Bank of Albania

QUARTERLY MONETARY POLICY REPORT

2017/IV

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Sheshi "Skënderbej", Nr.1, Tirana, Albania
Tel.: + 355 4 2419301/2/3; + 355 4 2419401/2/3
Fax: + 355 4 2419408
E-mail: public@bankofalbania.org

www.bankofalbania.org

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OBJECTIVE

Bank of Albania's primary objective is to achieve and maintain price stability. Promoting long-term investments, maintaining the purchasing power of money, enhancing the efficiency of fund allocation in the economy and safeguarding the financial stability are some of the benefits of an economic environment characterized by stable prices. Stability is the greatest contribution by the central bank to sustain a steady and long-term economic growth.

In line with its approved Monetary Policy Document, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0% in the medium term. The announcement of the quantitative inflation target aims at anchoring economic agents' expectations and reducing the risk premiums.

In view of achieving this goal and enhancing its transparency, the Bank of Albania prepares and publishes the Monetary Policy Report quarterly. This Report is the main instrument of the Bank of Albania to communicate its monetary policy to the public. It provides a thorough assessment of the latest macroeconomic developments and the factors expected to contribute to consumer prices in Albania.

This Report refers to the Supervisory Council's Decision No. 60, dated 01.11.2017. The economic, financial and monetary analysis in this Report is based on the latest data avaiable as at 20 October 2017.

FOREWORD BY THE GOVERNOR

The economic activity at home continued to improve over the second and third quarters, driven by the favourable external environment, improvement of economic agents' confidence, and better domestic financial conditions. On the other hand, overall inflationary pressures remain weak and inflation declined in the third quarter.

This diverging trend shows that the Albanian economy continues to operate below its potential and inflation remains subject to continuous supply-side shocks.

The new information and the updated forecasts have not changed the expected trend of economic and financial developments, but have postponed our estimation for the return of the economy to equilibrium and of inflation to target.

The annual inflation rate averaged 1.7% in the third quarter, down from the rates recorded in the previous two quarters. The deceleration reflected mainly the fall in food items inflation, as a result of higher domestic supply, appreciation of the exchange rate, and slowdown in inflation for these products in global markets.

In macroeconomic terms, the Bank of Albania assesses that inflation slowed down due to supply-side shocks, whose effect is expected to be of limited intensity and short lived. However, the low core inflation suggests that, even though they are increasing, medium-term pressures on inflation remain weak. The improvement in the domestic economic activity has brought the Albanian economy closer to equilibrium, as illustrated by the fall in the unemployment rate and the upward trend in the firms' capacity utilisation rate. The Albanian economy, however, continues to operate below potential, with a containing effect on pressures for an increase in wages and production costs.

According to INSTAT data, the Albanian economy grew by 4.1% in the second quarter, close to the first quarter growth rate. The growth was driven by the expansion of domestic private demand, improvement of the trade balance, and increase in public spending and high foreign direct investments during this period. The indirect available indicators suggest that economic activity continued to grow at a similar pace in the third quarter.

The positive performance of economic activity in Albania continues to benefit from our accommodative monetary policy stance, which maintains a financial environment with low interest rates and ample liquidity. It is also aided by the consolidatory fiscal policy, which reduces risk premia and increases the space for financing the private sector. The Bank of Albania deems that these factors will continue to contribute to economic growth, and the return of the economy to equilibrium and of inflation to target.

Financial markets continue to be characterised by low interest rates. The upward trend of yields on treasury bills has not affected the cost of credit to the private sector, which - in the third quarter - remained at their historical low levels. In response, the credit to the private sector grew 3.1% on average in the third quarter, almost entirely attributable to the expansion by 9.7% of the credit portfolio in the Albanian lek. The growth of credit demand, especially in the corporate segment, was a positive development in the third quarter. Furthermore, the standards of credit to the private sector eased, although these standards remain relatively conservative.

Judging on the current development trends and the balance of underlying factors, the Bank of Albania deems that the medium-term perspective of economic development remains positive. The improvement in the economic environment is expected to support the return of inflation to target, within the first half of 2019.

Compared to the previous forecasting round, the Bank of Albania has revised slightly upward the outlook for economic growth throughout the three-year forecast horizon, whereas the projections for the return of the economy to equilibrium and of inflation to target have been somewhat postponed.

The projection for higher economic growth is underpinned by the upward revision of the assessment for the potential growth pace, in response to structural reforms that have taken place in the Albanian economy. At the same time, the upward revision of the potential postpones our projections for the return of the economy to equilibrium and of inflation to target. It implies that, compared to our previous assessments, the economy has larger production capacities and their full utilisation would require a longer time. Concerning inflation, the postponement of reaching the target reflects also the need for fully absorbing supply-side shocks and fading deceleration effects arising from the appreciating trend of the exchange rate.

The projections mentioned above factorise the strengthening of the accommodative stance of monetary policy throughout the medium-term horizon. They also remain conditioned by the materialisation of expectations for a more favourable external environment and a faster recovery of lending activity in Albania. The fall to 14.78% of the non-performing loans ratio in September shows that the balance sheets of the banking sector are improving and that the credit risk is reducing.

In this context, the Bank of Albania judges that the growth in credit demand must be followed by more favourable and far-sighted lending policies by the banking sector. In the event this is not the case, the further misbalance in the credit demand and supply would decelerate the pace of economic growth and would be a missed opportunity for the banking sector.

The new information and the updated forecasts have confirmed that the current monetary policy stance is adequate, and have underlined the need for an even more accommodative monetary policy in the medium-term horizon. This monetary stimulus will be necessary for boosting the aggregate demand in line with the production capacities of the country and for the return of inflation to target.

1. PRICE STABILITY AND BANK OF ALBANIA'S MONETARY POLICY

The main objective of the monetary policy in Albania is to achieve and maintain price stability, defined in quantitative terms as maintaining inflation at around the 3% target. Through the achievement of this objective, the monetary policy supports the stable and long-term growth, promotes the financial stability and supports the welfare of citizens.

Over the last years, the Bank of Albania has been implementing an accommodative monetary policy, to boost the expansion of aggregate demand and the increase of inflation toward the target. The new economic and financial information points to further expansion of economic activity and employment in the second quarter, whereas inflation declined over the third quarter. This decline is assessed as temporary: the return of economic activity to its potential parameters would create the right conditions for the sustainable return of inflation to target. Inflation is expected to gradually increase and return to the Bank of Albania's target within the first half of 2019. The achievement of this objective requires maintaining the current intensity of the monetary stimulus for some quarters.

The Albanian economy continues to maintain a positive development trend, albeit the improvement in economic activity is not reflected in inflation's performance. Available data suggest that economic activity and employment increased over the second and third quarters, and economic agents' confidence has been improving. One the other hand, the average inflation of the third quarter dropped at 1.7%, from 2.0% in the previous quarter. Particularly, inflation fell in August and September, standing at 1.6%.

Economic growth in the second quarter resulted higher than our expectations, whereas inflation in the third quarter was lower. The performance of economic activity and inflation at opposite directions seems to reflect the continued effects from supply-side shocks.

In more concrete terms, inflationary pressures from the external environment slowed down, for both commodity and consumer prices. The rise in inflation in euro area countries and those in our region, at the beginning of the year, decelerated in the last months, re-introducing low inflation rates in these economies. Taking into account the reducing impact of lek's appreciation in the domestic foreign exchange market, pressures from imported inflation have been downward. Also, the higher supply for some seasonal products drove to a faster reduction of their price during the last two months of the quarter.

Notwithstanding supply-side shocks, the Bank of Albania assesses that the overall economic and monetary environment continues to generate low inflationary pressures, which are insufficient for the return of inflation to target. The boost in aggregate demand is not translated in stable pressures for the increase of wages and consumer prices yet, in line with our inflation target. In our assessment, economic recovery in the last three years has reflected not only the positive performance of some cyclical demand factors, but also the improvement of structural production factors. The improvement of these factors enhanced the Albanian economy's ability to accumulate capital and provided higher contribution of labour to economic growth, thus expanding the Albanian economy potential. On the other hand, these structural improvements imply that the return of the economy to equilibrium - that is a more complete utilisation of production capacities and upward domestic inflationary pressures - will require higher economic growth rates.

The performance of economic activity over the last two years, characterised by the acceleration of growth rates, is an encouraging signal. Nevertheless, high economic growth rates are still needed for the return of the economy to equilibrium, which remains an objective that may be achieved only in the medium run.

Considering the negative impact of supply-side transitional factors on inflation, the Bank of Albania assesses that annual inflation for 2017 will average around 2.0%. The Bank of Albania estimates that, in parallel with the weakening of supply-side factors' action, the continuing growth of the economy, approaching the equilibrium and the better anchoring of medium-term inflation expectations will provide the premises for the build-up of domestic inflationary pressures. These factors will contribute to the gradual increase of inflation and its return to target within the medium term.

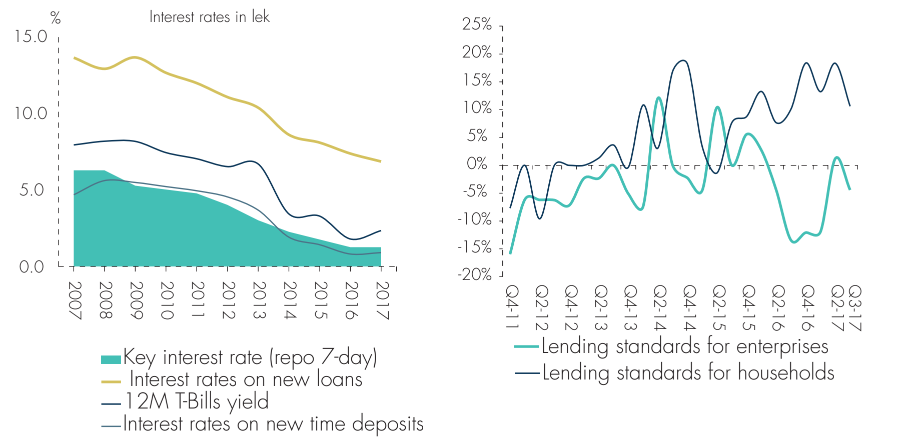
The new available information is overall consistent with these expectations. In more concrete terms:

(i) Statistics published by INSTAT show that the Gross Domestic Product grew by 4.1% at annual level, in 2017 Q2. Economic activity was fuelled by the growth of consumption and investments, both supported by improved situation in employment and confidence, and the favourable financing conditions. Also, the economic expansion was supported by the accelerated pace of realisation of the planned budget spending and the higher foreign demand in tourism. Available data show that these trends continued in 2017 Q3.
(ii) In line with the positive performance of economic activity, the capacity utilisation rate was up as well. Employment increased while unemployment fell at 13.9% at the end of 2017 Q2, down from 15.5% in the previous year. Short-term statistical data by INSTAT show a slight rise of wages in the sectors of the economy.
(iii) Medium-term inflation expectations measured by surveys have been

upward, showing better anchoring to the central bank's target.

(iv) Financing conditions remain favourable and non-price credit conditions seem to shift towards easing. This performance is a reflection of the Bank of Albania's accommodative monetary policy. The minimum level of the monetary policy rate, supply of the market with the needed liquidity and the forward guidance instrument contributed to the reduction of interest rates and risk premia in the financial markets.

Chart 1 Interest rates in the financial market and lending standards



Source: Bank of Albania.

In response, credit portfolio in lek continued to show positive signs, recording annual average growth at around 10% over 2017. Its share to total credit was up at 45.1%, at the end of the first nine-month period of the year, or 1.6 percentage points higher from the end of 2016.

The Bank of Albania expects the economy to grow steadily in the medium-term horizon. The above-stated factors - favourable financing conditions, improved confidence, employment and external environment - will continue to support the expansion of aggregate demand, steering the economy toward its potential. More intensive use of production capacities is expected to build up domestic inflationary pressures. Production costs and wages are expected to rise, to be reflected in the progressive increase of core inflation and the return of inflation to target in 2019 Q2.

In this round of forecasts, the convergence of inflation to target is postponed compared to the previous forecasts. This revision reflects in part the need to absorb supply-side shocks, and in part the presence of lower inflationary pressures from the domestic economy, in response to the structural improvements in it.

The balance of risks to inflation projections remains on the down side. It mainly relates to uncertainties in the external environment, future developments in the foreign exchange markets, and the ability for the needed improvement of the bank credit supply to respond to the expected increase of credit demand.

The baseline scenario of macroeconomic developments requires maintaining the accommodative monetary policy stance, to enable the increase of inflation to target in the medium term. For that reason, based on the available information, the Bank of Albania assesses that the intensity of the monetary stimulus will not diminish for some quarters ahead. Also, the monetary policy will remain stimulating throughout the medium-term horizon, to ensure the sustainable convergence of inflation to target.

2. EXTERNAL ECONOMIC ENVIRONMENT

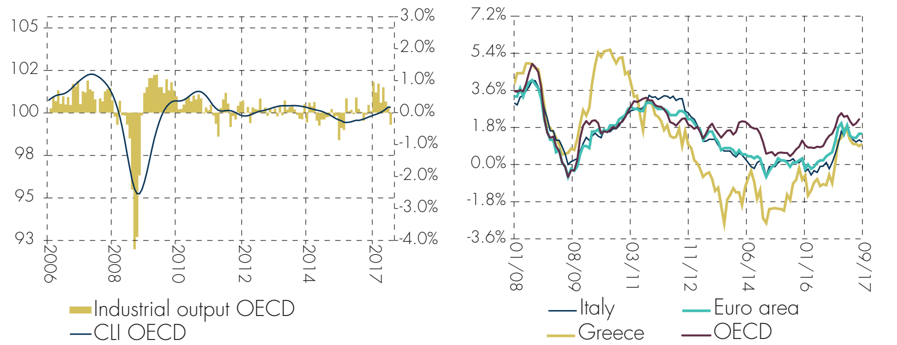
The global economic activity has shown a stable positive performance over several periods. The latest data show the GDP growth rates picked up again in advanced and emerging economies, following a slowdown at the beginning of 2017. In particular, in the euro area the economic activity accelerated and the economic environment improved, but its transmission to the expected rise of prices is sluggish. Also, the rise in commodity prices has slowed down, decelerating the rise of consumer prices inflation. Financial markets showed low volatility, as a result of the improved global economic activity.

The global economic outlook is also positive. Economic growth is expected to continue throughout the current year. Risks to this forecast are present mainly on the down side, but weakening. The inflation rates are low, but forecasts point to their gradual growth in the medium-term, supported by the expansion of the economic activity.

2.1. GLOBAL ECONOMY

The global economy has continued to expand at a steady pace. The leading economic indicators for July, August and September are positive and support the strengthening of the economic growth in the second half of the year. The global composite indicator of output and economy[1] as well as the leading

Chart 2 Composite Leading Indicator (CLI) of GDP and Industrial Output* in main countries** (left) and inflation in main countries and trading partners (right)



* Industrial output is a quarterly moving average of monthly change, whereas CLI's long-term is 100.
**OECD countries and Brazil, China, Russia, India and South Africa.
Source: OECD.

[1] *The global composite output PMI and Global manufacturing PMI, Markit, July, August and September 2017.*

indicator of GDP in these months registered values above their long-term averages, signalling further growth in the global manufacturing and services sectors. Inflation[2] increased in July and August, mainly driven by the increase in energy prices. Stable inflationary pressures continue to remain overall low.

UNITED STATES ECONOMY

The economy of the US accelerated the growth rate in Q2, growing 3.1% from 1.2% a quarter earlier[3]. The main contributors to the expansion of the economy were the growth of non-resident investments, the acceleration of consumer spending, the increase of central government expenditures, and expansion of exports. On the other hand, the slowdown of local government expenditures, and of resident investments, and the increase of imports have been decelerating factors on economic growth. According to higher-frequency indicators, the economy is expected to continue to develop at stable positive rates. The improvement of the consumer confidence, coupled with low unemployment rates, is expected to fuel consumer spending growth. Also, the improvement of financial conditions and of corporate balance sheets is expected to bring an increased flow of investments in the period ahead. Inflation has followed an upward trajectory over the last quarter, reflecting temporary supply-side factors from the storms that hit the South of the country. Core inflation has been low in the last months, but this trend is expected to be temporary. Improvements in the labour markets are expected to increase inflationary pressures, placing inflation on a steady upwards trajectory.

Table 1 Key macro-economic indicators

Countries	GDP change Q2-2017		Unemployment rate	Annual inflation
	Quarter	Annual	August 2017	September 2017
USA	0.8	2.2	4.2*	2.2
Euroarea	0.6	2.3	9.1	1.5
Germany	0.6	2.1	3.6	1.8
France	0.5	1.7	9.8	1.1
UK	0.3	1.7	4.3	3.0

Source: Eurostat and respective statistical institutes.
**Data for September 2017.*

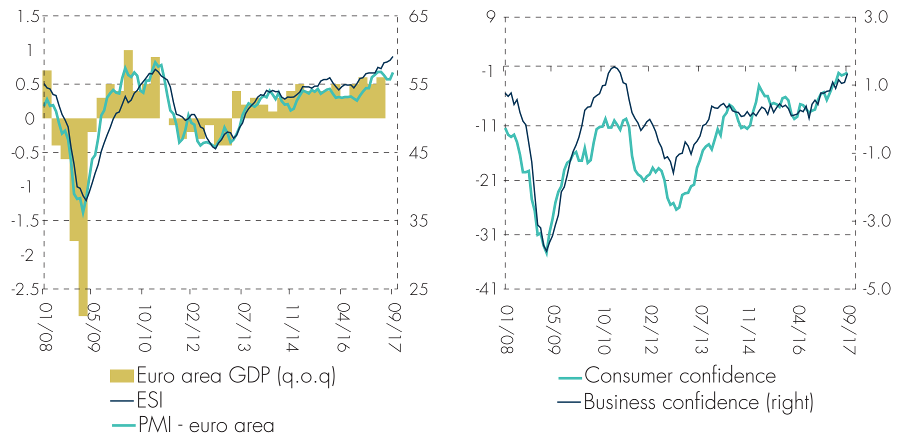
EURO AREA ECONOMY

The economic growth in the euro area has accelerated in Q2 and GDP grew by 0.6%. The main contribution to this growth came from domestic demand together with a smaller contribution from net exports. Leading indicators[4] of economic developments as well as confidence indicators, in August and September, continued to increase, confirming the positive momentum of the euro area economy. The favourable financing conditions and the improvement of employment indicators are expected to boost consumption and recovery of

[2] *Annual inflation of OECD countries in August resulted at 2.2% from 2.0% in July and 1.9% in June.*
[3] *Annualized quarterly growth.*
[4] *The economic sentiment indicator (ESI) and the business confidence indicator (BCI) for the euro area in August, September 2017.*

investments. Also, the strengthening of the global economic growth and the improvement of foreign demand in the euro area[5] are expected to support the economic activity. Inflation increased at 1.5% in August and September from 1.3% in June and July. Its growth is mainly driven by rising energy prices. Core inflation, which excludes high volatility groups (including energy) remains low and stable inflationary pressures are contained.

Chart 3 Composite output index (PMI), ESI and quarterly GDP (left) and the trend of business and consumer confidence surveys (right) in the euro area



Source: Markit, Eurostat, European Commission.

The economies of Albania's trading partners, **Italy** and **Greece** registered a positive growth in Q2 in line with the positive momentum in the euro area. However, their growth rates are below the average level of the region. In Italy, consumer spending, government spending and investments contributed positively to the aggregate growth, while net exports contributed to the opposite direction. In Greece, investments contracted, but the increase in consumer and government spending as well as in net exports fuelled the economic growth. The annual inflation in both countries has slowed down and stood below the average of the euro area, in Q3.

REGIONAL ECONOMIES[6]

The economies of the region grew in 2017 Q2, with a positive contribution mainly from investments and foreign demand. Macedonia is an exception. The economic growth has not been followed by rising inflation in the region, which remains below central bank targets. While the labour market has improved, unemployment rates remain high. In 2017, the economies of the region are expected to grow at higher rates than the previous year, supported by domestic demand and the positive performance of euro area countries.

The economic activity in **Kosovo** registered a rapid growth in Q2, with positive contribution from investments and net exports. Consumption contracted, driven by

[5] *ECB projections, September 2017*
[6] *Main trading partners in the Balkans, non-EU.*

the decrease of government spending. The economic activity growth in **Serbia** was sluggish in Q2 as well, as a result of the effect from adverse meteorological conditions on agriculture and construction. On the demand side, growth was supported by a broad base, with the improvement of consumer spending, government spending, investments and net exports. The economy of **Macedonia** contracted in 2017 Q2, driven by an uncertain political situation that discouraged investments, which decreased rapidly, particularly in the sectors of construction and industrial output. The exports suffered from this negative effect as well. On the positive side, consumer and government spending increased, providing low positive contributions to economic growth. The economy of **Turkey** grew rapidly in 2017 Q2, supported by investments, which increased rapidly, mainly as a result of developments in the construction sector. Net exports improved, while consumer spending slowed down their growth rates. The contraction of government spending has driven economic growth downward.

The economies of the region are characterized by low inflation rates, as a consequence of low commodity prices and appreciation of the domestic currencies. Turkey is an exception to this trend, where annual inflation remains at double digits, overshooting the central bank's target range. In Serbia, the increase of cereal prices was followed by the increase in inflation in September. In the other countries, inflation rates remain low, with a slight upwards tendency in the last months.

Table 2 Economic indicators for the countries in the region

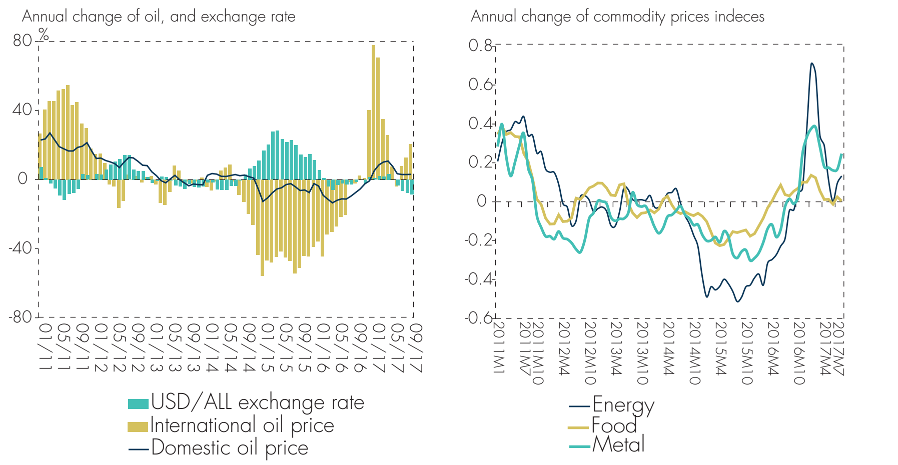
Countries	Annual change of GDP 2017 Q2	Annual inflation September-2017	Unemployment rate 2017 Q2
Italy	1.5	1.3	11.2*
Greece	0.8	1.0	21.2
Macedonia	-1.8	1.7	22.6
Serbia	1.3	3.2	11.8
Turkey	5.1	11.2	10.2
Kosovo	4.6	1.7	30.6
Albania	4.1	1.6	13.9

Source: Respective statistical institutes.
*Note: *The value for August 2017*

2.2. MAIN COMMODITY PRICES IN GLOBAL MARKETS

Commodity prices showed a slowdown trend of their increase. This performance was dictated by food prices, whose index registered lower increase in July and August, as a consequence of the high supply in major grain producer countries. The Oil Price Index showed a slow rise as a consequence of the higher supply by producer countries outside OPEC, which met the shortages created by the deceleration of production in OPEC countries. The Metal Price Index increased, reflecting the augmented demand by emerging economies, where investments continue to be the driving factor of economic growth. Brent oil price followed a rising trend in September, reaching 56.2 USD/barrel.

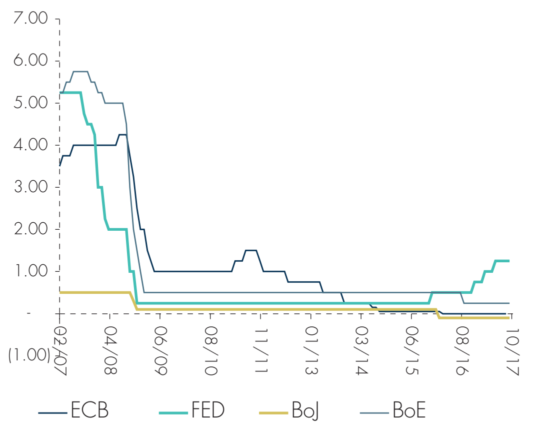
Chart 4 Commodity prices, annual change



Source: EIA, IMF, staff's calculations.

Forecasts for the main indexes suggest a slight increase in 2017 Q4 and the beginning of 2018, as a result of the improvement of the global economy activity. Uncertainties on oil prices are on both sides, since it is expected to be significantly affected by geopolitical factors in the producer countries.

Chart 5 Key interest rates of selected central banks



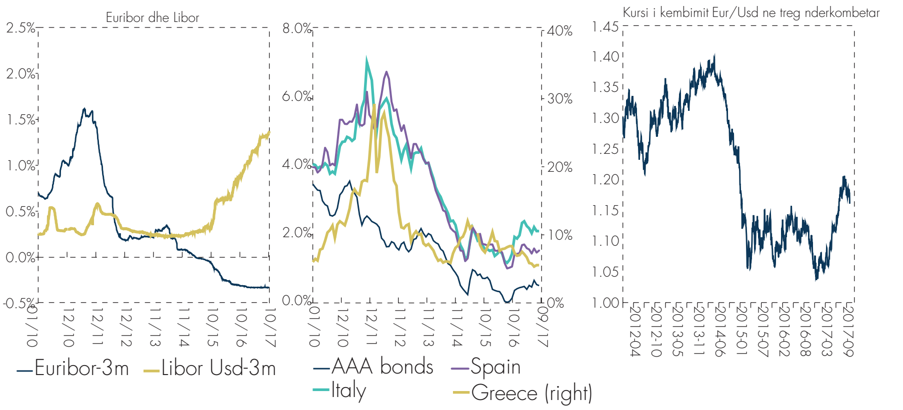
Source: Central banks (ECB, Fed, BoJ and BoE).

2.3. FINANCIAL MARKETS

In this quarter the major central banks have not changed their respective key rates. ECB's key rate remains at 0.0%, Fed's at 1.25%, Bank of England's at 0.25% and Bank of Japan's at -0.1%. On the other hand, the Fed's Federal Open Market Committee (FOMC) decided to start in October reducing the size of assets it acquired through quantitative easing programmes in post-crisis years. It has not signalled what the targeted level of assets will be, but it shows that the current position of the monetary policy is accommodative, and in the future, further monetary tightening is expected.

Interests of money market instruments in the euro area did not change in the third quarter, remaining at low levels. In the financial markets of the euro area, yields on government and enterprises securities' remained largely unchanged from the previous quarter. During the quarter, they have shown volatility, driven by expectations of market participants regarding the future the monetary policy stance. This development was reflected in the temporary increase of yields. However, the unchanged position of the ECB and the Fed regarding monetary policy restored yields at the previous levels. The spread between the securities

Chart 6 Selected global financial indicators

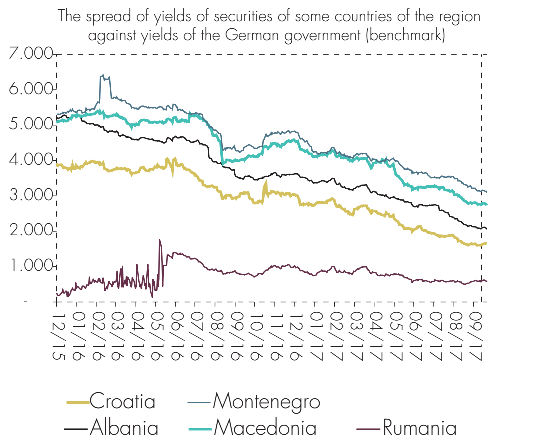


Source: Bloomberg, Reuters, Eurostat and ECB.

of countries with fiscal consolidation needs (Italy, Spain, Greece) against Germany's bonds have not changed, remaining at low levels.

The yield on the sovereign debt of the regional countries, issued in the international markets, shows a positive perspective of these countries. Risk premiums have decreased as a result of the improvements of economic indicators. In August, Moody's affirmed the rating of the Albanian sovereign debt at B1 and that its outlook remains stable. This assessment was supported by the commitment in the implementation of the measures for a consolidating fiscal policy, which aims to reduce the vulnerability of the public debt, as well as by the continuation of the reforms in the framework of complying with EU accession standards.

Chart 7 Government security yields of the countries of the region



Source: Bloomberg, Reuters.

In Q3, the euro appreciated against the US dollar and other major currencies, in the foreign exchange market. In average terms, compared with Q2, the euro appreciated by 6.6% against the US dollar; meanwhile, compared with the previous year, it stands 5.2% higher.

3. FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

The financial markets are characterized by adequate liquidity and low risk premiums. In line with the accommodative monetary policy, the interest rates on loans and deposits remained at low levels. Meanwhile, the yields' curve shifted slightly upwards, dictated by lower demand from investors, whereas risk premiums did not change.

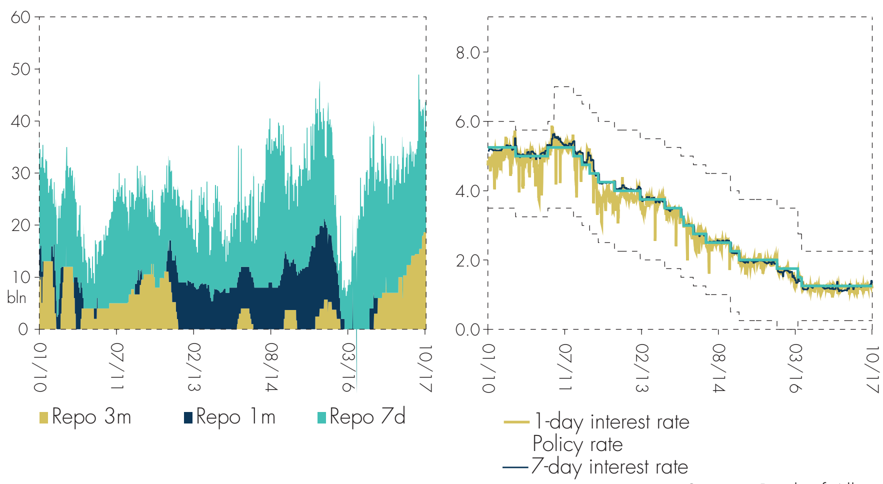
In Q3, the banks' balance sheets show an improvement of lending in line with the expansion of the credit demand. The credit growth in this quarter has been observed in both the households and enterprises segments. By currency, the high increase of the growth of credit in lek offset the contraction of credit in foreign currency, supporting the further shift of the portfolio towards the domestic currency. Despite the positive signals on lending, its growth remains moderated. The sluggish credit expansion continues to condition a low monetary expansion, which continues to be affected also by the preference for diversification of savings in non-liquid instruments.

3.1. FINANCIAL MARKET DEVELOPMENTS

INTERBANK MARKET

The interbank rates continued to be low during 2017 Q3. The interbank market was characterized by a good liquidity situation, which supported this performance of the interest rates. Compared with the previous quarter, money market interest rates registered a slight increase, but their level remains very

Chart 8 Bank of Albania open market operations and interbank rates



Source: Bank of Albania.

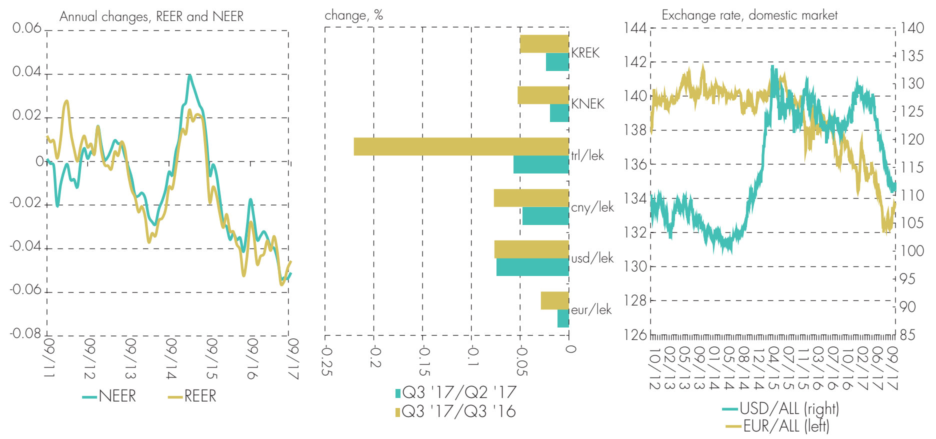
close to the policy rate. The volatility indicator[7] decreased from the previous quarter. The volume exchanged by banks resulted stable, near that observed in 2017 H1. The maturity profile remained the same, with the 2 or 3-day exchanges added to the main overnight and weekly transactions.

The Bank of Albania continued to supply liquidity through its main instrument, the one-week repo, and through three-month maturity repo agreements. The average injected amount was slightly larger than in the previous quarter, whilst interest rates in the auctions were very close to the policy rate.

DOMESTIC FOREIGN EXCHANGE MARKET

Lek continued to appreciate during Q3 as well, but at a more contained pace. The annual appreciation of lek in effective nominal terms[8], registered 5.1% in September, after peaking 5.3% in June-August. This trend is dictated by the smaller appreciation of lek against the euro, while against the other basket currencies the lek has continued to appreciate at the same pace. In real terms, lek's appreciation was moderated compared with the nominal appreciation in 2017 Q3, as a result of lower inflation in Albania compared with to the average of the partner countries. The real annual appreciation decreased at 4.6% in September, from 5.6% registered in June.

Chart 9 Effective exchange rate and individual currencies of the basket



Source: Bank of Albania.

[7] In Q3, the standard deviation of the overnight interbank rate was 0,032 from 0,072 in the previous quarter.

[8] The nominal effective exchange rate (NEER) is calculated against the currencies of the five major trading partners (Italy, Greece, Germany, Turkey and China), using the relevant market weights. For the purpose of calculating the lira/lek and the renminbi/lek rates, the official reference rates remain those of the Turkish lira and the Chinese renminbi against the US dollar. The real effective exchange rate (REER) is calculated similarly to the nominal, but it considers the domestic inflation and those in the trading partners, as well.

The appreciation of the lek in the last two years is driven by the relative acceleration of economic growth in Albania, expectations for the continuation of this trend in the future and the reduction of the risk premium for the Albanian economy. The evidenced speed of this appreciation is due to two simultaneous developments: high foreign exchange inflows in the form of foreign direct investments and the narrowing of the current account deficit. These developments resulted in a surplus of foreign currency in the market, which also led to the rapid appreciation of the lek during this period.

Lek depreciated against the euro during 2017 Q3. The EUR/ALL rate, after its trough in the second half of June, at 132.0 ALL/EUR, increased in the two following months, reaching 133.5 ALL/EUR at the end of August and maintained on average this level during September. At the end of September, the lek lost 0.8% of the value it had against the euro at the end of June. These developments have been reflected in the curbing of the annual appreciation of the lek against the euro during Q3. The annual appreciation of the lek against the euro resulted on average 2.9% in this quarter, from the high appreciation level of 3.4% registered in June.

The ALL/USD rate has been in line with the depreciation of the American currency against the euro in the international foreign currency market. The lek strengthened against the US dollar by around 2.7% per month during the period July-August, decreasing from 118.6 ALL/USD in June at 112.2 ALL/USD in August. In September, it resulted steadily close to the levels of August. In annual terms, the appreciation of the lek against the US dollar has accelerated, reaching 8.5% in September.

The developments observed in the first half of October point to a stable ALL/EUR rate close the average of September, while the US dollar has depreciated, in the international market as well.

PRIMARY MARKET

T-bills and bond yields continued the gradual upward trend in this quarter. The increase of yields continued from the previous quarter and followed a similar pace in these months as well. The ratio of investors' demand against government supply in T-bills auctions, although higher than 1, resulted downwards compared with the previous quarter, thus being a factor in the upward trend of yields during this period[9]. The yield analysis shows that yields increase was contained and present across all traded maturities, reflected in the upward shift of the yield curve, but not in the change in its slope.

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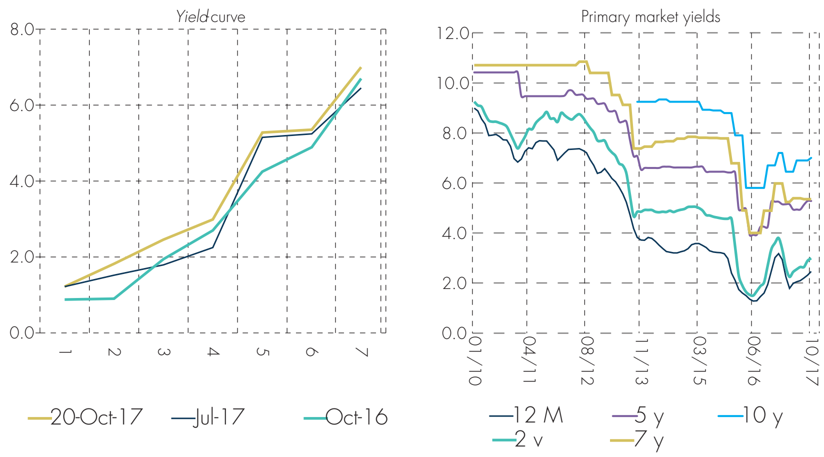
[9] *The hedging ratio for 12-months T-bills was in average 1.0 in 2017 Q3, from 1.1 and 1.6 in Q2 and Q1, respectively. The same ratio for bonds decreased at 1.2 in Q2 and Q3, from 1.7 in 2017 Q1.*

Chart 10 Yields in the primary market

Chart 10 Yields in the primary market*



*The chart includes data from auctions held on 20 July 2017.
Source: Bank of Albania.

The average yield of the 12-month Treasury bills increased to 2.31% in September, from 2.05% in June. Also, in the auction conducted in the first week of October, the 12-months T-bill yields increased again to 2.46%. The bond yields followed that of T-bill yields. The 2-year bond yield increased to 2.99% at the last auction in October, from 2.55% in June. The 5 and 10-year bond yields, resulted at 5.28% and 7.0%, respectively, from 4.64%, 6.90% registered in the previous respective auctions. An exception from this behaviour was the 7-year bond yield, which registered a slight decrease at 5.35%, from 5.39% of the previous auction[10].

In August euro bonds were issued with a nominal value of EUR 39.62 million. The demand of banks for this security was high and the yield resulted at 0.8%, the same yield as the 2-year bond issued in January this year.

3.2. INTEREST RATES ON LOANS AND DEPOSITS AND FINANCING STANDARDS[11]

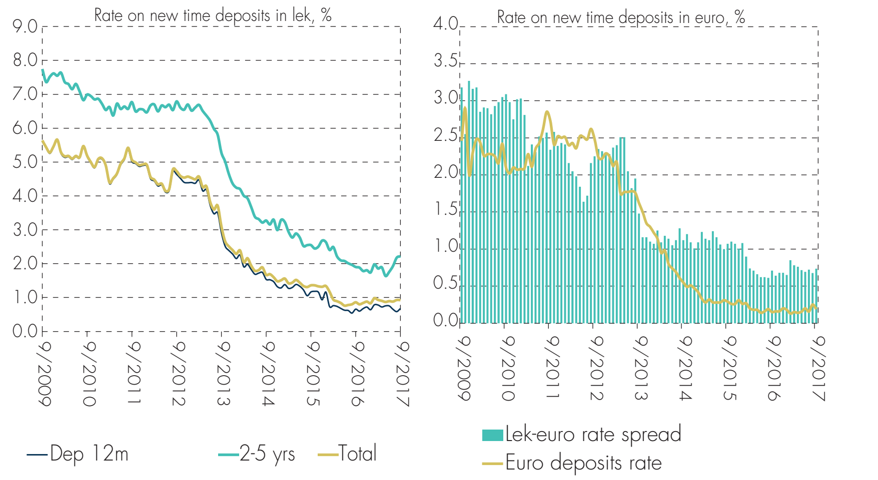
Interest rates on **new deposits in lek** in 2017 Q3 were stable, close to their minimum levels. The average interest rate resulted at 0.9%, as in the first two quarters of the year. During this quarter, the interest rates in the high maturity segments, as well as placements in these maturities increased. Interest rates on **new deposits in euro** in Q3 resulted at 0.2%, registering a marginal increase against the two previous quarters. The increase was present in longer maturities,

[10] *The auction conducted in June for the 7-year bond was in the form of re-opening the March auction, and for this reason, the effective maturity of the bond issued in August was 6.5 years. As a result of this change in maturity, its yield is not directly comparable with that of the 7-year bond issued in May.*

[11] *The latest official data related to interest rates on new loans and deposits are as of September 2017.*

with the purpose of attracting the seasonal foreign currency flows in this period. The spread between interest rates on deposits in lek against those in euro continues to be at a minimum level, about 0.7 percentage point.

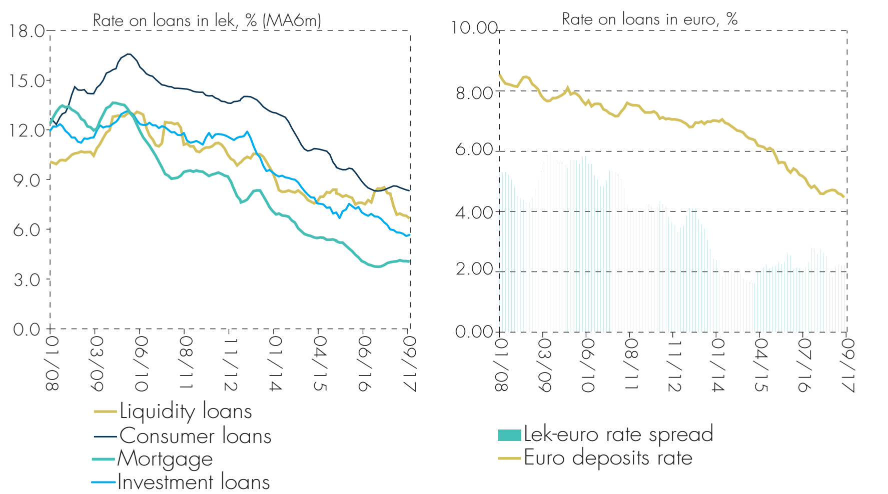
Chart 11 Interest rates on new deposits



Source: Bank of Albania.

The transmission of the accommodative monetary policy stance of the Bank of Albania in low costs of banking activity funding has created the premises for lower interest rates on loans to the private sector. The average interest rate on **new loans in lek** resulted at 6.8% in Q3, slightly up from Q2 (6.4%). The latter was mainly determined by a loan granted in April with a particularly low rate. Excluding this loan from the average of the previous quarter, the interest rates for new loans in Q3 are at similar level of Q2[12] and lower than 2017 Q1. The

Chart 12 Interest rates on new credit, 6-months moving average



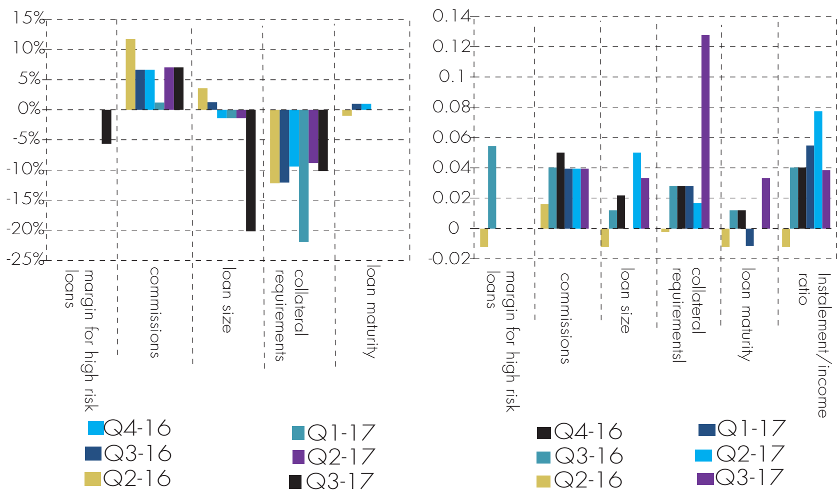
Source: Bank of Albania.

[12] *Cleared from this loan, the average interest rate in 2017 Q2 resulted at 6.7%. The following analysis is based on calculations excluding this loan.*

loan interests in Q3 also resulted lower than the same period of the previous year. Their dynamic within the quarter shows a downward trend month after month. The analysis by client and purpose of use shows that interest rates resulted close to the levels of the previous quarter on all the segments of loans, both to enterprises and households. In the span of a year, the rates have fallen sharply on loans to enterprises, by around 1.1 percentage points on loans for liquidity and around 1.6 percentage points on loans for investments. They remained unchanged for consumer and mortgage loans.

The average interest rate on **new loans in euro** was downward in this quarter. It decreased at 4.1% from 4.7% in the previous quarter. Interests for loans in euro decreased across all the maturities, with the main contribution by long-term loans. By purpose of use, the decrease was considerable in the interest on loans for investments to enterprises as well as consumer loans to households. Meanwhile, the interest rates on mortgage loans to households have not change from the previous quarter. The spread of the average interest rate of loans in lek against that in euro expanded slightly in this quarter, reflecting the decrease of interest rates on loans in euro, but in average terms for this year it remains close to the level of the previous year (2.4 p.p.).

Chart 13 Credit standards (to enterprises left, households right)



Source: Bank Lending Survey, Bank of Albania.

Bank lending survey results in 2017 Q3 show that standards of credit to enterprises remained relatively unchanged. By purpose of use, lending standards for investments tightened, while those for liquidity eased. On the tightening side, the impact came from the increase of collateral requirements, the decrease of the loan size, as well as higher margins for loans with risk, while commissions contributed to the easing side. However, few banks have tightened the lending standards, while others have kept them unchanged.

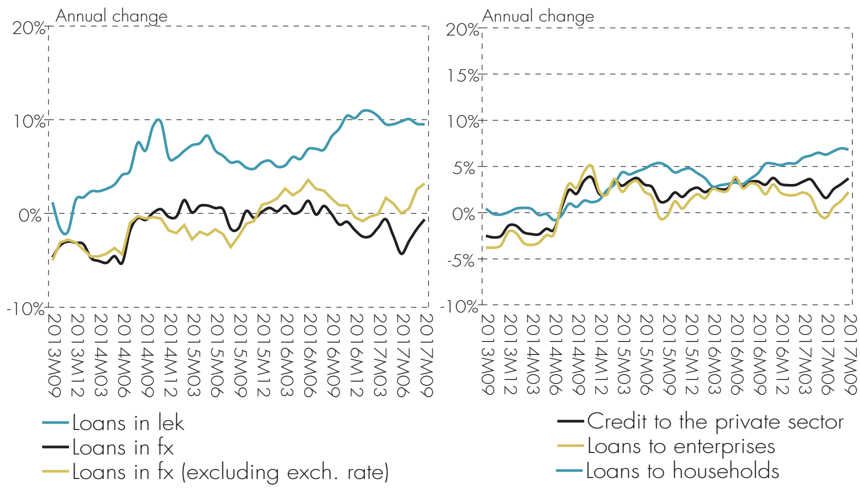
In the households segment, lending standards remained eased similar to the previous quarter. Based on survey results, standards were somewhat eased both in the mortgage loans and in the consumer loans segments. The banks used the reduction of collateral requirements as the main instruments for easing lending standards to households. Also, on the easing side, but to a lesser extent, other conditions were employed, like the increase in instalment-to-income ratio, and other conditions, such as the increase in debt-to-income ratio, the increase in the loan size and the decrease of commissions.

3.3. CREDIT TO THE PRIVATE SECTOR

The growth of credit to the private sector[13] improved in 2017 Q3. The improvement this period is supported by the increased demand from economic agents for funding, particularly enterprises. The positive trend of lending seems to have reflected the improvement of economic activity in Albania, the decrease of uncertainties, the improvement of banks' balance sheets and the easing monetary standards in the economy. Nevertheless, the growth of credit to the private sector remains moderate. In relation with GDP, credit to the private sector is estimated to be around 36.7%, at similar levels with the end of the previous quarter (36.6%).

The outstanding credit to the private sector registered an average annual growth of 3.1%, compared with 2.6% of Q2, while in absolute terms this portfolio grew by around ALL 10 billion. The growth of lending in 2017 Q3, particularly in July and August, resulted high, despite the low seasonality that characterizes this period of the year. The expansion of credit to the private sector continues to be supported by the stable growth of loans in lek (9.7% annually). Loans in foreign currency, adjusted for the exchange rate effect, improved the growth rates (around 2% annually) and were granted mainly for investments to enterprises.

Chart 14 Lending to private sector by currency and economic agent

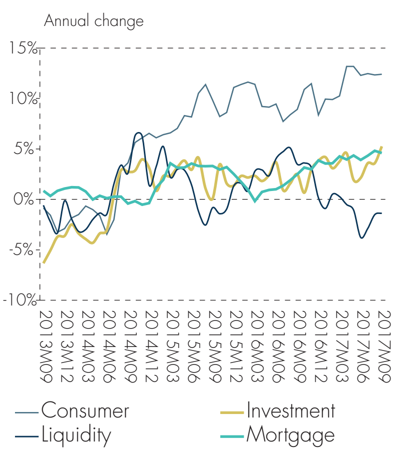


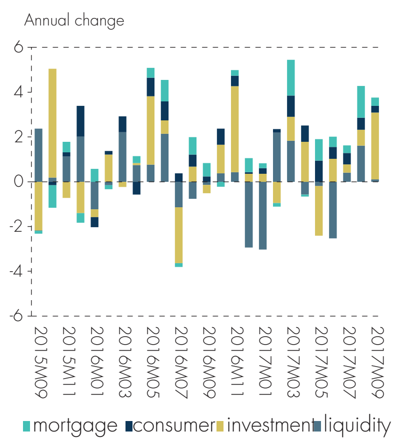
Source: Bank of Albania.

[13] *Lending analysis is based on monetary data adjusted for written off loans.*

By segment, loans to enterprises improved in 2017 Q3, whose outstanding amount registers an average annual growth of 1.4%. This portfolio expanded by around ALL 6.2 billion since the end of June. Credit demand[14] shows growth, supported mainly by the need for funding investments. Loans for investments show a steady growth, registering an average annual increase of 4.1% in 2017 Q3. Loans for liquidity remain in negative territory (-1.9% annually) and continues to be characterized by volatility in monthly terms, depending on the short-term needs of enterprises for funding.

Chart 15 Credit to the private sector by purpose of use





Source: Bank of Albania.

The continuous lending to the households segment is reflected in the improved average annual rates of this portfolio, at 6.8%. Since the end of June, these loans have increased by around ALL 3.5 billion. The good performance of loans to households is supported by both the higher demand for funding and favourable lending standards, which have been on the easing side. By purpose of use, consumer loans continue to support constantly the growth of loans to households (12.4% annually). In Q3, a further improvement of the mortgage portfolio was observed (4.6% annually), continuously supported by attractive promotions for this product.

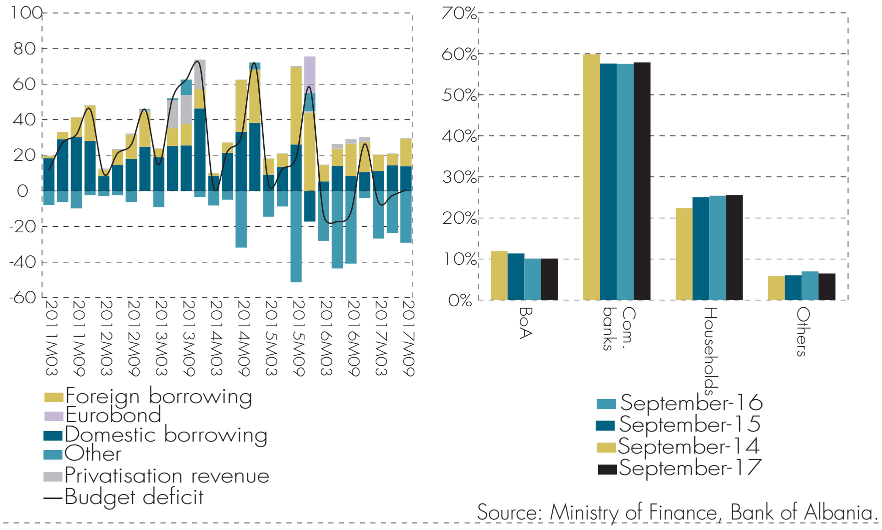
3.4. FINANCING TO PUBLIC SECTOR

In the third quarter, unlike the previous one, the government's borrowing profile was determined by the increase in foreign currency debt, at the same time, by decreasing the domestic currency debt. In more concrete terms, in this quarter, borrowing in the primary market of securities fell by ALL 0.5 billion, resulting in a total borrowing for a 9-month period to ALL 13.7 billion. The

[14] *The credit analysis is also supported by the bank lending survey, which may be accessed at: https://www.bankofalbania.org/web/Vrojtimi_per_aktivitetin_kredites_T3_2017_7867_1.php?kc=0,22,15,2,0*

lower net domestic borrowing rates are a result of partial maturation for several instruments that the government preferred to carry out during this period. On the other hand, net foreign borrowing increased by ALL 9 billion in Q3 as a result of the financing for "Budget Support", disbursed in September of this year.

Chart 16 Budget deficit and its financing instruments, in ALL billion (cumulative) and main holders of government's domestic debt



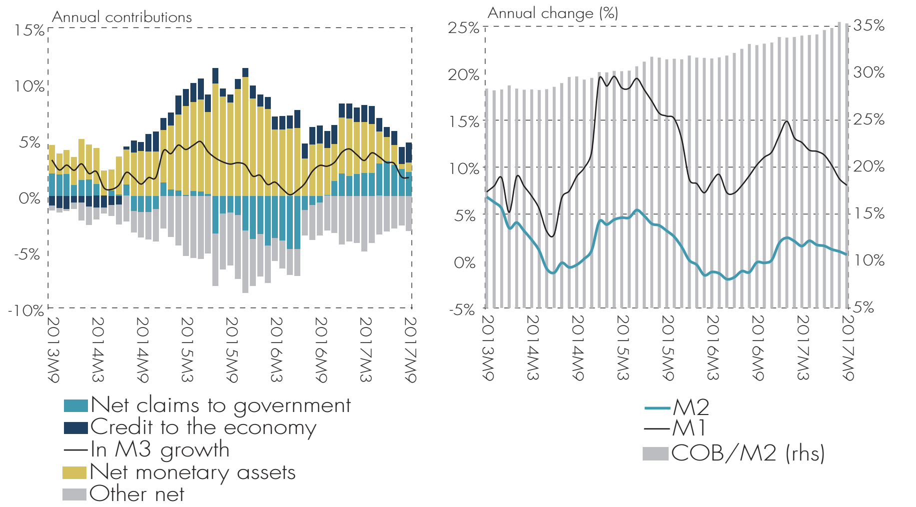
Source: Ministry of Finance, Bank of Albania.

The profile of public debt by holder remained almost unchanged from a year earlier. At the end of Q2, it was formed at 55.8% from domestic debt, about 1.5 percentage points higher than in the same period a year earlier. On the other hand, the stock of domestic debt continues to be owned, at the highest level (58%), by commercial banks.

3.5. PERFORMANCE OF DEPOSITS AND MONEY SUPPLY IN THE ECONOMY

The expansion of money supply decelerated further in Q3. The broad money aggregate, M3, expanded on average 2.1% in annual terms, from 3.4% in the previous quarter. This slowdown was more notable in August, reflecting partially the effect of the high comparative base a year earlier. At the same time, during this quarter, deposits continued to shift, in part, toward maturity terms over two years, which are not included in the calculation of monetary aggregates. The low level of the M3 aggregate also reflects the effect of the domestic currency appreciation against the two major currencies, the euro and the US dollar. The money aggregate in lek, M2, slowed down the growth rate on average by 1% in Q3, compared to 1.8% in Q2. The creation of money in the domestic currency is supported by the credit to the private sector in lek and the financing of the government with domestic financial instruments. On the liabilities side, the M2 aggregate slowdown mainly reflects the considerable shift of lek deposits toward maturities over two years. The narrow money indicator, M1, also slowed down the growth rate, to 9% on average over Q3 or about 2.6 percentage points less than in Q2. The ratio of currency outside banks to M2 was 35.3% at the end of September.

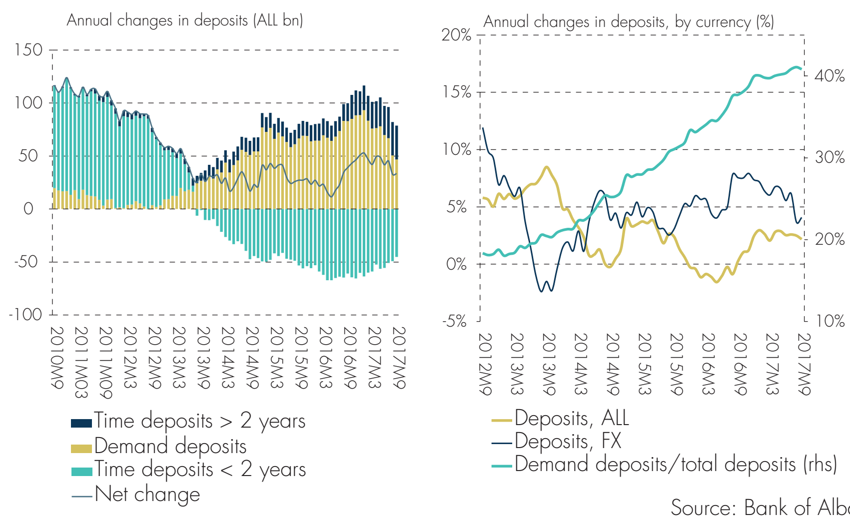
Chart 17 Performance of monetary indicators



Source: Bank of Albania.

Deposits in the banking system recorded 3.5% average annual growth in Q3, about 1 percentage point lower than in Q2. Foreign currency deposits recorded about 4.6% average annual growth, whereas those in lek by about 2.4%. The seasonal growth of deposits during the summer months, especially in foreign currency, was lower than a year earlier. This performance, coupled with the effect of the exchange rate appreciation, is reflected in the slowdown of annual growth rates of deposits. The deposit growth in the banking system has mainly taken the form of households' deposits in foreign currency. Business deposits also increased, almost entirely in the domestic currency.

Chart 18 Deposits in the banking system



Source: Bank of Albania.

The time structure of deposits shows a shift toward its liquid component and a shift toward deposits with maturity of over two years. The shifts in the latter were high, with a considerable part of them in foreign currency, unlike in previous cases. This performance is influenced not only by the preference of households to benefit from the higher interest rates on long maturities, but also by the bank's policies with summer promotions for long-term deposits. Despite the high expansion of deposits with maturity of over two years, the largest shift in the deposit structure results in its liquid component. At the end of September, current and demand deposits accounted for about 40.8% of total deposits, or about 0.5 percentage point higher than at the end of the second quarter.

4. INFLATION AND ECONOMIC GROWTH

Average inflation in the third quarter was 1.7%, down from the second quarter. The decline in inflation was mainly driven by the deceleration of foreign inflationary pressures, due to the appreciation of the exchange rate and slower rise in foreign prices. In parallel, the domestic inflationary pressures were low, reflecting the continuation of the negative output gap and slow growth of wages. The effect of the exchange rate is expected to be lower in the rest of 2017, while inflationary pressures from the demand side are expected to strengthen gradually.

Economic growth resulted higher than expected, reaching 4.1% in 2017 Q2. The growth of aggregate demand, as expected, was supported by the expansion of investments, mainly public investments, as well as by consumption and net exports. On the production side, the expansion of real economic growth was mainly supported by the construction activity; also, industry and services provided significant positive contribution. Available data suggest a more moderate growth in the third quarter.

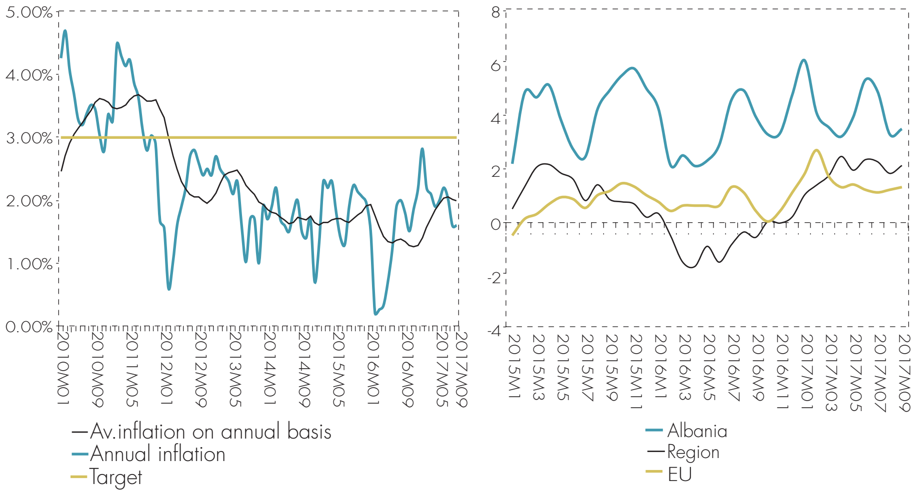
The economy is expected to progress along a stable upward trajectory in the period ahead, gradually converging toward its potential. This process is expected to increase medium-term inflationary pressures, contributing to the return of inflation to target within 2019.

4.1. INFLATION

Annual inflation averaged 1.7% in 2017 Q3, standing 0.3 percentage point lower than in the previous year. The fall of inflation rate was generated mainly by the fall of inflation of prices of processed foods and transport services. The downward trend of food-items inflation is also present in the majority of the countries in the region, during the third quarter. Other basket categories retained the same profile of contributions like in the previous quarter. Appreciation of the exchange rate continued to exert disinflationary pressured on the economy.

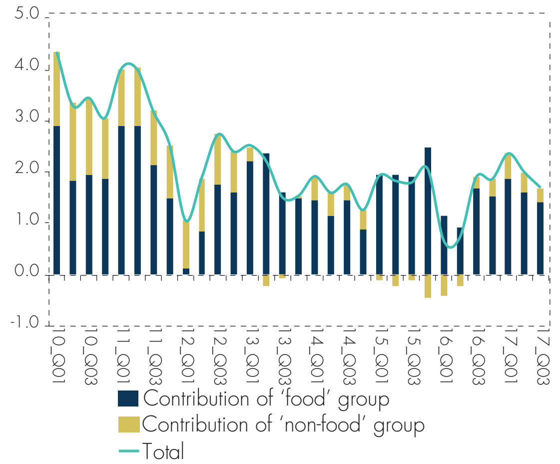
Both food categories continue to maintain the dominant share in the formation of headline inflation (around 80%). However, their contribution fell from 1.6 percentage points in Q2, to 1.4 percentage points in Q3. The main contribution to the decline was provided by **"Processed foods"**, whose contribution dropped from 0.5 to 0.2 percentage point. Grain prices, as an important part of this category, showed downward inflation rates compared to the beginning of

Chart 19 Annual inflation and target (left). Food-items inflation in regional and EU countries (right)



Source: INSTAT and Bank of Albania calculations.

Chart 20 Contributions by food and non-food categories to headline annual inflation



INSTAT and Bank of Albania calculations.

this year. Compared to the previous quarter, the contribution of "Unprocessed foods" increased.

The positive contribution of **"Non-food consumer goods"** maintained almost the same value (0.2 percentage point) as in the previous quarter. Within this category, contributions of fuel and the "footwear" sub-group slowed down sharply.

Lower contribution was also provided by **"Services"**, due to the fall in the prices of transport services and of vehicle insurance. **"Housing"** and **"durable consumer goods"** contributed at the same extent to the headline inflation as in the previous quarter. Even in this quarter, the second category was the only one that provided negative contribution (-0.1 percentage point).

*Table 3 Contribution of main categories to annual inflation**

	Q3:15	Q4:15	Q1:16	Q2:16	Q3:16	Q4:16	Q1:17	Q2:17	Q3:17
Processed food (pp)	0.1	0.0	-0.4	0.1	0.4	0.6	0.6	0.5	0.2
Bread and grains (pp)	0.0	-0.1	-0.2	-0.1	0.0	0.1	0.1	0.0	0.0
Alcohol and tobacco (pp)	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Non-processed food (pp)	1.8	2.6	1.5	0.9	1.2	0.9	1.3	1.1	1.2
Fruits (pp)	0.8	0.9	0.7	0.6	0.4	0.2	0.3	0.3	0.5
Vegetables (pp)	0.9	1.7	0.8	0.3	0.8	0.6	0.9	0.7	0.7
Services (pp)	0.0	0.0	-0.1	0.0	0.2	0.2	0.2	0.2	0.1
Goods with regulated prices (pp)	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Fuels and energy (pp)	0.0	-0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Housing (pp)	0.0	-0.2	-0.2	0.0	0.0	0.0	0.0	0.1	0.1
Non-food consumption goods	-0.2	-0.3	-0.3	-0.3	-0.1	0.1	0.3	0.2	0.2
Durable consumption goods (pp)	0.0	0.0	0.1	0.1	0.1	0.1	0.0	-0.1	-0.1
Consumer Price Index (annual change%)	1.8	2.1	0.7	0.7	1.9	1.9	2.4	2.0	1.7

Source: INSTAT and Bank of Albania.

** The table shows some of the main groups of categories.*

In our assessment, the fall in inflation in Q3 was temporary. Inflation is expected to follow an upward trajectory in the quarters ahead, in response to the weakening of the action from supply-side factors and the expected narrowing of the negative output gap.

4.2. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND PERFORMANCE

According to INSTAT, the Gross Domestic Product (GDP) increased annually by 4.1% in 2017 Q2. The growth rate was 0.1 percentage point higher than in 2017 Q1. By sector, manufacturing, mainly the high growth of construction activity, provided the main contribution to the growth of GDP. In terms of aggregate demand, economic growth was supported by both domestic and foreign demand. The gross capital formation was the main contributor.

4.2.1. OUTPUT BY SECTOR[15]

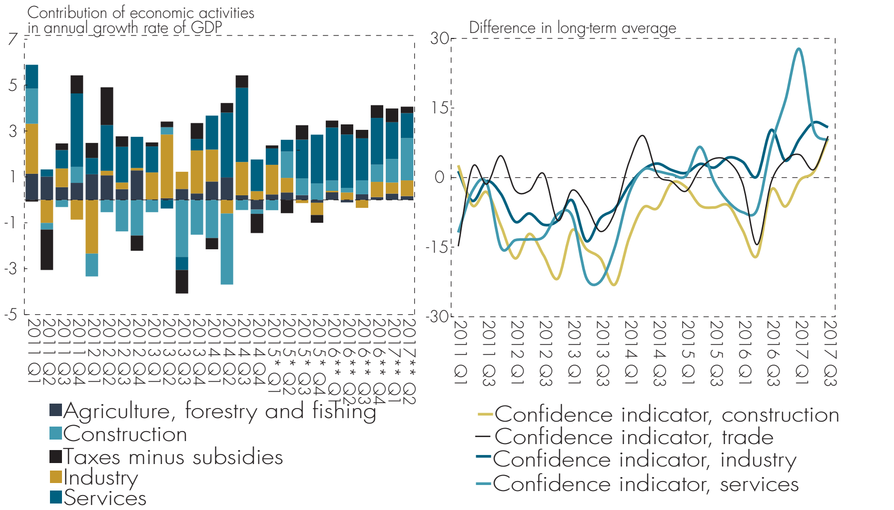
The manufacturing sector was the main contributor to the growth of the economic activity in the second quarter, mainly due to the high growth rate of the construction activity. Industry and services activities also provided significant contributions to growth, while the positive contribution of the agricultural sector was low. Indirect indicators suggest that economic growth in the third quarter will continue to be supported by the positive contribution of the services sector, while the positive contribution by the construction and industry sectors was more reduced.

The contribution of the **manufacturing sector** to economic growth in 2017 Q2 is estimated at about 2.7 percentage points. The value added to the sector accelerated its growth to 6.1%, after the 4.4% annual rate recorded in 2017 Q1. This performance was mainly attributed to the expansion of construction, which contributed by 1.8 percentage points to the GDP growth. Also, the improvement of industrial activity was translated into an increased contribution by 0.7 percentage point. Agriculture, forestry and fishing activities continue to provide low contribution to economic growth, by 0.2 percentage point from 0.3 percentage point a quarter earlier. Meanwhile, the slowdown in the growth of the **services sector** was reflected in the decline of its contribution to economic growth, to 1.1 percentage points from 1.6 percentage points a quarter earlier. Also, the **net tax** component provide lower contribution to GDP, by about 0.3 percentage point compared to 0.6 percentage point in the first quarter[16].

[15] *GDP performance and gross added value by sectors is treated in terms of real annual changes. The analysis is based on the latest GDP data according to the production method for 2017 Q2, published by INSTAT on 29 September 2017. The differences between the sectors' growth rates of this publication and those analysed in the Monetary Policy Report 2017/III are the result of the series' review.*

[16] *Mainly affected by the lower contribution of tax on products.*

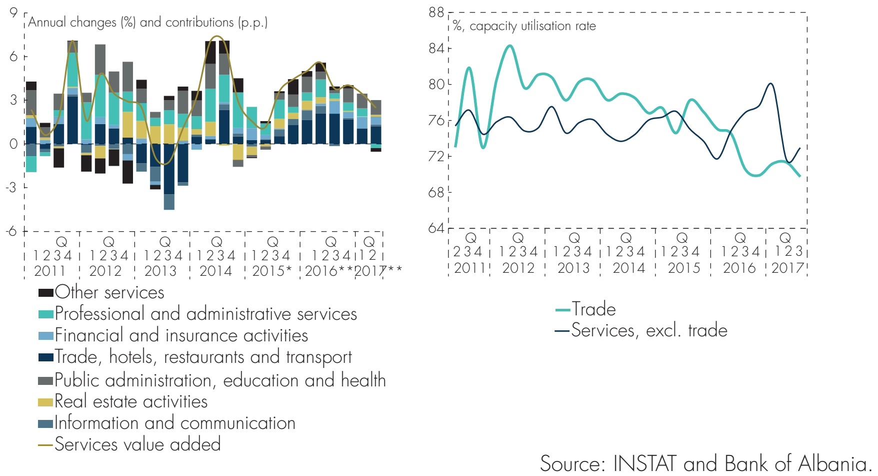
Chart 21 Gross domestic product by output and confidence indicators



Source: INSTAT and Bank of Albania. * Data are preliminary. **First estimate.

The **service sector** continued to slow down its growth to 2.5% in the second quarter compared to 3.4% in the previous quarter and the historical average growth of the sector by 3.1%. The slowdown is mainly attributable to the contraction of value added in *"Professional Activities and Administrative Services"*[17] and *"Other Services"*, by 2.3% and 4.6%, respectively, in annual terms. Also, the added value of financial and insurance activities grew at a slower pace[18], thus supporting the performance of the sector to a lesser extent than in the first quarter (by 0.5 percentage point and 0.8 percentage point, respectively). Meanwhile, services related to information and communication and real estate, recorder slightly higher

Chart 22 Contribution of branches and capacity utilisation rates in the services sector



Source: INSTAT and Bank of Albania.

17 *According to the statistical classification of economic activities NVE Rev. 2, this branch also includes the activities of call centres. Their activity is influenced by the entry into force of the law "On De-localization" in Italy which tightens the rules for relocation of the activity from Italy to non-European Union countries.*

18 *The annual growth of added value of this branch was about 10.6% from 15.8% in the first quarter.*

annual growth rates of value added, by about 2.0% and 0.9%, respectively. "Trade, hotels, restaurants and transport" and "Public Administration, education and health", continue to remain the branches with the highest contribution to the annual performance of services in total, by 1.2 and 1.0 percentage points, respectively.[19]

Chart 23 Value added in construction and capacity utilization rate

Source: INSTAT and Bank of Albania.

The services sector is expected to have had a positive performance in the third quarter as well. This is signalled by the increase in the capacity utilisation rate in this sector and the improvement of confidence in trade.

The construction sector stood out for its rapid growth dynamics in the second quarter. Following the growth by 14.3% in the first quarter, construction activity accelerated even further and was reflected in the annual increase of the value added by 22.7%.[20] The positive performance of the sector is supported by both the increase in public investments[21], and the continuation of works related to the Trans Adriatic Pipeline (TAP). By type of construction, the activity is largely influenced by the engineering works, while positive effects were also given by the categories of new constructions and reconstructions. Meanwhile, the continuation of growth of leading indicator, the proxy of building permits, is mainly attributed to residential construction and engineering works.[22]

[19] *The value added by "Trade, hotels and restaurants" and "Public administration, education and health" increased annually by 3.5% and 4.3% respectively, after its growth by of 3.3% and 3.9% in the first quarter.*

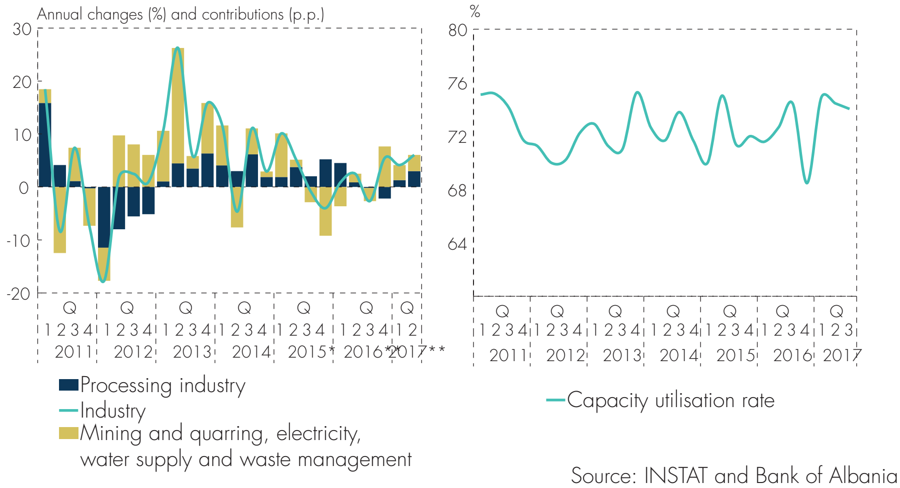
[20] *The significant expansion of the sector is evidenced by the high growth of the net sales index in volume and production volume. The indicator of net sales volume for construction increased by 33.9% annually from 13.6% in the first quarter, whilst the production volume expanded by 32.9% from 24.2% in the previous quarter.*

[21] *Capital budget expenditures marked a significant annual growth in the second quarter of this year.*

[22] *Even the category of other buildings marked an increase in the approximate value of building permits, giving a lower positive contribution to the total value compared with the category "Housing buildings" and engineering works" The total number of building permits was 197 permits from 101 approved permits in the previous quarter and from 98 permits in the second quarter a year earlier. However this total remains below the historical average. Although the permits granted for buildings for residential purposes is larger (about 121 permits), there has been an increase in the number of permits granted for other buildings, up to 76 permits compared to 25 in the previous year.*

The dynamics of the construction sector is expected to be upward in the third quarter as well. These expectations are underpinned by the larger number of approved building permits and the increase of confidence indicator in construction, while the implementation of investment projects continues. However, slowdown of public investments[23] and the lower capacity utilisation rate in construction signals for lower growth rates of the construction sector in the third quarter.

Chart 24 Branch Contributions to Value Added in Industry and Capacity Utilization Rate



Source: INSTAT and Bank of Albania.

The industry sector continued the upward trend for the third consecutive quarter. Industrial activity generated growth of value added by 6.0%. This annual rate is higher than the 4.1% growth recorded in the previous quarter. Both "Extracting industry, Energy, Water and Waste treatment" and the "Processing industry" contributed to the increase of value added of the sector at the same extent (about 3 percentage points). The dynamics of value added growth of these branches accelerated in the second quarter against the performance in the first quarter, for the processing industry[24] about 6.3% from 3.2% and for the extracting industry, energy, water and waste treatment by about 5.9% from 5.5%. The performance of the second branch was driven by the recovery of activity in the extracting industry[25], while the production of electricity shrank[26].

23 Estimates are based on preliminary data of central government capital expenditures for the third quarter, which decreased compared to the same period a year earlier.

24 Developments in this branch of industry continued to be affected by the high contribution of textile, clothing and footwear, as confirmed by the increase in exports in value of goods related to these industries. Also increase in the exports for other sub-branches of processing industry related to plastic products and metal and metal-based products confirm the positive impacts of these sub-branches.

25 According to short-term statistics, the output volume index of extracting industry accelerated its annual growth rates up to 32.5% from 29.9% in the previous quarter. Also net sales in the volume of this industry were higher compared to the previous year. Being an export-oriented industry, the positive performance is estimated to be affected by the growth of some of the major exports related to it.

26 Production volume index for "Electricity, gas and air conditioning" fell averagely by 15.7% in the first two quarters, in annual terms. By the electricity balance sheet, in the first half of the year, net domestic electricity production was about 1.9% lower than the same period a year earlier.

Developments in the industry sector will remain positive in the third quarter of this year. This opinion is based on the upward trend of some of the groups of exports in industrial products[27]. The confidence indicator and the capacity utilization rate in industry remain above their historical averages, in line with the expectations for sector's positive performance. However, their slight decline during the third quarter signalled a lower growth of the industry sector compared to the second quarter.

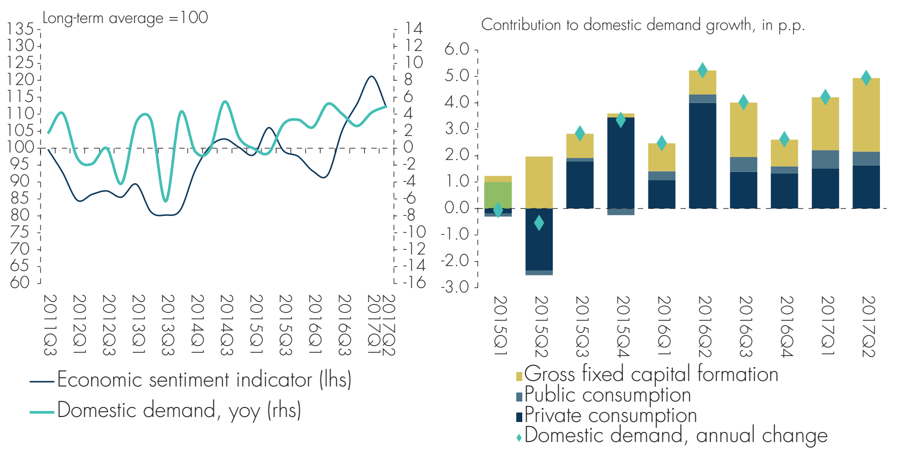
4.2.2. AGGREGATE DEMAND

Aggregate demand continued to reflect high growth rates in 2017 Q2, driven by both domestic and foreign demand. Gross capital formation generated the highest contribution, followed by the population consumption and net exports. Public consumption gave a slight positive contribution as well.

The information from indirect indicators suggest for aggregate demand continued to grow during 2017 Q3, mainly supported by population consumption. On the other hand, positive contributions from capital formation and net exports are estimated to slow down.

Domestic demand expanded by 0.5% in 2017 Q2. Formation of the capital followed by the population consumption provided high positive contributions. Public consumption provided also positive contribution, but at a lesser extent. In the case of capital formation, it is estimated that the positive contribution is largely linked to public investment, with low positive contribution from the private component.

Chart 25 Economic sentiment indicator and the structure of domestic demand



Source: INSTAT and Bank of Albania.

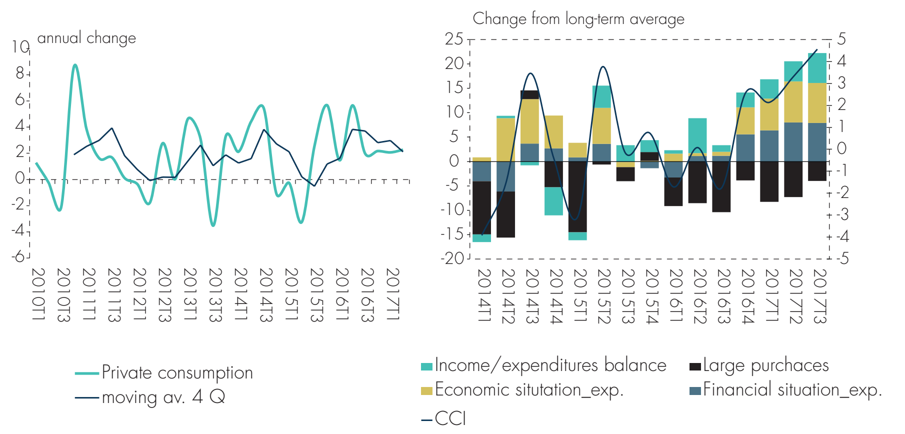
[27] *Linked to both the processing industry and extracting industry.*

Leading and indirect indicators suggest an increase in domestic demand during 2017 Q3. Population consumption is expected to increase its contribution to domestic demand growth, while the positive contribution of investments is expected to be lower than in the second quarter.

Private consumption increased by 2.3% in 2017 Q2. Although the growth rate accelerated by 0.2 percentage point compared to 2017 Q1, it remains below the 2.9% increase registered in 2016. Based on the disaggregated retail trade index and other indirect data[28], the growth of private consumption in Q2 is supported by higher consumer spending for durable goods.

The growth of private consumption was supported by positive developments in employment and by the improvement of consumer confidence. The consumer confidence indicator improved by 1.2 percentage points in Q2, standing above the historical average for the third consecutive quarter. In addition to more employment, the easing of lending standards and rising remittances contributed to the financing of private consumption in the economy.

Chart 26 Private consumption and consumer confidence index



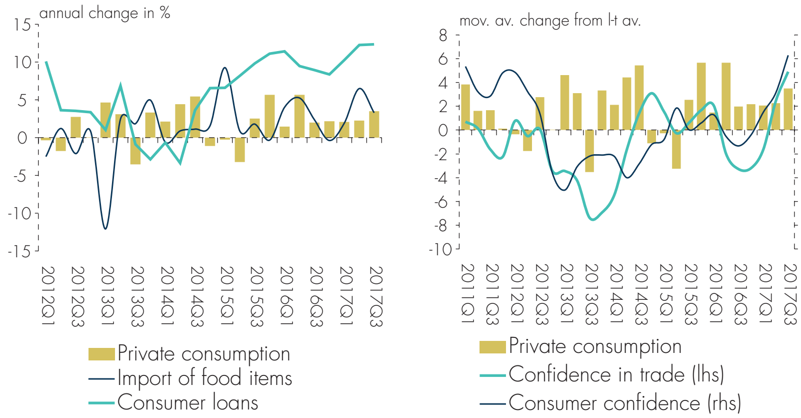
Source: INSTAT and Bank of Albania.

Indirect indicators suggest private consumption continued the upward cycle in Q3. Improvement of the consumers' confidence during Q3 will continue to support the customer's propensity to spend. Positive signals also come from confidence indicators in the services and trade sectors, whose levels stand above the respective historical averages. Some of the quantitative indicators that increased during Q3, signalling the growth of private consumption are:

[28] *The retail trade index of household appliances and computer equipment increased in the third quarter by 6.1% and 16.7% respectively, higher compared with the previous quarter (5% and 5.3%) and the average of 2016 (7.5% and 12.3%. On the other hand, the value added in the services sector without trade, recorded a more moderate growth in the second quarter (2.8% from 3.7% in the first quarter).*

food imports and auto vehicles imports, higher value added tax revenues, and consumer credit growth.

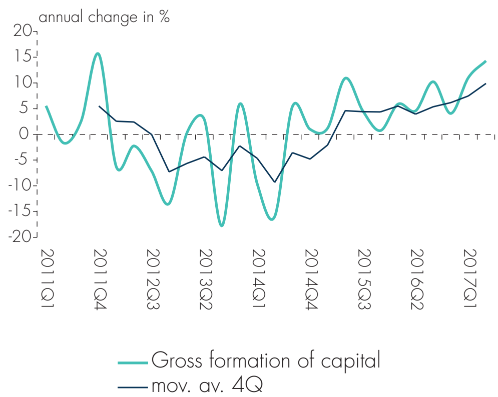
Chart 27 Indirect quantitative (left) and qualitative (right) indicators for private consumption in 2017 Q3



Source: INSTAT and Bank of Albania.

The annual growth of **investments** in the economy was 14.3% in 2017 Q2, the highest growth rate since 2011 Q4. The acceleration of growth in investments in the economy is estimated to be largely supported by the public component with lower positive contribution from the private component. Private investments in general were positively supported by the improvement of business confidence and financial situation, the recovery of private demand and the pursuit of major investment projects in infrastructure. Private investments in the construction sector were supported by the recovery of demand for house purchasing[29] as well as from the increase in building permits.

Chart 28 Gross fixed capital formation, annual changes

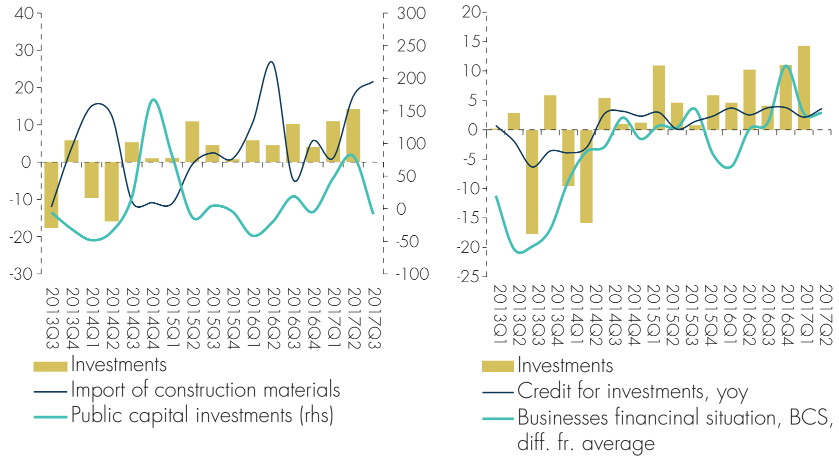


Source: INSTAT.

Investments in the economy are expected to continue to grow in Q3, largely supported by the expansion of private investment. The underlying factors to this performance are the gradual improvement of demand for products and services, the increase in the number of building permits, the continuation of major investment projects in infrastructure and the improvement of confidence in the economy. Indirect information available for Q3 indicates an increase in the import of materials used in the construction sector, a small but positive growth of credit for investment purposes, and a rapid growth of the confidence indicator in the construction sector.

[29] *According to the Bank Lending Survey, the net balance of households' demand for loans for house purchasing improved by 4.9 percentage points in the second quarter.*

Chart 29 Short-term investment indicator Q3

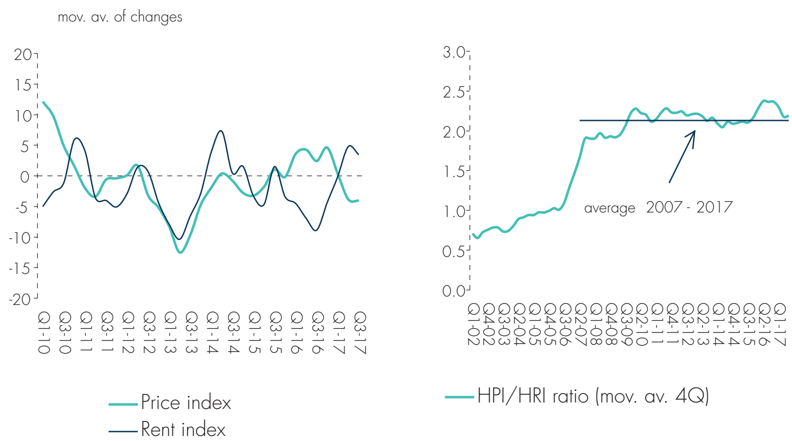


Source: INSTAT and Bank of Albania.

INFORMATION BOX 1: PRICES IN THE HOUSING MARKET[I]

The indices of house and rent prices declined during 2017 Q3. The House Price Index continued to fall for the third consecutive quarter, albeit at a more moderate pace compared with the first half of the year. The annual decline of the house price index is 2.8% compared to 5.9% and 11.5% decline in the first and second quarters. After rising for four quarters, the rent price index declined by 5.3% in 2017 Q3. The latest developments in the housing market prices have brought the house to rent ratio closer to the long-term average of the last ten years.[II]

Chart 30 Price and Housing rent indexes and their ratio.



Source: INSTAT and Bank of Albania.

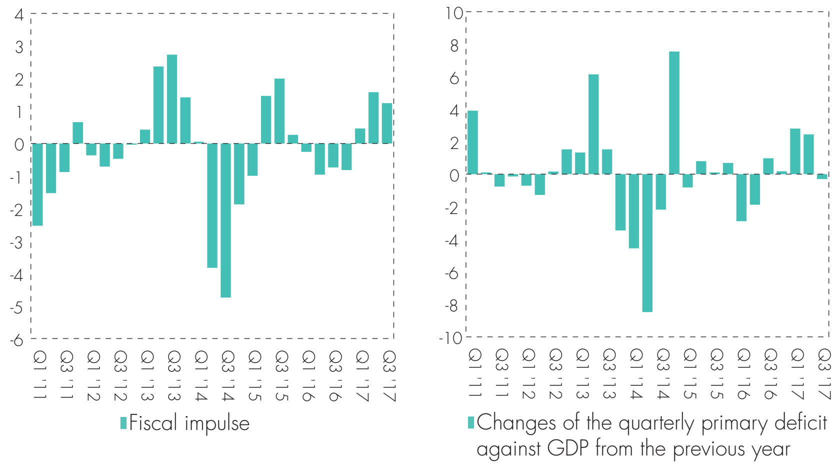
I *House price and rent analysis is based solely on the information on prices and rents in Tirana.*

II *The performance of this ratio summarizes in a single indicator the overall dynamics of the housing market price and is used as an alert of housing price "bubbles".*

PUBLIC SECTOR DEMAND AND FISCAL POLICY[30]

Unlike the first two quarters, the public sectors' impact on aggregate demand growth is assessed to have declined in the third quarter, mainly due to the lower intensity of the reaslisation of public investments. However, fiscal policy until the end of Q3 is estimated to have been materialized in a positive fiscal impulse of 1.4 percentage points of GDP[31]. After the positive values during the first 8 months of the year, the budget balance was negative at the end of September, by about ALL 2.5 billion.

Chart 31 Orientation of fiscal policy



Source: Ministry of Finance, INSTAT, calculations of BoA staff.

The fiscal policy stance pursued until the end of the 9-month period and the one planned for the last quarter suggests that this policy will have a positive effect on economic growth in 2017. The positive contribution is estimated to be generated simultaneously by higher government consumption, mainly in the form of increase in wages[32] higher public investments, as well as from the strong fiscal adjustment of public finances in the previous year.

Budget expenditures slowed down their annual growth rates to 7% in Q3, from 15.7% in the first two quarters of 2017. The deceleration of expenditure growth rates in this quarter was a consequence of the lower annual level of operating and slowdown in the pace of capital expenditures.[33] On the other hand, the expenditures for local government, social securities and personnel

[30] *Fiscal data for the 9-month period are preliminary.*

[31] *In the absence of the adjusted fiscal indicators for business cycles, the fiscal stimulus is approximated by the annual difference of the primary deficit created within a fiscal year to GDP, compared to the previous year. Positive values are interpreted as the positive impact of fiscal policy on aggregate demand and the contrary for negative ones.*

[32] *The 2017 budget plan foresees an increase in the salaries of the public administration by about 10% starting from March.*

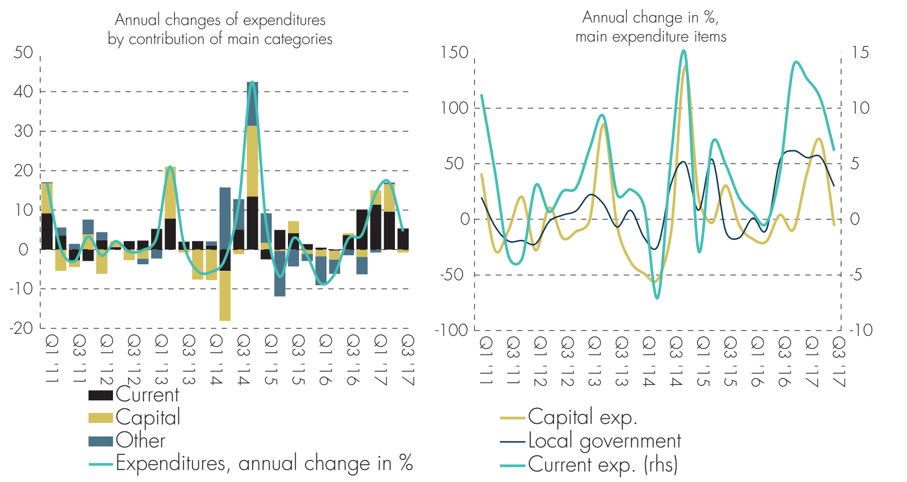
[33] *Interest expenses were also one of the items with negative growth rates, with 11.7%, but their dynamics was the same as in the first two quarters of the year.*

supported the increase in total budget expenditures. Local government expenditures continue to have the highest share in total expenditures growth for 5 consecutive quarters.

In the first 9 months of the year, expenditures were 12.5% higher than a year earlier. The two main categories of expenditures, current and capital, increased annually by 9.8% and 35.1% respectively.

Budget revenues, unlike expenditures, showed an almost uniform dynamics throughout the year. Their 7.6% increase continues to be driven by the tax component, whose expansion offsets the negative contribution of the non-tax revenues and grants. On the other hand, the profile of tax revenue growth was not similar to the first half of the year, largely determined by the revenues from VAT and social securities. Unlike in the first two quarters, when they had the largest share of growth in the total, in Q3, the national taxes shrank in annual terms[34]. By contrast, VAT revenues, profit tax, personal income tax and social security revenues improved in the third quarter compared with the first half of the year.

Chart 32 Expenditures 2011 Q1 - 2017 Q3.



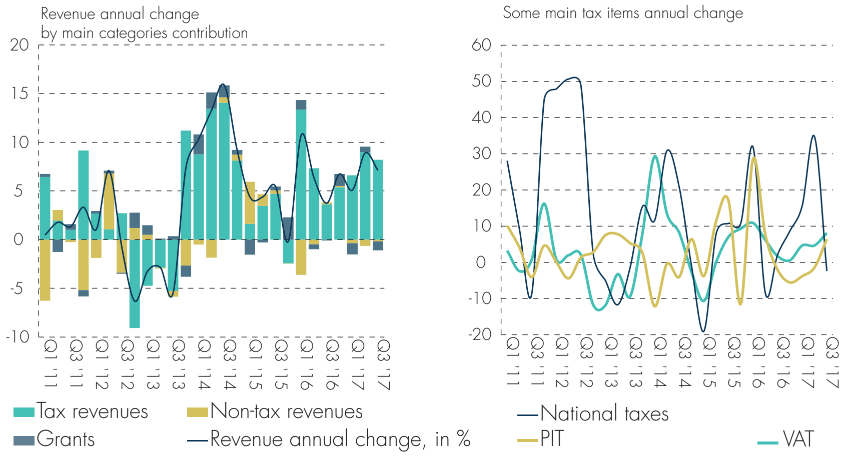
Source: Ministry of Finance

The revenues, during this year, in the presence of a tax policy almost unchanged since 2015, are in line with the increase of imports[35] and signal positive developments in the labour market and improved aggregate demand.

34 *In the first two quarters this item recorded high growth rates as a result of accumulated revenues under Law 81/2016 "On the revaluation of real estate" which was in force until the end of May. This legal measure allowed natural and legal persons to re-evaluate real estate at 2% and 3%, respectively, compared to the taxable base 15% in the current law.*

35 *Import of goods in the first nine months of the year increased by 6.8% in annual terms. VAT revenues on goods imports accounted for 20% increase in total revenues in the first nine months of the year.*

Chart 33 Budged revenues 2011 Q1- 2017 Q3

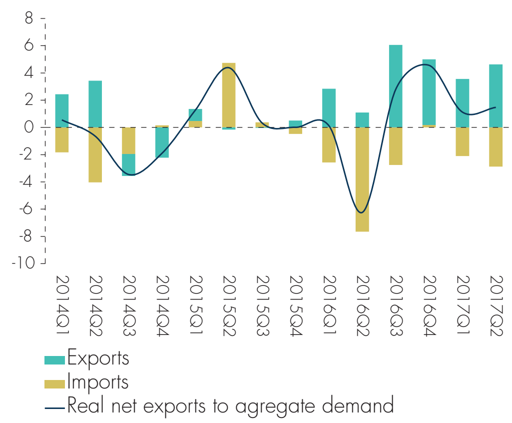


Source: Ministry of Finance

4.2.3. FOREIGN DEMAND AND FOREIGN TRADE

Real trade deficit in goods and services narrowed in 2017 Q2. In real terms, the narrowing resulted at 8.1%. The increase in the export of services by 22.0%, in annual terms, was the main driver of this development. Export of goods, which expanded by 4.3%, in annual terms, provided also positive contribution. Regarding imports, the overall total was up by 6.4%, mainly driven by the increase of imports of services, by 14.7%. Also, imports of goods expanded by 2.6%, in annual terms.

Chart 34 Contribution of net exports to aggregate demand (in percentage points)

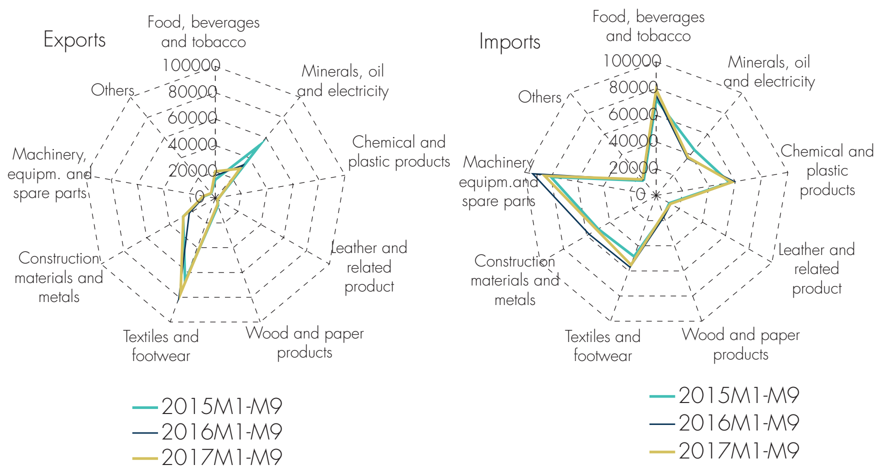


Source: INSTAT and Bank of Albania.

Data on exports and imports of goods for 2017 include statistics for the third quarter of the year. The trade deficit of goods expanded by around 5.9% in annual terms, driven mainly by the rapid increase of imports, whose effect has exceeded the positive impacts related to the high increase in exports.

The export of goods expanded by around 13.0%, in annual terms, in 2017 Q3, accelerating from the second quarter. The growth of exports of "Construction material and metals" and "Textiles and footwear" provided the main contribution to this performance. Also, positive contributions of "Food, beverages, tobacco" category expanded compared with 2017 Q2. The positive contribution to this category was provided mainly by the higher exports of processed food (meat and fish). This phenomenon was also noted in the previous quarters of this year. The sub-category of "Vegetables" provided lower contribution due to the lower annual growth rates (a common development in the third quarter).

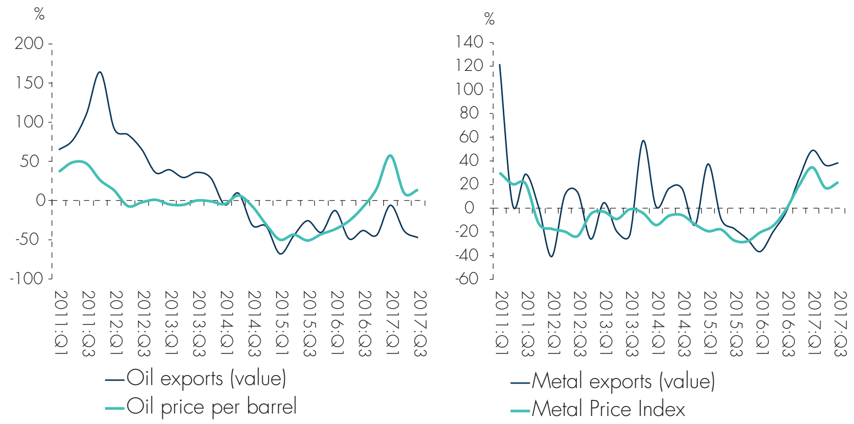
Chart 35 Import and export by category (in ALL million)



Source: INSTAT.

The only category that generated decreasing contribution was "Minerals, fuel, electric energy, like in the previous quarter. The fall in annual terms, characterised both the performance of fuels and the exports of minerals.

Chart 36 Annual Brent oil prices, domestic oil export (left), metal prices and domestic metal export (right)



Source: INSTAT, FMN, EIA, London Metal Exchange, Marketindex, Cameco.

Imports increased by 8.8% in annual terms, considerably higher from 2017 Q2. "Minerals, fuels, electric energy" broadly determined this dynamic, due to the high growth in the imports of both electric energy and fuels. Also, other categories provided positive contributions, but at a lower degree.

By partner country, the countries of the European Union, and particularly Italy, remain our main trading partners for both exports and imports. Related to the neighbouring countries, Kosovo and Macedonia increased their shares in terms of exports, driven by the growth of exported values of food items and construction materials to these countries. The growth in food exports, mainly processed food items, contributed to the increase of shares to some more distant destinations, such as Sweden and Estonia. In terms of imports, Switzerland, Serbia and Russia increased their relevant shares mainly due to the higher imports in fuels and cereals (in the case of Serbia and Russia), from these countries.

BOX 2: BALANCE OF PAYMENTS 2017 Q2

The net position of the current account recorded EUR 231.0 million deficit in 2017 Q2, narrowing by around 19.7%, annually. It was estimated at 7.5 % of nominal GDP, around 2.8 percentage points lower than in the same quarter of the previous year. This dynamic was determined by the expansion of exports of goods and services by around 24.8% annually, largely affected by the expansion in the export of services by 29.8% in annual terms. Also, the export of goods expanded by around 11.3%. Overall imports expanded by around 8.3% in annual terms, with major contributions from imports of services, which expanded by around 16.8% compared to the previous year. Also, the import of goods was up by 4.4%. Net remittances expanded by around 5.7%. Regarding the primary income account, the surplus resulted at EUR 38.6 million, from EUR 50.6 million in the previous year, mainly owing to the developments in income from the investments account.

In the financial account, net direct investment inflows decreased by 14.2% in annual terms. About the current deficit financing by flow profiles, the non-debt-creating flows provided the main contribution, whereas debt-creating flows were down. Reserve assets decreased by EUR 76.2 million.

Table 4. Balance of payments indicators (in EUR million)

	2015 Q4	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2
Current account (in EUR million)	-291.3	-197.7	-287.7	-148.6	-177.6	-151.7	-231.0
yoy (%)	-11.9	-5.6	148.7	-44.4	-39.0	-23.3	-19.7
/GDP (%)	-10.9	-8.3	-10.3	-5.6	-6.2	-5.8	-7.5
Goods and services	-564.5	-403.3	-555.1	-410.9	-436.9	-311.8	-483.1
yoy (%)	4.4	8.2	54.0	-13.7	-22.6	-22.7	-13.0
Exports, f.o.b.	714.7	608.5	717.2	926.8	857.0	773.2	895.2
yoy (%)	-0.7	2.5	1.6	18.1	19.9	27.1	24.8
Imports, f.o.b.	1279.1	1011.9	1272.3	1337.6	1293.8	1085.0	1378.3
yoy (%)	1.5	4.7	19.3	6.0	1.1	7.2	8.3
Net Travel	51.6	67.3	72.8	153.1	95.7	75.6	80.1
Primary income	72.1	36.5	50.6	52.0	34.9	-8.9	38.6
Credit	150.2	89.3	116.3	97.6	105.5	79.6	126.3
Debit	78.1	52.8	65.7	45.6	70.6	88.5	87.6
Net income from Direct Investments	-31.7	-15.6	-36.2	-18.3	-26.8	-56.3	-60.6
Secondary income	201.0	169.1	216.8	210.3	224.4	169.0	213.4
Credit	247.2	205.0	250.1	250.7	255.4	198.3	242.2
Debit	46.2	35.9	33.2	40.5	31.0	29.3	28.7
Net Remittances	153.9	135.7	153.8	159.6	165.4	135.1	162.7
yoy (%)	-10.0	-4.2	-4.8	14.2	7.4	-0.5	5.7
Capital account	32.8	6.6	7.2	3.1	49.4	23.8	25.3
Net Borrowing/Net lending	-258.5	-191.2	-280.5	-145.5	-128.2	-127.9	-205.8
Financial account	-195.3	-139.1	-267.1	-91.0	-119.4	-294.6	-188.0
yoy (%)	-33.2	-6.0	65.5	-18.0	-38.9	111.8	-29.6
/GDP (%)	-7.3	-5.8	-9.6	-3.4	-4.2	-11.3	-6.1
Direct investments	-120.0	-126.4	-250.9	-302.4	-256.7	-202.6	-215.3
yoy (%)	-46.1	-50.2	27.7	21.9	113.9	60.2	-14.2
Portfolio investments	-124.1	111.1	-5.7	5.7	114.1	-139.0	-23.2
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investments	-120.3	-74.2	-10.5	261.7	-130.1	38.4	126.7
Reserve assets	169.1	-49.6	0.0	-56.1	153.3	8.6	-76.2
Errors and omissions	63.2	52.1	13.4	54.5	8.9	-166.7	17.8

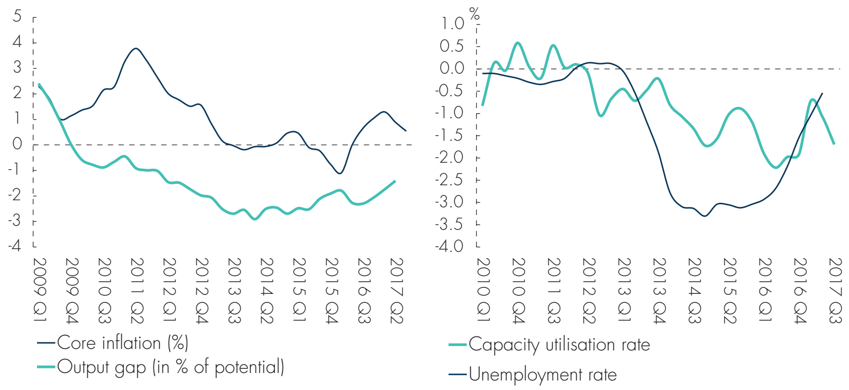
Source: Bank of Albania.

4.3. CYCLICAL SITUATION OF THE ECONOMY AND DOMESTIC INFLATIONARY PRESSURES

The growth of domestic demand continues to support the convergence of the economy to potential. Yet, the economy continues to operate in the presence of spare capacities in the labour and capital markets, suggesting that the output gap remains in negative territory and inflationary pressures in the economy from the demand side are still low. Economic performance and expectations for the future show that the economy is in the cyclical improvement stage and the output gap is narrowing. In addition to the improved cyclical position, the increase of inflationary pressures from real economy is expected to gradually contribute to the return of inflation to target within 2019 H1.

Albeit the improvement of economic activity, cyclical indicators of capital and labour markets suggest that the Albanian economy continues to operate below its potential.

Chart 37 Indicators of the cyclical situation of the economy*



*Output gap is the average of several measurements on which the moving average method is applied. The capacity utilization rate gap and the unemployment rate is calculated as the deviation of the actual value of the respective historical averages, then the moving average with 4 terms methodis applied. The unemplyment rate gap is assessed as the average of the umemployment gaps by 3 methods, which assess the balance rate of unemployments (NAIRU and NAWRU). The unemplyment gap is expressed as the difference of the equilibrium level of unemplyment and then the moving average with 4 terms methodis applied .

Source: INSTAT and estimations of the Bank of Albania.

According to Business Confidence Survey data, the capacity utilisation rate stood at around 71.0%[36] in 2017 Q3. Notwithstanding the slight increase by 0.2 percentage point from the previous quarter, the capacity utilisation rate remains below its historical average by around 2.7 percentage points. The dynamic of this indicator shows that the economy continues to operate under spare capacities. Furthermore, current development trends suggest these spare capacities are somewhat higher than our previous estimations, reflecting the fact that the potential growth pace of the Albanian economy appears to have shifted upward.

[36] *Starting from 2017 Q1, the capacity utilisation rate indicator is analysed adjusted for seasonality.*

BOX 3: POTENTIAL OUTPUT AND THE UNCERTAINTIES SURROUNDING ITS ESTIMATION[I]

This box addresses the main issues pertaining to the estimation approaches for potential output, with a special focus on the experience of the Bank of Albania. It summarizes the various theoretical and practical aspects on this matter (which are discussed in detail in the respective Study Project[II]), and discusses the latest updates regarding the estimations.

Potential output and potential growth estimation: uncertainties associated with the nature of the indicator, data quality and the estimation approaches

Potential output and output gap indicators are crucial to macro-economic policy design. However, the estimation of such indicators represents a serious challenge that economists and policy-makers face. The main uncertainty derives from the unobservable nature of the indicators and the fact that they cannot be measured directly through statistical techniques. Economic literature suggests the adoption of all available approaches in the estimation process that can potentially be utilised. Estimation results are further filtered through a meticulous process involving economic expert judgment.

The estimated output is very sensitive to the quality and length of input data. Additionally, experience suggests that potential output and output gap estimations tend to be highly affected from historical data revisions. If such revisions are frequent and involve considerable shifts in the data, they can produce major changes in the output gap depth and the speed associated with the gap closure.

Estimation approaches are grouped into four principal categories. The first group involves the earlier statistical approaches featuring Trend estimation and Hodrick-Prescott filtration (HPF). The main constraint associated with these approaches relates to the fact that they rely only on actual statistics (such as actual GDP and unemployment rate) and are prone to end sample bias. These methods do not take into account the structural interconnections that help explain inflation dynamics.

Semi-structural approaches include potential output estimations within the adoption of different specifications of Cobb-Douglas production functions (CD-F). The methods incorporate more detailed filtration processes, which try to capture certain structural links, in particular those connecting the output gap (or unemployment rate) to inflation (Elmeskov technique and Kalman Filter). The main downside is that important micro-economic processes, particularly those associated with price and wage formation, are disregarded. These disadvantages are corrected to a certain extent by adopting approaches that fall into the third group including purely structural methods (Wage Setting – Price Setting models), which provide more precise estimations.

A separate group incorporates more direct approaches based on surveys in the economy. The term direct derives from the fact that these methods do not include an estimating model, but are solely based on direct business answers on the matter (not subject to revision).

In the case of the Bank of Albania, the more advanced semi-structural and direct approaches are adapted aside from the purely statistical methodologies (Trend and HPF). Unfortunately, purely structural models are impossible to implement for the time being as the detailed data required are not yet available.

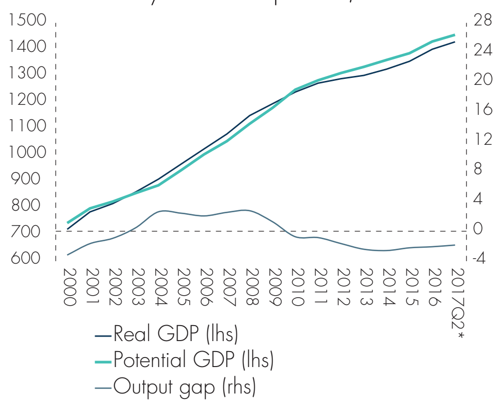
Potential output and potential growth estimation: economic uncertainties, the crisis and structural changes

The application of the above-mentioned methods and the necessity for updates received special focus during the years of the Global Financial Crisis. Discussions associated with alterations in potential growth trend were the centre stage in economic and policy-making debate. The crisis itself produced a new type of uncertainties – those of economic nature.

According to Bank of Albania estimates, potential growth shrank from 6% in the period 2002-2009, to nearly 3% in the following years. Additionally, it is estimated that the economy operated below its potential after 2008 and the negative output gap enlarged gradually to reach the largest depth in mid-2015. This was reflected in actual unemployment rising above its natural rate, a slow-down in investment activity and a lower productivity contribution to economic growth. Estimations showed that the reduction in the economic pace was principally a structural phenomenon. As such, it was caused by a slowdown in potential growth rates as a result of unfavourable financing conditions and the demand for structural reforms in the economy. Meanwhile, it mirrored only partially a cyclical phenomenon caused by an insufficient aggregate demand not able to trigger a full utilization of productive capacities in the economy[III].

The latest data suggest that some improvements have occurred in the past two years in terms of economic growth. The analysis emphasizes improvements in the cyclical position of the economy, as well as stronger potential growth. The first phenomenon is associated with the shrinking of the negative output gap and higher capacity utilization rates in the economy. On the other hand, potential output growth has also increased driven by positive developments in investment and employment. Recent updated estimates on potential output in the economy[IV] suggest that the annual potential growth has accelerated from 3.2% to 3.5%.

Chart 38 Potential output estimations – the structural indicator and the output gap (the cyclical component)*



*The data are annualised. The average is assessed by the semi-structured and the direct methods.
Source: Authors' assessments.

The upward shift in potential growth is attributed mainly to the recouping of capital, as a result of increased investment. Structural improvements are also emanating from the surge in confidence in the economy, specific developments in certain sectors and better international environment.

The following table summarizes actual and potential growth according to sub-periods and the respective contributions from production factors.

Table 5. Real and potential growth disaggregation according to production factors 2000-2015

Sub-period	Economic growth (%)		Factor contributions to real and potential growth (pp)					
			Capital		Labour		Productivity	
	Real	Potential	Real	Potential	Real	Potential	Real	Potential
2000 - 2008	6.1	6.2	3.1	3.0	0.9	1.1	2.0	2.1
2009 - 2015T2	2.4	3.3	1.3	1.3	0.7	1.0	0.4	1.0
2015T3 - 2017	3.4	3.5	1.95	1.95	0.82	0.9	0.6	0.65

Source: Authors' estimations.

In spite of these developments, potential growth is not foreseen to return to pre-2009 levels, at least in the medium term. Population aging, emigration and weak productivity growth remain as major inhibitors for potential growth rate acceleration.

Although actual estimations signal slight improvements in potential growth, they are still surrounded by uncertainties. These uncertainties are not only associated with the continuation of positive international developments, but, more importantly, with the pace and effectiveness of structural reforms in the country.

I By Evelina Çeliku, Iris Metani and Enian Çela (Monetary Policy Department, Bank of Albania)

II E. Çeliku, E. Çela dhe I. Metani (December, 2016) – Study Project: "Potential output and growth, output and unemployment gap in Albania – comparative analysis of recent estimations – 2015" – forthcoming publication.

III a –Bank of Albania, Monetary Policy Report, 2011-Q1 Box 2, "Potential output and output gap"
b –Bank of Albania, Monetary Policy Report, 2014-Q1, Box 2. "Trend in potential output and potential growth perspective " (by E. Çeliku);
c-E. Çeliku, "Exploring the main factors of the potential output growth in Albania 2003-2013", Bulleting of the Bank of Albania 2014-H1, pp 165-177;
d-E. Çela dhe L. Skufi, "Natural Rate of Unemployment: Reduced Form Approach", Conference Proceeding, 8th South-Eastern European Economic Research Workshop, 3 December 2014, Tirana, Albania;
e- Bank of Albania, Quarterly Monetary Policy Report, 2017-T1, Box 3:"Potential output, the natural rate of unemployment and the respective gaps: conclusions based on the assessments in the case of Albania" (by E. Çeliku, E. Cela dhe I. Metani)

IV Updates are conducted every 2-years at the Bank of Albania.

Labour market continued to show improving trends during 2017 Q2. Employment in the economy increased by 3.4%. This annual rate was slightly lower than the 3.5% increase in the previous quarter.[37] The slowdown trend of employment was mainly attributable to the faster annual fall of employment in agriculture (by -1.7%, from -0.9% in 2017 Q1), and the lower increase of employment in industry (by 2.5%, from 3.0% in 2017 Q1). Meanwhile, employment in services accelerated the annual increase at 9%, contributing to the growth of employment in the economy. The quarterly performance of

[37] The analysis of employment and unemployment is based on the data of the quarterly Labour Force Survey, and it refers to the indicators for those 15 years old and up

employed persons was also positive[38], supported by the three above-stated sectors.

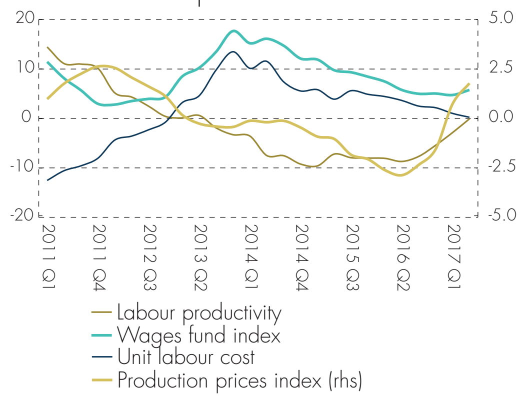
The unemployment rate fell by 0.3 percentage point in Q2, standing at 13.9%. The unemployment rate, affected by the increase in employment, stands lower than the level recorded in the same period a year earlier, by 1.6 percentage points. Assessments show that unemployment rate still stands above its equilibrium rate, remaining one of the inhibitors to the strengthening of the upward pressures on wages in the economy.

The unit labor cost[39] continued to slow down the upward trend at 0.2% in 2017 Q2, after the 1.0% increase in the previous quarter. The labour cost per unit was mainly determined by the improving trend of labour productivity, against the slight rise of real average wage for the activities covered by short-term statistics. The dynamics of real average wage mainly reflected the increase of this indicator in the construction sector. Meanwhile, the real average wage decelerated the downward pace in the sectors of industry and services. The quarterly developments affirm that the labour market still does not generate strong growth signals for the domestic inflationary pressures.

The increase in other production costs also was slower in the second quarter. Industry production costs increased by 2.0% in annual terms, against the 5.1% increase in the previous quarter. Also, construction production costs[40] recorded 0.8% annual increase, after 0.9% increase in the first quarter. At the same time, the decrease of the import price index accelerated. Over the second quarter, the respective index fell 1.5% in annual terms, while the negative rate was 0.3% in the first quarter.

The presence of the negative output gap, albeit a narrowing trend over the last quarters, kept inflationary pressures at low levels even during 2017 Q3.

Chart 39 The average hammered annual changes of productivity, labour costs and production*



* On annual changes of indicators were applied four terms moving averages, to mitigate random fluctuations.
Source: INSTAT and estimations of the Bank of Albania.

[38] *Quarterly employment growth was 1.8% in the quarter under review, from 0.2% in the first quarter. The number of employed with quarterly frequency from the Labour Force Survey has been published since 2012 Q1. The aggregated series does not show seasonality, and as a consequence quarterly changes are calculated on series non-adjusted for seasonality.*

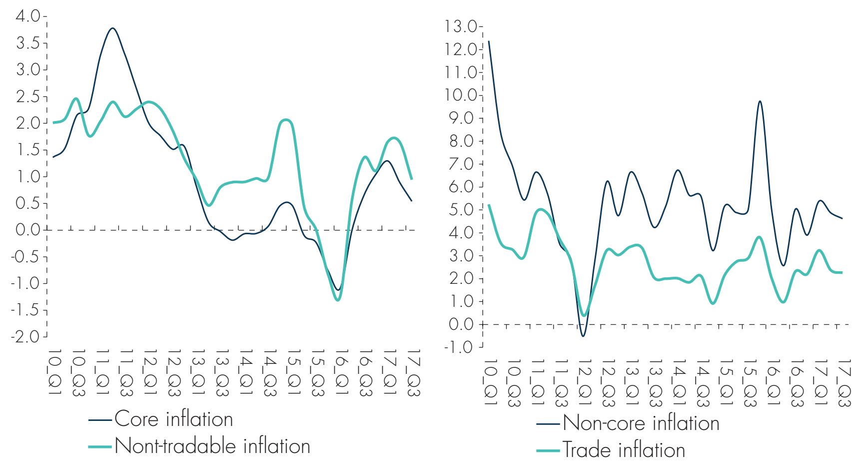
[39] *The proxy indicators of labour productivity and labour costs per unit of output are calculated by the Bank of Albania, using the total series of short-term statistics (STS, INSTAT, 2017 Q2). Their calculation includes: the index of paid employees, the net sales volume and total wage fund for the total of activities covered by the survey of STS. The reported growth rates are referred to the four terms moving average of the annual changes of the indicator. In this regular publication, INSTAT had reviewed the short-term statistics series starting from 2016 Q1. This explains the differences between the growth rates in this Report to the previous Monetary Policy Report.*

[40] *Construction cost index for apartments includes prices of building materials, labour force and other capital expenditures used for the construction of a typical 8-10 storey building.*

The positive developments in the output gap, in wages, in productivity and in the labour market were not translated in sustainable increase of long-term inflationary pressures. Core and non-tradable inflation rates of the CPI basket were 0.5% and 0.9%, respectively, in 2017 Q3, down compared with 2017 H1. The upward effect from the negative output gap trend in the above components of inflation was offset by prices in certain groups of processed food and of some services. The exchange rate depreciation continued to contribute to this slowdown.

Inflationary pressures in this quarter were also curbed by the developments in non-core and tradable inflation rates of the CPI basket. They resulted 4.6% and 2.3%, respectively, lower than in the previous quarter, reflecting the increase of the domestic supply and the low prices in foreign markets coupled with the performance of the exchange rate.

Chart 40 Long-term inflation expectations (left) and short-term expectations (right)



Source: INSTAT and estimations of the Bank of Albania.

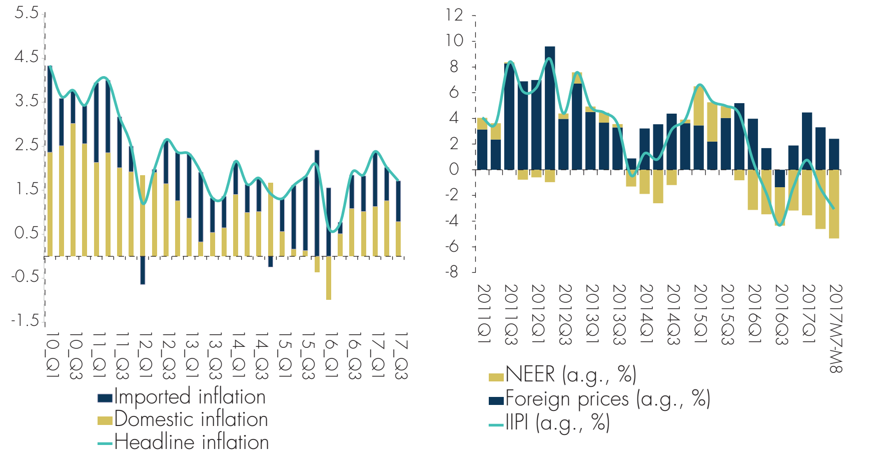
Developments in core inflation and in the domestic inflation are not reflecting at the expected degree and intensity of the effects of the economy's cyclical improvement, due to shocks from short-term factors, while inflationary pressures from domestic demand are yet to be consolidated.

Imported inflation is assessed to have contributed 0.9 percentage point to the formation of headline inflation in 2017 Q3, close to the value in the previous quarter. The upward Imported Inflationary Pressures Index (IIPI) preceded this development[41]. Meanwhile developments of IIPI for the period signal a deceleration of imported inflationary pressures for the rest of the year. IIPI further narrowed during July and August, averagely assessed at 3.1%. On the one hand, it was driven by the slowdown in the increase of the "foreign

[41] *IIPI is calculated as the annual growth of the imported prices index and the NEER index for the respective month. Inflationary pressures of foreign origin are assessed to affect domestic inflation with around 1-5 months lag.*

prices" index[42], which expanded by 2.4% in average annual terms, during July and August 2017. This rate was lower compared with 2017 Q2, when the index increased by 3.3%. At the same time, the appreciation of the nominal effective exchange rate (by 5.4% on average in the same period) continued to decelerate the transmission of the imported prices' effects to the IIPI.

Chart 41 Contributions of imported and domestic inflation to annual headline inflation (left). IIPI and contributions of its components (right)



Source: INSTAT and estimations of the Bank of Albania.

Both the imported and the domestic inflation determined almost equally the inflation rate in the quarter under review.

INFLATION EXPECTATIONS[43]

Based on the survey results of various agents of economy, short-term inflation expectations continue to undershoot the inflation target, in 2017 Q3. Medium-term expectations continue to be better anchored close to the 3.0% rate during this quarter.

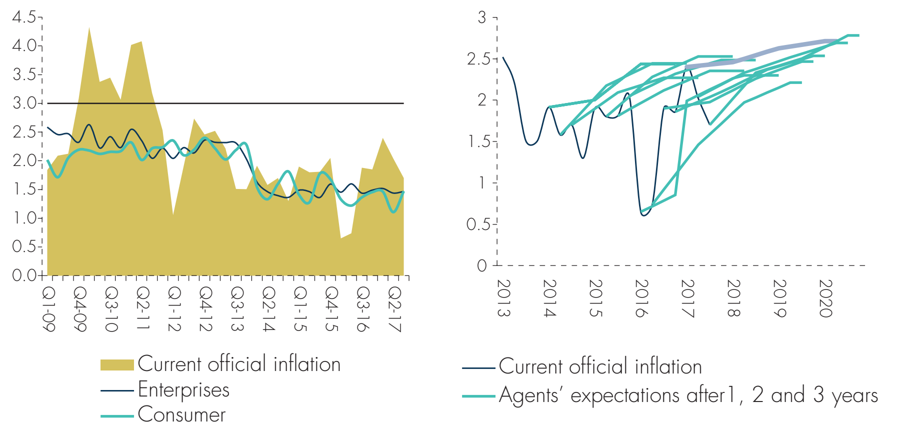
Consumers' expectations were revised upward by 0.4 percentage point in Q3, after a fall at the same degree in Q2. Currently, their level remains 0.5 percentage point below the historical average of the series. Financial agents' expectations were revised upwards for the three-year horizon, by 0.1 percentage point. Expectations for the one and two-year horizon did not change. Financial agents' expectations are closer to the respective historical

[42] It is a proxy of imported inflation pressures, comparable to tradable goods sector inflation of Albania's CPI basket The foreign price index is based on the values of: the inflation of "Food, beverages, tobacco" for the 18 main countries; and inflation of "items" (i.e.,, not only foods) for Bulgaria, Germany, Greece, Italy and Turkey. Some of the goods marked annual price growth, while imports share of the respective states also increased. This caused the index final value (the weighted average of aforementioned CPI with their imports monthly shares) to significantly increase.

[43] The analysis on inflationary expectations is based on the results of the business and consumer confidence survey, as well as on the financial agents' expectations survey.

average for the three time horizons. In 2017 Q3, enterprise's expectations have remained almost at the same level as in Q2, and stands 0.5 percentage point below the long-term average.

Chart 42 Inflation expectations for enterprises and consumers' (left), and financial agents (right), annual change in %



Source: INSTAT and Bank of Albania.