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MONETARY POLICY DEPARTMENT

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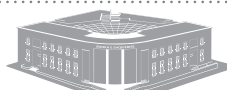
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INTRODUCTION¹

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. 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 preserving price stability, the Bank of Albania helps establish an environment with few unexpected events and assists Albanian households and enterprises in planning their own consumption and investments.

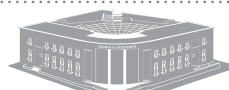
The Supervisory Council of the Bank of Albania holds 8 meetings each year to decide on monetary policy, aimed at achieving the price stability objective. The Supervisory Council sets the key interest rate. Changes in the key interest rate affect, with a time lag, other interest rates in the financial market, for example, yields on government's securities and the interest rates on loans. These changes drive 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 prices channel. The Bank of Albania has constructed models to forecast changes in all 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 opposite is also valuable. 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 against 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.

The Monetary Policy Report is published on a quarterly basis. The Monetary Policy Department at the Bank of Albania compiles this Report and the Supervisory Council approves it. The current report contains data, as of 23 January 2023. The Supervisory Council reviewed and adopted this Report at its meeting on 1 February 2023.

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/



FOREWORD BY THE GOVERNOR

Inflation continued to remain high in the Albanian economy in the fourth quarter of 2022 as well, by: feeding the uncertainties of enterprises for the future; dampening the purchasing power of households; and conditioning every aspect of economic life in Albania.

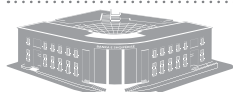
However, the new information attained over this quarter has been overall better than our expectations.

First, consumer price inflation declined in November and December 2022, for the first time after almost 12 months. This is an encouraging signal that the inflation trajectory has reached a turning point in this period. Inflation declined mainly on the back of lower oil price, and we believe this indicator will continue to fall in the next months.

The stability of prices in international markets, the good performance of the exchange rate, the downward revision of inflation expectations, coupled with the effects from the normalisation stance of monetary policy will underpin the fall of inflation in Albania. This normalisation, as transmitted through a gradual raise of policy rate, has established the premises for a better demand and supply balance in the economy. Thus, based on the current trends, inflation is expected to return to our 3.0% target within the first half of next year.

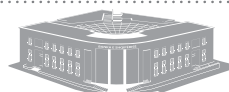
Second, the Albanian economy has proved quite resilient against foreign supply shocks and tighter monetary conditions in both Albania and the world. Economic growth in 2022, fuelled by the dynamism of private sector, is expected to reach around 4%, while having a good allocation across sectors. In addition, employment and wages increased rapidly, while unemployment rate has remained at its historical low. The Albanian economy will continue to create new jobs and generate positive growth rates in 2023, despite the growth rate is expected to edge up slightly.

Third, financial markets remain relatively calm, even in presence of globally tighter financing conditions, while banks' balance sheets appear sound. Our monetary policy pass-through has been more complete in financial markets. The credit flow continues to remain positive and banking sector continues to provide the necessary funding to the Albanian economy for both the expansion of the activity and the covering of liquidity needs. In parallel, lek exchange rate remains strong, by supporting the overall economic and financial stability of Albania.



Based on these conclusions, which are elaborated in this Report, the Supervisory Council decided to maintain the monetary policy stance in the meeting of 1 February 2023. The Supervisory Council deems that the monetary conditions remain adequate for the return of inflation to the target, at the lowest costs on the economic activity.

Nevertheless, the Supervisory Council emphasised once again the need for continuing the normalisation of monetary policy stance in the course of 2023, and its willingness to continue in this regard.



1. INFLATION AND MONETARY POLICY STANCE

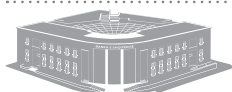
The economy and financial markets in Albania continue to be impacted by external shocks, expressed in high inflation, in both Albania and globally, heightened uncertainty of the economic agents, and tighter financial conditions. Economic growth in Albania was relatively solid in the second half of 2022, whereas consumer price inflation fell in November and December. The projections of this Report suggest that these trends will continue in the future as well. Based on these conclusions, in the meeting held on February 1st, 2023, the Supervisory Council of the Bank of Albania decided to maintain the monetary policy stance unchanged. However, the Supervisory Council noted that domestic and imported inflationary pressures remain high, dictating the need to further normalise the monetary policy stance, in order to safeguard the price stability objective.

The global economic activity was better than expected in the last quarter of the year. Inflation has been decelerating, due to a slower rise in commodity prices and fewer supply-side bottlenecks. Meanwhile, economic growth was stable and the labour market continued to show positive trends. The same performance was witnessed in the euro area, where inflation declined to 9.2% in December, and economic growth in the third quarter was higher than expected. The European Central Bank has continued the normalisation of the monetary policy stance, in response to rising inflation rates and a strong labour market. The uncertainty about the global economic outlook, though reducing, continues to be high, reflecting the unclear developments of the war in Ukraine, the elevated geopolitical tensions, the persistence of supply-side bottlenecks, and dilemmas of the monetary policy stance.

The external environment is expected to remain challenging during 2023 as well, characterised by high inflation, tightened financial conditions, and expectations for a slowing economic activity.

Inflation in Albania has been slowing down in the last two months of 2022. In terms of the CPI basket, inflation performance reflected the decline in the oil and some food prices, driven by the reduction of the latter in international markets.

In macroeconomic terms, inflation performance reflected the decrease of imported inflation and the weakening of its direct impact on the Albanian economy. On the other hand, our analysis suggest that domestic inflationary pressures remain high, due to the stable demand for goods and services, the transmission of rising production costs onto the final prices, and inflationary



expectations of economic agents and financial markets. This mix bag of factors is expected to continue in the future, suggesting that the inflationary trajectory in the upcoming quarters will increasingly depend on domestic inflationary pressures and second-round effects.

The Albanian economy has continued to grow in the second half of 2022.

Following a slowdown in the second quarter, economic growth accelerated to 4% in the third quarter. The economic activity was more positive than our expectations, demonstrating a more stable domestic demand. The expansion of the economic activity was underpinned by private consumption and investments, whereas the public sector and net foreign demand had a hindering effect. The profile of aggregate demand prompted an increase in the activity of construction and services sector, while industrial activity contracted and agricultural production remained almost unchanged.

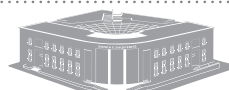
The increase of demand was accompanied by lower unemployment and higher employment and wages. In the third quarter of last year, employment rose by 4.2%, the unemployment rate fell at its new historical minimum of 10.6%, whereas the average wage in the private sector recorded an annual growth of 12.4%. The positive performance of the labour market created the premises for a sustainable economic growth in the future.

High inflation and the overall increase of inflationary pressures have driven to the normalisation of the monetary policy stance. The Bank of Albania increased the key interest rate five times over 2022, bringing it from its historical minimum of 0.5% at the beginning of the year, up to 2.75% in November.

The normalisation of the monetary policy stance was reflected in financial markets, although it differs across various segments. Despite rising interest rates, financial markets remain liquid, with contained risk premia, whereas lending conditions are still accommodative. In the foreign exchange market, lek has been appreciating against the main foreign currencies, due to high foreign currency inflows during the year. The positive performance of lek has helped absorb part of foreign shocks on inflation.

The financial conditions remain accommodative to the economy and credit to private sector continues to increase. Credit has financed the consumption and investments of households and enterprises, while also fulfilling their needs for liquid financial assets. The financial stability of the banking sector and its positive approach towards lending, has created the necessary conditions for the continuous funding of the economy.

The economic activity in Albania is expected to expand over the upcoming years. However, the growth momentum is expected to slow down in 2023, and gradually return to normality in the next year. In the short run, the deceleration is expected to reflect a weaker growth of foreign demand for goods and services, the lingering high uncertainties of economic agents, as well as the negative



impact of high inflation on households' purchasing power. On the contrary, the reduced uncertainties and lower inflation, in the medium term, will pave the way to a faster economic growth after the first half of 2023.

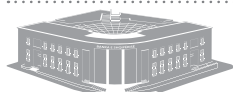
Inflation is forecasted to gradually decline in 2023 and return to the target in the first half of 2024. The decline in inflation over 2023 takes into account the expected fall in food and oil inflation in the global market, due to the base effect and the stabilisation of commodity prices. Simultaneously, the normalisation of the monetary policy in Albania will create the adequate monetary conditions that provide a better balance between demand and supply, in the domestic economy.

The risks to economic growth perspective continue to be on the downside, particularly in the short run, which is related to the war dynamic in Ukraine, a weaker foreign economy, and the tighter financial conditions. The risks to inflation perspective are mainly on the upside. In the short run, they spring from a possible increase in commodity and energy prices, whereas, in the medium term, from a progressive increase of inflationary expectations and their reflection in the wage and cost performance in the domestic economy.

Congruent to the analysis and forecasts introduced in this report, the Supervisory Council decided to maintain the monetary policy stance unchanged.

This decision is consistent with the domestic economic development trends, and with our inflation target in the medium term. It provides the necessary time for the full transmission of the previous monetary policy decision to the financial market and enables a more coherent assessment of the overall inflationary pressures.

At the same time, the Supervisory Council emphasizes that it deems it necessary to continue the normalisation of the monetary policy as a required precondition for safeguarding price stability in the medium term. As per the above, it will continue to closely analyse the situation, in order to adjust the pace of the monetary policy normalisation according to the new data and the performance of inflation and economic growth.



2. EXTERNAL ECONOMIC ENVIRONMENT

The external environment remains unfavourable, dominated by an economic slowdown and high prices in most countries. Global economy continues to be subject to the effects of war in Ukraine, the restrictive measures in China, and the normalisation of the monetary policy stance, globally. However, the supply and transportation chains have improved at the end of the year, as agents are adapting to new conditions, and uncertainties for the future are reducing.

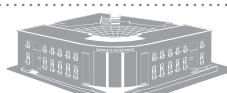
Inflation peaked in the last quarter of the year, whereas the lower energy prices led the downward trend during December. Nonetheless, inflation rates remain significantly above the central banks' targets, demonstrating that inflationary pressures are stable and the second-round effects are present. Central banks are expected to further tighten the monetary policy stance over 2023.

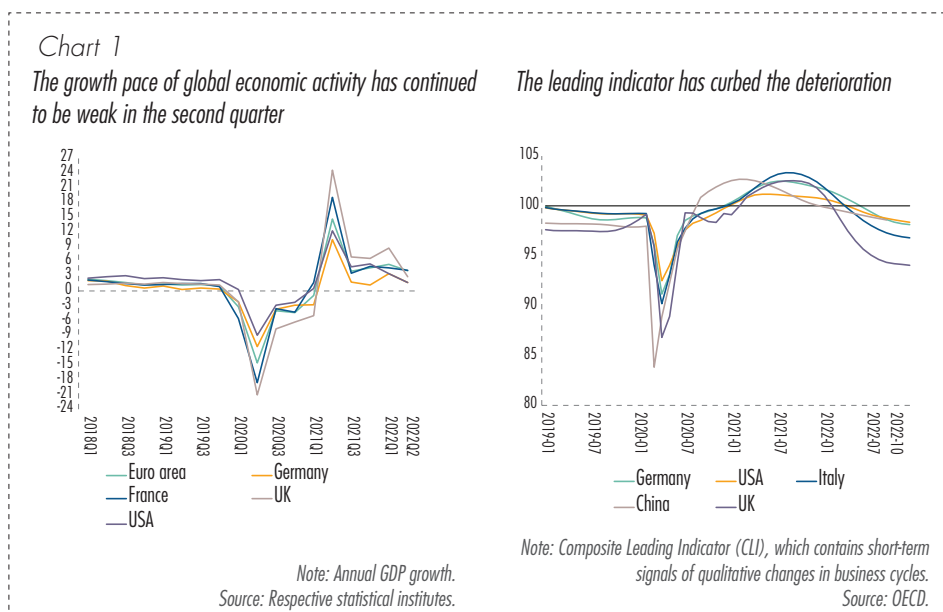
High prices, the reduced fiscal space and the tighter monetary conditions are expected to dampen expenses and investments in the short run.

2.1. ECONOMIC GROWTH

Global economy has continued to slow down in 2022 Q4. The performance of economic activity over 2022, has been driven by the shock stemming from the war in Ukraine, but the impact of this shock on the economy has diminished in the second half of the year. Supply and distribution chains bottlenecks, which obstructed global trade in the first half of the year, has been reducing in the fourth quarter. Also, consumer spending, which suffered as a consequence of feelings of uncertainty for the future, has been boosted by governments' stimuli, thus slightly improving in the fourth quarter.

Inflation rates seem to have reached a turning point in the fourth quarter, by settling on a downward trajectory. This dynamic reflects the performance of energy and food prices, which have increased at the end of the year, but not as much as expected. However, inflation continues to remain considerably above the central banks' targets. Not least, core inflation rates remain high, showing that food and energy price pressures have been transmitted to the other categories of goods and services.



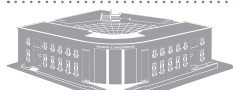


From the geographical standpoint, the Western advanced economies have grown at higher than expected rates in 2022 Q3. Consumer spending and trade activity were more positive than forecasts, while industrial production continued to suffer from supply-chain bottlenecks. In the same vein, economic performance results for the last quarter in China, were above expectations, following the lifting of Covid-19 restrictions which triggered the improvement of expectations for the near future.

Forecasts show that global economic growth will continue moderate in 2023, given the war in Ukraine, high prices, unresolved bottlenecks in supply chains, and rising interest rates which will continue to weigh on the global economy. On the other hand, inflation performance is expected to follow a downward trajectory, affected also by a higher comparative base in 2022.

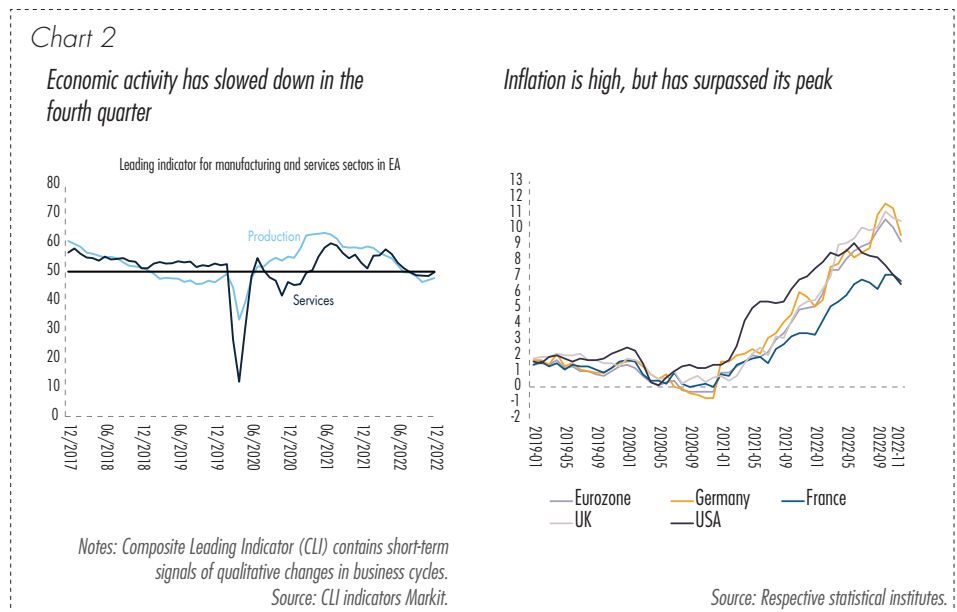
EURO AREA ECONOMY

The economy of the euro area continued to grow, in annual terms, in the third quarter of the year, albeit at a more moderate pace (annual rate stood at 2.3%, from 4.3% in the second quarter). Economic growth was underpinned by domestic demand, particularly investments and consumer spending, whereas the contribution of government spending was almost neutral. Also, higher imports had a negative contribution in net exports. In the fourth quarter, indirect data also show a slowdown of economic activity, although above previous forecasts, which indicated recession in some major countries. The positive performance of consumer spending was also driven by a relatively warm weather, which has lowered the demand for energy products. This has engendered a lower than previously expected rise in their prices. The unemployment rate has followed a downward trajectory over the year, but it remained unchanged in November, at 6.5%.



The inflation rate in the euro area fell for the second month in a row, registering 9.2% in December. Soaring energy and food prices, which increased at a slower pace, were the main contributors to inflation. On the other hand, core inflation rate cranked up in December, demonstrating that the economy is under inflationary pressures.

The European Central Bank’s projections suggest that the economic growth of the euro area will slow down further in 2023, and it will pick up only during 2024. Also, the inflation rate is expected to follow a downward trajectory in 2023-24, remaining above the ECB’s target, of 2%.

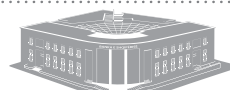


REGIONAL ECONOMIES²

Economic activity in the region has remained positive in 2022 Q3, driven mainly by expansion in consumer spending. However, expect Kosovo and Albania, economic growth has decelerated during this period. In Kosovo, the acceleration of economic growth in the third quarter, spurred from consumer spending and net exports, whereas sluggish investments have hindered economic activity. In Serbia, the slower economic growth was mainly affected by a contraction in investments and government spending, whereas consumption and net exports have provided a positive contribution. The economy of North Macedonia experienced a slower growth pace, reflecting the sharp contraction of government spending and the rapid increase of imports, while consumer spending and investments have gone up.

In December, the inflation rate was high across all countries, with some variations between them. Similarly to our trading partners, the soaring rates were driven mostly by high prices of energy and food. In Kosovo inflation went

² Main trading partners outside the European Union (Kosovo, North Macedonia, Serbia).



up in December, after going down previously. In Serbia, the rate in December was unchanged from the preceding month, while in North Macedonia, inflation declined. The rate of inflation in the region is deemed to have reached its peak in 2022 Q4, and is expected to come down, remaining high nonetheless.

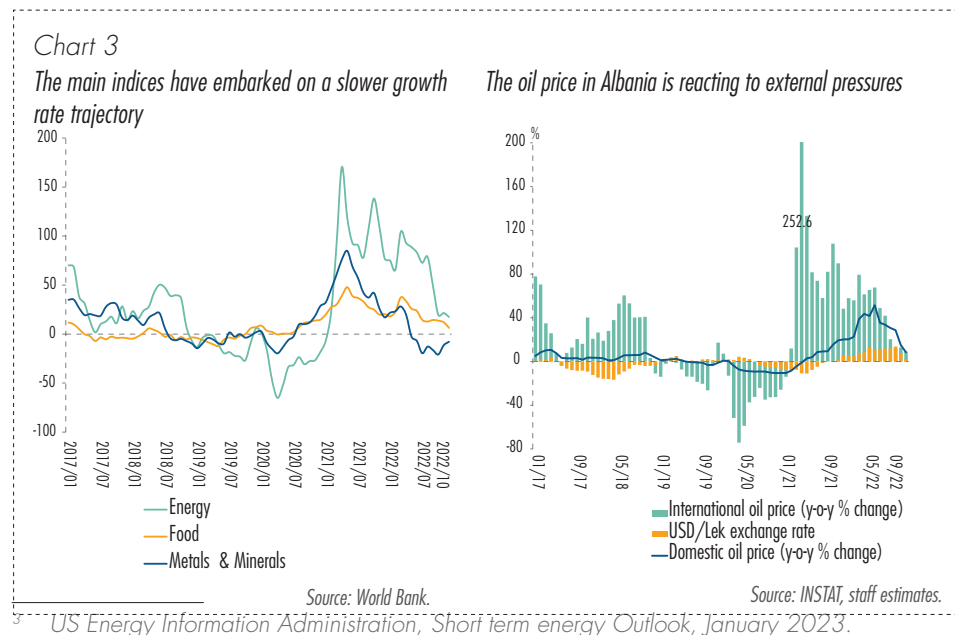
Table 1 Economic figures for countries in the region

	Annual change of GDP		Annual inflation	Unemployment
	2022 Q2	2022 Q3	December 2022	2022 Q3
Italy	5.0	2.6	12.3	7.8*
Greece	7.1	2.8	7.6	11.4*
North Macedonia	4.0	2.0	18.7	14.3
Serbia	3.9	1.0	15.1	8.9
Kosovo	2.1	3.3	12.1	20.5**
Albania	2.6	4.0	7.4	10.2

Source: Respective statistical institutes.
*November 2022, **2022 Q2.

2.2. COMMODITY PRICES IN GLOBAL MARKETS

Overall, commodity prices in global markets continued to increase in the fourth quarter, albeit at a more moderate pace than in the third quarter. This performance reflected both the dropping demand and the mitigation of some obstructions in supply. In December, the price of Brent oil stood at \$80.9/barrel, slightly down from September, but up by around 9.1% than the previous year. The sluggish economic activity has pushed demand down, forcing a drop in oil prices. This price is expected to remain at the current level in the short run, but higher, nonetheless, prior to the war in Ukraine.³ The situation in other commodity markets has not changed. The food price index slowed down the surge pace in the second half of the year, and increased by 6.4% in annual terms, in December. The metal price index shrank in annual terms throughout the entire second half of the year, but the contraction was moderated in December.



This performance affected the economic activity in China, which is among the countries with the largest demand for these commodities. The price of electricity has subsided the steep rise during the last months of the year, reaching around 261.4 Euro/MWh in the Hungarian Stock Exchange in December,⁴ slightly up from the previous year.

2.3. GLOBAL FINANCIAL MARKETS

The financial conditions in international markets have continued to tighten in the fourth quarter, but expectations regarding their impact on inflation curbing, have reduced the financial agents' uncertainties.

Central banks have continued to tight the monetary conditions in the fourth quarter as well, through raising the key interest rate. However, they warned that the pace of raising key interest rate will slow down in 2023. Central banks have reacted rapidly, decisively, and simultaneously, an act which is expected to put breaks on inflationary pressures during 2023. Also, soaring prices and rising interest rates are affecting the slower economic activity, although the latter is more resilient than previously expected.

The European Central Bank (ECB), the Federal Reserve (Fed) and the Bank of England (BoE), have increased the key interest rate twice, in the fourth quarter - once by 0.75 percentage point and another time by 0.50 percentage point – in the fourth quarter. During 2022, the ECB increased the key interest rate by 2.50 percentage points, to 2.50%; the Fed increased it by 4.25 percentage points, to 4.50%, and the BoE by 3.25 percentage points, bringing it to 3.50%. Central banks have declared that the pace of monetary tightening will ease in 2023. In the USA, inflation has dropped also in its base components, whereas economic data show that demand is slowing down. In the euro area, signals of a curbing inflation are weak, while core inflation remains high. This has caused markets to take into account several other increases of the key interest rate in 2023, but at lower degrees than those of 2022. The same situation is experienced by the Bank of England, as well, where inflation continues to be double-digit.

The monetary policy and the communications of the central bank have passed through in financial markets, where financial instrument's interest rate have increased progressively over 2022. Yields on sovereign securities have slightly decreased at the beginning of January. Also, their spread with corporate bonds have shrank, reflecting the falling risk premia. Given that in 2022, the economic performance is better than expected, equity markets have remained in a positive level.

⁴ Hungarian Power Exchange (HUPX), energy prices in basic profile.

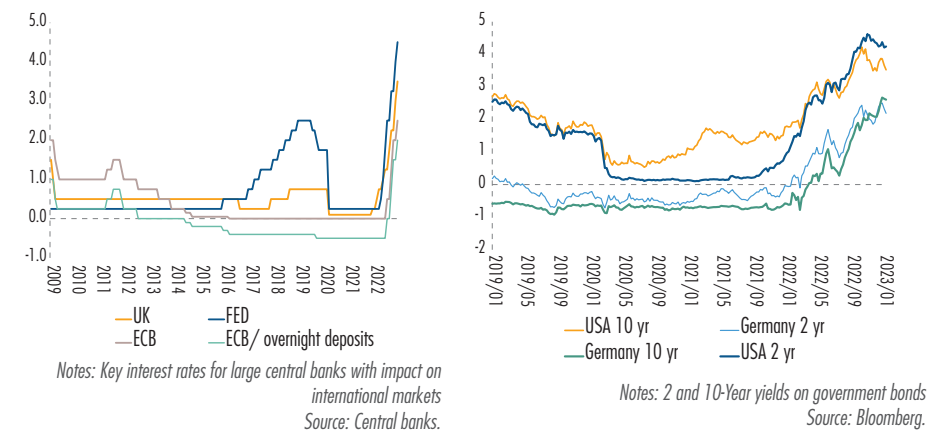


The improvement of supply chains, coupled with the lifting of the restrictive measures against Covid-19 in China, have boosted the economic agents' sentiment. Inflation rates have slowed down, but labour markets and the support of consumers with fiscal measures are keeping inflationary pressures at high levels. The preliminary data on the economic activity, particularly for the euro area, suggest that the expected deceleration of economic activity might be more moderate. In this context, risks to the interest rate performance are on the upside, and the ECB might continue to raise the key interest rate, and the financial conditions might turn tightened faster in 2023, as well.

Chart 4

Central banks have continued to raise the key interest rate in order to curb inflationary pressures, but the speed of reaction is expected to be slower

The tightening of the monetary policy has engendered continuous higher yields. They have slightly decreased in 2023, as inflation has slowed down



3. FINANCIAL MARKETS AND LENDING CONDITIONS

The domestic financial market appears relatively calm, reflecting the normalisation of the monetary policy stance. The changes of the policy rate have been immediately transmitted to the interbank market and, more gradually, to the loans and deposit interest rates, while yields' volatility in the primary market of government securities is declining. The foreign exchange market was dominated by appreciating pressures, whereas the trade conditions have remained within the normal market parameters.

Credit to enterprises and households continues to grow. However, its growth pace appears to be slower, affected by both the demand performance and a more prudent behaviour of banks regarding lending.

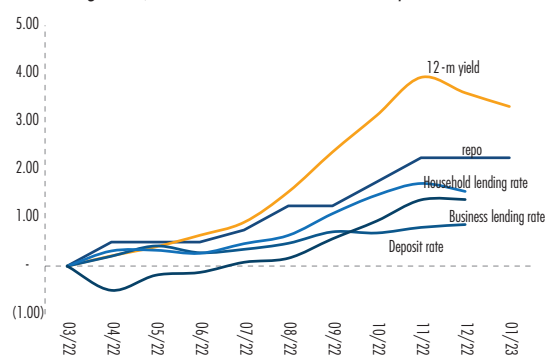
3.1. DOMESTIC FINANCIAL MARKET⁵

The normalisation of monetary policy is being reflected in the interest rates in financial market. However, the intensity of this reflection varies depending on the sector, congruent to the qualities of each segment and in the same line with the time lags of the monetary policy transmission mechanism. Transmission in the interbank market was immediate and complete, slower for the time deposit segment and for loans to large enterprises, and more direct for loans to households and small enterprises. Meanwhile, yields on government securities, after recording a sharp rise in July-November 2022, have started to drop, reflecting the stabilisation of market expectations on the performance of the policy rate in the future.

Interest rates in the interbank market have transmitted, in full, the monetary policy decisions and remain anchored close to the policy rate⁶. Interest rates in the interbank market have followed the latest changes in the policy rate in October and November, in the same vein with the monetary policy signal. The Bank of Albania continued to supply liquidity through its one-week instruments. The market has not experienced additional liquidity pressures. Meanwhile, the Bank of Albania continued to supply liquidity regularly in the system through its main

Chart 5

The increase of policy rate is being reflected across all the financial market segments, albeit at a different scale and speed

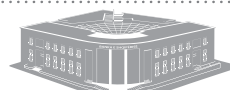


Notes: Cumulative changes of interest rates since March 2022: repo, time deposits, 12-month T-Bills, loans to enterprises (3-month rolling average) and loans to households (3-month rolling average).

Source: Bank of Albania.

⁵ The following analysis is based on the data available up to 23 January.

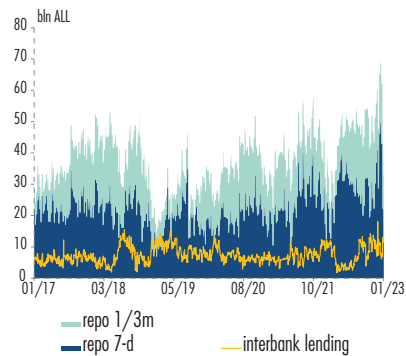
⁶ In 2022 Q4, the standard deviation of overnight interbank rate was 0.42, from 0.26 in Q3.



instrument, the one-week repo, in addition to the injections through the three-month maturity repo agreements. The total amount injected in this quarter was almost similar to the one in the previous quarter.

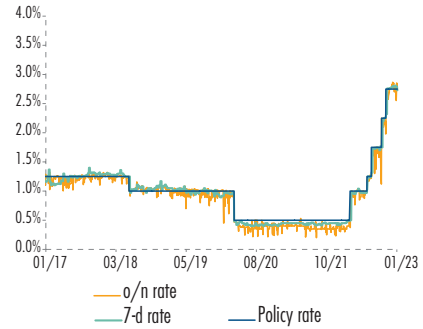
Chart 6

The liquidity situation of banks remains favourable to the satisfactory transmission of the monetary policy



Notes: Daily 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 immediately followed the recent increase in the policy rate and remain anchored close to it



Notes: The data shows the daily performance of interbank market interest rates, alongside the policy rate and overnight deposit and loan rates.
Source: Bank of Albania.

Appreciating pressures on the domestic currency continue to dominate the domestic foreign exchange market, whereas trade conditions remain within normal parameters. In October and November, the EUR/ALL exchange rate stood close to the average of the last quarter, of 117.1 ALL/EUR. In December, the EUR/ALL exchange rate dropped to 114.9 ALL/EUR, with an annual lek appreciation of 4.9%. In the first three weeks of January, the EUR/ALL exchange rate has fluctuated close to the average level of 116.4 ALL/EUR. In December, lek appreciation made a small step backwards, although it remained below the level recorded prior to this month.

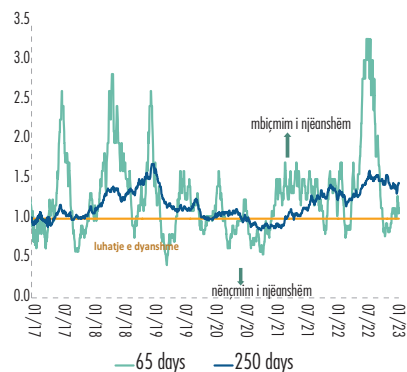
Chart 7

The lek has appreciated against the euro and against the US dollar

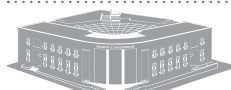


Notes: Data show the daily performance of ALL exchange rate against Euro and US dollar.
Source: Bank of Albania.

The appreciative pressures dominate the foreign exchange market



Notes: The data present the indicator of bias for appreciation/depreciation.
Source: Bank of Albania.



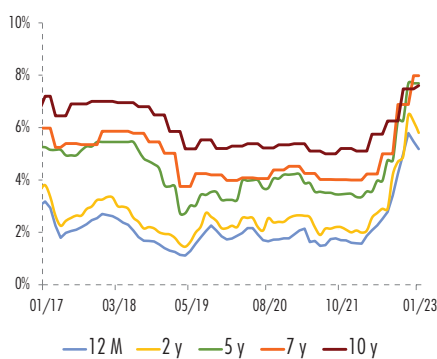
As evidenced by the performance of the bias indicator⁷, during this year, the foreign exchange market was characterised by appreciation pressures of lek against the euro, which have become more pronounced in June. These pressures seem to reflect the positive performance of the balance of payments in Albania during 2022, driven by the satisfactory tourism season and a high level of foreign direct investments. However, these pressures were not followed by market disturbances. The foreign exchange market has been calm and has operated within normal trading conditions. Both the euro/lek exchange rate fluctuation and the bid-ask spread, have resulted close to their normal values.

Lek has also appreciated against the US dollar, right after the first ten days of November, reflecting the appreciation of the latter against the euro in international markets. As the increase of interest rate by the Federal Reserve was expected to be less aggressive than forecasted, the strong appreciation of the US dollar in the international market pared back. The US dollar was quoted at an average of 108.5 ALL in December, from 119.3 ALL in October, and has continued to fluctuate close to this level in the first three weeks of January as well. Lek continued to depreciate against the US dollar compared to the previous year, but at a more mitigated rate, of 1.4%.

The yields on Government securities have decreased in 2022 Q4, reflecting the reduced inflationary pressures on them. Since the monetary policy commenced its tightening cycle, yields were characterised by significant volatility, often overreacting toward the rising policy rate. Their dynamic has reflected agents' uncertainties in the context of accelerating inflation and expectations for a

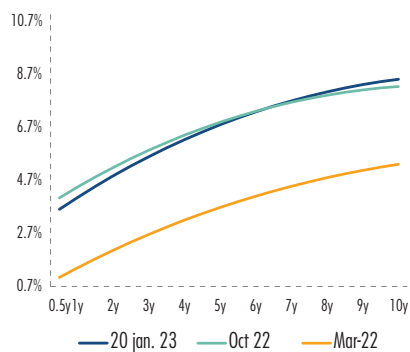
Chart 8

Yields in primary market have stabilised with a downward trend



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

The yield curve has shifted higher, but its slope has remained unchanged



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

⁷ 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).



rising policy rate. In the last month of 2022, inflation dropped and demand for government debt instruments reignited, by curbing the upward trend of yields, in turn being materialised in a decline in the yields on 12-month T-bills. The yield spread between government securities and the policy rate is approaching its historical average, although the gap between the maximum and minimum asked premia in auctions shows that there are still signs of uncertainty. The yield on 12-month T-bills fell to 5.0% in the latest auction in January, from 5.8% recorded in November.

This downward trend has also affected securities, as yields realised in the latest auctions confirm that investors' demand has increased and the asked premia has decreased. The participation of banks and the bid-to-cover ratio of debt securities auctions has increased considerably, for both T-bills and bonds. The yield on 2-year bonds, which is distributed monthly, has decreased in December and January, falling to 5.8%, from 6.5% recorded in November. Whereas, at the latest auction organised in January, the yield on 10-year bonds was 7.6%, similar to the value recorded in October.

The 15-year bonds' yield spread between the two issuances of September and November was 0.5 percentage point lower than the increase of repos during this period (1.0 pp). The results of the long-term debt instruments are another evidence that increasing pressures on yields are mitigated, and they are returning to normality. The yield curve reflects these developments, where, despite shifting higher, its slope remains unchanged.

3.2. LENDING CONDITIONS

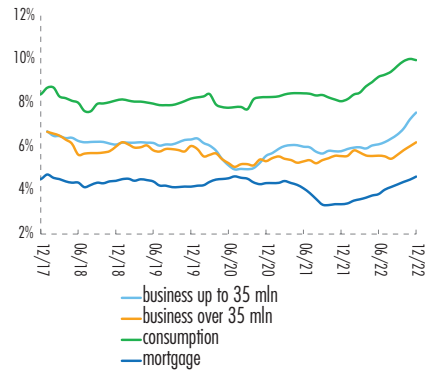
The interest rates on new loans and deposits in lek continue to increase gradually. The average interest rate on new loans to enterprises in lek was 7% in 2022 Q4, from 6.2% in the third quarter, and 5.7% in the first half of the year. The analysis of the interest rates on loans by the amount granted shows that interests on small loans (up to ALL 35 million) have increased significantly in this quarter. Meanwhile, the rising of interest rates on average and large loans (over ALL 35 million) became apparent only in the last four months, a more delayed response compared to the interest rate on small loans to enterprises. The rise in interest rates is more evident in loans with a fixed interest rates in the first year, which is also the segment that is the fastest in transmitting the monetary policy.

The interest rate on **loans to households** has shown a stronger transmission of the monetary policy normalisation cycle. It was 8.0% on average in the fourth quarter of 2022, from 7.6% in the third quarter, and 6.7% in the first half of the year. The spike in the last quarter was present mainly in mortgage loans, while the average interest rate on consumer loans has remained unchanged from the previous quarter.



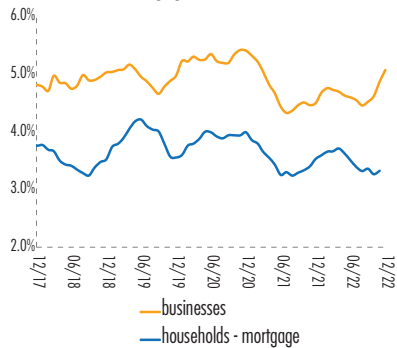
Chart 9

In addition to the interest rates on small loans to households and loans to enterprises, interest rates on large loans have also increased



Notes: The data indicate the interest rates of new loans in lek in %; 6-months moving average. Source: Bank of Albania.

The interest rate of loans in euro has slightly gone up for enterprises, while it continues to fluctuate at low levels for mortgages



Notes: The data indicate the interest rates of new loans in euro in %; 6-months moving average. Source: Bank of Albania.

The interest rate on **new loans in euro** appear to increase at a slower pace compared with interest rates on loans in lek. They started to go up since September, and have continued on this track in the fourth quarter. In 2022 Q4, the average interest rate on new loans in euro to enterprises was 5.4%, from 4.8% in the third quarter, and 4.6% in the first half of the year. The interest rates have increased mainly for the category of loans higher than EUR 250 thousands, with a fixed initial average rate, up to one year. The average interest of loans in euro to households for house purchases was 3.4%, remaining close to the low levels present during this year. The spread interest rate has widened on the back of the faster increase of interest rate on loans in lek compared to loans in the euro. In 2022 H2, it stood at 2.7 percentage points, on average, against the 1.9 percentage points average in the first half of the year and in the previous year.

BOX 1

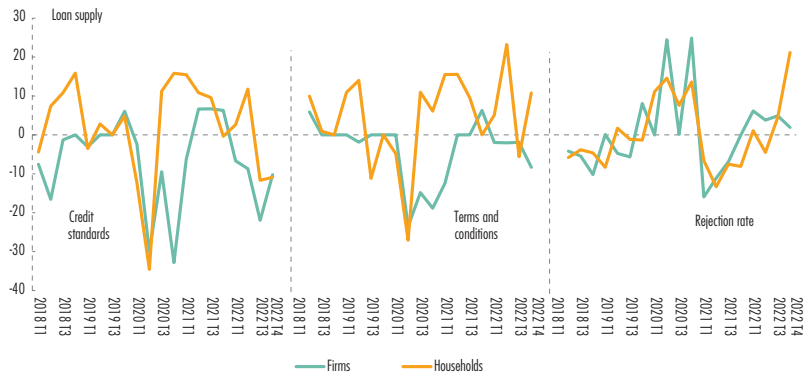
SUPPLY CONDITIONS AND DEMAND FOR LOANS IN 2022 Q4¹

Overall banks' credit supply conditions for economic agents remain tightened in 2022 Q4. The lending policies adopted by banks reflected their added caution, due to the uncertainties regarding the economic performance and the solvency of borrowers in the future. Lending standards were more tightened across all new loans granted to households and enterprises in the last quarter. Bank's prudent approach regarding lending, was apparent in the increased rejected loan ratio for all agents. Meanwhile, given the high competition of the system, individual banks applied easier lending terms and conditions to households. Enterprises, on the other hand, experienced tighter lending terms and conditions.



Chart 1 Box 1

Credit supply conditions tightened

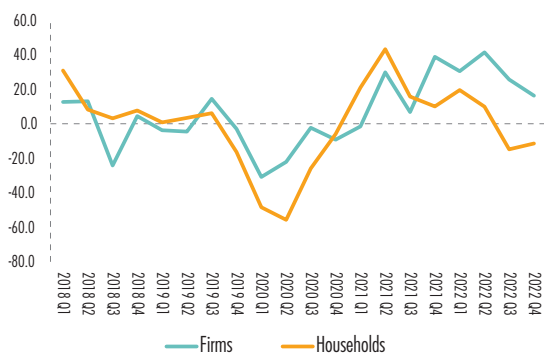


Source: Bank of Albania.

Values on the chart are calculated as net percentage. Positive values indicate easing of terms and conditions and vice versa. Positive values indicate increase of the scale of application refusal and vice-versa.

Chart 2 Box 1

Kërkesa për kredi u perceptua në rritje për bizneset dhe në rënie për individët



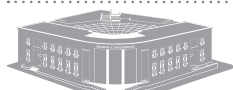
Source: Bank of Albania.

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

Enterprises' demand for loans continued to remain high in the last quarter, more pronounced in the segment of large enterprises. Enterprises increased their demand for loans due to higher costs of inputs and larger inventories. On the other hand, households were more hesitant in their loan demand during this quarter, due to rising interest rates, and the additional uncertainties regarding the housing market perspective.

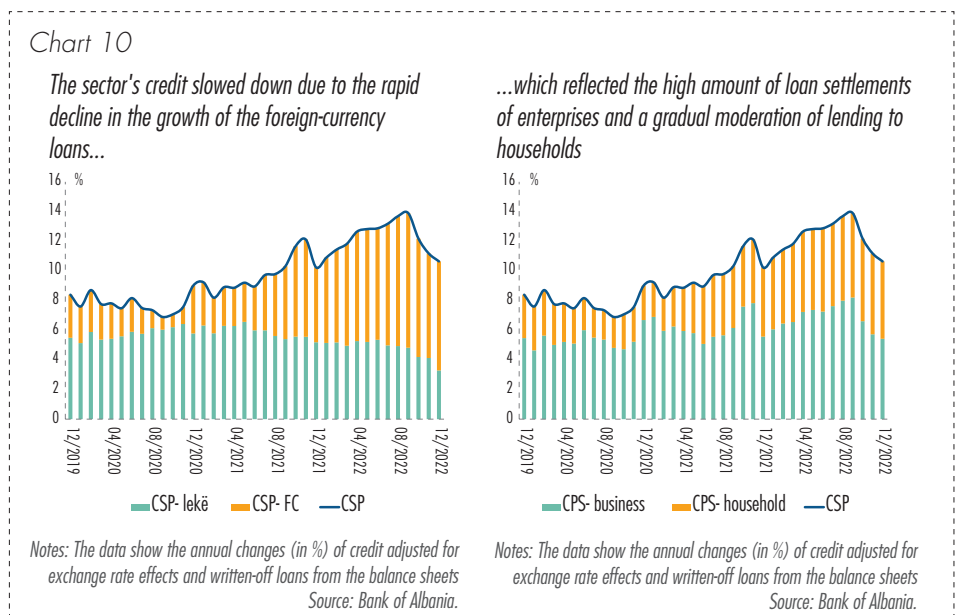
¹ The analysis is based on Bank Lending Survey, conducted on quarterly bases and is published at: www.bankofalbania.org/

Following the start of the monetary policy normalisation, banks have started to gradually raise the interest rates. The average interest rate on **time deposits in lek** reached 1.5% in December, with a 0.9 percentage point cumulative increase compared to the first quarter of the year. The same trend was noticeable in the **interest rates on deposits in euro**, which reached 0.7% in December, from below 0.2% recorded in the previous four years. The interest rates of deposits in lek and euro are increasing almost at the same speed, maintaining their spread, close to the average of 0.5 percentage point in the past three years.



3.3. CREDIT TO THE PRIVATE SECTOR⁸

Credit to the private sector grew at a slower pace in the last quarter. Thus, after peaking to 14% in the third quarter, the annual growth rate of credit portfolio declined to 10.6% in December⁹. As a consequence, lending to both enterprises and households slowed down. By currency, the slowdown of credit reflected the faster decline in the growth of foreign currency loans than domestic currency loans. However, lending in foreign currency performed better during 2022, as the annual growth rate recorded 15.3%, while loans in lek grew by 6.3%.



The deceleration of loans to enterprises to 8.5%, reflected the weak performance of credit for liquidity and investment purposes, which grew by 11.2% and 6.5%, respectively, down by around 4 pp. than in the previous quarter. The slower growth of loans to enterprises in the last quarter was impacted by tighter credit supply conditions as well as by improvements of enterprises' liquidity¹⁰. Meanwhile, during this period, loans to households expanded by 14.5%, down by around 1.3 pp. than the peak growth of 15.8% recorded in the summer months. This slowdown reflected the subdued loans for house purchase (which recorded a high annual growth rate of 16.4%, nonetheless) compared to the stable growth pace of consumer credit (9.3%). Based on the Bank Lending

⁸ Credit analysis is based on the new set of data prepared by the Statistics Department, 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. As a result of methodological changes, the current values are higher than the growth rates analysed until 2021. Despite the differences, both series show the same trend in lending in time. In September, the Department of Statistics reviewed these series for the period 2018-September 2022.

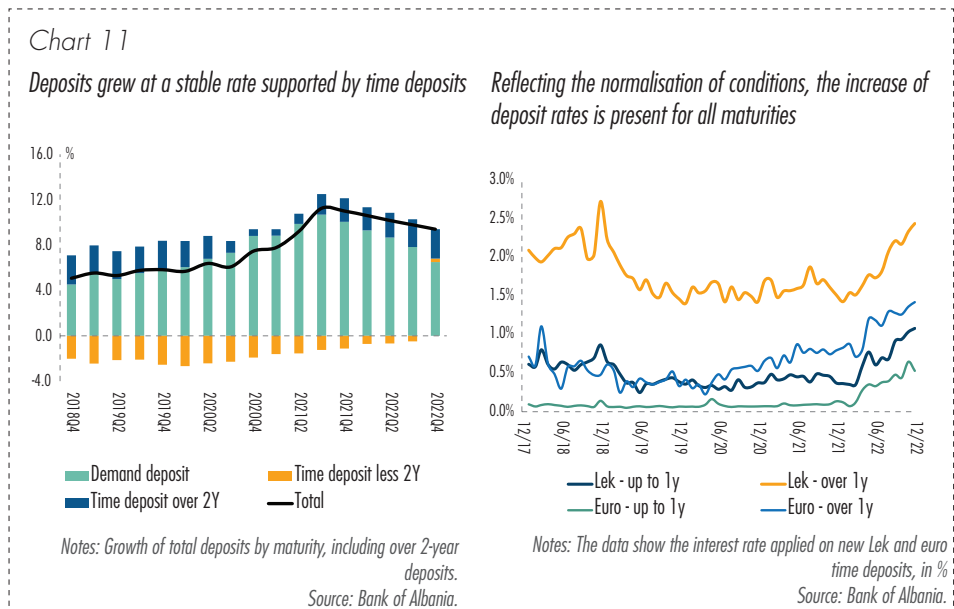
⁹ Lending developments for enterprises in December were affected by the earlier settlement of loans in lek for investment in one of the banks. In exception to the one-off effect of this credit, lending grew at a moderate pace.

¹⁰ As demonstrated by the performance of enterprises' deposit.

Survey, the household segment has reacted toward the tighter credit supply conditions, by being more cautious regarding their financing demand from banks.

Regarding bank funds, the normalisation of the monetary conditions has continued to drive the shift towards time deposits, particularly those with 2-year maturity. Therefore, the slower annual growth rate of demand deposits at 11.6% (from 22% at the beginning of the year), was balanced by the stronger growth rate of time deposits at 6.6% (from 2.7% at the beginning of the year). This performance was driven by the steep growth of 2-year time deposits, which strengthened particularly after the summer months. Shifting savings toward long-maturity time deposits, in both lek and foreign currency, was due to banks' offers for these products, as well as individual preferences for high returns.

According to economic agents, households' deposits grew by 7.9% year-on-year in the last quarter, decelerating by 1 percentage point compared to the third quarter. The stable growth rate of total deposits of 9.4%, was impacted by deposits of enterprises, which recorded an annual growth of 16% (from 13.5% in Q3), reflecting mainly the higher amount of liquidity in foreign currency. Meanwhile, the composition of deposits by currency, shows that deposits in lek grew at a slower pace due to the consolidating stance of the fiscal policy and the higher interest for investments in government securities, during the last quarter. On the other hand, the growth rate of deposits in foreign currency improved to 17.3%, returning to the high rates recorded during summer.



4. ECONOMIC GROWTH

GDP growth accelerated at 4.0% during 2022 Q3, on the back of the recovered activity in the construction sector and the continued positive trend of the service sectors. From the aggregate demand point of view, economic growth was supported by the positive progress of consumption and private investments as well as by the increase in the export of goods and services. Meanwhile the expansion of imports and the low realization rate of public investments provided a decelerating impact. These dynamics reflected the sound financial balances of enterprises and households, the increase in wages and employment, as well as the continuous support with bank loans. Economic growth for the fourth quarter is expected to be at similar levels to that of the previous quarter.

The relatively stable demand for goods and services has brought an increase in employment and wages in the economy, suggesting upward inflationary pressures from the domestic economy.

Our projections suggest the Albanian economy will continue to grow in the medium term. The rate of economic growth is expected to slow down during 2023, and return to normal during 2024, by establishing adequate premises for meeting the inflation target.

4.1. GROSS DOMESTIC PRODUCT

Gross Domestic Product recorded an annual growth of 4.0%, in the third quarter of 2022, improving compared to the previous quarter.¹¹ The services sector continues to provide the main support in GDP expansion, contributing with 3.4 percentage points to this growth. On the other hand, the growth pace improvement, reflected the recovery of the production sector, which contributed by 0.8 percentage point to GDP, from -0.7 percentage point in the previous year. Meanwhile, the net tax contribution shifted into a negative territory by 0.2 percentage point (Chart 12, left).

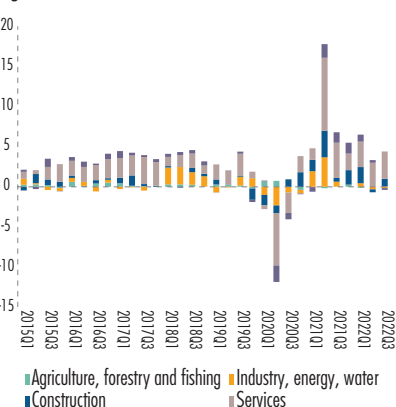
The recovery of the **production sector** was affected by the strong acceleration in "Construction". The economic activity in this branch recorded an annual increase of 10.7%, contributing by 1.0 percentage point to the annual GDP

¹¹ The economic growth in the second quarter was revised to 2.6% from 2.2% in the previous publication by INSTAT.



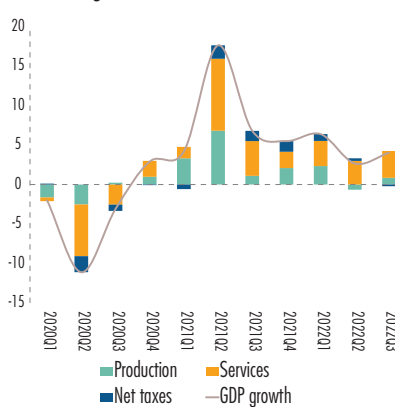
Chart 12

The acceleration of economic growth is mainly driven by the construction activity, alongside the growth of services



Source: INSTAT and Bank of Albania.

The services sector gave the main contribution to growth, while production sector generated the accelerating effect



Source: Bank of Albania.

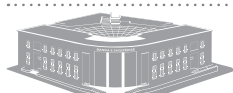
growth.¹² Other branches of production have provided no contribution in this growth. “Industry” continued to slow down in annual terms (-1.4%), driven by the contraction of the activity in the “Extracting industry” sub-branch. Meanwhile, “Agriculture” continued to record growth rates close to zero (0.2%). The **services sector** provided the main contribution to growth in 2022 Q3, by 0.4 percentage point higher than in the previous quarter. The main contributions within the services sector continued to come from the “Trade, transport, accommodation and food service” branch, where the “Accommodation” sub-branch stands out in reflection of the good performance in the tourism sector during 2022 Q3. Furthermore, the growth acceleration of the services sector during the third quarter, was dictated by the expansion of the activity of “Real estate” and “Arts, entertainment, leisure” branches.

Based on indirect and partial data for the fourth quarter of 2022, the economic growth is expected to be at similar levels of those in the previous quarter. The domestic demand, tourism sector and related activities are expected to mainly affect this growth.

4.2. AGGREGATE DEMAND

The growth of aggregate demand has been improving in 2022 Q3. This recovery reflected the sharp growth of investments, materialized in the expansion of construction activity (Chart 13, left). In parallel, “Consumption of population” continued to highly contribute in a stable manner, to the economic growth. On the contrary, the contributions to the economic growth of “Public consumption” and “Net exports”, continued to remain in a negative territory.

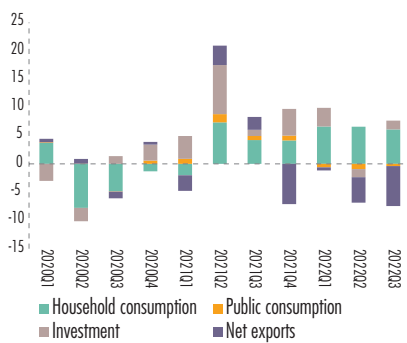
¹² During 2022 Q2, “Construction” slowed down by 3.5%, determining the general slowdown of economic growth compared to the first quarter of the year, where growth spiked to 6.4%.



Domestic demand grew by 6.9% in annual terms in 2022 Q3, from 3.7% in the previous quarter. This acceleration came from the better performance in “Investments” which annually grew by 7.1%¹³ This performance reflected the expansion of private investments, while public investments continued to register an annual contraction. The consumption of population marked an increase comparable to that of the previous quarter (around 8.1%), maintaining the high contributions of this component in the expansion of the economic activity. In contrast, public consumption continued to annually decline, but at slower rates compared to the first half of the year.

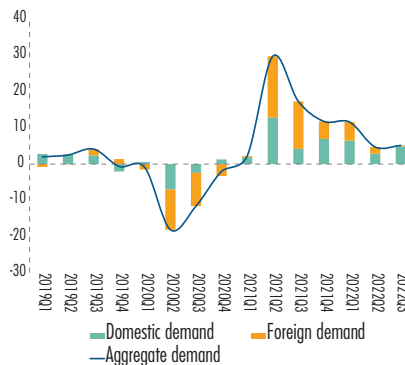
Chart 13

The acceleration of aggregate demand came from investments and high contributions from consumption of population, the impacts of net exports remain negative



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

In 2022 Q3, the growth of aggregate demand was mainly as a result of the domestic demand



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

Private consumption increased by 8.1% in the third quarter of the year, following the increase of 8.4% and 8.6% in the previous two quarters. The growth of private consumption in the third quarter was supported by: the stabilisation of uncertainty; the increase of employment; the growth of wages in real terms; as well as by the positive performance of consumer credit. The increase in consumption was reflected in the categories of services and food items, while purchases of durable goods had a slower performance (Chart 14, right).¹⁴

Private consumption is expected to provide the main contribution in the economic growth during the fourth quarter as well.

Total investments returned to positive growth rates in the third quarter, up by 7.1%, driven by private investments (Chart 15). Data from the import of goods as well as from the Gross Value Added by sectors indicate an increase in private investments for the two main categories: “Construction” and “Machineries and equipment”. The financial situation above the historical average, the

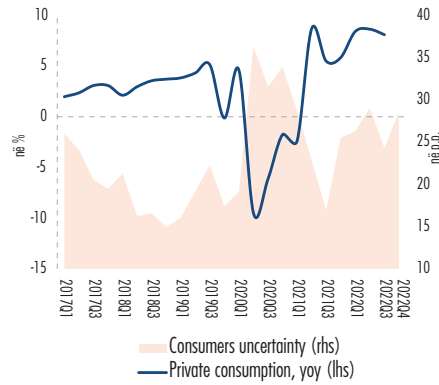
¹³ The same component influenced the apparent slowdown of economic growth in 2022 Q2, when investments fell by 5.2%

¹⁴ The analysis of private consumption by category is based on data from the retail trade index, confidence surveys as well as data from GDP measured by the production method.



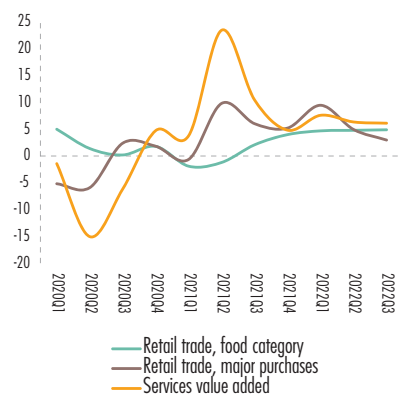
Chart 14

Private consumption continued to grow in the third quarter



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.

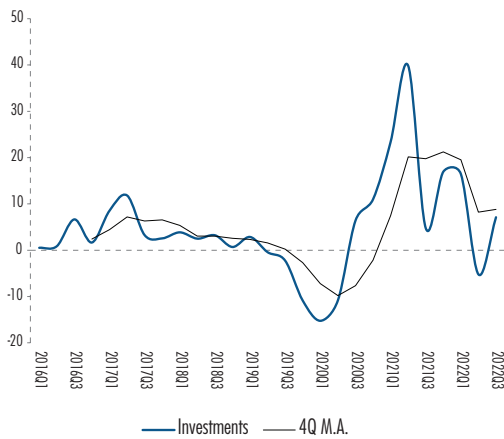
Expenditures increased mainly for services and food, whilst for major purchases they decreased



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

Chart 15

Total investments in economy returned to grow in 2022 Q3



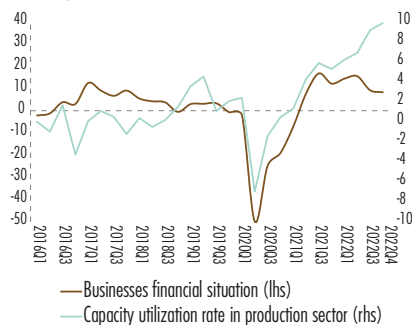
Source: INSTAT and Bank of Albania.

higher utilization of production capacities, timely adaptation to the situation of increased prices as well as stable consumer demand, are the factors that have encouraged enterprises to invest during the third quarter of the year (Chart 16, left). On the other hand, public investments component continued to negatively contribute to their growth.

Available indicators for investments, in the fourth quarter of 2022, suggest a similar profile of their growth. The import of machineries and equipment has continued to grow in real terms, suggesting an increase in investments by enterprises in this category (Chart 16, right).

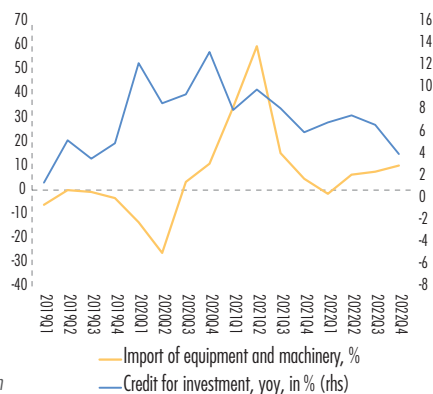
Chart 16

Capacity utilisation rate and the financial situation of enterprises remain above the long-term average in the fourth quarter



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 loan suggest positive developments of private investments



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

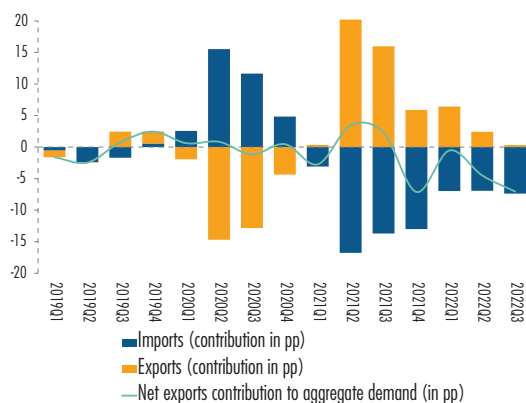


Net exports continued to negatively contribute to the growth even during the third quarter of the year (Chart 17). This performance reflected- on the one hand- the slowdown in growth rates of real exports (at 0.8%) and- on the other hand- the continuation of the upward trend. The slowdown in exports was affected by the fall in annual terms of the export of services (-2.7%), despite the strong contribution of tourism to this growth. As in the previous quarters, this is related to the rather high values of export deflators for both goods and services compared to imports.

The data on foreign trade of goods for the fourth quarter indicate a slowdown in growth rates for both, exports and imports. This is related to a slower increase in international prices as well as to a slight expansion of traded quantities. The slowdown is more noticeable in imports, also related to a strong negative effect from imports of electrical power. As a result, the nominal trade deficit decreased by 5.1%, an opposite trend when compared with the performance of the first nine months of the year, when the deficit expanded at a double digit pace.

Chart 17

The negative impact from net exports deepened during 2022 Q3

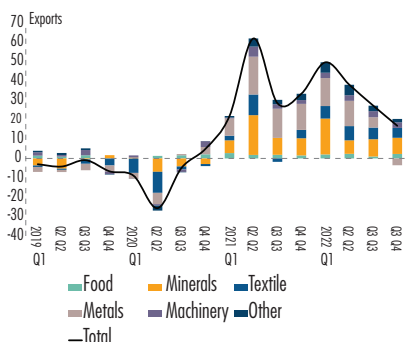


Notes: Contribution of imports and exports in economic growth. Source: INSTAT and estimations of the Bank of Albania.

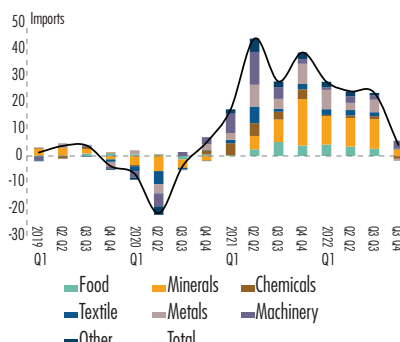
In 2022 Q4, the exports of goods grew by 16.8% in annual terms, slowing down from the rate of the previous quarter (27.2%) (Chart 18, left). The categories “Minerals, fuel and electricity” and “Textile and footwear” provided the main contribution in this growth. Meanwhile the slowdown in export growth was a result of negative contributions from the construction materials and metals category. The latter had significantly slowed down its growth pace since in the previous quarter.

Chart 18

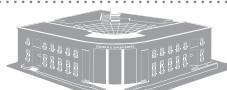
The annual growth of exports slowed down during 2022 Q4, mainly as a result of the downward impact from “Construction materials and metals”



The growth of imports has significantly slowed down due to the negative contributions from electricity and from categories related to the construction sector



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



Imports of goods recorded an annual growth of 4.1%, in the fourth quarter of the year, a rate that slowed down considerably compared to the previous quarter (23.7%) (Chart 18, right). The positive impacts are related with the categories "Machinery, equipment, spare parts" and "Minerals, fuels, electricity". In the second case, growth was quite slow compared to the previous quarter due to the negative effect from electricity. Meanwhile, the categories related to the construction sector, namely "Construction materials and metals" and "Chemical and plastic products" contributed negatively by further slowing down the growth pace of imports.

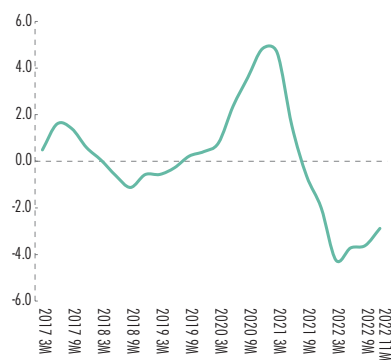
In terms of the main trading partners, the growth of exports was influenced by the European Union member partners, mainly Italy and Spain. Neighbour countries have also provided positive contributions. In regard to imports, the negative contributions have come from both the European Union and neighbour countries. Other countries, mainly Turkey and China provided positive impacts.

Fiscal policy has had a consolidating nature over 2022¹⁵, reflected in a fiscal surplus which was present during the major part of the year. This policy has restrained the pace of expansion of aggregate demand, but on the other hand, has improved the indicators of fiscal sustainability. However, following this philosophy, the fiscal policy has made sure to take supportive measures to partially offset the negative effects of the increase in domestic and foreign prices on the balance sheets of households and enterprises.

The fiscal impulse¹⁶ was estimated at about -2.9 percentage points of GDP, in November. The negative values of the fiscal impulse are attributed to the slow

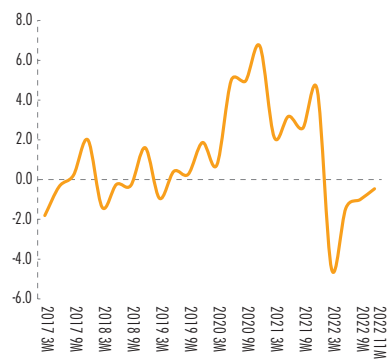
Chart 19

The fiscal impulse remained on negative territory...



Notes: Change in primary deficit ratio to GDP for 12 months, from the previous year. Positive values of this indicator show that fiscal policy has generated increased impulse into the economy
Source: Ministry of Finance and Economy, MPD calculations.

... as a result of fiscal surpluses created during the year



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

¹⁵ Recent data published for public sector till the preparation date of the report are as November 2022. The fourth quarter of year, Q4* in Charts, shows the performance of each indicator in October and November

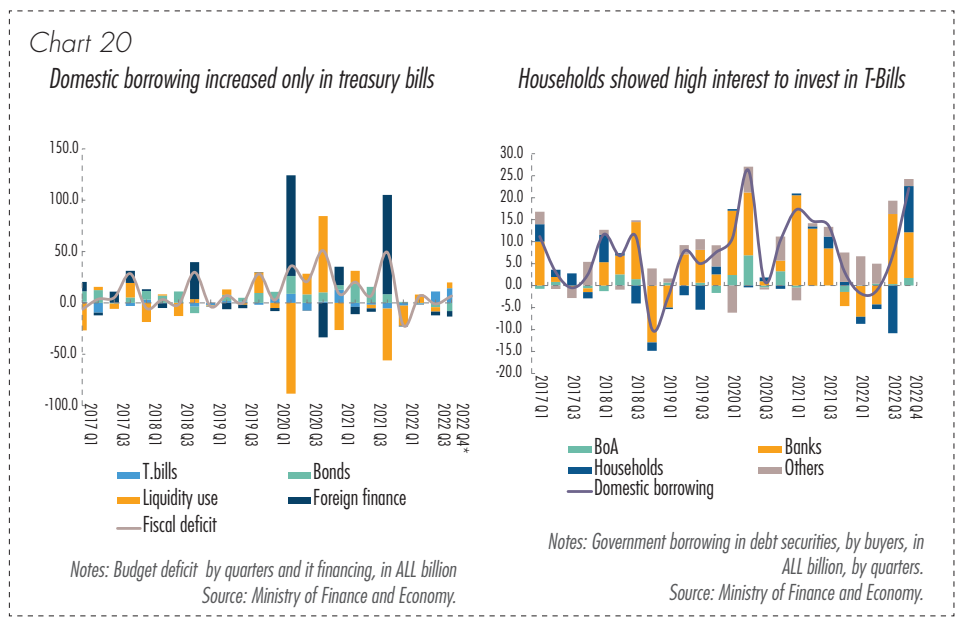
¹⁶ Energy support funds are not included in the calculations of the fiscal impulse, as it is a temporary measure and has no permanent impact of the fiscal position.



pace of realization of public investments¹⁷, which positively affected the values for the fiscal balance until the end of November. **The budget balance** was positive at ALL 9.2 billion at the end of November, or about 0.5% of GDP¹⁸.

Net **borrowing** in the domestic market of securities grew by around ALL 22 billion in 2022 Q4¹⁹. The reluctance of market actors to invest in government bonds after the first quarter of the year, shifted most of the additional borrowing planned for 2022 to the last quarter. The total new borrowing in lek for 2022 was ALL 30.1 billion. The increase in treasury bills was about ALL 32.4 billion, while the decrease in new borrowing in ALL in bonds of different maturities was ALL 2.3 billion. The investment policies of the main market actors in government securities, especially after the first quarter of the year, were oriented towards short-term instruments, dictating an adaptation of the government’s borrowing strategy to their likings. This way, the portfolio of government bonds during 2022 was expanded only by short-term instruments, which have partially replaced long-term ones.

The net foreign borrowing, as at end of November 2022, was about ALL -9.7 billion, as a result of external debt servicing at a greater extent compared to foreign currency inflows from abroad for budget deficit financing. Most of the inflows in foreign currency during this year, about 17.1 billion ALL, were in the form of budget support from international institutions. The performance of both fiscal surpluses, throughout the year, and borrowing in the domestic and foreign markets have been factored into quite high liquidity surpluses of

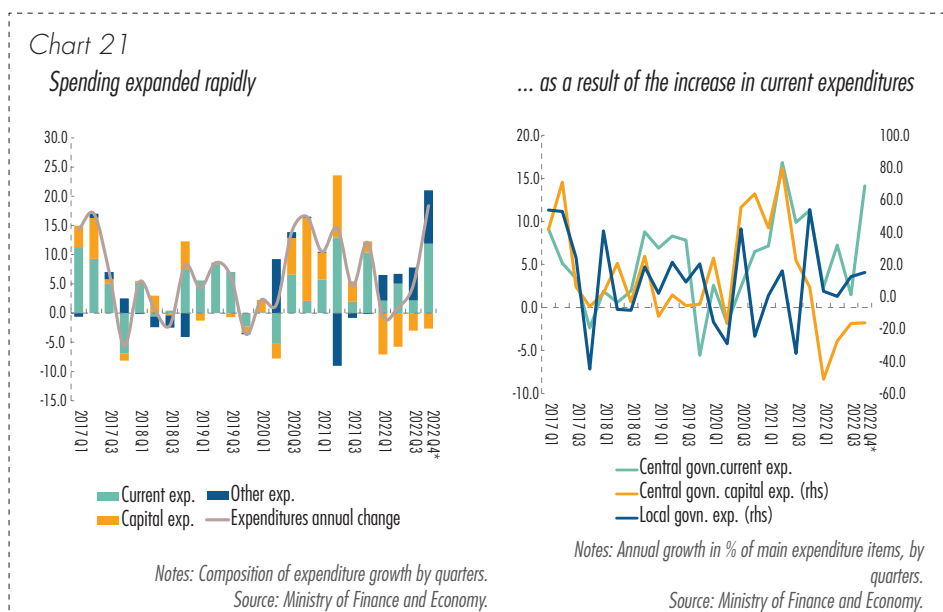


¹⁷ In the previous year, public investments contributed the largest extent to the increase in total government spending throughout the year.
¹⁸ Assuming that the annual plan of ALL 84 billion is fulfilled, the month of December alone should carry a deficit of 93 billion lek.
¹⁹ Based on the operational data of auctions conducted until 30 December 2022.

the government, a part of which has been transferred to be used to finance expenses during 2023.

The main holders of the domestic government debt remain commercial banks, which account for 60% of domestic public debt. However, a significant part of the increase in borrowing in the last quarter of the year was borne by households. The latter increased their exposures to government securities, as a result of the sharp increase of return rates from investments in short-term securities.

Budget expenditure, in October and November amounted around ALL 104 billion, with an annual growth of 18.4%. Half of the increase was formed by the support with ALL 8 billion, which the government granted to the energy sector to enable partial compensation of the costs of the high price of electricity imports. The support fund for this sector, as at end of November, was about ALL 24 billion, from ALL 28 billion planned for the whole year 2022. However, other expenditure items have also given positive contributions, somewhat higher than in the previous three quarters of the year, suggesting their positive impact on the expected expansion of aggregate demand in the last quarter.



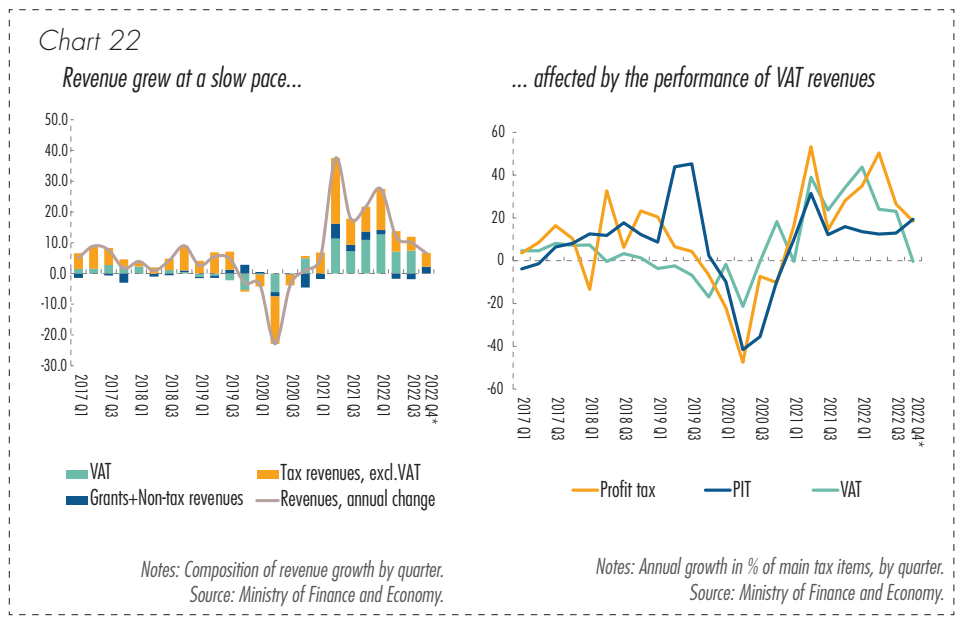
Public investments, as in the other three quarters, continued to decrease in annual terms, around 16%, in October and November. Their low realization throughout most of the year can increase the intensity of spending in December beyond the seasonality that characterizes this month.

For the first 11 months of the year, expenditures were about ALL 514 billion, or around 4.5% higher than the same period in the previous year. The profile of expenditure growth did not show any significant changes during the year. Thus, the increase of spending was dominated by the support that the government has given to the energy sector. Public investments, on the



other hand, have eroded the growth of total expenditures, giving a negative contribution of around 4.9 percentage points.

Revenues resulted in about ALL 97 billion in October and November, or 6.6% higher compared to the same period a year ago. Revenue growth slowed in the last months of the year, from averagely 16.5% in the first three quarters. The main impact was given by VAT revenues on imports of goods, which contributed by -0.6 percentage point to the increase of total revenues, from an average of +6.7 percentage points in the first three quarters. The items that supported the expansion of revenues in October and November were: social insurance contributions, by about 2.8 percentage points; personal income tax, by about 1.3 percentage points; and profit tax, by about 1.2 percentage points.



In the first 11 months of year, revenues reached around ALL 523 billion, or around 14.1% higher from the previous year. Despite the developments during the last two months, VAT revenues dominated the growth of total revenues in 2022, accounting for half of them. Developments regarding income based on imports have reflected, to a high extent, the rapidly soaring prices in international markets throughout 2022, as well as the effect of the domestic currency depreciation against the US dollar, averagely 9.9%.²⁰.

²⁰ The groups of import goods which are quoted in the US dollar, like fuels, metals, etc., have a considerable share in total imports in value.

5. INFLATION, PRICES AND COSTS IN THE ECONOMY

Average annual inflation stood at 7.9% in 2022 Q4, unchanged from the previous quarter's rate. The upsurge in commodity and food prices until October drove to the expanded headline inflation, through the imported channel and the price-formation chain, from production to the final consumption. The inflation curve has been declining in the last two months of the year, mainly due to the mitigation of external pressures. On the other hand, domestic inflationary pressures appeared more stable.

Inflation is expected to pursue a downward trajectory during 2023, affected by the decreased pressures in foreign markets and the normalization of the monetary policy stance, which helps mitigate the second-round effects and anchor inflationary expectations.

5.1. CONSUMER PRICES

Annual inflation averaged 7.9% in 2022 Q4, standing at almost the same average values of the previous quarter. The average of annual inflation was 6.7% in 2022, shifting it 4.7 percentage points above last year's average (Chart 19, left). After a progressive increase over a period of about one year, inflation recorded a decrease for the first time in November and December²¹. A strong slowdown in oil prices and a drop in the transport costs of goods mitigated the pressure on prices in global terms. This development is also reflected in the downward trend of inflation in the Albanian economy. This performance was also verified across most of both the European Union and regional countries of (Chart 3, right)

The lower level of inflation in Albania compared to regional countries and beyond, is the result of keeping the electricity fee on households unchanged, the increase in the supply of domestic production for unprocessed foods, as well as the appreciating behaviour of the domestic currency in the foreign exchange market. The normalizing effects of the monetary policy are expected to materialize further in curbing the second-round pressures and anchoring inflationary expectations in a medium-term period.

²¹ The first differences for the annual inflation for the two months of November and December together, resulted at -0.9 percentage point.

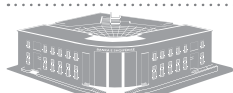
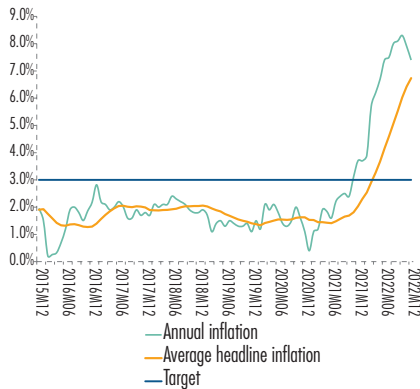


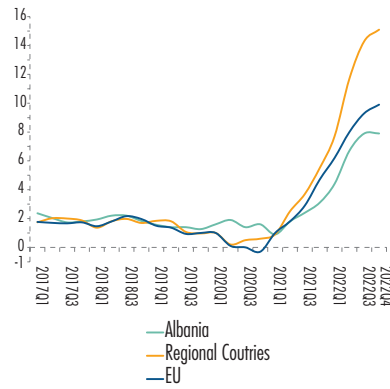
Chart 23

Inflation in Albania slowed down, mainly due to the weakening of inflationary pressures from abroad



Source: INSTAT and Bank of Albania's calculations.

Decelerating upsurge in oil prices and transport costs have dictated the inflation performance in the region and beyond



Source: INSTAT and Bank of Albania's calculations.

“**Processed foods**” (43%) continued to considerably determine the annual inflation in the fourth quarter. However, the contribution of this category resulted in a slight slowdown; such behaviour was not encountered since the second quarter of last year (Table 2). Within this category, a general slowdown of its sub-categories is observed, with the exception of the “milk, cheese and eggs” sub-category, prices of which continued to increase. “**Unprocessed foods**” contributed at a larger extent than a quarter ago, but increased the headline inflation by only 0.1 percentage point. The subgroups “fruits” and “vegetables” demonstrated a downward trend of contributions in December, thus mitigating the pressures resulting from the increased demand for goods in this category. The contribution of “**Non-food items**” was -0.3 percentage point lower than in the previous quarter. This development was more pronounced in December, reflecting the significant slowdown in the increasing pace of commodity prices, combined with the effects coming from the US dollar depreciation in international and domestic foreign exchange markets.

The prices of other more stable components of inflation, which include the categories “**Services, housing and goods**”, resulted in almost the same value of the contribution to inflation formation compared to a quarter ago. The “Housing” category continued the upward trend, conveying the high pressures from construction prices. Meanwhile, contributions from the “Services” category, decreased, mainly due to the lower prices of tourist packages. In addition, the prices in “Hotels, bars and restaurants” sub-category also showed a slight slowdown, especially in December. The category of goods and services at “regulated prices” maintained negligible contributions to the formation of headline inflation in the quarter under review. Keeping the electricity prices for household consumers, unchanged, played a decisive role in this development.



Table 2 Contribution of key categories to annual inflation (p.p.)*

	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	Annual inflation 2022 Q4 (%)
Processed food	0.6	0.4	0.6	0.9	1.4	3.0	3.5	3.4	15.1
Bread and grains	0.1	0.1	0.1	0.2	0.4	0.7	0.6	0.6	16.1
Milk, cheese and eggs	0.2	0.1	0.1	0.2	0.3	0.9	1.0	1.2	24.3
Unprocessed foods	0.3	0.9	1.0	1.0	1.5	1.2	1.7	1.9	10.8
Fruits	0.2	0.1	0.1	0.4	0.2	-0.1	0.0	0.1	2.6
Vegetables	0.0	0.6	0.8	0.4	0.9	0.5	0.6	0.8	12.9
Meat	0.1	0.1	0.1	0.2	0.4	0.7	1.0	1.0	12.7
Services	0.1	0.2	0.2	0.3	0.4	0.5	0.6	0.5	3.5
Goods with regulated prices	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Housing lease	0.0	0.1	0.2	0.2	0.1	0.2	0.3	0.4	3.4
Non-food consumer goods	-0.3	0.1	0.3	0.6	1.0	1.6	1.5	1.2	8.5
Fuel	-0.3	0.0	0.2	0.4	0.7	1.4	1.3	0.9	17.3
Durable consumer goods	0.1	0.1	0.1	0.1	0.0	0.2	0.3	0.4	0.1
Inflation (%)	0.9	1.8	2.4	3.1	4.4	6.7	7.9	7.9	7.9

Source: INSTAT and Bank of Albania's calculations.

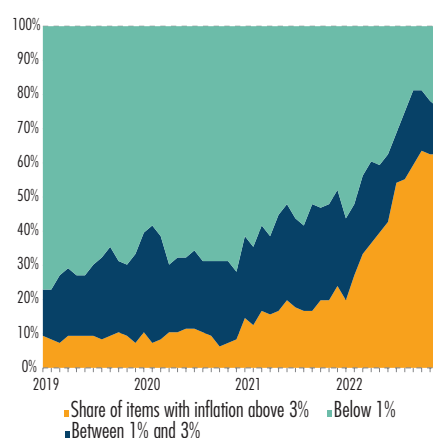
*The Table shows the contributions in inflation by composing categories and some of their main items. Also, the Table shows the average inflation rate in 2022 Q4.

The slowdown of headline inflation in the last two months was reflected in a reallocation of basket's items according to inflation rates²². In December, the share of items with inflation between the range 1-3% and over 3% decreased by 4 percentage points and 1 percentage point, respectively. At the same time, the number of CPI basket items with inflation below 1% increased by 5 percentage points (Chart 24, left). The shifts in the lower inflation range of the "Tourist packages" and "Entertainment and culture services" items are more pronounced.

Despite this shift, items with stable inflation continued to maintain high values, reflecting the high intensity of pressures over 2022. This assessment is also

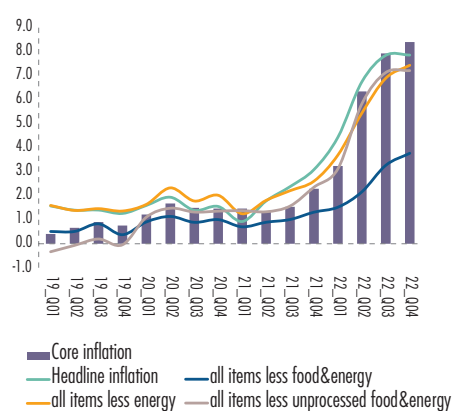
Chart 24

The share of items with inflation lower than 1% has expanded during the last two months of the year



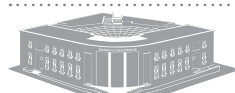
Source: INSTAT and Bank of Albania's estimations.

Growth in all measurements of net inflation weakened slightly in this quarter



Source: Bank of Albania.

²² The assessment is based on the annual inflation data for a detailing at a 2-digit level pursuant to COICOP classification of CPI basket items. This detailing included a total number of 96 goods and services.



supported by the performance of measurements of net inflation,²³ which remained above the 3% rate (Chart 24, right).

5.2. INFLATION DETERMINANTS

The curbing and decrease of inflation during the fourth quarter was determined by the fall of direct external inflationary pressures. On the other hand, pressures of domestic nature remain relatively high, dictated both by the cyclical position of the Albanian economy and the second-round effects. This is evident in the high values of core inflation and in the considerable and added contributions of domestic inflation in the fourth quarter of 2022.

The relatively high demand for goods and services is reflected in continuous improvements in the labour market indicators during 2022. These trends continued in the third quarter as well. Employment recorded further growth, the unemployment rate continued to fall to historically low levels, and the capacity utilization rate remained significantly above the average. These developments were accompanied by a double-digit increase in wages across the private sector.

Despite the slowdown, inflation remained high and above the target in the last quarter of 2022. This performance seems to reflect the stability of the core and domestic components of inflation, following the materialization of second-round effects and pressures coming from the labour market and wages.

The formation of inflation in 2022 Q4 was dominated by the increasing impacts of its more stable and of domestic origin components. For the same period, the most volatile and foreign components recorded slightly lower contributions throughout the quarter (Chart 25). Core inflation and domestic inflation were 8.4% and 6%, respectively, following upward trajectories, but at a slower pace than before. This development was driven by the relative stability in the prices of services and more durable goods. Their annual growth, as measured by net core inflation, was around 3.8%, recording a more moderate expansion than before²⁴ (Chart 26). The above developments led to higher contributions from core and domestic components, 72.7% and 58.5% respectively, against a slight reduction in contributions from non-core and imported components.

²³ These measurements include the effects of prices with more volatile prices and are assessed as different alternatives of core inflation, which should be impacted directly by the decision-making of the monetary policy.

²⁴ Net core inflation excludes the sub-groups of processed foods (including bread and grains) from the measurement of the core inflation. Net core inflation considers 44.1% of the current CPI basket. During the fourth quarter, the core net inflation in annual terms was stable close to 3.8% in each month of the quarter, expanding by 0.5 percentage point compared to the previous quarter. In the third quarter, this measurement marked a significant acceleration, by 1.2 percentage point, compared to the value of the previous quarter.

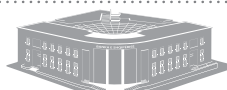
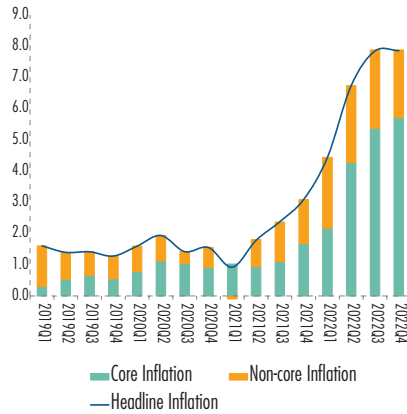


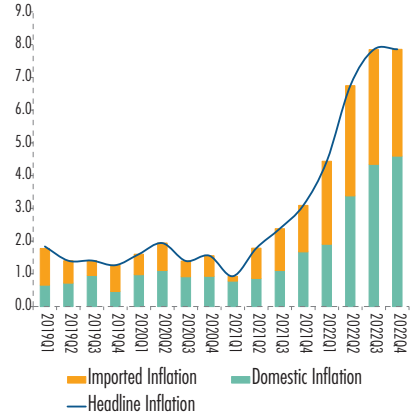
Chart 25

Contributions of core inflation remained high and at close values in the last two quarters of the year



Source: INSTAT and Bank of Albania's estimations.

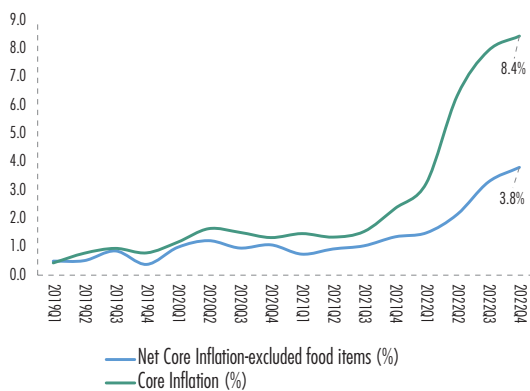
The increase in domestic contribution was offset by the mitigation of imported contributions at the end of the year



Source: INSTAT and Bank of Albania's estimations.

Chart 26

Core net inflation rose more slowly than before, reflecting the stability of prices of services and durable goods, during 2022 Q4



Source: INSTAT and Bank of Albania's estimations.

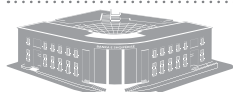
The decline in food and oil inflation played an important role in slowing the non-core and imported components of inflation in November and December²⁵. They stood at 6.7% and 14.3%, respectively, in the fourth quarter of the year, reducing their contributions to headline inflation.

Cyclical position. Estimations suggest a positive cyclical position during the third quarter. The increase in employment accelerated, unemployment reached the lowest level recorded, while wages in private sector continue to pursue the double-digit rise. This has been reflected in high core inflation rates in 2022 H2.

The capacity utilisation rate in economy stood at around 78.1% in 2022 Q4, slightly higher compared with the previous quarter. This rate continued to stay above the historical level.

Employment and unemployment. Employment continued to expand during 2022 Q3, at similar rates compared to the previous quarter. The increase was 4.2%, from 4.1% in the second quarter of 2022. Broad-based contributions came from all sectors of the economy. The number of employees continued to grow beyond the pre-pandemic level, a level that had been exceeded since the second quarter of 2022.

²⁵ The subgroup "Goods and services for personal means of transport" showed sharp slowdown of annual inflation, due to the item "fuels". For the first time in December 2022, the annual inflation of this subgroup resulted in a single-digit value (6.4%), after double-digit increases around an average of 20.8% for the period October '21-November '22.



The **unemployment rate** continued to fall to new historical minimums. Unemployment decreased to 10.6%, the lowest rate ever recorded. Compared to the previous quarter, this indicator decreased by 0.5 percentage point (Chart 28). In annual terms, the unemployment rate was down by 0.7 percentage point.

Wages, productivity and labour costs. The average wage in private sector continued expanding at a double-digit pace in 2022 Q3. Annual increase reached at 12.3%, from 11.9% in the previous quarter (Chart 29, left). Among the sectoral contributions, the branches “Trade, transport, accommodation and food services”, “Industry”, “Public Administration” and “Information and communication” have provided pronounced contributions in this regard. On the other hand, the growth rate of the real wage slowed down to 4.2% in the third quarter, as a result of the acceleration of inflation in this period.

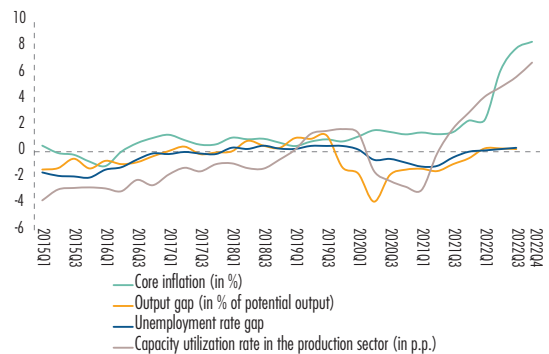
The *unit labour cost*²⁶ during the third quarter increased at similar rates as in the previous quarter (3.6% compared to 3.4%). The effect from wages is stronger than the impact from productivity growth, just like in the previous quarter (Chart 29, right). The unit labour cost started the expansionary trend in the second quarter of 2022, after a contracting trend that lasted from the beginning of last year. This is related to both the strong wage increase and the slower growth in labour productivity. This trend has come as a result of the faster recovery of employment against the expansion of gross value added in the non-agricultural sector of the economy.

Other output costs continued to expand with double-digit terms during 2022 Q3. Industrial producer prices accelerated by 20.9%; those for the domestic market increased by 17.0% and those for export by 30.2%. Rapid growth was also noted in construction production costs, where the index expanded by 7.2% in annual terms in the third quarter, from 6.2% in the previous quarter.

Imported inflationary pressures remained high during 2022 Q4. The annual increase of the imported inflationary pressure index (IIPI)²⁷ reached 27.8%,

Chart 27

Cyclical position of economy remained at positive levels in the third quarter reflecting high rates of core inflation

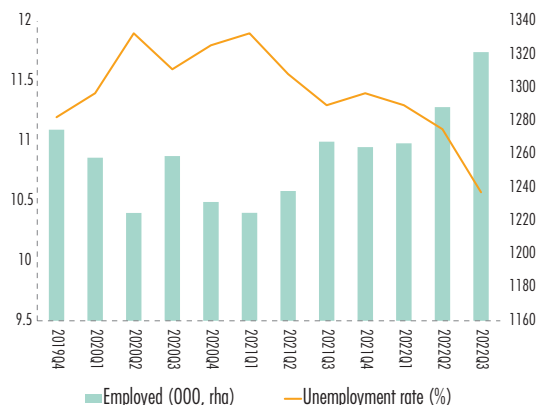


Source: INSTAT and Bank of Albania's estimations.

Notes: The output gap is the average of several measurements on which the method of moving average is applied. The capacity utilization 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 assessed 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.

Chart 28

The continuous increase of employment has incited a further decline of unemployment rate at lower historical level



Source: INSTAT and Bank of Albania's estimations.

²⁶ Unit labour costs are estimated for the non-agricultural private sector based on the National Accounts statistics, of employment and wages.

²⁷ IIPI is calculated as the annual growth of the imported prices index and the NEER index for the respective month. From the correlation analysis of the relevant indicators with different time delays, IIPI anticipates the developments in the imported inflation component by about 3-5 months.

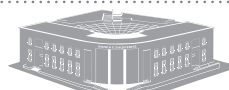
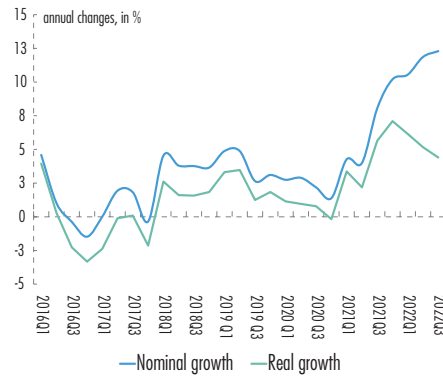


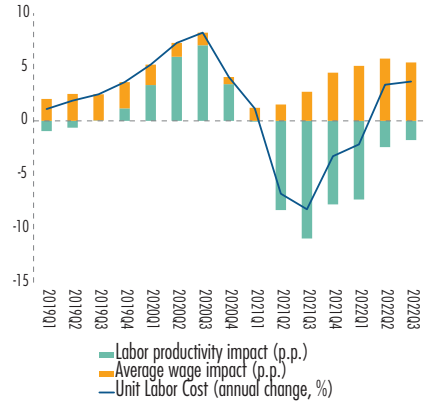
Chart 29

Nominal wages in the private sector continue to grow in double digits, but higher inflation continues to slowdown the real wage growth



Source: INSTAT.

The salary has influenced more than the productivity in the unit labour costs, causing them to increase in annual terms, just like in the previous quarter

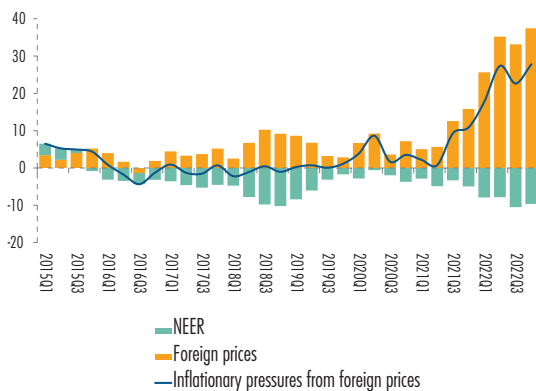


Source: INSTAT and Bank of Albania.

from 22.6% in the third quarter of the year (Chart 30). The acceleration came as a result of the stronger increase in foreign prices, 37.4% in the fourth quarter, against 33.2% in the third quarter. The nominal effective exchange rate has followed an appreciating trend, offsetting to a considerable extent the pressures from foreign prices. The appreciation in annual terms was 9.7%, from 10.5% in the third quarter of previous year.

Chart 30

The upsurge in imported inflationary pressures remains high during 2022 Q4, with a slight acceleration compared to the previous quarter



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

Developments in IPI during the third quarter of 2022 have been materialized in a slight reduction in the contributions of imported inflation to headline inflation during the fourth quarter of the year. Imported inflation is estimated to have contributed by 41.5% to the formation of the headline inflation, or about 3.2 percentage points less than a quarter ago (Chart 25, right), against the slight expansion and non-transitory behaviour of domestic inflationary pressures.

Inflation expectations remained at historically high levels and above target even during 2022 Q4²⁸. However, short-term inflation expectations from enterprises and financial agents declined in the fourth quarter, following a strong upward trend throughout 2022. On the other hand, consumer expectations continued to increase in the last quarter. Thus, they expect inflation to be 11.0% in the next year.

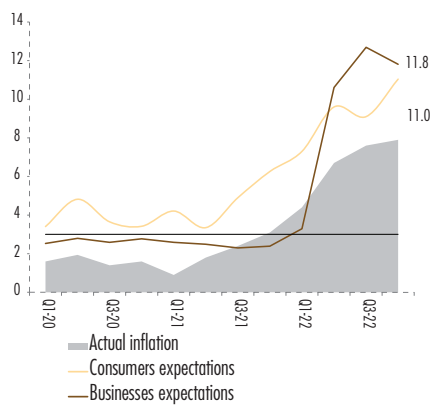
²⁸ The analysis on inflation expectations is based on the results of the business and consumer confidence survey, as well as on the financial agents' expectations survey.



Expectations of financial agents have been revised downward by 0.3 percentage point, for one- and two- year time horizons. Currently, they stand at 5.7% and 4.4%, respectively. Their inflation expectations for three years ahead are 4.0%, around 0.1 percentage point higher than in the third quarter. On the other hand, enterprises' expectations were revised downwards by 0.9 percentage point in the fourth quarter.

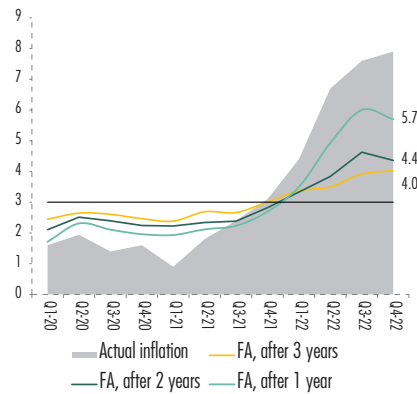
Chart 31

Expectations on inflation one-year-ahead of enterprises and consumers



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

Expectations on inflation of financial agents by three time horizons



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



