Bank of Albania

MONETARY POLICY REPORT

2023/IV

MONETARY POLICY DEPARTMENT

Published by: Bank of Albania
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C O N T E N T S

INTRODUCTION[1]

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

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

The transmission mechanism encompasses various channels through which prices may change, for example: the exchange rate channel; the inflationary expectations channel; and the foreign 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 deviations in inflation from target, and the time needed for the economy to react against changes in interest rates.

The Supervisory Council makes decisions on the monetary policy based on a variety of information, including estimations regarding economic developments, forecasts in relation to inflation, the performance of financial markets, risks and uncertainties surrounding forecasts. The Monetary Policy Report - which is the main 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 citizens.

The Monetary Policy Report is published on a quarterly basis. This Report is compiled by the Monetary Policy Department at the Bank of Albania and it is adopted by the Supervisory Council. The current Report contains data, as of 20 October 2023. The Supervisory Council reviewed and adopted this Report at its meeting on 1 November 2023.

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

FOREWORD BY THE GOVERNOR

The Albanian economy has exhibited a good resilience to the adverse shocks caused by the rapid upsurge in prices in global markets, originating from the war in Ukraine.

Economic activity has been growing in the first half of the year, enabling an increase in employment and wages and an improvement in the financial position of enterprises. In parallel, both public debt and the foreign debt of the Albanian economy have been reduced, the lek exchange rate against foreign currencies has appreciated, the non-performing loans ratio has remained at low levels, and the overall financial situation of the banking sector appears sound.

On the other hand, inflation continued to come down during the third quarter of the year, recording an average rate of 4.1%. However, this decline was slower than the rates recorded in the first half of the year and lower than our expectations. In particular, domestic inflationary pressures continue to remain relatively strong, fuelled by the high demand for goods and services and the rapid growth in production costs.

Against this backdrop, the Bank of Albania decided to continue the normalisation drive of the monetary policy stance, by rising the policy rate to 3.25%. This increase aims, first of all, to create the necessary preconditions for the return of inflation to the target, in a reasonable time and at the lowest possible costs for the economy. It is consistent with the previous communications of the Bank of Albania, as well as with the stabilization of the exchange rate in the third quarter. The latter has been an important factor underpinning the reduction of inflation in Albania during 2023, but it is not sufficient for its sustainable return to the target.

For this reason, the Bank of Albania decided to further reduce the monetary stimulus, while further shifting the overall stance of monetary policy towards a neutral position.

Our forecasts for the outlook remain positive. We expect the Albanian economy to further grow in the coming years, by factoring the context of the external economic environment, the favourable trends of economic developments in Albania coupled with the reaction of our monetary policy. This growth will continue to be accompanied by a growth in consumption and investments, as well as an increase in employment and wages. On the other hand, the reaction of our monetary policy will ensure that this growth does not translate into inflation, protecting the purchasing power of Albanian households and helping the overall financial soundness of the economy. According to our forecasts, inflation is expected to return to the target in the second half of next year.

We deem that the monetary policy will continue to maintain its crucial role for bolstering the overall well-being of the Albanian society, through both guaranteeing price stability and enhancing the financial soundness of the economy.

This philosophy has guided and will continue to guide our policies and measures in the future.

1. INFLATION AND MONETARY POLICY STANCE

This Quarterly Report shows that the Albanian economy has displayed a relatively good performance over 2023. In the face of foreign supply shocks, increased uncertainty and growth of financing costs, the economic growth in Albania remains relatively solid. It has been accompanied by an increase in employment and wages, as well as relatively high domestic inflationary pressures. Against this backdrop, the Supervisory Council decided to continue the normalisation of monetary policy stance, rising by 0.25 percentage points the key interest rate.

This decision helps return the economy back to balance, reduce imbalances in the labour market and anchor inflation expectations. These are necessary premises to return inflation to our target of 3%, within a reasonable period of time, as well as to support the sustainable and long-term growth of the country. The normalization of the monetary policy stance will enable the gradual reduction of inflation in the next quarters and its return to the target during 2024 H2.

The quarterly report concludes that uncertainties regarding the future have strengthened and risks to inflation have also increased. Against this backdrop, the future decisions of the monetary policy will continue to be oriented by new data and toward achieving our price stability target.

Global inflation continued its downward trend, but prices remain high and risk factors for the future have strengthened. The commodity prices stabilization and the rapid increase in interest rates by main central banks contributed to the decline of global inflation. However core inflation remains high, as a result of shortages in the labour market. Despite the slowdown of the global economic growth, labour markets continue to appear resilient, with low unemployment rate and rapid wage growth. The persistence of these pressures has driven central banks to maintain the tightening side of the monetary policy. During the last two months, the European Central Bank (ECB) increased the policy rate twice, reaching at 4.5%. Uncertainties regarding the future have strengthened, in view of new geopolitical tensions, the persistence of inflation and the tightening of financing conditions.

In this global context, economic trends in Albania are overall positive. Economic activity, employment and wages have continued to grow, while inflation has continued to decline. It fell to an average of 4.1% in the third quarter, from 6.5% and 4.6% in the first and second quarters of the year, respectively. The downward inflation trend was impacted by the decrease in oil prices and the lower food inflation, reflecting the decline in these prices in global markets and the exchange rate appreciation. On the other hand, core inflation and, in particular, service inflation continue to remain at high levels, contributing steadily to inflation and curbing it from reducing even more.

Likewise in partner economies, the return on inflation to target is expected to be a gradual process, as domestic pressures on prices, especially from labour market are stable. The latest economic information shows that demand in the economy is growing faster than the economy's ability to service it. Thus, economic growth accelerated to 3.2% in the second quarter and indirect data suggest a faster growth in the remaining half of the year. Economic growth was driven by increased consumption, investment and export of services, as well as supported by the good financial soundness of the private sector, its high levels of confidence and the rapid growth of tourism. At the same time, it has generated a high demand for employment. This demand is having difficulty being met by the labour market. Market conditions continue to be tightened, reflected in historically low levels of the unemployment rate, historically high levels of labour shortages, and rapid wage growth. The latter accelerated the growth rate to 16.9% at the economy level and 15% in the private sector, in the second quarter. The increase in wage provides support for household incomes, but it also increases production costs and keeps domestic inflationary pressures high.

In these circumstances, the Bank of Albania deems that establishing a more balanced ratio between demand and supply is necessary to enable inflation to return to the target. High inflation damages households and enterprises because it erodes the purchasing power of income, devalues savings, makes future planning difficult and it risks being associated with an ineffective allocation of the economy's productive and financial resources. To this view, the Bank of Albania remains determined to take all the necessary measures to guarantee the return of inflation to target; in the most reasonable time and with the lowest costs.

Our forecasts show that inflation will decline over the coming quarters, returning to our target of 3% starting in 2024 H2. This forecast factorizes the reduction of foreign inflationary pressures, as well as the normalization of the monetary policy stance. This normalization, which implies a gradual reduction of the monetary stimulus in the economy and the return of the monetary policy to a more neutral position, aims to establish a suitable financial environment for safeguarding the monetary and financial stability in Albania. At the same time, it does not affect the positive trend of economic growth, a trend which enables further increases of wages and employment and maintains sound financial balances for Albanian enterprises.

The new available information shows that risks to inflation have built up in the presence of new geopolitical tensions. In particular, the new pressures for an increase in oil and food prices pose new potential risks for higher global inflation, but also for the unfolding of second-round effects in the form of elevated inflationary expectations, especially of households whose sensitivity toward these prices is higher.

The evidence gathered over the last few months, shows that the inflationary pressures from the domestic economy appear relatively stable and require the undertaking of a new step in regard to the normalization of the monetary policy stance. The previous increases in the policy rate have been transmitted to financing costs; also the interest rates on loans and deposits in lek are higher than their level before the start of monetary policy normalization. However they have been reducing during the last two quarters, reflecting the reduction of perceived risk premiums and increased competition in the banking sector. On the other hand, the lek exchange rate against the euro was stable and the foreign exchange market stabilized. Despite tightened, financial conditions have not contained credit growth, which recorded 6.8% in the third quarter. Its growth pace slowed down during 2023, in line with the declined credit demand and the improved liquidity situation of enterprises.

In accordance with the above analysis and forecasts, the Supervisory Council decided to raise the key interest rate by 0.25 percentage points, to 3.25%. This increase is necessary to bring back to equilibrium the demand and supply for goods and services, to reduce imbalances in the labour market and to keep inflation expectations anchored. These premises are necessary for inflation to return to the target by mid-2024.

The next monetary policy decisions will continue to be guided by new economic and financial data. In particular, the external environment still remains challenging, the domestic inflationary pressures are yet elevated and the experience in the last year has taught to not exclude the possibility of unexpected shocks. For these reasons, we will continue to monitor the situation, to be always ready to undertake the right monetary policy measures for supporting the monetary and financial stability of Albania.

2. EXTERNAL ENVIRONMENT

Global economic activity is slowing down, impacted by the rapid increase of funding costs, high inflation and lingering uncertainty regarding the geopolitical situation. Economic growth is expected to be weaker during 2023-2024, but remain positive and uneven among countries.

The economy of our main trading partner, the euro area, is showing a weak consumption and investment growth and persistent inflationary pressures from the strong labour market. The European Central Bank continued to increase the key interest rate, signalling thus that this stance will continue for a relatively long period of time.

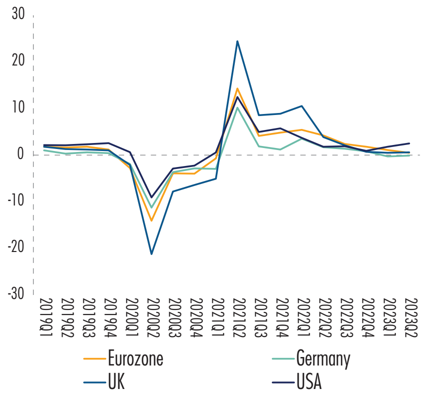
Even though inflation is expected to come down gradually in the medium term, risks on its outlook are titled on the upside. Uncertainties regarding the performance of prices have increased, after the start of the conflict in the Middle East and the volatility in the commodity markets.

2.1. ECONOMIC ENVIRONMENT

The positive performance of the global economic activity exceeded the expectations in the first half of the year. At the same time, it was considerably uneven across countries. Economic activity in the second quarter of the year, was relatively stronger than expected in the US, whilst the economy in the euro area had a weak activity (or a contraction, in the case of Germany). Emerging countries showed higher growth rates, with the exception of the Chinese economy, which has expanded more slowly than expected. Leading

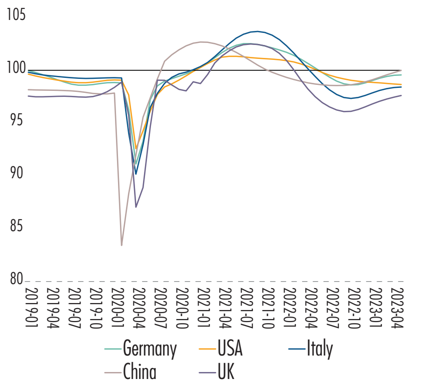
Chart 1

The growth rate of economic activity has been uneven across countries



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

Leading economic indicators suggest slower growth rates in the third quarter



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

indicators on global economic growth slowed even further during the third quarter. Confidence indicators suggest that uncertainties about economic performance have increased.

The tightening of financial conditions led to the slowdown in the demand for goods and services. Central banks continued to rise the interest rates in the third quarter, while funding costs have increased and bank lending has slowed down.

Inflation rates have been downward in the third quarter, where in addition to the comparative effect with the previous year, when inflation peaked, the pressures from the labour market have also slowed down. Commodity prices, despite the fluctuations in September, are lower compared to the previous year, and are negatively affecting the inflation rates. However, the long-term inflationary pressures in the core inflation are not yet in line with meeting the central banks' objectives. The latter stated that the interest rates will continue to remain high.

Global economic activity is expected to slow in 2023 and record growth rates below historical levels. According to the latest IMF forecasts, global economic growth is expected to be 3.0% in 2023 and 2.9% in 2024, compared to 3.5% in 2022. Moreover, this trend varies across economies, hence advanced economies are expected to slow down even more, whilst emerging economies are expected to grow at similar rates to those in the previous year. Inflation rates are expected to decline gradually in 2024 and 2025.

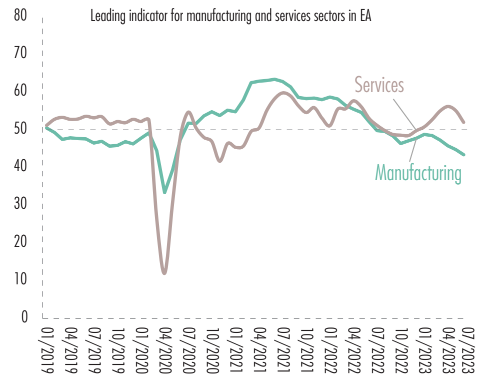
EURO AREA ECONOMY

The economic growth pace in the euro area almost decreased in half, in the second quarter, when economic activity expanded by 0.5% from the previous year, (1.1% in 2023Q1). Economic growth was yet uneven across countries, where advanced countries in some cases experienced contractions of the economic activity due to weak foreign demand and increase of production costs. Net exports declined, private consumption remained unchanged, while investments and government expenditures slightly increased. Leading indicators suggest the economy expanded at a slower pace in the third quarter. The acceleration of the service sector's growth, which was the main supporter of economy in the first half of the year, has passed the positive moment. High prices and tighter financing conditions are reflected in weaker demand for this sector. The unemployment rate remains at historically low levels, but the growth pace of wages is slowing down. The economic growth of the euro area is expected at 0.7% in 2023, from 3.3% in the previous year[2].

[2] *IMF, World Economic Outlook, October 2023; ECB staff macroeconomic projections, September 2023.*

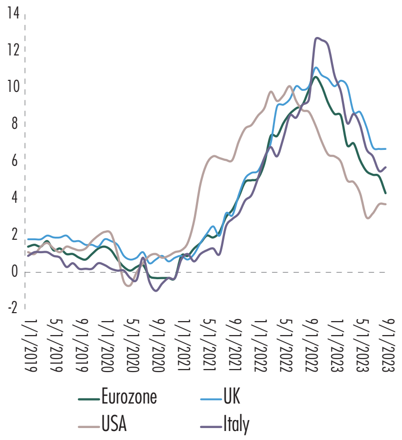
Chart 2

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.

Inflation rate dropped to 4.3% in September from 5.5% in June, impacted by the comparative effect with the previous year (9.9%), the negative contribution from energy prices, as well as the gradual decline of core inflation. The performance of core inflation encourages the tightening of monetary policy by the European Central Bank. However, core inflation remains high, at 4.5% in September, and inflationary pressures are estimated to be stable amid a still strong labour market. The ECB foresees that inflation will be able to return to 2.0% target only in 2025, while the risks related to this forecast are on the upside. Intensification of geopolitical conflicts, changes in commodities supply conditions, or a stronger than expected labour market, could lead to a higher inflation.

REGIONAL ECONOMIES[3]

The slowdown of the economy in Europe has been reflected in lower rates of exports and consumption in the partner economies of the Western Balkans. Economic growth in North Macedonia decreased to 1.1% in the second quarter, while the growth pace of private consumption decreased in half. In Serbia, consumption continued to contract for the second consecutive quarter, while economic growth was supported by infrastructure investments. The weak growth of exports of goods was reflected in the slowdown of economic growth in Kosovo, while exports of services, with the focus on tourism have increased and supported the economy. Preliminary data indicate acceleration of domestic demand in Serbia and a slower growth in Kosovo and North Macedonia in the third quarter. Economic activity in 2023 in neighbouring countries is expected to reflect the slowdown of the euro area economy, as the region's main trading partner. The region's medium-term outlook is positive.

With the exception of Kosovo, where inflation increased as a result of service prices, inflation rates in the region has been decreasing. Pressures from

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

core inflation remain relatively high, supported by the continued growth in wages. Inflation rates are expected to decrease in the next year, reflecting the stabilization of commodity prices in international markets and the slowdown in demand.

Table 1 Economic indicators for main trading partner countries

	Annual change of GDP p.p		Annual inflation (%)		Unemployment, in %
	2023 Q1	2023 Q2	June 2023	September 2023	2023 Q2
Italy	2.1	0.3	6.7	5.7	7.3*
Greece	2.0	2.7	2.8	2.4	10.9*
Kosovo	3.9	2.0	2.8	4.2	11.8**
North Macedonia	2.1	1.1	9.3	6.6	13.2
Serbia	0.9	1.7	13.7	10.2	9.6
Albania	2.8	3.2	4.5	4.1	10.7

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.
**August 2023, ** 2022 Q4*

2.2. COMMODITY PRICES IN GLOBAL MARKETS

Commodity prices in global markets have fluctuated in the third quarter of the year, reflecting the heightened uncertainties in the economic, financial and geopolitical environment. The slowdown of economic activity in terms of the increase of interest rates, and consequently, a lower demand, exert pressures on commodity prices. On the other hand, geopolitical tensions related to oil exporting regions, as well as OPEC's decisions to reduce production quotas, put pressure on oil prices and related costs.

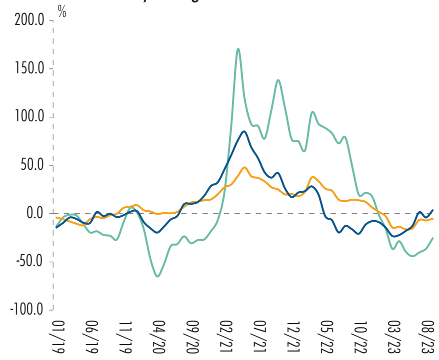
The price index of commodities measured by the World Bank increased by 5% in the third quarter compared to the second quarter, affected by the performance of energy prices. However, they remain around 20% lower compared to the previous year, which impacted the reduction of inflation rate. The oil price, in particular, increased significantly in August and September, when production cuts were announced up to the end of the year. Brent oil prices were quoted around the average of $94/barrel in September, for the first time this year, recording an annual rise by 4%. The electricity power price averaged 104 Euro/MWh at the Hungarian Power Exchange[4] in September, or 73% lower from the previous year. The warmer weather is postponing the energy demand. The oil price stabilized in October, meanwhile the conflict at the Israeli border caused volatility of its performance at the beginning of October.

Food prices continue to fall, supported by the expansion of production and the improvement of trade routes. However, the annual decline pace on these prices have slowed down. The decline in metal prices stopped in September. Their performance is being affected by the Chinese government's measures on the support of its economy, while global industrial demand remains weak.

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

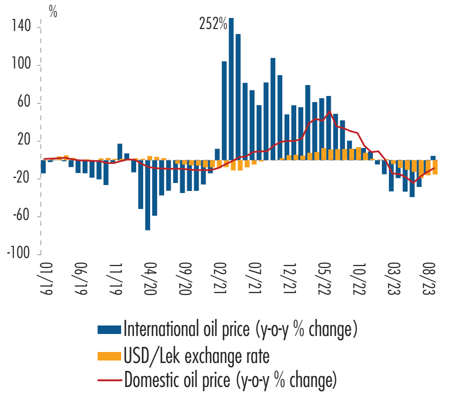
Chart 3

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 continue to affect the 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.

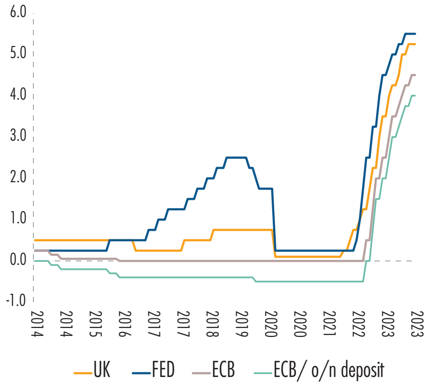
2.3. INTEREST RATES

Financing conditions have tightened further across international markets, reflecting the tighter monetary policy of central banks and information on still strong inflationary pressures. Central banks continued to raise interest rates during the third quarter, while core inflation decreased more slowly than headline inflation. This drove agents to expect a higher interest rate environment for a longer period of time than what they expected at first.

The ECB has increased twice the key interest rate by 0.25 percentage points, in July and September, to 4.50%; The Bank of England increased the policy interest rate by 0.25 percentage points in August, at 5.25%, and the Federal Reserve increased the policy interest rate by 0.25 percentage points in July, at 5.25%-5.50%. Tight financing conditions are gradually leading to a slowdown in demand and curbing the lending. Central banks have stated that interest rates are already in the tightening side and that the effects of the monetary policy will be more evident in the economy in accordance with the time delays of the transmission mechanism. Market experts deem that the interest rates are close to their maximums in this cycle, although a worsening of inflation outlook could lead to further increases of interest rates. Inflationary pressures from the labour market and wages are still strong, reflected in high core inflation. For this reason, interest rates are expected to remain high for a longer period of time. These expectations have been translated into increased public and private bond yields in the third quarter, and consequently weighing on the financing costs in the balance sheets of enterprises and households.

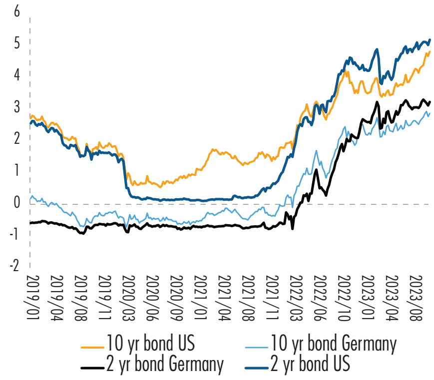
Chart 4

Central banks have continued to increase the key interest rate aiming to curb 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 Markets expect interest rates to remain at high levels



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

3. FINANCIAL MARKETS AND LENDING CONDITIONS

The financial market has shown contained and decreasing risk premiums, as well as low levels of interest rates during the third quarter. Yields on Government securities remained anchored near the key interest rate in the short term, but trending upward in the long term. Loan interest rates remained overall unchanged or decreased in certain segments. However, the growth of bank funding to the private sector slowed down, reflecting the lower need for business financing.

In the foreign exchange market, the increased volatility and uncertainty that characterized July, have been reduced and the exchange rate against the euro has fluctuated between increasingly narrow ranges during August-October.

3.1. DOMESTIC FINANCIAL MARKET[5]

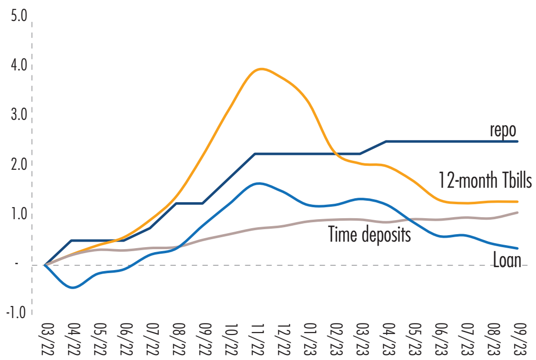
The financial market is characterized by declining risk premiums, which is also reflected in low interest rates. Interest rates in the interbank market fully reflect monetary policy signals. The yield curve in the primary market remains near the key rate in the short-term horizon, but it has shown a slight upward trend in the long-term horizon, as a result of increased government demand for funds in this segment. Loan interest rates remained almost the same or decreased in certain categories. The partial pass-through of key interest rate changes onto loan interest rates has been influenced by the strong decrease in yields, as representatives of the risk-free rate of return, by the reduction of interest margins, as a result of the perceived decline in risk premiums in the economy, as well as from the slow growth of interest on deposits, as a determinant of the cost of financing banking activity.

The foreign exchange market stabilized after the uncertainties in July. In annual terms, lek continues to be appreciated, but the demand/supply ratios have stabilized close to the current exchange rate levels.

The interbank market continued to be characterised by low interest rates and minimum spread vis-à-vis the policy rate. Interbank market interest rates did not change in the third quarter of the year, remaining at similar levels of the second quarter. Their spread from the key interest rate remains minimal and volatility

Chart 5

Weak cost pressures, low yields and reduced perceived risk have led to the continuation of the low interest rates



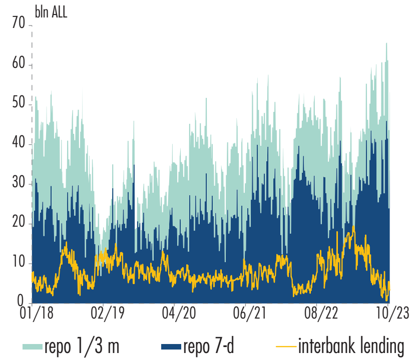
Note: Cumulative changes of interest rates in lek since March 2022: repo, 12-month T-Bills, time deposits and loans.
Source: Bank of Albania.

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

indicators[6] remain low. The market has not experienced additional liquidity pressures. Meanwhile, the Bank of Albania continued to supply liquidity through one-week and three-month repo instruments. The amount injected was slightly higher than in the second quarter of the year.

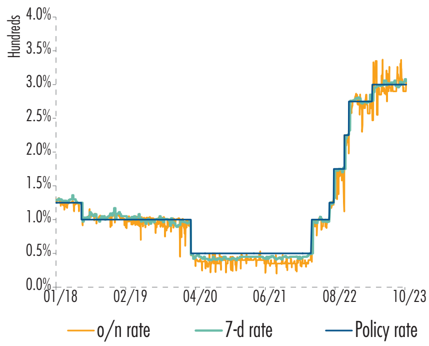
Chart 6

The liquidity situation of the banks has not changed, ensuring a good transmission of the monetary policy



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

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



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

Since August, the appreciating pressures on the domestic currency have eased. The rapid appreciation of the lek in July was also followed by an increase in volatility and quotation spreads beyond normal values. The appreciating trend of the lek is widely estimated in line with the fundamentals and continuous improvements in the external sector of the economy. However, its strengthening during that period also carried short-term deviations, driven by psychological factors, which were especially evident in the second half of July[7]. However, these pressures eased after the press release of the Supervisory Council in 2nd August, during which the Bank of Albania underlined its willingness to intervene in the foreign exchange market in case the performance of the exchange rate became a risk that would burden meeting the inflation objective.

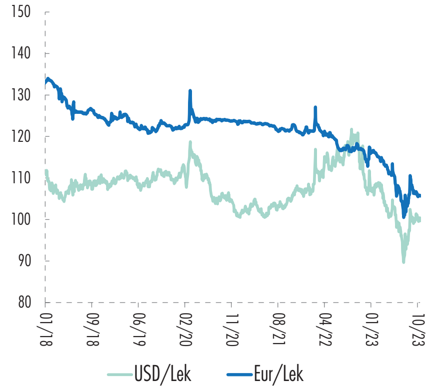
The euro/lek exchange rate increased on average at ALL 105.7 in August, from the average ALL 103.2 recorded in July. Households' demand for the euro increased in August, dictating the depreciation of lek during this period, and the euro recorded a maximum value of ALL 110.6. Starting from the end of August and throughout September, when demand for the euro decreased, the lek began

[6] *The standard deviation of daily and weekly interest rates in the interbank market this quarter was 0.11 and 0.03, respectively. In 2023 H1, this indicator was 0.17 and 0.04, respectively.*

[7] *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).*

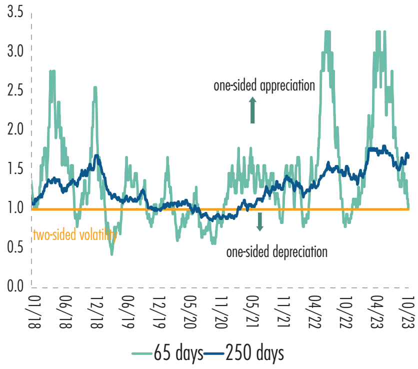
Chart 7

The appreciation of the lek moderated after July ended



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

Appreciating pressures eased, but they remain present in the long-term

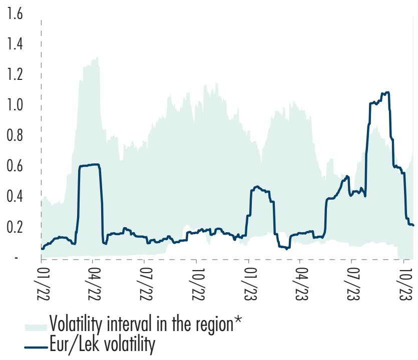


Notes: The data present the indicator of bias for appreciation/depreciation
Source: Bank of Albania.

to appreciate, but at a contained pace. At the same time, trading conditions have stabilized; the volatility of the exchange rate has decreased significantly, while the spread between the buying and selling price of the euro is converging towards its normal values. During the first weeks of October, the Eur/ALL exchange rate was relatively stable, fluctuating around the average of ALL/Eur 105.8. The annual appreciation of lek during August-October decreased at averagely 9.4% from 12.1% in July.

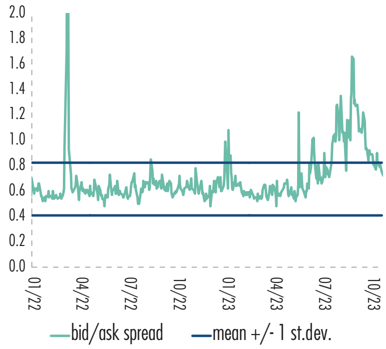
Chart 8

EUR/ALL exchange rate volatility has dropped



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 and Romania.
Source: Bank of Albania and respective central banks.

...and bid/ask spreads are converging within the normal range



Note: The chart shows the spread between the quotations of the bid/ask price of euro The interval is calculated as an average +/- standard deviation.
Source: Bank of Albania.

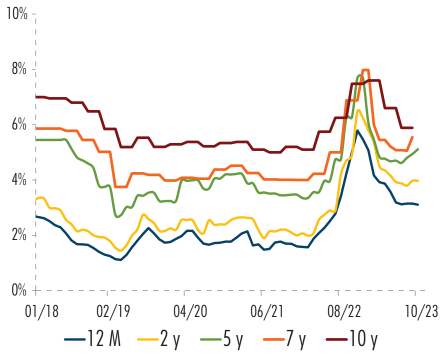
The performance of the Eur/ALL exchange rate also dictated the fluctuations of the exchange rate of other currencies. The US dollar recorded the lowest average in July, at ALL 93.4, whilst it increased at 100.0 lek in September. During the first three weeks of October, the exchange rate against the US dollar was stable, on average ALL 100.3. The appreciation of the lek against the US dollar in these three weeks, fell to 15.9% from 19.0% in July.

Yields on government securities did not show significant changes in the third quarter, while their spread from the policy rate remains minimal. Since the beginning of the year, yields in the primary market have been on the downward trend, but starting in August, T-bills premiums stopped decreasing, while long-terms yield recorded a minimum growth. The performance of yields reflected the shift in the financing structure, from T-bills to long-terms bond by the government in the recent months. Beyond the monthly developments, the overall panorama of yields shows contained risk premium as, the spread of the 12-month yield with the policy rate; the spread between the latter and long-term yields; and the one between the maximum and minimum yields required in auctions; remain low.

The 12-month yield was 3.1% at the last auction in October, being the same as the average of the third quarter and below the values of the first half of the year. Meanwhile, 3-, 5-, 7- and 15-year bond premiums increased averagely about 0.26 p.p. during this period. However, they remain much lower compared to the values at the beginning of the year and those of the previous year. The yield curve reflected these developments by marginally increasing the slope and level compared to the end of the second quarter. From a long-term point of view, the slope of the yield curve has not experienced substantial changes. Compared to the moment of the beginning of the normalization of the monetary policy, the curve has shifted upwards and has an unchanged slope.

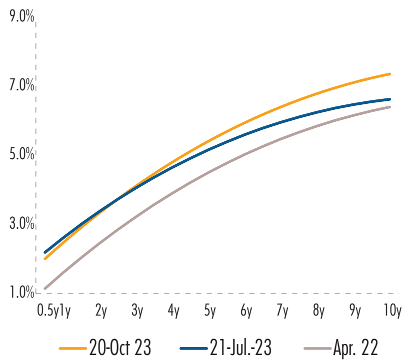
Chart 9

Yields on government securities have appeared stable at low maturities and slightly rising at mid- to long-term ones



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 slope of the yield curve has slightly increased compared to the end of the second quarter, but remains unchanged in the long-term perspective



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

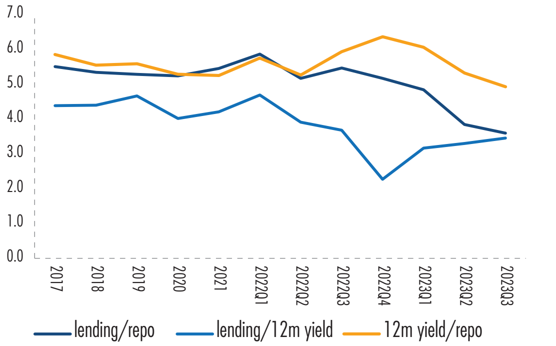
3.2. LENDING CONDITIONS

The interest rates on new loans in lek remained stable, at low levels during the third quarter of the year, with marginal changes in certain segments. Beside the monthly volatility, the loan interest rates during this period seem to have been affected by the downward trend of T-bills yields. The analysis by category shows that interest rates on mortgage loans to households, which are more closely parameterized with the 12-month yield and largely drive its performance, have been declining in recent months.

Another factor that keeps loan interest rates low is the evidence of the decline in overall risk premia, expressed in lower loan interest rate margins compared to the policy rate and to T-bills. The good performance of economic activity and the improvement of the financial situation of enterprises and households have incited a more positive attitude of banks towards lending and the reduction of the perceived risk of loans to customers or good projects. The spread between loan interest rate and policy rate has decreased to 3.6 p.p. in the third quarter, from the average of 5.4 p.p. of the last five years. Although to a lesser extent, margins have also narrowed against the 12-month T-bills yield.[8] On the other hand, banks continue to have weak pressures from funding costs in terms of increasing interest rates of loans. Although deposit interest rates continue to increase on a monthly basis, these increases remain minimal. After the rise experienced in the second half of last year, the spread between the loan interest and that of term deposits is currently below the average of recent years.

Chart 10

The low lending interest rates reflect the narrowing of margins against the policy rate and the 12-month yield amid sluggish growth of deposits interest rates



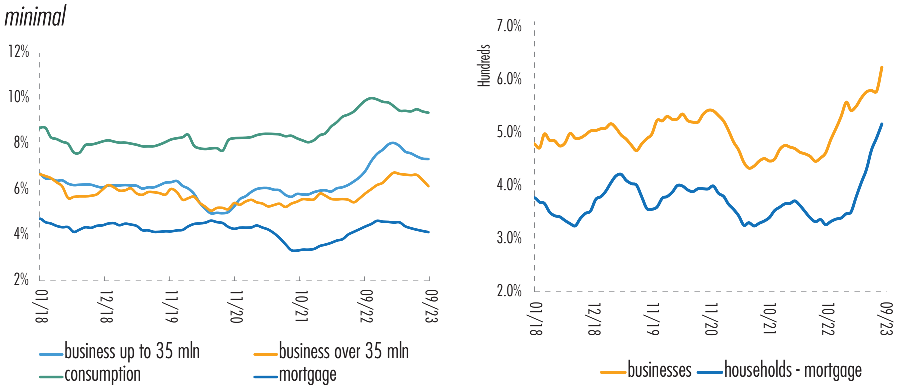
Note: Credit interest rate spread to Repo, 12-month T-bills and interest rates of term deposits.
Source: Bank of Albania.

The average interest rate **on new loan in lek to enterprises** was stable in the last three months. It was 6.4%, close to the value recorded in the second quarter at 6.5%, and below the average of the first half of the year at 6.9%. The analysis

Chart 11

The interest rate for loans in lek decreased for mortgage loans, while in other segments the changes have been minimal

Interest rates on loans in euro continue to increase



Note: Interest rates on new loans in lek as 6-month moving average.
Source: Bank of Albania.

Note: Interest rates of new loans in euro as 6-months moving average.
Source: Bank of Albania.

[8] *If these two margins had not changed from their 2017-2021 averages, loan interest rates would have been 0.8 - 1.8 p.p. higher, reflecting to a greater extent the increases in the policy interest rate.*

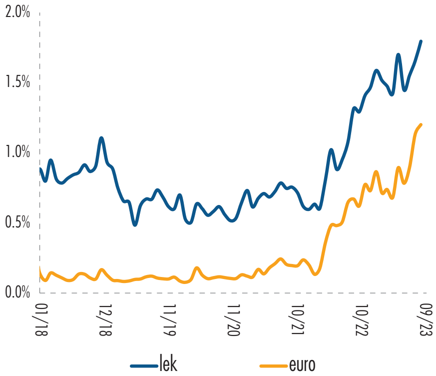
by loan size shows that, compared to the beginning of the year, the largest decrease was recorded in the interest rates on medium-sized and large loans (over ALL 35 million).

The interest rate on mortgage loans to households continued to decrease during this quarter as well. The interest rate was 4.0%, compared to 4.3% in the previous quarter. Meanwhile, interest rate on consumer loan slightly decreased, at 9.3%, from an average of 9.4% in the first half of the year.

Interest rates on loans in euro continued to increase in this quarter, both on loans to households and enterprises. The average interest on new loans in euro to enterprises was 6.4% from 6.1% in the second quarter and 5.4% in the beginning of the year. Interest rates of mortgage loans in euro to households increased more significantly. This quarter, it was 5.3%, compared to 4.3% in the first half of the year. The spreads between the interests on loans in lek and those on loans in euro have narrowed significantly for both enterprises and households, as a result of the rapid growth of the latter.

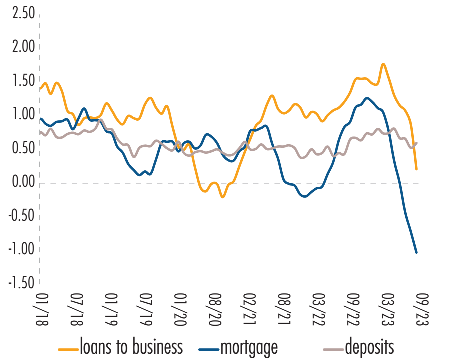
Chart 12

The interest rate for time deposits continues to increase gradually



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

Lek/euro interest spreads narrowed further 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, 6-month moving average loans, mortgage loans and time deposits.
Source: Bank of Albania.

The interest rates on time deposits in lek continued to increase, albeit in a gradual manner. On average terms, they were 1.7% this quarter, from 1.5% in the first half of the year. Since the beginning of the normalization of the monetary policy (April 2022), the interest on deposits increased by 1.2 p.p. The interest rates on time deposits in euro also slightly increased during these months, reaching 1.1%, from 0.8% in the previous two quarters.

BOX 1 SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2023 Q3[1]

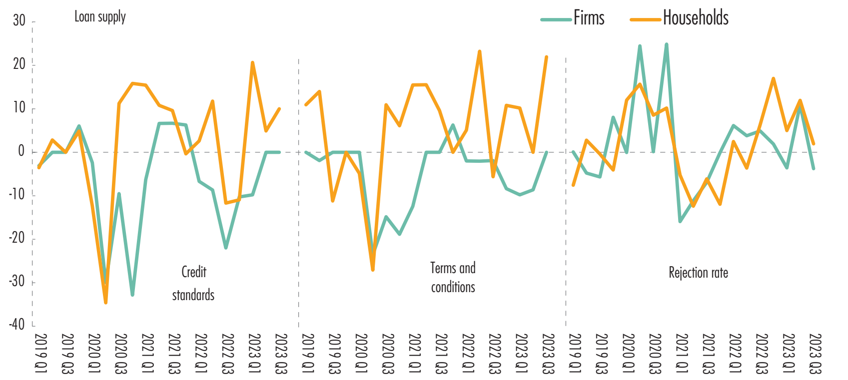
The increase in competition as well as the banks' optimism about the future developments of the Albanian economy were reflected in more favourable lending policies during the third quarter. Loan demand improved this quarter as well, more pronounced among households.

Commercial banks formulated their lending policies for businesses within a wider range of risk tolerance, as a result of their positive perceptions of the current and expected performance of the domestic economy. Banks maintained the same standards of lending to enterprises, for both, loans for financing investments and those for working capital financing. Likewise, terms and conditions on new loans to enterprises did not change, after a tightening for six months in a raw. Banks remained vigilant regarding risk assessment, however, in this quarter the rejected loans ratio to enterprises fell, driven by the quality of loans and the high level of liquidity that enterprises have in the banking system.

Banks continued to maintain a supportive approach in terms of lending to households in the third quarter, expressed by eased lending standards, terms and conditions for all types of loans. Banks have accommodated the credit demands of households, by reducing margins in addition to easing some other elements of non-price conditions, such as increasing the size of the loan, as well as lowering collateral requirements.

Chart 1 B1

Loan supply conditions appeared to improve

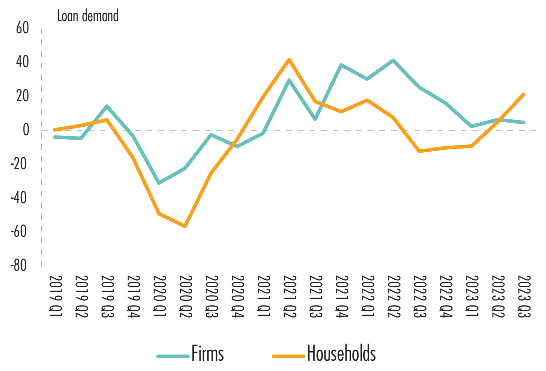


Source: Bank of Albania.
Values on the chart are calculated as net balances. Positive values indicate easing of terms and conditions and vice versa. Positive values indicate increase of the scale of application refusal and vice-versa.

Loan demand was reported as picking up, mostly from households, for all types of credit use. In regard to enterprises, the net balance reflects the increased demand for investment loans and the low demand for liquidity. More specifically, large enterprises increased their demand for loans to expand their production capacities. On the other hand, the increased demand for loans in the household segment was reported by some banks, for the second consecutive quarter. The

Chart 2 B1

Credit demand was high across all segments



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.

factors that have supported this growth are the higher needs for financing the purchase of houses, and those for consumption financing, which have dominated the hindering factors for the expansion of credit demand, such as high interest rates or current and expected developments in the housing market.

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

3.3. CREDIT TO THE PRIVATE SECTOR[9]

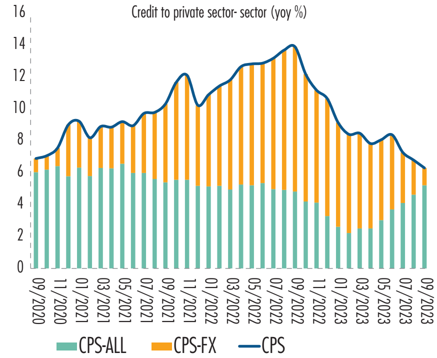
In the third quarter, **credit to the private sector** has slowed down by 1.3 percentage points to 6.8%, compared to the previous quarter. This performance has reflected the slowdown of lending in foreign currency, particularly to enterprises, due to the strengthening of the exchange rate, the narrowing of the spread of interest rates between lek and foreign currency, and the improvement in the liquidity situation. Meanwhile, lending to households continued to grow at a stable rate. In parallel, the quality of credit portfolio remains high; the non-performing loans ratio to the total stayed close to the minimum levels of the recent years, at 5.2%.

The performance of credit portfolio by currency shows that lending in lek grew at a rapid pace, peaking at 10% in September. In parallel, the growth rate of lending in foreign currency contracted significantly to 2.0%. The third quarter saw the portfolio shift towards lending in lek on account of the rapid narrowing of the spread between interest rates of lending in lek compared to that in foreign currency, as well as the appreciation of domestic currency against Euro. A detailed analysis on credit portfolio indicates that this shift has been present in both the households' and enterprises' segment. Against this backdrop, the ratio of loans in lek to the total rose by 55%, up by 4 p.p. compared to the end of 2022.

[9] 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 rate and loans written off of balance sheets.

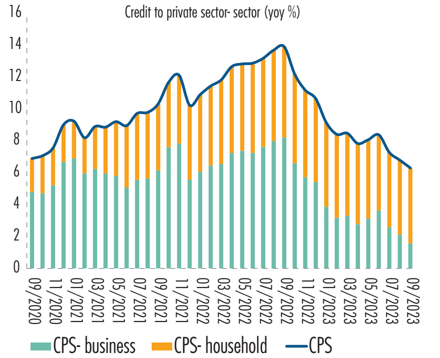
Chart 13

Lending to the private sector slowed down because the rate of lending in foreign currency dropped



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.

The slowdown of lending was affected by the weak performance of loans to enterprises



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.

The slowdown of credit growth reflected the performance of lending to enterprises. Thus, the annual average growth of this portfolio recorded roughly 3.4%, down by 1.6 p.p. compared to the second quarter. By segments, this slowdown reflected the high level of repayments of loans obtained for liquidity, which, in September, was 1.6% lower than in the previous year. Meanwhile, loans for investment increased by 5%, on average, recording a higher rate than the previous quarter. These developments indicate that the enterprises' liquidity is high and the demand for financing investments has gone up.

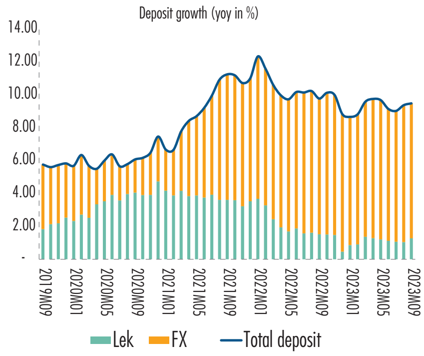
In contrast to enterprises, **bank financing to households** has maintained the same pace as in the first half of the year. The annual growth rate of this portfolio was 12.5%, close to the average recorded in the second quarter. By sub-segments, the growth of consumer credit improved to 10% during this quarter, offsetting the deceleration in mortgage growth rate, which stood at 13%. The latter was impacted by issues in the system after property registers were digitalized. However, data from the Lending Activity Survey shows that the demand for house purchases continues to be high, and banks have eased some of the terms and conditions for this segment, in response to added competition.

Deposits in the banking sector grew by 9.3%, annually, during the third quarter of the year, continuing the positive trend of the previous periods. This performance was underpinned by the rapid increase of deposits in foreign currency, which recorded a 15.5% annual growth due to the high foreign-currency inflows during the period. Whereas, deposits in lek grew at a slower pace, of 2.5%, mostly reflecting the fiscal consolidation of the period. These developments reflected the further increase in the share of foreign-currency deposits to the total, to 55%, or up by 1 p.p. than the level recorded last year.

By economic agents, deposits expanded by 5.4 p.p. during the year, driven mainly by households, whereas enterprises' contribution edged up. Households' deposits grew by 7% on average in the third quarter, edging down quarter after quarter. This performance reflected the development of the interest rates of deposits and opportunities for investing savings in securities or investment funds. On the other hand, the growth rate of deposits to enterprises stood at 20% in Q3, reflecting the satisfactory liquidity situation.

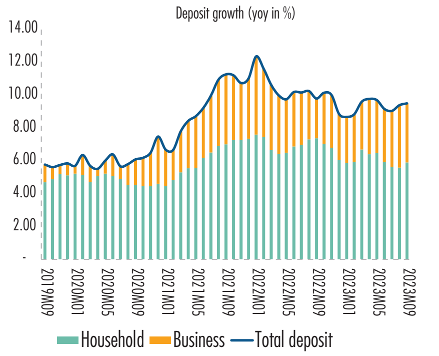
Chart 14

Deposits grew at a stable rate supported by foreign-currency deposits



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

Due to the added liquidity of enterprises, their contribution to total deposit growth has been rising



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

4. ECONOMIC GROWTH

The annual economic growth in 2023 Q2 stood at 3.2%, higher than the previous quarter, despite the tighter financing conditions and the deceleration of external demand.

Economic growth was supported by the private sector's expansion of demand for consumption and investments and a better performance of exports and services, whereas fiscal policy remained consolidated and the export of goods declined. From sectorial point of view, the higher demand for goods and services translated into an expansion in the activity of services and construction, whereas the activity volume of the industry sector dropped and that of the agriculture sector remained almost unchanged.

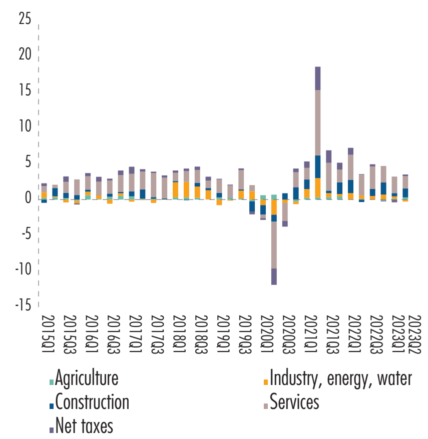
Our projections suggest that the economy will continue to grow at relatively higher rates, in the second half of the year as well.

4.1. GROSS DOMESTIC PRODUCT

GDP grew by 3.2% in 2023 Q2, picking up from the previous quarter when growth stood at 2.8%[10]. In terms of sectors, the acceleration of economic growth reflected the rapid expansion of "Construction" (Chart 15, left), whereas "Services" continued to provide a positive contribution, albeit at a slower rate compared to the previous quarter. Net taxes have gone from making negative

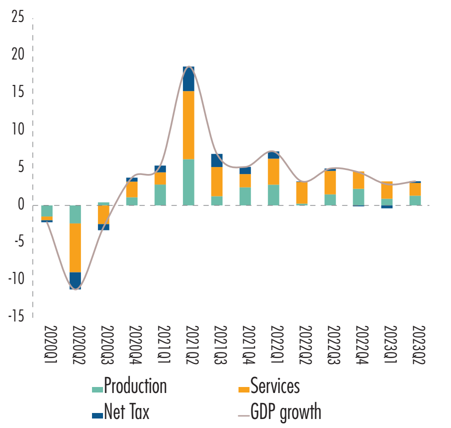
Chart 15

"Construction" activity led the acceleration of economic growth...



Source: INSTAT and Bank of Albania.

...whereas "Services" have slowed down somewhat.



Source: INSTAT and Bank of Albania.

[10] The economic growth in the fourth quarter was revised to 2.8% from 2.7% in the previous publication by INSTAT.

contributions to making positive ones (0.2 percentage points)[11], thus driving the acceleration of economic growth during this quarter (Chart 15, right).

Contribution of the production sector rose to 1.1 percentage points, from 0.9 percentage point in the previous quarter. The acceleration is driven by the annual growth rate of "Construction", which picked up to 14.6%, from 4.8% in the previous quarter. Despite the positive performance of "Construction", the steep double-digit growth reflects the statistical effects of the low comparative base of the previous year as well[12]. The respective rising contribution jumped to 1.4 percentage points, from 0.4 percentage points in the previous quarter and -0.3 percentage points during the previous year. The other branches of the production sector recorded negative annual growth rates. "Industry" contracted by 2.4%, contributing -0.3 percentage points to the economic growth. The negative effects sprang from the "Extracting" and "Processing" industries, following the declining performance of industrial exports during this period. "Agriculture" had a negative contribution close to zero.

The contribution of the services sector to economic growth was 1.9 percentage points, decelerating compared to the previous quarter. By sub-branches, it was "Real estate" that provided main contributions to the growth. This branch is linked closely to the construction activity and its upcoming contributions are on the rise. In parallel, "Public administration, security, education and health" have also made a large impact on growth. As regards the branches of "Trade, transportation, accommodation" and "Arts, entertainment and leisure" the sector's contribution decelerated.

4.2. AGGREGATE DEMAND

The expansion of aggregate demand was supported by the increase of domestic demand, whereas net exports had a negative contribution on economic growth (Chart 16). Additional contributions sprang from "Consumption" and "Investments" as well. The increase in consumption was underpinned by the expansion recorded by both private and public consumption. On the other hand, the increase of investments was driven entirely by private investments, whilst public sector's investments fell down. Contrarily, net exports made a negative contribution; the increase in the export of services could not offset the fall in the export of goods and the overall expansion of imports.

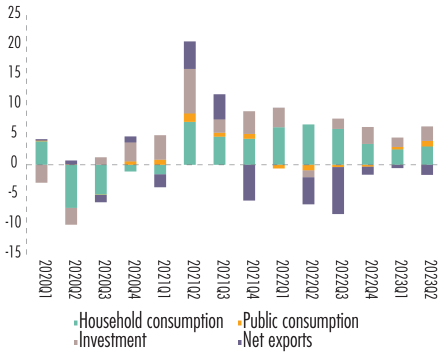
The growth of domestic demand accelerated to 5.9% in Q2, from 4.3% in Q1, driven mainly by a broadly-based increase in its components. "Population consumption" increased by 4.0%, from 3.4% in the previous quarter. Compared to the last period, "Public consumption" grew by 9.3%, from 4.1%; and

[11] *Contribution in 2023 Q1 was -0.4 percentage points.*

[12] *Construction recorded a -3.5% annual rate in 2022 Q2, reflecting the difficulties in the production and supply chains due to the war in Ukraine, as well as rising uncertainties regarding raw material and transportation prices in international and domestic markets.*

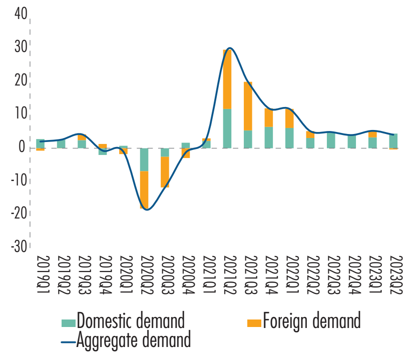
Chart 16

The acceleration of economic growth was driven by domestic demand, with added contributions from "consumption" and "investments"



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

The increase of aggregate demand was underpinned by domestic demand, at a time when external demand has shrank due to falling exports



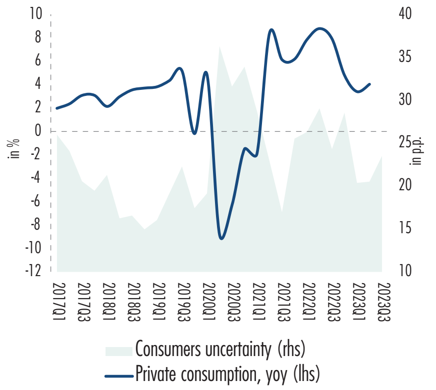
Notes: Domestic and foreign contribution to the annual growth of aggregate demand.
Source: INSTAT and Bank of Albania.

"Investments" went up by 11.0%, from 7.1%. Private investments supported the growth of overall investments, whilst public investments seemed tighter.

Private consumption grew by 4% in Q2, recording a higher rate compared to the previous quarter of the year (Chart 17, left). Private investments provided the main contribution to the increase of aggregate demand. Households made larger expenses for short- and long-term consumer goods, as well as services[13] (Chart 17, right). The growth of consumption was supported by: better employment indicators; an increase of income from wages; expansion of remittances and consumer loans; as well as improved confidence indicators. The available data shows that private consumption is expected to rise with a similar pace in Q3.

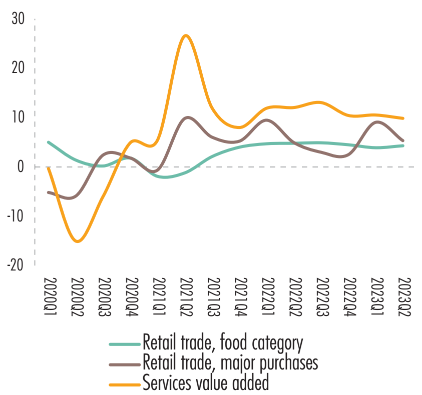
Chart 17

Private consumption accelerated in Q2



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

The rise in expenses was broadly based by main consumption categories



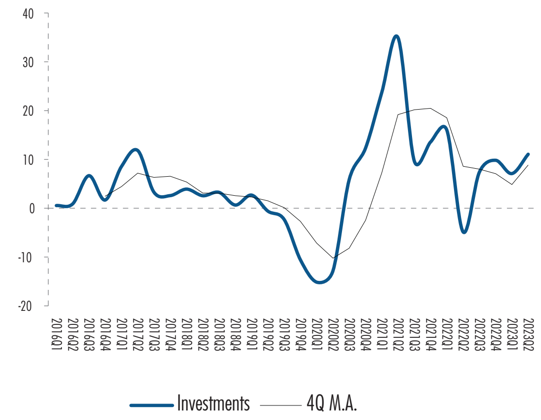
Notes: Indicators are stated in annual changes, in %.
Source: INSTAT and Bank of Albania.

[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.

Total investments grew at an accelerated rate of 11.0% in Q2, compared to 7.1% recorded in Q1 (Chart 18). The assessments on the available indirect indicators show that investment growth was supported by the expansion of private investments, whereas public investments made a negative contribution. The acceleration of private investments is related mainly to the recovery of investments in construction, given the growth recorded in this specific sub-branch. However, import data suggest a higher level of investments toward "Machineries and Equipment" as well.

Chart 18

Investment growth accelerated in Q2



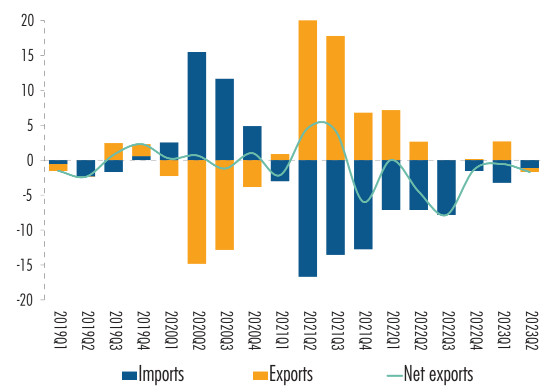
Source: INSTAT and Bank of Albania.

The good financial standing of businesses suggests that there was a higher level of investments financed from own funds, which corroborates with a slower expansion of investment loans. Also, Direct Foreign Investments provided a rising contribution, as the flows increased at an accelerated rate in Q2.

The available indicators suggest that investments will continue to grow in Q3 as well. The increase in the import of construction materials and machineries and equipment continued during this quarter, suggesting that both components (construction and machineries and equipment) had a positive contribution on investments. The positive signals obtained from the indicators of the financial situation and liquidity of enterprises further support investment financing from own funds, whereas the growth rates of investment loans has further decelerated.

Chart 19

Net exports continued to provide an increasing negative contribution on growth during 2023 Q2



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

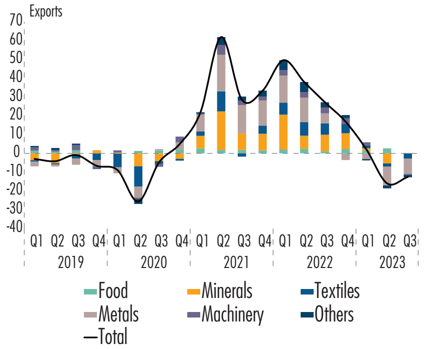
Net real exports continued to have a negative contribution on growth during Q2 (Chart 19). Both imports and exports contributed negatively. Real exports of goods and services shrank by 1.5%. This performance reflects the fall by 26.8% in the volume of exports of goods; this decline was not able to be offset by the 9.1% expansion of the real exports of services. In parallel, the increase in the import of real goods and services was 2.4%, supported broadly by the 8.4% increase in the import of services. On the other hand, the increase in the import of goods was close to zero.

Nominal exports and imports of goods continued to shrink in Q3, bringing about a reduction in trade deficit. This dynamic reflects a faster decline of imports relative to exports. The main factor behind this occurrence remains the decline in prices internationally (Chart 20, left). On the other hand, the contraction in the export of goods reflects the impact of both prices and volumes. Trade deficit of goods contracted by 17.2%, while in the second quarter it expanded by 12.4%.

The export of goods shrank by 12.6% in 2023 Q3 (Chart 20, left), where "Construction materials and metals" and "Textile and clothing" were the main negative contributors. Less negative contributions were registered in other categories. What stood out during Q3 was the crossing of "Food, beverages and tobacco" into negative territory. This category had a positive impact in the previous quarter. However, the fall in annual terms of respective exports is related with the downward trend of prices rather than that of exported volumes.

Chart 20

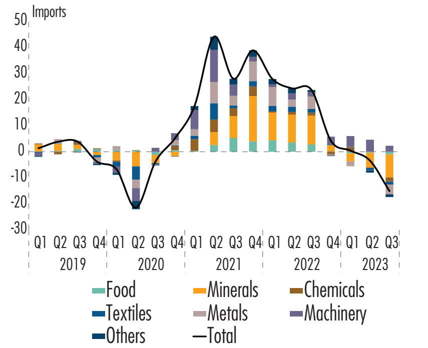
Exports contracted in Q3, impacted by the decline of international prices as well as the volume of exports for special categories



Note: Contribution of the main categories in the goods market, in percentage points.

Source: INSTAT and Bank of Albania calculations.

The contraction of imports have become more pronounced mainly due to the effect of prices and the fall in the import of electricity



Note: Contribution of the main categories in the goods market, in percentage points.

Source: INSTAT and Bank of Albania calculations.

Imports of goods dropped by 15.1%, whereas in Q2 they declined at 3.4% (Chart 20, right). The negative impacts are related with the category of "Minerals, fuels, electricity", due to the decline in the imported energy. Furthermore, the negative contributions rose mainly due to "Construction materials and metals", but this is related to the downward performance of prices. The same outlook is observed for the other categories of imports as well.

Fiscal policy continued to be consolidating in the third quarter. The fiscal surplus continued to expand even more, reaching ALL 52 billion, from ALL 46 billion at the end of the first half of the year. Throughout the year, budget surplus has maintained its highest historical values. However, the fiscal impulse[14] was assessed to be positive, at around 0.4 p.p. of GDP at the end of Q3. This positive value reflects the high level of primary deficit observed in 2022 Q4.

In 2023 Q3, **budget expenditure** were ALL 152 billion, expanding by 4.2% in annual terms. The increase of expenditure was driven by higher social insurance spending, which reflected the effect of the low comparative base of the previous year; and by staff expenses, as public wages went up. Staff expenses increased annually by 24%, marking the highest rise recorded within

[14] *The correction of the fiscal impulse, which accounts for the ALL 28 billion support and loan to the energy sector in 2022, was implemented to gauge at a higher degree of accuracy, the direct effect of fiscal policy on the economy.*

Chart 21

Fiscal impulse shifted to negative territory | *Fiscal surplus is relatively high*

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

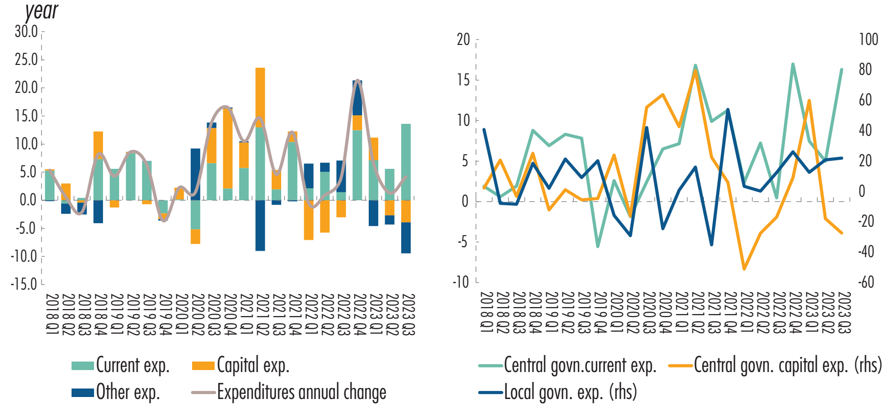
Notes: Budget deficit to GDP. Calculations based on quarterly flows. Positive values show deficit, negative values show budget surplus.
Source: Ministry of Finance and Economy.

one quarter in the past twenty years. Capital expenses shrank by around 27% annually, negatively contributing to the increase of total expenses, by 3.5 p.p.

For the first 9 months of the year, the level of realized expenditures were about ALL 426 billion, or around 3.8% higher than the previous year. The profile of increasing expenses changed after the first quarter of the year, shifting toward investments for current expenses. In the group of current expenses, despite staff expenses, the contribution of expenses for local government and interest rates on loans stood out. The last factor reflects the high-interest-rate environment in both the domestic and foreign market. The slow pace of the increase of expenses in 2023, reflects the high effect of the comparative base of the previous year for expenses related with transfers to the energy sector.

Chart 22

Expenditure increased in line with the first half of the year | *The contraction of capital expenses accelerated*



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

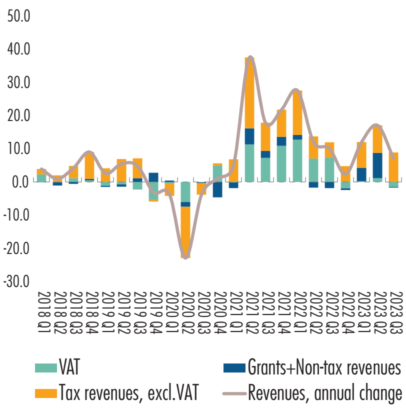
Notes: Annual growth in % of main expenditure items, by quarters.
Source: Ministry of Finance and Economy.

In 2023 Q3, **budget revenues** were about ALL 157 billion, slowing down the annual growth rate to 7.1%, from the average 14.5% recorded during the first half of the year. The slowdown of revenue growth is mainly attributed to the lower revenues collected from VAT on imported goods, as well as the lack of grants, which provided an essential contribution during the first half of the year. Revenues from VAT on imported goods have diminished in annual terms throughout the year, peaking in the third quarter. This performance reflects the rapid appreciation of the exchange rate and the stabilisation of commodity prices in international markets.

In the first nine months of 2023, the total level of revenues reached ALL 477 billion, with an annual growth rate of 12%. Around 30% of the growth was composed of grant revenues, due to their high level of disbursement in energy-focused projects in the first half of the year. Revenues from VAT contributed negatively to revenue growth by 0.1 percentage points, due to the negative impact from imported goods. The contribution of personal income tax on revenue performance has been positive and consistent. The latter reflected the increase in wages for the public and private sector.

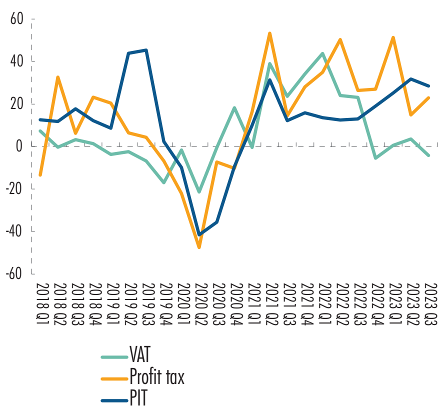
Chart 23

Revenue grew at a slower pace....



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

...on account of lower revenues from imports



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

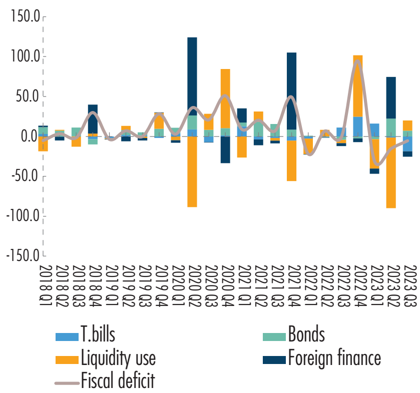
At the end of 2023 Q3, **budget surplus** expanded to ALL 52 billion, from ALL 46 billion at the end of 2023 H1. Fiscal surplus was assessed at 3% of GDP, or 2 p.p. higher than in the same period of the previous year. The annual expansion of surplus is attributed mainly to the lower level of expenses in terms of GDP.

In 2022 Q3, **net borrowing** in the domestic market of government securities declined by around ALL 11.5 billion. The level of borrowing for the first nine months reached at ALL 22.1 billion, from ALL 25 billion planned for the entire year. The lower level of borrowing in this quarter was a result of government's plan to shrink the short-term securities portfolio and enlarge the long-term one.

Thus, in Q3, borrowing in the form of government securities fell by around ALL 18.7 bln, whereas that of long-term securities increased by ALL 7.2 bln. The performance of net borrowing in the domestic market was reflected in a lower level of exposure of banks against government securities, since they were responsible for almost 60% in the fall of the net borrowing. Households' securities portfolio also shrank by ALL 2.3 billion in Q3.

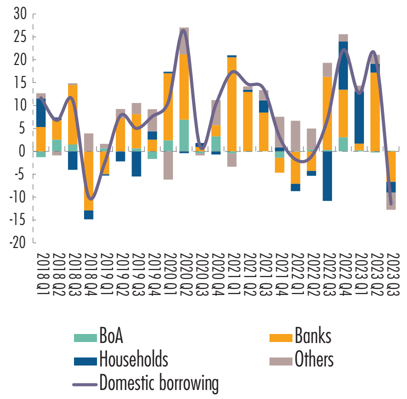
Chart 24

Net borrowing in the domestic market contracted



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

All market agents reduced the level of securities under possession



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

Net borrowing in the foreign market declined by ALL 6.6 billion in the third quarter, since the principal payments on external debt were higher in value than external debt disbursements. However, government's liquidity surplus remains high due to the Eurobond issued in 2023 Q2, as well as the slow rise of expenses vis-à-vis the more rapid increase of budget revenues.

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

The average annual inflation slowed down to 4.1% in the second quarter, from 4.6% in the previous quarter. However, the declining pace was slower than in the first six months of the year. The fall of imported inflation was more contained, due to the rise in oil prices in global markets and the deceleration of the exchange rate appreciation in August and September. On the other hand, albeit the downward trajectory, domestic pressures remain high, and they dominate the formation of inflation during the third quarter.

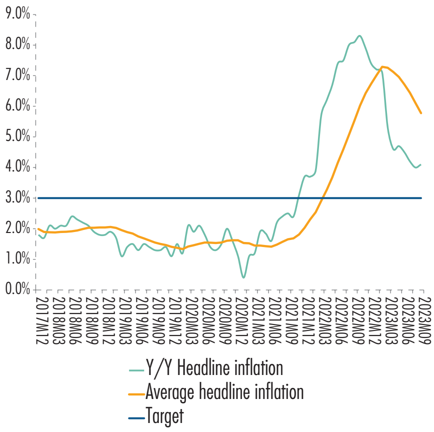
The future inflation trajectory is expected to continue declining due to the further moderation of aggregate demand, as a result of the normalisation cycle of the monetary policy stance, lower global costs of production and transportation, and the reduction of inflationary expectations.

5.1. CONSUMER PRICES

Average inflation slowed down over the third quarter, standing close to 4.1% (Chart 25, left). The inflation profile in Albania is similar to the one of the economies of the region (Chart 25, right), driven mainly by the fall in the prices of food in international markets. Meanwhile, oil prices have picked up again in global markets due to restrictions in supply. Consequently, the declining pace of inflation, domestically and globally, has mitigated. However, inflation in Albania is lower than in the countries of the region and EU, due to the easing effect of the exchange rate appreciation, the fixed energy prices paid

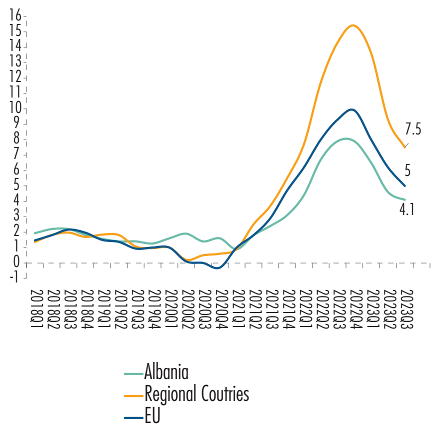
Chart 25

The easing of inflation has continued although not at the same rate as in the first half of the year



Source: INSTAT, BoA's calculations.

Oil prices have started to pick up, slowing the downward pace of global inflation



Source: INSTAT, BoA's calculations.

by businesses and consumer households, as well as the reduced share of oil and energy products in the CPI basket.

"Unprocessed foods" (55%) had a considerable weight on determining annual inflation in the third quarter (Table 2). Since March, this category has become the main contributor to total inflation. The category of **"processed foods"** contributed 0.5 percentage point less to the formation of total inflation than one quarter ago. Almost all its comprising sub-categories made downward contributions. The contribution of **"non-food items"** to total inflation recorded lower negative values. This development continues to be led by the quarterly discrepancy in the contribution of the **"fuel"** sub-category (+0.3 p.p.), reflecting the rising of energy commodity prices in international and domestic markets over the recent months.

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, in specific months, prices fluctuated on both directions, not least the prices of industrial goods, although they remained in almost similar values than the previous quarter. Nonetheless, prices in the service industry remained high, particularly due to the increase of demand in tourism and other related activities, as well as rising labour costs, the share of which is relatively significant in this industry.

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

	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	Annual inflation 2023 Q2 (%)
Processed food	**0.9**	**1.4**	**3.0**	**3.5**	**3.4**	**2.8**	**1.3**	**0.8**	**4.1**
Bread and grains	0.2	0.4	0.7	0.6	0.6	0.6	0.2	0.1	2.4
Milk, cheese and eggs	0.2	0.3	0.9	1.0	1.2	1.3	0.8	0.6	10.4
Unprocessed foods	**1.0**	**1.5**	**1.2**	**1.7**	**1.9**	**1.9**	**2.5**	**2.3**	**13.5**
Fruits	0.4	0.2	-0.1	0.0	0.1	0.1	0.4	0.3	7.4
Vegetables	0.4	0.9	0.5	0.6	0.8	0.7	1.1	1.3	22.2
Meat	0.2	0.4	0.7	1.0	1.0	1.0	0.9	0.7	9.7
Services	**0.3**	**0.4**	**0.5**	**0.6**	**0.5**	**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**	**0.1**	**0.2**	**0.3**	**0.4**	**0.4**	**0.4**	**0.4**	**2.8**
Non-food consumer goods	**0.6**	**1.0**	**1.6**	**1.5**	**1.2**	**0.4**	**-0.6**	**-0.4**	**-3.1**
Fuel	0.4	0.7	1.4	1.3	0.9	0.0	-0.9	-0.6	-17.1
Durable consumer goods	**0.1**	**0.0**	**0.2**	**0.3**	**0.4**	**0.5**	**0.5**	**0.4**	**4.7**
Inflation (%)	**3.1**	**4.4**	**6.7**	**7.9**	**7.9**	**6.5**	**4.6**	**4.1**	**4.1**

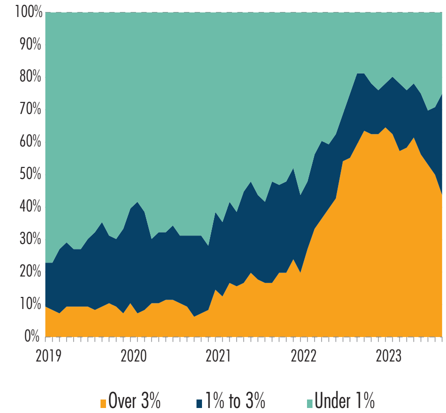
Source: INSTAT and Bank of Albania's calculations.

**The Table shows contributions to inflation by composing categories and some of their main items. The Table also shows the average inflation rate in 2023 Q2.*

The fall of inflation in Q3 is also reflected in the distribution of basket articles by growth intervals. The share of articles with inflation over 3%, is 49% in Q3. This consists of a decline by 10 p.p. compared to the share of the second quarter (Chart 26, left). This share was redistributed to the other two groups which registered an increase of inflation below 1% and in the 1%-3% interval.

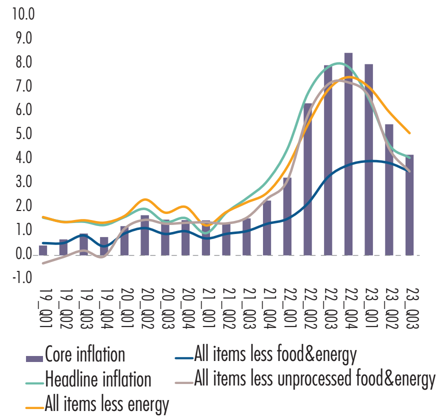
Chart 26

The share of items with in¬flation above 3% further declined



Source: INSTAT and Bank of Albania's estimations.

Net inflation, particularly in the services sector, fell slightly by all measures



Source: Bank of Albania.

These developments were reflected in the deceleration of various measurements of net inflation. Among them, net inflation (less food and energy), not least the one representing services and durable consumer goods fell at the lowest degree, confirming the presence of domestic inflationary pressures, which have remained high and above target (Chart 26, right).

5.2 INFLATION DETERMINANTS

The cyclical position of the economy remains positive. Employment continued to increase, unemployment rate dropped, while production, labour and capacity utilisation rate gaps remain on the positive side. The tighter labour market conditions were accompanied by a sharp increase of wages in the private sector. These developments continue to keep core inflation high, albeit it slowing down in the third quarter. On the other hand, pressures on prices in international markets are still present, but their spread into the Albanian economy was cushioned by the exchange rate appreciation.

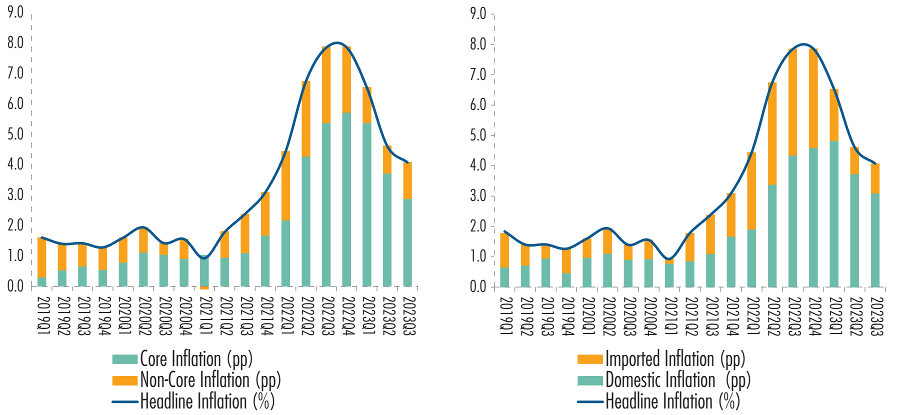
Although decelerating, inflation continues to remain above target, affected for the most part by domestic pressures. The effects of the monetary policy are gradually normalizing these pressures, reflected also in the anchoring behaviour of inflationary expectations toward medium-term inflation target.

The deceleration of total inflation continued in Q3 as well, although more gradually compared to 2023 Q1 and Q2. These occurrences were driven by falling values in core and domestic inflation, whereas the values of non-core and imported inflation dropped slightly. Core and domestic inflation were 4.2% and 3.8% in Q3, declining by 1.3 p.p. and 0.8 p.p., respectively, *compared to the previous quarter. Although on the decline, core and domestic components of inflation remain at high historical values, accounting for the persistent high value of total inflation as well (Chart 27). The slowdown of these components reflects the high comparative base of the previous year, a period when they rose significantly[15].*

Chart 27

Domestic and core inflation decelerated, but continued to dominate total inflation

Imported and non-core inflation made a slightly higher contribution than the previous quarter

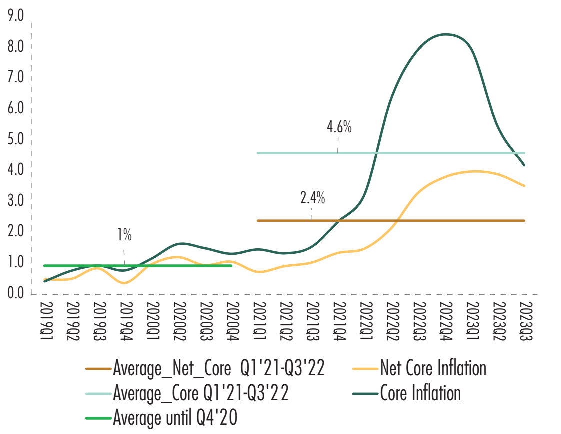


Source: INSTAT and Bank of Albania's estimations.

Source: Bank of Albania.

Chart 28

Net core inflation decelerated at a much slower pace than the other core measurement



Source: INSTAT and Bank of Albania's estimations.

The high and relatively sustainable pressures from the domestic economy are identified more clearly upon measuring net core inflation[16], which stood at 3.5% during this quarter. The deceleration was more relaxed, and the specific value remained stable, standing above the average of the past three years, a period during which inflation delivered a sharp blow (Chart 28). The most volatile components of inflation - non-core and imported - increased in the third quarter of the year, cushioned by the effect of falling oil prices and rising unprocessed foods prices. The annual rates were 3.8% and 5%, respectively, up by 1.0 p.p. and 0.5 p.p. compared to the previous quarter.

[15] Core inflation rose to 7.9% in 2022 Q3, from 6.3% in Q2. Domestic inflation climbed to 4.3%, from 3.4% in the same period last year. The first and most intense jump occurred at the beginning of the war in Ukraine, when core and domestic inflation recorded almost double the values of the first quarter.

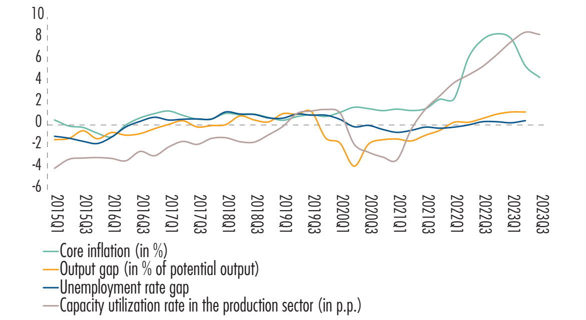
[16] Core inflation considers over 69.2% of the current CPI basket; net core inflation that excludes the sub-groups of processed foods (including bread and grains) considers over 44.6% of the basket.

The improvement of demand in the economy, additional market pressures and labour costs, and above-target inflation expectations have kept headline inflation at high values, driven by the essential contributions of core and domestic inflation on total inflation in the third quarter of 2023 as well (respectively 71% and 76%).

The economy continued to operate while exceeding its potential in 2023 Q3 (Chart 29), which is reflected in low unemployment rates, the inability of businesses to acquire a new labour force, a rapid increase in wages and a high capacity utilisation rate. The capacity utilisation rate in the economy was 80.5% in 2023 Q3, a level close to the one recorded in Q2, remaining above the long-term average of said indicator.

Chart 29

Economy's cyclical position appears positive in 2023 Q3



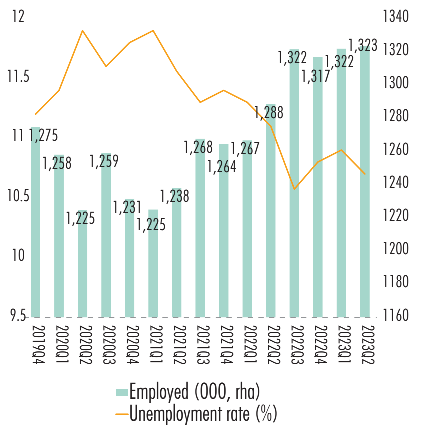
Notes: The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilisation rate gap is estimated as a deviation of the current value from the relevant historical average, and then the moving average method is applied. The unemployment rate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

Employment and unemployment. Employment increased by 2.7% in 2023 Q2 (Chart 30, left). The positive contributions were entirely driven by the services sector, whereas "Agriculture" and "Industry" had a negative impact. The unemployment rate edged down to 10.7%, compared to 10.9% in 2023 Q1. In the same vein, the participation rate of the labour force has widened, reaching 7.5% in this quarter (Chart 30, right).

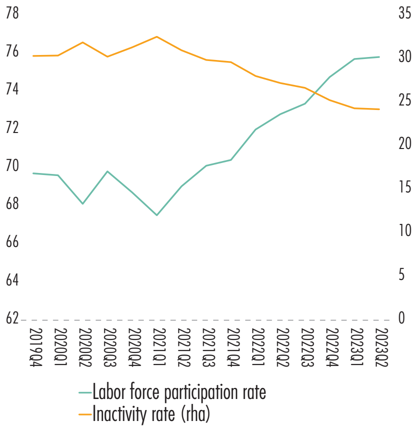
Chart 30

Employment continued to increase and unemployment dropped during 2023 Q2



Source: INSTAT.

Participation in the labour force has increased somewhat, despite the impeding inactivity of the labour force



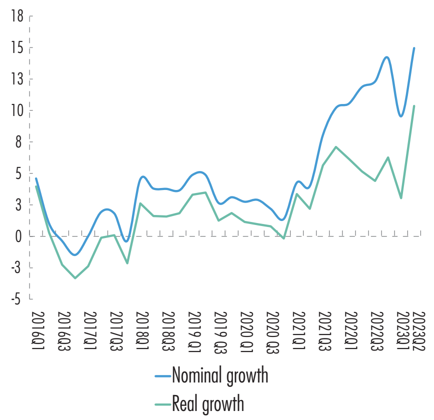
Source: INSTAT.

Wages, productivity and labour costs. The increase of the average wage in the private sector accelerated to 15.0% during 2023 Q2, from 9.5% in Q1. The positive contributions were broadly based, mainly concentrated in the branches of "Trade, transportation and hotel accommodation" and "Industry".

The accelerating wage increase of the sector indicates tighter labour market conditions. The apparent acceleration of the private sector's wages, in nominal terms, and the deceleration of inflation compared to the first quarter of the year, was reflected in a faster increase of real wages. In Q2, the real growth of private sector's wages reached 10.4%, from 3.0% in the previous quarter (Chart 30, left).

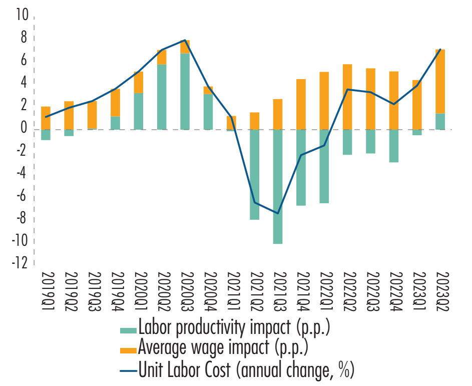
Chart 31

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



Source: INSTAT.

Labour cost per unit expanded with a faster pace during the second quarter, owing to the effect of wages



Source: INSTAT and Bank of Albania.

Note: The positive contribution of labour productivity (LP) in the calculation of the annual changes of unit labour cost (ULC), shows that LP index gave negative annual rates.

The unit labour cost[17] accelerated to 7.1% in 2023 Q2 compared to the previous quarter (3.9%), reflecting the growth of wages in the private sector (Chart 31, right). On the other hand, labour productivity has shown a negative tendency, further increasing the unit labour costs.

Other output costs have gone up, but at a slower pace compared with the previous quarter. Producer prices increased by 6.9%, from 9.4% in Q1, as domestic producer prices slowed down less than export producer prices. Domestic and export producer prices rose by 8.3% and 4.6%, down by 1 p.p. and 4.5 p.p., respectively, compared to the previous quarter. Lastly, the construction cost index rose by 4.7%, from 5.3% in the previous quarter.

The rising oil prices in international markets during 2023 Q3 was reflected in the expansion by 24% of the contribution of imported inflation to headline inflation, from 19% in the previous quarter (Chart 27, right). The appreciation of the exchange rate has helped to relatively mitigate the transmission of the pressures rising from the monthly rise of oil prices on inflation, domestically.

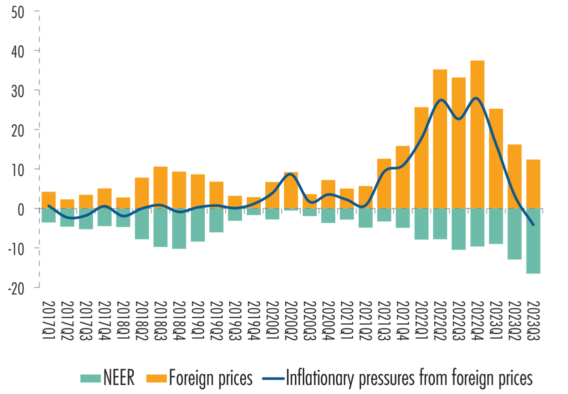
Imported inflationary pressures shifted to a negative territory during 2023 Q3. The imported inflationary pressure index (IIPI) shrank by 4.2% in Q3, after

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

increasing by 3.3% in Q2 (Chart 32) as a result of the decelerating tendency of rising international prices and the appreciation of the exchange rate. International prices rose by 12.4% during Q3, from 16.2% in Q2. In parallel, the effective nominal exchange rate appreciated by 16.5%, from 13.0% in the previous quarter, reducing the imported inflationary pressures. The occurrences related to imported inflation are expected to be transmitted to headline inflation in the upcoming periods[18].

Chart 32

The increase of Imported Inflationary Pressures has shifted to negative territory during 2023 Q3



Source: INSTAT and Bank of Albania's estimations.

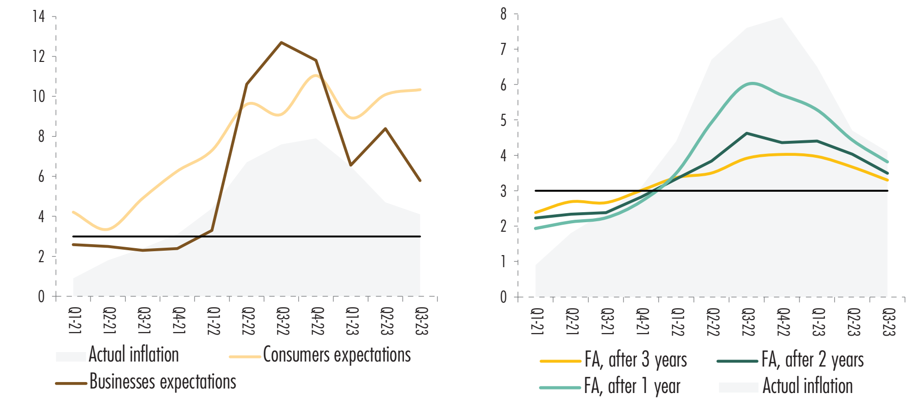
Inflation expectations from financial agents have continued to fall in Q3, while expectations from enterprises and consumers increased[19]. Inflation expectations from enterprises increased to 8.4%, against the 6.6% registered in the previous quarter. Consumers expect inflation to be 10.1% after one year, up by 1.2 percentage points from the first quarter.

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

Chart 33

One-year-ahead expectations on inflation from enterprises and consumers

Expectations on inflation of financial agents over three time horizons



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

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

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18 *IIPI is calculated as the annual growth of IPI and NEER for the respective month. From the correlation analysis of the relevant indicators with different time delays, IIPI anticipates the short-term developments in the imported inflation component by about 1-2 months.*

19 *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.*