

on the largest Italian banking groups show that the value of investments in subprime mortgage market-securities amounted to 1.3 billion euros, which is less than 1.5% of core capital. Meanwhile, no Italian banks have extended non-performing loans to US partners.

3. MACROECONOMIC SITUATION IN ALBANIA

3.1 ECONOMIC GROWTH

The economy grew at stable rates during the entire 2007. The economic sectors which were extended more loans by the banking sector provided most of the contribution to the economic growth. Construction seems to have slowed down, signalling the need for continuous monitoring of the real estates value used as collaterals in the credits lent by the banking sector and for the diversification of the types of the collateral. The future perspective for an economic stability of productive activities will largely depend on the speed of reforms in the key sectors of the economy, the steady improvement in the energy supply and in the production structure through structural reforms in agriculture.

The 2007 economic growth is estimated to be at 6%, despite the increasing costs in production and services as a result of the supply-side shocks stemming from the regional drought and the energy crisis in the second half of the year. Preliminary projections show that economic growth will remain stable during the entire year 2008, given the improved energy supply and exports' performance.

The indicators by production sectors presented in table 3.1 show that the sectors of industry, transportation and telecommunication, trade, hotels and restaurants provided the main contribution to the economic growth, while the sales index indicates a drop in the sector of construction and the sub-sector of energy, gas, steam and water supply. Relative to the previous year, construction sector saw considerable drop by 25% in terms of new constructions and 13.7% in terms of sales during the year 2007, excluding the price effect (table 3).

The annual downward tendency of new constructions during the entire 2007 signals the reduction of companies' demand for real estates, which has generated the price fall in the first quarter of 2008. The performance of real estates' price index for the capital city is given in chart 8, which shows that the sales have continued to fall in real terms. This fall also owes to the high price rise rate in the last quarter and to the expected effects of the change in the tax on real estates' sale. The risk materialization of the fall of demand for houses and a possible further drop of real estate prices implies negative consequences for the wealth of households and companies

and for the collaterals' market value of banks engaged in mortgage lending and lending to construction. This effect is not expected to be considerable in the entire banking sector; however, its level in certain banks should be monitored prudently.

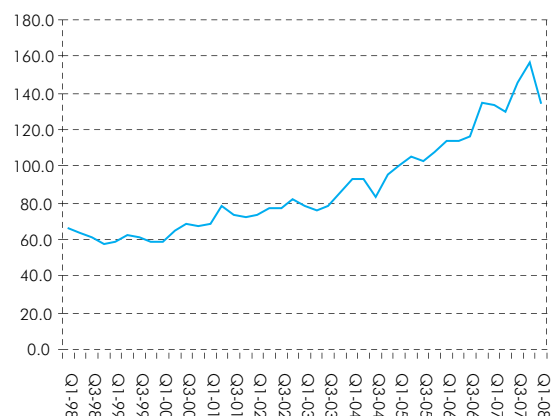
Another factor which is expected to provide its effect on the performance of construction and on the income generated by this sector is the progress of the legalization and registration process of real estates. This process is expected to have a direct effect on the increase of the collateral pledged for different loans, increasing as such the demand for loans and boosting the high credit growth. On the other side, this process is likely to be followed by a fall in the prices of real estates situated in certain areas, leading to the risk exposure of some financial institutions that have lent in these areas. *This element of risk will moderate if the supervisory authority continues to put pressure on the financial institutions to pay careful attention to the financial situation of the credit applicant during the credit application analysis.*

According to the assessments of representatives of construction industry, the poorer financial performance of this sector also relates to some decisions of public decision-making authorities. They state that there has been an unfavourable situation in the demand/supply in the construction market and that this sector is often faced with concerns related to the complete formalization of the activity. However, some of the concerns of the representatives of this sector that are linked with the delays in studying and analyzing the projects, extending construction permits and registering the properties in the real estates registration offices, as well as with the immediate application of some tax measures, which have a negative impact on demand in the construction market, have the potential to intensify the difficulties this sector is experiencing.

The future perspective for economic stability of productive activities will largely depend on the speed of reforms in key sectors of the economy, the steady improvement in the energy supply and in the production structure through structural reforms in agriculture.

Given the considerable share of construction and trade sectors in banking sector's lending to the economy, it is assessed that greater diversification of the sectors would reduce the banking system's risk which stems from specific risks of the industries. Nevertheless, the structure of production is still imbalanced. Sectors such as agriculture and tourism are not yet provided with the appropriate and stable support causing the economic development to be undiversified and vulnerable to the unfavourable regional developments. In addition, this situation curtails the proportional allocation of economic development advantages to the entire population.

Chart 8 House Price Index



Source: Monetary Policy Department, Bank of Albania

Table 2 Annual changes by sectors of production

Indicator in %	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06	I-07	II-07	III-07	IV-07
	III-03	III-03	I-04	II-04	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06
Industry														
Turnover indicator	13.7	5	16.3	13.4	3.2	3.5	4.4	2.4	4.8	3.4	16.6	15.9	6.3	12.2
Employed people	-1.5	-2.7	-0.6	-1.2	-1.4	-0.9	-1.5	-0.7	-1.2	2.3	5.8	4.8	7.3	3.6
Wage	5.9	4.3	4.7	4.8	5	5.3	5.1	3.2	6	11.3	15.7	20.4	23	21.1
Extracting industry														
Turnover indicator	6.3	-10.1	-4.5	10.3	-10.9	-4.2	53.6	1.8	35.7	13.4	14.4	42.3	24	31.3
Employed people	-7.4	-8.2	-4.4	-2.4	5	-0.8	-2	-1.2	-0.6	0	4.3	10	10	12.9
Wage	-5.2	-7.7	-1.3	-4.8	17	17.5	11.7	16	10.1	11.5	21.6	27.8	25	24.8
Processing industry														
Turnover indicator	10.6	-4.2	5.8	8.8	1.9	8.4	4.6	10.5	11	13.1	26.5	17.2	8.5	10.5
Employed people	0.1	-1.8	0.8	-1.1	-2.3	-0.9	-3.2	-2.2	-2	4.7	9.9	7.5	11	2.8
Wage	7	8.6	6.2	7.9	4.9	3.6	3.5	-0.7	2	10.6	16.4	22.6	31	22.6
Energy, gas, steam and water supply														
Turnover indicator	22.6	29.6	19.9	27.4	14.5	-3.6	-4.5	-13.6	-14	-16.8	0	3.1	-7	8.5
Employed people	-2.6	-2.5	-2.2	-0.9	0.4	-0.5	2.1	2.9	0.4	-2.3	-2.7	-3.3	-3	1.1
Wage	9.2	2.3	4.7	3.4	0	3.3	5.3	5.9	12	12.8	11.4	12.2	6.7	16.0
Construction														
Turnover indicator	5.8	28.2	15.6	17.3	9.4	-4.2	-1.6	-6	-5.2	16.1	-1.3	-0	-14	-5.1
Employed people	12.9	11.2	12.4	8.1	-0.1	-2.4	-0.7	-1.8	-0.4	1.2	-1.7	-4.5	-7	-4.6
Wage	20.5	19.8	17.5	18.2	5.2	-0.2	5.4	4.2	3.8	10.8	10.2	15	19	22.6
Annual change in hotels														
Turnover indicator	20.6	23.7	-11	7.7	7.6	17.1	3.3	-14.1	8.2	20.7	26.7	34	6.8	2.3
Employed people	35.8	49	-2.2	0.6	0	-7.4	-1.7	-24.3	5.3	9.1	11.5	4	7.8	1.7
Wage	53.9	77	-8.1	0.7	-1.5	-19	1.3	-28.5	42.5	41.3	53	40	12	8.4
Annual change in postal services														
Turnover indicator	12	7.3	1.9	8.9	30.8	42.9	-10.4	-9.2	-12.8	5.2	55.6	57	26	20.4
Employed people	3.4	-0.1	1.6	2.3	4.6	5.1	5.3	5.4	3.3	12.9	18.1	20	21	12.1
Wage	14.7	10.6	9.7	10.9	12.7	10.7	24.6	4	3.6	11.9	17.4	19	21	15.3
Annual change in telecommunication														
Turnover indicator	11	3.2	19.8	18.6	8.6	19.9	-4.9	-16.1	1.6	3.1	17.7	21	12	0
Employed people	-6.5	-3.8	-13.4	-12.5	-3.8	-8.1	2.6	1.4	7	11.9	9.9	9.8	2.2	0.3
Wage	-6.3	-3.6	13.1	14.2	9.4	8.8	8.3	-6.7	6.1	13.8	13.9	12	18	-1.1
Railway transportation														
Turnover indicator	-6.8	-9.1	19.7	-20.9	-20.6	-27.6	-21.9	20.3	36.5	9.3	-4.7	42.9	15	25.1
Employed people	-38.2	-1.9	-0.2	-0.2	-1.5	-1	-35.4	-4	-7.7	-7.7	-5.8	-5.8	-4.1	-5.6
Wage	-29.6	0	5.8	4.4	-3.9	0.4	-24.8	-3.7	2.1	-3.5	-0.3	-2.6	-0.4	-1.0
Sea transportation														
Turnover indicator	0.3	-2	1.2	-5.3	-0.2	-8.1	30.6	105	98.3	30.2	0.7	-22	-18	-3.6
Employed people	7.7	7.7	50	50.6	42.9	42.9	4.8	52.4	60	60	22.9	-11	-6.5	-15.2
Wage	1.5	0.6	38	42.4	48.5	48.2	9.2	74.5	73.3	79.2	25.5	47.5	24	18.5
Air transportation														
Turnover indicator	-4.5	8.8	-0.5	-10.6	18	11.4	-28.5	-42.2	-23.2	-30	-5.2	-17	16	-12.0
Employed people	-7.5	6	-18.5	-22.3	-25.2	0	-28.2	-7.5	-4	0	0	0	0	26.7
Wage	-0.1	2	9.6	16.1	38.8	35.2	18.1	-1.1	44.5	-16.4	0	0	0	21.6

Source: INSTAT

Table 3 Indicators of construction sector

Construction volume	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06	I-07	II-07	III-07	IV-07
	III-03	IV-03	I-04	II-04	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06
Construction volume	6.6	36.5	16.8	19.9	13.8	-5.6	5	-7.8	-6.5	16.2	0.3	-1.9	-16	-7.6
New constructions	-2.9	42.4	17.3	6.9	13.5	9.4	23.8	4.3	2.7	8.6	-5.7	-10	-19	-23.3
Reconstructions	25.8	74.2	67.1	47.9	6.3	20.2	7.6	-4.8	-20	22.3	3.9	4.5	-36	-6.1
Engineering works	19	37	30.4	34.1	16.4	-30.3	20.40	-35.3	-11.8	8.8	21.9	19	1.6	15.1

Source: INSTAT

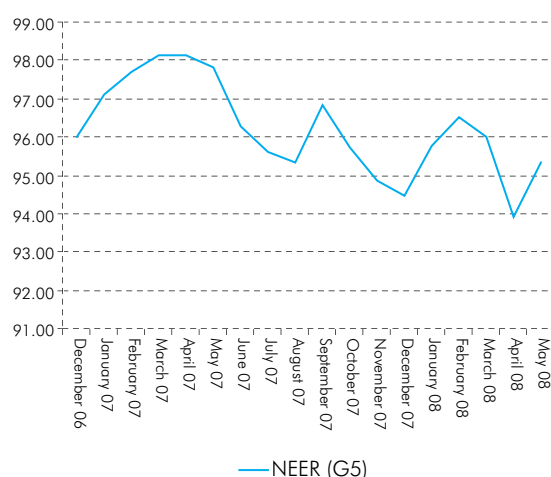
3.2 DEVELOPMENTS IN THE EXCHANGE RATE, INFLATION AND MONETARY POLICY

Inflation rate for year 2007 remained within the Bank of Albania target; however, at end-year 2007 and early 2008 the inflationary pressures, mainly on the supply-side, have increased. Domestic demand was also maintained at stable levels being encouraged among other factors by the considerable growth of credit to the private sector. The increase of the key interest rate to affect the inflationary expectations has increased the spread with the interest rates of the main currencies and it represents a factor that will keep the demand for credit denominated in foreign currency high. Hence, the transmission of this increase to the ALL credit interest rates may precede the increase of the specific share of foreign currency lending, increasing the exposure to the exchange rate. Hence, the credit risk caused indirectly by the exchange rate volatilities will be constantly present.

Average annual inflation rate was 2.9% in 2007, being very close to the 3% target of the Bank of Albania. Following the end of the year 2007, the inflationary pressures have been high, conditioning the maintenance of a tightening monetary policy. Inflation target was reached in average terms, despite the temporary fluctuations as a result of supply and demand-side shocks. The energy crisis, the ever-rising price of oil and grains and of imports in general were the main factors to affect the rise in prices during August – October 2007 (table 4). In addition to supply-side factors, there have also been demand-side factors such as the continuous growth of credit to the private sector and the inflationary expectations.

The tendency of lek appreciation against the main currencies basket shown in the third quarter of the year 2007 continued to pronounce in the last quarter both in nominal and real terms. This performance reflected the macroeconomic stability at home, the spread deepening of the interest rates between the lek and the foreign currencies and the comparable inflation rates with Albania's main trading partners (charts 9, 10 and 11). Consequently, the lek has appreciated continuously against the US dollar by an average of 12.4 %, being exchanged at 83.38 leks per dollar as of end period. It appreciated by 1.6% in annual terms to the euro exchanging at 121.69 ALL/EUR in the last quarter of the year 2007. However, relative to the previous year, the lek showed higher volatility during the entire year 2007 as a result of the developments in the international markets and

Chart 9 Nominal effective exchange rate



Source: Bank of Albania

Chart 10 USD/ALL nominal rate (January 2007-May 2008)

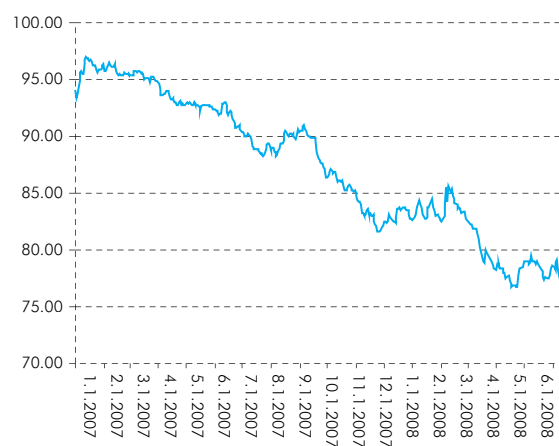
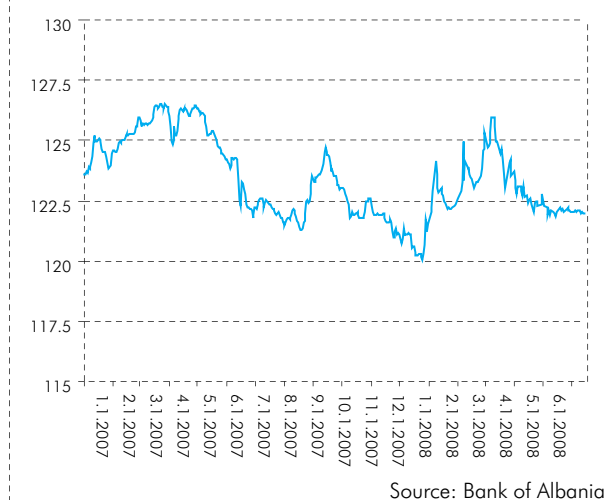


Chart 11 EUR/ALL nominal rate
(January 2007-May 2008)



the more active participation of domestic agents in the foreign exchange market.

In order to contain the inflationary pressures, the Bank of Albania intervened three times during 2007, which resulted in the increase of the key interest rate to 6.25%. Given that the interest rates provided by the banking system for ALL-denominated assets and liabilities have followed the key interest rate moves and these shifts have increased the spread between the interest rates of the lek and the main currencies, demand for credit denominated in foreign currency will remain high. Consequently, the credit risk caused by the shifts in the exchange rate will be constantly present. In order to contain this risk, the commercial banks should be prudent while lending loans in foreign currency.

They should first provide in their balance sheets a change between assets and liabilities denominated in foreign currency which is as small as possible. In addition, they should make a thorough and effective analysis of the borrower's creditworthiness and the collaterals guaranteeing the loan.

Table 4 Annual inflation rate during 2007

Month	Annual inflation
January 2007	2.9%
February 2007	2.9%
March 2007	2.7%
April 2007	1.9%
May 2007	1.4%
June 2007	2.0%
July 2007	2.1%
August 2007	4.2%
September 2007	4.4%
October 2007	4.2%
November 2007	3.5%
December 2007	3.1%
January 2008	3.0%
February 2008	3.6%
March 2008	4.6%
April 2008	4.4%
May 2008	4.2%

Source: Bank of Albania and INSTAT

3.3 EMPLOYMENT

Households' income continued to grow during the year 2007 owing to the growth of employment, the rise of wages in the public sector and the stable remittances flow. This growth of income has supported the growth of consumer loan, in particular of the loan denominated in foreign currency. However, the materialization of the scenario which considers a shift in the remittances' flow remains a source of risk. The reduction in remittances is a process which should however be gradual and smooth the risk characteristics that it may cause. The growth of income is a factor which has a positive contribution to the

financial system's stability for as long as households' creditworthiness performs better. However, the growth of income allows the increase of debt (in the form of credit received from banks). If this increase becomes hard to handle, debt servicing is put into question, hence transmitting concerns to the lender.

The year 2007 was characterized by a downward tendency in labour forces, increase in employment (mostly in the private sector) and the reduction in the unemployment rate and the number of unemployed workers (table 5). This performance is expected to have provided its influence on the growth of households' income per capita, which in turn affected the upward tendency of consumption and the consumer loan extended by the banking system.

With regard to wages in economy, average wage in the public sector rose during the year 2007. In the last quarter of the same year they rose nearly by 14% relative to the same period the previous year. There is no sufficient information on the performance of average wages in the private sector; however, we may presume that this sector has also maintained the same upward tendency as the public sector.

The growth of income has led to the growth of demand for consumer loan which is expected to accelerate during the year 2008 also as a result of the greater sources in lek for this type of loan. *From the regulatory viewpoint, it may be necessary to treat the risk that this type of loan bears with particular attention.*

Remittances represent another essential source of income to households. Given that migration accounts for 20-25% of labour forces, remittances provide overwhelming support to consumption and savings of households. In addition, it is an important factor which affects the performance of the exchange rate and debt servicing in foreign currency of households. Theoretically, there is a risk of a turning point in remittances, which is explained by the integration of emigrants into the economies they work in and the shift of the centre of economic interest of their families from the country of origin to the host country. So far, statistics on remittances do not seem to indicate this phenomenon. In 2007 remittances totalled 947 million euros, increasing slightly by 1.3% and accounting for 12% of the GDP. However, they remain closely related with the economies of foreign countries and they become a cause for the transmission of shocks present in these economies to the country of origin. *In more concrete terms, in case developed countries experience economic recession, the flow of workers' remittances would reduce the households' welfare and consequently the supply of deposits denominated in foreign currency and their ability to service the debt denominated in foreign currency reduces.*

On the other side, the ongoing preference of the financial sector and the borrowers to lend and borrow in foreign currency during the year 2008 increases the banking sector's exposure to the risk of workers' remittances reduction. *This risk would be gradually diminished if the regulatory requirements on the increase of the cost of credit denominated in foreign currency and the strengthening of risk analysis by banks were set for this type of activity.*

Table 5 Employment indicators

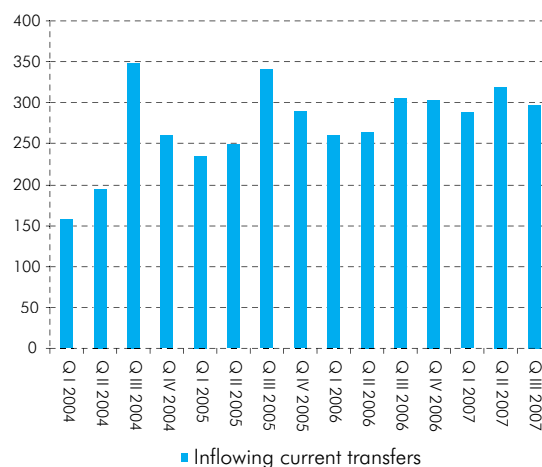
Main indicators	Unit												
		II-05	III-05	IV-05	I-06	II-06	III-06	IV-06	I-07	II-07	III-07	IV-07	
LABOUR MARKET													
Labour forces		1,086,000	1,086,000	1,086,000	1,082,900	1,081,328	1,084,072	1,084,545	1,080,467	1,078,103	1,077,908	1,081,821	
Employed workers	number	931,000	931,200	932,000	931,000	931,253	934,405	935,058	932,759	932,960	935,747	939,000	
a) In the public sector	number	175,600	175,600	175,000	174,000	172,126	170,500	169,000	167,500	166,800	167,100	167,100	
b) In the private non-agricultural sector	number	213,400	213,600	215,000	215,000	217,127	221,905	224,058	223,259	224,160	226,647	229,900	
c) In the private agricultural sector	number	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	
Unemployed workers	number	155,000	154,800	154,000	151,800	150,075	149,667	149,486	147,708	145,143	142,161	142,821	
Receiving unemployment compensation	number	11,500	11,500	11,200	11,500	11,249	11,360	11,297	10,334	9,857	9,659	9,540	
Unemployed	%	14.30	14.20	14.20	14	13.90	13.80	13.90	13.60	13.50	13.18	13.20	
INCOME													
Average monthly wage in the public sector	leks	26,612	27,197	27,333	27,333	27,606	28,950	31,400	31,850	31,850	35,650	35,650	
Minimum monthly base wage	leks	10,800	11,800	11,800	11,800	11,800	14,000	14,000	14,000	14,000	14,000	14,000	

Source: INSTAT

3.4 FOREIGN TRADE

Current account deficit grew during the year 2007, reflecting the high demand and the lack of productive capacities at home. Exports covered only ¼ of imports' value. The growth of the latter has mainly derived from the increase in the volume of imports, in particular of energy, and of the general price rise of prices. During the year 2007, the import of consumer products has fallen while the import of capital goods has increased (mainly of machinery and appliances), creating better premises for the increase of productive capacities and the growth of exports in the future. Hence, the relative effect of foreign trade on the general development would be positive and the domestic demand for foreign currency would reduce. Both these developments would be positive in the context of the financial system stability.

Chart 12 Quarterly flows of workers' remittances in millions of EUR



Source: Bank of Albania

The performance of the external sector of the economy shows further growth of domestic demand. Current deficit amounted to 878 million euros in 2007, increasing by 64% relative to the previous year. As of end year, trade volume totalled 3.8 billion euros, which is 26% higher relative to the year 2006, and accounted for 28% of the GDP. The deepening of the trade deficit, as a result of the high demand for import goods, reflected the general price rise in the region, the fluctuations in the exchange rate and the gradual reduction of customs tariffs which is part of the liberalizing trade processes.

The ratio of imports' coverage by exports remained low at the end of the year 2007 (26%). Despite the growth of exports during the year 2007, the low domestic capacities at home and the very high demand for imports decrease the trade deficit vulnerability to specific exports' factors. With regard to the structure of imports, consumer goods which share 30% of total imports have reduced by 7 percentage points. On the contrary, the imports of capital goods increased by 36% and at the end of the year they accounted for 14% of total imports. The high import of machinery and appliances, which increased by 30%, attributes to the development of the construction sector and investments in infrastructure. *This shift in the structure of imports to investment-related goods signals the increase of productive capacities by the companies, which in turn improves their net future value and decreases the credit risk for the banking system. In addition, this shift will in a later time narrow the trade deficit as a result of the growth of domestic demand.*

According to the Balance of Payments data, the unfavourable weather conditions and the high demand of the economy have encouraged the increase of the import of energy by 3.5 times as much relative to the previous year. In terms of value, the import was 6 times higher owing also to the price rise effect of energy in the global markets. *Trade deficit deepening may be a factor which exerts pressure on the exchange rate and increases the exposure*

of the economy to the depreciation risk, which will have consequences on the banking sector's credit portfolio.

3.5 FISCAL INDICATORS

As of end 2007, fiscal indicators met the objectives, although expenditures continued to be concentrated at the end of the year. The deepening of budget deficit by 5.2% for the year 2008 to carry out strategic investments required the pursue of a prudent policy in collecting the income (taxes, the privatization of key sectors and Government borrowing) and better allocation of expenditure to avoid the pressure on the interest rates, liquidity in the interbank market and to prevent the hampering of private companies' business development projects.

As of end 2007, fiscal indicators which relate to the level of income and public expenditure, budget negative surplus (deficit) and to the extent of financing of a part of expenditure with domestic sources of the financial market, met the objectives. Budget revenues grew by 12% relative to the previous year, attributing to the reform in the fiscal package, the application of the flat tax and the good performance of income from VAT. Budget expenditure continued to be concentrated at end-year increasing by 9%, which had its impact on the interbank market liquidity. Following the agreement between the Ministry of Finance and the Bank of Albania which provides for the investment of excess government liquidity in financial instruments offered by the Bank of Albania, the short-term pressure on the level of liquidity and on the interest rates in the interbank market reduced in the last quarter of 2007. Consequently, better conditions were created for the transmission of the change in the key interest rate by the Bank of Albania to the interbank market through open market operations.

Budget deficit is projected to deepen by 5.2% of the GDP in 2008, as a result of the strategic investments in infrastructure. The expansionary fiscal policy is expected to have the following effects:

- The growth of government public borrowing, part of which will be financed by the financial and banking sector; hence, turning the government into the main borrower and probably causing the credit supply to the private sector to reduce. It may occur that the construction sector benefits from the increased Government expenditure on infrastructure. However, the other sectors of the economy may face more difficult conditions in terms of financing the business development needs, in particular in case of time discordance between revenues and expenditures. This situation may appear more relaxed if the Government provides a large part of borrowing from the international market or if it results successful in the privatization of some major state-owned companies. Subsequently, the branches of foreign banks operating in Albania may increase lending following their release from the regulatory requirements applied for bank subsidiaries and the entry of large European banks;