Opinions expressed in these papers are those of the authors and do not necessarily reflect the official opinion of the Bank of Albania.
## CONTENTS

Review of the Monetary Policy of the Bank of Albania for the second half of 2007 7

Lecture of Mr. Ardian Fullani, Governor of the Bank of Albania
At Bocconi University “The convergence of economic systems and institutions of South East Europe towards the EU: a view from Albania”. Milan, Italy, 10 October 2007 40

Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the General Assembly of the Dealers Association. Tirana International Hotel, 25 October, 2007 53

Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the Forum organized by the Bank of Albania, jointly with the World Bank, “Trends in foreign reserve management”. Tirana International Hotel, 29 October 2007 58

Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the Joint Press Conference of the Ministry of Finance, the Bank of Albania and the International Monetary Mission following the conclusion of the discussions on the fourth review under the IMF-supported program. 14 November 2007 62

Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the Workshop “Economic research in South-Eastern Europe”. Tirana International Hotel, 15 November 2007 65

Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the press conference following the Bank of Albania Supervisory Council’s decision on increasing the key interest rate by 25 basis points. Tirana, 27 November 2007 68

Opening Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the VII Annual Conference of the Bank of Albania “Monetary Policy Strategies for Small Economies”. Tirana International Hotel, 6 December 2007 72

Speech by Mr. Ardian Fullani, Governor of the Bank of Albania
At the signing ceremony of the Memorandum of Understanding between the Bank of Albania and the Ministry of Education and Science. “Qemal Stafa” High School, 13 December 2007 79

Papers published in the Economic Bulletins of 2007 82

Labor productivity in Albania: The process of sectors’ convergence 84

The Main Methods of Temporal Disaggregation 97

Bank of Albania news over October - December 2007 109

Legal events over October - December 2007 116

Bank of Albania management 121

List of all entities licensed by the Bank of Albania 122
## Review of the Monetary Policy of the Bank of Albania for the second half of 2007

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Some main economic indicators in annual terms (in %)</td>
<td>10</td>
</tr>
<tr>
<td>2</td>
<td>Some main indicators of countries in the region (in %)</td>
<td>12</td>
</tr>
<tr>
<td>3</td>
<td>Contribution of items to annual inflation (in %)</td>
<td>14</td>
</tr>
<tr>
<td>4</td>
<td>Annual change rates of some PPI and CPI components of ‘processed foodstuffs’ (in %)</td>
<td>17</td>
</tr>
<tr>
<td>5</td>
<td>Annual changes in the import prices by commodity groups</td>
<td>18</td>
</tr>
<tr>
<td>6</td>
<td>Accomplishment of quantitative objectives</td>
<td>27</td>
</tr>
<tr>
<td>7</td>
<td>Indicators of credit portfolio</td>
<td>29</td>
</tr>
<tr>
<td>8</td>
<td>Indicators of trade balance for 2006-2007</td>
<td>30</td>
</tr>
<tr>
<td>9</td>
<td>Imports and exports (in million of EUR) and the annual growth by commodity groups</td>
<td>31</td>
</tr>
<tr>
<td>10</td>
<td>Contribution of the production growth by sectors to the real GDP growth (in %)</td>
<td>31</td>
</tr>
<tr>
<td>11</td>
<td>Performance of investment indicators</td>
<td>33</td>
</tr>
<tr>
<td>12</td>
<td>Annual growth of income and spending, fiscal balance and deficit financing in nominal terms</td>
<td>35</td>
</tr>
<tr>
<td>13</td>
<td>Average wage, minimal wage and economic assistance (in thousands of ALL)</td>
<td>37</td>
</tr>
</tbody>
</table>

## Labor productivity in Albania: The process of sectors’ convergence

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Aggregate productivity growth decomposition</td>
<td>91</td>
</tr>
<tr>
<td>2</td>
<td>Decomposition of aggregate productivity growth by sectors and effects</td>
<td>92</td>
</tr>
</tbody>
</table>

## The Main Methods of Temporal Disaggregation

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Quarterly figures of GDP (in million lek) derived from M3 and total volume of sales</td>
<td>107</td>
</tr>
</tbody>
</table>
Review of the Monetary Policy of the Bank of Albania for the second half of 2007

Chart 1 Total inflation and core inflation (annual changes in %) 13
Chart 2 Alternative measures of net inflation: Inflation excluding foodstuffs (left-hand side) and inflation excluding foodstuffs and administered prices and excluding foodstuffs and services (right-hand side) 13
Chart 3 Contribution of items to annual inflation (in %) 14
Chart 4 Annual inflation of ‘non-foodstuff consumer goods’ and ‘durable consumer goods’ (right-hand side) 15
Chart 5 Annual rates of core and total inflation (left-hand side), tradable and non-tradable (right-hand side) (in %) 16
Chart 6 Annual change in the index of import unit values, in the index of EU export unit values and the exchange rate 18
Chart 7 Annual change of domestic grain price (left-hand axis), foreign grain price and the exchange rate (right-hand axis) 19
Chart 8 Annual change of oil price in the country and abroad and the exchange rate 19
Chart 9 Interest rates in the money market 21
Chart 10 Yields in the primary market 22
Chart 11 Weighted-average interest rates of 12-month deposits (monthly data) 23
Chart 12 Difference between weighted-average interest rates of lek and euro deposits (monthly data) 23
Chart 13 Weighted-average interest rate of new credit (monthly data) 24
Chart 14 Annual changes of lek in nominal effective terms (NEER) and in real effective terms (REER), Daily performance of lek/euro and lek/usd 25
Chart 15 Annual growth rate of broad money (M3) and M1 (in %) 26
Chart 16 Performance of M2 aggregate (annual growth rate in real terms) 26
Chart 17 M3 structure—left-hand side; the difference between interest rates and the credit structure 27
Chart 18 Performance of credit portfolio 28
Chart 19 Foreign currency structure of credit by groups and the influence of the difference between lek/euro interest rates in this structure 29
Chart 20 Contribution by purpose of credit use to the quarterly portfolio growth (in %) 30
Chart 21 Indicators of energy balance sheet 32
Chart 22 Main fiscal indicators 33
Chart 23 Budget spending and revenue 34
Chart 24 Performance of unemployment and employed workers’ indicators 36
Chart 25 Performance of wages in industry and construction 37
Chart 26 Performance of average wage in the public sector (annual growth in %) 37

Labor productivity in Albania: The process of sectors’ convergence

Chart 1 Labor productivity by sectors, 1996-2005 86
Chart 2 Labor share by sectors to total employment 87
Chart 3 Real wages by sector 87

The Main Methods of Temporal Disaggregation

Chart 1 Quarterly GDP (in million lek) 104
Chart 2 Total volume of sales (in million lek) 104
Chart 3 Quarterly GDP with and without seasonality (in million lek) 104
Chart 4 Quarterly GDP (in million lek) 105
Chart 5 Quarterly GDP development (in million lek) 105
Chart 6 Difference rates between INSTAT and IMF figures 105

Bank of Albania
GOVERNOR’S SPEECH

The Albanian economy recorded a positive performance during 2007 being characterized by a stable annual growth in line with the projections, contained inflation and further consolidation of financial stability. The preservation of optimal macroeconomic parameters during this year required high attention to developments in the global markets and in Albania, prudent analysis of these developments and the timely undertaking of preventive measures aiming at avoiding negative implications in the medium run. Preliminary projections provide evidence for the continuity of the current economic growth during 2008 while the Bank of Albania remains cautious of the domestic and foreign developments in order to ensure the achievement of the 3% inflation target.

The Albanian economy continues to grow at stable rates and in line with the projections. Real economic growth for 2007 is estimated to be about 6% or the same as the previous year. Transportation and telecomunication, trade, hotels and restaurants and industry were the main contributors to this growth. The more intensive activity in these sectors has offset the slowdown in construction. Despite the high demand for investments in real estates there has been an annual dropping of new constructions by 19%. The Bank of Albania re-emphasizes the need for undertaking structural reforms in agriculture, in order to enhance the efficiency and production in this sector and reduce the extent and effects of external shocks related with agricultural products in the medium run.

Average annual inflation rate marked 2.9% in 2007 being close to the Bank of Albania target of 3%. In average terms inflation target was reached despite the considerable fluctuations between the quarters as a result of supply-side factors’ shocks which originated mainly from outside our economy and could not be forecasted earlier. Energy crisis, the rising oil and grain prices, and the import prices hike were the main supply factors to have led to higher inflation rates during August-September 2007. At the same time on the demand-side there has been a continuous growth of credit to the private sector. Although in the last two years it has grown at lower rates it remains a potential risk factor for achieving the inflation target.

In response to these developments and to the extent of their actualization in future inflation rates the Bank of Albania deemed it necessary to raise the key interest rate three times during 2007, by 75 basis points to 6.25%. By means of these decisions the Bank of Albania has aimed to mitigate expected inflationary pressures in economy in order to preserve the medium-term stability of consumer prices.
The developments in the external sector of economy provide evidence for the further growth of domestic demand. Despite the positive performance of exports, trade deficit increased by 27% in annual terms accounting for 28% of the GDP.

The second half of 2007 was characterized by a normal performance of budget spending and by the observance of new fiscal policy objectives announced at the beginning of the second half of the year in terms of revenues. According to the data made available by the Ministry of Finance the fiscal balance as of end November ended in a surplus of ALL 4.7 billion compared with the projected deficit of ALL 25.9 billion. The main reason behind this difference is the capital spending being only 3.4% higher than the same period the previous year.

The monetary developments in economy during the last quarter of 2007 were in line with the performance of real economic activity and observed the tendencies projected in the monetary programme. Broad money growth was characterized by a stable growth rate mainly supported by the maintenance of high lending rates to the private sector by the banking system.

The appreciating tendency of the lek to other foreign currencies observed in the third quarter of 2007 continued to be present in the last quarter both in nominal and real terms. It reflects the macroeconomic stability in the country, the increasing difference of interest rates between the lek and foreign currencies and the comparable inflation levels to our main trading partners. However, compared with the previous year, the lek fluctuated more during 2007 as a result of the developments in the international markets and the more active participation of domestic agents in the foreign currency market.

Although the credit growth rates have been continuously dropping in the last two years they remain high at about 48.5% as a result of the private sector’s high demand for credit and the commercial banks’ willingness to meet this demand. The share of credit to economy to the GDP grew considerably during 2007 by 8.8% accounting in December for 30%.

Worth considering is the fact that the high growth rates of credit portfolio represent a normal process for a developing economy like Albania, which is in need for further financial intermediation deepening. What is important in this process is that the credit growth is kept under control in order to prevent the jeopardy to price stability and at the same time ensure its soundness and avoid certain undesired implications to financial stability in the country. The commitment of the Bank of Albania in this context has been and remains at the maximum. Apart from the macro prudential measures taken at the beginning of 2007 for reducing the credit growth and maintaining its quality the beginning of 2008 marked remarkable progress in preserving financial stability with the establishment of Credit Registry.

In 2007 we were again witnesses of the vital importance to the entire economy of the financial system, of the extent and new formats the financial
crises may appear in as a result of the transformation of risk and the high velocity and level of their spreading due to the globalization of financial markets. Although our financial system does not seem to have been affected by these developments they have had our utmost attention in order to precede similar developments in the future when our markets become more sensitive to external shocks as a result of their integration and further deepening.

In conclusion I would like to re-emphasize the Bank of Albania commitment to achieving price stability. The Bank of Albania remains committed to timely and properly react to the added inflationary pressures or to the jump of inflationary expectations beyond our inflation target. I would also like to highlight that the anchoring of inflationary expectations is a duty and responsibility to be shared by all the decision-making institutions to the best of our work and joint success towards achieving long-term stability.
I. WORLD ECONOMY

Global economic growth rate slowed down in the last quarter of 2007. US economy and some industrialized economies showed signs of economic slowdown while developing countries continued to play the main role in the global economic growth. The turbulences in the US credit market, which went through a hard time in summer 2007, and the rise in energy and foodstuffs prices have affected the performance of world economy and the international financial markets.

The accelerated increase of inflation, mainly because of the rise in the oil and some agricultural products’ prices, may affect the demand as a result of the decreased purchasing power. Oil price in US dollar has risen following the high demand of developing countries, the stagnation in the oil supply and the geopolitical tensions. Agro-foodstuffs prices have risen as a result of the temporary reduction of supply, after the drought and the additional use of some agricultural products in the bio fuel industry.

### Table 1 Some main economic indicators in annual terms (in %)

<table>
<thead>
<tr>
<th></th>
<th>GDP annual growth, Q4</th>
<th>Unemployment rate in December</th>
<th>Inflation in December</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>2.5</td>
<td>5.0</td>
<td>4.1</td>
</tr>
<tr>
<td>Euro area</td>
<td>2.3</td>
<td>7.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Italy</td>
<td>1.9 *</td>
<td>6.0**</td>
<td>2.8</td>
</tr>
<tr>
<td>Greece</td>
<td>3.6</td>
<td>8.2**</td>
<td>3.9</td>
</tr>
<tr>
<td>Japan</td>
<td>1.8</td>
<td>3.8</td>
<td>0.7</td>
</tr>
</tbody>
</table>

* For the third quarter
** For September

Source: Eurostat, Report for January, Eurostat estimations of the unemployment rate and the CPI, December

US ECONOMY

US economy recorded high annual growth rates in the third quarter of 2007. Fixed investments of the companies and the increase of exports as a result of the US dollar depreciation provided the main contribution to the increase of the GDP. Consumption which has not been yet affected by the declining house prices played an important role in the growth of demand. Other indicators of the economy provide evidence for a slowdown in investments and an unsatisfactory performance of construction in the last quarter of 2007. The decreased sales of houses and the drop of investments in houses have aggravated the performance of real estates market. Unemployment rate increased in the last quarter. Inflation on the other hand continued to increase reaching 4% in the last quarter of 2007 from 2.4% the previous quarter. During September-December 2007, the Federal Open Market Committee lowered the key interest rate by 100 basis points. The aggravation of financial markets conditions and the unsatisfactory performance of house and labour market led to the further decrease of key interest rate by 1.25% to 3% in January 2008.
EURO AREA ECONOMY

During the third quarter 2007 gross domestic product grew by 0.8% compared to the previous quarter. Household consumption increased by about 0.5%, while gross fixed investments grew by 1.2%, following an unsatisfactory performance in the previous quarter as a result of the drop in investments in construction. Business investments and exports have been also decreasing, in particular in the last months of the year as a result of the appreciation of the euro and the reduced US demand. Short-term economic indicators for the last quarter of 2007 indicate a slowdown in the economic activity. The turbulences in the financial markets may affect the Euro area economy and aggravate the performance in some countries’ house market, construction and consumer spending. However the improvement of labour market conditions and the high profitability of companies lower the negative impact of turbulences on the gross domestic product.

Annual inflation rate reached 3.1% in December. The pressures in the global markets for energy and foodstuffs have led to the increase of inflation. According to the forecasts, the inflation rate will be 2.3% in 2008. ECB Governing Council changed twice the key interest rate during 2007 to 4%. Despite the further decline in the house market, the rise in the oil and foodstuffs prices and the continuous turbulences in the financial markets, the Governing Council has left the key interest rate unchanged for January and February 2008. ECB monetary policy continued to have as its main priority the anchoring of medium-term inflation expectations in line with the maintenance of price stability.

I.2 ECONOMY OF ALBANIA’S TRADING PARTNERS

ECONOMY OF ITALY AND GREECE

During the first half of 2007, gross domestic product of both countries recorded a high growth rate. The components of domestic demand, fixed capital investments and private consumption provided the main contribution to the economic growth. Employment grew as a result of the economic growth. During the second half of 2007 consumer spending and investments grew at slower rates. Consumer spending was mainly affected by the price rise of energy and foodstuffs as well as by the tightening of credit conditions. The appreciation of the euro and the slowdown in the markets led to the increase of exports at a lower rate than the imports. The main factors to have contributed to the deepening of Greek current account deficit are the higher trade deficit, the higher interest payments and the reduction in the current transfers’ surplus. Current account deficit of Greece was financed by the capital inflows.

ECONOMY OF FORMER YUGOSLAV REPUBLIC OF MACEDONIA (FYROM)

FYROM’s economic activity remained stable throughout 2007. GDP for 2007 and 2008 is projected to grow by 5%. In annual terms, gross domestic
product grew by 4.2% in the third quarter of 2007. Transportation and telecommunication and wholesale and retail trade had a positive performance. During January-October, foreign trade increased by 26%. The import of energy and the export of iron and steel provided the main contribution to the increase of imports and exports. During this period, trade deficit increased by 20%. Despite the higher foodstuffs prices, average annual inflation rate is forecasted at 2% for 2007 and 3% for 2008. Fiscal position continues to improve, while foreign reserves have increased and key interest rate remains low.

ECONOMY OF TURKEY

Turkey’s economic activity continued to grow moderately in the last quarter of 2007, although the growth rate was higher than the previous quarter. Gross domestic product grew by 5.1% in 2007. The tightening monetary policy and the worldwide aggravated situation in terms of lending restrained the growth of domestic demand which was mostly supported by the increase of exports. Deficit on current account was pushed by the more rapid increase of imports compared with exports. The disinflation process slowed down as a result of the price rise of energy, foodstuffs and administered prices. The control of core inflation allowed the decrease of interest rates by 2% during September-January 2008. Inflation rate reached 8.4% in 2007 from 9.7% that was recorded in December the previous year.

Table 2 Some main indicators of countries in the region (in %)

<table>
<thead>
<tr>
<th>Countries</th>
<th>GDP Annual Growth</th>
<th>Annual inflation</th>
<th>Unemployment</th>
<th>Fiscal balance (as a share to GDP)</th>
<th>Current account (as a share to GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>1.7</td>
<td>1.3</td>
<td>1.9</td>
<td>1.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Greece</td>
<td>3.9</td>
<td>3.6</td>
<td>3.2</td>
<td></td>
<td>8.5</td>
</tr>
<tr>
<td>Macedonia</td>
<td>5.0</td>
<td>5.0</td>
<td>2.0</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td>Serbia</td>
<td>6.0</td>
<td>5.0</td>
<td>6.4</td>
<td>8.8</td>
<td></td>
</tr>
<tr>
<td>Croatia</td>
<td>5.6</td>
<td>4.7</td>
<td>2.3</td>
<td>2.8</td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td>5.0</td>
<td>5.3</td>
<td>8.2</td>
<td>4.6</td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF, assessments.
World Economic Outlook, October 2007.

II. INFLATION DEVELOPMENTS

II.1 CONSUMER PRICES

In the last quarter of 2007 annual inflation marked the same rate of 3.6% as in the previous quarter. Following the high rate in October (4.2%), inflation rate dropped in the last two months of the year being close to the Bank of Albania target. This inflation trend was maintained in the first months of 2008 when inflation marked 3%. Compared with the last quarter 2006, average inflation rate was about 1% higher. Supply and demand-side factors exerted pressure on the increase of inflation although more moderately relative to the third quarter of 2007.
The performance of inflation in the last quarter of 2007 reflected the high level of some basic foodstuffs prices and the further rise in the oil price. The improved weather conditions favoured the domestic supply by exerting pressure on the drop of some seasonal unprocessed foodstuffs’ prices. On the other hand, the situation with the prices of some other foodstuffs, mainly processed ones (among which bread is the main product), remained unclear as a result of the dependence of these prices on import prices, which continued to record high inflation rates. However, there was a temporary stabilization. In addition, the further price rise of fuels, along with the energy crisis, caused the producer cost to rise, exerting further pressure on the consumer price rise. In the third and last quarter of the year, the inflation curve shifted downward as a result of the no longer presence of energy price and tobacco excise rise effect undertaken during 2006. This effect offset the supply-side factor by some per cent.

The alternative measures of net inflation indicate that the high inflation rate was mainly a result of the high contribution of processed foodstuffs’ price rise. On the other hand, the energy price rise did not occur in mid-2007 as projected. Consequently, the contribution of administered prices to total inflation rate was almost inconsiderable. Net inflation, excluding foodstuffs and administered prices marked 0.7% and 3.5% in the third quarter, in a period when total inflation was 3.6%.

‘Processed foodstuffs’, ‘unprocessed foodstuffs’, ‘housing’ and ‘services’ formed about 97% of annual inflation rate in the last quarter of 2007. Annual inflation for this period was mainly determined by the inflation of ‘processed
foodstuffs’. The latter recorded an annual inflation rate of 2.4% in this quarter while during the last eight years this item’s annual inflation has almost recorded inconsiderable rates. The high price rise in this item starting from August 2007 was mainly a result of the domestic price rise of bread. In addition there has been a rise in the prices of dairy products and oil, which reflect the higher producer costs following the energy crisis in the country and the price rise of these types of goods in Albania’s main trade partners (Italy and Greece).

Annual inflation of ‘unprocessed foodstuffs’ was 0.5%, maintaining almost the same rate as in the previous quarter. Within this item the price of vegetables dropped by 0.4% in annual terms. This drop may have also been caused by the statistical effect of the high comparative base with the last quarter of the previous year when inflation marked positive rates at end-year. The developments in this item’s prices are closely related to the agricultural domestic production which has influenced on the increase of domestic supply as a result of the favourable weather conditions. These favourable developments of domestic supply have reduced the inflationary pressures transmitted by the high demand characterizing this period of the year and by the high import prices.

The other items in the basket provided a moderate contribution to the 0.7% inflation in the last quarter. Annual inflation of ‘housing’ and ‘administered goods’ fluctuated around 4-5% until September while for the rest the average annual inflation was 0.8%. This decrease was also influenced by the statistical effect of the high comparative base with the last quarter of the previous year.

‘Services’ inflation continues to record high upward rates. This item’s annual inflation rate marked 4% in December. On average terms, inflation rate for the second half of 2007 increased by 1.5% compared with the first half of 2007 and the same period the previous year. This increase has to a large extent contributed to the rise in the annual average inflation rate for 2007.
extent reflected the price rise in hotels and restaurants, which had to face additional costs deriving from the use of alternative sources of energy.

Despite the price rise in fuels, the contribution of ‘non-foodstuff consumer goods’ to the last quarter inflation was inconsiderable. The same occurred with ‘durable consumer goods’ which have recorded negative inflation rates for a long period of time, most evident in the last quarter. The influence of these items’ inflation fluctuations on the total inflation rate will be more significant in the new inflation basket where both these items have a larger share in the average consumer spending.

II.2 OTHER INFLATION MEASURES

Core inflation. The increasing inflationary pressures in economy were reflected in high annual rates of core inflation in the second half of 2007. Core inflation marked 3.1% and 3.7% in the third and last quarter, reaching the highest rates in the last five years. Average core inflation rate was 2.6% in 2007 or 0.8% higher than the previous year. The constant price rise in some items\textsuperscript{7} which share a considerable weight in the consumer basket are believed to have contributed to the high core inflation rates. This trend caused the permanent inflation component\textsuperscript{8} to increase in the medium term while its average annual contribution to total inflation was about 2% in 2007\textsuperscript{9}. The performance of core inflation provides evidence for the presence of non-temporary inflationary pressures which have exerted pressure on the total rise of domestic consumer prices in the second half of the previous year.

Inflation of tradable and non-tradable goods. The price rise of tradable goods which are more sensitive to changes in the foreign markets’ prices played the main role in the increase of annual inflation during the second
half of 2007. Annual inflation of this item was 5.3% in the last quarter which is the highest rate from 2002. The increasing inflationary pressures deriving from outside our economy were reflected directly in the total inflation through the price rise of tradable goods. The volatile prices of this item largely depend on the prices of ‘foodstuffs’ in the consumer basket of Greece. The rise in the prices of oil, gas and energy in the international markets have influenced on the prices of imported raw materials and intermediate goods, causing the domestic producer and services costs to increase. During the last quarter there was a continuous drop of the contribution of non-tradable inflation of goods and services to total inflation. Its annual rate reached 2.2%, while being 3.4% in the previous quarter. This performance of non-tradable inflation may reflect the control of upward demand rates. Although the average annual rate of non-tradable inflation for 2007 was relatively high (3.6%), the inflation of this item has shown a downward trend since the beginning of 2005, dropping from about 7% to 2%.

II.3 PRODUCER PRICES

The changes in the Producer Price Index (PPI) are expected to provide their influence on the performance of consumer prices. However, based on the available data over the years there has not yet been identified a statistical relation between producer and consumer prices. The reason might be the fact that domestic production has not been a determinant in the supply of goods in the Albanian market, thus not having a direct impact on the consumer prices. On the other hand, the transmission of costs to the final consumption chain may have also been infringed by other factors such as the increase of competition in the retail trade and the lags caused by the transmission.

The increase of producer prices in 2007 was most evidently transmitted to the consumer prices. One reason is that the rise in the consumer prices has to a large extent derived from the price rise in goods (in particular of foodstuffs, oil,
gas and energy), while the price of services did not undergo significant changes. The unfavourable situation with the prices of goods in the global market had a direct impact over the prices of goods in the retail market (consumer prices) and over the domestic raw materials (producer prices). The aggravated situation with the energy in the second half of 2007 had a direct impact over the fall of productivity, by exerting pressure on the further increase of producer prices. Both the producer price and the import prices channels have exerted pressure on the increase of consumer prices. The fact that the production of processing industry is mainly supported by the imported raw materials caused this sector to record the largest annual rise of producer prices from 14.4% in the first quarter to 5.2% in the third quarter. On average, the producer prices for this sector have increased by about 9%, while last year’s increase was below 1%

Considerable increase in this industry was mainly recorded in foodstuffs, and textiles and clothing, which was also reflected in the performance of consumer prices. The annual change in the prices of production, distribution of energy, gas and water and extracting industry recorded downward rates.

Table 4 Annual change rates of some PPI and CPI components of ‘processed foodstuffs’ (in %)

<table>
<thead>
<tr>
<th></th>
<th>PPI Total processing industry</th>
<th>PPI Foodstuff processing industry</th>
<th>PPI Processed foodstuffs</th>
<th>CPI Extracting industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1:06/Q1:05</td>
<td>0.9</td>
<td>0.7</td>
<td>-0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Q2:06/Q2:05</td>
<td>-0.1</td>
<td>-0.5</td>
<td>-4.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Q3:06/Q3:05</td>
<td>0.4</td>
<td>1.2</td>
<td>-2.1</td>
<td>1.1</td>
</tr>
<tr>
<td>Q4:06/Q4:05</td>
<td>-0.7</td>
<td>1.5</td>
<td>1.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Q1:07/Q1:06</td>
<td>2.1</td>
<td>14.4</td>
<td>2.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Q2:07/Q2:06</td>
<td>3.3</td>
<td>7.3</td>
<td>11.3</td>
<td>2.9</td>
</tr>
<tr>
<td>Q3:07/Q3:06</td>
<td>3.8</td>
<td>5.2</td>
<td>12.8</td>
<td>7.3</td>
</tr>
<tr>
<td>Q4:07/Q4:06</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania estimations

II.4 IMPORT PRICES

Import prices may affect inflation in the country through the price of imported consumer goods and the influence on the business cost. The developments in the prices of consumer and producer goods’ provide evidence for the inflationary influence of import prices during 2007. Import prices measured by the index of import unit values recorded an average annual increase of 8% during the first nine months of 2008. The historical average of this index’s annual increase was 1.2% in 2001-2006.

The upward trend of the index of import unit values for January-September ‘07 was present in both the consumer goods and the producer raw materials. The consumer basket items of ‘processed foodstuffs’ and ‘non-foodstuff consumer goods’ recorded average annual changes of the unit price by 4.5 and -0.4% in the first nine-month period.

The price rise of raw materials’ import was shown in the producer price index which increased by 3.1% for the same period. From the Business Confidence
Survey it results that the increase of producer cost was about 2 times higher this year than the historical average.

Table 5 Annual changes in the import prices by commodity groups

<table>
<thead>
<tr>
<th>Table 5 Annual changes in the import prices by commodity groups</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consumer goods</strong></td>
</tr>
<tr>
<td><strong>2001-2006</strong></td>
</tr>
<tr>
<td>Animal products</td>
</tr>
<tr>
<td>Vegetable products</td>
</tr>
<tr>
<td>Animal and vegetable fats and oils</td>
</tr>
<tr>
<td>Prepared foodstuffs, beverages and tobacco</td>
</tr>
<tr>
<td>Textiles and textile articles</td>
</tr>
<tr>
<td>Footwear, headgear etc.</td>
</tr>
<tr>
<td><strong>Raw materials</strong></td>
</tr>
<tr>
<td><strong>2001-2006</strong></td>
</tr>
<tr>
<td>Mineral products</td>
</tr>
<tr>
<td>Products of chemical industry</td>
</tr>
<tr>
<td>Wood and articles of wood</td>
</tr>
<tr>
<td>Base metals and articles thereof</td>
</tr>
</tbody>
</table>

Source: INSTAT

The developments in the lek import prices are a combination of the performance of foreign prices in the currency of the exporting country and the exchange rate. Albania’s trade activity with abroad has been oriented to the EU countries. Lek exchange rate to the euro has a definable influence. Starting from the second half of 2006 the slight depreciation of the lek to the euro has allowed the transmission of inflationary pressures from foreign prices.

The prices of basic goods in the global market, such as grains and oil, have risen rapidly during the last 2-3 years. The rise of these prices partly reflects the growth of demand of some developing countries such as China, India etc., and the influence of some factors which have limited the supply of these goods. The reduction in the supply of grain has been affected by the drop in production – as a result of the drought in the large production countries of grain – and the reduction of the stock.

Apart from the reduced stock, the reduced free production capacities and the geo-political risks have led to the price rise of oil. The price of wheat in the global market went up by 32% during this year, compared with the average annual rise by 7% during 1999-2006. Given the absence of domestic production and the difficult energy situation, this development influenced on the price rise of bread and its products in the country.

Annual inflation of bread and grains index increased by 10% in 2007 compared with the 8-year stable period. This item contributed to the annual
rate of the second half by about 1.5% on average. The secondary effect of this increase was also shown in the prices of dairy products.

The appreciation in nominal terms of the lek to the US dollar by 8% has kept the full transmission of the price rise of grains in the country under control (the price at home raised by as much as 1/3 of the price abroad).

Oil price in the global market has been dropping on average terms; however there have been considerable fluctuations between the quarters. While in the first part of the year it recorded negative upward rates in the last quarter of 2007 the price rose by 51% annually. The dynamics of the oil price change in the global market was followed by the price of this product in the country. Oil price has remained almost unchanged in the first nine-month period and rose by 10% in the last quarter. As a result of the strong position of the lek to the US dollar the extent of this price change has been smaller than outside Albania. In nominal terms, the lek appreciated by 12% to the US dollar in the last quarter. However, the risk of further oil price rise remains present considering the uncertainty related with the performance of energy situation in the country.

II.5 MONETARY POLICY DECISIONS AND INFLATION TARGET

Average annual inflation for 2007 marked 2.9%, which is almost close to the 3% target of the Bank of Albania. The inflation objective was reached in average terms, despite the considerable fluctuations between the quarters as a result of the supply-side shocks deriving mainly from outside our economy. The influence of the monetary policy in reaching the inflation target should be analyzed in retrospective. It is widely acknowledged that monetary policy decisions affect the overall level of prices within a time period of 12-24 months. Hence, in order to assess the monetary policy effect on inflation for 2007, we need to analyze at least last year’s monetary policy stance.

In 2006 annual inflation of the following year was expected to increase and be within the upper half of the tolerance band (about 3-4%). In addition to the concerns related to the performance of domestic agricultural production, the energy crisis, the energy price rise and the oil price rise were assessed to continue to exert pressure on the increase of inflation during 2007. The
inflationary pressures deriving from the real economy could become significant under an accommodating monetary policy.15

In July and November 2006 the key interest rate increased by 25 basis points reaching 5.5% in November. Inflation was low at the beginning of 2006. However, the Bank of Albania assessed that the demand-side inflationary pressures were getting stronger. Both core inflation and non-tradable goods’ inflation displayed upward trend. Various economic indicators signalled the rapid growth of domestic demand. Banking loan continued to supply the demand of the economy, mainly the private sector’s, for money. In 2006, M3 grew by 16.7%. The rise in wages, in almost all sectors of the economy, was another development that could trigger inflationary pressures. In 2006, the wages rose by 15% on average compared with 11% and 7% in the previous two years. In light of the energy crisis, the rise in the energy price was expected to generate possible secondary effects in the increase of producer costs. The reduced appreciation of the lek to the main foreign currencies, in addition to the increasing use of the production capital, were possible risks that could lead to the increase of inflation in 2007. The increase of the key interest rate in July and November 2006 aimed to contain the demand-side pressures, transmit the institutional commitment of the Bank of Albania to maintain price stability in the medium run and anchor the inflationary pressures that could increase further as a result of supply-side shocks.

Forecasts of year 2006 for annual inflation were to a large extent actualized in 2007. The divergence between forecast in 2006 and actual average inflation in 2007 resulted 0.5%. This divergence came as a result of the non-rise of expected energy price and the lower influence than expected of the oil price rise in the international markets. The upward annual inflation was caused by the influence of foodstuffs prices, mainly of the price rise in bread. The Bank of Albania is trying to assess the duration of factors which influence on the annual inflation rate. In more concrete terms, the Bank will assess whether these factors are temporary or will extend to an indefinite period of time.

Since monetary policy is forward-looking as a result of the transmission mechanism lag, the inflation forecast and the projections for the performance of economy in the future are fundamental. The current economic conditions provide evidence for the growth of economic activity which has been followed by a larger demand for money. The low real interest rates encouraged the growth of credit. The increase of the key interest rate in 2006 allowed the reduction of the credit growth rates. However credit grew by 50.4% in 2007.

In addition to demand-side factors, the increase of producer costs as a result of the energy situation, the price rise of grains in the international markets, the oil price fluctuations and the domestic agricultural production exert pressure on consumer prices. The increase of inflation has mainly derived from the supply-side factors. The high increasing rates of inflation which has reached total inflation signal that the rapid growth of demand is leading to a pro-inflationary situation.
Considering these developments it becomes evident that the Albanian economy requires a more tightening monetary policy. During 2007, the Supervisory Council of the Bank of Albania raised the key interest rate three times by 75 basis points to 6.25%. These decisions aim to contain the expected demand-side inflationary pressures in economy in order to maintain the medium-term consumer price stability.

III. INFLATION DETERMINANTS

III.1 FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

III.1.1 Interest rates

Following the tightening monetary policy signals the interest rates continued to increase in the last quarter. The interest rates of lek denominated deposits increased considerably leading to the broadening of their difference with the interest rates of foreign currency denominated deposits. The interest rates of lek denominated credit increased at slower rates than of deposits and they fluctuate around the same average in the last two years.

In the last quarter of 2007 the short-term interest rates continued to reflect the tightening policy of the central bank signalled at end September and November. Open market operations consisted in the injection of liquidity of one-week maturity. The absence of liquidity was caused by autonomous factors.

These operations aimed to signal the orientation of the central bank monetary policy and they were held in the form of one-week reverse repo auctions with limited auction bid amount. The average interest rate in these operations was 6.35% in the last quarter from 5.81% the previous one. Lending interest rates in the interbank market fluctuated within the corridor re-set at end September and end-November after the increase of the key interest rate.

Unlike the previous quarter they showed lower fluctuation as a result of the more efficient provision of liquidity in the market. Weighted-average overnight loan rate marked 4.91% from 5.14% the previous quarter. In contrast the interest rates of one-week transactions increased to 5.92% from 5.70%. Total daily lending remained in the same levels of the previous quarter volume. It averaged ALL 2.2 billion being distributed almost equally between the overnight and weekly maturity term.

The results in the primary market were affected by both the interest rate changes and market factors. The primary market has swiftly reacted following
the increase of the key interest rate causing a parallel shift of T-bills’ yields. However, the latter fell again at the beginning of the present year. T-bills’ yields increased in October following the increase at end-September of the key interest rate by 25 points basis and fell slightly in November as a result of some unsuccessful bids with high yields.

Upon the second increase of the key interest rate at end November, the yields shifted further, this time with a higher magnitude than the monetary policy signal. In December the banks seemed to hesitate in investing in the T-bills’ primary market.

On one hand it brought the injection of liquidity while on the other the increase of the yields as all the bids resulted successful in order to reach the deficit domestic financing. At end December the yields reached 6.49% for the 3-month maturity and 8.41% for the 12-month maturity or 0.46% and 0.36% above the yields of November (prior to the increase of the key interest rate).

In the first two months of 2008, the T-bills’ yields in the primary market became stable and were close to the yields in November. Compared with the previous year the 12-month yields increased more rapidly than the 3-month yields, causing their curve to slope in 2007.

In the last quarter of 2007 the banking system preference to shift the portfolio toward 2-year bonds by dropping the T-bills’ preference was more evident. This tendency is in line with the domestic financing policy where the amount of issued bonds exceeds the matured ones. Considering the performance of domestic financing indicator at end year the participants in the auctions of 2-year bonds exerted pressure on its increase to 8.60%. This indicator fell again to the levels of November in January 2008 (8.35%). The yield of 3-year bonds increased by 0.65% in the last quarter; however this jump was mostly caused by the low participation in these auctions.
For the first time in December were issued bonds of 7-year maturity. What is to be highlighted in this development is not only the tendency of extending the debt terms, but also the participation of international financial institutions in the financing of public deficit. Albania’s satisfactory rating in terms of country’s risk by the relevant international institutions is expected to increase the interest of international institutions to invest in Albania\textsuperscript{19}.

The interest rate of lek denominated deposits increased significantly in the last quarter, transmitting the increase of the key interest rate to the public savings'. However the lek denominated liabilities have increased considerably starting from the third quarter as a result of liquid accounts inflow in December while time deposits grew relatively in similar terms as in the previous year.

Weighted-average interest rate of 12-month deposits reached 6.33% in December which is 0.63% higher than in September and 0.87% higher than the previous year, exceeding the margin signalled by the monetary policy.

The end of the year is usually characterized by commercials advertising high deposit rates. These commercials also aim to attract the workers’ remittances. Starting from the second half of the year the difference with the interest rates of euro denominated deposits (which share most of foreign currency denominated deposits) has increased and this fact is believed to have triggered the appreciation of domestic currency.
Following the growth of demand for lek denominated credit at the end of the year the interest rates increased to 14.1% in the last quarter from 13.1% in the previous one. The share of lek denominated credit remains low and the interest rates differ from one period to another depending on the lending distribution. On the other hand the enhanced competition in the banking system with respect to lending helped to maintain an average interest rate in lending regardless of the orientation of monetary policy. This performance has also brought a slight decrease of the difference between the interest rates of lek denominated deposits and credit during 2007. On average this indicator is estimated at 8.9% from 9.4% the previous year. This figure is lower for the euro. The interest rates of euro denominated credit increased during 2007 in line with the performance of euro interest rates in the international market, but their difference with the euro denominated deposits dropped to 5.25% from 5.50% in 2006.

III.1.2 The Exchange Rate

The appreciating tendency of the lek to the basket of foreign currencies which was shown in the third quarter of 2007 was more pronounced in the last quarter. In annual nominal effective terms, in the last quarter the lek appreciated to the foreign currencies by 4.0% on average, which is overwhelmingly higher than 0.9% it appreciated by the previous year. In addition, during the same quarter the real effective exchange rate has increased annually by 4.6% on average. This appreciation implies the decreased competition in relation to the international markets and higher attractiveness for imports of foreign goods. The appreciating performance of the lek both in real and nominal terms reflects the macroeconomic stability at home, the deepening of the interest rates difference and the comparable inflation rates with the main partners.
Compared with the previous year the lek showed higher volatility in 2007. The increased dynamics reflects the developments in the international markets and the more active participation of domestic agents in the forex market. The lek has been constantly appreciating to the US dollar by 12.4% on average, reaching 83.38 lek per US dollar at the end of the period. The performance of the lek to the US dollar was mainly influenced by the developments in the international markets where the US dollar has been constantly depreciating to the euro reflecting the hard time in the US economy. The average exchange rate of the lek to the euro was 121.69 lek/euro in the last quarter, appreciating by 1.6% in annual terms. Apart from the seasonal factors, the appreciation of the lek also reflected the effect of demand and supply for the European currency at the end year. The data for January 2008 show the termination of the seasonal effect and the return of the lek quotation close to average annual levels.

III.1.3 Monetary developments

The monetary developments in the last quarter of 2007 followed the tendencies envisaged in the monetary programme while being in line with the performance of real economy. The expansion rate of broad money in economy was stable being supported by the maintenance of high lending rates to the private sector by the banking system. However, the creation of monetary flows in the form of credit to the private and public sector was followed by the reduction of the banking system’s net foreign reserve which provided a negative contribution to the monetary expansion.

During the last quarter of 2007, annual growth of M3 aggregate slowed down to 13%, compared with 16.5% it grew by on average the first half of the same year. The moderate aggregates’ rates provide evidence for the stable domestic demand for money. This tendency becomes evident in the dropping
The downward trend of domestic money demand was also shown in the performance of monetary aggregates in real terms. Real M2 grew by about 2% in annual terms relative to the real M3 growth by 9.5%. The creation of lek monetary assets in the last quarter was triggered by the concentration of domestic borrowing by the public sector and the stable growth of lek denominated credit. In addition, the current dynamics of monetary aggregates partly evidences the shift of M3 foreign currency structure to the foreign currency component.

Macroeconomic factors exerted the main influence on the rate of money creation and consequently of deposits. However the demand for money in economy and the structure of annual flows are under the influence of interest rates difference.

The foreign currency structure of M3 aggregate maintained the tendency toward the foreign currency component. The share of foreign currency denominated deposits to M3 in the last quarter accounted for about 34% to the average of 30.5% in the first half of 2007.

The performance of public sector’s domestic borrowing in December provided the main influence on the return of currency to the banking system in the form of deposits. In monthly terms, lek denominated deposits grew by...
about 5.5% while currency outside banks grew by only 8.4%. In annual terms, currency outside banks dropped by 5%.

In addition, the more rapid growth of non-liquid assets was followed by the dropping of the ratio of currency outside banks to M3 to 20.4% from about 24% at the end of 2006\textsuperscript{23}. The implementation of the Bank of Albania monetary policy in 2007 took into consideration the accomplishment of quantitative objectives of the Bank of Albania.

**Table 6 Accomplishment of quantitative objectives\textsuperscript{24}**

<table>
<thead>
<tr>
<th></th>
<th>December ‘06</th>
<th>March ‘07</th>
<th>June ‘07</th>
<th>September ‘07</th>
<th>December ‘07</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net International Reserve of the Bank of Albania (in millions of USD)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Objective</td>
<td>1,343</td>
<td>1,318</td>
<td>1,337</td>
<td>1,459</td>
<td>1,593</td>
</tr>
<tr>
<td>Current</td>
<td>1,484</td>
<td>1,487</td>
<td>1,486</td>
<td>1,650</td>
<td>1,615</td>
</tr>
<tr>
<td>Difference (C-Obj)</td>
<td>141</td>
<td>169</td>
<td>149</td>
<td>191</td>
<td>22</td>
</tr>
<tr>
<td><strong>Net Domestic Assets of the Bank of Albania (in billions of ALL)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Objective</td>
<td>79</td>
<td>81</td>
<td>81</td>
<td>95</td>
<td>93</td>
</tr>
<tr>
<td>Current</td>
<td>78</td>
<td>74</td>
<td>73</td>
<td>59</td>
<td>76</td>
</tr>
<tr>
<td>Difference (C-Obj)</td>
<td>-1</td>
<td>-7</td>
<td>-8</td>
<td>-35</td>
<td>-17</td>
</tr>
<tr>
<td><strong>Net Domestic Credit to the Government (in billions of ALL)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Objective</td>
<td>342</td>
<td>339</td>
<td>347</td>
<td>346</td>
<td>357</td>
</tr>
<tr>
<td>Current</td>
<td>331</td>
<td>333</td>
<td>331</td>
<td>318</td>
<td>352</td>
</tr>
<tr>
<td>Difference (C-Obj)</td>
<td>-11</td>
<td>-6</td>
<td>-16</td>
<td>-28</td>
<td>-5</td>
</tr>
</tbody>
</table>

*Source: Bank of Albania*

---

**III.1.4 Credit to the private sector**

In the last quarter of 2007 the economy demand for money remained high. Although the credit growth rates slowed down it remains one of the main factors leading to the expansion of broad money in economy and becoming a potential factor which may generate inflationary pressures in the mid and long-term. Businesses provide the main contribution to the growth of credit, however during 2007 household credit maintained high growth rates contributing ever-increasingly to the growth of credit portfolio.
The growth rate of credit to economy continued to fall in the last quarter of 2007 to 50.3%. Although this figure represents the lowest growth rate of the last two years, the growth of credit portfolio during October-December 2007 reached the peak level of ALL 32.8 billion in absolute terms. Over half of this amount was extended in December. Despite the slowdown in the credit growth rates, the private sector’s demand for credit remains high. This fact is also evidenced by the commercial banks’ credit officers. In addition, the banks’ willingness to extend credit is high although the Bank of Albania took some prudential measures at the beginning of the year for keeping the growth of credit under control. The main reason why the banks’ policies with regard to lending may not have been duly affected by these measures stands in the fact that the Albanian banking sector provides relatively high return rates on equity. These returns maintain high levels even after the capital increases further in order to keep the adequacy ratio in the levels set by the Bank of Albania in case the credit growth exceeds the rate as defined in the regulation.

In 2007, the share of credit to economy/GDP grew considerably by 8.8%, accounting for 30% in December. Despite the risks related with the rapid developments in the credit portfolio, the level of credit to economy is yet low and the high growth rate of credit portfolio is a normal process for a developing economy. However, what is crucial in this process is that this growth is contained and sound in order to avoid undesired implications for the macroeconomic and financial stability in the country. The structure of credit by currency did not undergo significant changes.

Foreign currency credit dominates credit to economy. In the last quarter of 2007, it was characterized by higher growth rates (by 52.6% on average) than lek denominated credit (by 46.5% on average), contributing to the growth of credit to economy by 3 times higher. This type of credit distribution between the currencies was mainly favoured by the positive differences between the interest rate applied on the lek and the interest rate applied on the foreign currency, along with the stable appreciation of the lek in the last years.

The private sector remains the most credited, recording an annual growth of credit by 48.5%. Credit to business continues to provide the main contribution to this growth by 28.3%.

However, this contribution has been dropping under stable rates in the last two years as a result of higher growth rates of household credit to business credit. The lower growth of credit to business has been a result of the slower growth rates of credit for investment purposes and the more rapid growth of...
credit for working capital. The latter is characterized by short maturity terms and consequently the high levels of credit settlement affected the lower growth of outstanding credit.

In the second half of 2007 the business demand for credit to cover the liquidity needs, as confirmed by commercial banks’ officers, was higher than credit for investment purposes.

Table 7 Indicators of credit portfolio

<table>
<thead>
<tr>
<th>Credit portfolio (in billions of ALL)</th>
<th>Average annual growth in quarters (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>December '06</td>
</tr>
<tr>
<td>Credit portfolio (in billions of ALL)</td>
<td>287.5</td>
</tr>
</tbody>
</table>

Composition of credit portfolio in % (December '07)

| Credit to businesses | 64.2 | 54.15 | 54.0 | 50.6 | 46.6 | 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 | 65.5 |
| Consumption           | 9.1  | 121.78 | 101.2 | 100.9 | 106.7 | 61.5 |
| Real estates          | 26.7 | 58.62 | 67.4 | 66.3 | 62.4 | 76.8 |

The annual growth of credit to households was stable and remained in high levels, growing by 65% in 2007. This growth was supported by the high growth rates (by 77%) of the credit portfolio for real estates which dominates household credit. However, in the last quarter the growth of household credit portfolio was lower than the previous quarters. This reduction has resulted from the lower contribution provided by consumer credit. The survey carried out with credit officers indicates that although the demand for consumer credit is high the banks seem to be tightening the standards for extending this type of credit.
III.2 FOREIGN TRADE

Relative to the previous quarter, trade exchanges showed the trade deficit deepening by 20% in the last quarter, mainly triggered by the increase in the import of goods by 15%. The export of goods decreased by about 0.3%. The decrease of exports which has been characterizing the last two quarters of 2007 was lower than the previous quarter (5%). In annual terms, imports and exports grew by 29% and 18%. The level of imports’ coverage by exports of goods was 23%. Although this is the lowest figure for 2007, it is comparable with the same period the previous year (24%). In the last quarter trade deficit accounted for 28% of the GDP while the previous year it accounted for 24%.

<table>
<thead>
<tr>
<th>Table 8 Indicators of trade balance for 2006-2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q4 2006</td>
</tr>
<tr>
<td>Volume (in millions of EUR)</td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Imports</td>
</tr>
<tr>
<td>Trade balance</td>
</tr>
<tr>
<td>Annual change (in %)</td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Imports</td>
</tr>
<tr>
<td>Trade balance</td>
</tr>
</tbody>
</table>

Albania’s main trade partners from the EU remain Italy and Greece. Imports and exports of goods with these two countries account for 35% and 13% of total trade volume, which is about 2% lower than in 2006. Imports and exports of goods with Austria and Great Britain have increased; however, their share to total trade exchanges did not undergo significant changes (2%). Turkey, Macedonia and Croatia remain Albania’s main trade partners from the regional countries. Trade exchanges with Macedonia grew by 57% in 2007, mainly as a result of the growth of exports of goods (77%). The application of the free trade agreement with Macedonia is believed to have had a positive impact on the increase of exports. Croatia remains an important trade partner although the trade exchanges with this country recorded an annual drop by 17% in 2007. The volume of trade exchanges with China has also grown considerably in 2007 (46%).

Relative to the same period the previous year, during January-December 2007 the imports and exports of goods grew by 26% and 24%. ‘Minerals, fuels and energy’, ‘machinery, equipment and spare parts’ and ‘construction materials and metals’ recorded the highest growth in terms of imports. The growth in the import of ‘minerals, fuels and energy’ by about 50% mainly
reflects the increase in the volume and price of imported energy. Excluding the import of energy, the annual growth of the import of goods is 22%. The increase in the imports of capital goods observed throughout 2007 reflects the continuous increase of investments in the country. The imports of ‘foodstuffs, beverages and tobacco’ grew by 17%.

Table 9 Imports and exports (in million of EUR) and the annual growth by commodity groups

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foodstuffs, beverages, tobacco</td>
<td>506.00</td>
<td>17%</td>
<td>57.14</td>
<td>14%</td>
</tr>
<tr>
<td>Minerals, fuels, energy</td>
<td>508.04</td>
<td>51%</td>
<td>120.56</td>
<td>153%</td>
</tr>
<tr>
<td>Chemical and plastic products</td>
<td>318.39</td>
<td>18%</td>
<td>6.35</td>
<td>-5%</td>
</tr>
<tr>
<td>Leather and items thereof</td>
<td>62.79</td>
<td>18%</td>
<td>16.35</td>
<td>35%</td>
</tr>
<tr>
<td>Wood and paper</td>
<td>107.36</td>
<td>21%</td>
<td>24.37</td>
<td>20%</td>
</tr>
<tr>
<td>Textiles and footwear</td>
<td>315.79</td>
<td>11%</td>
<td>378.43</td>
<td>10%</td>
</tr>
<tr>
<td>Construction materials and metals</td>
<td>481.14</td>
<td>24%</td>
<td>123.83</td>
<td>17%</td>
</tr>
<tr>
<td>Machinery, equipment and spare parts</td>
<td>633.68</td>
<td>29%</td>
<td>31.38</td>
<td>26%</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>113.01</td>
<td>34%</td>
<td>23.27</td>
<td>24%</td>
</tr>
<tr>
<td>Total</td>
<td>3,046.20</td>
<td>26%</td>
<td>781.67</td>
<td>24%</td>
</tr>
</tbody>
</table>

Source: INSTAT

The growth rate of exports to EU and regional countries was 18% and 24%. The growth rate of exports to EU countries was similar to the previous year, while to the regional ones it grew by about 4%. ‘Textiles and footwear’ is the main item of the exporting industry (48.4%) however its export has decreased in the last years\(^10\). The exports of ‘construction materials and metals’ and ‘machinery, equipment and spare parts’ grew by 18% and 29%, although their share in the structure of exports has almost remained the same. The exports of ‘fuels, minerals and energy’ increased by 154%, reflecting the improvement of the hydro meteorological situation at home. This increase of exports helped to double the share of this item to total volume of exports relative to the previous year and reach 15% as of end 2007.

III.3 SUPPLY AND DEMAND-SIDE FACTORS

III.3.1 Production by sectors

Economic growth for 2007 averaged 6%, which is equal to the previous year. The biggest difference in the growth profile of these two years is the falling contribution of construction by 1.1%, the increase of transportation and telecommunication, trade, hotels and restaurants and industry.

Considering the lack of official data the real growth of agriculture is questionable. The projections for 2008 have been based on assumptions of the relative performance of sectors from 2007 to 2008\(^31\).

Table 10 Contribution of the production growth by sectors to the real GDP growth (in %)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>0.1</td>
<td>0.2</td>
<td>+ 0.1</td>
<td>0.5</td>
</tr>
<tr>
<td>Industry</td>
<td>0.9</td>
<td>1.1</td>
<td>+ 0.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Construction</td>
<td>1.4</td>
<td>0.3</td>
<td>- 1.1</td>
<td>0.8</td>
</tr>
</tbody>
</table>
Relative to 2006, domestic production of energy almost reduced by half in 2007. The imports of energy were about 3 times higher than the previous year. In 2007 the supply of energy (imports and production) was about 9% lower than the previous year. The businesses’ demand for energy has been growing while their consumption of energy increased by about 20% in 2007. Household consumption continues to receive most of the energy supplied (about 60%). In 2007 the ratio of technical and non-technical losses to total amount of energy supplied has been falling. The most considerable drop was recorded in technical losses.

III.3.2 Domestic demand and investments

DEMAND AND CONSUMPTION INDICATORS

The most recent data on the third quarter of 2007 provide evidence for the growth of domestic demand reflected in a number of economic indicators. Sales increased in all branches of services, where ‘trade, hotels and restaurants’ provided the main contribution by 65%. Apart from the growth of sales by 16%, this branch also recorded an increase in the number of employed and rise in wages by 7.8% and 11.5%. Retail trade increased by 9% relative to the previous quarter and by 15% to the same period the previous year. Households spent mainly on ‘foodstuffs, beverages and tobacco’, ‘clothes, footwear and leather’ and ‘household appliances’. The sales of these items grew by 3%, 17% and 18% respectively, relative to the previous quarter. Consumer demand grew by 17% relative to the previous quarter. The imports of televisions and washing machines grew most considerably by 34% and 27%. On the other hand, for the first time after several quarters in a row, the import of purchased vehicles dropped by 24%. Unlike the quarterly developments, the annual developments showed a decrease in the durable consumer goods by 6%. The import of washing machines and televisions fell by 1% and 14%, while the import of vehicles grew by 3%. All in all, the growth of consumer demand provides an explanation for the intensive activity in foreign trade, where the growth rate of the import of consumer goods has been recording 30% for several quarters. The increased consumer spending was mainly covered by the increase of income from labour, by the rapid expansion of lending to households and partly by workers’ remittances. Relative to the previous quarter, the rise of wages in both the public and private sector was followed by the increase in the number of employed by 0.2% and 1.1% respectively. In annual terms, credit to households grew by 62%. Its main items,
consumer credit and credit for real estates-purposes, grew by 50% and 75% annually. Workers’ remittances represent a considerable source of income for the Albanian consumer. Although they have dropped by 17% compared with the second quarter their annual increase for January-September 2007 was 22%. Consumer confidence continues to record negative values despite a slight improvement by 1.2% relative to the third quarter 2007.

INVESTMENT INDICATORS

Relative to the previous year, the performance of investment indicators for the third quarter of 2007 provides evidence for the increase of investments in all sectors of economy. Capital spending of the public sector almost doubled relative to the previous quarters’ spending. Foreign direct investments are another important factor to have helped the increase of investments in Albania. These investments reached EUR 216 million being several times higher than the previous quarters. The imports of intermediate and capital goods grew by 35% and 50% relative to the same period the previous year.

<table>
<thead>
<tr>
<th>Table 11 Performance of investment indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q2 ’06</td>
</tr>
<tr>
<td>--------</td>
</tr>
<tr>
<td>Import of intermediate goods (in millions of EUR)</td>
</tr>
<tr>
<td>Import of capital goods (in millions of EUR)</td>
</tr>
<tr>
<td>Government’s capital spending (in billions of ALL)</td>
</tr>
<tr>
<td>Foreign direct investment (in millions of EUR)</td>
</tr>
</tbody>
</table>

Source: Bank of Albania and Ministry of Finance

Banking system lending represents a considerable source for the financing of investments. In annual terms, credit extended to business for machinery and appliances and for real estates grew by 37% and 28%. The high demand of households and businesses to invest in real estates provides the explanation for the increase of banking system’s credit portfolio for real estates-purposes by 54.4%35. Despite the high demand for investing in real estates, construction recorded an annual drop by 19%36 in terms of new constructed buildings.

The pressure exerted by these two factors on the performance of House Price Index affected its increase by 24.8% relative to the previous quarter and by 16.7% to the previous year37. The information obtained from the Business Confidence Survey shows enhanced confidence in terms of investments and their financial situation.

III.4  FISCAL SECTOR

As of end November 2007, the performance of budget revenue was in the same line with the new fiscal policy objectives38, while budget spending has followed the usual realization trend.
In October and November 2007, there was a slowdown in the growth rate of budget revenue while spending increased moderately, thus not displaying significant change relative to the previous years. Unlike the projection of the Ministry of Finance, fiscal balance as of end November ended in a surplus of ALL 4.7 billion compared with the planned deficit of ALL 25.9 billion.

Relative to the previous year, budget revenue increased by 12%, being consistent with the average annual increase of the last seven years. Income from VAT provided the main contribution not only because of the weight it shares in total revenue but also because of the application of the additional ‘package’ that followed the new fiscal package which consisted in the removal of all facilities associated with the VAT previously. The application of the flat tax increased the amount of income collected from the tax on personal income by about 77% relative to the previous year\(^3\). In addition, this performance contributed to the total increase of revenue by 3%.

The rise in the excise duty for some goods was another element of the new fiscal package. The rise had a positive contribution to the annual growth of revenue. On the other hand, the reduction of customs duties deriving from the application of the SAA, the CEFTA and the Free Trade Agreement with Turkey provided a negative contribution to the increase of revenue.

Budget spending increased by 9% during the 11-month period, relative to the same period the previous year or by 3% above the annual average of the last 7 years. This increase attributes to short-term spending, mainly to spending on wages, insurance and pensions, being one of the main priorities of the new fiscal package. As of end November 2007 capital spending was far behind the projections of the Ministry of Finance, being only 3.4% higher than the same period the previous year.
In order to enable the efficient carrying out of unrealized spending during 2007, the Ministry of Finance issued in December a normative act which reallocates ALL 17.0 billion of budget spending. A considerable part of this amount has been channelled for the building of Durrës – Kukës motorway.

### Table 12 Annual growth of income and spending, fiscal balance and deficit financing in nominal terms

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>6%</td>
<td>16%</td>
<td>13%</td>
<td>11%</td>
<td>9%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>1.1 Income from tax and customs</td>
<td>1%</td>
<td>19%</td>
<td>9%</td>
<td>13%</td>
<td>10%</td>
<td>15%</td>
<td>14%</td>
</tr>
<tr>
<td>1.2 Other tax income</td>
<td>6%</td>
<td>24%</td>
<td>33%</td>
<td>13%</td>
<td>12%</td>
<td>6%</td>
<td>0%</td>
</tr>
<tr>
<td>1.3 Non-tax income</td>
<td>30%</td>
<td>-9%</td>
<td>-7%</td>
<td>-10%</td>
<td>-7%</td>
<td>-2%</td>
<td>54%</td>
</tr>
<tr>
<td>Spending</td>
<td>3%</td>
<td>10%</td>
<td>7%</td>
<td>9%</td>
<td>4%</td>
<td>3%</td>
<td>9%</td>
</tr>
<tr>
<td>2.1. Current spending</td>
<td>-2%</td>
<td>17%</td>
<td>12%</td>
<td>7%</td>
<td>5%</td>
<td>1%</td>
<td>11%</td>
</tr>
<tr>
<td>2.1.1 Spending on wages</td>
<td>17%</td>
<td>8%</td>
<td>8%</td>
<td>10%</td>
<td>10%</td>
<td>6%</td>
<td>10%</td>
</tr>
<tr>
<td>2.1.2. Spending on interests</td>
<td>-28%</td>
<td>13%</td>
<td>22%</td>
<td>-4%</td>
<td>-9%</td>
<td>-3%</td>
<td>-1%</td>
</tr>
<tr>
<td>2.1.3 Spending on insurance and pensions</td>
<td>8%</td>
<td>25%</td>
<td>18%</td>
<td>-15%</td>
<td>10%</td>
<td>8%</td>
<td>17%</td>
</tr>
<tr>
<td>2.2 Capital spending</td>
<td>21%</td>
<td>-9%</td>
<td>-15%</td>
<td>20%</td>
<td>-4%</td>
<td>17%</td>
<td>-2%</td>
</tr>
<tr>
<td>3. Fiscal balance (cumulative in millions of ALL)</td>
<td>-33,910</td>
<td>-31,487</td>
<td>-25,643</td>
<td>-24,791</td>
<td>-16,301</td>
<td>-1,467</td>
<td>4,707</td>
</tr>
<tr>
<td>3.1 Domestic financing</td>
<td>18,701</td>
<td>13,530</td>
<td>19,414</td>
<td>19,675</td>
<td>11,982</td>
<td>(5,808)</td>
<td>(6,819)</td>
</tr>
<tr>
<td>3.2 Foreign financing</td>
<td>15,210</td>
<td>17,957</td>
<td>6,226</td>
<td>5,115</td>
<td>4,319</td>
<td>7,275</td>
<td>2,109</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

One of the main objectives of the Government’s domestic borrowing policy for 2007 was the orientation to long-term debt instruments, which are represented by bonds of 2 to 7-year maturity. As of end November 2007, the Government debt stock in short-term instruments reduced by about ALL 21 billion. The financing of deficit with foreign resources maintained very low levels, sharing only 15% of Government net borrowing.

**IV. LABOUR MARKET**

**IV.1 EMPLOYMENT AND UNEMPLOYMENT**

Employment increased in the third quarter of 2007 causing the number of employed to reach about 936 thousand. Employment increased highly in industry and services. In annual terms, employment in industry increased by 7% as a result of the increase by 10% in extracting and processing industry. Employment index increased by 8% in services (hotels). The number of employed in construction fell in the third quarter, in parallel with the slowdown in the annual production and sales. Transportation continues to record a higher volume of sales while having a smaller number of employed.

The number of employed workers in the public sector fell by about 3 thousand in the third quarter of 2007 relative to the previous year while this number increased by 5 thousand people in the private sector. Annual employment
was higher in the private sector (about 4,700 persons). Unemployment rate reached 13.18% as of end the third quarter of 2007. In annual terms, this rate fell by 0.6% recording the highest fall of unemployment since 2004.

The more rapid fall in the number of unemployed than the increase in the number of employed was reflected in the drop of labour force. In annual terms, labour force reduced by 6 thousand in the third quarter of 2007. The higher occurrence of this phenomenon may result from the informal employment relationships, emigration and the inconsistency between supply and demand for labour. The implementation of professional programs for the jobseekers and the consolidation of professional training centres outside the capital city are expected to grow the labour supply in the following periods.

IV.2 PERFORMANCE OF WAGES

Wages continued to rise in the third quarter of 2007. However the rise in wages was dissimilar for the public and private sector. Unlike the two previous quarters the rise in wages was higher in the private sector than the private one. In annual terms the rise of average wages in the public sector was about 23% in the third quarter and about 12% relative to the previous quarter.

As of end the third quarter the average annual rise of wages was about 18%, which is the highest since 2002. Average wage rise in the private sector did not follow the significant rise of the second quarter and recorded an average annual rise of about 13% in the third quarter.

The rise in wages of industry and construction was higher by 23% and 19% respectively. Wages rose less in services by about 12%, which is 28% less than in the second quarter. Minimal wage approved and the unemployment benefits have not changed since 2006, while the number of unemployed workers provided with unemployment benefits has been decreasing.
Table 1

<table>
<thead>
<tr>
<th></th>
<th>Q1-06</th>
<th>Q2-06</th>
<th>Q3-06</th>
<th>Q4-06</th>
<th>Q1-07</th>
<th>Q2-07</th>
<th>Q3-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average monthly wage in the public sector</td>
<td>27,333</td>
<td>27,606</td>
<td>28,950</td>
<td>31,400</td>
<td>31,850</td>
<td>31,850</td>
<td>35,650</td>
</tr>
<tr>
<td>Monthly minimal base wage</td>
<td>11,800</td>
<td>11,800</td>
<td>14,000</td>
<td>14,000</td>
<td>14,000</td>
<td>14,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Monthly average assistance to families</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>full</td>
<td>2,442</td>
<td>2,455</td>
<td>2,477</td>
<td>2,883</td>
<td>2,621</td>
<td>2,536</td>
<td>2,482</td>
</tr>
<tr>
<td>partial</td>
<td>1,836</td>
<td>1,800</td>
<td>1,995</td>
<td>1,960</td>
<td>1,747</td>
<td>1,784</td>
<td>1,835</td>
</tr>
</tbody>
</table>

Source: INSTAT, Conjecture, third quarter 2007
NOTES

1 Starting from the beginning of 2007 the price has risen by more than 80%.
2 Annual inflation over the months: July 2.1%; August 4.2%; September 4.4%; October 4.2%, November 3.5%, December 3.1%.
3 Inflation rate for January was measured based on the new consumer basket (INSTAT, Consumer Price Index, January 2008).
4 Inflation rates of foodstuffs for Italy and Greece in the last quarter were high and stood at 3.8% and 4.6%.
5 Average annual increase for January ’99 – July ’07 is close to 0.
6 The reason behind the high inflation for ‘Housing’ at end 2006 was the considerable rise in dormitory tariffs paid by students, while for ‘Administered goods’ was the energy price rise by 14% in August 2007.
7 The price rise of bread and grains, including some other processed products as well.
8 Core inflation may be its appropriate approach.
9 Annual total inflation for 2007 was 3%.
10 Foodstuffs in the price index basket of tradable goods share about 70%.
11 Almost equal to the producer price index for the last quarter 2007, according to the Business Confidence Survey.
12 Foreign trade with EU countries shares 68% of the total.
13 Source: IMF Research Department, Products Division.
14 Average annual inflation for this group was 0.6% in 1999 – 2006.
15 Starting from March ’03 to June ’05, key interest rate has had a downward rate and remained unchanged at 5% (the lowest historical rate) until June ’06. Monetary aggregate M3 has been growing starting from 2003 and peaked in 2006.
16 It related with the fact that the energy price rise in 2005 did not affect the inflation rate as a result of its absence.
17 Annual core inflation and annual total inflation marked 3.6% in the last quarter of 2007.
18 In the third quarter there were also executed auctions of reverse repurchase agreements of one-month and three-month maturity.
19 In June, Moody Investors Service rated Albania B1 for the Government’s ability to pay the debts.
20 NEER – Nominal Effective Exchange Rate measured against two currencies according to an approximate share they have in trade with abroad, EUR (80%) and USD (20%). An increase of the NEER implies an appreciation of the lek.
21 REER- Real Effective Exchange Rate, CPI-deflated with the main partners.
22 In addition, the low M2 rate in terms of the realization of public sector’s domestic borrowing reflects the reallocation and the carrying out of the latter partly in foreign currency.
23 The performance of currency outside banks to M3 shows seasonality throughout the year.
24 The objective of Net Credit to the Government has been adjusted for the effect of ‘income from privatization’, and ‘securities for covering the BoA re-evaluation’. In addition, the reallocation of spending in the first two weeks of January 2006 and 2007 has also been considered.
25 According to the preliminary results of the survey on the lending activity of commercial banks in the second half of 2007.
26 In December 2006 the Bank of Albania approved an amendment to the Regulation “On credit risk management” which became effective in March 2007. According to this amendment the required capital from banks increases in case credit grows beyond the set limit.
27 In annual terms, trade deficit deepened by 32% relative to the same period in 2006.
28 In annual terms, exports and imports of goods with Austria and Great Britain went up by 37% and 16%.
29 The annual increase in the import of ‘machinery, equipment and spare parts’ and ‘construction materials and metals’ was 29% and 24%.
30 This item shares 48% in the total exports for January-September 2007, from 54% it shared in 2006 and 58% in 2005.
31 In more concrete terms, it is assumed that agriculture will improve slightly relative to 2006-2007; industry will continue to grow at the same rates with 2007; construction will grow better
than in 2007, but less than in 2005 and 2006 as a result of market abundance; trade and other services are expected to grow at similar rates with 2007, and the increase in transportation and telecommunication may drop slightly as a result of the slowdown in telecommunication.

33 This sector includes the sub-sector of trade, hotels and restaurants, transportation, telecommunication and other services such as financial intermediation.

34 The sales of ‘foodstuffs, beverages and tobacco’ recorded an annual drop by 28%, while the two other items an annual increase by 51% and 48%.


36 The reduction in the extension of new construction permits for a relatively long time may have led to the decrease in new constructions.

37 This index refers to Tirana.

38 Implemented in the second half of 2007.

39 This item’s average annual increase for the last 5 years is about 23%.

40 Given the absence of data for December, the analysis is not on quarterly basis. Therefore, the cumulative data for November in the last 7 years have been used.

Domestic financing includes: Issue of securities (bonds and T-bills) (+)
Income from privatization (+)
Actual excess of Government liquidity as of end each period (-)

41 3, 6 and 12-month T-bills.

42 As of end November Government debt increased by ALL 11.7 billion through the issue of securities, while foreign borrowing is ALL 2.1 billion in nominal terms.
LECTURE OF MR. ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA
At Bocconi University “The convergence of economic systems and institutions of South East Europe towards the EU: a view from Albania”
Milan, Italy, 10 October 2007

Good Afternoon Ladies and Gentlemen,

Dear Students, I am pleased to appear before you tonight. This is a fantastic occasion and I am delighted to share with you some of my thoughts and findings over my country and the Balkan region.

1. FEW WORDS ON ALBANIA

I would like to start my presentation by saying few words on my country, on its roots, on its past and its present.

Albania is a small country placed in the Southeastern Europe, bordering the Adriatic Sea and Ionian Sea, between Greece, Macedonia, Kosovo and Montenegro.

It is generally recognized today that the Albanians are one of the most ancient people in Southeastern Europe. All indications point to the fact that they are descendants of the Illyrians. Authors of antiquity relate that the Illyrians were a sociable and hospitable people, renowned for their daring and bravery at war. Illyrian women were fairly equal in status to the men, even to the point of becoming heads of tribal federations. The land of Illyria was rich in minerals--iron, copper, gold, silver--and Illyrians became skilful in the mining and processing of metals. They were highly skilled boat builders and sailors as well; indeed, their light, swift galleys known as liburnae were of such superior design that the Romans incorporated them into their own fleet as a type of warship called the Liburnian.

The famous Roman orator Cicero, astonished by the beauty of Apollonia named it in his Philippics, magna urbs et gravis - a great and important city. In the first century B.C., Octavian Augustus studied philosophy there until he heard news of Caesar’s murder in the Senate and went on to become the next Roman emperor.

More than thousand years after, Skanderbeg’s stronghold in the mountain town of Kruja, became highly significant to the Albanian people, as it strengthened their solidarity, made them more conscious of their national identity, and served later as a great source of inspiration in their struggle for national unity, freedom, and independence. Skanderbeg’s military successes evoked a good deal of interest and admiration of the Papal state, Venice and Naples, themselves threatened by the growing Ottoman power across the Adriatic.
Whoever discovered Albania (decided to visit Albania was marvelled by its beauty and the spirit of its inhabitants. World figures were usually so moved that the name of Albania became eternal in their masterpieces of art.

Albania has a reputation as a land of great natural beauty and romantic remoteness. These two characteristics have made it all the more attractive, mysterious, forbidding, challenging, or exasperating to outsiders, be they travellers, scholars, diplomats, or merchants. Many of them have referred to it as the “Switzerland of the Balkans” or as the “rock garden of Southeastern Europe.” On the other hand, the country’s uncommon isolation from the world, arising generally from its rugged, mountainous terrain, has led foreigners to speak of it as “the Tibet of Europe” or as a country more mysterious than central Africa.

The great eighteenth-century British historian, Edward Gibbon, speaking of Albania, said that it is “a country within sight of Italy, which is less known than the interior of America.”

The remoteness and isolation of the country became practically legendary and all too frequently gave rise to reports and descriptions of the land and of the people - even in books and encyclopaedias - that were closer to legends than to reality. Perhaps because of its romantic remoteness and other reasons, Albania has exerted a continuous fascination on artists, including poets, playwrights, composers, and more recently film makers and producers of television programs. Shakespeare set his comedy Twelfth Night in Illyria - the name by which Albania was known in ancient times. Lord Byron, who visited southern Albania in 1810, wrote some stirring lines about her landscape in his poem “Childe Harold”.

Morn dawns: and with it stern Albania’s hills... Robed half in mist, bedewed with snowy rills.

In Mozart’s comic opera “Così fan tutte” the principal male characters, Ferrando and Guglielmo, appear for the most part as two “Albanian noblemen” in clever scheme to test the love of their fiancés.

I was trying to bring a bit flavour of my country across centuries. Being a crossroad, the main gate from east to west, today Albania represents an important actor whose solely role is to provide peace and stability in the region.

2. ALBANIA THROUGH TRANSITION

For many decades Albania was cut off from other European countries, including the Central and Eastern European ones because of its extreme economic centralization and adherence with the principle of self-support. Transition brought about a structural change in the principles of economic philosophy. The market forces took over the distribution of economic
resources and the reduction of existing economic imbalances. This process resulted in increased unemployment, reduced output and consumption, while prices of consumption goods increased over 100 percent. Foreign reserves disappeared almost instantly under the pressure of reduced output and drastic devaluation of domestic currency. Meanwhile a relatively large and growing stock of foreign did not stop the declining trends. Public confidence dived and many Albanians emigrated mostly in neighbouring countries. Financial situation deteriorated at a fast pace as well. Monetary policy as we know it was inexistent for Albania did not have a modern central bank.

Early structural reforms focused on cutting the subsidies for insolvent state owned enterprises; massive price liberalization; privatization process; land reform; and provided the necessary incentives for the rapid macroeconomic consolidation of 1993 – 1995. During ‘90s Albania’s path has been quite disordered scoring one of the most unique transitory experiences. It was an experiment a trail and error by everybody. It was a quest to understand and the role and position in this new market economy; to rediscover the incentives of the private initiative and the risk that embodied in economic decision making. Along this process Albanian society established the foundations of the macroeconomic consolidations that started with the new millennium and accession to EU has scored significant progress. For a long period of time the economy has grown around 6 % percent annually, contributing to an upward trend of GDP per capita reaching around 2.500 Euro. Inflation has been quite stable within our target band 2 – 4 % supported by responsible Monetary and Fiscal policies.

Further structural reforms improved the functioning of the market economy. Privatization of big and medium enterprises, the privatization of former public banks, the modernization of legal framework and many other important reforms contributed to such impressive performance of Albanian economy.

In the last years I believe the country has made a substantial progress in its way towards European Union. After wasting our chances during ‘90s I believe we are in the right track and personally I’m confident that the distance to our final destination, Brussels is getting shorter day after day. The coming years are of a vital importance in adhering to EU as far as Albania is preparing itself to move with its own feet. The current agreement with IMF will finish at the end of 2008. I hope that Acquis Communautaire will become external driving forces guiding our country toward the European Family.

3. BANK OF ALBANIA

Albania had its first central bank institution in 1913. It was founded as an outcome of the agreement of the Ismail Qemali government with some representatives of an Austrian-Hungarian bank group and of the Banca Commerciale Italiana. The Institution did not live long due to the outbreak of the First World War and it was not before the year 1925 that the bank’s activity started under the name of the National Bank of Albania. During the
years 1944-1992, it was named State Bank of Albania, which at that time exercised both the functions of a central bank and those of a commercial one and only after 1992 the two-tier system is established and Bank of Albania starts performing the functions of a modern central bank. Based on a parliamentary law it has the attribute of the monetary and supervisory authority of the country.

The primary objective of the Bank of Albania is to achieve and maintain price stability. It seems that this way Bank of Albania has solved the dilemma of choosing the key objective of monetary policy in favour of price stability will contribute to sustainable growth and to generate equilibrium in the labour market over long term period. From the historic prospective, since the early stages of transition we adopted a monetary targeting regime. The choice was made believing in the Friedman’s postulate that Inflation is wherever and always a monetary phenomenon. Direct control on money growth, credit growth and interest rates were the operational tools of monetary policy aiming at the control of money supply, which served as the intermediate objective.

A free floating regime of exchange rate was chosen to match the monetary targets. Other forms of exchange rate regimes were never discussed due to lack of adequate foreign exchange reserves and therefore the incapability to support a fixed rate of domestic currency. In addition the floating regime was chosen as an automatic stabilizer of the fast growing current deficits. Therefore the choice between different alternatives of stabilization program was conditioned (and easy).

In general this regime has resulted successful and still continues to be the operating framework of the monetary policy. I believe that its success was conditioned by low financial intermediation and under developed financial markets. The presumed stable relationship between money and transactions and permitted for confident monetary programming based on the Fisher’s equation of exchange. However, as the efficiency and speed of financial intermediation increased and financial innovation set in motion, this policy setup become obsolete. Bank of Albania moved away from direct control on money in favour of indirect control of money supply in the economy.

In the context of reviewing our approach to monetary policy during the recent years we have dedicated the bulk of our research and analytical resources to better understand the relationship and causality between inflation and economic factors that influence it in the context of Albanian economy. For most of this period, we have integrated in our policy important monetary policy elements that define essential characteristics of the inflation targeting regime. Various internationally recognized experts of monetary policy have compared the current setup of monetary policy to a fully fledged inflation targeting framework.

During these recent years Bank of Albania has publicly announced a numeric objective of 3 percent with a tolerance zone of plus minus 1 percent for inflation
in the 12 coming months. In addition, weekly repurchase argument rate, the key policy rate, has become the most important instrument of monetary policy and signalling tool. Yet, we are still in the process of empirical investigation and quantification of the monetary transition channels, with particular focus on the efficiency of the inter-bank markets.

Modestly but surely I have to admit that the efficiency of our monetary policy has increased. In general we are satisfied with the reaction of the interest rate behaviour, which model the developments of the bank of Albania key rate with the appropriate lag structure. Moreover increased and more efficient communication with the public are reflected in contained inflation expectations which are anchored to Bank of Albania announced numeric objective. We are happy to observe that results of consumer and business confidence as well as financial market expectations surveys indicate these trends.

It is widely accepted that such results are outcome of our continuous attention toward ever lasting improvement of institutional and regulatory framework on which Bank of Albania operates. Particularly, this stand for: independence, transparency and accountability.

It is well recognized by foreign and domestic institutions that legal and real independence status of Bank of Albania enjoys satisfactory standards. On the other hand we believe that independence represents a dynamic rather than a static process, therefore we have adopted contemporaneous practices of communication explaining our decisions to Albanian public. This process is embodied in the continuous improvement of the monetary policy report, standard communication of the supervisory board monetary policy decisions, improved analyses and research efforts, and last but not the least, intensive public activity of the Bank of Albania Governor, with various groups of interest across the country. Taken together these have improved public understanding and expectation building for current and future developments in inflation and economic activity.

Our approach to communication has further improved our accountability and has resulted in increased credibility and authority within Albanian public.

During the past 2 – 3 years we have increased our ownership in the short and medium run economic and financial development programs. Since the beginning of transition the economic program has been designed and implemented under the setup of IMF support programs. The current program will end in 2008. Starting from 2009, the Bank of Albania and other Albanian authorities will have full ownership in the design and implementation of financial and monetary policies. In the meantime our relationship with IMF will continue under Article IV, moreover the IMF assistance will be considered a welcomed secondary factor.

In such contest bank of Albania has been working together with important Albanian institutions, first and foremost with fiscal authorities, different
European Central Banks, international financial advisories and academia to identify the new regime of monetary policy. The new regime must be efficient in the light of recent changes in financial markets and most importantly must provide good anchors for monetary policy and its sovereignty.

Please allow me to briefly describe the major characteristics of what we think will become the new regime.

A. Monetary policy regime. As I already mentioned we have been working on the new regime for more than two years. During this period we have been tossing ideas and scrupulously studying the details of a fully fledged inflation targeting regime. As you might well understand, we are getting ready to launch the new regime at the beginning of 2009. Our analyses show that, considering the current features and expected developments of the financial markets, inflation targeting provides the best policy choice for the future. A relatively long history of low and stable inflation, efficient monetary policy, sound banking system, free floating exchange rate, fiscal consolidation and last but not the least a suitable and reliable institutional framework, are important factors that have convinced us on the potential success of inflation targeting regime.

B. Institutional framework. The harmonization of monetary and fiscal policy will continue to be a challenge. I believe that long run success and real independence of monetary policy is gained in the well functioning of this simultaneous relationship. Albanian Constitution and the current Bank of Albania Law grants the responsibility of monetary policy design and implementation exclusively and without equivocation to the Bank of Albania. We believe that such legal framework and Albanian society aspirations and commitment toward Maastricht criteria’s of convergence provide essential assurance for future compliance of monetary and fiscal policy.

C. Financial market efficiency. Albania is a small open economy and relatively highly euroized. In general the financial markets are characterized by low trade volumes and interest rate volatility. This situation represents a high concentration in assets and liabilities in the banking system as well as a very limited supply of financial instruments in domestic currency. In this respect, we have been very aggressive to prepare and introduce a new set of rules for operational framework. The new regulation aims to increase the efficiency of the inter-bank borrowing market, it targets thinking on the margin behaviour of the banks by reducing the frequency of treasury bills auctions, rearranging required reserves regulation and introducing a prime rate. Our objective is to have this package operative by the beginning of 2008.

D. Financial stability. This process has progressed with the increase of the banking activity. However I have to admit that increase and consolidation of the banking activity is accompanied by a rapid growth of credit to economy. This rapid credit growth has become the challenge of the moment. However I believe that efficiency and soundness of financial system is a dynamic process and a continuous challenge. Frequently this challenge might generate from
international financial markets too. Globalization of financial markets has increased the risk of contagion. The recent developments in the sub-prime mortgage loans, must serve as a excellent reminder of the never ending surprises, which make the trade off between monetary policy and financial stability a difficult balance.

I want to make it clear that by financial stability I do not assume only the absence of a financial crisis, but a well functioning financial system that performs well its functions. I think too tight regulations that definitely minimize all the risks are not conducive to sustained growth. Therefore the real challenge for which we are working hard is to find an optimal balance between deregulation which promotes market forces and financial innovations and negative consequences of possible market failures and financial crisis.

4. BALKAN REGION: TRENDS AND MAJOR CHARACTERISTICS

Dear students,

The rest of my discussion will provide few remarks on the developments of the South East European region. I will briefly comment on the common problems and characteristics of the region and voice my opinion upon possible direction of progress and convergence in policies.

Recently the Governors of the Region have been increasingly concerned regarding the issues related with banking system activity, market efficiency, financial stability, risk exposure and of course the role of central bank.

All this discussion is structured by the context of regional aspirations for EU integration.

Not only because I’m a Governor but also due to my own philosophy I have come to believe that there could not be real political cultural and social integration without a reasonable financial integration. I share the same opinion with other European sensibilities on the values and importance of consolidation of democratic society and embrace of new social and cultural mentalities. Regardless I sincerely think that the process of transformation that has changed our societies since the fall of the Berlin wall is irreversible. The real question is how long this process will take to be complete. I believe that laying down solid foundations for efficient allocation of financial support and financial intermediation will significantly shorten this process. This will also provide the necessary infrastructure framework for the integration objectives and will supplement this process with the support of private initiative.

On the other hand, a developed and financially integrated region will be more attractive for foreign strategic investors, opening up the path toward regional development projects, particularly infrastructure, labour market, real estate ones where region’s banks might be the financing and co-financing ones.
If I would have been asked to say with simple word how I understand the convergence process my answer would be very simple: The convergence means a set of performance criterion and structural reforms benchmarks. This means that each country should adopt the standards stemming from the Acquis Communautaire and different international codes (Basle’s II) combined with energetic steps in improving economy, society, culture and environment as well. I think this is a MUST for promoting financial market efficiency in the entire Region.”

Allow me to summarize financial system in the region along the following characteristics:

- The system is dominated by commercial banks.

Financial intermediation role of the other financial institutions is weak. The insurance industry in most countries of the region is quite small and underdeveloped. Traditionally poor governance, inadequate risk management practices and lack of consumer confidence have limited total assets held by these institutions, in the same time limiting to some extent the possibility to present a source of systemic risk to the financial sector. However this sector’s rapid expansion in some countries including Albania calls for the development of an adequate legal framework for conducting insurance business and the strengthening of the supervisory framework. Other financial intermediation such as leasing activities have grown sharply in the last years (Serbia, Bosnia and Herzegovina) representing an important source of funding source for fixed investment and for small and medium-size enterprises. Micro credit institutions have a significant presence in Bosnia and Herzegovina, being mostly established with donor funds but over the last years having shifted their funding source toward bank loans. Consolidation into larger credit unions would be a viable method to be able to offer larger loans and provide more banking-like services. Financial Sector Assessment Program (FSAP) calls for further strengthening of the underlining of the supervisory framework, even though unified supervision under a single supervisory agency was considered premature. Capital and money markets are small or nonexistent. At this stage of development it is necessary that the policy of regulatory institutions should focus on enhancing infrastructure and governance.

- Banking system in the region is close 100 percent privately owned, with clear dominance of foreign capital.

The banking system in the region amounts from 40 percent of total assets to GDP in Macedonia to 119 percent of total assets to GDP in Croatia and is dominated by private foreign owned/joint ventures banks. The privatization of large state owned banks has been completed in all countries, except Serbia and representing approximately only 38 percent of total capital in the banking system respectively. The system is dominated by a restricted number of big European banks that have set presence across all countries in the region. Lately there is evidence of increasing interest of other banking groups as well.
- Increased financial intermediation of the recent years has led to a rapid credit expansion.

This trend reflects increasingly deep financial integration with EU Member States and supports rising trade, investment flows, and institutional strengthening. The expansion of the financial sector and inflows of foreign savings can strongly support real convergence. However, increasing credit to GDP ratio in all countries, ranging from 23 percent in Macedonia to 76 percent in Croatia also raises the concerns for a possible credit boom. There are some important trends worth being noted: Credit composition is dominated by consumer credit and less oriented to enterprises; Credit/deposit ratio has steadily increased indicating banks willingness to extend their lending activity at a faster pace than the growth of savings. However, the average of credit/deposit ratio of the region is still below the level of the new EU member; Lending is mostly in foreign currency as a result of high euroization of the economies and lower interest rates in foreign currency; Another structural change in credit portfolio relates to the upward trend towards longer-term lending, which at least in three countries of the region (Albania, Macedonia and Bosnia & Herzegovina) consisted of 50 percent or more than total lending; The spread between interest rates of deposits and credits remains high. There are several explanations to this such as lack of efficiency and competitiveness among banks, high premium risks of the economies in the transition period, collateral problems, legal system obstacles etc. However, it’s worth mentioning that the spread between deposit interests and credits has declined in the recent years, as a result of increased competition in the banking system.

Despite these characteristics it must be admitted that the share of the banking system in the economy is relatively small by European standards. The total of banking assets measured as percentage of GDP shows that our region lags behind when compared to developed economies. Meanwhile prudential measures indicate problems with the credit portfolio quality, and the speed of growth could be beyond what is generally accepted sound. The risks that usually accompany fast credit growth could soon exerting pressures on monetary policy and financial stability.

In my opinion the low financial and real economic integration among countries in the region constitutes as well as international financial markets constitutes another major problem in the region. The problem could become more severe if you were to keep in mind the very integrated ownership structure of banking system in the region.

Cross-border lending and borrowing, or other forms of international financial flows are still relatively insignificant. With the stabilization of the economy and the rescheduling of debts, the countries together with their financial sectors have started to be gradually integrated in the international markets. Sovereign ratings given for these countries have accompanied and accelerated in some cases these developments. While the financial sectors, and particularly commercial banks, have strengthened their international ties and have been gradually
integrated in the international financial markets, the competitiveness from cross-border banking activities remains still restricted. Cross-border lending activity increased slowly in the countries of the region. However, even in this field there is room to move more quickly. The foreign capital penetration in the countries I refer to is still low and mainly reflects the inability of our financial systems to facilitate the absorbing of foreign investments in our economies.

Finally, considering the above mentioned trends of financial intermediation the following region specific sources of risk need caution scrutiny, namely credit risk, indirect foreign exchange risk, and vulnerabilities associated with foreign branches entry.

- Credit risk.

The acceleration of credit growth rates in some countries of the region is warning when associated with an increase in the NPL ratio. Unfortunately there are chances that the build-up in credit risk may be underestimated. The deterioration in quality of disbursed credit is not immediately apparent as the increase in the share of new loans can temporarily depress the reported nonperforming loans (NPLs) and credit quality problems typically emerge with a delay. In the aftermath of deterioration in loan portfolio an increased risk of a credit crunch emerges; when banks recognize the extent of the build up they may sharply cut or reverse lending growth.

Specifically the domination of foreign banks in the region may possess additional risks associated with a possible credit crunch. As long as subsidiaries of foreign banks earn high profits, they have easy access to new capital from their headquarters given that they account for a small share of the loan book of their international banking group. If the build up in credit risk is underestimated, foreign banks will tend to set overambitious ROE targets. When the extent of underestimation is recognized, banks have to increase their provisioning rate in line with their upward reassessment of credit risk, reducing ROE projections. This could lead management of large foreign bank groups to conclude that their ambitious ROE targets cannot be met and curtail lending growth in response.

The entrance of big international foreign groups puts upward pressure on the entire banking system attempt to compete for borrowers. However, there is a risk that credit growth is associated with lower lending standards, enhanced by the lack of financial information available on potential borrowers that continues to be a problem in the region. As the FSAP for Albania indicates, in the area of corporate lending, firms balance sheets and income statements may be altered to avoid taxes, while information about remittance income for individuals is imprecise and unverifiable. The rising real estate prices in the region have also encouraged lending, using the real estate as collateral to a great extent. As real estate prices continue to rise, this could lead to an over-extension of credit, and if the real estate market becomes more speculative and more leveraged through bank loans, a decline in demand can cause a fall in real estate prices, causing both collateral to fall in
value, and the ability of borrowers to pay to decline. Thus, there is a greater need for authorities to monitor development in real estate prices and warn against possible asset bubbles, while the collateral needs to be less homogenous.

- Risks associated with the foreign exchange.

As a result of large financial assets euroization in all countries of the region, the foreign exchange rate fluctuations are an important source of vulnerability. Stress tests in almost all countries suggest that there is limited exposure of banks balance sheets to the direct exchange rate risk as banks are able to hedge foreign currency loans with FC deposits and sources from their parent banks. However, the dominance of loans either denominated in or linked to the euro to borrowers with income in national currency means that sudden exchange rate depreciation could threaten their capacity to repay.

- Vulnerabilities associated with foreign branches entry and domination.

 Turning to the issue of opening of the banking sector to foreign investors, specific issues need considerable attention by supervising authorities. The recently conducted Financial Sector Assessment Program in Serbia listed several benefits. Attracting funds from households that may be reluctant to deposit with domestic banks, providing new sources of funding for domestic credit, introducing new financial products and credit instruments, reducing the influence of vested interests, and enhancing competition by buying state banks and increasing the number of players. However, in presence of externally generated and domestically generated shocks the banking system in the countries of the region can be vulnerable to lower profitability, less willingness on the part of the banking group to provide capital, and, ultimately, generate a credit crunch. Among the external shocks were listed rises in Euro zone interest rates, adverse shocks to one or more of the countries of origin of the foreign banks, and contagion from an adverse shock elsewhere in the CEE region altering investor perceptions regarding the domestic economy. On the other hand domestic shocks such as declining margins from foreign banks fighting to gain market share, and lowering of credit portfolio induced by a weakening economy or an unexpected domestic political event could have large effects in the presence of less adequate risk management in the context of foreign owned banks rapid expansion and increasing euroization of financial assets.

5. POLICIES TO MITIGATE FINANCIAL VULNERABILITIES: CONSTRAINTS AND CHALLENGES

In some cases supervisory authorities (Serbia, Croatia) have recurred to less market oriented macro prudential measures to contain credit growth. While credit controls create the incentive to route lending through less regulated non-bank intermediaries, the imposition of such credit controls in Bulgaria and Croatia was accompanied by a jump in cross-border loans.
Watson (2007) argues that prudential policy needs to allow for the fact that foreign-owned financial institutions, with a majority of assets in most cases, have deep pockets in terms of capital and liquidity. Thus, prudential tightening may not be able to be transmitted to a significant part of the banking sector but it may affect only smaller locally-owned banks.

It follows from our discussion that the supervisory authorities may gain by the increasing transparency in financial markets which will allow consumers and other bank borrowers to be more aware of the risks inherent in foreign currency borrowing. Efforts to enhance this transparency could be encouraging or requiring banks to discuss exchange rate risks explicitly with borrowers before contracts are signed. On the other hand there is a need to discuss with banks means of assessing the risks arising from foreign currency denominated loans and adjust existing loan classification schemes or provisioning if warranted (FSAP recommendation for Albania).

Monetary policy is constrained by the degree to which policy instruments are able to transmit into the economy. A tightening of policy interest rates’ effect may be constrained even in floating rate or adjustable peg regimes. A moderate tightening of policy may not be very effective in slowing the economy because of the high degree of euroization and the uncertainty associated with the final effect of exchange rate changes in balance sheets and the real economy.

Many of the above issues require a significant degree of co-ordination between home and host authorities that can help fill supervisory gaps, given the very high levels of foreign bank ownership. In the process of improving the regulatory base, standards set by international institutions and especially the ECB are crucial in orienting regulators.

6. CONCLUDING REMARKS

The whole region is going under a political, economical and social consolidating process. Nowadays politicians, decision makers, analysts, almost everyone is stating the EU accession as the main priority, the top challenge for the next coming years.

How far are we? That’s a difficult question.

Many times I look behind my shoulders to see how far we have come. It is indeed a long way, full of ups and downs. Along this way we have scored positive developments as well as few setbacks. Yet it has been a road toward progress. However the modern attitude of central banking requires a forward looking approach. It is for this reason that in my public appearances have always stressed the vital importance of the integration process and related issues. The success of this process will depend first and foremost by our attempts and dedication. There is only one way to get closer to the finish line. That requires waking up every morning with a European mentality, and try
with all our efforts to make this dream come true. We all agree with the idea of not decorating our home with Fendi furniture whilst our roof is not yet fully covered.

I personally believe our societies are becoming mindful on their efforts towards European standards. We all understand the need for reforms, the need for stronger growth, the need for macro stability, the need for regional cooperation, the need for political stabilization and peace among the different nations of the region.

Therefore as my very last sentence I would envisage the need for greater reforms, greater efforts towards democracy and market economy.

In this respect, I would like to quote myself in Bosnia – Herzegovina, three weeks before “I see enormous possibility for cooperation and policy coordination in the direction of information sharing, institution building, modification of the legal infrastructure and lobbying in European structures. Facing these problems in group rather than separately will allow to benefit and embrace the positive effects of “economies of scale”. I also invite the ECB and EC to explore the possibility of adopting a “party” treatment for the entire SEE region, by adopting a specific program for a specific group of countries”. It might even sound overly optimistic I see this as a mutual beneficiary relationship. The region, on its account, does provide several important advantages: labour markets are positioned right in the middle between Asian countries and new EU members; sufficient investment opportunities in real estate and infrastructure as well as high return on capital; it counts more than 20 million people and represents a fantastic touristic attraction as a product of an interesting combination of different climates with diversified geographical features and multi ethnic and cultural traditions.

I think that means in real terms economic stability and sound long term regional geopolitical solution.

Thanking you for your attention I’m ready to take several questions.
SPEECH BY MR. ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA
At the General Assembly of the Dealers Association
Tirana International Hotel, 25 October, 2007

Mr. Chairman,
Distinguished Guests,

It is a great pleasure to be here amongst old and new friends and colleagues. I have dearly welcomed the reorganization and reactivation of the Albanian Association of Dealers, and the attempts made by its new board to affiliate ACI-Financial Market Association. I am confident that this reactivation will promote, above all, the market development, education and professional training of new members.

I deem that the meetings of the Dealers Association is a good opportunity to share with you some thoughts and concerns regarding the development of the Albanian financial market in general and the money market in particular.

I would like to emphasize that the interbank money market is the starting point to the transmission mechanism, driven by base interest rate change. Currently it is the most important channel of transmitting monetary policy decisions to the economy. I have to remind you that where you realize the profit, the Bank of Albania implements the monetary policy, whose efficiency depends directly on your capability to maximize profit in this market. This policy is based on the assumption that market participants are rational and their primary purpose is profit maximization under the conditions of a competitive environment. The current development of the interbank market in Albania does not fulfil these assumptions yet and therefore, it makes the work of the Bank of Albania difficult in carrying out this essential function.

Year 2002 recorded the start of the interbank market, the same year when the indirect instruments were introduced by the Bank of Albania to conduct its monetary operations. The Bank of Albania has attended the developments of the interbank money market in the last five years. During this period the trading volume has been fifteen folded, climbing from a daily average of 130 million lek in 2002 to a daily average of around 2 billion lek in 2007. Also there has been an increase in the maturity of the traded funds, from only trading overnight back in 2002 to trading up to three months in 2007.

Also there has been an increase in the maturity of traded funds, from only trading overnight back in 2002 to trading up to three months in 2007. From the beginning of this year, we have been able to publish the fixed interest rate indexes, TRIBOR and TRIBID, which is hoped to promote the development of the interbank money market.
However, we have to admit that this development has been a very slow one. During the last five years, the lek liabilities of the banking system have increased by 135 billion lek, which makes the increase in the trading volume of interbank market by a daily average of 1.9 billion lek, only a peanut in a big cake. On the other hand, besides an increase in the volume of one-week maturity transactions, longer term transactions are very sporadic. In addition, this low development of the interbank money market is also reflected to the wide spreads of the quotations for trading, published by commercial banks.

Nevertheless, the development of the interbank money market is made difficult also because of other reasons, some of which are of objective nature.

It can not be developed as an isolated market. It progress is highly correlated to the economic development in general and the development of other financial markets in particular. The financial market is still characterized by the domination of the banking system, while its other segments continue to be in a minor state of their development. There are interesting developments in the insurance companies market, while the segment of pension funds is still underdeveloped. Furthermore, other specialized intermediaries are completely missing, including here even the capital market. All the above and other reasons such as the high degree of informality in the economy, credit demand dominated in foreign currency, are factors which directly or indirectly impede the enhancement of money market efficiency.

However, rightly comprehending that many of the reasons are of objective nature, we believe that within the limitations imposed by the abovementioned factors, still there are gaps, about which I encourage you, to jointly fill as soon as possible.

In the latest survey conducted by the Bank of Albania on “Money Market Issues”, 7 out of 14 respondents (commercial banks), (which possess 59 per cent of the market share), outlined “the excess structural liquidity” as the main barrier to the development of the interbank money market, while 4 out of 14 banks (which have a market share of 30 per cent) highlighted “the credit risk” as the second most important barrier. The tendency to keep excess structural liquidity as a bank policy was pinpointed by 13 out of the 14 interviewed banks, otherwise meaning that banks that share 92 per cent of the market do have a tendency to keep excess structural liquidity.

We notice that the reasons and obstacles brought up by banks are mostly subjective, and their prevention depends more or less depend on their policies and behavior. Banks keep excess liquidity because there is no a developed money market where they could invest this liquidity at all times at a fair market price.

This market can not be developed on its own!

It is banks’ active liquidity management as opposed to a passive one that creates incentives for developing the markets. In this context, I would highly
recommend you to implement stricter internal control policies and procedures, so that they can identify opportunity cost and missed profit opportunities. Such a thing will lead to improved efficiency and competitive positions of the bank on the one hand and market development on the other. The Bank of Albania requires that you design management policies that are oriented toward profit maximization. The limitation to simple financial intermediation, such as collecting public savings and keeping them in the form of excess reserves waiting to be invested in low risk government papers, is not a characteristic of contemporary financial markets. All I mentioned above implies the indispensability for a more effective management under the conditions of enhancing the transparency.

As to the structural excess liquidity, the Bank of Albania is currently targeting to keep it under appropriate levels, in order to increase the degree of the banking system reaction to Bank of Albania’s operational decisions. At the same time, we are carefully evaluating necessary refinements to monetary policy instruments, to further promote the trading in the interbank money market.

Beyond the structural liquidity position, another important issue is the existence of limits that certain banks apply in lending relations with one another. From a pure academic viewpoint, it is quite easy to label these limits as an effort to ensure an oligopolistic structure in the market. I do not like to prejudice the prudent stance and measures reflected in these limits. However, I should state that in your business with non-bank clients, there may be identified elements, to which you take a higher degree of risk than the one materialized in interbank money transactions.

Considering the need for market development and the identification of the role of the Bank of Albania in these markets as the Lender of Last Resort as indispensable, we have prepared and will soon enough implement a complete package of regulations, whose purpose is to establish incentives and minimize risks in the Albanian financial market. Concretely, these changes consist in:

The law on repurchase agreements. There is compiled the draft-law, which enables the risk-free conduct of repurchase agreements among commercial banks. It will guarantee the prevention of credit risk, which is cited by commercial banks as one of the primary causes for the existence of limits in the lending relations among banks. This law will also prevent the legal risk the banks are faced with when using repurchase contracts.

Drafting of the regulatory framework and putting into application the custodian principle of delivery versus payment. In order to minimize the payment settlement risk and facilitate the intermediation in all types of transactions involving securities, such as collateralized loans, repurchase agreements, and outright purchase and sale of government papers, it is being worked on to put into practice the principle of delivery versus payment.

Reducing the frequency of government treasury bill auctions. In collaboration with the Ministry of Finance, we have agreed on less frequent and increased
size auction schedule of the government treasury bills. This less frequent auction schedule will limit the opportunity of banks to “be liquid” based on distributing their treasury bill investment in such a way that liquidity is generated by maturing these government papers.

Increasing the investment base of investors. In cooperation with the Ministry of Finance and the Financial Supervisory Authority, it is agreed upon increasing the investors’ base, eligible to directly invest in the auctions of government papers. The new agreement signed between the Bank of Albania and the Ministry of Finance provides the necessary regulative framework for giving an end to the monopoly that the banking system has had in investment in the primary market of government papers, leaving space to natural and legal persons, foreign and domestic individuals.

I do not feel well to assert that this step became indispensable, under the conditions of high commissions applied by commercial banks in providing this service, making the clients reluctant to this kind of investment.

Earnestly believing in the efficiency and development driven by competition, I am convinced that increasing the number of operators licensed to trade government papers has also become a necessity.

Primary rate for favorable clients. Being convinced that the monetary policy efficiency is enhanced through transparency, the Bank of Albania aims at including even this rate to the entirety of orientation rates used by commercial banks.

This package is designed to increase incentives for you to find new profit opportunities and secure the necessary liquidity at a fair price in the secondary security markets. These measures are oriented toward promoting the activity, so that you will not wait for the client to ask for the government papers but search and find this client yourself. And the very first step you should make in this direction is: abandon the traditional pension fund security portfolio classification as “hold to maturity”. In other words, this implies the necessity for more flexibility, more diversification and for the existence of efficient risk management structures.

A constant concern, which I want to pay particular attention and get your highest interest on it, is the professional development of human skills. I am not making any prejudice about the human resources that are currently working at the banking system, but I would like to point out that the mobilization of capable human resources, devoted to and shaped professionally is vital for the accomplishment of success. To be more competitive and bring new developments, we have to constantly upgrade the skills of each employee at all levels. It is true that the majority of the banks of our banking system represent international well experienced banking groups. However, I would like to emphasize that there is still room for more expertise and qualified human resources, so that the best practices of the international markets are infiltrated in our banking system.
In addition, within the framework of this association, I would advocate that the Dealers Association must very soon come up with a Code of Conduct, agreed by all its members. While this code is a non-statutory body, with no executive powers, it complements the self-regulation of the market by bringing together the best minds of the market participants and professionals to create a reliable trading practice.

Concluding, I would say that developing the interbank money and security markets is among the top priorities of the Bank of Albania. As such, we will make all our efforts to create the necessary conditions to minimize the trading risks, as well as create and support initiatives to active trading in these markets. I hope these efforts will receive your understanding and more important your cooperation. It will be very satisfactory indeed, that in my next appearance in this platform I will be able to bring concrete results of our common efforts to develop interbank money market and secondary market.

Concluding my speech, I would like to emphasize once more that no long-term and stable development may exist, without having effective financial markets. The financial market with all its segments, should precede the signals and novelties brought about by rapid dynamics of development of the private sector and the economy in general.

Thank you all for your attention!
Dear All,

It is my great honour to welcome you today in this forum jointly organized with the World Bank. The purpose of this gathering is to provide an opportunity for the discussion of the latest trends in the reserve management area by the central banks.

Referring to Nugee 2000, one’s country foreign reserve represents a part of national wealth. Being managers of this wealth, central banks are held accountable to the public. Foreign assets held in favour of the third parties always imply a high obligation of trust. Considering this, the Bank of Albania has built a bilateral institutional cooperation with the World Bank for the modern management of foreign reserve.

Following the 90’s the change of the concept of the role of foreign reserve, of its holding and management by the central bank made this initiative even more important.

The classical concept of foreign reserve as an amortizer to sudden exchange rate developments changed into a safety valve to capital flows ceases and associated exchange rate shocks. This was also because the radical changes in the liberalization of current account developed at a great extent the capital flow between different countries and the shift of exchange rate regimes from fixed or less flexible to totally free floating. Subsequently, developed countries had an upward trend in foreign reserve, while developing countries shifted from countries with net external debt to countries with net foreign assets.

We have witnessed a sharp increase in the foreign exchange reserves that are managed by the central banks globally. Starting the new millennium global reserves have more than doubled in size amounting up to 5.1 trillion USD by the end of 2006. This rapid growth in foreign exchange reserves has been associated with a shift of focus from liquidity and preservation of capital concerns only, to a total return management approach, which aims to reduce the opportunity cost caused by the holding of reserves. The implementation of this approach is closely related to the preliminary determination of what represents a sufficient level of reserves for meeting the main objective of the central bank.

There are several indicators that are used to first evaluate reserve adequacy and then decide on what portion of your reserves may be dedicated to active management.
I would like to take this opportunity and say a few words on the experience that we, at the Bank of Albania, have had on forex reserves management area. When the Bank of Albania was first established in 1992 our Forex Reserves were less than 2 million USD and now they amount at approximately 2 billion USD.

Year 2006 marked the beginning of a new era in the management of foreign reserve. First, we went through a complete review of the regulatory base on forex reserves management with the Investment Policy and the Governance Framework being the most important documents that were approved by our Supervisory Board. In comparison to the previous document the new Investment Policy clearly states the objectives that will guide the investment process of forex reserves. It has enabled the quantification of the sufficient level of reserves and the identification of areas for an active management. More specifically, the liquidity objective is referring to the availability of a sufficient level of reserves in order to:

- provide for import coverage;
- provide coverage for all short-term foreign debt obligations;
- support monetary and exchange rate policy;
- provide confidence in the economy by serving as a buffer in time of crisis.

The practical approach we have followed in implementing the new definition of liquidity objectives is by setting up several tranches which would serve to the fulfilment of our liquidity needs based on their specific maturity. Taking this into consideration and the criteria approved, in terms of return and the level of risk tolerance, benchmarks derived through a Strategic Asset Allocation process, are assigned to each reserve portfolio. As a result, the actual structure of net reserves reflects higher risk and return targets in accordance with the liquidity objectives, when moving from the Working Capital to the Liquidity and the Investment Tranche.

The Governance Framework was designed to specify the responsibilities of the Supervisory Board and the Investment Committee as related to the decision-making in the reserve management process. This document actually reflects a two-tier authorization decision-making structure, with the Supervisory Board which decides on the broad criteria for the investment process, while the Investment Committee assumes the responsibility of translating these criteria into actual benchmarks and risk limits.

The Investment Committee is much more actively engaged in the investment process now. It has the responsibility of reviewing yearly the Strategic Asset Allocation and make a decision on the new benchmarks, based on different market expectations scenarios. This and other decisions of the Investment Committee as related to active management, risk budgeting and risk limits are defined in the Operational Guidelines.

The above decision-making structure has already proved to be much more effective in that it provides for the flexibility needed to accommodate the
investment process to financial market developments, thus ensuring that no opportunity is missed and that any risk beyond the risk tolerance is avoided.

Having this new decision-making structure in place we are now focused on establishing an investment culture which is the key to proper and complete risk evaluation and for a more effective decision-making in the future. The development of this culture, in addition to the clear division and the delegation of responsibilities, also presupposes the establishment of proper conditions for the ongoing education of the staff and the growing team work.

The Investment Policy represents a document which leads and supports the investment process, and the Strategic Asset Allocation is the essential part of it. This is because more than 90 percent of the return of the portfolio is determined by the respective benchmark, which is derived through the SAA process. The rest of the return is determined by the allowed level for undertaking the risks during the active management. A successful active management is an indicator for very good abilities, first in assessing the profiting opportunities provided by the market and second, in measuring accurately the potential risks.

At last, I would kindly ask you some few more minutes to say some words on the excellent cooperation that we have had so far with the World Bank. It is almost two years now that the Bank of Albania has been engaged in an investment management and consulting agreement with the World Bank with the purpose of obtaining technical support in order to upgrade the reserve management operations at the Bank of Albania. The Sovereign Investments Partnerships Department at the World Bank has been providing during this two-year period valuable assistance and technical expertise in all areas that are related with the reserve management activity at a central bank. This cooperation has been especially priceless in terms of building and developing the professional capacities of the people who work in the forex reserves management area.

We should be initiating very soon an important project as related to the acquisition and implementation of a Portfolio Management System. We are all aware that the establishment of a good information technology infrastructure is quite critical in providing a solution to our immediate and future needs as concerning to the management of risks undertaken in the investment process. In addition, our near future plans include the selection and contracting of external managers, through whom it will be aimed the maximization of profit provided for the same level of allowed risk.

I believe today’s seminar will provide the answers to many questions which may naturally derive nowadays:

The modern management of foreign reserve, the shift from passive to active management requires a complete and clear concept of the foreign reserve and the way it is managed. It requires:
• Clear and accountable structures;
• Accountability and transparency;
• Organic relation between the participant units and the interested groups;
• High information technology and above all PROFESSIONALISM.

Thanking the World Bank once again for being involved in organizing this forum, I would like this forum to provide the answers to some critical issues such as:

• Why do central banks hold foreign exchange reserve?
• What is the optimal level and how does it conform to the latest trends?
• What does active management mean and how can we optimize the associating risk?
• How is the foreign exchange reserve increased and what are the associating costs?
• Which are the decision-making structures and what does strategic asset allocation mean?

There are a number of questions that may be asked; however, let us now turn to the experts and I invite you to listen to their presentations.

Thank you!
SPEECH BY MR. ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA

At the Joint Press Conference of the Ministry of Finance, the Bank of Albania and the International Monetary Mission following the conclusion of the discussions on the fourth review under the IMF-supported program 14 November 2007

Dear all,

During the last two weeks there have been intensive negotiations with the IMF mission with regard to the latest developments in economy, inflation, monetary indicators, financial market, banking supervision and monetary policy pursued by the Bank of Albania in the second half of 2007.

At the focus of our discussions were also the Bank of Albania expectations related to the inflationary developments in the near and longer future and the role monetary policy plays in anchoring these expectations.

As we have already informed in the last monetary policy report there has been a slight shift of the inflation rate above the upper tolerance band of 4 per cent. Based on some current developments, mostly supply-side related, it is assessed that the consumer prices performance for the following 12 months may continue to fluctuate around the current levels.

The IMF mission has assessed that the latest decisions of the Bank of Albania on tightening the monetary policy have helped to reduce the second round effects and to keep the inflationary expectations anchored around our numerical objective of 3 per cent.

Dwelling on the factors which have conditioned the inflation performance I would mention the following:

Performance of agricultural products prices

It is now an accepted fact that the domestic agricultural production was largely affected by the long drought, especially in the second and third quarter of the year. Our surveys indicate that the dependence of agricultural production on fuels and energy has increased considerably recently. As a result the hard time the latter have going through has had a direct impact on agriculture. On the other hand, it should be mentioned that the agricultural products prices have also risen in the international markets causing the imported inflation to be present in this period.

Energy crisis

Energy crisis, which has been present almost throughout 2007, was more intensive in the third quarter. The expenses made to provide alternative sources of energy are assessed to have exerted pressures on the costs of production.
and trading of goods and services. Its negative effects are direct while they may also be indirect implying the extension of this crisis implications in a later period.

Demand in economy

Regardless of the abovementioned factors it should be said that the economy has continued to be characterized by a growing demand which exerts pressure on consumer prices. The growth of demand for some basic Albanian exports, the favourable monetary conditions and the price rise of real estates have created an encouraging environment for borrowing and investment. In more concrete terms, credit to economy continued to grow at high rates during 2007. Credit to businesses grew by more than 50 per cent in August accounting for 16 per cent of the GDP, while credit to households continued to grow by about 70 per cent annually. Exports have also recorded considerable growth, growing by about 28 per cent in January-August 2007. Trade deficit deepening during this period by 4 per cent as a share to GDP does not only reflect the increase of consumption, but also the increase of investment. The import of capital and intermediate goods has increased by about 30 per cent in the first half of the present year. Foreign direct investments have also provided considerable contribution to the economic activity.

Based on the assumption that the abovementioned factors will remain present in the economic reality I would like to underline that the accommodation of inflationary pressures in the future has turned into a real and difficult challenge but not impossible to be faced with.

Assuming that the Government will continue to pursue responsible fiscal policies in the future and believing in an adequate perception and reaction by the market and public at large to the Bank of Albania decisions the inflation risks may be contained.

Considering public communication as crucial the Bank of Albania will continuously inform the public about the risks which may jeopardize the consumer prices stability in order to make it aware of:

- The future inflationary developments;
- The balance of risks;
- The keeping of inflationary expectations anchored around the 3 per cent target.

I would like to underline that the Bank of Albania monetary policy for the near future will continue to be accountable, which is the main tool to prevent short-term risks to consumer prices stability. The role of the interest rate in economy will be proactive aiming to contain the inflationary risks, whose probability to be materialized has increased.

A large part of our discussions focused on financial stability, with special emphasis on the banking system stability. The process of the banking system
consolidation continued during 2007. It continues to be well-capitalized and profitable. All the indicators provide evidence for its soundness and I would like to mention the share of non-performing loans which is very low at 3.4 per cent to the total.

However, it would not be too excessive for me to bring into the Albanian public’s memory the Bank of Albania’s commitment to the system’s financial stability and broader. To this purpose, we have recently strengthened banking supervision and have required the banking system greater transparency, better governance and more efficient internal control procedures.

We share the same opinion with the IMF mission that prudence in terms of credit portfolio quality is a constant priority considering its rapid and continuous growth. The growth of credit remains high and it may represent a potential source of risk for the macro and financial stability in this sector.

In conclusion I would like to thank Mr. Bell and other members of this mission for their responsible and devoted work during the last two weeks of their stay in Tirana.
Dear ladies and gentlemen!

It is a great pleasure to be here today and open the proceedings of the workshop “Economic research in South-Eastern Europe”. First, allow me to express my thanks to the representatives from the respective central banks for their participation in this workshop and all the other guests present today. Let us hope that this workshop will serve as a catalyst for a more intensified exchange of experiences among our region in the field of economic research. This process is of special importance with a view to improving the standards of economic research and for enhancing our know-how in this area.

Undoubtedly, timely and accurate economic research is vital for undertaking more sound economic policies for boosting a stable and non-inflationary growth and for coping with various risks under a dynamic and rapid integration of our economies.

From a central bank’s viewpoint, economic research should aim at reaching an optimal balance between the significance to the monetary policy or financial stability, their quality and timely availability. When compared to the academic economic research, a central bank’s economic research should manifest the same quality, but be positioned on assisting the monetary policy decision-making process. Otherwise, their added value is overwhelmingly reduced. The role of research in the monetary policy decision-making process becomes even more important under the inflation targeting regime that the Bank of Albania will fully adopt in the near future. Economic literature defines inflation targeting framework, inter alia, as “comprehensive and multi-dimensional information, analyses and statistics”.

As in many central banks which adopt the inflation targeting regime, the Bank of Albania has oriented its resources for economic research, mainly to understanding the process of inflation and of its forecasting, and to understanding the transmission mechanism of monetary policy. The building of a macroeconomic model for the Albanian economy is of special importance to the economic research of the Bank of Albania. Moreover, issues related to the real, foreign, financial and the fiscal sectors, as well as other issues related to the improvement of economic statistics are in focus.

Undoubtedly, the constant improvement of economic research, of their ethics, quality and significance to monetary policy should be of high priority. The Bank of Albania is conscious of the fact that research in the abovementioned areas should be further consolidated.
Dear friends!

Allow me to state my opinion that from the strategic point of view the consolidation of research requires the improvement of economic data, the enhancement of cooperation between the public administration institutions and the academia, as well as between various countries, and the absorption and increase of human capacities in this area. Following my speech I would like to briefly explore these three issues.

Economic research uses the economic data as its core input. Consequently, the availability and quality of economic data represent a key factor to the development of timely and accurate economic research, to the maximization of benefiting from them, as well as to the minimization of wrong decision-making and the costs it carries over. Unfortunately, the availability and quality of these data cannot be labeled as satisfactory. In addition to problems of collecting and calculating the statistical basis, the data base is related to and influenced by the speed and various stages of the development of the Albanian economy and by the changes of policies promoted by the taking place of these stages. The Bank of Albania has continuously and will constantly call on the improvement of economic data. In this context, today’s workshop places special emphasis on the discussion of the estimations and approximation of some economic time series for some important economic indicators, as well as on their role in the development, ethics and the quality of research of empirical nature.

Economic research is essential for a wide range of areas. Hence, no institution can and less can a small central bank cope by itself with all the needs for economic research. Quite contrary, the institutions need to identify the areas and issues of economic research where they possess certain comparative advantages and then, closely cooperate with each other. In this context, the cooperation between the institutions of public administration and the academia, the cooperation between different countries and the establishment of research nets on various areas are of prime importance. They would not only enhance the efficiency in carrying out the research, but also stimulate the professional critique and opposition and reach higher standards.

The research mission described above, clear and well-defined within the framework of a central bank should not be understood as an isolate mission. The studies can not take place in a closed environment. They need debate and exchange of ideas with the academy, business and other interested stakeholders. In this regard, it is my pleasure to state that the Bank of Albania has made its research subject to reviews in activities organized particularly for this purpose (inflation targeting, round tables, Friday workshops, etc). I invite you to do the same thing even during this activity. In view of debate and discussion, we have made constant efforts to attract academy and intellectuals in the discussion of our works. The Bank of Albania has introduced the “series of Friday seminars”, as an infrastructure to promote this debate. Twice a month this forum invites the interested persons within and outside the Bank of Albania to discuss their research on topics of economic nature. The activity
is as much open for home and foreign researchers from the academy and business as it is open for the Bank of Albania employees. In this point, I should emphasize that we expect and encourage more interest by home and foreign academics for this series of seminars. I invite the academy and all the researchers to consider this invitation as a repeated one and become more and more active in discussing the strategies and development of economic policies.

The Bank of Albania is entirely open and invites all the stakeholders to boost this cooperation. Today’s workshop represents in itself a concrete example of interest for cooperation between the parties and of our aim to boost it further. Moreover, distinguished personalities from the finance and the academia have been present in various lectures, workshops or conferences. I am personally involved in this open discussion through a cycle of lectures held in the Albanian universities and in eminent and prestigious European universities.

Young economists who represent the future and a key basis of human capacities should be also encouraged to do economic research. We aim at establishing a culture of research and of a supportive structure with new elements that do have not only the desire but also the necessary knowledge to study the economic phenomenon. To this purpose, the Bank of Albania organizes annually the Governor’s Award for the Best Diploma, which encourages the students of economics to carry out economic research, mainly focused on the areas of a central bank’s activity.

In conclusion, I encourage you to consider the benefits deriving from the useful critics and recommendations during this workshop. I also hope that your participation in this workshop results useful, in terms of exchanging the know-how on various issues and in particular, on the ethics and econometrical techniques.

It is with pleasure that I declare this workshop open and I invite you to deepen our knowledge!

Thank you!
SPEECH BY MR. ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA

At the press conference following the Bank of Albania Supervisory Council’s decision on increasing the key interest rate by 25 basis points

Tirana, 27 November 2007

In its meeting on 27 November 2007, the Supervisory Council of the Bank of Albania analyzed the economic and financial developments in the country.

Annual inflation rate marked 4.2 per cent in October, being above 4 per cent for the third consecutive month. However, average annual inflation rate remains close to the 3 per cent target of the Bank of Albania, reflecting the low inflation rates in the beginning of the year.

The supply-side pressures on inflation rate continued to be high. There have also been demand-side pressures which were manifested in a high core inflation rate of 3.5 per cent. This is about 2 per cent higher than the rate marked in the mid year.

The continuous increase of inflation during the last months has increased the consumers’ expectations for the price rise of goods. The expectations for the increase of inflation have a direct impact on preserving an inflationary environment in economy.

The monetary developments have reflected the performance of credit to economy and credit to the government. On one hand there is a stable growth of credit to economy by more than 50 per cent. On the other, fiscal balance is characterized by temporary absence of liquidity as a result of the non-timely execution of budget expenses.

Credit portfolio continued to grow over October. The annual growth of credit continues to be high by about 52 per cent. The growth rate of credit to businesses was about 44 per cent, while the growth rate of credit to households was about 68 per cent which reflects the high demand of the banking system for financing.

The increase of the lek interest rates dominated the money market, the securities market and the deposits market, reflecting a satisfactory level of transmission of the decision taken in September by the Bank of Albania which raised the key interest rate by 25 basis points to 6 per cent.

The banking system continued to operate under tight liquidity conditions causing the operational policy of the Bank of Albania to be oriented towards the short-term injection of liquidity through weekly reverse repo auctions in the open market. In October was injected a total of about ALL 3 billion at an interest rate of 6.3 per cent which is 30 basis points above the key rate.
Treasury bills yields in the primary market increased for all maturities, in particular for the 3-month maturity. As of end October the 3-month yield reached 6.08 per cent or 32 basis points higher than the end-September yield.

ALL deposits’ interest rates continued to increase following the signal for the increase of interest rates in the second half of the year. The average 12-month interest rate increased to 6.06 per cent in September from 5.78 per cent as of end June. Compared with the previous year average 12-month interest rates have increased by 0.84 per cent – during this period the core interest rate has increased by 75 basis points. Preliminary data indicate that the banking system will further increase the interest rates. This performance has led to the increase of the difference between the domestic currency and foreign currency interest rates in favour of the domestic currency.

The lek appreciated to the US dollar and the euro in October by 3.6 and 1.2 per cent. The considerable appreciation of the lek to the US dollar was mainly influenced by the developments in the international market where this currency has depreciated considerably to the euro. The developments in the domestic demand/supply ratio have supported the appreciation of the lek to the euro. The absence of the seasonal demand was accompanied by a higher supply of banks for foreign currency (as a result of the conversion of some banks’ capital), resulting in the appreciation of domestic currency. The appreciating pressures of the lek are also supported by the positive difference of interest rates between the domestic and foreign currency.

In nominal effective terms the lek appreciated by 3.3 per cent to other foreign currencies compared with the previous year. Worth mentioning is the fact that the appreciation of the lek by 8.7 per cent to the US dollar has absorbed a large part of the price rise of raw materials in the international markets.

The dynamics in the current and expected macroeconomic developments confirms the presence of inflationary pressures in economy whose balance is still on the upward side. The Supervisory Council of the Bank of Albania reached this conclusion after having analyzed:

- The Bank of Albania projections for the inflationary developments in the following 12 months;
- The fiscal budget projected for 2008;
- The banking system’s expectations of inflation, the exchange and interest rate for 2007 and 2008;
- The results of the business and consumer confidence surveys for the third quarter of 2007;
- The survey results on the possible influence of energy crisis of 2007 on the business performance.

After having carefully analyzed this information the Supervisory Council decided to communicate to the market, other economic agents and the public
at large the factors which are assessed as being risk factors to the future of price stability in economy.

CREDIT TO ECONOMY
The rapid growth of credit to economy in the last years has provided the grounds for the rapid growth of domestic demand in economy. This influence becomes even more significant when referring to the growth of consumer credit which directly supplies the economic agents’ sentiments to consume more leading to the increase of inflationary pressures in economy.

FISCAL POLICY
So far the positive net balance on fiscal account signals that the budget deficit of about 3.5 per cent projected for 2007 will actualize in December 2007 and in January 2008. As a result the effects on the aggregate demand will extend over 2008. 2008 fiscal deficit planned to increase will also add to this impulse. Compared with the present year, which has been mainly dominated by the positive fiscal balance, their total effect constitutes a considerable pressure on aggregate demand.

CURRENT ACCOUNT
According to the most recent data it is assessed that the deficit on current account accounts for about 9 – 10 per cent of the GDP which indicates a higher consumer trend and consequently pressures for the price rise in the domestic economy.

PRICES OF RAW MATERIALS AND THE SECOND-ROUND EFFECT
The current market situation has confirmed the presence of increasing pressures of prices in economy as a result of the effect of raw materials and oil prices and of the energy crisis. These effects are considered to be direct and they may generate second round effects. The general tendency is that the transmission of these costs to consumer prices will occur in the medium term.

THE RISE OF ADMINISTERED PRICES
In the context of the approximation of the sale prices with the purchase costs the KESH has recently made public the intention to further increase the energy price which will have a direct impact on the CPI for the following 12 months. Among others considering that energy is a consumer product it will also generate indirect effects.

Based on the abovementioned considerations the Supervisory Council of the Bank of Albania decided to increase the interest rate applied on repurchase agreements by 25 basis points to 6.25 per cent.

The increase of the key interest rate aims to better contain the pressures generated by domestic demand, to better accommodate the supply-side fluctuations and to orient the inflationary expectations to the Bank of Albania numerical target of 3 per cent.
Its reflection in the financial markets and the money market instruments will establish a more stable balance between the monetary stimulus of the economic activity and the generated inflationary pressures. In addition the increase of the key interest rate aims to preserve the time and foreign currency structure of monetary assets in line with their historical trends and to re-evaluate the incentives for keeping the savings in Lek.

The Bank of Albania remains vigilant and it will make its utmost efforts to keep its decisions in line with the main objective – maintaining consumer price stability.
OPENING SPEECH BY MR. ARDIAN FULLANI,
GOVERNOR OF THE BANK OF ALBANIA
At the VII Annual Conference of the Bank of Albania “Monetary Policy Strategies for Small Economies”
Tirana International Hotel, 6 December 2007

Dear ladies and gentlemen,

It is a great pleasure to open the proceedings of the 7th Conference of the Bank of Albania. On behalf of the institution and myself I take this opportunity to welcome all participants. I am confident that the following two days will instigate debate and discussion on key central bank issues.

This year’s main topic will focus on the classical function of a central bank: “monetary policy”. Institutional framework, decision making process, monetary transmission efficiency and other issues related with financial markets, macroeconomic and financial stability, will make interesting topics of discussions from our esteemed speakers.

I am confident that our panellists are well-known senior experts; therefore, on behalf of the institution I would like to thank them heartily for accepting to share with us their views and findings.

Given that the proceedings of the Conference will extensively cover theoretical models and countries experiences as well I would like to briefly present the evolution of our central bank during the last three years.

To our pleasure 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. Even the current policy setup is designed under such program. 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. After many hardships of transition, the Albanian authorities should have full ownership in the medium-term development programs of our country. This is the reason why the Bank of Albania has quite for long been engaged in a comprehensive process of scrutinizing and choosing the best options.

The year which is coming to an end marked another important chapter in this context. In contrast to the previous two years, the Bank of Albania has further deepened its cautious research of all aspects characterizing the present and future of monetary policy.
It has been quite for a long time that the central bank has publicly announced its efforts in assessing objectively and professionally the future of the Bank of Albania monetary policy. These were not sporadic efforts but part of a process which initiated three years ago with the only objective of finding the answers to the following questions:

Should we move to another monetary policy regime? What regime would be the most appropriate one?

I believe you share the same opinion with me that finding the answers to the aforementioned questions is not an easy thing. This is not a plain mechanical action.

In the last three years the Bank of Albania has been involved in an intensive process of assessment, analysis and conclusions for the future of monetary policy. And we have not been alone throughout this process.

Together with other Albanian institutions – first and foremost with fiscal authorities, different European and regional central banks, other international financial institutions and academia, we have tried to identify the most suitable monetary policy regime to be adopted.

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.

A relatively long history of low inflation, constant soundness of the macroeconomic situation, stable and sound banking system, free floating exchange rate, a suitable institutional framework, fiscal consolidation are important factors that have convinced us on the potential success of inflation targeting regime. However, we are aware that there is still a lot to be done in this context, in particular as far as monetary transmission mechanism and financial market efficiency are concerned.

Furthermore, under a relatively rapid and considerable development of the Albanian economy we are sure that the advantages a complete and independent monetary policy framework provides are larger in size than the disadvantages. Therefore, the currency board has not been considered a possible option for the future.

On the other hand, the current operational targets (quantitative limits on net assets of the Bank of Albania and the banking system), or the so-called performance criteria, which are part of today’s decision-making, might not be able to preserve their binding power after the expiration of the conditional agreement with the IMF in 2008. These intermediate objectives may be replaced by a concrete and transparent objective such as the inflation rate, which provides a more direct communication of monetary policy decisions.
in economy in order to achieve the main target of the Bank of Albania. Consequently, summarizing what has been previously said we have identified the inflation targeting regime as our best choice versus currency board and monetary targeting. Another argument which supports our choice is that various internationally recognized experts have compared the current setup of monetary policy to an implicit inflation targeting framework.

Furthermore, we believe this regime will provide a better platform for harmonizing the monetary policy with the fiscal one, implying that the fiscal authority will seriously commit to support the proposed setup.

To this purpose, we invite the Albanian Government to reach a consensus on the key objectives of both policies, monetary and fiscal, adopting the convergence criteria as a strategic goal.

Success in this endeavour requires Albania, among other things, not only continuity on the path of sound macro policies but even strengthening them further. This means a monetary policy focused on maintaining price stability and a prudent fiscal policy which will ensure that Albania’s deficits and debt ratios are sustainable and at low levels to increase the attractiveness to international investors. Put differently pursuing a monetary policy focused on price stability and a prudent fiscal policy, will no doubt reduces Albania’s risk premium. The benefit of this achievement will be felt throughout the economy.

To support my idea I have to tell you one fresh news. Yesterday Albania succeeded to sell internationally a seven year fixed rate bond in Lek. This was not a result of a toss of coin, but a reflection of international confidence in the Albanian economy and its macro policies. This confidence should increase in 2008, 2009 and beyond.

Regardless of the monetary policy regime it is to be said that the chances for this setup to be successful are greater under a developed financial market, which understands properly the monetary policy signals and transmits them adequately to the economy. Monetary policy efficiency implies the financial market efficiency.

This issue has been part of my earlier discussions; however I would like to highlight that only recently we have taken concrete steps which will improve certain financial market segments.

We have currently tried to adopt a set of measures which will facilitate the reformation process of the financial market by further deepening it. In more concrete terms, the Government securities market and the interbank market have been most particularly under our special focus.

After several consultations with all actors in place we decided to come up with a package of initiatives and priorities during 2008 whose purpose is to establish incentives and minimize risks in the Albanian financial market:
• Broadening and deepening the base of participants in the Government securities market

Starting from January 2008 we will increase the investors’ base, eligible to directly invest in the auctions of Government bonds. We believe it will increase the competition while so-far this was a privilege enjoyed by the banking system.

• Reducing the interbank market risk

So far, the banking system has applied limits on the amounts it can lend in the interbank market. Therefore, we are working on introducing a new law on repurchase agreements, which will enable the risk-free conduct of repurchase agreements among commercial banks.

• Establishing the delivery versus payment system

In order to minimize the payment settlement risk and facilitate the intermediation in all types of transactions involving collateralized loans, repurchase agreements and outright purchase and sale of Government papers, we are working to put into practice the principle of delivery versus payment system.

• Enhancing the interbank market efficiency

In collaboration with the Ministry of Finance we have agreed on less frequent Government treasury bills auctions. Moreover the size to be issued in each auction schedule will increase. This less frequent auction schedule will increase the number of transactions in the interbank market for the period in-between the two auctions as banks will try to reduce the costs of liquidity. On the other hand it will limit the opportunity of banks to be liquid based on distributing their treasury bills investment and consequently, they will seek other market options such as the interbank market.

• Introducing the prime rate

Being convinced that the monetary policy may be efficient through transparency the Bank of Albania aims to introduce in the first half of 2008 the “prime rate” to the set of orientation rates used by commercial banks.

Regardless of the measures to be adopted I would like to say that other financial market segments need to come along with us in this challenge. I have to say that the financial intermediation role of other financial institutions is weak and it has no substantial influence on the intermediation and reallocation of financial funds in economy. I think today’s reality provides a lot of room for making the capital market reactive. According to our estimates, the number of major companies certified by well-known international auditors is ever-increasingly becoming larger.
Further to my speech I would like to focus on another priority of the Bank of Albania, that of financial stability. It holds true that 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, macroeconomic stability without financial stability would be a utopia; it would be like a non-standing bridge. This is the reason why we have been paying special attention to financial stability throughout 2007. The recent developments in the sub-prime mortgage loans must serve as an excellent reminder of the never ending surprises which from time to time cause a lot of turmoil for the financial market stability. Moreover this episode once more highlights the necessity for more harmony between monetary policy and financial stability. I want to make clear that by financial stability I do not assume only the absence of a financial crisis. First and foremost it implies a functional and efficient financial system in its intermediation role.

I personally believe that too tight regulations truly minimize all the risks, but on the other hand they might not always be conducive to sustained growth.

Therefore, the real challenge we are facing is to find an optimal balance between deregulation, which promotes market forces and financial innovations, and negative consequences of possible market failures and financial crises.

Obviously, this optimal balance is hard to be actualized in the daily practice. Therefore more empirical studies need to be made, which I believe is one of the main priorities of the newly established Financial Stability Department.

However, I would like to underline that as a supervisory authority we have been very prudent during the present year, considering among others the rapid growth of credit portfolio in the last 2-3 years. I take this opportunity to inform the banking system and the public at large that starting from January 2008 the Credit Registry will begin to operate.

Special attention has been paid to strengthening banking supervision, in particular to that part which relates to the governance of commercial banks. Moreover, we have required more transparency from the banking system and a more accountable relationship with the public. The continuous improvement of human capacities involved in internal control and risk management has for a long time been a concern for the Bank of Albania. With reference to the latter I would like to underscore that we have already identified three greatest risks whose presence would have severe consequences on the financial stability. I have to say that this group of risks characterizes the whole region; consequently there is a lot of room for cooperation in this context.

1 – Credit risk

Credit risk directly relates to the boom of credit to economy in the last years. Although the statistics indicate that the share of non-performing loans is low,
prudence is required. We all do know that the rating and re-rating methods may be a tool in the hands of banks to keep the reality away from the truth. The entrance of big international foreign groups puts upward pressure on the other banking operators attempt to compete for borrowers which may often deteriorate the credit portfolio quality. Moreover, let us not forget that the companies’ balance sheets lack transparency which makes another issue for this matter. To conclude I would like to say that the current developments in the real estates market may potentially have a negative impact. A considerable rise in prices when real estates account for about 80 per cent of the collateral may have a negative impact in case there is a sudden fall of prices in the fixed assets market.

2 – Exchange rate risk

As of November 2007 outstanding credit is shared by 70 per cent of foreign currency credit and 30 per cent in the local currency. It is my impression that the figures are similar to the whole region. Extending credit in foreign currency to borrowers with income in national currency means that a sudden exchange rate depreciation could threaten their capacity to repay.

3 – Contagion risk resulting from the presence of big banking groups throughout the region

Currently we are all witnesses of a large-scale penetration of some big international banking groups throughout our region. This development has obviously been welcome as it has provided a better and more efficient allocation of free assets in economy. However, I believe that more prudence is required in this context. A disturbing issue for the parent bank or a concern of one of its branches in the region may cause turbulences for the fact that these banking groups have large market shares. Moreover, host-host supervision-related concerns have not been covered by the Basle standards which makes the whole situation even more complex.

In conclusion, I would like to highlight that our work has been guided by a simple but progressive philosophy which has aimed at:

• Establishing sound and operating structures;
• Concluding and improving the legal and regulatory base; and
• Absorbing qualified and professional human capacities to cope with the future challenges.

I express my belief that the Bank of Albania is fully capable to have the full ownership of designing and implementing the monetary policy.

Dear participants,

I tried to give a short overview of our work in the last years. I am sure than the speakers’ presentations and discussions in this conference will help us to better understand certain issues and provide the answer to several questions.
I truly believe all the participants will be active by bringing and focusing on new aspects, different experience and alternative perspectives to our viewpoints.

I wish you good proceedings.
SPEECH BY MR. ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA
At the signing ceremony of the Memorandum of Understanding between the Bank of Albania and the Ministry of Education and Science “Qemal Stafa” High School, 13 December 2007

Dear Honourable Minister,

Dear students, dear guests!

It is a pleasure to be here among you today. For all of us there has been a “golden” time of being a high school student! This is that day for you. Try to respect and make it serve at its best to your own future!

I shall refrain myself from acting the teacher or the rigorous parent. I just want to be close and well understood by you. The reason of our being here today with you is to explain the importance of a central bank and what its functions are. What is the importance of a central bank in everyone’s life? How useful is a central bank for the wellbeing of its country and ultimately, can a country’s economy be developed without the existence of a central bank? All these questions definitely get their answers nowadays. The central bank is useful, indispensable and closely related to the life of people living in a modern world.

One may ask: What does it have to do with me?

I personally think this question deserves the classic answer: “You, the young, are the future of society”. The Albanian society aims to integrate into the United Europe. In simple words, our society endeavours to integrate its best values with the already integrated European countries. I have my full conviction that you are indefinitely one of the values our society may be proud of.

Focusing on our topic I would like to briefly present our Central Bank. It is called the Bank of Albania and as you may already know it is situated in Scanderbeg Square, in a solid 70-year building. Its main function is to maintain price stability. Consequently, it contributes to our country’s economic development and wellbeing. The provision of the banking system’s stability is another important task of the Bank of Albania. The Bank of Albania also has the exclusive right to issue the national currency, the Lek as you already know.

Another important task of the Bank is the responsibility for the well-functioning of payments in the national currency.

These and other important functions are carried out by the Bank of Albania in order to assist the development of our economy and the wellbeing of all Albanians. To achieve this goal, the Bank of Albania does not act on its
own, isolated or detached from the reality. It is fundamental for the Bank of Albania to be independent and distant from any kind of influence. On the other hand, independence implies accountability and transparency which combined together provide high confidence. The latter is key condition for achieving the aforementioned objectives.

Within this institutional framework, in co-operation with specialized international institutions, the Bank of Albania has drafted and approved contemporary laws and regulations, which allow it to carry out its activity in a sound and safe regulative environment.

Moreover, the Bank has invested in establishing a modern technological base. Our staff operates with updated programmes and systems allowing the Bank to observe the best standards in this area and be in line with the overall development level of banking today.

However, the greatest investments of all that the Bank of Albania has made over the years is the well-educated, qualified and specialized staff which may be comparable to many other central banks’, far more developed than Albania.

One may ask: How many people in Albania are aware of all these things? I have another question: How many people need to know about the Bank of Albania? The answer comes natural. Everyone needs to know! By having information on a given institution and its tasks you may establish a relationship with it. In our case, for the relationship to be stable and work for everyone’s best it should be a relationship based on trust, growing from constant communication.

In its endeavours to earn and preserve public trust, the Bank of Albania is in constant communication with the public, based on the principles of transparency and reciprocal values.

I take this opportunity and to be open, it is not usual for me to be in front of such a promising audience, to say a few words on this educational programme that the Bank of Albania has designed and started to implement called “Central Bank in everyday life!”

You should not be surprised if I tell you that you are our main target group. Earlier I mentioned our great ambition to integrate into Europe; however, I have my strong conviction that finance as any other thing needs to be learned and this is the right age for you when learning is your main focus.

To this purpose, the abovementioned programme includes the following three directions:

1. Training seminars for high school professors teaching economics, focussing on the area of economy, finance and banking in general and central banking, in particular.
2. Meetings with third grade high school students studying economics, having talks on topics related with economy, personal finance management and the role and functions of a central bank in particular. Moreover, the Bank of Albania will distribute to the public at large our educational brochures.

3. The organization of a competition among high schools in Tirana titled “The Real Value of Money”. Through this competition we do not only aim to enlarge your knowledge on the way the central bank operates in order to achieve its main objective, maintain price stability, but also help you to develop your work in group skill to achieve the result and obviously to entertain yourselves.

Ultimately, it is very important for me to remind and at the same time assure you that I would really welcome any of your comments, requests, ideas or suggestions related to this topic.

I assure you that they will be reflected in our further work in the education area. Only in this way, this relationship will prove to be useful to all of us.

Thank you for accepting me as a friend into your school and for giving me the pleasure to address to you.
March 2007

INFORMATION ON INTERNATIONAL RESERVES AND FOREIGN CURRENCY LIQUIDITY TEMPLATE
Hilda Shijaku

This paper provides some information on the compilation of international reserves and foreign currency liquidity template, as an important macroeconomic statistics, mandatory to be reported as one of the standards of the SDDS Project Albania aims to subscribe in by the end of 2007. The compilation of this statistic is in line with the “International Reserves and Foreign Currency Liquidity Guidelines for Data Template, IMF, 2001”, and for the first time, it is being compiled in Albania.

ALBANIAN PRICE DEVELOPMENTS IN COMPARISON WITH GREECE AND ITALY. WHAT ABOUT CONVERGENCE?
Elvana Troqe, Valentina Semi

Since one of the primary objectives of Albania is to become a European Union (EU) member country and one of the main criteria to become an EU member and then a Monetary Union (EMU) member is that of price stability, this article examines the price developments in the country while comparing them to those of Greece and Italy. These countries are taken into consideration because they are EU member states and Albania’s main trading partners. To compare price developments between the countries, in absence of absolute price data, we are based on the series of consumer price indices. These indices have the same division into 12 main groups for the three countries, but they have differences in the weights of these groups, in the division of groups into sub groups and in their respective weights. The main conclusion of this paper is that in all cases we do not find divergence in inflation rates for the 12 groups of the consumer price indices between Albania and the two other countries, Italy and Greece.

June 2007

THE LAW “ON BANKS IN THE REPUBLIC OF ALBANIA” AND ITS COMPLIANCE WITH THE SUPERVISORY REGULATING FRAMEWORK.
OBULATION WITH REGULATORY CHANGES IN THE IMPLEMENTATION OF THE DIRECTIVES OF THE EUROPEAN UNION
Juna Bozdo, Irini Kalluci

This paper deals with the compliance of the Law No. 9662, dated 18.12.1996 “On Banks in the Republic of Albania” with the existing regulatory framework, and the obligations for regulatory changes arising from the implementation

LENDING ACTIVITY: THE ABSENCE AND THE ADVANTAGES OF A CRUCIAL DEVELOPMENT FACTOR
Elona Bollano, Gerond Ziu

This paper discusses the issue of the country’s rapid credit growth, which exercises a considerable impact, not only on the banking activity but also on the economy as a whole. The paper tries to examine the progress of lending activity based on literature and the experience of foreign countries, indicating the impulses of the activity and some of the motives that influenced the rapid lending boost, including the structural characteristics of this activity. Also, the paper attempts to identify the risks and possibilities that can be identified, as a result of rapid developments, an aftermath of the lending activity and the progress of the banking system.

NATIONWIDE REMITTANCE BENEFICIARIES SURVEY
Argita Frashëri

This study addresses the issue of workers remittances that Albanian households receive. Notwithstanding many studies over the economic, demographic and social impact of international migration, there is only a partial knowledge of this phenomenon. Very little is known about the characteristics, the dynamics, trends and impact on various levels of the personal, household and community life. This study is an additional contribution to our knowledge of migration phenomenon, from the beneficiary households’ point of view.

REAL ESTATE PRICES AND FINANCIAL STABILITY
Juna Bozdo

This paper assesses the correlation between bank lending and property prices. From the theoretical viewpoint causality may go in both directions. On one hand property prices may affect bank lending via various wealth effects. And on the other hand, bank lending may affect property prices indirectly, augmenting the funds at the borrowers’ disposal. As a result, from the practical viewpoint it can be said that property prices fluctuation might influence the level of risk that banks take during the lending process, as well as their loan extension policies. The paper makes an assessment of real estate lending, treating the subject from the supervisory point of view. The paper also makes use of the results attained from a questionnaire delivered to the banks of the system as to identify the types of real estate loans that exist and the risks that the lending process of these types of loans bear.

* Opinions expressed in these papers are those of the authors and do not necessarily reflect the official opinion of the Bank of Albania.
LABOR PRODUCTIVITY IN ALBANIA: THE PROCESS OF SECTORS’ CONVERGENCE*

ABSTRACT

This paper investigates the impact of sectors’ convergence in labor productivity growth in Albania over the period 1996-2005. A decomposition exercise is utilized for this purpose. The results show that there is sectors’ convergence especially for the agriculture sector, while the other sectors tend to move towards a higher equilibrium point. However sectors’ developments support an ongoing labor productivity growth in Albania.

I. INTRODUCTION

Basic growth theories (Solow model and endogenous growth) account for physical and human capital as determinants of economic growth. Non developed countries are characterized by a shortage of capital; i.e. capital earns high profits which stimulates its inflow from other countries. As a result, a convergence process should develop and the difference between developed and non developed countries should diminish. However, new empirical evidence derived from micro data shows that regardless of capital flows towards less developed countries, there is no economic convergence (Burges, 2003).

The economies of countries with different levels of development manifest a lot of heterogeneities and dynamics in sector or firm level. These countries are characterized by different levels of productivity and its performance is the fundamental long term source of economic growth. Differences in total productivity between countries have mainly two reasons (Kilvits, 2002):

• The productivity in (sub)sectors is different (technological level, capital–output ratio, skilled labor);
• Labor is concentrated into (sub)sectors of different productivity. This is caused by earlier activities and investments undertaken according to the special characteristics of each country;

If labor is concentrated in sectors of different productivity which is inefficient, then a re-structuring process will take place. Labor source will shift from less productive sectors to more productive ones. The process will lead to labor source reallocation resulting in higher aggregate and sectors’ labor productivity, thus in higher economic growth of the country.
This process of labor source reallocation is of particular interest for the emerging economies of Central and Eastern Europe and former Soviet Union. These countries have moved from a central planning system (thus concentrating labor in strategic sectors regardless of the efficiency level) to a market based economy (productivity determines sectors’ employment). As a consequence, there is a strong need for restructuring the economic activities and reallocating the labor input.

Estrin and Svejnar (1998) find that in Czech, Slovak Republic and Poland there was a quick employment adjustment by firms at the start of transition. The same pattern appears also for Brown and Earle (2005), who find that job reallocation in Ukraine has increased considerably after liberalization and that the employment reallocation has become productivity-enhancing. However, the study undertaken by Loecke and Konings (2005) for the manufacturing sector in Slovenia, finds that substantial total factor productivity growth, was mainly explained by firms becoming more efficient and entry of more efficient firms, rather than a shift in employment shares towards the more efficient existing firms.

The purpose of this paper is to study labor source reallocation across the Albanian sectors and thereby quantify its impact on aggregate labor productivity. Albania is a successful story of economic growth reaching a level of 6 percent per year. Given that aggregate data suggest substantial labor productivity growth, it is interesting to identify the factors contributing to this growth. For this purpose, the methodology applied decomposes aggregate labor productivity growth in the contribution of three factors: intra-sector productivity growth, labor source reallocation and sectors’ convergence to a mean productivity level, which can be considered as an equilibrium level.

The outline of the paper is as follows. Section II gives the basic pattern of labor productivity in Albania. Section III discusses in detail the methodology, data construction and sources; section IV presents the results in the aggregate and sector level of the economy. Conclusions are given at the end of the paper.

II. GROWTH AND PRODUCTIVITY TRENDS

During the start of transition¹, 1990-1992, Albania’s real GDP decreased by a cumulative of 39 percent. The macroeconomic stabilization policy established in 1993, led to a sustainable economic recovery. Between 1993 and 1996 the average annual growth picked up to 9.3 percent. The pyramid scheme crisis in 1997 caused an economic decline of 11 percent. However Albania was able to recover fast and growth rate of real GDP for 1998 reached 8.6 percent. This growth pattern was even higher for the next year, and stabilized during 2001-2002 with an average of 6.5 percent. During the energy crises of 2002 the economy grew only with 4.3 percent. Meanwhile, starting from 2003 the average annual growth rate was 6 percent.

Albania inherited a non-efficient structure of the economy and definitely the transition process led to restructuring of the economy’s composition.
Starting from 1990 the share of the industry sector has declined from 39 percent to about 24 percent in 2004. However, within the industrial sector, the construction sector experienced a great expansion from about 3 percent of GDP in 1990 to 13 percent in 2004. The tightening experienced by the industry sector allowed resources to be used by other sectors, such as services that increased its share of GDP from 33 percent to 54 percent. The share of agriculture sector first increased from 23 to 32 percent up to 1997 and then went back to 21 percent in 2005.

The substantial restructuring of the economy’s composition in Albania suggests that transition caused resource reallocation from less productive activities to more productive ones. Below we present labor productivity performance of the four major sectors, differences in employment shares and real wage developments.

Chart 1 presents labor productivity for the sectors of: agriculture, manufacturing, construction and services. The productivity is given as the ratio of real value added to employment for each sector. Chart 1 suggests that the process of sectors’ convergence toward the mean aggregate level of productivity is missing or is irrelevant. In general, the sectors’ development of productivity shows similarities only over the period 2002-2005, while most of the sectors experience productivity growth. Further in the material we will discuss the case when all of the sectors are converging towards a higher equilibrium level different from the aggregate level of the economy. Below we analyze the individual development of the productivity indicators for each of the sectors.

Over the period 1996 to 2000, manufacturing sector was the most productive in terms of labor input; however from 2001 to 2004 it ranked the second after the services sector. This impressive difference in the productivity levels of the two consecutive years may be induced by a structural break in data due to INSTAT new methodology for employment\(^2\). The new classification of employment for each sector during this period is reflected in the labor productivity developments. This change has a notable impact on the construction sector whose employment weight after 2000 increased considerably.

The agriculture sector ranks the last in terms of productivity performance. This development implicates expected developments of two possible processes:

- a) Low levels of agricultural productivity should lead to labor source reallocation from this sector towards more productive sectors.
- b) If there is a sectors’ convergence process, then the agriculture sector should reflect higher productivity growth in order to catch the aggregate mean of labor productivity.
The analysis we carry out in this material tests which one of this processes has been developed in the Albanian economy.

Chart 2 gives labor share of sectors to total employment. Agriculture sector has the largest share of employment; though it has decreased from about 74 percent to 64 percent. Services labor share has increased to about 20 percent of total employment. However the largest increase in labor share is experienced from the construction sector which in 1998 had only 1 percent of the total employees, but in 2005 it already grew to more than 6 percent. Manufacturing labor share does not reveal significant changes and is stable at the rate of 8 percent.

The developments presented in Chart 2, indicate that there is no relevant labor reallocation among the sectors. Only after 2000 employment in the services sector, with a high level of productivity, is increased considerably; and agricultural employment with low productivity is decreased. Over the period 2000-2001 (the restructuring of the employment classification) the process of labor reallocation among sectors is relevant.

Chart 3 presents the developments in real wages for the sectors of manufacturing, services and construction. Their performance helps to estimate the level of convergence among sectors. If there is a convergence of the sectors’ productivity, this process is also expected to cause also wage convergence.

The manufacturing sector has the highest level of real wages while the construction sector has the lowest, which does not fit with its high productivity. A preliminary conclusion is that there is no wage convergence. Starting from 1997 there is a tendency of wages to diverge, especially for the manufacturing sector. Following the theoretical assumption that productivity convergence is translated to wage convergence, given that this process is missing, it might implicate that there is no productivity convergence to the equilibrium level.

III. LABOR SOURCE REALLOCATION AND ITS IMPACT ON LABOR PRODUCTIVITY

III.1 METHODOLOGY

This section investigates the contribution of labor shifts across sectors to productivity growth. We use the method of aggregate productivity growth
decomposition as presented by Maliranta and Ilmakunnas (2005). This method is extensively used to analyze the impact of labor reallocation on labor productivity (e.g. Fagerberg, 2000; Timmer and Szirmai, 2000; Jalava et al., 2002; Van Ark and Timmer, 2003).

Below aggregate labor productivity is decomposed by sectors:

\[ LP_t = \frac{Q_t}{L_t} = \sum_i \frac{Q_{it}}{L_{it}} \cdot L_{it} \]  

where \( LP_t \) stands for aggregate labor productivity, \( Q_t \) is total aggregate output, \( L_t \) stands for total employment, \( Q_{it} \) for total output in the relevant sector \( i \) and year \( t \) and \( L_{it} \) is the respective employment. Equation (1) gives aggregate labor productivity as a weighted sum of the labor productivities of individual sectors and weights being the share of each sector employment in total labor. Terms without subscripts refer to entire economy measures. The term \( L_{it} / L_t \) in equation (1) refers to labor share of the sector \( i \) in total labor and the term \( Q_{it} / L_{it} \) refers to labor productivity of the same sector. Renaming the former as \( LSH_i \) and the latter as \( LP_i \), equation (1) can be rewritten as follows:

\[ LP_t = \sum_i LP_i \cdot LSH_i \]  

Next we consider changes in labor productivity from one year to another. This change can be written simply by subtracting the level of labor productivity at the end of period (1) from that at of period (0):

\[ LP_1 - LP_0 = \sum_i LP_{i,1} \cdot LSH_{i,1} - \sum_i LP_{i,0} \cdot LSH_{i,0} \]  

Rearranging with some algebraic manipulations, the following is obtained:

\[ LP_1 - LP_0 = \sum_i \frac{LSH_i}{LP_i} \cdot \Delta LP_i + \sum_i \frac{LP_i}{LSH_i} \cdot \Delta LSH_i \]  

where \( \frac{LSH_i}{LP_i} \) is the average labor share of sector \( i \) for the periods 1 and 0 and \( \Delta LP_i \) is labor productivity difference for sector \( i \) is for the same periods, \( \frac{LP_i}{LSH_i} \) is the corresponding average productivity level and \( \Delta LSH_i \) is the labor share difference of sector \( i \) for the periods 1 and 0. This formula is applied over the period 1996 to 2005 resulting in 9 figures for labor productivity change (\( LP_1 - LP_0 \)). Renaming labor productivity change as \( \Delta LP_i \) and dividing each side by the average aggregate productivity of the two corresponding years (\( LP_i \)) to rearrange equation (4) in growth terms, the following is obtained:

\[ \frac{\Delta LP_i}{LP_i} = \sum_i \frac{LSH_i}{LP_i} \cdot \frac{\Delta LP_i}{LP_i} + \sum_i \frac{LP_i}{LPH_i} \cdot \Delta LSH_i \]  

The first term on the right-hand side in equation (5), i.e. average labor share of sector \( i \) for year 1 and 0 multiplied by labor productivity change during this period, describes internal productivity growth within the individual sector and measures the “intra-sector productivity growth”. Therefore, intra sector
effect measures the change in aggregate labor productivity growth if the labor share does not change over time. The second term measures changes in aggregate labor productivity due to changes in labor share of the sectors (i.e. labor shifts) with sector productivity being held constant. In other words, this effect measures the changes in aggregate labor productivity resulting from the movements of labor across sectors with different productivity levels. When the employment share of sectors with high productivity levels rises, this implies a reallocation of labor towards sectors whose productivity is growing rapidly.

However, the denominator used in the sum on the right-hand side of equation (5) is the average aggregate productivity, \( \bar{P}_t \), not the average productivity of the respective sector \( i \), \( \bar{P}_i \). In order to get a pure intra sector effect, the average productivity of the sector \( i \) should be used as a base. Maliranta (2003) decomposes further the first term on the right-hand side of equation (6) as:

\[
\sum_i \bar{L}S_i \frac{\Delta P_i}{\bar{P}_i} = \sum_i \bar{L}S_i \frac{\Delta P_i}{\bar{P}_i} + \sum_i \bar{L}S_i \left\{ \frac{\bar{P}_i}{\bar{P}_t} - 1 \right\} \cdot \frac{\Delta P_i}{\bar{P}_i} \tag{6}
\]

where the first term on the right-hand side can be called the pure intra sector effect, which is the labor share weighted productivity growth of sector \( i \). The second term can be considered as a convergence term. If a sector \( i \) experiencing productivity growth \( \frac{\Delta P_i}{\bar{P}_t} > 0 \) has an average productivity larger than average aggregate productivity, \( \frac{\bar{P}_i}{\bar{P}_t} > 0 \), it shows that sector \( i \) is trying to catch up sectors with high productivity growth, that is, sectors’ labor productivity are converging.

Finally equation (5) is rewritten including the new decomposition given in equation (6):

\[
\frac{\Delta P_t}{\bar{P}_t} = \sum_i \bar{L}S_i \frac{\Delta P_i}{\bar{P}_i} \cdot \frac{\Delta P_i}{\bar{P}_i} \cdot \frac{\bar{P}_i}{\bar{P}_t} + \sum \bar{L}S_i \left\{ \frac{\bar{P}_i}{\bar{P}_t} - 1 \right\} \cdot \frac{\Delta P_i}{\bar{P}_i} + \sum \frac{\bar{P}_i}{\bar{P}_t} \cdot \Delta LSH_i \tag{7}
\]

Productivity growth is decomposed in 3 main effects: intra sector effect, convergence term and labor reallocation across sectors of different productivity. During the next section, the above decomposition is applied to Albanian data in order to test which effect has contributed more to the labor productivity growth.

III.2 DATA DESCRIPTION

Labor productivity during a period \( t \) (\( LP_t \)) is measured as output (\( Q_t \)) divided by labor input (\( L_t \)):

\[
LP_t = \frac{Q_t}{L_t} \tag{8}
\]
Output can be represented by value added or gross output. Although which one to use depends on the availability of data, the use of value added is preferred in case of sectors’ productivity because changes in labor productivity estimates based on gross output, may not reflect a change in technology or efficiency but rather, substitution between labor and intermediate inputs (Cobbold, 2003).

Taking into account both reasons, output in this paper is represented by real value added for the four major sectors: agriculture, manufacturing, construction and services. Sectors’ value added data are obtained from the national account statistics (INSTAT). Value added data are normalized by the respective deflators with the 1996 as the base year to calculate real value added.

The most appropriate method to compute real value added is to use the double deflation method where intermediate goods deflated by its price index is deducted from the real gross output (Cobbold, 2003). However, the unavailability of the intermediate good price index in Albania does not allow using this method.

The labor input is represented by the number of employee as data on working hours are not available. Labor data source is INSTAT.

Data quality is crucial for conducting good economic analyses. Data on agriculture employment are problematic as they follow the assumption that all persons owning a land (and their family members) are employed. As a result of this methodology, there is an overestimation of employment in this sector which might underestimate its labor productivity. The agricultural sector in transition countries has low productivity thus even if employment is overestimated, regardless of the possible shift in productivity, its performance will still be lower compared to other sectors.

Data on employment in nonagricultural sectors are obtained once data on informal market measured through Statistical Observation of Families (LMSI) is added to official employment. However, this methodology does not guarantee that the final result gives the real developments of labor market; the informal sector might be larger than measured by LMSI.

The inclusion of informal market in the data used in this paper even if it didn’t affect productivity, would estimate a pure labor source reallocation across sectors. Labor market informality is estimated through nation consumer’s questionnaires, which goes beyond the purpose and possibilities of this study. The result we will present will be discussed keeping in mind the restrictions of official data.

IV. RESULTS OF LABOR PRODUCTIVITY DECOMPOSITION BY EFFECTS

The results of the decomposition exercise for the entire economy are presented in Table 1. The average aggregate productivity growth for 1996-
2005 is around 7.6%. The Intra sector effect, i.e within sector productivity growth, is the major contributor to aggregate productivity growth for all the period 1996 to 2005 excluding 2001. On average it contributes by 105 percent of labor productivity growth for the whole period. During 2001 intra sector effect is outperformed by labor shift effect. The results are expected as the change in classification of employment by economic activities by INSTAT, means labor source reallocation across sectors. Therefore the analysis will be conducted for two periods, 1996-2000 and 2001 to 2005.

For the period 1997 to 2000 average labor productivity growth is about 4.46 percent. The largest contribution with more than 100 percent is given by the within sector productivity growth. On average only about 12 percent of aggregate productivity is caused by labor source reallocation across the sectors, while the convergence term indicates the presence of catch up process, excluding 1997. During 1997 there was a decline in aggregate productivity therefore the negative convergence term indicates divergence of the sectors from the aggregate productivity level.

For the period 2001 to 2005, excluding the first year, the largest contribution on labor productivity growth is given by the intra sector effect. However, compared to the first period, its contribution has diminished. As expected, labor source reallocation had the largest contribution during 2001, with an impact of over 100 percent. Starting from 2002, labor shift effect has a negative impact on aggregate productivity. But on the other side, the convergence term starts to contribute positively to productivity growth, with an average of 22 percent. The large impact of labor source reallocation during 2001 is also reflected in high sectors catch up for this year, being mainly a statistical issue.

It appears that 2001 is the turning point for the contribution of the sources of productivity growth. Before 2001, labor source reallocation was sustaining the within sector productivity growth. After 2001, the intra sector effect was supported by the convergence term, while there is no positive contribution of labor source reallocation across sectors.

Below we extend our analysis in sector level. Table 2 presents the contribution of the sectors to the sources of productivity growth. The results indicate that much of the intra sector contribution came from the agriculture sector with an average of 65 percent for the whole period. This sector has

Table 1 Aggregate productivity growth decomposition

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate productivity growth (%)</td>
<td>-8.1</td>
<td>7.6</td>
<td>12.9</td>
<td>5.5</td>
<td>22.9</td>
<td>3.5</td>
<td>4.2</td>
<td>7.8</td>
<td>11.8</td>
<td></td>
</tr>
<tr>
<td>Intra-sector effect (%)</td>
<td>169.9</td>
<td>122</td>
<td>61.7</td>
<td>116.7</td>
<td>87.9</td>
<td>83.9</td>
<td>105.4</td>
<td>97.5</td>
<td>76.6</td>
<td></td>
</tr>
<tr>
<td>Labor shift (%)</td>
<td>45.2</td>
<td>-59.4</td>
<td>9.6</td>
<td>50.9</td>
<td>119.3</td>
<td>-3.1</td>
<td>-10.6</td>
<td>-27.8</td>
<td>-9.6</td>
<td></td>
</tr>
<tr>
<td>Convergence term (%)</td>
<td>-115.1</td>
<td>37.4</td>
<td>28.7</td>
<td>-67.6</td>
<td>-107.2</td>
<td>19.2</td>
<td>5.2</td>
<td>30.3</td>
<td>33</td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s calculations
*Implies the effect with the largest contribution.*
consistently contributed to productivity growth, while the other sectors have at times counter affected productivity growth.

Table 2 Decomposition of aggregate productivity growth by sectors and effects

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Aggregate productivity growth (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Percentage of aggregate productivity growth explained by:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.1 Intra sector component</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>155</td>
<td>63</td>
<td>31</td>
<td>91</td>
<td>118</td>
<td>34</td>
<td>26</td>
<td>40</td>
<td>29</td>
<td>65</td>
</tr>
<tr>
<td>Production</td>
<td>33</td>
<td>32</td>
<td>15</td>
<td>45</td>
<td>-4</td>
<td>-11</td>
<td>57</td>
<td>15</td>
<td>13</td>
<td>22</td>
</tr>
<tr>
<td>Construction</td>
<td>-4</td>
<td>3</td>
<td>1</td>
<td>5</td>
<td>-18</td>
<td>35</td>
<td>33</td>
<td>10</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Services</td>
<td>-14</td>
<td>25</td>
<td>15</td>
<td>-24</td>
<td>-8</td>
<td>26</td>
<td>-12</td>
<td>32</td>
<td>29</td>
<td>8</td>
</tr>
<tr>
<td>Total (a)</td>
<td>170</td>
<td>122</td>
<td>62</td>
<td>117</td>
<td>88</td>
<td>84</td>
<td>105</td>
<td>98</td>
<td>77</td>
<td>102</td>
</tr>
<tr>
<td>2.2 Labor source reallocation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>-6</td>
<td>10</td>
<td>-1</td>
<td>4</td>
<td>-28</td>
<td>1</td>
<td>6</td>
<td>7</td>
<td>2</td>
<td>-1</td>
</tr>
<tr>
<td>Production</td>
<td>-7</td>
<td>-3</td>
<td>-2</td>
<td>-68</td>
<td>17</td>
<td>-1</td>
<td>-13</td>
<td>20</td>
<td>0</td>
<td>-7</td>
</tr>
<tr>
<td>Construction</td>
<td>22</td>
<td>-16</td>
<td>0</td>
<td>16</td>
<td>59</td>
<td>1</td>
<td>-2</td>
<td>-9</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Services</td>
<td>37</td>
<td>-50</td>
<td>13</td>
<td>99</td>
<td>72</td>
<td>-4</td>
<td>-1</td>
<td>-45</td>
<td>-12</td>
<td>12</td>
</tr>
<tr>
<td>Total (b)</td>
<td>45</td>
<td>-59</td>
<td>10</td>
<td>51</td>
<td>119</td>
<td>-3</td>
<td>-11</td>
<td>-28</td>
<td>-10</td>
<td>13</td>
</tr>
<tr>
<td>2.3 Convergence term</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>-81</td>
<td>-34</td>
<td>-17</td>
<td>-53</td>
<td>-63</td>
<td>-17</td>
<td>-13</td>
<td>-21</td>
<td>-16</td>
<td>-35</td>
</tr>
<tr>
<td>Production</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>27</td>
<td>-2</td>
<td>-2</td>
<td>19</td>
<td>9</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>Construction</td>
<td>-8</td>
<td>7</td>
<td>4</td>
<td>15</td>
<td>-29</td>
<td>7</td>
<td>13</td>
<td>6</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Services</td>
<td>-30</td>
<td>62</td>
<td>38</td>
<td>-56</td>
<td>-13</td>
<td>32</td>
<td>-14</td>
<td>37</td>
<td>37</td>
<td>10</td>
</tr>
<tr>
<td>Total (c)</td>
<td>-115</td>
<td>37</td>
<td>29</td>
<td>-68</td>
<td>-107</td>
<td>19</td>
<td>5</td>
<td>30</td>
<td>33</td>
<td>-15</td>
</tr>
<tr>
<td>3 Total effects</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Author’s calculations

On average, the manufacturing sector has contributed negatively to labor source reallocation, which means that its labor share of employment is reduced. This result is expected. The agricultural and manufacturing sectors have low productivity. Therefore labor is expected to shift from these sectors to services and construction, with high productivity. However, the negative effect of reallocation is expected to be higher for the agricultural sector than for manufacturing, as agriculture has very low productivity.

An explanation for why the agriculture sector is not reallocating its labor resource is that the labor force that is shifted, does not possess the relevant skills required in the more productive sectors, or is reluctant to change jobs. This problem points to the need for skills upgrading to induce higher productivity and economic growth in Albania.

Finally we analyze the contribution by sectors of the convergence term. The agricultural sector is the only sector with lower than average productivity. The convergence term for agriculture is expected to be negative reflecting its catch up process. Over the whole period the low level of agriculture productivity is offset by positive growth rate of this indicator, indicating a catch up process of this sector towards the economy’s average.

The sectors of construction, manufacturing and services have higher productivity than average. If these sectors were also catching up to the average level, their productivity growth would be negative, resulting in a negative convergence term.
Excluding 2001 when labor reallocation induced sector convergence, construction, manufacturing and services systematically diverge from the average aggregate level. This process means that the more productive sectors continue to have high efficiency growth and regardless of the convergence of the agriculture sector, the economy has not achieved a steady level of productivity, yet.

The process of continual productivity growth of the productive sector together with the convergence of the non-efficient sector will result in further productivity improvement in Albania.

These results indicate that the process of convergence and labor reallocation across sectors is low. Official data on employment for the sector is sustainable, probably due to non including informal market. Another possibility, which should be part of future research, is whether the Albanian economy has free capacities, thus it has not achieved a steady economic growth. In this case, free labor force might be able to satisfy the sectors demand for employment, without the need of labor reallocation.

Also, the convergence as used in this paper means convergence toward an average aggregate level of the economy. Our findings indicate that only the agriculture sector is converging to this level. However, given that the productive sectors have positive growth rates even though they are diverging more from the economy’s average, these sectors might be converging toward a joint equilibrium. Such a process, might implicate that the Albanian economy has not achieved the steady level and is moving toward it. Even though as used in the paper, the sectors appear to diverge, they may be converging to a higher equilibrium point.

Lastly, the material discusses linear convergence of sectors productivity but this process might be represented better by another functional form. Using other methodologies might determine better this process.

**V. CONCLUSIONS**

This paper presents the basic trends of labor productivity and its decomposition into the effects of employment and convergence. The results indicate that within productivity sector growth is the largest contributor to aggregate productivity. Regardless of the expectations of a high labor source reallocation, its impact is small. A preliminary conclusion is that the Albanian economy has free capacities, reducing the need for labor shifts across sectors.

High productivity growth in efficient sectors and the convergence of the agriculture sector toward high productivity level, support the continuous growth of this indicator in Albania. The Albanian economy has not achieved the steady level of economic growth yet, and is characterized by a dynamic and permanent stimulation of efficient production. Productivity is the promoter factor of long run economic growth and its positive growth rate will continue to induce development.
NOTES

* Vasilika Kota, Research Department, Bank of Albania.
Opinions expressed in this paper are those of the author and do not necessarily reflect the official opinion of the Bank of Albania.

1 Source data is WDI for 2003 for the period 1990 to 1995, INSTAT for the period 1996 to 2005.

2 Employment according to the economic activities for the private nonagricultural sectors, up to 2000 is classified using data from the General Directory of Duty-Taxes. Starting from 2001 the classification is estimated using data from: Ministry of Labor and Social Affairs, General Registration of the Population and Housing and statistical observation of the families (LSMS) conducted by INSTAT.

3 Wage data for the major sectors are collected from the Annual Business Structural Survey, carried out by INSTAT. In order to compute real wages, these data are deflated by the value added deflator for the major sectors.

4 To verify that equation (4) equals equation (3) we follow these steps:

\[ LP_1 - LP_0 = \sum_i \left( \frac{LSH_i}{2} \right) \Delta LP_i + \sum_i \frac{\Delta LSH_i}{2} \]

\[ LP_1 - LP_0 = \sum_i \left( \frac{LSH_i}{2} \right) LP_i + \sum_i \left( \frac{\Delta LSH_i}{2} \right) + \sum_i \frac{LP_i LP_i,0}{2} + \sum_i \frac{\Delta LSH_i}{2} \]

\[ LP_1 - LP_0 = \sum_i \left( \frac{LSH_i}{2} \right) LP_i + \sum_i \left( \frac{\Delta LSH_i}{2} \right) + \sum_i \frac{LP_i LP_i,0}{2} + \sum_i \frac{\Delta LSH_i}{2} \]

\[ LP_1 - LP_0 = \sum_i \left( \frac{LSH_i}{2} \right) LP_i + \sum_i \left( \frac{\Delta LSH_i}{2} \right) + \sum_i \frac{LP_i LP_i,0}{2} + \sum_i \frac{\Delta LSH_i}{2} \]

\[ \frac{\partial LSH_i}{LP_i} \partial LP_i,0 \]
REFERENCES


Brown David, Earle John, (2005), Job Reallocation and Productivity Growth in the Ukrainian Transition, Heriot-Watt University, Upjohn Institute for Employment Research Central European University

Burgess Simon, Mawson Dan, (2003), Aggregate Growth and the Efficiency of Labour Reallocation, University of Bristol, August

Cobbold, Trevor, 2003, A comparison of gross output and value-added methods of productivity estimation, Productivity commission, Australia, November


Maliranta Mika, Ilmakunnas Pekka, “Decomposing productivity and wage effects of Intra-establishment labor restructuring”, Nr. 993, 2005


1. INTRODUCTION

Many time series are observed only at a low frequency (for example, annually), while most of the economic analyses study the behavior of the economy in the short run, increasing in this way the requirement for high frequency data. The process of deriving high frequency data from low frequency data is usually referred to as temporal disaggregation.

The use of temporal disaggregation techniques by the statistics institutions is a practice, well known in many states. These techniques play a fundamental role, particularly in compiling quarterly national accounts.

The final aim of temporal disaggregation techniques is derivation of high frequency data and obtaining quarterly estimates even when the annual data may not yet be known. These temporal disaggregation techniques use all the available information in the best possible way, within a given model, guaranteeing that the high frequency information is coherent with the low frequency data.

Estimating the components of GDP is another important field in which temporal disaggregation techniques are intensively applied. Nowadays, different countries estimate monthly indicators as well using all the available information and also guaranteeing consistency with the quarterly data.

This paper is organized as follows: section 2 describes the main methods of temporal disaggregation; section 3 presents the disaggregation of GDP in Albania and section 4 concludes.

2. ALTERNATIVE METHODS OF TEMPORAL DISAGGREGATION

Different studies have shown that there exist a number of techniques which can be classified as follows:

• Methods that do not use high frequency indicators to disaggregate data

This category includes methods which derive quarterly estimated from annual data based on purely mathematical criterion, providing smoothed quarterly series related to annual data. These methods can be used when there is missing information on the series to be disaggregated.
• Methods that make use of related indicators with high frequency to disaggregate data

These methods use all the available information from other indicators with high frequency to disaggregate the series.

Despite what method is used to disaggregate the series, all methods should take in consideration some main principles:

1. The model should include those statistical variables with high frequency, which are considered as good proxies of the aggregates to be estimated.
2. The set of basic information should include only variables associated with the economy of the country for which the quarterly estimations are compiled.
3. The mathematical and statistical models should not include any relationships between quarterly aggregates of different countries, except those regarding international relationships.

While, the estimations from the disaggregation methods should fulfill the below listed characteristics:

First: Time consistency
The sum of quarterly values of GDP must be equal to the annual value.

Second: Coherency
The sum of quarterly values of the GDP components should be equal to the corresponding quarterly value of GDP.

The processes of temporal disaggregation of annual data may be described as one of the below processes:

Distribution: when the annual data are either sums or averages of quarterly data (e.g. GDP, consumption, in general all flow variables, price indexes, etc).

Interpolation: when the annual value equals the value of the fourth quarter (e.g. population at the end of the year, money stock and in general all stock variables).

Extrapolation: when estimates of quarterly data are made as the relevant annual data are not yet available and not necessary the sum of quarterly value equals the respective annual value.

Based mainly on residual modeling we classify temporal disaggregation methods as following groups:

• smoothing methods;
• two-steps adjustment methods;
- time series methods;
- optimal methods;
- dynamic model methods.

SMOOTHING METHODS

These methods are usually based on purely mathematical techniques and are used when there is a lack of high frequency information.

Smoothing methods assume that the unknown quarterly trend can be described as a function of time. These techniques minimize the discrepancy between known annual values and quarterly estimations. Boot, Feibes and Lisman (1967) are the first authors that have used smoothing methods as temporal disaggregation techniques.

TWO-STEPS ADJUSTMENT METHODS

These methods take in consideration all the available information from quarterly indicators which is used as a dynamic path of quarterly estimated series. The two steps adjustment methods divide the process on compiling the data in two parts.

The first step consists of a preliminary estimation of quarterly data. These estimations can be provided directly or indirectly. Different tests have indicated that preliminary quarterly estimates are not accurate, as in general do not fulfill the main characteristics of time consistency and coherency.

The second step makes the adjustment of the preliminary estimations by distributing the discrepancy between annual data and the preliminary estimates. After the adjustment process, the estimated data have the same characteristic with the annual data.

One of the adjustment methods is that implemented by Denton (1971). In this procedure the final quarterly estimates are obtained by minimizing a quadratic loss function, which involves the preliminary estimates. A simple adjustment rule is “dividing by four” of discrepancy between the annual value and the sum of the preliminary estimates. However, this method is not advisable because it can create an unjustified discontinuity between the estimate for the fourth quarter of one year and the first quarter of the following year.

TIME SERIES METHODS

Time series methods can be used when there is a lack of information and also as optimal adjustment methods. These techniques take into account the time series approach and to interpolate and extrapolate the data are based mainly in ARIMA models. Time series techniques include not only all the available information obtained from quarterly indicators but also dynamic elements of aggregated series.
Time series methods are particularly useful in situations with lack of quarterly information. They can be used to produce forecasts within the year, if quarterly time series related to the annual indicator are missing. This characteristic derives from the time series nature of the estimation process.

The time series methods were first presented by Wei and Stram (1989, 1990), who based their techniques on the relationship between covariance of the aggregate and disaggregate model.

In 1989 AL-Osh used a state space model for the ARIMA approach, which takes into account the characteristics of annual series to derive quarterly estimations. The estimated vectors and the corresponding covariance matrix are obtained by using the Kalman Filter procedure.

**OPTIMAL METHOD**

Optimal methods merge the steps of preliminary estimation and adjustment process in one statistically optimal procedure. This can be done using all available information from annual and quarterly data in a statistical regression.

The main characteristic of these techniques is the ability to evaluate the errors covariance matrix. The optimal estimation approach offers a natural and coherent solution to the disaggregation problem. The new estimated data of quarterly series are directly compiled from the quarterly regression model.

The technique proposed by Chow and Lin (1971) is the most intensively used in National Statistical Institutes to disaggregate the data, especially in France and in Italy. Different versions of these techniques have been developed according to the different hypotheses related to the structure of the error in the regression model. The main error models are classified as follows:

- **AR (1) model** (Bournay dhe Laroue, 1979).
- Random walk model (Fernandez, 1981).

The first model supposes that residuals follow an AR (1) process and are generated from the first condition of Markov process. This technique is based on the assumption that there is no correlation between series and it is appropriate when the series of residual are stationary.

In 1989 Fernandez proposed another method, which assumes that residuals follow a random walk distribution:

$$u_{t,i}^* = u_{t,i-1}^* + \varepsilon_{t,i}^*$$  \hspace{1cm} (1)

where: $i$ presents the quarters and $t$ the year, $u_{t,0}^* = u_{t,4}^*$ and $\varepsilon_{t,i}^*$ is white noise with $\sigma^2$ variance and as a first condition, Fernandez supposes that $u_{0,4}^* = 0$. 
The assumption made by Fernandez, improves the technique proposed by Chow and Lin, but this assumption is very specific for the behavior of residuals because it implicates the presence of a filter, that should eliminate the correlation of residuals of quarterly series.

In 1983 Litterman, showed that this filter can not eliminate all the correlation between the series, so he assumed that residuals can be described with the downward equations.

\[ u_{t,i}^* = u_{t,i-1}^* + \varepsilon_{t,i}^* \]  

(2)

\[ \varepsilon_{t,i}^* = \lambda \varepsilon_{t-1,i}^* + \varepsilon_{t,i}^* \]  

(3)

where \( \lambda < 1 \) and \( u_{0,0}^* = \varepsilon_{0,0}^* = 0 \)

**DYNAMIC METHODS**

Dynamic methods are an extension of optimal methods, but also include dynamic elements in the estimation. They take into account the impact of related indicators in the short run, and also their past impact on the variable we want to estimate.

According to Mazz and Savio (2005), the main difference between the above mentioned methods is the assumption used for the errors’ distribution.

In general, the disaggregation methods can be described as below:

Let \( y_{4(t-1),+i} \) be the unknown quarterly value of the aggregate in quarter \( i \) of the year \( t \), and let \( y_{a,t} \) be the correspondent known annual value where \( t = 1 \ldots n \).

When disaggregating, the relationship between \( y \) and \( y_a \) can be written as:

\[ y_{a,t} = y_{4(t-1),+i} \text{ for } t = 1, \ldots, n \]  

(4)

The relationship between the quarterly series and the annual figures can be reformulated in a matrix form as presented below:

\[ y_a = By \]  

(5)

where \( y \) is a vector with dimensions \((N x 1)\) of the unknown quarterly values and \( y_a \) is a vector with dimensions \((nx1)\), which includes annual values of the series to be disaggregated. \( N \) is usually equal to \( 4n \), however in the case of data extrapolations \( N = 4n + q \), where \( q > 0 \) after over sample estimations are obtained using annual figures. \( B \) is a matrix with dimensions \((nxN)\), where its form depends on the disaggregation we want to consider:
\[
B = \begin{bmatrix}
  c & 0 & \ldots & 0 \\
  0 & c & \ldots & 0 \\
  \vdots & \vdots & \ddots & \vdots \\
  0 & 0 & \ldots & c
\end{bmatrix}
\]

where:
- \( c = (1 \ 1 \ \ldots \ 1)' \) for flow variables in the disaggregation process
- \( c = \frac{1}{4}(1 \ 1 \ \ldots \ 1)' \) for indexes in the dissagregation process

3. ALBANIA’S CASE

Data are considered as an important source of information on different economic indicators. They provide information on annual developments of the indicators but also on their fluctuations. Institute of Statistics (INSTAT) is the main institution which collects and calculates statistical indicators in Albania. The main indicators, which are published by the INSTAT, may be divided into two main groups: economic indicators and social indicators. The social indicators provide information on social and economic life evolution of the Albanian economy, while the economic indicators provide information on the performance of the whole economy.

However, time series in Albania are short and with low frequency. Most of the problems relate to the real sector of the economy, such as GDP which is published on annual basis with a time delay.

The above mentioned techniques showed that annual figures of national accounts may be disaggregated to higher frequencies if we have additional information related to the original series, and information on other indicators of the same economic environment, given that they are affected by the same factors. Below, we will present a first attempt to obtain quarterly GDP figures for the period 1996-2006 using the method of two-steps adjustment presented by Denton (1971).

The first step to disaggregate the data is determining the indicators to be used as the main forecasters for our series. There are two ways of determining the indicators:

1. Economic Intuition

To disaggregate GDP we may use its components: Consumption, \( C \); Investment I, Government expenditures \( G \) and Net exports \( NX \). The method of disaggregating GDP through its components is good, as it takes into account the characteristics of a small open economy like Albania, the business cycles of our country and that of foreign partners. Data on exports, imports and government expenditures may be provided on monthly basis but the other components are not only available on annual basis, but also estimated as residuals. According to this method, we should determine high frequency
indicators for these components which will serve as forecasters of their development. Another alternative method is to use the total volume of sales in the economy as a whole or that of the sectors, which is an indicator widely used in countries such as France, Italy, Malaysia, etc.

2. Statistical Estimation

According to this method, we choose an indicator closely related to GDP based only on the statistical characteristic of the model, for example: the highest coefficient of determination $R^2$, the lowest standard deviation, no autocorrelation, and no heteroskedasticity, etc.

To disaggregate GDP we use two different indicators, M3 and total volume of sales. We choose these indicators for a number of reasons:

The aggregate M3 is chosen instead of M1 and M2, because its relationship with the GDP has the highest $R^2$ (0.98), Durbin-Watson = 1.43 and the lowest standard deviation. We also know that monetary aggregate M3 includes all the currency outside banks, demand deposits and time deposits in domestic and foreign currency. Given that interest rates of deposits denominated in foreign currency are not affected by the politics of the Monetary Authority, the Bank of Albania, this indicator is more suitable for disaggregation purposes than M1 and M2. A good example of using the monetary aggregate is Chile, which uses State space model and Kalman Filter technique, as one of the most advanced methods.

On the other side, we choose total volume of sales as it serves as a good forecaster of the total production in a given period. This indicator is on quarterly frequency and is also used in many countries. Below we present the GDP disaggregation for Albania.

Data on monetary aggregate M3 are provided by the Bank of Albania for the period 1996Q1-2006Q4. After we aggregate quarterly M3 to annual figures, it shows that there is a strong positive relationship between M3 and GDP with a correlation coefficient of 0.98. The regression between GDP and M3 is given below:

$$ GDP = c(1) + 1.15* M3 + \xi t(6) $$

$$ t-stat (9.59) (31.14) $$

where: $R^2 = 0.98$, D-W = 1.43, $\xi t$ is the residual and $c(1)$ a constant.

The preliminary results of the quarterly GDP are adjusted by the residuals generated by the method of Denton of “dividing by four”. The final results are given in Chart 1. The estimations are consistent because the sum of the quarters adds to the annual figure of GDP for the representative year.
The same procedure is applied for total volume of sales, which gives the absolute value of sales of the main sectors of the economy for each quarter. The series is provided by INSTAT for the period 2001Q1-2006Q4. A graphical representation of the quarterly figures for total volume of sales (Chart 2) shows that the series is seasonal. Therefore, we use two series of sales to disaggregate GDP, one with seasonality and the other seasonality adjusted with Tramo/seats method.

After aggregating both series of total sales in annual figures, we find that there is a strong positive relationship of this indicator with the GDP, which is reflected in the high correlation coefficient (0.98). The models are given below:

Model with unadjusted total volume of sales

\[ GDP = c(2) + 0.92 \times \text{Sales} + \mu t \quad (7) \]

\[ t\text{-stat} (9.28) \quad (20.58) \]

Where: \( R^2 = 0.98 \), \( DW = 1.59 \), \( \mu t \) errors and \( c(2) \) is a constant.

Model with adjusted total volume of sales

\[ GDP_{sa} = c(3) + 0.93 \times \text{Sales}_{sa} + \nu t \quad (8) \]

\[ t\text{-stat} (9.39) \quad (21.17) \]

where: \( R^2 = 0.98 \), \( DW = 1.64 \), \( \nu t \) errors and \( c(3) \) is a constant.

After obtaining the preliminary results and adjusting them, we derive the quarterly figures of GDP with and without seasonality. Even in this case, the sum of the quarters adds to the annual figures of GDP of the respective year. The results are presented in the chart below.

Chart 4 presents quarterly GDP obtained from the above mentioned models. We note that the series generated from M3 and un-adjusted volumes of sales indicate almost the same patterns and trends on different quarters, showing the same cyclical developments of the Albanian economy. On the other side, GDP series disaggregated with the total
the same trend as the other series, but it is smoother. Also, it is important to note that quarterly GDP estimations are both time consistent and coherent.

One of the main disadvantages of the two-steps adjustment method presented by Denton is the discontinuity between the fourth quarter of a given year and the first quarter of the following year. This drawback is not reflected largely in the case when the total adjusted volume of sales is used. The results of GDP quarterly estimations are presented in table 1.

The quarterly estimations of GDP are compared with the estimations of IMF. Chart 6 indicates the development of GDP derived from M3, total volume of sales and IMF estimations.

The above figure indicates that the IMF estimations are relatively close to the series derived from total volume of sales seasonally adjusted. During 2004-2006 the quarterly series of IMF is lower than our estimations because the annual figures of GDP published by INSTAT differ from those of the IMF. Chart 7 presents the difference rates between annual GDP estimated by IMF compared to annual figures published from INSTAT for the period 1996-2005.

4. CONCLUSIONS

The process of data disaggregating is important and indispensable in case of missing information. This process is useful to derive long time series, estimate unknown figures and improve short term economic analysis. Many methods can be used to disaggregate annual series and are related to the available information on a given variable. In this paper, we present a first attempt to generate quarterly GDP figures from two series, M3 and total volume of sales. Both models have high determination coefficient $R^2 = 0.98$, thus 98 percent of GDP variation can be explained by M3 or total volume of sales. The models have also satisfactory DW figures. Given that the annual number of observations used in modeling is low and differs between the two cases, it is hard to compare their performance. However, the results may be considered as satisfactory for the
first phase of GDP estimation, given that the series are short and do not allow further testing. As future research, it is important to generate quarterly GDP data using other disaggregation methods, high frequency information, longer time series and other software packages such as ECOTRIM, RATS etc.
### ANNEX

<table>
<thead>
<tr>
<th>Years</th>
<th>GDP_M3</th>
<th>GDP_Sales</th>
<th>GDP_Sales_SA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996Q1</td>
<td>65,972</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996Q2</td>
<td>74,463</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996Q3</td>
<td>89,044</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996Q4</td>
<td>107,129</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997Q1</td>
<td>66,337</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997Q2</td>
<td>81,734</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997Q3</td>
<td>95,426</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997Q4</td>
<td>110,144</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998Q1</td>
<td>85,965</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998Q2</td>
<td>97,143</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998Q3</td>
<td>110,170</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998Q4</td>
<td>123,730</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999Q1</td>
<td>97,382</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999Q2</td>
<td>114,909</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999Q3</td>
<td>126,657</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999Q4</td>
<td>141,633</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000Q1</td>
<td>121,290</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000Q2</td>
<td>124,949</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000Q3</td>
<td>137,196</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000Q4</td>
<td>149,542</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001Q1</td>
<td>126,831</td>
<td>126,301</td>
<td>138,719</td>
</tr>
<tr>
<td>2001Q2</td>
<td>136,396</td>
<td>154,925</td>
<td>157,028</td>
</tr>
<tr>
<td>2001Q3</td>
<td>152,513</td>
<td>146,676</td>
<td>142,746</td>
</tr>
<tr>
<td>2001Q4</td>
<td>174,542</td>
<td>162,379</td>
<td>151,789</td>
</tr>
<tr>
<td>2002Q1</td>
<td>151,774</td>
<td>137,402</td>
<td>152,389</td>
</tr>
<tr>
<td>2002Q2</td>
<td>148,961</td>
<td>152,492</td>
<td>154,561</td>
</tr>
<tr>
<td>2002Q3</td>
<td>160,878</td>
<td>165,047</td>
<td>160,226</td>
</tr>
<tr>
<td>2002Q4</td>
<td>169,725</td>
<td>176,397</td>
<td>164,161</td>
</tr>
<tr>
<td>2003Q1</td>
<td>159,836</td>
<td>157,471</td>
<td>174,848</td>
</tr>
<tr>
<td>2003Q2</td>
<td>164,076</td>
<td>171,148</td>
<td>173,006</td>
</tr>
<tr>
<td>2003Q3</td>
<td>181,754</td>
<td>182,204</td>
<td>176,275</td>
</tr>
<tr>
<td>2003Q4</td>
<td>191,284</td>
<td>186,128</td>
<td>172,820</td>
</tr>
<tr>
<td>2004Q1</td>
<td>166,229</td>
<td>162,960</td>
<td>181,213</td>
</tr>
<tr>
<td>2004Q2</td>
<td>171,817</td>
<td>182,496</td>
<td>184,984</td>
</tr>
<tr>
<td>2004Q3</td>
<td>197,815</td>
<td>197,388</td>
<td>191,422</td>
</tr>
<tr>
<td>2004Q4</td>
<td>216,507</td>
<td>209,524</td>
<td>194,749</td>
</tr>
<tr>
<td>2005Q1</td>
<td>175,345</td>
<td>172,028</td>
<td>192,550</td>
</tr>
<tr>
<td>2005Q2</td>
<td>192,220</td>
<td>207,565</td>
<td>210,702</td>
</tr>
<tr>
<td>2005Q3</td>
<td>219,458</td>
<td>216,227</td>
<td>209,323</td>
</tr>
<tr>
<td>2005Q4</td>
<td>235,012</td>
<td>226,216</td>
<td>209,460</td>
</tr>
<tr>
<td>2006Q1</td>
<td>192,072</td>
<td>188,602</td>
<td>213,090</td>
</tr>
<tr>
<td>2006Q2</td>
<td>201,567</td>
<td>211,511</td>
<td>215,028</td>
</tr>
<tr>
<td>2006Q3</td>
<td>231,412</td>
<td>234,538</td>
<td>226,925</td>
</tr>
<tr>
<td>2006Q4</td>
<td>271,249</td>
<td>261,649</td>
<td>241,256</td>
</tr>
</tbody>
</table>

**NOTES**

* Elona Dushku, Research Department, Bank of Albania.

Opinions expressed in this paper are those of the author and do not necessarily reflect the official opinion of the Bank of Albania.

1 We have used preliminary estimation of IMF for annual value of 2006.
REFERENCES

“A proposal to obtain a long quarterly Chilean GDP series” CUADERNOS DE ECONOMÍA, VOL. 43 (NOVIEMBRE), PP. 285-299, 2006

ABEYSINGHE, L; LEE, C “Best Linear Unbiased Disaggregation of Annual GDP to Quarterly Figures: The Case of Malaysia” (1998)


BRUNO, G, DI FONZO, T; GOLINELI, R; PARIGI, G “Short-run GDP forecasting in G7 countries: temporal disaggregation techniques and bridge models” (2005).


GUJARATI, D, “Basic Econometrics”, Fourth edition, United States Military Academy, West Point.


LITTERMAN, R: “A random Walk, Markov Model for the distribution of the time series” (1983)

MAZZI, G; SAVIO, G “Theory and applications of univariate and multivariate models for temporal disaggregation” Eurostat (2005)


BANK OF ALBANIA NEWS OVER OCTOBER - DECEMBER 2007

On 17-23 October, 2007 a delegation of the Bank of Albania, headed by the Governor, Mr. Ardian Fullani, also the Governor of Albania to the International Monetary Fund, participated in the annual meetings of the IMF and the World Bank Group, held in Washington D.C.

In the meetings held with the high officials of the IMF, the World Bank and those of central and commercial banks, Mr. Fullani presented the performance of the Albanian economy, the areas that should be subject to improvements and the assistance to be provided by these institutions. The Minister of Finance, Mr. Ridvan Bode, was also present in the majority of the meetings. More specifically, in his meetings with high officials of the IMF, Governor Fullani focused on issues relating to the monetary and financial stability in Albania, to the factors that have increased inflationary expectations and to the stability of the banking system in the country. Governor Fullani also underlined that the credit portfolio quality remains one of the priorities of the Bank of Albania.

The high officials of the IMF congratulated the work of the Bank of Albania in terms of controlling inflation and enhancing public confidence. They also stated that the Bank of Albania represents a positive example of good inflation management. Assistance was provided to the Bank of Albania and the Ministry of Finance in terms of the acceleration of structural reforms, improvement of the administration procedures of internal debt management, the enhancement of efficiency in the financial and banking market, etc.

During the meetings with the high officials of the World Bank, Governor Fullani presented the macroeconomic developments in Albania, and the measures taken by the Bank of Albania to safeguard macroeconomic stability from inflationary pressures present in the Albanian market. He also presented the objectives of the Bank of Albania to develop the financial and banking markets, to boost their efficiency and to further develop the payments system.

The World Bank representatives expressed their support in the steps taken by the Bank of Albania. The World Bank provided its assistance on matters such as financial infrastructure, stating that microfinance institutions, savings and credit associations and the development of markets are very important elements of this sector.

On 29 October 2007, a forum called “Trends in foreign reserve management”, organized by the Bank of Albania, in collaboration with the Treasury Department of the World Bank, was held in Tirana International
Hotel. The forum was attended by World Bank experts working in the sector of investments, representatives of the Bank of Albania, as well as those of other central banks. The country manager of the World Bank office in Tirana, Ms. Camille Nuamah was one of the guests in the forum.

The forum intended to discuss the current global trends related to the ways that central banks adopt to manage foreign exchange reserves. During the last couple of years, there has been a sharp increase in the foreign exchange reserves that are managed by the central banks globally. This is also confirmed by the fact that from 2000 till 2006 these reserves have more than doubled in size, amounting up to 5.1 trillion USD by the end of 2006.

On 30-31 October 2007, in the premises of “Mondial” hotel, the Bank of Albania started the first round of training seminars for the high school teachers of Tirana. This activity is part of the educational program “The Central Bank in Every Day Life” and will be organized four times per year, in two day sessions.

Seminars of this nature aim to introduce high school teachers of the capital city with the role, the activity and the monetary policy of the Central Bank, with the main issues of central and commercial banking and with the basic concepts of economics. Activities of this nature represent a good chance for the Bank of Albania “to discuss” with the teachers, as well as “to get introduced” with their demands and proposals regarding the needs of young people in general and of their students in particular, for a proper economic and financial education.

During the two day seminar the teachers listened to presentations and discussed with the representatives of the Bank of Albania the following topics: “The Central Bank and its objectives”; “The institutional pillars of the Bank of Albania: Autonomy-Accountability-Transparency.”; “Inflation: what we should know about it. The role of the Bank of Albania in preserving price stability”; “The Central Bank and inflation targeting.”

At the end of the seminar the 40 participant teachers left their impressions and suggestions in the questionnaires that were prepared for this activity.

An IMF mission led by Mr. Gerwin Bell visited Tirana during October 31–November 14, 2007. The purpose of this visit was to discuss the fourth review under the IMF program and the impact of the ongoing energy crisis on the fiscal, financial, and macroeconomic situation. The mission met with Prime Minister Berisha, Minister Bode, other key ministers of the cabinet, Governor Fullani, as well as other senior officials and representatives of the civil society and the international community.

On 31 October -1 November representatives of the mission met with Bank of Albania directors and specialists and discussed the following issues:
monetary policy, inflation, interest rates, the Treasury bill market, BoA Treasury bill window, interbank market, bank liquidity, the foreign exchange reserves, the Balance of Payments data for 2007 Q1-Q3 to the extent available and prospects for 2008, plans for the development of Delivery-vs-Payment system for trading treasury bills, functioning of RTGS (AIPS) and Bulk Settlement payments (ÆCH) system—functioning of payments systems, existing problems and degree of acceptance by users, as well as needed improvements, developments of the economy in 2006 with respect to growth and inflation, revised macroeconomic projections, the establishment of a Credit Information Bureau in Albania, trends in tax on income, the structural influence on tax administration, the situation of the banking system, new prudential regulations, the credit growth, the legal issues and priorities facing BoA (including legislation to improve execution of collateral, and legal support for Credit bureau), monetary data issues and the discussion of recommendations of the recent MCM TA mission on internal audit.

In the press statement on these meetings, the IMF staff mission to Albania stated that: “Monetary policy, which has been well managed in an increasingly challenging environment, should remain the main policy response to short-term threats to price stability, but anchoring inflation expectations requires other actors to also play their roles.”

In addition, the IMF representatives affirmed their support for the Bank of Albania’s efforts to reinforce safeguards for financial stability, including the establishment of Memorandums of Understanding with the home country executives of the major banks, and measures to improve the ability of banks to execute collateral.

On 8 November 2007, the visit of Bank of Albania specialists to “Alex Buda” high school in Tirana opened the round of visits to the high schools of the capital city. On this occasion, the Bank of Albania specialists met with third year students for an one class session and briefly presented to them the role and the functions of the Bank of Albania, as well as the importance that this institution has for the welfare of every Albanian. During the lectures, the students listened to and discussed personal budget matters, the main products offered by commercial banks, the widespread use of electronic money, as well as financial-economic subjects that are of most interest to them. Until now, the representatives of the Bank of Albania have visited 10 schools, where there have been distributed around 6000 educational and around 350 questionnaires. Based on the information obtained from the questionnaires, we were pleased to understand that the high school students of Tirana do not only appreciate presentations of this nature, but are also interested to learn more about the role that the Central Bank plays in the economy and in our everyday life.

These visits are part of the educational program “The Central Bank in everyday life”, initiated by the Bank of Albania in 2007. The newest educational program of the Central Bank aims to enrich and improve the new educational program...
tradition and the transparence to the public at large. The program includes other activities apart from the visits and the distribution of brochures in the high schools of the capital city, such as the organization of training seminars for the high school teachers, as well as the organization of the “The Real Value of Money” competition.

On 15-16 November, 2007, the Bank of Albania organized in the premises of “Tirana International” hotel the workshop “Economic research in South East Europe”. Representatives from research departments of the central banks of the region, as well as representatives from the Austrian, Hungarian, Turkish and Romanian central banks were invited to take part in the activity. Dr. Rebecca Newmann, professor in the University of Wisconsin-Milwaukee, was also one of the attendees.

16 study materials which focused on monetary policy issues, the foreign sector of the economy as well as general economic issues, were presented and discussed in this activity, which aimed to promote collaboration and dialogue among the researchers and specialists of economic research, working in the specific departments of South East European central banks; to encourage debate on core economic issues that influence the decision making process in these countries; and to reinforce the ethics and standards applied in the economic research field.

On 3-7 December 2007 the Department of Banking Supervision in collaboration with the FSVC organized in the premises of “Tirana International” hotel, a seminar on the International Accounting Standards (IAS), today known as the International Financial Reporting Standards (IFRS). The transition from the IAS to IFRS standards represents one of the most important developments in the field of accounting.

IFRS represents a set of 41 financial reporting standards which are mainly related to the banking and financial field, as well as other economic fields. Starting from the financial year of 2005 the European Commission has imposed the employment of these standards on 7000 businesses operating in the public sector of the European Union. Together with all non-member countries, Albania is still in the comprehension and implementation phase of these standards.

Judging from their importance and the innovations they will bring forward for the implementation of our countries accounting principles, the rapid familiarization with these standards is not only an urgent must, but above all a new challenge for the inspectors of the Supervisory Department of the Bank of Albania.

On 6 and 7 December 2007, in the premises of “Tirana International” hotel, the Bank of Albania organized its VII Annual Conference “Monetary Policy Strategies for Small Economies”. This conference was conceived as
a combination of the traditional Bank of Albania annual conferences set up and those of the round tables dealing with topics related to the perspectives of monetary policy in Albania.

The two days of the conference instigated debate and efficient discussions on this year’s main topic, which focused on the classical function of a central bank: “monetary policy”, as well as on the institutional framework, the decision making process and the monetary transmission efficiency. In addition, topics related to financial market issues and macroeconomic and financial stability were also discussed by the main speakers.

During the first day of the conference the presentations were held by experts and international academics of the central banking field. The lecturers discussed their international experiences relating to the formulation and implementation of monetary policy for small scale economies, and shared with the public practical aspects of these experiences.

The second day of the conference opened with the Governor’s award ceremony for the Best Diploma Thesis. The award goes to the student(s) that write the best diploma thesis.

The second day discussions were entirely dedicated to the progress that the Bank of Albania has made for the future adoption of the new monetary policy regime. Representatives of the Bank of Albania presented and discussed with the participants the conclusions reached in their research.

The conference was attended by experts of central banks and those of international financial institutions, well known academics, representatives from the banking system, representatives from other important institutions in the country, as well as from other local and foreign personalities.

On 7 December 2007, during the second day of the Seventh Annual Conference of the Bank of Albania, the winners of the competition “The Governor’s Award for the Best Diploma Thesis” for 2007 were announced.

Following the experience of the best central banks and the consultations with important actors of the economic and political life in the country, the Bank of Albania has decided to turn the organization of this competition into an annual tradition. This activity does not only represent a source of motivation for the students that aspire to make academic research in the central banking field and the economy in general, but also an attempt to increase public awareness on the importance that the absorption of promising elements inside and outside the country, presents for the future of the Albanian institutions.

The Bank of Albania aims to be the first of the list when it comes to professionalism and will do so by absorbing new elements who seek development and a promising career.
The Evaluation Committee of the Bank of Albania, after examining the numerous applications submitted by students graduated from the most well known Albanian and European universities, decided to assign the following prices:

- The first prize to Mr. Drini Imami and Mr. Endrit Lami, students of the European Economic Sciences Master, University of Tirana and University of Bamberg, for the thesis “Research for a political business cycle in Albania”.
- The second prize to Ms. Ersida Doçaj, London Metropolitan University graduate, for the thesis “What has been the impact of the banking system in the economic development of Albania, during 1992-2006?”
- The third prize to Mr. Afrim Laçi, University of Shkodra graduate for the thesis “Tourism and its potential in diversifying the economy in the Puka region”.

On 13 December 2007, the Bank of Albania and the Ministry of Education and science signed in the Library of “Qemal Stafa” high school, a Memorandum of Understanding. This memorandum has enabled the two institutions to specify new collaboration ways in favor of the education of the public on general economic issues, as well as on central banking ones. This collaboration targets mainly the young generation, more precisely the students of primary schools, high schools and universities.

On this occasion the Governor of the Bank of Albania, Mr. Ardian Fullani met with the teachers and students of “Qemal Stafa” high school. He briefly presented to them the role and the functions of the institution he leads and the newest educational program designed by the Bank of Albania, “The Central Bank in everyday life”. This program is mainly intended for the economic and financial education of the young people, especially that of high school students. At the end of his speech, Governor Fullani invited the students to share with him their ideas, demands or comments that, as he stated, would contribute to making the Bank’s future work for public education even more efficient.

On 13-14 December, 2007 in the premises of hotel “President” in Tirana, the Bank of Albania organized the second round of seminars for the high school teachers of the capital city.

This two days seminar, which will be held 4 times per year, is part of the new educational program of the Bank of Albania, known as “The Central Bank in everyday life”. The welcoming speech for the occasion was held by the Governor of the Bank of Albania, Mr. Ardian Fullani together with the Minister of Education and Science, Mr. Genc Pollo. Minister Pollo valued the activities of the Central Bank as very efficient and the educational brochures written with a clear and comprehensible language, understandable for the public at large.
Governor Fullani stated that during the last two years the Bank of Albania has been very interested in issues related to public education, aiming to create solid relations with the Albanian public.

While the first part of the seminar was dedicated to topics relating to the Bank of Albania and its role, the second part of the activity dealt with topics regarding the banking system and financial stability.

The seminar was attended by 40 high school teachers, who listened and discussed the following topics: “The Albanian banking system and its supervision”, “Financial stability and the role of the Bank of Albania in its preservation”. As a reply to the reflections coming from the participant teachers, the lecturers also discussed other topics related with the Central Bank activity.
LEGAL EVENTS OVER OCTOBER - DECEMBER 2007

BANKING SUPERVISION

On 15 October 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 57, the Regulation “On risk management in the foreign banks branches activity”. Its purpose is to define the instruments that ensure a safe and stable activity of the foreign bank branch; to set the maximum limits of the exposure towards some of the risks in exercising the activity of the foreign bank branch; as well as to determine the requirements and the obligations on reporting and on the verifying documentation due to the implementation of this regulation.

On 15 October 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 58, the Unified Reporting system – URS for the branches of the foreign banks. URS is the only reporting system for the second-tier banks, for banking supervision and monetary statistics purposes, and it is a competence of the Supervisory Council to modify it. This reporting represents the most important source for the compilation of the monetary statistics and of the external sector, and they provide the judgment basis for the assessment of the banks’ performance.

On 27 November 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 70, some amendments to the Regulation “On the Operation of the Credit Registry at the Bank of Albania”, approved upon decision of the Supervisory Council No. 38, date 18.07.2007.

On 27 November 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 71, the Guideline “On the procedure for issuing a report on the borrower and reviewing data held in the Credit Registry”. The purpose of this guideline is to define the procedures for the application, acceptance and issuance of the report on the borrower, and also the procedure for reviewing the data held in the Credit Registry.

On 27 November 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 72, “The fees for using the information held in the Credit Registry of the Bank of Albania”. According to this Decision, the fee for the banks request shall be ALL 110, payable monthly, while the fee for the request of the registered entity shall be ALL 500, payable at the application acceptance.

On 7 November 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 73, some amendments to the Regulation “On
the licensing, organization, activity and supervision of foreign exchange bureaus”, approved upon the Decision of the Supervisory Council of the Bank of Albania No. 31, date 06.06.2007.

On 12 December 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 77 “The indirect holding transfer at 70 per cent of the equity capital of the Raiffeisen Bank sh.a., from Raiffeisen Zentralbank Osterreich AG, to Cembra Beteiligungs GmbH, Austria”. After the approval of the transfer of the qualifying holding, the only change consists in the structure of the shareholders with indirect rights on the shares of Raiffeisen Bank sh.a., Albania.

On 12 December 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 78, “The merger by absorption of Banca Italo-Albanese Sh.a. by the American Bank of Albania Sh.a.”. With the approval of this merger the structure of the shareholders’ capital of the American Bank of Albania will be owned by the following shareholders according to the respective ratios: Intesa Sanpaolo S.p.A. 78.49 per cent; Albanian-American Enterprise Fund 12.22 per cent; European Bank for Reconstruction and Development 7.78 per cent; and SIMEST S.p.A. 1.51 per cent.

PAYMENT SYSTEMS

On 15 October 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 61, the “Acceptance of the “VISA” company, as an indirect settlement participant in the AIPS system”.

On 14 November 2007, the Supervisory Council of the Bank of Albania adopted upon Decision No. 66, the Regulation “On the operation of the accounting and treasury management system (ATM)”. The purpose of this regulation is to assure the well-functioning of the accounting and treasury management system (ATM), which consists of all the operational systems, the database, the instructions and operational manual of the information systems realized as part of the ATM project, that are going to be subject to continuous improvements and modifications.

MONETARY POLICY

On 31 October 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 63, the opinion of the Bank of Albania “On the quarterly review of the Albanian economy over the third quarter of 2007”. According to this statement, the Albanian economy marked positive annual growth rates over the nine-month period of 2007, while consumer prices inflation has been quite low for most of the period.

On 27 November 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 69, the increase of the interest rate of repurchase
and reverse repurchase agreements from the Bank of Albania by 25 basis points. Upon the entry into force of this Decision, the interest rate applied on the repurchase and reverse repurchase agreements raises from 6.00 per cent, to 6.25 per cent.

On 27 December 2007, the Supervisory Council of the Bank of Albania approved upon Decision No. 85 “The Monetary Policy Document for 2008”. This Document details all the concrete elements of the monetary policy for 2008, in particular in the field of monetary policy objectives and its operational framework. To be more precise, over 2008 the Bank of Albania shall work to enhance its analytical abilities; to broaden the information range used in the decision-making process; to increase the efficiency of the transmission channels; and to raise the extent and quality of its communication with the public.

ECONOMIC POLICY

On 3 October 2007, the Council of Ministers adopted the Decision No. 628 “On the approval of the Albanian Model of the Electrical Energy Market”. This model aims to establish suitable conditions for a consolidated market, to provide transparent and efficient capital flows and accounts, and to allow market-oriented trading of the electric energy, saving the clients’ profits. Its structure forecasts the development on consolidated basis of the electrical energy market, in conformity with EU directives.

On 10 October 2007, the Council of Ministers approved upon Decision No. 860 the Regulation on the establishment and operation of the economic areas. The purpose of this Regulation is to determine the rules on the establishment and operation of the economic areas, as well as the procedures for supervising and controlling them.

On 22 October 2007, the Parliament of the Republic of Albania passed upon Decision No. 9817 the Law “On agriculture and rural development”. This Law defines the targets, measures and programme of agriculture policies and rural development, agricultural public services, research and professional training, and also of the database and information on the policies of the agriculture and rural development sectors.

On 25 October 2007, the Parliament of the Republic of Albania ratified upon Decision No. 9820 “The Memorandum of Understanding for the coordinated development of Black Sea Ring Highway”. The highway consists of an international road round the Black Sea, with a length of about 7000 km, running through 12 states, providing services of an adequate quality for the up-to-date traffic and, thus, it will facilitate economic and social development of the entire European continent.

On 29 October 2007, the Parliament of the Republic of Albania ratified upon Law No. 9821, “The loan agreement between the Republic of
Albania, represented by the Council of Ministers, and the Council of Europe Development Bank for the project “House construction for social purposes”. According to this agreement, the Council of Europe Development Bank will extend a loan of EUR 15 million, to the Council of Ministers, in order to partially finance the housing for social purposes. The settlement period of the loan shall be 20 years from the disbursement date.

On 7 November 2007, the Council of Ministers approved in principle upon Decision No. 736, the financial agreement between the Republic of Albania and the European Investment Bank (EIB), for the financing of the project of Levan – Vlorë road. According to this Decision, EIB shall take part in financing the project of Levan – Vlorë road, by EUR 23 million.

On 7 November 2007, the Council of Ministers approved in principle upon Decision No. 737, the financial agreement between the Republic of Albania and the European Bank for Reconstruction and Development (EBRD), for the financing of the project of Levan – Vlorë road. According to this Decision, EBRD shall take part in financing the project of Levan – Vlorë road, by EUR 22 million.

On 12 November 2007, the Parliament of the Republic of Albania ratified upon Decision No. 9830, “The Istisna’a Agreement between the Council of Ministers of the Republic of Albania and the Islamic Development Bank for the construction of the road segment Kalimash - Rexhepaj, part of the road project Durrës – Morinë” and “The Agency’s Agreement between the Council of Ministers of the Republic of Albania and the Islamic Development Bank for this project attached to the Istisna’a Agreement”. According to the above agreement, IDB shall extend to the Albanian Government a loan not exceeding ID 6.66 million (approximately equal to USD 10 million), for a 25-year period, including a deferment period (without paying interests) of 7 years, for taking part in the financing of the road project Durrës – Morinë (Kalimash – Rexhepaj Segment).

On 10 December 2007, the Parliament of the Republic of Albania ratified upon Decision No. 9842, “The loan agreement between the Council of Ministers of the Republic of Albania and the Dutch Bank “ING Bank N.V.”, for financing the project “Vlorë water infrastructure rehabilitation””. The loan granted by the Dutch Bank “ING Bank N.V.” goes up to EUR 12 million four hundred forty-seven thousand, five hundred twenty-four, with a 12-year maturity, including a 3-year grace period, without paying the collateral and the interest.

On 12 December 2007, the State Aid Commission approved upon Decision No. 23 the Guideline “On some categories of horizontal aid”. The purpose of this Guideline is to facilitate the work of the state aid givers, at central and local level, through a deeper treatment of the concepts, criteria and procedures applied for some categories of horizontal aids. The state aid is considered as one of the intervention mechanisms of the State in order to compensate for market failures, without distorting the normal functioning of
a market economy, preserving a balance with the other economic and social development policies of special regions and of the entire country.

On 19 December 2007, the Council of Ministers approved the Decision No. 171 “On the approval of intra-sector strategy for consumer protection and market surveillance, over 2007 – 2013”. The vision of the Strategy is that the Albanian consumers should have a better position in assessing the market situation, through contemporary supervision and market effective transparency. Among its main objectives are guaranteeing a high level of consumer protection in the domestic market, ensuring the presence of safe products and services in the market, providing practical implementation of the consumers and market surveillance legislation, and establishing an operational and efficient system of market supervision in the entire country.
**BANK OF ALBANIA MANAGEMENT**  
**31 DECEMBER 2007**

**SUPERVISORY COUNCIL**

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARDIAN FULLANI</td>
<td>Chairman</td>
</tr>
<tr>
<td>FATOS IBRAHIMI</td>
<td>Vice Chairman</td>
</tr>
<tr>
<td>TEFTA ÇUÇI</td>
<td>Member</td>
</tr>
<tr>
<td>LIMOS MALAJ</td>
<td>Member</td>
</tr>
<tr>
<td>KSENOFON KRISAFI</td>
<td>Member</td>
</tr>
<tr>
<td>ADRIAN CIVICI</td>
<td>Member</td>
</tr>
<tr>
<td>ARJAN KADAREJA</td>
<td>Member</td>
</tr>
<tr>
<td>HALIT XHAFI</td>
<td>Member</td>
</tr>
</tbody>
</table>

**GOVERNOR**  
ARDIAN FULLANI

**GOVERNOR'S OFFICE**  
GENC MAMANI

**DEPUTY GOVERNORS**  
FATOS IBRAHIMI  
First Deputy Governor

**GENERAL INSPECTOR**  
TEUTA BALETA

**DEPARTMENTS AND OTHER UNITS**

<table>
<thead>
<tr>
<th>Department</th>
<th>Person</th>
</tr>
</thead>
<tbody>
<tr>
<td>HUMAN RESOURCES DEPARTMENT</td>
<td>Dashmir Halilaj</td>
</tr>
<tr>
<td>MONETARY POLICY DEPARTMENT</td>
<td>Gramoz Kolasi</td>
</tr>
<tr>
<td>RESEARCH DEPARTMENT</td>
<td>Alin Tanku*</td>
</tr>
<tr>
<td>MONETARY OPERATIONS DEPARTMENT</td>
<td>Marian Gjergeni</td>
</tr>
<tr>
<td>SUPERVISION DEPARTMENT</td>
<td>Indrit Banka</td>
</tr>
<tr>
<td>FINANCIAL STABILITY DEPARTMENT</td>
<td>Kodoron Shuhu</td>
</tr>
<tr>
<td>INFORMATION TECHNOLOGY DEPARTMENT</td>
<td>Xhilda Kanini Delyana</td>
</tr>
<tr>
<td>STATISTICS DEPARTMENT</td>
<td>Kliti Ceka</td>
</tr>
<tr>
<td>ISSUE DEPARTMENT</td>
<td>Valer Miso</td>
</tr>
<tr>
<td>ACCOUNTING AND FINANCE DEPARTMENT</td>
<td>Aran Toro</td>
</tr>
<tr>
<td>PAYMENT SYSTEMS DEPARTMENT</td>
<td>Marseda Dumanu</td>
</tr>
<tr>
<td>LEGAL DEPARTMENT</td>
<td>Toni Gogu</td>
</tr>
<tr>
<td>AUDIT DEPARTMENT</td>
<td>Teuta Balaeta</td>
</tr>
<tr>
<td>FOREIGN RELATIONS, EUROPEAN INTEGRATION AND COMMUNICATION DEPARTMENT</td>
<td>Ina Kraja</td>
</tr>
<tr>
<td>ADMINISTRATION DEPARTMENT</td>
<td>Agron Skenderaga</td>
</tr>
<tr>
<td>SECURITY AND PROTECTION DEPARTMENT</td>
<td>-</td>
</tr>
<tr>
<td>PRINTING HOUSE</td>
<td>Alfons Theka</td>
</tr>
</tbody>
</table>

**BRANCHES**

<table>
<thead>
<tr>
<th>Branch</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>SHKODRA</td>
<td>Ermira Istrefi</td>
</tr>
<tr>
<td>ELBASANI</td>
<td>Valentina Dedja</td>
</tr>
<tr>
<td>GJIROKAstra</td>
<td>Anila Thomaj</td>
</tr>
<tr>
<td>KORÇA</td>
<td>Liliana Zjarri</td>
</tr>
<tr>
<td>LUSHNJA</td>
<td>Shpresa Meço</td>
</tr>
</tbody>
</table>

*From November 2007.*
LIST OF ALL ENTITIES LICENSED BY THE BANK OF ALBANIA*

BANKS AND BRANCHES OF FOREIGN BANKS

1. ITALIAN - ALBANIAN BANK (JOINT-STOCK COMPANY)†
   Licence No. 1/1996, dated 17.07.1998
   Certificate No. 1 “On Deposit Insurance”.
   Director: Luigi MASTRAPASQUA
   Address: Rruga “Barrikadave”, Nr. 70, Tirana, Albania
   Tel.: 23 39 65, 23 56 97, 23 56 98, 22 62 62
   Fax: 23 30 34

2. RAFFEISEN BANK (JOINT-STOCK COMPANY)
   Licence No. 2/1998, dated 11.01.1999
   Certificate No. 2 “On Deposit Insurance”.
   Director: Steven GRUNERUD
   Address: Bulevardi “Bajram Curri”, European Trade Center, Tirana, Albania
   Tel.: 22 66 99, 22 45 40, 22 26 69, 22 54 16
   Fax.: 27 55 99, 22 35 87, 22 36 95, 22 40 51

3. UNITED BANK OF ALBANIA (JOINT-STOCK COMPANY)
   Licence No. 3/1998, dated 11.01.1999
   Certificate No. 3 “On Deposit Insurance”.
   Director: Abdul Waheed ALAVI
   Address: Bulevardi “Dëshmorët e Kombit”, Nr. 8, Tirana, Albania
   Tel.: 22 84 60, 22 38 73, 22 74 08
   Fax: 22 84 60, 22 83 87

4. ITALIAN BANK OF DEVELOPMENT (BANCA ITALIANA DI SVILUPPO)
   Licence No. 5/1998, dated 11.01.1999
   Certificate No.4 “On Deposit Insurance”.
   Director: Libero CATALANO
   Address: Bulevardi “Dëshmorët e Kombit”, Ndërtesa Kullat Binjake, Tirana
   Tel.: 28 03 51 / 2 / 3 / 4 / 5
   Fax: 28 03 56

5. NATIONAL COMMERCIAL BANK (JOINT-STOCK COMPANY)
   Licence No. 6/1998, dated 11.01.1999
   Certificate No. 5 “On Deposit Insurance”.
   Director: Seyhan PENCAPLIGIL
   Address: Bulevardi “Zhan D’Ark”, Tirana, Albania
   Tel.: 25 09 55
   Fax.: 25 09 56

* As of December 31, 2007.
† The licence of Italian-Albanian Bank is under the revocation process as a result of the merger by absorption with the American Bank of Albania.
6. TIRANA BANK (JOINT-STOCK COMPANY)
Licence No. 07, dated 12.09.1996
Certificate No. 6 “On Deposit Insurance”.
Director: Dimitrios FRANGETIS
Address: Rruga “Dëshmorët e 4 Shkurtit”, Tirana, Albania
Tel.: 26 96 16/7/8; 23 34 41/42/43/44/45/46/47
Fax.: 23 34 17

7. NATIONAL BANK OF GREECE (JOINT-STOCK COMPANY) – TIRANA BRANCH
Licence No. 08, dated 25.11.1996
Approved by the Supervisory Council Decision of the Bank of Albania No. 4, dated 14.03.1996.
Certificate No. 7 “On Deposit Insurance”.
Director: Ioannis LEIVADITIS
Address: Rruga “Durrësit”, Godina Comfort, Tirana, Albania
Tel.: 27 48 02; 27 48 22
Fax.: 23 36 13

8. INTERNATIONAL COMMERCIAL BANK (JOINT-STOCK COMPANY)
Licence No.09, dated 20.02.1997
Certificate No. 8 “On Deposit Insurance”.
Director: Mahendra sing RAWAT
Address: Qendra e Biznesit, Rruga “Murat Toptani”, Tirana, Albania
Tel.: 25 43 72 / 25 62 54
Tel/Fax: 25 43 68

9. ALPHA BANK (JOINT-STOCK COMPANY) – ALBANIA
Licence No.10, dated 07.01.1998
Certificate No. 9 “On Deposit Insurance”.
Director: Andreas GALATOULAS
Address: Bulevardi “Zogu I”, Nr.47, Tirana, Albania
Tel.: 23 35 32; 23 33 59; 34 04 76/77
Tel/Fax: 23 21 02

10. AMERICAN BANK OF ALBANIA (JOINT-STOCK COMPANY)
Licence No.11, dated 10.08.1998
Certificate No. 10 “On Deposit Insurance”.
Director: Lorenzo RONCARI
Address: Rruga “Ismail Qemali”, Nr. 27, P.O. Box 8319, Tirana, Albania
Tel.: 24 87 53/4/5/6
Tel/Fax: 24 87 62

11. PROCREDIT BANK (JOINT-STOCK COMPANY)
Licence No. 12, dated 15.03.1999
Approved by the Supervisory Council Decision of the Bank of Albania No. 22, dated 03.03.1999.
Certificate No. 11 “On Deposit Insurance”.
Director: Frieder WOEHRMANN
Address: Rruga “Sami Frashëri”, Tirana e Re, P.O. Box. 2395, Tirana, Albania
Tel.: 27 12 72/3/4/5
Tel/Fax: 27 12 76
12. FIRST INVESTMENT BANK (JOINT-STOCK COMPANY) - TIRANA BRANCH
Licence No. 13, dated 16.04.1999
Certificate No. 12 “On Deposit Insurance”.
Deputy Managing Director: Svetoslav MILANOV
Address: Bulevardi “Zogu I”, Nr. 64, Tirana, Albania
Tel.: 25 64 23, 25 64 24
Tel/Fax: 25 64 22

13. EMPORIKI BANK OF ALBANIA (JOINT-STOCK COMPANY)
Licence No. 14, dated 28.10.1999
Certificate No. 13 “On Deposit Insurance”.
Director: George CARACOSTAS
Address: Rruga “Kavajës”, Tirana Tower, Tirana, Albania
Tel.: 25 87 55/ 56/ 57/ 58/ 59/ 60
Tel/Fax: 25 87 52

14. CREDIT BANK OF ALBANIA (JOINT-STOCK COMPANY)
Licence No. 15, dated 28.08.2002
Certificate No. 14 “On Deposit Insurance”.
Director: Kamal Abdel MONEIM
Address: Rruga “Perlë Rexhepi”, Al-Kharafi Group Administration Building, Kati 1&2 Tirana, Albania
Tel.: 27 21 68, 27 21 62
Tel/Fax: 27 21 62

15. CREDINS BANK (JOINT-STOCK COMPANY)
Licence No. 16, dated 31.03.2003
Certificate No.15 “On Deposit Insurance”.
Director: Artan SANTO
Address: Rruga “Ismail Qemali”, Nr. 21, Tirana, Albania
Tel.: 22 29 16, 23 40 96

16. POPULAR BANK (JOINT-STOCK COMPANY)
Licence No. 17, dated 16.02.2004
Certificate No.16 “On Deposit Insurance”.
Director: Henri Maus de ROLLEY
Address: Bulevardi “Dëshmorët e Kombit”, Ndërtesa Kullat Binjake, Kulla 1, Kati 9, Tirana, Albania
Tel.: 27 27 88 / 89 / 90 / 91
Fax: 27 27 81

17. UNION BANK (JOINT-STOCK COMPANY)
Licence No. 18, dated 09.01.2006
Certificate No.17 “On Deposit Insurance”.
Director: Gazmend KADRIU
Tel.: 25 06 53
Fax: 25 06 54

As a result of its transformation into a subsidiary, the revocation of the licence is in process. The new licence is no.19.
18. FIRST INVESTMENT BANK (JOINT-STOCK COMPANY)
Licence No. 13, dated 16.04.1999
Approved by the Supervisory Council Decision of the Bank of Albania No. 35, dated 27.06.2007.
Deputy Managing Director: Svetoslav MILANOV
Address: Bulevardi “Dëshmorët e Kombit”, Kullat Binjake, Kulla 2, Kati 14, Tirana, Albania
Tel.: 25 64 23/4; 28 02 10
Tel/Fax: 25 64 22

In addition to banks and branches of foreign banks, the Bank of Albania has as of 31 December 2007 licensed the following entities:

<table>
<thead>
<tr>
<th>NO.</th>
<th>ENTITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>NON-BANK INSTITUTIONS</td>
</tr>
<tr>
<td>113</td>
<td>FOREIGN EXCHANGE BUREAUS</td>
</tr>
<tr>
<td>2</td>
<td>UNIONS OF SAVINGS AND CREDIT ASSOCIATIONS</td>
</tr>
<tr>
<td>131</td>
<td>SAVINGS AND CREDIT ASSOCIATIONS</td>
</tr>
<tr>
<td>1</td>
<td>REPRESENTATIVE OFFICES OF FOREIGN BANKS</td>
</tr>
</tbody>
</table>