

GOVERNOR'S SPEECH

Honourable Ms. Chairwoman,
Honourable ladies and gentlemen,

Year 2005 was generally characterized by positive developments, which further improved the country's economic-financial environment, contributing to further maintaining and consolidating of macroeconomic stability.

Making a synthesis of all the developments verified in the economy, it is estimated that during 2005 the economic activity of the country was further extended, under the conditions of a controlled inflation and further budget deficit reduction. Intensive developments have been recorded even in financing the economy with banking credit, which almost doubled in comparison to 2004.

The Bank of Albania has managed to successfully fulfil its legal mission, managing efficiently the inflationary pressures in the economy. Even though under the conditions of an already private and more dynamic banking market, we have tried to better manage the liquidity situation in the economy, ensuring a constant supply of the economy with money, in accordance with the country's needs for economic development. The monetary policy implemented by the Bank of Albania was vigilant, pursuing domestic and international developments step by step.

Special attention is paid to the maintaining of banking system stability, at a time when commercial banks constitute the most active segment of the financial sector. Strengthening the supervisory capacities and the regulatory framework, in general, remain our absolute priority. This constant commitment of the Bank of Albania takes special importance under the conditions of increased lending activity, implying more efficient reporting systems, more prudent controls, more corrective operations and measures.

Further extension and expansion of the country's financial market has been on the focus of our work. In our everyday activity, attention is paid to curtail cash economy, considering it as a factor related directly to economy informality. Therefore, we have undertaken various projects with relevant groups of interest, intending not only their awareness but also the building of infrastructure and creation of other facilities that positively impact on this direction.

Further to my speech, I will treat in detail some of the main developments that characterized the economic-financial performance of our country throughout 2005, paying special attention to the role and decisions made by us, in fulfilling the legal obligations that regulate the Bank of Albania's activity.

1 ALBANIAN ECONOMY

During 2005 Albanian economy recorded an economic growth close to 6 percent level, with a relatively low inflation of about 2 percent and a budget deficit under control.

The country's economic activity during 2005 is estimated to have grown¹ by 5.5 percent in real terms, about 0.5 percentage point less than the year-start forecast. According to latest analyses, it seems that the long post-electoral situation, the reduced fiscal promotion in the second quarter of the year, and the escalation of electricity crisis during October – November 2005, have led to non-fulfilment of the forecasted growth rates.

Notwithstanding the satisfactory growth of Gross Domestic Product (GDP), the unemployment rate reduction continues to be low, either in absolute value or in relative terms. We should mention here the quality of employment statistics, which, impacted by large and unmonitored movements of population within the country and abroad and by a high degree of informality in the labour market, may conceal the real employment performance.

Savings - Investments balance is estimated to have recorded a performance slightly different from that of the last year. Public savings have recorded a positive level, though a modest one, only 0.1 percent of GDP. In the meantime, private savings have decreased by around 2.6 percentage points to GDP.

During 2005 the external sector of the economy was presented with a negative balance sheet in the current account, caused by further trade deficit enlargement. Capital inflows have generally been sufficient for compensating the current deficit, thus enabling a positive external balance sheet.

2 SECTORAL DEVELOPMENTS

Year 2005 has recorded a growth of the economic activity in all its sectors. As in the preceding years, services and construction continue to be the most dynamic sectors. On the other hand, the estimates indicate that notwithstanding the positive growth rates, the sectors of agriculture and industrial output are still far from their potential.

2.1 AGRICULTURE

Besides the growth of about 2 – 3 percent per year evidenced recently, the contribution of agricultural product has been decreasing year on year, down to around 3 percent of GDP over 2005. Agriculture continues to be characterised by huge problems related to land ownership, thus weakening the interest of big investors in producing various agricultural products.

The parcelling of land into plots, first of all reflected in the incapability of using agricultural mechanism to a large scale, has made the agricultural output be far from its potential. On the other hand, continuous migrating movements from rural areas to large inhabiting centres have made a major part of agricultural soil be left uncultivated. With the passing of years, this has led to a market filled with a wide range of foreign agricultural products, mainly imported from neighbour countries.

The livelier segment of agricultural product seems that has to do with the ceaseless rise of processing and manufacturing capacities of animal and agricultural inputs. Even during 2005, the agro-food industry branch further increased, by about 10 percent in real terms, at almost the same level with that of 2004.

Nonetheless, this branch with a great potential, according to latest estimates, continues to absorb very few investments, only 0.3 percent of GDP. The distance of the banking business from rural areas and all the earlier mentioned problems in this analysis, we believe, constitute the main factors behind this situation.

2.2 INDUSTRY

The industrial production sector still presents a kind of contraction, which reflects, above all, a non-activation of productive capacities, mainly in extractive and process industries. Both these branches, due to lack of investments during fifteen last years and little interest of domestic and foreign business, have constantly deteriorated, currently coming down to a total collapse. Low profitability, high costs and high degree of their amortization may make their survival almost impossible. Even some of enterprises granted with concession to foreign investors are in a difficult economic-financial position, thus making no significant contribution to re-activation of these industries.

2.3 TRANSPORT

Transport sector has played a dynamic role in the economic growth over the recent years. It has had high growth rates, rendering a positive contribution to economic development. The increased pace of the sales volume of transport sector has been positive during all the time, manifesting their revival after a slowdown noticed in 2004. All its components were revived: the air, sea, and road transport. Meanwhile, the railway transport continues to manifest clear collapse signs, deteriorating gradually year on year.

2.4 CONSTRUCTION

Faced with the needs for improving housing conditions, extending productive capacities and creating a modern infrastructure, the construction sector has

recorded high growth rates during ten last years. Construction sector has grown on average by 13 percent a year during this period, being transformed into one of catalysers of the country's economic development and doubling its share to GDP. This sector contributed by 9 percent to 2005 GDP formation.

High demand for products of this branch is noticed even in the sales price performance, particularly in the prices of living apartments and surfaces destined for economic activity during the period of 2002 – 2004. These developments should be attended prudentially, to rightly assess risks accompanying the reduction that may follow the rapid boom of real estate prices. Particularly this would have negative effects on the banking system, under the conditions when 80 percent of collaterals pledged for extended loans are in the form of real estates.

It should be pointed out that according to INSTAT, construction cost has been increased very slightly during 2005, a fact that highlights a huge non-compliance between cost rise and sales price rise. So, we have to do with a strong demand, which, however, does not spring from steady income. Such resources as income from emigration or from illegal activities, are temporary financial resources, difficult to be forecasted, while they are the main items that actually finance construction. Therefore, a possible rapid reduction of the above mentioned resources would strongly limit the demand, putting into difficulty not only construction producers but also its related branches.

2.5 SERVICES

Services sector developed considerably during past years, becoming the main contributor to GDP growth. According to latest estimates, this sector's share to GDP is about 45 percent. An upward performance of the branches of trade and tourism is noted within this sector, while many other new segments, though still with a fragile economic activity, have started to grow, comprising premises for a stable long-term performance of this sector.

Tourism has also experienced quantitative developments that testify its growth. Out of available data, an increasing performance of all indicators is evidenced. There exist additional accommodating capacities, double expenditures for marketing, increased volume of investments and satisfactory rise in the number of foreign visitors.

Sales index and retail market index. Total sales of the economy have increased by 16.1 percent during the first nine-month period of 2005, against a growth of only 6.1 percent in the same previous year period. Notwithstanding the rapid rise of domestic demand, the annual inflation during this period remained under control, indicating a corresponding growth of production in the economy.

It should be emphasized that the economic analysis of 2005 would have been more complete if we had data about the last quarter of 2005. As it is already

known, this period coincided with a strong crisis of electricity production. Our preliminary estimates indicate that the limitation of the economic activity in real growth terms of GDP, because of the energy problems of the end-year 2005, was about half percentage point. To face the difficulties of electricity shortages, most of businesses started to use alternative resources, which are assessed to have caused no small cost to their activity. Though initially it was thought that the crisis might have had graver consequences, its absorption by the economy was relatively fast.

3 FISCAL SECTOR

Fiscal policy is an important determining factor for the macroeconomic stability. Year 2005 was characterised by a disciplined fiscal policy following the implementation of the Mid-term Budget Program for 2005-2007. This program has aimed at increasing fiscal incentives in the economic growth and macroeconomic stability, through consolidating budget indicators and prioritizing budget expenditures in the sectors of health, education, and infrastructure. In this sense, the overall budget expenditures, education, and health had the allocation of the highest resources in comparison to other government functions, by respectively 3.4, 3.0 and 2.5 percent of GDP in 2005.

Budget revenues continued to be increased even during 2005, while budget deficit decreased further, from 5.1 percent in 2004 to 3.9 percent of GDP in 2005, recording the lowest level in eight last years. Government demand for domestic borrowing is estimated at 2.8 percent of GDP. Total revenues and expenditures for the past year were performed respectively at 97 and 92 of the plan or 23.4 and 26.7 percent of GDP. Nonetheless, as in the preceding years, the allocation of budget expenditures still had a non-uniform shape, indicating a concentration in the middle of the past year.

4 INFLATION AND MONETARY POLICY

Consumer prices were relatively stable during 2005, marking another positive year in terms of achieving and maintaining price stability, the primary Bank of Albania's objective. The annual inflation rate resulted 2.0 percent at end of the year, while the average annual inflation rate was 2.4 percent. These living cost indicators fell in comparison with the previous year, fluctuating around the lower limit of the target. Annual inflation stayed within the 2 – 4 percent band along the major part of the year.

Monetary policy of the Bank of Albania generally maintained a neutral stance over 2005. The key interest rate cut by 0.25 percentage point at end of the first quarter was pursued by a period of steady inflationary pressures in the rest of the year. After the first quarter, the key interest rate was held unchanged, at 5 percent. The dynamics of macroeconomic development and monetary conditions in the economy exerted pressures for a slight consumer price rise,

in line with the inflation target. Lending to the economy was the main source of monetary expansion during this period, unlike in the preceding years, when this function had been realised by government borrowing or foreign currency inflows. Increased credit to the economy at high paces has compensated the government borrowing reduction.

The Bank of Albania, in line with the maintaining of foreign reserve target, intervened in the foreign exchange market during the second half of the year. It purchased foreign currency almost throughout the whole period, mitigating the appreciating pressures on the exchange rate and injecting liquidity into the market. It is estimated that about ALL 12.4 billion of liquidity was injected through its interventions in the market, thus assisting the banking system with liquidity and contributing to financial indicators stabilization.

As an economy exposed to imports, Albania is inevitably impacted by exchange rate developments. The impact of this factor must be analysed not only about the effect it provides on transmitting the supply shocks, such as oil price rise, but also on the imported inflation level. The domestic currency appreciation was moderated significantly during 2005 compared with the previous year appreciation. The lek was appreciated on average by 2.6 percent against the American dollar and by 2.7 percent against the euro. During the previous year this appreciation had been 15.7 percent and 7.2 percent respectively. The lek's appreciation against the euro and the steady inflation rates in two main trading partners, Italy and Greece, created conditions for stability in external trading environment, thus easing the inflationary pressures transmitted by this factor of the demand.

Performance of agricultural product over 2005 provided a different impact on inflation during various periods of the year. While during the first half of 2005 this supply factor impacted on inflation rate reduction, it acted on the opposite direction over the remaining period of the year. The lowest growth of domestic agricultural product, combined with increased inflationary pressures generated from higher foodstuff prices in partner markets and with the smoothed compensating effect of the lek's weakest appreciation against the euro, resulted at higher prices of these goods over the second half of the year.

In general, year 2005 was characterised by low growth rates of production prices. After a quarter with a double-figure growth, the annual change of production price index recorded low growth rates during April – September 2005. At end of the first nine-month period of the year, production prices were 2.3 percent higher than their level over the same previous year period.

Salaries. Year 2005 was associated by a steady situation in the private sector's salaries and a moderate rise in those of the public sector. This rise did not transmit inflationary pressures through the salary-inflation spiral.

Oil price. Oil price rise has been a constant concern in terms of raising the living cost during 2005. Average oil price rise in world market by 43.0

percent over the first half of the year and 34.0 percent over the second half of the year was translated into a rise of 27 percent of oil price in the domestic market. However, the small weight of this product to consumer goods basket implies a small impact of oil price rise on total inflation. The lower oil price rise in the country is due to some factors. First, the lek's strong positions against the US dollar during two last years have amortised a part of oil price rise in international market. The smoothing down of the lek's appreciation against the dollar during the second half of 2005 impacted on a faster rise of oil price over this period. Second, domestically produced oil price had a lower rise by 3.2 percent in annual level. Substituting a part of imports, it has somewhat mitigated the international oil price shock. Finally, importers have been restricted in applying very high prices, given that oil price rise has brought about reduced demand for this product. Hence, in the fourth quarter, the oil demand decreased by 21 percent in annual terms. The living cost is raised not only by the direct effect on inflation but also by the increased costs related to oil prices. However, during this year, no significant indirect or second round effects were observed in the form of transmitting this cost to other products' prices.

5 MONEY SUPPLY DEVELOPMENTS

Monetary developments over 2005 consisted in relatively high money supply (M3) growth in comparison with its historical trend, further reduction of money velocity, and a higher intermediation of the banking system in the economy. Annual money supply growth reached its peak in summer, due to high demand of the economy for monetary assets and unexpected rise of government's demand for budget deficit financing. During the last quarter, the growth rate of the demand for monetary assets turned towards its historical trend.

The time frame and foreign currency structure of money supply has undergone positive developments. Currency outside banks rose by only 8.4 percent in 2005. In absolute value, this indicator grew by ALL 11.6 billion, against the rise by ALL 34.7 billion of the money supply in ALL expressed by the M2 aggregate. Following this growth, the ratio of currency outside banks to M2 resulted to 35.1 percent at end of 2005, against 35.3 percent at end of 2004. The falling of this ratio was in line with the monetary program of the Bank of Albania. During the year, the sustainability of currency outside banks to M2 aggregate transmitted positive signals for inflationary pressures reduction in the economy. The downward trend of currency outside banks is even more highlighted in ratio to broad M3 aggregate, due to rapid growth of foreign currency deposits. At end of the year, this ratio resulted to 25.9 percent or 1.3 percentage points less than in 2004.

The time component of money supply reflected the Bank of Albania forecast on the performance of the economy demand for monetary assets in ALL. The annual growth of ALL deposits resulted 9.1 percent. This growth comprised the increased ALL deposit level in the banking system by ALL 23.2 billion

during the whole 2005. Positive real interest rates ensured the channelling of money in deposits. The overall deposit level has been sufficient to cover the banking system needs for liquidity.

Foreign currency deposits presented positive growth rates over 2005. At end of the year they constituted 26.3 percent of money supply, about 4.3 percentage points more than in 2004. Performance of foreign currency deposit level manifested a faster growth compared to that of the previous years. Their annual growth resulted to 31.2 percent at end of 2005. The main source of foreign currency deposit growth consists in foreign exchange remittances, whose channelling through the banking system has demonstrated an upward trend. This source has been present in years. However, the lek's exchange rate performance is reflected in the size of foreign currency inflows denominated in domestic currency. The exchange rate effect for the foreign currency deposit level denominated in ALL is around ALL 5.8 billion.

6 DEMAND FOR MONETARY ASSETS

Under the conditions of fiscal policy consolidation over 2005, a shifting of the demand for monetary assets from the government to the economy was noticed. For the first time in 2005, credit to the economy was the main promoter of the demand for money, contributing to 75 percent of the annual money supply growth.

Foreign currency position of the banking system did not have significant changes over 2005. Net foreign assets of the banking system remained at USD 2 billion, due to balanced developments in foreign assets levels of the Bank of Albania and of commercial banks. Net foreign reserve of the Bank of Albania amounted to USD 1.3 billion at end of the year, marking an annual growth of USD 59 million. The upward trend of net foreign reserve was noticed during the second part of the year, as a result of foreign currency purchases of USD 126 million by the Bank of Albania. Performance of net foreign assets of commercial banks has been more fluctuant, reflecting relative performance of indicators that impact on these assets. In general, acceleration of foreign currency credit rise during the year has exceeded the growth of foreign currency deposit inflow in commercial banks, by reducing even the level of net foreign assets. In annual terms, these assets decreased by USD 63 million

Budget deficit financing during 2005 was covered almost totally by domestic financing – the banking system and the public. At end of the year, the total level of domestic financing was ALL 20.6 billion. The Bank of Albania was present in financing the deficit during July and September, with the purpose to prevent large interest rate fluctuations in inter-bank market and in treasury bill one. Two- and three-year government bonds were the main budget deficit financing source. During 2005 the Government sold ALL 18.6 billion two-year government bonds. Government bonds of three-year maturity, sold in total about ALL 6 billion, were issued for the first time during this year. The

issued treasury bills level decreased by about ALL 4 billion during 2005. The Treasury bill portfolio of commercial banks decreased by about ALL 21.9 billion. On the contrary, the households and the Bank of Albania increased their Treasury bill portfolios by ALL 12.2 and 3.1 billion respectively. Treasury bill portfolio of non-bank financial institutions was slightly increased by about ALL 0.1 billion. Active participation of households in purchasing treasury bills indicates a positive phenomenon, either in Treasury bill market extension or in Treasury bill portfolio diversification as concerns to their holders.

Credit to the economy recorded an obvious growth during 2005. The banking system credit portfolio was increased by 74.3 percent or ALL 52 billion in absolute value. The credit growth rate over 2005 was twice higher than the one recorded in the previous year. This rapid growth is reflected even in the improved banking system intermediation indices. Hence, at end of 2005, outstanding credit to the economy constituted 25 percent of the total banking system assets. Also, at end of 2005, outstanding credit to the economy recorded 14.6 percent of GDP, constituting an annual growth of 6.2 percentage points. Growth of long-term credits has impacted on shifting the credit portfolio structure to long-term maturities. The weight of over 5-year maturity credit rose constantly during 2005, while the weight of short-term credit to the total fell. Credit allocation, in credit to households and credit to businesses, did not have significant changes during 2005. At year-end, credit to households constituted 31.6 percent of the total of credit, recording a slight rise of 1 percentage point against 2004. Credit to businesses constituted around 69 percent of the total. This credit recorded an annual growth of 74 percent during 2005. Unlike the previous year, credit to corporations has also been driven by the banks' orientation to extend domestic currency credit to businesses. Year 2005 was characterised by a rapid growth of credit in ALL, whose annual growth recorded 127 percent. Unlike in 2004, in 2005 the banks' commitment to extend ALL loans not only to households, but also to businesses, was noticed. Exchange rate stability and reduced interest rate spreads for credit in foreign currency against that in ALL might have attracted business interest in receiving credit in ALL. However, credit in foreign currency continues to occupy the major share in lending, comprising 74.5 percent of the total. Sectoral credit distribution for 2005 testifies banks' raised interest in the sectors of real estates, construction and more moderate in agriculture. Generally each sector's weight to the total increased by 4.4, 3.2, and 1.2 percentage points respectively, compared with the previous year. In the meantime, trade continues to be the most credited sector of the economy, by 18.9 percent of the total of loans, from 23.3 percent it occupied in 2004.

7 FINANCIAL MARKETS AND INTEREST RATES

The financial market activity and interest rates underwent higher fluctuations during 2005. Growth of banking system deposits and reduction of the government demand for monetary assets over the first half of the year made the banking system create excess liquidity (on average ALL 7.4 billion), leading to reduced interest rates. Following the trend noticed over two last years, the

interest rates of accepting deposits in ALL reached the lowest historical levels, 3.5 percent in June.

During the third quarter, the rise of credit to the economy, the concentrated demand for budget deficit financing in pre- and post- electoral period, and the slow-down of deposits inflow led to rapid decrease of liquidity in the system. This brought about increased interest rates in inter-bank market and in treasury bill one.

Lack of liquidity was mostly felt in the primary market, when the government demand for financing in some cases remained unfulfilled, whereas the treasury bill yield was significantly increased, from 6.77 percent in June to 9.14 percent in September for the twelve-month term. For managing this situation, initially the Bank of Albania changed the side of monetary operations, intending to meet the short-term needs of the system for liquidity, through carrying out reverse repos. Continuous purchasing of treasury bills and intervention in foreign exchange market were additional instruments employed by the Bank of Albania for soothing the financial markets.

Year 2005 recorded a significant rise of the households' interest in investing in treasury bills. The households financed a considerable part of the budget deficit during the past year. The Bank of Albania has supported and encouraged this development, as a necessary step for extending the Treasury bill market and for increasing the use of financial instruments in the economy. In absence of the participation of households, Treasury bill yield fluctuations would have been larger and their effects would have been more serious.

8 MONETARY POLICY INSTRUMENTS

Implementing its monetary operations, the Bank of Albania has made the facilities of its operational framework available to commercial banks. Repurchase agreement of one-week maturity, of the set price type was the main instrument used during the first half of 2005. Weekly average level of liquidity withdrawn during this period was ALL 6.35 billion. Also, the need to structure the high level of liquidity conditioned the employment of repurchase agreement auction of one-month maturity by the Bank of Albania at the fixed amount of ALL 1.5 billion during the first half of the year.

The constraining of liquidity conditions in the system and the tendency to raise Treasury bill interest rates in the third quarter of the year made necessary the Bank of Albania intervention through its injecting instruments. So, the liquidity injected through reverse repurchase agreement of weekly maturity at fixed price was ALL 2.4 billion during August – September. The operations undertaken by the Bank of Albania in securities and foreign exchange markets also served for injecting liquidity into the market. The Bank of Albania purchased ALL 3.5 billion treasury bills in the securities market and ALL 2.5 billion in the foreign exchange market. In total, the injected amount reached ALL 8.5 billion. These interventions returned the excess liquidity situation in the

banking system and mitigated the interest rate pressures in securities market. The passing of the banking system in liquidity excess during the last quarter was associated with the changed direction of banking market intervention, by withdrawing liquidity through one-week fixed price agreements.

Better functioning of inter-bank market during 2005 limited the use of overnight deposit and overnight credit, respectively in investing on average ALL 0.76 billion a day and in withdrawing credit on average ALL 0.02 billion a day, by commercial banks. Lombard loan was not employed during 2005.

The employment of the required reserve instrument has served the implementation of monetary policy and the maintaining of significant risk under control. The Bank of Albania has made available to commercial banks the facility of using 20 percent of the required reserve for meeting short-term liquidity needs of the system. So, during 2005, banks used on average around 11 percent out of the 20 percent maximum level permitted for using the required reserve. In comparison with the previous year, reduced employment of this facility is noticed. Simultaneously, the Bank of Albania has continued the implementation of required reserve remuneration policy. The remuneration rates have reflected the key interest rate changes of the currencies in which the required reserve is held. The overall level of the account statement is well-managed by banks of the system, reducing cases of required reserve non-fulfilment to minimum.

9 BANKING SUPERVISION

Year 2005 was characterised by continuation of the dynamic development of the banking system in Albania. This dynamics is reflected in the extension of the banking activity in general, where we can mention: significant credit growth; new applications for a banking license; selling and changes of the bank shareholders' structure; and a powerful extension of the existing banks' network in various areas of the country.

In February of the past year a preliminary licence was granted to a new Albanian bank, and at end of December this bank was granted a definitive licence for conducting banking activity in the Republic of Albania. Upon its licensing, the number of banks with entirely Albanian capital goes to three and the total number of banks operating in Albania goes to 17.

In June of 2005 the approval on changing the ownership of "Dardania" Bank was made. During the past year, another licence application was submitted by another bank, which will be transformed from branch of a foreign bank to subsidiary of that bank.

During 2005, the extension and expansion of the network of banks with branches and agencies underwent more development than in the previous year. Throughout the year the consent was given for the opening of 48 new branches and agencies in the whole territory of the Republic of Albania.

The banking system reports a positive net result for 2005, about ALL 6.6 billion or 29.2 percent higher than in the previous year. The main profitability indicators, Return on Average Assets (RoAA) and Return on Average Equity (RoAE), have performed well during 2005. The Return on Assets presented a faster increase than the Return on Equity, reflecting also the increased legal requirements for equity by the Bank of Albania. The RoAA growth confirms a qualified improvement of the banking system profitability. In spite of the high level of return on shareholders' equity, earnings are not distributed to shareholders but have served as a good support of banks for carrying out their activity through capital addition.

During 2005, the banking system assets recorded a growth of ALL 70.1 billion (or 16.4 percent), about ALL 17.3 billion higher than the assets growth evidenced in 2004. Besides large banks, some medium- and small-sized banks also contributed to the extension of the balance sheet of the system.

During 2005, the banking system outstanding credit grew by about ALL 52 billion, from ALL 19.3 billion in the previous year. The high growth rate speaks for a considerable extension of the banking system in lending, encouraged even by the privatization of the largest bank of the system, the Savings Bank. The indicator "non-performing loans to outstanding loans (net)", which measures the net size of exposure to credit risk, recorded low levels and a downward trend through 2005. Also, the banking system ability to cover with capital the losses incurred from loans was improved, due to higher growth rate of regulatory capital (+34.7 percent) to net balance growth of non-performing loans (+23 percent).

Capital adequacy ratio of the banking system recorded 19 percent at end of the year, observing and exceeding the minimum capital adequacy level of 12 percent. However, there are evidenced some banks which during 2005 had the levels of this indicator very close to the minimum. This development makes us pay special attention to financial stability indicators of the banking system, and illustrates the need for its further consolidation.

10 BANK OF ALBANIA BALANCE SHEET

During 2005, the total of assets of the Bank of Albania was further increased, recording ALL 224.6 billion, about 11 percent higher than that of end of 2004.

Both constituent groups, foreign assets and domestic ones, reflected a rise, while the first group occupied about 68 percent of total of assets, from 65 percent at end of the previous year. On the liability side, foreign liabilities stayed at the same level with that of the previous year, while domestic liabilities rose by 11 percent. Currency in circulation is the indicator that provides the main impact on this rise.

In general, Bank of Albania accounting balance sheet and income and expenditure statement, reflect some of the basic developments recorded in

the economy, where the Bank of Albania plays an important role. Reflecting a reduction of the lek's interest rates in general, income realised from them is smaller than that of 2004, while income realised from foreign currency interest rates is higher, reflecting the interest rate performance in world's foreign exchange markets.

In conclusion, given the fact that 2005 fiscal year expenditures are almost the same with those of the previous year and the other fact that income from ALL transactions is not compensated fully by income from foreign currency transactions, Bank of Albania net profit is estimated at ALL 5, 2 billion, about ALL 281 million less than the net profit realised during 2004.

11 OTHER ACTIVITIES

The automated electronic clearing house was implemented over the past year. It is a very up-dated payment system, which, combined with another system, the Real Time Gross Settlements, has created a safe ground for further perfection. Besides rapid developments noted over 2005, the Bank of Albania deems that there is plenty of room particularly for paying private sector's salaries through banks, settling utility bills through banking accounts and increasing the number of electronic payments.

Another important aspect has to do with our country's aspirations for a possible membership to the EU. The Bank of Albania has been committed to official negotiations for signing the Stabilization and Association Agreement (SAA) between Albania and the European Union, and has kept close contacts with the European Integration Ministry. During the last year direct contacts were established with the European Commission, the European Central Bank, and relations with the Bank for International Settlements and with many other institutions of the Euro system were revived and advanced. Currently, we have set up some various projects of bilateral and multi-lateral cooperation with central banks of the Euro zone, central banks of new members of the EU and Brussels's institutions as partners. Simultaneously, in the framework of developing the regional cooperation, close contacts with central banks of the region are established. Memoranda of Understanding in banking supervision area are signed with the Banking and Payment Authority of Kosovo, with the National Bank of the Republic of Macedonia, and with the Central Bank of Montenegro.

Year 2005 further enhanced close cooperation relations between the Bank of Albania and the International Monetary (IMF). Assessments made by the IMF's experts have been generally characterised by positive notes concerning the Bank of Albania's achievements in maintaining macroeconomic stability, controlling inflationary pressures, and in steps taken to develop and consolidate the banking system. In November the Albanian authorities negotiated with the IMF's mission on the new arrangement, which was made official in January 2006. This arrangement is a combination of the program for Poverty Reduction and Growth Facility and the program for Extended Fund Facility, which provides a borrowing closer to commercial terms.

The successful cooperation between the Bank of Albania and the World Bank has continued intensively even during 2005. This cooperation is focused on the financial and technical assistance that the World Bank continues to provide to the Bank of Albania. In this context, of special importance is the financial support on the Automated Electronic Clearing House project (AECH), which was successfully completed and made operational in July.

Undoubtedly, the most striking contribution of both above-mentioned institutions has to do with the implementation of the Financial Sector Assessment Program (FSAP) in Albania. For this purpose, a joint mission of both institutions visited Albania in February and May, while the conclusions of the FSAP report were made public in July. The FSAP report generally assessed the compilation, decision-making and implementation of monetary policy with positive notes, and simultaneously assessed the Albanian banking system as steady and healthy. Also, the report issued a number of recommendations to responsible institutions for maintaining the country's financial stability. Based on above recommendations, the Bank of Albania is committed, in cooperation with respective institutions, to draft a concrete plan of implementation measures, which will address the priorities presented in the FSAP report.

Another very important project is the signing of the Agreement "On Reserves Advisory Management Program" at the World Bank's head office in Washington, in September. This Agreement provides, besides the management of a part of Bank of Albania foreign reserve by the World Bank, the ensuring of assistance and qualified programs for Bank of Albania technical staff involved in foreign reserve management process.

During 2005 the legal and regulatory framework continued to be further completed and amended. These changes were carried out in the framework of commitments deriving from the process of Stabilization and Association Agreement with the European Union, and were dictated by rapid development needs of the Albanian banking system. In the framework of the process of Stabilization and Association, the Bank of Albania has carried out satisfactorily the short-term priorities specified in the National Plan on the Approximation of Legislation to that of the EU and the Implementation of the Stabilization and Association Agreement.

Bank of Albania transparency enhancement during 2005 has been on the focus of our work. We have tried to present analyses, studies and conclusions of our projects for the future, advice to other institutions of the country, and many other issues of such nature to scientific forums, to roundtables, participating actively within the country and abroad, without leaving behind other activities within the institution.

However, I would like to say that after the Fifth Conference of the Bank of Albania in March 2005, in Durrës, the climax of public activity was achieved in December of the past year, when in the presence of the General Manager of the Bank for International Settlements, Mr. Knight, of many honoured governors, of an elite group of international experts, the Bank of Albania

introduced its aspirations of the future monetary policy stance towards the updated regime of inflation targeting.

Honourable deputies,

I hope that in my speech I have clearly presented our activity during 2005. Of course, the challenges ahead require higher paces. Therefore, in our work programs of 2006 we are more demanding and more orientated towards policies and practices that advance the process of the country's integration.

The Bank of Albania, evaluating its role as one of the key institutions in successfully fulfilling its ambitious objectives of the mid-term program, has already drafted its monetary program for 2006. Based on the underlying assumptions of this program for an economic growth of 5 percent under the conditions of an average inflation of 3 percent, the Bank of Albania forecasts that the supply growth will be at 11.8 percent. This growth is estimated as sufficient for satisfying the economy needs for monetary assets, and particularly for enabling an extension of credit at the limit of ALL 53 billion or around 45 percent of the total. Continuing the positive economic logics of 2005, the budget deficit financing from the banking system is forecasted to consume around ALL 12.8 billion or $\frac{1}{4}$ of funds forecasted for lending. The Bank of Albania estimates that the increasing support of the Albanian business with domestic funds constitutes a positive premise for maintaining high economic growth rates even in the future.

Naturally, the fulfilment of legal requirements for controlling inflation will remain our fundamental task, but we will always pay great attention to maintaining and promotion of the banking system financial stability. For this purpose, we will remain deeply committed, and availing myself of this oratory, I would like to assure the People's Assembly that the Bank of Albania will be a responsible, transparent and independent institution for meeting its objectives.

Ardian FULLANI



Governor of the Bank of Albania

Note

¹ The 2005 economic growth estimate is a joint outcome of the IMF's EU1 Mission, the Ministry of Finance and the Bank of Albania.

