

GOVERNOR'S SPEECH.

At the first decade of the transitional period, Albanian economy recognized a great circle-like development. The macro-economic imbalance in the years '91-'92 and '97 is followed by efforts for reforms and equilibrium re-establishment. As a result of applying these stability programs, Albanian economy has recognized a relatively great development, budget deficit reduction and price stability. The average annual inflation of 3,5% for the period '98-02 is considerably lower than that of other East and Central European countries.

I. ALBANIAN ECONOMY IN 2002.

I.1. DEVELOPMENT IN PRODUCTION.

The growth rates of Albanian economy for 1998-2002 period are considered high. However, they have shown a falling tendency during all this period. Bank of Albania assesses that the economy growth rate slowdown is a result of:

- Not fully applying the structural reforms;
- Low foreign investment rate;
- Unfavorable international conjuncture after the events of September, the 11th 2001;
- The soothing of the economic activity after its considerably high growth in '98-'99.

The economic growth in Albania for 2002, at 4,7%, as a result of the private sector expansion, relied mainly on transport, services and construction activities. The public sector is shrinking.

However, the economic growth in 2002 is lower compared to the period 1998-2002 and with 1,3% deviation from the objective declared at the beginning of the year (6%). Nearly all the economic branches have manifested lower growing rates than predicted especially agriculture and industry. The structure of Albanian economy is also changing. The agriculture and animal farming weight, sectors that have traditionally supported the economic growth, are weakened, and the contribution of services and construction sectors is increasing. These structural changes are in complete harmony with the development that a country should experience, whose objective is its integration in European Union, but still it is noticed that the industry sector has no important role. In order to support stable long-term economic growth, we think it is important that the governmental authorities must give priority to the industrial production stimulus.

Agricultural production for 2002 increased at 2,1%. It's years since agriculture does not contribute anymore by 50% to the country's economy, but considerably less. It seems that this sector's growth rate can not rely only on its extensive aspect. It is necessary that certain adjustments be performed in this sector,

which in turn would lead to productivity growth. The agriculture problems relate to: land parceling, and conflicts related to its ownership, and this does not allow long-term investments in this sector; lack of investment in technology; undeveloped rural infrastructure and the considerable disparities from a certain region to another; limited conservative abilities of agriculture and animal farming products; as well as the inadequate support provided to this sectors by funds. In spite of these problems, the agriculture sector suffered the autumn floods of year 2002. In this sector, the developments, somehow better, in animal farming and agro-industry compensates for the problems of the agriculture sector.

The industrial production for 2002, increased at 2% having the lower growth rate compared to other branches. More than any other branch, industry has suffered electric power problems that exist since at least three years ago. It is obvious, now, that the resolution to this problem is vital to the country's development. But, I have to stress that the situation is even more vexatious. Due to the observations Bank of Albania has periodically performed near the businesses of the industry sector, it has been emphasized that the country's energetic situation has led to weakening the optimism of the future business development, that's to say the stability of the economic growth is in danger.

The transport branch is assessed to have grown at 10,1% having the highest growth rate in comparison to other branches. Perhaps, this sector would have grown at 11% as predicted, had the investments been performed at a better level during 2002. The investments are performed at 79,4% of the ones planed and mainly as an aftermath of their increase in the last three months of the year.

The construction sector continues to maintain high growing rates. It is assessed that this sector's production has grown at 9,1% for the year 2002. However, construction is showing a slowing down trend in its activity extension. This is a natural trend as a result of numerous new buildings during the last ten years, and meeting the requirements. But, in the short-term period the endeavors for the constructing activity formalization will exert much influence.

On the whole, the lowest economic growth rate for the year 2002 is the aftermath of foreign investments lower rate and capital expenditures shrinking, as well as of political developments accompanied by frequent changes in government. The direct foreign investments decreased by 31% compared to year 2001. Considering that the country's political and macro-economic situation is similar to that of a year ago, foreign investments decrease is because of strategic institutions privatization deficiency, especially that of Savings Bank and Alba-Telecom. On the other hand, capital expenditures are realized at lower rates. In concrete terms, in 2002, nearly 73% of the planed capital expenditures were returned compared to 96% a year ago. The factual capital expenditures for 2002 fell by 13,8% compared to the previous year.

At year-end 2002, the number of the employees reached 921 000. In compliance with economy's development and its structural change, the employing structure

in the country has also changed. So, the employees in the agriculture sector constitute 57% of all the employees from 71,5% a year ago. Migration toward towns and the private sector expansion have attracted a considerable part of the working force. So, the employment in the private non-agriculture sector occupies 23% of the employment on the whole from 15, 8% a year ago. However, Albania still has a high unemployment rate of 15,8%. Private activity expansion and public investments still are not at such rates to prosper sufficient working positions.

Anyway, the fact that the Albanian economy has insured economical growth for the fifth consecutive year has also led to per capita income increase. For year 2002, per capita incomes accounted as GDP evaluated in dollars, compared to the country's population, are assessed at USD 1500, on average. Although this income rate remains one of the lowest of the region, we can again say that the "The Strategy for Economic and Social Development" application is taking effect. Immigration continues to be an important income source for Albanian families. These incomes have reached at USD 606,8 million for 2002, ensuring 52,5% trade deficit coverage.

At year 2002, Albanian economy trend has reflected also the effect of the overall slowdown of world economy growth, especially the impact of the problems accompanying the region's economy and the main trade partners.

I.2. DEVELOPMENTS IN ECONOMY'S EXTERNAL SECTOR AND EXCHANGE RATE.

Albanian economy competitiveness in the domestic and foreign markets is still low. The trade deficit has shown an upward trend for the last three years. For 2002, trade deficit results at 24,6% of GDP. Trade deficit escalation is the outcome of higher levels of imports compared to exports.

Albanian exports volume increased by USD 330,2 million. Re-exports occupy the main weight of Albanian exports at 74%, whereas domestic product exports remain at low rates. Albanian exports are limited in raw material production as a result of the non-expansion of domestic manufacturing capabilities. In this way, domestic production exports could not be accompanied by investment expansion and new work positions. As far as re-exports are concerned, it seems that they contribute somehow to employment, making use of free labor force in Albania. This activity represents also the most important investments of two neighbor countries in Albania: Italy and Greece. However, it remains unclear the fact that such investments are accompanied by investments in advanced technology which would serve as a premise to productivity growth.

Albanian import volume reached USD 1,5 billion. Imports include consumer goods, machinery and equipment. Machinery and equipment imports constitute 16% of imports or 5% of GDP. Indirectly this indicator points that private investments have increased.

Current deficit deteriorated, recording 9,5% level of GDP from 6,1% a year ago. The current deficit deterioration was the outcome of trade deficit escalation. Immigrants' incomes and tourism mainly enable current account financing. Current deficit, marking USD 447,6 million level is financed by capital inflows at 75% rate. Direct foreign investments (USD135 million) and foreign debt (USD 142,7 million) have the main weight in its financing.

The unfavorable developments in economy's external sector have exercised no strong pressure for domestic currency depreciation. During 2002, the foreign exchange rate towards the main currencies has especially tracked the factual seasonal tendencies even in previous years, the main exchange currency trend in the international exchange market, too. In comparison with last year, Lek was depreciated by 3,03 percentage points on the average, compared to EURO and was appreciated by 2,32 percentage points compared to USD. The banking panic of March-April period, accompanied by the confidence shrinking in domestic currency and the increase of money circulation is considered as a crucial factor counting for Lek depreciation. But the developments in international markets are those which determine domestic currency movements. EURO/USD rate in international market determined Lek's depreciation towards EURO.

Depending on those developments, Bank of Albania has intervened in the domestic foreign exchange market, during 2002, in two phases: March-April-May and December. The intervening direction was different for both phases. In the first phase, nearly USD 5 million were sold out, whereas in December, nearly USD 2 million were bought.

II. INFLATION AND MONETARY POLICY

The annual inflation rate at year-end 2002 reached 2,1%. The developments in consumer prices during 2002 showed a different tendency from the last year one. If in 2001 inflation remained at relatively low rates and within the objective, pressures for higher inflation increased in its last months, resulting in a 3,5% inflation rate reached at year-end. Year 2002 started with high inflation rates, nearly the twice of the objective's ceiling. Rates higher than the objective were present almost during the whole year and considerably decreased in its last two months. In general, the mid-term inflation has shown an upward trend. The average annual inflation rate increased from 0,4% and 0,1% in 1999 and 2000, into 3,1% and 5,4% correspondingly in 2001 and 2002, as a result of the most inflationary economic environment during 2002.

In 2002, many factors have operated and have dictated the developments in consumer price. These factors have operated in both directions: the demand and the offer direction. These factors operation at certain ratios and the fact that demand factors operated in continuation of one another giving even longer-term effects, made Bank of Albania respond prudently.

Among the main factors operating in the inflation trend, worth mentioning are:

- ◆ Money growth outside banks over forecasts, in certain periods of the year and the weight increase of a more liquid aggregate, M1 in the monetary offer at the first half of the year;
- ◆ Domestic currency depreciation at the first half of the year as well;
- ◆ Foodstuff price increase in markets from which Albania imports and a higher inflation compared to the objective in Eurozone;
- ◆ Electrical power price increase in December 2001 reflected in consumer goods prices, especially at the first half of the year. Also, the unstable power situation operated as an important factor for higher prices;
- ◆ Climate conditions, such as the cold weather at the beginning of the year and autumn floods, influenced on transport price increase and as a result on food product increase.
- ◆ Speculative increase of prices, especially on the verge of feasts at year-end.

Since these operating factors intensity was stronger in the first half of the year, inflation rates resulted to be higher in this period and became smoother later. The prudence in budgetary expenses performing, the price reduction in "communication" group as a result of the mobile service invigoration in Albania and also campaigns undertaken by Bank of Albania at year-end influenced on inflation reduction, in order to smooth the phenomenon of speculation with prices. The monetary policy tracked by Bank of Albania in 2002 was somehow changed compared to years '98-00. In general, monetary policy applied during last years has had a soothing character. In 2001, responding to pressures for high inflation, monetary policy was neutral, whereas in 2002, for most of the time it became tightening. In addition to that, different from the ten-year activity history of Bank of

Albania, banking system stability maintenance was given priority for nearly three months. By this decision, Bank of Albania avoided banking panic expansion and extension for a longer period of time. Although at first sight, the maintenance of banking system stability seemed to threaten the achievement of the inflation objective, in fact it serves to long-term price stability. The developments till year-end 2002 proved that Bank of Albania took the right decision.

On the whole, monetary policy in 2002 was a tighten policy responding to the pressures for high inflation rates. But, it has not uniformly been tighten during the whole year. In compliance with inflation and monetary developments trend, monetary policy of Bank of Albania during 2002 may be divided into three periods:

- **In January-February, a neutral monetary policy was adopted.**

High inflation rates at the beginning of 2002, influenced by the offer factors, made interest growth rate not necessary. In general, the monetary indicators improved and liquidity was quickly returned to the system. Bank of Albania withdrew excessive liquidity by means of REPO auctions. It did not finance the budget deficit. Interest rates have generally been stable.

- **In March-September a tightening monetary policy was tracked.**

Deposit withdrawal from the two greatest banks of Albanian banking system, which started at mid March 2002, changed the course of monetary developments and rose up additional pressures about inflation. Panic expansion was an unpredicted phenomenon. At least, banking system situation did not cause it. Despite certain problems supervised by Bank of Albania and made known to public through the threatening toward the financial system, Banks in Albania show a healthy financial situation. Albanian banking system is being consolidated year on year. Therefore, the panic could not be urged or based on banking system situation. Panic was assessed to be the aftermath of the political situation aggravation at that period, misinterpretation of the law "On deposit insurance" and of insufficient information to depositors, too. As a result, deposits worth Lek 23,4 billion were withdrawn from the banking system, 73% of that represented the withdrawal of deposits in Lek. These withdrawals represented 8,3% of deposits set on in Albanian banking system. Deposit withdrawal caused difficulties for banks short-term liquidity and for budget deficit financing through the primary market of treasury bills. This difficulty was even more aggravated when it became clear that the privatization process in 2002 would not progress as forecasted. Monetary indicators deviated from the program. Money outside banks during this period increased at Lek 16,4 billion. Only in April was the annual growth rate of this indicator 35,6%, and this is the highest growing rate during the last five years. On the other hand, Lek was depreciated compared to the two main foreign currencies and at the same time pressures for inflation

increase was strengthened. As a result, banking system passed from its position of excess liquidity of Lek 1,6 billion in February into liquidity deficiency.

In order to overcome this situation, Bank of Albania strategy consists in:

- Allowing the deviation from the monetary program and meeting banks needs for liquidity. By injecting the liquidity needed in markets, banks had the possibility to meet the requirements for deposit withdrawal and in this way this served as a measure to prevent panic expansion. In spite of this, since having liquidity banks operated normally in the primary market of treasury bills.
- Financing the government to ensure normal expenditures continuity. But, since pressures for inflation were strengthened, Bank of Albania searched and found Albanian government's understanding to be extremely prudent in performing expenses. The fiscal quantitative objectives were rigorously respected. Supervisory Council of Bank of Albania decided that the government should be financed at least by 8% of average budgetary incomes for the three last years. But, the premature situation improvement made this measure implementation not necessary;
- Increasing the interest base rate by 1,5 percentage points to foster deposit interest rate increase. This amount ensured higher real deposit incomes and promoted them to turn money in banks. Despite this, deepening the difference with foreign currency interests was aimed at, so that pressure could be applied to not allow Lek depreciation;
- Explaining to public the banking system real situation, as well as the effects and benefits of the law "On deposit insurance" in order to smooth the negative psychological effect that occurred.

The precautions ensured the interruption of deposit withdrawal by the end of June 2002 and the whole situation recuperation within year 2002.

- **In October-December a neutral monetary policy was adopted.**

Considering liquidity return in the system, which led monetary condition improvement, relative interest rate stability and inflation pressures smoothing, Bank of Albania has applied a prudent monetary policy, with a smoothing tendency, in the two last months of the year. In November, it adopted a neutral attitude toward interest rates. In December, the neutral character of monetary policy stability was further strengthened due to the changes of auction's form from fixed amount auction into unfixed amount auction of fixed interest rate. This change represents a significant lending cost reduction in the banks.

As a consequence, the required quantitative objectives to be applied by Bank of Albania were respected. Net domestic assets resulted to be Lek 7,97 billion less than their above-mentioned objective; net foreign assets resulted to be 3,55 million USD more than the objective floor. In conformity to the actual monetary policy regime, Bank of Albania aims at economy's liquidity control, considering it as closely linked to prices level. Liquidity condition and economy's monetary

indicators are controlled by the respect shown towards these quantitative objectives.

III. PUBLIC FINANCES

Budget indicators trend for year 2002 was conditioned because of privatization incomes deficiency; deposit withdrawal and the unrealized forecast for economic growth and this means less budgetary incomes. Therefore, in order to maintain the equilibrium of these indicators and to respect the quantitative objectives, everything was operated by a rigorous control in expense performance.

Budgeted deficit reached 6,2% toward GDP or 2,4% points less than a year ago. Albanian state finances consolidation resulted from the continuation of a clear tendency of budget deficit reduction for the period 1999-2002. Budget deficit reduction was ensured by the higher income growth compared to expenses.

Budgetary incomes increased by 11,4% compared to those of a year ago. However, the planned rate was realized at 95%. Expenditures increased by 3,2% compared to a year ago and the realized plan level was 90%.

The level of the realized budgeted income plan is influenced by taxation and custom incomes plan realized at 92% and 91%. It is clear that the budgetary income rate remains negatively influenced by fiscal evasion, domestic contraband and corruption level. On this ground, strengthening the precautions toward these phenomena is directly linked to fiscal position improvement.

As far as expenses are concerned, it is noticed that capital expenditures are realized at 73% rate, meanwhile current expenses hold 81% of all the expenses, from the forecasted 74,6%.

Year 2002, as well, did not avoid the usual phenomenon of expenses concentration in December. Expenses rate in December surpassed budgeted plan. The same situation is maintained since at least 1997, and this makes us paying more attention to the harmonization of expenses rhythm necessary.

IV. DEVELOPMENTS IN BANKING SYSTEM

The situation of Albanian banking system for 2002 is assessed to be healthy. Banking system activity is expanded by Lek 21 billion or 3,4% in real terms. The resulting profit is Lek 3,9 billion. Capital's position is further strengthened and capital adequacy rate reached 31,5% from 12% of the allowed minimal rate.

Albanian banking system is expanded by new entities and its network has further extended. In 2002, Albanian Credit Bank was licensed. Actually, 14 trade banks operate, and they have expanded their network by 9 new branches and 1 new agency. Despite banks, new financial institutions are being set up and licensed

and they will influence in developing the financial system in Albania and will lead to reducing banking system weight in it. Therefore, in 2002, 1 non-bank financial institution, 20 foreign exchange bureaus, 113 saving-credit associations and 2 unions to these associations were licensed.

The increase in the number of financial institutions and their activity's expansion will rise up the financial intermediation level in Albania. Despite positive developments in last years, still financial mediation is at low levels, even lower compared to the region. Term deposit ratio is nearly 40,1% of GDP from 50% of the average level in East and Central European countries. In the meantime, domestic credit is nearly 35,1% of GDP, but the credit to economy is 7,2% from nearly 40% on the average in East and Central European countries. The difference between domestic credit indicator and credit to economy, represents banking sector loaning to the government. Albanian government demand to finance budgeted deficit, still high in comparison to the most developed countries' level, keeps lending activity distorted. However, the developments in the last years have been positive. The continuous budget deficit reduction raised banks' ability to loan economy. Domestic credit ratio and economy credit ratio toward GDP a year ago were 45% and 4,6% correspondingly.

It's a positive fact that banking activity expansion is the result of a more intensive activity of private and joint venture banks. In this way, premise about the continuous reduction of Savings Bank dominating position is set up.

However, compared to the last year, the rhythms of banking activity expansion and profitability indicators have undergone a slight deterioration. Net incomes in comparison to average assets and their banks' funds, for 2002 result 1,2% and 19,1% from 1,5% and 21,6% a year ago. This situation reflects the influence of the panic caused in March-April 2002 over the banking system. Consequently, Bank of Albania concludes that the banking system is sound, but its stability is still fragile.

Banks lending activity for domestic economy is performed at satisfactory paces. The new credit cultivated by banks, has been Lek 62,6 billion from Lek 40,6 billion in 2001. Banking system credit outstanding, at year-end 2002 turned out to be Lek 47,4 billion or 16,6% of this system deposits. In general, credit indicators have improved. In years 1993-2000, the banking system granted credit at Lek 79,5 billion. The new granted credit for the period 2001-2002, reaches Lek 103,2 billion. This means that the average annual lending for these two years is nearly 5 times more than the period 1993-2000. Banking network and activity expansion makes us feel optimistic about lending increase in the future.

Despite banks, micro-credit scheme and non-bank financial institutions expansion is another fruitful development, which will lead to the increase of economy's loaning. It is assessed that Lek 4 billion credits is granted by these institutions during 2002. Micro-credit schemes have precedence because they

expand even in regions where there are no bank branches, especially in rural regions and create loaning possibilities for small business. These are the reasons by which it is assessed in general that informal lending is shrinking.

The credit granted by banking system has maintained its structural characteristics even in 2002. So, it is 67% in foreign currencies; 100% for the private sector and 71% short-termed. In spite of that, the trade sector continues to be the favorite in lending.

Banks lending activity, regardless of the last years acceleration is not accompanied by credit portfolio quality deterioration. Bad credits represent 5,6% of credit portfolio from 6,9% marked a year ago. Bad credit structure as well, has not underwent changes by not reflecting any trouble toward the increase at the highest risks which is the risk of loans classified as lost.

V. BANKING SUPERVISION

The function of banking supervision constitutes the second key pillar of Bank of Albania activity. The mission of Bank of Albania as a regulatory authority is:

- to insure banking system stability and support deposits and wide audience interests;
- to insure a sound banking system, whose activity should be transparent and conducted toward market economy;
- to increase investors and depositors trust by supporting the development of banking industry and its efficiency.

The main strategic objective is the one declared by the BIS Bazel Committee for banking supervision: **“No entity is to escape supervision and supervision must be adequate”** and the observance of the Committee’s 25 key principles about prudent banking supervision.

Banking supervision activity, in 2002, is concentrated in meeting and reviewing the regulatory framework, analyzing and inspecting banking and other institutions’ activity supervised by Bank of Albania. Many new laws and regulations were drafted in the regulatory framework and they aimed at not leaving certain institutions activity out of supervision.

During 2002, 13 complete inspections and 11 partial ones were performed and it was noticed that:

- ◆ Lending activity expansion is accompanied by credit portfolio improvement, although it still evidences certain deficiencies such as the beginnings of lending activity without firstly ensuring a well-prepared group; non-reliance on complete and adequate policies and procedures.
- ◆ Public trust in the banking system is returned after the panic prevailing in March-April 2002 period.

- ◆ Banks top management, in general, has positively reacted to problems raised by the performed examinations, but has not shown the proper caution in: improving banking activity procedures and policies; meeting the regulatory framework of banking activity; applying bank's business plan.

During the performed inspections, certain violations of different nature are observed. In general, these violations are assessed as trivial and of no serious consequences for banks. According to the evidenced violations, the corrective and punitive actions are determined, based on the provisions of the law "On banks in the Republic of Albania" and on the by-laws of Bank of Albania such as recommendations and suggestions to correct the little irregularities such as the requirement to present in Bank of Albania a certain program of measures for managing bank's situation. In case of encountering a certain irregularity it determines the corresponding terms, too; punitive actions for the managers involved in the observed violations toward the regulative and legal framework in power.

Considering the importance that banking supervision function has, the plan of medium-term banking supervision development is drafted having an effect till year 2004. Applying this plan aims at increasing the banking system security level in Albania by efficiently performing the standards for a safe and sound banking activity.

Strengthening the supervising abilities is considered as an important duty aiming at deterring problems and minimizing risks to which banking system is exposed. The importance of this undertaking grows more when facing the attempts and implementation of the measures for the further liberalization of economy and level of its integration increase.

VI. THE FINANCIAL SITUATION OF BANK OF ALBANIA.

For year 2002, the opinion of independent auditors is that the financial reviews of Bank of Albania reflect directly, in all material aspects, Bank's financial position and the results of its activity, changes in its capital and cash flows at year-end are in accordance with International Accounting Standards.

The total balance sheet of Bank of Albania turned out to be Lek 213 billion whereas net income reached Lek 9,7 billion or 8,9% higher than a year ago.

Foreign currency reserves constitute an important resource of foreign currency income for Bank of Albania. At year-end 2002, foreign currency reserves reached USD 838,9 million or 13,8% more than a year ago.