards. Albeit, pressures from demand, although weak, are assessed as stable.

By category of the CPI basket, unprocessed food prices continued to drive the fluctuations of inflation, albeit smoother than the previous quarter (Box 2). The prices of this category contributed upwards, particularly in April (+0.7 percentage points), while in the following two months they fluctuated at lower values. The contribution of this category to headline inflation increased by 0.6 percentage point (Chart 24, Table 2). This development was caused mainly by the performance of inflation in the "Vegetable" subgroup. The contribution of the other food category, "Unprocessed food", to headline inflation was downward (by -0.2 percentage point). Global market developments affected mainly the "Non-food consumer goods" category, which continued to record upward rates to the contribution. This development was driven by oil prices. Meanwhile, in the March-June period of the previous year, oil prices fell sharply, recording an increase in the respective months in 2021. Their direct contribution to inflation returned to positive values in May-June 2021, while previously contributions were in the negative territory. The value of added contribution to headline inflation for this category is 0.4 percentage point compared with the previous quarter.

The prices of more stable components of inflation – such as services, housing and long-term consumer goods – added to the contribution by 0.1 pp, due to the increase of rent prices. Other categories maintained the same contribution.

Chart 24

The "non-food "group restarted to contribute to the formation of inflation, while the "food "group recorded an increasing intensity



Source: INSTAT, BoA calculations.

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

	Q.2'19	Q.3'19	Q.4'19	Q.1'20	Q.2'20	Q.3'20	Q.4'20	Q.1'21	Q.2'21	Inf. Q2'21 (%)
Processed foods	**0.2**	**0.3**	**0.3**	**0.4**	**0.5**	**0.5**	**0.5**	**0.6**	**0.4**	**2.5**
Bread and corn	0	0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.4
Unprocessed foods	**0.8**	**0.7**	**0.8**	**0.8**	**1.2**	**0.8**	**1.0**	**0.3**	**0.9**	**4.5**
Fruits	0	0.1	0.4	0.7	0.7	0.5	0.2	0.2	0.1	2.4
Vegetables	0.8	0.6	0.4	0.2	0.4	0.2	0.6	0.0	0.6	9.8
Services	**0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.0**	**0.1**	**0.1**	**0.1**	**1.4**
Regulated prices	**0**	**0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.1**
Housing (rent)	**0.2**	**0.1**	**0.0**	**0.2**	**0.3**	**0.3**	**0.2**	**0.0**	**0.1**	**0.4**
Non-food consumer goods	**0.2**	**0.1**	**0.0**	**0.0**	**-0.2**	**-0.2**	**-0.4**	**-0.3**	**0.1**	**0.9**
Fuel	0.1	0	-0.1	0.0	-0.3	-0.3	-0.4	-0.3	0.0	1.9
Durable consumer goods	**0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	**0.7**
Inflacton (%)	**1.4**	**1.4**	**1.3**	**1.6**	**1.9**	**1.4**	**1.6**	**0.9**	**1.8**	**1.8**

*Source: INSTAT and Bank of Albania's calculations. *The table shows some of the main groups and items of the categories.*

BOX 3: THE SOURCE AND NATURE OF INFLATION FLUCTUATION IN ALBANIA AFTER 2019

The purpose of this Box is to shed light to the degree and the main sources of inflation fluctuation in Albania in the last years. The research conducted in the past decade concur that behind the low inflation, which stands below central banks' targets, are primarily the demand-side factors as well as structural changes to labour markets, wages and productivity[1]. In addition to the downward trend of inflation, its rates have been significantly affected also by supply-side shocks, which are assumed to have a short-term impact and are isolated on prices of certain items in the CPI basket.

The case of inflation in Albania shows that supply-side shocks are often engendered by irregular fluctuations in food prices. Similar to other regional and developing economies, in Albania as well, the share of food in the CPI basket is significant. This renders headline inflation more sensitive to movements of relevant prices. The group "Food and non-alcoholic beverages" accounts for around 35% of the CPI basket and "Fruits and vegetables" subgroup, which show the highest fluctuations, accounts for 9.5% of the basket (INSTAT, 2021). Meanwhile, for the 27 EU countries, the shares of "Food and non-alcoholic beverages" and "Fruits and vegetables" are 18% and 3.6%, respectively (Eurostat, 2021). Hence, as regards comparable shocks from the food category, the headline inflation for the EU countries experiences much weaker fluctuations than that of candidate countries, including Albania, due to the essential differences in the respective shares.

The composition of annual inflation in Albania (Chart 1, left) shows that the increase of inflation fluctuation is driven by the "Fruits and vegetables" sub-group. The behaviour of core inflation, which accounts for 71% of the CPI basket, shows an increasing stability, by contributing to decelerate the overall fluctuation. The fluctuating effects from other sub-groups, which account for relatively lower shares in the basket, have either compensated one another or have slightly impacted the degree of inflation fluctuation.

Chart 1 Box 3

The performance of inflation is affected by the volatile contributions of "fruits-vegetable" inflation*

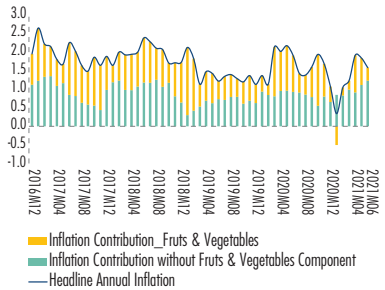
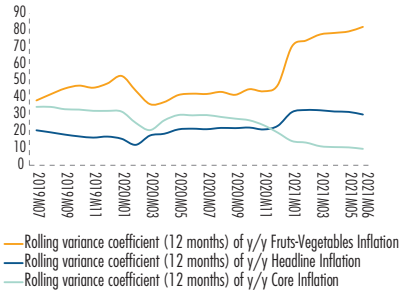


Table 1*	Variance coefficient (%)	
Sub-periods	16M06 - 18M 12	19M01 -21M6
Fruits-veg. inflation	29.2	62.9
Annual headline inflation	15.7	24.8

Source: INSTAT and author's assessment.

*The fluctuation** of annual headline inflation increased during 2021 H1, due to the shocks of "Fruits-vegetables" prices fluctuation*



Notes:

**) Fluctuation is measured by the variance coefficient in %. For each inflation component and for the headline inflation and by the two sub-periods, the indicator is calculated as the ratio of standard deviation to respective average.*

***) The performance of fluctuation is measured as the moving average with 12 terms of variance coefficient, for the core annual inflation, headline inflation and that of fruits and vegetables. For visual convenience, the other sub-groups of inflation are not included.*

Source: Bank of Albania.

The past two years have been characterised by recurring episodes of supply-side shocks from the group "fruits and vegetables", notably: the beginning of 2019, "fruits and vegetables" contributed with maximum values; low values were recorded one year later (partially a base effect as well); inflation increased at the beginning of the restrictions implemented due to the pandemic (March-April 2020); the period of easing the anti-COVID measures (May-July 2020) reflected in the faster decrease of the contributions from the relevant food component, against the base one. In the beginning of 2021, inflation values were extremely low for fruits and vegetables, with a deep negative contribution to the headline inflation. This sub-group shows added volatility in the first half of 2021 (Chart 1, right). The volatility reflects almost completely supply-side shocks for these basket items. A part of them is related to developments in 2020, which was an extraordinary year, with high uncertainties in terms of external and domestic demand for agricultural products as well. As a result, the fluctuation of headline inflation increased by around 9 percentage points during the period 2019:M1-2021:M6 against 2016:M6-2018:M12 (Table 1). Whereas the stability of core inflation has been increasing, by mitigating supply-side shocks (Chart 1, right).

Inflation volatility driven by food prices, more specifically "fruits and vegetables", has been treated as a transitory development. Episodes have been recurring in the last two years, by making the inflation rate "hard to read", albeit in the short-term. The inconsistency of fluctuations in the "fruits and vegetables" sub-group, has affected the short-term predictive performance of relevant inflation. The predictive models of this sub-group contain an auto-regressive component of the first rank with a regress coefficient of around 0.9. Thus, these unexpected shocks are also carried over in the short-term forecast of the sub-group and of headline inflation. But these shocks are eliminated in the preceding 3-4 months period, by not affecting medium-term inflation forecasts, which support the decision-making of the monetary policy. In this framework, a major contribution was derived by putting breaks on the volatility of core inflation, as part of inflation related mostly with pressures from demand and with a medium-term nature on the monetary policy decision-making. Under these conditions, the monetary policy has decided not to react against short-term fluctuations, but keeps them under supervision. It has aimed to prevent the appearance of chain effects and those of second rounds in prices by analysing the nature and source of supply-side shocks and their degree of persistence over time, thus helping to anchor public expectations on inflation.

1 *"Low inflation in the euro area: Causes and consequences" Ciccarelli, M., Osbat, (2017), Occasional Paper, ECB;*
"Factors behind low inflation in Albania", Çeliku, E., Kristo, Metani, Çela, Hashorva, (2020), Working Paper, Bank of Albania.

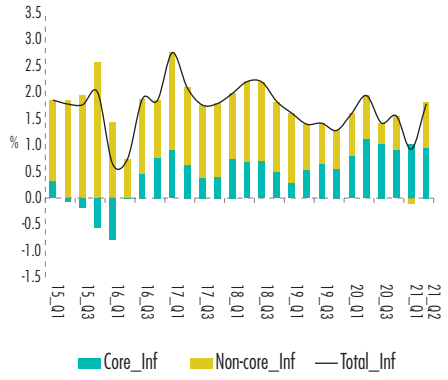
5.2. DETERMINANTS OF INFLATION

The formation of inflation continued to be supported in a stable manner by its long-term and domestic components during 2021 Q2 (Chart 25). Contributions by short-term components were notably higher than in the first quarter of the year. Core inflation and domestic inflation converged towards the value of

1.3%, contributing to inflation by 0.9 pp (or 50%) in the second quarter. Despite preserving the stability, the abovementioned components remain at low levels, due to still weak pressures from demand. For the same quarter, the short-term components of inflation – the non-core one and CPI basket's trading sector – recorded values higher than the previous quarter, at 2.9% and 2.4%, respectively. As a result, the higher headline inflation was defined by both the stability of long-term and domestic pressures and the increase of the long-term ones.

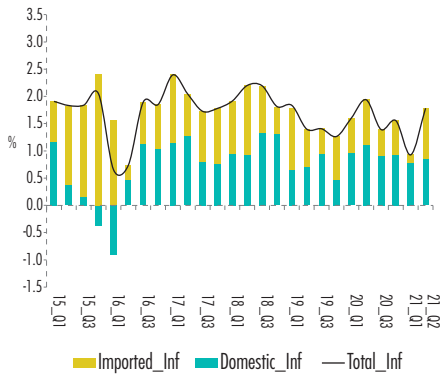
Chart 25

Medium-term inflationary pressures slightly strengthened throughout the second quarter



Source: INSTAT and Bank of Albania's calculations.

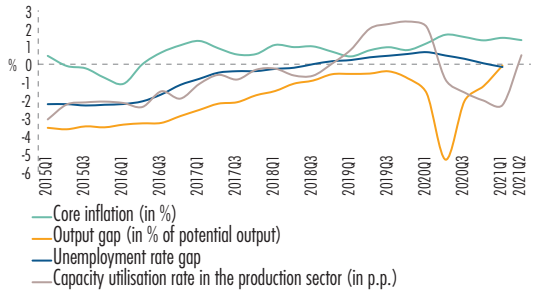
Short-term and imported pressures increased during the second quarter



Source: INSTAT and Bank of Albania's calculations.

Chart 26

The cyclical position of the economy continued to improve in 2021 Q1 and Q2



Note: The cyclical position is assessed by the indicators or output gap, unemployment, and capacity utilisation rate.*

** The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilisation rate gap is estimated as a deviation of the current value from the relevant historical average, and then the moving average method is applied. The unemployment rate gap is assessed as an average of unemployment gaps according to three methods, which assess the equilibrium or structural level of unemployment. It is stated as the difference of equilibrium unemployment rate to actual unemployment rate and then the method of moving average is applied.*

Source: INSTAT and estimations of the Bank of Albania.

Cyclical position. The faster recovery of the economy contributed to the improvement of the overall cyclical position. Although the unemployment rate expanded slightly and stands above the pre-pandemic level, our assessments identify a tightening trend of the gaps. This is assessed to have contributed in maintaining domestic inflationary pressures at stable levels, which are expected to strengthen further, by reflecting the recovery of the economy.

The capacity utilisation rate in the economy remained around 74.1% in 2021 Q2, slightly overcoming the historical average. Enterprises in both production and services sectors reported an increase in the utilisation of production capacities by 2.2 percentage points during this quarter.

The expected acceleration of economic activity due to the improvement of the healthcare situation and the further removal of restrictive measures, as well as the monetary and fiscal stimulus, will increase the capacity utilisation rates of

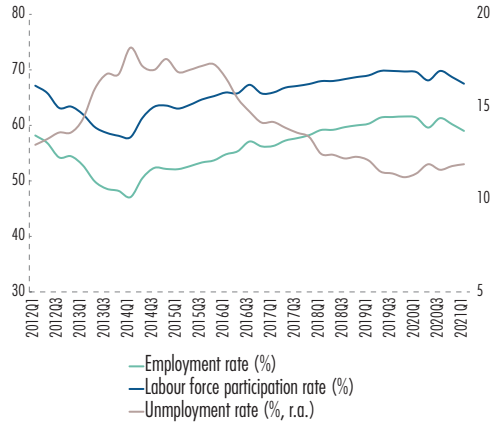
production in the economy. These developments are expected to further trigger domestic inflationary pressures.

Employment and unemployment. In 2021 Q1, employment fell and unemployment rate increased slightly. Employment declined by 2.6%, affected almost completely by developments in the agricultural sector. Meanwhile, the other sectors reported an increase in the level of unemployment. In quarterly terms, the decline of employment has slowed down (-0.5% against -2.2% in the previous quarter), suggesting a lower impact from the pandemic. It is assessed that the labour market reacts with a time lag towards production developments. Survey indicators signal an increase in the level of employment in the following periods.

The decline of employment engendered a slight unemployment rate increase to 11.9%, or 0.1 percentage point higher than the previous quarter. The indicator stands 0.5 percentage point higher than the level recorded in the same period in the previous year. The decline of employment is accompanied by the exit from the labour market in the third quarter as well. This movement is reflected in the decrease of the participation rate in the labour market at 67.5%, from 68.7% in the previous quarter (Chart 27). The decline of the participation rate accompanied by the slight increase of the unemployment rate suggest that the phenomenon of "inactive" employee status has persisted over 2021 Q1 as well.

Chart 27

The labour market reflected a slight increase in the unemployed rate in 2021 Q1



Source: INSTAT and estimations of the Bank of Albania.

Wages, productivity and labour costs. Gross average monthly wage per employee[18] was characterised by an accelerated increase in 2021 Q1. The annual growth rate resulted 5.2% (4.3% in real terms), notably higher compared to 2020 Q4 (2.7%). The increase of the minimum wage has provided an essential contribution in this growth in this quarter (Chart 28, left). The sector with the main impact to this growth was the "Public administration and defence; mandatory social insurance; education; healthcare and social work activities".

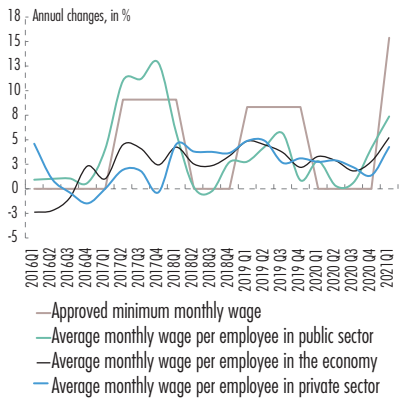
Unit labour costs[19] accelerated the downward trend despite wage's increase in the economy. The annual decline of the indicator resulted 2.2% higher compared with 2020 Q4 (1.3%). The performance of the indicator was defined mainly by the higher contribution of labour productivity (Chart 28, right).

[18] *This indicator refers to the gross monthly average wage received per employee and is based on the payroll data declared at the General Directorate of Taxation (INSTAT 2021 Q1).*

[19] *Proxies of labour productivity, unit labour costs and average wage in accordance with short-term statistics are calculated by the Bank of Albania using the total series of Short-Term Statistics (SHTS, INSTAT, 2021 Q1).*

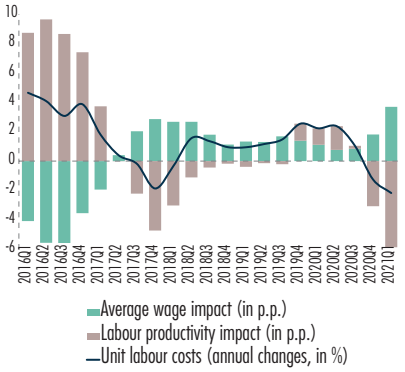
Chart 28

The annual growth of monthly wage accelerated reflecting the approved increase of the minimum wage



Source: INSTAT.

The downward trend of labour costs accelerated due to the impact of productivity



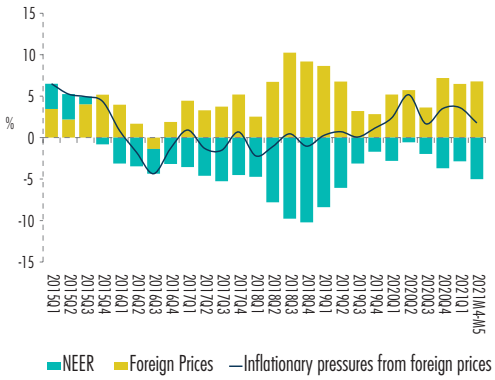
Source: INSTAT and Bank of Albania.

Other output costs continued the downward trend in 2021 Q1, but at a slower pace. Industrial production prices fell by 0.6%, while recording a 3.6% decline in 2020 Q4. Export production prices (reduced by 0.2% in annual terms) provided the main contribution. On the other hand, production prices for the domestic market expanded by 0.2%, crossing over the positive territory for the first time since the beginning of 2019. At last, production costs in the construction sector[20] increased by 0.6% in annual terms.

Imported inflation. During April-May 2021, the Imported Inflationary Pressure Index (IIPI)[21] expanded by 1.8% in annual terms (Chart 29). The main contributions to the expansion of IIPI were driven by the annual growth of Import Price Index (IPI) by 6.8%, a rate comparable with the first quarter (6.5%). Meanwhile, the deceleration of the upward dynamics of IPI is related to the acceleration of the appreciating trend of the effective nominal exchange rate (ENER) by around 5.0% during the period under review, against 2.9% in the previous quarter. These developments were reflected in the higher contributions of imported inflation, which formed around 5.0% of headline inflation in the second quarter (Chart 25, right). Whereas, the performance of IPI is expected to impact headline inflation in the following months, through this component[22].

Chart 29

The annual growth of Import Price Index defined the annual growth of IIPI, but the stronger appreciating trend decelerated the upward rate



Source: INSTAT and estimations of the Bank of Albania.

20 *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.*

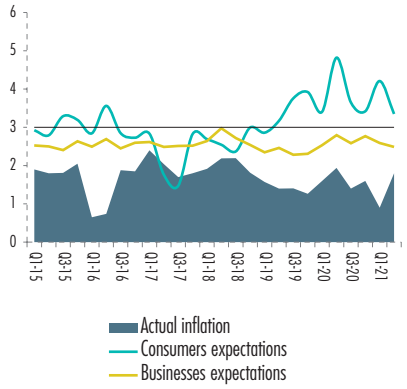
21 *IIPI is calculated as the annual growth of the import price index and the NEER index for the respective month.*

22 *From the correlation analysis of the relevant indicators with different time delays, IIPI anticipates the developments in the imported inflation component by about 3-5 months.*

Financial agents' expectations for inflation[23] remained stable in 2021 Q2 and near the relevant medium-term averages. Compared with the previous quarter, expectations of enterprises and consumers for inflation decreased, while financial agents' expectations increased slightly. *Enterprises* expect that inflation after one year stands at 2.5%, or 0.1 percentage points lower compared with the 2021 Q1 (Chart 30, left). The expectations of *consumers* for inflation, which generally show more pronounced fluctuations, fell by 0.9 percentage point this quarter. Consumers expect that inflation after one year reaches 3.4%. The expectations of financial agents for inflation after one, two and three years registered an increase in the second quarter by 0.2 percentage point on average. Notwithstanding this development, financial agents' expectations remain below expectations of enterprises and consumers for inflation and still below the medium-term target of inflation of the Bank of Albania (3%) (Chart 30, right).

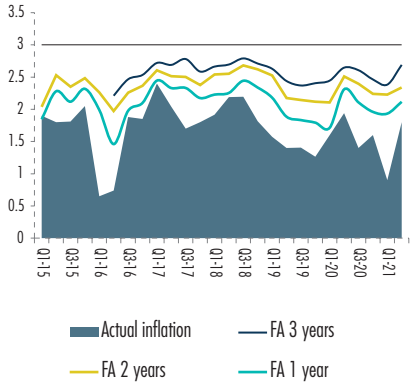
Chart 30

Expectation for inflation one-year-ahead of enterprises and consumers



Notes: Annual changes in %.
Source: INSTAT and Bank of Albania.

Expectations on inflation of financial agents by three time horizons



Notes: Annual changes in %.
Source: INSTAT and Bank of Albania.

[23] *The analysis on inflation expectations is based on the results of the Business and Consumer Confidence Survey, as well as on the Financial Agents' Expectations Survey.*