ANNUAL REPORT 2007

Bank of Albania

C O N T E N T S

T A B L E S

C H A R T S

Governor of the Bank of Albania, Mr. Ardian Fullani

Bank of Albania Supervisory Council

From left to the right in front:

KSENOFON KRISAFI	Member
ARDIAN FULLANI	Chairman (Governor of the Bank of Albania)
TEFTA ÇUÇI	Member
FATOS IBRAHIMI	Vice Chairman (First Deputy Governor)

From left to the right in the back:

HALIT XHAFA	Member
ARJAN KADAREJA	Member
LIMOS MALAJ	Member
ADRIAN CIVICI	Member
BENET BECI	Member

GOVERNOR'S SPEECH

Honourable Ms. Chairwoman,
Honourable Deputies,

It is with great privilege that I present to you the annual activity of the Bank of Albania. I take this opportunity to express my gratitude to the Albanian Parliament for the persistent assistance and support provided to our institution. This support has been and remains vital in terms of providing the continuous public confidence in the Bank of Albania.

Year 2007 provided evidence for a stable dynamics with respect to economic growth and macroeconomic stability. The financial system and the banking sector in particular have played a key role in intermediating the financial resources of the economy.

In addition, the Bank of Albania has been prudent in the formulation of the monetary policy and in its role as the financial system's supervisor. The provision of price stability in the long-run and the preservation of a stable financial system and stable macroeconomic balances in general remain our main objectives.

Allow me to dwell in the following on some key issues presented in the Annual Report of the Bank of Albania:

1. ECONOMIC ACTIVITY

The Albanian economy is estimated to have grown by about 6% in 2007. The growth of gross domestic product was provided by the performance of services, industry, transportation and telecommunications. Year 2007 recorded a high figure in foreign direct investments which account for 6% of the GDP.

The positive exports' performance which resulted 28% higher in 2007 than the previous year is another factor to have affected the economic growth. Domestic demand remained high throughout 2007, reflecting to a large extent the growth of consumer credit and of imports.

Significant structural reforms were undertaken in 2007, notably the establishment of Credit Registry, the re-organization and strengthening of financial sector's supervision, the improved tax and public spending management, the privatization of Albtelecom, the establishment of the National Business Registration Centre and the further reduced customs duties.

Year 2007 evidenced a number of challenges which are vital to the Albanian economy.

In addition, our economy went through one of the hardest times with respect to production and consumption of energy.

For a considerable part of the year Albania was challenged with a difficult situation which had at its core the drastic fall in domestic production while the alternative sources of energy, such as oil and its by-products, hit record prices in the international markets. In light of these developments, the import of energy was deemed as the sole alternative to put the energy deficit to an end.

In 2007, the total volume of energy sources was estimated to be about 13% lower than in 2006, while production dropped by about 50% relative to the same year. In terms of millions of euro, imports, excluding exchanges, were about 4.8 times higher in 2007 relative to 2006. The considerable reduction in the domestic production of energy was among others fuelled by the unfavourable weather conditions.

Year 2007 once more highlighted the necessity for building new alternative sources of energy and improving the technical capacities to import. The improved independence to hydro-energy resources represents a key strategic national priority. On the other hand, the reduction of network losses is of the same priority. Although they have dropped by 16% in 2007, they remain critical and with direct consequences on the financial situation of the KESH. In this respect, the timely conclusion of the distribution net privatization would be a positive development.

The year 2007 was not a good year for the construction sector as well. According to the available data, the construction sector has almost recorded no growth; hence its contribution to the economic growth has been inexistent.

However, house prices continued to go upward in the last months of 2007, although at slower rates.

Despite the recent positive developments, agricultural production continues to be faced with a number of challenges. The Bank of Albania, as in many other cases, deems that structural reform in agriculture is indispensable and it should aim to encourage all factors which would lead to growth of agricultural production efficiency. Recently, the phenomenon of agricultural products' price rise is ever-increasingly being referred to as food crisis. According to many experts, its duration will be relatively considerable, thus increasing the uncertainties in many poor economies. In these circumstances, the rational use of agricultural land is of primary importance aiming to augment the planted areas and the productivity per unit.

To this purpose, the Bank of Albania will support and be willing to be active in any initiatives that would lead to the growth of domestic production and the decrease in some agriculture-related items' import.

The entire economic activity in Albania was supported by an encouraging environment in terms of inflation which was kept under check despite the unfavourable global economic developments. Year 2007 and the early months of 2008 were faced with a relatively complex situation in terms of global developments. We are currently facing strong price hikes of raw materials and foodstuffs, which are mainly driven by a high and increasing demand of developing countries. In addition, the financial markets continue to reflect the negative effects of mortgage loans crisis generated by the US economy.

In contrast to the preliminary assessments it seems that its spreading is even larger affecting a considerable number of financial institutions.

The central banks have been constantly injecting liquidity while the FED has aggressively cut the key interest rate to avoid a possible decline in the US economic activity.

These developments have provided their impact on the Albanian economy mainly in the performance of consumer prices. During 2007 the inflation rate fluctuated considerably peaking 4.4% in September. In the last two months of 2007 inflation dropped. In December annual inflation marked 2.9% being close to the 3% quantitative target of the Bank of Albania.

The alternative measures of net inflation indicate that the price rise in processed foodstuffs provided the main contribution to the inflationary developments.

The increasing inflationary pressures in economy are also confirmed by the upward trend of core inflation. In 2007 average inflation rate marked 2.6% or 0.8% higher than the previous year. The inflationary pressures increased in the second half of 2007. During this period the average annual core inflation rate marked 3.4%, reaching the highest rate of this indicator for the last five years.

The increasing inflationary pressures originating from outside the Albanian economy were reflected directly in the total inflation of 2007 through the price rise of tradable goods.

Based on the available official data for the end of the third quarter 2007 it may be concluded that the number of employed people has shifted upward. In general there is a coherent concordance between the performance of economic sectors and the developments in the labour market. Employment has increased at high rates in industry and services.

Wages have gone up in all sectors during 2007. In annual terms, average wage in the public sector was about 23% higher in the third quarter relative to the same period the previous year.

In 2007, the key decision-makers in financial and economic policies, the Government of the Republic of Albania and the Bank of Albania, managed to synchronize the two fundamental policies in economy, the fiscal and the monetary one.

The end-year picture shows stable performance of main fiscal indicators. For the most part of 2007 fiscal policy was rather tight since it was much more inclined to collecting revenues rather than to spend. However, just as in previous years, spending accumulated heavily in the last month of the year.

According to not-yet final data of the Ministry of Finance, as of end year budget revenues were met by 96% of the planned target, whereas budget spending was met by 94%. Relative to the previous year the share of spending on social and health insurance has expanded relative to a year ago, whereas the fiscal burden for servicing the public debt has contracted. Characteristic of domestic debt is the extended maturity time-length from 242 days in 2006 to 346 days in 2007.

The budget deficit resulted 33.7 billion leks while its share to the GDP was around 3.3-3.4%. Quasi 85% of the budget deficit has been domestically financed. Privatization receipts provided a positive contribution to the financing of budget deficit, thus dropping the financing through securities.

The external sector of the economy reported further deepening of current account deficit which in 2007 was estimated at 11% of the GDP relative to the 2006 level of 7.3%. The widened gap in the current deficit reflects higher activity in trade exchanges reflected in the growth of imports. Just as in previous periods, workers' remittances largely financed the trade balance by about 58%. However, it should be emphasized that the annual growth of remittances in 2007 was only 1.3% relative to the growth by 8.7% and 4.6% in 2005 and 2006 respectively.

The year 2007 was characterized by very large flows in capital account, both as income and outgoing flows. The most remarkable development relates to foreign direct investments in economy whose relative indicator to the GDP accounted for 6%.

The privatization of Albtelecom and the growth of foreign capital shares in the domestic financial sector have proved crucial to FDIs' growth. Investors from the European Union continue to lead investments in the processing industry of textiles and footwear.

2. MONETARY DEVELOPMENTS

The performance of monetary indicators continues to show high rates of credit to economy vis à vis a mitigated domestic demand for money. The annual growth rate of broad money, M3 aggregate, slowed down to about 13% from around 16% the previous year.

The analysis of sectoral structure of monetary developments has evidenced high generating rates of money flows in the form of domestic credit, mainly as credit to economy. On the other hand, just as in the last years, the contribution of the public sector to the growth of money remains stable at about 2%.

In total, the analysis of the balance of domestic credit to economy, followed by the downward contribution trend of net foreign assets to the generation of the M3 has occurred analogously to the deterioration of the external account of the economy to about 11% of the GDP and hence, to the savings-investments ratio.

The share of broad money to the GDP has grown while outstanding credit to economy has increased to about 30% of the GDP.

The ratio of credit to economy to the GDP grew by 8.8%. This tendency was also reflected in the growth of the ratio of credit to M3 and to the system's assets, which reached 38% and 40% in 2007. During the same year, the annual growth rate of credit reached to 47.7%, which is less than the previous year. However, the credit growth remains high and it bears potential risks in the medium run both for price and financial stability. Businesses provide the main contribution to the growth of credit, sharing 63%. Nonetheless this contribution has been falling in the last two years due to banks' orientation to retail banking, mainly to household financing.

The Bank of Albania's endeavour during 2007 to improve the financial market has been overwhelming. In this context, in addition to the constant pressures on the banking system several concrete measures have been adopted. Accordingly, it was decided that the government's excess liquidity be placed in a deposit held with the Bank of Albania rather than be injected into the system. In addition, a structural shortage of liquidity would provide more grounds to the Bank of Albania in its role as a lender of last resort.

Another measure undertaken related to the formulation of the draft-law on repurchase agreements between banks. This judicial act aims to avoid possible risks in transactions between banks hence making the application of restraints in the borrowing relationships between various banks ineffective.

I take the opportunity to express my conviction that the Albanian Parliament will duly and professionally analyze this important draft for the future progress of the interbank market.

The development of the money, interbank and securities' markets is of high priority for the Bank of Albania. However, their development implies a harmonious progress of all financial market segments. I believe time is ripe to proficiently use these priorities by activating schemes that would lead to the minimization of possible future issues and pressures.

One of these priorities relates to the young age prevailing in Albania and to the use of this factor to conclude the pension reform.

The experience of numerous developed European countries indicates that the ageing of the population has been challenging the pension's system. This reform would lead to a more liquid government's bonds market. In addition, the prime rates would be introduced for the mortgage and corporates' liabilities markets, thus creating a safer ground for banks in the lending process. They

would all be translated into a more active financial market that would arouse the interest of foreign actors.

Going back to the developments in 2007, I would like to underline that the Bank of Albania has been present in the banking market, in view of implementing the operational policy. Throughout 2007 the interventions in the open market were the main tool in implementing monetary policy.

The monetary operations have allowed the management of liquidity in the system and the stability of short-term interest rates be in line with monetary policy targets. The higher demand for liquidity was met through open market operations. The average daily liquidity is 4.8 billion leks relative to 7.4 billion leks the previous year.

In order to maintain a qualitative liquidity management in the system the Bank of Albania has since July introduced the facility of investing the Government's excess liquidity in time deposits held with the central bank. Consequently, the liquidity management entirely through the central bank has allowed the enhancement of operational policy efficiency.

In 2007 the short-term interest rates have entirely reflected the central bank's monetary policy signalled in June, September and November. Lending interest rates in the interbank market fluctuated within the range re-defined from the key interest rate change by +1.75%.

These developments were transmitted to the long-term instruments' markets. In the primary market, the T-bills' yields have been affected by both interest rates' shifts and other market factors. In March, the yields fell by about 0.7% relative to 2006 end-year. They reflected a correction to their increase at end-year (due to meeting Government's financing) and the high excess liquidity during the first quarter 2007. Alongside, the interest rates of lek denominated deposits have followed the upward trend.

The interest rates of lek denominated deposits have fully and promptly reacted to the monetary policy signals transmitting the raise of the key interest rate. As of end 2007 average interest rate of 12-month lek denominated deposits reached 6.3% or about 0.85% higher relative to 2006.

In addition, in view of achieving the net international reserve objective the Bank of Albania was present in the foreign exchange market. The exchange rate was stable during 2007 although with a slight appreciating tendency of the lek mainly in the last quarter. In annual nominal effective terms, the lek has appreciated to foreign currencies by an average of 1.4%.

In order to meet the price stability objective successfully, the Bank of Albania has estimated risks stemming from the developments in demand and supply and responded accordingly three times by tightening the monetary policy. Hence, starting from November 2007, the repurchase agreement rate of one-week maturity reached 6.25%.

3. BANKING SUPERVISION

In addition to its work for designing and implementing the monetary policy the Bank of Albania has paid special attention to the banking system's financial stability in particular considering the rapid growth of credit to economy and issues generated by the worldwide credit crisis. To this purpose the Bank has been cautious and prudent in terms of knowing and identifying the risks, designing the relevant measures to be taken and implementing them in everyday practice.

In view of that the Financial Stability Department was established, whose main duty will be to investigate and identify potential risks that may jeopardize the financial stability in general and the banking system, in particular.

Year 2007 generally recorded positive and stable developments in the banking system. The banking system's assets grew by 118.6 billion leks or by 19% during 2007. Outstanding credit in the banking system grew by 94.5 billion leks or 47.7% more relative to 2006 end-year outstanding credit. The net positive result of the banking system is reported about 42% higher in 2007 relative to the previous year.

Commercial banks continued to enhance their electronic products provided to their clients. Presently, there are 11 banks in the Albanian banking system that use electronic-based transactions. In addition, internet banking services expanded to other three banks in the system. The substantial expansion in the banking system with new branches and agencies attested to higher banking competition and higher volume in the financial transactions through banks.

Thus, the number of branches and foreign agencies operating within the Republic of Albania increased by 103 in 2007, out of which 43 were opened in Tirana.

Another important achievement relates to the establishment of the Credit Registry which is considered focal in guaranteeing the banking system's stability. Credit Registry represents the electronic database for the borrowers of the Albanian banking system. Its scope is to process information and data in terms of credit exposure of each borrower and related people. This Registry aims to facilitate opportunities for sound credit transactions through access to information on the borrowers, rendering the credit process efficient and safe.

Several structural changes took place in the banking industry during 2007, mainly as a result of the consolidation process in the form of merger by absorption.

Another achievement relates to the improvement of the regulatory framework of banking supervision, by ever-increasingly complying it with the provisions of the new law and with the international directives for an effective supervision stemming from the Basle Committee accords.

The Bank of Albania believes that the financial system and the banking sector in particular will play an active role in the financial intermediation and in supporting the country's economic development, while safeguarding stability and good financial performance.

4. BALANCE SHEET AND THE FINANCIAL RESULT

As of 31 December 2007 total assets of the Bank of Albania reached 260.1 billion leks, increasing by 2% relative to end-year 2006. Assets held in foreign currency increased by about 8 billion leks sharing 70%.

The Bank of Albania income grew by 22% in 2007 relative to 2006 mostly attributed to the foreign currency denominated income which increased by 22% relative to the previous year. The growth in foreign reserve and the increase of return from its investment provided the main contribution in this group of income.

The Bank of Albania expenses reduced by 17% in 2007 relative to 2006.

Interest and commission expenses in lek from operations with residents, which share 59% of total expenses, increased by 33%. The increase in absolute terms of the required reserve and consequently the increased expenses for its remuneration provided the main contribution.

The Bank of Albania ended with a net profit of 8.2 billion leks in 2007 relative to 5.2 billion leks in 2006, otherwise increasing by 58% in relative terms.

Several important improvements were made to the Bank of Albania accounting during 2007, which were in accordance with the external auditors' recommendations, the international accounting standards and the best practices of the European System of Central Banks.

In more concrete terms:

• The tangible fixed assets, property and building, were revaluated in accordance with the International Accounting Standards, according to the replacement cost method, including all the assets in both the head office and in branches.
• After constant recommendations of the external auditor the Printing House was given legal status by decision of the Council of Ministers.
• The Ministry of Finance approved the increase of the Bank of Albania's capital from 750 million leks to 2.5 billion leks, hence meeting one of the constant recommendations left by the external auditor and the IMF expert mission.
• The legal status of the ownership over gold was conclusively resolved, transferring it under the ownership of the Bank of Albania.

The activity of the Bank of Albania is audited by the Audit Department.

Considering the findings, assessments and recommendations left in the audits conducted for 2007 the audit inspectors have assessed that the general ledger and other statements truly reflect the financial situation and they are in accordance with the Accounting Manual of the Bank of Albania and the law 'On the Bank of Albania'. The financial statements have been duly prepared and they are free from material misstatement. They provide a true and fair view of the Bank of Albania financial position.

Honourable deputies,

The enhancement of analytical and modelling capacities of the Albanian institutions has been widely recognized yielding a greater ownership in our medium-run economic and financial development programs.

Since the beginning of transition most of these programs have been designed and implemented under the setup of IMF conditional support programs.

We currently believe this is the final one which gets IMF financial support implying that our economy is matured and that Albania is on the right track. For the first time the Albanian authorities will have full ownership over the medium-term development programs and policies of our country.

This is the reason why the Bank of Albania has quite for long been engaged in this context by not considering it a plain mechanical operation. We have been involved in an intensive process of assessment, analysis and conclusions for the future of monetary policy.

During the last three years we have been tossing ideas and scrupulously studying the details of a fully fledged inflation targeting regime. Based on the current features and expected developments of the financial markets, we believe the inflation targeting regime provides the best policy choice for the future.

Success in this initiative does not only require Albania to continue adopting sound macroeconomic policies but also further deepen them implying a monetary policy focused on price stability and a prudent fiscal policy in particular in terms of fiscal indicators' shares to the GDP.

In this context I would like to highlight that the main objective of the Bank of Albania is consumer price stability.
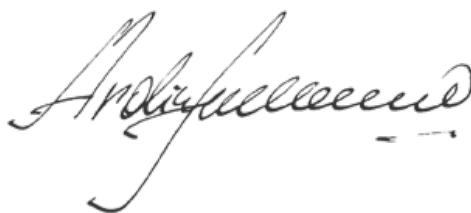
Macroeconomic stability is crucial and precedes all other important economic and financial developments. Without macroeconomic stability there is neither growth, nor foreign investment or reallocation, consequently there is no development.

However I believe that monetary policy and financial stability are closely related to each other. Presently financial stability is of prime importance considering the rapid growth of the negative effects of the credit crisis in the international markets.

Therefore, the real challenge we are facing is to find an optimal balance between these two priorities. Every investment made today to guarantee financial stability will lead to a more efficient monetary policy.

On behalf of the Supervisory Council of the Bank of Albania I would like to assure you and the Albanian public at large that the Bank of Albania remains a fully accountable institution, deeply engaged in rigorously meeting all the obligations stemming from the law and other by-laws.

Thanking you for your attention I am open to any further questions or clarifications.

CHAPTER 1 WORLD ECONOMY

1.1 LARGE ECONOMIES AND CENTRAL BANKS

The global economy is currently undergoing a low-growth cycle, after a 6-year economic boom with an average annual growth rate of 5%. The global economic activity is estimated to have grown by an annual rate of 4.7% in 2007, 70 basis points lower relative to 2006 annual growth rate[1]. Economic growth is projected to reach 4.6% during 2008.

The American economy and that of some industrialized developed countries suffered a slowdown, while large economies of developing countries continued to play the key role in promoting the expansion of the world economy. Risks, impacting the performance of world economy, have multiplied during the second half of 2007. The risk basis has its roots in the deterioration of the financial markets, particularly in the U.S.

Generally speaking, large developing countries refer to western financial markets for capital orientation. The key problem to the American economy is the recent weakening of the real estate market and its potential implications in the mortgage market, and eventually in the real economy. These outcomes have been followed by an accelerated rate of inflation. The hike in oil prices and in some agricultural products' prices may impact the real economic demand, as a result of a declining purchasing power. Recent assessments argue that the oil price hike sold in dollars is owed to the high demand for oil in developing countries and to a stagnant supply. Furthermore, geopolitical frictions certainly have an impetus on the supply side and in waning expectations in price developments in international stock exchanges.

	2005	2006	2007*	2008*
World Economy	4.8	5.4	5.2	4.8
Industrialized Economies	2.5	2.9	2.5	2.2
Eurozone	1.5	2.8	2.5	2.1
- Germany	0.8	2.9	2.4	2.0
- France	1.7	2.0	1.9	2.0
- Italy	0.1	1.9	1.7	1.3
USA	3.1	2.9	1.9	1.9
Japan	1.9	2.2	2.0	1.7

Table 1 Economic growth developments

Source: IMF, World Economic Outlook, October 2007
*Projections

Agricultural goods' prices have gone up due to a temporary slide in the supply side. It is argued that the dry climate conditions shrank the supply, while the use of certain agricultural products in the bio-fuel industry[2] has expanded the demand shooting prices upwardly.

*Table 2 Main macroeconomic indicators (*annual growth in %)*

	GDP-Q3*	Unemployment Rate*	CPI*	Budget deficit (in % of GDP)
USA	+3.5	4.9 (December)	+3.4 (December)	-3.7
Eurozone	+1.6	8.3 (November)	+2.2 (December)	-2.9
- Germany	+1.4	11.2 (December)	+2.1 (December)	-3.9
- France	+1.8	9.6 (November)	+1.5 (December)	-3.2
- Italy	+0.1	7.5 (September)	+2.0 (December)	-4.3
United Kingdom	+1.7	5.0 (November)	+2.0 (December)	-3.1
Japan	+2.9	4.6 (November)	-0.8 (November)	-6.5

Source: US Department of Labor, US Trade Department, 'The Economist', January 21, 2006.

- *US ECONOMY*

The US economy suffered a drop in its economic growth during 2007, after a good performance for a number of years. Real estate market fluctuations and residents' diminishing propensity to invest impacted the growth rate. The drop in real estate prices led to a shrinkage in credits and liquidity in the market. In order to prevent a broader impact on the economy, the FED lowered the key interest rate by 1% in the last four months of 2007[3].

The US economy saw a higher annual growth rate in the third quarter of 2007. On annual basis, GDP reached 2.8% and 2.5% in the last two quarters of 2007, after growing at lower rates during the first half of 2007. Fixed corporate investments and export growth owed to the dollar devaluation were the main contributors to GDP growth. Consumption, which has not yet been susceptible to the drop in real estate prices, has played a key role in demand growth. The real estate market has negatively impacted the growth rate during the year. Other economic indicators attest to a weak performance in the construction sector during the last quarter of 2007. Market housing conditions have deteriorated due to the decline in real estate sales and investments. The unemployment rate picked up by 0.4% during the last quarter of 2007, relative to same period last year. The FED lowered the key interest rate in mid-September by 0.5%, due to sub-prime loans and financial market volatility. Additionally, the FED lowered the key interest rate by another 0.5% during October and December, pushing the interest down to 4.25%.

The rate of consumer price inflation eased up during the June-August period, after shooting up quicker during the first months of 2007. Meanwhile, the average annual inflation increased from 3.4% during the third quarter of 2007 to 4% during the last quarter. The boom in oil prices, in other product prices listed in international stock exchange markets and in food prices, all fueled inflation. Following these developments, the FED lowered the key interest rate during January of 2007 by 1.25%, during an unplanned meeting. Through this move, the FED aimed to save the real economy from declining as a result of further liquidity and loan contraction[4].

- *THE EUROZONE ECONOMY*

The economic activity within the Eurozone has continued to expand at a modest rate during 2007, relative to 2006. The Gross Domestic Product

grew by 2.7% in 2007, compared to 2.8% in 2006, referring to the latest European Commission assessment. In 2007 one may take note of a slow-down in industrial production, a rise in service sector and improvement in the labor market conditions.

Short-term macroeconomic indicators attest to a slow-down in economic activity. Short-term macroeconomic indicators attest to a deceleration in economic activity. The GDP reached the highest rate of growth during the third quarter of 2007. All of the components of domestic demand and net exports led to economic growth. Business investments and exports have been declining during the last months of the year, due to the strengthening of the euro against the dollar and to the diminishing demand in US markets. The deterioration of liquidity has spilled over to European financial markets. These recent developments may impact the Eurozone economy, by weakening the housing market in some of the member countries as well as in the construction sector and consumption spending. However, improved labor market conditions and higher rates of return to private corporations have mitigated the negative impact of market volatilities on the GDP. According to recent European Commission projections (as of February of 2008), the Eurozone economy is expected to grow by 1.8% during this year.

The consumer price inflation has shifted within the target rate of 2% since the end of 2006. However, consumer price inflation tendency has been upward since September of last year. The annual rate of inflation increased to 3.1% in December, relative to the September rate of 2.1%. Oil shocks and food price pressures internationally have led to the rise of inflation. The European Central Bank (ECB) has forewarned that the high growth rate of monetary aggregates signals risks on price stability in the medium and long-term period. Nonetheless, current projections suggest that the rate of inflation will be 2.3% in 2008.

The ECB increased the key interest rate twice by 0.25% during the first half of 2007, pushing it up to 4%. Despite a further weakening in the housing market, the oil price boom, hikes in food prices, and continued financial market volatility, the ECB did not change the key interest rate in the second half of the year. The ECB monetary policy emphasizes the prioritization of price stability and anchoring of medium-term inflation expectations.

- *OIL PRICES*

The world demand for oil has arguably increased by 1.4% relative to a year ago. Oil prices in international markets started at $55/barrel at the beginning of the year, reaching up to $90/barrel in the last two months of 2007. Price hikes during 2007 did not only offset the drop in the second half of 2006 but also reached new levels. Factors stemming from the demand side have led to the boom in oil prices. Worth mentioning, technological and economic challenges have made it more difficult for the supply to match the demand growth rate. In addition, geopolitical frictions add to the temporary rise in prices. Based on current estimations, oil supply from non-OPEC countries has increased by 0.6% during 2007.

Approximately 1/3 of the world demand growth during 2005-2007 is owed to China only. The high economic growth of China, India and Middle East has offset the decline in the U.S. economy, which is presently the largest oil consumer in the world. Oil demand has been the lowest in OECD countries, while there has been a decline in consumption in Europe and Japan during the first half of the year. High weather temperatures have reduced oil demand in these countries. The high consumption expansion in non-OECD countries, despite high prices, reflects the high rate of returns in developing countries. The high rate of economic growth in developing countries has continued to increase the demand for oil, despite a weakened growth perspective in developed countries.

In addition, the depreciation of the dollar has certainly impacted oil prices, given that oil producers ask for a higher price so as to get the same value of return in their own native currency. Oil prices have been lower when converted at the average euro/usd exchange rate. In euros, the 2007 average crude oil price was approximately 52.5 euros/barrel, relative to the 2006 average annual price of 52 euros/barrel. However oil prices have risen up to 62-63 euros/barrel in the last quarter of 2007.
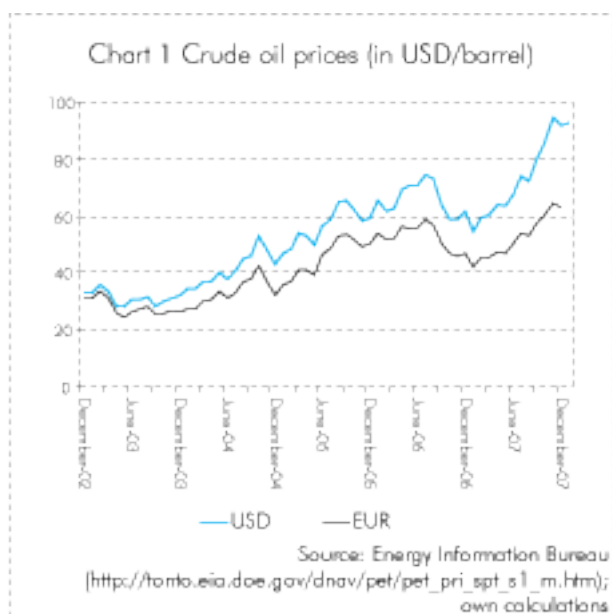
The rise of oil prices was dictated also from investors' choice to invest in alternative assets, rather than financial assets expressed in dollars, concentrating on oil and other primary products. The devaluation of the dollar, combined with the financial volatilities in the US credit market, has stirred investors' behavior. Unlike the oil crisis of the 70s and 80s, the 2007 crude oil price rise has not provoked economic recession or substantial fall in consumption spending. The deceleration of economic growth in the US and in other oil-consuming countries, such as China and India, is expected to bring the demand for oil into more stable levels during 2008. According to OPEC projections for 2008, the world demand for oil will increase only by 1.4%, while the supply will increase by approx. 1.1%. Average oil prices are projected to reach $90.6/barrel in 2008.

Chart 1 Crude oil prices (in USD/barrel)

Source: Energy Information Bureau (http://tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_m.htm); own calculations

1.2 THE ECONOMY OF REGIONAL COUNTRIES

• *THE GREEK ECONOMY*

Greece has recorded a relatively high economic growth, deepening of the current account deficit, and unemployment fall relative to the Eurozone economies.

Economic growth is estimated to be at 4%, while it is expected to stabilize under this level during 2008-2009. Domestic demand has driven economic

growth, while foreign trade has had negative effects on growth, owed to imports outdoing exports (import volume grew higher than the export volume). The current account deficit has grown deeper in 2007, beyond 14% of GDP. This has reflected into higher trade deficit, higher interest payments and lower current transfer surplus. Unemployment fell to 8.6% during the first half of 2007, indicating the side-effects of economic growth. Fiscal deficit is projected at 2.5% of GDP, relative to the 2006 level of 2.7% of GDP.

- *ITALIAN ECONOMY*

The Italian economy features lower economic growth relative to the previous year, and lower investments and unemployment levels.

Economic growth was lower during the first half of 2007, prompted by lower export growth. Fix investments followed the same pattern of GDP. Foreign demand was driven by the appreciation of the euro. Unemployment fell lightly at the beginning of the year, continuing on with same pattern during the second half as well. Economic growth is projected to reach potentially 1.5% during 2008 and 2009.

- *FYROM ECONOMY*

The FYROM economy has recorded a higher annual economic growth relative to 2006, accompanied with higher inflationary pressures during the end-year and improvements in the labor market and in the fiscal position.

The GDP is projected to grow at 5% during 2007 and 2008. The transport and communication sector as well as the retail and wholesale trade, have shown good performance. Consumer price inflation has seen substantial rise at 2007 end-year, following the hike in food prices, power and housing. The average annual inflation rate was 2.3% during 2007 and is expected to reach 3% in 2008. Currency reserve stock has expanded and the interest rate base continues to be low. Export growth and high inflow of remittances has played a key role in macro developments. During the January-October period, foreign trade increased with annual rate of 26%. Electricity imports and iron and steel exports were the main contributors to imports and exports respectively. During this same period, the trade deficit expanded by 20%. At the same time, the current account reached a higher surplus of 4% of GDP during the first three quarters of the year.

- *TURKISH ECONOMY*

The economic activity expanded at a lower rate relative to the last 2 years given the falling annual rate of inflation, while the fiscal situation has deteriorated.

OECD projections suggest that the gross domestic product has increased by 5.1% during 2007. In the absence of exogenous shocks, it is expected

that the economy will grow by 6% in 2008 and 2009. The tight monetary policy and the deterioration of credits in an international scale have skewed the growth in domestic demand. The improved current account has positively impacted the economic activity. The current account deficit is estimated at approx. 7.7% of GDP relative to the 2006 level of 8.1% of GDP.

Table 3 Main macroeconomic indicators for regional economies during 2005*

Countries	GDP growth (in %)		Annual inflation (in %)	Unemployment (in %)	Fiscal balance (in % of GDP)*	Current account (in % of GDP)*
	2006	2007*				
Bosnia & Herzegovina	6.2	>6	1.0(T3)	43.5(T3)	....	-13.7(T3)
Kosovo	3.1	3.5	4.9(T3)	45*	6.5	-24
Croatia	4.8	6.0	2.5*	11.0*	-2.2	-8.5
Montenegro	6.5	7.1(T3)	5.1(T3)	11.9	8.7(T3)	-31.1(T3)
Macedonia	3.7	5.0	2.3	34.4*	-0.9	-2.8
Serbia	5.7	7.2 (T3)	6.6	19.6 (T3)	-0.2 (T3)	-16.8(T3)
Turkey	6.1	5.1	8.8	9.7*	-0.7	-7.9

Source: European Commission, 'Candidate and Pre-Accession Countries' Economies Quarterly, current update January 11, 2008'.
*Projections.

Macro developments have taken place under the 2006 tight monetary policy climate and the unstable political situation. After the economy slowed down at the beginning of the year, the Turkish economy performed better following the summer elections. The disinflation process has decelerated following higher electricity tariffs, food prices and higher administered prices. The rate of inflation has reached the 8.4% level in December of 2007, relative to 9.7% that was in the same period of 2006. 2007 general elections certainly had an impact on the fiscal picture. The fiscal deficit for 2007 is expected to be higher than 1% of GDP.

ENDNOTES

[1] *IMF assessment (www.imf.org).*
[2] *The use of agricultural goods for energy production.*
[3] *FED: Open Market Federal Committee.*
[4] *The scenario of economic recession assumes that the economy is suffering constant decline and/or growth of unemployment during many quarters. Such a situation could yield marginalisation (loss) of the monetary policy role and further economic bust.*

CHAPTER 2 ECONOMIC ACTIVITY

2.1 THE ECONOMY IN A FEW WORDS

The 2007 economic growth is estimated to be at 6%. As in previous years, the rising performance in the service, industry, transport and telecommunication sectors lead to economic growth. At the same token, according to most recent estimations, the construction sector continues to run into problems, which have slowed down its productivity.

Foreing Direct Investments (FDIs) performed better in 2007, reaching up to 6% of GDP. Better performance of exports in 2007 have boosted up economic growth, reaching a level that was 28% higher than in 2006.

Table 1 Main macroeconomic indicators

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Real growth of GDP (in %)[1]	8.9	7.7	6.5	4.7	6.0	6.0	5.5	5.0	6 .0
GDP (in current price, billions of Lek[2])	489	531	589	625	683	766,	836	896	980
GDP (in current prices, in billions of dollars)[3]	3.5	3.7	4.1	4.5	5.6	7.4	8.4	9.1	10.3
GDP (per capita, in dollars)	1052	1086	1329	1438	1807	2389	2672	2903	3256
Unemployment (in thousands)	1081	1068	1065	921	928	917	932	934	936
Unemployment rate	18.0	16.9	14.6	15.8	15.0	14.6	14.2	13.8	13.2
Inflation rate (y/y)	-1.0	4.2	3.5	1.7	3.3	2.2	2.0	2.5	2.9
Budget deficit (including grants, in % of GDP)	-12.1	-8.2	-7.9	-6.6	-4.5	-5.1	-3.6	-3.1	-3.4
Public debt (in % of GDP)	69.7	71.3	66.8	65.3	61.7	56.6	56.7	55.9	37.5
Foreign debt (in % of GDP)[4]	-32.3	29.4	25.8	23.5	20.6	18.0	17.5	17.2	16.9
Current account (without official transfers, in % of GDP)	-8.5	-7.0	-6.1	-10.0	-7.9	-5.6	-7.7	-7.2	-10.0
Average exchange rate, Lek/Usd	137.7	143.7	143.5	140.1	121.9	102.8	99.8	98.1	90.4
Average exchange rate, Lek/Euro	147.0	132.6	128.5	132.4	137.5	127.7	124.2	123.1	123.6

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

Domestic demand remained high during 2007, sustained by consumer-credit expansion and import growth (in particular, with higher imports of machinery and equipments. The entire national economic activity has progressed under the premises of keeping inflation under control, despite instability stemming from uninterrupted shifts in food prices worldwide. The prices of grains increased substantially, with general food prices following in the same upward pattern.

In order to meet the price stability target successfully, the Bank of Albania has estimated risks stemming from demand and supply fluctuations and responded accordingly three times by tightening the monetary policy. Hence, the rate of repurchase agreement of bonds with 1-week maturity reached 6.25% since November of 2007. The sound fiscal policy has also had positive effects on the overall economic performance of 2007. By and large, the fiscal policy is of a disciplined nature, where a lower-than-planned budget deficit prevails.

2007 marks a year of fundamental economic reforms. Among others, there are the completion of the Credit Registry, reorganization and strengthening of the financial sector monitoring, better tax and public spending administration, the privatization of Albtelecom, better business climate reinforced by the establishment of the National Center of Business Registration and further reduction in customs duties on a number of products, in compliance with obligations stemming from the Free Trade Agreement with the European Union.

2.2 PRODUCTION BASED ON INDUSTRY

During the first 9-months of the year, productive enterprises have accrued 18% higher sales relative to the same period in 2006. The industry, trade, transport, telecommunications and other services sectors have all recorded the highest rates of annual growth.

Chart 1 Nominal and real growth in producing sectors sales

Source: INSTAT and Bank of Albania estimations
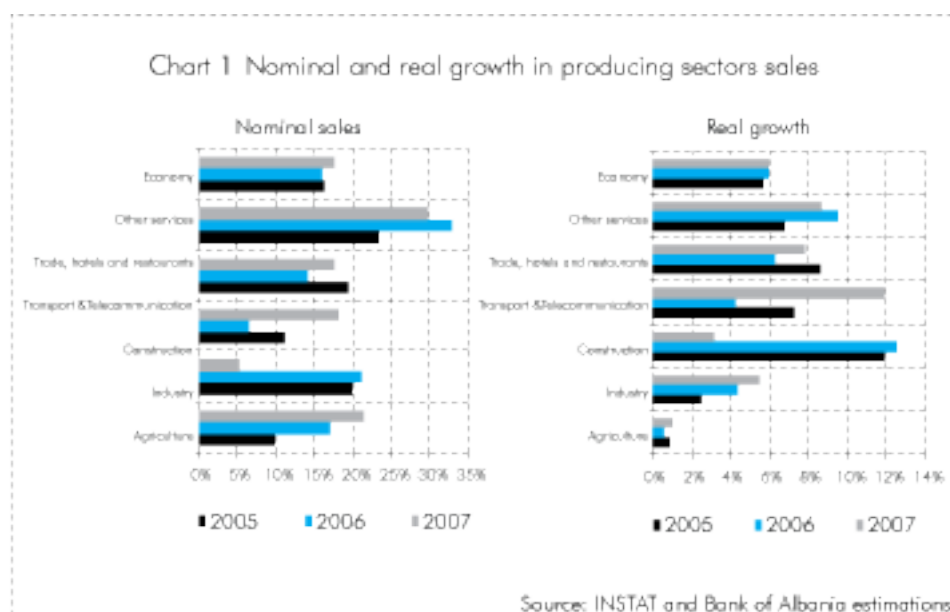
The construction sector yielded lower sales for the January-September period, for the second year in a row. Relative to previous years, sectors that have yielded sales growth at accelerated rates are: industry, wholesale trade, transport and telecommunications, as well as other services.

2.2.1 INDUSTRY

The extraction sub-industry brings in 8% of total industry sales[5]. Extracting industry sales have increased by 20% during 2005-2006, but in the first 9-months of 2007 grew by approx. 50%.

		Sales	Employment			Wages
	2006	2007*	2006	2007*	2006	2007*
Exctracting industry	30.7	50.8	0.2	5.7	3.0	7.0
Processing industry	22.7	18.1	1.2	1.4	2.7	5.9
Energy, water, gas	0.9	22.6	-0.6	0.2	3.1	0.9
Total industry	17.7	21.3	0.6	1.5	2.8	4.7

Table 2 Industry sectors' indicators for 2006 and January-September 2007 (annual change in %)

Source: INSTAT, Sales from VAT and short-term statistics

2.2.1.1 Extracting Industry

Extracting industry sales during the first 9-months of 2007 were 50% higher compared to the same period in 2006. This is one of the steep raises for the first 9-months, since 2003. In the absence of production data, the performance of this sub-industry is based on the metal and minerals export performance analysis.

These exports made up 30% of the total national export volume for 2007. During 2007, Albania exported a volume of base metals and derivative items valued at 117m euros. This monetary value was 15% higher than that of 2006 exports.

The export of different articles derived from base metals, made up approx. 30% of the total metal export value. Iron, steel, copper and aluminum were key exported items for 2007, amongst all processed metals group.

Exported minerals rose by approx. 160% during 2007. Of which, 35% consisted of exported crude oil and 30% of chromium.

Chart 2 Minerals and metal exports (exports in millions of euros on the left-hand side and annual growth in % on the right-hand side)

Source: ACIT
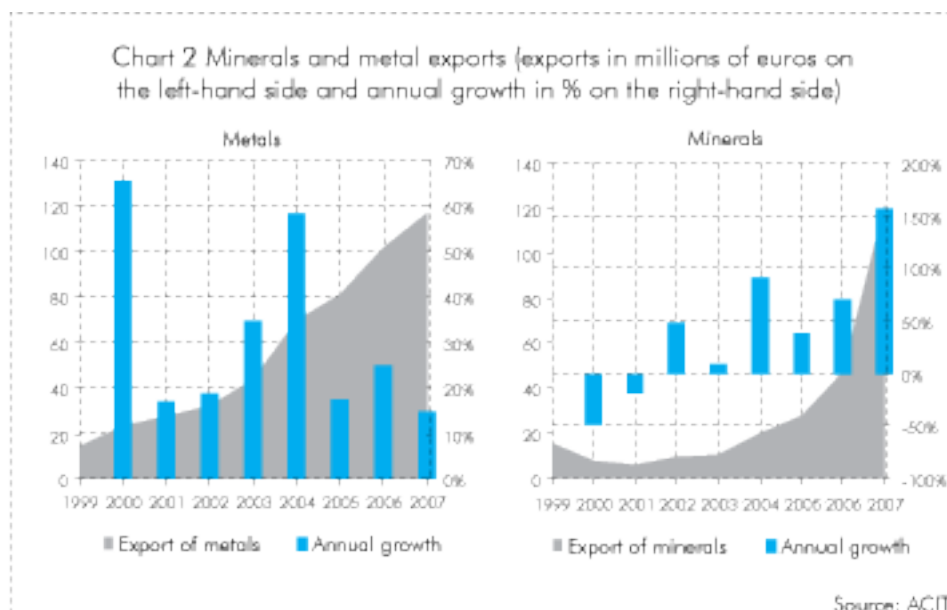
Exports of these two types of items were twice as high in 2007 relative to 2006 exports. International price hikes in these products drove the high rate of export growth.

2.2.1.2 Processing Industry

Processing industry sales grew by approx. 18% during the first 9-months of 2007. The food industry captured the highest annual sale growth (28%). This industry brought in an average of approx. 20% of total sales in the processing industry during recent years. The textile industry has recorded positive rates of sales growth during the first 9-months of the last two years, in contrast to the negative growth of 2004-2005.

The leather and footwear sub-industry has seen gradual improvements, growing at 8% and 15% in the last two years, respectively[6]. Production of non-metallic minerals has expanded by more than 20%, relative to last year, making a turn for the better since 2006.

Table 3 Annual sales growth in processing sub-industries (in %)

Sub-industry[7]	2002	2003	2004	2005	2006	2007
Food	-2	12	11	-9	20	28
Textiles	0	20	-12	-11	5	18
Leather, footwear	-5	27	1	6	8	15
Wood products	-4	-24	22	-7	-7	8
Paper, cardboard	-20	22	-10	25	2	3
Refined products	-3	-23	67	18	111	10
Chemical products	7	-33	21	5	14	13
Rubber and plastics	-18	108	-21	72	11	16
Non-metallic minerals	-18	26	17	38	-6	23
Metal processing and metallurgy	-24	17	5	30	29	16
Machinery, equipment and spare parts	-31	68	-24	-2	20	-6
Electric and electronic devices	34	95	52	-13	28	10
Transport means	5	-81	113	-6	-13	1
Other, processed	4	160	22	6	-8	33
Total Processing Industry	9	15	9	11	20	18

Source: INSTAT

2.2.1.3 Power production and consumption

2007 marks one of the most difficult periods in domestic power production and consumption. In large part, Albania faced a very challenging situation stemming from drastic reduction (by half as much) in domestic power production.

Table 4 Power balance (in GWH)

	2006	2007	Annual change (in %)
Sources	6,794	5,881	-13
Domestic production	5,551	2,947	-47
Imports (including exchanges)	1,242	2,935	136
Consumption	6,794	5,881	-13
Consumption / Losses in the net	102	48	-53
Exports (including exchanges)	637	106	-83
Losses in the net	2,481	2,085	-16
- Losses during distribution	2,260	1,873	-17
Power consumption	3,573	3,641	2
- Household consumers	2,124	2,078	-2
- Non-household consumers	1,448	1,563	8

Source: INSTAT

Under these circumstances, the import of power was deemed as the sole alternative, while alternative sources to power, such as oil and its by-products reached record prices in international markets.

At a quick glance to production and consumption statistics, one may note that household-based consumption prevails, while losses in the net consist 70% of the total consumed power.

The volume of power-production sources in 2007 was approx. 13% lower than in 2006. The 2007 power-production was 50% lower than 2006 and imports were 1.4 times as much as in 2006.[8] The 2007 import value in millions of euros, excluding exchanges, was 4.8 times as much as in 2006. The nature of power use did not differ significantly from previous years.

Approx. 35% of the supplied power has been lost in the distribution net, while households and non-household consumers have consumed 35% and 27% of the total power supply, respectively.

The scarce domestic power production, and in particular the hydro-generated power, was a result of unfavorable weather conditions, among others.

Last year confirmed once again the indispensability of tapping into new alternative sources of energy. Reinforcing the economy's immunity against hydro-generated sources has become a national priority of strategic nature.

Chart 3 Imports (in millions of euros) and power consumption (in % of total source share)

Source: Imports– ACIT, Power balance – INSTAT
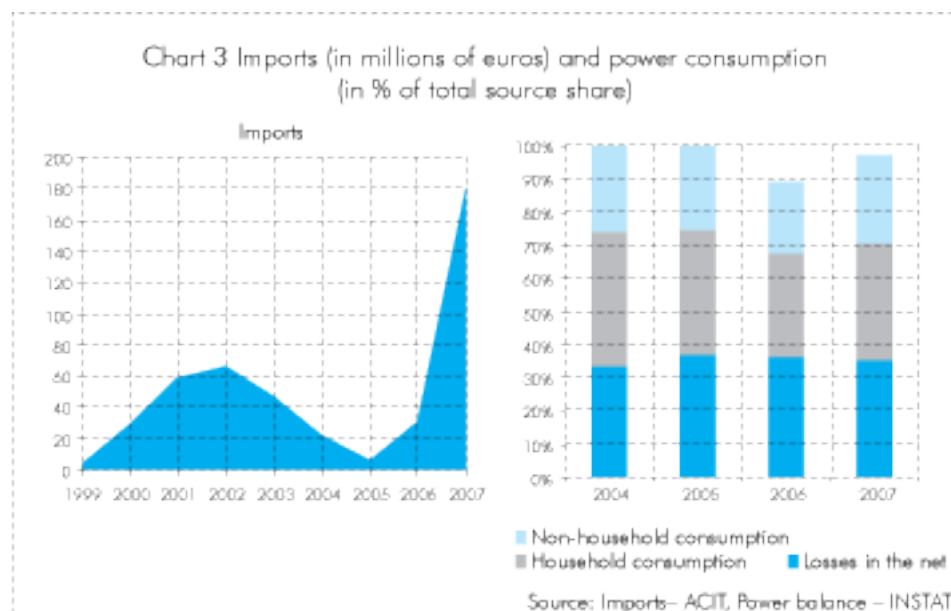
On the other hand, loss minimization should take same priority; even though losses have been reduced by 16% in 2007, they still continue to remain at critical levels with direct impact on the financial situation of KESH.

2.2.1.4 Construction

The year 2007 was not a good year for the construction sector. According to available data, the construction sector has had almost no growth during last year; hence its contribution to the economic growth has been inexistent.

The Bank of Albania has emphasized in its analysis of the last two-three years the attention that should be paid to the construction sector, which has been a leading force in the economy.

Table 5 Construction sector indicators 2004-2006 and for the January-September period of 2007 (annual change in %)

	2004	2005	2006	2007*
Sales	23.8	19.9	21.1	5.4
Employment	9.8	4.5	-0.4	-4.3
Wages	16.3	10.2	6.1	14.9
Volume	15.0	11.2	1.7	-5.8
-New constructions	21.1	11.8	9.9	-11.7
-Reconstructions	38.1	35.4	1.3	-9.0
-Engineering projects	8.8	12.7	-15.4	14.2

Source: INSTAT, Short-term statistics

The annual sales' growth in the construction sector during 2007 has been quasi negligible, being several times lower than the annual average of the last three years (5% to approx. 20%).

The overall construction volume as well as the new construction volume have declined on a per annual basis for the Jan-Sept period of 2007.

Table 6 Construction sector indicators (annual change in %)

	2006		2007		
	III	IV	I	II	III
Construction volume	-6.5	16.2	0.3	-1.9	-15.8
New constructions	2.7	8.6	-5.7	-10.4	-19.1
Employment index	-0.4	1.2	-1.7	-4.5	-6.7
Cement consumption	19.24	-6.40	-27.01	6.00	-7.81
Construction Cost Index	1.8	2.4	3.3	3.0	2.1

Source: INSTAT

Engineering projects have been higher than a year ago, but new housing constructions and reconstructions have significantly dropped compared to last year. The employment index within the construction sector has been approx. 4%, while wages have increased by approx. 15%.

2.2.1.5 House Price Index

House prices have continued to go upward during the last months of 2007, even though the growth rate has declined relative to the previous quarter.

Thus, house prices in Tirana - measured by the house price index on a per annual basis - have gone up by 16.7% in the last quarter of the year relative to the 24.8% growth rate of the previous quarter.

The rise in house prices is arguably owed to market pressures stemming from shrinking capacity. According to INSTAT's short-term statistics, the overall construction volume and the new construction volume in particular have reported negative growth during the third quarter, for the second quarterly period in a row. The deceleration in construction volume expansion bears out in the continued drop in the cement consumption and employment index. Construction costs which are measured by the construction cost index have continued to go up during the same period. However, the production cost growth rate is several times lower than the house price growth rate.

Chart 4 House price index and construction cost index (annual changes in %)

Source: INSTAT and Bank of Albania estimations

2.2.1.6 Hotel Activity

Turnover indicator generated from hotels' activity has gone up extensively during the 9-month period of 2007 relative to the 2006 average rate of growth. This growth was at a peak during the first 2 quarters of the year. The number of hotel employees has increased approx. by 8%, while their salary has increased approx. by 35%, relative to the same period last year.

	2006	Q1-07	Q2-07	Q3-7
Turnover indicator	5.4	26.7	34.4	6.8
Employed people	-2.9	11.5	4.0	7.8
Wages	14.2	53.0	40.2	11.5
Nights of stay	16.7	14.4	27.3	4.8
Albanians	11.6	17.0	29.4	3.1
Foreigners	23.5	8.5	21.8	18.7

Table 7 Hotel activity indicators for 2006 and first 3 quarters of 2007 (annual change in %)

Source: INSTAT, short-term statistics.

The duration of stay in hotels for residents and non-residents has gone up by 15-16% during 2007 relative to 2006.

2.2.1.7 Transport and Telecommunication

Transport sales were approx. 44% higher during the first 9-months of 2007, relative to the same period in 2006. Workers employeed in the railway system have continued to decline in number, while the number of workers employed in the marine transport has remained unchanged on average throughout 2007, after it increased by approx. 45% in 2006.

	2006	Q1-07	Q2-07	Q3-7
Transport – annual change of VAT sales	-5.5	49.3	46.8	37.7
A. Railway transport				
- Employed people	-13.7	-5.8	-5.8	-4.1
- Wages	-7.5	-0.3	-2.6	-0.4
B. Sea-based transport				
- Employed people	44.3	22.9	-10.9	-6.5

Table 8 Transport and Telecommunication activity indicators for 2006 and for the first three quarters of 2007 (annual change in %)

- Wages	59.1	25.7	47.5	24.3
C. Air-based transport				
- Employed people	-31.0	0.0	0.0	0.0
- Wages	11.3	0.0	0.0	0.0
Communication – annual change of VAT sales	12.0	-5.4	23.3	9.6
- Employed people	5.7	9.9	9.8	2.2
- Wages	5.4	13.9	11.8	18.4

Source: INSTAT, short-term statistics

The wage level in the marine transport has continued to grow at high annual rates, despite the 2006 growth of approx. 60%. The communication sector has recorded average positive growth in sales during the Jan-Sept period of 2007. The number of employed people and wage-levels in this sector have continued to go up in each of the 2007 quarters relative to corresponding 2006 quarters.

2.3 PRICES

2.3.1 CONSUMER PRICES

The inflation rate shifted noticeably in 2007, going from the lower levels in the second quarter (1.8%) to doubling in value in the subsequent two quarters of the year. The annual inflation rate in the last quarter of 2007 was the same as the previous quarter, at 3.6%. Inflation was the highest in September (4.4%), while in the last two months of the year inflation fell, reaching to the inflation target range of the Bank of Albania.

Chart 5 Headline and core inflation (annual change in %)

Source: INSTAT and Bank of Albania estimations
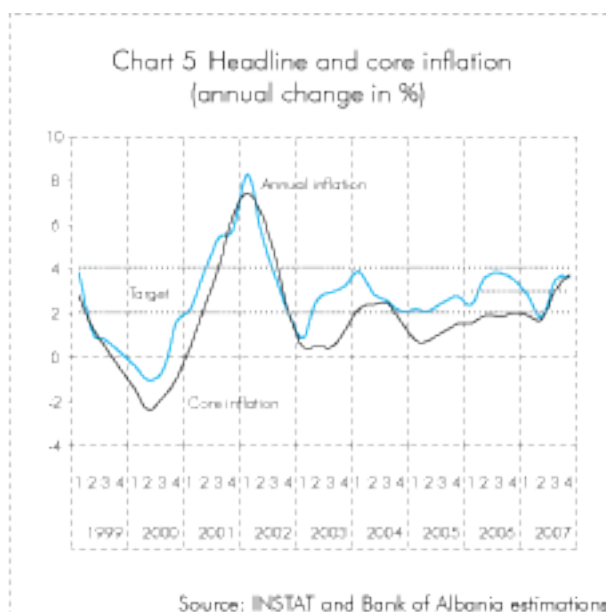
Supply and demand factors have exercised upward pressure on inflation during the second half of the year, although pressures have settled in the last quarter of the year, compared with the same period of the previous year.

The inflation trend in 2007 unveiled the high level of prices for base food products and the further rise in oil prices. Favourable weather conditions in the last quarters, and especially in the second quarter, expanded domestic supply exercising downward pressure on prices of unprocessed seasonal food products. Conversely, prices of processed foods (the most important of which being bread) constantly kept increasing since the third quarter of the year, which directly impacted on headline inflation rise.

Despite a temporary price-stability, the price levels for these types of goods continued to be unclear during the end-year, depending on import price levels, which kept showing high inflation rates. Furthermore, continued hikes in fuel prices together with the power crisis led to a climb in the cost of

production, which put extra upward pressure on consumer prices. In the third and last quarter of the year, the inflation curb shifted to the left (falling) as a result of the offsetting effect by the electricity tariff increase and higher excises on tobacco put in place since 2006. This offset with a few percentage points the supply-side effects.

Alternative measures of net inflation show that the high rate of inflation was due to higher processed food prices. On the other hand, the electricity tariff increase did not happen in mid-2007, as first projected. Consequently, the impact of administered prices on the overall inflation rate was quasi negligible.

Chart 6 Alternative measures of net inflation: inflation excluding food prices (left) and inflation excluding food and administered prices, and excluding food prices and services (right)

—Excluding foods —Total

—Excluding foods and administered prices
—Excluding foods and services

Source: INSTAT and Bank of Albania estimations
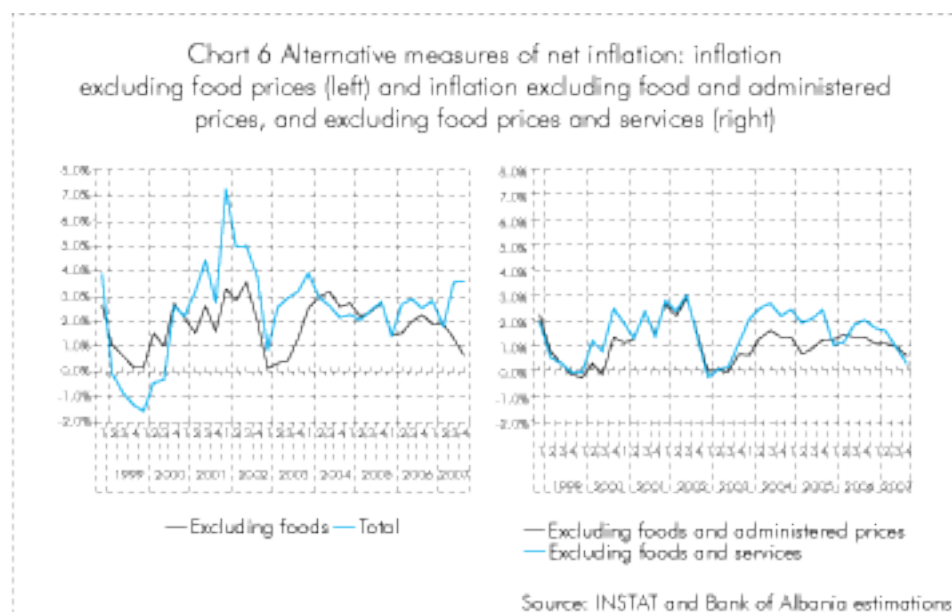
The categories of 'processed foods', 'unprocessed foods', 'housing', and 'services' made up the greatest share of the annual inflation rate during 2007.

The relatively high annual inflation rate in the third and last quarter of 2007 was dictated by inflation in the 'processed foods' category.

Box 1 Food price trends in international markets and in Albania

Food and agricultural goods prices in international markets reported an upward trend since 2001, with rates going up quicker during the second half of 2007.

According to the European Central Bank[9], the latest rise in food products prices is a result of supply-side factors, such as: energy price hikes, chemical waste price hikes, lower reserves and dry weather.

However, demand-side pressures have not been idle, which have been prompted by two factors:

Chart 7 Foods price index[10]

Source: IMF, Food Price Index in US dollars, base year-2005

The first relates to consumer behavior changes in some developing countries, such as China and India; also, it relates to changes in agricultural products use in feeding animals.

The second relates to government initiatives in developing alternative sources to fuel production (bio-fuel), by using agricultural raw materials.

Hence, farmers have been inclined to produce these types of goods (corn, for instance), leading to a supply reduction in other agricultural goods and consequently to their price climb.

Food products price hikes in international markets have led to substantial price growth in almost every European country. However, this has spilled over variably in key countries.

Market structure for retail trade, competitiveness and the distribution net may explain the retail traders varying reaction trends to external shocks, and hence, variability in price consumptions patterns for these products.

Table 9 Annual inflation for 'foods and non-alcoholic beverages' (%)

	EU	Greece	Italy	Hungary	Slovenia	Romania	Turkey	Croatia	Macedonia	Serbia	Albania
2003	1.9	4.9	3.2	1.4	4.5	14.6	27.6	0.6		0.9	4.1
2004	3.0	0.9	2.1	5.6	0.2	9.4	8.6	0.2	-1.6	11.1	-0.1
2005	0.9	0.8	-0.1	1.6	-1.0	6.1	3.9	3.2	1.6	19.5	-0.4
2006	2.3	3.4	1.8	8.2	2.3	3.9	7.8	-2.0	3.3	10.6	1.1
2007	3.4	2.2	2.9	12.0	7.2	3.9	12.4	0.8	1.6	6.0	3.1
2008 M1	6.3	5.2	4.5	13.6	13.0	10.0	9.2				

Source: EUROSTAT, HCPI and National Statistics Institutes of the last 4 countries

Changes in food products prices worldwide, yield effects on ready-to-consume imported food product prices and on prices for raw materials used for domestic production in import-oriented countries, such as Albania.

Chart 8 Annual change index of per unit imported food products (in %)

■ Vegetable products
■ Animal and vegetable oils and fats
■ Prepared foodstuffs, alcoholic beverages & tobacco
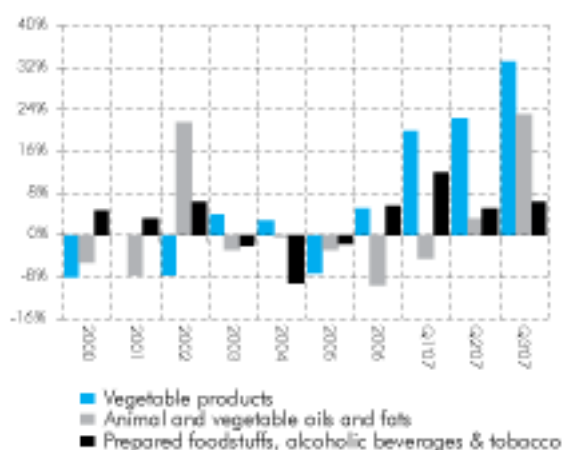
Source: INSTAT

Based on a regional comparative analysis, Albania is one of the countries that has felt the impact of price hikes in food products (particularly grains) the most. The burden of higher costs has been carried by domestic consumers, since the category of 'unprocessed foods' makes up the greatest share in the consumer goods' basket (approx. 24%), while domestic production falls short and prices are subject to speculations by retail traders.

The future of food prices internationally and domestically remains uncertain. Although agricultural goods supply will have to go up in order

to match the rising demand, the adjusting period may be accompanied by added costs. In addition, food products price trends depend on factors hard to predict, including weather, technological innovations and energy policies. Furthermore, the greatest producers of grains have adopted protective policy measures, imposing higher tariffs on exported grains. The risk is estimated to be essential in the medium term.

Chart 9 Domestic grain and imported grains

Domestic production (in 1000 ton)
Annual change of imported grains (in value)
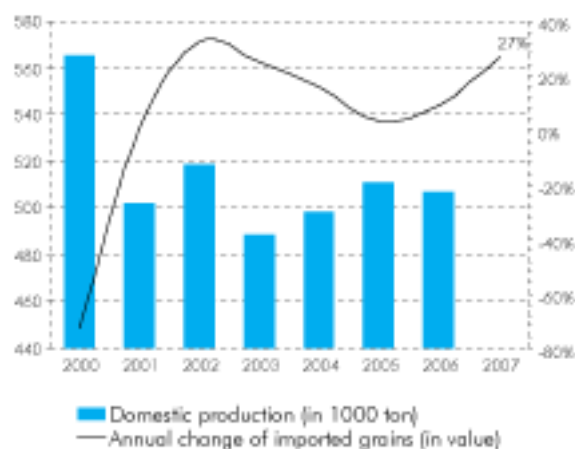
Source: Annual Statistics, MAFCP, ACIT

The 'processed food' category reached the annual inflation rate of 9.5% and 10.6% during the last two quarters of the year, respectively. Interestingly, the annual inflation rate for this category has been quasi negligible for the past 8 years. Since August of 2007, high price levels have been driven by domestic bread prices.

Prices of sub-category products such as dairy products and cooking oil have gone up, reflecting higher costs of production due to the domestic power crisis, and higher prices of same products in trade-partner countries, such as Italy and Greece.

The annual inflation rate for the 'unprocessed foods' category fell lightly downward during the last quarter of the year (to 5.5%), relative to the 6.6% rate of the previous quarter. All considered, these rates were far from the rates of the first two quarters, being at -0.5 and -3.6% respectively. Vegetable prices saw the highest drop amongst all other goods in this category, on a per annual basis.

Chart 10 Contribution to annual inflation, as per category (in %)

Unprocessed foods
Processed foods
Administered goods
Services
Housing
Total

Source: INSTAT and Bank of Albania estimations

Table 10 Contribution to annual inflation, as per category (in %)

	Q4-06	Q1-07	Q2-07	Q3-07	Q4-07
Unprocessed foods (pp)	0.5	0.7	0.6	1.6	2.4
- Bread and grains* (pp)	0.1	0.0	0.3	4.5	7.2
- Alcohol and tobacco* (pp)	1.6	1.7	1.9	1.3	0.7
Unprocessed foods (pp)	-0.2	0.2	-0.7	0.4	0.5
- Fruits* (pp)	-1.4	-2.4	-3.1	1.1	2.6
- Vegetables*(pp)	0.0	3.0	-0.6	1.7	-0.4
Services (pp)	0.2	0.2	0.3	0.4	0.4
Administered prices (pp)	0.9	0.8	0.8	0.4	0.1
- Fuel energy prices* (pp)	7.8	7.6	7.8	2.7	0.3
Housing (pp)	1.1	0.9	0.9	0.6	0.2
Consumer Price Index (y/y, %)	2.6	2.8	1.8	3.6	3.6

Source: INSTAT and Bank of Albania estimations
*Category contribution to annual inflation.

Price trends in this category are linked to domestic agricultural production, which – given favorable weather conditions – has helped to expand domestic supply at particular times of the year. Favorable developments in the domestic supply have relaxed inflationary pressures stemming from high demand for daily consumer goods and high import prices.

Other categories of the basket of goods provided diminishing contribution to the 2007 inflation rate. The annual inflation of 'housing' and 'administered goods' shifted around 4-5%, up to September. The average annual inflation rate was at 0.8% for the remainder of the year. This drop has also been subject to statistical effects of a high comparative base in the last quarter of the previous year. The inflation rate for 'services' continue to grow at higher rates. Its annual inflation rate reached 4% in December.

On average, the inflation rate in the second half of 2007 has increased by 1.5% relative to the first half of 2007, and to the same matching period in 2006. This rise has in large part, reflected price hikes in hotel services and restaurants, which have faced higher added costs related to the use of alternative substitutes of power-production, so as to ensure uninterrupted supply of electricity.

Chart 11 Annual inflation rate for 'non-food consumer goods' (left) and 'durable consumer goods' (right)

Source: INSTAT and Bank of Albania estimations

Despite the boom in fuel prices, the category of 'non-food consumer goods' has not had any visible impact on this year's inflation. This applies to the category of 'durable consumer goods', which has reported negative rates of inflation for a long time – a trend that became even more obvious in the last quarter. Inflation fluctuations of these two categories will have a deeper impact on the overall inflation level with the creation of the new basket of goods, where these categories make up the greatest share in average consumption expenditures.

2.3.2 OTHER INFLATION MEASURES

Core Inflation: The average inflation rate throughout 2007 was 2.6% or 0.8% higher than the inflation rate of the past year. The upward propensity of core inflation since 2005, confirmed the presence of temporary inflationary pressures in the domestic economy. Their multiplication was felt the most during the second half of 2007, which was then converted into high rates of core inflation. The average annual rate of core inflation reached 3.4% in this period, reaching the highest level in the last 5 years. The continued rise in prices of some goods[11], prompted relatively high rates of the permanent inflation component[12] in the medium term; while its average annual contribution to the 2007 headline inflation[13] was quite ample, with approx. 2%.

Chart 12 Annual core and headline inflation (left); calculations according to commodity groups (right) in %

— Core inflation
— Headline inflation

— Foodstuffs inflation - Greece
— Non-tradable inflation
— Tradable inflation

Source: INSTAT, http://epp.eurostat.cec.eu, and Bank of Albania estimations
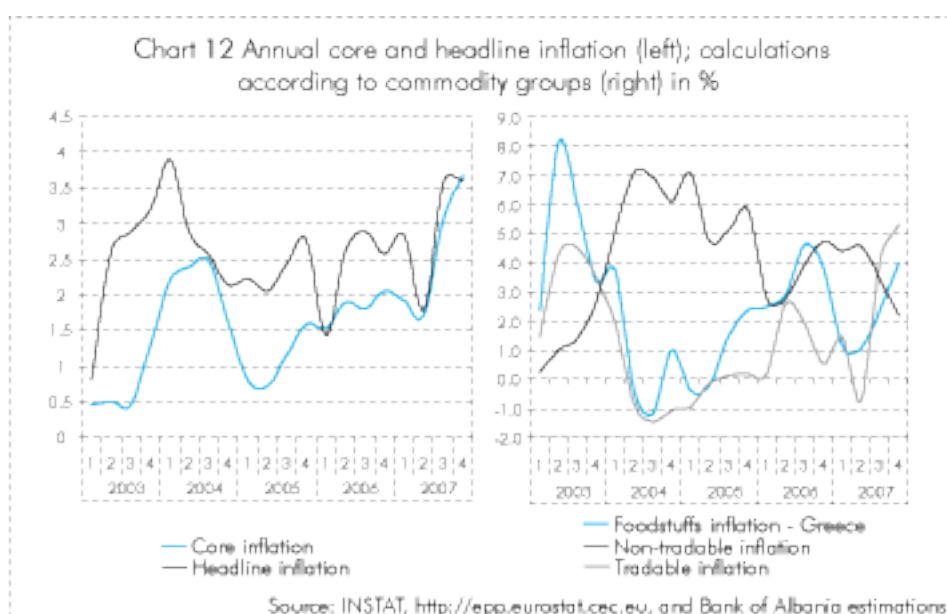
Inflation of tradable and non-tradable goods. Added inflationary exogenous pressures have directly impacted the total 2007 inflation, through tradable price rise[14], particularly during the second half of the year. Tradable goods' inflation during 2007 reflected the unfavorable fluctuations and conjectures in international market. Domestic prices have been driven by prices of the 'food' category of the Greek basket of consumer goods.[15]

Price hikes of fuel, gas and energy products internationally have impacted the prices of raw materials and imported intermediate goods, adding to the cost of production and services in the home market. As a result of the above-mentioned factors, the annual consumer price inflation for tradables fluctuated noticeably during 2007. While the period of Jan-Jul of 2007 was characterized by low historical levels with an average of 0.3%, the remainder of the year showed considerable rising values for this indicator. September of 2007 yielded the highest historical annual inflation in tradables (7.1%), while recent months showed refraining growth, shifting around the 5.3% average. Consumer price inflation of non-tradables is dominated by services and other non-imported goods. This explains in a direct manner inflationary

pressures stemming in great part from domestic demand. These pressures continued to be at considerable levels during 2007, an assessment that is supported by relatively high rates of average annual inflation in non-tradables (3.6%). The average rate of inflation was around 4.5% during the Jan-Jul period of this year, with refraining growth first showing up after August of 2007 and onward. Beginning with August, the electricity tariff increase, administered during the previous years failed to yield any effects. The diminishing propensity of inflation in non-tradables has arguably impacted past monetary policy decisions[16], which have aimed to curb the domestic aggregate demand.

Box 2 News on the 2007 CPI basket update

- *Comparing basket of goods*

Based on a comparative observation on the HCPI basket structure of the countries categorized per their membership-length in the EU[17] we can assess that:

(i) *According to the main 12 groups, the basket structure is relatively more stable throughout this period than those countries with better consolidated economies, longtime (Annex 1 - Table 1);*

(ii) *Amidst old members, the greatest share in the HCPI basket during 1996-2008 consists of expenditures on services, housing, fuel and energy, while expenditures on other goods (foods and non-foods) make up 1/3 of the share.*

(iii) *Amidst new members, the share of expenditures on services, housing, fuel and energy has declined, reaching 57% and 44% on average, respectively for each group, (Annex 1 - Table 2 and 3),*

(iv) *One notes substantial changes in the basket structure, going from older members of the EU to newer members,*

(v) *New members of the EU show higher rates of reduction in time of the 'food and non-alcoholic beverages'*

(vi) *New CPI basket of Albania: December 2007*

The history of drafting and reviewing the CPI basket in Albania, beginning with 1992-1993, counts for three reviews that took place in 1993, 2001, and 2007 respectively. The structure of average household expenditures according to the old basket indicated that approx. 83.5% of those concentrated on 'foods and non-foods' and only 16.5% of those concentrated on other services and for 'rent, water bill, fuel and electricity'.

The 2001 CPI basket generated a more detailed list of groups, comprising expenditures on consumption, comparable to international statistics standards.[18]

The food group suffered a reduction in share, while expenditures on 'rents, water bill, fuel and electricity' increased considerably and the group 'hotels, coffee shops and restaurants' was featured as a share on its own in the consumer basket. The new CPI basket composition and items weights were determined based on its 'Survey of the household budget' held by INSTAT during the October 2006-September 2007 period, with a wide-range sample of families spread throughout the country.

This survey collected data on household expenditures at the county level in city and village areas. In the 2001 basket review, relevant data were collected only

in urban areas. The 2001 basket included 262 items, on which price information was collected; while the new basket will include prices of a wider range of items, a list of 272 items. Another aspect of the latest CPI basket review consists of weight differentiation of items on a per-county base. Thus, basket items will have different weights among different counties, depending on the household consumption model in each county. The new basket will gather information on self-consumption, which is supposed to take up a relatively considerable share in the consumption of rural families. December of 2007 will serve as base-period in calculating the price index. The new basket structure (Table 3) indicates a mild weight drop in 'foods and non-alcoholic beverages' and 'hotels, café and restaurants', a considerable weight drop in 'rent, water bill, fuel and electricity bills' and a sizeable weight enhancement for items in the 'furniture' group. The weight increase of items belonging to the groups of 'health', 'transportation' and 'communication' is rather modest. Connecting the CPI of the old basket to the new basket has taken place in the most fitting manner possible.

However, the effects of going from the old basket (2001) to the new one (2007), including a full series of the CPI, are expected to be fully eliminated 12 months after the new indexed basket was first presented.

2.3.3 PRODUCER PRICES

Fluctuations in the Producer Price Index (PPI) are expected to impact consumer price performance. However, a statistical link between producer and consumer prices based on available data throughout the years, has not yet been determined. The reason for this incompatibility may be the fact that domestic production has not determined the market supply volume at home, not directly impacting consumer prices. On the other hand, cost-carrying to the last chain of consumption may have been hindered by other factors as well, such as higher competition in the retail market and delays in time-adjustment.

During 2007, the rise in the cost of production was carried in a higher scale by consumer prices. The rise in consumer prices has been owed to a great extent to higher prices of goods (particularly, food and energy products), with service prices remaining relatively stable. The unfavorable conjecture of prices of goods in the international market directly impacted prices of goods in the home retail market (consumer prices) and prices of raw materials used for domestic production (producer prices). The deteriorated power-supply situation during the second half of the year led to diminishing productivity, exercising further upward pressure on the cost of production. As a conclusion, the cost of production and import prices led to the rise of consumer prices. Given that the 'processing industry' works at a great extent with imported raw materials, price levels reached their annual peak, going from 14.4% in the first quarter to 6.7% in the last quarter. On average, production prices in this sector increased considerably by approx. 9%, relative to a year ago, when growth was less than 1%. The considerable rise was most obvious in the 'food industry' and 'textiles and clothing industry', being reflected in the performance of consumer prices as well. Annual price changes in the 'production and

distribution of power, gas and water' sector and in the 'extracting industry' reported diminishing rates relative to a year ago, but without necessarily impacting total production prices.

Table 11 Annual rates of changes in PPI and CPI components, as pertaining to 'processed foods' category (in %)

	PPI	PPI – Total Extracting Industry	PPI – Food Processing Industry	CPI - Processed Foods	CPI – Extracting Industry
Q1:06/Q1:05	0.9	0.7	-0.1	0.0	7.3
Q2:06/Q2:05	-0.1	-0.5	-4.4	0.5	10.8
Q3:06/Q3:05	0.4	1.2	-2.1	1.1	8.4
Q4:06/Q4:05	-0.7	1.5	1.4	2.4	8.3
Q1:07/Q1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/Q2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/Q3:06	3.8	5.2	12.8	7.3	0.9
Q4:07/Q4:06	5.2	6.7	16.5	10.8	3.2

Source: INSTAT and Bank of Albania estimations

2.4 LABOUR MARKET

2.4.1 EMPLOYMENT AND UNEMPLOYMENT

Based on the official available data for the third quarter of 2007, we can conclude that the number of unemployed people has shifted upward. At the same time, the same estimations as in previous years apply this year to the number of employees in agriculture. The number of employees in this sector was 936 thousand at the end of September.

Overall, developments in the labour market have progressed in a coherent fashion parallel with the development in economic sectors. Employment has increased at high rates in the industry and service sectors.

Put in more concrete terms, the employment level in the industry sector went up by 7% on a per annum basis, due to the 10% growth in the extracting and processing industries. Employment index illustrates an 8% growth in the hotel-services sector.

The number of employed workers in the construction sector has declined during the third quarter, parallel to the slow-down in constructions and sales on a per annum basis. The transport sector continues to bring in higher sales with a relatively smaller number of employees.

The number of employees in the public sector fell by 3000 during the third quarter of 2007 relative to a year ago, while the number of hired workers in the private sectors counted for approx. 5000. The annual growth in employment was higher in the private sector (around 4700 workers). The unemployment rate reached 13.18% at the end of the third quarter of 2007. This level fell by 0.6% on a per annum basis, reaching the highest drop in unemployment since 2004.

	2005 IV	I-06	II-06	III-06	IV-06	I-07	II-07	III-07
Labour force	1086	1083	1081	1084	1085	1080	1078	1078
Total employment	932	931	931	934	936	933	933	936
Sectors								
- public sector	175	174	172	171	169	168	167	167
- non-agricultural sector	215	215	217	222	224	223	224	227
- agricultural sector	542	542	542	542	542	542	542	542
Unemployment	154.0	151.9	150.1	149.7	148.6	147.7	145.1	142.2
Unemployment benefits	11.2	11.5	11.2	11.4	11.3	10.3	9.9	9.7
Unemployment rate	14.2%	14.0%	13.9%	13.8%	13.7%	13.7%	13.5%	13.2%

Table 12 The trend in employment and unemployment indicators (in thousands of people)

Source: INSTAT

Unemployment went down quicker than the growth in employment, explained by a drop in the number of labour forces. Labour forces went down by 6000 persons/year during the third quarter of 2007.

The high magnitude of this phenomenon may be owed to informal relations at the work-place, immigration and a mismatch between supply and demand for work.

The implementation of professional practices for jobseekers and the consolidation of vocational centers outside of Tirana in 2007 will arguably increase the labour supply in the future.

2.4.2 WAGES TREND

The wage levels[19] have gone up in all sectors during 2007, although this has not been uniform. The rise in average wages for the public sector was 23% on a per annum basis during the third quarter of the year and around 12% relative to the previous quarter.

The annual average growth of the wage levels at the end of the third quarter was approx. 18% higher than in 2002. The average growth rate of wages in the private sector did not grow as much as it did during the second quarter, reaching an annual average growth of 13% in the third quarter.

The legal minimum wage and the unemployment benefit level have remained unchanged since 2006, while the number of those who receive unemployment benefits has been falling.

Wages increased at higher rates in the industry and construction sectors, by 23% and 19% respectively.

Chart 13 Wage trends in industry and construction sectors

Source: INSTAT

Chart 14 The rate of average wages in the public sector (annual growth in %)

Source: INSTAT

Whereas, wages increased at lower rates in the service sector by approx. 12%, which is 28% less than in the second quarter of the year.

2.5 FISCAL SECTOR

In 2007 the key decision-makers in financial and economic policies, the Albanian government and the Bank of Albania managed to synchronize the two fundamental policies in economics, the fiscal and monetary ones. This was unfolded in the national economic development program for the medium term, which enjoyed sustained support from the IMF even during 2007, as part of its PRGF and EFF facilitation programs. The end-year picture presents satisfying progress of key fiscal indicators, which have remained within target ranges set by the Ministry of Finance. The fiscal policy for the most part of 2007 was rather tight, because it was much more inclined to collect revenues rather than to spend. However, just as in previous years, expenditures accumulated heavily in the last month of the year, which prompted interest rates in financial markets to highly oscillate. Meanwhile, the profit tax begs for more thorough analysis, which in 2007, quite rarely, suffered a drop relative to the previous year.

Table 13 Fiscal indicators as a share to GDP

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenues	25.05	26.12	24.98	24.97	24.83	24.09	24.55	24.98	25.69	25.70
- Tax revenues	17.74	17.72	19.91	19.59	20.71	20.95	22.10	22.49	23.01	23.33
Total expenditures	34.61	35.14	32.62	31.89	30.92	28.98	29.62	28.43	28.98	29.14
- Capital expenditures	5.92	7.24	6.94	7.44	6.09	4.53	5.10	4.69	5.72	5.79
Budget deficit	(9.56)	(9.02)	(7.64)	(6.93)	(6.09)	(4.89)	(5.07)	(3.45)	(3.29)	(3.44)
- Domestic financing	6.74	5.92	5.73	4.85	3.44	3.45	4.11	2.85	2.65	2.94
- Foreign financing	2.81	3.10	1.92	2.08	2.65	1.44	0.96	0.60	0.64	0.50

Source: Finance Ministry: Fiscal indicators according to the consolidated budget

At end-year, budget revenues were met by 96% of the planned target, whereas budget expenditures were met by 94% of the planned target.[20]

Chart 15 Main fiscal indicators trends during 2007 (in billions of Leks)[21]
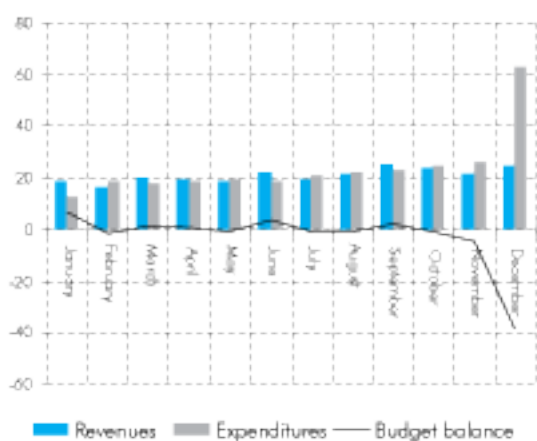
Source: Ministry of Finance, Fiscal indicators according to the consolidated budget

Both indicators suffered a growth deceleration relative to a year ago. However, the annual growth of 9.7% in revenues and that of 10.2% in budget expenditures is well above the average rate of growth of the last 8 years. The fiscal picture, proportionate to the GDP, does not pose any significant changes when compared to last year, because the ratios as a share to the GDP have stayed relatively the same (respectively, 25.7% in revenues and 29.1% in expenditures). Budget revenues have been evenly allocated during the year, while budget expenditures have been executed at lower rates up until the last month of the year, at which point the pace picked up and 20% of total expenditures were met. Different from what was planned out, there was budget deficit only in December (around 3.44% of GDP), while

there was budget surplus during the previous 11 months of the year, ranging between 4.7-10.2 billion Lek.

2.5.1 Budget Revenues

The new fiscal policy, which was first implemented at the beginning of the second half of the year, and reforms aimed at improving the tax administration, helped in meeting tax revenue targets. Budget revenues brought in 251.6 billion Lek; this met the annual plan at 95.8%, and generated an annual growth of 9.7%.

Despite being positive, the annual growth in revenues has been relatively lower than the last 3 years. Revenues from local governments, profit tax revenues[22] and customs duties have been diminishing relative to the past year. Lower revenues from customs duties imply the implementation of policies rooted in free trade agreements.

Table 14 Annual growth in key budget revenue indicators (in %)

	Average 00-07	2006	Q1 07	Q2 07	Q3 07	Q4 07	2007	As a share to GDP
Total revenues	9.4	12.4	6.7	16.5	13.1	3.8	9.7	25.7
Tax revenues	13.5	11.8	7.5	10.3	12.1	13.9	11.1	23.3
- VAT	14.6	15.1	25.8	18.5	18.9	11.9	18.2	9.0
- Tax on profit	17.5	15.7	- 11.5	- 4.0	- 10.2	4.1	- 5.4	2.1
- Excises	20.0	24.2	15.8	27.7	31.4	22.7	24.9	2.9
- Tax on personal income	23.6	15.9	19.4	57.1	125.5	80.5	73.0	1.5
- Customs duties	- 1.0	2.7	- 23.6	- 33.9	- 31.8	- 28.8	- 29.6	1.0
- Local governments	23.0	- 7.5	- 9.2	- 5.1	- 16.3	- 30.4	- 15.4	1.0
- Independent budget	11.1	8.6	- 3.1	3.1	0.2	28.6	7.4	4.3
Non-tax revenues	- 12.3	12.1	- 1.0	42.7	129.5	21.4	38.5	2.2

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

Revenues from the value added tax in 2007 made up 38% of tax revenues and 34% of total revenues. The new fiscal packet removed tax exemptions and tax brakes applied on the VAT prior to this packet. One of the key features of the fiscal policy was the flat tax charged on personal income, which aimed to abolish progressive taxation, so that the fiscal burden would be distributed evenly. There has been an annual growth of 74% in revenues accrued from personal income taxes, which contributed by 2.7% to the total revenues.

Another key feature of the new fiscal packet consisted of higher excises on alcoholic beverages and tobacco. As a result, higher revenues from excises added 2.5% to the total revenues' annual rate of growth for this year.[23]

The new fiscal packet reallocated the share of each revenue component. VAT revenues, profit tax revenues and non-tax revenues carried large shares when computing the total revenue, due to higher dividends collected once Albtelecom was privatized. Profit tax revenues, customs duties, revenues generated from local governments and social security and health insurance

Chart 16 Total revenues according to category
(as % of the total share)
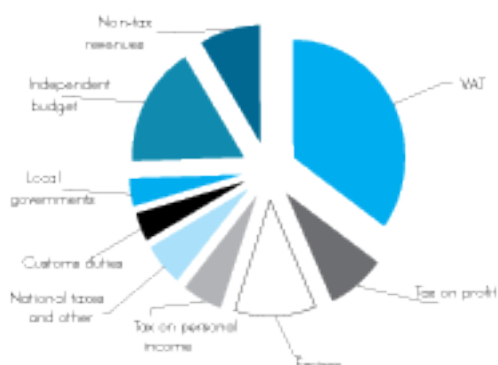
Source: Ministry of Finance, fiscal indicators
according to the consolidated budget

contributions carried lower shares proportionate to the total revenues. The right policies and reforms that have focused on further fiscal consolidation so as to safeguard macroeconomic stability have facilitated the revenue collection process in concordance with set parameters.

2.5.2 Budget Expenditure

Reforms undertaken within the frame of 1 year aimed at increasing efficiency in budget spending while preserving the propensity for higher public investments.

Budget expenditures in the amount of 285.3 billion Lek make up 93.5% of the planned target, while their annual growth equaled 10.2%. The high annual rate of growth in current spending contributed by 8% to the annual growth, while capital spending contributed by 2.2%.

The latter were met 83% of the planned target. Current and capital spending were respectively 23 and 5.8% of GDP. The growth rate of capital spending shrank in 2007 relative to the past year, although the annual growth was 3% higher than the average rate of growth of the past 8 years.

Table 15 Annual growth of key budget spending indicators (in %)

	Average 00-07	2006	Q1 07	Q2 07	Q3 07	Q4 07	2007	As a share to GDP
Total spending	7.1	11.4	14.7	7.2	16.6	6.6	10.2	29.1
Current spending	7.0	5.6	9.5	7.1	11.9	10.4	9.8	23.0
-Personnel	8.5	5.7	1.1	1.3	2.0	10.2	4.2	6.0
- Social insurance	9.7	7.4	14.2	17.3	17.7	16.7	16.5	1.0
- Interests	- 3.2	-3.9	-7.2	6.2	- 12.7	27.9	2.1	2.6
Domestic	- 3.8	-5.0	- 7.1	4.9	- 12.8	32.9	2.3	2.4
Foreign	22.5	9.9	-8.8	17.3	- 11.3	- 4.2	0.3	0.2
-Operational Maintenance	3.8	-7.0	19.2	9.9	11.4	8.0	10.7	2.6
- Local government budget	18.2	13.6	31.6	1.6	- 17.1	- 12.1	- 5.9	2.2
Capital spending	7.8	33.2	78.8	8.1	52.5	- 2.3	11.0	5.8
Domestic financing	16.9	45.7	149.2	2.7	27.0	33.8	36.1	4.9
Foreign financing	- 5.2	11.5	- 37.4	21.9	189.4	- 75.3	- 45.8	0.9

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

The structure of budget spending was similar to that of the past year. Current and capital spending make up 79 and 20% of the total spending, respectively.

The share of expenditures on social security and health insurance has expanded, relative to a year ago, whereas the fiscal burden for servicing the public debt has contracted relative to last year.

The reduced fiscal burden for servicing the domestic debt is owed in part to the extended maturity time-length, going from 242 days in 2006 to 346 days in 2007.

The extended maturity on government debt reflects the Ministry of Finance policy to shift from issuing short-term treasury bills to long-term ones.

This process has also included the launching of new debt instruments, such as 7-year bonds. The transfer of 8.0 billion Lek to KESH is a new feature of the budget spending structure. This transfer has been extended partially in the form of a loan and partially as government financial grant so as to improve the financial status of this corporation, which has been quite wrenching during the last years.

2.5.3 Budget Deficit

The budget deficit of 33.7 billion Lek was approx. 8.7 billion Lek below the target set by the Ministry of Finance. The deficit expanded by 14.7% on a per annum basis, while its share to the GDP has remained unchanged, around 3.3-3.4%. Quasi 85% of the budget deficit has been domestically financed.

The financing of the budget deficit via treasury bills was relatively smaller in 2007, whereas its financing through privatization receipts[24] was much larger in 2007 relative to the previous two years.

The trend followed by the budget deficit has been a function of the Ministry of Finance policies and strategies aimed at minimizing fiscal risks while safeguarding macroeconomic stability in the country.

Chart 17 Total spending according to each category (in %)
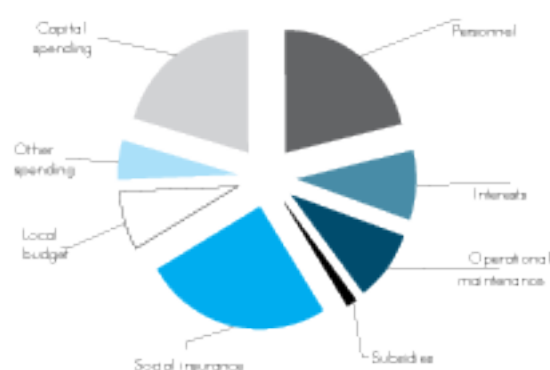
Source: Ministry of Finance, Fiscal indicators according to the consolidated budget

Chart 18 Expenditures on interest payments on the domestic and foreign debt interests (as a share of GDP)
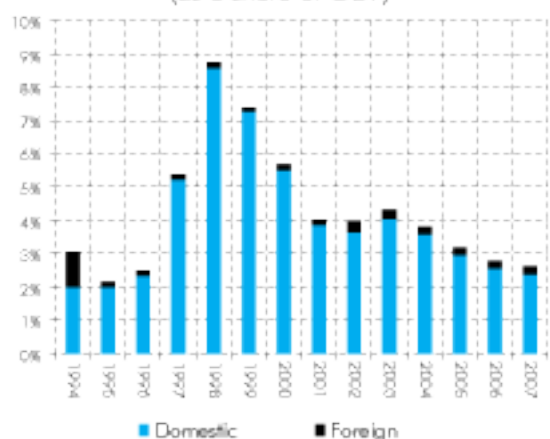
Source: Ministry of Finance, Fiscal indicators according to the consolidated budget

Table 16 Annual growth of key budget deficit indicators (in %)

	2000	2001	2002	2003	2004	2005	2006	2007	Average	% GDP
Deficit	- 6.0	1.1	- 6.2	- 10.5	12.2	- 26.0	4.2	14.7	-2.1	- 3.4
Domestic Financing	7.3	- 5.7	24.3	11.8	29.0	- 24.5	1.4	21.8	2.1	2.9
Foreign Financing	- 31.4	21.2	6.1	- 39.5	- 27.9	- 32.4	17.9	- 14.6	-8.8	0.5

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

Box 3 New fiscal policy features and structural reforms undertaken within one year's timeframe

A number of reforms and initiatives, consolidated in the approved new fiscal packet launched at the start of the second half of the year, took place in 2007. Key features of this new packet comprise:

- *Flat tax charged on personal income, set at 10%.*
- *Higher excises imposed on alcoholic beverages and tobacco, approaching regional standard levels.*
- *Higher national taxes which incorporates higher import tariffs charged on second-hand vehicles or better known as the environmental tax.*
- *Higher local taxes, or rather higher taxes levied on properties (taxes on wealth, property-ownership) which are located in touristic villages.*
- *Customs tariffs reduction, following free trade agreements.*
- *From a budget-spending standpoint, the fiscal policy has aimed at raising wages in different sectors of the economy, prioritizing the education and health sectors, as well as reduce social security contributions.*

Among other structural reforms that have taken place within a year's timeframe, which can be considered as a positive influence on the fiscal performance, are the following:

- *Reference monthly wages, which are deemed to be an important tool in fighting informality and fiscal evasion.*
- *Reforms in tax administration, which have not only improved the business climate but are also key measures in improving the tax collection rate.*
- *Reforms so as to better and more efficiently allocate funds for public spending, while prioritizing key economic sectors.*
- *Extending the maturity deadline for the domestic debt and launching of new debt instruments.*
- *Albtelecom privatization.*
- *Setting boundaries for cash-based transactions. This compels and bounds by law all of the employees to make payments through the banking system.*
- *Fiscal facilities for the energy and agricultural sectors.*

2.6 BALANCE OF PAYMENTS

2.6.1 KEY DEVELOPMENTS

The external sector of the economy reported further deepening of the current account deficit, which in 2007 was estimated at 11% of the GDP, relative to the 2006 level of 7.3%. The widened gap in the current deficit reflects higher activity in trade exchanges, which despite an export growth, still reports mounting trade deficit. Remittances from immigrants largely financed the trade balance (approx. 44%) just as in previous periods. However, it should be emphasized that remittances growth in 2007 was only 1.3%. This year saw higher rates of capital flows, consisting mainly of foreign direct investments. The FDIs were 6% of GDP, with a growth of 2% relative to a year ago.

Table 17 Summarized indicators of the Balance of Payments

	In millions of euros			As a share to GDP		
	2005	2006	2007	2005	2006	2007
Current account	(492.1)	(535.1)	(878.1)	7.3	7.3	11.0
Trade balance	(1,476.7)	(1,685.4)	(2,135.1)	21.9	23.1	26.8

- Exports	530.2	630.6	786.3	7.9	8.6	9.9
- Imports	(2,006.9)	(2,316.0)	(2,921.5)	29.8	(31.7)	36.7
(Net) Services	140.4	(66.8)	2.8	2.1	0.9	0.0
(Net) Revenues	136.1	208.6	216.3	2.0	2.9	2.7
(Net) Current Transfers	988.9	1,008.5	1,037.9	14.7	13.8	13.0
(Net) Capital Account	438.5	552.1	838.7	6.5	7.6	10.5
Overall Balance	125.1	206.6	148.6	1.9	2.8	1.9

Source: Bank of Albania

2.6.2 CURRENT ACCOUNT

The external sector displayed intense activity in 2007, implying sizeable growth in current spending and revenues. The volume of current transactions has gone up by 20% relative to 2006, reaching 8.3 billion euros, 60% of which has been attributed to spending.

Over 96% of the current spending has been allocated to purchase goods and services. Meanwhile, exported goods and services have brought in 60% in revenues, while current transfers (33%) and returns from labour and investments (7.4%) have generated the rest. The 2007 current deficit amounted to 878 million euros, with a 64% growth relative to 2006, and equaling approx. 11% of GDP.

Chart 19 Current deficit as a share to GDP

Current deficit
Current deficit as a share to GDP (right-hand scale)
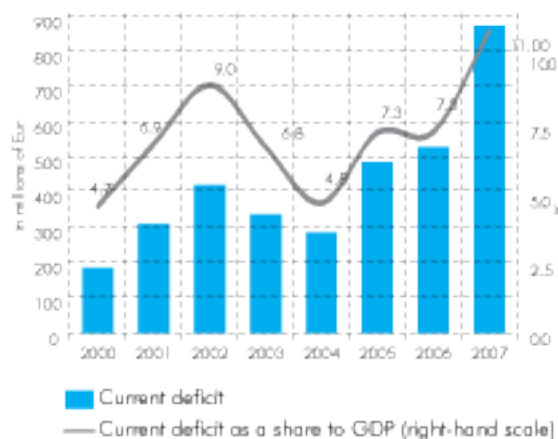
Source: Bank of Albania

2.6.2.1 Trade of Goods

The high trade flows in 2007 led to an overall trade volume of 3.8 billion euros, which was 26% higher than the previous year. The contribution of the trade in goods to the current account remains quite high, approx. 44% of all current annual transactions. Factors such as the general price hikes, fluctuations in the rate of currency exchange and the gradual drop in customs tariffs, part of the trade liberalization process – all led to highly intensified trade activity.

Even though trade dynamics suggest that there are higher rates of growth in both imports (26%) and exports (25%), the low export base could not help to improve the trade deficit. The latter amounted to 2.1 billion euros, being 27% higher than in 2006.

Chart 20 Divergence in exports and imports (annual growth rate)

Exports growth rate   Imports growth rate

Source: Bank of Albania

The share of imports' coverage by exports remains low, at 26% (during the last 5-year period, this share has shifted around this level) given that the

capacity to produce at home is insufficient to meet the increasing demand in the Albanian economy for goods.

Based on an import analysis that examines the final use of imported goods, it is deduced that intermediate goods make up the greatest share (53%), while capital and consumption goods make up 30% and 14% of the total 2007 imports, respectively.

Intermediate goods consist primarily of processed industrial goods (60%) and fuels for industrial purposes.

In 2007, there was a drop in imported consumption goods by 7% relative to 2006, while imported capital goods increased by relatively 36%[25].

Table 18 Foreign trade structure

	Imports (in %)		Exports (in %)		'07/'06 in %	
	2006	2007	2006	2007	Imports	Exports
Food and animal stock	13.3	12.5	4.2	3.6	18.2	6.2
Beverages and tobacco	3.2	2.9	1.3	1.4	15.6	32.4
Unprocessed materials	3.6	2.2	5.5	9.6	(20.8)	116.9
Fuels	10.6	14.7	4.3	7.9	75.1	129.1
Animal or vegetable fats and oils	1.3	1.1	0.1	0.1	7.7	61.1
Chemical products	10.5	9.9	1.0	1.0	19.7	32.1
Processed goods	25.6	24.8	22.4	21.3	22.1	18.3
Machineries and equipment	20.1	20.7	3.9	4.2	30.2	34.9
Other processed goods	11.8	11.2	57.2	50.8	19.2	10.7
TOTAL	100.0	100.0	100.0	100.0	26.3	24.7

Source: Bank of Albania

There was sizeable growth in all of the categories of exported goods. The textile and footwear industries contributed greatly to exports, yielding 48% of the total share. It is worth mentioning that exported mineral products (3 times higher than 2006 exports) and crude oil (72%) saw high growth rates in 2007. This is owed primarily to re-initiation of chromium exports toward China and Sweden.

Customs duties on a number of products were reduced at the head-start of 2007, as part of the Free Trade Agreement with the European Union. This liberalization has led to diversification of trade activity and distribution countries, reducing Italy and Greece's traditional preeminence as dominant destinations.

Table 19 Imports according to trading partner countries

	Share to Total Imports			'07/'06
	2005	2006	2007	in %
EU Countries - 15, of which:	60.4	57.5	54.1	18.9
Germany	5.4	5.6	5.5	22.5
Greece	16.6	15.8	14.6	16.7
Italy	29.3	28.1	27.2	22.0
New EU members – of which:	6.9	8.1	5.7	(11.0)
Bulgaria	2.8	2.7	1.8	(18.1)

Czech Republic	1.0	1.1	0.8	(8.1)
Romania	0.7	1.7	0.4	(68.8)
Other European Countries, of which:	8.0	9.1	11.6	61.3
Russia	4.1	4.1	4.1	25.9
Ukraine	2.9	3.9	2.6	(14.5)
The Balkans	11.0	12.3	13.2	35.8
Bosnia and Herzegovina	0.1	0.3	0.3	40.3
Kosovo	0.4	0.5	0.6	53.2
Croatia	1.2	1.4	0.9	(20.1)
Macedonia	1.2	1.6	1.9	52.0
Serbia-Montenegro	0.6	0.9	2.2	207.2
Turkey	7.5	7.6	7.3	21.3
USA	2.1	2.0	2.5	60.8
Asian Countries, of which:	7.5	6.7	7.6	44.2
China	6.7	6.0	6.7	40.5
Others	4.2	4.5	5.3	47.7
Total	100.0	100.0	100.0	26.2

Source: Bank of Albania

The unification of trade relations with regional countries[26] had immediate effects on trade as these countries manifested higher rates of growth. Exports saw the highest growth, being 71% higher than the previous year. The Kosovo market seems to be absorbing the greatest share of our exports to the region, being also the only trade partner with which we have surplus. The low-cost goods originating from countries such as Turkey and China have increased their leverage on the domestic consumption market. These countries' importance to the domestic market continues to grow at stable levels, while other trading partners such as Germany, Switzerland and Russia are being consolidated in the Albanian market.

	Shares to Total Exports			Changes
	2005	2006	2007	2007/2006 (%)
EU countries - 15, of which:	88.0	87.8	81.8	16.1
Germany	3.3	3.2	2.4	(3.6)
Greece	10.5	9.6	8.3	7.2
Italy	72.4	72.6	68.0	16.8
New EU members – of which:	1.4	0.8	1.3	90.6
Bulgaria	0.6	0.4	0.7	105.8
Czech Republic	0.1	0.1	0.0	(46.2)
Romania	0.2	0.1	0.3	355.2
Other European Countries, of which:	0.1	0.1	0.3	200.5
Russia	0.1	0.1	0.3	485.1
Ukraine	0.0	0.0	0.0	115.6
The Balkans	8.5	8.8	12.1	70.9
Bosnia and Herzegovina	0.2	0.5	0.4	(8.3)
Kosovo	4.1	3.8	4.8	58.7
Croatia	0.0	0.3	0.1	(59.0)

Table 20 Exports according to trading partners

Macedonia	1.6	1.6	2.4	83.7
Serbia and Montenegro	0.8	1.4	2.2	106.2
Turkey	1.7	1.3	2.2	116.3
USA	1.1	0.5	0.7	63.3
Asia, of which:	0.5	1.6	2.6	98.0
China	0.5	1.1	2.6	180.4
Others	0.3	0.4	1.3	370.0
Total	100.0	100.0	100.0	24.7

Source: Bank of Albania

2.6.2.2 Services

Service transactions have increased by 3% relative to 2006, reaching up to 37% of GDP. The net value of the trade in services has been positive due to the higher rate of growth in export revenues (22%) relative to import expenditures (15%) in this sector.

The trade in services seems to be quite dynamic, particularly exports, which continue to outdo exports of goods, being 1.9 times as much.

With demand increasingly going upward, travel services make up the greatest group in both exported and imported services, with 69% and 64% respectively. Net revenues from exported services in 2007 were higher than a year ago; as such, they have financed quasi 4% of the 2007 trade deficit.

Returns from exports in tourism have boomed, approaching 1 billion euros or 27% higher than exported goods; this attests to where Albanian resources are being directed toward.

Simultaneously, the demand for goods and services from Albanians who travel to foreign countries pushed imported travel services to 923 million euros. These expenditures, whose annual growth is approx. 20%, make up 97% of remittances.

Albania is a net importing country of transport and insurance services which is fueled by higher imported goods.

The insurance market has progressed positively, attracting more and more foreign investors interested in purchasing several companies.

All of the other service sectors show improved balance of trade. Amongst other developments in services, the financial and communication services sectors have expanded rapidly; the technology and information sectors have also swelled; cultural services have diversified in multitudes, winning potential competitiveness in the international market of services.

2.6.2.3 Income and Current Transfers

Factorial income yielded a positive balance at end-year (216 million euros), which is estimated to be 3.6% higher than the previous years. The level of this growth runs parallel with the 10% drop on a per-annum basis in returns from labour generated by seasonal and cross-border workers.

During 2007, Albania paid off 24 million euros on foreign debt interests, which have lightly fallen relative to 2006 (4%).

The 2007 total remittances are estimated to be 947 million euros (slightly growing at 1.3% y/y) or 12% of GDP. This growth rate is arguably the lowest in the last 10 years (the average growth rate is 11.7%); this is owed to the fact that part of remittance flows are being used for investments (real estates or investing on financial assets). Remittances have contributed with 44% to the reduction of the trade deficit – 11% less contribution than last year.

Official transfers, mainly as technical assistance, are estimated to be 60 million euros, going up by 18 million euros relative to last year.

2.6.3 CAPITAL AND FINANCIAL ACCOUNT

Voluminous capital flows have moved both ways in 2007, as income and outgoing flows. Excluding unilateral capital transfers, the financial account this year yields both higher financial obligations that Albania owes to the rest of the world, and higher Albanian-owned assets abroad.

However, the capital and financial account closed the year with a positive balance of 839 million euros, shelling up to 96% of the current account deficit. Capital transfers, consisting of investment grants in the public and private sectors, reached 90 million euros.

The Albanian economy absorbed 806 million euros in foreign capitals during 2007. This value was 45% higher relative to 2006; its growth is attributed to direct investments through long-term concessional borrowing and non-residential deposits in our banking system.

Foreign direct investments reached a record number in 2007: bringing in approx. 463 million euros which was 75% higher than last year. The privatization of Albtelecom and the growth of foreign capital shares in the domestic financial sector have proved crucial to FDIs expansion. Investors from the European Union (Italy and Greece) continue to lead investments in the processing textile and footwear industries.

Long-term credits and soft foreign loans, which comprise another important factor in the rise of financial obligations that Albania owes to the rest of the world, amounted to 129 million euros in 2007, 93% of which went to the public sector. This growth has principally helped to finance infrastructural investments.

Servicing the external debt for 2007 has reduced our obligations by 54 million euros. This makes up only 7% of our 2007 exports, which reveals a satisfactory ability to pay our debt. At the same token, private borrowing seems to yield diminishing growth rate.

Short-term obligations in the form of higher non-residential deposits and other obligations accrued by financial and non-financial sectors have been of particular significance this year. They amount to 248 million euros, 66% of which is denominated in euro currency.

This growth is attributed to remittances' shifting from current transfers into deposits in our banking system. Obligations in the form of commercial credit increased by 11.8 million euros, which reflects the growth of imports during this period.

Currency assets invested abroad increased by 57.4 million euros, and consist primarily of short-term and medium-term investments of currency reserves of our banking system in non-residential financial institutions.

Chart 21 Foreign reserve in monthly imports

- Foreign reserve
- Average monthly import
- Foreign reserve in monthly imports

Source: Bank of Albania

2.6.4 FOREIGN RESERVE

The general status of the balance of payments is positive, yielding a growth of 148.6 million euros in foreign reserve held by the monetary authority. Hence, their level at the end of 2007 reached 1.5 billion euros, sufficient enough to shell approx. 4 months of imported goods and services.

2.6.5 INTERNATIONAL INVESTMENT POSITION

The international investment position reached 1.2 billion euros or approx. 15% of GDP, at the end of 2007. The net debit status was 2.2 times higher than that of the 2006 end-year. The deepened negative net position is owed to the higher growth in obligations in the form of direct investments in Albania, relative to other assets and investments. Given higher obligations, primarily higher foreign investments, the degree of financial openness to international financial markets is 73% or 5% higher relative to 2006[27].

Table 21 Albania's international investment position (at the end of the period, in millions of euros)

Total at the end of the year	2006	2007	Change
Foreign assets	2,316.95	2,345.11	28.16
Foreign obligations	2,860.25	3,562.62	702.37
Net Investment Position	(543.30)	(1,217.51)	(674.21)

Source: Bank of Albania

Foreign assets went up by only 0.176 billion euros in annual terms. The monetary structure of total assets, counting for 2.3 billion euros, is entirely liquid. Foreign reserves take up 61% shares of the total, while other investments, primarily commercial banks deposits take up 34% in shares. In contrast, the total of foreign obligations, counting for 3.6 billion euros consists of long-term investments, 43.6% of which were foreign direct investments and 56.4% other investments[28].

Total at the end of the year	2006	2007	Change in %	Structure
Direct investments abroad	18.35	13.06	-28.9%	0.6
Portfolio investments	87.47	61.26	-30.0%	2.6
Other investments	809.63	800.50	-1.1%	34.1
- of which, currency and deposits	752.2	759.5	1.0%	32.4
Reserve assets	1,401.51	1,470.29	4.9%	62.7
Total Assets	2,316.95	2,345.11	1.2%	100.0

Table 22 Foreign assets composition, in millions of euros

Source: Bank of Albania

2.6.5.1 External Debt

Albania's external debt kept growing during 2007, although at lower rates relative to 2006. The total external debt went from 1.8 billion euros at the end of 2006 to 2 billions. This is owed primarily to the growth of short-term obligations that commercial banks owe (in the form of credits, currencies and deposits).

Considering the external debt composition, long-term credits dominate taking up 73% shares of the total debt. Short-term credits take up 11.3%. Meanwhile, currencies and deposits take up 3.5% of the total debt.

External debt relative indicators seem to be improved at the end of 2007. The external debt ratio against year-long exported goods and services reached to 87.8% at the end of 2007, falling by 12% relative to end-year 2006. The

Chart 22 The gross external debt ratio as a share to GDP and exports

Source: Bank of Albania
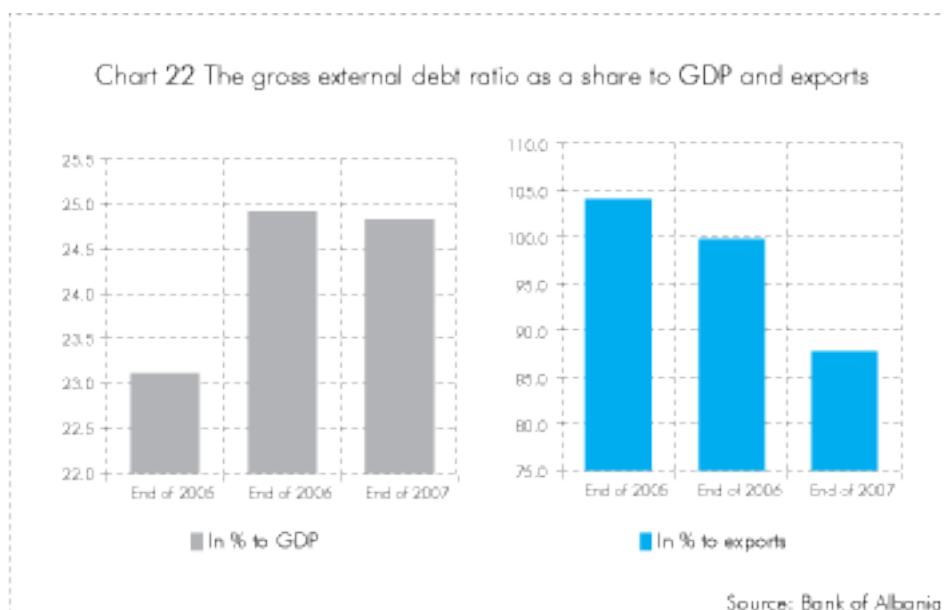
slide in this ratio is an outcome of Albanian exports expanding more rapidly this year than foreign debt obligations.

Meanwhile, the external debt ratio against the gross domestic product is almost the same as last year, at 25% of GDP.

At the end of 2007, obligations in euros made up the greatest share of the external debt, at 49%, followed by SDR at 36%. External debt obligations in the form of assets in US dollars make up a small share (approx. 7%) of the total obligations.

ENDNOTES

[1] *Data on GDP and its real growth during 1999-2000 are received from INSTAT. The rest consist of data from the Ministry of Finance estimations, IMF and Bank of Albania data.*

[2] *The table is based on reviewed nominal GDP.*

[3] *Nominal GDP, converted at the average currency exchange rate during this period.*

[4] *Government debt including the guaranteed government debt.*

[5] *Average of 2001-2007.*

[6] *During the January-September period for each year.*

[7] *The rate of growth is calculated for the January-September period of every year, to be compared with 2007.*

[8] *In volume, measured in GwH.*

[9] *Monthly Bulletin, September 2007.*

[10] *Includes prices of grains, vegetable oil, meat, fish, sugar, bananas, and oranges*

[11] *The growth in bread and grains prices and then processed products. These items take up considerable share in the consumer price basket.*

[12] *Similar to that is the core inflation which is calculated for over 78% of the CPI basket.*

[13] *Total annual inflation rate was 3% in 2007.*

[14] *Tradable goods prices take up to 52% of the CPI basket.*

[15] *Foods in the basket of tradable goods price calculation take up to 70%.*

[16] *In January 2006-December 2007, the key interest rate raised 5 times, each by 25 basis points.*

[17] *Tables 1 to 3 (excluding Albania) include countries according to their membership-length in the EU (from the oldest to the newest members). Table 1 lists some EU countries which are Albania's main trade partners.*

[18] *According to EUROSTAT's COICOP classification.*

[19] *As for employment the data are available for the first 9-months.*

[20] *The latest plan was revised in November upon the approval of the normative act for the reallocation of budget expenditures. According to this schedule total revenues and expenditures were projected at lower levels from the supplementary budget approved in July this year by 1.7 billion Lek and 4.7 billion Lek, respectively.*

[21] *The data made available by the Ministry of Finance for 2007 are preliminary data.*

[22] *Profit tax revenues are believed to have dropped from the previous year as a result of the aggravated financial situation of public companies.*

[23] *In other words, the increase in revenues from excises contributed by 2.5% to the annual growth rate of total revenues of 9.7%.*

[24] *The receipts from the privatization of the Albtelecom, which represent the financing of the deficit, are about 13.3 billion Lek. While the issue of securities was about 17.3 billion Lek or 3.7 billion Lek lower than the previous year.*

[25] *The import of energy contributed to the increase in imports. Detailed data related to this sector are reported in Section '2.2.1.3. 'Power Production and Consumption'.*

[26] *CEFTA, the Central European Free Trade Agreement, entered into force in July 2007.*

[27] *The difference between a country's external financial assets and liabilities is the international investment position. While the financial openness is measured as the ratio of total gross foreign currency assets and liabilities to the GDP. These measures include the financial and real sector of the economy.*

[28] *The exchange rate performance affected the net international position. The depreciation of the US dollar to the Euro led to the reduced growth of net foreign currency assets. Foreign assets instruments denominated in the US dollar account for about 37% of assets with abroad relative to about 7% of liabilities with abroad.*

CHAPTER 3 MONETARY DEVELOPMENTS

3.1 MONETARY DEVELOPMENTS

The trend of monetary indicators shows high rates of money supply in the form of credit to economy vis à vis a weaker domestic demand for money. By and large, these trends have developed in tune with the propensity to lower money circulation in economy and with the financial intermediation deepening in economy. Money supply has grown more rapidly as a ratio to GDP and the credit surplus has gone up to 30% of GDP. However, pressures on consumer and production pries have built up during 2007.

Chart 1 Annual growth of M3 and money demand elasticity

—Money demand elasticity to national revenues
—Average trend

—Annual growth of M3

Source: Bank of Albania
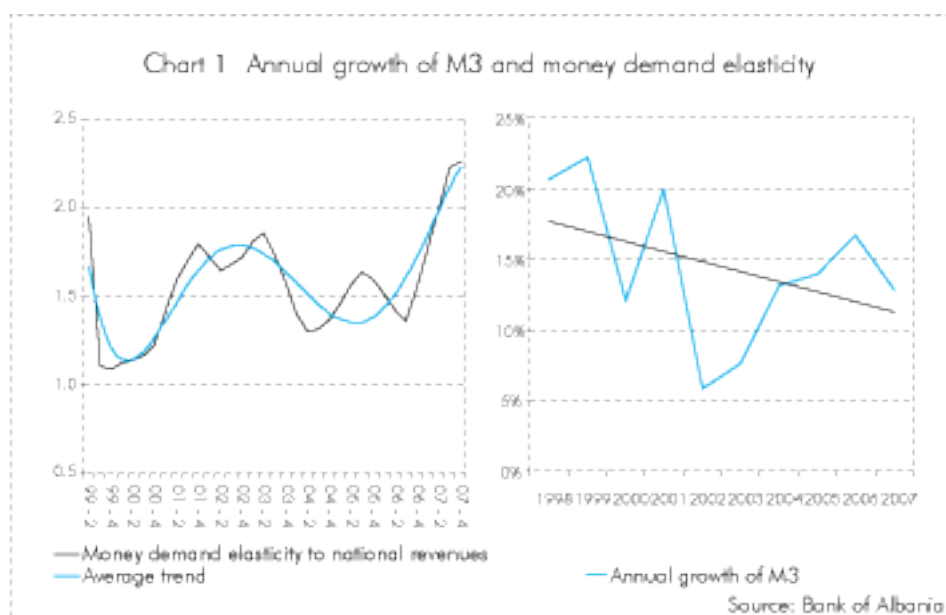
The annual growth rate of M3 broad money aggregate has decelerated to 13%. Lower rates for monetary aggregates relative to higher rates of credits at the end of the year, balanced out the domestic demand for monetary assets. Parallel to that, the reduced contribution of net currency assets to the broadening of M3 provides evidence for the higher impact of supply flows toward the external orientation of the economy. On the same note, given stable developments in Lek-denominated credits lent to the public sector, the annual growth rate of M2 has declined to 5% relative to the 2006 rate of 12%.

The sectorial structure of money stock shows higher rates of generating money in the form of domestic credit. Credits to the private sector continue to lead the sectorial structure of money stock in 2007. On average, credits to the private sector of the economy has generated money flows of about

15-16%, in M3 terms. Meanwhile, just as in the last years, the public sector has contributed to money broadening with a stable rate of about 2%. The diminishing contribution of net currency assets to M3 has occurred analogous to the deterioration of the external account of the economy and to the enlarged gap in the savings-investments ratio.
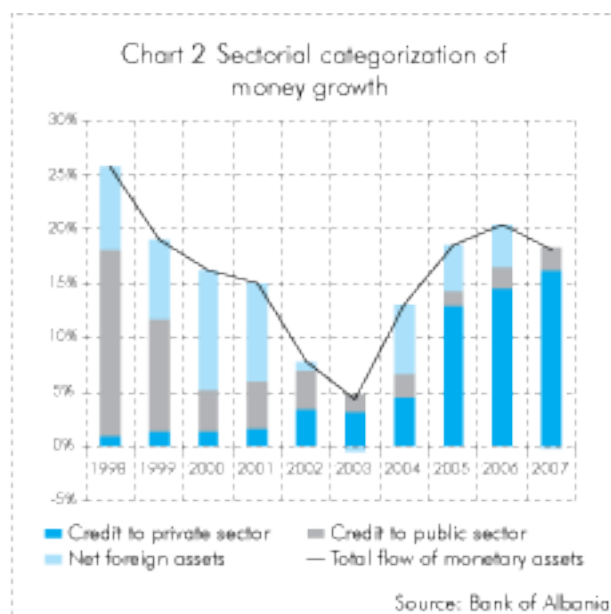
Currency developments have reported seasonal vacillations during the year, even though a lower demand for liquid money during the second half of the year suggests that developments are becoming relatively more stable. The demand for liquid money partially reflects the supply of monetary assets focused on the public sector, at the end of the year. However, the demand for liquid money in 2007 is lower relative to 2006. Currency outside banks has declined by 5% in annual terms.[1] In addition, there have been fluctuations in broad money developments, in real terms. At the end of the year, M3 grew by 10%, relative to the 15% annual growth attained in the first quarter.

Chart 2 Sectorial categorization of money growth

Credit to private sector
Net foreign assets
Credit to public sector
— Total flow of monetary assets

Source: Bank of Albania

Chart 3 Annual growth rate of M3 real and currency outside banks (in %)

—CoB   —Average trend

—Annual change of M3 real

Source: Bank of Albania
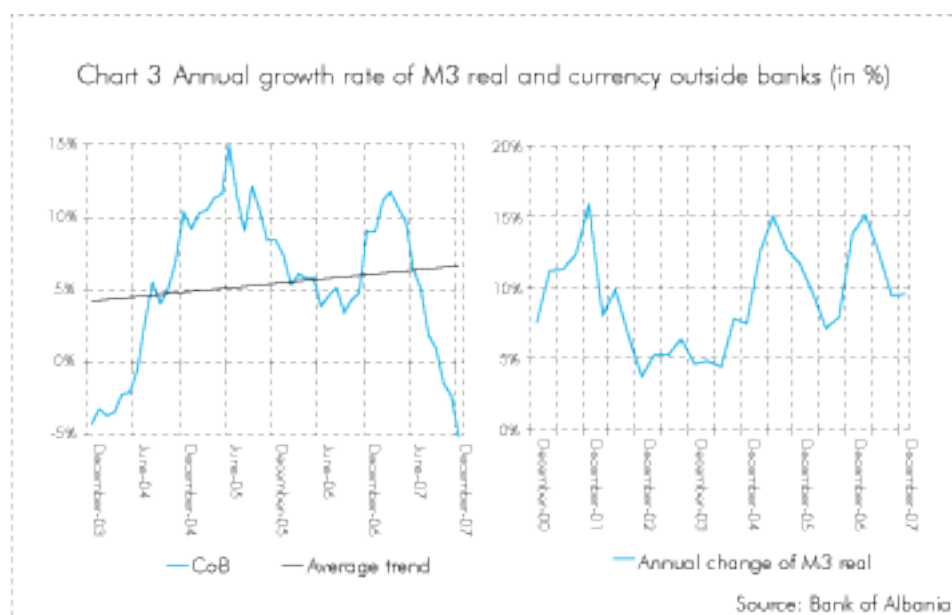
3.1.1 DEVELOPMENTS IN M3 TIME STRUCTURE

The time structure of broad money in the economy has preserved the tendency to shift toward non-liquid components. This tendency is well aligned with higher intermediation in the banking system. The total share of deposits to the M3 aggregate has increased to 80% at the end or expressed differently it is 4% higher relative to 2006. During the last 4 years, deposits share to M3 has bee increasing, although the real interest rate has varied. The mild rise in

the inflation rate has diminished real returns to savings. However, the growth in the key rate and its delayed effect-transmission into money markets has replaced the real rate of return to above 2%.

Chart 4 The real interest rate of deposits in Lek (and repo rate) – left; deposits share to M3 – right

Source: Bank of Albania
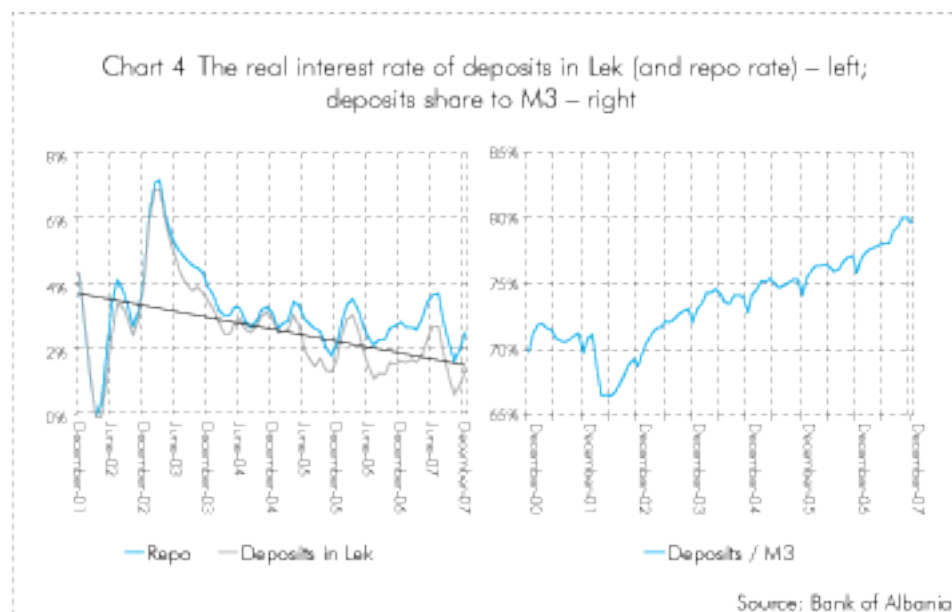
Along macroeconomic developments, continued improvements in the payment system and the deepening of the banking network in the country, have positively affected the time structure of broad money and reduced cash money supplies in the economy.

3.1.1.1 Currency outside banks

Currency outside banks into the economy primarily reflects the demand for transactions. During 2007, the ratio of currency outside banks to GDP has shifted around 16-17%. The macroeconomic stability and the low inflation rate in the economy during recent years have been followed by stable developments of this indicator, whereas, the demand for liquidity has undergone seasonal shifts through out the year. On average, the ratio of the money stock to the GDP has seen a light drop by 0.5%, to 16% relative to 16.5% in 2006.

In terms of broad money, the currency outside banks makes up around 20% of M3. At the end of 2006, this ratio was 24%. The downward propensity of shares of currency outside banks to M3 corresponds with the upward propensity of banking intermediation in these recent years. Trends of currency outside banks in annual terms have been under the influence of end-year seasonal factors. Thus, at the end of 2007, the annual growth of currency outside banks was -5%, relative to the positive growth of 9% in 2006.

Chart 5 Currency outside banks as a share to GDP and to M3

— CoB / GDP   — CoB / M3
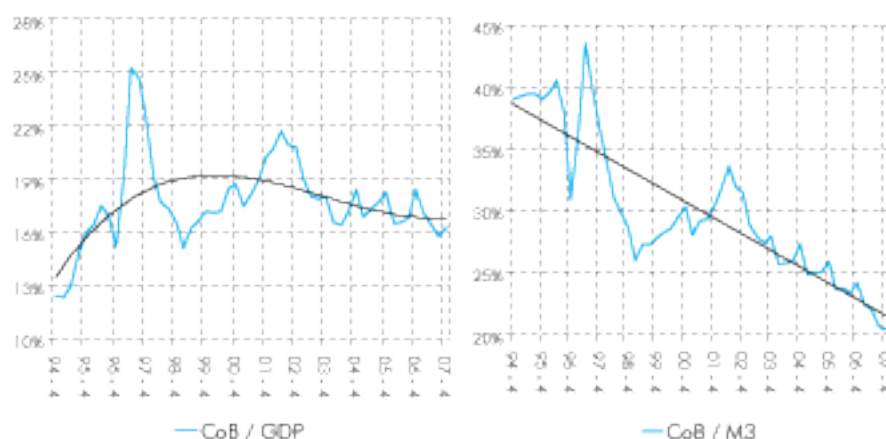
Source: Bank of Albania

3.1.1.2 Lek deposits

The level of Lek deposits went up by 10% in 2007. In the medium-term, the time composition of the M2 aggregate has shifted toward Lek deposits. At the end of 2007, their share to M2 increased to 69% relative to last year's 66%. In addition to this tendency, seasonal developments in money markets have impacted the demand for liquidity, and consequently the M2 structure. Under these circumstances, the banking system has maintaned liquid stability in the medium term. However, in the short-term period the demand for liquidity has been prone to seasonal changes in the demand for monetary assets. The banking system generated liquid surplus in the first half of the year, while during the second half of the year the demand for liquid money has been rising. Matching this seasonal demand has fostered stable interest rates.

Chart 6 Time structure of M2 and annual growth of M2
and Lek deposits (right)

— Deposits in Lek / M2   — Deposits in Lek   — M2
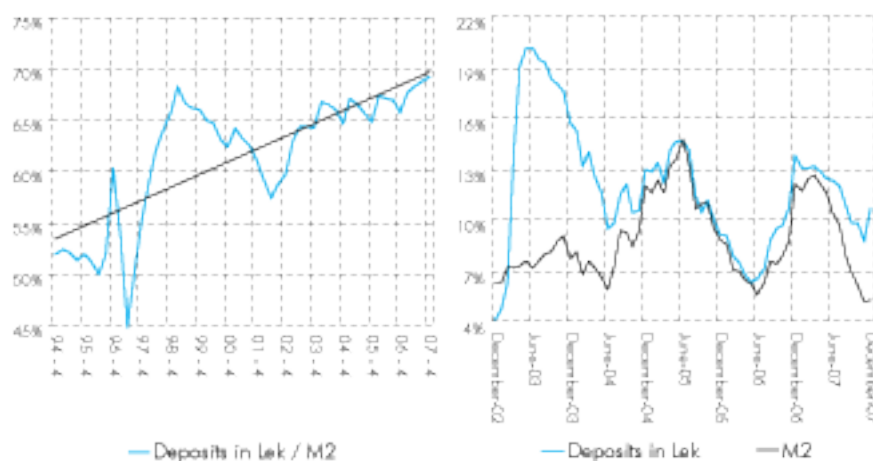
Source: Bank of Albania

3.1.1.3 Developments in the foreign currency structure

The growth of broad money in the economy has yielded high currency flows in the form of deposits. In recent years, the growth of foreign currency deposits as e result of remittances have been followed by money flows in foreign currencies generated by the financial intermediation. Thus, while the level of net currency assets in the banking system has been relatively stable, the level of deposits in foreign currency has grown at high rates. The share of foreign currency deposits to total deposits has increased to 42.5% at the end of 2007, relative to 38.5% in 2006. The share of net foreign currency assets to total deposits has declined to 10% in 2007, relative to 14% at the end of 2006.

Chart 7 The share of foreign currency deposits and foreign currency assets to total deposits

■ Net foreign assets / Total deposits   ■ Deposits in foreign currency / Total deposits

Source: Bank of Albania
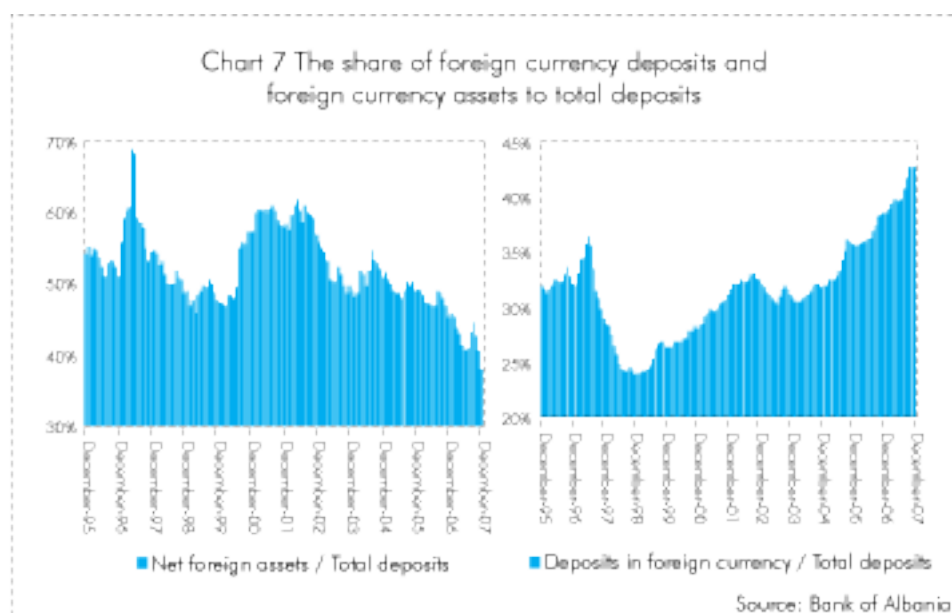
Under these circumstances, the currency structure of M3 has shifted toward currency components of deposits, partially including money flows generated by domestic demand for monetary assets in the economy. During 2007, foreign currency deposits grew by approx. 30%, while net currency assets remained the same as in 2006. Additionally, the share of foreign currency deposits to M3 went up to 34%, relative to 29% at the end of 2006.

Box 4 Euro-ization and currency structure of money

The level of dollarization (or euro-ization) in a given economy is intricately linked to the optimization of the financial situation and to risks carried by economic agents. The strategy of agencies responds to due performance and to macroeconomic policies in this country, as well as to technological innovations. The simultaneous convolution of these elements renders any relation between the euroization level and any macroeconomic indicator quite unstable. The reaction of these economic agents to macro policies of euroization complicates the drafting and implementation of standard policies. However, there is a plethora of theoretical literature on the behavior of agents that opt for euroization, which helps to interpret all possible links between the euroization level and variable macroeconomic indicators.

One of the key reasons for adopting euroization has to do with transitional stagnation or transitional fluctuations in financial service markets. Generally, their stability is not followed by an opposite process of de-euroization. The euroization consists primarily of foreign currency deposits. The economic literature counts for a number of factors that may act against the currency structure of broad money. Apart from transitional effects such as temporary instability, which instigate the process of euroization, there are psychological effects as well, and other factors to consider. Thus, the intensity with which changes in the exchange rate are transmitted, interest rate changes and price indexes may lead to high or low euroization. However, it is difficult to interpret every relation between the euroization level and such factors in a cause-consequence relation. The level of euroization (dollarization) in transitional countries during the 90s, ranged from 40% to approx. 80%. This level of euroization indicates the share of foreign currency deposits against total deposits in the banking system. In Albania the foreign currency deposits' share to total deposits is around 40%. Among potential factors that supplement the process of euroization, the annual increase of interest rates is the rationale behind shifts in the euroization level during the 90's.

Chart 8 Foreign currency deposits' share to total deposits and other indicators

— Deposits in foreign currency/Total deposits (left)
— Net foreign assets/Total deposits (right-hand scale)

— Interest rate (right-hand scale)*
— Deposits in foreign currency/Total deposits (left)

* The interest rate represents the 12-month interest changes over the years.
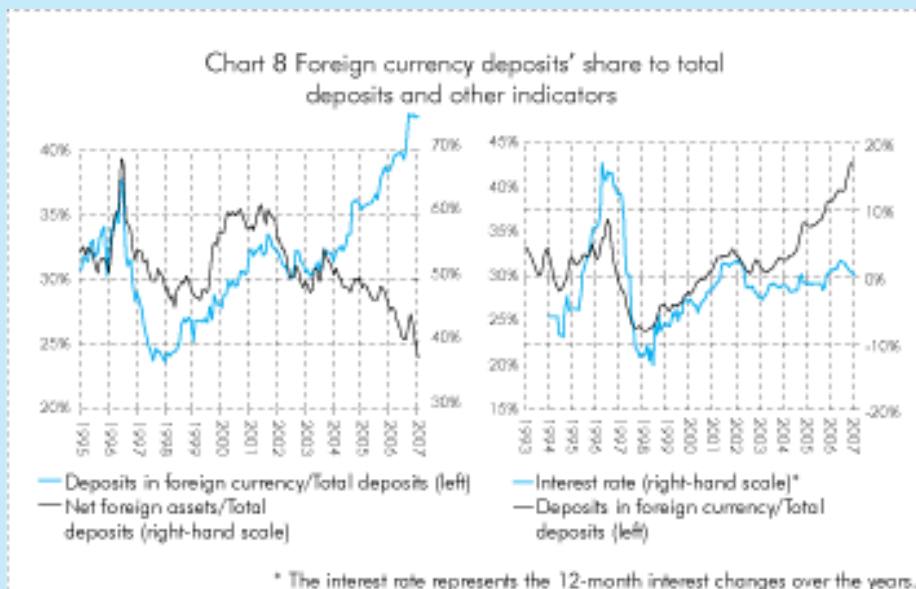
3.1.1.4 Credits to the private sector

Under a stable macroeconomic framework, the demand for financing in 2007 has been quite high. Commercial banks have expanded their role as financial intermediaries in responding to this demand, by offering new products, well-suited to their clients' needs. These positive developments have expanded the credit portfolio and substantially improved financial intermediation indicators.

The ratio of credits to gross domestic production grew by 8.8%, reaching 30.1% at the end of the year. The ratio of credits to money supply and to banking activities has also expanded at the same rate, reaching 38% and 40%, respectively in December of 2007.

However, the credit growth rate decelerated to 50.4% during 2007[2], reaching the lowest rate in the last two years. Despite this, the credit portfolio expansion is still high and carries potential risks in the medium term for price and financial stability.

Chart 9 Performance of credit portfolio

Average annual growth for the quarter (%)

	December '06	Q1'07	Q2'07	Q3'07	Q4'07
Credit portfolio (in bll of Lek)	287.5	56.3	57.8	55.2	53.6	50.9
Composition of credit portfolio in % (December '07)						
Credit to businesses	64.2	54.15	54.0	50.6	45.6	43.7
Working capital (+overdraft)	30.1	47.8	47.8	64.2	61.8	58.0
Investments	34.1	67.1	59.0	40.9	36.2	33.2
Credit to households	35.8	63.90	65.8	68.2	67.5	66.5
Consumer credit	9.1	121.78	101.2	100.9	106.7	61.5
Real estates	26.7	58.62	67.4	65.3	62.4	76.8

Source: Bank of Albania

The credit structure by currency has not changed significantly during the year. Credit in foreign currency dominate outstanding credit with a 72.3% share of the portfolio, relative to the 71.1% in December of 2006. Unlike the last two years, in 2007 banks were relatively more prone toward credits in foreign currency. Particularly, during the second half of the year, credits in foreign currency grew at higher rates (on average at 53.3%) relative to credits in Lek (on average, at 49.8%)

The credit portfolio distribution by currency is favored by the noticeable difference between the interest rate on Lek-credits and the interest rate on

Chart 10 Credit portfolio by currency
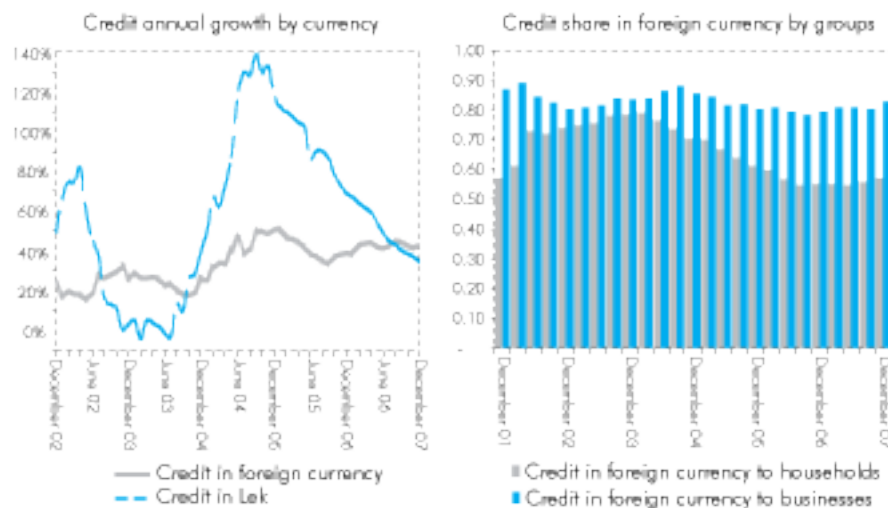
Source: Bank of Albania

foreign currency-credits, followed by a relatively stable Lek during recent years. In addition, price quotes of some intermediate and final goods[3] denominated in foreign currency (euros) arguably fuels the demand for euro-based credits. This type of credit reached up to 90% of the share of the foreign currency-credit portfolio in December of 2007.

Credit-growth is sustained by businesses which lead the credit portfolio with 63% in shares. However, during the last two years this has persistently diminished at a constant rate due to banks' orientation toward retail banking – financing individuals. In December of 2007, the annual rate of growth for businesses fell to 43% due to diminished growth of investment credits and due to higher rates of growth for working capital credits. The latter are of short-term maturity; hence, high rates of credit payments have led to lower growth in business credits. During this year, banks have mostly financed businesses involved in trade activities (38.1%), industry (26.1%) and construction (21.1%). Agriculture remains the least financed sector by the banking system, absorbing only 1.2% of business credits.

Chart 11 Business credit portfolio

Credit to businesses

Credit to businesses by main sectors of economy

— Annual growth of credit to businesses
Ratio of credit to businesses to GDP (right-hand scale)

Agriculture Industry Construction Trade

Source: Bank of Albania
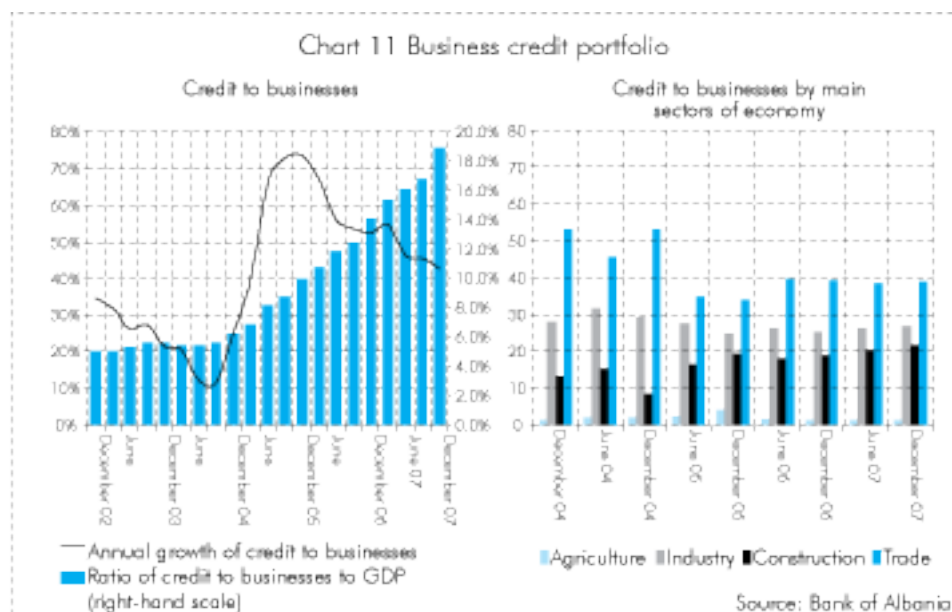
Household credit has maintained high rates of growth, on average at 67% for 2007, providing a higher boost for credit portfolio expansion. This performance is sustained by high rates of growth of real-estate credits (on average, 77%), which takes the lead in individual financing. Under the pressure of market competition, banks have come up with attractive offers that have better matched the increasing demand for mortgage loans. Meanwhile, consumer credits grew at lower rates in 2007. This led to lower shares to total credits for individuals, at 25.5% relative to the 2006 share of 27.5%. In July, consumer credits grew noticeably by 5 billion Lek fueled by the demand to finance summer vacation. Unlike the previous year, this failed to repeat during winter holidays. The slowdown in consumer credit growth, particularly during the last quarter was owed to higher costs imposed on this type of credit and to the banks' tendency to be rather prudent in expanding this product.

Chart 12 Households' credit portfolio

Household credit portfolio

Contribution of credit by purpose of use

—Annual growth of credit to households
■Credit to households/GDP
(right-hand scale)

■Credit to real estate
▨Consumer credit
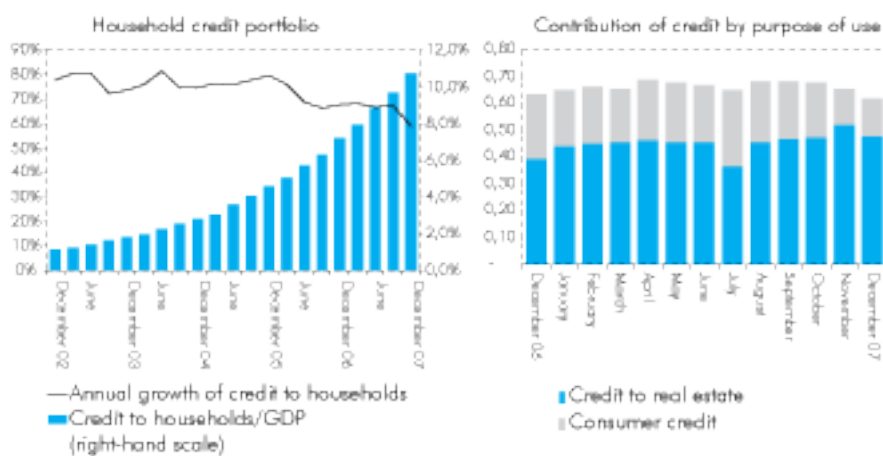
Source: Bank of Albania

Box 5 Mortgage loans crisis in the US and its implications on the financial stability

In response to the high demand for purchasing homes at the end of the 90s and during 2001-2005, home mortgages in the US grew substantially. In the presence of low interest rates, high liquidity and high house prices, American banks offered mortgage loans with relaxed conditions, increasing their exposure to high-risk credit borrowers. Such mortgage loans given to individuals with a possibility of non-payment, called subprime mortgages, is estimated to make up 15-25% of total mortgage loans in the United States. Credits were given to this category initially at a fixed interest rate for two years, followed then by variable rates depending on market interest rates. Higher interest rates in the US, which began in mid-2004 rendered more costly credit payments by credit-borrowers while diminishing home prices, used as collateral, further limited the possibility of borrowers to sell their homes in order to pay off their loans. This situation fueled bad credits, particularly deteriorating the market of subprime mortgage loans.

The above-mentioned problems in the US banking market shocked international financial markets due to the transformation of subprime mortgage loans into investment instruments. Thus, subprime loans were grouped and then sold to investors as treasury bills. These bills were mainly purchased by pension funds, insurance companies, investment firms and international banks, and were used as collateral in order to earn short-term financing in the inter-bank and money markets. The process of transformation of subprime mortgage loans into treasury bills, not only spread out the risk to banks that offered such credits, but also disconnected the risk assessment unit (the bank) from the risk-carrier unit (buyers of treasury bills shored by subprime mortgage loans).

The augmentation of bad credits in the subprime mortgage loans market become even more obvious during the first months of 2007. Banks started to strengthen credit-giving standards, while risk assessment agencies started to lower the quality ratings of treasury bills shored by subprime mortgage loans. Low investors' confidence in such treasury bills led to diminishing demand. Such developments certainly transmitted uncertainty into the inter-bank market and many banks were

not so keen any more to offer short-term funds to other banks. This confidence and trust crisis soon transformed into a liquidity crisis in early August, when 1-day LIBOR increased by 50% within one day.

Under these circumstances, the European Central Bank - aware that the chaos in American markets was spilling over to the European money and inter-bank markets – injected over 130 million euros of liquidity through reverse repurchase agreements, so as to avoid any possible liquidity crisis in the European banking system. Such an action did not take place since September 11, 2001. Meanwhile, the Federal Reserve Bank, in addition to injecting liquidity in the market, lowered the interest rate many times. The Bank of England exercised its role as 'lender of last resort' in order to save the Northern Rock British bank, which funded its crediting activities through short-term financing, and hence was the most hit of all other institutions from this financial turmoil.

Chart 13 LIBOR performance and survey results of banks' credit analysts
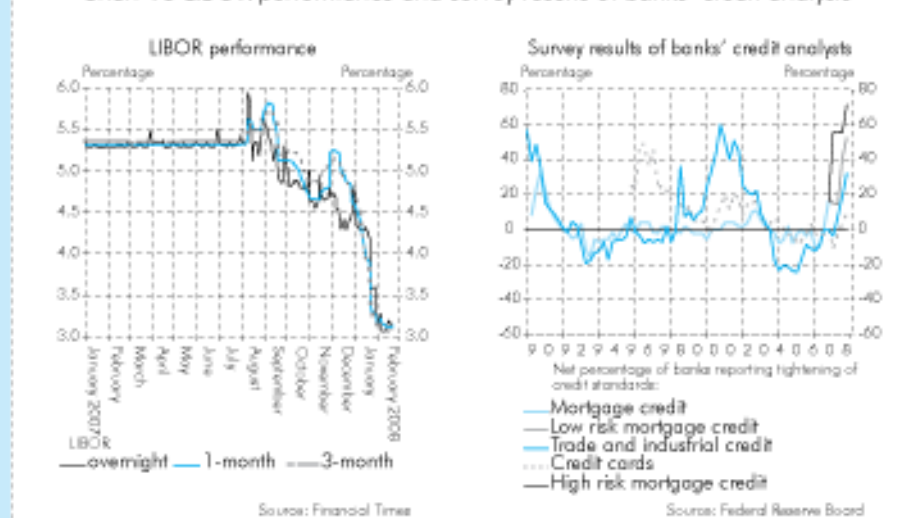
Negative outcomes of the subprime mortgage loans crisis on international financial markets were managed a bit from central banks' measures. Despite the fact that some large institutions reported major losses following their investments in treasury bills shored by such bad credits, until now there have not been severe consequences in developed or developing country-markets. However, the summer 2007 crisis' ramifications may continue to be felt even during 2008, given that problems with subprime mortgage loans have not yet fully materialized, remaining potential risk factors threatening regional and international markets' stability.

This crisis' outcomes into European and American financial markets may have not been transmitted into the Albanian banking system. The banks that operate in Albania are branches or spin-offs of foreign banks, mainly Italian, Austrian, French, Turkish and Greek. According to assessments analyzed by each of these countries central bank, none of the banks seems to have been infected directly from this crisis; furthermore, their indirect exposure seems to be quite mild. Based on such assessments, and on the fact that the branches of the parent banks that operate in this country represent a minor share of their activity, we can assume that even in the event that this crisis does emit future problems, their consequences will be minimally felt by our banking system.

Even though developments in international financial markets do not pose risks for our financial system, they serve as good examples to extract lessons from. The first and main lesson revolves around bad consequences that relaxed conditions and standards of credit-lending - in the presence of high demand for credits and increasing competition between banks – may yield. This is similar to the situation that our banking system is undergoing. Furthermore, the mortgage loans market at home has been expanding for some time now. This entire situation begs for utmost prudence from banks so as to preserve credit quality, and continued monitoring from the Bank of Albania. Lastly, and above all, the crisis originated from subprime loans best illustrates how risk may transform and may be underestimated or not estimated at all by investors. Hence, what is always necessary is prudent and effective monitoring from responsible institutions that oversee the smooth progress of the financial system, so that its further expansion is kept under control and within sound parameters.

3.2 FINANCIAL MARKETS AND INTEREST RATES

3.2.1 OPEN MARKET OPERATIONS

Interventions in open markets have been the primary tool in implementing the monetary policy during the year. Such interventions have targeted the management of liquidity in the banking system and short-term interest rates within target ranges set in the monetary policy. In general, the year 2007 has seen higher demand for liquidity, which has been met through open market operations. The daily average liquidity level is 4.8 billion Leks relative to last year's level of 7.4 billion Leks, but this has not been the same throughout the year. While in 2006 the demand for liquidity surfaced in the last quarter of that year, in 2007 liquidity demand surfaced in the second quarter. In the first quarter of 2007, the system reported liquidity excess, fueled by the return of money to the system, positive outcomes of government actions, and liquidity generated from auctions of reverse repurchase agreements from last end-

Chart 14 Average daily volume in repo auctions and reverse repos (in billions of Lek) – left; weighted average interest rate in repo and reverse repo auctions of 1-week maturity and changes in the key interest rate – right

Source: Bank of Albania
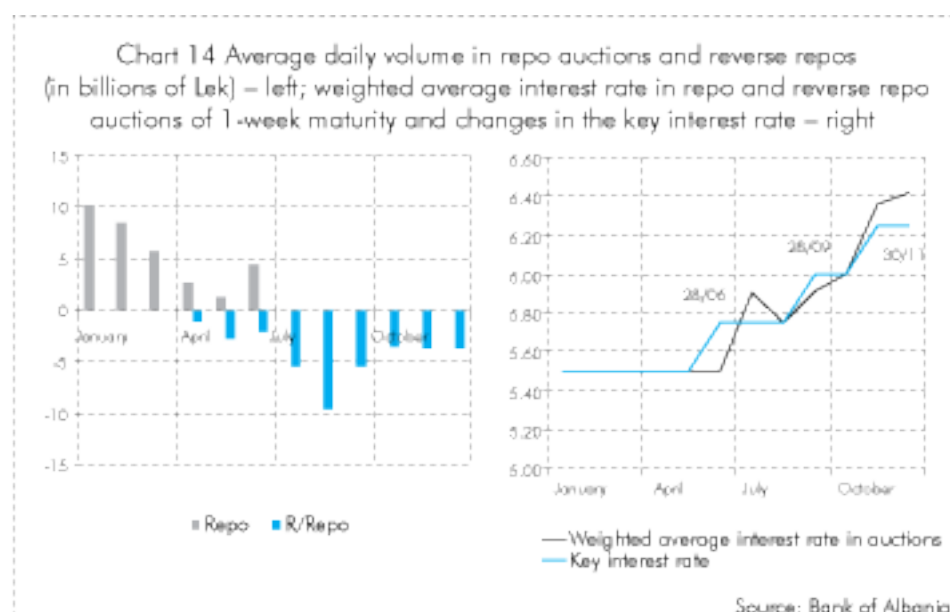
year. This level of liquidity has been drawn through auctions of repurchase agreements of weekly maturity term, structural operations, and auctions of repurchase agreements of 1-month and 3-month maturity. The daily average volume drawn by such operations is estimated at 7.9 billion Lek, relative to last year's 5.2 billion Lek. The banking system showed increasing demand for liquidity during the second quarter of the year and forward. This led to a change in operations toward the use of instruments of reverse repurchase agreements, injecting liquidity in the market (on average, 2.2 billion Lek). Its absence during this period is owed primarily to money-exit during the summer season and the high level of budget surplus. Part of this surplus has been invested, since July, in time deposits with the central bank, as an alternative that was introduced during this time.

In addition to effectively managing liquidity, open-market operations have aimed to be in concordance with monetary policy decisions taken by the Supervisory Council of the Bank of Albania. Auctions with undefined prices and limited amounts took place during the second half of the year. Overnight deposit has been used pretty much homogeneously throughout the year. The daily average volume of the overnight deposit amounts to 1.5 billion Leks, approaching the amount of last year, of 1.6 billion Leks. The overnight credit has been used quite rarely and in small amounts, while short-term liquidity needs have been met through the interbank market.

3.2.2 INTEREST RATES

Short-term interest rates have reflected the tightening policy of the central bank signalled at end-June, end-September and end-November. Credit-lending interest rates in the inter-bank market shift around the range re-defined from the key rate change by +0.75%. This market has served to meet the 1-day and 7-day needs for liquidity, while longer-term needs have been met through open market operations. The daily average volume of credit-

Chart 15 Interest rates in the interbank market (left) and credit-lending volume (right, in billions of Lek)

— Overnight interest rate in the interbank market
— Overnight deposits
— Weekly repo
— 7-day interest rate in the interbank market
— Overnight credit

Source: Bank of Albania
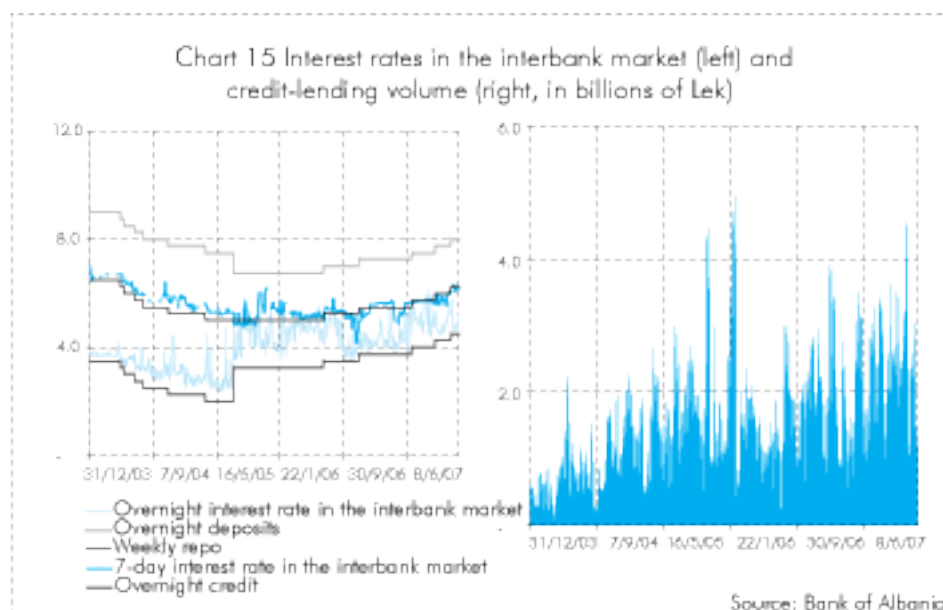
lending has increased relative to last year, going up from 1.5 billion Lek to 2 billion Lek, the highest level reached in recent years but highly concentrated during the second half of the year.

Except for the third quarter, the market has not functioned under pressures for liquidity shortage, which has helped to keep overnight interest rates within limits. The average weighted interest rate for overnight transactions reached 4.80% in 2007, relative to 4.60% in 2006. The interest rates for weekly transactions have shifted around the rates for repurchase agreements of weekly maturity term, and for the most part, even under this level. The average interest rate for weekly transactions went up by 0.43% relative to last year, to 5.67% following the key interest rate pattern.

Treasury bonds' yields in the primary market have been determined by interest rates' shifts and other market players. In March, yields fell by around 0.70% relative to 2006 end-year, self-adjusting against a rise that occurred during the end of the year and against high liquidity.

At the end of June, the 12-month yield reached 7.99%, relative to the end-March level of 7.07%. Higher yields during this period are owed partially to expectations for higher key interest rates (which increased by 0.25% in June 28).

During the second half of the year, after the rise in the key interest rates, yields increased by almost the same signaled amount (for 3-month bonds) and afterwards have fluctuated, depending on the supply/demand ratio. On a wider outlook, the primary market features liquidity injection, given the government's lowered demand to finance with treasury bills (short-term assets), and the orientation to finance with bonds (long-term assets).

Banks were reluctant to invest in the primary market of treasury bills during December. This led to further liquidity injection and higher yields, under the conditions where all of the bids to meet the limit of domestic financing of the deficit resulted successful. At the end of December, the 12-month yield reached 8.32% or 0.44% higher than last year.

Chart 16 Treasury bills' yields in the primary market

— 27/12/07   — 6/12/07
— 11/10/07   — 5/7/07   — 29/12/07

Source: Bank of Albania
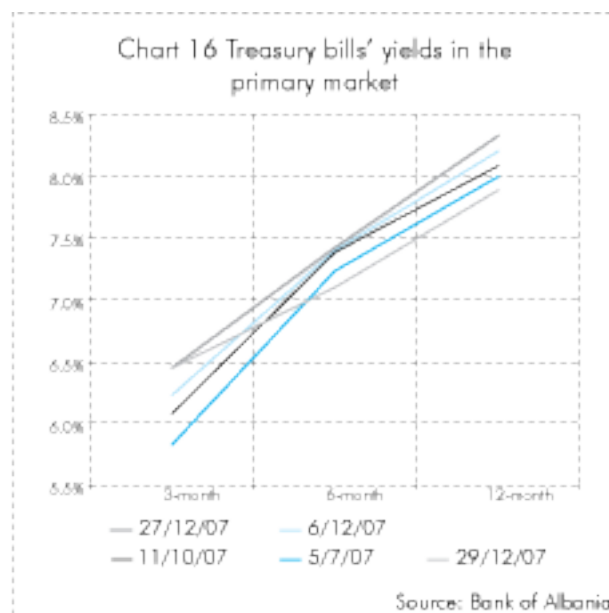
Banks' portfolio with government bonds has expanded by 55 billion Lek during 2007. The preference of the banking system to enrich the portfolio with more bonds and fewer treasury bills became quite evident during this year. This propensity is consistent with the policy of domestic financing, where issued amounts for bonds surpassed the maturity ones. At the end of the year, treasury bills' yields were at the same level as a year ago, at 8.95% for 3-year bonds and at 9.65% for 5-year bonds. The demand to invest in these bonds was high during the year, without necessarily exercising upward pressures.

Chart 17 Performance of Treasury bills and bonds' yields

— 3-year bond yield
– - 12-month T-bill yield   — 5-year bond yield
— 3-month T-bill yield   — 2-year bond yield
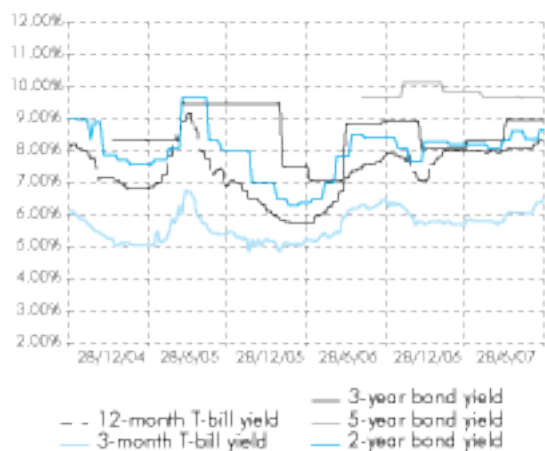
Source: Bank of Albania

Auction bidders of 2-year bonds exploited the trend of the domestic financing indicators, and hence exercised upward leverage toward increasing this indicator up to 8.60%. This indicator fell again in January of this year to the November level of 8.35%.

Bonds of 7-year maturity term were issued for the first time in December. This marked not only a tendency to lengthen the maturity of the debt, but also to invite foreign financial institution to finance the public deficit. Albania's rating from legitimate international institutions is expected to attract more foreign institutions to invest in the country. The secondary market for government's securities continues to be underdeveloped; hence, transactions in this market are limited in number of participants and amounts. This has restricted any assessment on the trend of treasury bills' prices in the capital market.

Interests on deposits have increased, leading to higher savings flows. Interests on Lek denominated deposits have rapidly and fully reacted to the monetary policy signals, in emulating the rise in the key interest rate applied to the value of public savings.

At the end of 2007, the weighted average interest rate on 12-month Lek denominated deposits reached to 6.33%, or 0.87% higher than a year ago, surpassing the 0.75% margin of growth of the key interest rate.

Foreign currency deposits continue to grow at high rates, on average at 35% in 2007, relative to 27% in 2006, despite larger differences between interests

Chart 18 Average interest rates of 12-month deposits (left) and the difference in interest rates between deposits and the base rate (Lek-euro) (right)

— Usd   — Eur   — Lek   — 12-month deposits interest rate   — Key interest rate
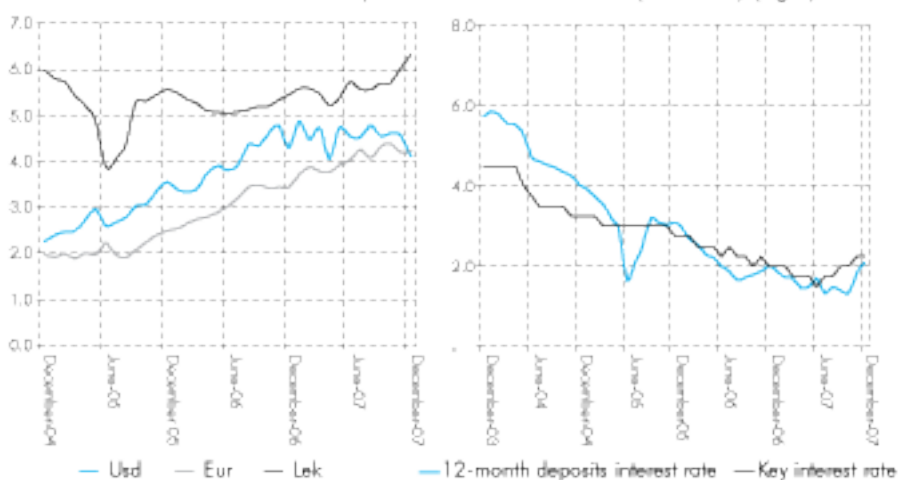
Source: Bank of Albania

applied on different currencies. 12-month interests denominated in euros went up by 0.78% during the year, from 3.45% to 4.23%. Simultaneously, the reference rate for euros has increased by 0.50%, from 3.50% to 4.00%. The difference in interest rates on euro denominated deposits (which make up the greatest share of foreign currency deposits) has widened, since the second half of the year, which has supposedly sustained the value of the domestic currency.

The higher demand for consumer credits during the year and efforts to increase market-share in this portfolio seem to have reduced interest rates of Lek denominated credits during the second and third quarters of the year.

Strengthening of inflationary pressures and stronger credit-lending conditions have led to lower interest rates for Lek credits and to slower growth of consumer credits during the last quarter of the year. The share of Lek denominated credits remains low and interest rates for this indicator are varying from one period to the next, depending on the distribution of credit-lending.

The weighted average interest rates of Lek-credits during the year reached 13.57%, relative to last year's average of 13.61%. Higher competition in the banking system for credit-lending has led to the preservation of the average rate of credits, independently of the orientation of monetary policy.

This has led to lower intermediation costs during the year. On average, this indicator is estimated at 8.9% relative to the average of last year, at 9.4%. This number is relatively lower for euro denominated credits. Higher interest rates on the euro in the European market during the second half of the year have impacted the credit market, but at relatively lower intensity than the impact on deposits. The average rate of new credits denominated in euros during 2007 has increased by 0.45%, to 8.43%. Higher interests on euro-credits have narrowed the difference between that and Lek-credits. This indicator has gone down to 5.1% in 2007, compared to 5.6% in 2006 and 6.2% in 2005. However, interest rates on euro-credits relative to Lek-credits are still attractive and euro-credits lead credit-lending by the banking system, with the largest share.

Chart 19 Weighted average interest rate for new credits

—Lek —Eur

Source: Bank of Albania

Chart 20 Difference between credit and deposits' interest rates (weighted average)

— Lek — Eur — Linear (lek) — Linear (eur)

Source: Bank of Albania
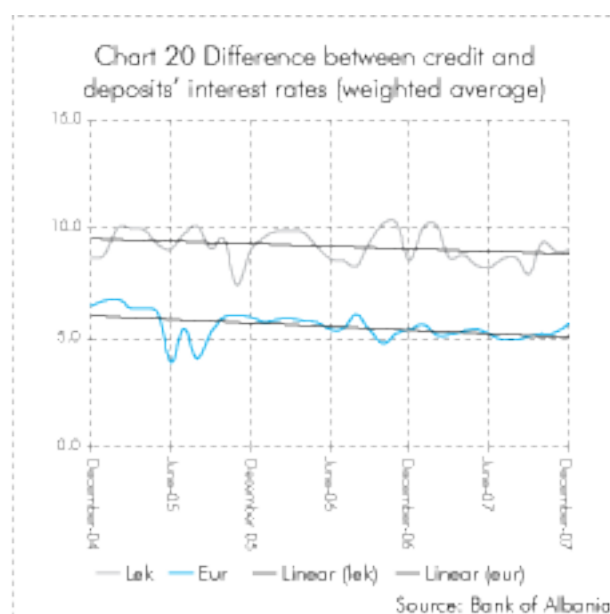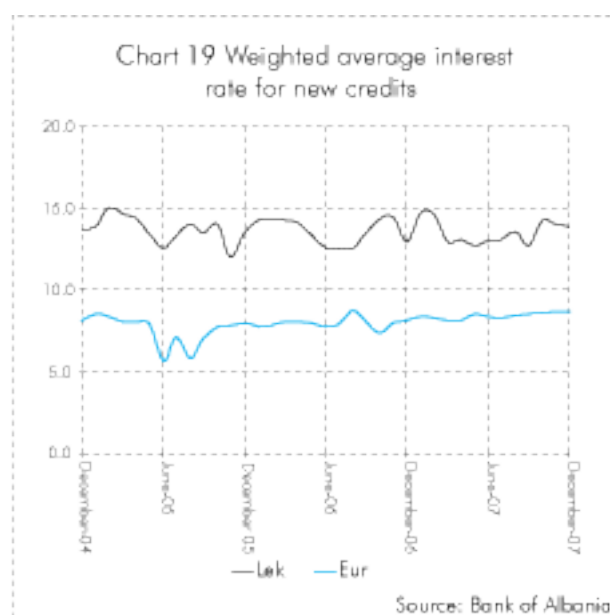
3.2.3 THE EXCHANGE RATE

The overpricing tendency on the Lek has persisted strongly during 2007, culminating in the last quarter. In annual nominal effective terms, the Lek was overpriced relative to foreign currencies during the year by 1.4% on average, relative to the 1.1% overprice in 2006. Parallel to that, the real effective exchange rate increased in 2007 by 4.4%, on average per annum basis; meanwhile, a year ago the Lek overprice relative to foreign currencies was 1.0%. This overprice implies lower competition in international markets and higher demand for imported foreign goods. On the other hand, the overprice of the effective exchange rate has helped to transmit imported inflation at a low degree and has mitigated headline inflation. Lek's overpricing behavior in real and nominal terms illustrate the macroeconomic stability at home, deepening of the difference in interest rates and comparative levels of inflation with key trade partners.

The Lek fluctuated highly in 2007, relative to a year ago. This dynamic hype reflects developments in international markets and more active participation of domestic agents in the currency market. In addition to demonstrating recent changes in the international market (where the dollar has constantly lost points against the euro, alluding to problems in the American economy), the rate of exchanging Lek for other currencies has been subject to demand/supply ratio changes at home. The Lek has strengthened during periods of seasonal remittance inflows denominated in foreign currencies, during conversions of some of the banks' capital and during returns from privatizations. The position of the Lek kept constantly appreciating against the US dollar, at 7.8% on average, reaching to 83/38 Lek/USD at the end of 2007. In average terms, the euro/Lek quote was 123.63 Lek in 2007, while it reached its lowest rate in December, at 120.91 Lek per euro.

Chart 21 Annual changes of Lek in nominal effective terms (NEER) and real effective terms (left); daily exchange rates of Lek/Euro and Lek/USD (right)

Source: Bank of Albania
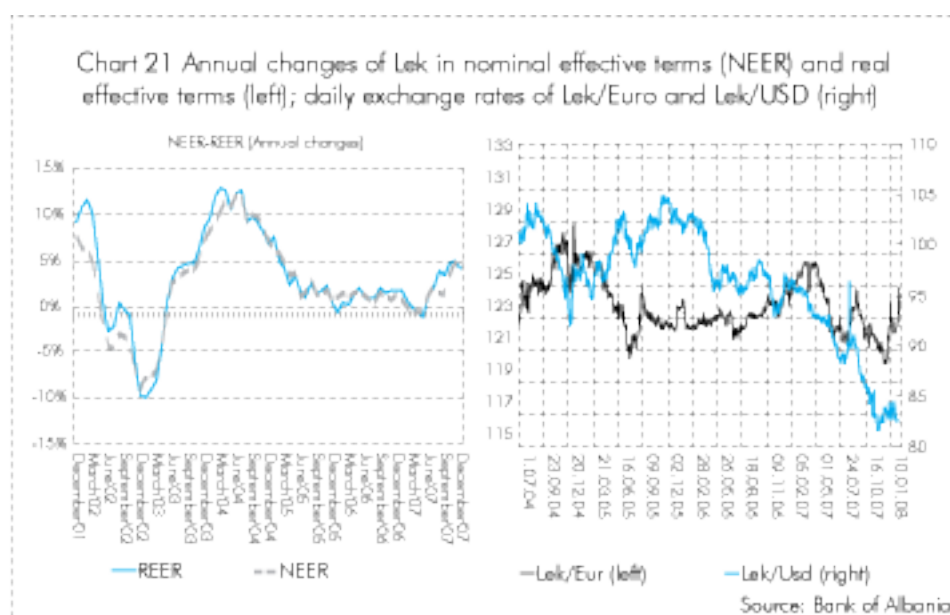
Box 6 Transmission of exchange rates' shifts onto the inflation rate

The link between prices and the exchange rate has earned interest during the 60s and in early 70s. Initially, there were models that assumed a unitary relationship relying on the 'Laws of one price' theory. Then, there were models on the 'parity of the purchasing power – absolute and relative' which were used to identify shifts in rates of exchange. However, many empirical tests did not support these assumptions, discarding the idea that shifts in the exchange rate do not fully reflect the level of prices in a given country (incomplete transmission of the exchange rate). Now there is a plethora of models and theories that explain why this kind of transmission is incomplete. Lastly, many empirical trails have proved that in addition to being incomplete, this transmission is diminishing.

In literature, the term 'to transmit' has different definitions. Often, these definitions are categorized in two groups, divided according to the transmission phase of the exchange rate. The first-level transmission refers to a nation's import price sensitivity against changes in the exchange rate in that country. The second-level transmission refers to consumer price sensitivity against changes in import prices. In any case, many literary works do not distinguish between these two phases, directly defining a nation's consumer price elasticity against changes in the exchange rate of that country as exchange rate transmission. Hence, by virtue of this definition, fluctuations in the exchange rate include effects on both import prices as well as on prices in the consumer basket.

The literature on the Albanian monetary policy often considers the exchange rate channel as the most important channel to explain inflationary developments in Albania (Muça et al., 2004). Based on the significant role of the exchange rate in a small and open economy such as the Albanian one, the central bank has not ignored developments in the exchange rate of the Lek. The Bank has paid careful attention to such developments, and has intervened in key moments, so as to avoid fluctuations that may be distorting. Furthermore, the exchange rate is one of the key variables incorporated in the inflation forecasting process, in addition to other factors that put on inflationary pressures. This same literary work has also observed the change in relation between the exchange rate and inflation after 2000 (Peeters, 2005). In addition and analogous to findings in other countries, the exchange rate transmission on consumer prices in Albania is quasi complete but diminishing. (Istrefi and Semi, 2007)

Results show that consumer prices react quickly to shocks on the nominal effective exchange rate. The transmission of this shock on the exchange rate goes to 42% in the first four months. The transmission reaches its peak in the ninth month within the year, at 99%. Shocks to the exchange rate are relatively crucial in explaining fluctuations in consumer prices, vis à vis other determining

Chart 22 The annual growth of the nominal effective exchange rate and annual inflation (in %)

——NEER ------Inflation
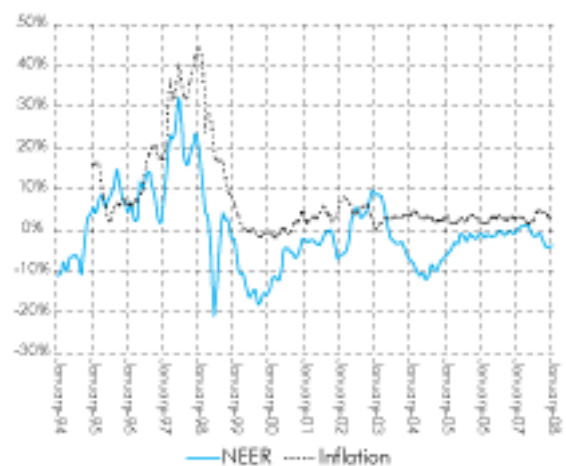
Source: INSTAT and Bank of Albania

Chart 23 The accumulated transmission of the nominal effective exchange rate on consumer prices
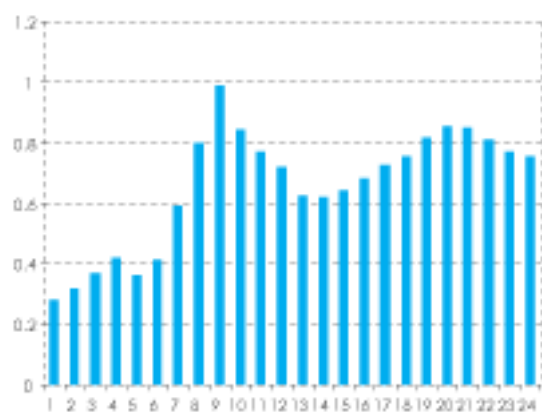
Source: Bank of Albania

factors. 24.5% of price fluctuations is owed to shocks on the nominal exchange rate, while the rest is owed to fluctuations within consumer prices themselves.

Both micro and macroeconomic factors explain changes in the transmission behavior. Developments in the market structure, Lek's stability, the inflationary environment and the Bank of Albania's credibility after 2000 seem to be good 'rationale' for a low transmission of the exchange rate on consumer prices.

However, this does not necessarily mean that developments in the exchange rate are irrelevant to consumer price formation in Albania. The results' performance suggests that there is asymmetry in transmitting the exchange rate: the transmission is higher when Lek is undervalued and vice versa in the case of overvaluation.

Taking into account the fact that shifts in the exchange rate have been relatively low during the last five years, it is rather complicated to identify statistically important relationships with other macroeconomic indicators. Thus, the monetary authority must be cautious in selecting the right approach and response against shifts in Lek's exchange rate.

ENDNOTES

[1] *The indicator of currency outside banks has been assessed as a more appropriate indicator of the performance of M3 liquid component as opposed to M1 aggregate. M1, other than currency outside banks, includes demand deposits in Lek. The latter have fluctuated considerably in the last years which do not show the performance of demand for liquid money in economy.*
[2] *December 2007.*
[3] *In more concrete terms, we refer to euro quotation of real estates, vehicle and products or raw materials' prices imported by businesses involved in construction, trade and industry.*

CHAPTER 4 BANKING SUPERVISION

4.1 LICENSING AND REGULATORY FRAMEWORK

The entry into force of the law no. 9662, dated 18/12/2006 'On banks in the Republic of Albania' and ongoing implementation of medium-term and long-term objectives of the Bank of Albania, solidified the review process of the regulatory framework of banking supervision as complying with the new law, better intertwined the implementation of concepts reviewed by the Basle Committee for an effective supervision and new concepts of the New Capital Accord; and merged European Council guidelines with best practices in the field of regulation and supervision of financial institutions licensed by the Bank of Albania.

4.1.1 REGULATORY FRAMEWORK

In 2007, two new regulations were added to the regulatory framework, while some of the existing ones underwent further improvement.

The regulation 'On risk management in foreign bank branches' activity' lays the foundation for the regulatory and supervisory framework for foreign bank branches. This regulation assumes that the branch activity is administratively dependent and authorized by the parent bank. Also, the plethora of risks and exposure to these risks is the responsibility of the parent bank, and it is assessed in the context of the entire bank. This regulation identifies the tools that ensure a safe and stable activity of the branch, licensed to operate in Albania.

The regulation 'On licensing, organization, activity, and supervision of foreign exchange bureaus' encompasses requirements that relate with integrity and transparence with the client, documentation process, capital level, reporting process, supervision, etc. This regulation anticipates a lower demand for capital from all subjects that engage in foreign currency exchange.

Further improvements were made to the regulation 'On the capital adequacy ratio'. They relate with the use of the 150% coefficient on bank's assets, with partial weighting of good credits, and/or with problems arising when some of the indicators surpass their limits set in the regulation 'On credit risk management'

Thus, assets weighted at 150% are added to risk-weighted assets, which serve in calculating the capital adequacy.

4.2 LICENSING

The Bank of Albania faced substantial structural changes in the banking industry in 2007, given the consolidation process that included the banking system. Following quantitative and qualitative changes, the structure of capital share in the banking system increased in favor of the foreign capital participation.

Meanwhile, the number of banks with private Albanian capital was reduced to only one bank (Union Bank), from three banks that were last year - a sign that indicates an increasing interest of powerful European banks and the quality of domestic investments.

Changes in the bank capital ownership and in the shareholders' structure during 2007, included:

- In early June 2007 was approved the sale of 80% of the shares of the American Bank of Albania capital owned by the Albanian-American Fund for Enterprises, to the new shareholder Intesa SanPaolo S.p.A., Italy.
- In July 2007, a final licence was granted to the First Investment Bank, Albania sh.a. to exercise its banking activity in Albania. This bank was the result of the transformation from a branch of the First Investment Bank in Bulgaria into a subsidiary.
- During the same period, 75.006% of capital shares of 'Popular Bank' owned by 32 Albanian shareholders were sold to the French Bank, Societe General.
- In August, 76.129% of capital shares of the Albanian-Italian Bank owned by the shareholder SanPaolo IMI, S.p.A, Italy, were transferred to the new share holder Intesa Sanpaolo, S.p.A., Italy. This transfer took place once SanPaolo IMI S.p.A., Italy was acquired and then merged with Intesa S.p.A., Italy, in forming the Intesa Sanpaolo S.p.A., Italy.
- The integration phase that accompanied many European banks in 2007 included the Albanian banking system as well, through the integration of two of Albanian banks in favor of the largest bank. As a first-time practice in the Albanian market, in December of 2007 the absorption (merge & acquisition) of the Albanian-Italian Bank with the American Bank of Albania finally went through.
- The shareholder BFSE Holding BV, Holland requested its participation in the Credins Bank through the acquisition of existing shares of the bank, and ownership of new shares, at 22.17% of total bank capital shares. This change in the shareholders' structure of the Credins Bank was approved in February of 2008.
- ProCredit Holding AG, Germany, increased its ownership in capital shares of the ProCredit Bank through share acquisition previously owned by IFC, US and FEFAD, Albania. ProCredit Holding's shares will be at 80% of the total bank shares once this transaction is completed.

Banks continued to enhance their electronic products during 2007 to better serve their clients. Presently, there are 11 banks in the Albanian banking

system that use electronic-based transactions according to products listed in the table below.

What was noticeable this year was that internet-banking services expanded to an additional three banks in the system, while another bank is in the process of being approved for this, in compliance with requirements in the regulation 'On the supervision of electronic banking transactions'.

The substantial expansion in the banking system with new branches and agencies attested to higher banking competition and higher volume in inter-bank financial transactions. Thus, the number of branches and agencies opened in the Republic of Albania during 2007 reached to 103, of which 43 were opened in Tirana.

At the same time, in 2007 the American Bank of Albania expanded (supplemented) its banking net outside the country with two additional branches in Greece.

	Branches in the country	Agencies	Branches outside the country	Total	Of which, in Tirana	Under the process of approval
Total	59	42	2	103	43	23

Table 1 New branches and agencies during 2007

Almost every commercial bank was included in the expansion of the banking net.

Nr.	Banks	No. of branches in the country	No. of agencies	No. of branches outside the country
1	Raiffeisen Bank	98[1]		
2	National Commercial Bank	21	20	1
3	United Bank of Albania	3	1	
4	Italian-Albanian Bank		7	
5	Italian Development Bank	4		
6	Tirana Bank	39	4	
7	National Bank of Greece – Branch	5	19	
8	International Commercial Bank	5		
9	Alpha Bank – Branch	23	1	
10	American Bank of Albania	8	15	4
11	ProCredit Bank	24	1	
12	First Investment Bank – Branch	1	3	
13	Emporiki Bank	4	7	
14	Credit Bank of Albania	2	1	
15	Credins Bank	21	4	
16	Popular Bank	33		
17	Union Bank	12	12	
18	First Investment Bank		3	
	Totali	303	98	5

Table 2 Banks' expansion indicators at the end of 2007

The license no. 09 dated 06/06/2007 was granted to 'Albanian Partner in Micro-credits' sh.a. in 2007 to operate as a non-bank entity. Also in 2007,

'Besa' Foundation has applied for the same license to be able to operate as a non-bank entity.

The non-bank entity 'Credit Card Services' sh.p.k (formerly known as 'Diners Club Albania' sh.p.k.) notified the Bank of Albania in February of 2007 that it ceased to function, through voluntary closure and gave back its licence granted by the Bank of Albania.

In May of last year, the non-bank entity 'Credins' sh.a., requested that its financial activities be supplemented with an additional service. This request was approved by the Bank of Albania, granting to the company 'Credins' sh.a. the right to offer financial leasing services.

Currently, there are 6 non-bank entities that are licensed and exercise their activities in Albania.

With the passing of the law no. 9662 dated 28/12/2006 'On banks in the Republic of Albania' in June 2007, and with the regulation 'On the licensing, organization, activity, and supervision of foreign exchange bureaus' approved by the Supervisory Council's decision no. 31 dated 06/06/2007, and then amended by Supervisory Council's decision no. 73, dated 27/11/2007, entities' requests to formalize the foreign exchange activity soared. Only in the second half of 2007, there were 58 applications for licensing of foreign exchange bureaus, which were then granted. In addition, some of the licensed foreign exchange bureaus expanded their activity by launching new offices. Six (6) foreign exchange bureaus had their licence revoked in 2007.

Seven (7) new savings-loan associations were granted licences to operate, while 2 other associations had their licence revoked. The savings-loan associations that had their licence revoked have merged as two existing savings-loan associations.

Table 3 The list of licensed entities granted from the Bank of Albania

No.	Entities	2000	2001	2002	2003	2004	2005	2006	2007
1	Banks and branches of foreign banks	13	13	14	15	16	17	17	17
2	Non-bank financial entities	2	4	5	7	7	7	6	6
3	Foreign Exchange Bureaus	19	38	58	58	54	58	60	112
4	Savings-Loan Association			113	131	130	131	125	130
5	Unions of Savings-Loan Associations			2	2	2	2	2	2

4.3 THE BANKING SYSTEM PROGRESS

Overall, there were positive and stable developments that took place within the banking system.

The net result of the banking system in 2007 is reported to be approx. 41.8% more than the 2006 net result. As a share of GDP, the net result has increased its share considerably, indicating a better efficient banking sector,

relative to other economic sectors. This ratio is estimated to be around 1.1% relative to the 2006 and 2005 ratio of 0.8%.

	December '05	December '06	December '07
Net Result	6.60	7.45	10.6

Table 4 Net result, in billions of Lek

Returns from key activities (net interest returns) accrued to 27.3% more than last year, which further confirm quantitative and qualitative changes in assets and liabilities' shares and structure. Data shows:

- Considerable growth in the system's assets, higher shares of high-risk assets but with higher potential returns[2];
- Distinctive change in the maturity structure of high-risk assets[3];
- Higher shares of own resources, and consequently better opportunities to generate cost-free financing sources;
- Higher portfolio shares of other treasury bills (including government bonds) which generate alternative interest rates, higher than those of treasury bills.

Even net result from other activities has increased, at a higher degree relative to net result from interests, by approx. 30%. Despite this, we can assess that the dependence of the banking system's result on the result of its key activities continues to be stable.

Positive developments in the net interest return indicator reflect into the dynamic of the net interest margin (NIM), which has continued to rise even if by only 0.1% relative to last year's 0.5%. The NIM's rise is owed to the growth of high-risk assets[4], and to changes in the deposits' structure, in favor of deposits denominated in foreign currency[5]. This implies lower interest rates for foreign currency-held deposits, relative to those in Lek.

Table 5 Net interest margin, %

	December '05	December '06	December '07
Returns from interests / average assets that yield returns (1)	6.81	7.05	7.72
Expenditures on interests / average assets that yield returns (2)	3.08	2.83	3.37
Net interest margin [(NIM)[(1) − (2)]	3.73	4.22	4.35

The performance of key profitability indicators, RoAA and RoAE respectively, seems to be good in 2007. The banking system demonstrates higher returns from average assets. The direction of RoAA's shifts is the same as the direction of NIM, unlike two periods ago. This attests to a better-controlled impact from higher expenditures in activities and provisions in calculating net returns to the banking system. Higher RoAA is attributed to higher rates of growth in the net result, by approx. 41.8% relative to average assets' growth rate of 23.3%.

Indicators	December '05	December '06	December '07
RoAA	1.40	1.36	1.57
RoAE	22.24	20.17	20.74

Table 6 Profitability indicators, %

The dynamic of the efficiency indicator measured as a ratio of expenditures over operational revenues[6], shows that in a year's time-length (in accumulative terms) the efficiency of the banking system has improved from 0.52 to 0.49. The banking system shows a higher rate in assets broadening, following higher expenditures in activities by approx. 20.3%. Meanwhile, we can argue that the highest growth rate in operational expenditures during 2006 has led to productivity growth and further consolidation of the banking system in 2007.

During 2007, the assets of the banking system grew by 118.6 billion Leks, or are 19% higher relative to end-year 2006. This provided positive developments in the banking system toward better allocation of resources and assets between banks. In 2007, large banks (grouped under G3) made up a sizeable share of total system's assets (respectively, 65% of total assets). Banks grouped in the middle group, G2[7] contributed the most to the growth of this year's assets, by 52.2 billion Lek relative to G3's 50.4 billion Lek, or 32.3% higher relative to G3's 11.7%. Despite G3's stable activity, its diminishing shares' propensity in the market signals that the banking activity is attempting to reduce concentration.

Table 7 H (Herfindahl) Index of assets, deposits and credit concentration

	2001	2002	2003	2004	2005	2006	2007
H Index (assets)	0.37	0.32	0.30	0.27	0.21	0.18	0.15
H Index (deposits)	0.43	0.37	0.35	0.31	0.24	0.20	0.17
H Index (credits)	0.20	0.17	0.15	0.11	0.10	0.11	0.11

The level of concentration in the credit-lending activity was even closer to the perfect level of 0.06.

Table 8 Total assets in billions of Leks (end of period)

	2000	2001	2002	2003	2004	2005	2006	2007
Total assets	270.8	318.5	339.3	373.6	426.4	496.6	624.3	742.9
Total assets/GDP	50.2	53.5	51.6	50.2	51.9	59.3	69.4	75.9
Total credits/GDP	5.3	4.7	5.9	6.8	8.5	15.3	22.0	29.9

Outstanding credit in the banking system grew by 94.5 billion Leks in 2007 or 47.7% more relative to 2006 end-year. Outstanding credit according to maturity term continues to show gradual orientation toward long-term credits.

The rapid credit growth has been followed by higher portfolio of non-performing credits, which has gone up by approx. 3.8 billion Leks relative to end-year 2006. The share of the non-performing credits indicator to the total credit portfolio (in gross terms), is estimated at 3.4% relative to 3.1% in end-year 2006. Whereas, the 'non-performing credits / outstanding credit' (net) indicator, which calculates the net exposure level to credit risk, continues to be low, at only 1.8% relative to 1.36% at end-year 2006.

As of end December 2007, the share of net non-performing credits to the system's regulatory capital reached 11.2% relative to 6.8% as of end December 2006. The increase of this indicator generally serves as an indicator of the system's limited ability to cover the potential credit losses with the regulatory capital.

December '06	March '07	June '06	September '07	December '07
6.8	7.4	7.9	8.5	11.2

Table 9 Net non-performing credits / regulatory capital ratio performance (in %)

The ratio of capital adequacy in the system was at 17.1% at end-year 2007 or 0.9% lower than end-December 2006. This indicator has displayed diminishing propensity, the same as in previous years. The drop is owed to higher rates of growth in total assets and items off the balance (25%), relative to the growth of the regulatory capital (15.6%). The value of this indicator for individual banks, at end-December 2007 varies from 11.3% to 106.5%. While, its minimum value of 12% has been infringed by only two banks in the system.

The ratio of capital adequacy in %	Banking System	G1	G2	G3
December 2007	17.1	45.1	15.8	15.5
December 2006	18.0	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

Table 10 Capital adequacy

The banking system's liquidity in 2007 had a satisfactory progress. Based on the analysis of the liquidity's indicators, it shows that liquid assets take up half of total asset shares, and manifest diminishing propensity from 58% to 50%, or 63% at the end of 2005. Reviewed in groups, the G3 bank group took up the greatest share of total assets, relative to other groups of liquid assets, at approx. 55%. The share of G2 and G1 groups seems to be relatively low, respectively at 38% and 49%. In addition, the liquidity GAP values are under manageable limits. Furthermore, short-term assets cover for the greatest part of short-term liabilities, while stable resources manifest increasing propensity in the system.

Under the conditions of a relatively inactive money market and in the absence of capital market, clients' deposits continue to serve as the primary source of funds' generation in the system. At the end of 2007, their share of total obligations in the system is at 93% or 2% higher than at end-year 2006.

4.4 ON-SITE EXAMINATIONS

The work carried by the on-site inspectors during 2007 has served to fulfill the rights ensured by the legal and regulatory framework. The following examinations took place in 2006:

Banks:	14 full-scope examinations
	33 theme-based examinations*
	17 examinations related to credit registry
Non-bank financial institutions:	5 full-scope examinations
Savings-credit associations:	1 full-scope examination
Foreign exchange bureaus:	50 examinations

* This includes supervision-related examinations and examinations in collaboration with other authorities.

By and large, the status of the banking system, as per on-site examinations, is arguably fairly good. Some of the findings from the on-site examination process during 2007 include:

- The banking activity has continued to expand even during 2007. This expansion has been followed by intense financial intermediation, by a multitude in offered products, by a geographical stretching of services reaching far out to more and more territorial areas, and by an augmentation of the clients' base in existing locations and in new areas. It is noted that the banking business undertakes constant efforts in order to establish a wider base of clients, increasing the competition in all products offered by banks. So far, there are no banks with a distinct scope of activity, which preserves the same nature of activity throughout.

- The credit activity draws particular attention this year as well, increasing substantially in absolute value, while suffering a drop in the growth rate, relatively speaking. The credit activity has continued to sustain the economy, increasing its share to key resources, to total assets and to the gross domestic product. This activity is by far one of the most critical banking enterprises, and has been constantly under monitoring and subject to on-site examination.

- The expansion of activity and of types of products has led to necessary internal changes in some areas: in structure, in distribution of responsibilities, in support of policy and manual developments, in staffing. Further development of the credit activity has impacted other structures and operations. Using fund sources increasingly in credit-lending compels for thorough review of the nature of investment. This phenomenon has seen dynamic changes, placing banks into active positions to administer liquidity situations and to meet activity expectations.

- Shareholders' urge to maximize profits have induced banks to undertake more risks. Thus, in addition to credits, banks have extensively exhausted opportunities to profit from currency exchanges or through diversification of investments in securities, compared to traditional choices to put money on low-yielding investments.

- Having larger banks with a broad international presence has led to new developments in the nature of administration. Relations with parent banks have solidified both from a financial standpoint and from the operations' orientation standpoint. The banks have enjoyed continuous support in meeting the best standards in banking activity, through training and through application of practices put in place in the countries of origin.

In addition to full-scope examinations, there have been 50 partial examinations. The scope of such partial examinations is to evaluate the transparency of banks in dealing with clients, in meeting their obligations

with regards to fighting terrorist-financing and money laundering, in using accuracy while inputting data in the Credit Registry, and in the banks' relations with insurance companies in Albania.

4.5 FINANCIAL STABILITY

The financial system in Albania has kept growing at a stable rate during the second half of 2007. Rather satisfying financial outcomes in the banking and non-banking sectors are owed to the most efficient allocation of financial resources and to continued expansion, relatively rapid in high-yielding investment activities. The tendency for the gradual slide over the long term in the capital indicator of the financial sector, and particularly of the banking one, has continued, although at a slower rate. This performance has been defined by the relatively more active behavior of banks and financial institutions, whose capital indicators are pretty close to minimum required levels from the legal and regulative framework. During this period, inflows of foreign capital have continued to enter toward financial institutions, while institutional merging has taken place, which further consolidates the financial market. Based on the analysis of the regulatory authorities, no risk has been found, which may have been spilled over by regional, global or domestic developments and has good chance to materialize and instantly strike heavily the activity of the financial system. In this context, we can argue that the risk spectrum in the financial system is widening and thus begs for prudent and constant monitoring, backed up by correcting and timely regulatory measures.

Comprehensively, the financial sector assets have seen stable growth. However, the part of the non-banking financial sector has not yet managed to increase its share in the financial market. Total assets in the financial system were close to 78.5% of the GDP at the end of 2007. The banking sector makes up approx. 76% of GDP, relative to last year's 69.4%. The crucial segment in the non-banking financial sector consists of insurance and re-insurance companies. According to the Albanian Financial Supervisory Authority (FSA), the total assets of insurance and re-insurance companies reached 12.98 billion Leks in September of 2007, or 12% higher in annual terms.

The banking sector has enlarged investments in credits and treasury bills, while ensuring pretty good yields from this activity, but revealing a mild drop in the capital and liquidity indicators. At the end of 2007, the credit portfolio in the financial sector reached approx. 40% of total assets in this sector.

The risk analysis on financial activities shows that risks have multiplied overall and calls the need for continued monitoring by financial institutions themselves, regulatory authorities and by the public. The Bank of Albania argues that the intricate situation in international financial markets represents a new type of risk for the Albanian financial system. However, as long as it does not transform into a global financial crisis with ramifications on the real economy worldwide, and particularly in Europe, this situation will relatively

be of little effect to the domestic market. There are a number of players that determine the line of this reasoning, among which are:

a) Relatively low growth of the domestic financial market, and lack of similar and sophisticated products, whose value was distorted lately in international financial markets. We emphasize that the supervisory regulatory framework of banking activities in this country does not anticipate in any case differential treatment of borrowers (and the credits they apply for) for the sake of 'good' and 'less good' perceptions, including those who apply or qualify for credits used in purchasing or reconstructing real estates. On the contrary, the supervisory regulatory framework guides banks toward financial analysis of the borrower, independently of his/her characteristics and of the object of his/her credit, putting in place a few unique and ground rules, which banks need to abide by in any given case.

b) Very unnecessary aptitude to finance in international financial markets from the part of Albanian financial institutions, and even more so from the banking sector, when there is enough space and opportunity to secure financing of development activities through domestic means.

c) The lack of direct exposure of Albanian financial institutions and banks to other institutions and financial products, whose values have been negatively impacted from liquidity problems in international financial markets. If this exposure may be otherwise indirectly, stemming from a certain category in the portfolio of treasury bills of foreign currency-held debt, its impact is irrelevant due to low shares of such investments per bank and in total, as well as due to the very good financial position of the banking sector.

d) Limited and financially tolerable exposure of European bank groups that operate in Albania against the scheme and products of 'subprime' mortgage loans financing in the United States. Financial data published from these institutions themselves, from different market analysts, and from supervisory bodies in their home countries, confirm this assessment.

e) Good financial performance of financial institutions and European bank groups in recent years, which has shelled finances through necessary contingencies and adequate capitalization of activity, apt for absorbing such shocks.

Despite the assessment above, there do exist some elements that need to be considered for a more profound analysis of this phenomenon, in the context of Albania.

Firstly, the features of the risk carried by fast credit-lending, and more so foreign currency-denominated credits, which dominates financing from the banking sector, are very likely to exacerbate under an unstable international financial market.

Secondly, the vulnerability and behavior of financial institutions and banking sector against these types of situations depend on the instant exposure of sectors that are negatively impacted from financial adversities.

Thirdly, we must consider the fact that adversities that international financial markets face take place simultaneously with adversities dictated by energy and foods' raw materials prices on a world scale.

Fourthly, it is imperative for a thorough process of cost/profit analysis at a microeconomic and sectorial level to pave the way for decision-makers prior to taking decisions of importance to the progress of stable economic developments and to the financial stability of the country and financial institutions here.

Despite the challenges that public authorities and different economic agents face, the Bank of Albania believes that implementing approved policies and keeping a flexible economy will help the economy to grow at a stable rate in 2008. The financial system and particularly the banking sector will play an active role in financial intermediation and in supporting economic development at home, while preserving stability and good financial performance.

4.6 THE ESTABLISHMENT AND FUNCTIONING OF THE CREDIT REGISTRY

The Bank of Albania helped to conceptualize and put into work the Credit Registry within the targeted date of 31 December of 2007.

The implementation of the Credit Registry represents an important step in developing the Albanian financial infrastructure. The Credit Registry composes the electronic data base for borrowers of the Albanian banking system. Its scope is to process information on data, in terms of the credit exposure of each borrower and related people. The implementation of this Registry aims to facilitate opportunities for sound credit transactions, through access to information on borrowers, rendering the credit process efficient and safe. More concretely, the Credit Registry allows commercial banks to have access to necessary information in order to appropriately and quickly determine the capability to pay back financial dues and the credibility of the credit applicant. This curtails the necessary time needed to take decisions in credit-lending and helps to enhance the quality while reducing credit costs.

The Credit Registry Bureau has been set up within the Supervision Department and reports directly to the Director of the Department. The operation of the Credit Registry Bureau within the framework of the Supervision Department serves to the execution of the supervisory and regulative role of this department. In this context, the Credit Registry offers a supplementary and valuable tool to deepen the analysis, not only in evaluating the overall quality of the credit portfolio, but also in identifying credit concentration according to banks and borrowing entities; in evaluating the detailed exposure of banks and borrowing entities against financing by currency; in evaluating the types of collateral and guarantees utilized in the process; in identifying links that exist between different borrowing entities, in identifying related persons, etc.

ENDNOTES

[1] *The number of branches and agencies of Raiffeisen Bank was made more accurate based on the information submitted by the Bank in February 2007.*

[2] *The share of credits to total system's assets grew from 31.5% as of end 2006 to 39.1% at end 2007.*

[3] *The share of long-term credits grew to 43.6% relative to 38.4% the previous year, while the share of short-term credits has remained almost unchanged. We accentuate that the weighted average interest rate of long-term credits is usually higher than for short-term credits.*

[4] *Credit portfolio, whose share has grown from 31.9% to 39.1%.*

[5] *The share of deposits denominated in foreign currency has grown from 38.7% to 42.8%.*

[6] *Operational expenditures consist in activity expenditures while operational revenues are a result of net revenues from interests and net revvenues from other activities.*

[7] *In the assets' growth of this group was excluded the transfer effect of Emporiki Bank from small banks group (G1) to medium banks group (G2).*

CHAPTER 5 OTHER ACTIVITIES OF THE BANK OF ALBANIA

5.1 DEVELOPMENTS IN THE PAYMENT SYSTEM

A safe and efficient payment system is indispensable to successfully implement the monetary policy, to pay off transactions in financial markets and to the financial stability at home.

The Bank of Albania owns and administers two payment systems in Lek: 'The real-time gross settlement system – AIPS' and 'The automated electronic clearing house system – AECH' - already in operation for almost four years, which suggests with every passing year steps toward the modernization and efficiency of the systems.

5.1.1 THE PERFORMANCE OF THE AIPS AND AECH SYSTEMS DURING 2007

The number of processed transactions in the AIPS system during 2007 has increased by 17% relative to 2006. While payments processed in the AECH system during 2007 have almost doubled, with a growth of 47% relative to 2006. This suggests of higher public confidence in using the banking system to pay off financial dues. On average, there are around 183 transactions processed every day in the AIPS system, with a total value of 15.1 billion Leks. Meanwhile, there are 290 transactions in the AECH system with a daily total value of 48 million Leks.

The following tables indicate the number and total value of processed payments in the AIPS and AECH systems respectively, during 2007 vis à vis 2006:

The AIPS system	2006	2007
The number of transactions	38,793	45,480
The value of transactions (in billion Leks)	3,376	3,745
The average value of transactions (in million Leks)	87.01	82.34
The AECH system	2006	2007
The number of transactions	48,889	71,857
The value of transactions (in billion Leks)	7.77	11.99
The average value of transactions (in million Leks)	0.16	0.17

Table 1 Transactions by systems

In addition to the growing number of processed transactions in these systems, their value has seen considerable growth as well. The growth of values of processed transactions into the AIPS and AECH systems in 2007 is at 11 and 56% relative to 2006. The total value of paid off balances in the

payment systems during 2007 is almost 4 times as high as the value of the gross domestic product (GDP) for the year.[1]

In a more detailed fashion, the types of transactions processed in the AIPS system during 2007 and their relative share are indicated in the table below:

Table 2 Types of payments

Type of payment	Volume		Value (in billion Leks)	
	Absolute value	Relative share	Absolute value	Relative share
BoA transactions	7,467	16.4%	2,166.55	57.9%
Fund transfers, *cash*	8,455	18.6%	221.43	5.9%
Inter-bank payments	7,831	17.2%	664.49	17.7%
Payments to clients	16,506	36.3%	134.93	3.6%
Disbursements (net basis)	3,224	7.1%	8.99	0.2%
Disbursement of government' securities	1,997	4.4%	548.46	14.6%
Total	45,480	100%	3,744.85	100%

Vis à vis the same indicators of the last year, considerable share in the increase of the number of transactions takes the number of payments to clients. With regards to the transaction value, transactions initiated by the Bank of Albania and interbank transactions display higher rates of value growth. In 2007 there has been a drop in the number and payments value for disbursing government's securities, in contrast with the overall inclination of payments.

During the 1-year period, clearance of payments with an average value has been higher in the first session rather than in the second, while the highest volume of payments has cleared in the second session. From the perspective of monitoring and assessing the payment systems' stability, payments have concentrated at particular nods of the net. Concentration indicators for both AIPS and AECH systems are shown below:

Table 3 Payment concentration (AIPS)

	Transaction volume	Transaction value (billion Leks)
AIPS System	Share/Total	Share/Total
3 Banks[2]	33%	30%
5 Banks	45%	39%
Total (absolute value)	45,480	3,745

Table 4 Payment concentration (AECH)

	Transaction volume	Transaction value (billion Leks)
AECH System	Share/Total	Share/Total
3 Banks[3]	50%	53%
5 Banks	66%	65%
Total (absolute value)	71,587	11,997

In 2007, the indicator of intra-day loan facility (ILF) is not of lesser importance. We stress that the intra-day loan has a collateral at 0 interest, that the Bank of Albania offers to commercial banks in order to administer daily liquidity. Intra-day loan allocation procedures are pretty simple and funds flow within 10:00 A.M. following bank's request. Relative to 2006, the number and value of flowing ILFs have increased by 52% and 47% respectively in 2007.

	2006	2007
The number of transactions	444	675
The value of transactions (in billions of Lek)	146.32	217.51
The average value of transactions (in millions of Lek)	329.55	322.24

Table 5 Intra-day loan facility

During 2007, 11 out of 17 banks participating in the AIPS system have made use of intra-day loans (3 banks have used it relatively more than in 2006). Based on the analysis of transaction-concentration per each bank and with regards to the frequency of credit flows, 5 banks have actively used this tool in order to administer daily liquidity. On the other hand, the highest intra-day loan value allocated to banks, around 85% of the total value, has concentrated only in two banks. Considering the payment system as a whole, the Bank of Albania offers both the clearance and disbursement services on a net basis of the value of processed checks by other banks. The use of paper-checks as payment method has been declining during 2007 as well. Results show 45% less disbursed checks and 65% less disbursed monetary value, relative to 2006. The primary reason for this is the increasingly diminishing use of bank checks.

	2006	2007
Number of disbursed checks	994	544
Check value (in billions of lek)	3.76	1.33

Table 6 Check disbursement in AIPS

5.1.2 ELECTRONIC PAYMENTS INSTRUMENTS

The electronic payments instruments and the number of electronic-based transactions are increasing ever more. The performance of the number of bank cards in use and of ATM and POS machines that enable card-holders to carry out electronic transactions is illustrated in the table below. The number of cards in use, primarily debit/cash cards grew considerably during 2007, by approx. 74% relative to 2006. The number of card-operating stations, mainly POS ones (which facilitate payments for goods and services purchased in retail centers) has increased also, by 47% relative to their number at end-year 2006. With regards to geographical distribution of ATM and POS machines made available by banks, we can state that they are highly concentrated in Tirana, respectively with a share of 78% and 59% of the total number of machines. However, it is worthy of note the increasing propensity for their market-stretch in other cities of Albania.

	2006	2007
Number of transactions (thousands)	8,053	9,249
The value of transactions (billions of Lek)	47.81	59.04
The average value of transactions (Lek)	5,940	6,390

Table 7 Debit Cards

	2006	2007
Number of cards (thousand)	176	363
The value of transactions (billions of Lek)	3.2	5.3
The average value of transactions (Lek)	18,207	14,635

Table 8 Credit Cards

Based on statistical data reported by banks, the number and value of card-based transactions has increased by respectively 17% and 26%. However, this growth is not at the same rate as the growth in the number of cards or card-operating machines. This is due to the fact that even though the number of cards in use has increased, card-holders do not exert enough confidence or do not have the right opportunity to use the card as a payment method. In other words, in proportion with the total population number[4], on average, only 1 in 5 persons is a card-holder and each colder carries no more than 16 transactions a year. Thus, the banking system is still in its first phase of using electronic payments methods, vis à vis with reported statistics from regional countries.

There is a positive trend in the use of 'home banking' as an electronic payment method. Currently, there are three banks in Albania that offer this type of service. The number of Home Banking transactions increased by 122% in 2007 relative to 2006, while the value of these processed transactions increased by 188% in 2007 relative to 2006. This is owed to the fact that two additional banks offered this type of service in 2007. Following the agreement with the VISA company for the disbursement of visa-transactions in Lek, the Bank of Albania facilitated its disbursement through the AIPS system. The number of banks that participated in this disbursement increased during this year to 8 banks, relative to 2006's 5 banks. Vested with the responsibility of a clearing house, the VISA company prepares the net amounts for each bank and sends them to the Bank of Albania, in order to be disbursed through AIPS. The net disbursement activity is shown in the table below:

Table 9 Visa disbursement

	2006	2007
The number of net disbursement transactions	1,487	2,481
The value of transactions (millions of Lek)	299	518

5.2 DEVELOPMENTS IN INTERNAL AUDIT

Bound by article 54 of the law no. 8269 dated 23/12/1997 'On the Bank of Albania' of the Audit Department regulation approved by decision No. 59 of the Supervisory Council dated 04/07/2001, and referring to international and internal audit standards, the audit inspectors have audited the administration and operations of the central bank, the general ledger and other statements, and the budget, accounting and control procedures.

Based on findings, evaluations and recommendations made by audit sessions that took place in 2007, we are of the opinion that the general ledger and other statements truly reflect the financial situation and they are in accordance with the Accounting Manual of the Bank of Albania and the law 'On the Bank of Albania'. The financial statements have been duly prepared and they are free from material misstatement. They provide a true and fair view of the Bank of Albania financial position.

The audit process of the Bank of Albania units shifted in 2007 to the audit of the central bank's functions and their processes. The shift in the audit

objective helps to fully assess risks and internal audits targeting risk reduction at all levels, without limiting solely to the audit of certain areas of the functions carried by specific units of the bank.

5.3 EUROPEAN INTEGRATION MATTERS AND THE BANK OF ALBANIA

The ratification process of the Stabilization and Association Agreement (SAA) with EU country members continued throughout 2007. Simultaneously, the Multilateral Trade Agreement and Matters Related to Trade between the Republic of Albania and the European Community, ratified on 1 December 2006, continued to be implemented during 2007. The Bank of Albania's obligations stemming from the SAA relate with:

• Meeting the Copenhagen economic criterion for EU membership;
• Guaranteeing the right of decision-making and the freedom to provide financial services to EC banks and other financial institutions;
• Liberalization of capital flows and of payments between Albania and the EU;,
• Approximating the Albanian legislation with the European Community (*acquis communautaire*).

In line with these initiatives, the new law 'On Banks in the Republic of Albania', approved in December of 2006, entered into force on 1 June 2007. This law rests on the obligations stemming from the SAA and Basle Principles, adopting the majority of the provisions outlined in the Directive 2000/12/EC 'On the taking up and pursuit of the business of credit institutions'

The Bank of Albania has been involved in the updating process of the National Plan for the Implementation of the SAA (2007-2012), approved by the Council of Ministers on September 5, 2007. As pertaining to this, the Bank of Albania will engage in:

• Safeguarding macroeconomic stability at home;
• Adopting and accurately implementing the *acquis* with regards to the right of establishment and to supply banking services;
• Ensuring freedom of capital movement, and;
• Running and supervising the payment systems.

In accordance with these initiatives the Bank of Albania has undertaken a number of regulatory steps,

• In September, the Supervisory Council of Bank of Albania approved the regulation 'On the functioning of Albanian Interbank Payment System' and the regulation 'On the functioning of the Albanian Electronic Clearing House System – AECH', aiming to approximate the Albanian legislation with that of the European Community, and particularly with the Directive 98/26/EC 'On the settlement finality in Payment and Securities

Settlement Systems'.

- In October, the Supervisory Council approved the regulation 'On the risk management in foreign bank branches' business', which aims to identify tools that ensure a safe and sustainable business of the foreign bank branch's activity.

The European Commission's Annual Report for Albania published on 6 November 2007 analyzed the progress Albania has achieved from 1 October 2006 to 30 September 2007 in meeting all of the Copenhagen criteria.

- The report identified and assessed the safeguard of the macroeconomic stability at home.
- The European Commission also assessed the Bank of Albania's credibility of the monetary policy in keeping inflation within the target range.
- The European Commission underlined positive developments in the domestic banking system, highlighting the strengthened prudent supervision aimed at preserving credit-portfolio quality, and evaluated the regulating framework of banking supervision.
- The Commission took note of the approval and entry into force of the new law 'On Banks in the Republic of Albania' which removed the provisions that allowed differential treatment between Albanian banks and foreign bank branches. The Commission underlined the need for further approximation of this law to the *acquis communitaire*.

The Commission accentuated the need to further strengthen prudent banking supervision and to improve cooperation between authorities responsible for the supervision of different financial sectors. Additionally, the Commission underscored the need for legal amendments with regards to the liberalization of freedom of capital movement, in line with obligations stemming from the SAA.

5.3.1 RELATIONS WITH THE INTERNATIONAL MONETARY FUND (IMF)

The IMF's allocated amount to the Republic of Albania remained at 48.7 million SDRs[5], as did its votes (737 votes or 0.03% of the total votes of all IMF members). Albania is part of the same constituency as Italy, Greece, Portugal, Malta, San Marino and East Timor. This constituency is entitled to a total of 90.968 votes (4.11% of total votes of IMF members) and is led by the Italian representative Mr. Arrigo Sadun, who acts as Executive Director of the constituency.

On 11 January and 19 June 2007, the Albanian authorities represented by the Prime Minister, the Governor of the Bank of Albania and the Minister of Finance officially submitted to the IMF the Memorandum of Understanding and the Memorandum of Economic and Financial Policies.

Based on such documents and assessments from IMF review missions that visited Albania in October-November 2005 and April-May 2007, the IMF Executive Board executed the second and third review, respectively on 2

February and 9 July 2007, on Albania's progress as per the implementation of the three-year PRGF/EFF agreement, approved on 27 January 2006. These reviews made it possible for the sum total of 4.8 million SDRs to be disbursed to Albania in 2007, driving the total of the circulated amount since the signing of this agreement up to 9.7 million SDRs.

The Executive Board conferred in its conclusions at the end of these reviews that the macroeconomic performance of Albania has continued strong, underlining the powerful commitment from the part of Albanian authorities in pursuing the adequate macroeconomic policies. At the same token, the Board draw attention to ensuring that long-term solutions are given to problems in the power sector, to implementing structural reforms, so as to preserve such accomplishments.

In the realm of consultations on evaluating the implementation of obligations stemming from the three-year PRGF/EFF agreement, the third and fourth IMF review missions visited Albania during April-May and October-November of 2007, respectively.

Moreover, Albania has paid 9.8 million SDRs to the IMF in 2007, in an effort to pay off its dues (principal payments, interests, periodic expenditures, etc) inherited from past PRGF agreements and the existing one PRGF/EFF.

At the same time, the Governor of the Bank of Albania has regularly represented the Republic of Albania in the decision-making process of the Board of Governors, which is the highest body of the IMF. Of importance in the relations with the IMF this year have been the spring and annual meetings of the IMF and the World Bank, held in April and October. During these meetings, the Bank of Albania delegation headed by the Governor met with high representative of the IMF to discuss recent macroeconomic developments as well as matters that pertain to the monetary and financial stability. In the process, very good relations between the IMF and Albanian authorities have been established, while it has been appreciated the good work of the Bank of Albania in keeping inflation under control and in strengthening credibility and public confidence. High IMF representatives have expressed their support in terms of technical assistance to the Bank of Albania so as to accelerate structural reforms, improve procedures of domestic debt administration and increase financial and banking market efficiency.

The May visit of the IMF Deputy Managing Director, Mr. Murilo Portugal, to Tirana marked a critical turning point in the Bank of Albania's relations with this institution. At the end of his meeting with the Governor, Mr. Portugal praised the role of the central bank in keeping price stability and monitoring the banking system. Mr. Portugal also took note of the Bank's projects and plans to improve the technical expertise in bolstering transparency.

During 2007, an audit mission of the IMF visited the Bank of Albania in order to evaluate the internal audit procedures, which recommended afterwards the

need to consolidate this function; yet another consulting mission was here to draft the 2008 budget.

The Bank of Albania continued to benefit from IMF technical assistance in 2007, with regards to training its staff. The IMF has offered consultation in terms of improving the drafting process of the monetary policy, model-building and economic projections, and establishing the Credit Registry.

5.3.2 RELATIONS WITH THE WORLD BANK GROUP

Albania became a member of the World Bank Group in October of 1991 and has benefited from this institution a total sum of around 925 million dollars in funds for 64 projects.

The collaboration between the central bank and the World Bank Group rests on grounds of the agreement: 'On the administration and consultation of Foreign Reserves Investments', signed in September of 2005. Thus, the World Bank Group has offered technical assistance to the Bank of Albania through the RAMP (Reserves Administration and Management Program) program, under the umbrella of Sovereign Partnerships Investments (SPI). This consultation and technical assistance has materialized through country visits of World Bank Treasury experts and Bank of Albania's employees participation in seminars put together by the World Bank abroad. The technical cooperation in terms of the RAMP program has focused on drafting a new regulatory base and addressing a number of technical matters that relate to the administration of reserves.

In the context of this project, the World Bank in cooperation with the Bank of Albania organized in October a regional forum in Tirana, themed: 'Trends in foreign reserve management'. Many high level officials from regional central banks participated in this forum. The presentations and discussions led during this forum focused on the way central banks manage reserves, on the latest trends and on the impact higher reserves have on the process of key asset distribution.

During meetings with high officials of the World Bank Group, in the framework of spring and annual meetings of the IMF and the World Bank, the Bank of Albania delegation presented the macroeconomic developments in Albania and measures taken to safeguard the macroeconomic stability from inflationary pressures. The World Bank officials have expressed their support for steps undertaken by the Bank of Albania and have offered their expertise in financial infrastructure, particularly in developing microfinance institutions and savings-loan association.

On March 29, 2007 the Board of Executive Directors of the World Bank approved a loan of 10 million USD for development policies. This is the first time in a series of three economic development policies that support the National Strategy for Development and Integration (NSDI) drafted by

the Albanian government that aims to boost the economic growth rate, to enhance public services in social sectors and to improve good governance and accountability.

5.3.3 RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

The Bank of Albania kept constant open communication with the EBRD during 2007, mainly with regards to access to information and statistics on the overall economic development of Albania, and on the financial sector specifically. In the 2007 Transition Report, the EBRD positively graded the monetary policy framework of the Bank of Albania, in terms of keeping inflation within target range, of strengthening banking supervision through the approval of the new law 'On Banks in the Republic of Albania', and of taking measures to curb the rapid growth of credit-lending.

At the same time, the Bank of Albania has kept close relations with the Bank for International Settlements. In 2007, the Governor of the Bank of Albania participated in the 77th Annual Meeting of the BIS that took place in June, in Basel, Switzerland. During these meetings with representatives from this institution and other member banks, the Governor stressed the importance of deepening technical cooperation between the Bank of Albania and other central banks in common interest areas. BIS has been proactive in offering technical assistance to the Bank of Albania through panels and workshops organized by the Financial Stability Institute. This institution promotes international financial stability through information sharing and cooperation in the area of financial system supervision.

In addition, Bank of Albania representatives participated in the 2007 meeting of technical cooperation and training coordinators, from the G10 countries, Austria, IMF, European Central Bank, Central and Eastern European countries and Independent States Group, put together by BIS. Different matters pertaining to cooperation areas and matters related to expanding the central bank's benefits from technical assistance put forth by other participating central banks, were discussed during this meeting.

5.3.4 RELATIONS WITH CENTRAL BANKS AND TECHNICAL COOPERATION

Following intense bilateral relations with other central banks, the Governor of the Bank of Albania paid official visits in 2007 to the Bank of France, the National Bank of Belgium, the Central Bank of Luxembourg, the Bank of England, and the Popular Bank of China where he met with his homologues. During his visit at the National Bank of Croatia, the Governor met with the Deputy Governor of this institution. Meanwhile, the Governor of the National Bank of Bulgaria and the Deputy Governor of the Bank of Sweden visited

the Bank of Albania in May of the same year. All of these visits have helped to consolidate and further develop the exponentially growing technical cooperation between the Bank of Albania and these institutions.

On the regional front, the Bank of Albania had its 17th and 18th meeting with the Central Bank Governors' Club of the Central Asia, Black Sea Region and Balkan Countries, which took place in Serbia in May and in Montenegro in September. The Governor of the Bank of Albania was Deputy Chairman of the Club in 2007, and will continue to be so in 2008. The next round meeting of the Club will take place in Tirana in May of this year.

The regional governors and the heads of supervisory authorities met in July in Athens, at the initiative of the Bank of Greece, in order to improve the new regional cooperation framework in the field of banking supervision. Additionally, a memorandum of multilateral cooperation was signed, which outlined the areas and terms of cooperation between the banking supervisory authorities of Southeast European countries, in synch with the existing supervisory and regulating regimes in each country.

The Bank of Albania organized a regional meeting in November regarding economic research, attended by representatives of regional central banks. The scope of this activity was to encourage dialogue and cooperation between researchers and field specialists in economic research belonging to appropriate departments in Southeast European central banks; to encourage debate around key economic issues that affect the decision-making process in these countries; to exchange experiences in the field of empirical research and to reinforce the ethical code and standards in research.

Officials and experts from the European Central Bank, few central banks members of the European System of Central Banks, the European Commission, EBRD, BIS and some of the regional central banks participated in the 7th annual conference of the Bank of Albania, themed: 'Monetary Policy Strategies for Small Economies', organized in December where matters related to the drafting and implementation of the monetary policy were presented. Also, here was presented a progress review of the Bank of Albania in 2007 with regards to the preparatory process and adaptation of the new monetary policy regime in the future.

The Bank of France, the National Bank of Austria and the Bank of Italy offered the most technical assistance to the Bank of Albania during 2007, mainly through workshops, seminars and short-term research visits focused on specialized areas. The Bank of Albania has also benefited in technical assistance by the central banks of Germany, England, USA, Greece, Turkey and the European Central Bank. At the same time, technical cooperation relations with the central banks of Poland, the Czech Republic, Bulgaria and Romania – as new members of the European System of Central Banks - have intensified. The start of the long-term technical cooperation with the Bank of Sweden in drafting and implementing the monetary policy, monetary operations and financial stability is yet another key feature of 2007.

Another new development in technical cooperation during 2007 is the technical expertise that the Bank of Albania provided to the Central Banking Authority of Kosovo (CBAK). During the second half of 2007, CBAK delegations paid official visits to the Bank of Albania, centered on internal auditing, accounting standards, monetary operations and Back-Office work, payment systems, human resources policies and legal services.

The Financial Services Voluntary Corpus (FSVC) has continued to provide technical assistance to the Bank of Albania during 2007, focusing on introducing derivative tools, liquidation of banks, and international accounting standards.

5.4 ECONOMIC AND FINANCIAL EDUCATION OF THE PUBLIC

5.4.1 BANK OF ALBANIA AND EDUCATION

Modern central banks around the world pay careful attention to as well as invest substantial human resources and financial capital in the financial and economic education of the public at large. This, because, knowledge on economic and financial issues is becoming ever more important. Such a well-informed culture certainly helps consumers, producers and investors to take sound financial decisions and helps the central bank to attain its goals rather easier.

The Bank of Albania considers public education as a better opportunity to foster a suitable environment for developing its activities; as a must to establish the foundation for developing an interactive communication between the bank and the public; as an irreplaceable instrument that serves to elevate its reputation and credibility and as an efficient way to increase the transparency and responsibility that the bank wants to convey to the public.

For many reasons that relate to the past of this country, the public at large is little familiar to issues of an economic and financial nature. However, if economic information is made accessible followed by necessary tools to better decipher its message, and if its terminology is rather simple and readable, then public reckoning of economic policies and decisions will be more rational, thus, disciplining public economic behavior and better orienting it.

Ultimately, this helps the Bank of Albania put in place and at work efficient mechanisms of transmitting its decisions to the economy. If no one truly understands why a particular decision is taken on monetary policy, then no decision will truly have the desired effects, and the market signals that will be sent to the central bank will be confusing, making it even more difficult to take other decisions.

These are the reasons that have induced the Bank of Albania to dedicate to matters of public education and to undertake concrete initiatives in this respect.

On December 13, 2007, the Bank of Albania signed a Memorandum of Understanding with the Ministry of Science and Education, in the field of public education on general economic matters and particularly in matters of the central bank. The scope of this MoU is to determine ways of cooperation between these two institutions, so as to foster reciprocal cooperation in educating students in the fields of economics, finance and banking.

5.4.2 EDUCATIONAL PROGRAMS

In October 2007, the Bank of Albania launched its economic-financial education program 'The Central Bank in everyday life' as an all-inclusive program. Initially targeted to high school students and professors, this program has been further upgraded, aiming to reach out to university students in the country.

The first goal of this program is to introduce the Bank of Albania to a selected group of people, as a unique institution in the economic life of this country. However, in order to put it into a large picture and to better accommodate the group's interests, this program aims to further enrich and improve the culture and general knowledge of this audience in economics, finance and banking.

In the context of implementing this program, a plethora of diverse activities took place during 2007, targeted to different age-groups. Such activities have consisted of training seminars, meetings and lectures, and educational brochures written precisely for different ages.

The program 'The Central Bank in everyday life' meant for high school students and professors, is based on three types of activities spread throughout the academic year:

1. 4 two-day training seminars for professors of applied economics;
2. A competition between high-schoolers testing their knowledge of the central bank entitled: 'The real value of money';
3. Preparing and distributing educational brochures for high-schoolers followed by direct conversations with students in school campuses.

A pilot program that took place during May-June 2008 preceded the program 'The Central Bank in everyday life'. During this phase, there was a 1-week seminar for professors of economics; meetings and conversations with students of three high schools in the capital; and a massive distribution of educational brochures of the Bank of Albania to all of the public and private schools in Tirana. Answers gathered from surveys distributed to participants of such activities ascertained that both students and professors found the Bank of Albania initiative very beneficial. Also, important comments on better addressing students' needs and interests in the future program were gathered during this program.

In the spirit of the 'The Central Bank in everyday life' the Bank of Albania staff visited in 2007 twelve (12) high schools in Tirana where it met with junior-level students and discussed themes related to the central bank, its role in the banking system and economy at large, key banking products, the personal budget and administering personal finances. 17,000 brochures of an educational nature with different themes written precisely for juniors were distributed to students.

5.4.3 SEMINARS AND TRAININGS

5.4.3.1 Training seminars for journalists

Being aware that the method in which information flows shared in our era is as important as the message it contains, the 2007 series of seminars aimed to help broadcast the information from the Bank of Albania directly to the public through the media.

The fourth cycle of seminars designed by the Bank of Albania for economic journalists of printed and online media, which took place from September to December of 2007, primarily touched upon themes related to the internal activity of the central bank and to the banking system in Albania, and invited journalists to be more proactive through questions and comments on such themes and/or pressing matters of the day.

5.4.3.2 Training seminars for professors of economics

A seminar entitled 'The role of the Bank of Albania in the economy' was put together for the first time on June 25-29 of 2007 for professors of applied economics. This seminar was attended by 40 high school professors in Tirana and dealt with different themes ranging from finance, economics and banking.

The series of seminars for the 2007-2008 academic year was construed based on the format of the first seminar and on suggestions collected via surveys distributed to participating professors. This activity, part of the educational program 'The Central Bank in everyday life' is likely to take place four times a year with two-day sessions. In this context, two training seminars took place during 30-31 of October and 13-14 of December 2007, targeting high school professors of applied economics.

This series of seminars aims to help professors - through discussions on the activities and role of the Bank of Albania in the banking system and in the economy - to better comprehend the dynamics of the market economy, the banking system, and to shed light on different matters that they may have come across during their teaching sessions. These seminars are certainly a better opportunity not only to build up professionally but also to educate the new generation on the economic-financial spectrum.

5.5 2007 AMENDMENTS TO THE BANKING LEGISLATION

5.5.1 AMENDMENT TO THE REGULATIVE FRAMEWORK WITH THE ENTRY INTO FORCE OF THE LAW 'ON BANKS IN THE REPUBLIC OF ALBANIA'

On June 1 2007 the Law no. 9662 dated 18/12/2006, 'On Banks in the Republic of Albania' entered into force. This Law represents the first phase of legislation alikeness to the *Acquis Communautaire* in line with undertaken initiatives of the Stabilization and Association Agreement.

This law anticipates clearer principles and rules on the risk management that banks may follow during their activities, protecting investors' deposits and safeguarding the stability of the banking system. Technical details on risk management are anticipated to be defined in the by-laws of the Bank of Albania.

In 2007, the Bank of Albania launched the review process of the existing regulative framework (by-laws) in the supervision area, so as to adapt this one to the new law. The review of these by-laws aims to bring the domestic banking legislation closer to *Acquis Communautaire* as it relates to adopting technical instruments to conduct a prudent supervision of banking and financial activities, of all banking and non-banking subjects that engage in these types of activities.

Also, in enforcing this law in terms of prohibiting and penalizing illegal foreign currency exchanges, along with other measures taken to reduce market informality, the Bank of Albania reviewed by-laws pertaining to the establishment and licensing of foreign exchange bureaus and their supervision.

Legal amendments consisted of easing up criteria on establishing and licensing of these bureaus, which has led to higher demand and applications for licences of foreign exchange bureaus. This measure makes it possible to have a more efficient supervision of the foreign exchange activity and to implement the Bank of Albania foreign exchange policies, based on more complete market data collected from periodic reports of the foreign exchange bureaus.

5.6 AMENDMENTS TO THE REGULATIVE FRAMEWORK

In the framework of measures taken to reduce the physical money in the Albanian economy, the Bank of Albania – in an effort to attain its objective of promoting and developing the payment system - has taken a few regulatory measures so as to modernize the payment system in the Republic of Albania.

5.6.1 ELECTRONIC PAYMENT SYSTEMS

The ratification of the new law 'On Banks in the Republic of Albania' which in accordance with *Acquis Communautaire* sanctions principles and rules on the use of electronic payment systems, generated improved standards in this field.

In order to put to practice these standards, the entire regulatory framework on the organization and operation of electronic payments used in payoffs and clearance, was reviewed – synchronizing this part of the Albanian legislation with the appropriate directives of the European Union. This synchronization ensures a suitable regulative framework for the well-functioning of these systems and strengthens due measures safeguarding the interests of participants in these systems.

5.6.2 LONG-DISTANCE PAYMENT METHODS AND ELECTRONIC MONEY

Along with measures on better channeling payments and paying off obligations through the banking system, the Bank of Albania, in cooperation with this system's players, reviewed this year the regulative framework that relates to electronic payments services offered by banking entities.

New rules regarding this field prompt a higher scale of compatibility between the Albanian legislation with *Acquis Communautaire*. They aim to modernize electronic payments via long distance, clearly defining the existing types of methods of long distance payments, while determining new methods, conditions, and rules of using electronic money instruments.

Taking into account the specificity and complexity of these services, amendments to these regulations focused on establishing a set of criteria and conditions necessary for transparency toward clients – who use these instruments – regarding the method of use, obligations and due rights, as well as protection of their interests.

5.7 MONEY ISSUE

Currency in circulation reached a value of 161,161,883 thousand Lek at the end of 2007, relative to 168.234.883 thousand Lek at the end of 2006. The structure of circulating paper money featured a higher share of large notes of 1,000 and 5,000 Lek. This has been a result of higher demand from commercial banks concerning ATM funds. In addition, the structure of coins featured a higher share of large coins of 50 and 100 Lek. One of the key reasons that led to the coins' larger share was their increasingly gradual use in replacing 100 Lek in paper money.

Chart 1 Currency in circulation and its structure

Performance of currency in circulation 1995-2007

Coins/Banknotes 2007

Banknotes structure 31.12.2007

Coins structure 31.12.2007

Source: Bank of Albania
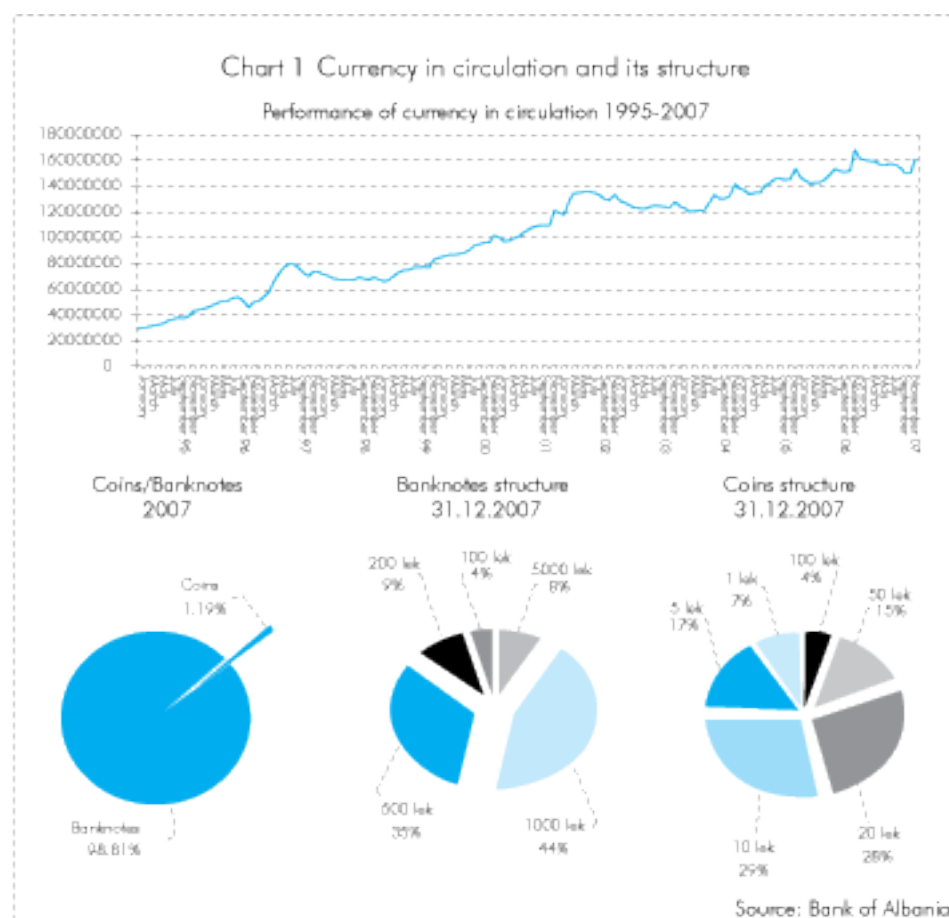
At the end of 2007, the share of paper money value to coins value had increased. The coefficient of money return to the Bank of Albania was 0.75 in 2007 relative to 0.70 in 2006. Thus, the need for money in circulation has decreased. The value of money leaving the Bank of Albania toward commercial banks was approx. 22% less than in 2006, while the value of money returned to the Bank from commercial banks was relatively the same as last year.

5.7.1 CURRENCY PROCESSING AND ITS QUALITY

The number of paper money and coins processed by the Bank of Albania in 2007 was approx. 1.5% higher than a year ago. In implementing current standards and given the rapid multiplication of ATM machines in commercial banks, in 2007 the Bank of Albania retrieved back from circulation 25.8 million in paper money stock that were no longer suitable for use, replacing them with new paper money. This has improved the quality of paper money in circulation. Also, the implementation of the project for printing new paper money with a 2,000 Lek value and reprinting the notes of 5,000, 1,000, 500 and 200 Lek in paper money belonging to the current circulating series, is expected to improve the quality of money in circulation.

ENDNOTES

[1] *Source: Country Report IMF – February, 2008.*
[2] *The banks having the largest share of payments in number and value from 17 banks participant in the AIPS system.*
[3] *The banks having the largest share of payments in number and value from 15 banks participant in the AECH system.*
[4] *INSTAT – Number of population, January 2005.*
[5] *On 31 December 2007 (according to the IMF official website), the official exchange rate of SDRs to the US dollar and the EUR was: 1 SDR = 1.580250 USD, 1 SDR = 1.073460 EUR.*

CHAPTER 6 INDEPENDENT AUDITORS' REPORT AND FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED DECEMBER 31, 2007

Deloitte.

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, 2007, 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. 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

In our opinion the accompanying financial statements present fairly in all material respect the financial position of the Bank as of December 31, 2007, 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

1. The disclosures in the Statement of Changes in Equity and in Notes 10, 19 and 37/1 to the financial statements showing that as of December 31, 2007 the total of paid up capital and liabilities of the bank exceeds the assets by LEK 1,210 million (2006: 740 million) and the Bank has paid as profit to state budget during the year ended December 31, 2007 an amount of LEK 5,010 million (2006: 4,664 million), in pursuance of an agreement dated March 26, 2003 with the Ministry of Finance. In accordance with 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. 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 would be necessary to remedy the deficiency.

2. In the past years the Republic of Albania has subscribed to a number of subscriptions in International Financial Institutions, including International Bank for Reconstruction and Development, International Development Agency, Multilateral Investment Guarantee Agency, International Finance Corporation, European Bank for Reconstruction and Development and Islamic Development Bank. The amount of such subscriptions by the Republic of Albania as of December 31, 2007 includes paid in subscriptions in an amount of LEK 991 million and callable subscription in an amount of LEK 8,001 million, of which, as detailed in Note 7 of "Other Assets (In Foreign Currency)", the Bank has paid an amount of LEK 498 million (2006: LEK 522 million) to
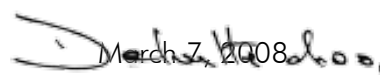
support the Republic of Albania but has not recognized any liability for the callable subscription.

The Bank of Albania and the Government of Albania are currently negotiating a Memorandum of Understanding for the purpose of allocating the original contributions and ownership of the subscriptions in the International Financial Institutions between both parties. It is not possible to quantify the impact of the outcome of the final agreement on the accompanying financial statements as of the date of this report.

Tirana, Albania

Zagreb, Croatia

March 7, 2008
BANK OF ALBANIA

March 7, 2008

BALANCE SHEET
AS AT DECEMBER 31, 2007
(all amounts are expressed in million LEK, unless otherwise stated)

ASSETS	Notes	As at December 31, 2007	As at December 31, 2006
Assets denominated in foreign currencies			
Gold and precious metals	3	923	797
Deposits with the International Monetary Fund	4	7,031	7,867
Deposits with non resident banks	5	40,976	38,157
Available for sale investments	6.1	124,096	117,404
Held for trading investments	6.2	8,747	9,636
Other foreign assets	7	752	726
Total assets denominated in foreign currencies		182,525	174,587
Domestic assets			
Gold and precious metals	3	63	53
Transit credits	8.1	95	139
Loans to resident banks	8.2	1,509	8,904
Available for sale investments	9	66,523	67,575
Investments in local currency	10	5,909	-
Other domestic assets	11	3,503	4,223
Total domestic assets		77,602	80,894
Total Assets		260,127	255,481
LIABILITIES			
Liabilities denominated in foreign currencies			
Due to the International Monetary Fund	12	13,946	15,256
Due to non-resident financial institutions	13	1,183	1,246
Other foreign liabilities		251	186
Total liabilities denominated in foreign currencies		15,380	16,688
Domestic liabilities			
Currency in circulation	14	161,162	168,234
Due to resident banks	15	67,051	53,575
Due to the Government	16	14,313	15,944
Deferred income	17	3	76
Other domestic liabilities	18	927	954
Total domestic liabilities		243,456	238,783
CAPITAL AND RESERVES			
Capital	19	2,500	750
Legal reserve	20	5,181	3,750
Revaluation reserve	21	(22,759)	(15,856)
Fixed assets revaluation surplus	11	1,755	2,660
Other reserves	22	14,614	8,706
Total capital and reserves		1,291	10
Total liabilities, capital and reserves		260,127	255,481

The accompanying notes on pages 131 to 158 are an integral part of these financial statements.

BANK OF ALBANIA

INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2007
(all amounts are expressed in million LEK, unless otherwise stated)

	Notes	Year end December 31, 2007	Year end December 31, 2006
Operations with non-residents			
Interest and commission income	23	7,151	5,870
Interest and commission expense	24	(337)	(494)
Operations with non-residents, net		6,814	5,376
Operations with residents			
Interest and commission income	25	4,633	4,020
Interest and commission expense	26	(2,302)	(1,731)
Operations with residents, net		2,331	2,289
Other operating income / (expenses), net	27	286	(1,367)
(Loss)/Profit from exchange rate		(8,035)	(3,341)
Total income from Banking activities		1,396	2,957
Other administrative expenses			
Personnel expenses	28	(660)	(584)
Depreciation	11	(117)	(122)
Amortization	11	(69)	(114)
General and administrative expenses		(420)	(319)
Total other administrative expenses		(1,266)	(1,139)
Net income from Banking activities		130	1,818
Transfer from/(to) revaluation reserve		8,035	3,341
Net profit before allocation		8,165	5,159
Distribution of profit to Albanian Government		5,010	4,664
Distribution of profit to other reserves		-	495
Distribution of profit to paid in capital		1,750	-
Distribution of profit to legal reserve		1,405	-
Total		8,165	5,159

The accompanying notes on pages 131 to 158 are an integral part of these financial statements.

BANK OF ALBANIA

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED DECEMBER 31, 2007
(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, 2005	750	3,750	(12,452)	983	8,182	-	-	1,213
Net income from Banking activity	-	-	-	-	-	-	1,818	1,818
Transfer to / from revaluation reserves	-	-	(3,341)	-	-	-	3,341	-
Securities revaluation	-	-	(67)	-	-	-		(67)
Surplus of revaluation from fixed assets	-	-	-	1,706	-	-	-	1,706
Release of tangible fixed asset revaluation surplus	-	-	-	(29)	-	29		-
Other revaluation	-	-	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
Net income from Banking activity	-	-	-	-	-	-	130	130
Transfer from / to revaluation reserves	-	-	(8,035)	-	-	-	8,035	-
Securities revaluation	-	-	1,124	-	-	-	-	1,124
Adjustment for the revaluation of fixed assets in 2006				(1,706)				(1,706)
Increase in fixed assets revaluation during 2007	-	-	-	827	-	-	-	827
Government funds for covering the temporary capital deficit					5,908		-	5,908
Release of tangible fixed asset revaluation surplus	-	-	-	(26)	-	26	-	-
Other revaluations	-	-	8	-	-	-	-	8
Profit distribution	1,750	1,431	-	-	-	(26)	(8,165)	(5,010)
As at December 31, 2007	2,500	5,181	(22,759)	1,755	14,614	-	-	1,291

The accompanying notes on pages 131 to 158 are an integral part of these financial statements.

BANK OF ALBANIA

STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2007
(all amounts are expressed in million LEK, unless otherwise stated)

	Notes	Year ended December 31, 2007	Year ended December 31, 2006
Cash flows from operating activities			
Net profit for the year		8,165	5,159
Non-cash items in the statement of operation			
Gain from Forward Contracts		(41)	-
Provision for doubtful loans		(2)	5
Depreciation and amortization		255	237
Discount amortization of available for sale investments		(4,714)	(3,920)
Interest income		(6,816)	(5,533)
Interests expense		2,384	1,802
Loss from sales of available for sale investments		114	1,503
Profit realized from sale of held for trading securities		(41)	(72)
Profit unrealized from sale of held for trading securities		(215)	(5)
Grant amortization (deferred income)		(73)	(53)
Cash flow before the movement of working capital		(984)	(877)
Changes in working capital			
Decrease in deposits with the IMF		831	564
(Increase) / Decrease in other foreign assets		(37)	(171)
Decrease in transit credits		44	68
Increase / (decrease) in other domestic assets		688	(1,865)
Decrease in due to the IMF		(1,313)	(892)
Decrease in due to financial institutions		(62)	(73)
Increase on other foreign liabilities		65	186
Increase in due to resident Banks		17,657	4,688
(Decrease) / Increase in due to the Government		(1,631)	9,588
(Decrease) / Increase in other domestic liabilities		(27)	193
Purchase of held for trading securities (in foreign currency)		(18,185)	(25,726)
Sale of held for trading securities (in foreign currency)		18,155	16,281
Cash flows generated from operations		16,184	2,841
Interest received		6,857	5,396
Interest paid		(2,364)	(1,788)
Net cash from operating activities		19,693	5,572

BANK OF ALBANIA
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2007
(all amounts are expressed in million LEK, unless otherwise stated)

	Notes	Year end December 31, 2007	Year end December 31, 2006
Cash flows from investing activities			
Purchase of fixed assets		(206)	(75)
Purchase of intangible assets		(15)	(2)
Purchase of available for sale investments (in foreign currency)		(242,240)	(289,309)
Purchase of available for sale investments (domestic assets)		(180,212)	(181,866)
Sale and maturity of available for sale investments (in foreign currency)		230,159	300,050
Sale and maturity of available for sale investments (domestic assets)		185,658	184,832
(Decrease) / increase of repurchase agreement		3,143	(5,156)
Adjustment for effect of foreign exchange		(143)	506
Net cash (used) / generated in investing activities		(3,856)	8,980
Cash flows from financing activities			
Payment of matured debts		-	1,726
Revaluation of the head quarter		827	1,706
Adjustment of the revaluation of the main building in 2006		(1,706)	-
Revaluation of other reserves		8	4
Increase in the general reserve		1,431	-
Increase in other reserves		-	524
Increase in the shareholder's equity		1,750	-
(Decrease) / Increase in money in circulation emissions		(3,500)	9,000
Profit distribution		(8,191)	(5,188)
Net cash (used) / generated in financing activities		(9,382)	7,772
Increase in cash during the year		6,455	22,324
Cash and cash equivalents at the beginning of the year	29	46,714	24,390
Cash and cash equivalents at the end of the year	29	53,169	46,714

The accompanying notes on pages 131 to 158 are an integral part of these financial statements.

These financial statements have been approved from the Supervisory Council of the Bank on March 26, 2008 and signed on its behalf by:

Ardian Fullani
Governor of the Bank

Artan Toro
Head of Accounting and
Finance Department

BANK OF ALBANIA
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED DECEMBER 31, 2007
(all amounts are expressed in million LEK, unless otherwise stated)

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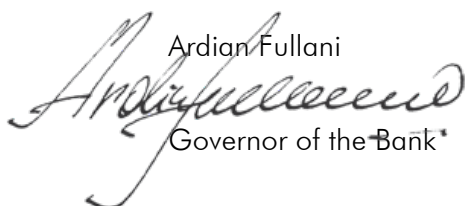
The Bank of Albania (the 'Bank') is the central Bank of the Republic of Albania and was established according to the Law No. 8269, dated December 23, 1997 'On the Bank of Albania'. Under the terms of its charter the Bank's main responsibilities are:

- 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 the Republic of Albania;
- supervision of commercial bank activities including issuance of licences to all banks; and
- issuing of licences 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 in the Bank's Accounting Manual approved from the order No.50 of the Council of minister, dated January 26, 2001 and other policies approved by the Supervisory Council of the 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 combined with elements of other methods, which are based on the market value, 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').

a.   Basis of preparation of financial statements (continued)

The Bank controls the operations of the Printing House, a business entity engaged in the printing of Government high security material and publications of Bank of Albania. The Supervisory Council 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.

Based on Decision of the Council of Ministers No.598 dated September 5, 2007 the economic and financial activity of the Printing House will be terminated on March 31, 2008.

The Bank has not consolidated the financial operations of the Printing House due to its unclear status related to the ownership with the Government of Albania.

The financial position of the Printing House as at December 31, 2007 and 2006 is set out in Note 30 to these financial statements.

b.   Deviation from International Financial Reporting Standards

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

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

Reporting and accounting of Pension Fund is not still 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. The guideline approved during the year 2007 foresees the function of this fund as a defined contribution fund, by disclosing the accounting treatment of the pension fund in compliance with the above mentioned standards.

-      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.

-      IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'

In the prior year the Bank has revaluated its main building using the method of capitalization of rental income and selling prices for new business centers in neighborhood. During the year the Bank has decided to revalue the Bank's main building using Deprecation replacement cost method. The adjusting entry of the reversal of the revaluation of the prior year is recorded in the current year and this method is not in accordance with IAS 8.

- IFRS 7 'Financial Instruments: Disclosures'

The Bank has not presented all disclosures related with the policies and procedures for managing, measuring and monitoring the risks that the Bank faces and other disclosure as required by IFRS 7 'Financial Instruments: Disclosures'.

c.   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.

d.   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, 2007 and 2006 were as below:

	December 31, 2007	December 31, 2006
United States dollar (USD)	82.89	94.14
European Union currency unit (EUR)	121.78	123.85
British pound (GBP)	166.02	184.65
Special Drawing rights (SDR)	130.84	141.51
Japanese yen (JPY)	0.7401	0.7919
Gold ('XAU')	1onz = 69,337.49	1onz = 59,844.80

e.   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 the 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 and 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.

f.   Repurchase agreements and reverse repurchase agreements

Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements) are generally treated as collaterised financing transactions and are carried at the amounts of cash advanced or received, plus accrued interest.

Repurchase agreements are recorded in the balance sheet item 'Due to domestic Banks'. Based on the Bank's regulation on repurchase agreements, the Bank is not required to put up any collateral for these securities.

Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements is recognized as interest income or interest expense, over the life of each agreement using the interest rate approved by the Supervisory Council of the Bank of Albania.

g.   Fixed assets

The fixed assets are stated at historical cost less accumulated depreciation except the bank's building, which are stated at revalued amount, calculated using the replacement cost method. (see Note 11). 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 2007 are the same as year 2006:

	2007
Building – Head office	40 years
Buildings – At branches	25 years
Vehicles	5-10 years
Furniture, fixtures and equipment	3-20 years
Computer software	2 years

h.   Printing and minting costs

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

i.   Taxation and profit allocation

The Bank is not subject to income tax based on the law 'On Bank of Albania' and referring to it the Bank allocates all the realized profit to the State Budget after having fulfilled its entire requirement for reserve fund as required from the Supervisory Council of the Bank.

j.   Legal reserve

In accordance with the Law 'On the Bank of Albania', the Bank has established a legal reserve into which 25% of the net profit for the year is transferred until the reserve amounts to 500% of the capital.

k.   Grants

Grants are initially recorded in the balance sheet at the amount received. Grants related to expenditure items are released to income during the period of the related expenditure. Grants related to the purchase of property, equipment and software are released to income over the life of the relevant assets at an amount corresponding to the associated depreciation/amortization charge on that asset.

l.   Cash and cash equivalents

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

m.   Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

n.   Changes in accounting policies

In the prior years the Bank has stated the value of its buildings, except main building, at historical cost less accumulated depreciation. During the year ending December 31, 2007 the Bank has finalized the revaluation process for the whole class of building and changed the recognition criteria from cost method to revaluated model.

The accumulated depreciation at the date of the revaluation is eliminated against the gross carrying amount of the buildings and the net amount restated to the revalued amount of the buildings.

3.   GOLD AND PRECIOUS METALS

As at December 31, 2007, the value of gold owned by the Bank placed in gold time deposits abroad was LEK 923 million (2006 - LEK 797 million), being 13,319 troy ounces of gold (2006 – 13,319 troy ounces).

Gold is valued at the London fixing rate on the balance sheet date. The difference of LEK 126 million (2006 – LEK 89 million) resulting from the revaluation of gold is recorded in the revaluation reserve. As at December 31, 2007 the price for one troy ounce of gold was USD 836.5 (2006 – USD 635.7).

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 57 million as at December 31, 2007 (2006 – LEK 48 million) and LEK 6 million of non monetary gold (2006 – LEK 5 million).

4.   DEPOSITS WITH THE INTERNATIONAL MONETARY FUND

	As at December 31, 2007	As at December 31, 2006
International Monetary Fund (IMF)	6,868	7,012
Special Drawing Rights ('SDR')	160	847
Accrued interest	3	8
Total	7,031	7,867

Deposits with the IMF resulted from the membership of the Republic of Albania in the IMF, according to Law No.8269 dated December 23, 1997 'On the Bank of Albania'. These deposits have as counterparty accounts the loans granted by IMF to the Republic of Albania as disclosed in Note 12.

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, 2007 was 3.5 % (2006 – 4.07 %).

5.   DEPOSITS WITH NON RESIDENT BANKS

	As at December 31, 2007	As at December 31, 2006
Current accounts	9,472	17,281
Short-term deposits	31,369	20,803
Accrued interest	135	73
Total	40,976	38,157

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 0.66% to 6.63% (2006 – from 0.17% to 5.29%).

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, 2007	As at December 31, 2006
	(in million)	(in million)
EUR	226	197
USD	100	96
GBP	9	7
JPY	4,897	4,022

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, 2007	As at December 31, 2006
Foreign Governments treasury notes	89,821	87,190
Bank for International Settlements: medium-term investments	26,448	18,212
Fixed rate investments (FIX BIS)	6,432	9,711
French Government treasury bills	-	1,818
United States agencies notes	1,395	473
Total	124,096	117,404

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 2.05% and 9%. Interest is paid semi-annually (USD) and annually (EUR and GBP) and maturities vary between April 2008 and October 2016. The yields vary between 2.95% and 5.8% (2006 – 2.8% and 5.66%).

Bank for International Settlements – medium term investments comprised of fixed coupon securities denominated in EUR, USD and GBP with coupon rates varying between 2.5% and 4.7%. Interest is payable annually for investments in EUR and semi-annually for investments in GBP and USD, and maturities range between March 2008 and March 2014. The yields vary between 3.30% and 5.95% (2006 – 2.87% and 5.28%).

Fixed rate investments (FIX BIS) issued by the Bank for International Settlements are denominated in EUR and JPY with yields that vary between 0.32% and 4.39% (2006-3.56% and 5.3%) and maturities range between January 2008 and July 2008.

United States agencies notes are denominated in USD with coupon rates between 3.25% and 7.12%. Interest is paid semi-annually and maturities range between February 2009 and November 2011. The yield is between 4.24% and 5.20% (2006 – 2.4%).

Foreign investments portofolio classified as available for sale disclosed in nominal value and by currency are as follows:

	As at December 31, 2007	As at December 31, 2006
	(in million)	(in million)
USD		
United States Government treasury notes	382	388
Bank for International Settlements: medium-term investments	72	32
United States agencies notes	16	5
Fixed rate investments (FIX BIS)	-	2
Total	470	427
EURO		
French Government treasury notes	87	199
German Government treasury notes	326	169
Bank for International Settlements: medium-term investments	147	112
French Government treasury bills	-	15
Fixed rate investments (FIX BIS)	10	60
Total	570	555
GBP		
United Kingdom Government treasury notes	34	27
Bank for International Settlements: medium-term investments	15	7
Fixed rate investments (FIX BIS)	-	11
Total	49	45
JPY		
Fixed rate medium term investment (FIX BIS)	7,000	-
Total	7,000	-

6.2. HELD FOR TRADING INVESTMENTS (FOREIGN CURRENCY)

Held for trading portfolio measured at market value is presented as follows:

	As at December 31, 2007	As at December 31, 2006
United States Government treasury notes	5,818	6,407
United States agencies notes	2,929	3,229
Total	8,747	9,636

United States Government treasury notes, denominated in USD, have coupon rates varying between 3.37% and 6%. Interest is paid semi-annually and maturities vary between December 2008 and August 2012.

United States agencies notes are denominated in USD with coupon rates varying between 4.12% and 5.37%. Interest is paid annually or semi-annually and maturities range between October 2008 and November 2010.

Starting from July 25, 2006, this portfolio is administrated from International Bank for Reconstruction and Development (IBRD) as stated in the agreement 'On the administration and technical assistance on investing the foreign 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 FOREIGN ASSETS

	As at December 31, 2007	As at December 31, 2006
Quotas in international financial institutions		
International Bank for Reconstruction and Development subscriptions (IBRD)	353	358
International Development Agency subscriptions (IDA)	12	12
Multilateral Investment Guarantee Agency subscriptions (MIGA)	6	6
International Finance Corporation subscriptions (IFC)	61	69
European Bank for Reconstruction and Development subscriptions (EBRD)	48	55
Islamic Development Bank subscriptions (IDB)	19	22
Total Quotas	498	522
Cash on hand in foreign currency	4	15
Receivables from International Bank for Reconstruction and Development	250	189
Total	752	726

As at December 31, 2007, other foreign assets are comprised of subscriptions for participation of the Bank of Albania in International Institutions on LEK 498 million (2006 – 522 million LEK) and cash on hand in foreign currency of LEK 4 million (2005 - LEK 15 million).

International Bank for Reconstruction and Development subscriptions (IBRD) in amount of LEK 353 million (USD 3.6 million) relates to the amount of paid subscription to this financial institution. As of December 31, 2007 the amount of callable portion of subscription with IBRD is LEK 8,001 million (USD 96.5 million) which are presently the subject of ownership discussions between the Bank of Albania and the Government of Albania. Both parties are currently negotiating a Memorandum of Understanding on the split of the original contributions and ownership of subscriptions in international financial institutions between the Bank of Albania and the Republic of Albania.

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 95 million (2006 – LEK 139 million) represent credits for services provided to the Italian-Albanian Bank for further distribution to ultimate borrowers to support state development programs (See Note 13). 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-tier banks in amount of LEK 1,509 million (2006 – LEK 8,904 million), with maturing terms of one week. On December 31, 2007 the interest rate of reverse repurchase agreement was 6.25% (2006: 5.6% and 6.51%).

9.   AVAILABLE FOR SALE INVESTMENT (DOMESTIC ASSETS)

	As at December 31, 2007	As at December 31, 2006
Short-term treasury bills	66,523	67,575
Total	66,523	67,575

Short-term treasury bills as at December 31, 2007 relate to Government of Albania zero-coupon treasury bills, with short-term maturity, ranging between January 2008 and September 2008, with yields varying between 6% and 7.94% (2006 – 5.4% and 7.1%).

10. INVESTMENTS IN LOCAL CURRENCY

On December 31, 2007 the Ministry of Finance issued a security with a nominal value of 6,000 million LEK, interest bearing as the t-bills yield of the last three month and maturity date is March 27, 2008 with a call option conditionally to the transfer of Gold from the Albanian Government. The Ministry posses the right of withdrawing the security once finalized the transfer of Gold ownership from the Albanian Government to the Bank of Albania, as detailed in Note 37.1.

The Ministry of Finance has transferred to the Bank the above mentioned interest bearing negotiable government securities because as of December 31, 2007 the Bank's total of paid up capital and liabilities exceeds the assets by LEK 7,118 million. The securities are issued based on article 7, of the Law 'On the Bank of Albania' No.8269, dated December 23, 1997 for the purpose of remedying the above mentioned deficiency.

11. OTHER DOMESTIC ASSETS

	As at December 31, 2007	As at December 31, 2006
Tangible fixed assets, net	2,263	3,123
Intangible assets, net	111	166
Loans to employees	1,037	857
Other debtors	3	6
Numismatic	40	39
Inventory	38	25
Other	11	7
Total	3,503	4,223

On December 31, 2007 the Bank involved independent valuer in the process of the revaluation of the buildings of Bank of Albania, included in the category 'Land, building and general constructions'. The revaluation method used is the replacement cost method which showed a revalued amount of the class of buildings of LEK 1,938 million, from a net book value of the class of buildings of LEK 1,179 million. The increase from the revaluation of the Bank of Albania buildings in amount of LEK 826 million is credited directly in Revaluation reserve line in Shareholder's Equity, while the decrease from the revaluation of the assets in the amount of LEK 69 million was included under 'General expenses of the Bank'.

In the prior year effective December 26, 2006 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 which raised a revaluation surplus of LEK 1,706 million. The tangible assets (buildings) of the bank have been revaluated with the replacement cost method as required by the independent auditor and based on the requirement of IAS 16 'Property, Plant and Equipment'. The reversal of this transaction is recorded in the financial statements of the Bank for the year ending December 31, 2007.

Loans to employees include a provision for legal claims of LEK 10 million at December 31, 2007 (LEK 15 million at December 31, 2006).

Loans to employees are collaterised by security such as mortgages, totaling approximately LEK 1,218 million at December 31, 2007 (LEK 990 million at December 31, 2006).

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, 2007	2,964	710	200	33	3,907
Additions	6	121	41	39	207
Disposals	-	(53)	-	-	(53)
Transfers	24	-	-	(24)	-
Reversal of revaluation in 2006	(1,706)	-	-	-	(1,706)
Reversal of the elimination of revaluation 2006	189	-	-	-	189
Revaluation of the bank buildings	758	-	-	-	758
Eliminated on revaluation	(293)	-	-	-	(293)
Balance at December 31, 2007	1,942	778	241	48	3,009
Accumulated depreciation					
Balance at January 1, 2007	69	560	155	-	784
Charge for the year	35	67	15	-	117
Disposals	-	(51)	-	-	(51)
Reversal of the elimination of the revaluation in 2006	189	-	-	-	189
Eliminated on revaluation	(293)	-	-	-	(293)
Balance at December 31, 2007	-	576	170	-	746
Net book value					
Balance at December 31, 2007	1,942	202	71	48	2,263
Balance at December 31, 2006	2,895	150	45	33	3,123

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, 2007	338	2,454	2,792
Additions	15	-	15
Disposals	-	(1)	(1)
Balance at December 31, 2007	353	2,453	2,806
Accumulated depreciation			
Balance at January 1, 2007	314	2,312	2,626
Charge for the year	24	45	69
Balance at December 31, 2007	338	2,357	2,695
Net Book Value			
Balance at December 31, 2007	15	96	111
Balance at December 31, 2006	24	142	166

12. DUE TO THE INTERNATIONAL MONETARY FUND

	As at December 31, 2007	As at December 31, 2006
Poverty Reduction and Growth Facility ('PRGF')	6,821	8,364
IMF securities account	5,042	4,812
IMF account in LEK	2,077	2,077
Accrued interest	6	3
Total	13,946	15,256

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, 2007 was SDR 19,660,900 (2006 - SDR 28,668,900). 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, 2007 is SDR 27,600,000 (2006 - 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 (PRGF 4)' and 'Extended Fund Facility' are approved from a three year agreement signed on January 27, 2006 in amount of SDR 17,045,000.

The disbursement of the second two entrenchment of PRGF 4 loan in amount of SDR 2,435,000 is made during 2007, with a semi annual interest payable of 0.5% and the balance as of December 31, 2007 is SDR 4,870,000. This facility is repayable after a grace period of five and a half years in 10 semi-annual equal installments.

The loan 'Extended Fund Facility' (EFF) disbursed in the amount SDR 4,870,000 during the period 2006-2007 is equivalent of LEK 690 million. The facility is repayable after a grace period of five and a half years and will be repaid within 10 years. The interest on these loans is floating and payable each three months. As at December 31, 2007 the interest rate was 4.77%.

13. DUE TO NON-RESIDENT FINANCIAL INSTITUTIONS

	As at December 31, 2007	As at December 31, 2006
Transit credits (Note 8.1)	95	139
Loan from the Republic of Greece	1,072	1,090
Due to the World Bank	12	12
Accrued interest	4	5
Total	1,183	1,246

Transit credit (Note 8) of LEK 95 million represents the outstanding loan received from the European Investment Bank and is compounded from EUR 0.8 million (Note 8.1). 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 Republic of Greece 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.

14. 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, 2007 and 2006:

	As at December 31, 2007		As at December 31, 2006	
Nominal value LEK	Number in thousand	Total LEK (million)	Number in thousand	Total LEK (million)
100	5,906	591	9,244	924
200	13,183	2,637	15,799	3,160
500	52,883	26,441	66,541	33,271
1,000	69,202	69,202	72,601	72,601
5,000	12,074	60,368	11,351	56,755
Coins		1,923		1,523
		161,162		168,234

15. DUE TO RESIDENT BANKS

	As at December 31, 2007	As at December 31, 2006
Foreign currency		
Compulsory reserve	23,848	18,273
Accounts of second-tier banks	1,964	67
	25,812	18,340
Domestic currency (LEK)		
Compulsory reserve	32,837	30,122
Accounts of second-tier banks	3,148	453
Repurchase agreements	-	4,199
Overnight deposits	5,211	436
	41,196	35,210
Accrued interest	43	25
Total	67,051	53,575

Interest on compulsory reserves is calculated as follows:

- LEK balances: 70% of the yield on the repurchase agreements: 4.375% as at December 31, 2007 (70% of the yield on the repurchase agreements: 3.85% as at December 31, 2006);

- USD balances: 70% of the one-month USD LIBOR rate: 3.40% as at December 31, 2007 (70% of the one-month USD LIBOR rate: 3.75% as at December 31, 2006);

- EUR balances: 70% of the one-month EUR LIBOR rate: 3.11% as at December 31, 2007 (70% of the one-month EUR LIBOR rate: 2.57% as at December 31, 2006).

Overnight deposits from domestic banks own interest of 4.5% (2006 - 3.75%).

16. DUE TO THE GOVERNMENT

	As at December 31, 2007	As at December 31, 2006
Profit to be distributed to the Government	-	-
Deposits received on behalf of the Government	14,280	15,922
Other	33	22
Total	14,313	15,944

Deposits received on behalf of the Government in the amount of LEK 14,280 million, include the main account of LEK 7,622 million, international donor funds deposited at the Bank for subsequent transfer to aid projects in Albania, of LEK 2,790 million and an amount of LEK 1,348 million representing a reserve fund account of the government on behalf of the Social Insurance Institute and Health Insurance Institute and other funds for other financing activities in the amount of LEK 2,520 million.

'Other' includes funds received by the Bank of LEK 19 million (2006 – 22 million) from a loan granted to the Government by the Islamic Arabian Bank of Development and the withholding tax over the interest of treasury bills in the amount of LEK 14 million.

17. DEFERRED INCOME

	World Bank grant	Other	Total
Balance at December 31, 2006	132	36	168
Disposal	(64)	(36)	(100)
Balance at December 31, 2007	68	-	68
Accumulated depreciation			
Balance at December 31, 2006	92	-	92
Charge for the year	37	-	37
Disposal	(64)	-	(64)
Balance at December 31, 2007	65	-	65
Net Book Value			
Balance at December 31, 2007	3	-	3
Balance at December 31, 2006	40	36	76

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. Decrease of grants in amount of LEK 64 million is caused from the amortization of the grant received for the implementation of Accounting Automated Electronic Clearing House (AECH) project.

The amount of 36 million LEK included in 'Other' represents the value of the two donated buildings in Korça and Berat. On December 31, 2007 the Bank recognized the whole amount of grants received previously as income of the period.

18. OTHER DOMESTIC LIABILITIES

	As at December 31, 2007	As at December 31, 2006
Due to Printing House (Note 30)	215	233
Deposits of individuals from the participation in Treasury Bills	586	636
Net obligation / Pension fund	6	6
Other	120	79
Total	927	954

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, 2007 the amount of pension funds assets invested in treasury bills matured within 12 month, is LEK 391 million and the amount invested in treasury bills matured within 5 years, is LEK 69 million. Total amount of

contributions paid from the Bank's employees till December 31, 2007 is LEK 36 million (LEK 24 million as at December 31, 2006) and the total amount of contributions paid from the Bank till December 31, 2007 is LEK 298 million (LEK 251 million as at December, 2006).

'Other' includes accrued expenses of LEK 54 million (2006 – LEK 29 million) related to maintenance of ATM system, services for statistical information, commission for managing the foreign reserve by IBRD, etc. Also included here are the claims for several legal litigations raised in the normal course of business. A net provision of LEK 20 million has been recognized in relation to these claims for the year ended December 31, 2007 (2006 – LEK 22 million). During the year ending December 31, 2007 the Bank has recognized additional provision of LEK 8 million and retaken provision previously recognized in amount of LEK 6 million (see Note 27).

19. CAPITAL

Based on the requisition No.9852 of the Ministry of Finance dated December 28, 2007 and based on the decision of the Supervisory Council No.4 dated January 23, 2008 the capital of the Bank is increased by LEK 1,750 million.

20. GENERAL RESERVE

Following the increase in the Bank's capital and according to the Law 'On the Bank of Albania', at the end of each financial year the Bank shall allocate an amount equivalent to 25 percent of the net profits for that year to the general reserve until the General Reserve Fund amounts to 500 percent of the paid-up capital of the Bank of Albania.

The decision for the increase in the paid in capital of the Bank is taken on December 28, 2007 and for this purpose the Bank couldn't increase general reserve to the limits of 25% of the net profits, but transferred there only an amount of LEK 1,431 million.

21. REVALUATION RESERVE

The components of the revaluation reserve are as follows:

	As at December 31, 2007	As at December 31, 2006
Revaluation of foreign currency and gold balances	(23,540)	(15,505)
Reserve of security revaluation	747	(377)
Revaluation of historic notes and coins	34	26
Total	(22,759)	(15,856)

During year 2007, the net loss arising from the revaluation of foreign currency and gold balances was LEK 8,035 million (2006 – net gain of LEK 3,341 million).

The revaluation of securities with the market value, during the year ended as at December 31, 2007 resulted in a gain of LEK 1,124 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 2007 the Ministry of Finance issued securities by a total of LEK 15,505 million, to cover the negative balance of the revaluation reserve arising from Bank's activity till the end of year 2006. These securities are recorded as off-balance sheet items and have a renewable maturity of six month.

The total amount of LEK 15,505 million covers the loss for the period 2003 up to 2006.

22. OTHER RESERVES

The components of the other reserves are as follows:

	As at December 31, 2007	As at December 31, 2006
Special reserve for Balance of Payments	7,209	7,209
Government funds for covering the temporary capital deficit (note 10)	5,908	-
Investment fund	301	301
Other	1,196	1,196
Total	14,614	8,706

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 the aim to purchase 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.

23. INTEREST AND COMMISION INCOME (NON-RESIDENTS)

	Year ended December 31, 2007	Year ended December 31, 2006
Interest income from securities	5,436	4,811
Interest income from time deposits	1,145	684
Interest from SDR deposits with IMF	33	51
Other	537	324
Total	7,151	5,870

24. INTEREST AND COMMISION EXPENSE (NON-RESIDENTS)

	Year ended December 31, 2007	Year ended December 31, 2006
Amortization of premium on securities	222	406
Interest expenses on loans of foreign institutions	13	13
Interest expenses on IMF accounts	69	59
Other	33	16
Total	337	494

25. INTEREST AND COMMISSION INCOME (RESIDENTS)

	Year ended December 31, 2007	Year ended December 31, 2006
Interest income from securities	4,362	3,902
Interest income from Government loans	6	6
Income from repurchase and reverse repurchase agreements	227	55
Other	38	57
Total	4,633	4,020

26. INTEREST AND COMMISSION EXPENSE (RESIDENTS)

	Year ended December 31, 2007	Year ended December 31, 2006
Interest expense on compulsory deposits	1,915	1,440
Interest expenses on REPO agreements	140	233
Interest expenses on Government deposits	184	-
Other	63	58
Total	2,302	1,731

27. OTHER OPERATING INCOME / (EXPENSES), NET

	Year ended December 31, 2007	Year ended December 31, 2006
Net loss from the sale of available for sale investments	(114)	(1,503)
Net profit from the sale of held for trading investments	41	72
Grants depreciation (note 17)	73	53
Provision for legal claims and other (note 18)	(8)	(25)
Other (note 11 and 18)	38	32
Unrealized profit from fair value revaluation of held for trading investments	215	4
Net gain from Forward Contracts	41	-
Total	286	(1,367)

28. 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, 2007, the Bank had 391 employees (2006 – 378 employees).

29. CASH AND CASH EQUIVALENTS

	Year ended December 31, 2007	Year ended December 31, 2006
Deposits with foreign banks (Note 5)	40,841	38,084
Domestic currency on hand	11,338	7,765
Foreign currency on hand (Note 7)	4	15
Gold held abroad (Note 3)	923	797
Gold and other precious metals held domestically (Note 3)	63	53
Total	53,169	46,714

30. PRINTING HOUSE

As detailed in Note 2(a), the Bank controls the operations of the Printing House. Based on Decision of the Council of Ministers No.598 dated September 5, 2007 the economic and financial activity of the Printing House will be terminated on March 31, 2008.

The financial position of the Printing House as at December 31, 2007 and 2006 is as follows:

	Year ended December 31, 2007	Year ended December 31, 2006
ASSETS		
Tangible fixed assets	6	11
Inventory	49	25
Amount due from the Bank (see Note 18)	215	233
Total assets	270	269
EQUITY AND LIABILITIES		
Capital	51	51
Legal reserve	19	19
Investment reserves	24	24
Other reserves	6	6
Retained earnings	169	168
Total capital and reserves	269	268
Other liabilities	1	1
Total equity and liabilities	270	269

	Year ended December 31, 2007	Year ended December 31, 2006
Income	52	72
Expenses	(51)	(65)
Profit of the year	1	7

31. 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, 2007 treasury bills issued from the Ministry of Finance for the purpose of covering the revaluation reserve created during the period 2003 - 2006 in amount of LEK 15,505 million have a renewable maturity of six months.

32. MANAGED ASSETS

As at December 31, 2007, the Bank held as custodian short-term treasury bills, at nominal value LEK 246 billion, and treasury bills with maturity 2 up to

7 years at nominal value LEK 122 billion. These are securities issued by the Albanian Government.

At as December 31, 2007, the Bank held as custodian gold and other precious metals on behalf of the Government, at market value of LEK 6,129 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, 2007 and 2006 is as below:

	As at December 31, 2007	As at December 31, 2006
Monetary gold held in foreign banks	2,584	2,230
Non monetary gold held in foreign banks	1,292	1,115
Non monetary gold held in Albania	2,041	1,761
Other precious metals	212	202
Total	6,129	5,308

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 2007 the interest received is of 5.5 ounces. The difference of LEK 821 million is a result of the fluctuation of exchange rates (Note 3).

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

33. 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, 2007 and December 31, 2006, transactions made with related parties comprised:

	As at December 31, 2006	As at December 31, 2005
Loans to employee		
- Directors	110	84
Total assets	110	84

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, 2007	Year ended December 31, 2006
Administrative expenses		
- Mobile expenses		
- Directors and Supervisory Council Members	4	4
- Salaries and Bonuses		
- Directors and Supervisory Council Members	90	78
- Bank contribution to pension plan scheme		
- Directors	7	7
Total of administrative expenses	101	89

34. RISK MANAGEMENT

The reserve is under the administration of the Bank of Albania and its investment is performed by the Monetary Operations Department, which is based on the regulation 'On foreign reserve management policy', 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 Council 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 Council, 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 35 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.

35. INTEREST RATE SENSITIVITY

	Up to one month	One to three months	Three to six months	Six to twelve months	One to five years	Over five years	Non-interest sensitive	Total
Assets								
Gold and precious metals	-	-	-	-	-	-	923	923
Deposits with the IMF	160	-	-	-	-	-	6,871	7,031
Deposits with non residents banks	32,961	7,880	-	-	-	-	135	40,976
Available for sale investments (foreign currency)	3,705	6,646	9,479	13,679	88,586	2,001	-	124,096
Available for trading investments (foreign currency)		-	-	659	8,088	-	-	8,747
Other foreign assets	250	-	-	-	-	-	502	752
Gold and other precious metals	-	-	-	-	-	-	63	63
Transit credits	-	-	-	-	-	-	95	95
Loans to domestic banks	1,508	-	-	-	-	-	1	1,509
Available for sale investments (domestic assets)	26,650	19,328	19,597	948	-	-	-	66,523
Investments in local currency	-	5,909	-	-	-	-	-	5,909
Other domestic assets	-	-	-	-	-	1,048	2,455	3,503
Total Assets	65,234	39,763	29,076	15,286	96,674	3,049	11,045	260,127
Liabilities and equity								
Due to the IMF	218	139	347	555	4,324	1,928	6,435	13,946
Due to non-resident financial institutions	-	-	-	-	-	1,072	111	1,183
Other foreign liabilities	251	-	-	-	-	-	-	251
Currency in circulation	-	-	-	-	-	-	161,162	161,162
Due to resident banks	61,896	-	-	-	-	-	5,155	67,051
Due to the Government	-	-	-	-	-	-	14,313	14,313
Deferred income	-	-	-	-	-	-	3	3
Other domestic liabilities	-	-	-	-	-	-	927	927
Capital and reserves	-	-	-	-	-	-	1,291	1,291
	62,365	139	347	555	4,324	3,000	189,397	260,127
Balance sheet gap as at December 31, 2007	2,869	39,624	28,729	14,731	92,350	49	(178,352)	-
Cumulative interest rate sensitivity gap - 2007	2,869	42,493	71,222	85,953	178,303	178,352	-	-

	Up to one month	One to three months	Three to six months	Six to twelve months	One to five years	Over five years	Non-interest sensitive	Total
Assets								
Gold and precious metals	-	-	-	-	-	-	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 (foreign currency)	-	473	664	23,009	90,969	2,289	-	117,404
Held for trading investments (foreign currency)	-	-	-	1,253	8,383	-	-	9,636
Other foreign assets	189	-	-	-	-	-	537	726
Gold and other precious metals	-	-	-	-	-	-	53	53
Transit credits	-	-	-	-	-	-	139	139
Loans to resident banks	3,350	5,500	-	-	-	-	54	8,904
Available for sale investments (domestic assets)	25,013	23,932	18,630	-	-	-	-	67,575
Other domestic assets	-	-	-	-	-	857	3,366	4,223
Total Assets	60,418	36,970	19,294	24,262	99,352	3,146	12,039	255,481
Liabilities and equity								
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 domestic liabilities	-	-	-	-	-	-	954	954
Capital and reserves	-	-	-	-	-	-	10	10
Total Liabilities and Equity	53,451	150	319	627	4,929	3,548	192,457	255,481
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	-	-

37. CURRENCY NET POSITION

	LEK	USD	EURO	GBP	Other	Total
Assets						
Gold and precious metals	-	-	-	-	923	923
Deposits with the International Monetary Fund	6,429	-	-	-	602	7,031
Deposits with non resident banks	-	8,286	27,552	1,514	3,624	40,976
Available for sale investments (foreign currency)	-	39,969	70,638	8,303	5,186	124,096
Held for trading investments (foreign currency)	-	8,747	-	-	-	8,747
Other foreign assets	335	415	2	-	-	752
Other gold & precious metals	63	-	-	-	-	63
Transit credits	-	-	95	-	-	95
Loans to resident banks	1,509	-	-	-	-	1,509
Available for sale investments (domestic assets)	66,523	-	-	-	-	66,523
Investments in local currency	5,909	-	-	-	-	5,909
Other domestic assets	3,497	2	4	-	-	3,503
Total Assets	84,265	57,419	98,291	9,817	10,335	260,127
Liabilities and equity						
Due to the International Monetary Fund	7,120	-	-	-	6,826	13,946
Due to non-resident financial institutions	11	-	1,172	-	-	1,183
Other foreign liabilities	-	251	-	-	-	251
Currency in circulation	161,162	-	-	-	-	161,162
Due to resident banks	41,225	6,274	19,552	-	-	67,051
Due to the Government	8,797	310	5,205	1	-	14,313
Deferred income	3	-	-	-	-	3
Other domestic liabilities	895	21	11	-	-	927
Total Liabilities	219,213	6,856	25,940	1	6,826	258,836
Net currency position as at December 31, 2007	(134,948)	50,563	72,351	9,816	3,509	1,291
Net currency position as at December 31, 2006	(132,642)	52,343	73,612	9,753	(3,056)	10

38. POST BALANCE SHEET EVENTS

1)   Transfer of Ownership of Gold and Precious Metals to Bank of Albania

On February 11, 2008 the President of Albania, based on the proposal No.5613 dated February 11, 2008, has approved the Law No. 9862, and dated January 24, 2008 'On the transfer of ownership of gold and other precious metals from the Albanian Council of Ministers to the ownership of the Bank of Albania'. After its approval the Law was published in the Official Gazette No.10, dated February 13, 2008 and has become effective on February 27, 2008. The amount of Gold and Precious Metals is equivalent to LEK 7,042 million.

2)   Revaluation of land and buildings of the Printing House

Land and building of the Printing House have been revaluated resulting in a revaluation surplus in the amount of LEK 230 million. This will be recorded in the accounting records after the transfer of the ownership to Bank of Albania from the Government of Albania.