Bank of Albania

MONETARY POLICY REPORT

2023/III

MONETARY POLICY DEPARTMENT

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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 affect the increase or decrease of 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 assets channel. The Bank of Albania has constructed models to forecast changes in all elements which affect prices and to forecast inflation for up to three years. When forecasts show a dominance of low inflationary pressures, which may drive inflation below the 3.0% target, this is a signal that the monetary policy should be accommodative – interest rates should stay at low levels. The opposite is also valuable. However, drafting a monetary policy is not a mechanical process. Monetary policy decision-making considers the reasons for the deviations of inflation from target, and the time needed for the economy to react against changes in interest rates.

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

The Monetary Policy Report is published on a quarterly basis. This Report is compiled by the Monetary Policy Department at the Bank of Albania and it is adopted by the Supervisory Council. The current report contains data, as 21 April 2023. The Supervisory Council reviewed and adopted this Report at its meeting on 2 August 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 economic developments in the first six months have been, overall, in line with our expectations. Inflation progressively declined meanwhile economic activity, employment and wages continued to grow, while the country's overall economic and financial equilibriums improved.

This is a positive development, especially in the context of the challenges we have faced as a result of the new economic reality that Russia's military aggression against Ukraine has created. Albania has had and continues to have one of the lowest rates of inflation and one of the highest rates of economic growth in the region.

This progress has reflected the flexibility of the private sector, the financial soundness of the economy, as well as the appropriate response of economic policies. In particular, in line with our legal goal, we have started a gradual and controlled normalization of our monetary policy stance. This process - formatted as a gradual increase of the policy interest rate towards its equilibrium level - aimed to create the appropriate conditions for the return of inflation to the target, within a reasonable time horizon and at the lowest possible costs for the Albanian economy.

Our monetary policy stance has also taken into account the rapid strengthening of the exchange rate of the lek against the euro and the fiscal consolidation by the public authorities. These factors have enabled us to maintain a lower level of the policy interest rate, providing lower financing costs for the Albanian economy, encouraging the expansion of consumption and investments and easing the financial burden on borrowers.

The insofar effects of our monetary policy are encouraging. The response of the monetary policy has helped to control inflationary expectations and has prevented the transmission of the external shock in the wage-inflation spiral, by creating the optimum premises for inflation to return to the target. At the same time, this reaction has helped the smooth functioning of financial markets and has maintained the positive trend of credit growth.

The forecast update suggests that the Albanian economy will continue to grow over the coming years, while inflation will return to our 3% target next year. This forecast factorises the further decrease of inflation in our trading partners, a more balanced development of demand and supply in the economy, as well as the strong exchange rate of the lek against the euro.

Based on the above, in the meeting on 2nd of August, we decided to keep the monetary policy stance unchanged.

However, our analysis shows that domestic inflationary pressures continue to be high. For this reason, we remain committed to work toward further normalising the stance of monetary policy in the future, if new data will make this action necessary.

As usual, we will make sure to reduce, as much as possible, the negative impact of our monetary policy on the economic activity and financial stability of the country. In particular, our monetary policy stance will continue to take into account the dynamics of the exchange rate and the stance of the fiscal policy, aiming to provide the best monetary conditions for the sustainable and long-term development of the country.

1. INFLATION AND MONETARY POLICY STANCE

The Supervisory Council decided to keep the key interest rate unchanged, at 3%, in the meeting held on 2 August 2023. This decision factorized the reduction of inflation in Albania and abroad, the projections for its progress in the future, the insofar pass-through of the monetary policy stance normalization, the expected direction of fiscal policy and the strengthening of the exchange rate of the lek against the euro.

According to our projections, inflation is expected to return to target in mid-2024. Currently, the monetary conditions are considered suitable for the materialization of this forecast. Future monetary policy decisions will be driven by the available data, but they will always be in line and consistent with our price stability objective.

Inflation and global economic growth have slowed down in 2023 H1. Inflation fell relatively fast, driven by the decrease in the energy prices and the high comparative base effect with of a year earlier. Meanwhile, the domestic inflationary pressures generated by the high demand for goods and services and the shortages in the labour market remain strong, being reflected in high levels of both services and core inflation. These trends are expected to be present during the upcoming quarters as well. In particular, the pressures generated by strong labour markets require the continuation of the tightening of monetary policy. After raising the key interest rate to 4.0% in June, the European Central Bank (ECB) committed to another hike at its next meeting.

Inflation in the country fell considerably during the first half of the year, but it remains above the 3% target. Annual inflation in the second quarter was 4.6%, from 6.5% in the previous quarter. The fall in inflation was broad-based, but it was faster in oil and processed food prices, as a result of the latter's decline in global markets and the exchange rate appreciation. On the other hand, inflation components more closely related to demand and labour market performance – such as services inflation, durable goods inflation, and core inflation – remained at high levels.

Despite the economic slowdown at the beginning of the year, the Albanian economy continues to be characterized by a relatively high demand for goods and services. Economic growth slowed to 2.7% in the first quarter, mostly affected by the reduction in the construction and industrial activity. From the viewpoint of demand, household consumption and investment slowed down, returning back to historical growth rates, while tourism exports followed the accelerating trend of the past two years. From the macroeconomic perspective, economic growth continues to be supported by the sound financial balances of the private sector, the rapid growth of tourism, the still easing monetary conditions, the high levels of confidence from households and enterprises, as well as the positive performance of the labour market. Indirect data suggest faster economic growth in the upcoming quarters.

Expanded demand for goods and services continues to face difficulties in being accommodated by the labour market. Employment growth continues at high rates and the unemployment rate fluctuates close to its historically low levels. In the first quarter, it stood at 10.9% from 10.8% at the end of 2022. Wages continued to grow this beginning of the year, albeit at a slower pace. After increasing by 14.2% at the end of 2022, private sector wages rose by 9.5% in the first quarter. The lack of labour force continues to be reported by enterprises as a restrictive factor for the expansion of the activity.

The increase in the policy rate since last March is being transmitted in the financial markets. Despite short-term fluctuations, interest rates on government securities, loans and deposits are higher compared with the previous year. At the same time, the appreciation of the exchange rate of the lek against the euro has increased, reflecting the significant improvement of the external sector of the economy[2].

Bank loans continued to finance the private sector expenditures, albeit at lower rates. Credit volume to this sector slowed to 8.1% in the second quarter, from 8.7% at the beginning of the year and 12.3% at the end of 2022. The slowdown has been broad-based, but more even in the households segment and more fluctuating in the enterprises segment, mainly reflecting the short-term liquidity needs. We expect a further expansion of lending, in line with the growth rates of the economy and supported by the good soundness of the banking sector.

Forecasts for the future speak of increased economic activity and further reduction of inflation over the next two years.

Economic growth is expected to be slower during 2023, reflecting the weakening of the economy in the euro area, the reduction of monetary stimulus and fiscal consolidation. On the other hand, the expected increase in employment and wages, the reduced inflation and high levels of confidence are expected to support households' revenues and consumption. At the same time, the increase in consumer demand, a still favourable financing environment and the reduction of uncertainty are expected to support the enterprises revenues and their investments. By sector, economic growth is expected to continue with a relatively broad base where, in particular, the good performance of tourism is expected to support the related sectors.

[2] *An analysis dedicated to the reasons for the appreciation of the exchange rate and its implications is provided in Box 2 "Strengthening of the exchange rate and its impact on the economy".*

Inflation is expected to subside during 2023 and return to the 3.0% target in 2024. The slowdown of inflation is expected to be driven, initially, by falling prices in global markets, related base effects and exchange rate appreciation. In a longer time horizon, the normalization of monetary policy and the establishment of a fairer ratio between demand and supply in the economy are expected to reduce domestic inflationary pressures, thus enabling inflation to return to the target.

Forecasts in baseline scenario are surrounded by risks from both sides. In particular, an increase in wages not supported by productivity or higher global inflation compared to current expectations would be factors with an increasing impact on inflation. Conversely, a slower economic growth and stronger fiscal consolidation would generate lower inflation levels in regard to our expectations.

In congruence with the analysis and the forecasts outlined in this report, the Supervisory Council decided to keep its monetary policy stance unchanged. The Supervisory Council has assessed that monetary conditions are adequate for a sustainable return of inflation to the target by 2024. This decision factorizes the reduction of inflation and expectations in the future and the continuous monitoring of the normalization of monetary policy stance in the financial markets.

Future monetary policy decisions will continue to rely on new data and updated projections of inflation and economic developments. For this purpose, the Bank of Albania will continue monitoring the situation.

2. EXTERNAL ECONOMIC ENVIRONMENT

The economic activity of trading partner countries is expected to expand slowly during 2023, while uncertainties about future developments are high. The economic growth in the euro area slowed in 2023 Q1, while indirect data point to a slight improvement in the second quarter. Economic growth in 2023 is expected to be weak, reflecting still high prices and tight financial conditions.

The decrease in energy prices has brought down inflation, but core inflation remains stable and at high rates. This has led to the continuation of interest rate increases by the ECB, with the aim of slowing down consumption. Interest rates are expected to be high for a longer time than initial expectations, until the tightening of financial conditions provides the expected effects on inflation.

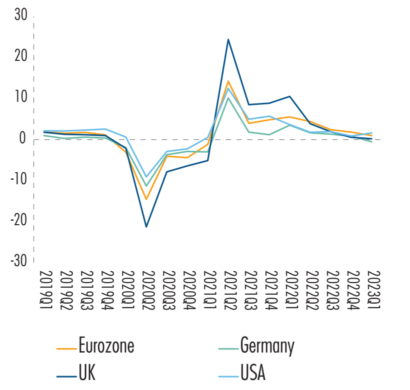
2.1. ECONOMIC GROWTH

The global economic activity improved in 2023 Q1, albeit not evenly across regions. Emerging-market economies experienced higher growth rates, thanks to China's economy reopening from pandemic restrictions. Advanced economies experienced a slowdown of the economic growth pace. Economic activity was mainly supported by the services sector, while the manufacturing sector exhibited weak performance. Indirect data for the second quarter show positive but slower growth of the economic activity. This performance continues to be affected by the consequences of Russia's attack on Ukraine, associated with pressures on prices, the rapid normalization of monetary policy stance, the withdrawal of fiscal incentives and the slowdown of private consumption and investments. Survey on enterprises in June show that the manufacturing sector is still suffering from the effect of high prices and inventories, while the services sector is also slowing down, especially in emerging-market economies.

Inflationary pressures from energy prices and cost of transport have eased and inflation rates have declined. However, core inflation remains stable and at high levels. The labour market remains relatively solid, and advanced economies recorded increase in employment and growth in nominal wages. Central banks have continued to tighten monetary policy, in some cases beyond initial expectations. Financing conditions for the economy tightened and are slowly curbing consumption demand.

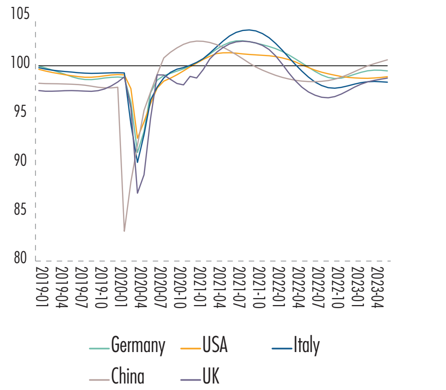
Chart 1

Global economic activity slowed the growth momentum in the fourth quarter



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

The leading indicator of economy has contained the deterioration



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

Forecasts for the future show that the world economy will register low growth rates during the current year, especially in advanced economies. The growth dynamic is expected to decline gradually until the end of year 2023.

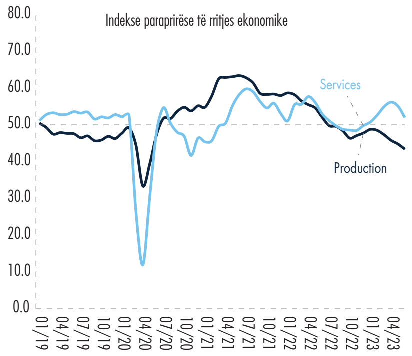
EURO AREA ECONOMY

The euro area economy shrank by 0.1% for the second consecutive quarter, marking a technical recession in 2023 Q1. The situation was very different within the member countries, where the contraction of the region was mainly affected by the poor performance of the German economy. The quarterly decline of the activity was dictated by the contraction of consumer and government spending as well as the fall in inventories. Net exports and total investments contributed positively to the quarterly change of GDP. The annual GPD growth pace was positive, at around 1.3%. Indirect data from the second quarter indicate a slight economic growth, led by the services sector. The latter has recovered after the removal of restrictive measures due to the pandemic and it has been reflected in high inflation rates for this sector. The surveys on the economy for June show that this positive momentum is getting weaker and that high prices and the tightening financial conditions will weigh on consumption and investments.

The inflation rate declined to 5.5% in June from 6.9% in March, thanks to the drop in energy prices. Food prices continue to have a positive, though more subdued, impact on inflation. On the other hand, core inflation has slowly declined and remains high, at 5.5% in June from 5.7% in March. This performance largely reflects inflationary pressures from the labour market, where the unemployment rate of 5.9% in May stands at its historical low level, and the wage growth rate at the highest level in a decade. The latter have triggered the decisions of the European Central Bank (ECB) to continue with the increase of the policy rate and the tightening of monetary conditions. Interest rates on loans increased and lending to the economy slowed down. However, according to the assessment by the ECB, the transmission of its decisions in the economy is not yet complete and will be more obvious in the upcoming quarters.

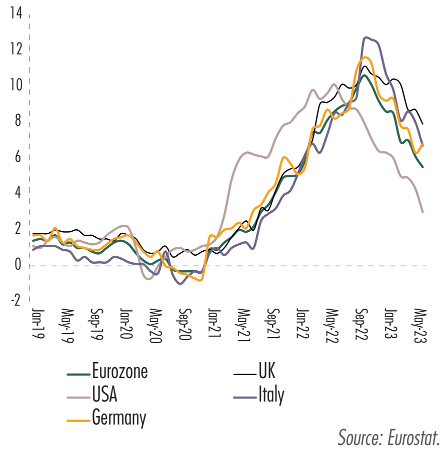
Chart 2

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



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

Inflation has been declining since the end of last year.



Source: Eurostat.

The ECB foresees a weak growth of the economy for 2023, influenced by the tightening of financing conditions and high uncertainties. The inflation rate is expected to follow a downward trajectory, but will remain above the ECB's target level of 2.0% during 2024 as well.[3] Uncertainties in regard to these expectations are high. Intensification of geopolitical conflicts, tight monetary conditions or a stronger than expected labour market may bring different outcomes.

REGIONAL ECONOMIES[4]

The economies of Kosovo, North Macedonia and Serbia have recorded higher annual growth rates in the first quarter of 2023, compared to the previous quarter. Economic growth was mainly driven by net exports and the recovery of private investment. Private consumption slowed down significantly, and it also contracted in Serbia. Also, public spending declined in all three neighbouring countries, partially reflecting the withdrawal of government support measures during the pandemic.

Employment rates increased, while the unemployment rate remains at lower levels compared to a year ago. Inflation slowed down during the second quarter in every country, impacted by lower prices of energy and food items. However, it remains above the banks' targets, urging the latter to stay on the upward trajectory of policy rates.

[3] *Euro system staff projections for the economy foresee a growth by 0.9% in 2023 and 1.4% in 2024. Average inflation for 2023 is expected to stand at 5.4%, and that for 2024 at 3.0% (Euro system staff macroeconomic projections, June 2023).*

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

Economic activity in these countries is expected to slow down during 2023, driven by expectations of lower economic growth in the euro area, as the region's main trading partner, and expectations for a slowdown in consumption. Inflation rates are expected to decrease during 2023, reflecting the stability of prices in international markets and the tightening of financial conditions.

Table 1 Economic indicators for main trading partner countries

	Annual change of GDP p.p		Annual inflation (%)		Unemployment, in %
	2022 Q4	Q1 2023	March '23	June '23	2023 Q1
Italy	1.4	1.9	7.6	6.7	7.6*
Greece	4.8	2.1	4.6	2.7	10.8*
Kosovo	3.6	3.9	7.6	2.8	16.6**
North Macedonia	0.6	2.1	14.7	9.3	13.4
Serbia	0.4	0.7	16.2	13.7	10.1
Albania	4.7	2.7	5.3	4.5	10.9

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 continued trending downwards in 2023 Q2, driven by the eased pressures on transport routes, expectations for a slowdown in the economic activity, as well as improved supply for some goods. The price index of commodities, in June, as measured by the WB has shrunk by 7% from March and by about 37% from the previous year. Energy commodity prices are the ones that declined at a faster pace, correcting part of the immediate increase they experienced after the start of the war in Ukraine. The Brent oil price registered $75 per barrel in June, or 39% cheaper compared to the previous year. The electricity power price was 96 Euro/MWh at the Hungarian Power Exchange[5], or 59% lower from the previous year.

The drop in oil prices has been reflected in the reduction of food production costs and their prices. The decline of the latter was also favoured by a good harvest season. The food price index has decreased by about 15% compared to the previous year. However, food prices continue to remain relatively high. The index of metal prices also continued to decline in the second quarter, influenced by expectations for a slowdown in investment.

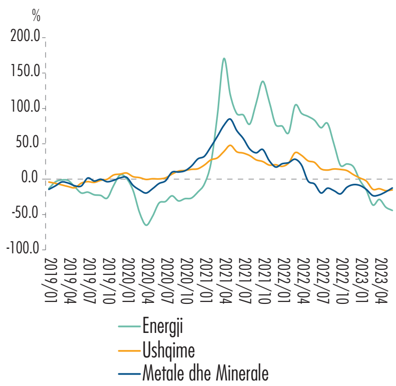
Falling oil prices have driven the downward trend in inflation in most countries. The Brent oil price is expected to remain on a slightly upward trajectory, around the average level of $79/barrel for the rest of 2023, influenced by the reduction of production quotas by OPEC.[6] However, uncertainties regarding the performance of oil prices and other commodities items increased in the short term. The conclusion of the agreement with Russia for the transportation of grain

[5] *Hungarian Power Exchange (HUPX), energy prices in basic profile.*
[6] *US Energy Information Administration, Short term energy Outlook, June 2023.*

from Ukraine in July has increased the uncertainty regarding a price increase of these goods. Also, measures taken to stimulate the economic activity in China, one of the main contributors to the demand for commodities goods could further shift their prices.

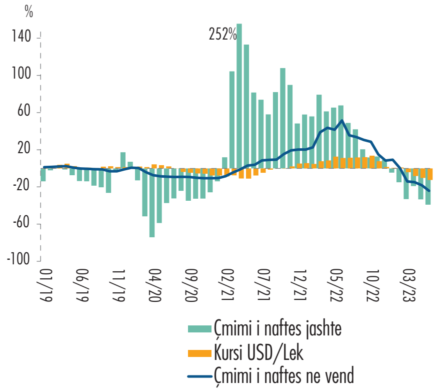
Chart 3

Commodity prices across international markets have reduced from a year ago.



Note: 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.



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

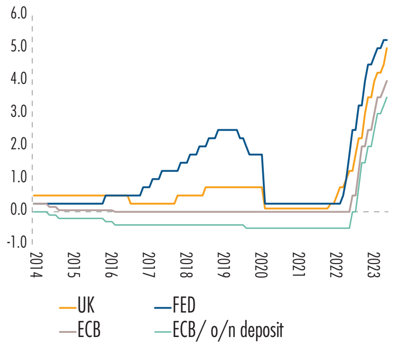
2.3. GLOBAL FINANCIAL MARKETS

Financial conditions in international markets continued to tighten, reflecting the tightening policy of central banks and information on the sustainability of inflationary pressures. Central banks raised interest rates more than initially announced, causing traders to expect a higher interest rate environment for a longer period of time.

Although inflation rates are downward, core inflation remains at relatively high levels. Stable inflationary pressures from the services sector and the labour market have incited central banks to continue raising policy interest rates consecutively in the second quarter. The ECB has twice increased the policy rate by 0.25 percentage point, reaching at 4.00% in June. The Bank of England has also increased the policy rate twice by 0.50 percentage point, reaching 5.00%; while the Federal Reserve increased the policy rate by 0.25 percentage points in May, at 5.00%-5.25%. They have notified us that the cycle of interest rate increases has not ended, as long as they estimate that inflationary pressures remain high. The ECB has announced that it will stop the reinvestment of securities under the asset purchase program, as an instrument to strengthen the tightening of its monetary policy.

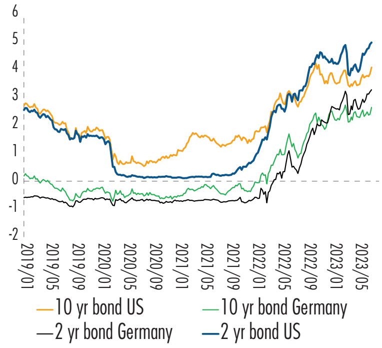
Chart 4

Central banks have continued to raise the key interest rate aiming at curbing the persistent 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, especially in the short term of maturity. Markets expects interest rates to be high in 2023.



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

The monetary policy pursued by central banks has caused tighter financial conditions in the economy. Public and private bond yields continued to increase in the second quarter, especially for short-term maturities. Slower inflation rates and the pas-through of higher interest rates to slowing economic activity suggest that inflationary pressures are weakening, and that interest rates may be close to their maximum in this tightening monetary policy cycle. This has been reflected in a more moderate increase in long-term interest rates.

3. FINANCIAL MARKETS AND LENDING CONDITIONS

The financial market continues to reflect the normalization of the monetary policy stance, simultaneously displaying controlled and decreasing risk premiums. In the primary market of government securities, high investors' demand has led to further declines in yields. The interest rate on loans in lek increased for enterprises and remained stable for households. Their slow reaction reflects both the slow rise in banks' funding costs and the market's perception of a reduction in overall risk premia. On the other hand, the foreign exchange market has experienced intensification of appreciation pressures on the domestic currency, as a result of high foreign currency inflows into the economy.

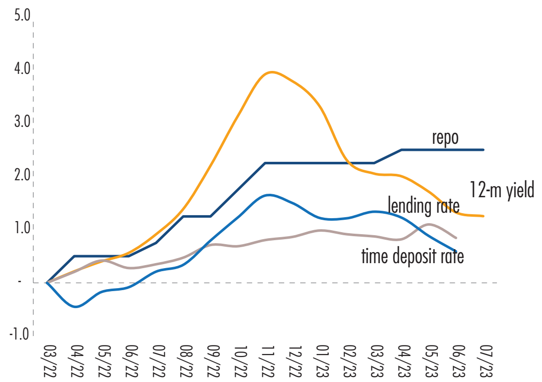
Credit growth rates for the private sector continued to decrease in the second quarter. This slowdown has reflected the performance of loans in foreign currency, while loans in lek appear to be improving, as a result of the spread narrowing between the interest rates of loans in lek and in the euro. Deposits continue to grow at high rates, reflecting - mostly - the increase in foreign currency deposits, in response to the expansion of foreign currency inflows in Albania.

3.1. DOMESTIC FINANCIAL MARKET[7]

Transmission of monetary policy signals to the interest rates in the financial market continues, but at a different extent and speed by its segments. Transmission is complete in the interbank market, while yields have moved in the opposite direction to the policy interest rate in recent months, reflecting the high demand for investment in government securities. On the other hand, the increase of interest rates on time deposits continues to be slow. Both factors have dictated the slow response of loan interest rates in the short run.

Chart 5

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



Note: Cumulative changes of interest rates in lek since March 2022: repo, 12-month T-Bills, time deposits and loans, the last two are 3-month moving averages.
Source: Bank of Albania.

Interbank market is characterised by stable interest rates and low liquidity premia. The interest rates required by banks in the exchange of funds between them have shown minimal differences from the policy rate and low volatility.

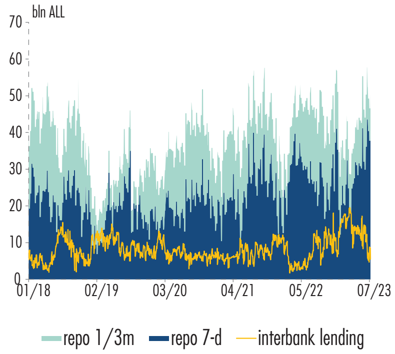
The Bank of Albania has continued to carry out regular liquidity injections operations through its main instrument, the one-week repo. In addition the injections through the three-month maturity repo are used as well. The amount injected during this quarter has been increasing compared to the first quarter

[7] *The following analysis is based on the data available up to 21 July 2023.*

of the year, but still remains at suitable levels for the transmission of monetary policy signals to the market and the overall performance of liquidity premia.

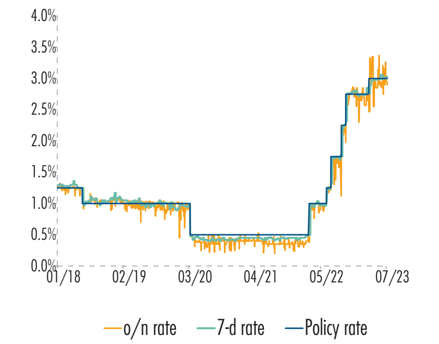
Chart 6

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



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

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

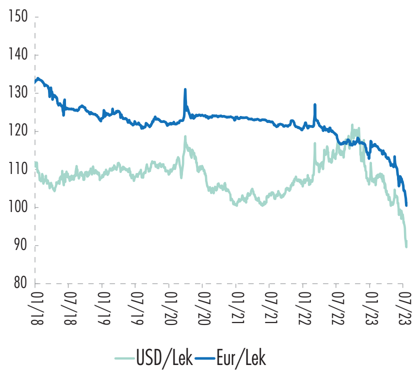


Note: Data show the daily performance of interest rates in the interbank market, in addition to the policy rate and overnight deposit and loan rates.
Source: Bank of Albania

In the foreign exchange market, the appreciating pressures of the exchange rate on the lek intensified in the second quarter, while trading conditions remain broadly within the normal parameters. The euro/lek exchange rate dropped to an average of 107.3 in June, from 115.5 in the first quarter of the year. In the first three weeks of July, the appreciation of the lek accelerated further, where one euro was quoted averagely by 103.3 lek, or 12.0% less than in the previous year.

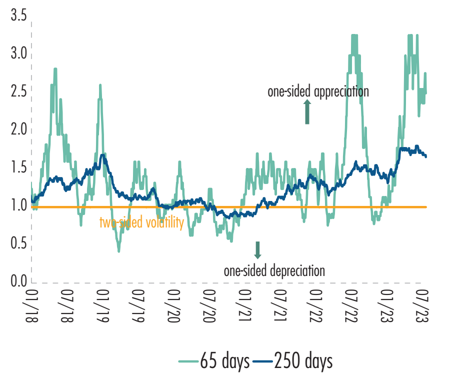
Chart 7

The lek has been significantly appreciated in the second quarter of the year...



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

...reflecting strong intensification of appreciating pressures during this period

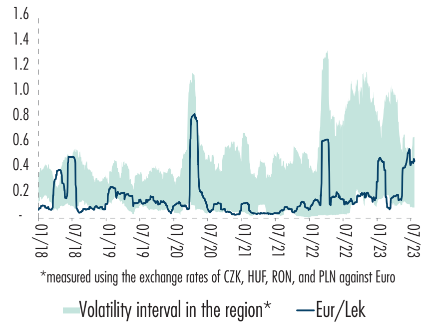


Notes: The data present the indicator of bias for appreciation/depreciation.
Source: Bank of Albania

The performance of the bias indicator[8] evidences appreciation pressures in the foreign exchange market since last year and their intensification during this year, in particular, after March. This development reflects the increased supply of foreign currency in the market, closely related to the high flows of tourism, remittances and foreign direct investments. It is worth noting that, despite the increase in lek appreciation rate, trading conditions in the foreign exchange market remain stable, showing no evidence of the impact of speculative factors or portfolio shifts on the performance of the exchange rate. Although the pace with which the lek is strengthening causes increased exchange rate volatility, the latter remains within the range of countries in the region that implement a floating exchange rate regime. At the same time, the spreads between bid and ask quotas have not shown significant deviations from their average, except for sporadic cases, mainly in June and July.

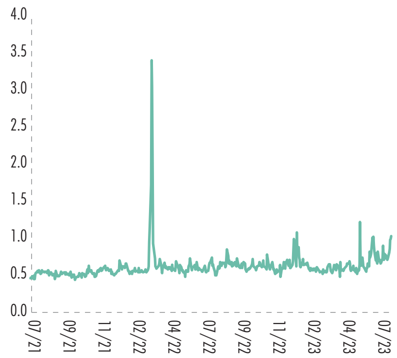
Chart 8

The euro/lek exchange rate volatility remains within the range of countries in the region



Note: The chart shows the volatility of the EUR/LEK exchange rate, measured as a 22-day standard deviation, where the interval for the region is determined by the volatility of the exchange rates against the euro for the currencies of the Czech Republic, Hungary, Poland, Romania and Serbia.
Source: Bank of Albania and respective central banks.

The bid-ask spread, have has not shifted much from its average



Notes: The chart shows the spread between the quotations of the bid/ask price of euro
Source: Bank of Albania

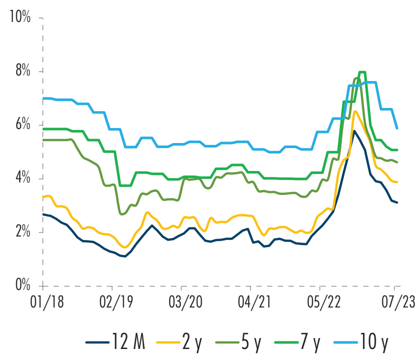
The appreciation of the lek against the euro has also determined its strengthening against the other currencies. Thus, the value of the US dollar decreased averagely at ALL 93.5 in the first three weeks of July, down by 18.9% compared to July in the previous year. In addition to the appreciation of the lek against the euro, this trend has also reflected the depreciation of the US dollar against the latter in the international market (7.8% in the first three weeks of July compared to the previous year).

[8] *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).*

In the primary market of Government' debt securities, yields on T-bills and bonds in average terms continue the downward trend which began at the end of the last year. The 12-month bond yield was 3.1% at the last auction in July, down by 0.7 p.p. compared with at the end of April. The decrease in bond yields has also been at similar levels in these three months. 12-month yield spreads with the policy rate reached the historical lows in recent auctions, confirming strong downward pressures on yields these months. The reduction in yields is mainly determined by the huge competing demands of investors. The ratio between their demand and the government's offer remains high even in the second quarter[9]. Overall yields decreased, but this decline was more pronounced for the 12-month yield. With expected time delays, it is then transferred to long-term maturities. Bond yields decreased averagely by 0.40 p.p. compared with the first quarter. The yield curve has reflected these developments by decreasing its level compared to the first quarter of the year. It remains higher when compared to the previous year, but it is flatter, as a result of the higher demand in medium and long term maturities and the largest decrease in these yields.

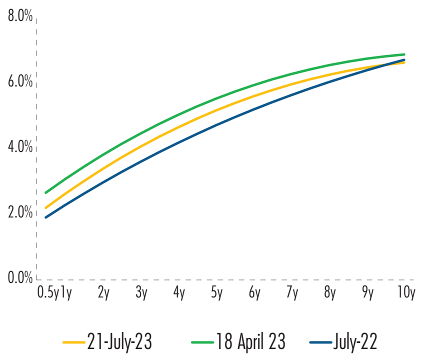
Chart 9

Yields in the primary market have continued the downward trend in the second quarter



Note: 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 remained close to that of April



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

3.2. LENDING CONDITIONS

Lek credit interest rates have shown a partial pass-through of monetary policy signals in recent months. With the very gradual increase of the deposit interest rate, cost pressures for banks have remained weak, determining a slow transmission to loan interest rates. Both rates are currently around 0.9 percentage point higher compared to their levels in 2020-2021. On the other hand, although the amplitude of the change in yields and their volatility is not fully transmitted to the loan interest rates, the fact that the risk-free rate of return in the economy has decreased in the last six months has kept pressures low in regard to their growth during this period.

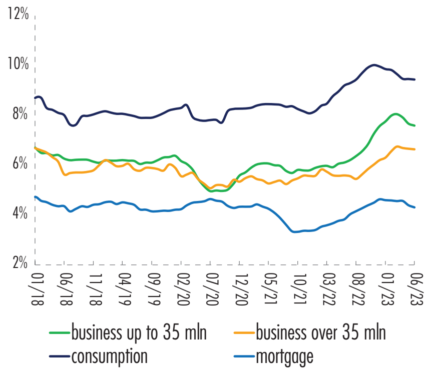
[9] *The bid/cover ratio in primary market auctions from December 2022 fluctuates in the range of 1.5-1.7 from 0.9 that was averaged in the first 11 months of 2022.*

The interest on new loans in lek to enterprises was 6.5% in the second quarter, from averagely at 7.3% in the previous quarter. Its decline is noticeable across all sizes of loan, but mainly in medium-sized loans. Compared to 2021, before the start of the normalization of the monetary policy, the interest rates are 1.4 percentage point, 1.2 percentage point and 0.6 percentage point higher, for small loans (up to ALL 35 million), medium-sized loans (ALL 35- 140 million) and large ones (over ALL150 million), respectively

During the quarter under review, interest rates on loans **to households** fluctuated close to the average levels of the first quarter of the year. The interest rate on mortgage loans and consumer loans stood at 4.3% and 9.4%, respectively. Compared to 2021, the current level of these rates is respectively 1.2 percentage point and 0.5 percentage points higher.

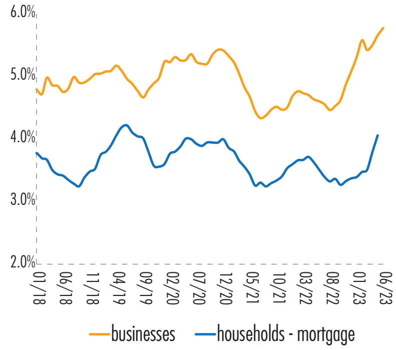
Chart 10

The interest rate on loans in lek increased for enterprises and remained stable for households



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

Loans in euro are increasing considerably



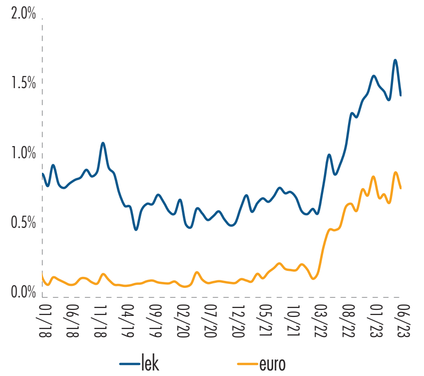
Note: The data indicate the interest rates of new loans in euro in %; 6-months moving average.
Source: Bank of Albania

Interest rates on loans in euro increased rapidly during the recent months, following the increase in reference rates in the international market[10]. The average interest rate on new loans in euro **to enterprises** averaged 6.1% in the second quarter, from 5.4% in the previous two quarters. The increase in interest rates has been more pronounced for small loans (up to EUR 250.000) and medium-sized loans (250.000 up to EUR 1 million). Compared to last year, the average interest rate on loans in euro to enterprises is about 1.3 percentage points higher. In the second quarter, the increase in the interest rate on mortgage loans in euro **to households** is more pronounced. Compared to the average of the first quarter of this year and the previous year, it increased by 1.4 percentage points, reaching 5.0%. The spreads between the interests of loans in lek and those of loans in euro have narrowed significantly, as a result of the rapid growth of the latter.

[10] *Specifically, the 12-month Eurobor rate reached 4.0% in June, from 0.29% in the same month of the previous month.*

Chart 11

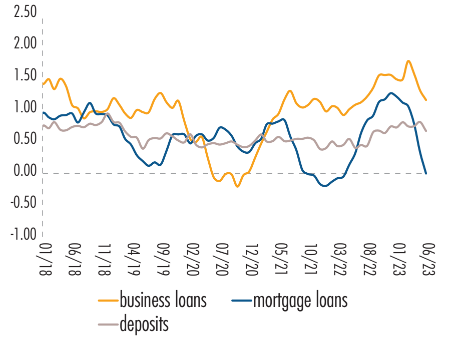
Interest rates for term deposits remained stable in the second quarter of the year



Note: The data show the interest rate applied on new lek and euro time deposits, in %

Source: Bank of Albania

The interest spread between loans in lek and loans in Euro narrowed significantly this quarter, especially for mortgage loans



Note: The data show the spread between the interest rates in lek and loans in Euro, in percentage points, for: business loans, mortgage loans and deposits.

Source: Bank of Albania

The average **interest rate on time deposits in lek** remained stable in the second quarter of the year, at 1.5%. The average interest rate for time deposits **in euro** stood at 0.8%. The spread between interest rate in lek and euro for deposits stands at 0.7 percentage points for three consecutive quarters, from the average of 0.5 percentage point in 2020, 2021 and 2022 H1.

BOX 1: SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2023 Q2[1]

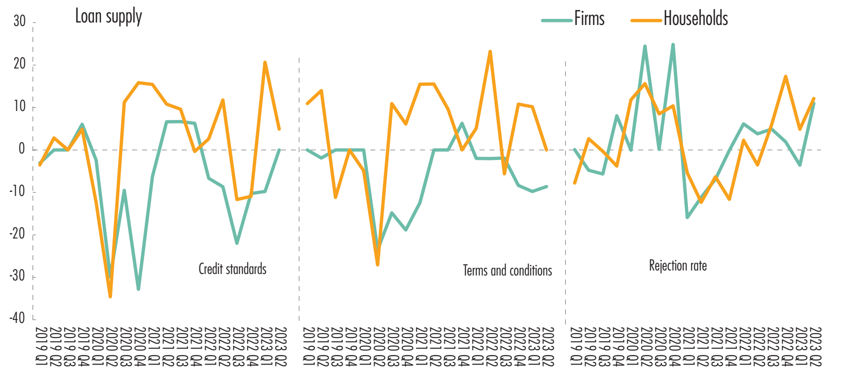
In 2023 Q2, the overall terms of credit supply had a differentiated performance according to economic agents, while loan demand expanded on a broad basis.

Credit standards on new loans to enterprises aimed at expanding investment capacities and covering the needs for working capital and inventories creation, remained unchanged in the second quarter, after tightening for five consecutive quarters. Lower costs of funds and balance sheets constraints favoured the lending policies applied by banks to enterprises in this quarter. On the other hand, banks remained reluctant to expand the band of tolerance toward risk, which they perceive to be still present in the domestic economy. In the spirit of prudence, banks tightened the terms and conditions on loans to enterprises, for the sixth consecutive quarter, through the increase of margins, as well as through higher loan covenants with enterprises. In addition, the higher loan rejection rate reported by banks, reflects their added caution.

Lending policies to households were more favourable, expressed with easier credit standards, for the second quarter in a raw. Pressure from high competition was reported as the key factor that drove banks to implement eased lending policies to households in this quarter. On the other hand, although the overall lending terms and conditions were reported unchanged, some banks showed initiatives to reduce margins, mainly on the back of rapidly elevated reference rates on loans denominated in foreign currency. Banks reported an increased rejected loan ratio to the total loan applications for households in this quarter.

Chart 1 Box 1

Credit conditions contracted for enterprises and eased for households



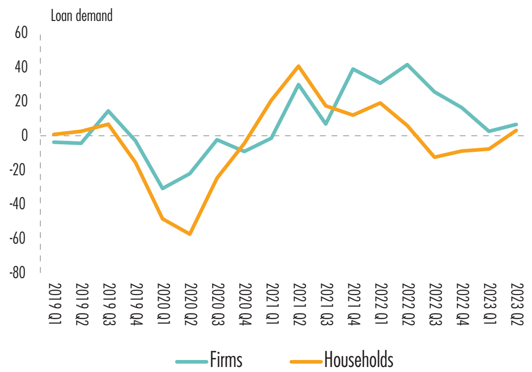
Source: Bank of Albania

Values in chart represent net balances. Positive values indicate easing of terms and conditions and vice versa. Positive values indicate increase of the scale of application refusal and vice-versa.

Banks reported a higher loan demand from both enterprises and households. Enterprises' demand for loans, unlike the previous quarter, was oriented only toward financing working capital and creating or adding inventories. On the other hand, the increase in loans demand from households was broad-based, for both consumption and house purchase financing.

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.

[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[11]

Bank financing to the private sector increased by an average of 8.1% during the second quarter, 0.6 percentage point lower than the annual growth of the first quarter. This slowdown has been observed in both enterprises and households. Developments by currencies show developments in opposite directions of lending in lek and in foreign currency. Thus, the growth rate of the loan portfolio in the domestic currency accelerated to 7.1% in June, or 3 percentage points more than the lowest level recorded in February. The improvement has been led by the return of financing to cover short-term needs for both enterprises and households from banks. Meanwhile, lending in foreign currency has maintained the slowing trend of the beginning of the year. The annual rate of this portfolio reached 10.3% or 5 percentage points less than at

[11] *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.*

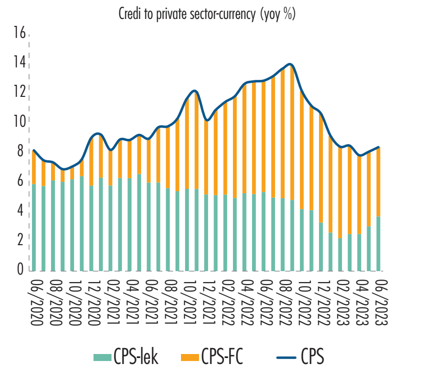
the end of 2022. Also, the recovery of the demand for financing in lek reflects the rapid narrowing of the spread between the interest rates of loans in lek and loans in euro.

Loans to enterprises increased by an average of 5% in the second quarter, slowing down by 0.4 percentage point less compared to the previous quarter. Developments within the main segments show that higher rates of credit growth for liquidity have somewhat offset the further slowdown of loans for investment. Thus, the loan for liquidity increased on average by 6.8% compared to 6.1% in the first quarter. Meanwhile, investment credit increased by 3.8% or 1 percentage point less than in the first quarter. The expansion of credit has been observed mostly in enterprises which exercise their activity in the trade and accommodation sector, in the service sector and in the construction sector.

Loans to households has continued to slow down at a steady rate. The portfolio growth rate of 13.4% was about 1 percentage point less than in the first quarter. This slowdown has reflected the lower growth rates of house purchase loans by 2 percentage points, to 15.2%. While loans for consumption showed a slight improvement - especially during May - June, increasing by 9%. According to the currencies within this portfolio, lending in lek improved, while loans in foreign currency slowed down. This trend reflects the return of attention towards lending in the domestic currency, influenced by the opposite movements of interest rates in financing products for this segment.

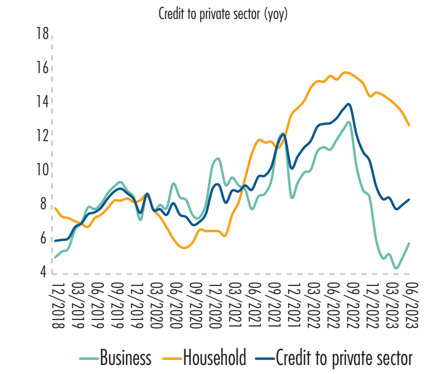
Chart 12

Credit to the private sector slowed down, due to the decline in the growth rates of the foreign currency 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 slowdown in lending to both enterprises and households

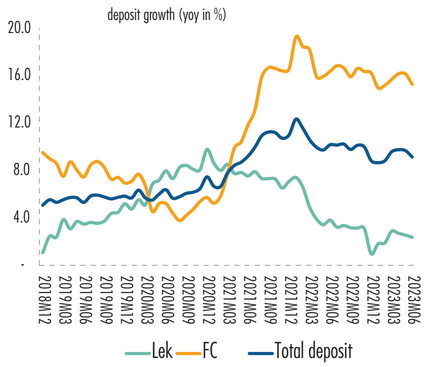


Notes: The data show the annual changes (in %) of credit adjusted for exchange rate effects and written-off loans from the balance sheets.
Source: Bank of Albania

Bank deposits continued to grow at stable rates in the second quarter. Thus, compared to the previous year, they were about 9.5% higher, or 0.5 percentage point more than in the first quarter. Deposits in foreign currency have contributed mostly to this expansion, but at the same time deposits in lek have been improving. Thus, the annual growth rates of deposits in foreign currency and those in lek improved to 15.9% and by 2.6%, respectively. Developments picture according to currencies has remained unchanged for more than a year, influenced by the high presence of foreign currency funds that are deposited in banks. On the other hand, the moderate levels of increase in lek deposits reflect both fiscal consolidation and the increased preference to invest savings in government securities.

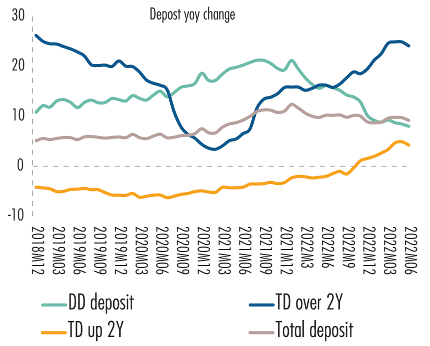
Chart 13

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, in %, adjusted by exchange rate fluctuations.
Source: Bank of Albania

The structure of deposits by maturity shows that the trend towards time deposits has continued in the second quarter, despite the fact that interest rates have changed very little to support this trend. Demand deposits slowed down their growth rates to 8.4%, while time deposits continued their double-digit growth with 11.1%. The ratio of the latter to total deposits reached 41.5% or 1.5 percentage point more than at the end of 2022. Meanwhile, the second quarter was characterized by a stronger improvement in the enterprises' deposits compared to those of households' deposits. Thus reflecting the good liquidity and in general the improvement of their financial condition.

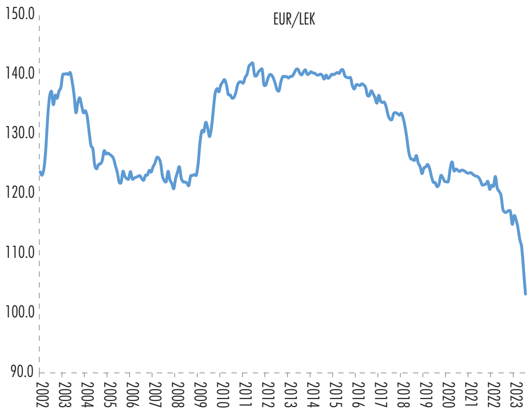
BOX 1 THE STRENGTHENING OF THE EXCHANGE RATE AND THE IMPACT ON THE ECONOMY

The exchange rate of the lek against the euro experienced a rapid decline during 2023, leading to an appreciation of the lek exchange rate against the main foreign currencies. In July, the exchange rate of the lek against the euro was 12.1% stronger compared to a year ago, while the exchange rate itself dropped to the average level of 103.2 lek/euro. Naturally, given the fact that Albania is a small, open economy with a relatively high level of euro use in its financial system, this development has been in the focus of economic analysts and the public.

This box aims to reflect the Bank of Albania's point of view on the reasons for the appreciation of the exchange rate and its consequences, as well as to discuss the Bank of Albania's behaviour so far. Following, the first section provides a summary of the lek exchange rate history against the euro in Albania, the second section reflects the conclusions of our analysis on the reasons for the appreciation of the exchange rate, the third section delineates the consequences of the exchange rate appreciation, while the response of the Bank of Albania in regard to this phenomenon is shown in the fourth section.

Chart 1 Box 2

The performance of the exchange rate during the last two decades (lek / euro)



Source: Bank of Albania

1. Historical performance of lek exchange rate against the euro

As a country with a floating exchange rate regime, the exchange ratio of our domestic currency against the euro has undergone significant fluctuations over the past two decades, which are shown in the chart below.

The performance of exchange rate has gone through the following chronological stages:

- *a relatively strong depreciation in 2002 – 2003. This period corresponds to the fluctuation in confidence and the withdrawal of a part of deposits from the Albanian banking sector;*
- *a correction of the exchange rate over the next two years, dictated by the return of deposits to the system and the restoration of confidence in our domestic currency;*
- *a period of stability during 2006 - 2009, around the level of 120-125 lek/euro;*
- *a significant weakening during 2009-2010, a period which coincides with the global financial crisis;*
- *a stabilization at high levels during 2011 - 2015, a period which coincides with the increase of risk premia across financial markets as a result of the sovereign debt crisis in the euro area;*
- *a slight appreciating trend during 2016 - 2019, a period which coincides with the improvement of the external balance of the Albanian economy;*
- *a stabilization around the level 120 ALL/euro during 2019-2021, a period which coincides with the pandemic; and,*
- *a faster appreciating trend over the last two years, a period characterized by a rapid improvement in the current account deficit. In the prospect of a longer term, the performance of the last two years looks like a continuation*

and acceleration of the appreciating trend of the lek that started in 2016 and was interrupted by the pandemic.

This chronological analysis shows that the performance of the exchange rate of the lek against the euro in the first decade was dictated - mostly - by financial shocks. In particular, the exchange rate has been weakened by negative financial shocks, of external or internal origin. On the contrary, the dynamics of the exchange rate during the recent years seems to be dictated - to the main extent - by the performance of the balance of external and financial trade, while public confidence in our domestic currency has been improving.

2. Which factors are affecting the appreciation of the lek exchange rate?

The Bank of Albania has a rich portfolio of models[1], which are used to assess the performance of the exchange rate and the nature of the underlying factors.

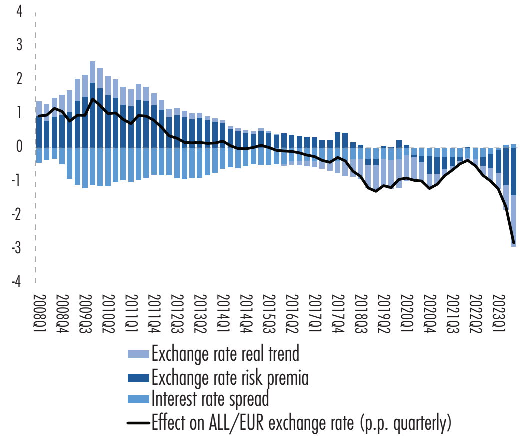
One of the theoretical frameworks that is broadly employed is the Uncovered Parity of Interest Rates (UIP). This estimation model, an integral part of our medium-term forecasting model, considers the performance of the nominal exchange rate as a function of several economic and financial variables. More specifically, these variables are:

- *The spread between the interest rates in lek and euro, respectively affected by the monetary policy of the Bank of Albania and that of the European Central Bank. An increase (decrease) in the spread between the return offered by financial instruments in lek compared to those in euro, would increase (decrease) the interest to save in lek and would result in an appreciation (depreciation) of the nominal exchange rate.*
- *The performance of required premia by investors, as compensation for the risk undertaken by investing in the currencies of less stabilized economies. For emerging economies in a convergence stage such as Albania, these risk premia tend to have positive values and act toward weakening the exchange rate. They are the reason why emerging economies tend to have higher interest rates than advanced economies. However, in practice, the performance of these premia fluctuates over time, dictated - among other things - by the phase of the business cycle and by factors of a transitory nature. In the context of our analysis, a decrease in risk premia leads to an appreciation of the exchange rate and, conversely, an increase in them leads to a depreciation.*
- *Finally, the trend of the lek real exchange rate. This variable takes into account the speed of convergence of the Albanian economy in terms of prices (and therefore productivity and income), with our main trading partner: the euro area. In theory, a faster convergence trend, supported by productivity growth and structural – i.e. sustainable – improvements in the external position of the economy, will be absorbed through the strengthening of the nominal exchange rate and not through a higher level of inflation.*

Using this logic and the available data, the performance history of the exchange rate of the lek against the euro is shown in the chart below.

Chart 2 Box 2

Current deficit and its components (left) and ratio of net FDI to current deficit (%, right)



Source: Bank of Albania

Focusing on the most recent period, this decomposition shows that the appreciation of the nominal exchange rate during the last quarters has mainly happened as a result of: (i) the strengthening of the real exchange rate trend, or – in other words – the structural improvement of the external sector of the economy and the overall growth of its productivity; and (ii) the decline of risk premia, or – in other words – the strengthening of public confidence in the domestic currency. In contrast, the interest rate spread had an increasingly lower impact on the performance of the exchange rate, which– for the first time in history – was able to have a depreciating impact on the exchange rate during the second quarter.

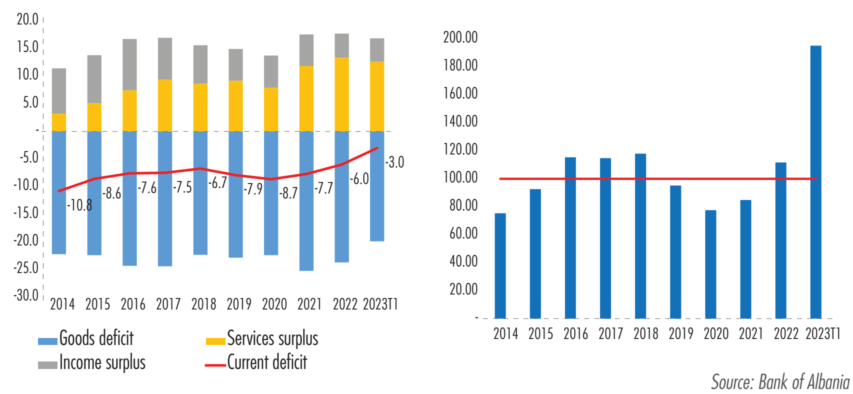
In light of the above analysis, the main reason for the rapid appreciation of the lek exchange rate is the dynamics of the real exchange rate trend and the reduction of risk premia. Both factors seem to be dictated by the structural improvement of the external balance of the Albanian economy, an improvement which is illustrated by several indicators:

- *The current account deficit had a significant downward trend during this period, from 7.7% of GDP in 2021 to 6.0% in 2022 and – further – to 3.1% in 2023 Q1. This improvement is dictated by the increase in foreign demand for Albanian tourism services. Tourism inflows reached at EUR 2.8 billion in 2022 and EUR 624 million in 2023 Q1, significantly accelerating the growth rates. At the same time, remittances have been increasing, providing a foreign currency inflow of around EUR 833.7 million in 2022 and EUR 213.7 million in the first quarter of the current year;*
- *Foreign Direct Investment (FDI) inflows reached historic high of EUR 1.3 billion in 2022, increasing by 33.0%, and remained high in the first quarter of 2023 as well (period covered by the official data).*
- *In the same line, and equally important, the current account deficit financing ratio has been upward. FDIs are more than sufficient to finance the entire current account deficit and result in a surplus of foreign currency in the market. In 2022, this ratio remained at 111.7%, while in 2023 Q1 it increased at 195.2%.*

These developments imply that foreign currency inflows in Albania have been higher than the outflows, leading to an outstanding foreign currency supply in

Chart 3 Box 2

The impact of the components of the UIP equation on the development of the lek/euro exchange rate



Source: Bank of Albania

Summarizing, the analysis suggests that the appreciated exchange rate direction is – overall – in line with the medium and long-term factors determining its performance. Despite its results do not exclude the deviation possibilities from the equilibrium levels; these deviations appear to be low and transitional up to 2023 Q2.

the market, which has created the premises for a continuous appreciation of the domestic currency.

Summarising: this analysis suggests that the appreciation of the exchange rate is – overall – in line with the medium- and long-term factors that determine its performance. Although its results do not exclude the possibility of deviations from equilibrium levels, these deviations appear to be small and transitory up to the second quarter of 2023.

3. The exchange rate impact on the economy

In light of the above conclusions, the impact of the exchange rate on the economy can be summarized as follows.

In macroeconomic terms, the appreciation of the lek provides its impact in several directions:

- *First, the appreciation of the exchange rate has been the main factor for the low rates of inflation in Albania, which have been and remain the lowest in the region, hence reducing the negative consequences of the foreign impact on the purchasing power of Albanian households. In parallel, the lower inflation rate dictated a slower normalization of monetary policy stance, keeping financing costs low and supporting the performance of consumption and investments in Albania.*

Our estimations suggest that in absence of the exchange rate appreciation in the last two years: the inflation rate would have been 2.2 p.p higher. The higher level of inflation would dictate a more aggressive normalization of the monetary policy stance than the one implemented by the Bank of Albania, by increasing financing costs for Albanian enterprises and households. In these circumstances, higher inflation and tighter financing conditions would have a restraining effect on economic activity. For 2022, the economic cost of this faster normalization of monetary policy would be ALL 32 billion (or more than 1% of GDP). For 2023, the additional economic cost of this normalization would be about ALL 60 billion, or more than 2.5% of GDP.

- *Second, the appreciation of the exchange rate has helped to strengthen financial stability, through the improvement of financial balances of borrowers in foreign currency and the positive effect on non-performing loans ratio, which remains at low levels.*
- *Third, the appreciation of the exchange rate has increased the stability of the foreign and public debt of the Albanian economy, indirectly helping to reduce the debt servicing and refinancing costs.*

Against this backdrop, in presence of strong inflationary pressures in international markets, the lek appreciation has helped to: safeguarding the purchasing power of Albanian households; maintaining low levels of interest rates and financing costs in the domestic currency; promoting consumption and investment; as well as supporting the country's financial stability.

By sector, although the exchange rate appreciation originates from the aggregate growth of the Albanian exports and the improvement of its external position, it has uneven consequences in the exporting sectors. Thus, while tourism is experiencing a positive impact of foreign demand, other exporting industries - and mainly those of goods - are facing a slowdown in the global demand for these products and an increase in costs due to the exchange rate appreciation.

These cross-sectoral divergences are ever-present in the economy. From a general viewpoint, they send signals for the redistribution of production resources – labour and capital – to the sectors which are more productive and offer the prospect of faster growth in the medium and long term. However, this process of restructuring the economy can be difficult in the presence of rapid exchange rate movements, requiring – potentially – the attention of public economic policies.

4. The response of the Bank of Albania

In accordance with its objective of price stability, the Bank of Albania implements a floating exchange rate regime. This regime implies that the exchange rate of the lek against foreign currencies is determined freely in the foreign exchange market, in accordance with the performance of demand and supply for foreign currency.

This regimen provides several advantages.

- *First, it enables the compilation of an independent monetary policy, oriented exclusively towards the objective of price stability. In the free regime, the role of the exchange rate is that of an automatic stabilizer against economic shocks. For example, in the presence of an increase in foreign demand for Albanian goods and services, as is the current case of the rapid increase in income from tourism, it enables the absorption of a part of the pressures that the increase in aggregate demand brings to the surge in prices through the appreciation of the exchange rate. In the absence of this mechanism, the central bank would have to intervene by increasing interest rates, bringing negative consequences on those sectors of the economy that serve the internal market and are not experiencing an increase in demand for their products. Likewise, in the absence of a floating exchange rate and an independent monetary policy, the Albanian economy would have a hard time facing negative shocks to production or demand, such as the earthquake in 2019 or the pandemic in 2020, which would yield longer-lasting and more severe crises.*
- *Second, the floating exchange rate offers better results for economies in the convergence phase, such as Albania, which have an appreciating trend of the real exchange rate, offering a more stable monetary environment. In the absence of this regime, these economies would ''pay'' for exchange rate stability through increased price volatilities and a higher inflation rate. Both of these factors would negatively affect households and the most vulnerable strata of society, such as pensioners and households in need, thus reducing the social welfare.*
- *Third, the floating exchange rate regime provides better results for those economies that have relatively stabilized financial markets.*

These economies, experience more real sector shocks compared with financial sector shocks and have the floating exchange rate as an additional instrument for their absorption. In this context, strengthening financial stability and reducing the frequency of financial crises provides an additional argument for the benefits that the floating exchange rate regime provides.

In accordance with this regime, the Bank of Albania has responded to the appreciation of the lek during the last quarters by applying a slower normalization of the monetary policy stance, the benefits of which regarding the macroeconomic aspect are elaborated above.

However, we always remain attentive to the performance of the exchange rate, especially in the presence of rapid fluctuations such as those of the last quarters, aiming to understand their reasons and consequences. This helps us in formulating the monetary policy stance and in meeting our price stability objective, with the lowest possible costs for the economy and society.

[1] *The results of some of the studies of the Bank of Albania have been published and discussed as papers dedicated to the exchange rate, or even as part of the papers that treat the exchange rate as an integral element of modelling.*

4. ECONOMIC GROWTH

In 2023 Q1, economic growth stood at 2.7%, lower than our expectations and the rate registered in the previous quarter. Economic growth was mainly driven by the service sector, underpinned by branches of "Entertainment", "Trade", and "Real estate", whereas the production sector, particularly "Construction", had a dampening effect. Domestic demand has continued to be the main promotor of growth, but the slowdown was reflected in both its key components: "Consumption of population" and "Investments". Public investments had the main contribution to investment growth, whereas private investments decelerated. Net exports continued to have a negative contribution, but the annual expansion of trade deficit in real terms slowed down compared to 2022 Q4.

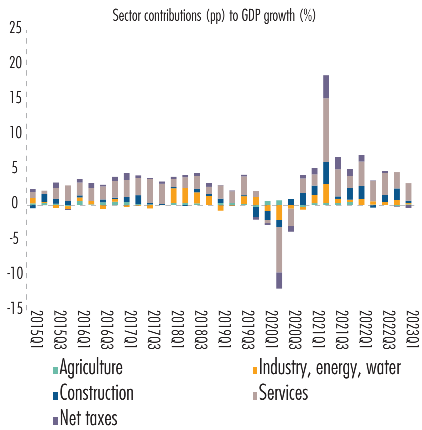
Based on the available data, the economic growth is expected to accelerate over the second quarter of the year. It will be driven by the further growth of consumption, investments and export of services, and it will be reflected in the expansion of the activity of construction and services.

4.1. GROSS DOMESTIC PRODUCT

GDP grew by 2.7% in the first quarter of 2023, slowing down compared to the previous quarter, where growth stood at 4.4%[12]. The deceleration of economic growth reflected - for the most part - the performance of the production sector, as its contribution fell from 2.2 to 0.7 percentage point during this period. On the other hand, the contribution of services expanded slightly, from 2.3 to 2.5 percentage points. The net tax contribution was negative (-0.4 percentage points), deepening compared to the previous quarter (-0.1 percentage point) (Chart 14).

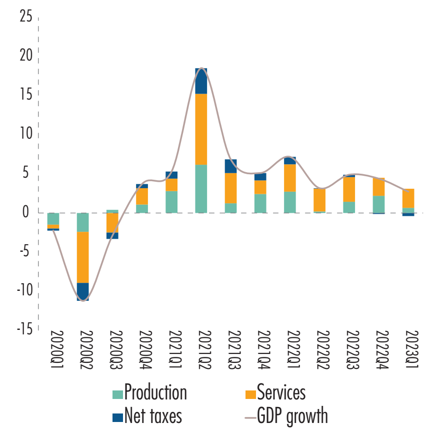
Chart 14

Economic growth appears slower in 2023 Q1



Source: INSTAT and Bank of Albania

The deceleration is driven by the performance of production sector



Source: INSTAT and Bank of Albania

12 The economic growth in the fourth quarter was revised to 4.4% from 4.7% in the previous publication by INSTAT.

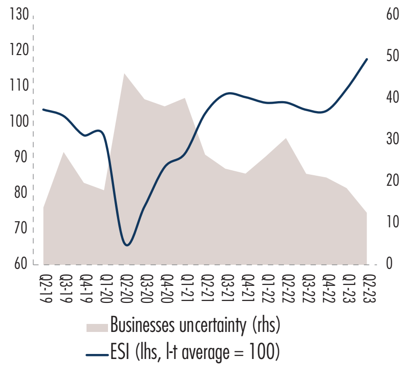
The contribution of the production sector to economic growth fell due to a slower activity recorded in the "Construction" sector. The annual growth rate of this sector fell from 14.4% to 4.5%, reducing its contribution to total growth from 1.7 to 0.4 percentage points. In the same vein, fewer contributions were observed from the "Industry" sector. This performance was driven mainly by the slower growth of the "Processing industry" and the steeper decline in the "Manufacturing industry", reflecting a lesser performance in the export of goods over the same quarter as well.

The growth in the services sector was mainly affected by "Trade, transport and accommodation", "Real estate" and "Arts, entertainment and leisure". The added contribution within the services sector came from the "Arts, entertainment, leisure'', whereas "Trade" and "Real estate" made a lesser contribution. The sub-branch of "Accommodation" appears to be on an upward trajectory, albeit with a lower contribution compared to 2022 Q4.

Based on indirect data for the second quarter of 2023, the economic growth is expected to pick up speed compared with the previous quarter. The economic sentiment indicators have recorded their highest historical levels, uncertainty has subsided, whereas other indirect indicators such as consumption and investments, indicate that they will increase at a faster rate (Chart 15). On the other hand, the export of services is expected to increase, driven by tourism, whereas export of goods has declined over the second quarter.

Chart 15

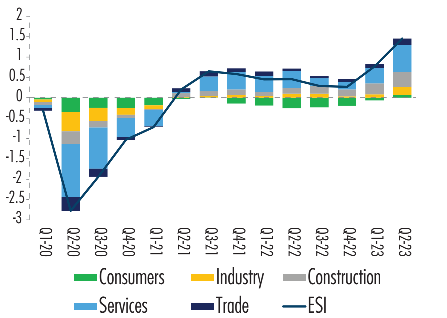
Confidence improved at a faster rate as uncertainty of enterprises decreased at a continuous pace in the second quarter



Source: Bank of Albania

Note: The economic sentiment and uncertainty indicators are derived from Confidence Surveys.

The improvement of the confidence indicator appears broad based and suggests that economic growth will accelerate in the second quarter



Source: Bank of Albania

Note: The economic sentiment indicator is presented in its standardized form, and its increase is decomposed by sectors. The standardization corrects discrepancies between the averages and standard deviations of the confidence indicators of various sectors.

4.2. AGGREGATE DEMAND

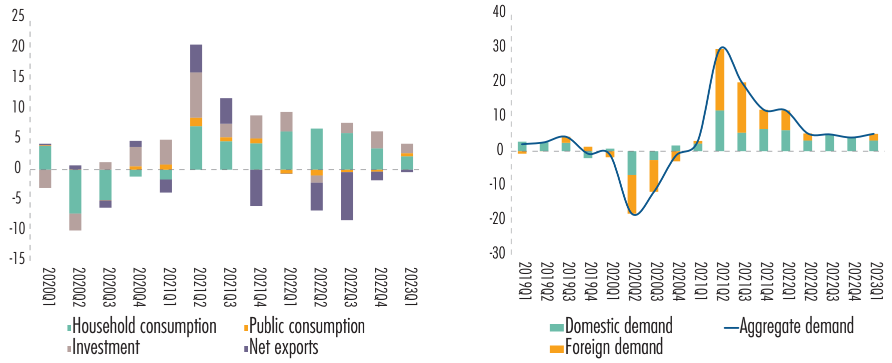
The expansion of domestic demand continues to provide the main contribution to economic growth in 2023 Q1. However, this contribution was slower compared with the previous quarter, both in regards to "Population consumption" and "Investments". The fall in the contribution of investments is caused by a significant slowdown in the growth of private investments, whereas the growth of public investments was higher, somewhat offsetting the decelerating effect of private investments. On the other hand, the contribution of "public consumption" increased compared to 2022 Q4. And lastly, "Net exports" continue to have negative contributions, although at a lesser degree compared to the previous quarter.

Domestic demand grew by 4.0%, from 4.9% in the previous quarter. The deceleration came from the performance of "Population consumption" and "Investments". The real consumption growth dropped to 3.0%, from 4.8% in the previous quarter. "Investments" grew by 7.0%, whilst growth registered 9.8% in the previous quarter. The deceleration is related to the performance of private investments, as public investments recorded a considerable growth.

Chart 16

Economic growth continues to be underpinned mainly by Private Consumption and Investments, but contributions have decelerated compared to the previous quarter

The contribution of domestic demand remains dominant despite the slowdown, meanwhile foreign demand has made a higher contribution



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.
Source: INSTAT and Bank of Albania.

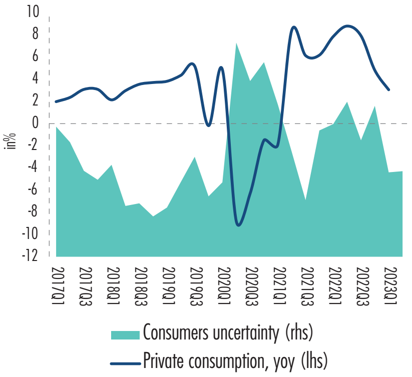
Private consumption increased by 3.0% in the first quarter of the year, at a slower pace compared to the previous quarter. The growth in private consumption, which was recorded in all the main categories,[13] was supported by: the improvement of confidence and fall of uncertainty (Chart 17, left); the higher level of disposable income; as well as the further expansion of consumer loan. Based on indirect indicators, private consumption has continued to increase in the second quarter, with a similar pace of the previous quarter.

Total investments grew by 7.0% in the first quarter, down by around 2.8 percentage points than the previous quarter, and at the same rate of the average growth of 2022 (Chart 18). Public investments provided the main

[13] *The analysis of private consumption by category is based on indirect data from the retail trade index and GDP measured by the production method.*

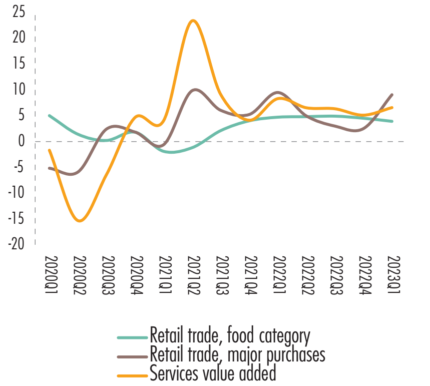
Chart 17

Private consumption grew at a lower rate in the first quarter



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

Expenditures increased mainly for major purchases in the first quarter



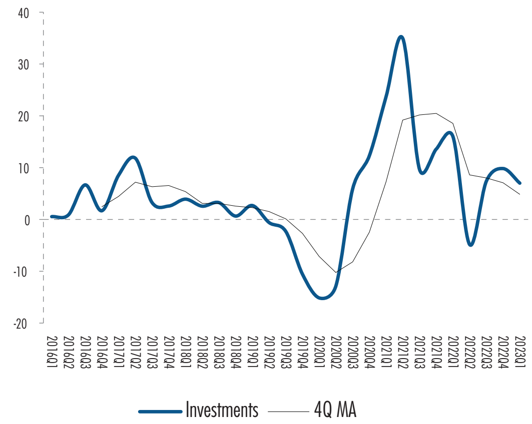
Notes: Indicators are stated in annual changes, in %
Source: INSTAT and Bank of Albania.

contribution to the increase of investments. On the other hand, the slowdown of the growth rates is related to the performance of private investments. Investment growth decelerated as the sector of "Construction" reflected a lower growth. On the other hand, import data suggest that a higher level of investments went toward "Machineries and equipment". As the financial situation of enterprises improved, production capacity utilization increased, and confidence ameliorated, investments continued to grow during the first quarter of 2023.

The available investment indicators for the second quarter, suggest that growth will be faster. Thus, the confidence indicator in construction and the financial situation of enterprises have improved in the second quarter (Chart 19, left). Also, the import of machineries and equipment has grown at a higher rate in the second quarter as compared to the previous quarter. However, support with bank loans is weaker in this quarter (Chart 19, right).

Chart 18

Total investment growth decelerated in 2023 Q1

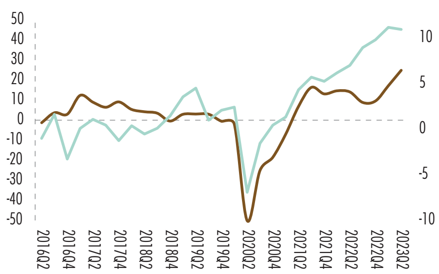


Source: INSTAT and Bank of Albania

Net exports continued to negatively contribute to the growth, but at a lower degree compared to the previous quarter (Chart 20). This performance was determined mainly by the growth in annual terms of imports by 7.2%, which was driven by an increase in the import of services by 29.6%, whereas the import of goods fell by 0.7%. On the other hand, the growth of real exports has accelerated compared with the previous quarter (8.3%, from 0.6%). The export of services, which expanded by 19.8%, was decisive to both the level and the acceleration of total export growth. The more pronounced growth of the export of services has mitigated the negative

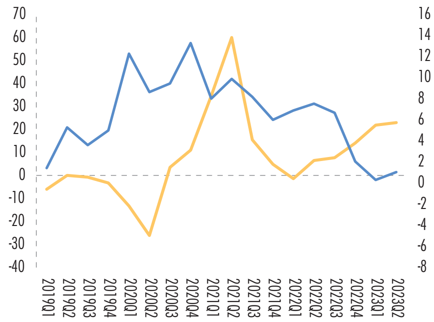
Chart 19

Capacity utilisation rate and the financial situation of enterprises remain at high levels in the first quarter



Notes: Financial situation of enterprises is an average of balances from confidence surveys. Capacity utilisation rate is in percent of total capacity. Indicators are a difference from the long-term average.
Source: INSTAT and Bank of Albania.

Quantitative indicators from imports suggest an increase of investments, being less supported with bank loans

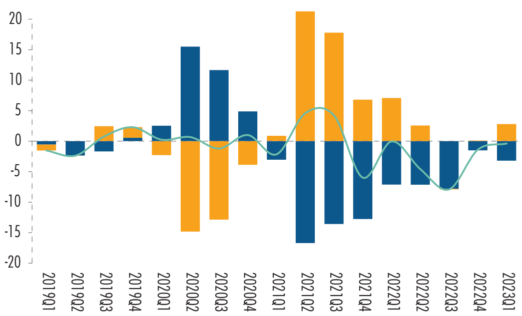


Notes: Indicators are annual changes in percentage.
Source: INSTAT and Bank of Albania

contribution of net exports compared with the previous quarter. On the other hand, the export of goods decreased by 12.3% compared with the previous year.

Chart 20

Net exports continued to provide an increasing negative contribution throughout the first quarter of 2023, albeit at a lower degree



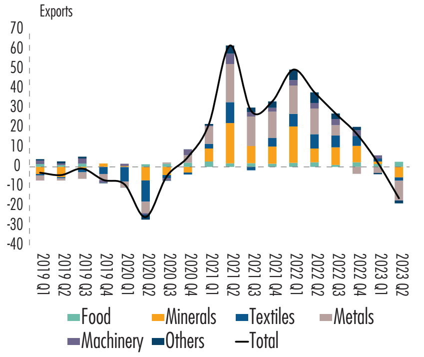
Notes: Contribution of imports and exports in economic growth.
Source: INSTAT and Bank of Albania's estimates.

Partial data from the second quarter suggest that nominal exports and imports of goods have contracted in annual terms. The decline is more pronounced in terms of exports and less so in terms of imports. The drop in international prices remains the main factor underlining the negative performance recorded in both cases. But, in the case of exports, there is a stronger negative impact (compared to the previous quarter) regarding quantities. On the contrary, the quantity of imports has been upwards. Trade deficit of goods expanded by 12.4%, while in the first quarter it contracted by 1.9%.

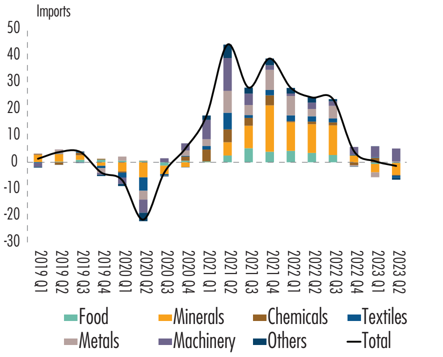
The exports of goods shrank by 16.0% during the second quarter, while growth in the first quarter stood at 2.1% (Chart 21, left). The categories "Construction materials and metals" and "Minerals, fuel and electricity" provided the main negative contribution in this growth. The positive or negative rates of the other sets of goods have been quite low. The only significant positive contribution came from the category of "Food, beverages and tobacco".

Chart 21

Exports shrank in the second quarter, due to the impact of both falling international prices and the decline in the quantities of certain exported categories



Compared to exports, the decline in imports was more moderate, caused mainly by the drop in international prices



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

Imports of goods contracted by 3.4%, while their growth was positive during the first quarter (0.4%) (Chart 21, right). The negative impacts are related with the category of "Minerals, fuels, electricity", due to the decline in the value and volume of imported energy as domestic production improved. The other categories have also recorded low negative contributions. The only positive impact is related with the category of "Machinery, equipment, spare parts", indicating the continuous support of investments from this component in Albania.

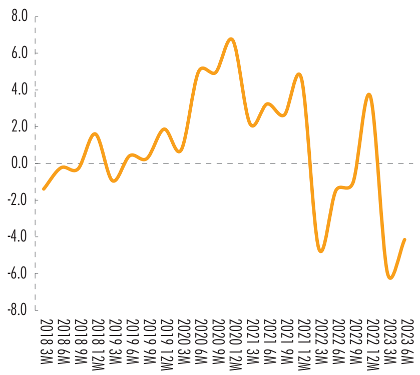
Fiscal policy has had a consolidating nature over the first half of the year, marked by a higher intensity than the plan drafted for this period. *Fiscal surplus reached at ALL 47 billion, the highest value ever to be recorded. The fiscal impulse recorded negative values, driven almost equally by a rapid increase of income and a slow increase of expenses.*

Chart 22

The fiscal impulse remained on negative territory

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

The fiscal surplus was relatively high



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.

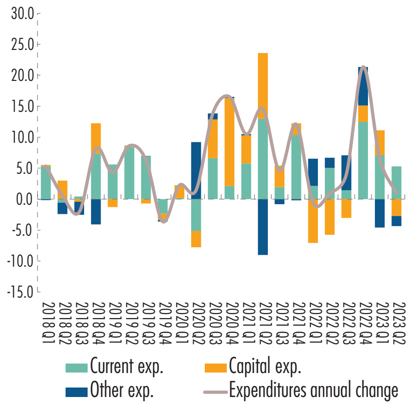
Adjusted for the effect of supportive measures of the energy sector one year ago, the fiscal impulse was assessed at around -0.5 p.p. of GDP at the end of the first six months.

Budget expenditure amounted to around ALL 148 billion, with a marginal expansion of 0.9% in annual terms. As public sector wages increased, staff expenses had the main impact on the increase of expenditure during this quarter, by 2.5 percentage points[14]. Expenses for local authorities were the other item with a significant impact on the expansion of expenditures, by around 1.9 percentage points. Capital expenditure were lower, by around 18% from the same quarter last year, reflecting the low values planned and realised for the Reconstruction Fund[15]. The expenses of the present quarter reflect in addition the negative effect of the comparative base with the previous year, when fiscal transfers supported the energy sector.

At the end of the first half of the year, expenditures reached around ALL 273 billion, expanding by around 3.4% in annual terms. Compared to three months ago, the slowdown in the upward trend of expenses is attributed to the performance of public investments. The other items maintained a similar profile, expect staff expenses, which due to the policy of increasing public sector wages, had the highest historical contribution to expanding total expenses.

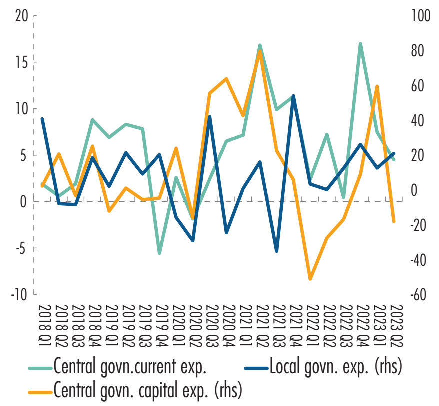
Chart 23

Spending expanded marginally...



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

due to lower public investments



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

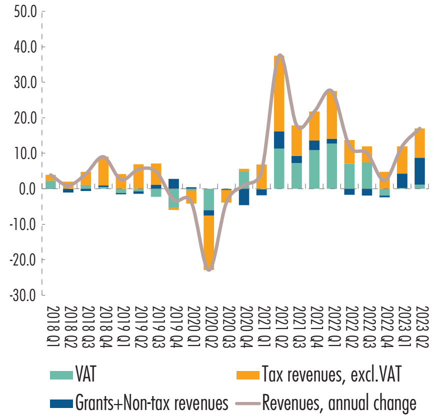
Budget revenues recorded about ALL 164 billion, or around 17% higher in annual terms. Grant revenues accounted for the main contribution, by around 8 percentage points. The other two items with a high positive contribution to total revenue growth were: social insurance contributions, by 3.8 percentage

[14] *Wages in the public sector increased differentially since April. Staff expenses in the second quarter expanded by around 18% in annual terms.*
[15] *Capital expenses minus the Reconstruction Fund effect were 13% higher in annual terms.*

points and personal income tax, by 2.5 percentage points. The high impact of these two components on the expansion of total revenues is attributed mainly to the latest decisions issued by the fiscal authority for the increase of the minimum wage country wide, as well as the increase of public sector wages since April of this year. VAT revenues went up slightly, contributing 1.2 percentage points to the total expansion, from 6.8 percentage points contributed on average in the last two years.

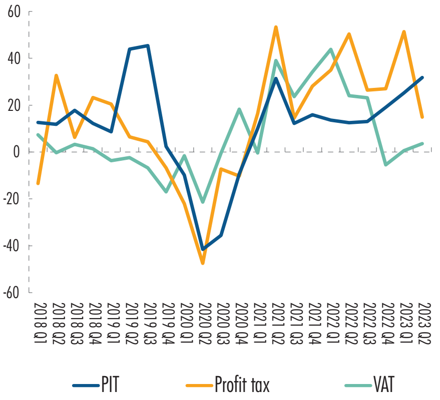
Chart 24

Revenue grew at a rapid pace...



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

...with the main contribution provided by grants.



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

In 2023 H1, total revenues reached at around ALL 320 billion, with an annual growth of 14.5%. Around 41% of growth resulted from grant revenues, which were among the key components of revenue expansion throughout the first quarter of the year as well.

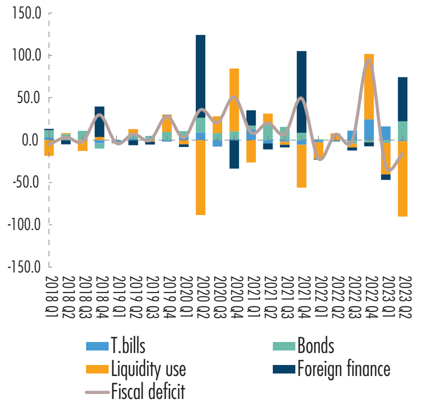
At the end of the second quarter, **budget surplus** expanded to ALL 47 billion, from ALL 31 billion at the end of the first quarter. Fiscal surplus was assessed at 4.1% of GDP, from 1.5% recorded during the same period last year. Surplus expansion was underpinned by almost the same degree of lower spending ratios and higher revenue levels in terms of GDP.

Borrowing in the domestic market of government securities grew by ALL 21 billion in the second quarter, from 12.7 billion in the previous quarter. The additional borrowing in the second quarter as compared to the first quarter, consisted only of long-term instruments. Around 83% of the increase in domestic borrowing was financed by commercial banks. There was no added interest from households to invest in government securities in this quarter, as they purchased only 10% of the additional domestic debt, from 80% recorded in the previous quarter.

The Eurobond valued at EUR 600 million with a 5-year maturity was issued in June. The performance of revenues and expenses, coupled with the additional borrowing in the domestic and foreign market resulted in high liquidity surpluses in lek and foreign currency, available for spending in the following months.

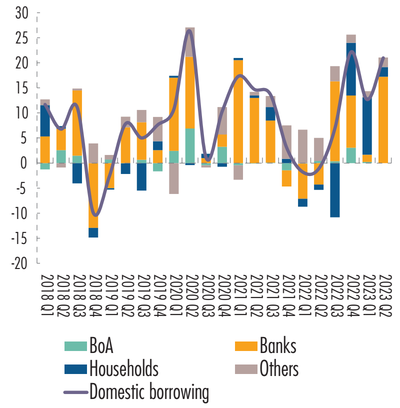
Chart 25

Net borrowing in domestic market picked up



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

Banks played the primary role in securities purchasing



Notes: Government borrowing in debt securities, by purchaser, in ALL bln, by quarter.
Source: Ministry of Finance and Economy.

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

Average annual inflation slowed down to 4.6% in the second quarter, from 6.5% in the previous quarter. In macroeconomic terms, inflation fell due to a weaker inflation in international markets and the appreciation of the exchange rate. On the other hand, domestic inflationary pressures remain high, driven by the restricted labour market conditions and the fast wage growth. Nonetheless, the normalisation of the monetary policy stance has kept in check the economic agents expectations on inflation, and has created the conditions for a more balanced performance of demand and supply in the economy.

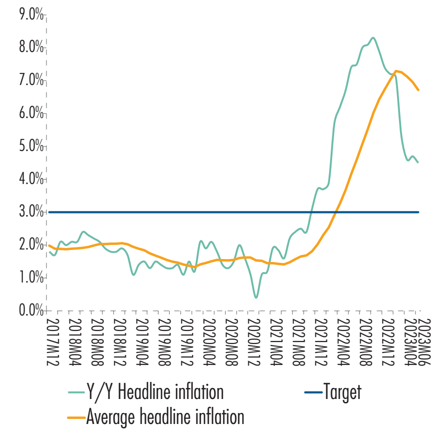
The inflation trajectory is expected to continue its downward trend as pressures from international price are more moderate. Domestic inflationary pressures are expected to subside following the impact of the normalisation cycle of the monetary policy and the downward trend of medium-term inflationary pressures.

5.1 CONSUMER PRICES

Annual inflation averaged 4.6% in 2023 Q2, dropping by 1.9 percentage points from the value of the previous quarter (Chart 26, left). The inflation profile in Albania is similar to the one of the economies of the region and EU (Chart 26, right), which was driven mainly by the deceleration of oil prices and imported food products. The downward trajectory came as a result of falling inflation in our trading partners, the appreciation of domestic currency, the impact of the high comparative base of the previous year, as well as a decline in inflation expectations. The latter reflected also the monetary policy normalisation course

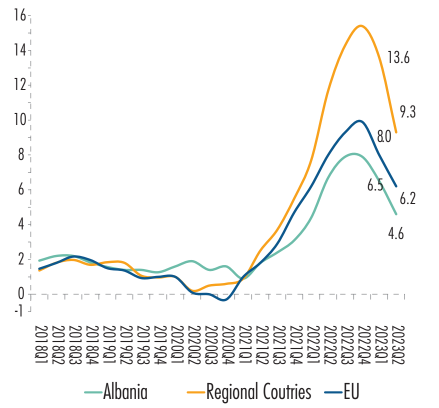
Chart 26

Inflation continued to decelerate on the back of decreased energy and imported goods prices



Source: INSTAT, BoA's calculations.

The decreased energy prices continued to contribute in the fall of global inflation



Source: INSTAT, BoA's calculations.

adopted by the Bank of Albania, mitigating thus the second-round effects of inflation domestically.

"Unprocessed foods" (55%) had a considerable weight on determining annual inflation in the second quarter (Table 2). Since March, this category has become the main contributor to total inflation. Within this category, the contribution of some of the most important sub-categories, particularly "vegetables", increased. The **"Processed foods"** category had a significantly lower contribution than in the previous quarter, reducing total inflation by 1.5 percentage points. Within this category, almost all the other component sub-categories recorded a decline in inflation. The contribution of **"non-food items"** to total inflation contracted by 1 percentage point. This development continues to be led by a lower contribution from the "fuel" sub-category, reflecting energy commodity prices in international and domestic markets and the appreciation of the domestic currency against the US dollar.

The prices of other more stable components of inflation - **housing, services, and durable consumer goods** - contributed with the same value to inflation formation. Within them, prices fluctuated on both sides in certain months, but at almost similar values with the previous quarter. Nonetheless, prices for services remained high, due to the increased demand in the sector of tourism and its related services. In addition to this, the considerable share of labour cost in the service industry because of the rapid increase of wages, has caused high pressures on service prices.

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

	Q3'21	Q4'21	Q1'22	Q2'22	Q3'22	Q4'22	Q1'23	Q2'23	Annual inflation Q2'23 (%)
Processed food	**0.6**	**0.9**	**1.4**	**3.0**	**3.5**	**3.4**	**2.8**	**1.3**	**6.6**
Bread and grains	0.1	0.2	0.4	0.7	0.6	0.6	0.6	0.2	4.7
Milk, cheese and eggs	0.1	0.2	0.3	0.9	1.0	1.2	1.3	0.8	14.7
Unprocessed foods	**1.0**	**1.0**	**1.5**	**1.2**	**1.7**	**1.9**	**1.9**	**2.5**	**13.7**
Fruits	0.1	0.4	0.2	-0.1	0.0	0.1	0.1	0.4	9.8
Vegetables	0.8	0.4	0.9	0.5	0.6	0.8	0.7	1.1	18.4
Meat	0.1	0.2	0.4	0.7	1.0	1.0	1.0	0.9	11.8
Services	**0.2**	**0.3**	**0.4**	**0.5**	**0.6**	**0.5**	**0.5**	**0.5**	**2.9**
Goods with regulated prices	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.1**
Housing lease	**0.2**	**0.2**	**0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**3.0**
Non-food consumer goods	**0.3**	**0.6**	**1.0**	**1.6**	**1.5**	**1.2**	**0.4**	**-0.6**	**-4.8**
Fuel	0.2	0.4	0.7	1.4	1.3	0.9	0.0	-0.9	-22.9
Durable consumer goods	**0.1**	**0.1**	**0.0**	**0.2**	**0.3**	**0.4**	**0.5**	**0.5**	**5.5**
Inflation (%)	**2.4**	**3.1**	**4.4**	**6.7**	**7.9**	**7.9**	**6.5**	**4.6**	**4.6**

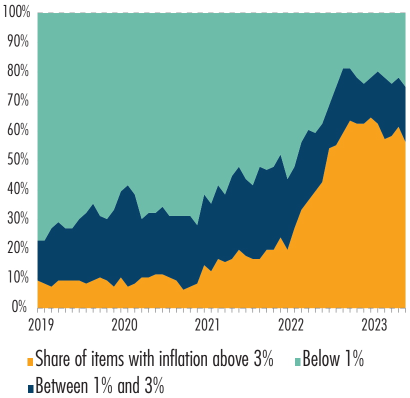
Source: INSTAT and BoA's calculations.

** 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 Q2.*

In the second quarter, the share of basket items with inflation over 3% decreased slightly to 58.7%, from 61% in the previous quarter (Chart 27, left). The shift of items was observed mainly in the category with inflation below 1%. This category included 23.6% of the CPI basket items in the second quarter, against the 21% recorded in the previous quarter. On the other hand, the share of items with inflation between the ranges of 1-3% has not recorded considerable quarterly changes, and currently consists of 17.7% of the CPI basket items. These developments were also reflected in the measurements of net inflation, which slowed down slightly, with the exception of net inflation (less food and energy), of mainly services. It maintained almost the same value of the previous quarter (3.8%), confirming the presence of domestic inflationary pressures, which are relatively stable and still high and above the target (Chart 27, right).

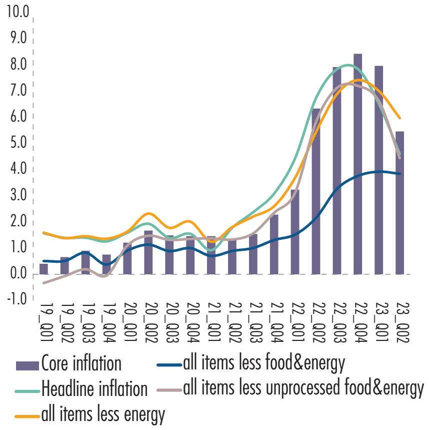
Chart 27

The share of items with inflation above 3% diminished in the second quarter



Source: INSTAT, BoA's estimations

Net inflation, mainly in services and durable goods remained unchanged in the first half of year



Source: Bank of Albania

5.2 INFLATION DETERMINANTS

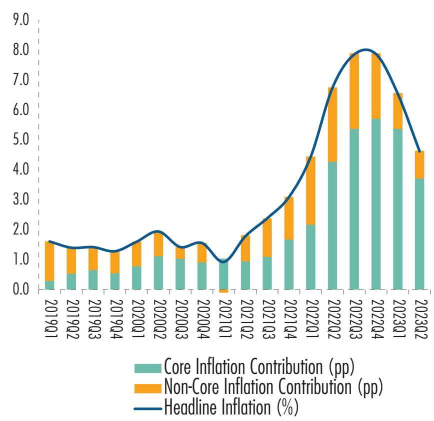
The cyclical position remains positive in the first half of 2023, despite the slower economic growth. Output, unemployment, and capacity utilisation gaps have remained above their potential levels. Employment has continued to grow at the same rate of the previous quarters, and survey indicators show that growth will continue over the second quarter as well. Consequently, long-term inflationary pressures of domestic origin remain persistent, keeping inflation above the target over the second quarter.

The impact from falling commodity prices and the appreciation of domestic currency have not spread broadly to the domestic components of inflation, due to continuing high pressures from the labour market and wages. The normalisation cycle of the monetary policy stance has calmed the overall inflationary pressures and has affected the decline of medium-term inflationary expectations.

In the second quarter of the year, the downward trend of headline inflation was affected by the slowdown of its core broad-based components (Chart 28). In spite of the above, the downward speed and intensity were not simultaneous and equivalent for all the components. After a fast decline in March (6.5%), core inflation dropped to 5.5% in the second quarter, slowing down gradually over the months. This development was driven by falling contributions of some processed foods - part of the specific sub-basket - and the effects of high comparative base of the previous year. Net core inflation[16] stood at around 3.9% in the second quarter, the same value recorded in the previous quarter, and slightly above the one of the previous year. This development shows that the inflation of services and durable goods remains stable and at the highest historical levels (Chart 27). Domestic inflation was around 4.6% in the second quarter, with an upward trend over the months, although remaining below the average of the first quarter of current year.

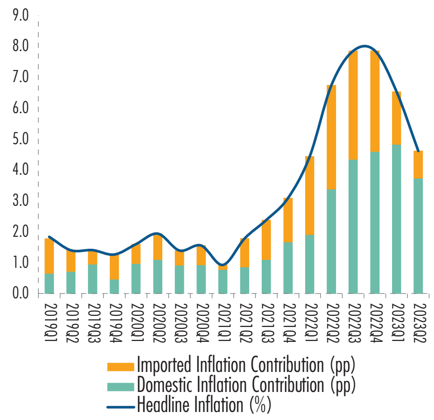
Chart 28

The contributions from both domestic and core inflation continued to drive the formation of headline inflation



Source: INSTAT And BoA's estimations.

The contribution of imported inflation reduced compared to that in the first quarter



Source: INSTAT And BoA's estimations.

The most volatile components of inflation, the non-core and imported one, recorded 2.8% and 4.5%, respectively, in the second quarter of the year, slowing down compared to the previous quarter, and approaching the respective averages of the pre-Russian-aggression-on-Ukraine period[17].

The weaker imported inflationary pressures have not widely spread to the other more stable components of inflation due to high pressures springing from the labour market and wages. As a result, the value of headline inflation continues to be driven by the high and above-target rates of domestic and core inflation, contributing around 81% to the formation of headline inflation.

[16] *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.*

[17] *The average annual non-core and imported inflation were 3.1% and 4.5%, respectively, during 2021.*

The cyclical position of the economy remains positive, despite a sluggish economic growth in 2023 Q1. The labour and production market have exceeded their potentials, supported by a relatively high demand for goods and services, reflecting in higher wages and cost of labour in the private sector.

The capacity utilisation rate in economy stood around 80.2% in 2023 Q2, a higher rate compared with the previous quarter. This rate continued to stay above the historical level.

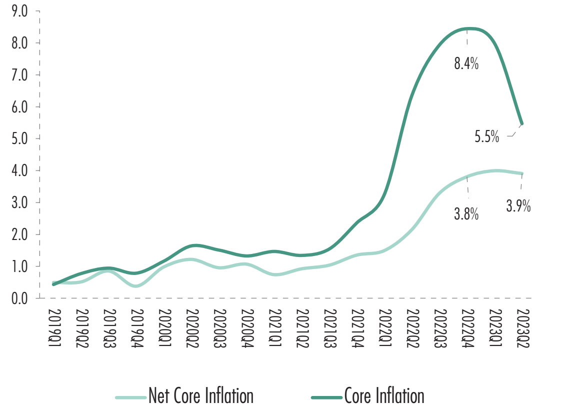
Employment and unemployment: Employment grew by 4.4% in annual terms during the first quarter of 2023, at similar rates compared to 2022 H2 (Chart 31). The positive contributions are entirely related to the services sector. In parallel, the participation in the labour force has increased further.

The unemployment rate has risen slightly compared with the previous quarter, despite the annual and quarterly expansion of employment. Unemployment stands at 10.9%, 0.1 percentage points higher than 2022 Q4. The increase of unemployment rate as employment grew, suggests that there is a higher interest and supply in the labour market due to rising wages, which is also reflected in a higher degree of participation.

Wages, productivity and labour costs. The increase in the average wage in the private sector decelerated for the first time since the end of 2021. The annual growth stood at 9.5%, from 14.2% in the previous quarter (Chart 32, left). The main sectors supporting the wage rise were: "Trade, transport, accommodation and food services", "Industry", "Public Administration and Insurance''. The deceleration of the growth rate is related to sectors with relatively higher wages such as "Real estate", "Information and communication" and "Financial activities and insurance." These were the sectors which contributed to the increase of wages in 2021 H2. The faster deceleration of the nominal wage growth compared to inflation brought about a more modest increase of the real wage in the first quarter (3%), compared to the previous quarter (6.3%).

Chart 29

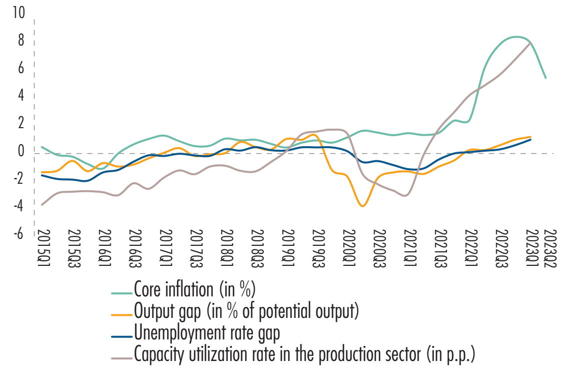
Net core inflation remained stable at historical high values throughout 2023 H1



Source: INSTAT and BoA's estimations

Chart 30

Cyclical position of economy remains positive in 2023 Q1 as well

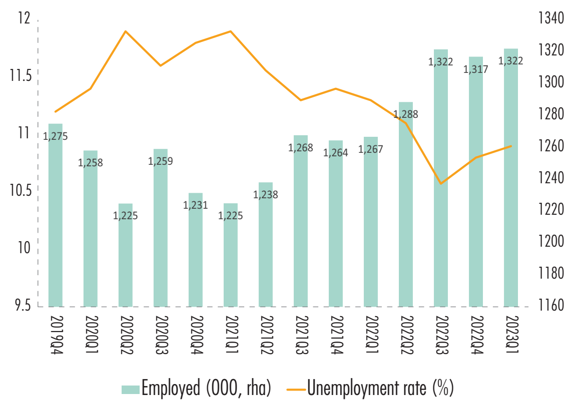


Notes: The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilisation rate gap is estimated as a deviation of the current value from the relevant historical average, and then the moving average method is applied. The unemployment rate 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.

Source: INSTAT and BoA's Estimations

Chart 31

Employment has continued to pick up in both annual and quarterly terms, though unemployment rate has expanded slightly



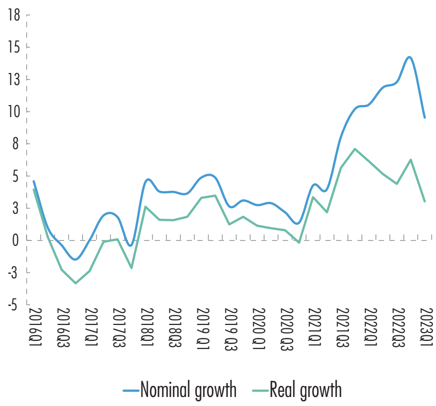
ource: INSTAT and Bank of Albania's calculations

The unit labour cost[18] increased at a faster rate in 2023 Q1 than in the previous quarter (3.9%, form 2.3%). The effect from the wage increase has remained dominant against productivity growth, a trend which started since the second quarter of the previous year (Chart 32, right). Meanwhile, the weaker growth of labour productivity was impacted by the slower economic activity in this quarter.

Other output costs have gone up, but at a slower pace compared with the previous quarter. Overall producer prices expanded by 9.4%, from 21.4% in the last quarter of the previous year. Domestic market producer prices expanded by 9.3%, from 19.4% in the previous quarter. The increase of export producer prices fell to 9.1%, from 24.2% in the last quarter of the previous year. Lastly, the construction cost index rose by 5.3%, from 7.0% in the previous quarter.

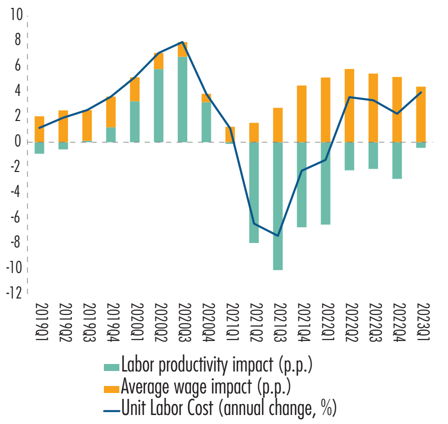
Chart 32

Wages in private sector grew at a decelerated pace in both nominal and real terms



Source: INSTAT

The unit labour costs expanded again on the back of the stronger impact from wages compared to productivity



Source: INSTAT and Bank of Albania

Imported inflationary pressures have slowed down in 2023 Q2. The annual increase of the imported inflationary pressure index (IIPI)[19] dropped to 3.4%, from 16.3% in the previous year (Chart 33). The deceleration is related to the performance of international prices, as their annual growth fell by 16.2%, from 25.3% in the previous quarter. In parallel, the appreciation of the exchange rate expanded compared to the first quarter of the year. The appreciation in annual terms increased to 12.8%, from 9.0% in Q1.

As the imported inflationary pressures mitigated, the contribution of imported inflation to headline inflation has continuously declined during the entire first

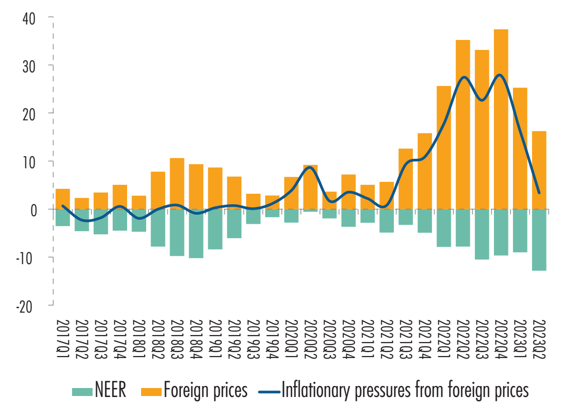
[18] Unit labour costs are estimated for the non-agricultural private sector based on the National Accounts statistics, of employment and wages.

[19] IIPI is calculated as the annual growth of the imported prices index and the NEER index 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.

half of 2023 (Chart 28, right). The declining impact of raw energy prices and food in foreign markets, as well as the appreciation of the domestic currency have been transmitted more evidently through the marketable components the CPI basket items. Thus the share of imported inflation to headline inflation fell to 19% in 2023 Q2[20], from 26% in the previous quarter. As a result, the contribution of imported inflation to overall inflation has decreased to 0.9 percentage point, from 1.7 percentage points in 2023 Q1.

Chart 33

Imported inflationary pressures have decelerated considerably in the second quarter of 2023



Source: INSTAT, Eurostat and Bank of Albania's calculations

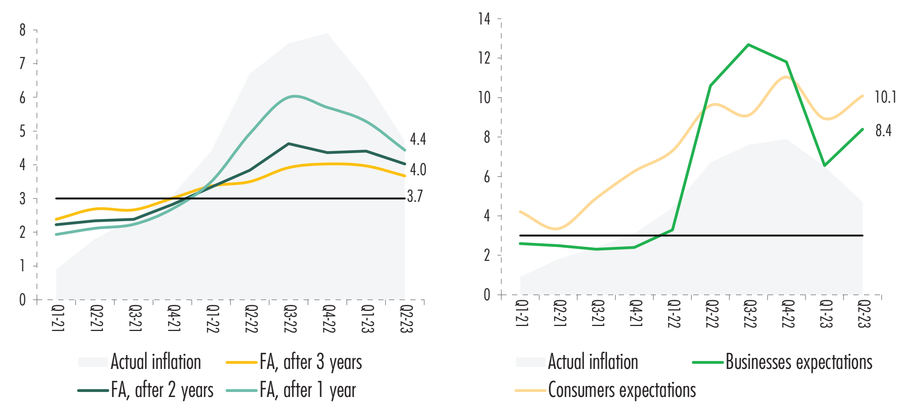
Inflation expectations from financial agents have continued to fall in Q2, while expectations from enterprises and consumers edged up[21]. Inflation expectations from enterprises increased to 8.4% after one year, against the 6.6% registered in the previous quarter. Consumers expect inflation to be 10.1% after one year, up by 1.2 percentage points from the previous quarter.

One year from now, financial agents forecast inflation to be 4.4%, downward compared to 5.3% recorded in the first quarter (Chart 34, right). Inflation expectation over two- or three-year time horizons are low, at 4.0% and 3.7%, respectively.

Chart 34

Inflation expectations after one year of enterprises and consumers

Financial agents' expectations on inflation by three time horizons



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

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

[20] *The contribution of imported inflation in the formation of headline inflation was within the minimum historical range of the relevant series in June, as it dropped to 0.7 percentage points, or 14.5%.*

[21] *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.*