

# ANNUAL REPORT 2006

B a n k o f A l b a n i a



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*Governor of the Bank of Albania, Mr. Ardian Fullani*



*Bank of Albania Supervisory Council*

*From left to the right in front:*

ELISABETA GJONI  
ARDIAN FULLANI  
TEFTA ÇUÇI

Member  
Chairman (Governor of the Bank of Albania)  
Member

*From left to the right in the back:*

LIMOS MALAJ  
ARJAN KADAREJA  
HALIT XHAFA  
FATOS IBRAHIMI  
KSENOFON KRISAFI  
ADRIAN CIVICI

Member  
Member  
Member  
Vice Chairman (First Deputy Governor)  
Member  
Member

## GOVERNOR'S SPEECH

*Honourable Mr. Chairman,*

*Honourable ladies and gentlemen, members of the Economy and Finance Commission,*

It is a special privilege for me to present to you, pursuant to law requirements, the 2006 Annual Report of the Bank of Albania.

This report provides a summary of the Bank of Albania activity in implementing the legal and constitutional obligations. First of all let me focus on the national economy performance, and then on more specific parts related to the institutional responsibilities and direct contributions of the Bank of Albania to subduing inflation, maintaining financial stability, enhancing the financial infrastructure and on our role to European and regional integration.

### 1. ECONOMIC DEVELOPMENTS OVER 2006

The country's economic development over 2006 has generally complied with its medium-term development plan. The overall Albanian economy has undergone comparably satisfactory growth rates, due to the private sector's dynamism, macroeconomic stability and the fruits of the so-far structural reforms. The banking system has provided a powerful incentive to economic activity sustainability and to growth of credit to the economy by about ALL 70 billion or above usd 700 million.

Based on available economic indicators, the growth rate is estimated at about 5 percent. This growth has been associated with price stability, reflected in an annual average inflation rate of 2.4 percent. The monetary conditions, characterised by historically low interest rates and exchange rate stability have favoured the rise of investments and consumption in the economy. In particular, they have also been reflected in rapid credit growth, by further sustaining the economy growth. The fiscal developments have taken place within the programmed limits, contributing to further consolidation of public finances and budget deficit control.

However, the realization of capital expenditures requires a larger focus on the programmed level, as concerns the pace these expenditures have been carried out.

The economic growth has been reflected also in the labour market. The number of employed persons in the country has boosted, though it has not yet fully reflected the developments in other sectors of the economy. The country's

economic activity extension has been associated with increased foreign trade exchanges. The balance of payments has been closed in positive terms, thus supporting the exchange rate stability.

The quantitative and qualitative indicators of economic performance show a satisfactory growth, based mainly on the activities of services and industrial production. The sales carried out by economic enterprises during the first nine-month period accounted for about 11 percent higher than in 2005. The fact that the first quarter recorded a high annual growth of sales shows that services and production enterprises overcame the problems entailed by power supply constraints at end of 2005. The industry sector, particularly the process industry has recorded positive developments. The country's trade activity continues to ensure the majority of sales, and to record significant annual growth rates.

It is estimated that construction sector has performed almost at the same level with that of the previous year. Direct and indirect indexes of this sector impose the necessity for a broader attention, particularly to a better allocation of private or public financial resources. Construction developments over the recent years, and particularly the extreme concentration of constructions on certain territories, prove the lack of efficient urban development policies, without guaranteeing long-term sustainability of the branch. Furthermore, construction continues to be dominated by housing buildings, lagging behind other strategic items, such as investments in road infrastructure, in industrial constructions, in land improvement and in agricultural infrastructure, as well as other investments directly related to the standard of living of small urban and rural communities.

Agricultural production during 2006 partly recovered the growth rate decline noticed in 2005. The sector growth projection stands at 2.5 per cent for 2006, higher than the growth of 2005, but lower than the average growth rate noticed over five latest years. Investments in agricultural sector and financing by the banking system will increase in accordance with the potential of this branch, providing that hurdles arising from various structural problems are eliminated.

Agricultural land is not used at maximum, because of external and internal migration and the problems with ownership titles. The relatively underdeveloped rural infrastructure makes more difficult the emerging of products in the market. The parcelling out of agricultural land impedes the effective organisation of production, decreases the profitability and raises the agricultural mechanics utilization cost.

The Bank of Albania deems that energy remains our main challenge in the short-run and in the medium-run.

We have been faced with underlined power supply constraints for about a decade. The current crisis coincidence in time with a global environment that is rather sensitive to this problem has relatively increased the energy import costs,

which could be unsustainable in the long run. It has resulted out of Bank of Albania surveys that the negative consequences arising from this situation are numerous and directly related to the economic activity of the productive sector, in both levels, corporate and small and medium sized enterprises. The frequent recurrence of such situation poses the risk that periods of significant power constraints are no longer regarded as accidental shocks, but they are more and more classified as permanent factors that should be factorised in the production cost, and hence should be taken into account in pricing policies and their expectations.

To this end, the Bank of Albania estimates that, starting from 2007, all the respective decision-making stakeholders should apply a new concrete management policy, different from the 15-year practice. An integral part of it should be not only the management of current energy resources, but also concrete steps in the distribution network, as short-term measures to pass to long-term operations, which would imply the establishment of alternative energy sources. The solution of the energy situation at the soonest time possible will provide positive impacts on the Albanian business, the soundness of public finances, the country's sustainable economic development and the macroeconomic stability.

Concluding this part, I would like to point out some other issues, which I think should be encompassed in the priority list of the country's medium-term economic and financial development. The Albanian economy is leaving the status of a transition economy and is approaching to that of a developing economy. This qualitative step requires further deepening of structural reforms, enhancement of effectiveness of development policies and enlargement of the country's absorbing capacities in terms of fostering the Albanian economy competitiveness at regional context and beyond it.

I would highlight the constant trade deficit deepening, as an issue of the present and the future. Even though the current cross-border position of the country is not problematic, being materialised in such indicators as external debt, foreign reserve level or overall balance of payments position, I would point out that the rise of exports is not sufficient, particularly in the context of high reliability of the Albanian economy on remittances. The relatively high current deficit, around 7.6 percent of GDP, is another argument in this regard. The latter one, also in the presence of a fiscal deficit, increases our economy's exposure and makes necessary the provision of foreign currency inflows of a more steady nature. This would be translated into a need for more qualitative foreign direct investments, which in turn, would contribute to a steady growth of exports.

To this end, taking advantage of the global environment, which is constantly searching for new markets, I would suggest a more qualitative national marketing strategy. This strategy should highlight professionally and contemporarily, all the recent incentives and the multiple opportunities Albania provides. Also, I think it is just the time to integrate even the joint regional projects into our long-term development plans. Road infrastructure, energy, communication, tourism and other areas are still underdeveloped in regional level. Therefore, I assess that regional projects of strategic nature raise the interest of domestic and foreign investors. If taken separately the

economies of the region are relatively small, but altogether they form an attractive market, with more investment opportunities.

In recent years, it is noticed that the penetration of foreign investments in our region is relatively small and mainly, it reflects the privatization process of important public properties. The same thing has occurred to the Albanian economy. More concretely, during 2000 – 2006, the overall foreign direct investments, according to the balance of payments statistics, are estimated to about usd 1.45 billion, about 3.5 percent of GDP realised over the same period.

If we would identify the reasons why FDI inflows are so modest, we might mention the complex problems characterising our region, while different reasons that reduce the absorbing capability of our economy exist even in the national plan.

The Bank of Albania deems that the country's current stage of development creates great possibilities in this regard. The experience of the newly acceded countries has indicated that the signing of the Stabilisation and Association Agreement and the following negotiations have been associated by high FDI inflows. However, we can not assume that this phenomenon will be automatically present even in Albania. Therefore, the Bank of Albania deems that further deepening of structural reforms is necessary and that this process should be followed by improvements in the business climate and by enhancement of the degree of law enforcement.

The last but not the least, I would like to point out that the degree of economic activity coverage with statistics is still low. The monetary policy that we are following is an as much dynamic as visionary process. Besides the existence of efficient markets, it also needs to be supplied with new and methodologically accurate statistics.

Besides our constant efforts and good understanding with INSTAT, we find it necessary to appeal for a greater attention of the whole society and of respective institutions in particular, to increasing statistical information and further consolidating the existing one. It is just the time that all the monitoring, licensing and decision-making institutions, including also the numerous non-governmental organisations, must feel a great responsibility in this regard. It is just the moment that they develop indirect measuring and estimating approaches for many demographic, economic, social and financial indicators.

Let me now present another important issue in my speech, which has to do with one of the main legal responsibilities of the Bank of Albania, i.e., consumer price stability.

## 2. INFLATION AND MONETARY POLICY

Consumer goods price inflation over 2006 was generally within the Bank of Albania's targeted range of 2 to 3 percent. Year-end recorded a 2.5 percent



annual inflation rate. It was almost similar to the 2005 annual inflation rate of 2.4 percent. Inflationary pressures, though moderate, have been increasing over 2006. The average annual inflation rate amounted to 2.7 percent during the second six-month period of the year, from 2.0 percent it was in the first half of the year.

In general, the annual average inflation steadiness during the recent years, speaks for the inflation rate stability, in spite of the fluctuations in time and size of the factors that have conditioned the consumer price performance. Developments on the demand and supply side of the economy have been balanced, without creating premises for inflationary pressures.

The fiscal policy has observed the programmed indicators on annual basis, stabilizing the impact of the public sector component on the aggregate demand. Also, the monetary policy has controlled liquidity conditions and interest rate developments, and has attended the exchange rate performance, monitoring through them the economic activity financial stimuli. On the other hand, the low inflation rates in the recent years have been reflected in anchoring the inflationary pressures of the economy close to the Bank of Albania's target. The latter might have contributed to constraining the second-round effects that may be caused in the Albanian economy by some supply shocks, such as high oil prices and managed price rises, with which the Albanian economy was faced.

- MONETARY CONDITIONS AND MONETARY POLICY DECISIONS

Monetary policy decisions on the key interest rate in the economy have been taken on the basis of constantly analysing the current and expected developments of the demand and supply factors springing from internal and external environment. Under the conditions when an enlivening of inflationary pressures was evidenced and in the presence of a number of factors expected to further favour this situation, the Bank of Albania decided on changing its monetary policy stance, at the beginning of the third quarter of 2006. This change occurred after a neutral period that had lasted about one year and a half. The monetary policy change was materialised in raising the key interest rate twice during the second half of 2006. In July and November 2006 the one-week repo rate was lifted respectively by 0.25 percentage point. The maturity in monetary policy decision-making was reflected in the time lag between both tightening movements in the interest rates.

In July-November 2006, many assessments have been made on the degree of banking market response and sensitivity to monetary policy stance on interest rates. The interest rate rise by 0.5 percentage point is estimated to have normalised the annual monetary supply growth rates, fully responding to the public and private sector demand for monetary assets. Monetary policy operations have assisted in stabilizing inflationary pressures of economic agents in the medium run.

- FISCAL POLICY

The Bank of Albania has estimated that during 2006, the fiscal policy provided a satisfactory support to inflation developments. Fiscal indicators

were realised in accordance with the budgetary program, preventing premises for inflationary pressure rise in the economy. During the fourth quarter of 2006, a high concentration of budgetary spending was noticed. The budget deficit realization as of year-end, estimated at about 3.2 percent of GDP or 0.7 percentage point less than that of the previous year, has influenced on the contraction of inflationary pressures and control of monetary expansion.

- DEMAND FACTORS

During 2006 domestic demand has significantly sustained the positive economic growth rates. Good performance of the domestic demand has been indicated by a number of economic activity indicators. Hence, the sales index for the first nine-month period of the year recorded an annual growth of 12.4 percent. In particular, the rise of imports of machinery and equipment and the real estate credit growth are indicators of investment expansion in the country. The domestic demand has been increasing also due to rapid growth of lending activity, which recorded a 57 percent increase in annual terms. Notwithstanding the positive effects of investment expansion, the domestic demand growth exercises pressure on the overall price rise.

In absence of any obvious inflationary pressures on the demand side, it is estimated that the Albanian economy is making use of free capacities without raising the costs and final prices of goods and services. Also, it should be highlighted that part of this domestic demand has been met by rise of imports and trade deficit, thus mitigating the pressure on consumer prices.

- SUPPLY FACTORS

*Import prices.* The Albanian economy is a relatively open economy and therefore, import prices constitute an important element of the country's inflation. Generally speaking, the economic conditions of trade partner countries of Albania have been favourable during this year, easing the control on supply side pressures and enabling the observance of inflation target.

*Oil prices:* Consumer prices during 2006 were influenced by a stressful situation in the interbank oil price market. The impact of this factor, as concerns the intensity of operation in inflation rate, was not uniform, being higher during the first nine months of the year and recording a decline during the last quarter.

*Exchange rate:* During 2006 exchange rate developments have dampened inflationary pressures of the supply side. The national currency has been appreciated against the American dollar and has maintained unchanged its position vis-à-vis the euro. The lek's appreciating tendencies, though weakened in the recent months, have led to the decline of import price in domestic currency. In this way, the exchange rate has contributed to containment of the high international oil price effect and to maintaining a low inflation rate.

*Agricultural production:* Agricultural production is one of the main domestic factors, which condition the consumer price developments. The quantity of domestic agricultural production influences instantly on foodstuff price level.



During 2006, the seasonal effect of agricultural production rise appeared later than in the preceding years, leading to foodstuff price decreases only in September and October.

*Production prices:* During 2006 the production prices continued the downward trend noticed since April 2005. However, the concentration of production price index on the productive sector of industry makes difficult its comparison to consumer price index. Also, the domestic production share is not yet a determinant component of goods supply in the domestic market, thus not affecting the consumer prices.

*Wages and unemployment:* The good performance of the economic activity during 2006 was also reflected in labour market indicator, and particularly in unemployment rate. New employment possibilities were created, making unemployment rate continue its downward trend observed since more than two years ago. Improvements have also been made in terms of incomes. So, government sector wages, the minimum wage and pensions have increased in accordance with the budget plan. The so-far inflation performance shows that Albanian economy does not suffer from any significant discrepancy between wage rise and productivity.

*Inflationary expectations:* The business and public expectations in short- to medium-term have fluctuated around the inflation rates recorded. According to Bank of Albania periodic estimates, the public expectations have converged, mostly around 1-3 percent. In the meantime, the business expectations on price performance have reflected a high volatility. The monetary policy and the consolidation of macroeconomic stability have played an important role in anchoring the expectations of public at large to Bank of Albania's inflation targeted rate.

### 3. MONEY SUPPLY

During the major part of 2006, monetary indicators have reflected the stabilised demand for monetary assets. The average M3 growth rate resulted to 12 percent. The demand for money of the public sector grew by 3.3 percent during 2006. This relatively low borrowing has balanced the high lending rates of the private sector, positively impacting on the maintaining of monetary stability. In compliance with the trend noticed over the latest years, monetary developments have been characterised by shifting to longer-term monetary assets.

Currency outside banks has followed the general trend of the demand for money. The currency outside banks to M3 stood at 24.2 percent at year-end or 1.7 percentage points less than in the previous year. In nominal terms, the currency outside banks grew by ALL 13.6 billion or 9.1 percent.

The macroeconomic environment during 2006 has been favourable for a steady growth of banking system lek deposits. The positive real interest rates have been associated with further rise of lek deposits. They rose by 38 billion

during 2006, satisfying the needs of the economy for ALL 35.9 billion and the needs of the government for credit in ALL.

In 2006 foreign currency deposits rose by about 29.4 percent. The higher growth rate of foreign currency deposits versus the money supply growth rate led the ratio of foreign currency deposits to M3 to about 29 percent. The share of foreign currency deposits to total deposits rose to 38.5 percent, against 35.5 percent in 2005.

#### 4. DEMAND FOR MONEY

The increase in the demand for money reached its peak in December, by an annual rise of 16.7 percent. The main contribution to the increased demand for money throughout the year was rendered by credit to the economy. This contribution recorded its maximum in June, being mitigated during the coming months due to growth of public borrowing. Foreign currency position has maintained a relatively steady weight in establishing monetary assets during the year.

- CREDIT TO THE ECONOMY

The banking system developments and the increased role of banks as financial intermediaries, have led to significant expansion of lending activity during the recent years. The loans portfolio amounted to ALL 191.2 billion or 21.3 percent of GDP at end of 2006. The loans portfolio for the economy constituted 31.3 percent of total banking system assets and about 37.4 percent of the banking system deposits.

During 2006, credit to the economy increased by ALL 69.3 billion in absolute terms, compared to ALL 52 billion in 2005. During two latest years, commercial banks have better met the increasing demand for ALL loans, which at end of 2006 constituted 29 percent of the loans portfolio, thus evidencing a moderate extension of its share.

Corporate credit constitutes the main share of banks' portfolio, amounting to 66.5 percent of the total at end 2006. In annual terms, corporate credit increased by 52 percent. The credit distribution structure by use has tended to be more uniform in comparison with the previous year. Most of corporate loans (34.5 percent) have been used for purchasing machinery and equipment, while 23.2 percent of corporate loans portfolio has been used for financing investments in activity area expansion.

In 2006 the household credit was 7 percent of GDP, or 33.5 percent of the total loans portfolio. More than half of loans to households (59.3 percent) have been extended for financing real estate purchases, while the financing of consumer goods purchases has also increased. The ratio of consumer loans to total household portfolio is 27.3 percent, from 20 percent in the previous year. In particular, consumer loans increased obviously during the summer holidays and during the end-year celebrations.

Concerning lending to specific sectors, it should be underlined that trade remains the sector mostly credited by the banking system, by 22.4 percent of the loans portfolio. The growth rate of credit to construction has been inhibited during 2006. This sector presented temporary improvement signs during the summer, then turned back to the downward trend. In the meantime, the low volume of credit to agriculture speaks for constant structural problems that inhibit lending to this sector.

Given the geographical coverage with loans, it is observed that 68 percent of the portfolio is concentrated in Tirana. Durrës and Vlora come afterwards, by respectively 8 and 4 percent of the loans portfolio. This reveals the high economic importance of Tirana, and the need for improving the economic infrastructure in the rest of the country.

- NET FOREIGN ASSETS

The foreign currency position of the banking system improved during 2006. Net foreign assets of the banking system amounted to US\$ 2.4 billion at year-end, recording an annual growth of about US\$ 440 million.

- GOVERNMENT DEMAND FOR MONEY

The government account has had an unusual performance during 2006. During the major part of the year, the government demand for money was negative, concentrating the planned domestic borrowing on two last months of the year. The overall deficit financing for 2006 resulted to about ALL 22.6 billion.

## 5. FINANCIAL MARKET AND INTEREST RATES

Year 2006 was characterised by an increased activity in money and capital market, while the interest rate performance was generally oriented by the Bank of Albania's monetary policy. Under the conditions of excess liquidity, the interest rates had a downward trend during the first half of the year. The interest rates went upward after the tightening signal of monetary conditions in the second half of the year.

The interbank market was more active during 2006, thus ensuring a more efficient way of banks' excess liquidity management. The average daily volume of transactions amounted to ALL 1.6 billion or ALL 0.2 billion more than the previous year average. The interbank market was characterised by narrowing the interest rate spread according to maturities and their positioning close to key interest rate. The average overnight-weekly interest rate spread dropped to 0.7 percentage point in 2006, from 1.6 percentage points in 2005.

In the first half of 2006, there was a constant decline in treasury bills yields and government bonds, due to low government demand for funds. In the second half of 2006, following the Bank of Albania's tightening signals and the increased demand for liquidity in the system, there was a gradual rise

of these yields. The yields increased respectively by 0.83, 0.45 and 0.98 percentage point in comparison with the previous year.

The government bonds issues has increased compared to the previous year, making the banks' portfolio, as the sole participants in this market, increase to ALL 37.0 billion. The share of bonds to total government securities increased 22 percent in 2006 from 12 percent in the previous year. Their maturity structure varies from 2 to 5 years. Five-year bonds were issued for the first time in November of this year, for the amount of ALL 6.3 billion. The demand for them resulted higher than the issued amount.

Lek deposit interest rates went down during the first half of 2006, and up after the tightening monetary policy signals. The interest rates were raised faster for long-term maturities, reflecting the adjustment of their term to long-term government debt rise.

Lek credit interest rates went down for all maturities during 2006. The weighted average interest in December 2006 fell to 12.92 percent, from 13.50 percent it was in the previous year. Though the intermediation cost declined in comparison to the previous year, the spread level is still high. It is influenced by imperfect competition in this market and by higher risk nature of loans extended in ALL.

The interest rates of deposits denominated in lek and euro continued to go up, as a result of monetary policy tightening by the Fed and the European Central Bank during 2006. Simultaneously, the interest rates of loans extended in these currencies went up. The interests of six-month to one-year loans in Euro and six-month loans in usd underwent the highest rise. At end of 2006, the weighted average interests of loans in usd amounted to 9.42 percent and interests of loans in Euro amounted to 8.17 percent, from 8.47 percent and 7.95 percent they were respectively at end of the previous year.

## 6. EXCHANGE RATE

During 2006, the Albanian lek has maintained its appreciating trend against the principal foreign currencies, though at a low intensity. In effective nominal annual terms, the lek has been appreciated on average by 1.1 percent during 2006. During the previous year, this appreciation was 2.8 percent. The lek-foreign currency interest rate spread, though downward during three latest years, continued to be at positive levels.

Economic developments during 2006 have sustained a stable domestic currency. The lek's appreciating pressures have been concentrated mainly on July - August and December. Besides the seasonal entry of foreign currency, which is the main factor of the lek's appreciation over this period, the key interest rate increase has also been reflected in the market. The high foreign currency supply over this period has been absorbed partly by the Bank of Albania's interventions, in respect of the target on the rise of net international reserve and in compliance with the country's overall macroeconomic program.

## 7. MONETARY POLICY INSTRUMENTS

Fixed-price one-week repurchase agreement is the main instrument employed during 2006. According to the liquidity situation, the Bank of Albania has switched from repurchase agreements to reverse agreements, while the maturity term has changed from weekly to quarterly. This spectre of movements has been imposed by seasonal factors, by the budget behaviour and by the need to reveal certain monetary policy signals.

To meet longer-term needs of the market for liquidity during the four last months of 2006, four Treasury bill outright purchase transactions were carried out, at a total nominal value of ALL 3.2 billion.

During 2006 commercial banks employed the overnight deposit facility for investing their free liquidities with the Bank of Albania, on average at ALL 1.6 billion a day or ALL 0.82 billion more than in 2005.

Overnight credit has been employed only in seven cases, despite the lack of liquidity over the third quarter of the year. For the fourth consecutive year, the final lending facility of the Bank of Albania, i.e., the Lombard loan was not employed at all.

The required reserve instrument was used constantly even during 2006, for withdrawing the banking system liquidity. The monthly pace of ALL required reserve rise during 2006 was on average higher than in 2005, 0.92 percent versus 0.76 percent, reflecting the rise in the respective categories included in the required reserve account.

## 8. FOREIGN RESERVE MANAGEMENT

During 2006 the gross foreign reserve, estimated and reported in USD, has been increased by usd 368.06 million, recording the value of usd 1,793.12 million as at end of December.

Out of this growth, about usd 205 million is accumulated from Bank of Albania's interventions in foreign currency. They were intended at meeting the quantitative target for these assets and mitigating the volatility over the peak periods of foreign currency supply. While the exchange rate effect has been positive, at usd 106 million, the rest of the growth has been contributed by receipts from foreign disbursements.

## 9. BANKING SYSTEM PERFORMANCE

The banking system continued its stable development during 2006. The net banking system result for 2006 stood at a profit of ALL 7.45 billion, about 12.9 percent more than in 2005. Revenues from the principal activity (net income from interest) resulted to 31.2 percent more than in the previous year,

reflecting the banking system orientation to activities of higher return and a rise in the overall volume of assets.

At end of 2006, the net income from interests was 92.6 percent of the gross banking system incomes, compared to 84 percent at end of 2005. This indicator has recorded constant growth, particularly over three last years, reflecting the overall net income sustainability for the banking system.

During 2006, the banking system assets grew by ALL 127.7 billion, or about ALL 57.6 billion more than the growth of assets noted in 2005. The main contribution to the growth of banking system assets was given by large banks, though their share in the market is downward. The estimates show that the lending activity concentration level is lower than that of assets and deposits concentration.

The significant growth of lending has been associated with increased share of non-performing loans portfolio, by about ALL 3.1 billion compared to end of 2005. The loans portfolio quality indicator, expressed as a ratio of non-performing loans to total loans portfolio in gross terms, is estimated at 3.1 percent as at year-end, against 2.3 percent as at year-end 2005.

The banking system capability of covering loss loans with capital has been downward, but still at good levels. The "non-performing loans to outstanding loans (net)" indicator, which estimates the net size of exposure to credit risk, continues to be at low levels, by 1.4 percent as at year-end 2006.

Compared to year-end 2005, the capital adequacy ratio of the system decreased by 0.5 percentage point down to 18.1 percent at end 2006. The capital adequacy ratio for 2006 continued to maintain the downward trend reflected in the preceding years. Large banks have recorded a rise of capital adequacy indicator, mainly due to increased regulatory capital at end of the year, by about 62.3 percent.

At end of 2006, the ratio of liquid assets to total assets of the banking system recorded 57.6 percent, compared to 62.6 percent it was at end of December 2005.

During 2006 the banking system underwent important qualitative and quantitative developments. At end of 2006 the Albanian banking sector consisted of 17 banks, of which three are of fully Albanian private equity. At the beginning of 2006 the Union Bank commenced its activity. On May 2006, there was approved the selling of the Italian-Albanian Bank's 80 % stake, which belonged to the Ministry of Finances of the Republic of Albania and to Capitalia S.A., Italy, to the new stockholder SanPaolo IMI S.p.A., Italy. At the same period, there was also approved the 60 percent (plus 2 shares) ownership transfer of the National Commercial Bank's stake from Kent Bank/Bayindir Bank, to the new Turkish institutional stockholder, Çalik-Seker Konsorsiyum Yatirim Anonim.

On August 2006 the ownership transfer of 11.25 percent of the ProCredit Bank's stake, from EBRD to ProCredit Holding AG (existing shareholder) was approved. On October 2006, the 71.97 percent transfer of the stake of Emporiki Bank S.A. of Greece to Credit Agricole S.A., France shareholder was approved. This transfer influenced also the indirect participation of Credit Agricole S.A. to the Emporiki Bank of Albania's equity, to the same extent.

During 2006, the banks' network was extended also by 62 new branches and agencies, in the whole territory of Albania and abroad, having the highest share in Tirana, with the establishment of 30 new branches and agencies. Also, the opening of two branches outside the territory of Albania was approved and the opening of two other new branches is under the process of approval.

## 10. NEW ACTIVITIES OF THE BANK OF ALBANIA

### • PAYMENT SYSTEM

From the regulatory and operational point of view, the payment system in Albania has already created the physiognomy of a modern system. The number of transactions processed during 2006 has increased by 13 percent, compared to 2005. In the meantime the value of transactions has increased by 21 percent during 2006, amounting to ALL 2,664.43 billion. Compared to 2005, the daily average number of payments (in both systems) has increased from 312, to 352 or 40 more transactions per day. In 2006, a new bank was added to the payment system, leading the number of participants to 17 banks.

On March 2006 the e-payment settlement by VISA cards started. Currently, this scheme counts 6 member banks. The number of cards in circulation has increased by 9 times during 2006, compared to 2004. The addition in cards number counts 127,552 cards compared to 2005, i.e., about 56 percent. Parallel to increased number of cards, the number of ATMs and POSs has also increased, respectively by 130 and 404.

### • INTERNATIONAL INTEGRATION AND COOPERATION

The Bank of Albania's obligations stemming from the SAA relate to the meeting of the economic criteria of Copenhagen, guaranteeing the right of establishment and freedom of services for banks and other communautaire financial services, liberalizing capital movement and current payments between Albania and the EU, and approximating Albanian legislation to that of the *acquis communautaire* in these areas.

One of the most important developments during 2006 regarding the approximation of national legislation to that of the *acquis* was the drafting of the Law "On Banks in the Republic of Albania". This Law has adopted the largest part of the provisions of the 2000/12/EC Directive, with regards to initiation and continuation of credit institutions activity.

On 8 November, 2006, the European Commission published the Albania 2006 Progress Report. The European Commission evaluated in the report the

policy followed by the Bank of Albania in terms of cooperating with international financial institutions and maintaining inflation under control, contributing to keeping a steady macroeconomic environment in the country.

At the same time, the Commission also evaluated the reliable monetary policy followed, highlighting particularly the measures taken by the Bank of Albania in terms of gradually changing its monetary policy strategy towards explicit inflation targeting regime, aiming at enhancing transparency and credibility of its monetary policies.

The report highlighted also the positive developments in the banking sector of the country and assessed the progress achieved regarding the establishment of the loans register, free movement of banking and financial services, freedom of establishment of foreign banks and further liberalization of capital movement.

On 27 January, 2006, the Executive Board of the IMF adopted the three-annual agreement with Albania, at SDR 17.045 million. The main targets of the new program have to do with the maintaining of macroeconomic stability, as a prerequisite for economic growth, and the improvement of financial institutions.

Under Reserves Advisory and Management Program (RAMP), during 2006 the World Bank's group provided consulting and technical assistance to the Bank of Albania for foreign reserve management.

During 2006 the Bank of Albania established constant contacts with the EBRD, mainly in terms of providing information and statistics for the development of the Albanian economy in general and financial sector in particular. The Transition Report 2006 assessed positively the maintaining of inflation within the Bank of Albania's target and the consolidation of the banking system over 2006.

The Bank for International Settlements (BIS) is another institution with which the Bank of Albania kept close contacts during 2006. The BIS has been particularly active in providing technical assistance to the Bank of Albania, through workshops and training courses organised by the Institute of Financial Stability, which promotes the international financial stability through information sharing and cooperation in financial system supervision area.

During 2006 the Bank of Albania enhanced the mutual relations with the central banks of the region and beyond it. Personally, I have paid official visits to many central banks of the region and Europe, discussing about latest developments in the Albanian economy and further extension of mutual cooperation and technical assistance that these banks can provide to the Bank of Albania. In June the Governor of the Bank of Greece, Mr. Nicholas C. Garganas paid a two-day official visit to Albania. It took place in the light of mutual relations between both institutions, laying special emphasis on sharing of information and experience in banking supervision area.



Enhancing relations with central banks of the region reached the peak in the round table of October 2006 held in Tirana, where the governors of the central banks of Rumania, Serbia, Montenegro, Bosnia and Herzegovina and Kosovo discussed about financial stability of the region.

In the framework of the Bank of Albania's objective to benefit from the experience of the central banks of the CEE, recently acceded in the European System of Central Banks (ESCB), during 2006 the cooperation relations with the Central Bank of Poland, National Bank of the Czech Republic and the National Bank of Bulgaria have been intensified.

- CURRENCY ISSUING

The increase of currency in circulation over 2006, by ALL 14, 7 billion is a response to the balanced macroeconomic development of the country. The commercial bank's receivables by the Bank of Albania during 2006 stood at ALL 105 billion, remaining almost at the same level with that of 2005. Concerning cash payments, from Bank of Albania's cash-boxes to commercial banks, the supply was carried out according to their requests, and intending, at the same time, to maintain the currency in circulation structure within the projected limits for year-end 2006.

The velocity of money circulation over 2006, for the shortened cycle of circulation, totalled almost at the same level as in 2005. However, the velocity of circulation underwent changes for certain denominations of banknotes and coins. Hence, a significant increase of velocity of circulation was proved in the 5.000 lekë, 1.000 lekë and 500 lekë denominations, respectively by 13.3 percent, 38.9 percent and 8.3 percent.

- CHANGES IN BANKING LEGISLATION

During 2006, further to the signing of the Stabilization and Association Agreement on 12 June, 2006, the banking legislation was amended and improved substantially once the Law "On the Banks in the Republic of Albania", No. 9662 of 18.12.2006 was passed by the Assembly of the Republic of Albania, which shall become effective on 1 June, 2007.

The Law "On the Banks in the Republic of Albania" enables the European Union member states banks and all foreign banks to provide banking services to Albania, through their branches or subsidiaries, without making any distinction in the licensing terms for their branches and subsidiaries and for Albanian banks. Furthermore, in line with the SAA provisions, the adopted law requires their treatment as Albanian banks in every aspect, once they are granted the licence to carry out banking business and financial activity.

The new law provides for clearer rules on management of risk the banks may be faced with while carrying out their activity, in order to guarantee and strengthen the protection of depositors and investors and to maintain banking system stability. Given the current conditions of rapid credit growth in the banking system, the new law treats fully the other types of risks as well, other than that of credit risk, with which banks may be faced, and the permitted exposures of the latter ones when faced with such risks.

The law requires for the first time, inter alia, the establishment and maintaining by the Bank of Albania of the loans register. Under the conditions of a rapid credit growth, the purpose of establishing such a register is to assist banks in making well-informed decisions when extending loans to their clients, as well as to strengthen the Bank of Albania's supervision on the Albanian banking system.

During 2006 the Bank of Albania started examining the prerequisites and implementation conditions over a mid-term period (year 2009), of a new monetary policy regime. In this context, analyses are carried out about the possibilities of improving the legal infrastructure for the creation of such conditions in compliance with international standards in this area. Also, the possibility of improving the organic law of the Bank of Albania has been considered, coinciding with the prediction of its alteration as a mid-term priority of the National Plan for the Implementation of the SAA.

It is forecasted that these alterations will stipulate clearly the competences and procedures for the decision-making process of the Bank of Albania and the transparency of this process, which constitutes also a substantial precondition for the compilation and implementation of an effective monetary policy.

In the framework of the legal reforms undertaken by the Ministry of Justice for the amendment and improvement of the Civil Procedure Code, the Bank of Albania has been fully committed to cooperating with the banking sector for the completion and accuracy of mandatory execution procedure of executive titles.

The Bank of Albania proposals have aimed at improving the legal base on the application of procedures for the execution of acts that constitute executive titles. The main purpose is to cut the time for the execution of those acts, aiming to increase security in the lending activity, thus reducing the credit risk the banks are faced with.

At end of 2006, the Bank of Albania closely cooperated with the Ministry of Finance in compiling the draft-law "On Preventing Money Laundering and Terrorism Financing". In accordance with the respective European Union directives and other international recommendations, the Bank of Albania, being the supervisory authority of the banking system, regards with priority the legal framework improvement for preventing the use of banking system for laundering money and wealth that derive from criminal activities.

During this year, with the assistance of the World Bank, the drafting and completion of the regulatory framework for foreign reserve management was carried out successfully, reviewing the Bank of Albania's policy on the management of such reserve, the management criteria and terms, as well as the decentralization of decision-making competences during this process.

- INTERNAL AUDIT

In 2006, 44 audits and 3 verification procedures were carried out. The inspectors presented 269 findings and 197 recommendations out of these

audits, which were carried out at the Bank of Albania and at its five district branches, the Printing House included.

## 11. BANK OF ALBANIA BALANCE SHEET

During 2006, the Bank of Albania assets further increased, totalling ALL 255.5 billion, about 14 percent higher than at end 2005.

The constituent groups, both foreign currency and domestic assets, have reflected growth, while the first group occupies about 68 per cent of total assets, the same level as that of the previous year. On the liability side, foreign currency liabilities fell slightly (from 8 to 7 percent of the total) in comparison with the previous year, whereas domestic liabilities increased by 16 percent. Currency in circulation is the indicator that bears the main weight in this growth (about 45 percent of the growth), followed by the "due to the government" item (about 29 percent of the growth) and "due to banks" item (about 26 percent of the growth).

In general, the accounting balance sheet of the Bank of Albania and the income and expenditure statement reflect some basic developments that have occurred in the economy, where the Bank of Albania plays an important role.

The revenues realised during 2006 outstripped the level of the previous year only by about 5 percent. The main impact on this growth was given by income on foreign currency interests (about 20 percent more than in 2005). This reflects the performance of interest rates in foreign exchange markets. This effect absorbs the reduction of "income from ALL interests" item (about 7 percent less than in 2005), which reflects an average interest rate below that of 2005, irrespective of the upward trend at year-end.

On the other hand, interest expenses outstrip the previous year level by about 25 percent, reflecting the positive phenomena of the increased level of deposits and liquidity position in the banking system. Foreign currency interest expenses have been outstripped by 64 percent compared to the previous year, whereas ALL interest expenses have increased by 14 percent. Other (operational and amortization) expenditures are almost at the same level with that of the previous year.

Finally, the almost full compensation between increase of incomes and expenditures makes the net profit of the Bank of Albania for 2006 be in the same level with that of the previous year, at about ALL 5.16 billion (or 99.6 percent of the profit for 2005).

*Honourable deputies,*

Concluding my speech, I would like to underscore that during 2006 the Bank of Albania included in its agenda all the recommendations given by the

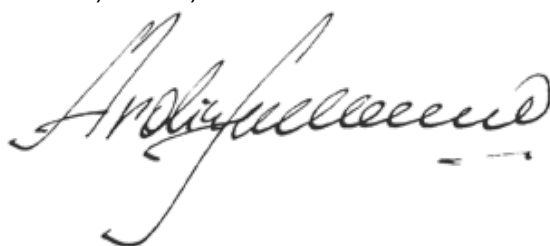
Albanian Parliament in its resolution adopted on 25 May, 2006. I would also like to assure you that even in 2007, the same philosophy will characterise our work. Understanding correctly the role and mission of our institution, on behalf of the Supervisory Council of the Bank of Albania, I declare that the Bank of Albania will continue to be an accountable institution, deeply committed to fulfil its obligations vested by the Law and the Constitution.

We have many priorities for 2007, but let me highlight the most important ones:

- Maintaining consumer price stability remains the main legal target of the Bank of Albania. We are confident that the decisions taken in 2006 were appropriate and have served to orient inflationary expectations to the targeted range. Based on our forward-looking philosophy, we will prudentially evaluate all the risk factors, so that we operate on due time and intensity.
- Macroeconomic stability is of primary importance, but definitely the financial stability is also of as much crucial importance. Given the importance and the current level of economic and financial development of the country, this priority assumes extraordinary importance. Furthermore, the rapid credit growth is an argument for more prudence, particularly with regard to its quality. Being fully aware of our role as a decision-making and regulatory institution, we have decided to raise our vigilance in this regard, establishing the Financial Stability Department as a first step.
- Once more, the Bank of Albania emphasises its objective for further consolidation of the banking system. This process, which was present during 2006, should further continue in the current year. Our intention is that the banking system becomes a unity of sound institutions: that are supported by powerful shareholders, experienced in banking industry; that apply best standards of accountability in management; that carry out a balanced activity with well-managed risks; that are able to be faced with and develop under the open market competition provided by an open and integrated market into the international financial market; that support the economic development of the country and that transparently provide efficient and qualitative banking products and services to the public.

I would like to thank the Albanian Parliament once more for the good understanding and constant support it has given to the Bank of Albania.

*Thank you for your attention.*



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## CHAPTER I WORLD ECONOMY

### I.1 THE WORLD ECONOMY AND FINANCIAL MARKETS

The world economy was characterised by positive developments during 2006. The maintaining of high growth rates and the expansion of the base line of economies contributing to it, testify the consolidation of expansion cycle. The sharp oil price rise and grave geopolitical situation have put the stability of economic activity into difficulty, without managing to reverse it. Macroeconomic policies have remained on the encouraging side, though the largest central banks have taken measures to tighten the monetary policies, in response to inflationary pressures. Favourable liquidity conditions and historically low interest rates have favoured the financial market development. Their dynamism and the increasing globalization of the economy have played an important role in transmitting growth impulses beyond the geographic limits.

	2004	2005	2006	Projection 2007
World output	5.3	4.9	5.1	4.9
Advanced economies	3.2	2.6	3.1	2.7
Euro area	2.1	1.3	2.4	2.0
Germany	1.2	0.9	2.0	1.3
France	2.0	1.2	2.4	2.3
Italy	1.1	-	1.5	1.3
USA	3.9	3.2	3.4	2.9
South and eastern Europe	6.5	5.4	5.3	5.0

Source: IMF, "World Economic Outlook", September 2006

Table 1 Annual growth and 2007 projections

According to IMF estimates, the world economy grew by 5.1 percent during 2006. The economic growth for 2004 – 2006 has recorded the highest levels since the beginning of '70s. During 2006 a balancing of the global economy was noticed. The economic activity has been moderate in the United States of America and Japan, but has gained momentum in Europe. Developments in China, India, Russia and in many other developing countries continue the positive performance of recent years.

	Annual GDP growth, Q4	Unemployment rate, December	CPI December
USA	+3.5	4.5	2.0
Euro area	+3.3	7.5	1.9
Germany	+3.7	7.9	1.4
France	+1.9*	8.5	1.7
Italy	+2.9	6.7 **	2.1
Japan	+1.7*	4.	0.3

\* Third quarter;

\*\* September. Source: Eurostat; Economic Research Office; Labour Statistics Office

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

On the other hand, the economic growth extended over a long period of time has made the economies of many countries increase the use of free capacities, adding inflationary pressures. Intensive economic activity has brought about increased demand for oil and other goods, resulting to continuous targeting of their prices.

- EURO AREA ECONOMY

After a long period of contraction, the Euro area economy gained a new impetus in 2006, beyond expectations. The economic growth has been widespread either geographically or in different components of the demand. According to the latest estimates of the European Commission, GDP grew by 2.7 percent in 2006, from 1.4 percent in 2005. Increased consumption and private investments have been the driving force of this upswing. The improved domestic demand has created foundations for a sustainable and long-lasting growth. Evidence from different confidence surveys also supports the estimates for strong growth and improved labour market.

The ECB's monetary policy has helped in anchoring inflationary expectations around the target of 2 percent. Consumer price inflation ascended during the first half of the year, peaking by 2.5 percent in June. The inflation of this period was mainly due to direct impact of high price of oil and its sub-products. The trend of consumer price inflation reversed during the second half of 2006. The second-round effects of high energy prices<sup>1</sup> have been limited, but core inflation and producer price index have started to signal probable inflationary pressures for 2007 and 2008.

In October, the member states of the Euro area submitted to the European Commission the deficit and debt data for 2005, the performance over 2006 and projections for 2007. Notwithstanding the slow pace, the overall trend reveals budget balance improvements. Commitments taken in the framework of the reviewed Stability and Growth Pact have been carried out by all Member States. The favourable economic situation of the Euro area constitutes a good moment for budget consolidation in many countries.

- USA ECONOMY

After some years of high growth rates, the USA economy started to enter into a period of moderate, but steady growth rate. After a high growth in the first quarter of 2006, the growth rate of Gross Domestic Product moderated in the rest of the year. The main reason of economic activity slowdown related to reverse developments in the housing market, providing impact also on construction sector. However, the housing market spillovers have not been transmitted significantly to other sectors of the economy. Consumer expenditures, constituting the base for the growth in the latest years, have continued to be in high rates. The business sector continues to be in very good financial conditions, with high profit and liquidity. The good financial position has been supportive to capital business expenditures and has impacted on a satisfactory and steady labour demand.

Inflationary pressures were somewhat subdued during the last months of



the year, after the high levels recorded in the first half of the year. Inflation had an overall downward trend, mostly due to decreased price of oil and its products, likewise in Euro area. The degree of using the capacities was high, whereas the compensation per employee increased slightly in 2006. Labour productivity and transfer of additional labour costs to prices will impact on inflationary pressures of the economy.

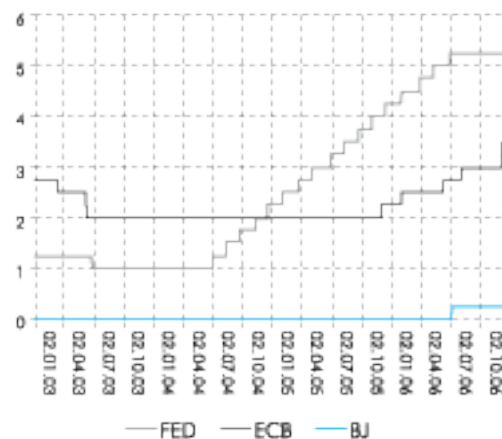
- KEY INTEREST RATES

The monetary policy pursued by most of monetary authorities of advanced economies has had an overall tightening stance, though at present the central banks are under different stages of the monetary cycle. The central bank of the United States of America (Federal Reserve) is making a pause, after 17 consecutive hikes of the key interest rate, expecting the materialization of their effects on the economic development. The USA key interest rate is higher for large economies, to 5.25 percent.

The European Central Bank (ECB) started to tighten the monetary policy at end of 2005. During 2006 the Governing Council of the ECB increased the key interest rate five times, leading it to 3.5 percent in the last month of this year. Given the low interest rates, the money growth and high lending to the economy, the ECB regards the monetary conditions of the Euro area as supportive to economic activity growth.

The Bank of Japan increased the key interest rate by 0.25 percentage point in June, without applying other moves since then. Inflation rise at lower rates than expected is the main reason for the decision on keeping the key interest rate unchanged.

Chart 1 Key interest rate in the Euro area, USA and Japan



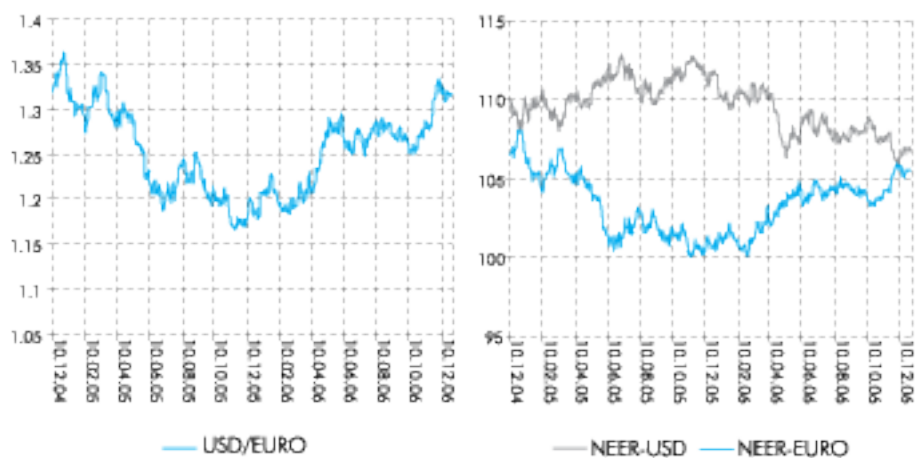
Source: European Central Bank; Federal Reserve; Bank of Japan

- EXCHANGE RATE

After gaining some ground at year - start 2005 and maintaining a period of some-month steadiness, the American dollar depreciated against the euro and the Japanese Yen in 2006. The dollar's depreciation in this year mostly reflected the international market expectations, that upon the moderation of the USA economic activity, the positive interest rate spreads between US\$ and different currencies might decrease. Also, the deepening of American current account deficit and the expansion of current account surplus of oil exporting countries and developing countries of Asia, constitute another concern that influences the foreign exchange markets. In the wake of a slowdown during 2006 the foreign exchange market volatility has returned to normal values, reflecting the fact that monetary policy decisions are being better transmitted to foreign exchange market.

- OIL PRICE

After reflecting stabilization signs during the fall of 2005, the oil price rose sharply in the first half of 2006, reaching a new historical high of usd 78 per

Chart 2 USD/Euro exchange rate and NEER-euro and NEER-usd<sup>2</sup>


Source: European Central Bank; Federal Reserve

Chart 3 Crude oil prices (in USD per barrel)

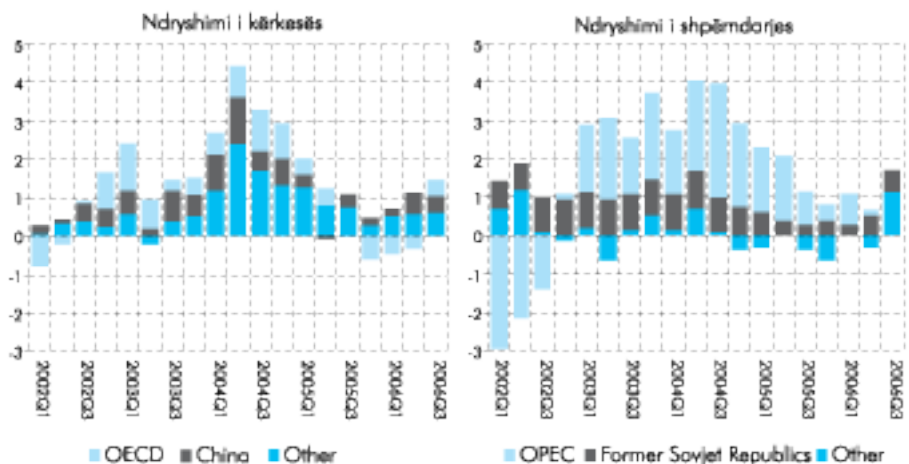


Source: Bloomberg

barrel at the beginning of August. In the coming months, the oil price stabilized and the crude oil was traded in the 2005 year-end levels.

Market fears stemming from an expected decline of production by main oil exporting countries in the wake of added geopolitical tensions, impacted on price rise over the first half of the year. However, the overestimation of the importance of some factors, an unusually mild start to the winter in most parts of the northern hemisphere, lower demand and the increased OPEC supply above the announced levels have impacted positively on the stabilization of the situation.

Chart 4 Change in crude oil demand and distribution, in millions of barrels per day



Source: World Bank

## I.2 ECONOMIES OF THE REGION

### MAIN HIGHLIGHTS

The countries of the region<sup>3</sup> are gradually approximating their economic and monetary developments to Western European Countries. This is reflected also in the faster growth rates of these countries compared with those of the Euro area. So, the real GDP growth, from 4.7<sup>4</sup> percent in 2005 is expected to be about 5.9 percent for 2006, thus being some percentage points higher than that of the Euro area countries. Foreign direct investment inflows and higher domestic demand, encouraged also by rapid credit growth, are among the main factors influencing the significant economic growth. On the other hand, domestic demand and high energy prices are exerting inflationary pressures throughout the region. Furthermore, domestic savings are insufficient to cover investments, thus resulting to high current account deficit. However, further economic growth is exposed to risks coming from global imbalances and increased interest rates in the OECD countries, thus weakening the interest for investing in these countries. Foreign direct investments are expected to somewhat decline in comparison to the levels observed in 2004-2005.

Problems stemming from rapid growth of credit, of real salaries expressed in high domestic demand have been reflected in the measures taken by the central banks of the countries of the region. Many central banks have decided on introducing stricter regulations on minimum required reserves or taking other measures against inflation. Under this background, overall fiscal policies have been very easing to effectively contain the domestic demand. The case of more tightening fiscal policies is becoming more necessary from the outlook of long-term implications of population aging, which will exert a significant pressure on the fiscal budget perspectives.

Table 3 Main indicators on region economies

Countries	GDP growth (in %)		Annual inflation (in %)	Unemployment rate (in %)	Fiscal balance* (% of GDP)	Current account* (% of GDP)
	2005	2006*				
Greece	3.7	4.2	3.2	8.7 q3	-2.6	-11.4
Italy	0.0	1.5	2.1	6.9 q2	-4.0	-1.4
Kosovo	-0.2	--	0.7 (November)	--	--	--
Croatia	4.1	4.6	2.0	16.9 (November)	-3.0	-6.8
Macedonia	3.8	3.8	2.9	37.1*	-0.6	-3.1
Serbia	6.3	5.5	6.6	26 (September)	+0.8	-10
Turkey	7.4	6	9.7	9.1 (September)	-3.6	-8.1

Source: Eurostat, IMF, Central Banks.

\*Projections

It is forecasted that over the medium run the Southeast European economies will continue to have significant growth rates, though somewhat slower for 2007. Such developments are expected to reflect the progress in structural reforms and the increased integration into the world economy.

- ECONOMY OF GREECE

The economic activity has significantly grown during 2006. GDP over the third quarter of the year grew by 4.4 percent in annual terms or almost two times higher than in the euro area. Rise in investment and consistency in consumer expenditures are the main factors leading to this growth. Notwithstanding the expectations of monetary policy tightening by the European Central Bank, the economic performance is expected to be satisfactory even for 2007 and reach 3.9 percent. High domestic demand and high oil price have been reflected also in the deepening of current account deficit, which for 2006 is expected to top 11 percent of GDP. Fiscal situation improved during 2006. Government account deficit for 2006 is expected to decline to 2.6 percent of GDP, from 5.2 percent it was in the previous year.

- ECONOMY OF ITALY

Improved economy of Italy in 2006 signals the end of a four-year period of an almost economic stagnation. Rise of exports, easing lending terms, reforms oriented to increase of employed number and improved confidence level are the main forces driving the positive performance. Full implementation of reforms in commodity market is an important factor, which will influence on subduing inflation in the coming period. Settling payments in a more decentralised way will further impact on compensating previous competition losses. Fiscal deficit for 2006 is estimated to 4 percent of GDP.

- ECONOMY OF KOSOVO

The reduced aids from donators and decreased presence of international community have influenced on Kosovo's economic development slowdown. However, the private sector recovery over 2006 has positively influenced on expectations for GDP growth of this year. Trade deficit during the first three quarters of 2006 reached to 39 percent of GDP. Current deficit financing continues to be based on foreign assistance in the form of support, more by projects and less by private capital transfers. The slowdown in economic activity has also been presented in a moderate inflation rate. Fiscal developments over the first nine months of the year have been better than expected. Fiscal account recorded a consolidated budget surplus of Euro 119.7 million in November.

- ECONOMY OF CROATIA

Gross Domestic Product over the first quarters of 2006 recorded a growth of 4.7 percent. Economic activity growth has continued to be driven by high domestic demand. This economic performance has also been associated by increased employment rate. Current deficit account for the 12-month period until end of September has deepened to 8.2 percent of GDP. Average inflation rate has increased during three latest years, coming to a moving average of 3.3 percent in November 2006. Monetary policy has continued to be subject to the primary target of maintaining price stability. The consolidated government deficit is forecasted to drop to 3 percent of GDP, according to July forecasts.

- ECONOMY OF MACEDONIA

During the first nine months of 2006, the annual growth rate of economic

activity was reduced to 2.7 percent, from 3.8 percent in 2005. The slowdown represents the lowest growth of industrial output and construction activity. This economic development has been associated with improved external account during the first three quarters of 2006. In September the current account balance recorded a surplus of about 2 percent of GDP. Inflation rate rose during 2006, though remaining in low negative levels of 2.9 percent in December. Monetary conditions have been further eased during 2006, reflecting the increased confidence in exchange rate stability. Fiscal balance is expected to record a fiscal deficit of 0.6 percent of GDP.

- **ECONOMY OF SERBIA**

The Gross Domestic Product over the first nine months of 2006 increased by 5.4 percent in annual terms. Domestic demand has been the main contributor to GDP growth. Trade deficit during the first eleven months of the year was deepened by 9.7 percent. Annual inflation rate recorded 6.6 percent in December 2006, from 17.5 percent it was in the previous year. The national currency appreciation vis-à-vis the euro, oil price decline in international market during the second half of the year, delays in arranging some managed prices and the tightening monetary conditions led to reduced inflation rate. The falling inflation rate has been reflected in easing the monetary policy by cutting the key interest rate by 4 percentage points over the last months of the year. The National Bank of Serbia modified the monetary policy regime in 2006, switching to inflation targeting regime.

- **ECONOMY OF TURKEY**

The pace of GDP growth decreased during 2006 in comparison to the previous year. So, GDP increased only by 3.4 percent in the third quarter of 2006, from 7 percent it was over the first half of the year. The economic slowdown was caused mainly by decreased private consumption in consequence of the tightening monetary policy, higher interest rates and credit reduction. Disinflation has been rapid during the last three years, but its pace has decreased, mainly due to national currency's appreciation and the energy price rise, leading the inflation rate to 9.7 percent in December 2006. The current account deficit, expected to achieve the level of 8 percent of GDP for 2006, is financed by rise in the private debt and foreign direct investments. The maintaining of fiscal discipline and particularly the confidence in the monetary policy, through consolidating the central bank's independence, are decisive factors for maintaining the country's macroeconomic stability.

## NOTES

<sup>1</sup> Crude oil price is transmitted to diesel, and heating oil price, and to other energy products used by consumers.

<sup>2</sup> Nominal effective exchange rate is calculated as a weighted average of nominal exchange rates against main trade partner countries' currencies.

<sup>3</sup> The countries of the region include: Italy, Greece, Kosovo, Croatia, Bulgaria, Rumania, Bosnia and Herzegovina, Former Yugoslav Republic of Macedonia, Serbia and Montenegro.

<sup>4</sup> According to the European Bank for Reconstruction and Development.

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## CHAPTER II ALBANIAN ECONOMY

### II.1 GDP AND MACROECONOMIC STABILITY

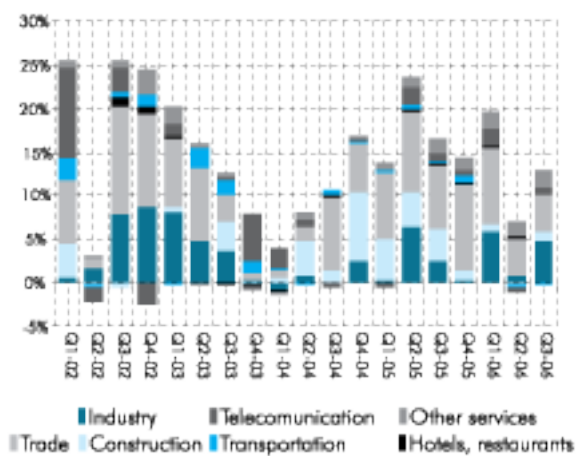
The country's economic development over 2006 has generally been in line with the projected developments. The economic growth and macroeconomic stability have been influenced by relatively accommodating macroeconomic policies and improved structural environment.

Based on available economic indicators, the growth rate is estimated at about 5 percent. This growth has been associated with price stability, reflected in an annual average inflation rate of 2.4 percent. The monetary conditions, characterised by historically low interest rates and exchange rate stability have favoured the rise of investments and consumption in the economy. In particular, they have also been reflected in rapid credit growth, by further sustaining the economy growth. The fiscal developments have taken place within the programmed limits, contributing to further consolidation of public finances and budget deficit control.

Nonetheless, the realization of capital expenditures requires a larger focus not only on meeting the programmed level but also on its pace. The rise of some managed prices during the second half of the year has not influenced on creating any inflationary spirals or on production decline. The burden such increases cause to consumers has been mitigated by price cut of some important goods of the consumer basket. The oil price cut in the international market during last months of the year has influenced on decreasing production and transport cost in the country. The economic growth has been reflected also in the labour market. The country's employed number has boosted, though it does not yet reflect the overall developments of other sectors of the economy. The country's economic activity expansion has been associated with increased foreign trade exchanges. The balance of payments has been closed in positive terms, being supportive to exchange rate stability. However, the ensuring of a stable economic development in the future would require the drafting of integral strategies for controlling the high trade deficit.

The quantitative and qualitative indicators of economic performance show a satisfactory growth, based mainly on the activities of services and industrial production. The sales carried out by economic enterprises during the first nine-month period accounted for about 11 percent higher than in 2005. The fact that the first quarter recorded a high annual growth of sales shows that services and production enterprises overcame the problems entailed by power supply constraints at end of 2005. The industry sector, particularly the process industry has recorded positive developments. The country's trade activity continues to ensure the majority of sales, and to record significant annual growth rates. Construction sector has increased, though in lower levels than in the previous year. Agricultural output has grown at modest levels and has been concentrated

Chart 1 Contribution of sales growth by the economy sectors (in percentage points)



Source: INSTAT, Bank of Albania estimates

on the second half of the year. The Bank of Albania surveys on the past and expected developments of the economy have supported the above conclusions about specific sectors of the economy.

Three first quarters of 2006 recorded a slight reduction of unemployment rate, while the highest rise in the employed number has been observed in the non-agricultural private sector. About 65 percent of the unemployed are lasting unemployed, which speaks for deep and inherited problems of the labour market in Albania. The economic growth, inter alia, has also been reflected in the increase of tax and overall revenues. Budget spending has taken place within the forecasted level of 2006, remaining below the programmed level in capital expenditure items.

The observance of 2006 budget targets, particularly in operational expenditures and in those of the domestic borrowing has contributed to maintaining and consolidating the macroeconomic stability, without generating excessive pressures through fiscal stimulus of the economy. Nonetheless, budget expenditures underwent obvious deviations from their planned allocation along the year, bringing about financial market volatility and making difficult the harmonisation with monetary policy measures at operational level. External sector developments in the economy have followed the previous year trends. The volume of current transactions increased even during 2006. Merchandise exports and imports recorded an annual growth of respectively 19 percent and 15 percent.

However, the current deficit continued to be in high levels, 7.6 percent of GDP. The current account performance continued to be determined by the performance of merchandise trade and by current transfer inflows, which are the main source of financing the import of goods and services. External debt as at year-end is estimated at about 17 percent of GDP. It is much lower than the external debt of the Central and South-eastern European countries, which fluctuates around 50 percent of GDP.

Table 1 Some economy indicators over years

	2000	2001	2002	2003	2004	2005	2006*
Real GDP growth (in %) <sup>1</sup>	7.7	6.5	4.7	6.0	6.0	5.5	5.0
GDP (current prices, ALL million) <sup>2</sup>	530,900	588,700	624,700	682,700	766,100	836,600	896,300
GDP (current prices, usd million) <sup>3</sup>	3,694	4,102	4,459.0	5,600.5	7,452.3	8,382.8	9,136.6
GDP (USD per capita)	1086	1329	1,438.4	1,806.6	2,328.9	2,619.6	2,855.2
Number of the employed (in thousands) <sup>4</sup>	1068	1065	921	928	917	932	934
Unemployment rate (in %)	16.9	14.6	15.8	15.0	14.6	14.2	13.8
Inflation rate (y/y)	4.2	3.5	1.7	3.3	2.2	2.0	2.5
Budget deficit (grants included, in % of GDP)	-8.2	-7.9	-6.6	-4.5	-5.1	-3.6	-3.1
Public debt (in % of GDP)	71.3	66.8	65.3	61.7	56.6	56.7	55.9
External debt (in % of GDP) <sup>5</sup>	29.4	25.8	23.5	20.6	18	17.5	17.2
Domestic debt (in % of GDP)	41.9	41.0	41.8	41.1	38.6	39.2	38.7
Current account (in % of GDP)	-7.0	-6.1	-10.0	-7.9	-4.8	-7.3	-7.6
Average ALL/USD exchange rate	143.7	143.5	140.1	121.9	102.8	99.8	98.1
Average lek/euro exchange rate	132.6	128.5	132.4	137.5	127.7	124.2	123.1

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

\* Preliminary estimates

Signals from external macroeconomic environment have been conveyed to the national economy, mainly through oil price movements and partner countries' inflation. The domestic fuel market has reflected loyally the international oil price rise or fall. The highest fuel selling value was noticed in August and the lowest one in December. The ALL-USD exchange rate impact on transmitting the international price to domestic price during 2006 was almost insensitive. While in 2005, the lek's appreciation against the American dollar contained, to a certain extent, the domestic oil price rise, in 2006 the exchange rate did not play any significant role in this regard. The consumer price performance of the trade partner countries of Albania has also been reflected in the domestic consumer prices. This phenomenon appeared stronger during the third quarter, when a rise in foodstuff prices was recorded in Italy and Greece. Nonetheless, the "import" of inflation has been moderate, without putting the maintaining of the country's inflation target at risk.

Besides external factors, the consumer price inflation was influenced also by internal factors, such as agricultural output and decisions on changing the managed prices. The average price rise rate on annual base was 2.4 percent during 2006. The highest weight in this rate was given by the item "Rent, water, fuels and energy" that has contributed on average by 1.4 percentage points to each month of the year. The largest effect of price rise of this item was recorded in the second half of the year, reflecting the power consumer price rise by 13.7 percent in August. The inflation of foodstuff items has contributed by about 0.4 percentage point to the overall inflation rate, but the contribution has not been uniform throughout all months of the year. This item recorded high inflation rates during most of the first half of the year, under the impact of restrictions in agricultural product supply. During the second half of the year, foodstuff price cut has counter-balanced the power price rise and the effect of the increased excise tax on some goods.

## II.2 PRODUCTION BY ECONOMY SECTORS

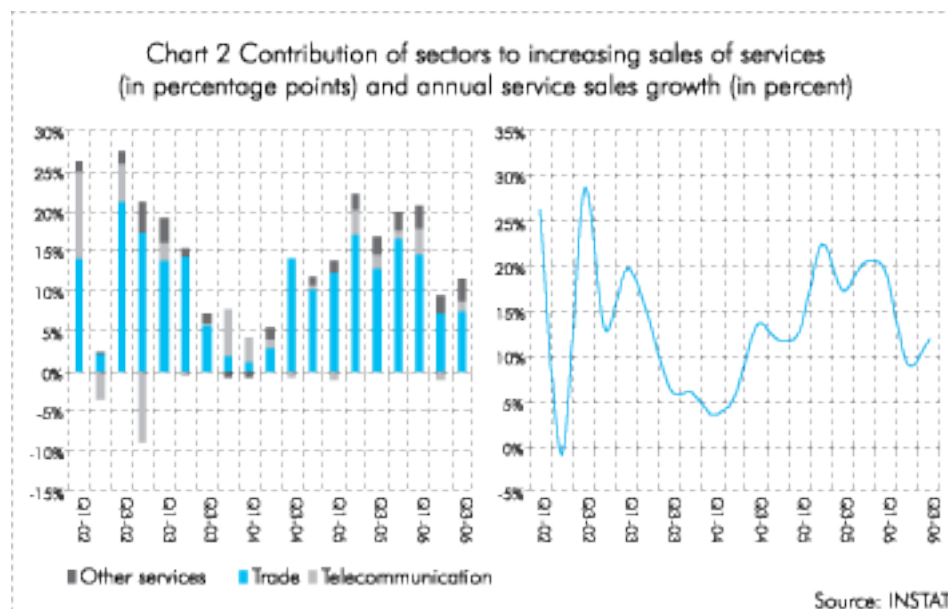
- TRADE AND OTHER SERVICES

Services sector is one of the most dynamic sectors of the Albanian economy, constantly providing a high contribution to the economic activity and growth of the country. The weight of this sector to the economy has been increasing, recording a trend expected to continue even in the future.

The assessment of performance of this sector is based on the sales index of economic enterprises by services items in wholesale and retail market, hotel and restaurant services, telecommunication and other services. Revenues generated from sales of these services have increased constantly during latest years and currently constitute about 60 percent of overall revenues of economic enterprises.

During first nine months of 2006, the sales value of services sector increased by about 13 percent compared to the previous year. Trade continues to render the main contribution to service sales. Telecommunication has generally

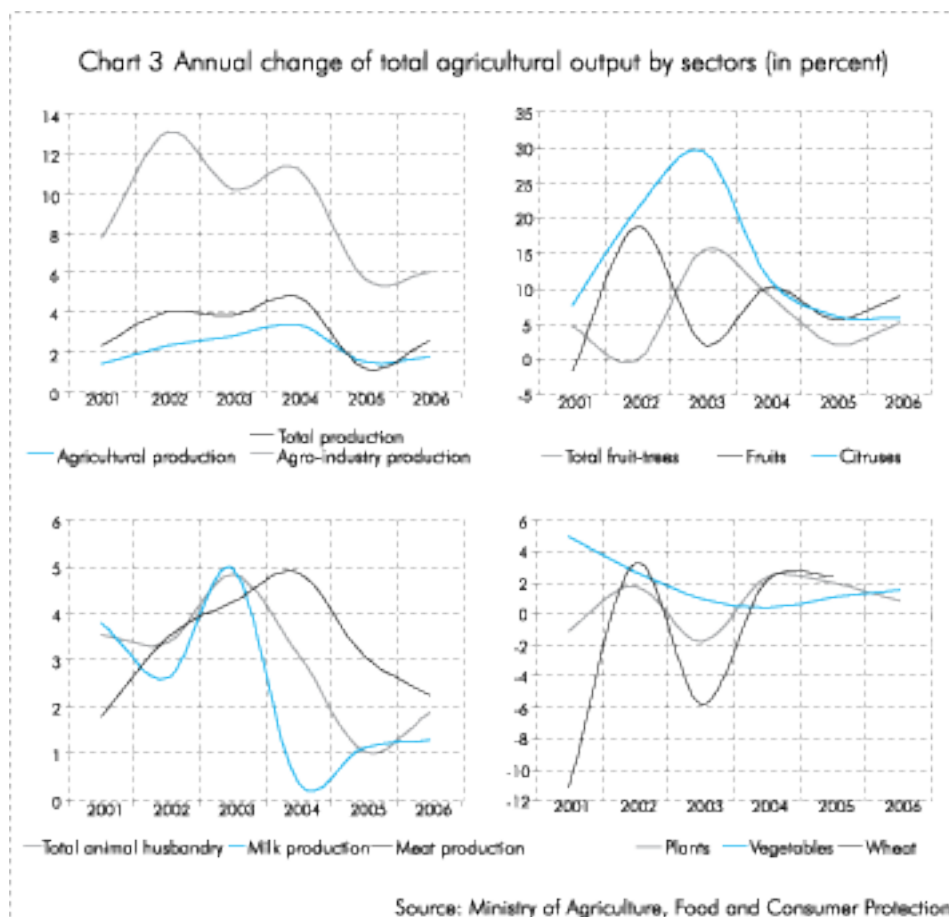
recorded positive developments over 2006, notwithstanding a slowdown noticed during the second quarter. Other service sales have also increased along the first nine-month period of the year. The sales value of financial services, real estate ones, and collective and individual social services has increased by about 40 percent compared to 2005. Meanwhile, indirect estimates of economic developments for the fourth quarter suggest the continuation of this view even over the fourth quarter.



#### • AGRICULTURE

Agricultural output during 2006 has partly recovered the growth rate reduction noticed in 2005. The projection on the sector growth in 2006 is estimated at 2.5 per cent, being higher than the growth in 2005, but lower than the average growth rate over five last years. The developments in agriculture continue to be impeded by numerous structural problems. The relatively underdeveloped rural area infrastructure makes more difficult the appearance of products in the market. The parcelling of land into plots impedes the effective organisation of production, reduces the profitability and increases the utilization cost of agricultural mechanics. In the meantime, agricultural land is not used at maximum, due to external and internal migration. This phenomenon, associated with ownership problems, has continuously restricted investments in agriculture. During 2006 credit extended to agricultural activities was still at low levels, irrespective of the significant growth of credit to the economy.

Production of agriculture sub-branches representing about 80 percent of the whole agricultural output, increased by 1.8 percent during 2006. This estimate is based mainly on the protected planting surface growth size of agricultural products and on operational data<sup>6</sup> on agricultural output performance. The moderate agricultural output growth has been associated with increased imports of agricultural products. Foodstuff imports recorded an annual growth of 17 percent during 2006.



	2001	2002	2003	2004	2005	2006*
Agriculture	1.4	2.3	2.8	3.4	1.6	1.8
- Animal husbandry	3.5	3.4	4.8	3.1	1.1	1.9
- Plants	-1.1	1.8	-1.7	2.3	2.0	0.9
- Fruit-trees	4.7	-0.2	15.5	9.2	2.0	5.1
Agroindustry	7.8	13.1	10.2	11.2	5.7	6.0
Total	2.3	4.1	3.9	4.7	1.2	2.6

Source: Ministry of Agriculture, Food and Consumer Protection

\* MAFCP forecasting

Table 2 Annual growth of agricultural output

The agricultural product processing industry or agroindustry has presented a better development than the agriculture branch. The agroindustrial output, representing about 20 percent of the whole agricultural production, is estimated to have increased by about 6 percent in 2006. According to data from an Agroindustry Survey<sup>7</sup>, during the first nine months of this year, the agroindustrial output recorded 9 percent annual growth, in spite of the slowdown observed over the third quarter of the year. The perspective of agroindustrial output growth is good, because of productivity growth in animal husbandry, in fruits and vegetable production, and the increased demand for domestic products. Agroindustrial output growth, and particularly the one related to processing of fruits and vegetables influenced the export growth of these items during nine first months of 2006.

- CONSTRUCTION

During latest years construction has turned out to be one of the main pillars of the Albanian economy, because of its weight in the overall production and the high growth rates evidenced in this sector. Since some years earlier, the annual growth of this sector has fluctuated around 10-15 percent, making this sector be the first in the list of economy sectors for development.

Nonetheless, direct and indirect indexes of this sector's output indicate that further progress requires a broader attention, particularly to a better allocation of financial, private or public resources. Construction developments in recent years, particularly their extreme concentration on certain territories, prove the lack of efficiency of urban development vision, not guaranteeing long-term

sustainability of the branch. Furthermore, construction is still dominated by housing buildings, lagging behind all other strategic items, such as investments in road infrastructure, industrial constructions, land improvement and agricultural infrastructure, and other investments directly related to the standard of living of small urban and rural communities.

The developments taking place in 2006 indicate a slowdown of expansion in construction activity, while there are not yet data on its activity in the last quarter of 2006. Final sales of economic enterprises in construction sector, in annual terms, have recorded a modest rise of 4 percent. The obvious cement consumption during the first nine-month period of the year was almost the same as that of 2005.

The number of new construction permits given during January-September 2006 was almost the same as that of the same period of the previous year. As in the preceding years, most of new constructions have been for housing. Compared to 2005, there is noticed a reduction in the number of commercial building permits and a rise in the number of industrial building permits.

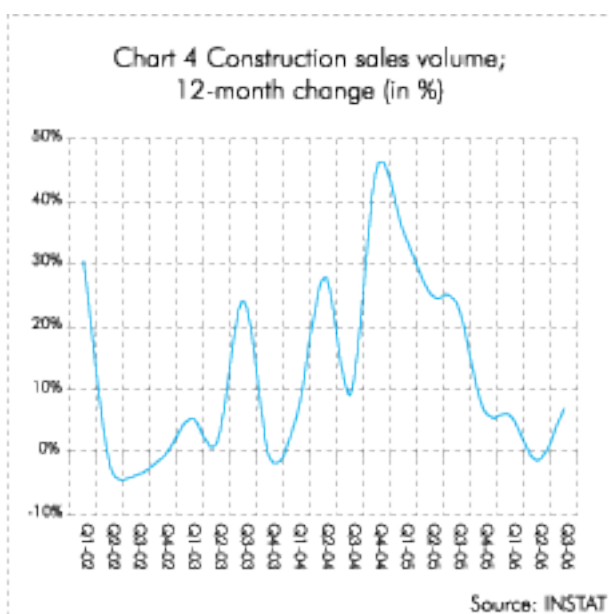


Table 3 Buildings, either new or under renovation (in ALL billion)

	2001	2002	2003	2004	2005	First 9-M 06
New engineering constructions	2.0	1.9	2.8	3.9	3.1	1.4
New buildings	22.8	45.8	68.0	30.7	57.8	38.1
Total new constructions	24.8	47.8	71.0	34.6	60.8	39.5
Engineering constructions - renovations	1.1	1.3	0.4	1.7	30.9	14.7
Renovations - buildings-	0.4	0.2	0.4	0.3	6.3	0.6
Total buildings under renovation	1.5	1.5	0.8	2.0	37.3	15.3

Source: INSTAT



### Box 1. Opinions on housing prices in Tirana

Nowadays there is accepted the negative impact, which has a bubble effect, of real estate prices on the economic growth. The rapid price rise of houses, not justified by basic economic factors, may lead to inappropriate investments, which will reduce the economy efficiency. The house price, likewise the price of any other asset, influences significantly on the production and inflation in the economy, because when the house prices go up, the expectations on their future performance are positive. Such a fact will encourage the increased demand. Also, a higher house price increases the wealth of the individuals, encouraging consumption rise and in consequence, even the aggregate demand.

Recently, in Albania, more and more discussions are taking place on rapid price rise of apartments. To study closer the developments in real estate market and particularly, taking into account the lack of official statistics on this performance, in June-July 2006 the Bank of Albania carried out a survey on price performance in the Tirana house market. 16 real estate agencies, 12 construction firms and 17 commercial banks participated in this survey. The following conclusions came out of the elaboration of the survey results:

In the real estate market, it is assessed that living apartments constitute 68 percent of the constructed areas, whereas the rest are business premises. The constructed area structure has changed in time towards the preference to construct business premises. However, as accepted by most of market stakeholders, the number of sales-purchases of apartments has been increasing 2006. The opposite has occurred concerning business premises. Most of the interviewed expressed themselves that the sale-purchase of these premises has decreased, due to the reduced demand for them during the same period. The main factor having caused the price rise on the supply side is the reduced number of construction permits. In the meantime, the reduction of building areas and the land price are of an above-average importance, having influenced the price rise on the supply side. Essential factors that encourage the demand for living apartments are the increasing demand for house, driven also by demographic movements, the increased preference to invest in long-term periods and increased household incomes (particularly those of emigrants). Also, the changed tradition and culture of the Albanian society, tending to live in small families, is estimated by some agencies as an important factor.

Given the collected opinions about price performance in various areas of Tirana, a significant volatility from one area into the other is noticed. Such a fact may arise not only from the variety of apartments with specific characteristics, built in various areas, but also from the higher demand. It is noticed in the concluded opinions that changes in rents according to areas, varies at a narrower band. The high supply of houses on rent creates a more competitive market and less room for volatility at rent levels.

In the meantime, it seems that apartment price does not change considering whether the apartment is bought for the first time or is re-sold (an old one). The prices of resold apartments vary from one area into another. However, some of the interviewed think that the high price of buildings constructed earlier than 1990, comes from the belief of a better quality of buildings, and also from the fact that many of them are restored in accordance with the requirements of the time.

Most of current transactions for house purchase are based on individual savings. Also the emigrants' remittances contribute on average by 30 percent to financing the house purchases. According to collected opinions, most of sale transactions are carried out in the euro, above 90 percent of the cases. Even when the payment is made in lek,

*the value of house purchase is quoted in the euro. Concerning the way the payment is made, the agencies underline that paying by instalments represents about 53 percent of the cases, while the rest is made in the form of a down payment.*

*Presently, a considerable part of real estate purchases is financed by the banking system. Most of market stakeholders are of the opinion that bank loans increased in the last year. Real estate loans extended by the banking system usually constitute 80 percent of the collateral value. All the banks of the system use the market value approach for evaluating the collateral. Also banks apply fixed and variable interest rates for mortgage loans.*

#### • INDUSTRY

Positive developments characterised the industry sector in 2006. The sales volume of industry, occupying about one fourth of the overall sales volume of economic enterprises, makes the industry sector be the second one from the importance, following that of services. Notwithstanding a slowdown observed in the second quarter of 2006, the first nine-month period was closed with a growth of 15 percent. Generally, the process industry continues to give

an important contribution to the rise of the sales volume of industry. The extractive industry and the process one have generally recorded similar annual growth rates during 2006, but the process industry continues to represent the major part of industry, ensuring about 70 percent of its total sales. The small share of extractive industry is due to lack of domestic and foreign investments. The process industry has recorded positive upward rates since the first quarter of 2005. This branch recorded a rise in the sales volume by 19 percent in the first nine-month period of 2006. The growth of this sub-sector has been driven by the vitalization of metallurgy and that of the material processing, particularly in the third quarter of the year. The good performance of this industry has been associated with an increased number of employed persons at this sector.



#### • ELECTRICITY PRODUCTION

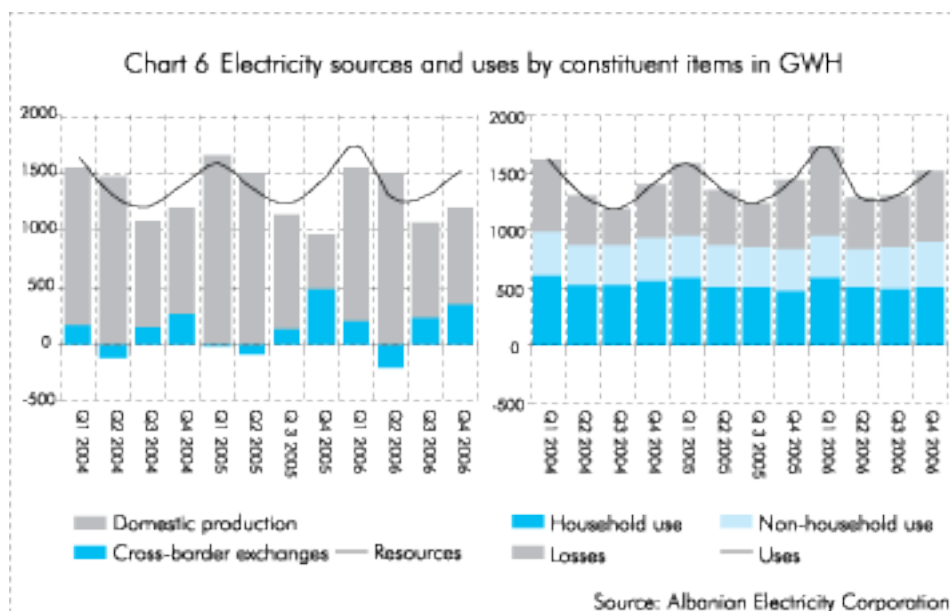
Electric power is the main source of energy in the country used by industrial, services and household consumers. Lack of new productive capacities, high technical losses, unfavourable weather conditions, and irregularities in bill payments have generated a number of problems accumulated over years. Restrictions in electricity production against the increasing demand have led to re-occurrence of energy crisis in December 2006, impeding the economic activity in many enterprises.

The electricity demand and supply structure during 2006 was similar to that of the latest years. The produced quantity of electricity along the year



was almost the same as the one produced in 2005, while the net balance of exchanges was 16 percent higher than in the previous year. The domestic production during 2006 has ensured about 90 percent of the total quantity of electrical power supplied. The domestic production share to overall energy sources has been downward since 2005. During 2006, the average household consumption has recorded a modest rise of 0.7 percent, while the non-household consumption has increased by 2 percent. However, the quantity of electricity consumed by non-households remained low even during 2006, occupying only 25 percent of the overall electrical power consumption.

Year 2006 did not record positive developments about reducing the energy losses. The share of loss to supplied electricity is still high, at 40 percent. During this year a rise was evidenced in technical losses, while the losses from unbilled consumption have decreased compared to the previous year.



#### • TRANSPORT

Transport has recorded satisfactory growth rates over the recent years, providing a significant contribution to the economy development. Regardless of this sector's potential, various indicators provided contradictable signals on the activity performance during 2006. Unlike the preceding years, the sales index showed a slowdown of transport activity. The sales over the first nine-month period of this year were about 8 percent lower than those carried out during the same previous year period, with a more underlined reduction observed in the second quarter. Given the sales volume, the activity in 2006 is almost at the same level with that of 2004. The fourth quarter, being generally one of the most dynamic quarters of the year, may positively impact on the view created until end of the third quarter.

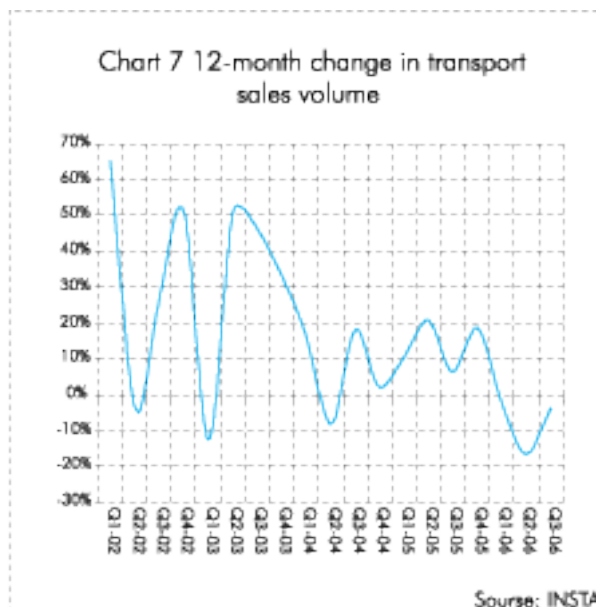
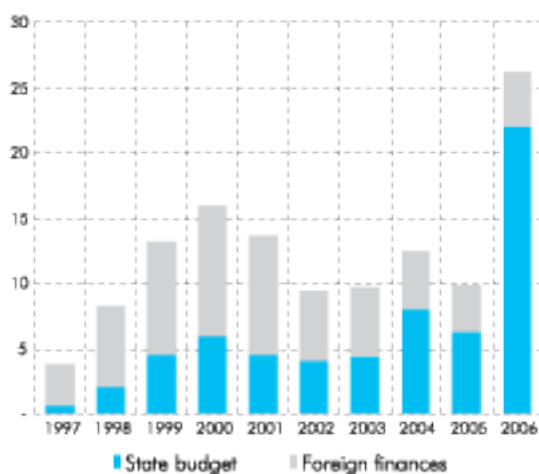


Chart 8 Transport investments by sources  
(in ALL billion)



Source: Ministry of Public Affairs, Transport and Telecommunication

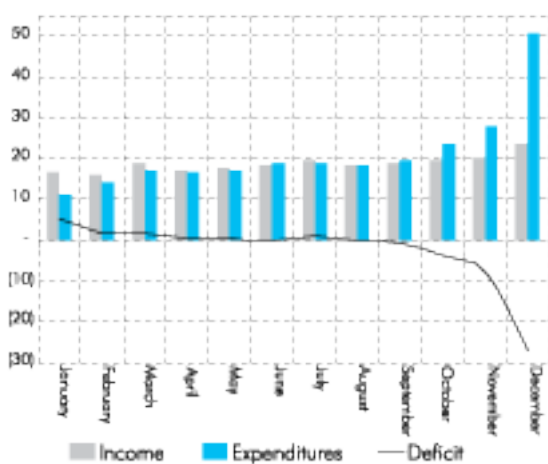
The number of passengers transported by air, sea and railway transport rose during 2006, respectively by 15, 6 and 15 percent. The traffic of seat transport grew significantly by 20 percent in the number of foreigners visiting Albania. The railway transport has recorded positive developments in both, transport of goods, and that of passengers. A positive signal on export performance comes from sea merchandise transport. Even though exports constitute only 15 percent of the volume of goods transported by sea, their annual growth by 70 percent, is a positive indicator of the country's economic development. In the main ports of the country, particularly in that of Durres, Vlora and Saranda, an increased volume of merchandise transport by 10 percent has been recorded.

More than 80 percent of investments in transport during 2006 were ensured by government budget. Overall investments along this year recorded about ALL 26 billion in absolute terms, being about 2.5 times higher than in 2005. Investments were concentrated mainly on the fourth quarter, withdrawing about 60 percent of the whole year investments.

### II.3 FISCAL SECTOR

Fiscal developments over 2006 were characterised by increased budget revenues, a better orientation of public expenditures to priority needs of the economy and the maintaining of predicted levels of borrowing. The controlled fiscal policy has generally provided a positive impact on the macroeconomic stability. The observance of the programmed limits in the 2006 budget has contributed to controlling the fiscal stimulus of the economy, assisting in balancing the aggregate demand with the aggregate supply and putting inflation under control. On the other hand, the concentration of expenditures and the fiscal deficit on the last quarter of the year have increased liquidity and interest rate volatility in the financial markets.

Chart 9 Main fiscal indicators in 2006  
(in ALL billion)<sup>a</sup>



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

Budget indicators have been realised within the programmed parameters. So, total revenues and expenditures account for 98.4 and 95.4 percent of the annual plan, being increased respectively by 12.6 and 11.3 percent. The positive trend of the rise in budget revenues has been reflected in their increased share to GDP by 25.2 percent, against 21-24 percent of GDP in the preceding years. The maintaining of expenditures at historical average levels against the increased revenues has been associated with an annual budget deficit reduction.

Table 4 Fiscal indicators as a percentage of GDP

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total revenues	22.7	22.7	22.7	20.9	22.2	22.4	21.9	24.0	25.2
- Tax revenues	13.8	13.8	15.8	14.1	15.3	19.5	19.7	22.0	22.8
Total expenditures	34.4	34.9	32.1	28.9	28.4	27.0	26.5	27.3	28.3
- Capital expenditures	5.9	7.2	6.8	6.9	5.6	4.2	4.6	4.2	5.3
Budget deficit	-11.7	-12.3	-9.4	-8.0	-6.2	-4.6	-4.5	-3.3	-3.2
- Domestic financing	6.0	5.9	5.6	4.7	3.2	3.2	3.7	2.8	2.6
- Foreign financing	5.6	6.4	3.8	3.3	3.1	1.3	0.9	0.6	0.6

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

In general, the monthly performance of fiscal indicators has followed the budget deficit realization trends of the preceding years, undergoing an obvious growth in the second half of the year.

Also, the maintaining of current expenditures within the projected parameters against rise of incomes has enabled a higher rate of public savings. This has led to increased financing of capital expenditures by budget sources. Public savings accounted for 2.43 percent of GDP, from 1.24 percent in 2005. In parallel, public debt stock in ratio to GDP dropped to 55 percent of GDP, against 56.9 percent in 2005.

- BUDGET REVENUES

Total revenues by ALL 226.3 billion accounted for 98.4 percent of the planned amount, being increased by 12.6 percent in annual terms<sup>9</sup>. The improved management of tax revenues has followed the overall fiscal policy trends pursued recently. Tax revenues constitute an increasing source of budget revenues and the main element of maintaining fiscal balances. The performance of this indicator has been positive in the fiscal sustainability perspective.

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

	Average '98-06	2005	Q1 06	Q2 06	Q3 06	Q4 06	2006	Percentage to GDP
Total revenues	11.7	8.9	14.3	11.6	15.0	10.1	12.6	25.2
- Tax revenues	12.9	10.8	15.2	13.3	13.8	11.4	11.8	22.8
-Value added tax	23.1	11.0	16.3	17.3	14.4	13.0	15.1	8.3
-Income tax	22.1	18.0	24.4	27.7	13.5	0.7	15.7	2.5
-Excise tax	1.7	17.2	34.1	21.1	24.3	20.1	24.2	2.6
-Customs duties	48.9	-1.7	18.0	21.7	-4.1	-16.0	2.6	1.6
-Local government	46.3	25.0	-13.4	8.0	-7.8	-12.9	-7.5	1.2
-Tax on small business	17.5	-6.6	-26.7	-35.9	-12.9	-42.8	-30.8	0.3
-Independent budget	12.2	8.8	11.5	11.7	15.0	-2.0	8.6	4.4
-Non-tax revenues	-1.6	-11.4	24.8	1.9	-15.1	35.7	12.6	1.8

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

Value added tax is closely related to the performance of circulation of goods and services in the economy. This indicator has the largest share in the tax revenues group, constituting about 33 percent of total 2006 budget revenues. During this year reduction of the seasonality of this indicator was noticed, whereas revenues from VAT were realized at 97.7 percent of the annual plan. The annual growth of this indicator accounted for 15.1 percent,

increasing its weight to GDP by 0.6 percentage point against the previous year.

Income tax is also another important indicator, closely related to the country's economic activity. The positive trend of this indicator was manifested in its annual growth by 15.7 percent. The first and the third quarter of the year had the highest growth in comparison to the same previous year period. The annual rate of 15.7 percent has been realized under the conditions of a tax rate lower than that of 2005. In parallel, excise tax revenues recorded the highest growth of annual inflows in the group of 2006 tax revenues. Under the conditions of minimizing customs barriers, customs tax revenues recorded an annual growth of 2.6 percent. This indicator grew significantly in the last quarter of the year, due to increased consumption in year-end celebrations.

The overall performance of revenue indicators is in line with the positive trend of gradual and steady growth of total receivables and improved tax revenue management, in view of fiscal balance and macroeconomic stability.

#### • BUDGET EXPENDITURES

Budget expenditures grew by 11.3 percent during 2006, accounting for 95 percent of the planned amount. Total expenditures reached 28.3 percent of GDP, being 1 percentage point higher than the one recorded over 2005. The budget expenditure growth was mainly influenced by capital expenditure growth for public investments. Capital expenditures grew by 5.3 percent of GDP, against 4.2 percent in 2005. Current budget surplus has amounted to ALL 21.9 billion, against about ALL 7 billion in 2005<sup>10</sup>. From the macroeconomic perspective, the increased share of public investment expenditures constitutes a positive development. However, the concentration of budget spending on the last quarter of the year created problems for the management of currency markets and for monetary policy implementation.

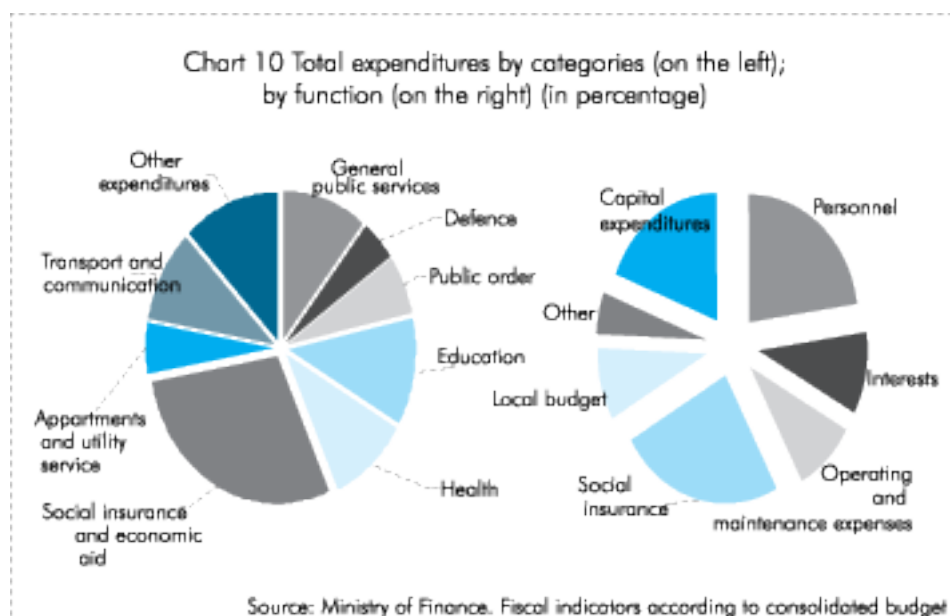
Table 6 Annual growth of main budget spending indicators (in percentage)

	Average 98-06	2005	Q1 06	Q2 06	Q3 06	Q4 06	2006	Percentage to GDP
Total expenditures	7.7	2.7	-8.9	-6.0	-3.4	53.0	11.3	28.3
Current expenditures	7.3	5.3	-6.0	-0.3	2.0	21.9	5.4	22.7
Personnel	9.1	9.6	-0.2	5.7	4.9	10.7	5.6	6.3
Social insurance	12.9	11.2	5.7	7.6	7.5	8.6	7.4	6.7
Interest	-3.4	-8.4	-9.0	-5.9	-2.0	2.1	-3.9	2.8
Domestic	-4.3	-9.5	-10.2	-6.9	-2.2	0.4	-5.0	2.6
Foreign	21.1	7.8	20.3	3.2	3.9	14.3	9.9	0.2
Maintenance operational expenditures	3.7	2.1	-30.7	-15.4	-16.6	21.2	-6.9	2.5
Local budget	6.4	25.9	48.5	115.7	13.3	42.4	13.4	2.5
Capital expenditures	10.7	-9.6	-33.7	-39.0	-31.4	171.4	36.3	5.3
Domestic financing	19.8	-12.0	5.3	-42.6	-22.4	173.1	45.7	3.9
Foreign financing	0.0	-3.7	-58.8	-27.4	-57.8	166.7	14.8	1.3

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

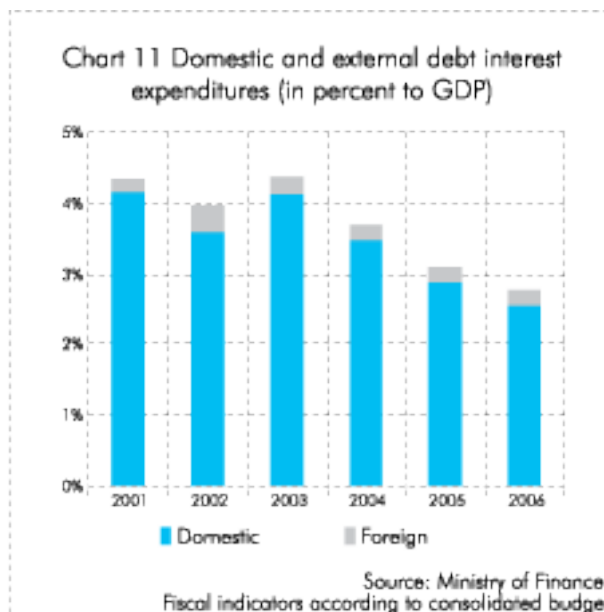
Current expenditure destination structure has been in line with the overall trend of maintaining fiscal stability. Personnel expenditures for 2006 maintained steady paces against the economy growth. IN GDP terms, the

share of personnel expenditures maintained the level noted in 2005, by about 6.3 percent. In parallel, expenditures for “social insurances and other transfers” maintain the same share to GDP, by about 6.7 percent against 2005. The expenditures for these two items constitute the main share of current budget expenditures by about 57 percent. In terms of total expenditures, they constitute about 45.8 percent against 18.6 percent of capital expenditures.



The fiscal view on the interest expenditures side presents a positive development of the long-term fiscal account sustainability. Fiscal burden of expenditures in the framework of public debt service is following a downward trend. Public debt interest payments have decreased to 2.8 percent of GDP, against 3.1 percent in 2005. This fiscal burden decrease of debt service is attributed partly to debt service term extension from 195 days in 2005 to 235 days at end of 2006. Issuing long-term securities enables steady interest rates for refinancing the public domestic debt. The shifting to long-term bonds issuing led to reduced public debt service cost, by 0.4 percentage point to GDP during 2006. In nominal terms, interest expenditures fell by ALL 1 billion or 3.9 percent against the level of 2005.

During 2006 the interest expenditures and budget deficit went downward, but the upswing continued in public investments. Capital expenditures increased to ALL 47.5 billion or 36.3 percent against the level of ALL 34.9 billion in 2005. Their share to total expenditures has increased to 18.6 percent. The 2006 capital expenditures constitute 5.3 percent of GDP or 1.2 percent more than in 2005. Capital expenditure financing has been realized by 75 percent through domestic assets, whereas one fourth



has been financed through foreign resources. In the long run, the tendency to increase capital expenditures of fiscal deficit tends to positively impact on the economic development.

- BUDGET DEFICIT

The budget deficit of about ALL 28.5 billion in 2006 was in line with the overall macroeconomic framework. The current budget deficit level constitutes a lower share to GDP against the historical average and contributes positively to reduction of interest expenditures share for the public debt service. Whereas in nominal terms, the budget deficit has had an annual growth of ALL 0.6 billion, in GDP terms the budget deficit has maintained the same share, by about 3.2 - 3.3 percent. The budget deficit growth at a lower pace than the economic growth has contributed to reducing public debt indicator to GDP and its service cost.

The deficit financing has been realized mainly through domestic borrowing by about ALL 20.7 billion. Foreign deficit financing constitutes only ALL 5.4 billion, whereas privatization revenues have financed about ALL 2.0 billion<sup>11</sup>.

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

	2002	2003	2004	2005	2006	Average 1998-06	Percentage to GDP in 2006
Deficit	-13.7	-19.3	12.4	-27.0	2.3	-5.1	-3.2
Domestic financing	-25.5	11.8	29.0	-24.6	-1.0	0.6	2.6
Foreign financing	3.4	-51.6	-27.2	-37.3	19.0	-12.2	0.6

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

## II.4 LABOUR MARKET

Improved employment is one of the main priorities for the growth and development of the country's standard of living. However, labour market developments during the latest years have been slow, particularly compared to the significant economic growth. Excluding inaccuracies created by still-under developed employment statistics, this particularity speaks for structural problems in the labour market and for the low degree of the work force movement in the regions of the country or among the economy sectors. During four latest years, only about 50 percent of the working age population has been employed. In the meantime, we should emphasise the distinctions existing in the distribution of work force among the regions of the country.

Also, during 2006, the decreased number of the unemployed was not in line with the increased number of the employed, suggesting that part of the labour supply has been met outside its formal market. The labour force migration, either inside the country or abroad and the presence of informal economy have made the monitoring of labour market performance more difficult. These features seem to have hampered accurate estimates of the number of those employed in private agricultural sector, which for many consecutive quarters has recorded an unchanged number of the employed. According to official



statistics, at end of the third quarter 2006, the working age population was about 1.084 million persons, while the unemployment rate was estimated about 13.8 percent, or 0.4 percentage point lower than in 2005.

	2005				2006		
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III
Total labour forces (in thousand)	1087	1086	1086	1086	1082.8	1081.3	1084.1
A. Total employed (in thousands)	931	931	931.2	932	931	931.3	934.4
i) public sector	176	175.6	175.6	175	174	172.1	170.5
ii) private non-agricultural sector	213	213.4	214	215	215	217.1	221.9
iii) private agricultural sector	542	542	542	542	542	542	542
B. Unemployment (in thousand)							
i) total unemployed persons	156	155	154.8	154	152	150.1	149.7
C. Unemployment rate (in %)	14.3	14.3	14.2	14.2	14	13.9	13.8

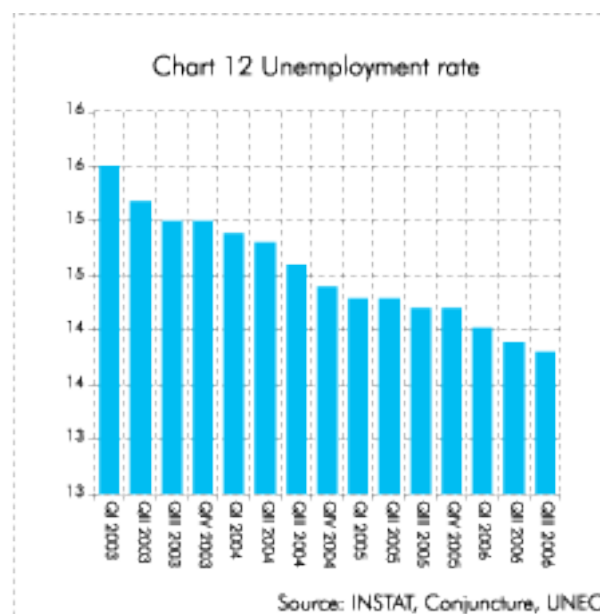
Source: INSTAT, Conjuncture

Table 8 Labour market indicators (in thousand persons)

During the previous year, further to a three-year period of growth, employment rose by 0.3 percent, recording about 934 thousand employed persons. Out of them 58 percent are self-employed in agricultural sector, 18 percent are employed in public sector and 24 percent in other private sectors of the economy. This distribution indicates the dominant role the agricultural sector plays in employment.

According to INSTAT, given the division by private sectors of the economy, employment increased mainly in trade, process industry and construction, which have also been the main sectors contributing to economy growth. The public sector's labour force decreased by about 5 thousand persons, while the private non-agricultural sector recorded a rise of about 8 thousand persons in the number of the employed persons.

On the most important social indicators of a country – the long-term unemployment rate to total employment number – recorded 66 percent at end of 2006. This rate is more or less at the same level as that of the previous year.



## II.5 INFLATION AND MONETARY POLICY

The price inflation of consumer goods over 2006 mostly fluctuated around the targeted band of 2 - 3 percent, being close to 3 percent target of the Bank of Albania and within its tolerance band. Year-end recorded a 2.5 percent annual inflation rate. It was almost similar to the 2005 annual inflation rate of 2.4 percent. Inflationary pressures have been increasing over 2006. The average annual inflation rate amounted to 2.7 percent during the second six-month period of the year, from 2.0 percent it was in the first half of the year.

In general, the average annual inflation stability of recent years speaks for inflation rate steadiness, notwithstanding any fluctuations in time and size of the factors that have influenced on consumer price performance. Developments on the demand and supply side of the economy have been balanced, without creating premises for inflationary pressures.

The fiscal policy has observed the programmed indicators on annual basis, stabilizing the impact of public sector component on the aggregate demand. Also, the monetary policy has controlled the liquidity conditions and interest rate developments, and has attended exchange rate performance, monitoring the financial incentives of economic activity through them. On the other hand, low inflation rates over the recent years have been reflected in anchoring inflationary pressures of the economy. The latter factor might have contributed to containing second-round effects caused by some supply shocks the Albanian economy was faced with, such as high oil prices and managed price rises

Table 9 Annual inflation rate

	2001	2002	2003	2004	2005	2006
January	2.2	6.5	0.0	3.3	3.3	1.4
February	1.5	7.7	1.1	4.4	1.8	1.3
March	2.9	7.6	1.3	4.0	1.6	1.5
April	3.0	6.6	2.3	3.2	1.3	2.4
May	2.5	4.6	2.8	2.6	2.0	3.1
June	4.0	3.8	2.6	2.9	2.9	2.4
July	5.6	4.3	3.0	3.1	1.8	3.2
August	4.1	5.5	3.0	2.7	2.3	2.9
September	3.5	5.4	2.8	2.0	3.1	2.6
October	1.8	6.1	2.9	2.0	3.3	2.2
November	2.8	4.1	3.4	2.2	3.0	2.9
December	3.5	2.1	3.3	2.2	2.0	2.5
Average inflation	3.1	5.4	2.2	3.0	2.4	2.4

Source: CPI, INSTAT, 2006

First months of 2006 recorded low annual inflation rates that fluctuated below the lower limit of the tolerance band. The reduction in the annual price rise pace was mainly due to extinction of electricity price rise effect in January 2005. Therefore, at end of the first quarter, the inflation of "Rent, water, fuel and energy" recorded the lowest rate since 2003, leading the overall inflation rate to lowest levels. During this period, the demand factors have positively impacted on the inflation performance, while the presence of shock factors in the economy has almost been insignificant.

During April - August 2006, the annual inflation rose. The main cause for this price rise was the delayed impact of seasonal factors created by unfavourable weather conditions. This phenomenon led to contraction of domestic agricultural product supply in the country. At the same time, the exchange rate developments of the lek against the euro, the upward trend in import prices due to increased inflation in trade partner countries and oil price rise at very high levels reinforced inflationary pressures on the supply side.

The period of September - December was characterised by smoother developments in consumer price performance. The climatic conditions,



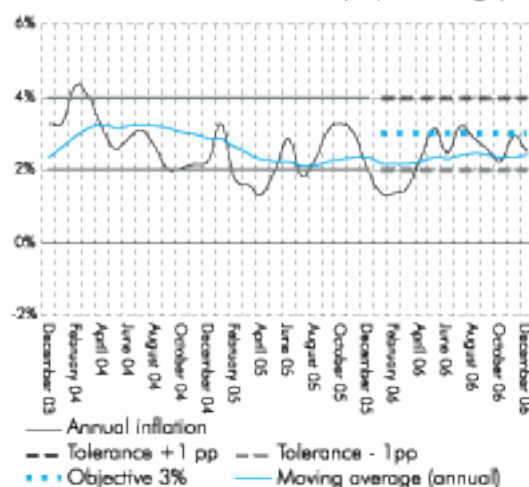
not typical for the period, favoured the domestic agricultural output. At the same time, monetary and fiscal control of the demand pressures and the significant reduction of oil prices made inflation rate of this period be outside the Bank of Albania's target, but within the tolerance band.

### II.5.1 INFLATION AND CONSTITUENT ITEMS

During 2006 the main items contribution to annual inflation rate presented a different structure than in the previous year. Some of the factors determining this change were: different seasonal panorama of domestic agricultural output, power price rise in August, oil price performance and price rise of some excise commodities.

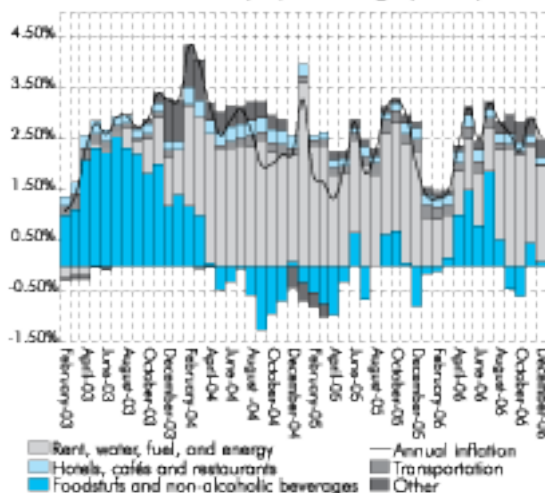
Inflation rate of "Rent, water, fuel and energy" has been determinant in the overall inflation rate in the second half of the year, due to power price rise in August by 13.7 percent. The average contribution of this group to annual inflation rate after August amounted to 2.0 percentage points, from 0.9 percentage point in the first six-month period. The modest power price rise in the eight first months of the year was a result of extinction of energy price rise effect a year earlier. The prices of other constituents of "Rent, water, fuel and energy" have not undergone underlined deviation from the annual average, except specific periods such as that of new academic year-start. In September-October, the house demand rise by students has led to temporary rise in the house rents.

Chart 13 Annual inflation (in percentage)



Source: Bank of Albania, 2006

Chart 14 Contribution of main annual inflation items (in percentage points)



Source: INSTAT and Bank of Albania estimates

Table 10 Total annual inflation rate and that of "Rent, water, fuel and energy" item, as well as its contribution and that of sub-items to total inflation

	March	June	July	August	September	October	November	December
Total annual inflation (in %)	1.5	2.5	3.2	2.9	2.6	2.3	2.9	2.5
Item inflation (in %)	3.2	3.9	3.2	6.5	8.5	8.0	7.0	7.0
Contribution to total inflation (in percentage points)								
Rent, water, fuel and energy	0.9	1.0	0.9	1.8	2.3	2.2	1.9	1.9
Rent	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Imputed rent	0.7	0.9	0.8	0.8	1.2	1.1	0.9	0.9
Fuel, energy	0.0	0.0	0.0	0.9	0.9	0.9	0.9	0.9

Source: Bank of Albania, INSTAT, 2006

Annual inflation of "Foodstuff and non-alcoholic beverages" item reflected a different performance during 2006, compared to two preceding years. The average contribution of inflation of this item to overall inflation in 2006 was

0.4 percent, while in two preceding years it had been respectively 0.0 and -0.2 percent. The largest share of this item to consumer price index basket has made the price performance of this item determine the overall price performance. Particularly during May-July, this item exercised pressure on the increasing side of inflation, determining on average 50 percent of the overall inflation rate. In general, the prices of this item during the major part of the year reflect the imported merchandise prices, taking into account that most of market supply is satisfied through external trade, excluding April-September, when the domestic production increased the overall supply and satisfied the consumer demand better. The weather conditions of this year created a high volatility in foodstuff supplies. During this year, a shifting from the seasonal frame of domestic agricultural output was noticed. As of September, the reverse climacteric conditions influenced negatively on supply, encouraging the entry into the domestic market of high price import goods. Under the conditions when the prices of these goods reflected downward trends in European markets, the favourable exchange rate behaviour of the lek against the euro managed to somewhat mitigate the effect of foreign prices rise above the domestic prices.

During the last quarter of the year, the price situation was favourable, since the aforementioned factors changed direction. Favourable weather conditions, low inflation in main trade partner countries, strengthening of efforts for preventing speculations mainly in taxation and customs area at end of the year, made the foodstuff prices go up moderately.

Table 11 Annual inflation of "Foodstuffs and non-alcoholic beverages" in the country and abroad and its contribution to total inflation (average value by quarters)

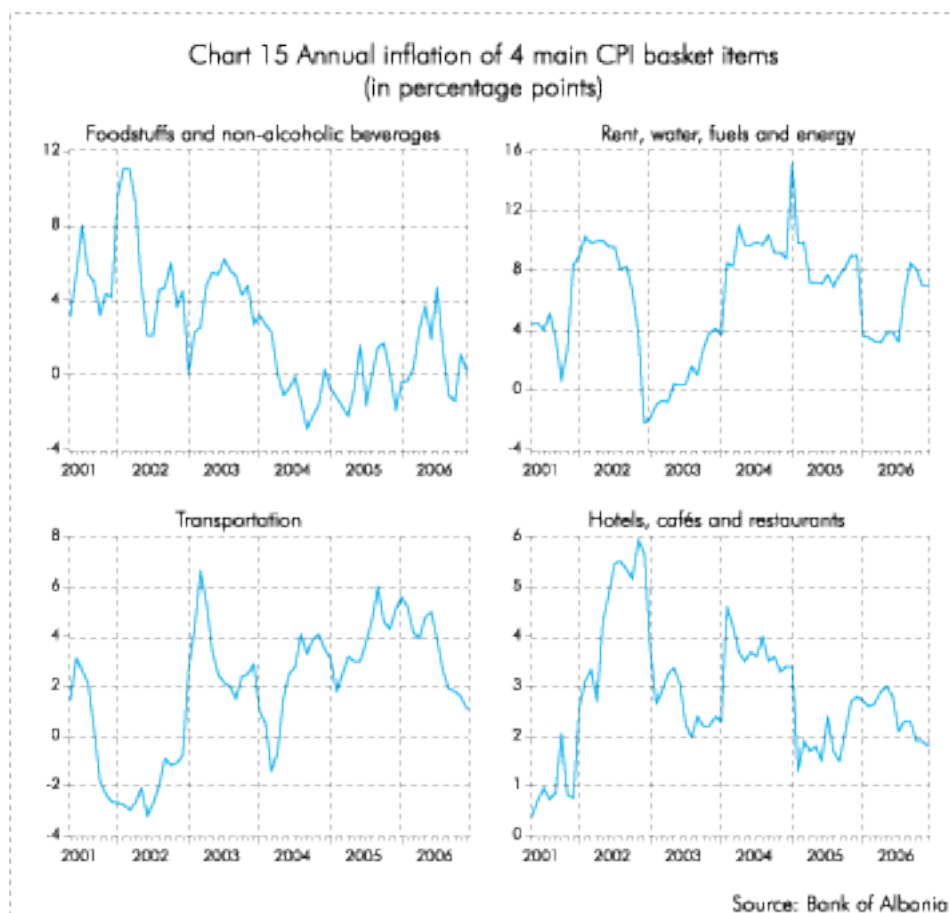
	Annual inflation '05	Contribution (pp)	Annual inflation '06	Contribution (pp)	Italy <sup>12</sup> Annual inflation '06	Greece <sup>13</sup> Annual inflation '06	Euro area <sup>14</sup> (12 countries)
Q1	-1.2	-0.5	-0.1	0.0	1.6	2.4	1.0
Q2	-0.5	-0.2	2.7	1.1	1.8	3.0	1.1
Q3	0.0	0.0	1.6	0.6	2.9	4.6	2.2
Q4	0.0	0.0	-0.1	0.0	2.9	3.8	2.8

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

During 2006 inflation was mostly conditioned by the decisions on some excise and managed price rises. Besides the electricity price rise, "Education service" price also went upward. This rise was materialised in an annual inflation rate of this group by about 8 percent in October. During 2006 a rise was noticed in the prices of some goods subject to excise tax included in "Alcoholic beverages and tobacco" item. Starting from August this item impacted significantly on the annual inflation rate rise.

"Transport" prices were influenced by oil price volatility in domestic and international market. The oil price rise in international market was also reflected in the domestic market until September. Then, prices started to go down, helped by the underlined appreciation of the lek against the American dollar. The small share of "Transport" to consumer basket in general makes almost insignificant the direct effect of oil price rise to personal transport.

However, oil price movements, particularly on the increasing side, have been considered as sources of inflationary pressures, mainly due to second-round effects of oil price rise.



Contribution of other items has not undergone any underlined fluctuations in size or in the side on which they have influenced the annual inflation rate. Their contributions have been low and have tended to compensate each other. So, the low positive inflation of "Hotels, cafés and restaurants" has been counter-balanced by the deflation of "Clothes and footwear" and "House furniture, equipment, and maintenance".

## II.5.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

During 2006 consumer prices recorded an average annual growth rate of about 2.4 percent for the second consecutive year. Inflation performance during recent years has been in line with the country's macroeconomic forecasting program, supporting and creating conditions for a sustainable economic growth. Even though inflationary pressures did not lack, particularly during the second half of 2006, the annual inflation rate has fluctuated within the narrow band of 1.3 - 3.2 percent. Inflationary pressures appeared on both, supply and demand side. Prudential monetary policy and observance of main parameters by the fiscal policy have played an important role in

terms of controlling these pressures. Observance of the specified targets of the Bank of Albania's monetary program during 2006 has generated a suitable monetary climate for controlling inflationary pressures of economy duly and timely. Reflecting the tightening monetary policy signals, real interest rates of 12-month maturity increased during last months of the year. Such a tendency has contributed to good management of banking system liquidity and to containment of monetary expansion, which was more underlined in the end of the year. The lek's relatively steady position in foreign exchange market has favoured the mitigation of inflationary pressures stemming mainly from the external environment. In the meantime, the main indicators performance in public finances area has favoured the establishment of proper spaces for an efficient operation of monetary policy decisions.

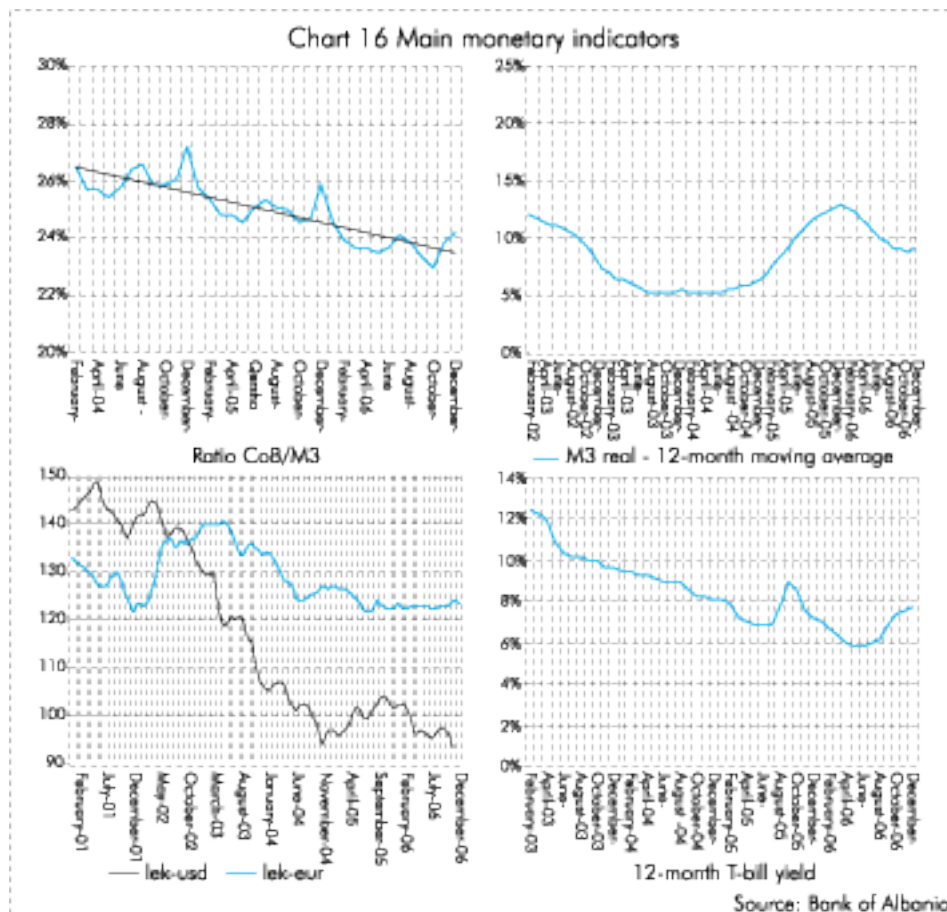
- MONETARY CONDITIONS AND MONETARY POLICY DECISIONS

Monetary policy decisions on key interest rate in the economy have been based on constant analyses of current and expected developments of demand and supply factors stemming from internal and external environment. Under the conditions of an increasing inflation and in the presence of a number of factors expected to further favour the price rise, the Bank of Albania decided on changing the monetary policy stance at the beginning of the third quarter of 2006. This change occurred after a neutral period that lasted about 1.5 years. The change in monetary policy stance was materialised in raising the key interest rate twice during the second half of 2006. In July and November 2006 the one-week repo rate rose respectively by 0.25 percentage point. The maturity of monetary policy decision-making was reflected in the time lag between both interest rate tightening movements.

In July-November 2006, many assessments have been made on the degree of response and sensitivity of interbank market to monetary policy stance about interest rates. The total rise of the latter ones by 0.5 percent is estimated to have normalised the annual growth rates of money supply, fully responding to the public and private sector demand for monetary assets. Notwithstanding the seasonal growth of money supply at end of the year by about 17 percent, the ratio of currency outside banks to money supply continued to maintain low historical levels. This ratio was 24.2 percent, being 1.7 percentage points lower than that of the same previous year period. The reduction of this ratio indicates that the Bank of Albania and the banking system have been more active than a year earlier in addressing money to formal channels.

This development has been reflected also in high credit growth rates, under the increasing demand of the private sector for extending the economic activity. The Bank of Albania, assessed the expansion of credit to the economy as a welcomed development, but also bore in mind the fact that such a phenomenon would increase inflationary pressures on the domestic demand side. Compared to the increased demand of the private sector, the public sector demand resulted in lower levels than in the previous years, when it had dominated the monetary expansion paces. On the other hand, good management of liquidity needs has made the interest rate volatility be low, ensuring a satisfactory stability in money market.

Monetary policy tightening during the second half of 2006 was channelled to meeting the market demand for liquidity, maintaining low levels of currency outside banks and relatively disciplining the increasing paces of the domestic demand for monetary assets. Monetary policy operations have assisted in maintaining price stability in the medium run.

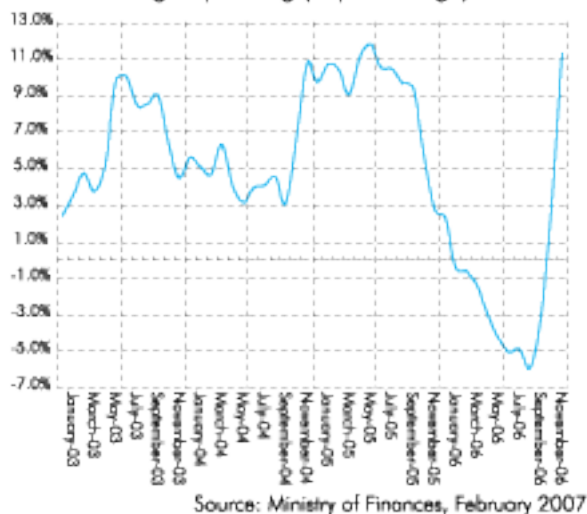


- FISCAL POLICY

Fiscal policy constitutes one of determinant aspects in meeting the targets of the country's macroeconomic program. The degree of its success and efficiency guarantees to a great extent the Bank of Albania's monetary policy results, having price stability as the primary target. At the same time, the maintaining of price stability, denominated in low annual inflation rates, constitutes an important condition for ensuring a stable growth in the long run. In this multi-dimensional relationship, the Bank of Albania has assessed that during 2006 the fiscal policy provided a satisfactory support to inflation developments.

Fiscal indicators were carried out within the budgetary program limits, preventing premises for any rise of inflationary pressures in the economy. During the fourth quarter of 2006, a high concentration of budget spending was noticed to higher levels than those of the preceding years. This concentration caused short-term pressures on prices; however its long-term

Chart 17 12-month change trend for budget spending (in percentage)



pressures remained limited in the impact it provides on monetary market and on economy expectations for inflation. The Bank of Albania deems that both these indicators remained unaffected.

The budget deficit realization at year-end, estimated at about 3.2 percent of GDP or 0.7 percentage point less than that of the previous year, reflects the prudential fiscal policy followed by the government. An important role in achieving lowest historical values of budget deficit financing has been played by the controlled level of domestic borrowing. At end of 2006 the government demand for domestic loan was about 2.6 percent of GDP. The lower rates of this indicator than in the previous year have influenced on contracting inflationary pressures and controlling monetary expansion.

#### • DEMAND FACTORS

During 2006 the domestic demand significantly sustained the positive economic growth rates. The good domestic demand performance was reflected by a number of economic activity indicators. Hence, the sales index for the first nine-month period of the year recorded an annual growth of 12.4 percent. In particular, rise of imports by 16 percent and exports by 17 percent speak for an intensive external trade activity. The rise of imports was due to rise of imports of consumer goods and of those used in investments, respectively by 32 and 11 percent. The domestic demand has been increasing also due to rapid credit growth, which recorded a growth of 57 percent in annual terms. The performance of these indicators speaks for the good performance of consumption and investment in the country. In particular, the rise of machinery and equipment import and increased lending for real estates indicate the expansion of investments in the country. Besides the positive effects of investment expansion, the domestic demand growth exercises pressure on the overall price rise. In absence of any obvious inflationary pressures on the demand side, it is estimated that the Albanian economy is using the free capacities, without raising costs and final prices of goods and services.

#### • SUPPLY FACTORS

*External environment.* Developments in the external environment of the economy during this year may be summarised in the positive performance of the trade partner economies and the downward trend of oil prices mainly during the second half of the year. These trends, combined with exchange rate stability and the presence of internal factors have created suitable conditions for maintaining inflation rate within the Bank of Albania target.

*Import prices.* The Albanian economy is a relatively open economy and therefore, import prices constitute an important element to the country's



inflation. Generally speaking, economic conditions of the trade partners of Albania have been favourable during this year, easing the control of pressures on the supply side and enabling the observance of inflation target.

The main trade partners of Albania, i.e., Greece and Italy, and other countries of the Euro area recorded stable inflation rates during this year. However, prices of certain items, such as oil and foodstuffs have frequently reflected rising trends, impacting on inflation of respective categories of consumer goods in the country. Oil price cut in the international market was reflected in decreasing the inflation rate of "Transport" item, particularly over the last quarter of the year. Price rise of foodstuffs in trade partner countries during the third quarter of the year was transmitted to price rise of goods of these categories in the country. However, imported inflation impact has not been as strong as to put at risk the meeting of the target for maintaining consumer price stability.

Chart 18 Annual rate of consumer price index and import price index change (in percentage)

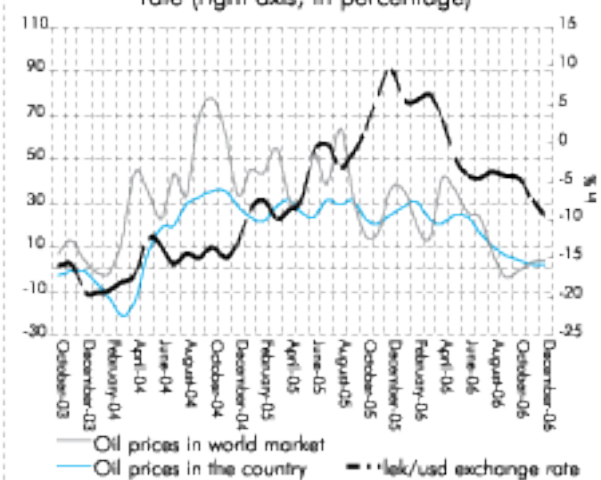


Source: CPI, INSTAT, January 2007; Bank of Albania, January 2007

**Oil prices.** Consumer prices during 2006 were influenced by the stressful situation in international oil price market. The impact of this factor, as concerns the intensity of operation on inflation rate, was not uniform. During January-September, the oil price rise impact on the overall inflation of the country was on average 0.2 percent. During the fourth quarter, inflation of "Transport" item and its contribution to overall inflation rate decreased constantly. The Lek/Usd exchange rate impact, which translates the international oil price into the domestic oil price, was almost insignificant during 2006. The oil price rise in the country during 2005 was much smaller than that of the international market, while in 2006 the domestic market loyally reflected the international oil price performance. This development may be explained mainly due to the fact that the lek's appreciation against the American dollar has been much smoother during this period compared to the previous year.

**Exchange rate.** During 2006 the exchange rate developments dampened inflationary pressures of the supply side. The national currency was appreciated against the American dollar and maintained a steady position against the euro. The Lek's appreciating tendencies, though weakened in the recent months, have made the import price in domestic currency decline. In this way, the exchange rate has contributed to constraining the high international oil price effect and to maintaining a low inflation rate.

Chart 19 Annual change of oil price (left axis, in lek/usd) and of exchange rate (right axis, in percentage)



Source: Bank of Albania, INSTAT, Bloomberg, December, 2006

Table 12 Annual inflation rate of Italy, Greece, Euro area and annual exchange rate change (in percentage)

	Q1-06*	Q2-06*	Q3-06*	Q4-06*
Greece <sup>15</sup>	3.2	3.2	3.4	2.9
Italy <sup>16</sup>	2.2	2.2	2.2	1.8
Euro area <sup>17</sup>	2.3	2.4	2.1	1.8
Lek/Euro	-2.9	-1.4	0.1	0.7
Lek/Usd	5.7	-1.1	-4.1	-7.0

Source: CPI, INSTAT

Note: (\*) Quarterly figures are an average of relevant monthly indicators

### Box 2. Price trend in Albania compared to Greece and Italy. What can we say about convergence?\*

One of the most important objectives of transition economies of the South Eastern Europe is membership to the European Economic and Monetary Union. Accession to Monetary Union and adoption of Euro as a national currency require the meeting of some economic and legislative criteria. The economic criteria are known as convergence criteria and briefly they include: low inflation, steady exchange rate, healthy public finances and low inflation rates. Besides them, the central banking legislation of each country should meet some requirements. As an approximation to integration, it is thought that the price differences in most integrated and competitive markets are small. From this viewpoint, the price convergence or divergence constitutes an important issue for analysis, given that the future of Albania is accession to the EU. To this end, the Bank's staff, in one of its materials in 2006, treated the consumer price performance in our country compared to those of Italy and Greece, as two main trade partners of our country and as member states of the EU. \*

For comparing price performance between Albania on the one hand and Italy and Greece on the other, in absence of information about the absolute price values, the material was based on the data series of consumer price index. The various degree of economic development between these countries, changes in consumer price index composition, changes in the division into sub-items and in various weights of items and sub-items, as well as the short period of time of series used in this approach should be taken into account in the conclusions of this material.

The price trend comparison of 12 CPI items between Albania, Italy and Greece revealed two main trends:

1. A downward trend in the price level of "Clothes and footwear", "House equipment", "Recreation and culture" and "Miscellaneous goods and services", in comparison to those of two partner countries, where price trend was upward.
2. A faster rise in the price level of "Rent, water, fuel and energy", "Health", "Communication", and "Education" items in comparison to those of Italy and Greece.

The price performance in the first case may be explained by market liberalization, signing of Free Trade Agreements with the countries of the region, domestic production growth and exchange rate appreciation. In the second case, where Albanian prices grow faster than prices of two other countries, the behaviour may be explained by the characteristics of these goods and services and by the fact that a good part of their prices are managed ones.

The price performance analysis enables us to distinguish whether the series of CPI 12 items have converged, are converging or diverge from relative prices or inflation rates.



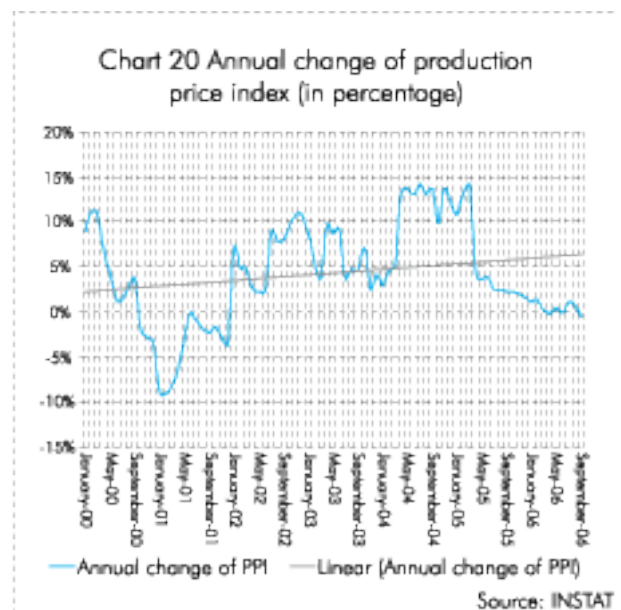
*In most cases, the tests lead to the conclusion of convergence in price level differences. However, we highlight the most important conclusion that in all the case, tests reject the thesis of divergence from inflation. This finding is of interest, since it indicates that the inflation of CPI items is consistent with the inflation of Italy and Greece, member states of the EU, and may reflect the long-term perspective of inflationary processes in the country, in the context of the European integration process.*

*\* Price trends in Albania, compared to Greece and Italy. What can we say about convergence? – Research paper*

#### • INTERNAL ENVIRONMENT

**Agricultural output.** Agricultural output is one of the main domestic factors that condition consumer price developments. The quantity of agricultural domestic output influences immediately on the foodstuff price level. During 2006, the seasonal effect of agricultural output growth appeared later than in the preceding years, recording foodstuff price decline only in September and October. Unfavourable weather conditions, particularly during spring, influenced negatively on agricultural output level. On the other hand, domestic production supply in August-October, managed to balance inflationary pressures created by price rise of electricity, rent and excise during August and September.

**Production prices.** During 2006 the production prices continued the downward trend noted since April 2005. It is expected that production prices, as the first link of cost formation be materialised to consumer prices. Such a thing has not been observed in the relation between both indexes. The non-compliance in time and direction of movement may be explained either in the form of these indexes or the structure of goods supply in the domestic market. Concentration of producer price index on the productive sector of industry makes difficult its comparison to consumer price index. Also, it is assessed that the domestic production share is not yet a determinant component of the goods supply in the domestic market, thus not influencing the consumer prices.



**Wages and unemployment.** Good performance of economic activity during 2006 was also reflected in the labour market indicator, and mainly in unemployment level. New employment possibilities were created, making the unemployment rate continue its downward trend observed since more than two years ago. Improvements were observed also in income terms. So, government sector wages, minimum wages and pensions were increased pursuant to budget plan. The so-far inflation performance shows that the Albanian economy does not suffer from any significant discrepancy between wage rise and productivity.

*Inflationary expectations.* The business and public expectations in short-to medium terms fluctuated around the recorded inflation rates. According to Bank of Albania periodic estimates, the public expectations have converged mostly around 1 - 3 percent. In the meantime, the business expectations on price performance, though having reflected a higher volatility, have tended to follow the historical trends. Monetary policy and macroeconomic stability consolidation have played an important role in anchoring the expectations of public at large. Business and consumer inclinations have been channelled to the proper direction, without adding uncontrolled inflationary pressures to the economy.

## II.6 BALANCE OF PAYMENTS

During 2006 the external sector of the economy was presented with an increased negative balance of current account, caused by high trade deficit.



The relative indicator of current deficit to GDP is estimated at about 7.6 percent, from 7.3 percent in 2005. However, the inflows in capital account have been sufficient to cover the current deficit, enabling an overall positive balance, at euro 207 million.

Trade deficit has constituted a permanent feature of foreign trade developments, dictating high current account deficit levels. The Albanian economy, as a developing economy, has been characterised by a high demand for import goods, thus covering the upward consumption in the economy and the addition of new capacities. This dynamics has evidenced import rise in recent years. Nonetheless, the import rise during 2006 has been influenced by some external factors, such as unusual oil price rise and price rise of some international market products, and by some internal factors, such as worsened energy situation in the country leading to high imports of electrical power. Therefore, the relative indicator of imports to GDP for 2006 is estimated at about 31.7 percent, from 29.8 percent in 2005. In 2006 Albania recorded the highest trade deficit in years, by eur 1.7 billion. Intermediate goods and capital imports constitute about 64 percent of the total, while the domestic demand for consumer goods has remained high.

The export slowdown in the previous year was recovered during 2006. Revenues from exports are estimated to about 8.7 percent of GDP, representing the highest level in years.

Significant inflows in the form of current transfers have helped in mitigating the high trade deficit, leading to easing of the balance of payments position. During 2006 the net current transfer inflows amounted to about eur 979 million, from which 95 percent are contributed by Albanian emigrants. Remittances

for 2006 are estimated to eur 934 million or about 12.8 percent of GDP. On the other hand, the current deficit financing of this year has been completely possible through foreign capital inflows, in the form of capital transfers, and through financial inflows in the form of foreign direct investments and foreign borrowing. These capital inflows made the overall balance of payments close with a surplus of about eur 210 million, from eur 125 million in 2005. The overall balance surplus led to increased foreign exchange reserves (which were estimated to about eur 1.3 billion at end of 2006).

Sufficient foreign exchange reserves, economic growth and overall macroeconomic stability justify the existence of high deficits in the short run. External debt service is estimated to modest levels. For 2006 it is estimated to about 4.1 percent of total services. Nonetheless, the debt sustainability in the long run should be regarded with priority in compiling the development policies. These policies should intend to generate long-term inflows in the form of increasing the basis of export, supporting import-substituting industries or encouraging the use of the country's tourism potential. Also, foreign direct investments constitute a key source of financing, taking into account the stable nature of these inflows and the fact that they contribute to technology and management. Though during privatization Albania has attracted high foreign direct investments, their relative indicator to GDP is still low. For 2006 this indicator is estimated to 3.6 percent of GDP.

	2004	2005	2006	2004	2005	2006
	In million euro			in percentage to GDP		
Current account	(286.2)	(492.1)	(556.4)	(4.8)	(7.3)	(7.6)
Trade balance	(1276.7)	(1476.7)	(1685.4)	(21.3)	(21.9)	(23.1)
Export	485.6	530.2	630.6	8.1	7.9	8.6
Import	(1,762.3)	(2,006.9)	(2,316.0)	(29.4)	(29.8)	(31.7)
Services (net)	(40.5)	(140.4)	(65.4)	(0.7)	(2.1)	(0.9)
Income (net)	140.7	136.1	215.3	2.3	2.0	2.9
Current transfers (net)	890.3	988.9	979.0	14.8	14.7	13.4
Capital account (net)	422.9	438.5	557.8	7.0	6.5	7.6
Overall balance	233.7	125.1	209.6	3.9	1.9	2.9

Source: Bank of Albania

Table 13 Main balance of payments indicators as a share of GDP

## II.6.1 EXTERNAL SECTOR INDEXES

Many key indexes of the balance of payments indicate the improvement of 2006, though some weaknesses appear in other indexes. The degree of Albania's market openness<sup>18</sup> has improved to 74 percent, from 68 percent in the previous year, though it has remained in rather low levels in relation to the economy of the region. Taking into account the relation between market openness and economic growth, the increased market openness in the country is a welcomed development. However, such a development would be more encouraging if originated from exports, since the export-oriented companies, which are faced with a strong international competition, are frequently more efficient. Unfortunately, this year the improvement of this indicator was mainly due to rise of imports.

During 2006, the export (in goods and services) was increased by about 22 percent compared to the previous year. The external debt service is estimated to modest levels, reaching about 4.1 percent of total exports or much below the level of 25 percent generally regarded as a critical level.

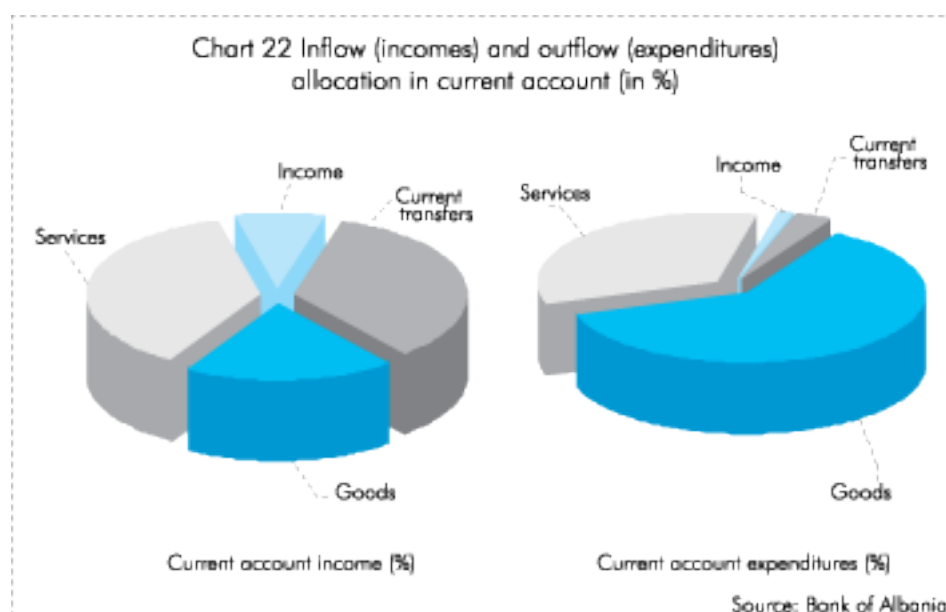
The imports role in increasing the market openness index has been reflected also in current deficit ratio to GDP, which may be used as a measuring instrument of current account sustainability. Due to large growth of imports, this ratio has deteriorated during two latest years. The current deficit excluding official transfers reached 8.3 percent.

The relative indicator of foreign direct investments to GDP was 3.6 percent, with a slight rise of about 0.3 percentage point against the previous year. This ratio is regarded in low levels also compared to economies of the region.

Finally, the adequacy of reserves, for example, the import covering ratio that measures the economy's ability to satisfy its needs for imports (of goods and services) through its reserves is a critical indicator of the external sector. For 2006 this ratio is estimated to 4.5 import months and constitutes a satisfactory level<sup>19</sup>.

## II.6.2 CURRENT ACCOUNT

Year 2006 was characterised by a more intensive activity in the external sector, expressed in significant increased current incomes and expenditures. The volume of current transactions increased by 14 percent compared to 2005, recording the level of eur 6.9 billion. More than 95 percent of current expenditures have been used for purchasing goods and services. About 35 percent of current incomes have entered in the form of current transfers, while services and exports of goods have ensured respectively 37 percent and 20 percent of income.



The current deficit for 2006 is estimated to eur 556 million, with an increase of 13 percent against 2005, being 7.6 percent of GDP. The high trade deficit characterising external sector' developments of the economy along this year neutralized the positive effects of significant reduction of deficit in services account and the increased positive flows of net factorial incomes, remaining the main cause in deepening the current deficit of this period.

Though the annual growth rate of exports was higher than that of imports, the high volume of the latter ones made the trade deficit increase by about eur 209 million or by 14 percent.

The services account recorded a rise during this year, in both income and expenditure side. Compared to 2005, incomes increased faster than expenditures. Therefore, the net result in services transactions has led to significant reduction of deficit of this account by about eur 75 million.

The positive balance of current inflows in the form of transfers and incomes is estimated to about eur 69 million higher than in the previous year. Such a development is mainly due to increased income from interest on investment of cross-border resident units, while current transfers have dropped by eur 10 million – for the effect of official transfer reduction.

- **MERCHANDISE TRADE**

Year 2006 was closed in a volume of trade transactions of eur 2.9 billion, representing 42 percent of total current transactions. Merchandise import expenditures recorded approximately eur 2.3 billion or eur 309 million more than in 2005. Merchandise export revenues are estimated to about eur 631 million, with a nominal growth of about eur 100 million.

External trade developments reflect divergences in import and export growth. Though the export growth during this year (by 19 percent) has outstripped the import growth (by 15 percent), the trade deficit has continued to deepen, reaching the level of eur 1.7 billion.

Nonetheless, a positive development is noticed in improving the ratio of covering imports by exports, which for this year recorded 27 percent, a rise by 1 percentage point against 2005.



The export slowdown, observed over the last year – as a consequence of increased competitive pressures in key industries of Albanian exports (textile and footwear), European market openness to Far East Countries (China, India) and Turkey, economic growth slowdown in partner countries, and deteriorated situation in power supply in the country - has been significantly recovered during this year.

Anti-dumping measures taken by the EU<sup>20</sup> impacted significantly on improving the situation of processing industry in the country (textile and footwear). Precisely, the trade deficit coming from this industry during the year resulted to 45 percent higher than that of the previous year. The footwear and textile industry constitutes the essence of export industry in the country, contributing by about 55 percent to annual revenues from merchandise export.

In the meantime, domestic export has reflected positive developments (export in copper, minerals and fuels), contributing significantly to increased export revenues for 2006.

The export of copper and other articles was tripled, with a market oriented mainly towards Italy. Their contribution to annual export growth is estimated at about 15 percent. Export of minerals has grown by about 72 percent and has contributed by about 20 percent to the increase of total revenues from merchandise export.

The export of chromium and iron provided the main impact on increasing the volume of export of minerals during this year. The chromium export increased by 4 times, both in nominal and quantity terms, having the destination to China. In the meantime, the export of iron was doubled, with markets oriented to countries of the region (mainly to Macedonia). The price rise in international markets for these products is considered to have influenced significantly on their performance.

The fuels export also doubled. Crude oil represents about 70 percent of exports of this category. Italy was the main destination of these exports. The effect of these exports on total revenues from export for 2006 is estimated to 12 percent, an effect amplified also by oil price rise.

Table 14 Export/import distribution by merchandise items<sup>21</sup> (in million euro)

Code	Description	Import		Export		Import	Export
		2005	2006	2005	2006		2006/2005
		Structure in %		Structure in %		Change %	
0	Live animals and animal products	13.1	13.3	3.9	4.2	17.8	31.1
1	Beverages and tobacco	3.1	3.2	1.8	1.3	19.5	-13.5
2	Raw materials	3.6	3.6	4.8	5.5	13.4	36
3	Fuel	8.7	10.6	2.9	4.3	40.2	77.6
4	Vegetable and animal fat and oil	1.4	1.3	0	0.1	10.7	88.4
5	Chemical products	9.7	10.5	0.9	1.0	25.2	30.1
6	Processed goods	24.5	25.6	21.6	22.4	21.3	23.8
7	Machinery and equipment	23.5	20.1	4.2	3.9	-0.9	10.7
8	Other processed goods	12.5	11.8	59.9	57.2	9.5	13.6
	Total	100	100	100	100	15.7	19

Source: Bank of Albania

Imports continue to be the dominant side of trade exchange flowing of Albania with the world, representing more than 79 percent of the trade volume.

Variety of merchandise items and high volume of imports (31.8 percent of GDP), represent the economic growth rate of the country, with increased construction sector and investments in infrastructure, which require machinery and merchandise imports. It also reflects a high degree of imports in consumer goods, whose demand, as the one in construction, is satisfied by remittances and the lek's appreciation.

The unusual oil price rise, high power imports and metal price rise in world markets, together with the high demand for consumer goods, constitute the main factors of import growth over 2006.

The meeting of domestic needs for electrical power, and the energy price rise – following the oil price developments – have increased fivefold the import expenditures of this category, while the imported quantity also increased significantly, by about 3.5 times compared to the previous year. Also, the fuels import resulted to 22 percent higher than in 2005. The electrical power and fuels contribution to total import growth is estimated respectively 8 percent and 12 percent.

The ever increasing demands of construction sector, combined also with the price rise, led to 30 percent growth of imports of metals. In the meantime, machinery and equipment, which occupy the most important share, about 14 percent of imports, underwent a slight decline over this year, (by 1 percent), breaking the upward curve characterising this item over the recent years. However, their imports over this year remain about 30 percent higher than the average of machinery and equipment imports during 2000-2005.

EU dominates in trade exchanges of our country with the world, representing 64 percent of their total. The low diversification of geographic distribution of trade indicates an underlined dependence on neighbour countries, i.e., on Italy and Greece, thus drawing the attention to exploring new markets.

Year 2006 also recorded the signing of two extremely important agreements for our country, that of the EU and that of Turkey. During the recent years Turkey has been transformed into one of the main trade partners of Albania, with a volume of transactions by eur 190 million, drawing the attention to FTA with this country. Also, the crowning of negotiations for signing the SAA is expected to provide significant effects on market openness with these countries. These agreements entered into force respectively on December 1, 2006 and January 1, 2007.

Export	Share to total exports			Change (2006/2005)
	2004	2005	2006	%
Total	100.0	100.0	100.0	19.0
EU-countries -15	89.9	88.0	87.7	18.6
Italy	73.0	72.4	72.6	19.3
Greece	12.0	10.5	9.6	9.4
Germany	3.1	3.3	3.2	13.1
South-Eastern Europe	8.5	9.2	9.3	19.8

Table 15 Export distribution by trade partners over years and the annual change for 2006



Serbia-Montenegro	0.4	0.8	1.4	91.0
Macedonia	1.2	1.6	1.6	20.9
Kosovo	4.5	4.1	3.8	8.6
Turkey	1.9	1.7	1.3	(12.2)
Other countries	1.6	2.7	2.9	28.5

Source: Bank of Albania

The paces of export growth to EU countries and to those of the region seem to have been side by side during this year, respectively 18.6 and 19.8 percent. The contrary is presented in imports, having a large flow from the countries of the region, with a rise of 32 percent. It seems that the fuels and energy supply during this year has been provided from the Balkan and precisely from Romania, which in turn recorded a more significant growth in imports (about 170 percent). Also other partners of the region have had high growth rates of imports, indicating a better advantage of the FTA on their side, as compared to our country.

Re-establishment of quotas for the export of textiles in June 2005 by the WTO brought about a smoothening of the Chinese competition impact. This was felt also during 2006, when imports from this country underwent a modest growth by 4 percent.

Table 16 Import distribution by trade partner countries in years and the annual change for 2005

Import	Share to total imports			Change (2006/2005)
	2004	2005	2006	%
Total	100.0	100.0	100.0	15.7
EU countries - 15	65.0	60.4	57.5	10.1
Italy	32.6	29.3	28.1	10.9
Greece	18.6	16.6	15.8	10.0
Germany	6.2	5.4	5.6	20.7
South-East Europe	12.8	14.8	16.9	32.1
Bulgaria	2.0	2.8	2.7	12.0
Bosnia-Herzegovina	-	0.1	0.3	142.8
Croatia	1.3	1.2	1.4	38.5
Kosovo	0.2	0.4	0.5	47.9
Serbia-Montenegro	0.6	0.6	0.9	64.0
Macedonia	1.0	1.2	1.6	50.4
Rumania	0.4	0.7	1.7	173.5
Turkey	7.1	7.5	7.6	17.4
Other countries	22.1	24.8	25.6	19.5
Russia	2.8	4.1	4.1	16.1
Ukraine	2.5	2.9	3.9	54.5

Source: Bank of Albania

#### • SERVICES

The services sector development in Albanian economy has led to expansion of services trade activity with the world, an indicator of an expansion of Albanian economy openness to international market. This has been indicated also by the volume of these transactions by about eur 2.5 billion, estimated with an annual growth of 18.3 percent. The import of services, by about eur 1.3 billion is estimated with an annual growth of 13.7 percent. Revenues from services export (about 1.2 billion) are estimated to about 1.9 times higher



than the merchandise export, leading to services trade deficit reduction by about 2 times against the previous year.

For more than 7 years, tourism has played a very important role in our exports, representing on average 77 percent. Year 2006 recorded a flow of revenues from tourism by eur 805 million, or 16 percent more than in the previous year. This rise is noticed in revenues from services provided to non-resident passengers, visiting Albania for business or personal reasons (mainly in the third quarter, underlining the seasonal effect of tourism in Albania). It is worth mentioning that the rise by 21.2 percent of the number of non-residents visiting the country, notwithstanding the slight decline in expenditures and their staying days in Albania, has led to increased revenues from this activity by 18 percent. These revenues have indirectly increased the demand for production factors (land, labour, capital), and in consequence even the contribution to national revenues, transforming tourism into an activity of high productivity. According to sales index, the "hotels and restaurants" sector, with a rise of 17 percent, is estimated as one of the sectors having the highest growth rate, particularly during the third quarter.

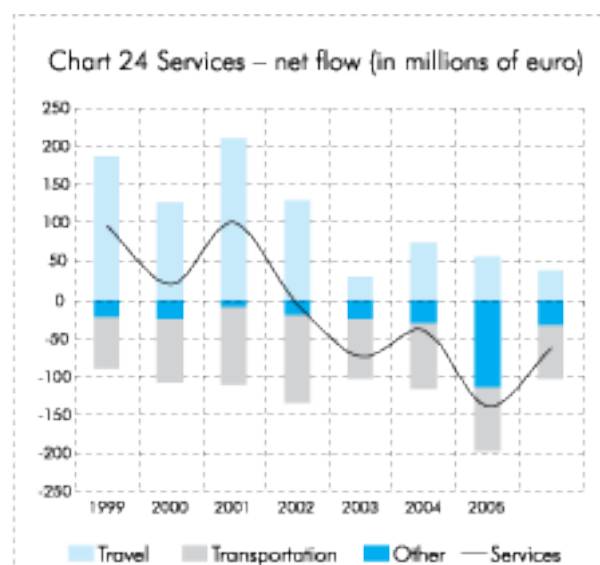
At the same time, the demand for goods and services of Albanian passengers, residents to the EU countries represented by Greece and Italy, countries of the region such as Kosovo, Montenegro, Macedonia, led to an estimate of tourism services import by about eur 768 million. These expenditures occupy about 82 percent of remittances and are estimated to an annual growth of 21 percent. This growth is attributed to the rise by 22.4 percent of the number of passengers, since their time stay has decreased by 10 percent but the expenditures have maintained the previous year level.

However, year-end recorded a positive balance of tourism services, highlighting the competitive advantage of Albania in the international market for this kind of services.

In addition to tourism services, an improvement of the balance of trade is noticed almost in all services sectors. The developments of services is characterised by market liberalization, technology expansion in information services, variety in cultural services and increased volume of financial services. In the meantime, it is noticed that Albania continues to be a net importer of transport services and of goods security, a phenomenon that relates naturally to growth of merchandise imports and that impacts directly on services trade deficit.

#### • INCOME AND CURRENT TRANSFERS

The positive balance sheet of factorial incomes at end of the year (euro 215 million) is estimated to have increased significantly compared to the



Source: Bank of Albania

previous year (58 percent). This growth is not attributed only to income from seasonal and border workers and accumulated interests from banking system foreign reserve investment to non-resident financial institutions, but also to income earned from our cross-border direct investments, and investment of financial assets in the form of portfolio investments. Labour income represented about 58 percent of the positive balance of income, while the net incomes in the form of investment interests have increased by 42 percent. During 2006 Albania paid about eur 24 million to settle the interests for its external debt, which had slightly decreased in comparison with 2005 (by 4 percent).

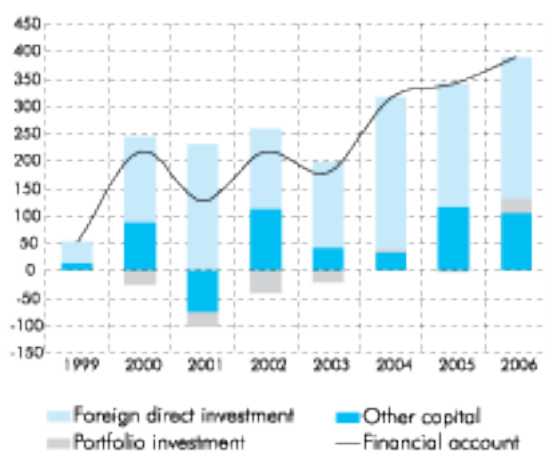
Remittances, being of a crucial importance for most of Albanians, have become a typical phenomenon in the Albanian economy. Recently, this money is not regarded only as income sources for non-productive purposes, for meeting essential needs related to improved standard of living, but also as sources of financing for productive purposes, in the form of real estate investments or other long-term investments.

Total emigrants' remittances for 2006 are estimated to about eur 933 million or 12.8 percent of GDP. Their contribution to trade deficit smoothing is estimated at about 55.4 percent or 5 percentage points less than in the previous year. Remittances have also been associated with official transfers, mainly in the form of technical assistance (eur 39 million), which are estimated to have slightly declined by 17 percent against the previous year.

### II.6.3 CAPITAL AND FINANCIAL ACCOUNT

Year 2006 was characterised by a large movement of capital on sides, inflows and outflows. Except one-sided capital transfers, the financial account of 2006 is defined with a large increase in Albania's liabilities to the world and in Albania's assets outside the Albanian economy. However, the year was closed with a positive balance of capital and financial account (about eur 558 million), enabling the complete financing of the current deficit.

Chart 25 Financial account over years – net flow (in millions of euros)



Source: IMF, Bank of Albania

Capital transfers, which are mainly characterised by grants of investment character, either in public or private sector, are estimated at eur 167 million, about eur 68 million more than in the previous year.

A significant rise of our foreign assets invested outside the Albanian economy, mainly those of the banking system, represented by short-term and medium-term investments, is noticed in our financial account. The large accumulation of foreign assets to commercial banks has made them choose the option of expanding their investment at cross-border financial institutions, reducing the growth rate of lending to the economy by 11 percent.

Foreign assets owned by the banking system in the form of foreign deposits, which occupy the largest share of assets growth have increased (about eur 157 million) compared to the decline of the previous year. Given their composition, 55 percent of them were denominated in dollar, whereas the rest were in Euro (39 percent) and in British pound (6 percent). The growth of these assets was due to growth of resident and non-resident deposits with our banking system, which in turn, has invested them in cross-border financial institutions. Simultaneously, a change has also been noticed in the ratio of investment assets. The banking system has preferred to shift assets from portfolio investment to cross-border deposits. So, financial assets in the form of portfolio investments have recorded eur 84.3 million, marking an annual decline of about eur 27 million. Given the structural composition by currencies, the portfolio investments were dominated by those in dollar by 77 percent, in eur by 16 percent and in British pound by 7 percent.

Simultaneously, even in 2006 the Albanian economy expected foreign capital inflows, increasing its liabilities by about eur 546 million. This growth, estimated to about 51 percent higher than in 2005 is mainly attributed to direct investments, investments through long-term borrowing with soft terms, and liabilities created by non-residents' deposits with our banking system.

Foreign direct investment inflow during 2006 recorded eur 260 million against eur 224 million realised in the previous year. They continue to be a dominant factor in the growth of financial liabilities and in the development of capital and financial transactions of the country. Investors from EU countries (Italy, Greece), which are trade partners of Albania continue to dominate these investments, which are mainly focused on textile manufacturing industry (clothes and footwear).

Free Trade Agreements with the EU are expected to influence significantly on the rise of these investments, impacting on production improvement through transfer of technology and increased technological capacities of production in compliance with international standards, which will lead to increased trade with these countries. Construction sector seems that is drawing the attention of foreign investors. The presence of foreign capital in this sector has increased significantly during two last years, bringing about new foreign capital inflows in new areas supportive to this sector, such as architectural and engineering activities. Also, an increase in foreign capital is noticed in financial system and in the field of telecommunication.

Foreign direct investment inflows have been associated with capital flows in the form of borrowing, thus increasing Albania's external debt. Long-term and soft-term credit extensions, which remain another important factor in increasing financial liabilities of Albania with the rest of the world, are estimated to eur 147 million, from which 80 percent has been posted to Government sector. This growth has mainly financed investment and consumption, being reflected also in rise of imports for consumption and the needs for capital and/or capital goods of companies. The growth of these liabilities has led to rise of future payments of external debt.

External debt service for 2006 reduced our liabilities by about eur 55 million, representing only 3 percent of exports during 2006, which indicates solvency within the accepted levels. In the meantime, private borrowing has slowed down its growth rates. Compared to 2005 the rise of liabilities of this sector is estimated as much as half of inflows of the previous year and occupies 20 percent of the borrowing. External debt structure created by the borrowing is dominated by SDR (58% percent), followed by the European currency and the American dollar.

Financial liabilities created in the form of increased non-residents' deposits with the banking system by eur 119 million assumed primary importance during 2006. It is worth mentioning that this growth is also attributed to placement of deposits of emigrants with our banking system, which speaks for an increased interest of emigrants to invest in Albanian economy.

Liabilities in the form of commercial credit rose by eur 7.5 million, reflected in the rise of imports over this period.

#### II.6.4 FOREIGN RESERVES

Foreign asset inflows in the form of financial capitals were reflected in the rise of foreign reserve of the monetary authority, by about eur 207 million. Foreign reserve stock at end of 2006 recorded eur 1.3 billion, being sufficient for covering about 4.5 months of import of goods and services.

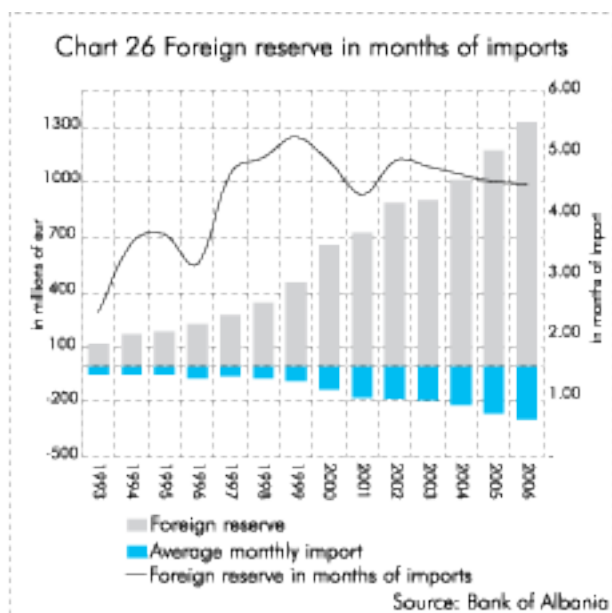


Table 17 Balance of payments in years (in millions of euros)

	2000	2001	2002	2003	2004	2005	2006
Current account	(186.6)	(314.6)	(426.5)	(336.2)	(287.8)	(492.1)	(556.4)
Merchandise export	277.2	339.7	350.5	397.0	485.6	530.2	630.6
Merchandise import	(1,168.4)	(1,484.9)	(1,576.6)	(1,583.4)	(1,762.3)	(2,006.9)	(2,316.0)
Trade balance	-891.2	-1,145.2	-1,226.1	-1,186.3	-1,276.7	-1,476.7	-1,685.4
Services: Credit	486.4	595.0	621.0	638.9	807.5	967.3	1,194.9
Services: Debit	(466.7)	(495.4)	(626.5)	(712.4)	(848.0)	(1,107.7)	(1,260.3)
Income: Credit	123.0	170.3	160.0	173.0	166.5	178.4	262.6
Income: Debit	(9.9)	(15.0)	(21.9)	(21.7)	(24.0)	(42.3)	(47.3)
Private unrequired transfers	469.4	544.3	626.4	718.8	826.3	927.6	936.5
Official unrequired transfers	102.5	31.4	40.6	53.5	60.7	61.4	42.5
Capital account	84.8	131.3	128.7	139.3	106.2	99.2	167.2
Financial account	195.7	114.3	212.6	169.3	306.8	329.9	384.9
Direct investments	155.2	231.2	143.3	158.1	278.4	224.1	259.8
Portfolio investments	(27.2)	(26.1)	(39.1)	(20.0)	4.6	(2.0)	27.2
Other capital*	67.7	-90.7	108.4	31.2	23.8	107.7	97.9
Net errors and omissions	28.2	217.3	109.9	106.2	98.7	178.6	205.2
Overall balance	143.2	161.7	30.4	88.5	233.7	125.1	206.6
Reserve assets	(143.2)	(161.7)	(30.4)	(88.5)	(233.7)	(125.1)	(206.6)
Use of Fund credits and loans	20.9	13.4	5.6	9.9	9.6	9.4	5.8
Total change in reserves	(141.8)	(146.0)	(103.0)	(158.0)	(276.1)	(179.0)	(157.3)
Of which: change due to exchange rate	(1.4)	(15.7)	72.7	69.6	42.4	53.9	(49.3)

\* Use of Fund credits and loans is not included.

Source: Bank of Albania

## NOTES

<sup>1</sup> The data on GDP and its real growth for 1999-2000 are obtained from INSTAT. The rest are estimates of the Ministry of Finance, the IMF and the Bank of Albania.

<sup>2</sup> The table is set up on the basis of the reviewed nominal GDP.

<sup>3</sup> Nominal GDP converted with the average rate of the period.

<sup>4</sup> The data on the employment and unemployment rate for 2006 as of September, according to INSTAT.

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

<sup>6</sup> Operational data from the Ministry of Agriculture, Food and Consumer Protection (MAFCP)

<sup>7</sup> Source: Ministry of Agriculture, Food and Consumer Protection

<sup>8</sup> Preliminary data of 2006 are obtained from the Ministry of Finance.

<sup>9</sup> According to Ministry of Finance, this growth has been realised under the conditions of a significant reduction of tax burden to economic subjects, aiming at a flat tax level. Among the main indicators influenced by this fiscal policy are: reducing the small business tax by halve, deducting by 9 percent the social insurance contribution, decreasing the income tax from 23 to 20 percent, and minimizing customs barriers in implementation of regional and European agreements.

<sup>10</sup> Current deficit is estimated as the difference between incomes and current expenditures. It measures the financing of public investments by budget revenues.

<sup>11</sup> The rest is financed from other sources.

<sup>12</sup> Source: ISTAT; website: <http://www.istat.it>

<sup>13</sup> Source: National Statistical Service of Greece; website: <http://www.statistics.gr>

<sup>14</sup> Source: Eurostat; website: <http://epp.eurostat.cec.eu.int>

<sup>15</sup> Source: National Statistical Service of Greece; website: <http://www.statistics.gr>.

<sup>16</sup> Source: Institute of Statistics of Italy; website: <http://www.istat.it>.

<sup>17</sup> Source: EUROSTAT; website: <http://epp.eurostat.cec.eu.int>.

<sup>18</sup> Calculated as a ratio of trade volume on goods and services to GDP

<sup>19</sup> No specific criterion exists; it depends on the circumstances, covering with reserves of 3-6 import months is considered as sufficient.

<sup>20</sup> During 2006, an anti-dumping investigation commission of the EU discovered state subsidies in footwear industry of China and Vietnam. The EU levied an additional customs duty, by 19 percent for imports from these countries.

<sup>21</sup> According to SITC

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## CHAPTER III MONETARY DEVELOPMENTS AND MONEY MARKETS

### III.1 MONETARY PROGRAM AND QUANTITATIVE OBJECTIVES

Bank of Albania's monetary policy compilation and implementation forecasts the monitoring and control of main monetary indicators in the economy. Bank of Albania's monetary program analyses the quantitative information revealed by monetary indicators about expected monetary developments in the economy. This analysis orients the monetary policy decision-making towards meeting the inflation target.

The monetary program is based on forecasts and fulfilment of non-inflationary money demand of the economy. The demand for monetary assets represents the channelling of monetary flows to private and public sectors of the economy, and the performance of the balance of payments. During 2006 the annual flows of the demand for money – about 70 percent of total demand – have been oriented mainly to the private sector of the economy. The public sector of the economy has absorbed less than 10 percent of net monetary flows generated in the economy during this year. The rest of these flows, about 20 percent have gone for increasing net foreign assets of the banking system.

This distribution represents the upward tendency to channel money to private sector and to reduce the domination of public sector domestic borrowing in monetary developments. This constitutes a positive development for the economy and for increasing the financial system efficiency. Rapid credit growth of the private sector is in line with the overall trend observed in the developing economies. In terms of economic growth, this phenomenon is generally associated with increased productive potential of the economy and productivity of production factors. Also, the positive flow of net foreign assets of the banking system represents the adequacy of capital inflows for financing the current account deficit for 2006, thus contributing to exchange rate stability.

Credit growth at about ALL 71 billion during 2006<sup>1</sup> has generated broad money growth by about 16 percent, whereas the average inflation rate rested close to 3 percent target of the Bank of Albania. Though the high lending paces to private sector are reflecting a downward trend towards steady rates, they constitute an increasing contribution to current monetary expansion. The Bank of Albania is continuously monitoring these trends and their implications for maintaining the country's macroeconomic stability in the future.

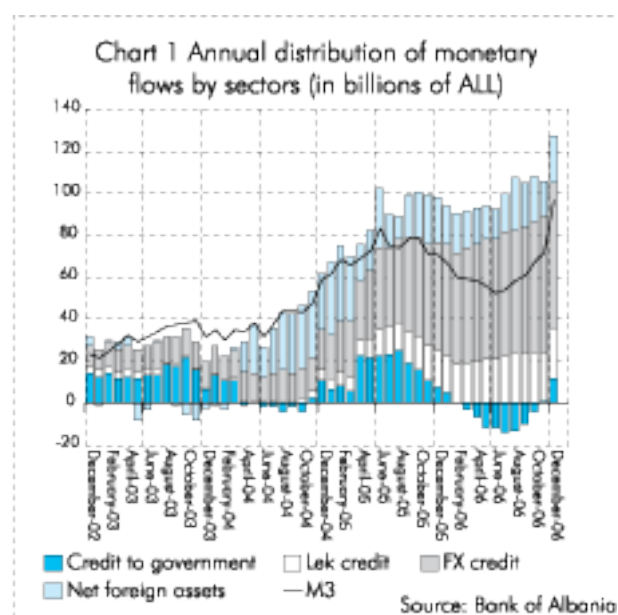


Table 1 Performance of main indicators vis-à-vis the monetary program

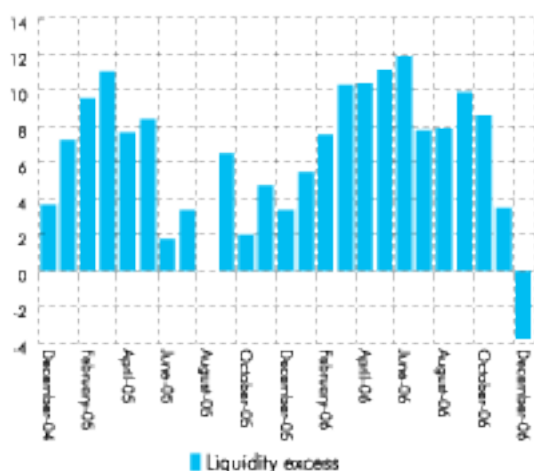
Annual growth of demand factors (ALL billion)	Forecast	Actual
Credit to the economy	63.0	70.8
Government demand	19.3	10.9
Net foreign assets of the system	20.9	22.4
Total	103.2	104.1
Annual growth of supply aggregates (in percentage)		
M3	15.2	16.3
M2	11.0	11.9
Base money	10.4	9.8
Weight of M3 components as of year-end (in percentage)		
Currency outside banks / M3	25.0	24.5
Foreign currency deposits / M3	28.3	28.4

Source: Bank of Albania

Foreign currency structure of credit to private sector has been slightly shifted to ALL credit. In 2006 foreign currency credit ratio to total credit dropped to 71 percent against 74.4 percent it was in 2005. The shifting to ALL credit constitutes a positive tendency for maintaining financial stability in the future. The high foreign currency credit weight over the latest years has maintained the financing cost of private sector to low levels. The gradual shifting of this financing to ALL credit increases the average credit cost. However, this factor will be compensated by enhanced competition and efficiency of the banking system in ALL credit. On the supply side, the Bank of Albania has met the liquid money demand through increasing net foreign assets by about ALL 22.4 billion, while slightly reducing net domestic assets by ALL 3 billion. Base money indicator expresses the economy demand for liquid money. At end of 2006 the base money underwent a rise of 9.8 percent, being lower than credit expansion rates of private sector and money supply.

Performance of the demand and supply balance for liquidity has dictated the

Chart 2 Monthly balance of system liquidity (as at month-end) (in ALL billions)



Source: Bank of Albania

framework of instruments used by monetary policy. The Bank of Albania has withdrawn about ALL 3.9 billion liquidity over the first half of 2006, passing to the injection side over the second half of the year. This development is attributed to money demand intensification at year-end and concentration of budget deficit over this period. The Bank of Albania's presence in liquidity market has aimed at short-term balancing of the demand for monetary assets, enabling the smoothing of fluctuations in money market interest rate performance.

Management of net foreign assets and net domestic assets, as part of the operational framework of monetary policy implementation has enabled the BoA's observance of quantitative targets, in view of maintaining monetary stability.

	December '05	March '06	June '06	September '06	December '06
Net International Reserve(USD millions)					
Objective	1,172	1,117	1,112	1,252	1,268
Actual	1,172	1,202	1,224	1,296	1,394
Difference	0.0	85.3	112.4	44.5	126.8
Net domestic assets (ALL billion)					
Objective	82.0	85.0	90.0	82.9	86.9
Actual	76.9	61.9	67.8	71.2	73.2
Difference	-5.1	-23.1	-22.2	-11.7	-13.7
Net Domestic Credit to Government (ALL billions)					
Objective	317.8	325.7	329.7	335.7	341.7
Actual	317.7	313.7	306.6	307.9	329.2
Difference	-0.1	-12.0	-23.2	-27.9	-12.5

Source: Bank of Albania

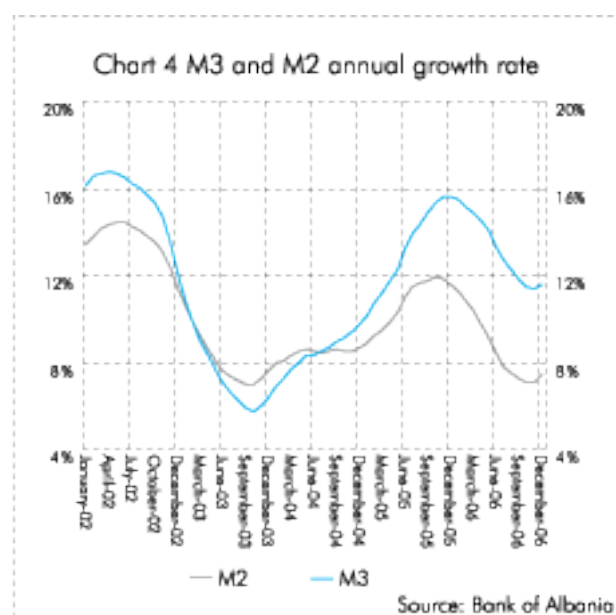
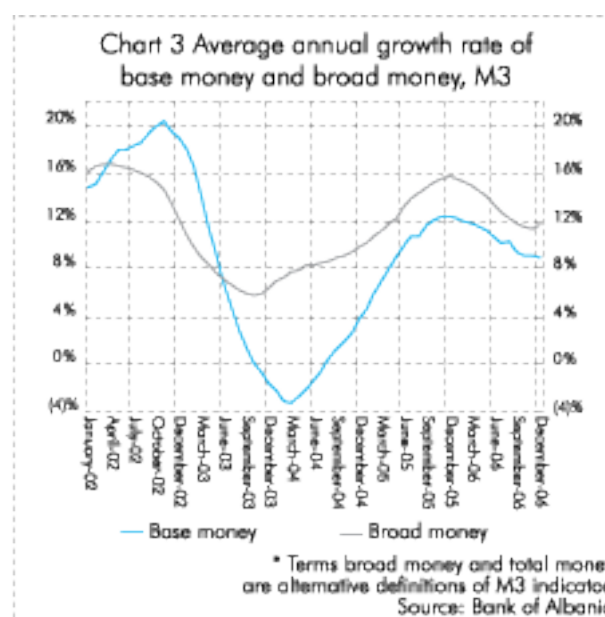
Table 2 Meeting quantitative objectives of the Bank of Albania

### III. 2 MONEY SUPPLY DEVELOPMENTS

During the major part of 2006, monetary indicators reflected a stabilized demand for monetary assets. The average M3 growth rate resulted to 12 percent<sup>2</sup>. Public sector money demand grew by only 3.3 percent during 2006. This relatively low borrowing has balanced high paces of credit to private sector, influencing positively on the maintaining of monetary stability. In compliance with the trend noticed in recent years, monetary developments have been characterized by shifting to long-term monetary assets. This tendency is illustrated by low annual growth of base money by about 9 percent. Reduced liquidity of monetary assets illustrates growth of confidence in the banking system and stabilization of inflationary expectations in the economy.

Monetary indicators reflected obvious volatility during the year, as a result of the seasonal element of the demand for money. Annual M3 growth has fluctuated between the minimum rate of 9.7 percent in June and maximum rate of 16.7 percent in December. The seasonality of the demand for monetary assets by the public sector contributes to M3 growth rate volatility. The private sector's demand for money, the main source of broad money growth, has been oriented to foreign currency. This tendency has turned out to relatively higher paces of M3 aggregate against M2 aggregate. The annual average growth of this aggregate resulted to about 7.6 percent<sup>3</sup>.

However, the increased demand for monetary assets at year-end has influenced both monetary

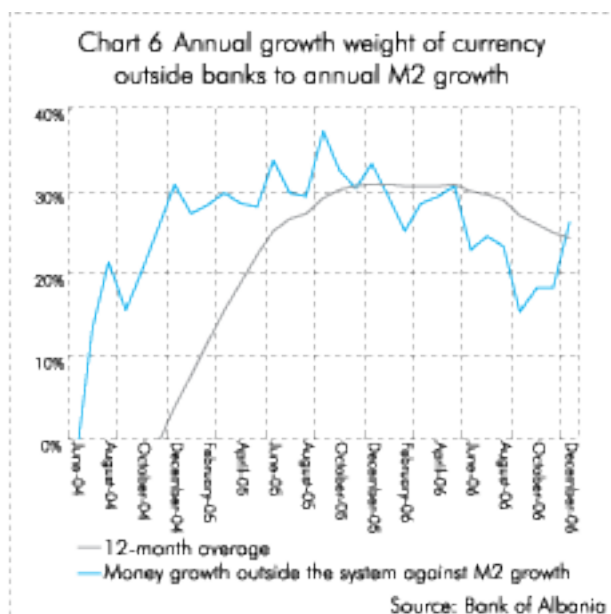
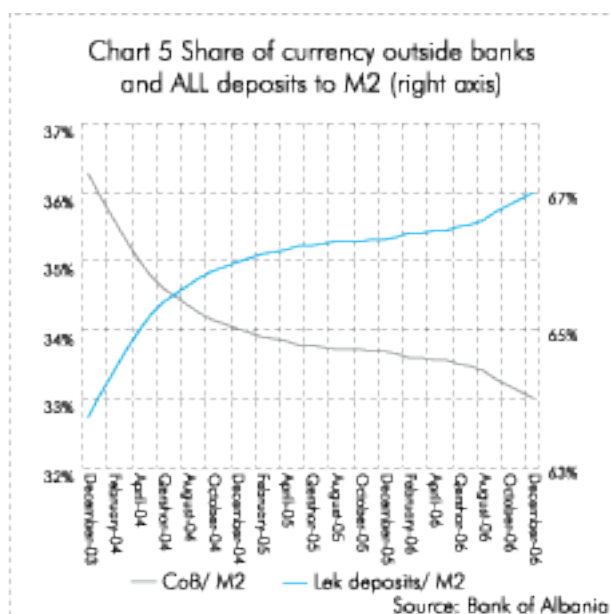


aggregates. The annual M3 and M2 growth, respectively by 16.7 and 12.1 percent in December resulted above the average annual rates.

Table 3 Monetary indicators performance

	Annual growth rate (in percent)				December -2006 level (in ALL billions)
	2003	2004	2005	2006	
M1	-5.2	19.4	31.7	8.7	248
M2	7.6	12.0	8.9	12.1	478
M3	7.6	13.1	14.0	16.7	674
Base money	-2.0	11.2	11.0	9.8	218

Source: Bank of Albania



### III.2.1 M3 TIME STRUCTURE DEVELOPMENTS

The time structure of ALL monetary supply has been shifted towards deposits. This tendency has been associated with reduced use of cash in the economy. The currency outside banks to M2 aggregate has declined by about 1 percentage point during 2006. In general, reduction of cash used in the economy enables the increase of financial intermediation and reduction of cost of money for financing the economic activity. The real ALL interest rate stability and the shifting of the demand for money structure towards credit to private sector favour the downward trend of the demand for liquid money. The time structure of total deposits has not undergone any obvious changes. The share of ALL and FX demand deposits to time deposits resulted to 43.6 percent against 43.3 percent in 2005.

#### • CURRENCY OUTSIDE BANKS

The performance of currency outside banks has followed the overall trend of the demand for money. Generally, macroeconomic factors of the demand side have influenced the performance of this indicator. On the supply side, money demand outside banks has been supplied through money market monetary operations. The return rate on money system injected in the market has resulted in compliance with the mid-term trend of M2 time structure shifting towards deposits. The share of currency outside banks to M2 dropped to 34.2 percent, from 35.1 percent it was in 2005. The share of currency outside banks to M3 recorded 24.2 percent at end of the year, or 1.7 percent less

than in the previous year. In nominal terms, currency outside banks increased by ALL 13.6 billion, or 9.1 percent.

Performance of currency outside banks has had an obvious seasonal character along the year. Concentration of budgetary and consumer expenditures over the last quarter of the year made the level of currency outside banks increase by about ALL 17 billion in this period.

- ALL-DENOMINATED DEPOSITS

The macroeconomic environment favoured the stable growth of banking system ALL deposits during 2006. The positive real interest rates were associated with further growth of ALL deposits. They grew by ALL 38.0 billion during 2006, satisfying the needs for ALL 35.9 billion of the economy and of the government for ALL credit. The maintaining of positive rates of deposits preserved the balance of the demand against the supply for money, whereas the real interest remained at steady rates above 2 percent.

The ALL-denominated money supply, M2 has been shifted easily to ALL deposits. The annual growth rate of ALL deposits resulted to 13.7 percent, whereas the M2 aggregate growth resulted to 12.1 percent. Also, the level of ALL demand deposits has been stabilized close to ALL 80 billion, whereas their ratio to ALL time deposits has recorded an annual decline of 2.8 percentage points, to 36.6 percent.

### III.2.2 DEVELOPMENTS IN FOREIGN CURRENCY STRUCTURE

Foreign currency constituent of money supply has recorded relatively high paces of annual growth. In 2006, foreign currency deposits grew by about 29.4 percent. The highest growth rate of foreign currency deposits against money supply growth rate has made the ratio of foreign currency deposits to M3 to about 29.1 percent<sup>4</sup>. Also, FX deposit share to total deposits increased to 38.5 percent, against 35.5 percent in 2005.

Foreign currency structure of money supply over the long run has been influenced by interest rate spread between ALL and FX monetary assets, either in banking system assets or liabilities. The creation of foreign currency money in the economy, as a

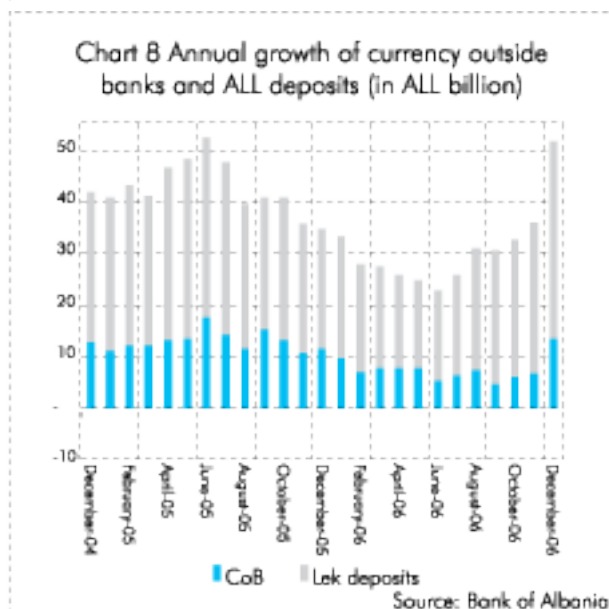
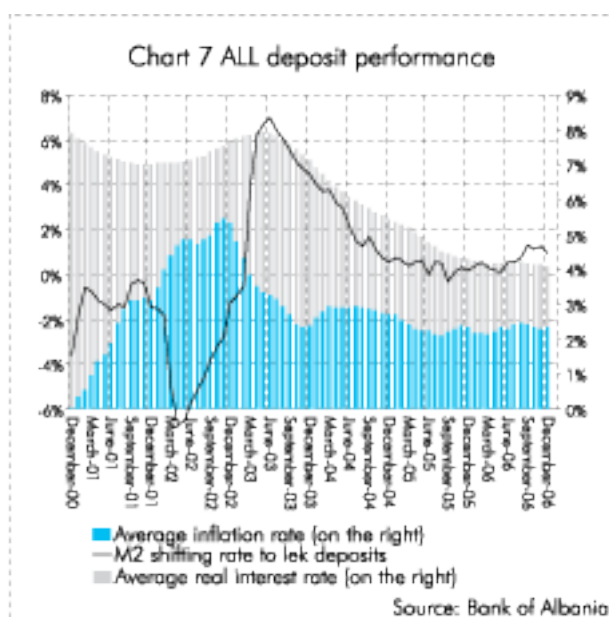
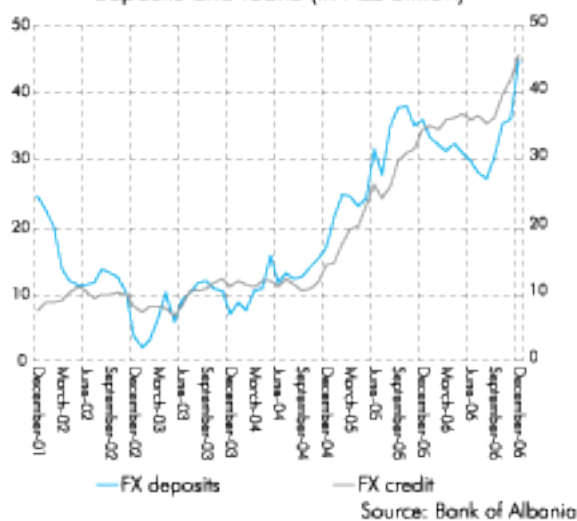




Chart 10 Annual growth of foreign currency deposits and loans (in ALL billion)



result of demand for credit, has been reflected in broad money supply side. However, FX deposit performance has been also favoured by FX inflows of the balance of payments account, mainly in the form of remittances, making the assessment of the balance of these factors difficult.

Time structure of FX deposits during this year indicates a faster growth of FX demand deposits by about 37.7 percent against the growth of 25 percent of time deposits. The tendency of FX demand deposit growth is observed in the performance of FX demand deposits to FX time deposits ratio. This ratio has increased to 56.4 percent against 51.2 percent in 2005.

Table 4 Monetary indicators

	December	Annual change	
	2006	In ALL billion	In percentage
Currency outside banks	163.3	13.6	9.1
Total deposits	511.0	82.7	19.3
- in ALL	314.5	38.0	13.7
- in foreign currency	196.5	44.7	29.4
Demand deposits	155.1	25.6	19.8
- in ALL	84.2	6.2	8.0
- in foreign currency	70.9	19.4	37.7
Time deposits	355.9	57.0	19.1
- in ALL	230.2	31.8	16.0
- in foreign currency	125.7	25.2	25.1
M3	674.3	96.3	16.7

Source: Bank of Albania

### Box 1. Dollarisation and monetary policy: implications for the price stability

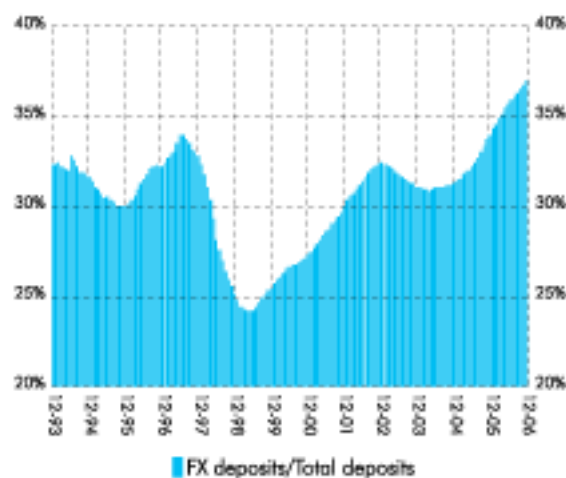
Dollarisation – the use of a foreign currency, mainly of the American dollar to an economy – may appear in some forms. Unilateral (de facto) dollarisation takes place when to an economy that has its own official currency in circulation, financial transactions and payments are taking place in foreign currency. There are three main forms of dollarisation: payments dollarisation (transactions taking place in foreign currency), financial dollarisation (holding residents' assets in foreign currency) and real dollarisation (indexing some prices or payments in foreign currency). In Albania, dollarisation has appeared in the three forms. House price index and in consequence, performance of transactions in foreign currency, and the presence of banking deposits and loans in foreign currency are evidences of dollarisation in the three forms. The Albanian economy has had financial dollarisation since 1992. Measured in the form of the ratio of deposits in foreign currency to total deposits, financial dollarisation has fluctuated mainly within the 25-35 percent range. However, in recent years this indicator has reflected an upward trend, recording about 39 percent in 2006.

Academic assessments converge to a common conclusion, that dollarisation in many economies has emerged as a protecting measure against inflation rate volatility and price level instability for the future, against smaller exchange rate volatility. Though price volatility risk is minimised over time, the economy may remain financially dollarised because of inertia. Also, economic openness of external and capital account tends to be associated with dollarisation of small economies. In general, a mutual link exists between monetary policy and dollarisation, due to interrelationship of exchange rate with inflation rate in the economy.

Various empirical studies suggest that unilaterally dollarised economies are faced with an additional challenge for designing monetary policy under inflation targeting regime. Unilateral dollarisation and high rate of exchange rate effect transmission to price level highlight the need for a consistent and controllable target by monetary policy, enabling price stability in economy. Adopting exchange rate as an intermediate objective of monetary policy has been a successful option in '80s. Development stage and low level of economic openness against actual paces, made fixed exchange rate an appropriate regime for maintaining price stability in that period. While in 1985 fixed exchange rate regime was the official monetary policy stance in almost half of advanced economies, in 2005 it was applied at about 5 percent of the countries. In developing countries, fixed exchange rate regime is applied to about half of the countries, though with a tendency to switch to other regimes against about  $\frac{3}{4}$  of them in '80s. Exchange rate regime success relates generally to low level of economic openness, particularly of capital account. This may explain why developing countries still find fixed exchange rate regime as suitable. Low economic openness level in developing countries enables advantages of this regime. Economy openness means transmitting external shocks to money demand, to inflation rate and to economy through exchange rate. Under other similar conditions, economic openness is associated with increased dollarisation (ze and Levy Yeyati, 2003). Due to such economic openness implications, fixed exchange rate regime becomes less steady in the presence of external shocks.

Economic openness has been associated with a tendency to switch from exchange rate regime, mainly to monetary targeting regime, upon gradual rise of financial dollarisation. However, upon rise of dollarisation, monetary targeting effectiveness becomes more difficult. Generally, financial dollarisation of an economy is associated with a less steady demand for money. The demand for money of an economy becomes more volatile due to shifting of monetary assets easily to foreign currency deposits and loans. These broad money elements are influenced at a different time lag by national currency components, while they are also under exchange rate effect. The exchange rate involvement in the link between monetary policy and broad money, changes the dynamics of monetary policy transmission mechanism. So, exchange rate appreciation or depreciation provides direct impacts, not only on import prices but also on money demand. In the presence of certain level of financial dollarisation, control on broad money, as an intermediate objective of monetary policy for achieving price stability, becomes more difficult.

Chart 1 Financial dollarisation in Albania



Source: Bank of Albania

Table 1 Dollarisation level in countries of the region

Country	Financial dollarisation* (in percentage)
Albania	36.6
Macedonia**	56.5
Turkey	28.3
Romania	32.0
Bulgaria	48.8
Serbia	72.1

\*Calculated as a ratio of FX deposits to total deposits of the banking system. The data of first half of 2006.

\*\* The data of 2005.

Source: "Southeastern Europe and Mediterranean emerging market economies bulletin", Vol. 7, Publication 3 NBG.

Switching to more flexible exchange rate regimes has been combined with implementation of new monetary policy strategies. Under the conditions of an increasing dollarisation, the demand for money has become more stable, encouraging switching to a more general monetary policy framework. Also, effective management of external shocks has increased the need for central bank independence and monetary policy transparency. The factorisation of these monetary policy elements has been formalised under a new regime, i.e., under inflation targeting. While the implementation of monetary targeting regime has been one of the tendencies of transition economies in '90s, inflation targeting regime has turned out to be a successful option for anchoring inflationary expectations in recent years. Implemented initially in '90s by the New Zealand, as a general framework of anchoring inflation expectations, inflation targeting regime has been consolidated into a genuine monetary policy regime. Formal adoption of inflation targeting regime is an open recognition of price stability target, against real macroeconomic objectives that are beyond monetary policy possibilities to influence.

The countries applying such a monetary policy strategy are numerous and institutional and operational aspects of the countries enjoy various characteristics. However, inflation targeting regime constitutes some criteria that condition its implementation. Main features consist in institutional commitment to price stability and public announcement of numeric inflation target, encompassing broad information in decision-making process, besides monetary aggregates and exchange rate, increase of central bank's responsibility and independence for achieving inflation targeting regime and for enhancing its transparency. Central bank's performance under this regime is measured by inflation rate performance against its specified target. Though many central banks have not implemented a formal inflation targeting regime, they practice a number of features similar to this regime, such as focus on inflation and central bank reliability, early assessment and response to inflationary pressures and enhancement of monetary policy transparency.

Inflation targeting regime is an option to challenges of economic openness dollarisation through large involvement of information in monetary policy decision-making and in anchoring inflationary expectations. Also, financial dollarisation requires prudential implementation of strict supervision regulations on the financial system, so as to ensure system stability and resistance to external shocks.

\* Official dollarisation occurs when a foreign currency is adopted to circulate as official currency in an economy. Dollarisation may take place at any moment of a consolidated economy, but this phenomenon is known with the generic term "dollarisation".



### III.3 DEMAND FOR MONEY

The expansion of the demand for money peaked in December, with an annual growth of 16.7 percent. Credit to the economy has provided the main contribution to money demand growth during the year. This contribution peaked in June, weakening in the coming months, due to increased volume of public borrowing. Foreign currency position has maintained a relatively constant share to monetary assets creation along the year (see Chart 1).

#### III.3.1 CREDIT TO THE ECONOMY

Banking system development and increased role of banks as financial mediators have brought about an obvious expansion of lending in recent years. Credit portfolio reached ALL 191.2 billion or 21.3 percent of GDP at end of 2006. Credit to economy portfolio constituted 31.3 percent of total banking system assets and about 37.4 percent of the banking system deposits. In absolute terms, credit to the economy increased by ALL 69.3 billion during 2006, compared to the increase of ALL 52 billion in the previous year. However, its annual growth rate declined during 2006, generally in all categories. This development reflects mostly the obvious expansion of its base during two latest years. Annual credit growth in 2006 was 56.7 percent, being supportive to economy needs.

Table 5 Performance of main money demand indicators

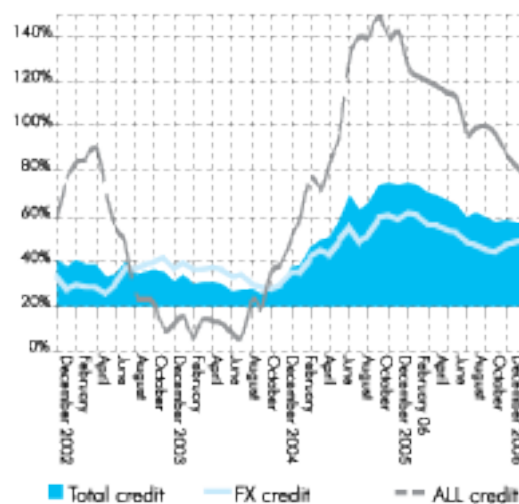
	2003	2004	2005	Q1 '06	Q2 '06	Q3 '06	Q4 '06
Money supply (in billions of ALL)	448.4	507.2	578.0	580.4	594.5	627.0	674.3
Domestic credit (in % to M3)	71.5	68.9	70.0	70.1	71.0	69.8	71.8
- Credit to government (in % to M3)	60.2	55.1	48.9	46.9	45.3	43.4	43.4
- Credit to economy (in % to M3)	11.3	13.8	21.1	23.2	25.7	26.4	28.4
Credit to economy (in % to total assets)	13.7	16.9	25.1	26.4	28.7	29.8	31.3
Credit to economy (in % to GDP)	6.8	8.4	14.6	15.9	17.7	18.7	21.3
Credit/deposit ratio (in %)	15.7	19.0	28.5	30.4	33.7	34.5	37.4
Annual credit growth (in %)	31.1	38.1	74.3	68.6	59.4	56.3	56.8

Source: Bank of Albania

During 2006 the banking system extended ALL 157 billion credit, or 32 percent more than in the previous year. Credit acceleration was based on lengthening of credit maturities (an increasing orientation towards medium-term and long-term loans) and maintaining high levels of new credits. Under the pressure of competition, banks were more aggressive in lending, using new credit market segments, such as consumer credit or real estate loans.

During two last years, commercial banks have better satisfied the increasing demand for ALL credit. At end of 2006, ALL credit constituted 29 percent of credit portfolio, recording a moderate expansion of its share.

Chart 11 Credit performance by currencies

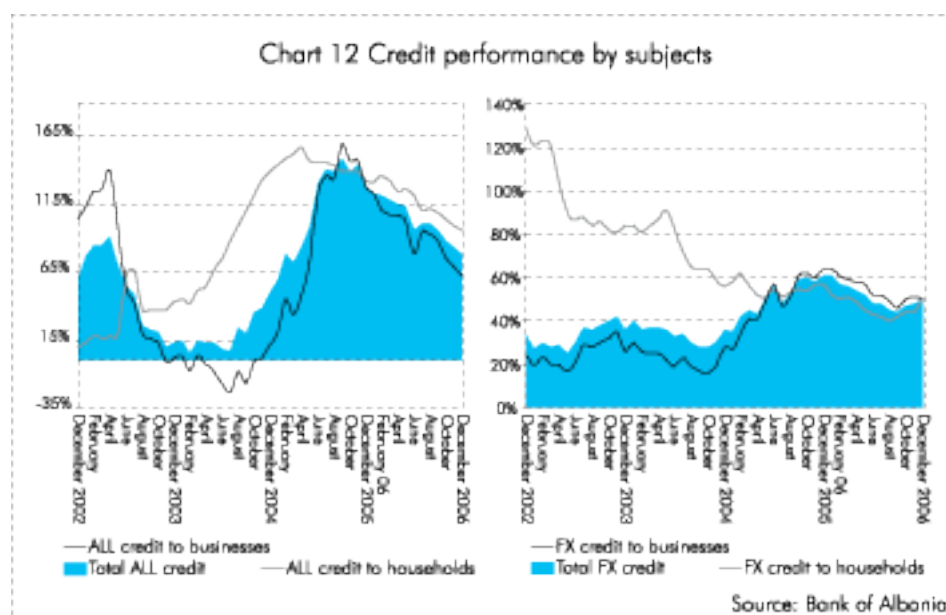


Source: Bank of Albania

However, the growth rates of ALL credit declined during 2006, dropping to 78.2 percent, from 127 percent recorded in the previous year. In spite of rapid ALL credit growth, banks' portfolio continues to be dominated by foreign currency credit. During two last years, foreign currency credit structure has tended towards increasing the share of loans denominated in euro compared to those in USD. As of December, credit in euro constituted 82 percent of total credit in foreign currency.

#### • CREDIT BY SUBJECTS

Credit to businesses constitutes the main part of banks' portfolio, accounting for 66.5 percent of the total at end of 2006. In annual terms, credit to businesses increased by 52 percent. The distribution structure of this credit by usage has tended to become more uniform compared to the previous year. The major part of credit to businesses (34.5 percent) has been used for purchasing machinery and equipment. Financing business investments in expanding areas for carrying out an activity has had a better performance out of credit to businesses. This credit constituted 23.2 percent of credit to business portfolio at end of 2006.



Credit to households amounted to 7 percent of GDP in 2006, or 33.5 percent of total loans portfolio. Annual growth rate of credit to households recorded 68 percent, standing at lowest levels in three latest years. More than half of credit to households (59.3 percent) has been extended for financing real estate purchases. Banks have expanded lending to households for financing consumer goods purchases. The ratio of consumer credit to total household portfolio is 27.3 percent, from 20 percent in the previous year. Particularly consumer credit has increased obviously over the period of summer holidays and end-year celebrations. Banks' commitment to satisfy household demand for credit and particularly to finance consumer goods purchases has encouraged ALL credit growth.

## Box 2. Lending to households

Lending to households is growing rapidly in Albania. Annual growth rate of this credit is significantly higher than that extended to businesses. Factors contributing to this growth are low inflation and interest rates, higher income levels, higher asset prices (more specifically house prices), financial system liberalization and greater banks' orientation towards retail banking. Given that these factors will continue to influence lending performance even in the future, consumer credit is expected to maintain high growth paces.

Regardless of positive performance of credit to households in Albania, it is still at low levels compared to countries with advanced financial markets and countries of the region. Total credit to households in Albania accounts for 33 percent of loans portfolio and annual growth rate records 67.7 percent at year-end 2006. As a share of GDP, credit to households reached 7.2 percent, from 4.6 percent in the previous year. Most of this credit by 59.3 % constitutes real estate loans extended mainly in foreign currency.

In Euro area, credit to households accounts for 44 percent of GDP and reflects an annual growth rate of 8.2 percent, whereas in the countries of the region credit to households records about 9 percent of GDP. However, when we compare these ratios among countries, we should take into account that developments in individuals' debt are also conditioned by other factors of taxation system, lending terms, percentage of population owning a house, etc..

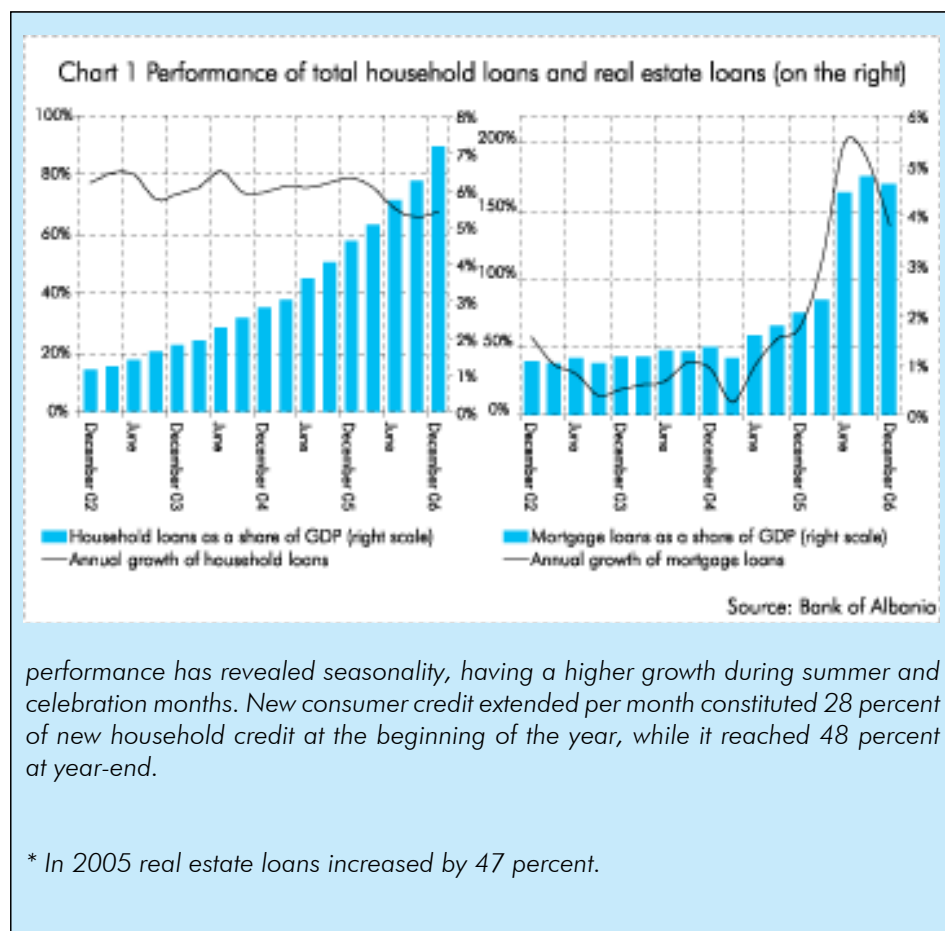
Table 1. Indicators of credit to households (in percentage)

Country	Household loans		Real estate loans	
	to GDP	Annual growth	to GDP	Annual growth
Albania	7.2	67.7	4.6	140
Bulgaria	16.1	37.1	5.8	68.4
Romania	10.6	90.2	2.1	54.7
Macedonia	8.8	35.9	1.5	40
Serbia	8.7	85.7	--	--
Turkey	11.7	74.7	3.9	250.5
Eurozone	44	8.2	37	9.5

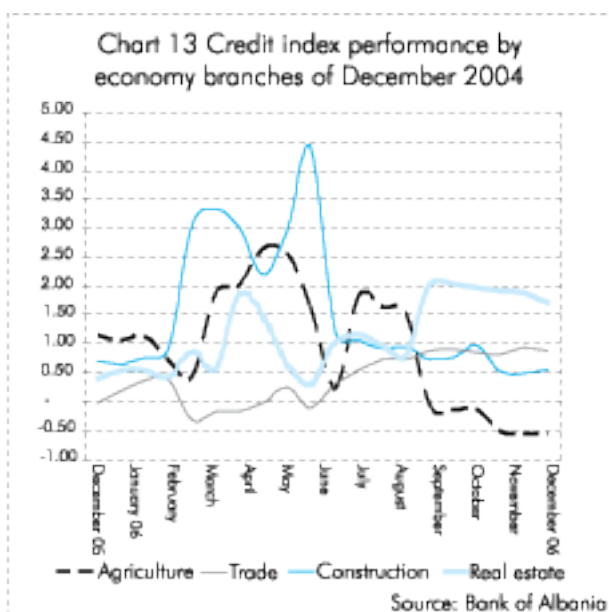
Source: Economic bulletin- National Bank of Greece, September 2006; Monthly Report of ECB, January 2007; Bank of Albania.

During recent years real estate credit has increased substantially to high levels\*. In 2006, this credit constituted about 24 percent of the banking system portfolio and an annual growth by 59 percent. Currently, the housing loan level stands at 4 percent of the country's GDP or 96 euros credit per citizen. The last indicator approximates to the level of countries aspiring EU accession, but it is far from the levels of EU member states that entered EU some years ago or from advanced Western European economies.

Year 2006 demonstrated expansion to household credit in ALL, encouraged by significant rise of consumer credit. In the meantime, consumer credit at end of 2006 accounts for 27.6 percent of total credit to households, from 20 percent in the previous year. Compared to total credit, consumer credit has doubled its weight to 10 percent within the year. However, positive performance of consumer credit to loans portfolio has appeared somewhat limited, due to its short-term nature. Also, consumer credit



#### • CREDIT BY ECONOMY SECTORS



Credit for real estate purchases underwent the highest growth in 2006. It constituted 24.6 percent of credit portfolio at end of the year. However, trade remains the most credited sector by the banking system. Credit to this sector constitutes 22.4 percent of credit portfolio.

Credit to construction sector has reflected growth rate constraint during 2006. This sector presented temporary upswing during summer, then turned back to downswing. In the meantime, low volume of lending to agriculture indicates constant structural problems that impede credit to this sector. The solution of these problems would release a part of financial potential of the economy towards this important sector of the country's economic development.<sup>5</sup>

Table 6 Outstanding credit by economy branches (in percentage to total credit)

		2002	2003	2004	Q4-05	Q1-06	Q2-06	Q3-06	Q4-06
1	Agriculture, hunting and silviculture	0.8	1	1.5	2.7	2.2	0.9	0.7	0.7
2	Fishery	0.2	0	0.1	0.1	0.1	0.1	0.1	0.1
3	Extractive industry	0.2	1	0.3	0.5	1.4	2.3	1.0	1.0
4	Process industry	17.0	17	17.1	13.8	14.2	15.3	15.5	14.3
5	Electricity, gas and water production and distribution	3.3	3	2.8	2.6	2.4	1.1	1.2	1.5
6	Construction	8.6	10	9.8	13.0	13.0	12.2	12.6	12.6
7	Trade, automobile and home appliance repairing	40.4	34	23.3	18.9	19.0	22.5	23.1	22.4
8	Hotels and restaurants	6.0	6	8.3	4.3	4.8	4.1	3.9	3.5
9	Transport and telecommunication	2.4	1	2.0	1.48	1.3	1.6	1.6	2.0
10	Financial activities	-	0	0.2	0.8	0.7	1.3	0.8	2.1
11	Real estates	9.1	13	9.8	14.2	14.6	25.5	25.7	24.6
12	Health and social activities	0.5	0	0.5	0.6	0.6	0.6	0.3	0.0
13	Social, personal and collective services	4.2	8	4.8	5.8	4.6	1.7	2.0	0.6
14	Consumer credit				4.5	4.9	6.1	7.7	9.1
15	Others	7.3	4	19.3	16.7	16.2	4.6	3.8	5.5
	Total	100	100	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bank of Albania

#### • CREDIT BY GEOGRAPHIC DISTRIBUTION

It is noticed out of the geographic distribution of credit that 68 percent of the portfolio is focused on Tirana. Outside it, only coastal cities of Durrës and Vlora extend a significant part of credit, respectively by 8 and 4 percent of loans portfolio, with the other districts extending the remaining part. Concentration of credit to Tirana district has been influenced by higher presence of customers (businesses and households) in this district, as compared to other districts. Year 2006 demonstrated the same geographic distribution throughout all the quarters.<sup>6</sup>

	March	June	September	December
Tirana	64.3	68.0	67.8	67.5
Durrës	9.0	7.8	7.7	7.6
Elbasan	4.4	3.6	3.2	3.2
Shkodër	4.0	2.4	2.5	2.5
Korcë	2.3	2.3	2.4	2.3
Vlorë	3.7	3.4	3.5	4.0
Lushnjë	2.1	1.3	1.3	1.2
Gjirokastër	0.7	1.4	1.4	1.3
Fier	3.3	3.6	3.5	3.9
Other	6.2	6.2	6.7	6.5

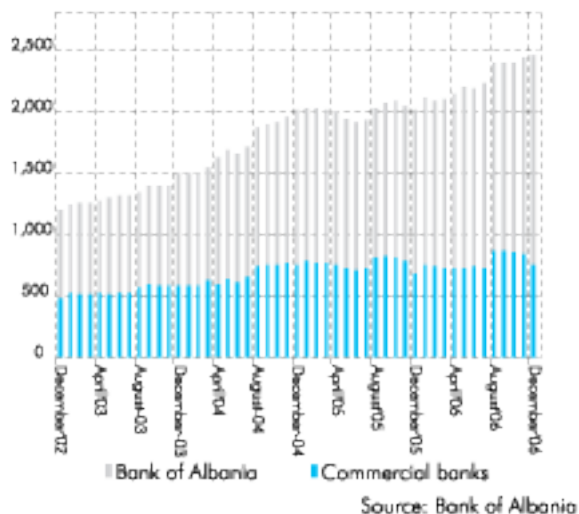
Source: Bank of Albania

Table 7 Geographic distribution of credit by main districts (in percentage)

### III.3.2 NET FOREIGN ASSETS

Banking system foreign currency position improved over 2006. Net foreign currency assets of the banking system amounted to usd 2.4 billion at end of this year, recording an annual growth of about usd 440 million. About 84 percent of this growth is attributed to accumulation of Bank of Albania net foreign exchange reserve. Avoiding exchange rate effect, the growth of these assets is estimated at about usd 302 million.

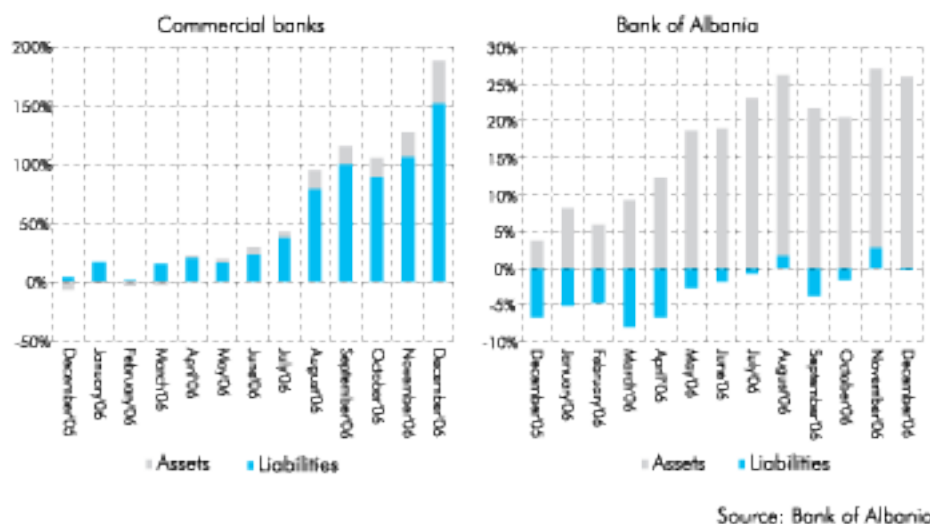
Chart 14 Banking system net foreign assets (in usd millions)



Bank of Albania's net foreign exchange reserve has been constantly increasing during 2006, recording the level of usd 1.69 billion, or usd 371 million more than in the previous year. Out of this growth, about usd 138 million are accumulated from Bank of Albania's foreign exchange interventions. These interventions have intended to fulfil the quantitative target for these assets and to smooth the fluctuations under peak periods of foreign currency supply. About usd 114 million are due to exchange rate effect, appreciation by 8.9 percent of the euro against the dollar during 2006. The rest of growth is due to inflows from foreign disbursements.

At end of 2006 net foreign assets of commercial banks recorded usd 762 million, or usd 67 million more than in the previous year. Developments in these assets reinforce the idea of a seasonality also noticed in the preceding years. The strongest growth of foreign assets takes place during the third quarter of the year, when usually there is a significant growth of foreign currency deposits. So, only in August of this year, net foreign assets grew by USD 145.4 million. Foreign currency credit had a positive performance during 2006, often surpassing FX deposit growth and reducing net foreign assets.

Chart 15 Annual growth of banking system foreign assets and liabilities



During 2006 a rapid growth was noticed in foreign currency liabilities of commercial banks. These liabilities were mainly in the form of loans from non-residents and demand deposits of foreign banks.

American dollar occupied the major part in foreign assets structure of commercial banks during 2006, by about 50 percent. Banks denominated in



dollar most of securities of non-residents and most of time deposits at foreign banks. Cash in hand and loans extended to non-residents are mostly in euro. On the other hand, about 70 percent of foreign liabilities were denominated in euro, mostly composed of loans extended by foreign banks.

### III.3.3 GOVERNMENT DEMAND FOR MONEY

Government account underwent an unusual performance during 2006. While in the preceding years the government had increased constantly the net financing, this year the demand was negative for the major part of it, with its total concentration over two last months. The fiscal data of government required that the level of domestic financing for 2006 reached ALL 22.8 billion. Until end of October this financing was negative, while in December the gross financing resulted to about ALL 22.6 billion.

During 2006, the government improved its debt structure, extending its schedule, and issuing foreign currency debt for the first time. This policy has intended to enhance flexibility in borrowing and reduce debt cost in the long run. The government debt has been oriented towards long-term maturities, highlighting reduced issuing of treasury bills and shifting to two-, three-, and five-year bonds. The latter ones were presented for the first time in November of this year. In December the government issued for the first time treasury bills in foreign currency, of 9-month period.

The government has presented an increasing demand for liquidity, though under the conditions of a positive fiscal balance over most of the year.<sup>7</sup> The government demand for money has been mostly covered by commercial banks, mainly through purchasing government bonds, and partly it is covered by privatization<sup>8</sup> and foreign financing. During 2006, the two-, three-, and five-year bonds portfolio has increased respectively by 20.9, 9.96 and ALL 6.36 billion. In the meantime, the treasury bill portfolio decreased by ALL 23 billion. About 90 percent of this decrease is due to commercial banks' Treasury bill portfolio reduction. In the meantime, foreign currency treasury bill issue accounted for ALL 2.6 billion.

Under the conditions of budget surplus, until November, the government invested its excess liquidity in the form of reverse repos for commercial banks. Meanwhile, the remaining part passed to government deposits with the Bank of Albania.

Chart 16 Gross domestic financing of Government (All million)

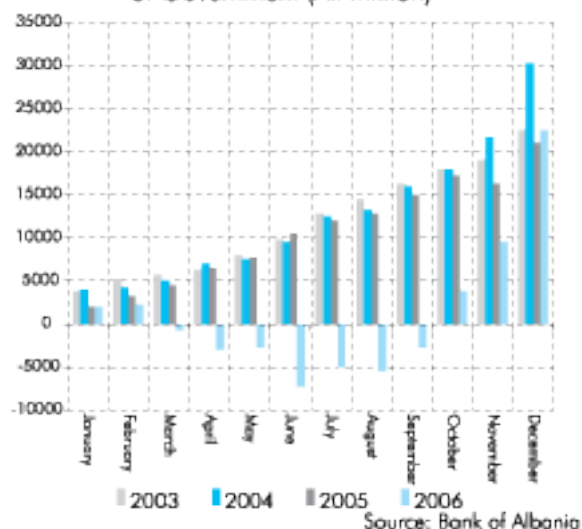
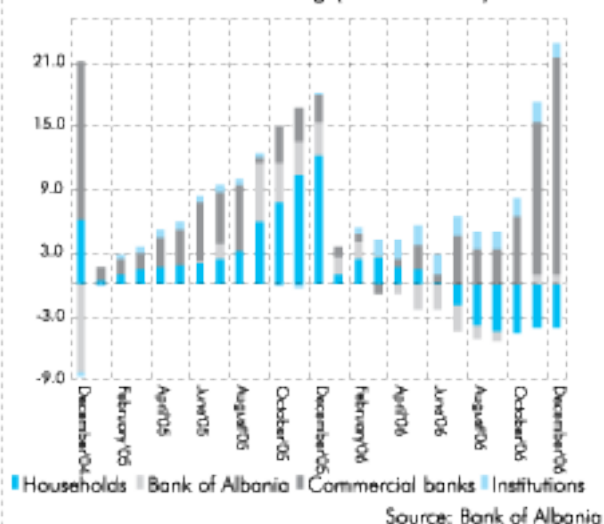


Chart 17 Cumulative performance of government's domestic financing (in ALL billion)



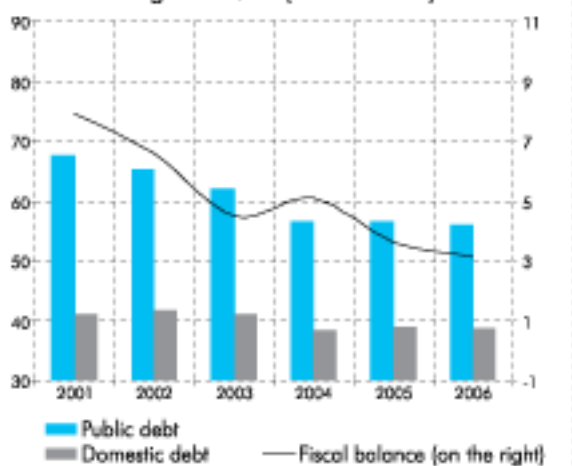
### Box 3. Public debt characteristics and macroeconomic implications

Nowadays many governments are presented as permanent borrowers, repaying old debts by new borrowing. Such a situation is normal as long as the debt level to GDP is not high<sup>9</sup>. Government debt structure may influence on monetary conditions of a country. Substantial changes in size, structure and composition of government debt instruments may influence on financial stability. So, with the purpose to maintain monetary conditions and financial stability, it is important to monitor the structure, characteristics and risk level in debt portfolio.

#### • PUBLIC DEBT SIZE

Fiscal discipline is regarded as a precondition for maintaining price stability, particularly for developing economies and those in transition. In these countries, frequently governments are based on creating money to cover their expenditures, since receiving debt in financial markets is not easy. Such an action has inflationary consequences. However, in our country, monetary and fiscal policies have been on the same line for strengthening macroeconomic stability. During five last years fiscal deficit has been constantly declining, along with public debt level to GDP. Compared to convergence criteria, the current budget deficit level is close to its maximum limit of 3 percent to GDP, whereas public debt is below the limit of 60 percent to GDP for three consecutive years.

Chart 1 Public debt, domestic debt and budget deficit \* (in % to GDP)

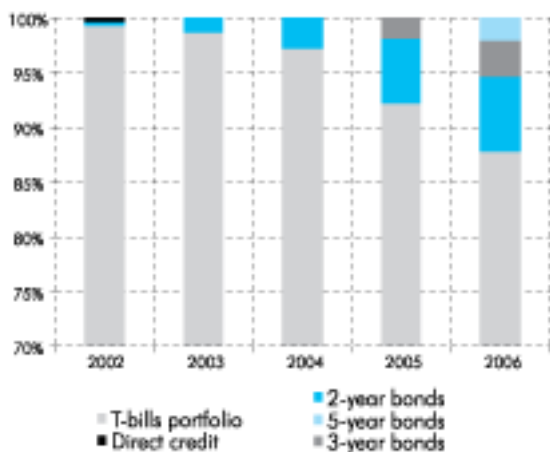


\*Budget deficit is presented with a positive sign in the chart  
Source: IMF

#### • PUBLIC DEBT COMPOSITION

Until September 2002, domestic Albanian government debt was expressed in the form of tradable securities (treasury bills) of short-term maturities, i.e., of 3, 6 and 12 months. In the meantime, during 2002 - 2006, the government raised its debt maturity, by issuing longer-term instruments, with the purpose to enhance flexibility of the borrowing and reduce volatility of debt service cost. At end of 2002 debt structure was extended by a new instrument, 2-year government bonds. Further on, important changes in this structure have to do with the issuing of 3-year bonds in 2005, 5-year bonds and foreign currency debt in 2006.

Chart 2 Gross government domestic debt portfolio



Source: Bank of Albania

Launching into the market new debt instruments constitutes a positive development, since it brings about a number of benefits, either for the issuer or for the development of financial markets. Through these instruments, the government ensures stable financing sources, preventing lack of liquidity for the public debt. At the same time, these instruments allow a better debt management. More possibilities are given to investors for holding their savings. In most cases these instruments are an essential part of collaterals in financial markets. Also, the interest rates of long-term government debt instruments lengthen the yield time curve, serving as a benchmark for long-term interest rates, such as loans.

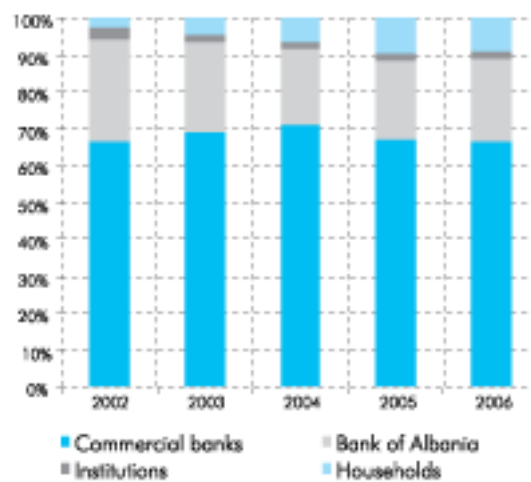


- **PUBLIC DEBT HOLDERS (PRIMARY MARKET)**

Government debt purchase by the private sector is regarded as a less damaging manner of government financing. The literature suggests that government debt purchase by commercial banks may reduce banks' supply for credit to private sector, whereas government debt purchase by central bank raises inflationary pressures.

The Albanian government debt investors' basis remains limited. Commercial banks are its main holders, being direct participants to purchasing treasury bills and government bonds. The Bank of Albania keeps a part of the government debt (Treasury bill) accumulated mainly in '90s, when Treasury bill market was limited. Individuals and institutions take part only in purchasing treasury bills.

Chart 3 Portfolio of gross domestic government debt holders



Source: Bank of Albania

### III. 4 FINANCIAL MARKET AND INTEREST RATES

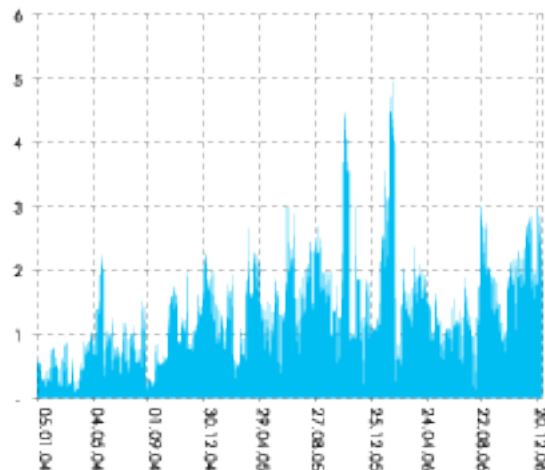
Year 2006 was characterized by increased activity in money and capital market and by reduced interest rates. The latter ones have been generally oriented by the Bank of Albania's monetary policy. Under the conditions of liquidity excess, the interest rates underwent a downward trend during the first half of the year. After the signal of monetary stance tightening over the second half of the year, the interest rates started to increase.

- **MONEY MARKET**

Interbank market was more active during 2006, ensuring a more effective way for managing excess liquidity of banks. The average daily volume of transactions reached the figure of ALL 1.6 billion, or ALL 0.2 billion more than the previous year average. The increased trade volume is mainly due to increased volume of weekly transactions, while the overnight loan has remained almost at the same levels of 2005, by ALL 0.7 billion.

Notwithstanding the interbank market developments during 2006, it still remains far from the parameters of a developed competitive market. So, transactions in this market continue to be of short-term, overnight and seven-day maturity. As such, they enable only the meeting of short-term needs for liquidity and oblige banks to use the restructuring of their balance or the borrowing from the Bank of Albania, as a means to satisfy

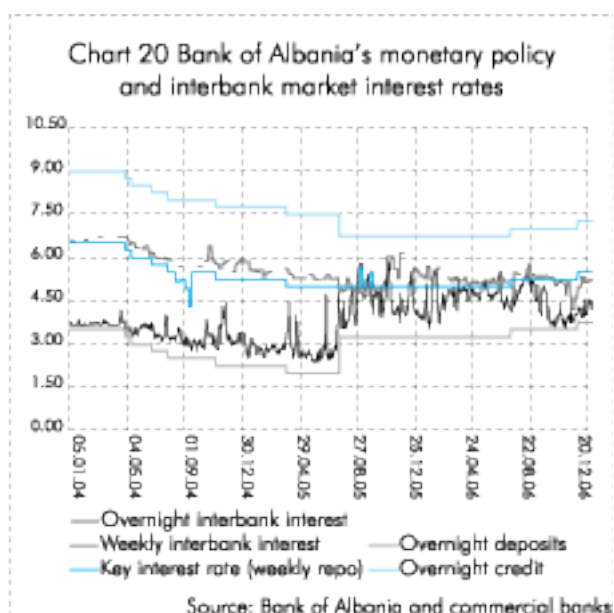
Chart 19 Borrowing in interbank market (ALL billion)



Source: Bank of Albania

the long-term needs. Also, trade volume and commercial banks' position are conditioned by trading limits the banks have with each other, which are specified on the basis of assessed credit risk.

Interbank market was characterized by spread narrowing between interest rates according to maturities and their position close to key interest rate. The average spread between overnight and weekly interests dropped to 0.7 percentage points in 2006, from 1.6 percentage points in 2005. Along with market stability, this inclination was influenced also by the change in the corridor of the stand-by facilities of the Bank of Albania, from an asymmetric corridor into a narrower symmetric one<sup>10</sup>. At end of 2006, interest rates reached to 4.52 percent for overnight transactions and 5.24 percent for weekly transactions, compared to 4.13 percent and 5.43 percent respectively at end of 2005.



Due to high growth of lending in ALL and growth of government's borrowing, liquidity needs had a long-term nature during the second half of 2006. They were fulfilled by reverse repurchase agreements of the Bank of Albania, while the inter-bank market has had sufficient liquidity to satisfy short-term needs, influencing on the respective interest rate cut in this market.

Over the first half of 2006, government bonds and Treasury bill yields decreased constantly, due to low demand of government for financing. Over the second half of 2006, after the tightening signals of the Bank of Albania and the growth of the demand for liquidity in the system, these yields underwent a gradual rise. At end of 2006, they reached to 6.45 percent for 3-month maturity, 7.10 percent for 6-month maturity and 7.89 percent for 12-month maturity. Compared to the previous year, the yields have increased respectively by 0.83, 0.45 and 0.98 percentage points.

Table 8 Interbank market and primary market interest rates (in percentage)

	December-04	December-05	June-06	December-06
Key interest rate	5.25	5.00	5.00	5.50
Overnight interbank market	3.26	4.10	4.21	4.52
Weekly trade market	5.90	5.6	5.15	5.24
Primary market				
3-month treasury bill yield	6.09	5.41	5.23	6.45
6-month treasury bill yield	7.22	6.73	5.42	7.10
12-month treasury bill yield	8.11	6.91	5.74	7.89
Bonds market				
2-year bond yield	9.00	8.00	6.38	8.40
3-year bond yield			7.50	8.80
5-year bond yield				9.68

Source: Bank of Albania and commercial banks

- CAPITAL MARKET

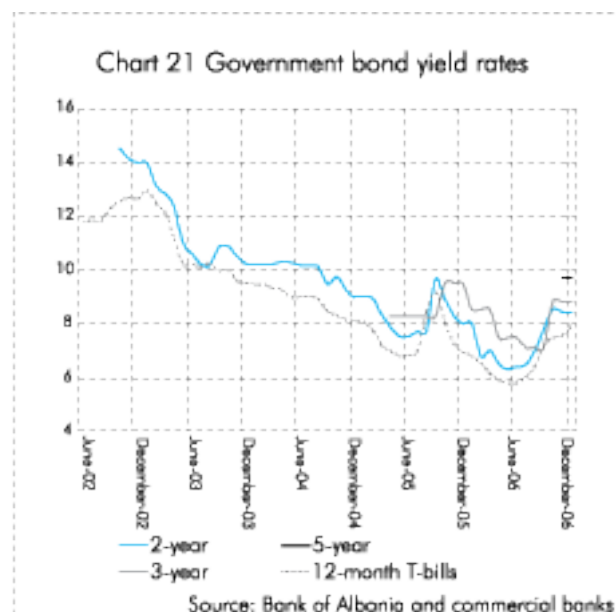
Capital market is limited to investing the Government's long-term securities, which started to be issued in 2002. Their increased volume has ensured an extension in the time structure of Government financing and has brought about their increased share to investors' portfolio. Government bonds issues have increased compared to the previous year, making the portfolio of banks, the only participants in this market, increase by ALL 37.0 billion. The share of bonds to total securities of the government increased to 22 percent in 2006, from 12 percent in the previous year. Their maturity structure varies from two to five years. Five-year bonds were first issued in November of this year for the amount of ALL 6.3 billion. The demand for them resulted higher than the issued amount.

Notwithstanding the increased activity and competition in primary market, the secondary government security market remains relatively underdeveloped. Buying-selling operations in the interbank market are limited, though they have increased compared to the previous year. Year 2006 enumerates 44 transactions (the volume of ALL 5.6 billion) in Treasury bill trading, from 36 transactions (the volume of ALL 4.2 billion) in 2005. For bonds trading, the number of transactions has gone up from two (for the amount of ALL 80 million) to three (for the amount of ALL 600 million).

In December 2006, two-year government bonds reached to 8.40 percent, from 8.00 percent they were in the previous year. Three-year bond interests dropped to 8.90 percent, from 9.50 percent at end of the previous year-end.

- DEPOSIT AND LOAN INTEREST RATES

ALL deposit market was characterized by decreased interest rates over the first half of 2006 and by their growth after the tightening monetary policy signals. Growth rates of ALL deposit interest rates were lower than the growth rates of primary market interest rate rise. Interest rates increased faster for long-term maturities, reflecting the adjustment of their time duration to the increased long-term government debt.<sup>11</sup>



	December-04	December-05	June -06	December-06
Key interest rates	5.25	5.00	5.00	5.50
ALL deposits				
1-month deposits	3.39	3.35	3.11	3.35
3-month deposits	4.48	4.07	3.74	3.94
6-month deposits	5.41	4.77	4.35	4.64
12-month deposits	5.99	5.57	5.05	5.46
24-month deposits	6.98	6.82	5.90	5.88
36-month deposits		6.49	5.94	6.42
ALL loans				

Table 9 ALL deposit and loan interest rates (in percentage)

Loans of up to 6 month	10.98	12.90	11.28	12.18
Loans of 6 months – 1 year	13.73	12.16	11.80	11.16
Loans of 1-3 years	20.42	18.07	15.89	17.61
Loans above 3 years	12.89	12.23	11.42	12.20
Weighted average interest rate	13.71	13.50	12.55	12.92

Source: Bank of Albania and commercial banks

ALL loan interest rates decreased for all the maturities during 2006. Weighted average interest rate of December 2006 dropped to 12.92 percent, from 13.50 percent it was in the previous year. The largest loan interest rate cut, compared to that of ALL deposits, brought about reduced intermediation cost<sup>12</sup>, from 8.13 percent in December 2005 to 7.54 percent in December 2006 for 6-month maturity and from 6.59 percent to 5.70 percent for 12-month maturity. Regardless of the reduced intermediation cost compared to the previous year, the spread level remains still relatively high. It is influenced by non-complete competition in this market and by high risk nature of loans extended in ALL.

Table 10 Interest rates in FX deposit market (in percentage)

	December-04	December-05	December-06
In American dollars			
Key interest rate of FED	2.25	4.25	5.25
1-month deposits	1.48	2.36	3.03
3-month deposits	1.69	2.81	3.44
6-month deposits	1.88	2.99	3.87
12-month deposits	2.27	3.56	4.29
24-month deposits	2.65	4.15	4.86
In Euro			
Key interest rate of the ECB	2.00	2.25	3.50
1-month deposits	1.65	1.82	2.54
3-month deposits	1.75	2.01	2.91
6-month deposits	1.78	2.20	3.29
12-month deposits	1.97	2.49	3.45
24-month deposits	2.31	3.27	4.16

Source: Bank of Albania and commercial banks

Interest rates in dollar and in euro of the foreign currency deposit market continued their upward trend, due to monetary policy tightening by the Fed and the ECB in 2006. At the same time, interest rates of loans extended in these currencies have also been raised. The largest interest rate rise has been in loans of 6 months to one year maturity in euro, and in loans of up to 6 months in dollar. At end of 2006, the weighted average interests of loans in dollar reached to 9.42 percent and interests of loans in euro reached to 8.17 percent from 8.47 percent and 7.95 percent they were respectively at end of the previous year.

Table 11 Interest rates of FX lending market (in percentage)

	December-04	December-05	December-06
In American dollar			
6-month loans	7.47	7.92	9.76
6 month – 1 year loans	7.71	8.92	9.11
1-3 year loans	8.22	8.23	10.0
Loans of above 3 years	8.52	8.97	9.06

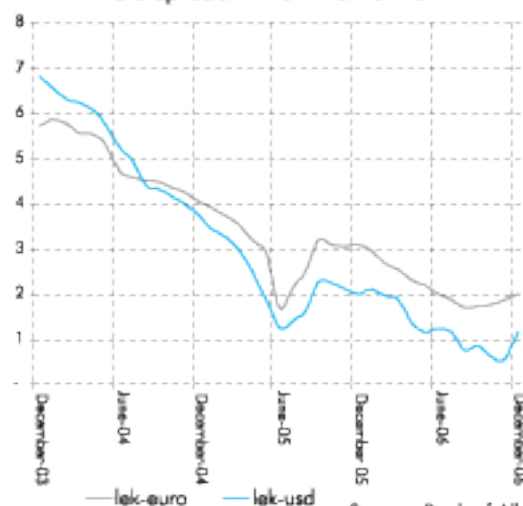
Weighted average interest	7.79	8.47	9.42
In Euro			
6-month loans	7.57	8.07	7.63
6 month – 1 year loans	8.07	7.31	8.45
1-3 year loans	9.02	8.28	8.45
Loans of above 3 years	8.25	8.22	8.34
Weighted average interest	8.17	7.95	8.17

Source: Bank of Albania and commercial banks

Interest rate cut in ALL deposits on the one hand and interest rate rise of foreign currency deposits on the other, have led to spread narrowing between ALL deposit interest rates and those in FX, which in some cases reached the lowest historical levels.

However, after a long downward period, this spread started to grow, upon rise of ALL deposit interest rates. At end of the year, it reached to 1.17 percentage point for the dollar and 2.01 percentage points for the euro (of 12-month maturities).

Chart 22 12-month ALL – FX deposit interest rate spread in nominal terms



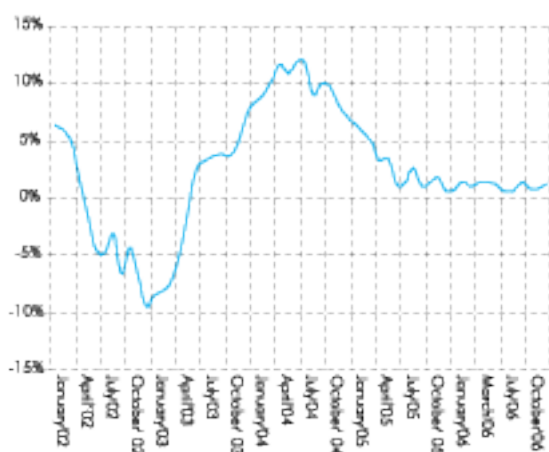
Source: Bank of Albania

#### Box 4. Interbank market interest rate

Euribor (Euro Interbank Offered Rate), Libor (London Interbank Offered Rate), Tibor (Tokyo Interbank Offered Rate), etc., are terms investors refer to when having to do with interbank market interest rate level for the euro, dollar, yen, etc.. Recently an increasing investment of central banks of advanced economies in publishing interbank market interest rates of money has been noticed<sup>13</sup>. This fact is related to central banks' goal to encourage participation in interbank money market, with the purpose to extend and expand this market. This influences the establishment of advanced and efficient interbank money markets, making this market a better transmitter of monetary policy.

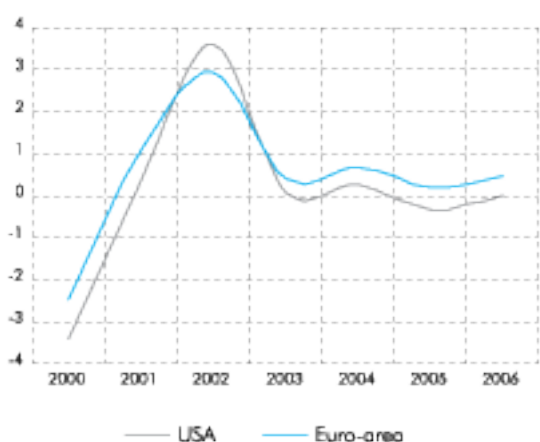
In recent years the Bank of Albania has intensified the efforts for creating a more developed and efficient financial structure, aiming at harmonising the financial markets with the Euro area standard. In this framework, and given the legal right of the Bank of Albania to encourage and support financial market, for the first time in 07.02.2007 the Bank of Albania disclosed fixed interest rates in interbank money market, TRIBID (Tirana Interbank Bid Rate)<sup>14</sup> and TRIBOR (Tirana Interbank Offer Rate)<sup>15</sup>. Calculation and publication of fixed interbank market interest rates aims at encouraging further the activity of commercial banks in the interbank money market. This is expected to contribute to efficiency of banking system liquidity circulation, to setting the price of this liquidity, to well-functioning and development of this financial market, serving to better transmit the Bank of Albania's monetary policy. These rates may also serve for referring, assessing, statistical and accounting purposes.

Calculation and publication of these rates takes place daily for 1-week, 1-month, 3-month, 6-month and 12-month transactions. More concretely, calculation is done from 12.30 o'clock to 13.00 o'clock and is disclosed immediately at Bank of Albania's website: [www.bankofalbania.org](http://www.bankofalbania.org) and at its REUTERS site, using the code TRIBOR. Interest rates - TRIBID and TRIBOR – in compliance with international practices are calculated as a simple average of selected banks' quotations. However, given that the number of banks may change daily depending on banks' activity in interbank market, there are specified such methods of calculation that avoid more extreme quotations. The applied methods are so that fixed interest rates of interbank market are better approximates to rates applied by active banks in this market.

Chart 23 Annual NEER change<sup>14</sup>

Source: Bank of Albania

Chart 24 Differences in inflation of the lek, usd and the Euro (in percentage points)



Source: Bank of Albania

### III.5 EXCHANGE RATE

The Lek maintained the appreciating trend against the principal foreign currencies during 2006. However, the ALL exchange rate developments have confirmed the slowdown of its appreciating trend against the principal foreign currencies. In annual nominal effective exchange rates, the lek appreciated on average by 1.1 percent during 2006. This appreciation was 2.8 percent in the previous year.

Performance of key economic factors has given a shape to the lek's exchange rate behaviour in the long run. Macroeconomic conditions have ensured an appropriate environment for maintaining appreciating positions of the lek over five last years. During this period, the Albanian economy has undergone steady growth rates in an environment of low inflation rates. Economic theory and experience show that low inflation currencies tend to appreciate against high inflation currencies. Over four last years, the differences in inflation between our currency and the euro and the dollar have been narrow, around zero. Also, high economic growth rates associate with appreciation of the currency, to the extent that this economic growth improves the competitive position of the country and is reflected in structural changes of price ratio of tradable and non-tradable goods.

The ALL-foreign currency interest rate spread, though downward during three last years, has continued to be in positive levels, supporting the lek's positions. The world central banks have been characterized by a



tightening monetary policy during 2006. Even the Bank of Albania has been part of this development, mitigating the downward trend of the lek-foreign currency interest rates.

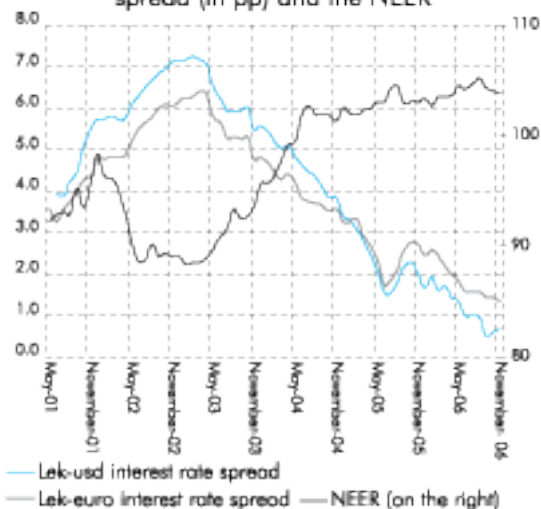
On the other hand, the upward trade deficit has encouraged a higher demand for foreign currency. This effect has been balanced by steady foreign currency inflows, mainly in the form of private transfers, making the balance of payments turn out positive. However, the long-term perspective of the balance of payments and of the exchange rate will be significantly influenced by the ensuring of stable foreign currency assets in the economy, in the form of revenues from exports and direct foreign investments.

Economic developments during 2006 have supported a strong national currency. Appreciating pressures of the lek have been concentrated mainly on July-August and December. Besides the seasonal foreign currency inflow, which is the main factor of the lek's appreciation over this period, the increased key interest rate by the Bank of Albania has also been reflected in the market. High foreign currency supply in this period has been partly absorbed by Bank of Albania interventions, aiming at meeting the net international reserve target and mitigating foreign exchange market volatility. The Bank of Albania purchases in foreign exchange market were about usd 138 million during 2006.

The depreciation of the dollar against the euro in the international foreign exchange market continued to favour the appreciating trends of the lek against the dollar during 2006. On the other hand, the lek was more stable against the euro, with a slight depreciating trend. In the international market, the Usd/Euro exchange rate closed the year at 1.32 against 1.18 traded at the beginning of 2006. In our market, the American dollar depreciated by 9.25 percent against the lek, while the euro closed the year about 0.9 percent higher than its opening.

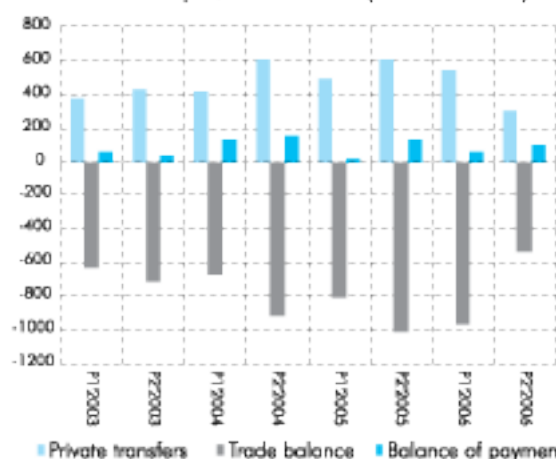
In general, the lek presented a lower volatility against two main currencies during 2006, complying with the downward trend observed over years. The lek's stability is attributed to improved foreign exchange market and positive developments in a number of macroeconomic factors.

Chart 25 Time deposit interest rate spread (in pp) and the NEER



Source: Bank of Albania

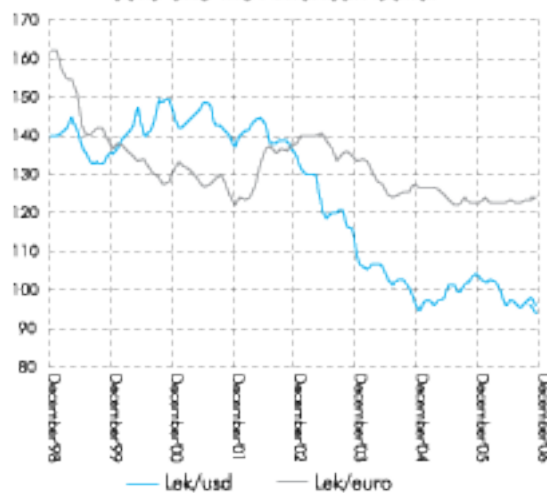
Chart 26 Performance of balance of payments, trade balance and private transfers (in usd million)\*



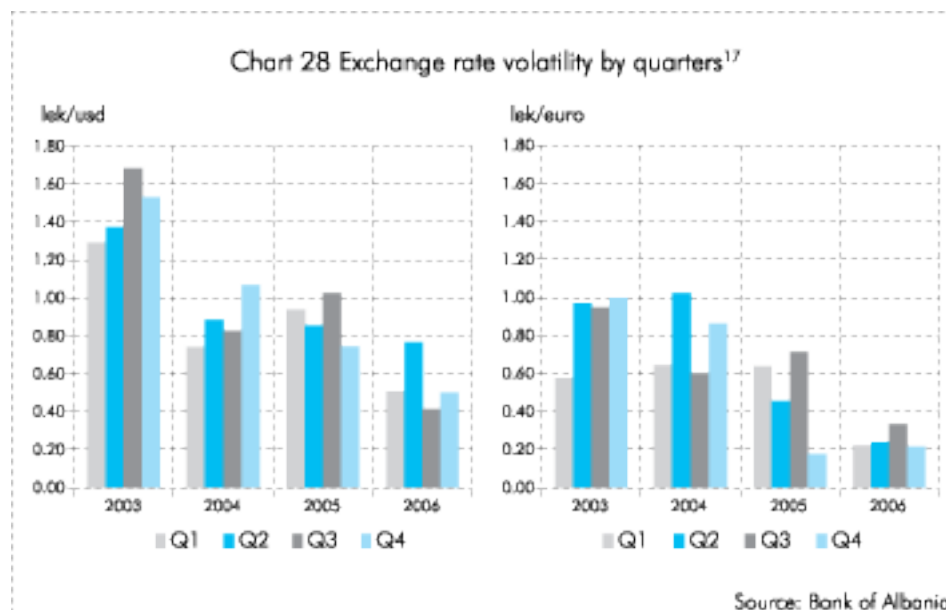
Source: Bank of Albania

\*The second part of 2006 includes only third quarter data

Chart 27 The lek's performance against the euro and the American dollar



Source: Bank of Albania



Also during this year, a shifting tendency of foreign exchange activity towards the banking system has been noticed in foreign exchange market. The volume of foreign currency traded against the lek by the banking system increased by 36 percent in 2006. This indicates increased importance of the banking system as partner in foreign exchange market transactions. This development has been encouraged and supported by the Bank of Albania through improved institutional relations with commercial banks. On the other hand, the increased number of banks and their branches has driven a higher competition to the banking system, which has been reflected in narrowing the spread between foreign currency buying and selling price they apply, a signal of increased efficiency of the banking foreign exchange market.

### III.6 MONETARY POLICY INSTRUMENTS

- REPURCHASE (REPO) AND REVERSE REPURCHASE AGREEMENTS (R/REPO)

As in the previous years, the repurchase agreement of fixed-price, one-week maturity was the main instrument used in 2006. Under the conditions of liquidity excess of the banking system during first ten months of the year, the Bank of Albania withdrew ALL 3.21 billion on average daily, through repurchase agreement of one week maturity. To minimize pressures for cutting interest rates under the conditions of high excess liquidity during the first half of the year, the Bank of Albania intervened in the money market also through repurchase agreements of a longer maturity than a week. Repurchase agreement of one-month maturity was used in three cases, withdrawing on average ALL 0.95 billion from the banking system. A broader use took place for repurchase agreement of three-month maturity, through which during February-August 2006, on average ALL 3.1 billion was withdrawn.



The seasonal growth of the demand for money during the summer and the concentration of the government demand on the second half of the year reduced the banking system liquidity, making necessary the injection of banking system liquidity during the last quarter of 2006. The Bank of Albania injected liquidity through reverse repurchase agreement of one-week, one-month and three-month maturity. The banking system preferred longer-term borrowing, using the reverse repurchase agreement of one-week maturity only in thrice, at the amount of ALL 0.93 billion. Along with intervention with weekly reverse repurchase agreements during two last months of 2006, the Bank of Albania injected on average ALL 4.20 billion a day through quarterly reverse repurchase agreements. In one case, reverse repurchase agreement of one-month maturity was also applied at the amount of ALL 1.00 billion.

- **OUTRIGHTS**

Four outright transactions, purchasing treasury bills at the nominal value of ALL 3.2 billion were carried out to meet longer-term liquidity needs of the market during 4 last months of 2006.

- **OVERNIGHT DEPOSIT**

To invest free liquidities, commercial banks employed overnight deposit instrument of the Bank of Albania. Investment in this instrument averaged ALL 1.58 billion, or ALL 0.82 billion more than in 2005. During 2006 a rise was noticed in non-invested liquidity level (free reserves) and in liquidity invested in shorter-term instrument - overnight deposit.

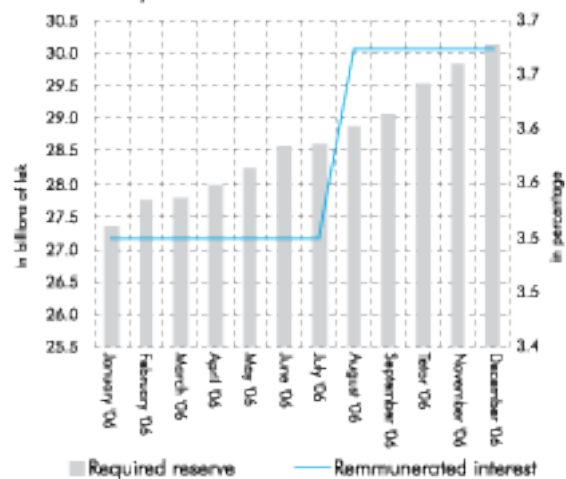
- **OVERNIGHT AND LOMBARD LOANS**

Better development and functioning of interbank market during 2006 reinforced the central bank's role as lender of last resort. Overnight loan was used only seven times during 2006. Notwithstanding the lack of liquidity over the third quarter of the year, its injection through this instrument was on average ALL 4.58 million a day, compared to ALL 23.96 million in 2005. For the fourth consecutive year, the final lending instrument of the Bank of Albania, i.e., Lombard Loan was not employed.

- **REQUIRED RESERVE**

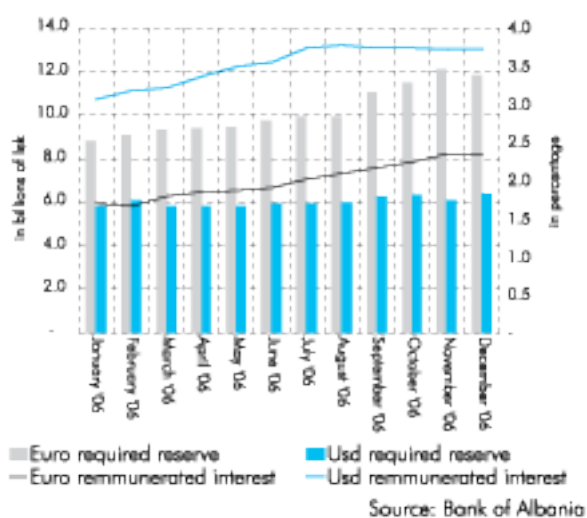
Required reserve instrument was constantly used even during 2006 for withdrawing banking system liquidity. The monthly growth rate of the required reserve in ALL during 2006 was on average higher than in 2005, 0.92 percent against 0.76 percent, reflecting the rise in respective categories included in required reserve calculation. ALL remuneration rate of required reserve reflected the key interest rate rise of the Bank of Albania in July, remaining constant in the rest of the year. At end of the year this rate was 3.68 percent in comparison with the respective value of 3.50 percent in the previous year.

Chart 29 ALL required reserve of the banking system and remuneration rate



Source: Bank of Albania

Chart 30 Foreign currency required reserve of the banking system and the remuneration rate



During 2006 banks used on average about 12.85 percent of the maximum permitted level (20 percent) of the required reserve for satisfying their daily liquidity needs, a figure close to that of the previous year. The limited use of this facility is due to the tendency of a limited number of banks of the system to maintain high position of free reserves. The account position is well-managed by banks of the system, reducing cases of required reserve non-fulfilment to minimum.

Upward trend of the required reserve in euro re-confirmed the depositors' preference for this currency, while the required reserve in dollar converted into the national currency remained almost constant throughout the year, likewise in 2005. Foreign required reserve remuneration rate reflected rise of libor and euribor interest rates. Euro

required reserve remuneration rate underwent the highest rise, being increased by 0.69 percentage point compared to year-end 2005, thus amounting to 2.36 percent level, whereas Usd required reserve remuneration rate rose by 0.55 percentage point, amounting to 3.72 percent level.

### III. 7 FOREIGN RESERVE MANAGEMENT

During 2006 gross foreign reserve, appraised and reported in usd has increased by usd 368.06 million, recording at end of December the value of usd 1,793.12 million. The factors that have positively influenced on gross reserve growth are:

- Inflow from loans extended by the International Monetary Fund, International Development Agency, etc., at usd 120.93 million;
- Foreign currency purchases by commercial banks, Ministry of Finance and other institutions at usd 204.79 million:
  - usd 138.53 million (banking system),
  - usd 63.7 million (Ministry of Finance),
  - usd 2.56 million (other institutions);
- Amounts deposited by commercial banks at the Bank of Albania for satisfying the required reserve or other operations related to their capital, usd 75.39 million;
- Incomes from foreign reserve investment as of end of December to about usd 45.5 million;
- Exchange rate volatility of currencies composing the foreign reserve has significantly influenced the gross reserve value, recording a positive effect of about usd 106.03 million in 2006.

Outflows, amounting to usd 214.73 million, have given reverse impact on gross reserve. They are represented by transfers carried out by an order from

the Ministry of Finance, from other commercial banks (totalling about \$135.86 million) and from external debt settlements for the Albanian Government (USD 67.65 million) or from settlement of Bank of Albania's dues to the IMF (USD 11.22 million).

#### *Box 5. Developments in RAMP program*

*Further to the agreement signed with the World Bank in September 2005, during 2006 the Bank of Albania continued to be assisted by the World Bank in its activity for foreign reserve management.*

*Fundamental restructuring of the regulatory basis that relates to foreign exchange reserve management constitutes one of the main developments for 2006. In the essence of this restructuring stands the delegation of competences from the Supervisory Council to Investment Committee and Monetary Operations Department. The Supervisory Council adopts the overall criteria of foreign exchange reserve management, stating clearly objectives and limitations that will accompany the process in compliance with long-term, mid-term and short-term needs for liquidity, as specified in the Law on the Bank of Albania and other essential documents. On the basis of these criteria, other structures develop and ensure the use of proper methodologies for specifying the benchmarks, designing the procedures, selecting the financial institutions or carrying out any other activity needed for foreign exchange reserve management. Hierarchical division of responsibilities has made the process of foreign exchange reserve management very flexible and close to best accepted international standards in this area, both in the aspect of achieving return objectives and in risk accompanying investment.*

## NOTES

<sup>1</sup> The measuring of monetary indicators for the effect of drafting the program is based on "Monetary statistics" standard, which changes slightly from International Financial Statistics standard. Though changes in these standards are subject to standardization of data with other countries, they do not constitute any fundamental change for the effect of monetary policy compilation and implementation.

<sup>2</sup> Annual growth rate is calculated as a twelve-month average of the annual growth of this indicator.

<sup>3</sup> M2 aggregate is composed of currency outside banks and deposits in ALL, whereas M3 includes M2 and deposits in foreign currency.

<sup>4</sup> Data on monetary developments are reported according to "International Financial Statistics" standard. Compared to "Monetary Statistics" standard, figures may present slight changes.

<sup>5</sup> Significant reduction of credit to agriculture after June 2006 is attributed to portfolio review of one of the system banks.

<sup>6</sup> Obvious deviations during the second quarter are mainly due to introduction of the form for the first time by the districts.

<sup>7</sup> Government borrowing under budget surplus has resulted to increasing the government's liquidity excess.

<sup>8</sup> The privatization of the state's share of the Italian-Albanian Bank.

<sup>9</sup> According to Maastricht criteria, annual budget deficit to GDP should not exceed 3 percent. Gross government debt rate to GDP should not exceed 60 percent.

<sup>10</sup> This corridor was changed in July 2005, from an asymmetric corridor (+2.50/-3.00 percentage points) around the key interest rate, to a symmetric corridor (+1.75/-1.75 percentage point).

<sup>11</sup> At the same time ALL deposit interests of 24 month-maturity are raised, but this indicator, calculated as a weighted average for the whole banking system results lower than in June, due to time structuring of deposits by a bank.

<sup>12</sup> Intermediation cost is calculated as a difference between credit and deposit interest rates for the same currency.

<sup>13</sup> "Interbank money market" is the market where commercial banks carry out lending and borrowing operations among themselves, in the national currency, i.e., in lek.

<sup>14</sup> Fixed interest rate calculated on the basis of reference banks' quotations to accept deposits in interbank money market.

<sup>15</sup> Fixed interest rate calculated on the basis of reference banks' quotations to put deposits at interbank money market.

<sup>16</sup> NEER – nominal effective exchange rate calculated against both currencies according to an approximate weight they occupy in external trade, euro (80 percent) and usd (20 percent). Since April 2004, NEER has been above the level of 100. A rise in the NEER will be translated into the lek's appreciation.

<sup>17</sup> Calculated as a quarterly average of exchange rate volatility. Exchange rate volatility is measured as a standard deviation  $\sqrt{\sum (x_i - \bar{x})^2 / (n - 1)}$ ,  $x_i$  – exchange rate for the period  $i$ ,  $\bar{x}$  – average of the period  $i$  (for example, exchange rate of a certain day of the year  $i$  minus average rate of the month of the year  $i$ ).

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## CHAPTER IV BANKING SUPERVISION

### IV.1 BANKING SYSTEM PERFORMANCE

The banking system went on its stable development also during 2006. Its financial position is assessed as satisfactory, with a good and steady performance of the profitability indicators; with a capital adequacy above the minimum level defined by the Bank of Albania but also with a slight downward trend, as a reflection of its consolidation; with an increased depth of banking intermediation, reflected in the increase of the loans portfolio ratio to total banking assets and in the increase of the overall ratio of total banking assets to GDP; with a continuous expansion of bank' network and with the entry of new banks in the market; with an increased number of new banking products, such as ATMs and e-banking, and with their increased use<sup>1</sup> as an expression of the increased volume of the overall banking activity; as well as with a satisfactory liquidity situation, where the Bank of Albania has played an active role in providing facilities for enabling the banking system liquidity management.

The net result of the banking system for 2006 turned out with a profit of about ALL 7.45 billion, about 12.9 percent more than in 2005. For 2006, this figure is 0.83 percent of GDP, compared to 0.79 percent it was in the previous year.

	December '04	December '05	December '06
Net result	5.11	6.60	7.45

Source: Bank of Albania

Table 1 Net result (in ALL billion)

Revenues from the main activities, which are represented by net interest income, resulted to 31.2 percent more than in the previous year, reflecting the banking system orientation to activities of higher return<sup>2</sup> (and higher risk level); change in the maturity structure of higher risk assets<sup>3</sup>; and increased volume of overall assets, under the conditions when the increased key rate for the three principal currencies of the balance sheet (lek, euro, usd), is generally reflected with a higher growth rate for assets, compared to liabilities.

Positive developments in net interest income indicator were also reflected in the performance of net interest margin (NIM), which increased by about 0.5 percent. Rise of return on average interest-earning assets (that bring about income) and cost reduction of financing the average interest-earning assets, have contributed almost at the same extent to the NIM performance. We deem that the reduction of the second component of NIM indicator, when the key interest rate for the main currencies has increased, is due to reduced share of deposits to total



liabilities, to 83.3 percent (from 87.2 percent), and the significant contribution of costless liabilities<sup>4</sup>, as for instance, the paid-up capital.

Table 2 Net interest margin  
(in percentage)

	December '04	December '05	December '06
Interest income / average income earning assets (1)	6.96	6.81	7.05
Interest expenses/ average income-earning assets (2)	3.88	3.08	2.83
Net interest margin [(1) – (2)]	3.08	3.73	4.22

Source: Bank of Albania

At end of 2006 the net interest income was 92.6 percent of gross banking system income<sup>5</sup>, compared to 84 percent at end of 2005. This indicator has recorded a constant growth, particularly over three latest years, expressing the overall net income sustainability for the banking system.

The performance of the main profitability indicators, respectively return on average assets (RoAA) and return on average equity (RoAE) was fairly good also for 2006.

Table 3 Profitability  
indicators (in percentage)

	December '04	December '05	December '06
RoAA	1.28	1.40	1.36
RoAE	21.10	22.24	20.17

Source: Bank of Albania

The banking system recorded a slight reduction in the return on average assets (RoAA) and return on average equity (RoAE). However, the reverse side of movement of RoAA and RoAE against the NIM speaks for the upward impact given by increased activity expenditures and provisions on net income of the banking system. We deem that developments in activity expenditures and provisions generally indicate growth in the banking system activity and improvement of intermediation.

Reduction of the RoAA by 0.04 percent is explained by the higher growth rate of average assets (16.7 percent) to net income. Also for the RoAE, the fastest growth of the RoAE to net income constitutes the basis of reduction of this indicator. The entry of new banks into the market, which during the initial stage of their activity contribute more to growth of assets of the system and less to its financial result, influenced on the performance of these indicators. Under other unchangeable conditions, these indicators would perform better, which is proved also in the concrete case.

Also, the relatively high levels of the return on equity have not evidenced any probably forecasting for distributing the shareholders' earning. On the contrary, incomes have served as a good support of banks for further extension of their activity.

The large banks (peer group 3) provided the main contribution to the growth of assets of the banking system even during the previous year, though

their share in the market is falling. The estimates show that the concentration level for lending activities is lower (here the competition is higher), compared to the concentration level for assets and deposits.

	2001	2002	2003	2004	2005	2006
H index (assets)	0.37	0.32	0.30	0.27	0.21	0.18
H index (liabilities)	0.43	0.37	0.35	0.31	0.24	0.20
H index (credit)	0.20	0.17	0.15	0.11	0.10	0.11

Source: Bank of Albania

Table 4 H (Herfindahl) index of asset and deposit concentration

During 2006, banking system assets grew by ALL 127.7 billion (or 25.7 percent), about ALL 57.6 billion more than the growth of assets evidenced in 2005. Along with large banks, some small- and medium-sized banks also contributed to the extension of the balance sheet of the system.

Table 5 Performance of total assets by years

	December '00	December '01	December '02	December '03	December '04	December '05	December '06
Total assets (ALL billion)	270.8	318.5	339.3	373.6	426.4	496.6	624.3
Total assets /GDP	50.2	53.5	51.6	50.2	51.9	59.3	69.4
Total credit /GDP <sup>6</sup>	5.3	4.7	5.9	6.8	8.5	15.3	22.0

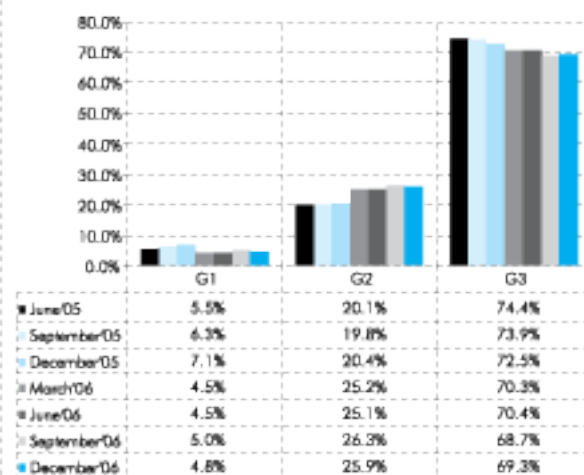
Source: Bank of Albania

Outstanding credit of the banking system<sup>7</sup>, during 2006, grew by ALL 70.2 billion or 55 percent, from ALL 57.6 billion over the previous year. In the meantime, outstanding credit in ALL has increased by ALL 24.4 billion or 78.2 percent, whereas outstanding credit in foreign currency has increased by ALL 45.7 billion or 47.4 percent. The upward performance of lending speaks for the high economy demand for financing and the ever increasing possibilities of the banking system for satisfying this demand.

The considerable extension in lending has been associated with increased size of non-performing loans, by about ALL 3.1 billion or 103 percent compared to end of 2005. At end of the year, the loans portfolio indicator, expressed as a ratio of non-performing loans to total gross loans portfolio is estimated at 3.1 percent, compared to 2.3 percent at end of 2005.

The banking system ability to cover loss loans with capital<sup>8</sup> declined, but is still at good levels. This indicator has been influenced by higher growth rate of net non-performing loans<sup>9</sup> (+120 percent) against the regulatory capital growth (+41.2 percent). The indicator "non-performing loans to net

Chart 1 Share of peer groups by total of assets



Source: Bank of Albania

outstanding credit, which estimates the net amount of exposure to credit risk, continues to be estimated at low levels, by 1.4 percent at end of 2006.

Capital adequacy ratio of the system at end of 2006 recorded the level of 18.1 percent, or about 0.5 percentage point lower than at end of 2005. This slight reduction of this ratio is attributed to comparable growth rates of its components. Concretely, the regulatory capital of the system has increased by about 41 percent, whereas the total of assets and off-balance sheet items, weighted by risk coefficients, has increased by about 45 percent. Capital adequacy ratio for 2006 continued to maintain the downward trend reflected in the preceding years. The value of this indicator for individual banks at end of December 2006 varies from 12.4 percent to 166.1 percent. During the year, its minimum required value of 12 percent has been infringed temporarily only in two cases. Large banks recorded a rise of capital adequacy indicator, mainly as a result of increased regulatory capital at end of the year, by about 62.3 percent.

Capital adequacy indicator continues to reflect higher levels in (G1 peer group) small banks by about 41.3 percent, followed by (G2 peer group) medium banks and (G3 peer group) large banks, respectively by about 15.9 percent and 16 percent.

Banks of G1 peer group, reflected a significant growth of capital adequacy ratio by about 6 percentage points, due to decrease in assets and in off-balance sheet items, weighted with the risk coefficient by about 6.9 percent, while the regulatory capital increased by about 10.7 percent. At the same time, the change the composition of small banks underwent during the first quarter of 2006 is considered as the main cause for the rise in their adequacy indicator.

Table 6 Capital adequacy  
(in percentage)

	Banking system	G1	G2	G3
December 2006	18.1	41.3	15.9	16
December 2005	18.6	35.0	19.4	14.4
December 2004	21.6	47.3	17.8	17.3

Source: Bank of Albania

At end of 2006, the ratio of liquid assets to total assets of the banking system, recorded the value of 57.6 percent, compared to 62.6 percent at end of 2005. Banks in general continue to record satisfactory liquidity levels, whereas the banking system is presented with excess liquidity. Based on operational data, the system banks have been more active in the market compared to 2005, which has been reflected in the growth by 7 percent of the average volume of international monthly transactions.

Also, deposits with the banks, which constitute the main weight of the assets of the system, have had an upward trend during 2006. The prudent monetary policy of the Bank of Albania on maintaining under control inflation and real rate of return in ALL, increasing interest rate of deposits in usd and euro, and

expanding the network of the banks of the system, has contributed to deposit stability in the system.

Also, liquidity dynamics is estimated as normal for 2006. The Bank of Albania has managed the liquidity situation in inter-bank market by means of combining the operational open market instruments, such as repo and reverse repo agreements and outright purchases. Banks have also used overnight loan and overnight deposit facilities for satisfying their daily needs for liquidity.

## IV.2 LICENSING AND THE REGULATORY FRAMEWORK

At end of 2006, the Albanian Parliament passed the new law "On the Banks in the Republic of Albania", which shall regulate the activity of banks and foreign bank branches operating in the country. The law was a product of the experience of multi-year developments in the Albanian banking system and of the coordination with best European experiences. The law has provided more details on bank licensing requirements and foreign bank branches, on banks transparency with the public, best standards on banking management accountability, conservatorship and receivership process, authorised accounting experts, the needs for capital, consolidated supervision, etc., aiming at meeting the financial stability target.

The preparation of this law and other regulatory assets represented an important development in banking supervision during 2006.

Based on best standards for an effective supervision specified by the Basel Committee, the work for enriching and improving the regulatory supervisory framework went on during 2006. In this framework, a new regulation was adopted and some other existing ones were amended.

Concretely, the Regulation "On using information technology at entities licensed by the Bank of Albania" was drafted and approved. Its purpose is to specify some basic criteria to be implemented by BoA licensed entities for minimizing risk deriving from inappropriateness or malfunctioning of information and technology systems. These requirements are envisaged to be flexible for the level of development itself and for the rather rapid change in this area.

The following regulations and guidelines were changed and amended:

- a) The Regulation "On supervising the Savings and Loans Associations and their Unions". The change specifies accurately the elements of computing capital adequacy ratio;
- b) The Regulation "On management of banks and foreign bank branches". The change allows the members of audit committee of banks to be at the same time members of its governing board. So, a better integration of information on the bank and increased accountability of the leading structures in its management and control, are aimed at;

- c) The Guideline "On regulatory capital of banks", was amended with the requirements for a more complete verification of the resources of bank shareholders, offered in the form of subordinate debt;
- d) The Regulation "On granting a licence to conduct banking business in the Republic of Albania". The change creates possibilities for the bank to require the preliminary consent of the Bank of Albania and to fill in the documentation pursuant to this regulation, in case of changing the indirect shareholder;
- e) The Regulation "On credit risk management": The change was aimed at adding the number of requirements for a better management of developments in the credit area by the banking system and for maintaining its quality. The main changes include: specifying accurately the need for improving the system of bank analysis, for the loans portfolios according to their characteristics, with the purpose to monitor the developments of these portfolios in real time. New requirements relate to:
  - i) banks' transparency with their borrowers, motivated by practice, with the purpose to protect customers on the one hand and the bank on the other, as well as to improve the way of conducting the market competition;
  - ii) Specification of some requirements related to the operations to be undertaken by bank management, with the purpose to better manage credit risk and preserve the quality of its portfolio. The requirements ensure at the same time, the necessary flexibility in carrying out the activity, as well as offer necessary elements for a fast decision-making in terms of maintaining credit quality; Amendments relate to
    - a) collateral in the borrowing process, intending loans security and;
    - (b) definitions of maintaining credit classifications, to carry out this process in a documented and prudential way.

#### LICENSING

During 2006, the banking system underwent important qualitative and quantitative developments. At year-end, the Albanian banking sector was composed of 17 banks, out of which 3 were of fully national private capital.

The Union Bank started its activity at the beginning of 2006. In February, the preliminary consent for a licence was given to the First Investment Bank. Jnt. Stk., (under the process of its transformation from a branch into a subsidiary of the First Investment Bank in Bulgaria).

Changes in bank capital ownership indicate the interest of powerful financial groups and European banks for investing in the Albanian banking sector. Concretely:

- On May 2006 the selling of 80 percent of the shareholder's equity of the Italian-Albanian Bank, which belonged to the Ministry of Finances of the Republic of Albania and Capitalia S.A., Italy, to SanPaolo IMI S.p.A., Italy was approved.

- At the same period, the 60 percent (plus 2 shares) ownership transfer of the shareholders' equity of the National Commercial Bank from Kent Bank/Bayindir Bank to the new institutional Turkish shareholder, Çalik-Seker Konsorsiyum Yatirim Anonim was approved.
- On August 2006, the 11.25 percent ownership transfer of shareholders' equity of ProCredit, from the EBRD to the ProCredit Holding AG (existing shareholder) was approved.
- On October 2006, the transfer of 71.97 percent of the stock of the Emporiki Bank Jnt. Stk., of Greece to Credit Agricool S.A., France was approved. This transfer also influences on indirect participation of Credit Agricool S.A. to the shareholder equity of Emporiki Bank of Albania Jnt. Stk., at the same amount.

Changes are expected to take place in the Italian-Albanian Bank's shareholders, under the conditions when their shareholder, SanPaolo IMI S.p.A has been taken over by the Intesa Bank and the new Intesa-SanPaolo S.p.A has been established. These changes will be examined by the Bank of Albania after the submission of documentation, pursuant to requirements of the Law "On granting a licence to conduct banking business in the Republic of Albania".

The extension of banks' network within the territory of Albania continued also during 2006. So, the number of new agencies and branches went to 62, being established in the whole Albania and outside it. Tirana occupies the largest weight, with the establishment of 30 new branches and agencies. In this way, banking services are provided not only in the areas where production, trade and services are concentrated but also in suburban areas.

During 2006 the consent was given for the establishment of two bank branches outside the territory of Albania and two other branches are under the process of approval.

Table 7 Indicators of banks' network extension at end of 2006

No.	Banks	No. of branches within the country	No. of agencies	No. of branches outside Albania
1	Raiffeisen Bank	37 <sup>10</sup>	46	
2	National Commercial Bank	21	10	1 <sup>11</sup>
3	United Bank of Albania	3	1	
4	Italian-Albanian Bank		6	
5	Italian Development Bank	1 <sup>12</sup>		
6	Tirana Bank	32	4	
7	National Bank of Greece (Tirana Branch)	4	6 <sup>13</sup>	
8	International Commercial Bank	5		
9	Alfa Bank (Tirana Branch)	9	1	
10	American Bank of Albania	8	11	2
11	ProCredit Bank	21	1	
12	First Investment Bank (Tirana Branch)	1	2	
13	Emporiki Bank	3	4	
14	Credit Bank of Albania	2	1	
15	Credins Bank	11	4	
16	Popular Bank	29		
17	Union Bank	3	4	
	TOTAL	190	101	3

Source: Bank of Albania

During 2006, banks submitted 71 applications for the approval of the administrators appointed by them, under the requirements of the Law "On Banks in the Republic of Albania". There were no decisions for turning down any of administrators appointed by them.

Also raising the licence level, from the first level to the second one has been requested by the American Bank of Albania and Italian-Albanian Bank. The completion of documentation, pursuant to the respective regulation for the Bank of Albania's approval, is expected from banks.

The Bank of Albania has been notified about changes in banks' statutes, related to increase of paid-in capital, change in the structure of shareholders and ownership on shares of less than 10 percent of bank's capital, etc. These changes have been reflected in banks' registers held at the Bank of Albania and at its regional branches.

The banks have met the level of the minimum initial capital required and recorded, pursuant to decisions No. 3 and No. 4 of 26.01.2005 of the Supervisory Council of the Bank of Albania "On an amendment to the Regulation "On granting a licence to conduct banking business in the Republic of Albania".

During the previous year, 9 applications were submitted to the Bank of Albania for licensing foreign exchange bureaus and all of them were approved. At the same time, due to irregularities noticed by on-site examinations, the licence of 7 other exchange bureaus was revoked.

In 2006, four new savings and loans associations were licensed and ten licences of other associations were revoked. The savings and loans associations, whose licence was revoked, have been united on the basis of 6 existing savings and loans associations.

During 2006 the approval of electronic products used by commercial banks in service to customers started. The placement of ATM service and the issuing of debit and credit cards are highlighted in all banks, increasing not only the speed of services but also their quality. E-banking has been extended in some banks.

At end of 2006, given the changes taking place, the list of entities licensed by the Bank of Albania according to years, is presented as follows:

*Table 8 Entities licensed by the Bank of Albania*

No.	Entities	2000	2001	2002	2003	2004	2005	2006
1	Bank and foreign bank branches	13	13	14	15	16	17	17
2	Non-bank financial institutions	2	4	5	7	7	7	6
3	Foreign exchange bureaus	19	38	58	58	54	58	60
4	Savings and loans associations	- -	- -	113	131	130	131	125
5	Unions of savings and loans associations	- -	- -	2	2	2	2	2

*Source: Bank of Albania*



### IV.3 ON-SITE EXAMINATIONS

During 2006, 14 full-scope examinations and 13 partial examinations were carried out at commercial banks, 5 full-scope examinations at non-bank financial institutions, 2 full-scope examinations at savings and loans associations and 53 examinations at foreign exchange bureaus. Also, in the framework of increased demand for opening new bank branches, 70 examinations were carried out on the security of working premises of these branches and of foreign exchange bureaus.

On-site examinations have aimed at carrying out the legal competencies of the Bank of Albania in terms of verifying the exercising of banking activity, in conformity with the legal and regulatory basis, the guaranteeing of a safe financial position of the overall banking system and of each bank in particular.

Periodical analyses have highlighted the most important issues resulting from individual controls, thus enabling the making of generalizations at system level in a second moment.

Among these issues, we point out: the growth rate of credit to the economy and its constitution (according to currencies, maturity, sectors); effects on capital adequacy, as a result of changes assumed in interest rates, exchange rate and in any possible deterioration of credit quality (*stress-test analysis*); indispensability for constant improvement of governance, of transparency and domestic control in commercial banks; improvement of information technology systems; reporting and other problems.

Banks' reaction to recommendations and measures put forward by the Bank of Albania has been fast and generally complete. However, all the banks should pay maximum prudence to always operate within the regulatory framework requirements, so that they carry out a stable and equilibrated banking activity.

## NOTES

<sup>1</sup> The operational data point out that 6 banks have presented ATMs and 7 banks have presented e-banking.

<sup>2</sup> The share of total assets of the system increased to 31.5% at end of 2006, from 25.6% at end of 2005.

<sup>3</sup> The weight of medium-term loans grew to 33.2% to 29.7% of the previous year, while the short-term loans weight decreased to 28.8%, from 32.3% at end of 2005. We underline that the weighted average interest for medium-term loans is calculated higher than for short-term loan, particularly for ALL loans.

<sup>4</sup> Generally the cases of dividend allocation by banks in Albania are fairly rare.

<sup>5</sup> The total of net result from interests and other activities.

<sup>6</sup> Total loans encompass loans extended to residents and non-residents.

<sup>7</sup> Total loans extended by the banking system, including credit to non-residents.

<sup>8</sup> The ratio of "net non-performing loans to regulatory capital" is estimated at 6.8 percent, from 4.3 percent at end of 2005.

<sup>9</sup> Net outstanding non-performing credit of the banking system is evidenced at ALL 2.6 billion, from ALL 1.2 billion at end of 2005.

<sup>10</sup> The number of branches and agencies of banks is made accurate based on the annual information banks send to the Bank of Albania.

<sup>11</sup> Prizren and Prishtine branches have been approved preliminarily.

<sup>12</sup> No locations have been specified for Durres and Vlora branches.

<sup>13</sup> The "Shtraus" square and the "Tirana – Durres" highway and the Saranda agencies are in process.

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## CHAPTER V OTHER ACTIVITIES OF THE BANK OF ALBANIA

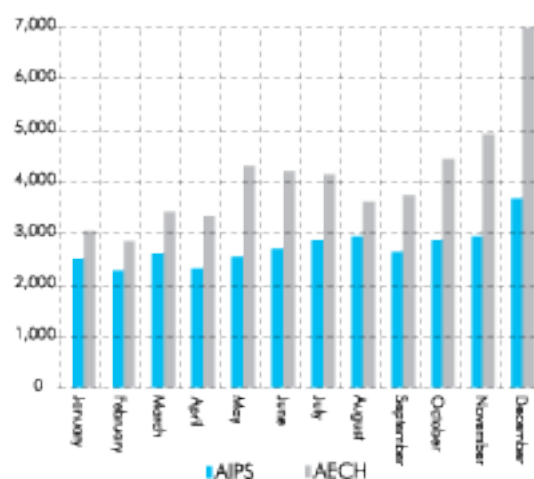
### V.1 PAYMENT SYSTEM DEVELOPMENTS

#### V.1.1 PAYMENT SYSTEM DEVELOPMENTS IN ALBANIA

Payment system in Albania has already created the physiognomy of a modern system from the regulatory and operational viewpoint. Year 2006 recorded the meeting of basic infrastructure for further modernising the payment system in particular and the financial system in general. The number of transactions processed during 2006 increased by 13 percent, compared to 2005, and the value of transactions increased by 21 percent during 2006, amounting to ALL 2,664.43 billion.

The outcomes of the systems for the settlement of large-value payments (Albanian Interbank Payment System) and low-value payments (Automated Electronic Clearing House) indicate not only increased number of payments carried out, but also larger effectiveness of both systems. The Bank of Albania has provided low commissions, intending reduced transaction costs among banks and customers' approaching to banks' windows. During the past year, technological improvements were made for both systems, influencing on enhancement of effectiveness and competition among banks, as well as on a more rapid development of services market.

Chart 1 Number of transaction in payment systems: AIPS and AECH for 2006



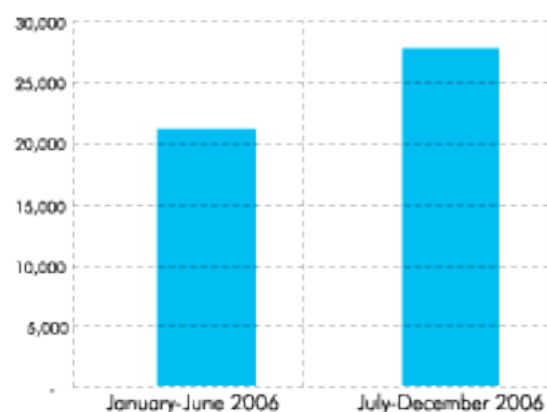
Source: Bank of Albania

#### V.1.2 PAYMENT SYSTEM STATISTICS AECH AND AIPS

Compared to 2005, the average daily number of payments (in both systems) has increased from 312 to 352 or to 40 transactions more per day<sup>1</sup>. In 2006, a new bank was added to the payment system, leading the number of participants to 17 banks.

The increased number of transactions channelled into the AECH, by about 49 thousand, and in consequence also their value of about ALL 8 billion should be regarded as a satisfactory growth,

Chart 2 Number of transactions in the AECH system in 2006



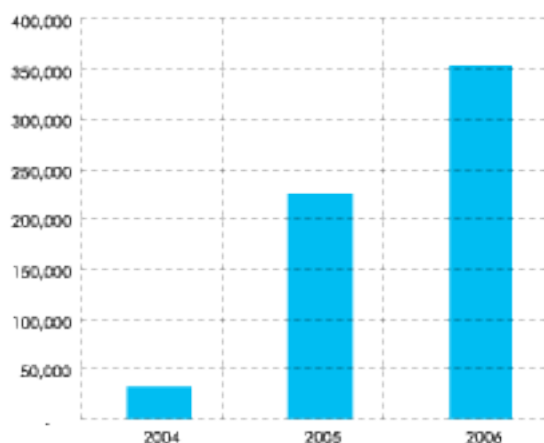
Source: Bank of Albania

Chart 3 Number of settlements by VISA and the value in billions of ALL for 2006



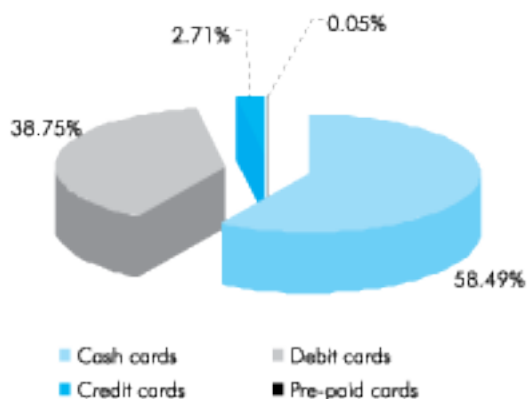
Source: Bank of Albania

Chart 4 Performance of number of cards in circulation by years



Source: Bank of Albania

Chart 5 Cards structure, 2006



Source: Bank of Albania

though it should be taken into account that the system capacity offers possibilities similar with more advanced standards.

On March 2006 the e-payment settlement by VISA cards started through AIPS. Presently, 6 member banks are included in this scheme, carrying out in total a volume of payments of ALL 0.30 billion. The following chart presents settlement performance by Visa cards.

Banking cheque is another payment instrument, which continued to be used manually during 2006. It should be underlined that its use is in modest levels and more concretely, the total value of cheques cleared throughout the year was approximately ALL 4 billion.

Year 2006 was also associated with increase and variety in e-payment instrument use. The number of cards increased nine-fold during 2006, compared to 2004. Compared to 2005, the number increased by 127,552 cards, by almost 56 percent.

Out of total cards issued, the number of cash cards dominates. Nevertheless, during 2006 the debit cards number was increasing, accounting for 38.75 percent of total cards in circulation.

Also, another positive indicator is the increased credit cards number by 5,816, occupying 2.71 percent of total cards. This indicates a curtailing of cash in circulation year on year, and increased lines of consumer credit.

It is obviously noticed that the increased number of issued cards was associated with increased volume of transactions. During 2006 the transactions number went up from 644,987 in January, to 1,697,301 in December. Whereas, the total value of card transactions at year-end amounted to ALL 187.66 billion.

Parallel to increased number of cards, the number of ATMs and POS has also increased. In consequence, this year was associated with extension of ATMs in the territory of Albania.

The following chart shows that, compared to the preceding years, the increase is respectively 130

ATMs and 404 POS, implying that banks have increased the number of terminals at points of sales and ATMs, once the number of card users went up, so as to better satisfy the customer demand.

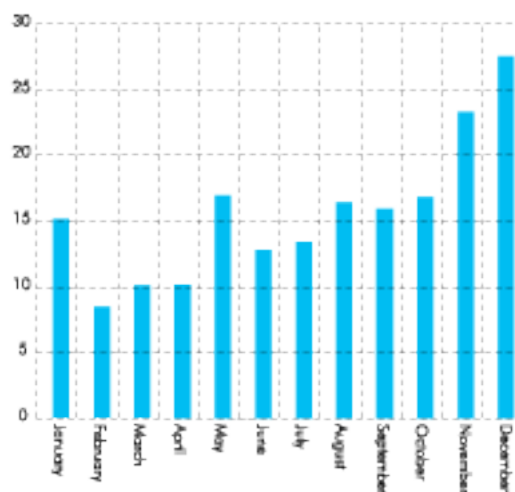
The establishment of an electronic communication between the Bank of Albania and the Ministry of Finance and the respective interfaces between the payment system and the system that the Ministry of Finance is implementing for treasury management is a project initiated during the past year. The completion of this project in 2007 will be associated with a shortening of time for the operation of treasury operations, a better liquidity management and an increased security of the system.

### V.1.3 PAYMENT SYSTEM SUPERVISION

The mission of payment system surveillance at the Bank of Albania is reduction of the system risk and enhancement of its efficiency in compliance with the EU directives and standards applied by central banks of the EU countries. The Payment System Surveillance Office established to this end is working for approximating the regulatory basis and for applying it into practice.

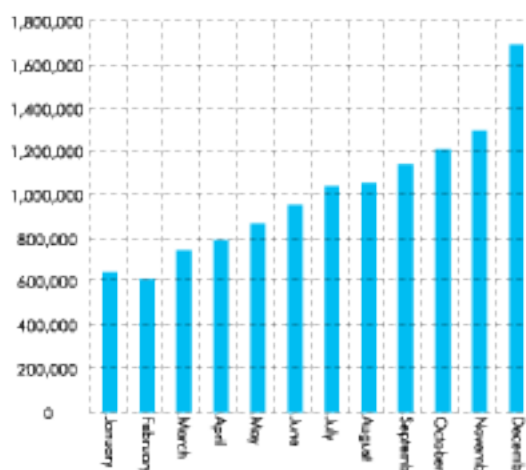
1. New regulations and manuals completed over 2006
  - a. Manual "On Payment Division procedures for the settlement of VISA operations through AIPS",
  - b. Draft-regulation "On carrying out the ALL-denominated cheque clearing at the Bank of Albania", which after consultation also with commercial banks, was adopted by the Supervisory Council of the Bank of Albania on 15.11.2006.
2. New regulations under process
  - a. Regulation "On electronic payments"
  - b. Draft-regulation on "Direct debit".

Chart 6 Value of cards transactions in 2006



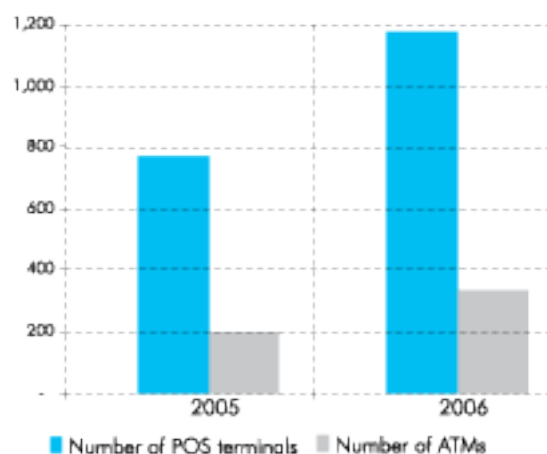
Source: Bank of Albania

Chart 7 Number of cards transactions in 2006



Source: Bank of Albania

Chart 8 Number of ATMs and POS 2005 - 2006



Source: Bank of Albania



### 3. Existing regulations reviewed

The work for reviewing the regulations on AIPS and AECH has already started. It will be finalised in 2007.

#### V.1.4 INCENTIVES FOR PAYMENT SYSTEM ENHANCEMENT DURING 2007

##### a. Albanian payment system law

To further fulfil the regulatory aspect of a modern payment system, the need to draft the Albanian law on the payment system has arisen. Its drafting will be carried out in cooperation with the Bank of Albania, the financial system and the Albanian government. During 2007 the preparation of a platform for such a law is intended.

##### b. IBAN

Further to EU directives for the countries aspiring accession to the EU, the main cause in terms of the payment system is the existence of the IBAN in all transactions of payments effected within the Euro area. In 2007 an informing material will be introduced for commercial banks and a regulatory basis will be designed, having its implementation by banks in the future as final goal.

##### c. Drafting of the policy of payment system supervision

During 2007 work will be carried out for drafting a policy on payment system supervision, implementing the Bank of Albania's function as the supervisor of the payment system in Albania and enhancing transparency with commercial banks as participants of this system.

##### d. Red Book

The perfection of payment instrument ratios by commercial banks will be aimed at, in order to pass to the establishment of a preliminary Red Book model and then to its publication.

#### V.2 EUROPEAN INTEGRATION AND INTERNATIONAL COOPERATION

##### V.2.1 EUROPEAN INTEGRATION

On June 12, 2006, the Republic of Albania signed the Stability and Association Agreement with the European Community and the Member States. After the Ratification by the Albanian Parliament of the Stabilisation and Association Agreement on July 27, 2006, the Stabilisation and Association Agreement is expected to enter into force, after the ratification by the parliaments of the member states of the EU, thus replacing the Trade and Co-operation Agreement of 1992 between the EU and Albania. The Bank of Albania has been actively committed to official and technical negotiations for the signing of the Stabilisation

and Association Agreement. This agreement provides reciprocal rights and obligations for the parties and creates mechanisms for cooperation in areas of joint interest, having Albania's accession to EU as the final goal.

The Bank of Albania's obligations arising from the Stabilisation and Association Agreement relate to accomplishing the economic criteria of Copenhagen<sup>2</sup>, guaranteeing the right of establishment and freedom of services for banks and other *communautaire* financial services, liberalization of capital movement and current payments between Albania and the EU, and approximation of the Albanian legislation to those of the *acquis communautaire* in these areas.

The Bank of Albania has given its contribution also to updating the National Plan for the Stabilisation and Association Agreement, which was approved in July 2006. This plan is in line with the priorities of the final Document of the European Partnership with Albania, adopted by the EU on January 2006. Besides legal incentives and implementing activity to be undertaken by the Albanian institutions within the clearly defined terms, the Plan has also envisaged financial costs and necessary technical assistance for the fulfilment of these commitments. In the framework of this Plan, the Bank of Albania's priority remains the commitment to maintain macroeconomic stability in the country and the adopting and proper implementation of the *acquis* in the domestic banking system, as a fundamental condition for Albania's integration to the Internal EU Market.

In this framework, one of the most important highlights during 2006 regarding the approximation of national legislation to those of the *acquis* was the drafting and passing of the Law "On the Banking System in the Republic of Albania", based on obligations deriving from the Stabilisation and Association Agreement and the Basel Principles. The target of this law is the stipulation of rules for the establishment, licensing, organising, managing, conservatorship and receivership of banks and foreign bank branches for carrying out banking business in the Republic of Albania. This Law has adopted the largest part of provisions of the 2000/12/EC Directive, with regards to initiation and continuation of activity of credit institutions.

On November 8, 2006, the European Commission published the Albania 2006 Progress Report. The report analysed the progress Albania has reached over the period of October 2005 – September 2006 in terms of fulfilling the Copenhagen criteria. The European Commission appraised the policy followed by the Bank of Albania in terms of cooperating with international financial institutions and maintaining inflation under control, contributing to keeping a steady macroeconomic environment in the country.

Also, the Commission assessed the reliable monetary policy followed, highlighting particularly the measures taken by the Bank of Albania in terms of gradual switch of its monetary policy strategy towards explicit inflation targeting regime, aiming at enhancing transparency and credibility of its monetary policies.

The report highlighted also the positive developments in the banking sector of the country and appraised the progress achieved in terms of establishing a loans register, free movement of banking and financial services, freedom of foreign bank establishment and further liberalization of capital movement. On the other hand, the Commission appealed for continuing the efforts for the approximation of national legislation to the *acquis* even after the passing of the Law "On Banks in the Republic of Albania", for ensuring the prevention of restrictions in portfolio investments and other short-term capital movements, and also required the undertaking of further reforms in the payment sector, to ensure full interaction of cards infrastructure.

On December 2006 the Republic of Albania submitted to the European Commission, the 2006-2008 Economic and Fiscal Program. It is based on programs of Pre-accession Fiscal Supervision Procedure of candidate countries, as part of the Economic and Monetary Union, and is submitted for the first time by potential candidates, Albania included. This document contains information on medium-term objectives about macroeconomic indicators, objectives in the area of public finances and the priorities in the framework of structural reforms needed for accession into the EU. The Bank of Albania has participated in the drafting of those parts of this Program that have to do with monetary policy and exchange rate, external sector of the economy and financial sector developments.

During 2006, the Bank of Albania participated in: The 7<sup>th</sup> Meeting of the European Union and Albania on Economic and Financial Issues, presenting the latest developments in the Albanian economy and in the banking sector of the country; The 9<sup>th</sup> Meeting of the Joint Committee between the EU and Albania, reporting about the latest developments in legal and administrative banking framework in Albania, with a particular focus on adopting the new Law "On Banks in the Republic of Albania".

## V.2.2 INTERNATIONAL COOPERATION

### Relations with the international monetary fund (IMF)

During 2006 Albania's quota with the IMF remained unchanged, at the amount of SDR 48.7 million<sup>3</sup>, likewise its votes (737 votes or 0.03% of total votes). Albania is of the same constituency with Italy, Greece, Portugal, Malta, San Marino and Eastern Timor. This constituency has a total of 90.968 votes (4.12% of total votes) and is headed by the Italian representative Mr. Arrigo Sadun, who serves as an Executive Manager of the constituency.

On January 11, the Albanian authorities represented by the Prime Minister of the Republic of Albania, the Governor of the Bank of Albania and the Minister of Finance submitted officially to the IMF the Letter of Understanding and the Memorandum of Economic and Financial Policies.

Based on these documents and on the evaluation of the mission that had visited Albania on November 2005, the Executive Board adopted a new three-

year agreement with Albania, at SDR 17.045 million on January 27, 2006. This agreement is a mixing of the program of Poverty Reduction and Growth Facility (PRGF) and the program of Extended Fund Facility (EFF), which is a borrowing closer to commercial terms, thus reflecting the progress made by Albania during the implementation of the previous PRGF 3 program.

The main targets of the new program have to do with the maintaining of macroeconomic stability, as a precondition for economic growth, and the improvement of fiscal administration, public debt management and financial institutions' supervision.

The adopting of the arrangement by the Executive Board of the IMF enabled also the immediate extension of an EFF loan tranche and PRGF loan tranche of SDR 1.217.500 each, respectively on 1 and 10 February.

During 2006, in the framework of consultations for assessing the meeting of obligations (Article IV of the Articles of the Arrangement with the IMF) that derive from the three-year PRGF/EFF agreement, Albania was visited by two IMF review missions in April – May and October – November,.

During their stay in Albania, the missions had special meetings with the administrators and the staff of the Bank of Albania. They assessed positively the accomplishments of the institution in the framework of the Memoranda of Economic and Financial Policies. At the same time, they observed that the progress achieved in implementing structural reforms has been satisfactory and also evidenced the importance of continuing these reforms, being focused mainly on taking further regulatory measures for maintaining financial stability under the conditions of rapid credit growth. In this framework the establishment of a Credit Register was regarded of substantial importance.

In its meeting of 24 July, 2006, the Executive Board of the IMF, based on the conclusions of the reviewing mission, carried out the first review of Albania's performance under PRGF/EFF arrangement and approved the extension (on 26 July and 4 August) of an amount equal to SDR 2.43 million, leading the overall amount of the loan extended under this arrangement to SDR 4.86 million.

During 2006 Albania also paid to the IMF about SDR 7.9 million in the framework of settlement of dues to the IMF (payment of principal, interests, interim expenditures), which arise from the previous PRGF and existing PRGF/EFF arrangement.

The Governor of the Bank of Albania, Mr. Ardian Fullani has regularly represented the Republic of Albania in the decision-making of the Board of Governors, which is the highest body of the IMF. An important place in relations with the IMF during this year was occupied by annual and spring meetings with the World Bank and the IMF. The meetings have evidenced the positive performance of macroeconomic indicators and particularly the economic growth, price stability and further consolidation of fiscal indicators, as well

as the meeting of performance and structural criteria set in the framework of the arrangement with the IMF. The top representatives of the IMF have expressed good understanding to continue the technical assistance projects for the Bank of Albania, in terms of monetary policy perspective, credit register establishment, internal control and public debt management.

Also the Bank of Albania continued to benefit from the technical assistance of the IMF, regarding its staff training. During 2006 the Bank of Albania was visited by a public debt management mission, which was focused on the central bank's role in the process of managing this debt and the ROSC Mission (*Report on Observance of Standards and Codes*), which assessed monetary and financial statistics and balance of payments statistics, drafted by the Bank of Albania. This mission issued recommendations also for further improving the drafting of these statistics.

#### Relations with the World Bank Group

Further to the agreement on "Reserves Advisory Management Program"<sup>4</sup>, during 2006, the World Bank's group provided technical assistance to the Bank of Albania, in the framework of RAMP. The assistance was focused on designing a new regulatory basis and on addressing some technical issues in terms of foreign exchange reserve management.

During the annual meetings of the IMF and the WB, the Bank of Albania's delegation has carried out meetings with senior representatives of the World Bank, discussing about further consolidation of macroeconomic stability, and particularly about maintaining inflation within the targeted range. At the same time, these meetings have highlighted the need to undertake further structural reforms in the Albanian economy.

On January 10, 2006, the World Bank adopted the new three-year country assistance strategy for Albania, at the value of USD 196 million. For the first time since the starting of transition, Albania will be extended a half-commercial term loan from the International Bank for Reconstruction and Development (IBRD) at USD 111 million. The soft loan from the International Development Association (IDA) is envisaged to be USD 86 million. Priorities of the new strategy include fostering economic growth through support to private sector development and improving public service delivery, particularly in social sectors.

#### Relations with other international financial institutions

During 2006 the Bank of Albania has had constant contacts with the EBRD, mainly in terms of providing information and statistics for the developments of the Albanian economy in general and the financial sector in particular. The 2006 Transition Report assessed positively the maintaining of inflation within the Bank of Albania's targets and the adopting of the new law "On the Banking System in the Republic of Albania".

The Bank for International Settlements (BIS) is another institution the Bank of Albania kept close contacts with during 2006. The Governor Fullani participated in the 76<sup>th</sup> Annual Meeting of the BIS. He has underlined in the meetings with representatives of this institution and other member banks the importance of the absorption by the Bank of Albania of ever more qualified technical assistance, particularly in such priority areas as monetary policy and banking supervision, which would assist in achieving updated standards in these areas. The BIS has been particularly active in providing technical assistance to the Bank of Albania, through workshops and training courses organised by the Institute of Financial Stability, promoting the international financial stability through exchanging information and cooperation in the area of the financial system.

#### Relations with central banks and technical assistance

Further to intensification of mutual relationships with central banks of the region and beyond, the Governor Fullani, being invited by the governors of some central banks, has paid official work visits to these institutions. In this framework, during 2006, the Governor Fullani paid official visits to the Bank of Italy, National Bank of Poland, Central Bank of Bosnia and Herzegovina, meeting his homologues. These visits have signed a step forward under the process of an increasing technical cooperation between the Bank of Albania and these central banks.

On April the governor had meetings with Ms. Susan Bies Governor of the Board of Federal Reserve in Washington DC, and with Mr. Timothy Geithner, President of the Federal Reserve in New York. These meetings have discussed about recent Albanian economy developments and further enhancement of mutual cooperation and technical assistance the Federal Reserve may provide to Albania. On June, with an invitation from the Governor Fullani, the Governor of the Bank of Greece, Mr. Nicholas C. Garganas paid a two-day official visit to Albania. This visit has taken place in view of the mutual relations between both institutions, with particular emphasis on exchanging information and experience in banking-supervision area.

During 2006 closer relations were also established with central banks of the region, which have supported the Bank of Albania's incentive for enhancing the regional cooperation. Regional cooperation for financial stability was the main focus of the round table, which gathered together the governors of central banks of Rumania, Serbia, Montenegro, Former Yugoslav Republic of Macedonia, Bosnia and Herzegovina and Kosovo, in the sixth panel of the VI Annual Conference of the Bank of Albania that took place in October.

The Governor Fullani also participated in the XV and XVI meetings of the Governors' Club of the Black Sea, Central Asia, and Balkan, taking place in Russian Federation, respectively on May and September.

The central banks of Italy, France, Germany, Netherlands, Czech Republic, Austria, Poland, USA and Turkey continued to provide active technical

assistance to the Bank of Albania during 2006. This was done mainly through carrying out short-term courses and workshops in specialised areas and through study visits paid to these banks.

In view of the Bank of Albania's target to benefit from the experience of central banks of Central and Eastern Europe (CEE), acceded recently in the European System of Central Banks (ESCB), during 2006 the cooperation relations with the Central Bank of Poland, National Bank of the Czech Republic and the National Bank of Bulgaria were intensified.

During 2006 the cooperation with GTZ (the German Agency for Technical Cooperation) in the framework of the Protocol of Financial and Technical Cooperation between the Republic of Albania and the Federal Republic of Germany was further enhanced. The main goal of this cooperation is further institutional and operational approximation of the Bank of Albania with the ESCB standards. Some of workshops carried out by the Bank of Albania in cooperation with the GTZ have had a regional character. Experts from the Central Banking Authority of Kosovo, from Former Yugoslav Republic of Macedonia and from Montenegro have participated in them. Approximate conditions and similar challenges have been the main drivers for organising these workshops, influencing also on the development of fostering technical cooperation among central banks of the region.

The Financial Service Volunteers Corps is another institution, which during 2006 provided assistance to the Bank of Albania in some areas: such as banking supervision, establishment of loan register, statistics and internal audit.

### V.3 CURRENCY ISSUE

In implementing the constitutional obligations and the amended Law No. 8269, dated 23.12.1997 "On the Bank of Albania" the economy demand for money was fulfilled on the basis of the monetary policy and monetary program adopted by the Supervisory Council.

Also, pursuant to the strategy of the Bank of Albania over the medium-term period of 2006-2008 and in the framework of issuing plans for satisfying the economy demand for money, projects for reprinting Albanian banknotes and for printing new ones, i.e., the 2000 lekë denomination were adopted.

During 2006 a contemporary centre of cash was also set up, aiming at implementing the updated central banking standards in money administration area.

#### V.3.1 PERFORMANCE OF CURRENCY IN CIRCULATION

The increase of currency in circulation over 2006, by ALL 14, 7 billion has responded to the balanced macroeconomic development of the country. Unlike

in the previous year, during 11 months of 2006, the currency in circulation progressively recorded only reduction and the whole annual increase was verified on December 2006.

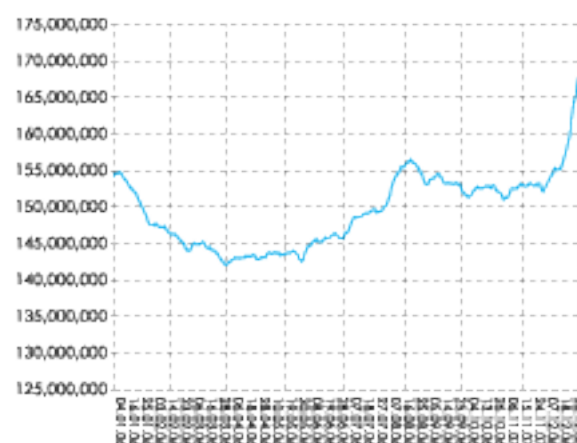
The concentration at ALL 14.7 billion, of the rise of currency in circulation over the last months of the year, along with the historical trend, is also due to higher payments (expenditures) of certain entities taking place at end of the year.

The commercial bank's receipts by the Bank of Albania stood at ALL 105 billion, remaining almost at the same level with that of 2005. Re-circulation by banks themselves of money received by clients, money repaid for meeting customer demand, after being processed and checked, have also influenced on this indicator.

Concerning cash payments from the Bank of Albania's cash-boxes to commercial banks, the supply has been carried out according to their requests. At the same time, it has aimed at maintaining the currency in circulation structure within the limits programmed for year-end 2006.

Banknotes and coins deposited by commercial banks at the Bank of Albania have been processed by high technology sorting machines, ensuring accuracy in the whole counting and checking of the Albanian currency authenticity.

Chart 9 Performance of currency in circulation in 2006, in thousands of ALL



Source: Bank of Albania

### V.3.2 VELOCITY OF CURRENCY IN CIRCULATION

During 2006, the Bank of Albania increased significantly the support to commercial banks, in the framework of their customer activity expansion for currency withdrawals from automated teller machines. The number of ATMs installed and put into operation by the banks at end of 2006 amounted to 335. The payment activity extension by ATMs, along with facilities in customer services, has also impacted on curtailing cash operations.

	2003	2004	2005	2006
No. of ATMs	15	69	165	335
Annual growth (in times)	-	3,6	1,39	1,03

Table 1 Number of ATMs installed by the banking system through years

Over 2006 the velocity of currency in circulation for the shortened cycle of circulation (commercial banks – Bank of Albania), was in total almost at the same level as in 2005. However, it underwent changes in certain denominations of banknotes and coins.



Hence, a significant increase of velocity of circulation was proved in the 5000 lekë, 1000 lekë and 500 lekë denominations, respectively by 13.3 percent, 38.9 percent and 8.3 percent. These are also the denominations ATMs work with.

The velocity of banknotes and coins of 200 lekë and 100 lekë denominations has decreased.

The velocity of coins circulation has generally decreased. This is so because coins usually stand in individuals' hands for carrying out low-value payments.

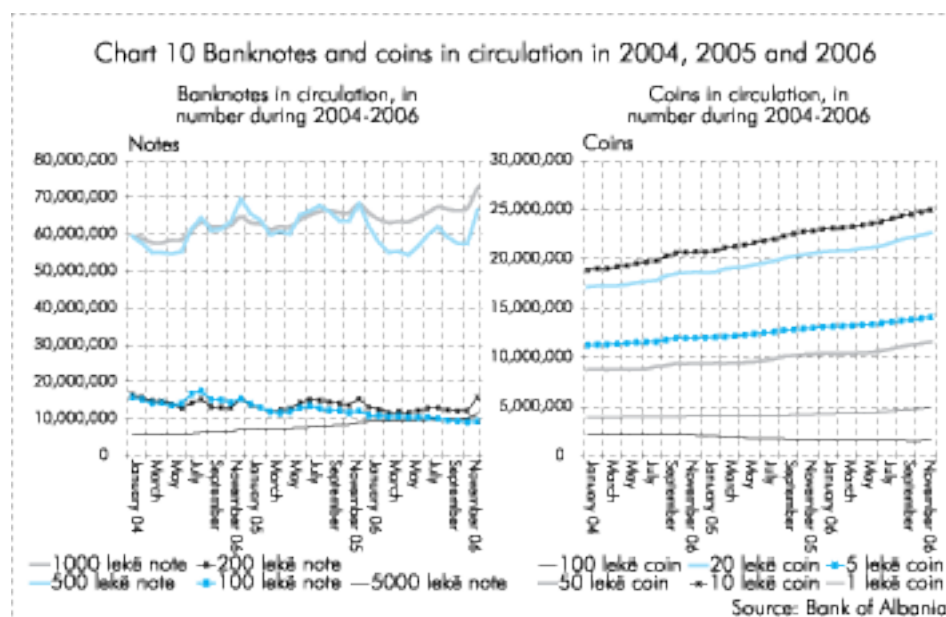
Table 2 Structure of currency in circulation at end of 2006 (in percentage)

Denominations	5000	1000	500	200	100	100	50	20	10	5	1
Structure as of 31.12.2004	25.77	46.13	24.81	2.18	1.11	15.78	35.44	28.25	15.69	4.54	0.30
Structure as of 31.12.2005	29.86	44.83	22.47	2.03	0.80	12.14	37.07	29.48	16.35	4.65	0.30
Structure as of 31.12.2006	34.04	43.55	19.96	1.90	0.55	10.99	37.99	29.70	16.38	4.62	0.32

#### Protection from counterfeit banknotes

Protection of Albanian banknote from counterfeiting and the maintaining of its authenticity continued to be to Bank of Albania's attention, aiming at protecting the public and increasing its confidence in the national currency.

The share of confiscated counterfeit banknotes from 1992 to 31.12.2006 to the overall banknotes launched into circulation by the Bank of Albania constitutes only 0.006 percent of them, an utterly insignificant figure that does not break the public confidence in the national currency.



### V.3.3 NUMISMATICS

In 2006 the minting of two sets of coins for numismatic purposes was completed, with the topic "Tirana capital city for 85 years" and "Objects of cultural inheritance (Popular costumes in Albania)". These coins were minted at the Office of Coins Production and Processing of the Issue Department.

Production of coins for numismatic purposes by the Bank of Albania itself constitutes a successful accomplishment and establishes bases for further developments in this area.

During 2006 the procedures for minting another coin of the subject "'Codex Purpureus Beratinus'", which is a unique object of Albanian cultural inheritance, was included in the Memory of the World Programme of UNESCO on June 25, 2005.

## V.4 CHANGES IN BANKING LEGISLATION

### V.4.1 PASSING OF THE NEW LAW "ON THE BANKING SYSTEM IN THE REPUBLIC OF ALBANIA"

During 2006, further to the signing of the Stabilization and Association Agreement on 12 June, 2006, the banking legislation was amended and improved substantially once the Law "On the Banking Sector in the Republic of Albania", No. 9662 of 18.12.2006 was adopted, which shall become effective on 1 June 2007.

This Law, drafted by the Bank of Albania with the support of the IMF, is in line with the obligations deriving from the Stabilization and Association Agreement (SAA), in the field of financial area in general and banks in particular. These obligations have to do with freedom of establishment, free movement of banking and financial services, and approximation of national legislation with that of the European Union.

In this regard, the adopted law enables banks of member states of the European Union and all foreign banks to provide banking services in Albania through a branch or subsidiary, without making any distinction between the licensing terms of these branches and subsidiaries and the Albanian banks. Furthermore, in line with the provisions of the Stabilisation and Association Agreement, the adopted law requires their treatment as Albanian banks in all aspects, once they are granted the licence to carry out banking business and financial activity.

Unlike the existing effective law, the new adopted law provides a more liberalised regime for carrying out financial services. It requires other conditions for carrying out additional financial activities by banks and foreign bank branches, without conditioning them with the achievement of a certain

capital level, as specified in the existing effective law. In this way, the adopted law requires that the Bank of Albania may licence an entity for carrying out some of financial activities specified by law right from the licensing moment, giving it the right to request the performing of other additional activities after the licensing, based on its performance and other financial parameters. The appraisal of these parameters by the Bank of Albania will be based on clear rules and criteria defined by law, regarding the banking system supervision, in line with the core Basel principles and the respective EU directive.

These rules address to one of the obligations of short-term priorities of the European Partnership with Albania, that is the strengthening of the legal and supervisory framework on the banking system, and improving the prudential monitoring of the financial sector, according to recommendations stated also in the Annual 2006 Report of the European Commission for Albania.

Unlike the effective law, based on the adopted legal provisions, the banking system supervision will be extended on all banks and foreign bank branches operating in Albania, and on branches of banks licensed by the Bank of Albania operating abroad. This supervision will be carried out through licensing, regulatory framework in compliance with the European Union standards and Basel principles, financial and forecasting analysis, examinations, corrective operations and cooperation agreements with supervisory authorities of other countries. Regarding the supervision of foreign bank branches operating in Albania, specific provisions on the supervision of these branches are required, in line with the respective EU directive.

For the first time, pursuant to Basel principles and standards specified in the relevant European Union directives for a prudential supervision, consolidated supervision has been treated in this law. It creates necessary legal space for concluding agreements with authorities of other countries, in view of increasing the quality of the consolidated supervision of financial and banking groups that will operate in Albania.

To guarantee and strengthen the protection of depositors and investors, and to maintain banking system stability, the new law provides clearer rules for risk management, which banks may be faced with while carrying out their activity. Given the current conditions of rapid credit growth in the banking system, the new law treats in a more complete and detailed way other risk types as well, different from credit risk banks may be faced with and their permitted exposures when they are faced with such risks.

#### V.4.2 ESTABLISHMENT OF LOANS REGISTER, DRAFTING OF PROCEDURES AND ITS REGULATORY FRAMEWORK

For the first time the law requires the establishment and maintaining by the Bank of Albania of a loans register. Under the conditions of a rapid credit growth, the purpose of establishing such a register is to assist banks in making well-informed decisions when extending loans to their clients, as well

as to strengthen the Bank of Albania's supervision over the Albanian banking system.

Presently, the Bank of Albania, in close cooperation with commercial banks, is completing the process of drafting the by-laws. This will specify the way of organizing and functioning of the Credit Register, the type of information and data, the manner and terms of their reporting, as well as the manner and conditions for use of infrastructure and the above-mentioned information by authorised users of the Loans Register.

#### V.4.3 IMPROVEMENT OF LEGAL INFRASTRUCTURE FOR IMPLEMENTING A NEW MONETARY POLICY REGIME

During 2006 the Bank of Albania examined the prerequisites and implementation conditions over a mid-term period (2009), for a new monetary policy regime. In this context, the possibilities of improving legal infrastructure for creating such conditions in line with international standards in this area were analysed. Also, the possibility of improving the organic law of the Bank of Albania was considered, coinciding with the forecasting of its alteration as mid-term priority in the National Plan for the Implementation of the Stabilisation and Association Agreement. These changes are expected to define clear competences and procedures regarding the decision-making process of the Bank of Albania, and the transparency of this process, what constitutes also a substantial precondition for designing and implementing an effective monetary policy.

#### V.4.4 DRAFTING THE PROPOSALS FOR CHANGING THE CIVIL PROCEDURE CODE OF THE REPUBLIC OF ALBANIA

In the framework of legal reforms undertaken by the Ministry of Justice for amending and improving the Civil Procedure Code, the Bank of Albania has been fully committed to cooperating with the banking sector for completing and making accurate the mandatory execution procedure of executive titles.

The Bank of Albania's proposals, which have been mostly taken into account, have aimed at sorting out some problems encountered in the banking activity, which relate to the execution of executive titles by the execution office bodies. The proposals have intended to improve the legal base for applying the procedures with efficiency, decreasing the time of title execution, making accurate the procedures for setting the commodity value used as collateral for the meeting of the obligation, and providing some alternative options for the debtor, for the execution of the obligation after receiving the court's decision. These improvements will create favourable conditions and will increase banking system security in carrying out the lending activity, thus reducing credit risk the banks are faced with.

#### V.4.5 COOPERATION WITH THE MINISTRY OF FINANCE FOR DRAFTING THE LAW "ON PREVENTING MONEY LAUNDERING AND TERRORISM FINANCING"

At end of 2006, the Bank of Albania closely cooperated with the Ministry of Finance in the process of compiling the draft-law "On Preventing Money Laundering and Terrorism Financing". The Bank of Albania, as the supervisory authority of the banking system, regards with priority the improvement of the legal framework for preventing the use of banking system for laundering money that has derived from criminal activities and wealth, in accordance with the European Union directives in this area and reviewed recommendations of the FATF. From this viewpoint, inter alia, this improvement aims at maintaining public and investor confidence in the Albanian banking system.

#### V.4.6 ESTABLISHMENT OF REGULATORY FRAMEWORK FOR FOREIGN RESERVE MANAGEMENT

During this year the drafting and completion of the regulatory framework for foreign currency reserve management was completed successfully, with the assistance of the World Bank, reviewing the Bank of Albania's policy for the management of such reserve, the management criteria, and conditions and the decentralization of decision-making competences during this process.

### V.5 INTERNAL AUDIT DEVELOPMENTS

In 2006, 44 audits and 3 verification procedures were carried out. An audit procedure was carried out engaging 32 audit-work days on average. Out of audits carried out, the inspectors presented 269 findings and provided 197 recommendations. The audit tasks were carried out by 6 auditors, among whom one is an information technology specialist. The audit function at the Bank of Albania is usually covered by 1.4 inspectors per 100 central bank employees, with an average work experience of 10 years at the central bank's audit. The audits were carried out on the Bank of Albania and on its five regional branches, as well as on its Printing House.

During 2006, regular 6-month meetings were held between the Inspector General and non-administrative members of the Bank of Albania Supervisory Council, with the purpose to increase the role of internal audit, as a function that supports and reinforces the accountability of central bank management, for improving its governance. These meetings served the increase of the degree of information of the members of the Supervisory Council, for taking decisions on the basis of more transparent and more complete information. Also, the internal audit work program was adjusted to include suggestions of the Supervisory Council members, aiming at treating the aspects of primary issues and at carrying out independent analyses of various aspects of the Bank of Albania's activity. This process of discussion and mutual information

improved the degree of understanding of Supervisory Council's expectations from internal audit and ensured a better coherence of internal audit's targets with those of the Bank of Albania.

## NOTES

<sup>1</sup> There were 247 effective working days in 2006.

<sup>2</sup> EU membership criteria are otherwise referred to as the Copenhagen criteria. They have been laid down at the June 1993 European Council in Copenhagen and require from the candidate country for membership to the EU:

- To have achieved stability of institutions, guaranteeing democracy, the rule of law, human rights and respect for and, protection of minorities (political criterion);
- The existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union (economic criterion);
- The candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.

<sup>3</sup> On the closing date of reporting (February 14, 2007), the official rate of the SDR and the American dollar was 1 SDR = 1.49671 USD.

<sup>4</sup> The agreement "On management and consultancy of foreign exchange reserve" was signed between the Bank of Albania and the World Bank on September 2005.

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## CHAPTER VI INDEPENDENT AUDITORS' REPORT AND FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED DECEMBER 31, 2006

### INDEPENDENT AUDITORS' REPORT

TO THE SUPERVISORY BOARD OF THE BANK OF ALBANIA:

We have audited the accompanying financial statements of Bank of Albania. (the "Bank"), which comprise the balance sheet as at December 31, 2006, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

#### MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting policies adopted by the Supervisory Board of the Bank of Albania as disclosed in Note 2 to the financial statement. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

#### AUDITORS' RESPONSIBILITY

Our responsibility is to express an opinion on these financial statements based on our audit. Except as discussed in paragraph under our opinion, we conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## OPINION

As discussed in Note 10 to the financial statement, a revaluation of the head quarter building has been performed by an independent appraiser based on capitalization of rental income and selling prices for new business centers in neighborhood. Due to specific nature of this building and lack of market-evidence of fair value, in our opinion, this method is inappropriate. Accordingly, we are unable to express an opinion on the accuracy of the market value of the head quarter building as at December 31, 2006.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the accompanying financial statements present fairly in all material respect the financial position of the Bank as of December 31, 2006, and the results of its operations, changes in shareholders' equity and its cash flows for the year then ended, in accordance with the accounting policies adopted by the Supervisory Board of the Bank of Albania as disclosed in Note 2 to the financial statements.

## EMPHASIS OF MATTER

Without further qualifying our opinion, we draw attention to the Statement of Changes in Equity and to Note 18 to the financial statements. The total of paid up capital and liabilities of the bank exceeds the assets by LEK 740 million as at December 31, 2006 and the Bank has paid an amount of LEK 4,664 million as profit to state budget during the year ended December 31, 2006, in pursuance of an agreement dated March 26, 2003 with the Ministry of Finance. In terms of Law no. 8269 article 11 no transfer, redemption or payment under Articles 8, 9 or 10 of this law shall be made if the assets of the Bank are less than the sum of its liabilities and paid-up capital. Furthermore, if the Bank would have not recorded the revalued amount of the headquarter building as referred in the paragraph above, the financial statement as at December 31, 2006 would present an excess of liabilities and paid capital over assets amounting to LEK 2,446 million. Under such conditions, based on the Law nr.8269 under article 7, the Ministry of Finance might have to transfer to the Bank interest bearing negotiable government securities, in such amount as should have been necessary to remedy the deficiency.

Tirana, Albania  
February 23, 2007

*DELOITTE ALBANIA sh.p.k.*

Zagreb, Croatia  
February 23, 2007

*DELOITTE d.o.o.*

## BALANCE SHEET AT DECEMBER 31, 2006

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

		As at December 31, 2006	As at December 31, 2005
<b>ASSETS</b>	<b>Notes</b>		
Assets denominated in foreign currencies			
Gold and precious metals	3	797	708
Deposits with the International Monetary Fund	4	7,867	8,431
Deposits with non resident banks	5	38,157	10,175
Available for sale investments	6.1	117,404	133,464
Held for trading investments	6.2	9,636	-
Other assets	7	726	551
<b>Total assets denominated in foreign currencies</b>		<b>174,587</b>	<b>153,329</b>
Assets denominated in local currency			
Gold and precious metals	3	53	50
Transit credits	8.1	139	207
Loans to resident banks	8.2	8,904	-
Available for sale investments	9.1	67,575	66,821
Held to maturity investments	9.2	-	1,725
Other assets	10	4,223	2,523
<b>Total assets denominated in local currency</b>		<b>80,894</b>	<b>71,326</b>
<b>Total Assets</b>		<b>255,481</b>	<b>224,655</b>
<b>LIABILITIES</b>			
Liabilities denominated in foreign currencies			
Due to the International Monetary Fund	11	15,256	16,145
Due to non-resident financial institutions	12	1,246	1,319
Other foreign liabilities		186	-
<b>Total liabilities denominated in foreign currencies</b>		<b>16,688</b>	<b>17,464</b>
Liabilities denominated in local currency			
Currency in circulation	13	168,234	153,550
Due to resident banks	14	53,575	45,182
Due to the Government	15	15,944	6,356
Deferred income	16	76	129
Other liabilities	17	954	761
<b>Total liabilities denominated in local currency</b>		<b>238,783</b>	<b>205,978</b>
<b>CAPITAL AND RESERVES</b>			
Capital		750	750
Legal reserve		3,750	3,750
Revaluation reserve	18	(15,856)	(12,452)
Fixed assets revaluation surplus	10	2,660	983
Other reserves	19	8,706	8,182
<b>Total capital and reserves</b>		<b>10</b>	<b>1,213</b>
<b>Total liabilities, capital and reserves</b>		<b>255,481</b>	<b>224,655</b>

The accompanying notes on pages 150 to 174 are an integral part of these financial statements.

INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2006  
(all amounts are expressed in million LEK, unless otherwise stated)

	Notes	Year ended December 31, 2006	Year ended December 31, 2005
Operations with non-residents			
Interest and commission income	20	5,870	4,345
Interest and commission expense	21	(494)	(660)
Operations with non-residents, net		5,376	3,685
Operations with residents			
Interest and commission income	22	4,020	4,328
Interest and commission expense	23	(1,731)	(1,393)
Operations with residents, net		2,289	2,935
Other operating expenses, net	24	(1,367)	(360)
(Loss)/Profit from exchange rate		(3,341)	3,841
Total income from Banking activities		2,957	10,101
Other administrative expenses			
Personnel expenses	25	(584)	(528)
Depreciation	10	(122)	(115)
Amortization	10	(114)	(159)
General and administrative expenses		(319)	(280)
Total other administrative expenses		(1,139)	(1,082)
Net income from Banking activities		1,818	9,019
Transfer from/(to) revaluation reserve		3,341	(3,841)
Net profit before allocation		5,159	5,178
Allocation of profit to state budget		4,664	5,100
Allocation of profit to other reserve		495	78
Total		5,159	5,178

The accompanying notes on pages 150 to 174 are an integral part of these financial statements

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED  
DECEMBER 31, 2006  
(all amounts are expressed in million LEK, unless otherwise stated)

	Capital	Legal reserve	Revaluation reserve	Fixed assets revaluation surplus	Other reserves	Retained earnings	Net profit	Total
As at December 31, 2004	750	3,750	(15,836)	1,012	8,075	-	-	(2,249)
Net income from Banking activity	-	-	-	-	-	-	9,019	9,019
Transfer to revaluation reserves	-	-	3,841	-	-	-	(3,841)	-
Securities revaluation	-	-	(447)	-	-	-	-	(447)
Release of tangible fixed asset revaluation surplus	-	-	-	(29)	-	29	-	-
Other revaluation	-	-	(10)	-	-	-	-	(10)
Profit distribution	-	-	-	-	107	(29)	(5,178)	(5,100)
As at December 31, 2005	750	3,750	(12,452)	983	8,182	-	-	1,213
Net income from Banking activity	-	-	-	-	-	-	1,818	1,818
Transfer from revaluation reserves	-	-	(3,341)	-	-	-	3,341	-
Securities revaluation	-	-	(67)	-	-	-	-	(67)
Fixed assets revaluation increase	-	-	-	1,706	-	-	-	1,706
Release of tangible fixed asset revaluation surplus	-	-	-	(29)	-	29	-	-
Other revaluations	-	-	4	-	-	-	-	4
Profit distribution	-	-	-	-	524	(29)	(5,159)	(4,664)
As at December 31, 2006	750	3,750	(15,856)	2,660	8,706	-	-	10

The accompanying notes on pages 150 to 174 are an integral part of these financial statements.

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31,  
2006

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

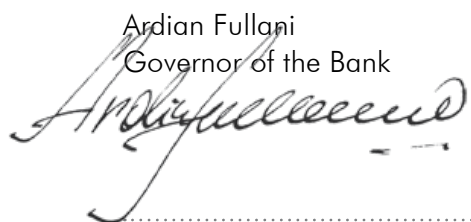
	Notes	Year ended December 31, 2006	Year ended December 31, 2005
Cash flows from operating activities			
Net profit for the year		5,159	5,178
Non-cash items in the statement of operation			
Provision for doubtful loans		5	6
Depreciation and amortization		237	274
Discount amortization of available for sale investments		(3,920)	(3,760)
Interest income		(5,533)	(4,300)
Interests expense		1,802	1,457
Loss from sales of available for sale investments		1,503	397
Profit realized from sale of held for trading securities		(72)	-
Profit unrealized from sale of held for trading securities		(5)	-
Grant amortization (deferred income)		(53)	(41)
Cash flow before the movement of working capital		(877)	(789)
Changes in working capital			
Decrease in deposits with the IMF		564	8,359
(Increase)/Decrease in other assets (in foreign currency)		(171)	8
Decrease in transit credits		68	70
(Increase) in other assets (in local currency)		(1,865)	(36)
(Decrease) / increase in due to the IMF		(892)	197
(Decrease) in due to financial institutions		(73)	(208)
Increase on other foreign liabilities		186	-
Increase in due to resident Banks		4,688	7,629
Increase in due to the Government		9,588	1,054
Increase in other liabilities (in local currency)		193	181
Grant received		-	64
Purchase of held for trading securities		(25,726)	-
Sale of held for trading securities		16,281	-
Cash flows generated from operations		2,841	17,318
Interest received		5,396	3,993
Interest paid		(1,788)	(1,465)
Net cash from operating activities		5,572	19,057

	Notes	Year ended December 31, 2006	Year ended December 31, 2005
<b>Cash flows from investing activities</b>			
Purchase of fixed assets		(75)	(152)
Purchase of intangible assets		(2)	(59)
Purchase of available for sale investments (in foreign currency)		(289,309)	(234,083)
Purchase of available for sale investments (in local currency)		(181,866)	(180,421)
Sale and maturity of available for sale investments (in foreign currency)		300,050	207,802
Sale and maturity of available for sale investments (in local currency)		184,832	181,506
(Decrease) / increase of repurchase agreement		(5,156)	(1,758)
Adjustment for effect of foreign exchange		506	158
<b>Net cash used in investing activities</b>		<b>8,980</b>	<b>(27,007)</b>
<b>Cash flows from financing</b>			
Payment of matured debts		1,726	-
Revaluation of the head quarter		1,706	-
Revaluation of other reserves		4	(10)
Increase in other reserves		524	107
Increase in money in circulation emissions		9,000	15,000
Profit distribution		(5,188)	(5,207)
<b>Net cash generated in financing activities</b>		<b>7,772</b>	<b>9,890</b>
<b>Increase in cash during the year</b>		<b>22,324</b>	<b>1,940</b>
<b>Cash and cash equivalents at the beginning of the year</b>	26	<b>24,390</b>	<b>22,450</b>
<b>Cash and cash equivalents at the end of the year</b>	26	<b>46,714</b>	<b>24,390</b>

The accompanying notes on pages 150 to 174 are an integral part of these financial statements.

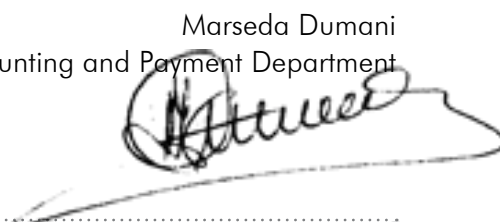
These financial statements have been approved from the Supervisory Board of the Bank on March 1, 2007 and signed on its behalf by:

Ardian Fullani  
Governor of the Bank



Bank of Albania

Marseda Dumani  
Head of Accounting and Payment Department





## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED DECEMBER 31, 2006

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

### 1. GENERAL INFORMATION

The Bank of Albania (the "Bank") is the central Bank of the Republic of Albania and was established according to the Law No. 8269, dated December 23, 1997 "On the Bank of Albania". Under the terms of its charter the Bank's main responsibilities are:

- establish and maintain price stability;
- supporting the development of a foreign exchange regime;
- management of money in circulation;
- management of interest rates;
- compilation, approbation and application of monetary policy of Republic of Albania;
- supervision of commercial Bank activities including issuance of licenses to all Banks; and
- issuing of licenses for international Banking institutions operating within the Republic of Albania.

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

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### a. Basis of preparation of financial statements

The financial statements have been prepared in accordance with the Albanian Law "On Accounting and Financial Statements" and in accordance with accounting policies adopted by the Supervisory Board of Bank of Albania. This accounting policy is broadly in line with International Financial Reporting Standards ("IFRS") approved by the International Accounting Standards Board ("IASB"). IFRS are used in the preparation of the accompanying financial statements to the extent they do not contradict to the Law "On the Bank of Albania".

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

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

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

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

The financial position of the Printing House as at December 31, 2006 and 2005 is set out in Note 27 to these financial statements.

b. Interpretations issued but not yet effective

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Bank's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements are presented as part of the relevant accounting policy disclosures.

The Bank has chosen not to early adopt the following standard and interpretations that were issued, but not yet effective for accounting periods beginning on January 1, 2006:

- IFRS 7 Financial Instruments: Disclosures (effective January 1, 2007);
- IAS 1 Amendment - Additional disclosures regarding capital (effective January 1, 2007);

The application of these new interpretations will not have a material impact on the Bank's financial statements in the period of initial application.

c. Deviation from International Financial Reporting Standards

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

- IAS 16 "Property, Plant and Equipment"

The revaluation of the head office building as detailed in Note 10 was not in accordance with the revaluation requirements set out in IAS 16 on "Property, plant and equipment" to the extent that the revaluation was not conducted for the entire class of building.

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

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

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

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

d. Interest and commission recognition

Interest income and expense are recognized in the income statement on an accrual basis. Interest income and expense include the interest earned on coupons, as well as the amortization of any discount or premium or other differences between the initial carrying amount of an interest bearing instrument and its amount at maturity calculated on a straight line basis

Fee and commission income and expenses arise on financial services provided by the Bank and are recognized when the corresponding service is provided. Other operating income/expense includes gains and losses arising from disposals and changes in the fair value of financial assets and liabilities held for trading and available for sale assets.

e. Foreign currency translation

Transactions in foreign currencies are recorded at the rates of exchange prevailing at the dates of the transactions. At each balance sheet date, monetary items denominated in foreign currencies are retranslated at the rates prevailing at the balance sheet date. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences initially are recognized in profit or loss in the period in which they arise, and after that transferred in "Revaluation reserves" in capital, according to the Law No. 8269, dated December 23, 1997 "On the Bank of Albania".

The applicable official Bank rate (LEK to the foreign currency unit) for the principal currencies as at December 31, 2006 and 2005 were as below:

	December 31, 2006	December 31, 2005
United States dollar (USD)	94.14	103.58
European Union currency unit (EUR)	123.85	122.58
British pound (GBP)	184.65	178.65
Special Drawing rights (SDR)	141.51	148.03
Japanese yen (JPY)	0.7919	0.8826
Gold ("XAU")	1 onz = 59,844.80	1 onz = 53,136.54

f. Financial assets

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

Financial assets are classified as follows:

*Loans originated by Bank*

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

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

*Held-to-maturity*

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

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

*Available for sale investments*

Available for sale investments are recognized on a settlement date basis and, after initial recognition, are remeasured at fair value. Gains and losses arising from changes in fair value are recognized directly in equity in the investments revaluation reserve with the exception of impairment losses. Where the investment is disposed of or is determined to be impaired, the cumulative gain or loss previously recognized in the investments revaluation reserve is included in profit or loss for the period.

*Financial assets at fair value through profit or loss*

This category comprises financial assets classified as held for trading are those that the Bank maintains for short term profits. Those are recognized and derecognized on a trade date where the purchase or sale of an investment is under a contract whose terms require delivery of the investment within the timeframe established by the market concerned, and are initially measured at fair value. Any realized loss/profit in the fair value is directly recorded in the income statement.

*Fair values*

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

For investments where there is no quoted market price, a reasonable estimate of the fair value is determined by reference to the current market value of another instrument, which is substantially the same.

*Impairment and uncollectability of financial assets*

Financial assets, other than those “Held for trade”, are assessed for indicators of impairment at each balance sheet date. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted. For financial assets carried at amortized cost, the amount of the impairment is the difference between the asset’s carrying amount and the present value of estimated future cash flows, as follows:

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

g. Repurchase agreements and reverse repurchase agreements

Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements) are generally treated as collateralised financing transactions and are carried at the amounts of cash advanced or received, plus accrued interest.

Repurchase agreements are recorded in the balance sheet item “Due to domestic Banks”. Based on the Bank’s regulation on repurchase agreements, the Bank is not required to put up any collateral for these securities.

Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements is recognized as interest income or interest expense,

over the life of each agreement using the interest rate approved by the Supervisory Board of the Bank of Albania.

#### h. Fixed assets

The fixed assets are stated at historical cost less accumulated depreciation except the headquarter building, which is stated at revalued amount (see Note 10). Any revaluation increase arising on the revaluation of the head office building is credited in equity to the properties revaluation reserve, except to the extent that it reverses a revaluation decrease for the same asset previously recognized in profit or loss, in which case the increase is credited to profit or loss to the extent of the decrease previously charged. A decrease in the carrying amount arising on the revaluation of such land and buildings is charged to profit or loss to the extent that it exceeds the balance, if any, held in the properties revaluation reserve relating to a previous revaluation of that asset.

If the fair value of a fixed asset is lower than its carrying amount, due to circumstances not considered to be temporary, the fixed asset is written down to its fair value.

Gains and losses on disposal (sell or out of use) of fixed assets are determined as the difference between net disposal proceeds and the carrying amount of the asset and are recognized as income or expense in the statement of income and expenditure in the year of disposal.

Depreciation is provided on all fixed assets based on the historic cost except for the headquarter building, which is stated at revalued amount. The annual charge for depreciation is computed using the straight-line method, using rates specified for each depreciable asset based on estimated useful lives. The estimated useful lives applied during 2006 are the same as year 2005:

	2006
Building – Head office	40 years
Buildings – At branches	25 years
Vehicles	5-10 years
Furniture, fixtures and equipment	3-20 years
Computer software	2 years

#### i. Printing and minting costs

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

#### j. Taxation and profit allocation

The allocation of profit from operations of the Bank is carried out in accordance with the “Law on the Bank of Albania”. In accordance with this law, Bank allocates 100% of the realized profit to the State Budget. The Bank is not subject to income tax.

## k. Legal reserve

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

## l. Grants

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

## m. Cash and cash equivalents

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

## n. Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

## o. Comparison

Certain corresponding figures in income statement and capital and reserves statement have been reclassified to conform to current year financial statements presentation.

## 3. GOLD AND PRECIOUS METALS

As at December 31, 2006, the value of gold owned by the Bank placed in gold time deposits abroad was LEK 797 million (2005 - LEK 708 million), being 13,319 troy ounces of gold (2005 – 13,319 troy ounces).

Gold is valued at the London fixing rate on the balance sheet date. The difference of LEK 89 million (2005 – LEK 168 million) resulting from the revaluation of gold is recorded in the revaluation reserve. As at December 31, 2006 the price for one troy ounce of gold was USD 635.7 (2005 – USD 513).

Other gold and precious metals included within domestic assets include platinum and silver in a domestic vault, valued at the London fixing rate on

the balance sheet date, amounting to LEK 48 million as at December 31, 2006 (2005 – LEK 45 million) and LEK 5 million of non monetary gold (2005 – LEK 5 million).

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

	As at December 31, 2006	As at December 31, 2005
International Monetary Fund (IMF)	7,012	7,128
Special Drawing Rights ("SDR")	847	1,295
Accrued interest	8	8
Total	7,867	8,431

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

The Special Drawing Rights (SDR) represents deposits placed in the International Monetary Fund. The SDR holdings bear interest, which is determined on weekly basis. The interest rate prevailing as at December 31, 2006 was 4.07% (2005 – 3.03%).

#### 5. DEPOSITS WITH NON RESIDENT BANKS

	As at December 31, 2006	As at December 31, 2005
Current accounts	17,281	7,996
Short-term deposits	20,803	2,175
Accrued interest	73	4
Total	38,157	10,175

Short term deposits and current accounts earn interest at rates mostly based on the currency of the deposit or current account, and at rate varying from 0.17 % to 5.29% (2005 – 1.25 % to 4.53%).

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

	As at December 31, 2006 (in million)	As at December 31, 2005 (in million)
EUR	197	25
USD	96	28
GBP	7	11
JPY	4,022	2,615



## 6. INVESTMENTS IN FOREIGN CURRENCY

### 6.1 AVAILABLE FOR SALE INVESTMENTS (FOREIGN CURRENCY)

The portfolio of available for sale in foreign currency is disclosed using market value as follows:

	As at December 31, 2006	As at December 31, 2005
Foreign Governments treasury notes	87,190	99,043
Bank for International Settlements: medium-term investments	18,212	4,577
Fixed rate investments (FIX BIS)	9,711	24,817
French Government treasury bills	1,818	2,443
United States agencies notes	473	2,584
Total	117,404	133,464

Foreign Governments treasury notes include treasury notes issued by the United States Government, denominated in USD, treasury notes issued by the French and German Governments, denominated in EURO, and also treasury notes issued by the United Kingdom Government, denominated in GBP. Foreign Governments treasury notes have coupon rates varying between 2.5% and 9%. Interest is paid semi-annually and maturities vary between May 2007 and October 2016. The yields vary between 2.8% and 5.66% (2005 – 1.6% and 5.82%).

Bank of International Settlements – medium term investments comprise of fixed coupon securities denominated in EUR, USD and GBP with coupon rates varying between 2.95% and 4.6%. Interest is payable annually for investments in EUR and semi-annually for investments in GBP and USD, and maturities range between September 2007 and March 2014. The yields vary between 2.87% and 5.28% (2005 – 2.87% and 5.1%).

Fixed rate investments (FIX BIS) issued by the Bank of International Settlements are denominated in USD, EUR and GBP with yields that vary between 3.56% and 5.3% (2005-2.04% and 4.53%) and maturities range between May 2007 and December 2007.

The French Government treasury bills are denominated in EUR and matures on August 2007 with purchasing yields 3.5 % (2005 – 2.1%).

United States agencies notes are denominated in USD with coupon rates up to 2.37 %. Interest is paid semi-annually and maturities range lasts until February 2007. The yield is 2.4% (2005 – 2% and 2.4%).

Foreign investments classified as available for sale disclosed in nominal value and by currency are as follows:

	As at December 31, 2006 (in million)	As at December 31, 2005 (in million)
USD		
United States Government treasury notes	388	388
Bank for International Settlements: medium-term investments	5	24
United States agencies notes	2	25
Fixed rate investments (FIX BIS)	32	77
Total	427	514
EURO		
French Government treasury notes	199	442
German Government treasury notes	169	-
Bank for International Settlements: medium-term investments	60	10
French Government treasury bills	112	20
Fixed rate investments (FIX BIS)	15	125
Total	555	597
GBP		
United Kingdom Government treasury notes	27	26
Bank for International Settlements: medium-term investments	11	4
Fixed rate investments (FIX BIS)	7	9
Total	45	39

## 6.2. HELD FOR TRADING INVESTMENTS (FOREIGN CURRENCY)

Held for trading portfolio measured at market value is presented as follows:

	As at December 31, 2006	As at December 31, 2005
United States Government treasury notes	6,407	-
United States agencies notes	3,229	-
Total	9,636	-

United States Government treasury notes, denominated in USD, have coupon rates varying between 3.37% and 4.87%. Interest is paid semi-annually and maturities vary between August 2007 and April 2011.

United States agencies notes are denominated in USD with coupon rates varying between 2.37% and 6.62%. Interest is paid annually or semi-annually and maturities range between October 2007 and November 2009.

Starting from July 25, 2006, this portfolio is administrated from International Bank for Reconstruction and Development (IBRD) as stated in the agreement "For the administration and technical assistance on investing the valutory reserve of Bank of Albania (Reserves and Advisory Management Program) signed between Bank of Albania and World Bank on September 23, 2005. This portfolio is recognized in balance sheet on a trade date basis.

## 7. OTHER ASSETS (IN FOREIGN CURRENCY)

	As at December 31, 2006	As at December 31, 2005
Quotas in international financial institutions		
International Bank for Reconstruction and Development subscriptions	358	361
International Development Agency subscriptions	12	12
Multilateral Investment Guarantee Agency subscriptions	6	6
International Finance Corporation subscriptions	69	76
European Bank for Reconstruction and Development subscriptions	55	61
Islamic Development Bank subscriptions	22	24
Total Quotas	522	540
Cash on hand in foreign currency	15	11
Receivables from International Bank for Reconstruction and Development	189	-
Total	726	551

As at December 31, 2006, other foreign assets are comprised of subscriptions for participation of the Republic of Albania in International Institutions on LEK 522 million (2005 – 540 million LEK) and cash on hand in foreign currency of LEK 15 million (2005 - LEK 11 million).

Receivables from International Bank for Reconstruction and Development represent the amount of cash to be received from the sale of securities administrated from IBRD, during the period within the trading date and settlement date (refer to note 6.2).

## 8. LOANS DISBURSED TO THIRD PARTIES

## 8.1. TRANSIT CREDITS

The total of LEK 139 million (2005 – LEK 207 million) represent credits for services provided to the Italian-Albanian Bank for further distribution to ultimate borrowers to support state development programs (See Note 12). This loan has not been secured by any collateral.

## 8.2. LOANS TO RESIDENT BANKS

Loans to resident banks represent reverse repurchase agreements signed between the Bank of Albania and second level banks in amount of LEK 8,904 million (2005 - nil), with maturing terms of one month and three month. On December 31, 2006 the interest rate of reverse repurchase agreement vary between 5.6% and 6.51%.

## 9. INVESTMENTS IN LOCAL CURRENCY

### 9.1 AVAILABLE FOR SALE INVESTMENTS (LOCAL CURRENCY)

	As at December 31, 2006	As at December 31, 2005
Short-term treasury bills	67,575	66,821
Total	67,575	66,821

Short-term treasury bills as at December 31, 2006 relate to Government of Albania zero-coupon treasury bills, with maturities 3 to 6 months, ranging between January 2007 and June 2007, with yields varying between 5.4% and 7.1% (2005 – 5.38% and 8.64%).

### 9.2 HELD TO MATURITY INVESTMENTS (LOCAL CURRENCY)

	As at December 31, 2006	As at December 31, 2005
Zero- coupon bond for capitalization of National Commercial Bank (NCB)	-	1,725
Total	-	1,725

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

## 10. OTHER ASSETS (IN LOCAL CURRENCY)

	As at December 31, 2006	As at December 31, 2005
Tangible fixed assets, net	3,123	1,464
Intangible assets, net	166	278
Loans to employees	857	707
Other debtors	6	5
Numismatic	39	38
Inventory	25	25
Other	7	6
Total	4,223	2,523

The headquarter building of the Bank, included within the category "Land, buildings and general constructions", was revalued on December 2006 in amount of LEK 2,660 million from a net carrying amount of LEK 954 million, outstanding

from the prior revaluation performed on March 2000. The revaluation was effective on December 29, 2006, and was conducted by an independent valuation appraiser. The methodology of the valuation was the income approach, based on capitalization of rental income and selling prices for new business centers. The revaluation surplus of LEK 1,706 million was credited to the revaluation reserve and is amortized monthly in accordance with the respective amortization rate. No other buildings owned by the Bank were revalued.

Loans to employees include a provision for legal claims of LEK 15 million at December 31, 2006 (LEK 10 million at December 31, 2005).

Loans to employees are collateralised by security such as mortgages, totaling approximately LEK 990 million at December 31, 2006 (LEK 851 million at December 31, 2005).

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

	Land, buildings and general constructions	General equipment	Transport vehicles	Work in Progress	Total fixed assets
Cost / Valuation					
Balance at January 1, 2006	1,443	682	173	17	2,315
Additions	4	28	27	16	75
Revaluation of head quarter building	1,706	-	-	-	1,706
Eliminated on revaluation	(189)	-	-	-	(189)
Balance at December 31, 2006	2,964	710	200	33	3,907
Accumulated depreciation					
Balance at January 1, 2006	220	490	141	-	851
Charge for the year	38	70	14	-	122
Eliminated on revaluation	(189)	-	-	-	(189)
Balance at December 31, 2006	69	560	155	-	784
Net book value					
Balance at December 31, 2006	2,895	150	45	33	3,123
Balance at December 31, 2005	1,223	192	32	17	1,464

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

	Computer software	Banknotes printed and coins minted	Total intangible assets
Cost			
Balance at January 1, 2006	336	2,454	2,790
Additions	2	-	2
Balance at December 31, 2006	338	2,454	2,792
Accumulated depreciation			
Balance at January 1, 2006	266	2,246	2,512
Charge for the year	48	66	114
Balance at December 31, 2006	314	2,312	2,626
Net Book Value			
Balance at December 31, 2006	24	142	166
Balance at December 31, 2005	70	208	278

## 11. DUE TO THE INTERNATIONAL MONETARY FUND

	As at December 31, 2006	As at December 31, 2005
Poverty Reduction and Growth Facility ("PRGF")	8,364	9,513
IMF securities account	4,812	4,881
IMF account in LEK	2,077	1,751
Accrued interest	3	-
Total	15,256	16,145

PRGF borrowings related to the Republic of Albania's IMF quota and were drawn down on behalf of the Government for macroeconomic reforms. These loans are compounded from the following component facilities:

The loan "Poverty Reduction and Growth Facility 2" is approved from the agreement dated May 13, 1998 totaling SDR 45,040,000 and was drawn down during the period 1999 to 2001. The outstanding balance as at December 31, 2006 was SDR 28,668,900 (2005 - SDR 36,265,400). This facility is repayable by 2011 in 10 semi-annual installments commenced in 2004. Interest is payable, at 0.5% semi-annually.

The loan "Poverty Reduction and Growth Facility 3" is approved from the agreement dated June 21, 2002 totaling SDR 28,000,000 and the last disbursement was made on June 20, 2005. The balance as of December 31, 2006 is SDR 28,000,000 (2005 - SDR 28,000,000) with an interest rate of 0.5% payable semi-annually. This facility is repayable after a grace period of five and a half years in 10 semi-annual equal installments.

The loans "Poverty Reduction and Growth Facility 4 (PRGF4)" and "Extended Fund Facility" are approved from a three year agreements signed on January 27, 2006 in amount of SDR 17,045,000.

The disbursement of the first two entrenchment of PRGF4 loan in amount of SDR 2,435,000 is made during 2006, with a semi annual interest payable of 0.5 %. This facility is repayable after a grace period of five and a half years in 10 semi-annual equal installments.

International Monetary Fund account is increased in amount of LEK 353 million, because of the disbursement during 2006 of the first two entrenchment of EFF loan totaling SDR 2,435,000. This facility is repayable after a grace period of four and a half years for a period of ten year. The interest on these loans is floating and payable each three month. As at December 31, 2006 interest rate on EFF loan was 5.26%.

## 12. DUE TO NON-RESIDENT FINANCIAL INSTITUTIONS

	As at December 31, 2006	As at December 31, 2005
Transit credits (Note 8)	139	207
Loan from the Hellenic Republic	1,090	1,079
Due to the World Bank	12	28
Accrued interest	5	5
Total	1,246	1,319

Transit credit (Note 8) of LEK 139 million represents the outstanding loan received from the European Investment Bank and is compounded from USD 0.1 million and of EUR 1 million (Note 8). Interest is paid by the recipients of these transit credits (Banks and domestic companies) directly to the providers of the funds.

The loan from the Hellenic Republic (in amount of EUR 8.8 million) was granted for the purpose of funding the balance of payments of the Republic of Albania. The interest rate is 1.17% per annum, payable semi-annually. The loan matures in 2018.

Due to the World Bank represents the accounts of the international organizations such as International Bank for Reconstruction and Development, International Development Agency, Multilateral Investment Guarantee Agency, International Finance Corporation in the Bank of Albania.

## 13. CURRENCY IN CIRCULATION

The exclusive rights of national currency issue are vested with the Bank. This item comprises valid domestic Banknotes and coins in circulation issued by the Bank.

The following Bank notes and coins were in circulation as at December 31, 2006 and 2005:

Nominal value LEK	As at December 31, 2006		As at December 31, 2005	
	Number in thousand	Total LEK (million)	Number in thousand	Total LEK (million)
100	9,244	924	12,167	1,217
200	15,799	3,160	15,481	3,096
500	66,541	33,271	68,373	34,187
1,000	72,601	72,601	68,218	68,218
5,000	11,351	56,755	9,087	45,435
Coins		1,523		1,397
		168,234		153,550

## 14. DUE TO RESIDENT BANKS

	As at December 31, 2006	As at December 31, 2005
Foreign currency		
Compulsory reserve	18,273	14,683
Accounts of second level banks	67	118
	18,340	14,801
Domestic currency (LEK)		
Compulsory reserve	30,122	26,980
Accounts of second level banks	453	1,800
Repurchase agreements	4,199	505
Overnight deposits	436	1,082
	35,210	30,367
Accrued interest	25	14
Total	53,575	45,182

Interest on compulsory reserves is calculated as follows:

- LEK balances: 70% of the yield on the repurchase agreements: 3.85 % as at December 31, 2006 (70% of the yield on the repurchase agreements: 3.5 % as at December 31, 2005);
- USD balances: 70% of the one-month USD LIBOR rate: 3.75 % as at December 31, 2006 (70% of the one-month USD LIBOR rate: 3.07 % as at December 31, 2005);
- EUR balances: 70% of the one-month EUR LIBOR rate: 2.57% as at December 31, 2006 (70% of the one-month EUR LIBOR rate: 1.7% as at December 31, 2005).

On December 31, 2006, nominal value of repurchase agreements between Bank of Albania and second level Banks is LEK 4,199 million, with maturing terms of one day.

Overnight deposits from domestic Banks own interest of 3.75% (2005 - 3.25%).

## 15. DUE TO THE GOVERNMENT

	As at December 31, 2006	As at December 31, 2005
Profit to be distributed to the Government	-	547
Deposits received on behalf of the Government	15,922	5,785
Other	22	24
Total	15,944	6,356

Deposits received on behalf of the Government includes the main account of LEK 13,048 million, international donor funds deposited at the Bank for



subsequent transfer to aid projects in Albania, of LEK 2,087 million and an amount of LEK 787 million representing a reserve fund account of the government on behalf of the Social Insurance Institute and Health Insurance Institute.

“Other” includes funds received by the Bank of LEK 22 million (2005 – LEK 24 million) from a loan granted to the Government by the Islamic Arabian Bank of Development.

## 16. DEFERRED INCOME

	World Bank grant	Other	Total
Balance at December 31, 2005	289	36	325
Disposal	(157)	-	(157)
Balance at December 31, 2006	132	36	168
Accumulated depreciation			
Balance at December 31, 2005	196	-	196
Charge for the year	53	-	53
Disposal	(157)	-	(157)
Balance at December 31, 2006	92	-	92
Net Book Value			
Balance at December 31, 2006	40	36	76
Balance at December 31, 2005	93	36	129

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

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

## 17. OTHER LIABILITIES (LOCAL CURRENCY)

	As at December 31, 2006	As at December 31, 2005
Due to Printing House (Note 27)	233	212
Deposits of individuals from the participation in Treasury Bills	636	469
Net obligation/ Pension fund	6	6
Other	79	74
Total	954	761

Pension plan scheme consists of employee contribution of 2% of gross salary and employer contribution of 15% on the total payroll amount. On December 31, 2006 the amount of pension funds assets invested in treasury bills matured within 12 month, is LEK 366 million. Total amount of contributions paid from the Bank's employees till December 31, 2006 is LEK 24 million (Lek 19 million as at December, 2005) and the total amount of contributions paid from the Bank till December 31, 2006 is LEK 251 million (Lek 203 million as at December, 2005).

"Other" includes accrued expenses of LEK 29 million (2005 – LEK 23 million) related to maintenance of ATM system, repair and maintenance of sorting machines, Reuter services, statistics information, commissions for the management of the valutory reserve from IBRD, etc. Also included here are the claims for several legal litigations raised in the normal course of business. A net provision of LEK 22 million has been recognized in relation to these claims for the year ended December 31, 2006 (2005 – LEK 22 million). During the year ending December 31, 2006 the Bank has recognized additional provision of LEK 19 million and retaken provision previously recognized in amount of LEK 19 million (see Note 24).

## 18. REVALUATION RESERVE

The components of the revaluation reserve are as follows:

	As at December 31, 2006	As at December 31, 2005
Revaluation of foreign currency and gold balances	(15,505)	(12,164)
Reserve of security revaluation	(377)	(310)
Revaluation of historic notes and coins	26	22
Total	(15,856)	(12,452)

During year 2006, the net loss arising from the revaluation of foreign currency balances was LEK 3,341 million (2005 – net gain of LEK 3,841 million).

In accordance with the Law "On the Bank of Albania" article 64, point (a), the net gain / losses arising from the revaluation of assets and liabilities denominated in foreign currencies, is transferred to the equity on a revaluation reserve account "Revaluation of foreign currency balances".

Pursuant to the above article, point (b), during the year 2006 the Ministry of Finance issued securities by a total of LEK 12,164 million to cover the negative balance of the revaluation reserve arising from Bank's activity till the end of year 2005. These securities are recorded as off-balance sheet items and have a renewable maturity of six month. The amount of LEK 7,672 million (securities issued for covering foreign exchange revaluation difference created during 2003) is renewed on July 31, 2006 bearing interest of 5.56 %. The amount of

LEK 3,828 million (securities issued for covering foreign exchange revaluation difference created during 2004) is renewed on September 1, 2006 bearing interest of 5.83 % and the amount of LEK 664 million (securities issued for covering foreign exchange revaluation difference created during 2005) is renewed on July 3, 2006 bearing interest of 5.42%.

## 19. OTHER RESERVES

The components of the other reserves are as follows:

	As at December 31, 2006	As at December 31, 2005
Special reserve for Balance of Payments	7,209	7,209
Investment fund	301	301
Other	1,196	672
Total	8,706	8,182

The special reserve for the Balance of Payments relates to funds provided by the European Community as a financial assistance to support Albania on its transition towards the market economy. These grants have been transferred during the period 1992 – 1993 supporting the long-standing of the Balance of Payment and reserves balance and no movement have been incurred in this reserve since 1995.

Investment fund consists of a fund created with decision of Supervisory Council with aim purchase of a new building for the Bank of Albania.

“Other” includes reserves created from the allocation of profits for years 2002 - 2006 based on the Supervisory Council decisions on the respective following years. As at December 31, 2006, the increase in “Other reserves” includes a further allocation of LEK 495 million from the profit of year 2006, and a transfer of LEK 29 million from tangible fixed asset revaluation surplus, based on the Decision No 13, dated March 1, 2007 of the Supervisory Council.

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

	Year ended December 31, 2006	Year ended December 31, 2005
Interest income from securities	4,811	3,578
Interest income from time deposits	684	508
Interest from SDR deposits with IMF	51	170
Other	324	89
Total	5,870	4,345

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

	Year ended December 31, 2006	Year ended December 31, 2005
Amortization of premium on securities	406	594
Interest expenses on loans of foreign institutions	13	13
Interest expenses on IMF accounts	59	48
Other	16	5
Total	494	660

## 22. INTEREST AND COMMISSION INCOME (RESIDENTS)

	Year ended December 31, 2006	Year ended December 31, 2005
Interest income from securities	3,902	4,194
Interest income from Government loans	6	30
Other	112	104
Total	4,020	4,328

## 23. INTEREST AND COMMISSION EXPENSE (RESIDENTS)

	Year ended December 31, 2006	Year ended December 31, 2005
Interest expense on compulsory deposits	1,440	1,176
Interest expenses on REPO agreements	233	196
Other	58	21
Total	1,731	1,393

## 24. OTHER OPERATING EXPENSES, NET

	Year ended December 31, 2006	Year ended December 31, 2005
Net loss from the sale of available for sale investments	(1,503)	(397)
Net profit from the sale of held for trading investments	72	-
Grants depreciation	53	42
Provision for legal claims and other (note 10 and 17)	(25)	(6)
Other	32	1
Unrealized profit from fair value revaluation of held for trading investments	4	-
Total	(1,367)	(360)

## 25. PERSONNEL EXPENSES

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

Social costs represent mainly compulsory contributions to the Social Security Fund. As at December 31, 2006, the Bank had 378 employees (2005 – 427 employees).

## 26. CASH AND CASH EQUIVALENTS

	As at December 31, 2006	As at December 31, 2005
Deposits with foreign Banks (Note 5)	38,084	10,171
Domestic currency on hand	7,765	13,450
Foreign currency on hand (Note 7)	15	11
Gold held abroad (Note 3)	797	708
Gold and other precious metals held domestically (Note 3)	53	50
Total	46,714	24,390

## 27. PRINTING HOUSE

As detailed in Note 2(a), the Bank controls the operations of the Printing House. The financial position of the Printing House as at December 31, 2006 and 2005 is as follows:

	As at December 31, 2006	As at December 31, 2005
<b>ASSETS</b>		
Tangible fixed assets	11	16
Inventory	25	37
Trade accounts receivable	-	2
Amount due from the Bank (see Note 17)	233	212
Total assets	269	267
<b>EQUITY AND LIABILITIES</b>		
Capital	51	51
Legal reserve	19	19
Investment reserves	24	24
Other reserves	6	6
Retained earnings	168	161
Total capital and reserves	268	261
Other liabilities	1	6
Total equity and liabilities	269	267

	As at December 31, 2006	As at December 31, 2005
Income	72	99
Expenses	(65)	(97)
Profit of the year	7	2

## 28. CONTINGENCIES AND COMMITMENTS

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

On December 31, 2006 treasury bills issued from Albanian Government for the purpose of covering the revaluation reserve created during the period 2003 - 2005 in amount of LEK 12,164 million have a renewable maturity of six months.

## 29. MANAGED ASSETS

As at December 31, 2006, the Bank held as custodian short-term treasury bills, at nominal value LEK 269 billion, short-term treasury bills, at nominal value Euro 45 million, and medium-term treasury notes, at nominal value LEK 75 billion. These are securities issued by the Ministry of Finance.

At as December 31, 2006, the Bank held as custodian gold and other precious metals on behalf of the Government, at market value of LEK 5,308 million.

As the Bank acts as custodian for these assets, it does not bear any credit risk related to them.

The value of gold held on behalf of the Government as at December 31, 2006 and 2005 is as below:

	As at December 31, 2006	As at December 31, 2005
Monetary gold held in foreign Banks	2,230	1,980
Non monetary gold held in foreign Banks	1,115	990
Non monetary gold held in Albania	1,761	1,564
Other precious metals	202	160
Total	5,308	4,694

Interest received from the deposit of government gold reserves is recognized as income from interest due to Government, increasing the liability due to Government. For year 2006 the interest received is of 6 ounces. The difference of LEK 614 million is a result of the fluctuation of exchange rates (Note 3).

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

## 30. RELATED PARTIES

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the party in making financial and other decisions.

In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

The only related parties of Bank of Albania are the relations with directors and the members of the Supervisory Council. As at December 31, 2006 and December 31, 2005, transactions made with related parties comprised:

	As at December 31, 2006	As at December 31, 2005
Other domestic Loans		
Loans to employee		
- Directors	84	79
Total assets	84	79

The loans have interest rate of 0.5% and are repayable after a grace period of two years in 30 years, by monthly equal installments. The home loans are collateralized.

	Year ended December 31, 2006	Year ended December 31, 2005
Administrative expenses		
- Mobile expenses		
- Directors and Supervisory Board Members	4	4
- Salaries and Bonuses		
- Directors and Supervisory Board Members	78	67
- Bank contribution to pension plan scheme		
- Directors	7	6
Total of administrative expenses	89	77

### 31. RISK MANAGEMENT

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

#### LIQUIDITY RISK

Policies to monitor and address liquidity risk are set by the Supervisory Board of the Bank. The Monetary Operations department of the Bank monitors the liquidity risk on a continual basis by analyzing liquidity ratios, gaps and economic scenarios. The Bank manages its liquidity risk by investing in short term deposits with foreign Banks. Liquidity management policies are set to ensure that, even under adverse conditions, the Bank is in a position to meet its obligations.

#### CREDIT RISK

The Monetary Operations department of the Bank, under the control of the Supervisory Board, is responsible for assessing the credit risk associated with the Bank's operations. The credit risk is mitigated by the Bank transacting largely with international and governmental institutions. Loans to domestic Banks are secured by Government of Albania treasury bills.

## PRICE RISK

The key elements of price risk affecting the Bank are:

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

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

The Monetary Operations department of the Bank monitors interest rate risk. The Bank mitigates such risks by maintaining a significant excess of interest bearing assets over liabilities (as detailed in Note 31 below). The Bank maintains a portfolio of interest bearing financial assets and liabilities such that the generated net interest income is significantly in excess of operating requirements, which minimizes the potential adverse effects of interest rate fluctuations. Interest rates applicable to financial assets and liabilities are disclosed in each relevant note to the financial statements.

## 32. INTEREST RATE SENSITIVITY

	Up to one month	One to three months	Three to six months	Six to twelve months	One to five years	Over five years	Non-interest sensitive	Total
<b>Assets</b>								
Gold and precious metals	-	-	-	-	-	-	797	797
Deposits with the International Monetary Fund	-	847	-	-	-	-	7,020	7,867
Deposits with non resident Banks	31,866	6,218	-	-	-	-	73	38,157
Available for sale investments	-	473	664	23,009	90,969	2,289	-	117,404
Held for trading investments	-	-	-	1,253	8,383	-	-	9,636
Other foreign assets	189	-	-	-	-	-	537	726
Other gold & precious metals	-	-	-	-	-	-	53	53
Transit credits	-	-	-	-	-	-	139	139
Loans to resident Banks	3,350	5,500	-	-	-	-	54	8,904
Available for sale investments	25,013	23,932	18,630	-	-	-	-	67,575
Other assets	-	-	-	-	-	857	3,366	4,223
<b>Total Assets</b>	<b>60,418</b>	<b>36,970</b>	<b>19,294</b>	<b>24,262</b>	<b>99,352</b>	<b>3,146</b>	<b>12,039</b>	<b>255,481</b>
<b>Liabilities and equity</b>								
Due to the International Monetary Fund	235	150	319	627	4,929	2,458	6,538	15,256
Due to non-resident financial institutions	-	-	-	-	-	1,090	156	1,246
Other foreign liabilities	186	-	-	-	-	-	-	186
Currency in circulation	-	-	-	-	-	-	168,234	168,234
Due to resident Banks	53,030	-	-	-	-	-	545	53,575
Due to the Government	-	-	-	-	-	-	15,944	15,944
Deferred income	-	-	-	-	-	-	76	76
Other liabilities	-	-	-	-	-	-	954	954
Capital and reserves	-	-	-	-	-	-	10	10
<b>Total Liabilities and Equity</b>	<b>53,451</b>	<b>150</b>	<b>319</b>	<b>627</b>	<b>4,929</b>	<b>3,548</b>	<b>192,457</b>	<b>255,481</b>
Balance sheet gap as at December 31, 2006	6,967	36,820	18,975	23,635	94,423	(402)	(180,418)	-
Cumulative interest rate sensitivity gap - 2006	6,967	43,787	62,762	86,397	180,820	180,418	-	-



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

### 33. CURRENCY NET POSITION

	LEK	USD	EURO	GBP	Other	Total
<b>Assets</b>						
Gold and precious metals	-	-	-	-	797	797
Deposits with the International Monetary Fund	6,538	-	-	-	1,329	7,867
Deposits with non resident Banks	-	9,096	24,496	1,380	3,185	38,157
Available for sale investments	-	40,239	68,791	8,374	-	117,404
Held for trading investments	-	9,636	-	-	-	9,636
Other foreign assets	335	379	12	-	-	726
Other gold & precious metals	53	-	-	-	-	53
Transit credits	-	15	124	-	-	139
Loans to resident Banks	8,904	-	-	-	-	8,904
Available for sale investments	67,575	-	-	-	-	67,575
Other assets	4,219	2	2	-	-	4,223
<b>Total Assets</b>	<b>87,624</b>	<b>59,367</b>	<b>93,425</b>	<b>9,754</b>	<b>5,311</b>	<b>255,481</b>
<b>Liabilities and equity</b>						
Due to the International Monetary Fund	6,889	-	-	-	8,367	15,256
Due to non-resident financial institutions	12	15	1,219	-	-	1,246
Other foreign liabilities	-	186	-	-	-	186
Currency in circulation	168,234	-	-	-	-	168,234
Due to resident Banks	35,227	6,472	11,876	-	-	53,575
Due to the Government	8,890	338	6,715	1	-	15,944
Deferred income	76	-	-	-	-	76
Other liabilities	938	13	3	-	-	954
<b>Total Liabilities</b>	<b>220,266</b>	<b>7,024</b>	<b>19,813</b>	<b>1</b>	<b>8,367</b>	<b>255,471</b>
Net currency position as at December 31, 2006	(132,642)	52,343	73,612	9,753	(3,056)	10
Net currency position as at December 31, 2005	(117,926)	49,795	65,013	9,029	(4,698)	1,213



