

First Chapter

Economy : Developments and Policies

It was at the beginning of the last decade that Albania started the political, economic and social transformation toward a market economy, with the final target being its integration in the structures of the world community and more in particular, to the European Union. Main pillars on which the transformation process was based included a deep and wide program of liberalisation and privatisation of the economy, supported by a stable macroeconomic environment.

During these years of transition, many achievements and failures have been present in the Albanian experience. Episodes of “stabilization - destabilisation” are clearly distinguished during 1991-'95 and 1996-'99, although the dimensions of the phenomenon observed differ on their scale and magnitude.

In both cases, economic recession, inflation acceleration, current deficit; the economic-financial crisis in general, were kept under control through adoption and implementation of tough emergency programs.

In order to achieve and maintain stability in a longer term, three-year programs, consisting of deep structural, legal and institutional reforms to be followed, have been drafted. The programs aim at providing such conditions, which would support further consolidation of the economic achievements (i.e., ensuring a relatively high growth, low inflation, enforcing the fiscal and monetary discipline etc.).

It is however true to be noted that, after a decade of transition, Albanian society entered the new millennium inheriting a number of critical issues, which will give shape to the agenda of the government's actions to be undertaken in the years to come. The country was not successful in implementation in full of the most important part of the medium term development program, i.e., that of structural, institutional, legal and administrative reform.

The weakest points of transition can be summarised as weak governance, a lack of transparency, a large fiscal evasion, the level of corruption and smuggling, etc. All these observed phenomenon hindered the consolidation of democracy and of state and the rule of law - the result of which was the 1997 crisis.

Notwithstanding the positive developments during the last two years, the Albanian economy continues to suffer from non-performance of required deep structural reforms, weak governance and problems, which relate to the enforcement and the application of law and fragile security and public order.

During 1998, macroeconomic equilibrium was restored; a high growth rate of 8 per cent was achieved, under a high rate of disinflation, bringing the consumer price index to 8.7 per cent from 42 per cent registered at the end of 1997. Restoring of the economic equilibrium was a result of relatively tight monetary and fiscal policies and a further enhancing and improvement of legislation. Both fiscal and monetary policies were designed to bring inflation under control, following rigorously the quantitative monetary objectives and limits set on the financing of the budget deficit.

From a general point of view, economic developments during 1999 may be considered as a natural development of the consolidation of the last year achievements.

The most remarkable element of the program was the maintaining of price stability.

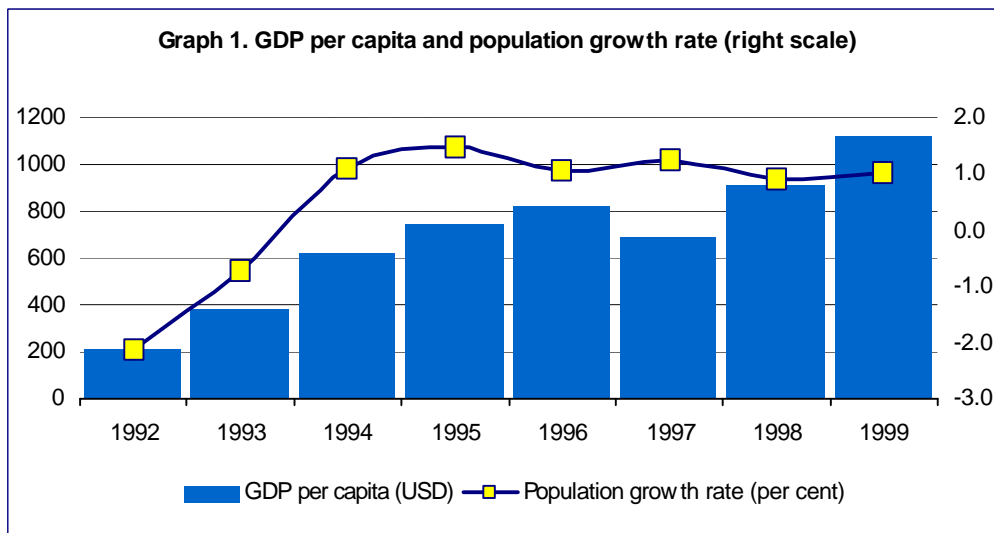
It was projected an inflation rate of 7 per cent and an economic growth of 8 per cent. Fiscal consolidation had to continue, limiting financing of the budget deficit by domestic sources to 5.9 per cent of GDP.

Deepening of the structural reforms was considered as decisive in ensuring the long standing of the macroeconomic policies. Main priorities agreed upon were: acceleration of privatization (including state owned banks); completing of the transparency process of the 'pyramid schemes'; a reduction of the employment in the state administration to 130 000 employees by end of March 1999; strengthening of the regulatory and supervisory framework for the banking system and measures in fighting of corruption and illegal activities.

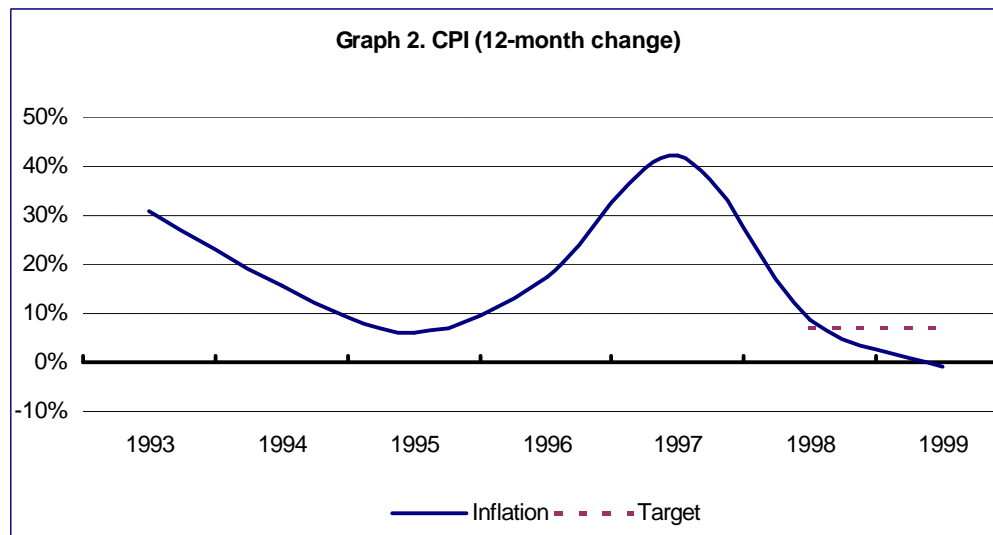
The conflict in Kosova resulted in a large number of ethnic Albanians fleeing Kosova and entering the Albanian territory. At one point these people represented about 15 per cent of the total population of Albania. Uncertainties surrounding the perspectives of ending the conflict resulted in a dilemma in achieving the 1999 economic program.

However, with strong support from the international community, it was possible to avoid the consequences of the conflict. Macroeconomic developments remained on track.

Latest figures indicate that the economy grew by 8 per cent, while inflation decreased at an unprecedented rate. The economic growth contributed to a further increase of GDP per capita, which in dollar terms is estimated to be at USD 1100.



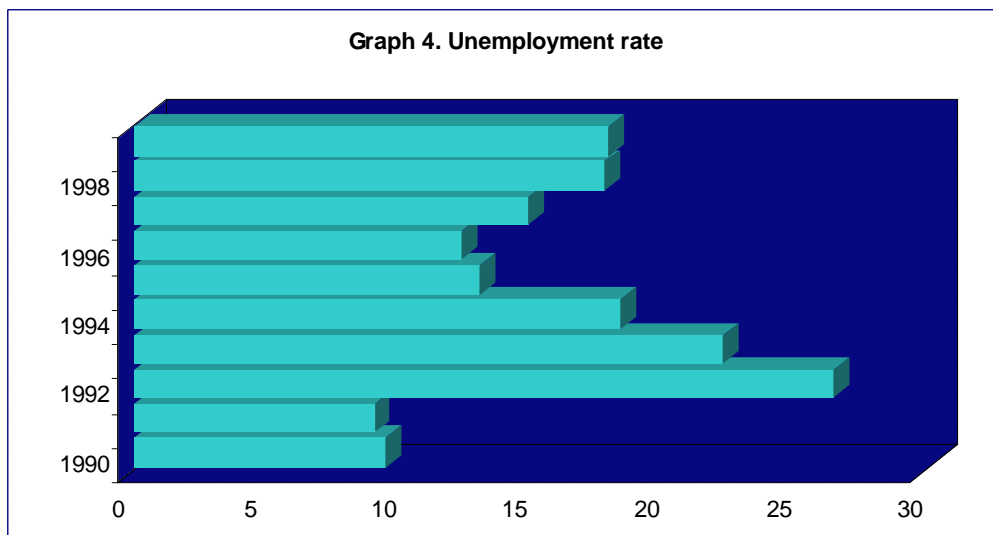
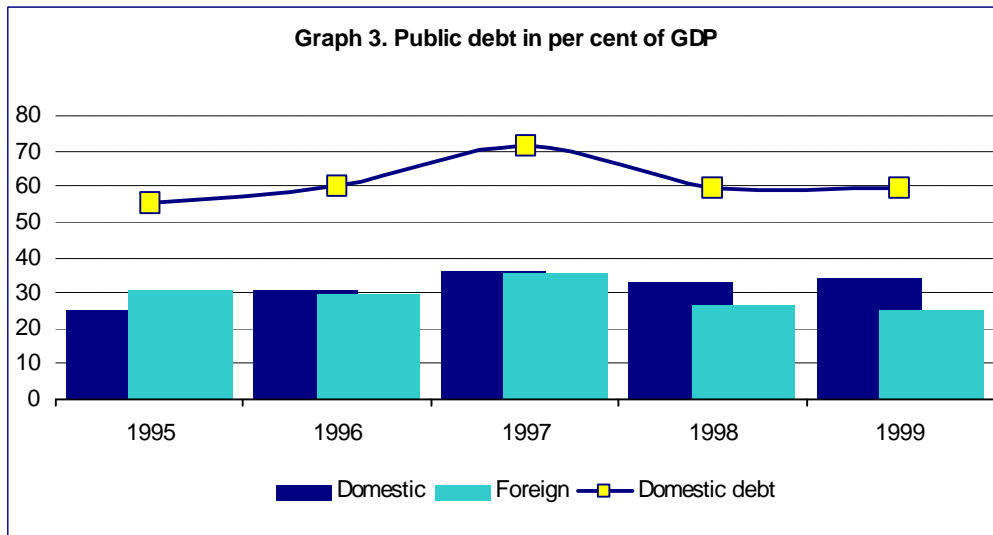
Beyond any expectation, **the annual inflation rate at the end of December 1999 was negative, at 1.03 per cent.** However, the average annual inflation rate was positive, at the level of 0.4 per cent. Both monetary and fiscal policies complied with the commitments of the authorities, and as a result their effect on inflation was positive. On the other hand, the large capital inflows registered during 1999 had a direct influence on the exchange rate, contributing further to the price stability. The challenge remains to ensure the price stability in the longer term.



Foreign exchange reserves of the Bank of Albania increased during 1999, covering 5.2 months of imports of goods and services. Current account increased by 2.6 percentage points as compared to the previous year, mounting to 4.1 per cent of GDP. Foreign debt was further reduced to 25.4 per cent of GDP. During the whole year, the domestic currency, Lek was stable, with some slight appreciation tendencies, mainly contributed to the larger inflows as compared with the previous year.

According to official sources on employment, it is observed that the labour market continued to decline. The unemployment rate registered by end of December was 18 per cent. Incomes (reported by the average wages of the public sector) increased by 32 per cent¹ in real terms compared with the previous year.

¹ Source: INSTAT



Despite the difficulties because of the developments in the region, both monetary and fiscal policies proved to be effective. Pressures to deviate from the fiscal targets were largely smoothed by contributions of the international community, and therefore, the budget deficit remained within the projected targets. However, on the income side, with the starting of the conflict in Kosova there was a decline in tax collections, while on the expenditure side, realisation of the programmed investments and timely spending of public funding, continued to be serious problems for financial authorities.

Favourable developments on prices, on performances of the local currency and bank deposits, provided an environment for a relaxing monetary policy, which continued during the whole year of 1999.

Minimum deposit interest rates for time deposits in local currency placed with state owned banks were permanently reduced. The Bank of Albania complied with the three settled quantitative targets, thus contributing to the aggregate demand management.

Box 1 : Statistics in Albania.

Real economic data continued to suffer from the poorly developed statistics. There is still a lack of statistical information regarding private sector development. While it is accepted that private sector contribution to GDP is substantial, data for monitoring of this sector is missing.

Although a decade is gone since the beginning of the transition, statistics on national accounts are not yet available. This permanent lack of statistical information is making it more and more difficult for the analysts to monitor and model economic transition and for the decision making authorities to take proper measures on economic issues.

In brief, we consider that statistics are not timely disclosed, that they are not correct and a large part of the data is still missing. This phenomenon is becoming a serious handicap for analysing and monitoring the economy and providing the decision-makers with the appropriate advises and policy tools.

Box 2 : Impact of Kosova crisis.

With the starting of the crisis during the second quarter of 1999, uncertainties regarding economic development increased. The conflict was initiated by mass deportation of the Albanian population of Kosova toward the neighboring countries, with the most intense movement toward Albania. Within two weeks, Albanian population increased by about 15 per cent. Given the infrastructure conditions and the fragility of the domestic stability, difficulties rose to an unprecedented level. The situation became even more difficult to handle in cases of armed conflicts with military forces of former Yugoslavia.

However, the quick reaction from the international community as well as full commitment from the Albanian government and a very positive and welcoming attitude from the population, the crisis was well managed and the economy remained broadly within the projection made at the beginning of the year. Furthermore, the country was prepared to host a larger number of Kosovars and for a period which could exceed the end of 1999.

However, the attitude of Albania toward the crisis substantially improved the image of the country, which was very badly perceived during the 1997 crisis. The interest and the support of the international community toward Albania were increased.

According to estimations of research institutions², the crisis compromised the perspectives of the economic development of the Southeastern European countries. A study of WIIW, estimates that costs of the conflict, in terms of Gross Domestic Product, for some countries could be: ex-Yugoslavia 28 per cent; Bosnia Herzegovina and FYROM 5 per cent; Bulgaria and Albania 2 per cent; and Croatia 1 per cent. Another study of the European Commission offers total humanitarian costs of the crisis including the budgetary support for the affected countries, which is estimated to be some 340 to 780 million dollars. While the IMF estimates these costs from 400-760 million dollars. European Commission study estimates that reconstruction costs of the Kosova crisis could be 2-3.5 billion dollars while the total reconstruction costs for the Southern Balkans could mount to 30 billion dollars³.

The main implications of the crisis and how they affected the economy in the opinion of the Bank of Albania, can be summarized as follows:

- * The lack of proper social and economic infrastructure to shelter such a large number of persons fleeing to the Albanian territory. This incurred additional costs for the country.
- * The substantial part of the existing infrastructure, such as Durrës Port, Rinas Airport that was granted to military troops and the energy supply of the refugee camps, which deprived the state budget from such sources of revenue collection.
- * The crisis stopped the trade relations among the region countries. Albania, in particular, was not greatly affected due to the nonexistent commercial relations with former Yugoslavia.

² BEBRD, Transition Report - Ten years of transition, 1999, p. 82-86.

³ See: Stephan Barisitz, "The Southeast European Non-associated Countries - Economic Developments, the Impact of Kosova Crisis and Relations with the EU", in focus on Transition I/ 1999, Oesterreiche NationalBank.

- * The crisis affected mostly investors' confidence and the tourism sector of the countries of the region. In the Albanian case, it added to the shaken confidence of the investor community since the 1997 crisis. However, the foreign military troops, journalists and international organizations staff that visited Albania during the Kosova crisis, pushed up the services sector.
- * A longer-term effect of the crisis could be related to the structural reform process in general and the progress in the privatization process in particular. The implication of such delays will affect the speed of the "catching up" process and the accomplishment of the longer-term objectives of economic development.
- * Albania is believed to benefit in moral and historical aspects. Firstly, the shaken image of Albania from 1997 events was improved. Secondly, different regional and international organizations as well as other countries showed greater interests and support towards Albania.

In conclusion, the Kosova conflict had complex effects on Albania. They were managed successfully and the Albanian economy performed better compare to the pre-crisis period.

1.1. WORLD ECONOMY

Perspectives for the development of the world economy during 1999 became more optimistic by the middle of the year. Demand and production of the US economy exceeded expectations made at the beginning of the year; and, a further expansion is expected. Economic activity in the Euro-area during the last quarter increased more than projected, despite the Euro position against the major international currencies. There are indications of a slight improvement of demand in Japan and a recovery of trade activity with Asia is registered.

The end of 1999 saw an increase in the prices of some commodities, with the most remarkable development in oil and energy prices. Assuming a further increase of price levels, which are expected to occur in the course of the year, Central Banks are faced with taking decisions for tightening the monetary policies.

“Clouds” surrounding projections for the development of the world economies for the year 1999, became more optimistic by mid-year, when crisis situations changed in a number of developing economies.

World output⁴ is expected to register a 3 per cent growth (3/4 per cent higher than projected at the beginning of 1999), which is 1/2 per cent higher than real growth of 1998.

This achievement reflects better than expected economic performances by the countries, which suffered, by the last crisis. Furthermore, the deep decline of Asian economies was followed by a better than expected improvement; the monetary crisis in Brazil ended in a shorter time; developments in the energy prices and depreciation of the national currency, helped the Russian economy to recover from the crisis of 1998. Private capital⁵ inflows in developing economies stabilized at 136 billion dollars, which is about the same level of inflows registered during 1998. However, capital inflows in these countries continue to be halved of their level registered during 1995-97.

The main engine behind the world economic growth continues to be expansion of the US economy, which is expected to grow by 3.7 per cent compared to 1998.

⁴ IMF, World Economic Outlook (Washington D.C.), October 1999.

⁵ Institute of International Finance, Inc., Capital Flows to Emerging Market Economies (Washington D.C.), 25 September 1999.

The source of that growth is its domestic demand, particularly from the private sector. Other contributing factors are an expansion of fixed investments and capital stock as well as the technological progress. Economic growth is considered to be admirable taking into account the inflation behavior, which is estimated to increase by 1.4 per cent by end of the year. In response to inflation pressures observed by end of the last year, by November the Fed increased the interest rates by quarter points (similar rate increases were made in June and August of 1999).

With the economic growth registered during the first half of the year, the Japanese economy technically is out of its recession, which started in 1992. In order to keep with the positive tendencies, the Japanese government adopted in September another fiscal stimulus package (eleventh package since 1992) to promote public investments. Effects of such fiscal stimulus, the strengthening of private consumption and a change in export developments, are expected to support a 1 per cent growth during 1999, following a permanent decline since the beginning of '90s.

Improvements on the external environment, easing of monetary conditions by the European Central Bank and depreciation of the Euro since the new currency was launched, are considered as main factors driving optimistic expectations for the economic growth of the region.

Annual growth in the Euro area is expected at 2.1 per cent, whereas inflation will remain below the 2 per cent target, despite the pressures exerted by the oil price increase and monetary depreciation (box 3).

Economic growth in countries with economies in transition is expected at 0.8 per cent. Optimism is based on facts that the Russian economy is out of crisis (following a 4.7 per cent decline registered during 1998, Russian official sources estimate that gross domestic product will grow by 1.5 per cent during 1999) and improvements on the commodity prices in the international markets. For the economies of Central and Eastern European countries a deeper decline than that of the previous year is expected. The worst performers are considered Rumania (by –4 per cent), Former Yugoslav Republic of Macedonia (by –6 per cent) and economies of Croatia, Czech Republic and Bulgaria (by –1 per cent to –1.5 per cent). According to different sources, the Kosova crisis affected negatively in many South East European economies (box 2).

Box. 3 : Developments of the new European currency – EURO.

One year is too short a period of time to make an assessment on the performances of the newly born currency, and therefore we are providing some general views on the main developments during 1999⁶.

Implementation of the monetary policy was conducted smoothly and efficiently. The singly monetary policy has guaranteed price stability and has been supportive of the economic growth of the area. The inflation target, defined to be fewer than 2 per cent, was achieved and the economy is expected to grow by about 3 per cent during 2000. Such positive achievements are considered to have contributed to the enhancing of the credibility of the Euro-system in general.

The Euro became one of the leading currencies in the international markets for investment and trade. Preliminary statistics show that Euro-denominated bonds accounted for about 40-45 per cent of new issues, roughly matching the market share of bonds denominated in US dollar. More than 50 European and African countries have adopted foreign exchange arrangements in which the national currency is linked to the Euro or a basket of currencies in which the Euro is an important component. However, private investors have adopted a more careful attitude toward the new currency in issuing securities denominated in this currency. Successful implementation of the payments system TARGET contributed to a better integration of the European money markets.

Despite progress made, European financial markets continue to suffer from a high level of segmentation and a lack of competition between countries, low trading volumes, high transaction costs and hesitation in the issuing of new financial instruments. Another important point in the development of financial markets is the harmonization of national legislation and regulations of the member countries; harmonization of the technical infrastructure of management, etc.

⁶ Benefits from monetary union are of long-term and structural nature. Therefore, it is not fair to assess the euro developments based on its exchange rate only.

Box. 4 : Stability Pact.

With the ending of the Kosova crisis, attempts by the international community in promoting closer integration processes of the Balkan countries and between the region and the European Union were intensified. Main basis of such cooperation are presented in the Stability Pact for Southeast Europe, a document which was finalized in the G-7 meeting in Cologne, and formally ratified at the Sarajevo Meeting.

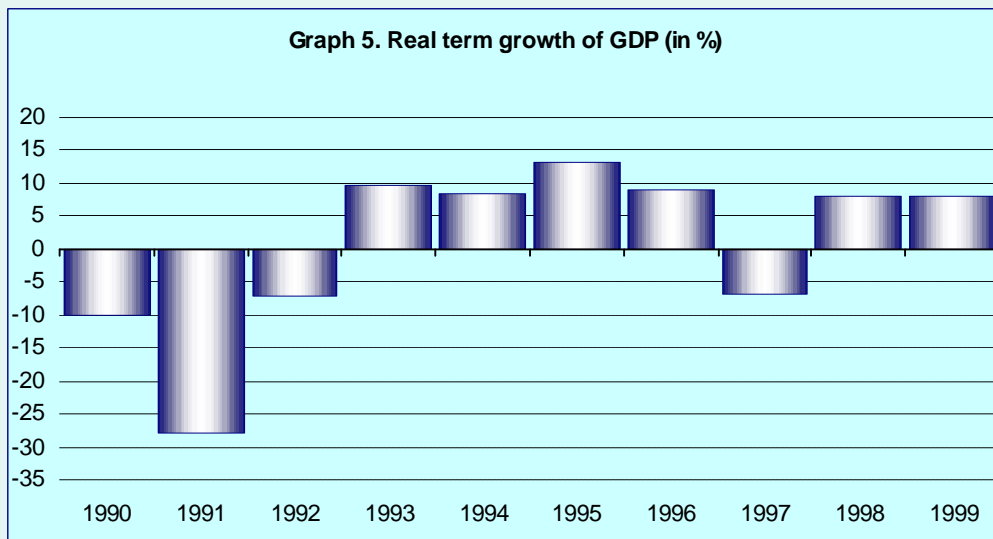
Main organizational structure of the Stability Pact is the Regional Table for Southeastern Europe, under the chairmanship of the Special Coordinator of the European Union for the Stability Pact. The Regional Table, composed of representatives from participating countries, coordinates activities of three working tables: democratization, economic reconstruction and regional security. The Pact aims at consolidation of the democratic process and promoting security in the region, as the main preconditions for the economic development and promotion of private sector.

In the framework of this Pact, the European Union has initiated an Association and Stabilization Process, as a way for the progressive integration of these countries with the European structures. The instrument used is the Association and Stability Agreement, as a preliminary step toward membership in the European Union. It is expected that negotiations could start within 2000 with Former Yugoslav Republic of Macedonia and Albania.

The impact of the Pact for Albania is considered to be very important, not only in terms of economic recovery, but also the elimination of the main barriers for economic growth, such as corruption, security, transparency on foreign financing, etc.

1.2. GROSS DOMESTIC PRODUCTION

Since 1993, excluding 1997, Albanian economy grew continuously with high rates (graph 5). After a collapse, economy grew at relatively high rate of 10 per cent in 1993. The same trend was observed in the following years at even higher rates in 1995 and 1996, which was adverse in 1997 when the economy shrank at 7 per cent. The negative effect of 1997 is overpasses by the economic growth in the proceeding two years period (1998-1999).



Generally, the Albanian economy grew relatively at high rates during the transition period mainly due to the inherited economic structure and the policies adopted and the reforms implemented.

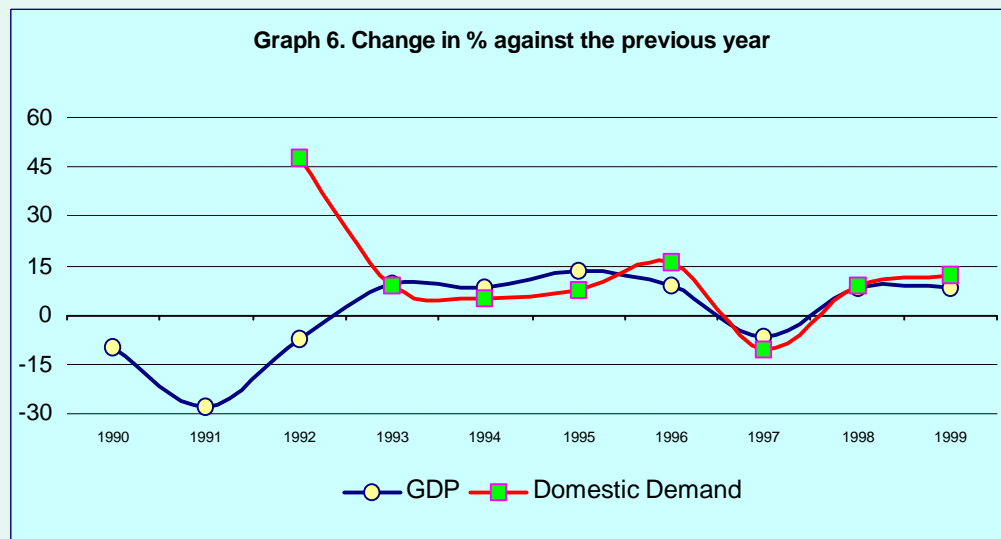
Three main factors contributed to the economic growth: First, Albanian economy dominated from the agricultural sector. The agriculture land was quickly privatized, which gave rise to productivity. Hence the agricultural production grew 12.5 per year on average during 1992 - 1995. Second, the isolation during communist regime and the low integration even with Eastern and Central European market served as "a protecting shield" (or defense line) from losing the traditional ones, unlike similar countries. Third, unlike other former-socialist countries, especially neighbor countries, Albania started the transition period from a low level of development and income.

This was more evident in construction sector reflecting the needs of an emerging market and the poor infrastructure inherited from the past. Services and transport sectors have increased their contribution to GDP throughout the transition period.

After 1995, agricultural production growth seemed to have stopped due to a slow pace in structural reforms. Therefore, its contribution to GDP decreased on average.

“The rise, the fall and the post-fall period” of pyramid schemes had also direct effects on the economic growth. First, the mushrooming of such schemes during 1996 the apparent improve in the population wellbeing, associated with a loosening in fiscal and monetary aspects, induced unprecedented boom of households’ consumption. This contributed to industrial production increase. Second, pyramid schemes were considered as a source for easy money harming farmers’ mentality. They were not interested to manage their small farms, which caused a slow pace in agricultural production growth and in some cases several farms were destroyed. Third, in the post-fall period, construction and service sectors, which were seriously affected by the fall of pyramids, showed a stronger recovery. The needs for infrastructure and residential building reconstruction were met mainly by private remittances.

During 1993 -1995 the aggregate demand curve (graph 6) fall under GDP growth rate curve. In 1996 the growth pattern changed in favor of consumption.

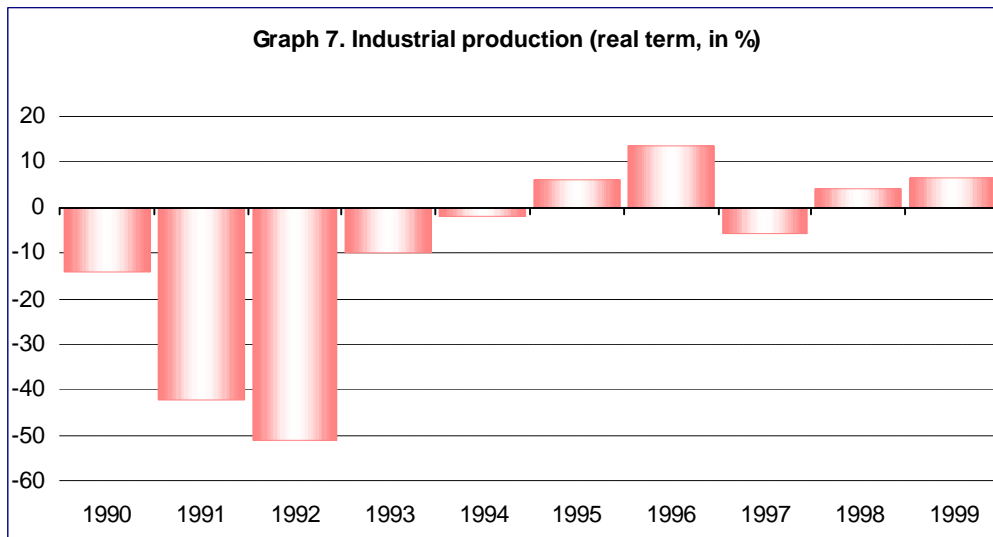


The higher increase of demand relatively to production is evident during the last two years as well. In 1998 the domestic demand increase is natural, while in 1999 it was mainly induced by extraordinary factor, namely Kosova crisis. Data on consumption and investments⁷ support this conclusion. During the early years of transition both indicators showed downward trends while the last two years trends are upward ones at rates comparable to GDP growth rates. However, investments remain at low level compare to the large needs of the country and when exports are still low and very volatile.

Albania successfully escaped the negative effect of the regional conflict on economy. The sectors, which were mostly affected by the crisis, have relatively low contribution to GDP. On the other hand, the substitution effect (the negative effects on some sectors were offset by the boom of the other ones, especially in service and construction sectors) was present.

GDP in 1999 grew at 8 per cent, which was mainly contribution of agriculture, construction and services.

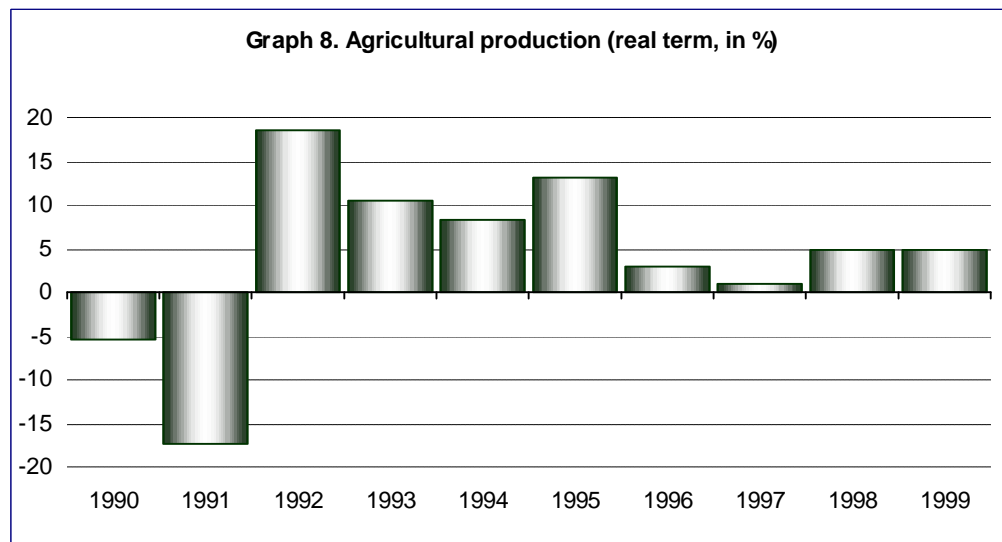
Industrial production in 1999 grew 6.4 per cent comprising 12 per cent of total GDP. It is believed, due to few available data, that industrial production growth was supported by the growth of the private sector while the public sector remained unchanged.

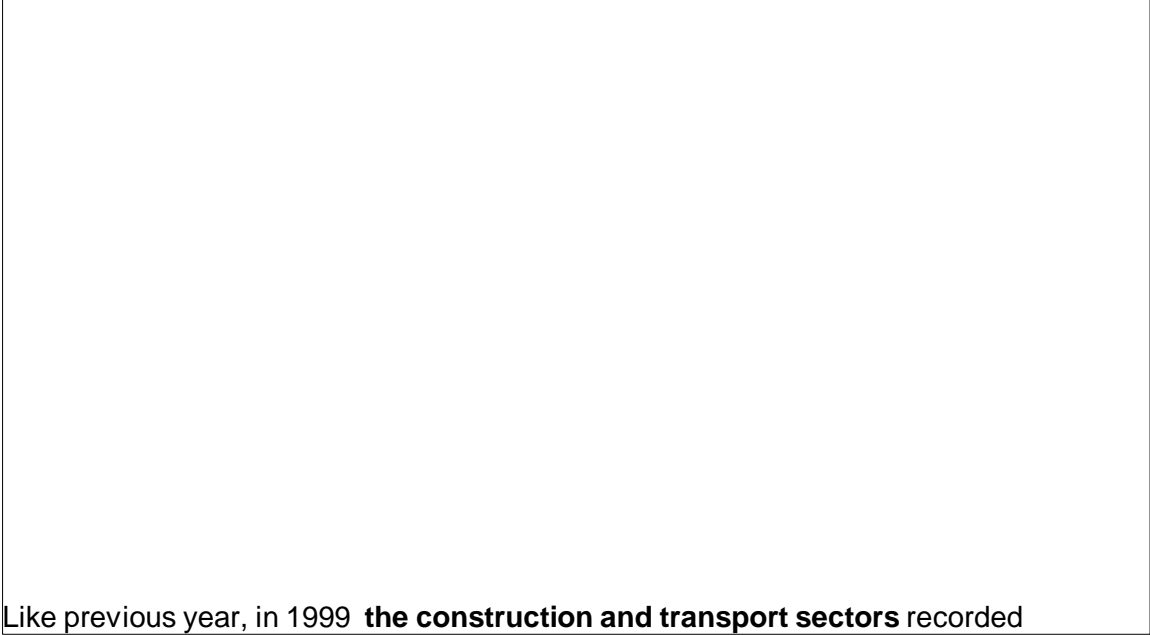


⁷ Data on consumption and investments are merely estimations.

Net materials product as of the end of December 1999, compared with a year ago dropped by 13.4 per cent. The production of extracting industry, especially copper and chromium was reduced to half of the one realized in the previous year. In other sectors, excluding the production of electric power, the production of cement, construction materials and metallurgy remained weak too. On the other hand, even there have been some restructuring and privatization in these sectors, yet nothing has improved.

Agricultural production grew at 5 per cent, with the same rate as a year ago. Agricultural sector was not affected by the crisis and preserved the constant growth rate contributing, also, to the overall production growth in Albania. However, its relative importance to GDP reduced for the second consecutive year reaching 53 per cent by the end of 1999 down from 56 per cent by the end of 1998. To further increase the agriculture contribution to the economic growth, a further increase in productivity is required to be supported by the new technology. The land was privatized in early stage and it has not changed since then. The main obstacle in agricultural development and the implementation of the economy of scale is considered to be the division of land in small areas (each landowner poses 1 ha on average).





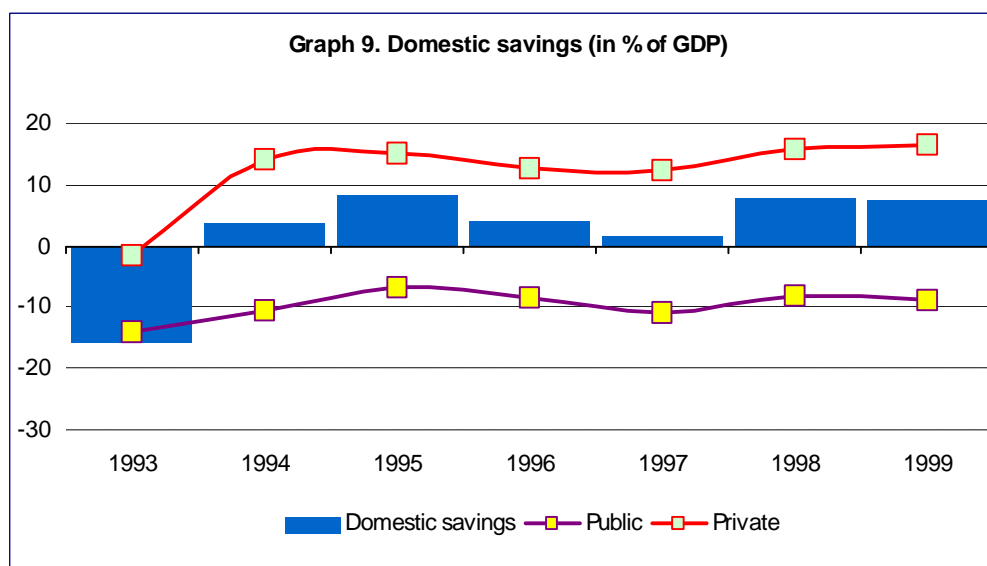
Like previous year, in 1999 **the construction and transport sectors** recorded the highest increase at 15 per cent each. However, their contribution to GDP differs considerably, from 13.4 per cent for the former to 3.2 per cent for the latter. In addition to traditional factors (private sector consolidation), construction growth was supported by the implementation of many public projects financed by international community, NATO and different NGOs.

After the 1997 shock, service sector has rapidly recovered. During 1999 it grew at 12 per cent following a 10 per cent growth in 1998. Its relative importance to GDP, although still below the 1996 level, showed an upward trend.

1.3. SAVINGS AND INVESTMENT

National domestic savings⁸ by the end of 1999 remained at 7.5 per cent of GDP. This reflects an increase of private sector savings and a deeper deficit of public sector savings. As seen in graphic 10, savings from the private sector increased as compared to 1998, while savings from the public sector decreased in this period.

Following the trends of previous years, public sector savings during 1999 amounted to –8.9 per cent of GDP, which is 0.8 per centage points above the figure of 1998. This negative level was mainly because of problems with tax collection caused by the Kosova crisis and nonperformance of budget expenditures, in particular of capital expenditures.



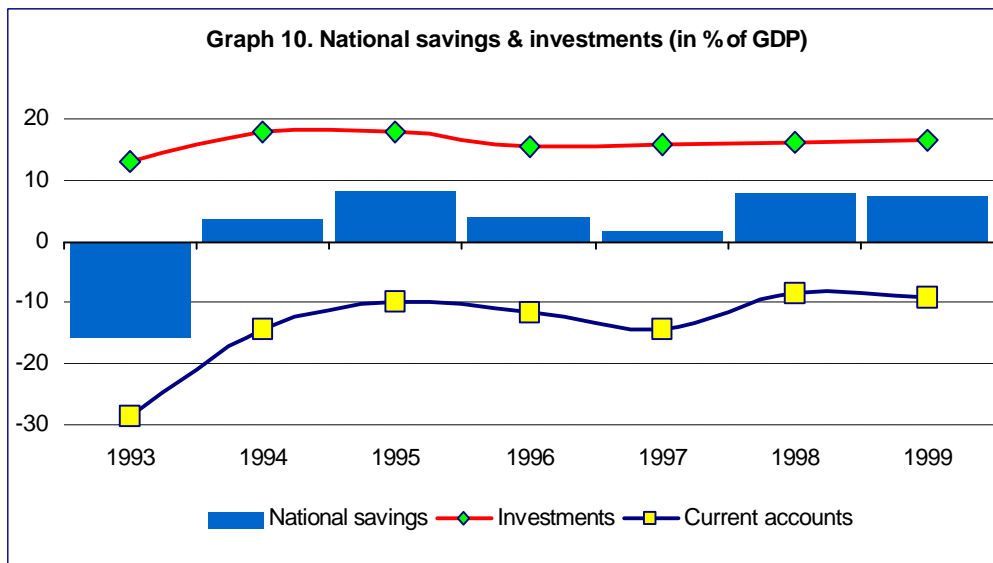
Private sector savings⁹ increased by 0.5 per centage points. It is estimated that this is mainly contributed to individuals while nothing can be said for the role played by the private business.

⁸ Balance that results from the difference between revenues and current expenditures.

⁹ In the absence of national accounts statistics, figures for savings and investments are estimations, with the most disputable ones those figures offered for the private sector. Since their are not classified according to the SNA standards, the figures are detailed in two levels : savings from the public sector and savings from the private sector. In the second group, there are included all savings items that is not a product of budget accounts. Therefore, savings from the individuals, business and financial sector are all included in private savings.

The lack of a financial market that continued even during 1999 offered as the only place for investments of the private savings, the bank deposits. According to end of year figures, time deposits of individuals placed with banks amounted to Lek 158,4 billion, which is about Lek 27,6 billion above the registered figure of the previous year. In relative terms, time deposits amounted to 31,6 per cent of GDP, up from 29,7 per cent for 1998.

Because of inefficiency of transmission mechanism in the financial intermediation process, private savings could not be used to finance investments in the economy. According to some estimations offered by independent research institutions, it is worthy to mention that the part of the private savings placed with banks represents only a fraction from the total private savings. This finding can be supported by the fact that the informal sector is estimated to be more than 50 per cent of the total economic activity of the country¹⁰.



For the above mentioned reasons and the fact that investment expenditures by the state budget (in terms of the ratio to GDP) declined, the overall level of gross investment increased slightly, by 0.7 per centage points. However, in absolute terms and as per centage of GDP, the level of investment continues to be at very low figures.

¹⁰ Albanian Center for Economic Research, 1999 "Informal sector in Albania: an empirical report", *Ekonomia dhe Tranzicioni* nr. 1 (19); Dr. Nexhmedin Dumani, 1999 "Informal sector: possible ways of his minimization", *Ekonomia dhe Tranzicioni*, nr .1 (19).

Box. 5 : Why Albania lacks investments? – A critical view.**I. Public Investments:**

In its role as investor, the government allocates the budget financing of investments through a document that is known as the Public Investment Program. This document started to be compiled for the first time in 1993, and is revised each year, reflecting the changes on the state of the economy and market forces influences. The first consideration after a very brief review of the accomplishments of the program, is that public investments have been characterized by a permanent low absorbing capacity of planned financing. Why are the planned investments not absorbed in full? It can be said that this phenomenon is totally attributed to strengthening of institutional capacities, and of the programming, negotiating and monitoring activities of the responsible institutions. Non preparation of the feasible investment projects, non absorbing of the committed funds by the international financial organizations and bilateral donors, delays on fund disbursement and therefore non performing of the planned investments, are witness of the poor institutional development and lack of distinguished professional expertise of the line ministries. Partnership between the public and private sectors in public investment did not provide any new development since 1996 when the law on concession was adopted by the Albanian Parliament. Although some concession contracts, mainly on the exploitation of natural resources are under discussion with foreign investors, disclosure of more information to the public regarding the process is essential to the transparency of the process.

II. Private Investments:

As *regulator*, the government should clarify rules for conducting a business and law enforcement to be ensured by the courts. There is a general feeling by the private operators that “rules of the game” are not clearly defined, that there ambiguities on the laws enacted which leave space for subjective interpretation by the administration, that there is a unfair competition in the market which seriously impedes the private sector’s development, that licensing criteria are not deeply developed and transparent; that the procurement practices by the state administration are highly corrupted and corruption is seen as endemic; that there is not a developed financial market and modern financial services are not offered to the private sector; that the obsolete infrastructure badly affects their activities and operations, that land ownership is still unclear; etc. While the transition is a long term process and therefore there will be changes and improvements on the laws, the delays on new rules and institutional development and law enforcement, are seriously damaging the private sector’s development. New initiatives which were promoted in the media regarding the increasing of the transparency of the public administration towards the private sector and facilities to be offered, went to vain.

Thus, the investors’ community has considered all these steps merely as propaganda activity. As such the investors prefer to shrink their investments and wait for better times.

If a dispute between two entities happens, the role of the courts in settlement of the dispute becomes essential.

There is enough anecdotal evidence that courts do not base this process on law clauses; instead, in many cases other considerations prevail. Nëse ndodh një mosmarrëveshje qoftë midis subjekteve private apo një subjekti privat dhe shtetit, roli i gjykatave bëhet esencial në dhënien e së drejtës subjektit që i takon. *In the direct form*, government support consists of providing direct financing to the private sector. The authorities have not been able to absorb the committed financing of the foreign donors for the Albanian private sector. According to sources in the Ministry of Economic Cooperation and Trade, from 170 million dollars financing committed, only 85 million dollars were disbursed.

In the indirect form, government support consists of easing the tax obligations of the private sector, by offering tax holidays. Justification for granting of such incentives is that it reduces the investment costs and increases profitability of an investment project. According to an EBRD report (1999), from 26 countries with economies in transition, 12 of them explicitly declare they offer such incentives while many others do not offer information on the fiscal treatment of investments. In fact, only three countries (Albania, Moldova and Estonia) explicitly declare they do not offer preferential fiscal treatment. Albania applied such a preferential fiscal regime to investors (both local and foreign investors) since the beginning of the reform, but the system started to change in mid-1995, with the imposing of custom duties on machinery and equipment and other capital goods. 1998 abolished all incentives. The increasing of the tax burden to private investments and high interest rates on loans (despite the permanent reductions by the Bank of Albania of the deposit rates), have contributed to a downward trend in investment activity of foreign companies, as reported in the Balance of Payments report. In evaluating the investment environment and the cost of investment, a particular emphasis should be made regarding the corruption tax. According to EBRD (1999) estimations, companies in Central Eastern Europe pay a corruption tax, which varies, from 2 per cent of the annual turnover in Croatia, to 8 per cent in Georgia. There is enough evidence to support that the level of corruption tax in Albania is even higher than that of Georgia, which badly affects the private sector development.

Attracting foreign investment is closely related to other factors, more specifically the dynamics of the privatization process. Privatization process did not comply with the declared time schedule. On the other hand, delays observed in the privatization according to the time schedule, indeed "bothered" the investors, where some of them left the country. Yet, tax legislation provides a different treatment between residents and nonresidents breaching the Albanian law on foreign investments and international conventions signed by Albania. More specifically, withholding tax (on dividends, capital gains and interest income) is 15 per cent for nonresidents versus 10 per cent for residents.

III. Portfolio Investments:

Although Albania lacks a real capital market, fully organized and well equipped with its actors and instruments, we stress that even the Treasury Bills market remained underdeveloped. Treasury Bills issued by the Ministry of Finance continued to be the only traded product in the stock exchange, and therefore the only alternative investment of domestic or foreign savings. The lack of brokerage houses or other financial companies which invest on capital market; the lack of a public awareness campaign, we believe have contributed to the nondevelopment of that market.

Attention should be given to the diversification of the products to be traded in the stock exchange, as it could be the privatization of parts of shares of "blue chips" through the stock exchange. The law on investment companies, accompanied by the proper bylaws, should be a priority for the government authorities.

1.4. EMPLOYMENT AND INCOME

As of August 1999, the unemployment rate in countries with economies in transition varied from 9 per cent to 19 per cent. During the whole year, this rate increased in average by 2-3 per cent, reflecting the deteriorated economic conditions and the regional crisis, as well as problems related to economic restructuring in these countries. Albania as well, could not escape to the increasing trend of unemployment.

The labour market remained stagnant during 1999 and government objectives could not be met. Implementation of employment policies did not succeeded in creating new jobs and improving living conditions of the most affected groups of population.

The unemployment rate stood at 18 per cent throughout 1999. That is the highest rate registered since 1995 and for three consecutive years that figure continues to increase. As compared to average unemployment rate for Eastern European countries (12.4 per cent), Albania's rate of 18 per cent is higher.



1.4.1 Labor Market.

There were unimportant changes in the labor market during 1999. Despite positive developments in the production sector observed for the second consecutive year¹¹, the situation of the labor market continued to deteriorate. Apart from the negative impacts of political developments during 1997, 1998, and the Kosova crisis of 1999, we could state that efforts of the government authorities have not been effective. Programs adopted during 1997-99 under the headline of "public works" seems to have not been effective and the resulting balance between demand and supply in the labor market continue to deepen during 1999. Furthermore, it seems this alarming high unemployment rate will continue even for the foreseeable future. Structural reforms regarding the reform of the public administration, privatization of state owned companies, and in particular those operating in strategic sectors (such energy company, Telecom, AMC, banks, etc.), unrealized public investments, etc., are convincing arguments that fighting unemployment will not yield much optimistic results.

On the other hand, despite revival of the private sector, official data indicate that this sector has not been able to generate new jobs. The majority of private companies employ less than 10 per cent (only 0.2 per cent of the total number of companies employ more than 100 persons). There are estimations that the black labor market is a common phenomenon for a majority of enterprises.

Developments in the labor market during 1999 reflected the influence of inherited problems that originated from the former economic system of the centralized economy. Structural employment was characterized by a concentration in few large inefficient enterprises. The labor force was employed mainly in industry, such as mining, metallurgy, chemical, textile, etc.

The largest portion of these industries was very obsolete and therefore they could not survive and resist to the pressures of the liberalization reforms undertaken in the course of transition. The direct impact was a dramatic increase in the unemployment level in urban areas.

During 1993-94, more than 50 per cent of the labor force in industry was cut-off. During the following years, the boom of services with the establishment of a large number of small private entities, reduced the unemployment, but it could not solve the issue. With the collapse of the pyramid schemes, a number of private companies could not survive; a consequence of the reduced demand and recession on the production activities, which contributed to increasing again of unemployment.

¹¹ Currently, the production capacity has not reached the one of 1989 (base year). As a consequence, the economic growth still is not accompanied by an employment increase. On the other hand, productivity increased, thus imposing less supply for employment.

On the other hand, the restrictive policies that were applied during this period in efforts to bring inflation under control may have contributed to the increasing in the short-term. However, we believe that the accommodation of the economy at a low inflation rate in the long term will contribute to stimulating of employment.

It is important to note that figures about employment (except for employment by public sector) are mainly estimations, which do not appear to be realistic, and therefore they need to be reviewed.

Box. 6: Emigration during '90.¹²

Mass emigration.

In the nine years since the beginning of the emigration (1991), about 450,000 Albanians or 14 per cent of 1997 population, mainly up to 30 years old, migrated to foreign countries, mainly in neighboring countries. Mass waves of emigration usually have followed political, economic and social developments of the country.

Mass emigration has affected a large part of the population. By 1995, it represented about 26 per cent of population in the working age, 35 per cent of the labor force and 43 per cent of the employed population. About 22 per cent of families, had one, two or more member of their family units emigrated abroad. This phenomenon largely affected economic and social developments of the country. It helped to smooth the consequences of the collapse of domestic production and the related decline in real wages. It helped to maintain consumption levels of the Albanian families, recovery of demand for consumption goods and imports and recovery of investment activity, particularly on construction and housing, agricultural machines, transport, etc.

Emigration has affected mainly the male population, which represents about 73 per cent of total emigration. Within this group, 34 per cent are of the age up to 34 years old, and the average age of emigrants is 28.8 years old. About 66 per cent of emigrants are from urban areas.

Countries to which they have emigrated are mainly those geographically close to Albania and those with certain economic, historical and cultural ties. It is estimated about 250,000 persons are settled in Greece, working mainly in agriculture, construction, trade and other housekeeping activities; about 150,000 persons are settled in Italy and the employment structure is broadly the same. In other Western European countries, in USA and Canada, about 50,000 persons have emigrated.

Mass emigration has helped to moderate the pressure on the active population and thus reducing the number of unemployment. Remittances have helped in smoothing the social costs of transition.

The last emigration wave was registered in the first months of 1997, mainly because of political and social unrest in the country caused by the collapse of the pyramid schemes. Some 15,000 persons emigrated to Italy and another 10,000 to Greece.

¹² Source: "Brain drain from Albania during the transition", Ilir Gëdeshi, Hekuran Mara, Rolanda Dhimitri, Ksenofon Krisafi, 1999.

Some features of brain drain.

Brain drain has affected mainly young persons (51 per cent are of the age up to 40 years old) of male gender (about 67.15 per cent) and mainly they have emigrated together with the families (66.5 per cent). These findings show that they have emigrated with the intention of being integrated in host countries.

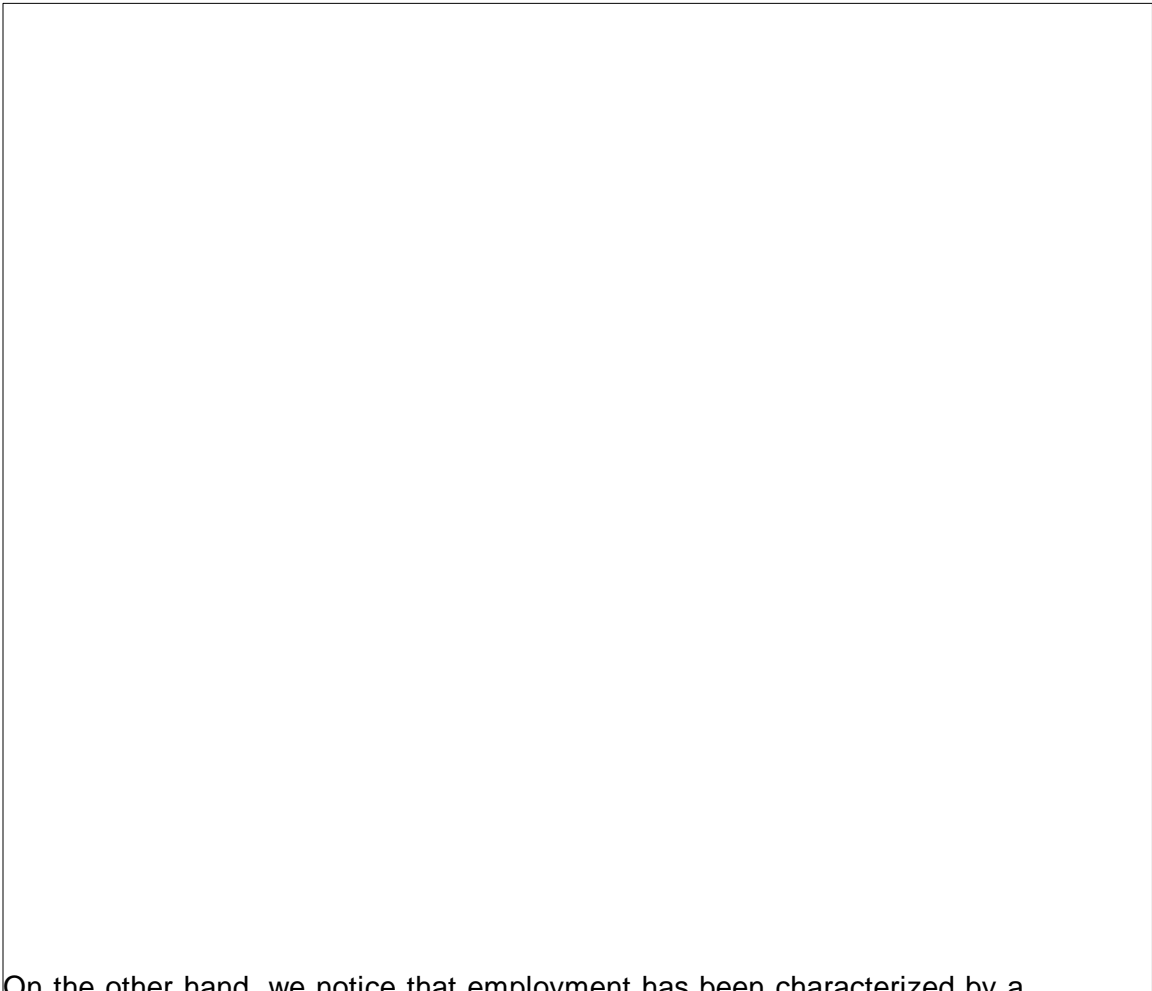
Another particular feature of the emigration of intellectuals is it has started later than the mass emigration. It coincides in time with the implementation of economic reforms, which brought a sharp decline to real wages and a sharp reduction in the number of personnel in the administration and scientific institutions.

The largest number of intellectuals are settled in United States, with 23 per cent of the total, followed by Greece and Italy, with respectively 19 and 18 per cent. Other countries are France, with about 13 per cent, and Germany, with about 7 per cent. Emigration to Canada started in 1994 and by early 1998, it accounts for about 2.8 per cent of emigration of intellectuals. The deepening of this tendency shows that emigration of this category of population is increasingly taking the features of a permanent and sustainable emigration.

1.4.2 Employment according to the sectors of economy.

From the point of view of demand and supply, the labor market reflects different developments (table 4).

According to official data, from 1994, the natural increase of population has been in positive terms. A constant increase is observed in the population of the working age and the labor force. This increase in these categories of population has been at a rate of about 1 per cent, which is considered to be natural.



On the other hand, we notice that employment has been characterized by a permanent decline especially 1994. The decline continued even during 1999. According to official data for the last year, it is estimated that the number of employment has further reduced by about four thousand persons.

The increasing supply of the labor market and corresponding decreasing demand has resulted at a permanent increase of the unemployment rate.

The sector, which generates the largest number of employment, continues to be agriculture, which is estimated to employ some 761 thousand farmers. This is explained in part with the substantial contribution of this sector to the domestic product. However, the number of employed by this sector needs to be reviewed. While the persons living in the countryside are not registered as unemployed, we can estimate that based on the agriculture land distributed, one person per family can be considered as employed.

In general, **the high unemployment rate continues to be a major social problem. However, the pressure on government has been softened as a result of employment in the informal sector and “black market”, and by the high rate of emigration**, which by end of 1999 is estimated to be some half million persons, or about 15 per cent of the total population. This rate of emigration has contributed as well to the improvement of the wellbeing of the families.

1.4.3 Income.

Wage, pension and unemployment benefit policies of the public sector, which continues to be a large provider of jobs, took into consideration the last year developments in inflation, and the overall government policies on expenditures and revenues. While in the private sector, wage setting is privately and freely negotiated by the market.

It is estimated that differences in wages between the private and public sector are in favor of higher wages provided by private enterprises. Market pressures and independence of the private firms; have enabled them to be more flexible in their wage policies.

Geographical location of companies is becoming a factor of wage differentials. Wages differ between the sectors, different types of ownership and between the regions, which has reflected the industry location in the regions.

By the end of 1999, the average monthly wages in the public sector amounted to 13,193 Lek, as compared with 10,079 Lek at the end of 1998. The increase of the nominal average wage by 31 per cent is witness that the increase was higher than that announced by the government in April 1999 (at 10 per cent). The reasons might be found on the differences between the coefficients on which are based wage formation.

During 1999, the minimum nominal monthly salary remained unchanged, at 5800 Lek. Unemployment benefits and minimum incomes for a family of four persons remained unchanged as well, at 2500 Lek and 4800 Lek respectively. While these levels reflect the conditions of the government budget, they remain at very low levels.

1.5. CONSUMER PRICES AND INFLATION

For the second consecutive year the inflation rate (the annual change of the consumer price index) decreased rapidly. In 1998, the inflation rate dropped to one digit. It continued to decrease rapidly and constantly throughout 1999, recording a negative level of 1 per cent at the end of the year.

Several thoughts were given to explain the unusual development of inflation during year 1999. First of all, the considerable inflows of goods and foreign exchange for the benefit of Albania in several ways. Foreign governments, international institutions, charity organizations and even the deported population from Kosova, became significant goods and foreign exchange sources in addition to the traditional ones, which remained almost at the same levels. Therefore, the exchange rate was relatively stable, indicating a clear appreciation trend. As a consequence, this became a crucial factor in eliminating the inflationary pressures in the short-term.

Policies implemented, as well as reforms undertaken in the course of the year 1999, also contributed to smooth inflationary pressures in the economy. Avoiding giving too many details, it is still to be confirmed the long-term utility of these adopted policies. The inability to speed up and increase the efficiency of the reforms is increasingly challenging the long run stability of inflation.

However, there may also be some inaccuracies in calculating the inflation rate, especially due to the relatively outdated data processing methodology. It should be outlined that the end-year 1999 situation is significantly different from that of six years ago. Consumer behavior of Albanians has changed. The geographic distribution of Albanian population has changed as well. Due to these underlining factors, it is important to confirm whether 73 per cent of the Albanians' income is still devoted to food consumption, and goods such as clothing, appliances, furniture, oil and gasoline, rents etc., continue to represent a small share in their spending. The outdated basket weights may be a good explanation as to why the recent increase of oil price induced no increase in consumer prices, while even the developed countries are sensitive toward fuel prices movements. Actually, over the last years, the inflation rate was identified merely with the changes of fruits, vegetables, and meat and dairy product prices.

It should also be mentioned that in general demand is driven by the behavior of the population in Tirana and the two to three biggest cities in Albania. Within this framework, monitoring price developments in Tirana and adjusting them with a certain elasticity coefficient, may be a fairly good approximation of the CPI for the country.

On the other hand, a sole indicator, namely CPI, measures devaluation effects in Albania. Other indices such as GDP deflator, retail prices index, export-import prices index etc., are not yet developed. Under these circumstances, the abilities to analyze the price behavior are somehow limited.

The deficiencies in methodology are becoming more relevant in the case where the inflation rate has dropped even under the level considered theoretically as a low rate (referring to theories elaborated for the developed countries). At this situation, the tolerance of greater than one per centage point is not acceptable. On the contrary, adverse effects are expected.

As a conclusion, the inflation challenge is still present. Unfortunately, the experience faced during the last decade was not very successful. To avoid the situation of year 1996, where the inflation rate increased three times compared to 1995, from happening again, the Bank of Albania believes that strictly complying with the objectives and economic reforms will ensure long term stability.

1.5.1 Economic policy effects.

During the last years, declaring a target for the annual inflation rate (the 12-months change in the per centage of year-end of CPI) was part of the framework for determining the general economic objectives for the country. The target is considered as a reference for the decision-makers and, by declaring it, the intention is to stabilize the inflationary expectations and approaching them to the targeted level. In this regard, the success or failure to hit the target depends to a considerable extent upon the monetary and fiscal policies pursued.

Fiscal policy is continuously under pressure to reduce budget deficit as a per centage of GDP. Monetary policy is required to control money supply. In both cases the result is a shrinking domestic demand and a relaxing of the pressure for consumer price increase.

1.5.1.1 Fiscal policy.

Fiscal policy, aiming at the reduction of budget deficit, does affect the short-term development of consumer prices. From the long run view point, the amount of public debt, the overall budget deficit and the sources used to finance it, are also factors that affect consumer price behavior. In the short term, inflationary developments depend, to a great extent, on the level of public expenditures, whose share in aggregate demand is significant, as well as on the amount of budget deficit. On the other hand, deviations from the projected budget deficit play a considerable role in inducing inflationary pressures in the economy.

For 1999, it may be outlined that the fiscal policy smoothed, to a certain extent, the inflationary pressures in the short run. Despite the unusual and unforeseen events that took place in 1999, which had direct implications in the tax collection process, the reduction in expenditures was enough to offset the adverse developments in the budget revenue. Therefore, the budget deficit at the end of 1999 was 11 per cent of GDP, or 2 per centage points below the targeted level.

Furthermore, budget deficit domestically financed amounted to only 4.9 per cent of GDP, 1.6 per centage points less than the previous year or 1 per centage point below the target for 1999.

In spite of the above-mentioned figures, the recent figures on total public debt as a per centage of GDP, remained unchanged compared to the previous year. In this respect, from the long-term point of view, fiscal policy supports the inflationary pressures in the economy.

1.5.1.2 Monetary policy.

The law “On the Bank of Albania” stipulates the main objective of the Bank of Albania as “achieving and maintaining price stability”. Obviously, monetary policy pursued by the Bank of Albania adheres to the underlined objective.

Naturally, in an open market and regulated economy (such as developed countries), monetary policy is implemented through managing short-term rates applied by a central bank for the loans extended to commercial banks. Under the circumstances of a transition economy, it is relatively difficult to transmit policy decisions. Therefore, a central bank needs to find new ways, relaying mostly on direct instruments, such as required reserves, credit ceilings and administrative control over interest rates offered by commercial banks for the deposits placed with them. In line with the latter, was the monetary policy formulated and implemented by the Bank of Albania, continuously, since its establishment. At the beginning, the Bank of Albania’s intention was to seal the monetary drain through direct restrictions on the assets side. In this regard, direct monetary instruments were used, where the credit ceiling played the most important role for several years. As time passed, especially during the peak of the pyramid scheme growth, the underlining instrument became inefficient. The relatively high interest rates offered in the informal financial market have pushed to the limit administrative controls on deposit interest rates. The low efficiency of monetary policy, associated with a strong devaluation of Lek, continued throughout the year 1997. As a result, the annual inflation rate at the end of 1997 was 42 per cent. Meanwhile, during the last months of 1997, it was observed that interest rates on three-month Lek deposit were becoming the reference rate (basic rate). Therefore, an immediate reaction happened, being more obvious in mid-1998, when the inflation rate was 2.5 times lower.

Since then, the Bank of Albania was able to transmit its decisions to the economy. However, it should be emphasized that inflationary developments depend, to a significant extent, on other non-monetary determinants. Even though during 1999, interest rates on time deposits in Lek dropped considerably, inflation rates generally reduced rapidly and resulted even at negative level.

Anyway, the shock factor (crises in the region) that emerged during the last year is to be taken into consideration. Although we lack accurate measurement of how much the inflation rate is affected by such shock factors, it is generally accepted that the developments of the domestic currency during 1999, affected to a great extent from the extraordinary goods and foreign exchange inflows, were a crucial factor in determining the inflation behavior.

Box 7 : Negative inflation.

The inflation rate developments for the first months of 2000 are in line with last year's trend. The annualized inflation rate as of the end February 2000 is minus 1 per cent. As a rule of thumb, negative inflation in the short term restricts a country's abilities to create new production capacities, limiting, therefore, economic growth and employment increase.

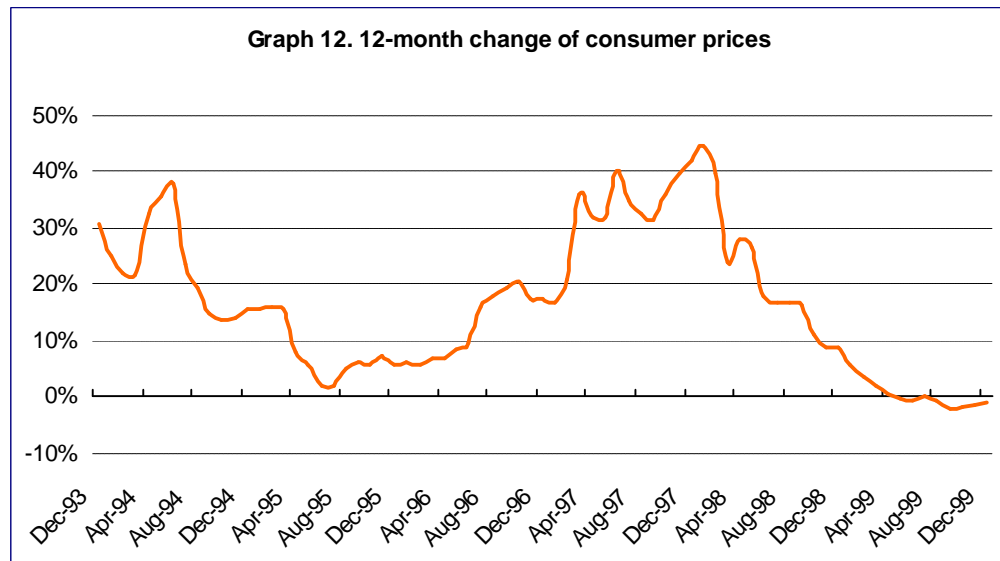
In the case of Albania, it is not possible to measure the correlation between inflation; economic growth and employment increase in the short run. However, the determined objective to maintain an average growth rate of 8 per cent for the next three years and reduce unemployment, can be triggered from the continuance of deflation. This does not imply to shift to expansionary monetary and fiscal policies. On the contrary, emphasis must be put on the improvement of the transmission mechanisms, development of markets, changing in the budget expenditures structure, favoring the capital expenditures in relation to current ones, as well as shifting from credits to the government to the private sector.

It should be underlined that the reduction of inflationary pressures in the economy, even below the present target, is viable to the level typically considered as "good inflation" (i.e., from one to three per cent). From this point of view, considering the ever-fragile Albanian economy, it is viable to maintain a positive inflation rate approaching the target.

1.5.2 Developments in the consumer price index.

Year 1999 inherited a one-digit inflation rate. The target for 1999 was closer to the 1998 inflation rate. The target of 7 per cent for the 12-months change of CPI was in line with the other ultimate objectives of the midterm program for country development (i.e., growth rate at 8 per cent and a current account deficit at 11.2 per cent of GDP).

Developments observed during the first months of 1999 signaled a better inflation performance than the target, despite the panic induced early in the second quarter due to the Kosova crisis. During the first half of the year prices were reduced considerably and unexpectedly by 2.8 per cent.



The second half of the year coincides with the immediate return of the deported population to Kosovo. Therefore, the international community's attention and aid were focused in Kosovo. On the other side, the Bank of Albania reduced rapidly interest rates indicating an obvious trend of a prudent relaxation of monetary policy. As a consequence, the inflation rate for the second half of the year recorded a positive level of 1.9 per cent. However, the annual inflation rate remained negative by 1.03 per cent.

Similar developments are observed based on other Bank of Albania approaches to measuring inflation. Considering core inflation, we observe that the year-end percentage is three times lower. Meanwhile, if food, beverages and tobacco are excluded, the 12-month inflation rate falls between the above mentioned indicators.

Box 8 : Core inflation.

Inflation rate excluding "food, beverages and tobacco".

Table 6 indicates inflation developments for only a part of the basket, after food, beverages and tobacco are excluded. Typically the above mentioned items made up 73 per cent of the basket. Therefore, price changes of these items determine the inflation rate in Albania. To develop inflation indicator, which is more, correlated with money; the Bank of Albania calculates several approximations of the core inflation. One of the latter indicators is presented in the following table. It is a well-known fact that food, beverages and tobacco prices are relatively volatile. However, the rate of change differs among the different sub-items. Taking into consideration this very fact, several scenarios are developed excluding, as the case may be, bread and cereal items; or seasonal food items; or the entire group of food, beverages and tobacco.

We see that the share of different groups of the basket, in the case where food, beverages and tobacco are excluded, increase. While the share of "individual goods" increases significantly to 30 per cent. The underlying group consists of furniture and appliances. The above calculations of inflation means that if food, beverages and tobacco were excluded from the basket then the spending for Albanians would be redistributed as shown in table 6, with 30 per cent of the total expenditures devoted to furniture and appliances. The foreign trade data indicate a constant decline of imports for the said items. On the other hand there is no domestic production for them. Yet, furniture and appliances prices dropped as well. The above mentioned facts indicate, to a certain extent, that the demand for such products shrunk. Data provided by INSTAT does support the explanation and, indeed, the phenomenon is a typical one for early '90s. As such, the share of furniture and appliances items may not be the same at the end of century, thus not reflecting the reality.



Both compositions, which derived after the deductions are made, still represent a significant share of food items, indicating even certain increase compare to the total (respectively 74 and 78 per cent of the basket). Therefore, the annual inflation rate for 1999, calculated based on the new basket, in both cases, remains negative. Actually, the new inflation rates are even lower.

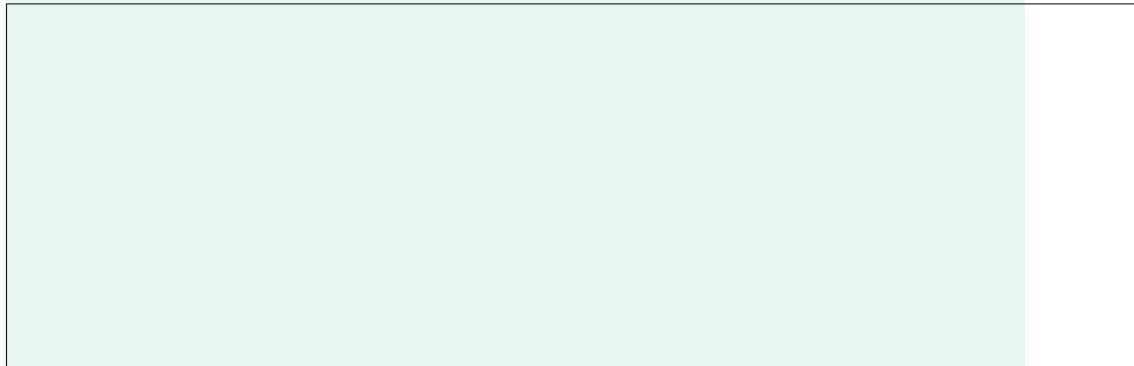
Core inflation.

Table 7 indicates two methods of calculating core inflation. The first column represents the inflation measure where 12.5 per cent of extreme changes (both positive and negative) in the subgroups of food, beverages and tobacco as well as at the remaining groups of the basket are not taken into consideration.

In essence, the most volatile items in the basket are excluded, resulting in a more reliable calculation for inflation rate. In the first case only one item in each of the extremes (two in total) is excluded. In the second one two items in each of the extremes (four in total), both positive and negative, are excluded.

Box 9 : Statistical data on inflation in Albania measured as a 12-month change of CPI (December 1993 - December 1999).

During the period 1994-1999 the average annual inflation rate changed from 0.4 in year 1994 to 32.9 in year 1997. 1999 has the lowest level of inflation ever seen during the underlying period. In addition to this, during 1999 inflation was rather stable (indicating the least volatility) as compared to the other years (with a standard deviation from the mean value at only 2.3). While the highest volatility is observed in year 1998 (with a standard deviation at 11.5 for the year). This is due to the significant reduction of inflation in 1998, where the annual inflation rate dropped from 42.1 per cent at end 1997 to 8.7 a year later, as well as due the high changes of monthly inflation rate. The mean value, however, is not very significant in the case of Albania. It is greatly influenced by the inflation development in each year of the period under examination. As it can be seen, the annual inflation rates do differ a lot and they resulted under the influence of certain specific events emerged over that particular year. The relatively high level of the mean standard deviation, at 12.9, also indicates that annual inflation rates in Albania were rather volatile. As it is shown in the following table, 1999 is rather stable and less inflationary. In this year, the minimum value of -1.9 per cent is observed. Meanwhile, the maximum level for the entire period was observed in 1998 at 44.6 per cent.



Based on the asymmetry of distribution of the inflation rate values, it can be seen that throughout the underlying period, the trend of lower inflation rate is stronger (a right asymmetry of values distribution, which becomes stronger in 1999). Year 1997 is an exception (left asymmetry) where the trend toward an increasing inflation rate was stronger.

1.6 BUDGET DEFICIT

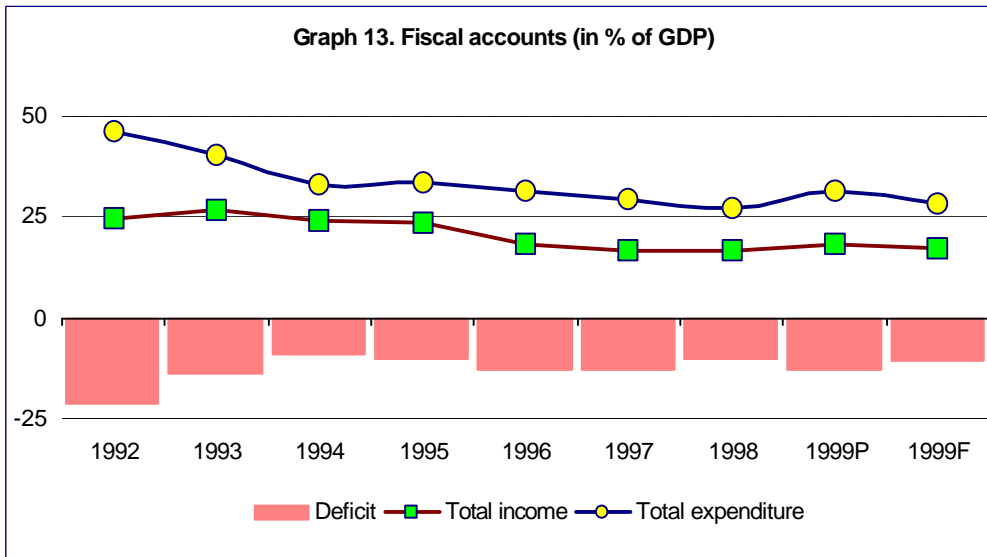
Fiscal consolidation is one of the most difficult tasks to accomplish for each economy, even for the developed ones. During the last decade, fiscal consolidation in all transition economies went through oscillations, reflecting at large scale the underdeveloped or nonconsolidated democracy of these countries. According to the latest EBRD data, fiscal consolidation during 1999 offered different developments for different countries.

Considering these data it is evident that all those countries, which during the course of the year carry on elections as well as all countries which have been affected by the conflict in Kosova, financial consolidation become doubtful. Meantime it was successful for the rest of the countries under transition.

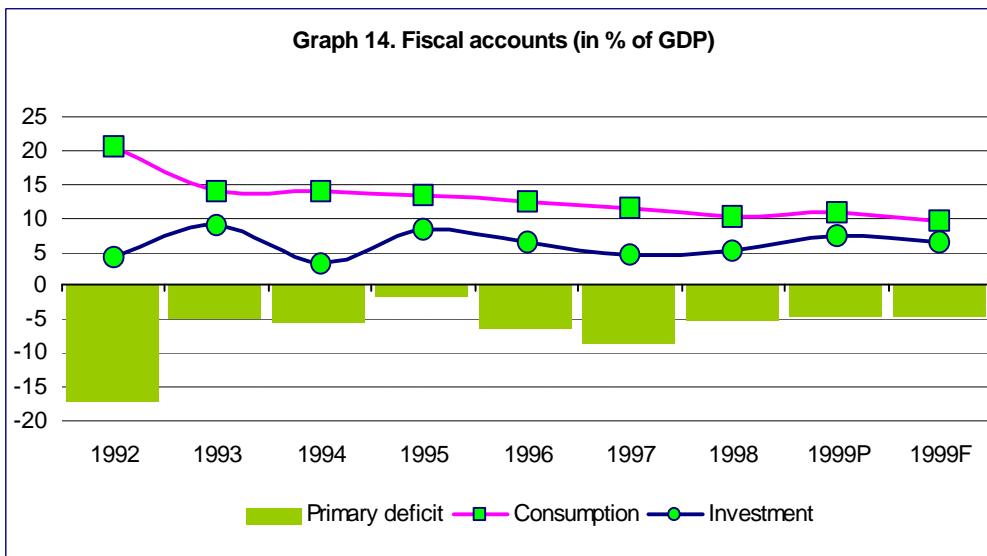
At the end of 1999, Albania fiscal deficit represents 11 per cent of GDP, which is the largest figure recorded among all transition economies for the year. However, fiscal deficit remained below the forecasted level, tax collecting underwent some problems, which were balanced through a cut in expenditures, especially capital expenditures. Tax revenues reached a figure of about Lek 6,5 billion or 1,6 per cent of GDP less than the program. About 50 per cent of this gap can be attributed to the low inflation rate and a persistently strong Lek during the period. What remains is considered direct consequence of persistent problems related to customs administration, smuggling and corruption, as well as a big increase of nontaxed imports during the Kosova crisis period.

The poor performance of budget expenditure compare to the projected levels, beside a shrink of the aggregate demand, caused a reduction of budgeted financing needs. In return, the budget deficit internally financed was reduced by Lek 2 billion compared to the forecasted one.

Government account statistics, by the end of the year show an optimistic picture where the most important development is the reduction of domestically financed fiscal deficit at 4.9 per cent of GDP, compared to 6.6 per cent in the previous year and 5.9 per cent forecasted under the monetary program.



Expenditures as a total registered a level of 28.1 per cent. The majority of them count for government consumption at about 10 per cent. Like in the previous years, during 1999, expenditure performance occurred at uneven trend. Growing steadily during all the year they reached their highest level in the last quarter, which generated about 32.6 per cent of the total revenues. Meanwhile the other quarters account for an average figure of 22.5 per cent.



This non-uniform distribution of expenditures during the course of the year created difficulties for the stance of monetary policy, because it is well known that at the end of the year the budgeted needs much more liquidity than in any other period of the year. The negative impact of these phenomena might influence the expected inflation figure. So, the considerable increase of expenditures at the end of the year was reflected in the level of expected inflation in the first quarter of this year.

Income had a more regular distribution among quarters. However, there was a decrease in income during the second quarter, due to the Kosova crises. Later during April and May a slight increase occurred, due to the presence of counterpart funds. Income reached a level of Lek 89.6 billion, and roughly 73 per cent of them derived from tax revenues.

The ratio of income to GDP for 1999 increased slightly vis-à-vis 1998. However in absolute figures, income from taxes did not achieve the forecasted level in the monetary program, indicating once more the existence of problems related to corruption, smuggling, etc.

Total expenditures compared to GDP recorded a considerable increase of 7.2 per cent compare to the previous year. This level was 3.3 per cent lower than the forecasted one.

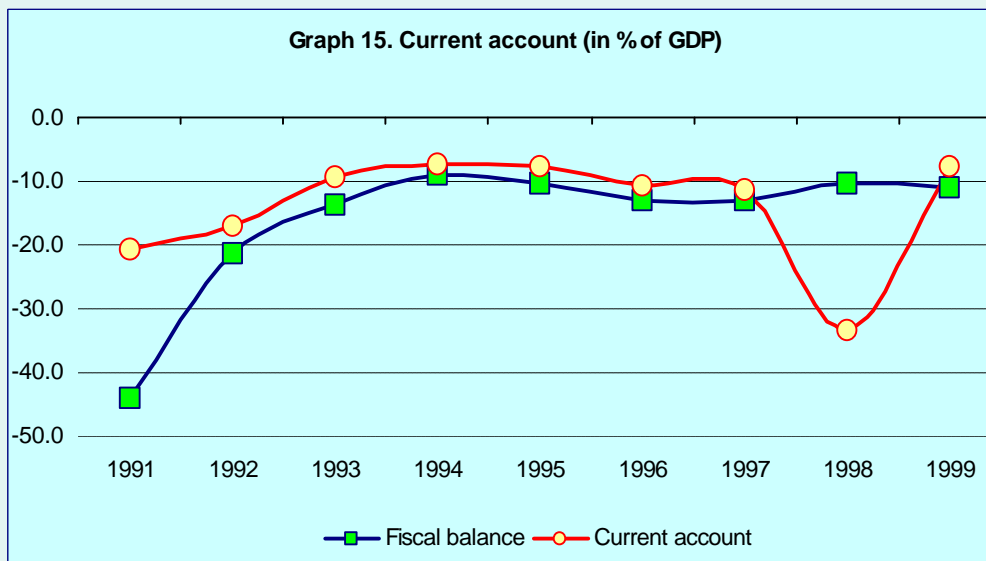
1.7 BALANCE OF PAYMENTS AND FOREIGN EXCHANGE RESERVES

It is not easy to summarize briefly the developments of the external sector of the economy. The most recent BOP figures outline a rising current account deficit, which was covered by large foreign exchange inflows on capital and financial account.

The year began with well-controlled and balanced developments, which improved particularly during the second quarter of the year under the effect of enormous increase in income from tourism services and foreign aid. As a consequence the first half of the year recorded a current account surplus of USD 48 million.

The second half of the year introduced a totally different picture. The decline in current income caused from a sharp reduction in income from tourism and remittances from expatriates resulted in a current account deficit of USD 203.5 million. Under the pressure burden of such developments the economy lost, at least partially, the advantages accumulated during first six months, causing a deficit of USD 155 million at the end of the year.

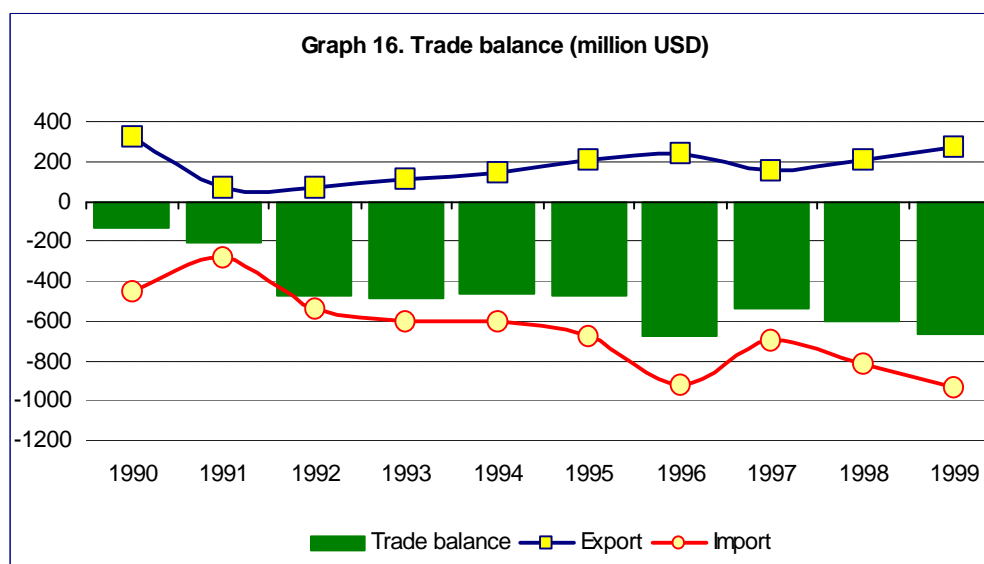
Current Account deficit compared to the previous year, increased by 3.4 times, representing 4.1 per cent of GDP against 1.5 per cent in 1998.



Current account deficit, excluding official transfers, increased only 2.3 times vis-à-vis last year. Despite the remarkable increase recorded in service accounts, the increase of trade deficit and decrease of remittances from expatriates were the most significant reasons behind the deficit deterioration.

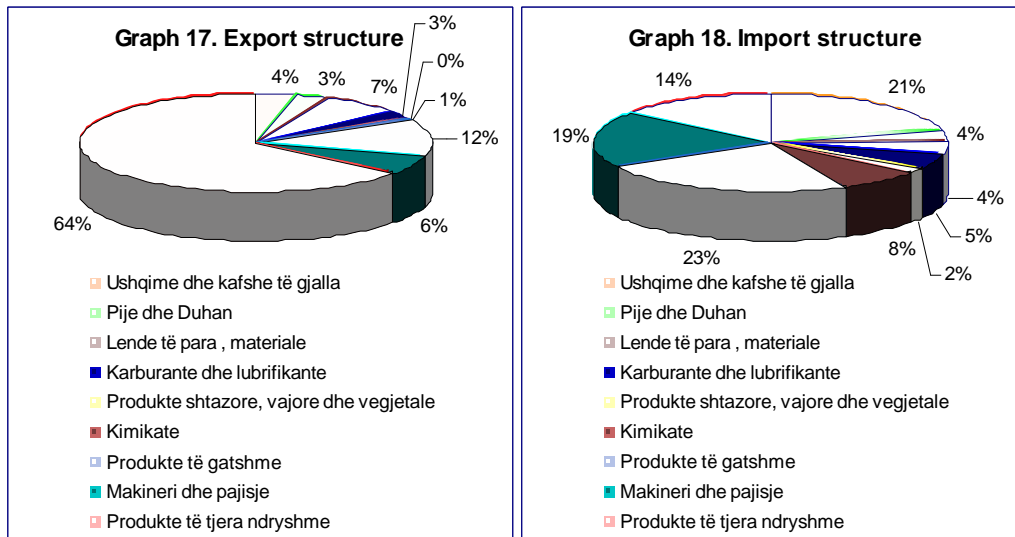
1.7.1 Current accounts and balance of payments developments.

The overall figure of foreign trade transactions in goods this year increased by 19 per cent, a 10 per cent increase in the trade deficit compared to the previous year. The foreign trade deficit for the year as a whole amounted to USD 630 million, representing 17 per cent of GDP or 3 percentage points less than in 1998.



Exports increased 32 per cent reaching the level of USD 275 million. The growth was mainly due from inward processing re-exports, which increased 52 per cent vis-à-vis 1998. Meanwhile domestic exports provided a poor contribution to this increase; they increased only 5 per cent. As a consequence the structure of exports shifted in the favor of re-exports from inward processing. That accounted for about 67 per cent of total exports. The same figure last year was 58 per cent. The majority (90 per cent) of these commodities represents re-exports of shoes and textiles; the rest was prepared food and electronic equipment.

Mineral products, metals, and vegetable products and tobacco dominate the structure of domestic exports during 1999. Mineral products that represent the biggest item in this category (minerals occupied 19 per cent of total domestic exports versus 27 per cent in 1998), decreased 25 per cent against last year. Export of other domestically produced commodities such as medicinal plants and tobacco decreased as well by 21 and 29 per cent respectively. However all these negative developments were softened due to the increase in exports of base metals by 17 per cent; machinery and equipment, which exports were twice as much as last year; export of wood and leather respectively by 12 and 5 per cent, etc.



Exports to Italy for this year recorded a figure about 33 per cent higher than in 1998. Exports to Germany increased 32 per cent, too. In both cases the increase in exports occurred due to the increase of re-exports of inward processing goods. Exports to Greece decreased 4 per cent. A shrink in re-exported inward processing goods as well as exports of tobacco caused the reduction.

Imports for the whole year 1999 are estimated at about USD 938 million, which represents an increase of 16 per cent vis-à-vis 1998. The increase in domestic demand and goods from aid as well, are the most important reasons behind that increase. That increase of over all volume of imports did not cause any change in the structure of imported goods. Imports of textiles and shoes (about 71 per cent of these group represent imported goods for inward processing), foodstuff articles machinery and equipment, vegetable products as well as mineral and metal products were the main commodities imported this year. With the exception of inward processing imports, all the other major groups increased compared to 1998. Among these commodities imports of food, beverages, tobacco, and, machinery and equipment registered the highest growth respectively by 49 and 34 per cent.

The European Union remains the largest trade partner in imports. However, this year demonstrated a remarkable increase in imports toward east European markets. Imports from Turkey increased 86 per cent; imports from Bulgaria increased 21 per cent and from Macedonia 54 per cent. All together these three states account for 10 per cent of the total import market. Within the European Community there was a shift in import markets. Italy lost its market share in favor of Greece, which this year occupied 28 per cent of our total imports. Greek imports expanded by 12 per cent, mainly due to the increase of fuel and cigarette imports. Despite the fact that Italy is the biggest partner for Albania, its share in imports decreased to 37 per cent from 42 per cent in 1998.

The end of the year registered a surplus of USD 106 million in the service account, which represent the first positive figure since the beginning of the transition period. The reason behind such a positive figure is the sharp increase of revenues from travel. Revenues from this activity are estimated to be USD 211 million and represent 5.6 per cent of the total GDP of 1999¹³. Those surprisingly high revenues were generated by the unexpected large number of tourists who visited Albania particularly during the second and third quarter of 1999. The Kosova crises attracted to Albania many news agencies, international organizations, humanitarian aid agencies, military troops, etc, which have also had an additional impact in the increase of revenues from trade in services.

Developments in trade of “other services” category mainly reflect the progress of travel activity. The sharp expansion of travel activity had a big impact on the increase of revenues from other services, particularly communication and government services which rose respectively 21 per cent and 4,3 times against 1998. As a consequence, the category other services recorded a surplus of USD 11,5 million against a deficit of USD 2 million last year. The growth of the import volume induced an inevitable increase in the deficit of transport and insurance services respectively by 20 and 15 per cent. This happened due to the fact that developments in both these categories of services are influenced by expenditures for transport and insurance services related to imported goods.

Income generated from compensation of employees and interest income on foreign exchange deposits of resident financial institutions overseas, provided a positive balance of USD 75 million, which was slightly below (only USD 2 millions less) the surplus of the previous year. In general the developments in income account did not reveal any important phenomenon, apart from an increase in payable interest on non-resident deposits with domestic banking system.

Current transfers surplus for the whole year was 37 per cent lower than those of 1998, however they represent the most important financing item covering about 49 per cent of the trade deficit. The shrinkage of the current account surplus was the outcome of a combined sharp increase in outflows of private transfers and a reduction in remittances from expatriates. The humanitarian emergency created by the Kosova crises generated a sharp increase in official current transfers, which increased 73 per cent more than last year. Current transfers in cash and goods increased respectively by 8.6 times and 41 per cent (the latter represents a Bank of Albania estimation). These transfers represent the European Community’s aid to support the government budget during the humanitarian emergency period.

¹³ For balance of payments statistics purposes, Kosovars who stayed in Albania during the Kosova crisis are classified as “tourists”. Therefore, their spendings are recorded as “income from tourism”.

In spite of the fact that official transfers increased as much as twice, their increase was not big enough to balance the negative effect of other current transfers (21 per cent decline in remittances from expatriates, and an expansion of more than 3 times of the outgoing private transfers vis-à-vis 1998). Large foreign exchange inflows supplied to the economy by Kosova Albanians might provide a good enough explanation for the weak performance of remittances from expatriates, which were significantly below the optimistic figure forecasted at the beginning of the year. Commercial bank statistics show an increase of nearly twice the level of foreign exchange remitted through commercial bank channels. However, this foreign exchange did not remain in banks but was circulated outside banking system, thus encouraging the increase of the trade deficit.

Capital and financial account transactions were a positive balance of USD 74 million. Capital inflows, which were about 24 per cent higher than in 1998, mainly reflect the increase of liabilities from official borrowing and deposits of non-residents with commercial banks, respectively 34 per cent and 4 times more than last year. During 1999, foreign creditors disbursed a total of USD 146.5 million, out of which 20.9 represented use of Fund Credit and Loans from IMF. The Government absorbed the World Bank and European Community represents the main creditors of the Albanian economy, of which 86 per cent.

Foreign direct investment (FDI) has performed poorly in the financing of current transactions. FDI inflows remain under impact from the difficult situation in the region and were estimated to be below the level of 1998. The considerably high capital imports were accompanied by relatively high capital exports and accumulation, which was estimated to be around USD 130 million.

During 1999 Reserve Assets increased by USD 123.6 million¹⁴. At the end of the year they were large enough to cover 5.2 month of imports. Foreign loan disbursements and cash grants represent the most important factors behind the increase in Reserve Assets.

Year 1999 registered a very large positive figure in the category "net errors an omission". The Bank of Albania comments that such a figure is related to inadequate official statistics as well as financing of the foreign sector of the economy from informal and vague activities.

¹⁴ Evaluation effect is excluded.

Box 10 : Albanian Exports to Kosova.

In our opinion exports to Kosova, particularly those during the third quarter, are not recorded in the customs statistics, or in the best case they are partially recorded. The reason behind that is the lack of custom office for a relatively long period (since the end of the conflict until October), in addition; shuttle trade exports have been significantly large. Therefore the above mentioned exports are not reflected in the custom statistics and accordingly they are not reflected in the foreign trade statistics of balance of payments. After the establishment of the custom office of "Qafë Morinë", Kosova became one of the main export partners (it was the forth partner during last quarter of 1999).

Box 11 : Foreign exchange inflows.

The eruption of Serb violence in Kosova was instantly followed by vast expulsion of Kosova Albanians from their motherland towards Albania and other neighbor countries. Very soon (in the course of three weeks) the number of the displaced Albanians approach 500,000 people, which equaled about 15 per cent of the actual Albanian population. That sharp increase brought several consequences in the balance of payments.

The majority of expatriated Kosova Albanians stayed in Albania until the end of the conflict, which ceased in middle of July. In the course of their stay in Albania, Kosova people spent a considerable amount of foreign exchange to buy goods and services besides the ones granted from aid from domestic or international sources. Therefore they become an additional powerful source of foreign exchange, compared to the relatively small Albanian foreign exchange market. According to Bank of Albania estimations¹⁵, average daily expenditure per person is 2.5 DEM (about 1.4 USD at the prevailing exchange rate of the period). Hence during their stay in Albania, Kosova Albanians must have supplied to the economy about USD 80 Million in cash. The Kosova crisis attracted to Albania many news agencies, international organizations, humanitarian aid agencies, military troops, etc, which also had an additional impact in the increase of revenues from trade in services. Their expenditures have provided an important contribution to cover partly the costs of the emergency situation and the increases of current income, most of it through travel and government services. The overall financing impact of the Kosova crisis to the Albanian economy is estimated to be an additional foreign exchange supply of around USD 300 Million. Such a figure is approximately equal to yearly remittances from expatriates. The most important consequences of these foreign exchange in the foreign sector has been:

- * Foreign exchange inflows have supported the revaluation of Albanian Lek against foreign currencies in the course of the year. That has a positive impact on inflation.
- * Incomes from export of services increased significantly, particularly those from travel services.
- * The sharp increase in the population was followed by a similar increase in the domestic demand, which caused a big increase in imports, mainly for consumption goods.
- * In the course of the year a huge increase in current transfers in cash and in kind as well as capital transfers, was recorded.
- * Large foreign exchange inflows granted through foreign aid in cash and official and other borrowing caused a sharp increase in official reserves.

¹⁵ Bank of Albania conducted a survey among the deported Kosova Abanians. The results presented in Box 11 are based on this survey findings.

1.7.2 Bank of Albania foreign exchange management.

During 1999, the stock of foreign exchange reserves of the Bank of Albania followed a continuous upward tendency. At the beginning of 1999, reserve assets were USD 348 million. At the end of the year it reached a level of USD 481 million, an increase of USD 97 million, which represented an increase of 25.3 per cent.

Among the most important factors which had an impact on this increase were:

- ❖ Foreign exchange inflows from foreign loan disbursements and cash grants;
- ❖ Interest incomes generated by the investment of these foreign exchange reserves;
- ❖ Transfers from a commercial bank in favor of the Bank of Albania.

However, there were several factors, which have had a negative impact on the increase of foreign exchange reserves, among the most important can be mention:

- ❖ The evaluation of US dollar in the international markets;
- ❖ Foreign loan repayments;
- ❖ Foreign exchange transfers to commercial banks.

In accordance with its foreign exchange reserve management policy, which is authorized by its Supervisory Board, the Bank of Albania has invested its foreign exchange assets in financial instruments, which satisfy the following conditions:

Low risk investments;

High liquidity ratio;

Satisfactory returns on investment.

The policy has changed in order to reflect the important developments of the international financial markets. Those changes aimed to increase flexibility in reserve administration. The introduction of the European currency (Euro) was followed by changes in the open position objectives regarding each currency, for that purpose Deutsche Mark and Italian Lira merged to EURO. There were additional changes in investment rules for the Treasury bond markets. So according to the new rules the maximum maturity period for investment in US treasury bonds was extended from 9 to 12 months. In addition, supervisory council approved the investment in Greek government bonds, this aim to cover the interest rate risk with reference to Greek loan extended to Albania.

Second Chapter

Policy and Monetary Instruments

2.1 MONETARY POLICY

For the second year of the mid-term economic development programme, the final objectives remained unchanged: full control over inflation, sustainable economic growth and a general equilibrium in the foreign position of the country. Within this general framework, the monetary policy goals, reflecting the 1998 achievements aimed at a further reduction in the inflation rate to 7 per cent under the assumption of 8 per cent real economic growth.

The operational targets, as well, remained unchanged. The main emphasis was put on the keeping the money supply under control, with the key control instrument interest rates for time deposits in Lek of state owned banks. The other monetary instrument, credit ceiling, heavily used in the past, during 1999, lost further its significance that brought to a total removal of it at the end of the year.

The Bank of Albania contribution would become effective only in the case of matching all three monetary programme quantitative objectives:

- * The floor for the level of net foreign exchange reserves of the Bank of Albania,
- * The ceiling for the level of net domestic assets of the Bank of Albania, and
- * The ceiling for the level of net domestic credit of the banking system to the government (for more detailed information on quantitative criteria (box 12).

Despite the instant “shock” generated by the crisis of Kosova, the downward trend in inflation verified since 1998, continued at the same pace during all 1999. The interest rate also recorded a continuing decline, by 6,5 percentage points in total, indicating de facto a relaxation of monetary policy.

Despite the lower price, credit to economy remained at low levels, manifesting the fragile and not yet consolidated position of private business in one hand and problems and uncertainties related with Albanian markets and transmission channels on the other.

On the hand, it should be mentioned the effect of Kosova crisis in the performance of monetary policy. This factor directly affected the inflation developments. However, it is difficult to measure the length of time and the magnitude of its impact.

Summarizing, the 1999-year could be considered, as the most powerful year in bringing inflation down, even the validity of the minus inflation will be a central issue of the research. Differently from the last decade, the inflation target for the first year of the new millennium, will be not any more a central figure but a straight range between 2 per cent and 4 per cent.

During 1999 the financial situation remained stable, contributing to further economic growth under the environment of the total absence of the inflationary pressures. The fiscal deficit counted Lek 40,5 billion (equivalent to 10,5 per cent of GDP), around Lek 8 billion less than 1998. Domestic financing was only 4,9 per cent of GDP.

Based on achievements noticed on prices, foreign exchange rate, fiscal deficit, monetary aggregates and credit allocation, monetary policy toward interest rates, was clearly in favor of reduction. Bearing in mind the positive return in real terms and the capacity of absorption, the Bank of Albania, during the year cut interest rates several times for all three-maturity terms. Starting smoothly in May and June (although the environment was favorable since April), interest rates were reduced significantly stopping at the end of the year at respectively 9,25 per cent, 9,25 per cent, 9,0 per cent for 3, 6 and 12 months maturity term deposits. The starting level as June first of 1999, was 16,5 percentage points equally for each maturity.

The lower level of inflation contributed to a consistent appreciation of the Lek. Persistently, the Lek gained ground against the US Dollar and all other European currencies, making easier the Bank of Albania work in conducting domestic foreign exchange market. In response to the large amounts of foreign exchange inflows — granted generously from western governments, NGOs, individuals and other foreign and domestic donors— the foreign exchange market remained stable and there was no need for Bank of Albania interventions. The foreign exchange reserves increased steadily and at the end of the year their level was counted for USD 428 million. The same phenomenon was recorded in the stock of DMBs foreign exchange assets.

During 1999, Bank of Albania has successfully adopted a very prudential and matured monetary policy, based on the usage and improvement of both direct and indirect monetary instruments.

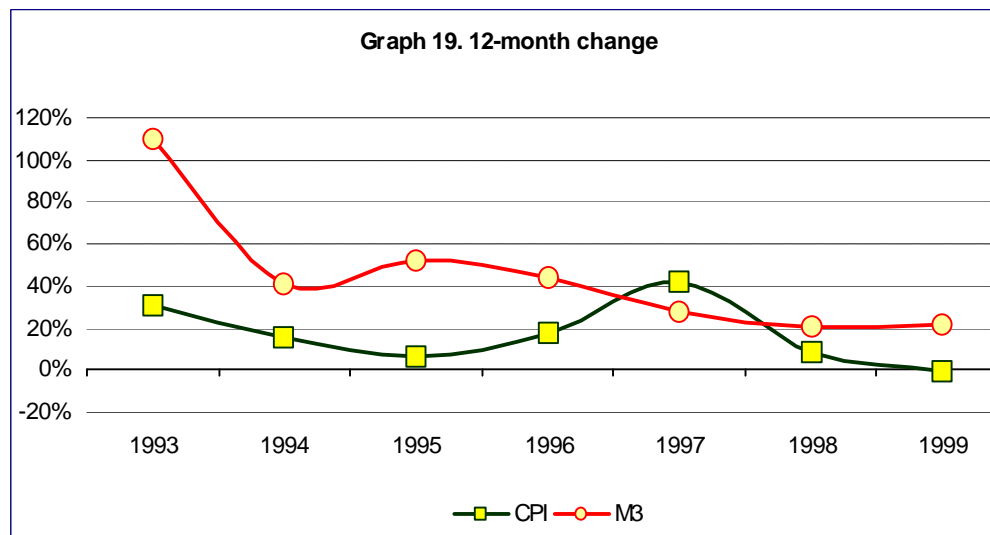
Bank of Albania has applied and still does the minimum level of interest rates for time deposits in Lek placed in state banks, as an appropriate mechanism for transmitting the monetary policy decisions. That is considered as an effective way for safekeeping and increasing the public confidence in the banking system and for keeping a balanced usage of administrative and market instruments.

Based on positive developments in banking supervision, including the regulatory framework as well as progress in the process of monetary stabilization, at the end of November 1999, the Bank of Albania Supervisory Board revoked the use of credit ceiling—for a long period of time, that instrument was not efficient. That decision could be considered as the first important step in the direction of the difficult objective of shifting from direct to indirect monetary control tools.

The decision was followed up by the removal of quantitative restrictions imposed on second-tier banks in their ability for granting credit to the economy. However, under the Bank of Albania supervisory competence, some “qualitative” restrictions will remain in Albanian banking system, focusing on the level of non-performing loans.

The overall liquidity position of interbank market has been satisfactory and stable, despite the last month of year. The sharp increase—that is a typical phenomenon for December of each year—in budgetary financial requirements created artificial obstacles for a normal liquidity level in the market.

In order to match both targets, inflation (7 per cent yoy basis) and economic growth (8 per cent in real term), the Bank of Albania Monetary Program set an objective for **money supply** growth (measured by M3) at a nominal percentage annual rate of 15 per cent. By the end of 1999, broad money increased by 22.3 per cent compare to the previous year (graph 19), and 7 percentage points higher than the projected level due to the significant increase of the banking system foreign exchange assets. The impact of shock —Kosova crisis— was sufficient enough not only to write-off the programmed decrease, but provided the above excess increase in the stock of NFA.



M3 growth higher than the projection was mainly a contribution of the net domestic assets at 15.2 per cent (credit to government only contributed to 10 per cent, while credit to private sector to 1.4 per cent). The net foreign assets of the banking system also affected it at 7.1 per cent.

The share of **the credit to government** is around 91 per cent of the **credit to economy**. The current budget expenditures were on track, while the capital expenditure and, as a consequence, investment expenditure, were restrained. On the other hand, “the old story” of limiting the expenditure during the first months of the year and spending excessively during the last month of the year, was repeated. However, it was managed not to hinder the target achievement. The demand for domestic financial sources, during December 1999 was covered to a certain extent from Bank of Albania profit.

Throughout 1999 Bank of Albania set as an upper for **the stock of the credit to non-government** at Lek 8 billion, considering the enlargement of banking system by two other private banks — FEFAD bank and First Investment Bank. The increase in the credit stock recorded an amount of Lek 2,2 billion that means around 27,5 per cent of the predetermined limit.

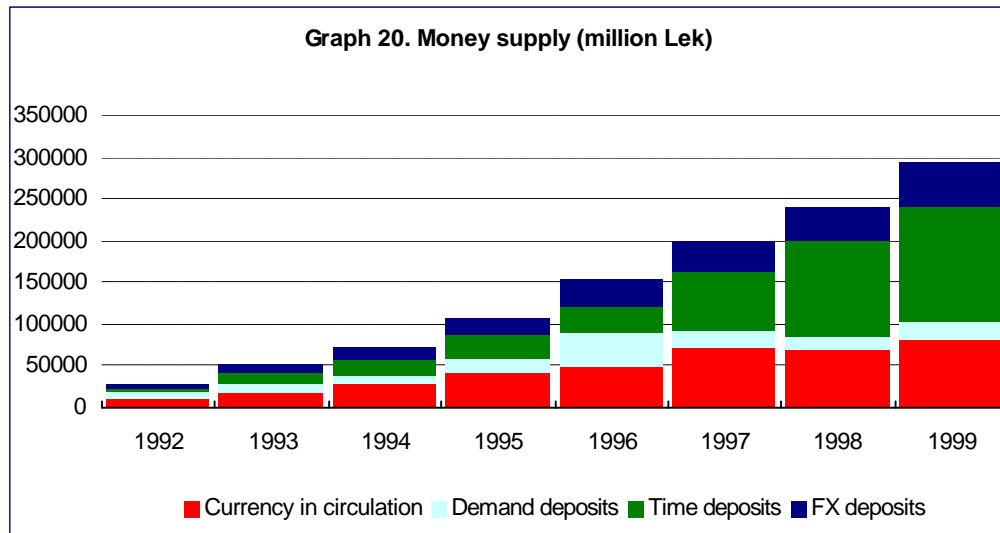
Another important financial source for the economy, in addition to the bank deposits, has to do with some foreign financing projects. Private banks served as channels to inject those funds in the economy.

During the early 1999, the situation of the Balkan region and in the country did not favor the investment and lending activities. Indeed during that period the banks were prudent and were mostly focused on market surveys. The new credit extended from the banking system in 1999 is accounted for around Lek 8 billion. The banking system has financed mostly activities as trade transactions, food processing, tourism, automobile services, etc.

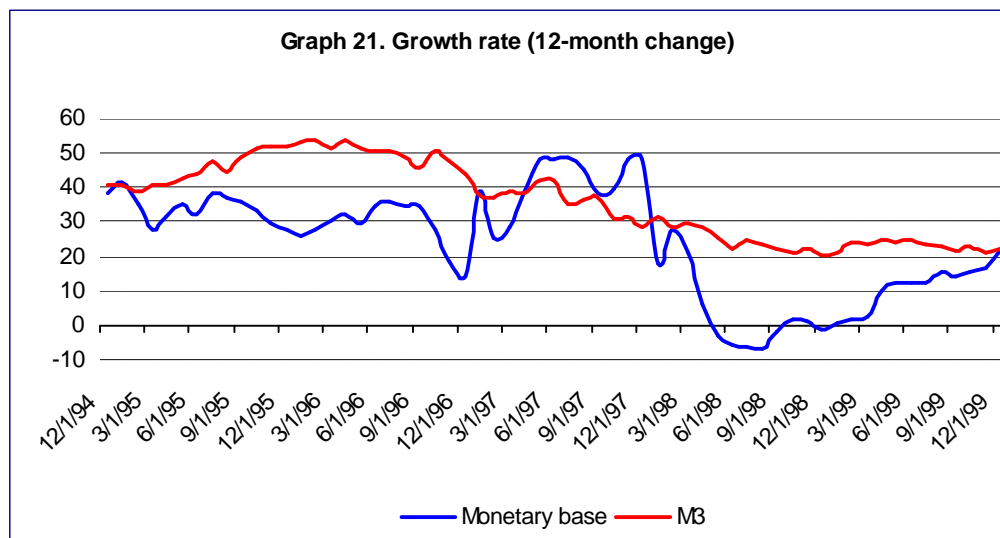
According to statistics available for the end of 1999, about 44,5 per cent of the stock of the credit are short term; meanwhile about 46 per cent of the total are extended in foreign currency. The share of public sector is declining, constituting only 8.4 per cent of the total of credit (Lek 19.9 billion). Lending in Albania is a risky activity. Several types of risks are estimated to be part of Albanian menu, and the consequences are shown to the high level of problematic credit. The problems that Albania faces with public order, legal framework, juridical system, corruption, smuggling, etc. has lifted very high the level the credit not paid in time. This state of high potential risk has raised the attention of commercial banks in selecting the possible users. Staying in a conservative position seems to be considered as the main factor in avoiding the losses derived.

Nevertheless, the Bank of Albania believes that the availability of credit in the country is higher. This idea stems from different foreign projects that are operative in Albania, i.e. SME, Albanian Fund of Development, Rural Fund, Albanian-American Fund for enterprise supporting, Projects assisted from IFDC, savings and loans associations that finance different activities and most notably the construction.

The share of total deposits raised further during 1999 (graph 20), totaling 72,2 per cent of the M3 (compare to 71,5 per cent in 1998). At the same, the share of currency outside banks in M3 dropped from 28,5 per cent at the end of 1998 to 27,7 at the end of 1999. This indicates that deposit contribution in money supply growth has been considerable at around 76 per cent of the M3 growth.



In response to lower levels than projected of both fiscal spending and economic activity, **currency outside banks (COB)** dropped during the first months of 1999, reaching the lowest level by the end of March. However, it could be considered as a seasonal phenomenon, a kind of relaxation in spending money and a dormant economic activity in general after a very intensive month of December.



The rapid deterioration of the situation in the Balkan region and the massive enforced deportation of Kosova people to Albania were reflected in the increase of money demand. Therefore, during April 1999, currency outside banks increased significantly. However, throughout the year COB increased on average within normal trends. The ratio of COB to total deposits declined slightly, from 39,9 per cent at the end of 1998 to 38,4 per cent at the end of 1999.

Total deposits increased by Lek 40,3 billion (23,5 per cent yoy basis). The most interesting development belongs to **foreign currency deposits (FXD)**. At the end of 1999, the share of foreign exchange deposits increased from 23,5 per cent at the end of 1998 to 25,2 at the end of 1999. Meanwhile, **Lek deposits** dropped from 76.5 per cent in 1998 to 74.8 per cent in 1999. The upward constant trend of FXD was apparent during the entire year. They increased by Lek 12,8 billion, of which Lek 7,8 billion are added amount in the first half of the year and Lek 5 billion in the second half of 1999. Based on maturity of FXD, demand deposits and time deposits grew by 39.9 per cent and 2.4 per cent respectively during the first six months. This pattern changed during second six months of years and time deposits increase prevailed.

Deposits in Lek increased by 20,9 per cent (Lek 27.3 billion) on yoy basis, mainly due to Lek 21,1 billion increase of time deposits compare to the Lek 6,2 billion increase of demand deposits.

Demand deposits were relatively volatile ranging from Lek 13 to 17.5 billion. However, at the end of the year, demand deposits increased considerably reaching Lek 21.6 billion reflecting the high budget requirements and seasonal effects related to the seasonal celebrations.

Time deposits in Lek increase constantly but it has been lower compared to the previous year (the average monthly growth throughout year has been Lek 1,7 billion, compared to Lek 3,7 billion a year ago). The appreciation of Lek in domestic market, a narrower spread between deposit rates in Lek and foreign currencies are listed as possible explanatory reasons. The higher ratio of FX deposits / Lek deposits showed a weaker demand for Lek.

Three months time deposits prevailed **the composition of time deposits in Lek** in 1999 consisting 53.2 per cent in December. Even the clear tendency of an increasing share of 6 and 12-month time deposits relative to 3-month maturity, still at the end of 1999, more 53 per cent (compare to 55.2 per cent in 1998) of the total of time deposits belongs to the latter. The share of 6 and 12-month maturity changed respectively from 5,5 per cent and 38,6 per cent at the end of 1998 to 7,0 per cent and 39,1 per cent at the end of 1999, respectively. These structural changes are evaluated to be positive because of a better situation of the banking system liquidity and a stronger public confidence for longer-term deposits.

The various sectors of the economy, continued to maintain unchanged position in the process of money supply creation. Households remained the largest source of liquidity for the banking system. More than Lek 31.2 billion out of an increase by Lek 40 billion of the total deposits, is provided from their savings. Meantime, the business sector contributed to the increase of total deposits by Lek 9.9 billion, while the deposits of nonfinancial public enterprises and insurance institutions dropped by Lek 0.8 billion.

The Savings Bank, as the largest operating bank within Albanian territory, holds more than 76 per cent of the total deposits (87 per cent of the deposits in Lek, and 44 per cent of the FXD).

In the course of 1999, the number of commercial banks rose to 13, as three new private banks joined the Albanian banking system (FEFAD Bank, First Investment Bank and International Commercial Bank). Both private and joint venture banks expanded their activity and recently they are looking to offer their services not only within Tirana territory. Their share in Lek and foreign exchange deposits also increased. In particular the share of these banks in total Lek deposits of the banking system increased from 1.7 per cent in 1998 to 3.6 per cent in 1999. On the other hand, their share in foreign exchange deposits grew from 28.8 per cent in 1998 to 40.7 per cent in 1999.

Box 12 : Target achievement.

1999 was **an important test for the Albanian authorities** in terms of target achievement under the middle term ESAF-2 program, a precondition for the continuing of the program and supporting Albania with domestic and foreign investments.

The Bank of Albania managed to conduct a fair monetary policy, drafted in cooperation with the International Monetary Fund, reflected in the attainment of targets of the 1999 monetary program. Target monitoring has also continued during this year and they were fully in line with the limits set.

Net international reserves of the Bank of Albania (in million USD, excluding the effect of exchange rate) by the end of 1999, following the joint review with IMF of the lower limit) amounted to USD 26.5 million above said limit. Establishment of a lower limit for net international reserves complies with the Bank of Albania policy that allows market forces to set the market value of LEK.

By the end of June reserves amounted to USD 79 million **above the lower program target** set at the beginning of the year. Increase in the first quarter is owed to tranche allocated by the European Community and the International Monetary Fund planned for this quarter whereas, in the second quarter, their increase of USD 64 million was the result of a large amount of currency deposits from various donors in support of this year's unplanned budget deficit, following Kosova crisis and the large number of displaced Kosovars into Albania.

During the second half of the year, international reserves rose by USD 29 million. In general, during 1999 (excluding the first quarter) the domestic currency appreciated against US dollar and the major European currencies.

Net domestic assets of the Bank of Albania during 1999 remained below the established upper limit of Lek 18 billion. This limit represents that portion of domestic funding of budget deficit to be covered by the Bank of Albania.

However, favorable monetary developments over the year enabled second-tier banks to finance most of the domestic budget deficit leaving only a smaller portion to be covered by the Bank of Albania. Therefore, after the review, this limit was changed into Lek 7 billion.

Setting the above-mentioned target aimed, on one hand, at preventing the Bank of Albania from creating excessive liquidity reserves within the banking system, and, on the other hand, it has enabled the expansion of the private credit sector.

Monetary base (except for the drop recorded in the first quarter compared to the end of 1998) during the other three-quarters increased by Lek 6.6, 4.4 and 6.6 billion respectively. Increase in the second quarter is owed to the increase of money outside banks (Lek billion 7). The increase of public demand for money, as well the increase of population during the same period, explains the increase of monetary base, which was nevertheless relaxed by the drop of excessive reserves in Lek.

Increase of the monetary base during this year was caused by a number of reasons:

- “ Kosova refugees who, in order to meet their personal needs, had to convert different foreign currencies into Lek.
- “ Various charitable organizations and NGOs had also to exchange foreign currencies into Lek.
- “ At the same time, government expenses increased above projections in order to meet the immediate needs of refugees and to strengthen security in the country.

During the third quarter, the increase of monetary base and of money outside banks marked a downward trend, whereas during the fourth quarter, financing of budget deficit from central bank loans reverted upwards.

Developments of the state budget in December led to an unprecedented, immediate and considerable increase of the monetary base and of banks' excessive reserves.

By the end of December, net domestic assets of the Bank of Albania were Lek 68.0 billion or Lek 1.5 billion below their upper limit (after the program review at the end of November). In general, during 1999 the Bank of Albania maintained the previous status of its portfolio of government securities, despite their frequent sales under repo agreements with second tier banks, which has brought about change in the monetary base or money reserves.

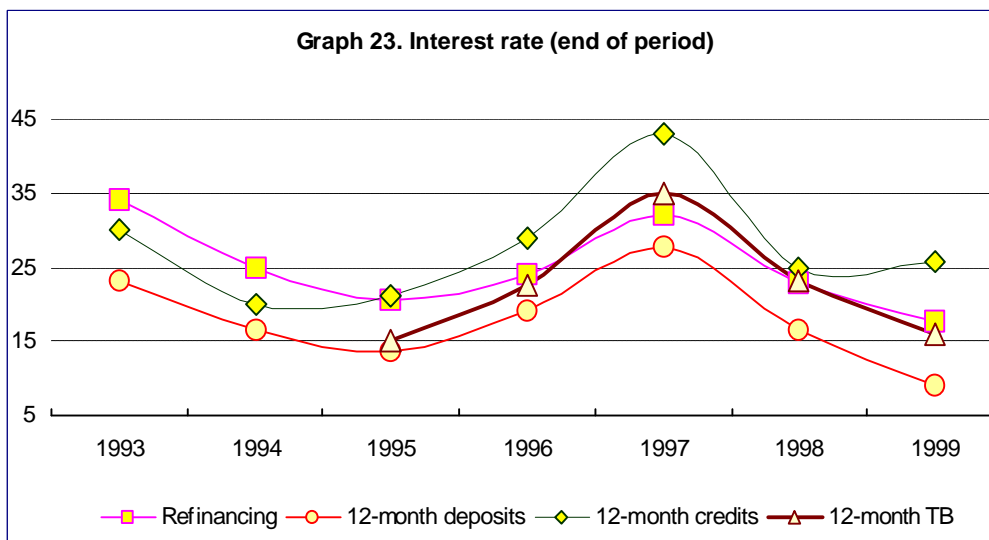
Net credit to government from the banking system throughout the year remained below the upper target limit, excluding December, when the credit to government exceeded the target by Lek 1.5 billion. As a result, the objective for internal financing of budget deficit from the banking system was met. On the other hand, Bank of Albania, to meet the extra government needs during April and December, acquired Treasury Bills at Lek 2.4 billion, which is considered as a direct credit to government.

2.2 MONETARY POLICY INSTRUMENTS

The main instrument to implement monetary policy remained the interest rate for time deposits in Lek, placed with the state-owned banks. Despite the efforts made, transmission of the decisions through market was limited reflecting the underdevelopment of the financial and money markets. During 1999, no specific developments occurred and, in addition to other problems, markets are suffering the monopoly held by the Savings Bank. Therefore, in all transactions, carried out both in money market and interbank market, the Savings Bank was the counterpart for the other operators, imposing, as such, the market behaviour (box 13). As a consequence, such behaviour assigned the administrative interest rate the attributes of the main interest rate in the economy.

2.2.1 Interest rates.

Bank of Albania used, and still does, the minimum interest rates for time deposits in Lek placed with the state owned banks as the most appropriate mechanism for transmitting monetary policy decisions. This because of the underdeveloped money market, which imposes the need to combine administrative decisions and market, forces to reach the savings supply-demand equilibrium in the economy. Through its own policy the Bank of Albania has tried to fit in the most natural way the financial sources mobilization process with the optimal method of distribution them. Meanwhile, the Bank of Albania was able to maintain a stable domestic currency, contributing to a greater public confidence to the Lek.



On the other hand, through implementing such a policy, the Bank of Albania aims at keeping under control the inflationary pressures in the economy. Keeping inflation as low as possible the Bank of Albania would meet the ultimate target, a lower price for the economic activity.

Looking very carefully at economic, financial and international developments and bearing in mind an appropriate positive level in real terms, the Bank of Albania cut several times the interest rates for time deposits in Lek. In more detail, there were six cuts bringing the rates at the end of year to 9,25 per cent, 9, 25 per cent 9,0 per cent respectively for 3, 6 and 12 month maturity from 13,5 per cent, 13,5 per cent, 13,5 per cent at the end of 1998.

A summary of the monetary developments that influenced this interest rates performance, is as follows:

- The persistent downward trend of the inflation. From 8,7 per cent at the end of 1999, the year on year inflation rate declined recording a disinflationary period from June 1999 to the end of the year. The outcome is a relatively high positive level of interest rates in real terms;
- The stable Lek. The domestic foreign exchange market remained strong during the year, registering a slight appreciation of Lek against US Dollar and more significantly against other major foreign currencies. Under such circumstances the nominal rates were considered to be much higher than the level suggested from principle of purchasing power parity of the Lek relative to other main foreign currencies.
- The steady increase in the stock of time and foreign currency deposits. In spite of the Kosova crisis, the performance of both types of deposits, in Lek and foreign exchange, is characterized by a constant monthly growth. However in certain months the tendency in specific type of deposits has been different from the remained items, providing reversal developments at specific month for deposits in domestic and foreign exchange denomination. However as mentioned above the increase of foreign currency deposits has been strong during 1999, in response to the large amounts of foreign currency inflows.

The developments in the interest rates of time deposit, in the attribute of the key rates, impacted directly on other rates. The response of the Treasury bill yield was apparent although the spread between average Treasury bill rate and deposit rates is still higher. The same behavior was seen in the rates at which the banking system is willing to credit the economy. However the pace at which the lending rate was cut came to late and was pretty small.

Obviously the differences between deposits rates and lending rates, are corresponding with current state of money market. An anticipated improvement of the money market will flatten these differences and will lead banks toward optimizing profits.

2.2.2 Repurchase agreement, Refinancing and Lombard facility.

Money market operations were mainly focussed on repurchase agreements and reverse repurchase agreement conducted with commercial banks, aiming at managing the level of excess reserves in the system. Actually the repurchase agreement instrument represents the most used money market operational tool.

Refinancing facility plays the role of the last resort of financing to commercial banks. This instrument was not applied in any case in the course of 1999, reflecting a better liquidity management from the second tier banks.

The same happened with Lombard facility loan.

2.2.3 Reserve requirement.

In the course of 1999, the rate of required reserves remained unchanged at 10 per cent, for both Lek and foreign currencies. Consequently, the evolution of required reserve mirrors only developments in the total of deposits.

Special stress should be put to the predisposition at which commercial banks have met the provisions of required reserve. The flexible way of maintaining reserve requirements – Lek denomination – created relief on meeting the daily requirements for liquidity. The usage of reserve requirements for daily liquidity purposes induced a new monetary instrument.

2.2.4 Credit Ceiling.

For 1999, the limit at which banking system was allowed to increase the stock of the credit to economy was fixed at Lek 8 billion, a higher level than the previous year. Different from the ceiling set, the amount of money realized was substantially below, evidencing the problems that credit-ceiling instrument was considered no more effective.

On the course of November 1999, based on more capable banking supervision, the stabilized monetary situation, etc. was allowed the abolition of the so-called credit ceiling for all commercial banks. This was a very important step, and should be considered as crucial action toward the use of indirect market instruments.

2.3. FORMAL AND INFORMAL FINANCIAL MARKET

The year 1999 did not marked any particular development on the organisation and functioning of the financial market in general. The situation continued to be characterised by a non-existing capital market, a limited money market and interbank market, and mixed picture on the foreign exchange market where it is difficult to recognise formal activities from the informal ones, non-monitored by the supervisory authorities.

2.3.1 Money Market.

During 1999, Bank of Albania's operations was focused on the repurchase and reverse repurchase agreements with the commercial banks. Overall volume of transactions on the repurchase agreements for the whole year amounted to Lek 87,615 million, in nominal terms. The highest transaction volumes were registered during March and October, with respectively 19.72 and 20.51 per cent of the total yearly transactions. Time length of these agreements was on the margins between 6 and 10 days at an average effective yield of 6.9 to 11.4 per cent. Calculation of the average effective yield was based on the yield rates of the latest T-bills auction at a commission remaining on the margins between 0.15 and 0.2 per cent. Therefore, for the repurchase agreements asked a period exceeding 7 days, the discount rate was increased by 0.15 to 0.2 per cent. As related to the trading volumes of the T-bills through the repurchase agreements, during 1999 an 302 transactions were done, with October marking the higher number of transactions done (36 transactions) and December (30 transactions).

The increase on time deposits with the banking system was reflected on the increased current accounts of the banks with the Bank of Albania. The average time length of repurchase agreements for the whole banking system during the last year was 7 days, which fits to the latest auction of the primary market.

As related to the position of the Bank of Albania on the repurchase agreements, monopoly position was hold by the Savings Bank which accounted for 80.8 per cent, or 70,860 million Lek of the operations on this instrument. It was followed by National Commercial Bank with 9.02 per cent or 7,900 million Lek, American Bank of Albania with 3.20 per cent, or 2,800 million Lek, Tirana Bank with 3 per cent or 2,600 million Lek, etc. On the number of transactions, the Savings Bank performed 93 transactions, followed by the American Bank of Albania with 67 transaction during the year. The average effective yield for the whole system was 8.6061 per cent.

It's worth to be mentioned these agreements were based on the initiatives of the banks and in the framework of short-term investments of their excess reserves. Time length of the repurchase agreements between banks varied between 1 to 12 days.

To match the needs of the banking system for liquidity on the short term, reverse repurchase agreements were used, which amounted at 2,269 million Lek of T-bills bought by the Bank of Albania, for a 1 to 6 days. This buying volume was done in 17 transactions in total.

In the conditions of short falls of the state budget during August 1999, the Savings Bank entered in a reverse repurchase agreement with the Bank of Albania for a 1,900 million Lek, which was the highest volume of transaction, ranking the Savings Bank as the first on the whole banking system on these transactions. Such agreement was reached with the Intercommercial Bank at a weight of 2.54 per cent, and National Commercial Bank at 7 per cent of the total. The calculated yield for these transactions was that of the market, based of the last yield rate for T-bills of 3 month of maturity, which ranged from 16.4 to 18.3 per cent.

Repurchase and reverse repurchase agreements reflected developments of banking system liquidity and they directly affected in the reduction of the monetary base.

Despite the average effective yield on these instruments was lower compared to a year ago, this did not affected the willingness of the banking system to invest their excess funds on the repurchase agreements with the Bank of Albania.

2.3.2 Foreign exchange market.

During 1999, the national currency was appreciated towards other main traded currencies on the local market. Lek appreciated by 3.9 per cent toward the US dollar and about 16.8 per cent toward the DM and other European currencies. This appreciation was mainly because of the developments on the international currency market.

In general, the Lek appreciation may be attributed to the influence of such factors as:

- * Tight monetary policy of the Bank of Albania, which resulted in a remarkable decline on the inflation rate.
- * A better management of the fiscal situation in general and of the budget deficit in particular.
- * Considerable inflows of cash and commodity aid from the international organisations to help for the deported population of Kosova settled in Albania.
- * Favourable developments on the international market, with appreciation of the US dollar and the increasing pressure of the later for the depreciation of the European currencies on the domestic market.

Box 13 : Money market operations.

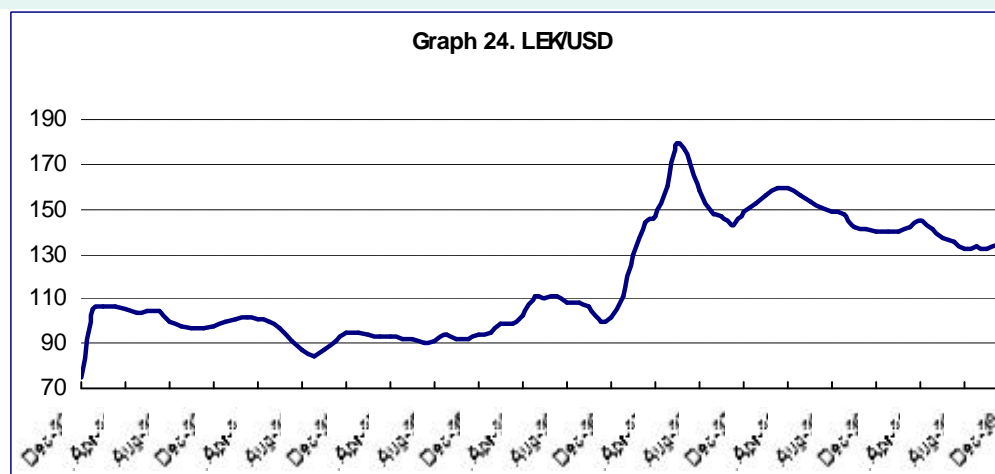
Repo operations according to the banks during 1999 in thousand Lek:

BANKS	Volume	Per cent to Total	Average Yield	Time length	Transaction
N.Comm.Bank	7.900.000	9.02	6.1902	5	38
American Bank	2.808.000	3.20	7.4542	7	67
Nat.BankGreece	30.000	0.03	9.6161	1	2
Inter.Com.Bank	54.000	0.06	7.5375	7	7
Intercomm.Bank	26.000	0.03	6.4324	8	5
Savings Bank	70.860.000	80.88	8.2162	8	93
Ital-Alb.Bank.	1.612.000	1.84	8.3814	7	37
Alpha Cred.B	1.165.000	1.33	8.8285	6	14
Tirana B.	2.630.000	3.00	8.6007	7	22
Fefad B	530.000	0.60	8.8037	10	17
Total	87.615.000	100.00	8.0061	7	302

Reverse Repo according to the banks during 1999, in thousand Lek:

BANKS	Volume	Per cent to total	Average Yield	Time length	Transaction
N.Comm.Bank	150.000	7.00	18.1884	2	2
Inter.Com.Bank	57.590	2.54	16.6862	3	8
Savings Bank	1.900.000	83.72	16.8130	3	2
Ital-Alb. Bank	140.000	6.17	18.3195	6	2
Alpha Cred B.	22.000	0.97	16.4322	4	3
Total	2.269.590	100.00	17.2879	3	17

As observed by the table, total number of transactions of 319 and volume of Lek 90 billion, market operations were limited. From 312 transactions on Repo agreements, in 93 cases and for 81 per cent of the volume of 87,6 billion Lek, the partner was the Savings Banks. From 17 reverse Repo transactions, Savings Bank participated two times only but the volume represents 83 per cent of the total.



- * A better functioning of the domestic foreign exchange market, by an increasing role of the commercial banks. According to 1999 figures, the share of the commercial banks in the total of foreign exchange transactions reported to the Bank of Albania, was 74.9 per cent.
- * An improvement of the social situation, as a result of softening of the political tensions and improvements on the domestic security.

The main event, which influenced the foreign exchange market, was the starting conflict in Kosova. At the very start, the closing of the Rinas airport made it difficult to supply of cash to the commercial banks. Bank of Albania however was able to provide the banking system with the required amount of foreign currencies and prevent the pressure on the domestic currency. After this initial period, the effect of the conflict resulted in an appreciation of Lek toward other currencies.

The highest recorded level of exchange rate of USD/Lek, was 149.00 while that of DEM/Lek, and was 82.70. These levels were registered by end March, when the military conflict started. The lowest levels of these rates were respectively 131.30 and 69.10, registered during the second half of the year. Based on the variation coefficient, volatility of Lek rate toward the US dollar was lower, except for 1995.

Currency transactions of the Bank of Albania during 1999 amounted to 109.36 million USD, of which buying amounted to 91.93 million USD while selling operations amounted to 17.43 million USD.

The highest level of transactions (96.6 per cent) was registered with the Government of Albania and the rest are transactions with foreign financial institutions such as IBRD, IDA etc. Buying operations from commercial banks have been negligible.

Selling operations were done with the commercial banks for 7.64 million USD and the Government of Albania for 9.78 million USD to cover the needs for the debt payments to the Paris Club and other creditors.

2.3.3 Informal market.

Experience of the recent years witnessed that the lack of the fiscal consolidation is not the only source of a financial crisis. Asian crisis proved that crisis may be generated even by the private sector, mainly because of the poor regulatory framework and lack of supervision.

In case of Albanian economy the potential for such a crisis remains high, considering the relatively high share of the informal private sector activity, which can not be monitored by the institutions.

Except for the banking system, regulatory framework for other financial institutions remains poorly developed. Bank of Albania has permanently made this fact clear.

However, the informal sector continues to remain high. 1999 performed the largest transactions on capital and current account performed by this market. The limited inherited experience, slow development of the markets, lack of transparency, low level of public awareness about new finances, poor supervision, etc., just to mention some of them, are main factors behind the illusions of many persons to achieve high profits at short time.

Box. 14 : What has changes since 1995 –1996.

Macroeconomic environment. Similar to 1995, economic situation is characterized by a high increase in GDP and low inflation rates. Loans extended to the economy continue to be contracted while the Bank of Albania continuously reduced the interest rates in response to inflation developments. Investment opportunities continue to be limited while inflows from the remittances continue to be relatively large.

Legal, regulatory and supervisory framework. Changes in this respect have been limited. They were mainly responding to changes in a clear definition on the role of the Bank of Albania and the environment for the commercial banking. Bank of Albania has revised the regulatory framework for the operating of the banking system, such as with the licensing procedures, etc. However, other substantial pieces of legislation, such as on money laundering, improvements on the Civil Code, etc., are not yet enacted.

Market development. Since 1995, there are no substantial improvements on the market development. Such terms as money market, interbank market, capital market, etc., barely exists and is mainly a matter of propaganda. As in 1995, we may distinguish that the only real functioning market is that of foreign exchange which continues to function on market principles. But even this market continues to operate not in a perfect environment, in terms of location, market participants and supervision. In the largest part, this market is operated by unidentified operators, not in an organized place and mainly is not supervised.

Structural reforms and liberalization of the economy. Structural reforms continue to surmount for a number of years, which is evident on the reports identifying the agenda for government actions. Since 1995, the priorities continue to be speeding of privatization of the economy, administrative reforms, banking system restructuring, restructuring of the judiciary system, etc.

Business development. Following the *shock* of 1997, private business seems to have entered in a reviving stage. However, this process will require additional financing, which in the absence of a proper banking response, will be met by informal channels.

A couple of other factors, which warns for the danger of informal market, may be listed. However, the mentioned factors are the most representatives and they make clear that priority for **the formalization of the informal markets is of strategic importance and is the main ingredient to ensure a sustainable long term economic growth.**

Chapter Three

Banking Supervision

During the '90's, the structure of the Albanian banking system has changed in favor of the increase of the number of banks in general and the increase of private banks with foreign capital. Starting from three commercial banks with state capital that were inherited from the past system, at the end of 1999 the Albanian banking system consisted of 13 second-tier banks. Three new private banks started their activity in 1999.

The geographical extension has been another characteristic of the Albanian banking system during the '90's. The banking network is concentrated in the city of Tirana. During 1997 the banking system underwent a notable reduction, as a consequence of the revoking of the license of the Rural Commercial Bank and the reduction of branches for the National Commercial Bank (both state owned banks). Since 1998-1999 the banking network is being slowly extended with the opening of other branches and agencies by private banks. Two bank branches and 3 agencies have been opened during 1999.

The total number of the employees in the banking system at the end of 1999 reached 2813.

Anyway, the banking system continues to be concentrated and the main burden of many banking activities is carried by the Savings Bank. A clear tendency of this bank to lose its shares in the market, which favors competition, is noted, but this process is slowly proceeding. So, there are still many problems in the Albanian banking market.

3.1. STRATEGIC OBJECTIVES OF BANKING SUPERVISION.

The strategic objective of the banking supervision is the establishing of a safe and sound banking system.

In this framework, the Bank of Albania is committed to provide within a mid term period:

the establishment of a legal and regulatory framework in compliance with the directives of the European Union and international standards of the Basle Committee on Banking Supervision.

✍ the adherence to the legal and regulatory framework.

✍ the restriction of excessive risks undertaken by banks, which, on their part endangers their depositors.

✍ the increase of co-operation with supervising authorities of other countries, mainly from those countries that has invested in the banking field in Albania.

The specific duties to be realized within a short-term period to be mentioned are:

I. The improvement of supervision towards allowing new banks in the country. The Bank of Albania aims at allowing other new banks and financial subjects that promise to establish safe and sound banking institutions and do not threaten the safety and stability of the banking system in the market. Ways ranked to achieve this are:

✍ the increase of minimum capital for new banks to USD 7 million, which is required by the directives of the European Union.

✍ the compilation of a licensing and regulatory framework for other non-banking financial institutions in order to increase the variety of “players” in the financial market.

✍ extension of the regulatory and licensing framework to deal with matters of ceasing and/or reducing banking activities, of mergers, acquisitions, divestiture of the banks and changes of bank management control. These are unfaced phenomena in the Albanian banking system until now.

II. The improvement of the regulatory and supervising framework of the second-tier banks. The main focus of this process will be strengthening enforcement of the approved rules, the holding of a more conservative position towards supervising norms and requests compared to the international standards due to the high risk represented by the Albanian economic environment; the strengthening of the correcting measures on second-tier banks; the strengthening of the inspection capacity and time reduction between inspections in a commercial bank from 18 to 12 months.

III. The strengthening of capacities to analyze the financial situation of the banks in order to develop an early warning system.

IV. The improvement of supervision of the process of dealing with problem banks.

3.2. LICENSING AND PRUDENTIAL REGULATIONS

The passing of the law on “The banks in the Republic of Albania” in July 1998 forced the reviewing of the whole regulatory framework of the banking supervision to provide compliance with the clauses of the new law. The accomplishment of the 25 core principles of the Basle Committee on Matters of the Banking Supervision was the focus of attention of the reformulation of supervisory rules. The standard manual of accounting for all banks was implemented in January 1, 1999. This required agreement between the new chart of accounts and the banking supervision rules, especially those that include accounts of different indicators.

13 regulations were revised or formulated as during 1999. Currently, the regulatory framework in the area of banking supervision is considered almost complete and broadly in accordance with the respective international standards.

In 1999 the Bank of Albania licensed:

-three new banks namely¹⁶:

FEFAD Bank ;

The First Investment Bank, Tirana branch ; and,

Intercommercial Bank ;

-a non-banking financial institution¹⁷ “Unioni Financiar” ; and

-ten foreign exchange bureaus¹⁸.

Based on the law “On Banks in the Republic of Albania”, the Bank of Albania is allowed to extend its supervising authority even on non-banking entities that exercise financial activity. For this reason, the framework of licensing regulations was further completed by the approval of the regulation “On licensing the financial activities of non-banking subjects in the Republic of Albania”. This increases the safety of the financial system in our country, especially after the disturbances caused by the 1997 crisis.

¹⁶ Licenses are given on the basis of the bank licensing regulation.

¹⁷ Licenses are given based on the non-banking financial subjects regulation.

¹⁸ Licenses are given based on the currency activity regulation.

Box 15 : Regulations approved and revised by the Supervising Council of the Bank of Albania during 1999.

* The regulation “On the amount and completion of the minimal initial capital for permitted activities for banks and foreign banks branches” sets the conditions when the extension of the activity of a bank is allowed.

* The regulation “On requirements to be met by the administrators of banks and foreign banks branches” the new version determining the conditions that are to be met by the administrators of the banks that exercise banking activity in the Republic of Albania.

* The guideline “On the regulatory capital of the bank” determines the ways of calculating this indicator, in order to cover credit risk.

* The regulation “On the foreign exchange open position” and the guideline “On the risks of foreign exchange”. Both documents aim at giving to the banks a set of rules to help reduce the risk in foreign exchange activity.

* The regulation “On the capital adequacy” that determines a more conservative standard for capital adequacy, increasing it from 8 to 12 per cent.

* The regulation “On foreign exchange activity” clarifies the allowed and non-allowed activities in the capital account and current account. The criteria based on which money transfer operations from and to the Republic of Albania are settled by this regulation, and the amounts of foreign exchange allowed to enter and to leave its territory are determined. The regulation divides the payments into commercial and non-commercial categories and describes the required documentation to accomplish the payments.

* The regulation “On the market risks” is a new regulation, introduced for the first time, describes the criteria base on which the adequate level of the regulatory capital to cover the market risks is determined.

* The regulation “On the large risks” describes the criteria based on which the large risks undertaken by a bank as a result of loan portfolio concentrations to a single borrower or a connected group of borrowers will be controlled.

* The guideline “On the internal control of the banks” gives instructions for the commercial banks on how to organize more effective internal controls and how to report the results of these controls to the Bank of Albania.

* The regulation “On the participation of the commercial companies capital from the banks and foreign banks branches”. In case the banks or the foreign bank branches require taking part in the capital of commercial companies, they should firstly provide themselves with the respective authorization from the Bank of Albania. Thus, this regulation categorizes the conditions under which such an authorization can be given and which criteria that should be met by each entity.

* The regulation “On the banks liquidity ratio” determines the quantitative levels based on which the banks would restrict liquidity risks. During the application of this regulation it was noticed that the determination of a quantitative level was not an efficient way to control and to manage the liquidity risk because it settled a unique norm for banks with different liquidity profiles. So, the regulation was revised in January 2000 determining the principles based on which each bank manages itself the liquidity risk.

3.3. THE SUPERVISION OF THE FINANCIAL SITUATION IN THE SECOND-TIER BANKS

One of the responsibilities of banking supervision is the analyzing of the financial situation of the banking system and of individual banks in regular time periods of three months. At the end of 1999, the Albanian banking system improved its financial situation. The profit resulted to be Lek 1.3 billion, while in the two previous years the banking system suffered considerable loses of Lek 7.9 billion and Lek 3.2 billion respectively for 1997 and 1998.

Considering the structure of the Albanian banking system it has been evaluated that the main reason for this profit is the favorable climate for the banks, caused by the continuous decrease of the interests of deposits in Lek. The reduction of this rate reduced the costs of funds (Lek liabilities¹⁹) of the banks. On the other hand, the yield of the treasury bills and the lending rates have been reduced, although at a slower pace. This has lessened the pressure on banks and has increased the possibilities for profits. So, the net income from interests for the banking system was a positive Lek 5.1 billion at the end of 1999, while at the end of 1998 it was negative for Lek 39.9 million. The profits of 1999 improved the capital position of the banking system. **In general, the Albanian banking system is inadequately capitalized because of the lack of capital in the group of state owned banks. The capital adequacy norm for the system of 8.2 per cent**, is below the standard. The profit of Lek 973 million of the state owned banks is one of the sources that will improve the capital basis. Actually, the capital's inadequacy in these banks has been reduced from 40per cent at the end of 1998 to 11 per cent at the end of 1999. Anyway, the capital adequacy level for the other two groups (joint-venture banks and private banks, respectively 44.9per cent and 43.5per cent) is higher then the minimum approved standard (12 per cent). This is an important fact that leaves space for these banks to extend their activity in the future without harming the capital position.

The capital position was strengthened even by the decision taken in March 31, 1998 by the Supervisory Council of the Bank of Albania to increase the minimum paid capital for the existing banks up to Lek 500 million by September 1999. Almost all banks increased their capital within the determined schedule. Only three banks did not respect the schedule. Considering the conditions and the reasons for not respecting the schedule, the Bank of Albania approved its postponing for one bank until February 2000 and for two other banks until the end of 2000²⁰.

¹⁹ Lek liabilities represent 69.5 per cent of total balance of banking system. Their concentration is different for different groups of banks. More specifically, the share of Lek liabilities in total liabilities are 81.9 per cent for state-owned banks and 8.4 and 18.8 per cent for joint-venture and private banks respectively.

²⁰ This bank increased its capital within February 2000.

Although it can be said that lending activities of the banking system is small compared to the total of the balance sheet, covering only 4.2per cent of it, it is important to deal with the quality of loan portfolio.

The most notable problems in the quality of loan portfolios were encountered during the '90's, forcing the Bank of Albania to suspend lending activities for the state-owned banks and one private bank. In 1999, as a result of the extension in this activity of many private banks, the situation of the credit portfolios somehow improved. Standard loans represent 39.7per cent of the total outstanding loans for the entire banking system, while 87.9per cent of the loan portfolio of the state-owned banks are non-performing loans. Anyway, such a classification of the portfolio, being an inherited problem throughout the years, has not significantly increased financial expenses through the creation of reserve funds to cover the credit losses. These expenses represent only 4per cent of the total of financial expenses for the banking system.

During 1999, the structure of the banking system didn't show any notable change. The Albanian banking system still remains dominated by the Savings Bank and its segmented activities. State owned banks are concentrated in Lek activity, while private banks in foreign exchange activity. In general, the banking system is not aggressive in the lending activity. Total loans during one year increased only 14per cent while the total of current accounts and deposits increased by 23 per cent.

Table 10: Relative importance of banks groups (in %).

Items	Group 1	Group 2	Group 3
1. Current and deposit accounts	84.8	4.5	10.6
2. Shareholder capital	6.6	38.1	55.3
3. Net loans	20.0	41.8	38.1
4. Treasury Bills	96.0	0.7	3.3
5. Placement with banks	56.2	11.7	32.2

Source: Bank of Albania

Table 11: Profitability, 1999 (in %)

Items	Group 1	Group 2	Group 3	Banking System
1. Net profit / GDP	0.19	0.04	0.02	0.24
2. ROA*	0.5	1.6	0.3	1.00
3. ROE**		6.1	2.0	27.90
4. Net interest income / Total average assets	2.1	4.1	2.9	2.3
5. Operating expenses / Total average assets	0.9	3.0	4.0	1.4
6. Provisioning / Total average assets	0.8	0.6	0.1	0.7

Source: Bank of Albania

3.4. ON-SITE INSPECTION

The On-site Inspection Unit carries out on-site inspections, which is part of the Bank Supervision Department. During 1999, 14 banking inspectors, who are responsible for inspecting 13 second-tier banks and 15 foreign exchange bureau, carried out the inspections. This is the number of inspections carried out:

22 general inspections, out of which:

7 in second-tier banks and ;

15 in foreign exchange bureau.

18 special-target inspections in the second-tier banks.

Banking supervision and bank inspections, based on the laws and rules in effect, are exerted on all banks without making differences due to the origin of their capital (foreign, domestic, state owned or private) or whether they are banks or foreign banks branches.

During 1999 examination of banking activities concentrated on evaluating the following:

- Strategic objectives developed by the individual banks and foreign branches;
- The reasonableness of individual business planed; and
- The adequacy of internal positions and procedures adopted by the banks and foreign branches.

Identifying, measuring, controlling and monitoring the risks the banks are faced with and especially the risks of the most important activities have been among the main directions of on site inspection. Special care has been taken towards the strengthening of the role of internal control, acquaintance with the bank staff with internal acts and supervising authority, the completion, apart of increasing the bank activity with the necessary structures.

The complete inspection period for each bank, as a general rule, has been decided to be carried out every 18 months. Anyway, the on site inspections are carried out starting from the risk scale and the financial situation of a particular bank in order to have enough time to take correcting measures.

An important development in the inspection process of the banks is considered to be the compilation and usage of the standard examination report. The examination report is the written communication that is used to present examination findings and recommendations to the directors of the Bank of Albania and to the directing council of the inspected bank. It contains the most important achievements, conclusions and recommendations for corrections, which are a result of an inspection.

Box 16 : Examined banking areas.

During 1999, the on site inspections have been mainly concentrated on:

* **Banking activities that represent high risk in lending activities.**

Several important problems have been made evident concerning lending activities. Several banks have not always followed adequate policies and procedures in lending area. In certain cases, the regulations and instructions of the Bank of Albania on loan classification and the creation of reserve funds to cover loan losses have not been taken into consideration. Infringement of supervision norms for a borrower or a group of connected borrowers has been made evident. The reserve funds created by the banking system to cover the losses caused by loans were Lek 12.8 billion. After the inspections it was determined that this fund was not adequate. An additional Lek 409 million or around 3.2 per cent more are to be set aside.

* **The functioning of the assets and liabilities management committee.**

It has been noticed that the procedures of the assets and liabilities management committee (ALCO) have not operated as an important part of bank management.

* **Foreign currency activity.**

Deficiencies concerning adequate procedures of foreign currency activity of the banks and the maintaining of open currency positions in conformity with the rules approved by the Bank of Albania were evident.

* **Applying the regulations of the foreign exchange activity.**

The regulation on "The foreign exchange activity" regulates the executing of current payments abroad and imposes several restrictions in the capital account. After several inspections in the country it resulted that some banks had not undertaken complete measures to apply the regulation.

* **Internal control functioning.**

Internal controls in some banks still present some deficiencies that have to do with the failure to have sufficient staff to cover all areas. In some cases the independence of the internal audit function is compromised because of inappropriate reporting lines (not directly to the Board of Directors).

Table 12: Banking system data.

Banks	No. of branches	Paid capital / Total balance (%)	Total deposits / Total balance (%)	Total net loans / Total balance (%)	Nonperforming loans / Total loans (%)	Treasury Bills in % of Banking system
1. National Commercial Bank	10	7.9	64.8	33.2	86.2	40.70
2. Savings Bank	30	0.3	90.8	4.3	88.2	89.70
3. Italian Albanian Bank		10.0	69.6	35.0	7.5	0.70
4. Arab Albanian Islamic Bank		78.3	32.8	0.0	0.0	0.00
5. Dardania Bank		8.9	32.8	0.0	100.0	0.00
6. Tirana Bank	2	13.8	75.1	15.8	15.9	1.60
7. National Bank of Greece, Tirana Branch		9.1	79.7	0.3	100.0	0.36
8. International Commercial Bank		49.4	55.7	46.7	0.0	0.00
9. Alpha Credit Bank, Tirana Branch		16.8	75.5	17.2	0.0	0.57
10. American Bank of Albania		10.3	88.6	9.4	0.2	0.34
11. FEFAD Bank	2	20.3	72.7	39.6	1.2	0.43
12. First Investment Bank, Tirana Branch		59.8	3.0	0.0	0.0	0.00
13. Intercommercial Bank		65.2	5.1	0.0	0.0	0.02

Source: Bank of Albania

The preparation of the complete inspection findings based on this report has improved the communication with banks. Bank managers can judge better and more quickly the bank's situation concentrates on the main problems and issues, without dealing details. The standardized report has notably enlightened the examining work and has increased its quality.

Chapter Four

Financial Statement of the Bank of Albania

4.1. BALANCE SHEET

ASSETS		1999
	Note no.	Lek (million)
Foreign assets		
Gold	3	977
Deposits with the International Monetary Fund	4	21,559
Deposits with foreign banks	5	41,382
Securities	6	13,791
Other foreign assets	7	431
Total foreign assets		78,140
Domestic assets		
Transit credits	8	6,686
Loans to the Government	9	32,258
Investments in securities	10	40,938
Other domestic assets	11	2,315
Total domestic assets		82,197
Total Assets		160,337

The accompanying notes are an integral part of these financial statements.

LIABILITIES		
Foreign liabilities		
Due to the International Monetary Fund	12	21,434
Due to non-resident financial institutions	13	8,118
Other foreign liabilities		19
Total foreign liabilities		29,571
Domestic liabilities		
Currency in circulation	14	82,946
Due to domestic banks	15	27,137
Due to the Government	16	3,559
Other domestic liabilities		67
Total domestic liabilities		113,709
STATUTORY FUND AND RESERVES		
Statutory fund		750
Legal reserve		3,750
Revaluation reserve		2,917
Other reserves		7,407
Retained earnings		2,233
Total statutory fund and reserves		17,057
Total liabilities and statutory fund and reserves		160,337

The accompanying notes are an integral part of these financial statements.

4.2. STATEMENT OF PROFIT AND LOSS

		1999
	Note no.	Lek (million)
Operations with non-residents		
Interest and commission income		2,381
Interest and commission expense		359
Interest and commission from operations with non-residents, net		2,022
Operations with residents		
Interest and commission income		15,105
Other operating income, net	17	18
Net operating income		17,145
Other non-operating expenses		
Staff costs	18	142
Depreciation		66
Amortization of printing and minting costs		244
General and administrative expenses		48
Other expense		50
Total other non-operating expenses		550
NET PROFIT		16,595

The accompanying notes are an integral part of these financial statements.

4.3. STATEMENT OF STATUTORY FUND AND RESERVES

Lek (million)	Statutory fund	Legal reserve	Revaluation reserve	Other reserves	Retained earnings	Total
As of December 31, 1998 (unaudited)	750	3,750	6,906	7,223	2,233	20,862
Net profit	-	-	-	-	16,595	16,595
Foreign currency and gold revaluation	-	-	(3,989)	-	-	(3,989)
Profit distribution	-	-	-	184	(16,595)	(16,411)
31 dhjetor 1999	750	3,750	2,917	7,407	2,233	17,057

The accompanying notes are an integral part of these financial statements.

4.4. GENERAL INFORMATION

The Bank of Albania (the “Bank”) is the central bank of the Republic of Albania and was established according to the “Law on the Bank of Albania” in 1992. Under the terms of its charter the Bank’s main responsibilities are:

- establish and maintain price stability;
- supporting the development of a foreign exchange regime;
- management of money in circulation;
- management of interest rates;
- prognosis and analysis of economic and social development indicators within the Republic of Albania;
- supervision of commercial bank activities including issue of licenses to all banks;
- operating within the Republic of Albania and issuing of permissions for undertaking international
- banking activities.

The Bank is subject to the regulatory requirements of the Parliament of the Republic of Albania and the “Law on the Bank of Albania”.

4.5. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared in accordance with the Law “On Accounting”. International Accounting Standards (“IAS”) have been used only where they are appropriate and applicable to the activities of a national central bank.

The significant accounting policies used by the Bank in these financial statements are set out below:

4.5.1 Basis of preparation.

The financial statements presented include the accounts of the Bank prepared on the historical cost basis of accounting modified to include the revaluation of foreign currency and gold.

The accompanying financial statements are presented in the national currency of the Republic of Albania, the Albanian Lek (“LEK”).

4.5.2 Interest and commissions.

In these financial statements, interest income and expense is recognized on the accrual basis.

Commission income is credited to income when received.

Commission expense is debited to expense when paid.

4.5.3 Foreign currency translation.

Transactions denominated in foreign currency are translated into LEK at the Bank’s official exchange rate on the date of the transaction.

Foreign currency assets and liabilities are translated into LEK at the Bank’s official exchange rate valid on the balance sheet date. Unrealized foreign exchange gains and losses are credited or charged to the revaluation reserve.

The applicable official Bank rates (LEK to the foreign currency unit) for the principal currencies as at December 31 were as follows:

	1999
United States dollar (“USD”)	135.12
German mark (“DEM”)	69.43
Italian lira (“ITL”)	0.07
European currency unit (“Euro”)	135.80
British pound (“GBP”)	218.22
Swiss franc (“SFR”)	84.66
Special drawing rights (“SDR”)	185.25

4.5.4 Investments.

Domestic treasury bills to cover the State budget are stated at cost plus amortized discount. United States treasury bills and domestic short-term treasury bills are stated at market value.

4.5.5 Repurchase agreements.

Securities purchased under repurchase agreements are accounted for as collateralized loans. Securities sold under repurchase agreements continue to be accounted for as securities and disclosed as "Treasury bills under repurchase agreements". As of December 31, 1999, there were no such securities outstanding.

4.5.6 Fixed assets.

The fixed assets are stated at historical cost less accumulated depreciation.

If the fair value of a fixed asset is lower than its carrying amount, due to circumstances not considered to be temporary, the fixed asset is written down to its fair value.

Gains and losses on disposal of fixed assets are recognized in the profit and loss account in the year of disposal. Depreciation is provided on all fixed assets based on the historic cost. The annual charge for depreciation is computed using the straight-line method using rates specified for each depreciable asset based on estimated useful lives. The estimated useful lives applied are:

B u i l d i n g s	3 3 v j e t
V e h i c l e s	5 v j e t
F u r n i t u r e , f i x t u r e s a n d e q u i p m e n t	1 0 v j e t
C o m p u t e r h a r d w a r e	3 v j e t

4.5.7 Printing and minting costs.

The costs of printing banknotes and minting coins are capitalized and amortized over two years and ten years, respectively.

4.5.8 Taxation and profit allocation.

The Bank is exempt from income tax according to the "Law on the Bank of Albania" and is required by law to pay 100per cent of its statutory profit directly to the State budget after allocations to replenish the levels of reserve funds directed by the Supervisory Council.

4.5.9 Legal reserve.

In accordance with Albanian banking legislation, the Bank has established a legal reserve into which 25per cent of the net profit for the year is transferred until the reserve amounts to 500per cent of the statutory fund.

4.5.10 Use of estimates.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

4.5.11 Managed assets.

At December 31, 1999, the Bank holds as custodian short-term treasury bills issued by the Ministry of Finance and gold and other precious metals on behalf of the Government. As the Bank acts as custodian for these assets it does not bear any credit risk related to them.

These assets are excluded from the Bank's balance sheet.

4.6. ASSETS

4.6.1 Gold.

As of December 31, 1999, the value of gold reserves owned by the Bank was LEK 977 million, being 16,302.056 troy ounces of gold placed in gold time deposits abroad (LEK 641 million) and 8,007.88 troy ounces in a domestic vault (LEK 336 million).

Gold is valued at the London fixing rate on the balance sheet date. Differences resulting from the revaluation of gold are recorded in the revaluation reserve. As of December 31, 1999, the price for one troy ounce of gold was USD 290.85.

4.6.2 Deposits with the international monetary fund.

As of December 31, 1999, deposits with the International Monetary Fund ("IMF") are comprised of:

International Monetary Fund	11,173
Special Drawing Rights ("SDR")	10,386
Total	21,559

Deposits with the IMF resulted from the membership of the Republic of Albania in the IMF, which is secured by a promissory note issued by the Government. SDR within the reserve tranche are equal to the Republic of Albania's membership quota paid to the IMF in SDR and LEK which represent the counterpart of loans which were granted to the Republic of Albania as disclosed in Note 12.

4.6.3 Deposits with foreign banks.

As of December 31, 1999, deposits with foreign banks are comprised of:

Current accounts	9,688
Short-term deposits	31,694
Total	41,382

Deposits with foreign banks are denominated mainly in USD and DEM.

4.6.4 Securities.

As of December 31, 1999, securities are comprised of:

United States treasury bills	13,158
Other investments	633
Total	13,791

The United States treasury bills mature on various dates between March and December 2000 and the income earned is derived from the difference between the nominal value on maturity and the discounted purchase value, which is amortized to income over the life of the Treasury bill. Other investments include participation in the European Bank for Reconstruction and Development and the World Bank and its associated organizations.

4.6.5 Other foreign assets.

As of December 31, 1999, other foreign assets are comprised of cash on hand in foreign currency of LEK 206 million and accrued interest on deposits with foreign banks of LEK 225 million.

4.6.6 Transit credits.

As of December 31, 1999, transit credits, by industrial sector, are comprised of:

Agriculture	1,437
Industry	4,245
Services and other	1,004
Total	6,686

Transit credits represent interest-free credit facilities, which were provided to credit institutions for further distribution to ultimate borrowers to support state development programs (See Note 13). The Government guarantees all loans.

4.6.7 Loans to the Government.

Of the total loans to the Government as of December 31, 1999 totaling Lek 32,258 million, LEK 22,829 million bears interest at an average rate of 5.5per cent during 1999 and LEK 9,429 million is interest free.

4.6.8 Investments in domestic securities.

As of December 31, 1999, investments in securities – domestic are comprised of:

Treasury bills to cover the State budget	24,592
Short-term treasury bills	13,240
Securities for cooperatives	1,958
Securities for the capitalization of the National Commercial Bank (“NCB”)	1,148
Total	40,938

Treasury bills to cover the State budget relate to loans given to the Government from 1994 to 1999, which were converted into bonds. The interest rate is set for 6 months based on the discount rate for short-term treasury bills which as at December 31, 1999 varies from 15.4per cent to 19.5per cent. The maturity for these bills is 6 months, which is normally renewed.

Securities for cooperatives relate to a loan to State agriculture cooperatives prior to 1992. The Government has issued securities in the amount of the loan. These securities bear interest at a rate of 1.5per cent.

Security for the capitalization of the NCB relates to a zero coupon bond which was issued by the Government to replace the Bank’s participation in the capital of the NCB. The security bears interest of 6per cent per annum and matures in 2006.

4.6.9 Other domestic assets.

As of December 31, 1999, other domestic assets are comprised of:

Accrued interest	1,027
Other debtors	352
Loans to employees	350
Fixed assets, net	292
Inventory	13
Other	244
Total	2,315

As of December 31, 1999, the net book values of fixed assets by category are comprised of:

Bank of Albania

Other fixed assets	278
Buildings	125
Vehicles	94
Construction work-in-progress	6
	<hr/>
	503
Accumulated depreciation	-211
	<hr/>
Total	292

According to Albanian law, the legal title on the Bank's buildings is unclear. The management is of the opinion that this issue will be resolved with the Ministry of Finance in the near future in favor of the Bank.

4.7. LIABILITIES AND CAPITAL

4.7.1 Due to the international monetary fund.

As of December 31, 1999, due to the International Monetary Fund is comprised of:

Enhanced Structural Adjustment Facility ("ESAF")	10,882
IMF securities account	8,727
IMF account in LEK	1,825
Total	21,434

ESAF borrowings related to the Republic of Albania's IMF quota and mature between 2003 and 2005. ESAF borrowings from the IMF were drawn down on behalf of the Government for macroeconomic reforms.

4.7.2 Due to non-resident financial institutions.

As of December 31, 1999, due to non-resident financial institutions is comprised of:

Transit credits (Note 8)	6,689
Loan from the Bank of Greece	1,237
Due to World Bank	192
Total	8,118

Transit credits were provided by Kreditanstalt fur Wiederaufbau (LEK 6,032 million) and the European Investment Bank (LEK 657 million). The domestic banks and companies pay interest directly to the providers of the finance.

The loan from the Bank of Greece (Hellenic Republic borrowing) was granted for the purpose of funding the balance of payments of the Republic of Albania. The interest rate is set as 4per cent per annum, payable semi-annually. The loan matures in 2018.

4.7.3 Currency in circulation.

The exclusive rights of national currency issue are vested with the Bank. This item comprises valid domestic banknotes and coins in circulation issued by the Bank.

As of December 31, 1999, the following banknotes and coins were in circulation:

Nominal Value	Number	Value
Lek	in thousand	Lek (million)
1	21,016	21
3	6,489	20
5	6,373	32
10	7,684	77
50	749	38
100	17,831	1,783
200	27,706	5,541
500	64,048	32,024
1,000	40,298	40,298
5,000	476	2,380
Coins		732
Total		82,946

4.7.4 Due to domestic banks.

As of December 31, 1999, due to domestic banks is comprised of:

Foreign currency	
Correspondent accounts of commercial banks	84
Cumulsory reserves of commercial banks	5,684
	5,768
Domestic currency (LEK)	
Demand deposits	20,584
Treasury bills under repurchase agreements	785
	21,369
Total	27,137

The Bank does not pay interest on demand and term deposits from resident banks.

4.7.5 Due to the government.

As of December 31, 1999, due to the Government is comprised of:

Deposits received on behalf of the government	1,562
Undistributed profit appropriation	1,903
Other	94
Total	3,559

Deposits received on behalf of the Government represent funds received by the Bank from a loan granted to the Government by the International Organization for Economic Development.

4.7.6 Other operating income, net.

For the year ended December 31, 1999, other operating income is comprised of:

Net loss from sales of investments	-1
Net profit from foreign currency and precious metals	3
Other income	16
Total	18

4.7.7 Staff costs.

Staff costs consist of employees' salaries, social and other costs. Social costs represent mainly compulsory contributions to the Social Security Fund, State Employment Fund and others. As of December 31, 1999, the Bank had 272 employees.

4.7.8 Contingencies and commitments.

The Bank is involved in a number of lawsuits and legal proceedings arising in the ordinary course of business. Management is of the view that these proceedings will not have a material effect on the financial position or operating results of the Bank.

There were no other significant commitments or contingencies.

4.7.9 Prior year balances.

The prior year balances were not presented, as these were prepared according to Albanian accounting requirements, which are significantly different from International Accounting Standards. Management believes that it would not be practicable to provide comparative information in the financial statements for the year ended December 31, 1999.

4.8. INDEPENDENT AUDITORS' REPORT

To the Supervisory Board of the Bank of Albania:

We have audited the accompanying balance sheet of the Bank of Albania (the "Bank") as of December 31, 1999. We were also engaged to audit the related statements of profit and loss and statutory fund and reserves for the year ended December 31, 1999. The balance sheet is the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as described in the following paragraph, we conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We did not audit the balance sheet as of December 31, 1998, since that date was prior to our appointment as auditors, adjustments to which could materially affect the determination of the statement of profit and loss for the year ended December 31, 1999; accordingly, we are unable to express, and do not express, an opinion on the statement of profit and loss and statutory fund and reserves for the year ended December 31, 1999.

In our opinion, the balance sheet presents fairly, in all material respects, the financial position of the Bank as of December 31, 1999 in accordance with International Accounting Standards ("IAS") modified for generally accepted accounting policies applicable to national central banks.

Deloitte & Touche, Sh.p.k

Tirana, Albania

March 31, 2000

Chapter five

Other activities of the Bank of Albania

5.1. PAYMENT SYSTEM

Strategic objectives for the development of the Albanian payment system

Increasing the currency circulation through the banking system and, therefore, reducing cash in the economy, remains a strategic objective for the Bank of Albania.

To achieve the said objective, two ways are identified: improve the interbank payment system and improve the small value payment system.

The Bank of Albania will also focus on the following targets:

- Implementing a RTGS for large value payment processing by the end of year 2001.
- Automatization of the existing clearing system for payment orders and checks as well as for the establishment of new clearing centers.
- Standardizing the payment instruments, focusing primarily on the standardization of the existing payment instruments (payment orders, checks) as well as approaching existing international standards.
- Enhancing the information and transparency with the public through increasing the number of publications dealing with the payment system and its components.
- Improving the legal and regulatory framework covering the payment system.

5.1.1 General information.

The payment system did not significantly improved during year 1999. In general, the payment system in Albania continues to suffer the same deficiencies observed over the previous years such as: a large amount of cash in circulation, delays in money transfers, particularly within the country, a large technological gap and banking network among the banks etc.

However, during 1999, several developments in the banking and financial system, such as establishment of new banks, consolidation of the existing banks, establishment of new branches from the private banks outside Tirana etc., induced an increase in the transaction volume carried out through the payment system. They also strengthened the need for prudent management of liquidity and risk from the banks. In this framework, during 1999, the Bank of Albania unified the required reserve account and excess reserves account of the banks held with the central banks. Therefore, the daily management of liquidity by the banks improved and, on the other hand, the payment system risk reduced.

Yet, several steps were taken in 1999 to affect the development and improvement of the interbank payment system in Albania. The Bank of Albania took a decision to implement a system, similar to RTGS, to minimize and monitor the payment system risk, improve interbank communicating infrastructure, support the further development of payment system, and reduce cash payments.

Complying with the Decision, during 1999, the Bank of Albania elaborated a document, namely “Business requirements for the RTGS system²¹”, that details all Bank of Albania technical and operational requirements for the system.

The Bank of Albania also implemented SWIFT to carry out customer payment orders clearing.

Finally, the National Payment Committee engaged mainly in the process of interbank harmonization and co-ordination with regard to the payment system. Steps were taken to standardize payment orders, checks, agreements regulating the use of direct debiting and standing order as well as to unify terms within Lek payments through payment orders and checks.

5.1.2 Payment instruments.

Payment instruments widely in use during 1999 continue to be the payment order and bank draft. Compared with a year ago they were used more extensively. The total volume of payments registered in clearing sessions during 1999 was roughly Lek 50 billion (or USD 357 million). This amount represents only 7.2 per cent of the total amount of money circulated in bank accounts. The clearing volume during 1999, as such, increases almost 35 per cent compare to 1998.

²¹ “Business requirements” or “Users requirements” describes the system which has to be developed from the user standpoint to realize all the undertaken improvements.

Payments executed through bank drafts for the entire year amounted to Lek 24.5 billion (or USD 175 million) or 57 per cent higher compared to year 1998. The number and amount of payments were also higher than the previous year by 21 and 32.6 per cent respectively. The increase was induced mostly by the use of bank drafts, particularly for the payment of customs duties as well as other duties. Businesses were assisted in their interest to increasingly get rid of cash payments. Payment orders, which amounted to Lek 25.6 billion (or USD 185 million), also, increased by 15.7 per cent compared to a year ago. The daily average amount of payment instrument settled in clearing sessions, at Lek 199 million (or USD 1.2 million), consists of payment orders at Lek 100 million and the rest are bank drafts. Both the numbers of payment orders and bank drafts processed increased from 43,183 and 4,800 respectively in 1998 to 53,357 and 7,000 respectively in 1999.

Yet, during 1999, several private banks introduced new payment instruments such as ATMs, Diners Club and Visa cards. Their use is still very limited. However, it is very important that Albanians devote the second-tier banks in Albania to the improvement of their internal infrastructure to support the use of non-cash payment instruments. This implies an improvement in banking technology in Albania, of the culture of the relations between banks and the population and, in the long run, will positively affect payment system development in Albania.

However, cash, considered as the main and most reliable means of domestic payments, still prevail the Albanian economy.

Table 13: Volume of clearing transactions in 1999.

Instrument	Volume		Value	
	1998	1999	1988	1999
Payment order	43.183	53.357	22,161,675.00	25,642,048.00
Bank draft	4.837	6.000	15,538,479.00	24,372,365.00
Total	48.020	59.357	37,700,154.00	50,014,413.00

Source: Bank of Albania

Table 14: Average value of the payment instrument

Instrument	Average value per instrument		Monthly average value	
	Year 1988	Year 1999	Year 1988	Year 1999
Payment order	513,204.00	480,575.15	1,846,806,226.00	2,136,837,333.33
Bank draft	3,212,421.00	4,062,061.00	1,294,873,247.00	2,031,030,416.67
			3,141,679,474.00	4,167,867,750.00

5.2. CURRENCY ISSUING

Currency issuing in the mid-term

The Bank of Albania aims at improving the currency in circulation structure in favour of large denominations of Lek 500 and 1000. Taking into account the need to substitute damaged banknotes as well as those that are to be withdrawn from the circulation, nearly 50 million pieces of banknotes will be printed. Their cost amounts to USD 2.5 million.

During 1999, the Bank of Albania Printing House printed 710.000 pieces of 5 Lek coins and 974.893 pieces of 1 Lek coins. Their total value amounts to Lek 4.524.893. **New issue amounts to Lek 85 billion while the outstanding issue amounts to Lek 174.6 billion.**

Currency in circulation increased compared with the previous year. The value of currency in circulation is estimated at Lek 82,908,074,567.25 or Lek 13,538,630,592.30 higher than in 1998. The main factors contributing to the increase of currency in circulation are the following:

- The increase of the Albanian population by roughly 15 per cent (due to the deported Kosovars who fled to Albania) which increased the demand for cash.
- The considerably amount of budget expenditures made during December 1999. Budget spending did not occur based on the approved distribution. They were concentrated in the last month of the year. Therefore, currency in circulation increased by Lek 6 billion, which represents 44 per cent of its annual incremental.

On the other hand, during 1999, the amount of destroyed currency also increased. The total amount of destroyed banknotes was 27,648,975 pieces representing a value of Lek 6,328,330,450 compare to Lek 4,251,561,600 in the previous year. The 100 Lek denomination continues to represent the highest share of damaged banknotes.

Year 1999 recorded a higher number and value of counterfeit banknotes captured than the previous year. Likewise during 1998, the counterfeit 500 Lek denomination issued in 1994 was more frequent. However, during 1999, the counterfeit 1000 Lek denomination issued in 1996 was captured in several cases. The counterfeit money was examined and it seems that money users can easily differentiate it.

Table 15: Number of counterfeit banknotes (pieces).

Denominations	Year 1999	Year 1998	Cumulative from year 1992
Lek 1000	579	103	9987
Lek 500	681	521	3202
Lek 200	125	1	182

Table 16: The structure of the currency in circulation as of the end of 1998 and 1999.

Denominations	Year 1998				Year 1999			
	000 pieces	%	000 Lek	%	000 pieces	%	000 Lek	%
K/m 5000					476	0.25	2,380,080	2.90
1000	37,219	22.24	37,219,387	54.14	40,298	21.00	40,298,040	49.04
500	51,152	30.57	25,576,070	37.20	64,048	33.37	32,023,948	38.97
200	21,667	12.95	4,333,518	6.30	27,706	14.44	5,541,295	6.74
100	14,223	8.50	1,422,334	2.07	17,831	9.29	1,783,140	2.17
50	769	0.46	38,472	0.06				
10	8,106	4.84	81,064	0.12	7,684	4.00	76,845	0.09
5	6,523	3.90	32,615	0.05	6,373	3.32	31,863	0.04
3	6,513	3.89	19,540	0.03	6,489	3.38	19,466	0.02
1	21,172	12.65	21,172	0.03	21,016	10.95	21,016	0.03
Total k/m	167,344	100.00	68,744,172	100.00	191,921	100.00	82,175,693	100.00
M/m 50	6,786	7.31	339,310	54.27	7,238	7.23	361,911	49.42
20	7,811	8.41	156,216	24.98	10,117	10.11	202,349	27.63
10	7,823	8.42	78,227	12.51	10,835	10.82	108,349	14.79
5	6,037	6.50	30,184	4.83	7,686	7.68	38,429	5.25
2	262	0.28	525	0.08	262	0.26	524	0.07
1	10,230	11.02	10,230	1.64	10,279	10.27	10,279	1.40
0.5	8,754	9.43	4,377	0.70	8,721	8.71	4,361	0.60
0.2	18,902	20.36	3,780	0.60	18,862	18.84	3,772	0.52
0.1	22,093	23.79	2,209	0.35	22,033	22.01	2,203	0.30
0.05	4,161	4.48	208	0.03	4,082	4.08	204	0.03
Total m/m	92,859	100.00	625,266	100.00	100,115	100.00	732,381	100.00
Total	260,203		69,369,438		292,036		82,908,074	

Monthly changes of the currency in circulation during the year, expressed in billions of Lek are as follows:

January	-1.5	April	3.5	June	0.4	October	0.3
February	-1.5	May	2.3	August	1.4	November	-0.1
March	0.8	July	1.7	September	0.1	December	6

5.3. INTERNATIONAL RELATIONS

Bank of Albania foreign relations, especially with the IMF, due to the Kosova crisis, were further intensified regarding the revision of macroeconomic objectives, state budget deficit, post-conflict emergency program and the Poverty Reduction and Growth Facility. On the other hand the agenda agreed with the World Bank was completely adhered to.

Bilateral and multilateral co-operation with the other central banks also increased. Early this year a Memorandum of Understanding in the area of banking supervision between the Bank of Albania and the Bank of Greece was signed. In addition to the Memorandum, relations with the central banks of the Governor are Club Member Countries strengthened. Similar steps to reach agreements with the central banks of Turkey and Bulgaria are being taken.

In the area of exchanging experience regarding legislative issues, monetary operations, payment system etc., the Bank of Albania closely co-operated with the central banks of the region such as Slovenia, Croatia, Romania etc. While the traditional good relations with Bank of Albania correspondents, such as the Federal Reserve Bank of New York and BIS Basle remained constant. Technical assistance was obtained through different programs organized by the central banks of Austria, France, England, Poland, Turkey and Germany.

Contacts were established for the first time with the European Central Bank, in the course of the general strategy of the country to join EU.

Chapter six

Bank of Albania strategic objectives in the mid-term

The Bank of Albania elaborated and made public for the first time ever since it was established, its objectives and targets. They were presented in the document: "The strategy for the development of Bank of Albania in the mid-term²²". The strategy prioritized the steps to be taken; issues to face in the course of approaching the strategic model and, above all, the sources to support the institutions, i.e., central bank staff, their ability and their willingness to work.

Aim of the Strategy

The Strategy was elaborated in order to:

- ✎ Evaluate the current level of development of the Bank.
- ✎ Determine short and mid-term objectives for the institutional development of the Bank of Albania.
- ✎ Establish deadlines within which the objectives are to be achieved.
- ✎ Rank the priorities for the institutional development of the Bank of Albania.

The importance of the Strategy

Elaborating the Strategy serves to:

- ✎ Enhance the transparency of the Bank of Albania with regard to its objectives.
- ✎ Avoid occasional developments of the institutions as well as to harmonizing the activities of different units within the Bank of Albania.
- ✎ Define the concrete ways, which lead to the achievement of the strategic objectives.

²² The Strategy for the development of the Bank of Albania in the mid-term was approved by the Supervisory Council of the Bank of Albania by issuing the Order No. 111, dated 17.11.1999.

General strategic objectives

The Bank of Albania's general strategic objectives includes all its activities.

✍✍ First, the document defines the institutional model to be considered from the Bank of Albania. That is the European Central Bank.

✍✍ Second, the Bank of Albania, as the central bank of the Albanian State, is committed to enhance its *de jure* and *de facto* independence to better perform its legal duties and responsibilities.

✍✍ Third, the Bank of Albania is committed also to enhance its accountability with regard to its actions and decisions. In this framework, it is engaged in increasing transparency with the public and "educating" the public on economic and financial issues.

✍✍ Forth, the Bank of Albania seeks to operate in a stable legal environment. In this respect, it aims to complete and improve the legal and regulatory package of the financial sector.

✍✍ "Achieving and maintaining price stability" is the most important strategic objective of the Bank of Albania. This objective is reflected through the commitment to maintain the annual inflation rate at 2-3 per cent. Monetary and foreign exchange policies will gear with the achievement of the underlying objective.

✍✍ Statistical information improvement is yet a priority for the Bank of Albania. Since statistics development in Albania is poor, the Bank considers it very important to engage in this process. It initiated the implementation of two projects for the development of statistics aiming at the participation of GDDS and SDDS.

✍✍ Development and improvement of the payment system to increase money circulation through the banking system. To achieve this objective, two ways have been identified: improve the interbank payment system and improve the small value payment system.

✍✍ Finally, the above mentioned strategic objectives are to be achieved through upgrading the Bank staff and developing information technology.