Bank of Albania

MONETARY POLICY REPORT

2024/II

MONETARY POLICY DEPARTMENT

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C O N T E N T S

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 rates with positive inflation 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 goods and services.

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 opposite is also valuable.

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

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

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.

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 3 May 2024. The Supervisory Council reviewed and adopted this Report at its meeting on 8 may 2024.

FOREWORD BY THE GOVERNOR

Albanian economy closed 2023 with a positive balance sheet.

Against the backdrop of a challenging economic environment, characterised by relatively elevated prices, uncertainties and financing costs, the volume of economic activity grew by 3.4%, exceeding the initial expectations. In parallel, employment and wages went up, helping the purchasing power of households, inflation came down progressively, while the main indicators of macroeconomic equilibriums improved.

The data of the first quarter suggest that this positive moment of development has continued during the current year.

The expansion in both consumption and private sector's investments, coupled with the growth in income from tourism bolstered economic activity continuing to grow. Also, inflation of consumer prices declined, down at the average of 2.7%. This fall was driven by a relatively fast stability in food prices, which reflected a similar performance across international market. We deem this development encourages the guaranteeing of price stability in Albania. However, our analyses suggest that inflation performance remains volatile and the stable return of inflation to the target will still take time.

The prudential monetary policy of the Bank of Albania has provided an important contribution in successfully tackling the shocks that the Albanian economy has experienced in the last two years.

The normalisation of monetary policy stance has helped to control inflationary pressures, enabling its gradual - but continuous and stable - reduction in the past two years. At the same time, the attention we have paid while calibrating the monetary policy has enabled the decline in inflation to not damage the positive economic growth prospects. The relatively low interest rates and financing costs in Albania, as well as the continuous growth of bank credit in support of consumption and investments, evidence this prudence.

Our monetary policy has been and will remain consistent with price stability, forward guidance, as well as harmonized with all factors affecting inflation.

Looking ahead, the update of forecasts suggests that current economic trends will continue in the medium term as well. The Albanian economy will continue to grow over the next three years - at a relatively similar pace to those of 2023- generating: new jobs; increase in wages; and improvement in the welfare of society. Also, inflation will continue to fluctuate around our 3% target. We consider, the base of factors underpinning price stability in line with our inflation target will continue to expand.

In our judgement, our current monetary policy stance provides the best balance between respecting our price stability objective and boosting economic growth.

1. INFLATION AND MONETARY POLICY STANCE

The new information analysed in this Report has resulted, overall, in line with our expectations. Inflation of consumer prices has continued to decline, economic activity has continued to grow, financial markets have functioned smoothly, and lending has been increasing.

The update of projections reaffirms our previous expectations. The Albanian economy will continue to grow in the medium term, boosted by both the expansion in tourism sector and the rise in consumption and sector's investments in Albania. The sound financial balance sheet of economy, the accommodative monetary and financial environment and the positive confidence for the future will support the expansion in consumption and investments of private sector. In parallel, inflation is expected to fluctuate close to our target. The current supply-side shocks, which drove to the fall of inflation faster than our forecasts, are assessed to be transitional. Further, the balanced supply and demand performance, in both goods and services market as well as in the labour market, are expected to be reflected in stable prices in line with our inflation target.

In these circumstances, the Supervisory Council deemed that the current monetary conditions are adequate for respecting inflation target and decided to keep the policy rate unchanged, at 3.25%.

Global economic prospects has been improving and inflation has continued to come down, approaching to central banks' targets. Inflation in euro area dropped to 2.4% in March. The falling in food and energy prices, the normalisation of supply conditions and the monetary policy tightening have helped to push down inflation. The tightening of monetary policy has driven economic activity to slow down, though the risk falling in recension seems to have been overcome. The European Central Bank expects inflation to return to 2% target in 2025. Nevertheless, the ECB highlights that interest rates will remain tight, despite the beginning of potential decreases of key interest rate, in the event the new data support this decision. Risks to global prospects are balanced for both economic activity and inflation; among them, the heightened geopolitical tensions pose a significant risk to inflation, and a downside-tilted risk to growth.

Inflation in Albania continued trending downwards at an accelerated pace in 2024 Q1. Inflation dropped to the average of 2.7% in this quarter, from 3.9% in the previous quarter. The falling inflation in food prices mainly pushed inflation down. This reflected a similar performance across international markets, but with a higher effect in Albania, due to the high share of foods in our consumer basket. This supply-side shock on inflation is expected to continue provide a falling effect in the period ahead, nevertheless it will be transitional. On the other hand, inflation in other categories of basket declined at a slower pace.

From the macroeconomic perspective, the fall in inflation reflected the decline in global inflation, the exchange rate appreciation and the normalisation of monetary policy stance. The two first factors were materialised in the fall of imported inflation, while the effects of monetary policy are materialised in reduced domestic inflationary pressures and in inflation expectations anchored close to 3% target. Core inflation, in their reflection, has been coming down and has fluctuated around 3%. Nevertheless, the falling pace of this indicator - alike the previous year - is slow, affected by the stability of aggregate demand and the strong labour market.

Economy grew by 3.4% over 2023, underpinned by a strong domestic demand in the first half of year and an increasing contribution of the foreign demand in the second half of 2023. By sector, economic growth reflected the increase in the activity in the sectors of services and construction. A stable financial environment, the decline in inflation, the strong labour market and the fast increase in the income from tourism fuelled the growth of the demand.

Available information as reported from this sector, as well as monetary and fiscal information, suggest economic activity to grow further in the first quarter of 2024. The sound financial balance sheets, business and consumer confidence, swift expansion in lending and the increased income from tourism continue to support the positive trend of these developments.

Labour market is characterised by a continuous growth in employment and wages. Unemployment rate fell to 10.7% at the end of 2023, employment grew by 1.5% and wages in private and public sectors grew by 13% and 17%, respectively. Private companies continue to report the lack of labour force as one of the main restrictive factors on the further growth of the activity, suggesting continuing pressures for increase in wages. The rise in wages has supported the growth in households' disposable income, thus financing the expansion in consumption. On the other hand, the increase in wages has driven up labour costs, by exerting pressures on the surge in prices.

Financial environment has been relatively calm over the first quarter of year. In particular, financing conditions have reflected both monetary policy decisions and contained risk premiums. The policy rate remained unchanged in the first quarter, at 3.25%. Interest rates, in reflection of this stability, have fluctuated close to the levels at the end of 2023. On the other hand, the exchange rate has maintained its appreciating trend, continuing to illustrate the improving trends in the balance of trade and financial exchanges with abroad.

Financing conditions and increased demand have supported the expansion in credit. In 2024 Q1, the volume of credit to private sector was on average 11.6% higher than a year earlier. The positive trends that accompanied lending over 2023, have expanded at the beginning of this year as well. Thus, credit growth continued to have a broad base, with high diversification in the purpose of use and with the main support from the increase in lek-denominated loans. These features suggest the stable and sound growth of lending in the period ahead.

Economic forecasts for the outlook remain positive. Economic activity in Albania is expected to grow further in the medium-term horizon, supported by the increase in consumption and private investments, and the continuous expansion of income from tourism. Growth pace is expected to decelerate somewhat in 2024, due to the economic decline in euro area and the tightening of financial conditions over the last two years, in Albania and abroad, and to normalise in the medium-term horizon. On the other hand, inflation is foreseen to be under the supply-side shocks in food prices in the short run. In the medium term, the persistence of inflation in services and of the core inflation will help inflation return to 3% target in 2025. The latter will be affected by a more balanced performance of the supply and demand in economy.

Risks to inflation are overall balanced, but uncertainty remains high and present in both sides. Upside risks are related to new supply side shocks in the external environment in presence of geopolitical tensions. Downside risks are related to a higher disinflationary impulse than expectations from exchange rate appreciation and/or the continuous fall of food prices.

According to the above-mentioned analyses and forecasts, the Supervisory Council decided to keep the policy rate unchanged, at 3.25%. Current monetary and financial conditions are consistent with meeting our price stability objective in medium term. Future monetary policy decisions will be guided by new data, aiming to react in timely manner and in the right direction, both to the overall balance of inflationary pressures and to possible domestic or external shocks. In any case, our decision-making will aim to create appropriate monetary conditions for guaranteeing the country's monetary stability and supporting financial stability.

2. EXTERNAL ENVIRONMENT

Global economic activity has slowed in 2023 H2, due to the slower aggregate demand in response to the tight monetary conditions across advanced and developing countries. However, high-frequency data and forecasts related to the market suggest a faster expansion of economic activity in the coming quarters.

Inflation rates have continued to maintain, overall, a declining trend, but still remaining above central banks' targets. Central banks are expected to maintain an unchanged monetary policy stance for some quarters as well, to enable the stable return of inflation to the target.

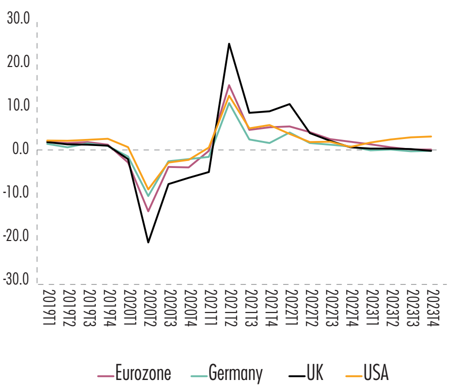
2.1. ECONOMIC ENVIRONMENT

Global economic activity grew at a slower pace in the last quarter of 2023, mainly on the back of low growth rates in some advanced countries. In particular, euro area economy expanded by 0.1% in annual level, at a similar pace with the previous quarter. Leading economic indicators for euro area suggest a slightly better performance in 2024 Q1. On the other hand, economic activity in the USA continued to expand at a sound pace over the last quarter of 2023. The annual growth pace accelerated at 3.1% from 2.9% in the first quarter. Leading economic indicators display a continuation of the positive performance in the first quarter of 2024 as well.

The tight financial conditions have continued to mitigate the demand for goods and services globally. Interest rates have been high and bank credit has continued to reduce. This trend is more pronounced across euro area countries.

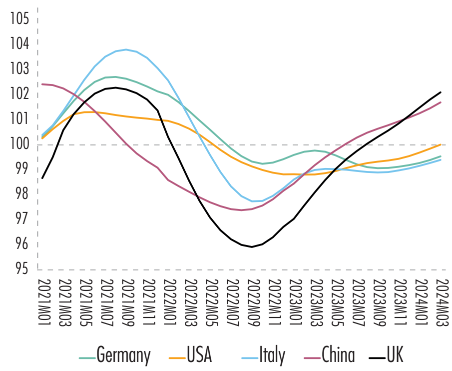
Chart 1

Economic activity was week, but...



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

... high-frequency leading indicators suggest a slightly better performance



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

Inflation rates have lowered further over 2024 Q1, in reflection of reduced commodity prices in the international market and the relatively weak demand across many advanced countries. Inflationary pressures with a persistent nature, in many advanced countries, still remain elevated, making central banks keep the interest rates unchanged in the meetings taking place in March and April.

Global economic activity is expected to maintain a slow growth pace in the medium term. According to the latest IMF's forecasts, global economic activity is expected to expand by 3.2% in 2024 and 2025, a similar pace with 2023. Nevertheless, developing economies are expected to expand at a faster pace than that across advanced countries. Inflation rates are expected to come down gradually in 2024 and 2025.

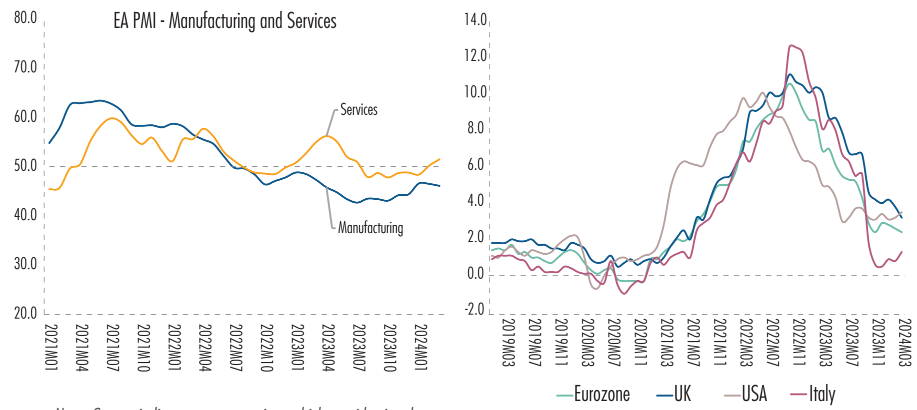
EURO AREA ECONOMY

The euro area economy expanded by 0.1% in annual terms in 2023 Q4. Economic growth pace was heterogeneous across euro area countries. GDP contracted in Germany, increased at a minimum in Italy and faster in Greece. Leading economic indicators in euro area suggest a faster expansion of economy in 2024 Q1, though at a low pace in historical context.

Business surveys carried out in March show that production sector was negatively affected by the increased costs and the weak demand, while activity in services improved further compared to the previous two months. Labour market continues to remain strong. Unemployment rate averaged 6.5% in the first two months of 2024. Data of the fourth quarter of 2023 show a rise in both employment and wages by 1.2% and 3.1%, respectively, at annual level.

Chart 2

Economic activity remains relatively weak | *Inflation declined in 2024 Q1*



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

Source: Eurostat.

Inflation in euro area dropped to an average of 2.6% in 2024 Q1, from 2.7% in the previous quarter. A measurement of core inflation - which excludes energy, food, tobacco and alcoholic drinks prices - shows that it decelerated to 3.1%, from the average 3.7% in 2023 Q4. However, this slowdown is still insufficient for inflation to return quickly to the target. Consequently, the ECB kept the key interest rate unchanged, at 4.5%, in the last meeting of April 2024.

The latest ECB's projections[2] for 2024 suggest a weaker economic growth and a lower inflation rate. The latter is expected to settle on a downward trajectory, though remaining above the 2.0% target over the course of 2024 as well. These projections are surrounded by heightened uncertainties. Intensified geopolitical conflicts, disruptions in commodity supply and the surge in prices in international markets may lead to economic developments different from these projections.

REGIONAL ECONOMIES[3]

Regional economies have displayed expanded economic activity at an accelerated pace in their latest reports. North Macedonia is the only exception. In 2023 Q4, the economic growth pace slowed to 0.9%, from 1.1% a quarter earlier. The sharp fall in investments provided the main impact on this performance. The economy in Kosovo expanded by 4.0% in 2023 Q4, from 3.0% a quarter earlier. The growth pace of GDP in Serbia accelerated to 3.8% in 2023 Q4 from 3.6% in the previous quarter.

Inflation has continued trending downward across most regional countries in 2024 Q1. North Macedonia and Greece are an exception, as annual inflation rates went up in the first quarter of 2024, and Kosovo, where they have remained unchanged. Pressures from core inflation remain at relatively high levels, supported by tight labour markets and historically low unemployment rates.

The latest projections[4] show inflation rate to slow further in 2024 and 2025, while economic activity is expected to grow at a faster pace in this period.

Table 1 Economic indicators for main trading partner countries

	Annual change of GDP p.p		Annual inflation (%)		Unemployment (%)
	2023Q3	2023Q4	2023M12	2024M03	Latest publication
Italy	0.5	0.6	3.7	3.4	7.5
Greece	2.1	1.2	0.5	1.3	11.0
Kosovo	3.0	4.0	2.3	2.3	11.5
North Macedonia	1.0	0.9	3.6	4.0	13.0
Serbia	3.6	3.8	7.6	5.0	9.1
Albania	3.8	3.8	4.0	2.3	10.7

Source: Respective statistical institutes.

2 *The ECB staff projections show economic growth is expected to be 0.6% in 2024, and to strengthen to 1.5% in 2025. Average inflation is expected around 2.3% in 2024 and 2.0% in 2025 (Source: ECB staff macroeconomic projections, March 2024).*

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

4 *"World Economic Outlook", IMF, April 2024.*

2.2. COMMODITY PRICES IN GLOBAL MARKETS

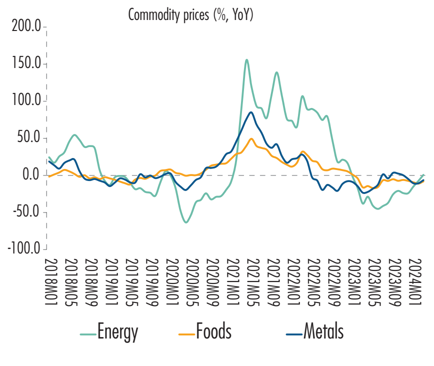
Commodity price index[5] maintained a downward trend in 2024 Q1 as well, diminishing by around 6.9% in annual level, as food and metal prices fell. The Brent oil price was quoted around the average level of USD 85.4/barrel in this quarter, with an annual increase of around 9%. This performance has reflected the geopolitical tensions in Middle East and uncertainties in maritime transportation across this region, as this effect has resulted sharper than the fall in the demand in advanced countries[6].

The fall in commodity prices in global markets has affected the decline in inflation rate in advanced and developing economies. In 2024 Q1, the food price index fell by around 9.5% in annual level, accelerating the pace compared to the last quarter of 2023. The performance of this index has reflected both the lower demand from advanced and developing countries, as well as the reduction of supply-side issues. On the other hand, the annual declining pace in the price index of energy goods slowed to 6.9%, from 22.8% in the previous quarter, reflecting the drop in electricity prices and the increase in oil prices.

Uncertainties about the performance of commodity prices remain heightened. Low demand from advanced countries is expected to continue to provide a downward impact on the performance of commodity prices. On the other hand, supply-side factors - such as climate change, geopolitical tensions, and difficulties on shipping in the Red Sea area - are expected to exert upside pressures.

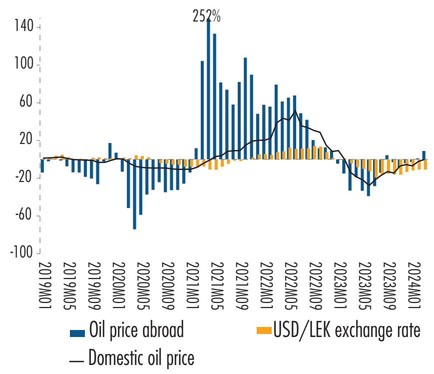
Chart 3

Commodity prices across international markets have contracted in annual level



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

Exchange rate strengthening has mitigated the increase pass-through to the interbank market



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

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

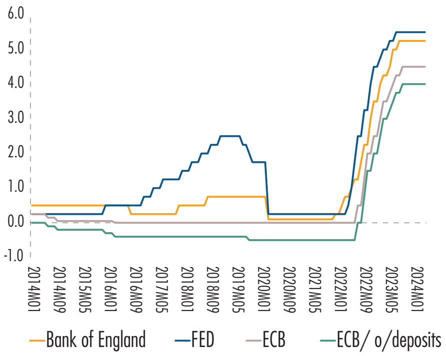
2.3. INTEREST RATES

Financing conditions in international markets are tight. They reflect the high policy rates, in response to inflation rates still above the targets of the main central banks. The latter have stopped increasing interest rates since September 2023 and have signalled the maintenance of current levels, until stable inflationary pressures are deemed consistent with the achievement of the respective objectives. Yields on 2-year government securities have risen somewhat in 2024 Q1, reflecting market uncertainty about the timing of the initiation of a change of the monetary policy stance. The tight financing conditions have been transmitted to the slowing of aggregate demand.

Tight labour markets and continued wage growth in the private sector are a key source of persistent inflationary pressures. The latest data shows that unemployment rates remain at low levels and that employment has grown at a healthy pace. However, aggregate demand in most advanced countries has been weak and core inflation has continued coming down. All main central banks - through factoring this macroeconomic information - have decided to keep their policy rates unchanged in recent meetings.

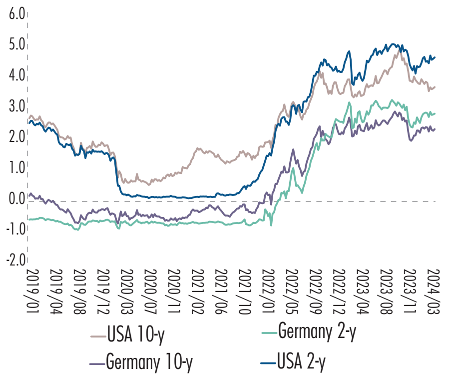
Chart 4

Policy rates have remained unchanged since September 2023.



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

2-Year yields have experienced a slight increase.



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

Thus, Bank of England and Federal Reserve, in the meetings of March, and the European Central Bank, in the meeting of April, kept the respective policy rates unchanged. These rates are 5.25%, 5.25%-5.50% and 4.50%. All these banks have communicated that the overall increase pass-through of interest rates, which in turn is affecting the economic activity and the return of inflation to the relevant target. The continuing convergence of inflation to the target in an uninterrupted manner will trigger a revision of the monetary policy stance. The consensus of markets suggest that the monetary policy will change stance within 2024.

3. FINANCIAL MARKETS AND LENDING CONDITIONS

In 2024 Q1, financial market was calm, characterised by low interest rates and contained risk premiums. Yields in the primary market on government securities fluctuated at stable levels, after reflecting the last increase in the policy rate in November 2023. Interest rates on loans have continued to rise across the main segments, but they remain low compared to the levels dictated by the normalising cycle of monetary policy, as a result of the reduction in both risk premiums and intermediation margin.

Lek exchange rate was relatively stable in the first two months of the quarter, but it started to strengthen in the second half of March, due to the growth in foreign currency inflows from tourism.

Banking sector has maintained favourable financing conditions and has increased lending, in all categories, in reflection of the private sector's demand picking up. The acceleration pace of credit growth was more pronounced in the segment of lek-denominated loans and in those to enterprises. In parallel with credit growth, enterprises have used also the accumulated liquidities to support the increased activity, which has affected the reduction of growth pace in their deposits, while households' deposits have continued to pick up at a stable pace.

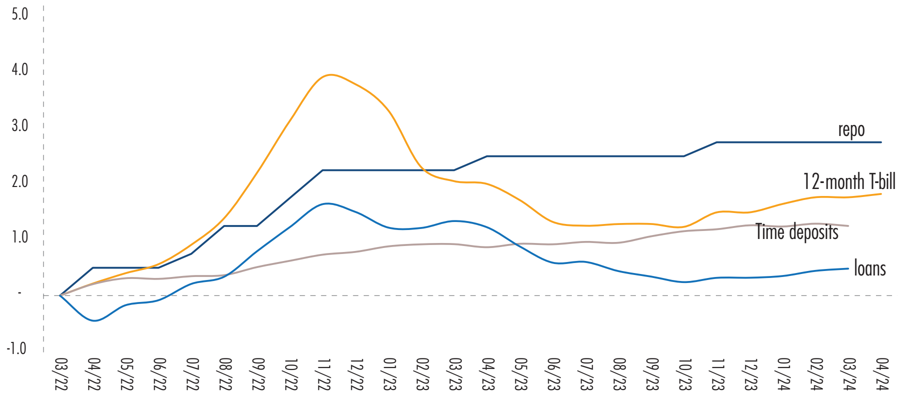
3.1. DOMESTIC FINANCIAL MARKET[7]

The last increase in the policy rate in November 2023 has been transmitted in the financial market, but the level of interest rates in this market still remains accommodative, reflecting low risk premia and enhanced competition. Yields on government securities continue to remain historically low against repo, as a result of faster growth in demand to supply ratio as well as reduced interest rate risk premia. At the same time, interest rates on deposits have restrained their growth, given the good liquidity situation in banks. The low levels of costs of deposits, yields and of perceived credit risk premia have driven to a slow increase in credit interest rate.

[7] *The following analysis is based on the data available up to 24 January 2024.*

Chart 5

The last increase in policy rate is reflected in the interest rates in financial market, but the low perceived risk premia from market yet dictate narrow spreads between them

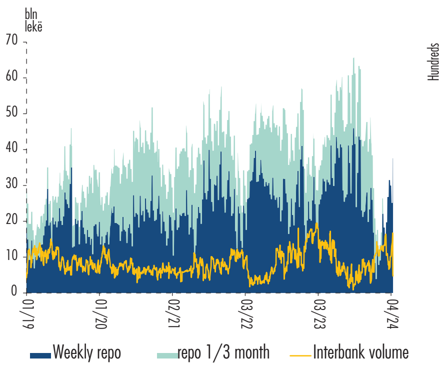


Note: Cumulative changes of interest rates in lek since March 2022: repo, 12-month T-Bills, time deposits and loans.
Source: Bank of Albania.

Interest rates in interbank market remain anchored close to the policy rate. They continue to be characterized by minimum spreads with the policy rate, being fully in line with the monetary policy signals. Similarly, the volatility indicators[8] remain at low levels, while market liquidity risk premiums remain at minimum levels. The Bank of Albania has continued to regularly inject liquidity in the market, through its main instrument, the one-week repo. The amount injected in the first quarter was lower than in the previous quarter, in line with market needs, but the liquidity level has been adequate for the transmission of monetary policy signals in the money market.

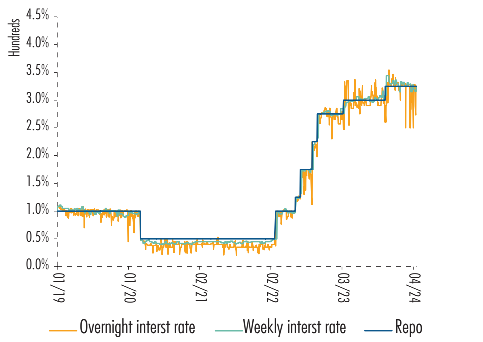
Chart 6

Liquidity situation in banks appears calm over the first months of year



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

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



Note: Performance of interest rates in the interbank market, in addition to the policy rate and overnight deposit and loan rates.
Source: Bank of Albania.

[8] The standard deviation of the daily interest rates in the interbank market in 2024 Q1 was 0.19 and 0.06 from 0.23 and 0.15 in the last quarter.

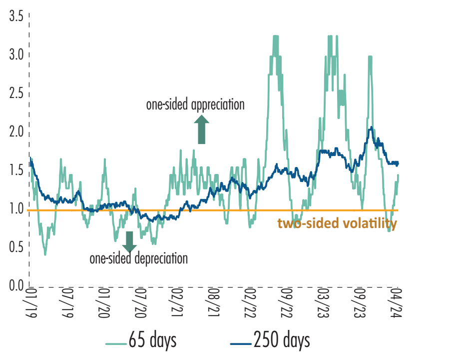
The exchange rate has appeared stable in the first two months of the year, while the appreciation pressures on the domestic currency have reappeared, starting from the second half of March. The EUR/ALL exchange rate averaged 103.9 in January and February, from 102.8 in December[9]. After fluctuating around this level in the first half of March, the exchange rate began to decline in the following weeks. In April, it averaged ALL 101.5.

Chart 7

Lek appreciation reappeared in the second half of March

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

Appreciating pressures reduced in the first quarter of 2024 and turned intensified in April



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

This appreciation is in line with the seasonal behaviour of the exchange rate, but the appreciation observed in the first four months of 2024 was lower than that recorded in the same period in the previous year[10]. The annual change in EUR/ALL exchange rate has moderated in the first months of 2024, down at 9.7% in April, from 10.6% in December 2023.

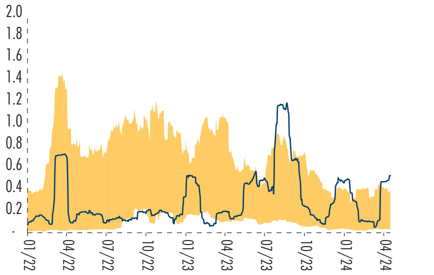
Situation in the foreign exchange market has been, overall, calm over the first four months of the year. Trading volumes have continued to remain high and **bid/ask** spread have resulted, overall, within their normal range. However, the lek appreciation during the last weeks has been accompanied by episodes of heightened quotation **spreads** and volatility in the market, proving that the sensitivity of market agents to exchange rate volatilities remains high.

[9] 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 of this indicator near 1 indicates an equal number of cases of appreciation and depreciation and it shows that there are no one-sided pressures for appreciation or depreciation. 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).

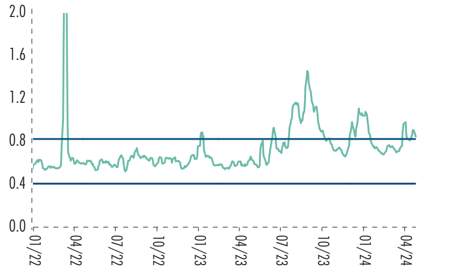
[10] Lek appreciation in April 2024 against December 2023 is 1.3%. In the same period a year earlier was 2.2%.

Chart 8

The EUR/ALL exchange rate volatility was contained in the first quarter...



...and the quote spread has mostly been within the average range



Notes: The EUR/ALL exchange rate volatility, measured as a 22-day standard deviation, where the interval for the region is determined by the volatility of the exchange rates against the euro for the currencies of the Czech Republic, Hungary, Poland and Romania.
Source: Bank of Albania and respective central banks.

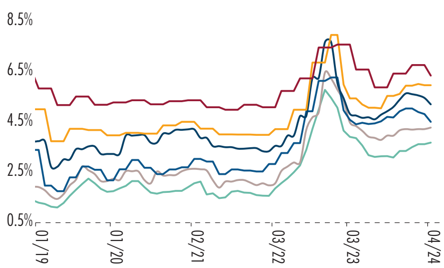
Notes: The spread between the quotations of the bid/ask price of euro, 5-daily moving average. The interval is calculated as an average +/- standard deviation.
Source: Bank of Albania.

The performance of lek exchange rate against the **US dollar** has reflected both the strengthening of the US dollar against the euro in the international market and the euro weakening in the domestic market. USD/ALL exchange rate appeared, overall, stable in 2024 Q1, fluctuating close to an average of ALL/USD 95.7. In April, the strengthening of lek resulted in an average exchange rate of ALL 94.6 against the US dollar. The annual appreciation of the lek against the US dollar has been decreasing during these months, standing at 7.6% in April, from 13.2% at the end of last year.

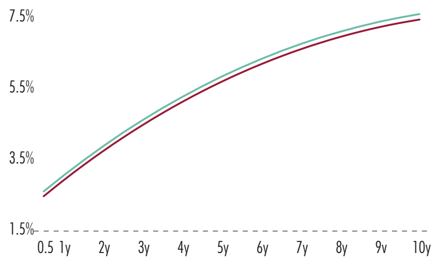
Yields on T-bills and bonds increased in 2024 Q1, reflecting the rise in the policy rate in November 2023. Once fully reflecting the signals of monetary policy, they changed at minimum levels during this period, while their spread with the policy rate remains low.

Chart 9

Yields in primary market went up in the first quarter compared to the previous quarter, reflecting the increase in the policy rate



The yield curve has shifted up by the size of the policy rate increase, but its slope has not changed



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

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

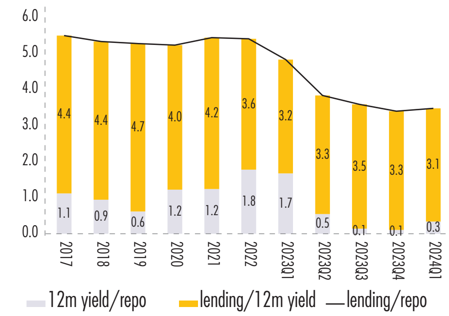
The average yield on 12-month T-bills was 3.6% in 2024 Q1, from 3.3% in 2023 Q4, upward in line with the latest change of the policy rate. Also, yields on bonds have shown similar performance to the 12-month T-bills, leaving the slope of the yield curve flat. Meanwhile, in April, changes were recorded in the downside in the yields on 3-, 5- and 10-year bonds, with an average of 0.3 p.p. This movement suggests the moderation of both risk premia and inflation, reflecting developments related to inflation in the beginning of this year and the expected stance by the market of monetary policy.

3.2. LENDING CONDITIONS

Interest rates in the main credit segments have increased in recent months, reflecting the rise in the policy rate in November 2023. However, their level remains low. The low yield spreads to the policy rate and the lack of pressures to increase interest rates on deposits interest have driven to a contained increase in interest rates on loans. Alongside these factors, their margins to yields have narrowed, as a result of the high competition between banks and the reduction in credit risk premia. The decline of the latter reflects the good performance of the economy, the sound balance sheets of economic agents and the non-performing loans ratio at minimum levels in the balance sheets of banks.

Chart 10

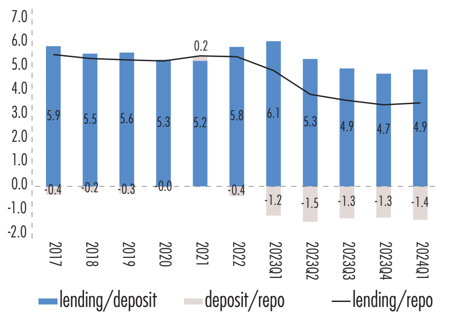
Low interest rates on loans reflect the tight bills-to-repo margins and the reduced credit risk premia...



Note: The data show the interest spread of new loans in lek against the repo decomposed into two components: the spread between the interest rate on loans and the 12-month T-bill and the spread between the 12-month T bill and repo.

Source: Bank of Albania.

...as well as the slightly declining brokerage margin and slow growth in interest rates on deposits



Note: The data show the interest difference of the new loans in lek against the repo decomposed into two components: the brokerage margin, expressed as the spread between the interest on new loans in lek and the interest of time deposits in lek, and the spread between the interest of deposits in lek and repo.

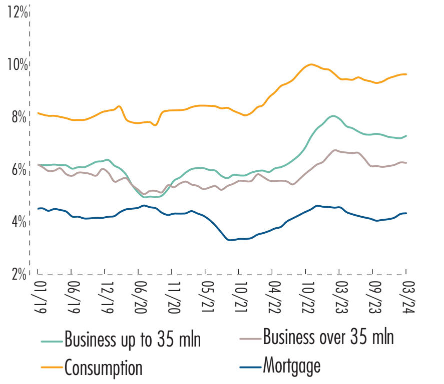
Source: Bank of Albania.

The average interest rate **on new loans in lek to enterprises** was 6.6%, recording a marginal increase from the fourth quarter of 2023. The rise in interest rates on loans to enterprises in this quarter was observed mainly in small loans (amount up to ALL 35 million), which are granted to small and medium-sized enterprises, and less in large loans. Since the beginning of the monetary policy normalisation cycle, the interest rate on loans to enterprises has increased by

1.0 p.p. The average interest rate on **mortgage loans** to households was 4.3% in this quarter, higher from 4.0% in the previous quarter. While, the interest rate on **consumer loans** stood almost flat from the previous quarter, at 9.7%. These interest rates have increased by 0.8 p.p. and 1.4 p.p., respectively, against their average levels before the increase in the policy rate (year 2021).

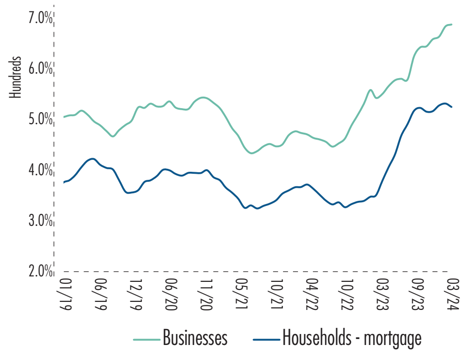
Chart 11

The interest rates in main segments of loans in lek have continued to increase marginally.



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

The interest rates on loans in euro continue to increase.

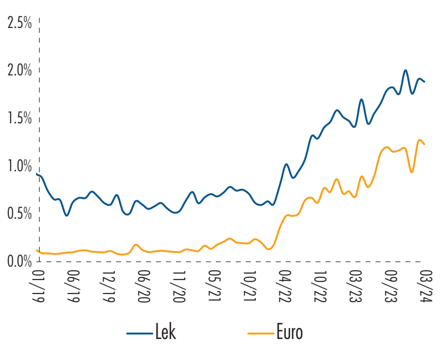


Note: Interest rates of new loans in euro as 6-months moving average.
Source: Bank of Albania.

In 2024 Q1, **the interest rates on new loans in euro** to enterprises increased further, at 7.0%, from 6.8% in 2023 Q4 and 5.4% in the previous year. Similarly, interest rate on loans to **households for house purchase** continued edging up, at 5.5%, from 5.0% in the last quarter of last year and from 3.6% a year earlier.

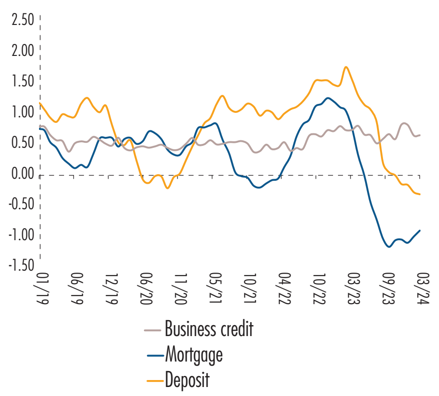
Chart 12

Interest rates on time deposits, in both lek and euro, have remained stable



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 is in negative territory for loans and remains at low levels for deposits



Note: The spread between the interest rates in lek and those in euro, in percentage points.
Source: Bank of Albania.

The slower increase of interests on loans in euro compared to loans in lek has led to negative spreads between them. This phenomenon was first observed in mortgage loans in the second quarter of last year, and then in loans to enterprises in the fourth quarter. In the first quarter of 2024, interest rates on loans in lek are around 0.3 p.p. and 0.9 p.p. lower compared to interest in euro to enterprises and on mortgage loans to households. This development has increasingly oriented the demand for loans in domestic currency, reducing the risk of loans exposed to exchange rate fluctuations and expanding the sphere of monetary policy impact.

Interests on time deposits continue to remain at low levels The average interest rate on **new time deposits in lek** was 1.9% in 2024 Q1, maintaining the average level recorded in the previous quarter. The interest rate on time deposits up to one year continued to increase gradually. Meanwhile, for the first time, since the start of normalisation cycle of monetary policy, the interest rate on deposits with higher maturity term declined in this quarter. The average interest rate on new **time deposits in euro** also remained virtually flat, at 1.1%, in this quarter. Signals for a decline of interest rates on deposits with long maturity terms are also noted in euro-denominated deposits, in reflection of market expectations for key rates remaining unchanged in the future. The difference of the interest rates on lek loans to euro loans remained stable close to the average levels of last year, of 0.7 p.p.

BOX 1: SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2024 Q1[1]

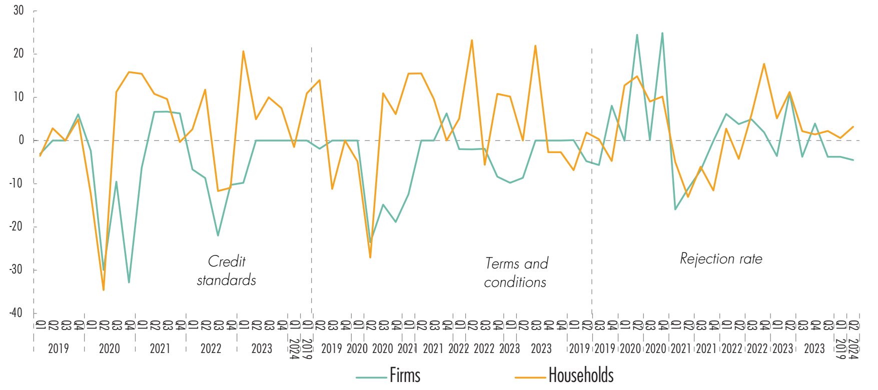
Supply conditions did not change much during 2024 Q1. Banks continue to perceive a positive perspective of the domestic economy. Such consideration factors the sound financial balances of enterprises operating in the country. The high demand for loans from economic agents has been accommodated by the banking system, in the conditions of a high competition in the market, also supported by optimism regarding the liquidity levels owned by the borrowers.

The approach of commercial banks towards lending to enterprises during the first quarter did not show significant changes from the previous quarter. Lending standards did not change in both, loans for financing investments and those for financing working capital. Likewise, terms and conditions on new loans to enterprises remained the same, after tightening for six consecutive quarters. Banks did not hesitate to reduce the margins on average loans, especially on loans to large enterprises, while they increased the margins on riskier loans. Although, banks continue to remain cautious in assessing risk, the loan rejection rate to enterprises fell in this quarter, driven by the amount of liquidity and sound balance sheets that enterprises currently have.

Supply conditions on loans to households were fragmented in this quarter, expressed in eased conditions for consumer loans and tightened conditions for house purchase loans. The current and expected developments in the housing market are considered by some banks as a key factor for the tightening of terms *of conditions on loans to households in this quarter. Banks somewhat tightened the price elements, through the application of higher margins, especially on loans to households for the purpose of house purchase. On the other hand, they have accommodated the loan demands of households in financing consumption, by increasing the loan size, applying lower margins and reducing commissions. The loan approval ratio to total loan applications was higher in this quarter, driven by banks' perception of households' solvency and credit history.*

Chart 1 Box 1

Loan supply conditions remained almost unchanged compared to the previous quarter.

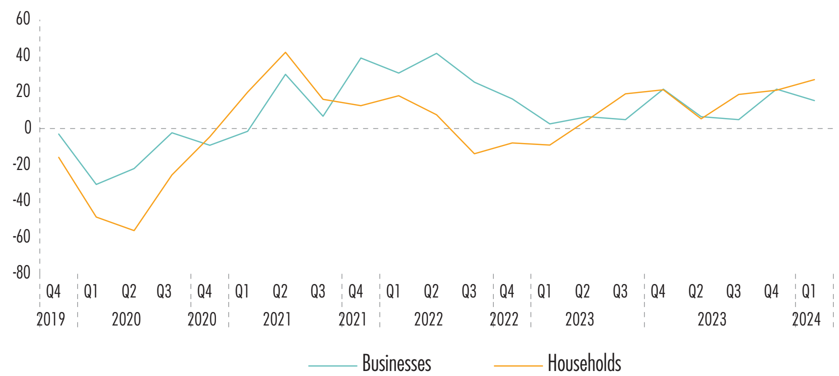


Notes: Values on the chart represent net balances. Positive values indicate easing of terms and conditions and vice versa. Positive values indicate increase of the scale of application refusal and vice-versa.
Source: Bank of Albania.

In line with banks' expectations, loan demand was high in all sizes of enterprises and for all types of loans by purpose of use. Enterprises, mainly large ones, increased their demand for loans in a situation of enhanced confidence and pressure from elevated needs for financing investments and working capital. Loan demand from enterprises continues to be high, after more than two years, supported by both, loans to cover short-term liquidity needs, and loans for the financing of investments.

Chart 2 Box 1

Loan demand was high in all segments.



Notes: Values on the chart are calculated as net percentage. Positive values indicate increase of loan demand and vice versa.
Source: Bank of Albania.

On the other hand, increased demand for loans was also reported in the households segment, for the third consecutive quarter. The factors that supported these developments were related to their increased needs for consumption and house purchase financings, as well as the reduced uncertainties and interest rate fluctuations in the domestic and foreign markets.

[I] The analysis is based on Bank Lending Survey, conducted on quarterly bases and is published at: www.bankofalbania.org

3.3. CREDIT TO THE PRIVATE SECTOR[11]

Bank financing to the private sector has significantly increased in 2024 Q1, reflecting both the high demand for financing from economic agents and the accommodative supply conditions. Credit to the private sector grew by 11.6% on average in the first quarter, or 3 p.p higher compared with the end of 2023. The quarterly growth by ALL 21 billion was the highest historical for this quarter, which is generally characterized by a slow seasonal performance. The expansion of the loan portfolio for the private sector was mainly in lek; the annual growth of this portfolio accelerated averagely 19.2%. This positive performance was supported by the continuation of lek financing trend for enterprises, backed up, by lower relative costs. Foreign currency lending continued to slow down and its growth rates of 31% is slightly lower than in the end of 2023. In reflection of these developments, the share of loans in the national currency increased by 7.7 p.p, to the total, reaching 57.2%.

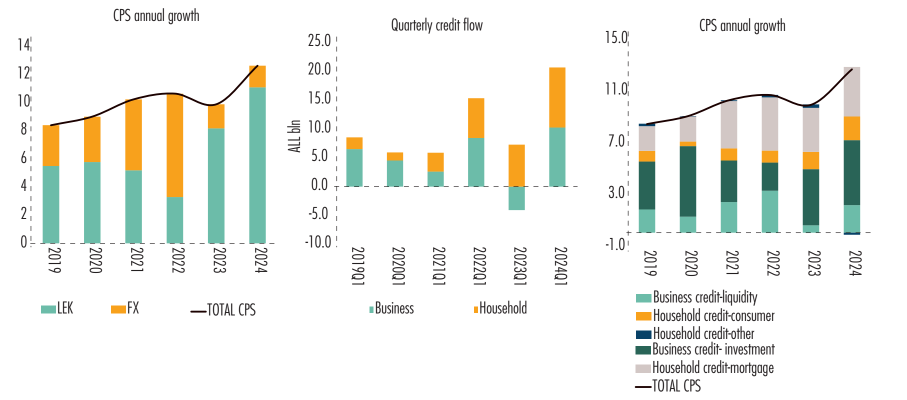
Credit expansion has been faster in the segment of enterprises, supported by a high demand for all categories. The annual growth of this portfolio by averagely 10.3% was about two times higher than the average of 2023. This rapid increase, mainly in lek, has helped to finance the liquidity and investment needs of enterprises. Loans for working capital grew annually by 6%, while loans for investments grew by about 13.5% y-o-y.

Banks continued to finance households at a steady pace. In the first quarter of 2024, the annual loan growth rate for this category averaged 13.5% - a similar rate to last year's average. Contrary to the previous year, loan for consumption, mainly in lek, improved this quarter. The mortgage loan segment, recorded an average growth of 15%, similar to last year's average growth, despite banks signalling tightening standards in this segment.

[11] 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 rates and written-off loans of balance sheets.

Chart 13

The expansion of credit to the private sector has accelerated, affected by the improvement of credit growth in lek and from the sharp growth of loans to enterprises



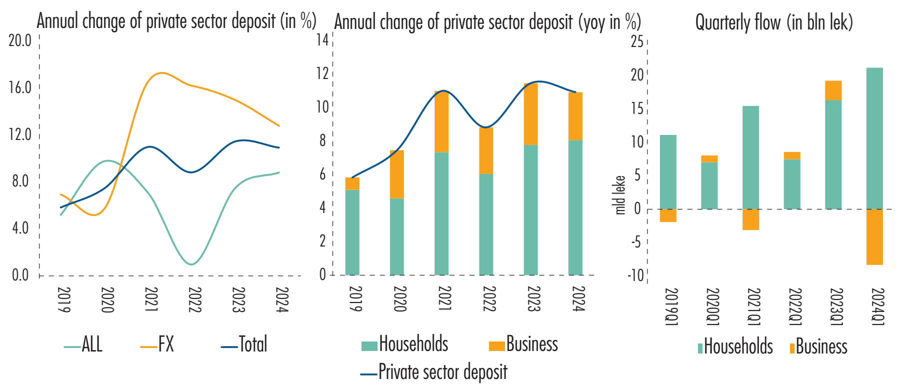
Notes: The data show the annual changes (in %) of credit adjusted for exchange rate effects and written-off loans from the balance sheets.
Source: Bank of Albania.

Banking sector has had stable fund sources, reflecting the high liquidity in the economy and the strengthening of relationships with banks. The deposits of the private sector recoded an annual growth by 11.4%, slightly higher compared with the rate of the previous quarter. This performance has reflected higher growth rates of deposits in lek - by 9.0% - which have compensated for the slowdown in the growth rates of deposits in foreign currency (13.5%). The latter mostly reflected the use of deposits in foreign currency by enterprises to support private investments and the positive macroeconomic perspective. As a result, the structure of total deposits by currency, has shown a decrease by 1.3 p.p of foreign currency deposits ratio to total deposits compared to the previous year at 52.9%.

Households' deposits continue to grow at stable rates and confirm a positive trend since September 2023, reflecting the growth in economic activity and the continuous improvement of employment. Households' deposits recorded an

Chart 14

Deposits have shown steadily growth rates supported by the good performance of deposits for households, mainly in lek



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

average annual growth of 10% in 2024 Q1, compared to 8.5% in the previous quarter and 7.5% the previous year. At the same time, the annual growth of enterprises' deposits showed a slowing trend throughout the quarter, to 15% in March 2024, reflecting the use of accumulated liquidity of enterprises.

4. ECONOMIC GROWTH

The economy recorded an annual growth of 3.8% in 2023 Q4, at a similar rate with the previous quarter. Economic growth in 2023 reached 3.4%. Both domestic demand and foreign demand underpinned this growth. The main contributions to this growth from the domestic demand, have come from public consumption, followed by private consumption and investments. The positive contributions from foreign demand were determined by the good performance of the export of services, reflecting the expansion of tourism activity. On the other hand, exports of goods have continued to decrease. This was reflected in the increaed contraction of processing industry.

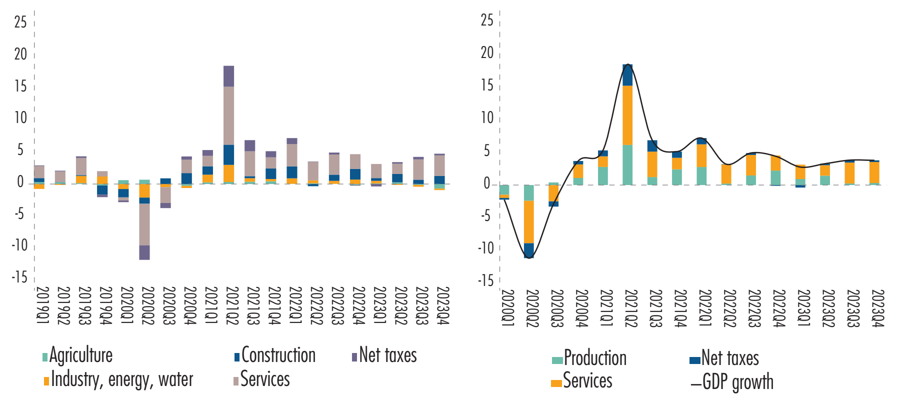
From macroeconomic perspective, the expansion of aggregate demand has reflected the sound financial balance sheets, improved confidence in the economy, accommodative financial conditions and increased foreign demand for services. These factors are expected to contribute in the expansion of economic activity during 2024 as well.

4.1. GROSS DOMESTIC PRODUCT

GDP grew by 3.8% in 2023 Q4, at a similar rate with the previous quarter[12]. The main contributions came from the branches of services, such as "Public administration, education and health", "Professional and administrative activities" and "Real estate" (Chart 15, right), as well as from the "Construction" activity. On the other hand, "Agriculture" and "Industry" continued negatively contribute to the economic growth (Chart 15, left).

Chart 15

The branches of services and construction supported the economic growth | *Contributions were plentiful from the services sector and quite low from production*



Source: INSTAT and Bank of Albania. | *Source: INSTAT and Bank of Albania.*

[12] In 2023 Q3, the economic growth was revised to 3.8%, from 3.5% by INSTAT

The production sector contributed by 0.3 percentage points to the economic growth in 2023 Q4. The "Construction" activity accelerated its growth rate (10.8%) compared to that of the previous quarter and, therefore, its contribution to the economic growth this quarter expanded by 0.6 percentage points. On the other hand, the performance of "Agriculture" and "Industry" sectors continued to be negative, as in the previous quarter. The negative contribution of the agriculture sector deepened to -0.7 percentage points, from -0.1 percentage point in the previous quarter. Simultaneously, the negative and broad-based contributions came from "Processing industry", compensated only partially by the increase in the activity in the "Extracting industry" and "Electricity" branches.

The services sector contributed by 3.8 percentage points to the economic growth in 2023 Q4. The main contributing sub-branches were: "Public administration, defence, education, health", "Professional and administrative activities" and "Real estate", while positive, albeit moderate contributions also came from other branches of services.

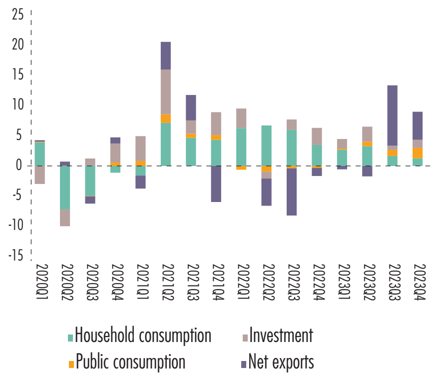
4.2. AGGREGATE DEMAND

Economic growth of 2023 Q4, was supported by both the domestic demand and foreign demand, with relatively similar contributions (Chart 16). The main contributions of the domestic demand came from the public consumption, which also accelerated its growth rates. In parallel, total investments recorded a positive contribution and acceleration of its growth pace, driven to the largest extend by the expansion of public investments. Finally, private consumption also contributed positively, but at a slower pace, compared to the third quarter and the first half of 2023.

Positive contributions from foreign demand originated from the growth in the export of services. Their expansion was driven by the increase in tourism export. On the other hand, the contribution from the export of goods remains in a negative territory, but more moderate compared to the second and third quarters of 2023

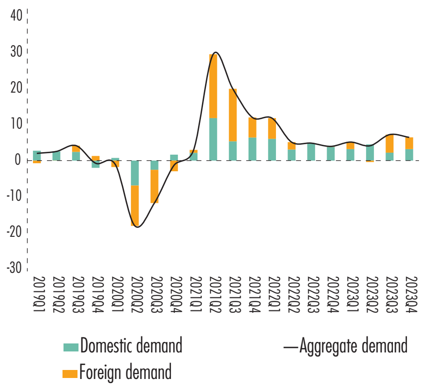
Chart 16

Both, domestic demand and foreign demand have simultaneously supported the economic growth



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

Domestic demand and foreign demand have provided almost similar contributions



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

Domestic demand expanded by 4.1% in in 2023 Q4, a higher rate than the previous quarter (3.1%). The acceleration of the growth rate was affected by public consumption and investments. Thus, public consumption recorded an annual growth of 16.1%, from 9.9% in the previous quarter, and investment growth climbed to 5.2% from 3.0% the previous quarter. The expansion of investments during the fourth quarter was mainly impacted by the accelerated growth rates of public investments.

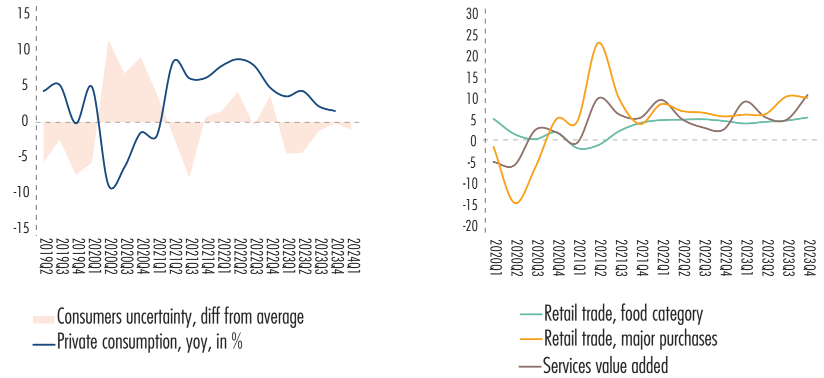
Private consumption grew by 1.6% in Q4, recording a slower growth compared to the previous quarter (Chart 17, left). Based on the performance of the indirect indicators available, consumption growth was reflected in both the goods and services category (Chart 17, right). The retail trade index for food items and major purchases recorded a real accelerated increase in the fourth quarter. Also, the indirect indicators on service expenditures suggest a continuation of their upward trend[13].

From the macroeconomic perspective, the surge in private consumption was supported by the rise in wages and remittances; increase of consumer credit, and enhanced consumer confidence in the fourth quarter. These factors are expected to have underpinned the growth of consumption in the first quarter of 2024 as well. This analysis is also supported by the positive performance of indirect quantitative and qualitative indicators available for this quarter.

Chart 17

Private consumption decelerated in Q4

Positive contributions from all three categories of private consumption



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: Indicators are stated in annual changes, in %
Source: INSTAT and Bank of Albania.

The growth pace of total investments accelerated to 5.2% in Q4, against the 3.0% recorded in Q3 (Chart 18). Investment growth was supported almost entirely by the expansion of public investments.[14] Indirect data suggest that the

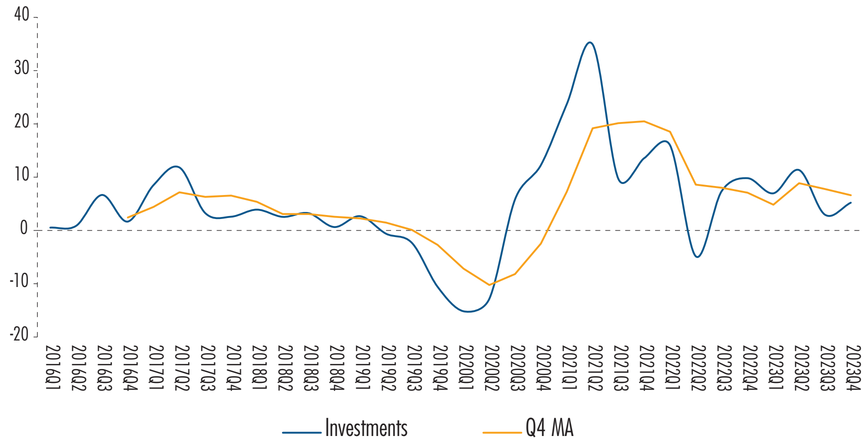
[13] *The analysis for the consumption of services is based on the indirect indicator of the increase in the value added in the services sector, according to the GDP with the production method.*

[14] *INSTAT does not publish disaggregated investments by type. The analysis on the performance of private and public investments and investments by category is based on internal assessments, which are conducted using the indirect indicators available.*

main contribution to the expansion of investments was made by investments in construction, while investments in machinery and equipment also contributed positively but to a lower extent. The expansion of public investments reflected the concentration of government expenditure in this period, while the expansion of private investments continues to be supported by: the high utilization rate of production capacities; the good financial situation of enterprises; and the accommodative financial conditions (Chart 19, left).

Chart 18

Total investment grew in Q4

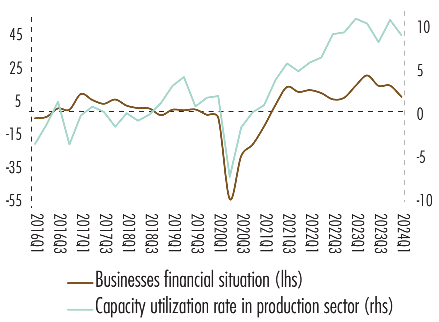


Source: INSTAT and Bank of Albania.

The available indicators for investments in the first quarter, suggest that investments will continue to grow. The capacity utilization rate of businesses and their financial situation continue to record high values even in the first quarter, remaining above the respective historical averages (Chart 19, left). Also, data from foreign trade in goods shows higher growth in the imports of machinery and equipment. Credit for investments expanded rapidly during 2024 Q1 (Chart 19, right).

Chart 19

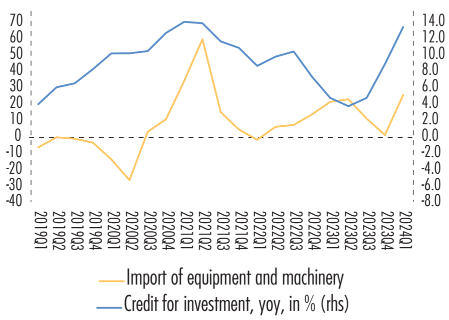
Capacity utilization rate and the financial situation of businesses stand above the long-term average



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.

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



Notes: Indicators are annual changes in percentage.

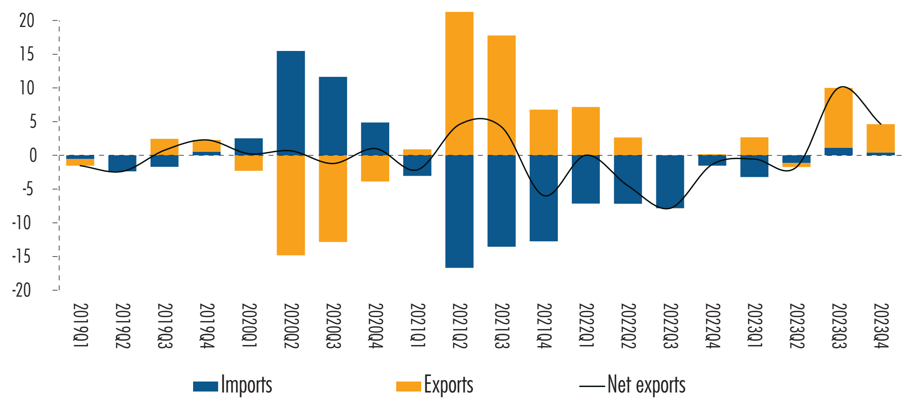
Source: INSTAT and Bank of Albania.

Real net exports of goods and services continued to positively contribute to the growth even during 2023 Q4 (Chart 20). Exports of goods and services increased by 15.1%, influenced by the growth of 22.8% in the export of services. The latter are closely related to the high tourist inflows. On the other hand, exports of goods continued to shrink. In the fourth quarter, export of goods decreased 3.8%. This decline rate appears slower compared to the previous three quarters of 2023 (-20.5%).

Real imports of goods and services decreased by 0.9% in the fourth quarter of previous year. This decrease reflected the contraction by 9.4% of the import of goods, while the import of services expanded by 23.8%, affected by tourism outflows services.

Chart 20

Net exports continued the positive contribution to economic growth in 2023 Q4



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

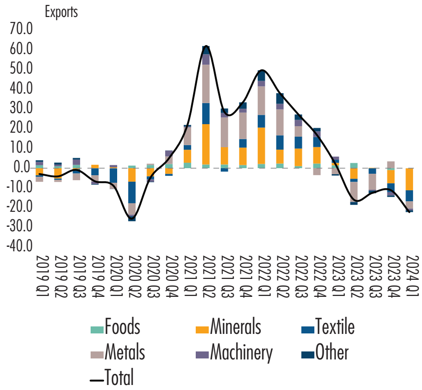
The data on the trade of goods in value for 2024 Q1 indicate a further decrease in exports and a slight increase in imports. This combination has driven the trade deficit expanding at 32.8%.

Exports of goods shrank by 22.3% during 2024 Q1 (Chart 21, left). The main negative contributors were: "Minerals, fuels, electricity" and "Textiles and shoes" branches, but all the other categories provided negative contributions as well. The decline of exports has mainly reflected the drop in prices and the effect of the appreciated exchange rate, but also the drop in exported quantities.

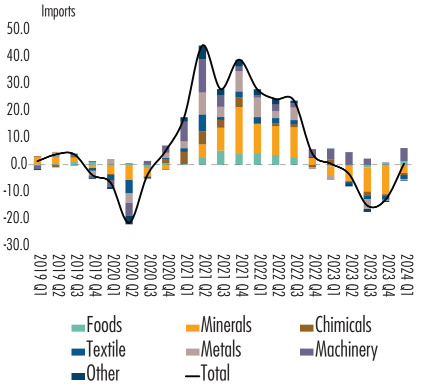
Imports of goods rose by 0.4% during 2024 Q1, discontinuing the downward trend of the past several quarters (Chart 21, right). The increase in imports was supported by the expansion of imported quantities, while prices have influenced in the opposite direction. The categories "Machinery, equipment and spare parts" and "Food, beverages and tobacco" provided positive contributions. The category "Minerals, fuels and energy" gave negative contributions.

Chart 21

The negative performance of exports continued for the fourth consecutive quarter



Imports have stopped their downward trend, shifting into the positive direction in 2024 Q1



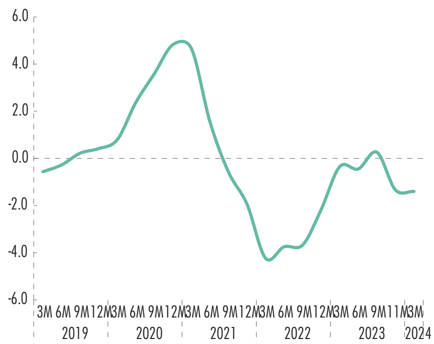
Source: INSTAT and Bank of Albania calculations.
Note: Contribution of the main categories in the goods market, in percentage points.

In 2024 the fiscal policy is designed to have a consolidating nature.

The fiscal impulse was negative at 1.4% of GDP, at the end of the first quarter, reflecting the high fiscal surplus throughout this period. The fiscal surplus, estimated at 6.2% of GDP in the first quarter of the year, was impacted by the faster growth of revenues as a ratio to expenditures, which reflected the rapid curbing of public investments during this period.

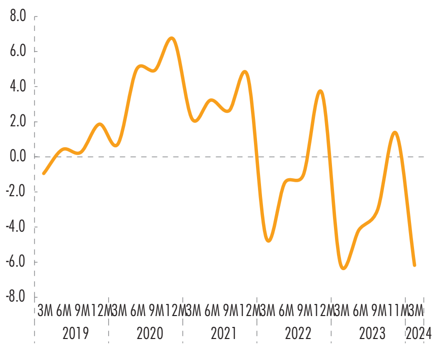
Chart 22

Fiscal impulse remained in negative territory



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.
Source: Ministry of Finance and calculations of MPD.

The fiscal surplus was relatively high

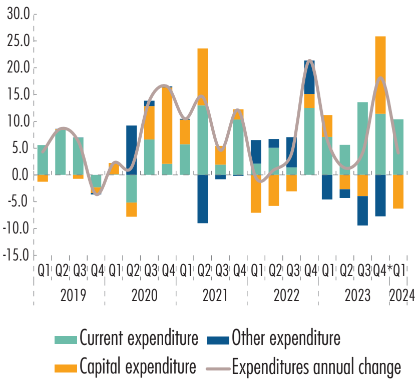


Notes: Budget deficit to GDP. Calculations are based on quarterly flows. Positive values show deficit, negative values show budget surplus.
Source: Ministry of Finance.

Public expenditure in the first quarter were around ALL 130 billion, up annually by 4.1%. Staff expenses, interest expenses on domestic debt and expenses on the pension scheme contributed positively to the expansion of the total. On the other hand, investment spending contributed negatively of 6.3 percentage points. The slowdown of expenditure for public investments appeared even stronger due to the seasonality that characterizes this item in the first quarter, reaching the lowest level within a quarter.

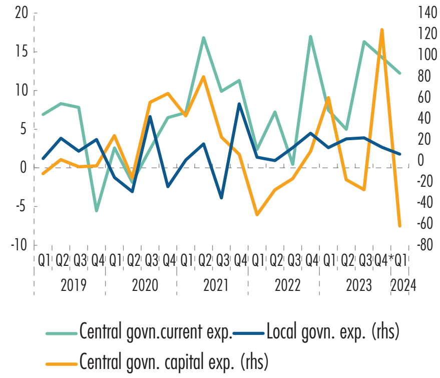
Chart 23

Expenditure grew at a contained pace....



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

...as a result of the contraction of public investments



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

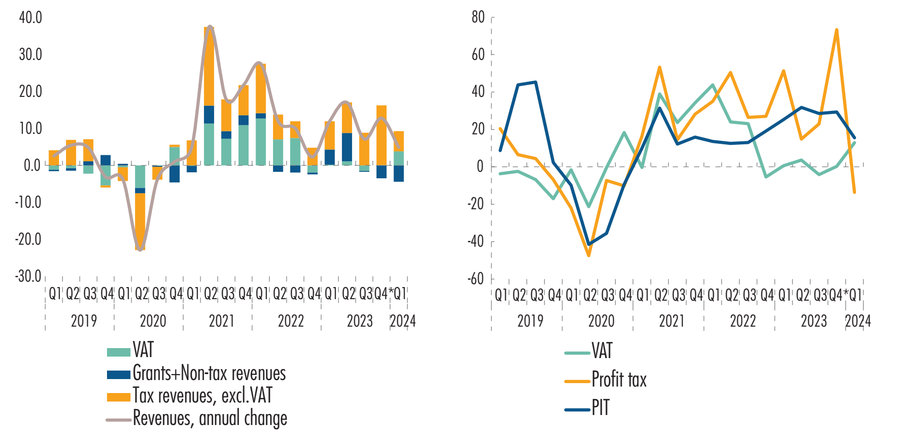
In 2024 Q1, **budget revenues** were around ALL 164 billion, annually increasing by 4.9%. The high revenue realisation rate recorded throughout 2023, averaging 12.4%, were restrained on the back of two factors. First, the revenues from grants recorded a negative contribution by 4.5 percentage points to the expansion of revenues, as a result of the high tranches granted a year ago by the European Commission in energy projects. Second the profit tax on companies recorded an annual decrease of 13.7%, contributing negatively to the expansion of total revenues by 1.9 percentage points. This item increased considerably during 2023, as a result of a special and temporary tax on companies involved in electricity trading.

VAT revenues on the imports of goods contributed positively, by 0.8 percentage points, to the increase of the total, for the first time after four quarters, reflecting the stabilization of the commodity prices in international markets and the stability shown by the domestic currency during the first quarter. On the other hand, VAT revenues on the production of goods and services in Albania contributed by around 2.9 percentage points to the expansion of the total, from an average of 2 percentage points throughout 2023[15]. Another item with a high positive impact on the expansion of the total was the income from social insurance, which contributed by around 3.5 percentage points, due to the high weight of this item in the total income, as well as in partial reflection of minimum wage increase in the second quarter of the previous year. Developments in revenues items in the first quarter give positive signals on labour market indicators, as well as on the production of goods and services in Albania.

[15] *VAT refunds during the first quarter were higher than the same period in the previous year.*

Chart 24

Revenues slowed down... | *...reflecting the baseline effect of the previous year*



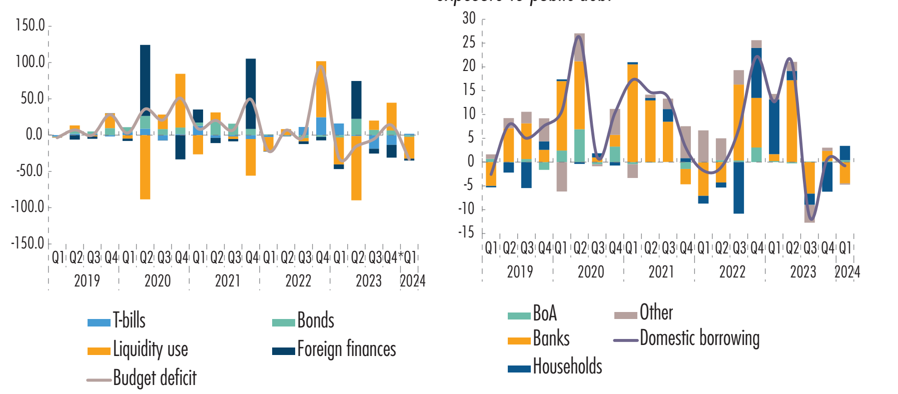
Notes: Composition of revenue growth by quarters.
Source: Ministry of Finance.

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

The budget balance in the first quarter marked a positive value of ALL 33 billion, estimated at 6.2% of GDP - the highest historical value recorded during a quarter. Net borrowing in the domestic market decreased by ALL 0.8 billion[16]. Borrowing in the form of bonds of all maturities decreased by ALL 2.5 billion, reflecting the high maturities of the 3- and 5-year benchmark securities. This has caused the banks' exposure to government debt financing to decrease in the first quarter, as a result of the high share (over 90%) owned by banks in the 3- and 5-year benchmark securities. The securities portfolio owned by households and other market actors (non-banks) increased by about ALL 3 billion. Net borrowing in foreign market, in the first three months of the year, was around ALL -2.6 billion, as a result of external debt repayment

Chart 25

Net borrowing in the domestic market contracted... | *... Followed by the decrease of the banking market exposure to public debt*



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

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

[16] *The initial plan of the Ministry of Finance showed a planned increase in domestic net borrowing by ALL 1.8 billion in the first quarter.*

at a greater extent compared to foreign currency inflows during the period. Developments in government borrowing along with fiscal surpluses values, have been factored into liquidity surpluses available to be used to finance expenses in the upcoming months.

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

In 2024 Q1, average inflation dropped to 2.7%, coming down beyond our expectations. This slowdown fully reflected the drop in inflation of unprocessed foods, as a result of the rapid fall in the prices of these products in trading partner countries. Meanwhile, pressures of domestic origin continued to reduce, at a gradual pace, giving the main contribution to headline inflation.

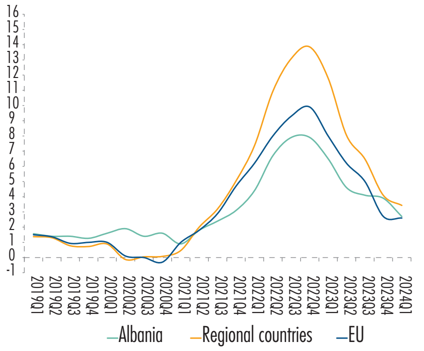
The inflation trend will reflect the positive supply-side shock from foreign food prices for the next several months. Furthermore, with their decrease, inflation performance is expected to return to the target, reflecting a more balanced performance of demand and supply, both in the market of goods and services and in the labour market, the full anchoring of inflation expectations at the target, as well as a smoother performance of imported inflationary pressures.

5.1. CONSUMER PRICES

Inflation decreased in the first quarter of the year, close to the average of 2.7% (Chart 26, left). Inflation rate decreased by 1.2 and 3.8 percentage points, respectively, compared to the previous quarter and the same period in the previous year. The fall in inflation during the first quarter mainly reflected the rapid decline in unprocessed foods' inflation, affected by the drop in prices in international markets, the appreciation of the exchange rate, as well as the presence of the effect of the high comparative base of the previous year. Inflation profile in Albania is similar to the one in both regional and the EU economies (Chart 26, right). On the other hand, the sharpest drop in inflation

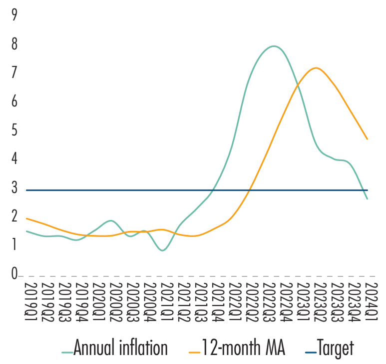
Chart 26

The slowdown in inflation continued at a higher pace compared to the end of the previous year



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

Food prices reduced the inflation rate in Albania and across the region



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

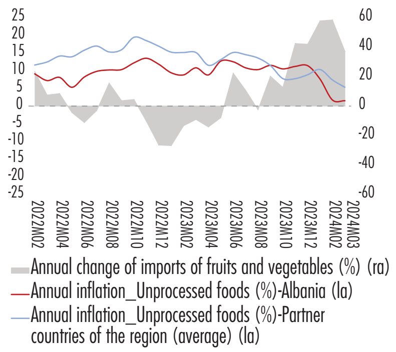
in Albania came as a result of the significantly higher share that food products have in Albania compared to EU countries. Meanwhile, due to the structure of consumption, fluctuations in oil prices in foreign markets contributed more to the increase of global inflation and less to inflation in the country.

The fall in inflation was almost entirely influenced by the sharp fall in the inflation contribution of **"Unprocessed Foods"** in 2024 Q1, decreasing from 2.1 to 0.9 percentage points. As a result, headline inflation reduced on average by 1.2 percentage points in this quarter compared to the previous quarter (table 2). This performance reflected the rapid decline in food inflation in the countries of the region and our main trading partners. This decline is quickly transmitted to the country, as a result of our high exposure to the import of fruits and vegetables (Chart 27).

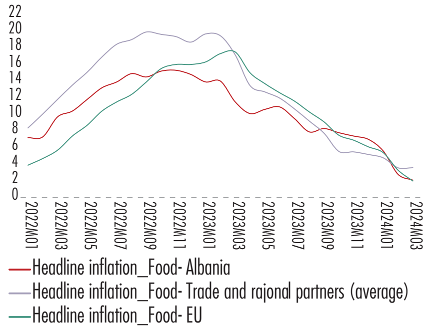
At the same time, the contribution from **"Processed foods"** on inflation fell by 0.1 percentage point, while the category "Non-food items" increased its contribution by 0.2 percentage points, as a result of the surge in fuel prices in foreign markets (Table 2).

Chart 27

Inflation of "Unprocessed Foods" also slowed down in the partner countries of the region, followed by an increase in the imports of fruits and vegetables



The rapid slowdown of inflation of the "Food" group in the country is in high convergence with that of the EU and partner countries across the region



Source: Eurostat - Harmonized Index of Consumer Prices by category (HICP); INSTAT and BoAs' calculations.
Note: The annual inflations of "Unprocessed Foods" and "Foods" are taken from Eurostat, based on HICP measurements for both Albania and other countries, in order to maintain comparability of measurement. Inflation for the region and partner countries are calculated as a simple average.

Prices of other more stable components of inflation, which include **services, housing and durable consumer goods**, contributed almost at the same extent as in the previous quarter to inflation. Also, the prices of services continue to remain high, due to the increased demand in the tourism sector and others related to it, as well as the increase in labour costs, the share of which is relatively significant in services (Table 2). The category of **goods and services with fixed prices** also experienced a slight expansion of the contribution, due to the increases in price indices of water supply sub-group and network maintenance payments[17].

[17] *Since January 2020, this sub-group had not increased.*

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

	Q3'22	Q4'22	Q1'23	Q2'23	Q3'23	Q4'23	Q1'24	Annual inflation 2024 Q1 (%)
Processed food	3.5	3.4	2.8	1.3	0.8	0.6	0.5	1.6
Bread and grains	0.6	0.6	0.6	0.2	0.1	0.1	0.1	1.4
Milk, cheese and eggs	1.0	1.2	1.3	0.8	0.6	0.5	0.3	4.7
Unprocessed foods	1.7	1.9	1.9	2.5	2.3	2.1	0.9	6.1
Fruits	0.0	0.1	0.1	0.4	0.3	0.3	0.1	2.6
Vegetables	0.6	0.8	0.7	1.1	1.3	1.3	0.5	8.2
Meat	1.0	1.0	1.0	0.9	0.7	0.4	0.2	4.1
Services	0.6	0.5	0.5	0.5	0.5	0.4	0.4	2.3
Goods with regulated prices	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6
Housing lease	0.3	0.4	0.4	0.4	0.4	0.4	0.4	3.6
Non-food consumer goods	1.5	1.2	0.4	-0.6	-0.4	-0.1	0.1	1.5
Fuel	1.3	0.9	0.0	-0.9	-0.6	-0.2	-0.1	-3.1
Durable consumer goods	0.3	0.4	0.5	0.5	0.4	0.4	0.4	3.9
Inflation (%)	7.9	7.9	6.5	4.6	4.1	3.9	2.7	2.7

Source: INSTAT and Bank of Albania's calculations.

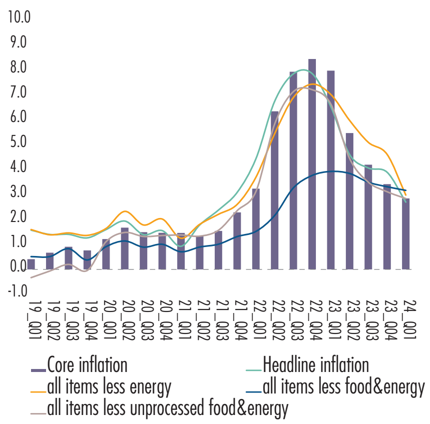
The breakdown of the item basket according to inflation rates shows that most of them have an inflation rate above 3% in 2024 Q1 (59%). However, this share has a tendency to drop below the average of the period 2022-2023 (Chart 28, left)[18], affecting the downward trajectory of total inflation.

Chart 28

The share of items with inflation of over 3% remained dominant this quarter as well

Source: INSTAT and Bank of Albania's estimations.

The decline in inflation has continued gradually even in some measurements of net inflation



Source: Bank of Albania.

The downward trend of inflation is reflected in the gradual decline of medium-term pressures on inflation (Chart 28, right). Among them, only the net inflation that excludes food and energy [19] recorded values similar to the previous quarter and remained above the level of total inflation and other net measurements. This confirms the presence of relatively stable domestic inflationary pressures, and isolated from short-term developments.

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

[19] This mainly includes durable services and consumer goods.

5.2. INFLATION DETERMINANTS

The rapid decline in inflation during the first quarter reflects the reduction in imported inflation, mainly in non-core basket items, as a result of the drop in international prices and the strong exchange rate. On the other hand, although decreasing, domestic inflationary pressures still remain high. This performance reflects the positive cyclical position of the economy. The recovery of the economic activity continued to be accompanied by employment growth, historically low levels of the unemployment rate, and rapid wage growth in the private sector.

Our projections for the future suggest that the positive supply shock to foreign prices will fade over the coming months, while domestic inflationary pressures will gradually return in line with our price stability target.

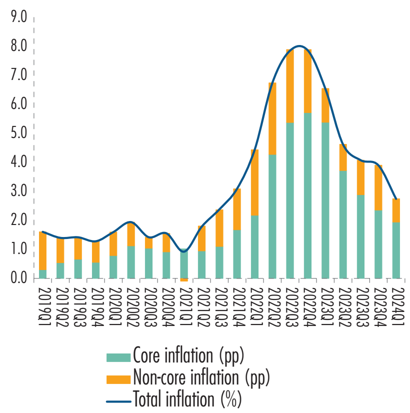
The downward trajectory of inflation during 2024 Q1 was determined by the strong slowdown of inflation across short-term and imported components. In parallel, the core and domestic inflation also decreased, but at a lesser extent than the other components (Chart 29).

Core and domestic inflation consolidated the convergence between them, at 2.8 and 2.9%, respectively during this quarter. Although down by about 0.6 percentage point compared to the previous quarter, they maintained higher rates than total inflation. Core net inflation[20] also slowed down, but at a more moderate pace, 3.2 from 3.3% in the previous quarter. Core net inflation continued to remain slightly above the target and above the average of the last three years, reflecting the stability of inflation of services and other durable goods (Chart 30).

The short-term and foreign components of inflation decelerated. Non-core inflation and imported inflation stood at 2.5% and 2.3%, respectively, these

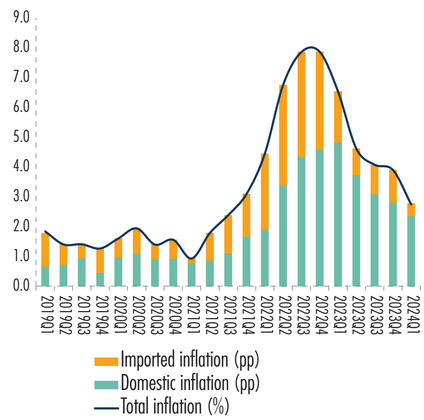
Chart 29

The contributions of core and domestic inflation prevailed more in the formation of total inflation



Source: INSTAT and Bank of Albania's calculations.

Diminishing contributions of imported and non-core inflation led to the rapid deceleration of total inflation



Source: INSTAT and Bank of Albania's calculations.

[20] *Core inflation is over about 69.03% of the CPI basket; net core inflation that excludes processed food subgroups (including bread and grains) and is about 46.03%.*

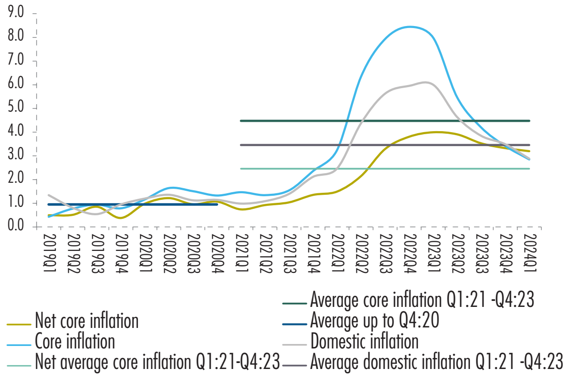
rates were halved compared to those of the previous quarter. The decline mainly reflected the apparent slowdown in unprocessed food inflation, as a result of the drop in food prices in foreign markets as well as the appreciation of the exchange rate.

The formation of total inflation maintained the same profile as before, with domestic contributions prevailing (2.3 percentage points). The intensity of domestic inflationary pressures remained relatively high, reflecting the high demand for goods and services and the increase in labour costs per unit.

The cyclical position remained at positive levels during 2023 Q4 as well. The output and unemployment gaps, as well as the capacity utilisation rate, continue to remain above their respective levels of long-term averages. On the other hand, core inflation continued to slow down gradually during 2024 Q1 (Chart 31), against the higher stability of its net component, which recorded almost the same value as that of the previous quarter.

Chart 30

*Core net inflation slowed much less than other measurements, remaining above the respective average for the period 2021-2023**



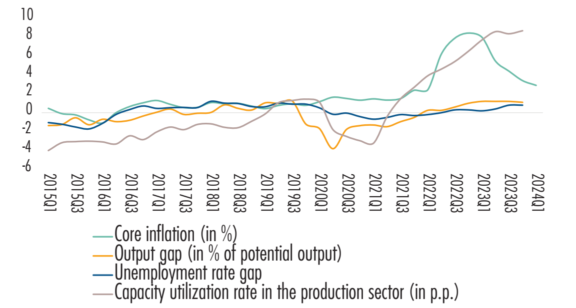
Source: INSTAT and Bank of Albania's estimations.

*Note: *The sub-period 2021-2023 is taken as the later comparative reference (benchmark) with high inflation.*

Employment and unemployment. Employment continued to increase during the fourth quarter of 2023 (0.6%), but at a slower pace than in the previous quarter (1.2%). The downward trend of employment rates has also characterized the first three quarters of 2023. The expansion of employment in the fourth quarter was driven by the increase in employment in the "Services" sector, while employment in "Agriculture" and "Industry" decreased, as a result of the contraction of the relevant economic activities during 2023. In terms of broader categories, employment expansion has been largely driven by the private non-agricultural segment. The increase in employment in this category was 2.8% in 2023 Q4, although slowing down compared to the previous months of 2023.

Chart 31

The cyclical position of the economy appears positive for 2023 Q4 as well for the future

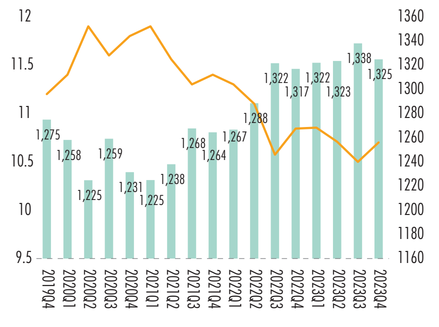


Notes: The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilisation rate gap is estimated as a deviation of the current value from the relevant historical average, and then the moving average method is applied. The unemployment rate gap is estimated as an average of unemployment gaps according to three methods, which assess the equilibrium of unemployment. The unemployment rate gap is stated as the difference of the equilibrium unemployment rate to the actual unemployment rate and then the moving average method is applied.
Source: INSTAT and Bank of Albania's estimations.

The unemployment rate fluctuated at historical lows, resulting 10.7% in the fourth quarter of 2023, or 0.1 percentage point lower than the same quarter of the previous year. In terms of quarterly changes, the unemployment rate remained 0.2 percentage point above the value of the third quarter, bearing the seasonal effect on employment due to the peak of the tourist season.

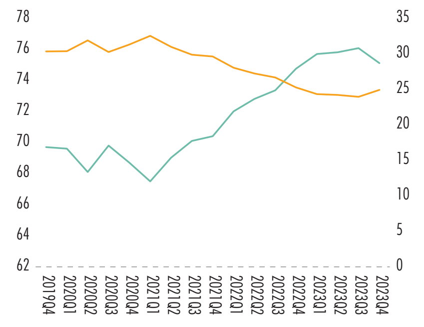
Chart 32

Employment continued to expand at a slower pace than before and the unemployment rate remained low in 2023 Q4



Source: INSTAT.

Labour force slowed in the fourth quarter, reflecting the drop in employment and the increase in the unemployment rate in quarterly terms



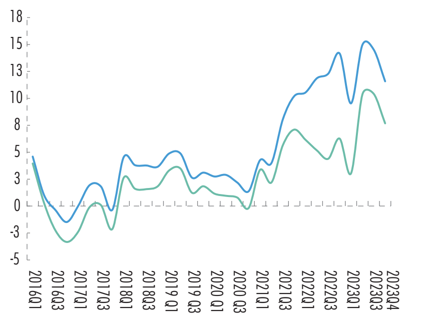
Source: INSTAT.

Wages, productivity and labour costs. The increase of the wages in the private sector slowed down during 2023 Q4, but it continued to remain a double digits value. It stood at 11.6%, from 14.5% in the previous quarter. The main impact on this slowdown came from the slowdown noticed in sectors with high salaries, and in particular in that of "Financial and insurance services". The slowdown in the growth rate also affected real wages, which expanded by 7.7% in the fourth quarter, compared to 10.4% a quarter earlier (Chart 33, left).

The labour unit cost[21] expanded to 5.4% in 2023 Q4, downward compared to the previous quarters (Chart 33, left). The slower growth of labour unit costs

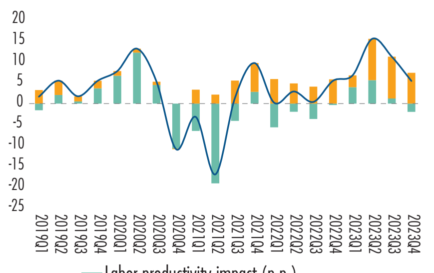
Chart 33

Wage growth in the private sector has slowed down in nominal and real terms, but it still remains high even in 2023 Q4



Source: INSTAT and Bank of Albania.

Labour unit costs increased at a slower pace over the last quarter of 2023



Source: INSTAT and Bank of Albania.

Note: The negative 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 positive annual growth and vice versa; data are not shown as moving averages.

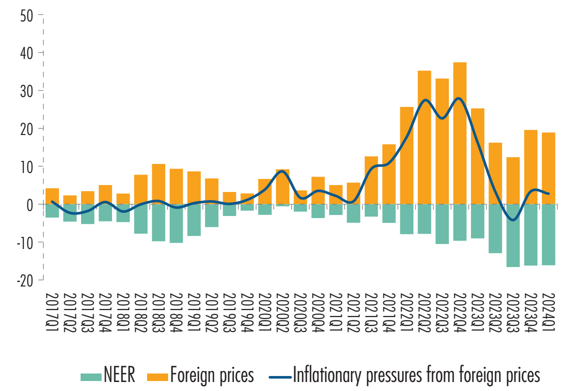
[21] Indicators of labour unit cost and of labour productivity are estimated by the Bank of Albania. Unit labour costs are estimated for the non-agricultural private sector based on INSTAT data on the National Accounts statistics, of employment and wages.

is dictated both by the slowdown in the growth rate of real wages and by the gradual transition of productivity growth from negative to positive values during the last quarter. As an average for the whole 2023, unit labour costs expanded by 9.7%, significantly higher compared to the previous year when growth was 2.3%.

Other output costs have continued the downward trend in 2023 Q4. Overall producer prices rose up by 3.1% from 5.2% in 2023 Q3. Producer prices for the domestic market decelerated more than those for export, increasing by 4.2% from 7.2% in the previous quarter.

Chart 34

Imported inflationary pressures have decelerated in 2024 Q1



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

Imported inflationary pressures decreased during 2024 Q1. The Imported Inflationary Pressures Index (IIPI) expanded by 2.8% during this quarter, from 3.4% in the previous quarter (Chart 34), mainly affected by the slowdown in foreign price growth by 18.9% from 19.6% in 2023 Q4. On the other hand, the appreciation of the nominal exchange rate has buffered the transmission of imported inflationary pressures. In Q1, the nominal effective appreciation was 16.1%, almost the same as the previous quarter[22].

The downward trend of IIPI is reflected in the significant reduction of the contribution of imported inflation in the total inflation formation during 2024 Q1. The contribution to the formation of total inflation resulted in an average of 0.4 percentage points against 1.1 percentage points in the previous quarter (Chart 29, right).

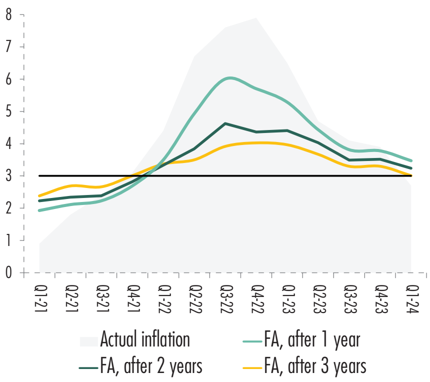
Inflation expectations of financial agents and consumers have been revised downward in 2024 Q1, while businesses' expectations have been slightly revised upwards[23]. Expectations of consumers on inflation for the next year is 9.1%, against 11.2% in the previous quarter. Businesses'expectations on inflation over the one-year horizon is 6.8% against expectations of 6% in the previous quarter (Chart 35, left). The expectations of financial agents, which historically remain below the rates expected by consumers and businesses, stood at 3.5% over the one-year time horizon. In the medium term, financial agents expect inflation to get closer to the target of 3.2 and 3% after two and three years, respectively (Chart 35, right).

[22] *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.*

[23] *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*

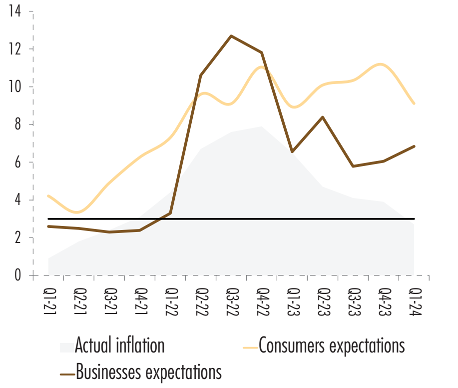
Chart 35

Inflation expectations from enterprise after one year are slightly up and inflation expectations from consumers are downward more rapidly



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

Inflation expectations from financial agents over three time horizons are decreasing and approaching the medium-term objective



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