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FINANCIAL STABILITY REPORT 2008

Bank of Albania

2008

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C O N T E N T S

T A B L E S

C H A R T S

FOREWORD

This is the second issue of the Financial Stability Report, published by the Bank of Albania on a yearly basis. The purpose of this Report is to detect and assess the risks the financial system and its infrastructure are faced with, in order to provide the public authorities the opportunity to identify the relevant measures for the necessary corrections. For the compilation of this Report we have used data available at the Bank of Albania, and information has been exchanged with other authorities supervising the activity of the financial market. The Report has also made use of information and analysis of public and private international financial institutions.

In order for this Report to have a wide and diverse audience, the language used and the information presented in it is aimed to be as clear and appropriate as possible. The improved quality of the Financial Stability Report, in particular in terms of the data it contains, will be our objective for the future issues of this Report.

The financial system stability has been assessed based on the performance and risks arising from its interaction with the overall internal and external economic environment, and from its activity. In order to evaluate the risks arising from its interaction with the surrounding environment, we have analyzed the latest developments in the international financial markets and developed and regional economies. We have also assessed their impact over the Albanian financial system and the banking sector. Among the domestic indicators, the present Report makes an assessment of the overall developments and expectations for the economic growth, trade balance, overall price level, exchange rate and fiscal indicators. It also provides an analysis of employment, personal income and its impact over the banking sector's borrower's solvency.

In order to assess the risks arising from the financial system's activity, the present Report also provides an analysis of the developments in its main financial soundness' indicators, namely the capital, assets' quality and financial performance. The magnitude of risks has been assessed through the stress test analysis. The Report also makes a brief assessment of the situation in non-bank financial sector.

The data and analysis mainly cover the developments over the course of the year 2008 and the first quarter of 2009. The expectations for future developments mainly cover the period until the year-end 2009.

1 SUMMARY

The financial crisis worsened significantly during the second half of 2008. A number of banks and important financial institutions in the U.S. went bankrupt while others were able to survive thanks to interventions from public authorities with liquidity assistance. The financial market response was very strong after these events, especially following the decision of the U.S. government to allow Lehman Brothers to go bankrupt, considering its active role in the global markets of mortgage-backed securities and derivatives. Financial markets and their institutions were clinched by the panic and the crisis that initially spread rapidly into the European markets, where some banks almost went bankrupt, and later it spread around the world. Interbank transactions in advanced economies decreased notably, focusing their transactions mainly on shorter term instruments, while the financing cost increased drastically. U.S. mortgage-backed securities continued to depreciate worsening banks' losses on their balance sheets. Markets for particular financial instruments vanished completely. Investors' and public confidence in banks and financial institutions were shaken on a global level, which led to the overall decrease of banks' stock price, tightening their financing abilities notably. According to the International Monetary Fund, indices of the largest stock markets, during October 2008 alone, decreased by 25 percent. In order to swiftly address the public loss of confidence in banks, the U.S. and European Union public authorities increased the amount of insured deposit for a limited time.

The financial sector crisis spread swiftly to the real sector of the economy as well. As a result of the non-functioning markets, the amount available for funding diminished and the financing cost increased, causing a decline in investment and trade, which hit domestic demand and induced significant economic slowdown on a global level. Unemployment increased in all developed countries, due to the enterprises' attempt to lower production costs in response to the shrinking demand. Most developed economies entered an economic recession phase in the second half of 2008, while the economic growth slowdown swept across the developing countries as well. According to the IMF[1], the world's annual gross domestic product declined to 3.4 percent in 2008 from 5.2 percent in 2007. The world trading volume of goods and services increased by only 4.1 percent in 2008, from 7.2 percent in 2007. Economic growth in developed countries declined to 1 percent in 2008 from 2.7 percent in the year 2007. The developing countries were not affected by the financial crisis initially, given their little integration with the global financial markets and low exposure to those financial instruments that were in the centre of the crisis. The further deepening of the crisis in the second half of the year and its implications on the real economy allowed the crisis to be transmitted to developing countries through financial and trading channels. As result, the economic growth of these countries declined to 6.1 percent in 2008, compared to 8.3 percent in 2007.

Under the financial crisis effects, the foreign exchange markets and energy and raw material markets were characterized by high levels of volatility. In the first six months, the U.S. dollar lost ground against the major currencies, especially against the Euro, reflecting investors' pessimistic expectations of the U.S. economy. Oil and raw material prices continued the upward trend that started in 2007, raising the inflationary pressures worldwide. The situation marked a turning point in the opposite direction during the period August-September 2008, when the U.S. dollar gained ground against the Euro as a result of the increasing investors' demand for the U.S. government debt securities, which are perceived to be low risk securities in a crisis situation. The lower demand from advanced economies and the slowdown of world economic activity affected the decline in demand for raw materials and food products, bringing moderated pressures for price hikes. Average annual growth of consumer prices in advanced economies and developing countries resulted in 3.5 and 9.4 percent, respectively, in 2008.

In response to the difficult situation created in 2008, public authorities in many countries formulated their own rescue plans. These plans generally included financial assistance to banks, the preservation of incentives for continued crediting from the banking sector to small and medium-sized enterprises as well as the insurance of public's savings in banks. The worsening and deepening of the financial crisis in the second half of the year required harmonizing actions on a global level, as well as strengthening of the role of international financial institutions such as the International Monetary Fund and the World Bank.

Through several meetings in the last quarter of 2008, most developed countries committed themselves to act according to some general principles which aimed at the commitment of these countries and international financial institutions to strengthening transparency, accountability and regulatory framework of financial markets, reinforcing international cooperation for the reforming and strengthening of the international financial institutions' financial resources and to increasing the resilience to actions that cause the closure of national economies to markets. In more concrete terms, the authorities of these countries were committed to ensuring appropriate liquidity conditions for financial institutions, relieving the tightened terms for funding banks, providing capital to support the financial institutions so that they maintain funding for the economy, efficiently recapitalizing banks that had problems, allowing the flexibility in interpretation of accounting rules in terms of market situation of emergency and the strengthening of cooperation procedures among countries.

These measures have played an important role in setting a limit on the loss of public confidence in their banks as well as maintaining the confidence among banks. In general, these measures have given the financial markets a "breather" to continue their actions, although the volumes and prices are still far from those of normal conditions. Given the history of past global crises, confidence in the financial markets and the return of lending to prior-crisis levels is expected to recover after some time. Moreover, the spread of the crisis to the real economy shows that most countries may continue to experience economic contractions and the recovery of the world economy to a sustainable growth can not occur within the near future. This scenario is also confirmed by the IMF's periodic evaluations.

On a global level, the financial system and banks will face difficulties during the year 2009. The financial result is expected to be weak, while demand for capital will be stable. In fact, these two indicators are expected to be so in the medium term, despite a partial improvement of banking activity in the short term. Factors associated with the lending activity decline and difficulties in the real sector of the economy, the durability of financing costs in the interbank market, the loss of assets' value, the increase of contingency funds as a result of the deteriorating assets' quality, etc, will contribute to the decline of the financial result. On the other hand, banks and other financial institutions can benefit from the stable liquidity conditions, increasing returns from trading activities of various financial products, the lower costs as a result of size reduction and synergy created from the mergers etc. However, the unstable income situation and the deterioration of assets' quality will adversely affect banks' capital adequacy levels and may further fuel their public capitalization schemes of operations.

In our country, the impact of the international crisis has increased due to its alteration into a real economic crisis of global proportions. Initially, the international financial crisis did not have a significant direct impact on the Albanian financial system, owing to the general lack of exposure of the banking sector and the financial system to products and financial institutions that were at the core of the crisis, as well as the low exposure to borrowing from the foreign markets. However, in the last quarter of 2008, due to the psychological impact caused by the deterioration of the international market crisis, the public pulled a portion of their deposits from the banking sector. As a consequence, there was a rising need for liquidity and a declining lending from the banking sector. The Bank of Albania took immediate measures to normalize the situation and restore public confidence in banks, by injecting liquidity in the market in different forms, as well as expanding opportunities for banks to access it[2]. These actions gave a positive effect to interbank activities in lowering the volatility level and the interest rates at the end of the year. As the financial crisis turned into a global economic crisis, its impact was materialized in our country in the form of financial resource limitation and increased cost of financing, for both the public and private sector, shrinking remittances and declining exports, increasing depreciating pressures on the domestic currency exchange rate against its major counterparts and a negative impact on future expectations of economic agents with respect to the financial welfare. The performance of these short-term effects in the near future will strongly depend on the capacity of economic public and private agents to adapt to these conditions, on the ability of the financial system to maintain sustainable growth rates in the financial intermediation process, as well as on the developments of external risk factors.

The banking and the financial system activity have increased at lower rates during 2008. The level of financial intermediation in Albania, computed as a ratio of the financial sector[3] assets to the GDP[4], has grown to 82 percent at the end of 2008, versus 79.4 percent at the end of 2007. Banks play a key role in the assets structure of the financial system. At the end of 2008, 16 banks operated in our country and their assets accounted for approximately 95.4 percent of total assets in the financial system and about 78 percent of the GDP. During the year 2008, activity in the banking sector continued to increase. Expressed in terms to total assets in the system, it amounted to ALL 843.1 billion, or 12.4 percent higher than the previous year. However, the performance of activity has followed a different dynamic this year. Total assets changed due to deposits withdrawal in the last quarter, which compared with the third quarter decreased by 2.7 percent. Lending activity, which accounted for about 48 percent of assets in December 2008, albeit upward since 2003, weakened especially in the last quarter of the year. The loan portfolio, accounting for about 37 percent of GDP, amounted to ALL 396.8[5] billion. Compared to the same period the previous year, this surplus attests to an increase of ALL 104.3 billion, or about 36 percent. The loan portfolio quality has deteriorated. Despite their upward share to total balance, foreign currency assets and liabilities of the banking sector attested to a balanced foreign currency exposure, reflected by their similar sizes. The financial result of the banking sector during the year 2008 was positive but lower than in 2007. Liquidity and capital indicators of the banking sector assess comfortable levels, despite the reduction of the financial results, the deposits' volatility and the deteriorated loan portfolio quality.

1.1 RISK SENSITIVITY ASSESSMENT OF THE BANKING SECTOR

The financial system stability, especially for the banking sector, is defined in terms of relations with the internal and external financial and economic developments, and of their interaction with the internal situation in the financial system. *Based on the development analysis of 2008 and the first months of 2009, general evaluations indicate that the level of risk for the financial system and the banking sector has increased. The main sources of risk are mainly linked to macroeconomic performance developments and some banking activity indicators, which require careful monitoring.*

More specifically:

1. *The sensitivity of the financial system and the banking sector to domestic macroeconomic developments has increased.* The main risks to the stability of the financial system and the banking sector relate to:

a. *The significant economic growth slowdown.* During 2008, the country's economic growth was stable and in line with expectations, backed by rising public spending and the banking sector momentum of high volume financing. However, the developments of the last quarter of 2008 and the first months of 2009 indicate that economic growth for the year 2009, although expected to be positive, will be lower.

The rationale behind the economic growth slowdown relates to the declining domestic demand, due to the lower revenues of domestic economic agents that interact with international markets, restrained expansionary fiscal policy and the significant reduction of funding from the Albanian banking sector. Preliminary estimates of the IMF evaluate an economic growth between 0 and 1 percent. For this reason, opportunities for activity expansion of the financial system will be more restrained and its financial results will be lower during 2009.

b. *The difficult financial situation of the real economy.* Expectations for economic slowdown have deteriorated the financial restraints for enterprises and households. Enterprises are facing less and more expensive financial resources. Internal resources for activity expansion in the form of income from main activity will be adversely affected by the decline of investment and sales. External sources of funding in form of borrowing from the banking sector are also falling sharply. Various surveys on the situation of the business sector in general confirm increasing financial restraints and the lack of optimism for the short-term developments. The difficulties of enterprises will adversely impact their ability to provide sustainable jobs hence leading to the decline of household income. The financial system and banking sector in particular will feel these unfavourable developments mainly in the form of deteriorating loan portfolio quality and public deposits' growth slowdown.

c. *Restrained expansionary fiscal policy.* The budget deficit increase in 2008 compared with the previous year represented an expansionary fiscal policy that backed the domestic economic growth. Deficit financing was conducted in more favourable conditions, domestically and externally. The expected economic slowdown and the financial constraints the real economy is going through will put public revenue under pressure, hence hindering their actualization according to the 2009 budget plan. On the other hand, the financing cost of the budget deficit increases as we face more liquidity constraints in the domestic and foreign financial markets, increasing the financial burden in the medium term. The actualization of the projected public expenditure is a desirable objective in a situation of economic slowdown. However, in the Albanian case, if no other sufficient alternative sources of income is found, the adaptation of public expenditure according to the level of actual income and the preservation of the budget deficit objective, would better serve to the implementation of lower cost financing and funds release for domestic market and private sector use.

d. *The resistance of the balance of payments' current account deficit.* Due to the instability of exports and declining remittances, the current account deficit in the trade balance shows to be unstable. If this trend strengthens, it could affect the structure of foreign currency flows in the domestic market, impacting the demand and supply with foreign currency, thus increasing the exchange rate volatility of the national currency. The flexible exchange rate offers an automatic correction tool for these imbalances in the demand and supply with foreign currency in the domestic market. Against this background, all economic agents should assess their sustainability and sensitivity to possible unfavourable shifts in the exchange rate, and take necessary protective actions. In turn, the banking sector is sensitive to exchange rate movements, particularly in terms of the impact on the quality of loan portfolio in foreign currency. Therefore, the course of the exchange rate for the first months of 2009 should promote all the required actions of the banking sector in order to reduce undesired effects on the financial situation.

2. *The sensitivity of the banking sector and the financial system to developments in the international markets has decreased.* Against this background, it is determined that:

e. *Public policies for the protection of European banking groups have reduced the uncertainty over their legal and financial abilities to provide assistance with investments in our country.* In fact, the packages of financial assistance, approved in Austria, Greece, Italy, France and other countries and the powerful liquidity injections by the European Central Bank have eased the difficulties of major European banks to ensure liquidity and to refinance their obligations in the market. The positive stock price performance of these banks' trading in the stock exchange, especially during the first months of 2009, attest to the improvement of the situation. In order for the European banking sector to substantially improve its financial situation, and to regain its full capacity to perform firmly its financial intermediation function, stimulating public policies, being accompanied by the necessary actions to clear the banks' balance sheets from unhealthy investment need to be considered. In practical terms, improving the financial situation of European banking groups means that now it is easier for them to meet the demands of their subsidiaries for credit lines or capital funding, providing an important contribution to the intermediating role of the banking subsidiaries of these groups in the countries where they operate. In the case of Albania, the banking sector benefited from the higher volume of this funding and injection of capital in the last quarter of 2008 and the first months of 2009. The improved financial situation for the European banking sector would further consolidate in the event the economic growth recovers. From this perspective, there would be higher guarantees for the progress of the Albanian banking sector.

f. *Although the economic and financial situation in Central and South-East European countries appears to be still unstable, the financial aid from the International Monetary Fund and the European Commission, have provided important support for the alleviation of negative expectations.* In the end of 2008, some of the countries in the region faced a complex financial situation, which emerged in the short-term with the deterioration of the current account deficit, a strong under priced exchange rate, high interest rates, increased credit default possibilities, etc.., which brought in turn a strong economic contraction and deterioration of public finances. Accordingly, the IMF and the European Commission offered to some of these countries, dozens of billions of Euros as financial assistance. In virtue of this arrangement, the under pricing pressures on the exchange rate were softened and interest rates fell to levels which stimulated the monetary circulation. Although the worsening rates have slowed, the situation in some of these countries is still unstable. However, actions that mitigate investors' uncertainty to developments in these countries, improve the perception of our country, in terms of relative similarities that exist, at least with the countries of our region.

g. *More signs are indicating a slow down of the global economic deterioration.* The economies of developed countries and the largest developing countries show some optimistic signals. In the financial world, in addition to improving shares' value of the financial institutions in the stock markets thanks to the improvement of their financial results, there is a general value increase of the stock market indices compared to last year. Simultaneously, in the U.S. and some EU countries, the indicators that evaluate the businesses' financial situation show a deterioration slowdown or a slight improvement, indicating that the financing opportunities of the economy are gradually improving. In terms of general economic developments, business and consumer confidence indices have shown signs of improvement, although they will be unstable as long as unemployment continues to increase. On the other hand, public finances are facing high costs. For the time being, it is still unclear how stable these developments will be and how quickly they will be translated into a resurgence of economic development. However, the perception of an improved global economic climate will positively affect economic actors in the domestic market, not only economically but also through the creation of optimistic expectations, supporting their return to normal relations with the banking sector.

3. *There is higher sensitivity of the financial system and the banking sector to the performance of some banking activity indicators.* Against this background, it is determined that:

h. *Prudent management of the banking sector liquidity demands is required.* Specifically, in order to cope with the decline of deposits in the last quarter of 2008, commercial banks reduced their liquid assets portfolio, and increased their borrowing from their parent banking groups and the Bank of Albania. The share of customers' deposits to financing banking activity incurred a decline, though it remains at high levels. This process should be monitored prudently so as to identify how stable it will be in time and to avoid significant shifts towards wholesale borrowing, particularly in foreign currency. When sources of foreign currency funding rely on foreign markets, the banking sector is more protected since the financing lines in foreign currency originate from the parent banking groups. This factor significantly lowers the debt renewal risk at the time of maturity. However, in the foreign markets, banks are currently making efforts to reduce the wholesale borrowing process and to increase customers' deposits, which are considered a much more stable source of funding. The Bank of Albania provides a stable source of funding in a particular situation for the banking sector and helps to improve the monetary policy transmission mechanism. This aspect is particularly important for banks that are not part of foreign banking groups. Simultaneously, the Bank of Albania allows commercial banks to develop policies that support financial activity in the national currency. From this point of view, the securities' portfolio management plays an important role as collateral for large amounts of borrowing. For such monetary transactions denominated in the Albanian Lek, commercial banks utilize government debt securities, such as treasury bills and bonds. Banks should establish and administer a special portfolio of these securities to use in case of unexpected liquidity needs. The actions for the further development of the secondary securities' market would be a supportive factor in this regard. Thus, to ensure that banks will apply more conservative policies in managing their liquidity risk, the Bank of Albania is preparing a special regulation that will require banks to improve their capacities in terms of forecasting the liquidity needs, as well as to establish more direct and close ratios between sources of financing and banks' investment, with regard to type of currency, changing of the maturity term, creation of specific collateral portfolios etc.

i. *The loan portfolio quality has entered a downward trend phase.* The constraints in the real sector of the economy, economic growth slowdown and the strong credit crunch due to the volatile liquidity situation in the recent months, has brought increasing volume of non-performing loans, regardless of the type of currency, purpose of use and user. The increasing number of non-performing loans has prompted tight lending procedures, shrinking the lending volumes and shortening loans' maturity term. Moreover, banks' provisions to cope with potential loan losses have increased, which has contributed to the decline of the banking sector financial result. The banking sector has to confront this situation, aiming at maintaining a stable financial intermediation activity, a very important function for the development of economy and the financial sector situation. For this reason, time is ripe for the banking sector to give priority to lending in domestic currency rather than in foreign, making better use of the greater opportunities that customer deposits and borrowing from the Bank of Albania offer. Therefore, the banking sector should pursue more appropriate credit price setting policies, in order to spur demand for loans in domestic currency.

j. *The banking sector is sensitive to exchange rate behaviour, particularly* *in terms of the impact it has on the quality of loan portfolio.* Foreign currency loans dominate the total loan portfolio of the banking sector. The rationale behind its growth associates with the balance sheet structure of the banking sector, lower interest rates compared to ALL denominated loans, as well as the perception that historic trends of the exchange rate for ALL will persist in the future. It is understandable that the under pricing of ALL in great value and in a short period of time, for those borrowers who do not have their income in foreign currency, leads to higher value of the ALL instalments for foreign currency loans. In return, this might cause loan payment delays that would classify these loans as non-performing. From this perspective, the public and the banks themselves as powerful players in the foreign exchange market would prefer to have a stable exchange rate. However, in this case, the best solution would be provided by implementing balanced lending policies targeting the increase of the share of ALL loans. In terms of foreign currency balance position, the banking sector continues to prefer to maintain a small net open position, limiting the magnitude of possible losses significantly.

k. *The financial result of the banking sector for the year 2009 will continue the decline that began in 2008.* In fact, this is a result of the declining operating income, due to the lower volume of activities with high return and the rising operating costs, particularly the increase in provisions to cope with potential loan losses. The declining net financial result implies that the banking sector will have less internal sources to support the operations and increase the capital. Banks that might experience a financial loss will have their funds reduced. Though the financial results' decline is not expected to have a significant impact on the capital values, banks must cautiously monitor the capital activity indicators, and increase the capital if necessary.

4. *The sustainability risk of the underlying infrastructure, such as the payment systems, has remained unchanged and at low levels for the financial system and particularly the banking sector.* Against this background, it is determined that:

l. *The payment systems that are managed by the Bank of Albania have operated in an optimal way.* This is confirmed by the stable growth of the number and volume of payments in 2008, which is expected to continue in 2009. For the normal functioning and oversight of payment systems, for large and small amounts, the Bank of Albania has positioned the necessary human, financial and technological resources, as well as worked to improve the regulatory framework that enhances efficiency and safety of the payment systems. In addition, the needs for the improvement of procedures and technological infrastructure, against a background of increasing volume of transactions, will be regularly assessed in order to support the normal functioning of these systems in the future.

In general, the ability of the financial system and particularly the banking sector to act in a sustainable manner and to be protected from the abovementioned risks will largely depend on the duration, the magnitude and the systemic value a certain unfavourable development manifests.

Based on the financial indicators of the banking sector, as well as assessing their volatility according to stress test analysis, the sustainability of the banking sector to the abovementioned risks is assessed as being good.

Box 1 IMF's forecasts

International Monetary Fund, in its "World Economic Outlook – Crisis and Recovery" of April 2009, states that world output for the year 2009 is projected to decline by 1.3 percent. Advanced economies will shrink by about 3.8 percent (for the first time since World War II), while the emerging and developing economies will grow by only 1.6 percent. Under the influence of measures to facilitate financing and the support of monetary and fiscal incentive policies, the world economy is projected to gradually remerge in 2010, when economic growth is expected to be about 2 percent. Despite significant fiscal stimulus (including the additional package of 787 billion dollars approved by President Obama administration), the U.S. economy is expected to shrink by 2.8 percent in 2009 and it is not expected to have a significant increase in 2010. Annual growth rate of consumer prices will be temporarily negative during the year 2009. Public finances will worsen, following a vast increase of the budget deficit to 12.3 percent of GDP for 2009.

For the Euro area countries, the IMF's expectations are even weaker. The economy of this region will shrink by 4.2 percent in 2009 and will grow only 0.4 percent in 2010. The economic situation will not be favourable for the countries in our region as well. According to January 2009 Interim Forecast of the European Commission, the Italian economy is expected to shrink by 2 percent in 2009 and recover growth in 2010. The projections are more optimistic for Greece, although the positive economic growth for the year 2009 is expected to be very low. Both these countries will experience an increase in the unemployment rate close to the average level of the Euro area in 2009. For the Central and East European countries, the IMF's expectations are for a contraction of the economy by 3.7 percent in 2009 and a growing economy of 0.8 percent in 2010. According to January 2009 Interim Forecast of the European Commission, unemployment in the European Union will increase significantly during this period (with an additional 3.2 million of unemployed people), and the unemployment rate will rise to 8.75 percent in 2009 (9.25 percent in the Euro area), and will continue to grow in 2010. According to the European Commission, the public finances will be severely hit in 2009. In the EU countries, the primary deficit is anticipated to rise to 4.5 percent of GDP (from 2 percent in 2008). Forecasts for public finances are negative for 2010. Inflationary pressures in the European Union are expected to be weak during 2009, due to the low demand for energy and raw materials. Annual consumer prices' growth rate for the Euro area and the European Union is expected to be 1 percent in 2009, and about 2 percent in 2010.

Table 1 GDP and inflation in 2007-2008 and projections for 2009-2010

	GDP Growth		Projection		Average Annual Inflation		Projection	
	2007	2008	2009	2010	2007	2008	2009	2010
Global Economy	5.2	3.2	-1.3	1.9	3.9	5.9	2.5	2.4
Advanced economy	2.7	0.9	-3.8	0.0	2.2	3.4	-0.2	0.3
United States	2.0	1.1	-2.8	0.0	2.9	3.8	-0.9	-0.1
Japan	2.4	-0.6	-6.2	0.5	0.0	1.4	-1.0	-0.6
Euro area	2.7	0.9	-4.2	-0.4	2.1	3.3	0.4	0.6
United Kingdom	3.0	0.7	-4.1	-0.4	2.3	3.6	1.5	0.8
Emerging and developing countries	8.3	6.1	1.6	4.0	6.4	9.3	5.7	4.7
Central and Eastern Europe	5.4	2.9	-3.7	0.8	6.1	8.0	4.6	4.2
China	13.0	9.0	6.5	7.5	4.8	5.9	0.1	0.7
India	9.3	7.3	4.5	5.6	6.4	8.3	6.3	4.0
Brazil	5.7	5.1	-1.3	2.2	3.6	5.7	4.8	4.0
Mexico	3.3	1.3	-3.7	1.0	4.0	5.1	4.8	3.4

*Source: *IMF (World Economic Outlook-January, World Economic Outlook – Crisis and Recovery, April 2009), IMF database*

2 GLOBAL DEVELOPMENTS

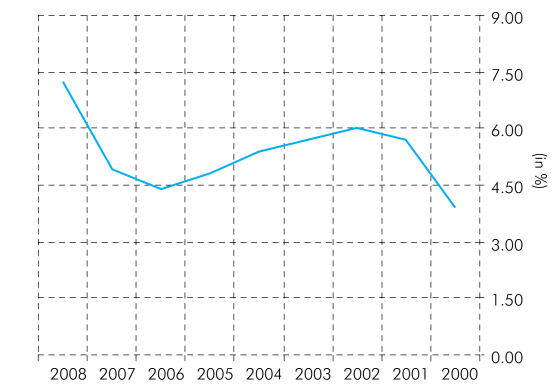
2.1 GENERAL GLOBAL ECONOMIC DEVELOPMENTS

During the year 2008, the international financial crisis swept through the global economy. The effects of this crisis appeared in the form of marked economic growth slowdown, trade volume decrease, lower non-financial products prices, higher financing constraints for enterprises and households, higher unemployment and worsened expectations for the economic welfare in the short term. Advanced economies were hit the most by the effects of the crisis, given their markets' high integration. But their ability to undertake measures in order to come out of crisis is stronger in comparison to the developing countries. In general, developing countries have amortized the crisis effects on global economy performance, due to their lower level of integration with the international financial markets, higher economic growth rates, different savings and consumption patterns from the public and private sector etc. However, developing countries appear more fragile in terms of ability to take the necessary actions to come out of the crisis, given the fiscal and monetary constraints and their unbalanced economic development.

In the United States, the financial and real sector indicators deteriorated during the year 2008, reflecting further deepening of the financial crisis and the transmission of the effects to the real sectors of the economy. Annual economic growth dropped to 1.1 per cent in 2008 versus 2.2 percent in the year 2007. Despite substantial monetary and fiscal incentives taken by public authorities, the IMF expects that the U.S. economy will continue to shrink during the year 2009 to 2.8 percent and begin to recover gradually only during the year 2010. The U.S. trade deficit has reduced by 6 percent in 2008 as a result of lower domestic consumption and investment. This consequence of the global crisis has a positive impact in the medium-term, in terms of improving the risk factors that prior the crisis originated from the unsustainable macroeconomic development balances. According to UN forecasts, the same trend will be also maintained in 2009.

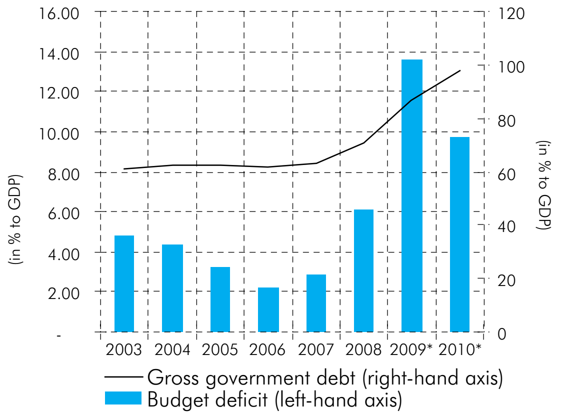
The high level of integration between the financial and non-financial corporate sector in the U.S. caused the crisis effects that swept across the financial system to quickly be transmitted to the business sector through the financing channels. The provision of new capital in the internal markets became harder and costly for the corporate sector, leading to a series of failures and to a general decline of activity in this sector. Many businesses found themselves forced to reduce their costs through cutting jobs, which shrank the labour market and increased the number of unemployed persons in the country. According to U.S. Bureau of Labor Statistics, in the end of 2008 the unemployment rate in U.S. resulted 7.2 percent compared to 4.6 percent in the end of 2007. For the year 2009, the financial situation of U.S. corporations will continue to be very difficult and failures are expected to be high in this sector. On the other hand, the U.S. households' financial situation deteriorated further during the year 2008 due to the continued decline of their financial and non-financial assets' value[6], rising unemployment, contraction

Chart 1 U.S. unemployment rate



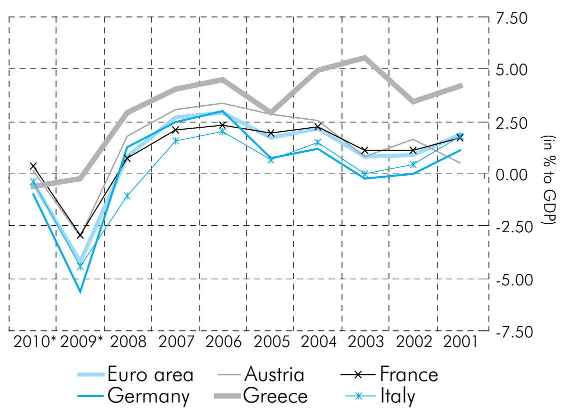
Source: U.S. Bureau of Labor Statistics

Chart 2 U.S. fiscal deficit and government debt (gross) for 2001-2008 and forecast for 2009-2010



Source: IMF – database (World Economic Outlook – Crisis and Recovery, April 2009)

Chart 3 Annual real GDP growth rate in some Euro area countries for 2001-2008 and forecast for 2009-2010



Source: IMF – database (World Economic Outlook – Crisis and Recovery, April 2009)

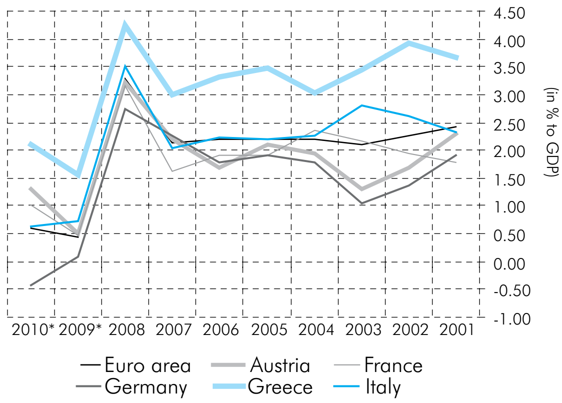
of consumer loans from banks given the tightening of lending conditions etc. All these, combined with a high degree of uncertainty for the future, have stimulated a significant drop of the private sector consumption, bringing about the decline of demand for imports.

In order to avoid a deeper contraction of the U.S. economy, the Federal Reserve and the U.S. government took a number of financial and fiscal measures[7]. The Federal Reserve pursued an expansionary monetary policy by reducing the key interest rate starting from October. On the other hand, the U.S. government actions aimed the acquisition of subprime assets from banks, increasing their capital and maintaining the credit flows in the economy. As a result of these measures, the U.S. budget deficit has grown to 6.1 percent in 2008, compared with 2.9 percent in 2007. The increase of domestic and foreign borrowing to finance this deficit has significant implications for the global financial stability, due to the size of U.S. debt securities' portfolio owned by foreigners, the future dynamics of the value they offer, as well as to the impact on other financial market segments.

For the same reasons, the economic situation in the EU was also significantly conditioned by the deteriorating financial sector situation. The rapid extension of the financial crisis to the real economy was mostly affected by the macroeconomic characteristics of the member countries and by the degree of impact of the banking and financial sector. In general terms, the economic activity of EU countries slowed significantly and many countries officially entered a phase of economic slowdown (recession) in the last quarter of 2008. According to Eurostat, the economic growth of EU and Euro area countries in the third quarter of 2008 was 0.8 and 0.7 percent, respectively, while in the fourth quarter it recorded -1.1 percent and -1.2 percent[8]. Great Britain, Italy and Spain and some new member states of European Union like Hungary and Latvia experienced the largest contraction of the economy in 2008. The weakening of economic activity in Europe is expected to deepen further during the year 2009, where almost all the Euro area countries are expected to experience economic recession. According to the IMF, the

Euro area economic growth will be -2.8 percent in 2009 and it may slightly recover in 2010 with 0.2 percent. The economic contraction in Europe waned the inflationary pressures significantly in the second half of 2008 leading the inflation rate to mark 1.6 percent in the end of year (from 4 percent six months before). The inflation rate is expected to further decrease during the present year and some developed countries risk to experience a period of negative growth of consumer prices (deflation).

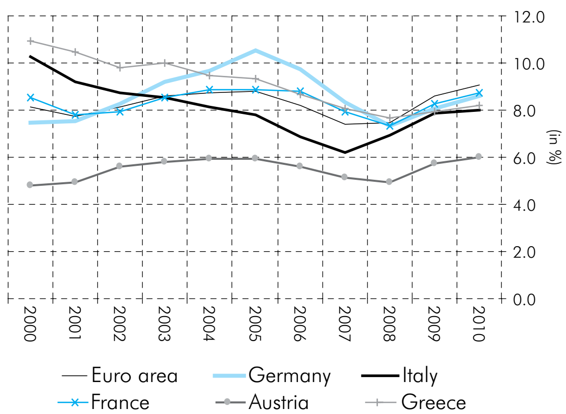
Chart 4 Average annual inflation in some Euro area countries for 2001-2008 and forecast for 2009-2010



Source: IMF – database (World Economic Outlook – Crisis and Recovery, April 2009)

The GDP growth slowdown in the EU countries has reflected the fall of domestic demand as a result of the lower household consumption (ascertained in the end of the year 2007), the fall of business investment (ascertained from the second quarter of the year 2008) and the decline of exports as a result of the weakened external demand. The general credit crunch that swept across the financial markets in the second half of the year deepened the negative pressures over the European non-financial corporations (especially in those operating in the U.S.), mainly in the last quarter of the year. The three main factors that led to the European non-financial corporate sector damage and which continue to represent a source of risk for the following year are: *first*, the continued and rapid decline of corporate profits during the year 2008[9], which led to falling stock prices and higher constraints to increasing the capital; *second,* the high level of debt in this sector, which increased the exposure to negative macroeconomic developments; and *third,* the increase of borrowing rates combined with the reduction of credit supply from banks, which hindered the provision of new financing, increased the business cost significantly and put their existence in serious difficulty. The consequence of this situation was the worsening of the labour market conditions and the increase in the number of unemployed persons. According to OECD, the average unemployment rate in Euro area countries for the year 2008 resulted 7.4 percent, but within the year it has increased by relatively rapid rates to later reach 8.1 percent in December. For the following periods, the situation in the Euro area labour market is expected to deteriorate further and the average unemployment rate is expected to reach 8.6 percent in 2009 and 9.0 percent in 2010.

Chart 5 Unemployment rate in some Euro area countries



Source: OECD Economic Outlook database

The tightening of lending conditions, the reduction of "wealth effect" due to the lower house prices and financial assets, the increased uncertainty and the job cuts, as well as the pessimistic expectations for the future brought about the contraction of European households' consumer spending and lower borrowing. In its Financial Stability Report for the second half of 2008, the ECB expects the abovementioned indicators to worsen over the course of the following year, decreasing the consumption level further.

The deterioration of business and household sector financial situation in the Euro area represents a source of risk for the financial stability in this region, as it is directly linked to their solvency and it impacts consumption and investment.

Regarding the Baltic and Central and Southeast European countries, since the year 2000 they have generally experienced stable economic growth and financial stability due to the structural reforms induced by the integration process, the increase of cash flows in the form of direct and indirect portfolio investment, the increase of productivity and strengthening of competitive position in foreign trade, the stable exchange rate, the increase of income and the fiscal consolidation. In the financial sector, these countries had incurred a significant transformation, shown by the increasing investment of powerful financial institutions, mainly in the Euro area countries. As a result, in some countries as Sweden, Austria, Greece and Italy, the exposure to the Baltic and Central and Southeast European countries in the form of banking sector lending is considerable[10]. This process was impelled by the priorities these countries offered: higher economic growth, higher banking intermediation opportunities especially in terms of lending, closeness and satisfactory integration with the developed financial centres etc. In some of these countries, the deposits' growth was insufficient to cope with the rapid growth of loans; therefore the lending process was backed by other financing sources, mainly through borrowing from the financial markets. The financing facility in international markets, for both the private and public sector, has stimulated the growth of aggregate demand beyond the economic growth rate and has led to the deterioration of the balance of payments and fiscal one for some of these countries. For this reason, this situation made them particularly sensitive to the sustainability of international financial markets.

The international financial crisis altered this fragile balance. The tightening of financial conditions in the international markets hindered the borrowing from the foreign banks and public institutions to refinance their short-term debts. At the same time, the declining raw material and energy prices led to lower inflows and imbalances in the fragile foreign currency position, which brought about the deterioration of the fiscal situation. Short-term and speculative portfolio investors began to withdraw from these countries' financial assets. The pressure over the exchange rate of domestic currencies was highly increased. For this reason, an increasing number of these countries were oriented towards the European Union and International Monetary Fund structures, seeking and providing substantial financial assistance to support the budget and the balance of payments.

These countries are already facing the significant price increase that must be paid to cover the risk of the government debt default, while the access of private sector to domestic and foreign borrowing is significantly limited. In addition, the banking and financial sectors are facing significant deterioration in terms of assets' quality and financial result and lower intermediation capacities owing to the liquidity shortages and the contracted lending to the economy.

All the above factors are expected to affect the economic development in the medium term. Forecasts for the economic growth in 2009 for the Baltic, Central and Southeast European Union member states indicate an economic contraction to 2.9 percent. Other countries in this region are expected to experience a significant fall in the economic growth rates. They are expected to face a more competitive environment to attract the necessary capital inflows. The excessive government debt supply of developed countries, which will overrun in the market in the next two years, will absorb money that otherwise would have been used in the markets, like those of this region. The insufficiency of foreign financing will extend the adaptation phase of the economies of these countries, delaying their stable economic recovery.

Box 2 Exposure of some Western European countries to Eastern European banks

Table 2 Exposure of Western European banking sectors to Central and East European countries, as at 30 September 2008

	Austria	Germany	Italy	France	Belgium	Netherlands	Sweden
TOTAL EXPOSURE							
In USD billions	277.6	219.9	219.6	155.1	136.7	122.2	106.5
As a share of GDP	74.8	6.6	10.4	6.0	30.1	15.7	23.4
EXPOSURE BY COUNTRIES (in USD billions)							
Romania	43.7	4.1	13.4	16.5	1.2	10.7	0.2
Hungary	36.9	35.1	27.0	10.1	17.9	6.1	0.3
Ukraine	14.3	4.8	4.9	10.1	0.8	3.7	5.7
Latvia	0.5	5.0	1.3	0.3	0.0	0.0	23.0
Lithuania	0.3	3.5	0.6	0.4	0.1	0.1	27.4
Estonia	0.3	1.0	0.4	0.1	0.1	0.0	29.9

Source: BIS, IMF, Reuters

Greek banks' exposure to South-eastern Europe.

National Bank of Greece, Alpha Bank, Piraeus Bank and Eurobank are present in Bulgaria, Romania, Serbia, Albania, Turkey, Poland and Ukraine. The total exposure of Greek banks to Central and Southeast European countries is estimated to be around EUR 55 billion or about 22 percent of GDP. Around 14 percent of total loan portfolio has been granted to Southeast European countries.

2.2 INTERNATIONAL FINANCIAL MARKETS' DEVELOPMENTS

During 2008, international financial markets were characterized by negative developments that caused a general loss of confidence from the public and investors, and severely damaged their normal activity. Financial institutions experienced a decrease in the value of their assets and losses of their financing sources. After the end of the financial year 2007, the losses of banks and other financial institutions from assets based on U.S. subprime mortgages were very large and persistently growing, while these assets were constantly losing market value. This generated a situation of panic resulting in a tightening of credit conditions and a pronounced lack of liquidity throughout 2008. Against this background, the financial markets' activity, especially in the U.S. and Europe, had serious difficulties.

2.2.1 MAIN DEVELOPMENTS IN THE MONEY MARKETS

The crisis of confidence that swept the financial markets during 2008 caused a pronounced lack of liquidity in the financial markets, depleted the banks' financing sources and had an exceptional impact on banks that relied on (wholesale) money markets for obtaining their financing. The fast downgrade of their credit ratings, the losses due to on-balance sheet assets write-downs and the appearance of huge off-balance sheet liabilities increased the risk awareness among counterparties and determined a higher degree of cautiousness in the lending activity of banks and other investors. As a consequence, financial institutions started to accumulate and preserve liquidity, seriously damaging the interbank market activity and causing the increase of interbank lending interest rates. The collapse of Lehman Brothers toughened the effects of the loss of confidence and extended them to other financial market segments, such as private and public debt securities, of medium and long-term maturities. The activity of the markets that trade instruments linked to the subprime mortgage products and their derivatives almost completely froze. The segment of commercial papers, which represent tradable commitments to pay back uncollateralized loans of companies and financial institutions, as well as bonds issued by banks, also experienced serious difficulties in the money markets, especially after September 2008. The uncertainty related to these institutions' exposure to the crisis effects and the tightening of the lending conditions, increased the risk faced by the investors in this market segment. The investors' reluctance was followed by the tightening of the financial requirements for the participation in investments (premiums) and by the liquidity depletion. The lack of funds and the increase of their cost raised difficulties in the financial intermediation markets, in different currencies. European banks, for example, were having great difficulties to finance their positions in U.S. dollars. Against this background, many financial institutions were facing a hard time repaying their short-term liabilities. In order to facilitate the situation, central banks of the most developed countries approved some programmes[11] that encompassed concrete actions aiming at injecting liquidity into the market, through the signing of repo agreements of extended maturities, the diversification of types and maturities of securities that served as collateral, the use of some special financing programmes for certain categories of debt securities and the pursuing of an easy monetary policy. Moreover, they understood the importance of a harmonized, deep and globally extended action, aiming at injecting short-term liquidity and provide medium-term liquidity to the banking sector.

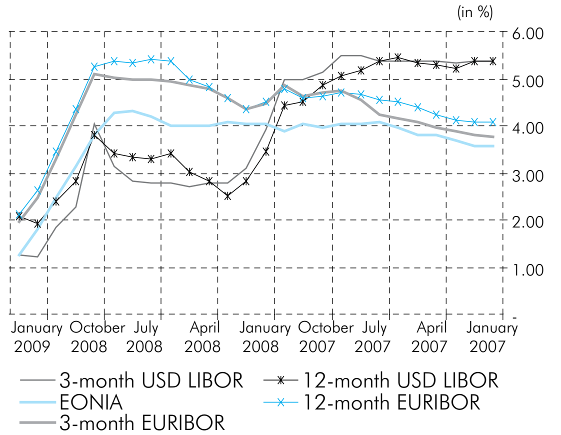
The central banks' actions avoided the further deterioration of the situation and gradually eased the financing conditions in the interbank markets, reducing the interest rates' volatility and causing their decline toward more acceptable levels (see Chart 6).

2.2.2 MAIN DEVELOPMENTS IN CAPITAL MARKETS

The deterioration of the financial markets' developments in the third and last quarter of 2008 and the reflection of the crisis in the real economy oriented the financial investments toward lower risk assets. This triggered a massive shift of capital to government debt securities' markets, especially to the U.S., perceived as the safest assets. The rapid growth of demand for the government debt, influenced also by the significant cuts of the key interest rates in U.S. and Europe, brought about the increase of their value and the significant lowering of the investment rate of return (see Chart 7). On the other hand, because of this investors' attitude, the spread between the return on investment in corporate debt and that in government debt, which represents an indicator of credit risk, increased significantly throughout 2008, especially in the segment of lower rated debt instruments.

In the European markets, the investors' perception of the increased credit risk appeared initially in the financial institutions' debt. Given the spread and the deepening of the crisis in the last quarter of 2008 and the pessimistic forecasts of the performance of the world economy, the perception of an increased credit risk extended also to non-financial corporates, as shown by the higher price of the Loans Default Swaps[12]. Their persistent increase, both in the U.S. and the European markets, especially after the Lehman Brothers collapse, reflected the growing concerns of investors about the likely failure of the institutions that had issued the debt insured by the CDS contracts. In the Euro area, as of end November 2008, the price of the CDS surged to a record high of the last 10 years (see Chart 8). The biggest crunch was created in the structured financial products' markets, as those of ABS[13] and CDO[14], and especially in the segment of securities, whose underlying were mortgage loans. In the U.S. markets, the progressive lowering of the real estate prices, which served as collateral for the loans that

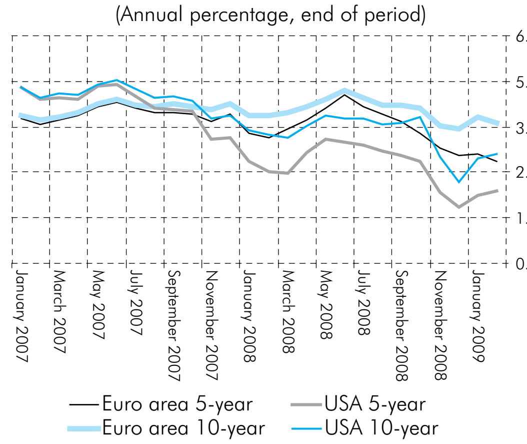
Chart 6 Performance of some money market interest rates (January 2007- February 2009)



Source: ECB and British Bankers' Association data

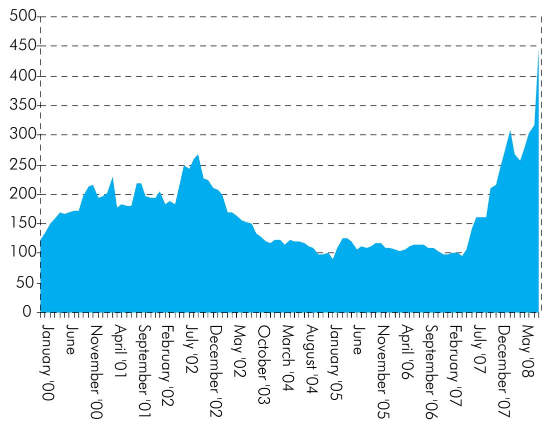
Chart 7 Government securities' yields in the Euro area and U.S. (January 2007 - February 2009)

(Annual percentage, end of period)



Source: The official websites of the European Central Bank and the Federal Reserve, April 2009

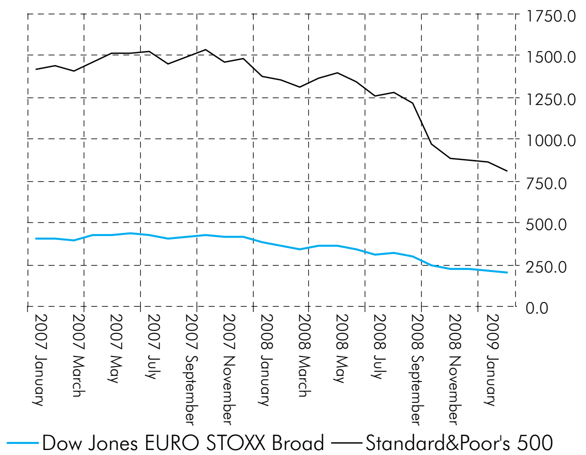
Chart 8 Spread of Merrill Lynch Global Corporate Bond Index (January 2000 – March 2009)



Source: IMF – Global Financial Stability Report, April 2008 were packaged in these instruments, and the uncertainty related to their risk evaluation, caused a very fast decrease of their demand and a reduction of their issuing to almost nothing, especially related to the higher risk tranches.

The actions of governments and central banks[15] in the U.S., European Union and other countries around the world, aimed at changing the risk perception in the financial market and restoring the investors' confidence. In U.S., the government plan allowed the Treasury to purchase the problematic assets of the financial institutions. Both in the U.S. and Euro area, the central banks' programs for the injection of liquidity allowed the use as collateral of those securities that relied on an income flow from lower risk assets. These measures influenced the change of perception about the risk of banks and financial institutions, leading to the decrease in the price of the CDS. Nevertheless, the CDS price for the big banking groups remained relatively high, reflecting the uncertainty that dominated the markets related to the implementation of these programs and to their influence on the financial situation of the abovementioned institutions.

Chart 9 Performance of main stock exchange indices (January 2007 - January 2009)



Source: European Central Bank

In 2008, the capital markets of financial and non-financial industries entered a deep correction period. The significant decrease of the financial institutions' income, the tightening of financing conditions and the investors' sell-off as the perception of the bankruptcy risk increased, brought a significant downfall of the major indices all over the world, especially in the U.S. and the Euro area. Even though the shares of the financial institutions suffered the major decline during the first half of 2008, the pessimistic expectations of the investors regarding the global economy performance and the deterioration of the business situation, extended the falling trend of the U.S. and European stock market prices to other non-financial sectors as well.

The financial crisis escalation in the second half of 2008, when many financial institutions and corporates announced their failure, deteriorated the stock markets' situation further. At the end of 2008, the stock prices had fallen to much lower values than those expected in the first half of the year. The Price/Earnings ratios of companies, which are generally an indicator of the shares' performance in the subsequent 12 months, showed that the share prices in the main stock markets had reported the greatest reduction[16] ever since the 1980s. The lack of financing and its significance for the very existence of the corporate sector induced the public authorities to include the easing of the lending terms in their packages of financial aid. The public authorities' measures encouraged stability in the main global stock exchange indices, however their volatility remains significant, as the investors' uncertainty of the companies' financial situation is still persistent. This is not expected to change in the short term as long as the recovery of the global economy will continue to be slow.

2.2.3 MAIN DEVELOPMENTS IN DEVELOPING COUNTRIES' FINANCIAL MARKETS

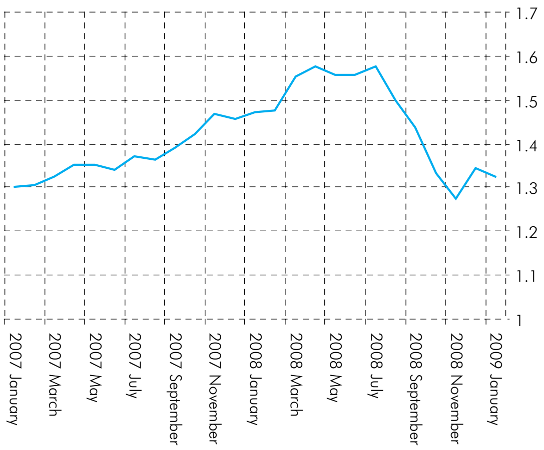
The financial markets of developing countries, which were relatively resilient during the first stage of the financial crisis, were faced with some important challenges in the second half of 2008. At the beginning, the persistent inflationary pressures in these countries and later, the fall of energy and commodity prices, which are important sources for their exports, put their public finances under pressure. The significant decrease of the global demand because of the economic slowdown in developed countries and the further deepening of the financial crisis in the form of lending conditions' tightening, heightened the uncertainty of foreign investors and led to lower investment. As a result, in May to November 2008, the main stock exchange indices of developing countries experienced a significant fall. According to the IMF, in October to November 2008, the stock markets in developing countries lost approximately 1/3 of their value in local currency and nearly 40 percent of their value in USD. The gap between the rate of return from the investment in the government debt of these countries and that of U.S. government debt securities, estimated by the Global Emerging Markets Bond Index, widened by more than 4 percentage points. The tendency of investors to reduce the emerging markets securities' portfolios increased the volatility in the foreign exchange markets, inducing the public authorities of these countries to sell their forex reserves in order to support their local currency, as was the case with some of the Central and Southeast European countries and in Russia, Brazil, Mexico and South Korea. The financial markets' performance of developing countries in 2008 attested to their vulnerability to the developments in the real and financial markets of developed countries and confirmed the fact that their interdependence was actually greater than expected at the beginning of the financial crisis.

The public authorities of the largest emerging markets have also taken some financial and reforming measures in order to fuel domestic demand and to support economic growth. Among these countries, we could mention China, Brazil, Russia and India. In China, these measures were announced in November and included mainly projects for the preservation of public welfare, investment in infrastructure, protection of environment and renewal of technology for a total amount of USD 585 billion. The public authorities of these countries believe these measures will restore a sustainable economic growth in 2010.

2.2.4 MAIN DEVELOPMENTS IN FOREIGN EXCHANGE AND RAW MATERIAL MARKETS

The high level of uncertainty that characterized the financial and economic developments during 2008 is significantly reflected in the performance of the foreign exchange and raw material markets. The financial crisis escalation in the U.S. deteriorated the expectations on the performance of the U.S. economy

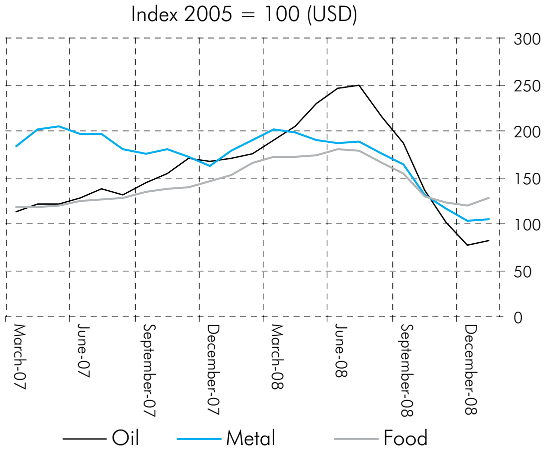
Chart 10 EUR/USD exchange rate (January 2007 – January 2009)



Source: ECB website

Chart 11 Performance of main raw material prices' indices

Index 2005 = 100 (USD)



Source: International Monetary Fund

and, at the beginning, reduced the demand for financial assets in U.S. dollars, especially for the private debt. This tendency reduced the demand for U.S. dollars further and deepened the depreciation of the U.S. currency vis-à-vis its major counterparts, in particular the Euro. In the first half of 2008, the value of Euro went from USD 1.47 in January to USD 1.57 in July. This tendency reverted in the second half of 2008 as the crisis spread in Europe and all over the world, causing a shift of global savings toward the U.S. Treasuries, which are considered the lowest risk securities. This situation caused a considerable increase of the demand for the U.S. dollar and, consequently, its significant appreciation vis-à-vis the other currencies (see Chart 10). The strained situation of the financial markets has augmented the uncertainty that generally characterizes the foreign exchange markets. For the foreseeable future, nevertheless, the markets are expected to favour the investment in the assets of the countries that will emerge from this crisis with the most stable macroeconomic indicators.

Raw material and energy prices increased during the first half of 2008, maintaining the trend that had started in 2000 as a result of the strong global economic development against a background of abundant liquidity and low interest rates. In mid-2008, the oil price reached USD 145 per barrel, almost five times higher than in early 2000. The increase owes to the growth of the overall demand for energy, especially from the large emerging countries, such as China, India, etc., and to the uncertainty about the future sufficiency of the oil supply. Food prices continued to rise dramatically until the mid-2008. In 2000 to mid-2008, global food prices increased by around 150 percent[17] (see Chart 11). This was partially a consequence of the increase in per capita income and to the higher food consumption in emerging countries, and partially lower supply. This tendency brought about a very difficult situation for countries with lower per capita income, which experienced a strenuous food situation in 2007 to the first half of 2008. Metal and raw material prices also experienced a significant rise until mid-2008, maintaining the trend that had started in 2007. Beyond the specific factors of each raw material category and the shifts in the supply-demand equilibrium in the various markets, a portion of the general price rise of the last two years owes to the beginning of the crisis in the financial markets. The large losses from the financial assets write-downs and the uncertainty that swept the financial markets stimulated the reallocation of the investors' funds toward the commodity market; hence increasing the latter's prices.

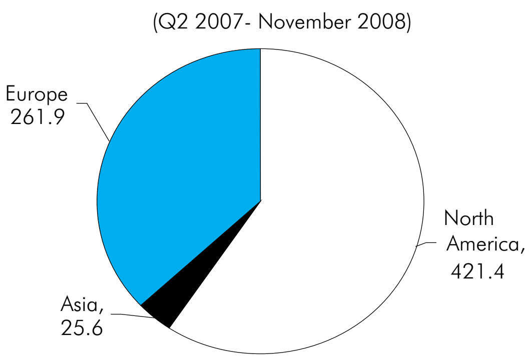
In the second half of 2008, the significant fall of demand in developed countries and the downturn of global economy altered the performance of raw material prices entirely. Despite the measures taken by OPEC to lower the production and the geopolitical tensions in the oil and its by-products producer countries, in November 2008 oil prices fell by nearly 60 percent compared to their highest level of mid-2008. Because of the general slump of global demand, metal and food prices also fell dramatically in the second half of 2008, providing a negative impact over the economic performance of their exporting countries the most. For the year 2009, the weak performance of the global economic activity and the further decline in demand from developed and developing countries is expected to maintain the oil and raw material prices at much lower levels compared to the first half of 2008. Nevertheless, the global economy recovery in the medium term will be followed by the growth of demand for these products and by higher market price. The positive side is the incentive it provides for the development of alternative sources of energy, which should balance supply and demand for the energy products in the long run.

2.3 BANKING SECTOR

The year 2008 was extraordinary in terms of economic and financial events and of their impact over the banking activity. The abundant and low priced liquidity that persisted for several years against a background of improved inflation rate check, higher financial and non-financial assets' value and enhanced competition as profit rates were going down, provided wrong incentives in the banking industry regarding the recognition and evaluation of risk in the main areas of activity and in given financial instruments. This situation promoted the rapid growth of high risk trading assets in exchange for the long-term profitability of investments. Due to the decline in the rate of return and against a background of relentlessly looking for higher income, banks in developed countries, especially in the U.S. deepened the innovation process of some financial products further. These financial products mainly related to the tradability of the loan portfolio through its refinancing with securities issued for investors who were looking for certain features of investment risk and return. The increasing complexity of these financial innovations led to uncertainties in the risk evaluation of the main product, i.e. the loan, from the managing structures of financial institutions, from their shareholders, investors and supervisors. At the same time, the financing was being conducted in the financial markets and the banks were relying progressively less on financing through household deposits, thus increasing the instability of the financing sources. The high degree of financial markets integration, particularly among the developed countries, allowed the fast spread of this model. The public authorities were not able to consider and act in a timely manner in order to prevent this tendency. Their main focus was more on a national level and on the specific developments of individual institutions. Moreover there was a lack or insufficient regulation of the financial institutions acting as banks and for given financial products and there were insufficient sources and approaches on a national level. The increase of interest rates triggered by the inflationary pressures in mid-2006 in the U.S. set the deterioration of the mortgage loan portfolio in motion. Until that moment, it had been characterized by loose lending conditions by the banks and financial institutions as well as by an excessive household borrowing[18]. Since July 2007, the deepening of losses and banks' failure to refinance their positions in the financial markets because of the investors' reluctance brought about the loss of liquidity in these markets. The lack of refinancing stimulated the tightening of lending and the decrease of demand for non-financial assets, such as houses, cars, etc. The loan portfolio deteriorated further, while households and individuals lost the "wealth effect". These developments put the entire process into a worsening spiral, which was also fuelled by the financial assets write-downs as the mark-to-market accounting rule was applied. Against this background, many large and complex banking groups (LCBG) suffered significant losses in their balance sheets because of the constant market devaluation of their assets. The deterioration in the money and capital markets impaired their ability to raise new capital to cope with the losses and support the future activity. Given these circumstances, they addressed to the Wealth Funds of the respective states or to their governments in order to get financing. Consequently, their liquidity problem transformed into an impairment of their ability to survive financially and legally.

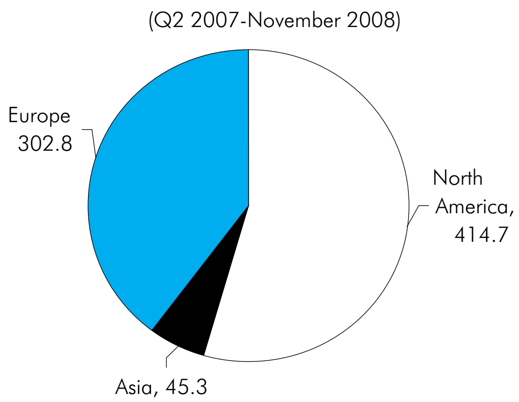
It is estimated that North American banks, followed by European banks and less by the Asian ones, have suffered the greatest losses[19] and, at the same time, have increased their capital the most in July 2007 to November 2008 (see Charts 12 and 13).

Chart 12 Banks' losses from assets write-downs (in USD billion)



Source: European Central Bank – Financial Stability Review, December 2008

Chart 13 Banks' capital increase (in USD billion)

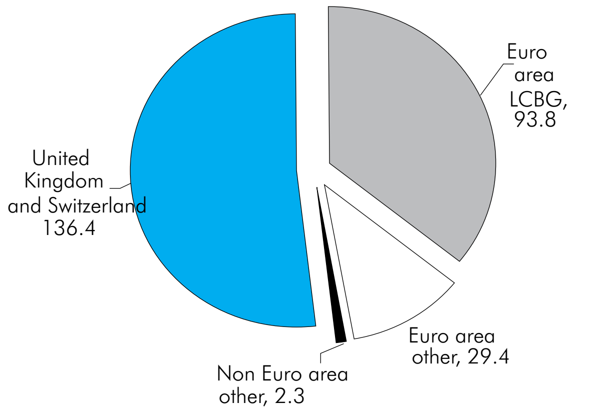


Source: European Central Bank – Financial Stability Review, December 2008

As a result of financial losses, the rate of return on the capital of the LCBG has progressively decreased. The average ROE for the LCBG of the Euro area fell from 12.6 percent in 2007 to -1.2 percent in the third quarter of 2008. Total amount of losses in Europe during this period reached nearly USD 262 billion, out of which 52 percent belonged to the British and Swiss banks (see Charts 14 and 15).

Chart 14 European banks' losses from assets write-downs (in USD billion)

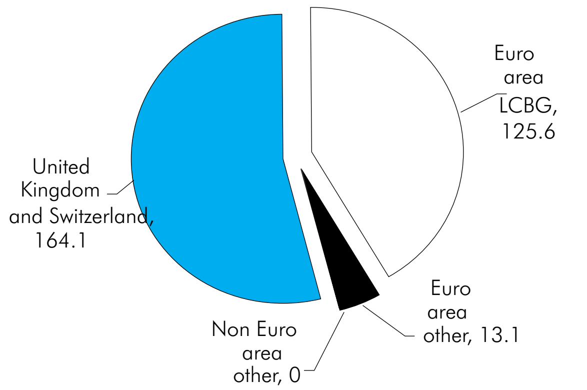
(Q2 2007-November 2008)



Source: European Central Bank – Financial Stability Review, December 2008

Chart 15 European banks' capital increase (in USD billion)

(Q2 2007- November 2008)



Source: European Central Bank – Financial Stability Review, December 2008

The failure process arising from the financial crisis began in July 2008 in the U.S., when the authorities decided to shut IndyMac Bank down. As the financing facilities did not seem to produce the expected effect, in September the U.S. authorities took over the two main financial institutions, Fannie Mae and Freddie Mac. The situation threatened to get out of control when one of the largest U.S. investment banks, Lehman Brothers, asked the government for help in order to cover the extraordinary financial losses arising from the exposure to subprime products and the impossibility to refinance its obligations. After unsuccessful negotiations with the U.S. authorities and other banks, aiming at finding a new buyer, Lehman Brothers, whose debt amounted to USD 613 billion, declared bankruptcy. In September, however, the U.S. authorities stimulated the agreement for the takeover of another investment bank, Merrill Lynch, by Bank of America for nearly USD 50 billion; induced the change of ownership of some other problematic banks and offered emergency lending to the AIG insurance company. At the end of September, the Federal Reserve approved the request of the two remaining investment banks to convert to bank holding companies, a status subject to more regulation, but with readier access to its emergency loan programme. In addition, Washington Mutual Bank was closed after its banking operations were bought by JP Morgan Chase.

In Europe also, some reputable banks and financial institutions, such as Dexia, Fortis and Hypo Real Estate, were in need of an immediate capital injection that was completed by the governments of France, Belgium, Luxembourg, Netherlands and Germany. In Great Britain, the authorities allowed the consolidation of non-bank financial sector, specialized in the mortgage lending, and stimulated the merger of Lloyds TSB and HBOS. The authorities also helped Bradford & Bingley, taking over a part of its operations before it broke-up.

Because of these events, banks had to face the decline of the savings' value and the shortening of their maturity terms as the public confidence in the banking sector was faltering.

At the end of 2008, the measures taken by the public authorities of developed countries[20], in an increasingly harmonised manner, reduced the systemic risk and helped in stabilizing the situation. These measures aimed at assisting with liquidity and recapitalizing the banking sector, guaranteeing their debt in the financial markets and increasing the deposit guarantees. They were also important for the developing countries as they minimized the bankruptcy risk of the banking groups in developed countries, which have expanded their investment to the banking sector of the developing countries.

As a result of the measures taken by the public authorities, the liquidity conditions, especially in the interbank market of developed countries, and the conditions of the short-term segment of the private debt securities' market improved significantly. Nevertheless, the problematic assets remaining in the banks' balance sheet and the uncertainty for the economic recovery velocity will continue to exert pressures over banks' financial results in the medium run.

Box 3 Measures taken by the international public authorities in the autumn of 2008

In the monetary area, the central banks of developed countries deepened the liberalization process of the liquidity injection in the respective markets through successive actions. For this purpose, there was a change in the instruments, the range of the participant financial institutions and that of collaterals accepted was expanded and the lending maturity was extended. Against this background, in order to meet the USD liquidity demands of the global financial markets, at the end of September, the Federal Reserve increased the swap authorization limits with other central banks, such as Bank of Japan, Bank of Canada, Reserve Bank of Australia, Bank of England, European Central Bank, Bank of Sweden, National Bank of Denmark, Bank of Norway and Swiss National Bank to USD 620 billion. At the end of October, the Fed set up a USD 15 billion swap line with the Reserve Bank of New Zealand, and another one of USD 30 billion with the central banks of Brazil, Mexico, South Korea and Singapore. At the same time, the central banks aimed at giving the economy a longer term stimulus, through a loose monetary policy, as the expectations for a significant slowdown dampened the inflationary pressures. Thus, in October the Fed cut its benchmark interest rate to 1 percent. Half of this reduction occurred on October 8, in a harmonised action with other central banks, including the ECB. In December, the Fed cut its benchmark interest rate again to a range of zero to 0.25 percent. The ECB decided to conduct a special term refinancing operation, in which the counterparties would be able to borrow any amount. Moreover, on October 8, the ECB cut the benchmark interest rate by 0.5 percent to 3.75 percent. Two other reductions (a total of 1.25 percent) were completed on November 12 and December 10. At the end of 2008, the ECB's *benchmark interest rate stood at 2.5 percent. During this period, other central banks reduced their key interest rates, such as Bank of England, Bank of Canada, Bank of Sweden, Swiss National Bank, etc.*

In the fiscal area, the actions taken by the governments of developed countries were extraordinary. At the beginning of October, the U.S. Congress enacted into law the Emergency Economic Stabilization Act, which authorized the creation of a USD 700 billion fund to purchase distressed assets and make capital injections into banks. As a result, until the end of December, the U.S. Government expanded the purchase of preferred stock of several banks, for an amount of USD 112 billion. At the same time, the U.S. Government and the Federal Reserve approved the request of the change in status, made by reputable financial institutions, including insurance companies, in order to gain access to the emergency fund. The use of this fund from the deposit-taking institutions or bank-holding companies was accompanied by some conditions that changed their decision making entirely.

In Europe, the taking of similar measures required more time, given the EU institutions' need to take harmonized actions. On October 12, the leaders of the Euro area member states and the ECB participated in a summit, in order to draw up a joint action plan. In the summit's official statement, the leaders supported the measures taken until then, in terms of supporting the systemically important financial institutions and preventing their bankruptcy, and ensuring full disclosure of the exposure to toxic assets, as well as improving the existing schemes of deposit insurance. To this purpose, the European Union decided to increase the minimum bank deposit guarantees to EUR 50,000.

At the same time, the authorities expressed their commitment to take coordinated actions, in a decided and adequate manner, in order to restore confidence in the normal functioning of the financial system, aiming at setting appropriate financing terms for the economy. More specifically, they stressed that they would take measures aiming at: a) ensuring appropriate liquidity conditions for the financial institutions; b) easing the tightened lending conditions for the banks; c) providing capital resources to financial institutions so that they could continue to lend to the economy; d) efficiently recapitalizing the distressed banks; e) flexibly interpreting the accounting rules in a context of extraordinary markets' circumstances; and f) enhancing the cooperation procedures among European countries.

Following these principles and directives, on November 26, the European Commission announced the European Economic Recovery Plan, whose purpose was to: a) take short-term measures to boost demand, save jobs and help restore confidence in the financial system; and b) efficiently invest to preserve economic growth and sustainable prosperity in the longer-term. This plan offered a fiscal stimulus for a total amount of EUR 200 billion or 1.5 percent of EU GDP that had to be timely offered, targeted and temporary. Prior to this plan, some countries such as Great Britain, Germany, Sweden, Portugal, Netherlands, France, Italy, Greece (EUR 28 billion), Finland, Spain, Austria (EUR 100 billion) and Slovenia had individually prepared their national plans to support the financial sector and ease the lending conditions, in compliance with the State Aid Rules of the European Commission. The packages of these countries were similar and almost all of them contained some temporary actions that included: the creation of a fund for the banks' capitalization, guarantees for the new debt of the local banks as well as some conditions for the management and activity's orientation for the banks that would make use of this fund. The ease of lending conditions called for the creation of special programs to support the financing (larger amounts, lower interest rates, collaterals etc.) of businesses in important sectors, especially of small and medium-sized enterprises that before the autumn of 2008 had been in a sound financial situation.

The harmonization of the actions was also achieved on a global level. To this purpose, the measures for facing the financial crisis were part of the G20 meeting discussions (the member countries represent 80 percent of the world economy), which took place on November 15, 2008. In this meeting, the leaders of these countries, in the presence of the leaders of European Union, UN, IMF, World Bank and Financial Stability Forum, reached an agreement on some core principles that aimed at reforming the financial markets in order to ensure that a similar global crisis would not happen again in the future. The principles expressed the commitment of these countries and of the international institutions to enhance transparency, accountability and the regulative framework of the financial markets. At the same time, these principles aimed at enhancing the international cooperation, reforming and strengthening of the financing sources of the international financial institutions as well as increasing the resilience to actions that cause the local economies to close to the markets.

*Box 4 The financial results of foreign banking groups present in the Albanian banking sector for the year 2008**

**Source: Annual reports published in the websites of the respective banks.*

1. RAIFFEISEN INTERNATIONAL (AUSTRIA)
Raiffeisen International Bank-Holding AG, member of the RZB Group, achieved a consolidated profit of EUR 982 million for 2008, up by 16.7 percent y-o-y. Provisions were raised by 119 percent compared to the previous year, reaching EUR 780 million. Their increase was far above the growth of business volume and the main reason was the decreasing creditworthiness of borrowers and the resulting lower internal and external ratings.

The consolidated profit for the last quarter of 2008 was EUR 120.5 million, down by 44 percent from the same period the previous year.

Pre-tax profit reached EUR 1 429 million (+16 percent). Due to the high provisions, this growth was lower than that of gross income. The rationale behind was the significant slowdown of the economic activity in the Central and Eastern Europe, which manifested its negative impact over the profits only in the last quarter of 2008.

The cost/income ratio stood at 54 percent, down by 3.6 percentage points, which reflects higher efficiency. The core capital ratio (Tier 1) was at 8.1 percent (-2.4 percentage points).

The return on equity after tax declined by 3.6 percentage points to 16.6 percent. The earnings per share (EPS) stood at EUR 6.39 (+10.2 percent) and the proposed dividend EUR 0.93 per share.

Total assets grew by 17.4 percent, reaching EUR 85.4 billion at the end of 2008. The customer deposits totalled EUR 44.2 billion, up by 9.3 percent from the end of the previous year, and the loans increased by 18.5 percent to EUR 57.9 billion.

The number of customers increased by 1 million totalling 14.7 million. Former Soviet Republics provided the main contribution to the group's results (40 percent of the group's gross income), followed by South-eastern Europe (33 percent) and Central Europe (27 percent).

As of end 2008, Raiffeisen Albania accounted for 2.38 percent of total assets of Raiffeisen International.

2. INTESA SANPAOLO (ITALY)
The 2008 consolidated net income (excluding the non-recurring items) was EUR 3.9 billion, down by 10.6 percent compared to the previous year.

Cost/income ratio increased by around 6 percentage points to 54.7 percent, reflecting an efficiency decrease compared to the end of 2007. The return on equity after tax was 5.2 percent or down by 14 percentage points from the previous year, showing again an efficiency decrease in the Group's activity. Net interest income rose to EUR 11 630 million, a 12.2 percent increase compared with the figure of 2007. The EPS stood at EUR 0.2 or 0.6 percent lower than the previous year. In order to strengthen the Group's capitalization (Tier 1 ratio reached 7.1 percent), the Management Board proposed not to pay dividends for 2008.

Net provisions totalled EUR 2 061 million (compared to EUR 811 million as of end of 2007 and EUR 970 million as of end the third quarter of 2008). The Group had a net risk exposure to structured loans products with underlying US subprime of EUR 29 million as at 31 December 2008.

As of end 2008, total assets increased by 5.1 percent, reaching EUR 636.1 billion. Loans to customers increased by 12 percent to EUR 395.19 billion, while customer deposits increased by 10 percent to EUR 430.9 billion. The net non-performing loans/total loans ratio remained broadly unchanged at 1%.

The Supervisory Board approved the Management Board resolution for the issue of EUR 4 billion of subordinated debt to be subscribed by the Ministry for Economy and Finance as part of the aid package of the Italian government in order to strengthen the bank's capital and to expand the lending activity.

Retail operations in Italy account for 74 percent of revenues. The exposure to Central and Eastern Europe is limited and well-diversified, with customer loans in the region accounting for only 7 percent of the Group's total loan book and customer deposits well-balanced against customer loans.

As of end 2008, Intesa Sanpaolo Bank Albania accounted for around 0.1 percent of total assets of Intesa Sanpaolo group.

3. PIRAEUS BANK (GREECE)
As of end 2008, the net profit of Piraeus Bank amounted to EUR 315 million (compared to EUR 503 million the previous year). The main reason for this significant increase is the additional provisions of EUR 215 million (in addition to the initially estimated EUR 173 million). Thus, at the end of 2008, the Group reported total provisions of EUR 388 million or up by EUR 272 million from the previous year. Net interest income increased by 26 percent y-o-y to EUR 1.16 billion and net commercial banking commissions increased by 30 percent to EUR 200 million. These two components account for 82 percent of total net revenues. Net interest margin remained at 3 percent.

Loans to deposits ratio stood at 112 percent (improved from 121 percent at the *end of 2007), after two new loan securitizations of EUR 2.5 billion and the Group's participation in the government support measures that injected EUR 750 million.*

The group's total assets increased by EUR 8.5 billion to EUR 55 billion in 2008. Non-performing loans stood at 1.9 percent with provisions coverage ratio at 96 percent. Return on Equity stood at 11 percent (down from 24 percent in 2007) and Return on Assets at 0.7 percent (down from 1.4 percent in the previous year).

Lending increased by 27 percent in Greece and by 42 percent in the subsidiaries abroad. Tier 1 ratio was at 8 percent and will increase to 8.9 percent after the completion of the capital injection within the framework of government support programme. Piraeus will issue preferred shares in exchange for a EUR 370 million capital increase.

As of end 2008, Tirana Bank, the Albanian branch of Piraeus, accounted for 1.20 percent of the total assets of Piraeus Group.

4. ALPHA BANK (GREECE)

Alpha Bank reported a net income of EUR 512 million for 2008 or 33.5 percent lower than in the previous year.

During 2008, Alpha Bank channelled EUR 5.2 billion of loans to the Greek economy and EUR 3.6 billion to the South-Eastern European Countries (SEE). Despite the difficult conditions, new loans amounted to EUR 1.4 billion in the last quarter. During 2008, EUR 7.9 billion were new deposits, causing total deposits to amount to EUR 42.5 billion. Total assets reached EUR 65.3 billion or 19.4 percent higher than the previous year.

Net interest income reached EUR 1.8 billion, up by 12 percent, translating into a resilient net interest margin of 3 percent (3.1 percent in 2007). Cost/income ratio stood at 50.2 percent.

Alpha Bank will participate in the government support scheme by utilising EUR 4.6 billion in terms of liquidity and EUR 940 million in preference shares. Tier 1 ratio stood at 8.3 percent.

As of end 2008, the branch of Alpha Bank in Albania accounted for 0.9 percent of total assets of the Alpha Group and for 8.5 percent of total assets of the Albanian banking sector.

5. SOCIÉTÉ GÉNÉRALE (FRANCE)

Société Générale reported a net income of around EUR 2 billion for the year 2008, more than the double of the previous year. Net banking income fell by 3.9 percent in 2008 to EUR 21.9 billion. The rise in operating expenses (+6.2 percent vs. 2007) reflects the ongoing investment associated with the group's organic growth in businesses and regions with potential and enhancements to its risk control infrastructure. As a result, Société Générale's cost/income ratio was 71 percent in 2008.

At the end of 2008, the international retail banking of Société Générale had a loan to deposit ratio of 102 percent. During 2008, the deposits of this part of the group increased by 6.6 percent and the loans by 25.7 percent. The net income of the international retail banking was EUR 608 million for 2008.

The return on equity stood at 6.4 percent, increasing by 2.8 percentage points relative to the previous year.

Total assets at the end of 2008 stood at EUR 1 130 billion, increasing by 5.4 percent relative to the previous year.

As of end 2008, Banka Popullore accounted for 0.03 percent of total assets of the Société Générale group.

6. NATIONAL BANK OF GREECE (GREECE)
The National Bank of Greece net income fell by 5 percent relative to the previous year, standing at EUR 1.5 billion. The high provisions and the slow-down of lending activity affected the bank's profit negatively.

Return on Equity stood at 26.2 percent, increasing by 0.1 percentage points relative to the end of 2007. The cost/income ratio reflected an increase in efficiency, falling by 4.4 percentage points to 46.6 percent. Net income from the SEE branches increased by 28 percent to EUR 202 million, accounting for 13 percent of the Group's profit.

Non-performing loans ratio stood at 3.3 percent or 0.1 percentage points lower than at the end of the previous year. As a result of an adverse environment, due to the global financial crisis, the Group increased its provisions by 57 percent (to EUR 520 million for the year as a whole, and EUR 228 million for the last quarter alone).

Total Group lending in 2008 amounted to EUR 66.1 billion (compared with EUR 56.3 billion in 2007), up by 18 percent y-o-y, confirming the Group's support to the economic growth of Greece and the regional countries.

At the end of 2008, NBG's total assets amounted to EUR 101 billion (+12 percent). Loan-to-deposit ratio stood at 95 percent (+5 percentage points).

The Tier 1 ratio stood at 10.4 percent (+1.2 percentage points).

As of end 2008, the NBG branch in Albania accounted for 0.44 percent of total assets of NBG Group.

7. CREDIT AGRICOLE (FRANCE)
Credit Agricole Group reported a net income of EUR 1 billion for the year 2008 and a loss of EUR 309 million for the last quarter. Net banking income stood at nearly EUR 16 billion, 4.8 percent lower relative to the previous year. The operating expenses fell by 0.7 percent, reaching EUR 12.6 billion. Risk-related costs had a significant increase (66.8 percent), totalling EUR 3.2 billion. This increase reflects the deterioration of the global financial conditions. The risk-related costs were particularly high in international retail banking (EUR 880 million), especially at Emporiki, which reinforced its provisions significantly.

At the end of 2008, Tier 1 ratio stood at 9.1 percent and the Credit Agricole's capital at EUR 83 billion. Risk-weighted assets amounted to EUR 338.5 billion, a decline of EUR 6.6 billion from 31 December 2007, due to the transition to Basle II.

Non-performing loans accounted for 3.1 percent of gross amounts, of which 69.7 percent were covered by provisions.

As of end 2008, Emporiki Bank in Albania accounted for 0.01 percent of total assets of the Credit Agricole Group.

8. EMPORIKI BANK (GREECE)

Emporiki Bank is part of the French banking group Credit Agricole. Emporiki Bank reported a net loss of EUR 491.8 million for the year 2008 against a profit of EUR 73.4 million for the year 2007.

Emporiki Bank maintained a high level of commercial activity over the course of 2008, in a context of progressive slowdown of the economy. The loan portfolio increased in all segments with an average y-o-y growth of 21 percent to EUR 24 billion on December 31, 2008. Bank deposits increased by 1.2 percent y-o-y to nearly EUR 17.8 billion.

The net banking income (EUR 757 million, down by 20 percent relative to the previous year) has been adversely affected by reduced margins in the Greek market and the increased cost of liquidity due to the international financial crisis. New pricing policies on loan portfolios have been introduced as from mid-2008, allowing enhanced spreads to better align with present market conditions.

Net interest income was EUR 648.7 million, down by 13.6 percent, due to intensified competition in loans and deposits, as well as the increased cost of funding. Total expenses, excluding provisions, increased by 0.9 percent to EUR 666.3 million, as a result of a very tight cost control policy. Total loan loss provisions amounted to EUR 474 million.

The 2008 results were significantly and adversely affected by the deteriorating environment. Assuming there is no further deterioration in market conditions, the Bank expects a steady improvement in its future developments based on its existing positioning.

As of end 2008, Emporiki Bank Albania accounted for 0.7 percent of total assets of Emporiki Bank.

3 MACROECONOMIC DEVELOPMENTS OVER THE YEAR 2008

The year 2008 was positive in terms of economic growth, which is estimated to have exceeded the 6 percent annual objective. The Albanian economic growth has been sustained by a considerable fiscal and monetary stimulus in view of the budget expenditure and banking sector lending. However, the effects of the international financial crisis emerged in the last quarter of 2008 as shown by the balance of payments performance, the contracted lending growth and the deteriorated business and consumer expectations of the developments in the short run.

The unfavourable performance of a number of indicators at end 2008 will deepen in 2009. Accordingly, the Albanian economy will be affected by the consequences of the international crisis in 2009 mainly in the form of a marked economic growth slowdown and lower revenue. As a result of the significant decline in economic growth, fiscal situation will face lower revenue actualization, which will in turn hinder the financing of the projected expenditure. Given this situation, public expenditure needs to be revised and aligned with the revenue actualization. Accordingly, better conditions would be created for maintaining the expected budget deficit level at 4.2 percent of GDP. Keeping the budget deficit at this level is of paramount importance under the conditions when the intermediation activity of the banking sector and the financial system on the whole, to meet the financial needs of the public and private sector in particular, is expected to be lower and at higher costs owing to the unstable demand and supply-side factors. Additionally, the foreign markets will continue to experience the investors' reluctance over financing the emerging countries' debt, implying that they will keep a higher return on investment demand in order to offset the higher risk. Under this situation, the countries willing to preserve fiscal and monetary discipline will benefit the most. The Albanian business entrepreneurship and households will face higher financing difficulties, which will in turn prompt a restructuring process that will be challenging and provide a negative impact over the performance of employment. The expectations are also reflected in the business expectations of the future performance of the Albanian economy and domestic demand.

With respect to developments in trade balance, the current account deficit deepened over the course of the year 2008 and early 2009 owing to the larger decline in exports relative to imports and the weakened remittances. The imbalanced foreign currency flows provided room for higher pressure over the exchange rate of the domestic currency in the last quarter of 2008, which was most evident in the first quarter of 2009. The depreciation of the Albanian Lek exchange rate reminded the economic agents the fact that the exchange rate of the national currency against its counterparts is freely determined in the foreign exchange market and that it represents a source of risk that should be comprehended and managed effectively. Consequently, their financial and balance sheet operations should aim at creating hedging instruments to be employed in the event of unfavourable exchange rate performance. The latter has increased the sources of risk on the expected level of prices; however, the inflationary pressures at end 2008 and early 2009 were low. After increasing the key interest rate in mid-2008, the Bank of Albania reduced it in January 2009 to 5.75 percent. The interest rates in the interbank market have reflected the Bank of Albania decision-making and the liquidity conditions. As from the last quarter of 2008, the Bank of Albania has injected liquidity in the interbank market, mainly through reverse repurchase agreements of one-week and three-month maturity.

Table 3 Main macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	2008
Real GDP growth (in %)[21]	7.9	4.2	5.8	5.7	5.7	5.5	6.0	6.0*
GDP (at current prices, in million ALL[22])	583,369	622,711	694,098	750,785	814,797	891,000	980,060	1,064,000*
GDP (at current prices, in million USD)[23]	4,065.3	4,444.8	5,694.0	7,303.4	8,164.3	9,082.6	10,841.4	12,681.8*
GDP (per capita in USD)	1,323	1,437	1,831	2,336	2,597	2,882	3,387.9	3,963.1*
Number of unemployed persons (in thousand)[24]	1065	921	928	917	932	934	935	970
Unemployment rate	14.6	15.8	15.0	14.6	14.2	13.8	13.4	12.6
Inflation rate (y-o-y)	3.5	1.7	3.3	2.2	2.0	2.5	2.9	3.4
Budget deficit (including grants, as a share of GDP)	-7.9	-6.6	-4.5	-5.1	-3.6	-3.1	-3.5	-5.7
Public debt (as a share of GDP)	66.8	65.3	61.7	56.6	56.7	55.9	52.2	55.9
External debt (as a share of GDP)[25]	25.8	23.5	20.6	18	17.5	17.2	14.4	18.3
Current account (excluding official transfers, as a share of GDP)	-6.1	-10.0	-7.9	-5.6	-7.7	-7.2	-11.2	-15.2
ALL/USD average exchange rate	143.5	140.1	121.9	102.8	99.8	98.1	90.4	83.9
ALL/EUR average exchange rate	128.5	132.4	137.5	127.7	124.2	123.1	123.6	122.8

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

3.1 PERFORMANCE OF THE ALBANIAN ECONOMY AND BUSINESSES

The Albanian economy grew steadily over the course of the year 2008, owing to the high growth in construction, industry and services. Turnover index for production and services (see Table 4) reached 147.0 percent at the end of the last quarter, up by 22 percent in annual terms from the same period in 2007. The sectors of electricity production, services and construction provided the main contribution. Their turnover volume increased by 29, 26 and 21 percent, respectively, relative to the same period in 2007. However, the activity in the three sectors was not uniform over the year. Construction recorded the highest annual growth in the third quarter by 51 percent. Investment in road infrastructure projects and the increase in the number of construction permits fuelled the growth in construction activity. In terms of volume, construction recorded an average annual growth of about 87 percent in the first three quarters, with the highest annual growth rate in the second quarter. For extracting industry, the annual change in the volume index fell by 17 percent in the last quarter, owing to the unfavourable developments in the primary commodity markets.

Industry, transportation and communication and hotels moderated their average turnover volume growth rates relative to the previous year. By contrast, the sector of trade has maintained a positive and stable trend.

Table 4 Turnover Volume Index

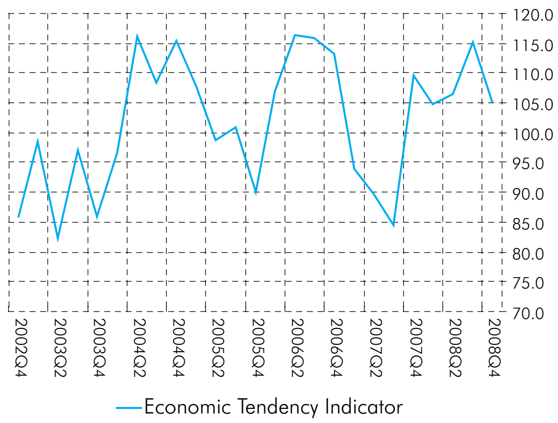
Turnover Volume Index	IV-06	I-07	II-07	III-07	IV-07	I-08	II-08	III-08	IV-08
Production and Services	112.6	94.7	105.6	112.9	120.7	111.6	118.9	136.2	147.0
Production*	118.5	92.1	113.2	108.1	134.7	114.1	137.0	146.0	160.8
Industry	106.5	108.7	126.2	112.6	112.7	112.5	130.2	133.3	131.7
Extracting Industry	99.7	116.2	172.5	144.5	125.3	116.5	177.3	147.3	109.5
Processing Industry	112.7	108.3	127	117.4	117.7	110.3	132.0	138.9	137.2
Electricity, Gas, Water	89.2	105.5	107.2	87.2	92.5	115.1	109.0	110.7	119.1
Construction	135.8	69	95.2	101.7	164.9	115.8	146.0	162.8	199.7
Services	109.3	96.3	101.2	115.6	112.7	110.1	109.1	130.8	139.4
Trade	108.6	94.6	100.8	115.5	112.7	109.9	108.5	129.2	141.5
Transportation and Communication	112.5	103.7	102.1	115.5	112.7	111.0	110.7	138.8	129.0
Hotels	131.2	78.7	117.2	141.6	129.7	103.1	114.1	142.9	108.6

**Production includes Industry and Construction sectors*

Source: INSTAT

Economic activity as measured by the Economic Tendency Indicator (ETI[26]), obtained through the business and household survey, provides further evidence for the above analysis. In 2008, the ETI (see Chart 16) increased in the second and third quarter to later decline in the last quarter by 10 percentage points; however, it remains well above the average of the last five years. The value of this indicator reflects the downward business expectations in industry and services related to their level of production, employment, demand and financial situation, as well the downward expectations of consumer demand. By contrast, construction-related businesses indicate for an improvement in their activity.

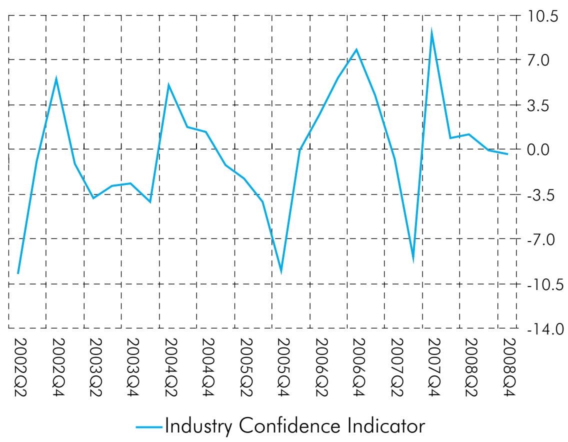
Chart 16 Economic Tendency Indicator



Source: Bank of Albania

Charts 17-20 show the confidence indicators of businesses operating in industry, services and construction and the consumer confidence index. These indicators provide assessments of the current and future performance of demand, production, employment, financial situation etc. Except for the construction sector, which improved in the last quarter of 2008, the rest of the indicators deteriorated in the second half of 2008 and in particular in the last quarter.

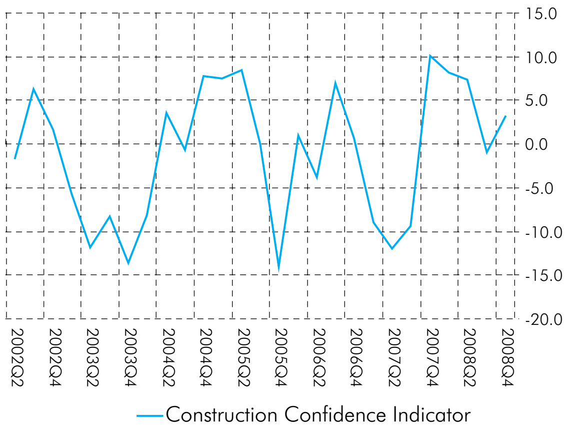
Chart 17 Industry Confidence Indicator



Source: Bank of Albania

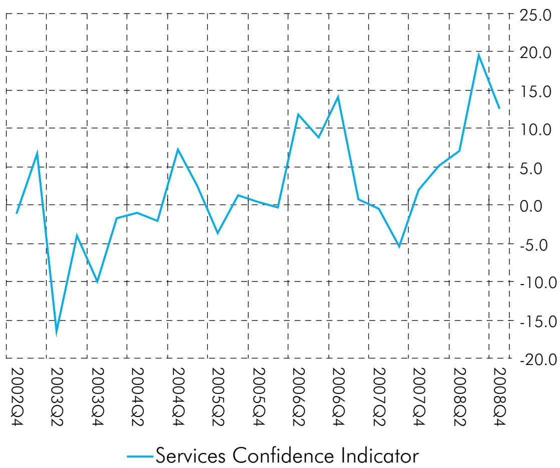
The assessment of firm's financial situation, which is strictly related to their solvency, is of great importance in terms of assessing the impact of business performance over the financial stability. In addition, the indicator of expected demand for the first quarter of 2009 is similarly important since it provides information on the potential growth of activity in these sectors and their ability to overcome this relatively more complex situation. The performance of the financial situation indicator for each sector and the financial situation of consumers is provided in Charts 21-24.

Chart 18 Construction Confidence Indicator



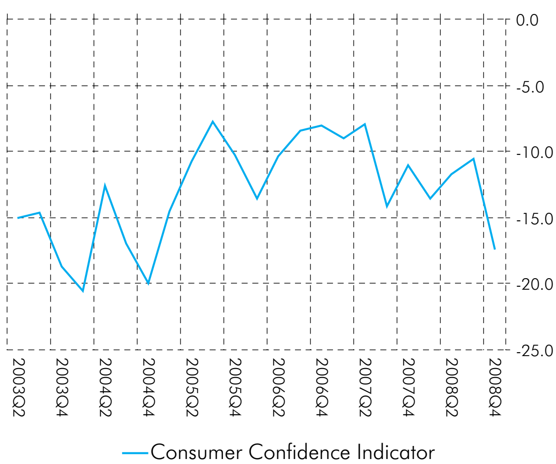
Source: Bank of Albania

Chart 19 Services Confidence Indicator



Source: Bank of Albania

Chart 20 Consumer Confidence Indicator



Source: Bank of Albania

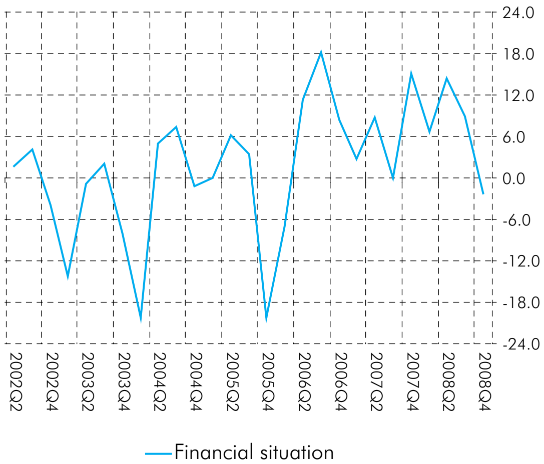
The financial situation of firms in industry and services has deteriorated considerably, in particular in the second half of 2008, implying that the credit risk related to these sectors may have increased. Moreover, the construction sector survey shows that the construction firms' financial situation deteriorated in the second half of 2008, although it remains above the average of the last three years. Households' financial situation – as indicated by the current and expected financial situation indicator – attests to the decline in savings and a higher risk with respect to the deterioration of individual loans' quality.

The sectors of industry (see Chart 21) and services (see Chart 23) in particular have provided negative expectations for the first quarter of 2009, while the situation in the construction sector (see Chart 22) appears more optimistic. In addition, total purchases from households are expected to be lower in the first quarter of 2009, as shown in Chart 24.

Charts 25-28 show the current and expected trend of demand for the sectors of industry, services and construction. For households, the indicator provides their expectations for future purchases. All indicators show a downward performance of expectations, reflecting the fact that the respondents have based their expectations on the current situation. Moreover, the expectations for a poor performance of demand and purchases precede the curb in production and expenditure, hence providing a negative impact over the development of the Albanian economy.

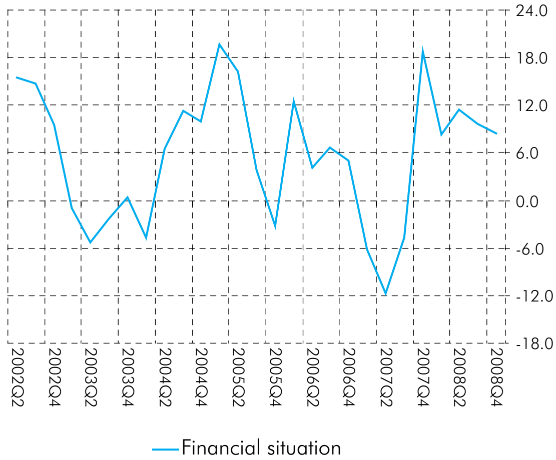
All indicators show a general deterioration of the financial situation of businesses and households, which is expected to remain so in at least the short run. This deterioration reflects the decline of demand for goods, lower investment arising from the constrained financing opportunities and it calls for an adaptation of the cost-savings pattern in terms of increasing the savings. If this process is strong, there is a risk that it may induce a self-tightening spiral. There may be a risk that the Albanian economy enters a cycle of constant fall in investment and demand for goods, with dire consequences over the financial situation of entrepreneurship and the level of employment. The deterioration of employment affects disposable income and consumer spending adversely, which in turn deepens the fall of overall

Chart 21 Financial situation in industry



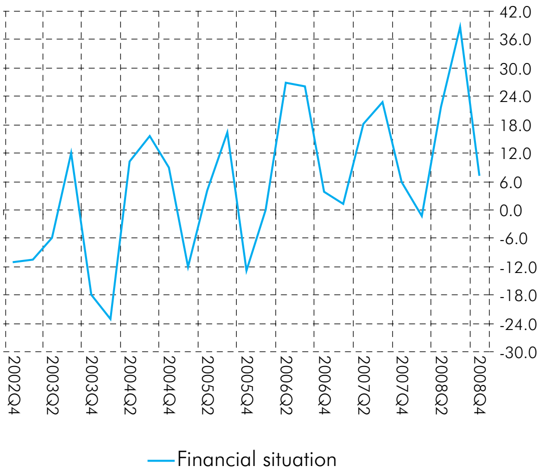
Source: Bank of Albania

Chart 22 Financial situation in construction



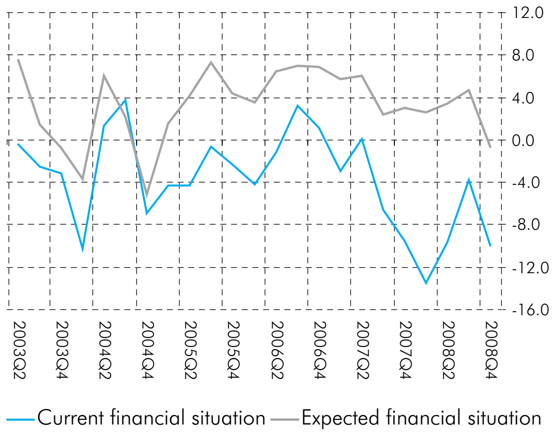
Source: Bank of Albania

Chart 23 Financial situation in services



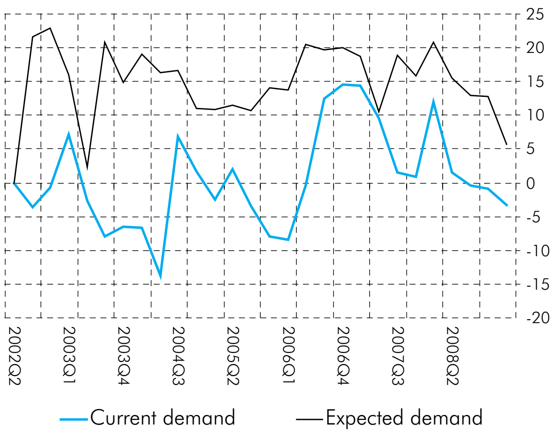
Source: Bank of Albania

Chart 24 Consumer current and expected financial situation



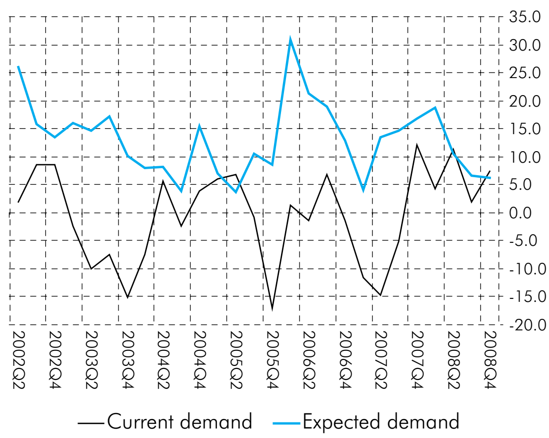
Source: Bank of Albania

Chart 25 Industry - current and expected demand



Source: Bank of Albania

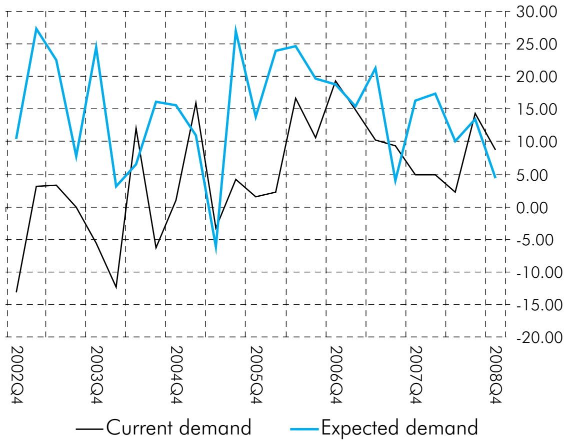
Chart 26 Construction – current and expected demand



Source: Bank of Albania

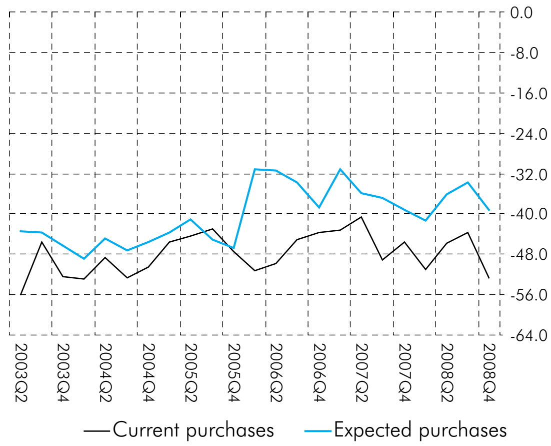
demand. By and large, the impact of these factors on economic growth will be negative. In order to mitigate this process, it is important to make use of all the private and public capacities that will back the financing flows for the entrepreneurship.

Chart 27 Services – current and expected demand



Source: Bank of Albania

Chart 28 Consumer current and expected purchases



Source: Bank of Albania

3.2 EMPLOYMENT AND HOUSEHOLDS' WELFARE

As a result of the difficulties to be encountered by entrepreneurships over the course of the year 2009, the developments in real economy will restrain the increase of household income through lower employment indicators in the private sector. Consumer confidence indicator fell to below its historical average in the last quarter of 2008. Consumer expectations for 2009 show more severe employment conditions, which is consistent with the business expectations.

Employment increased by 12.7 percent in 2008. Notwithstanding the natural increase of labour forces at home, the agricultural sector has managed to offset the increase by employing 27 thousand people in 2008, being at the same time the most conducive sector to the increase of employment over the past year. Worth noting is also the improved estimation of employment. The private non-agricultural sector has contributed by employing 8 thousand people.

Table 5 Labour market, in quarters

Labour market (in thousand people)	IV-06	I-07	II-07	III-07	IV-07	I-08	II-08	III-08	IV-08
Labour force	1,085	1,080	1,078	1,078	1,082	1,080	1,079	1,110	1,116
-Total employed persons	935	933	933	936	939	939	939	970	974
a) In the public sector	169	168	167	167	167	167	167	167	167
b) In the private non-agricultural sector	224	223	224	227	230	231	231	235	239
c) In the private agricultural sector	542	542	542	542	542	542	542	569	569
- Unemployed persons	149	148	145	142	143	141	140	140	141
Unemployment rate	13.9	13.6	13.5	13.18	13.2	13.04	12.97	12.62	12.68

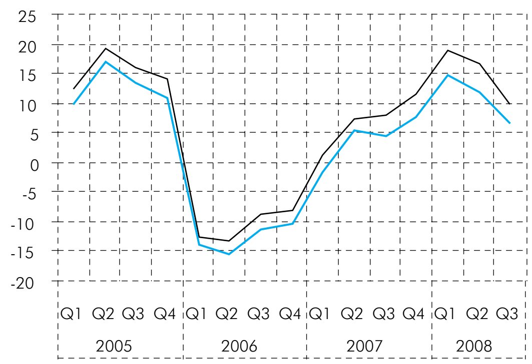
Source: INSTAT

The annual growth rate of wages slowed down for both the public and private sector in the first three quarters of 2008. In nominal terms, average monthly wage in the public sector[27] rose by 7.5 percent, while average wage in the private sector for the first nine-month period rose by about 15.1 percent[28]. In real and annual terms, average wage in economic enterprises rose by about 11.0 percent for this period.

Over the course of the first three quarters of 2008, average annual nominal wage in production sector rose by an average of 19.8 percent in construction and 11.8 percent in industry. In services, wholesale and retail trade posted a high average annual rise by 12.9 and 25.5 percent, respectively.

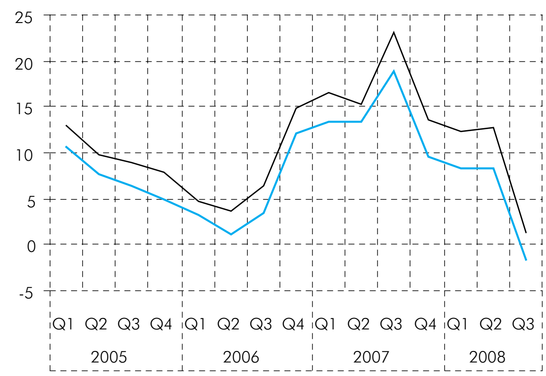
In order to better understand the dynamics of the performance of income, its analysis should be also supported with data on employment. To this purpose, the results of business and household surveys of employment (see Charts 31-34) have been analyzed. The consumer survey results show that unemployment increased substantially in the last quarter of 2008. The same is also confirmed by the survey results of the sectors of industry and services, which show a lower employment figure for the same period. By contrast, employment in the construction sector increased in the last quarter of 2008. Services and construction sectors' expectations of employment in 2009 remain however optimistic, reflecting the impact of seasonal factors and the stable public investment in road infrastructure-related projects. On the other side, industry expects lower employment capacities although at more moderate levels compared with the last quarter of 2008.

Chart 29 Average wage in production and services



Source: INSTAT, Conjuncture, Main Economic Indicators, July-September 2008, and Bank of Albania estimations

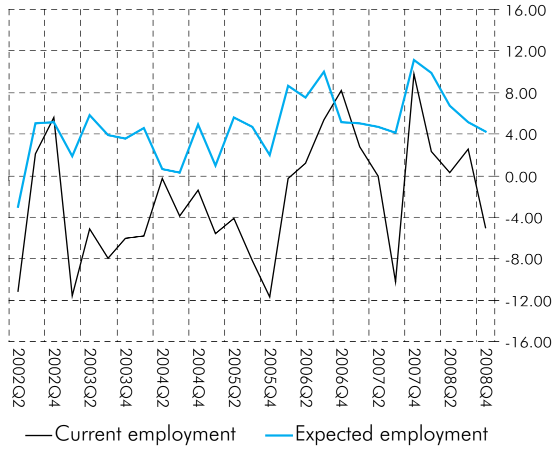
Chart 30 Average monthly wage in the public sector



Source: INSTAT, Conjuncture, Main Economic Indicators, July-September 2008, and Bank of Albania estimations

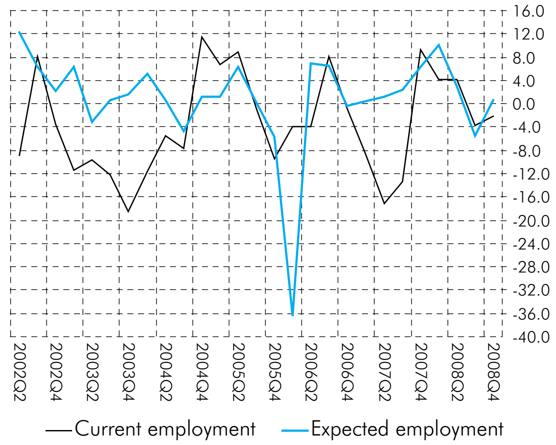
From the above analysis, it results that the household ability to generate income through employment may weaken in the event of stronger effects of the international crisis on Albania's economy. If the level of income reduces, there is a higher risk for the financial system that the quality of loans may deteriorate. Another effect relates to the subsequent decline in savings, which would in turn hinder the generation of the banking system's resources in the form of deposits. Moreover, given the enhanced household uncertainties, the consumption pattern is expected to be corrected in the future which will in turn rein in sales for businesses. After a relatively long period of rapid growth of demand, a similar correction may reduce the demand for imports and induce the trade deficit correction hence easing the pressures over the exchange rate. On the other side, a drastic decline in trade deficit would put its sustainability into question which would in turn increase uncertainty for the future.

Chart 31 Current and expected employment indicators - Industry



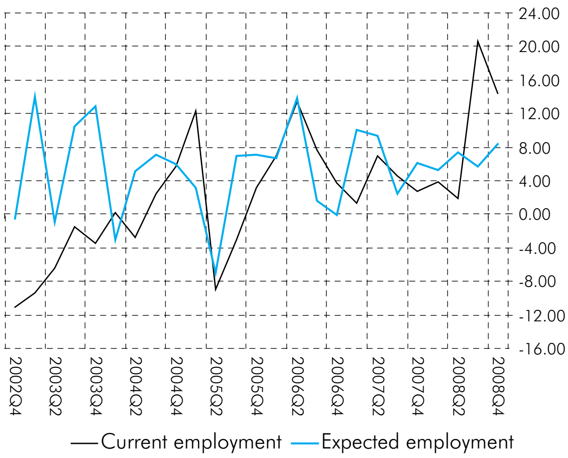
Source: Bank of Albania

Chart 32 Current and expected employment indicators - Construction



Source: Bank of Albania

Chart 33 Current and expected employment indicators - Services



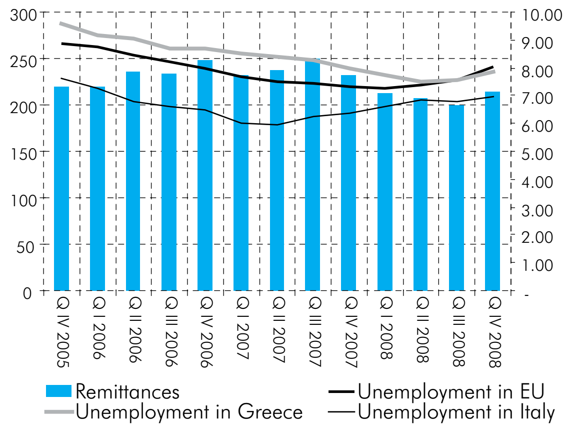
Source: Bank of Albania

Chart 34 Unemployment

Source: Bank of Albania

Remittances remain another important source of income for households. In 2007, they accounted for 12-13 percent of GDP. Remittances declined significantly in 2008 (see Chart 35), inflicted by the effects of the crisis that swept the advanced economies in Europe. As shown in Chart 35, there is a time-related concordance between the increase of the unemployment rate in the EU countries, in particular in Greece and Italy, and the decline in remittances. Since this phenomenon relies heavily on external developments, the volume of remittances is expected to be unstable in 2009 as long as employment and income indicators in advanced economies are downward. On the other side, following the consequences of the financial crisis and the gradual change in the business model, the European banks will pay an ever-increasing attention to the collection of deposits from households, the latter being a more stable financial resource compared with borrowing in the money markets. Consequently, there will be greater incentives for the emigrants to increase their savings in the banks in the countries they reside in, which will in turn reduce the amount of savings to be sent abroad. Accordingly, we may find ourselves in front of a structural change in the pattern that establishes the properties of remittances, which relate to the volume and time. This risk should be part of the public and private economic agents' scenarios in order to assess the possible effects in their financial balance sheets and future decision-making. In more concrete terms, the unsustainability of remittances will affect the Albanian households' disposable income adversely, hence hitting consumption and savings. More directly, the economic agents' foreign currency flows will become scarcer and bring about a relative decline of foreign currency supply in the domestic market. In such a situation, the maintenance of stable exchange rates would require the fall of demand for foreign currency, mainly in the form of lower imports. On the other side, the decline in the foreign currency savings of households whose loans are denominated in foreign currency may hinder their solvency. However, the decline in foreign currency savings may encourage the banking sector to increase lending in the domestic currency.

Chart 35 Remittances and unemployment rate in some European countries



Source: Bank of Albania

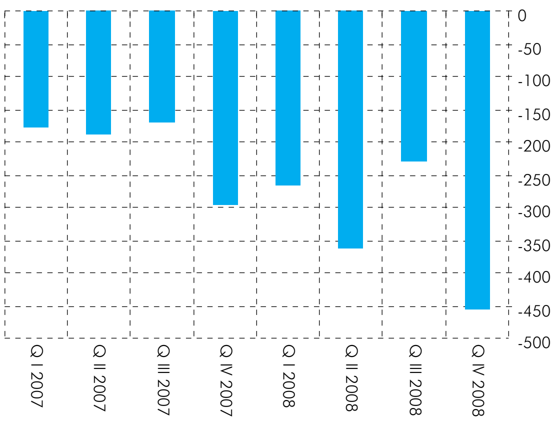
3.3 DEVELOPMENTS IN THE EXTERNAL SECTOR OF ECONOMY

The external sector of economy witnessed further deepening of the trade deficit, lower current transfers, higher financial liabilities to non-residents and higher foreign reserve over the course of the year 2008. By and large, the country's financial stability has become more sensitive to the developments in the external sector of economy.

As of end 2008, current account deficit accounted for 14.9 percent of GDP from 10.4 percent at end 2007, up by 55 percent. The current account deficit deepened further in the last quarter of 2008, being triggered by the decline of exports and remittances. Net current transfers are estimated to have decreased by about EUR 213 million. Trade deficit accounted for 27.9 percent of GDP in 2008 relative to 26.6 percent in 2007. The rationale behind its deterioration is the increase of the deficit in trade in goods by EUR 301 million.

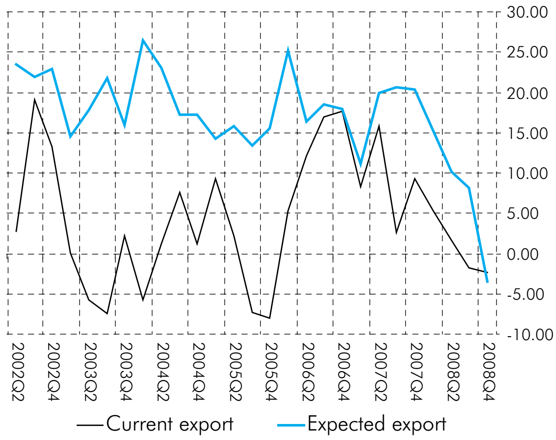
The decline in foreign currency inflows gave rise to higher pressures over the exchange rate in the last quarter of 2008 and the first quarter of the present year. In relative terms, imports also declined. Relative to December 2008, imports reduced by 11.6 percent in January 2009, the highest monthly decline in the last two years. In terms of imports' structure, imports of capital goods, such as machinery and appliances, recorded the highest decline by about

Chart 36 Current account deficit



Source: Bank of Albania

Chart 37 Current and expected export - Industry



Source: Bank of Albania

41 percent. Imports of industrial goods also decreased. If this performance persists in the rest of the year, it may trigger the contraction of manufacturing at home, following the fall of demand for exports and the contraction in the sales' markets as well as the tighter financial conditions. The business sector seems to expect the same since the survey for the sector of industry in the last quarter of 2008 indicated the decline of expected exports, the first since the year 2002 (see Chart 37).

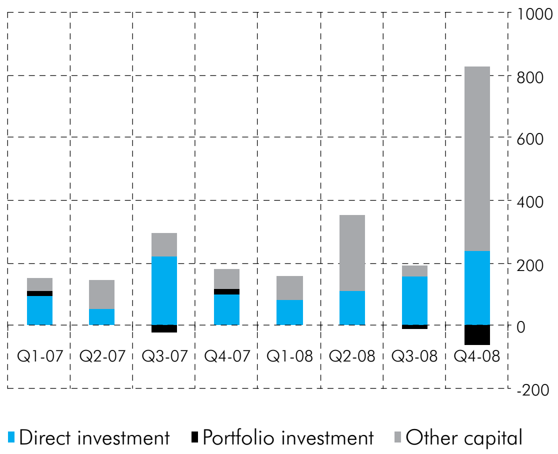
Financial account underwent significant changes in 2008, both in terms of volume and composition. Net flows in the financial account, which amounted to EUR 1.48 billion in 2008, were 1.9 times higher than in 2007. They managed to fully cover the current account deficit and increase the reserve assets by EUR 192 million. As a result of the aforementioned changes, the risk spectrum has also changed.

- Firstly, the increase of foreign direct investment by EUR 682 million, mainly in the form of investment in the financial sector and privatization proceeds, is assessed to have provided a positive contribution to the increase of banks' capital and to the creation of an additional financial incentive in the production sector, in order to support its activity amidst a more restraining economic environment.

- Secondly, the increase of public and private borrowing by EUR 456 million, out of which 74 percent from the public sector, has provided a financial resource which has alleviated the liquidity situation in the domestic market. However, owing to the borrowing terms, the cost of debt servicing for public borrowing will be considerable in the medium run. In addition to the expectations of refinancing the debt with more convenient terms through borrowing in the international market, the public sector should identify and formulate alternative ways of refinancing or payment. Private borrowing, mainly from the financial sector, increased substantially to EUR 119 from EUR 10 million the previous year. Given the liquidity constraints in foreign currency encountered by financial and non-financial businesses, the aforementioned risk is also relevant in this case. However, this risk is considerably more moderate since these borrowings are usually carried out within the same business group.

- Given the increased need for foreign currency liquidity, the foreign currency assets invested outside the Albanian economy recorded a net decline of EUR 94 million. The decline was mainly present in the banking system's investment in non-resident financial institutions (EUR 225 million). This performance was necessary in order to cope with the lower deposits in the banking sector, mainly in the last quarter of 2008. As a result of the banking sector's balanced foreign currency position and the Bank of Albania appropriate regulatory framework, the immediate demand of businesses and individuals for foreign currency was met without any pressures over the exchange rate. The withdrawal of foreign currency-denominated deposits from the public has altered the way they are held by the public and has increased their use for consumption–related purposes. On the other hand, the withdrawal of deposits has reduced the business sector's opportunity to obtain concentrated financing for efficient projects from the banking sector. Accordingly, although the withdrawal of deposits at first left the foreign currency balance in economy unchanged, it led to a more distorted foreign currency flow mechanism and lower efficiency in its use which mainly restrained the business sector's investment opportunities. The concentration of foreign currency in the hands of the public as cash – under a situation of constant business needs, tightening lending terms by the banking sector and the possibility for the foreign currency holders to have a higher rate of return – may prompt the revitalization of the informal financial intermediation where the borrowing process takes place outside the financial system. The prevention of this phenomenon calls for the public authorities' attention, which may prevent the outburst of this phenomenon with major social and economic consequences through administrative measures.

Chart 38 Financial account



Source: Bank of Albania

3.4 FISCAL DEVELOPMENTS OVER THE YEAR 2008

As of end 2008, budget revenue and expenditure were met by 97.3 and 98.7 percent of the projected target, hence meeting the budget projection for the year 2008. At the end of the year, budget revenue and expenditure were about 15 and 23 percent higher relative to the previous year. The high level of expenditure in the second half of 2008 led to a negative budget balance of about ALL 60 billion or nearly 5.6 percent of the GDP. The fiscal policy pursued over the year 2008 is in line with the medium-term budget programme for the 2008-2010 period.

Budget revenue attested to a satisfactory performance over the course of the year 2008, being sustained by the successful meeting of the projected revenue from value added tax (VAT), tax on profit and non-tax revenue. In terms of expenditure, personnel cost and social insurance outlays provided the main contribution to their increase. Despite the relative improvement, there was a non-uniform time-related allocation of expenditure over the course of the year 2008, being mostly concentrated in the last months of year, in December in particular. This setting provides a negative contribution to balances in the financial market and the interbank market in particular, where the performance of borrowing and public expenditure in terms of Government's meeting of budget indicators is overwhelmingly important. A non-uniform time-related allocation of expenditure exerts upward pressures over the liquidity interest rates in the interbank market and may restrain the business sector's development projects.

The higher increase of the budget deficit in 2008 relative to the previous year has been translated into higher (domestic and external) public debt, which accounts for about 56 percent of the GDP. Although this figure remains below the benchmark set by the Maastricht agreement, which requires a public debt/GDP ratio of no more than 60 percent, a full analysis needs to be made in order to assess the public authorities' ability to cope with the debt cost and its performance over time. To this purpose, the following need to be considered: prospects for economic growth, the debt structure and the way its financing takes place with domestic and external resources, the expected Government revenue, the situation in the foreign markets and their perception of Albania's risk level, the public authorities' ability to generate sufficient foreign currency-denominated resources, etc.. Against this background, all measures aiming at extending the debt maturity term are conducive to its better management. In view of implementing the fiscal policy, the Ministry of Finance continued to extend the public debt average maturity term over the course of the year 2008. Relative to the previous year, in the first half of 2008 the fiscal authority reduced the amount of debt in T-bills of up to 1-year maturity term by about ALL 30 billion and increased the debt stock in 2 to 5-year bonds by about ALL 46 billion.

Table 6 Domestic debt by year

In million leks	2005	2006	2007	2008
Domestic debt stock	327,353	348,936	369,536	400,456
T-bills	275,917	261,242	232,211	224,224
2-year bonds	32,210	53,120	66,460	65,730
3-year bonds	6,000	16,050	25,250	21,100
5-year bonds	-	6,360	24,110	45,910
7-year bonds	-	-	6,000	12,000
Foreign currency revaluation bonds with the Bank of Albania	11,500	12,164	15,505	23,540
Recapitalization bonds, BKT	1,726	-	-	-
Loans with the central bank	-	-	-	3000

Banking system	-	-	-	-
Banks' recapitalization	-	-	-	-
Domestic debt guarantee	-	-	-	4952
Domestic debt as a share of GDP	40.18	39.16	37.59	37.64

Source: Ministry of Finance

The budget deficit deepening and its financing in 2008 has steered the financial flows in economy. In general, large Government needs for borrowing lead to contracted supply with loans for the private sector. This was less pronounced in 2008 given the wider use of foreign resources to finance the budget deficit.

Tables 7 Credit to economy and Government from the banking sector

In billion leks	December 2006	March 2007	June 2007	September 2007	December 2007	March 2008	June 2008	September 2008	December 2008
Domestic assets	497.8	519.2	539.7	568.4	618.9	638.6	683.7	712.8	725.7
Net claims on Government	241.0	240.7	239.7	242.5	256.8	255.7	265.5	265.7	258
Claims on public non-financial corporations	0.17	0.66	2.3	1.5	3.9	4.4	4.5	7.2	12.9
Claims on the private sector*	192.	214.2	233.8	255.1	285.4	307	338.6	365.2	378

Source: Bank of Albania

Foreign financing covered about 60 percent of the budget deficit in 2008 vis-à-vis the domestic financing of about 40 percent. In 2007, the foreign and domestic financing accounted for 15 and 85 percent, respectively. Foreign borrowing in 2008 was about 6.7 times higher than in 2007, while domestic borrowing reached 85 percent of the previous year's. The decline in domestic borrowing has been also triggered by the fall of the banking sector's demand for Government debt instruments in the last quarter of 2008, which corresponds to the period when the banking sector was faced with the withdrawal of deposits and the need for a more efficient liquidity management.

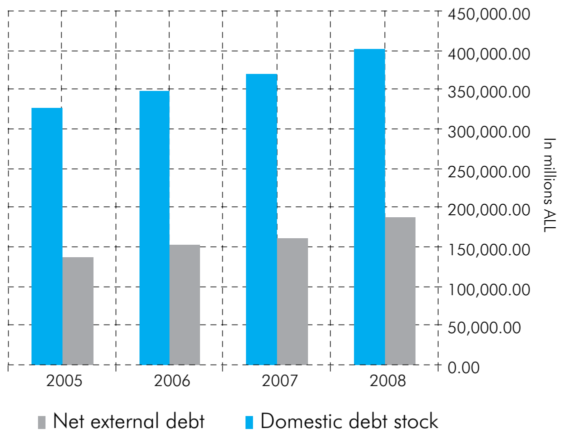
Table 8 Budget deficit financing

In millions leks	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Year 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Year 2008
Budget balance	6,401	3,749	-478	-43,791	-34,119	10,496	-12,826	-6,122	-51,736	-60,188
Financing	-6,401	-3,749	478	43,791	34,119	-10,496	12,826	6,122	51,736	60,188
Domestic	-6,416	-4,029	1,175	40,449	28,829	-10,589	11,789	-11,456	34,783	24,527
Foreign	15	280	1,653	3,341	5,289	93	1,037	17,578	16,954	35,662

Source: Ministry of Finance

Against a backdrop of normal developments in the international market, the financing through foreign resources in the case of Albania provides the opportunity to establish a better balance in the debt structure and it should aim at improving its cost in the medium run. If used wisely, the use of financing through foreign resources allows more appropriate value and time-related financing in line with the economic development objectives, hence providing a positive contribution to enhancing the flexibility in the decision-making process and improving the efficiency of expenditure. Moreover, the issue of Government debt instruments in foreign currency and their purchase by non-

Chart 39 Public debt components



Source: Bank of Albania

resident institutional investors is followed by some elements that induce fiscal discipline.

However, the upward foreign financing trend on non-concessionary terms should be followed up cautiously in order to assess the refinancing risk on unfavourable terms and the capacity to cope with the cost of debt. To this purpose, the following should be kept under consideration:

- Macroeconomic stability and strong fiscal and monetary discipline against a background of closer monitoring by the financial markets need to be preserved. The experience of different countries shows that because of the financial markets' hesitation related to these countries' ability to preserve financial discipline, the capacity to refinance debt on more convenient terms has restrained significantly. Therefore, willingness and prudence is required in terms of public revenue and expenditure and, if needed, they should be revised in order to ensure a downward budget deficit and public debt. This would, *inter alia*, improve the overall financial setting, allowing the banking sector to conduct its intermediation activity more efficiently while remaining well capitalized and liquid;

- Foreign debt criteria need to be strictly set out and met to the extent that the refinancing cost is faced and settled on the maturity date as established. To this purpose, in addition to prudence with respect to borrowing terms, the borrowing amount should consider the real capacities of the economy to generate sustainable funds in foreign currency over the same period, for example through exports and foreign direct investment. Therefore, the acknowledgement of foreign currency flows' balances in the Albanian economy are of prime importance in order to identify the impact of obtaining, using and settling the foreign debt on the performance of trade balance accounts and on the exchange rate. The last international financial crisis has reminded us how wrong it could be to fully rely on a stable liquidity situation in the international markets for the most convenient refinancing of debt. Starting from the second half of 2008, the interest of foreign investors in purchasing the emerging countries' debt has been decreasing markedly. This setting is not expected to change as long as the factors establishing it will persist. Accordingly, the possible refinancing of foreign debt on more favourable terms in the medium run should be cautiously analyzed, in order to provide for alternative options in the event this proves to be hard in practice.

- The efficiency of foreign financing will be also determined by its efficient use. Therefore, a better equilibrium between capital and current budget expenditure should be found, aiming at orienting them towards projects that enhance the production capacities of the economy, improve its productivity and competitiveness and increase employment. This will serve to the stable development of the Albanian economy in the medium and long-term, allowing for the real growth of different economic agents' income, particularly in the private sector. Worth noting in this context is that, given their nature, current expenditure tend to orient to higher consumption, which in the short-term may back the growth of imports, the increase of pressures over the exchange rate and the overall augmentation of inflationary pressures in economy. Moreover, this type of expenditure is rigid and irreversible, hence transforming into a burden for the fiscal budget and prompting higher costs for the private sector.

Economic growth downward rate will be more marked for the remaining of the year 2009, which will weigh down the meeting of public revenue collection-related objectives further. The unused budget reserve funds should represent that last back up in carrying out public expenditure and public investment in particular. It is fundamental that the general public expenditure depend on the performance of revenue, having as its main objective the preservation of budget deficit at 4.2 percent of GDP. Worth considering here is the possible restrained financing of deficit through domestic resources, owing to the lower financing from the banking sector. Upon the termination of some major public infrastructure works in 2010 and by pursuing strict projections with respect to income and public expenditure-related projections, the budget deficit may further reduce. The restoring of budget deficit downward trend is crucial in terms of lowering the magnitude and cost of financing, improving the liquidity situation in the financial market and allowing for more direct financial resources for the private entrepreneurship. The decline of the budget deficit provides greater opportunities for investors and in terms of external debt service it allows for more favourable refinancing over the time.

3.5 INFLATION AND MONETARY POLICY

The year 2008 attested to strong inflationary pressures in its first half to later moderate significantly in the second. The performance of consumer prices was mainly affected by the fall in production and energy commodity prices in the international markets and the downturn in economic activity in the last quarter of 2008. The increase of the annual CPI increase peaked in July with 3.7 percent to later maintain a downward trend and mark 2.2 percent at end-2008.

The Bank of Albania kept the key interest unchanged at 6.25 percent over the course of the year 2008, considering it adequate for preserving the public incentive to trust and invest in the national currency. The main objective is to anchor the economic agents' expectations of the annual CPI increase to around 3 percent.

The alleviation of inflationary pressures intensified in early 2009, when different indicators attested to the strong contraction of the European economy and the lower economic growth rates at home. Against a background of contracted liquidity situation in the interbank market, at end-January 2009 the Bank of Albania cut the key interest rate by 50 basis points to 5.75 percent.

4 MARKETS

4.1 FINANCIAL MARKET

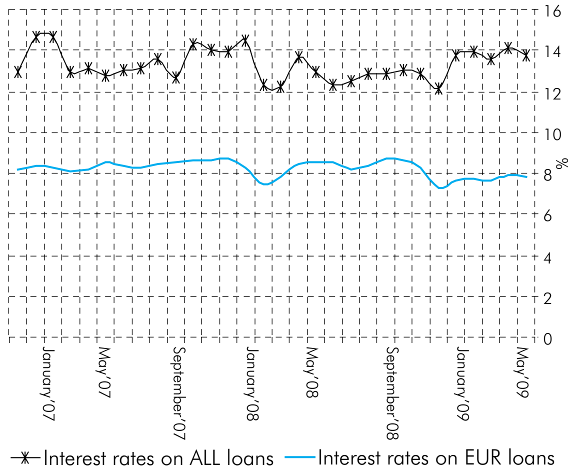
The Albanian financial market is dominated by the interbank, Government debt securities and foreign exchange market. The segment of this market that relates to the insurance and re-insurance and private pension funds, albeit upward, still has a low share to the total volume of the financial market activity. The latter was by and large stable over the course of the year 2008, with some segments having increased in terms of volume. This performance owes mainly to the increased activity in the primary market of Government debt securities and to the banking sector's higher demand for liquidity following the withdrawal of deposits in the last quarter. In order to meet the higher demand for liquidity, the Bank of Albania has conducted the necessary open market operations.

The performance of interest rates on deposits, loans and Government debt securities was reliant on the overall liquidity situation hence going through a relative increase.

Interest rates on ALL, EUR and USD deposits maintained an upward trend. Despite the decreasing interest rates of the main foreign currencies in the international market, banks have preferred to maintain relatively high interest rates on deposits in order to make them attractive to the public. The spread between the interest rates on deposits denominated in the Albanian Lek and in foreign currency remained positive and stable, reflecting the key interest rate and the banking sector's preferences with respect to the foreign currencies.

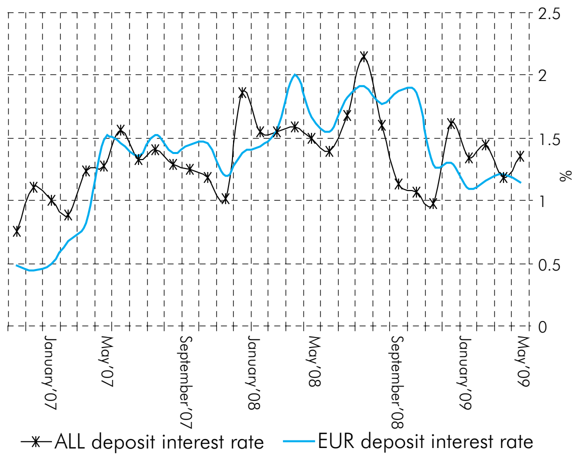
Unlike the performance of interest rates on deposits, loan interest rates showed a slight downward trend in 2008, leading to the narrowing of the spread between these two indicators and the relative decrease of the banking sector's intermediation cost. However, the unstable liquidity situation in the banking sector and the prudent selection of borrowers brought about the reduction in the amount of available funds for lending purposes and the increase of interest rates, being more evident in the first half of 2009. This year's tendency to lending in the domestic currency is considered positive and it should be further deepened by the banking sector through attractive incentive for the borrowers, which mainly relate with the loan price. In the medium run, it will help to establish a better balance in terms of the loan portfolio composition by currency.

Chart 40 Performance of interest rates on ALL and EUR loans



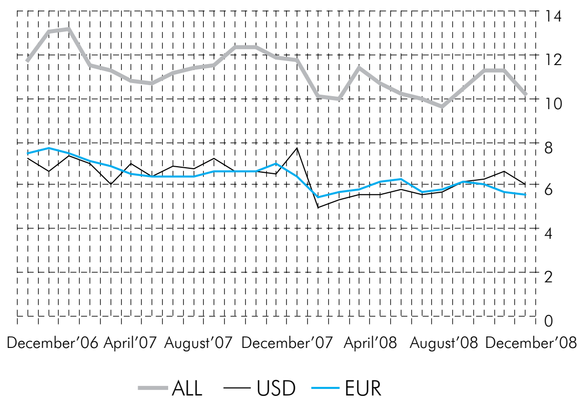
Source: Bank of Albania

Chart 41 Performance of interest rates on ALL and EUR deposits



Source: Bank of Albania

Chart 42 Loan-deposit interest rate spread by main currencies



Source: Bank of Albania

Foreign currency exchange market attested to stable trading volumes over the course of the year 2008. The traded volumes were mainly dominated by the banking sector in its relations with other non-bank financial institutions and customers. The volume of foreign exchange transactions from large public and private entrepreneurships grew over the last year. The prices of foreign currencies vis-à-vis the national currency have reflected the domestic situation of demand and supply with foreign currency and the developments in the international markets. The Albanian Lek exchange rate vis-à-vis its major counterparts was stable over the major part of the year. However, the pressure over the exchange rate began to go upward at year-end, reflecting the contraction of supply with foreign currency and the psychological effects triggered by the uncertain situation in the international financial markets.

As in the previous year, the insurance market structure consisted of ten insurance companies, out of which seven conducted non-life insurance activity, two life insurance and one life and non-life insurance. The year 2008 attested to positive developments in the insurance market, combined with the impact of the entry of foreign investors into this market, which allowed higher competition. This market's positive performance was materialized in higher assets, investments and payment of claims, as well as in higher income from gross written premiums dominated mainly by written premiums of compulsory insurance. However, based on the data of the Financial Supervisory Authority (FSA) for the first nine-month period of 2008, the claims payable as a percentage of premium income remains low at 29.1 percent for non-life insurance market and 8.9 percent for life insurance market.

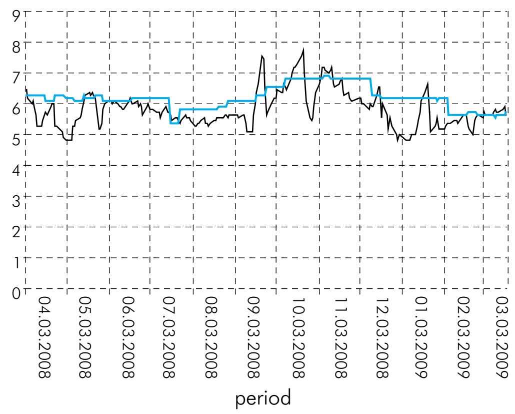
The private supplementary pension market witnessed the same level of development over the course of the year 2008 as in the previous year. Three private pension institutes continue to conduct their operations in Albania. Contributions in this market increased by 65 percent in 2008 relative to 2007, although this financial market segment remains at low development levels.

4.1.1 INTERBANK MARKET

Lending in the Albanian Lek in the interbank market grew in 2008 compared with the previous year. As at September, average daily lending volume grew by ALL 2.3 billion from ALL 1.8 billion in the same period the previous year. Despite the higher traded volumes, the interbank market is characterized by a relatively high concentration of lent funds and considerable interbank trading constraints owing to the internal bank policies.

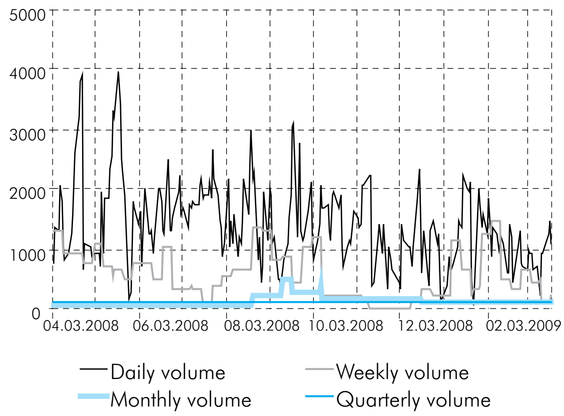
Interest rates on interbank market loans were more volatile than in 2007, reflecting the changes in the liquidity situation in the market. As at September, the interbank market interest rates fluctuated below the key interest rate while increasing during the banks' required reserve calculation and replenishment. The structural liquidity shortages during this period and the injected amount by the Bank of Albania drove the interest rates in the interbank market to get closer to the key interest rate and triggered interbank market activity, hence creating better conditions for the monetary policy transmission. The spread between the overnight interest rate and the key interest rate was approximately 70 basis points compared with 90 basis points the previous year. In the last quarter of 2008, the liquidity shortages triggered higher interest rates in the interbank market. In September to November, during the required reserve replenishment period (in September), the interest rate on overnight transactions increased to about 7.7 percent or 135 basis points above the interest rate on repurchase agreements. Consequently, the average interest rate on overnight transactions increased to 7.16 percent or about 90 basis points above the interest rate on repurchase agreements. Average lending volume in September to November was about ALL 1.6 billion, hence recording a fall owing to the preservation of the liquidity levels against a background of declining deposits. Against this backdrop, the Bank of Albania began to inject liquidity into the interbank market through its open market operations. The Bank of Albania intervention[29] triggered lower liquidity provision cost in the interbank market. In December, the interest rate on overnight lending dropped close to the average annual interest rate of about 5.85 percent.

Chart 43 Interbank market interest rates



Source: Bank of Albania

Chart 44 Interbank market lending volume (in million leks)



Source: Bank of Albania

4.1.2 OPEN MARKET OPERATIONS DURING 2008

The wavering public confidence against a background of international financial crisis triggered the withdrawal of deposits from banks in the last quarter of 2008, hence deteriorating the liquidity situation in the banking sector. In order to ease the banking sector's liquidity situation and keep the market interest rates under check, the Bank of Albania began to inject liquidity into the interbank market through its open market operations (see Box 5). Reverse repurchase agreement of one-week maturity was the main instrument employed. Reverse repurchase agreement of one and three-month maturity was also employed in order to provide liquidity of longer maturity term. The

Bank of Albania made it clear for the central banks that the injection of liquidity would persist until the situation was fully normalized.

Prior to the last quarter of 2008, the central bank loan to commercial banks was provided through short-term Government debt securities (Treasury bills), which were held by them. In order to provide banks with larger liquidity amounts as per their needs, the types of Government debt securities were to be diversified. To this purpose, the Bank of Albania made a regulatory amendment, which allowed the use of long-term debt securities (bonds) of remaining maturity up to 12 months in addition to the Treasury bills. Until that moment, long-term Government debt securities could be employed only as collateral for other Bank of Albania instruments, namely overnight loan and intra-day loan.

Another regulatory amendment, which aimed at enhancing banks' flexibility in terms of managing unexpected liquidity needs, related to the increase of the required reserve use from 20 to 40 percent. Upon this amendment, banks could use up to 40 percent of the reserve placed with the Bank of Albania, provided that the monthly average required reserve at the end of the holding period equals the amount of required reserve as established by law.

In addition to augmenting the amount of liquidity, the volatility of interest rates in the interbank market was also to be kept under check. To this purpose, the Bank of Albania approved the temporary shift to an asymmetric corridor of benchmark interest rates, reducing the spread between the interest rate on overnight loan and the repurchase agreement from 175 basis points (1.75 percentage points) to 75 basis points (0.75 percentage points). Accordingly, the lending interest rates in the interbank market can now fluctuate within a narrower range.

Box 5 (Monetary Policy) Open market instruments

Open market operations, which consist of the main operation, fine-tuning and structural operations are the basic operations for the liquidity management from the central bank. The dynamics of events in 2008 urged the use of all open market instruments:

- *The main market operation is represented by the repurchase agreement and the reverse repurchase agreement of one week maturity, which is conducted on weekly basis. During the past year, according to its positions of liquidity withdrawal or injection with the purpose of managing the liquidity situation in the market, the Bank of Albania withdrew liquidity through the repurchase agreement of one week maturity amounting to about ALL 3.6 billion a week; and injected an average of ALL 5.8 billion a week through reverse repurchase agreements of one week maturity.*

- *The fine-tuning market operations. In contrast to the main market operation, the fine-tuning market operations are used with an undetermined frequency, in specific situations when the mitigation of interest rates fluctuations caused by unexpected* *and/or long-term changes of the liquidity in the system is required. In the first quarter of 2008, repurchase agreements of one and three-month maturity were used to reduce the excess liquidity in order to dampen the pressures of the interest rates' decrease. The Bank of Albania, in order to alleviate the concern for the shortage of liquidity caused by psychological factors during the last quarter, along with the use of the main instrument, injected liquidity through reverse repurchase agreements of one and three-month maturity. The average amount injected was ALL 3.2 billion, respectively, in three one-month auctions and in two three-month auctions. One-month auctions had an average demand/supply ratio of 95 percent, while the same ratio for the three-month auctions was higher, 148 percent.*

- *Structural market operations. Structural operations are used to adjust the liquidity structure in the long-term. They are conducted through outright transactions of short-term government debt securities (Treasury Bills). In the beginning of 2008, in view of orienting the operations towards the establishment of a structural shortage of liquidity in the banking system, the Bank of Albania reduced its Treasury Bills portfolio by ALL 2 billion through one single auction. In the last quarter of 2008, structural interventions had a reverse direction, aiming at the injection of liquidity. The Bank of Albania, through the outright purchase of the Treasury Bills from commercial banks, increased their permanent liquidity by ALL 2.2 billion.*

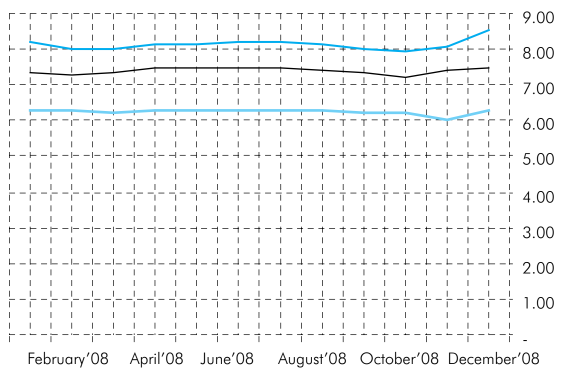
- *Standing facilities. Standing facilities - overnight deposit and overnight loan - are instruments available to commercial banks to allow them to manage liquidity on daily basis. In theory, against a background of the regular presence of the central bank in the market (through its main instrument), a developed interbank market and the possibility to use the required reserve on daily basis, the use of standing facilities from commercial banks should be minimal. However, the relatively low development of the interbank market caused those banks that had excessive liquidity and which chose to place it with the Bank of Albania, to extensively use the overnight deposit facility. During 2008, the average daily amount deposited with the Bank of Albania was about ALL 3.6 billion, compared with ALL 1.6 billion in 2007. Worth noting is that in 2007, the Bank of Albania was present during the first half of the year by withdrawing the liquidity through its main instrument, hence reducing the banks' opportunities to use the overnight deposit facility. While, in 2008, the central bank intervened for about ten months by injecting the liquidity, hence the banks' possibilities of using the overnight deposit were larger. On the other hand, the injection of liquidity via the main instrument has reduced the need to use the overnight loan. Throughout the year, overnight loan was used in 21 working days, with an average use of ALL 0.3 billion. Overnight loan was higher in the last quarter of the year, mainly from the small banks in the system which, due to the trading limits, were faced with hard times to find the liquidity in other forms.*

- *Additional liquidity providing instruments. Lombard loan represents the last lending instrument of the Bank of Albania, which is granted to banks with temporary liquidity problems, provided that they are financially sound. This instrument found no use during 2008.*

4.1.3 GOVERNMENT DEBT SECURITIES' PRIMARY MARKET AND THE INTEREST RATE (YIELD) PERFORMANCE

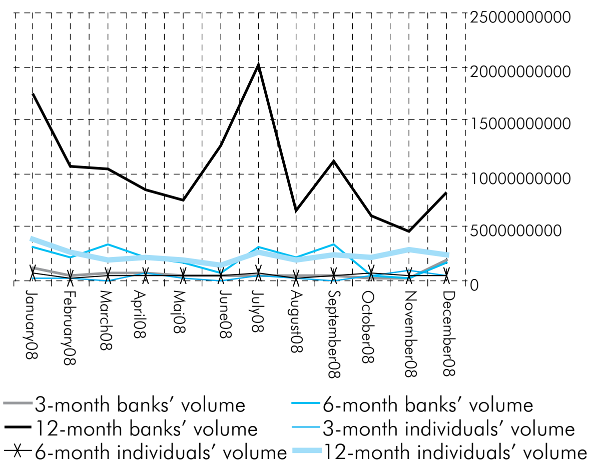
The return rates on investment in Treasury Bills in the primary market, by maturity terms, have been relatively stable during the major part of the year 2008. In

Chart 45 Government securities' yield



Source: Bank of Albania

Chart 46 Banks and individuals' participation in Government securities' auctions, in ALL



Source: Bank of Albania

the first months of the year, they have transmitted the increase of the Bank of Albania key interest rate in the end of 2007, showing an upward trend. In the third quarter, the return rates experienced a relative decline, following the massive liquidity excess generated in the market. The return rate on investment in Treasury Bills of 12-month maturity marked 7.94 percent in September compared with 8.23 percent in January. During the last quarter, the return rates increased, transmitting the tightening of the liquidity conditions in the banking sector and the increasing Government demand for domestic debt.

Particularly in the last two months of the year, banks were reluctant to invest in the Government debt securities' primary market to increase their investment or for reinvestment purposes. Against a background of low banks' participation in the auction and unstable meeting of Government demand for debt, the return rate on investment in Treasury Bills increased. In fact, in December, the return rate on investment in Treasury Bills of 12-month maturity marked 8.56 percent or 0.3 percentage points higher than the same period the previous year. During 2008, the same upward trend was shown in the return rate on investment in Treasury Bills of 6-month maturity, while the return rate on investment in Treasury Bills of 3-month maturity stood at an average of 6.25 per cent, almost close to the key interest rate of the Bank of Albania.

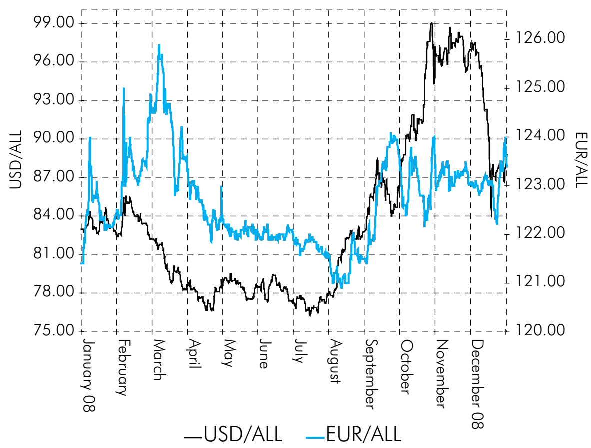
Bank's preference to invest in long-term instruments continued to grow in 2008 and demand for them was stable. The performance of the return rates on these investments has fluctuated depending on the changes in the supply/demand in the market. During the first part of the year, they had a stable downward performance, concentrated mainly in the third quarter. The spread between the return rates on securities of different maturities reduced, mitigating the slope of the curve. Worth noting is the narrowing of the spread between the return rate on investment in 5 and 2-year bonds, attesting to the lowering of the economic agents' perceived risk for these long-term securities. In the recent months, the banks' demand has been strongly reliant on liquidity-related issues in the market, along with a lower participation and requirements for higher return rate on investment. Thus, the average return rate on investment in 2-year bonds increased by 0.15 percent in 2008 y-o-y.

4.2 FOREIGN EXCHANGE MARKET AND THE EXCHANGE RATE PERFORMANCE

As at end 2008, the exchange rate of the ALL vis-à-vis the Euro and U.S. dollar reflected an annual decline of 0.37 and 10 percent, respectively, in nominal terms. This performance is mainly a reflection of developments in the international market. However, in average annual terms, the ALL appreciated by 0.66 percent vis-à-vis the Euro and by 7.23 percent vis-à-vis the U.S. dollar.

The exchange rate performance of the national currency vis-à-vis its major counterparts has been variable. The ALL has appreciated vis-à-vis its major counterparts in January to April, peaking in April when it appreciated by 6.2 percent in annual terms. In the second and third quarter, the annual appreciation rates slowed down to 1.4 percent in September. In the last quarter of the year, the exchange rate of ALL vis-à-vis its major counterparts depreciated by an average of 3.2 percent in annual terms.

Chart 47 Daily performance of EUR/ALL and USD/ALL exchange rate

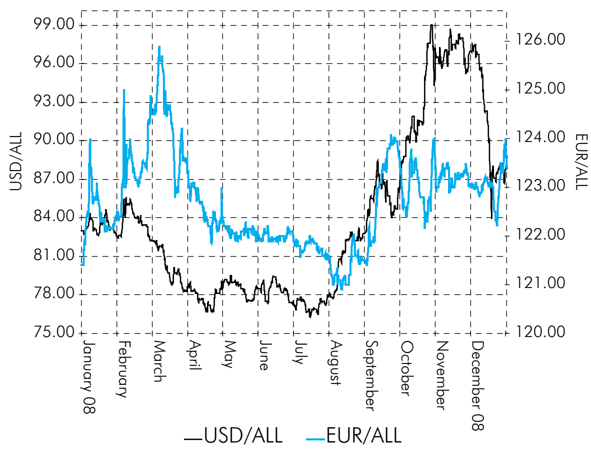


Source: Bank of Albania

The exchange rate performance of the ALL has by and large reflected the stable macroeconomic indicators at home, the positive spread of interest rates by currencies, the developments in the international foreign exchange market and the temporary shifts in the supply and demand for foreign currency in the domestic market.

The foreign exchange activity in the domestic market has shown a persistent growth, not only as a result of the expanded trading activity, which grew by a total of 31.1 percent in annual terms in 2008, but also of the improved expertise of the market participants. The latter are ever-increasingly maintaining a preceding behaviour with respect to the exchange rate seasonality.

Chart 48 Total volume of foreign currency trading in 2008



Source: Bank of Albania

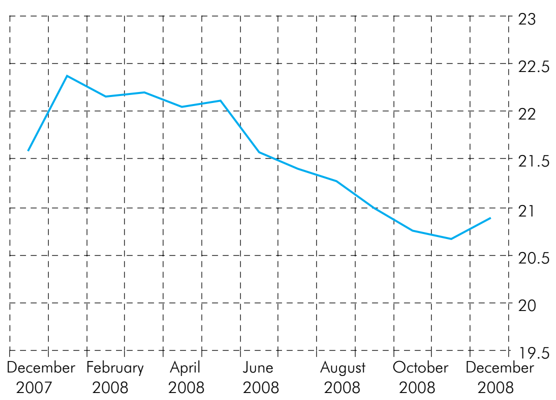
In the beginning of 2009, there were higher pressures over the depreciation of the ALL vis-à-vis its major counterparts. The decline of remittances in the last quarter of 2008, the lower exports and the international crisis were the economic and psychological factors altering the foreign currency demand and supply structure in the domestic market. The Bank of Albania has prudently monitored the situation and has conducted the necessary operations in the first quarter of the year, in order to reduce the volatilities and velocity of the exchange rate shifts, which may have an adverse impact over the behaviour of economic agents and inflation. In addition, the Bank of Albania has once more reminded all the economic, institutional and individual economic agents that the exchange rate is free-floating. To this purpose, all the economic agents need to recognize and assess the risk arising from the unfavourable exchange rate shifts and manage this risk by conducting the necessary operations.

4.3 REAL ESTATE MARKET

The housing market witnessed contained price rise rates and volatile rent index in 2008.

Average house price index for the district of Tirana dropped by 0.3 percent in annual terms, in contrast to its performance in the preceding three years when the index marked substantial increase. The contained house price growth rates may associate with the lower house price and the higher supply. According to the lending activity survey, banks report a decline in demand for individual loans on housing purchase, as well as a contraction of the lending standards for this purpose. The tightening of lending conditions for housing, in particular in the second half of the year, may have affected the relative fall of this demand.

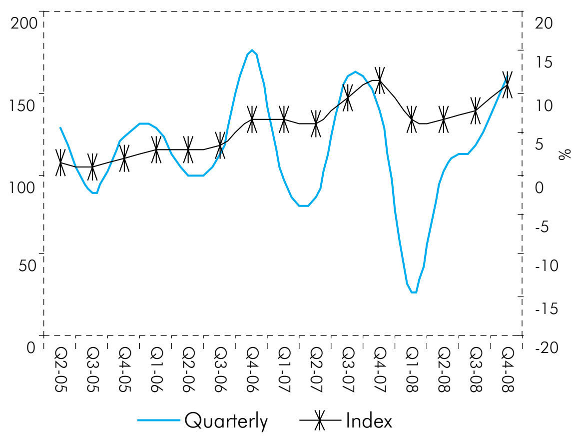
Chart 49 Share of real estate loans as a percentage to outstanding loans



Source: Bank of Albania

As far as supply is concerned, the number of new constructions increased in 2008, providing considerable impact over the containment of price rise. This is also attested by the performance of the real estate house index for the capital, Tirana, as shown in Chart 50.

Chart 50 House Price Index for Tirana



Source: Bank of Albania

Construction Cost Index, which assesses the performance of construction costs, did not seem to witness significant changes over the course of the year 2008. Compared with the same period the previous year, it increased by 1.4 percent in the last quarter of 2008. The rationale behind is the positive change of the price index of "direct expenses" by 0.2 percent from the previous quarter and by 2.4 percent from the last quarter of 2007. This group of expenses shares 67.6 percent of total construction expenses. Within this group, "personnel expenses" and "machinery expenses" rose by 1.6 and 0.3 percent, respectively. "Material expenses" fell by 0.2 percent in the last quarter of 2008, however this figure is 1.1 percent higher compared with the end of 2007. Within this subgroup, the construction material prices fell by 0.3 percent. Electric material prices rose by 3.8 percent in the last quarter while being up by 7.8 percent compared with the end of 2007. There are no significant changes in the percentage of projected profits. The performance of this index shows that prices in the housing market did not completely reflect the performance of the construction cost, implying the lowering of the profit margins for the construction industry.

The performance of house prices is of great significance to the construction industry, the public and to the financial system at home. Given the important role of houses and other real estates to consumers' long-term consumption, the banking sector and the financial system, the recognition of their price performance and the factors affecting them is crucial. At present, in order to draw conclusions on the housing price performance trends in the future, the methodology of collecting the information needs to be improved. This would provide greater geographical coverage and a more accurate assessment in terms of types of housing, area, location, year of construction, way of financing and payment, etc.

5 ANALYSIS OF THE FINANCIAL SYSTEM'S SOUNDNESS INDICATORS

The analysis of the financial system's soundness indicators focuses on the key developments of the intermediation banking activity during the year, including the relations between the balance sheet items and the change of their structure, the quality of the financial system's investment, capitalization, etc. This analysis covers the financial system and the banking groups, based on the size of their activity, in order to identify the systemic risk factors. The information on the financial soundness indicators for non-bank financial intermediaries is given in Box 8. The analysis is completed with stress test analyses for the banking sector, which are summarized in Box 7.

The analysis has been also extended to the banking groups, namely: Group 1, which includes the banks sharing 0-2 percent of total banking sector assets each; Group 2, which includes the banks sharing 2-7 percent of total banking sector assets each, and; Group 3, which includes banks sharing more than 7 percent of total banking sector assets each.

5.1 GENERAL DEVELOPMENTS IN THE FINANCIAL SYSTEM AND THE BANKING SECTOR

Financial intermediation in Albania, estimated as the ratio of the financial sector's[30] assets to the GDP[31], increased to 82 percent at the end of 2008 from 79.4 percent as at end 2007. Table 9 shows the share distribution of the financial system's entities to the GDP in years. As at end 2008, the assets' volume of financial institutions operating in Albania grew by 12.6 percent compared with the end of 2007. Banks play the major role in the financial system's assets structure. As at end 2008, 16 banks operated in Albania and their assets shared approximately 95.4 percent of total financial system's assets and about 78 percent of the GDP.

Table 9 Share of financial system's assets to GDP in years (by entity, in %)

Year	2005	2006	2007	2008
Banking system	60.4	69.6	75.9	77.7
Non-bank institutions	1.32	1.52	1.48	1.55
Insurance companies	1.24	1.29	1.36	1.52
Pension funds	-	-	-	-
Savings and loan associations	0.46	0.52	0.63	0.71

Source: Bank of Albania, Financial Supervisory Authority

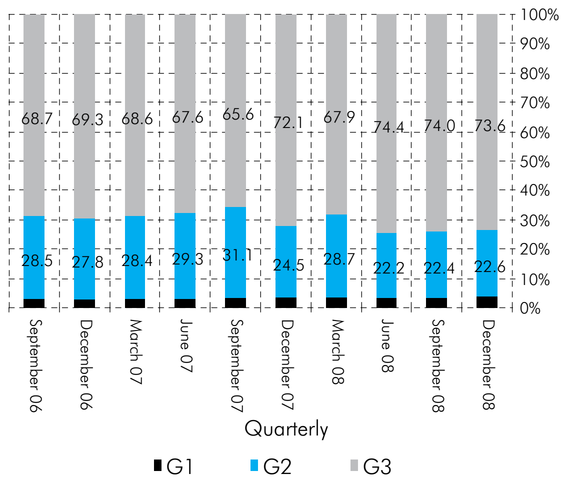
The banking sector's activity continued to grow in 2008. In terms of total system's assets, it amounted to ALL 843.1 billion or up by 12.4 percent from the previous year. However, the performance of the banking sector's activity pursued a different dynamics over the course of the year. Due to the withdrawal of deposits in the last quarter of 2008, there was a -2.7 change in total assets compared with the third quarter.

Lending activity, which accounted for about 48 percent of assets in December 2008, albeit upward since 2003, slowed down in particular in the last quarter. Loan portfolio amounted to ALL 396.8[32], sharing about 37 percent of GDP. Compared with the same period the previous year, this surplus attests to an increase by ALL 104.3 billion or about 36 percent. Despite their ever-increasing share to total balance sheet, the banking sector's foreign currency-denominated assets and liabilities witnessed a balanced foreign currency exposure, which is reflected in their comparable sizes.

With respect to activity financing, the customers' deposits share the main weight on the banking sector's liabilities side. They amounted to ALL 645.1 billion ALL, up by 2.4 percent from end of 2007, and accounting for about 77 percent of total assets. After several years of increasing trends, the share of public deposits to total banking sector's assets dropped in 2008, owing to the withdrawal of public deposits in the last quarter. It is estimated that about ALL 49.1 billion or about 7 percent has been withdrawn in the third quarter. Own funds, represented by the shareholder's equity, amounted to ALL 80.4 billion, up by 1.3 percentage points from the end of 2007 and 0.7 percentage points from the third quarter. Despite their ever-increasing share to total balance sheet, foreign currency-denominated assets and liabilities attested to a balanced foreign currency exposure. As at end 2008, the banking sector's foreign currency assets accounted for about 48.9 percent of total assets, while the foreign currency liabilities accounted for about 48.5 percent.

With respect to activity concentration, worth noting is that the large banks' assets, part of Group 3, shared 73.6 percent of total banking sector's assets as at end 2008. Group 3 banks grew their share after the number of participant banks increased in the second quarter. The importance of their activity progress has increased and their role in systemic risk has strengthened. However, the increase in the number of banks within a given group leads to lower concentration of activity within the group and the banking sector as a whole. The assets of Group 2 banks share 22.6 percent, while those of Group 1 banks share 3.8 percent of total banking sector's assets (see Chart 51).

Chart 51 Share of each peer bank group to total assets



Source: Bank of Albania

The following provides a detailed analysis of the characteristics of the banking system's intermediation activity, focusing on the analysis of the financial soundness indicators. The main financial soundness indicators for 2008 and the first quarter of 2009 are provided in Table 8.

Table 10 Financial soundness indicators

(%)	December '07	March '08	June '08	September '08	December '08	March '09
CAPITAL BASED INDICATORS						
Regulatory capital as a percent of risk-weighted assets	17.08	17.23	17.27	17.50	17.23	17.05
Tier 1 capital as a percent of risk-weighted assets	16.01	16.35	16.45	16.64	16.31	16.15
Tier 1 capital as a percent of total assets	6.57	6.93	7.12	7.57	7.83	8.15
Regulatory capital as a percent of total assets	7.01	7.30	7.47	7.96	8.28	8.60
Shareholders' equity as a percent of total assets	7.62	7.87	7.94	8.00	8.57	8.91
Net non-performing loans as a percent of capital						
Net non-performing loans as a percent of Tier 1 capital	10.72	11.86	14.60	12.02	22.97	23.20
Net non-performing loans as a percent of regulatory capital	10.05	11.25	13.91	11.43	21.74	21.97
Net non-performing loans as a percent of shareholders' equity	9.14	10.55	12.91	11.52	21.08	22.61
NON-PERFORMING LOANS (GROSS) AS A PERCENT OF TOTAL LOANS	3.36	3.92	4.31	4.12	6.64	7.55
RETURN ON EQUITY (ROE) (annual basis)	20.74	16.28	16.62	16.33	11.35	1.49
RETURN ON ASSETS (ROA) (annual basis)	1.57	1.28	1.31	1.29	0.91	0.13
Income and expenses indicators						
Interest margin to gross income	92.67	100.02	99.20	97.65	106.50	133.50
Non-interest expenses to gross income	58.51	73.29	72.05	71.98	81.36	151.87
LIQUIDITY						
Liquid assets as a percent of total assets	49.77	48.94	47.05	45.86	42.83	41.27
Liquid assets as a percent of short-term liabilities	73.96	71.36	66.15	68.39	64.86	57.13
Net open position in foreign currency as a percent of capital						
Net open position in foreign currency as a percent of Tier 1 capital	1.80	9.91	(0.58)	5.69	4.54	1.39
Net open position in foreign currency as a percent of regulatory capital	1.69	9.40	(0.55)	5.41	4.30	1.31
Net open position in foreign currency as a percent of shareholders' equity	1.57	7.65	(0.53)	5.27	4.05	1.24

Source: Bank of Albania

5.2 ASSETS AND LIABILITIES OF THE BANKING SECTOR AND THEIR STRUCTURE

The loan portfolio, which accounts for 47.6 percent of total assets - 3.5 percentage points higher than its share as at end the third quarter of 2008 and 8.2 percentage points higher than its share the previous year - shares the main weight to the banking sector's assets. The share of the loan portfolio to total banking sector's assets has progressively increased starting from the end of 2003 (see Table 11). "Treasury and interbank transactions[33]" is the next largest item with the main share to the banking sector's assets. As at end December 2008, this item amounted to ALL 251.4 billion or 30.1 percent of total assets. Its share to total assets maintained a downward trend (see Table 11), down by 5 percentage points relative to the end of the third quarter of 2008 and 9.3 percentage points relative to the previous year. Within the "Treasury and interbank transactions", T-bill transactions have the main share. They amounted to ALL 107 billion and account for 12.8 percent of total assets. Their performance however has been downward. The share of "securities transactions" (ALL 166.7 billion in December 2008 and 20 percent of total assets) is up by 2 percentage points from the previous year and 1.7 percentage points from the third quarter of 2008. The other items of the banking sector assets continue to have a negligible share.

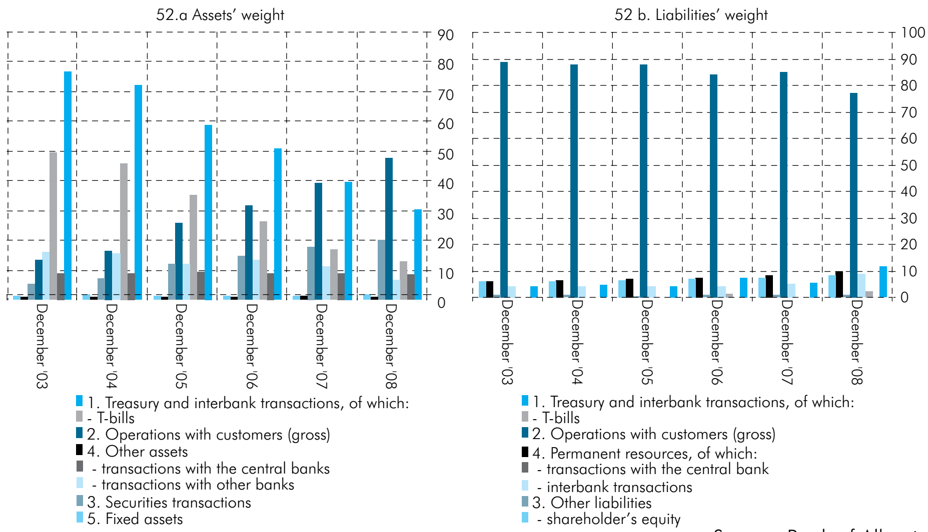
Table 11 Share of assets by item (December 2003 – December 2008)

Share to total assets (in %)	December 2003	December 2004	December 2005	December 2006	December 2007	December 2008
1. Treasury and interbank transactions, of which	76.5	72.4	58.8	50.6	39.5	30.1
- transactions with the central bank	8.7	8.7	9.3	8.9	9.0	8.3
- T-bills	49.6	45.8	35.3	26.3	17.1	12.8
- transactions with other banks	16.2	15.6	12.2	13.2	11.2	6.6
2. Operations with customers (gross)	13.5	16.4	25.7	31.7	39.4	47.6
3. Securities transactions	5.4	7.0	12.2	14.7	18.0	20.0
4. Other assets	0.8	0.8	0.7	0.9	1.3	1.0
5. Fixed assets	1.5	1.9	1.5	1.5	1.5	1.8
Total assets	100	100	100	100	100	100

Source: Bank of Albania

On the liabilities side of the banking sector, customer deposits share the main weight to total liabilities (about 77.3 percent) (see Chart 52 b and Table 12). The share of deposits to total liabilities has been downward compared with the end of the third quarter of 2008 and the end of 2007, by 3.7 and 7.5 percentage points, respectively. The second major important liability item is "treasury and interbank transactions[34]", which as at end December 2008 accounted for 11.8 percent of total liabilities, about 3.2 and 6.2 percentage points higher from the end of the third quarter of 2008 and the end of 2007. "Permanent resources[35]" had an upward trend. As at end 2008, they accounted for 9.6 percent of total banking sector's liabilities, up by 0.7 and 1.3 percentage points, respectively, from the end of the third quarter of 2008 and the end of 2007. Within "permanent resources", shareholder's equity shares 89 percent, amounting to ALL 71.4 billion as at end 2008 and accounting for 8.6 percent of total liabilities. The item's share has also maintained an upward trend compared with the end of 2007, increasing by 1.3 percentage points (see Chart 52 b). As at end December 2008, "other liabilities[36]" accounted for only 1.1 percent of total liabilities, up by 0.1 percentage points from the previous year.

Chart 52 Share of assets and liabilities by item (December 2003 – December 2008)



Source: Bank of Albania

Table 12 Share of liabilities by item (December 2003 – December 2008)

Share to total liabilities (in %)	December 2003	December 2004	December 2005	December 2006	December 2007	December 2008
1. Treasury and interbank transactions	4.4	4.5	4.1	7.6	5.7	11.8
- transactions with the central bank	0.2	0.2	0.2	0.2	0.0	0.1
- T-bills	0.0	0.0	0.0	1.4	0.2	2.4
- Interbank transactions	4.2	4.3	4.0	4.0	5.3	9.0
2. Operations with customers (gross)	88.7	88.1	88.1	84.2	84.9	77.3
3. Other liabilities	0.7	1.0	0.6	0.8	1.0	1.1
4. Permanent resources, of which:	6.2	6.3	7.2	7.4	8.4	9.6
- shareholder's equity	5.9	6.1	6.6	6.8	7.5	8.6
Total liabilities	100	100	100	100	100	100

Source: Bank of Albania

Banking activity continues to be mostly dominated by domestic resources, of which the deposits have the main share. However, due to the decline of the banking sector's deposits in the last quarter of 2008, denominated mainly in foreign currency, the financing of activity through foreign resources, in the form of higher liabilities to non-residents, rose at the end of 2008 to 10.1 percent of the total balance, from 8.3 percent in September 2008 and 6.1 percent as at end 2007.

5.3 BALANCE SHEET ITEMS

5.3.1 BALANCE SHEET COMPOSITION BY CURRENCY AND NET OPEN POSITION IN FOREIGN CURRENCY

As at end 2008, the banking sector's assets denominated in foreign currency accounted for about 48.9 percent of total assets, down by 1.7 percentage points from the end of September 2008 and up by 2 percentage points from the end of 2007. For the same period, the banking sector's liabilities denominated in foreign currency accounted for about 48.5 percent of total assets, down by 1.7 percentage points from the end of September 2008 and up by 1.6 percentage points from the end of 2007.

With respect to their share to total assets, foreign currency-denominated assets and liabilities have almost always recorded close values, attesting to the balanced exposure to the banking sector's activity in foreign currency. Table 13 shows their performance in periods:

Table 13 Share of foreign currency-denominated assets and liabilities to total banking sector's assets

Share to total banking sector's assets (in %)			
Period	Foreign currency assets	Foreign currency liabilities	Difference (1)-(2)
December 2005	41.1	41	0.1
March 2006	41.5	41	0.5
June	41.6	41.6	0
September	43.3	43.2	0.1
December	44.2	44	0.2
March 2007	45.6	45.2	0.4
June	45.7	45.7	0

September	46.6	46.5	0.1
December	46.8	46.9	-0.1
March 2008	47.9	47.7	0.2
June	48	48.1	-0.1
September	50.6	50.2	0.4
December 2008	48.9	48.5	0.4

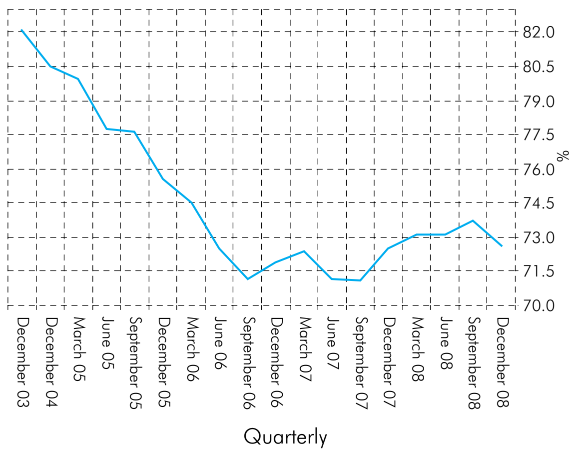
Source: Bank of Albania

Although balanced, the banking sector' activity in foreign currency has been steadily growing, as attested by the share performance of foreign currency-denominated assets and the liabilities in the last three years.

Since the deposits and loans have the largest share in the balance sheet, they determine the bank's sensitivity to the foreign currency exposure to the largest extent. As at end December 2008, foreign currency-denominated deposits accounted for about 43.1 percent of total deposits. This ratio varies from 29 to 70 percent for banks. For the same period, foreign currency-denominated loans accounted for 72.6 percent of total loans. Chart 53 shows the performance of this ratio.

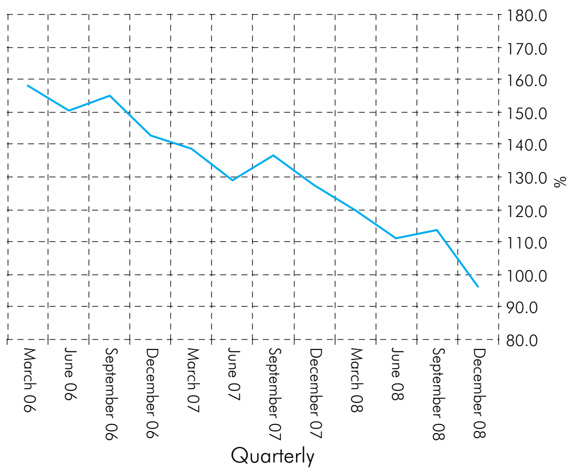
Chart 54 provides the performance of this ratio in terms of peer bank groups. As shown by the chart, Group 1 banks have preferred the foreign currency-denominated loans the most and this ratio has been upward compared with the third quarter 2008. The ratio for the two other peer bank groups stands between 69 and 75 percent. In contrast to Group 1, this ratio has been decreasing compared with the third quarter of 2008.

Chart 53 Foreign currency-denominated loans to total loans (in percent)



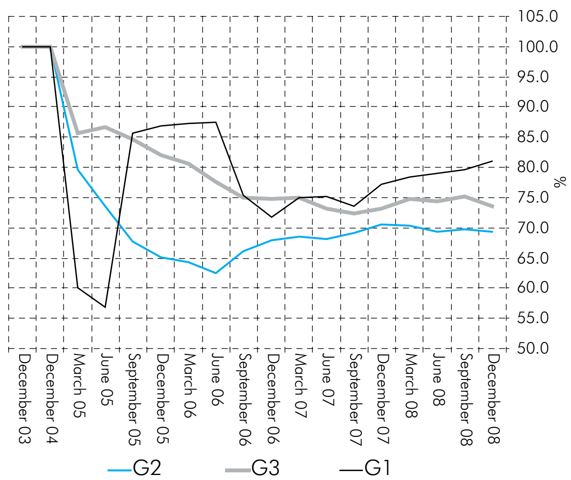
Source: Bank of Albania

Chart 55 Foreign currency-denominated deposits to foreign currency-denominated loans



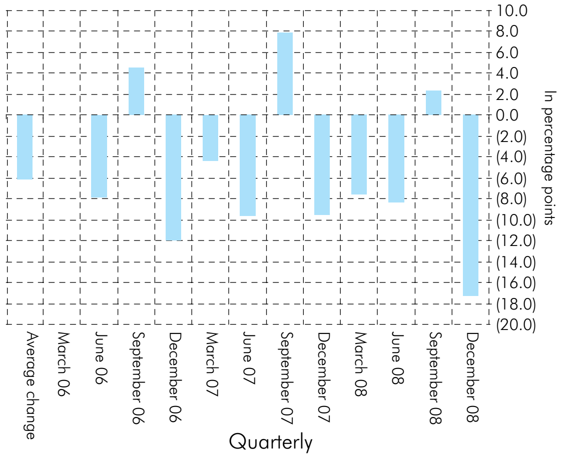
Source: Bank of Albania

Chart 54 Foreign currency-denominated loans to total loans for peer bank groups



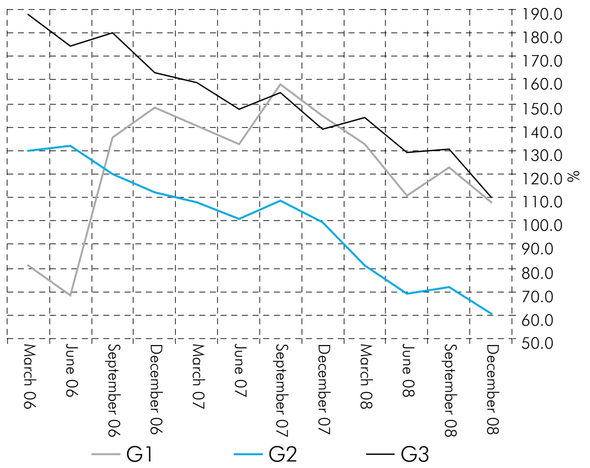
Source: Bank of Albania

Chart 56 Quarterly change in foreign currency deposits to foreign currency loans (in percentage points)



Source: Bank of Albania

Chart 57 Foreign currency deposits to foreign currency loans by peer bank groups



Source: Bank of Albania

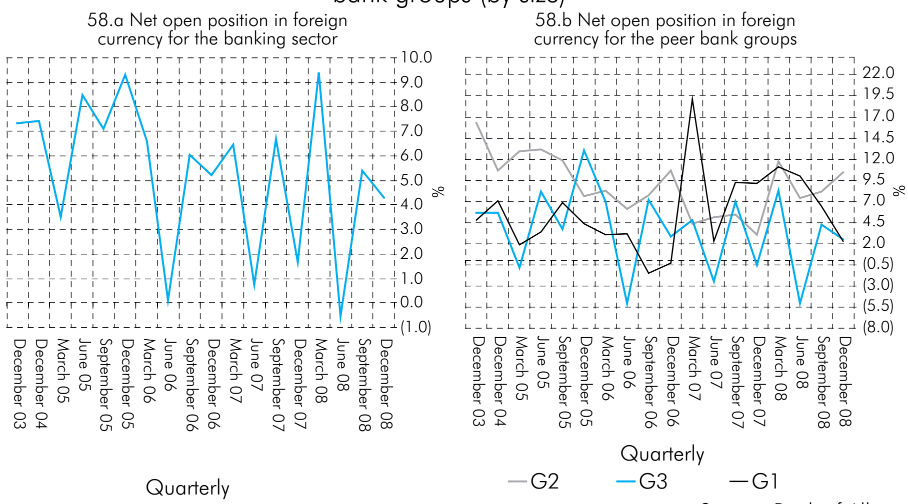
The size of the foreign currency use in the banking sector' intermediation activity is also shown by the ratio of foreign currency-denominated deposits to foreign currency-denominated loans, whose performance is shown in Chart 55. In the last quarter of 2008, the ratio of foreign currency-denominated deposits to foreign currency-denominated loans for the whole banking sector, declined for the first time to below 100 percent, 96.5 percent as at year-end.

The substantial decrease of this ratio in the last quarter of 2008 owes to the decline of foreign currency-denominated deposits following their withdrawal from the banking sector. The quarterly change of this ratio is shown in Chart 56.

In terms of peer bank groups, the ratio for Group 2 banks is below 100 percent standing close to 61 percent, while the ratio for Groups 1 and 3 banks is about 110 percent. This ratio implies that the lending activity in foreign currency for Group 2 banks is financed through other resources in addition to deposits, where the credit lines from parent banks have the largest share. This exposure makes banks more sensitive to the financing conditions in the international markets.

As at end December 2008, the banking sector's net open position in foreign currency accounted for 4.3 percent of regulatory capital (see Chart 58.a). This indicator has almost always been moderately

Chart 58 Exposure to exchange rate risk for the banking sector and the peer bank groups (by size)



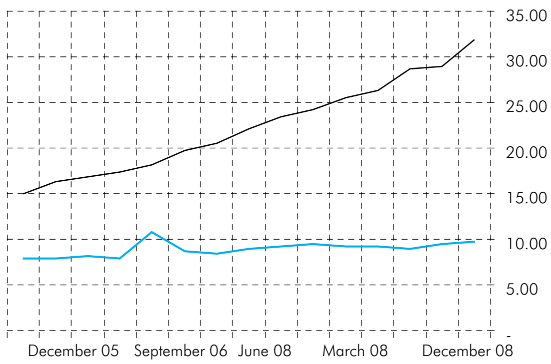
Source: Bank of Albania

"long" over the past years to an interval of 0-10 percent. In terms of peer bank groups, Group 2 banks seem to have maintained a stable and relatively higher long net foreign currency position (see Chart 58.b) than the other peer bank groups. This behaviour probably owes to the structure of their resources (insufficient deposits) and to the necessity of having available liquid assets in foreign currency in order to meet the various demands.

5.3.2 COMPOSITION BY MATURITY TERMS

As at end 2008, the banking sector' assets had an average remaining maturity[37] of about 31.8 months, from 28.8 months the previous quarter and 25.5 months the same period in 2007. For the same period, the banking sector's liabilities had an average remaining maturity[38] of about 9.7 months from 9.4 months the previous quarter and 9.2 months the same period the previous year. Chart 59 shows the performance of average maturity for the assets and liabilities in the recent years.

Chart 59 Average remaining maturity of assets and liabilities



Source: Bank of Albania

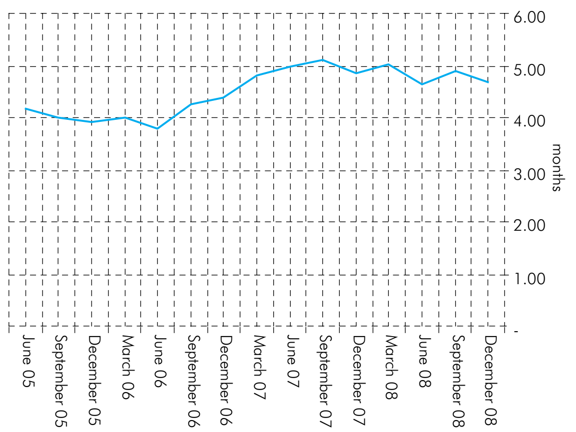
The chart shows that the average maturity of the banking sector's assets has increased by about 16.7 months (from 15 months to 31.7 months) starting from June 2005. Liabilities show the same performance, where their average maturity has increased by about 1.9 months (from 7.8 months to 9.7 months). The difference in terms of maturity between assets and liabilities has widened, a trend which will attempt to persist furthermore in the future. The widening of this difference makes the banking sector more sensitive to the liquidity and market risks; therefore more prudent attention is required from the banking industry.

Worth noting is that the classification of assets and the liabilities in terms of "days" refers to the remaining maturity term and not to its tradability. Securities are assumed to be held to maturity. When the analysis of liquidity indicators is made, the tradability of a product determines its liquidity characteristics and it affects the general liquidity indicators of the bank.

With respect to the assessment of the maturity terms by individual items in the balance sheet, we focus on the deposits and loans as products that affect the maturity gap of balance sheet items the most. As at end the last quarter of 2008, average maturity terms of deposits[39] was about 4.7 months, compared with about 4.9 months in the third quarter and in the same period the previous year. As at end 2008, the loan portfolio average maturity[40] decreased to 47.4 months compared with 47.7 months as at end the third quarter. However, the average maturity term of loans remains about 1.9 months longer than the previous year.

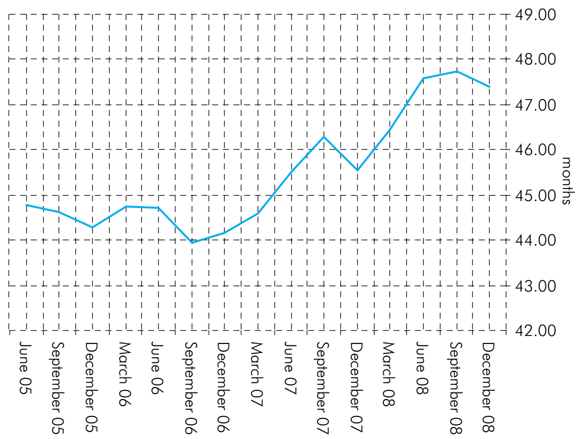
Charts 60 and 61 show the performance of deposit and loan portfolio average duration.

Chart 60 Average remaining maturity of deposits (monthly)



Source: Bank of Albania

Chart 61 Average remaining maturity of loans (monthly)

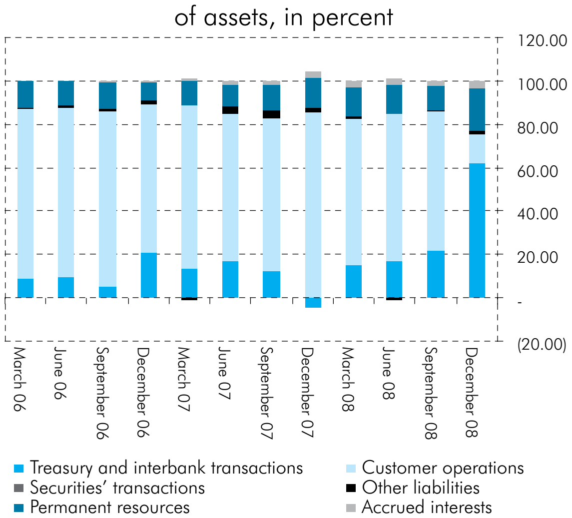


Source: Bank of Albania

5.3.3 COMPOSITION BY FINANCING

The contribution of deposits to assets' growth reduced substantially in 2008. Their growth contributed by only 13 percent to the assets' growth, much lower than the average[41], attesting to a substantial decline from September 2008. On the other hand, the contribution of "treasury and interbank transactions", which include the credit lines from the foreign parent banks, was 62 percent, therefore attesting to a much higher value than the average – the highest in the last three years. This shows a shift in the financing of domestic banks' activity, which have relied on borrowing from abroad following the decline of deposits during this period. The growth of deposits provided the main contribution to the growth of assets in the first three quarters of 2008. Box 6 provides detailed information of the performance of deposits in 2008 and the first quarter of 2009.

Chart 62 Contribution of resources to the growth of assets, in percent



Source: Bank of Albania

"Permanent resources" contributed by 19 per cent to the growth of assets, which is above the average. The contribution of other items, such as "Other liabilities" and " Accrued interests" shows values above the average, 2 and 4 percent, respectively.

As a share to total liabilities of the banking sector, liabilities to non-residents, which are mainly affected by the borrowings from the holding banking groups, increased in the last quarter of 2008 and the first quarter of 2009 (see Chart 63).

As shown in Chart 64, Group 2 banks provide the main contribution to the performance of liabilities to non-residents.

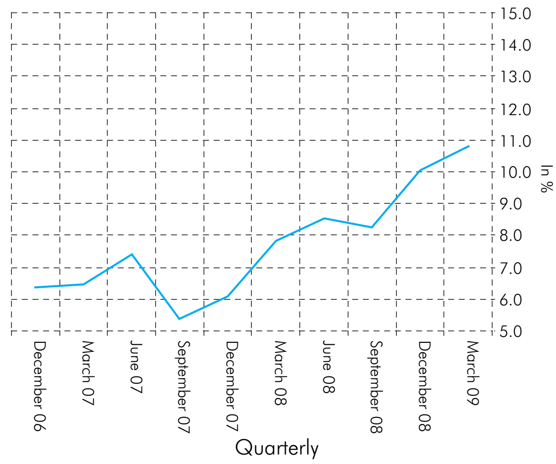
With respect to banks operating in Albania, liabilities to non-residents represent credit lines obtained from holding banking groups and not borrowings from other foreign banks. Therefore, they are considered highly safe in terms of stability over time.

Since the borrowings from parent banks are always in foreign currency, starting from the last quarter of 2008, their increase has led to higher share of liabilities to non-residents to total foreign currency-denominated liabilities to 21.8 percent as at end the first quarter of 2009 (see Chart 65). The decline in foreign currency-denominated deposits of the banking sector in the last quarter of 2008 has led to the increase of this ratio.

Chart 66 shows the performance of the Herfindahl Index, which indicates a downward concentration of the banking sector's liabilities to non-residents starting from September 2008.

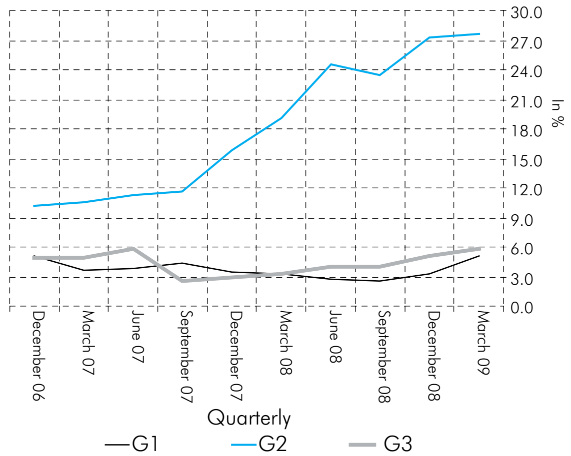
With respect to the use of foreign financing, we note that starting from December 2006 there has been a shift from assets from non-residents to foreign currency assets (see Chart 67), which

Chart 63 Liabilities to non-residents as a share to total liabilities



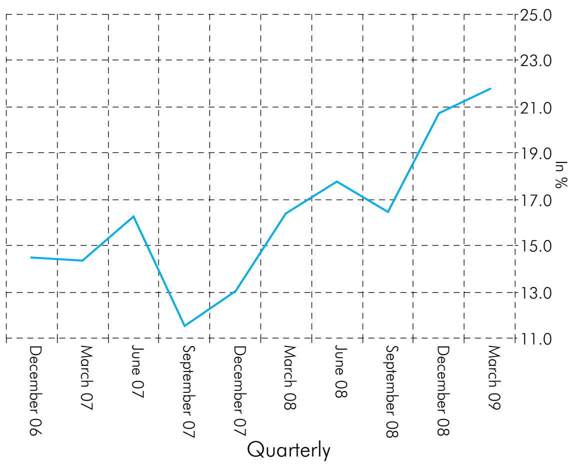
Source: Bank of Albania

Chart 64 Liabilities to non-residents as a share to total liabilities by peer bank groups



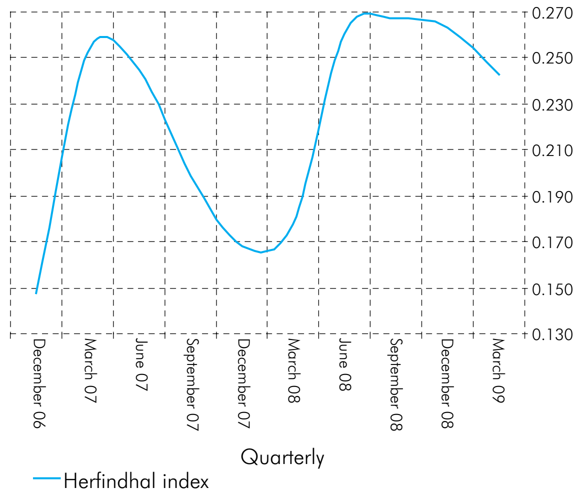
Source: Bank of Albania

Chart 65 Liabilities to non-residents to total liabilities in foreign currency



Source: Bank of Albania

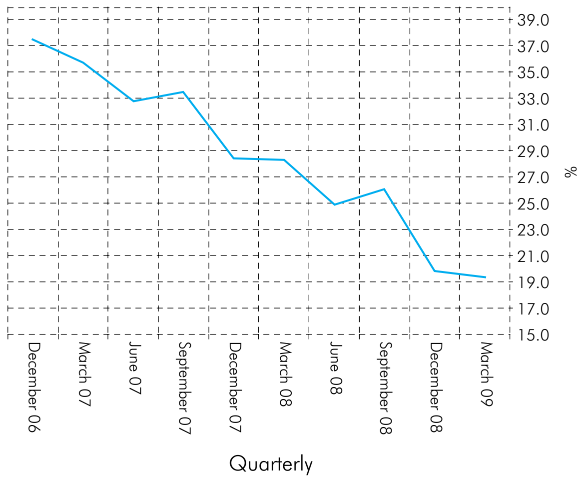
Chart 66 Concentration of liabilities to non-residents



Source: Bank of Albania

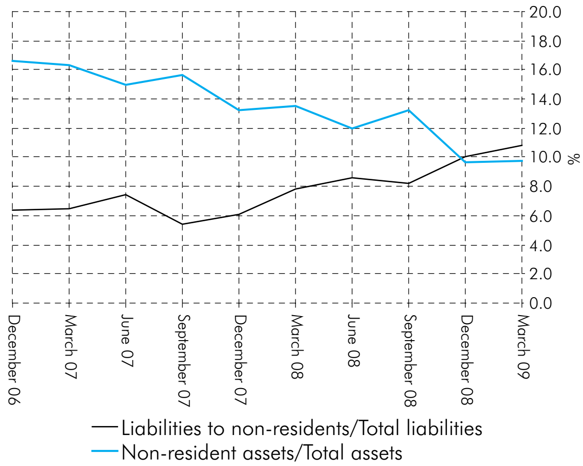
include domestic borrowing denominated in foreign currency. In fact, since December 2006, the banking sector has been investing less in the respective holding banking groups. This is witnessed by the persistent decline of assets to non-residents compared with foreign currency-denominated assets. This has occurred at a time when foreign currency-denominated assets have increased, hence providing evidence for the priority given by the banking sector to financial intermediation at home through lending in foreign currency. Worth noting for the last quarter of 2008 is that this performance has been also fuelled by the short-term need to reduce assets with non-residents and use them as assets to offset the reduced amount of deposits in foreign currency.

Chart 67 Non-resident assets



Source: Bank of Albania

Chart 68 Banking sector position to non-residents



Source: Bank of Albania

The spread between the banking sector's non-resident assets and liabilities to non-residents has been narrowing (see Chart 68). For the first time in the first quarter of 2009, the banking sector was presented as a "debtor" to non-residents, that is liabilities to non-residents are higher than non-resident assets.

Box 6 Deposits and their performance

The banking sector's deposits level declined in the last quarter of 2008, impacting significantly their annual growth, which turned out to be weak. Deposit decline was triggered by the shaking of public confidence in the banking sector stability, due to psychological effects related to the development and severity of international financial crisis and uncertainty about its effects on the Albanian banking sector. Because of a fairly good liquidity position and capitalization of activity, the banking sector withstood the situation created quite well. Notwithstanding the overall deposit decline, new deposits with banks were considerable, reflecting also the banks' efforts to increase them through promotional interest rate offers. Deposits continued to be concentrated in the largest banks, but the degree of their concentration declined.

Total deposits recorded a growth of about 2.4 percent compared to year-end 2007, while their growth for the last two years stands at about 20 percent (see Table

14). In the meantime, by the end of September 2008, total deposits declined by 7 percent owing to the intensification of bank customers' withdrawals during October-December 2008.

Table 14 Banking sector's annual growth of total deposits during 2004-2008

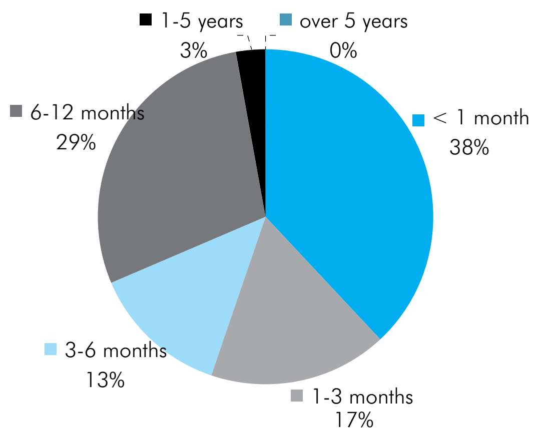
	2004	2005	2006	2007	2008
Total deposit growth (in %)	13.4	16.4	20.1	19.9	2.4

Source: Bank of Albania

In analyzing the deposit-maturity structure, it is noticed that as at December 2008, most of deposits with the banking sector, about 66 per cent, were of up to one-year maturity (see Chart 69). Relative to September 2008, time deposits of up to one-month maturity increased by 0.2 percentage points; deposits of more than 5-year maturity, whose share is negligible, were almost unchanged, whereas those of other maturities declined. Against year-end 2007, time deposits of 6-12 month maturity increased by 3.7 percentage points, those of 1-3 month maturity increased by 0.1 percentage point, time deposits of above 5-year maturity were unchanged, whereas deposits of other maturities declined.

Chart 69 Deposit-maturity structure of the banking sector

(December 2008, in %)



Source: Bank of Albania

Concerning deposit structure by currency, it is noticed that at year-end 2008, ALL deposits accounted for 57 percent of total deposits, amounting to ALL 367.3 billion, while those in foreign currency accounted for 43 percent of total deposits, amounting to ALL 277.9 billion. ALL deposit share has increased by 2.5 percentage points relative to September and decreased by 0.2 percentage points relative to end-2007.

New deposit performance has reflected the marked situation of overall deposit performance, particularly in the last quarter of the year. In December, about ALL 30.5 billion new ALL-denominated deposits were accepted, about 20 percent less than as at December 2007. Notwithstanding the decline, new ALL deposit performance by months of the last quarter of the year recorded a rise. New ALL deposits accepted in December were respectively 10 and 31 percent higher than those of October and November. As concerns the new deposit-maturity structure for year-end 2008, an increase is shown in the share of new deposits of up to 6-month maturity (particularly for those of 1 to 3- month maturity).

Table 15a New ALL-denominated deposit structure held with the banking sector

Maturity share (%)	December 2007	March 2008	June 2008	September 2008	December 2008
2-year	2.12	1.37	0.78	2.04	1.31
1-year	29.96	28.35	24.21	41.72	29.60
6-month	17.99	19.04	22.04	15.74	17.10
3-month	15.82	22.72	22.04	18.52	23.91
1-month	33.76	28.12	30.46	21.39	27.77

Source: Bank of Albania

Average interest rate on new ALL-denominated deposits was 5.48 percent in December, relative to 4.9 percent in the same period the previous year. The higher interest rate has reflected the grown demand of the banking sector for ALL-denominated deposits, against a background of their decline. New EUR-denominated deposits lodged with the banking sector in December 2008 were EUR 751 million, or

ALL 92.2 billion. Their performance during the last quarter of the year was downward, though at a slower rate. New EUR-denominated deposits accepted in December 2008 were 15.2 percent and 9.4 percent lower, respectively, than those of October and November. Compared to September, this figure is almost similar, whereas it is about 68 percent higher than in December 2007. Related to the maturity structure of new EUR-denominated deposits, it is noticed that the public has preferred 1-month deposits, which constitute also the major part of them. (See Table 15b)

Table 15b Structure of new EUR-denominated deposits held with the banking sector

Maturity share (%)	December 2007	March 2008	June 2008	September 2008	December 2008
2-year	0.51	0.18	0.24	0.36	0.13
1-year	8.24	5.76	5.51	9.45	3.56
6-month	6.64	6.02	4.98	4.19	2.18
3-month	10.98	23.50	9.55	8.97	8.78
1-month	73.49	64.41	79.63	76.85	85.31

Source: Bank of Albania

Average interest rate on new EUR-denominated deposits was 3.14 percent in December 2008, against 3.01 percent in the same period the previous year. The higher interest rate on EUR-denominated deposits has reflected the higher demand of the banking sector for EUR-denominated deposits, against a background of their decline.

New USD-denominated deposits held with the banking sector in December 2008 were USD 63.8 million, or ALL 5.3 billion. Their performance during the last quarter of the year was downward, though at a slower pace. New USD-denominated deposits accepted in December were 68 percent and 53 percent lower than those of October and November, respectively. This figure is 54 and 48 percent, respectively, lower than in September and December 2007. Throughout 2008, deposits of less than 3-month maturity term accounted for above 70 percent of total new USD-denominated deposits (see Table 16).

Table 16 Maturity structure of new USD-denominated deposits held with the banking sector

Maturity share (%)	December 2007	March 2008	June 2008	September 2008	December 2008
2-year	0.33	0.18	0.37	0.16	0.12
1-year	21.48	12.38	10.33	16.64	15.82
6-month	10.59	11.63	10.87	10.42	12.42
3-month	21.82	24.07	21.23	26.04	22.55
1-month	45.47	51.06	57.14	46.56	49.09

Source: Bank of Albania

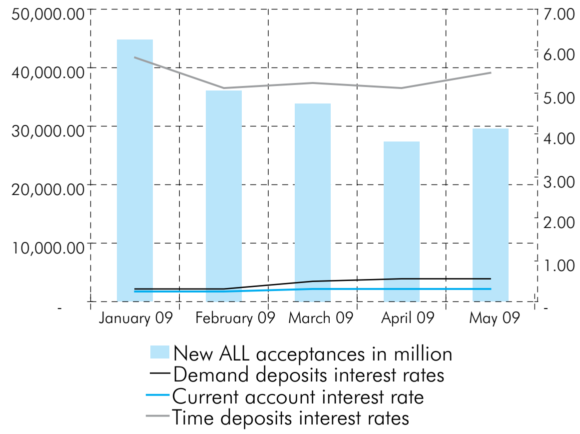
Average monthly interest rate on new USD-denominated deposits was 2.01 percent in December 2008, against 3.66 percent in the same period the previous year.

Concerning the first months of 2009, new acceptances of ALL-denominated deposits and current accounts have reflected a monthly downward trend, decelerating slowly. This has coincided with the downward trend of deposits over the first quarter of 2009. Since May, the stock of deposits has re-started to grow, thus reflecting a larger stability of existing deposits.

Acceptance of new EUR-denominated deposits and current accounts has reflected a stable performance during the first months of 2009. In the meantime, a steadier improvement has been noticed in new USD-denominated deposits and current accounts.

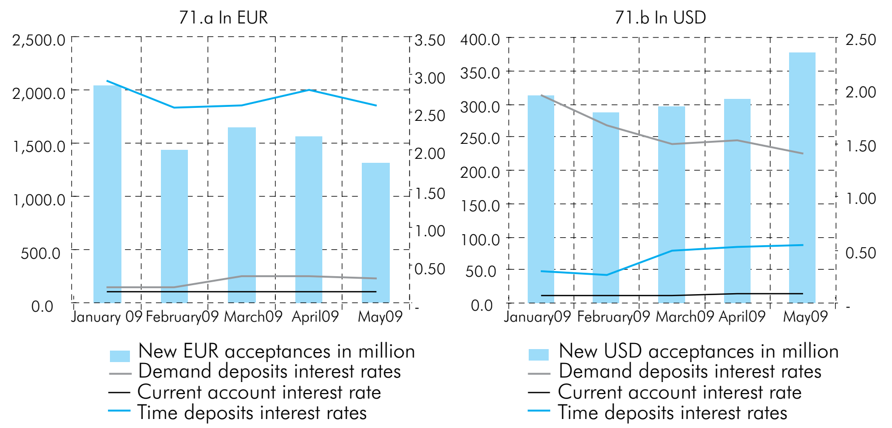
In general, new deposit performance attests to the fact that the returning of deposits to the banking sector is not yet placed on stable growth rates. Also, other factors related to the likely unfavorable performance of the protracted global crisis, lower expectations for remittances, difficulties in the overall growth of economic agents' income and deceleration of loans' growth may defer and decrease the desired recovery of deposits to the banking sector. Therefore, the banks' liquidity position should be prudently and constantly monitored.

Chart 70 Total volume of new ALL acceptances against average interest rates on ALL current accounts, time and demand deposits, respectively



Source: Bank of Albania

Chart 71 Total volume of new EUR-denominated acceptances against average interest rates for current accounts, demand and time deposits denominated in EUR and in USD, respectively



Source: Bank of Albania

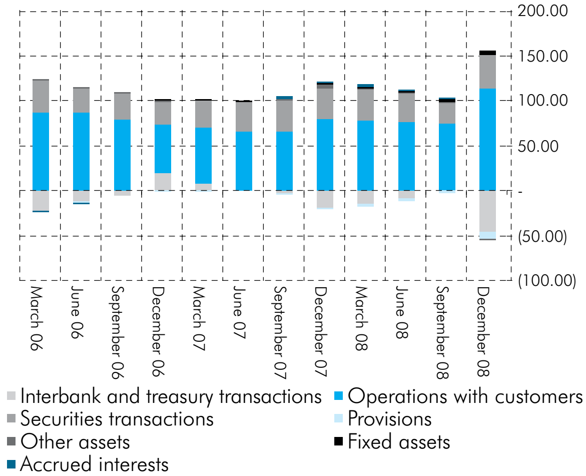
5.3.4 INVESTMENT DISTRIBUTION AND QUALITY

Investment distribution in the banking system reflects the performance of asset items in the course of time, thus observing the bank-oriented investments and the degree of operational risk taken by the banking sector.

Chart 72 provides the distribution of asset items' contribution during a three-year period[42], starting from March 2006.

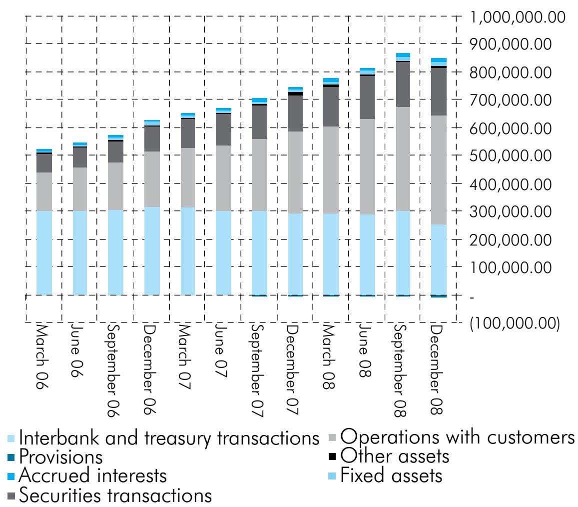
The chart shows that the contribution of asset items until the third quarter of 2008 performed normally, quite close to average historical values. The largest contribution to assets' growth was provided by "operations with customers, gross", which represents the lending activity. Hence, in the third

Chart 72 Distribution of asset items' contribution, in percent



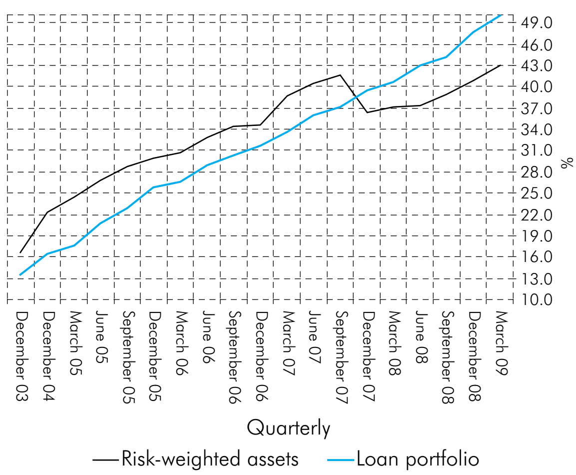
Source: Bank of Albania

Chart 73 Asset items' performance



Source: Bank of Albania

Chart 74 Banking sector's risk-weighted assets



Source: Bank of Albania

quarter of 2008, this item contributed 74.5 percent to assets' growth, quite close to an average of 73.5 percent estimated since March 2006. "Securities transactions" for the same period contributed 22.4 percent to assets' growth, less than the historical average of 30.4 percent. Among asset items, "other assets" and "fixed assets" contributed less, respectively 1.9 and 2.6 percent. The historical average contribution of these items is estimated at 1.1 and 1.3 percent, respectively. The decline of "interbank and treasury transactions" and the rise of "provisions" have negatively contributed to assets' growth.

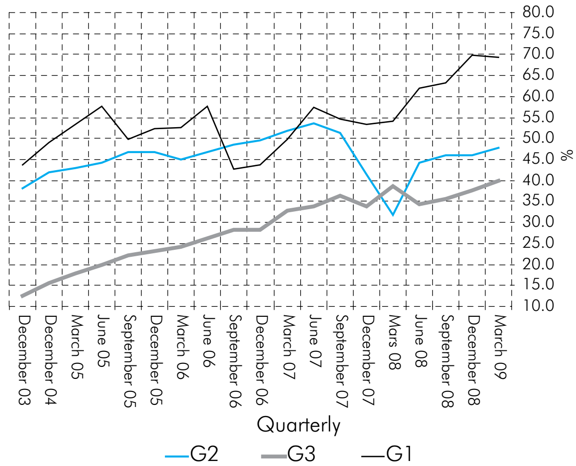
Chart 72 shows that during the last quarter of 2008, asset items deviated from their normal trends, due to international financial developments, thus contributing to the reduction of the banking system's asset level. Chart 73 provides a better insight into the assets' performance by items over the last quarter of 2008 and their stock position.

Chart 73 indicates that the upward long-term trend of the banking sector's assets is "broken" temporarily in the last quarter of 2008, a period when assets dropped by 2.7 percent. "Securities transactions" maintained their trend over time. "Operations with customers, gross", which represent lending, have been steady but have recorded decelerated growth rates in the last quarter of the year. "Interbank and treasury transactions" of the banking sector declined to 16.6 percent compared with the previous quarter. The main impact on this decline was provided by "deposits with banks, loans and other financial institutions", which dropped 49 percent relative to the previous quarter and 38 percent relative to the same period the previous year. In parallel with that, banks decreased the Treasury bill portfolio by 9.4 percent relative to the previous quarter and 15.8 percent relative to the same period the previous year. The higher liquidity demands pushed banks to withdraw their lodgements from parent banks, in order to finance their domestic needs. Also, during this period banks started to rapidly raise provisions for covering any possible loan losses. As shown by Chart 73, "provisions" increased by 46.6 percent in the last quarter of 2008 compared to the previous quarter.

In order to better assess the risk level attached to investment of asset items, we make an analysis of the performance of banking sector's risk-weighted assets, as shown in Chart 74.

The performance of banking sector's risk-weighted assets continued to present a downward trend, though at a lower pace during 2008. At year-end 2008, they accounted for about 40.8 percent of total assets, from 38.9 percent in the previous quarter and 41 percent in the same period the previous year. This quarterly increase was mainly an outcome of the decreased level of low-risk assets[43]. The performance of risk-weighted assets is mainly determined by the loan portfolio performance[44], which in December 2008 accounted for 47.6 percent of total assets, compared to 44 percent in the preceding quarter and 39.4 percent in the previous year. As concerns the peer bank groups (see Chart 75), the ratio of "risk-weighted assets to total assets" has increased particularly for G1 and G3 peer banks, since the loan portfolio for banks of both these groups has expanded at more accelerated rates (for G1 peer group: from 36.5 percent of total assets in December 2007 to 47 percent in December 2008; for G3 peer group: from 33 percent to 43 percent of total assets for the same period).

Chart 75 Risk-weighted assets to total assets by peer bank groups



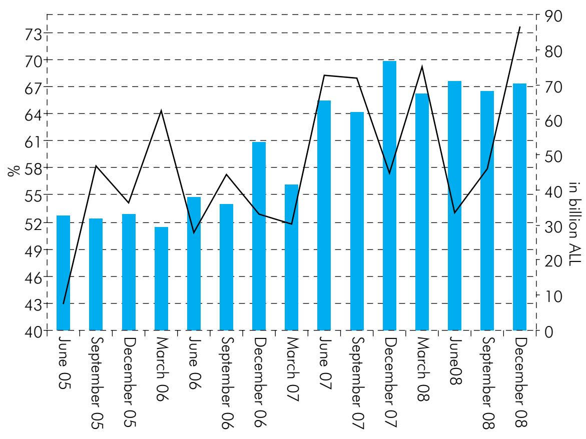
Source: Bank of Albania

In addition to the distribution of financing to different activities, special attention has been paid to loan portfolio features. To this end, the following presents a detailed analysis on: credit growth rate and its use; loan portfolio composition by borrower, use, foreign currency, duration and sectoral breakdown; and non-performing loan portfolio and coverage by collateral.

As at last quarter of 2008, new loans extended by the banking sector were ALL 70.3 billion, from ALL 68.1 billion the previous quarter and ALL 77 billion in the same period the previous year. During the same period, loans collected by the banking sector were ALL 51.7 billion, from ALL 39.4 billion in the previous quarter and 44 billion in the same period the previous year. As a result, the outstanding loan portfolio grew to ALL 396.7 billion, up by 5 percent from the previous quarter and 35.6 percent from the previous year.

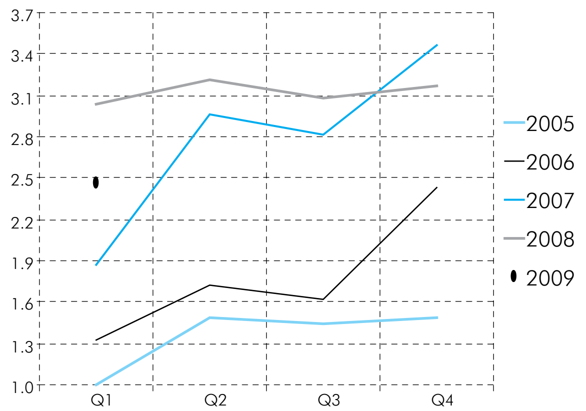
Collected loans to extended loans ratio represents the loan use indicator. At end-December, this ratio accounted for 73.6 percent, from 57.8 percent at end-September 2008 and 57.4 percent the same period the previous year (see Chart 76). In March 2009, this indicator dropped to 64 percent. Since March 2006, this indicator has averaged to 60 percent. The growth of this indicator during the last quarter of 2008 attributes to greater efforts of banks to collect loans against a background of higher liquidity needs. Its performance as at the first quarter of 2009 was conditioned by the decline in new loans.

Chart 76 New loans (right-hand) and use of loans (left-hand)



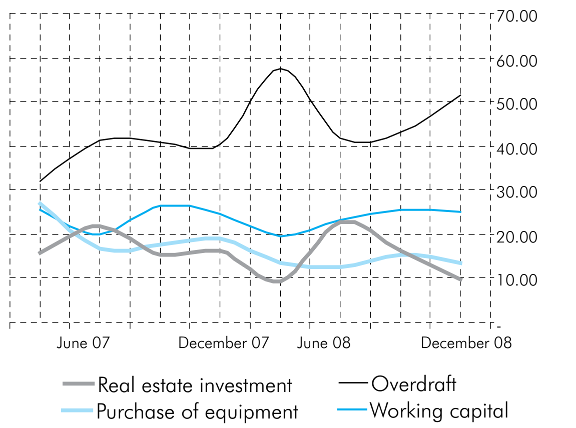
Source: Bank of Albania

Chart 77 New loans by quarters (March 2005 = 1)



Source: Bank of Albania

Chart 78 New business loans by purpose of use, in percent



Source: Bank of Albania

Chart 77 shows new loans by quarters as a percent to their amount in the first quarter of 2005.

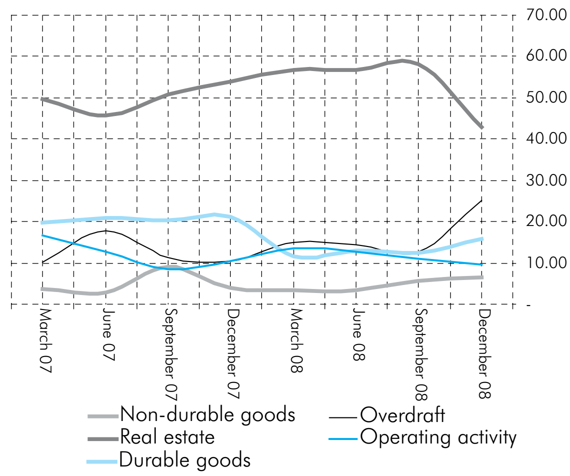
The chart highlights the stable lending of new loans during 2008 and its decline in the last quarter of the year relative to the same period in 2007. The chart also shows the deceleration in new loans' extension over the first quarter of 2009.

In terms of users, during 2008 the business sector benefited about 80 percent of new loans or nearly ALL 208 billion, up by ALL 34 billion or 19.6 percent compared to the previous year. Unlike the business sector, new household loans extended during 2008 resulted to ALL 69 billion, about ALL 3.6 billion or 4.9 percent less than in the previous year.

New business loans by purpose of use are shown in Chart 78. It is noted that the new loans for real estate investment purposes have a higher share by about 23 percent in the second quarter of the year and a marked decline in the last quarter of the year by 10 percent (see Chart 78).

New household loans by purpose of use are shown in Chart 79. New household loans for the year 2008 are mainly concentrated in real estate investment, with the largest share in the third quarter of the year, by about 58 percent. In the last quarter of the year, there was a shift to overdraft loans, whose share reached 25 percent. At the same time, the share of real estate investments dropped to 43 percent.

Chart 79 New household loans by purpose of use, in percent



Source: Bank of Albania

In terms of foreign currency composition, new ALL-denominated loans grew in the last quarter of 2008. During this period, about ALL 26.2 billion new ALL-denominated loans were extended to businesses and households, accounting for about 37.2 percent of total new loans for the quarter. In terms of new foreign currency-denominated loans, EUR-loans (to businesses and households) were about ALL 35 billion or about 50 percent of total new loans, compared to about ALL 48 billion or 62 percent in the same period the previous year. The share of new loans extended in U.S. dollar was smaller, accounting for approximately 12.6 percent of total new loans. Loans extended in other currencies accounted for only 0.5 percent of total new loans extended by the banking sector.

More specifically, Table 17 shows the composition of new loans extended to businesses and households during the last quarter of 2008, by purpose of use and in terms of foreign currency.

Table 17 New loans for the last quarter of 2008

Businesses (000 lek)	53,491,011	%	Households (000 lek)	17,120,000	%
ALL	17,039,444	31.85	ALL	9,123,908	53.29
Overdraft	8,025,898	47.10	Overdraft	1,843,467	20.20
Working capital	6,060,468	35.57	Consumption of non-durable goods	690,787	7.57
Investment in purchase of equipment	1,761,154	10.34	Consumption of durable goods	2,056,981	22.54
Investment in real estates	1,191,923	7.00	Real estate purposes	3,219,785	35.29
USD	7,964,507	14.89	Operating purposes	1,312,888	14.39
Overdraft	5,072,230	63.69	USD	900,865	5.26
Working capital	1,958,309	24.59	Overdraft	709,323	78.74
Investment in purchase of equipment	885,156	11.11	Consumption of non-durable goods	46,917	5.21
Investment in real estates	48,812	0.61	Consumption of durable goods	27,434	3.05
EUR	28,468,642	53.22	Real estate purposes	112,906	12.53
Overdraft	14,536,432	51.06	Operating purposes	4,286	0.48
Working capital	5,307,187	18.64	EUR	6,467,310	37.78
Investment in purchase of equipment	4,624,189	16.24	Overdraft	1,624,140	25.11
Investment in real estates	4,000,836	14.05	Consumption of non-durable goods	360,564	5.58
Other currencies	18,418	0.03	Consumption of durable goods	475,433	7.35
			Real estate purposes	3,691,524	57.08
			Operating purposes	315,651	4.88
			Other currencies	335,716	1.96

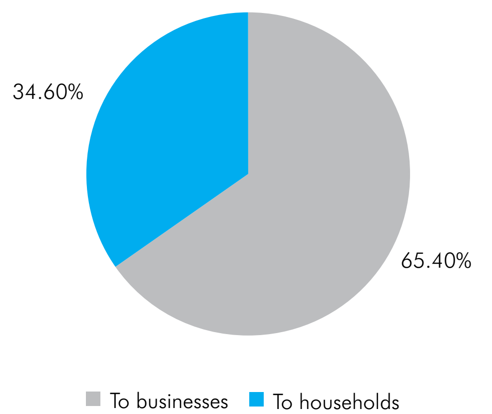
Source: Bank of Albania

In terms of maturity term for 2008, new short-term loans were estimated at ALL 150.4 billion, about ALL 30.6 billion or 25.5 percent more than in the previous year. For the same period, long-term loans are estimated at ALL 75.2 billion, about ALL 1 billion or 1.4 percent more than in the previous year. Medium-term loans are estimated at ALL 51.2 billion, recording a decline of ALL 1.2 billion or 2.4 percent compared to the previous year. In terms of quarters, short-term loans recorded the largest share in the last quarter of the year, by about 60 percent, whereas long-term loans in the third quarter of the year, by about 34 percent.

In terms of new loans by sectors of economy for the year 2008, 26.3 percent were extended to trade, repair of vehicles and household appliances;

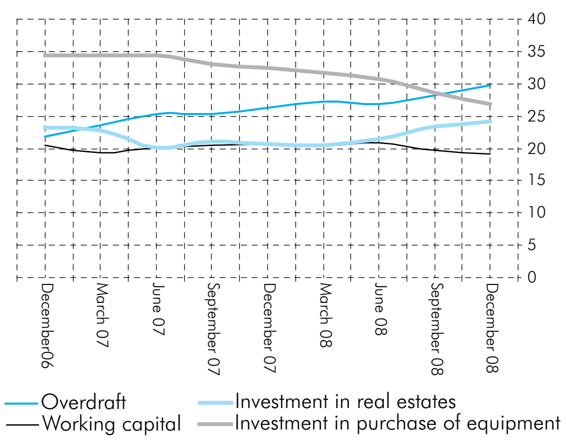
about 12.3 percent to transportation, storage and telecommunication and about 9.7 percent to industry (from 11.1 percent in 2007). In terms of quarters, there has been a significant growth of new loans to the trade sector in the last quarter of 2008, accounting for 35 percent of new loans for the period; a decline in new loans to industry in the third quarter of the year, accounting for 7.8 percent, and an underlined growth of new loans to transportation, storage and telecommunication, accounting for 26 percent, in the first quarter of the year. In general, this behaviour is greatly influenced by the performance characteristics of each individual sector, including various cycles of investments, sales, seasonality, import and export, etc.

Chart 80 Loan distribution, December 2008



Source: Bank of Albania

Chart 81 Share of outstanding business loans by purpose of use to total business loans (in percent)



Source: Bank of Albania

In terms of outstanding loan portfolio, the banking sector's outstanding loans as at year-end 2008 recorded ALL 396.7 billion, accounting for 37 percent of the GDP[45]. About ALL 254 billion were business loans, up by ALL 69.6 billion or 38 percent compared to the same period the previous year, and up by ALL 13.6 billion or 6 percent relative to the third quarter of the year. Household loan portfolio is estimated at about ALL 134.3 billion, up by ALL 31.3 billion or 30.3 percent compared to the same period the previous year. Relative to the third quarter of the year, household loans grew by ALL 4.9 billion or 3.8 percent. The share of loan portfolio invested in real estates is approximately ALL 149.8 billion.

Out of business loans as at year-end 2008, about ALL 75.6 billion (or 29.7 percent) is extended in the form of overdraft, about 48.7 billion (or 19.2 percent) is granted as working capital loans, about ALL 68.3 billion (or 27 percent) represents investment in machinery and equipment purchases and about ALL 61.2 billion (or 24 percent) represents investment in real estates.

For the last three years, outstanding business loans have reflected a gradual shift towards overdrafts and investment in real estates, stability in working capital loans and a decline in loans extended for investment in equipment purchases.

Out of household/individual loans, about ALL 7.5 billion (or 5.6 percent) were extended in the form of overdraft, ALL 3.8 billion (or 2.9 percent) consumer loans, ALL 22.3 billion (or 16.6 percent) for the purchase of durable goods, ALL 12 billion (or 8.9 percent) for operating activity and ALL 88.6 billion (or 66 percent) for the purchase of real estates.

In years, outstanding loans to households have been concentrated in investment in real estates (see Table 18).

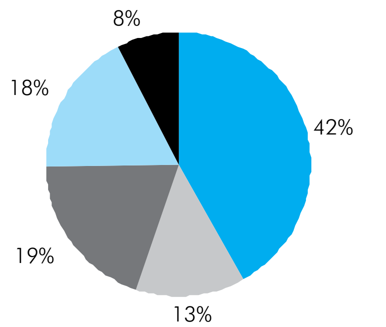
Table 18 Share of household loans by purpose of use to total household loans (in percent)

	IV-06	I-07	II-07	III-07	IV-07	I-08	II-08	III-08	IV-08
Overdraft	4.7	4.84	4.86	5.06	4.4	4.5	4.6	4.8	5.6
Working capital	3.08	2.1	2.3	2.4	2.04	2.1	2.03	3.4	2.9
Investment in purchase of equipment	19.5	17.7	19	19.1	19	17.3	17	16.4	16.6
Investment in real estates	59.3	62	61.1	62.4	63.9	65.7	66.2	65.7	65.9
Operating activity	13.4	13.3	12.6	11.1	10.6	10.4	10.1	9.6	8.9

Source: Bank of Albania

As at year-end 2008, loans extended for pure consumption, identified as household loans in the form of overdraft, for the consumption of durable and non-durable goods are estimated at ALL 33.7 billion, or about 8.7 percent of total loan portfolio, 25.1 percent of loan portfolio extended to households and about 3.1 percent as a share of GDP. Loans for investment purposes (purchase of machinery and equipment and for operating activity) are estimated at about ALL 80.3 billion or 20.7 percent of total loan portfolio and 7.5 percent of GDP. Loans for real estate investments (to businesses and households) are estimated at ALL 149.8 billion or 13.9 percent of GDP. Chart 82 shows the loan portfolio by purpose of use.

Chart 82 Loan portfolio by purpose of use (as a share to total) as of December 2008



Source: Bank of Albania

In terms of geographical distribution, the banking sector's lending activity has been concentrated in Tirana, Durrës, Elbasan, Shkodra, Fier and Vlora districts. In the last quarter of 2008, the share of loans extended to these districts to total loans is estimated at 88.3 percent. The lending activity has the largest concentration in Tirana, where the extended loans amount to approximately ALL 264 billion or about 68 percent, almost equal to that of the previous year (see Table 19).

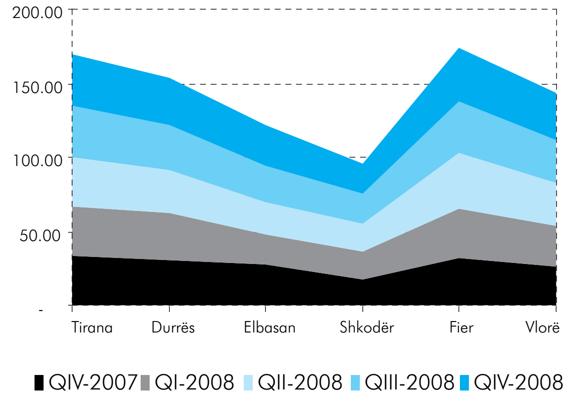
Table 19 Share of loans by main districts, in percent

	IV-06	IV-07	III-08	IV-08
Tirana	67.5	67.2	67.7	67.9
Durrës	7.6	7.6	7.5	7.4
Elbasan	3.2	3.4	3.2	3.2
Shkodër	2.5	2.5	2.6	2.6
Fier	3.8	3.8	3.4	3.4
Vlorë	4.0	3.8	3.7	3.8

Source: Bank of Albania

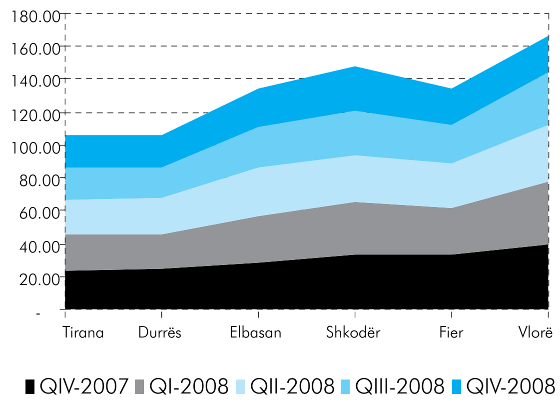
Charts 83, 84 and 85 show the distribution of loans by maturity term for the main districts. We note that the largest share of long-term loans is extended in Shkodra, about 52.3 percent, whereas the largest share of short-term loans is

Chart 83 Short-term loans by districts



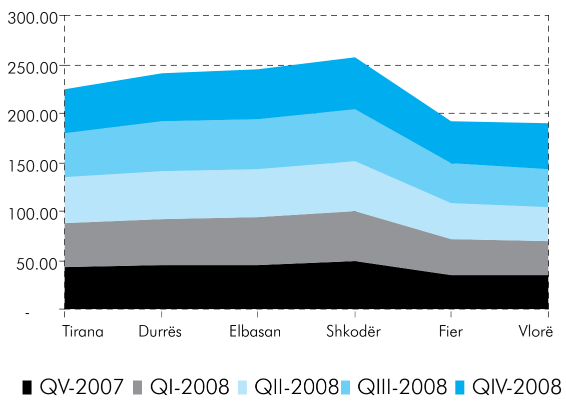
Source: Bank of Albania

Chart 84 Medium-term loans by districts



Source: Bank of Albania

Chart 85 Long-term loans by districts



Source: Bank of Albania

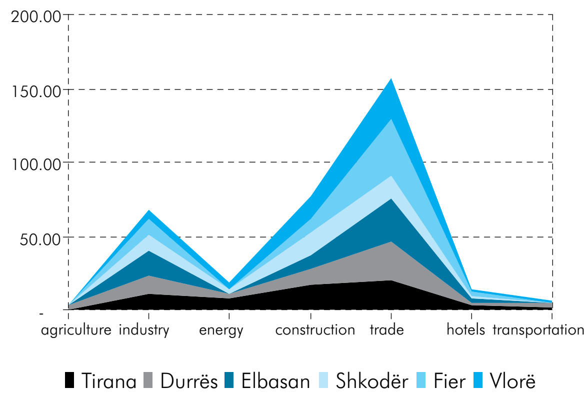
extended in Fier, about 36 percent. The distribution of loans in Tirana is dominated by long-term loans, accounting for about 45.5 percent of total loans extended.

In terms of composition by currency, the largest share of ALL-denominated loans was recorded in Elbasan, accounting for 46.5 percent of extended loans, whereas the largest share of foreign currency-denominated loans was recorded in Tirana, accounting for about 79 percent of extended loans.

With respect to composition of loans by user, the largest share of business loans is recorded in Tirana, accounting for 70 percent in the last quarter of 2008. The largest share of household loans is recorded in Shkodra, accounting for 49 percent. The share of consumer loans, measured as the percentage of outstanding consumer loans to total outstanding household loans for each individual district is estimated at 42 percent for the last quarter of 2008.

In terms of loans by sector of economy for the last quarter of the year, loans to the trade sector are higher in Fier, about 38 percent, and in Tirana, about 20.5 percent. Industry sector accounts for the largest share in Elbasan, about 18 percent of total loans extended to this district.

Chart 86 Loans by sectors of economy in the main districts, in percent (Q4-2008)

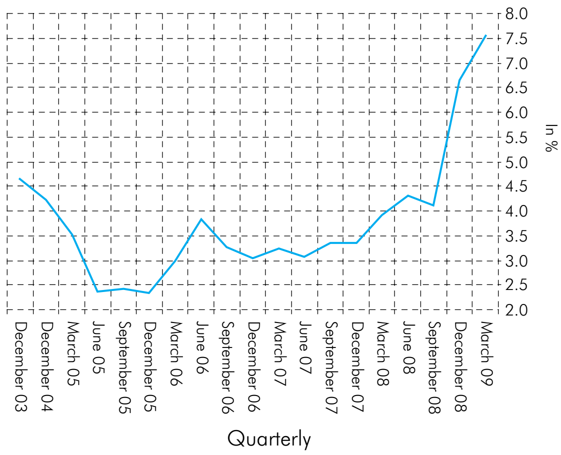


Source: Bank of Albania

5.3.4.1 Loan quality

Loan quality deteriorated in 2008. The ratio of non-performing loans to total gross loans amounted to 6.6 percent in the end of 2008, against 4.1 percent in the third quarter of the year and 3.4 percent in the end of 2007 (see Chart 87). Only during the last quarter of the year, the banking sector's non-performing loans increased by about ALL 10.7 billion or 69 percent compared to the previous quarter, while outstanding loans for the same period grew by about 5.1 percent. Compared to the same period in 2007, non-performing loans grew by about ALL 16.5 billion or 168 percent, while outstanding loans grew by about 36 percent.

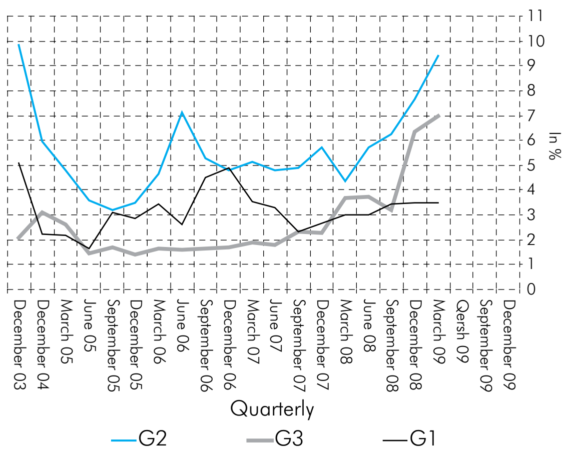
Chart 87 Non-performing loans to total gross loans



Source: Bank of Albania

In terms of rating categories, it is noted that as at year-end 2008, 78.3 percent of loan portfolio is regarded as "standard", implying that it is paid back regularly, and only 1.3 percent is regarded as "lost loans", for which banks have already started to execute a recovery procedure through collateral execution. The rest of loans, classified under three categories, include loans whose borrowers fail to repay loans as they fall due or any other problems, but however, they pay up within a time limit specified by the bank.

Chart 88 Loan portfolio quality (gross) for peer bank groups



Source: Bank of Albania

As concerns the peer bank groups, as at the last quarter of 2008, G3 peer group recorded the largest growth of "gross non-performing loans to total loans", accounting for 6.4 percent from 3.2 percent in the previous quarter. The highest level of the above ratio was reached by G2 peer group by about 7.7 percent, from 6.3 percent in the previous quarter. This ratio is estimated at 3.5 percent for G1 peer group, with an almost negligible change from the previous quarter (see Chart 88).

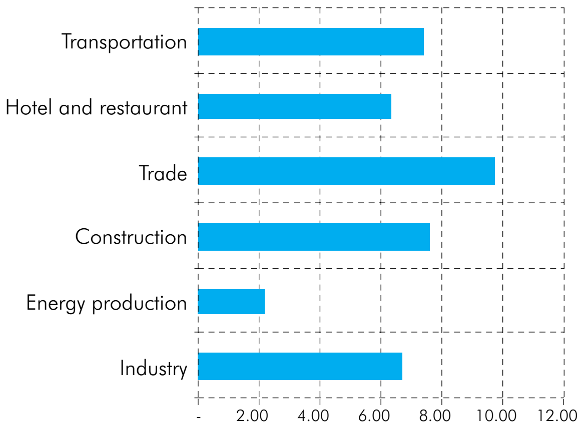
A clearer view of the loan portfolio performance may be drawn from the comparison between outstanding non-performing loans to total loan portfolio, excluding the new loans effect, which raise the denominator of the ratio but reflect problems with a lag. For the last quarter of 2008, this ratio increased to 8.1 percent. The performance of this ratio highlights the downturn reflected by the banking sector's loan portfolio quality.

In terms of users, the loan quality has deteriorated for both, businesses and households. Non-performing loans to outstanding loans for households and businesses is estimated at about 5.5 and 7.6 percent, respectively, compared to 3 and 3.6 percent at year-end 2007.

In terms of currency, in the last quarter of 2008, non-performing loans to outstanding loans in ALL and in foreign currency resulted 7.5 and 6.3 percent, respectively, from 3.9 percent and 3.2 percent at year-end 2007. Throughout 2008, a steady decline of ALL loan portfolio was noted, with the ratio peaking in the last quarter of the year.

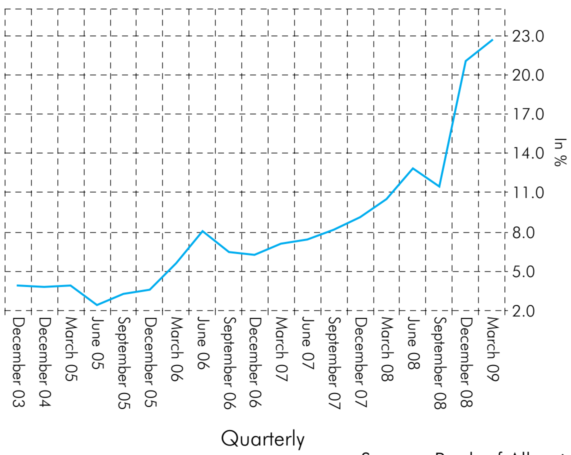
The indicators estimating the quality of foreign currency-denominated loan portfolio, when the borrower is hedged against the exchange rate risk[46] or unhedged against it[47], were 6.3 and 5.9 percent, respectively, against 3.2 and 3.4 percent as at year-end 2007.

Chart 89 Loan quality by sector of economy, in percent



Source: Bank of Albania

Chart 90 Net non-performing loans as a percentage of shareholder's equity for the banking system, in percent



Source: Bank of Albania

In terms of sectors of economy, in the last quarter of 2008, trade sector recorded the highest share of non-performing loans by about 32 percent of total non-performing loans, followed by construction sector by about 16.4 percent and industry sector by about 11 percent. As a matter of fact, these sectors are provided with the largest portion of loans from the banking sector. The ratio of non-performing loans to total outstanding loans extended to each of the above sectors was 9.7 percent for trade, 7.6 percent for construction and 6.7 percent for industry (see Chart 89).

It is important to assess the banking sector's ability to withstand likely losses of loan portfolio through its capital. At year-end 2008, the ratio of non-performing loans (net) to capital components has increased compared to the same period the previous year, implying a rise in the size of capital needed to cope with non-performing loans. In concrete terms, net non-performing loans to core capital" reached 22.9 percent, about 12.2 percentage points higher than in the previous year. Net non-performing loans to regulatory capital and net non-performing loans to shareholders' equity were 21.7 and 21.1 percent, respectively, picking up by 11.7 and 11.9 percentage points, respectively, from the previous year (see Chart 90). The performance of these ratios shows that the banking sector's ability to cover with capital any possible losses from lending activity dropped during 2008. However, various assessments and stress test analyses indicate that the banking sector's capital remains adequate[48] to withstand any possible significant losses.

In terms of peer bank groups, in the last quarter of the year, G3 peer bank group recorded the largest growth on average for the indicator "net non-performing loans to capital" to 22.3 percent, picking up by 15 percentage points relative to the previous year. G2 peer group recorded the highest value of "net non-performing loans to core capital", to 33 percent, about 7.3 percentage points higher than in the previous year. G2 peer group recorded the highest value of "net non-performing loans to shareholders' equity", to 32 percent, up by about 16 percentage points from the previous year. For G1 peer group, the average value of the above indicator remains at low levels.

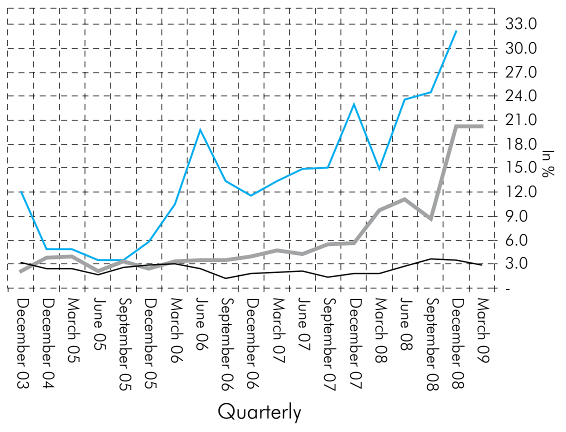
5.3.4.2 Provisions for covering loan losses

Against a background of deteriorated loan quality, the banking sector has raised the provisions in accordance with the requirements of the regulatory framework. In the last quarter of the year, provisions for the banking sector amounted to ALL 11.3 billion[49], about 47 percent higher than in the previous quarter and about 139.2 percent higher than in the previous year. As at year-end 2008, "provisions for non-performing loans/non-performing loans" (loan coverage ratio) dropped to 43 percent, due to the increase of non-performing loans (69 percent) at a higher rate than that of provisions (47 percent) for the last quarter of the year.

Non-performing loans continued to grow in the first quarter of 2009. As of first quarter-end, the ratio of non-performing loans to total loan portfolio amounted to 7.5 percent. This trend is expected to persist and peak in the second half of the year. Naturally, it will affect the financial result of the banking sector and its ability to lend steadily during both, the current and next year. As at end the first quarter of 2009, the loan coverage ratio (provisions to non-performing loans) amounted to 46.7 percent. If this expectation turns out to be steady, it will lead to decelerated non-performing loans' growth rates.

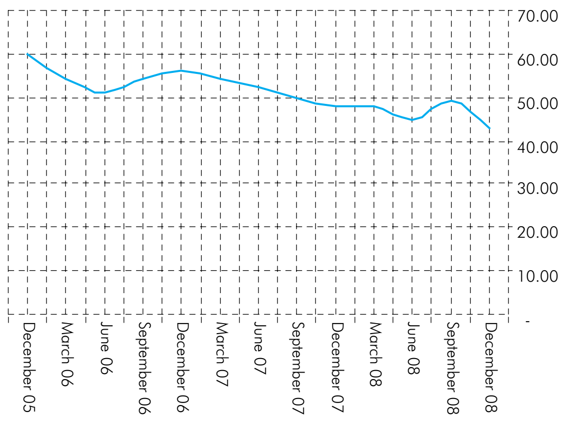
The collateral, as the last resource for recovering either partial or complete non-performing loans, plays an important role in the lending process. As of year-end 2008, the value of loans secured by collateral, mainly in the form of real estates, resulted about 60 percent of total loan portfolio, almost at the same level as in the previous year. The collateralized non-performing loan portfolio for the year-end 2008 is estimated at about 69.3 percent, compared to about 76.5 percent for the

Chart 91 Net non-performing loans as a percentage of shareholders' equity, for peer bank groups, in percent



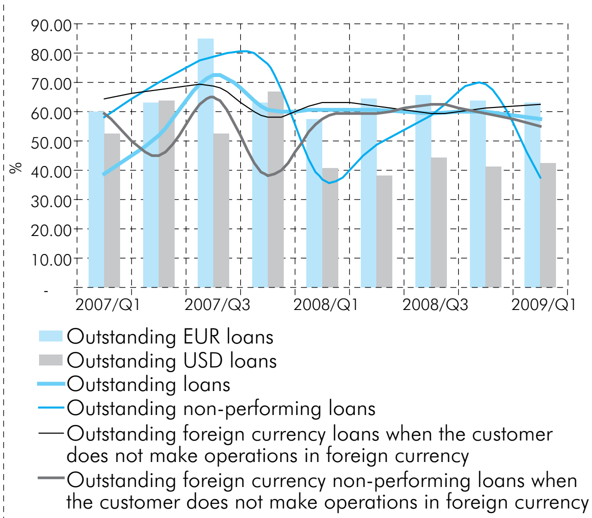
Source: Bank of Albania

Chart 92 Coverage ratio of non-performing loans with provisions, by quarters, in percent



Source: Bank of Albania

Chart 93 Collateralized loans



Source: Bank of Albania

same period the previous year. In the case of foreign currency-denominated loans, when the borrower's income is not generated in foreign currency, the collateral value covers about 61 percent of the loan value.

5.4 OFF-BALANCE SHEET ITEMS

As at year-end 2008, total off-balance sheet items accounted for 89 percent of total banking sector's assets, to a total of ALL 743 billion. At year-end 2007, this indicator was 54 percent. This ratio has increased significantly starting from August 2008, when it reached 79 percent relative to 59 percent in June. "Guarantees received" from customers constitute the main share in off-balance sheet items.

"Commitments received", which include financing commitments and guarantees received from customers and financial institutions, reached ALL 640 billion and account for about 86 percent of total off-balance sheet items. In "commitments received", the "guarantees received"[50] have the major share, reaching ALL 617 billion in December 2008, or 83 percent of total off-balance sheet items. The share of "guarantees received" to total off-balance sheet items increased by 4 percentage points against year-end 2007.

"Commitments given", amounting to ALL 51 billion, account for only 6.9 percent of total off-balance sheet items. In "commitments given", the major weight is shared by "guarantees given", mainly for customers, by 3.6 percent of total off-balance sheet items and "financing commitments", mainly for customers, by 3 percent of total off-balance sheet items. In general, the share of "commitments given" followed a downward trend during 2008. As at the end of the year, they declined by 1.8 percentage points relative to the third quarter-end, by 5 percentage points to the second quarter-end, by 5.7 percentage points to the first quarter-end and by about 6.7 percentage points to the end of 2007.

Among other off-balance sheet items, "foreign currency transactions" account for 6.9 percent of total off-balance sheet items, whereas "other commitments" and "commitments for financial instruments" have negligible shares.

5.5 FINANCIAL RESULT AND THE CAPITAL

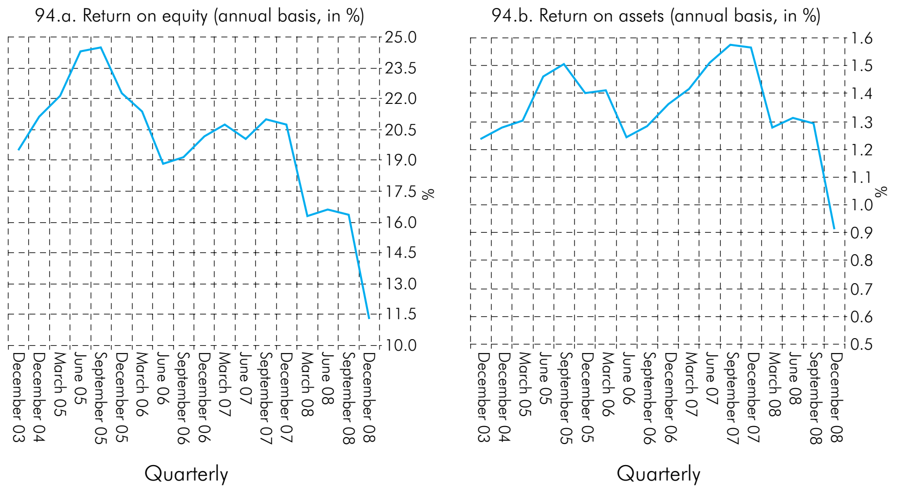
5.5.1 FINANCIAL RESULT AND EFFICIENCY IN USING RESOURCES

During 2008 the banking sector had a positive net financial result, but lower than in 2007. By quarters, a negative financial result was recorded in the last quarter of the year, mainly due to higher provisions for covering loan losses, lower average term and lending volume and reduced investments with non-residents. The downward trend in profit is expected to persist in 2009 as well. As at year-end 2008, the banking sector recorded a positive net financial result at ALL 7.3 billion. This result is ALL 0.3 billion or 4 percent, lower than that of the third quarter of the year and ALL 2.6 billion, or 26 percent lower than the financial result reported as at year-end 2007. The financial result for the last quarter of the year was negative (loss) at All 333.4 million.

For the same period, the annual rate of return on equity (RoE)[51] recorded 11.4 percent, whereas the annual rate of return on assets (RoA) recorded 0.9 percent. Return on equity of the banking sector was 5 percentage points lower than in the third quarter-end and 9.4 percentage points lower than at year-end 2007. The performance of this indicator has been downward in 2008, excluding May, June and July (see Chart 94.a). Return on assets was 0.4 percentage points lower than in September and 0.7 percentage points lower than at year-end 2007. This indicator declined during the last quarter of the year (see Chart 94.b).

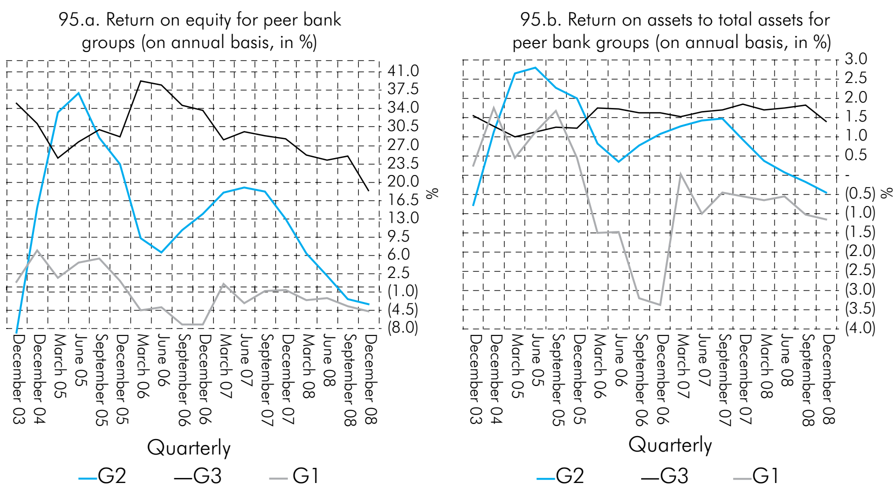
Chart 95 shows the performance of return on equity and return on assets to total assets for peer bank groups.

Chart 94 Return on equity and assets to total assets for the banking sector



Source: Bank of Albania

Chart 95 Return on equity and assets to total assets for peer bank groups

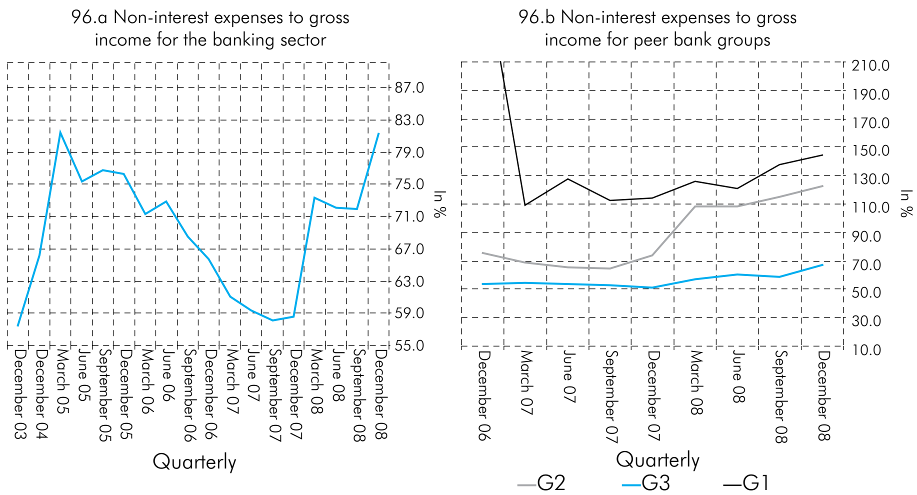


Source: Bank of Albania

Chart 95 shows that G2 peer group provided the main impact on the decline of both indicators (RoE and RoA), recording a rapid decline of these indicators during 2008.

The decline of these indicators was conditioned by the performance of some indicators in the income statement of the banking sector. Chart 96.a shows that "non-interest expenses to gross income" increased during the first quarter of 2008, fell again in April, maintaining steady values until September and increasing during the last quarter of 2008, picking up to 81.4 percent at end December. In terms of peer bank groups (see Chart 96.b), as at the last quarter of the year, the growth of the above indicator for G3 peer group is estimated at half of the growth recorded for this group during 2008.

Chart 96 General non-interest expenses to gross income for the banking sector and for peer bank groups



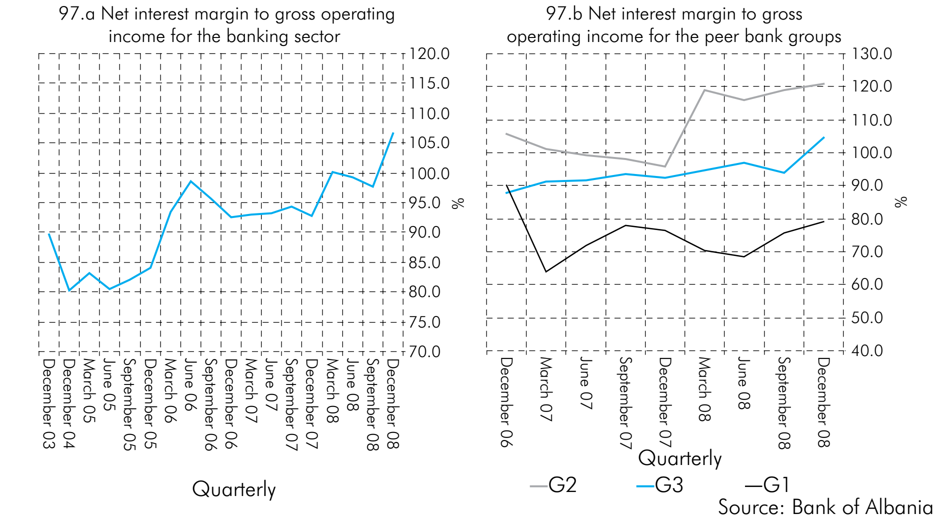
Source: Bank of Albania

The increase of "non-interest expenses" of the banking sector was affected by the higher raised provisions by about ALL 8 billion during 2008. Almost half of this increase in provisions was materialized in the last quarter of the year. On the other hand, the actualization pace of gross operating income dropped to ALL 5.4 billion in the last quarter of the year, against the average of ALL 7.9 billion in the previous quarter of 2008. Therefore, at the end of 2008, the "provision expenses to gross operating income" ratio recorded 29.3 percent, up by about 10 and 17 percentage points, respectively, against the end of the third quarter and the previous year.

"Net interest margin/gross operating income" ratio is analysed to assess the contribution provided by underlying intermediation activity to overall income of the banking sector. As at end-December 2008, this ratio recorded 106.5 percent, 9 percentage points higher than in the third quarter and 14 percentage points higher than in the previous year (see Chart 97.a). The analysis of the constituent parts of this ratio indicates that during the last quarter of 2008, the growth rate of interest income was higher than that of gross operating income. Compared to year-end 2007, net interest income for the banking sector increased by 12.3 percent, against the 0.4 percent decrease in gross operating income. The lower gross operating income owe to the rise in operating expenses, particularly in provision ones.

This ratio was upward even in terms of peer bank groups (see Chart 97.b). In the last quarter of 2008, G3 peer group experienced the largest growth by about 10.7 percentage points relative to the previous quarter. The largest growth relative to the previous year-end was shown by G2 peer group, by about 24 percentage points.

Chart 97 Net interest margin to gross operating income for the banking sector and for peer bank groups



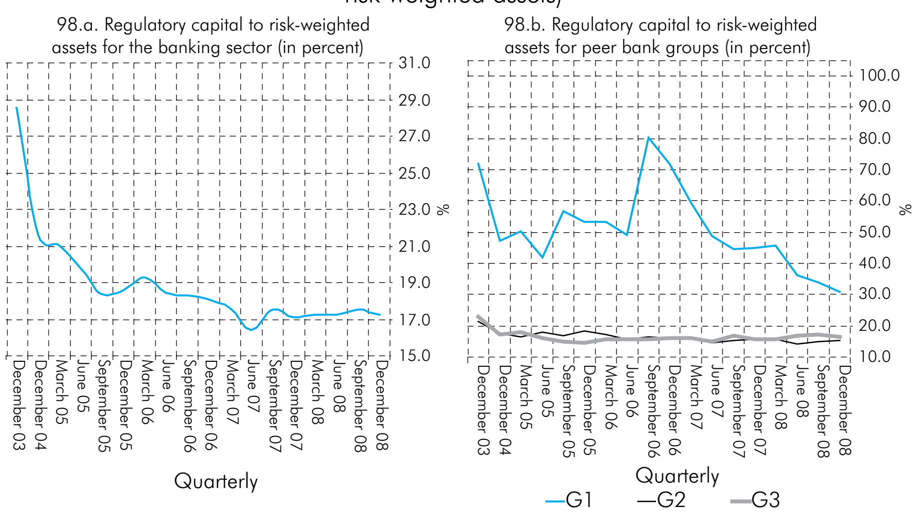
5.5.2 CAPITAL INDICATORS

As at year-end 2008, regardless of the phenomena observed in the aftermath of global financial crisis, the banking sector continued to be well-capitalized. Capital adequacy indicator, estimated as the ratio of regulatory capital to risk-weighted assets, recorded 17.2 percent[52], falling by 0.3 percentage points compared to the end of the third quarter and picking up by 0.2 percentage points against year-end 2007 (see Chart 98.a). Taking into consideration the components of this indicator, we note that at the end of 2008, the banking sector's regulatory capital amounted to ALL 58.6 billion. This indicator reflected an upward trend since year-end 2007, by about 27 percent. Total risk-weighted assets and off-balance sheet items climbed to ALL 340.2 billion, being 25.7 percent higher than in year-end 2007.

In terms of peer bank groups, as of year-end 2008, the capital adequacy ratio was 31 percent for G1, 15 percent for G2 and 17 percent for G3 peer group. Since September 2006, this indicator has maintained a marked downward trend for G1 peer group, whereas for G2 and G3 peer groups it has reflected steadiness in the recent years (see Chart 98.b).

When compared to risk-weighted assets, the Tier 1 capital tracks the regulatory capital performance (see Chart 99.a). As of end 2008, this ratio

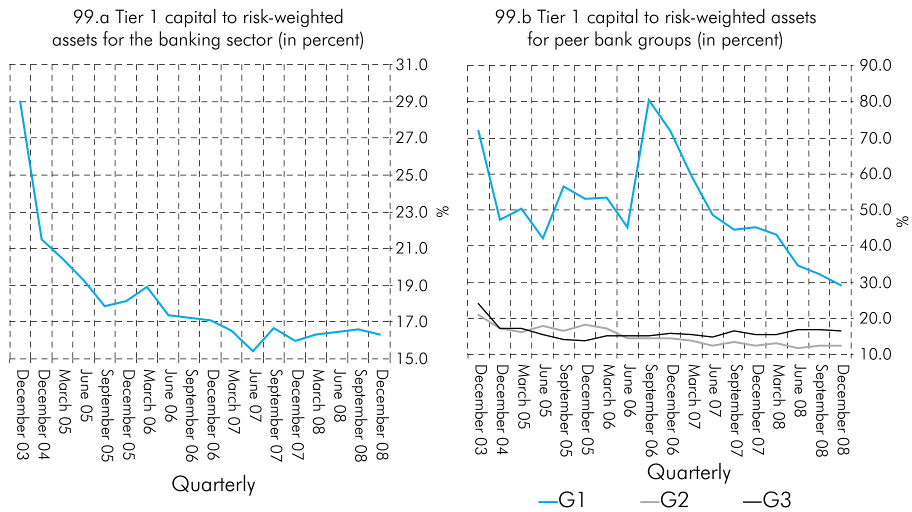
Chart 98 Capital adequacy ratio for the banking sector (regulatory capital to risk-weighted assets)



Source: Bank of Albania

stood at 16.3 percent for the whole banking sector. In terms of peer bank groups (see Chart 99.b), it was about 29 percent for G1, 12 percent for G2 and 17 percent for G3 peer group.

Chart 99 Tier 1 capital to risk-weighted assets

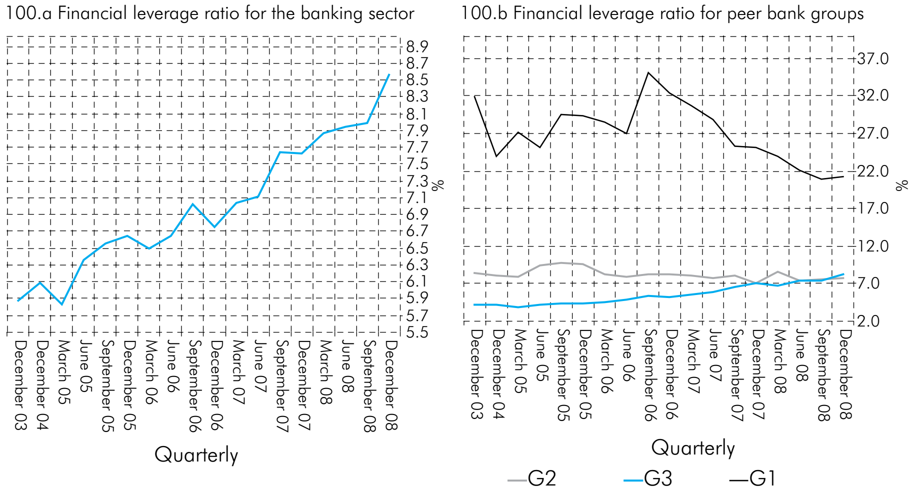


Source: Bank of Albania

As at end December 2008, the shareholders' equity accounted for 8.6 percent of total banking sector's assets. This indicator grew by 0.6 percentage points relative to the third quarter-end of 2008 and by 0.9 percentage points relative to the year-end 2007. The indicator has reflected an upward trend on an annual basis, though the growth rate has started to decelerate (see Chart 100.a).

In terms of peer bank groups, as of year-end 2008, "shareholder's equity to total assets" ratio stands at about 21 percent for G1 peer group, 7.7 percent for G2 peer group and 8.2 percent for G3 peer group (see Chart 100.b). In the medium-term, this indicator has increased slightly but steadily for G3 peer group, whereas for G1 peer group it has been persistently declining since December 2006. Regarding G2 peer banks, it has been stable.

Chart 100 Financial leverage ratio

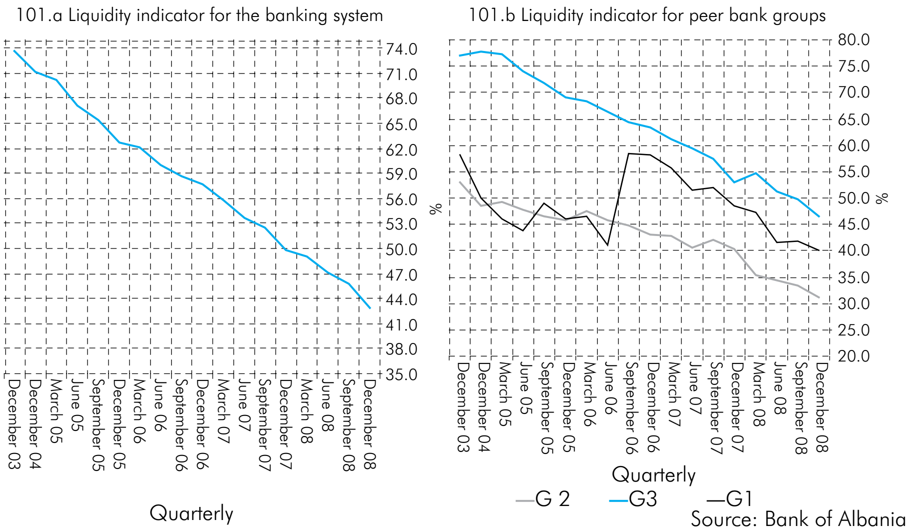


Source: Bank of Albania

5.6 LIQUIDITY INDICATORS

Notwithstanding the withdrawal of deposits in the last quarter of 2008, liquidity indicators do not reveal any significant decrease, remaining far from the critical levels. The higher demand of the banking sector for short-term funds in foreign currency and ALL during this period has been met through the reduction of liquid investments, loans acquired from the holding banking groups and the liquidity borrowed from the Bank of Albania. Nevertheless, the higher demand for short-term funds has restrained the banking sector's ability to lend the economy. Liquidity balance denominated in foreign currency has increased the reliance on foreign financing lines.

Chart 101 Liquidity indicator for the banking system and peer bank groups

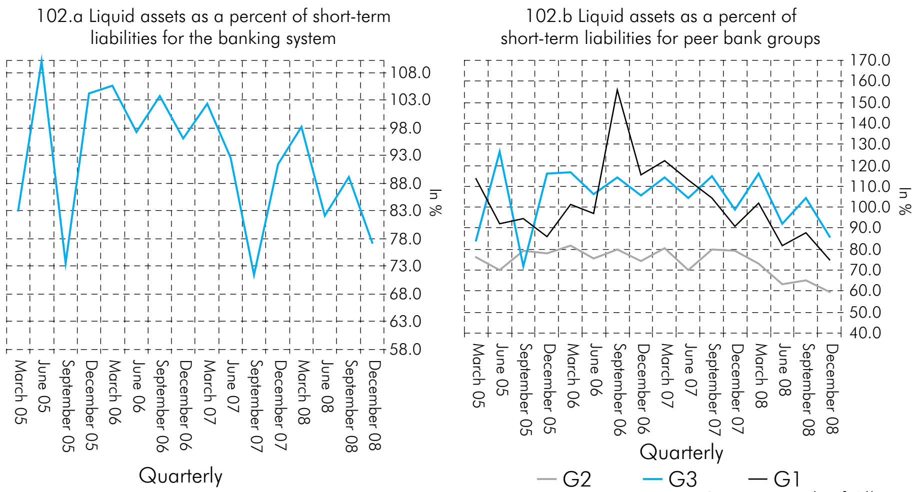


Source: Bank of Albania

Despite the downward trend of the recent years, the liquid assets as a percent of total banking sector's assets continue to stand at good levels. As at year-end 2008, this indicator marked 42.8 percent from 44 percent at the end of 2007 (see Chart 101.a). In terms of peer bank groups as at the last quarter of 2008, there has been a considerable decrease of liquid assets to total assets for G3 banks by 8.8 percentage points relative to the same period in 2007, hence reaching 46.5 percent from 55.4 percent. On quarterly basis, liquidity for this group fell by 3.3 percentage points (see Chart 101.b).

Liquid assets as a percent of short-term liabilities for the Albanian banking sector have been falling since the beginning of the year. As from January 2008, this indicator has declined by approximately 14 percentage points. In terms of peer bank groups, this indicator recorded significant decline for G1 and G3 banks compared with the same period the previous year. As at year-end 2008, liquid assets as a percent of short-term liabilities for G1 banks declined to 63.6 percent from 79.9 percent the same period the previous year, maintaining a downward trend throughout the course of the year 2008. With respect to G3 banks, for the same period, this ratio fell to 69.3 percent from 83.3 percent in 2007 and 74.7 percent at the quarter-end of 2008 (see Chart 102).

Chart 102 Liquid assets as a percent of short-term liabilities for the banking system and peer banks groups



Source: Bank of Albania

Box 7 Stress Test Analysis

The stress test analysis assumes extreme shifts, and at a low probability of occurrence, of the exchange rate, interest rates, loan quality, etc. Based on these shifts, we assess their impact on the banking sector's capital indicators. It should be taken into account that the effects of extreme shifts in the abovementioned indicators are assumed as abrupt, against a background of invariable capital figures. In practice this is almost impossible. The shift of indicators usually occurs during a given time span, which may be short but not abrupt, and banks may increase their capital to cope with the various future risks. There are two levels in the interpretation process of stress test results. The first level is represented by the concept of "vulnerability" and assesses *whether the shock triggers significant shifts in the capitalization indicator but without reducing it to below the required minimum. The second level is represented by the concept of "risk" and assesses whether the shock triggers the decrease of capital adequacy rate below the required minimum of 12 percent.*

As at year-end 2008, the stress test analysis reveals that: a) the banking sector appears resilient to direct exchange rate risk, interest rate risk and indirect credit risk through changes in the interest rates; and b) mainly for G2 peer bank groups, the indirect exchange rate risk, particularly in terms of activity in Euro, and credit risk are the main risks, which in an intentionally deteriorated scenario, trigger a more significant decline of the capital adequacy rate. Nevertheless, the banking sector's exposure to these risks is limited.

Table 20 shows the summarised results of the stress test analysis.

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Table 20 Stress test results

		Shocks	Banking sector	Peer Bank groups		
				G1	G2	G3
Credit risk Increase of non-performing loans by 100%			No risk	No risk	No risk	No risk
			Vulnerability	No vulnerability	Vulnerability	Vulnerability
Direct interest rate risk	1. ALL	Increase of ALL interest rate by 3%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	Vulnerability
		Increase of ALL interest rate by 4-10%	No risk	No risk	No risk	No risk
			Vulnerability	No vulnerability	No vulnerability	Vulnerability
	2. USD	Increase of USD interest rate by 3%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
		Increase of USD interest rate by 3 -10%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
	3. EUR	Increase of EUR interest rate by 3%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
Direct exchange rate risk	1. USD	Depreciation of USD against ALL by 50%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
	2. EUR	Depreciation of EUR against ALL by 50%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability

Indirect interest rate risk	1. ALL	Increase of the interest rate of ALL-denominated loans by 5%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
	2. USD	Increase of the interest rate of USD-denominated loans by 5%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
	3. EUR	Increase of the interest rate of EUR-denominated loans by 5%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
Indirect exchange rate risk	1. USD	Depreciation of ALL against USD by 50%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	No vulnerability	No vulnerability
	2. EUR	Depreciation of ALL against EUR by 50%	No risk	No risk	No risk	No risk
			No vulnerability	No vulnerability	Vulnerability	No vulnerability

EXCHANGE RATE RISK

Exchange rate risk assesses the effect that arises from the appreciation/deprecation of the domestic currency against the two main foreign currencies (USD and EUR) on the capital adequacy rate and the regulatory capital.

In general, the normal fluctuations of the exchange rate do not affect the banking sector's capital indicators considerably under the conditions when the banking sector's open foreign currency position is restricted by regulation and banks themselves in practice prefer to have an almost closed position. In case of an appreciation of the foreign currency vis-à-vis the ALL, the impact on capital indicators is insignificant, under the conditions when a considerable portion of the capital is denominated in foreign currency and all indicators are expressed in ALL. The depreciation of the main foreign currencies vis-à-vis the ALL provides the most significant effect on capital indicators.

An assumed depreciation of the US dollar to ALL by 50 percent decreases the banking system's capital adequacy rate by 0.1 percentage points to 17.1 percent. For the majority of banks, the changes in the capital adequacy rate are negligible. In terms of peer bank groups, capital adequacy rate for G3 banks declined by 0.2 percentage points to 16.4 percent, while other banking groups incurred slight changes and appeared slightly vulnerable to these shocks. For the same shock, the regulatory capital decreases by ALL 0.5 billion to ALL 58.1 billion.

In case of a depreciation of the EUR to the ALL by 50 percent, the banking system's capital adequacy rate declines slightly by 0.1 percentage point to 17.1 percent. In terms of peer bank groups, capital adequacy rate declines more for G2 and G1 banks by 0.3 percentage points, respectively.

INTEREST RATE RISK

This scenario tests how the capital adequacy rate and the regulatory capital are affected by a change in the interest rate. This shock is applied on the ALL, US dollar and EUR. The weighted average interest rate of new deposits and loans in the banking system is considered as the reference interest rate. The applied shock value is added to the current interest rate value.

After an assumed increase of the ALL interest rate by 3 percentage points (from 6.9 to 9.9 percent), the capital adequacy rate for the banking system declines by 1.5 percentage points to 15.7 percent. For the same shock, the regulatory capital decreases by ALL 5.4 billion to ALL 53.2 billion. In terms of peer bank groups, G3 banks recorded the highest decrease in the capital adequacy rate by about 2 percentage points to 14.6 percent. Capital adequacy rate for G1 and G2 banks reduces at the same extent by 0.5 percentage points. In the event of higher interest rate shocks (4 to 10 percentage points), capital adequacy rate fluctuates considerably, however remaining above the required minimum. In this case, banks need to be assessed individually.

The second shock tests the influence that a 3 percentage points increase in the USD current interest rate (from 3.4 to 6.4 percent) has on the banking sector's regulatory capital and capital adequacy rate. According to the test results, capital adequacy rate drops slightly by 0.1 percentage point. In terms of peer bank groups, capital adequacy rate for G1 and G3 banks reduces at the same extent by 0.2 percentage points, while it remains the same for G2 banks. In the event of shocks higher than 3 percentage points, the banking system appears protected with the adequacy capital rate remaining within the required minimum.

The third shock tests the influence that a 3 percentage points increase in the EUR current interest rate (from 3.7 to 6.7 percent) has on the regulatory capital and capital adequacy rate. According to the test results, the banking sector's capital adequacy rate drops by 0.1 percentage point, while the regulatory capital decreases by ALL 0.3 billion to ALL 58.3 billion. In terms of peer bank groups, capital adequacy rate for G1 and G3 banks is not affected by the shock application, while capital adequacy rate for G2 banks reduces by 0.2 percentage points. No significant changes in the capital adequacy rate are identified in terms of individual banks. Worth noting is that in the event of shocks higher than 3 percentage points (4 to 10 percentage points), the banking sector appears protected with the capital adequacy rate remaining above the required minimum. The same holds true for individual banks as well.

In conclusion, the capacity of the banking sector to cope with the losses arising from unfavourable shifts in the interest rate is adequate.

CREDIT RISK

The banking sector's resilience to credit risk is assessed by assuming considerable shifts in non-performing loans and by measuring their effect on the regulatory capital and capital adequacy rate. We assume an increase in non-performing loans by 10 percent, 50 percent and 100 percent up to 200 percent.

Test results show that an increase in non-performing loans by 10 percent reduces the banking sector's capital adequacy rate by 0.2 percentage points to 17 percent. In terms of peer bank groups, G2 banks record the highest decline in the capital adequacy rate by 0.3 percentage points to 15.1 percent.

The increase of non-performing loans by 50 percent augments the vulnerability of the banking sector and the capital adequacy rate falls by 1.1 percentage point to 16.1 percent. Regulatory capital reduces by about ALL 4.5 billion to ALL 54.1 billion. In terms of peer bank groups, G2 banks are the highest exposed to this shock, with the capital adequacy rate falling by 1.4 percentage points to 13.9 percent. Individual banks remain above the minimum required capital adequacy rate.

The increase of non-performing loans by 100 percent reduces the banking sector's capital adequacy rate by 2.2 percentage points to 15 percent. In terms of peer bank groups, G2 banks followed by G3 banks incur the highest drop in the capital adequacy rate by 2.9 and 2.2 percentage points, respectively, to 12.5 and 14.5 percent. In this case, banks need to be assessed individually.

The increase of non-performing loans by 180-200 percent reduces the banking sector's capital adequacy rate however remaining above the minimum required. In this case, individual banks incur a considerable fall of the capital adequacy rate, even below the minimum required.

INDIRECT CREDIT RISK THROUGH CHANGES IN THE EXCHANGE RATE

This scenario tests the indirect credit risk arising from unfavourable changes in the exchange rate and their impact over the loan portfolio denominated in foreign currency, when the customers have their income in the domestic currency. The unfavourable change in the exchange rate increases the instalment value in ALL of the loan extended in foreign currency, hence restraining the borrower's solvency. The impact on capital adequacy rate and regulatory capital needs to be assessed as well.

An assumed depreciation of the ALL vis-à-vis the USD by 50 percent reduces the banking system's capital adequacy rate by 0.1 percentage point to 17.1 percent. In terms of peer bank groups, the decrease in the capital adequacy rate is 0.6 percentage points for G1 banks and 0.1 percentage points for G2 and G3 banks. No significant changes in the capital adequacy rate are identified for individual banks.

The second shock assumes the depreciation of the ALL vis-à-vis the EUR by 50 percent. This shock affects the capital adequacy rate considerably in terms of the banking sector, peer bank groups and individual banks, since the lending activity is mostly concentrated in EUR. In more concrete terms, the depreciation of the ALL by 50 percent decreases the banking system's capital adequacy rate by 1.3 percentage points to 16 percent. Meanwhile, the regulatory capital reduces by about ALL 5.2 billion to ALL 53.4 billion. In terms of peer bank groups, G2 banks appear the highest vulnerable as the capital adequacy rate falls by 2 percentage points to 13.3 percent. In G3 banks, the capital adequacy rate decreases by 1.1 percentage points to 15.5 percent. In terms of individual banks, we note that the capital adequacy rate for some of them is very close or below the minimum required.

The application of shocks higher than 50 percent, for instance within a range of 60 to 100 percent, reduces the banking sector's capital adequacy rate considerably, however remaining above the minimum required. In terms of individual banks, the capital adequacy rate falls to below the minimum required, hence restraining the coverage of losses with capital.

INDIRECT CREDIT RISK THROUGH CHANGES IN THE INTEREST RATE

Borrowers' solvency is closely related with the changes in the interest rates of the *foreign currencies they have received their loans in. The changes in the interest rate do not only reduce the bank's capital in the event of a wide gap between the assets and liabilities which are affected by the interest rate, but they also increase the loan cost for the borrower. Consequently, the borrowers' solvency deteriorates and non-performing loans increase. This test considers the impact of interest rate shocks on the credit portfolio in ALL, EUR and USD, respectively. As at the end of December, average interest rates of loans denominated in ALL, EUR and USD are 11.7, 7.3 and 6.85 percent, respectively.*

An assumed increase of the interest rate by 5 percent (and even higher, 10 percent) for ALL, EUR and USD-denominated loans does not affect the banking sector, peer bank groups and individual banks' capital adequacy rate considerably. The capital adequacy rate after these shocks has decreased by 0.2 percentage points in terms of the banking sector and peer bank groups. Individual banks are also slightly exposed to these assumed shocks.

INDIRECT CREDIT RISK THROUGH SCENARIOS' COMBINATION – DYNAMIC MODEL

This test attempts to combine the effect that the scenarios of lower economic growth rates, higher EUR interest rates and the depreciation of the ALL exchange rate vis-à-vis the EUR have on non-performing loans as a percent of total loans after six months.

Using the data as at year-end 2008, the ratio expressing the loan quality in terms of deteriorating scenarios is shown in Table 21.

Table 21 Risk scenarios

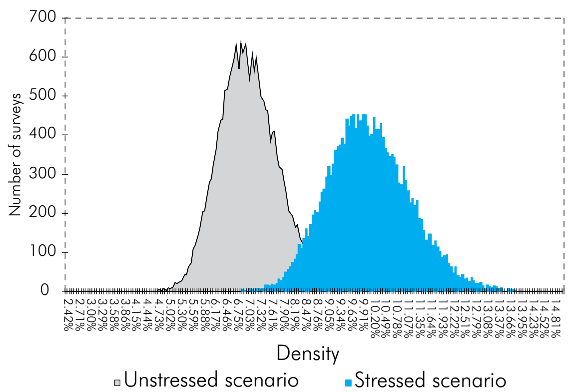
	Scenario 1 (unstressed)	Scenario2 (stressed)
Economic growth	1%	0%
Euribor rate change	+0.5 %	+1%
Exchange rate depreciation	5%	20%
Results:		
- Average	7.0 %	10.1%
- Standard deviation	0.00758764	0.0105302
- Interval estimation of 90% level of confidence	6.1%- 8. %	8.8%-11.5%
- Interval estimation of 95% level of confidence	5.9%-8.3%	8.5%-11.9%

In the event Scenario 2 takes place, against a background of no economic growth and an increase in the Euribor rate by 1 percentage point and the depreciation of the ALL exchange rate vis-à-vis the EUR by 20 percent, the point estimate of non-performing loans as a percent of total loans would escalate to 10.1 per cent. The last three rows of Table 21 provide the standard deviation of this estimation and the interval estimations (range of possible values) of 90 and 95 percent level of confidence.

Chart 103 shows the distribution of non-performing loans for June 2009, simulated using the Monte Carlo method for both scenarios.

The same test carried out for the data of the first quarter of 2009 produces the point estimates of "non-performing loans as a percent of total loan portfolio" for the third

Chart 103 Occurrence probability of a non-performing loan as measured by the ratio of non-performing loans in optimistic, normal and pessimistic scenarios



Source: Bank of Albania

quarter of 2009, at 8.5 percent and 12.2 percent, respectively, for the two scenarios.

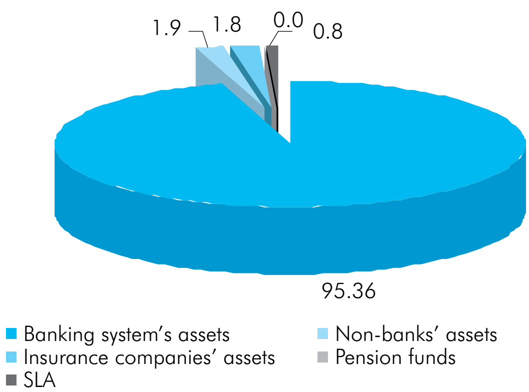
Considering the capitalization levels of the banking sector in March 2009, the stressed scenario (Scenario 2) does not reduce at any case the capital adequacy ratio for the banking system to below the required minimum.

Box 8 Non-bank financial institutions

Non-bank financial institutions have a small share in terms of total financial system and consequently, the risks arising from their activity are not systematically important. They comprise non-bank financial institutions, savings and loan associations licensed by the Bank of Albania and insurance companies and private supplementary pension funds licensed by the Financial Supervisory Authority (FSA).

Non-bank financial institutions conduct financial intermediation-related activities but do not accept deposits from the public. They comprise 7 non-bank financial institutions, 2 savings and loan unions and their participant companies, and a considerable number of foreign exchange bureaus. As at year-end 2008, assets of non-bank financial institutions (excluding foreign exchange bureaus) accounted for 1.9 percent of total financial system's assets (relative to 1.87 percent of year-end 2007), accounting for 1.5 percent of GDP, with a negligible growth from the same period the previous year. The share of savings and loan associations as at year-end 2008 accounts for 0.87 percent of the total financial system and 0.71 percent of GDP. Relative to the same period in 2007, they were 0.79 and 0.63 percent, respectively.

Chart 104 Assets of financial system's entities as a percent of total system's assets, year-end 2008



Source: Bank of Albania

Insurance companies, private supplementary pension funds and the securities' market are other non-bank financial institutions that are licensed and monitored by FSA and which constitute integral segments of the financial system. As at year-end 2008, insurance companies' assets accounted for 1.86 percent of total financial system's assets, from 1.7 percent in 2007. Their share to GDP accounts for 1.52 percent.

The securities' market is not very developed and only a few entities, mainly banks, are the sole traders. Tirana Stock Exchange is the only organized market, which however is not fully operational yet.

FINANCIAL ANALYSIS OF NON-BANK FINANCIAL INSTITUTIONS' ACTIVITY

The activity carried out by non-bank financial institutions throughout the year 2008 attests to positive developments in terms of growth of assets, profit and capitalization and developments in their supervision-related regulatory framework. As at the last quarter of 2008, assets of non-bank financial institutions amounted to ALL 16.6 billion, up by 4.9 percent from the previous quarter and 14.9 percent from the same period the previous year (see Chart 105).

Operations with customers provide the main contribution to the growth of balance sheet items for the last quarter of 2008, accounting for about 74 percent, followed by cash on hand, deposits and accounts, 21 percent, and fixed or non-financial assets, 17 percent.

As at end the last quarter of 2008, capitalization level, expressed as the ratio of capital account to total assets was 51.3 percent (from 52.4 percent the previous quarter and 48.8 percent the same quarter in 2007), observing the regulatory capital adequacy rate of above 10 percent for non-bank financial institutions. The highest capital adequacy rate for 2008 was recorded in the first quarter, 54.6 percent (see Chart 106). The ratio of capital to total tangible and intangible assets, net, is another indicator measuring the capitalization level. As at end the last quarter of 2008, it stood at 959 percent, up by 15 percentage points from the previous quarter and 86 percentage points from the same period in 2007. This indicator is also higher than the required level of 100 percent set out as a regulatory rate for this indicator.

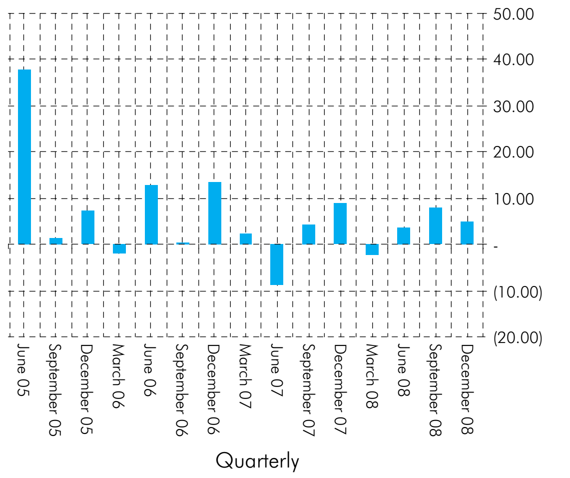
Loan portfolio pointed to ALL 9.5 billion in the last quarter of 2008, up by ALL 1.8 billion or 23.5 percent higher from the same period the previous year. Loan portfolio quality, measured as the ratio of non-performing loans to outstanding loans improved in the last quarter of 2008 compared to the previous quarter, reaching 2.6 percent from 3.2 percent. In the same period the previous year, it stood at 1.6 percent (see Chart 107). The highest ratio of non-performing loans was recorded in the third quarter of 2008, about 3.2 percent.

Another indicator of the assets' quality is derived using the ratio of net total tangible and intangible assets to total assets, which has slightly improved to 5.4 percent in the last quarter of 2008, from 5.6 percent in the same period the previous year.

Profit-loss account for the last quarter of 2008 attests to a satisfactory performance. The year's profit amounts to ALL 1.2 billion (from ALL 744.5 million the same period the previous year).

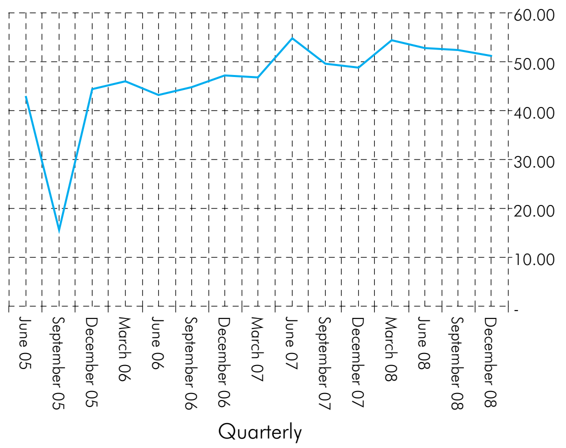
As at end the last quarter of 2008, income amounted to ALL 4.6 billion, up by 21.9 percent from the third quarter and 15.1 percent from the same period in 2007. Interest income provided the main contribution to the growth of income, accounting for 53.2 percent of total income (from 49.7 percent in the previous quarter and 43.2 percent in the last quarter of 2007). The share of commission income increased in the last quarter of 2008 by 1.3 percentage points from the previous quarter, accounting for 12.9 percent of total income (from 11.6 percent in the previous quarter and 15.6 percent in the last quarter of 2007). Extraordinary activities' income have a small

Chart 105 Assets' growth by quarters, in percent



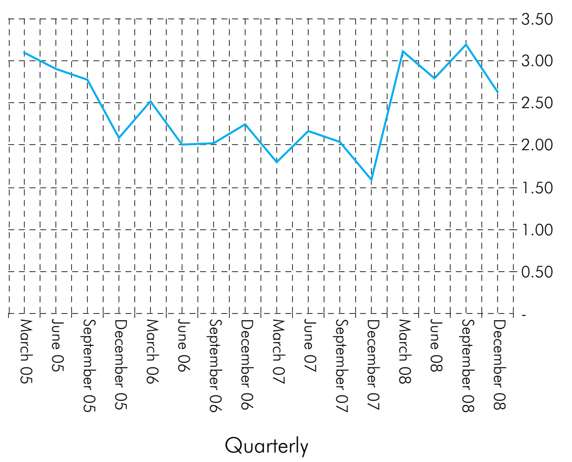
Source: Bank of Albania

Chart 106 Capitalization ratio of non-bank financial institutions, in percent



Source: Bank of Albania

Chart 107 Loan portfolio quality ratio



Source: Bank of Albania

share accounting for 1.8 percent of total income as at the last quarter of 2008 (from 1.6 percent in the previous quarter and the same share relative to the last quarter of 2007).

In view of carrying out its supervisory function on the entities it licenses and supervises, the Bank of Albania makes ongoing improvements in the regulatory framework. Pursuant to Law No. 9662, dated 18 December 2006 "On Banks in the Republic of Albania", the Bank of Albania has recently amended the Regulation "On non-bank financial entities' licensing and activity". The amendments to this Regulation consist in:

- *The inclusion of foreign exchange operations in the activity carried out by non-bank financial entities;*
- *The establishment of capital requirements to conduct the financial leasing and factoring activities, in compliance with the capital levels as required by the laws regulating these activities;*
- *The setting out of facilities on the required capital for micro-credit financial institutions in their licensing procedure;*
- *The setting out of the requirement on the minimum required capital in the national currency (ALL);*
- *The setting out of the requirement on the verification of the capital source, which requires a statement from the founder supported by other certifying documents.*

ACTIVITY OF SAVINGS AND LOAN ASSOCIATIONS

Savings and loan associations are licensed and supervised by the Bank of Albania. Given their nature of activity, they accept deposits from members of the associations and report to the Bank of Albania on the financial situation and supervisory norms. Currently, 128 savings and loan associations carry out their activity as part of 2 large unions.

Savings and loan associations recorded an increase of 24.4 percent as at end 2008 relative to the same period the previous year. Total assets of savings and loan associations amounted to ALL 7.6 billion, accounting for approximately 16.7 percent of non-bank financial institutions' assets (including insurance companies and pension funds). Their share to total financial system's assets is small – 0.87 percent.

Lending activity plays the main role. In the last quarter of 2008, savings and loan associations reported a total of 82 percent of their assets invested in lending activity (see Table 22).

Portfolio quality, gross, for savings and loan associations deteriorated slightly in the last quarter of 2008, 1.3 percent from 1 percent in the previous quarter and 0.5 percent in the same period the previous year. This figure owes to the higher growth rate of non-performing loans (177.3 percent) as a share to outstanding loans' growth (16 percent) relative to year-end 2007.

Table 22 Activity of savings and loan associations, quarterly

	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Total assets (in million leks)	6,153,850	6,575,290	7,237,454	7,517,095	7,657,331
Outstanding loans	5,415,833	5,778,238	6,078,940	6,215,071	6,283,464
Outstanding loans/total assets (in %)	88.01	87.88	83.99	82.68	82.06
Non-performing loans	29,694	35,623.00	44,876	65,352	82,352
Non-performing loans/outstanding loans (in %)	0.55	0.62	0.74	1.05	1.31

Source: Bank of Albania

As at end 2008, the net result of savings and loan associations amounted to ALL 109.2 million, up by 2.4 percent relative to the previous year.

INSURANCE COMPANIES AND PRIVATE SUPPLEMENTARY PENSION FUNDS

Insurance market grew its assets by 22 percent compared to the previous year, being supported by investment in deposits, real estates and tangible and intangible assets. 692 thousand insurance contracts were concluded in 2008 or about 27 percent more than the previous year. Income from insurance gross written premiums amounted to ALL 7.1 billion or about 19 percent higher than the previous year. The insurance structure changed in 2008. Gross written premiums of voluntary and compulsory insurance shared 44 and 56 percent, respectively, of the market. In 2007, compulsory insurance shared around 65 percent of the market. According to the FSA, gross claims paid grew by 19 percent compared to the same period the previous year.

As at the third quarter of 2008, insurance sector's assets amounted to ALL 16.3 billion, 6.5 percent higher than in the previous quarter and 21.8 percent higher than the last quarter of 2007, accounting for about 1.85 percent of the financial system and 1.5 percent of GDP. "Deposits, certificates of deposits and accounts with banks" provided the main contribution (63.5 percent) to the growth of assets for the third quarter of 2008 relative to the previous quarter. In the last quarter of 2007, this item contributed by 45.8 percent. The next second item in terms of contribution is "investment in real estates", contributing by 7 percent to the total growth of insurance companies' assets. As at end 2007, it contributed by 14 percent. As at the third quarter, "fixed (tangible and intangible) assets" contributed less, by 5 percent, to the growth of assets relative to the previous quarter.

The ratio of capital to total assets resulted 50.3 percent in the third quarter of 2008, down by about 3 percentage points from the previous quarter and up by 1 percentage point from the last quarter of 2007. The ratio of capital to technical reserves is another indicator showing the ability to cover the losses arising from the exposure to potential risks. For the third quarter of 2008, this indicator stood at 126.5 percent, down by 5 percentage points compared to the previous quarter, however improving markedly by 9 percentage points from the last quarter of 2007.

Technical provisions amounted to ALL 1.4 billion in the third quarter of 2008, 7.5 percent higher than the previous quarter and 19.8 percent higher than as at year-end 2007. The share of technical provisions to total insurance companies' assets is about 9 percent.

Insurance companies' profit for the third quarter amounted to ALL 805 million from ALL 936.2 million the same period the previous year.

FSA has improved on ongoing basis the regulatory framework regulating this market and the technological infrastructure of its monitoring. In view of this, over the course of the year 2008, FSA drafted and approved guidelines and regulations on the entities falling under its jurisdiction:

- *Guideline No. 15, dated 22 February 2008, "On the content of audit report on insurance companies and the statutory auditor companies".*
- *Regulation No. 61, dated 22 May 2008 "On the handling procedures of insurers' complaints".*
- *Regulation No. 120, dated 2 October 2008 "On licensing and supervision of titles' stock exchange".*

- *Draft law on voluntary pension funds, whose purpose is to set out the required standards for the establishment and management of voluntary pension funds.*
- *Draft law on collective investment undertakings, drafted against a background of increasing market demand or long-term investments, etc.*

Private supplementary pension fund market increased over the course of the year 2008 relative to the same period the previous year. The number of contributors increased to 3,861 from 2,872 in 2007. In terms of value, contributions amounted to ALL 53.1 million from ALL 32 million in 2007, up by 65 percent.

6 PAYMENT SYSTEM DEVELOPMENTS

The payment system has operated efficiently throughout the year 2008, with a minimum number of technical problems. A number of banks with a high share in terms of total activities in the system are considerably concentrated in AIPS and AECH systems. Payments' volume augmented significantly and the same is expected for 2009 as well. The last quarter of 2008 witnessed the largest volume of payments processed in AECH, attesting to the ongoing increase of payments processed through this system. Banks have increased the number of ATMs and POS machines for the use of cards. However, the use of cash remains high, since the largest portion of these transactions are withdrawals from ATMs. Electronic payments and account access via "home banking" still remain at their first steps; consequently, the risks associated to these instruments remain limited.

For the year 2008, the payment systems reflected security and efficiency, which are indispensable features for the smooth operation of the payment system. Clearing and payments settlement among banks, in the national currency, is carried out through two payment systems: "The Real Time Gross Settlement System - AIPS" and "The Automated Electronic Clearing House System - AECH", in compliance with the interbank payment settlement rules. The Real Time Gross Settlement System (AIPS) was accessed by participants to 99.88 percent of its operating schedule. Stated otherwise, during 246 business days, the system was unavailable for only 2 hours and 22 minutes, due to technical and/or communication-related problems with the SWIFT.

6.1 REAL TIME GROSS SETTLEMENT SYSTEM - AIPS

A total of 56,717 transactions were processed and settled in the AIPS system, with an average value per settled transaction by ALL 91 million. Relative to 2007, the payments' volume settled in 2008 increased by 25 percent, while the settled transactions value increased by 37 percent.

Table 23 Transactions through the AIPS system by year

AIPS system	2006	2007	2008
Number of transactions	38,793	45,480	56,717
Value of transactions (in billion leks)	3,376	3,745	5,146
Average value per transaction (in million leks)	87	82	91

Source: Bank of Albania

The greatest number of settled transactions was concentrated in the second quarter of year, while the largest liquidity flow took place in the third quarter of 2008.

Table 24 Transactions in the AIPS system by quarters of 2008

				Quarter	Year
AIPS system	I	II	III	IV	2008
Number of transactions	12,845	15,147	14,005	4,720	56,717
Value of transactions (in billion leks)	1,047	1,237	1,576	1,286	5,146
Average value per transaction (in million leks)	82	82	113	90	91

Source: Bank of Albania

About 231 transactions were processed and settled on average per day through the AIPS system, with an average daily circulation of ALL 21 billion. The total value of liquidity circulated through the AIPS system during 2008 is estimated at about 5 times Gross Domestic Product (GDP) for the year[53]. Currently, all banks operating in Albania are direct participants for settlements through the AIPS.

In a more detailed way, the types of transactions processed and settled through the AIPS system during 2008 and their relative share to the total are shown in the following table:

Table 25 Types of transactions through the AIPS

	Volume		Value (in billion leks)	
Type of transactions through AIPS	Number of transactions	Relative share	Absolute value	Relative share
BoA financial transactions / instruments	4,364	8%	3,053.2	59%
Cash transfers to/from issue	9,052	16%	249.3	5%
Interbank transactions	8,512	15%	833.8	16%
Customer transactions	29,068	51%	484.9	9%
Settlements for net clearing systems[54]	5,721	10%	524.7	10%
Total	56,717	100%	5,146	100%

Source: Bank of Albania

Out of total transactions processed and settled through the AIPS during 2008, around 51 percent represent customer payments that banks settle among themselves, including also the payments banks post daily to the government budget account, for the account of their customers. With regard to the value of transactions, transactions initiated by the Bank of Albania account for about 59 percent of the total, for the purpose of meeting its operational targets.

From the surveillance and assessment of payment systems' stability viewpoint, the concentration degree of payments at particular (participating) nods of the network is assessed. The concentration indicators for the AIPS reflect the share of a certain number of banks' activity (3 or 5 banks) to total activity in this system.

Table 26 Concentration indicators for the AIPS

	Volume of transactions	Value (in billion leks)
AIPS system	Share/Total	Share/Total
3 banks	51%	70%
5 banks	62%	85%
Total (in absolute value)	56,717	5,146

Source: Bank of Albania

Intraday Loan Facility (ILF)[55] is a key instrument in the AIPS, which is a collateralized interest-free loan that the Bank of Albania extends to participant banks for the purpose of managing their intraday liquidity.

Table 27 Intraday loan facility

Intraday Loan facility (ILF)	2007	2008
Number of transactions	675	579
Value of transactions (in billion leks)	218	221
Average value of transactions (in million leks)	322	382

Source: Bank of Albania

6.2 AUTOMATED ELECTRONIC CLEARING HOUSE SYSTEM - AECH

A total of 113,682 payment transactions were cleared through the AECH system during 2008, with an average value per settled transaction by ALL 150 thousand. Relative to 2007, the payments' volume cleared during 2008 increased by 58 percent, while the value of cleared transactions increased by 47 percent.

Table 28 Transactions in the AECH system by year

AECH system	2006	2007	2008
Number of transactions	48,889	71,857	113,682
Value of transactions (in billion leks)	7.77	12.01	17.61
Average value per transaction (in million leks)	0.16	0.17	0.15

Source: Bank of Albania

The AECH system processes customer payments of below ALL 1 million and calculates the net multi-lateral positions for net settlement in the AIPS. Out of 16 banks operating in the Republic of Albania, 14 banks are currently direct participants in the AECH system, processing their customers' payments daily in the system. The AECH system processes on average about 462 payments a day, with an average daily value of ALL 71.6 million. The highest volume and value of payments processed in the AECH system is noted in the last quarter of 2008.

Table 29 Transactions in the AECH system by quarter of 2008

				Quarter	Year
AECH system	I	II	III	IV	2008
Number of transactions	24,317	29,179	27,872	32,314	113,682
Value of transactions (in billion leks)	3.88	4.45	4.29	5.00	17.61
Average value per transaction (in million leks)	0.16	0.15	0.15	0.15	0.15

Source: Bank of Albania

It is noted that for the one-year period, the largest volume and value of customers' payments are cleared in the first session[56] of processing.

Table 30 Payments cleared through the AECH system by session

		Session	Year
AECH system	I	II	2008
Number of transactions	63,266	50,416	113,682
Value of transactions (in billion leks)	10.69	6.92	17.61
Average value per transaction (in million leks)	0.17	0.14	0.15

Source: Bank of Albania

Concentration indicators for the AECH system reflect the share of a certain participant banks' activity in the system to total activity in this system. The concentration indicator shows that 5 banks own about 63 percent of total small value payments in the banking system.

Table 31 Concentration indicators for the AECH system

	Volume of transactions	Value of transactions (in billion leks)
AECH system	Share/Total	Share/Total
3 banks	45%	49%
5 banks	63%	64%
Total (absolute value)	113,682	17,612

Source: Bank of Albania

6.3 ELECTRONIC PAYMENTS INSTRUMENTS

In view of the publication of statistical indicators on payment instruments in Albania, during 2008, the methodology "On the payment instrument reporting" was reviewed, based on the data reported by banks on the payment instruments.

The new methodology aims at: a) collecting and processing the periodical data and establishing a database on the use of payment instruments in Albania, for the purpose of analyzing the tendencies and help public to get acquainted with the payment system developments in Albania; b) monitoring the payment system developments to assess their degree of risks and ensure transparency in the agreements related with the payment instruments and services; c) complying with the statistics reported by the European Central Bank and the Bank for International Settlements, aiming at providing data on Albania in the *Blue Book* and *Red Book* (ECB's publications on payments).

It results out of banks' reporting that as at end 2008, the total number of bank customer accounts valid for making payments in ALL or in foreign currency was 1,573,830, of which 91 percent are individual accounts. Less than 1 percent of the total number of accounts is accessible through home banking for making payments or for checking the account statement.

Table 32 Composition of bank accounts

Account description	Total accounts	Accessible from home-banking
Customer accounts (1+2)	1,573,830	11,108
1- resident accounts (a+b)	1,564,084	10,751
a - individual	1,429,294	6,958
b - corporate	134,790	3,793
2- non-resident accounts (a+b)	9,746	357
a - individual	9,311	314
b - corporate	435	43

Source: Bank of Albania (Banks' reporting according to "Methodology on the payment instrument reporting").

As at end of 2008, 16 banks operating in the Republic of Albania provide payment services in 438 branches/banking agencies throughout the country. The number of ATMs and POS terminals has risen for card use by 45 and 61 percent, respectively, relative to their number as at year-end 2007.

Table 33 Number of ATMs and POSs

Description	Total
Automated Teller Machines (ATM)	642
of which:	
1 - ATMs for cash withdrawal	642
2 - ATMs for transfer orders	59
3 - ATMs for depositing cash	73
POS (Point of Sale)	2,953
out of which:	
1- POS for cash withdrawal	907
2- EFTPOS payment terminals	2,915
Terminals for the use of e-money	-

Source: Bank of Albania (Banks' reporting according to "Methodology on the payment instrument reporting"

A very widespread form of making payments is also the use of electronic payment instruments, which are being used more frequently even in Albania. As at December 31, 2008, the number of cards circulating increased by 17 percent relative to the year-end 2007. Credit cards issued during this year had a considerable weight. Their number increased by 53 percent relative to the year-end 2007.

Table 34 Banking cards in circulation

Number of cards by function	As at December 31, 2008
Cards with cash function	512,232
Cards with the payment function	498,003
of which:	
1- debit cards	482,072
2- credit cards	15,931
Cards with the e-money function	-
Total number of cards in circulation	512,232
of which:	
- cards with more than one function	498,003

Source: Bank of Albania (Banks' reporting according to "Methodology on the payment instrument reporting"

Card transactions processed during 2008 totalled 8,205,143, with a total annual circulation of ALL 93.7 billion. Out of total transactions, about 96 percent are cash transactions from ATMs, an indicator of an economy with a high use of cash. In other words, in proportion to the number of population[57] in Albania, on average one out of six persons is a card holder. Every card holder performs not more than 16 transactions a year, of which 15 are cash withdrawals from banks. Accordingly, the use of electronic payments instruments from the public is still in its first steps compared to the statistics reported from the regional countries.

Table 35 Card transactions by type

Card transactions by type	Volume	Value (ALL million)
1- ATMs for cash withdrawal	7,910,609	89,067.43
2- ATMs deposits	133	2.10
3- Transfer orders through ATMs	271	9.37
4- Cash withdrawals at POS	2,999	451.51
5- Card payments at POS	291,131	4,196.19
of which:		
- payments through debit cards	187,720	2,013.81
- payments through credit cards	103,411	2,182.38
Total cards transactions	8,205,143	93,726.60

Source: Bank of Albania (Banks' reporting according to "Methodology on the payment instrument reporting"

As at end 2008, six banks provided home banking services in the form of products allowing the access of the bank account from home, through an internet line or software the bank makes available to the customer.

The use of this service is closely related to the existence of infrastructure and the customer's ability to use the internet and up-to-date technology. Relative to 2007, home banking transactions in terms of number and volume increased by 108 and 116 percent, respectively, in 2008.

Table 36 Use of home banking

Home banking	2006	2007	2008
Number of transactions	19,096	42,447	88,261
Value of transactions (in billion leks)	16.83	48.49	104.88

Source: Bank of Albania (Banks' reporting according to "Methodology on the payment instrument reporting"

6.4 BANK OF ALBANIA'S ROLE AS SUPERVISOR OF THE PAYMENT SYSTEM

During 2008, the Bank of Albania has focused on harmonizing the current regulatory framework of the payment systems with the *Acquis Communautaire* and the best international standards of the payment systems. To this aim, a number of regulations have been reviewed and several new regulations have been approved, aiming at their direct adjustment to the EU directives.

- *REGULATION "ON ELECTRONIC PAYMENT INSTRUMENTS"*

The review of this Regulation aimed at improving the regulatory framework for issuing and using the electronic payment instruments, in view of carrying out the Bank of Albania's function for promoting and supervising the smooth functioning of the payment system in the Republic of Albania. The purpose of this Regulation is to set out the transparency standards to the customer with regard to the conditions, rules and procedures for making payments through the electronic payment instruments in the Republic of Albania, and to set out the types of electronic payment instruments and the way for keeping and reporting information while using them.

- *REGULATION "ON THE STRUCTURE AND USE OF INTERNATIONAL BANK ACCOUNT NUMBER (IBAN)"*

The Regulation "On the structure and use of International Bank Account Number" aims at standardising the account numbers used for making payments, with the purpose to promote and improve the payment system in the Republic of Albania. The purpose of this Regulation is to set out the structure of International Bank Account Number in the Republic of Albania (Albanian IBAN) and to lay down the procedures for the establishment, validation check and its use by banks and/or branches of foreign banks licensed by the Bank of Albania. IBAN implementation project is planned to take place in two phases:

(1) Creating and informing the customers on their account number in the IBAN format. The banks may decide on their own the accurate date of the complete transfer in the IBAN format, and the transfer process duration, provided that the transfer is concluded within June 1, 2009;
(2) The mandatory use and checking of IBAN regarding all delivered/received payments to/from banks. Starting from January 1, 2010, banks are obliged to check the validity of IBAN of the sender/

beneficiary's account included in the payment instruction, incoming and outgoing money transfer, irrespective of the information received on the IBAN via e-mail or a letter. Starting from this date, the Albanian payment systems shall check the validation of accounts included in payment instructions, and in any event of inaccuracy, they shall reject the related payment order.

- *DOCUMENT "PAYMENT AND SETTLEMENT SYSTEMS' SUPERVISION POLICY"*

The Document "Payment and settlement systems' supervision policy" aims at clarifying the supervision objectives on payment and settlement systems, the role of the Bank of Albania, scope of supervision, the way supervision process is carried out, the principles and standards this process is based on, and the cooperation with other supervisory authorities. The purpose of this Document is to describe the underlying responsibilities of the central bank in supervising the payment system and pursuant to these responsibilities, the objectives and activities of supervision based on the international principles and standards. The Document also highlights the need for cooperating with other central banks and supervisory institutions.

The drafting of the Albanian Law "On payment system" is assessed as crucial to further complete the legal framework of a contemporary payment system. The drafting of this Law is projected to finalize during the year 2009. The commitment of the public institutions and the cooperation with commercial banks shall assist the Bank of Albania in achieving this goal, as an indispensable condition for the operation of the national payment system and the compliance with the EU Directives.

ENDNOTES

[1] "World Economic Outlook – Crisis and Recovery" Report, April 2009.
[2] A detailed description of the Bank of Albania operations is provided in Section 4.1.2 "Open Market Operations during 2008" and in Box 5 "(Monetary policy) Open market instruments".
[3] This includes banks, non-bank financial institutions, savings and loan companies, insurance companies and supplementary private pension funds.
[4] ALL 1,072.60 billion, according to IMF estimates.
[5] Including accrued interest.
[6] According to the United Nations Global Outlook Report, house prices declined in 2008 at an annual rate of 17 percent, while mortgage delinquency rates surged, particularly for sub-prime loans. No less than 40 percent of the sub-prime mortgage loans originated in 2006 were delinquent by the second half of 2008.
[7] See Box 2.
[8] Measured as the change in percentage of the GDP in quarters, compared with the same quarter the previous year.
[9] The annual share profits' growth rate for non-financial business listed in EURO STOXX Dow Jones Index decreased from 10% in June 2008 to -3% in November 2008.
[10] See Box 2.
[11] See Box 2.
[12] CDS (loans default swap) – a swap contract in which the buyer of the CDS makes a series of periodic payments to the seller and, in exchange, receives a payoff if the financial instrument that is object of the contract goes into default. These contracts are similar to insurance for the loans instruments.
[13] ABS (Asset Backed Security) – a security whose value and income payments are derived from and collateralized by a specified pool of underlying assets, as for example by a pool of loans.
[14] CDO (Collateralized Debt Obligation) – a type of structured ABS, whose value and payments are derived from a portfolio of fixed-income underlying assets. CDOs are assigned different risk classes, or tranches. Interest and principal payments are made in order of tranches, so that higher risk tranches offer higher interest rates (and lower prices) to compensate for additional default risk.
[15] See Box 3.
[16] It is estimated that in the period July 2007 – December 2008, the fall experienced in the world stock markets have caused a loss of value of around EUR 16 thousand billion for the listed companies, around 1.5 times higher than the EU GDP.
[17] Bank for International Settlements, quarterly report.
[18] In the U.S., in 2005 and 2006 the savings rate became negative, while it accounted for 7 percent of disposable income in 1990. The subprime mortgages increased from USD 180 billion in 2001 to USD 625 billion in 2005.
[19] The losses of the banking sector and insurance companies in July 2007 to December 2008 are estimated to be around EUR 1 thousand billion.
[20] See Box 3.
[21] The data on GDP and its real growth for 2001-2006 are provided by INSTAT. The rest of the data are Ministry of Finance and IMF assessments and Bank of Albania data.
[22] The table has been constructed based on the revised nominal GDP.
[23] Nominal GDP converted with the average exchange rate of the period.
[24] The data on the number of employed people and unemployment rate for 2008 refer to the third quarter, INSTAT.
[25] Government debt including the Government guaranteed debt.
[26] ETI aggregates specific indicators of the main sectors of economic activity (industry, construction and services) and of consumers. The series of indicators, which are based on the information obtained from confidence surveys organized by the Bank of Albania and used in the construction of the ETI, are seasonally adjusted.
[27] Budget and non-budget (INSTAT, Conjuncture, main economic indicators, July-September 2008).
[28] Annual Report of the Bank of Albania 2008.

[29] In November, the Bank of Albania changed the form of auctions for open market operations from determined into auctions with undetermined amount (the interest rate is fixed with the key interest rate). Moreover, in December, the interest rate on overnight loan – an instrument provided by the Bank of Albania – dropped by 100 basis points.
[30] Banks, non-bank financial institutions, savings and loan associations, insurance companies and private supplementary pension funds.
[31] ALL 1,072.60 billion, according to the IMF assessment.
[32] Including accrued interests.
[33] Commercial banks' transactions with the Central Bank (deposits, required reserve, open market operations – repurchase and reverse repurchase agreements) T-bill transactions and operations among commercial banks (deposits, current accounts, loans, etc.).
[34] In addition to the transactions with the Central Bank and T-bills, these include the borrowings from foreign banks (from the banking group they belong to).
[35] This item includes the capital (shareholders' equity, the retained earnings/loss, the current year profit/loss), reserves (general, specific), revaluation account etc.
[36] Inter-office accounts, suspense accounts and position accounts.
[37] The weighted average of the assets' distribution is calculated based on the reported maturity terms. For each interval, the mid value is taken "a priori". Specifically, the interval which includes the "0-10 days" remaining maturity assets, the average duration considered is 5 days, for the one of "10 days to 1 month", the average duration considered is 20 days; for the "1-3 months", the average duration considered is 2 months; for the "3-6 months", the average duration considered is 4.5 months; for the interval of "6-9 months", the average duration considered is 7.5 months; for the interval of "9-12 months", the average duration taken into consideration is 10.5 months; for the interval of "1-5 years", the average duration considered is 36 months; for the interval of "over 5 years", the average duration considered is 10 years or 120 months (since the majority of this segment is represented by mortgage loans with an initial maturity of 15 years).
[38] The weighted average of the liabilities' distribution is calculated based on the reported maturity terms. For each interval, the mid value is taken "a priori". Specifically, the interval which includes the "0-10 days" liabilities, the average duration considered is 5 days; for the one of "10 days-1 month", the average duration considered is 20 days; for the "1-3 months", the average duration considered is 2 months; for the "3-6 months" the average duration considered is 4.5 months; for the "6-9 months", the average duration considered is 7.5 months; for the interval of "9-12 months", the average duration considered is 10.5 months; for the interval of "1-5 years", the average duration considered is 36 months; for the interval of "over 5 years", the average duration is 6 years or 72 months.
[39] The weighted average of the deposits' distribution is calculated based on the reported maturity terms. For each interval, the mid value is taken "a priori". Specifically, the interval which includes the "up to 1 month" deposits, the average duration considered is 0.5 months, for the "1-3 months" interval, the average duration considered is 2 months; for the "3-6 months" interval, the average duration considered is 4.5 months; for the interval of "6-12 months", the average duration considered is 9 months; for the interval of "1-5 years", the average duration considered is 36 months; for the interval of "over 5 years", the average duration considered is 6 years or 72 months.
[40] The weighted average of the loans allocation is calculated based on the reported maturity terms. For each interval, the mid value is taken "a priori". Specifically, the interval which includes the "up to 1 month" loans, the average duration considered is 0.5 months, for the "1-3 months" interval, the average duration considered is 2 months; for the "3-6 months", the average duration considered is 4.5 months; for the interval of "6-12 months", the average duration considered is 9 months; for the interval of "1-5 years", the average duration considered is 36 months; for the interval of "over 5 years", the average duration considered is 10 years or 120 months (since the majority of this segment is represented by mortgage loans with an initial maturity of 15 years).
[41] Measured since March 2006.
[42] Contribution is calculated on an annual basis.
[43] They represent investments in deposits, securities, etc.., which decreased due to the need for meeting higher demands for liquidity in the last quarter of the year.
[44] Normally, the value of risk-weighted assets should be higher than the loans value (since it includes the latter) and therefore, the share of risk-weighted assets to total assets should be higher.

The change to the regulatory supervision framework for branches of foreign banks has avoided the mandatory reporting on risk-weighted assets value, but has preserved the reporting on loan portfolio value, which continues to be reported and included in the calculation of indicators.

[45] According to IMF estimates, GDP is estimated at 1.072 billion for 2008.

[46] It is calculated by foreign currency non-performing loans (the borrower's income is in foreign currency)/total foreign currency-denominated loans (the borrower's income is in foreign currency).

[47] It is calculated by foreign currency non-performing loans (the borrower's income is in lek)/total foreign currency loans (borrower's income is in lek).

[48] In spite of this, for safety reasons, the Supervision Department has required from banks to raise their capital and monitor the lending activity prudently. The banks' shareholders that were subject to this requirement responded immediately, raising the capital without any reluctance.

[49] Including also the provisions for investment abroad (loans extended by the foreign branches of domestic banks), the reserve funds amount to ALL 12.6 billion.

[50] In the form of real estates, securities, other collaterals such as: deposits, vehicles, machinery and equipment, etc.

[51] When referring to RoE and RoA, we always imply annualized indicators.

[52] The minimum level of this indicator required from the regulatory supervisory framework is 12 percent.

[53] Source: GDP rate obtained from "Country Report IMF – October 2008".

[54] The section "Settlement for net clearing systems" contains net settlement transactions resulting from the clearing systems, as: clearing of small-value payments in AECH system; clearing of banking and personal cheques in ALL, net settlement of Government securities and net settlements of the results of payments in ALL via credit cards, about which the Bank of Albania plays the settlement agent's role.

[55] Procedures on providing intraday loan facility are rather simple and the extension of funds is carried out within 10.00 o'clock of the business day after the bank application.

[56] The payments cleared through the AECH system are processed in two sessions (session 1 - 09.00 to 11.00 hours; and session 2 - 12.00 to 14.30 hours) during the business day, and they are settled for the net result through the AIPS at the end of each session.

[57] INSTAT – Population number, January 2008.