Bank of Albania

QUARTERLY MONETARY POLICY REPORT

2024/IV

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INTRODUCTION[1]

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

The Supervisory Council of the Bank of Albania holds 8 meetings each year to decide on monetary policy, aimed at achieving the price stability objective. The Supervisory Council sets the key interest rate. Changes in the key interest rate affect, with a time lag, other interest rates in the financial market, for example, yields on government's securities and interest rates on loans. These changes drive an increase or decrease in the demand for goods and services through a chain known as the "transmission mechanism". Changes in the demand for goods and services bring about increases or decreases in the prices of these.

The transmission mechanism encompasses various channels through which prices may change, for example: the exchange rate channel; the inflationary expectations channel; and the foreign assets channel. The Bank of Albania has constructed models to forecast changes in various elements which affect prices and to forecast inflation for up to three years. When forecasts show a dominance of low inflationary pressures, which may drive inflation below the 3.0% target, this is a signal that the monetary policy should be accommodative – interest rates should stay at low levels. The reverse is also possible. However, drafting a monetary policy is not a mechanical process. Monetary policy decision-making considers the reasons for deviations in inflation from target, and the time needed for the economy to react to changes in interest rates.

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

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

The Monetary Policy Report is published on a quarterly basis. This Report is compiled by the Monetary Policy Department at the Bank of Albania and it is adopted by the Supervisory Council. The current Report contains data, as of 30 October 2024. The Supervisory Council reviewed and adopted this Report at its meeting on 6 November 2024.

FOREWORD BY THE GOVERNOR

The Albanian economy progressd significantly over 2024.

Inflation halved from the levels of the previous year, driving to reduced cost of living and increased value of income and savings for Albanian families. The monetary policy's appropriate reaction and in a timely manner, has provided a significant contribution in this regard, beyond the decline in inflation across global markets. The prudential normalisation of our monetary policy stance over 2022 and 2023, enabled the gradual reduction of inflation, without undermining the positive economic growth trend and the financial balances soundness of the economy.

Economic growth remained at high rates, driving to increase in employment and wages and generating higher incomes for Albanian households and businesses.

In addition, *the economic and financial soundness* improved; external debt and public debt declined; financial balances of businesses and families remain sound, while stability and intermediation indicators of banking sector were consolidated.

Albania, in reflection of these positive trends, has experienced an improvement in its public debt ranking from the prestigious international agencies. This improvement - the first in the post-transition history - will enable us to reduce financing costs of both public and private sectors in international markets.

However, external shocks have been present. Inflation came down faster than expected, affected by the drop in food and oil prices and the continued strengthening of the lek. In 2024 Q3, inflation dropped to 2.0%. Overall, such shocks have a transitional impact on inflation if they do not affect the expectations of economic agents on inflation in the future. Managing these expectations is a priority for our monetary policy at the moment.

Against this backdrop, at the meeting of 6 November 2024, after reviewing this Report, we decided to ease the financing conditions in the economy. At this meeting, the Supervisory Council decided to cut the policy rate by 0.25 percentage points to 2.75%. This decision was a necessary step to keep inflation contained and for its return to the target in the next year.

Forecasts on the future are positive.

The increase in consumption, investments and in Albanian exports, particularly in tourism, will continue to fuel the solid growth of economy. In addition, the good financial situation of private sector and its optimism for the future, the low interest rates, increased lending, and foreigners' interest in visiting and investing in the Albania will underpin the economic growth. The further expansion in employment and wages, as well as the increase in the well-being of Albanian families will accompany this growth. On the other hand, inflation is expected to fluctuate close to current levels in the rest months of 2024 and to gradually converge to the 3% target in the first half of the next year.

Guaranteeing a low and stable inflation is the best contribution the Bank of Albania can provide in supporting economic growth and social welfare. Recent global developments trigger uncertainties and risks for the future. Accordingly, our decisions will continue to be new data-guided and will provide a careful balance of risks to inflation and economic growth in both the short run and medium term. In any case, decisions will serve to achieving and preserving price stability.

1. INFLATION AND MONETARY POLICY STANCE

The new information resulted, overall close to our expectations. In broad terms, this information shows that the Albanian economy withstood and overcame the shock originating from elevated prices in global markets, without undermining the economic rebound trend after the pandemic or compromising the economic balances and financial stability of Albania. In more concrete terms, the economy and the labour market have performed positively over the first three quarters of 2024; the financial environment has been overall calm, characterized by low costs of financing, rapid credit growth, and sound balance sheets of banking sector; while public debt and external debt have been declining. On the other hand, inflation continued to fluctuate around 2% in the third quarter, as the decline in food and oil prices continued in international markets and domestic inflationary pressures moderated further.

Projections for the future remain positive. The volume of economic activity, as well as employment and wages, are expected to continue to grow over the next three years, the financial environment is expected to be calm, while inflation is expected to gradually increase towards the target during the next year.

[Based on current information and expectations for the future, at the meeting of 6 November 2024, the Supervisory Council decided to lower the policy rate to 2.75%. This move aims to create more appropriate monetary premises to guarantee the return of inflation to the 3% target, projected for the first half of 2025.]

Global economy is growing more slowly than expected during 2024, while inflation continues trending downwards. These trends are also present in the euro area economy, which grew at a lower rate than 1% in the first half of 2024, while recording an inflation rate of 1.7% in September. Inflation declined as prices of energy items were down. Meanwhile the service prices still remain under the pressure of the increase in wages. The European Central Bank (ECB), motivated by the weakness of economic activity and the decline in inflation, decided to lower the key interest rate again in October. However, despite the reductions in place, the ECB deems that the monetary policy in the euro area remains in the tightening side. Future monetary policy decision-making will carefully balance the two-sided risks to inflation.

Inflation in Albania pursued the downward trend started since the beginning of the year, dropping to 1.9% in September. In terms of consumer basket, this trend was dictated by the rapid decline in the prices of food items until July, while oil and rent prices dictated its fall in the next months. Other categories have shown low and balanced fluctuations over the months.

Overall, inflationary pressures have been declining, but this trend has been particularly fast in case of external pressures. The reduction in imported inflation is driven by the drop in inflation in trading partners, the fall in commodity and oil prices, as well as the further strengthening of the exchange rate during 2024. On the other hand, the decline in domestic inflationary pressures is fuelled by the normalization of monetary policy stance over the past two years. This normalization has: enabled the anchoring of inflation expectations; supported the smooth functioning of financial markets; and affected the reduction of uncertainties. In reflection, core inflation and domestic inflation have decreased from the high levels of the past two years, although this reduction is slower than the decline in the inflation of imported items, in line with our medium-term price stability objective. In particular, the high inertia of domestic inflation is driven by the relatively high demand for goods and services and the strong labour market.

Economic growth accelerated to 4.1% in 2024 Q2, from 3.8% in the previous quarter. The expansion of economic activity this quarter was on a broader sectoral basis, evidencing the growth in agriculture sector alongside the increase in the activity of construction and services sectors. On the other hand, industrial activity remained in negative territory. On the demand side, the surge in consumption, investments and tourism fuelled the economic growth, while increased imports provided a negative contribution.

The sound balance sheets and the optimism of the private sector, the positive performance of the labour market and the supportive financial environment continue to feed the economic growth.

In particular, the available information on the labour market[2] shows the continuation of positive trends in employment and wages. The rise in employment and wages, as well as the decline in inflation, have expanded households' income and bolstered consumption growth over 2024. The dynamics in the labour market are expected to be positive, in presence of a solid demand for goods and services.

Likewise, the financial environment with low interest rates and contained risk premia has supported the financing of the economy. Interest rates have displayed a slight declining trend across all market segments, in reflection of the eased monetary policy taking place in July, in turn reducing financing costs for the private sector. In parallel, the exchange rate has maintained its appreciating trend, despite this appreciation has been softer- also reflecting the increased

2 Official data from the labour market survey are unavailable and the analysis relies on administrative data, short-term statistics and confidence surveys for the second and third quarters.

presence of the Bank of Albania in the foreign exchange market, while banks continue to maintain a positive approach to lending to the private sector.

Credit to the private sector has continued trending upward, supported by a high demand and favourable financing conditions. The credit growth rate for the private sector reached at 16.8% in the third quarter. Credit expansion continues to have a broad base of use, customer coverage and currency composition, in addition to continuing maintaining a good quality, as shown by the reduced non-performing loans ratio. These features of lending and the good health of the banking sector are expected to enable a stable growth of credit in the future as well.

The Albanian economy is expected to grow in the short run and medium term, while inflation is expected to return to our 3% target by mid-2025. Growth in Albania, in view of a slow rebound in partner economies, is expected to be mainly supported by domestic demand. In particular, consumption and investment growth will be fuelled by rising income of the private sector and high confidence about the future, as well as accommodative financing conditions and credit growth. Also, tourism will continue to give positive impulses to the economy. On the other hand, inflation is projected to fluctuate around current levels during the rest of 2024 and to increase towards target during 2025, underpinned by economic growth near potential and the stabilisation of food and oil prices in regional markets.

Inflation risks in the short term have shifted on the down side, while in the medium term they are generally balanced. In particular, a further decline in commodity prices, a faster exchange rate appreciation, or a downward shift in the expectations of economic agents for future inflation, could lead to lower inflation than forecast. On the other hand, a faster-than-expected economic growth or a stronger transmission of wage growth to the final prices of consumer products could push inflation to the upper side of our forecasts.

The Supervisory Council, in accordance with the above analysis and forecasts, decided to cut the policy rate to 2.75%. This is the second reduction taking place this year. The continued fall in inflation and the risk that this trend will affect the expectations of economic agents for the future drove to lower the policy rate. As such, it serves inflation to return to the target within the first half of 2025.

Future monetary policy decisions will always be in fulfilment of the main objective: achieving price stability. They will be new data-guided, aiming to react in timely manner and on the right side, both to the overall balance of inflationary pressures and to possible domestic and external shocks.

2. EXTERNAL ENVIRONMENT

Global economic activity has continued to recover in 2024 Q2, though the economic growth remains subdued. On the other hand, inflation slowed in the third quarter, driven by the contraction in oil prices in global markets. High-frequency data suggest continued modest growth rates in the third quarter.

The decline in inflation and the decelerated economic growth have established the premises for monetary policy easing. In particular, the European Central Bank (ECB) has carried out two consecutive cuts in the key interest rate in September and October. The extent to which inflation, economic activity and labour market indicators react to these decisions will guide central banks' decisions on key interest rates in the future.

2.1. ECONOMIC ENVIRONMENT

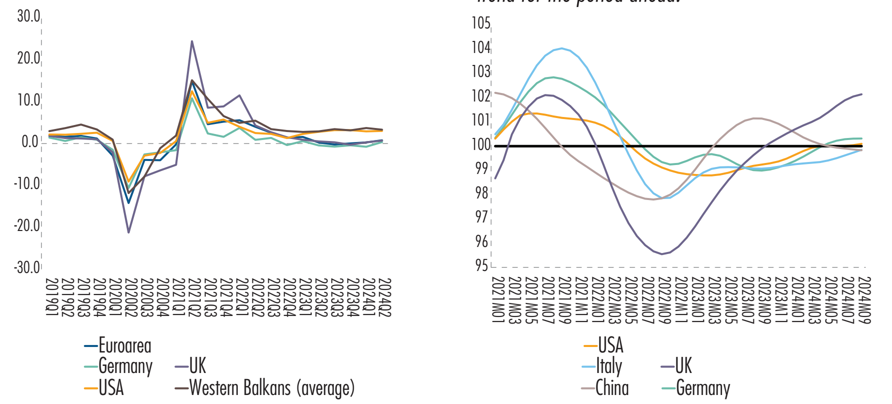
Global economic activity continued to grow in the second quarter of 2024, but at a slower pace (Chart 1, left). The euro area economy expanded by 0.8%, compared to 0.3% in the previous quarter, while the US economy expanded by 3.0% in the second quarter, a comparable pace with the previous quarter (2.9%). Preliminary data for these economies suggest economic growth will continue in the third quarter, at a similar pace with eh first half of year (Chart1, right).

Inflation rates have generally followed a slowing trend across regional countries, dictated by the decreased oil prices in international market, the slow economic growth and the anchored inflation expectations. The latest data for September showed inflation fell to 1.7% in the euro area, below the ECB's target, to 2.4% in the US and 1.7% in the UK.

Chart 1

Economic activity improved...

...high-frequency leading indicators suggest a positive trend for the period ahead.



Note: Annual GDP growth.
Source: Respective statistical institutes.

Note: Composite Leading Indicator (CLI) contains short-term signals of qualitative changes in business cycles.
Source: OECD.

As a result, the central banks of major economies cut their key interest rates during the third quarter. The ECB again lowered the key interest rate by 25 basis points in October, while the Federal Reserve lowered the key interest rate by 50 basis points, implemented as such, for the first time in four years, at the September meeting. On the other hand, the Bank of England kept it unchanged in September, justifying the decision with the presence of high rates of inflation of services.

Global economic activity is expected to maintain a slow growth pace in the medium term. According to the October estimates[3], global economic activity is expected to expand by 2.6% and 2.5% in 2024 and 2025, respectively, with the economies of developing countries expected to grow at faster rates than those of advanced countries, while inflation is expected to decrease.

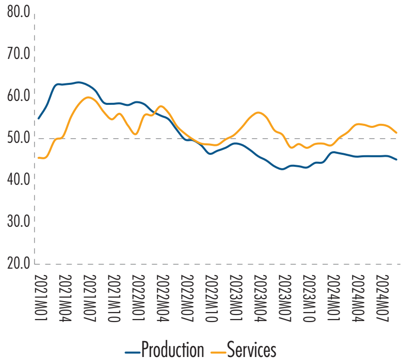
EURO AREA ECONOMY

Euro area economy expanded by 0.8% in annual terms in 2024 Q2, a slightly higher rate compared with the previous quarter, but lower than expectations. Private consumption, supported by the increased disposable income, fuelled economic growth over the first six months of year. The increase in disposable income reflected the strong labour market and wage growth. Meanwhile, the increase in net exports particularly benefited the growth in the second quarter.

Economic activity expanded, though unevenly, in almost all member countries. Economic growth was higher in Italy and Greece (Table 1), while the German economy grew by 0.3%, for the first time after contracting for almost a year. The labour market remains strong in the euro area, characterized by employment growth – by 0.8% in the second quarter – and wage growth, by 4.5% for the same period.

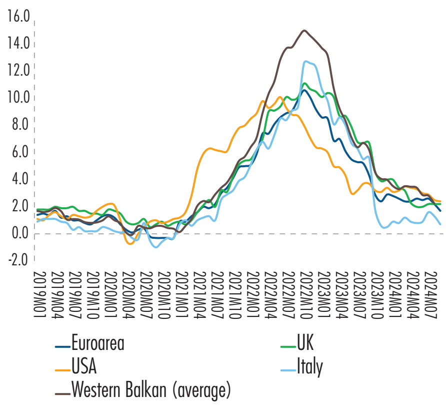
Chart 2

The activity in the services sector is assessed to have continued improving



Note: Survey indicators on enterprises which signal the progress of economic activity in the short-term.
Source: PMI indices.

Annual inflation has continued trending downward



Source: Eurostat, national statistics institutes.

[3] *The monthly publication of Consensus Forecast provides forecasts made by various banking and financial institutions, geographically divided by continents.*

Inflation in euro area continued slowing trend over the third quarter, down to 2.2%, from 2.5% in the previous quarter. In September, inflation dropped to 1.7%, remaining below the ECB's target. In comparative terms, inflation performance was uneven among member countries; inflation has slowed down in Germany but it has accelerated in Italy and Greece (Table 1).

The latest macroeconomic projections of the ECB for economic growth and inflation in the euro area have remained almost the same as the forecasts from the previous round. They predict slow economic growth and a continued decline in inflation towards the 2.0% target[4].

REGIONAL ECONOMIES[5]

Regional economies have, overall, displayed high growth rates in the second quarter of 2024, with Kosovo, Albania, and Serbia leading with growth rates above 4% (Table 1). Expansion of economic activity in North Macedonia has accelerated, but remains lower compared to other regional countries. Economic growth has been supported by private consumption in almost all countries, while in the economies of Serbia and Kosovo, investments have also contributed in this regard, whereas in North Macedonia, public consumption and net exports.

Inflation rates have, in general, pursed a slowing trend across regional countries. This trend has been particularly strong in Kosovo and North Macedonia. Thus, inflation in Kosovo dropped to 1.8% in the third quarter, down from 2.4% in the previous quarter, while in North Macedonia to 2.6% from 3.9% in the second quarter. On the other hand, inflation in Serbia was relatively stable. Despite this, the National Bank of Serbia lowered the key interest rate by 25 basis points in September, following a reduction in July of this year. The National Bank of North Macedonia implemented the same policy in the same month.

Recent forecasts for the countries of the region indicate a slowdown in inflation rates during 2025, while economic growth is expected to be similar to that of 2024.

Table 1 Macroeconomic indicators for main trading partner countries

	Annual change of GDP p.p		Annual inflation (%)		Unemployment, in %
	2024Q1	2024Q2	2024Q2	2024Q3	Latest publication
Italy	0.2	0.9	0.9	1.2	6.2
Greece	1.6	2.7	2.7	3.1	9.5
Kosovo	5.6	4.3	2.4	1.8	10.7
North Macedonia	1.2	2.3	3.9	2.6	12.5
Serbia	4.6	4.0	4.4	4.3	8.2
Albania	3.8	4.1	2.1	2.0	10.7

Source: Respective statistical institutes.

4 *ECB staff macroeconomic projections for the euro area, September 2024. These projections have been conducted and published prior to the publication of inflation of September 2024. The ECB staff projections show economic growth is expected to be 0.8% in 2024 and 1.3% in 2025. Average inflation is projected at 2.5% and 2.2% in the respective years, equal to the previous forecasts.*

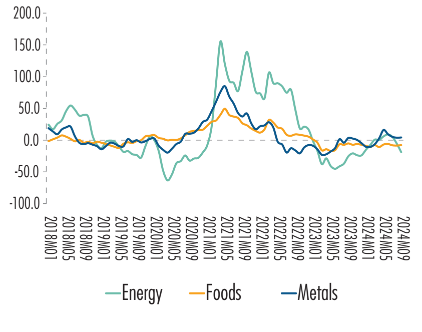
5 *The main trading partners outside the European Union (Kosovo, North Macedonia, Serbia).*

2.2. COMMODITY PRICES IN GLOBAL MARKETS

The decline in commodity prices index[6] has returned to a downward trend during the third quarter of the year, decreasing by 4.1% (Chart 3, left). The drop in energy and food prices have provided the main contribution in this regard, while metal prices continued picking up over this quarter as well. The slower global demand has affected the declining trajectory of prices in international markets. Meanwhile, the geopolitical tensions in Ukraine and Middle East remain risk factors that could endorse a reverse of this trend in the future.

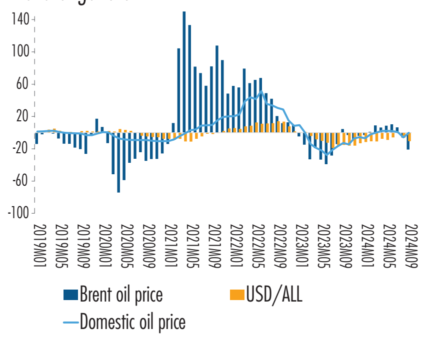
Chart 3

Pressures on an increase in commodity prices in international markets remain present



Note: Main commodity price indices, annual change (%)
Source: World Bank

Oil prices in Albania have partially reflected the decreased oil prices abroad and the strengthened exchange rate



Note: Indicators annual changes. Oil price in Albania is approximated to the oil price in consumer basket.
Source: INSTAT, staff estimates

The Brent oil price was quoted around the average level of USD 80.2$/barrel during the third quarter, with an annual decline of 7.6% (Chart 3, right). The reduced production quotas from OPEC countries, related to the forecasts on a lower global demand in the short-tern future, have been reflected to the developments of this quarter[7].

In 2024 Q3, the food price index has contracted by 8.2% in annual terms, similar decline to the previous quarter. This trend continues to reflect the growth in global supply and exerts decreasing pressures on global consumer price inflation. However, geopolitical tensions remain a risk factor that could drive prices up in the future.

[6] *Monthly frequency indices published by the World Bank.*
[7] *US Energy Information Administration, Short term energy Outlook, October 2024.*

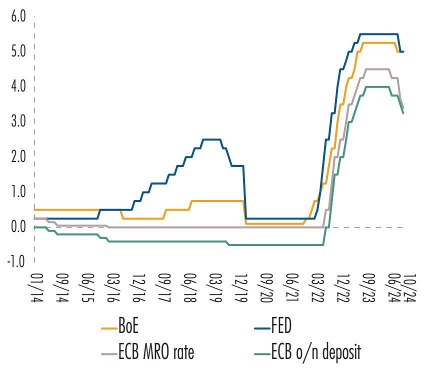
2.3. INTEREST RATES

Financing conditions in international markets were slightly more accommodative in the third quarter of 2024. The ECB lowered the key interest rate twice (at a total of 85 basis points) during this period, down to 3.40%. The performance and outlook of inflation, as well as the preliminary indicators related to the economy, led to the decision to ease the monetary policy stance. The Federal Reserve lowered its interest rate in September, while the Bank of England kept it unchanged after the reduction implemented in August.

Yields on long-term government securities in major markets have decreased, reflecting the side of decisions by major central banks, as well as expectations for inflation. Yields on 2-year and 10-year government securities have decreased in August and September. However, their performance in these months also recorded episodes of high volatility, as a result of investors' strong reactions to the publication of some economic preliminary indicators that differed from expectations. The tensions were short-lived and quickly offset once the key data was released. These developments, however, highlighted the increased market sensitivity to the publication of macroeconomic developments.

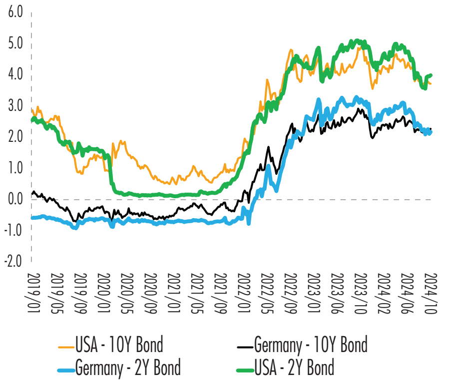
Chart 4

The ECB lowered twice the key interest rate in September and October



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

Yields have reflected the cut of interest key rate by the ECB and the Federal Reserve



Notes: 2 and 10-Year yields on government securities
Source: Respective central banks.

3. FINANCIAL MARKETS AND LENDING CONDITIONS

Developments in the financial market during the third quarter reflected the easing of the monetary policy stance in July and the low risk premia on liquidity and loans. The foreign exchange market was calm, with normal trading parameters and an increase of its volumes. Lek continues showing appreciating trends, though less intensively than in the previous year.

Lending to the private sector continued to expand at a fast pace, fuelled by high demand, improved confidence in the economy, and the accommodative supply of bank credit. In particular, the acceleration of credit in the third quarter was driven by loans granted to enterprises in foreign currency, while lending to households continued to show high and stable growth rates.

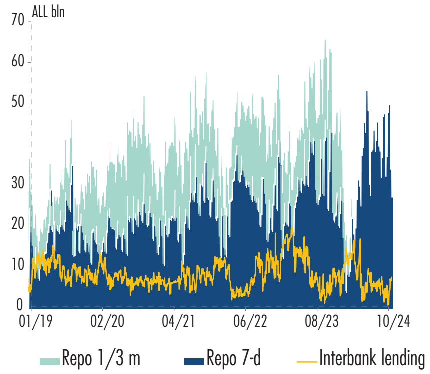
3.1. DOMESTIC FINANCIAL MARKET[8]

The financial market was characterized by an overall decline in interest rates during the third quarter, reflecting the reduction in the policy rate and low risk premia. Meanwhile, strengthening pressures on the exchange rate remained present, although with a lower intensity compared to the previous quarters.

Interest rates in interbank market remain anchored close to the policy rate, showing slight fluctuations and their spread from policy rate remains minimal. Banks' needs for liquidity were higher this quarter, reflecting the expansion of lending to the private sector and investments in government securities. The Bank of Albania continued to supply liquidity through its main one - and three - week

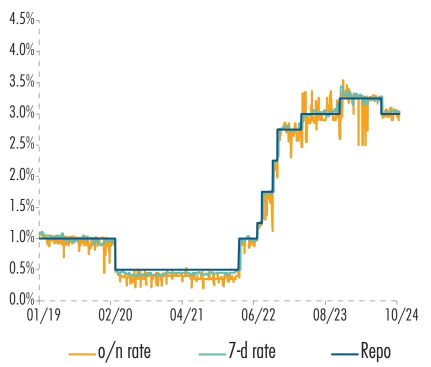
Chart 5

The injections by the Bank of Albania into the interbank market increased during the third quarter



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

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



Note: Data show the daily performance of interest rates in the interbank market.
Source: Bank of Albania

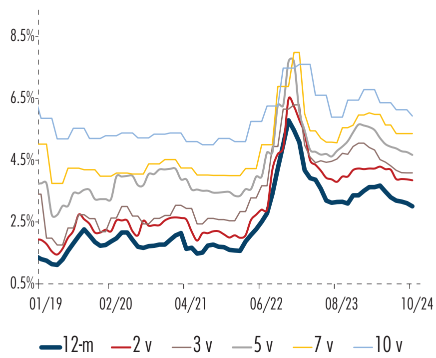
[8] *The following analysis is based on the data available up to 30 October 2024.*

repo instruments, as well as by three-month liquidity injections. The liquidity injected in the third quarter was higher compared to the amount injected in the previous quarter.

The yields on government securities continued the downward trend in the third quarter, while their spread from the policy rate remains minimal. Beyond the accommodative stance of monetary policy, the performance of yields has also reflected the low premiums on liquidity risk, maturity risk, and inflation, as shown by the mitigation of the curve. Investors' demand in the primary market has continued to be relatively high in relation to the government's financing needs[9]. The decline in yields has extended across all maturities, but with a slightly greater trend toward the longer-term maturities. The yield of 12-month T-bill fell to 3.1% in September from 3.5% in the second quarter, while the premiums on 3-, 5-, 7-, 10-, and 15-year bonds decreased by 0.3 percentage points during this period.

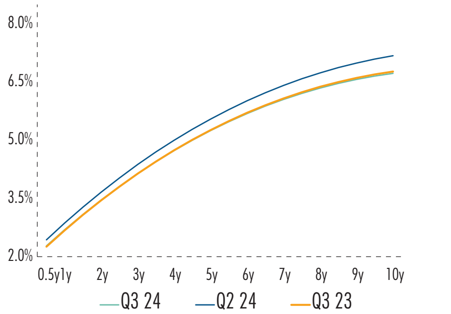
Chart 6

Yields in the primary market have shown a downward trend beyond reflecting the change in the policy rate



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

The yield curve is the same as it was in the previous year and it has slightly flattened both in slope and level, compared to the second quarter



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

The exchange rate of the lek against main currencies continued to be characterized by strengthned pressures during the third quarter. The appreciation of the lek reappeared in August, although not at the same pace as at the beginning of the second quarter of the year. The EUR/ALL exchange rate gradually declined to 100.0 in August, and further to 99.4 in September, after stabilizing at an average of 100.4 observed during the May–July period. This trend continued in the first weeks of October, with the euro being quoted at an average of ALL 98.7. Meanwhile, after reaching the lowest level of 2.8% in July, the annual appreciation reduced in the following three months, averaging

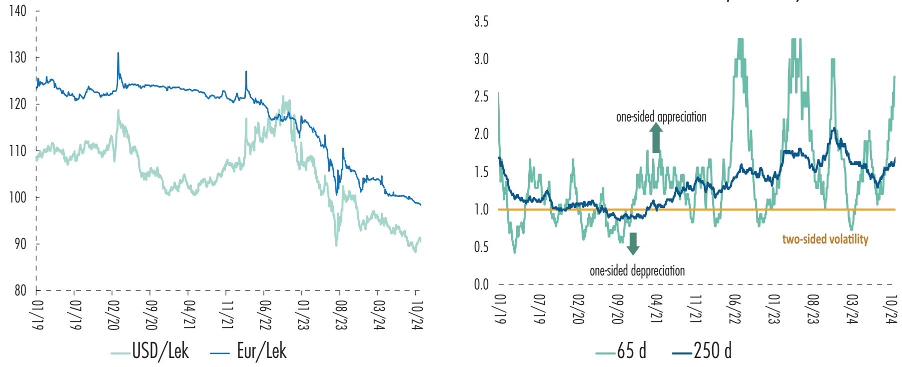
[9] *The bid/cover indicator for T-bills and bond auctions was 1.3 in the third quarter, compared to 1.5 in the second quarter.*

6.4%.[10] This level, however, remains below the average annual appreciation of 9.3% observed during the first six months of the year.

* The appreciation/depreciation bias is calculated as the ratio of the number of days when the exchange rate is appreciated against the number of days when the exchange rate is depreciated, over a moving time horizon that may vary, e.g. from 22 days (one calendar month) up to 250 days (one calendar year). The value 1 for this indicator represents the equilibrium value, where the number of days when the exchange rate is appreciated is equal to the number of days it is depreciated. If the value of this indicator is above 1 (below 1), then in the market there are signals for one-sided expectations for exchange rate appreciation (depreciation).

Chart 7

The Lek has appreciated slightly in the third quarter of the year | *Appreciating pressures returned in August, but they remain less intense than in the previous year*



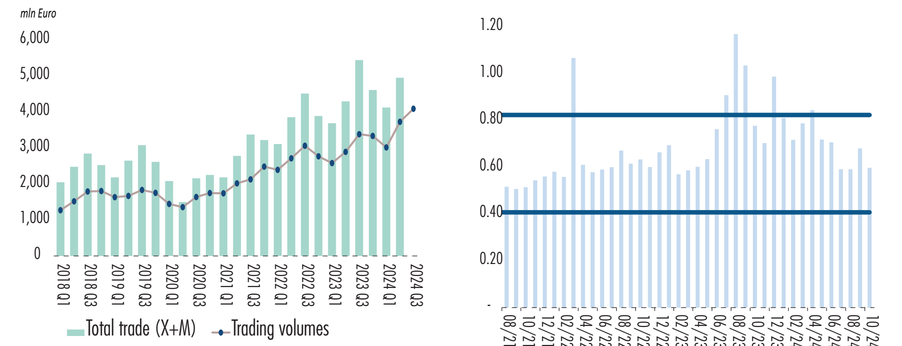
Note: Data show the daily performance of ALL exchange rate against Euro and US Dollar
Source: Bank of Albania.

Notes: The data reflect the appreciation/depreciation bias.*
Source: Bank of Albania.

The foreign exchange market continues to be characterized by an increase in volumes, in line with developments in external trade, as well as by normal trading conditions. The annual growth in trading volumes was 21.0% in the third quarter, remaining at double-digit levels, as it was in the first half of the year. At the same time, the volatility and spreads between the selling and buying quotes for the euro have resulted within their normal range.

Chart 8

Trading volumes in the foreign exchange market have continued to grow | *Quotation spreads have resulted within their normal range*



Notes: The data presents the quarterly trading volumes in the foreign exchange market and the value of trade in goods and services (imports + exports), in EUR mln.
Source: Bank of Albania.

Notes: The chart shows the spread between the quotations of the bid/ask price of euro, monthly average. The interval is calculated as an average +/- standard deviation.
Source: Bank of Albania.

[10] *Although the monthly appreciation was lower in the third quarter compared to the second quarter, the annual appreciation accelerated after July due to the differing dynamics of the exchange rate this year compared to the previous year. In 2023, the eur/lek exchange rate reached its lowest in July, and the lek was depreciated in August and September. This year, the exchange rate continued to appreciate during these two months, albeit at a slower pace.*

The U.S. Dollar has shown a similar trend to the Euro in the third quarter, reflecting its depreciation against the Euro in the international market. The USD/LEK exchange rate dropped to 89.4 in September, from 93.2 at the end of the second quarter. In the first weeks of October, the USD/LEK exchange rate averaged 90.4, which is 9.7% lower compared to October of last year.

3.2. LENDING CONDITIONS

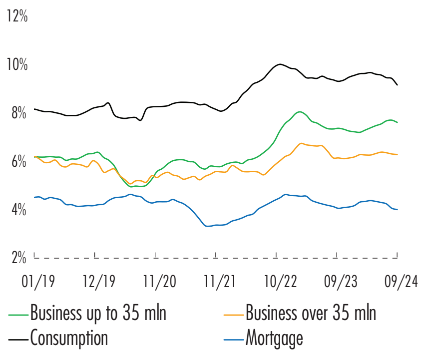
Interest rates on new loans in lek decreased in the third quarter of the year, following signals from monetary policy, also in reflection of a positive approach by banks toward lending.

Interest rates on mortgage and consumer loans began to fall in the second quarter of the year, and after the cut of the policy rate, they now stand at lower levels than a year ago The interest rate on mortgages stood averagely at 3.9% in the third quarter, from 4.1% and 4.5%, respectively in the second and first quarter of the year. The interest rate on consumer loans has also decreased to 8.8%, from 9.5% and 9.7% in the previous two quarters.

Interest rates on loans to enterprises have also decreased. The average rate was 6.5% in the third quarter, down from 6.8% in the previous quarter. An analysis of loan interest rates based on the loan amount evidences that the downward trend in interest rates in recent months has been mainly driven by loans above ALL 35 million, while interest rates on loans up to all ALL 35 million, which primarily finance small enterprises, have seen a marginal decrease. The current average interest rate on loans to enterprises is the same as it was a year ago, when the policy rate and yields on government securities were also at the same levels.

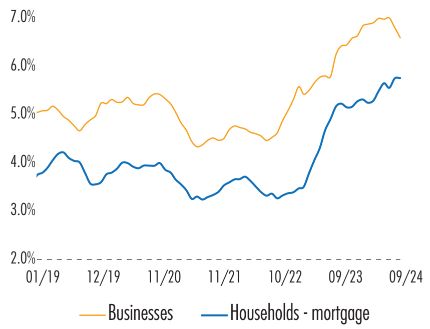
Chart 9

Interest rates on loans in lek decreased in the third quarter, reflecting the change in the policy rate



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

Interest rates decreased for loans in euro to enterprises and less so for those for house purchase



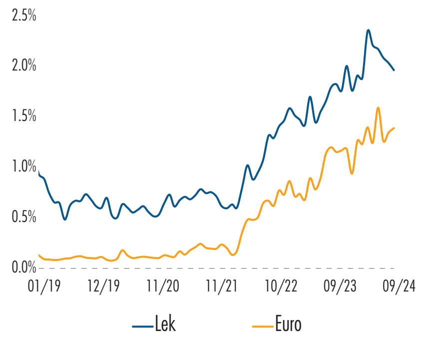
Note: Interest rates of new loans in euro as 6-months moving average.
Source: Bank of Albania.

The interest rates on loans in euro have decreased since August, following the trend of the European Central Bank's policy rate. The average interest rate on new loans in euro to enterprises stood at 6.2% in the third quarter, from 7.0% in the two previous quarters. Meanwhile, average interest rate of the mortgage loans in euro to households remains high. In this quarter, it showed a marginal reduction to 5.7%, down from 5.8% in the previous quarter. The lek/euro interest rates spread has shifted into positive territory for enterprises, while it remains negative and has further deepened for financing house purchases, as a result of the rapid decline in interest rates on loans in lek.

Interest rates on time deposits in lek also decreased in the third quarter of the year. On average, they were 2.0%, down from 2.2% in the second quarter. Interest rates on deposits decreased more for maturities over one year. Interest rates on time deposits in euro recorded a marginal decline, falling to 1.3% from 1.4% in the previous quarter. The spread between interest rates on deposits in lek and those in euro remains stable.

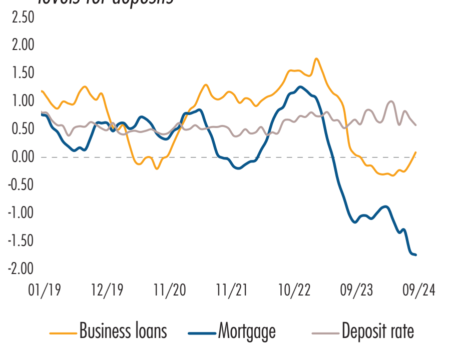
Chart 10

Interest rates on time deposits have decreased, both for lek and for euro, reflecting signals from the monetary policies of central banks



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

Lek/euro interest rates spread has deepened for mortgage loans, while it remains at low and stable levels for deposits



Note: The data show the spread between the interest rates in lek and loans in euro, in percentage points, for: business loans, mortgage loans and deposits.
Source: Bank of Albania.

BOX 1
CREDIT SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2024 Q3[11]

The banks' approach to credit to the private sector remained almost unchanged during the third quarter. The lending policy framework remained favourable for enterprises, while the prudence displayed by one bank in the system led to tighter standards and conditions on loans to households. Demand for loans remained high even in the third quarter, reflecting increased financing needs across all the economic agents.
Banks kept credit standards to enterprises unchanged during the third quarter, whether for short-term liquidity needs or for investments financing. However,

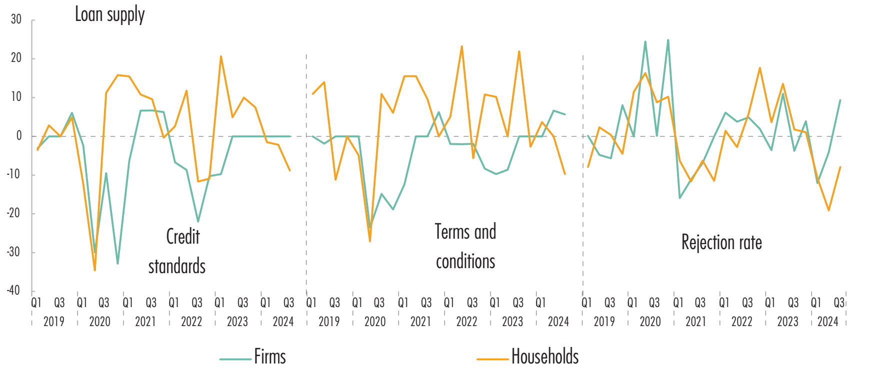
[11] *The analysis is based on Bank Lending Survey, conducted on quarterly bases and is published at https://www.bankofalbania.org/Politika_Monetare/Vrojtimet/Vrojtimi_i_aktivitetit_kreditues/*

the macroeconomic and financial outlook, as expected by the banks, combined with lower balance sheet costs and constraints, allowed banks to apply more favourable terms and conditions on loans to enterprises. Banks reduced the margins thus contributing to the easing of credit terms and conditions, for the second consecutive quarter, for this segment. The loan rejection rate - in relation to the total number of loan applications - was reported to be higher compared to the previous quarter, as a result of the banks' perception on borrower's creditworthiness.

Credit standards for consumer loans and those for house purchase were tightened, determined only by one bank of the system The risk perception by this bank on borrowers' creditworthiness seems to have fostered a more cautious approach to lending to households during this quarter. However, banks continue to support the increased demand for loans from households, both to finance consumption and house purchases, driven by high competition in the banking system. The loan rejection rate was reduced for the third consecutive quarter, mainly due to the banks' assessments on the borrowers' quality and their employment history and stability in the labour market.

Chart 1 Box 1

Loan supply conditions remained almost unchanged compared to the previous quarter



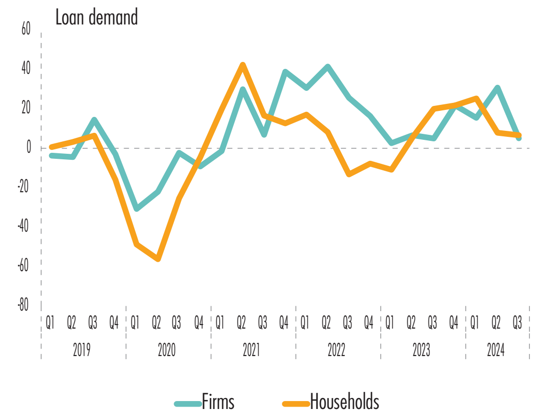
Source: Bank of Albania.
Values on the chart represent net balances. Positive values indicate easing of terms and conditions and vice versa. Positive values indicate increase of the scale of application refusal and vice-versa.

In line with banks' expectations, loan demand was high in all sizes of enterprises and for all types of loans by purpose of use. The environment of lower interest rates in both the domestic and foreign markets, along with the further improvement in business confidence, encouraged enterprises to demand higher loan amounts to meet their increased needs. The liquidity levels available to enterprises remained high; however, these did not discourage the demand for loans, either for financing inventories and working capital or for planned investments.

In line with expectations, loan demand from households was reported to be high for the sixth consecutive quarter. The increased demand for loans was driven by lower interest rates and fulfilled the growing needs for consumer financing and house purchases.

Chart 2 Box 1

Loan demand was high across all segments



Source: Bank of Albania.
Values on the chart are calculated as net percentage. Positive values show increase of credit demand, while negative values show its decrease.

3.3. CREDIT TO THE PRIVATE SECTOR[12]

Credit to private sector continued to follow a positive trajectory, started since the middle of the previous year. The annual growth rate of credit reached 16.8% in the third quarter, which was around 2 percentage points higher than the previous quarter and almost double the rate recorded in 2023. The positive development of the Albanian economy, expressed in the sustainable growth of economic activity, the decline in risk premiums, and the soundness of the banking sector, has bolstered both the increase in demand for financing from the private sector and the growth of credit supply from the banking sector.

The analysis on foreign currency composition of the credit portfolio shows that the acceleration of credit in the third quarter was mainly driven by the growth of loans in foreign currency. These loans recorded an annual growth rate of 13% during this period, affected, among other things, by the disbursement of a syndicated loan provided by four banks in the system. At the same time, the loan portfolio in lek recorded an annual growth of 18.6%, in the third quarter. Although slowing down, this high growth rate reflects a relatively high demand for loans in lek and an environment with favourable interest rates.

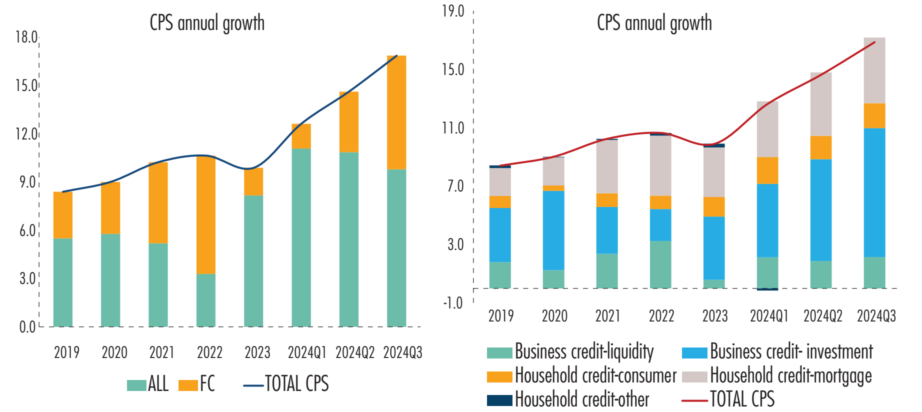
The main driver of the credit acceleration was the growth of loans to enterprises. Credit to this segment grew averagely by 17%, up from 14% in the previous quarter[13]. The main reason for business financing was the increase in investments; the credit portfolio for this segment grew by 23% in the quarter under review, reaching the highest level of the last decade. Meanwhile, liquidity loans showed a stable growth rate of 8.9%, the same as in the second quarter.

On the other hand, credit to households was stable. The average growth rate of this portfolio, at 15%, remained very close to the rate of the two previous quarters. Its expansion continued to be dominated by the increase of loans in lek, which benefits from low interest rates in lek and the negative gap with the interest rates in euro. Within this segment, consumer credit growth slowed to 14.4% (from 15.2% in the second quarter), while loans for house purchase accelerated to 17% (from 16% in the second quarter). House purchase loans account for around 80% of the households' loan portfolio.

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

[13] *Even when excluding the syndicated loan, the expansion of the credit portfolio to enterprises remains on a positive trajectory.*

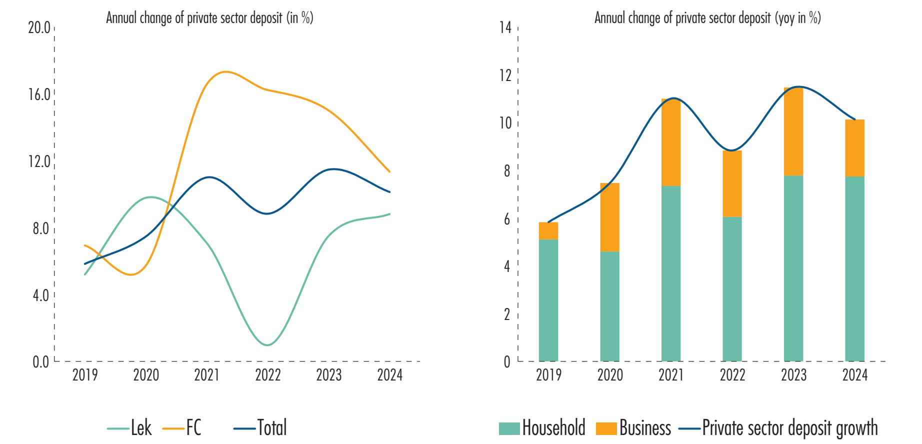
Chart 11
Expansion of private sector credit has accelerated, influenced by all categories, but it has been stronger for loans in foreign currency and loans to enterprises



Notes: The data show the annual changes (in %) of credit adjusted for exchange rate effects and written-off loans from the balance sheets.
Source: Bank of Albania.

Deposits in the banking sector continued to grow during the third quarter, although at a slower pace. The annual growth rate of deposits during this period was 10.3%, down from 11.1% in the second quarter. This performance was mostly affected by the slowdown in the growth rate of foreign currency deposits, which dropped to 10.4%, while lek deposits slightly improved to 9.8%. The trend in lek deposits continues to reflect, among other factors, the high accumulation of government liquidity in the account held at the Bank of Albania.

Chart 12
Deposits have shown stable growth rates supported by the good performance of deposits to households



Notes: Increase in total deposits by currency, in % adjusted for exchange rate fluctuations.
Source: Bank of Albania.

The growth in deposits was present in both segments: time deposits and demand deposits. The respective annual growth rates were 9.4% and 11.3%. In the category of time deposits, stable growth rates were present for deposits with maturities of up to two years, while growth rates for deposits with maturities over two years slowed down, although the latter remain at high levels, around 17%. The share of deposits with maturities over two years in the total increased further to 18.4%, or 1 percentage point higher than at the end of 2023.

4. ECONOMIC GROWTH

The Albanian economy recorded an annual growth of 4.1% in 2024 Q2, continuing the positive trend of the previous quarters.

Economic growth was driven by the expansion of consumption, investment, and service exports, and was reflected in increased activity in the sectors of "Construction," "Services," and "Agriculture." On the other hand, exports of goods and the "Industry" sector continued to contribute negatively. From a macroeconomic point of view, the positive performance of economic growth has been supported by monetary stimulus, reflected in the continued growth of credit to the economy, disposable income, and the increase in foreign direct investments.

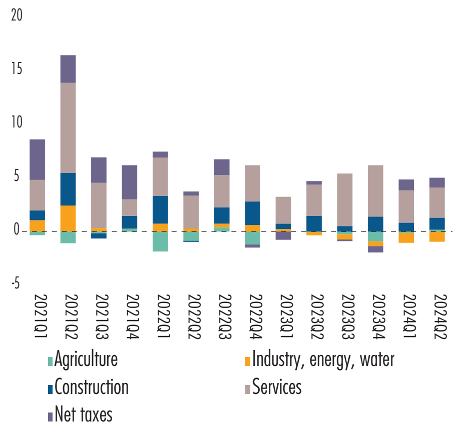
Projections for the future remain positive, both in the short-term and medium-term horizons.

4.1. GROSS DOMESTIC PRODUCT

Gross Domestic Product (GDP) grew by 4.1% in 2024 Q2, recording a slightly higher rate compared to the first quarter[14]. The main drivers of economic growth came from "Construction," "Public administration, Education, Health," "Trade, Transportation, Accommodation, and Food Services," and "Professional and technical activities" (Chart 13, right). Additionally, "Agriculture" had a small

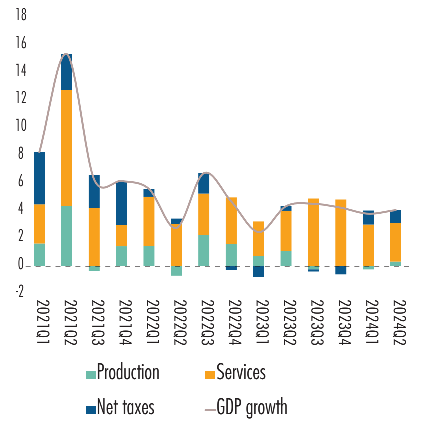
Chart 13

Economic growth has accelerated due to "Construction" and "Services"



Source: INSTAT and Bank of Albania.

Economic growth has been primarily influenced by the expansion of the services sector



Source: INSTAT and Bank of Albania.

[14] *INSTAT has published quarterly GDP series for the period 2018-2024 Q2, following a major methodological revision. The revision affected both nominal and real series, in sectoral terms and for components based on the expenditure approach. For the first time, GDP has been published in nominal terms with an annual frequency for the period 2018-2023, measured using the income method.*
The real growth rate for the first quarter of 2024 is revised at 3.8%, up from 3.6% previously, and the average for 2023 has also been revised upwards, increasing to 3.9% from 3.45% under the previous methodology. The GDP publications make the revised series available from 2018 onwards (For more information, see INSTAT publications of 27 September and 1 October 2024).

positive impact. On the other hand, the "Industry" sector had a negative contribution to economic growth.

The contribution of production sector to economic growth was 0.3 percentage points during 2024 Q2, with positive impacts from "Construction" and "Agriculture" (Chart 13, right). The "Construction" sector grew by 10.1%, a rate higher than the previous quarter's 8.1%. Meanwhile, after nearly a year and a half of negative dynamics, the "Agriculture" sector returned to positive growth, recording an annual increase of 0.6% in the second quarter. On the other hand, the volume of activity in the "Industry" sector shrank by 8.9%, continuing the trend that began at the beginning of 2023. The annual decline was observed in both "Mining" and "Manifacturing" branches.

The contribution of the services sector to economic growth was 2.8 percentage points, similar to the previous quarter. The main contributing sub-sectors were "Trade, transportation, accommodation, and food services," "Public administration, defence, education, and health", and "Professional and technical activities." At the same time, other service sectors also made positive contributions, although these were downward. An exception to this trend is the "Information and communication" sector, which slightly declined compared to the previous year.

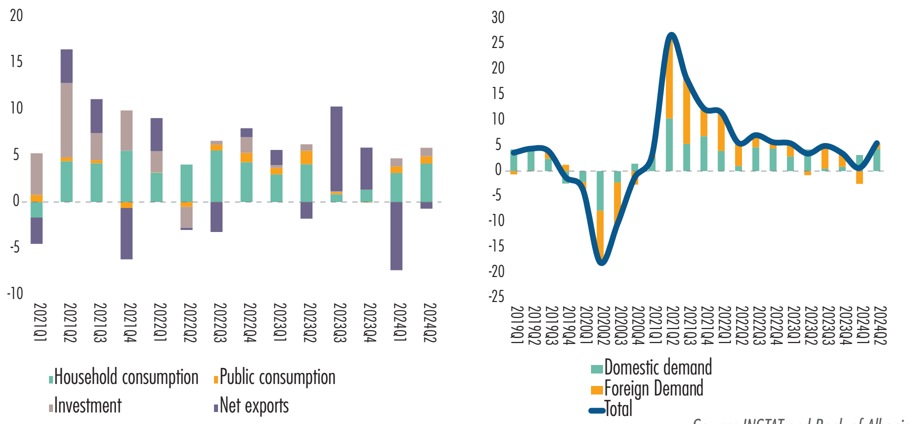
4.1. AGGREGATE DEMAND

Economic growth was mainly supported by the expansion of domestic demand, which grew by 5.7% in 2024 Q2, up from 4.2% in the previous quarter. The acceleration in growth reflected a faster increase in household consumption and stable investment growth.

In parallel with domestic demand, exports of goods and services contributed positively (Chart 14, right). In contrast to the first quarter, exports of goods increased reversing the shrinking performance of the previous quarters.

Chart 14

The economic growth was underpinned mainly by domestic demand | *with positive contributions from foreign demand as well*



Source: INSTAT and Bank of Albania.
Notes: Contribution of demand components to economic growth

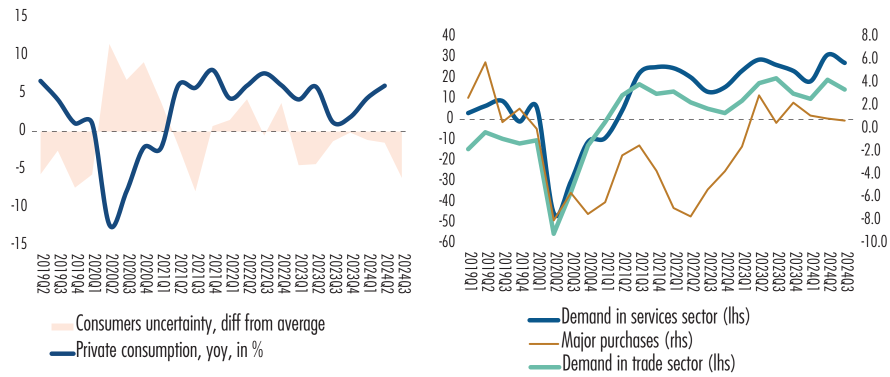
Source: INSTAT and Bank of Albania.
Notes: Domestic and foreign contribution to the annual growth of aggregate demand.

Private consumption grew by 6.0% in Q2, accelerating compared to the previous quarter (4.4%) and the average growth rate during 2023 (4.0%). Consumption grew mainly in the categories of durable goods and services (Chart 15, right)[15]. This expansion was supported by the rise in real household income, the decline in consumer uncertainty (Chart 15, left), and accommodative financing conditions.

Confidence survey data suggest that consumption continued to grow in Q3. Services and trade - related businesses have positively assessed the demand for their products, while the balance of major consumer purchases has improved since 2023[16]. Financing conditions remain favourable, supporting high growth rates in consumer and mortgage loans, both in 2024 Q2 and Q3.

Chart 15

Private consumption accelerated in Q2 | *Survey indicators suggest that growth continued in Q3*

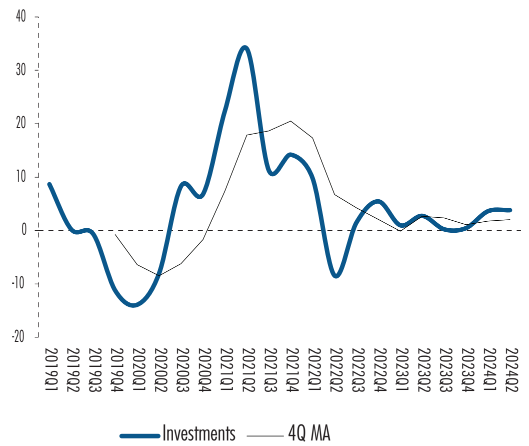


Notes: Indicator of consumer uncertainty is measured from Consumer Confidence Survey and expressed as net balance in percentage points. Source: INSTAT and Bank of Albania.

Notes: The indicators are net balances, in percentage points, and are based on business and consumer confidence surveys. The indicators are presented as changes from the relevant long-term averages. Source: Bank of Albania.

Chart 16

Total investments increased in the second quarter



Source: INSTAT and Bank of Albania.

Total investments grew by 3.8% in the second quarter, a growth rate similar to that of the first quarter of the year (Chart 16). For the most part, these investments were in the form public infrastructure, business premises, and residential buildings, as suggested by the increase of about 10.1% in value added in construction. At the same time, business investments in machinery and equipment went up, as indicated by the rise in their imports in the second quarter.

[15] The analysis of service consumption is based on the indirect indicator of value-added growth in the services sector, as measured by GDP using the production method. The analysis of consumption in both consumer goods and durable goods is based on data from the retail trade index.

[16] Before 2023, the balance of large purchases has remained consistently below its historical average for a period of three years; however, from 2023 onward, this balance has fluctuated above the average.

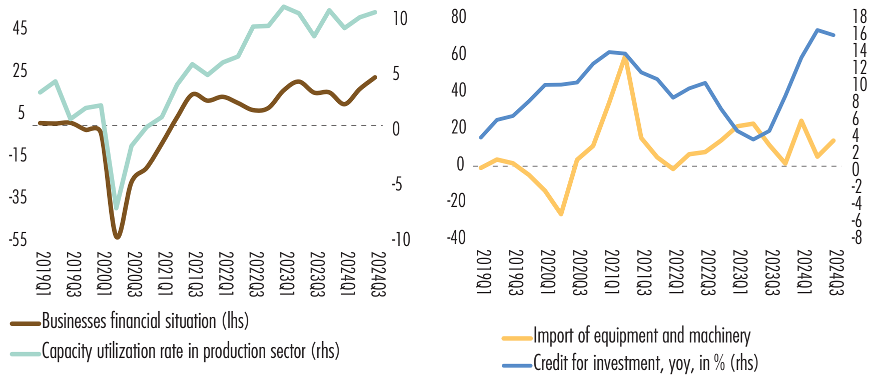
The expansion in investments continues to be supported by the need for capacity expansion in production and services, in response to the insufficiency of existing capacities (Chart 17, left), positive confidence for the future, liquidity balances (Chart 17, left), favourable financing conditions, and rapid expansion of credit.

Indirect quantitative data and survey results suggest a similar investments growth rate in the third quarter (Chart 17). Imports of machinery and equipment recorded a double-digit growth. The capacity utilization rate in production stands at quite high levels, and the financial condition of businesses has continued to improve this quarter.

Chart 17

The capacity utilisation rate and the enterprises' financial situation improved in the third quarter.

Quantitative indicators from imports and bank credit signal for an increase in investments.



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

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

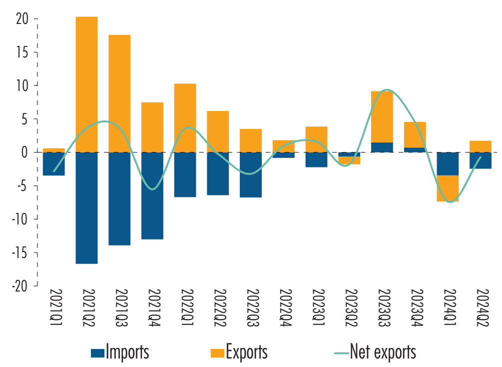
Exports of goods and services grew by 4.9% in real terms. The main contributor was the export of services, which grew by 5.25%, a factor present for several years now. On the other hand, in contrast with the previous quarters, export of goods also resumed their growing trend, recording 3.6% in Q2.

Import of goods and services expanded by 5.6% in Q2, decelerating compared with the previous quarter. The growth of import was supported mainly by the expansion in the import of services, up by 10.6% than last year. In the same vein, import of goods recorded an increase of 3.6%.

Despite the growth in exports, the overall trade deficit increased in Q2, having a growing negative contribution (Chart 18). The expansion by 17.9% of the deficit was driven by the strong growth of imports over this period.

Chart 18

Net exports had a growing negative contribution on economic growth in 2024 Q2, but at a lower magnitude compared to the previous quarter.



Source: INSTAT and Bank of Albania's estimations.
Notes: Contribution of imports and exports in economic growth.

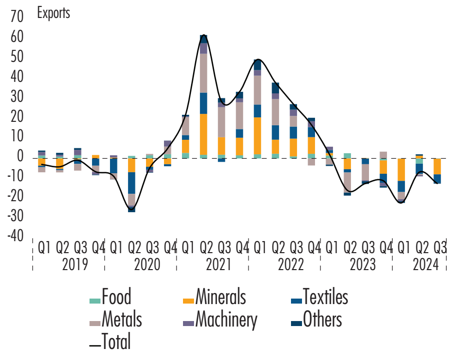
In 2024 Q3, the trade of goods in nominal terms performed in a similar fashion with the previous two quarters, identifying the falling exports and the increasing imports. The trade deficit in goods grew by 23.4%, driven by the same amount by the fall in exports and the rise in imports.

Exports of goods reduced by 12.6% during 2024 Q3 (Chart 19, left). The main contributors were the categories of "Minerals, fuel and electricity" and "Textile and footwear." In the first case, the contraction of exports reflects the effect of prices and the appreciating exchange rate, whereas the quantity of exports fell for the second category. Over the quarter, there is a relatively high volume of exports in the category of "Food, beverages and tobacco," but the growth is reflected in the expansion of the total value of exports as prices for this class of goods fell down.

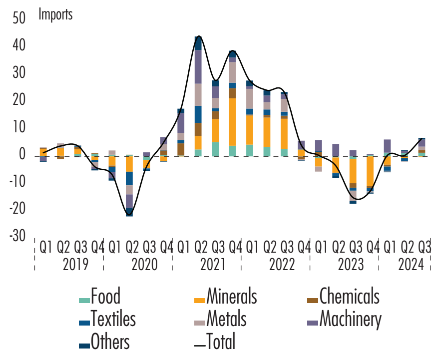
Imports of goods grew by 6.6% during the quarter under review, continuing the upward trend present in the beginning of the year (Chart 19, right). The positive contributions were provided by the categories of "Machinery, equipment and spare parts," "Food, beverages and tobacco" and "Construction materials and metals." On the other hand, the negative contributions were subdued and were narrow based. The expansion of nominal imports continues to be affected by the increasing quantity of imports, whereas the price-falling trend and the exchange rate appreciation steered the indicator in the opposite direction.

Chart 19

The performance of exports appears to be declining, driven mainly by the drop in energy and food prices, as well as the reduction in volume for some categories of goods.



The higher quantity has driven up imports, at a time when prices and the appreciated exchange rate have had the opposite effect.



Source: INSTAT and Bank of Albania calculations.

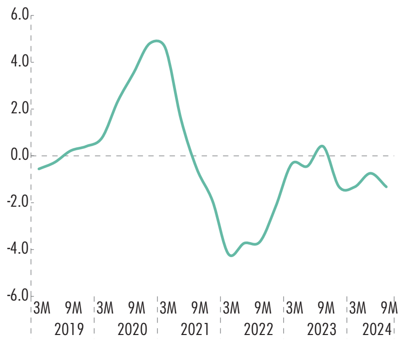
Note: Contribution of the main categories in the goods market, in percentage points.

The fiscal policy continued consolidating in the third quarter as well, and was expressed in relatively high budget-surplus values. The rapid increase of revenues and a slower performance of public expenditure were reflected in higher surplus values exceeding the level planned for this period. At the end of the nine-month period, the fiscal surplus amounted ALL 69 billion, accounting for 3.7% of GDP, reaching the highest historical level record for this period of the year.

The fiscal impulse by the end of the nine-month period remained in the negative territory, at 1.3 percentage points of GDP[17]. As revenues increased at an elevated pace over the last quarter, the negative values of fiscal impulse became more prominent, from 0.7 percentage points at the end of the first half of the year.

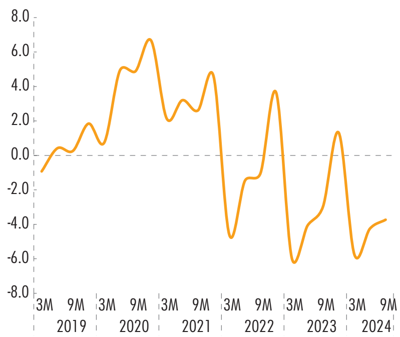
Chart 20

Fiscal impulse remained in negative territory



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

Fiscal surplus recorded the highest historical values



Source: Ministry of Finance.
Notes: Budget deficit to GDP. Calculations are based on quarterly flows. Positive values show deficit, negative values show budget surplus.

Budget expenditure in the third quarter stood at ALL 167.7 bln, up by 10.2% in annual terms. This growth rate was higher than the one recorded in the previous quarter due to the faster expansion of public expenses. The latter grew by 36.6% in annual terms, contributing by 3.7 percentage points to the expansion of expenses in the third quarter. By the same token, the increase of total expenses in Q3 was supported also by the higher level of expenses in the pension scheme, as well as the increase in personnel costs, reflecting the rise in public sector's wages; these two items account for around 56% of the total increase in expenses. On the other hand, the other items recorded minimal annual changes.

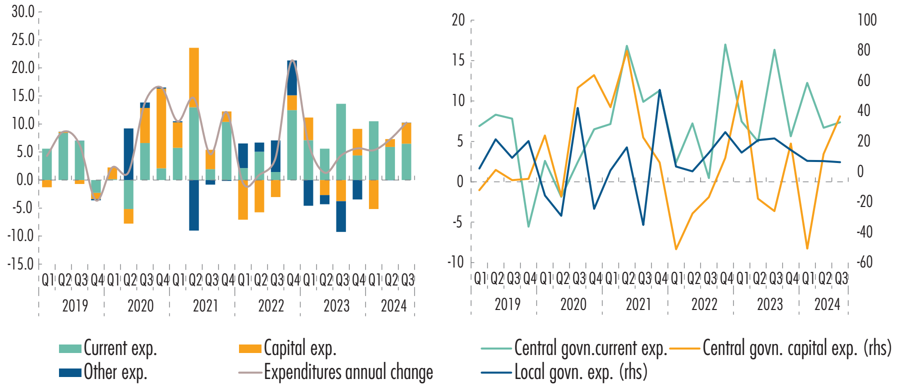
In the first nine months of the year, expenditures amounted ALL 459 bln, or around 7.8% higher than in the same period of last year. Current and capital expenditure expanded by 8.4% and 2.8%, respectively, in annual terms.

---

[17] *The fiscal impulse is calculated by comparing the ratio of primary deficit (budget deficit minus interest rate expenses) recorded over a 12-month period to GDP with the same ratio recorded at the end of the same period in the previous year. If the difference between these two ratios is negative, the fiscal policy has been consolidating and vice-versa. This calculation of primary deficit does not include temporary government measures, regarding both revenues and expenditures.*

Chart 21

Expenditures grew at an accelerated pace.... *...reflecting the higher level of investments in Q3*



Source: Ministry of Finance.
Notes: Composition of expenditure growth by quarters.

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

In Q3, budget revenues were around ALL 185.3 bln, accelerating the annual growth pace to 17.8%, from the 7.2% on average recorded in the first two quarters of the year. Similarly to the previous quarter, the growth of revenues was driven mainly by non-tax revenues, recording a contribution of 5.7 percentage points. In this quarter, the transferring of the unspent balance of the expropriation fund, valued at ALL 8 billion, to the government's budget, had a positive impact on revenues.

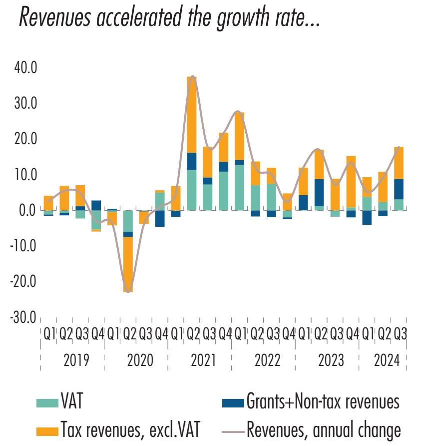
By the same token, all the other tax-related revenue items (expect value-added tax) had an increasing positive contribution[18]). Therefore, VAT revenues contributed by 3.1 percentage points to revenue expansion, around 41% of which comprised of VAT collected on goods and services produced in Albania. Furthermore, revenues from personal income tax, excise tax, local taxes and social insurance made a positive contribution to the expansion of revenues, ranging from 1-2.6 percentage points.

At the end of the first nine months of the year, revenues reached ALL 491.6 bln, up by 11.6% than in the same period last year. Almost 1/3rd of this growth comprised of non-tax revenues. In the last two quarters, this item had a positive impact on revenues due to the transfer of funds from the Social Insurance Institute to the state's budget, which reflected the improved financial results of this institution during the 2023 fiscal year, as well as the transferring of the unspent balance of the expropriation fund.

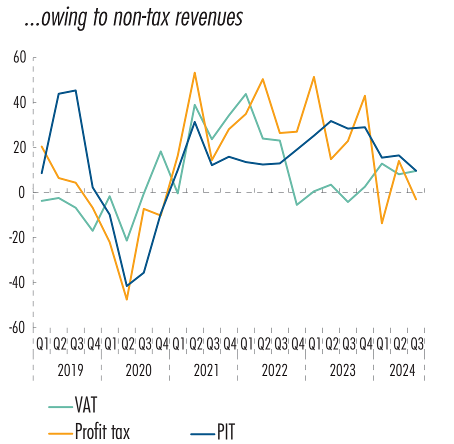
The budget balance was also positive in Q3, standing at around ALL 17.6 bln.

[18] *The negative dynamic of the value-added tax in the third quarter reflects the base effect of the previous year, when the second instalment of the special tax levied on companies involved in electricity trading, was transferred to the state's budget.*

Chart 22



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



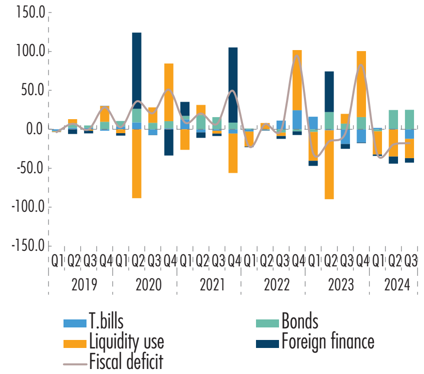
Source: Ministry of Finance.
Notes: Annual growth in % of main tax items, by quarters.

Net new borrowing in the domestic market increased by ALL 13 billion in Q3, where the shrinkage of ALL 12 billion in the T-bills portfolio was offset by the expansion of bonds with 2-15 years of maturity. Most long-term securities were purchased by banks in Q3, which financed around 86% of the additional government borrowing. In the same vein, non-resident investors continued to purchase government securities during Q3. They financed around 29% of the new domestic debt created over this period. Their portfolio at the end of the nine months registered ALL 9.7 bln, or 1.2% of the total domestic debt. Recently, the Bank of Albania reduced by ALL 3.6 billion its exposure to government securities over the third quarter, as it reduced the level of borrowing in Treasury bills from the Ministry of Finance.

Net borrowing in foreign market in the third quarter of the year decreased by ALL 5.6 billion, as the share of debt settlement exceeded foreign currency inflows during the period. In the first nine months of the year, net borrowing in the foreign market was ALL 16.6 bln. The liquidity surplus in foreign currency inherited from the previous year, which resulted from the issuance of the Eurobond, was used to service the foreign debt throughout 2024. The performance of both government borrowing and fiscal surplus over the course of this period, have been factored into liquidity surpluses, available to be used to finance expenses in the coming months.

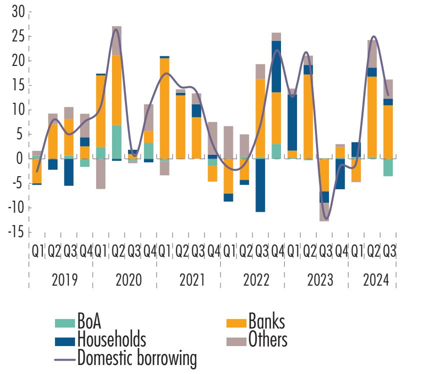
Chart 23

Net borrowing in the domestic market expanded for long-term securities only...



Source: Ministry of Finance.
Notes: Budget deficit by quarters and its financing, in ALL billion.

...as a result, the exposure of the banking sector to government financing increased further.



Source: Ministry of Finance and Bank of Albania.
Notes: Government borrowing in debt securities, by buyers, in ALL billion, by quarters.

Public debt was estimated at around ALL 1.3 trillion at the end of Q3, and accounted for 54.1% of GDP[19]. Public debt in terms of GDP continued its downward trajectory over this quarter, reducing by 1.1 percentage points compared to the previous month, and by 3.4 percentage points from the end of 2023. The factors underpinning its decline during this year were: the appreciation of domestic currency against the Euro; the consolidating fiscal policy stance; and the relatively rapid expansion of the economic activity. Foreign debt was estimated at 23% of GDP, down by 1.1 percentage points from the previous quarter, whereas domestic debt maintained the same ratio with the previous quarter, at 31.1% of GDP.

[19] *Ratios to nominal GDP were created by taking into account the latest INSTAT reviews.*

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

Inflation fluctuated around to 0.2% over the third quarter, slightly down compared to the values recorded in the second quarter. This performance was affected by the decline in imported inflationary pressures, which reflected the fall of fuel inflation and the appreciation of the exchange rate. On the other hand, domestic inflationary pressures continued to be the main cause behind rising consumer prices and remain - overall - consistent with our medium-term inflation target.

Inflation is expected to fluctuate close to its current level over the fourth quarter as well. Further, the normalisation of commodity prices in foreign markets, as well as a more stable performance of the exchange rate are expected to reduce their declining impact on domestic inflation. By the same token, as economic growth moves close to its potential, inflation will approach its 3% target within 2025.

5.1. CONSUMER PRICES

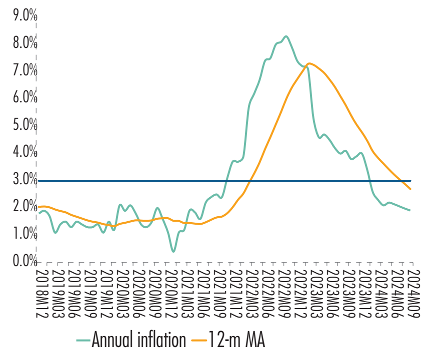
Inflation slowed down slightly in the third quarter, remaining close to the average of 2.0%. The 1.9% value of inflation recorded in September was the lowest since July 2021 (Chart 24, left). The fall of inflation in Q3 was mainly the result of the negative contribution of fuel inflation, and the reducing base effects of rent prices, which recorded a relatively sharp rise during the previous year. On the other hand, processed food inflation has gone up. In macroeconomic terms, imported pressures have subdued, owing to the falling inflation in our trading partners economies and the appreciation of the exchange rate. Whereas, domestic pressures remain stable and the main drivers of total inflation.

The inflation profile of Albania over the course of time is similar to the one in both regional and the EU economies (Chart 24, right). Nonetheless, the sharper fall of domestic inflation stems from differences in consumer structure, since the share of food items is significantly higher compared to countries of the euro area[20].

[20] *According to the harmonised index of consumer prices (HICP) for 27 EU countries, the share of "Foods and non-alcoholic beverages" account for 16.8% of the CPI basket in 2024. For the same HICP index, the share of "Foods and non-alcoholic beverages" in Albania for the same year accounts for 34.7% of the basket (according to Eurostat Database, October 2024).*

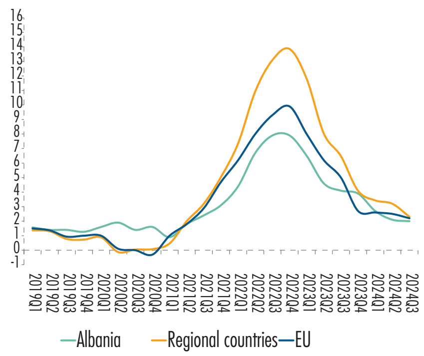
Chart 24

The slowdown in inflation continued at lower rates compared to the previous quarter



Source: INSTAT, BoA's calculations.
Note: The inflation target is the annual change in the Consumer Price Index (published by INSTAT).

The fall of fuel prices decelerated inflation in Albania, the region and the EU



Source: INSTAT, BoA's calculations.
Note: Inflation rate are annual changes, in percentage.

The slowdown of inflation over the third quarter was impacted mainly by subdued imported inflationary pressures. In particular, the contribution of the category of "**Non-food goods**" contracted by 0.2 percentage points on average compared to the second quarter of the year. This development was driven by the reduction in the contribution of the fuel subcategory (-0.3 percentage points), reflecting the prices of energy raw materials in foreign and domestic markets, coupled with the effects of the appreciating exchange rate.

In parallel, the prices of some categories including housing, services, and **durable consumer goods** had a lower contribution to inflation formation. This came as a result of rent price contributions falling by 0.1 percentage point, due to the negative impact of the high comparative base of the previous year.

On the other hand, a higher positive contribution was recorded by the food price inflation. The category of **"Processed foods"** recorded an increased contribution by 0.1 percentage points in Q2. This increase was particularly pronounced in August, marking the first expansion recorded for this specific contribution over the year. Almost all the sub-categories recorded increased contributions particularly that of "milk, cheese and eggs." The category of **"Unprocessed foods"** also recorded a slightly higher contribution (by 0.05 percentage point on average).

Table 2 Contribution of the main categories in the annual inflation market, in percentage points.

	Q1'23	Q2'23	Q3'23	Q4'23	Q1'24	Q2'24	Q3'24	Annual inflation Q3'24 (%)
Processed food	2.8	1.3	0.8	0.6	0.5	0.4	0.5	2.0
Bread and grains	0.6	0.2	0.1	0.1	0.1	0.1	0.1	1.3
Milk, cheese and eggs	1.3	0.8	0.6	0.5	0.3	0.2	0.3	3.9
Unprocessed foods	1.9	2.5	2.3	2.1	0.9	0.3	0.4	2.8
Fruits	0.1	0.4	0.3	0.3	0.1	-0.2	-0.1	-3.7
Vegetables	0.7	1.1	1.3	1.3	0.5	0.3	0.4	5.2
Meat	1.0	0.9	0.7	0.4	0.2	0.1	0.2	3.0
Services	0.5	0.5	0.5	0.4	0.4	0.4	0.3	1.9
Goods with regulated prices	0.0	0.0	0.0	0.0	0.1	0.1	0.1	1.5
Housing lease	0.4	0.4	0.4	0.4	0.4	0.4	0.3	2.2
Non-food consumer goods	0.4	-0.6	-0.4	-0.1	0.1	0.3	0.1	1.1
Fuel	0.0	-0.9	-0.6	-0.2	-0.1	0.1	-0.2	-4.7
Durable consumer goods	0.5	0.5	0.4	0.4	0.3	0.3	0.3	3.4
Inflation (%)	6.5	4.6	4.1	3.9	2.7	2.1	2.0	2.0

Source: INSTAT and Bank of Albania's estimations.

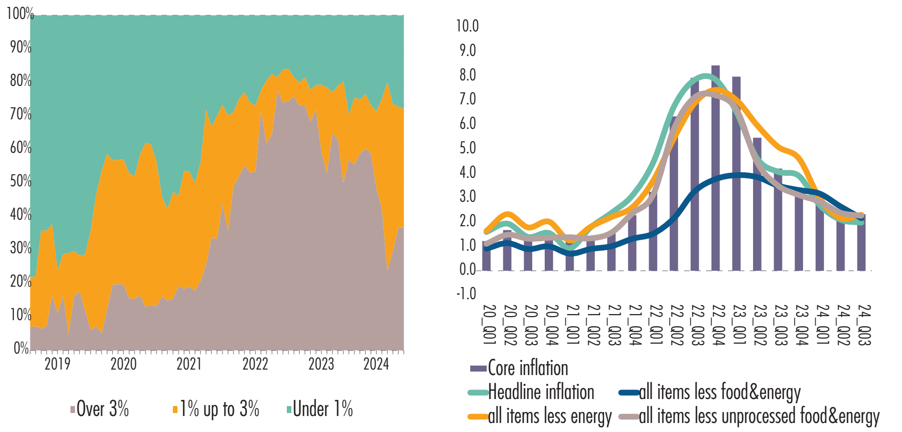
Structurally, the fall of inflation in Q3 was driven by the reduction in the share of basket items with an inflation over 3%[21]. The share of the items in this category shrank by 4 percentage points compared to the second quarter, dropping to 34% in the third quarter. On the other hand, the share of items with inflation below 1% was up by 3 percentage points, and the share of items with inflation between 1% and 3% increased by 1 percentage point (Chart 25, left).

In tandem with these transitory factors and the fall of imported inflation, core inflation has also been on a slightly downward trend (Chart 25, right). Thus, net inflation which excludes food and energy[22] stood at 2.3% in Q3, slightly downward compared to the second quarter of the year. Nonetheless, it remains

Chart 25

The share of items with inflation above 3% fell considerably in 2024 Q3

The mitigated fall of inflation was also verified by net inflation measurements



Source: INSTAT and Bank of Albania's estimations. *Source: Bank of Albania.*

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

[22] This includes in large part durable services and consumer goods.

above headline inflation, indicating the domination of domestic inflationary pressures, which are relatively isolated to short-term trends.

5.2. INFLATION DETERMINANTS

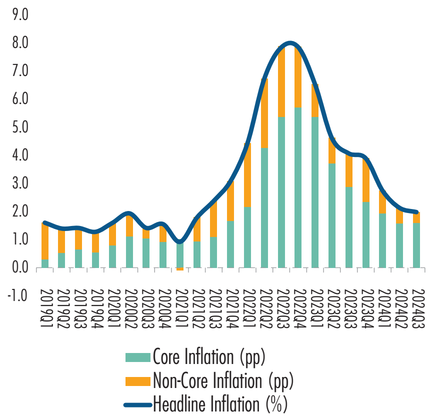
Economic activity has remained in a positive stage of business cycle over the second and third quarters of 2024. The utilisation rate of production capacities remains above the long-term average and the production trajectory above its potential. Private sector wage has continued to grow, albeit at a slower rate than previously, reflecting the base effect of the higher minimum wage last year, whereas labour productivity has accelerated. Consequently, the intensity of inflationary pressures from labour cost per unit appears somewhat eased.

Despite the gradual slowdown of domestic and core inflation over the course of the year, these indicators remain consistent with the medium-term price stability, whilst the impact of short-term and imported components were close to the historical minimums.

The inflation trend in Q3 reflected the decelerating inclination of non-core inflation, while the core inflation was stable (Chart 26, left). It remained unchanged at 2.3%, fluctuating close to its long-term average[23]. Almost the same value was recorded by net core inflation[24], although said indicator still remains above its historical average (Chart 26, right). On the other hand, non-core inflation remained close to its historical average of 1.2% in Q3, owing to the fall of oil prices and the appreciation of domestic currency.

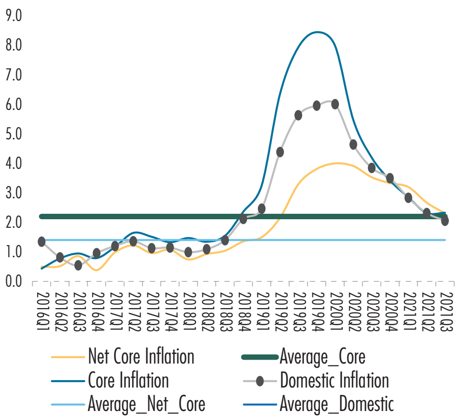
Chart 26

The contributions of core inflation slightly expanded in Q3



Source: INSTAT and Bank of Albania's estimations.

Net core inflation fell in Q3, albeit remaining above headline inflation



Source: INSTAT and Bank of Albania's estimations.

23 *Long-term annual averages of core and non-core inflation were 2.2% and 5%, respectively.*

24 *The sub-basket which measures core inflation accounts for 69% of total CPI; net core inflation excludes the sub-groups of some processed foods with stable inflation. It is measured based on over 46% of the CPI basket.*

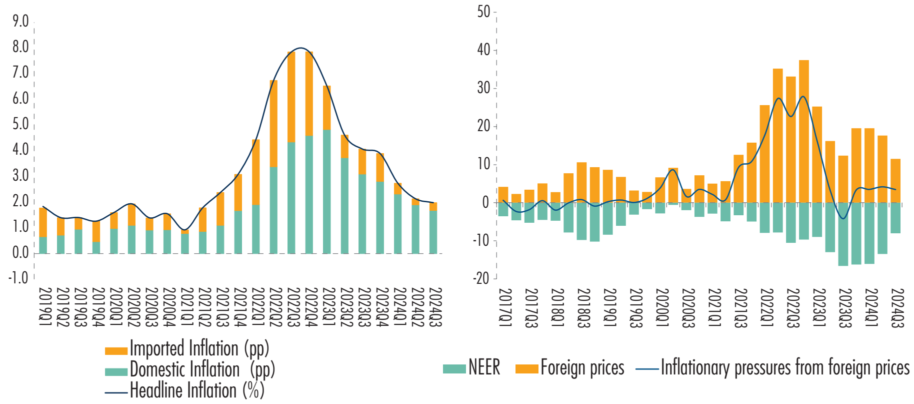
The fall of inflation in Q3 reflected in large part the deceleration of imported inflation. This trend was driven by the lower inflation recorded by our trading partners and the exchange rate appreciation. As a result, imported inflation contributed by 0.3 percentage points in the formation of headline inflation (Chart 27, left).

The lower imported inflationary pressures is present in the behaviour of Imported Inflationary Pressures Index (IIPI), which was up by 3.5% in Q3 from 4.2% in Q2 (Chart 27, right). This development was driven mainly by the decelerating imported prices by 11.5% in Q3, from 17.6% in Q1. On the other hand, the appreciation of the effective nominal exchange rate moderated to 8.0% in Q3, against the 13.5% in the preceding quarter[25].

Chart 27

Domestic inflation contributions, although on the decline, continued to dominate the formation of headline inflation in Q3 as well

The imported inflationary pressures have become slightly weaker during 2024 Q3



Source: INSTAT and Bank of Albania's estimations.

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

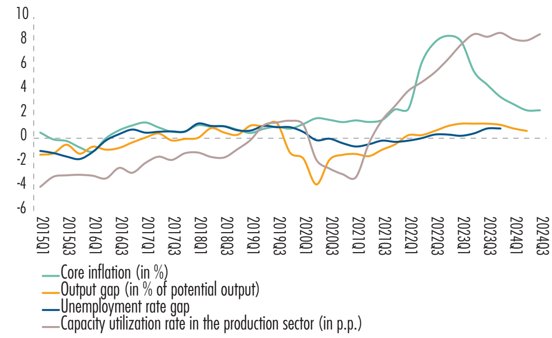
In parallel, domestic inflation registered around 2.1%, from 2.3% in the previous quarter. Nonetheless, both domestic and core inflation reflect, although at a lower degree, the impact of the stronger exchange rate of Lek against the other currencies. Also, these indicators remain close to the long-term historical averages and contributed by 81% and 85%, respectively, to the formation of headline inflation.

The economy is assessed to be in a positive stage of the business cycle, as it is evidenced by the positive production gap, the below long-term average of unemployment rate, and the above historical average of capacity utilisation rate.

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

Chart 28

Cyclical position of economy appears positive in 2024 Q3 as well.



Source: INSTAT and Bank of Albania's estimations.

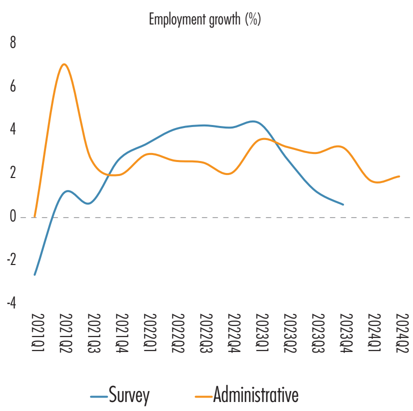
Notes: The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilisation rate gap is estimated as a deviation of the current value from the relevant historical average, upon which the moving average method is then applied. The unemployment rate gap is estimated as an average of unemployment gaps according to three methods, which assess the equilibrium of unemployment. The unemployment rate gap is measured as the difference of the equilibrium unemployment rate to the actual unemployment rate, upon which the moving average method is then applied.

Employment and unemployment. Data on employment for the first half of 2024 is still unavailable. Information pertaining to the administrative labour market indicators and indirect indicators from surveys show that there is a growth of employment and restrictive labour market conditions continue to persist (Chart 29, left). Survey indicators show that businesses' expectations on employment are relatively stable over the next quarter (Chart 29, right).

Wages, productivity and labour costs. Wages in the private sector have continued to grow in Q2, but at a slower pace than previously. This growth dropped to 6.9%, from 12.7% in the previous quarter (Chart 30, left). This slowdown points to a strong statistical base effect compared to the previous year, when the growth of private sector's wages was 15.0%, owing mainly to the increase of the minimum wage. The impact of the increase of the minimum wage has dissipated in the second quarter of current year. The deceleration of the nominal wage growth rate was reflected by its real growth as well, which dropped to 4.8% in Q2, from 10% in Q1.

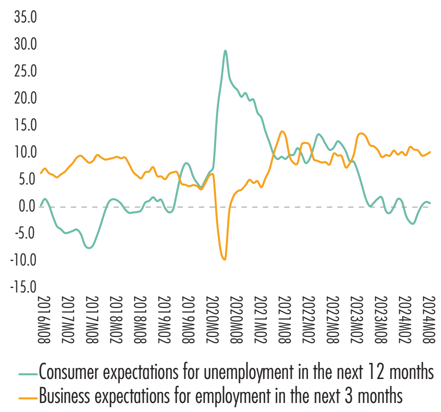
Chart 29

Labour market's administrative indicators suggest a slow growth of employment over 2024 Q2



Source: INSTAT.

Short-term statistics indicate that the employment expectations of businesses are stable



Source: INSTAT.

The unit labour costs[26] have risen at a slow pace over Q2. They have gone up by 2.2%, from 7.8% in Q1. The deceleration during the quarter under analysis

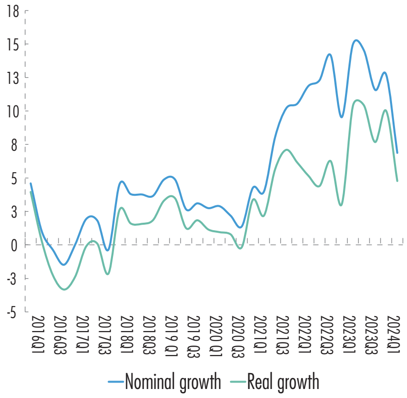
[26] *Indicators of labour unit cost and of labour productivity are estimated by the Bank of Albania. They refer to the non-agricultural private sector and are calculated based on the data collected quarterly by INSTAT on the National Accounts statistics, labour market administrative indicators and wages.*

was affected by the slower real wage growth against the faster rise of labour productivity (Chart 30, right).

The rise in **other production costs** has continued to cool down over the second quarter of the year. The production price index (PPI) was 1.7%, from 2.8% in the previous quarter. The falling pressures were mainly as a result of the deceleration of production prices in the domestic market (2.3%, from 3.5%), whereas prices for export production slowed down at a moderated rate (0.2%, from 0.5%). Lately, the Construction Cost Index (CCI) recorded an annual increase of 2.5% in Q2, or down by 0.9 percentage points than the previous quarter.

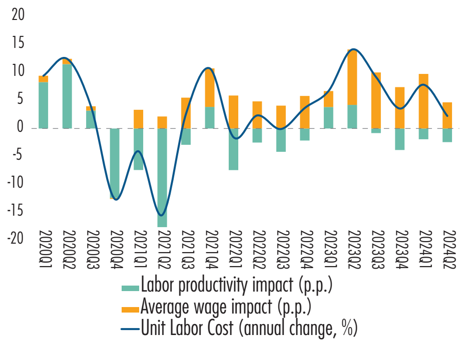
Chart 30

Wages in the private sector grew at a decelerated pace over 2024 Q2



Source: INSTAT and Bank of Albania.

Labour unit costs increased at a slower pace in 2024 Q2, mainly due to the slower real wage growth



Source: INSTAT and Bank of Albania.

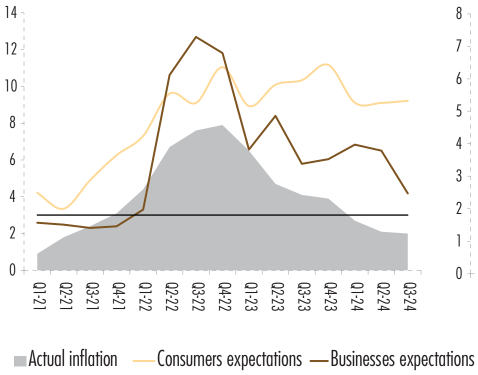
Note: The positive contribution of labour productivity in the calculation of annual changes of the unit labour cost indicator shows that the labour productivity index has resulted in negative annual rate.

Inflation expectations of financial agents and businesses have been revised down, while consumers' expectations have remained unchanged in the third quarter[27]. Short-term expectations of businesses have dropped to 4.2%, against the 6.5% recorded in the previous quarter. Short-term inflation expectations from consumers stood at 9.2%, close to the 9.1% recorded in the first two quarters of the year. On average, short-term consumer expectations in 2024 were around 1 percentage point below the ones recorded in 2023 (Chart 31, left). Financial agents' expectations were revised down, converging all three time horizons close to the 2.7% value (Chart 31, right).

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

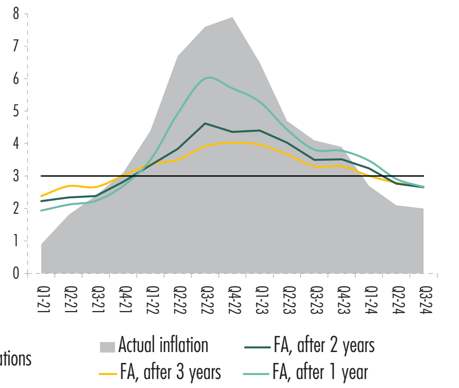
Chart 31

Businesses expectations on in¬flation have fallen down, while consumers have not changed their expectations



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

Financial agents' expectations on in¬flation appear to be falling and converging close to target



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