

## CHAPTER I WORLD ECONOMY

### I.1 LARGE ECONOMIES AND CENTRAL BANKS

World economy continued to expand over 2005. Preliminary estimations indicate that the economic activity in world level grew by 3.2 percent during the last year<sup>1</sup>. This growth was encouraged mainly by favourable stages of economic cycle of the American economy and of Asian economies, by the world trade growth. Notwithstanding the tightening direction, the macroeconomic policy stood at stimulating levels, positively impacting on the economic activity. On the other hand, year 2005 was characterized by a number of events that restrained economic growth. The high oil price and investments cycle maturity after a year of rapid economic growth, made the economic activity in 2005 be slower than the level recorded in 2004. The slow-down of economic growth is estimated to have included almost all economic regions. This phenomenon is noticed even in developing countries, which have demonstrated, during the recent years, faster growth rates than in the advanced economies. However, thanks to their large weight, the latter ones remain the world development engine.

	2003	2004	2005 (estimate)	2006 (forecast)
World economy	2.5	3.8	3.2	3.2
Developed countries	1.8	3.1	2.5	2.5
USA	2.7	4.2	3.5	3.5
Euro area	0.7	1.7	1.3*	1.4
Japan	1.4	2.6	2.3	1.8
Developing countries	5.5	6.8	5.9	5.7

Table 1 Economic growth performance

Source: World Bank, "Prospects for the Global Economy," November 2005

\*Source: Eurostat, Preliminary Estimate

	GDP-Q3	Unemployment rate	CPI	Budget deficit (as a percentage of GDP)
USA	+3.5	4.9 (December)	+3.4 (December)	-3.7
Euro area	+1.6	8.3 (November)	+2.2 (December)	-2.9
Germany	+1.4	11.2 (December)	+2.1 (December)	-3.9
France	+1.8	9.6 (November)	+1.5 (December)	-3.2
Italy	+0.1	7.5 (September)	+2.0 (December)	-4.3
Great Britain	+1.7	5.0 (November)	+2.0 (December)	-3.1
Japan	+2.9	4.6 (November)	-0.8 (November)	-6.5

Table 2 Main economic indicators in annual terms (in percentage)

Source: American Department of Labour, American Department of Trade, "The Economist", January 21, 2006

#### • AMERICAN ECONOMY

Economic growth of the United States of America has slowed down its rate to 3.5 percent<sup>2</sup> during 2005. The low long-term interest rates have influenced

positively on fuelling the domestic demand, while the dollar's accumulated depreciation has helped American exports. The American economy has also benefited from constant productivity growth during 2005. Besides the positive impact on the economic growth, this factor has helped in smoothing the inflationary pressures by not escalating the price level further. The annual inflation rate in December was 3.4 percent, from 3.3 percent it was in the previous year. The economic growth has also helped in the creation of new jobs. The unemployment rate in December was 4.9 percent, from 5.4 percent it was in the previous year, recording the lowest levels in the developed countries.

Short-term forecasts for the American economy remain positive, in spite of the concerns on federal budget performance and on high current account deficit. The budget deficit of 2005 is estimated at 3.5 percent of GDP. Also, the economic growth slowdown in the fourth quarter, owing to high oil prices and damages caused by hurricanes, has raised doubts about maintaining economic growth in the same paces for 2006.

- EURO AREA ECONOMY

Economic growth rate for 2005 is estimated to 1.6 percent in the full, 25 countries of the European Union and 1.3 percent<sup>3</sup> in the Euro area. The economic growth rate slowdown in the last quarter was less marked than in the United States of America. Annual inflation rate in harmonized terms was 2.2 percent in December, standing above the European Central Bank's target. The recent changes of administered prices and indirect taxes, significant monetary growth and increased volume of lending under the conditions of ample liquidity in the Euro area, as well as the possibility of making concrete the indirect effect of soaring oil price on other price index items, strengthen the likelihood of rising inflationary pressures in the medium and long run. However, these risks are not fully manifested in mid-term inflation expectations, which should remain stable in compliant with price stability. In this way, the monetary policy stance of the ECB is considered to have had a positive effect on the sustainable economic growth and on gradual reduction of unemployment rate during 2005.

On the other hand, the situation in the external sector of the Euro area seems to have reversed. The current account until October recorded a deficit of Eur 9 billion, compared to a surplus of Eur 43 billion recorded over the previous year. This shifting is owing to significant growth in the value of imports as compared to that of exports, caused mainly by import price rise.

Most of the countries of the Euro area have signed renovated programs of stabilization, including also the mid-term budget plan. The assessment of these programs by ECOFIN<sup>4</sup> Council and their implementation constitute a possibility for reinforcing the commitment to a sound fiscal policy and rigorous implementation of the Stability and Growth Pact<sup>5</sup>. It will have a significant positive impact if importance is laid on the consolidation reliability, limiting expenditures and including fiscal measures in a comprehensive agenda of reforms.

### • INTEREST RATES

The Federal Reserve Bank (FED) continued to apply a tightening monetary policy during 2005. The key interest rate rose 8 times during 2005, reaching to 4.25 percent at end of the year, from 2.25 percent it was at the year start. The European Central Bank raised the key interest rate by 25 points in December of 2005, leading it to 2.25 percent. This was the first time that the ECB changed its monetary policy from the lowest historical levels since mid of 2003. The main reason that led the policymakers of the ECB to increase the key interest rate in economy was the identification of some pressures on price stability during 2005. Meanwhile, the Bank of Japan continues the policy of maintaining the interest rate unchanged, close to zero, in an effort to fight prolonged price deflation, expected to come to an end during 2006.

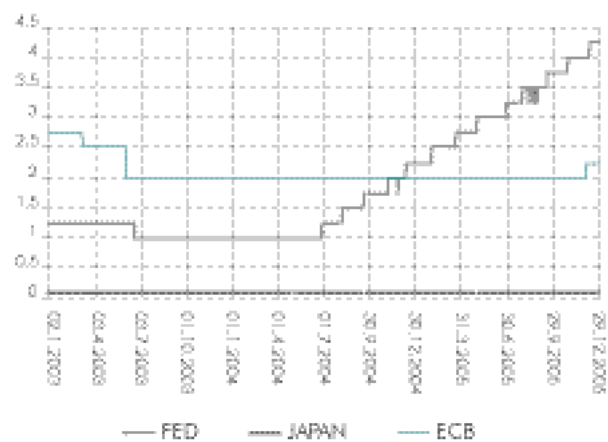
### • EXCHANGE RATE

Start of 2005 found the American currency exchanged at an inferior price with the common European currency. However, the exchange rate of both currencies started to change gradually from the high initial levels, testifying, time and again, an appreciating trend of the American dollar almost throughout the year. At end of December 2005, 1 euro was exchanged with USD 1.179, from the record of USD 1.362 it reached in December 2004, thus being appreciated by 13.4 percent. The appreciation of the American currency is mainly due to continuous rise of short-term interest rates by the Federal Reserve Bank in the USA during 2005, and cutting on the other hand of the long-term interest rates in Europe, caused by a slower performance of the economic activity in the Euro area. The large spread between interest rates set forth by both central banks impacted significantly on the growth of financial assets issued in American dollar, despite the frightful fiscal deficit and the exaggerated negative balance of the current account in the USA, which for 2005 is forecasted to exceed USD 750 billion<sup>6</sup>.

### • OIL PRICE

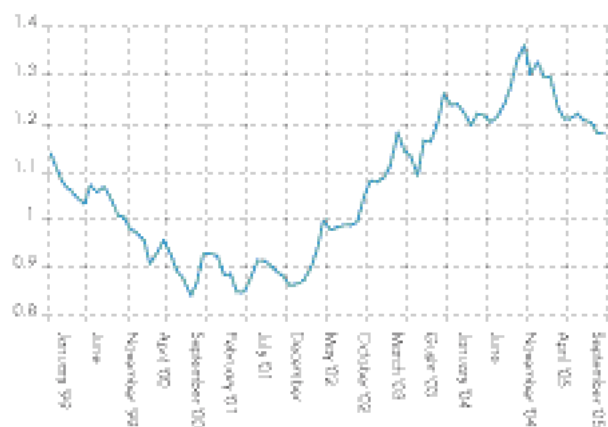
The world economic growth has brought about increased demand for oil over 2005. The world

Chart 1 Key interest rates in large economies (in percentage)



Source: Central Banks

Chart 2 Exchange rate performance of USD/EUR



Source: European Central Bank

Chart 3 Crude oil prices (in USD per barrel)



Source: Official energy statistics of the American Government

demand for oil reached a daily average of 83.3 million barrels per day during the last quarter of the year, recording a growth of 1.2 million barrels. In spite of rapid expansion of demand, the oil price rise is attributed mainly to erosion of excess capacities and to other problems along the chain of oil supply in the market.

The average world oil demand in 2006 is forecasted to increase by 1.6 million barrels a day or 1.9 percent from 2005. However, the supply increase of oil producing countries and the expected expansion of processing and storing capacities suggest fewer pressures on oil prices over 2006.

## 1.2 ECONOMIES OF THE REGION

Economies of the region have generally had a satisfactory performance during 2005. The economic growth rate of the Southeast Europe<sup>7</sup> is estimated to fluctuate around 5 percent. Though the growth rate recorded a slowdown from the 6.5 percent economic growth noted during 2004, it remains obviously higher than the Euro area economy<sup>8</sup>. Domestic demand remains the main source of growth of the Southeast Europe. Its slowdown in 2005 brought about growth rate decline as well.

*Table 3 Main macroeconomic indicators on some region economies over 2005\*.*

	Real GDP (in %)	Annual inflation (in %)	Fiscal balance (% of GDP)	Current account (% of GDP)	Unemployment rate (in %)
Greece	3.5	3.6*	-4.6	-3.2*	10.0*
Croatia	3.4	3.0*	-4.2	-6.9 (T2)	13.8 (November)
Serbia & Montenegro	4.8	15.4*	1.2	-10.6*	32.6*
Macedonia (FYROM)	3.8	0.6	-0.8	-7.4	28.0 (September)
Bosnia & Herzegovina	5.4	3.5	0.1	-16.8*	35.9 (November)
Kosovo	-0.5	-1.5*	-4.2	--	46.3 (November)
Turkey	5.0	8.0*	-4.4*	-6.2*	9.4

Source: IMF, Central Banks

\* Forecasts

Southeast Europe economies progressed in consolidating the macroeconomic stability during 2005. Inflation has been in relatively low levels. Also, the average budget deficit for these countries is lower than that of new accession countries of the European Union. The average budget deficit of this period is also expected to stand almost at the same level with the one recorded over the previous year, at about 2 percent of GDP. In general, good fiscal position has reflected increased revenues caused by economic growth, while budget expenditures have remained under control. High current account deficit remains one of the main macroeconomic problems for these countries. This deficit is expected to deepen further during 2005 due to high trade deficit which is impacted even by energy price rise. On the other hand, the rapid integration of these economies with much more developed and prosperous economies of the European Union may impact on the deepening of current account deficit of these countries. Integration of merchandise trade

makes foreign borrowing more attracting, while domestic financial market liberalization and interest rate reduction encourages consumption and inflation instead of saving, tending to reduce the current account balance.

Also year 2005 progressed in terms of accomplishing the aspirations of many countries of the region for integration to the European Union. Many countries have opened either preliminary or definitive negotiations with Brussels. Recently Albania also joined this group, by opening preliminary negotiations for signing the Stabilization and Association Agreement.

### Box I.1 Convergence criteria

*Membership in the European Union requires the satisfying of a number of economic and political criteria. The Maastricht criteria, referred to as convergence criteria, are the economic criteria the countries should meet to become members in the European Monetary Union. More concretely, these criteria are:*

- *The ratio of the annual government deficit to gross domestic product must not exceed 3 percent.*
- *The ratio of gross government debt to GDP must not exceed 60 percent.*
- *Price stability. Average inflation rate must not exceed by more than 1.5 percentage points that of the three best-performing Member States in terms of price stability during the year preceding the examination of the situation in that Member State.*
- *The nominal long-term interest rates must not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price.*
- *The exchange rate must not exceed the normal fluctuation margins during the two years preceding the examination of the situation and the Member State must not have devalued its currency on its own initiative against the currencies of other Member States.*

### • GREECE ECONOMY

Greek economic growth has been considerable during recent years. It has been impacted positively by significant interest rate cut due to adoption of the euro, by rapid growth of lending to private sector which followed fiscal sector's liberalization, and by fiscal policy which has had expansionary features. In the meantime, completion of expenditures for organizing the Olympic Games brought about fiscal policy tightening. Budget deficit is forecasted to reach to 4.6 percent of GDP in 2005, recording a decrease of two percentage points as compared to 2004. Partly because of this reason, the GDP growth was slowed down to 3.5 percent during 2005, from 4.7 percent recorded in 2004. However, this growth remains considerable compared to other countries of the Euro area. Inflation rate has constantly been above the average rate of the countries of the Euro area during 2005.

- MACEDONIA (FYROM) ECONOMY

Economic activity of Macedonia (FYROM) has performed well during the first half of 2005. GDP of January – June has grown by 4.7 percent in annual terms. Economic developments and price stability are achieved maintaining inflation at an average level of 0.6<sup>9</sup> percent. Industrial output for 2005 was increased by 7 percent. A reduction of trade deficit to Eur 50.6 million or 5 percent was recorded in foreign trade. Unemployment rate reached to 28 percent, remaining to high levels, similar to other countries of the region.

- KOSOVO ECONOMY

Kosovo's economy performed weakly during 2005. It was influenced negatively by ambiguities about Kosovo's final status, thus restraining the domestic and foreign investments. Kosovo's economy underwent stagnation during 2005. GDP growth for 2005 is forecasted to be -0.5 percent<sup>10</sup>. High unemployment rate remained one of the main problems in the country, recording 46.3 percent in November.

Trade deficit during January – November reached at about Eur 1 billion. Exports level is very low, estimated at Eur 42.8 million. Products of base metals and mineral products are the main products exported during the year. Imports are in very high level. Foodstuff, beverages and tobacco are the main items impacting on import rise.

- SERBIA ECONOMY

According to latest estimates of the International Monetary Fund, economic growth of Serbia for 2005 is 4.8 percent. Good performance of exports, high level of domestic demand and growth of investments by domestic and foreign companies are the main factors impacting on economic growth rate improvement. Inflation rate has been high throughout the year, reaching to 18 percent in October. For this reason, a tightening monetary policy has been pursued, aiming at containing credit expansion, particularly consumer lending. Notwithstanding the improvement, the current account deficit remains high, at 10.6 percent of GDP. External debt is about 60 percent of GDP.

- ECONOMY OF CROATIA

Economic activity of Croatia is characterized by a moderate economic growth, low inflation rate, and exchange rate stability. Economic growth is forecasted to reach 3.4 percent over 2005. The main contribution to economic growth improvement was rendered by rise of consumer spending. Inflationary pressures, caused by energy price rise and foodstuff price rise because of unfavourable weather conditions, have brought about average annual inflation rate rise from 2.1 percent in 2004 to 3 percent in September 2005. On the other hand, exchange rate stability of Kuna<sup>11</sup> against euro has impacted on inflationary expectations stability. Budget deficit is forecasted to reach to 4.2 percent of GDP at end of 2005, from 4.9 percent it was in the

previous year. Current account deficit for the first half of the year has been deepened, by reaching to 6.9 percent of GDP from 5.3 percent it was in 2004.

- ECONOMY OF TURKEY

Economy of Turkey performed well during 2005. Inflation is at single digit figures and the economic growth, though moderate, still remains steady. The economic growth rate for 2005 is forecasted to be around 5 percent and to maintain the same rate even for 2006. Investments and construction activity were among the main factors having impacted positively on economic growth during this year. Inflation rate for 2006 is forecasted to drop under 8 percent, the targeted rate for 2005 year-end. Positive economic developments and prudent fiscal policy have impacted on reducing the overall budget deficit under 3 percent of GNP<sup>12</sup> and the public debt under 60 percent of GNP. The oil price rise and the appreciation of national currency have impacted on deepening the current account deficit, whose reduction is one of the challenges of Turkey's economy.

Continuation of prudent monetary and fiscal policies and further progress in structural reforms will enable maintaining of economic growth sustainability for the coming year.

## NOTES

<sup>1</sup> According to World Bank's estimate

<sup>2</sup> Data on the American economy are obtained from the American Department of Labour, American Department of Trade, and Executive Office of the President of the United States of America

<sup>3</sup> Source: Eurostat, preliminary estimate

<sup>4</sup> A regular gathering of EU economics or finance ministers of the European Union

<sup>5</sup> 1997 Agreement among the countries participating in the European Monetary Union on the co-ordination of fiscal policies, with the purpose to limit the debt and the budget deficit

<sup>6</sup> World Bank

<sup>7</sup> The Southeast Countries include: Albania, Bosnia - Herzegovina, Bulgaria, Croatia, Ex-FYROM, Rumania and Serbia and Montenegro.

<sup>8</sup> United Nations, Economic Situation and Prospect 2006

<sup>9</sup> [www.stat.gov.mk](http://www.stat.gov.mk) Press release, February 02, 2006

<sup>10</sup> [www.bpk-kos.org](http://www.bpk-kos.org). Monthly Statistical Bulletin, November '05, No.51

<sup>11</sup> Domestic currency

<sup>12</sup> GNP – Gross National Product



## CHAPTER II ALBANIAN ECONOMY

Albanian economy entered the 2005 as part of an ongoing macroeconomic consolidation process. This process is generally materialised in an economic growth of around 6 percent, with a controlled inflation around 3 percent, a contracted budget deficit, and a constant improvement of monetary conditions. The country's economy is estimated to have grown by 5.5 percent in real terms during 2005, being associated with a low inflation maintained within the targeted band of the Bank of Albania.

A number of direct or indirect indices have manifested signs of economic growth. Among them, we highlight the growth by 13.8 per cent of the real sales of the economy, satisfactory increase of VAT revenues and profit tax revenues, and the increased number of employed persons in the economy. This growth is reflected even in the businesses' and consumers' opinion (see Box. II.3). Surveying of business confidence index and consumer confidence index reveal an improvement of economic conditions over 2005, notwithstanding the slowdown in the last quarter. On the other hand, developments in the financial sector and particularly the obvious expansion of lending to the economy illustrate growth of investments and consumption in the economy.

However, year 2005 was not immune from unexpected developments or from those of shock nature, which impacted on economic growth rate reduction by 0.5 percentage point from the forecast. Furthermore, these events presented real challenges for the management of economic and monetary balances. On a political plane, political elections for the new Parliament were the main events. The long post-electoral situation, the escalation of electricity crisis during October – November 2005, and the oil price rise have impacted on the economic growth rate reduction (see box II.1 and II.2). These factors have also impacted on banking system liquidity fluctuation during the second half of the year and on increasing the Treasury bill interest volatility.

GDP growth has enabled rise of income per capita beyond USD 2500 per year, which, however, remains among the lowest figures of the region. Notwithstanding the ongoing GDP growth in years, employment performance reflects a moderate behaviour. Unemployment rate reduction continues to be insignificant, either in absolute value or in relative terms. Perhaps, the weak quality of employment statistics, mostly impacted by large and unmonitored movements of population within the country and by a high degree of informality in the labour market, may hide real employment performance. On the other hand, it is possible that productivity rise due to technology investment does not require much labour force. Nonetheless, it is clear that employment statistics need further improvement, implying both, their qualitative and quantitative improvement.

Savings - Investments balance is estimated to have recorded a performance slightly different from that of the last year. For the first time, public savings have recorded a positive level, though a modest one, only 0.1 percent of GDP, while private savings are contracted to a certain extent, being decreased by around 2.6 percentage points. The narrowing of the spread between interest rates in lek and in foreign currency, global and national environment with relatively low return rates for a relatively long period, extension of consumer credit to households, as well as other causes impossible to be identified with the current statistical information level, have impacted on a more aggressive behaviour of households towards consumption.

Under the conditions when investment performance has been much similar to that of 2004, reduction of private savings has led to a deepening of current deficit<sup>1</sup>, which is estimated to 5.5 percent of GDP in 2005, from 3.8 percent of GDP in 2004. External sector of the economy during 2005 is presented with a deep negative balance sheet in the current account, caused by further trade deficit enlargement. Capital inflows have generally been sufficient for compensating the current deficit, thus enabling an overall positive balance sheet.

Current account deficit enlargement does not any longer constitute a surprise for the economy of the East Europe, Albania being part of it. Rapid integration of merchandise trade with larger and richer economies of the European Union makes foreign borrowing more attractive to us, while the domestic financial market liberalization and its accompanying with decreased interest rates increase pressures for raising expenditures to savings.

Other economic – financial indicators have generally maintained the trends noticed over the previous periods, with slight deviations from the programmed limits.

Table 1 Main economic indicators

	1999	2000	2001	2002	2003	2004	2005
Real growth of GDP (in %) <sup>2</sup>	8.9	7.7	6.5	4.7	6.0	6.0	5.5
GDP (in current prices, in millions of ALL <sup>3</sup> )	488611	530900	588700	630000	695100	780100	836800
GDP (in current prices, in millions of USD)	3548	3694	4102	4497	5702	7581	8379
GDP per Capita (in USD) <sup>4</sup>	1052	1086	1329	1460	1833	2434	2550
Number of employed (in thousands)	1081	1068	1065	921	928	917	931
Unemployment rate (in %)	18.0	16.9	14.6	15.8	15.0	14.6	14.2
Inflation rate in percentage (y/y)	-1.0	4.2	3.5	1.7	3.3	2.2	2.0
Budget deficit (with grants, as a % of GDP)	-12.1	-8.2	-7.9	-6.6	-4.9	-4.9	-3.8
Public debt (as a % of GDP)	69.7	71.3	66.8	65.1	60.7	55.3	54.9
External debt (as a % of GDP) <sup>5</sup>	-32.3	29.4	25.8	23.4	20.7	17.8	16.8
Current account (free of official transfers, as a % of GDP)	-8.5	-7.0	-6.1	-10.2	-8.2	-6.2	-7.0
Average exchange rate, ALL/USD	137.7	143.7	143.5	140.1	121.9	102.8	99.8
Average exchange rate, ALL/Eur	147.0	132.6	128.5	132.4	137.5	127.7	124.2

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

Financial sector of the country, during 2005 was subject to a prudent assessment by the World Bank's and International Monetary Fund's missions. The analysis on each cell of the financial sector highlights its progress made in the course of last years. Conclusions coming out of this assessment are

a great assistance to all the supervisory authorities of the financial sector. Recommendations provided are already converted into comprehensive work agenda, with concrete measures and decisions, whose implementation started since the last year and will be further intensified in the coming years.

However, it should be noted that after so many years of transition, direct or indirect statistical data, which shed light on the overall economic activity of the country, are still not complete; therefore even the degree of analysis, particularly in quantitative terms, continues to reflect these statistical limitations. Besides scarcity of information on production, ensured from certain sectors of the economy, the problem of their delayed publication still exists. Furthermore, in some cases of statistical information published on the economy performance by quarters, oscillations are observed, making the degree of its accurate comprehension and interpretation difficult.

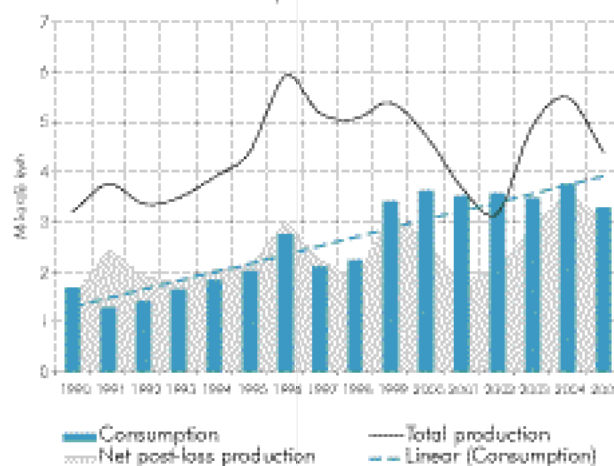
### Box II.1 Electricity problems and domestic production

Since 1990 electricity consumption in Albania has increased on an annual average rate of 6 percent, not far from the average rates of the real economy growth. On the other hand, gross electricity production is characterised by obvious fluctuations during the same period. Network losses have been considerable, standing above 30 percent of production. In spite of problems in electricity production and distribution, business activity growth over 1990 might have not been limited significantly from electricity supply. In 2000s the needs of economic activity reached levels exceeding domestic resources capacities. This made the electricity import level in 2000 rise some times compared with the import of 1990s.

The nature of electricity market does not allow its timely conservation or replacement; therefore it is necessary to accurately forecast the needs for domestic resources, taking into account higher import prices. The problem of minimising costs is complicated by the dependence of freer domestic production on weather conditions. Projecting more import would increase cost, loading the budget deficit, but projecting less might lead to a similar situation to that of the past year, when Albania was faced with a decline in the domestic production, being partly compensated by import.

What was the cost of non-meeting the economy needs for electricity? Based on Bank of Albania surveys, the economic business activity during the crisis was limited by about 27 percent against the level of activity expected during the same period. Converted in real GDP growth terms, this figure is about 0.5 percentage point, reducing the real annual growth to 5.5 percent, from 6 percent expected. Many businesses tried to offset electricity shortages with alternative sources, mainly with oil generators, increasing costs by about 20 percent. The cost increase was reflected in both, reduced production and employment, and in losing a part of investments. The most affected sector was that of production, where the use of substituting alternatives could not easily cover the considerable needs this sector has for electricity. The business expectation that

Chart 1 Box 2 Electricity Production and Consumption in Albania



*upon improvement of the situation, the economic activity will be recovered within the first quarter of 2006 remains positive. Latest developments in energy sector seem to support the conditions for materializing this expectation.*

*Notwithstanding the rapid recovery of the economy from the last electricity crisis, in a longer-term plan, it testifies clearly that the sorting out of electricity problems in relation to domestic production or the timely satisfying of needs for imports has become critical for ensuring the sustainability of high economic growth rates.*

## II.1 PRODUCTION BY ECONOMY SECTORS

### II.1.1 AGRICULTURE

Besides the growth of about two – three percent per year evidenced over two or three last years, the contribution of agricultural product has been decreasing year on year, reaching to 22.8 percent of the overall product, a low level in ratio to its contribution by end of '80 to mid of '90. Though a relatively long period has passed by, agriculture continues to be characterised by huge problems, dominated by those related to land ownership, thus weakening the interest of big investors in producing various agricultural products.

The parcelling of land into plots, reflected in the incapability of using agricultural mechanism to a large scale, has made the agricultural output be far from its potential. On the other hand, continuous migrating movements from rural areas to large inhabiting centres, have made thousands of hectares of agricultural soil be left uncultivated. All these have created an appropriate environment for the entry into the country of a wide range of foreign agricultural (unprocessed) products, coming mainly from neighbour countries.

Other sub-branches of agriculture, such as animal farming and fruit-growing, also seem as if they are not reaching steady development paces. Animal farming, after a qualitative leap at the beginning of '90s, seems that is currently suffering from lack of specialised veterinary service and proper infrastructure for ensuring food and up-dated livestock breeding. Also the fruit-growing continues to suffer a lot of damages in fruit-trees occurring over the recent years, thus weakening significantly a big priority the Albanian climate ensures in this regard. In spite of sporadic efforts of some domestic investors, still the fruit-growing inventory recovery is still at a low scale, making the contribution of this sub-branch to overall agricultural production be low.

However, as noticed from the following table, all agriculture branches are estimated to have undergone positive growth rates in real terms, leading to a possible growth of the whole agricultural production to 3.7 percent, about 1 percentage point less than in 2004 and also, somewhat less than earlier assessments during 2005. Problems causing land floods in first months of the previous years, under the conditions of an inexistent marketing of a non-

efficient collection system and of a weak watering and draining infrastructure, constitute the causes of this falling performance of agricultural production for 2005.

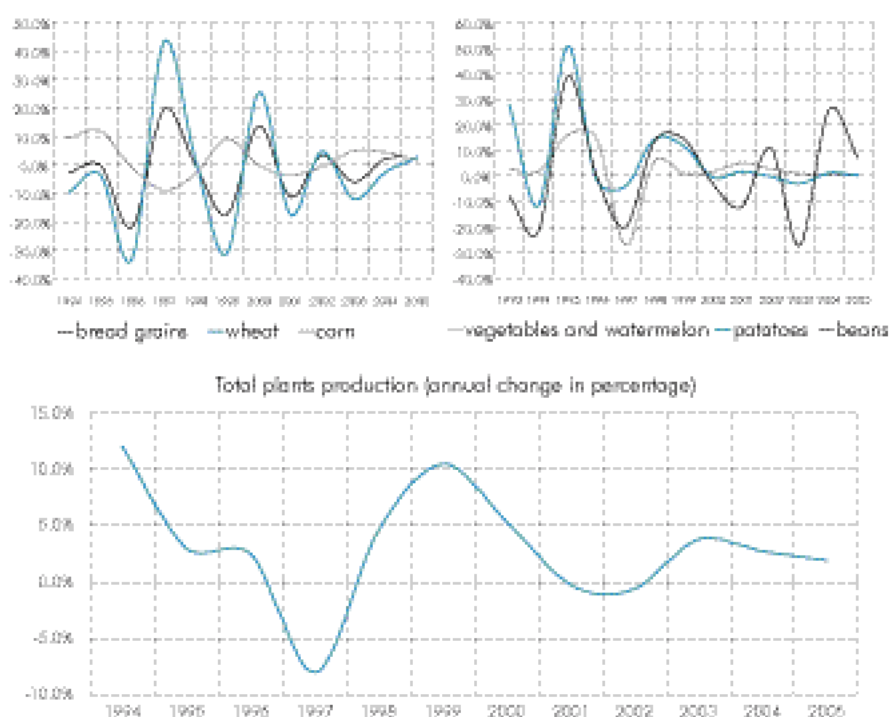
	2001	2002	2003	2004	2005
Agriculture	1.4	2.3	2.8	3.4	2.3
- Animal farming	3.5	3.4	4.8	3.1	3.9
- Plants	-1.1	1.8	-1.7	2.3	
- Fruit-trees	4.7	-0.2	15.5	9.2	
Agro-industry	7.8	13.1	10.2	11.2	10.0
Fishery	4.0	18.8	9.7	7.9	10.0
Total	2.3	4.1	3.9	4.7	3.7

Table 2 Agricultural production (with prices of 2000)

Source: Ministry of Agriculture, Food and Consumer Protection

Regarding the physical production of plants, year 2005 has recorded further growth of all the main items, either in grains, vegetables or industrial plants. Nonetheless, as it noticed from the following chart, the plants production during the whole period of 1993 – 2005 appears with obvious oscillations, in spite of a kind of stabilization at the level of 2 – 3 percent in annual change terms over the recent years. According to recent assessments, there is noticed a kind of sporadic development of industrial plants, which continue to be in very small quantities and somewhat with obvious changes year on year.

Chart 1 Plants production (annual change in percentage; in thousands of tons)



Source: Institute of Statistics and the Ministry of Agriculture, Food and Consumer Protection, Statistical Year-Book

In 2005, an overall increase in the surfaces of land sown with wheat, and planted with additional olive-trees is noticed. Also, large growth is occupied by land sown with vegetables, corn and vineyard. Perhaps these developments have impacted on a kind of price fall of the fruits – vegetables group during the first nine months of 2005. Meanwhile, as noted above, the surfaces planted with fruit-trees have decreased in comparison to the previous year, highlighting a 10 percent slowdown in the growth of fruit-tree planted surface.

A large potential is carried over by greenhouse production, which in spite of the growth evidenced in the following table, still occupies the smallest share to total production. In the meantime, it is noticed that the yield of greenhouse production has fluctuated significantly year on year, mostly reflecting problems regarding material-technical base, infrastructure and lack of agencies specialised in collecting and processing their products.

However, it should be underlined that their physical production during 2005 was about 41 percent higher than the production of 2000.

Meantime, it seems that the livelier sector of agricultural production has to do with the ongoing increase of processing and confecting capacities of agricultural and animal inputs. It seems that even during 2005, the branch of agro-food industry further increased by about 10 percent in annual terms, almost at the same level with that of 2004.

Table 3 Agricultural production in greenhouses

	2000	2001	2002	2003	2004	2005
Sown land (in hectares)						
Heating greenhouses	17	13	13	19	28	35
Solar greenhouses	445	424	496	533	632	615
Total	462	437	509	552	660	650
Yield in ql./ha.						
Heating greenhouses	992	541	675	847	708	737
Solar greenhouses	829	795	795	795	826	912
Total	835	720	814	854	821	916
Output in tons						
Heating greenhouses	1,688	714	877	1,610	1,983	2,580
Solar greenhouses	36,892	33,712	41,520	45,529	52,209	6,082
Total	38,580	34,426	42,661	47,139	54,192	58,662

Source: Ministry of Agriculture, Food and Consumer Protection

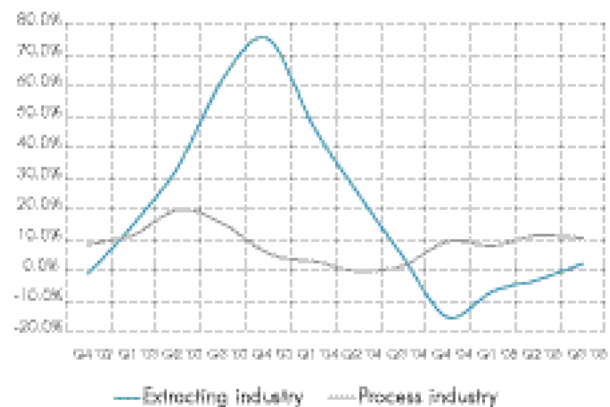
However, this high potential branch, according to latest estimates, seems that is not yet able to absorb a high degree of investments. Similar to the previous years, investments in all private, public, and bank credit forms, seem not to surpass the limit of 0.3 percent of GDP, a rather low figure needing no comment. The distance of private business from rural areas and all the problems mentioned during this brief analysis constitute the main factors behind this low figure. Other agriculture branches, animal production and fishery represent a larger sustainability in their growth rates.

## II.1.2 INDUSTRY

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

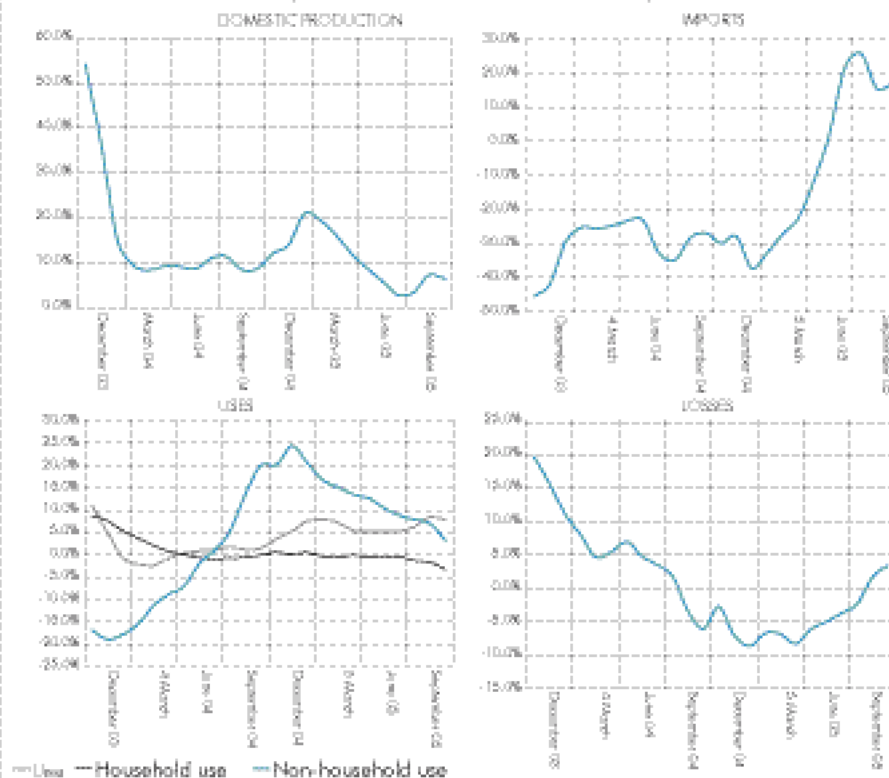
During 2005 this branch of economic activity is estimated to have contributed 13.8 percent to GDP. Lacking complete data on the analysis of this sector, we have referred to the volume of sales in value<sup>6</sup>. As it is noticed from the above chart, the sales performance of extractive industry has dropped sharply since the beginning of 2004.

Chart 2 Sales volume (constant prices;  
12-month series; annual change)



Source: INSTAT and Bank of Albania estimates

Chart 3 Electricity production and use\*  
(December '03 – November '05)



\* Production in GWh; annual change; 12-month series

Source: Albanian Electricity Corporation and Bank of Albania staff estimates



On the other hand, the process industry reflects a more stabilized performance and as it is noticed in the last year, it has had a kind of stability around the level of 10 percent in real terms. However, it should be emphasised that the image on 2005 would have been more complete if the data of the last quarter 2005 were available to us. As it is already known, this period coincided with a strong crisis in electricity production<sup>7</sup>, reflected in a downward revising of the economic growth by 50 points of percentage against earlier estimates. Though initially it was thought that the crisis would have had graver consequences, its mitigation in December enabled its relatively quick absorption by the economy. Also, though presently we are at end of the first quarter of 2006, the so-called second round effects are not verified yet. This is so because of the factors relating with the presence of weak trade unions, high informality characterising our economy, etc.

Concerning the energy sector, it is noticed that starting from March 2005, the twelve-month performance of electricity production had a downward curve, while imports recorded a reverse performance. Also, losses, starting from medium of the previous year, recorded an upward trend<sup>8</sup>, coming to a climax on November 2005. On the other hand, it seems clearly that the use of electricity during most of 2005 had a constant performance, within 5 – 10 percent.

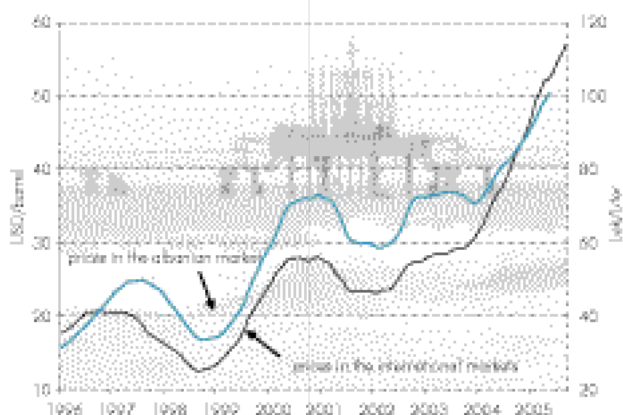
Considering its constituent items, it is noticed that sharp increased demand for electricity by non-household users was constantly smoothing during 2005, recording only 3 percent growth in annual terms. Use of electricity by households, after remaining constant around the level of 0 for a long time over last months of 2005, has undergone negative increase in annual terms.

### Box II.2 Oil prices and Albanian economy

*International oil prices have boosted significantly over the recent years. Supply side factors are directly related to instability that has characterised the main exporting countries throughout this period, such as: the difficult situation in Middle East countries, as the richest region for oil; the concern on internal stability of the Saudi Arabia; and political developments in Venezuela. Oil extracting cost rise has also influenced. Nonetheless, the highlight of new historical levels of oil prices rests on structural changes of the world economy that have significantly impacted on the demand for this product. The living-up of large economies, such as that of China and India, has brought about a rapid increased international demand for oil and its sub-products. Given these structural changes, new price levels are expected to be present for a long time.*

*International oil price rise may lead to an economic growth slowdown. The International Agency of Electricity estimates that a 10 dollar rise of oil price reduces the world economic growth by 0.5 percentage*

Chart 1, Box 2 International oil prices (on the left) and domestic market (on the right)



Source: Institute of Statistics



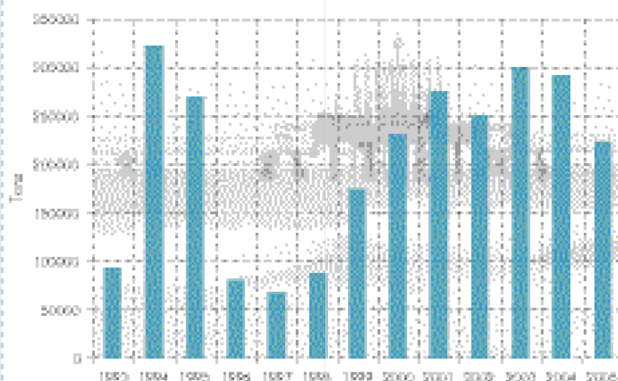
point. Developing countries are characterised by a lower efficiency of exploiting raw materials, therefore they are more affected by oil price rise than the developed countries. So, going further with the above example, the 10 dollar oil price rise would cause economic growth reduction in the Asian countries by 0.8 percent and by 1.6 percent in poor countries, from 0.4 percent for OECD countries.

The Albanian economy is also a net importer of oil product, since the capacities of domestic resources do not fulfil the domestic demands for oil. Currently the domestic production covers only 30 percent of the needs, and the rest is covered by imports. Being an importing country, the oil price in Albania has tightly pursued the oil price fluctuations in international markets (figure 1). This oil price rise has led to cost rise of the production factors and therefore to price rise of goods and services in the market. It results out of some estimates based on business opinion that oil price rise has impacted on average by 3.2 percent on price rise of production, construction and services. Oil price rise has started to exert pressure also on the economic activity of businesses that are more sensitive to market demand and have difficulties in conveying cost rise to consumers.

Oil price rise has had an even more direct impact on the households' budget, through transport cost rise. This may lead to decreased expenditures for other products, regardless of the decreased use of transport vehicles. Hence, 30 percent of Albanian consumers have modified their behaviour by decreasing the demand for other products in the market, while 43 percent have reduced the use of vehicles.

High oil price impact on our country's economy has been more mitigated due to use of alternative energy sources, mainly electrical one. Presently, the electricity consumption to total energy occupies about 62 percent. In this way, high oil prices increase further the pressures for improving electricity situation in the country.

Chart 2, Box 2 Oil Import (in tons)



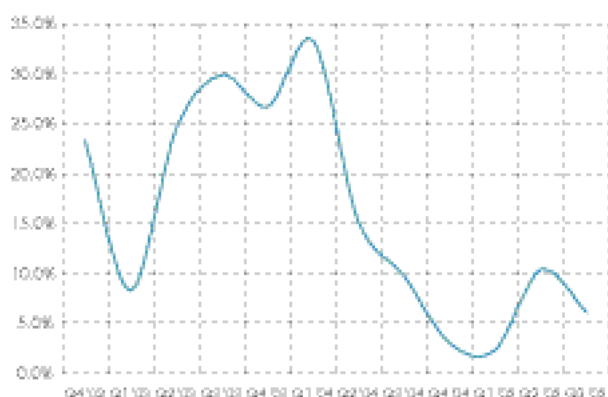
Source: Bank of Albania

### II.1.3 TRANSPORT SECTOR

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

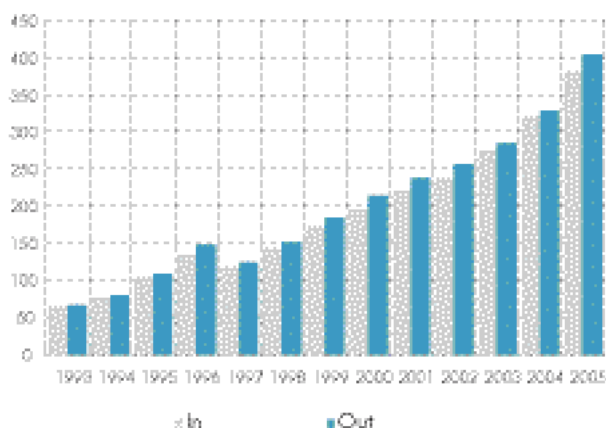
However, negative effects of fuel price rise over the second half of 2005 have provided their influence, as it comes out clearly in the following chart, when the sales curve has again changed the direction. This has made the weight of this sector in the economy undergo a very modest increase, climbing to 9.3 percent from 9.0 percent it was in 2004.

Chart 4 Sales volume (constant prices; 12-month series; annual change)



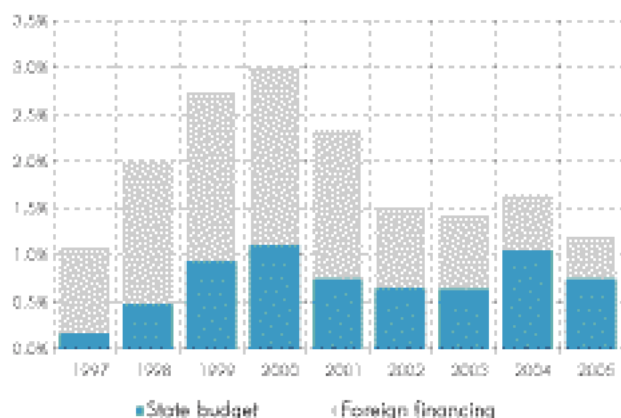
Source: Institute of Statistics and Bank of Albania staff estimates

Chart 5 Air and sea traffic of passengers over years (in thousands of persons)



Source: Ministry of Public Affairs, Transport and Telecommunication

Chart 6 Transport investments (as a percentage of GDP)



Source: Ministry of Public Affairs, Transport and Telecommunication

Air transport has had an average annual growth of about 15 percent during 10 last years. This positive performance continued even during 2005, when flights and passengers' movement rose by 20 percent.

Sea transport of passengers dropped totally by 0.7 percent during 2005 compared to the same period of the previous year. Albanian passengers comprise about 76.7 percent of sea traffic against 23.3 percent comprised by foreign passengers. The number of incoming passengers rose by 0.4 percent, while the number of outgoing passengers dropped by 1.8 percent.

Sea transport of goods underwent a growth of about 12.2 percent during 2005 compared to the same period of the previous year. The increased volume of sea transport was due to the growth by 8.7 percent of merchandise imports and growth by 14.4 percent of their exports. The Port of Durrsi, as the main port in the country, transports about 79 percent of total goods at the ports. The volume of transport of goods in it was increased by 5.1 percent over 2005. Also, transport at the ports of Vlora, Saranda, and Shëngjini was increased respectively by 34.2 percent, 30.6 percent and 17.4 percent.

Railway transport in Albania represents only 1 percent of the transport of goods and passengers. In 2005 the railway transport of passengers decreased by 59 percent, whereas railway transport of goods dropped by 3 percent. Also, the investments in this sector dropped by 20.7 percent in absolute value compared with the previous year. Total public investments and those of foreign projects are still in low levels to GDP, averaging 2 – 3 percentage points, while over two last years this level decreased, reaching the climax in 2005 by only 1 percent of GDP.

It is difficult to make any comment on investments financed from domestic resources, whereas those financed from foreign resources have continued their downward trend, either in relative or absolute value. Investments in transport sector have been more and more supported by budget funds. So, during 1997

– 2003, budgetary investments averaged 33.1 percent of total investments in this sector against 66.9 percent covered by foreign investments. This situation has changed considerably over two last years. Budgetary investments constitute 63.4 percent of total investments against the value of 36.6 percent financed from foreign investments.

The main objective of transport sector's strategic development is the gradual creation of a unique and connected circulation space in national and regional level. The creation of a modern infrastructural network will assist in the economic development; therefore it deserves a primary attention in allocating budgetary funds.

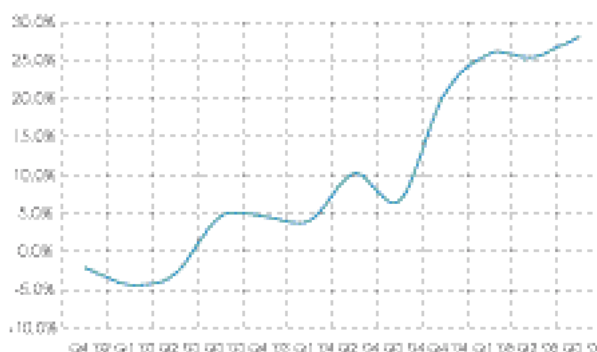
#### II.1.4 CONSTRUCTION SECTOR

Responding to the needs for improving housing conditions, extending productive capacities and creating a modern infrastructure, the construction sector has recorded high growth rates during ten last years. Construction sector has grown on average by 13 percent a year during this period, being transformed into one of catalysers of the country's economic development and doubling its weight to GDP. This sector contributed by 9 percent to 2005 GDP formation.

Year 2005 continued to record positive developments in construction sector. The volume of sales realised by this sector has been raised significantly from one period to the other, manifesting a sharp upward trend. More concretely, during the third quarter of 2005, twelve-month volume of sales in constant terms reached its peak to 28 percent, thus indicating that this sector has been very attractive for the business in general even during 2005. Developments have been very dynamic, reflecting an ever increasing demand. According to data of the nine-month period, it is estimated that the consumption of cement has recorded a constant growth from one quarter into the other against the same periods of the previous year. First, second and third quarters of 2005 recorded a consumption of respectively 20, 34 and 14 percent higher than in the same periods of the previous year.

High demand for products of this branch seems even in the sales price performance, particularly in the prices of living apartments and surfaces destined for economic activity. Though no data are available in this aspect, the daily reality reveals a constant rising trend in prices. This fact should be studied prudentially, to rightly assess any possible risk associating the fast boom of real estate prices. A "bubble" effect is undesirable and it could create negative chain effects on all the network of businesses that nourish and supply the construction industry.

Chart 7 Sales volume (constant prices; 12-month series; annual change)



Source: Institute of Statistics and Bank of Albania staff estimates

Moreover, the contaminating effect would be extended even on the banking system itself, since about 80 percent of collaterals pledged for extended loans are in the form of real estates.

Construction costing index has undergone a modest rise of only 0.7 percent during 2005, while direct expenditures are somewhat more, about 1.5 percent. So, though the construction cost has changed so little during 2005, a huge non-compliance is noticed between cost rise and sales price rise. This is a significant factor that indicates the presence of a strong demand in construction, which, however, does not spring from steady income resources. Such resources and income from emigration or from illegal activities are estimated as temporary financial resources that are difficult to be forecasted, while they are the main items that actually finance construction. Therefore, a possible rapid reduction of the above mentioned resources would sharply limit the demand, putting into difficulty not only construction producers but also its related branches.

Chart 8 Construction costing index (12-month change)



Source: Institute of Statistics

Chart 9 Constructions by types (in billions of ALL)



Source: Institute of Statistics

Another indicator of a high growth of construction has to do with increased investments in this sector, always referring to absolute values. During the first nine months of 2005, investments in dwelling and industrial buildings experienced an annual growth of 157 percent and 38 percent respectively. As it can be observed, each depreciating effect, either measurable or not, would not be able to "eliminate" this strong growth in nominal investment terms.

Nonetheless, turning back to 2005, it should be stressed that there is a strong tendency towards dwelling constructions, while the motivation or usefulness of other constructing destinations still remains low.

## II.1.5 TRADE AND TOURISM

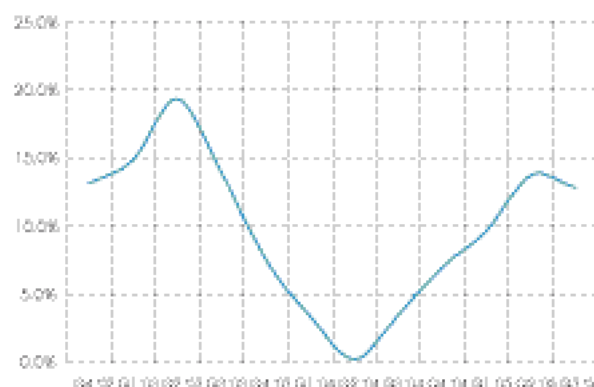
Services sector has been developed considerably during last years, becoming the main contributor to GDP growth. According to latest estimates, this sector's share to GDP is at about 45 percent. An upward performance of the branches of trade and tourism is noted within this sector, while many other new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

According to data on the sales volume realised by trade and tourism, it is noticed that their annual growth in constant terms during three first quarters 2005, has been relatively stable, within the band of 10 – 15 percent. The wholesale trade, retail trade, and vehicles trading, their maintenance and repairing included, have recorded the strongest increase. Even other items have recorded increased sales volume; however the intensity of their growth is somewhat lower, below the pace of the total of this branch.

Tourism has also experienced quantitative developments, testifying its growth. Though no data are published yet on the last quarter of 2005, there is evidenced an increasing performance of all available indicators. There exist additional accommodating capacities, twofold marketing expenditures, increased volume of investments, etc.

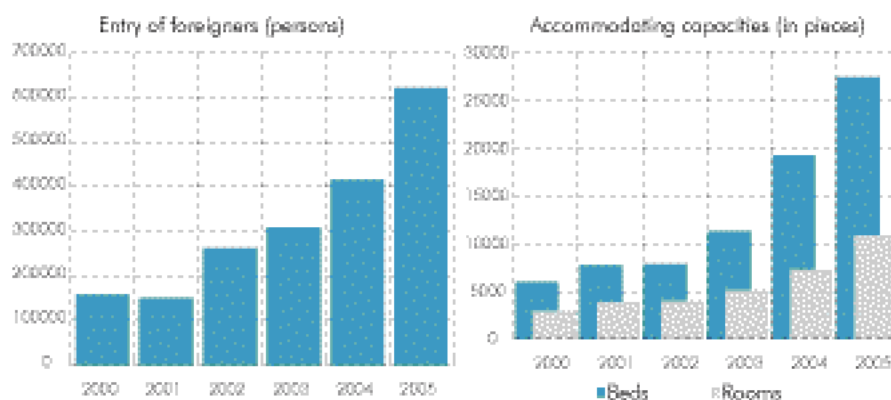
More concretely, accommodating capacities rose significantly during the first nine-month period of 2005. Number of beds has increased by 43 percent, while the number of rooms has increased by 48 percent. This sharp growth of accommodating capacities is associated with twofold expenditures for marketing, though it should be accepted that the absolute value is still small.

Chart 10 Sales volume (constant prices;  
12-month series, annual change)



Sources: Institute of Statistics and Bank of Albania staff estimates

Chart 11 Tourism in years



Sources: Directorate of Tourism, Ministry of Tourism, Culture, Youth and Sports

Number of foreigners visiting Albania has also been raised, thus creating important resources for current account deficit financing. Only in the first nine months of 2005, about 50 percent more visitors entered the country than the whole 2004.

### Box II.3 Business Confidence Index and Consumer Confidence Index

Among economic indicators the international markets refer to, the confidence indexes are also listed as of high importance. This is so because they are interpreted as forecasts on economy performance for a near future. Confidence indexes are based on periodic surveys on a selected group of businesses and consumers. They tend to dictate changes in the economic activity – a rise of business/consumer confidence is interpreted as an inclination for economic activity growth in a short-term period and vice versa. In fact, the experience in building the confidence index series has indicated that there exists a stable statistical link between the inclinations collected from confidence indexes and actual indicators. The need for creating confidence indexes springs from the fact that notwithstanding the degree of development of a country's statistics, the surveying method is the faster and more direct for collecting information.

The work for building confidence indexes at the Bank of Albania has started since 2002. The surveys are carried out on a quarterly basis. In cooperation with representative of the Institute of Statistics, businesses from sectors mostly contributing to GDP growth are selected for surveying businesses. The survey on consumer confidence index is based on casual selection of individuals living in rural areas, where CPI is measured. Also, the questionnaires used are adjusted according to standards set by the European Committee for this purpose, establishing bases for their comparability with these countries.

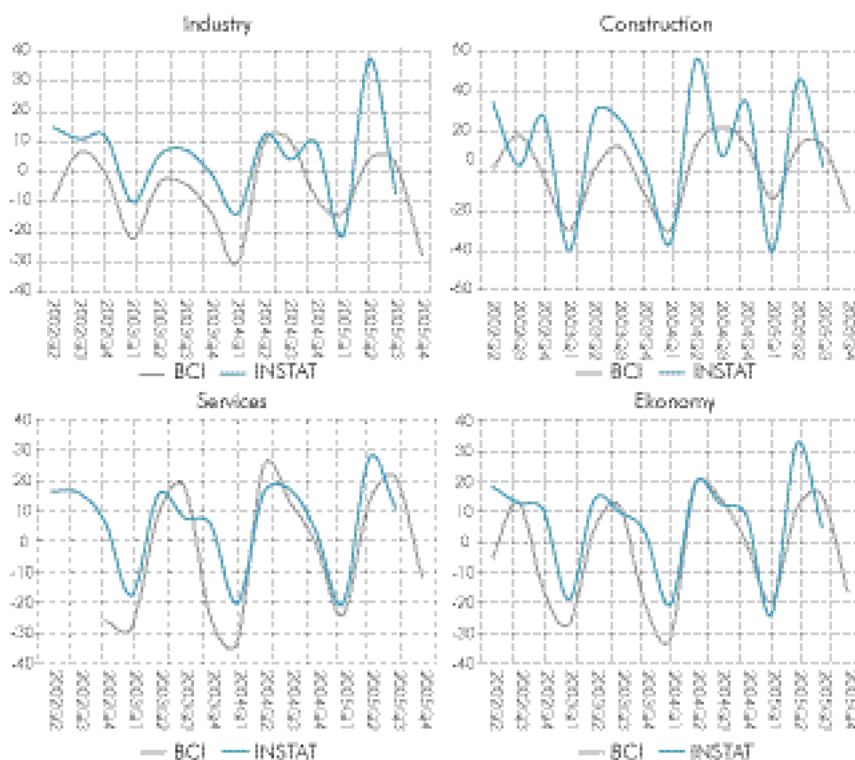
In Albania's case, the creation of confidence indexes assumes more importance due to the fact that they fill in today's information system, for that part of statistics of real sector of economy that relates to employment, investment, competition, public perceptions on inflation, etc. Currently, data on real economy are published on a three-to-six month delay, while not all indicators are covered by data. Therefore, the interpretation of evaluations ensured from surveys is difficult, since the latter ones can not be compared with accurate statistics. Along with standard questions, the characteristics of selecting surveys permit the using of special sections, with questions made on specific phenomena of Albanian economy.

So far, the survey results have presented a satisfactory compliance with statistical data. Business opinions have indicated a high correlation on actual performance of sales, published by the Institute of Statistics. This correlation is higher for the services sector and industry, while obvious deviations in construction sector may be explained by the nature of work in this sector, where there is a time variation between production and product's sale. As it is noted in Figure 1, according to businesses themselves, the economic activity in the fourth quarter of 2005 is contemplated to have undergone a more sensitive deterioration than in the previous years. Such behaviour is a logical consequence of the electricity crisis our country was faced with during this period.

Consumer survey intends to identify changes in the consumer behaviour of households from one quarter to the other, which relate closely with price expectations and with the tendency to save. For the Bank of Albania, the assessment of consumer expectations on price performance constitutes the main aspect of making use of this survey for the moment. The so-far surveys indicate a clear link between consumer expectations on prices and their actual performance. Though the answers to questions are qualitative, consumer perception is accurate as concerns to price change direction. Currently, efforts are made for quantifying these sensations in concrete values for inflation expectations and their inclusion in statistical models for inflation forecasting.



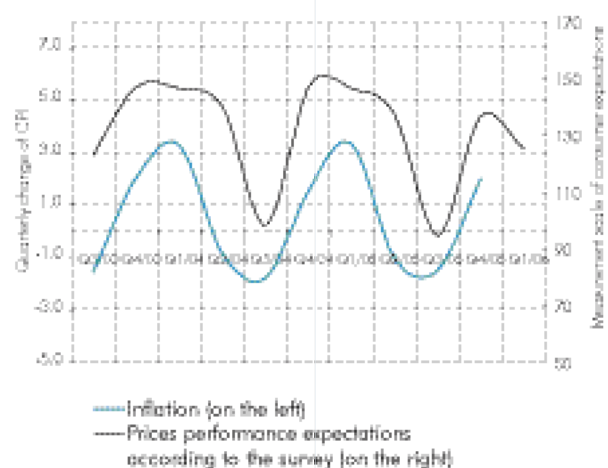
Chart 1, Box 3 Business opinion on their economic activity and sales measured by the Institute of Statistics



Confidence surveys undoubtedly constitute a useful information source, as concerns to its content and short time in which it is ensured.

However, it should be emphasised that these indexes are based on subjective answers. As such, they remain orienting and not decisive of what is expected to happen in the short run. In Albania's case, their use should be carefully assessed, for the fact that their history is brief to prove index consistency. The Bank of Albania is working for their further consolidation, so as to enhance the degree of business confidence indexes, as representatives of economy performance.

Chart 2, Box 3 Inflation rate and consumer expectations on price performance



## II.2 FISCAL SECTOR

Fiscal authorities have pursued a prudential budgetary policy during 2005, following the implementation of the Mid-term Budget Program for 2005-

2007. This program has aimed at increasing fiscal incentives in the economic growth and macroeconomic stability, through consolidating budget indicators and prioritizing budget expenditures in the sectors of health, education, and infrastructure. Analysing this program, it comes out that budget revenues continued to increase even during 2005, while the budget deficit further decreased. So, total revenues and expenditures were realised respectively at 97 and 92 percent in comparison to the plan, while both these indicators were increased respectively by 8.9 percent and 2.7 percent in comparison to the previous year. On the other hand, the share of revenues, expenditures and deficit to GDP was respectively 23.4 percent, 26.7 percent and 3.2 percent for 2005.

Table 4 Fiscal indicators as a percentage of GDP

	1998	1999	2000	2001	2002	2003	2004	2005
Total revenues	22.68	22.67	22.72	20.88	22.20	22.41	21.93	23.4
Tax revenues	13.76	13.79	15.83	14.06	15.25	19.48	19.71	21.4
Total expenditures	34.35	34.93	32.14	28.85	28.41	26.95	26.46	26.7
Capital expenditures	5.87	7.19	6.83	6.94	5.60	4.22	4.58	4.1
Budget deficit	-11.67	-12.27	-9.41	-7.98	-6.20	-4.55	-4.53	-3.2
Domestic financing	6.03	5.89	5.64	4.71	3.16	3.21	3.67	2.7
Foreign financing	5.64	6.38	3.77	3.27	3.05	1.34	0.86	0.5

Source: Ministry of Finance. Fiscal indicators according to consolidated budget

## II.2.1 BUDGET REVENUES

Total revenues were increased by 8.9 percent during 2005, accounting for 97.3 percent of the planned amount. This increase was lower than the forecasted level of 11.9 percent. Also, it was lower than the average growth of 11.6 percent over seven last years. Even though the main items of budget revenues recorded a rise, still it fell short of the plan. So, customs income and non-taxable income have had a weaker performance in comparison to the plan.

Table 5 Annual growth of main indicators of budget revenues (in percentage)

	Q1 05	Q2 05	Q3 05	Q4 05	2003	2004	2005	Average of 1998-05	Plan Real. 05
Total revenues	9.8	7.7	6.1	11.6	11.1	10.4	8.9	11.6	97.3
- Taxable income	8.8	8.7	8.6	10.8	40.7	14.2	10.8	18.8	100.9
Value added tax	7.9	8.2	10.4	16.1	9.8	14.9	11.0	12.5	101.9
Income tax	35.1	6.4	9.7	22.0	7.8	24.1	18.0	24.2	120.1
Excise tax	20.4	11.1	11.7	27.0	31.5	28.9	17.2	21.8	101.3
Personal income tax	-2.3	15.5	10.5	8.6	4.3	6.8	8.0	38.2	97.1
Customs tax	-4.0	-8.3	1.4	2.6	3.5	0.1	-1.7	1.6	87.4
Local Government	-0.2	13.5	22.4	90.6	196.0	21.3	25.0	57.0	116.1
Tax on small business	-22.0	17.0	-55.8	125.0	15.6	37.8	-6.6	24.3	97.3
Independent budget	11.7	10.6	7.3	6.4	11.9	15.9	8.8	12.7	98.7
-Non-taxable income	6.1	-6.3	-10.8	-22.7	-10.7	-16.7	-11.4	3.7	81.7

Source: Ministry of Finance. Fiscal indicators according the consolidated budget

Increase of taxable income has been a priority of administration in recent years, because these incomes constitute the main source of total revenues.



Improvements in taxation administration are expected to result to annual growth of the number of tax-payers by 10,000 entities per year.

Value added tax (VAT) is closely related to the performance of circulation of goods and services in the country. Due to good economic performance during 2005, revenues from VAT were realized at 101.9 percent of the plan. Also, this indicator has the largest weight in the group of taxable income, constituting 32.1 percent of total budget revenues of 2005. In general, quarterly situation of revenues from VAT is presented in a progressive rise, reflecting highest growth in the third quarter.

Income tax is another important indicator, which is closely related with the country's economic activity. So, positive economic growth in the country led to satisfactory growth of this tax, exceeding the plan for this indicator by 20.1 percent. First and last quarters of the year had the highest growth in comparison to the same period of the previous year. It should be pointed out that the growth by 22 percent in the last quarter is realized under the conditions of a tax rate lower than that of 2004.

Excise tax revenues had the highest growth of annual inflows in the group of taxable income for 2005. Fourth quarter was the most productive for excise tax revenues, recording the highest income growth by 27 percent in comparison to the same period of the previous year.

For various reasons, starting from problems on planning to plan realization outcome, the customs income, unlike the taxable ones, are realized at 87 percent. However, it is true that there was a slowdown in harvesting the customs income during the political transition months while in the last months of the year, because of the impact of seasonal effect or the high efficiency of customs authorities, an increase in customs income was evidenced.

Revenues from personal income tax for 2005 had satisfactory growth rates but did not reach the level forecasted in the year-start budget. High fiscal evasion remains a problem in this area. Even though the forecasted level was not realized, income from independent budget (contributions) had a growth of 8.8 percent. Public administration has continued its program to include as many private sector employees as possible in the social insurance scheme.

## II.2.2 BUDGET EXPENDITURES

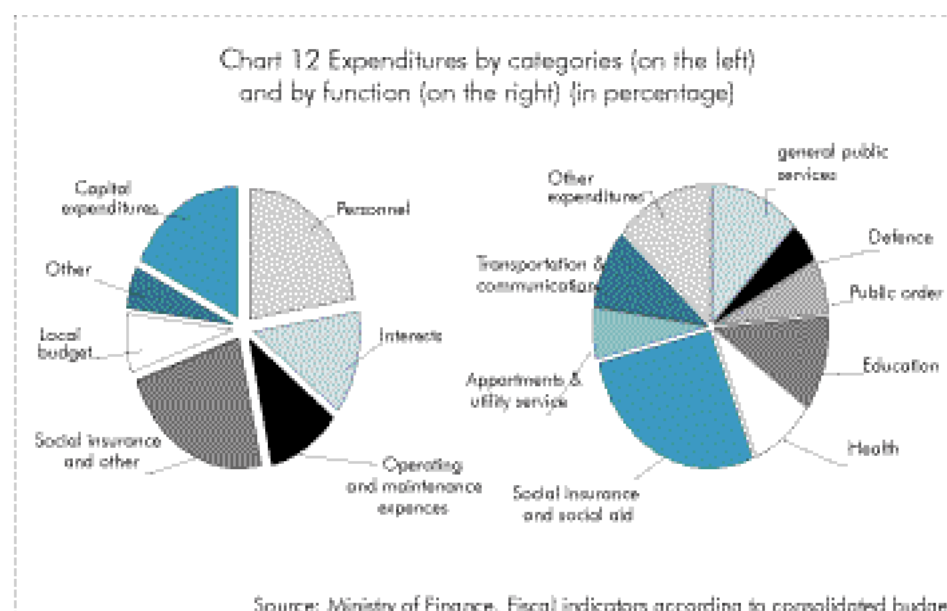
Budget expenditures accounted for 92 percent of the planned amount for 2005. The growth of 2.7 percent of total expenditures is obviously lower than the average growth rate of this indicator over seven last years. Reduction of expenditures by 6.1 percent in the last quarter has contributed to the low expenditure rate. Current expenditures continue to keep high ratio to capital expenditures, constituting respectively 84.8 and 15.2 percent of total

expenditures for 2005. While the current expenditures were in line with the planned amount, the capital ones were realised only at 69 percent, constituting respectively 22.6 and 4.1 percent of GDP.

Table 6 Annual growth of main indicators of budget expenditures (in percentage)

	Q1 05	Q2 05	Q3 05	Q4 05	2003	2004	2005	Aver. 1998-05	Plan Real. 05
Total expenditures	7.9	9.9	3.4	-6.1	4.5	10.7	2.7	7.2	92.0
Current expenditures	8.0	6.7	5.4	2.2	9.8	8.5	5.3	7.6	100.6
Personnel	11.7	9.5	11.2	6.7	6.7	9.5	9.6	9.6	97.2
Social insurance	8.4	11.8	11.4	9.0	12.7	10.0	10.2	17.1	99.4
Interest	-7.0	-21.5	-3.8	1.9	20.4	-4.7	-8.4	-3.3	87.2
Domestic	-7.0	-23.4	-4.4	-0.1	12.7	5.5	-9.5	-4.2	88.6
Foreign	-5.4	2.5	9.4	19.6	-28.1	3.8	7.8	22.7	71.4
Maintenance operational expenditures	10.2	6.5	-5.8	0.5	8.0	8.3	2.1	5.2	111.6
Capital expenditures	7.5	33.4	-5.7	-31.6	-17.0	22.5	-9.6	7.1	69.0
Domestic financing	-19.0	52.5	-2.9	-35.3	-3.7	50.7	-12.0	16.1	86.9
Foreign financing	36.2	-4.8	-12.8	-18.8	-30.4	-16.7	-3.7	-2.1	46.8

Source: Ministry of Finance. Fiscal indicators according to consolidated budget



Personnel expenditures over 2005 reached to 6.3 percent of GDP, being increased by 9.6 percent in comparison to the same period of the previous year. Reductions occurring over the last months in public administration personnel are not expected to be associated with obvious and immediate decrease of this indicator, since many of these employees will continue to be compensated for a one-year period.

Interest payments reached 3 percent of GDP in 2005, falling short of the plan by 12.8 percent and being 3.3 percent lower than in the previous year. Both the low interest rates in the borrowing market and the reduced public debt ratio to GDP have impacted on this reduction.

The overall public expenditures, health, and education also had the allocation of the highest resources in comparison to other governmental functions for 2005,

constituting respectively 3.4, 3.0 and 2.5 percent of GDP in 2005. Health and education had considerable rise in expenditures, being increased respectively by 8.9 and 11.8 percent, in comparison to the previous year. Protection expenditures decreased by 7.7 percent compared to the same period.

Capital expenditures were performed only at 69 percent of the plan. Capital expenditures for 2005 constituted 4.1 percent of GDP, reflecting strong seasonality over the last quarter of the year. Foreign financing capital expenditures have reflected the weakest performance in this direction. The cause of non-realization of foreign-financed investments is related to inaccurate forecasting problems and to non-fulfilment of conditions provided in the loan and grant agreements. This area requires a larger attention in the future in order to better respond to the country's development needs.

### II.2.3 BUDGET DEFICIT

The budget deficit was reduced by 27 percent during 2005, being the largest reduction over eight last years. Budget deficit reduction is attributed to implementation of successful measures taken for it. Also, the lowest interest rates have impacted on disburdening the settlement of domestic debt. During 2005 there were recorded four months in which the budget had a surplus while since 8 last years there has resulted on average only one month per year with a surplus.

Deficit went on having falling rates to GDP, down to 3.2 percent. As concerns to deficit distribution along this period, it is noticed that third quarter had the highest deficit level by ALL 9.5 billion.

	2001	2002	2003	2004	2005	Aver. 1998-05	Plan Real. 05	Percentage to GDP
Deficit	-2.6	-13.7	-19.3	12.4	-27.0	-6.2	66.1	3.2
Domestic financing	-4.1	-25.5	11.8	29.0	-24.6	0.9	84.2	2.7
Foreign financing	-0.3	3.4	-51.6	-27.2	-37.3	-16.7	33.0	0.5

Source: Ministry of Finance. Fiscal indicators according to consolidated budget

Table 7 Annual growth of main budget deficit indicators (in percentage)

### II.3 LABOUR MARKET

Labour market and employment indicators, though in modest levels, were characterised by positive developments in 2005, reflecting the good economy performance along this period. The number of employed persons during 2005 was increased on average by 8 thousand persons in comparison to the average of the previous year. According to data of the Institute of Statistics, the number of employed persons totalled 931 thousand in the third quarter of 2005, recording a rise of 1.5 percent in comparison to the year-start.

The number of persons employed in private non-agricultural sector continued to increase, accompanied by a rise in the number of persons employed in

agriculture sector during 2005. Also, the number of public sector's employed persons has increased. The employment structure according to economy sectors did not undergo any significant changes during 2005. Agriculture continues to occupy the main share, employing about 58 percent of total number of employed persons in the whole economy.

Based on the data of the Ministry of Labour, Social Affairs and Equal Opportunities for 2005, one fourth of the total number of employed persons in the Albanian economy is in Tirana district. The districts that have the lowest number of employed persons are Kuksi, Gjirokasta, and Vlora, constituting approximately only 10 percent of the total number of the employed.

Table 8 Labour market indicators (in thousand persons)

	2004				2005		
	Q. I	Q. II	Q. III	Q. IV	Q. I	Q. II	Q. III
Total labour forces (in thousands)	1080	1081	1080	1074	1087	1086	1086
A. Total employed (in thousands)	919	921	922	917	931	931	931.2
i) public sector	179	179	177	171	176	175.6	175.6
ii) private non-agricultural sector	206	208	211	212	213	213.4	214
iii) private agricultural sector	534	534	534	534	542	542	542
B. Unemployment (in thousands)							
i) total unemployed persons	161	160	158	157	156	155	154.8
ii) beneficiaries of unemployment payment	11.7	12.3	12	11	11.5	11.5	11.5
C. Unemployment rate (in %)	14.9	14.8	14.6	14.4	14.3	14.3	14.2

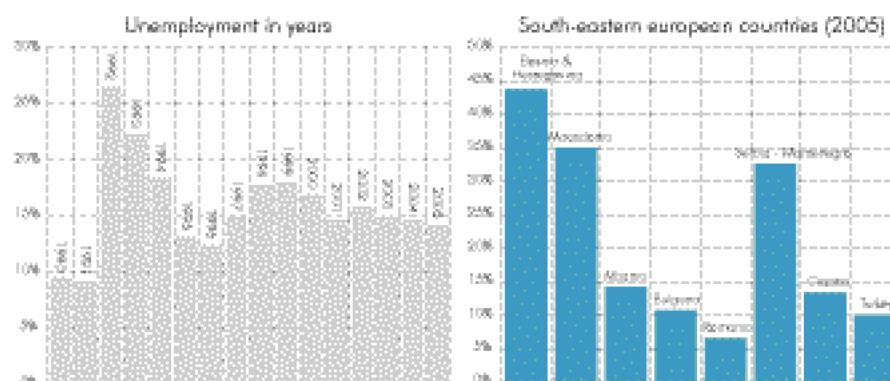
Source: Institute of Statistics, Conjunction

After a long falling trend, year 2005 recorded a growth of working age population, due to rise in the number of employed persons in the private sector of the economy. According to information available from the Ministry of Social Affairs and Equal Opportunities, the unemployment rate dropped by 2.4 percent over 2005 compared to 2004. The unemployment rate, measured as a ratio of the number of unemployed persons to working age population, has been decreasing from quarter to quarter. This indicates that ever less persons are registered as unemployed jobseekers. According to the country's regions, the highest unemployment rate is in Kuksi, 34 percent and the lowest in Tirana, only 8.4 percent. The fact that long-term unemployment constitutes 83 percent of the total unemployed persons is a concerning problem in the labour market.

Unemployment is felt more in the age group of 35-45 years old, who have more difficulties in finding a new job and adjusting to market conditions. More than half of unemployed persons are of eight-year cycle education.

Information available on salaries is not sufficient and covers only data about the public sector. The salary in the public sector has been increasing

Chart 13 Unemployment rate



Source: Institute of Statistics, Conjecture;  
European Commission, Economic Forecasts, Autumn 2005; National Data

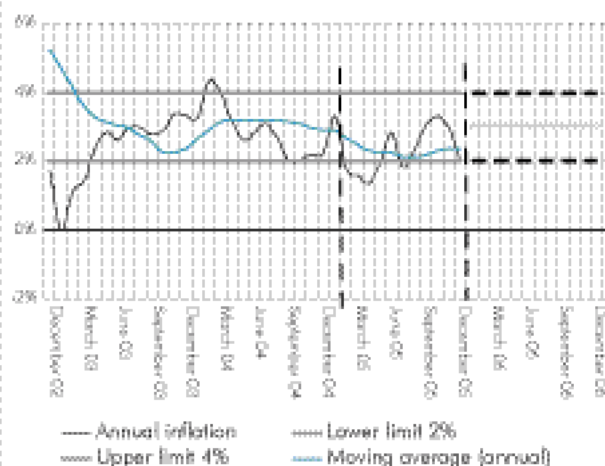
during 2005 and at end of the third quarter it averaged ALL 27 179, a rise of ALL 2 200 from the third quarter 2004. This increase is impacted by rise of salaries in the health and education sectors during the first half of the year, and in some military categories over the second half of the year. Salary rise in the public sector is also impacted by minimum salary rise by 1 thousand ALL during the third quarter of the year.

## II.4 INFLATION DEVELOPMENTS AND MONETARY POLICY

Consumer prices were relatively stable during 2005, marking another positive year in terms of meeting the primary BoA target, achieving and maintaining price stability<sup>9</sup>. The annual inflation rate resulted 2.0 percent at end of the year, while the average annual inflation rate was 2.4 percent. These living cost indicators fell in comparison with the previous year, fluctuating around the lower limit of the target. Annual inflation stayed within the 2 – 4 percent band along the major part of the year.

The revival of economic activity during 2005<sup>10</sup>, macroeconomic policies oriented to maintaining macroeconomic stability, exchange rate stability and moderate rise of salaries<sup>11</sup>, have all contributed to inflationary pressures control. On the other hand, price performance over 2005 was also impacted by some factors of shock nature, such as oil price rise and grave electricity situation. These factors impacted on inflation rise during the second semester of the year, but without compromising the observance of inflation target and long-term price stability perspective.

Chart 14 Annual Inflation (in percentage)



Source: Institute of Statistics, Bank of Albania

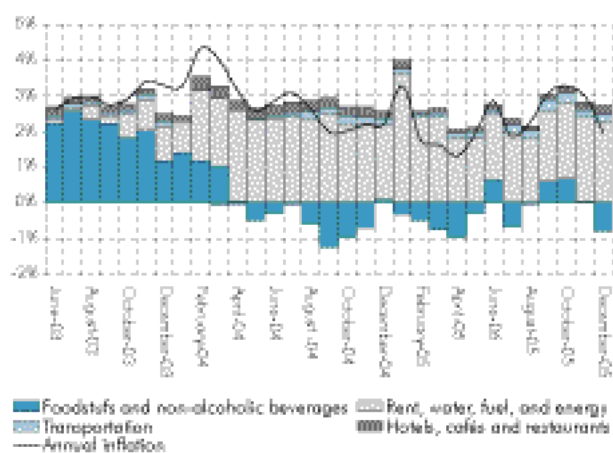
Annual inflation rate fluctuations during 2005 reflected mainly the underlined foodstuff price movements, because of their large weight in consumer price basket. The annual inflation had a falling trend during first four months of the year, dropping under the lower limit of the Bank of Albania target. This reduction was influenced by significant foodstuff price cut and smooth effect of electricity price rise. Also, appreciating positions of the lek against foreign currencies helped in absorbing inflationary pressures of the supply factors. The mitigation of reducing effect of negative inflation of agricultural products impacted on inflation rise during the second and third quarters of the year. Consumer prices were also impacted by oil price rise during the second half of the year. The impact of this factor was reinforced by the smooth compensating effect given by the lek's exchange rate against the dollar<sup>12</sup>. Besides this factor, the temporary electricity crisis also impacted on the inflation of October – November 2005. Shortage of electricity, causing rise in the fuel prices, and high foodstuff prices made inflation attain rates close to mid of the targeted band. Meanwhile, the low intensity of speculative price rise in December impacted on annual inflation falling of this month at 2.0 percent.

Table 9 Annual inflation rate  
(in percentage)

	2001	2002	2003	2004	2005
January	2.2	6.5	0.0	3.3	3.3
February	1.5	7.6	1.1	4.4	1.8
March	2.9	7.5	1.3	4.0	1.6
April	3.0	6.5	2.3	3.2	1.3
May	2.5	4.6	2.8	2.6	2.0
June	4.0	3.7	2.6	2.9	2.9
July	5.6	4.2	3.0	3.1	1.8
August	4.1	5.5	3.0	2.7	2.3
September	3.5	5.3	2.8	2.0	3.1
October	1.8	5.8	2.9	2.0	3.3
November	2.8	3.7	3.4	2.2	3.0
December	3.5	1.7	3.3	2.2	2.0
Average	3.1	5.2	2.2	2.9	2.4

Source: Institute of Statistics, Bank of Albania

Chart 15 Contribution of main CPI basket items  
(in percentage points)



Source: Institute of Statistics, Bank of Albania

#### II.4.1 INFLATION AND CONSTITUENT GROUPS

The 2005 tableau of inflationary pressures has not undergone any significant changes from that of the previous year. Annual inflation is impacted on its upward trend by "Rent, water, fuel and energy" item, while the "Foodstuffs and non-alcoholic beverages" item has contributed mainly to annual inflation reduction. Other basket items have had marginal effect on the annual inflation rate.

"Foodstuff and non-alcoholic beverages" item recorded a negative annual inflation during the first seven months of 2005<sup>13</sup>, following the falling

trend observed since May 2004. Price performance of this item contributed on average by 0.4 percentage points to annual inflation rate reduction for this period. Price fall of this item was led by low prices of agricultural products, which provide fluctuation in the prices of this item. Inflation rise of "Foodstuff and non alcoholic beverages" item during the rest of the year was impacted by the acting of internal and external factors. The agricultural production performance below forecasted levels, smoothing of compensating effect of the lek's appreciation against the euro, as well as price rise of these goods in partner markets of Albania (Italy and Greece) added inflationary pressures on foodstuff prices.

	Annual inflation'04	Contribution (pp)	Annual inflation'05	Contrib. (pp)	Italy <sup>14</sup> Annual inflation'05	Greece <sup>15</sup> Annual inflation'05
March	2.3	1.0	-1.7	-0.7	-0.2	-1.4
June	-0.7	-0.3	1.6	0.7	-0.5	-0.5
September	-2.9	-1.2	1.5	0.6	0.1	2.1
December	0.3	0.1	-1.9	-0.8	0.8	0.9

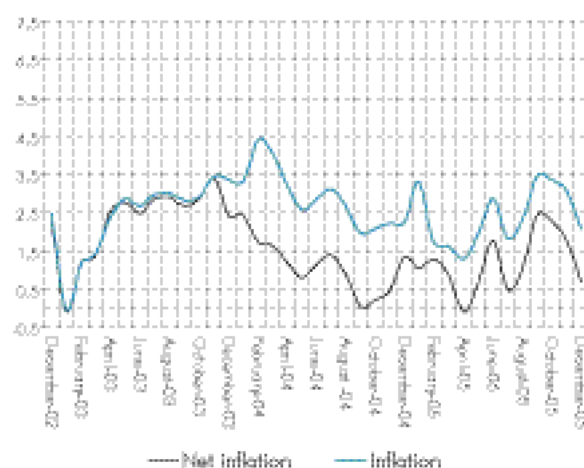
Source: Bank of Albania; General Secretariat of the National Service of Statistics of Greece, ISTAT- Italy

Table 10 Annual inflation of "Foodstuff and non-alcoholic beverages" item and its contribution to total inflation

Similar to previous year, inflation remained under the strong impact of administered prices<sup>16</sup>, which were the main source of inflation during 2005. Their average contribution to inflation was 1.4 percentage points. The rise by 25.7 percent of the electricity price in January and of health and education fees during last months of the year, were the main factor in this contribution. Public fees for health and education services marked an annual increase of 20.4 percent during first nine months of the year<sup>17</sup>. Therefore, the "Health" and "Education service" items contributed to annual inflation rate on average by 0.1 and 0.07 percentage points.

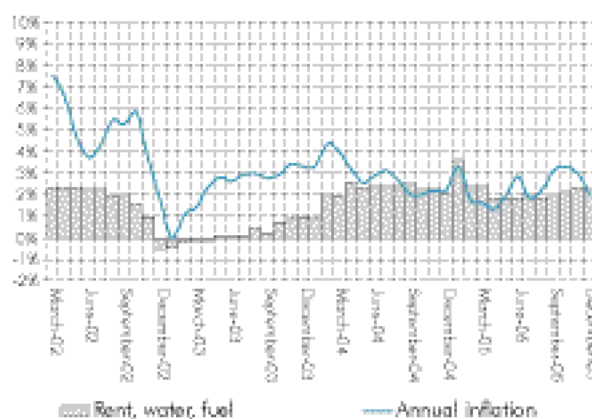
Price developments in "Rent, water, fuel and energy" item continued to form the annual inflation rate even during 2005. This item provided an average contribution of 2.2 percentage points to annual inflation over 2005, i.e. the same contribution with the one given over the previous year. Along with administered energy price rise, the "Rent, water, fuel and energy" item was significantly impacted also by market price rise almost in all constituent items. Rent and imputed rent prices recorded high rates during first quarter of the year. Average growth rate of this period was 5.7 percent. Along the rise of these prices, the grave electricity situation gave temporary shock on gas and fire woods

Chart 16 Annual and net inflation performance<sup>18</sup>



Source: Institute of Statistics, Bank of Albania

Chart 17 Annual inflation of "Rent, water, fuel and energy" item and its contribution to total inflation (in percentage)



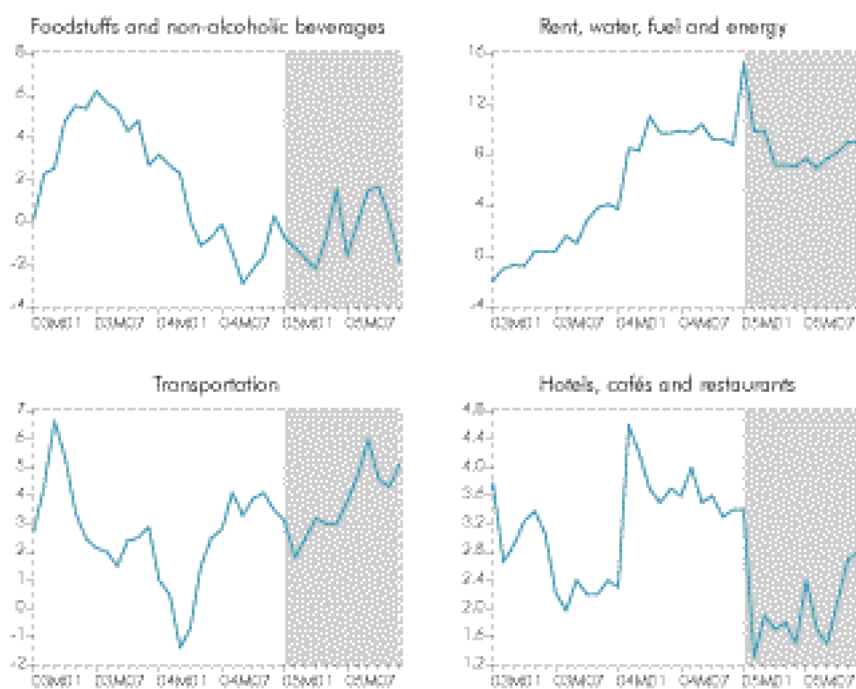
Source: Institute of Statistics, Bank of Albania



prices. Increased demand for these goods as substitutes for electricity brought about their price rise during the last quarter.

“Transport” item was influenced by oil price rise in world markets and by exchange rate performance of the lek against the American dollar. Since two years ago, oil price rise has acted as inflationary factor in many importing countries. However, its impact on our country was felt mainly on the second semester of 2005. The delayed and relatively insignificant effect on consumer prices was an outcome of the significant appreciation of the lek against the American dollar in 2004 and first half of 2005. Also, the small weight this item hold in the consumer basket<sup>19</sup>, has limited its impact on overall inflation. In the meantime, the lowest rate of the lek’s appreciation against the American dollar during first nine months of 2005, as well as the changed ratio between these two currencies during last months of the year (the lek was depreciated on average by 5.7 percent during October – November – December ‘05) did not manage to alleviate this cost for the Albanian consumer. “Transport” item raised the annual inflation rate on average by about 0.2 percentage point, in comparison to 0.1 percentage point given in annual inflation of the previous year.

Chart 18 Annual inflation of 4 main items of the CPI basket (in percentage)



Source: Institute of Statistics

Year 2005 was characterised by lower rise in services sector prices. The “Hotels, cafés and restaurants” item recorded positive inflation rates, mainly during the second half of the year. However, this group has given an average contribution of 0.16 percentage point to annual inflation rate.



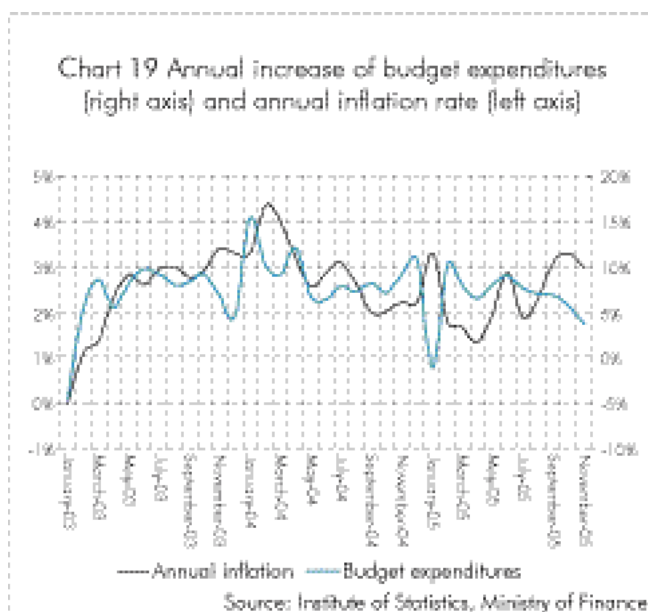
Other basket items have maintained their trend throughout the year. Positive growth rates have been marked by the items of "Alcoholics and tobacco" and "Miscellaneous goods and services". Developments in these items have been counter-balanced by negative inflation of "Clothes and footwear" and "House furniture, equipment, and maintenance". The resultant of their contribution to annual inflation of this year was 0 percentage point.

#### II.4.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

Moderate rise of consumer prices during 2005 was favoured by the fruitful coordination of monetary and fiscal policies. These policies helped in controlling the domestic demand by creating a favourable macroeconomic environment. Monetary policy has been successful in creating appropriate monetary conditions for controlling inflation rate. Prudential implementation of fiscal policies, by observing the planned parameters of fiscal indicators, has not transmitted excessive inflationary pressures and has contributed to maintaining price stability. Also, developments in the external economic environment characterised by appreciation of exchange rate of the lek against the euro and by steady inflation rates in partner countries, have not exerted inflationary pressures.

- Fiscal policy and fiscal indicators

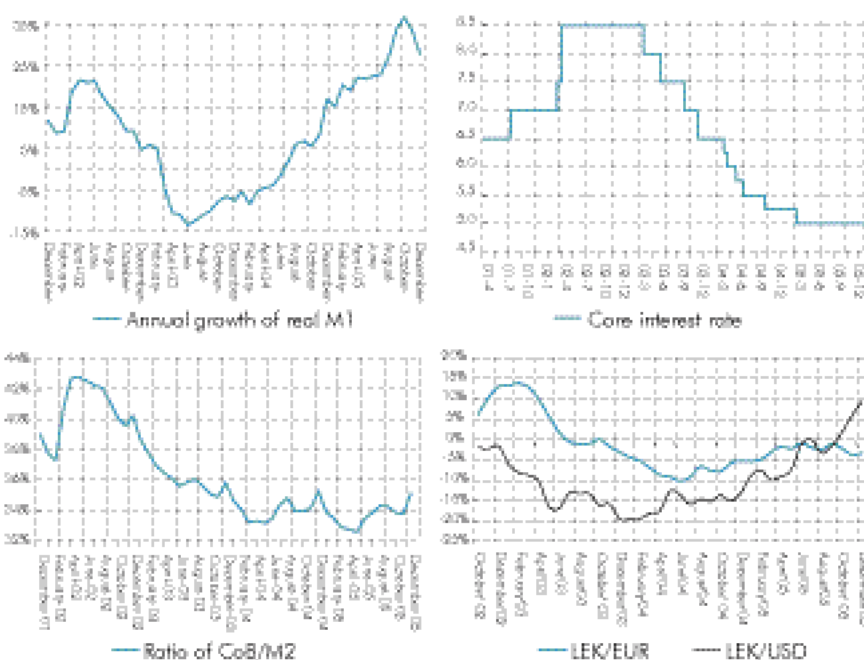
Fiscal policy is an important determinant factor for the economic growth and macroeconomic stability. Year 2005 was characterised by a prudent fiscal policy. Fiscal indicators<sup>20</sup> were realised within the levels provided in the approved budget. Budget expenditures recorded accelerated growth rates during the first months of the year, which were eased during the second semester. Budget deficit at end of this year is estimated at 3.9 percent of GDP, about 1.2 percentage points less than that of the previous year. Government's demand for domestic borrowing is estimated to 2.8 percent of GDP. This indicator that serves for measuring inflationary pressures injected by this factor of the demand, points to a slight growth against the previous year (2.3 percent of GDP), but without creating pressures on monetary indicators.



- Monetary policy

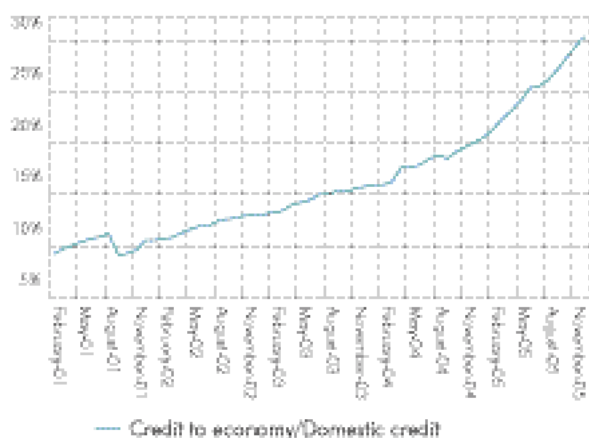
Monetary policy of the Bank of Albania has generally had a neutral stance over 2005. Interest rate cut by 0.25 percentage point at end of the first quarter was pursued by a period of steady inflationary pressures in the rest of the year. After the first quarter, the key interest rate was held unchanged,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

Chart 20 Monetary conditions in the economy



Source: Bank of Albania

Chart 21 Contribution of the economy demand to domestic credit expansion



Source: Bank of Albania

Favourable monetary conditions have been associated with increased demand for monetary assets. Lending to the economy has been the main source of monetary expansion during this period, unlike in the preceding years, when this function had been realised by government borrowing or foreign currency inflows. The rapid growth of credit to the economy has compensated the reduction of the government's borrowing. Low inflation rates during this period have enabled high growth rates of monetary aggregates in real terms. Annual real M3 growth has maintained an upward trend over two last years.

Bank of Albania presence in currency markets during the first semester of the year was limited in withdrawing liquidity through fixed-price and unlimited-amount repurchase agreements. Also, the Bank of Albania has facilitated the functioning of monetary markets through its supporting instruments, mainly through applying overnight deposits. Developments of monetary operations have created conditions for monetary policy transmission and are associated with stability of monetary markets. Financial markets underwent a significant volatility during the third quarter as

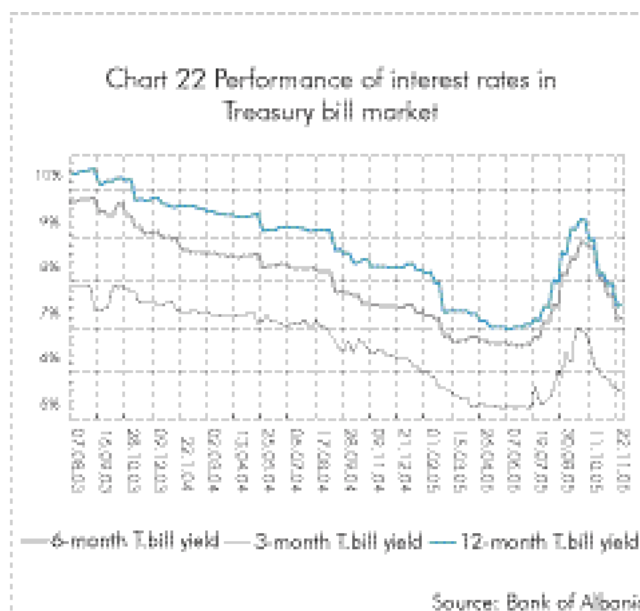
a result of rise in the economy and government demand for monetary assets, bringing about lack of liquidity into the system. Lack of liquidity was further transmitted to rapid rise of Treasury bill yield during the third quarter of the year. This volatility made necessary Bank of Albania intervention for interest rate stabilization. Under these conditions, monetary operations were focused on satisfying the market needs for liquidity and on mitigating pressures on currency market interest rates. Therefore, the Bank of Albania changed the direction of repo operations, transforming them into liquidity injectors in the system. The average volume injected through reverse repo instruments was ALL 1.7 billion during July-September. Also, temporary employment of direct credit to the government enabled prevention of speculations and excessive pressures in terms of increasing Treasury bill yield. Development of these operations enabled the satisfying of needs of the banking system for liquidity and returned Treasury bill yield close to previous trend.

The Bank of Albania intervened in the foreign market during the second semester of the year. It purchased foreign currency almost during the whole period, smoothing down the appreciating pressures on the exchange rate and injecting liquidity into the market. It is estimated that about ALL 12.4 billion of liquidity was injected through these interventions, assisting the banking system with liquidity and contributing to stabilization of financial indicators.

- Imported inflation

As an economy exposed to imports, Albania<sup>21</sup> is inevitably impacted by exchange rate developments. The impact of this factor must be analysed not only in the effect it provides on supply shocks transmission, such as oil price rise, but even on the imported inflation level. Out of a survey made by the Institute of Statistics during 2004, it resulted that about 46 percent of the consumer basket goods are imported goods. Therefore, their price performance (combining their price in the national currency with the exchange rate) takes much importance in explaining the inflation rate in the country.

During 2005 the domestic currency followed the appreciating trend inherited from the previous year, but at smoother appreciating rates. The lek was appreciated on average by 2.6 and 2.7 percent against the dollar and the euro. A year ago this appreciation was respectively 15.7 percent and 7.2 percent.



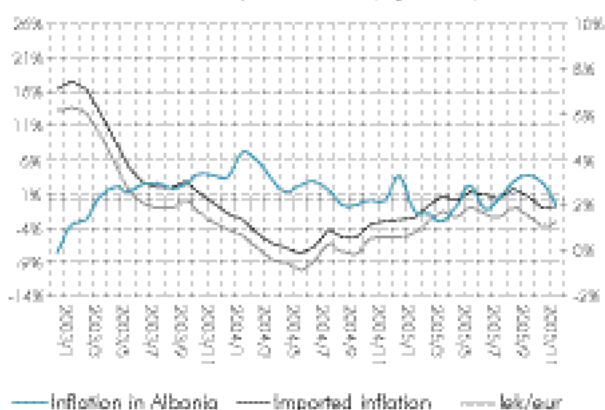
	March	June	September	December
Lek/Euro	-3.1	-1.0	-1.0	-3.2
Lek/Usd	-9.8	-1.2	-1.4	9.5
Greece <sup>22</sup>	2.9	3.3	3.9	3.4
Italy <sup>23</sup>	1.7	1.8	2.0	2.0

Source: Institute of Statistics, General Secretariat of the National Service of Statistics in Greece.  
ISTAT-Italy

Table 11 Annual inflation of partner countries and annual exchange rate spread (in percentage)

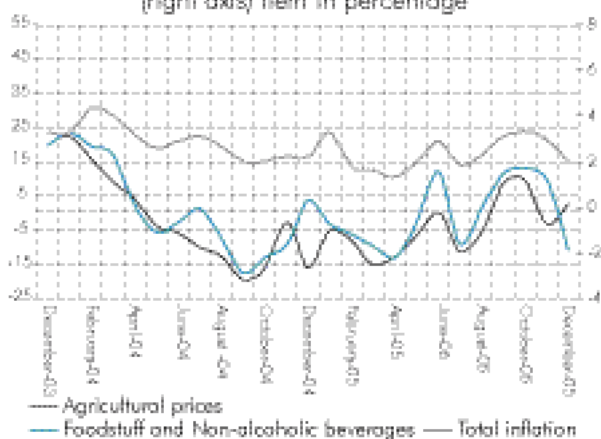
Though downward, the annual appreciating dynamic of the lek has managed to amortise inflationary pressures of imported goods. The main actors in trading relations continue to be Italy and Greece – whose exports and imports represent respectively 83 percent and 47 percent of the overall volume. The lek's appreciation against the euro, and steady inflation rates in these countries have created conditions for stability in foreign trade environment, thus smoothing the inflationary pressures transmitted by this factor of the demand.

Chart 23 Annual change of nominal lek/euro exchange rate, of imported inflation (left axis) and country's inflation (right axis)



Source: Bank of Albania, General Secretariat of the National Service of Statistics of Greece, ISTAT - Italy

Chart 24 Annual change of the agriculture price index (left axis) and annual inflation, and of the "Foodstuff and Non-alcoholic beverages" item in percentage (right axis)



Source: Ministry of Agriculture, Food and Consumer Protection, Institute of Statistics, Bank of Albania

#### • Domestic agricultural production

Performance of agricultural production over 2005 provided a non-uniform impact on inflation rate. During 2004 and first semester of 2005, this supply factor impacted on inflation rate reduction. For the rest of the year it acted on the opposite direction. The ample production of the previous year and combination of foodstuff price cut in foreign markets with the most significant appreciation of the lek against the euro during the first months of 2005, brought about price cut of these goods in the domestic market. The downward effect of this factor on foodstuff price cut did not operate with the same force during the rest of the year. Data of the Ministry of Agriculture, Food and Consumer Protection speak for a pessimistic forecast of the agricultural production of this year. Forecasting of the year-start on agricultural production rise was 2.5 percent (against the growth of 3.3 percent recorded in 2004). Meanwhile, recent data speak for a growth close to 1.3 percent.

The lowest growth of domestic agricultural production, combined with increased inflationary pressures generated from higher prices of foodstuff in partner markets and with the smoothed compensating effect of the weakest appreciation of the lek against the euro, resulted at higher prices of these goods during the second semester.

#### • Production price index <sup>24</sup>

In general, year 2005 was characterised by low growth rates of production prices. After a quarter when double-figure rise was noticed, the annual change of production prices index marked low growth rates during April – September 2005. At end of the first nine-month period of the year, the production prices were 2.3 percent higher than their level over the same previous year period. The overall price cut in the first link of trading was headed by price performance almost in all sectors. "Process

industry" sector marked the highest reduction from 13.5 percent in the first quarter of the year, to 1.5 percent in the third quarter. In this industry reduction was recorded mainly in the sectors of "Food industry", "Tobacco industry" and "Textile and clothes industry". Price performance of these industries is reflected even in the consumer price performance. Annual price change in "Production, distribution of electricity, gas and water" sector dropped from 17.8 percent in the first quarter of the year, down to 4.4 percent in the third quarter. The sectors that recorded a growth were: "Extractive industry", "Silviculture, woods exploitation and additional services" and "Fishery, fish cultivation, water culture and services".

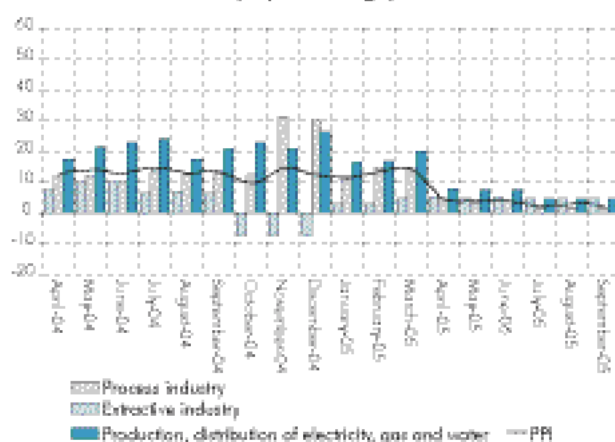
Regardless of higher prices in the first link of trading, the final prices the consumer pays are not raised under the pressures of higher costs. This is attributed to increased competition in all Albanian economy segments.

- Other indicators

Sales index and retail market index<sup>25</sup>. Total sales of the economy were increased by 16.1 percent during the first nine-month period of 2005, against a growth of only 6.1 percent during the same period of the previous year. Notwithstanding the rapid rise of domestic demand, the annual inflation remained under control, indicating a corresponding growth of production in the economy.

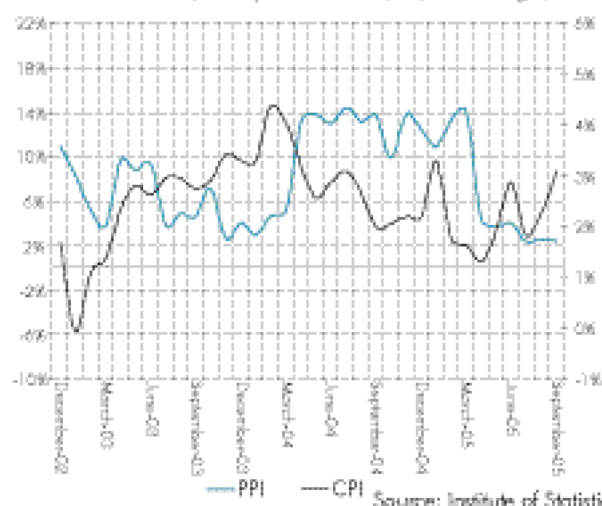
Unemployment – salary: Year 2005 was associated by a steady situation in the labour market. Unemployment rate marked a slight reduction along the year. This indicator fell from 14.4 percent in the first quarter to 14.2 percent in the third quarter of the year. This situation was associated by a moderate rise of salaries in the public sector. The average salary of this sector was increased by 3.0 percent during the first quarter and by 2.2 percent in the third quarter of the year. Also, the minimum salary was raised by 9.3 percent in the third quarter. These increases have not conveyed inflationary pressures through the salary-inflation spiral.

Chart 25 Annual change of prices in main industries, and of production and consumer prices index (in percentage)



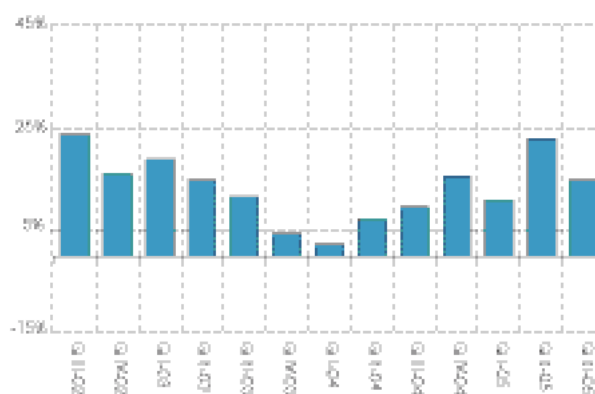
Source: Institute of Statistics

Chart 26 Annual change of production and consumption price index (in percentage)



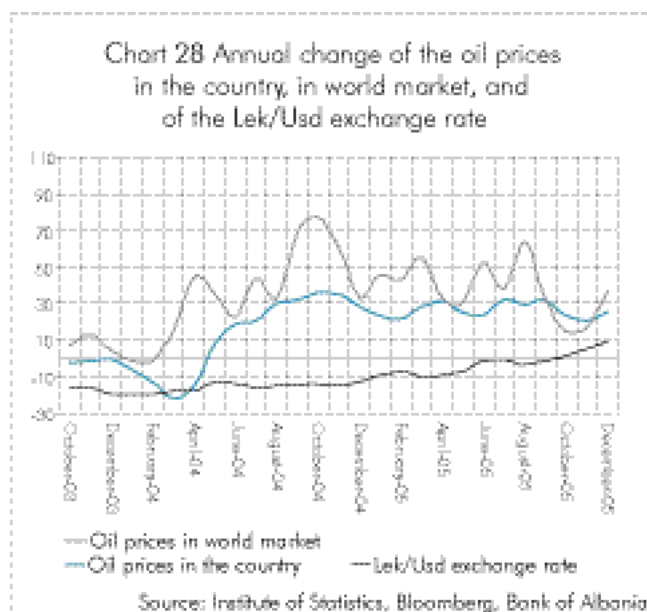
Source: Institute of Statistics

Chart 27 Annual change of the sales index on a quarterly basis (in percentage)



Source: Institute of Statistics

**Oil price:** Oil price rise has been a constant concern in terms of raising the living cost during 2005. Average oil price rise in world market by 43.0 percent and 34.0 percent respectively during the first and second semesters of the year was translated into a rise of 27 percent of oil price in the domestic market, in each semester. Nonetheless, the small weight<sup>26</sup> of this product in consumer goods basket implies a small impact of oil price rise on total inflation. This factor increased the living cost of the Albanian consumer by 0.2 percentage point over 2005.



The lowest oil price rise in the country is due to some factors. First, the lek's strong positions against the US dollar during two last years have amortised a part of oil price rise in international market. The smoothing down of the lek's appreciation against the dollar during the second semester has impacted on a faster rise of oil price over this period. Secondly, oil price produced in the country has had a low rise by 3.2 percent in annual level, substituting a part of imposts from the market and enhancing the competition. Finally, oil price rise has brought about decreased demand for this product, by limiting the possibility of applying higher prices. Hence, in the fourth quarter the oil demand decreased by 21 percent in annual terms<sup>27</sup>.

The living cost is raised not only by the direct effect on inflation but also by the increased costs related to oil prices. However, during this year no second round effects are noticed, in the form of transmitting this cost to other products' prices.

Macroeconomic developments have enabled the creation of a favourable environment for maintaining price stability. Weak inflationary pressures owing to fiscal policy, prudent monetary policy, and stability of the lek's positions against foreign currencies, have ensured a low positive inflation rate over 2005.

#### Box II.4 Bank of Albania forecast

*Monetary policy, like other economic policies in general, provides its impact some periods after the moment it is applied. This means that decision-making should precede future economic developments. Therefore, better knowledge on expectations is crucial for the effectiveness of economic policies. In central bank's case, inflation control is inevitably related with knowledge on price expectations. For discovering these expectations, the Bank of Albania is based on some methods.*

*The first group of methods consists in directly questioning the consumers and businesses about price expectations, by means of questionnaires. Questionnaire is*



*an efficient way that provides rapid information on sensations of economic agents. At the same time, questionnaire serves as a confidence index of the policy pursued by the central bank. If expectations do not indicate large deviation from the central bank's objective, this may be interpreted as a sign that the policy followed is on the right track. But, experience has indicated that consumer expectations and businesses may change soon enough, without giving warning signs. Therefore, the need for using new forecasting methods arises, so as to timely catch the changes that may skip the eye of a consumer or of an individual business.*

*Forecasting methods are categorised in non-structural methods and structural ones. Non-structural methods consist in relatively simple methods, based on correlation noted between different variables in the course time. These models are largely used nowadays in financial markets for forecasting various indexes, including price changes as well. Performance of non-structural models has been satisfactory until now, in spite of the minimum economic logics after these models. But, it is precisely the latter one that makes them not very appropriate to analyse the reaction of expectations to unusual shocks, with which the economy may be faced with. For example, these models may not be able to catch accurately any second round effects of an immediate oil price rise.*

*On the other hand, structural models are largely based on economic theories and consider price movements as an outcome of interaction of various economic variables (income, consumption, savings, investments, etc). Structural models constitute a complex system of theoretical identities on the way the economy functions, where each identity has a theoretical and empirical background as much rich. These models make the judgement for future developments of the economy more structured in the aspect of theoretical - practical assumptions and arguments. Structural models can not be treated simply in the framework of forecasting models.*

*These models, usually referred to as macro models, allow the simulation of various scenarios on possible risks or shocks a country's economy may be faced with. What is more important, central bank may use these models to estimate how much its monetary policy instruments should be changed (in Bank of Albania's case the key interest rate) for achieving and/or maintaining inflation target. But, these models allow the central bank to analyse reaction of a large number of economic variables beyond prices, making it aware even of the volatility of other economic indicators that may cause its policies.*

*In order to minimise the error in estimating expectations, the Bank of Albania currently combines the results of all above methods. Surveying of consumers and businesses and non-structural or half-structural models have entered into a consolidation phase. While the preparation of structural models, for its complex nature and intensity of the series of economic data it requires, is a process somewhat extended in time. In spite of the development level of each method, they are under constant review and improvement, not simply with the latest theoretical developments but also with structural changes our country's economy is undergoing. Time after time these models will be published even in the form of working papers.*

*The expectations results of various methods constitute only a part of information and of larger analyses on which monetary policy decision making is based. Expert judgement remains an important component of decision-making for interpreting information and results of various models, which though minimizing the abstract judgement spaces, they can not fully replace it.*

Chart 29 Performance of savings and investments in percentage to GDP

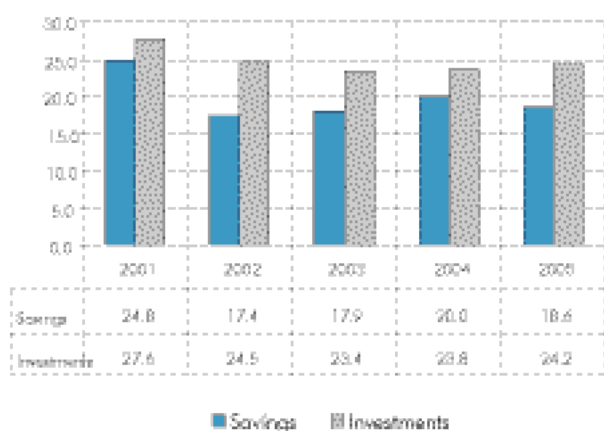
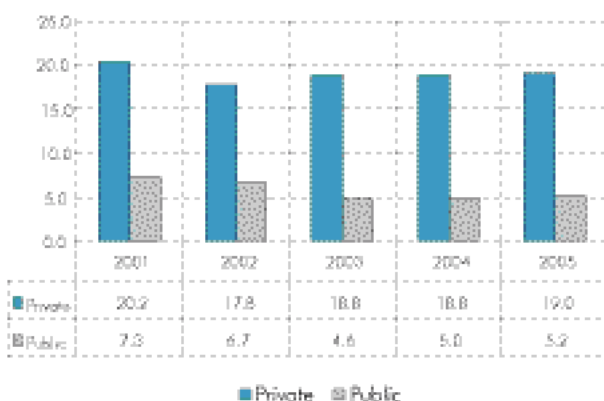
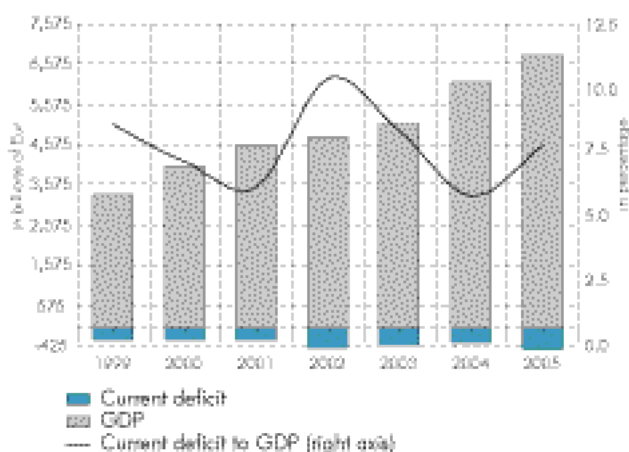
Source: IMF, January 2006<sup>29</sup>

Chart 30 Performance of public and private investments to GDP



Source: IMF, January 2006

Chart 31 Current deficit to GDP (as a percentage)



Source: IMF, Bank of Albania

## II.5 SAVINGS AND INVESTMENTS

Imbalance of domestic savings and investments was increased to 5.5 percent of GDP over 2005, against the level of 3.8 in 2004<sup>28</sup>. This fact is manifested even in the enlargement of current account deficit. The enlargement of this difference reflected the opposite performance of savings and investments. So, the ratio of investments to GDP was increased by 0.4 percentage points over 2005, while the ratio of savings to GDP was decreased by 1.4 percentage points. Low interest rates have reduced the incentive for saving, urging simultaneously a rise in investments. Reduction of domestic investments over 2005 was due to decrease by almost 2.7 percentage points of private savings ratio to GDP. On the other hand, public savings were increased by 1.3 percentage points compared to the previous year. Budget deficit improvement in terms of fiscal consolidation influenced the rise of public savings.

Ratio of investments to GDP was increased by 0.4 percentage point over 2005, amounting to 24.2 percent of GDP, maintaining the same average level of 4 last years. Both public and private investments were increased by 0.2 percentage point over 2005. This growth is assessed as satisfactory, given that public investments rise during this year was not impacted by revenues realised from public property privatization, but was based mainly on domestic resources. Besides low real interest rates, private investments rise is backed even by rapid growth of bank lending. Also, continuation of the period of economic growth and consolidation of macroeconomic stability has created a proper environment for carrying out long-term investments and for a longer-term timely distribution of consumption.

## II.6 BALANCE OF PAYMENTS

External sector of the economy over 2005 is presented with a deep negative balance sheet in the current account, caused by a high trade deficit. Capital inflows have generally been sufficient for compensating the current deficit, enabling an overall positive balance sheet.



Relative current deficit indicator (excluding official transfers) to GDP has reached to 7.7 percent in 2005 from 5.7 percent estimated for 2004. The current deficit deepening is caused by trade balance deterioration – along a period of the lek's constant appreciation (during two last years the real effective exchange rate – calculated on the basis of consumer price index - is estimated on average by 5 percent).

Export has slowed down the growth rates. The annual export growth during this year was estimated at about 9 percent, against 23 percent in the previous year. Besides the loss in competitive abilities (exchange rate developments), the export slowdown is regarded as a consequence of increased competition in the textile sector, upon European markets opening towards China and India. It should be stated that textiles and shoes have represented on average 64 percent of our exports for 2000-2004. The degree of their representation to total exports decreased over this year to 58 from 61 percent in 2004.

At the same time, high oil prices in international markets and growth of lending have led to rise of imports by about 16 percent. As a result of faster rise of imports compared to exports, the covering of imports by exports has decreased to 26 percent, from 28 percent in the previous year.

The balance of payments statistics for 2005 indicate that foreign trade in services is evidenced as a very important activity for the Albanian economy. So, services transactions (about Eur 2 billion) have recorded a rise of 22.5 percent against 2004.

The trade deficit (goods and services) is estimated to have amounted to 24 percent of GDP or 4 percentage points more in comparison with the previous year.

	2004	2005	2004	2005
	In millions of euro		As a % of the GDP	
Current account	-347.0	-519.0	-5.7	-7.7
Trade balance	-1,276.7	-1,476.7	-20.8	-21.8
Export	485.6	530.2	7.9	7.8
Import	-1,762.3	-2,006.9	-28.7	-29.6
Services (net)	-40.5	-167.1	-0.7	-2.5
Income (net)	140.7	144.3	2.3	2.1
Current transfers (net)	890.3	1,045.8	14.5	15.4
Capital account (net)	179.6	297.7	2.9	4.4
Overall balance	233.7	124.8	3.8	1.8

Source: Bank of Albania

Table 12 Main indicators of the balance of payments in ratio to GDP

Increased volume of transactions for goods and services over 2005 led to improvement of Albania's economic opening indicators<sup>30</sup>, which for this year is estimated to about 68 percent, from 64 percent in 2004.

High trade deficits have been financed not only by capital inflows but also by a considerable financing possibility observed within the current account itself, through remittances. During 2005 the net flow of current transfers was estimated to about Eur 1 billion, from which more than 90 percent are

Albanian emigrants' contribution. Remittances for 2005 are estimated to Eur 939 million or to about 14 percent of GDP.

Net capital inflows recorded a level of Eur 423 million, financing the current deficit to 93 percent. This capital import is also reflected in the foreign reserve growth of monetary authority, by about Eur 197 million. Foreign reserve at end of 2005 marked the value of Eur 1.204 billion, being sufficient for facing about 4.7 months of import of goods and services.

#### II.6.1 CURRENT ACCOUNT

Year 2005 is characterised by an intensive activity in the external sector of the country, expressed in a considerable growth of current income and expenditure. The volume of current transactions is raised by 21 percent compared to 2004, marking a level of Eur 6.2 billion. More than 93 percent of current expenditures went for purchasing goods and services from non-residents. About 43 percent of current income has derived in the form of current transfers, while the exports of services and goods have ensured respectively 32 percent and 18 percent of income.

Current deficit, compared to the previous year, is raised by about Eur 168 million, recording Eur 454 million. Trade deficit growth in goods and services was partly balanced by increased net income in transfer and income accounts. Trade deficit has composed a permanent feature of foreign trade developments, dictating high levels of current account deficit. Relative indicator of imports to GDP is estimated at about 30 percent. About 58 percent of the total import during this year is presented in capital merchandise imports and in intermediate merchandise imports, while the domestic demand for consumer goods has remained high.

Though private investments in the productive capital are associated with rise of productive capacities for exports, low level of exports remains a striking feature of the economy. Along 2005 they constituted an average of about 7.8 percent of GDP, facing the financing of only about 26 percent of import volume in economy. The services account over 2005 recorded an increase both in income and expenditure. In comparison to 2004 expenditures have increased faster than income. Net result of transactions in services has led to rise of deficit of this account, by about Eur 127 million.

Meanwhile, the positive balance of current inflows in the form of current income and transfers is estimated at about Eur 159 million higher compared to the previous year. This growth is an effect of increased current income in the form of remittances, while the positive balance of income account has recorded a modest growth.

- Merchandise trade

The foreign trade volume, imports plus exports, is estimated at about Eur 2.5 billion, representing about 41 percent of total current transactions.

Expenditures for merchandise imports recorded on average Eur 2 billion or Eur 245 million more compared to 2004. Incomes from merchandise export have increased by 9 percent, reaching Eur 530 million.

The degree of covering imports from exports resulted 25 percent, marking a slight reduction from the level of 27 percent of the previous year, thus resulting to a further deepening of trade deficit. Albanian economy, since more than a decade, has created its profile characterised by high merchandise imports. This is indicated even by the fact that during this year imports represented 80 percent of the volume of foreign trade. Trade deficit over 2005 reached to Eur 1.5 billion, being 16 percent higher than that of the previous year.

Code	Description	Import	Export	Trade balance
0	Live animals and animal products	272.33	20.41	(251.91)
1	Beverages and Tobacco	64.71	9.64	(55.07)
2	Raw material	75.91	25.62	(50.29)
3	Fuel	181.77	15.35	(166.42)
4	Vegetable and animal fat and oil	28.50	0.24	(28.26)
5	Chemical products	201.75	4.77	(196.97)
6	Manufactured articles	509.85	114.31	(395.54)
7	Machinery and equipment	488.97	22.14	(466.83)
8	Miscellaneous manufactured articles	260.07	317.70	57.64
9	Unclassified articles	-	-	-
	Total	2,083.85	530.19	(1,553.66)

Table 13 Export / import distribution according to merchandise groups<sup>31</sup> (in millions of USD)

Merchandise export continues to suffer a low degree of diversification, even though modest positive signs are noticed in this direction. Most of it is represented by exports of textile products, footwear, and base metals. It is emphasised that textile products have maintained almost the same levels as in the previous year, while export of two other categories has increased.

Even during this year the merchandise export was determined obviously by changes in the country's process industry. Exports of this category realized 70 percent of annual revenues in merchandise exports. During this year, we observe an underlined growth of exports from domestic production, representing 30 percent of the total, compared to 25 percent of the previous year. The demand for exports has remained high. It is positive the fact that the annual growth in imports is caused considerably by growth of imports in machinery and equipment and in means of transport. The weight these imports occupy to total is about 24 percent, maintaining the same representation levels as in the previous year.

Private sector's high demand for capital goods is a positive indicator for the level of investments, for the renovation of technology basis and its productivity. Raw material imports for the domestic active process industry, focused mainly on textile products, footwear and metals, has increased by representing 15 percent of the total, from 17 percent in the previous year. The performance of these imports reflects developments noticed in the re-export sector.

Table 14 Exports distribution  
by trading partners in years  
and the annual change over  
2005

Export	Share on total export			Change (2005/2004)
	2003	2004	2005	%
Total	100	100	100	9.2
EU countries - 15	93.3	89.9	88.0	6.9
Italy	74.9	73.0	72.4	8.3
Greece	12.8	12.0	10.5	-5.1
Germany	3.4	3.1	3.3	17.2
South-eastern European countries	4.0	8.5	9.2	19
Former Yugoslavia	0.6	0.4	0.8	143
FYROM	0.7	1.2	1.6	38
Kosovo	1.7	4.5	4.1	-1
Other countries	2.7	1.6	2.7	86

From the geographical viewpoint, the European Union remains the main destination of Albanian products, occupying 88 percent of total exports. Sales in European markets have recorded an annual growth of Eur 30 million or 7 percent against the previous year. However, this market has lost terrain in the favour of market extension to the region countries.

Exports with region countries of the South-eastern Europe, with which Albania trades under free trade agreements, have increased by 19 percent compared to the previous year, extending the Albanian export market in this area from 8.5 to 9.2 percent of total exports. Kosovo and Macedonia represent the largest markets for exporting Albanian products.

As concerns to imports, trading geography presents a larger variety of markets. The European Union satisfies about 60 percent of domestic needs for imports and during 2005 imports increased by 5.7 percent. Italy and Greece remain the main trading partners of Albania. Imports from both countries altogether occupy 76 percent of expenditures of the Albanian economy in the European Union markets. Imports with the regional South-eastern European countries included in the process of creating free trading area, have reflected a considerable growth, about 31.5 percent and their share to total imports has increased from 12.8 percent in 2004 to 14.8 percent in 2005.

Table 15 Imports distribution  
by trading partners in years  
and the annual change for  
2005

Imports	Share on total imports			Change (2005/2004)
	2003	2004	2005	%
Total	100	100	100	13.8
EU countries -15	78.2	65.0	60.4	5.7
Italy	38.1	32.6	29.3	2.4
Greece	24.2	18.6	16.6	1.5
Germany	6.3	6.2	5.4	-0.9
South-eastern European countries	14.7	12.8	14.8	31.5
Bulgaria	2.9	2.0	2.8	60.2
Bosnia & Herzegovina	0.1	0.0	0.1	195.6
Croatia	1.7	1.3	1.2	5.0
Serbia Montenegro	0.5	0.6	0.6	23.3
FYROM	1.0	1.0	1.2	35.0
Rumania	0.9	0.4	0.7	92.3
Turkey	7.5	7.1	7.5	19.4
Russia	2.8	2.8	4.1	63.7
Ukraine	2.5	2.5	2.9	31.6
Other countries	7	22	25	27.5

- Services

Services trade over 2005 is characterised by a high net deficit of Eur 167 million in comparison to the deficit of Eur 40 million in 2004. Services trade balance sheet was closed with a negative balance of Eur 167 million, considerably upwards against the deficit of Eur 40 million recorded in 2004. This deficit was mainly due to a negative balance in the category of other cultural and business services.

Income from tourism services reinforce once more the fact that this sector is creating to Albanian economy concrete trading opportunities, notwithstanding the development level. Hence, according to Bank of Albania estimates for 2005, the export of tourism services has generated income of Eur 692 million, about 30 percent higher than the ones generated from merchandise export. This growth is attributed mainly to increased flows of foreigners and emigrants visiting our country and the slight increase of daily expenditure evaluating coefficients. Over 2005 the number of foreigners visiting Albania increased by 21 percent compared with 2004, and the main weight of this increase falls on seasonable periods of holidays and end-year celebrations. A growth at high annual rates is noticed even in import of tourism services. Year 2005 recorded about Eur 635 million, a figure equal to about 68 percent of emigrants' remittances.

It is already known that transport and insurance services follow developments in the merchandise trading activity. Increased import volume has led to import growth of services of this category. Hence, at end of the year, the import of services of this category is estimated respectively at about 12 and 38 percent higher than those of 2004.

Telecommunication services were closed with a positive balance of about Eur 46 million, due to expansion of the range of services provided by telecommunication sector.

"Other services" category has undergone a considerable growth in terms of imports, which together with transport services have led to deficit of the services balance sheet over 2005.

- Income and current transfers

Yearly the Albanian economy benefits foreign assets from the work of seasonal workers and from foreign reserve investments of the banking system in non-resident financial institutions, paying at the same time interests on external debt. The positive balance sheet of income at end of 2005 is estimated to about 144 million, being 4 million higher compared to 2004. Labour incomes represent about 70 percent of the positive balance of income. Net inflow of income of this category has dropped by about 3 percent against the previous year, when the organisation of Olympic Games held the

Chart 32 Services – net flow in millions of euro



Source: Bank of Albania

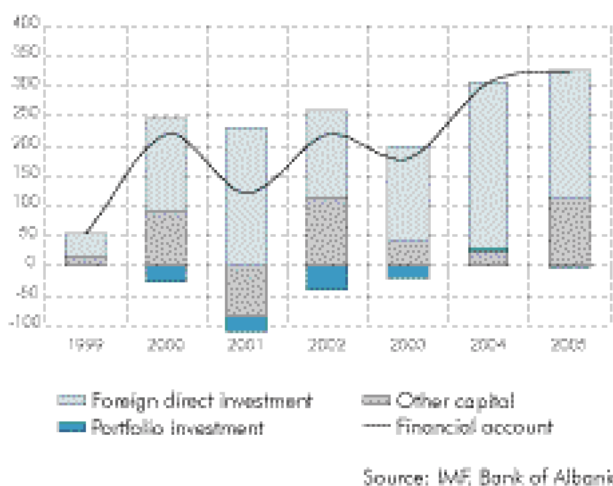
demand for labour force high in the neighbouring country and therefore it generated a high flow of incomes from labour. Meanwhile, net income in the form of interest on investment has increased (about 19 percent or Eur 7 million). During 2005 Albania has paid Eur 22 million to settle the interest on its external debt or 19 percent more than in the previous year.

Emigrants' remittances have shaped current transfers, as in the previous years. Remittances represent an important source that backs the Albanian economy, providing a continuous flow for current deficit financing. Total remittances are estimated at 939 million or 14 percent of GDP over 2005. Their contribution to the smoothing down of trade deficit is estimated at about 64 percent. Inflows from emigrants are also associated with official transfers, mainly in the form of technical assistance (Eur 47 million), which are estimated to be slightly upward versus the previous year (4 percent).

## II.6.2 CAPITAL AND FINANCIAL ACCOUNT

Capital movements over 2005 resulted in a net inflow of about Eur 423 million, enabling the current deficit financing by 93 percent. Capital transfers marked Eur 99 million or 7 million less compared to end-year 2004, while the financial account was closed with a positive balance of Eur 323 million.

Chart 33 Financial account over years – net flow in millions of euro



Albania's financial liabilities to the rest of the world have increased by about Eur 346 million and are estimated to be 22 percent less than in the previous year. This increase has come from inflows of foreign direct investments and external debt.

Foreign direct investment over 2005 amounted to Eur 213 million versus Eur 278 million realised over the previous year. It should be mentioned that in 2004 capital inflows in the form of privatization have been a factor that determined the size and character of foreign investments in the country. Capital inflows in the form of FDIs have been transformed into a dominant factor in increasing financial liabilities and in developing capital and in effecting capital and financial transfers of the country. FDIs are estimated

as an important source for covering the current deficit and the fiscal one. Also, compared to other financing capacities, FDIs allow technology transfer and dissemination of knowledge. They also contribute to the opening of new job opportunities, as well as help domestic companies participate in foreign markets, etc. Although Albania presents relatively less restrictions on foreign investors' activity compared to other South East European countries, it seems to have absorbed less direct investments in comparison with other countries of the region.

A marked feature of financial developments of Albania with foreign countries during the recent years is the external debt accumulation, increasing the level of liabilities for repayments and interest payments. Until end of 2005, Albania collected an external public debt of Eur 1.039 billion and a guaranteed public debt of Eur 145 million.

This debt level, either in absolute terms or estimated to GDP (about 18 percent on average for 2004-2005) or as a stock of per capita liabilities, is presented relatively low in comparison with other countries of the region. Annual addition of external debt stock during this year is estimated at Eur 139 million, against Eur 181 million recorded over the previous year. This growth has mainly financed the consumption to the economy, reflected in the rise of imports for consumption and has also financed the needs for capital and/or for capital goods of companies. Use of the Fund's loans and credits, of Eur 9.4 million, are not included in this debt.

According to statistics, the government's borrowing occupied the main weight in external debt's position, being increased by Eur 84 million at year-end 2005. Meanwhile, the private sector's participation in the foreign borrowing activity is a recent development. For 2005, the private borrowing amounted to about 39 percent of the total, with an annual growth of Eur 54 million, thus raising the level of representation to total external debt. External debt's structure by currencies is dominated by Sdr, (about 56 percent) followed by the European currency and American dollar.

External debt service is estimated to modest levels, reaching to about 4 percent of total exports over 2005 or much below the level of 25 percent considered as a critical level. Generally, it is drawn the conclusion that Albania is not on the threshold of facing the external debt solvency. Financial liabilities in the form of non-residents' deposits with our banking system have dropped by about Eur 30 million. Liabilities in the form of commercial credit have increased by about Eur 8 million, being reflected even in a rise of imports over this period. A considerable growth of Eur 47 million was noticed in other foreign liabilities in the form of short-term loans received from non-resident units.

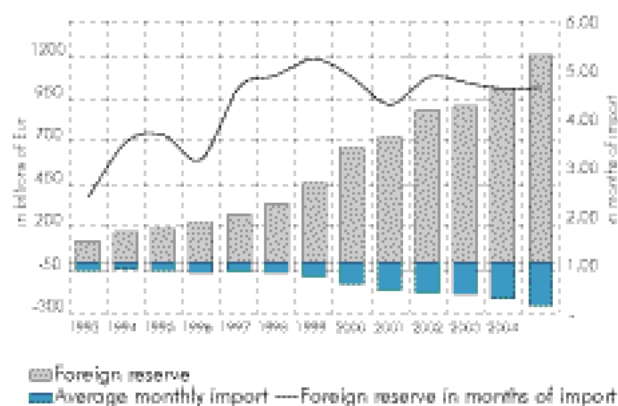
Albania's financial claims on the rest of the world have increased by Eur 22 million. The major contribution has come from foreign assets growth in the form of medium-term and short-term loans given by non resident units abroad. This growth is about Eur 69 million or about 44 million higher than in end of the previous year.

Foreign assets owned by the banking system in the form of foreign deposits, dropped by about Eur 53 million. This reduction may be due to upward policies of commercial banks' lending. In the composition of deposits owned by the banking system, 55 percent of them were denominated in dollar, whereas the rest were in euro (40 percent) and in British pound (5 percent).

Over 2005 the cash foreign assets recorded a growth of Eur 1.4 million and did not reflect any significant fluctuations. In their composition at year-end



Chart 34 Foreign reserves in months of import



Source: Bank of Albania

2005, cash foreign assets in dollar accounted for 29 percent and those in euro 66 percent, while British pound 4 percent and Swiss franc 1 percent. Position of foreign assets in the form of portfolio investments accounted for Eur 120 million, recording an annual growth of about Eur 2 million. The portfolio investments during this year were dominated by those in dollar, about 70 percent, in euro 26 percent and in British pound 4 percent.

### II.6.3 FOREIGN RESERVES

Foreign assets inflows in the form of financial capitals were reflected in the rise of foreign reserves of the monetary authority, by about Eur 197 million. Foreign reserves at end of 2005 accounted for Eur 1.204 billion, being sufficient for covering about 4.6 months of imports of goods and services.

Table 16 Balance of Payments in years (in millions of euro)

	2000	2001	2002	2003	2004	2005
Current account	(179.8)	(245.2)	(440.0)	(355.3)	(286.2)	(453.7)
Merchandise export	277.0	340.3	348.4	396.1	485.6	530.2
Merchandise import	(1,174.2)	(1,489.1)	(1,566.5)	(1,577.0)	(1,762.3)	(2,006.9)
Trade balance	(897.2)	(1,148.8)	(1,218.1)	(1,180.9)	(1,276.7)	(1,476.7)
Services: credit	482.9	596.8	612.3	635.2	807.5	930.4
Services: debit	(471.1)	(497.0)	(620.5)	(707.6)	(848.0)	(1,097.5)
Income: credit	126.9	181.9	155.4	172.9	164.0	183.3
Income: debit	(10.0)	(15.0)	(21.8)	(21.6)	(23.3)	(39.1)
Private unrequired transfers	484.2	605.6	611.9	693.4	829.7	984.5
Official unrequired transfers	104.6	31.4	40.7	53.2	60.7	61.4
Capital account	84.8	131.9	127.4	138.7	106.2	99.2
Financial account	200.1	108.9	218.9	167.8	297.4	313.9
Direct investments	156.6	230.7	141.4	157.4	267.4	212.6
Portfolio investments	(28.7)	(25.7)	(40.3)	(20.6)	4.6	(2.0)
Other capital*	72.2	(96.1)	117.8	31.0	25.4	103.3
Et errors and omissions	22.3	152.1	118.8	128.1	106.5	156.0
Overall balance	147.0	161.4	30.6	89.3	233.7	124.8
Reserves and related items						
Reserve assets	(147.0)	(161.4)	(30.6)	(89.3)	(233.7)	(124.8)
Use of Fund credit and loans	19.5	13.6	5.5	10.0	9.6	9.4
Memorandum items						
Total change in reserve assets	(141.4)	(146.2)	(102.7)	(158.6)	(276.1)	(47.4)
Of which: change due to exchange rate	(5.6)	(15.2)	72.1	69.3	42.4	(77.4)

\* Use of Fund credit and loans is not included

Source: Bank of Albania

## NOTES

<sup>1</sup> In the case of savings-investment balance sheet, the current deficit plus official transfers is used for computing foreign investments.

<sup>2</sup> Data on the real growth of GDP for 1999-2000 are sourced from the Institute of Statistics. Other data are estimates of the Ministry of Finance, the IMF and the Bank of Albania.

<sup>3</sup> The table is established based on the reviewed nominal GDP.

<sup>4</sup> Nominal GDP converted with average rate of the period.

<sup>5</sup> Government debt, including the debt secured by the government

<sup>6</sup> For analysis reasons, the volume of sales in absolute value at current prices, information supplied by the INSTAT on quarterly basis, is deprived of inflationary influences, using consumer price index. For the moment, this indicator constitutes the only indicator available and reliable to calculate the depreciating effects in the economy.

<sup>7</sup> See Box.II.1 regarding the negative effects of electricity crisis according to a questionnaire addressed to businesses.

<sup>8</sup> Losses seem as the item determining the upward trend of total use of electricity over September '05 – November '05.

<sup>9</sup> Law No. 8269, dated 27.12.1997 "On the Bank of Albania"

<sup>10</sup> Economy sales index has marked satisfactory growth during nine first months of the year.

<sup>11</sup> Data of salary rise cover the public sector, but they serve as an indicator even for private sector's salaries.

<sup>12</sup> Exchange rate appreciation of the lek against the dollar, the currency in which most of oil imports are invoiced, helps in amortising the transmission into the country of the oil price rise in international markets.

<sup>13</sup> Except June, when inflation rise of this item was due to temporary contraction of supply, because of substitution of glass-house products with field products.

<sup>14</sup> Source: ISTAT; web site <http://www.istat.it>

<sup>15</sup> Source: General Secretariat of the National Service of Statistics of Greece; web site: <http://www.statistics.gr>.

<sup>16</sup> Administered prices include energy, water, bread, health care, education and communication prices. These products constitute 15.6 percent of the consumer price basket

<sup>17</sup> Source: INSTAT; Conjuncture July – September '05, Prices

<sup>18</sup> Net inflation is computed as a difference of total inflation and administered prices inflation

<sup>19</sup> "Transport" item occupies a share of 4.8 percent, whereas the sub-item measuring directly price changes of this product occupies about 1.6 percent.

<sup>20</sup> Budget revenues and expenditures were realised respectively at 97 percent and 92 percent of the annual plan, during 2005.

<sup>21</sup> Imports resulted 3.6 times higher than exports during first nine-month period of 2005.

<sup>22</sup> Source: General Secretariat of the National Service of Statistics; web site: <http://www.statistics.gr>.

<sup>23</sup> Source: ISTAT; Web site <http://www.istat.it>

<sup>24</sup> Source Institute of Statistics, Production price index

<sup>25</sup> Source INSTAT – these indexes may be used to estimate the domestic demand performance.

<sup>26</sup> “Transport” item’s weight to consumer goods basket is 4.8 percent. The weight of the sub-item “Services to personal vehicles”, oil included constitutes only 1.6 percent.

<sup>27</sup> Source: INSTAT, Conjuncture July – September 2005

<sup>28</sup> The difference between domestic savings and investments. According to basic macroeconomic identities, this difference reflects the performance of current account deficit.

<sup>29</sup> Data on savings and investments are referred to estimates published by the IMF in Albania, Basic Indicators and Macroeconomic Framework, 2001-2009, January 2006.

<sup>30</sup> Computed as a ratio of the trade volume in goods and services to GDP

<sup>31</sup> According to SITC rating

## CHAPTER III MONETARY DEVELOPMENTS AND MONEY MARKETS

### III. 1 MONETARY PROGRAM AND QUANTITATIVE OBJECTIVES

Bank of Albania monetary policy implementation forecasts the monitoring of monetary indicators and analysis of their consistency in ratio to inflation target for maintaining price stability in the economy. In view of the monetary policy, the Bank of Albania compiles annually a monetary program, which serves as an orienting scenario of desired economic and monetary conditions. In compliance with the targeted inflation rate of 3 percent, the monetary program defines the short-term framework of monetary developments.

Based on the assumptions<sup>1</sup> of increasing the volume of lending to the economy and on the expectations of high foreign currency inflows, the 2005 monetary program provided an annual money supply growth of 14.1 percent. In absolute value, the money supply was forecasted to grow by ALL 70.9 billion. Money supply expansion would support the economy growth by 5-6 percent and the maintaining of inflation close to the 3 percent targeted rate.

Monetary developments and monetary indicators performance during 2005 was in compliance with the monetary policy target for maintaining inflation rate over the mid-term period close to 3 percent targeted rate of inflation. Growth of money supply at end of the year resulted to 13.8 percent. This high rate reflected the intensification of the country's financial expansion and the acceleration of credit to the economy. However, due to decreased money velocity, money supply growth did not transmit excessive inflationary pressures to the economy.

	Forecast	Actual
Annual growth of demand factors (in billions of ALL)		
Credit to the economy	47.0	52.6
Government demand	12.4	6.0
Net foreign assets of the system	22.6	21.9
Annual growth of supply aggregates (in percentage)		
M3	14.1	13.8
M2	8.2	8.4
M1	35.8	31.5
Base money	11.8	11.0
Weight of supply components at end-year (in percentage)		
Currency outside banks / M3	26.3	26.1
Deposits in foreign currency / M3	25.9	25.6

Source: Bank of Albania

Table 1 Performance of main indicators vis-à-vis the monetary program

Growth of credit to the economy higher than the forecast is balanced by a lower borrowing of the government from the banking system over 2005. Also, higher growth of the M3 against the growth by 8.4 percent of the M2 aggregate

confirms the positive contribution of foreign currency inflows in the form of foreign currency deposits of the banking system. These deposits are the main source of funds that finance growth of foreign currency credit to the economy. The economy demand for foreign currency during 2005 constituted about 2/3 of total lending to the economy by the banking system. Compared to the previous year, this ratio results lower. ALL lending to the economy had upward trends even during 2005. Reduction in absolute and relative terms of the government's borrowing has encouraged growth of domestic currency lending to the economy.

Notwithstanding the higher growth of lending to the economy than the forecast, the base money growth has performed in compliance with the monetary program forecast. This has enabled control of quantitative objectives of the Bank of Albania. Quantitative objectives over the first semester, which coincided with the completion of the three-year Poverty Reduction Growth Facility of the IMF, have been met. Meanwhile, the second semester of 2005 was not covered with formal arrangements between international financial bodies and Albania. However, the Bank of Albania has managed to keep these indicators within stable parameters with mid-term price level stability.

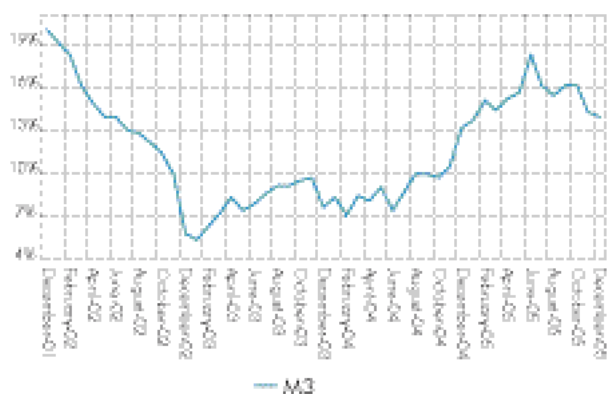
Table 2 Meeting quantitative objectives of the Bank of Albania

	March'05	June'05	September'05	December'05*
Net foreign reserve (USD millions)				
Objective	1,073	1,086.7	1,094.6	1,184
Actual	1,107	1,098.0	1,094.6	1,184
Difference	35	11.3	0.0	0
Net domestic assets (ALL billions)				
Objective	61	60.0	65.7	82.0
Actual	53	63.6	65.7	82.0
Difference	-8	3.6	0.0	0
Net domestic credit to government (ALL billions)				
Objective	292	297.7	302.7	306.7
Actual	288	294.4	301.6	306.7
Difference	-4	-3.2	-1.1	0

Source: Bank of Albania

\* Operational data

Chart 1 Money supply growth rate



Source: Bank of Albania

### III. 2 DEVELOPMENTS IN MONEY SUPPLY

Monetary developments over 2005 consisted in relatively high M3 growth, further reduction of money velocity and a high intermediation of the banking system in the economy. Annual money supply<sup>2</sup> growth reached the peak in summer, due to high demand of the economy for monetary assets and high non-seasonal demand of the government for budget deficit financing. Meanwhile, in the last quarter, the growth rate of the demand for monetary assets underwent a reduction turning to the historical trends.

In the second semester of the year, the high M3 growth rate was supported by foreign currency inflows to the banking system in the form of deposits. This tendency is sustained by the obvious slowdown in the second semester of the year of the M2 monetary aggregate, which does not include foreign currency deposits of the banking system. The liquid money aggregate M1 has undergone high annual growth rates due to rise of demand deposits in ALL after the reclassification of a part of time deposits into demand deposits.

	Annual growth rate (in %)				Level
	2002	2003	2004	2005	2005
Currency outside banks	9.8	-4.3	10.3	8.4	149.7
Total deposits	4.2	13.1	14.2	16.1	428.4
- ALL deposits	4.1	15.7	12.9	9.1	276.5
- Foreign currency deposits	4.2	7.6	17.1	31.2	151.9
M1	6.8	-5.2	19.4	31.7	227.7
M2	6.4	7.6	12.0	8.9	426.2
M3	5.9	7.6	13.1	14.0	578.0
Base money	7.7	-2.0	11.2	11.0	198.2

Source: Bank of Albania

Table 3 Monetary indicators  
(ALL billions)

### III.2.1 M3 TIME STRUCTURE

The time structure of money supply in recent years has positively reflected the monetary conditions in the economy and the country's macroeconomic stability. . Notwithstanding the downward trend of nominal interests, the real interest rates in the economy have stood at positive intervals, motivating the increased weight of deposits to money supply. Sustainability of deposits weight has enabled a rise of the banking system intermediation in financing the economic activity. Channelling savings through the banking system encourages reduction of the spread of funds use by the system, and leads to intermediation process cost reduction. Under the conditions of lower interest rates, the positive effects of increased deposits weight to M3 on promoting the economic activity are mutual.

- Currency outside banks

The sustainability of currency outside banks to M2 aggregate has been a positive factor in financial stability of the system. However, in the presence of rapid growth of foreign currency deposits, the ratio of currency outside banks to money supply displayed falling trends during 2005.

Performance of the ratio of currency outside banks to money supply and to M2 aggregate in the medium run tends to pursue the macroeconomic

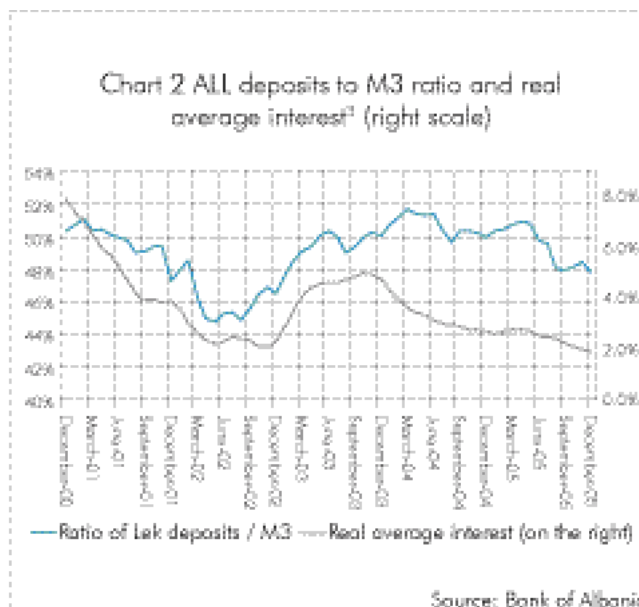
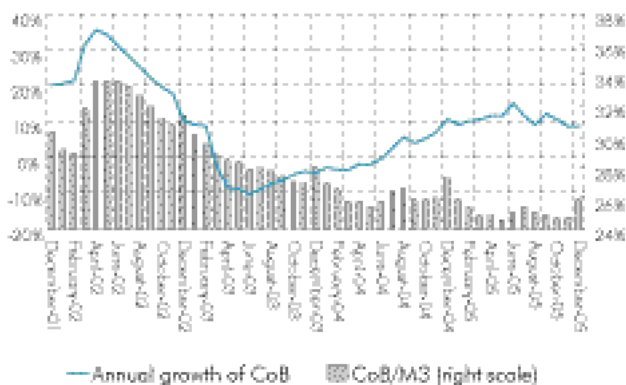
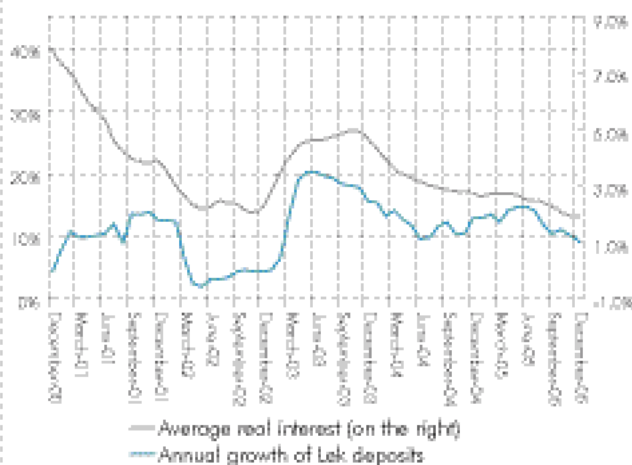


Chart 3 CoB/M3 ratio and annual growth of currency outside banks (right scale)



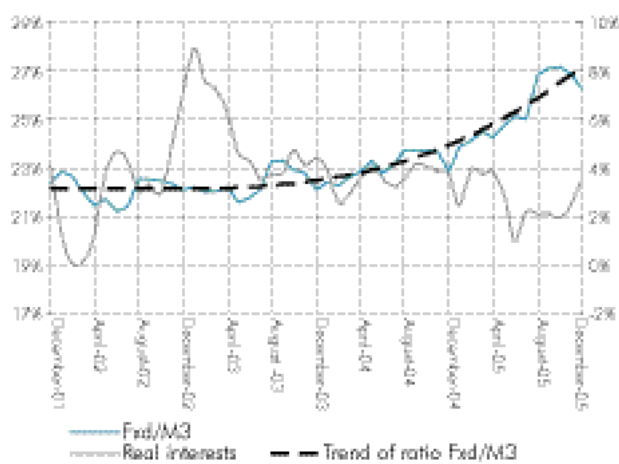
Source: Bank of Albania

Chart 4 Performance of ALL deposits



Source: Bank of Albania

Chart 5 Foreign exchange structure of M3 and real interest of ALL deposits (on the right)



Source: Bank of Albania

consolidation paces of the Albanian economy and the financial system development rates. Further opening of the economy to foreign competition and the entry of new financial products contribute positively to further reduction of the ratio of currency outside banks to M2 and M3 aggregates. The maintaining of such a tendency in the future will have positive effects in expanding the potential of economic growth.

- ALL deposits

Performance of aggregate demand in the economy and sustainability of interest rates have resulted sufficient for guaranteeing generation and circulation of monetary assets that ensure an economic growth in compliance with the productive potential. The whole financial system was able to intermediate successfully in the lending to the economy during 2005, without creating inflationary pressures on the demand side. High growth rates of ALL deposits in the banking system have mostly financed the ALL lending to the economy, while the government debt financing has deviated only  $\frac{1}{4}$  of total growth of ALL deposits, by about ALL 23.2 billion generated during 2005. Annual growth of ALL deposits at end of 2005 was estimated at 9.1 percent.

### III.2.2 FOREIGN EXCHANGE STRUCTURE

Foreign currency deposits presented positive developments over 2005. At end of the year they constituted 26.3 percent of money supply, being increased by 4.3 percentage points compared to 2004. In nominal terms, foreign currency deposits reflected significant acceleration of annual growth, from 17.1 percent in 2004, to 31.2 percent in 2005. Depreciation by 11 percent of the ALL against the dollar has balanced its slight appreciation to the euro, providing a positive outcome to foreign currency deposits. Clearing the series from effects of exchange rate fluctuations over years, in real terms the foreign currency deposits have maintained the same annual growth rate of 27.3 percent, similar to 2004.



Foreign currency component of aggregate supply in 2005 has followed its positive trend in response to narrowing the interest rates between deposits in ALL and those in foreign currency. The spread narrowing has followed the interest rate rise in foreign currency in response to international developments. However even for 2005, it is considered that emigrants' savings and their channelling through the banking system remain the main source of growth of foreign currency deposits. Time foreign currency deposits reflected further growth during 2005, constituting 66 percent of total foreign currency deposits, compared to 63 percent at end of 2004.

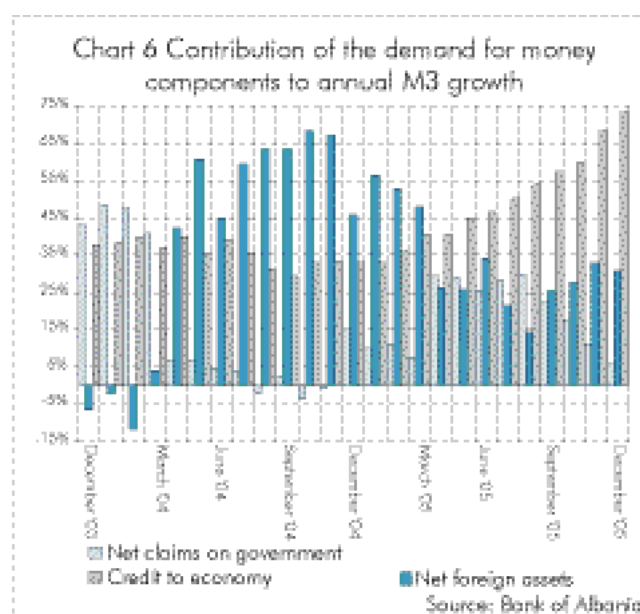
In ALL millions	December 2005	Annual change	
		absolute	percentage
Currency outside banks	149.7	11.6	8.4
Total deposits	428.4	59.2	16.1
- ALL deposits	276.5	23.2	9.1
- Foreign currency deposits	151.9	36.1	31.2
Demand deposits	129.4	51.9	66.9
- in ALL	78.0	43.3	124.6
- in foreign currency	51.4	8.6	20.1
Time deposits	298.9	7.4	2.5
- in ALL	198.5	-20.1	-9.2
- in foreign currency	100.4	27.5	37.7
M1	227.7	54.9	31.7
M2	426.2	34.7	8.9
M3	578.0	70.8	14.0
Base money	198.2	19.7	11.0

Source: Bank of Albania

Table 4 Monetary indicators

### III.3 DEMAND FOR MONETARY ASSETS

Under the conditions of fiscal policy consolidation during 2005, a shifting of the demand for monetary assets is noticed from the government to the economy. For the first time in 2005, lending to the economy has been the main promoter of the demand for money, contributing to 75 percent of the annual money supply growth. Meanwhile, the contribution of 30.4 percent of net foreign assets to annual M3 growth has been lower than the one recorded over 2004.



#### III.3.1 NET FOREIGN ASSETS

Foreign currency position of the banking system has not undergone any significant changes during 2005. Net foreign assets of the banking system

Chart 7 Banking system net foreign assets  
(in millions of USD)

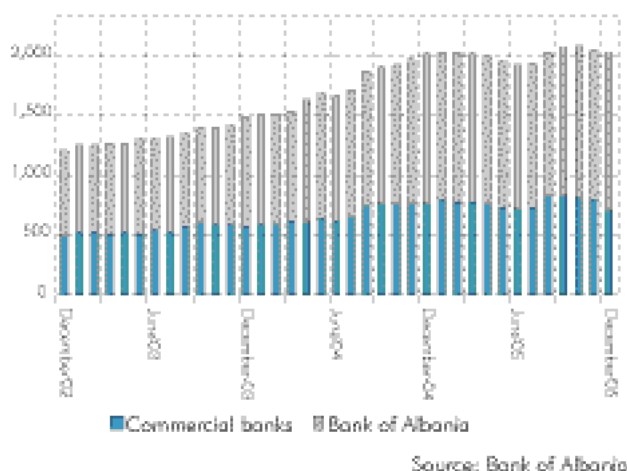


Chart 8 Net domestic borrowing<sup>5</sup> to GDP  
(in percentage)

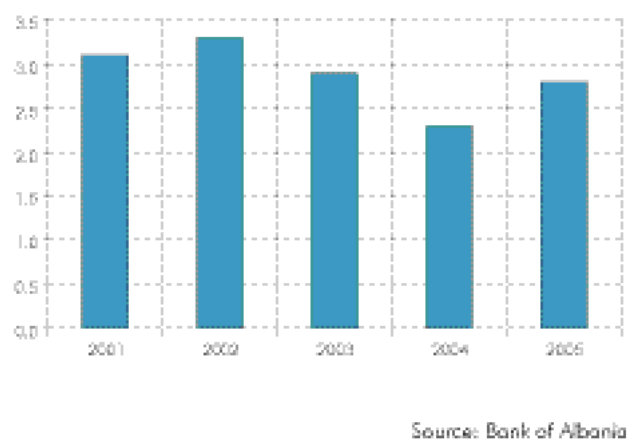
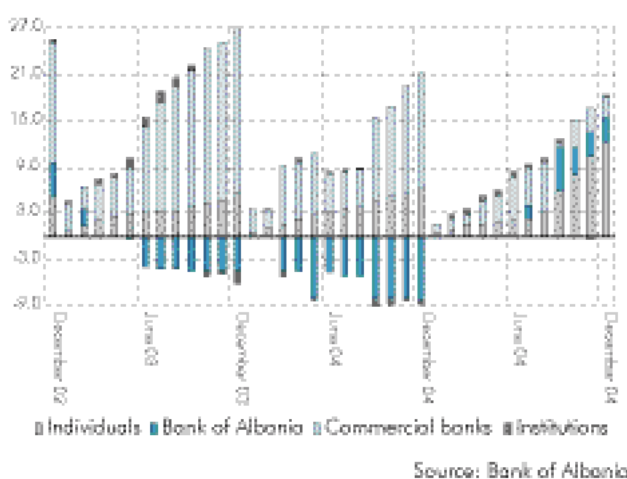


Chart 9 Cumulative performance of budget  
deficit financing (in billions of ALL)



have remained at USD 2 billion, due to balanced developments in foreign assets levels of the Bank of Albania and of commercial banks. Bank of Albania intervention in foreign exchange market and the expansion of foreign currency credit have mostly influenced the performance of these assets during 2005.

Net foreign reserve of the Bank of Albania amounted to USD 1.3 billion at end of the year, marking an annual growth of USD 59 million. An upward trend of net foreign reserve was noticed during the second part of the year, due to foreign currency purchases of USD 126 million by the Bank of Albania. Omitting the exchange rate effect<sup>4</sup>, the real growth of Bank of Albania's net foreign reserve was about USD 143 million over the year.

Performance of commercial banks' net foreign assets has been more volatile, reflecting relative performance of indicators that impact on these assets. In general, the speeding-up of foreign currency credit rise during the year has exceeded the growth of foreign currency deposit inflow at commercial banks, by reducing the level of net foreign assets. In annual terms, these assets have dropped by USD 63 million.

### III.3.2 GOVERNMENT DEMAND FOR MONEY

Results of fiscal consolidation process became evident during 2005. They are reflected in the fiscal balance improvement and in the reduction of government demand for domestic financing. Budget deficit of 2005 reached to 3.8 percent of GDP, while this indicator was at 5.1 percent over 2004. The preceding years' trend – concentration of budget deficit on the second part of the year – was present even during 2005, being even more emphasized. Monthly growth of deficit in December was about ALL 9 billion or 44 percent of total deficit.

Budget deficit was covered almost totally by domestic financing – banking system and the public. At end of the year, the total level of

domestic financing marked ALL 20.6 billion. The Bank of Albania was present in financing the deficit during July and September, with the purpose to prevent interest rate fluctuations in interbank market and in treasury bills one.

Two- and three-year government bonds have been the main budget deficit financing source. During 2005, the Government sold ALL 18.6 billion two-year government bonds. Government bonds of three-year maturity, sold in total about ALL 6 billion, were issued for the first time during this year. The issued treasury bill level decreased by about ALL 4 billion during 2005. Treasury bill portfolio of commercial banks has decreased by about ALL 21.9 billion. On the contrary, the households and the Bank of Albania have increased their Treasury bill portfolios by ALL 12.2 and 3.1 billion respectively. Treasury bill portfolio of non-bank financial institutions has slightly increased by about ALL 0.1 billion. Active participation of households in purchasing treasury bills indicates a positive phenomenon, either in Treasury bill market expansion or in Treasury bill portfolio diversification as concerns to their holders.

### Box III.1 Bank of Albania independence aspects

*"...If government wanted money, it should be obliged to raise it in the legitimate way; by taxing the people; by the issue and sale of exchequer bills; by funded loans; or by borrowing from any of the numerous banks which might exist in the country; but in no case should it be allowed to borrow from those who have the power of creating money".*

David Ricardo (1824)\*

*Though Ricardo attracted attention on this issue about 180 years ago, only in recent decades, central banks have managed to say "No" to budget deficit financing. There has always existed a conflict between independence of a central bank and budget deficit financing by it, which is frequently solved to the detriment of inflation. Studies indicate that countries with more independent central banks (legally) tend to have lower inflation rates. Economic literature knows some dimensions of a central bank's independence:*

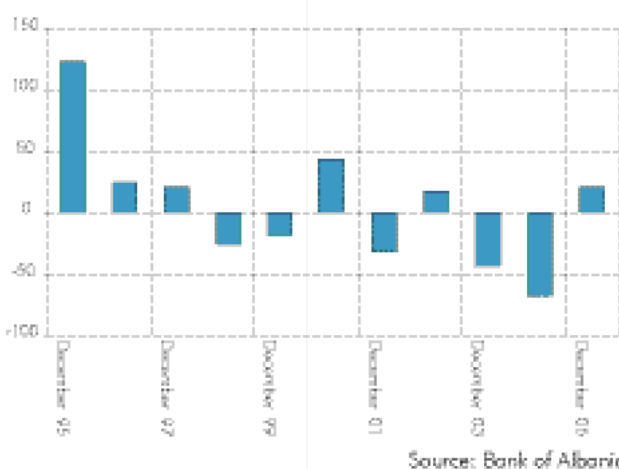
1. *Institutional independence – implies independence in meeting the obligations and responsibilities required in the central bank's law.*
2. *Operational independence – implies independence in setting the inflation target and instruments for fulfilling the target.*
3. *Personal independence – implies avoiding political pressures on appointment or dismissal of the members of the board of directors of a central bank.*
4. *Financial independence – implies the terminating of any type of direct financing of the public sector and its representatives.*

*Starting from its establishment in 1992, the Bank of Albania has had a relatively satisfactory legal independence. While three first dimensions of independence are provided by the existing law of the Bank of Albania, the fourth dimension that of financial independence, is not yet in proper levels. Law No. 8269, dated 23.12.1997 (On the Bank of Albania) allows the direct financing of the government by the Bank of Albania. The amount of the loan or credit the Bank of Albania may extend to the government during the year is based on some conditions specified by law. According to the law, the non-disbursed part of the loan must not exceed the value of 5 percent of the average of normal incomes of the budget of the Government of the Republic*

of Albania, during three preceding years. Seen in the context of the time the law was drafted, the forecasting of such a legal ground was based on the idea that the development level of transition economies, such as Albania, does not create security for covering the necessary budget expenditures with budget revenues.

Financial reality has evolved rapidly during the recent years. Extension of credit to the government by the Bank of Albania over years has been in low levels and with a downward trend.

Chart 1, Box 1 Bank of Albania's contribution to budget deficit financing (in percentage)



Since time from now, the Bank of Albania has been assessing the possibility of preventing the government financing, as a precondition for implementing monetary policy more effectively. This step is in compliance with European Union standards, and moreover, a legal requirement of the integration process. Furthermore, this step is in line with the requirements for adopting inflation targeting regime, a regime that the Bank of Albania intends to adopt in the mid-term period.

The Bank of Albania deems that the preventing of the possibility of direct financing should be a gradual process, since it is aware of the difficulties the government may face from immediate absence of this form of financing. This process would be facilitated by improving short-term forecasting of government's liquidity, collecting information from commercial banks or from Treasury branches in due time. Also, the world experience provides acceptable solutions even in the case of contingency needs for liquidity. The Bank of

Albania deems that the joint work of the Ministry of Finance in this direction would create proper conditions for a gradual and smooth prevention of direct financing to the government.

\* "Plan for establishment of a national bank", David Ricardo, 1824.

### III.3.3 CREDIT TO THE ECONOMY

Credit to the economy recorded an obvious growth during 2005. Banking system credit portfolio was increased by 74.3 percent or ALL 52 billion in absolute value. The credit growth rate over 2005 was twice higher than the one recorded in the previous year. This rapid growth is reflected even in the improved banking system intermediation indicators. Hence, at end of 2005, outstanding credit to the economy constituted 25 percent of the total banking system assets. Also, at end of 2005, outstanding credit to the economy recorded 14.6 percent of GDP, constituting an annual growth of 6.2 percentage points. Steady macroeconomic and financial environment has created proper conditions for credit expansion. It has also influenced on lengthening the time horizon of lending, better serving the economy needs and impacting on speeding-up the credit expansion. Besides these factors, the boom in lending is also impacted by enhancement of competition in the banking system, strengthening of bank-client relationships and exploitation of uncovered spaces of the market, through introduction of new credit instruments.

Table 5 Performance of some main indicators

	2002	2003	2004	2005			
				Q1	Q2	Q3	Q4
Money supply (in billions of ALL)	416.7	448.4	507.2	521.6	541.8	566.2	578.0
Domestic credit (in % to M3)	70.8	71.5	68.9	68.7	69.9	69.1	70.0
- credit to government (in % to M3)	61.5	60.2	55.1	53.4	52.2	50.3	48.9
- credit to economy (in % to M3)	9.3	11.3	13.8	15.3	17.7	18.7	21.1
Credit to economy (in % to total assets)	11.5	13.7	16.9	17.9	20.8	22.2	25.1
Credit to economy (in % to GDP)	5.7	6.8	8.4	9.5	11.5	12.7	14.6
Total deposits (in % to GDP)	42.2	43.4	44.1	46.9	48.5	50.7	51.2
Credit /deposit ratio (in %)	13.5	15.7	19.0	20.3	23.6	25.0	28.5

New credit extended during 2005 was about ALL 120 billion or about 20 percent higher than in 2004. Meanwhile, the time structure of this credit has had an obvious shifting to med-term and long-term maturities, the weight of which to total new credit has increased by 13.5 percentage points during 2005.

	2002	2003	2004	Q1-05	Q2-05	Q3-05	Q4-05	2005
New credit (in billions of ALL)	62.6	92.6	99.7	22.1	32.8	32.1	32.9	119.9
Short-term credit	44.7	63.1	62.3	53.2	47	47.4	48.7	48.8
Mid-term credit	13.0	22.2	22.5	22.4	31	30.3	25.6	27.7
Long-term credit	4.8	7.4	14.9	24.4	22	22.2	25.7	23.5
ALL	20.8	30.8	32.5	30.1	32.8	30.2	31.4	31.2
Foreign currency	41.8	61.8	67.2	70	67.2	69.8	68.6	68.8

Table 6 Performance of new credit over years (in percentage)

Rise of long terms credits has impacted on shifting the credit portfolio structure to long term maturities. The weight of over 5-year maturity credit rose constantly during 2005, while the weight of short-term credit to the total fell. However, compared to the previous years, a shifting of credits of 1-5 year maturity towards long-term investments of above 5 years is noticed. Such a fact is driven by the increasing commitment of banks to real estates and to finance long-term business projects.

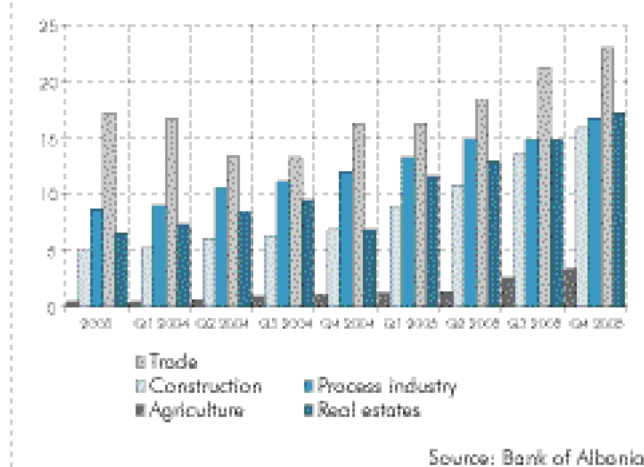
Credit distribution, in credit to households and credit to businesses, did not have any significant changes during 2005. At end of the year, credit to households constituted 31.6 percent of the total of credit, recording a slight rise of 1 percentage point against 2004. The market of credit to households has had a rapid development during two last years. Banks are showing an increasing interest in it, given the fact that it has been a relatively undeveloped segment, which offers high interest rates.

Credit to businesses encompasses about 69 percent of the total. This credit marked an annual growth of 74 percent during 2005. Unlike in the previous year, credit to corporations has been driven even by the banks' orientation to credit businesses in domestic currency.

Table 7 Performance of outstanding credit indicators (in percentage)

	2002	2003	2004	Q-1 '05	Q-2 '05	Q-3 '05	Q-4 '05
Credit outstanding (in billions of ALL)	38.7	50.7	69.3	79.0	95.9	106.0	121.9
Short-term credit	53.8	46.0	34.0	34.1	33.7	31.6	32.8
Mid-term credit	30.1	33.3	36.0	34.5	33.1	31.2	30.3
Long-term credit	16.1	20.7	30.0	31.4	33.1	36.9	37.0
Credit to households	24.3	24.5	30.6	31.0	30.8	31.4	31.6
Credit to private sector	75.7	75.5	69.4	69.0	69.2	68.6	68.4
ALL	21.3	19.6	19.5	20.1	22.9	23.7	25.5
Foreign currency	73.7	80.4	80.5	79.9	77.1	76.3	74.5

Chart 10 Credit to main sectors of the economy (in billions of ALL)



Year 2005 was characterised by a rapid rise of credit in ALL, whose annual growth recorded 127 percent. Unlike in 2004, over 2005 the banks' commitment to lend in ALL is noticed, not only to the households but also to businesses. Exchange rate stability and reduced interest rate spread for credit in foreign currency against that in ALL has attracted the business interest in receiving credit in ALL. Meanwhile, the annual growth rate of credit in foreign currency was almost two times lower than that of credit in ALL. Therefore, the weight of credit in foreign currency to total credit was decreased by 6 percentage points during 2005. However, the credit in foreign currency continues to maintain the major share in lending, by 74.5 percent of the total.

Sectoral distribution of credit for 2005 indicates banks' raised interest in the sectors of real estates, construction and more moderate in agriculture. Generally each sector's weight to the total has increased respectively by 4.4, 3.2 and 1.2 percentage points compared to the previous year. Meanwhile, trade continues to be the most credited sector of the economy, by 18.9 percent of the total of loans, from 23.3 percent it occupied in 2004.

Table 8 Credit balance according to economy branches (in percentage)

	2002	2003	2004	Q-1 '05	Q-2 '05	Q-3 '05	Q-4 '05
1 Agriculture, hunting and silviculture	0.8	1	1.5	1.5	1.5	2.4	2.7
2 Fishery	0.2	0	0.1	0.1	0.1	0.1	0.1
3 Extractive industry	0.2	1	0.3	0.7	0.6	0.5	0.5
4 Manufacturing industry	17.0	17	17.1	16.7	15.6	13.9	13.8
5 Electricity, gas, and water production and distribution	3.3	3	2.8	2.3	2.9	2.9	2.6
6 Construction	8.6	10	9.8	11.2	11.2	12.8	13.0
7 Trade, automobile and home appliance repairing	40.4	34	23.3	20.6	19.1	20.0	18.9
8 Hotels and restaurants	6.0	6	8.3	5.2	4.7	4.4	4.3
9 Transport and telecommunication	2.4	1	2.0	1.8	1.7	1.7	1.48
10 Financial activities	-	0	0.2	1.0	1.1	0.7	0.8
11 Real estate	9.1	13	9.8	14.7	13.5	13.9	14.2
12 Health and social activities	0.5	0	0.5	0.8	0.4	0.6	0.6
13 Social, personal and collective services	4.2	8	4.8	6.5	7.4	5.9	5.8
14 Consumer credit						3.3	4.5
15 Others	7.3	4	19.3	16.7	20.2	16.9	16.7
Total	100	100	100.0	100.0	100.0	100.0	100.0



### Box III.2 Implications of credit expansion in Albania's case

Most of theoretical and empirical studies underline the positive link that exists between financial development and economic growth. Financial sector plays a fundamental role in allocating savings to businesses, enhancing economic efficiency and easing capital accumulation. Also, the possibility for taking a bank credit allows the households to increase their well-being, adjusting the current level of consumption with the long-term flow of their income. In this context, rapid growth of credit during 2005 presents a positive development for the Albanian economy. The deepening of financial intermediation is a process, from which the whole economy is expected to benefit.

However, as any other variable, the credit growth has implications for other economic indicators and for the macroeconomic and financial stability. Being one of the main factors impacting on investment and consumption, the rapid growth of the volume of credit causes a rise in the aggregate demand, which may lead to macroeconomic imbalances. In 2005, in spite of accelerated paces of credit, its growth impact on breaking the economic and financial equilibriums has been moderate.

From macroeconomic viewpoint, this consideration is based on the following arguments:

- Rapid and obvious credit expansion carries as a matter of fact a smaller effect over the real economy than the figures indicate. This is so because a part of credit extended through the banking system has substituted the non-official credit market\*.
- In spite of rapid growth of credit, Albania remains the country with lowest relative credit indicators among the region countries. Also, banks in Albania intermediate only 28.5 percent of deposits for satisfying the economy needs, thus comprising the country with the lowest level in the Balkan region. The low base from which credit starts in Albania shows that the Albanian economy has space for a faster expansion of lending.

Table 1, Box 2 Main credit indicators performance in region countries

	Deposits / GDP	Annual growth rate	Credit / GDP	Annual growth rate	Real credit interest rate
Bulgaria	42.4	30.9	42.3	35.3	-
Rumania	25.4	30.6	19.7	50.7	17.8
Macedonia	34.6	22.8	25.2	21.8	12.1
Albania	51.2	16.1	14.6	74.3	11.3
Serbia & Montenegro	21.1	46.6	23.5	52.6	13.9
Region's average	34.9	29.4	25.1	46.9	13.8

Source: South-eastern Europe and Mediterranean emerging market economies bulletin, volume 6, published by NBG

- On the other hand, credit growth has mostly been extended to business activity expansion, while consumer credit has remained in relatively low levels.
- Also, the speeding-up of banking system credit is somewhat balanced by the pursuing of a prudent fiscal policy. Government demand for monetary assets has been low during 2005, leaving space for a faster expansion of credit to the economy.

Credit expansion along with macroeconomic implications is associated with a possible rise in non-performing loans, impacting on the banks' financial performance. In general, upon credit portfolio growth, banks are more exposed to credit risk. Risk of



non-performing loans becomes more real under the conditions of a not very developed credit market, which has many infrastructure problems such as: law enforcement problems, particularly for meeting loan contract obligations; mortgage problems, real estate recording problems; existence of non-formal credit market; lack of a Credit Information Bureau, etc. Under these conditions, credit expansion makes necessary the strengthening of the regulatory and supervisory banking system and prudent follow-up of indicators that will timely signal the problems of the system.

Finally, even though the Bank of Albania supports credit expansion in the context of economic developments, it is not ready to compromise long-term perspective of the economy growth in the interest of short-term development. Therefore, it will continuously monitor the credit performance, to timely notice the appearance of above-mentioned effects, reserving the right of employing its own instruments for preventing them.

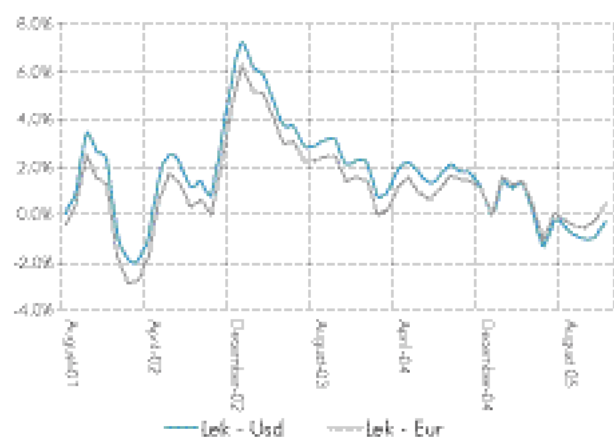
\* For more details, see the survey on "Depositing and lending activity of commercial banks on the second semester of 2005" by the Bank of Albania, February 2006.

Chart 11 Annual spreads of the NEER<sup>7</sup> (+/appreciation)



Source: Bank of Albania

Chart 12 ALL - USD real interest rate spread



Source: Bank of Albania

### III. 4 EXCHANGE RATE PERFORMANCE OVER 2005

Over a three-year period the ALL has maintained appreciating trends against the main foreign currencies. At end of 2005 it was appreciated on average by about 23 percent against the US dollar and 11 percent against the Euro, compared to three years ago. The constant ALL appreciation has mostly reflected the positive performance of the balance of payments, particularly considerable foreign currency inflows through private transfers. Furthermore, this appreciation is also an expression of the ALL - foreign currency interest rates spreads. Also, economic data suggest the effect of productivity improvement of tradable goods sector (Balassa Samuelson<sup>6</sup>) as a possible factor that impacts on the lek's appreciation, a characteristic of the developing countries.

The appreciating trend of the lek was weakened during 2005. Against the previous year, the lek was depreciated on average by 9.25 percent against the US dollar and was appreciated on average by 3.32 percent against the euro. Pursuing of an easing monetary policy by the Bank of Albania until March 2005 brought about the narrowing of the ALL-foreign currency interest rate spread, weakening the support of this factor in the lek's appreciation. However, even though

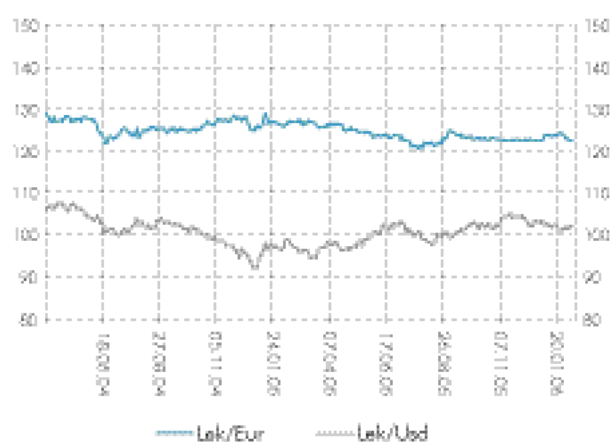
interest rates have been constantly falling, low inflation rates have contributed to holding high real interest rates in ALL. In effective nominal terms, at end of 2005, the lek was depreciated by 0.8 percent against the previous year.

The weak seasonal effect of summer on the lek's appreciation has been a characteristic of 2005 in the exchange rate behaviour. Summer period was characterised by a high supply of foreign currency, but also by a high demand for it, as a result of tourism activity growth of Albanians abroad. On the other hand, the economic life of the country is developed under an insecure atmosphere, as a result of general parliamentary elections, by slackening exchange rate developments.

The Bank of Albania has been relatively active in the foreign exchange market during the second half of the year, purchasing foreign currency with the purpose to accomplish the targeted level for Net International Reserve. In September – December 2005, the Bank of Albania purchased about USD 126 million from commercial banks. This intervention impacted on maintaining the exchange rate in relatively steady levels over the second semester of the year. During the foreign intervention process, the Bank of Albania has assigned primary importance to the communication with foreign exchange agents on intervention goals. This communication has helped significantly the realization of intervention, without causing excessive exchange rate fluctuation.

Exchange rate performance in international market has mainly impacted on the behaviour of the lek's exchange rate against the dollar. During 2005, the dollar's appreciation by about 12 percent against the euro in the international market was reflected in an appreciation of the dollar against the lek by 11.8 percent. The lek's exchange against the euro is mostly impacted by internal factors, given that the euro is the main currency of the foreign trade and occupies a significant part in domestic transactions of the home market.

Chart 13 ALL exchange rate performance

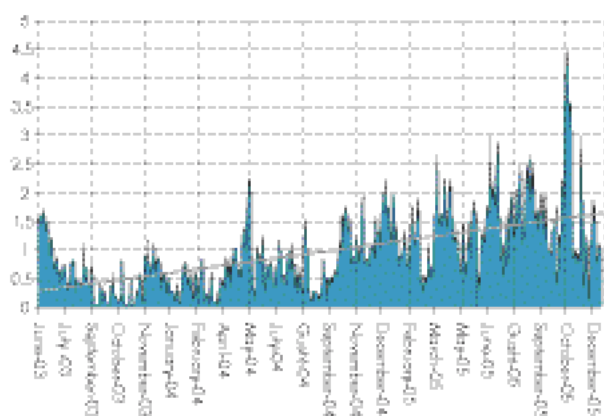


Source: Bank of Albania

### III.5 FINANCIAL MARKETS AND INTEREST RATES

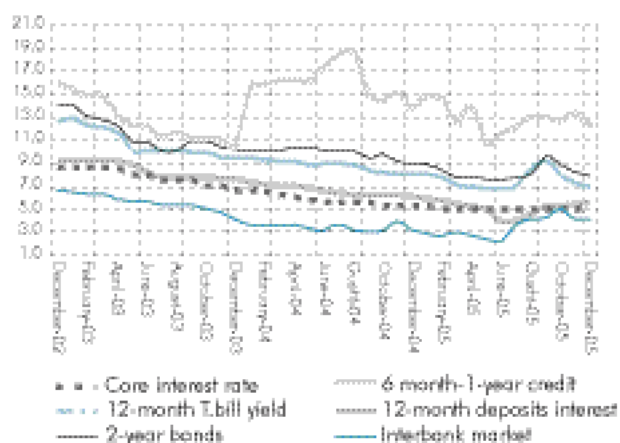
The financial market activity and interest rates underwent considerable volatility during 2005. Growth of banking system deposits and reduction of the government demand for monetary assets over the first half of the year made the banking system create excess liquidity (on average ALL 7.4 billion). Moving according to their tendency noticed over two last years, the interest rates of accepting deposits in ALL reached the lowest historical levels. This situation was reversed in the third quarter. Due to the slow down of rise of deposits in ALL, increase beyond expectations of lending in domestic currency

Chart 14 Daily volume in interbank market  
(in millions of ALL)



Source: Bank of Albania

Chart 15 Market interest rates  
(in percentage)



Source: Bank of Albania

and increase of government borrowing, the banking system passed to lack of liquidity during this period. Lack of liquidity brought about increased lending activity in the interbank market and rise in its interest rates.

At this time, lending rates in interbank market were impacted even by the changed interests of Bank of Albania daily facilities, which aimed at narrowing the corridor of their facilities. The lack of liquidity was mostly felt in the primary market, when the government's demand for financing remained unfulfilled in some cases, whereas Treasury bill yield was significantly increased, from 6.77 percent in June to 9.14 percent in September for the twelve-month term.

Lack of liquidity continued for a four-week period (August – September 2005). The Bank of Albania intervention with structural operations, by constantly injecting ALL 3.5 billion, and the increased depositing at the banking system and treasury bills, stimulated by rise of the interest rate spread in these markets, turned back excess liquidity situation in the banking system during the fourth quarter. At end of the year, Treasury bill yields returned to mid-year values, whereas their spread with ALL deposit interest rate is the lowest over three preceding years.

- The interbank market

Inter-bank market activity during 2005 recorded the highest volume ever reached. The average daily level of weekly transactions reached ALL 0.71 billion, from ALL 0.25 billion in 2004; whereas the average daily level of overnight transactions was about 0.30 billion more than in the previous year, about ALL 0.70 billion. This year recorded even the first case of using fortnight transactions. Further development of interbank market during 2005 is evidenced even by the fact that simultaneous use of the Bank of Albania facilities is limited only in 10 cases during 2005, which, however, have been in very small amounts.

Interbank currency market interest movement were in compliance with monetary policy facilities in March 2005 and with the narrowing of the corridor of daily facilities in July 2005. At end of May 2005, interests on overnight transactions reached their lowest historical levels, down to 2.37 percent. On the other hand, they have fluctuated continuously depending on the demand-supply ratio in the market. Upon growth of the demand for liquidity and the placement of a new corridor, interests for overnight transactions amounted

to 5.83 percent (in September), getting closer to weekly transactions. The placement of the new corridor made the interbank market interest rates fluctuate around the key interest rate. At end of the year, the overnight transaction interest rate and the weekly one recorded 4.13 percent and 5.43 percent respectively.

Average interest of weekly agreements during 2005 is estimated at 5.31 percent compared to 6.15 percent in 2004, whereas average interest of daily agreements rose to 3.64 percent, compared to 3.44 percent in 2004.

- The primary treasury bill market

Primary Treasury bill market remains the main investment instrument of banking system liquidity, notwithstanding the reduction of the government's issue of such securities. This market was characterised by a stable liquidity level in the first half of the year, enabling, in all cases, the fulfilment of government demand for financing. In fact, the ratio of liquidity offered for purchasing treasury bills against the amount announced for issue over this period, is estimated at 1.4:1. Enhancement of competition for investing in treasury bills brought about continuous yield cuts of these securities. At end of June, the yield level according to three-, six-, and twelve-month maturity was 5.05, 6.42, and 6.77 percent respectively, being reduced by 0.96, 0.78 and 1.33 percentage points in comparison to 2004 end-year level.

Lack of liquidity in the banking system in the third quarter impacted on reduction of government's financing from the banking system and exerted pressure for raising the Treasury bill yield. In some cases, the liquidity supplied in auction did not fulfil the needs for financing, while there were cases when some of supplies were excluded because of rather high yield. Bank of Albania interventions for stabilizing the liquidity position and restraining further yield rise resulted successful. At end of the year, the respective level of yields dropped to 5.35 percent for the quarterly term and 6.91 percent for six- and twelve-month term.

- The primary bond market

Besides two-year bonds, during 2005 three-year bonds were issued for the first time. This market started to function in April and auctions for these securities are conducted quarterly. Long-term security investment by the banking system has

Chart 16 Overnight interest transactions in inter-bank market and Bank of Albania facilities

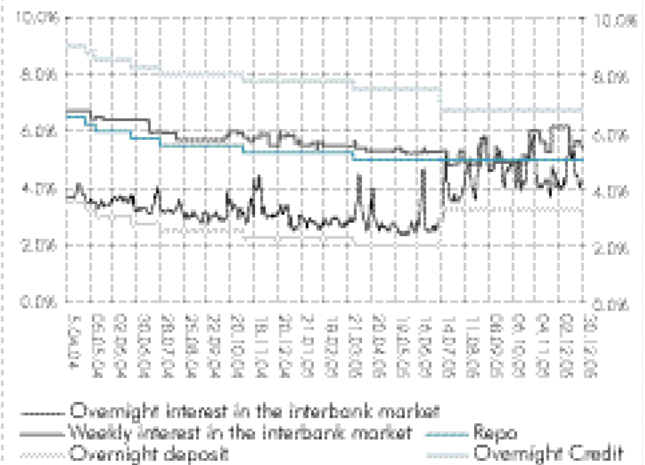
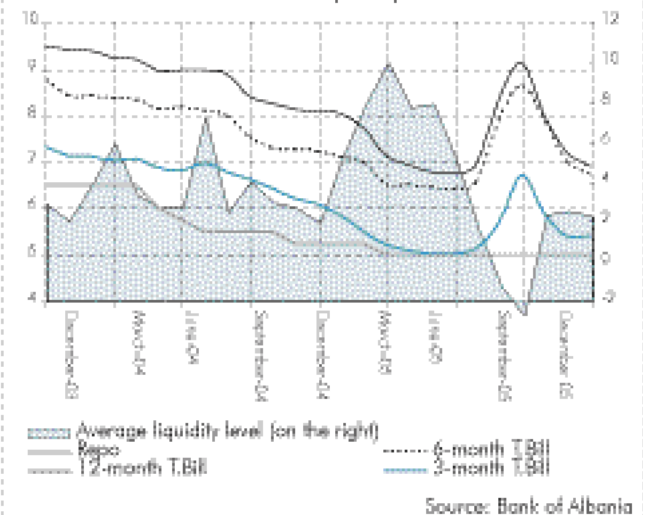


Chart 17 Banking system liquidity (billions of ALL) and Treasury bill yield



increased compared to the previous year. At end of 2005, the debt of two- and three-year maturity constituted 17.0 percent of total portfolio of government's debt, compared to 6.1 percent at end of 2004. In parallel, the Treasury bill yield in the securities portfolio has decreased by 11 percentage points.

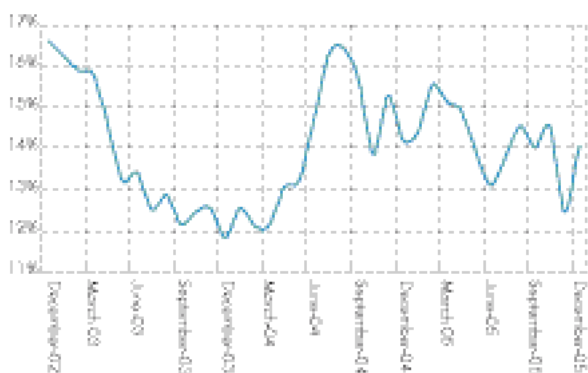
As in other markets, the bond yield trend initially was downward, moreover down to the lowest historical levels in May 2005<sup>8</sup>, when two-year bond yield reached 7.55 percent, from 9.00 percent at end of 2004. After the temporary yield rise in the third quarter, at end of 2005, it dropped to 8.00 percent, whereas the three-year bond yield stood at 8.50 percent (January 2006), from 8.30 percent it was in its first issue.

- Deposit and loan interest rates

Over the first half of 2005, under the conditions of an easing policy, commercial banks continued the downward trend of ALL deposit interest rate, started since 2003. In June 2005, ALL deposit interest rate reached the lowest levels in 13 last years. This situation was soon corrected in July, given that banks were faced with the slowdown of ALL deposit flow. This brought about the return to stability, which was reflected initially in short-term deposit interest rates (1-, 3-, and 6-month deposits), while a later response is expected even to long-term interest rates. Another feature of 2005 was the deposit extension to more than two-year terms, thus becoming a support for the development of long-term lending market and government bond market.

The ALL lending market is significantly impacted by risk factors and those of changing the lending structure from one month to the other, being characterised by interest rate fluctuations and more delayed response to monetary policy signals. However, during 2005 the weighted average level of ALL loan interest rates has followed more or less the trend of other markets. Interest rate fluctuations for all terms have taken place in narrower limits than in two previous years, which indicates increased stability and competition in this market.

Chart 18 Weighted average interest rate of ALL loans



Source: Bank of Albania and commercial banks

Strong upward interest trends have been noticed in the foreign currency deposit market during the whole year, particularly in those of American currency for long terms. These trends have been impacted by the tightening monetary policy pursued by the Federal Reserve, which has raised the key interest rate 8 times by 25 percentage points during 2005; expectations on raising the key interest rate by the European Central Bank (which is reflected more in raising long-term interests); raising the key interest rate after two years and a half by the European Central Bank by 25 percentage points; rapid rise of libor and euribor interests in international markets; enhanced competition in foreign currency deposit market, etc.

The opposite tendencies, particularly over the first half of 2005, of ALL time deposit interest rates and those in foreign currency, have led to obvious narrowing of the spread between these interest rates in rather low levels.

In June 2005, 12-month ALL-foreign currency time deposit interest rate spread resulted in record low levels of 13 last years (-1.22 percentage point ALL-USD spread and -1.63 percent ALL – Euro spread).

Over 2005 the foreign currency lending market was characterised by interest rate fluctuations. In December 2005, on weighted average rate, the interests of loans in dollar reached to 8.47 percent, from 7.79 percent they were in the previous year, whereas interest rates of loans in Euro reached to 7.95 percent from 8.17 percent they were in the previous year. Rise of foreign currency deposit interest rate, rise of libor and euribor in international markets, changed lending structure from one month to the other, increased competition due to participation of the Raiffeisen Bank in this market, degree of credit risk according to credit type, its term, or collaterals provided by the borrower, extension in some cases of loans at lower interest rates for preferential clients, policies banks apply for lending in foreign currency, etc, all impacted on the performance of foreign currency credit interest rates.

Chart 19 Foreign currency deposit interest rate

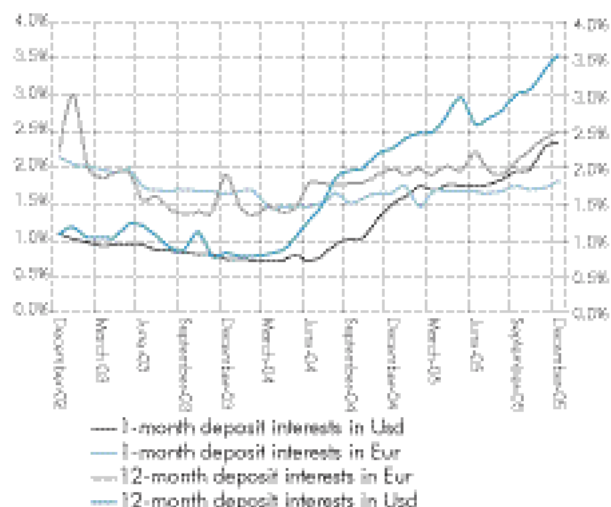
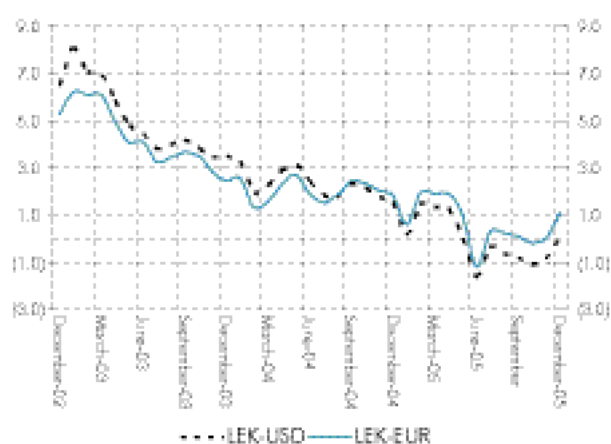


Chart 20 Spread – between real interests of deposits in ALL and those in foreign currency



### III.6 MONETARY POLICY INSTRUMENTS

#### III.6.1 REPURCHASE (REPO) AGREEMENTS AND REVERSE REPURCHASE (R/REPO) AGREEMENT

Repurchase agreement of one-week maturity of the set price type is the main instrument used during the first half of 2005. Weekly average level of liquidity withdrawn during this period was ALL 6.35 billion. To structure the high liquidity level, at the beginning of the year the Bank of Albania, along with auctions of weekly repurchase agreements, also held repurchase agreement auction of one-month maturity, at the set amount of ALL 1.5 billion.

Liquidity reduction during the third quarter of 2005 made necessary injection of liquidity by the Bank of Albania. The instrument employed was the reverse



repurchase agreement of weekly maturity at fixed price. Weekly average level of liquidity injected during August – September was ALL 2.4 billion. To stimulate primary market competition, aiming at mitigating the pressures on Treasury bill interests, the Bank of Albania, notwithstanding the excess liquidity position in the banking system, went on organising injecting operations until the second half of October. The instrument employed during this period was reverse repurchase agreement of weekly maturity at announced amount, an instrument the banking system lacked interest to employ during this period. Upon liquidity return to the banking system and smooth pressures on primary market interests, the Bank of Albania changed the direction of intervention, by withdrawing ALL 1.97 billion liquidity with weekly agreements until end of 2005.

### III.6.2 OUTRIGHT TRANSACTIONS

To reduce pressures and prevent speculations with primary market interest rates while liquidity was lacking, two outright transactions were carried out over September, with a total value of ALL 3.5 billion. These interventions returned the excess position in the banking system and served to restrain the rise of primary market yields.

### III.6.3 OVERNIGHT DEPOSITS

To invest free liquidities, the commercial banks employed overnight deposit instrument with the Bank of Albania. The investment in this instrument averaged ALL 0.76 billion or ALL 0.08 billion less than in 2004. This instrument was mostly used during two first weeks of October, when the Bank of Albania intervened with reverse repurchase agreements under the conditions of excess liquidity in the banking system.

### III.6.4 OVERNIGHT AND LOMBARD LOAN

Notwithstanding a lack of liquidity over the third quarter of the year, the better functioning of interbank market limited the use of overnight loans over 2005. Liquidity injection through this instrument was on average ALL 0.02 billion per day, compared to ALL 0.16 billion that was the respective level over 2004. Lombard loan, the final lending instrument of the Bank of Albania was not used during 2005.

### III.6.5 REQUIRED RESERVE

Even during 2005 the required reserve instrument continued to be used for withdrawing banking system liquidity. Growth of the required reserve level in ALL reflected the rise in respective categories included in accruing the required

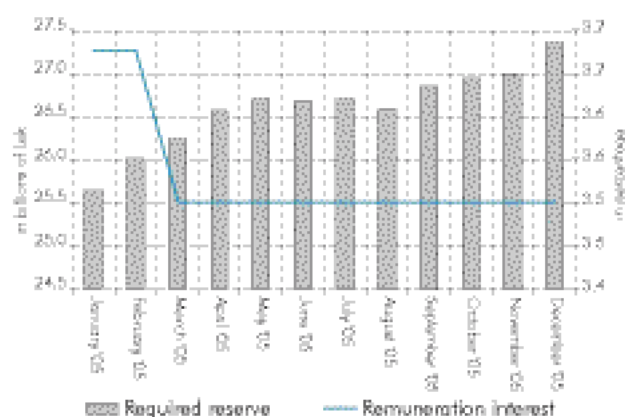


reserve. August is excluded, when, as a result of time deposit interest rate cut at one of the banks of the system, deposit withdrawal occurred, which was soon recuperated by the rest of the banking system in the following months. In March, the ALL remuneration rate of the required reserve reflected the key interest rate cut by the Bank of Albania, remaining constant over the next nine-month period of the year. At end of the year, this rate was 3.50 percent in comparison to the respective value of 4.05 percent of the previous year.

Banks have used on average about 11 percent of the maximum permitted level (20 percent) of the required reserve for satisfying their daily liquidity needs. In comparison to the previous year, a reduction is noticed in the employment of this facility. This is so because year 2005 had a tendency to maintain high position of free reserves by a limited number of banks of the system. The account position level is well-managed by banks of the system, reducing cases of required reserve non-fulfilment to minimum.

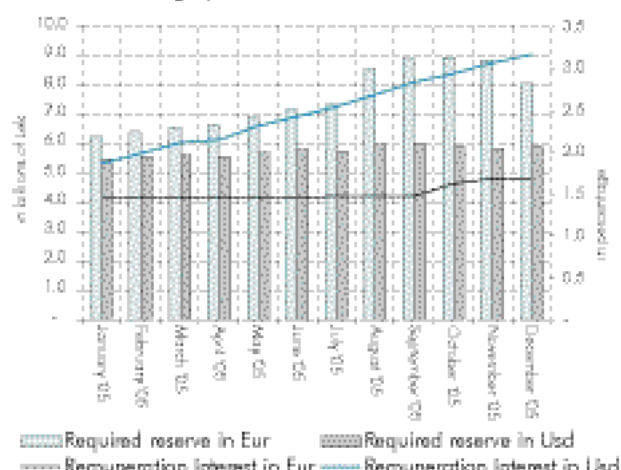
Significant growth of required reserve in euro indicated increased preference of depositors for this currency, while the required reserve in dollar remained almost constant during the whole year. The remuneration rate of required reserve in foreign currency reflected rise of libor and euribor interest rates. Libor rate had the highest rise, which was increased by 2.02 percentage points in comparison to 2004, at the level of 3.17 percent, whereas the euribor rate was increased by 0.21 percentage point, at the level of 1.67 percent.

Chart 21 ALL required reserve of the banking system and remuneration rate



Source: Bank of Albania and commercial banks

Chart 22 Foreign currency required reserve of the banking system and remuneration rate



Source: Bank of Albania and Commercial Banks

### III.7 FOREIGN RESERVE MANAGEMENT

The Bank of Albania is involved in the Reserve Advisory Management Program (RAMP) established by the World Bank, with the purpose to provide necessary assistance in foreign reserve management. The arrangement, pursuant to which assistance will be provided, presupposes the passing of USD 100 million under the World Bank's administration (IBRD). This arrangement, signed by the governor in September, aims at professional growth of the Bank of Albania staff, committed in each chain of foreign reserve management process. This program, projected to last for a three-year period, will enable the provision of a very valuable experience expected to be realised through a close cooperation with World Bank's experts.

- Changes in regulatory framework

In May, after the annual review, a new Regulation was adopted by the Supervisory Council "On foreign reserve management policy". This regulation reflected, inter alia, the foreign reserve re-composition (change of the percentage each currency occupies), from the viewpoint of currencies in the portfolio composition, better reflecting orientation of the Albanian economy towards euro area countries. Currently, the common European currency occupies a larger weight in the foreign reserve as compared to the American dollar.

- Statistics

During 2005 the gross foreign reserve rose by only USD 50.87 million, recording at end of December the value of USD 1,425.05 million. The factors having impacted positively on gross reserve growth are:

- Inflow from the loans extended by the International Monetary Fund, International Development Agency, etc., at USD 61.3 million;
- Foreign currency purchase transactions by commercial banks, Ministry of Finance, and other institutions at USD 136 million;
- USD 8.5 million (Ministry of Finance),
- USD 125.7 million (banking system),
- USD 1.8 million (other institutions);
- Amounts deposited by commercial banks at the Bank of Albania for satisfying the required reserve or other operations related to their capital, USD 54.9 million.

In the meantime, incomes from foreign reserve investment till end of December account for USD 36.3 million. Exchange rate fluctuations in currencies composing the foreign reserve have significantly influenced the gross reserve value, recording a negative effect over 2005, about USD 100 million.

During this period outflows from foreign reserve amounted to USD 135 million and are represented by transfers carried out by an order from the Ministry of Finance, from commercial banks (in total about USD 74.5 million), and from effecting external debt payments for the Albanian Government (USD 51.4 million) or for settling the dues of the Bank of Albania to the IMF (USD 9 million).

## NOTES

<sup>1</sup> Monetary Program of the Bank of Albania is reviewed semi-annually, with the purpose to encompass various phenomena impacting on the monetary indicators trend and their analysis in view of inflation perspective. The most up-dated values of the 2005 monetary program are taken into account in this analysis.

<sup>2</sup> The terms money supply and broad money are used as synonymous terms of the technical term M3 aggregate.

<sup>3</sup> Average real interest is accrued as a twelve-month moving average of real interest.

<sup>4</sup> Along one year the euro is depreciated by 13.2 percent against the USD, decreasing the investment value in euro denominated in USD.

<sup>5</sup> For 2004 the lowest borrowing level is attributed to budget deficit financing by means of revenues from Savings Bank's privatization

<sup>6</sup> For a detailed discussion, see: "Is inflation rather high in Albania? Macroeconomic foundations and economic – social development" Jan-Peter Olters, Conference V of the Bank of Albania, Durrës 2005.

<sup>7</sup> NEER – effective nominal exchange rate accrued against two currencies, according to an approximate weight they occupy in the foreign trade, euro (80 percent) and USD (20 percent).

<sup>8</sup> Downward trend of T-bill yield and two-year government bond yield has impacted on reducing the cost of government's domestic debt.



## CHAPTER IV BANKING SUPERVISION

### 1V.1 LICENSING

Year 2005 was characterised by continuation of the dynamic development of the banking system in Albania. This dynamics, in the sense of licensing banks and other non-bank financial institutions, is reflected in new applications for a banking license, in sale and change of the bank shareholders' structure and in a powerful extension of the existing banks' network in various areas of the country. In February of the past year, a preliminary licence was granted to a bank and at end of December this bank was granted a definitive licence for performing banking activity in the Republic of Albania. Upon licensing of the Union Bank, the number of banks with entirely Albanian capital goes to three and the total number of banks operating in Albania goes to 17.

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

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

No.	Banks	No. of Branches	No. of Agencies
1	Raiffeisen Bank	14	83
2	National Commercial Bank	20	5
3	United Bank of Albania	3	
4	Italian Albanian Bank		5
5	Italian Development Bank (former Dardania Bank)	1	
6	Tirana Bank	25	2
7	National Bank of Greece (Tirana Branch)		4
8	International Commercial Bank	4	
9	Alpha Bank (Tirana Branch)	8	1
10	American Bank of Albania	5	7
11	Procredit Bank	16	
12	First Investment Bank (Tirana Branch)		2
13	Emporiki Bank	2	1
14	Credit Bank of Albania		1
15	Credins Bank	7	2
16	Popular Bank	22	
	T O T A L	127	113

*Table 1 Indicators of banks' network extension at end of 2005*

During 2005 the licensing activity underwent dynamic developments. Briefly, these developments are summarised as follows:

- In the beginning of 2005, preliminary licence was granted to Union Bank, Jnt. Stk, a company with domestic capital, for commencing banking business. The definitive licence was granted to this bank by the Supervisory Council of the Bank of Albania in December 2005.
- Also in 2005 the First Investment Bank – Bulgaria, an entity with foreign capital, applied for receiving a licence to perform banking business for the First Investment Bank – Albania. The preliminary licence was granted in January 2006 and the definitive licence is expected to be granted during 2006. This application has a distinction that relates to transformation of the branch to a subsidiary of the First Investment Bank – Bulgaria.
- Albanian banking system underwent a striking development in 2005 in terms of its network extension within the territory of the Republic of Albania. In 2005 48 new branches and agencies were opened throughout Albania, with Tirana occupying the major weight. 23 new branches and agencies opened in Tirana, are extended in its whole territory, covering with banking services even periphery areas and areas where business activity of production, trade and service, are focused.
- In June of 2005 the sale of Dardania Bank's 100 percent stock was adopted, to an individual and a bank of Italian origin.
- Foreign capital interest in investing in the Albanian banking system has increased. So, after the completion of the process of changing the ownership of the former-Dardania Bank (currently, the Italian Development Bank), the process of selling the Albanian State's shares to the Italian Albanian Bank has advanced. Simultaneously, the application for changing the ownership of the shares of the National Commercial Bank's capital is being prepared. These changes are expected to be adopted in 2006.
- During 2005 no applications have been submitted by banks for increasing the level of capital that relates to increase of permitted financial activities.
- In 2005 the approval was given on changing the name of the Dardania Bank into Italian Development Bank.
- In 2005 six applications for licensing foreign exchange bureaus were submitted. The licence was granted to these bureaus and it was revoked to 2 other foreign exchange bureaus that had interrupted the activity.

During 2005 three new savings and credit associations were licensed and seven new associations were revoked. Savings and credit associations that were revoked the license then united on the basis of three existing associations.

At end of 2005, after the changes that had occurred, the list of entities licensed by the Bank of Albania by years is presented as follows:

No.	Entities	2000	2001	2002	2003	2004	2005
1	Banks and branches of foreign banks	13	13	14	15	16	17
2	Non-bank financial institutions	2	4	5	7	7	7
3	Foreign exchange bureaus	19	38	58	58	54	58
4	Savings and credit associations			113	131	130	131
5	Unions of savings and credit associations			2	2	2	2

Table 2 Entities licensed by the Bank of Albania

## 1V.2 BANKING SYSTEM PERFORMANCE

During 2005 the banking system highlights a positive performance. Its financial position is assessed as a good one: with a very good performance of profitability indicators; capital adequacy above the minimum level set by the Bank of Albania and with a downward trend; increased banking intermediation as an expression of the rise of credit portfolio ratio to total assets and increased total of assets in general; constant expansion of the banks' network and entry of new banks into the market; new banking products supplied and increased use of them, as an expression of the increased overall banking activity volume; as well as a satisfactory liquidity situation, where the Bank of Albania has played an active role in providing facilities for enabling the banking system liquidity management.

The banking system reports a positive net result for 2005, about ALL 6.6 billion or 29.2 percent higher than in the previous year. In ratio to GDP, this figure constitutes 0.79 percent of GDP versus 0.66 percent accrued for 2004.

	December '03	December '04	December '05
Net result	4.45	5.11	6.60

Table 3 Net result (in billions of ALL)

Income from main activities, reflected in net income from interest, are estimated at 40.7 percent more than in the previous year, reflecting the orientation of the banking system activity towards riskier assets and the increased volume of total assets. Net income from interests constitutes about 84 percent of gross income of the banking system<sup>1</sup>, from about 80 percent of the previous year, an expression of the overall net income stability. The main profitability indicators, RoAA and RoAE have performed well during 2005.

	December '03	December '04	December '05
RoAA	1.24	1.28	1.40
RoAE	19.5	21.10	22.24

Table 4 Profitability indicators (in percent)

The banking system reflects an upward trend of profitability, which has undergone an obvious positive development, particularly during 2005. The RoAA indicator presents a faster increase than the RoAE indicator, showing



that the growth rate of net income has been higher against average assets than the average shareholder capital of the banking system. Also, the RoAA growth confirms a qualified improvement of the banking system profitability. Notwithstanding the high level of return on shareholders' equity, earnings are not distributed to shareholders but have served as a good support of banks for carrying out their activity through capital addition.

During 2005, the banking system marked positive signs in terms of better allocation of financial resources and in consequence, even of assets among banks. Notwithstanding the positive developments, the largest banks (aggregated to G3), continue to dominate the banking market. The share of total assets for these banks to total assets of the system, of 72.5 percent, indicates the stability of their activity. However, the downward trend of the G3 contribution to growth of the system speaks for reduced concentration of the banking activity.

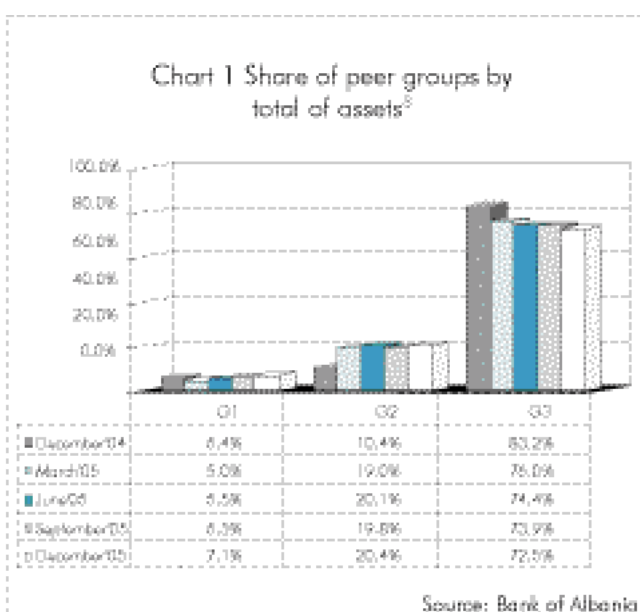
Table 5 H (Herfindahl)  
index of asset and deposit  
concentration

	2000	2001	2002	2003	2004	2005
Index H (assets)	0.44	0.37	0.32	0.30	0.27	0.21
Index H (liabilities)	0.50	0.43	0.37	0.35	0.31	0.24

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

Table 6 Performance of total assets over years (in billions of ALL)

	December '99	December '00	December '01	December '02	December '03	December '04	December '05
Total of assets	249.5	270.8	318.5	339.3	373.6	426.4	496.6
As a percentage of GDP	49.2	50.2	53.5	51.6	50.2 <sup>2</sup>	51.9	59.3



During 2005, the banking system outstanding credit grew by ALL 57.6 billion<sup>4</sup> or 82 percent, from ALL 19.3 billion in the previous year. The high growth rate speaks for a considerable extension of the banking system in lending, encouraged even by the Savings Bank's privatization by the Raiffeisen Bank (RZB). Though at end of 2005 the RZB evidenced a relatively low credit portfolio to total of assets, it is this bank that has the largest contribution to credit portfolio growth, by about 28 percent. The other banks have also reflected good performance in lending, though they do not dominate the banking market.

The indicator "non-performing loans to outstanding loans (net)", which measures the net

size of exposure to credit risk, recorded low levels and a downward trend through 2005<sup>5</sup>.

Finally, the banking system ability to cover with capital the losses incurred from loans<sup>6</sup> is evidenced as improved, due to higher growth rate of regulatory capital (+34.7 percent) to net balance growth of non-performing loans<sup>7</sup> (+23 percent). Relatively non-material size of the above ratios speaks for a limited exposure of the banking system to credit risk.

Capital adequacy ratio <sup>8</sup> of the banking system recorded, at end of the year, the level of 19 percent or about 3 percentage points lower than in end of 2004. Banks have observed the minimum level of capital adequacy by 12 percent, while there are evidenced some banks, which during 2005 had the levels of this indicator very close to the minimum. Reduction of the important indicator of capital adequacy ratio constitutes a consolidated trend throughout 2005, following and according to the downward trend of the previous years. The main impact on the reduced levels of the indicator is given by higher growth rates of risk-weighted assets (by about 57 percent), compared to growth rates of regulatory capital, (by about 35 percent).

A glance at capital adequacy of the peer groups of the system distinguishes the same position of the indicator as in the year-end 2004. G1 maintains the highest level of capital adequacy by 35 percent, G2 maintains the level of 19 percent and G3 has the lowest level, 14 percent. The downward trend of the indicator is more evident in the peer group of small banks, some of which have tended to expand the banking network rapidly, or extend in riskier investments.

	Banking system	G1	G2	G3
December 2005	18.6	35.0	19.4	14.4
December 2004	21.6	47.3	17.8	17.3
December 2003	28.5	72.0	21.4	23.0

Table 7 Capital adequacy in percentage

Banking system liquidity was satisfactory even during 2005. Banks were more active in the interbank market to meet their operational needs, whereas the Bank of Albania intervened in the market for absorbing excess liquidity or injecting liquidity. Also, the main liquidity indicators of the system present levels that have not affected liquidity situation, whereas the monetary policy of the Bank of Albania, on maintaining real interest rates in ALL and inflation rate under control, and the rise of interest rates for main foreign currencies, particularly USD, have contributed not only to deposits stability but also to their growth in the system.

### 1V.3 ON-SITE EXAMINATIONS

The Bank of Albania, in implementing its legal responsibilities, being the supervisory authority of banks and other entities, such as non-bank financial institutions, savings and credit associations and foreign exchange bureaus,

which perform financial activity licensed by the BoA, tried even during 2005 to ensure a sound banking system through off-site supervision and on-site examinations, thus maintaining banking system stability and enhancing public confidence in the banking system.

The supervision process during 2005 improved constantly, being oriented according to risk of certain institutions. So, special attention is paid to banks and non-bank entities with greater problems, analysing their riskier activities in detail. This attention was conditioned by introduction into the market of Raiffeisen Bank's products, providing a new dimension to banking market competition. Significant rise of bank lending reinforced requirements for a more qualified analysis of the borrowers. Due to significant rise of credit portfolio in particular and increased competition in general, the banking system followed prudentially their effect on capital adequacy, credit portfolio quality, interest rates, strengthening of the audit systems of commercial banks, by providing recommendations for improvements in the information technology system, for security conditions in carrying out the activity, for strengthening the role of internal audit and of management structures in general, etc.

The supervision process improved during 2005 in the aspect of communicating with banks' management structures, cooperating with supervisory authorities of countries from which foreign investments come in our banking system. So during 2005 many meetings with members of the banks' management boards, with members of audit committees and with executive managers of banks were organised. Problems of certain banks, market situation, and measures the banks should undertake to fulfil the recommendations given by the Bank of Albania were discussed in such meetings.

During 2005, more attention was paid to the cooperation with supervisory authorities. Cooperation agreements were signed with the Payments Authority of Kosovo, with the National Bank of the Republic of Macedonia and with the Central Bank of Montenegro. Also, general information is exchanged on banking system composition, work contacts are established and information is exchanged with the Bank of Italy, and a very fruitful cooperation has started with the Supervisory Authority of the Financial Market in Austria. Also, the relations with the Bank of Greece, with the Supervisory Authority of Turkey and with the National Bank of Bulgaria are revived.

During 2005 the following examinations were conducted:

1. Banks: 15 full-scope examinations, 14 partial examinations.
2. Non-bank institutions: 7 full-scope examinations, 7 partial examinations.
3. Savings and Credit Associations: 2 full-scope examinations, 2 partial examinations.
4. Foreign exchange bureaus: 41 examinations.

The main goal was to ensure a healthy activity in the business of banks and non-bank entities. The recommendations given by the Bank of Albania also served this function.

In general, the on-site examinations demonstrated a good banking system situation. Some of the main findings from the process of on-site examinations over 2005 are as follows:

- A rapid growth of lending to clients. Most of banks are very aggressive in terms of lending and have largely increased the range of their products. Besides credit to business, credit to households has undergone a significant increase, where housing loans and consumer loans hold the main weight. Banks have improved their internal lending systems, and have increased the number of their personnel dealing with the lending process. This rise in the volume of lending has, besides positive effects in the economic growth, made the public approach more and more to the banking system.
- Further extension of the network of branches and agencies. While 2004 was the year when banks started rapid extension of their network with establishment of 30 branches and agencies, year 2005 marks an acceleration of the growth rate of this network. Hence, during 2005, 48 new branches and agencies were established. Most of them (23) are opened in Tirana, but a considerable part is opened in small cities and towns of the country, which have not been covered well with banking services. This rapid extension of banks' network has contributed to a better provision of banking services to the population.
- Positive developments as concerns to extension of banks' network and lending and other services have made the public approach ever more to the banking system. This has in turn brought about a significant growth of bank assets. The largest growth took place in those banks that have been more aggressive in extending their network and lending.
- Banking system performance is fairly good and the net result of the banking system is higher than in the previous year. This has come due to increased activity, significant increased lending and income from other activities.
- Though there is a reduction in comparison to the previous year, the banks' liquidity continues to be high, generally due to investment in liquid items.
- There is a considerable rise in the number of ATMs and credit and debit cards. These cards are being largely used by the population. At the moment, they are used mainly for withdrawing cash from ATMs, but their use as payment means is being extended. So, numerous points of sale are installed near the selling units, where the customer may effect transactions electronically.

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 enhancing the responsibility of these bodies, emphasising (problems to the attention of the Board of Directors) problems considered as

critical for ensuring a safe and sound activity of banks. The underlining of these recommendations aims mainly at the exercising by these bodies their competencies and responsibilities, in providing banks with sufficient policies and procedures for their safe and sound activity, in preventing the boards of directors or audit divisions (in parent banks) from confusion or slowness in terms of solving problems of banks (subsidiaries or branches) that exercise activity in Albania.

The increased presence of audit committees in banks, closer cooperation with internal audit, increased responsibility about the presented problems, etc., are also required.

One of recommendations given more frequently is related to fulfilment of the documentation by senior managers, who should receive the preliminary consent from the Bank of Albania. Frequently, the delivery of this documentation is delayed. Banks' boards of directors in general have positively responded to recommendations. In view of increasing the cooperation between them and the Bank of Albania, as highlighted earlier, meetings and contacts between both parties have taken place.

- 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 arises. This problem is more tangible to new banks; therefore special attention is paid to them, through conducting frequent examinations to assess the fulfilment of internal policies and procedures, and their quality.

Even in this direction, banks have generally reacted well, but internal policies and procedures should be approved also by boards of directors.

Regarding the implementation of internal regulatory framework, some deviations are observed in some banks. In this context, increased responsibility and quality of the work of internal audit and audit committee is recommended.

- Problems related 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, in some cases even repetition of violations, are noticed. Violations are mostly noticed in the following Regulations:
  - a Regulation "On Credit Risk Management". Loan rating and addition of provisioning for re-rated loans has been one of the most debated issues between inspectors and bank managers. Deeper financial analysis of borrowers, on-site visits, filling in of files with necessary documentation are some of recommendations for bank lending process.
  - b Regulation "On Open Foreign Exchange Positions". It is worth mentioning that not all banks have such deviations. A small number

- of banks have violated the requirements of this Regulation.
- c Regulation "On Controlling Significant Risks". Exceeding of the concentration limits for a beneficiary is noticed mainly for placements with banks (particularly for foreign bank branches) and for some borrowers.
  - d 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.
  - e Regulation "On Money Laundering Prevention". Rigorous implementation of the requirements of this regulation for assigning bank's responsible persons for money laundering prevention in terms of customer identification and reporting of transactions according to specified limits, in terms of staff training for preventing money laundering.
- Problems related to technology and information systems. During 2005, thanks to assistance of Norwegian specialists, the procedures of on-site examinations for the information technology system were improved. During the controls carried out over banks, a number of problems related to drafting of procedures for implementation of this strategy were found out. Also, information technology risk assessment and its documentation, establishment of necessary organizational structures for ensuring the quality of information technology and its audit, drafting of a recovery plan in cases of disaster, automatic generation of necessary information, modules for various areas of activity, division of access for entering data and authorising operations, etc., should be made.

In the audit reports of 2005 the banks' response to given recommendations was assessed. It is noted that most of these problems continue to exist. Due to high costs going with necessary changes in these systems, banks are reacting relatively slowly.

- Problems related to accounting. Problems related to implementation of accounting manual spring from the fact that banks are allowed to hold the capital in the foreign currency. Some of banks continue to hold the profit and fixed assets in foreign currency, contrary to banking accounting manual.
- Other problems. Other problems evidenced during the examinations have to do with the perfection in terms of achieving the objectives set forth in the budget-plan, addition of staff and their training, improvements concerning employee salaries, staff leaving in some banks, etc.

Besides full-scope examinations, 14 partial examinations were also carried out. Partial examinations were aimed at assessing the fulfilment of recommendations

of full-scope examinations. It resulted out of these examinations that banks, non-bank entities or savings and credit associations and their unions have generally reacted positively to these recommendations.

Credit portfolio quality assessment. In October of 2005 a horizontal examination was carried out in eight banks that have the largest share of credit in the system, to assess the policies and procedures, organisation, analysis, monitoring, internal control and credit portfolio quality. It resulted out of these examinations that banks have improved their structures as well as policies and procedures in terms of lending. However, more work should be done for further improving these policies and procedures, to better organise credit departments in terms of analysis and monitoring, to raise internal audit's work efficiency and to pay more attention to implementation of the Regulation "On credit risk management", for classifying credits and especially during the creation of credit provisioning. Also, it came out of these examinations that Bank of Albania examination manual and the regulatory framework should be improved.

#### NON-BANK INSTITUTIONS

During 2005 all non-bank financial institutions (seven institutions) were audited:

Violation of prudent regulations and reporting. Such violations have to do with non-performing credit rates (for both institutions extending loans), liquidity and capital rates. Also, the reporting these institutions should make is not always regular and on due time. So far, no certain format and accurate line exist for reporting (Units of Supervision Department or of Information Technology). Recently the format and the reporting line have been defined. This will help the establishment of database for each institution, their comparison and aggregation, better follow-up of reporting and early identification of violation of prudential regulations.

Violation of licensing conditions. The evidenced violations of licensing conditions are provided below:

- a Opening of customer accounts by institutions. In such cases, there is required the explicit stipulation of the purpose of account opening in the agreement signed by both parties (only for activities the licence permits).
- b Provision of overdrafts (the immediate interruption of this activity is required).
- c Reduction of capital below the limit permitted for receiving a license as a result of losses. Addition of capital in the licence level is required.

Problems of information recording systems. Some of these institutions have started their activity at modest levels of activity and capital and their transactions are not complex. Therefore the systems used for the book-



keeping and maintaining of information are manual. Upon growth of activity and assets, which need prudential monitoring for maintaining information in compliance with legal stipulations, these systems do no longer meet the requirements. In such cases, the ensuring of a proper and automated information system is recommended, to record accurately all the operations and generate the necessary information for reporting to the Bank of Albania and to other authorities. On the other hand, these institutions should know better and apply rigorously the Banking Accounting Manual (those parts that cover their licensed activity).

Other recommendations. Other recommendations were aimed at increasing monitoring measures and protection from activity risks, money laundering prevention, improvement of structure and internal regulatory framework, rigorous implementation of the Regulation "On foreign exchange activities", etc.

During 2005 two full-scope examinations and two partial ones were organised on two unions of savings and credit associations, which collect deposits from their members and extend loans to them. The examinations found out that the activity of the union and its members generally was in accordance with the law and the regulatory framework approved so far.

Currently there exist 57 licensed foreign exchange bureaus. During 2005 about 41 foreign exchange bureaus were examined, and among the main problems evidenced, we may highlight the non-keeping of accounting in compliance with the law, non-maintaining of copies invoiced for each exchange activity, irregular reporting to the Bank of Albania. Relevant recommendations are given about these problems.

## NOTES

<sup>1</sup> Total of net result from interests and other activities

<sup>2</sup> Weight reduction is due to application of a new calculation method on estimated GDP.

<sup>3</sup> During the second quarter, the Alpha Bank (Tirana Branch) passed from G3 to G2, and the Credins Bank passed from G1 to G2.

<sup>4</sup> While the ALL credit outstanding has increased by ALL 17.5 billion or 128 percent, the foreign currency one marked an increase by ALL 40.1 billion or 71 percent.

<sup>5</sup> This indicator is estimated at 1 percent from 1.4 percent at end of 2004.

<sup>6</sup> The "net non-performing loans / regulatory capital" ratio is estimated to 4.3 percent, from 4.8 percent at end of 2004.

<sup>7</sup> Net non-performing credit outstanding for the banking system is evidenced at about ALL 1.2 billion, from ALL 976 million at end of 2004.

<sup>8</sup> CAR is estimated as a ratio of regulatory capital to risk-weighted assets expressed in percentage.

## CHAPTER V OTHER ACTIVITIES OF THE BANK OF ALBANIA

### V.1 EUROPEAN INTEGRATION AND INTERNATIONAL COOPERATION

#### V.1.1 EUROPEAN INTEGRATION

Even during 2005, the Bank of Albania was committed to official negotiations for signing the Stabilization and Association Agreement (SAA) between Albania and the European Union. Bank of Albania negotiators have participated in the Sixth Round of Official Negotiations held in May, and in the Ninth and Tenth Technical Round held respectively in February and September. During these negotiations, the final form is given to articles and annexes for the implementation of which the Bank of Albania is the responsible institution.

The Bank of Albania, in cooperation with the Ministry of European Integration, has also taken an active part in drafting the National Plan for Approximating the Legislation to that of the EU and for implementation of the SAA (NPAL), which was approved in May. This plan summarises all legislative and applicable measures, which should be adopted by Albanian institutions within the clearly specified terms. According to the NPAL, the Bank of Albania will be responsible for drafting the laws and by-laws and for adopting applicable measures in the chapters of macroeconomic stability, free capital movement, and freedom in providing banking services.

In the framework of implementing the NPAL, the Bank of Albania has also prepared two Progress Reports for June – September and October – December, where a detailed description of applied measures is made. More concretely, the Regulation on “Rules and Procedures of Albanian Interbank Payment System – AIPS” was revised in June, which is in full compliance with the Directive 98/26/EC “On finality of regulations in the payment system and securities”. At the same time, the Regulation “On organising clearing” is revised, and the Regulation “Rules and procedures on the Automated Electronic Clearing House – AECH” is adopted. During this period, even the draft-law “On Some Alterations to the Law “On Banks in the Republic of Albania” was completed and the stage of negotiating with interested institutions and actors has already started.

On November 9, the European Commission published its Annual Report on Albania. The Commission evaluated the maintaining of macroeconomic stability, placement of an appropriate banking supervision framework and development of the payment system in our country. On the other hand, the Commission appealed for further free capital movement and a larger coordination of efforts and commitment to the fight against money laundering.

Based on conclusions of the Annual Report, the European Council of the EU adopted in December a revised Document of the European Partnership, enlisting short-term and mid-term priorities for Albania. In this framework, the Bank of Albania will be committed to review some parts of NPAL to better respond to priorities of the new European Partnership.

Besides issues related to the SAA, the Bank of Albania has also participated in two meetings held between the EU and Albania in the framework of the 1992 Trade and Cooperation Agreement, respectively in the Sixth Meeting of the EU-Albania Work Group on Economic and Financial Issues (April) and in the Eighth Meeting of the EU-Albania Joint Committee (May). Macroeconomic issues such as: GDP growth, inflation, trade deficit, current account deficit, foreign direct investment, emigrants' remittances, development of the Albanian banking system, etc., were discussed in these meetings.

### V.1.2 INTERNATIONAL COOPERATION

- Relations with the International Monetary Fund

Year 2005 further enhanced very close cooperation relations between the Bank of Albania and the International Monetary Fund (IMF). Hence, in the framework of consultations on assessing the meeting of obligations deriving from the three-year PRGF arrangement (Poverty Reduction Growth Facility) and negotiations for a new arrangement between Albanian authorities and the IMF, Albania was visited by three reviewing missions of the IMF, in May, October and November of 2005.

During their stay in Albania, the missions met with Bank of Albania administrators, assessing the Bank of Albania achievements in the framework of Memorandum of Economic and Financial Policies signed between the Bank of Albania, the Albanian Government and the IMF as very successful, laying special emphasis on the maintaining of macroeconomic stability, economic growth, inflationary pressures control and steps undertaken for the banking system development and consolidation. Other topics discussed in these meetings and in contacts of members of the mission with Bank of Albania specialists were: Monetary developments and inflation, exchange rate development, growth of lending, real sector's development and banking system regulatory framework.

During 2005 a special place was occupied by annual meetings of the IMF and the World Bank, where Bank of Albania delegation has received full support in terms of continuation of reforms, enhancement of responsibilities and commitments to the accomplishment of the institution's objectives.

Based on the reports of its missions and the goals stated by the Albanian Government in the Memorandum of Economic and Financial Policies, the Executive Board of the IMF, in February and August, made respectively the fifth and sixth review of the economic performance under the PRGF program adopted on 21.06.2002. These reviews generally assessed the satisfactory

performance of Albania during the third and last year of the PRGF program, with a strong economic growth, a reliable liquidity management by the Bank of Albania, a low inflation rate, decreased current account deficit, dynamic financial sector, etc. The Executive Board of the IMF approved the extension of two tranches by respectively about USD 6.1 million and USD 5.8 million, and decided on lengthening the program until 20.11.2005.

In November the Albanian authorities negotiated with the IMF' mission on the new arrangement expected to be adopted on January 2006. This arrangement is expected to be a combination of the program for Poverty Reduction and Growth Facility and the program for Extended Fund Facility, which provides a borrowing closer to commercial terms.

During 2005, as in the previous years, the Bank of Albania benefited from the technical assistance of the IMF concerning its staff training and organization of conferences and different seminars. The so-far assistance by the IMF to the Bank of Albania is regarded as very fruitful, impacting significantly on the achievement of up-dated central banking standards.

- Relations with the World Bank Group

Successful cooperation between the Bank of Albania and the World Bank has continued intensively even during 2005. This cooperation is focused on the financial and technical assistance that the World Bank continues to provide to the Bank of Albania.

In this context, of special importance is the financial support on the Automated Electronic Clearing House project (AECH), which was successfully completed and made operational in July. The settlement system of law value payments enables significant reduction of the time needed for processing these payments, thus raising the banking payments popularity and offering a more qualified service to bank clients. At the same time, this system marks another step made to further modernization of the payment system and its approximation to international standards, by contributing to cash reduction in the economy.

The financial assistance by the World Bank has also consisted in the support of the FSAP program for Financial Sector Assessment Program (FSAP), which is drafted in cooperation with the IMF' s team. Therefore, a joint mission of these two institutions visited Albania in February and May, while the conclusions of the FSAP report were made public in July. The FSAP report generally assessed the compilation, decision - making, and implementation of monetary policy with positive notes, and simultaneously assessed the Albanian banking system as steady and healthy. Also, the report issued a number of recommendations to responsible institutions for maintaining the country's financial stability. Based on above recommendations, the Bank of Albania is committed, in cooperation with respective institutions, to draft a concrete plan of implementation measures, which will address the priorities presented in the FSAP report.

Another very important highlight of 2005 is the signing of the Agreement “On Reserve Advisory Management Program” at the World Bank’s head office in Washington, in September. This Agreement provides, besides the management of a part of Bank of Albania foreign reserve by the World Bank, the ensuring of assistance and qualified programs for Bank of Albania technical staff involved in foreign reserve management process.

- Relations with Central Banks and technical assistance

During 2005 the relations of the Bank of Albania with other central banks outside the region generally continued in the same level as in the previous year. Worth mentioning: the relations with the central banks of France, Germany, the Netherlands, and the Czech Republic, USA, England, Austria, Poland, which continued to provide technical assistance to the Bank of Albania, mainly through organising short-term training courses and workshops in specialised areas.

Simultaneously, closer cooperating relations were established with the European Central Bank, which has expressed its interest to assist central banks of the region on their way to the European System of Central Banks (ESCB). During 2005, mutual relations with the Bank of Italy were intensified, through reviving the technical cooperation. In this framework, members of the Bank of Albania personnel participated in seminars and work visits, organised at this institution.

Year 2005 marked an obvious progress even as concerns to the cooperation with central banks of the region. It is worth mentioning the Memoranda of Understanding in Banking Supervision, signed with the National Bank of Macedonia and with the Central Bank of Montenegro. These memoranda constitute the main principles for exchanging information on licensing and supervision of banks in relevant countries. At the same time, the Governor of the Bank of Albania, Mr. Ardian Fullani held official meetings with the governors of the Bank of Greece and the National Bank of Serbia, where it was decided on establishing closer cooperating relations between respective institutions.

Further to the special care the Bank of Albania takes over the consolidation and intensification of the relations with the Banking and Payment Authority of Kosovo (BPAK), a delegation of the Bank of Albania headed by Mr. Fullani, organised in July a work visit to this institution, where it was agreed on the points of focus for mutual cooperation in the future. In this visit, the Memorandum of Understanding was signed with the BPAK in Banking Supervision area, replacing the previous memoranda.

The Bank of Albania has benefited from the technical assistance given by the GTZ, pursuant to the program “Approximation of the Bank of Albania to the ESCB”, in the framework of the Protocol of Technical and Financial Cooperation between the Republic of Albania and the Federal Republic of Germany. During 2005, priority areas of cooperation were specified with

the GTZ, and the implementation of technical assistance has started in some areas such as: European integration, communication, payment system, legal issues, etc.

Technical assistance to the Bank of Albania was also provided by the Financial Services Volunteer Corps (FSVC), mainly on legal issues of the banking supervision and on money laundering prevention.

## V.2 CURRENCY ISSUE

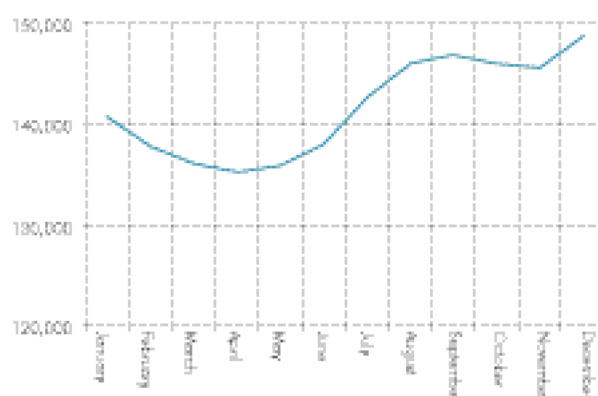
Year 2005 was characterised by positive developments in terms of effective administration of national currency, timely responding to the economy demand for money, thus ensuring protection of authenticity and quality of national currency launched into circulation, as well as by evidencing cultural and historical values of our nation, through projects for production of numismatic currencies for foreign and domestic collectors.

### V.2.1 PERFORMANCE OF CURRENCY IN CIRCULATION

The quantity of currency in circulation during 2005 continued its annual growth, in accordance with the country's economic growth. Currency in circulation for 2005 was increased by 8.42 percent or ALL 11.9 billion, reaching to ALL 153.5 billion at end of the year. During this year the performance of currency in circulation pursued the same annual trend, maintaining the same seasonality observed even in the previous years. High quantity of currency in circulation that resulted in 2004 because of end-year expenses started to return to the Bank of Albania in the first quarter and beginning of the second quarter of 2005, causing the reduction of currency in circulation in January, February, March, April, May.

A high level of receipts by commercial banks and a low level of payments to the banking system corresponded to this tendency over the first half of the year. During the second half of the year a rise in the quantity of currency in circulation was noticed, being impacted by tourism season expenses in June, July and August, as well as by electoral campaign. High levels of payments by

Chart 1 Performance of currency in circulation  
(in millions of ALL)



Source: Bank of Albania

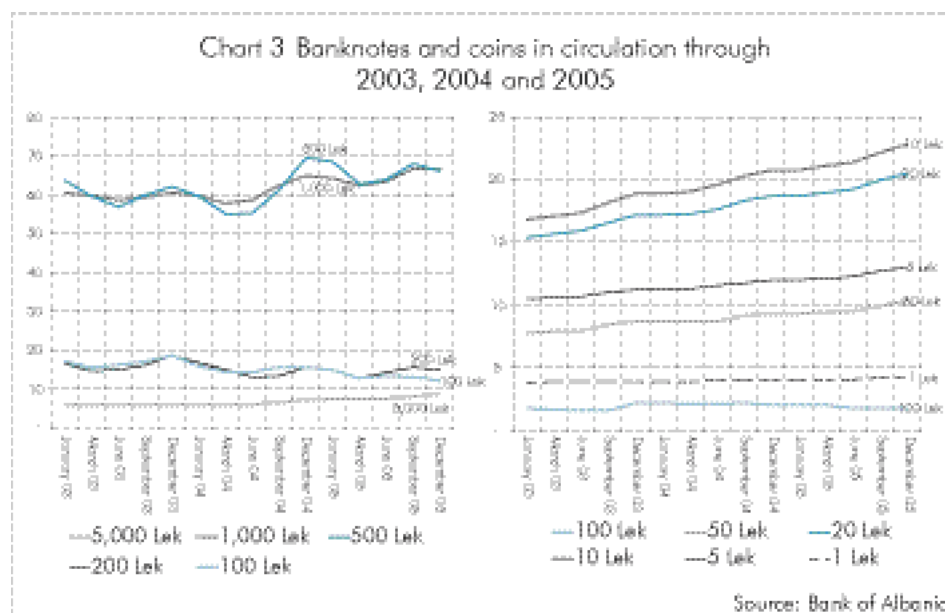
Chart 2 Receipts / Payments over 2005  
(in millions of ALL)



Source: Bank of Albania



the Bank of Albania have responded to this level of expenditures, in terms of commercial banks and lower levels of receipts. The same trend is noticed in December, due to expenditures carried out by consumers for year-end celebrations, public sector for the realization of budget items and Bank of Albania interventions in the market.



Receipts of commercial bank's money by the Bank of Albania during 2005 reached the level of ALL 109.6 billion, recording a growth of 19.8 percent compared to receipts level over 2004, whereas the payments to commercial banks reached the level of ALL 121.5 billion, with a rise of 15.4 percent compared to the level of payments in 2004.

Rise in the volume of receipts / payments implies even the rise in the quantity of funds processing, which is carried out by using sorting machines that enable accuracy in counting, checking, and selecting of damaged or counterfeit banknotes, enabling rise in the quality of banknotes launched into circulation and maintaining the authenticity of Albanian currency. Commercial banks are supplied with funds according to their demand, aiming at the same time the achievement of the objective for realizing the structure of currency in circulation for end of 2005.

## V.2.2 VELOCITY OF CURRENCY IN CIRCULATION

In the framework of the program for cash reduction in the economy, through extending the activity of the public and trading entities with commercial banks, attention is paid to supplying banknotes to banks for meeting their customer demands for currency withdrawal from automated teller machines (ATM). The number of ATMs installed by banks has been increasing upon the extension of the network of commercial banks' branches. This has impacted on rise of money velocity,<sup>1</sup> which for 2005 resulted to 0.707 times, compared with

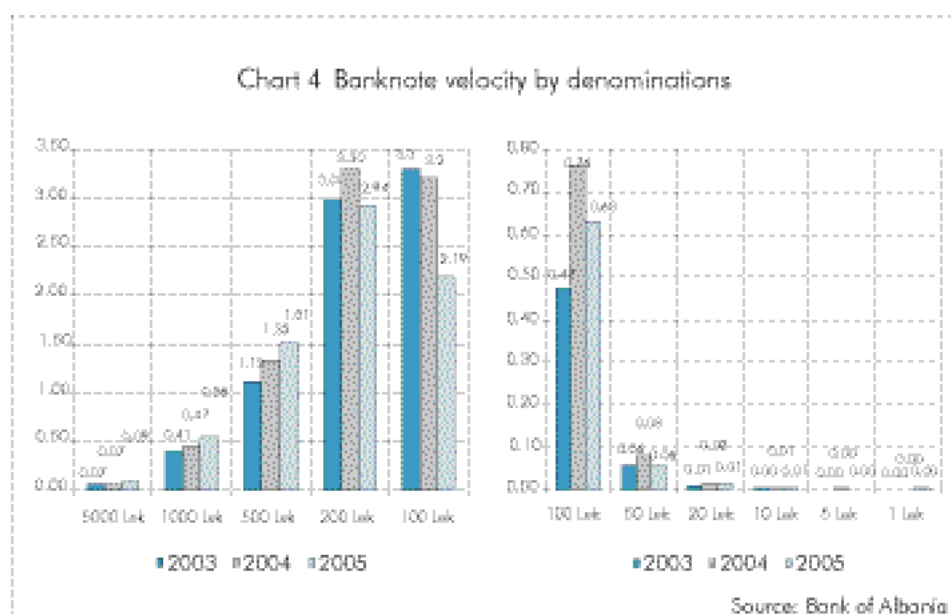
the level of 0.675 times over 2004. The largest impact on the rise of money velocity was given by 5,000 lek, 1,000 lek and 500 lek denominations, which are the denominations the ATM-s work with. Their money velocity has increased by 20 percent compared to 2004.

	2003	2004	2005
No. of ATMs	15	69	165
Growth %	-	360%	139%

Table 1 Number of ATM-s installed by the banking system through years

Table 2 Structure of currency in circulation (in percentage)

Denomination	5000	1000	500	200	100	100	50	20	10	5	1
Structure as at 31.12.2004	25.77	46.13	24.81	2.18	1.11	15.78	35.44	28.25	15.69	4.54	0.30
Structure as at 31.12.2005	29.86	44.83	22.47	2.03	0.80	12.14	37.07	29.48	16.35	4.65	0.30



As concerns to other denominations and coins, their velocity was decreased in accordance with the objective for increasing the quantity of coins available to the public.

### V.2.3 PROTECTION FROM COUNTERFEIT BANKNOTES

Special attention is paid to protecting Albanian banknotes from counterfeiting and to maintaining of authenticity, aiming at protecting the public and having the public confidence in the national currency. The confiscated counterfeit banknotes, which were withdrawn from circulation during 2005, constituted 10 percent of total quantity of counterfeit banknotes confiscated since 1992.

The highest share of counterfeit banknotes confiscated during 2005, as in the previous year, is occupied by 1,000 lek denomination, but the counterfeit quality is very weak and they may be easily detected. The total quantity of

counterfeit banknotes confiscated from 1992 till at present, in ratio to the overall quantity of banknotes launched into circulation by the Bank of Albania, constitutes only 0.032 percent of them, an entirely insignificant figure that does not infringe the public confidence in the national currency.

*Table 3 Share of counterfeit banknotes by denominations over 2005 (in percentage)*

Denomination	5000	1000	500	200	100
%	0	73	19.5	7	0.5

*Table 4 Share of counterfeit banknotes by denominations since 1992 (in percentage)*

Denomination	5000	1000	500	200	100
%	0	59	32	9	0

### V.3 DEVELOPMENTS IN INTERNAL AUDIT FUNCTIONING

In 2005 the inspectors of Audit Department discharged their tasks in compliance with the requirements of Article 54 of the Law "On the Bank of Albania" and the Regulation of the Audit Department, adopted by the decision of the Supervision Council No. 59, dated 04.07.2001.

During this year 47 audits and controls were carried out, with a monthly average of audits by about 4 per month. Implementing the annual program, 46 audits were carried out and only one was of a special procedure, realised according to suggestion by Bank of Albania's administrators.

The given recommendations have intended the correct implementation of laws, bylaws, decisions of the Supervisory Council, and other rules and regulations established, aiming at further enhancing the internal audit systems, thus contributing to raise the preventing role of audit.

### V.4 BANKING LEGISLATION CHANGES OVER 2005

During 2005 the legal and regulatory framework continued to be further completed and improved. These improvements are carried out in the framework of commitments deriving from the process of Stabilization and Association Agreement with the European Union, and are dictated by rapid development needs of the Albanian banking system.

In the framework of the process of Stabilization and Association, the Bank of Albania has carried out satisfactorily the short-term priorities specified in the National Plan for Approximating the Legislation to the EU and the Implementation of the Stabilization and Association Agreement. As legislative measures required, inter alia, were: (i) change of the existing Law "On Banks in the Republic of Albania"; (ii) Revising of the Regulation "Rules and Procedures of the Albanian Interbank Payment System – AIPS"; (iii) approval of the Regulation on "Rules and Procedures of the Automated Electronic

Clearing House (AECH), which will be presented even in the following section, according to areas of the Bank of Albania activity.

#### V.4.1 BANKING SUPERVISION LEGISLATION

Throughout the year it was worked for improving the existing Law "On Banks in the Republic of Albania". These improvements are dictated by the need of adjusting and implementing the European directives in this area, and the Basle principles for an effective banking supervision. The new project brings the banking legal framework closer to the European standards in supervision area, being based on legal models and experience of the region countries of the Western Balkan, which are close to association with the European Union.

The new draft-law improves the existing law in some directions, including the introduction of new concepts related to (i) consolidated supervision. Simultaneously, the draft requires (ii) stronger and clearer requirements in the licensing process of institutions conducting banking activity, (iii) stronger requirements in terms of banking activity transparency, (iv) better recognition of responsibility of the Board of Directors and the Audit Committee in terms of banking activity; (v) clearer procedures in terms of conservatorship or receivership of a bank.

The Bank of Albania and the International Monetary Fund are jointly working on this draft, which is currently under the negotiating process with the banking industry and with other important institutions of the country. The need to review all the by-laws and regulations in implementation of the existing law "On Banks in the Republic of Albania" will arise upon its adoption. However, during 2005, based on the current legal framework, the Bank of Albania reviewed and approved a number of acts, aiming at consolidating the supervision for ensuring a sound financial and banking activity in the country. Worth mentioning, among others:

1. Change of the amount of minimum initial capital paid for a bank's licensing and of the amount of initial capital granted for licensing the branch of a foreign bank, from ALL 700 million to ALL 1 billion (Decision of the Supervisory Council No. 03, of 26.01.2005: On a change in the Regulation "On granting a license for conducting banking activity in the Republic of Albania", and in its implementation, the Decision of the Supervisory Council No. 04, dated 26.01.2005 on "Specifying terms for meeting the requirement on bank required capital rise").

The purpose of changing the amount of initial capital is to create healthy conditions for good performance of the banking activity in the country, by ensuring sufficient solvency of commercial banks.

2. Decision of the Supervisory Council No. 28, dated 30.03.2005, for adopting the Regulation " On supervising e-banking transactions", which is aimed at stipulating:

- a Organisational conditions, related to personnel and technical conditions for carrying out e-banking;
  - b Requirements related to Bank of Albania verifications for e-banking service; and
  - c Principles of e-banking risk management.
3. Decision No. 31, dated 27.04.2005, on a change in the Regulation "On prudential regulations of non-bank entities that conduct financial activity", which regulates the way the non-bank entities report to the Bank of Albania according to the reporting system defined by the Bank of Albania, specifying a term not later than 40 days after the quarter end.
4. Decision No. 43, dated 08.06.2005, on adopting the Regulation "On supervising the savings and credit associations and their unions" and the decision No. 44, dated 08.06.2005 "On adopting the reporting system of savings and credit associations and their unions". These decisions have brought about a new and improved supervision regime of these entities, and a sophisticated and detailed reporting system of these entities.
5. Decision No. 32, dated 27.04.2005, on adopting the "Reporting system for non-bank entities that conduct financial activity" which for the first time started to be implemented for the first quarter of 2005, according to forms attached to this decision.
6. Decision No. 45, dated 08.06.2005, on some changes in the guideline "On Bank Regulatory Capital", which changed the definition and criteria of its involvement in end-year financial profit, implying the financial profit of the period: 01.01 to 31.12. Pursuant to this decision, this financial profit is included in the base capital, when the following conditions are simultaneously met:
- a It is verified by the Audit Committee and authorised chartered experts,
  - b The obligation to the state for tax on profit and the size of dividends required to be distributed are deducted from it.
7. Decision No. 46, of 08.06.2005, on adopting some changes in the Regulation "On capital adequacy", which stipulates that the items deducted also include: "the part of asset items of the bank's balance sheet, pledged with collateral account and /or frozen account for collateral booked at bank's balance sheet items".
8. Decision No. 68, dated 28.07.2005, on adopting the Regulation "For consolidated supervision", which creates the possibility for assessing the position to risk(s), not only of the association itself, but also of the activity of affiliates and its participations in other associations.
9. Decision No. 102, dated 28.12.2005, on adopting the guideline "On minimum technical and security conditions of the work environment of

entities licensed by the Bank of Albania" which specifies the conditions for protecting the physical non-tangibility of all environments where the entity is conducting the activity (including protection by electronic equipment and by respective security personnel) and of persons using these environments, as well as procedures for protecting the information technology systems and the requirements for commencing and continuing the operational activity by the entity.

10. Decision No. 88, dated 16.11.2005, for a change in the Regulation "On licensing non-bank entities", defining that with the exception of point 1.4.1., entities conducting only the financial leasing activity shall not be regarded as non-bank entities, according to definition given in this Regulation and that the activity of these entities shall be regulated pursuant to the Law No. 9396, dated 12.05.2005 "On financial leasing" and the regulations issued in its implementation.

#### V.4.2 LEGISLATION ON MONETARY POLICY DRAFTING AND IMPLEMENTATION

The new regulations adopted in the area of Monetary Policy implementation have reflected the latest developments in the financial market. They bring about improved communication between the Bank of Albania and commercial banks. Some of these regulations are as follows:

1. Decision No. 64, dated 20.07.2005, "On Establishing a Committee of Monetary Policy Implementation". This committee, based on the decisions of the Supervisory Council of the Bank of Albania on monetary policy, and on the situation of financial markets, has the authority to adopt decisions on intervening in the currency market and in the domestic foreign exchange market. Besides this function, this committee also has the role of the advisor to the Supervisory Council of the Bank of Albania, particularly for issues related to the monetary policy stance on key interest rate.
2. Decision No. 13, dated 09.02.2005, on approving the "Typical Contract for repurchase and reverse repurchase agreements of securities".
3. Decision No. 57, dated 13.07.2005, on adopting the Regulation "On Lombard Loan", which requires extension of Lombard loan by the Bank of Albania to any bank that lacks liquidity but is financially stable. Through this loan the meeting of short-term needs for liquidity of commercial banks is achieved. This type of loan represents the latest lending instrument for the banking system as well as the most expensive loan available to commercial banks.
4. Decision No. 92, dated 30.11.2005, on adopting the Regulation "On intraday credit to commercial banks", which stipulates the criteria of

extending intraday credit as a lending instrument to commercial banks, of a smaller maturity than one working day for meeting bank needs for intra-day liquidity and guaranteeing the normal continuation of the functioning of the inter-bank payment system.

5. Decision no. 59, dated 13.07.2005, on adopting the Regulation "On overnight credit", which defines the procedure of extending the overnight credit as a short-term debt instrument available to commercial banks, which aims at increasing liquidity in the banking system and at assisting in managing short-term interest rates, and which is extended to banks and bank branches that have account with the Bank of Albania.
6. Decision No. 84, dated 16.11.2005, on adopting the Regulation "On secondary interbank security market of the Government of the Republic of Albania", which organises the secondary market of securities issued by the Government of the Republic of Albania. This market serves for trading the above-mentioned securities in primary market auctions and the use of securities as means for guaranteeing the execution of various operations in inter-bank market.
7. Decision No. 56, dated 13.07.2005, on adopting the Regulation "On outright transactions" referred to Bank of Albania operations for outright selling/purchases in T-bills and securities market;
8. Decision No. 38, dated 19.05.2005, on adopting the Regulation "On Bank of Albania intervention procedures in domestic foreign exchange market", which defines procedures of Bank of Albania interventions in the domestic foreign exchange market, in implementing its objectives defined by law.

#### V.4.3 PAYMENT SYSTEM LEGISLATION

The decision No. 54, dated 29.06.2005, on some changes in "Rules and Procedures of Albanian Interbank Payment System – AIPS" and decision No. 51, dated 29.06.2005, on adopting the Regulation "On Procedures of Automated Electronic Clearing House System (AECH)" are bylaws that regulate the activity of the AIPS and AECH systems and improve the effective regulatory framework, in the area of Albanian payment system regarding some deficiencies observed during the process of effective implementation of this system, aiming at having a positive effect on its well-functioning.

#### V.5 PAYMENT SYSTEM DEVELOPMENTS

Law No. 8269 "On the Bank of Albania", specifies the task of the Bank of Albania to promote the smooth operation of the payment system. To achieve this target, the Bank of Albania is involved in some important activities, such as:



- Organization and settlement of payments and securities in the territory of the Republic of Albania through the infrastructure created by itself for this purpose;
- Constant development and improvement of the payment system infrastructure for approaching to the international standards;
- Compilation and reformation of the regulatory and procedural framework for the payment system and instruments;
- Payment system supervision.

A special attention is paid to banking system supervision, as an important responsibility of the central bank. The National Payments Committee, as a permanent inter-bank forum, and the Office of Payment System Policies and Supervision newly established in the Bank of Albania structures, realise the coordination of work for carrying out the payment system supervision.

## PAYMENT SYSTEM DEVELOPMENTS

- Albanian interbank payment system – AIPS

Year 2005 was the second year of operation for the Albanian interbank payment system (AIPS). During this year the system has executed gross and real time settlements of large-value payments according to effective rules and procedures for the payment system, without having any deviation or essential problem. During 2005, a volume of ALL 2,201 billion was circulated through AIPS, where approximately 55 per cent of which was composed of BoA initiated transactions, 22 percent by securities transactions, whereas 23 percent by inter-bank and customer transactions.

	2004		2005	
	number	value	number	value
Bank of Albania	15,143	1,254.10	13,598	1,215.72
Government securities	216	559.21	451	479.65
Interbank payments	5,075	276.15	5,732	419.03
Settlements to customers	7,407	63.53	9,169	76.04
Net clearing	739	23.44	580	10.58
Total	28,580.00	2,176.43	29,530.00	2,201.02

Source: Bank of Albania

Table 5 Dissemination of transactions in number and value (ALL billions)

Year 2005 underwent a rise of about 13 percent in the number of interbank payments, associated with a considerable increase of about 52 percent of their value. Also payments to customers had a rise of about 24 percent in number and about 20 percent in value. The items that declined by about 3 percent in value, are Bank of Albania initiated payments, which are composed mainly of monetary operations, cash transactions and government budget.

AIPS provides the possibility of liquidity management by each bank and also, creates the possibility to the Bank of Albania as the system operator, for the overall administration of liquidity in the system. With the purpose to

improve the work in this direction, during 2005 the existing Regulation "On intraday credit" was abrogated, and was replaced with the new Regulation "On intraday credit to commercial banks" adopted with decision No. 92, dated 30.11.2005 of the Supervisory Council. This new Regulation makes the use of this instrument more manageable and efficient.

The price policy in the AIPS is based on system's setting up cost recovery. It is being planned that in the future, this policy will be supplemented by another aspect that has to do with optimization of the payments flowing in the system. The lower charge during the first hours of the system will promote early dispatch of payments, thus reducing considerably the liquidity risk.

Currently in the AIPS, the requests for settlement derive from securities transaction, check clearing, and payment orders. During 2005 efforts were made for carrying out an agreement with the VISA International for settling transactions through cards in ALL of commercial banks in Albania, members of the Visa International. In December the signing of the agreement was carried out, expected to be implemented at early 2006.

- Automated Electronic Clearing House – AECH

July of 2005 marked the live operation of the Albanian Electronic Clearing House system – AECH. Implementation of the AECH system carried out the automation of the clearing service of small-value payments and further enriched the payment system infrastructure. This system is based on and integrated into the AIPS and is realised in compliance with the best international standards and principles, as well as is based on modern and up-dated technology. The AECH system was implemented under the assistance and consultancy of the World Bank.

The AECH system aims to:

- i) Increase the automation of the processes and simultaneously raise the accuracy and speed, as well as reduce cost of processing low value payments among banks;
- ii) Provide the Bank of Albania and commercial banks with efficient tools for monitoring and managing liquidity as well as for preventing credit and liquidity risks; and
- iii) Enrich the supporting infrastructure for further developments in the payment system and other financial systems related to it.

The Bank of Albania and commercial banks are participants in the system. The Bank of Albania is in the role of the owner of the system and supervises, organises, manages and operates the system.

The AECH system enables the net settlement of all low value payments, channelled electronically into the system by banks, at certain hours, according to a certain number of clearing sessions. The execution of these net settlements is conducted irrevocably and unconditionally in the AIPS. The banks have the

possibility to monitor and manage the queue of batch payments and their liquidity.

The legal grounds for the system operation are: The Regulation "On Procedures of the Automated Electronic Clearing House System (AECH)" adopted with decision No. 51, of 29.06.2005, by the Supervisory Council; the Contract on participating in the System, as well as Rules and Procedures for each participant in the system.

During 5 months of operation of the AECH system over 2005, the system carried out the clearing and settlement of low value payments with effectiveness. During this time the AECH system processed a total payment volume of 24 780 low value payments, with a value of ALL 3.9 billion.

- Cheques clearing

Even during 2005, cheque remained a payment instrument in modest levels, and the use of banking cheque was limited. The number of cheques cleared at clearing sessions during 2005 was 2 521, with a value of ALL 10.28 billion.

- Electronic instruments

During 2005 we have a constant improvement and additional efforts of the banking system to improve and upgrade the payment infrastructure, by investing further in terms of using electronic payment instruments. The number of accepting terminals has increased significantly as compared to that of the last year. At end of 2005 the number of ATMs was 205, whereas of POS/EFTPOSs was 779, against 93 and 155 respectively for end of 2004. According to banks' reporting to the Bank of Albania, the card accepting equipment (ATM and POS) operate mainly in ALL, but during this year POS/EFTPOS operating in foreign currency, exactly in USD, were also put into operation. During 2005, the number of (cash, debit and credit) cards in use was increased by about 7 times (in December 2005 the number of cards amounted to 225,913).

Cards are issued mainly in ALL. We also notice a change in the trend compared to 2004. While in 2004 the cash card prevailed, during 2005 we notice a rapid rise (from 6 552 cards in December 2004 to 182 113 cards in December 2005) of the number of debit cards. Also during 2005 the rise not only in the number (about 3 times) but also in type of credit cards was noticed.

## NOTES

<sup>1</sup> It speaks for the "Short cycle of circulation" of money (commercial banks – Bank of Albania).



## INDEPENDENT AUDITORS' REPORT AND FINANCIAL STATEMENTS FOR THE YEAR ENDED DECEMBER 31, 2005

### INDEPENDENT AUDITORS' REPORT

To the Supervisory Board of the Bank of Albania:

We have audited the accompanying unconsolidated balance sheet of the Bank of Albania (the "Bank") as at December 31, 2005 and the related income statement, changes in capital and reserves and cash flow for the year 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 audit.

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

In our opinion the unconsolidated financial statements present fairly, in all material respects, the financial position of the Bank as at December 31, 2005 and the result of its operations, changes in capital and reserves and cash flow for the year 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.

*Deloitte & Touche Sh.p.k.*

*Tirana, Albania*

*March 13, 2006*

## BALANCE SHEET

AS AT DECEMBER 31, 2005 AND 2004

(all amounts are expressed in million LEK, unless otherwise stated)

		As at December 31, 2005	As at December 31, 2004
ASSETS	Notes		
Assets denominated in foreign currencies			
Gold and precious metals	3	708	540
Deposits with the International Monetary Fund	4	8,431	16,817
Deposits with non resident banks	5	10,175	11,489
Securities available for sale	6	133,464	104,450
Other assets	7	551	559
Total assets denominated in foreign currencies		153,329	133,855
Assets denominated in local currency			
Gold and precious metals	3	50	40
Transit credits	8	207	277
Securities available for sale	9.1	66,821	63,786
Investments held to maturity	9.2	1,725	1,649
Other assets	10	2,523	2,553
Total assets denominated in local currency		71,326	68,305
Total Assets		224,655	202,160
LIABILITIES			
Liabilities denominated in foreign currencies			
Due to the International Monetary Fund	11	16,145	15,948
Due to non-resident financial institutions	12	1,319	1,527
Total liabilities denominated in foreign currencies		17,464	17,475
Liabilities denominated in local currency			
Currency in circulation	13	153,550	141,630
Due to resident banks	14	45,182	39,318
Due to the Government	15	6,356	5,302
Deferred income	16	129	106
Other liabilities	17	761	578
Total liabilities denominated in local currency		205,978	186,934
CAPITAL AND RESERVES			
Capital		750	750
Legal reserve		3,750	3,750
Revaluation reserve	18	(11,469)	(14,824)
Other reserves	19	8,182	8,075
Total capital and reserves		1,213	(2,249)
Total liabilities, capital and reserves		224,655	202,160

The accompanying notes on pages 145 to 169 are an integral part of these financial statements.

## INCOME STATEMENT

FOR YEARS ENDED DECEMBER 31, 2005 AND 2004

(all amounts are expressed in million LEK, unless otherwise stated)

		Year ended December 31, 2005	Year ended December 31, 2004
	Notes		
Operations with non-residents			
Interest and commission income	20	4,345	3,209
Interest and commission expense	21	(660)	(683)
Operations with non-residents, net		3,685	2,526
Operations with residents			
Interest and commission income	22	4,328	5,271
Interest and commission expense	23	(1,393)	(1,344)
Operations with residents, net		2,935	3,927
Other operating (expenses)/income, net	24	(360)	144
Net operating income		6,260	6,597
Other administrative expenses			
Personnel expenses	25	(528)	(436)
Depreciation	10	(115)	(110)
Amortization	10	(159)	(339)
General and administrative expenses		(280)	(253)
Total other administrative expenses		(1,082)	(1,138)
NET PROFIT FOR THE YEAR		5,178	5,459

The accompanying notes on pages 145 to 169 are an integral part of these financial statements.



STATEMENT OF CHANGES IN CAPITAL AND RESERVES  
FOR YEARS ENDED DECEMBER 31, 2005 AND 2004  
(all amounts are expressed in million LEK, unless otherwise stated)

	Capital	Legal reserve	Revaluation reserve	Other reserves	Retained earnings	Total
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)
Net profit for the year	-	-	-	-	5,178	5,178
Foreign currency and gold revaluation	-	-	3,841	-	-	3,841
Securities revaluation	-	-	(447)	-	-	(447)
Release of tangible fixed asset revaluation surplus	-	-	(29)	-	29	-
Other revaluations	-	-	(10)	-	-	(10)
Profit distribution	-	-	-	107	(5,207)	(5,100)
As at December 31, 2005	750	3,750	(11,469)	8,182	-	1,213

*The accompanying notes on pages 145 to 169 are an integral part of these financial statements.*

## STATEMENT OF CASH FLOWS

FOR YEARS ENDED DECEMBER 31, 2005 AND 2004

(all amounts are expressed in million LEK, unless otherwise stated)

		Year ended December 31, 2005	Year ended December 31, 2004
	Notes		
Cash flows from operating activities			
Net profit for the year		5,178	5,459
Non-cash items in the statement of operation			
Provision for doubtful loans		6	17
Depreciation and amortization		274	449
Discount amortization of securities available for sale		(3,760)	(4,643)
Interest income		(4,300)	(3,208)
Interests expense		1,457	1,405
Loss / (profit) from sales of securities available for sale		397	(80)
Grant amortization (deferred income)		(41)	(79)
Cash flow before the movement of working capital		(789)	(680)
Changes in working capital			
Decrease in deposits with the IMF		8,359	1,248
Decrease in other assets (in foreign currency)		8	27
Decrease in transit credits		70	107
(Increase) in other assets (in local currency)		(36)	(107)
Increase/(decrease) in due to the IMF		197	(1,530)
(Decrease) in due to financial institutions		(208)	(220)
Increase in due to resident banks		7,629	4,292
Increase/(decrease) in due to the Government		1,054	(162)
Increase in other liabilities (in local currency)		181	169
Grant received		64	68
Cash flows generated from operations		17,318	3,892
Interest received		3,993	2,955
Interest paid		(1,465)	(1,408)
Net cash from operating activities		19,057	4,759
Cash flows from investing activities			
Purchase of fixed assets		(152)	(88)
Purchase of intangible assets		(59)	(168)
Purchase of securities available for sale (in foreign currency)		(234,083)	(83,507)
Purchase of securities available for sale (in local currency)		(180,421)	(182,577)
Sale and maturity of securities available for sale (in foreign currency)		207,802	57,493
Sale and maturity of securities available for sale (in local currency)		181,506	195,614
(Decrease) / increase of repurchase agreement		(1,758)	1,059
Adjustment for effect of foreign exchange		158	(271)
Net cash used in investing activities		(27,007)	(12,445)

The accompanying notes on pages 145 to 169 are an integral part of these financial statements.

STATEMENT OF CASH FLOWS (continued)  
 FOR YEARS ENDED DECEMBER 31, 2005 AND 2004  
 (all amounts are expressed in million LEK, unless otherwise stated)

Cash flows from financing activities		Year ended December 31, 2005	Year ended December 31, 2004
	Notes		
Revaluation of other reserves		(10)	-
Increase in other reserves		107	197
Increase in money in circulation emissions		15,000	13,500
Profit distribution		(5,207)	(5,487)
Net cash used in financing activities		9,890	8,210
Increase in cash during the year		1,940	524
Cash and cash equivalents at the beginning of the year	26	22,450	21,926
Cash and cash equivalents at the end of the year	26	24,390	22,450

*The accompanying notes on pages 145 to 169 are an integral part of these financial statements.*

## NOTES TO THE FINANCIAL STATEMENTS AS OF AND FOR YEARS ENDED DECEMBER 31, 2005 AND 2004

(all amounts are expressed in million LEK, unless otherwise stated)

### 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 December 23, 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".

### 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, IAS 27 and IAS 20. 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 Lek ("LEK").

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### (a) Basis of preparation of financial statements (continued)

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, 2005 and 2004 is set out in Note 27 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.

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(b) Deviation from International Financial Reporting Standards  
(continued)

- IAS 20 "Accounting in Government Grants"

During years 1992-1993, the Bank has received grants from European Community and Swiss Government with the purpose of improving the balance of payment of Albanian Government. These grants have been recognized in capital and reserves under "special reserve for balance of payments" reserve. This is not in accordance with IAS 20 which requires that government assistance to be recognized as income over the periods necessary to match them with the related costs to which they are intended to compensate, on a systematic basis.

(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.

Commission income and expense is recognized in the income statement when services are provided or paid, respectively.

(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, 2005 and 2004 were as below:

	December 31, 2005	December 31, 2004
United States dollar (USD)	103.58	92.64
European Union currency unit (EUR)	122.58	126.35
British pound (GBP)	178.65	178.69
Special Drawing rights (SDR)	148.03	143.39
Japanese yen (JPY)	0.8826	0.9036
Gold ("Xau")	1 onz = 53,136.54	1 onz = 40,576.32

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### (e) Financial assets

All the financial assets are recognized initially, at their fair value of the consideration given plus, transaction costs that are directly attributable to the acquisition of the financial asset.

Financial assets are classified as follows:

#### Loans originated by Bank

Loans are financial assets with fixed or determinable payments that are not quoted in an active market and created by Bank providing money to a debtor. Loans comprise loans to employees.

At subsequent reporting dates they are carried at amortized cost, less any impairment loss recognized to reflect irrecoverable amounts.

#### 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. Fair value changes on available-for-sale assets are recognized directly in equity until the financial asset is derecognized, at which time the cumulative gain or loss previously recognized in equity is recognized in profit or loss.



#### 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.

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### (e) Financial assets (continued)

#### 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 loans originated by Bank – the recoverable amount of originated loans is calculated based on the year-end evaluations of loans, including the accrued interest. In determining the recoverable amounts of loans to employees, management considers the particular factors, including the review of repayment history of the debt by its former employees. The provision for impairment losses on loans is reported in the income statement as a charge and is deducted from the relevant asset category on the balance sheet. When it is determined that a loan cannot be recovered, all the necessary legal procedures have been completed and the final loss has been determined, the loan is written off.
- For financial assets held to maturity – 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 available for sale –when a decline in the fair value of an available-for-sale financial asset has been recognized directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized directly in equity shall be removed from equity and recognized in profit or loss even though the financial asset has not been derecognized.

### (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.

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### (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 determined as the difference between net disposal proceeds and the carrying amount of the asset and are recognized as income or expense in the statement of income and expenditure 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 2005 are the same as year 2004:

	2005
Building – Head office	40 years
Buildings – At branches	25 years
Vehicles	5-10 years
Furniture, fixtures and equipment	3-20 years
Computer software	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.

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(k) Grants

Grants are initially recorded in the balance sheet at the amount received. Grants related to expenditure items are released to income during the period of the related expenditure.

Grants related to the purchase of property, equipment and software are released to income over the life of the relevant assets at an amount corresponding to the associated depreciation/amortization charge on that asset.

(l) Cash and cash equivalents

For the purposes of cash flow statement, cash and cash equivalents is defined as cash in LEK and foreign currencies and foreign currency deposits with residual maturities of less than three months.

(m) 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.

(n) Comparison

Certain comparative figures in cash flow statement have been reclassified to conform to current year presentation.

## 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### (o) Managed assets

At as December 31, 2005, the Bank held as custodian short-term treasury, at nominal value LEK 292 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 4,694 million.

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, 2005 and 2004 is as below:

	As at December 31, 2005	As at December 31, 2005
Gold standardized abroad	2,970	2,268
Gold not standardized in Albania	1,564	1,194
Other precious metals	160	115
Total	4,694	3,577

Interest received from the deposit of government gold reserves is recognized as income from interest due to Government, increasing the liability due to Government. For year 2005 the interest received is of 6 ounces. The difference of LEK 1,117 million is a result of the fluctuation of exchange rates (Note 3).

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

## 3 GOLD AND PRECIOUS METALS

As at December 31, 2005, the value of gold owned by the Bank placed in gold time deposits abroad was LEK 708 million (2004 - LEK 540 million), being 13,319 troy ounces of gold (2004 - 13,319 troy ounces).

Gold is valued at the London fixing rate on the balance sheet date. The difference of LEK 168 million (2004 - LEK 56 million) resulting from the revaluation of gold is recorded in the revaluation reserve. As at December 31, 2005 the price for one troy ounce of gold was USD 513 (2004 - USD 438).

Other gold and precious metals included within domestic assets include platinum and silver in a domestic vault, valued at the London fixing rate on the balance sheet date, amounting to LEK 45 million as at December 31, 2005 (2004 - LEK 36 million) and LEK 5 million of non-international standard gold (2004 - LEK 4 million).

#### 4 DEPOSITS WITH THE INTERNATIONAL MONETARY FUND

	As at December 31, 2005	As at December 31, 2004
International Monetary Fund	7,128	7,476
Special Drawing Rights ("SDR")	1,295	9,306
Accrued interest	8	35
Total	8,431	16,817

Deposits with the IMF resulted from the membership of the Republic of Albania in the IMF, according to Law nr.8269 dated December 23, 1997 "For the Bank of Albania". These deposits have as counterparty accounts the loans granted to the Republic of Albania as disclosed in Note 11.

The Special Drawing Rights (SDR) represent deposits placed in the International Monetary Fund, which during the year 2005 was partially divided in the constituting currencies of SDR (EUR, GBP, USD, and JPY) in order to have a more active administration of these funds.

The SDR holdings bear interest, which is determined on weekly basis. The interest rate prevailing as at December 31, 2005 was 3.03% (2004 – 2.22%).

#### 5 DEPOSITS WITH NON RESIDENT BANKS

	As at December 31, 2005	As at December 31, 2004
Current accounts	7,996	11,109
Short-term deposits	2,175	379
Accrued interest	4	1
Total	10,175	11,489

Short term deposits and current accounts earn interest at rates mostly based on the currency of the deposit or current account, and at rate varying from 1.25 % to 4.53% (2004 – 1% to 4.56%).

Deposits and current accounts with foreign banks are denominated in EUR, USD, GBP and JPY which equate to the following foreign currency balances:

	As at December 31, 2005	As at December 31, 2004
	(in million)	(in million)
EUR	25	27
USD	28	85
GBP	11	1
JPY	2,615	-

## 6 SECURITIES AVAILABLE FOR SALE (IN FOREIGN CURRENCY)

Foreign securities disclosed in market value are as follows:

	As at December 31, 2005	As at December 31, 2004
United States Government treasury notes	40,218	34,277
French Government treasury notes	54,219	41,450
United Kingdom Government treasury notes	4,606	-
Bank for International Settlements: medium-term investments	4,577	5,672
United States agencies notes	2,584	4,625
French Government treasury bills	2,443	1,746
Fixed rate investments (FIX BIS)	24,817	16,680
Total	133,464	104,450

## 6 SECURITIES AVAILABLE FOR SALE (IN FOREIGN CURRENCY) (CONTINUED)

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

	As at December 31, 2005	As at December 31, 2004
	(in million)	(in million)
USD		
United States Government treasury notes	388	370
Bank for International Settlements: medium-term investments	24	-
United States agencies notes	25	50
Fixed rate investments (FIX BIS)	77	61
Total	514	481
EURO		
French Government treasury notes	442	328
Bank for International Settlements: medium-term investments	10	20
French Government treasury bills	20	14
Fixed rate investments (FIX BIS)	125	69
Total	597	431
GBP		
United Kingdom Government treasury notes	26	-
Bank for International Settlements: medium-term investments	4	18
Fixed rate investments (FIX BIS)	9	12
Total	39	30

United States Government treasury notes are denominated in USD and have coupon rates varying between 1.5% and 4.62%. Interest is paid semi-annually and maturities vary between March 2006 and October 2010. The yields vary between 1.6% and 4.5% (2004 – 1.05% and 4.65%).

The French Government treasury notes are denominated in EUR with coupon rates varying between 2.25% and 5.5%. Interest is paid annually and maturities range between March 2006 and July 2010. The yield varies between 2.03% and 3.08% (2004 – 2.06% and 4.21%).

United Kingdom Government treasury notes are denominated in GBP and have coupon rates varying from 5% to 8.5%. Interest is paid semi-annually and maturities vary between December 2006 and March 2008. The yields vary between 4.15% and 5.82%.

Bank of International Settlements – medium term investments comprise of fixed coupon securities denominated in EUR, USD and GBP with coupon rates varying between 2.95% and 4.3%. Interest is payable annually for investments in EUR and semi-annually for investments in GBP and USD, and maturities range between September 2007 and September 2010. The yields vary between 2.87% and 5.1% (2004 – 2.47% and 5.27%).

## 6 SECURITIES AVAILABLE FOR SALE (IN FOREIGN CURRENCY) (CONTINUED)

United States agencies notes are denominated in USD with coupon rates varying between 2% and 2.5%. Interest is paid semi-annually and maturities range between January 2006 and February 2007. The yields vary between 2% and 2.4% (2004 – 1.14% and 2.44%).

The French Government treasury bills are denominated in EUR and mature on various dates between January 2006 and March 2006 with purchasing yields 2.1 % (2004 – 2.11% to 2.21%).

Fixed rate investments (FIXBIS) issued by the Bank of International Settlements are denominated in USD, EUR and GBP with yields that vary between 2.04% and 4.53% (2004-1.85% and 4.99%) and maturities range between February 2006 and December 2006.

## 7 OTHER ASSETS (IN FOREIGN CURRENCY)

As at December 31, 2005, other foreign assets are comprised of cash on hand in foreign currency of LEK 11 million (2004 - LEK 11 million) and of subscriptions for participation of the Republic of Albania in International Institutions.

	As at December 31, 2005	As at December 31, 2004
Cash on hand in foreign currency	11	11
Other		
International Bank for Reconstruction and Development subscriptions	361	357



International Development Agency subscriptions	12	35
Multilateral Investment Guarantee Agency subscriptions	6	12
International Finance Corporation subscriptions	76	68
European Bank for Reconstruction and Development subscriptions	61	54
Islamic Development Bank subscriptions	24	22
Total Other	540	548
Total	551	559

## 8 TRANSIT CREDITS

The total of LEK 207 million (2004 – LEK 277 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). This loan has not been secured by any collateral.

## 9 INVESTMENTS (IN LOCAL CURRENCY)

### 9.1 SECURITIES AVAILABLE FOR SALE

	As at December 31, 2005	As at December 31, 2004
Short-term treasury bills	66,821	63,786
Total	66,821	63,786

Short-term treasury bills as at December 31, 2005 relate to Government of Albania zero-coupon treasury bills, with maturities 3 to 6 months, ranging between January 2006 and June 2006, with yields varying between 5.38% and 8.64% (2004 – 6.10% and 8.10%).

### 9.2 INVESTMENTS HELD TO MATURITY

	As at December 31, 2005	As at December 31, 2004
Zero- coupon bond for capitalization of National Commercial Bank (NCB)	1,725	1,649
Total	1,725	1,649

Security for the capitalization of the National Commercial Bank relates to a zero-coupon bond, which was issued by the Government of Albania to replace its participation in the capital of the National Commercial Bank. The security bears a rate of return of 6% per annum and matures in January 2006.

## 10 OTHER ASSETS (IN LOCAL CURRENCY)

	As at December 31, 2005	As at December 31, 2004
Tangible fixed assets, net	1,464	1,427
Intangible assets, net	278	378
Loans to employees	707	613
Other debtors	5	44
Numismatic	38	63
Inventory	25	26
Other	6	2
Total	2,523	2,553

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

	Land, buildings and general constructions	General equipment	Transport vehicles	Total tangible fixed assets
Cost/Valuation				
Balance at January 1, 2005	1,440	562	161	2,163
Additions	20	120	12	152
Balance at December 31, 2005	1,460	682	173	2,315
Accumulated depreciation				
Balance at January 1, 2005	182	424	130	736
Charge for the year	38	66	11	115
Balance at December 31, 2005	220	490	141	851
Net book value				
Balance at December 31, 2005	1,240	192	32	1,464
Balance at December 31, 2004	1,258	138	31	1,427

## 10 OTHER ASSETS (IN LOCAL CURRENCY) (CONTINUED)

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.

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

	Computer software	Banknotes printed and coins minted	Total intangible assets
Cost valuation			
Balance at January 1, 2005	277	2,454	2,731
Additions	59	-	59
Balance at December 31, 2005	336	2,454	2,790
Accumulated depreciation			
Balance at January 1, 2005	193	2,160	2,353
Charge for the year	73	86	159
Balance at December 31, 2005	266	2,246	2,512
Net Book Value			
Balance at December 31, 2005	70	208	278
Balance at December 31, 2004	84	294	378

Loans to employees include a provision for legal claims of LEK 6 million at December 31, 2005 and LEK 10 million at December 31, 2004.

Loans to employees are collateralised by security such as mortgages, totaling approximately LEK 851 million at December 31, 2005 and LEK 626 million at December 31, 2004.

"Other Debtors" include an amount of LEK 4 million, which presents the provisions for the uncollected amount from Government of Albania, in relation to prior year transactions with World Bank (see Note 24).

## 11 DUE TO THE INTERNATIONAL MONETARY FUND

	As at December 31, 2005	As at December 31, 2004
Poverty Reduction and Growth Facility ("PRGF")	9,513	8,953
IMF securities account	4,881	5,148
IMF account in LEK	1,751	1,847
Total	16,145	15,948

PRGF 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 PRGF facility was drawing down in 1993, repayable over 10 years, which commenced in 1999. The outstanding balance as at December 31, 2005 was nil (2004 – SDR 706,000).

An additional loan under this facility (known as Poverty Reduction and Growth Facility) approved by the agreement of May 13, 1998 totaling SDR 45,040,000, was drawn down during the period 1999 to 2001. The

outstanding balance as at December 31, 2005 was SDR 36,265,400 (2004 - SDR 41,728,200). 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 and the last disbursement was made on June 20, 2005. The balance as of December 31, 2005 is SDR 28,000,000 (2004 - SDR 20,000,000) 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.

## 12 DUE TO NON-RESIDENT FINANCIAL INSTITUTIONS

	As at December 31, 2005	As at December 31, 2004
Transit credits (Note 8)	207	277
Loan from the Hellenic Republic	1,079	1,112
Due to the World Bank	28	133
Accrued interest	5	5
Total	1,319	1,527

The loan for development of LEK 207 million consists of USD 0.5 million and of EUR 1.2 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 Hellenic Republic (in amount of EUR 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 International Bank for Reconstruction and Development, International Development Agency, Multilateral Investment Guarantee Agency, International Finance Corporation in the Bank of Albania.

## 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, 2005 and 2004:

Nominal value LEK	As at December 31, 2005		As at December 31, 2004	
	Number in thousand	Total LEK (million)	Number in thousand	Total LEK (million)
100	12,167	1,217	15,515	1,552
200	15,481	3,096	15,307	3,061
500	68,373	34,187	69,623	34,812
1,000	68,218	68,218	64,720	64,720
5,000	9,087	45,435	7,232	36,162
Coins		1,397		1,323
		153,550		141,630

## 14 DUE TO RESIDENT BANKS

	As at December 31, 2005	As at December 31, 2004
Foreign currency		
Compulsory reserve	14,683	10,826
Accounts of second level banks	118	65
Deposits taken as guarantee	-	104
	14,801	10,995
Domestic currency (LEK)		
Compulsory reserve	26,980	24,655
Accounts of second level banks	1,800	529
Repurchase agreements	505	2,263
Overnight deposits	1,082	855
	30,367	28,302
Accrued interest	14	21
Total	45,182	39,318

Interest on compulsory reserves is calculated as follows:

LEK balances: 70% of the yield on the repurchase agreements: 3.5 % as at December 31, 2005 (70% of the yield on the repurchase agreements: 3.675 % as at December 31, 2004);

USD balances: 70% of the one-month USD LIBOR rate: 3.07 % as at December 31, 2005 (70% of the one-month USD LIBOR rate: 1.69 % as at December 31, 2004);

EUR balances: 70% of the one-month EUR LIBOR rate: 1.7% as at December 31, 2005 (70% of the one-month EUR LIBOR rate: 1.52% as at December 31, 2004).

The Bank does not pay interest on correspondent accounts and current accounts.

Overnight deposits from domestic banks own interest of 3.25% (2004 - 2.25%).

## 15 DUE TO THE GOVERNMENT

	As at December 31, 2005	As at December 31, 2004
Profit distributable to the Government	547	400
Deposits received on behalf of the Government	5,785	4,880
Other	24	22
Total	6,356	5,302

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. 17 dated on March 15, 2006.

Deposits received on behalf of the Government includes the main account of LEK 3,338 million and international donor funds deposited at the Bank for subsequent transfer to aid projects in Albania, of LEK 2,447 million.

“Other” includes funds received by the Bank of LEK 24 million (2004 – LEK 22 million) from a loan granted to the Government by the Islamic Arabian Bank of Development.

## 16 DEFERRED INCOME

	As at December 31, 2005	As at December 31, 2004
World Bank grant	289	225
World Bank grant amortization	(196)	(155)
Other	36	36
Total	129	106

The World Bank grant relates to a grant received by the Bank during the years 2002-2005 for the purchase of computer software and equipment for the implementation of the ATM project (Accounting and Treasury Management) totaling LEK 157 million, for the RTGS project (Real time Gross Settlement System) of LEK 68 million, as well as for the AECH project (Automated Electronic Clearing House) of LEK 64 million.

The amount of 36 million LEK included in “Other” represents the value of the two donated buildings in Korça and Berat.

## 17 OTHER RESIDENT LIABILITIES

	As at December 31, 2005	As at December 31, 2004
Due to Printing House (Note 27)	212	217
Deposits of individuals from the participation in Treasury Bills	469	272
Net obligation/ Pension fund	6	1

Other	74	88
Total	761	578

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, 2005 and 2004 are as follow:

	As at December 31, 2005	As at December 31, 2004
Obligation value of 2% of contribution	19	15
Results of 2% contribution invested	4	3
Real value of the treasury bill portfolio	(21)	(17)
Net obligation of 2% contribution	2	1

	As at December 31, 2005	As at December 31, 2004
Obligation value of 15% of contribution	203	161
Results of 15% contribution invested	73	56
Real value of the treasury bill portfolio	(272)	(217)
Net obligation of 15% contribution	4	-

“Other” includes accrued expenses of LEK 23 million (2004 – LEK 29 million) related to maintenance of ATM system, repair and maintenance of sorting machines, Reuter services, statistics information, etc. Also included here are the claims for several legal litigations raised in the normal course of business. A net provision of LEK 22 million has been recognized in relation to these claims for the year ended December 31, 2005 (2004 – LEK 20 million) (see Note 24).

## 18 REVALUATION RESERVE

The components of the revaluation reserve are as follows:

	As at December 31, 2005	As at December 31, 2004
Revaluation of foreign currency and gold balances	(12,164)	(16,005)
Reserve of security revaluation	(310)	137
Revaluation of historic notes and coins	22	32
Revaluation of Head Office building (Note 10)	983	1,012
Total	(11,469)	(14,824)

During year 2005, the revaluation reserve for foreign currency and gold balances has increased by LEK 3,841 million (2004 – decrease of LEK 8,333 million) due to a further revaluation of currencies during the year.



In accordance with the Law "On the Bank of Albania" article 64, point b, and Law no.9339 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%, being renewed on August 1, 2005 with an interest rate of 6.588% with a maturity of six months. Also on September 1, 2005 the Ministry of Finance issued securities in amount of LEK 3,828 million with a maturity period on March 3, 2006 and an interest rate of 9.94%.

## 19 OTHER RESERVES

The components of the other reserves are as follows:

	As at December 31, 2005	As at December 31, 2004
Special reserve for Balance of Payments	7,209	7,209
Investment fund	301	301
Other	672	565
Total	8,182	8,075

The special reserve for the Balance of Payments 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 - 2005 based on the Supervisory Council decisions on the respective following years. A further allocation of LEK 107 million was made from the profit of year 2005.

## 20 INTEREST AND COMMISSION INCOME (NON-RESIDENTS)

	Year ended December 31, 2005	Year ended December 31, 2004
Interest income from securities	3,578	2,739
Interest income from time deposits	508	253
Interest from SDR deposits	170	177
Other	89	40
Total	4,345	3,209

## 21 INTEREST AND COMMISSION EXPENSE (NON-RESIDENTS)

	Year ended December 31, 2005	Year ended December 31, 2004
Amortization of premium on securities	594	622
Interest expenses on loans of foreign institutions	13	13
Interest expenses on IMF accounts	48	47
Other	5	1
Total	660	683

## 22 INTEREST AND COMMISSION INCOME (RESIDENTS)

	Year ended December 31, 2005	Year ended December 31, 2004
Interest income from securities	4,194	5,172
Interest income from Government loans	30	65
Other	104	34
Total	4,328	5,271

## 23 INTEREST AND COMMISSION EXPENSE (RESIDENTS)

	Year ended December 31, 2005	Year ended December 31, 2004
Interest expense on compulsory deposits	1,176	1,085
Interest expenses on REPO agreements	196	236
Other	21	23
Total	1,393	1,344

## 24 OTHER OPERATING (EXPENSES)/INCOME, NET

	Year ended December 31, 2005	Year ended December 31, 2004
Net (loss)/profit from the sale of financial assets	(397)	80
Grants depreciation	42	79
Provision for legal claims and other (note 10 and 17)	(6)	(17)
Other	1	2
Total	(360)	144

## 25 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, 2005, the Bank had 427 employees (2004 – 323 employees).

## 26. CASH AND CASH EQUIVALENTS

	As at December 31, 2005	As at December 31, 2004
Deposits with foreign banks (Note 5)	10,171	11,488
Domestic currency on hand	13,450	10,371
Foreign currency on hand (Note 7)	11	11
Gold held abroad (Note 3)	708	540
Gold and other precious metals held domestically (Note 3)	50	40
Total	24,390	22,450

## 27 PRINTING HOUSE

As detailed in Note 2(a), the Bank controls the operations of the Printing House. The financial position of the Printing House as at December 31, 2005 and 2004 is as follows:

	As at December 31, 2005	As at December 31, 2004
ASSETS		
Tangible fixed assets	16	23
Inventory	37	60
Trade accounts receivable	2	1
Amount due from the Bank (see Note 17)	212	217
Total assets	267	301
EQUITY AND LIABILITIES		
Capital	51	52
Legal reserve	19	19
Investment reserves	24	24
Other reserves	6	6
Retained earnings	161	159
Total capital and reserves	261	260
Other liabilities	6	41
Total equity and liabilities	267	301

	As at December 31, 2005	As at December 31, 2004
Income	99	117
Expenses	(97)	(114)
Profit of the year	2	3

## 28 CONTINGENCIES AND COMMITMENTS

The Bank maintains certain accounts in foreign currencies related to agreements concluded between Government of Albania and foreign governments and financial organizations. As these accounts do not present either assets or liabilities of the Bank, they have not been included within the Bank's balance sheet.

On November 10, 2005, Bank of Albania issued a one year guarantee in favor of Raiffeisen Bank sh.a, declaring the commitment of the Bank to guarantee the amount of LEK 29 billion in Treasury Bills of the Albanian Government in the Raiffeisen Bank portfolio. The price of this guarantee is 0.2% of nominal value per annum, payable quarterly.

## 29 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 December 31, 2005 and December 31, 2004, transactions made with related parties comprised:

	As at December 31, 2005	As at December 31, 2004
Other domestic Loans		
Loans to employee		
- Directors and Supervisory Board Members	79	46
Total assets	79	46
	Year ended December 31, 2005	Year ended December 31, 2004
Administrative expenses		
Mobile expenses		
- Directors and Supervisory Board Members	4	3
Salaries and Bonuses		
- Directors and Supervisory Board Members	67	42
Total of administrative expenses	71	45

## 30 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. The Bank manages its liquidity risk by investing in short term deposits with foreign banks. 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 fair value of financial instruments due to changes in foreign exchange rates; and
- interest rate risk associated with fluctuations in the fair 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 31 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.

## 31 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 non residents banks	11,489	-	-	-	-	-	-	11,489
Securities available for sale	7,850	4,110	13,569	14,710	64,211	-	-	104,450
Other 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 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 resident banks	38,724	-	-	-	-	-	594	39,318
Due to the Government	-	-	-	-	-	-	5,302	5,302
Deferred income	-	-	-	-	-	-	106	106
Other 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	-	-

## 31 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	-	-	-	-	-	-	708	708
Deposits with the IMF	-	1,295	-	-	-	-	7,136	8,431
Deposits with non residents banks	7,868	-	-	-	-	-	2,307	10,175
Securities available for sale	1,747	8,744	4,886	20,877	97,210	-	-	133,464
Other assets	-	-	-	-	-	-	551	551
Other gold & precious metals	-	-	-	-	-	-	50	50
Transit credits	-	-	-	-	-	-	207	207
Securities available for sale	23,371	25,038	18,412	-	-	-	-	66,821
Investments held to maturity	1,725	-	-	-	-	-	-	1,725
Other assets	-	-	-	-	-	707	1,816	2,523
	34,711	35,077	23,298	20,877	97,210	707	12,775	224,655
Liabilities and equity								
Due to the IMF	-	263	264	597	5,338	3,051	6,632	16,145
Due to non-resident financial institutions	-	-	-	5	-	1,079	235	1,319
Currency in circulation	-	-	-	-	-	-	153,550	153,550
Due to resident banks	43,264	-	-	-	-	-	1,918	45,182
Due to the Government	-	-	-	-	-	-	6,356	6,356
Deferred income	-	-	-	-	-	-	129	129
Other liabilities	-	-	-	-	-	-	761	761
Capital and reserves	-	-	-	-	-	-	1,213	1,213
	43,264	263	264	602	5,338	4,130	170,794	224,655
Balance sheet gap as at December 31, 2005	(8,553)	34,814	23,034	20,275	91,872	(3,423)	(158,019)	-
Cumulative interest rate sensitivity gap - 2005	(8,553)	26,261	49,295	69,570	161,442	158,019	-	-

## 32 CURRENCY NET POSITION

	LEK	USD	EUR	GBP	Other	Total
<b>Assets</b>						
Gold and precious metals	-	-	-	-	708	708
Deposits with the IMF	6,632	-	-	-	1,799	8,431
Deposits with non residents banks	-	2,863	3,012	1,992	2,308	10,175
Securities available for sale	-	53,275	73,151	7,038	-	133,464
Other assets	335	209	7	-	-	551
Other gold & precious metals	50	-	-	-	-	50
Transit credits	-	57	150	-	-	207
Securities available for sale	66,821	-	-	-	-	66,821
Investments held to maturity	1,725	-	-	-	-	1,725
Other assets	2,520	2	1	-	-	2,523
<b>Total assets</b>	<b>78,083</b>	<b>56,406</b>	<b>76,321</b>	<b>9,030</b>	<b>4,815</b>	<b>224,655</b>
<b>Liabilities</b>						
Due to the IMF	6,632	-	-	-	9,513	16,145
Due to non-resident financial institutions	28	57	1,234	-	-	1,319
Currency in circulation	153,550	-	-	-	-	153,550
Due to resident banks	30,377	5,897	8,908	-	-	45,182
Due to the Government	4,547	646	1,162	1	-	6,356
Deferred income	129	-	-	-	-	129
Other liabilities	746	11	4	-	-	761
<b>Total Liabilities, capital and reserves</b>	<b>196,009</b>	<b>6,611</b>	<b>11,308</b>	<b>1</b>	<b>9,513</b>	<b>223,442</b>
<b>Net currency position as at December 31, 2005</b>	<b>(117,926)</b>	<b>49,795</b>	<b>65,013</b>	<b>9,029</b>	<b>(4,698)</b>	<b>1,213</b>
<b>Net currency position as at December 31, 2004</b>	<b>(106,440)</b>	<b>47,130</b>	<b>50,066</b>	<b>5,586</b>	<b>1,409</b>	<b>(2,249)</b>







