

Bank of Albania

MONETARY POLICY REPORT

2024/I

MONETARY POLICY DEPARTMENT

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INTRODUCTION¹

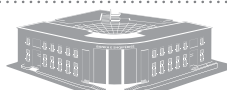
The primary objective of the Bank of Albania's monetary policy is to achieve and maintain price stability. This target implies reaching low rates with positive inflation and maintaining these for a relatively long period of time. In quantitative terms, the Bank of Albania has defined price stability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

The Supervisory Council of the Bank of Albania holds 8 meetings each year to decide on monetary policy, aimed at achieving the price stability objective. The Supervisory Council sets the key interest rate. Changes in the key interest rate affect, with a time lag, other interest rates in the financial market, for example, yields on government's securities and interest rates on loans. These changes drive an 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.

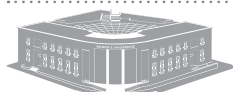
The transmission mechanism encompasses various channels through which prices may change, for example: the exchange rate channel; the inflationary expectations channel; and the foreign assets channel. The Bank of Albania has constructed models to forecast changes in various elements which affect prices 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 reverse is also possible. 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 to changes in interest rates.

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

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



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 29 January 2024. The Supervisory Council reviewed and adopted this Report at its meeting on 7 February 2024.



FOREWORD BY THE GOVERNOR

The Albanian economy pursued an overall positive stance throughout 2023.

The volume of economic activity has been growing, generated by an increase in both employment and wages. In parallel, inflation has been coming down leading to an improvement of households' purchasing power and reducing uncertainty in the future. Lastly, the main indicators of economic and financial soundness of the economy - public debt; external debt; and the non-performing loans ratio - recorded an improvement.

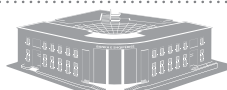
This positive panorama reflected the sound premises of the country's development. The improved confidence of households and enterprises has promoted a more positive approach towards investments and consumption. In addition, favourable monetary and financial conditions have bolstered the demand for goods and services. Reflecting this, credit to the private sector has been increasing, providing necessary funds to the economy for expanding activity and meeting liquidity needs. The Albanian economy has also benefited from fast growth in tourism revenues, which in turn has compensated for the decline in goods exports and has brought about a significant improvement in the balance of foreign trade exchanges.

The monetary policy of the Bank of Albania has made a significant contribution to this picture of developments.

The gradual and prudential normalization of the monetary policy stance over the last two years has enabled financial markets to function smoothly, has contributed to keeping inflation under control and has reduced uncertainties in the future. A decrease in inflation across the economies of our trading partners, the strengthening of the exchange rate as well as the reaction of our monetary policy have caused inflation to go back down. Inflation dropped to 4.0% from 7.4% over the course of 2023.

Our forecast for the future is positive.

The expanded consumption, investments and Albanian exports, particularly those in tourism, will continue to feed through economic growth in the coming years. This growth will translate into a further rise in employment and wages as well as in the well-being of Albanian households. On the other hand, inflation is expected to decline gradually and return to our 3% target by mid of 2024.



The Bank of Albania will continue to attentively follow economic developments and will take care, through its monetary policy, to establish appropriate conditions for achieving our price stability objective. Our monetary policy stance, expressed through the level of the key interest rate, will aim to guarantee a return of inflation to the target, in the shortest possible time and with the lowest costs on economic activity. This approach will be consistent with the balance of overall inflationary pressures, with fiscal policy and with the performance of the exchange rate, as factors with a primary impact on inflation performance.



1. INFLATION AND MONETARY POLICY STANCE

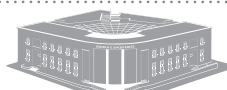
In 2023, economic activity, employment and wages increased, while the main indicators of the country's economic and financial stability improved. In particular, inflation continued to decline, as a result of a decrease in foreign inflationary pressures, appreciation of the exchange rate, and normalization of the monetary policy stance in Albania.

Current projections suggest that inflation is expected to return to the target in 2024 H2. This forecast follows expectations for a further decline of inflation in our trading partners, for a more moderate increase in demand for goods and services, for a reduction in imbalances in the labour market, and a gradual reduction in inflation expectations.

In conjunction with these conclusions, the Supervisory Council decided to keep the policy rate unchanged, at 3.25%. However, the persistence of domestic inflationary pressures may trigger continuation of the monetary policy normalization process. The Supervisory Council emphasised that it remains eager to take all the necessary measures, at the right time and to the right extent, to guarantee the return of inflation to target.

The global environment remains unstable and a decline in inflation is curbed by continued high pressures stemming from shortages in the overheated labour market and geopolitical risks. In a global context, the performance of different economies shows divergences among regions, sectors and indicators. In the euro area, economic growth slowed down significantly, while the labour market remains strong. In the US, economic activity appears more stable, as a result of the higher flexibility of the economy and lower exposure to the consequences of supply shocks in energy markets. The disinflation process continues to be present in most countries, but inflation remains above central banks' targets. Average inflation in the euro area rose to 2.9% in December, from 2.4% in November, highlighting the increase in labour market pressures. Inflation is expected to gradually decline over the current year and return back to the European Central Bank's target at 2%, in 2025. For this reason, the ECB has emphasized the need to keep the interest rate tight for a long period of time. Uncertainties related to the future remain high, in the presence of geopolitical conflicts and the effects of tightening monetary conditions.

During 2023, the Albanian economy displayed continuous growth of economic activity, employment and wages, a stable economic and financial environment and a downward trend in inflation.



In 2023, average inflation dropped to 4.8%, from 6.7% in the previous year. The drop of inflation was dictated by stabilization of food and oil prices in the global market, appreciation of the exchange rate and normalization of the monetary policy stance. However, the decline in inflation was relatively rapid up until mid-2023, reflecting the stabilization of commodity prices across global markets, and continued at a slow pace in the following months, as a result of the persistence of domestic inflationary pressures. Thus, the average inflation in the fourth quarter fell slightly by 0.2 percentage points, down to 3.9%.

Inflationary pressures from the domestic economy have been coming down, but they still remain high and inconsistent with our price stability objective. These pressures reflect both the high demand for goods and services, as well as the rapid increase in wages and production costs.

The new information shows a better performance of the economy in 2023 H1 and its growth by 3.5% in the third quarter.² Expansion of consumption, investments and revenues from tourism fuelled the economic growth. From the macroeconomic perspective, economic growth was underpinned by an improvement in business and consumer confidence, a rise in disposable income, an accommodative financial environment, and an increased interest of foreigners in Albanian tourism services.

The improvement of economic activity was reflected in positive developments in the labour market. In the third quarter, these trends were seen in a further increase in employment, a drop to an historical minimum of 10.5% in the unemployment rate, and a 14.5% increase in wages in the private sector. The rise in wages has supported an increase in the income of Albanian households, who have also been favoured by the fall in inflation, but at the same time it has driven up the production costs.

The objective of the monetary policy of the Bank of Albania has been and remains the return of inflation to target, at the fastest possible pace and with the lowest costs to economic activity. The normalizing cycle of the monetary policy stance that has been undertaken over the last two years, has aided in reaching this objective. Its pass-through in the interest rates of loans and deposits in lek has continued, in accordance with the time-lags and specifics of the segments of the internal financial market. However, the financial environment remains stimulating and risk premiums are low. In response, the growth rate of credit to the private sector has continued to improve, displaying a broad borrower base and high diversification in purpose of use.

Forecasts regarding the future suggest a continued growth of the economy and a return of inflation to the target in 2024 H2. The return of inflation to the target is expected to be supported by a slight reduction in the growth rate

² With the publication of the GDP for the third quarter, the growth rates for the first two quarters of 2023 were revised up.



of aggregate demand during 2024, which will enable a better balancing with supply and will ease pressures on the labour market. Further reduction of inflation in the foreign market and expected stability of the exchange rate will also provide support to this objective.

The pace of economic growth is expected to slow down slightly and temporarily in 2024, and to return to its potential in the following years.

This slowdown will reflect the weakness of economic activity in the euro area, tighter financing conditions in Albania and abroad, and shortages in the labour market. On the other hand, the expansion of economic activity will benefit from an increase in disposable income, supported by further growth in employment and wages, a fall in inflation, high levels of confidence in households and enterprises, continuous growth in the tourism sector, a stable financial environment with abundant liquidity, contained risk premiums and continuation of stimulating interest rates.

Balance of risks to inflation remain tilted to the upside. In particular, new pressures to increase oil and food prices in the presence of regional conflicts pose new risks for higher global inflation, but also for the emergence of second-round effects in the form of increased inflationary expectations. In parallel, pressures from the domestic labour market may turn out to be stronger and more stable, pushing up the projected trajectory of inflation.

At the conclusion of the above-mentioned analysis and forecasts, the Supervisory Council decided to keep the policy rate unchanged, at 3.25%. However, the Supervisory Council emphasized that the persistence of internal inflationary pressures and upside risks to inflation require continuous monitoring of the situation and response in a timely manner in relation to monetary policy, in order to guarantee compliance with our objective of price stability: achieving and maintaining an inflation rate around 3%.



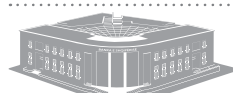
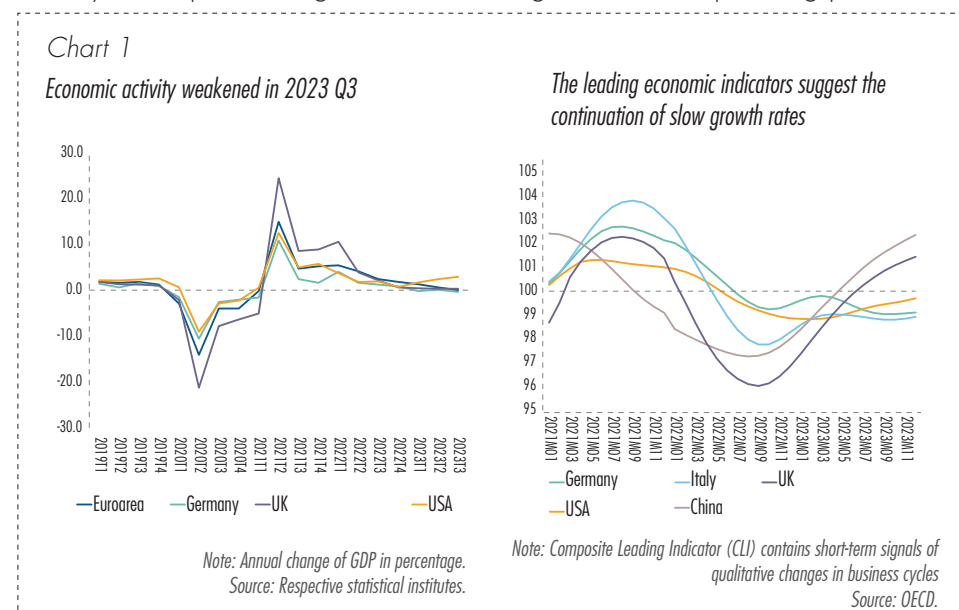
2. EXTERNAL ENVIRONMENT

Global economic activity has slowed down in 2023 H2, impacted by the tightening effect of high interest rates and lingering uncertainty regarding the geopolitical situation. High-frequency data and forecasts related to the market suggest lower rates of economic growth in the coming quarters as well.

Inflation rates continued to trend downward, but at a slower pace. This trend is also observed in the core inflation indicators, which have fallen to more moderate rates compared to the first half of the year. These dynamics suggest that overall inflationary pressures are still high and inconsistent with a sustained return of inflation to target. For this reason, the main central banks are expected to keep their interest rates relatively high and for a long period of time.

2.1. ECONOMIC ENVIRONMENT

Global economic activity has slowed down in 2023 Q3, mainly due to low growth rates in advanced countries. The economy of the euro area contracted by 0.1% on a quarterly level and remained at a similar level to the same quarter in the previous year. Economic activity in the US was stronger compared to what was expected in the third quarter of the year. Preliminary data from these economies suggest that growth rates for the last quarter of the year will continue to be low for the euro area economy and will continue to further improve for the US economy. Economic activity has been higher in developing countries. China's GDP expanded by 4.9% in the third quarter of the year, from 6.3% in the previous quarter, but structural weaknesses in the residential construction industry are expected to generate a slowing trend in the upcoming period.



Tight financing conditions are significantly contributing to the slowdown of demand for goods and services. Interest rates remained high, especially in the US, while bank lending continued to slow down, especially in the euro area.

Inflation rates have been volatile: after a rapid drop over October and November, inflation increased in December. This performance was dictated by the performance of commodity prices in international markets and the phasing-out of supportive measures, initiated at the end of 2022, for the protection of consumers in advanced countries against a rapid surge in energy prices. Beyond being short-term, the persistent inflationary pressures remain high and are not yet adequate to accommodate a rapid return of inflation to central banks' targets. Central Banks kept interest rates unchanged in November and December but have signalled for the achievement of a maximum limit of policy rates.

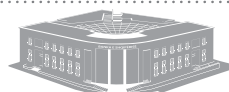
Global economic activity is expected to slow in 2023 and continue to maintain low growth rates in 2024. According to the latest WB forecasts³, global growth is expected to slow from 3.5% in 2022 to 2.6% in 2023 and 2.4% in 2024. This trend is uneven across economies, hence advanced economies are expected to slow down even more, while developing economies are expected to grow at relatively fast rates. Inflation rates are expected to decline gradually in 2024 and 2025.

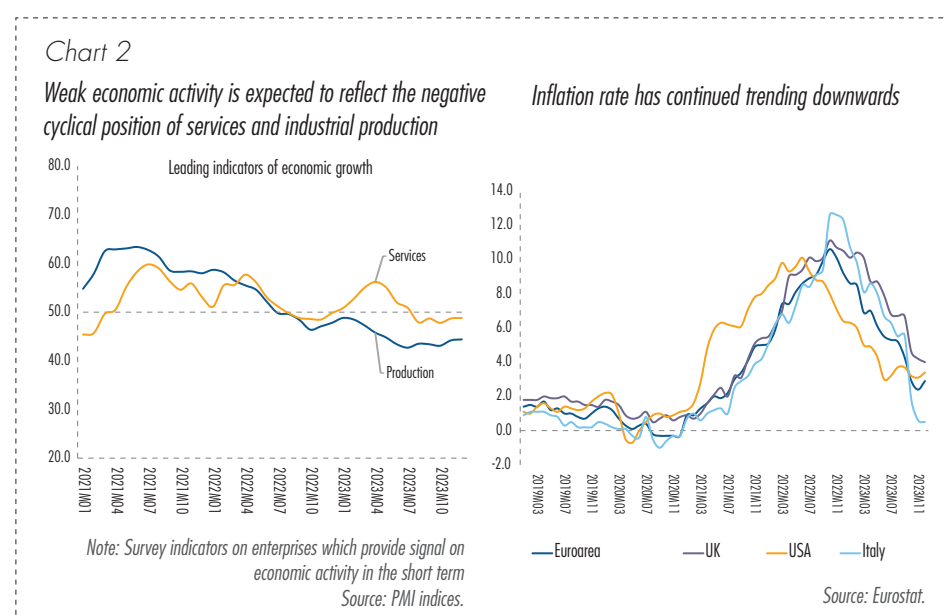
EURO AREA ECONOMY

The euro area economy did not grow in annual terms and contracted by 0.1% in quarterly terms in the third quarter of the year. The performance of economic activity among euro area countries was heterogeneous, hence activity in the largest economies generally contracted or grew minimally. Both final population consumption and public consumption contributed positively to the annual performance of economic activity.

Leading indicators suggest that the performance of economic activity remained unchanged in the last quarter. Business surveys in December show that the services and manufacturing sectors continue to remain in a negative cyclical territory, owing to increased costs and weak demand. The labour market remains tight. The unemployment rate decreased further, the growth pace of wages accelerated, employment grew and job vacancies are high.

³ The WB report, "Global economic prospects" published in January 2024.





Inflation rate dropped to 2.7% in the last quarter of 2023, from 5.0% in the previous quarter. Headline inflation appeared volatile during the quarter, falling to 2.4% in November from 2.9% in October and accelerating again to 2.9% in December. This volatility is dictated by the performance of energy prices, while the more stable inflation measurements indicate a slowing trend, albeit remaining high. Thus, core annual inflation slowed down to 3.7% in the second quarter, from 5.1% in the previous quarter.

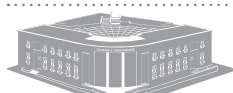
According to the most recent ECB projections, economic growth and inflation have been revised down for the period 2024-2025. The inflation rate is expected to remain above the target of 2.0% during 2024 and to return steadily to the target in 2025 H2⁴. Uncertainties regarding these forecasts are high and are related to geopolitical tension, to uncertain supply conditions for commodities, and to the reality of a stronger than expected labour market.

REGIONAL ECONOMIES⁵

Economic activity in the region accelerated in 2023 Q4, but with an uneven momentum of growth. The annual growth of Kosovo's economy accelerated to 3.0% in the third quarter of the year, from 2.4% in the previous year. The faster expansion of private consumption affected this performance. In the third quarter, data on economic activity in North Macedonia show an annual growth of 1.2%, or 0.1 p.p. higher than in the previous quarter. A positive performance of private consumption and a sharp decline in imports were the main contributors to the increase. In Serbia, the GDP expanded by 3.6% in the third quarter, reflecting higher consumer spending. Despite short-

⁴ The ECB staff projections expect the economy to grow 0.6% in 2023 and 0.8% in 2024. In 2024 the average inflation is expected to be around 2.7%, and in 2025 around 2.1%. (Source: ECB staff macroeconomic projections, December 2023).

⁵ Main trading partners outside the European Union (Kosovo, North Macedonia, Serbia).



term acceleration in growth rate, economic activity for 2023 in neighbouring countries is expected to reflect the slowdown of the euro area economy, and growth rates are expected to be lower in a historical context.

With the exception of North Macedonia, where annual inflation accelerated in December 2023, inflation rates in other countries of the region have been declining. In addition to a decrease in commodity prices, this performance was also influenced by the comparative effect of double-digit inflation in the previous year. Meanwhile, core inflation remains relatively high, underlined by tight labour markets and continuously declining unemployment rates.

Inflation rates are expected to be coming down in the next year, reflecting stabilization of commodity prices in international markets and lower demand in these countries. The latest forecasts point to a further slowdown in inflation in 2024 and 2025. Economic activity is expected to grow at a slow pace in 2023 and accelerate in 2024 and 2025.

Table 1 Economic indicators for main trading partner countries

	Annual change of GDP p.p		Annual inflation (%)		Unemployment, in %
	2023 Q2	2023 Q3	2023M09	2023M12	Latest publication
Italy	2.6	2.1	5.6	0.5	7.5
Greece	0.3	0.1	2.4	3.7	9.4
Kosovo	2.4	3.0	4.2	2.3	11.8
North Macedonia	1.1	1.2	6.6	3.6	12.8
Serbia	1.6	3.6	10.1	7.6	9.0
Albania	3.4	3.5	4.1	4.0	10.5

Source: Respective statistical institutes.

2.2. COMMODITY PRICES IN GLOBAL MARKETS

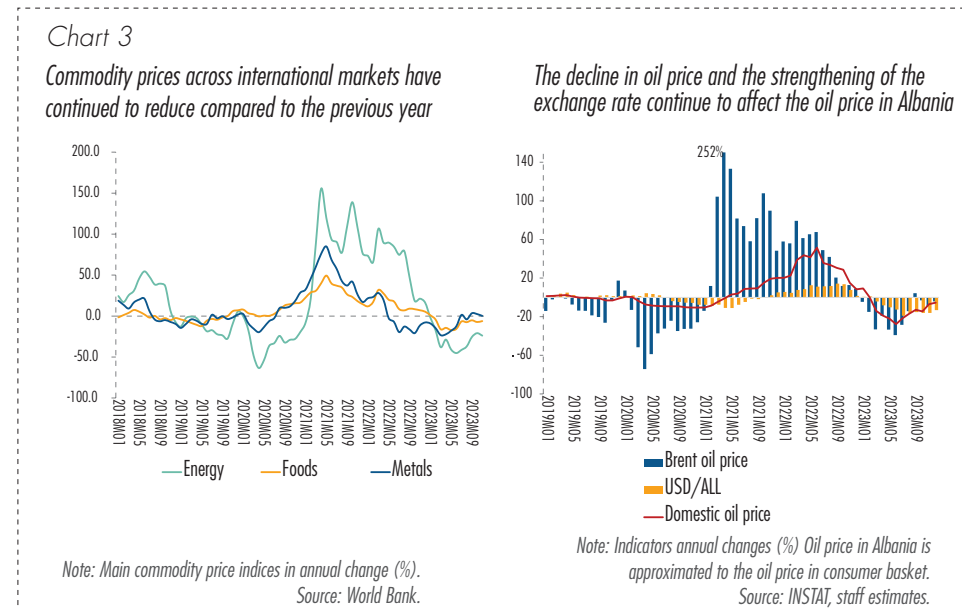
Commodity prices in global markets decreased in the last quarter of 2023, reflecting low demand and a challenging financial environment, despite geopolitical tensions in oil exporting countries as well as OPEC's decisions to reduce production quotas.

The commodity price index as measured by the World Bank decreased by 1.4% in the fourth quarter compared to the previous quarter. All major indices of energy, food and metal prices followed the same short-term trend.

In annual terms, the commodity price index is about 18% lower and it is closer to levels in the period before Russia's aggression in Ukraine. Brent oil prices in the international market were quoted around an average of \$78/barrel in December.



Throughout 2023, the price of oil in the international market decreased by about 18%, the index of metal and food prices by around 9%, and the energy price in the Hungarian Power Exchange⁶ by around 60%. The declines in commodity prices have helped to mitigate inflationary pressures of a short-term nature at the global level.



2.3 INTEREST RATES

Financial conditions in international markets are tight. They reflect the high level of policy rates and inflationary pressures, which, although slowing down, still remain high. Tighter financing conditions have dampened the aggregate demand, while markets' consensus suggests that interest rates are at their highest during this normalization cycle.

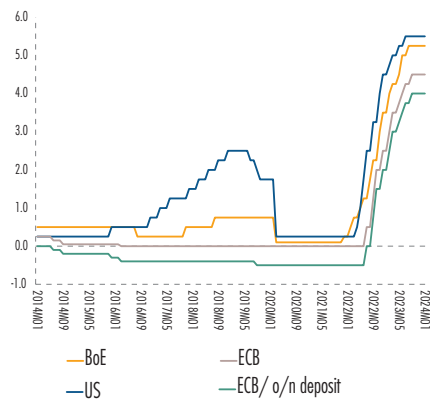
Central banks have stopped increasing interest rates since September 2023. The ECB kept the key interest rate unchanged at 4.50% in the latest meeting in December, the Bank of England kept the bank rate unchanged at 5.25% during the last November and December meetings and the Federal Reserve at 5.25%-5.50% in the meeting of December. These central banks have communicated that the overall increase in interest rates is affecting economic activity and inflation, and that the duration of the current levels of base interest rates will depend on the pace and stability of the return of inflation to the respective targets. In reflection of monetary policy decisions, the yields on public and private securities decreased somewhat during December and early January of 2024.

⁶ Hungarian Power Exchange (HUPX), energy prices in basic profile.



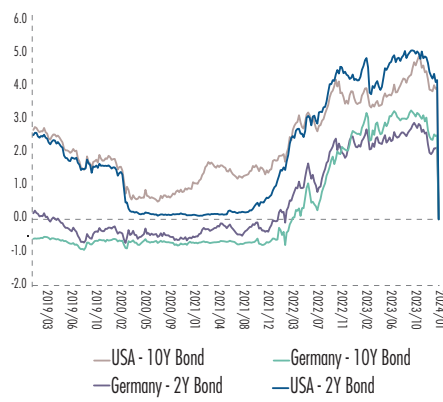
Chart 4

Central banks kept the policy rates unchanged



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

The tightening of the monetary policy has helped to maintain the high level of yields



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



3. FINANCIAL MARKETS AND LENDING CONDITIONS

The financial market has shown low risk premiums and has started to reflect the latest increase in the policy rate. Its pass-through to the interbank market interests and to the yields of government securities has been complete and immediate. In addition, interest also increased on deposits and certain segments of credit, in the two last months of the year. However, interest rates maintain minimum differences from the policy rate and among themselves, indicating low risk premiums perceived by market agents.

The foreign exchange market remained volatile even in the fourth quarter, but the exchange rate was more stable compared to the rest of the year. Also, quotation spreads were close to normal levels and trading volumes were high.

Bank financing to the private sector has increased, reflecting both the high demand for financing from enterprises and households and the willingness of banks to accommodate it. The good performance of credit quality, the perception of low-risk premiums in the economy, the increased competition and the sound position of the banks' balance sheets have maintained a positive approach in the banking sector towards lending.

3.1 DOMESTIC FINANCIAL MARKET⁷

The increase in the policy rate at the beginning of November has started to be transmitted to the financial market. It has been fully transmitted to interbank market rates and yields on government securities and has dictated a slight increase in interest rates on deposits and loans. However, the market's perception for low-risk premiums and increased competition in the banking sector continues to materialize in narrow spreads between the price of loans and that of government securities. This tendency has curbed the transmission of monetary policy to the overall costs of financing in the economy.

⁷ The following analysis is based on the data available up to 24 January 2024.

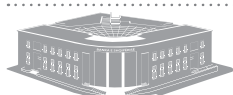
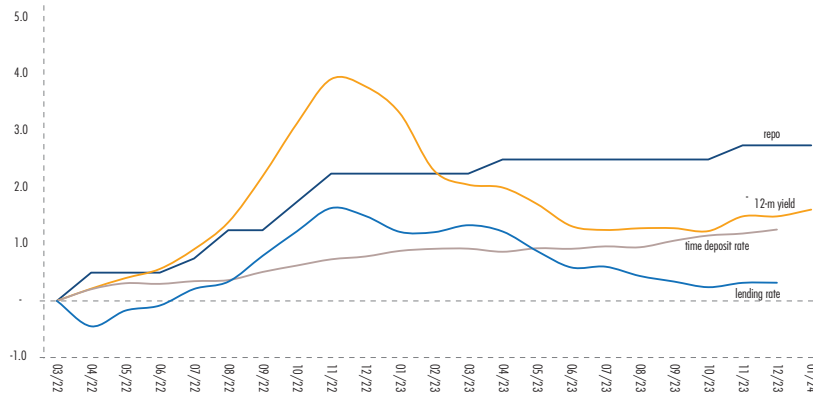


Chart 5

The recent increase in the policy rate has been reflected in the interest rates of financial market, but low-risk premiums as perceived by the market, still dictate accommodative financial conditions



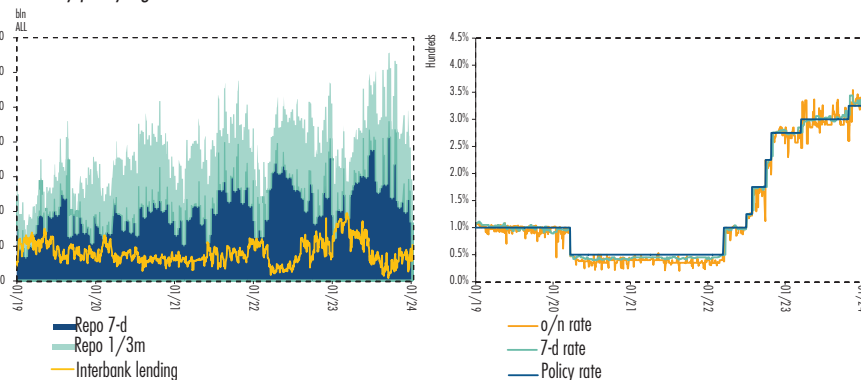
Note: Cumulative changes, since March 2022.
Source: Bank of Albania.

Interests in the interbank market reflected the increase in the policy rate in November and remain anchored closely to it. This market did not show increased pressures for liquidity. The Bank of Albania continued to inject liquidity into the system through its main instruments, the one-week repo, and the 3-month repo. The injected amount decreased during the fourth quarter, and was significantly reduced during December and January, as a result of the increased pace in realising budget expenditures for 2023.

Chart 6

Banks' liquidity deficit decreased in December and January, but this did not affect the pass-through of monetary policy signals

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



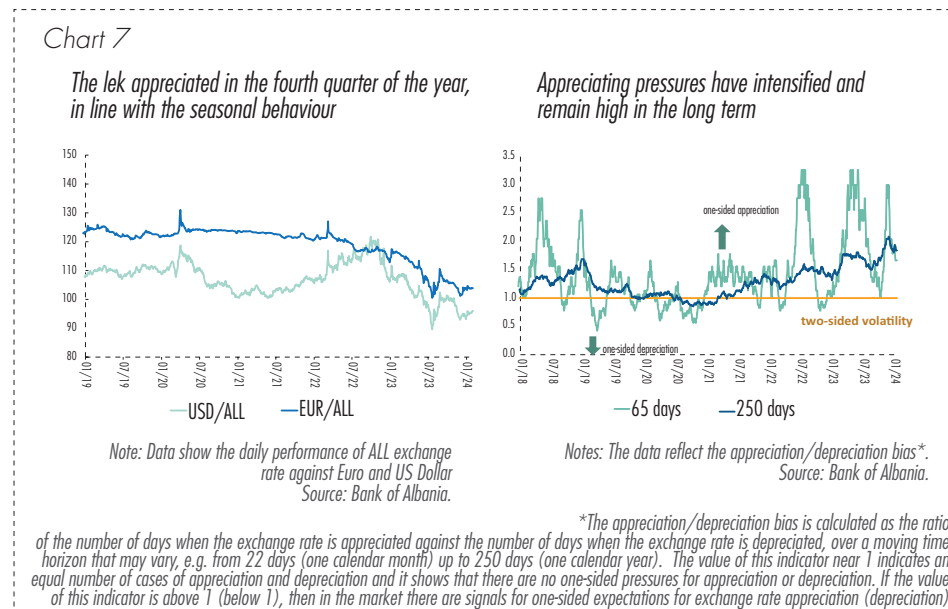
Note: Daily performance of liquidity supplied by the Bank of Albania through one-week and 1-3 month repo and traded volume by banks in the money market.
Source: Bank of Albania.

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

The appreciating pressures on the domestic currency continued during the fourth quarter of 2023. The quotation of the euro decreased on average to ALL 102.8 in December, from ALL 106.9 in September, with an appreciation of lek by 3.8% during this period. The strengthening of lek at the end of the year is in line with its seasonal behaviour, but, as was observed throughout 2023, the intensity of this phenomenon was higher compared to other years. The



annual appreciation of lek was 10.4% during the last quarter of the year, from 10.2% in the third quarter. The lek depreciated in January, which is typical for this month. The EUR/ALL exchange rate averaged ALL 103.9 in the first three weeks of January.

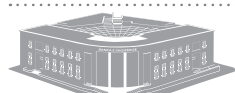


Appreciating pressures on the domestic currency during 2023 have reflected positive developments in the external sector of the economy. This performance reflected the high inflows in tourism and was illustrated in both trade surplus and the current account surplus during the third quarter. Indirect data indicate the continuation of this trend in the fourth quarter as well⁸. Also, trading volumes in the market continued to be high during this period. Overall, trading conditions in the foreign exchange market eased during this quarter, with the exception of December, when volatility and the bid/ask spread increased temporarily. The latter returned close to their normal values in January.

The appreciation of the lek against the euro has also dictated its strengthening against the US dollar during the last two months of the year. The USD/ALL exchange rate averaged ALL 94.2 in December, from ALL 100.0 in September. The annual appreciation of the lek against the dollar in the fourth quarter reduced to 15.1%, from 16.8% in the previous quarter. In the first three weeks of January, the US dollar was quoted, on average, at ALL 95.2, or 11.8% lower than in the previous year.

Yields on government securities reflected the increase in the policy rate in the fourth quarter of the year, while their spreads from this rate continue to remain minimal. Yields rose slightly in November, reflecting the increase in the policy rate. More specifically, the yield on 12-month T-bills increased to 3.6% in the last auction (January) from 3.1% in October 2023. Similarly, the yields

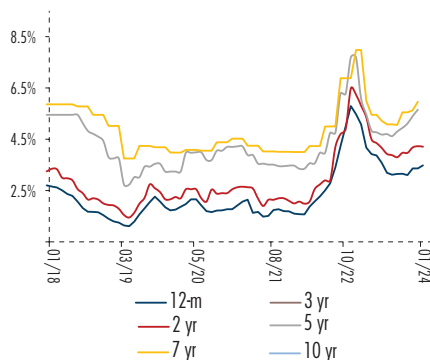
⁸ The inflows of foreigners in the fourth quarter of the year increased by about 66% compared to the previous year.



of 2-, 3-, 5-, 7- and 10-year bonds issued in the last three months were 4.2%, 5.0%, 5.6%, 5.9% and 6.8% respectively, increasing, on average, by 0.4 p.p. from their last values before the latest interest rates increase. As a result, the yield curve has slightly increased compared to the end of the third quarter, but its slope remained unchanged.

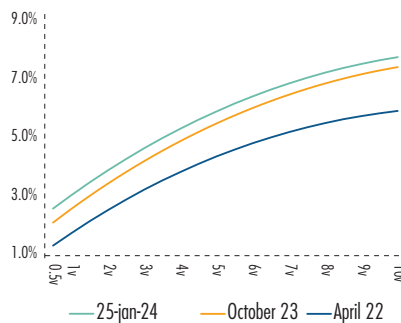
Chart 8

Yields have transmitted the increase in the policy rate, but maintain minimal spreads against it



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

The yield curve slightly increased, but its slope did not changed compared to its slope in October



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

The performance of yields, beyond the reflection of monetary policy decisions, displays contained risk premiums in this segment. Against a high and stable supply of funds in the primary market⁹, the course of the yield curve is determined by the level and structure of the government's demand for funds. The slight shift in the financing structure, from T-bills to bonds, during the second half of the year has also led to a slight increase in the slope of the curve compared to the beginning of the normalization of the monetary policy.

3.2. LENDING CONDITIONS

The increase in the policy rate in November was reflected at a faster pace in the price of loans to households and more slowly in the price of loans to enterprises. Interest rate increase was notable on loans to households, while the interest increase on loans to enterprises was observed only in the segment of medium-sized loans. Interest rates on loans continue to have historically low spreads vis-a-vis the policy rate, the 12-month yield and the deposit interest rate. This reflects the market's perception of low-risk premia, which has conditioned the slow increase in the loan interest rate since the beginning of monetary policy stance normalization.

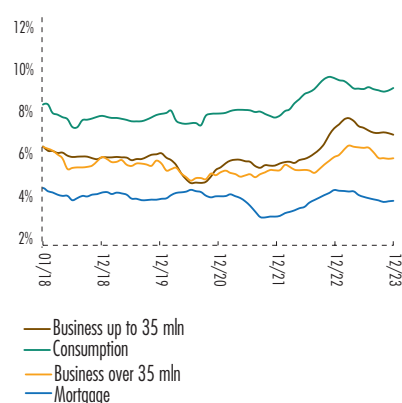
⁹ The bid/cover ratio in the primary market auctions in the last quarter of 2023 was 1.3 from 1.2 in the third quarter.



The average interest rate on new loans to enterprises in lek was 6.5% in 2023 Q4, showing marginal changes compared to the second and third quarters. However, in November and December, interest rates trended slightly up in this segment, concentrated mainly on medium-sized loans (ALL 35- 140 million). Interest rates of small and large loans did not show crucial changes during this period. On the other hand, **interest rates on new loans to households**, which are more closely related to the 12-month yield, increased after the change in the policy rate. Interest rates on consumer loans averaged 9.8% in November and December, up from 9.3% in October and the third quarter of the year. Likewise, the average interest rate on mortgage loans increased to 4.4% in December, from a 4.1% average during May-November.

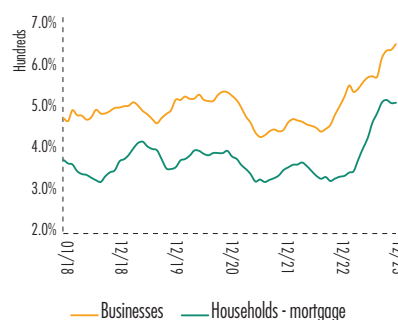
Chart 9

Interest rates for loans in lek to households and medium-sized enterprises have increased



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

Interest rates for loans in euro continued to increase for enterprises and decreased for mortgage loans



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

The interest rates on **new loans in euro** to enterprises continued to increase in the fourth quarter of the year, reaching 6.8% from 6.4% in the previous quarter. Interest rates increased mainly for medium-sized and large loans (over EUR 250.000). Meanwhile, interest rate on loans to households for house purchase fell in 2023 Q4, to 5.0% from 5.3% in the previous quarter.

The faster growth of interest rate on loans in euro compared to loans in lek has narrowed the lek/euro interest spread. In the last quarter of 2023, interest rates on loans in lek are lower than those in euro, respectively 0.3 p.p. and 0.8 p.p. for loans to enterprises and for mortgage loans. This development in the interest rates on loans by currency has also induced a shift of the loan portfolio from euro to lek during 2023.

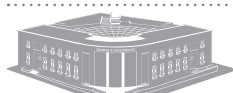
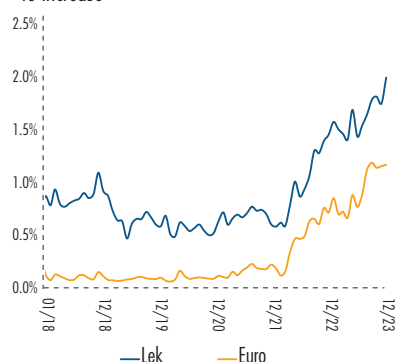


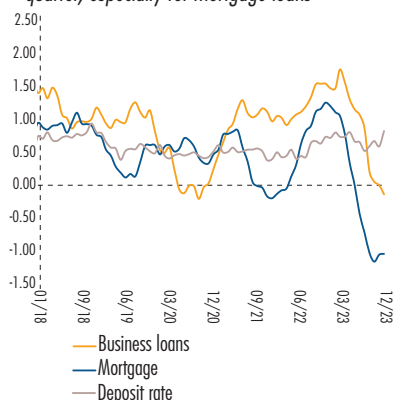
Chart 10

Interest rates for time deposits have continued to increase



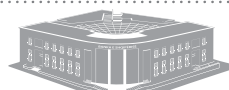
Note: The data show the interest rate applied on new lek and euro time deposits, in %.

ALL/EUR 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: enterprises, 6-month moving average loans, mortgage loans and time deposits.
Source: Bank of Albania.

Interest rates on **time deposits in lek** grew somewhat faster in the last quarter of 2023. In average terms, they reached 2.0% in December, from 1.7% in the third quarter and 1.5% in the first half of the year. Interest rates for time deposits in euro have restrained their growth in the fourth quarter. They averaged 1.2% in this quarter, unchanged from the end of the previous quarter. The difference between the average interest of deposits in lek and that of deposits in euro fluctuated narrowly within the range of 0.5 p.p.-0.8 p.p., being close to the steady average of the last seven years (0.6 p.p.).



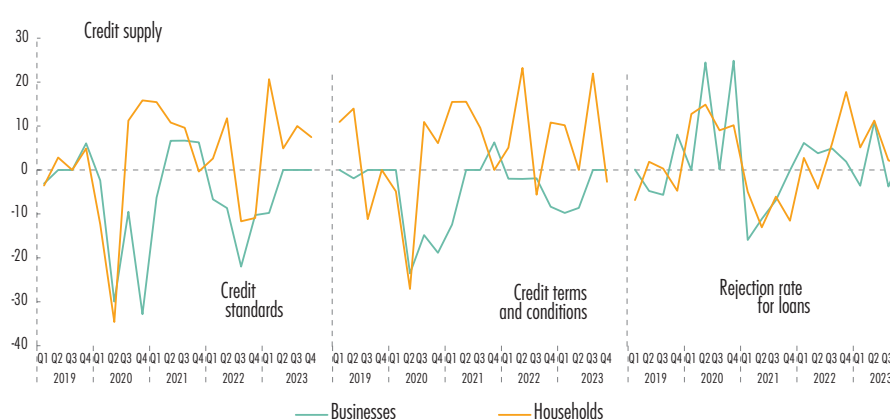
BOX 1: SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2023 Q4*

The performance of supply conditions reflected the accommodative approach of banks in regard to lending to the private sector over the course of the last quarter of 2023. Banks supported the high credit demand across all economic agents, under the perception of a lower risk for the overall macroeconomic performance and for borrowers' balances in particular. Along with this, high competition in the banking system has encouraged banks to be more risk tolerant in lending to the private sector.

Banks did not change the lending criteria for loans to enterprises in the last quarter of 2023. The credit policy framework was expressed in unchanged standards in loans across all sizes of enterprises and for all purposes of loan use. Likewise, lending terms and conditions did not change from a quarter ago, despite the higher margins applied on riskier loans. Pressure from high competition in the banking system remains the key factor that leads to the easing of credit supply conditions to enterprises and triggers a tightening effect on other factors, both on credit standards and on lending terms and conditions. Rejection rates increased insignificantly in this quarter, mainly related to the factors that explain the borrower's solvency. Other factors affected the downward trend in rejected loans to enterprises.

Chart 1 Box 1

Loan supply conditions appeared to improve



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

Banks adopted a supportive approach in lending to households in the last quarter, expressed in the easing of credit standards on both loans for house purchase and consumption financing. Although terms and conditions tightened in response to higher interest rates, banks supported households' loan demand by increasing loan sizes and adopting lower collateral requirements. The rejection rate slightly increased, driven mainly by factors related to the credit score of households. In contrast, the employment record had a downward impact on the rejection rates, marking the highest balance in the last three years.

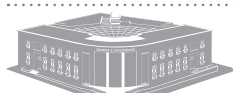
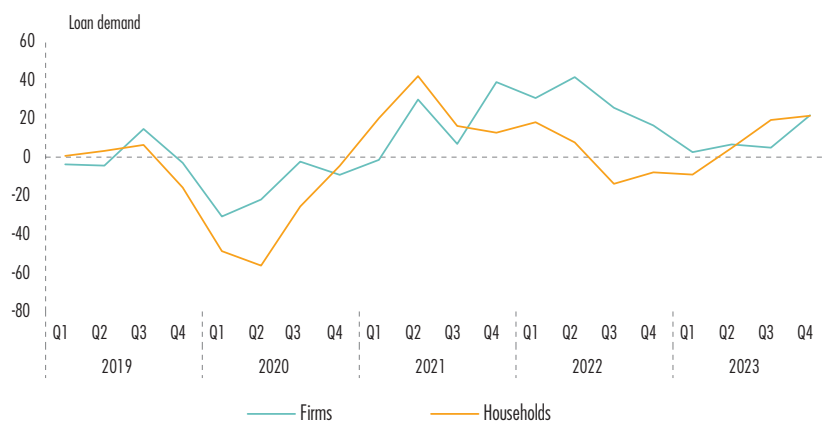


Chart 2 Box 1

Loan demand appeared high in all segments



Notes: Values on the chart are calculated as net percentage. Positive values indicate increase of loan demand and vice versa.

Source: Bank of Albania.

Enterprises' demand for loans was high across all categories of enterprises and for all types of purpose of use. The growth of loans to small and medium-sized enterprises and in loans for financing investments stood out this quarter, which was the highest positive balance of the last six quarters. Enterprises demand for financing from the banking sector have been restrained neither by high interest rates nor by the high level of enterprises' liquidity.

On the other hand, increased demand for loans was also reported in the households segment, for the third consecutive quarter. Households' demand for loans to finance the purchase of housing, or consumption, has been discouraged neither by high interest rates nor by the use of alternative sources of financing.

* 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 SECTOR¹⁰

Lending to the private sector improved in the fourth quarter, with an average annual growth of 8.7%, 2 p.p. higher than in the previous quarter. This performance led to a significant expansion of the portfolio in this quarter, by about ALL 28 billion. Most of this increase was recorded in December, mainly in the segment of enterprises. A high capacity utilization rate and high levels of confidence have affected the increase in the demand for loans. To meet this demand, banks accommodated an increased supply on the back of a perception of low-risk premia and an increase in risk tolerance given the pressure from increased competition in the sector.

The expansion of the loan portfolio for the private sector was mainly in lek in the last quarter of 2023. The growth of this portfolio (on average 13%) was one of the highest levels of the last five years. This performance was also supported by the phenomenon of the loan portfolio shifting from euro to lek, driven by the lower interest rates of loans in lek compared to those in euro and by the appreciation of the exchange rate. Consequently, credit in foreign currency continued to slow down and the average annual growth of 3.7% is 0.6 p.p. lower than in the third quarter. In response to these dynamics, the share of loans in lek to the total recorded another maximum value of 55.8%, 5 p.p. higher than in the previous year.

The performance of the portfolio by client shows that improvement in loan growth rates has been driven by the rapid expansion of credit to enterprises. The growth rate of this portfolio, after recording the minimum increase of 2.6% in September, improved throughout the fourth quarter, reaching 8% in December. The growth of this portfolio was particularly high in December, influenced by both financing for liquidity and investment purposes. Throughout the year, credit to meet liquidity needs has been fluctuating, affected by the high liquidity that has characterized enterprises, while that for investments trended upward since June.

The increase in lending to households has been stable, driven by a high and constant demand. The annual growth rate of 13% recorded in the fourth quarter is very close to the average of 2023, reflecting both the high financing needs and the eased conditions that banks offer for this segment. Banks eased the price and non-price components for this group amid increased competition. They have accommodated both the financing for house purchase and consumer loans which are characterized by unsecured loans. These dynamics have helped to increase the share of loans to households, amounting to 39.2% at the end of the year, or 1.5 p.p. higher than in the previous year.

¹⁰ Credit analysis is based on the new set of statistics, in line with the ECB methodology on "real" credit flows, which excludes both the effect of exchange rates and written-off loans of balance sheets.

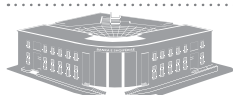
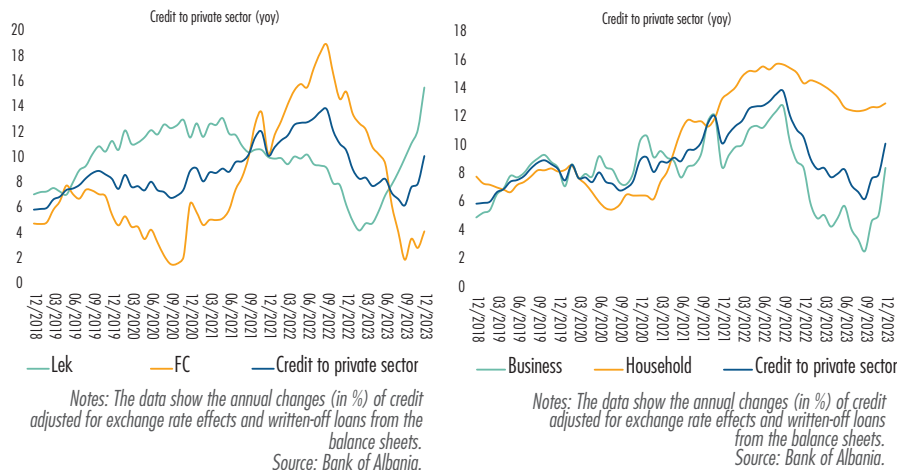


Chart 11

The expansion of lending to the private sector has accelerated, affected by the improvement of credit growth in lek and...

... from the strong growth of loans to enterprises

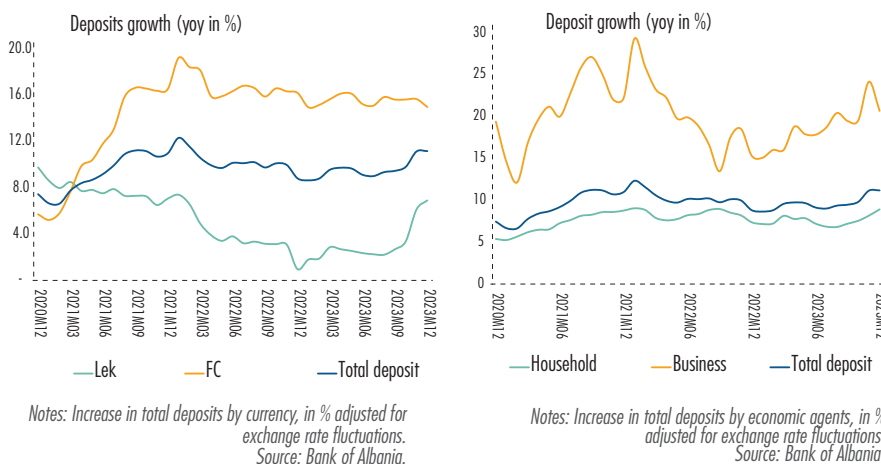


Deposits in banks recorded an average annual growth of 10.7% in the last quarter of 2023. In contrast to the previous quarter, this improvement reflected the performance of deposits in lek, which increased by an average of 5.5% from 2.4% in the previous quarter. This performance was influenced by a rapid increase in liquidity in lek, reflecting an increase in government expenditures, and by the upward trend in the interest rates of deposits, reflecting the monetary policy normalization. Short-term deposits in lek increased by ALL 37 billion in the last quarter of 2023, from an increase of around ALL 9 billion by the end of the third quarter. On the other hand, the performance of deposits in foreign currency is stable. Their double-digit growth of 15.5% remained at similar levels throughout the year.

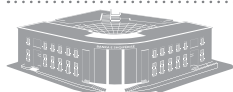
Chart 12

Deposits growth rate improved supported by deposits in lek

The increase in bank deposits has reflected the improvement in the growth rate of households' deposits



The growth of deposits was driven by both the expansion of households' deposits and expansion of enterprises' deposits. **Households' deposits** recorded an average annual growth of 8.2% during the fourth quarter, up from 7% a quarter earlier, while the expansion of households' foreign currency deposits continued to remain at high levels and similar to the previous quarters. Enterprises' deposits also improved, where the growth rates of 21% are higher than in the previous quarters.



4. ECONOMIC GROWTH

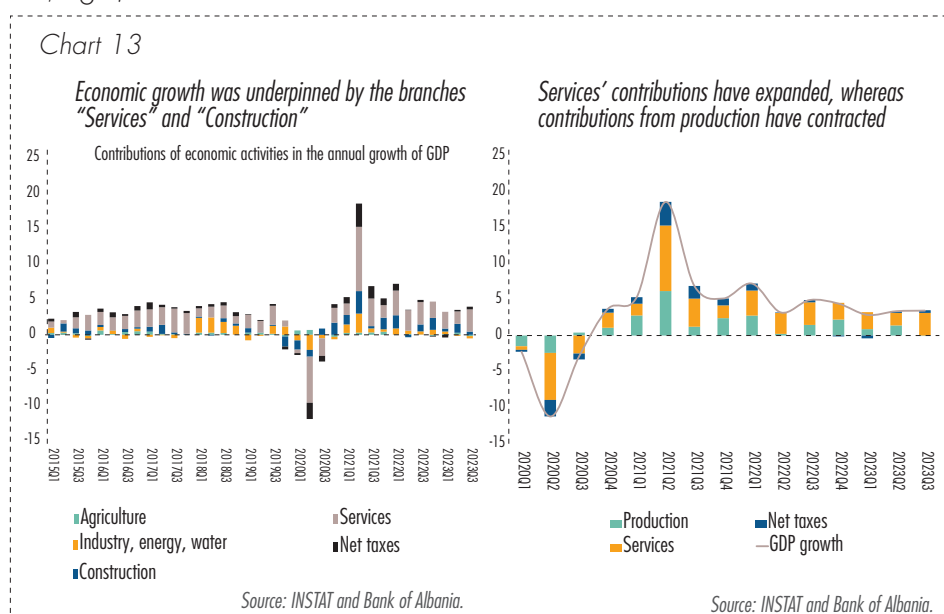
Economic activity grew by 3.5% in 2023 Q3, at a similar rate with the previous quarter. In contrast to the previous quarters, economic growth was mainly underpinned by the high external demand, not least the rapid growth in the tourism sector, and less so by domestic demand. Available data suggest that economic growth will continue at a similar pace during the fourth quarter.

The high demand for goods and services has pushed the economy into a positive phase of the business cycle. This performance is reflected in the historically low rate of unemployment, a rapid increase in wages and the high capacity utilisation rate.

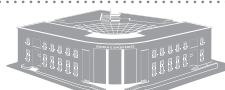
Future projections suggest that economic growth will slightly decelerate in 2024 and will normalise in the successive period, as it approaches its growth potential. The expansion of economic activity will be supported by the stable monetary and financial environment, the robust balance sheets of the private sector, as well as further growth in tourism sector.

4.1 GROSS DOMESTIC PRODUCT

GDP grew by 3.5% in 2023 Q3, a similar rate as in the previous quarter¹¹. In sectoral terms, economic growth was underpinned by broadly based expansion of activity in the sectors of services and construction (Chart 13, left). On the other hand, the industry and agriculture sectors have recorded a decline (Chart 13, right).



¹¹ In 2023 Q2, the economic growth was revised to 3.4%, from 3.2% by INSTAT.



The service sector made a positive contribution of 3.2 percentage points to economic growth in the third quarter. Compared to the previous quarter, this contribution was higher, and it was driven by a swift expansion in tourism. This was reflected in the branch of "Accommodation and food service" as it grew to 13.2%, annually, generating a 0.5 p.p. contribution to economic growth. In the same vein, the branches of "Real estate" and "Public administration, security, education and health" grew rapidly. Not least, the expansion of the latter reflected the growth in public administration wages. Furthermore, the other branches of the services sector had a positive impact on growth, but their contribution was lower.

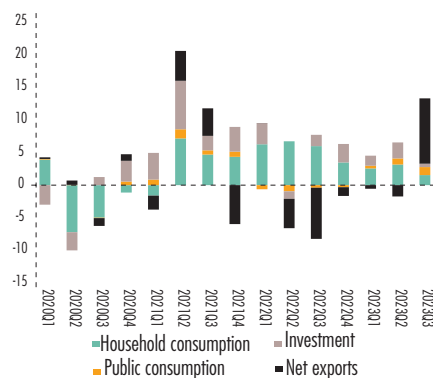
The production sector had a negative contribution of 0.1 percentage point to economic growth. Within the activities of production, the sectors of "Agriculture" and "Industry" performed negatively, with a declining trend which deepened in the third quarter of the year. Industry, in particular, shrank to 2.9%, reflecting a fall in the activity of extracting and processing. On the other hand, "Construction" grew to 4.7% and made a positive contribution of 0.5 p.p. to economic growth.

4.2 AGGREGATE DEMAND

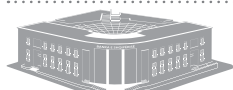
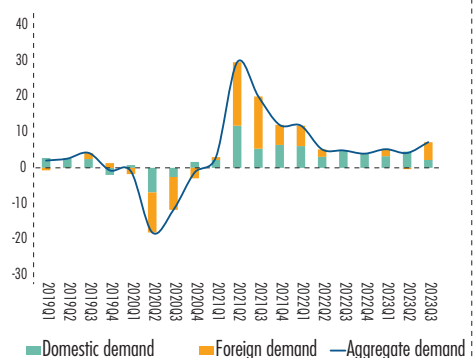
In contrast to the previous periods, economic growth in the third quarter reflected expansion in both domestic and external demands. The latter also had the main impact on the expansion of aggregate demand during the quarter under review (Chart 14, right). The high growth in exports was supported by the expansion of revenues from services, particularly tourism. This performance has made it possible to record a trade surplus, for the first time, in both nominal and real terms. Domestic demand has contributed positively to the growth, but at a slower pace than in the previous quarter, due to the deceleration in both consumption and investments (Chart 14, left).

Chart 14

Economic growth is mainly supported by foreign demand with slower impacts from domestic demand



The expansion of foreign demand has been entirely due to the increase in the export of services, mainly those related to tourism

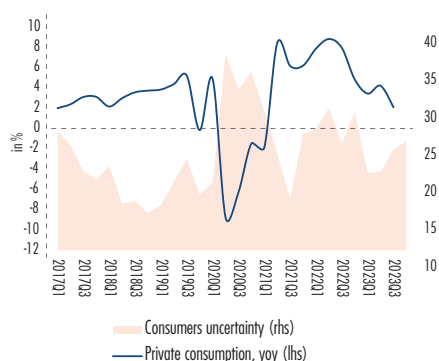


The growth of domestic demand recorded 3.0% in 2023 Q3, dropping from the 6% registered in the previous quarter (Chart 14, right). The two main components of domestic demand - "Private consumption" and "Investments" - decelerated their annual growth rate. Thus, the annual growth of private consumption fell to 2.1%, from 4.2% in the first quarter, whereas the one of investments to 2.1%, from 11.2%. Despite this slowdown, consumption and investments have broadly based factors which support their growth in the future. The growth of investments, particularly, was supported by the expansion of private investments, whereas public investments contracted annually. Lastly, public consumption grew by 12.3%, annually, from 9.3% in the previous quarter.

Indirect indicators (Chart 15, left) suggest that the slowdown of private consumption was reflected in the weaker growth of expenses for goods as compared to services (Chart 15, right). As a result, the index of retail trade for major purchases increased on average by less than 2.4 p.p. than the previous quarter, whereas consumption for services seems to have recorded a steep increase in the third quarter. The growth of consumption was supported by better employment indicators; an increase of income from wages; expansion of consumer loans; as well as a stimulating financial environment. The positive performance of consumption is expected to continue throughout the fourth quarter, as witnessed by the improvement of consumer confidence.

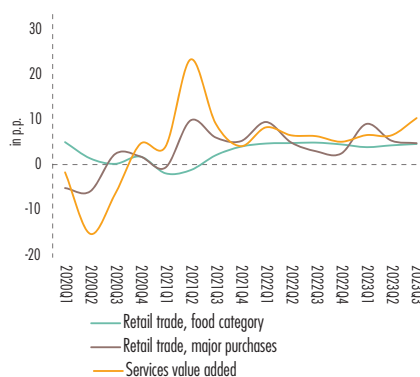
Chart 15

Private consumption decelerated in 2023Q3



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

The rise in expenses was channelled mainly toward services



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

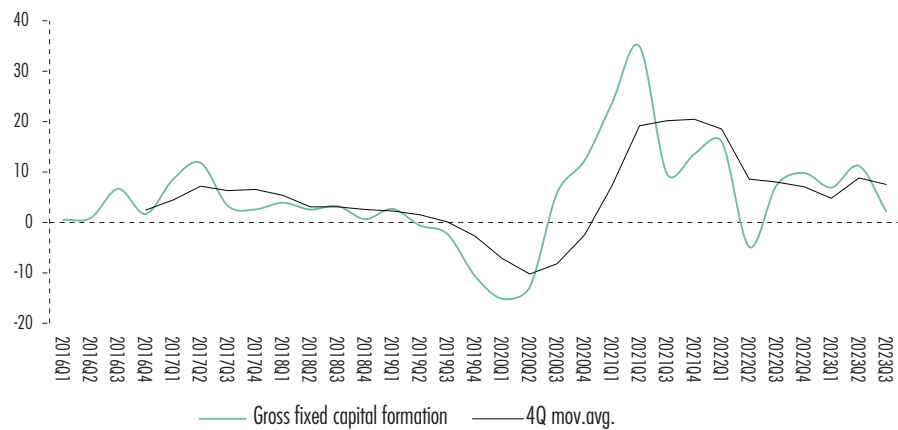
The pace of investments decelerated to 2.1% in the third quarter, against the 11.2% recorded in the previous quarter (Chart 16). Investment growth continues to be supported by the expansion of private investments, whereas public investments made a negative contribution, in keeping with the previous



quarter¹². The deceleration of investments is noticed in both investments for construction and machineries and equipment.

Chart 16

Total investment growth decelerated in 2023 Q3

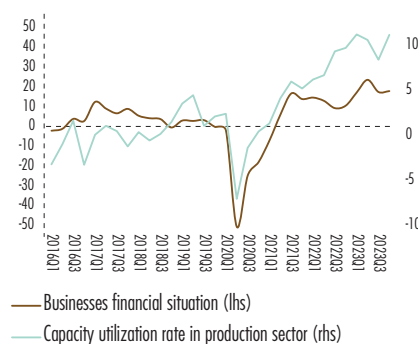


Source: INSTAT and Bank of Albania.

The available indicators for investments in the fourth quarter, suggest that investments will continue to edge up. The import of machineries and equipment suggest that investments will grow, whilst bank lending has also picked up in this quarter (Chart 17, right). The high-capacity utilisation rate, the stimulating financial environment, the sound balance sheets of the private sector, as well as positive consumer confidence indicators are expected to continue contributing to the growth of investments in the future.

Chart 17

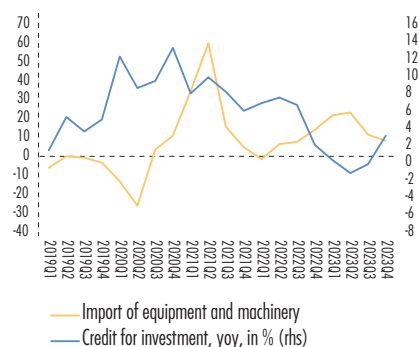
Capacity utilisation rate and the financial situation of enterprises remain at high levels



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

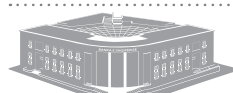
Source: INSTAT and Bank of Albania.

Quantitative indicators from imports suggest an increase of investments, which are less supported by bank loans

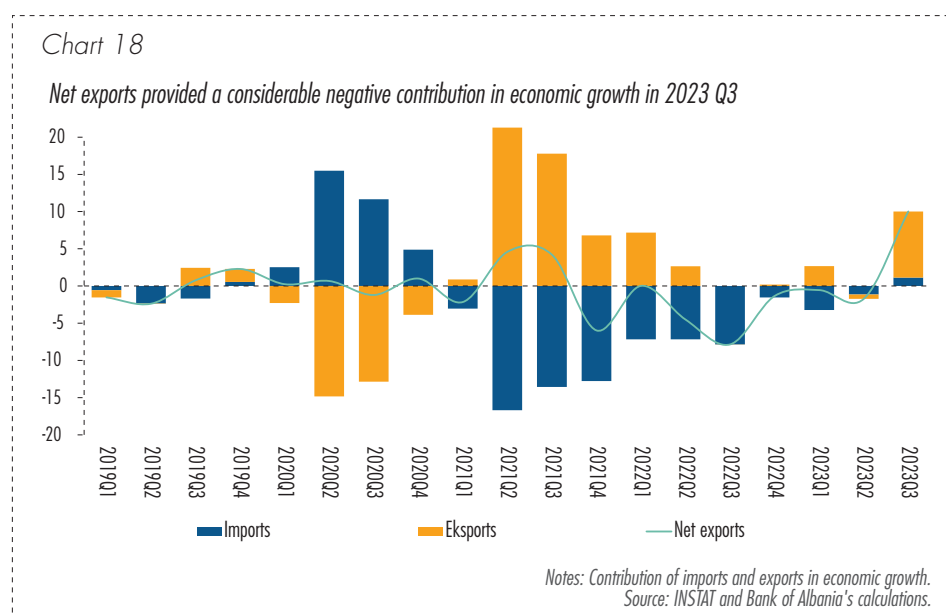


Notes: Indicators are annual changes in percentage. Source: INSTAT and Bank of Albania.

¹² INSTAT does not publish disaggregated investments by type. The analysis on the performance of private and public investments and investments by category is based on internal assessments, which are conducted using the indirect indicators available.



Net real exports had a positive contribution to economic growth in Q3 (Chart 18). Total exports rose by 17.9%, supported by the 29.8% growth registered from the export of services, mainly related to tourism. This factor was also reflected in the positive values of the trade balance (in real terms) for this quarter, whereas the export of goods shrank by 22.3%, continuing the declining trend of the first half of the year. The annual decline is also present in the case of imports (-2.1%), which was driven by a contraction of 14.0% in the import of goods, whereas the import of services grew by 25.3%.



Exports and imports of goods in nominal terms have continued to contract in the fourth quarter as well. The faster decline in imports relative to exports has affected the tightening of trade deficit by 14.3%. The decline in the export of goods during 2023 was driven by a combination of negative factors, as below: (i) the economic performance of our main partner, the Euro area, has not been positive and has hindered demand for Albanian products; (ii) the price of raw materials in the international market has dropped, which had a negative impact on the value of exports; as well as (iii) the strengthening of the exchange rate, which further reduced exporters' incomes who are unhedged against the exchange rate risk.

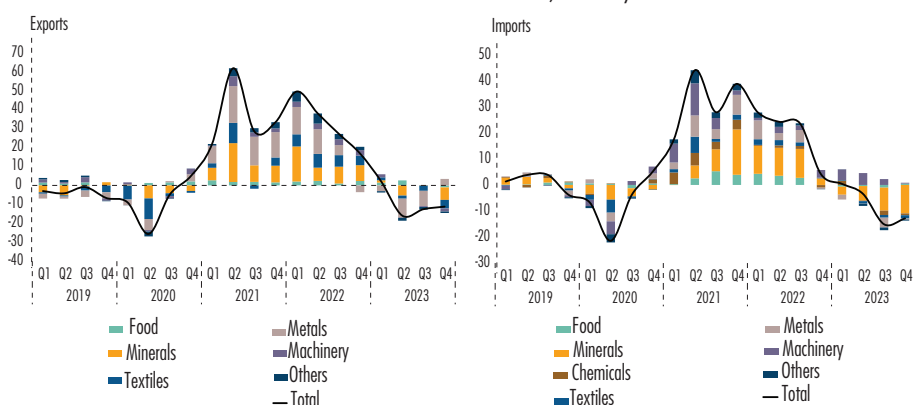
Export of goods shrank by 11.2% in 2023 Q4 (Chart 19, left), where the main negative contributors were: "Minerals, fuels, electricity" and "Textile and clothing", but all the other categories made negative contributions as well. The category of "Construction materials and metals" was an exception, as it returned to its positive growth rate.



Chart 19

Export of goods have continued to drop in the fourth quarter as well, affecting a series of categories

The fall of imports is also double-digit, but it is concentrated in the category of "Minerals, fuels, electricity"



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

Imports of goods shrank by 12.8% in 2023 Q4, after dropping by 15.1% in the previous quarter (Chart 19, right). The negative impact sprang mainly from the category of "Minerals, fuels, electricity", where the decline in the import of energy was more pronounced due to lower prices in international markets and better domestic production. The category of "Textile and clothing" had a similar impact to the above. The annual rate of decline for the other categories are quite moderate.

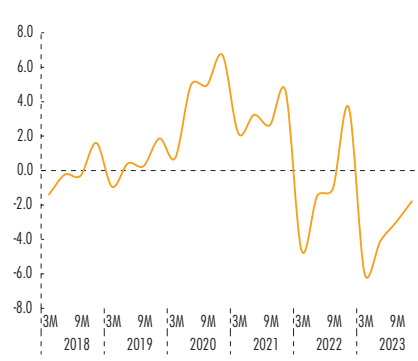
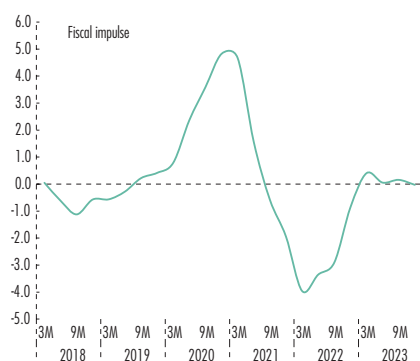
FISCAL POLICY CONTINUED TO BE CONSOLIDATING OVER 2023

Fiscal impulse stood close to zero until the end of November, underlying an almost neutral fiscal position.

Chart 20

Fiscal impulse was close to zero...

...due to fiscal surpluses created during the year

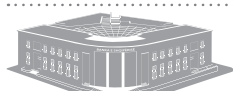


Notes: Change in primary deficit ratio to GDP for 12 months, from the previous year. Positive values of this indicator indicate an accommodative fiscal policy, while negative values indicate a consolidating one.

Source: Ministry of Finance and Economy and MPD calculations.

Notes: Budget deficit to GDP. Calculations based on quarterly flows. Positive values show deficit, negative values show budget surplus.

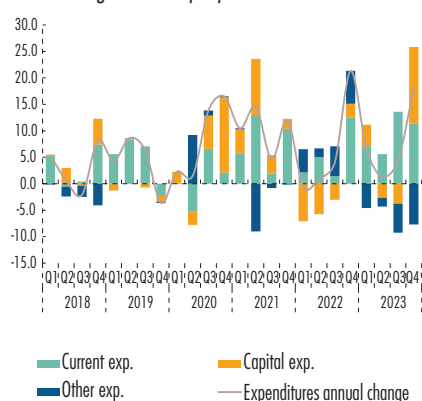
Source: Ministry of Finance and Economy.



Budget expenditure amounted to ALL 122.7 billion, in October and November, expanding by around 18.1% from the same period a year earlier. The increase of budget expenditure (around 14.5 p.p.) was driven for the most part by the expansion of public investments. After a slowdown in the second quarter of the year, public investments expanded at a faster pace during October and November, recording a rate almost twice as high as the same period of the previous year. In tandem with the performance of the third quarter, the other items contributing to the expansion of expenses were social insurance spending, by 4.8 p.p. and staff expenses, by 2.5 p.p. The increase in expenditure during October and November, also carries on the negative effect resulting from transfers to the energy sector of the previous year, by around -7.7 p.p.

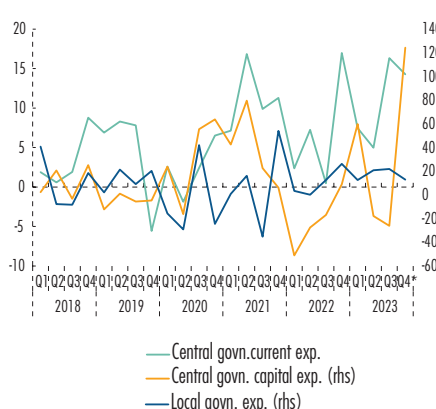
Chart 21

Revenues grew at a rapid pace...



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

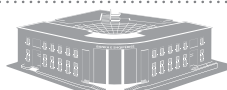
... due to the increase in investments



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

Expenditure in the first nine months accounted for around ALL 548.6 billion, or 6.8% higher in annual terms. The profile of rising expenses was similar only in terms of current expenditure, whereas capital ones concentrated mainly in the first and last quarter of the year. Staff expenses contributed by around 2.5 p.p. to the increase of spending in the first eleven months of the year. The contribution of this item to the expansion of spending was high compared to the historical average (0.3 p.p.) of the past ten years. This performance reflected an increase in the wages of public sector employees after the first quarter of 2023. Furthermore, the rising contribution of interest expenses on domestic debt, by around 0.9 p.p. for the first 11 months of the year, stood out. This event reflects the high interest rate environment and the increase of short-term debt instruments. The growth in total expenditure during 2023, reflects also the statistical effect of the high level of expenses recorded last year in the energy sector, which stood at around -4.7 p.p. in the first 11 months of the year.

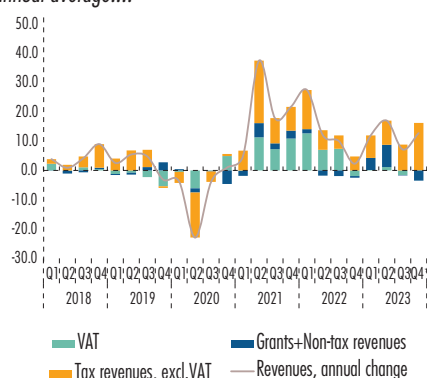
Revenues were about ALL 109.1 billion, in October and November, expanding by around 12.8% compared to the same period a year earlier. The growth recorded in these two months was similar to the average of 12.1% observed throughout the first nine months of the year. Around 41% of revenue growth



in the past months was formed by the item profit tax, due to the special profit budgeted from the energy companies of the private sector¹³. Revenues from local government were a large contributor to the higher revenues recorded during the period, as the local taxes collected were up by around 3.7 p.p. The last factor takes into account the number of construction permits and the square meters of new buildings in the third quarter of the year.

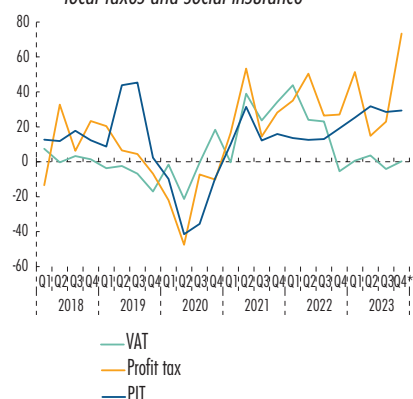
Chart 22

Revenue grew at a pace comparable to the annual average....



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

...on account of higher revenues from profit tax, local taxes and social insurance



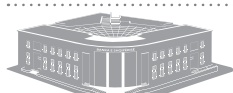
Notes: Annual growth, in %, of main tax items, by quarters.
Source: Ministry of Finance and Economy.

The revenues collected in the first eleven months reached ALL 586.3 billion, increasing by 12.1% annually. The main factors behind the expansion of revenues were the following: (i) revenues from social insurance, as they make up a large proportion of total revenues; (ii) profit tax, with 3.1 p.p., given the special taxing on businesses operating in the energy sector; (iii) grant revenues, at 2.4 p.p., as a high level was disbursed toward energy-focused projects in the first half of the year; (iv) personal income tax, with 2.3 p.p., given the increase in the wages of the public sector. VAT revenues for the first eleven months reached a level close to the one of the previous year. VAT revenues slowed down throughout 2023 due to less VAT collected from imports, since imports fell by around 6.5%, in annual terms, and the ALL appreciated¹⁴. On the other hand, the VAT collected on the production of goods and services in Albania contributed by around 1.4 p.p. to the increase of the total over the first eleven months, eliciting positive signals mostly from the services sector.

At the end of November, **budget surplus** stood at around ALL 37 billion, assessed at around 1.8% of GDP. The high increase of expenditure against revenues in October and November, was not sufficient to overturn the relatively high values of budget surplus noticed over the first three quarters of the year.

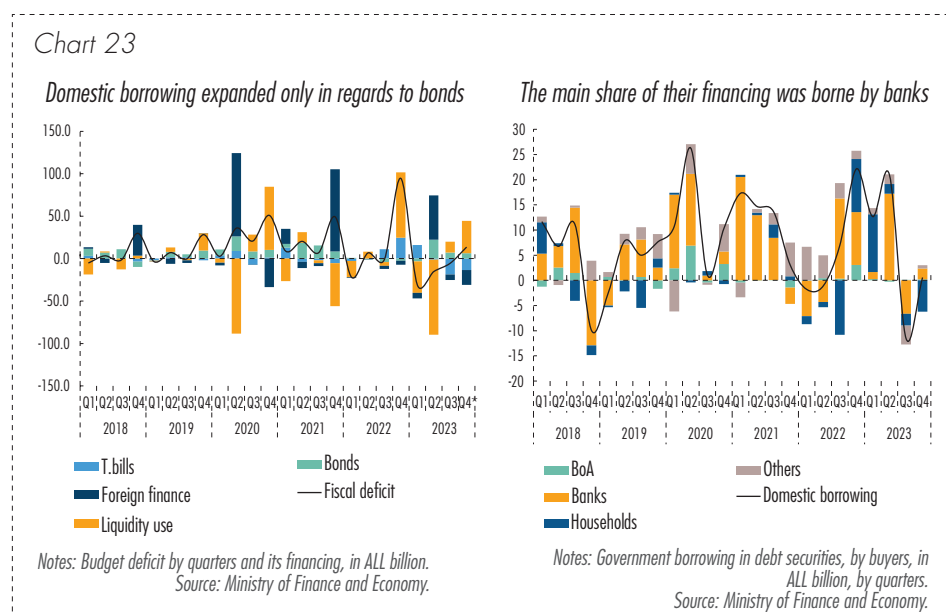
¹³ During 2023, private companies involved in selling electricity have paid for two periods (i.e., March and November) a special profit tax due to the high level of profits resulting from the rapid increase in the price of electricity over 2022.

¹⁴ ALL appreciated on average by 8.4% and 10.6% against the Euro and the US dollar, in the first eleven months of 2023.



The level planned for the budget deficit in 2023 was around ALL 55.5 billion, which signifies that the spending realisation rate will accelerate even further in December.

Net borrowing in the domestic market¹⁵ was around ALL 20.8 billion, from ALL 25 billion planned in 2023. In contrast to the previous year, the additional amount of borrowing in ALL was only in the form of long-term instruments, whereas net borrowing in the form of T-bills fell by around ALL 20.9 billion. Around 70% of the added new borrowing was borne by the banking sector, which is also the main holder of the government's securities portfolio. After their government securities portfolio grew rapidly over the first half of the year, individuals significantly reduced their participation in auctions during the remaining part. This was mainly due to the structure of government's borrowing, which focused solely on long-term instruments in the second half of the year, causing individuals to shift their savings from government securities to bank deposits.



Net borrowing was around ALL 21.6 billion in the first eleven months of the year. Its high value is attributed to the issuance of the 5-year Eurobond amounting to EUR 600 million, part of which was used to prematurely pay off the Eurobond issued in 2018. The remaining part, after servicing the foreign debt, is transferred over to 2024.

¹⁵ Data published by the Monetary Policy Department, which include the securities auctions held in December, was used for borrowing in the domestic market.



5. INFLATION, PRICES AND COSTS IN THE ECONOMY

The average inflation dropped to 3.9% in the fourth quarter, continuing the downward trend of the previous quarters. However, the declining pace was slower, reflecting both the persistent domestic inflationary pressures, which continue to dominate inflation formation, as well as the rise in oil prices in global markets.

Domestic inflationary pressures continue to fuel the high demand for goods and services, which keep profit margins at high levels; as well as labour shortages, which are reflected in the rapid increase of wages and production costs.

Inflation is expected to continue to fall during 2024, as demand and supply is expected to balance each other out, which will enable better management over the costs of productions and profit margins. In the same vein, the gradual decline of inflation in our trading partners and the stable exchange rate are expected to further reduce foreign inflationary pressures.

5.1 CONSUMER PRICES

Inflation averaged 3.9%, the fourth quarter, down by 0.2 percentage points against the previous quarter and 4 percentage points against the same period of the previous year (Chart 24, left). The falling trend of inflation was driven by the weakening of foreign inflationary pressures, the strengthening of the exchange rate and the gradual materialisation of the impact of the monetary policy normalisation stance. The intensity of inflation reduction decelerated progressively over the last three quarters. Not least, the deceleration of the downward trend of inflation in Q4 reflected both the slower decline in food prices in global markets as well as the surge in oil prices. Meanwhile, in parallel to the abovementioned effects in foreign markets, the rapid growth in tourism was reflected in high prices of services and rents during the fourth quarter (Chart 24, right).

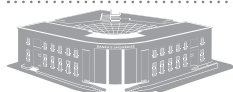
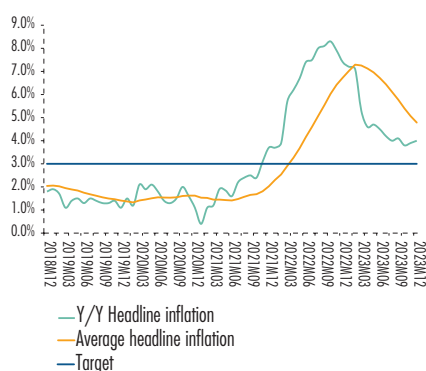


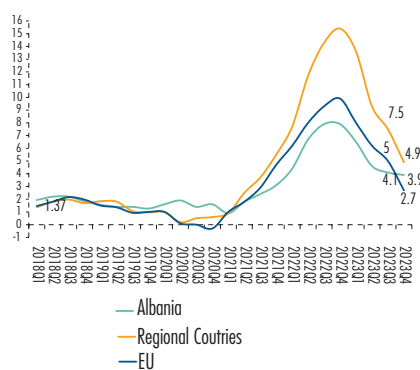
Chart 24

The deceleration of inflation continued at a slower pace compared to the first half of the year



Source: INSTAT and Bank of Albania's calculations.

Pressures from prices of oil and services kept the domestic inflation rate elevated



Source: INSTAT and Bank of Albania's calculations.

The inflation rate in Q4 continued to be driven by the high, albeit falling, contribution of the “**Unprocessed foods**” category (about 55%). In parallel, the contribution of the “**Processed foods**” category fell by 0.2 p.p. compared to the previous quarter. The prices of “**Non-food items**” continued to fall, although their negative contributions to total inflation during the quarter were lower. This was engendered by the reduced negative impact arising from oil prices, as compared to the first nine months of the year (Table 2). The other more stable components of inflation - **housing, services, and durable consumer goods** - made the same contributions as in the previous quarter (Table 2). The category of “housing lease” experienced the most significant rise, as prices of rents climbed in the last two months of 2023. Also, contributions from services remained considerable to total inflation formation, due to the high demand from tourism and other related sectors.

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

	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	Annual inflation 2023 Q4 (%)
Processed food	1.4	3.0	3.5	3.4	2.8	1.3	0.8	0.6	3.5
Bread and grains	0.4	0.7	0.6	0.6	0.6	0.2	0.1	0.1	1.1
Milk, cheese and eggs	0.3	0.9	1.0	1.2	1.3	0.8	0.6	0.5	7.8
Unprocessed foods	1.5	1.2	1.7	1.9	1.9	2.5	2.3	2.1	12.7
Fruits	0.2	-0.1	0.0	0.1	0.1	0.4	0.3	0.3	8.6
Vegetables	0.9	0.5	0.6	0.8	0.7	1.1	1.3	1.3	21.8
Meat	0.4	0.7	1.0	1.0	1.0	0.9	0.7	0.4	6.8
Services	0.4	0.5	0.6	0.5	0.5	0.5	0.5	0.4	2.8
Goods with regulated prices	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Housing lease	0.1	0.2	0.3	0.4	0.4	0.4	0.4	0.4	3.3
Non-food consumer goods	1.0	1.6	1.5	1.2	0.4	-0.6	-0.4	-0.1	-1.0
Fuel	0.7	1.4	1.3	0.9	0.0	-0.9	-0.6	-0.2	-9.2
Durable consumer goods	0.0	0.2	0.3	0.4	0.5	0.5	0.4	0.4	3.9
Inflation (%)	4.4	6.7	7.9	7.9	6.5	4.6	4.1	3.9	3.9

Source: INSTAT and Bank of Albania's calculations.

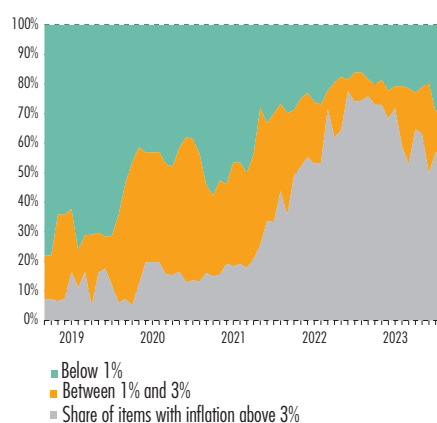
*The Table shows contributions to inflation by composing categories and some of their main items.



The falling trend of inflation during the year is also reflected in the progressive decline of core inflation determinants (Chart 25, right). It is also worth mentioning that the fall of inflation during the year, was present in a broad category of items, as is shown by the dynamic in the distribution of the frequency of inflation rate of CPI basket items, which demonstrates a gradual increase in the share of items with an inflation rate lower than 3% (Chart 25, left)¹⁶.

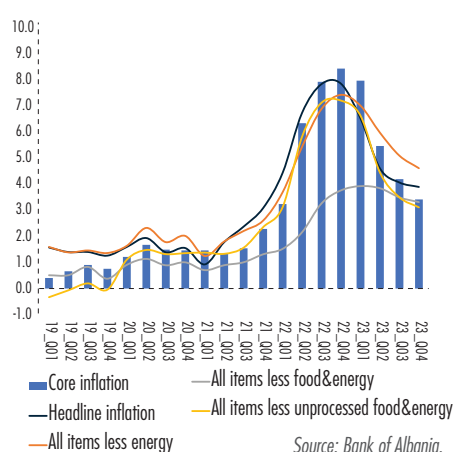
Chart 25

The share of items with inflation above 3% further declined in Q4



Source: INSTAT and Bank of Albania's estimations.

Net inflation fell at a more moderated rate



Source: Bank of Albania.

However, the level of these indicators remain above the BoA's target, confirming the presence of high and relatively stable inflationary pressures. Consequently, the net inflation indicator, excluding the price of energy and food, remained almost unchanged during Q4.¹⁷

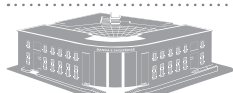
5.2 INFLATION DETERMINANTS

Inflation continues to remain above the target, affected for the most part by domestic pressures. On the other hand, foreign inflationary pressures, despite expanding, remained moderate in the last quarter.

The cyclical position of the economy remains positive. Employment has continued to increase, the unemployment rate has dropped, while production, labour and capacity utilisation rate gaps remain on the positive side. The tighter labour market has continued to push up wages in the private sector. These developments continue to keep core and domestic inflation at high levels, although they decelerated at a contained pace during the fourth quarter.

¹⁶ The assessment is based on the annual inflation data at a 2-digit level, pursuant to COICOP classification of CPI basket items, which includes a total number of 96 goods and services.

¹⁷ This calculation includes mainly services and long-term consumer goods.



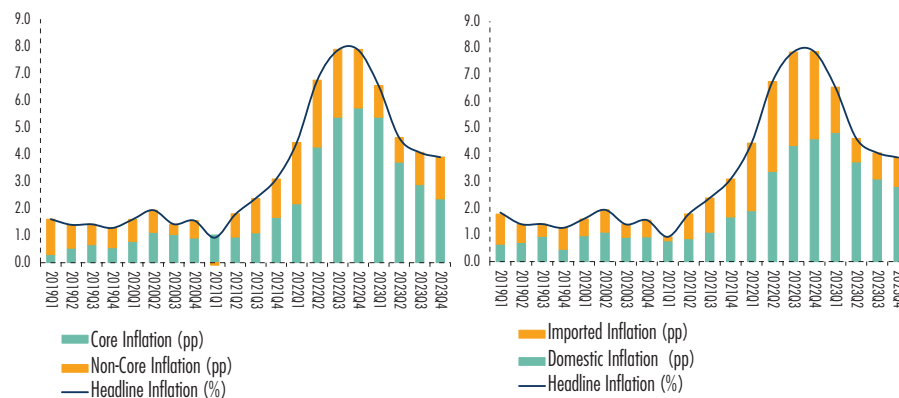
The effects of the monetary policy are gradually normalizing domestic pressures, reflected also in the better anchoring of medium-term inflationary expectations toward the inflation target.

Annual inflation recorded a slight decrease in the last quarter of 2023. This development reflected both the increase of non-core and imported inflation and the slower deceleration of core and domestic inflation (Chart 26). Core and domestic inflation, and net core inflation¹⁸, registered 3.4%, 3.3% and 3.5%, respectively, in the last quarter, standing on average 0.6 p.p. below the respective values of the previous quarter. This downward trend was 0.4 p.p. weaker than the one of the previous quarter, due to the rise in rent inflation during November and December.

Chart 26

The downward pace of domestic and core inflation decelerated, but their contributions to inflation remained high

Contributions of imported and non-core inflation expanded slightly in 2023 Q4



Source: INSTAT and Bank of Albania's estimations.

Source: INSTAT and Bank of Albania's estimations.

The short-term and foreign components of inflation accelerated. Non-core inflation jumped to 5% in the last quarter, from 3.8% in the previous quarter, whereas imported inflation rose to 5.6%, from 5% in these respective quarters. This rise reflected the lower negative contributions resulting from the inflation of fuels in Albania and some other goods which are subject to excise tax, as well as the inflation hike of unprocessed foods.

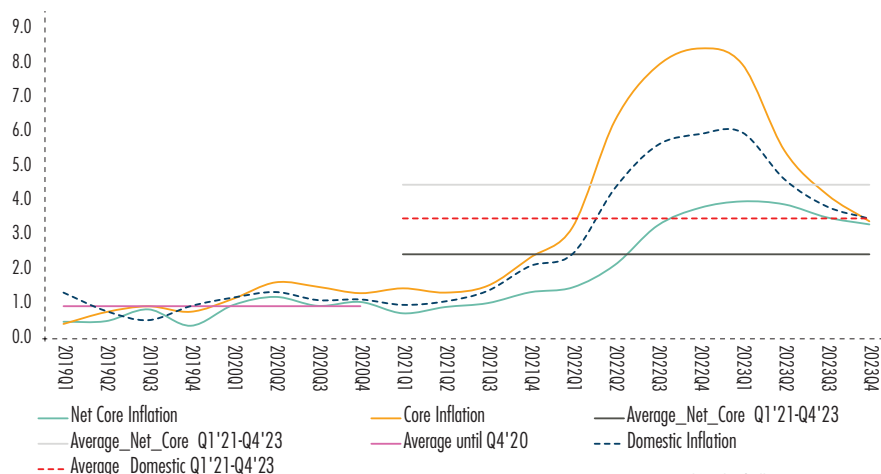
The downward trajectories of core and domestic inflation flattened out during the last quarter of the year, converging toward similar values (Chart 27). The deceleration of these indicators increased their share on headline inflation, contributing by 2.4 p.p. and 2.8 p.p., respectively. Not least, domestic inflation composed 72% of headline inflation in Q4. This performance illustrates the persistence of internal inflationary pressures, reflecting the high demand for goods and services, the rapid growth of wages and increase of production costs, due to a more constricted labour market, as well as the above-target inflation expectations.

¹⁸ 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.



Chart 27

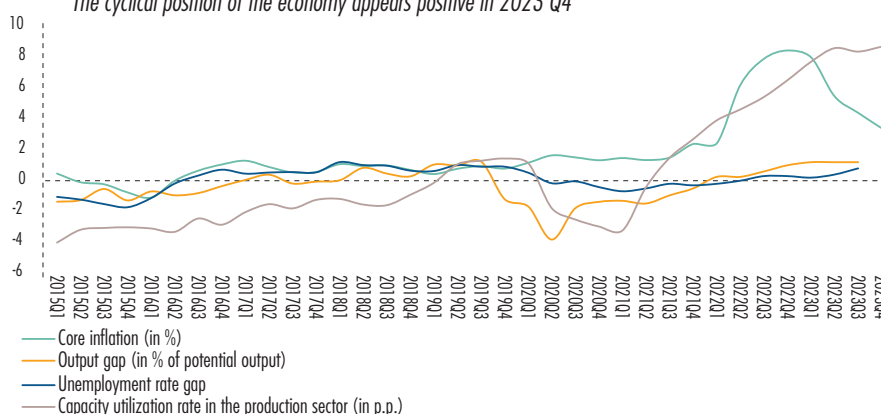
The trajectories of core and domestic inflation, although declining, have become flat in the fourth quarter, however net core inflation remains above the respective historical average of the high-inflation period



The high demand for goods and services was conducive to a positive business cycle, characterised by a high capacity utilisation rate, a historically low unemployment rate, as well as a rapid increase of wages and production costs (Chart 28).

Chart 28

The cyclical position of the economy appears positive in 2023 Q4



The **capacity utilisation rate** in the economy stood at 79.7% in 2023 Q4. It was slightly below the value recorded in the previous quarter, albeit considerably above the long-term average of the indicator (Chart 28).

Employment and unemployment. Employment grew by 1.2% in 2023 Q3 (Chart 29, left), slowing down compared to the previous quarter (2.7%). The positive contributions stemmed entirely from services, whereas the negative contributions came from "Agriculture" and "Industry". The unemployment rate fell to 10.5%, the lowest rate ever recorded. The participation rate of the labour force has continued to edge up during the third quarter (Chart 29, right).

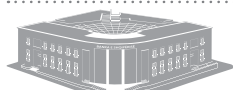
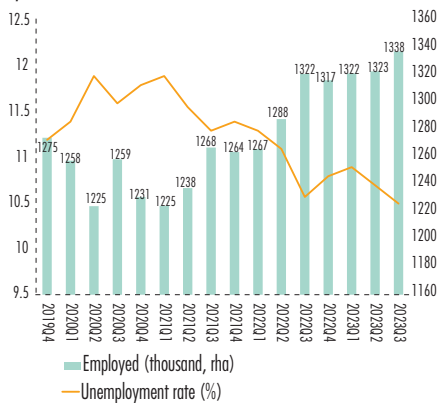


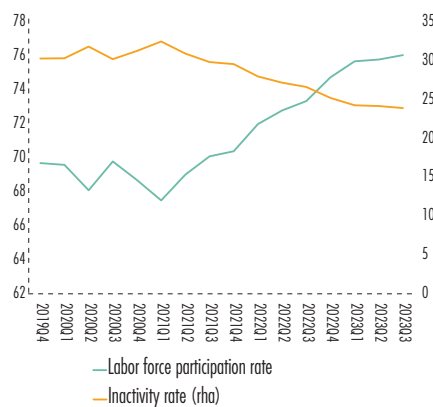
Chart 29

Employment continued to increase and unemployment dropped to a new historical minimum during the third quarter



Source: INSTAT.

Participation in the labour force has expanded despite the fall of the inactivity rate

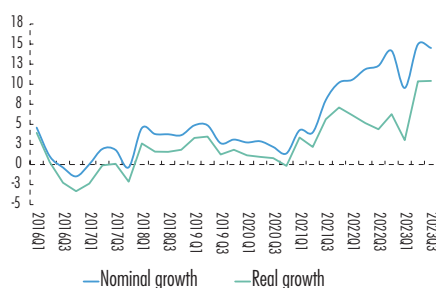


Source: INSTAT.

Wages, productivity and labour costs. The increase of the average wage of the private sector continued to record a double-digit value in 2023 Q3, as well. It stood at 14.5%, compared to 15.0% in the previous quarter. The positive contributions were mostly broadly based from the sectors of the economy. In real terms, the increase of the private sector's wages stands at 10.4%, at the same rate recorded in 2023 Q2 (Chart 30, left). The labour unit cost¹⁹ increased by 9.9% in 2023 Q3, accelerating against the 7.1% rate recorded in the previous quarter. The increase of the labour unit cost was driven by the rapid increase of wages in the private sector (Chart 30, right). Furthermore, labour productivity continues to shrink, contributing to the rise in the labour unit cost as well.

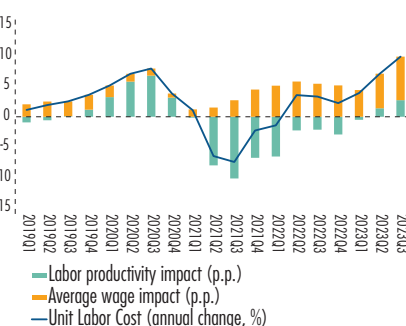
Chart 30

The increase of the private sector wages continues to record a double-digit value in 2023 Q3, as well



Source: INSTAT.

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



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 annual changes in LP and ULC are shown as moving average in four terms.

Source: INSTAT and Bank of Albania calculations.

¹⁹ Unit labour costs are estimated for the non-agricultural private sector based on the National Accounts statistics, of employment and wages.

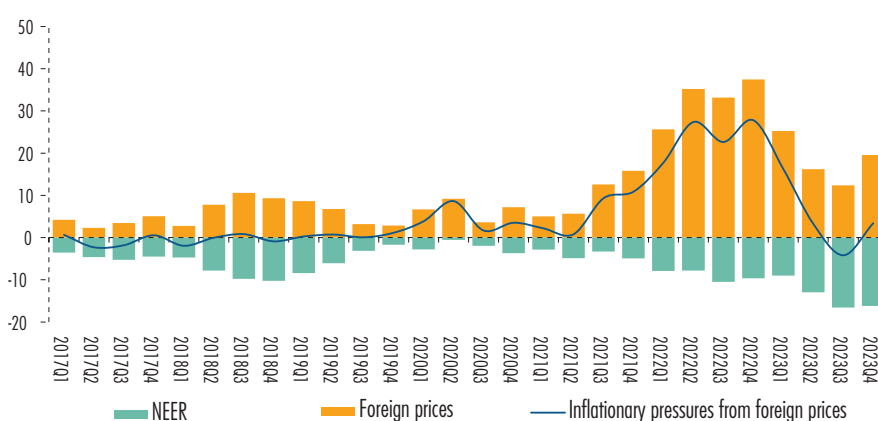


Other output costs have gone up, but at a slower pace. Producer prices rose by 5.2% during Q3, from 6.9% in Q2. For the same periods under comparison, the deceleration of producer prices in the domestic market was much more contained (7.2%, from 8.3%) than export producer prices (1.9%, from 4.6%). Lastly, the construction cost index rose by 4.2%, from 4.7% in the second quarter in 2023.

Imported inflationary pressures returned to their upward trend in 2023 Q4. The imported inflationary pressure index (IIPI) expanded by 3.4% in this quarter, from the 4.2% contraction registered during the previous quarter (Chart 31)²⁰. This performance shows the faster increase in foreign prices (19.6% during Q4, compared to 12.4% in Q3). On the other hand, the appreciation of the nominal exchange rate has buffered the transmission of foreign inflationary pressures. In Q4, the nominal effective appreciation recorded 16.2%, from 16.6% in Q3.

Chart 31

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

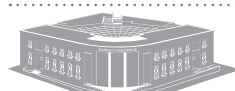


Source: INSTAT, Eurostat and estimations of the Bank of Albania..

The rise of IIPI has moved in tandem with the performance of imported inflation. The latter rose in the last quarter, contributing 28%, on average, to headline inflation formation, from 24% recorded in the previous quarter. The expansion in the contributions of imported inflation has not altered the profile of headline inflation, dominated by domestic pressures, which have continued to influence inflation rates, still keeping them below target (Chart 26, right).

Inflation expectations from enterprises and consumers have increased in Q4, whereas financial agents' expectations have remained unchanged compared

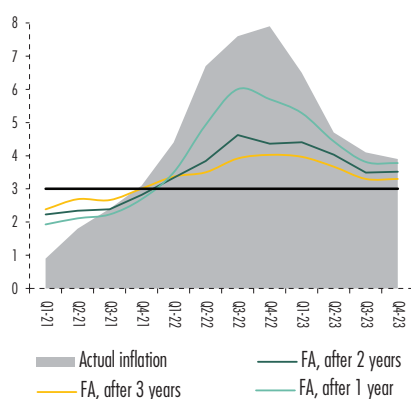
²⁰ IIPI is calculated as the annual growth of IPI and NEER for the respective month. From the correlation analysis of the relevant indicators with different time delays, IIPI anticipates the short-term developments in the imported inflation component by about 1-2 months.



to Q3²¹. Inflation expectations from the latter recorded lower values compared to enterprises and consumers, in all three time horizons under consideration. Financial agents expect inflation to be 3.8% after one year, 3.5% after two years and 3.3% after three years (Chart 32, right). One year from now, businesses' expectations on inflation are 6.0%, up by around 0.2 p.p. from the previous quarter. Consumers' expectations registered 11.2%, up by around 0.8 p.p. from the third quarter (Chart 32, left).

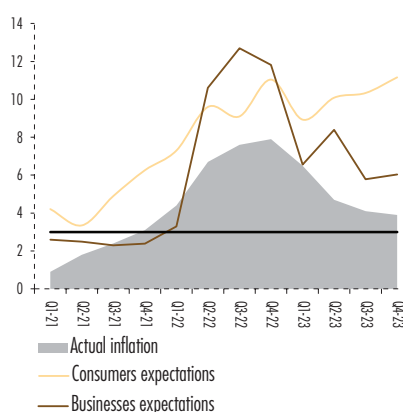
Chart 32

Inflation expectations from enterprises and consumers after one year, have gone up



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

Financial agents' inflation expectations were more stabilised during 2023 H2



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

²¹ The analysis on inflation expectations is based on the results of the Business and Consumer Confidence Survey, as well as on the financial agents' Expectations Survey.





