

**BANK OF ALBANIA**

**ANNUAL REPORT 2002**

**MARCH 2003**

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Published by : Bank of Albania, Sheshi "Skënderbej", Nr.1, Tirana.  
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Printed in the printing house of Bank of Albania.  
Printed in : 800 copies

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Bank of Albania Governor, Prof.Dr. Shkëlqim Cani.



## GOVERNOR'S STATEMENT

**A**lbanian economy in the first decade of transition indicated developments, which took the form of a cycle. Macroeconomic imbalances of years '91-'92 and '97 were followed by efforts for reforms and resettlement of balances. In consequence of implementing these stability programs, Albanian economy encountered relatively high development paces, a reduction of budgetary deficit and price stability. Annual average inflation of 3.5 % for '98-'02 was significantly lower than that of Central and Eastern Europe.

### I. ALBANIAN ECONOMY IN 2002

#### I.1. OUTPUT DEVELOPMENTS

**A**lbanian economy growth rates over the period 1998-2002 are considered as high. However, they have indicated a downward trend throughout the whole period. The Bank of Albania assesses that the slowdown of the annual growth rate of economy is as a result of:

- Incomplete structural reforms,
- Low level of foreign investments,
- Unfavorable international conjectures after the events of September 11<sup>th</sup>,
- The somewhat relaxed economic activity after the very high growth in years '98-'99.

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Albanian economic growth of 4,7 percent for 2002, attributed to the expansion of private sector, was mainly supported by transport, services and construction sector activity, while the public sector is constantly shrinking.

However, economic growth of 2002 is the lowest as compared to the period of 1998-2002, with a deviation of 1.3 percentage points from the announced target of the beginning of the year (6 percent). Nearly all economy sectors, especially industry and agriculture, have indicated lower growth rates than the projections. The structure of Albanian economy is changing as well. Agriculture and live animal sector, which traditionally have sustained economic development, have a reducing weight, while trade and services indicate an increasing contribution. These structural changes are in accordance with the ought-to- be- taken development of a country targeting integration in EU. However, the industry sector evidences no significant development yet. To back up a steady and long-term economy growth, we assess that it is important that government authorities view the promotion of industrial production as a priority.

Agricultural production for 2002 grew with 2.1 percent. It is a long time from now that agriculture does not contribute 50 percent in the national economy any more. It seems that this sector's annual growth rate can not be based anymore on its extensive aspect. This sector needs restructuring, which will lead to productivity increase. Relating to troubles in agriculture, they have to do with: parceling lands and conflicts resulted from ownership, prohibition of long-term investments in this sector, lack of investments in technology, undeveloped rural infrastructure in agriculture, and considerable disparity from one region of the country to another, limited capacities for preserving agricultural products and live animals' products, as well as insufficient financing provided to this sector. Additionally to these troubles, agriculture encountered damage from floods in autumn 2002. The somewhat better development of animal and rural industry is compensating problems of agricultural sector.

Industrial output was increased by 2 percent in 2002, indicating the lowest growth rate as compared to the rest of the sectors. Industry has been mostly suffering from the electric power problems, which have been present for almost three years, at least. As it is already clear to everybody, resolving this problem is vital for the country's advancement. However, I should stress that the situation is even more distressing. Starting from the Bank of Albania periodical surveys on businesses that operate in industry sector, it is emphasized that the situation of electric power in the country has led to a falling optimism on developing future businesses, which means that the economic growth stability may be put in danger.

Transport sector keeps on displaying high growth rates. In 2002, production from this sector reflected a 9.1 percent growth. Construction has got a slowdown trend. This is a natural trend as a consequence of innumerable new buildings and the meeting of requests during the previous decade. Attempts to formalize the construction activity will also provide impact in short term.

In general, the lowest economic growth for 2002 has been consequence of a lower level of foreign investments, shrinkage of capital expenditures, as well as political developments, which were associated with somewhat frequent changes of government. Foreign direct investments have been 31 percent less as compared to 2001. Given that the political and macroeconomic situation in the country resembles that of the previous year, the reduction of foreign investments is due to the lack of privatization of strategic subjects, especially that of Savings Bank and Albtelecom. On the other hand, capital expenditures have been realized in lower levels. Concretely, in 2002, about 73 percent of planned capital expenditures were carried out, against 96 percent of the previous year. Real capital expenditures were 13,8 percent less as compared to the previous year.

At the end of 2002, the employed number reached 921 thousand. The employment changing structure in the country has taken place in accordance with economy developments and its structural changes. Hence, the employed persons in agriculture comprises 57 percent of the total employees from 71.5 percent in the previous year. Migratory movements towards the cities as well as the expansion of the private sector have absorbed a considerable part of this labor force. Therefore, employment in non-agriculture private sector represents 23 percent of the total employment from 11 percent in the previous year. However, Albania indicates a high unemployment rate of 15.8 percent. The expansion of the private sector activity and public investments are not yet in such paces as to generate sufficient work places.

However, the fact that Albanian economy has ensured an economic growth for the fifth year successively made the income per capita increase. For 2002, income per capita, calculated as GDP denominated in USD, in ratio with the country's population, is estimated to be on average USD 1500. Although such income rate remains the lowest in the region, we may say that the implementation of the Strategy for Social and Economic Developments is providing effects. Emigrants' remittances remain an important resource for Albanian families. For 2002, they reached USD 606,8 million, covering 52.2 percent of external trade deficit.

Albanian economy performance in 2002 has also reflected the impact of a general slowdown of world economy growth, especially the impacts of the concerns that have accompanied the economies of the region and main trading partners.

## 1.2. EXTERNAL SECTOR AND EXCHANGE RATE DEVELOPMENTS

**A**lbanian economy competitiveness, either in domestic or international market, is very low. External trade deficit had a rising trend during three recent years. For 2002, external trade deficit

resulted as much as 24.6 percent of GDP. The extension of external trade deficit is attributed to the higher growth of imports, as compared to exports.

Albanian exports indicate a higher volume of USD 330,2 million. At 74 percent, re-exports hold the main share in Albanian exports, whereas exports from domestic production remain at low rates. Albanian exports are limited in producing raw material, due to the non-expansion of processing capacities in the country. Therefore, exports from the domestic production could not be accompanied by expansion of investments and the provision of new work positions. Regarding re-exports, they must be somewhat contributing in employment, using the relatively free labor force in Albania. This activity represents also the most important investments from both neighbor countries: Italy and Greece to Albania. However, it remains unclear whether such investments are accompanied by advanced technology investments, which would serve as a premise to increase the productivity.

Albanian imports reached the volume of USD 1,5 million. Imports include consumer goods and machinery and equipment. Machinery and equipment comprise about 16 percent of imports or nearly 5 percent of the GDP. This indicator indicates to us indirectly that there has been an increase of private investments.

Current deficit was deteriorated, recording 9.5 percent of GDP, from 6.1 percent in the previous year. The deterioration of the current deficit resulted from extension of trade deficit. The current account deficit financing was enabled mainly from emigrant remittances and tourism activity. The current deficit, recording USD 447,4 million, has been financed from capital inflows at 75 percent. Foreign direct investments (USD 143 million) and external debt (USD 142,7 million) occupied the main weight in financing the deficit.

The somewhat unfavorable developments in the external sector did not exercise strong pressures on the depreciation of the domestic currency. In 2002, Lek exchange rate to other foreign currencies has tracked previous year developments and exchange rate performance of major currencies internationally. Compared to average rate in the previous year, Lek depreciated by 3.03 percentage points in ratio to Euro and appreciated by 2.32 percentage points in ratio to USD. Banks panic of March –April is considered as an important factor for Lek depreciation, accompanied by the wavering confidence in domestic currency and the extension of currency in circulation. However, the international market developments are the ones that define the domestic currency developments. EUR/USD exchange rate by international market also defined Lek depreciation to EUR.

Subordinate to these developments in 2002, the Bank of Albania interventions in the foreign exchange domestic market have taken place in two periods: March –April and December. In both periods, interventions were effected in opposite direction. In the first period, USD 4,94 million has been sold at an average rate of Lek 145.02, and EUR 0,4 million at an average exchange of Lek 131.4. In December, USD 1,8 million have been purchased at an average exchange of Lek 133.74 and EUR 0,2 million at Lek 136.2 average rate.

## II. INFLATION AND MONETARY POLICY

Annual inflation rate at the end of 2002 reached 2.1 percent. Consumer price developments during 2002 disclosed a reverse trend as compared to the previous year. Whether in 2001, inflation remained in relatively low rates and within the target band, the pressures for a higher inflation were added in the last two months, making inflation rate at the end of the year reach

3.5 percent. Year 2002 started with high inflation rates, almost the double of the upper target rate. Higher rates than the target were present throughout the entire year and were significantly lowered during the two last months of the year. In general, inflation on the medium term has shown a rising trend. Inflation annual average rate went up from 0.4 and 0.1 percent in 1999 and 2000 to 3.1 and 5.4 percent respectively for 2001 and 2002, due to a more inflationist environment in 2002.

A number of operating determinants have dictated the consumer price developments in 2002. Such determinants have been active in both directions, either in demand or supply. These determinants, operating by certain ratios, as well as the fact that demand side determinants acted one after another, giving longer-term impacts, made the Bank of Albania react with prudence.

Amongst the most important determinants that affected inflation performance, we may mention:

- The increase beyond the projection of currency outside banks for certain periods of the year, as well as the rising share of the most liquid aggregate M1 in monetary supply in the first half of the year,
- Domestic currency depreciation, also in the first half of the year,
- The increase of foodstuff prices in the markets, where Albania imports from, and an inflation higher than the Euro area target,
- The increase of electric power price in December 2001, which was carried on consumer prices, especially in the first half of the year. Also, the unstable electric power situation acted as an important factor on higher prices.
- Weather conditions, such as the cold weather at the beginning of the year and the floods of autumn, exercised a higher impact on the rise of transportation prices and food prices as an aftermath,
- The speculative increase of prices, especially on the eve of the year-end holidays.

As the operating intensity of these determinants was stronger in the first half of the year, inflation rates were higher in this period and gradually started to drop. A reduced inflation was also affected by the care in performing budgetary investments, price reduction in "communication" group, due to the invigoration of mobile telecommunication services in Albania and the Bank of Albania campaign, which was undertaken at the end of the year to alleviate the phenomenon of consumer price speculation.

The Bank of Albania *monetary policy* in 2002 was somewhat different from what it had been in '98-'00. Monetary policy implemented in the recent years has generally reflected a mitigating character. In 2001, responding the higher inflationary pressures, monetary policy was neutral, whereas in 2002 it passed to a tightening monetary policy for the most part of the year. Furthermore, unlike its 10-year history, the Bank of Albania gave priority to the maintaining of banking system stability for almost 3 months. With this decision, the Bank of Albania avoided the diffusion of the banking panic and its stretching over a long-term period. The maintaining of the banking system stability, though at first sight it may seem as risking the achievement of inflation target, in reality it contributes to long-term stability of prices. Developments to the end of 2002, confirmed that the Bank of Albania had taken the right decisions.

In general, the monetary policy for 2002 has been tightened, responding to the pressures for higher inflation rates. However, it has not been evenly tightened throughout the whole year. In accordance with inflation performance and monetary developments, the Bank of Albania monetary policy for 2002 may be divided into three periods:

- *In January- February, the Bank of Albania followed a neutral monetary policy.*

High inflation rates at the beginning of 2002, being influenced from supply side determinants, enforced interest rate increase. On the whole, monetary indicators were improved and liquidity had a fast return into the system. The Bank of Albania attracted the excessive liquidity through Repo auctions. It did not provide financing to budgetary deficit. Interest rates have been generally stable.

- *In March -September, the Bank of Albania followed a tightened monetary policy.*

Deposit retraction from both largest banks of the system, which started in the middle of March 2002, changed the tide of monetary developments and created additional pressures on inflation. The spread of panic was an unexpected phenomenon. At least, it was not affected by the banking system situation. The Banks in Albania, in spite of some problems incurred, which are supervised by the Bank of Albania, and which are disclosed to the public as well, through the declaration on the financial system threat, present a safe and sound financial situation. The Albanian banking system has reflected consolidation year-in year-out. Thus, the panic could not have a spur or basis in the situation of the Albanian banking system. The panic was assessed as affected from the aggravation of the political situation in this period, the wrong-interpretation of the law "On deposit insurance" and the inadequate information on depositors. Therefore, Lek 23,4 billion deposits were withdrawn from the banking system, 73 percent of which represented the deposit retractions in Lek. These retractions represented 8.3 percent of deposits placed with the Albanian banking system. Deposit retraction created difficulties in the short-term liquidity of banks and deficit financing through the primary market of treasury bills. This difficulty was further aggravated under conditions when it was made clear that privatization process in the 2002 would not take place as expected. Monetary indicators deviated from the program. In this period, currency outside banks was added with Lek 16,4 billion. Only in April, the annual growth rate of this indicator was 35.6 percent, which represents the highest annual growth rate of this indicator during the five recent years. On the other hand, Lek depreciated against the two major currencies and at the same time there were strengthened the pressures for increasing inflation. Therefore, the banking system passed to a lack of liquidity as compared to the excessive position of Lek 1,6 billion in February.

The Bank of Albania strategy to overcome the situation consisted in:

- Allowing the deviation from the monetary program and meeting the banks needs with liquidity. Injecting the required liquidity in the market, the banks had the opportunity to meet the requests for deposit retractions and in this way this served as a measure to restrain the panic spread. Further more, having banking liquidity, the banks operated normally in the primary treasury bills market.
- Government financing to ensure a normal track of expenditures. But, given that the inflation pressures were stronger, the Bank of Albania requested and found the good-understanding of Albanian Government to be maximally prudential in performing the expenditures. Fiscal quantitative targets were rigorously adhered to. The Bank of Albania Supervisory Council took the decision that the Government be financed up to 8 percent of the average budgetary revenues for three recent years. However, the improving situation earlier than what it was expected made the application of this measure unnecessary,
- The increase of core interest rate by 1.5 percentage points to stimulate the increase of deposit rates. Such a measure ensured higher real earnings for depositors and urged

them to return money to banks. Apart from that, it was aimed at deepening the spread with foreign currency interests, with the purpose to exert pressure for preventing depreciation of Lek,

- Public clarification of the real situation of the banking system, as well as the effects and advantages provided by Law 'On Deposit insurance', in order to moderate the negative psychological effect created.

The measures taken ensured the preventing of deposit retractions by end of June 2002 and the full recovery of the situation within '2002.

- *In October-December, the Bank of Albania followed a neutral monetary policy*

Taking into account the returning liquidity in the system, which brought about an improvement of monetary conditions, a relative stability in interest rates and the mitigation of inflationary pressures, the Bank of Albania has implemented a prudential monetary policy, with a smoothing tendency in the last two months of the year. In November, it adopted a neutral stance against interest rates. In December, the neutral stance of monetary policy was further strengthened by changing the type of auction from a fixed amount auction to an unfixed amount auction and with a fixed interest rate. This change represents a significant reduction of banks' net borrowing costs.

Consequently, the Bank of Albania obligatory quantitative targets were met. Net domestic assets resulted Lek 7,97 billion less than their upper target rate; net foreign assets resulted USD 3,55 million more than their lower target rate. In accordance with the current monetary policy regime, the Bank of Albania aims at controlling the liquidity in economy, viewing it as closely related to the level of prices in economy. Liquidity condition and other monetary indicators in economy are checked through the observance of these quantitative targets.

### III. PUBLIC FINANCE

The performance of budgetary indicators for 2002 was conditioned by the lack of income on privatization; by deposit retractions, as well as by the lowering of economic growth projection, meaning less budget incomes. Therefore, to maintain the balance of these indicators and to respect the quantitative targets, it was acted with a rigorous control on performing the expenditures.

Budgetary deficit reached at 6.2 percent of GDP or 2.4 percentage points lower than in the previous year. The consolidation of Albanian government finances has resulted in the succession of clear tendency of reducing the budgetary deficit for period 1999-2002.

The reduction of budgetary deficit was ensured by the higher growth rate of incomes than expenditures. Budget revenues increased by 1.14 percent as compared to the previous year. However, the plan was realized at 95 percent. Expenditures were added with 3.2 percent as compared to the previous year and the level of plan realization was 90 percent.

The realization of the plan on budget incomes is affected by the realization at the quantity of 92 and 91 percent of the plan on taxation and customs revenues. It is clear that the level of meeting budgetary revenues remains negatively affected by the fiscal evasion, range of corruption and

illegal smuggling in the country. For this reason, strengthening measures against these phenomenon is directly related to fiscal position improvement.

Regarding expenditures, it is observed that capital expenditures are completed at 73 percent, while current expenditures share 81 percent of total expenditures from 74.6 percent expected.

Year 2002 did not escape the ordinary phenomenon of concentrated expenditures in December. Expenditures in December exceeded the budget plan. At least, since 1997, almost the same situation is maintained, which requires more attention in harmonizing the expenditure dynamics.

## IV. BANKING SYSTEM DEVELOPMENTS

**A**lbanian banking system situation for 2002 is sound. The banking system is expanded with almost Lek 21 billion or 3.4 percent in real terms. Net profit result is Lek 3,9 billion. Capital position is further strengthened and capital adequacy ratio has reached 31.5 percent from 12 percent that is the allowed minimum.

Albanian banking system has been expanded with new banks and has further expended its network. In 2002, the Credit Bank of Albania was licensed. Currently, 14 commercial banks operate in Albania, which expanded their networks with 9 branches and 1 new agency. Except banks, new financial entities are being created and licensed, which will influence on the financial system development in Albania and will lead to the reduction of the banking weight in it. Hence, in 2002: 1 non-bank institution; 20 foreign exchange bureaus; 113 savings and credit associations and 2 unions of these association are granted a license.

The increasing number of financial entities and the expansion of their activity will add the level of financial intermediation in Albania. Notwithstanding the positive developments in Albania during the recent three years, yet the financial intermediation is at low levels, ever lower than the region. Time deposit ratio comprises nearly 40.1 percent of GDP from nearly 50 percent average of East and Central European countries. Meantime, domestic credit is nearly as much as 35.1 percent of GDP, however credit to economy is only 7.2 percent against 40 percent average of East and Central European countries. The difference between domestic credit index and credit to economy, represents banking credit to Government. The still high demand of Albanian government to finance the budgetary deficit, as compared to the most developed countries, keeps the lending activity somewhat deformed. Nevertheless, recent years developments have been positive. The ratios of domestic credit and credit to economy against GDP of the previous year have been 45 and 4.6 percent respectively.

Positive is the fact that the expansion of the banking system is due to a more intensive activity of private and joint-venture banks. In this way, premises are being created even for a constant reduction of the dominating position of the Savings Bank.

However, as compared to the previous year, the dynamics of expanding banking activity and the profitability indicators reflect a slight deterioration. Net income expressed in ratio to average assets and banks own funds for 2002 have resulted 1.2 and 19.1 percent from 1.5 and 21.6 percent in the previous year. This situation reflects the panic effect on the banking system in March – April 2002. Accordingly, the Bank of Albania concludes that the banking system is sound and the stability remains fragile yet.

*Banks' credit* to domestic economy has recognized adequate development. New credits extended from banks have been Lek 62,6 billion from 40,6 billion in year 2001. Outstanding credit of the banking system at the end of 2002 is Lek 47,4 billion or 16.6 percent of the deposits held in the system. Credit indicators have been generally improved. In 2001-2002, the new credits extended reaches to Lek 103,2 billion. This means that the annual average lending for the recent two years is five times more than in the period of 1993-2000. The expanding network of banks and their activity makes us feel optimistic on the rising credit in the future.

Additionally to banks, the expansion of micro credit schemes and non-bank institutions is another useful development that will lead to the increase of credit to economy. These institutions are estimated to have extended Lek 4 billion credits during 2002. Micro-credit schemes have a priority because they stretch in areas where there is no banking activity, especially in rural areas of the country, as well as they create credit possibilities to small- size business. That is why it is assessed that informal credit is shrinking.

Credit extended by the banking system in 2002 has maintained its structural characteristics. Thus, it has been 67 percent in foreign currency, 100 percent to the private sector and 71 percent short- term. Apart from that, the trade sector continues to be the most preferred for lending.

Bank credit, irrespective of its acceleration in the recent years, is not accompanied with deterioration of the credit portfolio quality. Also, the structure of bad loans has not undergone any changes, showing no disturbances on the increase of higher risk category, which is the category of lost loans.

## V. BANKING SUPERVISION

**B**ank supervision comprises the second important pillar of the Bank of Albania activity. The Bank of Albania mission as a regulatory authority is:

- To ensure banking system stability and defend the interests of depositors and the public at large,
- To ensure a safe and sound banking system, whose activity should be transparent and oriented towards market economy,
- To increase the confidence of investors and depositor by supporting the developing of the banking industry and its efficiency.

The main strategic objective is the one announced by BIS Basel Committee on the banking supervision: "*No unit must escape banking supervision and supervision must be adequate*", as well as the observance of 25 basic principles of this Committee on a prudential banking supervision.

Banking supervision activity for 2002 has been concentrated in compiling and revising the regulatory framework, analyzing and inspecting banks or other financial institutions, which are supervised by the Bank of Albania. In the regulatory framework, a number of new rules were drafted, which aim at not letting the activity of any entities outside banking supervision.

During the 2002, there took place 13 full inspections and 11 partial inspections, and it was observed that:

- The expansion of lending activity is accompanied by an improvement of credit portfolio, though there are evidenced some deficiencies such as: the outset of lending activity, without previously ensuring a trained staff or team; non-basing on accurate and complete.
- The public confidence has been turned back, after the prevailing panic in March- April 2002.
- Generally, the high management of banks has reacted positively towards the findings presented in the examinations performed, but no proper care is shown on: improving bank activity procedures and policies; completing the regulatory framework of bank activity; executing the bank's business plan.

During the examinations performed, findings of various violations have been noticed. Generally, these violations have been assessed as unimportant, containing no serious consequences for banks. According to the violations highlighted, the corrective measures or penalties have been defined, pursuant to provisions of Law " On Banking System in the Republic of Albania" and Bank of Albania rules and regulations, such as: recommendations or suggestions to correct minor inconsistencies; the requirement to submit to the Bank of Albania a program of measures to rectify the current bank state, on the event of encountering irregularities, setting forth the respective terms; penalties to administrators, who have to do with the violations observed against laws and by-laws in force.

Given the significance of the bank supervision, a mid-term banking supervision development plan has been prepared, in cooperation with the World Bank, and it will have effect until 2004. The implementation of this plan aims at enhancing the banking system security in Albania, by applying efficiently the standards on a safe and sound banking activity.

Strengthening the supervisory capacities is considered an important duty to prevent problems and minimize risks, against which the banking system is exposed. This undertaking is even more important in the face of efforts and in implementation of measures for further liberalization of economy and for increasing its integration standards.

## VI. BANK OF ALBANIA FINANCIAL SITUATION

The independent auditors' opinion related to the Bank of Albania financial statements for 2002 is that they truthfully indicate, in all material aspects, the Bank's financial position and the results of its activities, the changes in own equity, and cash flows at the end of the year, which are in accordance with International Accounting Standards.

The Bank of Albania total balance result was Lek 213 billion, whereas its net profit result reached Lek 9,7 billion or 8.9 percent higher than in the previous year. About 70 percent of this profit is ensured from net earnings on interests, commissions and on revaluation of securities from resident operations. These net earnings increased nearly 29 percent as compared to 2001. The main factor has been the changing direction of monetary operations and the Bank of Albania core rate increase.

Earnings in foreign currency exceeded the plan, mainly due to the increase of foreign reserve. Earnings from government operations recorded excess, due to the extension of securities portfolio, conversion of direct credit into tradable debt, for Lek 5,8 billion, and the rise of the treasury bills yield.

Expenditures on Lek liabilities have been less than the projection, reflecting the uncommon events of deposit withdrawal in March –April, while the attraction of excessive liquidity was expected in the system for an amount over Lek 4 billion, mainly through Repo agreements. Administrative expenditures are less than the project, nearly by all component elements. In this framework, the Bank of Albania is focused on being more cautious in implementing the expenditures plan, especially those expenditures directly related to staff efficiency enhancement.

Foreign reserves comprise an important resource of the Bank of Albania net foreign inflows. At year-end 2002, foreign reserves reached at USD 838,9 million or 13.8 percent more than in the previous year.



### Supervisory Board of Bank of Albania.

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Front row (left to right) :

Dr. FATOS IBRAHIMI	Vice chairman and First Deputy Governor
Prof.Dr. SABAH HILMIA	Member
Prof.Dr. SHKËLQIM CANI	Chairman and Governor
Prof.Asocc. Dr. DRINI SALKO	Member

Back row (left to right) :

Prof.Dr. SULO HADËRI	Member
BAJRAM MUÇA	Member
Prof.Asocc. Dr. TONIN KOLA	Member
LLAZI BALLIU	Member

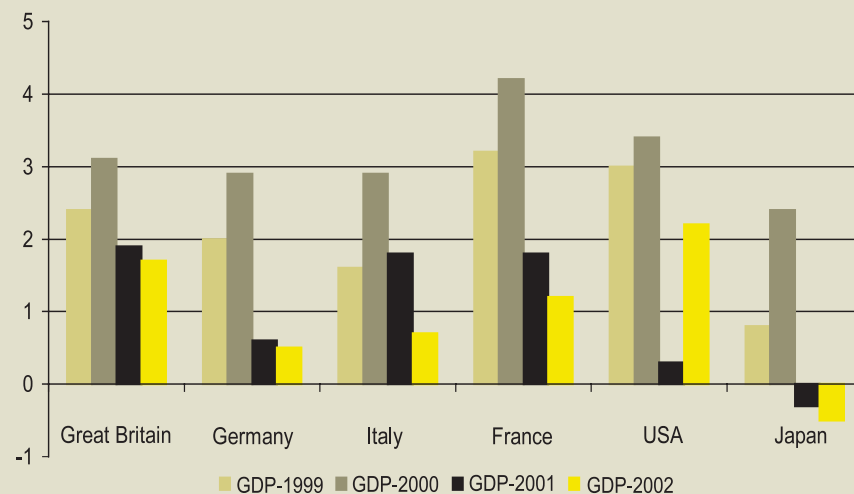


## CHAPTER I: WORLD ECONOMY

### I. WORLD ECONOMY DEVELOPMENTS IN 2002

**I**n 2002 world economy encountered low growth. After the events that shocked the world in the second half of 2001, projections on world economy performance fluctuated between the modest growth and the sharp slowdown. The outset of 2002 gave positive signals, which were gradually eclipsed with the outbreak of the financial scandals in USA<sup>1</sup>. Such event was added to the unfavorable economic situation, making the stock markets weaken continuously and leading to USD depreciation. Under these terms, the financing on developing markets recognized a falling trend. In mid 2002, it was evaluated that the world economy growth projections in 2002 and 2003 were more optimistic than what recent developments promised. In this moment, as the inflation disturbances, either in Euro area or USA, were flattened, it was estimated that macroeconomic policies would be more accommodating for a longer period than it was initially projected. Monetary policy alleviation was chosen as the main way to ensure the inducement of world economy.

Graph 1: Economic growth for the period, 1999-2001 and related estimates for 2002.



#### I.1. EUROPEAN ECONOMY

**E**uro area economy during 2002 developed with slower than projected rates<sup>2</sup>. This reflects mainly the large insecurity characterizing the economic and political environment. Geopolitical tensions with serious consequences in oil prices, financial market developments, the slow economic growth the whole world, are factors that have impacted and continue to impact negatively on the confidence. These factors have negative impacts on Euro area consumption, on investments made, as well as on labor markets.

Price performance has reflected developments relating to effects of previous oil prices or foodstuff rise, as well as a limited impact due to physical changeover of Euro. The constant increase of wages has also been a factor that has influenced on inflation performance. Subsequently, the annual rate of inflation has rested over the 2 percent rate, almost throughout most of the year.

<sup>1</sup> See: World Economic Outlook, September 2002.

<sup>2</sup> European Central Bank Bulletin – December 2002.

**Table 1: Inflation and unemployment, in percent.**

	Inflation- December		Unemployment -December	
	2001	2002	2001	2002
France	1.4	2.3	8.8	9.1
Germany	1.7	1.1	9.6	10.1
Italy	2.4	2.8	9.3	8.9
Euro area	2.0	2.3	8.1	8.5

Source: "The economist", January -February 2003

## 1.2. USA ECONOMY

The last months of 2002, confirmed that the full economic regeneration of USA has a long way to do. The factors that have affected positively on American economy, such as the strong customer request, the low inflation and the rising productivity, seem to have confronted the effect of negative factors, such as the slow increase of unemployment and the inadequate performance in production<sup>3</sup>.

The customer demand in 2002 and in the last quarter 2001 has continued to represent the strongest economic growth, in spite of the military tensions, from the partial paralysis of labor market and corporate scandals.

Year 2002 is characterized by low and the stable inflation. Core inflation, (including food and power costs) had a falling trend from year 2001 and rests at 2.2 percent, resulting significantly lower than that in the previous year (2.6 percent).

During the last year, a factor behind the modest growth of US economy was the need of business firms to renovate their profits, which had dropped significantly before and during the recession. The need to renovate profits forced many business firms to reduce investment expenditures and cut work posts. Subsequently to these developments, unemployment in USA reached the highest rate in the eight recent years.

**Table 2: Growth rates of main economic growth components in USA.**

	2000	2001	Q1-02	Q2-02	Q3-02	Q4-02
Economic growth	3.8	0.3	5.0	1.3	4.0	1.4
Personal consumption	4.4	2.5	3.1	1.8	4.2	1.5
Non-residential investments	7.8	-5.2	-5.8	-2.4	-0.8	2.5
Residential investments	1.1	0.3	14.2	2.7	1.1	9.4
Service and commodity exports	9.7	-5.4	3.5	14.3	4.6	-4.4
Service and commodity imports	13.2	-2.9	8.5	22.2	3.3	7.2
Government consumption	2.7	3.7	5.6	1.4	2.9	4.9

Source: Bureau of Economic Analysis, macroeconomic data-<http://www.bea.gov/bea/glance.htm>.

<sup>3</sup> Source: US. Economy, national Update, December 2002, <http://www.dallasfed.org/eyl/usecon/0212update.html>.

### I.3. CENTRAL BANK OPERATIONS ON INTEREST RATES

World's two most important central banks<sup>4</sup>, the Federal Reserve and the European Central Bank put to use the refinancing rates only once during 2002. The Federal Reserve was the first to operate in November 6<sup>th</sup>, reducing the refinancing rate with 0.5 percentage points (from 1.75 to 1.25 percent). The Federal Reserve decision for cutting interest rates came after a long series of unfavorable economic developments. In the declaration announcing interest rate reduction, it was stressed that the American economy had reached to a point where expenditures production and investments were restricted due to insecurity and specifically due to threatening of war in Iraq.

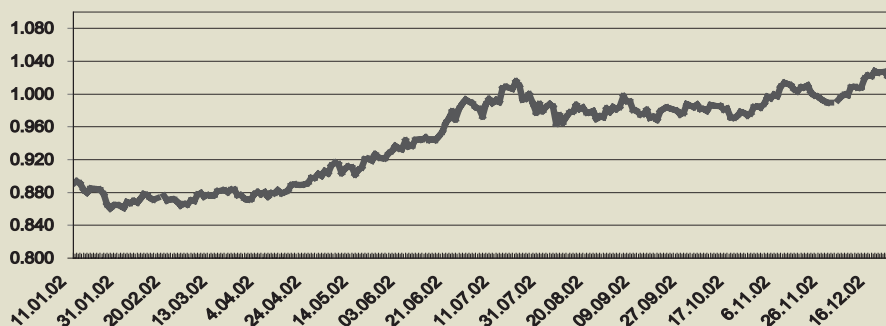
Contrary to expectations, ECB reaction was not instantaneous. ECB, though it expressed its attitude on the slow economic growth of Euro area, it delivered the signal that the urging of economic growth is not a duty of monetary policy. ECB decision on not changing the interest rate in November was justified by concern on inflation. The latter is defined in ECB mandate and is aimed to be kept between the rates of 0 and 2 percent. In October, annual inflation, being affected by an obvious money supply growth, was higher as compared to September. In spite of this, the ECB at the beginning of December "resigned" to the pressure to cut interest rate by 0.5 percentage points (from 3.25 to 2.75 percent) mainly based on the concern on German economy and on its impossibility to perform the required structural reforms.

### I.4. EXCHANGE RATE DEVELOPMENTS

In the year that just ended, Euro is assessed as appreciated by about 20 percent compared to USD. Three are the key moments of the moving prices of Euro expressed in USD.

Euro began in 2002 at 0.87 USD/Euro. After this rate, it kept growing in terms of USD, reaching the peak in July, by USD/EUR 1.01. Financial scandals related to accounting practices of some companies mainly in USA caused USD depreciation in this period of the year. Therefore, the insecurity that seized American stock markets urged investors be more oriented to Europe. After that, Euro exchange rate to USD moved within the parity range to further proceed with USD appreciation at USD/Euro 0.97 in October.

Graph 2. EUR/USD exchange rate by international market for 2002.



Source: [www.x-rates.com](http://www.x-rates.com).

<sup>4</sup> In preparing the material, there have been used the websites of the Federal Reserve and the European Central Bank as well as "The economist", November 7, 2002.

USD appreciation was supported by stock market investments and the not so good news regarding the budgetary deficit of Euro area. Later on, the direction of moving the currencies was changed again, according to which Euro kept appreciating to reach USD/EUR 1.06 at the end of the year. USD depreciation at the end of the year was a product of a number of factors in USA such as: financial scandals, the aggravation of relations to Iraq, the high deficit of current account, insecurity, the low economic growth and low interest rates.

## 1.5. OIL PRICES

**Y**ear 2002 has been characterized from a rising trend of oil prices<sup>5</sup>, accompanied with some slight falls along it. At the end of the year, oil price recorded EUR 33 per barrel or 22 percent increase compared to January. After stabilizing them until the beginning of August, another increase of oil prices restarted with the reappearing of the geopolitical tensions (conflict USA-Iraq), almost reaching at EUR 32 per barrel. Thanks to a slight improving of international framework in November, oil price dropped to EUR 27 per barrel. Future contracts, reflecting a fall of international tensions anticipated a gradual decline of oil prices for 2003. Contrary to that, December was characterized by a re-aggravation of international relationships and higher possibilities for potential war on Iraq. This one, along with the general strike in Venezuela, which stopped oil exports, made oil price reach at EUR 33 per barrel at the end of the year.

## II. ECONOMIES OF THE REGION

**I**n 2002, almost in all transition economies of the region, the aftermath of crisis taking place during 2001 "have been healed". In general, figures indicate a positive trend of GDP. The undertaking of various reforms, as well as the emergence from the crisis, made possible that economic and price stability be the core target.

### II.1. TURKEY

**E**conomic growth<sup>6</sup> for the third quarter reached the level of 7.9 percent, leading the GDP growth rate to 6.5 percent for the whole nine-month term. Meanwhile, industrial production growth of 8.8 percent rate for 10 first months of the year, as well as the upward tendency in the rate of using the capitals (80.6 percent in October from 73.3 percent in October 2001) indicate that the Turkish economy will be recuperated with a 5.5 percent growth rate in 2002, as compared to 7.4 percent contracted in 2001.

Inflation and its expectations continue to drop due to the tightened monetary policy followed by the central bank of Turkey. Annual inflation in November reached 27.1 percent, implying that inflation rate at the end of the year will be rather lower than the targeted rate of 35 percent.

<sup>5</sup> Source: [www.dansercontainerline.com/oil02.htm](http://www.dansercontainerline.com/oil02.htm).

<sup>6</sup> Source: National Bank of Greece, South Eastern Europe and Mediterranean Emerging Market Economies, Bulletin, December 2002.

## II.2. F.Y.R.O.M.

**T**he economic activity in the former Yugoslavian Republic of Macedonia recorded a moderate growth in 2002. New government elections in October and the stabilization of the political situation are assessed to have a positive impact on domestic economy. Industrial output for 2002 is estimated as slightly improved, after the sharp recession in 2001. Referring to the latest data<sup>7</sup>, growth rate records -9.5 percent from -10.6 percent of the same previous year period.

Related to the inflation rate, the cumulative growth of the first ten months of the year records 2 percent. Based on this fact, it is estimated that the inflation rate is within the target rate, at 3.5 percent at the end of the year. Inflation increase has been mainly due to the rising wages and pensions in June 2002. The return of the public confidence in the domestic currency and the reduction of the current account deficit is worth mentioning.

## II.3. SERBIA & MONTENEGRO

**S**erbia & Montenegro continued the acceleration of reforms. Economic growth is assessed to reach at 4.1 percent from 5.9 percent in 2001. Undertaking economic restructuring reforms has enabled that the industrial product contribution in GDP be zero, similar to 2001.

Inflation keeps falling year in year out. At the end of the year, inflation is assessed to rest to the band of 15-17 percent from 39 percent in 2001 and 114 percent in 2000.

## II.4. CROATIA

**G**DP for 2002 is assessed to grow with a lower rate than in 2001. Therefore, in the first ten months of the year, industrial output cumulative growth reached at 4.6 percent from 6.1 percent of the same period of the previous year.

Inflation at the end of the year is assessed to reach the target band of 3-4 percent. For the first 11 months of the year, cumulative inflation rate kept 2.3 percent but the implementation of a new measuring system of electric power and a colder winter are assessed to bring about a higher inflation.

## II.5. ITALY

**T**he preliminary data indicate that the Italian economy had a slow development in the third quarter of 2002. One of the problems, which continued to disturb the economy, was the organization of strikes from one of the biggest trade unions in the country. The movement and coordination of trade unions was revived as result of the FIAT company decision to shorten 8100 hands in a big factory of Italy. Trade unions have criticized the government budget for 2003, since, according to them, it is insufficient to lower the unemployment rate, which in Southern part of the country reaches to 18 percent. Business' confidence in the country kept growing on the approach of year-end celebrations. Nevertheless, the analysts do not expect a complete recovery until the second half of 2003.

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<sup>7</sup> The data on industrial output refer to the end of the nine-month term of the year.

## II.6. GREECE

**E**UROSTAT decision<sup>8</sup> to redefine the computing of the public debt has encroached the basis of Greek economy. According to the new definition, the public debt of Greece has reached the range of 107 percent of GDP (from 99.6 percent), turning the surpluses proposed for the budget of 2001-2004 into deficits. Greek Government performance has already fallen to the levels of prior entry of Greece to EMU. Inflation remains at high levels, as compared to 2.3 percent of Euro area. Consumer prices are expected to fall during the next two years, though the difference between Greece and other Euro area partners is expected to expend. However, such development is exerting a negative impact on Greece competitiveness, making it difficult for producers to export and keep their market position inside the country. Current account deficit is expected to be at about 6.2 percent of the GDP for 2002. Prior to enjoying partnership in EMU, this deficit would have requested controls on imports or depreciation of currency. Such a thing is not going to happen now, since the current account deficit of Greece comprises less than 2 percent of the Euro area deficit and it does not bear a strong influence on the Euro exchange rate. Nevertheless, this deficit is expected to affect unemployment, which still remains high (10 percent), in spite of high government expenditures to lower it.



*Albanian Prime Minister, Mr. Fatos Nano  
Photo from III National Conference "Bank of Albania on the second decade of Transition".*

<sup>8</sup> Source: <http://www.invgr.com/indicators.htm>.

## CHAPTER II: ALBANIAN ECONOMY

### I. GENERAL CONSIDERATIONS

Domestic economy for 2002 grew with 4.7<sup>9</sup> percent as compared to the previous year. It is already the fifth year that the economic activity estimates growth. But, this has been the lowest growth rate in the time series of 1998-2002 (what is more, with an apparent deviation from the projected rate of 6 percent).

**Table 3: Overall macroeconomic indicators**

	1996**	1997	1998	1999	2000	2001*	2002*
Real growth of GDP (%)	9.1*	-10.3	12.7	8.9	7.7	6.5	4.7*
GDP (at current prices, in millions of Lek)	315835.0	333071.0	425356.0	488611.0	551282.0	590237.0	658062.0*
GDP (at current prices, in millions of USD)	3022.5	2236.5	2824.4	3548.4	3836.3	4113.7	4695.4*
GDP (in USD per capita)	920.6	672.9	842.1	1052.0	1128.0	1332.6	1521.0
Number of employees ('000 persons)	1116.0	1107.0	1103.0	1081.0	1068.0	1065.0	921.0
Unemployment rate	12.4	14.9	17.8	18.0	16.9	14.6	15.8
Inflation rate (y/y)	17.4	42.1	8.7	-1.0	4.2	3.5	2.1
Budgetary deficit (as % of GDP)	-11.4	-13.2	-11.3	-11.9	-9.1	-8.6	-6.2
Domestic Debt (as % of GDP)	30.7	36.2	35.1	36.3	41.0	40.9	38.7(Q3-02)
Current account (as % of GDP)	-2.1	-11.3	-2.3	-3.7	-4.3	-5.3	-9.5
External Debt (as % of GDP)	29.2	35.6	26.5	25.8	29.2	28.2	24.6*
Average exchange rate, Lek/USD	104.5	148.9	150.6	137.7	143.7	143.48	140.15

Note: \* The data taken from Ministry of Finance and IMF- staff estimates.

\*\* The data on GDP and its real growth for years 1996-2000 are INSTAT staff estimates.

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

The so far analysis has indicated that growth is mostly due to further expansion of the private sector, while the role of the public sector in GDP has been falling.

**Table 4: Real growth of GDP by economy sectors for 2002 compared to 2001.**

Real growth of GDP by sectors	Early year projections	Fact
GDP	6.0	4.7
Industry	5.0	2.0
Agriculture	3.0	2.1
Construction	11.5	9.1
Transport	11.0	10.1
Services	6.5	5.5

Source: Ministry of Finance, March 2003

<sup>9</sup> According to IMF- staff estimates, January 2003.

GDP growth would have been closer to projection if such sectors as industry, agriculture and construction would not have manifested lower growth rates than the projections.

On the other hand, GDP structure is constantly leaving the underlined livestock and agricultural profile of the previous years, being focused on services, transport and construction. The Bank of Albania assesses that the new structural trends would be more efficient if evidenced in the industry sector, which might support a more stable economic growth on long- term periods.

**Table 5: Economic sectors' contribution over years**

<b>GDP structure (in %)</b>	<b>1992</b>	<b>2001</b>	<b>2002</b>
GDP	100.0	100.0	100.0
Industry	16.9	13.2	12.8
Agriculture	54.2	34.2	33.3
Construction	7.6	10.3	10.8
Transport	3.0	10.1	10.6
Services	18.3	32.2	32.5

Source: Ministry of Finance, March 2003

It has been already stressed that the significant reduction of the contribution of agriculture in GDP is mostly related to serious problems of agricultural sector.

The apparent recession of industrial production for 2002, as compared to the previous year and to the projections, expresses the straightforward facing of this sector with the factor of "lack of electric power".

On the other hand, there should not be ignored other problems affecting the development of this sector, which relate with:

- The existence of low efficiency in using the main production factors: human resources and productive capitals,
- The attendance of a frequently unfavorable environment for the business, which is mostly related to the problems of the legislative, juridical system, the transparency of the high government administration and the development of cooperation links,
- The existence of a certain stability by Albanian business especially the productive in the first half of 2002, created from the ambiguities in political developments of the country,
- The existence of gross difficulties in finding markets, inside the country or abroad.

## **I.1. AGRICULTURAL PRODUCTION**

**T**he latest estimates indicate that the agricultural growth is about 2.1 percent or nearly 1-percentage points below the projection for this sector.

Amongst the main factors that continued to hamper the wanted growth of agricultural and animal production even during 2002 may be mentioned:

- The low level of organization in this sector, which is expressed in the presence of the phenomenon of land parceling into ever smaller parts, the obsolete technology and mechanization in agriculture, the obvious deficiencies in organizing marketing of domestic products,
- The undeveloped infrastructure of rural areas, especially in the north of the country,
- The low preserving capacity of agricultural and live animals products in the country,
- The leaving aside of this sector by the banking system, which is reflected by a rather low supporting with the necessary financial resource.

Except the above factors, year 2002 evidenced even the natural factor, having the floods in the period of August – September.

In the conditions of the existence of very limited statistical information it is estimated at least that output in the rural industry is one of the positive elements affecting the growth of agriculture. More precisely at the end of 2002, food industry recorded nearly 13 percent growth.

#### **Box 1: THE METHODOLOGY FOR MEASURING GDP**

##### **A brief history on the measurement of GDP**

*The estimation of the production indicator until the beginning of '90's relied on the estimation according to the methodology of the Material Production System (MPS). The ensuing period 1990-1992 recorded the passing from the estimation according to MPS into the National Accounting. From this transformation in the accounts system, the indicator of the National Incomes was converted into that of Gross Domestic Production (GDP). Since 1991, GDP is estimated by the macroeconomic unit at the Ministry of Finance, while INSTAT, with the assistance provided by IMF, accomplished GDP calculation on statistical basis for the first time for the period of 1996-2000.*

##### **Applied methodology**

*The final result of the productive activity of the resident productive units is represented by GDP. GDP calculations include all current products and services destined for trade and those produced for individual consumption by all resident units operating in the "economic" territory of the Republic of Albania. INSTAT has applied production and expenditures methodologies on current and constant prices based on the United Nations National Accounts System of 1993. It estimates that the production methodology expresses GDP more really, basing this reasoning on the fact that the data used in the application of this methodology are actually more complete and reliable.*

##### **The new methodology:**

- *Conducts GDP on the basis of statistical measurements, while the previous methodology relied only on assessments of economic activity tendencies in the country,*
- *Measures the contribution of each sector in GDP on the basis of eight sectors of economy, while the previous estimates were only based on five of them.*

*Results from this methodology indicate that the real growth of GDP and the contribution of main economic sectors in GDP present a performance, which has significant differences in comparison with previous assessment methodology. Therefore, agriculture records a significant falling weight, whereas the contribution of the service sector is increased.*

Table 6: Resulted measurements from both methodologies for period, 1996-2000.

	1996		1997		1998		1999		2000	
Methodologies	I*	II**	I	II	I	II	I	II	I	II
Real growth of GDP compared to the previous year (in %)	9.1	9.1	-7.0	-10.3	8.0	12.7	7.3	8.9	7.8	7.7
The contribution of economy sectors in GDP (in %)										
1. Agriculture, animal husbandry and forests	51.5	30.8	56.0	31.2	54.4	30.7	37.2	28.5	35.9	28.1
2. Industry		15.5		13.8		11.4		11.4		11.7
- Ore-extracting	12.2	1.1	12.4	1.01	12.0	0.7	13.5	0.8	13.2	0.8
- Processing		14.4		2.8		10.7		10.6		10.9
3. Construction	11.2	4.6	11.2	4.3	12.6	4.1	8.9	4.9	9.7	6.1
4. Trade, hotels and restaurants		24.3		20.8		21.2		23.2		21.3
5. Transportation	3.2	5.4	2.7	6.0	3.0	8.8	9.0	8.9	9.5	7.9
6. Post office and telecommunication		1.0		1.6		1.4		2.0		2.0
7. Other services	21.9	21.1	17.7	25.9	18.0	27.9	31.4	25.9	31.8	26.4
8. Intermediate financial services indirectly measured		-2.7		-3.6		-5.5		-4.9		-3.8

Intermediate financial services indirectly measured

The most apparent deviations between the results from both methodologies are evidenced in:

- The economic growth indicator of 1998
- Apparent changes in the structure of agriculture and construction sectors, throughout the entire period 1996-2000.

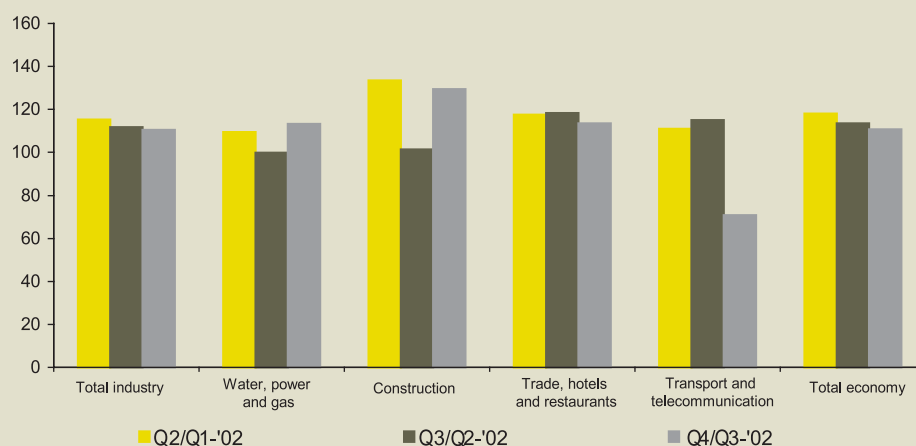
Source: 1) INSTAT, Gross Domestic Product, 1996-2000, January 2003.

2) Bank of Albania, Statistical Report, December 2002 and January 2003.

## I.2. INDUSTRIAL OUTPUT

**The index of sales.** The dynamics of sales index during 2002, on the whole economy, marked a slight falling trend q/q. "Transport and telecommunication", "Industry and Trade", "Hotels and restaurants" indicated a sharp falling trend, whereas the index of construction and "power, water and gas" sectors indicated an apparent oscillating performance. From a falling trend in the third quarter as compared to the second one, which might have been effected due to the unusual weather conditions accompanied with heavy rainfalls, the fourth quarter recorded almost 29.5 percent growth against the previous quarter. In this turning point of the trend, the impact given by the payment of "installments", which concentrate in year-ends, as well as the concluding of new contracts with construction companies, cannot be left out. On the other hand, knowing that the cost indexes in construction marked once more an increase, it appears that the sales index growth on construction sector might have been affected even by this fact.

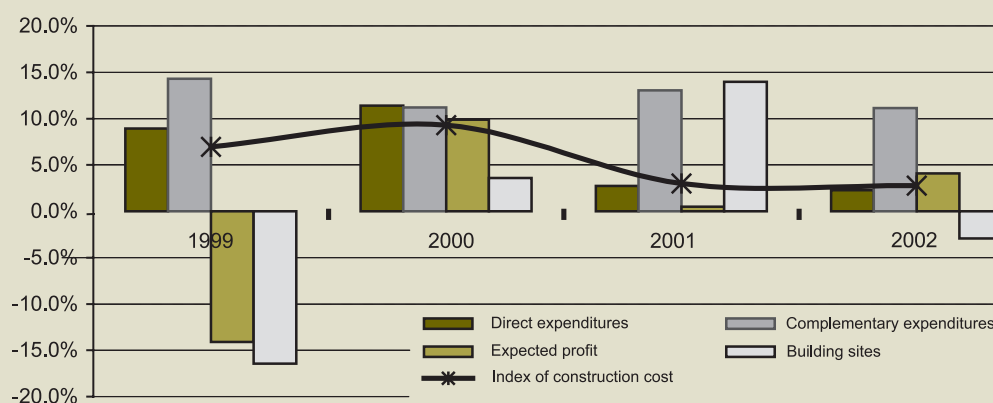
Graph 3: The dynamics of the index of sales for some economy sectors during 2002 (in percent).



Source: INSTAT, Conjecture, March 2003.

Construction sector is estimated as increased by 9.1 percent. This sector remains one of the most vital ones in Albanian economy. However, the formalization of the construction activity and the gradual glut of market demand for buildings provide affect the slowdown of this sector. Construction cost index has recorded a 2.8 percent rise compared to the previous year. This change has been mainly due to increasing item of "complimentary expenditures", whose index, compared to the previous year, has been moving upward throughout the whole year. Meantime, the annual change of direct expenditures has been negative throughout all the quarters, except for the fourth quarter of the year. In the fourth quarter, expenditures for building materials, wages and machineries caused the main growth of direct expenditures. "Building sites," indicates a falling trend. During the three recent years 2000-2002, its index reached the highest value in the fourth quarter of 2001 and tracked a fall during 2002. But, it is already clear that this sector's statistics suffer from the deficiency of complete and accurate evidences.

Graph 4: The annual change of cost index in construction, in percent.



### I.3. TRANSPORTATION

Unlike the previous year, where transportation was characterized by high investment rates, aiming at improving the country situation in infrastructure, this trend has fallen significantly in 2002. Compared to the previous year, investments in transportation are 31.2 percent less. Their realization level according to plan resulted 79.4 percent, while a year ago, the investments recorded a surplus of about 17.5 percent. We emphasize that the investments performance during the first three quarters has been low, making possible that even their accomplishment be lower than the plan for this period (65 percent). Meantime, an invigoration of investments is evidenced in the fourth quarter, which resulted with a surpassing of the plan of this quarter by 19.5 percent. Such a distribution of investments, inconsistent with the previously made projections, leaves room for thinking of an inefficient administration of them, dictated to a certain degree by the liquidity situation in the first half of the year 2002.

Table 7: Investments by resource, in millions of Lek

Indicators	1998	1999	2000	2001	2002
Total investments	8,269	13,129	15,997	13,653	9,400
Budgetary investments	1,969	4,447	5,977	4,423	4,077
Investments by foreign credits/aids	6,300	8,682	10,020	9,231	5,323

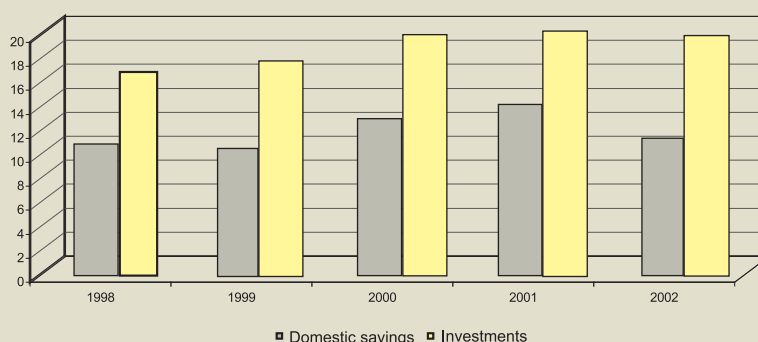
In the loading and unloading sector, an increase of the railway activity is evidenced, though they contribute at 8 percent of the total volume of loading and unloading, whereas the rest is covered from harbors. It is assessed that with the functioning of Bajze- Borderline (Montenegro) railway and later on with that of Shkoder-Bajze, the share of railways in the loading and unloading volume will be raised.

### I.4. SAVINGS AND INVESTMENTS

Year 2002, like two-three recent, has been characterized by faster growth rate of investments against domestic savings. Therefore, the gap created between them is financed from foreign savings, estimated at 8.9 percent of the GDP.

Domestic savings<sup>10</sup> for 2002 are found at 10.3 percent of the GDP from 13.1 percent in 2001. Meantime, investments indicate 0.4 percent falling as compared to the previous year, resting at 19 percent of the GDP.

Graph 5: Savings and investments performance as % of GDP



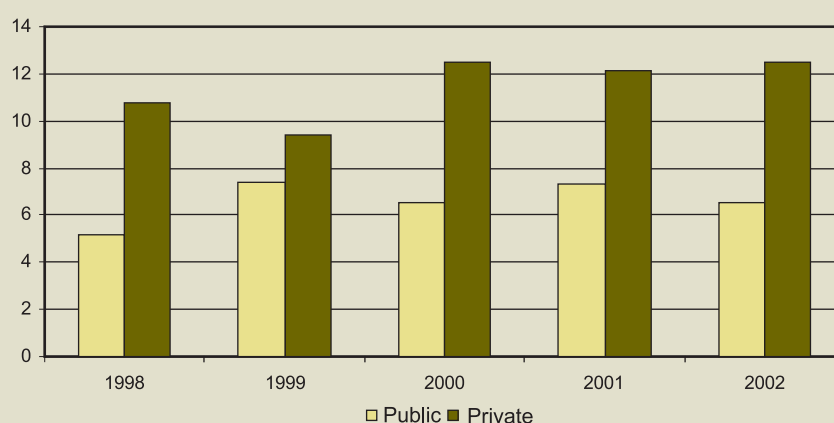
<sup>10</sup> The data on savings and investments refer to IMF estimates.

Public finances are further consolidated either with respect to collecting incomes or disciplining expenditures. However, non-completion of privatization receipts is deemed as one of the reasons to have affected the reduction of domestic savings and investments in 2002 versus 2001.

Domestic savings are mainly attributed to the private sector, by 11.1 percent of GDP, while the public sector presents a negative range of investments at -1 percent of GDP. On the other hand, public sector investments are estimated at 6.5 percent of GDP, whereas those of the private sector hold the main share calculated at 12.5 percent of the GDP.

Public investments, as envisaged in the national strategy of economic and social development, mainly concentrated in the primary sectors of economy, such as the health care education and infrastructure. For the latter one, extremely important are the foreign financing, whose contracting in 2002 was concentrated in the rehabilitation of APC (Albanian Power Corporation) and the road infrastructure improvement.

Graph 6: Investments by sectors as % of GDP.



Investments increase comprise an important element of economic growth. Also, the extension of domestic investments is considered as much important, since it reflects economy potentials for further investments and in consequence stability in the rise of the GDP. The attraction of foreign savings through foreign investments remains one of the priorities of Albanian authorities, as an essential factor to support investments programs.

#### **Box 2. PRIVATIZATION**

*The privatization of the Savings Bank and Albtelecom Company, as part of the structural reforms, could not be carried during 2002. The sale of the Savings Bank, planned to start in September 2001, failed as a result of the inappropriate tender. Only three banks expressed their interest to purchase the Savings Bank in September 2001. But this effort failed as a result of the uprising in FYROM, the financial crisis in Turkey, and the events of September 11<sup>th</sup> in USA. Therefore, the selling of the Savings Bank shares initially at 35 percent minimum and later at 49 percent was put off for June 2002.*

*The second endeavor, in June, to sell at least 35 percent of the Savings Bank shares failed again. Two Italian banks, San Paolo IMI and IntesaBCI competed to purchase the Savings Bank. Austria Bank, as part of the HVB group, gave up tender procedures. The two Italian banks retracted from the purchase of the Savings Bank, due to troubles presented by complete restructuring of the Savings Bank and their commitment in other privatization processes in the southeast Europe. According to them, the Savings Bank needed a profound renovation. The Savings Bank dominates the deposit market, occupying 60 per cent of it. To facilitate the privatization process, in May, Albanian Parliament allowed the exclusion of the Savings Bank from the law on competition, which forbids different companies to control more than 40 percent of the market. The Savings Bank sale represents the core element to create a more vital banking system.*

*To facilitate the privatization process, the Albanian authorities are committed in revising the Savings Bank privatization strategy, as deferments in this process may raise further troubles for budget financing. International Monetary Fund and the World Bank are giving their assistance in this process.*

*The privatization of the fixed telecommunication operator Albtelecom resulted in an unsuccessful effort in 2001. The strategic investor of Albtelecom would purchase 51-76 percent of the company shares, leaving a considerable part in the hand of state. Tendering condition required a strategic investor ready to invest USD 300 million and paid up capital of USD 150 million.*

*Albtelecom could not attract foreign investors although the deadline was postponed for June 2002. The delay is attributed to the general slowdown in the global market of telecommunication and the unresolved matters between Albtelecom and the third parties. After this moment, taking institutional responsibilities for the privatization of Albtelecom presented another difficulty. Related to Albtelecom, its balance is full of financial problems, requesting a solution to increase the value of the company before its privatization, which is expected to take place in 2003.*

*In May, the Parliament approved the modified formula for the privatization of INSIG Company, allowing international financial institutions to buy shares and run the company for nearly 3 years before privatization. The government has decided to sell up to 40 percent of the shares to IFC or EBRD and a year later it shall be offering to a private company of insurances at least 51 percent of the legal framework of INSIG. Privatization process is expected to set out in 2003. Albtelecom could not be attractive for foreign investors although the deadline was deferred for June 2002. The deferment is attributed to the slowdown in the global market of telecommunication and unresolved issues between Albtelecom.*

## II. LABOR MARKET

**T**he data on the labor market for 2002 do not simply reflect such market developments but also the changes that came as result of the General Census of the Population and Dwellings.

Major changes relate to the reduction of the labor force and the change of employment structure. For the first time in 2002, a reduced figure, of 526 thousand persons, was evidenced in the total number of persons employed by the private sector of agriculture. This figure counts for 235 thousand persons less compared to 761 thousand persons at the end of 2001. The number of

employed persons by the private sector of non-agriculture, as a result of the migration of the country population to urban areas, has been increased by almost 90-95 thousand persons.

The difference between the changes by both sectors (agricultural and non-agricultural) by nearly 140 thousand persons has lowered the number of the labor force during this year and has raised the unemployment rate, although the unemployment rate in absolute figures encountered decrease along the whole year. Thus, the rising unemployment by the private sector of non-agriculture has been insufficient to fully compensate the free labor force created in the private sector of agriculture.

### Box 3: CHANGES BY LABOR STATISTICS

Year 2002 recorded some changes in the measurement of labor market indicators, due to the General Census of Population and Dwellings. The most important changes were:

- The data on employment in the private sector of agriculture for 2002 are on the basis of results taken from the General Census of the Population and Dwellings. The data until 2001 are based on the general record of the rural economic units of 1998. The General Census brought about some changes in the structure of the population. The ratio of the urban and rural population by place of residence in 1998 was namely 39.8 to 60.2 percent moved to 42.2 and 57.8 percent in 2001. Such a thing conducted a decrease of rural economic units surveyed in 1998. Therefore, the number of unemployed persons had a reducing trend from 761 to 526 thousand persons.
- The data on the employment by the private sector of non-agriculture are taken from the Labor Directorate attached by the Ministry of Labor and Social Affairs, as these were previously ensured from data on the record of enterprises by INSTAT.

Table 8: Labor market indicators<sup>11</sup>

Indicators	2001				2002			
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III	Q.IV
Total labor force (000)	1277	1263	1256	1247	1096	1093	1094	1094
A) Total employed (000)	1072	1071	1069	1065	918	917	919	921
a) By public sector	195	194	192	191	189	188	187	187
b) By the urban private sector	116	116	116	113	203	203	206	208
c) By the private sector of agriculture	761	761	761	761	526	526	526	526
B) Unemployment (000)								
Total unemployed	205	192	187	182	178	176	175	173
Unemployment fee beneficiaries	21	18	16	15	13	13	12	11
Unemployment rate (in %)	16.0	15.2	14.9	14.6	16.2	16.1	16.0	15.8

Source: INSTAT Conjecture, March 2003.

<sup>11</sup> Calculations reflect changes in labor market statistics.

Labor force at the end of 2001 counted for 1,1 million persons, whereas at the end of 2001, it was 1,2 million. This figure covers 36 percent of the total number of the population in the Republic of Albania.

At the end of 2002, it is evidenced that the changes in the labor force, as compared to the year-start, are very insignificant, recording 2 thousand persons less. The further lessening of the labor force at the end of 2002 indicates that important labor forces, including those accessed for the first time, emigrate or finish in the informal market of labor.

Employment indicator at the end of the fourth quarter, compared to early year, records 3 thousand more.

The increase by employment indicator is mainly as a result of the rising number of the employed by the private sector of non-agriculture. Such a rise reached 5 thousand persons at the end of 2002 as compared to year onset.

An important indicator inside this sector is employment by retail trade. This is due to the fact that retail trade or the so-called small business, continues to dominate the non-agriculture private sector, occupying 22.5 percent of the total employed. This sub-sector is assessed to employ a considerable part of the labor force by the small business sector, either in retail trade or services. Employment by retail trade in 2002 increased by 2.9 percent as compared to 2001.

Labor market indicators during 2002 have been positive, being characterized by a constant quarterly reduction of unemployment. Unemployment was nearly 5 thousand persons less, reaching 173 thousand persons at the end of the year as compared to year onset.

In 2002, the number of persons, who benefit unemployment benefit, recorded positive indicators as well. At the end of the year, unemployment bonus beneficiaries were 4 thousand less than at the end of 2001. This has been mainly due to the partly re-employment of these persons (as they are trained or retrained for the period they are registered by the labor offices as unemployed), since the payment for these category of people is very low and makes it impossible to live with these incomes.

### III. FISCAL SECTOR DEVELOPMENTS

#### III.1. GENERAL CONSIDERATIONS

**F**iscal consolidation has been at the center of government's economic program for 2002. This consolidation would be achieved by extending the fiscal basis and by the rising skills of respective authorities to collect taxes, reduce budgetary expenditures and improve their efficiency.

During this year, an important development in the economic policy of the country was the setting of government's fiscal targets on medium term, so that the budgetary deficit of the country would reach 5.8 percent of the GDP at the end of 2005.

Year 2002 recorded a lower deficit than the plan, about 6.2 percent of the GDP, following its downward trend during the recent years. Revenues and expenditures for 2002 were expected to be 23.4 and 31 percent of GDP respectively, while they actually reached a ratio of 22.9 and 29.1 percent respectively.

Table 9: Fiscal indicators as % of GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Revenues	24.1	23.4	16.3	17.02	22.0	22.0	21.9	23.0	22.9
From these: fiscal revenues	16.0	13.2	10.7	9.8	12.3	12.9	15.6	15.6	15.7
Expenditures	33.1	33.6	31.3	27.7	30.2	33.3	30.9	31.5	29.1
Capital expenditures	3.4	8.3	4.9	4.2	5.7	5.8	6.6	7.4	5.6
Budgetary deficit	-9.0	-10.2	-11.4	-13.2	-11.3	-11.9	-9.1	-8.6	-6.2
Domestic financing	8.6	6.5	9.0	11.3	6.5	6.9	5.4	4.8	3.2
Foreign financing	0.4	3.7	2.4	1.9	4.8	6.2	3.7	3.8	3.0

Budget revenues in absolute value were 11.4 percent higher compared to the previous year and their realization of the plan was at 95 percent. Non-fulfillments are evidenced in the collection of revenues either from customs or from duty-tax institutions. On the other hand, the government has been vigilant to control budgetary expenditures. As compared to the previous year, they were increased only by 3.2 percent in absolute value, whereas their realization according to the budget plan was 90 percent.

Table 10: Meeting fiscal indicators according to plan, in percent.

	2001	2002
Total revenues	96	95
Tax	96	92
Non-tax	91	107
Social contributions	97	98
Total expenditures	95	90
Current	99	98
Capital	96	73
Budgetary deficit	92	77

### III.2. BUDGET REVENUES

**B**udget revenues for 2002 were almost at the same ratio to GDP as in the previous year. Although, according to the budget plan, central and local government revenues were planned to ensure 71 percent of the total revenues, this item reached only 68.5 percent of them. Meeting the plan on them, this year suffered a slight decrease, reaching 92 percent from 96 percent in the previous year.

Table 11: The structure of revenues in percent

	1998	1999	2000	2001	2002
Total revenues	100.0	100.0	100.0	100.0	100.0
Customs and duty tax revenues	59.9	60.0	68.6	66.2	66.7
VAT	30.8	27.7	31.6	30.4	30.6
Profit tax	4.6	5.6	6.7	7.6	8.1
Excises	5.3	6.5	7.6	7.0	6.2
Small business tax	1.0	1.1	1.4	1.5	1.7
Private income tax	1.2	2.9	3.8	4.6	4.1
National tax	3.3	3.7	4.8	5.1	6.7
Customs tax	13.5	10.7	11.2	9.4	8.9
Solidarity tax	0.2	1.8	1.5	0.6	0.5
Local government tax	0.8	0.8	1.1	1.5	1.8
Contributions	16.9	16.9	16.6	16.6	17.0
Non-tax revenues	22.2	22.1	13.7	15.6	14.6

It is evidenced that the weight of revenues on customs tax has been less, compared to the previous years. These revenues for 2002 are 91 percent of the plan.

### III.3. BUDGET EXPENDITURES

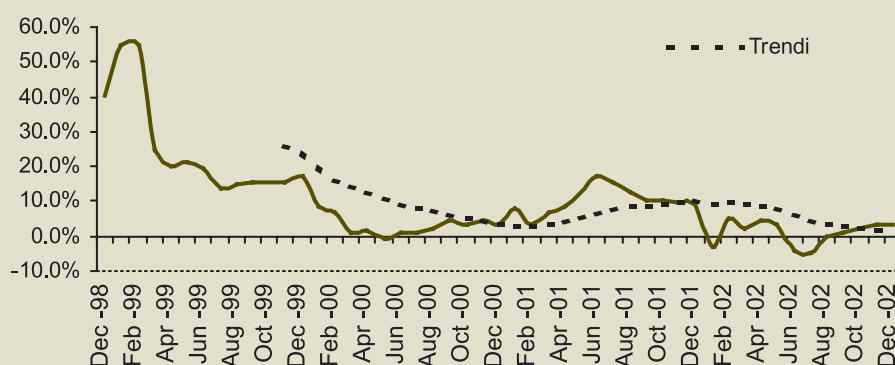
**B**udget expenditures as percentage of GDP have been falling from 31.5 percent in 2001 to 29.1 percent in 2002. Current expenditures shared 81 percent of the total expenditures, while according to the budget plan, this ratio was planned at 74.6 percent. The rest of the budget would be used for capital expenditures. In fact, the latter occupied only 19.4 percent of the total expenditures, recording an accomplishment rate at the degree of 73 percent. Compared to the previous year, capital expenditures were 13.8 percent less.

**Table 12: The structure of budget expenditures in percent.**

	1998	1999	2000	2001	2002
Total expenditures	100.0	100.0	100.0	100.0	100.0
Current expenditures	82.9	79.1	78.1	76.0	80.6
Personnel	20.0	18.8	19.5	22.2	21.9
Maintenance	13.1	12.1	11.3	13.5	10.7
Subventions and other social insurance	17.2	20.5	21.9	23.6	24.2
Interests	25.3	21.1	17.3	13.0	12.9
Other	5.7	5.0	5.0	4.7	4.5
Capital expenditures	17.1	20.6	21.3	23.2	19.4
Bank restructuring	-	0.3	0.6	0.8	-

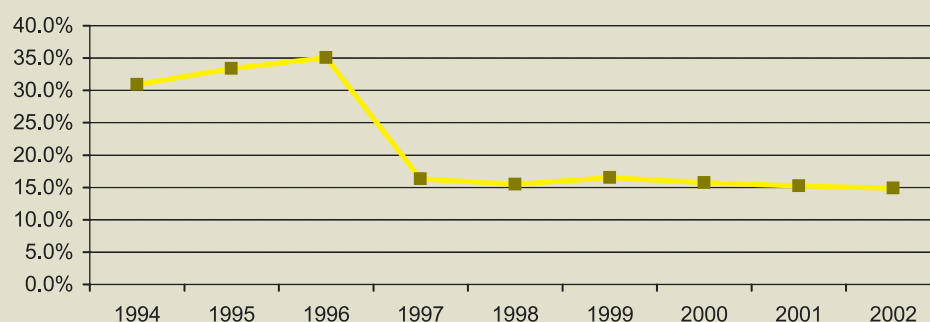
The government reduced the budget expenditures to ensure the observance of fiscal quantitative targets. This reaction was dictated by the lack of privatization receipts and the difficulties in financing budgetary deficit, as a result of liquidity situation created in interbank market.

**Graph 7: The annual change rate of budget expenditures**



December was the only period, when the monthly expenditures were over those projected in the budget plan. The higher rate of budgetary expenditures, compared to the other months of the year, is one of the features of this indicator. It is evidenced that after 1997, the share of budget expenditures in December against the annual expenditures is almost the same, every year.

Graph 8: The share of budget expenditures against the total expenditures in December

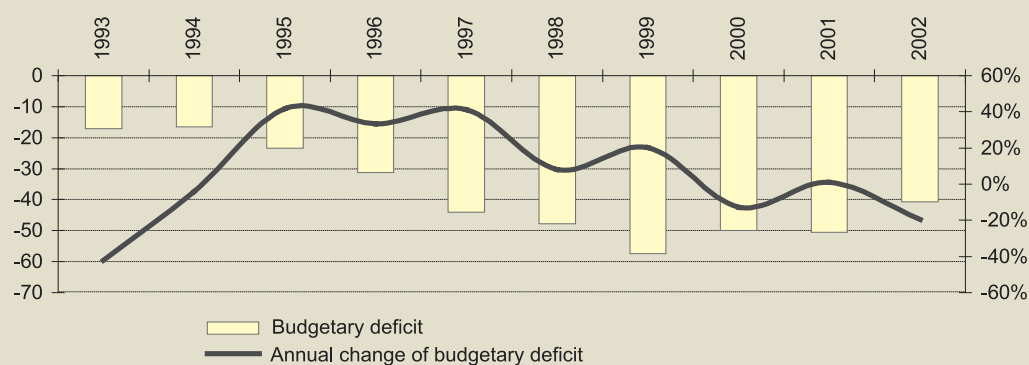


#### III.4. BUDGETARY DEFICIT AND FINANCING

**B**udgetary deficit in 2002 resulted 1.3 percentage points lower than the plan and 19.4 percent lower than that in the previous year. This indicator reached the figure of Lek 40.8 billion or 12,2 billion under the level forecasted in the budget plan. Such fall is in line with the reducing trend of budgetary deficit over the last years.

41

Graph 9: Budgetary deficit (in billions of Lek) and its annual change in percent.



Relating to deficit financing, about 51.4 percent of it has been covered by domestic resources and the rest by foreign resources. The domestic financing is Lek 1,4 billion over the rate projected in the budgetary plan, whereas its foreign financing is about Lek 12 billion under the plan. Totally, Government's internal debt in 2002 is 9.6 percent higher, compared to the previous year, when a part of its domestic financing (domestic financing in 2001 was 56.3 percent of budgetary deficit) has been covered by privatization receipts.

The lack of privatization receipts made possible that the main burden for covering the budgetary deficit with domestic assets rest in the banking system. However, the massive retraction of deposits from commercial banks in March brought about a lack of liquidity in the system and a change in the structure of budgetary deficit financed by domestic resources as an aftermath. The Bank of Albania changed the orientation of its main target, the maintaining of price stability. It ensured sufficient liquidity in the market and moreover, it took the position of the main government lender during the first half of the year. Its financing has been in the form of direct credits and the outright purchase of the treasury bills. At the end of the first half of the year, the Bank of Albania reached Lek 6 billion, being close to the permitted limit of 6,06 billion<sup>12</sup>.

Graph 10: Deficit financed through treasury bills in Lek<sup>13</sup>.

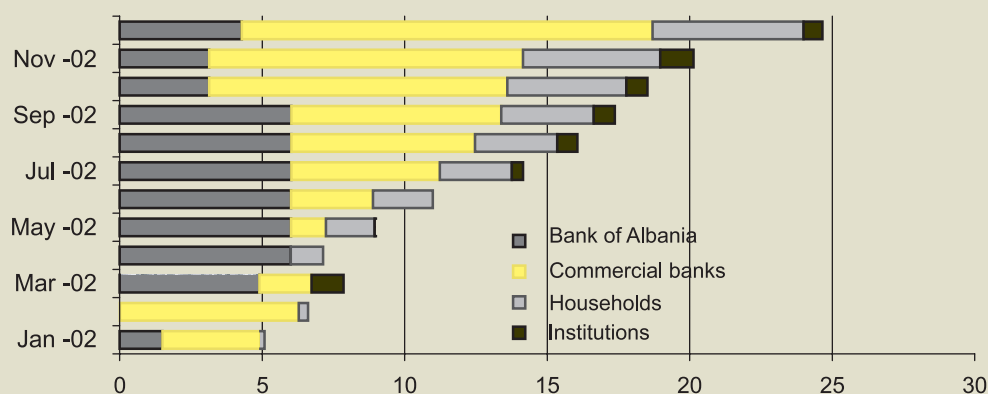


Table 13: Budget consolidated indicators (in billions of Lek)

Indicators	2000	2001	2002	Plan on 2002
Total revenues	120.6	135.5	150.9	159.4
-Tax revenues	84.1	91.8	103.3	112.8
-Social insurance contributions	20.0	22.5	25.6	26.1
-Non-tax revenues	16.5	21.2	22.0	20.5
Total expenditures	170.6	185.9	191.7	212.3
-Current	133.3	141.0	154.6	158.5
-Capital	36.3	43.0	37.1	50.8
-Bank restructuring	1.0	1.9	-	-
Budgetary deficit	-50.0	-50.4	-40.8	-52.9
-Domestic financing	18.5	28.3	21.0	20.7
-Foreign financing	17.5	22.1	19.8	32.1

<sup>12</sup> Pursuant to Law "On the Bank of Albania" the legally permitted limit on deficit financing is 5 percent of the average budgetary income on the three recent years.

<sup>13</sup> Data source: Bank of Albania.

## IV. INFLATION DEVELOPMENTS AND MONETARY POLICY

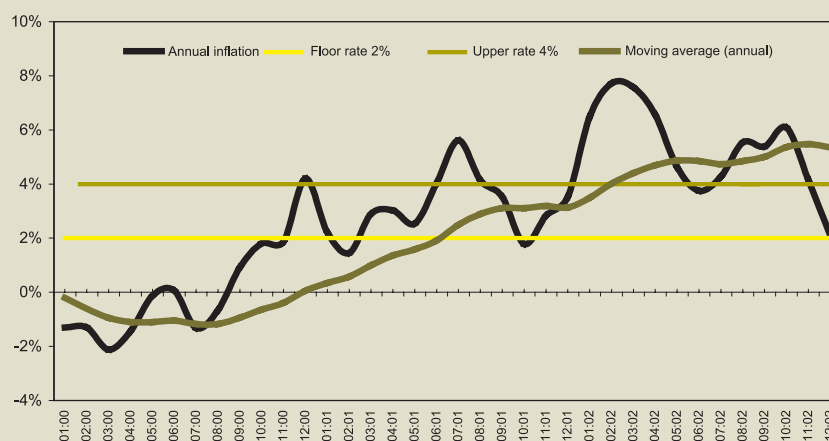
### IV.1. INFLATION IN ALBANIA IN 2002

Year 2002 ended with 2.1 percent rate of annual inflation, ensuring in this way the observance of the Bank of Albania 2-4 percent targeted band. However, the average inflation in 2002 recorded a higher figure of 5.4 percent.

Table 14: Annual inflation rate

	1999	2000	2001	2002
January	6.0	-1.3	2.2	6.5
February	3.5	-1.3	1.5	7.7
March	2.0	-2.1	2.9	7.6
April	0.4	-1.4	3.0	6.6
May	-0.1	-0.1	2.5	4.6
June	-0.6	0.1	4.0	3.8
July	0.1	-1.3	5.6	4.3
August	-0.6	-0.7	4.1	5.5
September	-1.9	0.9	3.5	5.4
October	-1.8	1.8	1.8	6.1
November	-1.2	1.9	2.8	4.1
December	-1.0	4.2	3.5	2.1
Average inflation	0.4	0.1	3.1	5.4

Graph 11: Annual inflation rate, its target and average rate in percent.



The first months of 2002 manifested high annualized inflation rates and even higher rates than the Bank of Albania target. In January–April, annual inflation moved through annual values of 6.5 and 7.7 percent. Inflation in this period continued to be influenced by the group, “rent water fuels and power” mainly as a result of the rising price of electric power in December 2001. The second quarter was characterized by an unusual falling trend of monthly and annual inflation rate. Inflation in this quarter reached the average value of –1.06 percent. The Bank of Albania has estimated that the seasonal factor, which historically influences on inflation decrease in summer, in 2002 was shifted to one-month ahead in 2002. The significant decline in prices of May and June is explained with the seasonal effect of foodstuff group, which was felt earlier than usual.

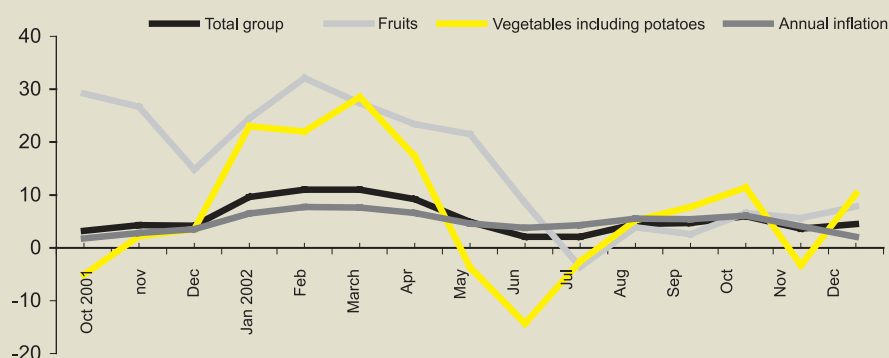
Also in the third quarter, inflation recorded a deviation from its historical behavior, marking higher values than those of the previous years. Specifically, there were increased the prices of services and foodstuff of the sub-group "hotels and restaurants". In the third quarter of 2002, inflation rate had an almost normal development. The increase of the new educational services by the private and public sector made annual inflation rate during October be higher than the monthly rate of October 2001. December 2002 was characterized by a lower inflation rate than in the two previous years of 3.2 percent, bringing it closer to the historical mean of 2.43 percent but significantly higher than all the other months of 2002.

It must be stressed that both values of monthly inflation rates, apparently lower, in May and November, respectively -1.6 and 0.0, affected the falling turns of annual inflation rates.

#### IV. 2. INFLATION BY MAIN GROUPS OF MERCHANDISE

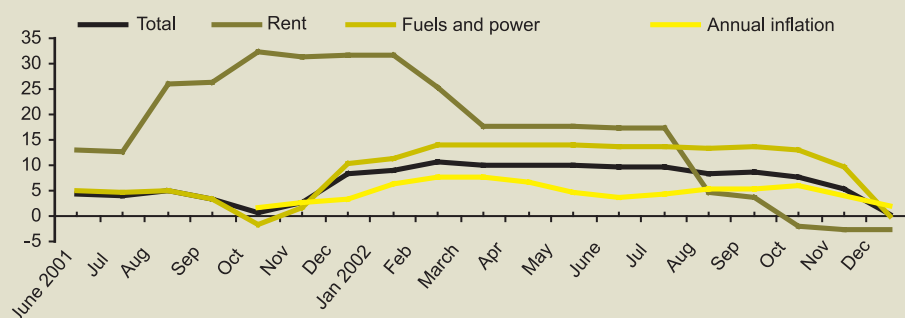
**T**otal inflation performance during 2002 has been set from consumer price performance of tradable and non-tradable goods, where the main share is held by foodstuff. Within the foodstuff group 'food and non-alcoholic drinks' gave the strongest effect on inflation values.

Graph 12: Annual inflation rate of "food and non-alcoholic drinks"



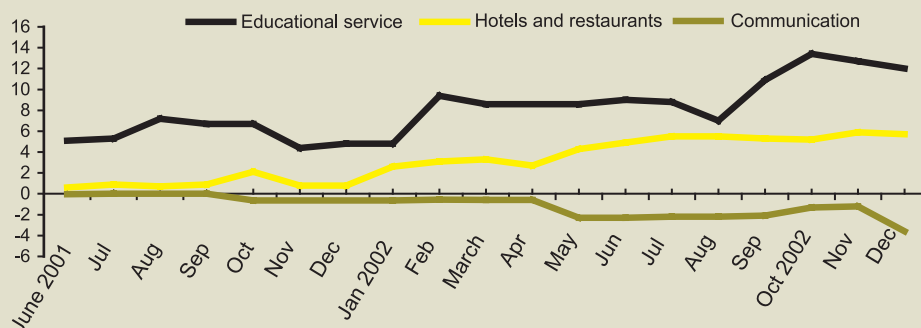
Another most important group, based on the share held in the basket of consumer prices index, is the "rent, water, fuels and power". This group weight in the new basket was increases significantly, due to the addition of the concept of "input rent" in this group. The increase of electric power price in December 2001 was reflected in the increase of consumer price index of the whole group. However, in this year, this group was characterized by stable prices, whereas a constant decline was evidenced in the prices of separate sub-groups, such as that of rent, after an apparent rise at the beginning of the year.

Graph 13: Annual inflation rate of "rent, water, fuels and power".



Among the other merchandise groups to have given an effect in 2002, "hotels, cafes and restaurants", "communication" and "educational services" are worth mentioning. These three groups indicated the greatest effect in the third quarter. The rising index of these group prices was also affected by "hotels, cafes and restaurants", due to the increased number of foreign tourists (mainly from Kosova) and emigrants' returning to pass their holidays in their home country, a fact that led to the price rise of services and goods of the sub-group "hotels and restaurants". It is worth mentioning that "educational service", although at an insignificant weight in the CPI basket, indicated a significant increase at the beginning of the school year, due to the rising price of public and private education. The passing of this stage made the prices of this group get stable in December. Inflation by "communication" group was reduced throughout the whole 2002, due to the promoting framework offered by cellular operators.

Graph 14: Annual inflation rate of "communication", "educational services" and "hotels, cafes and restaurants".



### IV.3. INFLATION DETERMINANTS

Years 2000-2002 has generally indicated rising inflationary pressures, appearing not only in the annual average inflation increase, but also in the highest values of the months. These pressures have been most apparent in 2002. Since the beginning of the month, there were evidenced some factors that might put to risk the achievement of inflation target such as:

Demand determinants:

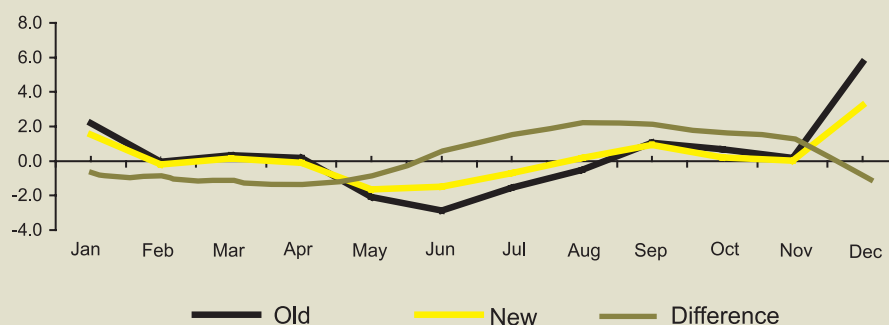
- Increase of currency in circulation and M1 aggregate,
- Foreign currency basket, added with a new currency,
- Higher import prices,
- Year-end holidays,
- Uncertainty in the exchange rate performance.

Supply determinants:

- Electric power situation, which continued to be unsafe,
- Enforcement of new taxes
- Bad weather.

Additionally to these factors, special for 2002 was also the fact that the consumer price index began to be calculated with the new basket of goods and services. The statistical effect of including new articles in the basket had an effect on the descending side for the first half of 2002 and on the rising side for the second half of the year, with an annual result of 0.3 percentage points.

Graph 15: Annual inflation rate according to new and old weights in percent for 2002.



**Box 4: NEW BASKET ON MEASURING THE CONSUMER PRICE INDEX.**

The consumer price index, starting from January 2002, was calculated with the new basket and the new weights of goods and services, based on the results of the Household Budget questionnaire organized in Albania in 2000. The total of selected articles by the new basket went to 262, from 221 articles in the previous basket. The new index is calculated on the basis of 12 groups of merchandise, from 8 in the old basket. "Food, beverages and tobacco" as the main group in the previous basket was split into three groups "food and non-alcoholic drinks", "alcoholic drinks and tobacco" and "hotels, cafes and restaurants".

**Table 15: The structure of weights by the old and the new basket in percent.**

	Old	New
1 Food and non-alcoholic drinks	69	43
2 Alcoholic drinks and tobacco	3	3
3 Clothing and footwear	3	4
4 Rent water, fuels and power	6	24
5 Household appliances, furniture and maintenance	8	5
6 Health care	1	2
7 Transport	4	5
8 Communication	1	1
9 Recreation and culture	3	3
10 Educational service	1	1
11 Hotels, cafes and restaurants	1	7
12 Different goods and services	0	2

The index contains a selection of cities resembling the official structure of prefectures, used by the government for other statistical ratios on urban basis. In view of this fact, the new basket in 2002 was assessed to reflect a reverse structure of the average consumption of Albanian families.

Even in 2002 the total inflation performance has been set from the consumer price performance of tradable goods, where foodstuffs bear the main weight.

A more important group, based on the weight it bears in the CPI basket, is "rent, water, fuels and power". This group weight by the new basket had a high increase, making this group be decisive for the overall performance of the index. Such growth is as a result of "input rent" concept added to this group. Input rent is a potential expense performed by Albanian customer for hiring a house. Among the main reasons, for including goods and services of "input rent" in new basket, we may mention:

- Out of the household budget questionnaire, it has been evidenced that expenditures for this basket group hold a considerable weight in Albanian customer average expenditures.
- About 93 percent of Albanian citizens resulted owners of their dwellings, a fact that changes then into potential renters of their homes at any time of the month. The impossibility to measure this item monthly is resolved by the "input rent".

It has been assessed that the data on inflation measured according to the new basket basis is more real. This fact is obvious if we study the oscillation of the monthly index of inflation measured by the old and new basket weights. The new measurement has leveled out the seasonal oscillations, adding the possibility for more accurate projections.

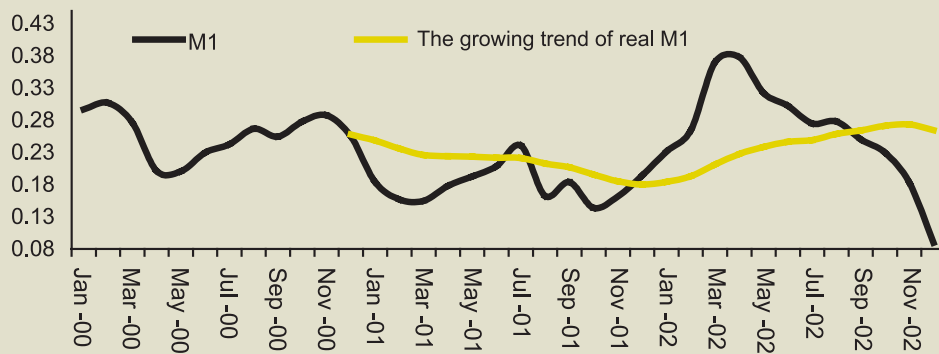
Amongst the most important factors affecting the annual inflation rate, we may mention:

### 1. Monetary developments

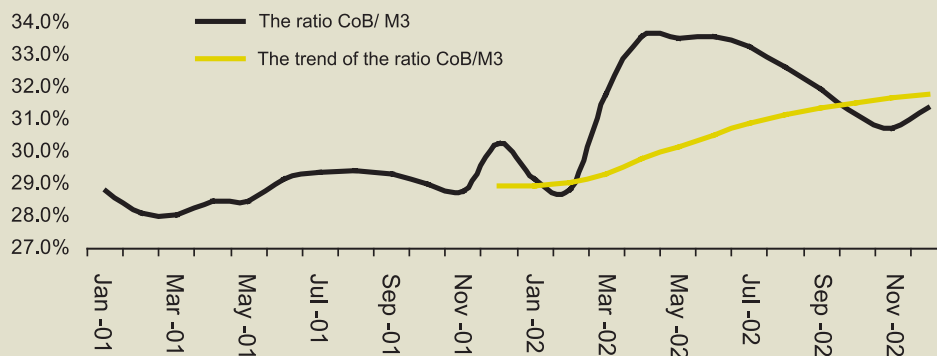
The financial stability of the country was shocked in the first half of the year. The banking system was faced with a significant deposit retraction in March-April period, which forced the currency outside banks extend by 15 percent, increasing inflationary pressures in economy as well.

The tightening of monetary policy affected the normalization of monetary indicators over August–December and the defining of the declining trend of annual inflation during the last months of 2002. Starting from August, real M1 is under the historical trend. The ratio of currency outside banks against monetary supply has been reduced to 31.4 percent throughout the whole period and in December it converged the 31 percent target for the end of the year.

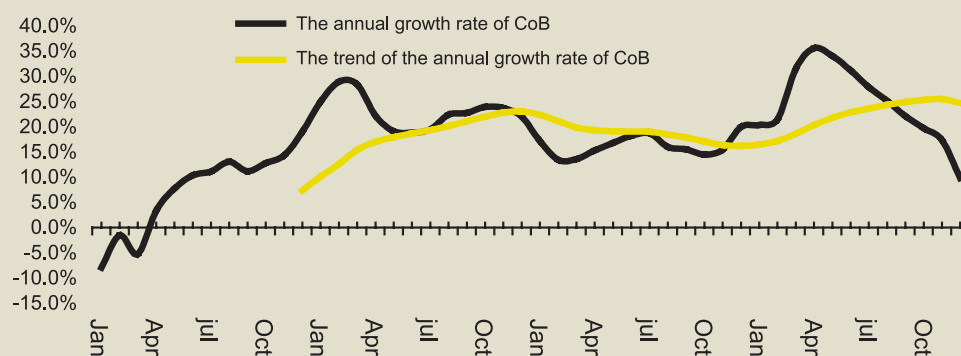
Graph 16: Liquidity performance in economy, the annual changing rate of real M1.



Graph 17: Currency outside banks against M3



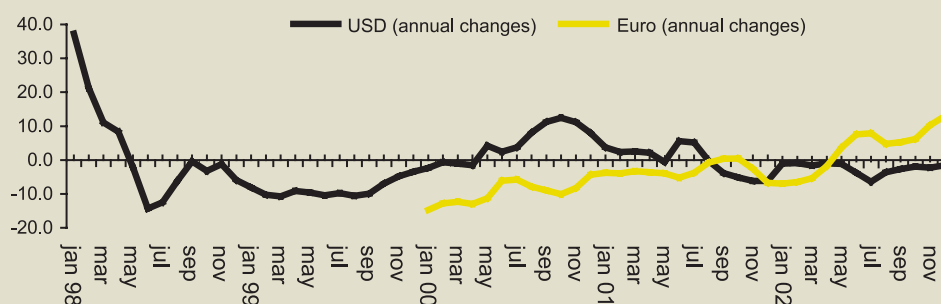
Graph 18: Currency outside banks annual growth rate



## 2. Exchange rate

Exchange rate performance presented instability in the first quarter of the year, due to Euro introduction in the market. Also, the highest depreciation of Lek against both currencies in May, which are assessed to have been caused mainly due to the hard situation the banking system is passing through, influenced on the rising side of inflation until July 2002. It was precisely in this moment that Euro was, for the first time, equal to USD. The period until the end of the year was almost characterized by a symmetrical behavior of exchange rate. While Euro appreciated against Lek, USD depreciated against it during the year. It has been assessed that the exchange rate behavior (in real average terms) at least, did not influence the addition of inflationary pressures during the second half of the year.

Graph 19: Annual changes of Lek /USD and Lek/EUR exchange rates



## 3. Budgetary expenditures

Budgetary expenditures have been kept under control during 2002. Budgetary expenditures' effect is assessed as operating on inflation rate by nearly 5-6 months lag. So, the expenditures of June-July 2002 have been realized at 87 percent of the plan, without affecting, in this way, on the increase of inflation rate at the year-end.

#### 4. Imported inflation

Imported inflation is assessed to have exercised a rising effect. Inflation by Euro area countries resulted higher than the 2 percent forecasting on annual basis. This influenced the increase of imported goods prices. A feature of the previous year was the fuss made on the increase of inflation as a result of Euro introduction, in almost all EU countries.

##### **Box 5: WAS 2002, THE YEAR OF THE DRASTIC RISE OF CONSUMER PRICES IN EU?**

*A year after the Euro introduction, many customers continue to express that they “feel” the rapid growth of prices. Several have been the protests of Europeans throughout the previous year that felt concerned about this phenomenon tangible to all European countries.*

*On the other hand, official European statistics assert a slight growth of annual inflation rate surpassing ECB target of 2 percent by 0.2 percentage points.*

*In fact, many services and products prices increased significantly. Bad weather conditions in many European countries damaged lots of agricultural products. Higher taxes increased significantly the price of tobacco and luxury articles. Urban transport prices were sometimes three times higher. Some dishonest businesspersons increased the prices by a simple “rounding up” in the conversion of the domestic currency value to Euro, without respecting the respective exchange rate.*

*However, the economists’ evidence that for every increase of the consumer goods price, mainly foodstuffs, there was a significant decline especially for electronic and household appliances. Also, electronic power price was stable, due to Euro appreciation to USD. In Italy, where this phenomenon was moreover verified than in other countries, its impact has been estimated at only 0.2 percentage points in the increase of inflation rate.*

*Economists are already clear that the big change between price perceptions on customer’s behalf and their real state is simply a psychological **phenomenon**. “Customers note that goods and service prices, for which they pay in cash or which they regularly purchase, are increased, but they do not see that prices for purchasing cars or PC’s are significantly less”.*

*Source: David Fairlamb; Gail Edmondson: Business Week, September 16, 2002.*

Higher food prices in partner countries have given a rising effect on inflation rate in Albania, where the structure of the consumer price index, unlike the European countries, continues to be mostly comprised by these kinds of goods. These have given a negative impact, even on making a fuss on rising the reference prices by customs, which might have injured, to some extent, the expected effect of the campaign for preventing the speculative factors in the market at year-end.

## 5. Specific determinants

Some special determinants that have affected inflation increase in 2002, we may mention:

- Inflation in the year just ended **kept reflecting rise of the electric power price, applied in December 2001**, indirectly to non-tradable goods sector. According to estimates, such rise has been gradually and indirectly transmitted even in the tradable goods sector, almost throughout the first quarter of 2002.
- **The unstable electric power situation** is considered as a factor that kept the consumer price performance under constant tension mainly on rising direction, especially in the service sector, even during 2002. The impact has been stronger during the first months of the year, as well as during July-August.
- **The bad weather at the early year as well as the floods in September** affected rise on transport and as a consequence even on foodstuff prices.
- **The panic situation created in Albanian banking system.**

### **Box 6: TRADABLE AND NON-TRADABLE GOODS SECTOR AND INFLATION**

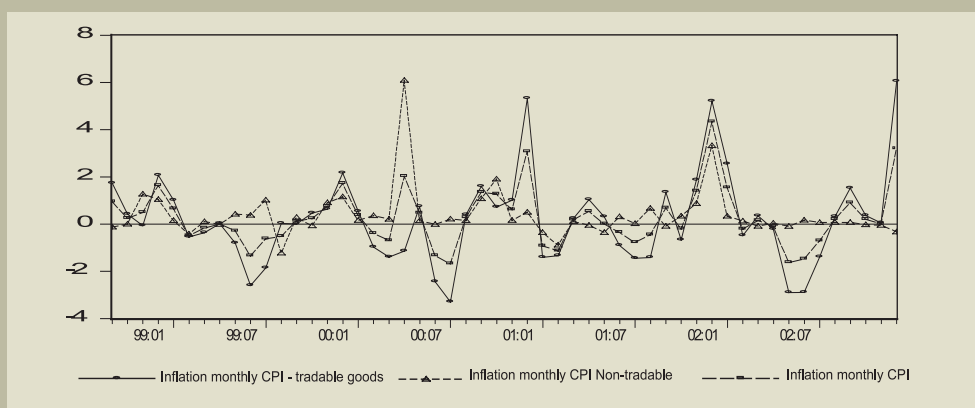
*The Bank of Albania study on inflation in 2002 was further extended with the examination of tradable and non-tradable goods contribution in total inflation.*

*Tradable goods sector is very exposed to competition. This fact explains a very distinctive feature of goods price, which comprise it, that is, the deviations between prices are insignificant. Differences between tradable goods prices reflect a pure falling trend, the more are added the requests to ensure and/or increase profits from the rise of productivity, the higher and the faster is the rise of productivity in the conditions of a complete competition realizing this trend.*

*Non-tradable goods sector or the “under shelter” sector as it may be called figuratively, due to the feature it displays, is that sector where additional costs, which contribute in the increase of productivity, are more obviously reflected in the rise of wages and prices accordingly.*

*If both sectors are compared from marginal costs viewpoint, which contribute in the improvement of productivity, it could be concluded that these are very different from one another. Marginal cost of the non-tradable goods sector, is mostly some times higher than that of tradable goods sector. In terms of inflation, this would mean that an increase of costs, aiming at improving the productivity of non-tradable goods sector is reflected more intensively and at a higher magnitude by the rise of wages in this sector, thus higher prices and in consequence higher inflation rates by this sector.*

Graph 20: Monthly change of consumer price index by sectors



*Empirically, concluded was that:*

- *Whether the two sectors are compared on the whole period, tradable goods sector is the one giving the main trends on total inflation.*
- *Inflation by non-tradable goods sector has explained that of tradable goods at 7.8 percent and this correlation has been strengthened during the 4 recent years.*
- *1998-2002 has evidenced a relatively strong seasonality for tradable goods over December. It is assessed to increase inflation of this group by 3.6 points percentage over the average performance of December. Inflation at year-end, due to seasonal factor, from both sectors, is assessed to be increased, on average, 2.5 points percentage.*

*On the other hand, the impact of special groups on one-another and on the total inflation, presents much interest for viewing the impacts on actual and expected inflation. The study indicated that it is just the time that the inflation may not have only tradable goods as subject to it, but the non-tradable goods as well. Empirical results are for a more complete model on inflation forecasting, based on respective results by each sector. Concretely, regressive analysis cast a light on:*

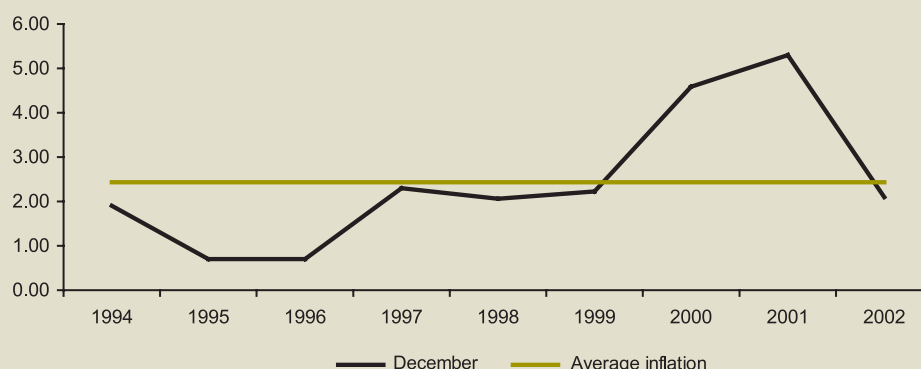
- *Inflation forecasting by tradable goods sector through changes in import prices. Furthermore, this conclusion is worth viewing when it is known that the weight of tradable goods in imports is still assessed as considerable.*
- *Inflation forecasting by non-tradable goods sector through such variables as budgetary expenditures and banking system deposit rates.*

*It is very important that the forecasts take into account the expected increase of the non-tradable goods prices so that the impact on tradable goods prices or the total inflation is assessed. This becomes more apparent, especially when it is expected a rise of electric power and water price, without leaving aside oscillations in rent prices.*

The following specific factors have affected the mitigation of inflationary pressures during 2002:

- The Bank of Albania increasing interest in March–April 2002 has contributed in expanding the difference between Lek and main market currencies' interests, leading to high real interests. This has influenced investment decisions of individuals, assisting in smoothing the inflationary pressures.
- **The relatively stable political situation** affected the keeping of inflation under control, during the second half of the year.
- **The Bank of Albania campaign** to make customers and traders aware of the speculative increase of prices at the eve of holidays affected inflation decrease in December. The seasonal speculative factor of December was moderated, verifying only at 90 percent of its historical value in the four recent years. The monthly inflation growth in December 2002 was lower than the expectation.

Graph 21: Monthly inflation rate performance in December and historical mean in percent.



**Box 7: THE BANK OF ALBANIA CAMPAIGN TO ALLEVIATE THE PHENOMENON OF SPECULATING WITH PRICES.**

*In November 10, 2002 – January 10, 2003 the Bank of Albania organized the campaign to alleviate the phenomenon of speculating with prices for the first time. The extension of the customers demand for some certain products in the recent two or three years was accompanied by the increase of the prices by these products. The intensity of the rising the prices was stronger at New Year eve. Such rise of prices happened at the defiance of the fact that December market, the highest imports by these products. This meant that the consumer price increase was due to the fact that the customer demand presented as inflexible. The source for the inflexible demand is the tradition of celebrating the New Year and the concentration of some holidays at the end of the year. The source of the rising price even in the conditions of the added demand is the speculative nature of Albanian markets, the weak competition and the lack of the transparency in setting and publication of prices. The result of this phenomenon is the market instability and setting consumer price performance under the effect of the casual events.*

*The Bank of Albania campaign placed at the center the customer to make him aware in connection with this Albanian market phenomenon and shape his behavior at the eve of the holidays so as they set up resistance against the increase of prices. Apart customers, the campaign covered Albanian businesses to make them sensible on the matter as well. Sensibility was ensured through developing a publicizing campaign. Alongside with the campaign, the Bank of Albania requested cooperation from media and government authorities. Media assisted it with message and analysis transmission to common public. Cooperation with the government authorities helped it resolve long-term concerns. These problems related to:*

- *The maximum elimination of operations favoring the speculative increase of prices such as the customs operations on reference prices, maximal commitment to secure incomes and perform expenditures which leads to the concentration of these indicators and influences the addition of currency in circulation at the end of the year;*
- *The improving transparency in the publication of prices.*

*The third major element of the campaign was the daily track of prices for a group of articles and the discovery of the fact that whether these prices increase or not and the responsible markets for this. The daily track of these prices was ensured through an established and financed network from GTZ foundation, which financed the entire campaign. The price analysis was daily reported for the public. For the first time in its campaigns the Bank of Albania widely used the publication of data by its website.*

*Finally, it was concluded that:*

- *The phenomenon of speculating with prices is present in Albanian market,*
- *The rise of prices is particularly high at New Year's Eve. Other holidays already have an insignificant effect confirming the traditional nature of this phenomenon,*
- *The public campaign had its own effects, which was reflected in the attention it attracted for the groups it was bound for.*
- *The campaign had its own effect on inflation by moderating the seasonal effects influencing inflation increase.*

*Finally the Bank of Albania estimated that undertaking this campaign was useful and its continuation is as much necessary as to secure the maximum alleviation of speculation phenomenon.*

#### IV.4. GENERAL CONSIDERATION ON THE MONETARY POLICY OF 2002

**T**he Bank of Albania monetary policy, its stance towards interest rates and the defining of operating framework, are oriented to achieving the main target: that is achieving and maintaining the stability of prices. Monetary policy general framework in 2002 has been kept almost unchanged against that in 2001. The Bank of Albania targeted the keeping of monetary aggregates growth under control, compliant to economy demand on them. Theoretically, the Bank of Albania views

the price performance as closely related to the quantity of monetary assets circulating in economy. For this reason, it sets a target on monetary supply growth, in accordance with its projections on economic growth. From operational viewpoint, the Bank of Albania aims that, by using its own instruments, it should keep financial market rates at an adequate range with the inflation target.

In accordance with the inflation performance and monetary developments, the Bank of Albania monetary policy may split up into three periods.

- ***In January- February, the Bank of Albania followed a neutral monetary policy.***

Following interest rates in August 2001, the Bank of Albania kept a neutral stance and banking system had a rapid return of liquidity. The Bank of Albania attracted the excessive liquidity through Repo auctions and did not finance the budgetary deficit over this period and interest rates have been generally stable.

However, year 2002 started with a higher inflation rate than the Bank of Albania target. Average inflation during the first two months of the year was 7.1 percent, almost doubling the Bank of Albania upper rate.

- ***In March-April, the Bank of Albania followed a tightening monetary policy.***

Taking into account the high inflation rate, the Bank of Albania increased the interest rates by 0.5 percentage points at March<sup>14</sup>. However, such rise was insufficient in the light of monetary developments over March –April. The banking system faced a deposit retraction, bringing the increase of the liquidity in economy. Deposit retraction brought about the increase of liquidity over its historical trend, pointing out clearly inflationary pressures for the most part of the year to October 2002.

Found under a similar situation, the Bank of Albania evaded temporarily from the programmed exchange rate for attaining its principal target, that is the maintaining of consumer price stability and the observation of its quantitative targets, and defined as priority the keeping of banking system financial stability. It further increased the interest rates by 1 percentage point in April, reviewed the momentum of monetary operations and was forced to finance the budgetary deficit<sup>15</sup>.

- ***In October- December, the Bank of Albania followed a neutral monetary policy.***

Considering the return of liquidity by the banking system, which brought about improvement of monetary conditions, a relative stability of interest rates and the alleviation of inflationary pressures, the Bank of Albania has applied a prudential monetary policy with moderating tendency in the last two months of the year. In November, it adopted a neutral stand against interest rates. In December, monetary policy neutral stand was further strengthened with the changing type of auction from fixed price to a diversified price auction and fixed interest rate. This change represents a significant decrease by banks borrowing costs.

<sup>14</sup> Consistent with the inflation performance and forecast, the Bank of Albania Supervisory Board decided to increase the interest rate by 0.5 percentage points at March 20, 2002.

<sup>15</sup> Deposit retraction consequences and the Bank of Albania monetary policy in this period have been up and dealt with in the following point.

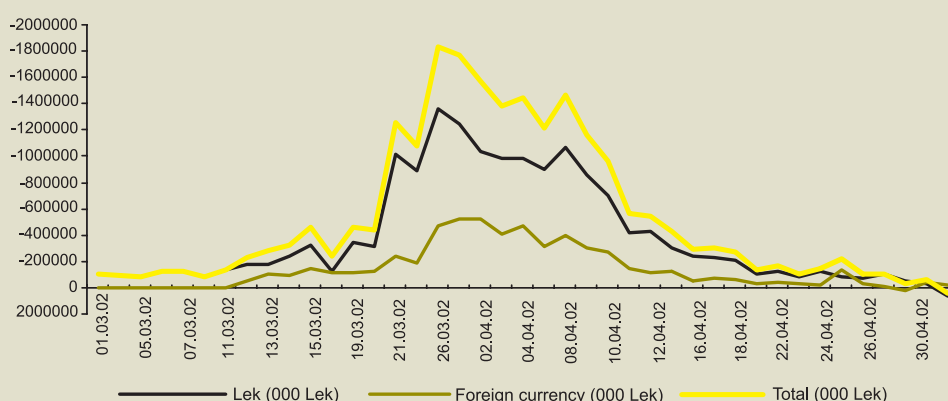
#### IV.4.1. DEPOSIT WITHDRAWAL IN MARCH-APRIL 2002, AN UNEXPECTED EVENT

In March-April 2002, the banking system encountered a massive deposit retraction from two largest banks in the country. The shock of the banking confidence accompanied with the massive retraction of deposits by the two largest banks in the country was caused from the speculation with the Savings Bank privatization and the wrong-interpretation of the draft-law on "Deposit insurance" during discussions in Parliament and the emerging problems with the new owner of the National Commercial Bank and the aggravated political situation. The lack of information and its asymmetry affected the formation of inexact public expectancies for the events banking system was passing through.

The phenomenon emerged with the largest intensity in the last two weeks of March and was initially localized in some districts of the country, mainly in rural areas such in Vlora, Fier and Lushnja. From the two largest banks' windows, there were withdrawn Lek 23,4 billion deposits from which 17,1 billion were Lek deposits and 6,3 billion were foreign currency deposits. Deposit retraction made the currency outside banks increase by Lek 16,4 billion and the banking system passed from Lek 1,6 billion excessive liquidity in February at the constant deficiency of liquidity throughout the rest of the year. In this period, there were retracted 8.3 percent of the total deposits.

This situation contained a high resemblance to the created situation in 1997. The shock that the Albanian banking system encountered in spring 2002 was the second, after that encountered from this system in 1997. These two periods evidenced the hardest moments in the history. In these cases, the Bank of Albania has intervened to manage the trouble situations. The intervention consisted either in the increase of interest rates or the injection of liquidity in the market. The Bank of Albania passing to such a stand was made by considering the banking system stability as necessary for a broader macroeconomic stability of the country and the achievement of low inflation rate at long-time horizon.

Graph 22: Net deposit retractions from the savings Bank and the National Commercial Bank, in 000 Lek.



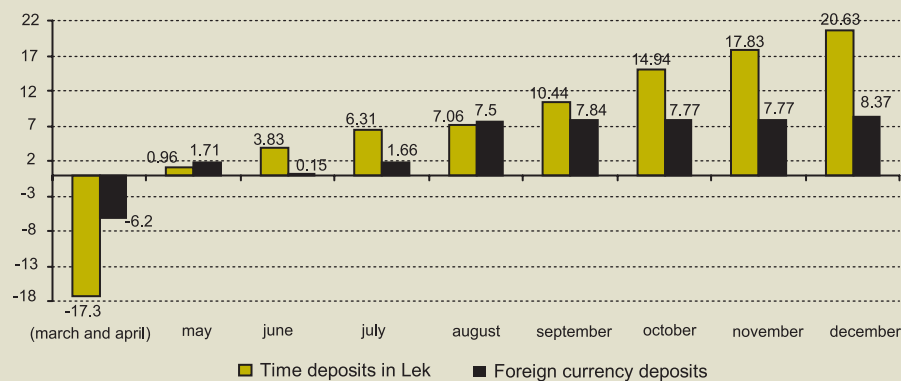
The Bank of Albania market interventions, as liquidity provider, helped banks resolve their immediate needs for liquidity and maintenance of public confidence in the system.

The Bank of Albania took a number of measures to manage the situation:

- The aggressive increase of interest rate was regarded as the main instrument that would help in the improving situation.
- The Bank of Albania used medias to clarify the public on the rather sound situation of the banking system.
- The Bank of Albania the Bank of Albania was committed in meeting and relieving the banking system needs for liquidity.
- The Bank of Albania supervisory council approved deficit financing within the within the legally permitted limit of 8 percent average of normal budget revenues during the latest three years. In absolute value this limit was Lek 9,7 billion. Improving the liquidity condition during the subsequent months made the Bank of Albania lessen its participation in financing the deficit. At the end of the year, deficit financing counted for only Lek 1,8 billion.
- From the operational viewpoint, the Bank of Albania changed the momentum of its main monetary operation from Repo to reverse Repo, changing into liquidity injector in the market. It used the instruments of Lombard facility monthly Repo and reverse monthly Repo as well as the overnight facility to temporary inject liquidity. Injecting liquidity in the system at normal conditions is a sign of a liberal monetary policy and at first sight runs counter to interest rate increase as a contracted measure of monetary policy. However, this stand was conditioned from the need to guaranty the confidence in the banking system. The Bank of Albania intended to maintain stability and banking system partnership in implementing monetary policy.

Monetary indicators in June indicated that the phenomenon of deposit retraction was the banking system was exceeded. In this month, there were noted the first signs of the returning currency in the banking system. The highest intensity of the return of household savings was noted in September and went on to the end of the year 2002. At the end of September, total deposits managed to exceed the rage at the end of 2001, whereas in November, it was managed the return of the total amount of retracted deposits during March –April. This cycle for foreign currency deposits was completed inside August.

Graph 23: The decrease of the deposit stock in March – April period, 2002 and the cumulative increase in May –December 2002, in billions of Lek.



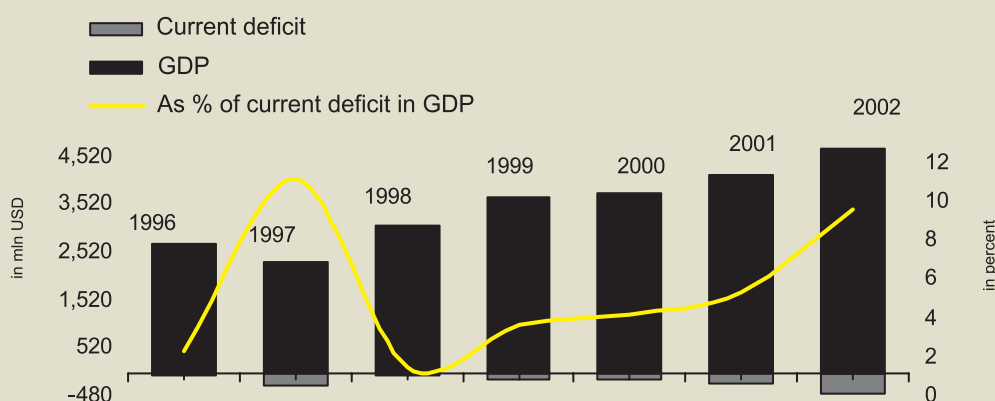
The effect of the Bank of Albania interventions for recovering the situation was reached sooner than in 1997. The Bank of Albania intervention in 1997 was lengthened in time due to the non-functioning of state in the first half of the year. The effect of its policy accompanied the second half of 1997. First results from the intervention were evidenced with six-month lag from the initial shock of the banking system at least. Whereas the Bank of Albania intervention against the shock in 2002 was right time and efficiently taken, setting and preserving the financial stability in the country and leading to the fast recovery of the hard liquidity condition. First results of intervention were evidenced 3 months lag from the initial shock of the banking system. Such an intervention was effective as it was taken in the terms of stable macroeconomic situation and a sound condition of the banking system.

## V. BALANCE OF PAYMENTS

### V.1. EXTERNAL SECTOR DEVELOPMENTS FOR 2002

The overall balance of payments for 2002 resulted in USD 28 million excess. Compared to the previous year, this surplus was nearly 80 percent lower. Capital inflows were insufficient to fully cover the increase of current deficit. Main balance determinants were the increase of external trade deficit, as a result of rising imports at a higher rate than exports, the addition of imported services at an accelerated rate than exports, the reduction of the growth rate of incomes and current transfers as well the addition of financial liabilities.

Graph 24: Current deficit



### V.2. TRADE BALANCE

Foreign trade transactions in 2002 state an expansion of Albania's trade transactions with the rest of the world. The overall trade volume accounts for USD 1,8 billion, representing almost 47 percent of current transactions volume. Year 2002 recorded the highest volume of transacted goods which, compared to 2001, is estimated as 12 percent higher.

Therefore commodity imports account for USD 1,5 billion or 12 percent more against 2001 and commodity exports at USD 330 million or 8 percent higher against the previous year.

Our economy continues to be oriented to imports, contributing to 82 percent in the external trade volume. The higher increase of imports compared to exports led to a further 12 percent extension of external trade deficit against the previous year. The constant deterioration of external trade deficit is linked with the low rate of competitive capacity of domestic output, as well as the incapacity to respond to the added demand for consumption in the last years. Export/Import ratio indicates a slight deterioration of this indicator, which from 23.8 percent in 2002 went to 22.8 and 22.2 percent respectively for 2001 and 2002.

The exports increase as a result of the rising volume from ordered products continue to hold the exclusivity of our exports, with nearly 74 percent of the their overall volume. Exports from domestic production were increased by 4 percent against the 8 percent rise in 2001. Textiles, footwear and headgear articles represent the main categories of processed products in the country, which occupy about 67 percent of the export volume category.

**Table 16: Export and import structure by groups of merchandise in millions of USD.**

HS	Description	Imports	Exports	Trade balance
I	Live animals and animal products	45.2	2.1	-43.0
II	Vegetal products	101.3	13.1	-88.2
III	Animal vegetal fats or oils	20.8	0.0	-20.8
IV	Prepared foodstuffs, alcoholic drinks, vinegar and tobacco	130.5	7.3	-123.3
V	Mineral products	192.3	9.1	-183.1
VI	Products of chemical or binding industry	86.1	1.6	-84.4
VII	Plastics and their products	44.7	0.7	-44.1
VIII	Raw hides, skins, leather and their products	36.8	14.8	-22.0
IX	Wood and articles of wood	16.3	8.6	-7.7
X	Pulp of wood, paper or paperboard	29.4	2.9	-26.5
XI	Textile and textile articles	163.0	124.4	-38.6
XII	Footwear, headgear umbrellas	55.6	95.3	39.7
XIII	Articles of stone, plaster, cement, ceramic products and glass	57.9	1.9	-56.0
XIV	Natural or cultured pearls and coins	0.4	0.4	0.0
XV	Base metals and articles	133.7	30.8	-102.9
XVI	Machinery and mechanical appliance and electrical equipment	240.4	8.4	-232.0
XVII	Vehicles and aircrafts	80.9	0.9	-80.0
XVIII	Optical photographic, measuring or medical instruments	14.3	0.3	-14.0
XIX	Arms and ammunitions	0.7	0.7	0.0
XX	Miscellaneous manufactured articles	36.5	6.8	-29.6
XXI	Works of art	0.5	0.0	-0.5
TOTAL		1487.3	330.2	-1157.0

Imports reflected a stable growth throughout the entire '2002. Imports of machinery and equipment, considered as an investment indicator, occupies the largest share of Albanian imports, by nearly 16 percent of the total. Based on the data, it seems that investments were carried out on information technology and communication (electronic media, electronic waves, etc).

Unlike the past years, which were characterized by a rising trend of imports in machinery and equipment, year 2002 recorded a slight fall on them (1 percent) as compared to the previous year, during which they were encouraged by the entry in the market of cellular operators, such as AMC and Vodafone.

The second group that has the largest share in imports is that of mineral products, by about 13 percent of the total, which are estimated at 4 percent higher as compared to 2001. The power crisis in the country has increased imports in electric power as well as has kept high imports in fuels to be used as substitutes. Power imports, During the year there are imported about kWh 395 million electric power more than in the previous year, leading to rise of electric power import expenditure by about 17 percent.

Textiles and footwear have also recorded a significant growth, contributing by 11 percent in the total imports. Their 19 percent rise against the previous year, which means extension of capacities for re-exports, is reflected in the increase of the latter ones for '2002.

Food imports for 2002 increased by 23.4 percent against the previous year, which indicates that the annual growth of agricultural output in 2002 has been insufficient to cover the domestic demand.

Albania's trade activity remains mainly oriented towards EU countries, having Italy, Greece and Germany as main partners. Trade in the region (Bulgaria, Bosnia and Herzegovina, Croatia, Yugoslavia, including Montenegro and Kosova, FYROM, Romania, Slovenia and Turkey) is estimated to rest at very low levels.

**Table 17: Imports by origin as percentage of the total**

	1996	1997	1998	1999	2000	2001	2002
EU countries (Italy, Greece and Germany)	76.0	83.5	83.0	80.0	77.5	71.4	75.1
Regional countries	15.8	11.5	10.3	13.6	14.8	13.3	15.9

**Table 18: Exports by destination as percentage of the total**

	1996	1997	1998	1999	2000	2001	2002
EU countries (Italy, Greece and Germany)	79.9	88.0	92.1	93.5	93.3	88	92
Regional countries	8.4	9.0	4.3	4.0	4.8	5.6	4.8

In the framework of concluding Free Trade Agreements between South East European countries in the future, an extension of Albanian trade transactions with the rest of the regional countries is expected. Currently, Albanian traders and producers have exported articles at low levels. This is also due to the low level of marketing and the lack of capacities to adapt to European standards.

**Table 19: Imports by regional countries as percentage of the total**

	1996	1997	1998	1999	2000	2001	2002
Bulgaria	3.8	2.8	2.7	2.8	2.5	2.0	2.4
Bosnia-Herzegovina	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Croatia	1.4	0.4	0.6	0.9	1.2	1.2	2.4
Yugoslavia	0.7	0.2	0.1	0.1	1.0	0.6	1.1
FYROM	2.1	2.1	1.4	1.8	2.2	1.2	1.2
Romania	2.4	0.3	0.4	0.7	0.6	0.9	0.9
Slovenia	1.2	1.2	1.7	1.8	1.9	1.9	1.5
Turkey	4.2	4.5	3.4	5.5	5.5	5.6	6.3

**Table 20: Exports by regional countries as percentage of the total**

	1996	1997	1998	1999	2000	2001	2002
Bulgaria	0.0	0.0	0.0	0.0	0.0	0.0	0.03
Bosnia-Herzegovina	0.0	0.0	0.0	0.0	0.0	0.0	0.03
Croatia	0.6	3.8	0.6	0.1	0.6	0.0	0.03
Yugoslavia	1.3	0.4	0.3	1.2	2.8	3.0	2.09
FYROM	2.5	2.6	1.5	1.5	07	1.5	1.5
Romania	0.1	0.0	0.1	0.0	0.0	0.0	0.03
Slovenia	1.0	1.2	1.2	0.6	0.1	0.0	0.01
Turkey	2.9	0.9	0.6	0.4	0.7	1.0	1.03

**Box 8: ALBANIA'S FREE TRADE AGREEMENTS WITH COUNTRIES IN THE REGION**  
**In 2002, Albania signed 6 Free Trade Agreements**

A Free Trade Agreement is a negotiated and an agreed upon document signed by both parties on trade liberalization. The main target of the agreement is the gradual creation of a free trade area over a transition period of six years at maximum, meaning that for goods exchanged after 2008, no customs tariffs shall be applicable. Special targets of the agreement contain:

(i) The expansion and extension of economic cooperation between the parties and the improvement of living standards of the population (ii) the gradual elimination of restrictions in trading goods, (iii) the setting forth of equal competitive conditions on trading of goods, (iv) the contribution in removing trade barriers for an harmonious development and expansion of world trade, (v) the establishment of terms and conditions on further encouraging the investments, especially encouraging the development of common investments in these countries /region, (vi) the encouragement of trade and cooperation between the parties with the third countries.

Creating a free trade area between the countries in the region affects mainly the industrial sector, whereas agricultural and food industry sectors, in most cases, anticipate a partial and gradual opening or maintenance of the current trade regime.

Concerning industrial products, these agreements anticipate:

- A category of products, whose customs tariffs immediately become 0 percent. Such a reduction is applicable to exports products or to products that have exports potential, which are not sensitive to imports provided from a partner country,
- Another category of products, whose tariff gradually goes to zero percent after a six year period at maximum. This happens for those export products that are sensitive to imports supplied by a partner country.

Although Albania's trade transactions with countries of the region has been small, the signing of these agreements is expected to intensify trade transactions in the region, bringing the provision of new business opportunities, encouraging investments, alleviating the unemployment, as well as transferring the new technology. The economic benefit from the rising trade shall compensate the eventual loss of fiscal income from customs. On the other hand, the expected free trade area comprises a market for nearly 60 million customers. This is particularly important based on the fact that these countries are small size economies, with limited capacities in the domestic market. Economic integration will make the region more attractive to foreign investors or international financial institutions.

Albania has already Free Trade Agreements<sup>16</sup> with:

- FYROM, applicable from 15.07.2002
- Croatia, ratified by the Republic of Albania Parliament

It is under the phase of signing technical agreement with:

- Bosnia- Herzegovina,
- FR of Yugoslavia
- Romania,
- Bulgaria,
- Also, it is under the process of negotiations with:
- Moldavia.

<sup>16</sup> Source: The National Strategy of Economic and Social Development.

### V.3. OTHER CURRENT ACCOUNT ITEMS DEVELOPMENT

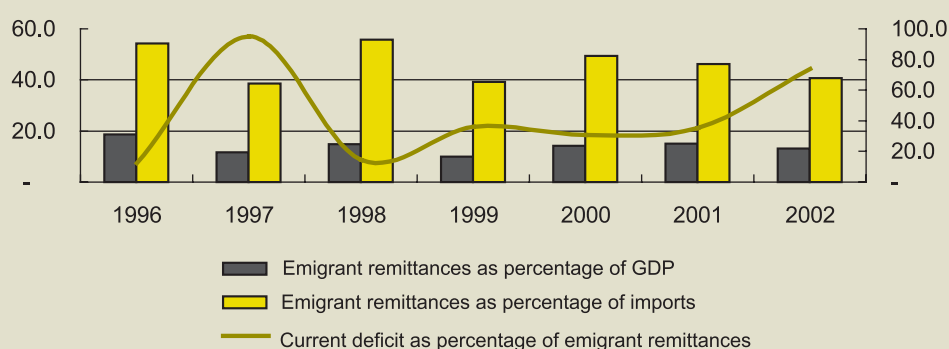
**T**ourism is an important activity of Albanian economy, remaining dominant on exports of services. According to the Bank of Albania estimates, tourism has generated about USD 486 million income on services or nearly 47 percent more than exports of goods, which has been either due to the rising of tourists' number or their daily expenditures. Albanians' expenditures in their travelling abroad the country comprised nearly USD 366 million or about 60 percent of the total of emigrant remittances. At the end of the year, the positive balance of this category was estimated at USD 121,4 million or about 35 percent less than in the previous year.

The rise in the import volume has effected import's increase of goods transportation services and insurance services. The deficit by transported goods services was estimated at 18.4 percent higher than in the previous year, whereas insurance services recorded a higher deficit than that of 2001.

"Other services" category had a positive contribution in the balance of payments, recording a surplus of USD 30 million. Compared to 2001, the balance of this account estimated a decline by 13.5 percent.

The positive balance of "income" transactions at the end of the year is estimated at USD 124 million, however it indicates a 16.8 percent fall against the previous year. In spite of an increase of USD 20 million of income on portfolio investments, the fall of this surplus relates to the reduction of net earnings from investments in the form of deposits abroad, as well as to the increase of outflows in the form of external debt payments (matured interest payments), which recorded the figure of USD 18 million.

Graph 25: Emigrant remittances over years



Hence, at the end of the year, the positive balance of the current accounts was estimated at about USD 588 million or about 3 percent higher than in the previous year. The rising surplus by this category is also dedicated to the fall of other out-going transfers, mainly those of the private sector. Emigrant remittances on 2002 were estimated about USD 606 million. Compared to the previous year, they present a slight fall by nearly 1.4 percent. Emigrant remittances have generally tented y/y increase, except years 1997 and 1999, which have been characterized by the lack of stability, either in the country or in the region. It has been estimated that 50 percent of emigrant remittances have been channeled through the banking system. These have been sufficient to

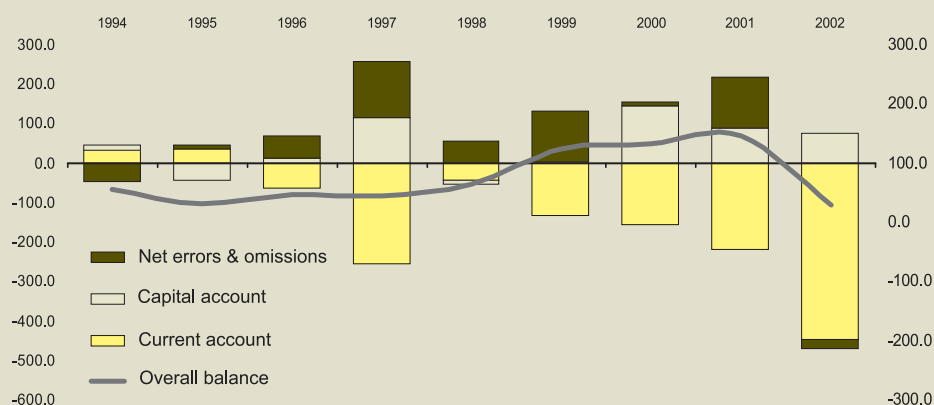
finance about 53 percent of the external trade deficit. Emigrant remittances have been generally characterized by large inflows during summer and at year-end. Whereas, during 2002, the largest inflows were recorded during its first half. This has been due to Euro component currencies that were sent for conversion in our banking system. Nevertheless, these remittances indicate a falling trend. The emigrants' integration in the society where they have emigrated, as well as the reinforcement of the fight against illegal emigration, affect on the reduction of these remittances. Meantime, the official transfers recorded USD 40 million and are represented by those of technical assistance and those that are in the form of aids in goods.

In conclusion, it is estimated that the current deficit recorded USD 447,6 million or nearly twice more than that in 2001. For 2002, the current deficit occupies 9.5 percent of GDP from 6 percent in 2001 and 4 percent in 2000. The total of current transactions is estimated at USD 3,9 billion or 10 percent higher compared to the previous year. Net capital flows, which increased by about 47 percent against the previous year, have financed the current deficit at the amount of 75 percent. While the financial and capital account developments have respected monetary program projections, the current deficit is evidenced to be at about 20 percent more than the projections.

### V.3.1. CAPITAL AND FINANCIAL ACCOUNT

The current deficit financing has been covered by capital inflows, which at year-end reached the range of USD 334,1 million or about 41 percent more than the previous year inflows.

Graph 26: Balance of payments structure



The financial liabilities of this year recorded about USD 272 million. The increase of liabilities was mainly due to net borrowings, foreign direct investments or other investments.

Long- and soft-term credit disbursements by foreign institutions have added Albania's external debt with USD 142,7 million. Foreign direct investments have been added to capitals invested in the form of net borrowing, which are estimated<sup>17</sup> at about USD 143 million. Financial liabilities

<sup>17</sup> IMF- staff estimates

in the form of deposits placed by foreign non-resident banks with our banking system are increased by USD 8,3 million. About 75 percent of them have been set in Euro and 21 percent in USD.

Our financial assets growth at the end of the year is by USD 59 million only. Such low growth is as an aftermath of the fall in the foreign assets placed by deposits. It is worth mentioning here the significant fall in the foreign assets held by Albanian residents with the banking system. This has been taking place in March- April 2002 as a continuation of the high demand of individuals to withdraw deposits, forcing resident banks withdraw their deposits abroad. Deposits composition has been at 54 percent USD denominated and 45 percent Euro denominated.

Meantime, portfolio investments recorded an increase of USD 36,8 million in 2002. The greatest increase was recorded by portfolio investments denominated in USD, comprising 85 percent of portfolio investments.

Foreign assets inflows in the form of financial capitals were reflected in the rise of monetary authority international reserves by about USD 29 million on 2002. Mainly, foreign assets record such a growth, while those on SDR estimate a fall. Gross international reserves at the end of the year were estimated at USD 838,9 million, sufficient to cover 4.8 months of imported goods and services against 4.9 percent projected in the monetary program.

Graph 27: International reserve performance by months of imports

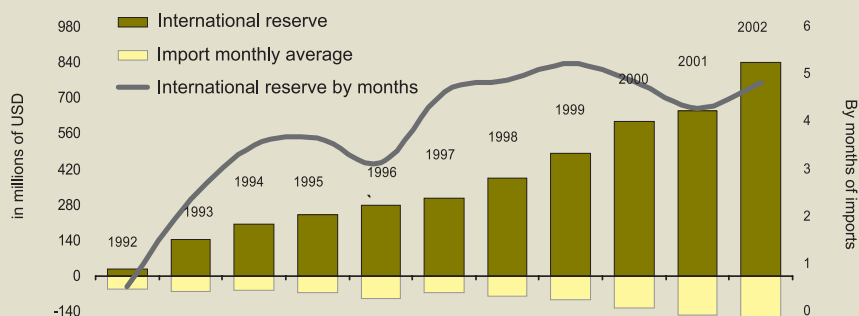


Table 21: Balance of Payments, in millions of Lek

	1995	1996	1997	1998	1999	2000	2001	2002
Current account	36.6	-62.3	-253.7	-65.0	-132.9	-163.1	-217.9	-447.6
Merchandise: Exports, fob	204.8	243.7	158.6	208.0	275.1	255.4	304.6	330.2
Merchandise: Imports, fob	-679.8	-922.0	-693.5	-811.7	-937.9	-1076.4	-1331.6	-1485.4
Trade balance	-475.0	-678.3	-534.9	-603.6	-662.8	-821.0	-1027.0	-1155.1
Services: Credit	98.2	127.3	67.9	86.6	266.7	448.1	533.5	585.0
Services: Debit	-106.3	-142.3	-101.1	-129.3	-165.4	-430.0	-444.2	-589.9
Income: Credit	70.8	83.5	61.6	86.1	85.6	115.9	162.5	143.8
Income: Debit	-28.5	-12.0	-11.9	-8.7	-10.3	-9.1	-13.4	-19.9
Private unrequired transfers	348.9	476.0	235.7	421.3	188.4	438.6	542.6	550.2
Official unrequired transfers	128.5	83.4	29	82.6	165.0	94.4	28.1	38.2
Capital account	389.5	4.9	2.1	31.1	67.5	78.2	117.8	121.2
Financial account	-414.5	49.6	140.7	16.0	36.8	182.5	115.2	212.9
Direct investments	70.0	90.1	47.5	45.0	41.2	143.0	207.3	143.0
Portfolio investments	0.0	0.0	0.0	0.0	0.0	-25.0	-23.4	-36.8
Other capital	-484.5	-40.5	93.2	-29.0	-4.4	64.5	-80.6	101.4
Net errors and omissions	7.9	54.8	142.5	69.4	131.3	15.0	129.9	142.1
Overall balance	30.6	47	43.8	59.4	123.6	131.9	145.0	28.6
Reserve and related items								
Reserve assets	-30.6	-47.0	-43.8	-59.9	-123.6	-131.9	-145.0	-28.6
Use of Fund credit and loans*	11.1	0.0	12.2	7.9	20.9	19.3	12.0	5.3
Memorandum items								
Total change in reserve assets	-30.6	-39.5	-28.3	-75.9	-97.4	-130.5	-116.2	-109.9
Of which: change from exchange rate	5.1	-7.3	-15.5	12.6	-26.2	-3.5	1.5	65.0

\* Not included the use of Fund credits and loans

## V. 4. INTERNATIONAL RESERVE AND MANAGEMENT

### V.4.1. INTERNATIONAL RESERVE DEVELOPMENT

Compared to the end of 2001, international reserve resulted as grown by 13.8 percent or USD 101,5 million. At the end of 2002, net international reserve value was USD 839,9 million.

The major inflows in absolute value, which have affected growth of international reserve are: the disbursements in the form of loans (from International Monetary Fund, World Bank, European Community etc), which in the end of 2002 reached the figure of USD 93,9 million; foreign currency purchases by commercial banks reached USD 45.1 million; income on foreign reserve investment interest reached USD 27.8 million, etc. The effect of exchange rate change (which is not included in the absolute factors) was positive during 2002, reaching the amount of USD 64.9 million.

The most important factors that have influenced on the reduction of foreign reserve value are: foreign currency payments serving the external debt of the Ministry of Finance and of the Bank of Albania reached the amount of USD 49,1 million; the Ministry of Finance transfers from foreign project accounts with the Bank of Albania to the respective accounts with the commercial

banks reached the amount of USD 100, 9 million; the commercial banks sales reached the amount of USD 13,8 million.

Some of the factors affecting the international reserve (such as income on investment interests and the exchange rate effect) have been under the direct effect of international market developments. During 2002, the hard situation kept running in the major world economies, where we specify that of United States. From a global viewpoint, the world economy continued to be under negative impact of geopolitical insecurity, recession (or in the best case, suspension) of growth by share markets, maintenance of low capital investments, increase of unemployment figures and weak growth of economy.

Under these conditions, major world economies followed the cycle of reducing the currency cost, started since the second half of 2001. Concretely, at the end of 2002, after the successive cuts, the Federal Reserve fixed the interest rate for *fed funds* rate at 1.25 percent, while the ECB fixed the Repo rate at 2.75 percent. The deterioration of future expectancies, as result of the added insecurity against the international terrorism, increased investors' interest on government issuing, whose price recognized a stable growth throughout the entire 2002.

Economic growth of USA in the last decade, as well as the following a strong dollar policy, were accompanied by an external trade imbalance and a significant deterioration of balance figures. Almost throughout the 2002, USA external trade deficit fluctuated by the band of USD 36-40 billion, touching the highest rate of the band by the end of the year. The stability of such negative figures, the release of confused declarations by respective American authorities, as well as the market conviction that as long as imbalance will be present capital flows to American economy are sufficient, exercised pressure on the exchange rate of the American monetary unit. USD exchanged to Euro is weakened by about 21 percent in face value. Its depreciation has been significant to British Pound, Canadian Dollar and Swiss Frank, while it remained stable to Japanese Yen, mainly as a result of the difficult situation the Japanese economy is encountering and the market scare on a potential intervention from the Bank of Japanese to hamper an appreciation of its monetary unit.

#### ***V.4.2. INVESTMENT MANNER***

**M**anaging international reserve in 2002 has been consistent with the specialist opinion on expected international market developments. To shape this opinion, there have been consulted materials, comments and analysis from reputable financial institutions and rising experience of specialists. It must be mentioned that opinions on the world economy performance have been variable for the first half of the year where optimistic projections were not deficient. Projections have been more real for the second half of the year. Depending on these projections, international reserve management targeted improvement of the securities portfolio (which will benefit from the rising price at an environment where interest rates had recorded a cut) as well as the prudential stretch of investment by longer terms, remaining close to the neutral span of the portfolio.

#### ***V.4.3. IMPROVING THE STRUCTURE OF DECISION- MAKING***

**T**o improve the transparency of its own operations in the process of international reserve management and the decision-making on these operations, and also based on the requirements provided in the document "The Policy and the Management of International Reserves" on January 16, 2002, the Governor released the order on the establishment of Investment Committee. To be specified in this order were the members of this committee. After that, on January 29, 2002 the

Governor approved the guideline "On the Functioning Procedures of Investment Committee" which paved the way to the instant functioning of this committee. On February 7, 2002, it was convoked the first meeting of Investment Committee, which has been regularly convoked on monthly basis after that. Additionally to the data analysis on the international market developments of international reserve in current period, investment committee has also examined problems related to certain procedures to settle the operation of international reserve management such as the way correspondent banks or other financial institutions as investment partners, have been expanded.

The main document that regulates the process of international reserve management "The Policy and the Management of International Reserve" has been reviewed in April 2002. The Bank of Albania Supervisory Council has approved the access and the use of some new debt securities and new benchmark concepts on these instruments.

Middle-office sector has been totally functioning in 2002. Actually, it has been changed into the only official resource of providing information for the high management in the Bank of Albania and as an independent unit from the management of international reserve function.

#### ***V.4.4. MANAGING THE PORTFOLIO OF COMPONENT CURRENCIES OF INTERNATIONAL RESERVE***

Year 2002 was a special year for the international market of foreign exchange, since the suspects of international market operators on the USD long-term trade in the recent two years, came true, with a global weakening of it.

From the Bank of Albania viewpoint, such a situation enabled that in the first half of 2002 be sold on profit a part of Euro quantity purchased in 2001 (mainly in June 2001). The profit was attained in the conditions of moderate risk as the completed purchases in 2001 aimed the return of open foreign positions, which to that moment were in sale, by benchmark rates. Meantime, Euro relatively fast appreciation by foreign exchange markets internationally has rapidly and repeatedly created open positions in purchase. These positions in most of the cases have been closed to disallow the excess of approved rates.

During the stability of EUR/USD ratio, in the second half of the year there have been used the moments of open market positions in purchase in USD to purchase EUR, which currency has emphasized its rise (appreciation) during December.

**Box 9: THE CONFERENCE “THE BANK OF ALBANIA IN THE SECOND DECADE OF TRANSITION”**

Ten years ago the Albanian Parliament approved the Law “On the Bank of Albania” and the Law “On the Banking System in the Republic of Albania”. This moment marked the creation of the two –tier-banking system in Albania and the central bank establishment. From that time onwards, although the central bank has only a ten-year activity, the financial segment it licenses and supervises has evolved quickly. This process has recognized the casual oscillations, but the resultant is apparently positive.

To discuss these developments and the challenges in front of the Bank of Albania in the second decade of transition, the Bank of Albania convoked its Third Conference in December 5-6 2002, to analyze the way our banking system has passed through; the way it has evolved and advanced, how much it has been left over, the lessons it has drawn from the difficulties it has come over; the public confidence in the new institution, on which the tradition has been unfamiliar.

The Bank of Albania has constantly strengthened its legal and real independence in the previous decade, even though it has been unanimously accepted that challenges for the other improvements with this aspect lay always opened to it in the way ahead.

The definition of the Bank of Albania future strategy remains a priority. In this framework, the Bank of Albania, as any other central bank institution wavers between the dilemmas of “a one-sided Euroism or an inflation targeting” which is not simple to work out. Arguments and contra arguments, as well as the economic implications of both regimes, were presented very clearly by the honorable speakers in this conference. Also, based on the same viewpoint, beyond the economic reasons, there are political and interinstitutional reasons oriented by the official structures of EU.

Adopting the inflation-targeting regime is studied as a viable alternative in the next five years. To this alternative, the Bank of Albania has enlisted by its agenda of operations, its efforts to ensure the consensus of Albanian executive bodies without which, it cannot successfully achieve the adoption of the new regime.

Anyway, the main efforts regarding the extensive study and functioning of Albanian economy parallel to appropriate models, as well as the discovery of the transmission mechanism rest with the central bank. Parallel to this study, the financial market development that will improve the process of transmitting decisions in economy assumes a special importance.

Banking system, as an important segment of the financial system, has a considerable significance in Albania. On the whole, the Albania banking system had a good progress in the recent decade. We can say that Albania has been amongst the most opened countries to attract the foreign bank capital and has attained that the banking capital have a considerable weight. Irrespective from the positive developments, the Albanian financial system has encountered troubles, which are overcome from any banking system in transition economies, such as the inefficient activity of public banks and needs for their liquation or privatization, the creation of bad loans, troubles with their governance, a weak customer relationship to banks, a low financial intermediation etc. These problems have been constantly handled during the process of banking system reformation and have been parallel to economy development. On the whole, the Albanian banking system could not be immune from confidence crisis, which contained political conflicts on their basis and not only of the macroeconomic nature or the financial system. Although this crisis might be over, one lesson remains clear: the cost of overcoming this crisis is considerable and requires great endeavors.

## CHAPTER III: MONETARY AND MARKET DEVELOPMENTS

### I. MONETARY PROGRAM AND QUANTITATIVE TARGETS

The Bank of Albania, based on its monetary policy, drafts its monetary program on one 1-year frame.

The Bank of Albania started 2002 with a program based on a normal performance of economy and monetary developments. Money supply projected growth rate was by 11.3 percent, almost at the same growth rate as the nominal GDP. Money supply was projected to grow with the same pace as the real growth of economy, being a premise on keeping inflation under control.

Currency outside banks and deposits growth rates were projected to be the same. This would serve as a good basis on the interest rate stability, assisting in the achievement of inflation target as well. Consistent with the monetary policy, a distinctive feature of the monetary program for 2002 was the Bank of Albania not financing the budgetary deficit.

Monetary developments in the first quarter of the year were very close to the monetary program. The currency had a fast return in the banking system. This brought about an increase of Lek deposits and led the banking system to an excessive liquidity condition. Deposit increase enabled normal credit to economy and coverage of government needs for financing. Inflation in this period was over the Bank of Albania target, mainly influenced by supply determinants.

Taking a hint from March-April events, revising the monetary program became necessary. More precisely:

- Economic growth projection changed from 7.0 to 6.0 percent and average inflation from 3.0 to 5.3 percent,
- The domestic deficit financing through domestic borrowing was increased to respond to the lack of privatization receipts,
- Money supply growth projection was reduced from 11.3 to 5.4 percent,
- Currency outside banks growth projection was changed from 11.3 to 15.0 percent, while the deposits were expected to have an insignificant growth,
- Also the government request for domestic financing of deficit was expected to increase. The lack of privatization receipts from 1.7 percent of the GDP shrank to 0.2 percent of GDP, adding the government request for financing from Lek 14,7 to 17,0 billion. The Bank of Albania was forced to project its financing at Lek 9,7 billion, to make the banking system improve its liquidity condition.

Monetary developments over April-October have been characterized by a gradual and constant improvement of monetary indicators and particularly of liquidity condition in economy. The ratio of the currency outside banks to money supply, after reaching the maximum at 33.6 percent, in June, has been constantly in recession. In October, the ratio of currency outside banks to M3 dropped to 31.2 percent, being 1.8 percentage points below the value provided in the monetary program. The Bank of Albania deficit financing over April-September was up to Lek 6 billion. Later on, it gradually reduced its financing, leaving more space to commercial banks to invests their funds in the treasury bills primary market. Notwithstanding the hard liquidity condition of the system, banks have been able to provide a good credit supporting

to economy. Credit to economy by banks in the system has continuously surpassed the monetary projection, which estimated an extension of this indicator by Lek 8,6 billion<sup>18</sup>.

The monetary program has generally had a good grasp of either its main monetary development trends or their size. Drafted during an unstable monetary situation, it has been rather conservatory on its projections. Monetary developments, such as Lek deposit increase in particular, budgetary deficit financing by the banking system, and the Bank of Albania injecting liquidity in the system, during the second and third quarter, were better than the monetary program projections.

Based on these considerations, the Bank of Albania reconsidered its monetary program for the last two months of the year. Changes related mainly with the involvement of the most recent monetary trends, the improvement of banks liquidity condition, the lowering projection on economic growth from 6.0 percent to the band of 4.5 –5 percent for 2002.

At the end of 2002, money supply annual growth rate resulted at 5.9 percent due to growth of currency outside banks, which represents the monetary aggregate with the fastest annual growth rate. Domestic and foreign currency deposits have been less than the monetary growth projection on them. On the whole, quantitative targets of the program were managed to be achieved.

**Table 22: Meeting the Bank of Albania quantitative targets during 2002, in billions of Lek**

	December 01	March	June	September	December 02
<b>Net foreign assets (USD million)</b>					
Target	542.6	536.6	530.6	546.6	558.6
Current	542.6	547.5	550.1	570.9	562.2
Difference	0.0	10.9	19.5	24.34	3.55
<b>Net domestic assets</b>					
Target	78.1	83.6	89.1	90.1	95.1
Current	78.1	84.8	87.6	83.5	87.1
Difference	0.0	1.2	-1.6	-6.60	-7.97
<b>Net domestic credit to government</b>					
Target	237.5	238.5	244.2	247.0	257.0
Current	237.5	240.5	246.8	247.0	259.6
Difference	0.0	2.0	2.6	0	2.6

The target of net domestic credit to government was exceeded in three quarters. This target has been met in September, which was also a performance criterion on the program of the country's economic growth and social development.

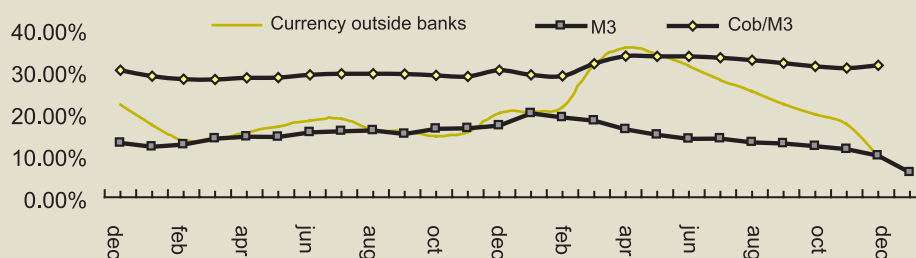
## II. MONEY SUPPLY DEVELOPMENTS

### II.1. CURRENCY OUTSIDE BANKS

**C**urrency outside banks has indicated an unstable performance. It extended by Lek 16,4 billion over March –April period. Annual growth rate in April reached 35.6 percent, which is also the highest growth rate over the last five years. After April, this indicator had a falling trend and at the end of the year its annual growth rate reached at 9.82 percent.

<sup>18</sup> Monetary program for 2002 forecasted that the outstanding credit for the public sector would reduce to Lek 0,4 billion and that of the private sector would increase by Lek 9,0 billion.

Graph 28: Annual growth rate performance of the CoB, M3 and the ratio CoB/M3.



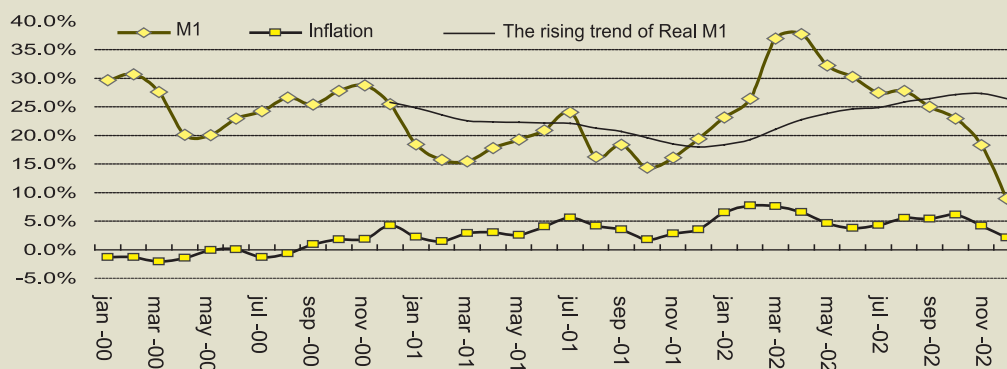
The reduction of the currency outside banks is as an aftermath of the Bank of Albania tightened monetary policy, through the increase of interests rates, as well as the low financing of budgetary deficit by the Bank of Albania. The contribution of this indicator in the money supply is much higher, compared to the previous years.

## II.2. M1 AGGREGATE

**C**urrency outside banks has determined the performance of M1 aggregate. In the period of deposit retraction, M1 annual growth rate reached 29.3 percent in April. Anyway, owing to the addition of the interest rates and the return of the currency in the system, the annual growth rate of M1 reached 6.7 percent at the end of the year.

The other M1 component, demand deposits in Lek, has generally been stable during the year. It has reflected a falling trend during the last two months of the year, when the increase of the real interest rate adds their liable cost against the time deposits in Lek.

Graph 29: M1 aggregate during 2002



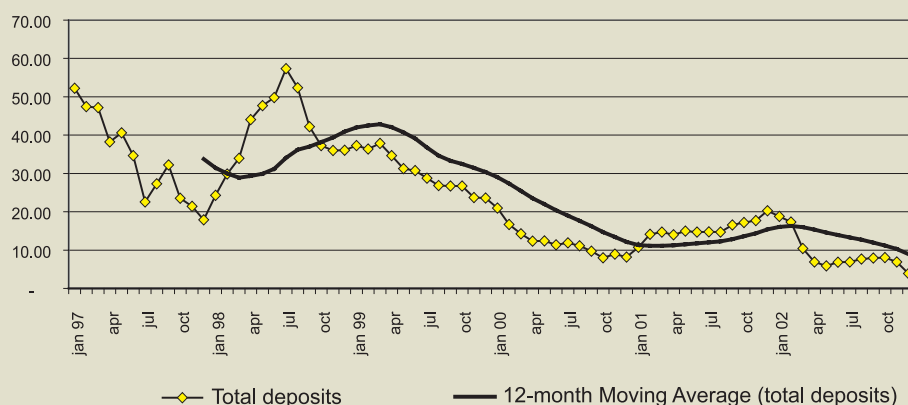
The Bank of Albania has followed attentively the development of M1 aggregate. Real M1 had an important weight in defining the monetary policy stance, as the econometric studies have indicated that it plays an important role in determining the prices level. The annual growth rate of real M1 fell below its historical trend in August. This has affected inflation decrease in the last quarter of the year.

### II.3. DEPOSITS

Deposit growth by banks in the system is Lek 10.6 billion or 4 percent, from 32 percent annual average over the 9 recent years. Lek deposits have indicated the main contribution in deposit growth by Lek 7,7 billion against an increase of Lek 2,9 billion of foreign currency deposits. Deposits' monthly average growth reached the rate of Lek 0.89 billion from 3,8 billion in the previous year.

Deposit performance in the previous year has displayed two different situations. After Lek 7,8 billion rise in the first two months of the year, deposit stock by the banking system dropped to Lek 23,4 billion for March- April period, which constituted almost 8.3 percent of total deposits of the system at end of February. The rest of the year was characterized by deposit growth of Lek 26,2 billion.

Graph 30: Annual growth of total deposits in percent

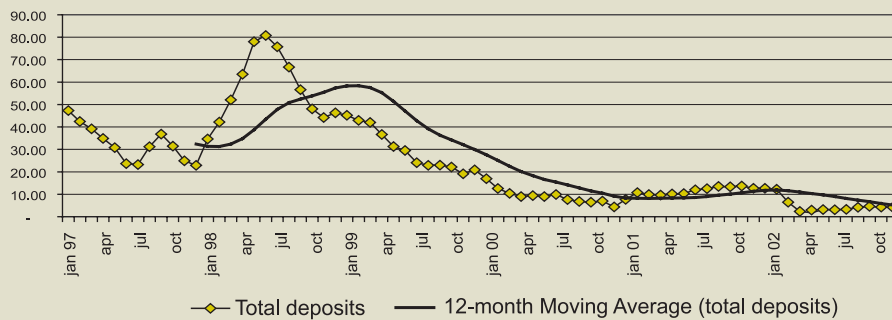


#### II.3.1. LEK DEPOSITS

Lek deposits recorded low annual growth rates, which, with the exemption of the first two months of the year, fluctuated by 2.0 –6.0 percent. These deposits rise at the end of the year has been 4.16 percent on annual terms.

The main growth resource of Lek deposits is comprised by time deposits of Lek 9,6 billion, while the demand deposit rates had a negative effect by Lek 1,8 billion. Lek deposits monthly average growth shrank to Lek 0,6 billion from Lek 1,7 billion in the previous year. Excluding March- April period, Lek deposits monthly average growth for 2002 accounts for Lek 2,4 billion, resting significantly over the levels of the two recent years or comparable to 1999.

Graph 31: Annual growth rate of Lek deposits in percent.

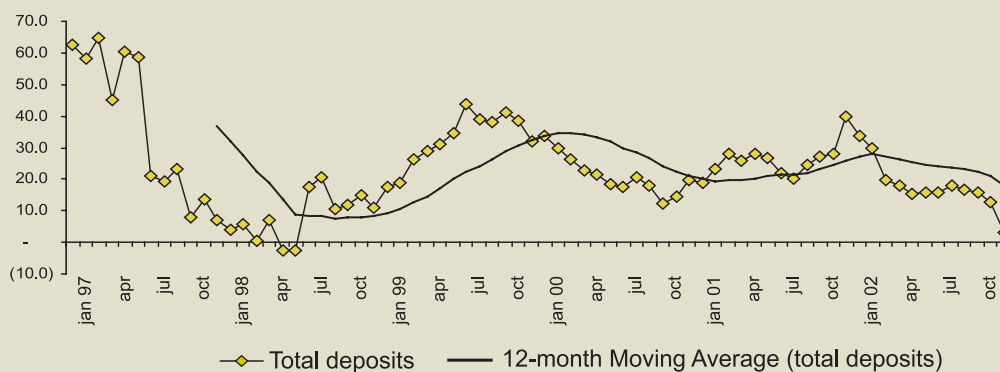


### II.3.2. FOREIGN CURRENCY DEPOSITS

Foreign currency deposits annual growth rate of 3.3 percent is the lowest value in the recent three years. Foreign currency deposits monthly average change got down to Lek 0,25 billion and is comparable to that of 1997. These deposits developments have been influenced by Euro introduction in the market at the beginning of 2002, the deposit panic, and the constant reduction of interest rates for foreign currency deposits along the year.

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Graph 32: Annual growth rate of foreign currency deposits in percent.



Euro introduction in the Albanian market at the beginning of 2002 had stimulated in the last months of 2001 the access of Euro based currencies in the form of deposits with the banking system, so as to be converted without commission. The intensity, with which this phenomenon emerged in December 2001, went on for inertia even in January 2002, where foreign currency deposits increased by Lek 2,3 billion. Along February- June, with the exemption of May, these deposits stock recorded a firm falling. Conversion process was accompanied with the withdrawal of Euro denominated deposits since February. The intensity of withdrawing deposits in foreign

currency was increased due to the diffused panic of depositors in the two subsequent months of the year.

The rapid growth of foreign currency deposits during July and August led to the returning of the previous level. August marked the peak of the monthly growth for these deposits, by Lek 5,8 billion or an annual growth rate of 17.8 percent, from 28.6 percent of annual historical average growth in this month. In general, foreign currency deposits presented a high annual growth rate in July and August, which is motivated by foreign currency inflows from emigrant remittances.

For the rest of the year, the foreign currency deposits position was presented as stable, with some slight fluctuations. The end of the rising trend was influenced by the further cut of USD and Euro denominated rates in the domestic market, dictated by the cut of core interest rates in both currencies.

### **II.3.3. DEPOSITS BY CONTRIBUTION OF ECONOMY SECTORS**

**H**ouseholds continue to be decisive for the deposit growth in the system while the other sectors of economy that mainly affect high liquid deposits have given an insignificant contribution, with slight falling inclinations.

The share of household deposits in the system indicates a stable growth for the three recent years. Compared to the previous year, household deposits increased by 1.4 percentage points while public sector and private business deposits result with a fall of 0.52 and 0.88 percentage points respectively.

**Table 23: Deposits by sector against the total deposits in percent.**

	1998	1999	2000	2001	2002
Public sector	10.72	9.76	7.60	6.22	5.70
Private business	10.13	11.91	12.80	13.03	12.15
Households	79.15	78.34	79.60	80.76	82.16

Household deposits are increased by Lek 9,4 billion and by 3.0 billion in foreign currency.

**Table 24: Deposits by source of origin in percent.**

	Required deposits in Lek			Time deposits in Lek			Foreign currency deposits		
	Public	Private	Households	Public	Private	Households	Public	Private	Households
1998	4.70	3.91	0.38	0.07	0.41	67.32	5.94	5.81	11.45
1999	4.69	3.84	0.74	0.13	1.21	63.02	4.94	6.86	14.58
2000	2.80	6.90	1.10	0.40	0.30	60.70	4.40	5.60	17.80
2001	2.25	5.43	0.99	0.16	0.82	58.01	3.80	6.78	21.76
2002	1.85	4.86	0.98	0.30	0.69	59.16	3.55	6.59	22.02

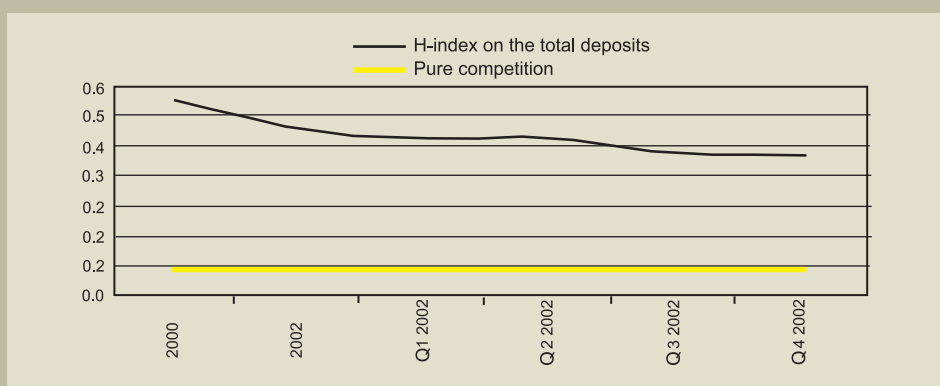
Private and public sector deposit behavior does not indicate apparent changes from one month to the other.

Regarding the share of different banks in the deposit market, we evidence that the Savings Bank keeps its dominant positions on Lek deposits yet. With regard to the foreign currency deposits, the market is oriented towards a pure competition.

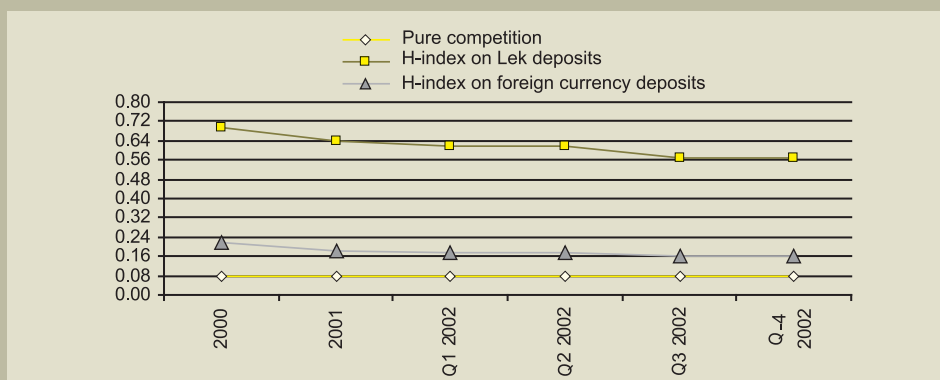
### Box 10: DEPOSIT CONCENTRATION, YEAR 2002

Deposit market concentration indicates a gradual and steady reduction in general.

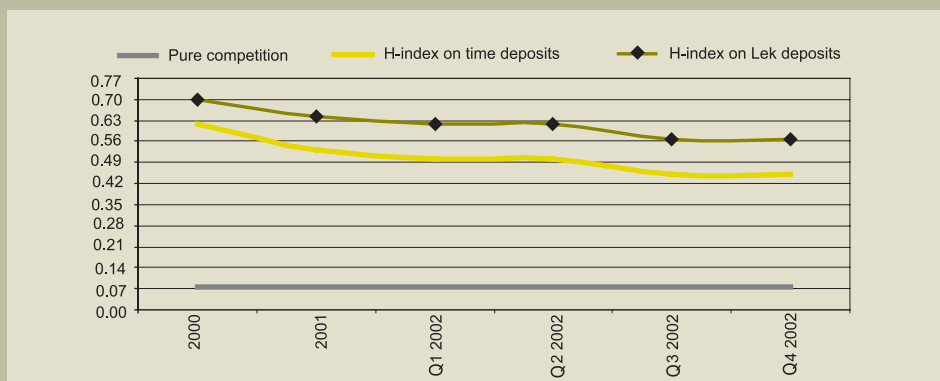
Graph 33: Herfindal index on the total deposits as banking system



Graph 34: Herfindal index on Lek and foreign currency deposits



Graph 35: Herfindal index on total deposits in Lek and time deposits



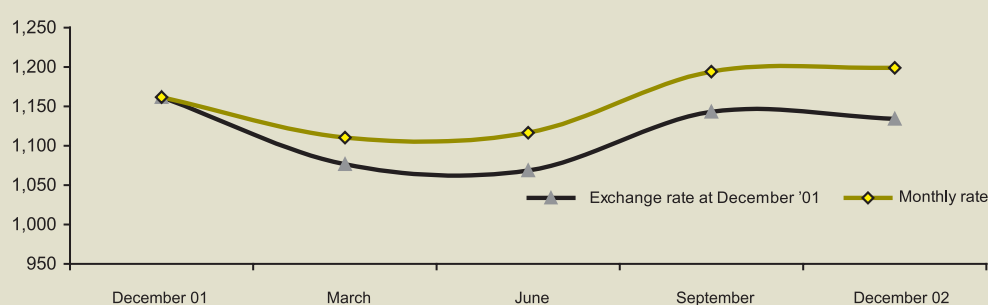
### III. MONEY DEMAND

#### III.1. NET FOREIGN ASSET DEVELOPMENTS

The banking system during 2002 has improved its net foreign position by increasing the level of international reserves by about USD 37 million or Lek 3,5 billion, as compared to the previous year. The rise of net foreign assets has given a contribution of 15 percent in the money supply growth.

The international reserve during 2002 has been under the range of December 2001<sup>19</sup>. The rise of the net international reserves is explained by Euro appreciation against USD in the international market during 2002.

Graph 36: Net international reserve performance of the system during 2002, in millions of USD.



The Bank of Albania net international reserve indicated a positive performance for 2002, increasing by USD 80 million. Foreign currency deposits have reflected an annual growth of nearly USD 36 million, while commercial banks net foreign position was deteriorated by USD 43,5 million.

The Bank of Albania has been active in the banking market during March–April period, selling about USD 5 million and purchasing about USD 2 million in December. These changes aimed at preventing the big oscillations of Lek exchange rate.

#### III.2. DOMESTIC CREDIT

Domestic credit represents the part of domestically financed deficit from the banking system<sup>20</sup>, as well as the economy sustainability by commercial banks' credit to economy.

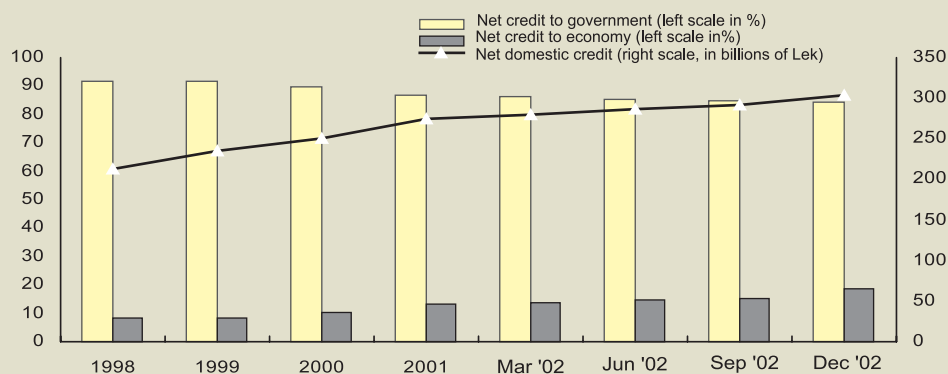
Net domestic credit at the end of 2002 reached Lek 304 billion or 10.4 percent higher, as compared to the previous year. Nearly 58 percent of this rise has been as a result of government budget crediting by the banking system. The rising credit to economy is higher than the growth

<sup>19</sup> For computation effects, the fixed rate of December 2001 has been used, which was 136.6 Lek /USD for the last day of the year.

<sup>20</sup> The Bank of Albania and commercial banks.

rate of budget financing. Thus, the domestic credit structure continues to encounter changes in favor of credit to economy, and this is more apparent in the fourth quarter of the year.

Graph 37: The structure of net domestic credit



### III.2.1. NET CREDIT TO ECONOMY

Net outstanding credit to economy reached Lek 47,4 billion in 2002. The new credit has been disbursed at Lek 62,6 billion or 54.2 percent more than in 2001. At the end of 2002, net credit to economy comprised 11.4 percent of the money demand, reflecting constant rising trends. These indicators confirm a more active participation of banks in the borrowing market.

This conclusion becomes more relevant, if the new credit extended by the banking system is compared to periods 1993-2000 and 2001-2002. In the first 8 years of transition, the net credit extended by banks in the system is Lek 79,5 billion or 9,9 billion on average, each year. For the last two years, the new credit reached the amount of Lek 103,2 billion, meaning that the annual average credit for year 2001 and 2002 is 5 times more than during the period of 1993-2000.

Table 25: Some core indicators performance

	2000	2001	Q-1 '02	Q-2 '02	Q-3 '02	Q-4 '02
Money supply (in billions of Lek)	328.1	393.6	396.4	395.4	406.4	416.7
Net domestic credit (as % of M3)	76.3	70.1	70.3	72.5	71.7	72.9
-Net credit to government (as % of M3)	68.4	60.8	60.7	61.9	60.8	61.5
-Net credit to economy (as % of M3)	7.9	9.3	9.6	10.6	10.9	11.4
Credit to economy (as % of GDP)	4.8	6.2	5.9	6.4	6.7	7.2*
Credit to economy (as % of total assets)	9.5	11.3	11.8	13.1	13.3	13.7
Credit/ deposit ratio (in %)	11.3	13.3	14.2	15.9	16	16.5

\*This ratio has been set up against GDP on annual basis for 2002.

Graph 38: Net credit performance to economy over years

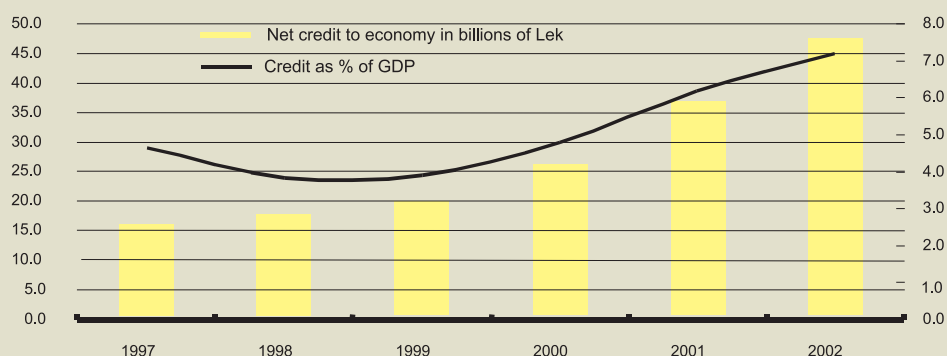


Table 26: The performance of credit indicators in percent

Indicators	Year 2000	Year 2001	Net outstanding credit in 2002			
			Q I	Q II	Q III	Q IV
Short-term credit	40	53	52	51	48	49
Mid-term credit	31	25	26	28	29	28
Long-term credit	29	22	22	21	23	23
Public sector	6	5	4	3	2.7	2
Private sector	94	95	96	97	97.4	98
Lek	40	35	32.5	32	33.1	34
Foreign currency	60	65	67.5	68	66.9	66
Net outstanding credit (in billions of Lek)	25.9	36.6	38.2	42	44.3	47.4 <sup>21</sup>

The following developments are specified in the structure of net outstanding credit for 2002 :

- *By term.* The short- term credit has dominated the credit portfolio as banking system for the three recent years. Short- and mid-term credits altogether comprise 51.3 percent of net outstanding credit at the end of 2002.
- *By currency.* The annual growth rate of outstanding credit in foreign currency, has fallen to 32.4 percent at the end of 2002 against 52.6 per cent it was at the end of 2001. Lek credit increase was as much as the previous year increases, at 24.3 percent. About 30 percent of net outstanding credit as banking system has derived from increase of net outstanding credit in Lek.
- *By sector.* Net outstanding credit by the public sector had a reducing trend, due to the constant payments and the non-credit of this sector. At the end of 2002, 97.7 percent of the outstanding credit corresponds to the private sector.

<sup>21</sup> Net outstanding credit includes credits transferred to BART from the Savings Bank the National Commercial Bank and the Rural Commercial Bank. Totally net outstanding credits transferred to BART reach the value of Lek 8,7 billion. Thus, stripping the net outstanding credit as banking system at the end of the 2002 from credits transferred to BART, the net outstanding credit is Lek 38,7 billion.

On monthly average basis, new credits accorded to the private sector and to households during 2002 are Lek 5,2 billion. Short-term credits (71 percent), foreign currency credits (67 percent) and the credits to the private sector<sup>22</sup> dominate the new credit structure. Year 2002 has been characterized by the increase of banks' interest in long-term investments, in credit to mid-size and the large size business (food processing industry such as that of refined oil, potable water and jams), and in the purchasing of apartments by individuals.

**Table 27: New credit performance over years in billions of Lek**

Indicators	Year 2000	Year 2001	Year 2002	New credit during 2002			
				Q I	Q II	Q III	Q IV
Short-term credit	12.9	27.6	44.8	9.5	10.7	11.4	13.2
Mid-term credit	10.0	10.4	13.0	2.4	3.1	3.5	4.0
Long-term credit	1.3	2.6	4.8	0.6	1.6	1.3	1.3
Short-term credit	0.2	0.5	0.05	0.02	0.03	-	0.00
Mid-term credit	24.0	40.1	62.59	12.5	15.4	16.2	18.50
Lek	4.4	10.0	20.9	2.1	4.3	6.6	7.9
Foreign currency	19.8	30.6	41.7	10.4	11.1	9.6	10.6
New credit (in billions of Lek)	24.2	40.6	62.6	12.5	15.4	16.2	18.5

During December 2001 and December 2002, trade sector remains to be the banks' most preferred sector for making credit, while banks' preference for construction indicates a significant fall. However, the new credit structure by sectors remains far from the economy structure.

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**Table 28: Net outstanding credit by economy sectors in percent**

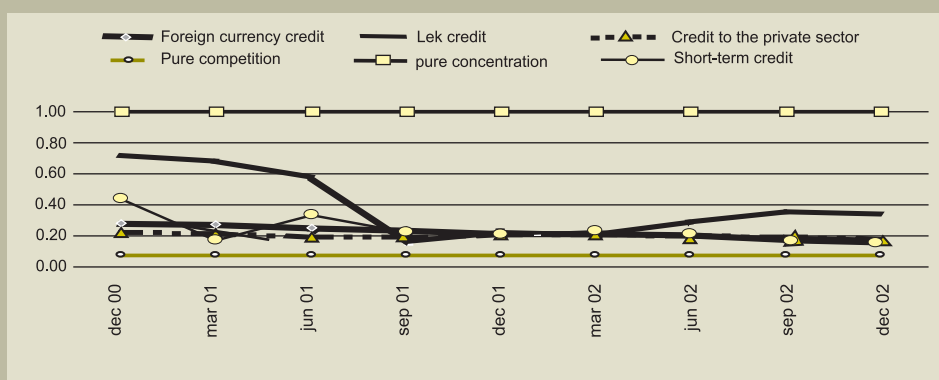
Nr	Economy sectors	Year 2000	Year 2001	Year 2002			
				Q I	Q II	Q III	Q IV
1	Agriculture, hunting and fruit-growing	0.9	1.0	0.9	0.9	1.0	0.8
2	Fishing	1.4	0.1	0.1	0.2	0.2	0.2
3	Extracting industry	0.7	1.6	2.1	0.2	0.3	0.2
4	Manufacturing industry	16.9	19.5	18.8	17.7	17.4	17.0
5	Production and distribution of electricity, gas and water	9.0	3.0	2.9	3.4	3.1	3.3
6	Construction	25.0	12.5	11.9	8.4	8.7	8.6
7	Trade, repairing cars and household appliances	26.7	41.3	41.1	43.5	41.8	40.4
8	Hotels and restaurants	4.5	4.3	4.9	5.9	5.1	6.0
9	Transportation and telecommunication	3.2	4.6	3.1	1.7	1.6	2.4
10	Financial activities	0.0	0.1	0.9	1.5	0.1	-
11	Real estates	5.4	6.3	6.5	3.4	8.1	9.1
12	Health care and social activities	3.2	1.2	1.2	5.3	0.6	0.5
13	Collective, social and personal services	3.0	3.3	4.4	2.0	5.0	4.2

<sup>22</sup> The new credit accorded to the public sector is only Lek 58 million.

### Box 11: THE CONCENTRATION OF BANK LENDING MARKET, 2002

During 2002, the concentration in bank lending market had a declining trend, as the number of the active participants in this market has recorded rise.

Graph 39: Herfindal index on some net understanding credit indicators

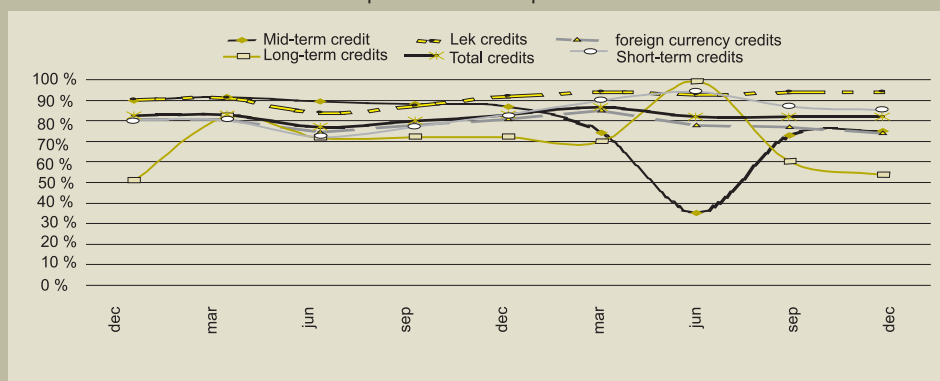


With regard to the new credit delivery, their level is significantly increased in the two recent years. Banks active participation has made that the phenomenon of new mid- and long-credit indicator is accompanied by a falling trends, compared to the end of 2001. The number of banks providing long-term credits is increased. This phenomenon on new credits accorded in Lek evidenced increase.

Table 29: N index performance in percent (the weight of 4 most active banks in the new credit delivery).

Period	Total credits	Short-term credits	Mid-term credit	Long-term credit	Credits to the public sector	Credits to the private sector	Lek credits	foreign currency credits
dec '00	83	81	90	51	94	83	90	81
mar '01	83	80	92	82	100	82	91	81
jun '01	77	72	90	72	60	78	84	75
sept '01	80	77	88	72	61	80	87	78
dec '01	83	83	87	72	64	84	92	81
mar '02	87	90	74	70	100	87	94	85
jun '02	82	94	35	99	100	81	93	78
sept '02	82	87	73	60	100	82	94	77
dec '02	82	85	75	54	100	82	94	74

Graph 40: N index performance



**Box 12: A SURVEY ON COMMERCIAL BANKS AND FINANCIAL NON-BANK LENDING IN 2002.**

*From the developed surveys on commercial banks, it was evidenced that mid-size business has been banks' most preferred to credit in 2002. Compared to the previous year, the credit preference for this business is significantly increased.*

*At the beginning of 2002, average credit presents a moderate growth in the second half of the year and a significant improvement of this indicator was evidenced. Average credit performance was affected by the political situation in the country, the power crisis and the fiscal contracted measures.*

*For 2002, it might be asserted that credit risk remains by average limits and with a slight growing trend, as compared to the previous year. Risk rather stable trend is explained with the political and economic conditions which have almost remained the same.*

*Credit risk in the future will be the same. This is because the country is not expected to change the political and economic circumstance.*

*Not a small number of foreign common and Albanian organizations and foundations are currently operating in Albania exercising credit activity to support the small-size businesses.*

*From the undertaken survey during 2002, it was evidenced that the average meeting of the credit plan by non-bank institutions has kept the same rates, as in the previous year. Amongst the main reasons, which have not accelerated the lending process, we may mention the power crisis, the very tight lending policies applied by foundations and the increase of competition by this market.*

*The power crisis had a slight effect in reducing the credit demand from financial non-bank institutions. Meantime, it has had a greater effect in the deferral of credit payments.*

*The current risk is estimated to have remained at the same rates as in the previous year. This is reasoned with the same macroeconomic situation, prudential lending policies, rising experience of members of saving and loan associations, etc. Forecasts for the next six months are for the same level of risk.*

**Box 13: INFORMAL CREDIT MARKET TREND**

*Informal credits market is estimated to have fallen in 2002. The further strengthening of bank institutions and the reduction of credit rates are assessed as the main factors to have affected this development. The increasing competition by the formal credit market, as well as the improving of quality of services provided by credit institutions, being adjusted to business needs, are all assessed to have exercised a pressure on this market shrinkage. The informal market activity is considered as being favored by "facilities in procedures" offered by the market.*

*The same conclusion is backed up by about 600 businesses, mainly classified as large medium and from output production and service sectors. The main reason according to them of the informal credit shrinkage is the high interest accorded by this market.*

*The reduction of the preference to be credited by the informal market is enhanced if we refer to business financing resources. As in 1999, we might say that the main financing resource of Albanian businesses remains the retained profit. However unlike 1999, financing from prepayments of orders and credits by bank institutions have assumed a great importance. Anyway, individual financing resources, implying the informal market, comprise a financing resource far off the business preferences.*

## IV. MONETARY POLICY INSTRUMENTS

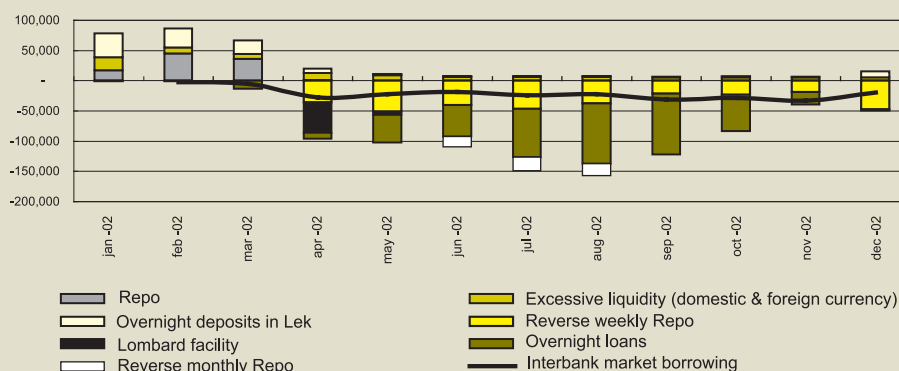
The Bank of Albania, for the second year in succession, based the implementation of its monetary policy on the open market operations, though the application of indirect instruments. The using of indirect instruments and facilities offered by the Bank of Albania reflected the conditions of deficient or excessive liquidity in the money market. The indirect instruments framework used by it was presented in line with the European Central Bank standards.

The previous year is estimated as a successful year of implementing monetary policy though indirect instruments, regarding the signalization of the monetary policy stance and the management of liquidity situation in the market.

### IV.1. WEEKLY REPO AUCTIONS AND INTEREST RATES

Unlike 2001, the banking system, for the most part of the year, was characterized by the lack of liquidity, where the massive deposit retractions had their impact as well.

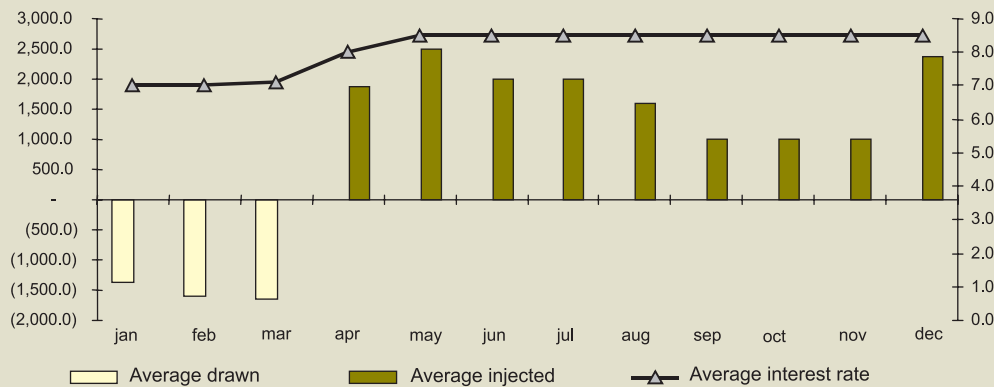
Graph 41: The change of conditions from the lack or excessive liquidity by the banking system.



In 2002 there has been applied a model on forecasting liquidity in the banking system. This model is further being processed to measure the impact degree of factors over the liquidity performance in the near future. The model is currently used to predict cash performance up to one month in the future. This model is only based on historical cash performance on three recent years. The applicable methodology bases its forecasting on the trend and the cyclic movements evidenced by cash time series. Obtained results from forecasting have demonstrated a statistically acceptable deviation from the current data.

Consistent with the change of the liquidity situation in the market, it was passed from the application of reverse Repo weekly auctions to reverse Repo auctions.

Graph 42: Repo/ reverse Repo weekly auctions average volume and interest rate.



(Left side in millions of Lek, right side in percent)

Table 30: Indicators of Repo/ reverse weekly Repo auctions

Period	No. Auctions	Volume (in millions of Lek)		No of participants		Type of auction
		Total	Average per auction	Total	Average per auction	
Jan - march	13	19,812	1,524	67	5	REPO
Apr - dec	39	67,393	1,728	70	2	R/REPO

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The Savings Bank has been the main participant of **Repo/reverse weekly Repo auctions**.

Due to the weight this bank occupies in these auctions, it has become:

- the main determinant of interest rate in diversified price auctions and
- the main determinant of the volume of transactions in fixed price auctions.

## IV.2. SETTLEMENT AND STRUCTURAL INSTRUMENTS

During the previous year, there were used reverse monthly Repo(s) and outright trading transactions to make longer than one- week settlements of liquidity in the banking system. The Savings Bank has been the only participant of reverse Repo monthly auctions.

Table 31: Reverse Repo monthly auctions during 2002

Reverse Repo monthly auctions	Market bid (Lek mln)	Market requested (Lek mln)	Admitted (Lek mln)	Interest (%)
Auction 1	1,000	1,000	1,000	9.2
Auction 2	1,000	1,000	1,000	9.2
Auction 3	1,000	1,000	1,000	9.2
Total	3,000	3,000	3,000	

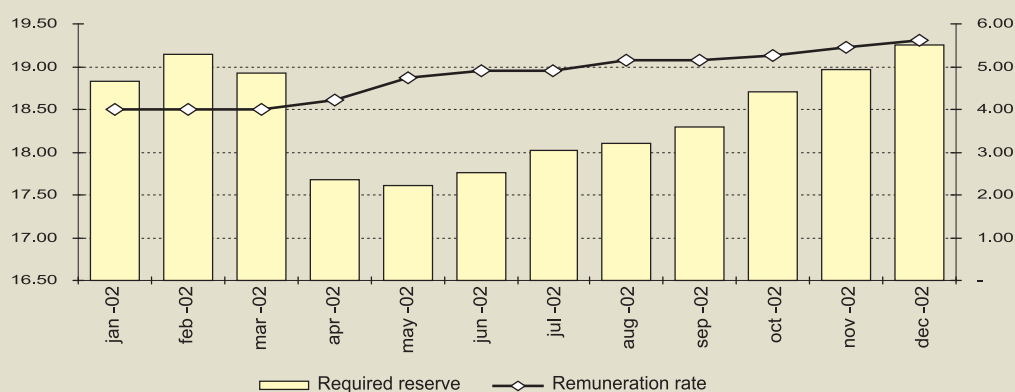
**Table 32: Outright sale transactions during 2002**

Outright sale transactions	Market bid (Lek mln)	Market requested (Lek mln)	Admitted (Lek mln)	Interest (%)
Auction 1	1,300	800	800	9.50
Auction 2	2,000	2,300	2,000	11.21
Total	3,000	3,100	2,800	

### IV.3. REQUIRED RESERVE, PERMANENT FACILITIES AND LOMBARD CREDIT.

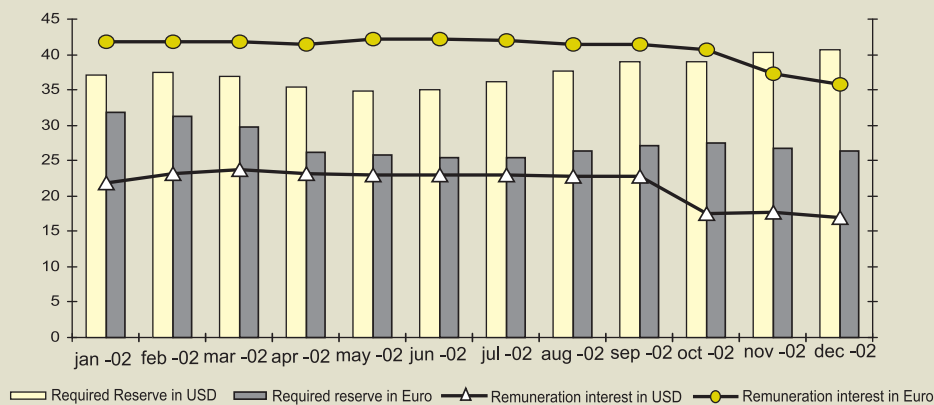
The required reserve instrument did not encounter changes during the previous year. The trend of the required reserve, denominated in Lek and USD, during the previous year, reflected developments in deposit stock.

Graph 43: Required reserve in Lek and remuneration interest



(Left side in billions of Lek, right side in percent)

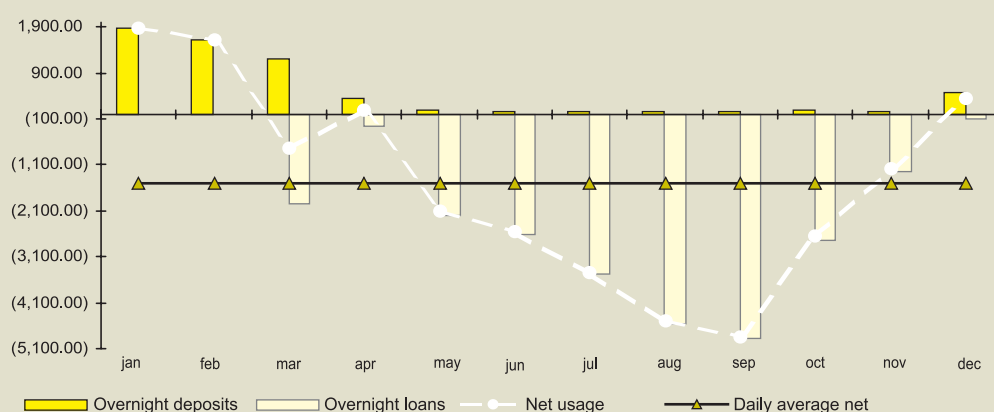
Graph 44: Required reserve foreign currency denominated and remuneration interest



(Left side in billions of Lek, right side in percent)

Required Reserve in USD Required reserve in Euro Remuneration interest in USD and Remuneration interest in Euro. The net annual average of using permanent facilities accounts for Lek 1,39 billion. As compared to the previous year<sup>23</sup>, during 2002, the total cumulative volume of overnight loans increased from Lek 9,8 to Lek 487 billion (50 times higher).

Graph 45: Permanent facilities daily average, monthly net and annual average use, in million of Lek.



**Overnight deposits**, though being a widely used facility in 2001<sup>24</sup>, it did not recognize a broad application in 2002. Furthermore, there have been days, during which this facility was not used by any banks at all. The cumulative range of overnight deposits has been half, compared to the previous year, from Lek 252 billion to 121,3 billion. For the first time, on a 10- days term, at the beginning of April, the Bank of Albania refused the receiving of overnight deposits to the banks.

The Lombard facility was only once applied on April 2002. In order to ensure the Savings Bank coverage of longer-term needs for liquidity, Lombard facility was accorded to the amount of Lek 2,5 billion over a 1-month term.

## V. MARKETS

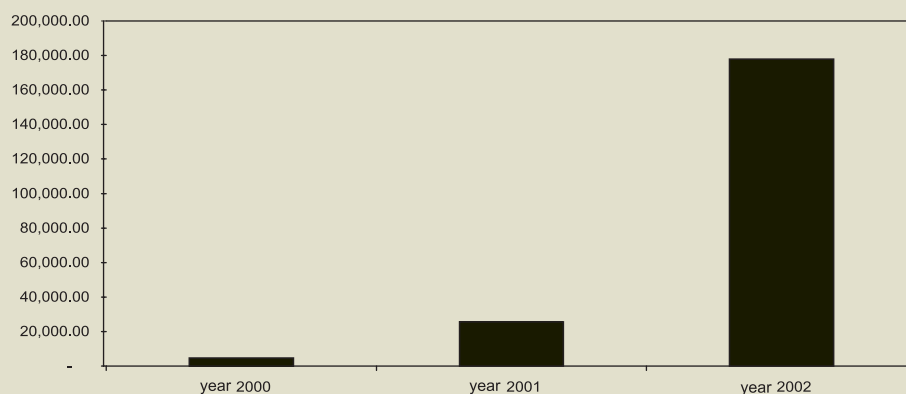
### V.1. INTERBANK MARKET

**I**nterbank market recognized as the market where banks trade their stocks and borrow without placing a collateral, recognized positive developments during the previous year. The rise of request for liquidity in the interbank market, especially by the Savings Bank, the temporary suspension of accepting overnight deposits by the Bank of Albania, the tightening of monetary policy, all affected on the extension of interbank market activity. In 2002, the volume of interbank transactions displays its highest level against year 2000.

<sup>23</sup> The overnight loan facility was for the first time used in 2001 as part of the operational framework of the Bank of Albania.

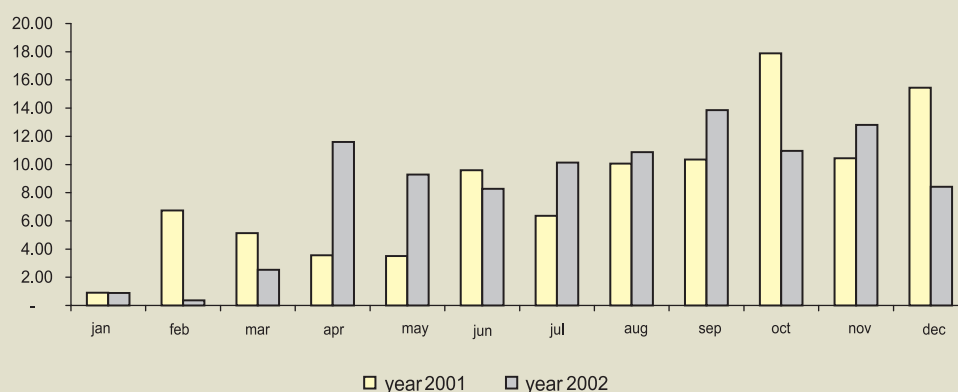
<sup>24</sup> Overnight deposit was for the first time used as facility in 2001, as part of the Bank of Albania operational framework.

Graph 46: The annual volume of interbank transaction, in millions of Lek.



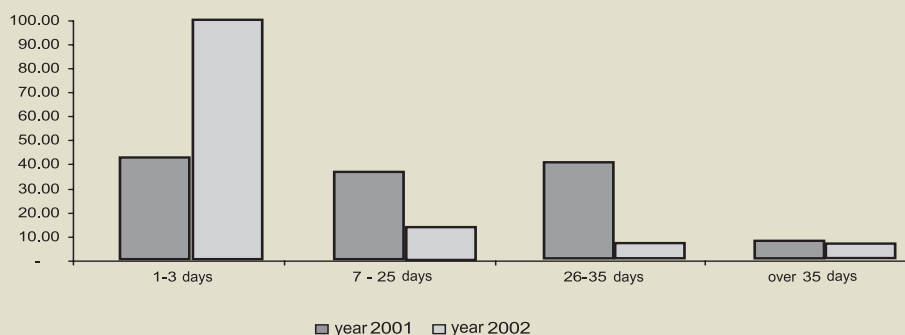
Interbank transactions monthly volume recognized growth, starting from April, precisely when the Savings Bank increased its request.

Graph 47: Interbank transactions monthly volume, in percent.



Division by maturity confirms that the majority of interbank transactions was concentrated in overnight segment, which recognized a rise of 57.2 percent compared to 2001. The 7-26-day transactions recognized shrinkage, whereas transactions by other maturities were reduced significantly or no such ones are used.

Graph 48: Transactions volume by term of maturity in percent.



## V.2. THE PRIMARY MARKET OF GOVERNMENT SECURITIES

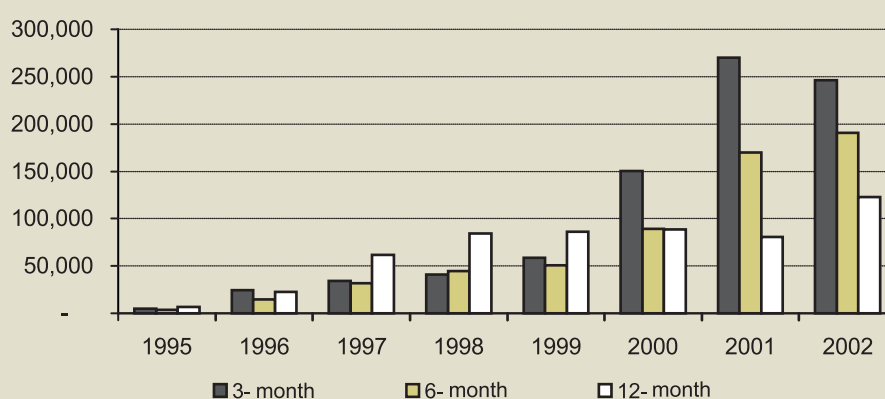
The primary market of government treasury bills was the main form for financing the budgetary deficit in 2002. The volume of transactions in the **primary market** had y/y rising trend.

Primary market participants have been the commercial banks, different financial non- bank institutions, and individuals. The commercial banks' portfolio for 2002 was reduced by 1.25 percentage points, while the individual's portfolio increased by 1.82 percentage points. The main part of such growth corresponds to direct operation of individuals to the Bank of Albania windows and to its affiliates in the districts. Individual's participation in this form of investment recognized an apparent rise, mainly after the period of the massive deposit retraction from the two major banks.

**Table 33: Individual investments in millions of Lek**

	Year 2001	Year 2002
In the banking system & the Bank of Albania	2,505	7,810
In the Bank of Albania	373	5,065

Graph 49: The volume of primary market transactions, in millions of Lek over years.



A distinctive feature of 2002 was the higher demand for funds by the government budget. It results that on average, in every auction organized during the previous year, the government has requested Lek 1,2 billion more than maturities. This happened under the conditions of not realizing the privatization receipts and revenues, as well as due to the level of the government's expenditures.

The increase of request in the primary market was faced with the rapid deterioration of liquidity situation in the banking system. This was also the investment market where the lack of banking system liquidity was obviously noticed. In some cases, the high level of non-fulfillment of amounts announced by the Ministry of Finance for treasury bills, created lack of liquidity in the government account, making indispensable the Bank of Albania intervention through direct credits. This brought about the displacement of deficit financed by commercial banks to the Bank of Albania. Therefore, there were raised the Bank of Albania net claims against government and it was deviated from the approved program, which did not anticipate deficit financing by the Bank of Albania. In June-July, the complete converting of direct government credit was performed by purchasing treasury bills by the Bank of Albania. The same situation was repeated at the end of

the year, when to cover the financing amount unfulfilled by the market, there was accorded a direct credit. Nevertheless, the assigned limit on domestically financed budgetary deficit was not transgressed.

Although the government liquidity situation on 2002 has been generally balanced, there were still evidenced moments of concentrated expenditures especially in the end of the year. The Ministry of Finance issued about Lek 1,6 and 3,4 billion treasury bills more than the maturities for November and December, respectively. To meet government needs for liquidity, at the beginning of December, with the decision of Domestic Loans Committee, the profit of December, at the amount of Lek 503 million, was placed in the budget account. Following the efforts to create the necessary balance in its account to realize year-end expenditures, the Ministry of Finance addressed the Bank of Albania for a direct credit, as well as for flowing the profit amount of Lek 1,95 billion over the plan. At the end of 2002, the Bank of Albania accorded the direct credit of Lek 1,1 billion to the Ministry of Finance. After recognizing the precise profit amount for 2002, the Bank of Albania transferred to the ministry of Finance account, the share of the profit value on January 14, 2003. All these operation enabled the transferring of required expenditures to the end of the year and the closure of operations of December 31 by mid-January 2003.

Graph 50: Meeting the government request for treasury bills in percent.

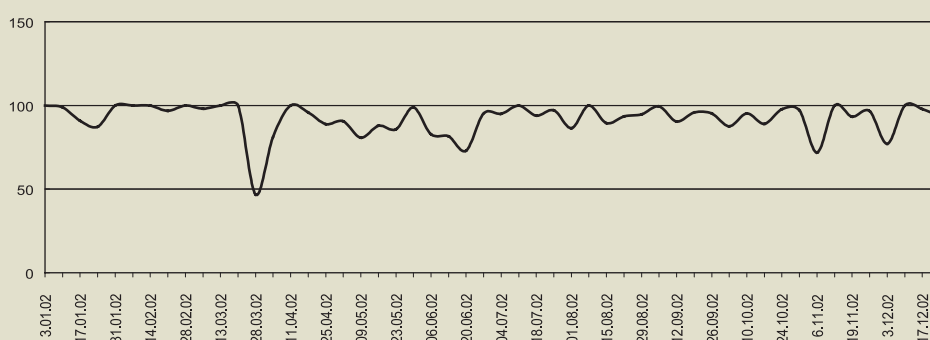


Table 34: Treasury bills issues and maturities in the primary auctions and the Bank of Albania delivery of direct credit, in billions of Lek.

	Government issued face value	Maturities face value	Government direct credit
First quarter	142.41	136.26	5.50
Second quarter	137.01	133.50	3.90
Third quarter	139.01	128.60	-
Fourth quarter	140.01	133.88	1.14
Total	558.47	532.25	10.54

For the first time in the previous year, the government issued two-year bonds. For their issuing, the auction form was applied and the price was uniform for all the requests. The coupon is fixed and payable every six months. These bonds are tradable before their maturity term.

**Table 35: Auctions of two-year government bonds**

Two- year bond auctions	Market bid	Participant banks	Interest offered	Interest
Auction 1	300	1	14.5	14.5
Auction 2	300	3	14.3	14.1
Auction 3	400	4	14.1	14.0

Although the offered amount of two –year obligations has been relatively small, banks interest and their competition to participate in these auctions had a rising trend. This was enabled by the provision of two –year deposits from banks.

### V.3. EXCHANGE MARKET

**L**ek exchange rate against the major currencies during 2002 has mainly tracked seasonal trends evidenced in the previous year and major foreign currencies performance internationally. At the end of 2002, there were needed Lek 133,8 and 140, 2 to purchase one USD and Euro, respectively. Comparing the exchange rates at the end of 2002 and the beginning of 2001, Lek was depreciated by 18,3 percentage points in ratio to Euro and was appreciated by 2.2 percentage points in ratio to USD.

The hard liquidity situation in the banking system in the first half of the year corresponded to a delicate moment in ratios between foreign exchange demand and supply for the foreign exchange market domestically. Deposit retraction (mainly those Lek denominated) from a part of second-tier banks increased the currency outside banks, which presented as due to the added supply (sales) Euro component currencies (DEM, ITL and GDR) at the end of 2001 and the beginning of 2002, a time when these were replaced by EURO. The combined effect of these developments caused a fast depreciation of Lek in March, April and May.

The political developments in the country and inflation rate developments, as well as the reverse foreign exchange fluctuations have target and managed to restrain a fast depreciation of Lek. However, at the end of May, restricted operations due to unwanted developments in NFA indicator and the fast strengthening of Euro internationally created conditions for the sharp weakening of Lek to Euro (3.0 percent within a week).

Banking system request for foreign exchange has been very high and concentrated in this period. Such a fact has effected some-day strong pressures, frequently considered as exaggerated. Meantime, the falling values in the period to come have been used to set up new foreign positions by domestic foreign currency market operators.

The high dependency of exchange rates on commercial banks is an ever rising and a welcome phenomenon, as it avails the Bank of Albania of better opportunities in transmitting messages by foreign exchange market operators. Responding to this higher market development, the Bank of Albania has attempted to constantly improve its analyzing and proceeding capacity regarding the timely identification of unwanted exchange rate developments and the specification of most appropriate manners to handle them. In any case, when the intervention is deemed as necessary, the achievement of the target is aimed, by as few operation as possible.

The Bank of Albania intervention<sup>25</sup> in the foreign exchange market domestically during 2002 is divided in two periods: March – April – May and December. The side of intervention has been different for either period. In the first period, the total sale counted for USD 4,94 million, computed at an average exchange rate of Lek 154.02 and Euro 0,4 billion at an average exchange rate of Lek 131,4. In December, there was purchased USD 1,8 million, at an average exchange rate of Lek 133.74 and Euro 0.2 million, at an average exchange rate of Lek 136.2.

#### V.4. CAPITAL MARKET

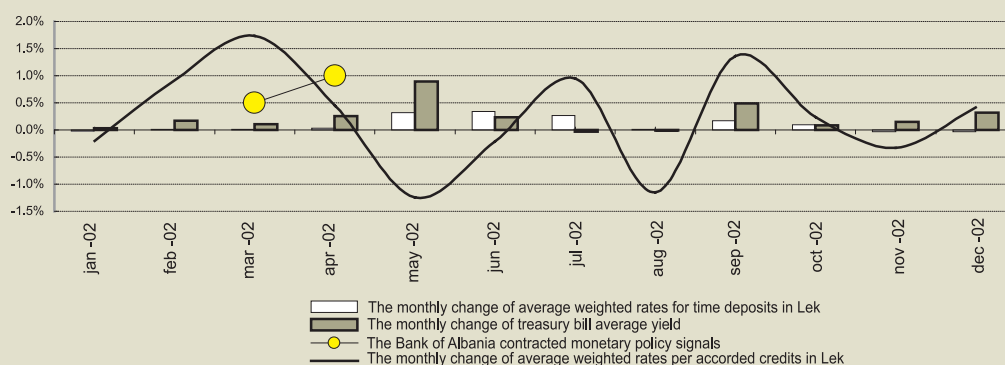
**C**apital market remains the most undeveloped element in the market union. Year 2002 involves the third year in succession that no single transaction of stock-holding company is listed by Tirana Stock Exchange sessions.

Finally Tirana Stock exchange was administratively separated from the Bank of Albania in June 2002. After that, in November 2002, the Securities Commission decided to grant a temporary license to Tirana Stock Exchange on securities market.

### VI. INTEREST RATES IN ECONOMY

**T**he Bank of Albania increased the core interest rate twice during 2002 by 0.5 and 1-percentage points respectively, based on the Supervisory Council decisions of March 21 and April 10, 2002. Therefore, the interest performance in economy reflected the tightening of the Bank of Albania monetary policy. The increase of interest rates in economy has been the general trend. However, the rate of reflecting monetary policy decisions in economy, either in time or magnitude, has been different for different markets. Thus, depending on the velocity of reaction, some markets reflected a faster and more immediate reaction, later on being characterized by interest rate stability. Other markets have reflected gradual change, until they approximated to the change of the core rate by the central bank.

Graph 51: Bank reactions against monetary policy signals.



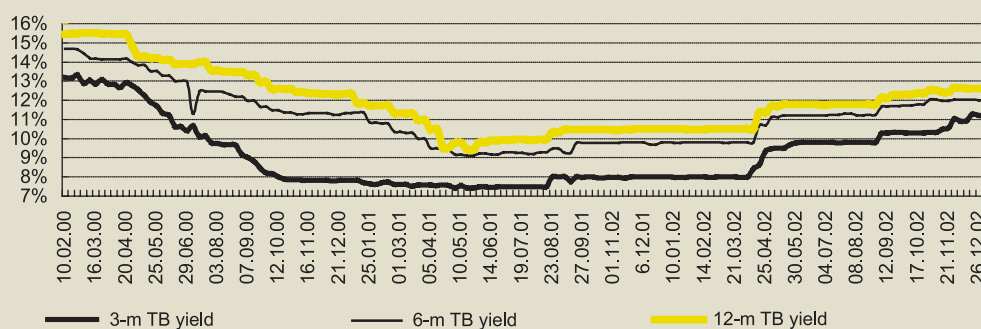
<sup>25</sup> In the form of commercial bank operations, active or passive, according to the weekly meeting decision.

**Table 36: The period when banks evidenced their strongest reaction, in percent.**

	Interest rate increase in this period to the total rise		
<b>Deposit market</b>	<b>May - June 2002</b>	<b>October 2002</b>	
1-month deposits	82		
3-month deposits	96		
6-month deposits	56	25	
12-month deposits	61	20	
<b>Primary market</b>	<b>April 11- May 2, 2002</b>	<b>September 5</b>	<b>November 27</b>
3-month treasury bills	46	15	15
6-month treasury bills	60	20	
12-month treasury bills	58	16	

Thus, the average yield has been 1.2 percentage points higher than the Bank of Albania signaled increase.

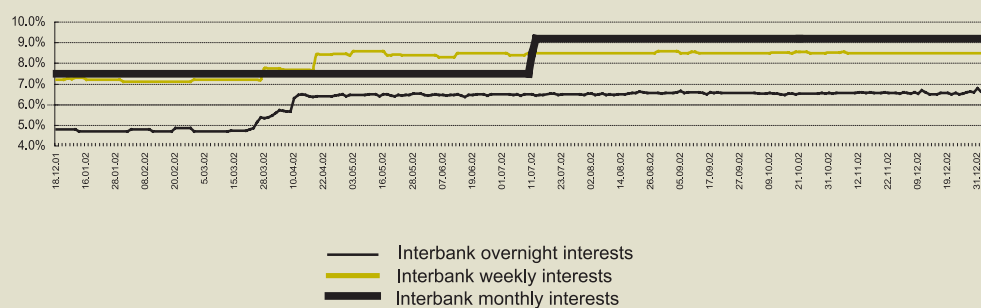
Graph 52: Primary market average weighted yield.



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Interbank market had a fast reaction against monetary policy signals

Graph 53: Interbank rates in percent.



The reaction against the changing monetary policy **by the deposit market in Lek** was initially delayed and later gradual and continuous.

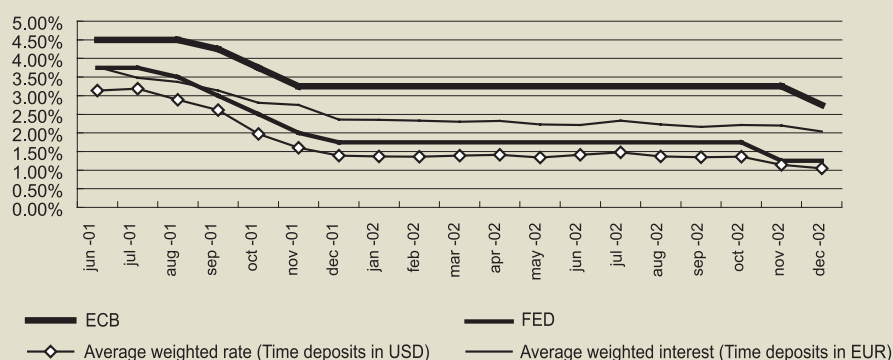
**Table 37: Banking system unused space to raise deposit rates in Lek.**

Time deposit rates	The increase of the average weighted rates on Lek deposits for January-December 2002	The change with the core rate increase
3-month	1.05	-0.45
6-month	1.52	0.02
12-month	1.49	-0.01
Total <sup>26</sup>	1,17	-0.33

Characteristic of deposit market is that:

- The change of the short-term rates is gradual and not fully transmitted by deposit rates
- From stimulation estimations, it is verified that only 70 percent of the effect of the changing interest rate is transmitted to deposit rates within a quarter. The rest of effect is later and slowly transmitted as an aftermath.

Graph 54: Comparing deposit rates in foreign exchange to core interests of FED and ECB.



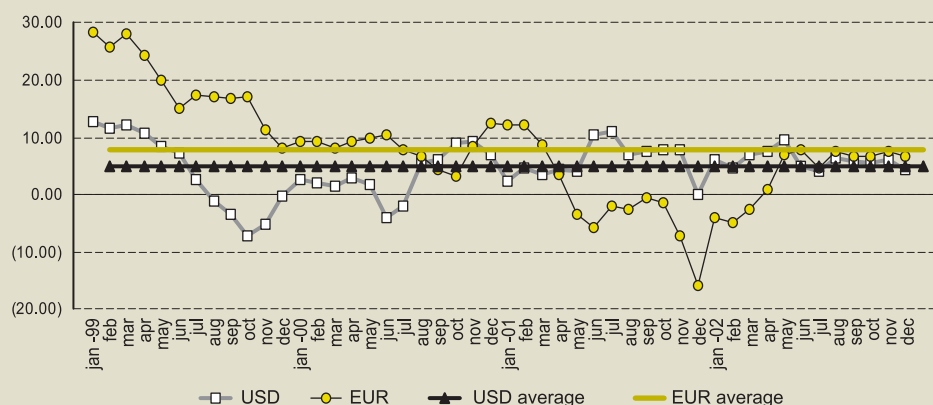
The reverse trend on the deposit performance in Lek and foreign currency has stimulated people to invest in Lek.

**Table 38: Annual average interest on 12-month deposits in Lek and foreign currencies converted in Lek, in percent.**

Year	Annual average interest in Lek	Annual average of USD interest converted in Lek	Annual average interest of Euro converted in Lek
1999	12.38	8.28	6.79
2000	7.99	4.	-0.30
2001	7.72	1.12	7.17
2002	8.54	1.00	4.37

<sup>26</sup> Calculated on the basis of average weighted interest on 3-6- and 12-month deposits.

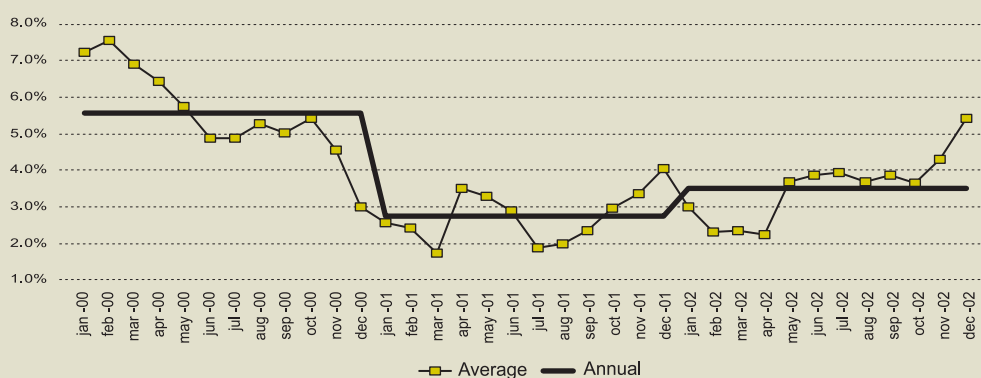
Graph 55: The difference between 12- month deposits interests in Lek EUR and USD and their mean historical in percentage points.



The real interest range<sup>27</sup> on Lek deposits recorded positive terms in the previous year. The rise of the net earnings gained by depositors from the banking system deposits in Lek, was affected by the increase of the nominal interest on 2-month deposits from 7.74 percent in January to 9.25 percent in December and by the downward trend of annual inflation from 6.5 percent in January to 2.1 percent in December, from one month to the other.

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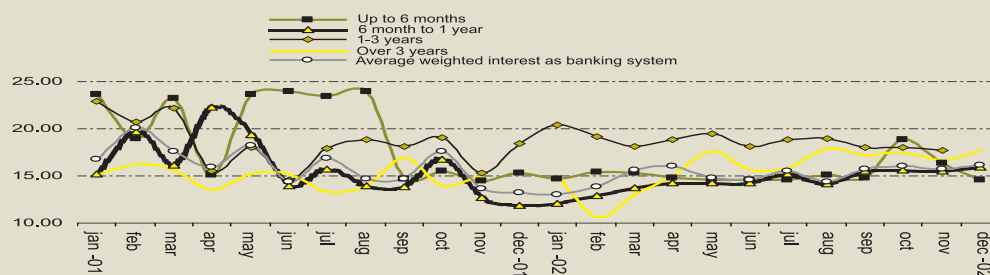
Graph 56: Real interest on 12- month deposits in Lek and annual average in percent.



Average weighted interest for credits accorded in Lek, as banking system at the end of 2002 recorded a rise by 2.91 percentage points compared to December 2001.

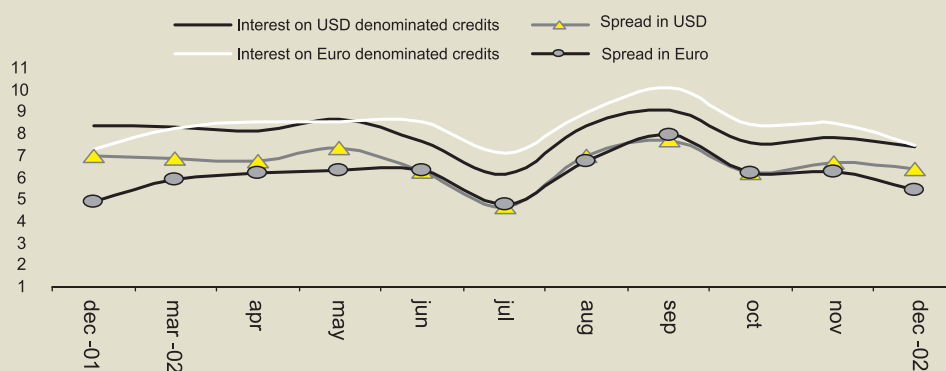
<sup>27</sup> The expected rate of real interests in Lek is accounted on the basis of the forecasted rate of annual inflation for 2003 according to the mean historical methodology.

Graph 57: Interest rate performance on credits by maturity term in percent.



The spread between average weighted interest on accorded credits and received deposits in Lek at the end of 2002 is 7.87 percentage points. Although the banks' number exercising credit activity in Lek is growing, yet one or two banks become determining of average weighted rate per accorded credits in Lek as banking system. The fluctuation of this spread is almost the same with that of Lek credit interests.

Graph 58: Average weighted rate performance per accorded credits in Lek and foreign currency in percent.



## CHAPTER IV: BANKING SUPERVISION

**B**anking supervision during 2002 has tried to ensure the application of laws and regulations established by the Bank of Albania, to help the creation of an efficient and competitive banking system, to assure the depositors and the stockholders on a better management of own assets. This has played an important role on evidencing and resolving special bank problems.

### I. LICENSING AND REGULATORY FRAMEWORK

#### I.1. LICENSING

**T**he licensing policy of banks or other financial entities did not change, as compared to 2001. The Bank of Albania has maintained the same requirement on minimum capital for opening a bank. The feature of this year is the submission of the request for a license to perform banking activity by Albanian legal entities and natural bodies.

In 2002:

- The Bank of Albania Supervisory Council took the decision on granting license to exercise banking activity in the Republic of Albania territory to "Albanian Credit Bank".
- The Bank of Albania has previously examined bank requests on opening 9 new branches and 1 new agency.
- It had been approved the license for the non-bank foundation "The Financing fund of highland areas" as a financial non-bank entity to exercise lending activity. From other financial non-bank entities, "The Albanian Post Service" A.E. has expanded its activity, serving as an agent or financial consultant. It has also been licensed to perform foreign exchange activity in some districts of the country.
- Based on the regulation "On licensing savings and loan associations and their unions" in cooperation with the Rural Financing Fund and the foundation "The movement for developing savings and loan associations" there were licensed 113 saving and loan associations and 2 unions".
- Banks and foreign bank branches change managers and their share- holders only after receipt of the Bank of Albania preliminary decision. The Bank of Albania has given its preliminary consent for almost 40 new foreign bank branch managers, where are included members of the board of directors, members of the audit committee, general directors, department directors and bank branch managers.
- In 2002, the Bank of Albania, pursuant to law " On banking system in the Republic of Albania" gave the preliminary consent on the participation of the Commerzbank AG, with 20 percent of the shares of FEFAD bank.

**Table 39: The list of the Bank of Albania permitted entities to operate in the Republic of Albania territory.**

No.	Entities	Year 2000	Year 2001	Year 2002
1	Foreign banks and branches	13	13	14
2	Financial non- bank entities	2	4	5
3	Foreign exchange bureaus	19	38	58
4	Saving and loan associations			113
5	Unions of saving and loan associations			2

## I.2. THE REGULATORY AND SUPERVISORY FRAMEWORK

In 2002, the Supervisory and regulatory framework was completed with new acts and regulations, related to the formalization and the regulation of the saving and loan associations and their unions and with bank custody and liquidation.

### 1. New regulations:

- a) The regulation "On licensing saving and loan associations and their unions" approved by the Bank of Albania supervisory Council decision no. 11, dated 27. 02. 02.

Licensing saving and loan associations and their unions is a qualitative step toward the returning of these micro-finance institutions to formal institutions, supervised by a responsible authority, such as the Bank of Albania. The law "On saving and loan associations and their unions" assigned the Bank of Albania as the supervisory authority of these institutions. On this basis, the Bank of Albania delivered domestic regulations on the licensing and the supervision of these micro-finance institutions. The format of the regulation is similar to the standard of some other licensing documents of other financial non-bank entities.

- b) The regulation on "The supervision of the saving and loan associations and their unions" approved by the Bank of Albania's Supervisory Council decision no. 67, dated, 28.08.2002.

The regulation "On the supervision of the saving and loan associations and their unions" is the second document, which completes the regulatory and supervisory framework on saving and loan associations and their unions. With the approbation of the regulation "On granting license to saving and loan associations and their unions", the formalization of these institutions by the financial market is enabled.

- c) The guideline "On the custody and liquidation of banks" approved by the Bank of Albania's Supervisory Council decision no. 45, dated 12.06.2002.

The guideline "On the custody and liquidation of banks" is pursuant to the Law "On the banking system in the Republic of Albania". The procedures treated in this guideline relate to the situations, when banks, as a result of their activity or their external developments, meet with financial problems and need outward intervention.

### 2. Improving the current regulations:

- a) A change in the regulation "On the management of credit risk" approved by the Bank of Albania Supervisory Board decision no. 31, dated, 05.08. 02.

The suggested alteration in the regulation "On credit risk management " was dictated by the practice of the credit ceiling application. These are clarifications and supplements, based on the regulatory framework of improving bank supervision efficiency for this special activity.

- b) For an alteration in the regulation " On capital adequacy " approved by the Bank of Albania Supervisory Board decision no. 72, dated 11.09. 2002.

## II. BANKING SYSTEM PERFORMANCE<sup>28</sup>

The financial and banking system situation at the end of 2002 is assessed as good. The banking system evidences positive net earnings at Lek 3,9 billion or nearly 0,6 percent of the GDP. This indicator, compared to the end of 2001 is Lek 0,4 billion lower or 9.4 percent (in real terms, the recession is 11 percent less). It is just the results of the policies and executive decisions of the financial institutions and their capacities of converting assets to net earnings, which are reflected in the profitability indicators. While ROA generally indicates the institution's ability to operate on profit, ROE indicates its possibility of rising investments. These indicators are evidenced within normal<sup>29</sup> standards.

**Table 40: Profitability indicators in percent for 2002.**

Indicators	Banking system	G1	G2	G3
ROA*	1.2	1.2	0.6	1.3
ROE**	19.1	47.6	3.4	13.1
Net earnings from interests / total average assets	2.7	2.2	3.2	3.5
Operation expenditures / total average assets	1.7	1.1	2.9	2.4
Provision expenditures / total average assets	0.3	0.1	2.0	0.5

\*Return on assets

\*\* Return on own equity/ funds.

**Table 41: Profitability indicators over years**

Indicator in %	December'99	December'00	December'01	December'02
ROA	0.5	2.1	1.5	1.2
ROE	15.7	20.6	21.6	19.1

Net earnings from the main activity of the banking system is Lek 11,2 billion almost at the same levels as '2001. Net earnings from interests, comprising about 78,7 percent of these incomes, continue to give the main contribution on these incomes, whereas the rest of them is from commissions and the foreign exchange operations.

**Table 42: Financial incomes and expenditures and net financial result performance.**

Indicators (in billions of Lek)	December '99	December '00	December '01	December '02
Total income	39.1	31.0	29.2	28.0
Total expenditures	37.9	25.7	24.9	24.1
Net result (profit)	1.2	5.3	4.3	3.9

<sup>28</sup> The market share licensed by the Bank of Albania is recognizing modest developments from one period to the other. Currently operating in the Republic of Albania territory are five financial non-bank institutions. The total assets of these institutions comprise about 0.9 percent of the total assets of the banking system. The modest share of these institutions confirms at the same time that the financial system in Albania is still identified with the banking system. Also, worth mentioning in the latter is the activity of 59 foreign exchange bureaus, 109 saving and loan associations and 2 unions of savings and loan associations.

<sup>29</sup> ROA normal rate is considered 0.5 –1.6 percent, whereas ROE's is 10-20 percent.

**Table 43: Incomes and expenditures and net earnings from the main activity**

Indicators (in billions of Lek)	December '99	December '00	December '01	December '02
Incomes from the main activity	37.5	27.0	26.1	26.9
Expenditures from the main activity	31.1	17.1	15.0	15.7
Net incomes	6.4	9.9	11.1	11.2
From these net incomes from interests	5.2	7.7	8.7	8.8

Banking system operation expenditures record Lek 5,5 billion, evidencing a rise of nearly Lek 0,7 billion compared to 2001, while even the provisioning expenditures evidence an increase of about Lek 0,04 billion. The relatively considerable level of these expenditures, though affecting negatively on net income of the system, serves the further extension of the banking system, improvement of technology and information, as well as the coverage of the possible loss from the non-performing loans (regulatory requirement).

**Table 44: Efficiency ratio**

Indicators (in billions of Lek)	Dec '99	Dec '00	Dec '01	Dec '02
Operation expenditures	3.2	4.0	4.8	5.5
Gross incomes	4.8	11.5	10.4	10.5
Efficiency ratio	65.9	34.5	46.3	52.7

Banking system assets are Lek 20,9 billion or 6,5 percent higher in nominal terms, while the real rise accounts for 3,4 percent. As compared to the previous year, which evidenced an optimal rise of the total assets of the banking system per 17,6 percent or Lek 46,7 billion, it should be mentioned that the cause for the lowest growth rate is the massive deposit retraction from the Savings Bank and the National Commercial Bank over March–April. Meanwhile, in February, the banking system evidenced a rise of Lek 7,3 billion, compared to the end of 2001. In March, the fall counted for Lek 7,6 billion compared to February and Lek 385,6 million compared to the end of the year. In April, these banks evidenced the greatest deposit retraction, which gave a falling impact on total assets of the banking system per Lek 3,9 billion in June compared to the end of 2001. Meantime, it is in August that the banking system indicated a rise compared to the end of the year and this rise kept displaying to the rest of 2002.

**Table 45: Total assets, y/y performance.**

Indicators (in billions of Lek)	Dec '99	Dec '00	Dec '01	Dec '02
Total assets	249.5	270.8	318.5	339.3
As % of GDP	51.1	49.1	53.5	51.6

In the bank group analysis of the system, the public banks group (currently comprised by the Savings Bank only) evidences a fall of total assets per Lek 4,9 billion. Joint-venture banks evidence a rise of Lek 447 million, while the private banks rise is per Lek 25,4 billion, confirming the importance of these latter to the increase of the total assets of the banking system during 2002.

The expansion of private banks' activity (G3) is approximating the contribution of this group in the banking system to that of state-owned banks. The 40,3 percent weight of G3 to the banking system is only 13.8 percentage points lower than G1 weight.

Graph 59: Bank groups ' weight to the banking system by the total assets over years.

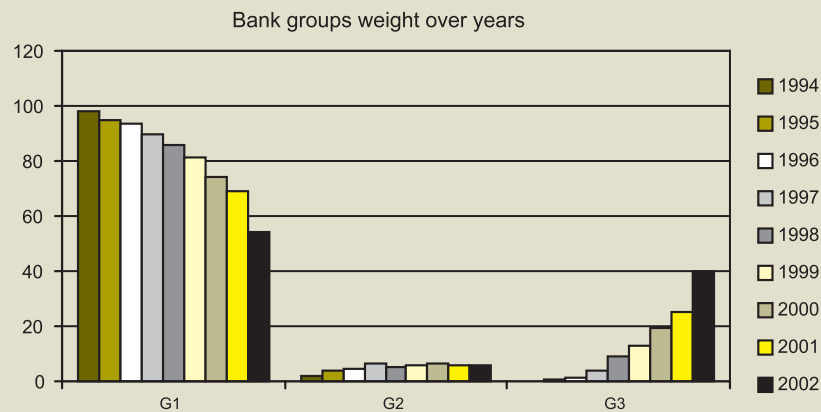


Table 46: Bank group weights by total assets to the banking system (in percent)

Indicator	G1		G2		G3	
	2001	2002	2001	2002	2001	2002
Current accounts and deposits	63.5	58.1	4.8	4.9	31.7	37.0
Share-holder's capital	20.9	24.7	18.6	16.3	60.5	59.0
Net credits	3.2	1.3	22.8	16.1	74.0	82.6
Treasury bills	81.2	78.2	0.9	1.4	17.9	20.4
Bank assets	40.0	36.7	10.5	11.5	49.5	51.8
Total assets of the group (in billions of Lek	188.5	183.6	18.6	19.1	111.3	136.7

In 2002, banks lending introduced a satisfactory performance, either in quantitative or qualitative aspect. Net outstanding credit evidenced a rise of Lek 10, 9 billion, mainly concentrated in the short-term loans, though at a falling trend during 2002.

This portfolio growth indicator (the ratio of problem loans to credit stock) accounts for 5.6 from 6.9 percent at the end of 2001. The lowest range of this indicator evidences improvement of the lending quality.

Table 47: Indicators of loans portfolio as percentage of classified loans

Indicator	Banking system		G1		G2		G3	
	2001	2002	2001	2002	2001	2002	2001	2002
Classified loans*	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Standard	88.3	89.9	72.3	79.8	66.4	70.1	96.0	94.4
Special mention	4.6	4.6	20.3	5.4	14.4	8.4	0.8	3.8
Substandard	4.0	3.0	0.6	1.6	14.0	11.9	1.1	1.1
Doubtful	1.7	0.7	0.2	0.4	4.8	3.0	0.8	0.2
Lost	1.3	1.8	6.6	12.7	0.3	6.6	1.3	0.6
Provision coverage	4.4	4.2	8.5	14.3	7.4	11.6	3.3	2.4

\*Standard and special mention loans are classified as regular loans, while the other three groups are treated as problem or non-performing credits.

Capital adequacy ratio, as an indicator that evaluates the bank's strength, makes available, at the same time, even the evaluation of banking system development and safety on the whole. At the end of 2002, banking system capital adequacy ratio keeps evidencing a rather high range of 31.5 percent<sup>30</sup>. Compared to end of 2001, this ratio indicates a recession.

**Table 48: Capital adequacy ratio by bank groups at the end of 2001**

Indicator	Banking system	G1	G2	G3
Capital adequacy ratio	35,3	29,9	40,4	35,7

Two are the elements of the capital adequacy ratio - *regulatory capital and classified assets by risk*- also giving an impact by these rates of the ratio. As the regulatory capital increases by 6.9 percent or nearly Lek 1,2 billion compared to the end of 2001, classified assets by risk relate an increase per 19.4 percent or about Lek 9 billion (mainly lending). It is precisely the private bank group, which by a higher stretch of risk related assets, gives the main impact on the falling ratio of the system. Capital adequacy ratio for the private bank group evidences the lowest rate of 28.9 percent for the public banks, 33.3 percent and 43.6 percent for joint-venture banks. Thus, the analysis of the capital adequacy ratio by banks groups of the system discerns the private banks group with a fall in the ratio, while the rest of the groups evidence growth. This evaluates once more the increase of the private banks contribution by high-risk assets, which contribution is expected to be higher in view of the inner capacities and the satisfactory range of capital adequacy by these banks.

**Table 49: the structure of classified by risk rate as percentage of the total assets and off- balance of sheet items classified by risk.**

Indicators	Banking system	G1	G2	G3
Free-risk assets	65.1	85.2	18.2	43.0
Low risk assets	21.3	12.6	38.1	31.4
Average - risk assets	3.0	0.1	23.3	4.0
High- risk assets	10.6	2.1	20.5	21.6

The analysis of core liquidity indicators evidences its satisfactory level even for 2002. The created situation from the deposit retraction in March –April, though successively faced by the Bank of Albania provided facilities, made the banking system reflect an asymmetric liquidity situation for the following period as well. On one hand, the Savings Bank was positioned as liquidity solicitor, extensively using the Bank of Albania offered facilities in the interbank market and on the other hand, the other banks of the system, generally presented with excessive liquidity. The satisfactory rate of liquid assets on the total bank assets (over 37 percent) and short-term liabilities (over 100 percent), as well as the Bank of Albania offered facilities on liquidity, made banks not significantly expose against liquidity risk this year.

The Albanian banking system continued to consolidate its sound financial system in 2002 as well.

<sup>30</sup> Capital adequacy ratio required minimum is 12 percent.

Table 50: Banking system indicators

Banks*	No. of branches	No. of agencies	Paid-up capital /Total balance sheet (%)	Total deposits/ Total balance (%)	Total of credits (net)/ Total balance (%)	Problem loans/ Total loans (%)	Treasury bills as percentage of the banking system
<b>GROUP I: PUBLIC BANKS</b>							
1. The Savings Bank	37	91	0.4	92.4	0.5	16.2	78.2
<b>GROUP II: JOINT-VENTURE BANKS</b>							
2. Albanian Italian Bank		3	10.5	76.0	37.0	22.5	1.4
3. Arab-Islamic Bank of Albania	1		63.4	36.0	6.3	0.0	0.0
<b>GROUP III: OTHER BANKS</b>							
4. National Commercial Bank	10	1	4.9	92.5	0.3	0.0	9.5
5. Dardania Bank			56.4	17.6	0.0	0.0	0.0
6. Tirana Bank	11		5.5	77.2	17.4	1.4	4.8
7. National Bank of Greece-Tirana branch		3	12.9	83.4	3.4	4.6	0.9
8. International Commercial Bank	1		43.4	55.9	33.5	10.5	0.2
9. Alpha Credit Bank- Tirana branch	5		7.7	49.7	51.0	1.6	0.4
10. American Bank of Albania	2		3.8	92.4	13.1	1.9	3.0
11. Fefad Bank	7	1	8.7	84.1	26.2	2.0	1.4
12. First investment Bank - Tirana branch			61.0	13.7	0.2	0.0	0.0
13. Commercial Bank of Greece			48.6	55.2	54.0	0.0	0.3

\*Banks division by groups is made according to ownership criterion. The first group includes public banks the second, joint-venture banks and the third group includes other banks.

### III. BANK INTERMEDIATION

Notwithstanding the positive developments evidenced in 2002, the level of bank intermediation remains low.

Table 51: Core macroeconomic indicators in a comparative analysis for 2002.

Indicators	Albania*	Bulgaria	Croatia	Macedonia	Romania	Slovenia	Turkey	Greece
Time deposits/GDP ratio	40.1	31.6	48.6	16.5	8	47.1	73.7	90.7
Domestic credit /GDP ratio	35.1	27.2	51.9	20.6	12.4	49.5	99.4	109.3
Credit to private sector / time deposits ratio	7.2	16.9	41.3	21.6	7.8	40	28	63.3
Credit to private sector / time deposits	17.5	53.4	85.1	136	99.8	85.1	37.3	69.78
Credit to private sector / domestic credit	20.0	62.2	79.7	78.3	63.2	81.0	28.1	57.9
Interest spread	7.9	9.8	6.3	8.8		5.2		5.3
No. Of banks per 100, 000 inhabitants	0.45	1.13	1.0	1.9		1.3	0.1	
No. Of bank subsidiaries & agencies per 100,000 inhabitants	2.7	69.23	18.1	76.4		29.8	10.7	31.2
No. Of bankers per 100,000 inhabitants	74.9		371.4	191.5		566.2	220.0	592.7

Source: IFS, June 2002 and Annual Reports of Banking Supervision.

\*Indicators for Albania refer to year 2002.

**Box 14: COMPARATIVE ANALYSIS OF INTERMEDIATION INDICATORS OF ALBANIAN TO THE REST OF THE COUNTRIES IN THE REGION.**

*In the comparative analysis of indicators measuring the standard of financial intermediation in Albania with countries in the region, we evidence these main features:*

- *Albania ranks amongst the countries having a good standard of deposit ratio to GDP (36.4 percent for 2001).*
- *The ratio of credit to economy to GDP indicates the lowest rate of countries in the region,*
- *Intermediation efficiency is sometimes lower than the rest of the countries,*
- *The ratio of credit to the private sector to domestic credit is at the lowest rate of all the countries taken under analysis,*
- *The size of the banking system is relatively small.*

*The above characteristics underline that banks in Albania are active in collecting deposits. They invest the majority of received deposits in treasury bills. This reinforces the idea that the standard of bank intermediation in Albania is the lowest of all the countries comparable to it. Banking system size indicators emphasize that there is a small number of banks operating in Albania but the some times lower indicator of bank intermediaries and agencies and hired employees by the banking sector indicate a limited stretch of the banking system. This has a significant impact on the bank competition and standard of bank intermediation.*

Banks, at the impossibility to invest their own funds on credits, continue to invest them mainly in treasury bills and that appears still in the low level that the credit to the private sector occupies against the total domestic credit provided by banks.

**Table 52: Albania intermediation indicators over years**

Indicators <sup>31</sup>	1994	1995	1996	1997	1998	1999	2000	2001	2002
Time deposits/ GDP (1)	17.0	21.4	15.3	25.9	29.4	32.7	33.2	36.4	40.1
Domestic credit /GDP (2)	13.4	17.7	26.0	27.5	28.2	30.4	30.6	32.5	35.1
Credits to the private sectors / GDP (3)	3.8	3.7	3.9	3.8	3.2	3.6	4.5	5.9	7.2
Credits to the private sectors / time deposits	22.5	17.2	25.3	14.6	11.0	11.0	13.6	16.1	17.5
Credit to the private sector / domestic credit	28.6	21.0	14.9	13.8	10.4	10.9	13.4	17.0	20.0
Intermediation margin <sup>32</sup>					9.0	7.9	6.4	4.1	4.17
Interest spread between time deposits and credits			10.1	-3.2	10.2	11.4	16.7	7.9	7.9

Year 2002 did not conduct any apparent change in banks intermediation costs, indicating that banks continue to hold the same margin between incomes on investments and the cost they must pay for collecting funds. When this spread is high it is considered as an obstacle for expansion and development of financial intermediation, since it discourages the possible saving persons for a low return on their deposits, and restricts the financing for potential borrowers, thus reducing the possibility for planned investments and economic growth.

<sup>31</sup> Note: "Time deposits include time deposits in domestic currency and foreign currency deposits. "Credit to the private sector" involve credits transferred to BART, as well.

<sup>32</sup> In 1998, reported data on bank supervision are made according to a new reporting system and cannot be compared to the previous data.

## IV. ON-SITE INSPECTIONS

Completing on-site inspections is made according to an approved program at the beginning of the year. It has the goal to perform full- scope inspections on all banks during the year. This program is also accompanied with partial and special trouble inspections incurred during the year.

Some of the main characteristics observed in the banking system during 2002 consist in:

1. The extension of lending activity is accompanied with an improvement of credit portfolio, although there are evidenced some of the deficiencies, where to be specified as the most important are the following:
  - The outset of lending activity without previously ensuring a prepared team to answer these this sectors requirements as well as the lack of the experience for monitoring credits.
  - Not – basing either on complete or accurate procedures and policies.
  - A market existence at an inappropriate range to respond to borrowing duties, which is not yet appropriately familiar with the principles of a market, oriented economy.
  - The unstable situation in some of the vital sectors of the economy as that of energy.
  - The non-functioning of legal aspects relative to lending process.
2. After the Savings Bank and the National Commercial Bank prevailing panic in March – April 2002, the public confidence returned to the banking system. These banks activity and liquidity condition specifically improved significantly, returning them by the normal run or flow.

The banking system generally indicated a good liquidity condition as a result of investments by liquid items such as: treasury bills of Albanian Government or other securities of other governments of A area countries.

3. The high management reaction has been generally positive to findings from performed inspections but has not indicated the proper care for:
  - Improving policies and procedures of bank activity,
  - Completing the regulatory framework,
  - Implementing bank's business plan.

In 2002 there were completed 13 full-scope inspections and 11 partial –scope inspections. From the performed inspections, there were evidenced various nature violations: such as:

- Transgressions of "Accounting" law and the incorrect application of "Bank Accounting Manual" on bookkeeping and financial result in domestic currency.
- Violations of law no.8365, dated 02.07.1998 "On banks in the Republic of Albania", article 6 on keeping the documentation and the correspondence in Albanian language.
- Violations of law no. 8365, dated 02.07.1998 "On banks in the Republic of Albania", article 20 on the dividing the position of the member of the Audit Committee from the position of the member of the Management committee.
- The incorrect application of law no. 8365, dated 02.07.1998 "On banks in the Republic of Albania", article 20, on increasing the role of audit committee and bank's internal control.

- Transgressions of the Bank of Albania approved regulations, such as;
- The classification of credit portfolio other than the Bank of Albania approved regulation "On the management of credit risk".
- The nomination and the start of duty by some banks administrators, without previously receiving the Bank of Albania preliminary consent.
- The respective documentation that must accompany banks' performed transfers did not respond to the provided specifications in the regulations no. 12, dated 21.02. 2001 "On the foreign exchange activity".

Depending on the evidenced violations, there have been set the corrective measures or penalties, based on the provided dispositions from Law no. 8365, dated 02.07.1998 "On Banking system in the Republic of Albania", Article and the Bank of Albania by-laws and regulations.

Applicable measures in 2002 consist in the following:

- Recommendations or suggestions to correct small inconsistencies,
- The request to submit to the Bank of Albania a program of measures on adjusting the bank's statement, in case of inconsistencies, by fixing the respective dates as well.
- Applying penalties or corrective measures against administrators, relating to the evidenced violations of the legal and regulatory framework in power.

Banks, in support of requirements recommendations provided by examination reports, (compared to the previous year), have paid attention to complete their internal acts, rules or regulations, especially in lending activity area, management of different risks etc. Banks are getting familiar with necessity to observe the law and by-laws, rules and regulations, as well as the Bank of Albania recommendations. These provide the premises for the correct development of the Bank of Albania relationships to commercial banks.

#### **Box 15: BANKING SUPERVISION MEDIUM-TERM DEVELOPMENT PLAN**

*Bank of Albania, in cooperation with the World Bank, has prepared a program for strengthening the supervisory skills with effect to 2004. The Implementation of this plan aims at increasing the banking system security in Albania, by applying efficiently the standards on a safe and sound banking activity.*

*To attain this core target, there were identified the needs related not only to improving the basic leading and regulative documentation, where the supervision is based on, but also to further development and improvement of the commercial banks' regulative framework and human resources within Supervision Department.*

*To serve this goal there were assigned some duties, a part of which are completed or are in process of application and are mainly related to:*

- *Reworking the declaration of the supervision mission in order to improve the transparency and responsibility in the public, the awareness of the public and the banking system, with the role of banking supervision.*
- *The extension of performed audits to banks from independent accounting experts and the perfection of their approving process from the Bank of Albania through the discipline of some contemporary criteria in the regulative framework.*
- *The assessment of the quality of work performed, regarding the entire process of bank examination and the improvements on the basis of conclusions.*
- *The accurate specification of decision making escalation through developing a matrix, starting from department directors, First-Deputy Governor, the Governor and the Supervisory Council.*
- *Developing a policy to assign the Bank of Albania available operations, in the cases when, it assesses their undertaking as necessary for the solution of issues related to the safe and sound activity or issues in consistency with the standards of this activity.*
- *The improving cooperation with banking industry within the country and supervisory authorities abroad, through opening or preserving communication channels.*
- *Developing an electronic data- base for all banks, in order to keep record or avoid an operating risk inside the department, receiving available information in time and keeping the track of supervision for every bank.*
- *Developing human resources inside the department, through drafting a policy and establishing some procedures to identify training applications from inspectors and attain their maximum satisfaction.*

## CHAPTER V: THE BANK OF ALBANIA BUDGET AND FINANCIAL STATEMENTS

### I. INDEPENDENT AUDITORS' REPORT

#### *TO THE SUPERVISORY BOARD OF THE BANK OF ALBANIA:*

**W**e have audited the accompanying balance sheets of the Bank of Albania (the "Bank") as at December 31, 2002 and 2001, and the related statements of profit and loss, changes in capital and reserves and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with International Standards on Auditing. Those standards require that we plan and perform the audits 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 audits provide a reasonable basis for our opinion.

In our opinion the financial statements present fairly, in all material respects, the financial position of the Bank as at December 31, 2002 and 2001 and the results of its operations, changes in capital and reserves and cash flows for the years then ended in accordance with International Financial Reporting Standards modified for generally accepted accounting policies applicable to national central banks.

Deloitte & Touche, Sh.p.k  
Tirana, Albania  
March 28, 2003

## II. BALANCE SHEET

		2002	2001
	Notes	Lek (mln)	Lek (mln)
<b>ASSETS</b>			
<b>Foreign assets</b>			
Gold	3	1,182	977
Deposits with the International Monetary Fund	4	19,824	20,830
Deposits with foreign banks	5	5,446	36,794
Foreign securities	6	95,814	52,569
Other foreign assets	7	63	645
<b>Total foreign assets</b>		<b>122,329</b>	<b>111,815</b>
<b>Domestic assets</b>			
Other gold and precious metals	3	40	32
Transit credits	8	7,323	6,254
Loans to domestic banks	9	3,402	473
Loan to the Government	10	1,148	2,710
Domestic securities	11	75,885	70,437
Other domestic assets	12	2,905	3,906
<b>Total domestic assets</b>		<b>90,703</b>	<b>83,812</b>
<b>Total Assets</b>		<b>213,032</b>	<b>195,627</b>
<b>LIABILITIES</b>			
<b>Foreign liabilities</b>			
Due to the International Monetary Fund	13	19,147	20,494
Due to non-resident financial institutions	14	8,770	7,537
Other foreign liabilities		5	8
<b>Total foreign liabilities</b>		<b>27,922</b>	<b>28,039</b>
<b>Domestic liabilities</b>			
Currency in circulation	15	133,115	121,334
Due to domestic banks	16	30,649	31,220
Due to the Government	17	3,024	2,734
Deferred income	18	151	-
Other domestic liabilities	19	376	155
<b>Total domestic liabilities</b>		<b>167,315</b>	<b>155,443</b>
<b>CAPITAL AND RESERVES</b>			
Capital		750	750
Legal reserve		3,750	3,750
Revaluation reserve	20	5,468	57
Other reserves	21	7,827	7,588
<b>Total capital and reserves</b>		<b>17,795</b>	<b>12,145</b>
<b>Total liabilities and capital and reserves</b>		<b>213,032</b>	<b>195,627</b>

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

		2002	2001
	Notes	Lek (mln)	Lek (mln)
<b>Operations with non-residents</b>			
Interest and commission income		4,076	4,206
Interest and commission expense		(814)	(219)
Gains arising from foreign securities		758	-
Losses arising from foreign securities		(435)	-
<b>Operations with non-residents, net</b>		<b>3,585</b>	<b>3,987</b>
<b>Operations with residents</b>			
Interest and commission income	22	7,819	6,628
Interest and commission expense		(1,015)	(1,367)
Gains arising from domestic securities		205	-
Losses arising from domestic securities		(215)	-
<b>Operations with residents, net</b>		<b>6,794</b>	<b>5,261</b>
<b>Other operating income, net</b>	<b>23</b>	<b>146</b>	<b>254</b>
<b>Net operating income</b>		<b>10,525</b>	<b>9,502</b>
<b>Other non-operating expenses</b>			
Staff costs	24	(304)	(249)
Depreciation		(120)	(105)
Amortisation		(202)	(154)
General and administrative expenses		(169)	(161)
<b>Total other non-operating expenses</b>		<b>(795)</b>	<b>(669)</b>
<b>Net profit for the year</b>		<b>9,730</b>	<b>8,833</b>

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

in (mln) Lek	Capital	Legal reserve	Revaluation reserve	Other reserves	Retained earnings	Total
As at December 31, 2000	750	3,750	5,281	7,426	4,312	21,519
Net profit for the year	-	-	-	-	8,833	8,833
Foreign currency and gold revaluation	-	-	(5,088)	-	-	(5,088)
Domestic treasury bills revaluation	-	-	(104)	-	-	(104)
US treasury bills revaluation	-	-	(9)	-	-	(9)
Release of tangible fixed asset revaluation surplus	-	-	(23)	-	23	-
Increase of pension fund investment	-	-	-	6	-	6
Profit distribution	-	-	-	156	(13,168)	(13,012)
<b>As at December 31, 2001</b>	<b>750</b>	<b>3,750</b>	<b>57</b>	<b>7,588</b>	<b>-</b>	<b>12,145</b>
Net profit for the year	-	-	-	-	9,730	9,730
Foreign currency and gold revaluation	-	-	5,526	-	-	5,526
Domestic treasury bills revaluation	-	-	(119)	-	-	(119)
Release of tangible fixed asset revaluation surplus	-	-	(28)	-	28	-
Increase of pension fund	-	-	-	22	-	22
Historic notes and coins revaluation	-	-	32	-	-	32
Profit distribution	-	-	-	217	(9,758)	(9,541)
<b>As at December 31, 2002</b>	<b>750</b>	<b>3,750</b>	<b>5,468</b>	<b>7,827</b>	<b>-</b>	<b>17,795</b>

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

	Notes	2002 Lek (mln)	2001 Lek (mln)
<b>Cash flows from operating activities</b>			
<b>Net profit for the year</b>		<b>9,730</b>	<b>8,833</b>
<b>Non-cash items in the statement of profit and loss</b>			
Depreciation and amortisation		322	259
<b>Changes in operating assets</b>			
Increase in foreign securities		(43,245)	(32,867)
Decrease in deposits with the IMF		18,805	(11,150)
Decrease/(increase) in deposits with foreign banks maturing after three months		1,006	978
Decrease/(increase) in other foreign assets		350	(209)
(Increase)/decrease in domestic securities		(5,448)	1,577
(Increase)/decrease in transit credits		(1,069)	295
Increase in loans to domestic banks		(2,929)	(473)
Decrease in loans to the Government		1,562	6,719
Decrease/(increase) in other domestic assets		821	(1,618)
<b>Changes in operating liabilities</b>			
Decrease in due to the IMF		(1,347)	(2,389)
Increase/(decrease) in due to non-resident financial institutions		1,233	(357)
Decrease in other foreign liabilities		(3)	(23)
Decrease in due to domestic banks		(571)	(1,351)
Increase/(decrease) in due to the Government		290	(1,201)
Increase in other domestic liabilities		221	45
		(20,272)	(32,932)
<b>Foreign exchange revaluation effect on operating assets and liabilities</b>		<b>5,408</b>	<b>(5,088)</b>
<b>Net cash used in operating activities</b>		<b>(14,864)</b>	<b>(38,020)</b>
<b>Cash flows from investing activities</b>			
Net purchases of tangible fixed assets		(142)	(139)
<b>Cash flows from financing activities</b>			
Profit distribution to the Government		(9,758)	(13,168)
Increase in other reserves		421	162
Increase in currency in circulation emissions		14,500	22,000
<b>Net cash from financing activities</b>		<b>5,163</b>	<b>8,994</b>
<b>Decrease in cash during the year</b>		<b>(9,843)</b>	<b>(29,165)</b>
<b>Cash and cash equivalents at the beginning of the year</b>	25	<b>25,918</b>	<b>55,083</b>
<b>Cash and cash equivalents at the end of the year</b>	25	<b>16,075</b>	<b>25,918</b>

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

## **1. 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 issuance of licenses to all banks; and
- 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".

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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The financial statements have been prepared in accordance with the Albanian Law "On Accounting" and all standards and interpretations approved by the International Accounting Standards Board (IASB) which are referred to as International Financial Reporting Standards (IFRS) with the exceptions related to IAS 16. These standards and interpretations were previously called International Accounting Standards (IAS). The revaluation methodology adopted for the revaluation of the head office building as detailed in Note 12 was not in accordance with the revaluation requirements set out in IAS 16 on property, plant and equipment to the extent that the revaluation was not conducted by independent, professionally qualified appraisers, the future cash flows were not discounted and the entire category of buildings were not revalued. The significant accounting policies used by the Bank in these financial statements are set out below:

### **(a) 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, gold and the head office building.

The accompanying financial statements are presented in the national currency of the Republic of Albania, the Albanian Leke ("LEK").

The Bank controls the operations of the Printing House, a business entity engaged in the printing of Government high security material and the minting of five and ten LEK coins. The financial operations of the Printing House have not been consolidated with those of the Bank as the ability of the Printing House to distribute its earnings to the Bank has yet to be determined. The financial position of the Printing House as at December 31, 2002 is set out in Note 26 to these financial statements.

#### (b) Interest and commissions

In these financial statements, interest income and expense is recognised on the accrual basis. Commission income is credited to income when received. Commission expense is debited to expense when paid.

#### (c) 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 monetary assets and liabilities are retranslated into LEK at the Bank's official exchange rate valid on the balance sheet date. Unrealised 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:

	2001	2002
United States dollar (USD)	133.74	136.55
European Union currency unit (EUR)	140.18	120.73
British pound (GBP)	215.31	197.87
Special drawing rights (SDR)	181.16	171.46

#### (d) Investments

##### Non-trading investments

These are classified as follows:

- Held-to-maturity; and
- Available for sale

All investments are initially recognised at cost, being the fair value of the consideration given including acquisition costs associated with the investment.

Premiums and discounts on investments designated as held-to-maturity or available for sale are amortised on a systematic basis to maturity using the effective interest method and taken to interest income.

##### Held-to-maturity

Investments which have fixed or determinable payments and which are intended to be held-to-maturity are subsequently measured at amortised cost, less provision for impairment in value. Amortised cost is calculated by taking into account any discount or premium on acquisition.

### Available for sale

After initial recognition, investments which are classified as “available for sale” are remeasured at fair value. Such fair value adjustments are reported as a separate component of equity until the investment is sold, collected or otherwise disposed of.

### Fair values

For investments traded in organised financial markets, fair value is determined by reference to stock exchange quoted market bid prices at the close of business on the balance sheet date.

For investments where there is no quoted market price, a reasonable estimate of the fair value is determined by reference to the current market value of another instrument which is substantially the same, or is based on the expected cash flows, or the underlying net asset base of the investment.

### Impairment and uncollectability of financial assets

An assessment is made at each balance sheet date to determine whether there is objective evidence that a financial asset or group of financial assets may be impaired. If such evidence exists, the estimated recoverable amount of that asset is determined and any impairment loss, based on the net present value of future anticipated cash flows, is recognized for the difference between the recoverable amount and the carrying amount as follows:

- For financial assets at amortised cost – the carrying amount of the asset is reduced to its estimated recoverable amount either directly or through the use of an allowance account and the amount of the loss is included in the statement of profit and loss; and
- For financial assets at fair value – where a loss has been recognised directly in equity as a result of the write-down of the asset to recoverable amount, the cumulative net loss recognized in equity is transferred to the statement of profit and loss.

### (e) Fixed assets

The fixed assets are stated at historical cost less accumulated depreciation except the head office building, which was revalued as at March 29, 2000 (see Note 12 to these financial statements).

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 recognised 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:

	2002	2001
Building - Head office	40	50
Buildings - At branches	25	33
Vehicles	5-10	5
Furniture, fixtures and equipment	2-20	10
Computer hardware	2	3

The effect on the profit and loss account of the above changes in accounting estimates was not significant.

#### (f) Printing and minting costs

The costs of printing banknotes and minting coins are capitalised as intangible fixed assets and amortised over two years and ten years, respectively.

#### (g) 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 100% of its statutory profit directly to the State budget after allocations to replenish the levels of reserve funds as directed by the Supervisory Council.

#### (h) Legal reserve

In accordance with the "Law on the Bank of Albania", the Bank has established a legal reserve into which 25% of the net profit for the year is transferred until the reserve amounts to 500% of the capital.

#### (i) 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 periods. Actual results could differ from those estimates.

#### (j) Managed assets

At as December 31, 2002, the Bank held as custodian short-term treasury bills issued by the Ministry of Finance and gold and other precious metals on behalf of the Government. As at December 31, 2002, the value of gold held on behalf of the Government placed in gold deposits abroad was LEK 2,523 million (2001 – LEK 2,078 million), being 55,036.5 troy ounces of gold (2001 – 55,036.5 troy ounces of gold) out of which 26,877.6 ounces of gold has been placed in time deposits. At the same date, the value of gold and other precious metals was LEK 1,467 million (2001 – LEK 1,221 million) including platinum, silver and other precious metals in a

domestic vault of LEK 80 million and LEK 1,387 million of non-international standard gold. 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.

#### (k) Grants

Grants are initially recorded in the balance sheet at the amount received. Grants related to expenditure items are released to income during the period of the related expenditure. Grants related to the purchase of property, equipment and software are released to income over the life of the relevant assets at an amount corresponding to the associated depreciation/amortisation charge on that asset.

### **3. GOLD AND PRECIOUS METALS**

As at December 31, 2002, the value of gold owned by the Bank placed in gold time deposits abroad was LEK 1,182 million (2001 – LEK 977 million), being 25,782 troy ounces of gold (2001 – 25,885.42 troy ounces).

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 at December 31, 2002, the price for one troy ounce of gold was USD 342.75 (2001 - USD 276.5).

Other gold and precious metals included within domestic assets includes platinum and silver in a domestic vault, valued at the London fixing rate on the balance sheet date, amounting to LEK 36 million as at December 31, 2002 (2001 – LEK 29 million) and LEK 4 million of non-international standard gold (2001 – LEK 3 million).

### **4. DEPOSITS WITH THE INTERNATIONAL MONETARY FUND**

	<b>2002</b>	<b>2001</b>
	Lek (mln)	Lek (mln)
International Monetary Fund	8,951	9,708
Special Drawing Rights ("SDR")	10,873	11,122
<b>Total</b>	<b>19,824</b>	<b>20,830</b>

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 of Albania. SDR within the reserve tranche approximate the Republic of Albania's membership quota paid to the IMF in SDR and LEK. This represents the counterpart of loans, which were granted to the Republic of Albania as disclosed in Note 13. The SDR holdings bear interest, which is determined on weekly basis. The interest rate prevailing as at December 31, 2002 was 1.91% (2001 – 2.23%).

## 5. DEPOSITS WITH FOREIGN BANKS

	2002	2001
	Lek (mln)	Lek (mln)
Current accounts	2,537	9,752
Short-term deposits	2,909	27,042
<b>Total</b>	<b>5.446</b>	<b>36.794</b>

Short-term deposits mature in January 2003 and earn interest in the range of 1.2% to 3.76% (2001 – 1.69% to 5.29%). Deposits with foreign banks are denominated mainly in EUR, USD and DEM which equate to the following foreign currency balances:

	2002	2001
	(in million)	(in million)
EUR	17	153
USD	19	113
GBP	2	15

## 6. FOREIGN SECURITIES

	2002	2001
	Lek (mln)	Lek (mln)
<b>Available for sale</b>		
Bank for International Settlements: medium-term investments	23,905	9,708
United States Government discounted notes	22,021	638
United States Government treasury bills	17,849	19,335
United States agencies treasury notes	12,436	2,811
United States agencies discounted notes	8,773	6,531
French Government treasury bills	5,530	-
French Government treasury bonds	2,669	6,103
Fixed rate investments (FIX BIS)	2,001	6,807
	95,184	51,933
<b>Other</b>		
Other investments	630	636
<b>Total</b>	<b>95,814</b>	<b>52,569</b>

United States Government discounted notes are denominated in USD and have coupon rates varying between 2% and 5.75%. Interest is paid semi-annually and maturities varying between February 2003 and May 2006. The yields vary between 0.97% and 4.75% (2001 – 2.13% and 4.75%).

The French Government treasury bonds are denominated in EUR with coupon rates varying between 3.5% and 8.5%. Interest is paid annually and maturities range between April 2003 and January 2007. The yields vary between 2.60% and 4.53% (2001 – 3.63%).

Bank of International Settlements – medium term investments comprise of fixed coupon securities denominated in USD and EUR with coupon rates varying between 4.6% and 5.5%. Interest is payable annually or semi-annually and maturities range between March 2003 to June 2006. The yields vary between 2.34% and 4.72% (2001 – 2.77% and 4.86%).

United States agencies discounted notes are denominated in USD with coupon rates varying between 3.25% and 7%. Interest is paid semi-annually and maturities range between February 2003 and April 2004. The yields vary between 1.59% and 4.71% (2001 – 3.27% and 4.71%).

The French Government treasury bills are denominated in EUR and mature on various dates between January 2003 and August 2003 with yields varying between 3.04% and 3.82% (2001 – 3.03% and 3.22%).

The Fixed rate investments (FIX BIS) issued by the Bank of International Settlements are denominated in USD, EUR and GBP with yields varying between 1.21% and 4.53% and maturities ranging between February 2003 and December 2003.

United States agencies treasury notes denominated in USD mature on various dates between January 2003 and June 2003 and yields vary between 1.77% and 2.51% (2001 – 1.84% and 3.74%).

The United States Government treasury bills denominated in USD mature on various dates between February 2003 and April 2003 with yields varying between 1.5% and 1.68% (2001 – 1.78% and 3.59%).

Other investments include participation in the European Bank for Reconstruction and Development, the World Bank and its associated organisations and the Arab Development Bank.

## **7. OTHER FOREIGN ASSETS**

As at December 31, 2002, other foreign assets are comprised of cash on hand in foreign currency of LEK 22 million (2001 - LEK 254 million) and accrued interest on deposits with foreign banks of LEK 41 million (2001 - LEK 391 million).

## **8. TRANSIT CREDITS**

Transit credits, by industrial sector, are comprised of:

	2002	2001
	Lek (mln)	Lek (mln)
Agriculture - KFW	1,475	1,278
Industry	4,966	4,091
Services and other	882	885
<b>Total</b>	<b>7,323</b>	<b>6,254</b>

Transit credits represent interest-free credit facilities, which were provided to credit institutions for further distribution to ultimate borrowers to support state development programmes (See Note 14). All loans are guaranteed by the Government of Albania.

## **9. LOANS TO DOMESTIC BANKS**

Loans to domestic banks as at December 31, 2002 total LEK 3,402 million (2001 – LEK 473 million). This comprises LEK 3,223 million of repo loans maturing on January 3, 2003 at an interest rate of 8.5% (2001 – none) and LEK 179 million of daily loans maturing on January 3, 2003 at an interest of 11% (2001 – Lombard loans of LEK 273 million at 13% and daily loans of LEK 200 million at 9.5%). These loans were secured by Government of Albania treasury bills held by the borrowers.

## **10. LOAN TO THE GOVERNMENT**

The balance as at December 31, 2002 of LEK 1,148 million (2001 – LEK 2,710 million) relates to a short-term loan given to the Government maturing on January 9, 2003 bearing interest of 12% (2001 – 9.7%).

## **11. DOMESTIC SECURITIES**

	2002	2001
	Lek (mln)	Lek (mln)
Available for sale		
Short-term treasury bills	74,436	69,070
Held-to-maturity		
Zero coupon bonds of the National Commercial Bank ("NCB")	1,449	1,367
<b>Total</b>	<b>75,885</b>	<b>70,437</b>

Short-term treasury bills as at December 31, 2002 relate to Government of Albania zero-coupon treasury bills, with maturities ranging between January 2003 and October 2003, with yields ranging between 10.30% and 12.51% (2001 – 7.26% and 19.94%).

Security for the capitalisation of the NCB relates to a zero-coupon bond which was issued by the Government of Albania to replace the Bank's participation in the capital of the NCB. The security bears interest of 6% per annum and matures in January 2006.

## **12. OTHER DOMESTIC ASSETS**

	2002	2001
	Lek (mln)	Lek (mln)
Accrued interest	5	3
Other debtors	112	1,597
Loans to employees	435	438
Tangible fixed assets, net (see below)	1,455	1,433
Inventory	18	16
Intangible assets, net (see below)	834	419
Other	46	-
<b>Total</b>	<b>2,905</b>	<b>3,906</b>

## 12. OTHER DOMESTIC ASSETS (CONTINUED)

The net book values of tangible fixed assets by category are comprised of:

	Land, buildings and general constructions	Technical & Office equipment	Transport vehicles	Total property, plant and equipment
<b>Cost/Valuation</b>				
Balance at January 1, 2002	1,320	347	146	1,813
Additions	40	93	9	142
Disposals	-	(3)	(1)	(4)
Reclassifications	(23)	17	6	-
Balance at December 31, 2002	1,337	454	160	1,951
<b>Accumulated Depreciation</b>				
Balance at January 1, 2002	90	204	86	380
Charge for the year	34	71	15	120
Disposals	-	(3)	(1)	(4)
Reclassifications	(11)	8	3	-
Balance at December 31, 2002	113	280	103	496
<b>Net book value</b>				
<b>Balance at December 31, 2002</b>	<b>1,224</b>	<b>174</b>	<b>57</b>	<b>1,455</b>
Balance at December 31, 2001	1,230	143	60	1,433

According to Albanian law, the legal title to 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 favour of the Bank.

The head office building of the Bank, included within the category "Land, buildings and general constructions", was revalued during the year 2000 to LEK 1,143 million from a fully depreciated historic cost amount of LEK 7 million. The revaluation took place on March 29, 2000, effective January 1, 2000, and was conducted by an internal valuation committee. The basis of the valuation was non-discounted future cash flows based on the potential market rental value of the property over an estimated useful life of 50 years. No other buildings owned by the Bank were revalued. The revaluation surplus of LEK 1,143 million was credited to the revaluation reserve.

## 12. OTHER DOMESTIC ASSETS (CONTINUED)

Net intangible assets are comprised of:

	2002 Lek (mln)	2001 Lek (mln)
Computer software	145	16
Banknotes printed and coins minted	2,383	1,895
Accumulated amortisation	(1,694)	(1,492)
<b>Total</b>	<b>834</b>	<b>419</b>

### 13. DUE TO THE INTERNATIONAL MONETARY FUND

	2002	2001
	Lek (mln)	Lek (mln)
Enhanced Structural Adjustment Facility ("ESAF") in SDR	10,803	11,360
IMF securities account in LEK	6,497	7,309
IMF account in LEK	1,847	1,825
<b>Total</b>	<b>19,147</b>	<b>20,494</b>

ESAF borrowings related to the Republic of Albania's IMF quota and were drawn down on behalf of the Government for macroeconomic reforms. There are 4 component facilities:

- The initial ESAF facility was drawn down in 1993 and is repayable over 10 years which commenced in 1999. The outstanding balance as at December 31, 2002 was SDR 10,589,000 (2001 – SDR 16,801,000) and the facility bears interest at 0.5%, payable semi-annually.
- An additional loan under this facility (known as Poverty Reduction and Growth Facility) was drawn down during the period 1999 to 2001. The outstanding balance as at December 31, 2002 was SDR 45,040,000 (2001 – SDR 45,040,000). This facility is repayable by 2009 in 10 semi-annual installments commencing in 2004. Interest is payable, after the grace period, at 0.5% semi-annually.
- The Emergency Post Conflict Assistance for Albania loan: This is a SDR 8,825,000 loan granted in 1997 repayable in 8 quarterly installments over 2 years after a 3 year grace period. The last installment for this loan has been repaid in November 2002.
- The Poverty Reduction and Growth Facility 3 for Albania loan: This is a SDR 28,000,000 loan facility approved by the IMF Supervisory Board on June 21, 2002. The first installment of SDR 4,000,000 was disbursed on June 28, 2002 with an interest rate of 0.5% payable semi-annually. This facility is repayable after a grace period of five and a half years in 10 semi-annual installments.

### 14. DUE TO NON-RESIDENT FINANCIAL INSTITUTIONS

	2002	2001
	Lek (mln)	Lek (mln)
Transit credits (Note 8)	7,326	6,256
Loan from the Bank of Greece	1,234	1,063
Due to the World Bank	210	218
<b>Total</b>	<b>8,770</b>	<b>7,537</b>

Transit credits were provided by Kreditanstalt für Wiederaufbau in DEM (converted into EUR equivalent during the year 2002) totaling LEK 6,797 million (2001 – LEK 5,680 million) and the European Investment Bank in USD and EUR totaling LEK 529 million (2001 - LEK 576 million). Interest is paid by the recipients of these transit credits (domestic banks and companies) 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 1.17% per annum, payable semi-annually. The loan matures in 2018.

## 15. 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.

The following bank notes and coins were in circulation:

Nominal value LEK	December 31, 2002		December 31, 2001	
	Number in thousand	Total LEK (mln)	Number in thousand	Total LEK (mln)
100	19,724	1,972	26,083	2,608
200	19,407	3,881	25,305	5,061
500	67,382	33,691	72,836	36,418
1,000	62,067	62,067	55,597	55,597
5,000	6,080	30,400	4,107	20,535
Monedha		1,104		1,115
<b>Total</b>		<b>133,115</b>		<b>121,334</b>

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## 16. DUE TO DOMESTIC BANKS

Interest on compulsory reserves is calculated as follows:

	2002	2001
	Lek (mln)	Lek (mln)
<b>Foreign currency</b>		
Correspondent accounts of commercial banks	69	60
Compulsory reserves of commercial banks	9,139	7,895
License application deposit	669	-
	9,877	7,955
<b>Domestic currency (LEK)</b>		
Demand deposits	20,764	22,037
Overnight deposits	8	780
Other	-	448
	20,772	23,265
<b>Total</b>	<b>30,649</b>	<b>31,220</b>

- LEK balances: 50% of the yield on 3-month domestic treasury bills: 5.6 % as at December 31, 2002 (4% at December 31, 2001);
- USD balances: 50% of the one-month USD LIBOR rate: 0.69% as at December 31, 2002 (0.94% at December 31, 2001);
- EUR balances: 50% of the one-month EUR LIBOR rate: 1.45% as at December 31, 2002 (1.65% at December 31, 2001);

The license application deposit relates to a license application deposit of USD 5 million deposited by Credins Bank sh.a. in anticipation of receiving a banking license.

The Bank does not pay interest on correspondent accounts, demand deposits and the license application deposit.

Overnight deposits from domestic banks mature on January 6, 2003 and attract interest of 6% (4.5% at December 31, 2001).

### **17. DUE TO THE GOVERNMENT**

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
Profit distributable to the Government	1,350	2,100
Deposits received on behalf of the Government	1,543	531
Other	131	103
<b>Total</b>	<b>3,024</b>	<b>2,734</b>

The profit distributable to the Government relates to the remaining part of the profit not yet distributed to the Government at the year-end based on the decision of the Supervisory Board no. 13 dated February 26, 2003.

Deposits received on behalf of the Government relate mainly to international donor funds deposited at the Bank for subsequent transfer to aid projects in Albania.

Other includes funds received by the Bank totaling LEK 31 million from a loan granted to the Government by the Islamic Arabian Bank of Development, LEK 75 million for interest income received from projects payable to the Government of Albania and LEK 25 million relating to a loan for courier system.

### **18. DEFERRED INCOME**

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
World Bank grant	157	-
World Bank grant amortisation	(6)	-
<b>Total</b>	<b>151</b>	<b>-</b>

The total of deferred income relates to a grant received by the Bank during the year 2002 for the purchase of computer software and equipment for the implementation of the ATM project (Accounting and Treasury Management) financed by the World Bank.

## **19. OTHER DOMESTIC LIABILITIES**

Of the other domestic liabilities total of LEK 376 million (2001 – LEK 155 million), LEK 104 million (2001 – LEK 112 million) relates to amounts due to the Printing House controlled by the Bank (see note 26).

## **20. REVALUATION RESERVE**

The components of the revaluation reserve are as follows:

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
Revaluation of foreign currency and gold balances	4,367	(1,159)
Revaluation of treasury bills	-	119
Revaluation of historic notes and coins	32	-
Revaluation of Head Office building (Note 12)	1,069	1,097
<b>Total</b>	<b>5,468</b>	<b>57</b>

The revaluation reserve component for foreign currency and gold balances increased to such an extent as to produce a credit balance of LEK 4,367 million as at December 31, 2002.

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## **21. OTHER RESERVES**

The components of the other reserves are as follows:

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
Special reserve for Balance of Payments	7,209	7,209
Investment fund	300	300
Personnel Pension Fund	127	79
Other	191	-
<b>Total</b>	<b>7,827</b>	<b>7,588</b>

The special reserve relates to funds provided by the European Community for the Balance of Payments and no movement have been incurred in this reserve since 1995.

The Investment and Personnel Fund have been created from the Bank's profit distribution since as directed by the Bank's Supervisory Board.

Other relates to a further reserve of LEK 191 million created from the transfer of profits from the year 2002 based on decision of the Supervisory Board no. 13 dated February 26, 2003.

## **22. INTEREST AND COMMISSION INCOME (RESIDENTS)**

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
Interest income from Government loans	186	35
Interest income from securities	7,263	6,501
Other	370	92
<b>Total</b>	<b>7,819</b>	<b>6,628</b>

## **23. OTHER OPERATING INCOME, NET**

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
Net profit from the sale of investments	115	70
Currency out of circulation written back	-	169
Other	31	15
<b>Total</b>	<b>146</b>	<b>254</b>

## **24. STAFF COSTS**

Staff costs consist of employees' salaries, social insurance and other costs. Social costs represent mainly compulsory contributions to the Social Security Fund. As at December 31, 2002, the Bank had 245 employees (2001 – 334 employees).

## **25. CASH AND CASH EQUIVALENTS**

	<b>2002</b>	<b>2001</b>
	<b>Lek (mln)</b>	<b>Lek (mln)</b>
Deposits with foreign banks - Total	5,446	36,794
Less: Deposits with foreign banks maturing after 3 months	-	(18,805)
	5,446	17,989
Domestic currency on hand	9,385	6,666
Foreign currency on hand	22	254
Gold held abroad	1,182	977
Gold and other precious metals held domestically	40	32
<b>Total</b>	<b>16,075</b>	<b>25,918</b>

## **26. PRINTING HOUSE**

As detailed in Note 2(a), the Bank controls the operations of the Printing House. The financial position of the Printing House as at December 31, is as follows:

	2002 Lek (mln)	2001 Lek (mln)
<b>ASSETS</b>		
Tangible fixed assets	38	41
Inventory	48	50
Trade accounts receivable	49	4
Amount due from the Bank (see note 19)	104	112
Deferred expenses	-	5
<b>Total assets</b>	<b>239</b>	<b>212</b>
<b>EQUITY AND LIABILITIES</b>		
Capital	52	52
Legal reserve	19	19
Investment reserves	24	24
Other reserves	6	6
Retained earnings	134	110
<b>Total capital and reserves</b>	<b>235</b>	<b>211</b>
Other liabilities	4	1
<b>Total equity and liabilities</b>	<b>239</b>	<b>212</b>

## **27. 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 significant commitments or contingencies.

## **28. RISK MANAGEMENT**

### **Liquidity risk**

Policies to monitor and address liquidity risk are set by the Supervisory Board of the Bank. The Monetary Operations department of the Bank monitors the liquidity risk on a continual basis by analysing liquidity ratios, gaps and economic scenarios.

Liquidity management policies are set to ensure that, even under adverse conditions, the Bank is in a position to meet its obligations.

### **Credit risk**

The Monetary Operations department of the Bank, under the control of the Supervisory Board, is responsible for assessing the credit risk associated with the Bank's operations. The credit risk is mitigated by the Bank transacting largely with international and governmental institutions.

Loans to domestic banks are secured by Government of Albania treasury bills.

#### Price risk

The key elements of price risk affecting the Bank are:

- currency risk associated with fluctuations in the value of financial instruments due to changes in foreign exchange rates; and
- interest rate risk associated with fluctuations in the value of financial instruments due to changes in market interest rates.

The Bank's exposure to currency risk is monitored on a continual basis by the Monetary Operations department. Financial assets denominated in foreign currencies are disclosed in each relevant note to the financial statements.

Interest rate risk is monitored by the Monetary Operations department of the Bank. The Bank mitigates such risks by maintaining a significant excess of interest bearing assets over liabilities (as detailed in Note 29 below). The Bank maintains a portfolio of interest bearing financial assets and liabilities such that the generated net interest income is significantly in excess of operating requirements which minimizes the potential adverse effects of interest rate fluctuations. Interest rates applicable to financial assets and liabilities are disclosed in each relevant note to the financial statements.

## 29. INTEREST RATES SENSITIVITY.

IN LEK (MILLION)

	Up to one month	One to three months	Three to six months	Six to twelve months	One to five years	Over five years	Non-interest sensitive	Total
<b>Assets</b>								
Gold	1,182	-	-	-	-	-	-	1,182
Deposits with the IMF	-	-	-	-	10,873	-	8,951	19,824
Deposits with foreign banks	5,446	-	-	-	-	-	-	5,446
Foreign securities	3,438	11,555	13,017	32,286	34,888	-	630	95,814
Other foreign assets	26	-	-	37	-	-	-	63
Other gold & precious metals	-	-	-	-	-	-	40	40
Transit credits	-	-	-	-	-	-	7,323	7,323
Loans to domestic banks	3,402	-	-	-	-	-	-	3,402
Loans to the Government	1,148	-	-	-	-	-	-	1,148
Domestic securities	22,170	31,527	20,783	38	1,367	-	-	75,885
Other domestic assets	5	-	-	112	-	435	2,353	2,905
	<b>36,817</b>	<b>43,082</b>	<b>33,800</b>	<b>32,473</b>	<b>47,128</b>	<b>435</b>	<b>19,297</b>	<b>213,032</b>
<b>Liabilities and equity</b>								
Due to the IMF	-	-	-	-	10,803	-	8,344	19,147
Due to non-resident financial institutions	-	-	-	-	1,234	-	7,536	8,770
Other foreign liabilities	-	-	-	5	-	-	-	5
Currency in circulation	-	-	-	-	-	-	133,115	133,115
Due to domestic banks	30,649	-	-	-	-	-	-	30,649
Due to the Government	-	-	-	-	-	-	3,024	3,024
Deferred income	-	-	-	-	-	-	151	151
Other domestic liabilities	376	-	-	-	-	-	-	376
Capital and Reserves	-	-	-	-	-	-	17,795	17,795
	<b>31,025</b>	<b>-</b>	<b>-</b>	<b>5</b>	<b>12,037</b>	<b>-</b>	<b>169,965</b>	<b>213,032</b>
<b>Balance sheet gap as at Dec 31, 2002</b>	<b>5,792</b>	<b>43,082</b>	<b>33,800</b>	<b>32,468</b>	<b>35,090</b>	<b>435</b>	<b>(150,667)</b>	<b>-</b>
<b>Cumulative interest rate sensitivity gap - 2002</b>	<b>5,792</b>	<b>48,874</b>	<b>82,674</b>	<b>115,142</b>	<b>150,232</b>	<b>150,667</b>	<b>-</b>	<b>-</b>

### III. BUDGET INDICATORS

The Bank of Albania drafts and implements its budget plan to attain the completion of functions assigned to it.

The Bank of Albania financial activity relies on the management of international reserve, credit to government and its relations to commercial banks to serve its monetary policy. The Bank of Albania aims to find reflection in budget indicators approved by the Supervisory Council.

While panning the indicators for 2002, it has taken account that:

- a Investment of international reserves be mostly carried in foreign currency securities of high guaranty, aiming at their efficient administrations, unlike 2001 and even before, when an important part of them was invested in deposits held with foreign banks.
- b The attained stability in macroeconomic indicators and the banking system expressed by the monetary program for 2002, considering a normal development of deposits, liquidity condition, and interest rates in the banking system.
- c The intensification of the operating activity and its modernization through improving information technologies and the strengthening of security systems.

Meeting the main budget indicators for 2002 is presented as follows:

No.	Indicators	Plan	Fact	Change	
				In value	in %
<b>1</b>	<b>Income from interests</b>	<b>9,489.4</b>	<b>11,635.1</b>	<b>2,145.7</b>	<b>123</b>
	-Foreign currency income	3,194.9	3,783.9	588.9	118
	-Income from government operations	6,294.5	7,484.9	1,190.45	119
	-Income from loans to fincial institutions		366.3	366.3	
<b>2</b>	<b>Interest expenditures</b>	<b>1,377.6</b>	<b>1,154.7</b>	<b>(222.9)</b>	<b>84</b>
	-Foreign currency expenditures	277.0	245.2	(31.9)	88
	-Lek expenditures	1,100.6	909.5	(191.1)	83
<b>3</b>	<b>Net income from interests</b>	<b>8,111.7</b>	<b>10,480.4</b>	<b>2,368.7</b>	<b>129</b>
<b>4</b>	<b>Other income (net)</b>	<b>15.5</b>	<b>43.9</b>	<b>28.4</b>	
<b>5</b>	<b>Total income (net)</b>	<b>8,127.2</b>	<b>10,524.3</b>	<b>2,397.1</b>	<b>129</b>
<b>6</b>	<b>Operating cots</b>	<b>665.4</b>	<b>473.3</b>	<b>(192.1)</b>	<b>71</b>
	-Personnel	372.7	304.4	(68.3)	82
	-Management	225.4	148.2	(77.2)	66
	-Expenditures for asset management	67.3	20.7	(46.6)	31
<b>7</b>	<b>Amortization expenditures</b>	<b>522.0</b>	<b>321.6</b>	<b>(200.4)</b>	<b>62</b>
<b>8</b>	<b>Profit prior to discounts (5-6-7)</b>	<b>6,939.8</b>	<b>9,729.4</b>	<b>2,789.5</b>	<b>140</b>

V.1.2.1. Foreign currency incomes exceeded the plan, mainly due to the effect of the extension of international reserves from USD 740 to 776 million and a higher average rate than planned (3.23 percent from 2.59 planned).

V.1.2.2. Net earnings from government operations result on excess due to the extension of securities portfolio from the conversion of tradable debt to direct credit per the amount of Lek 5,8 billion and the increase of the treasury bills yield, as a result of the Bank of Albania policy on interest rates.

V.1.2.3. Income from credits extended to financial institutions lacked a projection in the plan 2002. This year specific events with impacts on the lack of liquidity in the market, imposed the Bank of Albania stance, which turned to lender position for the banking system, contrary to the plan.

V.1.2.4. Foreign currency expenditures resulted not according to the plan, mainly due to non-completion of revaluation differences on securities according to the Bank of Albania projections and the reduction of interest rates on accounts (liabilities) held with the IMF and the commercial banks required reserves held with the Bank of Albania compared to the plan.

V.1.2.5. Expenditures to liabilities in Lek have been less than the projection, reflecting the uncommon events of deposits retraction of March- April, as the attraction of excessive liquidity in the system at a monetary amount of Lek 4 billion, mainly through Repo agreements was unexpected.

V.1.2.6. Managing expenditures have been less than those planned almost by all elements due to the untimely completion of some expenditures and the concept of the plan as a maximal limit. However, non-fulfillments have not hampered the work in the institution.

## CHAPTER VI: OTHER ACTIVITIES OF THE BANK OF ALBANIA

### I. PAYMENT SYSTEM

The Bank of Albania has as legal duty the incitement and the support of the payments system. For this, it has been engaged either in the operating plan as the only clearing and settlement institution of all Lek transactions or with the respect of inciting reforms in the payments system.

#### I.1. PROJECTS FOR THE DEVELOPMENT OF THE PAYMENT SYSTEM

The Bank of Albania continued attempts for building a safe and efficient Payment system, in compliance with the 10 Core principles on important payment systems defined from BIS/CPSS. As a result, the payment system has recognized developments, either in the operating or regulatory aspect.

In 2002, the Bank of Albania channeled its work with respect of the modernization of payment system, operating framework by their important projects,

##### o ATM project

In 2002, the implementation of a new accounting system, ATM (*Accounting and Treasury Management*) was over, aiming at the automation of central bank operations. The installment of this internal system at the Bank of Albania brought important benefits to interbank payments system. First the system offers possibilities and fast and safe means for processing and executing the interbank payments, monitoring the liquidity of commercial bank accounts and the exchange of information from participants in the system. Second, ATM system comprises a necessary infrastructure for the future systems to be applied at the Bank of Albania, and specifically for RTGS system that will perform the settlement of payments by the commercial bank accounts held with the Bank of Albania.

##### o RTGS system

RTGS (*Real time Gross Settlement*) project aims at implementation of a new Real Time Gross Settlement System for interbank payments at a gross value. The most important achievements for 2002 are the finalization of the designing system (the definition of technical and functional specifications).

##### o ACH project

The Bank of Albania contains in its plans the application of a new *Automated Clearing House (ACH)*. This system intends the automation of the clearing service that the Bank of Albania offers to commercial banks for processing payments to clients. The implementation of this system shall bring significant benefits to the national payments system, with respect to improving accuracy, speed and reduction of their processing costs. In 2002, the Bank of Albania defined the phases, through which the implementation of this system will run through, the time, and the means to attain this. The first phase consists of the finalization of a complete analysis of the current situation to identify prospect troubles and trends. In 2002, it was reached the selection of Consultant Company that will assist the Bank of Albania in the completion of this phase of the project. The World Bank will financially support such consultancy. The second phase of the project consists in the implementation of the ACH system, which will be efficient after the termination of the RTGS system.

## I.2. CLEARING SERVICE

The Bank of Albania provides **clearing** of interbank payment instruments in Lek, since 1997. These are mainly small amount payments initiated by clients.

In 2002, the total value of cleared instruments was nearly Lek 72,7 billion, marking 17.6 percent rise compared to 2001. Such constantly growing trend of using non-cash instruments indicates an ever more greater approaching of customers to banks.

**Table 54: The value of payment instruments cleared by the Bank of Albania clearing service, in billions of Lek.**

	1998	1999	2000	2001	2002
Payment -orders					
Checks	22.5	25.6	28.0	32.9	40.9

The most applicable instrument by the clients is the payment order. In 2002, interbank orders increased by 24 percent compared to 2001.

## I.3. INTERBANK PAYMENTS

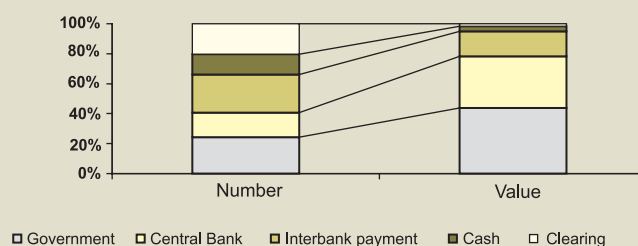
The Bank of Albania has constantly offered the settlement of interbank payments to commercial banks. These payments are a relatively large value and are mainly sourced from interbank transactions.

In 2002, interbank activity marked the highest increase, either in value or volume. The total value of transactions in commercial banks accounts in Lek held with the Bank of Albania reached at Lek 2339 billion, comprising 23 percent rise compared to 2001. Interbank payments comprise the largest number of these transactions, sharing 26 percent of the total number.

**Table 55: Cleared transactions by the interbank payments system in Lek, per 2002.**

	Number	Value (in billions of Lek)
Interbank payments	3,624	389.8
Clearing	2,906	42.3
Cash	1,949	78.2
Government	3,465	1,022.8
Central bank	2,346	804.0

**Cleared transactions by interbank market in Lek, for 2002**



## II. CURRENCY ISSUING

In 2002, currency issuing had an unexpected increase as a result of March-April events in 2002. To the end of the year, with measures undertaken, there was a gradual stabilization at the expected level.

Currency indicators as of December 31, 2002 is as below:

- Currency issuing: Lek 142,5000,000,000.00
- Currency in circulation: Lek 133, 115,483,581.00

Currency issuing for 2003 was added by Lek 14,5 billion, taking into account the meeting of economy demand for money by an optimal structure. The highest increase corresponds to March-April 2002, respectively by Lek 11,3 and 5 billion. In December, the increase by about Lek 4,4 billion, as result of the budget payments, is an ordinary phenomenon of this period.

**Table 56: Monthly changes of currency in circulation for 2002 in billions of Lek.**

No.	Months	Monthly change	Progressive from year outset
1	January	-2.5	-2.5
2	February	-0.8	-3.3
3	March	+11.3	+8.0
4	April	+5.0	+13.0
5	May	+0.6	+13.6
6	June	+0.6	+14.2
7	July	+0.1	+14.3
8	August	-0.9	+13.4
9	September	-1.5	+11.9
10	October	-3.3	+8.6
11	November	-1.2	+7.4
12	December	+4.4	+11.8

**Table 57: The structure of currency in circulation in percent.**

Denominations	1999	2000	2001	2002
5000	0.25	0.98	2.23	3.48
1000	21.00	23.30	30.23	35.54
500	33.37	33.23	39.60	38.58
200	14.44	13.02	13.76	11.11
100	9.29	9.43	14.18	11.29
10	4.00	3.68	0.0	0.0
5	3.32	3.06	0.0	0.0
3	3.38	3.13	0.0	0.0
1	10.95	10.16	0.0	0.0
<b>Total bank notes</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>
100	0.00	1.98	4.80	3.30
50	7.23	4.04	14.96	13.95
20	10.11	5.92	26.09	27.35
10	10.82	6.57	28.83	29.87
5	7.68	4.51	18.94	18.64
2	0.26	0.12	0.0	0.0
1	10.27	5.00	6.38	6.89
0.5	8.71	4.21	0.0	0.0
0.2	18.84	9.11	0.0	0.0
0.1	22.01	10.65	0.0	0.0
0.05	4.08	1.97	0.0	0.0
<b>Total coins</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>

In 2002, the structure of currency in circulation was held around the projected rate, with the exemption of 5000 denominations. The excess of this denomination in circulation, at about 4 percent over the forecast of February 2002, is as an outcome of covering the massive deposits retraction in March-April 2002, which denomination was subject to "treasury" from the broad mass of the people.

Concerning the counterfeited banknotes, it has been present in 2002, but at smaller dimensions. Compared to 2001, counterfeiting is significantly less, especially for Lek 500 and 1000 denominations.

Table 58: Data on counterfeited bank notes						
Lek denominations	In units			Progressive from 1992	2002/2001	In % (1992-2002) (1992-2001)
	2000	2001	2002			
1000	747	438	413	11647	94,3	103,6
500	1487	954	484	6188	50,7	108,5
200	834	259	287	1490	110,8	123,8
100	6	1	1	8	100,0	114,3
<b>Total</b>	<b>3074</b>	<b>1652</b>	<b>1185</b>	<b>19333</b>	<b>71.7</b>	<b>106.5</b>

Counterfeited banknotes are a reproduction of/or copies from color photocopies or offset appliances. These have been generally photocopied or printed at common paper and lack security features. The most exposed to forgery remain Lek 200, 500 and 1000 denominations, 1994 issues or reprints of year 1996, and this year, especially Lek 200 and 1000 denominations, a new issuing of 1996.

As to foreign bank notes, mainly ITL, GDR, DEM and USD, the quantity counterfeited is insignificant as compared to previous years and this is due to Euro introduction.

### III. CHANGES AND AMENDMENTS OF THE LAW ON THE BANK OF ALBANIA

The Bank of Albania, as the central bank of the Republic of Albania exercises its activity based on and pursuant to Law no. 8269, dated 23. 12. 1997 "On the Bank of Albania". Observing the Law on its entirety, it is observed that the Bank of Albania enjoys legal autonomy. An important step with the strengthening of this autonomy was the clear and unequivocal definition by the Republic of Albania Constitution (article 161), approved by Law no. 8417, dated 21.10.1998, of such elements that express directly the Bank of Albania exclusivity in:

- Issuing and circulation of Albanian currency – Lek
- Independent application of monetary policy
- Maintaining and administration of the Bank of Albania international reserves.

An important step targeting the extension of the Bank of Albania autonomy was the approbation by the Republic of Albania Parliament of some alterations and amendments in the Law "On the Bank of Albania"<sup>33</sup>. The areas where law is altered or clarified have to do with:

<sup>33</sup> Law no. 8893, dated 14.05.2002 "On some changes and amendments of law no. 8269, dated 23.12. 1997 "On the Bank of Albania" changed by law no. 8384, dated 29.07.1998.

- The specification of the Bank of Albania right to implement the monetary policy of Albania independently. This change emphasized the type of monetary policy autonomy.
- The Bank of Albania endowment of right to use monetary policy instruments independently. In this way the autonomy in implementing the monetary policy is underlined.
- The selection and the nomination of the Bank of Albania Governor. In the previous law, the Governor was proposed by the Prime Minister and nominated by the President. With the new law, the Governor shall be proposed by the Republic of Albania President and elected by the Republic of Albania Parliament. This alteration on electing the Governor by Parliament is in accordance to the institutional links of the Bank of Albania with Albanian Parliament, sanctioned by law "On the Bank of Albania".
- The avoidance of the conflict of interests of the position of the Supervisory Board member. The amendment made in the Law defines inconsistency of the function of Supervisory board member with that of the Bank of Albania employee, manager or stockholder with an influential participation in any of commercial banks or in any Bank of Albania institutions permitted to operate in the Republic of Albania territory. The purpose of this amendment is closely related to the preventing of conflict that may rise between the participation of the Supervisory Board member to other banks or institutions licensed by the Bank of Albania and the position he/she holds at the Bank of Albania. This is because, based on Law "On the Bank of Albania"<sup>34</sup>, the Supervisory board takes decisions directly linked to the interests of those entities exercising banking and financial activity, starting from the granting of license, the approval of regulatory and supervisory rules and regulations to the revoking of license.
- The respective change related to the Bank of Albania authority for holding and managing not only its international reserve (such as the invalidated disposition), but also the entire international reserve of the Republic of Albania.

#### IV. INTERNAL AUDIT DEVELOPMENT

The Bank of Albania internal audit is exercised pursuant to legal provisions of Article 54 of the Law "On the Bank of Albania". In all audits performed in 2002, the preliminary documents of audits are improved, defining the procedures and steps of performing the audits, controlling and enriching the documents of introducing the current internal audit systems, making comparisons and evidencing the changes encountered from the assessment of audit risks, drafting a history of assessing risk for every bank function.

During 2002, there are performed totally 45 audits, on a monthly average of 3,8. Out of them, 37 audits were planned in the annul program of the department and only 4 are procedures realized upon recommendation by bank administrators, which mainly have to do with the specialized audits on a specific subject matter. On behalf of Internal Audit department, there were performed 3 audits requested by the IMF Treasury Department. Meanwhile, this number does not include information prepared on reconciliation of special accounts, those prepared for controlling the financial statements, for realizing the programs of Supervisory board, as well as for verifications performed on the physical statement of monetary values.

In 2002, the quarterly reporting on audit results to the Supervisory Board was carried out, unlike the annual reporting carried out previously.

<sup>34</sup> Consult article 43, latter "c" and "e" of law no. 8269, dated 23.12.1997 "On the Bank of Albania".

In the audits performed, besides the evidenced discrepancy of respective recommendations, there have been given opinions or supplements regarding the improvement of regulations, job manuals and followed procedures. All recommendations targeted the correct application of law and other by-laws, rules and regulations, Supervisory Board decisions, and other consolidated rules established. It needs mentioning here that out of the controls performed on the Bank of Albania activity, no violation of laws is found. Concerning violation of the established rules during the exercised controls in 2002, disciplinary measures have been suggested, and only in one case there is observed economic damage and the relevant act of indemnity is issued.

## V. INTERNATIONAL COOPERATION AND INTEGRATION

### V.1. INTEGRATION IN EU

**Y**ear 2002 was an important year for Albania, in the framework of efforts for initiating the negotiations for concluding the Association and Stabilization Agreement with EU. After the suggestion of EU delegation on the commencement of a detailed study and evaluation of economy sectors, in the EU report of April 2002, there were identified troubles and measured related to different sector developments in the country, based on a matrix compiled on following the duties and the performance of duties of every institution in the country.

**Box 16: THE STABILISATION AND ASSOCIATION PROCESS FOR SOUTH EAST EUROPE  
- Extracts from the Annual Report of Commission of European Communities, april 2002.**

*The Stabilisation and Association process, as a long-term commitment, combines new contractual relationships (Stabilisation and Association agreements) and an assistance programme (CARDS), which helps each country to progress, at its own pace, towards the requirements of EU membership. The stabilization and association agreements are legally binding international agreements obligatory international agreements. They draw heavily on the Europe agreements with candidate countries and the experience of the enlargement process. They are ambitious demanding agreements, which have at their core the basic principles, which underpin membership of the Union. The SAAs require respect for democratic principles, human rights and the rule of the law; they foresee the establishment of a free trade area with EU; and they set out the rights and obligations in areas such as competition and state aid rules, intellectual property and establishment, which will allow the economies of the region to begin to integrate with that of EU.*

In June, the EU Council of General Affairs stressed that EU Council considers Albania a potential candidate to membership in EU, while in October 21<sup>st</sup>, there was approved in Brussels the draft-mandate on the Stabilization and Association Agreement with Albania. This paves the way to the initiation of negotiations for signing the agreement and is an opportunity given to Albania, along with other countries of Western Balkans, to show the possibilities and capacities of partnership with EU countries.

The problems laid down to solution and the progress recorded by different sector institutions, are subject to the reporting process on monthly basis. In this framework, the Bank of Albania, as the central bank of the country, not only gave its contribution in drafting the monetary policy

for 2002 for achieving its main target of price stability but also tried to strengthen the bank supervision through mid-term development of the Supervision Department, having the support of international organizations, the approval of law and later on the establishment of Deposit Insurance Agency, consolidation of growth in the banking and financial system, increase of transparency in its activity, improvement of the payments system, etc.

Meantime, evaluating the EU requirements on financial integration, a closer cooperation with one of the member countries of the community was requested, attained through Technical Cooperation Office with Germany (GTZ). To this end, there were established cooperation relationships with ECB and with Central Bank of Germany, and different projects would be coordinated by an ad-hoc group of the Bank of Albania directors, created on Europe.

With the establishment of the group on "Europe", it was raised the importance of the cooperation with European countries, assigning a coordinator of the Bank of Albania links and contacts on European projects, who attends its presentation in the group of negotiations for signing the Stabilization and Association Agreement with EU. The Bank of Albania goal is to be oriented towards ECB model. For this, there were established bridges of relationships with ECB and the Central Bank of Germany, Bundesbank.

European integration is important when the goal is understood and recognized. This is worth for the Bank of Albania and Albanian public. For this, with the proposal of the "Europe" group, it was decided to open a European Chamber at the Bank of Albania, containing information, economic and financial data, relations to websites, different activities, and in the framework of the overall transparency of its activity, be open to public visit.

## V. 2. RELATIONS TO IMF

**C**ooperation with IMF recognized further intensifications and developments, with respect to the exchange of information and the support offered by the IMF in 2002.

In the quality of the fiscal agent of the Republic of Albania, the Bank of Albania handles all financial operations with IMF. It keeps, under a special book entry, the IMF accounts and performs the systematic and due payment of the Republic of Albania liabilities, deriving from agreements with it: PRGF and ECPA loan contracts.

Year 2002 marked another important step in Albania's relations with IMF. Following the previous year-end consultations with the mission of European issues Department, IMF Executive Board approved a new three-year loan agreement (2002-2004) on PRGF agreement, at the amount of SDR 28,000,000. The first trench of SDR 4,000,000 was disbursed on 28.06.2002.

In the framework of technical assistance provided by IMF to member countries and at the Bank of Albania request, the Department of Exchange & Monetary Affairs assisted some of the Bank of Albania departments in various issues that have to do with the bank supervision and the monetary policy during 2002.

On the other hand, there have been kept contacts with IMF Treasury Department, which activity targets the assessment of the central banks security and risk.

### V.3. RELATIONS TO THE WORLD BANK GROUP

**A**lbania gained membership to the World Bank Group in October 1991. From that time, the World Bank has been actively involved in drafting and implementing the reform program in Albania, through advisory policies, financial support and technical assistance in different sectors.

In this framework, contacts have been kept well on track even this year, through world Bank missions, from which the Bank of Albania has secured the technical assistance and support related to the following of the medium-and long -term development plan of bank supervision.

This project will be also extended in the next year, with respect to following and treating technical matters of RTGS projects, accounting system, and establishment of credit information office. Apart from that, for the three last projects and the project of clearing system automation, the World Bank has offered its financial support related to the consultation, implementation, and preparation of functional and technical specifications.

The World Bank keeps regular contacts with the International Financial Corporation (IFC), through meetings, round tables, and the exchange of correspondence on important matters, such as the Savings Bank privatization, etc.

### V.4. INTERREGIONAL RELATIONS

**I**n 2002, the Bank of Albania relationships with homologue banks recognized further intensifications, with respect to institutionalization of relationships and the concrete steps making.

Thus, in April, the Framework Agreement, and the Memorandum of Understanding was signed in Pristine in the area of bank supervision, between the Bank of Albania and the Authority of Banks and Payments of Kosova. The agreements anticipate the systematic exchange of information on respective banking system and financial market developments, implementation of monetary policy, banking supervision, management of international reserve, etc. They encourage the extension of contacts between commercial banks, in both directions, as well as the provision of technical assistance by the Bank of Albania in the area of analysis, statistics, international payments, clearing- house, financial market of securities, etc., in accordance with international and European standards.

On the other hand, the cooperation in the framework of Memorandums of Understanding in the area of bank supervision, already signed with the Bank of Greece and the Authority of Banking Supervision of Turkey, which was respectively materialized in common inspections of some Greek banks operating in Albania, organization of round tables and gaining of experience in some areas such as liquidation and taking under custody.

Year 2002 can be mentioned for a satisfactory performance of central bank's developing relations with the regional and interregional central banks, in the area of technical cooperation, training, exchange of information and the absorption of the most striking experience. Along the year, there have been obtained trainings from G-10 countries, which comprise the majority of the Bank of Albania donors such as: the Federal Bank of Germany, the Bank of France, the Bank of England, the Bank of Italy, the Federal Reserve Bank of New York as well as from other countries such as: Austria, Switzerland, Turkey, Slovenia, Czech Republic and other international training institutions: the International Monetary Fund, the World Bank Group, the Bank of International Settlements.

## V.5. RELATIONS TO OTHER COMMERCIAL BANKS INTERNATIONALLY

In accordance to the policy "On the management of international reserve" approved by Supervisory Board decision, the Bank of Albania follows a prudential policy as to the selection of partner banks, establishing strong selective criteria on the investment of international reserves. Decision-making and the approval of new partner banks are processes completed by Investment Committee. Hence, in the framework of efforts to diversify the foreign reserve investment portfolio for 2002, along with the efforts for extending partner institutions, either in the level of central banks or commercial banks.

Efforts for establishing new relations are concentrated in opening accounts for trading securities and for maintaining them, while correspondent banks, with which we have had historical relationships, are most preferred for holding deposits.

In this framework, the preferences for the selection of the new partner banks, likewise before, considering the investment returns, the security they offer, as well as the geographical appropriateness, have been banks of Europe and the United States and mainly those established on important centers of financial world, such as in Berlin, London, Zurich, Milan, and New York. These banks rank at the top list of credit rating agencies.

## VI. THE BANK OF ALBANIA MEDIUM-TERM DEVELOPMENT PLAN

In 1996, the Bank of Albania processed and made public, for the first time, the document titled "Bank of Albania medium- term development plan". This document was prepared to set the Bank of Albania short- and medium- term development targets and the terms of attaining these targets, as well as to fix the priorities of institutional development. It has been generally assessed that the Bank of Albania managed to achieve its medium –term targets, set for the period 1999-2002. It has established the basis to further consolidate its achievements in order to fix even more ambitious targets.

The Bank of Albania mid-term development plan for the period 2003-2005 intends to offer a harmonized plan to ensure the improvement of work in all directions.

**Preparing for new monetary policy regime.** This underlines reinforcement of analyzing and forecasting skills, which would assist in defining the realistic objectives of monetary policy, in appropriate and timely decision- making. This aspect will be supported by improvement of the system of collecting, processing and distributing the data.

**Strengthening and developing supervisory skills.** The importance of developing this function increases under conditions when the number of market operators is being increased, the competition between them is being strengthened, the role of the banking system in the domestic economy is being enhanced, new products are being developed and the banking activity is being expanded.

**Increasing the Bank of Albania institutional accountability and transparency of its activity.** These are two elements that ensure not only the implementation of legal duties of the Bank of Albania but also the quality increase in executing these duties. They will also support the Bank of Albania in its efforts to strengthen its real autonomy.

**Developing human resources and establishing appropriate work conditions.** Both elements are assessed as necessary to ensure the achievement of medium-term targets set in the development plan.

