

CHAPTER III MACROECONOMIC DEVELOPMENTS

Albanian economy during 2010 was characterized by gradually improved aggregate demand, consolidated macroeconomic stability and decreased risk premiums. According to available data, the Albanian economy grew by 3.6% over the first nine months of 2010, whereas the average annual inflation ranged close to the Bank of Albania's target. Budget deficit to GDP decreased by 4 percentage points. Preliminary data suggest that the current account deficit narrowed by 5 percentage points of GDP.

Economic growth was supported mainly by foreign demand and increased Albanian exports, whereas the domestic demand was sluggish. The latter was also affected by consolidated public finances and reduced budget deficit in 2010, whereas consumer spending and investments were contained, due to uncertainty about the future and the spare capacity. In sectoral terms, the development of Albanian economy was supported primarily by the growth of service and industry sectors. Construction sector continued to be contracted over the first nine months of the year, whereas agriculture registered a satisfactory growth.

Table 1 Key economic indicators in the years

	2005	2006	2007	2008	2009	2010
Real GDP growth (in %)	5.7	5.4	5.9	7.7 ¹	3.3 ²	3.6 ³
GDP (at current prices, in ALL mln.)	814,797	882,209	967,670	1,088,132	1,143,610	NA
Number of people employed (in thousand)	932.0	935.1	939.0	974.1	899.3	916.9
Unemployment rate	14.2	13.8	13.2	12.7	13.7	13.5
Inflation rate (y-o-y)	2.0	2.5	3.1	2.2	3.7	3.4
Budget deficit (including grants, as a share of GDP)	(3.5)	(3.3)	(3.5)	(5.5)	(7.0)	(3.1) ²
Public debt (as a share of GDP)	57.4	56.2	53.5	54.8	59.7	58.4 ²
External debt (as a share of GDP)	17.2	16.6	15.3	18.0	23.4	25.1 ²
Current account (excluding official transfers, as a share of GDP)	(10.0)	(7.3)	(11.4)	(15.8)	(15.5)	(11.9) ²
ALL/USD average exchange rate	99.9	98.1	90.4	83.9	95.0	103.9
ALL/EUR average exchange rate	124.2	123.1	123.6	122.8	132.1	137.8
M3 aggregate (annual average)	15.6	11.6	15.8	12.3	6.0	10.6

1- Non-definitive; 2- Preliminary data 3 –Annual average growth over the first three quarters

Source: INSTAT, Ministry of Finance, IMF and Bank of Albania.

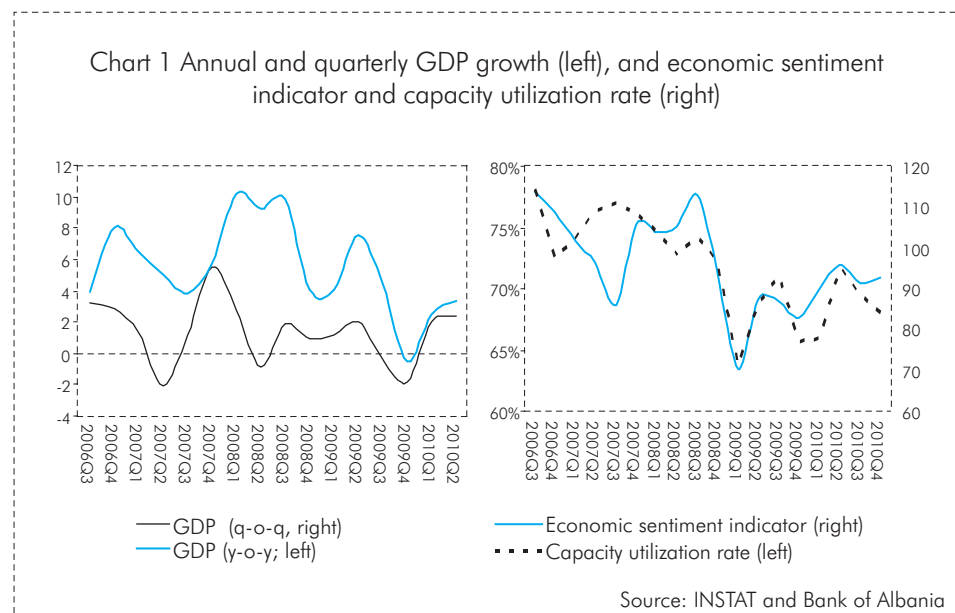
Financial market interest rates were downward during 2010, reflecting the easy monetary policy pursued by the Bank of Albania and the public sector's lower borrowing from domestic financial markets. On the other hand, the exchange rate continued to follow a slight depreciating trajectory in line with the structural changes in the Albanian economy and international financial markets.

The restored confidence in the financial system, stabilized macroeconomic situation and prudential and regulatory measures taken by the Bank of

Albania, led to the stabilization and improvement of capitalization, liquidity and profitability indicators of the banking system. This made the credit support of the economy be upward during the year. However, it is still suffering from lack of the demand and realistic, qualitative and creditable business plans, as well as from the banks' tight lending conditions. The easing of lending terms and conditions in 2010 H2 and the upward interest of the banks in financing domestic consumption and investments, decreased uncertainty and risk premiums, as well as the overall sound balance sheets of businesses and consumers, are expected to stimulate the domestic demand in 2011.

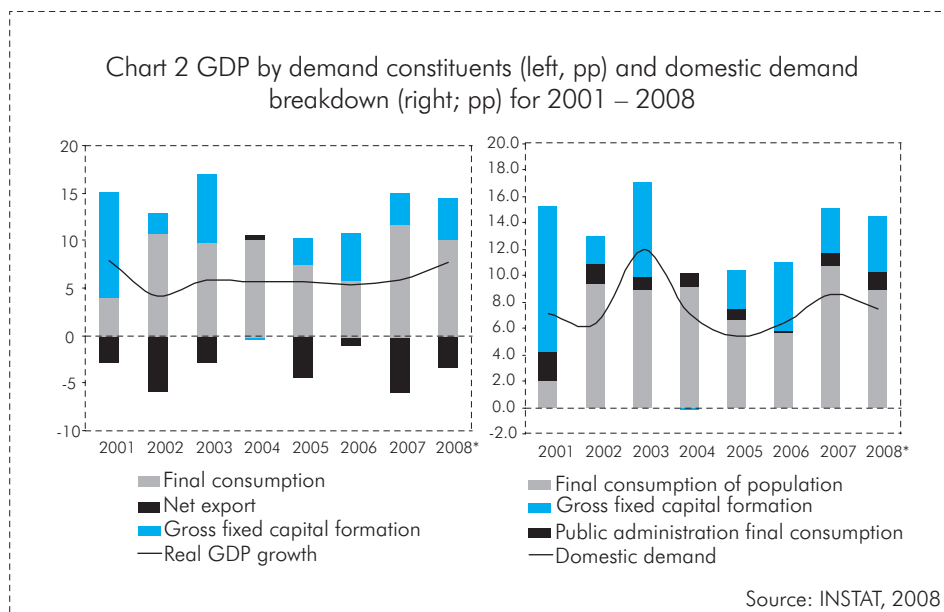
III.1. GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Aggregate demand has progressively increased year-on-year, after having contracted in 2009 Q4. The Albanian economy grew by 2.5%, 3.3% and 4.9%, respectively in 2010 Q1, Q2 and Q3. The strong upward trend of lending to the economy and of merchandise imports, increased budget revenues, and improved economic sentiment indicator in 2010 Q4 suggest ongoing positive economic growth rates for Q4.



Economic growth is supported mainly by foreign demand, whereas domestic demand continues to provide a low contribution. Ongoing global economy recovery and its positive impact on the demand for exports supported the country's economic growth during 2010. At the same time, consumer confidence indicator rose in 2010 H1, supporting the private consumption. While economic activity recovered in 2010 H1, private investments were generally more restrained, showing growth only in 2010 H2. On the other

hand, the contribution of public spending to aggregate demand and to economic growth was declining gradually over 2010.¹



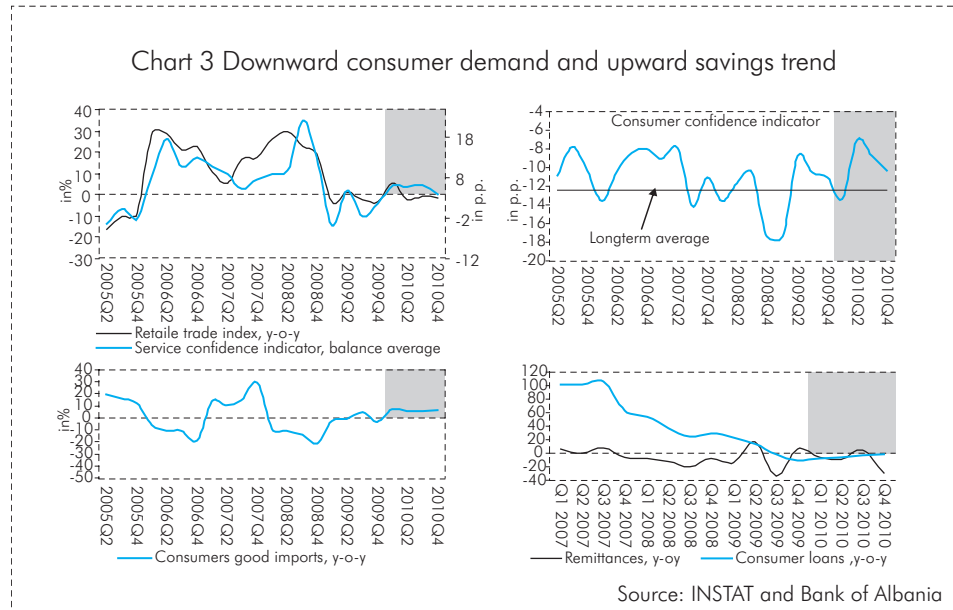
Indirect indices from official statistics and also qualitative confidence survey indicators show that private consumption grew slightly in 2010, influenced even by the statistical base effects of 2009 decline.

Private consumption growth q-o-q has been uneven. Indirect indices show that its recovery was more evident in 2010 H1. Retail trade index, which grew by 1.6% y-o-y in 2010 H1, fell by 0.9% in 2010 H2. On the other hand, consumer goods import experienced y-o-y growth throughout 2010, following the 2009 decline. Consumer goods import registered strong growth in Q1, by 7.3%. Over the next three quarters, the growth was decelerated, respectively, 5.9% in 2010 Q2 and Q3 and 6.4% in Q4.

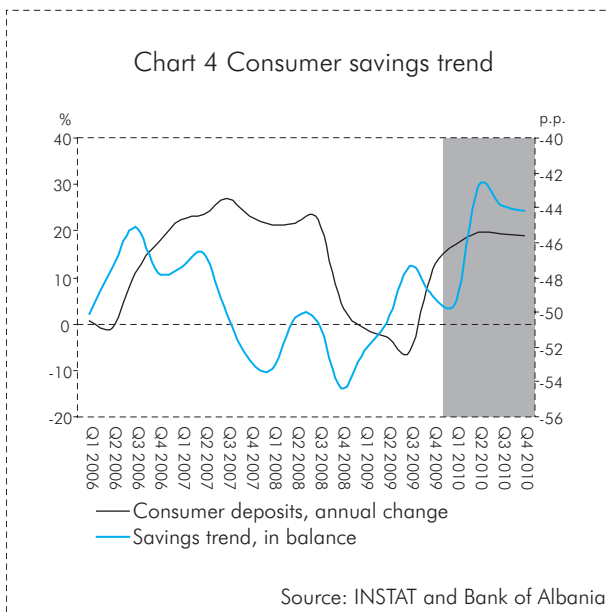
During 2010, private consumption was supported by rising disposable incomes, attributed mostly to wage increases. Other funding sources, remittances and consumer loans remained at low levels. Remittances dropped by 11.7% y-o-y and consumer credit shrank slightly. Meanwhile, the 2-4% inflation rate helped maintain positive real growth rates of disposable income.

Uncertainties around overall economic and financial situation and expectations for future employment were the main concerns leading to restrained consumption in 2010. After having registered significant increase

¹ Measurement of domestic aggregate demand by its expenditure items is estimated annually and becomes available with long lags. (Chart .2, till year 2008). Therefore, private consumption, investments, and other components of aggregate demand by quarters are estimated by using indirect data from consumer goods imports and investments, retail trade volume, qualitative data from business and consumer confidence surveys and funding sources of these components.

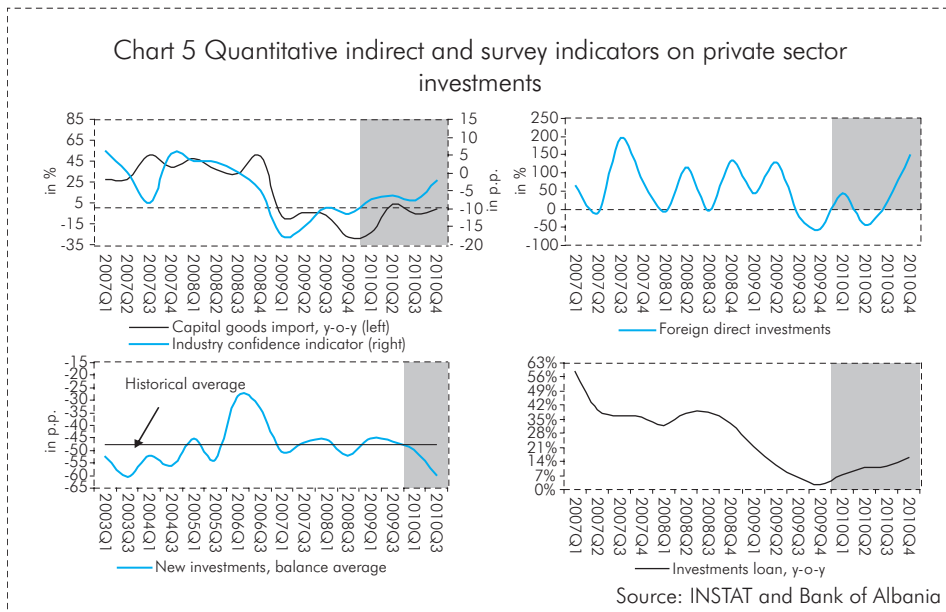


in H1, consumer confidence indicator fell in H2, being reflected in consumer behaviour with regard to consumption and savings. The ongoing upward household deposit trend and increased savings indicator obtained from consumer confidence survey, suggest continued cautious stance of households related to their spending.



During 2010, private investments slightly recovered the sharp descent having been registered a year earlier. However, their growth was slow, following the domestic economic activity recovery with a several-month lag. Foreign direct investments, which were volatile over the 2010 H1, registered significant growth in 2010 H2. During 2010 Q1, the process of inventory accumulation contributed positively to aggregate demand. In the next period, their contribution is estimated to have been negative.

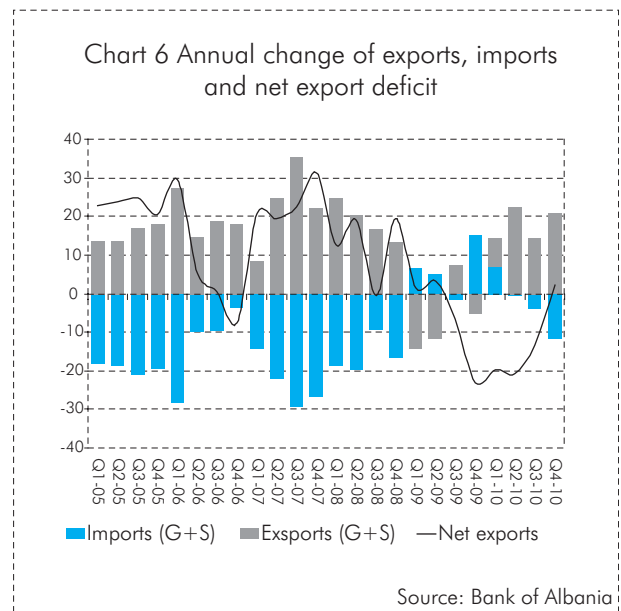
The contribution of private investments to aggregate demand growth was absent during 2010 H1. Affected by low capacity utilization rate and tight lending conditions, Albanian businesses have been reluctant to make new investments. In construction sector, the total building permits approved for housing and engineering constructions were downward for four consecutive quarters, starting from 2009 Q2. Meanwhile, indirect private investment indicators show that their level grew during the second half of the year. This performance was supported by improved business confidence indicator, sustainable external demand recovery, as well as increased bank credit to businesses, in response to eased credit conditions and banks' increased attention paid to lending. According to bank credit survey, investment standards stopped tightening in 2010 Q3 and



began easing in 2010 Q4. According to this survey, business loan demand for investment was low but upward throughout 2010.

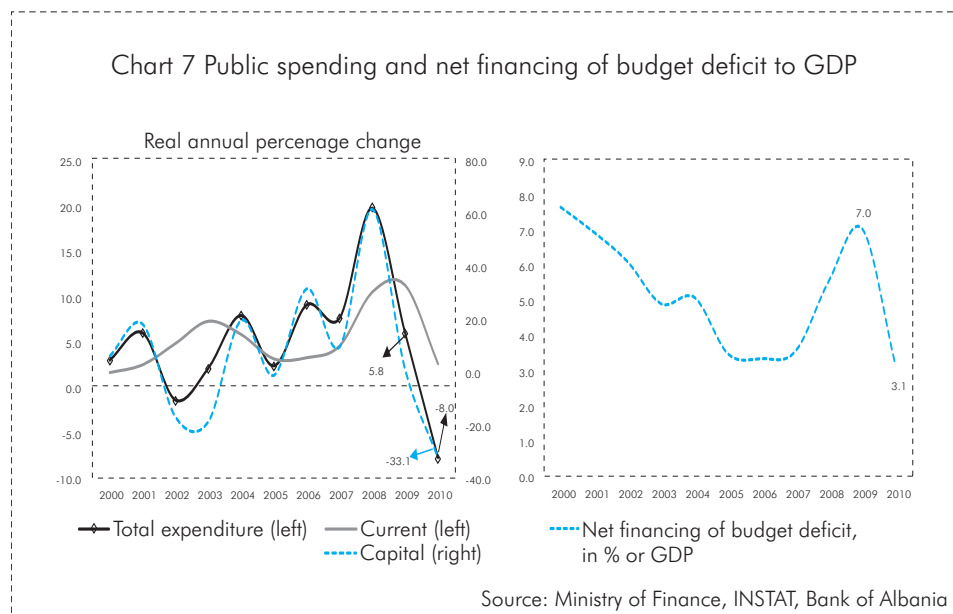
The annual deficit contraction of goods and services net exports during 2010 provided a positive contribution to annual GDP. Subsequently, net export indicator narrowed by 12.9% y-o-y. This development was influenced by rising exports of goods and services by about 16% y-o-y. The contraction of net export deficit is estimated to have provided a substantial positive contribution to economic activity during 2010.

Increased foreign demand for Albanian goods and services has supported domestic output growth. In particular, it is reflected in good performance of the sectors related to exports of goods and services, such as industry and tourism-related services. The recovery in the world activity, exchange rate adjustment, and the flexibility of Albanian businesses to find new markets for their products, have been determining factors in increasing exports and improving Albania's external sector's balance sheet. On the other hand, this trend has also reflected the statistical effects of Albania's weak export performance during 2009. It is also favoured by favourable conjunctural factors, such as high mineral prices in global markets and suitable weather conditions for hydroelectric generation. However, in 2010, export and import indicators, deflated from price volatility, shows that export growth was higher than what statistics show, whereas imports contracted in response to a still sluggish domestic demand. Overall, it is estimated that the contribution of net export narrowing to real GDP growth is even more positive. Notwithstanding



these positive developments, the maintaining of positive contribution of this aggregate demand constituent to economic growth in the years ahead will be one of the challenges of the Albanian economy.

Fiscal consolidation process was accompanied by a sharp reduction of public spending contribution to aggregate demand and economic growth in 2010. In real terms², budget spending contracted by about 8% in 2010, while budget deficit decreased by 4 percentage points as a share of GDP. Public investments experienced a real contraction by about 33.1% in 2010, vs. a real growth of 0.1% in 2009. Coupled with fiscal correction effect³, this public investment trend reflects also the statistical effect of the previous year's high investments⁴.



Due to restraining direct impact of fiscal consolidation on economic growth, the public sector's lower need for borrowing from domestic financial markets led to interest rate cut and increased the banks' attention to private sector lending. This phenomenon was especially evident during 2010 Q4, when the decreased government security portfolio was accompanied by rapid growth of lending to the economy. In the long run, keeping public debt level in check contributes positively to decreasing the financial market risk premiums and the real interest rates in the economy, as well as to increasing the long-term investments.

² Real change of budget spending is obtained by deflating nominal expenditures to average annual inflation per budget year.

³ Fiscal correction for 2010, which aimed at reducing budget spending, was mostly supported by reduced capital expenditure relative to the previous year.

⁴ Between the period 2008 and 2009 Q2, there was a high concentration of capital expenditures, due to Rrëshen-Kalimash road construction.

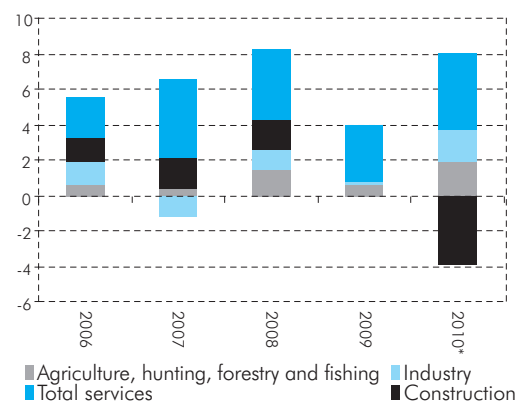
III.2. OUTPUT BY SECTORS OF THE ECONOMY

The economic growth over the first nine-month period of 2010 reflected mainly the strong growth in industry, followed by the growth in services and agriculture sectors. In the meantime, construction sector deepened the contraction having started since late 2009.

Production sector⁵ slowed during the first nine months of the year, reducing the positive contribution to economic growth. This contribution is estimated at about 0.4 percentage points, from 0.6 percentage points in the same period of 2009. Within the production sector, the value-added from industry and agriculture to GDP offset the descent in construction.

Industrial output for the first nine-month period of 2010 was up 19.8% y-o-y. Significant improvement⁶ of economic activity in this branch was mainly affected by increased foreign demand for Albanian products, their higher prices in international markets – while the national currency continues to be weak - and the base effect of comparison with the low level of 2009. This development was reflected in the growth in industrial exports and sales at home, as proxied by the volume turnover indicator. Industrial sector's sales accelerated their annual growth rate in the first three quarters, registering an annual average growth of about 36.5%. This increase was triggered mainly by accelerated sales growth in the extracting industry. Industrial goods export increased by 60.5% y-o-y over the first nine-month period of 2010, compared to the negative growth a year earlier.

Chart 8 Sectors' contributions to GDP growth* (in percentage points)



*Years are estimated as the annual growth average of first three quarters.
Source: INSTAT and Bank of Albania

	2008	2009	2010*
Industry	8.7	12.6	36.5
Extractive industry	-1.2	-6.8	56.7
Processing industry	8.8	11.0	13.2
Electricity, gas, water	15.6	25.2	104.3

Table 2 Industrial output (annual changes, %)

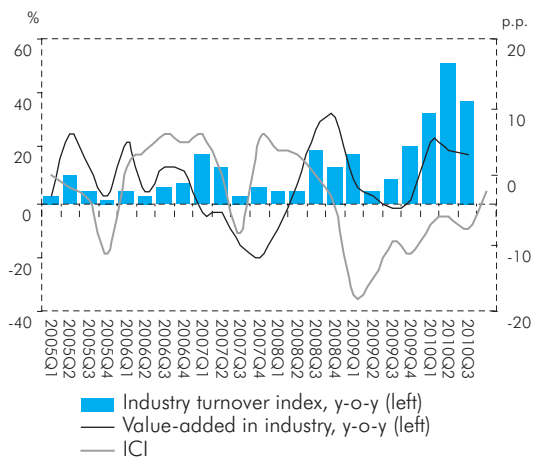
* Year 2010 is estimated according to the average of three quarters.
Source: INSTAT and Bank of Albania.

Positive growth rates of industrial output are expected to persist in 2010 Q4. Export of these goods grew by about 50% in this quarter. In the meantime, the industrial confidence indicator grew by 5.5 percentage points, up by 0.2 percentage points from its historical average. Also, information on new industrial orders and the upward trend of industrial loan support the outlook for recovery of its activity over the periods ahead.

⁵ Production sector includes industry, construction and agriculture.

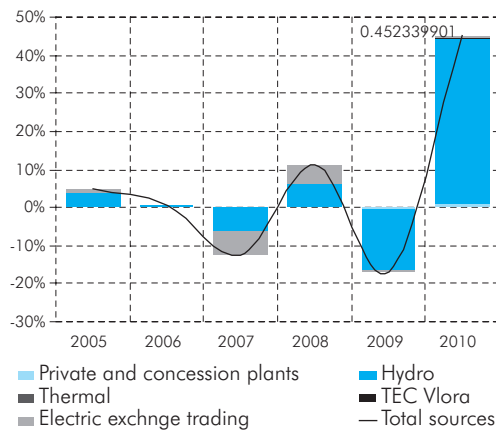
⁶ The average historical growth rate is 11.2 for the period between the years 2003 – 2008.

Chart 9 Value-added, turnover index and industrial confidence indicator



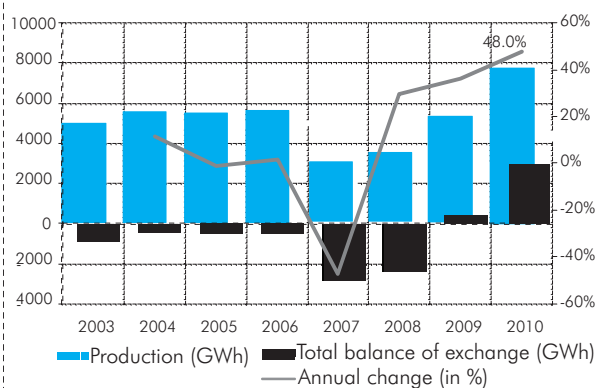
Source: INSTAT and Bank of Albania

Chart 10 Contribution by categories to sources of electrical energy and annual percentage change



Source: AEC and Bank of Albania

Chart 11 Electric power domestic production and balance of exchange (left) and annual change in production (right)



Source: AEC and Bank of Albania calculations

Electricity production grew by about 48.0% during 2010. Sources of electrical energy⁷ in the country increased by 45.2% during the year, mainly due to 43.4% rise in electricity generated from hydropower plants. Since early 2009, electricity generated from concession and private plants has been added to electricity generated from public thermal and hydropower plants⁸.

Net balance of electricity exchanged in 2010 totalled 2931.2.6 GWH, about 6.7 times higher than in the previous year. In 2010, exports accounted for about 37.9% of electricity generated domestically, up by 29.5 percentage points on a year earlier.

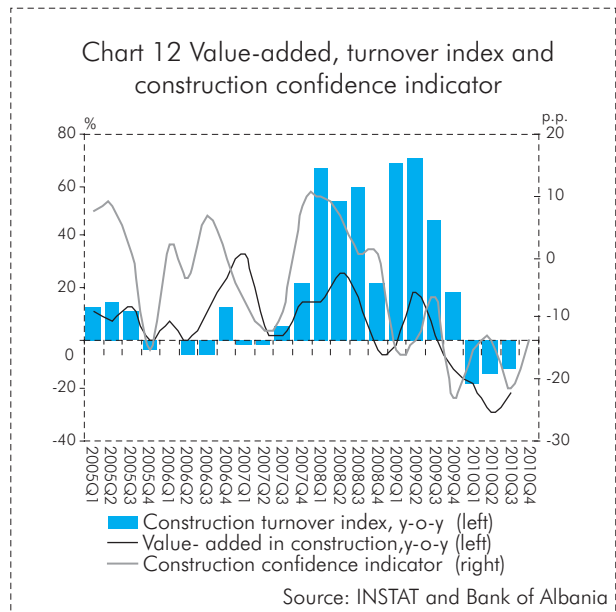
The slowdown in production sector's contribution to the country's economic activity growth during 2010 reflected mainly the contraction in construction.

The value-added generated from construction recorded an average annual contraction of -23.1% in the first three quarters of 2010. The deterioration in construction activity contributed negatively to gross domestic product, by -3.4 percentage points. While the activity of this branch fell sharply, the housing market price correction was slower.

7 Domestic electrical energy sources refer to electricity generated from hydropower plants, thermal electric plants, concession and private plants as well as imported electric energy (import and exchange-trading contracts).

8 Even though their present contribution to total sources of production is low, they remain a source of electrical energy supply in the domestic market.

During 2003 - 2008, construction experienced a double-digit growth, supported by the upward trend in approved permits for private constructions, a high demand for housing, the demographic dynamic movements as well as the favourable funding support. Starting from 2009 H2, construction activity has fallen significantly, being reflected in the decreased number of housing constructions (22.5% on average during 2010), stable or downward trend of house prices, decreased values in engineering constructions, road and highway sub-branch (20.3% average annual decline during 2010). The descent in the added construction volume over the past two years was driven by the decline in the demand for residential buildings, public investments, or expansion of enterprise manufacturing capacities and lower lending to construction during past two years, compared to preceding years. In particular, the demand for housing is decelerated in response to consumer uncertainty about the future and consumer expectations for house price correction.



Agriculture value-added grew on average about 9% y-o-y during the first three quarters of 2010, or up 5.8 percentage points from the figure marked over the same period of 2009. As a result, this sector is estimated to have provided a substantial contribution to annual GDP growth. Higher agricultural prices in global markets convey proper incentives for a long-term growth of agricultural production in the Albanian economy. Reforms and structural developments (aimed at enhancing efficiency in agricultural production, facilitating access of Albanian agricultural products to domestic and international markets, as well as supporting financially this sector's businesses and farms) should be a priority of economic development in Albania.

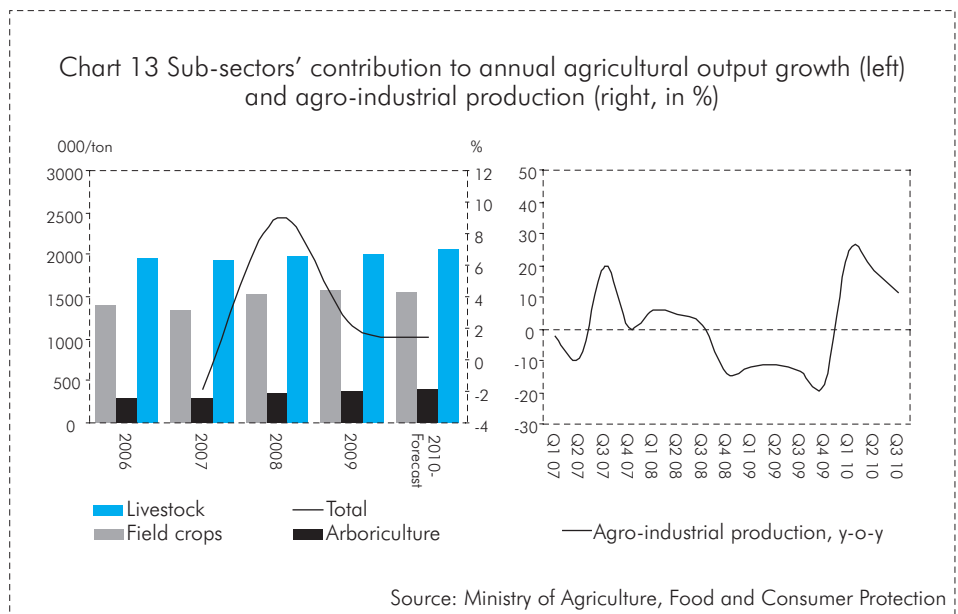
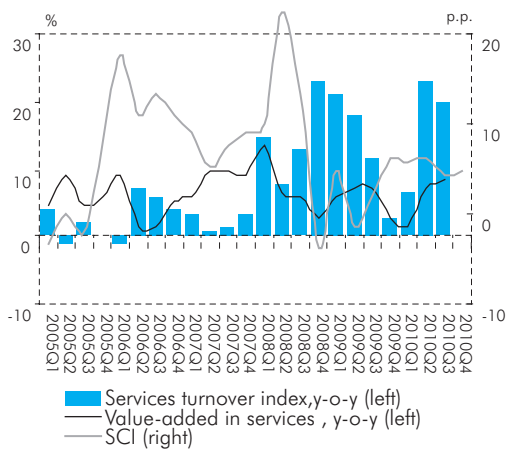


Chart 14 Value-added, turnover and service confidence indices



Source: INSTAT and Bank of Albania

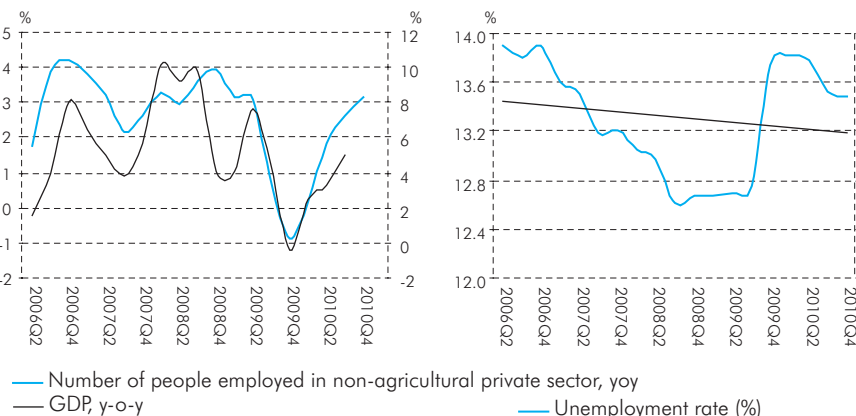
Service sector continued to provide a major contribution to generating positive economic growth rates. The service value-added contributed an average annual growth of about 3.2 percentage points to GDP for the first three quarters of 2010. Over this period, the value-added posted 5.6% average annual growth, showing a progressive trend from Q1 to Q3. Transport and Other services highlighted accelerated annual growth rates. Other services, which relate mainly with health, education and financial intermediation, have contributed by about 60% to Q3's economic growth. In the meantime, the value-added in Trade, hotels, and restaurants sub-branch, related closely to consumer spending, recorded a decelerated y-o-y and q-o-q growth rate⁹. Within the service sector, Post and telecommunication sub-branch dropped 7.2% y-o-y in the first nine-month period of the year (compared with up 36.5% in the same period a year earlier).

Based on data from business service surveys, this sector's confidence appears less optimistic in 2010 Q4, compared with the first nine-month period of the year. The confidence indicator of businesses operating in the service sector, having increased slightly in Q3, fell 2.2 percentage points in Q4. However, it is standing at its historical average.

III.3. THE LABOUR MARKET

Recovery of economic activity in 2010 conditioned the stabilization of the labour market during this period. Following the deterioration observed in

Chart 15 GDP at basic prices and the number of employed people (y-o-y percentage, left) and unemployment rate (right chart)



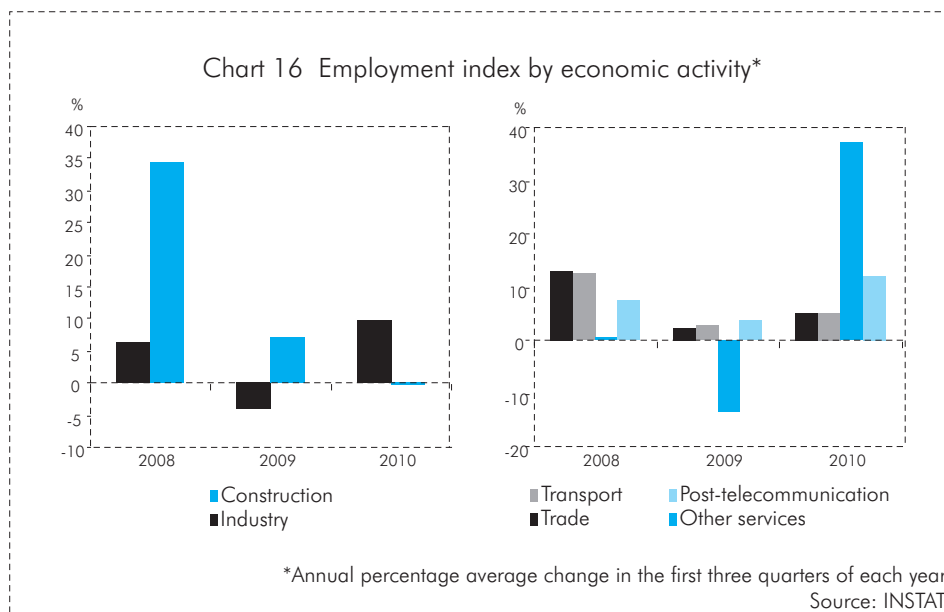
Source: INSTAT

⁹ The Q3's decelerated growth in this branch is unexpected because of its seasonality related to the tourism season.

2009 Q4, employment growth was slow but steady, while the increase in the number of unemployed people was lower. Unemployment rate fell by about 0.26 percentage points compared with the end of the previous year, standing at 13.49%. However, relative to previous years, it remains elevated, suggesting the existence of spare capacity in this market.

During 2010, the non-agricultural private sector's employment rate¹⁰ picked up by 1.9% in 2010. In contrast, the public sector's employment rate levelled out in average terms.

A more detailed sectoral analysis based on short-term statistical data shows that increase in the private sector's non-agricultural employment has derived primarily from better-performing branches. In the first nine months, the industry and service employment indices increased by 9.8% and 5.2% y-o-y, respectively. In contrast, construction employment index fell by 0.5% over this period. Quarterly distribution of this index attests to positive developments in construction employment during Q3, following the fall registered in the first two quarters of the year.



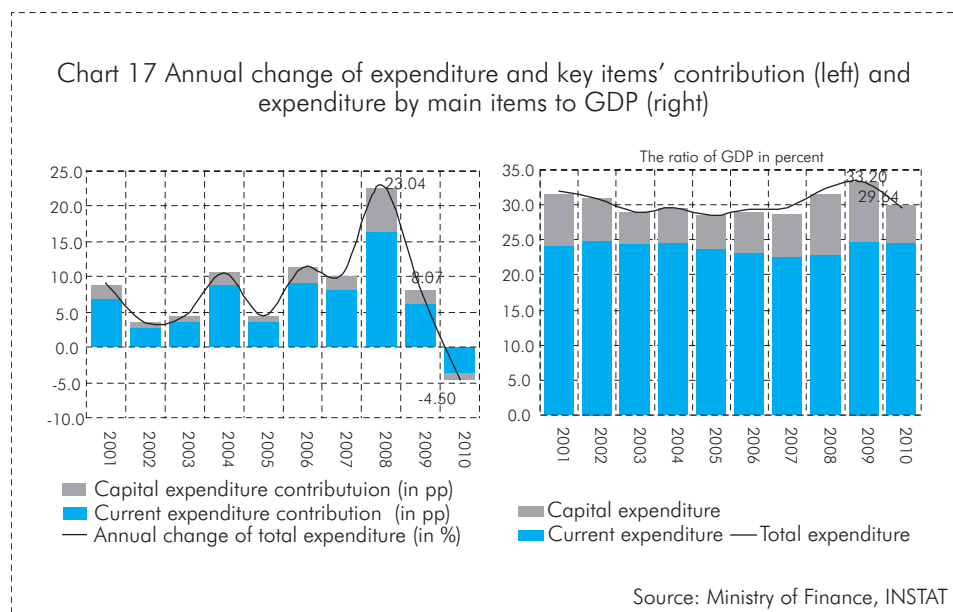
Data from surveys support the trend observed in the labour market. For Q4, survey indicators suggest further improved employment, which would be reflected in the production sector, whereas service sector is expected to maintain the Q3's levels.

¹⁰ The total number of people employed dropped by 6.7% in the first nine months of this year, due to decline in private agricultural sector, reflecting the statistical effect of their measurement. This is because the average number of people employed in the private agricultural sector from 2008 Q2 to 2009 Q3 is estimated according to the 2007 Labour Force Survey, whereas for 2009 Q4 it is estimated according to the 2008 Labour Force Survey (Source: INSTAT, "Conjuncture – Key economic indicators, January – March 2010").

III.4. FISCAL DEVELOPMENTS

Observing the public debt stock threshold below 60% of GDP, and maintaining low budget deficit levels, have been two most important operational objectives set forth under the 2010-2012 Fiscal Macroeconomic Framework¹¹. These two pillars have served as anchors to support fiscal sustainability in the medium and long run. Public finance sustainability became one of the most important issues in 2010 agenda, as a consequence of the deteriorating fiscal position on a year earlier. Increased public debt and budget deficit in 2009, as a consequence of fiscal stimuli in view of the revitalization of the economy, led to changing the fiscal policy stance in 2010. Against this setting, fiscal policy was oriented towards fiscal consolidation process that was accelerated especially after 2010 H1, with the approval of the revised budget that established a lower level of expenditure than the one projected at year-start. The 2010 fiscal consolidation was carried out by combining reduced expenditure and increased revenues. Though the measures taken in this regard included even the income-side correction, the 2010 fiscal consolidation essence consisted in controlling and curbing the budget spending. Consequently, in late 2010 the budget deficit was curbed by about 3.9 percentage points on a year earlier.

The 2010 budget spending was down by 4.5%¹² from the previous year's figure, thus suggesting a lower contribution of the public sector to aggregate demand. For 2010, total expenditure accounted for about 29.6% of GDP, against 33.2% on a year earlier. Current expenditure accounted for approximately 24.6% of GDP, from 24.8% a year earlier, while capital expenditure accounted for about 5.5% of GDP, marking about 2.9 percentage points lower than a year earlier.



¹¹ Fiscal Macroeconomic Framework is a constituent of the SPI and is compiled by the Ministry of Finance.

¹² Budget spending for 2010 is down 3.0% on a year earlier, if we exclude the "AEC loan repayment" as a total expenditure item.

Budget spending trend was dictated by lower annual growth rates of current expenditure and contraction of capital spending in annual terms. In late 2010, current expenditure grew 6.0% y-o-y, from 13.4% a year earlier. Meanwhile, capital spending was down 29.6%, from up 2.4% as at end-2009.

Tight fiscal policy pursued in 2010, has changed the budget spending composition, providing a structure of a lower share of capital spending to total expenditure, relative to the previous year¹³. Social security outlays still account for the highest share to total expenditure (about 29%¹⁴). This sub-item, together with interest expense on public debt, hit the highest growth in annual terms (respectively 9.8 and 14.6%). Interest expenses increased especially during the past two years due to increased interest payments on external debt. The increase in external debt share, in commercial terms, and the national currency's depreciation against a basket of major foreign currencies led to external debt's higher interest expenses.

In 2010, budget revenues performed differently from 2009. Although their growth rate remained below the historical average, its trajectory was steadier than in 2009¹⁵. Budget revenues as at end-2010 were up 8.4%, from up 2.8% on a year earlier¹⁶. As a share of GDP, fiscal revenues for 2010 are estimated at about 26.5%, up by 0.3 percentage points from the previous year.

Tax authority's decisions and developments in non-tax revenue item are two key factors that have positively influenced revenues. Increase in revenues from tax authority's decisions owes to adoption of several alterations to the fiscal package¹⁷, which are translated into increased direct and indirect taxes and duties. Another factor that has positively influenced 2010 budget revenue growth is the sharp increase in non-tax revenues, thanks to including a part of privatization receipts to this cluster of revenues.

VAT revenues, accounting for the largest share to total revenues (35%), increased at comparable paces to the previous year (3.6% versus 2.8% in 2009), levels significantly below their historical average¹⁸. Maintaining these rates suggests slower increase in the domestic demand. It should be highlighted that the increase in VAT revenues in 2010 was driven by increased value of import of goods subject to this tax type¹⁹. Increased revenues from VAT only thanks to tax on value of imported goods, is due to high share (about 74% in 2010) of VAT of these goods to total VAT, as well as the national currency's

¹³ In 2010, current and capital expenditures (excluding the "AEC loan repayment") accounted for 82% and 18%, respectively, to the total, from 75% and 25% in 2009.

¹⁴ The deficit resulting from social insurance scheme accounted for 138% of the total budget deficit.

¹⁵ In 2009, budget revenue growth paces decelerated after the first quarter of the year, while 2010, particularly the last five months highlighted their acceleration, with an annual growth rate standing at above 5.7%.

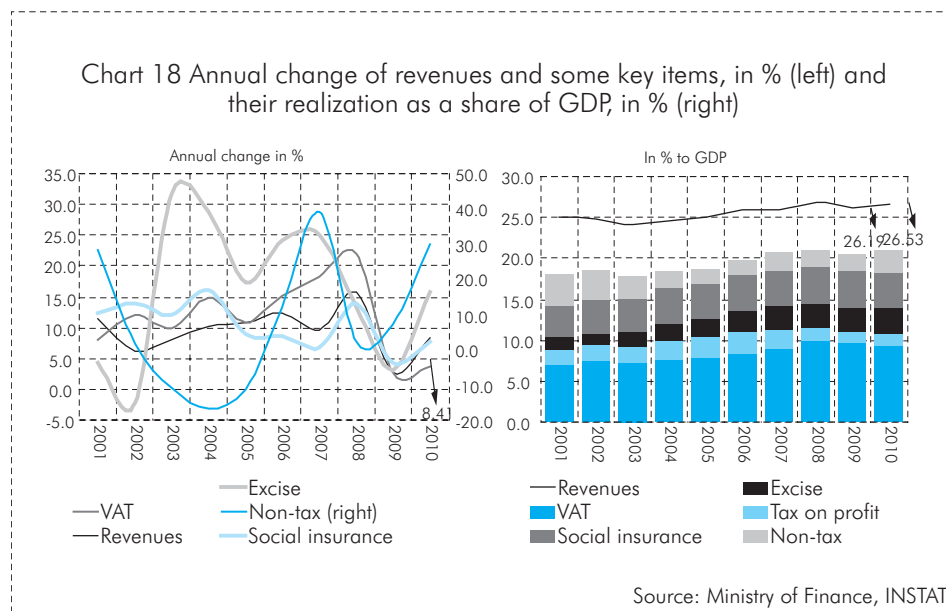
¹⁶ The 2010 annual budget revenue growth, excluding privatisation receipts, is 5.6%.

¹⁷ For more details on changes to fiscal package, see Box 2: "Fiscal Package adopted for 2010"

¹⁸ The historical average annual growth rate of VAT revenues is estimated at about 11.7% in 2001-2010.

¹⁹ Referring to SIT classification, excluding the "Beverages and tobacco" and "Fuels" items.

depreciating trend against the basket of major foreign currencies²⁰. On the other hand, in spite of measures taken by the tax authority to expand the scope of businesses for VAT registration, VAT revenues from production of domestic goods and services contracted in annual terms²¹.



20 In 2010, the national currency's depreciation averaged 9.3% vs. American dollar and 4.3% vs. Euro.

21 VAT revenues collected by tax administration dropped by 10.7% y-o-y.

BOX 2. FISCAL PACKAGE ADOPTED FOR 2010

Amendments to the 2010 fiscal package consisted in:

- Amendments to the VAT law. They brought about expanded scope of businesses for VAT registration, by lowering the business annual turnover threshold from 8 million to 5 million, as from January 1, 2010, as well as by setting a minimum threshold for Vat registration of ALL 2 million for liberal professions (lawyers and notaries; chartered accountants and professional accountants; doctors and dentists (including specialists), pharmacists, nurses, architects, engineers, veterinarians, agronomists, midwives and economists; and real estate assessors. The supply of educational services by public and private institutions is an exempt supply in the VAT law.
- Amendments to the Law on excise tax. Glass packaging, plastic packaging, piles and primary batteries, tires and fireworks were added to the range of goods subject to excise tax. At the same time, perfumes and different types of mineral water were excluded from excise tax. Also, the way of applying the excise tax for incandescent lamps was changed (from commodity value percentage into fixed amount) and also the existing excise taxes were increased for some oil sub-products (fuel type coal oil; crude oil as fuel; acyclic and

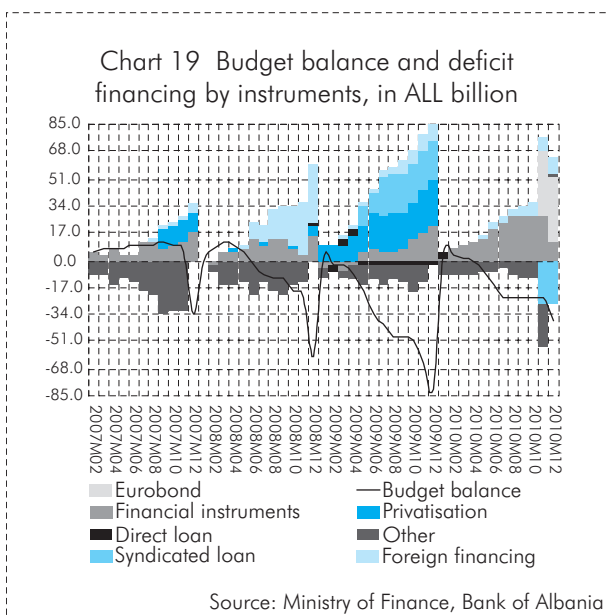
cyclic hydrocarbons). The excise tax was decreased solely for the item “No-baked decaffeinated or not decaffeinated coffee”.

- Amendments to the Law on “National Taxes”, counted the reviewing of the tax on used cars; setting forth a fixed tax for mineral rent; reviewing the carbon tax and changing the tax on games of chance.

Except excise tax revenues, the growth rates of other tax revenues were below their historical average. Excise tax revenues as at end-2010 grew by 15.8% y-o-y, remaining 1 percentage point above the annual average growth recorded over 2007-2009. Increase in the amount of imported fuel²² and tobacco, in excise tax for several oil products, as well as in the scope of goods subject to excise tax in 2010²³ are factors that have contributed to substantial pickup in excise tax revenues.

Personal income tax is another item that posted annual growth rates markedly below its historical average. At end-2010, in spite of application of the same rate as a year earlier, this tax revenue item grew by 0.9% y-o-y compared to the two-digit growth (over 10%) in the two previous years, suggesting the presence of automatic stabilizers along the year²⁴.

At end-2010, the budget deficit is estimated at about 3.1% of GDP, from 7.0% at the end of the past year. The difference by 3.9 percentage points from the previous year represents the fiscal correction extent to maintain sustainable public finances²⁵. In nominal terms, the budget deficit at end-2010 resulted about ALL 38.1 billion, being reduced by about 53% from end 2009.



In the first 10 months of 2010, budget deficit was financing according to the “traditional” way, through issuance of domestic debt instruments, as well as through external borrowing to finance the projects. In November 2010, a new instrument was added to the range of government borrowing, i.e., the EUR. 300 million Eurobond. With the Eurobond issue, the existing structure (the 10-month period) of deficit financing was changed. Of this amount, about EUR. 192.6 million was transferred to repay the syndicated loan²⁶, whilst the rest was used to

finance the deficit for the two remaining months of the year. On the other hand, in order to maintain the deficit within the limit specified in the 2010

²² Fuels account for the major share to imported goods volume, which are subject to excise tax.

²³ Goods added to 2010 excise tax list were glass packaging, plastic packaging, tires, fireworks, as well as piles and primary batteries.

²⁴ Automatic stabilizers imply the mechanisms that duly stimulate or contract the economy, without needing a change in the country’s economic policies.

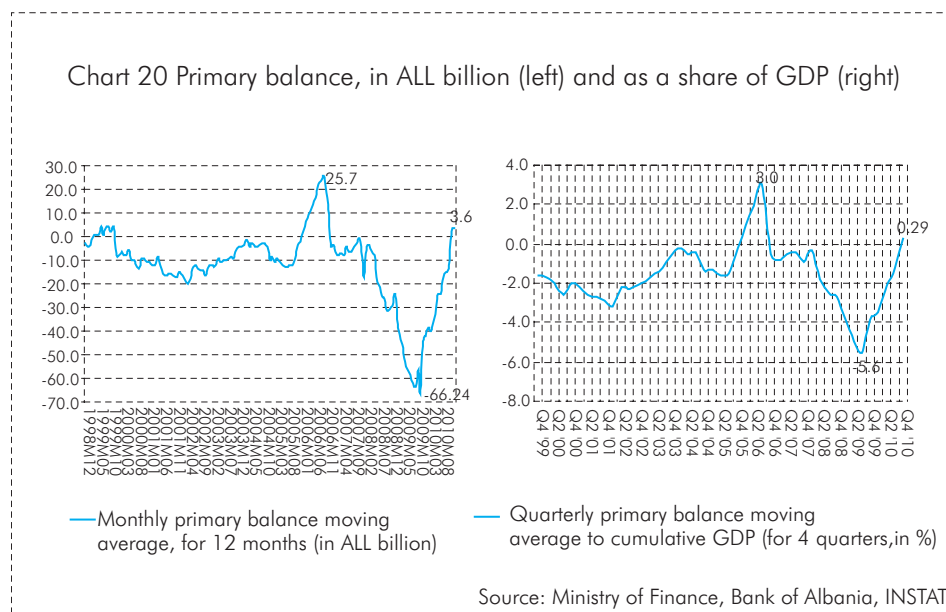
²⁵ It should be highlighted that it is difficult to define the fiscal correction size to support the fiscal sustainability.

²⁶ Syndicated loan granted in 2009 H1 falls due in 2011 H1.

budget law²⁷, in the last two months of 2010, domestic borrowing decreased by ALL 16.1 billion, an amount almost equal to the amount remaining from Eurobond issue.

At end-2010, budget deficit financing through bonds and treasury bills issuance was about ALL 11.1 billion, accounting for about 29% of net deficit financing for this budget year. Unlike the trend observed in 2009, especially in 2009 Q4, during 2010, market stakeholders' preferences were for long-term government securities. Their tendency to extend the investment horizon in government securities, combined with a high level of liquidity in the market²⁸ have contributed to reducing the government debt stock in short-term instruments (3- and 6-month T-bills), making more room for long-term domestic debt instruments. Only in December 2010, the tax authority issued about ALL 15.5 billion T-bills less than the amount that fell due within that month²⁹. This development is reflected mostly in reducing the T-bill portfolio owned by the Bank of Albania, offering a picture similar to that of advanced and emerging economies³⁰. On the other hand, the reduced domestic debt in short-term securities was transmitted to significant reduced T-bill yields, generating grounds for decreasing risk premium in the future. At end-2010, the short-term debt stock (in T-bills of the three maturities) resulted about 59% of total domestic debt, versus 63% a year earlier. This development is expected to be transmitted to reduction of debt refinancing risk in the future.

Budget deficit financing through foreign resources (excluding Eurobond) resulted 27% for 2010. Besides the above-mentioned instruments, receipts



²⁷ Referring to Budget Law revised in July 2010, as well as to 2010 Budget Law. Each of them provided for a budget deficit of ALL 38.1 billion.

²⁸ The government securities investors' bid was very high, since the bid-ask ratio with respect to the issued amount settled above 1 throughout 2010.

²⁹ Of this amount, ALL 9.1 billion belongs to 3-month T-bills, 3.9 billion to 6-month T-bills and 2.4 billion to 12-month T-bills.

³⁰ We refer to "Fiscal Monitor", November 2010, IMF, about fiscal developments in developed and emerging economies.

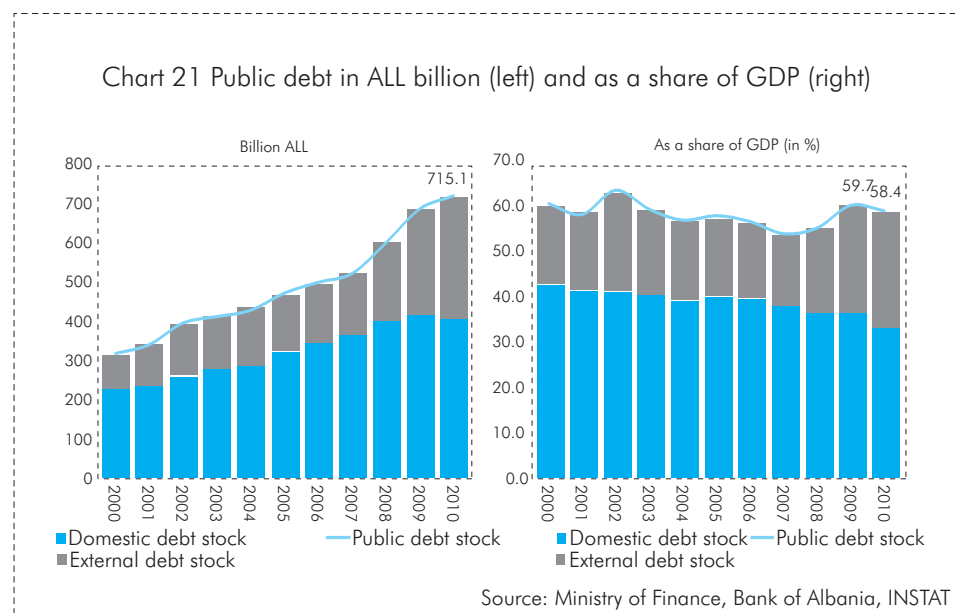
from privatization of state-owned enterprises constitute another budget deficit financing element. However, this item's share of 1% to total financing is almost negligible in comparison to 2009, when privatization receipts accounted for about 34% of total budget deficit financing.

In 2010, fiscal consolidation process is illustrated through the trajectory followed by the primary deficit during the year. Primary deficit, especially after 2010 Q2, significantly improved both in nominal terms and as a share of GDP. At period-end, this indicator recorded positive values for the first time since 2006 Q3.

Latest primary balance developments provided a positive contribution to public debt dynamics, especially in 2010 Q4.

At end-2010, public debt stock resulted about ALL 715.1 billion³¹, of which 57% represented the domestic debt stock and the rest represented the external debt. The public debt stock composition has changed from a year earlier, when these ratios were 61% and 39%, respectively. This public debt composition, which highlights an increased share of external debt to total debt y-o-y, carries higher exposure to changes in global financial markets and in foreign exchange ones. On the other hand, meeting the government's borrowing need with foreign resources made more room for private sector borrowing in the domestic market. This public debt structure, besides the risks it carries over, serves also as a driver to the country's economic activity growth, expands investors' scope in government securities and precedes the private sector's foreign borrowing.

Public debt as at end-2010 is estimated at about 58.4% of GDP, marking



a reduction of about 1.2 percentage points from the previous year. Domestic

³¹ External debt data on end-2010 are preliminary.

debt stock as at end-2010 was about 33.3% of GDP or down 3 percentage points from end-2009, whereas external debt was about 25.2% of GDP, from 23.4% at end-2009.

III.5.EXTERNAL SECTOR OF THE ECONOMY

Net current account balance resulted in a deficit of about EUR 1056.3 million in 2010. In annual terms, current account deficit shrank by approximately 21.5%, somewhat easing the problem of its sustainability. Consequently, current account deficit accounted for 11.9% of nominal GDP³² or down by 3.6 percentage points from the 2009's figure.

The analysis of current account by its main items points out the narrowing of net export deficit as a primary contributor to correction of the latter. At the same time, the net deficit narrowing of income account has provided a substantial positive contribution to the annual current account performance. Current transfers have recorded a similar value to 2009's, however, lower level of remittances by about EUR. 91.6 million this year is worth mentioning.

- *EXTERNAL TRADE*

The year 2010 was characterized by accelerated growth rate of our country's trade activity, mainly affected by the recovered trade exchanges in international conjuncture and expanded external demand. Trade recorded absolute values close to those of 2008 and increased by approximately 16.2% in annual terms relative to those of 2009. The ratio of import coverage by export was estimated at 33.7%, about 6.8 percentage points higher than the six-year historical average. The 2010 trade deficit dynamics shows that it narrowed by about 7.8% y-o-y, accounting for 25.9% of nominal GDP.

Table 3 *Export and import by group-items and trade deficit*

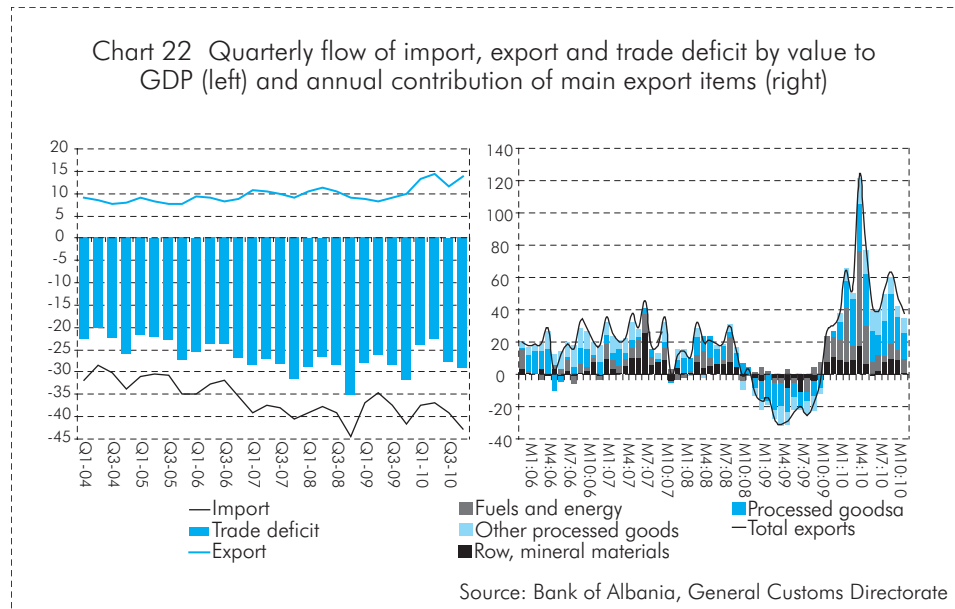
	Export (EUR. Million)	Annual change (In %)	Import (EUR. million)	Annual change (In %)	Trade deficit (EUR. million)	Annual change (In %)
Food and live animals	42.4	17.9	441.7	11.8	-399.28	11.17
Beverages and tobacco	4.5	33.8	143.3	15.7	-138.71	15.21
Raw materials and minerals	135.6	67.1	63.3	(33.8)	72.30	-596.40
Fuels	210.9	132.5	479.2	25.3	-268.27	-8.07
Animal and vegetable oils and fats	0.8	152.4	41.2	5.2	-40.45	4.04
Chemical products	11.2	(10.7)	387.3	6.8	-376.11	7.47
Processed goods	288.0	111.5	913.5	12.5	-625.47	-7.44
Machinery and equipment	49.2	41.2	673.5	(9.2)	-624.35	-11.70
Miscellaneous processed goods	428.8	20.6	331.0	11.8	97.78	64.29
Total	1,171.5	56.1	3,474.1	6.9	-2,302.55	-7.83

Source: General Customs Directorate, Bank of Albania.

Exports of goods by value showed an upward accelerated trend during the

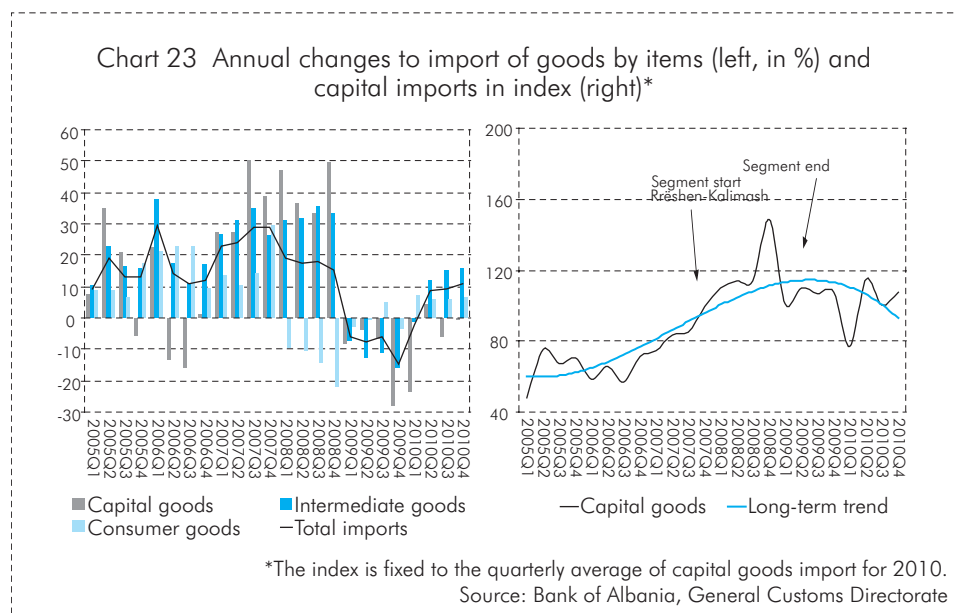
³² INSTAT's figure on nominal GDP is used for 2003 – 2009, whereas IMF's outlook on GDP is used for 2010, in line with the "IMF Article IV Consultation, 2010", July 2010.

year, up by about 56% y-o-y, to 13.2% of nominal GDP. This trend in exports, in addition to the impact of low base effect of comparison in 2009, was also affected by several important by factors, such as the national currency's depreciated position vs. the common European currency, the upward price trend for raw materials and base metals in international markets, improved



domestic demand in our main trading partners³³ and exploitation of new markets by domestic exporters. Thus, some of the major products that positively contributed to export growth this year were electricity, chrome ore, processed materials of aluminium, chromium and steel, cement and re-export textiles.

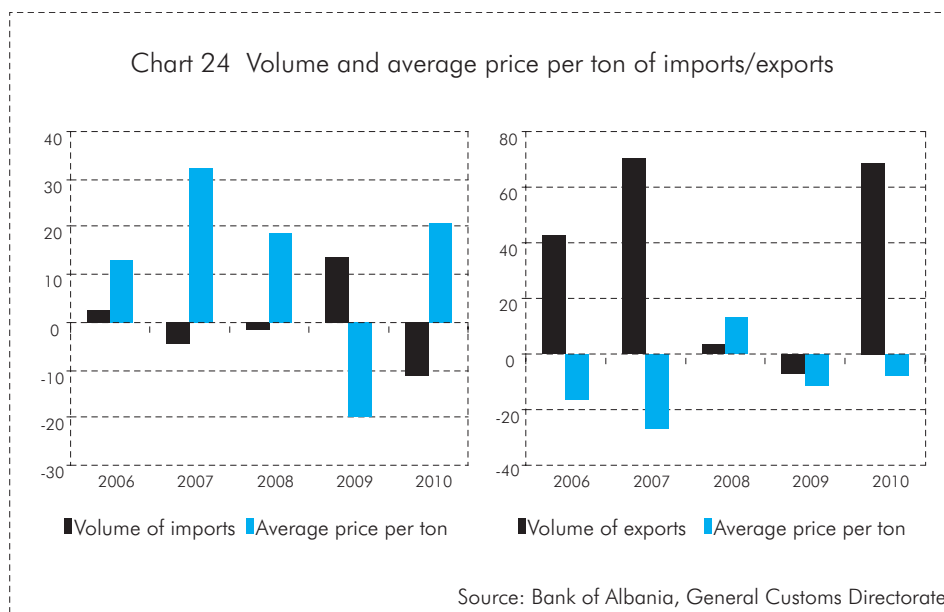
During the year, imports by value increased by about 6.9% compared to



³³ Though consumer spending in Greece was contracted during 2010, our exports to this country recorded positive upward rates.

2009, influenced by higher prices in international markets. Their ratio to nominal GDP was 39.1% or 1.9 percentage points lower compared to the previous year's figure. The division of imports according to their final use in the economy highlights 11% annual growth of intermediate goods import, which was influenced by the expansion of imports of intermediate industrial goods. The same trend followed the import of the item "consumer goods", which, as a result of expansion of household consumer goods import, rose by 6.3% y-o-y. On the other hand, in 2010 the import of capital goods fell by 6% y-o-y. Besides lower import of vehicles this year, the decline in import of machinery and equipment made a substantial contribution to this performance. Simultaneously, the effect of increased capital imports due to construction of Rreshen-Kalimash road over the previous years is estimated to have cancelled out during the first half of this year.

External trade results by volume for 2010³⁴ reflect an accelerated annual growth of total export volume and an annual decrease of total volume of goods import. Hence, if the volume of exports expanded by about 69% y-o-y, the average price per ton of exported goods fell by about 7.7% y-o-y. Against a backdrop of increased competitiveness from international exporters and positive impact of currency depreciation, domestic exporters have preferred



to compete on price, in order to keep their current market share and enter into new markets. In contrast, the import volume declined by about 11.5% y-o-y, whereas the average price per ton of imported goods rose by about 21% compared to 2009.

Albania's trade was concentrated in EU countries, where the combined share of trade exchanges with Italy and Greece accounted for 70% of the total. Exports experienced accelerated upward pace to countries such as Austria, Bulgaria, Switzerland, Czech Republic, Spain, Greece, Italy, Turkey and the United States and declined to Montenegro, Romania, and Former Yugoslav Republic of Macedonia. Imports grew from countries, such as Austria, Italy,

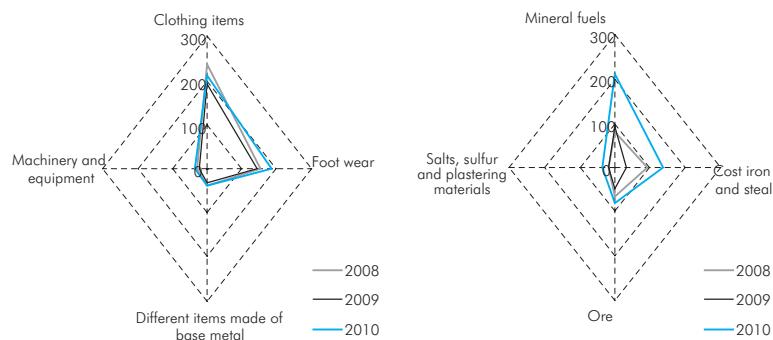
³⁴ Goods trade in volume is released monthly by the Directory of Customs.

CEFTA³⁵ member states, Poland, Romania and Slovenia, and decreased from Germany, Switzerland, China, Greece, Russia and Turkey.

BOX 3. EXTERNAL TRADE PROFILE

In the context of identifying trends and dynamics of Albania's external trade developments, a special importance is assigned to import and export data decomposition according to markets and main products. Although respective markets and products of imports and exports change over years, it is of interest to highlight

Chart 25 Value of export products by steady-growing products (left) and accelerated-growing products (right)

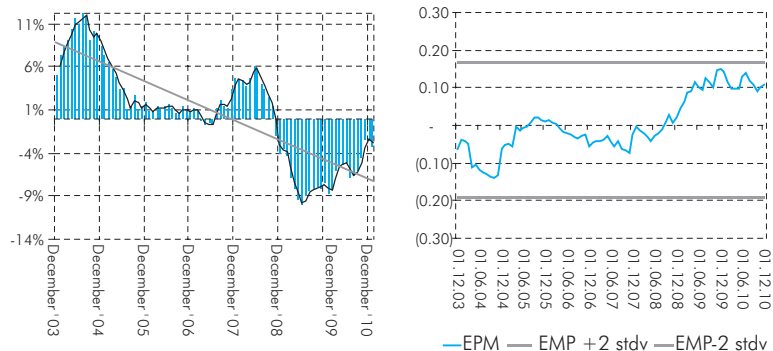


Source: Bank of Albania, General Customs Directorate

key components that affected the volatility of exports and imports during 2010.

After 2009 export contraction, the year 2010 registered an expansion of traditionally exported goods from Albania in the form of textile re-exports. Although assessed comparatively low in absolute terms compared to export of textile products, export of electric power machinery³⁶ and base metal articles³⁷ have demonstrated a

Chart 26 The lek's annual change in nominal effective terms (NEER*) (left) and the EMP index (right)



*NEER – nominal effective exchange rate, measured relative to both major currencies, according to an approximate weight they have when traded abroad, EUR (80 %) and USD (20 %). A rise in the NEER implies the lek's appreciation.

Source: Bank of Albania

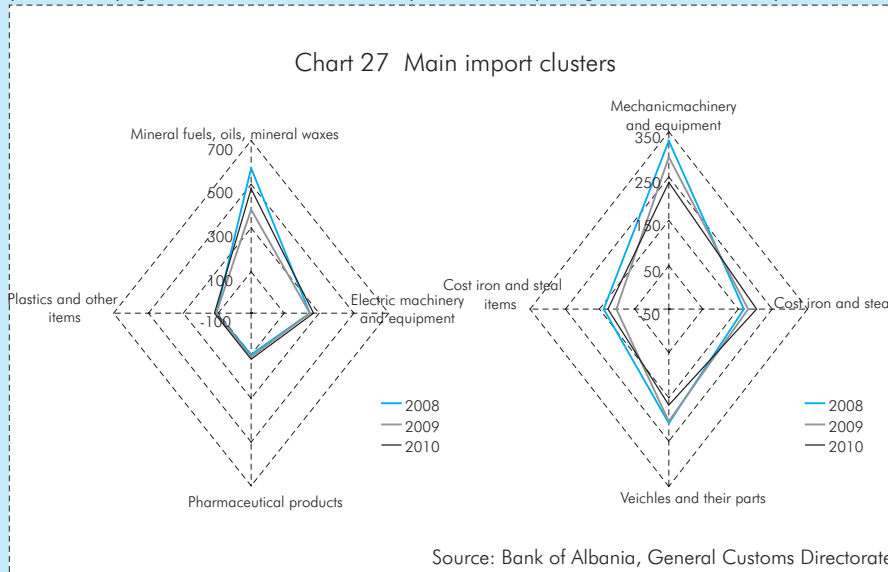
Former Yugoslav Republic of Macedonia, Montenegro, Serbia, Bosnia-Herzegovina, Moldova, Kosovo, Albania.

³⁶ Mainly electro motors, generators and electric equipment for landline telephony.

³⁷ Mainly metal equipment for doors.

sustainable growth rate. On the other hand, export of mineral fuels, steel and cast iron provided the major contribution to export expansion this year, featuring a three-digit growth rate. The same trend is shown by the two other groups which are affected by constant growth of export of cement and higher international prices in ore raw materials.

As concerns main markets where domestic exporters compete, though there appeared a tendency to penetrate into new markets, 50% of exports are addressed to Italy. At the same time, the speeded-up economic performance experienced in China and Turkey has helped attract our exports to these countries. In the meantime, the speeded-up growth of mineral fuels export has helped grow the share of penetration



to Swiss and Spanish markets.

Import products that have the largest share to total imports are mineral fuels, which are closely related to international oil and energy prices and electric equipment and machinery. Coupled with the import of electric machinery and equipment and of pharmaceutical products, both above-mentioned clusters form products with the lowest volatility among major categories of import in our country. On the other hand, import of vehicles and their parts, as well as of mechanical machinery and equipment recorded annual decline during 2009 and 2010. Two other constituent clusters of steel and cast-iron were volatile.

Italy and Greece remain the origin of the majority of imports. Meanwhile, annual imports from Greece, Russia, China, Germany and Turkey were downward during 2009 and 2010. Following a decline in 2009, imports from Italy showed a positive growth rate for 2010. However, during 2010 the more accelerated upward rate of imports from countries with the largest share to the total, was recorded with Croatia, up by 112% y-o-y.

Although during 2010, the scope of products exported from our country was expanded, still focus was on two types of exports: raw materials and textile products. These two types of exports represent two different implications on Albania's competitiveness against the regional markets. Export of raw materials in the form of ores, being subject to only one or two processing step, impacts on maintaining low value-added of these exports. Meanwhile, the comparative advantage in textile industry lies on low production costs, which make our exports more competitive in the market. In this way, long-term economic policies on competitiveness of our economy

should be addressed more to increasing the value-added of exports and enhancing their sophistication, investing in production technology.

- **SERVICES, REVENUES AND CURRENT TRANSFERS**

The combined net account position of services, income and current transfers increased the financing flows by about 7.2% y-o-y, funding about 49.3% of trade deficit over the observed period. Increased net foreign-currency inflows from services account was helped by the decline in outflows from tourism. Thus, although foreign-currency inflows from foreign passengers' personal expenses declined by about 2.6% y-o-y, contraction of resident travellers' expenses abroad by about 20.9% was the main contributor to growth of net services account position. Meanwhile, the annual performance of transport and insurance services followed similar trend to performance of the goods trade deficit.

Chart 28 Current account components to GDP in the years



Source: Bank of Albania

The negative balance recorded in income account in 2010, by EUR. 76.8 million, represented a reduction of this deficit by 23.6% y-o-y. Against the setting of high risk perception by foreign investors, 2009 highlighted an increase in the repatriation pace of profits from foreign direct investments. Although this trend continued during 2010, albeit at more moderate upward rates, higher net inflows of income from work and income from portfolio investments helped reduce the negative net account position.

Net current transfers resulted 1.7% lower this year compared with the previous year. Remittances continued their downward trend having started since 2007, due to labour market slack in countries where their concentration is higher and the cyclicity characterizing them. In 2010, these financial inflows fell by about 11.7% y-o-y, accounting for 7.8% of nominal GDP. On the other hand, government transfers and other transfers were higher this year.

- **CAPITAL AND FINANCIAL ACCOUNT**

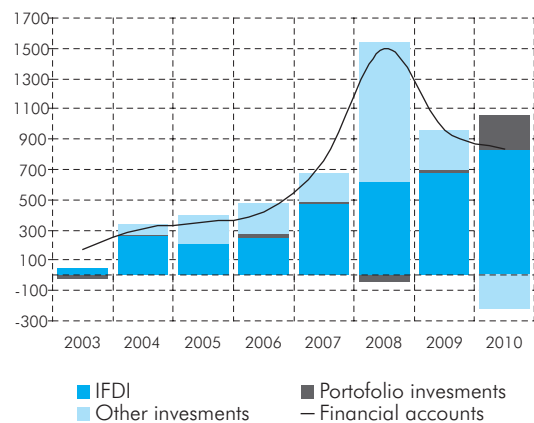
Net flows in capital and financial account recorded a surplus of about EUR 924.7 million during 2010, falling by about 11.2% compared to the same period the previous year. Decreased surplus in this account was caused by the y-o-y descent of financial account flows by about 12.3%. In relation to GDP, (net) capital and financial inflows represented about 10.4%, from 12.0% in the previous year. Currently, the surplus of this account managed to finance only 87.5% of the 2010 current account.

The flow of Albania's cross-border financial liabilities was EUR. 1081.2 million in 2010, up by 19.3% from 2009. The increase in financial liabilities was mainly due to increased foreign direct investments in Albania and

significant growth of portfolio investments. The portfolio investments increased in 2010 Q4 due to EUR 300 million Eurobond issue in international markets. The total borrowing flow (private and public withdrawals) during the year resulted EUR. 238.0 million, about 46.2% lower compared with a year earlier. External debt payments reduced Albania's cross-border liabilities by about EUR. 279.5 million during the year. These payments were offset mainly by using the Eurobond funds. Likewise in 2009, residents' liabilities abroad continued to decrease as a consequence of banking system short-term debt settlement.

Foreign direct investments inflows in 2010 yielded EUR. 827.4 million, up by about 17.1% y-o-y. Foreign direct investments in 2010 were oriented mainly to hydropower sector and hydrocarbon one. The ratio of net foreign direct investments (inflows - outflows) to nominal GDP for 2010 is estimated at about 9.4% or about up 1.6 percentage points from the previous year. Excluding privatization receipts, the inflows of foreign direct investments in 2010 increased by 66.4% compared to 2009. This change was due to a higher level of privatization receipts and the important role they played in FDI growth in 2009³⁸.

Chart 29 Financial account and main items-net flows in EUR million



Source: Bank of Albania, Ministry of Finance

Financial asset account in 2010 was characterized by a pronounced increase in our assets invested abroad compared with a year earlier. As a result of increase in our banks' deposits at non-resident banks and portfolio investments, our financial assets invested abroad are estimated at EUR. 242.1 million. A year earlier, our assets invested abroad dropped by about EUR. 50.2 million. During 2010, the "currency and deposit" account, as well as portfolio investments contributed respectively about EUR. 125.7 million and EUR. 89.0 million to our assets invested abroad.

Foreign reserves were up about EUR. 178.8 million in 2010, from down EUR. 32.0 million in 2009.

³⁸ During 2009, privatization revenues are estimated at Eur. 210.8 million, from only Eur. 3 million in 2010.



"Pursuant to the ratification of Convention of 1925, the first Albanian national banknote was issued, with the value: 5 lekë/1 gold franc (lekë was determined as the monetary unit, with the value: 5 lekë = 1 gold franc). This banknote was very soon withdrawn from circulation because the Albanian Government protested against the eagle stamped on it, which was of the Roman style, one-headed instead of a double-headed one. According to available documents, it was printed by "Richter" in Naples of Italy and was in circulation only for 5 days."

