Bank of Albania

MONETARY POLICY REPORT

2023/II

MONETARY POLICY DEPARTMENT

Published by: Bank of Albania
Sheshi "Skënderbej", Nr.1, Tirana, Albania
Tel.: + 355 4 2419301/2/3; + 355 4 2419401/2/3
Fax: + 355 4 2419408
E-mail: public@bankofalbania.org
www.bankofalbania.org

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 an environment with few unexpected events 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 transmission mechanism encompasses various channels through which prices may change, for example: the exchange rate channel; the inflationary expectations channel; and the foreign prices 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 is also valuable. However, drafting a monetary policy is not a mechanical process. Monetary policy decision-making considers the reasons for deviations in 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 input 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 publishes this Report on a quarterly basis and makes it available to the public.

The Monetary Policy Department at the Bank of Albania compiles this Report and the Supervisory Council approves it. The current report contains data, as of 20 April 2023. The Supervisory Council reviewed and adopted this Report at its meeting on 3 May 2023.

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

FOREWORD BY THE GOVERNOR

The Albanian economy has shown remarkable resilient, despite the shock from the global prices crises triggered by the military conflict in Ukraine. The new information, analysed in this Quarterly Report, suggests economic growth has experienced a relatively fast rebound over the past year, inflation has continued to edge down, and the main economic and financial balances have remained solid.

In particular, consumer price index (CPI) inflation declined to 5.3% in March, marking the lowest level in a year, and one of the lowest inflation rates across both the region and Europe. In the first quarter of the year, inflation fell on the back of stabilised prices in the international market, the strong exchange rate of lek against the euro, and the controlled cost-push in the Albanian economy.

The normalization of the monetary policy stance, undertaken through the gradual increases in the key interest rate, has played a decisive role in this positive performance.

The response of the monetary policy, in a timely manner, was essential for stabilizing the domestic financial markets and establishing a better balance between the demand and supply for goods and services, by creating the optimum premises for inflation to return to the target. In addition, the appropriate response of the monetary policy did not have any adverse impact on the positive trends of economic growth. The Albanian economy continues to grow and generate new jobs, rise in wages, and sound financial balance sheets for enterprises.

In this view, our monetary policy has served to the sustainable and long-term development of Albania, in turn to the growth of social welfare.

The downward trend of inflation encourages its return to the target in the next year. In addition, the resilience and flexibility displayed by our economy in withstanding the last three consecutive shocks - the earthquake, the pandemic, and the spillovers from the conflict in Ukraine- are encouraging premises for a continued growth in the future, as well.

Judging on the above, the Supervisory Council decided to maintain the monetary policy stance unchanged in its meeting on 3 May 2023. We deem that the current monetary conditions- the interest rates, the liquidity situation, and exchange rate dynamics - are adequate to achieving our objectives.

Nevertheless, the battle for the return of inflation to the target has yet to be won. In particular, the still challenging external environment, the elevating domestic inflationary pressures, and the experience in the last years has taught us to not exclude the possibility of unexpected shocks.

For these reasons, the Supervisory Council has re-emphasised to monitor the situation on an on-going basis, and reaffirmed that it will take all the necessary measures for guaranteeing the financial stability of Albania.

1. INFLATION AND MONETARY POLICY STANCE

The impact of external supply-side shock on the Albanian economy has been relatively contained. Economic growth appeared stable, the country's economic and financial balances have remained solid, while inflation has been declining over the last few months. The normalisation of monetary policy so far has had a positive impact on this trend, helping to control inflation and stable financial markets. The current monetary policy stance is consistent with inflation returning to target by 2024. However, high aggregate demand and rapid wage growth may require the normalisation of the monetary policy stance to continue in the future. Based on this judgement, the Supervisory Council decided to keep the key interest rate unchanged in the meeting held on 3 May 2023.

Although improving, the world economic outlook remains fragile, amid high inflation, the adverse effects of the war in Ukraine, and uncertainties fuelled by the turmoil in the financial sector. The decline in global inflation compared to the levels of last year reflected, at the largest extent, the rapid correction of commodity prices. Meanwhile, inflationary pressures of a persistent nature appear to be more stable, in the presence of lack of increasing labour shortages and dynamic wage growth. In their reflection, core inflation continues to increase or maintain high levels. The stable return of inflation to target remains the central bank's main challenge. The main central banks continued to communicate the need for further increases in key interest rates. In the last meeting in March 2023, the European Central Bank increased the key interest rate to 3.50%.

Overall, the external economic environment remains challenging for the Albanian economy, as a result of still high inflationary pressures, the tightening of financing conditions and the slowdown of economic growth.

Economic developments in Albania indicate inflation has continued trending downwards, at the start of 2023, while economic activity and the labour market remained relatively solid.

Annual inflation averaged at 6.5% in the first quarter, downwards from the average of 7.9% in the previous quarter. This decline accelerated particularly in March, when inflation reached 5.3%. In terms of the consumption basket, the drop in inflation reflected the decrease in food and energy prices, particularly in oil. In macroeconomic perspective, it reflected the decline of imported inflation. The latter reflected both the fall in prices in global markets, and the continued appreciation of the exchange rate. On the other hand, inflationary pressures from the domestic environment continued to be high. Core inflation stood at historically high levels of 8% at the beginning of this year.

Domestic inflationary pressures continue to be fuelled by stable demand and robust labour market. Economic growth was 4.8% for 2022, underpinned by the increase in households' spending, construction activity, and the dynamic of the tourism sector. This performance was supported by sound balance sheets of the private sector, the positive performance of labour market, and the improved confidence of households and enterprises. Indirect data suggests an increase in demand and production at the ouset of 2023 as well.

Labour market conditions are tight, and enterprises continue to face difficulties in finding labour force. Surveys on enterprises suggest a robust demand for labour force and pressures in increasing wages in the future. This development is reflected in the decrease to historical minimum levels of the unemployment rate, 10.8% at the end of 2022, as well as in the rapid growth of wages in the private sector.

The sustainability of economic activity[2] and the tight labour market conditions establish the premises for the sustainability of economic growth in the future, but also of domestic inflationary pressures.

The increase in inflation has led to the normalization of the monetary policy stance. Since the beginning of 2022, the Bank of Albania increased the key interest rate six times, up to 3.00% in March 2023.

The normalisation of the monetary policy stance is being transmitted to the domestic financial markets. The interest rates of the main financial products in lek - deposits, loans and government securities - have been increasing, and the exchange rate of the lek against the euro has followed the strengthening trends. However, the interest rates and financing conditions - although upwards - remain accommodative for the economy. In response to them, the credit continues to manifest positive monthly flows, though the growth pace has been slowing down. At the same time, credit portfolio quality stands at pleasant levels, as illustrated by the low levels of the non-performing loans ratio. Financial soundness of banking sector suggests that this sector will be able to continue to respond to the demand of economy for funds.

Our projections suggest the Albanian economy will continue to grow while inflationary pressures will be reducing, over the next two years.

Inflation is expected to gradually decline in 2023 and return to its target in the first half of 2024. The decline in inflation will reflect the further reduced inflation in international markets and the cumulative consequences of monetary policy stance normalisation in Albania. These consequences will continue to be

[2] *INSTAT revised as upward the level of GDP for 2020-2022, suggesting an economy more resistant to shocks than previous estimates.*

transmitted through controlled inflation expectations of market agents, sustained exchange rate and the better balance between the demand and aggregate supply in Albania.

Economic growth in Albania is expected to remain in positive territory, fuelled by the sound balance sheets of private sector, the positive prospect in labour market, and the ongoing increase in lending. Nevertheless, economic growth is expected to slow slightly down in 2023, and catch up with the historical growth momentum in both the medium and long term. This trend, mainly reflects the expected dynamics in the foreign demand.

The macroeconomic environment remains challenging and projections for the future are surrounded by increased uncertainty. These uncertainties are titled on the downside for economic growth, but appear more balanced for inflation. In particular, an increase in inflationary expectations above the target and an increase in wages not supported by productivity would be factors with an increasing impact on inflation, while a faster strengthening of the exchange rate would be a factor with a restraining impact.

In congruence with the analysis and the forecasts outlined in this report, the Supervisory Council decided to keep its monetary policy stance unchanged. The normalisation of monetary policy stance continues to be transmitted to the financial markets, while both inflation and economic agents'expectations obout it have set on a downward trajectory since the end of the last year. Currently, monetary conditions are assessed as adequate for the sustainable return of inflation to the target by 2024.

However, the Council concluded that the domestic inflationary pressures remain high and require further normalisation of the monetary policy stance. In a situation of prevailing uncertainties, the normalisation pace will be calibrated with the new economic and financial data.

2. EXTERNAL ECONOMIC ENVIRONMENT

The war in Ukraine and high inflation rates continue to weigh on the external economic developments. Economic activity in the euro area decelerated in the fourth quarter of 2022, though it showed stronger resilient than expected against the upsurge in prices. The first quarter of 2023 suggests a slow economic growth, supported by stable energy prices in global markets and a robust labour market. Uncertainties surrounding this trend are picking up, in the context of tightening of financing conditions and their effect on the financial system.

Inflation rates have declined due to the comparative statistical effect with previous year and the faster fall in energy price in March 2023. Nevertheless, pressures stemming from rising wages and increased cost pass-through in services continue to feed the core inflation. The performance of the latter, led the ECB to embark on a rising trend of the key interest rate.

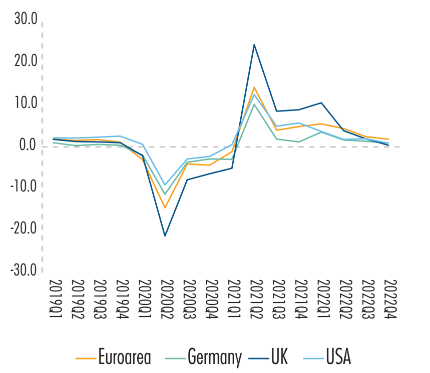
2.1. ECONOMIC GROWTH

Global growth slowed in 2022 Q4, weighed down by the war in Ukraine, the elevated prices and the increased interest rates. This slowdown has been milder than expected in advanced economies, prompting optimism for economic growth in 2023. Preliminary data in the first quarter of 2023 signal an improvement in economic activity pace, though uncertainties regarding the progress of this trend are intensified. In one hand, the reduced pressures on commodity prices, the improved supply chains of global trade, and the China's full reopening drove to the improved economic sentiment. On the other hand, the increasing interest rates have led to financial markets stress, while their effect in curbing consumption is expected to be felt in line with the time lag that characterises the monetary policy transmission mechanism.

Inflation rates declined notably in March reflecting the base effect from the sharp increase in prices a year ago and the hold back of commodity prices soaring. However, inflationary pressures are assessed to be strong, evidenced in high core inflation rates. They are fuelled by a robust labour market, high inflationary expectations and improved economic sentiment. In these circumstances, central banks are expected to continue tightening monetary conditions, though at a slower pace than in 2022.

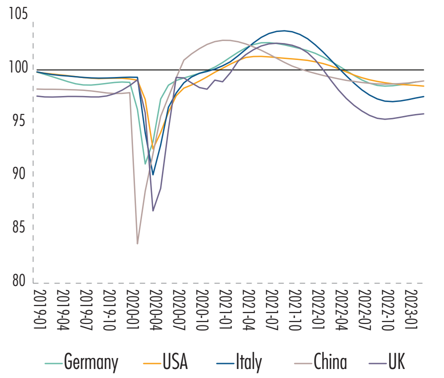
Chart 1

Global economic activity slowed the growth momentum in the fourth quarter



Notes: Annual GDP growth.
Source: Respective statistical institutes.

The leading indicator of economy has contained the deterioration



Notes: Composite Leading Indicator (CLI), which contains short-term signals of qualitative changes in business cycles.
Source: OECD.

The latest IMF forecasts indicate the global economic growth to fall from 3.4% in 2022 to 2.8% in 2023, before settling at 3.0% in 2024[3]. Uncertainties related to the war in Ukraine, hiking prices and increased interest rates will restrain the economic growth, more pronounced in advanced economies, as relevant forecasts show a considerable slowdown. Developing countries are expected to maintain a similar growth pace, driven by the recovery of the economic activity in China. Although inflation rates are set to decline gradually, they are still projected to remain at high levels in 2023-2024.

Euro area economy

The euro area economy has displayed greater resilience against shocks than was previously anticipated. Despite the fact that economic growth slowed down in the last quarter of 2022 (dropping from 2.4% in Q3 to 1.8%[4]), it still exceeded initial forecasts. The growth in net exports and the fiscal stimulus provided by governments were key factors in supporting economic growth in the fourth quarter. GDP growth was affected negatively by private consumption and investments, in this period. Both the service and manufacturing sectors exhibited weak performance at the end of the year.

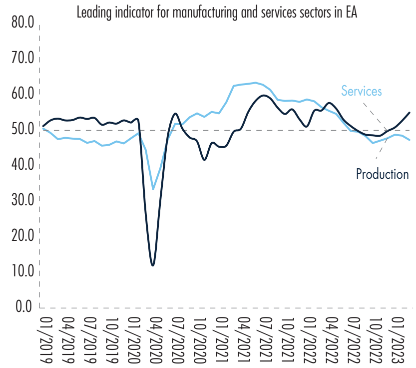
Preliminary data for the first quarter indicate an expansion in services activity, an improvement in economic sentiment, and growth in trade activity. The faster decline in energy prices in March is expected to have eased somewhat the pressures on production costs. Inflation rate declined to 6.9% in March, from 9.2% in December, mainly due to the base effect and a fall in energy prices. On the other hand, the core inflation rate, which excludes energy and food items remained at elevated levels, at 5.7% in March from to 5.2% in December. The low unemployment rate, steady wage growth and expectations

3 *World Economic Outlook, IMF April 2023.*
4 *Figures represent the annual change in real GDP.*

of an improving service sector are contributing to inflationary pressures in the euro area economy. The European Central Bank's projections indicate that inflation rate will not reach its target of 2.0% until 2025.[5]

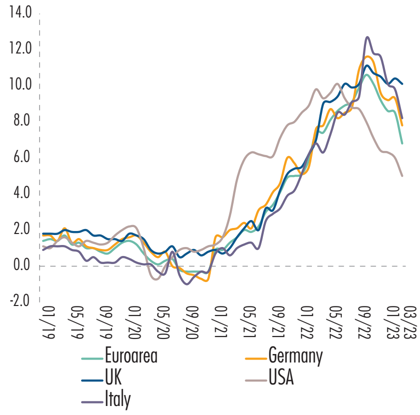
Chart 2

Economic activity improved in the first quarter bolstered by the sector of services



Notes: Survey indicators on enterprises which provide signal on economic activity in the short term
Source: PMI indices Markit.

Inflation has been declining since the end of last year



Source: OECD.

Expectations for a contraction in the European economy for 2023 have diminished, with new forecasts predicting positive growth, but at lower levels and at increased uncertainties[6]. The stability of commodity prices and the improvement of supply chains are expected to continue supporting economic activity. On the other hand, the withdrawal of fiscal stimuli and the expected tightening of financing conditions will weigh on both consumption and private investments. Uncertainties on the performance of the euro area economy have picked up after the volatility showed by financial markets in March.

Regional economies[7]

Economic activity across the regional countries was supported by private consumption and exports, in the last quarter of 2022. Government expenditure and investments contracted compared to the previous year. Except for Kosovo, all other trading partner countries in the region have recorded a slowdown in their economic growth pace. North Macedonia and Serbia have recorded the slowest annual growth rates since the first quarter of 2021. Kosovo, Serbia and North Macedonia have reported a faster growth in exports than imports, leading to a positive contribution of net exports. Private consumption experienced a positive growth rate, though it was notably lower than in previous quarter. Except for Serbia, inflation rates have declined in the first quarter of 2023,

5 ECB staff macroeconomic projections, March 2023.

6 The ECB staff macroeconomic projections for the euro area foresee annual real GDP growth to slow to 1.0% in 2023 before rebounding to 1.6% in 2024. (ECB staff macroeconomic projections, March 2023).

7 The main trading partners outside the European Union (Kosovo, North Macedonia, Serbia).

although they continue to remain at elevated levels. Foods continue to provide the main contribution in the formation of inflation in the region.

Economic activity in these countries is projected to slow down in 2023, as the lower economic growth expectations in the euro area - the region's main trading partner- will impact the demand for goods and inflows. Inflation rates are expected to decrease during 2023, reflecting the stability of prices in international markets. Although, they will remain at high historically levels across regional countries, by leading to the further slowdown in private consumption.

Table 1 Economic indicators for main trading partner countries

	Annual change of GDP p.p		Annual inflation (%)	Unemployment, in %
	2022 Q3	2022 Q4	March 2023	2022 Q4)
Italy	2.5	1.4	7.7	8.0*
Greece	4.4	5.2	4.6	11.4*
Kosovo	3.3	3.6	7.6	16.6**
North Macedonia	2.0	0.6	14.7	14.0
Serbia	1.0	0.4	16.2	9.2
Albania	4.9	4.7	5.3	10.8

Source: Respective statistical institutes.
Inflation for Italy and Greece is a measure by the national consumer price index and not by the Harmonised Index of Consumer Prices.
**February 2023, ** 2022 Q1.*

2.2. COMMODITY PRICES IN GLOBAL MARKETS

Commodity prices in global markets dropped at the end of the first quarter of this year, compared to the end of 2022 and with the previous year. Expectations on a slower demand and the reduction of some supply headwinds drove to a decrease of pressures on commodity prices. Nevertheless, their rates remain above those of 2021, being transmitted to relatively high levels in consumer prices.

Prices of energy products experienced the most considerable fall across commodity prices. Energy price index dropped by 21% at the end of t2022 and by 37% from the previous year. The Brent oil price registered $78 per barrel in March, from $81 per barrel in December, around 33% lower than in the previous year. Oil prices fell considerably by the mid of March 2023, driven by the uncertainties from news on risks to the banking system in the USA. The declining trajectory of oil price triggered OPEC reaction, which announced oil output cuts starting from May. Consequently, the oil price pushed up in April 2023. The Brent crude oil spot price is expected to average $86 per barrel in 2023.[8]

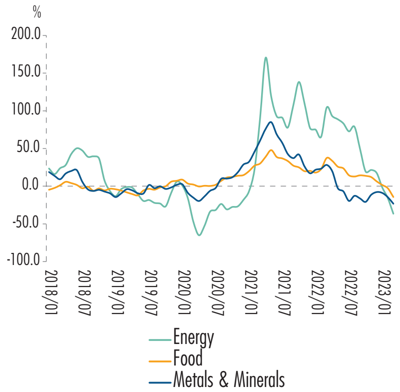
In March 2023, the electricity power price halved from the level of the end of 2022, due to a warmer winter, where the demand was lower. The average

[8] *US Energy Information Administration, Short term energy Outlook, March 2023.*

power spot price was 113.4 Euro/MWh at the Hungarian Power Exchange (HUPX)[9], or 60% lower from the previous year.

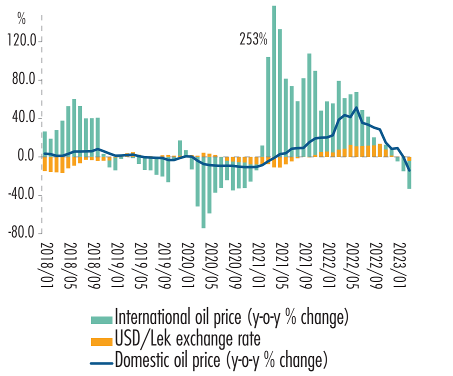
Chart 3

Commodity prices across international markets have reduced from a year ago



Notes: Main commodity price indices, annual change (%)
Source: World Bank.

The decline in oil price and the strengthening of the exchange rate have impacted the fall of oil price in Albania



Notes: Indicators annual changes Oil price in Albania is approximated to the oil price in consumer basket.
Source: INSTAT, staff estimates.

Food price index trended downwards in the first quarter of 2023. Food prices declined by around 14% compared to the previous year. Nevertheless, they continue to remain on historically high levels, despite the overall increase in harvests. Metal price index also continued to decline in annual terms, by 23%. In addition to the base effect, expectations on a slowdown in investments affected the performance of metal prices.

2.3. GLOBAL FINANCIAL MARKETS

Interest rates in international markets were slightly up in the first quarter while showing increased volatility.

Forecasts of central banks on tightening the monetary policy have oriented the interest rates. They have picked up till March 2023, by factorising consecutive increases in key interest rates. In March, the liquidity difficulties in two USA large banks and in a Swiss large bank created tensions in financial markets. Interest rated were reduced and risk premia on private sector's securities expanded. Stocks indexes, particularly of the banking sector declined. This moment was rapidly overcome with the intervention of monetary authorities to ensure liquidity and create guaranties for depositors.

Central banks have continued to tighten the monetary conditions in the fourth quarter as well, through rising the key interest rate. A better than expected

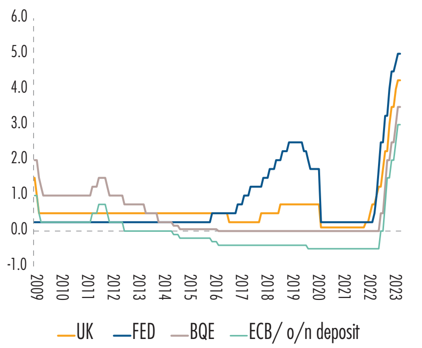
[9] *Hungarian Power Exchange (HUPX), energy prices in basic profile.*

economic activity and the continuation of the core inflation hikes have pushed central banks to increase the key interest rates on a consecutive manner. The European Central Bank raised twice by 0.50 basis points, reaching at 3.50% at the end of March 2023; the Federal Reserve raised twice the key interest rate by 0.25 percentage points, to 4.75%-5.00%; and the Bank of England increased twice the key rate by 0.75 percentage points, to 4.25%.

The tightening of monetary conditions aims at ensuring the return of inflation close to the central banks' target. Central banks have communicated that the increasing trajectory of inters rates will turn diminishing in the next part of year. This communication is clear to the Fed, where inflation in the USA base components of inflation has been falling. The ECB forecasts high inflation rates continue in the euro area for some periods, implying other raises of the key rate. In the United Kingdom, inflation continues to have a double-digit figure, turning into an argument for other increases in the interest rate by the Bank of England.

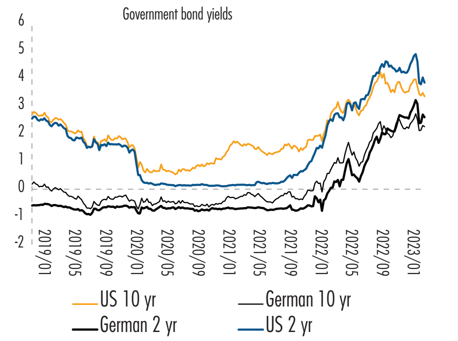
Chart 4

Central banks have continued to raise the key interest rate aiming at curbing the persistent the inflationary pressures



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

The contraction of the monetary policy has engendered higher yields Yields curb has been flattened (or vice versa in case of the USA) expecting lower interest rates by central banks in the medium-term period



Notes: 2 and 10-Year yields on government bonds
Source: Bloomberg.

3. FINANCIAL MARKETS AND LENDING CONDITIONS

Interest rates in the financial market are pushing up, in line with the normalisation of the monetary policy stance, while interest rate and liquidity risk premia appear contained. The fall in yields during the recent months has brought their spread from the policy rate closer to historical averages. The pass-through of policy rate increases also continued in the interest of loans and deposits in lek, but it is not yet complete in these segments. In the foreign exchange market, the appreciating pressures of the exchange rate of the lek against the euro prevail, as a result of the increased supply of foreign exchange, while trading conditions appear as normal.

Lending to the private sector slowed, in response to reduced demand and tightening of supply conditions. In particular, lending to enterprises reflected the decrease in the demand for working capital, as a result of the decrease in uncertainty and the high liquidity that this segment has. On the other hand, the slowdown in lending to the household segment has been more gradual, while banks appear more tolerant and have eased the supply conditions for this segment.

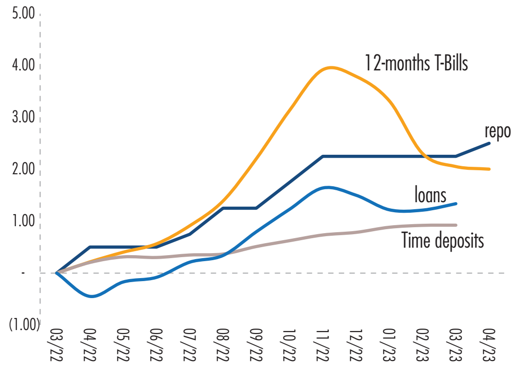
3.1. DOMESTIC FINANCIAL MARKET[10]

The transmission of monetary policy signals to interest rates in the financial market continues, but is not yet complete in their entire spectrum. Both the interbank and government securities markets now exhibit full transmission of policy rate changes. Interest rates on time deposits are rising steadily, but at a slow pace, reflecting banks' prudent behaviour towards expanding funding costs. Meanwhile, loan interest rates show a faster increase, but still differentiated by its various segments.

The interbank market continued to be characterized by stable interest rates and consistent with monetary policy signals in the first quarter of the year. The lack of liquidity pressures has helped overnight interest rates to mainly fluctuate below the policy rate, whereas their spread with this rate remains at minimum levels. Interest rates in the interbank market

Chart 5

The transmission of policy rate increases to interest rates in the financial market continues, but to a different extent and pace



Notes: Cumulative changes of interest rates in lek since March 2022: repo, 12-month T-Bills, time deposits and loans.
Source: Bank of Albania.

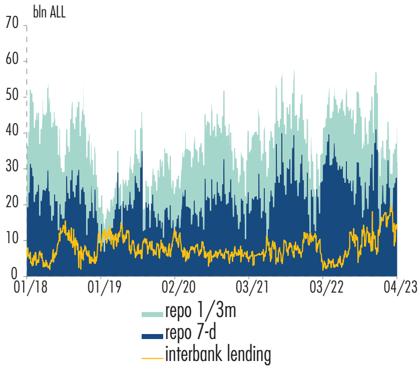
[10] The following analysis is based on the data available up to 20 April 2023.

have immediately reflected the latest change in the policy rate. Its increase by 0.25 percentage points at the end of March was immediately transmitted to the interest rates applied in the interbank market.

The Bank of Albania continued to conduct regular open market operations by injecting liquidity of 7-day and 3-month maturity. The liquidity offered this quarter was lower than the end of last year, but this did not affect the transmission of monetary policy signals to the market and the general performance of liquidity premia.

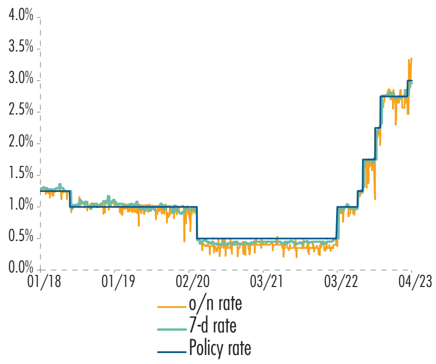
Chart 6

The liquidity situation of banks has remained calm in the first quarter



Notes: 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 interbank market remain anchored close to the policy rate



Notes: Data show the daily performance of interest rates in the interbank market, in addition to the policy rate and overnight deposit and loan rates.
Source: Bank of Albania.

Volatilities in the lek exchange rate in the foreign exchange market have been mainly in the appreciating side in the first quarter of the year and in April, while the trading conditions in this market remain within normal parameters. The appreciation of the lek became more pronounced in March and April, as evidenced by the bias indicator.[11] The euro was quoted at an average of ALL 114.4 and ALL 112.8[12] respectively, during these two months, from ALL 116.4 in the fourth quarter of last year and in January. The average level of the eur/lek exchange rate recorded in April represents an annual appreciation of the lek by 6.7%.

The performance of the exchange rate against the euro is a reflection of the increased supply of the foreign currency in the domestic financial market. It

[11] *The appreciation/depreciation bias 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. from 22 days (one calendar month) up to 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).*

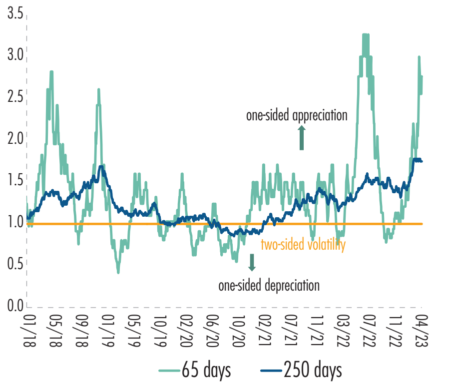
[12] *For first three weeks of April.*

Chart 7

The lek appreciated against the euro and against the US dollar

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

Appreciation pressures on the lek became more pronounced in March and April



Notes: The data present the indicator of bias for appreciation/depreciation.
Source: Bank of Albania.

is dictated by the improvement of the balance of payments as a result of high foreign currency inflows, which are estimated to be present in the first months of this year as well. Both the euro/lek exchange rate volatility and the bid-ask spread, have resulted close to their normal values. Also, lek has appreciated on the back of expanded positive spread between the return rate of funds in lek and that in the euro, in the domestic market (Chart 12, right).

In the first months of the year, lek has also strengthened against the US dollar. The US dollar was quoted ALL 106.9, on average, and ALL 103.1 in March and April, from ALL 108.0 in the first two months of the year, and ALL 114.5 in the fourth quarter of the previous year. This trend, besides the weakening of the US dollar against the euro in the international market, reflects, to a large extend, the appreciation of the lek against the latter. In April, one dollar was quoted 7.7%, on average, lower than in the previous year.

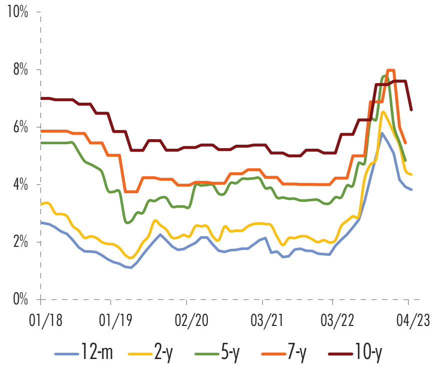
Yields on T-bills and bonds in the primary market followed a downward trend during the first months of the year, correcting their overreaction to the increase of policy rate in the second half of the previous year. The decline in yields, which first started with 12-month T-Bills in December of last year, has strengthened and then extended to all maturities. The spread of T-bills yield with the policy rate and between the maximum and minimum yields recorded in auctions have narrowed, thus confirming the downward pressures. One of the main factors that influenced this trend was the pronounced increase in demand[13] in the auctions held in this period.

At the beginning of April, the 12-month bond yield stood at 3.8%, from 5.5% at the end of December. Likewise bond yields have shown the same performance as T-bills in this period, where reductions in long-term maturities have often

[13] The bid/cover ratio of demand in T-bills and bond auctions was 1.8 this quarter, up from 1.3 and 1.1 in the last quarter and in 2022, respectively.

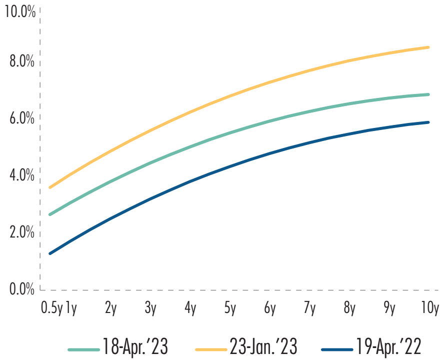
Chart 8

Yields in the primary market have strengthened the downward trend in the first quarter



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

The yield curve has shifted downward while its slope has slightly decreased



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

been stronger than those of treasury bonds. The 2-year bond yield was 4.3% in April, down from 5.8% in January, while 5-, 7-, 10-, and 15-year bond yields decreased by an average of 2.0 p.p. from the last respective values.

The performance of bond yields indicates a positive approach of the financial market to long-term maturities, as well as contained risk and inflation premia. The yield curve has reflected these developments, lowering the level and softening its slope.

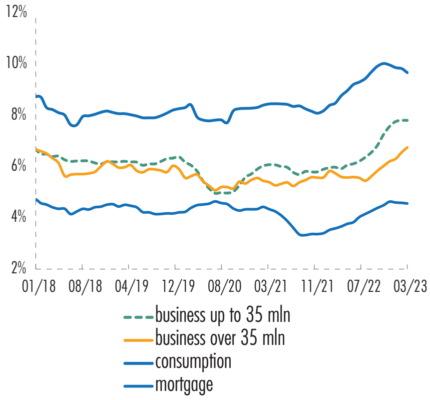
3.2. LENDING CONDITIONS

The interest rates on new loans and deposits in lek follow the upward trend, by gradually transmitting monetary policy signals. The average interest rate on new loans in lek to enterprises resulted at 7.3% in 2023 Q1, from averagely 7.0% in the previous quarter. This level is about 1.5 pp higher than in the first quarter of last year, before the start of the normalisation of monetary policy. The analysis according to the amount granted shows that this trend is determined by the acceleration of the increase in interest rate on large loans, which showed a delayed response in the previous year. Meanwhile, interest rate on small loans to enterprises, which reacted faster in the previous year, have been somewhat restrained in this quarter.

The rapid rise interest rates on loans to households has been curbed in the first quarter of this year. The average interest rate on loans to households was 7.6% form 8.0% in the previous quarter. The fall in interest rates was present on both consumer and mortgage loans. Loans with fixed interest rates dominated in these two segments, offered with preferential terms and conditions for the first or two first years. Also, the direction of the interest rates on loans to households

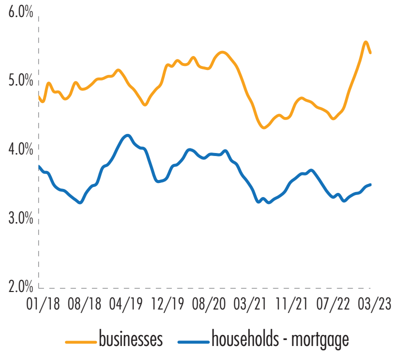
Chart 9

The increase in interest rates for loans in lek has continued for enterprises and has been restrained for households



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

Loan interest in euro increased for loans to enterprises, while mortgage loans to households recorded low values



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

has also reflected the dynamics of yields, although without transmitting the pronounced fluctuation that the latter showed in the second half of last year and in the first quarter of this year. Despite the short-term fluctuations, the trajectory of interest rates to households remains upward. They currently stand about 1.0 p.p higher compared to the first quarter of the year.

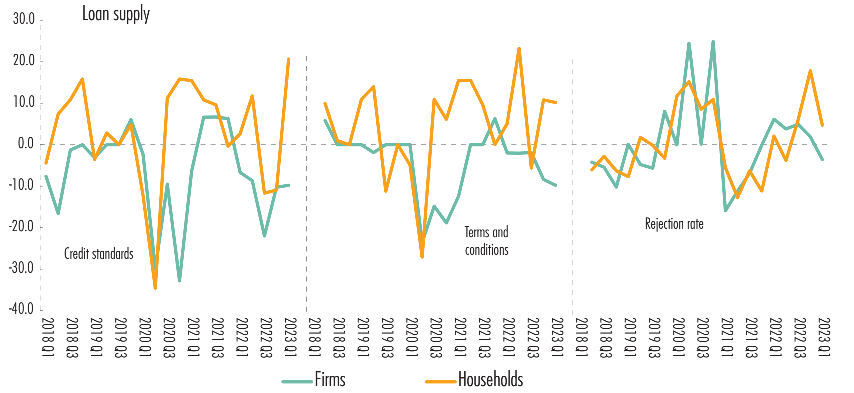
Interest rates on new loans in euro continue to increase at a slower pace compared with interest rates on loans in lek. The average interest of loans to enterprises was 5.4% in the first quarter, recording a marginal increase compared to the previous quarter. In regard to households, the interest rates on loans in euro for house purchase was 3.6%, standing close to the average of 3.4% in the two previous years. Interest rates on loans in euro – though higher than in a previous year- still remain at comparable low levels.

BOX 1: SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2023 Q1[1]

In 2023 Q3, the overall terms of credit supply had a differentiated performance according to economic agents. Banks have increased caution in regard to lending by further tightening the credit standards, along with the terms and conditions on new loans to enterprises. For more than a year, the increased caution of commercial banks towards lending to this segment continues to be mostly related to banks' perceived risk from borrowers' creditworthiness, as well as from uncertainties on the economic prospect, in presence of high production costs and supply of commodities Lending terms and conditions were tightened mainly through the increase of margins on risky loans, as well as through higher loan covenants with enterprises. Banks reported a slightly lower loan rejection rate in this quarter, after four consecutive quarters of increase.

Chart 1 Box 1

Credit conditions contracted for enterprises and continued to improve for households

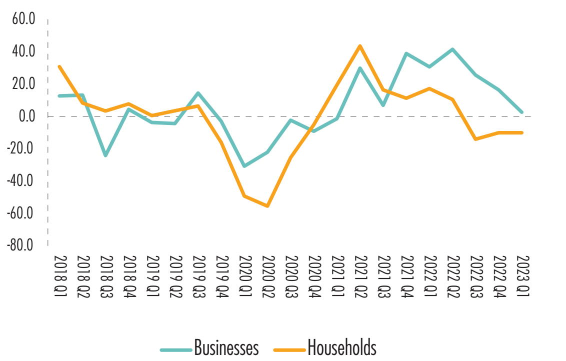


Source: Bank of Albania.

Values on the chart are calculated as net balances. Positive values indicate easing of terms and conditions and vice versa. Positive values indicate increase of refjection rate and vice-versa.

Chart 2 Box 1

Demand for credit was perceived to be increasing for enterprises and decreasing for households



Source: Bank of Albania.

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

In contrast to enterprises, banks applied more favourable lending policies in relation to households, by easing both credit standards as well as the terms and conditions. Pressure from high competition in the banking system has mainly driven banks to implement eased lending policies to households in this quarter. The terms of credit supply to households also reflected the banks' higher tolerance towards risk. The easing of credit terms and conditions was achieved through the narrowing of margins on average loans, as well as through of lower collateral requirements for house purchase loans. The rejection rate of loans remained high in this quarter.

Enterprises continued to display a higher loan demand, mainly driven by loans for investment financing. On the other hand, loan demand from households continued to be discouraged on the back of the elevated interest rates in the market and the increased uncertainties related to the future developments in the housing market.

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

3.3. CREDIT TO THE PRIVATE SECTOR[14]

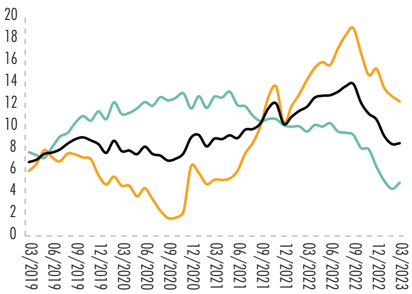
Bank lending activity followed a slowdown trajectory in 2023 Q1 as well. In annual terms, credit to the private sector grew by 8.5% from 10.6% at the end of the previous year. This performance was determined by both lower disbursements and high loan settlements by enterprises. Compared to the end of the year, the credit portfolio grew by ALL 3.2 billion, marking a return of the seasonal behaviour of lending activity in the first quarter, - unlike what happened in the previous year[15]. The slowdown in credit to the private sector reflects the weakening in both lek and foreign currency lending, which increased by 4.9% and 12.3%, respectively, or around 1.5 p.p. and 2.9 p.p. lower than in the previous quarter. These developments left the structure of the banks' loan portfolio unchanged, where loans in lek account for about 51% of the total.

Financing to enterprises by banks shrank during the first quarter and the annual growth rate slowed down by 3.3 p.p., to 5.2%. The tightening of credit conditions to enterprises, the good progress of the activity and high liquidity of enterprises, the stability of prices in the economy and the reduction of uncertainty, all led to the decrease in the loan demand for liquidity purposes from enterprises.

Credit to the households segment showed a contained slowdown. The annual growth of 14.3% of this portfolio is 0.2 p.p. lower than the one recorded in December. Loans to households continue to be mainly supported by the rapid growth of house purchase loans, by 16.7%. The high growth levels in this portfolio reflect the increase in prices in the housing market as well as the

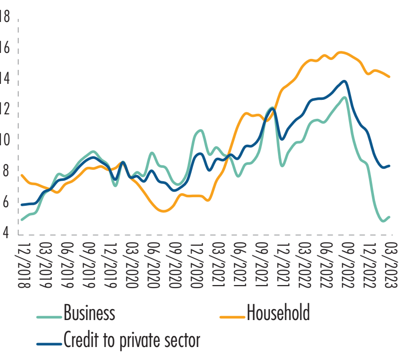
Chart 10

Credit to the private sector slowed down due to the rapid reduction in the growth rate of foreign currency -denominated loans



Notes: The data show the annual changes (in %) of credit adjusted for exchange rate effects and written-off loans from the balance sheets.
Source: Bank of Albania.

It has reflected the high amount of loan settlement of enterprises and a gradual moderation of lending to households



Notes: The data show the annual changes (in %) of credit adjusted for exchange rate effects and written-off loans from the balance sheets.
Source: Bank of Albania.

[14] *Credit analysis is based on the new set of statistics, in line with the ECB methodology on "real" credit flows, which excludes both the effect of exchange rates and written-off loans of balance sheets.*

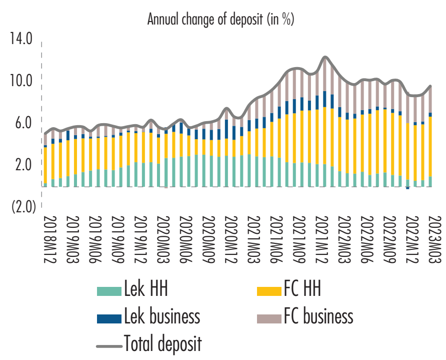
[15] *In the previous year, banks increased loan demand for liquidity to deal with the rapid surge in commodity prices.*

high demands for investments in this market. Moreover, the various offers that banks issued for this product - as a result of increased competition- supported this positive performance. On the other hand, consumer credit displays a slow growth.

At the end of the first quarter, **total deposits** in banks showed an annual growth of 9.6%, a similar level to the average growth recorded in 2022 H2. This performance reflects the slow increase of deposits in lek (2.9%), while deposits in foreign currency have continued to grow at double-digit rates (15.7%). The shift of individual savings towards investments in government securities, returns from which have grown significantly faster than those of deposits, has driven to the slow expansion in lek-denominated deposits. The structure of banks' funds continues to shift towards those in foreign currency, which account for around 54.1% of total, or 1.2 p.p. higher than in the same period a year earlier.

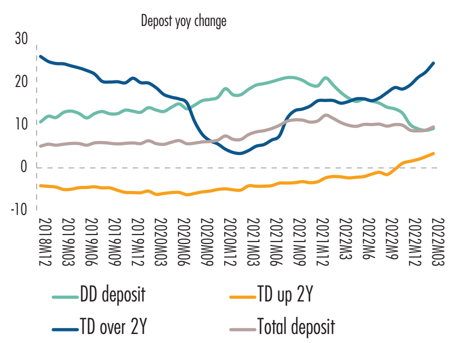
Chart 11

Deposits grew at a stable rate supported by foreign deposits



Notes: Increase in total deposits by currency and economic agents, in % adjusted by exchange rate fluctuations.
Source: Bank of Albania.

Deposits grew at a stable rate supported by time deposits



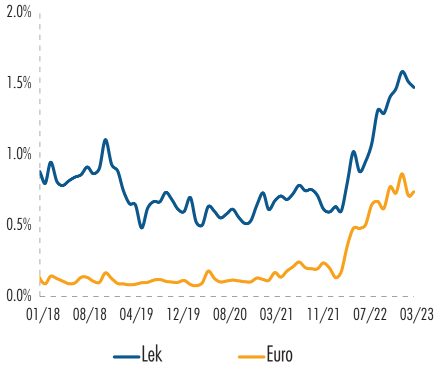
Notes: Growth of total deposits by maturity of deposits, including over 2-year deposits, adjusted by exchange rate fluctuations.
Source: Bank of Albania.

The increase in interest rates on deposit continued to encourage the shift of savings towards time deposits. Thus, demand deposits grew annually by 9.2%. This slowdown was recovered by the expansion in time deposits growth rates by 3 p.p, reaching 10.1%. The strong growth of over 2-years deposits has been the main contributor to this performance, expanding their share to 16% of total deposits of banks. Shifting savings towards deposits with maturities of over two years, both in lek and foreign currency, is due to banks' numerous offers as well as households' preference for high returns. These developments are reflected in the decreased ratio of time deposits to the total, from 56.9% at the end of 2022 to 55.9% in March.

The increase in the policy rate has been transmitted gradually to **the interest rates applied on deposits**. The average interest rate on time deposits in lek was 1.5% in the first quarter of the year, from 1.4% in the fourth quarter of previous year. This level is about 0.8 p.p. higher than the average level prior to the

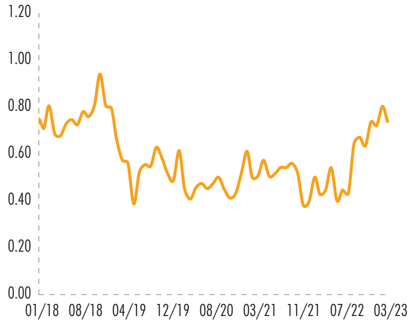
Chart 12

The interest rate for time deposits continues to increase gradually



Notes: The data show the interest rate applied on new lek and euro time deposits, in %
Source: Bank of Albania.

The interest differential between time deposits in lek and those in the euro increased during the recent months



Notes: Data shows the difference between interest rates of time deposits in lek and interest rates of deposits in foreign currency, in percentage points
Source: Bank of Albania.

normalisation monetary policy. At the same time, interest rates on time deposits in euro have also recorded positive marginal changes, standing at 0.8% in the first quarter of the year from 0.7% in the previous quarter. The difference between interest rates on time deposits in lek and that in euro increased to 0.7 p.p. in the last three months, from the average level of 0.5 p.p. in 2020-2021 and 2022 H1.

4. ECONOMIC GROWTH

GDP recorded a growth of 4.7% in the fourth quarter of 2022, remaining relatively stable compared to the rates recorded in the previous quarter.

From the sectoral perspective, economic growth was broad based. However, "Construction" and "Trade, transport and accommodation" sectors - due to the expansion of investments in the economy coupled with a good tourism activity- were the main contributors to this growth. From the perspective of the demand, economic growth reflected the expansion in both consumption and private investments, while the fiscal policy continued to show a consolidating nature and net exports had a curbing effect on growth. From the macroeconomic perspective, economic growth continues to be fuelled by: the relatively good financial situation of enterprises; the increase in employment and wages; the still favourable financial conditions; and by the improved confidence indicators in the last quarter.

Economic growth is expected to remain in a positive territory in 2023 Q1, though slightly slower compared to the previous quarter.

4.1. GROSS DOMESTIC PRODUCT

GDP expanded by 4.7% in 2022 Q4. The growth rate stands at similar levels of 4.9%[16] in the previous quarter. Throughout 2022, economic growth stood at 4.8%. Contributions to growth have been broad-based, both from production and services, with 2.2 and 2.6 percentage points, respectively. The impact of net taxes was negative, with -0.1 percentage points (Chart 13, left).

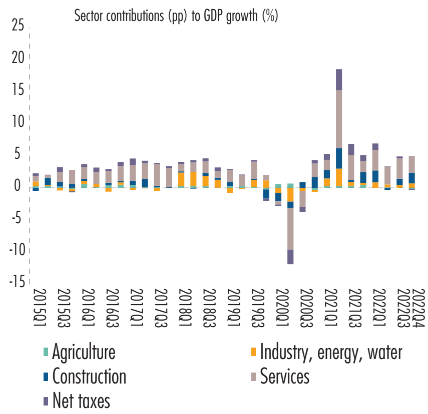
In terms of production sector, branch of Construction" contributed the most to the economic growth. The respective annual growth accelerated, reaching at 14.4%, contributing by 1.7 percentage points to the GDP growth. Positive contributions to the total growth came also from "Industry" (0.7 percentage points), with an annual growth of 6.2% and accelerated compared to the previous quarter. The growth of the industry has been supported by production in the "Electricity" and "Manufacturing Industry" branches. In contrast, "Agriculture" contracted by -0.1%.

The growth in the services sector was mainly affected by "Trade, transport

[16] *Economic growth in the third quarter was revised by INSTAT at 4.9% from 4.0%. The forecasts, on average upwards, also affected annual GDP changes for the previous two quarters of 2022, as well as 2020 and 2021.*

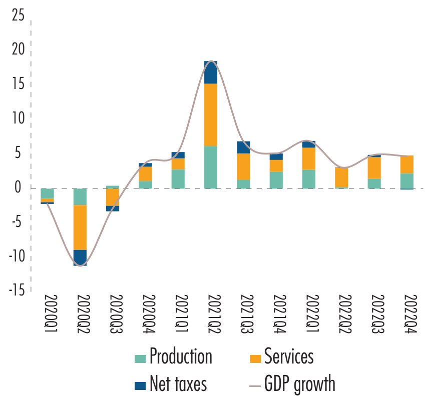
Chart 13

Economic growth has resulted in broad-based sectoral contributions



Source: INSTAT and Bank of Albania.

Positive contributions came from both manufacturing and services sectors



Source: Bank of Albania.

and accommodation", up by 5.6% and contribution of 0.9 percentage point. The "Trade" branch provided the main contribution, while high contributions came from the "Accommodation" branch, reflecting the positive progress of tourism in the Albania in the fourth quarter. This phenomenon is confirmed by the balance of payments data for tourist inflows. Positive contributions came also from "Public Administration, Education and Health", "Real Estate" and "Information and Communication" branches. The only negative impacts come from "Arts, entertainment and leisure" branch.

Economic growth is expected to remain in a positive territory in 2023 Q1, albeit slightly slower compared to the previous quarter. Confidence indicators suggest broad-based expansion from all sectors of the economy, including consumer-related indicators. Domestic demand will continue to be the main supporter to the economic growth. Also, tourism will again provide positive impacts given the high increase in tourist inflows in the first two months of 2023.

4.2. AGGREGATE DEMAND

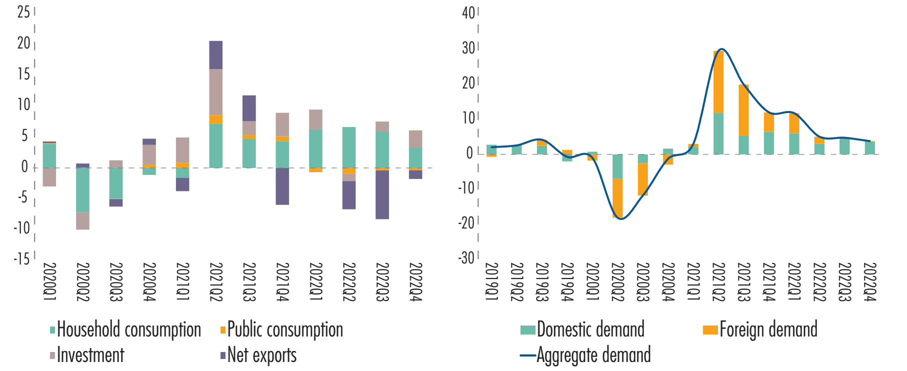
The expansion of domestic demand has the main contribution to the economic growth in 2022 Q4. The expansion was mainly underpinned by "Population consumption" and "Investments". The increase in investments was driven by "Private investments". On the other hand, public consumption and net exports continue contributing to the curbing of the economic growth.

Domestic demand grew by 4.7%, from 6.6% in the previous quarter.

Chart 14

Economic growth is mainly underpinned by "Population consumption" and "Investments"

Domestic demand continues to remain the only contributor to the growth of aggregate demand



Source: INSTAT and Bank of Albania.
Notes: Contribution of demand components to economic growth

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

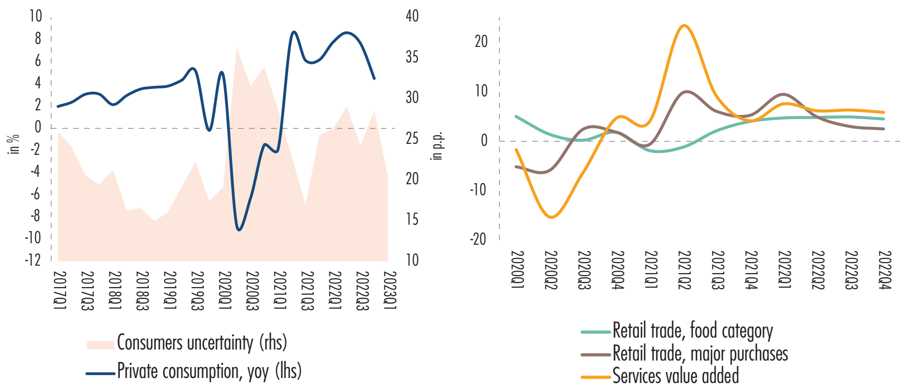
The slowdown of this component reflects a slower increase in "population consumption", while the growth of "investments" accelerated, supported by "private investments".

Private consumption rose 4.5% in the fourth quarter, after the average growth 8.0% in the first nine months of 2022. Despite slowing down, the growth of this component remains above the historical average. It was supported by improved consumer confidence, increased disposable income in response to rising employment, wages and remittances, and the further expansion of credit. Indirect indicators show a steady increase in expenditures across the categories of services and food items, while purchases of durable goods have marked a slowdown of the growth pace in the fourth quarter (Chart 15, right)[17]. The performance of available indirect indicators shows that private consumption

Chart 15

Private consumption grew at a slower rate in the fourth quarter

Expenditures increased mainly for services and food, whilst for major purchases they decreased



Notes: Indicator of consumer uncertainty is measured from Consumer Confidence Survey and expressed as net balance in percentage points.
Source: INSTAT and Bank of Albania.

Notes: Indicators are stated in annual changes, in %
Source: INSTAT and Bank of Albania.

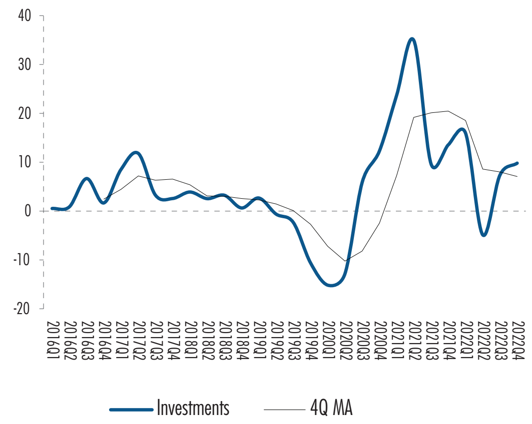
[17] *The analysis of private consumption by category is based on data from the retail trade index, confidence surveys as well as data from GDP measured by the production method.*

maintained similar growth rates during 2023 Q1 as well.

Total investments grew 9.8% in the fourth quarter, confirming the upward turn in the third quarter (Chart 16). The increase in investments was mainly determined by the elevated private investments of enterprises in construction as well as in machinery and equipment. The improved financial situation[18], the high capacity utilization rate, the reduced uncertainties, and the continuation of positive bank lending flows supported the growth in private investments.

Chart 16

Investment growth accelerated in 2022 Q4

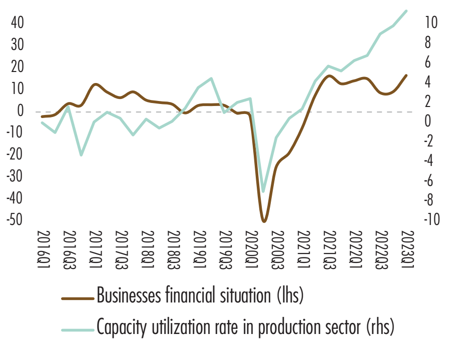


Source: INSTAT and Bank of Albania.

The available indicators suggest the continuation of the upward trend of investments in 2023 Q1. Surveys on enterprises, show the financial situation and the capacity utilisation rate of enterprises above the historical average (Chart 17, left). The import of machineries and equipment has continued to grow in real terms, and support with credit has continued also in the first quarter (Chart 17, right).

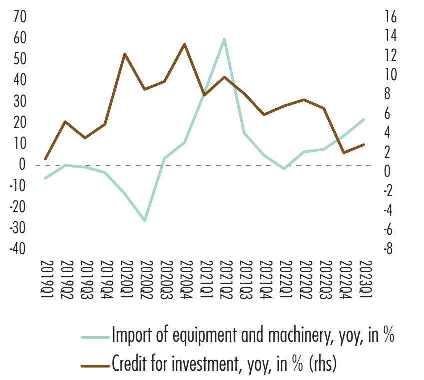
Chart 17

Capacity utilisation rate and the financial situation of enterprises have improved in the first quarter



Notes: The enterprises' financial situation is a balances' average from confidence surveys. The capacity utilisation rate is in percent of full capacity. The indicators are differences from the long-term average.
Source: INSTAT and Bank of Albania.

Quantitative indicators from imports and loan suggest positive developments of private investments



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

Net exports continued to negatively contribute to the growth, but at a lower magnitude compared to the previous quarters (Chart 18). Trade deficit expanded by 6.1% in real terms[19]. This performance was determined mainly

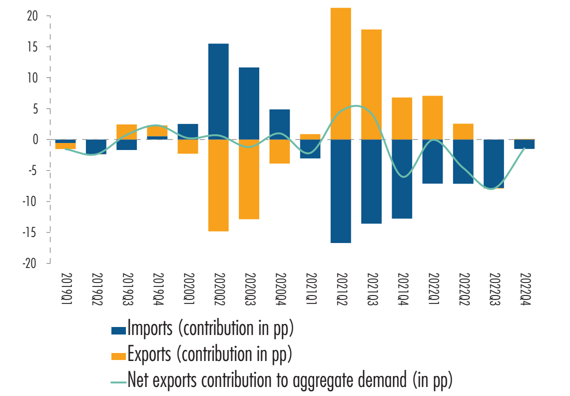
---

[18] *According to survey indicators.*

[19] *Just like in the previous quarters, the performance in real terms differs from that in nominal terms. Therefore, both national account data and payment balance data show that the trade deficit in nominal terms has narrowed. But, the comparably higher export deflators turn this performance upside down in regards to real terms.*

Chart 18

Net exports continued to provide an increasing negative contribution during 2022 Q4 as well



Notes: Contribution of imports and exports in economic growth.
Source: INSTAT and Bank of Albania's calculations

by the growth in imports by 3.1%, which was driven by an increase in the import of services by 24.2%, whereas the import of goods fell by 2.6%. On the other hand, real exports grew by merely 0.6%, affected mainly by the 1.2% increase in the export of goods.

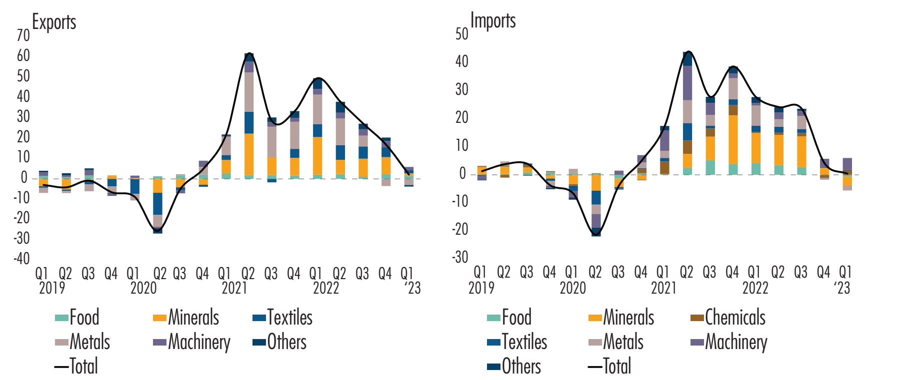
The data on trade of goods for 2023 Q1 indicate a slow growth rate in both exports and imports. This mainly reflects the reduced effect of the surging international prices. The trade deficit decreased by 1.9% due to the stronger effect from the growth in exports, compared to the growth in imports.

In 2023 Q1, the exports of goods grew by 2.1%, recording a significant slowdown compared with the previous quarter (16.8%). Contributions across all categories of goods have decelerated, whereas negative contributions are still related to the category of "Construction materials and metals," which continue to encounter difficulties, likewise in the previous quarters.

Chart 19

The annual growth of exports has continued to slow down during 2023 Q1 as well

The growth of imports appears also quite low, while many categories have made negative contributions



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

Imports of goods grew by 0.4%, at slower rates compared with the fourth quarter of the previous year. Except "Machinery, equipment, spare parts" and "Chemical and plastic products," the other categories display rising negative contributions. This is particularly notable in the categories of "Construction materials and metals" and in "Minerals, fuels and electricity". In case of imports, prices are assessed to have provided a stronger impact, whereas quantities appear upward.

Fiscal policy is projected to have a consolidating nature over 2023, supporting the improved fiscal position in the medium-term and beyond. The budget deficit is planned at around ALL 55 billion, or 2.4% of GDP, from 3.7% assessed in 2022.

At the end of the first quarter, the fiscal impulse[20], adjusted for the effect of energy support measures, was assessed at around -0.3 p.p. of GDP.

In the first quarter of 2023, the budget balance was positive at ALL 30 billion, the highest value reached within a quarter. In terms of GDP, fiscal surplus was assessed at 5.8% of GDP, from 4.6% recorded in the same quarter of the previous year. The highest fiscal surplus values are attributed mainly to the lower level of expenses in terms of GDP.

Chart 20

The fiscal impulse remained in negative territory | *The fiscal surplus was relatively high*

Notes: Change of the primary balance ratio for 12 months to GDP, from the previous year. Positive values of this indicator indicate an accommodative fiscal policy, while negative values indicate a consolidating one.
Source: Ministry of Finance and Economy, BoA calculations.

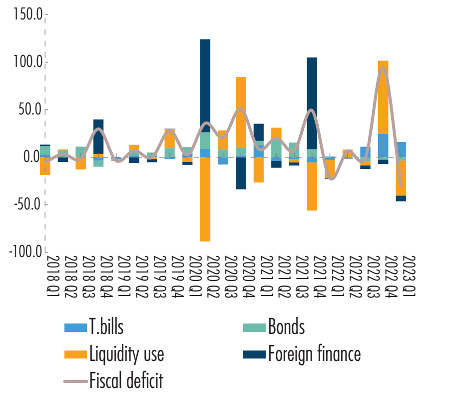
Notes: Budget deficit to GDP. Calculations based on quarterly flows. Positive values show deficit, negative values show budget surplus.
Source: Ministry of Finance and Economy.

Net borrowing in the domestic market of government securities grew by ALL 12.7 billion in the first three months of the year. This amount reflects half of the domestic borrowing planned (ALL 25 billion) for the whole 2023. The additional amount of borrowing consisted mainly in Treasury bills with one year maturity. In addition, borrowing expanded also by the issuance of long-term instruments with 10- and 15-year maturity, offsetting the higher maturities mainly in bonds with 2- and 3-year maturity. Market players displayed a relatively high demand for government securities, particularly one-year T-bills. In response, the government reviewed the borrowing plan to ALL 12.7 billion, from ALL 5 billion planned in the first quarter. Households financed most part of this additional amount, around 76%, given the higher interest to invest government securities, since October 2022. The expansion of households' securities portfolio in 2023 Q1 and 2022 Q4, driven by rising interest rate, offset the contraction experienced in the first quarters of 2022.

[20] *The correction of the fiscal impulse, accounting the support and loan to the energy sector amounting ALL 28 billion, in 2022, was implemented to more accurately measure the effect of the discretionary fiscal policy, which excludes the effect of temporary measures from the calculation.*

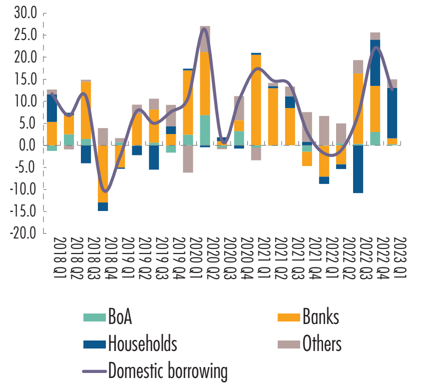
Chart 21

Net borrowing in the domestic market expanded...



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

...with the active participation of households



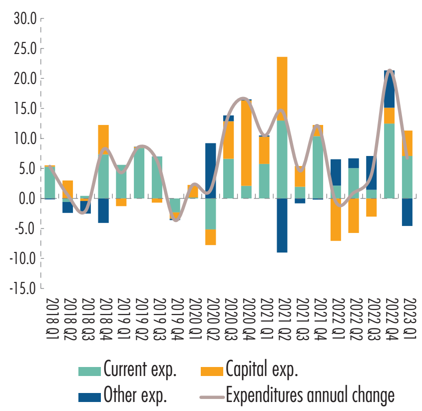
Notes: Government borrowing in debt securities, by buyers, in ALL billion, by quarters.
Source: Ministry of Finance and Economy

Net borrowing in the foreign market, in the first three months of the year, stood at around ALL -6 billion, since foreign debt settlement accounted for more than foreign currency inflows during the period. The performance of both government borrowing and fiscal surpluses over the period, have been factored into liquidity surpluses available to finance expenses in the upcoming months.

Expenditures in 2023 Q1 amounted to around ALL 125 billion, increasing by 6.7% in nominal annual terms. The total value increased mainly as a result of capital expenditures, which contributed by around 4.2 percentage points. The performance of capital expenditures reflects mostly the comparative base effect with a year earlier. In that period, part of public investments were temporarily suspended, due to high price fluctuations of raw materials used in construction in 2022 H1. The other items which contributed to the increase of expenditures

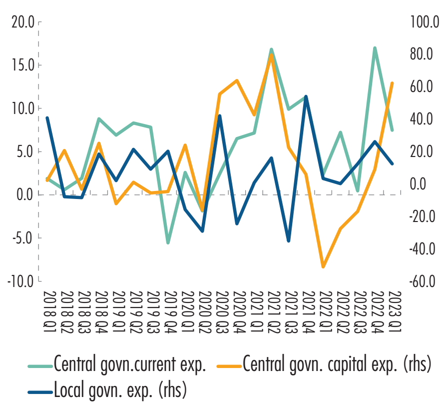
Chart 22

Spending increased...



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

...as investments provided a higher contribution



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

were: social insurance expenses (by 2.6 p.p.), staff expenses (by 1.4 p.p.), and local government spending (by 1.2 p.p.). The performance of these three components reflected the fiscal measures undertaken toward retirement indexing (twice throughout 2022, by 3.3% in April and 6% in September), as well as the partial increase of wages for the public sector. The annual spike in expenses for this quarter includes also the negative impact of -4.6 p.p. of the support provided to the energy sector carried out in the previous year.

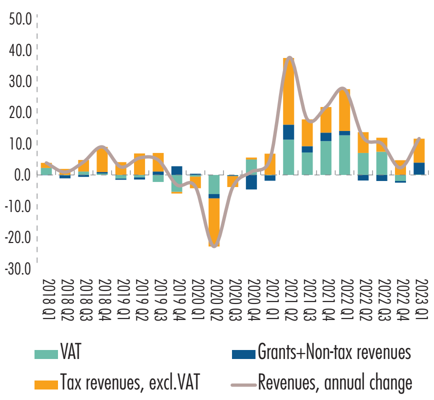
The up-to-date fiscal developments suggest that the items with a direct impact on aggregate demand - public consumption and public investments - will have a positive effect on its expansion.

Budget revenues in the first quarter were around ALL 156 billion, up by 11.7% in annual terms. Although the expansion of revenues, in nominal terms, was high, their growth profile differed from the previous quarters. Thus, revenues grew mainly due to corporate income tax (by 5.3 p.p.) and income from grants (by 3.7 p.p.). Revenues from profit tax have a propensity to provide the highest contribution during the first quarter of the year, which corresponds with the financial closure of the previous year.

VAT revenues on imported goods contributed by -0.8 p.p. in the total growth, from the average of +6.7 p.p. for more than one year. On the other hand, VAT revenues on the production of goods and services in Albania, contributed by around 1 p.p. in total revenues expansion, from an average of 2.3 p.p. recorded in the first three quarters of 2022[21]. Social insurance income contributed by 3.4 p.p. on total growth, from 2.5 p.p. in the previous year. The contribution of revenues from personal income tax stood at 1.9 p.p., up by 0.7 p.p., when

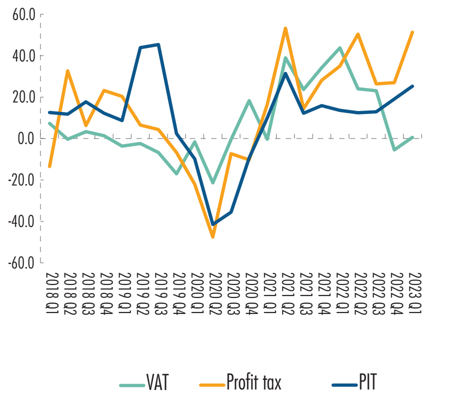
Chart 23

Revenues expanded...



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

...as profit tax provided the main contribution



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

[21] *2022 Q4 was not considered in the average, since the effect of the high VAT refunds during this period, which accounted for around 40% of total annual refunds, had a negative impact on total revenues.*

compared to the same period in the previous year. The developments recorded in these two items reflect mostly the impact of minimum wage increase, enacted twice within 2022, which, in addition to the positive impact on income from tax on wage, impacts also income from social insurances.

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

Annual inflation averaged 6.5% in 2023 Q1, down from the previous quarter. Inflation has decelerated since the end of 2022, although inflationary pressures, not least domestic ones, continue to be high. The inflation curve has settled on a downward trajectory, mainly on the back of the significant decrease in international prices combined with the appreciation of the exchange rate. On the other hand, domestic inflationary pressures have been intensified, driven by the improved demand, tight conditions in the labour market, and the fast growth in wages.

Inflation trajectory is expected to continue declining, due to the reduced energy prices, the lower cost of production and transportation, and the moderate global demand. In addition, domestic inflationary pressures are expected to be softer during 2023, led by the impact of the monetary policy stance normalisation.

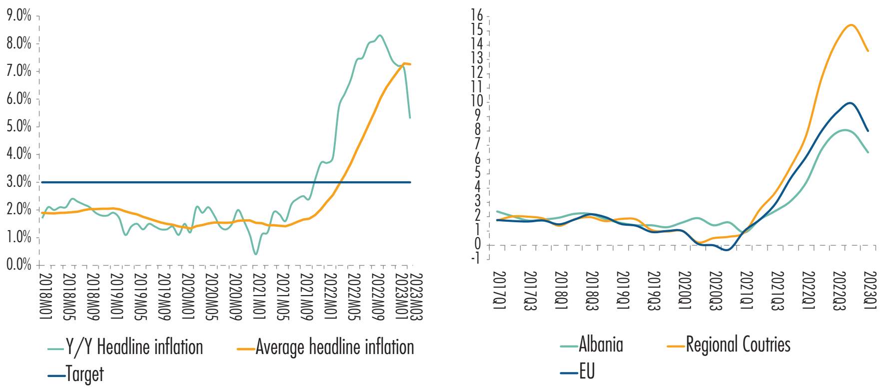
5.1. CONSUMER PRICES

Annual inflation averaged 6.5% in 2023 Q1, down by 1.4 percentage points compared to the average of the previous quarter. The declining profile of domestic inflation is similar to the one across both the EU and regional economies (Chart 24, right), as the rise in food and oil prices is decelerating. The high pressures from production and transport costs have been reduced on the back of lesser inflationary external environment, the effects of the high comparative base of the previous year, and the normalisation stance of

Chart 24

Inflation in Albania slowed down, mainly due to the reduction of in¬flationary pressures from abroad

Global inflation declined as the overall costs dropped



Source: INSTAT and Bank of Albania's calculations.

Source: Respective statistical institutes.

monetary policy. The lower level of inflation recorded in Albania as compared to the regional countries, reflects the easing effects from the exchange rate appreciation and the low inflation of goods at regulated prices, which includes households' electricity bill.

"Processed foods" (45%) continued to determine the annual inflation in the first quarter. However, the contribution of this category was notably slower; such behaviour was not encountered since the second quarter of 2022. As the contribution of this category fell by 1.2 percentage points in March, it also affected the value of the quarterly contribution (Table 2). **"Unprocessed foods"** provided the same contribution of the previous quarter. The contribution of this group on headline inflation increased in March, by exceeding the contribution of the other food category. The contribution of **"Non-food consumer goods"** was 0.8 percentage point lower than in the previous quarter. This development was more pronounced in March, reflecting the considerable slower increase in prices of energy commodities, particularly in oil price, in both international and domestic markets, in addition to the effect of a depreciating US dollar.

The prices of other more stable components of inflation, **services, housing and durable consumer goods**, mostly contributed to the formation of inflation (by around 0.2 percentage points). This movement was driven by the higher contribution from certain services in the first two months of the year, more pronounced from the sub-category "Hotels, bars and restaurants".

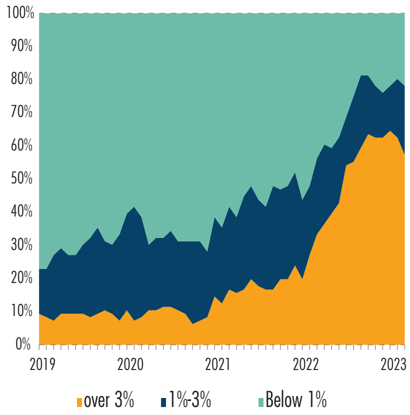
*Table 2 Contribution of key categories to annual inflation (p.p.)**

	2021 Q1	2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	Annual inflation 2023 Q1 (%)
Processed food	**0.4**	**0.6**	**0.9**	**1.4**	**3.0**	**3.5**	**3.4**	**2.8**	**13.6**
Bread and grains	0.1	0.1	0.2	0.4	0.7	0.6	0.6	0.6	12.0
Milk, cheese and eggs	0.1	0.1	0.2	0.3	0.9	1.0	1.2	1.3	25.0
Unprocessed foods	**0.9**	**1.0**	**1.0**	**1.5**	**1.2**	**1.7**	**1.9**	**1.9**	**9.5**
Fruits	0.1	0.1	0.4	0.2	-0.1	0.0	0.1	0.1	1.1
Vegetables	0.6	0.8	0.4	0.9	0.5	0.6	0.8	0.7	10.0
Meats	0.1	0.1	0.2	0.4	0.7	1.0	1.0	1.0	13.2
Services	**0.2**	**0.2**	**0.3**	**0.4**	**0.5**	**0.6**	**0.5**	**0.7**	**3.0**
Goods with regulated prices	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.1**
Housing lease	**0.1**	**0.2**	**0.2**	**0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**3.6**
Non-food consumer goods	**0.1**	**0.3**	**0.6**	**1.0**	**1.6**	**1.5**	**1.2**	**0.4**	**2.1**
Fuel	0.0	0.2	0.4	0.7	1.4	1.3	0.9	0.0	-1.6
Durable consumer goods	**0.1**	**0.1**	**0.1**	**0.0**	**0.2**	**0.3**	**0.4**	**0.4**	**5.9**
Inflation (%)	**1.8**	**2.4**	**3.1**	**4.4**	**6.7**	**7.9**	**7.9**	**6.5**	**6.5**

Source: INSTAT and Bank of Albania's calculations.
**The Table shows the contributions in inflation by composing categories and some of their main items. The Table also shows the average inflation rate in 2023 Q3.*

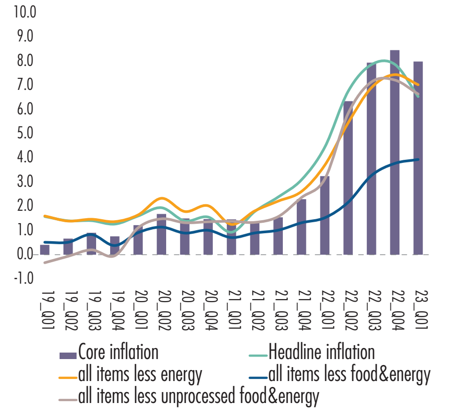
Chart 25

In 2023 Q1, the share of items with in¬flation over 3% diminished



Source: INSTAT and Bank of Albania's estimations.

Net inflation growth has become weaker in the first quarter, except inflation less food and energy



Source: Bank of Albania.

The slowdown of annual inflation in the first quarter, was also reflected in the decline in the number of CPI basket items with inflation over 3% (Chart 25, left)[22]. Since July 2022, the share of items with inflation over 3% remains the highest one. Despite being dominant, in March 2023, this share of items stood at 57%, or 5 percentage points lower than in the previous month. The shift of items was almost balanced between the other two groups, where the category with inflation "Below 1%" was 22% of the total, and that "Between 1% and 3%", around 21% of the basket's items, this month.

These developments were also reflected in net inflation calculations, which slowed down slightly, with the exception of net inflation (excluding foods and energy) that reflects the inflation of services and industrial durable goods (Chart 25, right). This indicator recorded a slight increase compared with the previous quarter.

5.2. INFLATION DETERMINANTS

In 2022 Q4, the cyclical situation appears positive on the back of a high economic growth. Indicators on labour market have continued to improve, the capacity utilisation rate has been increasing further above the historical average, while growth of wages in private sector has accelerated. Against this backdrop, domestic pressures have mainly fuelled inflation, while imported inflationary pressures have slowed down. This is reflected in high core inflation rates recorded in both 2022 Q4 and 2023 Q1.

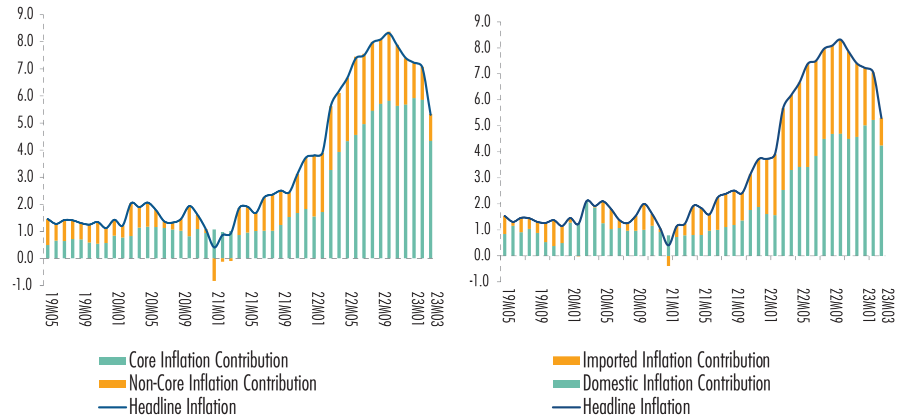
The decline in inflation in 2023 Q1 was in line with the forecasts, though the speed and rate of fall was neither even nor simultaneous across all its

[22] *The assessment is based on the annual inflation data for a 2-digit level detailing pursuant to COICOP classification of CPI basket items. This detailing included a total number of 96 goods and services.*

components (Chart 26). Overall, the decelerating behaviour was determined by the short-term and imported components of inflation. The core and domestic components of inflation recorded the first deceleration in March, after the accelerating trend in the preceding months. The fall of inflation reflected the effects of oil prices, the easing of their pressures pass-through to other prices, the impact of the monetary policy normalisation, and a much higher comparative base of the previous year. As a result, core inflation recorded 8% during the first quarter of 2023, a weaker deceleration than the one foretasted, remaining thus at high historical values. Domestic inflation displayed the same behaviour, standing close to 6%.

Chart 26

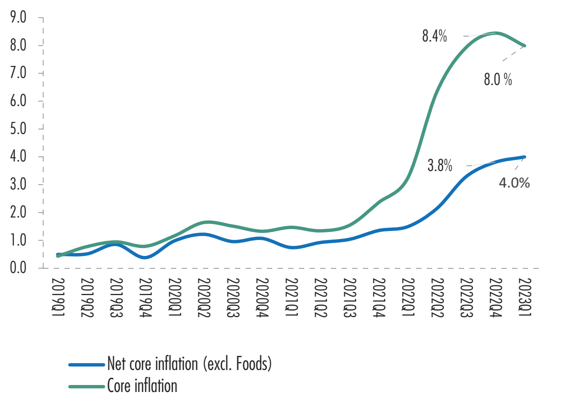
Pressures from core and domestic inflation were noticeably dominant during 2023 Q1 | *The contribution from imported inflation trended down rapidly*



Source INSTAT and Bank of Albania's estimations. *Source INSTAT and Bank of Albania's estimations.*

Chart 27

Net core inflation, despite declining slightly in March, recorded an uptick in 2023 Q1 compared to the previous year



Source INSTAT and Bank of Albania's estimations.

Net core inflation[23] recorded 4%, upward from the previous quarter (3.8%) (Chart 27). The performance of inflation for this group illustrates the presence of domestic inflationary pressures, as they remain high above the target, characterised by a slight strengthening behaviour. This development shows that the decline in core inflation, noticed mainly in March, is more statistical in nature rather than caused by weaker domestic pressures, which are highly persistent.

The short-term inflation components, such as the non-core and imported one, also dropped to 3.6% and 8.7%, respectively. The latter recorded, for the first time after one year, a single-digit value which was driven by the annual contraction in fuel prices,

[23] *Core inflation considers over 69.2% of the current CPI basket; net core inflation that excludes the sub-groups of processed foods (including bread and grains) considers over 44.6% of the basket, and domestic inflation over 80.4% of it.*

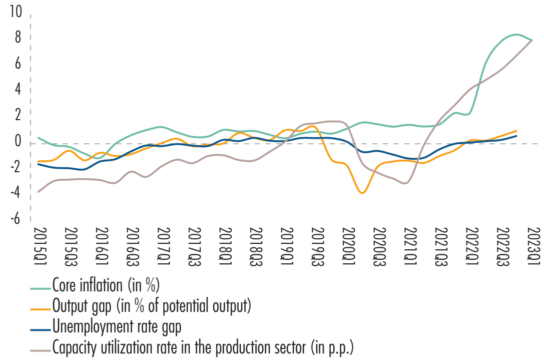
and a slowdown of processed foods' inflation. The above-listed developments have maintained and strengthened the dominant behaviour of the core and domestic components of inflation formation, with respective contribution of 82% and 75%, against the fast reduction of contributions by the non-core and imported components in inflation.

The cyclical position of the economy has continued to improve given also the high economic growth recorded. This is noticeable as employment figures have further improved and wage growth in the public sector has accelerated upwards.

The capacity utilisation rate stood at around 80.2% in 2023 Q1, continuously upward compared with the previous quarters, and significantly above the long-term average (Chart 28).

Chart 28

Cyclical position of economy has further improved in 2022 Q4 and 2023 Q1



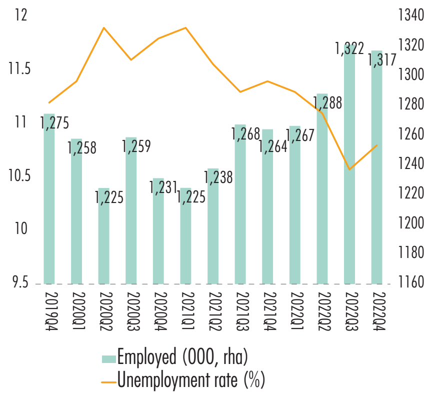
Source INSTAT and Bank of Albania's calculations.

Notes: 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 of unemployment. The unemployment rate gap is stated as the difference of the equilibrium unemployment rate to the actual unemployment rate and then the moving average method is applied.

Employment expanded by 4.2% in 2022 Q4, at a similar rate with the previous quarter. The sectors of "Agriculture" and "Services" have provided positive contributions. **The unemployment rate** registered 10.8% in the fourth quarter, dropping by 0.6 percentage points compared to the previous year[24] (Chart 29, left). In line with these developments, the labour force participation rate has continued to pick up, reaching 74.8% in 2022 Q4 (Chart 29, right).

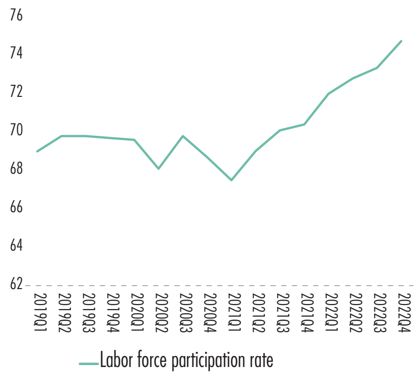
Chart 29

Employment has continued to grow in annual terms, but unemployment rate has risen slightly due to the quarterly seasonal effects on employment



Source INSTAT and Bank of Albania's calculations.

Labour Force Participation Rate continued to trend upwards



Source INSTAT and Bank of Albania's calculations.

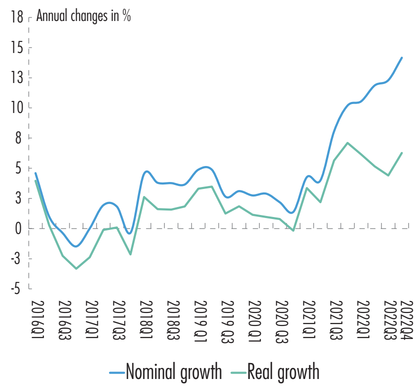
24 *Although employment increased in annual terms, it contracted by 0.3% in quarterly terms, reflecting the usual seasonal behaviour of this period. As a result, the unemployment rate increased by 0.2 percentage points in 2022 Q4, compared to Q3.*

The average wage in private sector continued to expand at a high and accelerated pace. Annual growth recorded 14.2%, from 12.3% in the previous quarter (Chart 30, left). Sectoral contributions were broadly based, particularly more pronounced in the branches of "Trade, transport, accommodation and food services", "Industry" and "Public Administration". Nominal wage growth has been sufficiently high in rolling back the accelerating pace also in the real wage indicator. The latter has picked up by 6.3% in annual terms, from 4.4% in the previous quarter.

Productivity and the Unit Labour Cost. Unit labour cost index[25] increased by around 2.0% on average, in 2022. This performance differs from 2021, when this index reduced by 1.6%. The unit labour cost increased due to the dominating effect engendered by the real wage growth against the opposite impact of productivity growth. Thus, the average real wage growth in 2022 was 5.2%, meanwhile the average labour productivity growth recorded 3.2% (Chart 30, right). The unit labour cost settled on the expansionary trend in 2022 Q2, after experiencing a contracting trend since the beginning of last year. This is related to both the ever stronger wage growth and the slower labour productivity growth.

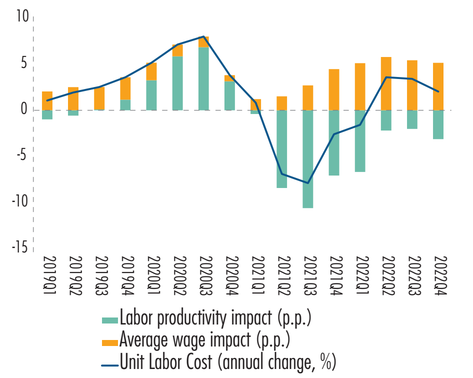
Chart 30

Private sector wages continue to grow at a double-digit rate, accelerating and broadly-based



Source INSTAT.

The unit labour costs have expanded again due to the stronger impact of wages as compared to productivity



Notes: The rolling average is applied over the indicators on four terms (for four quarters).
Source INSTAT and Bank of Albania.

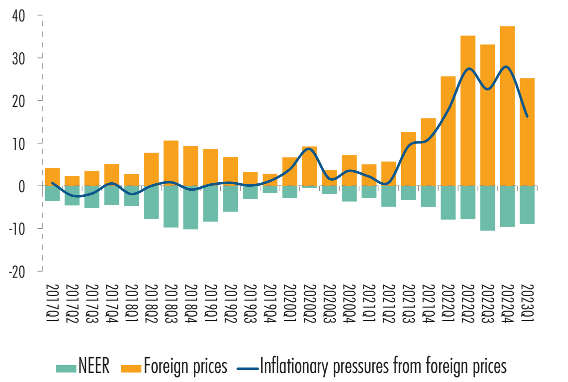
Other output costs continued to expand with double-digit rates. Industrial producer prices rose by 21.4% in 2022 Q4, as those for the domestic market accelerated by 19.4%. On the other hand, export producer prices increased by 24.2%, decelerating compared with 2022 Q3. Construction Cost Index has also slowed down slightly. The annual growth of this index recorded 7.0%, from 7.2% in the previous quarter.

[25] *Unit labour costs are estimated for the non-agricultural private sector based on the National Accounts statistics on employment and wages. Annual changes are shown as rolling averages of four quarters in order to mitigate the fluctuation of component indicators in the calculation of the unit labour costs.*

Imported inflationary pressures have decelerated in 2023 Q1. The annual increase in the imported inflationary pressure index (IIPI)[26] was 16.3%, from 27.8% in 2022 Q4 (Chart 31). The deceleration is related primarily to the performance of foreign prices, which rose annually by 25.3%, from 37.4% in the previous quarter. The nominal effective exchange rate (NEER) has followed an appreciating trend, albeit at a lower magnitude. The appreciation in annual terms reached to 9.0% from 9.7% in the previous quarter.

Chart 31

Imported inflationary pressures have decelerated in 2023 Q1



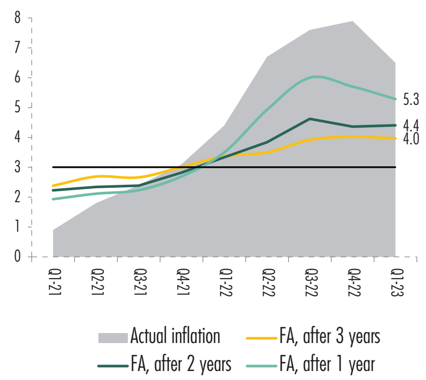
Source: INSTAT, Eurostat and estimations of the Bank of Albania.

The above developments have engendered a reduction in the contribution of imported inflation in 2023 Q1. The latter is estimated to have contributed by around 25% to the formation of headline inflation, or roughly 1.6 percentage points lower than in the previous quarter (Chart 26, right). This development has determined the deceleration of inflation, whereas the domestic component has expanded by around 0.2 percentage point in average terms.

Inflation expectations reached declining turn in 2023 Q1[27]. Inflation expectations from enterprises recorded a sharper fall by 5.3 percentage points after one year. Currently, enterprises expect inflation to be 6.6% after one year. Consumers expects inflation at 8.9% in the next year, around 2.1 percentage points lower than in the previous quarter. Financial agents expect inflation to be 5.3%, quite close to the current value of inflation recorded in the first quarter

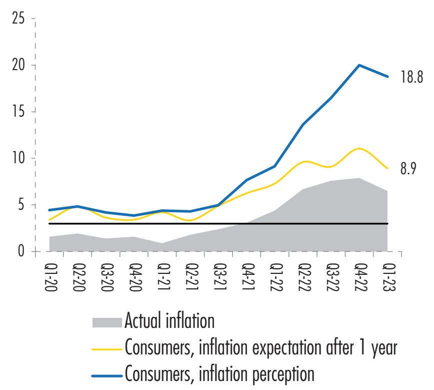
Chart 32

Enterprises and consumers expect inflation to decline in the following year



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

Financial agents predict that in the medium-term inflation will turn back to its target



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

---

26 *IIPI is calculated as the annual growth of IPI and NEER for the respective month. 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.*

27 *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.*

(Chart 32, right). These expectations are 0.4 percentage point lower compared to the fourth quarter in the previous year. On the other hand, medium-term expectations have remained balanced and closer to inflation target. According to economic agents inflation is expected to be 4.0% over a three-year horizon.

BOX 2: LABOUR-MARKET CONDITIONS CREATE THE PREMISES FOR ADDED PRESSURES ON WAGES AND DOMESTIC INFLATION

Over the past years, the labour market in Albania has been characterised by cyclical improvements and significant structural adjustments. These developments were driven by the higher labour demand from enterprises coupled with the long-term socio-demographic trends. Particularly, the 2021-2022 period experienced a positive performance in key labour-market indicators, a rapid wage growth, tight labour market conditions, and overall elevated inflationary pressures. In line with these developments, this box aims to have a closer look at labour-market developments and to identify their consequences on inflation.

Labour-market conditions tightened. *Data from INSTAT and our surveys on enterprises[I] show that labour-market conditions are increasingly tightening. Enterprises declare that the "lack of labour force" has turned into a serious issue. The importance of this limiting factor has risen by around 3-4 times during the 2021-2022 period against the average of the 2016-2020 period. According to a dedicated labour-market and wage performance survey[II], during the 2021-2022 period, the most pressing issues concerning the employment process are: mismatches between professional skills and the job requirements and disagreements about wage compensations. These issues are more relevant across industry and construction enterprises (Chart 1, left). Other factors identified by enterprises rank above the scale average. In 70% of cases, enterprises point out that "lack of labour-market supply" and "emigration" are major issues. The sectors that identify "emigration" as a factor with a significant share of responding cases are: construction (74%); industry (69%); and services (50%). Vacancies provide an alternative indicator to evaluate the enterprises' demand for employees, as labour-market supply falls short. Enterprises declare that the number of vacant positions have risen during 2022 (Chart 1, right). This rise is transversal by positions and sectors. All the sectors report an increase of*

Chart 1 Box 2

Recruiting issues ranked by degree of importance 1 (the least important) - 5 (the most important) during 2021-2022

The balance of vacancies by sectors and the total in 2022 compared to 2021 (in pp)

Notes: The "total" was calculated as a weighted average of the importance of issues for each sector with its relevant weight on employment.
Source: Bank of Albania, Business survey, February 2023.

Notes: The "total" was calculated as a weighted average of the balance for each sector with its relevant weight on employment.
Source: Bank of Albania, Business survey, February 2023.

vacancies in positions with a supportive and assisting role. Construction, industry and services report a considerable rise in vacancies for non-leading roles and lower growth for managers and executives officials.

Higher vacancies in 2022, are due to the rapid expansion in the demand for goods and services, which corresponds to the positive stage of the business cycle of the Albanian economy, as well as the long-term structural issues of the labour market. These problems arise partly due to unfavourable demographic developments and professional qualification issues.

Demographic developments will increasingly restrain the economic growth of Albania in the long run. *The Albanian population has shrank rapidly over the last decade[III]. The decline in population is due to falling birth rates, population ageing, and higher emigration.[IV] These trends have caused a narrowing of the population pyramid base and an increase in the ratio of ageing people to young people.[V] Demographic changes have also affected the growth composition in both the labour force and employment by age-group contributions. Specifically, during 2016 Q4 - 2019 Q4, these indicators increased because of the positive contribution from the 15-19 years-old age-group. Alternatively, during 2019-2022, the increase of employment and labour force was determined by the positive contribution of the 30-64 years-old age-group, whereas contribution from the younger age-group (15-29 years-old), was negative [VI].*

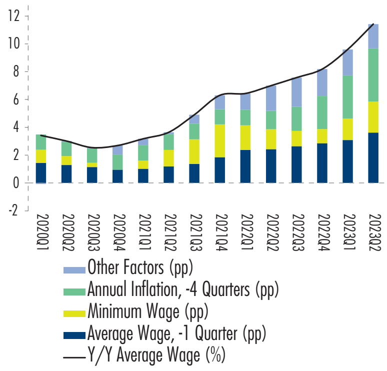
The inability of the market to respond to the additional labour demand, both quantitatively and qualitatively, turns into a premise for a rapid increase in wages, production costs and inflation.

Pressures on wage growth are strengthening. *The labour market situation described above has reflected a growth in wages in order to attract a qualified labour force. To analyse this phenomenon, we have built an economic model, which attempts to identify the factors behind the rapid wage growth, and their specific weights. The results of this analysis suggest that the average wage growth in the economy has been affected by the increase of the minimum wage; the rising inflation recorded over the past year; as well as other factors with an ever increasing importance in the past two years (Chart 2, left). These factors reflect the increasing contribution of a tight labour market, the rise in competition, and to a lesser degree, labour productivity growth.*

The above assessments are in line with the results of the business survey (Chart 2, right). Businesses declare that the most significant factors affecting the increase in wages over the past two years are: the increase of minimum wage and rising inflation. Simultaneously, other crucial factors are the lack of labour supply and, to a lesser extent the increase of productivity and efficiency. More specifically, over 50% of responses, indicate that the wage growth stems from a low labour-force supply and a high number of workers emigrating (around 80%). Only 14-20% of responding enterprises declare that the increase in wages came as a result of better performance, work stimulus, efficiency and good management. As per the surveyed enterprises, wage revision will also continue in 2023, but at a slower rate than in the previous year.

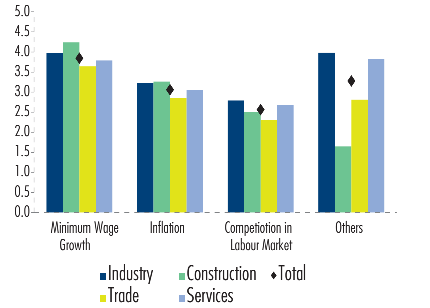
Chart 2 Box 2

Factor contributions on the growth of the average wage in the economy (in percentage points)



Notes: Assessments results of the econometric model.
Source: Bank of Albania calculations.

Reasons for wage revision measured by degree of importance from 1 (low importance) - 5 (high importance) during 2021-2022



Notes: The "total" was calculated as a weighted average of the importance of reasons for each sector with its relevant weight on employment.
Source: Bank of Albania, Business survey, February 2023.

In conclusion, *this analysis suggests that labour-market developments present significant medium and long-term challenges to the Albanian economy. In the cyclical and medium-term aspect, our analysis suggests that the domestic economy will continue to generate relatively strong inflationary pressures. In the structural and long-term aspect, the unfavourable demographic trends and the emigration process require structural reforms, geared toward enhancing professional qualification skills and encouraging productivity.*

I https://www.bankofalbania.org/Monetary_Policy/Surveys_11282/Business_and_consumers_survey/
II Special edition, Bank of Albania, February 2023.
III INSTAT: Population in January 1 by age-group and gender 2001 - 2022. http://databaza.instat.gov.al/pxweb/sq/DST/START__DE/POP01/
IV nstat.gov.al/en/statistical-literacy/the-population-of-albania/
V https://www.instat.gov.al/en/statistical-literacy/the-population-pyramid/
VI Changes to the structure calculated as accumulations for the periods 2016 Q4-2019 Q4 and 2019 Q4-2022 Q4.