

CHAPTER I WORLD ECONOMY DURING 2004

I.1 WORLD ECONOMY

In 2004 world economy experienced a higher growth than the last three years. The world economic growth included the main economic areas but it was stronger in the United States and in some areas of Asia, while the euro area and Japan experienced rather a moderate growth. Domestic demand was the generator of high economic growth of the United States and China. The effect of this growth affected also other regions through world trade growth.

During the second half of the year, world economy slowdown was due to oil price rise and the American dollar depreciation versus the main world currencies. High oil price has exerted inflationary pressures in the importing countries. However, primary and secondary effects on inflation have been moderate due to the high competitiveness in the world markets.

	GDP	Unemployment rate	CPI	Budget deficit (as a percentage of GDP)
USA	3.7 3rd Q	5.4 (December)	3.3 (December)	-4.4
Euro area	1.8 3rd Q	8.9 (December)	2.4 (December)	-2.9
Great Britain	2.8 4th Q	4.7 (November)	1.6 (December)	-3.2
France	1.9 3rd Q	9.9 (December)	2.1 (December)	-3.7
Germany	1.3 3rd Q	11.4 (January)	1.6 (January)	-3.9
Italy	1.3 3rd Q	7.7 (June)	2.0 (December)	-2.9
Japan	2.6 3rd Q	4.4 (December)	0.2 (December)	-6.5

Source: *The Economist*, February 2005

Table I.1 Macroeconomic data on the main economic areas

EURO AREA ECONOMY

The economy in the euro area countries developed at a slower pace compared to the United States. The annual GDP growth in the euro area was 1.8 per cent for the nine-month period of 2004 from 0.4 per cent being in the same period of 2003¹. Economic developments showed positive achievements during the first half of the year, while in the second half growth started waning. Private consumption fall is considered as one of the factors influencing the economic slowdown. Slow improvements made in the labour market and oil price rise are believed to have negatively affected the real income, this being reflected in the consumption fall. Labour market has been stable throughout the year; employment rate has been most of the year 8.9 per cent. Moreover, the foreign demand, which was reflected in the positive net exports contribution to GDP, was one of the main factors influencing the economic growth of the

¹ Data on the euro area economy performance are sourced from European Central Bank's monthly reports.

euro area during the first semester. However, competitiveness in European goods and services diminished due to the ongoing Euro appreciation over the last months of the year, this constituting a concern for the European economies². Many euro area countries have followed an expansionary fiscal policy, this being a continuous concern, since a considerable number of member countries have observed the Maastricht Treaty³ criteria on the budget deficit. Public finances in the euro area countries continued worsening over 2004. Budget deficit ratio to GDP is estimated at 2.9 per cent in 2004 from 2.7 per cent it was in 2003.

The average inflation rate in harmonized terms in the euro area was 2.4 per cent in 2004, while the average rate of energy group was 4.5 per cent. The rise of tobacco taxes and of some administered prices have been some of the factors that influenced the inflation rate increase throughout the year. But, the moderate increase of salaries, the slow economic performance and the Euro appreciation, having positively impacted the decline in prices of imports, are the main factors that have contributed to inflation control.

Current account in the euro area recorded a surplus even during 2004. But, the surpluses accumulated over the last twelve months have been dropping from a maximum of EUR 50 billion in July to EUR 39 billion (nearly 0.5 per cent of GDP) in November.

AMERICAN ECONOMY

The economic activity of the United States continued to expand over 2004. The stimulating fiscal policy associated with a supporting monetary policy, having maintained favourable financial conditions, has fuelled the internal demand for consumption and investments. In 2004 GDP increased by 3.75⁴ per cent from 4.5 per cent it was in 2003. Labour market conditions improved further, though improvement pace over the whole year was not uniform. The unemployment rate dropped to 5.4 per cent at the end of the year. The average annual inflation rate was 2.7 per cent in 2004 from 2.3 per cent being in 2003.

The economic growth was accompanied by a moderate inflation, regardless of the negative impact of oil price rise. General price rise has been controlled by the productivity growth, which led to a moderate labour cost rise, and by the producing cost reduction due to the US dollar weakening.

The United States fiscal policy has been a stimulating policy. The fiscal stimulation is mainly expressed in the reduction of personal tax, in the growth of protection expenses and in the fiscal support of business investments.

² Exports constitute about one-fifth of the European economy, a rate almost 2 times higher than the one of the United States. The negative impact of the Euro appreciation on exports brought about the falling of business confidence in the euro area.

³ One of these criteria provides to maintain a budget deficit at 3 per cent of GDP.

⁴ Data on the American economy performance are sourced from publications of Trade Department, Labour Department and Federal Reserve.

Budget deficit at the end of September, the closing period of fiscal year in the United States, represented 4.4 per cent of GDP. The current account deficit deepened further during 2004, reaching USD 660 billion or about 5.6 per cent of GDP. The deepening of current account deficit mirrors the deepening of trade deficit. Trade deficit deepened to about USD 660 billion in 2004 from about USD 500 billion it was in 2003. Oil price rise had exerted a considerable influence on the growth of imports.

MONETARY POLICY

The Governing Council of the European Central Bank estimated that the euro area economy has not been subject of significant inflationary pressures over 2004. As a consequence, the European Central Bank has decided to keep the two-per cent core interest rate unchanged. The Central Bank of Japan has observed the same line. The monetary policy followed during 2004 is considered as a policy characterised by tightening features in the most of the world's countries. In the United States, FOMC⁵ has raised the core interest rate 5 times, bringing it from 1 per cent being at the beginning of the year to 2.25 per cent in December. However, FOMC considers that the monetary policy stance in the United States is still stimulating, compared to historical standards.

EXCHANGE RATES

Exchange rates fluctuated over 2004. The American dollar was appreciated in the first part of the year due to expectations in the international markets that the United States monetary policy would tighten faster than the rest of the industrialized countries. At the beginning of September, the attention of participants in the international markets mainly focused on potential financial implications of the American current account deficit. For this reason, the US dollar started losing ground rapidly. The American dollar was depreciated at about 7 per cent versus a basket composed of Euro, British pound, Canadian dollar⁶, etc. during 2004. The American dollar depreciation has been less significant versus the Asian currencies⁷.

Chart I.1 Exchange rate performance
USD/EUR over 2004



Source: Bloomberg

⁵ Federal Open Markets Committee is the Federal Reserve body, which defines the United States monetary policy.

⁶ Nominal index, which denominates the value of U.S. dollar exchange versus major currencies basket (Nominal index - major currencies).

⁷ U.S. dollar is depreciated at about 4 per cent versus a basket of Asian currencies.

OIL PRICE

Oil price significantly rose over 2004. It has impacted not only the increase of inflationary pressures in the oil importing countries, but also

the slowdown of economic growth during the second part of the year. In October, the price per barrel reached the maximum historic level of USD 55. Oil price significantly rose due to the combining of demand and supply factors. At present, the demand for this product is estimated the highest one of the last sixteen years. The global economic growth and, in particular, the ongoing expansion of American economy and the accelerated development of Chinese economy have impacted the increase of demand for oil. But, on the other side, even oil producing countries have experienced a series of problems, which have induced an increasing uncertainty of production level reflected in the oil price rise.

Chart I.2 Oil price performance over 2004 (USD per barrel)



I.2 ECONOMIES OF THE REGION DURING 2004

Economies of the region are generally considered as emerging economies. Most of them continue to feel the consequences of the last decade's shocks, which have left traces in the political, economic and social field of these countries. The armed conflicts, political clashes and changes of economic regimes have generated problems in achieving the macroeconomic objectives. However, over the last years, almost all the countries of the region have succeeded to overcome a part of problems, showing positive signs in terms of economic growth, inflation reduction, political stability, etc.

Albania's trade with the countries of the region increased further either in imports or in exports. Although exports to the countries of the region remained in absolute value small, they occupy all together the fourth place after the exports of Italy, Greece and Germany, which are considered as the main destinations of Albanian exports.

Table I.2 Exports and imports with countries of the region for January-September (USD millions)

	2003	2004	2003	2004
	Exports	Exports	Imports	Imports
Bosnia and Herzegovina	0	0.4	1.2	0.4
Serbia & Montenegro	1.5	1.6	2.9	9.1
FYROM	2.3	5.0	11.1	15.4
Turkey	2.6	8.9	86.3	113.6
Croatia	0.3	0.4	22.9	20.7
Total	6.7	16.3	124.4	159.3

Over the last five years, Albania's economic and social relationships with Kosovo, favoured by the geographic and cultural vicinity, intensified. During 2004 exports to Kosovo increased allowing this destination be classified

the third one after Italy and Germany. Kosovo's progress over the last two-three years is significant. Reorganising of the economy and establishing of modern markets are undertaken alongside with the solution of political conflicts, making the country face a relatively considerable challenge. The good economic performance is helped not only by internal factors but also by the international factor, which has given its assistance in restoring peace and stability and in providing the technical and financial assistance as well. Future political and economic stability of Kosovo, and to some extent of the region, shall depend on the granting of the final status to the country.

Kosovo's economy increased by 3.2 per cent during January-November 2004⁸. The annual inflation rate is estimated at 1.5 per cent. The covering level of imports by exports is too low (3.6 per cent) and trade deficit at the end of October was about EUR 800 million. Unemployment (47.5 per cent) continues to remain the main concern for the country's economy.

The annual growth of real economy, over the third quarter of 2004 was estimated at 3.6 per cent in Croatia. The economic growth is supported by the consumer expending growth, while government expenditures and net exports are characterised by rather a modest growth. Inflation remains low.

	Real GDP (in %)	Inflation (in %)	Fiscal balance (% of GDP)	Current account (% of GDP)	Unemployment (in %)
Kosovo	3.2 (3 rd Q)	1.5	-	-	47.5
Croatia	3.6 (3 rd Q)	2.1	-	-	18.4
FYROM	2.6 (3 rd Q)	1.5	0.1	- 8.2	30.1
Serbia & Montenegro	7.2 (Annual)	13.7	1.6	-14.8	31.7
Turkey	8.7 (3 rd Q)	9.3	7.1	-5.1	10.1

Source: Relevant web sites of central banks

Table 1.3 Main macroeconomic indicators on some region economies over 2004

The Former Yugoslavian Republic of Macedonia experienced a long process of economic and political reforms over the last decade, aiming at establishing a modern society and developing a market economy. Year 2004 is characterised by a slower economic growth compared to 2003. However, positive developments have been experienced regarding budget deficit reduction (from 1.6 to 0.1 per cent of GDP), as a result of the strengthening of monetary and fiscal policy discipline. The most important challenges this country should face, in a near future, are the reduction of current deficit and of unemployment.

Serbia and Montenegro performed a satisfactory economic growth of 7.5 per cent over 2004. The economic growth is helped by the consumption growth in both the private and public sector and by the investment growth. During 2004 inflation exceeded the 8.5 per cent targeted rate of the National Bank of Serbia, reaching 13.7 per cent. The current deficit, relatively high (14.8 per cent of GDP), has exerted pressures toward the domestic currency depreciation. Serbia and Montenegro, with an unemployment rate of 32 per cent, remain certainly the country having the highest unemployment rate in the region.

⁸ Source: www.bpk-kos.org. Monthly Statistics Bulletin. November '04. No. 39.

During 2004 Turkish economic growth reached 9.89 per cent, a rate being one of the four highest rates recorded in the last 35 years. Inflation dropped to 9.3 per cent after three decades of two-digit and three-digit inflation. Year 2004 has marked record levels in ensuring investments, in making revenues from privatisation, in performing high exports and in growing foreign reserves of the country. The financial market is completely recovered after the 2001 crisis, while it is expected that the use of the new currency, since January 1st, 2005, facilitates the foreign investors business and improve the economy expectations. Turkish economy, though being a net oil and gas importing country, succeeded to successfully overcome the external shocks during 2004.

⁹ Burimi: <http://home.btconnect.com/turkisheconomy/economy/outcomes.htm>

CHAPTER II ALBANIAN ECONOMY

II.1 ALBANIAN ECONOMY DURING 2004

The development of the Albanian economy was during 2004 in compliance with the main objectives of the country economic development strategy. Preliminary economic evaluations revealed a 6 per cent growth in real terms, maintaining the average development rate of the last five years. The economic growth over this period is accompanied and supported by the ongoing consolidation of macroeconomic equilibrium, being evidenced in the low and stable inflation rates, in the reduction of budget deficit and public debt, in the improvement of the balance of payments and in the overall stability of monetary indicators. Albania's economic growth has been throughout this period higher than the growth of other South East European Countries or even than the one of the countries being new members of the European Union.

The development of the Albanian economy is attributed to the dynamic development of the private sector, particularly to the growth of sectors such as construction, services and transport. The primary objective of the public sector development has consisted in the consolidation of fiscal indicators, upgrading of the public administration performance in terms of collecting revenues, reorientations of budget expenses toward priority sectors of the economy, including infrastructure investments, and the budget deficit control. Investments in the economy, mainly represented by private investments, have remained at the same level compared to 2003, counting for around 25.4 per cent of gross domestic product. This development was highly backed up by the financial sector, through enhancing the lending activity and the range of the services provided. Credit to the economy increased by an average of 34 per cent over the last two years.

The positive moment of the Albanian economy development is also reflected in the labour market. The 2004 data speak for a gradual smoothing of the unemployment rate. Although the demographic changes that have come over the last years make difficult the statistical disclosure of labour forces displacement, the latest estimates suggest an unemployment rate of 14.6 per cent.

Inflation remained within the targeted band of the Bank of Albania for the most part of the year. The average annual inflation rate was estimated at 2.9 per cent. The control of internal demand pressures has contributed to maintaining price stability during 2004, being to a large extent supported by the growth of domestic agricultural production. The administered prices of electricity and fixed telephony have exerted strong pressures on the annual consumer price rise. Bank of Albania has followed a prudential monetary

policy, cutting on a continuous basis the core interest rate. The reduction of borrowing costs in the economy provided more spaces for enhancing the lending activity and developing the economy, without infringing the targeted inflation and monetary indicators equilibrium.

Fiscal indicators highlighted a stability and positive performance over 2004. Although expenses and budget revenues remained below the budget expectations, they evidenced a satisfactory increase in nominal terms. Budget deficit remained within the 2004-projected level, and no pressures on monetary indicators and inflation were exerted. The deficit financing is mainly carried out through domestic sources, where privatisation revenues played an essential role. The fiscal discipline and the control of budget deficit brought about a public debt reduction of 55 per cent of GDP. The reduction of public debt share reduces the cost of public debt service in the future, releasing more funds to be utilised for strategic investments.

Table II.1 Main economic indicators

	1999	2000	2001	2002	2003	2004
Real growth of GDP (in %) ¹	8.9	7.7	6.5	4.7	6.0	6.0
GDP (in current prices, in millions of ALL ²)	488611	530900	588700	630000	695100	780100
GDP (in current prices, in millions of USD)	3548.4	3694.5	4102.4	4496.8	5702.2	7,581
GDP per Capita (in USD) ³	1052.0	1086.3	1329.0	1460.0	1833.5	2,434
Number of the employed (in thousands)	1081.0	1068.0	1065.0	921.0	928.0	917.0
Unemployment rate (in %)	18.0	16.9	14.6	15.8	15.0	14.6
Inflation rate in percentage (y/y)	-1.0	4.2	3.5	2.1	3.3	2.2
Budget deficit (with grants, as a percentage of GDP)	-12.1	-8.2	-7.9	-6.6	-4.9	-4.9
Public debt (as a percentage of GDP)	69.7	71.3	66.8	65.1	60.7	55.3
External debt (as a percentage of GDP) ⁴	-32.3	29.4	25.8	23.4	20.7	17.8
Current account (free of official transfers, as a percentage of GDP)	-8.5	-7.0	-6.1	-10.2	-8.2	-6.2
Average exchange rate, ALL/USD	137.7	143.7	143.5	140.1	121.9	102.8
Average exchange rate, ALL/EUR	147.0	132.6	128.5	132.4	137.5	127.7

Source: Institute of Statistics, Ministry of Finance, IMF estimates and Bank of Albania

The influence of shocks, observed in the world economy during 2004, appeared to be a moderate one in the Albanian economy. Thus, oil price rise in the international markets affected to a moderate extent the Albanian economy. Its impact on inflation was limited, due to the small share of relevant subgroup in consumer basket. Moreover, the negative impact in transport sector, the more sensitive sector to oil price fluctuations, is not so obvious. Oil price rise in the international markets was amortised partially as a result of Lek appreciation and partially due to the rising of competition and the emerging of a certain flexibility of demand for this product.

¹ Data on the real growth of GDP for 1999-2000 are sourced from the Institute of Statistics. For the rest of the years, the respective data are estimates of Ministry of Finance, IMF, and Bank of Albania.

² The table is established based on the reviewed nominal GDP.

³ Nominal GDP is adapted by using the average exchange rate.

⁴ Government debt, including the debt secured by the Government.

The current deficit⁵ was evaluated at 5.3 per cent of GDP, revealing a significant decrease relative to the last two years. The reduction of this deficit is due to the improved trade deficit, which lowered to 21 per cent of GDP in 2004 from 23.4 per cent of GDP in 2003. Exports of goods marked a higher growth rate compared to imports, while the positive balance of current transfers evidenced a simultaneous increase with the trade deficit, inhibiting the deepening of current deficit. The coverage of imports by exports of goods reckoned 27.5 per cent, marking rather an improvement compared to 25 per cent in 2003. During 2004 Albania's balance of payments evidenced a flow of financial assets and capital of about 1.5 times higher than the previous year. The rise of inflows in the financial account and the non-deepening of current deficit brought about the growth of foreign reserves by about USD 290 million over 2004.

II.1.1 Production by economy sectors

The economic growth performed during 2004 showed approximately the same structure and size features as in 2003. Sectors that have given the highest contribution to the annual growth rate are deemed to be: "Trade, hotels, restaurants", "Construction", "Transport" and "Other services". These sectors contributed by about three-quarters to the economic growth over 2004.

The sectoral economic development has been a dynamic development over the last years, accompanied by redistribution of revenues and production factors by economy sectors. Sectors of construction, transport and services have evidenced high growth rates, enhancing proportionally their contribution to creating national revenue. In contrast, there are sectors such as industry and agriculture that, despite their considerable share in the GDP (22 per cent and 14.5 per cent, respectively), have given a modest contribution relative to their share.

	2002	2003	2004	Share '04 (in percentage)
Agriculture, hunting, silviculture	9.7	10.9	13.6	21.8
Industry	5.5	6.6	7.4	14.5
Construction	17.6	18.0	16.6	9.5
Trade, hotels, restaurants	20.5	20.3	20.0	19.0
Transport	18.4	16.2	14.9	9.0
Post and communication	4.0	3.9	3.9	3.7
Other services	24.2	24.0	23.6	22.5
Total	100.0	100.0	100.0	100.0

Source: Institute of Statistics, Ministry of Finance, and Bank of Albania estimates

Table II.2 Sectors contribution to annual growth and their share (as a percentage of GDP)

The Albanian economy has shown impressive signs of economic growth, following a somehow slow first quarter. Data over the nine-month period (the maximum period already covered by data) suggest that economy sales (excluding sales of agricultural products) increased by 4.7 per cent in comparison with the same period of the previous year. The most significant

⁵ Including official transfers.

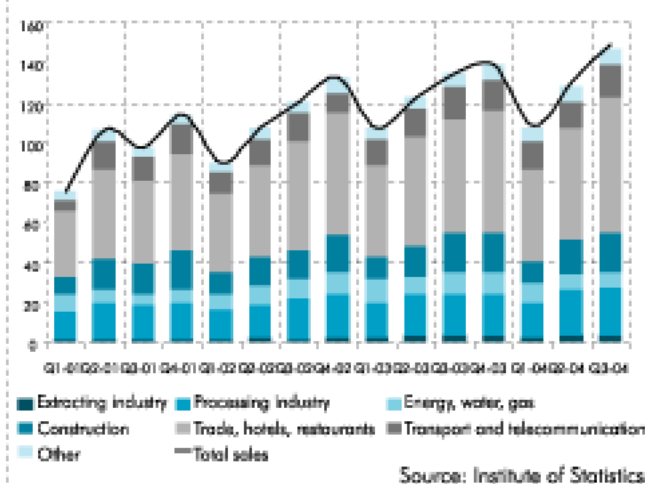
share in the economy sales is represented by sectors of trade, hotels and restaurants, at 44 per cent, followed by industry sector, which has performed 26 per cent of total sales. Based on the annual growth of retail sale index by 16.4 per cent in the fourth quarter, we estimate that the economic growth was continuous even during this quarter.

Table II.3 Sales performance by economy sectors⁶

	Sales share (% to total)	January – September '04/'03 (in %)
Total	100.0	4.7
Industry	26.0	-0.5
Construction	12.8	7.1
Trade, hotels, restaurants	44.0	6.2
Transport and telecommunication	11.8	5.0
Other	5.5	15.1

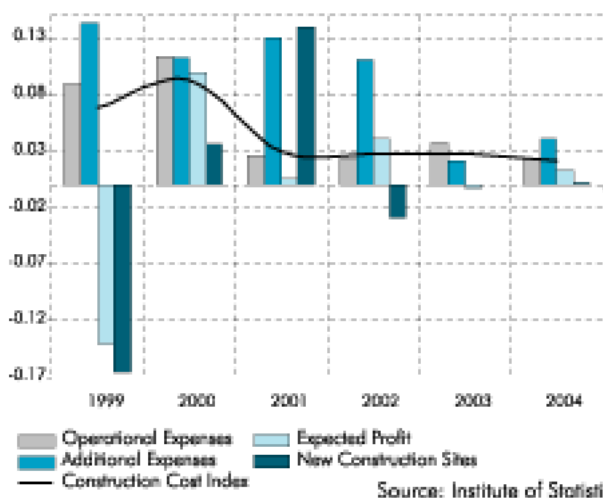
*Source: Institute of Statistics

Chart II.1 Economy sales by sectors (ALL billions)



Source: Institute of Statistics

Chart II.2 Construction Cost Index Movements



Source: Institute of Statistics

Sales showed the same seasonal nature in 2004 as in the previous years. They increased gradually from the first quarter to the fourth one.

• Construction

Construction is one of the most dynamic sectors of the Albanian economy. The high demand for developing the infrastructure, enhancing and extending the producing capacities as well as for housing made this sector be characterised by high developing rhythms. Since 1992, construction increased by an average of 13 per cent, a rate being two times higher than the overall economic growth. Construction sector has contributed by an average of 17 per cent to the economic growth of the last three years, even though the added value in this sector represents only 10 per cent of GDP over 2004.

Construction sector was characterised by positive achievements during 2004. After a first quarter being somehow weak, the activity of this sector is developed rapidly in the subsequent quarters. Sales in construction grew by 7.1 per cent during the first three quarters of the year. Sales performed from construction to the end of September 2004 indicate that construction sector remains an active sector of accelerated developing rhythm. Total cost of construction activity, measured by construction cost index, rose by around 2 per cent over 2004. Transport expenses, affected by oil price rise, climbed by 14 per cent, while salaries of construction workers increased by 7 per cent.

⁶ This table does not include sales in the agriculture sector.

- Trade, hotels and restaurants

Sales performed in this sector grew by 6.2 per cent over the nine-month period of 2004, compared to the same period of the previous year⁷. The third quarter of the year experienced generally higher sales and a more intense activity than the third quarters in the services such as hotels and restaurants. Meanwhile, sale volume index in the retail trade during the fourth quarter of 2004 ascended by 16.4 per cent compared to the fourth quarter of 2003, revealing a continuity of positive performance even in this quarter.

This sector marked an average annual price rise of about 3.6 per cent during 2004, while the average price rise during 2003 was 2.7 per cent, approximately in line with the overall price performance (for a discussion on the price performance of tradable and non-tradable goods, see Box II 1).

- Agriculture

Agricultural sector production grew by 4.9 per cent over 2004. Agricultural sector, in particular, which provides around 80 per cent of the overall agricultural production, increased by 3.8 per cent, while agro-industry branch marked a significant increase of 11.2 per cent. Also, animal products grew by 5 per cent over 2004, revealing the increased number of farms as well as their rentability.

Sectors	Weight (%)	Annual growth 2004/2003 (%)
A. Agriculture	80	3.8
A.1. Animal farming	37	4.9
A.2. Plants	43	2.9
B. Agro-industry	19	12
C. Fishery	1	10.7
TOTAL	100	4.9

Source: Ministry of Agriculture and Food

Table II.4 Growth of agricultural sector over 2004 (by branches)

Different factors influenced the positive development of agriculture over 2004. First, atmospheric conditions have been favourable for crops and fruit growing. Some products, whose production is deemed to have significantly grown during 2004, are: tobacco, vegetables, cereals and wheat, in particular. Wheat production marked an annual growth of 12 per cent. During 2004 production of vegetables showed significant improvements either in the earliness of their harvesting time or in the increase of their variety. These developments have provided favourable conditions to improve the export/import balance sheet for this product. The abundant production of vegetables is also reflected in the reduction of vegetables price index during May-June 2004. Also, the production of fruits, citrus and olives has been growing over 2004. Second, the rural surfaces planted by greenhouses in 2004 increased by about 20 per cent compared to 2003. The extension of surfaces planted by greenhouses allowed the greenhouse production be about 12.4 per cent

⁷ The period covered with sales data for this sector includes only the nine-month period.

higher than the one of the previous year. Third, the agricultural production growth was backed up by the growing investments, mainly in the agro-industry branch. During 2004 the Ministry of Agriculture and Food engaged in the implementation of 14 foreign-financed projects. Some of the most important projects are: irrigation and draining project, food production growth project, agricultural services project and real estate mortgage project.

Agricultural production marked an annual growth of 11.2 per cent. The agro-industry was backed up by agricultural and animal production growth, to increase the processed products. During 2004 the quantity of the processed products using fruits, olives, fresh meat and dairy products as raw material grew significantly, while an increase was evidenced even in the production of alcoholics. The growth of agricultural production and agro-industrial production allowed foodstuff imports in 2004 be the same as in 2003, while exports of these products increased by 12 per cent.

Agriculture development is a matter of strategic importance for the Albanian economy, considering the large quantity of population living in the rural areas. Under these conditions, this sector needs to be supported through creating appropriate developing conditions, including investments, to enhance its access to products and financial markets and complete land reform. During 2004 nearly 99 per cent of the surfaces planned for distribution was privatised and ownership titles were given for 98 per cent of the distributed lands.

- Industry

The industrial sector represented by sub-branches: "Extracting industry", "Processing industry" and "Electricity, water and gas" saw a slowdown during the nine-month period of 2004, mainly due to the reduction in sales of water and gas. The processing industry sub-branches such as foodstuff industry, manufactured mineral products and metallurgy, performed higher sales over the nine-month period of 2004 in comparison with the same period of the previous year. In contrast, sales of textile and processing leather industry evidenced lower levels compared to 2003. The extracting industry experienced a 6.8 per cent growth of sales. However, sales and share of this industry to general industrial product remain at pretty trifling levels.

Table II.5 Industry performance by branches (for the nine-month period)

	Share to total (in %)	Sales '04 / Sales '03 (in %)
Extracting industry	8.9	6.8
Processing industry	64.7	6.5
Electricity, water, gas	26.3	-16.2
Total industry	100	-0.5

Source: Institute of Statistics

Sales of water and gas evidenced a pronounced annual decrease. Nevertheless, year 2004 was characterised by a significant upturn in production and consumption of electricity.

	Year 2003	Year 2004	Annual growth (%)
Total resources	6,145	6,361	4
Production	4,904	5,493	12
Imports	1,242	869	-30
Exports (including exchanges)	326	390	20
Network loss	2,254	2,194	-3
Households consumption	2,220	2,250	1
Non-households consumption	1,290	1,510	17

Source: Institute of Statistics

Table II.6 Electricity balance
(in GVvH)

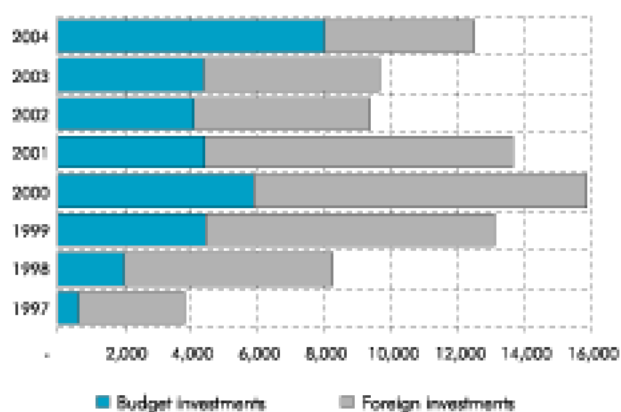
The quantity of the produced energy was during this year 12 per cent higher than in 2003. This growth is entirely attributed to the growing production sourced from hydroelectric stations. The domestic production growth is accompanied by a 30 per cent annual decrease of imports and by a 20 per cent increase of exports. Electricity production highlighted the highest level during the first quarter of the year and the lowest level during the third quarter. Network loss evidenced a slight decline, remaining, however at high levels, and representing about 34 per cent of total use. Year 2004 was characterised by a 17 per cent increase of electricity consumption from non-households. However, households remain the biggest consumer group, using approximately 60 per cent of total consumption.

- Transport

Transport sector provided along with construction a considerable contribution to the economic growth over the last years. Sales performed in this sector climbed by 5 per cent during the nine-month period of the year. The main objectives of the public administration to develop the transport are: setting up a modern infrastructure network, which will help the economic development; enhancing the operational efficiency and; fostering the cooperation between the public and private sector. These objectives are materialised in the investments growth of 29 per cent over 2004. Domestic-sourced investments evidenced a considerable increase of 84 per cent, while foreign investments in this sector dropped by 16 per cent.

Albania's route network is composed of roads being approximately 16,000 km long, of which 3,220 km are priority roads, 12,000 km of second and third degree, and about 1,000 km urban roads. The number of licensed entities for the transport of merchandise increased by 24 per cent in 2004 compared to the previous year, while the number of vehicles being at the disposal of these entities increased by 18 per cent. While the number of interurban vehicles for passengers increased by 21.6 per cent, and the number of licensed entities for conducting such an activity increased by 23 per cent. The air transport saw an average annual increase of 15 per cent over the last ten years. Flights rose by 16 per cent over 2004, being accompanied

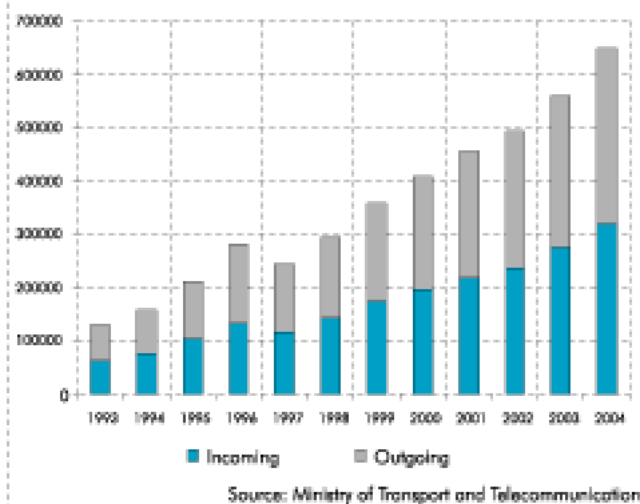
Chart II.3 Investments in transport sector by sources, over years (ALL millions)



Source: Ministry of Transport and Telecommunication

by the increased number of passengers that came in and went out of the country. In contrast, air transport of merchandise and mail dropped by about 4 per cent during this year.

Chart II.4 Number of Passengers over years

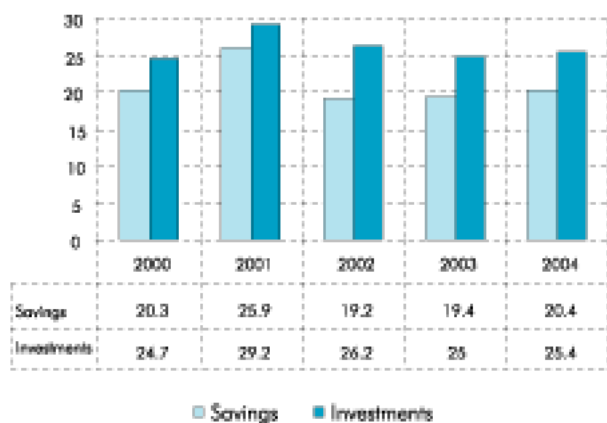


Albania's railway transport represents only 1 per cent of the transport of both merchandise and passengers. In 2004 railway transport of merchandise experienced a high decrease of 46 per cent, while railway transport of passengers dropped to 44 per cent.

II.2 SAVINGS AND INVESTMENTS

The balance of savings and investments did not reveal significant changes over 2004 compared to the previous year. The 2004-estimated ratio of savings to GDP was 20.4 per cent, while investments counted for around 25.4 per cent of GDP. The balance of savings and investments, compared to years 2002 and 2003, has been decreasing. The 2004 balance was 5 per cent of GDP, being lower than the one evidenced in 2002 and 2003, respectively 7 and 5.6 per cent of GDP. During the last year savings growth was two times higher than investments growth. The narrowing of the balance resulted in a reduction of the current deficit.⁸

Chart II.5 Savings and investments (as a percentage of GDP)



Domestic savings category evidenced the deepest annual change in the constituent items of the balance of savings and investments. These savings mounted by one percentage point in 2004, reaching 20.4 per cent of GDP. Public investments ratio to GDP increased by 0.4 percentage points over 2004. Meanwhile, private savings which represent about 98.5 per cent of the overall domestic savings, increased by 0.6 percentage points, reaching 20.1 per

cent of GDP. Growth of domestic savings over the last two years, after a fall incurred in 2002, is an important indicator for the Albanian economy. The savings growth is expected to give an impulse to new investments and to the economic growth as well.

⁸ The balance of domestic savings and investments is an indicator of great importance. It indicates the level of investments in the economy, which are not based on domestic savings. As such, it is accompanied by an increase of country's external debt and an increase of debt payments in the future.

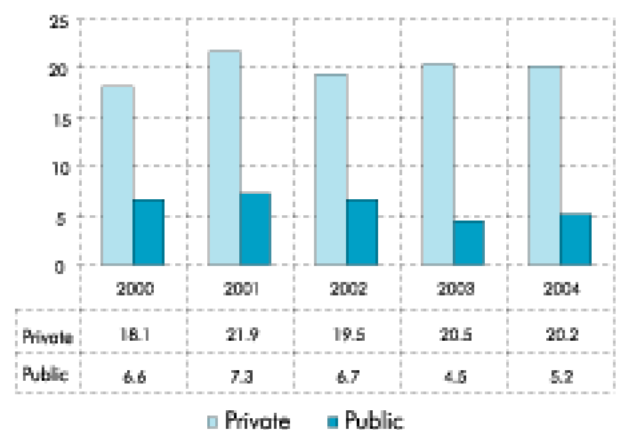
Although investments have evidenced an annual growth lower than savings, year 2004 has succeeded to prevent the investment fall against GDP observed in the last two years. Private investments continue to represent about 80 per cent of overall investments, revealing the Albanian economy support in accumulating the capital from the private sector. These investments dropped by 0.3 percentage points compared to 2003, while public investments marked an increase of 0.7 percentage points, passing from 4.5 per cent to 5.2 per cent of GDP. An important element of the balance for this year is the fact that public savings are disclosed in positive value, thus constituting an additional opportunity to investments to grow based on domestic savings, rather than on foreign capital inflow. The revenues performed from the privatisations of public property have impacted the growth of public investments⁹. Also, another factor, which is believed to have influenced the investment growth overall, is the reduction of real interest rates.

II.3 LABOUR MARKET

The available statistical data on labour market continues to be insufficient and, indeed, the frequency of their publication is low and very delayed in time from the reporting period. For this purpose, the small number of data must be construed with reserve, taking specifically into account the large share the informal economy occupies. Based on an analysis of the data we possess, it is evident that labour forces have continued falling throughout the quarters, revealing indirectly that labour force emigration still exists as a phenomenon. For inexplicable reasons, the figure of employed persons in the agricultural sector continues remaining constant, although migratory movements inside the country still persist.

The main factor that has characterised the structural employment changes is the continuation of reforms in the public sector. Year 2004 marked an 11 thousand decrease in the number of employed persons in the public sector and only a 1 thousand increase in the number of employed persons in the private sector. The labour force decreased by 17 thousand persons compared to the previous year. The indicator of labour force dropped mainly in the last quarter, when the number of employed persons in the public sector fell more than in the previous periods.

Chart II.6 Public and private investments
(as a percentage of GDP)



Source: International Monetary Fund

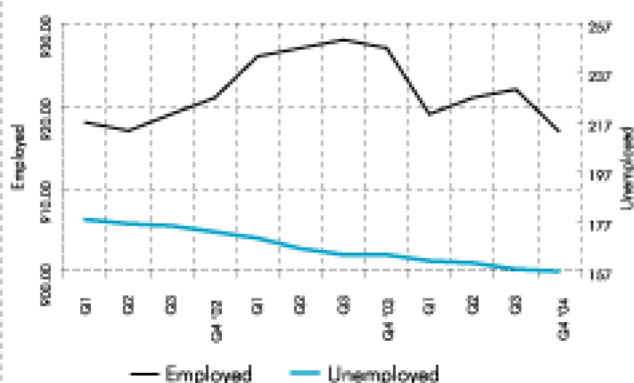
⁹ Albania has been characterised by a high-income inflow due to the privatisation of Savings Bank. Conversely, the rest of Western Balkan countries have known a fall in this indicator. Thus, foreign direct investment averaged only 3 per cent of GDP, from 5 per cent it was during 1997-2002. (Research paper, Western Balkan countries, European Commission, December 2004).

Table II.7 Labour market indicators¹⁰
(in thousands of persons)

	2003				2004			
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III	Q.IV
Total labour forces (in thousands)	1096	1093	1092	1091	1080	1081	1080	1074
A. Total employed (in thousands)	926	927	928	927	919	921	922	917
i) public sector	185	185	184	182	179	179	177	171
ii) private non-agricultural sector	207	208	210	211	206	208	211	212
iii) private agricultural sector	534	534	534	534	534	534	534	534
B. Unemployment (in thousands)								
i) total unemployed persons	170	166	164	164	161	160	158	157
ii) beneficiaries of unemployment payment	11	11	11	11	11.7	12.3	12	
C. Unemployment rate (in %)	15.5	15.2	15.0	15.0	14.9	14.8	14.6	14.6

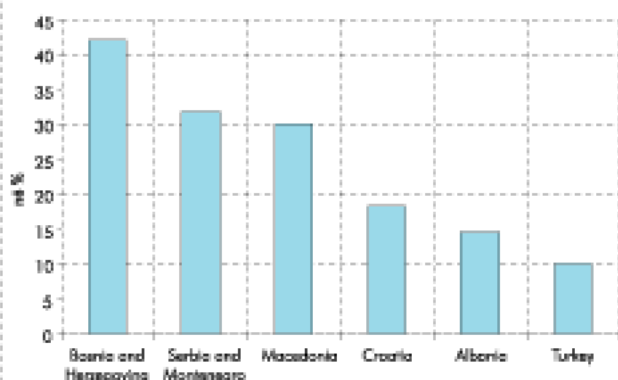
Source: Institute of Statistics, Conjunction, September 2004, Ministry of Labour and Social Affairs.

Chart II.7 Employment dynamics in Albania



Source: Institute of Statistics, Conjunction, September 2004, Ministry of Labour and Social Affairs

Chart II.8 Comparison of unemployment rate in the region



Source: Institute of Statistics, Conjunction, September 2004, Ministry of Labour and Social Affairs

During 2004 about 50 per cent of the labour force or 534 thousand persons were employed in the private agricultural sector. Their number remained unchanged over the whole year. The number of employed persons totalled by the end of the year 917 thousand persons or 10 thousand persons less than in the previous year.

Unemployment indicators have been decreasing even during 2004. Unemployment rate was ranging between 15 per cent. In December the category of unemployed persons numbered about 157 thousand persons or 6 thousand persons less than in 2003. From this category, 134 thousand persons are assisted by unemployment payment or other assistance schemes. In December 924 persons have been registered as jobseekers "unemployed for the first time", while 104 thousand persons have been registered as "long-term unemployed". Jobseekers who started a job during December were 1230 persons. The group of age with the greatest number of unemployed persons ranges between 25 and 34 years old, while the most part of unemployed persons (53 per cent) are only of eight-year cycle education.

The official figure of unemployment in Albania is the lowest one relative to some countries of the region (as disclosed in the following chart). However, the comparison becomes harder if we consider the role the informal economy occupies in the economy of each country and people's incitement to be registered as unemployed with the purpose to benefit from social assistance.

¹⁰ The data disclosed in Table 1 are sourced from Institute of Statistics till the third quarter of 2004, and from the Ministry of Labour and Social Affairs for the last quarter of 2004.

During 2004, like in the previous years, salaries of public sector's employees increased. During the third quarter of the year, the Council of Ministers decided to approve the minimum salary change from ALL 10060 to ALL 10800, resulting in a 7.4 per cent increase. This is reflected also in the average salary increase in the public sector, which increased by about ALL 25 thousand during this quarter. Even the minimum pension increased (from ALL 6.7 thousand in 2003 to ALL 7.3 thousand in 2004), as well as the average unemployment payment (from ALL 6.5 thousand to ALL 6.8 thousand in 2004), the minimum contribution payment (from ALL 10.3 thousand to ALL 11.4 thousand in 2004), etc. On the other side, we don't possess data on the salaries of private sector's employees and consequently, this lack of information does not allow us to conduct a comprehensive analysis on salaries. However, based on the surveys and the study "On the minimum salary by economy sectors" prepared by the Ministry of Labour and Social Affairs, it results that salary increase progress in the private sector should have followed the same trend.

During the recent years (2000-2004) the minimum salary increased more than the average salary in order to approximate it to the minimum living indicator. This is expressed in the improved ratio between the average salary and the approved minimum salary.

II.4 FISCAL SECTOR DEVELOPMENTS

The Albanian Government followed a prudential fiscal policy during 2004, under the Mid-Term Expenditure Framework for 2004-2006. The main objective of this policy was the improvement of fiscal indicators, aiming at consolidating the budget revenues, reducing the budget deficit and increasing the efficiency of public expenditure management.

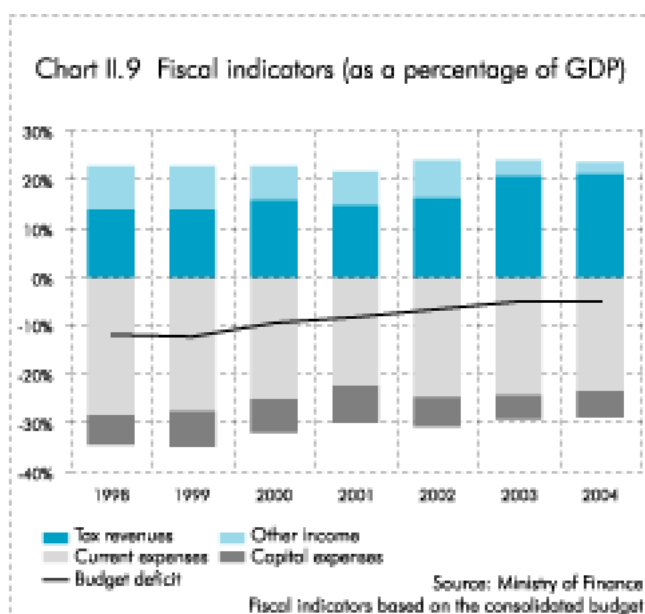
In nominal terms, the 2004 budget indicators evidenced an increase compared to the previous year. State budget revenues mounted by 10.4 per cent during 2004, representing 23.7 per cent of GDP. Budget expenditures marked an annual growth rate of 10.7 per cent, reaching the level of 28.6 per cent of GDP. However, these indicators have remained within the projected levels of the 2004 fiscal budget. Budget revenues are performed by 93.2 per cent while budget expenditures by 90.2 per cent in comparison to the annual plan. Expressed in GDP terms, budget indicators remain at approximate levels as those of year 2003, where the unchanged figure of budget deficit of 4.9 per cent is to be highlighted.

	Income	Expenses	Deficit
2003 (in billions of Lek)	167.2	201.2	-33.9
2004 (in billions of Lek)	184.6	222.7	-38.1
2004 annual growth (in %)	10.4	10.7	12.4
2004 projected growth (in %)	18.4	22.7	43.9
2003 as a percentage of PBB*	24.0	28.9	-4.9
2004 as a percentage of PBB*	23.7	28.6	-4.9

* Reviewed assessments on nominal GDP level are used for the evaluation of ratio to GDP.
Source: Ministry of Finance and Bank of Albania estimates

Table II.8 Performance of budget revenues and expenditures

In general, fiscal indicators revealed a stable and satisfactory performance. Positive performance was noted as well in the revenues from VAT, income tax, social insurance contributions, etc. Budget expenditures have been uniform throughout the year, without exerting additional inflationary pressures on the economy in specific periods. Government has continued to focus on further increasing the financing of strategic sectors like health and education, to which more funds were allocated compared to the previous years. However, capital expenditure performance still remains a problem that requires greater attention in the future. The deficit financing is mainly performed through domestic sources where privatisation revenues have played a significant role.



II.4.1 BUDGET REVENUES

One of the main objectives of the 2004 budget was the considerable increase of total revenues. The 2004-approved draft-budget projected a budget revenue performance estimated at 24.1 per cent of GDP, being resulted in an annual growth of 18.4 per cent. This ambitious objective was based on the projected economic growth for year 2004 and on the progress made for the collection of revenues. The application of new customs duties, under the terms of WTO, was expected to reduce the growth rhythm of customs revenues. Under these conditions, a particular attention in the 2004 fiscal budget was given to the collection of revenues from other taxes like income tax, value-added tax, excise, etc.

The 2004 budget revenues are estimated at 23.7 per cent of GDP, being about 0.3 percentage points lower than the previous year and about 0.4 percentage points lower than the projected level. Fiscal revenues are performed by 97.3 per cent in comparison the plan, while non-fiscal revenues by 76.9 per cent.

Table II 9 Performance of main revenue indicators (in percentage)

	2000	2001	2002	2003	2004	Growth '04
Total revenues	100.5	97.7	92.8	94.4	93.2	10.4
Value-added tax (VAT)	97.3	93.6	90.3	92.7	101.8	14.9
Excise tax	100.4	84.5	68.6	105.7	97.3	28.9
Customs tax	97.1	93.6	89.7	94.4	94.4	0.1
Personal income tax	122.2	106.0	93.2	86.3	83.9	6.9
Income tax	137.5	115.0	110.9	101.1	107.3	24.0
Social insurance contributions	101.0	97.1	98.3	93.3	98.7	16.0

Source: International Monetary Fund and Ministry of Finance

In the group of fiscal revenues, revenue collection from income tax and value-added tax, which represent 40 per cent of total revenues, has exceeded the plan, which is performed at 101.8 and 107.3 per cent, respectively. The value-added tax closely refers to the production and merchandise circulation in the country. The economic growth of 6 per cent for this year contributed

to the annual growth of this indicator at 14.9 per cent from 12.9 per cent as being projected. In general, the monthly performance of revenues from value-added tax reveals an upward progressive trend, meaning that monthly revenues have been growing from January to the end of the year. Income tax is another indicator, which closely refers to the overall economic activity. Year 2004 has continued exceeding the plan in performing the revenues from income tax, even though the projected growth for this year (15.6 per cent) was much higher than the one projected for year 2003 (6.6 per cent).

Collection of personal income tax has resulted in a fall, while collection of customs tax revenues was around 5 per cent lower than the plan and the same as the 2003-performed plan. Free trade agreements and obligations to the WTO have brought about the reduction of the average tax applied on imports, leading to the decline of growth rhythm of customs revenues.

Excise tax revenues have resulted lower than expectations, but higher than the previous years. Excise tax applied on some products has been subject of discussion for the central administration and legislative bodies. Excise tax revenues have been growing and marked even for year 2004 a high growth estimated at 28.9 per cent, even though basically the fiscal set structure for this type of tax was not radically changed. The third quarter experienced the highest level of excise tax revenues.

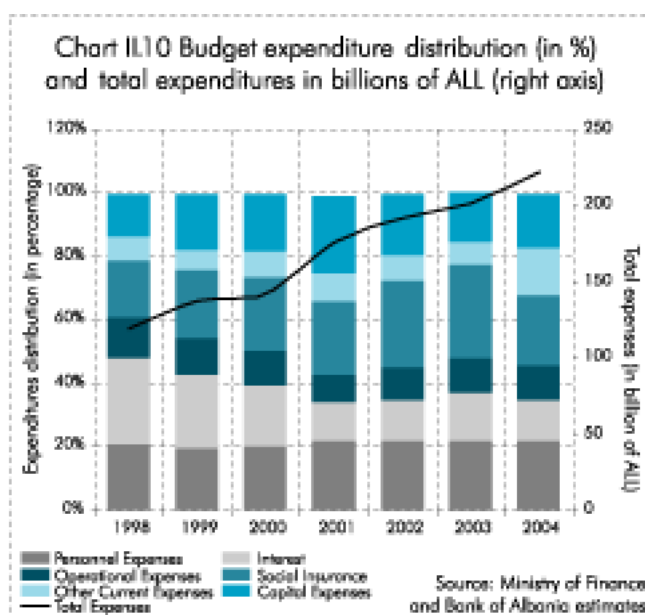
Revenues from local government have marked an annual growth rate of 21.3 per cent and are performed at 83.2 per cent. While revenues from income tax on small business are completely performed, the other local tax revenues (national tax, agricultural land tax, property tax and vehicle registration tax) are performed at 76 per cent. The annual growth of revenues from taxes on small business was about 38 per cent, being obviously higher than the revenue growth seen in 2003. However, the low level of revenue performance speaks for a low efficiency of local fiscal management.

Revenue performance from the independent budget was 99 per cent over 2004, while annual revenue growth was 16 per cent. The growth of social insurance contribution revenues is supported by the constant efforts of public administration to orient the private sector coverage towards registration of employees to social insurance institutions. However, the improved collection of revenues of this type constitutes a serious challenge for the future. According to a study conducted by the Ministry of Labour and Social Affairs, the evasion of contributions of this nature is calculated about ALL 1.1-1.3 billion annually.

Apart from its straightforward effect, this evasion affects as well the collection of personal income tax. The fiscal evasion from the private sector becomes more evident if we compare the share of employed persons in the public sector against the total number of employed persons (being around 20 per cent, according to the Institute of Statistics) with the contribution of these employees to overall payments of social insurance contributions (around 33 per cent). This fact implies the necessity to take further actions in this direction.

II.4.2 BUDGET EXPENDITURES

The 2004 budget expenditures reached 28.6 per cent of GDP, being about 0.6 percentage points lower than expectations¹¹. The 2004 budget expenditures, though they failed reaching the projected level, have attained the highest growth rate of the last five years. The expenditure distribution meets the identified strategic priorities under Mid-Term Expenditure Framework 2004-2006, of which we may mention the maintenance of social protection expenditure at a relatively high level and the increase of expenditure share for health and education.



The overall expenditures are performed at 90.2 per cent, being increased by 10.7 per cent. Current expenditures, which represent about 83 per cent of overall expenditures, were performed at 99.2 per cent. Capital expenditures evidenced the most pronounced deficiencies and performed only 70.5 per cent of the intended amount.

Personnel expenditures maintained the same weight against overall expenditures and marked an annual growth of 9.5 per cent. Interest payments reached 3.6 per cent of GDP in 2004, being 8.5 per cent lower than the plan and 4.7 per cent lower than the previous year. The interest rate fall in the domestic market has contributed to disburden the settlement

of domestic debt, whose interest payments represent about 94 per cent of the overall debt service. Also, the decline in interest payments is due to the application of successful measures taken for the reduction of budget deficit.

Social insurance and economic assistance expenditures increased by 14.7 per cent in 2004, being 3.5 per cent higher than the average of the last five years. These expenditures, which include pensions and social protection, represent 25.7 per cent of total expenditures according to their function, and 7.8 per cent of GDP.

Expenditure analysis by beneficiary sectors reveals that sectors such as health and education have withdrawn more funds from Government compared to years 2002 and 2003. Annual expenditure growth for education, health and social insurance and economic assistance was 12, 23 and 15 per cent, respectively, being higher than the respective figures in 2003.

¹¹ Pursuant to the budget income performance at 24.1 per cent of GDP and the maintenance of deficit at 5.1 per cent of GDP, the budget expenditures projected for year 2004 were estimated at 29.2 per cent of GDP.

	2000	2001	2002	2003	2004
Education	3.2	3.2	2.8	2.8	3.1
Health	2.3	2.0	2.0	2.1	2.5
Local government	1.1	1.5	1.3	0.9	2.0
Social insurance	7.5	7.4	6.7	7.2	7.4
Total	14.2	14.1	12.8	13.0	14.9

Source: Ministry of Finance

Table II 10
Expenditures according to the sectors (as a percentage of GDP)

	2000	2001	2002	2003	2004
Education	10.1	10.5	9.7	10.6	10.6
Health	7.3	6.5	7	7.9	7.8
Local government	3.4	5.1	4.6	3.3	7.1
Social insurance	23.6	24.2	23.1	26.8	25.9
Total	44.5	46.2	44.4	48.6	52.2

Source: Ministry of Finance

Table II 11 Expenditures according to the sectors (in percentage against total expenditures)

Capital expenditures attained the level of 4.9 per cent of GDP in 2004, being higher than the capital expenditures in 2003 (4.5 per cent of GDP), but lower than the level in 2002 (6 per cent of GDP). These expenditures are characterised even in 2004 by a high increase in the last quarter of the year. The capital expenditures were performed at 70.5 per cent in comparison to the plan. The major problems occurred in the implementation of foreign-financed projects, revealing the necessity for a more prudential planning of these projects and for greater efforts in upgrading the absorbing capacities of the economy.

II.4.3 BUDGET DEFICIT AND PUBLIC DEBT

The 2004 budget deficit attained the level of 4.9 per cent of GDP, being lower than the projected level of 5.4 per cent. In the last two years, the deficit stabilized around this value, marking a fall relative to the previous years. In nominal terms, the annual budget deficit growth was 12.4 per cent. The 2004 budget deficit financing was covered for the most part (81 per cent) from domestic sources. In the last three years, the share of domestic financing in the total financing has been increasing, while the foreign funding reckoned only 20 per cent of total financing. In 2004 about the half of domestic financing is provided from the privatisation revenues, which were higher than in the last two years and comparable to the level attained in 2001. Revenue growth from privatisation (mainly from the former Savings Bank's privatisation) led to the reduction of pressures as so to increase the public debt stock.

Meeting the budget deficit target as well as utilisation of the half of revenues from the Savings Bank's privatisation to reduce the public debt brought about the reduction of public debt to 55.3 per cent of GDP by the end of 2004. The domestic public debt saw a decline of 2.4 percentage points during 2004, reaching the level of 38.0 per cent of GDP by the end of the year, while the external debt reduced by about 3 percentage points.

Chart II.11 Annual change of budget deficit and its financing structure



Government has intended to orient the domestic debt towards longer maturity terms. Thus, the two-year bonds share in the domestic debt increased from 1.8 per cent in the previous year to 9.2 per cent at the end of the year.

II.5 INFLATION DEVELOPMENTS AND MONETARY POLICY

The Bank of Albania mission, as explicitly provided by the law "On Bank of Albania" is to maintain price stability. In concrete terms, this objective means reaching a low and stable inflation rate measured as annual change of Consumer Price Index. The 2004 inflation was set to be within the two-to-four per cent targeted range¹².

Annual inflation rate remained generally within the targeted band during 2004. Annual inflation stood at 2.2 per cent by the end of the year, while the average annual inflation rate during 2004 was 2.9 per cent. Inflation was maintained to the level of 3 per cent during the first part of the year and, further on, it evidenced a downward trend during the second part, approaching to the lower limit of the targeted band.

Table II 12 Annual inflation rate (in percentage)

	2000	2001	2002	2003	2004
January	-1.3	2.2	6.5	0.0	3.3
February	-1.3	1.5	7.6	1.1	4.4
March	-2.1	2.9	7.5	1.3	4.0
April	-1.4	3.0	6.5	2.3	3.2
May	-0.1	2.5	4.6	2.8	2.6
June	0.1	4.0	3.7	2.6	2.9
July	-1.3	5.6	4.2	3.0	3.1
August	-0.7	4.1	5.5	3.0	2.7
September	0.9	3.5	5.3	2.8	2.0
October	1.8	1.8	5.8	2.9	2.0
November	1.9	2.8	3.7	3.4	2.2
December	4.2	3.5	1.7	3.3	2.2
Average	0.1	3.1	5.2	2.2	2.9

Source: Institute of Statistics

Consumer price developments were favoured by a stable macroeconomic situation during 2004 and no negative developments were experienced on the supply. The fiscal policy followed during 2004 was a prudential policy, maintaining the fiscal indicators within the projected limits.

Also, monetary policy maintained the appropriate monetary conditions for the control of inflation in the economy, despite the easing trend evidenced throughout 2004. On the other side, aggregate supply developments failed generating inflationary pressures in consumer prices. The rise of administered prices of fixed telephony and electricity is compensated by the satisfactory performance of agricultural production. Also, the Lek appreciation versus the American dollar and Euro has contributed to keeping under control the inflationary pressures of imported merchandise prices.

¹² See the Monetary Policy Document, 2004.

II.5.1 INFLATION AND COMPONENT GROUPS PERFORMANCE

The first quarter of the year is characterised by high annual inflation rates. This tendency is attributed to the rise of administered prices of electricity¹³ and fixed telephony¹⁴, as well as to foodstuff price performance. Also, urban service price rise at 32.2 per cent and bread price rise at 11 per cent in February served as incentives for increasing inflation rate. Meanwhile, the second semester evidenced an average annual inflation rate of 2.4 per cent. The inflation fall during this period was mainly due to the abundant supply of agricultural production.

Under the effect of these factors, contributions of main items of consumer price basket in the annual inflation rates, during 2004, were different from the previous years. "Rent, water, fuel, energy" item played an essential role in creating inflation rate during 2004, unlike the previous years when this role was played by "Foodstuffs and non-alcoholic beverages" item.

Price index of "Rent, water, fuel and energy" item evidenced high annual growth rates over 2004. In addition to the energy price rise¹⁵, this item highlighted an increase in the rent price and imputed rent. The considerable share of this item¹⁶ made the fluctuations in the price index be reflected in the overall consumer price index. The contribution of this item in the annual inflation rate ranged between 2.0 and 2.54 percentage points, shaping the annual inflation rate throughout 2004.

Annual change rate of prices in "Foodstuffs and non-alcoholic beverages" item was negative during May-November. The average contribution of this item in the annual inflation during 2004 was – 0.04 percentage points, highlighting a

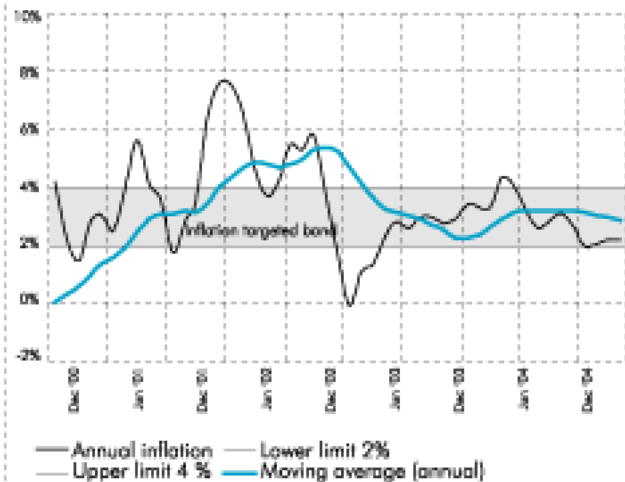
¹³ Electricity price rise by 31 per cent started being calculated in February 2004.

¹⁴ Rise by 68.8 per cent in December 2003.

¹⁵ "Fuel and energy" sub-group marked an average annual inflation of 35 per cent during February-April and 27 per cent for the rest of the year.

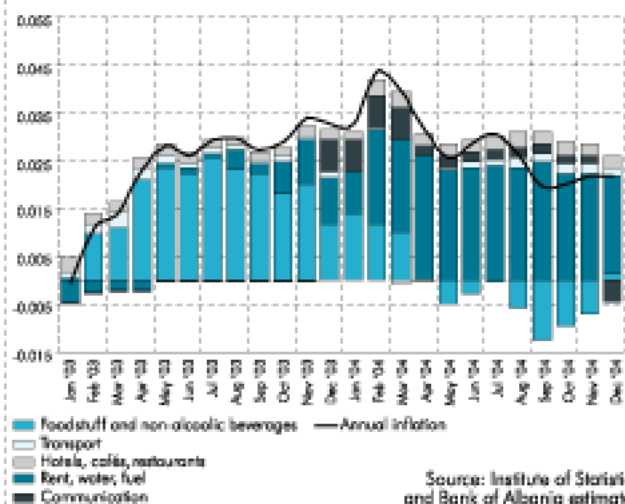
¹⁶ "Rent, water, fuel and energy" group is the second group in terms of size in the consumer basket, representing 24.4 per cent of total consumer expending.

Chart II.12 Annual inflation (in percentage)



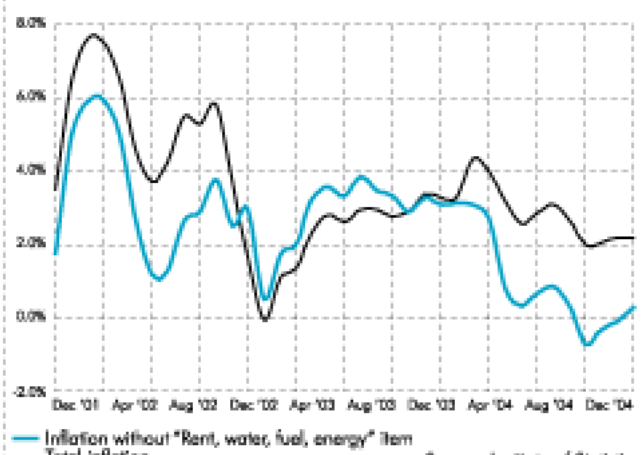
Source: Institute of Statistics

Chart II.13 Contribution of main items of CPI basket (in percentage points)



Source: Institute of Statistics and Bank of Albania estimates

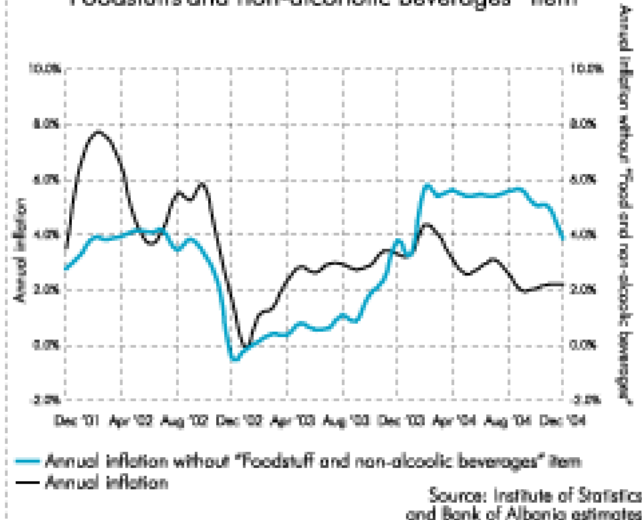
Chart II.14 Annual inflation without "Rent, water, fuel and energy" item



Source: Institute of Statistics and Bank of Albania estimates

visible turning of the trend seen in 2003 when this contribution was 1.75 percentage points. The contribution of this item in the annual inflation rate ranged from 1.4 percentage points (in January) to –1.25 percentage points (in September). The decline in prices of this item during May–November 2004 was due to the growth of domestic agricultural production, including greenhouse production. The most pronounced decline in prices was observed in the most fluctuated items of this group, more specifically in “Fruits and vegetables” item.

Chart II.15 Annual inflation without “Foodstuffs and non-alcoholic beverages” item

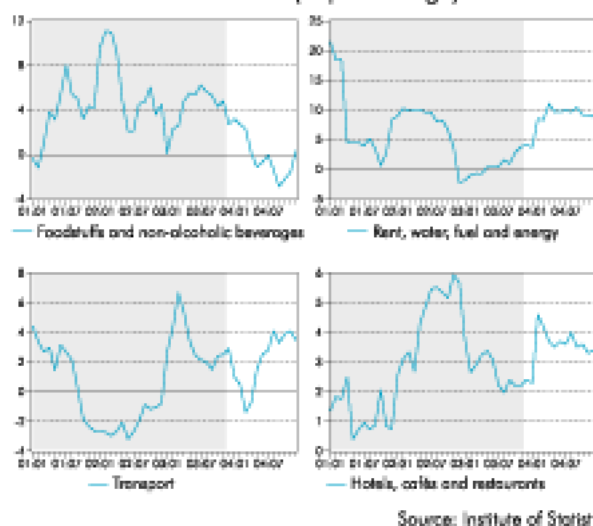


“Communication” item significantly influenced the annual inflation rate during the first part of the year due to the rise of administered fixed telephony prices, regardless of its small share in the CPI basket (1.3 per cent). The fixed telephony prices increased by 68.8 per cent in December 2003 and fell in April 2004. Consequently, the annual inflation rate of this item rose initially to 53.6 per cent and dropped later on to 17 per cent. Therefore, the contribution of this item to overall inflation was respectively 0.7 percentage points during December '03 – March '04 and dropped later on to 0.2 percentage points.

“Transport” item did not evidence a significant price rise over 2004. This item has contributed by an average of 0.1 percentage points to the annual inflation of 2004¹⁷. Although oil constitutes an important factor in creating the price index of “Transport” item (“Services to personal vehicles” sub-item), oil price rise in the international markets failed causing a high inflation of this item and affecting the overall inflation¹⁸.

Except for the first quarter, annual inflation of “Alcoholics and tobacco” item recorded negative rates. Also, “Clothes and footwear” item marked a decline in annual prices, over the whole months of the year. This decline in the final consumer price is helped by the decline of prices in the first trading links. Thus, the CPI in “Clothes and furs industry” item marked an annual decrease of 13.5 per cent.

Chart II.16 Annual inflation of four main items of ICP basket (in percentage)



¹⁷ “Transport” item represents a share of 4.8 per cent in the consumer price basket, while “Services to personal vehicles” sub-item, which measures directly oil price changes, represents about 1.6 per cent.

¹⁸ Another reason of non-disclosure of oil price rise in the overall annual inflation rate is the small share this item occupies in the consumer basket.

The generally non-tradable merchandise prices marked an increase annually. From January to October "Education service" item recorded annual inflation rates ranging between 8.2 per cent and 11.4 per cent, an increase being inherited from November 2003. The group of services having contributed more to annual inflation rate throughout the year was "Hotels, cafés and restaurants" item. This item has contributed by an average of 0.28 percentage points to the annual inflation rate of 2004. "Health services" item has also recorded positive annual inflation rates till October.

II.5.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

The favourable macroeconomic developments experienced during 2004 have provided an appropriate environment for inflation control. Two basic macroeconomic policies, monetary policy and fiscal policy, have contributed towards stabilization of economic activity, without exerting upward pressures on inflation rate.

- Fiscal policy and fiscal indicators

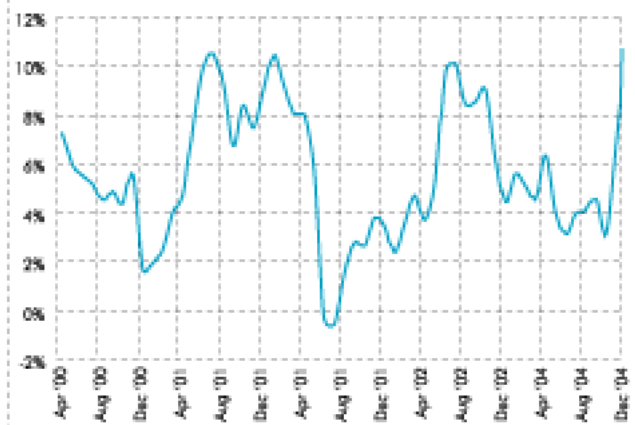
Year 2004 is characterized by a prudent fiscal policy. The budget expenditures resulted within the projected annual level¹⁹, being at the same time characterized by a relatively uniform distribution throughout the year.

Budget deficit was 4.9 per cent of GDP at the end of the year, remaining approximately at the same level as in 2003. Domestic government borrowing, a good measuring instrument of the pressure exerted by fiscal policy on monetary indicators, was 2 per cent of GDP during 2004. This parameter, compared to 2.9 per cent of GDP in 2003, highlights an upturn. Government demand for borrowing has been increasing during the second semester of the year, but without causing any inflationary pressure.

- Monetary policy and monetary indicators

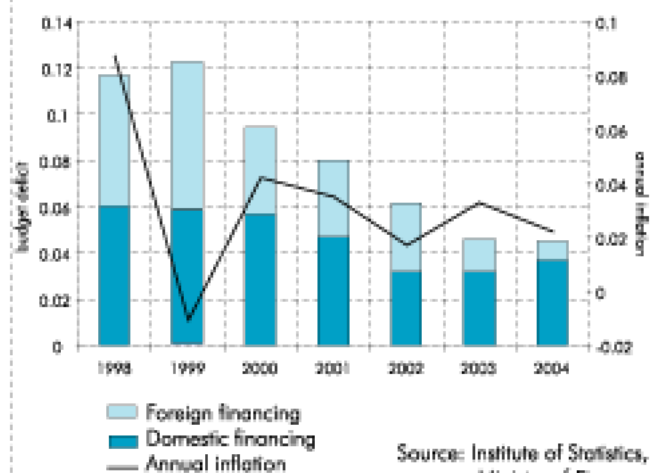
Monetary policy of the Bank of Albania has followed an easing trend during 2004,

Chart II.17 Annual change of cumulative budget expenditures of the last 12 months



Source: Ministry of Finance

Chart II.18 Budget deficit and annual inflation during 1998 – 2004



Source: Institute of Statistics, Ministry of Finance

¹⁹ During 2004 93.2 per cent of revenues and 90.2 per cent of expenditures were performed relative to the plan.

A significant development of monetary indicators during 2004 was also the appreciation of Lek exchange rate. These pressures have been supported during the last two years by the interest rates difference, a difference that has favoured the financial assets in Lek. Lek was appreciated against American dollar and Euro, respectively by 15.7 and 7.2 per cent, also due to the increase of foreign currency supply during 2004. Apart from inflation of partner countries, the imported inflation includes the exchange rate effect, which "translates" the foreign prices into domestic prices. In this context, the strong Lek has further reduced the imports cost, smoothing down the pressures on domestic consumer prices.

Demand factors control was an essential factor in the low inflation performance during 2004. However, this year has known positive developments even in terms of aggregate supply and production costs.

- Performance of domestic agricultural production

Inflationary pressures caused by the rise of some administered prices during the first quarter of the year have been balanced due to a decline in foodstuff prices. The agricultural production marked a satisfactory growth over 2004. The favourable atmospheric conditions and investment growth, mainly for constructing greenhouses helped increase the agricultural production on an annual basis. According to the Ministry of Agriculture data, domestic production increased by 3.8 per cent during this year, compared to a 2.9 per cent increase evidenced in 2003. Greenhouse surfaces increased by 20 per cent compared to the previous year. As a consequence, greenhouse production marked a 12.4 per cent increase compared to the previous year.

Also, the Production Price Index of foodstuffs marked a decline during the first three quarters of 2004 and a pronounced annual decline (23 per cent) during the third quarter. The reduction of foodstuff production costs exerted downward pressures on foodstuff prices, mainly during the third quarter. The food industry, during the nine-month period of 2004, performed sales of 22 per cent higher than the same period of the previous year. While the seasonal decline in foodstuff prices is signalled even in the previous years, the season's effect during 2004 was longer and extended beyond the month of August.

- Imported inflation

The appreciation of Lek exchange rate, accompanied by a stable inflation value in the largest trading partners of Albania, impacted the reduction of the imported inflation value over 2004. Albania is characterised by a relatively open economy. Merchandise imports count for a considerable part of the country's foreign trade and of consumption goods (80 per cent of foreign trade volume for the nine-month period January-September 2004), representing an important transmission channel of inflationary pressures from abroad. Inflation value of the two main partner countries, Italy and Greece, have been low, compared to Albania's inflation rates. Consequently, Albania's trade activity was not subject of imported inflationary pressures.

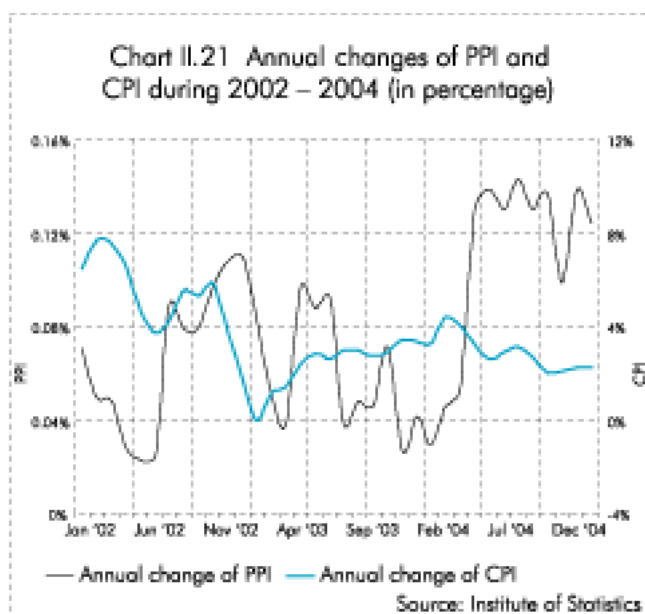
Table II.13 Annual inflation rate of main trading partners (in percentage)

	March	June	September	December
Greece	2.9	3.0	2.9	3.1
Italy	2.3	2.4	2.1	2.4

Source: Eurostat News Release

- Production cost performance

Production Price Index marked high annual growth rates during the nine-month period of 2004. However, the prices of consumption goods according to sectors failed reflecting an increase of production cost. This effect is due to the increasing competitiveness in the Albanian economy, which brought about a lower transmission of production price rise in consumer prices.



- Oil price

Oil price rise in the international market was one of the most important developments over 2004. However, oil price rise in the domestic market was much lower than the one in the international market. (This situation represents an obvious change since March-April 2003, when Iraq war caused a strong oil price rise in the international market and in the domestic one). During 2004 the appreciation of Lek exchange rate against American dollar was the principal factor which smoothed down the effect of oil price rise in the international market.

Other supply factors such as the moderate increase of public sector salaries and the reduction of unemployment rate²⁰ failed causing

inflationary pressures.

The weak inflationary pressures exerted by the fiscal policy, the good-management of money supply, as well as Lek appreciation, created the appropriate conditions for a moderate rise of consumer price during 2004. In general terms, the Bank of Albania believes that this favourable situation will continue to prevail even in the current year. Based on the available data and in the absence of shocks, the consumer price rise is expected to be within the targeted band of the Bank of Albania during 2005.

²⁰ Data are sourced from Institute of Statistics for the third quarter of 2004.

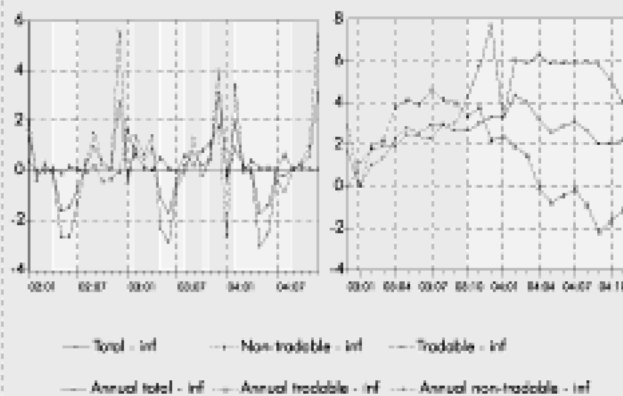
Box II 1 Inflation according to sectors

Discussion on the relatively low inflation in Albania over the last two years would be enriched with more essential theoretical arguments if we examine the inflation change between the sectors of tradable and non-tradable goods. The share of non-tradable goods sector, about 43 per cent of the basket, have increased significantly in comparison with the 1993 basket, where these goods represented less than 15 per cent. The Albanian consumer behaviour has developed generally towards a preference for services. The administered prices knew continuous changes during January 2002 – December 2004 but the transmission of these changes was characterised by a higher intensity from a sector to the other.

These considerations are also verified from the latest research results on inflation targeting in Albania. Thus, inflation rate position during January 2002 – December 2004, according to the tradable and non-tradable goods sectors, has been different from that of the previous years. It is evident that during the referring period the inflation rate in the non-tradable sector of consumer basket remained often

and obviously even for several months above the general inflation rate (see Chart 1). This allowed impacts of this sector on the general level of prices become stronger than in the period before 2001. There were not only the changes in the administered prices of some goods or services but also the strengthening of the indirect correlation in prices of non-tradable goods sector to the tradable sector during this period that have impacted on the trend of the annual general inflation rate (Table 1).

Chart 1 Monthly and annual inflation rates according to sectors



Source: Institute of Statistics and Bank of Albania estimates

Period	1998: 12 - 2001:12			2001: 12 - 2004:12		
	Annual Total Inflation	Annual Tradable Inflation	Annual Non-tradable Inflation	Annual Total Inflation	Annual Tradable Inflation	Annual Non-tradable Inflation
Annual Total Inflation	1.00	0.93	0.17	1.00	0.60	0.80
Annual Tradable Inflation	0.93	1.00	0.13	0.60	1.00	0.38
Annual Non-tradable Inflation	0.17	0.13	1.00	0.80	0.38	1.00

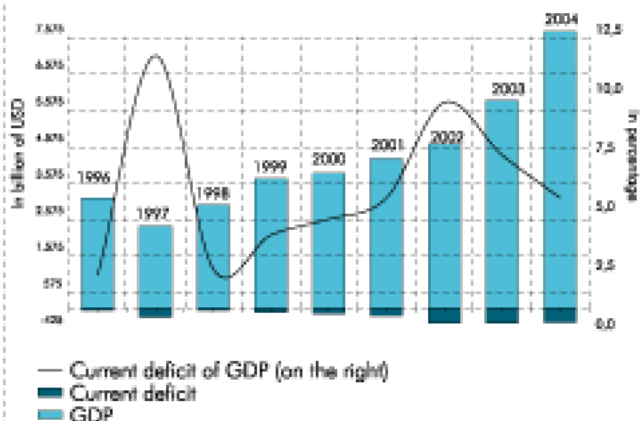
Sectoral inflation features cannot be left out of the effects that transmit to the latter ones the changes of working productivity according to the sectors. Empirical results of the study on the cause-consequence correlation between the effective nominal rate and sectoral inflations suggest that for the period 2002:0-2004:12 the most pronounced change of prices in the non-tradable goods sector relative to that of tradable goods has affected the exchange rate with a four-month delay. This observation serves as an important argument to explain the fact that the strengthening of domestic currency, especially in the last two years, is also influenced by the structural regulations of the Albanian economy. A stable growth of working productivity in the tradable goods sector for a considerable period, as revealed by the sectoral payment data (ASN, INSTAT 2003), has led to the increase of difference between the two sectors productivity, being transmitted in the overall inflation through the inflation of non-tradable goods sector.

Tabelë 1 Box 1. Matrix of linear correlation coefficients

II.6 BALANCE OF PAYMENTS

The favourable economic situation in the country is also reflected in foreign transactions. Current deficit reduced to 5.3 per cent of GDP from 7.1 per cent in 2003. The improvement of current deficit position is impacted by the significant improvement of trade balance. Trade deficit (goods and services) is estimated at 21 per cent of GDP, being reduced by 4 percentage points compared to the previous year. Net capital flows amounted to a record level of USD 530 million, rendering the current deficit financing completely possible. These flows led to a considerable growth of foreign reserve, which reached USD 1,374 billion by the end of 2004. Albania's foreign reserve is sufficient to cover about 5.2 months of imports of goods and services. Albania's external debt stock²¹ grew to USD 1.674 billion at the end of the year, being equivalent to 22 per cent of GDP from 25 per cent in 2003.

Chart II.22 Current deficit (as a percentage of GDP)



Source: Bank of Albania and International Monetary Fund

While evaluating the results of this analysis, we have to consider the fact that an important part of the growing transactions volume reflects the annual rate of depreciation of the reporting currency exchange rate – US dollar versus Euro (7.7 per cent) and versus Lek, the domestic currency, (15.7 per cent), resulted in 2004. Due to exchange rate fluctuations and given that most of transactions between residents and non-residents are made in Euro²² and not in the currency in which balance of payments is reported, analysis of current developments should provide for this effect.

II.6.1 CURRENT ACCOUNT

Year 2004 is characterized by an intensive activity conducted in the external sector of the country, reflected in a considerable growth of current income and expenditures. Current transactions volume increased by 24 per cent compared to 2003, amounting to USD 6.2 billion. More than 96 per cent of current expenditures were intended to purchase goods and services from non-residents. Current transfers have supplied about 40 per cent of current income, while services and exports of goods have supplied 33 per cent and 21 per cent, respectively. Current deficit during this year displays a slight decrease compared to the previous year, amounting to USD 404 million and being equivalent to 5.3 per cent of GDP. The deepening of trade deficit in goods and services was partially balanced by the growth of net incomes in transfers and income accounts. Exports of goods have shown a satisfactory performance, regardless of the appreciation of Lek exchange rate.

²¹ It includes public and private debt.

²² According to the General Department of Customs, about 57 per cent of transactions for imports of goods are made in European currency, Euro, 39 per cent in USD and about 4 per cent in other currencies.

Although the annual growth rate of exports was higher than that of imports, the extremely large share of imports enabled the trade deficit increase by about USD 255 million or by 19 per cent.

During 2004 services account marked an increase in terms of income and expenditures. Income increased more than expenditures compared to 2003. Net result of transactions in services brought about a reduction of deficit of this account by about USD 59 million. The positive balance of current inflows as current transfers and income is estimated at about USD 200 million higher than in the previous year. This growth has come as a result of current income increase in the form of emigrants' remittances, while the considerable decrease of income from investment interests of the resident units abroad made the positive balance of income account become USD 2.2 million lower than the balance in 2003.

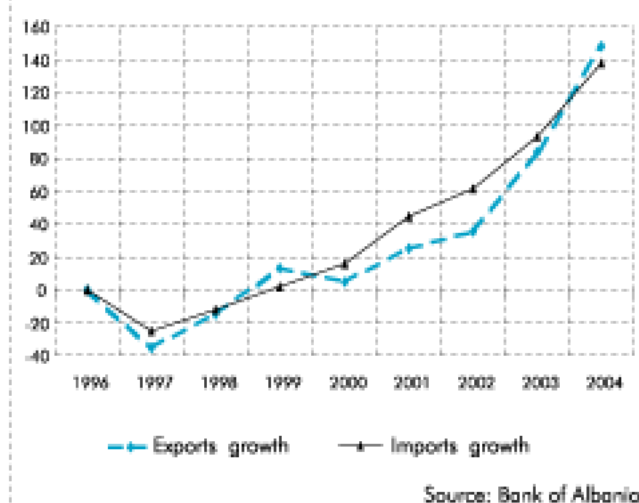
	2002	2003	2004	Change (%) 2004/2003
Current Account (1+6)	-420.8	-406.7	-404.2	-0.6
1. Goods, services and income (2+5)	-1,034.0	-1,248.6	-1,447.4	15.9
1.1 Credit	1,062.2	1,361.6	1,740.6	27.8
1.2 Debit	-2,096.2	-2,610.3	-3,187.9	22.1
2. Goods and services (3+4)	-1,160.4	-1,419.0	-1,615.5	13.9
2.1 Credit	915.3	1,166.9	1,544.1	32.3
2.2 Debit	-2,075.6	-2,585.8	-3,159.6	22.2
3. Goods	-1,155.1	-1,336.3	-1,591.6	19.1
3.1 Credit (f.o.b.)	330.2	447.2	603.3	34.9
3.2 Debit (f.o.b.)	-1,485.4	-1,783.5	-2,194.9	23.1
4. Services	-5.2	-82.7	-24.0	-71.0
4.1 Credit	585.0	719.7	940.7	30.7
4.2 Debit	-590.3	-802.4	-964.7	20.2
5. Income	126.3	170.3	168.2	-1.3
5.1 Credit	146.9	194.8	196.5	0.9
5.2 Debit	-20.6	-24.4	-28.3	15.9
6. Current transfers	613.2	841.9	1,043.2	23.9
6.1 Credit	671.7	924.2	1,134.1	22.7
6.2 Debit	-58.5	-82.3	-90.9	10.4

Table II.14 Current account Items (USD millions)

- Merchandise trade

Trade transactions during this year represent more than 45 per cent of current exchanges of Albania with the rest of the world. The total trade volume was USD 2.8 billion, marking an annual growth of 25 per cent compared to the previous year. Denominated in Euro, the exports growth rate has been almost two times higher than the imports growth rate. Income from exports of goods amounted to USD 603 million, being 35 per cent higher than the one of the previous year. Denominated in Euro, exports marked an annual growth of 23 per cent. The ameliorative signs of the European economy, the main trading partner of Albania, as well as the structural changes within the country, seem to give the desired effect. Despite the worsening in terms of competitiveness²³, export of goods is characterized by a promising growth over the last two years. The contribution of exports to GDP during this year is estimated at 7.9 per cent.

²³ Calculated as a change of annual averages, the real exchange rate was evaluated at 7.3 per cent during 2004, marking a turning of depreciation trend during 2003.

Chart II 23 Exports and Imports Growth
(Index 1996=100)

The coverage level of imports by exports was 27.5 per cent in 2004, marking a slight increase relative to the level of 25 per cent reached in the previous year. However, the Albanian economy continues to be an import-oriented economy, where imports represented 78 per cent of foreign trade volume during 2004. Expenditures for imports of goods are estimated at about USD 2.2 billion. The nominal annual growth of USD 411 million or 23 per cent (12 per cent in Euro) shows that this year too followed the pronounced upward trend that has characterized imports throughout 2000. The 2004 trade deficit amounted to about USD 1.6 billion, being 19 per cent higher than the one of the previous year. Trade deficit position to GDP is deemed to have improved, being 21 per cent from 23.4 per cent in the previous year. Imports

attained the level of 28.9 per cent of GDP during this year. The reduction of the domestic needs for electricity, stimulated by favourable atmospheric conditions, as well as the improvement of distribution network and the good-management of electricity, accompanied by a prudential fiscal policy, have impacted on the improving net trade position to GDP.

Table II.15 Exports/imports distribution by groups of merchandise²⁴
(USD millions)

Code	Description	Imports	Exports	Trade balance
0	Live animals and animal products	331,3	24,8	(306,51)
1	Beverages and tobacco	76,1	9,4	(66,79)
2	Raw material	73,0	23,0	(50,02)
3	Fuel	176,6	16,2	(160,35)
4	Vegetable and animal fat and oil	33,0	0,3	(32,65)
5	Chemical products	207,1	3,5	(203,57)
6	Manufactured articles	531,8	126,9	(404,89)
7	Machinery and equipment	538,4	23,7	(514,66)
8	Miscellaneous manufactured articles	312,6	375,4	62,79
9	Unclassified articles	-	-	-
	Total	2.280,0	603,3	(1.676,65)

Notwithstanding the positive developments that have characterised the exports of goods during this year, its structure continues to have a low degree of diversification. Yet, there is no evidence of marketing strategies of the Albanian businesses towards foreign markets. This allowed exports, for the most part, be represented from exports of textile products and footwear²⁵, of mineral and agricultural products, mainly medical plants. Thus, even this year the performance of exports of goods was considerably determined by the changes in the domestic processing industry. Exports of this category have performed about 75 per cent of annual income in exports of goods. However, the growth of exports from the domestic production mainly with regional markets, stimulated by free trade agreements in the region, is promising. By an annual growth of about USD 48 million, this amount raised the representation level of total exports to 25 per cent, from 23 per cent it was in the previous year.

²⁴ According to the SITC classification.

²⁵ Processed goods for exports from foreign businesses that conduct their activity in the country.

Demand for imports remains high. It's a positive fact that annual imports growth is considerably caused by the imports growth in machinery and equipment as well as in vehicles. Imports of these categories raised their representation level to 24 per cent of total expenditures for imports during this year from 21 per cent in the previous year. The high demand of the private sector for capital goods is a positive indicator for the investment level, the renovation of technological basis and for its productivity. The most advanced sectors in terms of renovation of technological basis are information technology and communication and construction industry. Raw material imports for the domestic active processing industry, mainly focused on textile sector, footwear and metals, grew by about 13 per cent. Imports expenditure of this category represents about 17 per cent of total imports expenditure performed during 2004. The performance of these imports reflects the developments noticed in the re-export sector.

Notwithstanding the significant depreciation of American dollar, oil price rise in the international market maintained fuel imports expenditure high. The domestic demand for these imports remains high, even though it marked a slight decrease compared to the previous year. The imported quantity throughout 2004 is estimated at 2.4 per cent lower than in 2003, while due to the price rise, annual fuel imports expenditure climbed by around 15 per cent. The positive performance of domestic electricity production during 2004 brought about a decrease of electricity imports compared to the previous year.

By absorbing 90 per cent of total exports, the European Union remains the main destination of the Albanian products. Sales in the European markets have recorded an annual growth of USD 215 million or 30 per cent compared to the previous year. However, this market has lost ground in the favour of market expansion in the countries of the region. With the free trade agreement with Moldavia, which entered into force in November 2004, Albania has completed the bilateral framework of Free Trade Agreements in the region. Exports with the South East European countries involved in the process of establishing the free trade zone (SEE-7) increased 2.3 times compared to the previous year, enlarging the Albanian exports market in this area from 4.3 per cent to 8.3 per cent of total exports. Kosovo and Macedonia represent the largest market for exports of the Albanian products. Also, trade with Turkey is seen as the one showing interest in the Albanian products. Total sales with this country increased from USD 3.7 million to USD 11.3 million in 2004.

Exports	Share on total exports			Change (2004/2003)
	2002	2003	2004	%
Total	100,0	100,0	100,0	34,9
EU countries – 15	92,1	93,3	89,9	30,1
Italy	71,7	74,9	73,1	31,6
Greece	12,8	12,9	12,0	25,7
Germany	5,5	3,4	3,1	23,2
Southeastern European countries	3,8	4,3	8,3	301,5
Of which:				
Former – Yugoslavia	2,2	2,6	4,9	155,0
FYROM	1,5	0,7	1,2	140,0
Other countries	4,1	2,4	1,8	0,6

Table II.16 Exports distribution by trading partners and annual change for 2004

As far as imports are concerned, their trade geography represents a greater variety of markets. The European Union supplies about 65 per cent of the domestic needs for imports. Total imports in this group (USD 1.5 billion) increased by about 17 per cent compared to the previous year). Italy and Greece remain the main trading partners of Albania. Imports from both countries represent 79 per cent of the Albanian economy expenditures in the European Union markets. Imports with the South East European countries involved in the process of establishing the free trade zone (SEE-7) have evidenced a moderate growth. Imports in this group increased by about 7 per cent, while the ratio of these imports to total imports declined to 5.4 per cent from 6.1 per cent recorded in 2003.

Table II.17 Imports
distribution by trading
partners and annual change
for 2004

Imports	Share on total imports			Change [2004/2003]
	2002	2003	2004	%
Total	100.0	100.0	100.0	22,8
EU countries* – 15	71,1	68,3	65,0	16,8
Italy	34,7	34,1	32,6	17,4
Greece	21,9	19,8	18,6	15,4
Germany	5,6	5,7	6,2	33,7
Southeastern European countries	7,1	6,1	5,4	6,9
Bulgaria	1,9	2,2	2,0	11,6
Bosnia & Herzegovina	0	0,1	0,1	22,8
Croatia	2,2	1,5	1,3	6,4
Former – Yugoslavia	0,8	0,6	0,6	22,8
FYROM	1,1	0,9	1,0	36,4
Romania	1,1	0,9	0,4	-45,4
Turkey	6,1	6,5	7,1	34,1
Russia	2,6	2,9	2,8	18,5
Ukraine	1,2	2,3	2,5	33,4
Other countries	11,9	13,9	17,1	51,0

* In May 2004 ten new countries joined the European Union (Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Cyprus, Czech Republic, Slovak Republic and Slovenia), enlarging the group to 25 Member States. For analysis purpose, in the European Union group are not included the new member states

- Services

During 2004 net exports of services were estimated at –24 million USD, being much lower than the value of –82.7 million USD recorded at the end of 2003. Income from exports of services grew by 31 per cent during this year, while expenditures by 20 per cent compared to 2003. Movements in service account are significantly influenced by “tourism” item whose positive balance is about three times higher than in the previous year. According to the Bank of Albania estimates, exports in tourism have generated USD 670 million as income inflows or nearly 11 per cent more than exports of goods. Despite the effect of fluctuations in the exchange rate EUR/USD, considering the fact that payments for tourism services are mainly made in Euro²⁶, the increased number of foreigners and emigrants who have visited the country and the slight increase of their daily expenditures have also influenced the annual income growth from tourism. During 2004 the number of foreigners who visited Albania increased by 16 per cent compared to 2003. Tourist inflows from Kosovo, Macedonia and Montenegro have been particularly

²⁶ According to the Bank of Albania estimates the total inflows include about 80 per cent of income in Euro (including nationals coming from the EU countries as well as from Kosovo and Montenegro).

increasing. Albania's residents have spent for their out-of-country tourism about USD 560 million or 58 per cent of total emigrants' remittances. A growth of daily expenditures from Albanians abroad is revealed, particularly for business purposes, which has affected the growth of total expenses for travel services. Transport services and insurance services in general follow the developments in the trade of goods. The growth of imports volume led to the growth of service imports for these categories. Simultaneously, the growing participation of the resident transport companies providing services in foreign trade has considerably raised the income of this category. However, deficits in transport and insurance services increased by the end of the year compared to the previous year. During 2004 five new insurance companies are introduced in the Albanian insurance market, which indicates the rising demand for this service.

"Other services" category has recorded a deficit of USD 11 million, remaining almost at the same level as in the previous year. The deficit of this year has been caused mainly as a result of the growth of government expenditure deficit and also of the deficit growth in cultural and business service categories. Meanwhile, a significant growth is evidenced in the income from telecommunication service category, which is closed with a positive balance of USD 54 million from USD 27 million recorded in the previous year. The growth in the income of this category, which is expected to continue at a higher pace in the future, was attributed to the extension of the range of products provided by the telecommunication entities.

Despite the growth in the volume of transactions of goods and services during 2004, the indicator of the economic openness of Albania²⁷ was falling. This year the economic openness of Albania reached the level of 62 per cent from about 66 per cent in 2003. Although Albania, thanks to the economic growth of 6 per cent for the second year in succession, is estimated as one of the fastest-developed economies in the region, the degree of economic openness still leaves room for improvement in comparison with the countries of the region.

- Income and current transfers

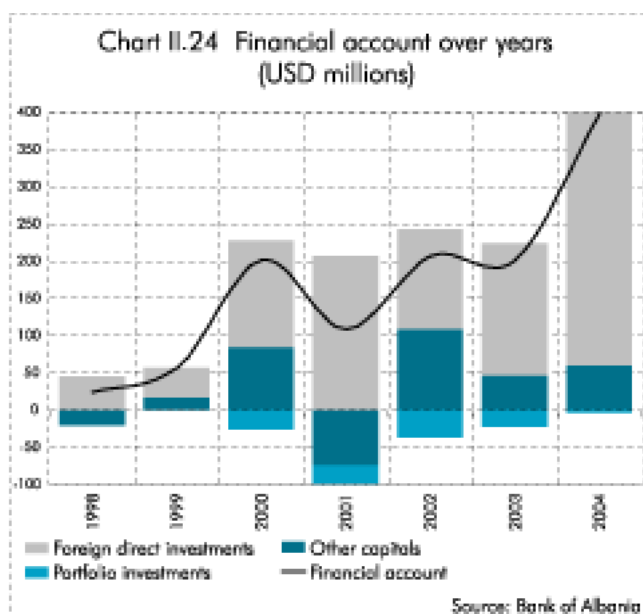
Income account has ended the year with a positive balance of USD 168 million. The reduction of net income inflows by USD 2.2 million, compared to the previous year, was mainly due to the fall of income as investment interest. Meanwhile, net income inflows from work grew by about USD 14 million. Income from work, which is estimated as a part of emigrants' remittances, presuming that a part of general number of emigrants is classified in the category of seasonal or border workers, represents 72 per cent of the positive balance of income account. Due also to the rising demand for labour force in Greece during the organization of the 2004 Olympic Games, income in this category highlighted an increase and amounted to USD 125 million. Current transfers, like in the previous years, have been shaped from emigrants' remittances. During 2004 remittances are estimated at USD 792 million,

²⁷ Calculated as a ratio of trade volume in goods and services against GDP.

being 25 per cent higher than in the previous year. Given that for the most part these transfers are denominated in Euro, the annual growth is partly attributed to the strong influence of American dollar (the reporting currency) depreciation versus the origin currency of remittances – Euro – during 2004 compared to the previous year. Emigrants' remittances represent an important source that supports the Albanian economy, providing a continuous flow for financing the current deficit. Total emigrants' remittances represent about 13 per cent of GDP for 2004. Transfers contribution to the easing of trade deficit is estimated at 61 per cent. Emigrants' remittances have been also accompanied by government transfers, mainly as technical assistance (USD 46 million), being estimated towards a fall (9 per cent).

II.6.2 CAPITAL AND FINANCIAL ACCOUNT

During 2004 capital movement recorded a net capital inflow of about USD 530 million, covering the total needs for the financing of the current deficit and contributing to the growth of foreign reserves. Capital transfers amounted to USD 132 million or USD 25 million less than the year-end of 2003, while financial account was closed with a positive balance of about USD 400 million.



Capital imports, mainly performed through absorbing foreign direct investments and extending long-term credits and loan facilities from abroad, brought about an increase of Albania's financial liabilities to the rest of the world, by USD 558 million. This amount is estimated at 70 per cent higher than the balance of the previous year. Foreign direct investment inflows amounted to USD 340 million. These capital flows have turned into a dominant factor in building up financial liabilities and in the performance of capital and financial transactions. During this year they are sourced mainly from the privatisation of the banking system. Foreign direct investments are estimated as an important source for covering the current and fiscal deficit (in case foreign direct investments derive from privatisation). Also, compared to other financing capacities,

foreign direct investments allow the transfer of technology and dissemination of knowledge, contribute to the opening of new job opportunities, help the domestic companies participate in foreign markets, etc.

During the last decade, the privatisation of strategic sectors has been the factor that determined the magnitude and the character of foreign investments in the country. Although Albania presents relatively less restrictions to foreign investors activity relative to other South East European countries, it seems to have absorbed less direct investments in comparison with the countries of the region.

Another important factor in adding up Albania's financial liabilities relates to the extension of long-term credits and soft credits from abroad. As a result of the new loan extended during 2004, Albania's financial liabilities increased by USD 230 million. This includes also the use of loans and credits of USD 12 million from IMF. About one-third of total credit is used by the private sector. External debt service in the form of payments of principal totalled to USD 48 million during the year. Financial liabilities as deposits of non-residents in our banking system increased by USD 23 million. This increase is reflected also in the rise of imports during 2004.

Albania's financial claims to the rest of the world increased by about USD 160 million or 27 per cent more than in the last year. The major contribution has come from the growth of foreign assets as deposits of resident units abroad. These high deposit inflows from inside to outside have come from the conversion of "Raiffeisen" bank's capital and from a restructuring of investment, being transferred from portfolio to deposits. Foreign assets owned by the banking system in the form of foreign deposits grew by about USD 90 million. Around 60 per cent of these assets are denominated in US currency while the rest are in Euro. As regards cash foreign assets, the last quarter of the year experienced a considerable growth. Assets denominated in Euro represent the majority or about 70 per cent of cash foreign assets. Cash foreign assets in US dollar account for 26 per cent, while in British pound 3 per cent and in Swiss franc 1 per cent.

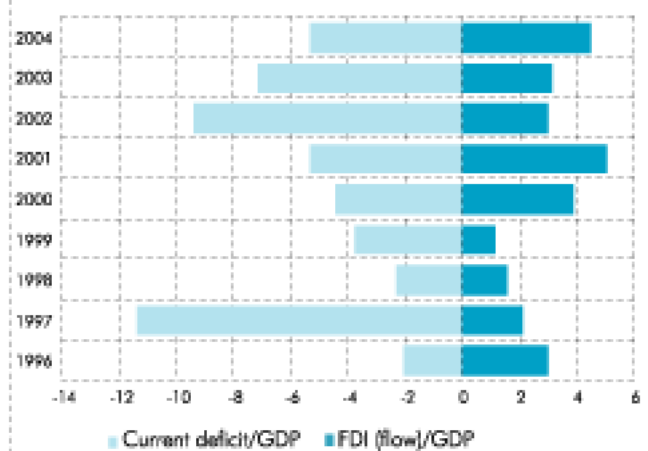
Stock of financial assets as portfolio investments amounted to USD 146 million, revealing an annual growth of USD 3.6 million. During 2004, in the structural composition as per currencies, investments in Euro account for about 70 per cent of total investments.

Meanwhile, the continuous depreciation of US currency during the last two years made the debt security in US dollar be less preferred. Stock of portfolio investments in these securities was about 28 per cent of total value at the end of 2004, marking a significant decline from the level of 84 per cent recorded at the end of 2003.

II.6.3 FOREIGN RESERVES

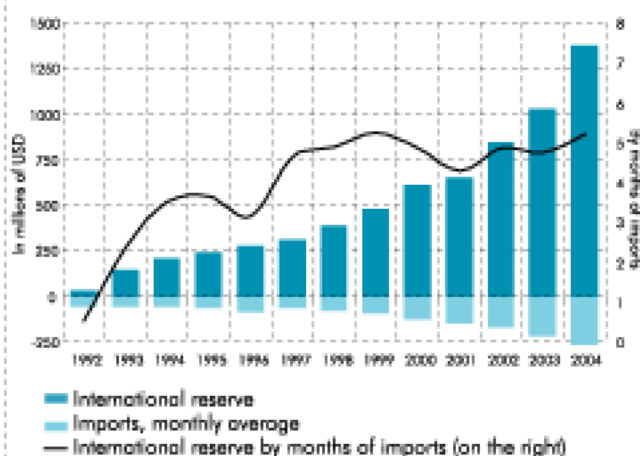
Foreign assets inflows as financial capital influenced the growth of foreign reserves of the monetary authority by USD 350 million. Foreign reserves amounted to USD 1.374 billion by the end of 2004. This level of reserves is considered sufficient to cover nearly 5.2 months of imports of goods and services.

Chart II.25 Financing of current deficit through foreign direct investments



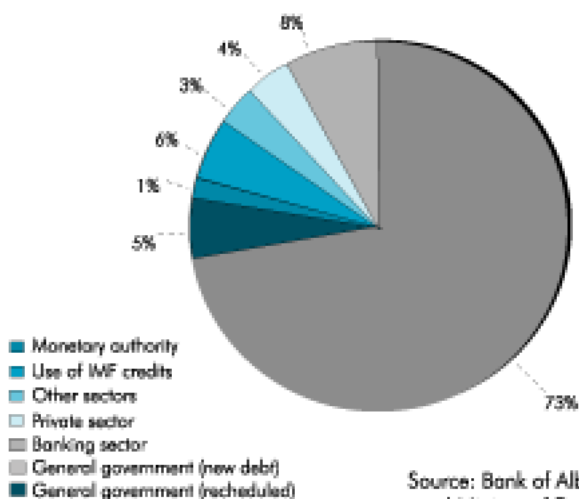
Source: Bank of Albania and International Monetary Fund

Chart II.26 Foreign reserve performance
(in months of imports)



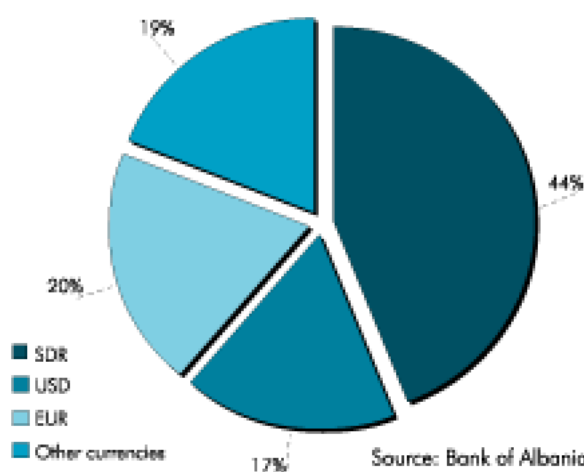
Source: Bank of Albania

Chart II.27 External debt structure
(as per debit sectors)



Source: Bank of Albania and Ministry of Finance

Chart II.28 External debt structure
(as per currencies)



Source: Bank of Albania and Ministry of Finance

II.6.4 EXTERNAL DEBT

At the end of 2004, Albania's external debt²⁸ increased by USD 220 million or 15 per cent compared to the year-end of 2003, totalling USD 1.674 billion. At present, external debt is estimated at 22 per cent of GDP, being about 3 percentage points lower than in 2003. According to the statistical data, government borrowing occupies the major share in the external debt position. Albanian Government's external debt is estimated at USD 1.299 billion at the end of 2004, representing around 78 per cent of total external debt. Albanian Government's new debt increased by USD 155 million, totalling USD 1.214 billion. Year 2004 marked a significant increase in terms of private sector debt. By an annual increase of USD 43 million, private sector debt has raised the representation level to total debt by 3 percentage points and contributed by 20 per cent to the total growth of external debt relative to the last year. Also, with the increase of foreign borrowing the representation level of the banking system in the total external debt of the country increased as well. This increase has mainly financed the economy consumption, influencing the growth of consumption imports. It has financed as well the needs for capital and/or capital goods of the companies. Monetary Authority debt is estimated at USD 120 million, of which USD 96 million have been used as loans from the Fund (IMF). In the other sectors²⁹ the debt stock is estimated at USD 54 million and increased by 23 per cent compared to 2003.

Data on government debt, which represents to a large extent Albania's external debt with the world, suggest that net transactions have contributed by USD 107 million or 69 per cent to the growth of USD 154 million, while the rest (about 30 per cent) was the result of exchange rate fluctuations. External debt structure as per currencies is dominated by SDR (about 56 per cent), followed by the European currency (12 per cent), US currency (11 per cent) and other currencies.

²⁸ This statistical item does not include the liabilities arising for foreign direct investments.

²⁹ This includes companies such as Albtelecom or Albanian Electro-Energetic Corporation, and Albanian Government being responsible for their debt.

The improvement of export capacities enhances the confidence in the administering ability of external debt. Moreover, a positive development for the country during 2004 was the fourth Memorandum signed in July with the International Monetary Fund for supporting poverty reduction and economic growth (PRGF).

II.7 FOREIGN RESERVE AND ITS ADMINISTRATION

Bank of Albania's foreign reserve grew by USD 348.63 million or equal to 34 per cent during 2004, totalling USD 1.37 billion by the end of the year.

During 2004 gross foreign reserve inflows of the Bank of Albania amounted to USD 562.39 million. The main sources of foreign currency inflows are presented below:

- privatisation inflows estimated at USD 138.46 million;
- disbursement of the loans extended from International Monetary Fund and International Development Agency (IDA), summing at USD 80.57 million;
- purchase of foreign currency from commercial banks and Ministry of Finance at USD 284.22 million;
- required reserves sediment from commercial banks to Bank of Albania totalling USD 34.14 million;
- income from the investment of foreign reserves during 2004 is estimated at USD 23.64 million.

Purchases of foreign currency from Ministry of Finance, whose most part relates to the use of funds from the Savings Bank's privatisation, as well as purchases from commercial banks in the context of Bank of Albania intermediation in the domestic foreign exchange market, are considered as the factor that has, like in the previous year, the most important impact in terms of foreign currency inflows.

Debits of foreign reserves during the year amounted to USD 275.18 million, consisting of USD 218.85 million transfers ordered by Ministry of Finance and commercial banks and USD 56.33 million instalments of government external debt.

Exchange rate fluctuations of the currencies that compose the foreign reserve have provided a positive significant effect over 2004, being estimated at USD 60.35 million.

Balance of payments (USD millions)						
	1999	2000	2001	2002	2003	2004
Current account	-132.9	-163.1	-217.9	-420.8	-406.7	-404.2
Merchandise: exports, fob	275.1	255.4	304.6	330.2	447.2	603.3
Merchandise: imports, fob	-937.9	-1,076.4	-1,331.6	-1,485.4	-1,783.5	-2,194.9
Trade balance	-662.8	-821.0	-1,027.0	-1,155.1	-1,336.3	-1,591.6
Services: credit	266.7	448.1	533.5	585.0	719.7	940.7
Services: debit	-165.4	-430.0	-444.2	-590.3	-802.4	-964.7
Income: credit	85.6	115.9	162.5	146.9	194.8	196.5
Income: debit	-10.3	-9.1	-13.4	-20.6	-24.4	-28.3
Private unrequied transfers	188.4	438.6	542.6	575.0	781.7	977.8
Official unrequied transfers	165.0	94.4	28.1	38.2	60.3	65.4
Capital account	67.5	78.2	117.8	121.2	157.0	132.3
Financial account	36.8	182.5	97.0	201.6	190.9	386.9
Direct investments	41.2	143.0	207.3	135.0	178.0	341.3
Portfolio investments	0.0	-25.0	-23.4	-36.8	-22.5	-3.6
Other capital*	-4.4	64.5	-86.9	103.4	35.3	49.3
Net errors and omissions	131.3	15.0	136.1	121.3	147.4	161.3
Overall balance	123.6	131.9	145.0	28.6	99.6	288.3
Reserve and related items						
Reserve assets	-123.6	-131.9	-145.0	-28.6	-99.6	-288.3
Use of fund credit and loans	20.9	19.3	12.0	5.3	11.1	11.9
Memorandum items						
Total change in reserve assets	-97.4	-130.6	-131.0	-97.1	-178.0	-343.0
of which: change due to exchange rate	-26.2	-1.3	-14.0	68.5	78.4	54.8

* / * / Use of fund credits and loans is not included
Source: Bank of Albania

Table II 18 Balance of
payments
(USD millions)

CHAPTER III. MONETARY DEVELOPMENTS AND MONEY MARKETS

III.1 MONETARY PROGRAM AND QUANTITATIVE OBJECTIVES

Monetary policy strategy of the Bank of Albania forecasts the monetary aggregate control as an intermediary instrument for meeting the price stability target. In compliance with this strategy, the Bank of Albania compiles annually the monetary program, which constitutes the basic scenario of economic and monetary developments within one year. In accordance with expected economic developments, the monetary program serves to orient the monetary policy towards maintaining appropriate monetary conditions for meeting the inflation target.

On this basis, the objective of money supply growth for 2004 was set at the level of 12.4 per cent. This growth was deemed to be sufficient to satisfy the economy demand for money under the conditions of an economic growth of 6 per cent and an inflation rate within the 2-4 per cent targeted range. The structure of funds utilization during 2004 was forecasted to shift in the favour of the private sector. This would be expressed in the increased weight of credit to the economy to domestic credit. Given the continuation of the easing tendency of monetary policy, the main program forecasts on money supply structure consisted in stabilizing the ratio of currency outside banks to M3 and in increasing the weight of foreign currency deposits to money supply.

Monetary developments over 2004 confirmed the basic monetary program assumptions. The values of monetary indicators at end of the year were generally in accordance with monetary program projections. The main deviations belong to larger money supply growth and larger value of currency outside banks to M3 ratio than the forecasts.

	Program	Actual	Change
Currency outside banks	135.6	138.1	2.5
ALL deposits	252.7	255.0	2.3
Foreign currency deposits	110.2	110.0	-0.2
M1	158.6	170.1	11.5**
M2	388.3	393.1	4.8
M3	498.4	503.1	4.6

* The values of indicators are accrued based on the "Standard of Monetary Statistics"
 ** The M1 deviation from the program value is due to deposits reclassification by the Raiffeisen Bank

Table III.1. Aggregates vis-à-vis the program (ALL billions)*

In December the annual M3 growth reached to 13.4 per cent, exceeding the projected annual growth by 1 percentage point. This was due to growth of economy demand for money, as a result of the consolidation of public confidence in macroeconomic stability and banking system. So, credit to the economy increased by ALL 19.4 billion, from ALL 16.5 billion projected. Also,

the use of a part of income from Savings Bank's privatization¹ for financing capital expenses impacted on money supply growth. The increased demand for monetary assets received mainly the form of demand for monetary balances in ALL, dictating the need for a higher growth of M2 aggregate. The demand for domestic currency was particularly obvious in summer, being also associated with appreciating pressures of ALL exchange rate. Most of foreign currency inflows of this period were oriented towards monetary assets in ALL, as a result of attractive interest rates of ALL deposits. The increased demand for ALL was partly met through liquidity injection by the Bank of Albania intervention in foreign exchange market².

Though the interest rates were falling, the ratio of currency outside banks to money supply during 2004 stood at low historical levels. The households' savings were channelled more and more into the banking system, due to increased confidence in it. The Bank of Albania interventions in the foreign exchange market, in the presence of a higher seasonal effect in December, brought about a rise in the ratio of currency outside banks to M3. The value of this indicator at end of the year marked the level of 27.5 per cent, from 27.2 per cent projected in the program. However, this rise is estimated as a temporary development; the indicator of currency outside banks is expected to turn back to its downward trend during the current year.

The monetary policy of the Bank of Albania and its operations in money market and in foreign exchange market enabled the observance of quantitative objectives. Also, the borrowing operations of the government were within the projected limits, thus creating necessary space for the Bank of Albania to successfully manage the liquidity.

Table III.2. Meeting quantitative objectives of the Bank of Albania

	Dec '03	March '04	June '04	Sept '04	Dec '04
Net foreign reserve of the Bank of Albania (US\$ millions)					
Objective	715.8	751.8	765.8	923.7	941.7
Actual	832.7	827.6	961.5	1044.6	1105.2
Difference	116.8	75.8	195.7	121.1	163.5
Net domestic assets of the Bank of Albania (ALL billions)					
Objective	96.0	83.0	85.0	70.0	79.0
Actual	72.0	66.4	54.7	55.4	61.0
Difference	-24.0	-16.6	-30.3	-14.6	-18.0
Net domestic credit to government (ALL billions)					
Objective	266.8	274.1	270.1	279.1	286.4
Actual	266.8	273.9	263.6	271.5	286.1
Difference	0.0	-0.2	-6.5	-7.6	-0.3

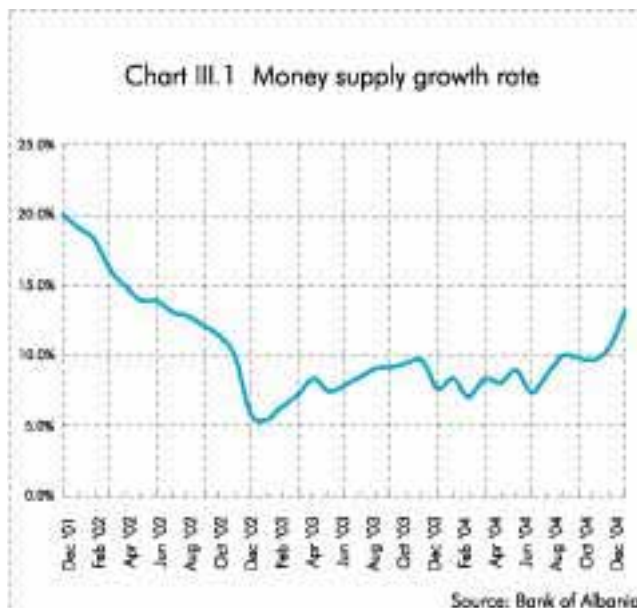
¹ The government destined half of the Savings Bank's privatization funds (USD 126 million) for the growth of capital expenditures. Next half was used for settling the domestic debt and did not impact on money supply growth.

² Also the presence of the Raiffeisen Bank in the market, converting its capital into euro was in the same direction with the foreign currency interventions of the Bank of Albania.

III.1 DEVELOPMENTS IN MONEY SUPPLY

Monetary developments during 2004 reflected the positive macroeconomic developments and the Bank of Albania's smoothing monetary policy. Money supply was increased by about 13 per cent, being based on the rise of economic activity and on the slight reduction of money velocity. The money supply level enabled the meeting of economy demand for liquid assets, without infringing the observance of inflation target.

Money supply components reflected similar growth rates during 2004, without causing any essential changes³ in the time structure or in the foreign currency one.



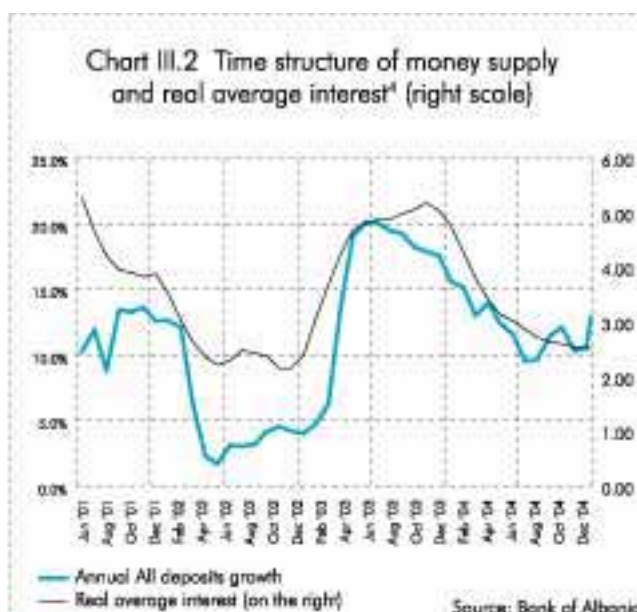
	Annual growth rate (in %)			Level 2004
	2002	2003	2004	
Currency outside banks	9.8	-4.3	10.3	138.1
Total deposits	4.2	13.1	14.2	369.1
- ALL deposits	4.1	15.7	12.9	253.3
- Foreign currency deposits	4.2	7.6	17.1	115.8
M1	6.8	-5.2	19.4	172.8
M2	6.4	7.6	12.0	391.4
M3	5.9	7.6	13.1	507.2
Base money	7.7	-2.0	11.2	178.6

Table III.3 Monetary indicators (ALL billions)

III.1.1 M3 TIME STRUCTURE

The smoothing of monetary policy by the Bank of Albania during 2004 did not affect the time structure of money supply. This structure implies the distribution of relative weights of monetary aggregates according to maturity terms in the money supply. As such, it contains relevant information on economic expectations. A rise of liquid aggregates weight in the money supply may be a sign of increased consumption and inflationary pressures in economy.

Irrespective of nominal interest rate cut, the low inflation rates made real interest rates stand

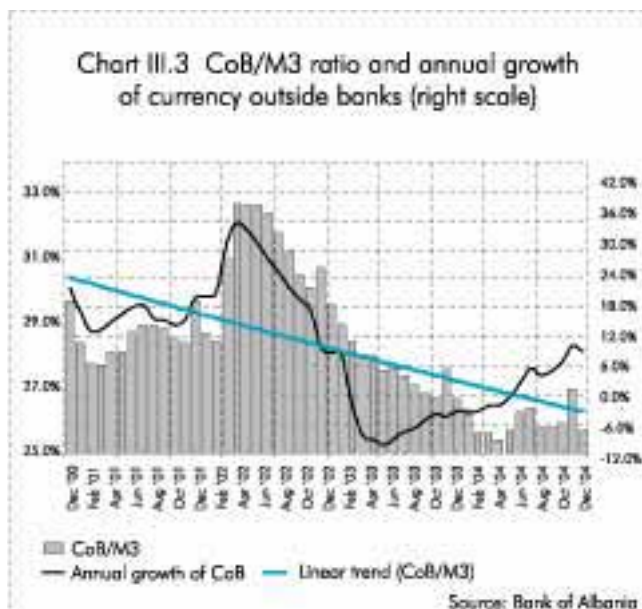


³ Changes in the time structure of money supply were due to reclassification of ALL time deposits into demand deposits.

⁴ Real average interest is calculated as a 12-month moving average of the real interest (the difference between nominal interest and actual inflation).

close to historical levels. This impacted on maintaining high annual growth rates of ALL time deposits and on meeting the economy and government demand.

- Currency outside banks

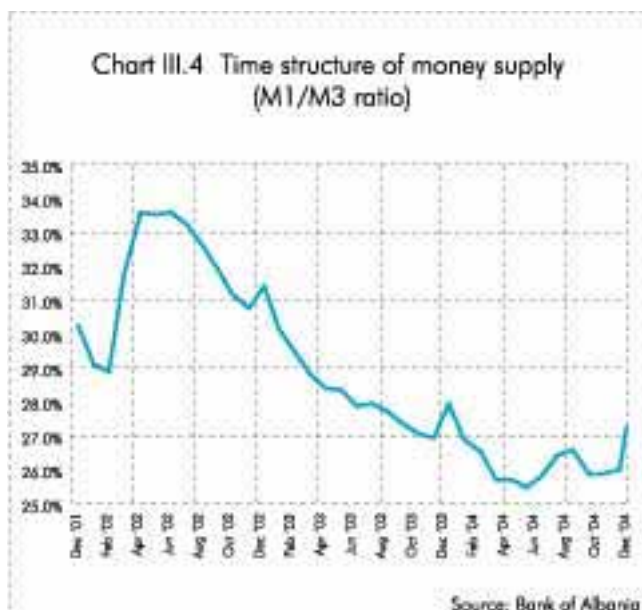


Currency outside banks reflected a steady performance during 2004. Its annual growth for 2004 resulted to 10.4 per cent. Though the annual growth of currency outside banks has turned back to positive levels, close to historical values, it is a consequence of total growth of monetary aggregates. The ratio of currency outside banks to money supply went on having a falling trend during 2003, but at slower paces. The slow down of the reduction of the ratio under discussion is due to the fact that it has already reached minimum historical levels. The relative weight of currency outside banks to money supply has fluctuated close to forecasted values.

- Deposits in ALL

In December 2004, the annual growth rate of ALL deposits was 12.9 per cent. Their growth is regarded as satisfactory, compared to the historical mean. However, as a result of the slower return of money into the system, the growth rate of ALL deposits for 2004 indicated a slow down by about 2.8 percentage points, compared to the previous year. In the meantime, the annual growth rate of the most liquid indicator of money supply, M1 aggregate, during 2004 was higher than in the previous year. This was due to general rise of economy demand for money. However, this factor did not impact on the relative weight

to money supply. Also, the revising of time deposit contracts at the Raiffeisen Bank raised the M1⁵. The effect of deposit shifts on M1 aggregate growth is obvious. In absence of this effect, in December, the annual growth rate of M1 would have resulted to 14.4 per cent or 5.0 percentage points lower than the actual annual rate. Also, in absence of this effect, the ratio of M1 to money supply would have dropped to 32.6 per cent in December, from 34.1 per cent it resulted upon inclusion of these deposits.



⁵ As a result of changing the time deposit contracts at the Raiffeisen Bank, a part of these deposits passed into demand deposits, expecting renovation of customers' contracts with the bank. This change led to higher growth of M1 aggregate than the Bank of Albania expected. It is worth mentioning that this shifting of ALL time deposits into demand deposits does not constitute any fundamental change in the time structure of money supply.

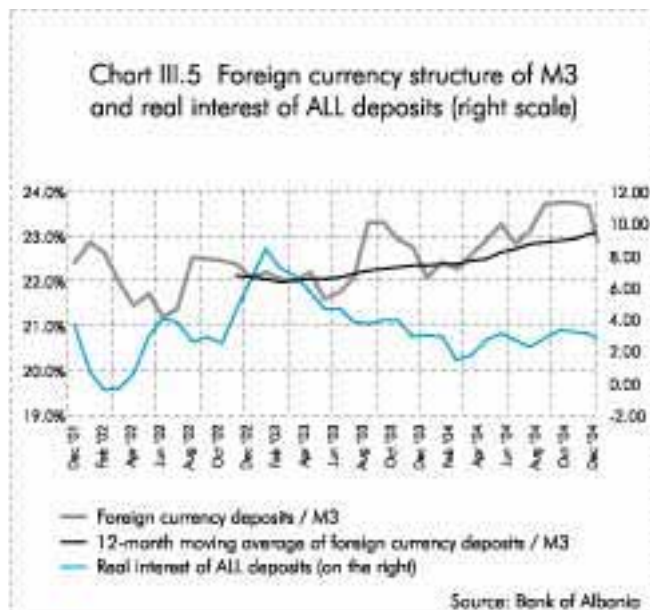
The annual growth of ALL deposits, in total ALL 29.0 billion, appeared mainly in the form of growth of households' deposits in ALL. Their weight constituted about 78.0 per cent of total growth of ALL deposits, while the growth of deposits of businesses constituted about 15.7 per cent of the total growth of ALL deposits⁶.

III.1.1 FOREIGN EXCHANGE STRUCTURE

Year 2004 did not mark any changes in the long-term trends of foreign exchange component of money supply. The ratio of foreign currency deposits to money supply at end of the year resulted to 22.8 per cent or 0.7 percentage points higher than in the same period of the previous year. In relative terms, the annual growth of foreign currency deposits was 17.1 per cent. The appreciation of the lek against the euro and the American dollar has negatively impacted on their performance. In absence of this appreciation, the annual growth of foreign currency deposits would result to 28.8 per cent. Also, the appreciation of the domestic currency has impacted on reducing the share of foreign currency deposits to total deposits and to money supply.

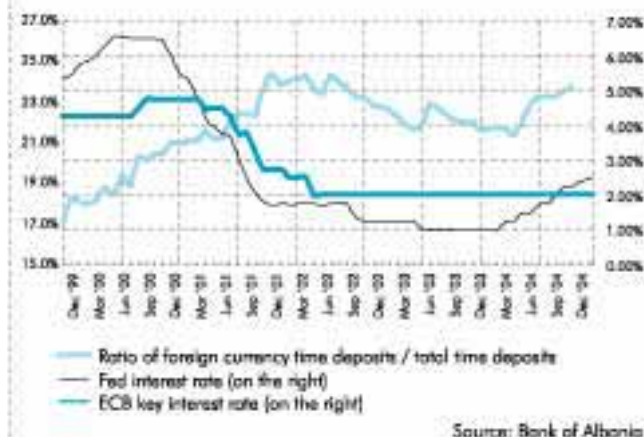
Foreign currency inflows from migrants were the main source of annual growth of foreign currency deposits. These revenues were higher during 2004, due to increased employment of Albanian migrants to Greece during the period of Olympic Games. Also, the rise of confidence in the banking system and the increase of banking products supplied made a part of foreign currency assets of economy held in the form of cash, find their way into the system in the form of foreign currency deposits.

About 60 per cent of foreign currency deposits are time deposits. Therefore, their return has fluctuated, depending on the performance of interest rates in international markets and on the interest rate spread of those in foreign currency vis-à-vis those in ALL. In the course of two latest years, the interest rates of both main currencies reached the lowest historical levels and relatively lower than the interest rates of ALL deposits.



⁶ The other part of the growth of ALL deposits was mainly due to growth of financial institutions' deposits and less due to those of local authorities, public administration and non-financial public enterprises.

Chart III.6 Weight of foreign currency time deposits to total time deposits



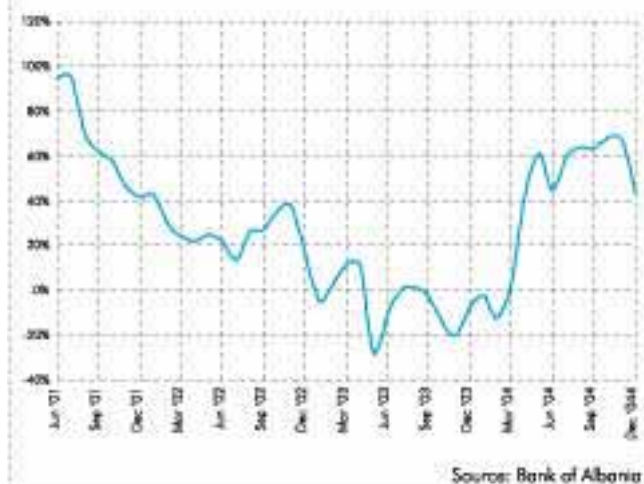
In absolute value, foreign currency deposits were increased by 16.9 billion ALL during 2004. The rise of households' deposits constituted about 97.1 per cent of this growth, while the rise of foreign currency deposits of businesses was only 8.0 per cent of the total growth of foreign currency deposits. The other contributors to growth of foreign currency deposits (financial institutions, local authorities, public administration and non-financial public enterprises), did not impacted on the growth of foreign currency deposits.

The Bank of Albania has withdrawn a part of foreign currency inflows in the country, aiming at smoothing the exchange rate fluctuations, balancing the demand with supply and injecting liquidity in compliance with its monetary policy.

III.1 DEMAND FOR MONEY

III.1.1 FOREIGN CURRENCY POSITION OF THE BANKING SYSTEM

Chart III.7 Contribution of net foreign asset to annual growth of M3



Net foreign assets of the banking system reached the level of 2 billion dollars at end of 2004. These assets were constantly increasing during 2004, marking an annual growth of 516.7 million dollars. This growth rendered a high contribution to annual growth of M3, the highest in three latest years. The inflow of privatization revenues, growth of foreign currency deposits, Bank of Albania purchases in foreign exchange market and the euro appreciation against the dollar in international market impacted on significant growth of net foreign assets of the banking system during 2004.

The Bank of Albania has rendered a contribution of USD 340 million to the growth of foreign assets of the system. Net foreign reserve of the Bank of Albania at end of the year reached the level of USD 1 259 million. The growth was mainly due to intervention (purchase) that amounted to USD 237.6 million. The Bank of Albania purchased USD 100.7 million from commercial banks and USD 128 million from the Ministry of Finance. The latter one belongs to foreign reserve inflows from the Savings Bank's privatization revenues, by USD 126 million. Also, the appreciation of the euro vis-à-vis the dollar in the foreign exchange market impacted on increasing the value of investments in euro expressed in USD. Excluding the exchange rate effect, the growth of net foreign reserve of the Bank of Albania is USD 288.5 million.

During 2004, the commercial banks' foreign assets underwent a growth of USD 176.8 million. The growth was observed mainly during the second part of the year, influenced particularly by the growth of foreign currency deposits. The level of net foreign assets was also impacted by the converting of the Raiffeisen Bank's capital into foreign currency.

III.1.1 CREDIT TO GOVERNMENT

During 2004, the government continued its efforts for consolidating fiscal accounts. In terms of GDP, the budget deficit stood almost at the levels of a year ago. The government demand for monetary assets was moderate, focused mainly on the second half of the year. This demand was met mostly from domestic financing. In this year the budget deficit domestic financing was 14.5 billion ALL, from 20.1 billion ALL in 2003. Including even the privatization revenues, the budget deficit domestic financing for 2004 was 28.1 billion ALL.

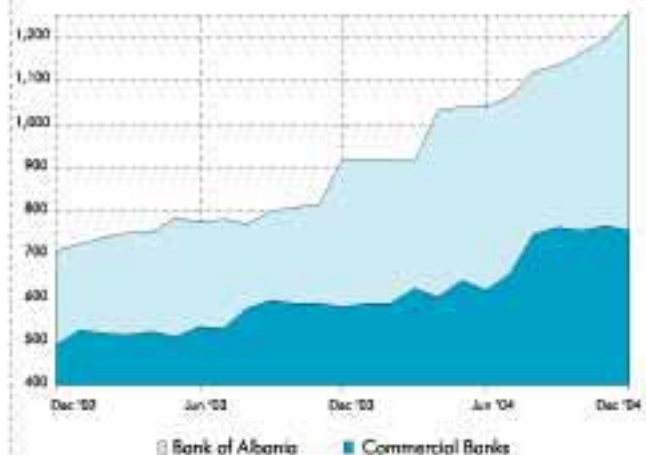
Banking financing through purchases of treasury bills and two-year bonds held the largest weight of domestic financing during the year. Commercial banks and households increased the treasury bills portfolios compared to a year ago, respectively by 6.5 and 6.2 billion ALL. During this period, the Bank of Albania reduced its treasury bills portfolio by 8 billion ALL, as a consequence of outright sales of treasury bills of its portfolio.

Institutions also reflected slight reduction of the portfolio. Government bonds worth 8.5 billion ALL were issued during 2004.

Revenues from Savings Bank's privatization constituted a significant financing source, particularly during the second half of the year.

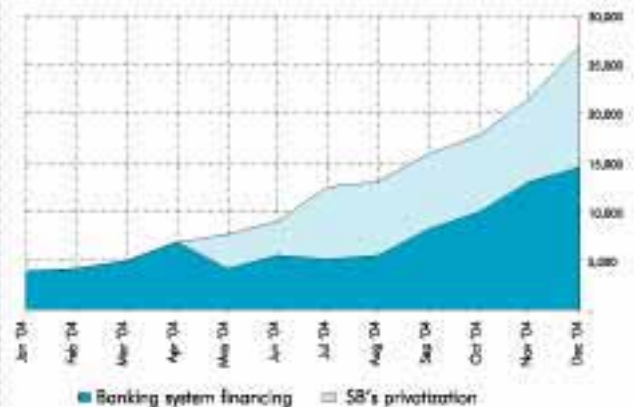
At end of the year, the deficit financing from the Savings Bank's privatization revenues reached to 12.5 billion ALL, whereas the revenues from the privatization of the Insurance Institute (INSIG) reached to 1.2 billion ALL.

Chart III.8 Net foreign assets of the banking system (USD millions)



Source: Bank of Albania

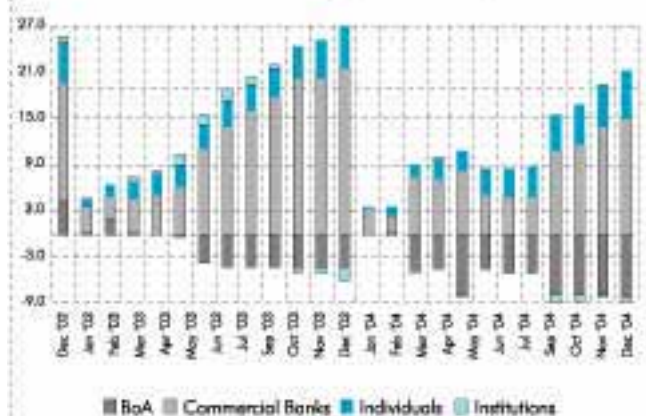
Chart III.9 Budget deficit domestic financing during 2004



*The banking system financing includes treasury bills purchases (banks and other entities) and two-year bonds

Source: Bank of Albania

Chart III.10 Cumulative performance of budget deficit financing (ALL billions)



Source: Bank of Albania

III.1.1 CREDIT TO ECONOMY

Allocation of funds in the productive sector of economy is the final end of the banking system intermediation. Credit to economy is occupying a more and more important place in the structure of investments ensuring income for the banking system. Credit to economy supports the new productive investments in economy, impacting on the increase of production, trade and services, etc.

During 2004 the banking system was obviously improved and developed in terms of financially supporting businesses or households by banking credits. The share occupied by credit to economy in the demand for money was increasing during 2004. At end of 2004, credit to economy constituted 8.4 per cent of GDP, marking a growth of 1.6 percentage points compared to 2003. Also, the credit/deposit ratio reached the value of 19 per cent at end of 2004, marking a growth of 3.3 percentage points compared to 2003.

Table III.4. Performance of some main indicators⁷

	2002	2003	2004			
			Q-1	Q-2	Q-3	Q-4
Money supply (in billion ALL)	416.7	448.4	456.0	458.2	487.6	507.2
Domestic credit (in % to M3)	70.8	71.5	71.6	69.5	67.4	68.9
- Credit to government (in % to M3)	61.5	60.2	59.9	57.1	54.8	55.1
- Credit to economy (in % to M3)	9.3	11.3	11.7	12.4	12.6	13.8
Credit to economy (in % to total assets)	11.5	13.7	13.7	14.6	14.7	16.9
Credit to economy (in % to GDP)	5.7	6.8	7.0	7.4	7.3	8.4
Total deposits (in % to GDP)	42.2	43.4	44.1	44.1	44.4	44.1
Credit/deposit ratio (in %)	13.5	15.7	15.8	16.7	16.9	19.0

Outstanding credit at end of December 2004 reached to 70 billion ALL, marking an annual growth of 19.4 billion ALL or 38 per cent. This growth was about 62 per cent higher than the growth realized in 2003. Credit to economy increased on average by 1.6 billion ALL per month, exceeding even the level projected in the monetary program of 2004. December of 2004 is assessed as the month having the highest monthly growth over two latest years, by 4 billion ALL.

The rising tendency of the weight of mid-term and long-term loans in the outstanding credit structure continued even during 2004. The mid-term and long-term loans constituted 66 per cent of the banking system credit portfolio at end of 2004, from 54 per cent it was a year ago.

⁷ This ratio is established to annual GDP for 2004.

Box III.1 Mid-term perspective of credit to economy

Banking system lending activity is expected to accelerate its growth rates in the future, reflecting the positive development impact on a number of macroeconomic and microeconomic factors.

In macroeconomic plan, commitment and concrete results of the government on the path to fiscal consolidation will open the way to gradual shifting of financial resources from the state sector to the private one. Decline of the government demand for financing will release a part of funds from domestic savings, necessary to finance the rise of credit to private sector in the future. The natural tendency of deepening the country's financial intermediation, a process which is expected to be materialized in cash reduction in economy and higher rise of deposits to GDP, will constitute another financing source. Both these processes take special importance under the conditions when the inflow of domestic savings is deemed to constitute the main source of financing credit to economy for a certain period of time.

Nevertheless, in the long run, Albanian banking system will be able to acquire more funds from external sources, which would allow rise of credit to economy beyond the restrictions determined by rise of domestic savings. The rise of banking system access in withdrawing foreign financing will come parallel to reduction of investment risk in the country, under the conditions when the difference between interest rates and expectations of real appreciation of the country's foreign currency will serve as a driver for foreign capital inflows.

In microeconomic plan, important positive changes were noticed in the factors, which until the present were an obstacle for lending market development. The main change belongs to privatization of the ex-Savings Bank from the Raiffeisen Bank; a foreign private investor, with a great expertise and reputation in the European banking market. The experience of many countries of the Eastern Europe and Balkan region shows that the private ownership and experience in financial area have been key factors impacting on rapid growth of banking credit to private sector in these countries.

However, the possibility of making this important structural change of the banking system have a stable impact on rise of credit to economy, will largely depend on the performance of legal and institutional environment where credit activity will be developed.

Currently credit risk is at high levels, reflecting numerous problems in terms of rules and practices on protecting creditors' rights. The solution of these problems in the future will be a key factor, which will sustain rapid growth of credit to economy.

Based on the above developments, the process of accelerating lending is expected to start in 2005, upon entry of the Raiffeisen Bank into lending market. Growth of outstanding credit to economy over the coming year is forecasted to be 27 billion ALL or about 2.3 per cent of GDP.

Credit in foreign currency again dominated the outstanding credit structure by currencies. At end of 2004, the Lek - foreign currency outstanding credit structure resulted to 20 - 80 per cent. The structure of foreign currency outstanding credit by currencies marked 35 per cent credit in USD and 65 per cent credit in euro at end of December.

Compared to end of 2003, this structure underwent an underlined shifting in favour of the euro, when this ratio was almost 50 - 50. The appreciation of the lek against the USD and the euro almost during the whole 2004 negatively impacted on the rise of outstanding credit. The annual exchange rate effect of both currencies, USD and euro, on the reduction of outstanding credit is estimated at about 5.3 billion ALL. Excluding this effect theoretically, the outstanding credit to economy would grow by about 24.5 billion ALL.

Table III.5 Performance of outstanding credit indicators (in percentage)

	2002	2003	Q-1 '04	Q-2 '04	Q-3 '04	Q-4 '04
Outstanding credit (ALL billions)	38.7	50.7	53.4	56.8	60.9	70.0
Short-term loans	53.8	46.0	41.6	35.4	34.0	34.0
Mid-term loans	30.1	33.3	35.4	37.8	37.0	36.0
Long-term loans	16.1	20.7	23.0	26.8	29.0	30.0
ALL	21.3	19.6	17.0	17.0	17.0	20.0
Foreign currency	73.7	80.4	83.0	83.0	83.0	80.0

The new credit extended over 2004 was about 100 billion ALL. At end of 2004 the new extended credit structure by terms resulted with a twofold of the level of long-term new credits, compared to the previous year. During 2004 the credit in foreign currency dominated, even though there was a rise in extending new credits in ALL.

Table III.6 Performance of new credit over years (ALL billions)

	2002	2003	2004	Q-1 '04	Q-2 '04	Q-3 '04	Q-4 '04
New credit (ALL billions)	62.6	92.6	99.7	27.9	28.5	18.0	25.4
Short-term loans	44.7	63.1	62.3	18.7	18.1	10.9	14.6
Mid-term loans	13.0	22.2	22.5	5.7	6.8	3.9	6.1
Long-term loans	4.8	7.4	14.9	3.5	3.6	3.1	4.7
ALL	20.8	30.8	32.5	8.80	8.9	6.0	8.8
Foreign currency	41.8	61.8	67.2	19.10	19.6	12.0	16.6

The banking credit during 2004 had some new developments in terms of backing the economy sectors with credits. So, upward lending tendencies were observed in the agricultural and manufacturing industry sectors. The agricultural sector during 2004 was credited about 1 billion ALL. It is estimated that the trade sector underwent a decline in terms of banking system financing.

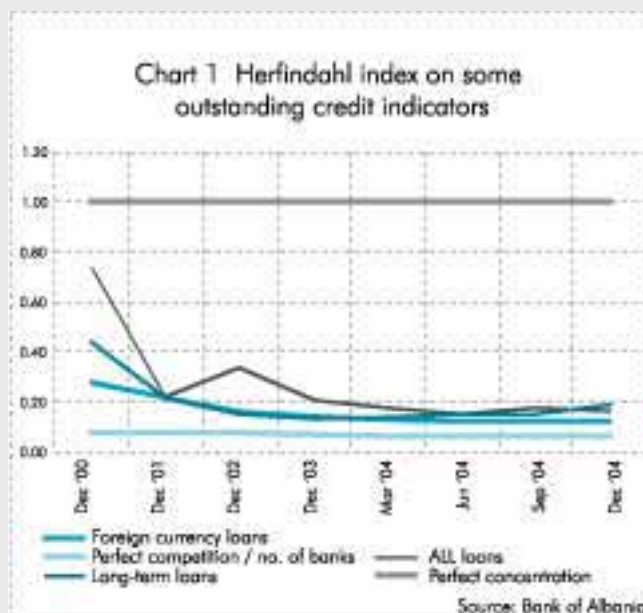
During three latest years this sector has been the most credited sector of economy.

		2002	2003	Q-1 '04	Q-2'04	Q-3'04	Q-4'04
1	Agriculture, hunting, and sylviculture	0.8	1	1.0	1.2	1.6	1.5
2	Fishery	0.2	0	0.1	0.1	0.1	0.1
3	Mining and quarrying	0.2	1	0.2	0.2	0.3	0.3
4	Manufacturing industry	17.0	17	16.9	16.4	18.2	17.1
5	Electricity, gas and water production and distribution	3.3	3	3.0	3.3	3.2	2.8
6	Construction	8.6	10	9.7	10.7	10.2	9.8
7	Trade, automobile and home appliances repairing	40.4	34	31.4	23.5	21.9	23.3
8	Hotels and restaurants	6.0	6	7.1	8.3	8.3	8.3
9	Transport and telecommunication	2.4	1	2.0	1.5	1.6	2.0
10	Financial activities	-	0	0.1	0.7	0.7	0.2
11	Real estate	9.1	13	13.7	14.8	15.6	9.8
12	Health and social activities	0.5	0	0.5	0.5	0.5	0.5
13	Social, personal and collective, services	4.2	8	4.2	4.5	5.3	4.8
14	Others	7.3	4	10.1	12.2	12.7	19.3
	Total	100	100	100.0	100.0	100.0	100.0

Table III.7 Outstanding credit by economy sectors (in percentage)

Box III.2 Concentration of bank lending market over 2004

The number of banks that were active in lending market increased during 2004 compared to a year ago, further orienting this market towards perfect competition. The value of H index on outstanding credit in lek was decreasing as compared to end of 2003. However, the lending market continued to be fragmented according to terms, foreign currency and credit nature. The concentration continued to appear in the long-term outstanding credit index, where the H index value was estimated with its added value compared to end of 2003. Even though the number of banks crediting in long-terms has increased, yet the banks crediting in large volume at long-terms has remained the same with that of the previous year.



III.1 EXCHANGE RATE PERFORMANCE

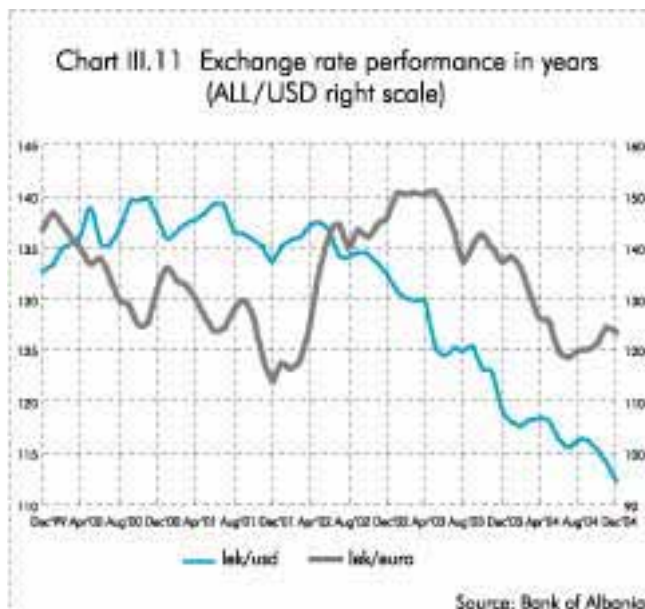
Year 2004 was associated with appreciating pressures for the lek, impacted by country's macroeconomic stability, increased confidence in the domestic currency and largest impact of seasonal effects. Compared to the previous year, the lek was appreciated on average by 7.2 per cent against the euro and by 15.7 per cent against the dollar.

The ALL appreciation is not a characteristic of 2004. The deep ALL appreciation signs appeared about two years ago against the dollar and about one year ago against the euro. Though the ALL against the Euro is

Table III.8. Annual changes*
of average exchange rate
(in percentage)

	2000	2001	2002	2003	2004
ALL / USD	4.4	-0.2	-2.3	-13.1	-15.7
ALL / EURO	-9.8	-3.1	3.0	3.9	-7.2

* The negative sign shows the appreciation of the ALL.



presented at the levels reached over a two-year period, its exchange against the dollar marked minimum historical levels of this ten-year period. During 2004 the ALL was appreciated by 13 per cent against the dollar, being exchanged up to the level of 92 ALL /USD.

The exchange rate performance during 2004 was impacted by long-term domestic factors and specific factors of the year. The specific factors relate to the starting of tourism earlier than in the previous years, rise of agricultural production, decline of demand for imports of agricultural products, impacting the supply and demand for foreign currency in the direction of the ALL appreciation. Even though the effects of some specific factors diminished over the second half

of the year, the long-term domestic factors have maintained and strengthened the position of the ALL. Among these factors, we mention:

- Constant consolidation of the country's economic activity. This stability has strengthened the confidence in Albanian financial system and in monetary assets in ALL. The Albanian economy has grown at high rates, associated with low and stable inflation rates.
- The interest rate spread between the ALL and the foreign currencies. This spread has encouraged a high demand for ALL. Even though the interest rates in ALL decreased for about a year, the low inflation rates have kept high real interest rates in ALL. This is noticed in the increased ALL deposits and increased demand for treasury bills.
- Consolidation of public finances and budget deficit has dictated a low demand of Government for monetary assets. Also, credit in ALL remained in low levels, limiting, to a certain extent, the generation of monetary assets in ALL.
- Stable remittances of Albanian migrants working abroad. Remittances constitute a constant source of foreign currency supply. Also, the privatization process and increase of foreign direct investments brought about further improvements of the balance of payments and increase of foreign currency supply in the country.

Developments in international foreign exchange market are reflected in our foreign exchange market. So, the Euro appreciation against the dollar has also been reflected for more than a year in the decline of the US dollar's

value even in our country, though the Euro's appreciation has not occurred. During 2004, the US dollar was depreciated by 7.5 per cent against the Euro in the international market.

During 2004, the Bank of Albania intervened in the foreign exchange market by purchasing foreign currency, in an effort to avoid large fluctuations reflected by the exchange rate, mainly during summer and end of the year. In total, the Bank of Albania purchased 237.6 million dollars during 2004, mainly during July, August and December. Commercial banks and the Ministry of Finance were the main partners in these purchases, purchasing approximately 100.7 and 128 million dollars.

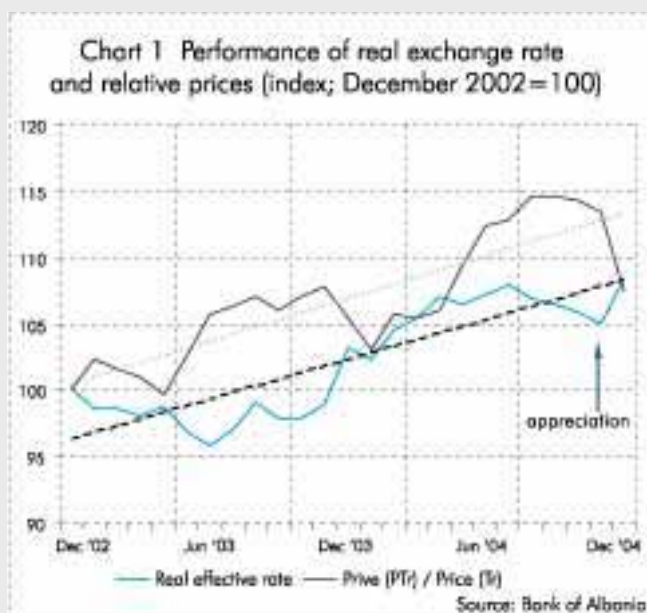
Box III.3 Balassa-Samuelson effect

One of the factors with long-term impact on exchange rate is even the difference in productivity growth between various sectors of economy. The contribution of this factor on the real exchange rate performance is known in economic literature as the Balassa-Samuelson effect.

A brief description of this phenomenon would start with division of consumer products (goods and services) into two main sectors: sector of tradable products (whose prices tend to be in line with prices of foreign products due to competition between them) and sector of non-tradable products (on which a difference exists between domestic and foreign prices due to high international arbitrage costs). Based on the theory of a price law in the long run, the nominal exchange rate performance would reflect changes in relative prices of domestic and foreign products only in the tradable goods sector.

The so-far experience shows that in most countries the productivity growth in tradable goods sector tends to be faster than in the non-tradable goods sector, a fact which relates to exposure of this sector to international competition. Growth of productivity increases the pressure for wage rise in tradable goods sector. This process, under the conditions of labour force movement between two sectors, will be associated with wage rise in non-tradable goods sector, even under the conditions when this sector's productivity is not raised. This factor will bring about relative price rise of non-tradable products in relation to tradable ones.

Difference in the productivity growth between two sectors is present either in developed economy or in developing countries. But low productivity base characterizing undeveloped countries and faster convergence of tradable goods sector towards productivity levels of developed countries, make the difference of productivity growth in tradable goods and non-tradable goods sectors of these countries be greater than in developed economies. Therefore, even the degree of relative price adjustments in these countries is higher, bringing about a larger rise in relative prices of non-tradable goods. So, for equal inflation rates in domestic and foreign tradable goods sector (which implies an unchanged level of nominal exchange rate in the long run), inflation in domestic non-tradable goods sector would be higher than the one in foreign non-tradable goods sector. As the category of non-tradable goods occupies an important weight in the consumer basket used for measuring the overall price index, the inflation rate in the country would be systematically higher than inflation rate in foreign countries. In this way, non-reflection of inflation differences in nominal exchange rate would result in an appreciating tendency of real exchange rate.



The fact that real exchange rate appreciation is caused by the operation of real mechanisms in economy restricts the monetary policy only in selecting the form in which the real exchange rate appreciation will be manifested: a higher inflation rate or a nominal exchange rate appreciation. In Albania's case, the inflation target (about 3 per cent) is higher than that of the euro area (2 per cent), serving for partial amortization of pressures on nominal exchange rate. However, in the presence of a strong effect of Balassa-Samuelson (a real annual appreciation higher than 1 per cent), observance of inflation target would require the transfer of burden towards nominal exchange rate appreciation.

Various empirical studies in Eastern Europe countries estimate the B-S effect in the interval of 0-4 per cent per year. At the moment a quantitative estimation for Albania's case appears difficult, since insufficient statistical data make impossible the separation of this effect from the general effect of factors impacting on exchange rate. However, what can easily be noted is the coincidence between the upward trend of real exchange rate and upward trend of relative

prices of non-tradable products, which can serve as an indirect indicator for the presence of the Balassa-Samuelson phenomenon. Even though no accurate conclusion can be drawn on the operation of this factor, its taking into account along with other factors would constitute an additional contribution to explaining the ALL appreciating trend during recent years.

III.5 DEVELOPMENTS IN MONEY MARKET AND INTEREST RATES

Adequacy of liquidity in the banking system, intensification of activity in the market, interest rates cut were the main features of money market over 2004. Under the impact of easing monetary policy, the interest rates in all the markets continued the falling trend of the previous year, reaching to minimum historical levels at end of 2004. The Bank of Albania cut the core interest rate by 1.25 percentage points during 2004, bringing it to 5.25 per cent, its lowest historical level.

Table III.9 Interest rates change (in percentage points)

	2002	2003	2004	Interest rate 31.12.2004 (in %)
Core interest rate	+1.50	-2.00	-1.25	5.25
Change of interest rates in inter-bank market				
Overnight	+2.00	-2.50	-0.93	3.27
Overnight	+1.20	-1.50	-1.24	5.86
Change of treasury bills yield				
3-month	+3.20	-3.90	-1.25	6.09
6-month	+2.20	-3.30	-1.54	7.22
12-month	+2.10	-3.10	-1.39	8.10
Change of interest rates in ALL deposit market				
3-month	+1.05	-2.50	-1.01	4.48
6-month	+1.52	-1.80	-1.66	5.41
12-month	+1.49	-1.60	-1.63	5.99

III.5.1 LIQUIDITY PERFORMANCE AND MONEY MARKET ACTIVITY

Excess liquidity characterizing the banking system since the second quarter of 2003 was also present during 2004. Excess liquidity of the system presented a steady trend, with some moments of its increase over the first quarter and over June-July.

Daily average liquidity level of the year resulted to ALL 4.7 billion, marking a growth of ALL 0.3 billion compared to the previous year. Liquidity level of the banking system is supported by the increase of ALL deposits during the year, particularly during its first quarter, and by low government demand for monetary assets⁸. The net budget deficit financing from the banking system during 2004 resulted to about ALL 3.1 billion lower than in the previous year.

This change was mainly due to increasingly meeting the government's need by other non-bank investors (households and financial institutions).

Furthermore, during summer the liquidity level was also impacted by foreign exchange operations of the Raiffeisen Bank, for changing the capital from ALL into euro.

In general, liquidity fluctuations around the average level have been relatively small, without constituting any problem for its management. Excess liquidity rise in June was caused by an isolated case of non-acceptance of banks' supply in the primary market, when these supplies deviated obviously from the overall yields trend. The Bank of Albania has also used the structural and fine-tuning operations to stabilize the liquidity level.

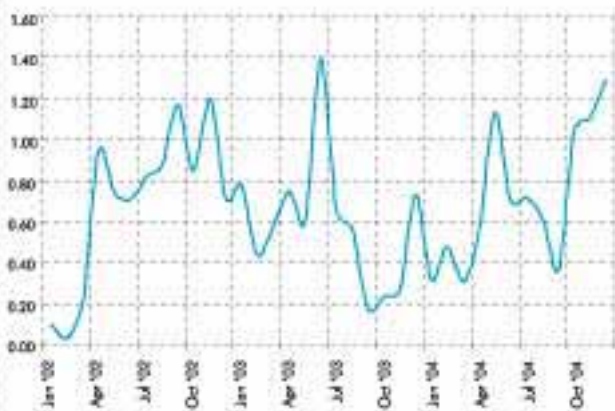
- Inter-bank market activity

Year 2004 recorded a rise of inter-bank transactions of a longer maturity term. The average daily level of weekly loans reached ALL 0.25 billion from 0.16 billion in 2003, and that of monthly loans reached ALL 0.023 billion. Such loans were lacking during the previous year. The average daily level of overnight transactions resulted almost the same with that of 2003, at ALL 0.4 billion.



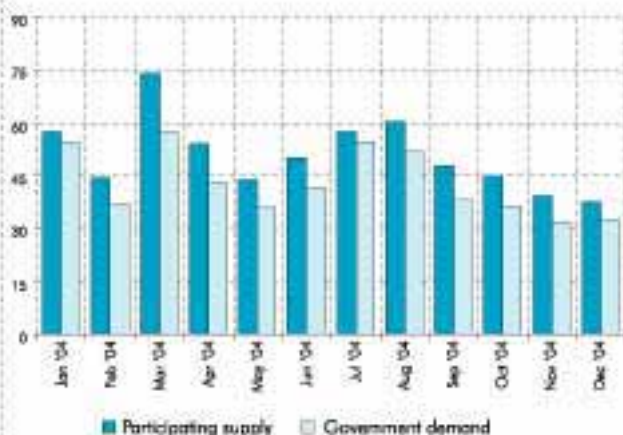
⁸ It is calculated by taking into account even the banking system dues to government. Also, the performance of credit in ALL is not sufficient yet to withdraw the liquidity of the system.

Chart III.13 Average daily volume in the inter-bank market (ALL billions)



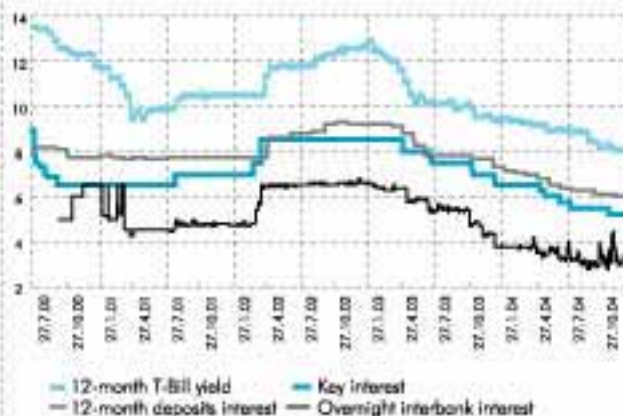
Source: Bank of Albania

Chart III.14 Demand and supply in primary treasury bills market (ALL billions)



Source: Bank of Albania

Chart III.15 Market interest rate behaviour depending on key interest rate



Source: Bank of Albania

- Treasury Bill primary market activity

Year 2004 witnessed a strengthening of the banking system interest in investing in longer term securities, such as two-year bonds. The weight of two-year bonds in the portfolio of banking system securities increased from 2.4 per cent at end of 2003 to 6.1 per cent in 2004, whereas that of three-month treasury bills decreased from 9.2 to 2.8 per cent.

Bank's supply to invest in government treasury bills has been larger than the amount issued in the primary market, being reflected in pressures for constantly cutting the yield.

III.5.2 INTEREST RATE PERFORMANCE

Interest rates in financial markets had clear falling trends during 2004. Except the easing policy of the Bank of Albania, these tendencies have also reflected the enhancement of competition in the banking system, as a result of the Savings Bank's privatization⁹.

- Inter-bank market

Interest rates in the inter-bank market dropped from 4.2 per cent at end of 2003 to 3.27 per cent at end of December 2004 for overnight transactions and from 6.99 per cent to 5.86 per cent for weekly transactions. The inter-bank market is the market with the fastest and more effective reaction to monetary policy signals, since transactions there have a short maturity term. Inter-bank market over 2004 was characterized by increased fluctuations of overnight interests, particularly in the period of estimating the required reserve, when the banks' demand for liquidity was increased. Segmentation of inter-bank market and lack of its treatment as a genuine active exchange market are other factors that have impacted on the fluctuation of overnight interest rates in this market.

⁹ The Savings Bank's privatization, the largest bank in the country, by the Reiffeissen Bank is deemed to have enhanced the banking system competition.

- Primary market

Treasury bills yield gradually dropped during 2004, reaching at end of the year its lowest historical levels, 6.1 per cent, 7.2 per cent and 8.1 per cent according to 3-, 6- and 12-month terms. Besides the easing monetary policy, the yield performance is supported even by increased demand of banks to invest in this market, which remains the most attractive market for investing banks' liquidity.

In the meantime, the two-year bonds yield dropped in smaller magnitude than other yields, from 10.2 per cent at end of 2003 to 9.0 per cent at end of 2004. The weakest reaction of the two year bonds yield to easing monetary policy of the Bank of Albania is explained mainly by lower competition in this market, where fewer banks are active.

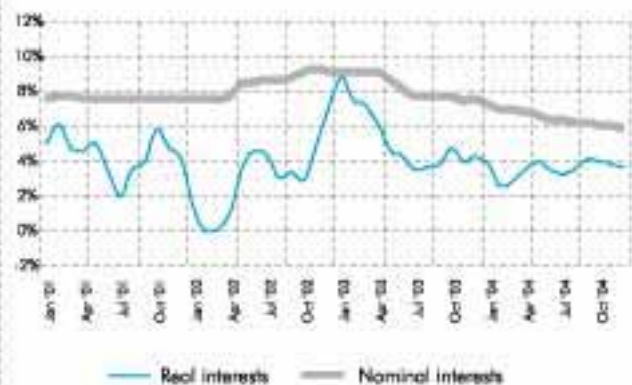
- Deposits interest rates

Interest rates in ALL deposits market have been cut by all banks and for all maturity terms. During 2004, the real interest rates of 12-month ALL deposits fluctuated on an average level of 3.6 per cent. This level resulted to 2.3 percentage points lower than a year ago, impacted mainly by constant cut of nominal interests of these deposits. Similar to two-year bonds, the reduction of long-term interests (two-year deposits¹⁰) was smoother.

Interest rates of foreign currency deposits displayed trends contrary to those of ALL deposits during 2004. This market is impacted by rise of libor and euribor interests in international markets, being reflected in the rise of interests of deposits in dollar and euro in the country. Compared to the previous year, the weighted interest rate of time deposits in USD was increased by 1.0 percentage point, at the level of 1.61 per cent, and that of time deposits in euro was increased by 0.3 percentage point, at the level of 1.71 per cent.

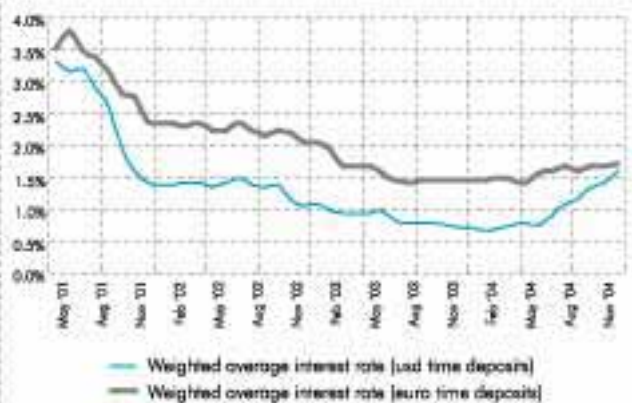
The trend in opposite directions of the ALL and foreign currency interest rates has caused further decline of the spread between interests of ALL - USD and ALL - EUR deposits. At end

Chart III.16 Real and nominal interests of 12-month ALL deposits



Source: Bank of Albania

Chart III.17 Interest rates of time foreign currency deposits



Source: Bank of Albania

¹⁰ The series of data on interest rates of 24-month ALL time deposits started in August 2004. Compared to this month, the interest of these deposits in December fell by 0.16 percentage points, at the level of 6.98 per cent.



of 2004, the interest rate spread of ALL - USD deposits reached 3.3 per cent and the interest rate spread of ALL - EUR deposits reached 3.2 per cent. Compared to the previous year, they have declined approximately by 2.25 and 1.6 percentage points.

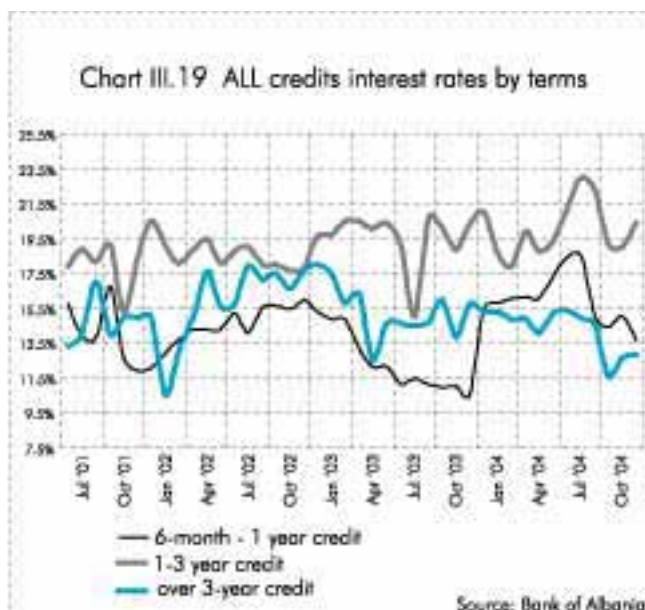
ALL time deposits went on constituting a more attractive investment alternative in ratio to foreign currency deposits. As it is indicated by the following table, the return rates of foreign currency deposits, expressed in ALL, have marked low or negative levels, reflecting the effect of the appreciation of the ALL vis-à-vis the foreign currencies.

Table III.10. Annual average interest of 12-month deposits in ALL and in foreign currency converted into ALL ¹¹ (in percentage)

	In ALL	In USD Converted into ALL	In Euro Converted into ALL
1999	12.4	8.3	-6.8
2000	7.9	4.5	-0.3
2001	7.7	-0.7	4.9
2002	8.5	-13.0	4.1
2003	8.4	-15.6	-7.2
2004	6.6	-7.5	0.1

- Credit interest rates

ALL credit interest rates have reacted more weakly to monetary policy signals compared to interests in other markets. The main impact on ALL credit interest rate fluctuation is given by the change of lending structure¹² from one month to the other; the lack of an active competition and the policy of various banks in lending. The latter one changes depending on reference interests, credit collateral elements, risk degree, type of credit extended, etc.



Due to low competition¹³, a big spread results between minimum and maximum interests applied by banks, within the same term. In some cases, the interests applied by some banks have been as much as double of the interests applied by other banks. The lack of a competitive ALL lending market makes more difficult the transmission of the Bank of Albania signals to the lending market.

¹¹ The annual average of foreign currency deposit interest rates, corrected with the change of exchange rate in the period of holding the relevant deposits.

¹² The change of loan amount by certain banks.

¹³ As a result of non-active participation of the banks with higher liquidity level in this market.

	2003	2004
Up to 6-month credit	11.9	12.9
6-month to 1-year credit	11.4	16.6
1 - 3 year credit	10.0	14.7
Over 3-year credit	8.0	10.0

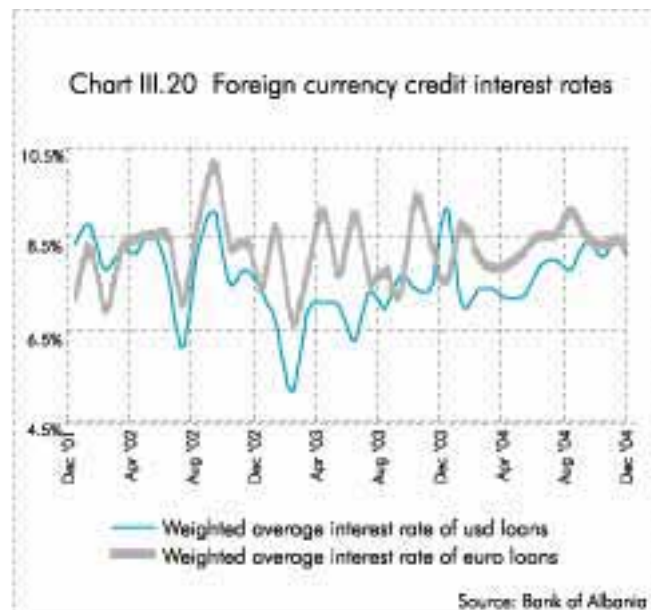
Table III.11 Spread between maximum and minimum interests applied by banks in ALL credit market (in percentage)

Upon rise of competition in the lending market, the spreads will be smoothed and the transmission of monetary policy signals will be more effective. In November 2004, for the first time after some-year detachment, the Raiffeisen Bank participated in the lending market. In 2005, this bank is expected to become an important competitor in this market, by impacting on the smoothing of interest rates.

	2002	2003	2004
Weighted average interest rate of ALL loans	15.1	13.1	13.6
ALL deposit-credit spread (in percentage)	7.4	5.9	8.1

Table III.12 Average annual interest rate and the spread of ALL loans (in percentage)

Foreign currency credit interest rates have indicated more moderate fluctuations in comparison to previous years and to ALL credit interest rates. During 2004 this indicator was featured by upward trends of interest rates, particularly over the first nine-month period. This performance was related mainly with the increase of libor interests in international markets and rise of foreign currency deposit interest rates in domestic market.



	2002	2003	2004
Weighted average interest rate of USD loans	7.9	7.1	7.7
Weighted average interest rate of Euro loans	8.3	8.1	8.4
Spread of deposits - loans in USD (in percentage points)	6.6	6.2	6.7
Spread of deposits - loans in euro (in percentage points)	6.1	6.5	6.9

Table III.13 Annual average interest rates and spreads of foreign currency loans (in percentage)

Chart 1 Interests of national currency deposits in the region countries (in percentage)

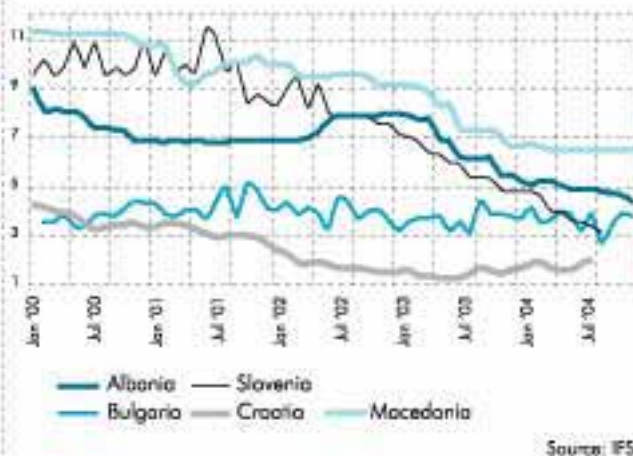
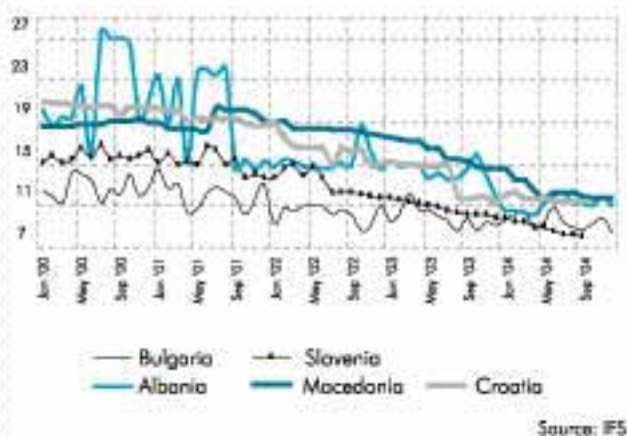


Chart 2 Interests of national currency loans in the region countries (in percentage)



Box III.4 Monetary policy of region countries and interest rate performance

Monetary policy of region countries, including that of Albania, has generally had an easing tendency during recent years.

This tendency is characterized by macroeconomic and regional stability, reforms in financial system, including the state-owned banks' privatization, increased trading relations with Euro area countries, etc.

Therefore, the spread between key interest rates of region countries has been narrowing.

Performance of key interest rate in percentage

The above developments made the interest rates of the region countries further approach key interests of ECB and FED. Also, this policy led to the narrowing of the spread between national and foreign currency interest rates.

III.6 MONETARY POLICY INSTRUMENTS

To achieve the monetary policy objectives, the Bank of Albania has continued to employ indirect instruments included in its operational framework. Under the conditions of excess liquidity, during 2004 intervention is made mainly with instruments for its withdrawal.

- Repurchase (repo) agreements

Withdrawal of excess liquidity is mostly realized by weekly repurchase (repo) agreements. In these auctions there was invested on average 3.3 billion ALL, compared to 3.2 billion ALL in 2003. The auctions were mainly of the "set price" type. In August and September 2004, the form of auction was changed, passing to limited amount repo interventions, where the interest rates were determined by the banks themselves. This changing of the form of auction was

intended to raise the pressures for the whole transmission of monetary policy decisions made during this period.

During June-July, a steady growth of liquidity level was observed as a consequence of primary market operations. Therefore, the Bank of Albania organized two monthly repo auctions, intending its longer-term withdrawal. Also, in one case there was intervened by employing overnight repo - fine-tuning operations.

- Outright transactions

For permanent withdrawal of liquidity and its structural regulation in the market, two outright transactions were carried out over the first quarter of 2004, with a total value of ALL 4.5 billion. These interventions realized the permanent decrease of liquidity and the stabilization of its level.

- Overnight deposits

The operational framework of the Bank of Albania provides even the overnight deposit facility, as an investment instrument of banks' liquidity (accrued interest: repo minus 3.0 percentage points). In this form, there are invested on average 0.8 billion ALL or 0.2 billion ALL less than in the previous year.

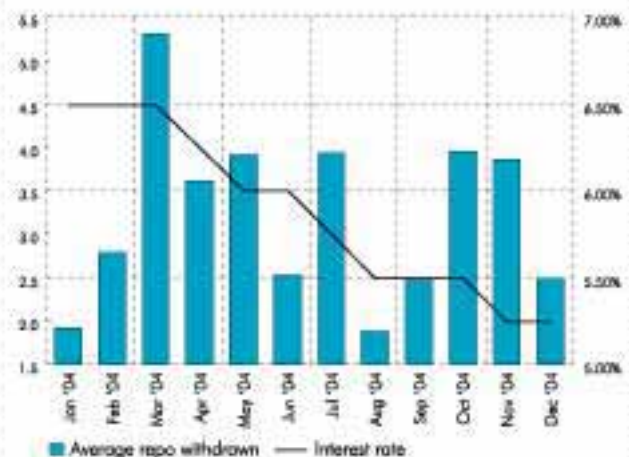
During 2004, the fluctuations of overnight deposit were smoother, except in September, when due to application of fixed amount repo auction, the excess liquidity was placed in the form of overnight deposit.

- Overnight and Lombard loan

Overnight loan (accrued interest: repo plus 2.5 percentage points), is used to satisfy short-term needs of banks. By means of this instrument, on average 0.16 billion ALL were injected, compared to 0.03 billion ALL in the previous year.

Lombard credit is the borrowing operation of highest cost for banks (accrued interest: repo plus 6.0 percentage points). It is regarded as the final crediting possibility for satisfying the long-term liquidity needs and is not used in any case during two last years. The demand for liquidity in the banking system has mainly been short-term and has been met mostly in the inter-bank market or through other more favourable facilities.

Chart III.21 Average volume (ALL billions) and interest rate in repo agreement auctions



Source: Bank of Albania

Chart III.22 Average overnight deposits and loans with the Bank of Albania (ALL billions)

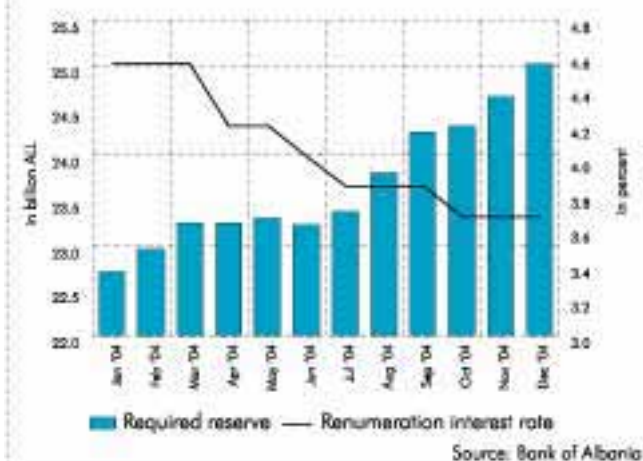


Source: Bank of Albania

- Required reserve

During 2004, the liquidity withdrawal from the market went on by using the required reserve instrument. Growth of the required reserve level in ALL and in foreign currency reflected growth of deposits in the banking system for all respective categories of liabilities included in the required reserve base. Along the year, the remuneration rate on required reserve in ALL reflected a falling trend as a consequence of repo reference rate cut. At end of 2004, this rate decreased to 4.05 per cent from 4.86 it was in the previous year.

Chart III.23 Performance of ALL required reserve of the banking system and remuneration rates



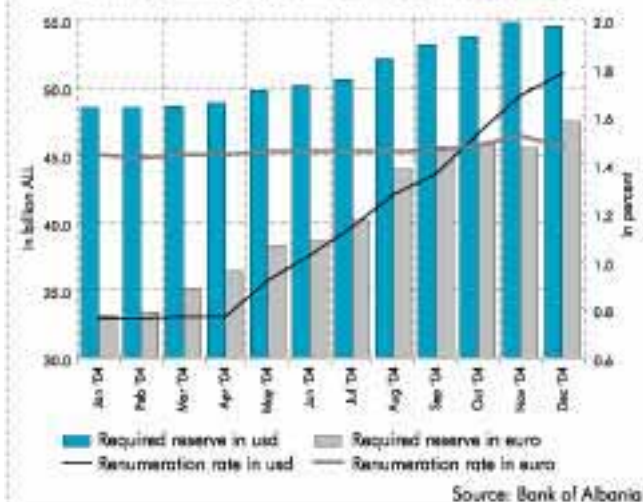
Banks used about 30 per cent of the maximum permitted level¹⁴ of the required reserve for satisfying their daily liquidity needs. The functioning of AIPS¹⁵ during this year created possibilities to banks for better managing the reserves, maintaining proper levels and reducing cases of non-fulfilment of reserve to minimum.

Foreign currency required reserve remuneration rates have been increased rapidly, reflecting consecutive rises of euribor and libor rates. Average remuneration rate in euro increased from 1.33 per cent at end of 2003 to 1.46 per cent at end of 2004, whereas that in dollar was almost doubled, from 0.69 per cent to 1.15 per cent.

- Operational framework improvements

On March 2004, the Bank of Albania adopted the Regulation "On intraday credit", with the intention to improve its operational framework and ease the functioning of Albanian Inter-bank Payment System (AIPS). The use of intraday credit, which started on May, has helped in meeting the needs for the settlement of intraday payments of commercial banks. Intraday credit is extended by the Bank of Albania only in ALL against collateral and does not attract interest. Collaterals used for extension of intraday credit are subject to evaluation at market prices in standard frequencies. The constant control on collateral terms that support intraday credit

Chart III.24 Foreign currency required reserve of the banking system and remuneration rate



¹⁴ The required reserve system allows banks to use up to 20 per cent of the calculated required reserve level, fulfilling the obligation of maintaining average reserve during the calculation period.

¹⁵ The new inter-bank payment system, implemented for the first time on January 31, 2004, aims at realizing real time gross settlements between banks, thus impacting on further banking system development.

lines prevents along the period the risk going with them under the conditions of lack of appropriate infrastructure. The volume of intraday credit used by the system during one day has fluctuated up to 1 billion ALL or 21 per cent of the total credit available to the banking system.

CHAPTER IV. BANKING SUPERVISION

IV.1 LICENSING AND REGULATORY FRAMEWORK

During 2004 the banking system in Albania was characterized by dynamic developments either in terms of increasing the number of banks operating in the market or in terms of extending the banking network in various areas of the country. On February of the past year the Popular Bank, Jnt. Stk, the second bank with wholly Albanian capital entered into the banking market. On April of 2004 the transfer of 100 per cent of the Savings Banks' stock to Raiffeisen Zentralbank Österreich Aktiengesellschaft was approved, as a crowning of the privatization process of this bank. In 2004, the application for establishing a new bank with wholly Albanian capital was submitted. This application has recently received preliminary approval for licence, pursuant to requirements of the Law "On Banking System of the Republic of Albania".

At end of 2004, the number of banks operating in Albania is 16, out of which 2 banks are with totally national capital and 14 other banks are dominated by foreign capital. The Albania's Assembly, with the proposal of the Government of the Republic of Albania, passed two laws on privatizing the stocks, property of Albanian State, at the Albanian Italian Bank and at the United Bank of Albania. Upon implementation of these laws, the Albanian banking system will be entirely with private capital.

IV.1.1 LICENSING

Licensing activity of the Bank of Albania underwent new developments during 2004. Briefly, these developments may be summarized, as follows:

- In 2004 the definitive licence was given to the Popular Bank, Jnt. Stk, which is a company with domestic capital, for commencing banking business. Preliminary licence was given to this bank by the Supervisory Council of the Bank of Albania on August of 2003.
- In 2004, another entity with Albanian capital, the Union Bank, submitted the application to receive a licence to carry out banking business. This application was considered and analyzed by the Supervision Department during the past year. The preliminary approval for a licence was granted at the beginning of 2005.
- One of the main characteristics of the Albanian banking system in 2004 was the extension of its network within the territory of the Republic of Albania. In 2004, 30 new branches and agencies were opened, geographically

extended from Shkodra to Saranda. A peculiarity is that these branches and agencies are opened not only in the main cities but also in other cities and towns. Also, the branches and agencies opened in Tirana are extended in its whole territory, covering even outlying areas with banking services.

- In 2004 the privatization process of the only state-owned bank was over. In April the ownership transfer of 100 per cent of the stocks of the Savings Bank's capital to Raiffeisen Zentralbank Österreich Aktiengesellschaft was made official. In August the Bank of Albania approved the request for the transfer of 100 per cent of the stocks of the Savings Bank's capital from Raiffeisen Zentralbank Österreich AG to Raiffeisen International Bank-Holding AG. Both these entities are part of Raiffeisen Zentralbank Österreich AG Group (RZB – Group). The capital transfer was aimed at maintaining the general structure of RZB – Group holding and does not provide any change in the control of the Savings Bank, which continues to be exercised by RZB.

- On May of 2004, the International Commercial Bank changed its capital structure by transferring the ownership of 100 per cent of the stock of bank's capital to the financial ICB Holding AG group.

- Upon the request by the Raiffeisen Bank, Jnt. Stk, the Bank of Albania approved in December 2004 the addition of some operations allowed in the annex of this licence, in compliance with the level of its paid in capital, which is higher than the triple of initial minimum paid in capital.

- The Bank of Albania made the decision to interdict the right of performing activities of the third level to two banks, as a result of reduction of the capital level, mainly due to exchange rate performance of the domestic currency versus the currency in which the banks' capital is held.

- In 2004 there was given the approval for changing the name of the Savings Bank into Raiffeisen Bank and of the Commercial Bank of Greece (Albania) into Emporiki Bank (Albania).

- In 2004 a licence application and an application for revoking the licence were submitted to the Bank of Albania for non-bank entities. "Tirana Leasing" Jnt. Stk., was granted the licence to provide "financial leasing".

- In 2004, 10 foreign exchange bureaus were licensed and 12 other bureaus, which were found as having violated the regulatory framework, were revoked the licence.

- During 2004, 11 savings and loans associations were licensed and 11 other associations were revoked the licence. 10 savings and loans associations, which are revoked the licence, are united on the basis of 5 existing savings and loans associations.

At end of 2004, after the changes that occurred, the list of entities licensed by the Bank of Albania by years is presented as follows:

No.	Entities	2000	2001	2002	2003	2004
1	Banks and branches of foreign banks	13	13	14	15	16
2	Non-bank financial agencies	2	4	5	7	7
3	Foreign exchange bureaus	19	38	58	58	54
4	Savings – loans associations			113	131	130
5	Unions of savings and loans associations			2	2	2

Table IV.1 Entities licensed by the Bank of Albania by years

1V.1.1 REGULATIONS

The regulatory framework of banking supervision was further amended and improved during 2004. Briefly, we would highlight the following improvements:

A. Drafting and adopting the Regulation “On Money Laundering Prevention”, referring to current law on combating money laundering and particularly 40+8 recommendations of FATF for preventing money laundering and fighting against terrorism financing. This Regulation is aimed at preventing the use of banks as a way to money laundering and terrorism financing, as well as preventing criminal operations in economic and financial area. On the other hand, it is taken into account that the use of banking system for money laundering and terrorism financing ruins the reputation of the Bank of Albania and of the country in general. To prevent these consequences, it is important that banks constantly apply best standards for preventing, identifying and reporting cases of money laundering or terrorism financing.

This Regulation provides all the procedures to be followed by banks for customer identification, their data recording, and terms for keeping documentation, how and when should be reported to the Directorate of Combat against Money Laundering and to the Bank of Albania, relevant structures to be engaged in this process and their responsibilities, etc.

Special place in this Regulation is occupied by the part of legislation on bank supervision by the Bank of Albania.

B. Modification of the Guideline “On Bank Regulatory Capital”, where the main alterations relate to:

- Harmonization in calculating the regulatory capital for covering credit risk (at capital adequacy ratio) and global regulatory capital for covering market risks.
- Methodology of calculating the base capital and additional capital is the same, but global regulatory capital for covering market risks includes even the capital surplus. (Tier 3). The calculations of additional capital are made according to residual base capital and residual additional capital. Precisely, improvements are made in accurate definition of the residual base capital and residual additional capital for calculating the global regulatory capital.
- Clearer definition of types of reserves that figure in bank capital.

C. Amendment of the Regulation “On Capital Adequacy”, with the following main changes:

- Dividing, for the effect of weighting the assets, from the counterparty of the countries of zones A and B, to the counterparty of member countries and non-member countries of OECD.
- Weighting (for the effect of risk and calculation of capital adequacy ratio) by 50 per cent of mortgage loans, only in cases of a residential property used for housing or renting.

D. Approval of the Regulation “On Credit Risk Management”.

The purpose of this Regulation is the credit risk management, so that banks minimize possible losses from credits and other similar assets, sensitive to interest rate movements. This Regulation defines the criteria, categories and methods of rating the loans and other bank assets, calculating an appropriate provisioning level for covering possible losses from incapability of recovering their total value. This Regulation provides more clearly the priority of assessing the criteria for defining the portfolio quality, periodic assessment of overall asset quality and of the commitments given.

E. In the course of this year much work was done for improving the existing Law “On Banking System in the Republic of Albania”, with the intention to pass it to the Assembly of Albania within 2005.

These improvements are dictated by the need to adjust to and implement the European directives in this area and the Basel principles for an effective supervision. The new draft improves the existing law in some directions, including the insertion of some new concepts related mainly to consolidated supervision. Simultaneously, the draft provides stronger and clearer requirements on granting a licence to institutions conducting banking business, stronger requirements on banking activity transparency, better acquainting with the responsibilities of the Board of Directors and the Audit Committee in terms of bank activity, clearer procedures on a bank’s administration or liquidation, etc. The Bank of Albania is closely cooperating with the International Monetary Fund about this draft. The draft will soon be discussed with the banking industry and other important institutions of the country.

1V.1 BANKING SYSTEM PERFORMANCE

The financial state of the banking system at end of 2004 is presented as good. The main profitability indicators have generally had a stable performance during the whole year, reflecting the prudential growth of the overall banking system and the extension of activity of most banks, with more products and larger presence in the market.

The banking system evidenced a positive net income over 2004, about 5.11 billion ALL or about 0.66 billion more than in the previous year. This figure constitutes 0.66 per cent of GDP accrued for 2004.

Table IV.2 Net result
(ALL billions)

	December '02	December '03	December '04
Net result	3.89	4.45	5.11

Net income from interests, representing even the net income from the main banking activity, resulted to ALL 11.66 billion, from 11.15 billion in the previous year. This income continues to provide the main contribution to gross revenues¹ of the system, about 80.3 per cent, expressing the stability of overall revenues.

Better state of the banking system is reflected even in the main indicators of profitability, RoA and RoE. These indicators stood at high levels. Furthermore, they underwent a slight growth in comparison to previous years. This shows that net result growth was not only due to banking system assets growth but also due to productivity growth of assets and capital.

	December '02	December '03	December '04
RoA	1.2	1.24	1.28
RoE	19.2	19.5	21.1

Table IV.3 Profitability ratios (in percentage)

During 2004 the banking system assets rose by 52.8 billion ALL (or 14.1 per cent), about 18.5 billion ALL higher than the growth of assets evidenced in 2003. This considerable growth of assets indicates that banks are becoming more aggressive to attract customers to the banking system, by providing a wide range of products and a higher quality.

	Dec '99	Dec '00	Dec '01	Dec '02	Dec '03	Dec '04
Total assets	249.5	270.8	318.5	339.3	373.6	426.4
As % of GDP	49.2	50.2	53.5	51.6	50.2 ²	51.9

Table IV.4 Total assets over years (ALL billions)

Upon the decision of the Bank of Albania on transferring the Savings Bank's stock to the Raiffeisen Zentral Bank on 14.04.2004, the change of the criterion on dividing banks into groups became necessary³. The new regrouping, which will be used in the coming periods will reclassify banks on the basis of assets size. Concretely, the first group (G1)⁴ includes banks, whose weight is below 2 per cent of total assets of the system; the second group (G2)⁵ includes banks that have a larger share than 2 per cent and less than 7 per cent of system assets; and the third group (G3)⁶ includes banks that exceed the level of 7 per cent of system assets. The above figure shows banking activity⁷ concentration in a small number of banks, though the H⁸(Herfindahl) index reveals downward values along the years.

¹ Total net result from interests and other activities

² Weight reduction is due to application of a new calculating method on estimated GDP.

³ Prior to ex-Savings Bank's privatization, the system banks were grouped by capital ownership. State-owned banks (G1); Joint-stock bank (G2); Private-banks (G3).

⁴ Popular Bank, Dardania Bank, Credit Bank of Albania, International Commercial Bank, First Investment Bank – Tirana Branch, United Bank of Albania, Credins Bank, Emporiki Bank.

⁵ Albanian- Italian Bank, Procredit Bank, National Bank of Greece- Tirana Branch.

⁶ National Commercial Bank, Tirana Bank, American Bank of Albania, Alfa Bank - Tirana Branch, Raiffeisen Bank (ex – Savings Bank).

⁷ Large banks possess above 80 per cent of total assets of the system.

⁸ $H = \sum (\text{assets of a bank} / \text{total assets of the banking system} - \text{average assets})^2 + 1 / \text{number of banks}$. This indicator is estimated as a measuring of banking system concentration.

Chart IV.1 Share of bank groups in the banking system by total assets (December '04)

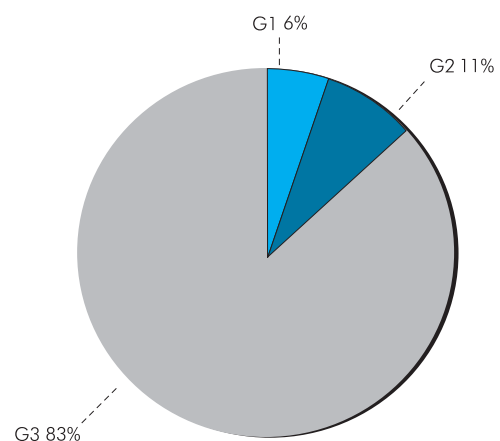


Table IV.5 Herfindahl index of asset concentration

	2000	2001	2002	2003	2004
Index	0.44	0.37	0.32	0.30	0.27

Year 2004 underwent a significant growth in lending activity. Lending constituted 16.4 per cent of total assets of the system at end of 2004, from 13.5 per cent in the same period of 2003. Finally, the lending quality indicator (problem loans to outstanding credit ratio) is estimated at 4.2 per cent, from 4.6 per cent at end of 2003. The lowest level of this indicator highlights improved lending quality and limited banking system exposure to credit risk.

Year 2004 was characterized by a downward trend of capital adequacy ratio, which is due to a better exploitation of banks' capacities in terms of extending in riskier investments. So, the CAR⁹ indicator on the banking system as of end of 2004 is 21.6 per cent or about 7 percentage points lower than end of 2003. Decline of capital adequacy ratio is attributed to higher growth rates of risk weighted assets (about 33 billion ALL or 52 per cent), compared to growth rates of regulatory capital (by about 3 billion ALL or 15 per cent).

Table IV.6 Performance of regulatory capital, risk-weighted assets and capital adequacy ratio over years

Indicator	2001	2002	2003	2004
Regulatory capital (in million ALL)	16 392	17 525	17 747	20 505
Risk weighted assets (in million ALL)	46 424	55 422	62 238	94 800
Capital adequacy ratio (in %) (1/2*100)	35.3	31.6	28.5	21.6

Banks of the system continue to maintain capital adequacy ratios above the minimum required levels (12 per cent).

Liquidity situation in the system is satisfactory. Facilities provided by the Bank of Albania on liquidity created possibilities, even during 2004, for absorbing excess liquidity to system banks and for meeting liquidity needs. Liquidity indicators at satisfactory levels do not expose the banking system to liquidity risk.

1V.1 ON-SITE EXAMINATIONS

The Bank of Albania, in implementing the legal responsibilities, being the supervisory authority of banks and other entities, such as non-bank financial institutions, savings and loans associations and foreign exchange bureaus, which perform financial activity licensed by the BoA even during 2004, tried to ensure a sound banking activity through off-site supervision and on-site examinations, thus maintaining the banking system stability and public confidence.

The supervision process during 2004 had risk assessment of banks' activity on its focus, trying to be proactive and continuous. As part of the requirements of Supervision Development Plan, in cooperation with the World Bank, the document on "Operative Policy of Supervision" was drafted and approved,

⁹ CAR is estimated as a ratio of regulatory capital to risk-weighted assets expressed in percentage.

stipulating banks' supervision principles. In view of this policy, the supervision cycle is lengthened from 12 months to 18 months for the banks presenting less concern to supervision, whereas it is reduced to 6 months for problematic banks. The supervision plan for 2005 is drafted on the basis of this document, including, inter alia, even some events that would happen during a supervisory cycle, transforming the supervisory function into a constant process.

During 2004 the following examinations were conducted:

1. Banks: 13 comprehensive examinations, 17 partial examinations.
2. Non-bank institutions: 7 comprehensive examinations (all institutions).
3. Savings and Loans Associations: Comprehensive examination of the Albanian Savings-Loans Union.
4. Foreign exchange bureaus: 42 examinations.

In general, the on-site examinations demonstrated a satisfactory banking system state. Some of the main findings from the process of on-site examinations over 2004 may be summarized as follows:

- A rapid extension of the number of bank branches and agencies. During this year, 30 new branches and agencies are established, naturally making this year witness the highest number of new branches. These branches are opened mainly in cities where the number of banks was low or inexistent. Branches are opened even in small regions of the country where no banking activity existed at all, thus contributing to providing banking services for a large part of the population of the country (new branches are opened in Kamez, Shengjin, Himare, Burrel, etc).
- A rise in the number and quality of services provided by banks. Numerous ATMs are opened by some banks and many will be opened in the near future (currently 8 banks provide the ATM service for a total of 76 ATMs). An ever increasing number of banks are offering debit and credit cards.
- A significant growth of lending to customers. This growth is associated with increased number of credit products offered to customers, as well as with faster lending extension practices. An ever large number of banks are extending loans for housing and consumer loans, thus contributing to attracting the public to banking sector.
- Significant growth of assets in some banks, which indicates a more aggressive policy by some banks and a larger approaching of customers to the banking system.
- Higher than in the previous year. This was due to the extension of their activity, significant growth of lending and income from other activities.
- Liquidity position in banks continues to be high, generally due to investment in liquid items.

Problems observed by on-site examinations may be divided into the following:

- Problems related to senior management (Board of Directors and Audit Committee). Recommendations of examinations are aimed at increasing the responsibility of these bodies, emphasizing problems which are considered as critical for ensuring a safe and sound activity of banks. The emphasizing of these recommendations aims mainly at their following-up by boards of directors and at assigning main responsibilities in case of their non-implementation. Also, closer cooperation with the internal audit, increased responsibility about the presented problems, increased independence and accountability on the latter one, performance of verifications in banks, etc., are requested from audit committees.
- Problems related to internal regulatory framework of banks. Upon extension of activity and increase of complexity of banking services, the need for constantly enriching and improving the internal regulatory framework emerges. This problem is more tangible to new banks, therefore special attention is paid to them, through carrying out more frequent examinations to assess the fulfilment of internal policies and procedures, and their quality.
- Problems relating to implementation of regulations. Though banks have tried to better implement the regulatory framework of the Bank of Albania, yet non-implementation of regulations or violation of the limits specified by them is noticed. Violations are mostly noticed in the following Regulations:
 - A. Regulation "On Open Foreign Exchange Positions".
 - B. Regulation "On Initial Minimum Capital". This Regulation is violated mostly by banks that have first level licence and have not added more capital than the minimum level. Because of exchange rate fluctuations (for banks which have paid the capital in US dollar), their base capital has dropped below the level of the minimum required capital. In such cases, the shareholders are requested to add the capital in order to bring it to the required levels.
 - C. Regulation "On Credit Risk Management". Addition of loans provisions has been one of the most debated issues between inspectors and bank managers.
 - D. Regulation "On Controlling Significant Risks". Exceeding the limits of concentration for a beneficiary is noticed mainly for placements with banks (particularly for foreign bank branches) and for some borrowers.
 - E. Regulation "On Foreign Exchange Activities". Remarks on implementation of this regulation generally relate to documenting the transfers by means of customs clearance documents. Staff training on formats and validity elements of customs clearance documents accepted as justifying documents for commercial transfers is recommended in many banks.
- Problems related to technology and information system. Problems evidenced relate mainly to automatic generation of necessary information,

modules used on various areas of activity, division of rights on entering data and authorizing operations, etc.

- Problems related to accounting. Problems related to accounting spring from the fact that banks are allowed to hold the capital in foreign currency, but they must hold the profit and accounting in domestic currency. Some of banks continue to hold the profit (changing the way of keeping the accounting is associated with cost) and fixed assets in foreign currency. These issues should be considered even in the framework of the Law on Accounting and its requirement for implementing international financial reporting standards.
- Other problems. Other problems evidenced during the examinations have to do with perfection of measures for money laundering prevention, achievement of objectives defined in the budget, increase of staff and trainings, etc.

Regarding above-listed problems, the Bank of Albania has also made relevant recommendations to each bank in particular, prescribing concrete terms for the implementation of these recommendations. A better reaction of banks is noticed for implementing the recommendations or the orders accepted. In general, banks have reacted to recommendations made by the Bank of Albania and have tried to fulfil them in time, however a part of recommendations are still under the realization phase. In such cases, based on importance of recommendations and bank's commitments, new terms are specified and attention of the bank is drawn to them.

No.	Banks	No. of Branches	No. of Agencies
1	Raiffeisen Bank	14	83
2	National Commercial Bank	15	1
3	United Bank of Albania	3	
4	Albanian Italian Bank		4
5	Dardania Bank	1	
6	Tirana Bank	18	2
7	National Bank of Greece-Tirana Branch		4
8	International Commercial Bank	2	
9	Alfa Bank – Tirana Branch	7	1
10	American Bank of Albania	6	5
11	Procredit Bank	16	
12	First Investment Bank – Tirana Branch		2
13	Emporiki Bank	1	
14	Credit Bank of Albania		1
15	Credins Bank	2	1

Table IV.7 Indicators of banks extension network at the end of 2004

CHAPTER V. OTHER ACTIVITIES OF THE BANK OF ALBANIA

V.1 PAYMENT SYSTEM

- Objectives of the system

One of the main tasks of the Bank of Albania (pursuant to the Law "On the Bank of Albania") is the encouragement and support of the development of a safe and efficient payment system.

In terms of promoting normal functioning of the payment system, the Bank of Albania is involved not only in drafting and reforming the regulatory and procedural framework for the payment system and instruments, but also in supervising the operations, being simultaneously the only institution that organises and facilitates the settlement of payments and securities in the country.

The intention of the Bank of Albania has been and continues to be the establishment of a payment system in compliance with 10 Core Principles on important payment systems, stipulated by BIS/CPSS.

- Communication and transparency

One of the responsibilities of the Bank of Albania as a central bank, in compliance with the core principles on important payment systems, is to supervise the system in an effective, responsible and transparent way.

To coordinate the work of all the participants in the system, the Bank of Albania has established a permanent inter-bank forum, the National Payments Committee. This Committee is summoned regularly to consult with, and to approve inter-bank agreements that are aimed at good functioning of the payment system in Albania. As part of the consultation mechanism, representatives from commercial banks are invited regularly (committees of coordinators on projects under process are established) to present their suggestions for upgrading the system.

The Bank of Albania discloses continuously information on payment system developments, on respective regulatory framework, and is engaged in the national campaign of channelling cash through the banking system.

V.1.1 PAYMENT SYSTEM DEVELOPMENTS

- Albanian interbank payment system – AIPS

Further to a prudential and intensive work done during 2003, January 2004 inaugurated the initiation of operations of the Albanian Interbank Payment

System (AIPS). It was an important project and was regarded as an essential infrastructure connecting almost the whole banking system. The system is implemented in accordance with best international standards and principles, based on modern and up date technology. The project was implemented under the assistance and counselling of the World Bank.

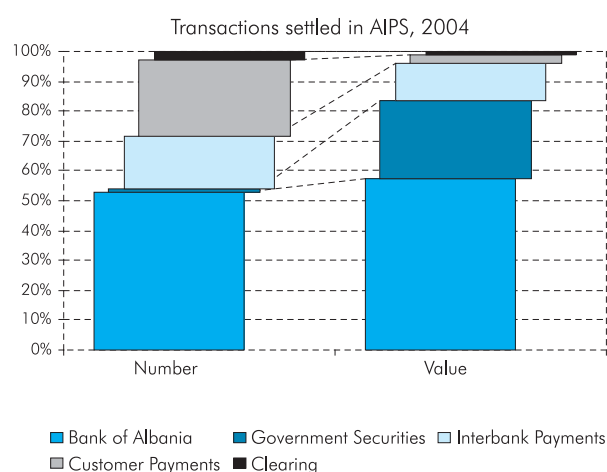
The system aims at:

- i) Improving security and efficiency in the banking system, enabling fast and electronic exchange and settlement of large-value payments between banks;
- ii) Providing the Bank of Albania with an efficient tool for systemic risk management; and
- iii) Establishing a proper technical and operational platform for further development of the payment system and related financial systems.

The Bank of Albania and all commercial banks are system participants (Dardania Bank is an indirect participant). The Bank of Albania is in the role of the owner of the system. It organizes, administrates, operates and oversees the system.

The AIPS executes gross settlement in real time of all large-value payments (otherwise categorized as systemically important payments, currently at a value of above ALL 1 million) within the territory of Albania, in an irrevocable and unconditioned way. (Banks have possibilities of assigning and managing priorities on their payments). The system enables the participants to better monitor and manage their liquidities. (The system ensures information in real time on account statement, free reserves, queued payments for settlement). Also, the AIPS creates the possibility of lending by the Bank of Albania to commercial banks, with the purpose to meet banks' needs for intraday liquidity and to guarantee normal functioning of the system, in accordance with approved decisions and objectives of the monetary policy.

Chart V.1 Dissemination of transactions by AIPS



Legal grounds for the functioning of the system are: the Regulation on "Rules and Procedures of Albanian Interbank Payment System - AIPS" adopted with the decision No. 103, dated 10.12.2003 of the Supervisory Council, the System Participation Contract, and Rules and Procedures for Each Participant in the System. Also, the Regulation "On intraday credit" was adopted during 2004, with the decision No. 20, dated 24.03.2004, where respective agreements between the Bank of Albania and commercial banks were based on.

During 2004, a volume of 2,176 billion ALL was circulated through the AIPS, where approximately 58 percent was composed of BoA initiated transactions, 25 percent by securities

transactions, whereas 17 percent by inter-bank and customer transactions. Transactions initiated by the Bank of Albania were composed mainly of monetary transactions (foreign exchange operations, securities investments, loans and deposits – 72 percent), cash transactions (the Bank of Albania supplies its branches and commercial banks with cash – 14 percent) and state budget transactions (transactions performed with the state budget account – 14 percent).

	Number	Value (€)
Bank of Albania*	15,143	1,254.10
Government securities (auctions)	216	559.21
Inter-bank payments	5,075	276.15
Gross settlements to customers (Payment order above 1 million ALL)	7,407	63.53
Net clearing (Payment orders up to 1 million ALL + Cheques)	739	23.44
Total	28,580	2,176.42

Table V.1 Dissemination of transactions in number and value (ALL billions)

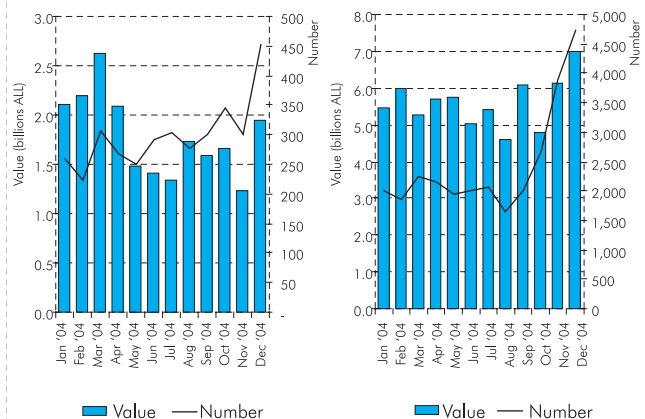
- Clearing service

Clearing service (provided by the Bank of Albania since 1997), supplies the processing and clearing of low value payment instructions and of paper instruments initiated by banks' customers.

The Bank of Albania enables net settlement of all low value payments, channelled into the system by banks at end of clearing session. Since 1999 most of payment orders have passed into the clearing through the SWIFT network, whereas the cheque clearing has been realized through their physical exchange at clearing sessions taking place daily at the Bank of Albania. The execution of these net settlement instruments is carried out through the AIPS.

During 2004, the payments of up to 1 million ALL were channelled through the clearing system (payment orders exceeding this value pass directly to AIPS, where gross settlements are made). The most used instrument during 2004 was the payment order, by 89 percent of the volume of payments and almost 76 percent of the value of payments to customers. The use of cheque as a payment instrument continues to remain in modest levels. The most useful type is the banking cheque.

Chart V.2 Use of cheques (on the left) and payment orders (on the right) over 2004



Value (ALL billions)	1998	1999	2000	2001	2002	2003	2004
Payment orders	22.50	25.60	28.00	32.90	40.90		67.16*
Cheques	15.50	24.40	26.30	28.90	31.80		21.40

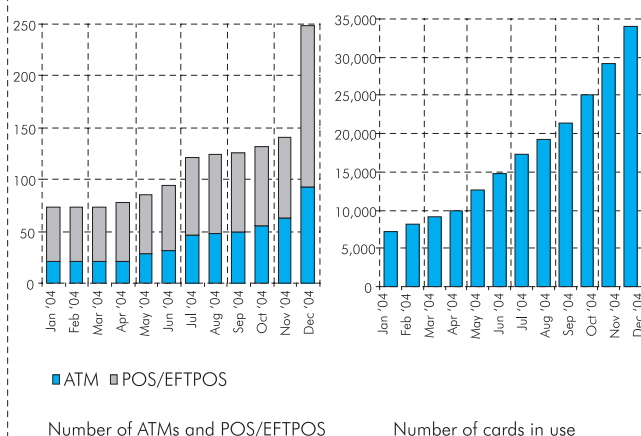
Table V.3 Use of cheque and payment order

- Electronic means

Year 2004 marked another step forward in the banking system efforts to improve and modernize the payment infrastructure, further investing in terms of using electronic payment means.

The number of accepting terminals has been increasing, a trend more obvious during the second half of 2004. At end of 2004 the number of ATMs amounted to 93, whereas that of POS/EFTPOSs was 155, against 22 and 53 respectively for end of 2003. According to banks' reporting to the Bank of Albania, the card accepting equipment (ATMs and POSs) operate mainly in lek.

Chart V.3 Performance of electronic payment systems



Only during 2004, the number of (cash, debit and credit) cards in use was increased by about 3.7 times (34,094 cards were counted on December 2004). Cards are mainly issued in lek, whereas the mostly used type is the cash card. We emphasize that given the recent developments in the provided services and the extension of card accepting equipment network, banks are adjusting their cash cards into debit cards. So, the same card may be easily used either at bank's ATMs or at any other point (POS/EFTPOS), where that card is accepted. Also, the majority of issued cards, function currently as one currency – one card, whereas only a small number of cards allow their user to have access to more than one currency.

V.1.1 FUTURE PROJECTS ON PAYMENT SYSTEM

- Automated Electronic Clearing House system – AECH

In line with the objective of developing a reliable, safe and integrated payment and clearing system, the second step undertaken during 2004 by the Bank of Albania was the initiation of implementation of the project on Automated Electronic Clearing House (AECH). This system that will be based on and integrated into the AIPS will enable the automation of clearing service currently provided by the Bank of Albania for processing low value payments. This project is being implemented under the assistance and counselling of the World Bank.

The implementation of this system (forecasted for the second half of 2005) will bring about significant improvements in the payment system in terms of automation of processes and simultaneously in terms of increasing the accuracy and speed, and reducing the processing cost.

AECH system enables the net settlement of all low value payments, channelled electronically into the system by banks (participation is similar to that of the AIPS), at certain hours (at end of clearing session (s)). The execution of these net settlement instructions will be conducted irrevocably in the AIPS. Banks have the possibility to monitor and manage the queue of batch payments and their liquidity.

- Card clearing project

Further to its objectives for increasing the circulation of money through the banking system, and in its role as the promoter of introducing new instruments of development and necessary infrastructure for modernizing the payment system, the Bank of Albania has in its projects the establishment of a system for electronic card clearing. The main purpose is to facilitate the use of electronic cards to customers and to clear the operations performed in domestic currency.

V.2 EUROPEAN INTEGRATION AND INTERNATIONAL COOPERATION

V.2.1 EUROPEAN INTEGRATION

Official negotiations for signing the Stabilization and Association Agreement between Albania and the European Union continued even during 2004. The Bank of Albania, which cooperates the work of relevant institutions in the process of the agreement with the European Union, has been an active participant in the Albanian government negotiation team.

In the framework of commitments deriving from the Stabilization and Association process, the Bank of Albania has cooperated and continues to cooperate with the Ministry of European Integration on drafting a National Plan for Approximating the Legislation, being focused on issues that have to do with chapter 4 (free capital movement) and chapter 11 (economic and financial union) of the European legislation.

At the same time, the Bank of Albania has prepared a preliminary version of the matrix on capital account liberalization. The drafting of this matrix is made by being based on obligations deriving from the draft Stabilization and Association Agreement and taking advantage of the experience of the region countries that have been engaged in the same process. The first estimates from the Executive Board of Economic and Financial Issues of the European Commission have been positive.

The strategic goal of the Bank of Albania is the institutional, organizational and operational approximation to the European System of Central Banks and more concretely to the European Central Bank. To this end, one of the issues of the Protocol of Albania's Economic Cooperation with the Federal Republic of Germany requires the provision of assistance for approximation to the European Central Bank. During 2004, in cooperation with the GTZ, a clear program was defined for the technical assistance to be offered by European experts along with necessary steps for implementation of this assistance. At the same time, the need for twinning relations of the Bank of Albania with a member bank of the European System of Central Banks is outlined, aiming at absorbing the expertise in a more constant basis during the approximation process.

The Bank of Albania has also informed the European Commission on the country's economic developments, monetary policy drafting and implementation, putting emphasis on the achievement of price stability as its main target, type of monetary policy and operational framework, banking system development and its supervisory function.

V.2.2 RELATIONS WITH INTERNATIONAL FINANCIAL INSTITUTIONS

- Relations with the International Monetary Fund

In the framework of consultations on assessing the fulfilment of obligations deriving from the agreement between Albanian authorities and the IMF, on April, July and December, Albania was visited by three reviewing missions of the IMF. During their stay in Albania, the IMF missions held meetings with the Bank of Albania administrators. In these meetings, generally, the Bank of Albania accomplishments were evaluated in the framework of the Memorandum of Economic and Financial Policies signed between the Bank of Albania, the Ministry of Finance and the IMF.

Particularly, the missions evaluated the maintaining of inflation within the Bank of Albania targeted band (2-4 per cent), the maintaining of a relatively stable exchange rate and the efforts for modernizing the banking system. At the same time, the missions expressed their support and encouraged the mid-term plan on cash reduction in economy. Monetary developments and inflation, exchange rate developments, rise of lending, development of the real sector and amendment of the regulatory framework of banking supervision were other topics discussed in the meetings and in the contacts of the members of the mission with the Bank of Albania experts.

Based on the consulting reports and on the goals expressed by Albanian Government in the Memorandum of Economic and Financial Policies, the Executive Board of the IMF, on January and July, made respectively the third and fourth review of economic performance under the Poverty Reduction and Growth Facility program (PRGF) approved on 21.07. 2002. After drawing the conclusion that the performance of Albania over the second year of the PRGF program has generally been satisfactory, with a strong economic growth, improved foreign payment balance sheet and foreign reserves that have exceeded the objectives of the program, associated with a reliable liquidity management by the Bank of Albania and by a low inflation rate, the Executive Board of the IMF approved the extension of two tranches by respectively USD 5.9 million and 6 million.

On February, the Bank of Albania was visited by the Mission of Technical Assistance of the IMF, which was focused on banking supervision area, implementation of international accounting and payment standards, application of monetary statistics standards and integration of the Bank of Albania into the European Monetary System, etc. At the same time, the Bank of Albania requested assistance in inflation targeting area. The so-far assistance by the IMF to the Bank of Albania is regarded as a steady and

fruitful one, impacting significantly on the achievement of up-to-date central banking standards.

- Relations with the World Bank Group

As in the previous years, a fruitful cooperation continued between the Bank of Albania and the World Bank. This cooperation is focused on the financial and technical assistance that the World Bank continues to provide to the Bank of Albania. In this context, of special importance is the financial support on the project of the Automated Electronic Clearing House Project (AECH), which will serve further modernization of payment system and its approximation to international standards. The work for implementation of this project was inaugurated on November 2004, with the participation of senior managers of the World Bank.

The financial assistance by the World Bank has also consisted in the support of the FSAP program for modernizing the banking supervision, developing and modernizing the Bank of Albania statistics and managing human resources. It is worth mentioning the fact that the World Bank has constantly expressed the willingness to assist the Bank of Albania in implementing the projects that have the consolidation, modernization and sustainability of Albanian banking system as their final end.

- Relations with the European Bank for Reconstruction and Development (EBRD)

The Bank of Albania, in the quality of a supervisor of the banking system and an independent observer of the economic developments in Albania, has held constant contacts with EBRD, mainly in terms of providing information and statistics for developments in Albanian economy in general, and in financial sector in particular. Privatization of the Savings Bank has impacted on upgrading the evaluation by EBRD for reforms in Albanian banking sector. Savings Bank's privatization, improved banking supervision and increased financial intermediation have impacted on raising the evaluation for Albania. So, the index on banking sector reforms marked a considerable growth from 2.3 to 2.7.

- Relations with central banks and other institutions

Even during 2004, the relations of the Bank of Albania with other central banks outside the region generally went on at the same level as in the previous year, with special emphasis on absorbing the experience of these banks in various areas and in organizing training operations. It is worth mentioning the relations with the central banks of France, Germany, the Netherlands and Czech Republic, which have been focused on provision of technical assistance, mainly through short-term training courses and workshops and through supplying necessary materials. A significant rise was noticed even in the cooperation with the Bank of Italy, making steps forward for intensifying the relations between both banks and for establishing constant and steady links with that bank.

Good relations are also kept even with central banks of the region. During the meetings organized, there was exchanged the work experience, and particularly the information that has served to perfect the steps in realizing the joint goal of all the Balkan countries, that of approximation to the European System of Central Banks. It is worth mentioning the cooperation with the Central Bank of Montenegro and the National Bank of Macedonia, with which the signing of the Memorandum of Understanding in Banking Supervision area is expected to take place soon.

Given the significant importance they have, the Bank of Albania has paid a special attention to consolidating and intensifying the relations with the Banking and Payment Authority of Kosova. In this framework, during 2004, the main areas of cooperation were specified between the Bank of Albania and the Banking and Payment Authority of Kosova, concretely in the payment system, monetary statistics and balance of payments.

V.3 BANKNOTES AND COINS

Year 2004 was characterized by positive developments in Albanian currency issuing and management. Currency issuing and currency in circulation have responded to the Bank of Albania monetary policy.

V.3.1 CURRENCY ISSUING

On September 1, 2004, the Bank of Albania launched into circulation the 5000 lekë banknote, issue of 2001. Upon launching this banknote into circulation, the launching into circulation of the reprinted banknotes, issue of 2001, with the nominal value of 5000 lekë, 1000 lekë, 500 lekë and 200 lekë was over.

Also, the Bank of Albania, on August 1, 2004, launched into circulation the 50 lekë coin, issue of 2003, with legal tender and with the subject "Albanian Antiquity". The issuing of this coin made available to the public a coin that was dedicated to Albanian history and culture.

V.3.2 CURRENCY IN CIRCULATION

Currency in circulation¹ was increased by 10.8 per cent or 13.8 billion ALL during 2004, reaching the level of 141 billion ALL at end of the year. The increased currency in circulation has responded to the Bank of Albania monetary policy, to economic growth and overall program of economic and financial development of the country. Cash placements of commercial banks from the Bank of Albania marked a considerable growth in 2004. This growth by 13.2 per cent speaks for the upward trend of currency circulation by entities and individuals, through banking channels.

¹ Currency in circulation changes from currency outside banks (analyzed in Chapter III) because of the commercial banks' cash state.

The first quarter of the year was featured by reduction of currency in circulation, due to high cash placements in January, February and March. In the second half of the year, and particularly in July, August, November and December, increase of currency in circulation was evidenced. The increase of currency in circulation was even due to growth of cash withdrawals attributed mainly to government public spending and the Bank of Albania interventions in the foreign exchange market.

In the framework of the program for cash reduction in economy, attention is paid to supplying banknotes to banks for meeting their customer demands for currency withdrawal from automated teller machines. The structure of coins and banknotes in circulation has generally been within the forecasts. Commercial banks are supplied with funds, taking into account either the structure of currency in circulation or their demand.

As concerns to funds processing, the funds sent by commercial banks to the cash boxes of the Bank of Albania were processed by sorting machines of high technology, which enabled accuracy in counting, checking, and selecting of damaged or counterfeit banknotes. They ensured that the banknotes launched into circulation be in accordance with regulations on protecting the authenticity of Albanian currency.

At the same time, the monetary reserves were sufficient to meet the economy demand for banknotes and coins, in compliance with the mid-term strategy of the Bank of Albania.

Attention is also paid to protecting Albanian banknotes from counterfeiting. Historically, the counterfeit banknotes have had an inconsiderable number in the totality of banknotes in circulation. Since 1992, the counterfeit banknotes represent about 0,012 per cent of the number of legal tender banknotes in circulation. During 2004, there were observed 973 counterfeit banknotes altogether by the banking system. According to denominations, they were as follows:

Chart V.4 Performance of currency in circulation (ALL millions)

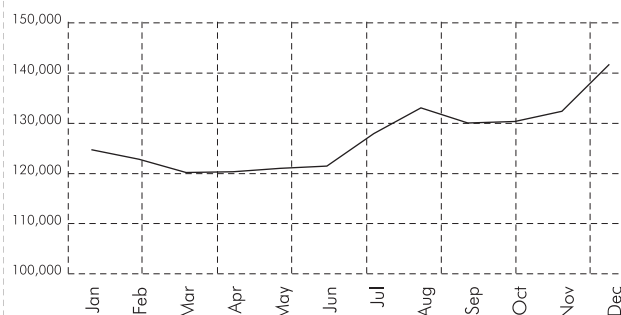


Chart V.5 Banknote velocity by denominations

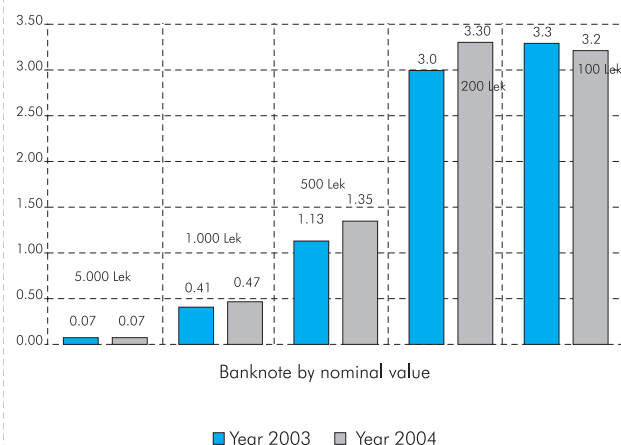


Chart V.6 Banknotes and coins in circulation over 2003 and 2004

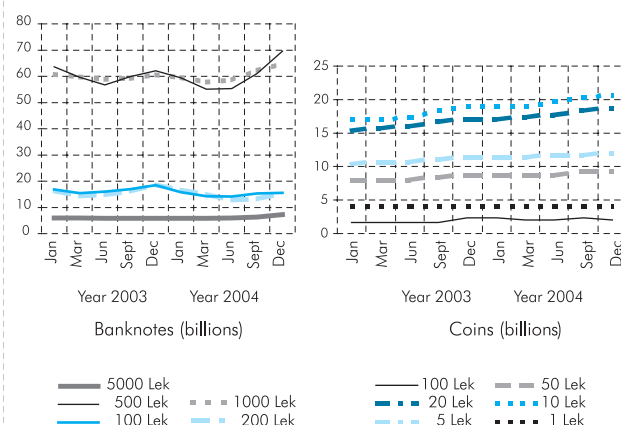


Table V.3. Weight of counterfeit banknotes by denominations (in percentage)

100 lek	200 lek	500 lek	1000 lek
1	33	47	19

V.3.1 NUMISMATICS

Further to practices of minting coins for numismatic purposes, during 2004, the Bank of Albania depicted two themes in the metallic coins, without legal tender: Albanian Antiquity; and Objects of Cultural Inheritance (popular costumes in Albania).

The themes were depicted 50 lekë coins, aiming at creating continuity in coins' size and their composition.



Coins without legal tender
"Albanian Antiquity"

In 2004, the mosaic of "The belle of Durrës", a cultural and historical object of the period of IV Century before Christ was selected out of the Albanian antiquity theme. This mosaic that was discovered in 1916 is with natural stones. The belle there represents the "Eulitheia" goddess. The mosaic is found at the National Historical Museum.

The other coin depicting the theme "Objects of Cultural Inheritance" was selected with the purpose to reflect Albanian tradition in this area.

This coin depicts the typical traditional Albanian costume, a man's kilt, obtained from a historical engraving of XIX Century, a period when this costume was used all over Albania, in North and South. After '30s, this costume continued to be used in the South of Albania. Also, there is selected a figurative element, that of the "Long Albanian Rifle", which is found with this name in the historical documents of XVIII Century.



Coins without legal tender
"Objects of Cultural Inheritance"

During 2004 the Bank of Albania web site was filled with materials on numismatics area. There are presented most of Albanian coins and banknotes by years. Also, in this web site, the reader is offered the possibility of finding information on Albanian numismatic coins. During 2004, the site "Currency" at the Bank of Albania web site is ranked among its most visited sites.

V.4 INTERNAL AUDIT

The Audit Department exercises its powers pursuant to requirements of Article 54 of the Law "On the Bank of Albania"

Even during 2004, the audit evaluated the implementation of laws and regulations at the Bank of Albania structures, on the basis of contemporary methods pursued even by other central banks. Along with membership in the Institution of Internal Auditing (IIA, USA), the Bank made possible the purchasing of a special program (ACL), assisting the Audit Department in performing audits as close as possible to international standards.

During 2004, a total number of 48 audits and controls were performed, on a monthly average of 4 audits per month. Out of them, 43 audits were planned in the annual program, and only 5 of them were realized according to suggestions and requirements of the Bank of Albania administrators, covering specific matters. The extension of the field where audits are performed, particularly in assessing their internal control systems on new Information and technology systems, currently installed or being installed at the institution, continues to be a characteristic.

In audits and controls exercised by auditors, along with non-compliances observed and relevant recommendations on them, recommendations for fulfilling and improving the regulations, procedures followed and work manuals are constantly given. All recommendations given were aimed at correct implementation of laws, by-laws, decisions of the Supervisory Council and other rules defined, thus aiming at strengthening the internal control systems and contributing to increasing the preventive role of control. Out of audits and controls performed over 2004, there were observed two cases of economic damage that were compensated by the persons held accountable for. Also, administrative measures were proposed to be taken against three persons.

CHAPTER VI. FINANCIAL STATEMENTS OF THE BANK OF ALBANIA

INDEPENDENT AUDITORS' REPORT

To the Supervisory Board of the Bank of Albania:

We have audited the accompanying unconsolidated balance sheets of the Bank of Albania (the "Bank") as at December 31, 2004 and 2003, 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 unconsolidated financial statements present fairly, in all material respects, the financial position of the Bank as at December 31, 2004 and 2003 and the results of its operations, changes in capital and reserves and cash flows for the years then ended in accordance with accounting policies adopted by the Supervisory Board of the Bank of Albania as disclosed in note 2 to the financial statements.

March 12, 2005

	Notes	As at december 31, 2004	As at december 31, 2003
ASSETS			
Assets denominated in foreign currencies			
Gold and precious metals	3	540	593
Deposits with the International Monetary Fund	4	16,817	18,056
Deposits with foreign banks	5	11,489	10,553
Securities available for sale	6	104,450	86,875
Other foreign assets	7	559	588
Total assets denominated in foreign currencies		133,855	116,665
Assets denominated in local currency			
Gold and precious metals	3	40	43
Transit credits	8	277	384
Securities available for sale	9.1	63,786	71,687
Investments held to maturity	9.2	1,649	1,573
Other domestic assets	10	2,553	2,635
Total assets denominated in local currency		68,305	76,322
Total Assets		202,160	192,987
LIABILITIES			
Liabilities denominated in foreign currencies			
Due to the International Monetary Fund	11	15,948	17,478
Due to non-resident financial institutions	12	1,527	1,747
Total liabilities denominated in foreign currencies		17,475	19,225
Liabilities denominated in local currency			
Currency in circulation	13	141,630	127,774
Due to domestic banks	14	39,318	33,970
Due to the Government	15	5,302	5,464
Deferred income	16	106	117
Other domestic liabilities	17	578	389
Total liabilities denominated in local currency		186,934	167,714
CAPITAL AND RESERVES			
Capital		750	750
Legal reserve		3,750	3,750
Revaluation reserve	18	(14,824)	(6,330)
Other reserves	19	8,075	7,878
Total capital and reserves		(2,249)	6,048
Total liabilities, capital and reserves		202,160	192,987

* The accompanying notes on pages 9 to 36 are an integral part of these financial statements.

	Notes	Year ended December 31, 2004	Year ended December 31, 2003
Operations with non-residents			
Interest and commission income	20	3,209	3,515
Interest and commission expense		(683)	(1,033)
Gains arising from foreign securities		-	963
Losses arising from foreign securities		-	(1,139)
Operations with non-residents, net		2,526	2,306
Operations with residents			
Interest and commission income	21	5,271	7,567
Interest and commission expense		(1,344)	(1,353)
Gains arising from domestic securities		-	796
Losses arising from domestic securities		-	(765)
Operations with residents, net		3,927	6,245
Other operating income, net	22	144	322
Net operating income		6,597	8,873
Other operating expenses			
Personnel expenses	23	(436)	(377)
Depreciation		(110)	(119)
Amortization		(339)	(320)
General and administrative expenses		(253)	(204)
Total other operating expenses		(1,138)	(1,020)
NET PROFIT FOR THE YEAR		5,459	7,853

	Capital	Legal reserve	Revaluation reserve	Other reserves	Retained earnings	Total
As at December 31, 2002	750	3,750	5,468	7,827	-	17,795
Net profit for the year	-	-	-	-	7,853	7,853
Net of pension fund	-	-	-	(148)	-	(148)
Foreign currency and gold revaluation	-	-	(12,040)	-	-	(12,040)
Security revaluation	-	-	270	-	-	270
Release of tangible fixed asset revaluation surplus	-	-	(28)	-	28	-
Increase of pension plan	-	-	-	20	-	20
Profit distribution	-	-	-	179	(7,881)	(7,702)
As at December 31, 2003	750	3,750	(6,330)	7,878	-	6,048
Net profit for the year	-	-	-	-	5,459	5,459
Foreign currency and gold revaluation	-	-	(8,333)	-	-	(8,333)
Securities revaluation	-	-	(133)	-	-	(133)
Release of tangible fixed asset revaluation surplus	-	-	(28)	-	28	-
Profit distribution	-	-	-	197	(5,487)	(5,290)
As at December 31, 2004	750	3,750	(14,824)	8,075	-	(2,249)

	Notes	Year ended december 31, 2004	Year ended december 31, 2003
Cash flows from operating activities			
Net profit for the year		5,459	7,853
Non-cash items in the statement of operation			
Increase in provision for doubtful loans		17	14
Depreciation and amortization		449	439
Discount amortization of securities available for sale		(4,643)	(6,543)
Interest income		(3,214)	(3,569)
Interests expense		1,405	1,416
Profit from sales of securities available for sale		(80)	(101)
Grant amortization (deferred income)		(79)	(70)
Adjustment for release of tangible fixed assets revaluation		28	28
Cash flow before the movement of working capital		(658)	(533)
Changes in operating assets			
Decrease in deposits with the IMF		1,248	1,794
Decrease in other foreign assets		27	55
Decrease in transit credits		107	6,939
Decrease in loans to domestic banks		-	3,405
Decrease in loans to the Government		-	1,150
Increase in other domestic assets		(107)	(39)
Decrease in due to the IMF		(1,530)	(1,669)
Decrease in due to financial institutions		(220)	(7,028)
Increase in due to domestic banks		4,292	2,093
(Decrease) increase in due to the Government		(162)	2,440
Increase in other domestic liabilities		169	60
Grant received		68	34
Cash flows generated from operations		3,892	9,234
Interest received		2,961	3,683
Interest paid		(1,408)	(1,440)
Net cash from operating activities		4,787	10,944
Cash flows from investing activities			
Purchase of fixed assets		(88)	(114)
Purchase of intangible assets		(168)	(35)
Purchase of foreign securities available for sale		(83,981)	(85,507)
Purchase of domestic securities available for sale		(182,577)	(201,809)
Sale and maturity of foreign securities available for sale		57,727	82,761
Sale and maturity of domestic securities available for sale		195,614	211,960
Increase of repurchase agreement		1,059	1,204
Adjustment for effect of foreign exchange		8,435	10,075
Net cash (used in) from investing activities		(3,979)	18,535

Cash flows from financing activities	Notes	Year ended december 31, 2004	Year ended december 31, 2003
Revaluation of other Reserves		(161)	114
Revaluation of foreign currency and gold		(8,333)	(12,039)
Deferred income		197	178
Increase (decrease) in money in circulation emissions		13,500	(4,000)
Profit distribution		(5,487)	(7,881)
Net cash used in financing activities		(284)	(23,628)
Increase in cash during the year		524	5,851
Cash and cash equivalents at the beginning of the year	24	21,926	16,075
Cash and cash equivalents at the end of the year	24	22,450	21,926

VI.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 No. 8269, dated 23/12/1997 "On the Bank of Albania". 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;
- compilation, approbation and application of monetary policy of Republic of Albania;
- supervision of commercial bank activities including issuance of licenses to all banks; and
- issuing of licenses for international banking institutions operating within the Republic of Albania.

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

VI.2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of preparation of financial statements

The financial statements have been prepared in accordance with the Albanian Law "On Accounting" and in accordance with accounting policies adopted by the Supervisory Board of Bank of Albania. This accounting policy is broadly in line with International Financial Reporting Standards ("IFRS") approved by the International Accounting Standards Board ("IASB") with the exceptions related to IAS 16, IAS 21, IAS 19, IAS 26 and IAS 27. These standards and interpretations were previously called International Accounting Standards ("IAS"). According to the local regulations IFRS are used in the preparation of the accompanying financial statements to the extent they do not contradict to the Albanian Law "On Accounting" and other local rules.

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

The financial statements presented include the accounts of the Bank prepared on the historical cost basis of accounting modified to include the revaluation of securities portfolio, foreign currency, gold, the head office building, and other financial assets and liabilities (available for sale). 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 publications

of Bank of Albania. The Supervisory Board of the Bank of Albania at the meeting dated April 1, 2003 decided that the Printing House should be under the supervision of Bank of Albania as a separated part of the organizational structure of Bank of Albania. The financial operations of the Printing House have not been consolidated with those of the Bank, because of the inability of the Printing House to perform the revaluation of its assets and its buildings consistent with the revaluation of the Bank's assets and buildings.

The financial position of the Printing House as at December 31, 2004 is set out in note 25 to these financial statements.

(b) Deviation from International Financial Reporting Standards

The following is a summary of the most significant deviations from IFRS:

- IAS 16 "Property, Plant and Equipment"

The revaluation methodology adopted for the revaluation of the head office building as detailed in Note 10 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.

- IAS 21 "The Effects of Changes in Foreign Exchange Rates"

The Law on the Bank of Albania requires the recognition of all the realized gain/loss from exchange rate revaluation in the balance sheet under the "Capital and Reserves" account and not as an income/expense for the period when revaluation occurred.

- IAS 19 "Employee Benefits" and IAS 26 "Accounting and Reporting by Retirement Benefit Plans".

Reporting and accounting of Pension Fund is not prepared in accordance with IAS 19 and IAS 26. Obligation due to Pension Fund is expressed as net value, but the calculation of this obligation is not in compliance with specifics of accounting standards to the extent that no actuarial estimation is performed.

- IAS 27 "Consolidated Financial Statement and Accounting for Investments in Subsidiaries"

The financial operations of the Printing House under the administration of the Bank have not been consolidated with those of the Bank, as it is explained above.

(c) Interest and Commission

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

of premium or discount on the securities, calculated based on the effective interest rate. Commission income is credited to income when received. Commission expense is debited to expense when paid.

(d) 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. Unrealized foreign exchange gains and losses are credited or charged to the revaluation reserve.

The applicable official Bank rate (LEK to the foreign currency unit) for the principal currencies as at December 31, 2004 and 2003 were as below:

	December 31, 2004	December 31, 2003
United States dollar (USD)	92.64	106.58
European Union currency unit (EUR)	126.35	134.32
British pound (GBP)	178.69	189.92
Special Drawing rights (SDR)	143.39	157.81
Gold ("Xau")	1 onz = 40,576.32	1 onz = 44,470.51

Revenues and expenses in foreign currency for the year are translated with the annual average exchange rate of the Bank as follows.

	2004	2003
United States dollar (USD)	94.58	108.69
European Union currency unit (EUR)	126.74	133.65
British pound (GBP)	182.47	190.25
Special Drawing rights (SDR)	145.58	159.37
Gold ("Xau")	1 onz = 41,867.86	1 onz = 44,356.73

(e) Investments

Securities held by the Bank are categorised into portfolios in accordance with the Bank's intent on the acquisition of the securities and pursuant to the Bank's security investment strategy. These are classified as follows:

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

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

Held-to-maturity

Investments held to maturity are financial assets with fixed or determinable payments and fixed maturities that the Bank has the positive intent and ability to hold to maturity.

Held to maturity investments are recognized on a trade-date basis and are initially measured at cost. At subsequent reporting dates they are carried at amortized cost, less any impairment loss recognized to reflect irrecoverable amounts.

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 organized 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.

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 and any impairment loss of that asset is determined, based on the net present value of future anticipated cash flows, and is recognized for the difference between the recoverable amount and the carrying amount as follows:

- For financial assets at amortized 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 recognized 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.

(f) Repurchase agreements and reverse repurchase agreements

Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements) are generally treated as collateralised financing transactions and are carried at the amounts of cash advanced or received, plus accrued interest. Repurchase agreements are recorded in the balance sheet item “Due to domestic banks”. Based on the Bank’s regulation on repurchase agreements, the Bank is not required to put up any collateral for these securities. Interest earned on reverse repurchase agreements and interest incurred on repurchase

agreements is recognized as interest income or interest expense, over the life of each agreement using the interest rate approved by the Supervisory Council.

(g) 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 10). 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 (sell or out of use) of fixed assets are recognized in the profit and loss account in the year of disposal. Depreciation is provided on all fixed assets based on the historic cost. The annual charge for depreciation is computed using the straight-line method, using rates specified for each depreciable asset based on estimated useful lives. The estimated useful lives applied during 2004 are the same as year 2003:

	2004
Building – Head office	40 years
Buildings – At branches	25 years
Vehicles	5-10 years
Furniture, fixtures and equipment	3-20 years
Computer hardware	2 years

(h) Printing and minting costs

The costs of printing banknotes and minting coins are capitalized as intangible fixed assets and amortized over 2.5 years and 10 years, respectively.

(i) 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 of the Bank of Albania.

(j) 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.

(k) 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.

(l) Managed assets

At as December 31, 2004, the Bank held as custodian short-term treasury, at nominal value LEK 298 billion. These are bills issued by the Ministry of Finance and gold and other precious metals on behalf of the Government, at market value of LEK 3,577. As the Bank acts as custodian for these assets it does not bear any credit risk related to them.

The value of gold held on behalf of the Government as at December 31, 2004 is as below:

	December 31, 2004 (in million LEK)	December 31, 2003 (in million LEK)
Gold standardized abroad	2,268	2,484
Gold not standardized in Albania	1,194	1,309
Other precious metals	115	119
Total	3,577	3,912

Interest received from the deposit of government gold reserves are recognized as income from interest due to Government, increasing the liability due to Government. For year 2004 the interest received is of 6 ounces. The difference of LEK 335 million is a result of the fluctuation of exchange rates. (Note 3)

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

(m) 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/amortization charge on that asset.

(n) Comparison

Certain comparatives figures have been reclassified to conform to current year presentation.

VI. 3. GOLD AND PRECIOUS METALS

As at December 31, 2004, the value of gold owned by the Bank placed in gold time deposits abroad was LEK 540 million (2003 - LEK 593 million), being 13,319 troy ounces of gold (2003 – 13,319 troy ounces).

Gold is valued at the London fixing rate on the balance sheet date. The difference of LEK 56 million (2003 – LEK 32 million) resulting from the revaluation of gold is recorded in the revaluation reserve. As at December 31, 2004, the price for one troy ounce of gold was USD 438 (2003 – USD 417.25).

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, 2004 (2003 – LEK 39 million) and LEK 4 million of non-international standard gold (2003 – LEK 4 million).

VI.4. DEPOSITS WITH THE INTERNATIONAL MONETARY FUND

	As at december 31, 2004	As at december 31, 2003
International Monetary Fund	7,476	8,407
Special Drawing Rights ("sdr")	9,306	9,623
Accrued interest	35	26
Total	16,817	18,056

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. The SDR holdings 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 11. The SDR holdings bear interest, which is determined on weekly basis. The interest rate prevailing as at December 31, 2004 was 2.22% (2003 – 1.57%).

VI.5. DEPOSITS WITH FOREIGN BANKS

	As at december 31, 2004	As at december 31, 2003
Current accounts	11,109	8,753
Short-term deposits	379	1,797
Accrued interest	1	3
Total	11,489	10,553

Short-term deposits mature in January 2005 and earn interest of 2.06% (2003 – 0.93% to 3.63%). Deposits and current accounts with foreign banks are denominated in EUR, USD and GBP which equate to the following foreign currency balances:

	As at December 31, 2004	As at december 31, 2003
EUR	27	41
USD	85	44
GBP	1	2

VI.6. FOREIGN SECURITIES AVAILABLE FOR SALE

Foreign securities disclosed in market value are as follows:

	As at december 31, 2004	As at december 31, 2003
United States Government discounted notes	34,277	33,587
French Government treasury notes	41,450	32,612
Bank for International Settlements: medium-term investments	5,672	4,046
United States agencies discounted notes	4,625	7,567
French Government treasury bills	1,746	2,662
Fixed rate investments (FIX BIS)	16,680	6,401
Total	104,450	86,875

Foreign securities portfolio disclosed in nominal value and by currency are as follows:

	As at december 31, 2004	As at december 31, 2003
USD		
United States Government discounted notes	370	315
United States agencies discounted notes	50	71
BIS: medium-term investments	-	5
Fixed rate investments (FIX BIS)	61	5
Total	481	396
EURO		
French Government treasury notes	328	243
BIS: medium-term investments	20	26
Fixed rate investments (FIX BIS)	69	20
French Government treasury bills	14	20
Total	431	309
GBP		
Fixed rate investments (FIX BIS)	12	16
BIS: medium-term investments	18	-
Total	30	16

United States Government discounted notes are denominated in USD and have coupon rates varying between 1.125% and 5.75%. Interest is paid semi-annually and maturities vary between January 2005 and November 2009. The yields vary between 1.05% and 4.65% (2003 - 0.95% and 4.65%).

The French Government treasury notes are denominated in EUR with coupon rates varying between 2.25% and 7.5%. Interest is paid annually and maturities range between January 2005 and July 2009. The yields vary between 2.06% and 4.21% (2003 – 2.06% and 4.53%).

Bank of International Settlements – medium term investments comprise of fixed coupon securities denominated in EUR and GBP with coupon rates varying between 3.15% and 5.5%. Interest is payable annually for investments in EUR and semi-annually for investments in GBP, and maturities range between June 2005 and September 2009. The yields vary between 2.47% and 5.27% (2003 – 3.11% and 4.72%).

United States agencies discounted notes are denominated in USD with coupon rates varying between 1.875% and 3.875%. Interest is paid semi-annually and maturities range between January 2005 and February 2007. The yields vary between 1.14% and 2.44% (2003 – 1.14% and 4.71%).

The French Government treasury bills are denominated in EUR and mature on various dates between April 2005 and September 2005 with yields varying between 2.11% to 2.21% (2003 – 1.86% and 2.18%).

The Fixed rate investments (FIX BIS) issued by the Bank of International Settlements are denominated in USD, EUR and GBP with yields varying between 1.85% and 4.99% (2003 – 1.02% and 4.16%) and maturities ranging between January 2005 and December 2005.

VI.7. OTHER FOREIGN ASSETS

As at December 31, 2004, other foreign assets are comprised of cash on hand in foreign currency of LEK 11 million (2003 - LEK 13 million) and of quotations for participation of the Republic of Albania in International Institutions.

	As at december 31, 2004	As at december 31, 2003
Cash on hand in foreign currency	11	13
Other		
World Bank quotation	357	362
International Development Agency Quotation	35	36
Multilateral Investment Guarantees Agency Quotation	12	13
International Finance Corporation Quotation	68	78
European Bank for Reconstruction and Development Quotation	54	62
Islamic Development Bank Quotation	22	24
Total Other	548	575
Total	559	588

VI.8. TRANSIT CREDITS

The total of LEK 277 million (2003 – LEK 384 million) represent credits for services provided to the Italian-Albanian Bank for further distribution to ultimate borrowers to support state development programs (See Note 12). All loans are guaranteed by the Government of Albania.

VI.9. DOMESTIC SECURITIES

VI.9.1 SECURITIES AVAILABLE FOR SALE

	As at December 31, 2004	As at December 31, 2003
Short-term treasury bills	63,786	71,687
Total	63,786	71,687

Short-term treasury bills as at December 31, 2004 relate to Government of Albania zero-coupon treasury bills, with maturities 3 to 6 months, ranging between January 2005 and June 2005, with yields varying between 6.10% and 8.10% (2003 – 7.25% and 12.95%)

VI.9.2 INVESTMENTS HELD TO MATURITY

	As at December 31, 2004	As at December 31, 2003
Zero-coupon bond for capitalization of National Commercial Bank (NCB)	1,649	1,573
Total	1,649	1,573

Security for the capitalization 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.

VI.10. OTHER DOMESTIC ASSETS

	As at December 31, 2004	As at December 31, 2003
Tangible fixed assets, net	1,427	1,449
Intangible assets, net	378	549
Loans to employees	613	477
Other debtors	44	84
Numismatic	63	50
Inventory	26	22
Other	2	4
Total	2,553	2,635

Loans to employees include a provision for legal claims of LEK 10 million at December 31, 2004 and LEK 14 million at December 31, 2003. Loans to employees are collateralised by security such as mortgages, totaling approximately LEK 626 million at December 31, 2004 and LEK 537 million at December 31, 2003. Net intangible assets are comprised of:

	As at december 31, 2004	As at december 31, 2003
Computer software	277	166
Banknotes printed and coins minted	2,454	2,397
Accumulated amortization	(2,353)	(2,014)
Total	378	549

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

In LEK mln	Land, buildings and general constructions	General equipment	Transport vehicles	Total property, plant and equipment
Cost/Valuation				
Balance at January 1, 2004	1,421	482	161	2,064
Additions	20	82	-	102
Disposals	(1)	(2)	-	(3)
Balance at December 31, 2004	1,440	562	161	2,163
Accumulated depreciation				
Balance at January 1, 2004	147	351	117	615
Charge for the year	35	62	13	110
Additions	-	13	-	13
Disposals	-	(2)	-	(2)
Balance at December 31, 2004	182	424	130	736
Net book value				
Balance at December 31, 2004	1,258	138	31	1,427
Balance at December 31, 2003	1,274	131	44	1,449

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 not based on discounted future cash flows, but 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 and is amortized monthly in accordance with the respective amortization rate.

According to Albanian law, the legal title of the building where the Bank is located is unclear. Bank of Albania is in process to determine the status of the ownership for the fixed assets managed by the Bank.

VI.11. DUE TO THE INTERNATIONAL MONETARY FUND

	As at december 31, 2004	As at december 31, 2003
Enhanced Structural Adjustment Facility ("ESAF")	8,953	9,599
IMF securities account	5,148	6,032
IMF account in LEK	1,847	1,847
Total	15,948	17,478

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 3 component facilities:

The initial ESAF facility was drawing down in 1993, repayable over 10 years, which commenced in 1999. The outstanding balance as at December 31, 2004 was SDR 706,000 (2003 – SDR 4,377,000) (being the last payment of this facility payable in June 2005) and the facility bears interest at 0.5%, payable semi-annually.

An additional loan under this facility (known as Poverty Reduction and Growth Facility) approved by the agreement of May 13, 1998 totaling SDR 45,040,00, was drawn down during the period 1999 to 2001. The outstanding balance as at December 31, 2004 was SDR 41,728,200 (2003 - SDR 44,451,500). This facility is repayable by 2011 in 10 semi-annual installments commenced in 2004. Interest is payable, after the grace period, at 0.5% semi-annually.

The Poverty Reduction and Growth Facility 3 for Albania loan: This is a SDR 28,000,000 loan facility approved on June 21, 2002 which will be disbursed until June 20, 2005. The balance as of December 31, 2004 is SDR 20,000,000 (2003 - SDR 12,000,000) 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 equal installments.

VI.12. DUE TO NON-RESIDENT FINANCIAL INSTITUTIONS

	As at december 31, 2004	As at december 31, 2003
Transit credits (Note 8)	277	384
Loan from the Bank of Greece	1,112	1,183
Due to the World Bank	133	175
Accrued interest	5	5
Total	1,527	1,747

The loan for development of LEK 277 million consists of USD 1 million and of EURO 1.4 million (note 8) by European Investment Bank. Interest is paid by the recipients of these transit credits (banks and domestic companies) directly to the providers of the funds. The loan from the Bank of Greece (Hellenic Republic borrowing of EURO 8.8 million) 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. Due to World Bank represents the accounts of the international organizations such as IBRD, IDA and MIGA in the Bank of Albania.

VI.13. 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 as at December 31, 2004:

Nominal value LEK	December 31, 2004		December 31, 2003	
	Number in thousand	Total LEK (mln)	Number in thousand	Total LEK (mln)
100	15,515	1,552	18,441	1,844
200	15,307	3,061	18,596	3,719
500	69,623	34,812	62,049	31,025
1,000	64,720	64,720	60,563	60,563
5,000	7,232	36,162	5,875	29,375
Coins		1,323		1,248
		141,630		127,774

VI.14. DUE TO DOMESTIC BANKS

	As at december 31, 2004	As at december 31, 2003
Foreign currency		
Compulsory reserve	10,826	9,140
Accounts of second level banks	65	51
Deposits taken as guarantee	104	-
	10,995	9,191
Domestic currency (LEK)		
Compulsory reserve	24,655	22,236
Accounts of second level banks	529	663
Repurchase agreements	2,263	1,204
Overnight deposits	855	652
	28,302	24,755
Accrued interest	21	24
Total	39,318	33,970

Interest on compulsory reserves is calculated as follows:

- LEK balances: 70% of the yield on the repurchase agreements: 3.675 % as at December 31, 2004 (70% of the yield on the repurchase agreements: 4.9 % as at December 31, 2003);
- USD balances: 70% of the one-month USD LIBOR rate: 1.69 % as at December 31, 2004 (70% of the one-month USD LIBOR rate: 0.8% as at December 31, 2003);
- EUR balances: 70% of the one-month EUR LIBOR rate: 1.52% as at December 31, 2004 (70% of the one-month EUR LIBOR rate: 1.49% as at December 31, 2003).

The Bank does not pay interest on correspondent accounts and demand deposits. The deposit taken as a guarantee is deposited by Dardania Bank (USD 1.1 million) as a guarantee for the protection of the customers in accordance with the Bank's order no. 4045 dated July 30, 2004. For this deposit the interest is calculated in accordance with the rates for the repurchase agreements at Federal Reserve Bank. Overnight deposits from domestic banks attract interest of 2.5% (2003 - 3.5%).

VI.15. DUE TO THE GOVERNMENT

	As at december 31, 2004	As at december 31, 2003
Profit distributable to the Government	400	200
Deposits received on behalf of the Government	4,880	5,230
Other	22	34
Total	5,302	5,464

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. 16 dated on February 23, 2005.

Deposits received on behalf of the Government includes the main account of LEK 3,181 million and international donor funds deposited at the Bank for subsequent transfer to aid projects in Albania, of LEK 1,699 million.

"Other" includes funds received by the Bank of LEK 22 million (2003 – LEK 24 million) from a loan granted to the Government by the Islamic Arabian Bank of Development.

VI.16. DEFERRED INCOME

	As at december 31, 2004	As at december 31, 2003
World Bank grant	225	157
World Bank grant amortization	(155)	(76)
Other	36	36
Total	106	117

The World Bank grant relates to a grant received by the Bank during the years 2002-2004 for the purchase of computer software and equipment for the implementation of the ATM project (Accounting and Treasury Management) totaling LEK 157 million and for the RTGS project (Real time Gross Settlement System) of LEK 68 million. "Other" includes the value related to the two buildings donated by the Savings Bank in the city of Korca and Berat.

VI.17. OTHER DOMESTIC LIABILITIES

	As at december 31, 2004	As at december 31, 2003
Due to Printing House (note 25)	217	176
Deposits of individuals from the participation in Treasury Bills	272	177
Net obligation/ Pension fund	1	1
Other	88	35
Total	578	389

Pension plan scheme consists of employee contribution of 2% of gross salary and employer contribution of 15% on the total payroll amount.

Net obligation/ pension plan as at December 31, 2004 and 2003 are as follow:

	As at december 31, 2004	As at december 31, 2003
Obligation value of 2% of contribution	15	12
Results of 2% contribution invested	3	1
Real value of the treasury bill portfolio	(17)	(12)
Net obligation of 2% contribution	1	1

	As at december 31, 2004	As at december 31, 2003
Obligation value of 15% of contribution	161	137
Results of 15% contribution invested	56	28
Real value of the treasury bill portfolio	(217)	(165)
Net obligation of 15% contribution	-	-

"Other" includes accrued expenses of LEK 49 million (2003 – LEK 7 million) related to maintenance of ATM system, repair and maintenance of sorting machines, Rojter services, statistics information, etc. The Bank is currently under claims for several legal litigations raised in the normal course of business. A net provision of LEK 20 million has been recognized in relation to these claims for the year ended December 31, 2004 included in the other operating income (2003 – nil).

VI.18. REVALUATION RESERVE

The components of the revaluation reserve are as follows:

	As at december 31, 2004	As at december 31, 2003
Revaluation of foreign currency and gold balances	(16,005)	(7,672)
Reserve of security revaluation	137	270
Revaluation of historic notes and coins	32	32
Revaluation of Head Office building (Note 10)	1,012	1,040
Total	(14,824)	(6,330)

During year 2004, the revaluation reserve negative balance for foreign currency and gold balances has increased by LEK 8,333 million (2003 - LEK 12,040 million) due to a further revaluation of currencies during the year. In accordance with the law "On the Bank of Albania" article 64/b, and law no.93339 dated December 21, 2004 "On the State Budget for 2005", the Ministry of Finance issued securities by a total of LEK 7,672 million to cover the negative balance of the revaluation reserve created during year 2003. These securities were issued on February 1, 2005, with a maturity of six months renewable and an interest rate of 7.10%.

VI.19. OTHER RESERVES

The components of the other reserves are as follows:

	As at december 31, 2004	As at december 31, 2003
Special reserve for Balance of Payments	7,209	7,209
Investment fund	301	301
Other	565	368
Total	8,075	7,878

The special reserve relates to funds provided by the European Community as a financial assistance to support Albania on its transition towards the market economy. These grants have been transferred during the period 1992 – 1993 supporting the long-standing of the Balance of Payment and reserves balance and no movement have been incurred in this reserve since 1995. Investment fund consists of a fund created with decision of Supervisory Council with aim purchase of a new building for the Bank of Albania. "Other" includes reserves created from the allocation of profits for years 2002 - 2004 based on the Supervisory Council decisions on the respective following years. A further allocation of LEK 197 million was made from the profit of year 2004.

VI.20. INTEREST AND COMMISSION INCOME (NON-RESIDENTS)

	Year ended december 31, 2004	Year ended december 31, 2003
Interest income from securities	2,739	3,234
Interest income from time deposits	253	103
Interest from SDR and IMF	177	163
Other	40	15
Total	3,209	3,515

VI.21. INTEREST AND COMMISSION INCOME (RESIDENTS)

	Year ended december 31, 2004	Year ended december 31, 2003
Interest income from Government loans	65	54
Interest income from securities	5,172	7,484
Other	34	29
Total	5,271	7,567

VI.22. OTHER OPERATING INCOME, NET

	Year ended december 31, 2004	Year ended december 31, 2003
Net profit from the sale of investments	80	246
Income from social aid	79	70
Other	2	20
Provision for legal claims and other (note 17)	(17)	(14)
Total	144	322

VI.23. PERSONNEL EXPENSES

Personnel expenses consist of employees' salaries, social insurance, pension plan contribution and other costs.

Social costs represent mainly compulsory contributions to the Social Security Fund. As at December 31, 2004, the Bank had 323 employees (2003 – 304 employees).

VI.24. CASH AND CASH EQUIVALENTS

	As at december 31, 2004	As at december 31, 2003
Deposits with foreign banks (note 5)	11,489	10,551
Domestic currency on hand	10,370	10,726
Foreign currency on hand (note 7)	11	13
Gold held abroad (note 3)	540	593
Gold and other precious metals held domestically (note 3)	40	43
Total	22,450	21,926

VI.25. PRINTING HOUSE

As detailed in Note 2(b), the Bank controls the operations of the Printing House. The financial position of the Printing House as at December 31, 2004 and 2003 is as follows:

	As at december 31, 2004	As at december 31, 2003
ASSETS		
Tangible fixed assets	23	30
Inventory	60	41
Trade accounts receivable	1	10
Amount due from the Bank (see note 17)	217	176
Total assets	301	257
EQUITY AND LIABILITIES		
Capital	52	52
Legal reserve	19	19
Investment reserves	24	24
Other reserves	6	6
Retained earnings	159	156
Total capital and reserves	260	257
Other liabilities	41	-
Total equity and liabilities	301	257

	As at december 31, 2004	As at december 31, 2003
Income	117	148
Expenses	(114)	(127)
Profit of the year	3	21

VI.26. CONTINGENCIES AND COMMITMENTS

On November 10, 2004, Bank of Albania issued a guarantee in favor of Raiffeisen Bank sh.a, declaring the commitment of the Bank to guarantee the amount of LEK 29 milliard in Treasury Bills of the Albanian Government in the Raiffeisen Bank portfolio. The price of this guarantee is 0.2 për qind on annual bases, with three months payments. This guarantee matures in November 5, 2005.

VI.27. RELATED PARTIES

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the party in making financial and other decisions. In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form. The only related parties of Bank of Albania are the relations with directors and the members of the Supervisory Council. As at 31 December 2004 and 31 December 2003, transactions made with related parties comprised:

	As at december 31, 2004	As at december 31, 2003
Other domestic Loans		
Loans to employee		
- Directors	46	40
Total assets	46	40

	Year ended december 31, 2004	Year ended december 31, 2003
Administrative expenses		
Mobile expenses		
- Directors	3	2
Salaries and Bonuses		
Directors	42	40
Total of administrative expenses	45	42

VI. 28. RISK MANAGEMENT

The reserve is under the administration of the Bank of Albania and its inventory is performed by the Monetary Operations Department, which is based on the regulation "About the policy of administrating the reserves", approved by the Supervisory Board. The reserve, in accordance with the liquidity needs, is invested in short-term securities and in fixed coupon instruments

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 analyzing 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.

The Monetary Operations department of the Bank monitors interest rate risk. The Bank mitigates such risks by maintaining a significant excess of interest bearing assets over liabilities (as detailed in Note 28 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.

VI.28. INTEREST RATE SENSITIVITY

	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
Assets								
Gold and precious metals	-	-	-	-	-	-	540	540
Deposits with the IMF	-	9,341	-	-	-	-	7,476	16,817
Deposits with foreign banks	11,489	-	-	-	-	-	-	11,489
Foreign securities available for sale	7,850	4,110	13,569	14,710	64,211	-	-	104,450
Other foreign assets	-	-	-	-	-	-	559	559
Other gold & precious metals	-	-	-	-	-	-	40	40
Transit credits	-	-	-	-	-	-	277	277
Securities available for sale	21,879	25,034	16,873	-	-	-	-	63,786
Investments held to maturity	-	-	-	1,649	-	-	-	1,649
Other domestic assets	-	-	-	-	-	613	1,940	2,553
	41,218	38,485	30,442	16,359	64,211	613	10,832	202,160
Liabilities and equity								
Due to the IMF	-	-	407	477	6,203	1,866	6,995	15,948
Due to non-resident financial institutions	-	-	-	5	-	1,112	410	1,527
Currency in circulation	-	-	-	-	-	-	141,630	141,630
Due to domestic banks	38,724	-	-	-	-	-	594	39,318
Due to the Government	-	-	-	-	-	-	5,302	5,302
Deferred income	-	-	-	-	-	-	106	106
Other domestic liabilities	-	6	-	-	-	-	572	578
Capital and reserves	-	-	-	-	-	-	(2,249)	(2,249)
	38,724	6	407	482	6,203	2,978	153,360	202,160
Balance sheet gap as at December 31, 2004	2,494	38,479	30,035	15,877	58,008	(2,365)	(142,528)	-
Cumulative interest rate sensitivity gap - 2004	2,494	40,973	71,008	86,885	144,893	142,528	-	-

VI.28. INTEREST RATE SENSITIVITY (CONTINUED)

	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
Assets								
Gold and precious metals	-	-	-	-	-	-	-	593
Deposits with the IMF	-	-	-	-	9,649	-	8,407	18,056
Deposits with foreign banks	10,553	-	-	-	-	-	-	10,553
Foreign securities available for sale	5,351	6,920	7,655	17,593	49,356	-	-	86,875
Other foreign assets	-	-	-	-	-	-	588	588
Other gold & precious metals	-	-	-	-	-	-	43	43
Transit credits	-	-	-	-	-	-	384	384
Securities available for sale	22,078	30,820	18,789	-	-	-	-	71,687
Held to maturity securities	-	-	-	-	1,573	-	-	1,573
Other domestic assets	-	-	-	84	-	491	2,060	2,635
	37,982	37,740	26,444	17,677	60,578	491	11,482	192,987
Liabilities and equity								
Due to the IMF	-	-	449	560	6,545	2,045	7,879	17,478
Due to non-resident financial institutions	-	-	-	5	-	1,183	559	1,747
Currency in circulation	-	-	-	-	-	-	127,774	127,774
Due to domestic banks	33,256	-	-	-	-	-	714	33,970
Due to the Government	-	-	-	-	-	-	5,464	5,464
Deferred income	-	-	-	-	-	-	117	117
Other domestic liabilities	-	-	-	-	-	-	389	389
Capital and Reserves	-	-	-	-	-	-	6,048	6,048
	33,256	-	449	565	6,545	3,228	148,944	192,987
Balance sheet gap as at December 31, 2003	4,726	47,389	25,995	17,112	44,384	(2,737)	(136,869)	-
Cumulative interest rate sensitivity gap - 2003	4,726	52,115	78,110	95,222	139,606	136,869	-	-

VI.29. CURRENCY NET POSITION

	LEK	USD	EUR	GBP	Other	Total
Assets						
Gold and precious metals	-	-	-	-	540	540
Deposits with International Monetary Fund	6,995	-	-	-	9,822	16,817
Deposits with foreign banks	-	7,893	3,406	190	-	11,489
Securities available for sale	-	44,570	54,481	5,399	-	104,450
Other foreign assets	361	191	7	-	-	559
Gold and other precious metals	40	-	-	-	-	40
Transit credits	-	95	182	-	-	277
Securities available for sale	63,786	-	-	-	-	63,786
Investments held to maturity	1,649	-	-	-	-	1,649
Other domestic assets	2,510	1	42	-	-	2,553
Total assets	75,341	52,750	58,118	5,589	10,362	202,160
Liabilities						
Due to the International Monetary Fund	6,995	-	-	-	8,953	15,948
Due to non-resident financial institutions	132	95	1,300	-	-	1,527
Currency in circulation	141,630	-	-	-	-	141,630
Due to domestic banks	28,319	5,204	5,795	-	-	39,318
Due to the Government	4,062	305	934	1	-	5,302
Deferred income	106	-	-	-	-	106
Other domestic liabilities	537	16	23	2	-	578
Total Liabilities, capital and reserves	181,781	5,620	8,052	3	8,953	204,409
Net currency position as at December 31, 2004	(106,440)	47,130	50,066	5,586	1,409	(2,249)
Net currency position as at December 31, 2003	(81,139)	41,891	40,524	3,602	1,171	6,048

