

1. FOREWORD BY THE GOVERNOR

The Albanian economy posted growth in the first half of the year. According to INSTAT data, the Gross Domestic Product increased by 3.9% in the first quarter, reflecting the positive contribution by almost all the constituent sectors and branches. Indirect available data suggest positive growth, though in slight moderation, in the second quarter.

From the aggregate demand perspective, the economic activity expanded reflecting both the growth of domestic demand and the improvement of the balance of trade with abroad. In greater detail:

- Private consumption and investments continued to grow in the first half of the year, on the account of favourable financing conditions, improved confidence in the economy, increased employment, and continued high Foreign Direct Investment flows.
- Similarly, the fiscal policy produced a positive stimulus. While this policy maintained the consolidation trend in the first half of the year, which is reflected in the positive values of the budget balance, the intensity of the fiscal consolidation appears lower than in the previous year.
- On the other hand, the improvement of the balance of trade has reflected the favourable international conjuncture, the added attention for Albania as a tourist destination, and structural improvements in the chain of extraction, processing and trading of oil in Albania.

Overall, the performance of the economic activity followed the expected trend, but the growth rate was higher than our projections. Our analyses indicate that the paces of improvement in the balance of trade during the first half, as well as the size of its positive contribution to GDP were dictated by factors that do not represent medium-term trends. As a result, our projections for economic growth in 2017 have been only slightly revised upward.

For the second quarter, inflation averaged 2.0%, downward from the 2.4% average recorded in the previous quarter. The fall in inflation in this quarter was dictated, in part, by the high inflation rates recorded in the previous quarter as a result of supply-side shocks and, in part, by the downward effect from the appreciation of the exchange rate. The exchange rate effect was more present in the fall of imported inflation, particularly in food items. Based on the performance in the second quarter, our projections for the average inflation in 2017 have been slightly revised downward, from 2.3% to 2.2%.



On the other hand, macroeconomic factors with a medium-term and long-term impact on inflation are in line with its further increase and return to target in the medium-term. Hence:

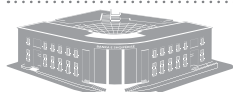
- The Albanian economy is gradually approaching its potential level, as reflected both in the decline in the unemployment rate, and in the medium-term trend of the increase of the production capacity utilisation rate. Such cyclical improvement will enable a gradual increase of wages and convergence of business profit margins with the historic average.
- In parallel, the adverse effect of the exchange rate is expected to dampen gradually. The Bank of Albania deems that the current intensity of the exchange rate appreciation - derived to a large extent by the rapid improvement of the balance of exchanges in trade and services and high foreign direct investment flows - will weaken. Under these circumstances, the deceleration effect on inflation from such appreciation is expected to progressively decline in the medium-term horizon.

The current and expected performance of both GDP and inflation is in line with the financial markets performance and our monetary policy stance.

Our accommodative monetary policy - implemented through the low policy rate, the continuous liquidity injection, and the forward guidance tool - has been fully passed through to the financial market segments. Such policy stance has: brought interest rates to the lowest historical levels, contributed to the progressive reduction of risk premiums, and annual growth by 9.3% of the lek credit portfolio.

Data for the second quarter, however, suggest that the credit performance remains moderate. Cleaned from the loan write off in the banks' balance sheets, credit to the private sector recorded 2% average growth in the second quarter, driven by the 3.2% annual decline of the foreign currency credit portfolio. In sectorial terms, lending showed faster and steadier growth in the segment of loans to households, especially with regard to consumer credit, whereas the growth of loans to enterprises showed more sluggish.

The still-moderate pace of credit growth reflects both the weak demand for credit and the prudent bank lending policies. The upward cycle of investments is financed, until now and to a large extent, by the use of enterprises own funds. Yet, looking ahead, the growing need for businesses financing is expected to be accompanied by growth of demand for loans. Likewise, the further improvement of the business climate, the reduction of the credit risk and the further improvement of the banking system balance sheets are expected to facilitate the credit supply. In this regard, the non-performing loans ratio was further lowered standing at 15.58% in June, illustrating the success of our measures and providing encouraging signals for the future improvement of the lending activity.



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Judging on the actual trends of the economic performance, and determining factors in both the internal and external environment, the Bank of Albania deems that economic growth will continue in the medium term. In our baseline scenario, this growth will be sufficient to place our economy on equilibrium and will be a determinant factor for the return of inflation to target within 2018.

The achievement of these objectives requires pursuing an accommodative monetary policy throughout the medium-term horizon to offset the short-term decelerating effect of the exchange rate.

