

## FOREWORD BY THE GOVERNOR

The new information analysed resulted, overall, in line with our expectations. Similarly, our forecasts on the economic and monetary outlook have remained largely unchanged.

Inflation rose slightly in the fourth quarter of 2017, illustrating the short-term nature of supply-side shocks, which had driven it down in the previous quarter. Headline inflation increased mainly due to the increase in the inflation rates in categories related to housing.

Albeit upward, domestic inflation remains subdued and below the 3% target of the Bank of Albania. In the macroeconomic aspect, this performance reflects the cyclical development stage of the Albanian economy and subdued imported inflation rates.

Although set on an upward path, aggregate demand remains inadequate to fully utilise production capacities, as illustrated by the fact that the unemployment rate remains above its natural level, and firms report that capacities are not yet fully utilised. This phenomenon impedes the increase in wages, production costs and profit margins, in line with our inflation target.

In parallel, inflation in our main trading partner countries continues to record low rates. The appreciation of the exchange rate in the recent quarters has decelerated further their pass-through to the Albanian economy.

The analysis of macroeconomic indicators suggests that the Albanian economy continued to grow in the second half of 2017, albeit at a slower pace than in the first half. INSTAT data shows that the Gross Domestic Product grew by 3.55% in the third quarter, slowing down from the 3.9% average growth rate registered in the first half of 2017.

From the sectorial perspective, economic growth continues to be supported by the activity in the services sector, whereas its deceleration reflects the deceleration of the activity in the construction sector and certain branches of the industry sector. From the aggregate demand perspective, economic growth was supported mostly by the expansion in the private consumption, whereas its deceleration reflected the slowdown in investments and the negative contribution from foreign trade. Indirect available data suggest a similar performance of economic growth over the fourth quarter.

The monetary policy of the Bank of Albania has played a significant role in sustaining the upward trend of the economy and building up domestic



pressures on inflation. The low policy rate, the use of the forward guidance for the markets, and the continuous liquidity injection in the interbank market have brought the private sector financing costs down, in turn, boosting consumption and investments. In parallel, the low interest rates have eased the debt servicing costs - therefore improving the soundness of the private sector balance sheets - and have attempted to decelerate the exchange rate appreciation pressures.

The financial markets appeared overall calm in the second half of the year. The interest rates on deposits and loans in the Albanian currency remain near historic lows, whereas the fluctuations in government security yields have not been transmitted to other segments of the financial market. On the other hand, the exchange rate resulted relatively steady over the fourth quarter; its appreciation was downward compared to the high levels recorded in the third quarter.

Against this positive backdrop, lending continues to be sluggish. Excluding the exchange rate effect, the portfolio of credit to the private sector registered 5% average annual growth in the fourth quarter. In line with our previous statements, the total credit growth continues to be supported largely by the expansion of lek credit. Its portfolio recorded 7.9% average annual growth in the fourth quarter, whereas foreign currency credit grew by 2.4%.

The slack credit growth reflects the simultaneous effect of the sluggish demand and tightened conditions from the supply side. The steady growth of lending will require the improvement of both demand and supply. In this regard, while our projections suggest demand will grow in the medium term, the Bank of Albania draws the attention to the fact that the banking sector should be more proactive in terms of its lending policies.

The banks financial soundness has been constantly improving. This performance is corroborated by the stable liquidity situation, the positive performance of profitability indicators and the progressive reduction of non-performing loans. The ratio of non-performing loans to total loans fell to 13.2% in December, reflecting the improvement of the economic activity, the effect of measures for reducing NPLs, and constant efforts by banks and firms to clean and restructure their balance sheets. In this context, the Bank of Albania believes that there is further scope for banks to factor in the reduction of the credit risk for easing their lending policies.

Our projections suggest the positive development trends will continue. The Albanian economy will continue to grow over the medium-term horizon, underpinned by the improvement in the external environment and the favourable financing conditions at home. These factors will absorb a part of the effect from specific shocks to certain sectors and of the reduction of the fiscal stimulus during 2018. The further growth of aggregate demand and a fuller utilisation of production capacities is expected to create the necessary preconditions for the return of inflation to target around mid-2019.

