

Albania Watch: It's the core inflation, stupid!

"It's the economy, stupid" is a phrase coined by James Carville in 1992. Carville was a strategist in Bill Clinton's 1992 presidential campaign against incumbent and Cold War triumphant George H. W. Bush. His phrase was directed at the campaign's workers and intended as one of three messages for them to focus on. We are borrowing the phrase to draw attention where to concentrate on, when considering the monetary policy.



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Call for vigilance on core inflation

Bank of Albania opted for another **pause** in its latest monetary policy meeting on February 1, contrary to our prediction for **another 25bp** hike. Even though inflation declined in December (to **7.4% from 7.9%** in the previous month), **we believed it was not enough to stop** the Central Bank from **raising the key rate further**.

Declines in overall inflation rates may have brought some comfort to consumers, but central bankers around the world are still wary of **drivers** of persistently high price dynamics. In the case of Albania, this is mostly affirmed by **core inflation**, which has been relentlessly increasing and has not been responsive to the aggressive cycle of monetary policy tightening up until December 2022.

Core inflation picked up pace again in **December, standing at 8.4%**, reflecting the spike in prices of food due to high demand during the festive season. In addition, the Albanian Lek has strongly appreciated towards euro, reaching a new **historical minimum of 112.8 EUR/LEK**. This strong and fast appreciation has probably helped the central bank in its evaluation of **forthcoming decreasing inflationary pressures from the imported items**. However, during January the exchange rate returned to more normal levels, diminishing therefore the long-lasting impact on the inflation of these items.

We project **inflation and core inflation will continue to be some way above the target during 2023**. These expectations are fueled by announcements made by the government related to a further increase in minimum wage. Recent news from the government mentioned **two wage increases during 2023**, which would mean a total increase of **approximately 12%** compared to the current level, if realized.

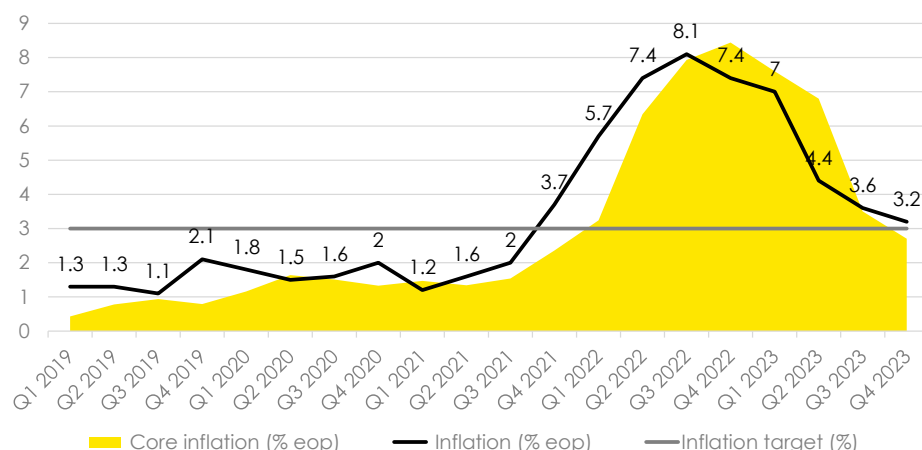
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Headline inflation slowly decreasing



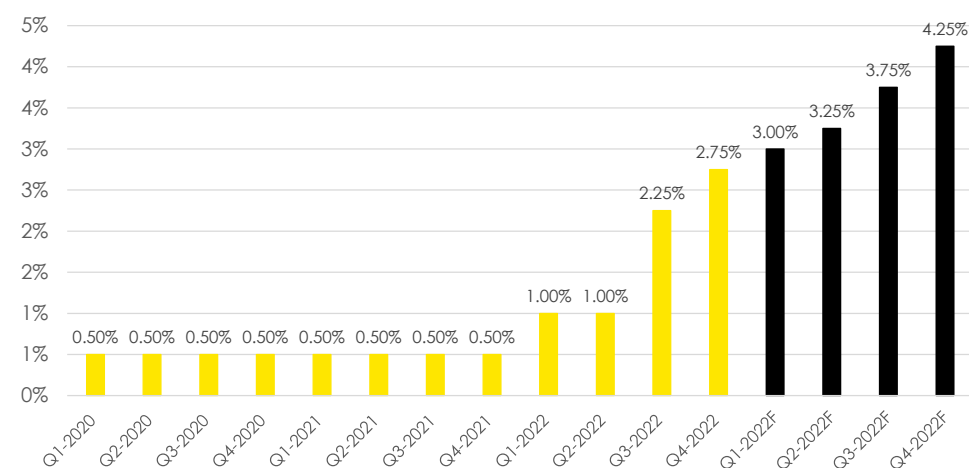
Source: Instat, Bank of Albania, RBI/Raiffeisen Research

Will Bank of Albania stay the course?

In the latest meeting, the Central Bank remained neutral and kept the **base rate unchanged at 2.75%**. In our opinion, high core inflation, potential wage growth and increased spending before municipality elections this year (May 2023) will further **enhance underlying inflationary pressures** and will make the Central Bank reluctant to take their foot off the economic brakes yet. Moreover, the Central Bank announced that, even though the key rate did not change this time, **further monetary policy normalization is needed**. In our view, BoA will stay the course and resume the tightening cycle with further base rate hikes in the coming periods and our projections show the base rate will reach as high as **4.25% in 2023**.

Key rate to reach neutral level by the end of 2023

Key rate (eop)



Source: Source: Instat, Bank of Albania, RBI/Raiffeisen Research

However, the latest pause in the monetary policy normalization comes with question marks. The decision of the governing council goes **against** parts of the final declaration by the central bank. Indeed, in its post meeting statement the central bank considers "inflation rates of **services** and other items remain at **high levels**, comparable with those in previous months."

Furthermore, "from the macroeconomic perspective, the decline in inflation reflected the reduction in the imported inflation, while **the domestic inflationary pressures remain high.**"

If BoA considers the inflation rate of services and the domestic inflation pressures to be high, it is not comprehensive then to pause the normalization of the monetary policy at this moment.

In addition, BoA states that "on the demand side, economic growth was driven by the **increased household consumption** and private investments, whereas public sector and net foreign trade exchanges provided a decelerating effect. Economic growth has been accompanied by **an increase in employment and wages**. Employment grew by **4.2% yoy**, the unemployment rate fell to a new **historical minimum of 10.6%**, and the average wage in the private sector expanded by **12.3% yoy** in the third quarter. The positive performance of the labor market establishes the premises for a sustainable economic growth in the future, while it signals also a **rapid increase in production costs and pressures on consumer prices.**"

The central bank remains optimistic on inflation expectations, and the published statement indicates that "these consequences appear in the form of **controlled expectations of market agents**, a sustained exchange rate and the better balance between aggregate demand and aggregate supply in Albania."

However, in January 2023, the financial agents expectations — which are more closely correlated to the inflation in the medium term — were not close to the **target of 3%**. Indeed, these expectations of **inflation stood at 4.2% and 3.8%, for after 2 and 3 years, respectively**, so quite distant from being anchored.

Concluding, we believe that underlying inflationary pressures continue to be very high, fed by still strong **private consumption, double-digit wage growth** in the private sector and additional **handouts** to part of the population. In addition, in the first half of 2023 (before the elections) the government is preparing another handout **package** which will add fuel to the domestic driven inflation.

With all these factors in mind, we **believe that BoA will resume its tightening cycle again in its next meeting**, but there is added **risk** that it will be forced to increase the amplitude of its hikes in the second part of the year. Thus, taking into consideration the abovementioned factors, we are — for the time being — **keeping our end of period base rate prediction of 4.25%.**

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Symbol	Date	Recommendation	Company
AL	24.11.2022	Under Revision	Albania
AL	07.07.2022	Under Revision	Albania
History of long term recommendations			
Symbol	Date	Recommendation	Company
AL	24.11.2022	Not rated	Albania
AL	07.07.2022	Not rated	Albania

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	Column A	Column B
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