

FOREWORD BY THE GOVERNOR

The information analysed in this report confirms previous assessments of the Bank of Albania on the actual situation and the outlook of the Albanian economy.

Available data suggest that economic activity at home continues to expand. This improved economic activity led to better labour market indicators and is reflected in a gradual rise of inflation towards the target. The accommodative monetary policy, as reflected in the reduction of financing costs and risk premia, remains a determinant factor in this development landscape. The outlook for the future remains positive. The Bank of Albania expects economic growth to pick up over the next two years and inflation to return to target within 2018.

Inflation has been trending upward in recent months, settling at 2.2% in December. In terms of composition, during the fourth quarter, inflation rose due to the increase in food and oil prices. From the macroeconomic perspective, during this period, the upward trend of inflation reflects the added inflationary pressures from the domestic environment and the reduction of disinflationary pressures from the external environment.

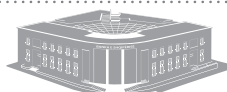
According to INSTAT data, the Albanian economy grew 3.3% in the first nine months of the year and 3.1% in the third quarter. Growth reflected the expansion of consumption and private investments and the increase in revenues from tourism. Domestic demand was supported by the stimulating monetary conditions, improvement of confidence, increase in employment and expansion of foreign direct investments. On the other hand, foreign demand contributed positively to the export of services, but the export of goods continued to show poor performance, as a result of still low commodity prices in international markets.

In our judgment, economic growth in the fourth quarter will be higher than in the preceding quarter. Economic growth for 2016 will be similar to that recorded in the first nine months, and higher than in 2015.

The expansion of aggregate demand has led to the increase in employment and decrease in unemployment. Data for the third quarter point to 8.5% increase in employment and a decrease of the unemployment rate to 14.7%.

Economic and financial developments have reflected the combined effect of the consolidating fiscal policy and the accommodative monetary policy implemented during the year.

The fiscal balance of the first 11 months resulted in ALL 7.1 billion surplus. The increase of revenues by 7.3% and reduction of expenditures by 2% contributed



to this result. This fiscal policy stance has kept the direct contribution of public expenditure to aggregate demand at low levels, but it has created more space for the pass-through of our monetary policy to the financial markets.

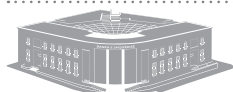
Our monetary stimulus has provided favourable financing conditions, even though the exchange rate appreciated from the previous year. The low policy rate has contributed to the reduction of interest rates across the board for financial products offered to the private sector. In particular, the average interest rate on lek loans in November was 0.6 percentage points lower than in the previous year. On the other hand, the yields on government securities in the primary market moved upward in recent months. This movement was partly due to a correction of their rapid decline in the first half of the year, and partly due to the effects from the supply and demand fluctuations in the auctions. The upward trend is expected to decelerate for as long as the monetary policy and the fiscal policy remain unchanged. Moreover, available data suggest that this trend has not resulted in a tightening of the price of credit to the private sector, and has not distorted the monetary policy pass-through.

In response to this policy, and reflecting the recovery in economic activity, the credit to the economy has been increasing. Excluding the effect of the loss loans write off from the balance sheets, the portfolio of loans to the private sector in November stood 3.4% higher than in the previous year. In more detail, the 10.4% domestic currency credit growth offset the contraction by 1.4% in foreign currency credit portfolio.

The Bank of Albania expects crediting to improve further in 2017. The expectations are based on the signals for a gradual recovery of credit demand and the positive effects on the supply side from the materialisation of measures for the reduction of non-performing loans. Data show that the ratio of non-performing loans fell to 18.2% in December. The reduction reflects the combined effects of the improvement of the economic situation, credit restructuring and loss loans write-off from balance sheets.

Our analysis suggests that economic and financing conditions are adequate for the return of inflation to target. Economic growth is expected to strengthen further in the next two years, creating adequate conditions for the return of the economy to equilibrium and of inflation to target within 2018. Meanwhile, for 2017, the Bank of Albania expects average inflation to hit 2.3% from 1.3% in 2016.

The realisation of this scenario requires maintaining the accommodative stance of the monetary policy in the medium-term horizon. However, the intensity of the monetary stimulus in this period will follow the improving trend in the economy, adapting to the needs of maintaining macroeconomic balances. Based on the available information and judging on the balance of risks, which remains on the down side, the Supervisory Council deems that the intensity of the monetary stimulus will not diminish before the fourth quarter of 2017.



This path of the monetary policy stance is in line with the accomplishment of our price stability objective. In parallel, the accommodative monetary policy also creates adequate conditions for the implementation of structural reforms. Such reforms are necessary - among others - for further expanding the production capacities of Albania and increasing the resilience of the economy against potential shocks.

