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MONETARY POLICY REPORT FOR THE FIRST QUARTER OF 2009

1. GOVERNOR’S SPEECH

Economic and financial events at home continue to occur amidst an unstable external setting. On a global level, the advanced and emerging and developing economies remain highly uncertain both in terms of crisis duration and extension of its negative impact. The tight financial situation and the reduced agents’ confidence brought about the substantial fall of aggregate demand and slump in economic activity. Consequently, imports and exports fell in all economies and foreign investments reduced owing to the tightened lending conditions by the financial institutions.

The latest data on global economy attested to the magnitude of this crisis. The Euro-zone economy recorded negative growth in the last quarter of 2008, the severest-ever contraction since the introduction of the Euro. The data on the first quarter of 2009 show that the Euro-zone economy may have continued to contract at the same rates for this period as well. The U.S. economy suffered deep contraction in the last quarter of 2008 as well. The first signs of economic recovery in the U.S. were evidenced in the first quarter of 2009, resulting from the substantial fiscal measures put in place to recover the economy and spur the consumer spending.

The downward inflationary pressures attributing to the lower raw material prices gave room to central banks to implement easy monetary policies in order to assist the banking system and fuel lending to economy. In January and March 2009, the European Central Bank eased the monetary policy further by slashing the key rate to historical low. The Federal Open Market Committee decided to keep the key interest rate at 0-0.25 percent, the record low in the U.S.

The Albanian economy performed amidst stable consumer prices. The annual change in the CPI in the first quarter of 2009 continued to maintain the same contribution pattern of goods and services as in the year-end 2008. Annual inflation marked 1.9 percent remaining close to the lower half of the tolerance band set by the Bank of Albania. The decrease of inflation over this period owes mainly to the global fall of raw material prices. The low core and non-traded inflation rates attest to the fall of inflationary pressures on the domestic demand side. The pronounced and swift fall of inflation -in particular in the last quarter of 2008 and the first quarter of 2009-, the slower credit growth rates and the worsened consumer and business expectations for the future performance of economic activity and prices signal the slump in domestic and foreign demand. According to
our analyses, the risks for inflationary pressures in the medium run are to a large extent balanced.

According to official data, the Albanian economy maintained the same rates over the last quarter of 2008 as in the previous quarters. Turnover indicator for the sectors of production and services increased by 22 percent in annual terms. Construction and services provided the main contribution to the growth of economic activity. In contrast to the satisfactory performance of domestic economy, the external sector attests to the decrease of trade exchanges with the world over January and February 2009. Imports and exports fell over this period being followed with the narrowing of trade deficit by 4.3 percent. Notwithstanding the higher downward rate of exports to imports, the latter’s high base has led to the narrowing of the trade deficit.

Fiscal developments over the course of the first quarter of 2009 were by and large in line with the budget framework for the year 2009. Fiscal policy was characterized by the rapid increase of capital expenditure and by controlled budget deficit levels. This deficit was mainly financed through the privatisation receipts over the first quarter. The tight liquidity conditions in the banking system were reflected in the banks’ reluctance to meet the Government’s need for funds and in the increased costs. In light of the possible fiscal risks in the short run, the tightening of lending conditions encumbers the financing of the planned budget deficit. To this purpose, the Bank of Albania calls for the revision of projected expenditures in order to make the necessary corrections according to the priorities.

Monetary developments over January and February 2009 attest to the slowdown of demand for money, owing mainly to the marked contraction of credit to economy. The tightening of lending standards and terms has led to reduced supply and demand for loans from the economic agents. This situation was reflected in a pronounced slowdown of money supply growth rates compared with September 2008. On the supply side, the monetary developments over this period were characterized by the tendency of shifting toward more liquid components. On the demand side, the structure of domestic demand for money remained relatively unchanged, being dominated by credit to the private sector. As of end February, the banking system intermediated 67 percent of total deposits to finance the private sector’s activity.

Owing to the reduced amount of liquidity in the banking system, the annual growth rates of lending shrank considerably in the first two months of 2009. Excluding the exchange rate effect, the annual growth rate of loan portfolio slowed down further to 29 percent in February. Although the slump in lending activity leads to stable foreign currency position at home, the prolonged contraction of lending may affect the economic activity in the country. Accordingly, the Bank of Albania is supplying the banking system with the necessary liquidity and in co-operation with the latter is working on controlling the credit elements that are non-cost-related but which affect its performance.
The performance of loans by currency attests to the banks’ tendency to shift from lending in foreign currency to lending in domestic currency. As of end February, Lek-denominated loans accounted for 29 percent of loan portfolio, up by 2 percentage points compared with the average share in 2008. This shift is considered a positive development for the Albanian banking system. Banks’ greater inclination to lending in the Albanian Lek gives more room for greater monetary policy efficiency and for its impact over the behaviour of economic agents. In addition, the shift of the loan portfolio to the Albanian Lek would lower the exposure of the banking system’s developments to the exchange rate movements and would contribute to strengthening and safeguarding financial stability at home.

The banking market experienced liquidity pressures in the last quarter of 2008. The Bank of Albania has been supplying the banking system with liquidity making use of its entire operational framework. The cut in the key interest rate in January aimed to reduce the banks’ borrowing cost giving them room to transmit this decision to other banking products as well. The interest rates in the inter-bank market have dropped while the other markets do not seem to have reflected this decrease yet. The increase in the risk premium in economy and the tight liquidity situation led to higher interest rates in the primary market. The performance of the yields will largely depend on the need to finance the budget deficit and on the consistency of fiscal indicators with the projected figures and their materialization by the economic agents.

The interest rates on loans remained almost unchanged over this period, reflecting the banks’ more prudent lending policies. On the other side, banks were inclined to maintain high interest rates on deposits, aiming at improving their liquidity situation. In turn, this has led to a widened interest rate spread between the Albanian Lek and foreign currency-denominated deposits, hence providing a positive impact on the exchange rate performance. The latter, being freely determined in the foreign exchange market by its supply and demand, depreciated in the first quarter. The same performance, although at higher intensity, was shown in other regional countries as well.

The global economic developments are expected to provide their impact over the Albanian economy as well. Our economy is integrated into the European financial markets and trade exchanges with the Euro-zone countries have a considerable share in the overall output. The potential impact of the global economic crisis is expected to materialize in a slower economic growth over the year 2009. In addition, the current performance of prices and the Bank of Albania inflation forecasts signal downward inflationary pressures over the period to follow.

The global events have attested to the high integration level and the chain effects of the crisis on the Albanian economy, hence calling for constant monitoring of the economic and financial activity at home and for co-ordinated measures to deal with the consequences of this crisis.
The Bank of Albania decided to cut the key interest rate by 50 basis points to 5.75 percent in January. This move attests to the persistence and commitment of the central bank to intervene timely and appropriately in order to meet its primary objective. The Bank of Albania will continue to work on anchoring the inflationary expectations to its 3 percent target, hence contributing to maintaining the macroeconomic balances and stimulating economic activity.

The Bank of Albania considers that the developments over the course of the first quarter of 2009 call for continued prudence in another pillar of vital importance – the financial stability. The harmonization of the two basic balances, the macroeconomic and the financial one, remain a constant challenge for any decision-making authority. The latest analyses evidence the risk factors this fundamental balance may be faced with in every economy. The Bank of Albania remains fully committed to further consolidating this balance.

2. WORLD ECONOMY

2.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

Notwithstanding the measures taken to cope with the crisis, global economy suffered a downturn in the first quarter of 2009, prompted by the technical recession in advanced economies and the economic activity slowdown in emerging and developing countries. Global inflation rates maintained their downward tendency owing to the rapid fall of food and energy prices. Along with the labour market contraction, the economic outlook remains highly uncertain.

EURO-ZONE ECONOMY

Euro-zone economy suffered deep contraction in the last quarter of 2008, shrinking by 1.5 percent compared with the previous quarter – the deepest contraction since the introduction of the Euro. This slowdown attributes to the large fall of domestic demand, which has reflected the fall of consumption and the rapid contraction of investment. Exports and imports experienced a substantial fall leading to reduced industrial production and slight drop in services. The construction sector hit a downturn as well, reflecting the adjustments in the house prices in most Euro-zone countries. According to the early 2008 surveys, consumer spending and investment maintained their moderate rates. Economic growth in the first quarter of 2009 seems to have recorded similar rates to the last quarter of 2008. Unemployment rate increased by 0.2 percent in February compared with the previous month, hence increasing for the eleventh month in a row. According to preliminary data, annual inflation rate in the Euro-zone fell to 0.6 percent in March 2009, compared with 1.2 and 1.1 percent earlier in February and January 2009. The fall in consumer prices in February 2009 owe to the large decrease in the price of energy, which however is slightly lower than the fall in January 2009.
Table 1 Some main macroeconomic indicators

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>-0.8</td>
<td>-6.3</td>
<td>8.51</td>
</tr>
<tr>
<td>Euro-zone</td>
<td>-1.2</td>
<td>-1.5</td>
<td>8.5</td>
</tr>
<tr>
<td>Germany</td>
<td>-1.6</td>
<td>-2.1</td>
<td>7.4</td>
</tr>
<tr>
<td>Greece</td>
<td>2.6</td>
<td>0.3</td>
<td>7.82</td>
</tr>
<tr>
<td>Italy</td>
<td>-2.9</td>
<td>-1.9</td>
<td>6.92</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.6</td>
<td>-3.2</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Source: BEA, Eurostat, Respective statistical institutes

1 Data for March.
2 Data for Q4 2008.
3 Data for February.

U.S. ECONOMY

The U.S. economy continues to be characterized by a weak activity in its main sectors, although some important indicators have shown their first signs of recovery. Final assessments on economic growth for the last quarter of 2008 attest to more accelerated contraction of the economy, with the fall in consumer spending and aggregate investment being the main contributors. Economic indicators over the first two months of 2009 show better performance in some sectors of the economy. Trade deficit narrowed in January and February as a result of more accelerated downward rates of imports compared with exports. Disposable income increased by an average of 2.5 percent over the same period owing to the decrease in the fiscal burden on U.S. households in order to recover the economy and underpin an increase in consumer spending. However, the latter continues to maintain a downward trend although at more moderate rates than the last quarter the previous year. The Fed has stated its commitment to purchase a large part of the Government debt in order to inject liquidity into the economy and enhance the lending capacity.

Consumer confidence index improved in January and February however remaining at low levels compared with the same months the previous year. According to the data on the performance of manufacturing industry, the business climate remains unfavourable. However, the house market improved its sales in February by 4.7 percent in monthly terms. Unemployment rate attested to the further increase in the number of unemployed persons in March to 8.5 percent. Inflation rate rose by 0.2 percent compared with the same month the previous year reflecting primarily the rise in energy price in the domestic market.

THE BRICS’ ECONOMY

Economic activity in the BRIC countries slowed down as a result of the rapid fall of foreign demand mainly from advanced economies. Foreign direct investment also fell owing to the tight lending conditions by the international financial institutions.

Chinese exports fell by 25.3 and 34.2 percent in January and February. Industrial production increased at moderate rates while construction
deteriorated in February. On the other side, the fiscal package approved by the Chinese Government at end 2008 has helped to maintain high investment and consumer spending growth rates.

In Brazil, the decline in aggregate investment and the fall in consumer spending moderated the growth rates in the last quarter of 2008. In annual terms, the economy grew by 1.3 percent. In the meantime, the early months of 2009 attest to the decline in industrial production and deterioration of the liquidity situation in the market. Against this background, the central bank took measures to spur credit to economy through the decrease of the required reserve and the cut in the key interest rate.

In India, the fall of exports over the first two months of 2009 exerted pressures over the utilization of domestic production capacities and aggregate demand. In March, the national currency depreciated by about 20 percent vis-à-vis the U.S. dollar in annual terms. In order to prevent the further weakening of the economy, the Indian Government approved the temporary cut of direct taxes, cut of taxes on the small and medium-sized enterprises, the increase of investment in infrastructure and the support to the exporting companies. In the beginning of March, India’s central bank cut the key interest rate.

The Russian economy was severely hit by the deterioration of the trading terms resulting from the fall in raw material and oil prices. In annual terms, the economy grew by 1.2 percent in the last quarter of 2008. This contraction owes to the fall in aggregate investment and exports’ volume. In addition, in order to prevent the further depreciation of the national currency, the Russian central bank continued to intervene in the market by reducing its foreign reserve substantially.

<table>
<thead>
<tr>
<th>Country</th>
<th>February 2009</th>
<th>March 2009</th>
<th>Q3 2008</th>
<th>Q4 2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual inflation rate</td>
<td>Real economic growth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>5.9</td>
<td>5.6</td>
<td>6.8</td>
<td>1.3</td>
<td>-0.3</td>
</tr>
<tr>
<td>China</td>
<td>1.0</td>
<td>-1.6</td>
<td>9.0</td>
<td>6.2</td>
<td>6.3</td>
</tr>
<tr>
<td>India</td>
<td>10.4</td>
<td>9.6</td>
<td>7.5</td>
<td>5.3</td>
<td>4.3</td>
</tr>
<tr>
<td>Russia</td>
<td>13.9</td>
<td>14.0</td>
<td>6.0</td>
<td>1.2</td>
<td>-5.6</td>
</tr>
</tbody>
</table>

Source: IMF, OECD, Respective statistical institutes
1 OECD Economic Outlook, Interim Report, assessments.
2 Data for January.
3 Data for February.

REGIONAL COUNTRIES’ ECONOMIES

ITALY

The latest figures on the economic activity in Italy for the first two months of 2009 attest to the deterioration of some main economic indicators. Aggregate investment and industrial production fell further. In annual terms, the latter fell by 20 percent in February. Construction is also suffering sharp contractions, with investment falling below the average of the last decade. Exports to EU
countries and broader and imports decreased. On the other side, consumer spending has increased and the automobile industry has recovered over January following some fiscal measures taken by the Italian Government. Lending conditions remain tight. In February, loans to business and firms recorded an annual drop of 4.9 percent. Consumer price index increased by 1.1 percent in March compared with the same month the previous year.

GREECE
Greek economic activity experienced contraction in some of the main industries over the course of the first months of 2009. In annual terms, construction, manufacturing industry and exports fell by 33.5, 10 and 20 percent in the first two months of 2009. However, the more accelerated fall of imports than exports in absolute terms has improved the current account deficit over the same period. The inability to increase business and household loans as a result of the tight liquidity conditions in the market led to the decrease of this indicator in annual terms in August by 15.3 and 10.3 percent, respectively. On the other side, the low annual inflation rates in the recent months have led to higher real wages hence providing a positive performance of consumer spending. Annual inflation rate as measured by the HCPI marked 1.1 percent.

TURKEY
Turkey’s economy shrank by 6.2 percent in the last quarter of 2008 compared with the same period the previous year, giving it an overall annual growth rate of 1.1 percent. The global economic and financial crisis gave rise to substantial contraction of exports and domestic demand. Although upward, public spending could not offset the drop in consumer spending and investment. Industry and construction recorded substantial fall. Growth prospects for the year 2009 remain uncertain. There has been a decrease in industrial production, increase in unemployment and contraction in lending. On the other side, confidence indices have improved although remaining at pessimistic levels. In February 2008, inflation fell by 0.3 percent in monthly terms, which is reflected in the annual inflation rate of 7.7 percent. This low rate compared with the inflation rate for 2008 owes to the continued downward trend of the food price rise.

MACEDONIA
Economic activity in Macedonia contracted sharply in the last quarter of 2008 to 2.1 percent from 5.7 percent in the first three quarters. Investment and industrial production recorded substantial drop surpassing the positive effect of the increase in consumer and public spending. The downward rates of industrial production in January and February 2009 attest to the further contraction in the first quarter of the present year. Unemployment increased in the last quarter of 2008; however this increase is similar to that in the last quarter of 2007 hence providing evidence for the seasonal effect rather than a reflection of the global crisis. Annual inflation in Macedonia maintained its downward trend and marked 0.2 percent in March. Average inflation for the first quarter marked 1 percent. In January 2008, annual
inflation reached 10 percent while in December 2008 it dropped to around 4 percent. The main driving forces were the rapid fall in the price of oil and its by-products as well as of food, which have a large share in the Macedonian consumer basket.

KOSOVO

According to IMF assessments, Kosovo’s economy grew by 5.4 percent in 2008 underpinned by the stable donations, workers’ remittances and the considerable increase of public investment. Inflation for the year 2008 averaged 9.4 percent after 0.6 in 2006 and 4.4 percent in 2007. In the last months of 2008, inflation fell sharply to 0.5 percent in December compared to 12-14 percent in May to July. The downward trend in inflation rates continued in the first months of 2009 moving towards deflation and marking -0.5 in January and -1.2 in February. Food and transportation and communication costs provided a negative contribution to the inflation rate while the energy price rise slowed down considerably.

<table>
<thead>
<tr>
<th>Country</th>
<th>Annual GDP growth</th>
<th>Annual inflation rate</th>
<th>Unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4 2008</td>
<td>March 2009</td>
<td>January 2009</td>
</tr>
<tr>
<td>Italy</td>
<td>-2.9</td>
<td>1.1</td>
<td>6.9²</td>
</tr>
<tr>
<td>Greece</td>
<td>2.6</td>
<td>1.5</td>
<td>7.8²</td>
</tr>
<tr>
<td>Macedonia</td>
<td>2.1</td>
<td>0.2</td>
<td>33.5³</td>
</tr>
<tr>
<td>Serbia</td>
<td>2.8</td>
<td>9.9</td>
<td>14.0⁴</td>
</tr>
<tr>
<td>Croatia</td>
<td>0.2</td>
<td>3.8</td>
<td>14.8⁴</td>
</tr>
<tr>
<td>Turkey</td>
<td>-6.2</td>
<td>7.9</td>
<td>15.5</td>
</tr>
<tr>
<td>Kosovo</td>
<td>5.4¹</td>
<td>-1.2</td>
<td>43.0⁵</td>
</tr>
</tbody>
</table>

Source: Respective statistical institutes, EuroStat, EcoFin

¹ Data for 2008.
² Data for February.
³ Data for the Q4 2008.
⁴ Data for October 2008.
⁵ Data for 2007.

2.2 MONETARY POLICY, FINANCIAL MARKETS AND THE EXCHANGE RATE

The global financial markets continued to suffer pressures and volatility in the first months of 2009 generated by the prolonged crisis. The severe financial situation affected the economic performance of the main advanced and emerging and developing countries, being reflected in negative growth rates and lower global trade volume. The severe situation in the banking system led to tighter lending, higher uncertainty and deteriorated stock market indices. Foreign capital flows have declined in most emerging and developing countries bringing about deteriorated macroeconomic indicators. The inflationary pressures have slackened as a result
of lower raw material prices hence providing room for central banks to implement relaxed monetary policies in order to assist the banking system and fuel lending to economy.

Against this backdrop, the ECB cut the key interest rate twice earlier this year, while the U.S. Government and the U.K. Government took active measures to support the banking system and encourage lending. The high volatility and uncertainty reigning on the global financial markets affected the market agents’ expectations and behaviour. The impact of these measures has been relatively successful being reflected in the partial improvement of the banking system’s financial indicators over the first months of 2009. However, the global economy continues to reflect the contraction and uncertainty of its main agents.

The ECB cut the key interest rate twice by 50 basis points in January and March to 1.5 percent, the lowest level in its 10-year history. The Federal Open Market Committee decided to keep the key interest rate unchanged at 0-0.25 percent, the record low in the U.S. The Bank of England slashed its key interest rate three times by 50 basis points each to 0.5 percent. These measures aimed at fuelling the market given the liquidity shortages in the system and the projections for an economic growth of 0 percent in 2009. This is the lowest rate since the central bank was founded in 1694. The Bank of Japan kept its benchmark interest rate unchanged at 0.1 percent.

The accommodating policies of central banks brought about an increase in their balance aiming at fuelling demand and lending in the banking system. Over the first months of 2009, Libor and Euribor interest rates in the money market fell considerably reflecting the cut in the ECB and Fed’s key interest rate and the persistent accommodating policy of the ECB and other important institutions in providing liquidity. One-month and three-month Euribor interest rates fell by an average of 224 basis points compared with the year-end, while one-month Libor interest rate fell by 262 basis points. Starting from the second half of December, overnight Eonia interest rate recorded rates below the benchmark financing rate. Although the interest rates in the inter-bank market show a downward tendency, the tensions and risk perception from the market agents remain high. This is reflected in the high spreads between the maturities and the insurance instrument premiums in the inter-bank market.

The bonds market in Europe and the USA was highly volatile and characterized by upward yields in the first months of 2008 to later relax and record downward yields in the months to follow. Worth noting is the increase of the business bond yields, in particular of those that received a non-positive assessment by the audit companies. The downward performance of the yields in the last period seems to have been triggered by the latest decisions of the U.S. Federal Reserve to pursue an easing monetary policy for a long period of time. In the Euro-zone, the central bank’s decisions and the aiding policies of the governments have provided less impact over the yields’ performance. The latter have shown higher volatility that in the other markets. In Japan, the yields have also maintained an upward tendency, however at lower levels than in the USA and the Euro-zone.
The main indices in the stock markets -Dow Jones, S&P and Nikkei- were characterized by a high volatility and considerable fall in the first months of the year 2009. The last weeks attest to an upward tendency and recovery owing mainly to the cut of the key interest rate in the major countries and the support plans the U.S. Government has committed to undertake to aid the businesses. The profits of a number of companies quoted in the global stock markets continued to record substantial fall over this quarter, deteriorating the market agents’ perspective. The losses were considerable and mainly concentrated in the financial sector.

Over the course of the first two months of 2009, the Euro depreciated vis-à-vis its major currency counterparts; however in March it changed direction and partly recovered its year-end position. The depreciating performance of the Euro owes mainly to the appreciation of the U.S. dollar, the Chinese renminbi and the British pound. Over the course of this month, the Euro appreciated mainly vis-à-vis the Swiss franc and the Japanese yen. Foreign currency markets have been highly volatile. Starting from the end of December, the Euro has maintained a depreciating trend vis-à-vis the U.S. dollar, which shifted in mid-March. The unsatisfactory data on the Euro-zone economy and the recent data on some macroeconomic indicators below the market agents’ expectations have provided their impact on the depreciating performance of the Euro vis-à-vis the U.S. dollar. The first signs signalling the stabilization of the financial situation in the Euro-zone led to the recovery of the Euro against the U.S. dollar. In March, the Euro appreciated by an average of 2 percent relative to the previous month. In early April, the Euro traded at USD 1.32 or 1.1 percent more than the average of the first quarter.

2.3 OIL AND RAW MATERIAL PRICES

Over the course of the first quarter of 2009, the international oil market continued to be characterized by the fall in the average price per barrel of
oil and the contraction of supply by some of the main oil producing countries. The price of one barrel of oil fell by about 57 percent in annual terms although in March it rose by nearly 19 percent in monthly terms. The strong U.S. dollar vis-à-vis the Euro relative to the same quarter the previous year and the weakened demand and supply ratio led the oil price to remain at similar levels with the year 2004. Global annual demand for oil fell by 2.6 percent in the first quarter of 2009 owing to the contraction in advanced economies, which are the major consumers of oil and its by-products. In the meantime, the economic downturn in some of the major emerging countries such as Russia or China could not offset the fall of demand in advanced economies. Demand for oil fell in Russia while in China it recorded similar growth rates in absolute terms as in the same period the previous year. Against this backdrop, OPEC member countries continued to lower the daily oil production quota in order to recover demand for oil and raise the price per barrel.

Notwithstanding the concerns in some of the major North Sea oil refineries, supply in OECD countries has been upward. International oil market is expected to maintain the same performance for the next quarters although the recovery of U.S. demand in monthly terms in February was considered a positive signal and an expected effect of the current low price of oil in the market.

The IMF’s Commodity Price Index reveals an annual decrease of 41.7 percent in the first quarter of 2009. Compared with the previous quarter, it decreased by 15.2 percent. Along the same line, the Fuel Price Index has declined by 47.6 percent in annual terms. Relative to the last quarter of 2008, it decelerated by 21.6 percent. For the same period, the Food Price Index declined by 23.3 percent, while in quarterly terms it has slightly increased by 1.2 percent. The lower price rates over this quarter relative to the previous one owe to the deceleration of the price fall during this period.

On the other side, the high annual fall rates are a result of the rapid price rise that began in the end of 2007 to the first months of 2008. The further fall in fuel and metal prices attests to the low demand for these goods as a result of the decelerated industrial production.
3. PRICE STABILITY AND THE BANK OF ALBANIA OBJECTIVE

Average annual inflation marked 1.9 percent in the first quarter of 2009, remaining close to the lower half of the tolerance band set by the Bank of Albania. In March, annual inflation declined further to 1.6 percent. The downward trend of the annual inflation rate, shown since the mid-2008, attributes mainly to the fall of primary commodity prices in the international market, the lower domestic demand, the tighter financial conditions and the downward inflation prospects. The absence of inflationary pressures from both the internal and external environment is also reflected in the downward trend of traded and core inflation, which marked 1.4 and 1.7 percent, respectively, over this quarter.

Average annual inflation\(^6\) marked 2.9 percent in the first quarter, which is close to the Bank of Albania target of price stability. The downward trend of this inflation measure was more pronounced over the course of this quarter with average inflation falling by about 0.5 percentage points relative to the last quarter of 2008.

BANK OF ALBANIA’S MONETARY POLICY

The implementation of the Bank of Albania’s monetary policy is fully consistent with the primary target of achieving and maintaining price stability. This target implies pursuing low and stable inflation rates. The latter promotes economic growth, curbs the reduction in personal income and helps to moderate volatilities in unemployment and production. The Bank of Albania is committed to meeting the price stability target, which in quantitative terms is defined as the keeping of an inflation rate at 3 percent, with a tolerance band of +/- 1 percentage point. This band guides the economic agents’ expectations and represents a nominal anchor of the economy.

Monetary policy is future-oriented given the lags it affects demand and prices. Present assessments suggest that monetary policy instruments have an effect with a time lag of 3 to 6 quarters\(^7\). Monetary policy decisions are based on the analysis and assessment of current and future economic developments and on the assessment of risks that may lead inflation to deviate from the target.

The Bank of Albania kept the key interest rate unchanged at 6.25 percent over the course of the year 2008. Given the lags in the transmission mechanism and the tight monetary policy pursued over the year 2007 it was assessed that the monetary conditions at home were appropriate for gradually restoring the macroeconomic balances and bringing inflation back to the tolerance band.
Average inflation marked 3.4 percent over the year 2008 resulting within the tolerance band. In absence of external supply-side shocks in the end of 2007 and early 2008, it would have been lower.

Notwithstanding the global crisis, the Albanian economy continued to maintain satisfactory economic growth rates, low inflation and stable banking system performance over the course of the year 2008. However, the pronounced and swift fall of inflation - in particular in the last quarter of 2008 and the first quarter of 2009-, the slower growth rates of credit to economy and the worsened consumer and business expectations for the future performance of economic activity and prices signal the possible shift in the economic situation at home. The decrease of inflation over the 2008:Q4 – 2009:Q1 period was mainly driven by the fall in global primary commodity prices. The low core and non-traded inflation rates attest to the plunge of inflationary pressures on the domestic demand side. As indicated by the current inflation rate, the Bank of Albania inflation forecasts for the period to follow and the economic agents’ (business and consumers) expectations for the inflation stand below the Bank of Albania target. Against this background, the Bank of Albania decided to cut the key interest rate in January by 50 basis points to 5.75 percent. The central bank’s response reflects its commitment to act timely and appropriately to risks that may jeopardize price stability, hence buttressing economic activity.

**MONETARY CONDITIONS INDEX**

Central banks use a number of indicators during the decision-making process, with each of them playing a specific role. It is widely acknowledged that this institution has a final target (inflation) and a range of instruments (the key interest rate), by means of which it pursues its monetary policy. However, worth noting is the fact that the relationship between the instruments and the final target is indirect and that it affects with time lags.

For quite a number of years, short-term interest rates have been the main operational target for monetary policy. The ever-increasing importance of the interest rate and exchange rate channel in the monetary policy transmission required the construction of a new index. The Monetary Conditions Index (MCI) provides complete information on the monetary conditions setting and their impact on the economy. This fact
implies that there is an ever-increasing interest in determining the quantitative effects of monetary instruments on inflation and output. In addition, their use in monetary policy decision-making becomes greater.

Making an analysis of the current developments in the Albanian economy, it is noted that the upward tendency of the MCI shown in the previous periods shifted to a pronounced decrease in the second half of 2008, reflecting the depreciation of the Albanian Lek in nominal effective terms. The decrease persisted in the first months of 2009 when the cut of the key interest rate by 50 basis points at end January underpinned this tendency culminating in March in negative terms. The decrease in the MCI over the course of this period primarily attests to the relaxation of the tight monetary conditions reaching at end period to easing conditions. This implies that the monetary conditions have accommodated the aggregate demand in economy and triggered it further.

3.1 PRICES OF MAIN CONSUMER BASKET ITEMS

The annual change of the CPI in the first quarter of 2009 continued to maintain the same contribution pattern of goods and services’ items as the end of 2008. The changes in ‘processed foods’, ‘unprocessed foods’ and ‘services’ provided the main influence on the consumer prices.

‘Processed foods’ and ‘administered prices’ recorded downward annual growth rates. The inflation rates of these two items are nearly three times lower than the same period the previous year. They contributed to the annual inflation rate for the first quarter by 0.9 and 0.1 percentage points, accounting for about 50 percent of the inflation rate. On the other side, ‘services’ which continues to contribute by an average of 0.4 percentage points to the inflation rate was complemented over the course of this quarter by the positive contribution of ‘unprocessed foods’ (0.6 percent). In terms of inflation, this item had not provided a positive contribution since November 2008. Among other items, ‘non-food consumer goods’ provided a negative contribution of -0.2 percentage points hence offsetting the positive contribution rates of other basket items. Since January 2008, ‘housing’ has been providing negligible contribution to the inflation rate (0.1 percentage points).

The downward trend in the inflation rate of ‘processed foods’ shown over August to December 2008 peaked this year in March when it marked 2.6 percent. This item’s inflation is recording similar rates to the ones prior to the price crisis in the second half of 2007. The terminated effect of the bread price rise over October 2007 to February 2008 -in addition to the more favourable global
conjuncture of this item’s prices of goods- has triggered the decrease of inflation substantially. The same period the previous year ‘bread and cereal’ contributed by 1.7 percentage points to headline inflation to later fall to 0.6 percentage points in the first quarter of 2009.

For the first time since November 2007, the annual inflation of ‘unprocessed foods’ marked a positive rate of 2.1 percent in January. In the subsequent two months, this item’s annual inflation rate increased further to 3.2 percent. Prices of fruit and vegetables provide the main impact over this item’s inflation owing to their high volatility and seasonal nature. The high inflation was mainly a result of the lagged seasonal effect (due to unstable weather conditions) and the entry of seasonal food products at higher prices than usual. In the meantime, the imported share of these products has been put under the pressure of relatively higher prices in Albania’s main trading partners and the exchange rate performance – the depreciation of the Albanian Lek vis-à-vis the two major currencies.

As a result of volatile prices in these two items, the structure determining the headline inflation rate has also undergone changes over the recent months. ‘Processed foods’ has recorded high positive rates starting from August 2007 to late 2008 being a determinant in the formation of the inflation figure. By contrast, ‘unprocessed foods’ has recorded negative rates throughout the year 2008, hence offsetting the other item’s high inflation. The opposite movements of these two items’ inflation rates caused their contribution to the formation of the inflation rate counterbalance in low but positive rates (by 0.9 and 0.6 percentage points, respectively).

<table>
<thead>
<tr>
<th>Table 4 Contribution of items to annual inflation (in percentage points)</th>
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<tbody>
<tr>
<td>Processed foods (pp)</td>
</tr>
<tr>
<td>Bread and cereal (pp)</td>
</tr>
<tr>
<td>Alcohol and tobacco (pp)</td>
</tr>
<tr>
<td>Unprocessed foods (pp)</td>
</tr>
<tr>
<td>Fruit* (pp)</td>
</tr>
<tr>
<td>Vegetables* (pp)</td>
</tr>
<tr>
<td>Services (pp)</td>
</tr>
<tr>
<td>Administered prices (pp)</td>
</tr>
<tr>
<td>Fuel and energy (pp)</td>
</tr>
<tr>
<td>Housing (pp)</td>
</tr>
<tr>
<td>Non-food consumer goods</td>
</tr>
<tr>
<td>Durable consumer goods (pp)</td>
</tr>
<tr>
<td>Consumer Price Index (q-o-q, %)</td>
</tr>
<tr>
<td>Source: INSTAT and Bank of Albania estimations</td>
</tr>
</tbody>
</table>

Annual inflation rate of ‘services’ marked 4.6 percent in the first quarter of 2009, upward compared to the same period the previous year (3.6 percent). Services’ inflation was characterized by high increasing rates reflecting primarily the price rise in transportation (14 percent relative to the first quarter of 2008) and hotel and restaurant services (2.1 percent relative to the first quarter of 2008).

The first quarter of 2009 attested to the continued fall of the oil price per litre in the retail market compared to the same period the previous year. Oil price per
litre in the retail market averaged ALL 100.72. Relative to the same period the previous year, the Albanian Lek depreciated by about 20 percent vis-à-vis the U.S. dollar over the first quarter of 2009. Although the depreciating tendency was shown in early January, the time lag in the transmission of the exchange rate effect to oil prices in the market -combined with the developments in the international oil market in March- provided their effect on the domestic market with a time lag of two months. Following a seven-month period of continued fall in the average price, in March oil price per litre recorded a monthly rise of 3 percent.

The main developments in the performance of prices over the first quarter of 2009 were noted in ‘administered goods’. In March, the effect of the energy price rise last March was completely terminated, hence shifting the contribution of this item to negative rates. The falling price level affected the headline inflation rate markedly despite the volatile prices in other items. This item’s contribution was 0.1 percentage points from 0.8 percentage points in mid-2008. Its annual inflation has been descending since October 2008 given that the increase in the inflation of ‘fuels and energy’ (inflation marked 15 percent in February) was offset by the falling prices in ‘communication’ by about 19 percent.
‘Housing’ continued to record very low inflation rates in the first quarter of 2009 (0.1 percent) owing to the fall in rent prices. This item has by and large displayed seasonal fluctuations in prices triggered by the domestic demand in the market. The latter’s lower levels—in particular in late 2008 and the first quarter of 2009—led to a period of ‘relaxed’ prices in the house and rent market.

Prices of ‘durable consumer goods’ and ‘non-food consumer goods’ have fallen. Within the first item, ‘audio-visual equipment’ continued to record a negative annual inflation rate of -6.2 percent in the first quarter of 2009. Fuel prices, in particular within the second item, have fallen by an average of 11.7 percent in the last quarter. The fall in the oil price starting from September 2008 and the favourable energy situation have curbed the inflationary pressures and have prompted a downward revision of market agents’ inflation expectations.

### 3.2 INFLATIONARY TRENDS BASED ON OTHER INFLATION MEASURES

The curb on inflationary pressures in the Albanian economy was reflected in the downward tendency of different core inflation measures in the first quarter of 2009. In annual terms, the average of its measures marked 1.7 percent for the reference period. For the first time since autumn 2007, the average of core inflation measures for the first quarter of 2009 marked rates below the lower half of the tolerance band set by the Bank of Albania. Annual core inflation measured by permanent exclusion and trimmed mean marked 2.2 and 1.3 percent. The terminated effect of the price rise in ‘bread and cereal’ since 2008 has been gradually reflected over the first quarter in the permanent exclusion-based method. If the latter excluded this sub-item, core inflation would have marked about 1.5 percent, attesting to a relatively high convergence between the inflation rates as measured by these two measures.

Annual inflation by sectors of goods and services with traded and non-traded prices marked 1.4 and 2.7 percent, respectively, in the first quarter of 2009. Traded inflation provided the main contribution to the downward trend of headline inflation over September 2008 to March 2009. In the first quarter of 2009, it marked similar rates to its historical average over the last decade.

Traded inflation rate was about 1.7 percentage points lower than the same period the previous year. It continued to reflect the downward trend of raw material and primary commodity prices in the foreign markets.

Annual non-traded inflation marked lower rates than the previous periods, mainly owing to the...
terminated effect of the administrative decision on the rise of the energy price last March.

The developments in inflation by the aforementioned components have been underpinning a uniform downward inflation, which has been characterizing the Albanian economy over the last three quarters\textsuperscript{16}. Average annual core inflation rate of the last four quarters (2.6 percent) is verging towards the average of annual headline inflation for this decade (2.7 percent). Traded and non-traded inflation stand at relatively low historical levels. These trends suggest the presence of the stabilizing role of domestic demand-side factors in the headline inflation, which have been adequately steered by the monetary policy decisions.

4. MACROECONOMIC DEVELOPMENTS AND THEIR IMPACT ON INFLATION

4.1 AGGREGATE DEMAND AND PRODUCTION

4.1.1 Production by sectors

According to official data\textsuperscript{17}, economic activity maintained high rates over the last quarter of 2008. Volume turnover generated from production and services increased by about 22 percent in annual terms. Relative to the previous period it increased by 8 percent. Services provided the main contribution to economic growth in the last quarter of 2009 being
mainly triggered by the increase in trading activity. Construction continued to share the main weight in production activity although twice lower than the preceding three quarters.

The sector of services recorded the highest annual increase of volume turnover – by about 23.7 percent in the last quarter of 2008. The sector of production increased at an annual rate of about 19.4 percent.

In the sector of production, volume turnover recorded the highest annual increase in construction -around 21.1 percent- relative to industrial activity, which increased by about 16.9 percent. Volume turnover for construction recorded the lowest annual increase over this quarter, while compared to the previous quarter, the higher increase (by about 22.7 percent) attested to the improvement of this indicator. In industry, ‘energy, gas and water’ recorded

**Chart 14 Volume turnover for the sectors of economy**

Source: INSTAT, Main economic indicators, October-December 2008

**Chart 15 Volume turnover in the services sector**

Source: INSTAT, Main economic indicators, October-December 2008
the highest annual increase by 28.7 percent. The two other sub-branches, manufacturing and extracting industry, increased by 16.5 and -12.6 percent in annual terms. Relative to the previous quarter, volume turnover decreased by 1.2 and 25.7 percent, respectively.

The annual increase of the volume turnover in the sector of services was the highest in the last quarter of 2008. Trading activity increased by about 25.6 percent in annual terms, the best performance for the services sector. In annual terms, the volume turnover for ‘transportation and communication’ increased by 14.5 percent, while for ‘hotels’ it fell by about 16.3 percent.

Over the course of the first two months of 2009, the energy sector maintained the positive trend in indicators as in the previous year. Relative to the same period the previous year, domestic production increased by 34.1 percent. The increase in production led to substantial fall in imports and energy shortages, which reduced by 57.5 and 95.5 percent, respectively.

Although Albania remains a net importer of energy, the data made available from KESH report for the first time that 88.3 GWh were exported during the first two months of 2009.

The consumption profile of energy has not changed substantially relative to the previous periods. Households remain the main consumer of energy accounting for 61 percent of the market, followed by the private sector and public institutions, which make up 25 and 14 percent, respectively, of the demand for energy.

Losses in the distribution system remained an issue for the early 2009 as well. The increase of losses by 22 percent in annual terms owes mainly to the increase in non-technical losses by 23.4 percent. The ratio of losses to net production reduced by 5.2 percentage points in annual terms.

### Table 5 Energy balance sheet annual indicators (in GWh)

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Net production</td>
<td>540</td>
<td>755</td>
<td>1,012</td>
<td>34.15</td>
</tr>
<tr>
<td>Import</td>
<td>541</td>
<td>523</td>
<td>222</td>
<td>(57.5)</td>
</tr>
<tr>
<td>Energy provided in distribution</td>
<td>1,013</td>
<td>1,172</td>
<td>1,184</td>
<td>1.08</td>
</tr>
<tr>
<td>Distribution losses</td>
<td>394</td>
<td>387</td>
<td>474</td>
<td>22.27</td>
</tr>
<tr>
<td>Distribution losses/Net production</td>
<td>73.1</td>
<td>51.3</td>
<td>46.8</td>
<td>(8.85)</td>
</tr>
<tr>
<td>Energy shortages</td>
<td>219.5</td>
<td>37.4</td>
<td>1.7</td>
<td>(95.5)</td>
</tr>
<tr>
<td>Invoiced energy</td>
<td>1,060</td>
<td>1,208</td>
<td>1,218</td>
<td>0.88</td>
</tr>
<tr>
<td>- Invoiced consumption</td>
<td>637</td>
<td>771</td>
<td>745</td>
<td>(3.43)</td>
</tr>
<tr>
<td>- Un-invoiced consumption</td>
<td>422</td>
<td>436</td>
<td>474</td>
<td>8.51</td>
</tr>
<tr>
<td>- Household consumption</td>
<td>380</td>
<td>476</td>
<td>459</td>
<td>(3.60)</td>
</tr>
<tr>
<td>- Non-household consumption</td>
<td>257</td>
<td>295</td>
<td>286</td>
<td>(3.16)</td>
</tr>
</tbody>
</table>

Source: KESH; * Bank of Albania estimations
Box 1 Performance of construction and concerns related to its development

Construction represents one of the most active sectors in the Albanian economy. In 2008, it accounted for about 14 percent of total GDP and provided 17 percent of total sales from the non-agricultural production sectors of the Albanian economy. About 18 percent of total employed persons in the private non-agricultural sector belong to the construction sector. The rapid output growth rates in construction (during the 1998-2007 period, construction output grew by an average of 23 percent a year) led to its substantial contribution to economic growth in the recent years.

Based on the data related to the number of construction permits approved, construction for residential purposes has been sharing an ever-increasing weight (59 percent until the third quarter of 2008, compared to 55 percent in 2005). New constructions make up the highest share in the anticipated number of construction permits compared with reconstructions. Based on the anticipated number of construction permits, in 2007 the private sector accounted for about 85 percent of construction activity, while in the first three quarters of 2008 it reached an average of 82 percent. With respect to the public sector, it has to a large extent concentrated on engineering works, which relates to the construction of roads and highways.

Activity in the construction sector has entered a new development phase starting from the end of 2007 following the solution of the new construction permits’ situation. Volume turnover has reflected the improved economic activity in construction over the year 2008. In addition, the number of employed persons in economic enterprises has recorded a substantial improvement in construction activity over the course of the year 2008.

The positive performance and the sharp upward trend in the last quarter of 2007 and the first two quarters of 2008 slowed down in the last two quarters. Construction sector survey attests to this performance as well. According to construction firms’ confidence survey, confidence in this sector has deteriorated due to the negative figures of the overall economic performance and the construction firms along with the downward output figures in construction. Construction firms’ inventories increased...
in the last quarter of 2008, contributing to the slight fall of housing prices in Tirana over this period. House Price Index fell by 4.3 and 0.9 percent in the last two quarters of 2008.

According to construction firms\(^{20}\), the informal economy is considered to be the main factor to have hampered the normal activity in this sector over the 2004-2008 period. The legal and institutional framework is ranked the second factor to have negatively affected its performance. Worth noting is that this factor has been ever-increasing over this period. In contrast to the preceding years, the year 2008 showed an increasing impact of the factor ‘relation with banks’, which was ranked the third to have hampered the activity of construction firms. Concerns related to the political climate and infrastructure have been decreasing following the year 2006 and their impact has been lower.

The latest data based on the construction confidence survey show that the construction firms expect an improved output situation in the first quarter of 2009. In addition, they expect the demand to be sufficient in order to reduce their inventories in the first quarter of 2009.

HOUSE PRICES\(^{21}\)

Relative to the previous year, the House Price Index increased by 9.2 percent in the first quarter of 2009, while down by 5.7 percent compared to the previous quarter. The annual increase over this quarter marks a turning point in the downward trend of the House Price Index, which began in the last quarter of 2007. In the preceding two quarters, this index had fallen by 4.3 and 0.9 percent, respectively.
In annual terms, the House Rent Index increased by 12.3 percent in the first quarter of 2009, after having fallen by 4.9 percent in the last quarter of 2008. Relative to the previous quarter it decreased slightly by 0.4 percent. The price/rent ratio decreased further in the first quarter of 2009. The downward tendency of this indicator began in the third quarter of 2008.

4.1.2 Developments in the external sector of the economy

FOREIGN TRADE

Trade exchanges amounted to EUR 593.7 million in January to February 2009, down by 9 percent compared to the same period the previous year. In annual terms, imports and exports fell by 7.3 and 16.1 percent, respectively. Coverage of imports by exports reached 23.1 percent from 25.5 percent the previous year. The fall of high prices in imported primary commodities and the global economic developments are believed to have provided their impact over the negative growth rate of imports and exports of goods over the course of the first months of 2009.

Against this backdrop, trade deficit narrowed by 4.3 percent in annual terms and amounted to about EUR 371 million. Worth to note is that the trade deficit widening - a phenomenon characterizing the Albanian economy - marks a turning point in its trend over the first months of 2009. Despite the higher downward rate of exports than imports, the high base of the latter and the lower value of imports in almost all commodities have triggered the narrowing of the trade deficit over this period.

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<tr>
<td>Volume (in million euros)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>53.1</td>
<td>58.3</td>
<td>132.8</td>
<td>111.5</td>
</tr>
<tr>
<td>Imports</td>
<td>-223.0</td>
<td>-259.2</td>
<td>-520.2</td>
<td>-482.2</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-169.9</td>
<td>-200.9</td>
<td>-387.4</td>
<td>-370.7</td>
</tr>
<tr>
<td>Change (in %)</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>9.9</td>
<td></td>
<td>-16.1</td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td>16.3</td>
<td></td>
<td>-7.3</td>
<td></td>
</tr>
<tr>
<td>Trade balance (deficit)</td>
<td>18.3</td>
<td></td>
<td>-4.3</td>
<td></td>
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</table>

Source: INSTAT and Bank of Albania estimations

Trade with EU countries accounts for 68.3 percent of Albania’s trade exchanges, up by 4.3 percentage points compared with the previous year. Despite the increasing share, the annual value of trade exchanges with Albania’s main trading partners, Italy and Greece, fell by 3 percent in January to February 2009. By contrast, trade exchanges with Great Britain and Germany have increased. Albania’s main non-EU trading partners by total trade volume include: Turkey, China, Ukraine, Macedonia and Russia.

Table 6 Trade balance indicators for the 2008-2009 period
Excluding Russia and Macedonia, with which there has been a considerable annual decrease in terms of volume in trade exchanges, trade with other countries has increased.

Excluding the imports of ‘construction materials and metal items’, ‘wood and paper products’ and ‘chemical and plastic products’, the value of all other items’ imports declined in annual terms. ‘Minerals, fuels and energy’, ‘leather and articles thereof’ and ‘food, beverages and tobacco’ recorded the highest annual decline in the imports’ value. Imports of ‘machinery, appliances and spare parts’ decreased slightly by 0.4 percent. In terms of exports, ‘construction materials and metal items’, ‘leather and articles thereof’, ‘minerals, fuels and energy’, ‘wood and paper products’ and ‘textiles and footwear’ recorded their highest annual decrease. By contrast, the exports of ‘chemical and plastic products’ and ‘food, beverages and tobacco’ increased in annual terms.

Table 7 Imports and exports by commodity groups (in million euros)

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<tr>
<th></th>
<th>Imports</th>
<th></th>
<th>Exports</th>
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<tbody>
<tr>
<td></td>
<td>February 2009</td>
<td>Monthly</td>
<td>January – February 2009</td>
<td>Annual change</td>
</tr>
<tr>
<td>Total</td>
<td>259.2</td>
<td>16.3</td>
<td>482.2</td>
<td>-7.3</td>
</tr>
<tr>
<td>Food, beverages and tobacco</td>
<td>43.0</td>
<td>14.1</td>
<td>79.3</td>
<td>-14.2</td>
</tr>
<tr>
<td>Minerals, fuels and energy</td>
<td>34.0</td>
<td>-8.7</td>
<td>69.5</td>
<td>-32.4</td>
</tr>
<tr>
<td>Chemical and plastic products</td>
<td>29.8</td>
<td>26.3</td>
<td>52.4</td>
<td>10.3</td>
</tr>
<tr>
<td>Leather and articles thereof</td>
<td>3.5</td>
<td>-0.4</td>
<td>6.9</td>
<td>-19.1</td>
</tr>
<tr>
<td>Wood and paper products</td>
<td>8.7</td>
<td>-7.4</td>
<td>17.6</td>
<td>10.9</td>
</tr>
<tr>
<td>Textiles and footwear</td>
<td>23.0</td>
<td>6.4</td>
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<td>-9.3</td>
</tr>
<tr>
<td>Construction materials and metal items</td>
<td>46.3</td>
<td>24.5</td>
<td>81.8</td>
<td>16.7</td>
</tr>
<tr>
<td>Machinery, appliances and spare parts</td>
<td>62.9</td>
<td>10.6</td>
<td>117.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>259.2</td>
<td>16.3</td>
<td>14.1</td>
<td>-18.8</td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania estimations

4.1.3 Fiscal indicators and fiscal policy

Unlike the previous three years, the first quarter of 2009 was characterized by the rapid increase of expenditure and budget deficit. In general, the maximum limit programmed for this period of time has been observed. Budget revenues and expenditure were estimated at ALL 72.3 and 76 billion, respectively, meeting the first quarter plan by 97 and 96 percent.
Budget Revenues

Revenues collected as of the first quarter of 2009 increased by 14 percent in annual terms, hence recording a lower growth rate compared with the previous year. VAT, tax on profit, excises, customs and social insurance lowered their contribution to the growth of total revenues relative to the previous year.

Although the standard rate remained the same (20 percent), revenues from VAT recorded the lowest annual increase of the recent years. The budget plan for this item was met at 92 percent.

Revenues from tax on profit accumulated over the first quarter of 2009 recorded an annual negative change of 9 percent, although at a similar standard rate as the previous year (10 percent). The first quarter plan for this item was met at 95 percent.

Although the excise duty on imported goods increased compared with the previous year, it did not reflect in the annual increase of revenues collected from this item. Excise revenue recorded an annual nominal increase of 6 percent, the lowest in the last seven years. This annual change may partly owe to the fall in fuel prices or to the lower import of goods that are subject to excise duty (alcoholic and non-alcoholic beverages, tobacco, fuel, coffee, etc.).

Revenues from customs duties displayed negative annual growth rates owing to the various agreements promoting the free movement of goods.

The contribution of non-tax revenues to the annual increase of budget revenues was higher than the previous year. The 3-month plan for this item was exceeded by about 53 percent. The positive performance of this item owes partly to the restructuring of some budget items in early 200927.
BUDGET EXPENDITURE

Budget expenditure amounted to around ALL 6 billion over the first quarter of 2009, 24 percent of which is shared by capital expenditure. This ratio represents the highest share of capital expenditure to total expenditure for the first quarter of the present year. Capital expenditure is about 2.6 times higher than the same quarter the previous year. They were mainly domestically financed (90 percent). Expenditure on the Durrës-Kukës road accounts for about 44 percent of total capital expenditure carried out over this period.

In annual terms, total expenditure increased by about 43 percent in the first quarter of 2009, the highest annual increase in the last decade. Expenditure on social insurance, capital expenditure and personnel expenditure provided the highest contribution to the increase of expenditure by 12, 10 and 8 percentage points, respectively.

As of end March, budget expenditure met 96 percent of the 3-month plan. Capital expenditure and personnel expenditure exceeded the 3-month plan by about 10 and 9 percent.

BUDGET DEFICIT

In contrast to the previous three years, the budget balance for the first quarter of 2009 recorded a negative value of ALL 0.8 billion from the planned ALL 4.7 billion. 80 percent of the budget deficit was financed through domestic financing. The main financing resource were the receipts from ARMO’s privatization.

<table>
<thead>
<tr>
<th>Table 9 Budget deficit financing: Q1 2005 – Q1 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget balance</strong></td>
</tr>
<tr>
<td>Domestic financing</td>
</tr>
<tr>
<td>- Privatization receipts</td>
</tr>
<tr>
<td>- Domestic borrowing</td>
</tr>
<tr>
<td>Foreign financing</td>
</tr>
<tr>
<td>Source: Ministry of Finance</td>
</tr>
</tbody>
</table>

The Government’s borrowing policy has aimed at increasing the amount of debt both for short and long-term instruments. The liquidity shortages in the Government securities’ market (reflected in the low demand of market participants for this type of instruments) brought about the reduction of the Government’s domestic debt stock and the increase in yields. Relative to year-end 2008, this stock reduced by about ALL 3.1 billion in the first quarter of 2009. In order to encourage the functioning of the financial markets and abate the pressures on the interest rates in the primary market, in March 2009 the Bank of Albania extended direct loans to the Albanian Government.
The primary deficit did not maintain a stable trend over the course of the first quarter of 2009, showing signs of deterioration solely in March 2009. Considering the effect that other macroeconomic variables (real interest rate on debt and economic growth) may have on public debt stock as unchanged from the year-end 2008, the primary deficit performance attests to the increase of the public debt stock only during March (mainly of foreign borrowing and long-term domestic borrowing).

4.1.4 Monetary developments

Over the course of the first quarter of 2009, monetary conditions indicators improved considerably, while demand for money contracted owing to the slowdown in lending. The tightening of lending standards and terms from commercial banks triggered the fall of supply and demand for loans from the economic agents. These developments led to sluggish money supply growth rates compared with September 2008.

Monetary growth slowed down further in January and February 2009 by an average of 4.4 percent in real terms from the average growth of 9 percent in the last quarter of 2008. Developments in broad money have mainly reflected the sluggish growth rates of credit to economy. Credit to the private sector contributed by about 11 percentage points to the annual growth of broad money. The contraction in the banking system’s foreign assets attests to its downward contribution to the M3 growth.

The monetary developments have been characterized by the tendency of shifting towards more liquid components, which in turn led to further growth of money base. The rapid growth of currency outside banks and the slower money growth rates exerted pressure over the contraction of the money multiplier to 3.02 from 3.2 the preceding quarter.

**Chart 23 Performance of monetary aggregates and money demand**

Source: Bank of Albania
DEVELOPMENTS IN MONETARY AGGREGATES

The developments in broad money have been mainly affected by the performance of the liquid component, which provided the highest contribution to the money growth. In average annual terms, the narrow monetary aggregate—monetary base—grew further by 24 percent in the early months of 2009 compared with the 17 percent growth in the preceding quarter.

The creation of monetary flows on the deposits’ side has been declining. In January and February, total deposits excluding the exchange rate effects reduced by an average of 3 percent in annual terms. However, the effects of the annual decline owe primarily to the last quarter’s performance since the situation in total deposits showed a stabilizing tendency in the early months of 2009. The decline was more pronounced in foreign currency-denominated deposits, which fell by an average of 5 percent in annual terms. Accordingly, the share of foreign currency-denominated deposits to M3 reduced further to 31.5 percent, 2 percentage points lower than the last quarter.

In average annual terms, ALL aggregate, M2, slowed down to about 9.4 percent vis-à-vis the 10.2 percent growth in the last quarter of 2008. The share of currency outside banks to M2 aggregate has been increasing to an average of 36.2 percent, 3 percentage points higher from the last quarter of 2008. The fall in deposits has been less pronounced for ALL-denominated deposits, which reduced by about 1.2 percent in average annual terms. The average share of ALL-denominated deposits to broad money was 43 percent, down by more than 1 percentage point from the preceding quarter.

The uncertainty reigning on global financial systems was reflected in the withdrawal of a part of deposits from the system in the last quarter of 2008. The withdrawal of deposits was higher for foreign currency-denominated deposits than for ALL-denominated ones. Accordingly, currency outside banks in the Albanian Lek grew rapidly contributing markedly to the growth
of monetary aggregates. Currency outside banks in foreign currency is not measured by the official data nor it is included in broad money. The change in this indicator can be measured through a proxy of the cumulative amount of foreign currency-denominated deposits out-flown by the banking system each month.

The inclusion of this indicator in the measurement of broad money results in the further growth of M3 aggregate compared with its growth rates when only currency outside banks in the Albanian Lek is included in it. The composition of M3 monetary aggregate suggests for the further shift of broad money towards more liquid components. This fact reflects the public inclination to keep money in its most liquid form instead of depositing it into the banking system. The increasing share of the liquid component in the money supply composition may also trigger upward inflationary pressures in economy.

**CREDIT TO THE PRIVATE SECTOR**

Lending growth rates have reduced substantially in the recent months. In February, the annual growth rate of the loan portfolio slowed down further to 28.5 percent compared with 44.2 percent in September 2008. Notwithstanding the positive effects on the external balance, this performance can negatively impact the economic development by affecting consumption and private investment. The performance of business loans plays a major role in this context. The contraction in lending to business investment projects exerts negative pressures on the economic growth rates. Moreover, the contraction in lending to households curbs consumption and wealth, which in turn exerts pressures on the further weakening of economic growth rates.
The latest developments in the loan portfolio attest to its reduction in quarterly terms by around ALL 0.3 billion. The moderate contraction in outstanding loans owes to the increase of lending to state-owned enterprises by around ALL 1.2 billion and the contraction in outstanding loans to the private sector in January and February the present year. Lending to state-owned enterprises was mainly in the Albanian Lek and of short maturity term.

The performance of loans by currency attests to banks’ inclination to shift the loan portfolio to the Albanian Lek. The preservation of lek-denominated loans growth rates by 36 percent compared with the constant decline in the growth rates of foreign currency-denominated loans (to 23 percent) shifted the portfolio to ALL loans. As of end February, ALL loans accounted for 29 percent relative to 27 percent it accounted for in September 2008.
The growth rates of business loans recorded a pronounced slowdown to 27 percent over the course of the first quarter. This performance reflects the slumping growth rates of working capital loans and the marked contraction in investment loans. The quarterly net change in investment loans shows a moderate decline attesting to the lower support to long-term projects from the banking system and to the weaker business demand for this type of loan. In light of the vague macroeconomic situation and the implications of the global financial crisis for the Albanian economy, a number of businesses have been reluctant to engage in investment undertakings. The bank lending survey for the first quarter of 2009 shows that banks have applied tighter standards on business loans as well. This approach has been triggered by the future economic uncertainties, the deteriorated conditions in individual economic sectors and the increase of non-performing loans.

The homogeneous slowdown in the growth rate of household loans persisted in the first quarter of 2009. The uncertainties over the source of household income, be it from the labour market or from other alternative sources, have made banks more conservative for this group of users. Consequently, the share of household loans to total loans fell to 34.7 percent from 36.5 percent the previous year. The quarterly developments in the household loan portfolio point to the contraction of consumer loans and a marked slowdown in the growth rates of housing loans. In annual terms, the growth rate of consumer loans reached 23 percent, down by 6 percentage points compared with the annual growth rate of September 2008. Housing loans increased by 22 percent in annual terms, down by 20 percentage points relative to the same period.
Box 2 Results of the lending activity survey in the first quarter of 2009

The results of the lending activity survey conducted in April 2009 identifies the changes in lending activity over the first quarter of the present year compared with the previous quarter and the expectations for possible changes in lending in the second quarter of 2009 as opposed to the current. The results obtained from this survey show that banks maintained the trend commenced in the second half of 2008, tightening the lending terms and standards further in the first quarter of 2009. In contrast to the previous survey, the tightening of lending standards has been sharper for enterprises than for individuals (net balance-net percentage of banks reporting looser lending standards is -66 percent for enterprises and -44 percent for individuals).

Banks anticipate a possible alleviation of the tight lending standards they will apply for the second quarter of 2009 compared with the current level of tightening both for enterprises (net balance of expectations is -21 percent compared with the current net balance of -66 percent) and individuals (net balance of expectations is -33.5 percent compared with the current net balance of -44 percent).

According to banks’ survey, demand for loans from enterprises and individuals fell in the first quarter of 2009. For the first time in this quarter, the net demand (net percentage of banks that have reported an increase in demand) for small and medium-sized enterprises is negative.

Business loans. In the lending activity survey for the first quarter of 2009, banks’ experts have reported a more pronounced tightening of lending standards for businesses compared with the previous survey (the net balance has reduced to -66 percent compared with -56 percent in the previous survey). The current and expected macroeconomic situation and the specific concerns of the sector the firms operate in are the factors to have led to tighter lending standards. Non-performing loans are another factor whose relevance in the tightening of lending standards increased in the first quarter of 2009. Banks however anticipate less tightening of lending standards over the course of the second quarter of 2009.

Net demand of enterprises for loans has been downward and negative in the first quarter of 2009. The negative demand of enterprises owed to the tight lending standards applied by banks and by the assessment of the current and expected economic situation.

Individual loans. The data obtained from the banks’ survey show less tightening of lending standards for individuals in the first quarter of 2009 compared with the second half of 2008 (the balance increased to -44 percent from -61 percent in the previous survey). Banks listed the households’ financial situation and the situation in the real estate market as the main factors to have led to tight lending standards over the first quarter of 2009.
Banks report a negative net demand of individuals for loans in the first quarter, reflecting mainly the developments in the real estate market. Banks anticipate the lending standards for households to slightly alleviate in the second quarter of 2009 (the balance of expectations is about 10 percentage points higher than the current balance).

**FISCAL SECTOR FINANCING**

The tightening of liquidity conditions in the banking system was also reflected in the financing of the Government’s needs for funds. In the first quarter of 2009, banks dropped their investment in the T-bill primary market maturing a part of their portfolio, while the financing with long-term instruments remained almost unchanged. Fiscal activity in the early months of 2009 seems to have been also supported by the privatization receipts in January. However, domestic financing has by and large been decreasing over this period. In the first quarter of 2009, there has been a substantial increase in financing from individuals by about ALL 3 billion, the largest portion of which belongs to March. The increase of savings in the primary market directly from individuals has helped to partly mitigate the effects deriving from banks’ non-participation in this market. Over the course of the recent months, the structure of domestic credit has remained unchanged, dominated by credit to economy which accounts for 55 percent.

**4.2 LABOUR MARKET AND WAGES**

**4.2.1 Labour market**

The labour market in the last quarter of 2008 recorded an increase in the labour forces, in the average number of employed people and an increase in the average number of unemployed people. Labour force totalled 1,115,562 persons, up by 5,594 persons compared with the previous quarter. In quarterly terms, the average number of employed people increased by 4,174 persons, with the private non-agricultural sector providing the main contribution. Average number of employed people in this sector totals 238,975. The average number of unemployed people increased in the last quarter of 2008 by about 1,420 people to a total of 141,495 people compared with the previous quarter.
quarter. Unemployment rate reached 12.68 percent in the last quarter of 2008 compared with 12.62 percent in the previous quarter.

Official data on the number of employed people in non-agricultural economic enterprises report high annual increasing rates in the last quarter of 2008 compared with the previous year. This indicator performed best in services – mainly in the wholesale trade.

4.2.2 Performance of wages

The latest data on the performance of wages in economy in the last quarter of 2008 attest to the increase of average monthly wage in the public sector in nominal terms by about 7.5 and 6.1 percent in annual and quarterly terms. In nominal terms, average wage in economic enterprises reduced the growth rates over the last quarter of 2008 to 7.1 percent compared with the highest annual growth by 18.4 percent in the first quarter. In the production sector, average wage in annual terms rose by about 20.3 percent in construction and 2.7 percent in industry. In the services sector, its average annual rise recorded high rates for the retail and wholesale trade by 28.6 and 13.2 percent, respectively.

Base minimal monthly wage stood at ALL 17,000 in the last quarter of 2008, up by 21 percent in
annual terms. As of end 2008, monthly unemployment benefit payment was ALL 5,980, up by 14 percent in annual terms.

4.3 PRODUCER AND IMPORT PRICES

Relative to the same period the previous year, the Producer Price Index increased by 4.2 percent in the last quarter of 2008. Despite the depreciating tendency of the Albanian Lek, businesses were faced with lower increasing rates in producer prices compared with the preceding two quarters.

‘Processing industry’, which has the main share in the PPI, recorded an annual increase of 1.8 percent\(^3\). The increase in this index at more moderate rates attributes to ‘food industry’ and ‘food and beverages industry’, the two sub-items sharing the main weight in ‘processing industry’. Their indices manifested a downward tendency in annual terms, attesting to the market correction following the high primary commodity prices in the second and third quarter of 2008. Producer prices in these industries seem to have provided their impact on ‘processed foods’ in the CPI basket as well. The latter showed lower increasing rates over the same period. Producer prices in ‘extracting industry’ continued to maintain upward rates over this quarter. Despite the low share to total basket components, its annual increase by an average of 9.2 percent contributed by 0.9 percent to headline PPI inflation.

<table>
<thead>
<tr>
<th></th>
<th>PPI Total processing industry</th>
<th>PPI Food processing industry</th>
<th>CPI Processed foods</th>
<th>PPI Extracting industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q3:06/Q3:05</td>
<td>0.4</td>
<td>1.2</td>
<td>-2.1</td>
<td>1.1</td>
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<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>3.6</td>
<td>6.3</td>
<td>14.7</td>
<td>7.3</td>
</tr>
<tr>
<td>Q4:07/Q4:06</td>
<td>7.5</td>
<td>10.2</td>
<td>18.6</td>
<td>10.8</td>
</tr>
<tr>
<td>Q1:08/Q1:07</td>
<td>7.4</td>
<td>6.8</td>
<td>20.5</td>
<td>11.2</td>
</tr>
<tr>
<td>Q2:08/Q2:07</td>
<td>7.4</td>
<td>6.9</td>
<td>14.6</td>
<td>12.9</td>
</tr>
<tr>
<td>Q3:08/Q3:07</td>
<td>7.1</td>
<td>6.1</td>
<td>7.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Q4:08/Q4:07</td>
<td>4.2</td>
<td>1.8</td>
<td>-1.1</td>
<td>7.1</td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania estimations

**IMPORT PRICES**

Imported inflation marked low growth rates in the first quarter of 2009 maintaining its performance of the last quarter of 2008. Annual imported
inflation rate marked 0.2 percent, down by 5 percentage points compared with the previous year and up by 1 percentage point compared with the last quarter of 2008. The weaker annual increasing rates owe mainly to the pronounced fall in foreign prices and to the retroactive effect of the Albanian Lek appreciation.

Foreign prices were highly volatile throughout the year 2008 recording rates from 2.1 to 4.3 percent. In annual terms, they increased by an average of 3.6 percent in 2008, exceeding their historical average by 1 percentage point. The annual change in the foreign price index in the first quarter of 2009 was 1.5 percent, the lowest in the last nine years. The fall in primary commodity prices (food and oil) and the economic growth downturn in Italy and Greece triggered the fall in consumer prices. Inflation in Albania manifested the same performance, attesting to the impact of foreign prices in the price formation process at home.

Developments in foreign prices are directly reflected in the processed foods of the consumer basket. The correlation coefficient attests to a stronger statistical relationship between ‘processed foods’ for Albania and Italy and Greece than between total consumer price indices. The linear correlation coefficient for the period 2006M1-2009M3 is 0.9 in the first case and 0.5 in the second. In annual terms, foreign and domestic food prices increased by 3.5 percent in the first quarter. Prices of processed foods in Albania were 6.7 percentage points lower than last year’s average. This reduction was prompted by the 2 percentage points fall in foreign prices of food products for the same period.

The inflationary pressures exerted by the imported inflation have been receding over the first quarter of 2009. The non-inflationary influence of this factor is believed to persist in the short-term, being mainly triggered by the fall in foreign prices. However, the depreciation of the Lek exchange rate vis-à-vis...
its major currency counterparts\textsuperscript{40} poses risks to this scenario. Empirical studies\textsuperscript{41} attest to the asymmetry of the exchange rate pass-through to consumer prices. The extent of the pass-through is greater and the lag is shorter in the case of the Lek depreciation than in the opposite case. The depreciation of the Lek translates into higher import prices, exerting upward pressures on the overall level of prices in Albania.

4.4 EXPECTATIONS FOR THE PERFORMANCE OF PRICES IN ECONOMY

The Bank of Albania conducts surveys in order to identify and quantify the short-term expectations (after 12 months) of various economic groups\textsuperscript{42} for the performance of inflation. The information obtained from these surveys is valuable since the expected inflation affects the behaviour of economic agents hence providing a direct impact on the ability of central banks to achieve price stability in economy. Consumer and commercial bank experts’ surveys show that the economic agents’ expectations have been anchored very close to the Bank of Albania’s inflation objective.

![Chart 39: Consumer and commercial banks’ expectations for the annual inflation after 12 months and the annual inflation rate measured by the CPI](chart)

Expectations for inflation after 12 months have been downward starting from the last quarter of 2008 (see chart above), consistent with the downward inflation rates as measured by the CPI. Consumer expectations for consumer prices have fallen at more accelerated rates than commercial banks’ experts’. According to the last consumer survey (Q4 2008), expected annual inflation for the last quarter of 2009 is 1.7 percent\textsuperscript{43}. Based on the results, the percentage of consumers expecting prices to rise after a 3-month period and after a 12-month period has dropped by 4 and 2 percentage points, respectively.

According to banks’ survey of March 2009, annual inflation after 12 months is anticipated to mark 2.7 percent, following a downward trend since October last year.
5. FINANCIAL MARKET, INTEREST RATES AND THE EXCHANGE RATE

5.1 INTEREST RATES

THE INTER-BANK MARKET

The first quarter of 2009 was characterized by downward interest rates in the inter-bank market and lower trading volumes in this market. The swinging interest rates were mainly present in the days when the required reserve was met. They were also induced by supply and demand-side factors in given banks under a frequent inefficient liquidity management. The interest rates in the inter-bank market have fallen as a result of the cut in the key interest rate and the lower liquidity pressures. Activity in the inter-bank market maintained its downward trend commenced in the last months of 2008, being lower than the preceding quarter – particular in overnight transactions.

Worth to note is that the provision of liquidity by the Bank of Albania in the form of variable-price and fixed-price auctions and the wider use of the required reserve has led to lower volumes exchanged from banks over this period. The distribution of liquidity in the system has been more uniform and the interest rate volatility has been more reduced.

In order to spur economic activity and lower the lending cost, the Bank of Albania decided to cut the key interest rate by 50 basis points to 5.75 percent at end January. The level of liquidity has lowered throughout the system owing primarily to the behaviour of banks in the primary market and the deposit withdrawal. The Bank of Albania continued to inject liquidity through its main open market instrument – the reverse repurchase agreement of one-week maturity term. The auctioned liquidity increased by an average of ALL 1.4 billion compared with the last quarter of 2008. In order to increase the liquidity level and create favourable conditions to spur banks’ activity in long-term investments, the Bank of Albania has widely employed the reverse repurchase agreement of three-month maturity term totalling ALL 12 billion.

In the inter-bank market, banks continued to position themselves in overnight borrowing although the one-week transactions have increased over this period. Accordingly, total borrowing increased relative to the previous quarter. The interest rates in the inter-bank market seem to have reflected the cut in the key interest rate. In average terms, overnight interest rate dropped to 5.42 percent from 6.33 percent the previous quarter; the one-week interest rate dropped to 5.83 percent, down by 0.85 percentage points. In the previous year, these rates marked 5.10 and 5.57 percent. Daily borrowing volume reduced to ALL 1.17 billion or down by 0.1 billion from the previous quarter. One-week borrowing volume increased by ALL 0.21 billion to ALL 0.624 billion over the same period. The recent data show that the non-use of the BoA’s overnight deposit from the lending institutions has been reflected in the increase of exchanged volume in the inter-bank market and in the lower interest rates.
THE PRIMARY MARKET

The primary market was characterized by a pronounced upward trend of the Government securities’ yields, which began in the end of the previous quarter. The banking system’s behaviour in the market—looking for higher return on investments—relates to the contracted liquidity, implying lower availability in meeting the Government demand. The banking system’s assets attested to the lower Government securities’ portfolio since some of the agents in the system have preferred to mature them in order to ensure funds. However, a portion of this withdrawal was offset by the increase of individuals participating in the auctions, who do not compete for setting the yield.

The more pronounced increase of the T-bill yields was shown for the longest maturity term, 12-month, extending the spread between the shorter maturity terms. As of end the first quarter, it marked 9.13 percent, up by 0.48 percentage points from December 2008. The current level is up by 1.00 percentage point from the previous year, the peak in the last four years.

The yields for other maturity terms, 6 and 3-month, have maintained the same tendency although more moderately. As of end March, the 6-month yield marked 7.61 percent, up by 0.19 percentage points. In early February, the 3-month yield fell by 0.32 percentage points, following the Bank of Albania’s decision to cut the key interest rate. However, this was temporary. In early April, although the short-term interest rates in the inter-bank market continued to fall, it increased to 6.31 percent, returning to the levels recorded in the beginning of the year prior to the change of the key rate.

The non-meeting of the Government demand for financing was also present in the primary bond market. The higher concentration of this market and the performance of T-bill yields have pushed the bond yields upward. The 2-year yield reached the highest rate of the last three years in January, 9.30 percent or up by 95 percentage from the previous year. The 5-year bond auction of a variable yield was held in the first quarter. Its level was higher than the preceding one owing to the higher reference yields. The auction of 3-year bonds was held in...
early April. Their yield was 9.61 percent, up by 0.63 percentage points from the previous year.

<table>
<thead>
<tr>
<th>Table 11 Interest rates on public debt instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average yield rate</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>2007</td>
</tr>
<tr>
<td>2008</td>
</tr>
<tr>
<td>December 2008</td>
</tr>
<tr>
<td>January 2009</td>
</tr>
<tr>
<td>February 2009</td>
</tr>
<tr>
<td>March 2009</td>
</tr>
</tbody>
</table>

Source: Bank of Albania

**INTEREST RATES ON DEPOSITS AND LOANS**

Interest rates on deposits dropped in February 2009 following the termination of banks’ promotional offers. Weighted average interest rate on deposits marked 5.12 percent in February, down by 0.72 percentage points relative to January.

Year-end promotional offers were not numerous and they mainly involved the short-term deposits. In terms of maturity, the weighted average interest rate on 3-month time deposits recorded the highest drop to 5.13 percent from 6.32 percent in January. The interest rate on 12-month time deposits was 6.68 percent in February (from 6.93 percent in January). Compared with the previous year, the interest rate on deposits is up by 0.07 percentage points in February. For the same period, the interest rate on the reverse repurchase agreement is down by 50 basis points.

The interest rates on Euro-denominated time deposits fell considerably in January and February the present year due to the cut of the ECB’s key interest rate twice in December 2008 (-0.75 percent) and January 2009 (-0.50 percent). The cut by 1.25 percentage points was not reflected equally in the interest rates on Euro-denominated deposits. In February, weighted average interest rate marked 2.56 percent from 2.92 percent in January, down by 0.58 percentage points from December 2008. In terms of maturity, the interest rates on 12-month deposits marked 4.47 percent in February, down by 0.24 percentage points from January the present year. The interest rates on 3-month deposits dropped by 0.84 percentage points in February, returning to the previous levels prior to the year-end promotional offers.

In February 2009, weighted average interest rate on ALL-denominated loans increased slightly -returning to the December level-, owing to the increase in the interest rate on long-term real estate.
loans in the Albanian Lek. Weighted average interest rate on ALL-denominated loans marked 11.73 percent in February from 11.65 percent in January. The interest rate on short-term loans decreased by 0.20 percentage points, while the average interest rate on ALL-denominated long-term loans (over 5 years) increased by 0.75 percentage points to 14.44 percent. The drop in short-term interest rates was prompted by individual banks -mainly in business overdrafts-, while the increase of the interest rate on ALL-denominated long-term loans owes to the performance of the 12-month T-bill yield.

Average interest rate on Euro-denominated loans diverged from the 12-month Euribor rate in the first two months of 2009. They were not affected by the decrease in the Euribor rate, which fell instantly after the ECB’s key interest rate cut. Instead, they increased in Albania. The interest rate on Euro-denominated loans increased slightly reflecting the banking system’s tightening of lending in foreign currency. In January, weighted-average interest rate was 7.68 percent, up by 0.36 percentage points from December (7.32 percent). In February, it marked 7.71 percent, while the Euribor rate in the international markets fell again to an average of 2.14 percent (from 3.45 percent in December 2008). The interest rates fell mainly for long-term real estate loans (over 5 years), recording a fall by 0.17 percentage points.

The loan-deposit spread in Lek increased in February to 6.61 percentage points from the fall in January to 5.81 percentage points. Average intermediation rate for the Euro increased to 5.14 percentage points, up by 0.38 percentage points from January. This increase owes mainly to the fall in the interest rates on deposits and the slight increase in the interest rates on loans in both currencies.

5.2 EXCHANGE RATE PERFORMANCE

The first quarter of 2009 reflected a persistent downward trend of the Lek vis-à-vis its major currency counterparts, shown since October 2008. The average change in the nominal effective exchange rate for this quarter is -4.14 percent compared with the last quarter of 2008.
and -6.14 percent relative to the same period the previous year. Worth noting is that the contraction of foreign currency supply over the last months of 2008 as a result of lower workers’ remittances and exports was followed in the early months of 2009 by the decrease in imports and trade deficit narrowing in annual terms. Although in monthly terms this indicator increased in February, it was moderate and did not maintain the same rates as in the previous years, which may have supported the exchange rate performance. In addition, the widening of the interest rate spread following the ECB’s key interest rate cut by a total of 1.25 percent may generate the balancing of the demand and supply in the months to follow.

Although the NEER monthly changes have been maintaining a downward tendency over the first quarter of 2009, the downward rate has been reducing to later appreciate slightly in the first two weeks of April. The persistent narrowing trend and the ongoing periods of devaluation improve the exchange rate pass-through to import prices, which for the moment are not of primary effect as a result of the fall of consumer prices at a global level (and their impact on inflation).

The performance of the Lek in the Albanian foreign exchange market during the first quarter of 2009 reflected the same depreciating behaviour vis-à-vis the U.S. dollar and the Euro. In quarterly and annual terms, the Lek depreciated vis-à-vis the U.S. dollar by 5.49 and 19.4 percent, respectively; the depreciation vis-à-vis the Euro was somehow more moderate to 4.0 and 3 percent, respectively.

The performance of the Lek vis-à-vis the U.S. dollar has mainly reflected the performance of the latter in the international markets. In January, the U.S. dollar lost ground vis-à-vis the Euro to later regain it in February. However, it could not halt a second depreciation in March. Worth to note however is that during the first quarter, the U.S. dollar reached the highest quotations in the recent years. Although at high levels, the USD/ALL volatility in Albania has been lower than the preceding quarter, reflecting the dynamics of this ratio in the international markets.
With respect to the performance of the Euro in the domestic market for the first quarter of 2009, the seasonal demand for foreign currency confronted with a more contracted supply owing to the poorer performance of workers’ remittances and exports. Worth noting also is the psychological effect related to the exchange rate performance, which is the rationale behind the risk reflected in the market quotations and the high volatility of this ratio compared with the last quarter of 2008 and the same period the previous year. However, the performance of the Lek to the Euro was more stable near the end of the period.
ENDNOTES

1 Preliminary assessment reported a fall of 6.2 percent in the U.S. economy, while the final assessment reports a fall of 6.3 percent in quarterly terms.

2 In February, manufacturing industry declined by 11.2 percent in annual terms.

3 Annual inflation in Turkey for the year 2008 was 10.4 percent.

4 Average oil price for the first quarter of 2009 was USD 42.5, while in March it was USD 46.5.

5 In February, U.S. demand grew by 2.2 percent in monthly terms.

6 Moving average of the last 12 months.


8 In December 2008, credit to economy grew by 35 percent compared with the annual average of 44 percent. In February 2009, the annual growth was 28.5 percent, lower than the year-end.

9 The results obtained from the Business and Consumer Confidence Survey for the last quarter of 2008.

10 “In the case of Albania, Monetary Conditions Index (MCI) is a weighted average of changes in the key interest rate and the nominal effective exchange rate (NEER) of the Lek against their respective values in a base period. The MCI ratio in the case of Albania is 1.82:1, implying that the effect of an appreciation of the NEER by 1.82 percent on aggregate demand would be offset by a cut in the key interest rate by 1 percentage point.” For more information, refer to “Assessment of the Monetary/Financial Conditions Index in the case of Albania”, M. Tase (2006).

11 1.1 percentage points lower than in the same period the previous year.

12 For the first three months, it marked 1.8, 1.7 and 1.7 percent, respectively.

13 Hereinafter referred to as traded inflation and non-traded inflation.

14 Traded inflation accounts for 62 percent of the CPI basket; the rest in non-traded.

15 For the period March 2008 to February 2009, average annual non-traded inflation marked about 3.8 percent.

16 Starting from the third quarter of 2008.

17 INSTAT, Conjuncture, Main Economic Indicators, October-December 2008.

18 Construction permits are classified by construction products: residential buildings, other buildings (hotels, commercial buildings, industrial buildings and other buildings) and engineering constructions (roads and motorways, water-supply, energy and telecommunication lines, plants in industrial yards and other engineering works).

19 The anticipated number of construction permits is estimated by the INSTAT, based on the number of permits by type of construction.

20 For more information, refer to the quarterly results of the construction firms’ confidence survey.

21 House Price Index is measured only for Tirana.

22 Exports and imports of goods with Italy and Greece make up 34.4 and 15.3 percent of total trade exchanges volume.

23 The share of trade with these two countries is 1.3 and 5.9 percent. Great Britain has doubled its share to total trade exchanges volume, while Germany has increased its share by 1 percentage points.

24 The share of trade exchanges with these countries to total trading volume over January to February 2009 is 6.5, 6.2, 1.8, 1.6 and 1.4 percent.

25 Trade exchanges with Russia and Macedonia have decreased by 62.2 and 20.9 percent.

26 The monthly plan we refer to is the one that has been revised recently, according to which about ALL 3.6 billion of revenues shifted from the first half of the year to the second.

27 In the beginning of 2009, revenues from services tariffs were added to non-tax revenues. They provided considerable contribution to the annual increase of this item.

28 In the 10 preceding years, the share of capital expenditure to total expenditure over the first quarter ranges from 8 to 13 percent.

29 The contribution of personnel expenditure to total expenditure owes to the weight this item shares in total expenditure and not as a result of the increase in the nominal value of this item compared with the previous year.

30 Although Armo’s privatization receipts entered the budget at end 2008, they became active in the budget deficit financing for the year 2009.

31 Primary deficit has been corrected for privatizations and grant revenues.
Monetary data released by the Statistics Department at the Bank of Albania and in particular the data on the loan portfolio are strongly affected by exchange rate movements. Given the marked devaluation of the Albanian Lek in the first months of 2009, the official data are appreciated. Therefore, the monetary data analysis in this section of the Report refers to the data series which excludes the change effects in the Albanian Lek exchange rate vis-à-vis the Euro and the U.S. dollar.

Key interest rate and the exchange rate performance.

From the year 2002 to the second half of 2008, the Bank Lending Survey has been conducted every six months. Starting from Q1 2009, this survey will be conducted on a quarterly basis.

Budget and non-budget (INSTAT, Conjuncture, Main economic indicators, October-December 2008).

Average wage is measured as the percentage of wages fund to the number of employed people – INSTAT’s methodology.

In annual terms, this index increased by 6.9 and 6.1 percent in the second and third quarter of 2008.

Measured as the weighted average of consumer prices in Greece and Italy, Albania’s main trading partners.

In March 2009, primary commodity prices as published by the IMF fell by 45 percent in annual terms.

In Q1 2009, the Lek depreciated vis-à-vis the Euro and the U.S. dollar by 3.7 and 19.4 percent, in annual terms.

Marga Peeters (2005) “What about Monetary Transmission in Albania? Is the Exchange Rate Pass-through (still) the Main Channel?”


Inflation expectations at the Bank of Albania are measured through the information obtained from confidence surveys and banks’ survey.

Consumer inflation expectations for inflation are quantified (qualitative information is transformed into quantitative form) based on the quantitative probability method.

In this auction were issued only bonds of variable yield. The accepted spread was lower than the previous, however the reference interest rate – 12-month yield – increased over this period. 5-year variable yield in the preceding auction was 10.17 percent.

Measured as the quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.
SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI

At the Press Conference on the Decision of the Bank of Albania’s Supervisory Council to Reduce the Key Interest Rate from 6.25% to 5.75%
January 28, 2009, Bank of Albania

The Bank of Albania’s Supervisory Council assessed at today’s meeting the country’s economic and financial developments, based on the latest available information.

World economy and particularly the financial system were severely hit in the second half of 2008. The crisis that struck the heart of the global financial system was progressively and relentlessly passed through the economic activity of advanced economies, leading some of the latter into recession.

The Albanian economy has been resilient amid this hitting wave. According to the available official data and judging upon a number of indirect indicators, the Bank of Albania notes that the economic activity throughout the year has performed in line with the early 2008 projections, both in terms of economic growth and preservation of macroeconomic balances. The Bank of Albania in particular has met its primary objective mandated by law, contributing to the maintenance of price stability.

Economic activity at home has been almost entirely sustained by domestic financial resources. Operating within all the parameters of financial soundness, the Albanian banking system has been dynamic and effective in channelling the savings towards the funding of corporate production or household consumption. This process has been also facilitated by the macroeconomic stability, which enabled the fall of risk premiums in economy and helped to gradually extend the investment horizon.

Notwithstanding the inflationary pressures of early 2008, mainly triggered by supply-side shocks, the annual consumer price inflation was brought back within the Bank of Albania’s target over the second half of the year. For this period of the year, annual inflation rates stood close to the Bank of Albania’s target, 3.0 and 2.5 percent respectively, in both quarters. The return of inflation to within the Bank of Albania’s targeted band was conditioned not only by the relaxation of supply-side shocks, but also by appropriate monetary conditions that enabled the balancing of demand and supply-side factors.

Monetary policy stance was neutral throughout 2008 and the base interest rate was kept unchanged, at 6.25 percent. Together with the strengthening of several banking supervision measures in terms of credit risk management, the monetary policy has led to a more balanced credit growth and has transmitted the appropriate stimuli for consumption and savings. The correct monetary policy and the keeping of inflation under check by the Bank of Albania have
been also reflected in anchoring the economic agents’ inflationary expectations close to the 3 percent target of the central bank.

In this context, worth noting is the contribution of fiscal policy which has ensured the preservation of macroeconomic balances by keeping the budget deficit at adequate levels. On the other hand, the external sector of the economy continued to be featured by the deepening of current account deficit. The third quarter of 2008 recorded an increased current deficit. It accounted for 13.7 percent of GDP. In addition to enlargement of trade deficit, the deepening of current deficit was also triggered by the narrowing of the positive balance of revenues and current transfers’ account. Therefore, the dynamics in the balance of payments developments remains an area which needs constant monitoring by the Bank of Albania.

Monetary indicators had a stable performance in the second half of 2008, although some slow growth rates of deposits and loans were noted in the last quarter. In relative terms, the slow-down made up a small share of commercial banks’ balance sheet, but did not affect the banking system’s soundness indicators or impair its solvency.

The performance of money markets during the second half of 2008 was conditioned by the developments in monetary indicators and the real economy. As experienced by many countries, the increased vulnerability of banks to liquidity has brought about reduced interbank trading volume and upward interest rates on deposits.

In the meantime, the coverage ratio of Government demand for money decreased and some risk premiums increased in the last two months. This performance brought about the increase in Government securities’ interest rates and in a few cases in the loan interest rates. In response to these developments, the Bank of Albania intervened in the money market by injecting liquidity of different maturity terms. Also, in order to better satisfy the banks’ needs, the Bank of Albania changed in November the repo auction form to auctions with undetermined amounts.

Following previous public statements, the Bank of Albania points out that the global crisis impact on the Albanian economy will depend on its intensity and duration. As I have also mentioned previously, reduction of foreign currency inflows, of both current and capital nature, and the tightening of overall financing conditions are the channels exposing the Albanian economy the most to shocks of the global economic environment. The expected potential impact of these factors would materialize in a slower economic growth in 2009. On the other hand, the latest forecasts of the Bank of Albania on consumer price performance during the current period reveal a relatively sensitive alleviation of inflationary pressures.

Taking into consideration the above, the Bank of Albania’s Supervisory Council decided to reduce the repurchase agreement interest rate by 0.50 percentage points, to 5.75 percent.
Based on analyses, surveys and facts, the Bank of Albania noted that in January premises were created for more manoeuvring, implying a change in monetary policy stance towards interest rate reduction.

The decision I just announced will, inter alia, reduce the borrowing cost of banks. The Bank of Albania assesses that this creates premises for a positive response from the banking system to cut the interest rates of loans denominated in ALL.

Today’s stimulus is a timely step for sustaining lending to the economy and for contributing to further consolidation of the financial stability of the system. Through this decision, more room is given to the country’s economic activity. It contributes directly to minimizing the negative effects deriving from the international crisis and helping the further maintenance of economic and financial balances at home.

The Bank of Albania will keep working on further consolidation of the financial stability, in the interest of the long-term economic development. In this regard, I would like to emphasize that confidence in the banking system and in its totally liquid and sound balance sheets would be the most rational behaviour for each individual, business or stakeholder of the Albanian society.
SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI
At the Meeting with Actors from Foreign Exchange Bureaus
February 5, 2009, Bank of Albania

Dear heads of Foreign Exchange Bureaus,
Dear cambists,

The country’s vigorous economic and financial development has promoted the development of the financial system. We have all witnessed its constant growth in a number of institutions, products and quality of services, as well as its geographic expansion. Financial intermediation has been increasing, enabling ever more effective transfer of unused funds for financing the economy needs.

From this viewpoint, the segment you represent has also played its important role. For many years on end, we have tried to transfer the foreign exchange business from informal to formal channels. This process has had its own ups and downs. However, it is with pleasure that I state that recently very positive developments have taken place. Since 2000, the number of entities carrying out foreign exchange business is ten-folded. The Bank of Albania has granted 227 licences to foreign exchange bureaus, with a comprehensive territorial extension.

During the period of June 2007 – December 2008, 136 foreign exchange bureaus applied for and obtained a licence. Allow me to remind you of the moment when the Bank of Albania adopted a set of more liberal rules on the conduct of foreign exchange business, particularly in terms of minimum required capital.

Today’s meeting is the first between the Bank of Albania and you, but it is a follow-up of meetings we have held with market stakeholders, with commercial banks’ representatives and other stakeholders, who are interested in and can impact on the accomplishment of these objectives.

The Bank of Albania has constantly assessed the foreign exchange market as the most developed market in the country, which is a reflection not only of the force of free market initiative, but also of the existence of a more competitive environment in it. We appreciate that foreign exchange bureaus have played and are playing an irreplaceable role in its development and performance. Notwithstanding the increased international market share and the ever larger role the commercial banks are playing in generating liquidity and in setting the price in this market, the Bank of Albania constantly regards your role as necessary for further enhancement of efficiency in foreign exchange market operation.
Leaving out of focus, just for the moment, the structural factors of the Albanian economy, which make necessary the existence of foreign exchange market share even in the form of cash, the Bank of Albania regards this role in view of your positioning as important mediators between cash operations and operations carried out through the banking system. In this aspect, I could not help mentioning also the obligation you have in terms of more rigorous implementation of money laundering prevention law.

As you may already know, presently Albania applies the flexible exchange rate regime, which means that market forces are the ones that determine its level. Your behaviour has constantly helped reflecting in this price the demand and supply for this commodity, preventing the risk of price mismatch to overall market conditions and to the macroeconomic climate of the country. In this framework, I would also like to highlight your positive behaviour, related to positioning future flows of the supply and demand for foreign currency, particularly during critical periods of the market, which relate to the seasonal exchange rate behaviour, as a rational behaviour that helps reducing exchange rate volatility.

Given the above, the Bank of Albania is highly interested in getting informed with your opinions about market operation, positive or negative changes having occurred recently, relationships between foreign exchange bureaus and commercial banks within the framework of competition and mutual benefit.

The Bank of Albania expresses its willingness to provide trainings on various products that may be traded by the domestic foreign exchange market. As the first step in this regard, we plan to deal with forward operations, which will better serve the smoothing of seasonal effects of exchange rate behaviour and the hedging against undesirable foreign exchange movements.

Highlighting the general but very important nature of the above issues, we would also like to share opinions on current economic situation with you.

Psychological effects on foreign exchange rate performance are another extremely important factor. Taking into consideration the current world crisis, the Bank of Albania, appreciating your position in generating information from both, businesses and the broad public, would be interested in your opinions. Moreover, it would welcome your suggestions about any possible forms of generating these opinions periodically.

In conclusion, intending to leave more room for discussing and exchanging ideas, we welcome your opinions even about other issues, related to reporting to the Bank of Albania or implementation of money laundering prevention law.
SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI

At the Meeting with Professors and Students of Fuat Babani High School in Bilisht and Raqiqinaxhi High School in Korça
February 12, 2009, Korça

EDUCATION IS EXPENSIVE BUT PRICELESS

As it can be understood, today’s meeting is on education. Is there any better place than in a high school classroom to discuss such a topic? Naturally education is a broad topic, but as the Governor of the Bank of Albania, I will discuss education and the building of an economic and financial culture with you today.

I. WHY SHOULD ECONOMIC AND FINANCIAL EDUCATION START EARLY?

Many of you could rightly think that this kind of information is gained through experience, schooling and as the time goes by. But, believe me, even after studying for 13 years in elementary and high school, 4 years in university and 2 years in post-university courses, 2/3 of aged Americans can not answer the question whether the quantity of goods purchased with one-year savings is the same, bigger or smaller when deposit interest rate has been 1 percent and annual inflation rate has been 2 percent.

Studies have shown that even in pioneering countries of sophisticated financial products and services, the economic and financial culture of the population leaves much to be desired, indicating that economic and financial education should start early. This becomes especially necessary for countries such as ours, where for decades on end the state was the one taking care of the security of citizens’ income.

A good economic and financial education would make citizens of our country tomorrow not hang back from such questions as: How to use a credit card? What can I benefit from a compound interest? How can I better invest my savings? Why do I need a pension fund? Let alone more complicated macroeconomic issues, such as supply and demand, overall output, monetary policy impact on everyone’s life and many other issues of the same nature.

Can you imagine, how much more efficiently the Bank of Albania’s Supervisory Council’s decisions on interest rate change would be understood, if the public were well-informed on the way a market economy operates?

Consumer behaviour has also to do with correction of damaging inclinations of human beings, mostly deriving from lack of proper education in finance. Given the above, we at the Bank of Albania like the philosophy of creating an economic and financial culture at a young age. Think for a moment, how...
much useful it would be in the everyday life, if a high-school student, having knowledge on Viktor Hugo’s masterpieces, trigonometry and biology, knew how to manage his own money!

II. CENTRAL BANK AND THE ECONOMIC AND FINANCIAL EDUCATION

First, I would like to say that the central bank’s commitment to economic and financial education of the public is related to the achievement of its primary objectives. We are aware that a well-informed public that understands our role in the economy is much more able to understand and accept the reasons behind difficult decisions the central bankers take time and again. Furthermore, monetary policy has to do with such issues as expectations on inflation, which is directly related to consumers, businesses and their confidence in central bank’s decisions. Therefore, a well-informed public that understands the economic and financial issues is very important to implementing our policies.

Secondly, there is also another reason, let’s say more commanding, which makes the central bank be earnestly committed to creating an economic and financial culture. To everyone living in a market economy, the meaning of underlying economic concepts and the taking of sound financial decisions is of primary importance. This culture influences the decisions of the citizens, which if appropriate, help forming a sound economic growth.

III. WHAT DOES HAVING AN ECONOMIC AND FINANCIAL CULTURE MEAN?

This question has not only one correct answer. Consumers would say that we should teach them to be “smart consumers”, i.e., teaching them to spend their money wisely, so as not to fall into the market “trap”. The proponents of economic and financial culture prefer focusing on the future of individuals, i.e., taking sound financial decisions today that will lead to smart use of their money and economic well-being tomorrow. There are some approaches concerning the economic and financial education. One is the direct approach, which teaches the underlying economic concepts. Another one considers the economic education as knowledge on specific topics, such as the benefit from free trade or from labour market globalization.

Which is the best approach? We at the Bank of Albania have not wasted our time by trying to answer a question that has more than one correct answer. Taking into consideration the great British economist, Alfred Marshall, who regarded the economy as “a study of mankind in the ordinary business of life”, we have tried to approximate the central bank to the everyday life of the public. Like Marshall, we believe that the best way to succeed is to help people understand the economy and everyday life relationship, which has to do with the ability to make proper economic decisions, establish a good standard of living, understand the market risks and assess the policy decisions that affect citizens’ life.
The Bank of Albania’s commitment to this area is earnest and ongoing. Initially, we needed three years to set up programs and establish cooperation, to arrive at where we are today. Our purpose was to reduce at maximum the mystery around the central bank, hoping to raise public confidence in its excellent operational and decision-making quality. As part of this endeavour, we have launched an education program titled “The Central Bank in everyday life”, whose activities you already know:

1. We distributed 80,000 educational brochures only in 2008;
2. We carried out training workshops for about 100 professors of economics in Tirana and Vlora;
3. We held meetings with about 2000 high school students in Tirana and Vlora;
4. We carried out the competition on “The real value of money” in Tirana and Vlora.

Many other projects are on the way. I am confident, this work will yield apparent results in raising confidence in us, policymakers.

The Bank of Albania is also committed to a more general economic education of the public. There are other factors that make this education more indispensable in everyone’s life, such as:

- Variety and sophistication of financial products and services. Numerous financial institutions carrying out their worldwide activity today are in a feverish race to create and launch numerous financial products and services. Lack of proper information and knowledge on them makes consumer orientation towards their usage almost impossible. For instance, pension funds, which provide new possibilities for well-being and financial cover.
- Rapid developments of technology. They have made lending more widespread. But lack of knowledge about it makes almost impossible the obtaining of proper and timely information and its use for facilitating the financial decisions of everyone’s life.
- Demographic movements of people from rural to urban areas have made many families be confronted with a financial system they almost didn’t know at all in the past.
- Personal history of everyone’s relations with finances. In some cases, bad past experiences make people lose confidence in financial institutions, and moreover, avoid them in everyday’s life. This group of interest is not only more prone to take wrong financial decisions on buying a house, a car, investing in children schooling or commencing a business. Also, it risks to fall prey to obscurities that are present in any market economy.

Concluding, it is clear that the modern world is complicated. It confronts us with complex economic and financial choices, which make us have more knowledge on these issues. Education on the underlying economic and financial concepts will not only make us more capable of facing the labour market or taking sound financial decisions, but will also help us become more
aware voters, taxpayers, and consumers. Therefore, the Bank of Albania is greatly committed to creating a real economic and financial culture. Financial knowledge is a key, not to enter the world of rich people as some of you may think about, but to live with dignity in everyday life.

Soon we will start implementing a new project that aims at raising public confidence in the Albanian banking system. I invite you, together with your mates from other schools of the country to join this new initiative of the Bank of Albania. In its focus will be young people, who after a massive training by the Bank of Albania, will address the community with relevant explanations on the indispensability for reducing cash in the economy, increasing the use of e-payments, understanding principles and rules of banking system transparency, explaining the need for savings, and many other concepts that have to do with money, banks and their products. This is a challenge that needs the commitment of field specialists, the cooperation of institutions and teachers and above all devotion, in order to make the coping with this challenge as entertaining as possible. It is difficult, but casting my eye to all the people gathered in this classroom, gives me strong reasons to be optimistic!
I feel very privileged to be among you again, in this marvellous audience of intellectual values and professionalism. It is the second time I visit Korça in the capacity of the Governor of the Bank of Albania and I observe with pleasure that this city has made admirable progress. Allow me to emphasise once more that Korça, this charming and hospitable city, has given and will always give me pleasure.

Usually favourite topics for a Governor are monetary policy, financial stability, banks and money, structural reforms and economic and financial policies. However, the current situation makes inevitable the communication on recent developments the global economy in general and the Albanian economy in particular are being faced with.

Global economy is confronted with numerous challenges. 2008 year-end and January 2009 have definitely confirmed recession in the USA, Germany, Britain and Japan, let alone many other European emerging economies, such as Ukraine, Hungary, Belarus, Serbia and any other country.

While risk of further financial stability shocks is overcome for the developed economies, the economic situation is deteriorating more and more, where unemployment is increasing rapidly, along with output reduction. In the meantime, the emerging economies are experiencing a deterioration of financial conditions, tightening of lending, pressure on exchange rate and at the same time significant reduced demand for some very important branches of the economy.

I made this introduction to make you understand that global economy is experiencing a great contraction, which as concerns the shocking intensity and extension, has never been experienced before in the modern history or after the second world war. Many taboos have fallen and continue to fall. The grave financial crisis ignited and erupted at the heart of capitalism, in the USA and from there it spread up quickly all over the world.

Though it may sound paradoxical, our economy has been resistant to this tsunami. According to available official data and judging upon a number of indirect indicators, we have concluded that the economic activity over 2008 performed in line with the early 2008 projections.

Generally the economic activity at home has been sustained by domestic financial resources, while the Albanian banking system has been dynamic and effective in channelling the savings towards the funding of corporate
production or household consumption. This process has been also facilitated by the macroeconomic stability, which has enabled the fall of risk perception in the economy.

Dwelling briefly on the fulfilment of legal obligations of the Bank of Albania, I would like to highlight that inflation returned within the 2 - 4 percent target of the Bank of Albania over the second half of the year. The relaxation of supply-side shocks and appropriate monetary conditions have been key factors enabling the balancing of demand and supply-side factors.

During 2008 the key interest rate was held unchanged, at 6.25 percent, aiming at and materializing the anchoring of economic agents’ inflation expectations close to the 3 percent target of the Bank of Albania. Money market activity was conditioned by the performance of monetary indicators and the real economy. In response to these developments, the Bank of Albania intervened in the money market by injecting liquidity of different maturity terms. Also, in order to better satisfy the banks’ needs, the Bank of Albania changed in November the repo auction form to auctions with undetermined amounts.

In the end of January 2009, the Bank of Albania’s Supervisory Council decided to reduce the key interest rate by 50 basis points, recording a turning point in the monetary policy stance in terms of easing it.

However, I should underline that developments during 2008 year-end and early 2009 enable an objective and real assessment of the overall economic and financial situation of the country for the present and the future. Let me mention two or three of them, bringing our insight to your attention.

1 – During January 2009 the logical reluctance of individuals towards their bank, reflected mainly in the form of deposit withdrawal over the period of October-December 2008, came to an end. Naturally this is a good news indicating that the Albanian banking system has passed a difficult exam, which many of its “colleagues” in the region and beyond could not pass. The liquidity situation has ameliorated. Symmetric distribution among banks has promoted increased volume of interbank market transactions, turning it back to normal trading levels. In response to Bank of Albania’s reaction, this has been associated with reduced interest rates for all instruments and maturities.

Is it accidental? Is it merely destiny?

No, it has neither to do with destiny, nor with turning back to any slogans of the centralised economy era.

According to latest data, the banking system appears profitable. Return on equity is 11.35 percent for 2008. In the meantime, banks have extended their investments but they have also increased their equity. Capital adequacy rate is 17.23 percent of total assets and risk-rated off-balance sheet items, while loan portfolio quality is at satisfactory levels.
Year 2008 coincides with increased prudential policies of the Bank of Albania in terms of adopting a more conservatory approach. The passing of the new banking law, the 2007 developments once credit bubble exploded in the USA and high lending rates over 3 – 4 last years were assessed with prudence by the Bank of Albania. Therefore, in early 2008 the Bank of Albania organised the first open forum with the banking system, submitting through an open communication, a new package of prudential regulations for being discussed there, aiming at consolidating the financial stability of the country.

The Bank of Albania’s Supervisory Council gave way to the approval of the whole proposed package, thus creating an effective vaccine, which has produced appropriate antibodies or has provided the immunity I mentioned earlier in my speech.

Which are these modifications that have increased our resistance so much?

• In compliance with the new law, there were approved new criteria for calculating, supervising and reporting large exposures of banks to parent banks and connected subjects, aiming at managing the risk deriving from concentrated exposure to them.

• In order to achieve a more effective management, a new regulation was drafted, strengthening the internal audit in banks and branches of foreign banks. It regards the internal audit as a part of the general governance of banks. It ensures the platform for creating an efficient internal audit system, as the main factor in management and administration of banks and branches of foreign banks.

• Special importance was given to transparency of banking and financial products and services. This is another aspect where we intervened during 2008. The new requirements standardise the way and form of supplying customers with information about banking products and services. Special emphasis was laid on obligatory publication of effective interest rates for deposits and loans. Through this information bank customers may get acquainted with the calculation of loan effective interest rate, elements of credit and deposit contract, marketing of products and services, maintaining of customer data and confidentiality, dealing with customer complaints and establishment of specific structures relating to such complaints.

• Part of the new package was also the standardization of obligatory information the banks and branches of foreign banks should disclose about the main business of banks, their organisation and management, financial performance and position, risk management and accounting policies.

• Taking into consideration the international situation and aiming at a better diversification of risk deriving from the concentration of bank investments in international financial markets, the Bank of Albania’s Supervisory Council made some other amendments to the Regulation on Risk Management, consisting mainly in putting more prudential benchmarks on large exposure indicators and on the techniques of collateral calculation and recognition.
After presenting the work we have done during 2008, naturally we have the right to claim that we have acted appropriately, taking many preventing actions, which have helped absorbing the negative effects of recent developments.

2 – Initial data of December 2008 indicate a contraction of credit to the economy, particularly of credit in foreign currency. Allow me to explain once more that it has to do with one of the gravest symptoms accompanying the latest financial crisis internationally. This is so real that in developed economies, credit to the economy and the interbank channels have almost stopped functioning or are operating at minimum levels.

Though peripherally, this development has been materialised even in our economy. However, I believe that, what really matters is the future. From the specific contacts we have had with banks operating in Albania, we have drawn the conclusion that we share the same concern that a drastic stoppage of credit to the economy would gravely damage the economic activity of the country and the financial system’s position. Therefore, we are constantly communicating with banks, to guarantee that during 2009 the Albanian economy will receive the deserved financial support from the banking system. I am confident that the presence of senior representatives of the banking system here in this hall testifies the awareness and understanding of this concern.

The decision made some days ago by the Bank of Albania, as also stated in the press release on the Supervisory Council’s meeting, creates “more breath to the economic activity of the country”. It is satisfactory to observe that the banking system has already reacted. Treasury-bill and interbank market interest rate reduction has been evidenced.

3 – Interbank money market development, as a necessary bridge for enhancing the effectiveness of monetary policy transmission, has been and will always be in Bank of Albania’s focus. As such the interbank market development has been subject to discussion in many meetings conducted by the Bank of Albania. In these meetings banks have highlighted credit risk as one of the main obstacles for the development of this market. To minimise this risk, the Bank of Albania drafted the Law on Repurchase Agreements and sample contracts.

The passing of this Law finalised the Bank of Albania’s endeavours to set up an appropriate legal infrastructure for the market of repurchase agreements among commercial banks. Following its passing, the Bank of Albania held a number of meetings, aiming to clarify its core elements. The main purpose of these meetings was to speed up the concluding of relevant contracts among banks, in order to materialise the practical implementation of this Law. The period we have left behind is regarded as sufficient for finalizing the process of drafting and signing individual contracts on repurchase agreements. Therefore, I draw the attention of the banking system to proceed quickly, sparing the time for signing respective contracts. The process finalization should be necessarily followed by daily quotations of banks in terms of interbank borrowing and lending.
The latest decision of the Bank of Albania’s Supervisory Council serves the spirit of transparency increase and customer protection, making compulsory the quotation of mortgage loan rate on the basis of Bank of Albania’s key interest rate.

Distinguished participants,

Recently the Bank of Albania has constantly stated that year 2009 carries over numerous challenges, which in the context of sharp global issues, make our task more difficult. However, I would highlight that assessing objectively the current situation and that of the near future is an expression of prudence. We at the Bank of Albania remain committed to monitor cautiously all the economic and financial developments, willing to take proper actions to further consolidate the macroeconomic and financial balances.

In this way we accomplish our constitutional service for the country’s sustainable growth and development. In this difficult task, I avail myself of the opportunity to invite all the stakeholders and the broad public to become part of the dialogue for finding ways and optimal solutions, in order to minimize the negative effects the international economy transmits to our country.
Distinguished participants,

We are holding this meeting to announce business and consumer survey results. These surveys represent an important long-run project of the Bank of Albania. Starting from today, the Bank of Albania will quarterly publish them, together with supporting materials for the user, including a publication schedule, the methodology applied for their compilation and the relevant questionnaires. Considering this day as a special one, I avail myself of the opportunity to share some ideas with you on the importance of confidence indicators, their methodology and the significance the Bank of Albania has given to this project.

The publication of business and consumer confidence indicators is an important moment for enhancing Bank of Albania’s transparency. For some years on end, these indicators have been produced and made use of by Bank of Albania’s experts and by its decision-making structures, but now it is just the time to share this useful product with potential users of all levels. I would like to highlight that the results obtained from the processing of businesses’ and consumers’ answers are totally independent of and not influenced by the Bank of Albania, by economic, political and social conjunctures at home and abroad. All the users of this information should be aware that this information does not substitute or duplicate the official macroeconomic statistics. These qualitative indicators are compiled on the basis of opinions and expectations of the interviewed economic agents.

I would like to be more concrete related to this point.

The Bank of Albania, having the awareness, independence and a certain degree of institutional transparency, and aiming at achieving high professionalism, plays an active and proactive role in the country’s economic development. Economic analysis is under direct function of the monetary policy decision-making process. In essence, the decision-making precedes the medium-term developments, sustaining the maintaining of price stability as the primary policy target drafted and implemented by the Bank of Albania. Profound analysis of the past, present and future developments of the economy contribute to appropriate decision-making. I assure you that building a complete “picture” of the present and the future of an economy is a rather difficult process, not only for an emerging economy, such as that of Albania, but also for the most advanced economies of the world. Economic and financial developments are accompanied by elements of insecurity, which have become, as you already know, dominant in last two years.
Making decisions on the future of this already globalised world of economic links, requires professional maturity. Assessing and selecting appropriate and reliable statistical information requires profound intuitive abilities. Making the selected data bank beneficial to the decision-making, requires analytical foresight. As a matter of fact forward-looking decisions should be made on the basis of an ever larger and timely information; they should be constantly consulted with specialized economic and financial market agents.

The Bank of Albania, likewise other central banks, endeavors to increase the qualitative and quantitative data base, in order to improve analyses and the decision-making process in making new steps. The finalization of the several-year project of the Bank of Albania, along which the Business and Consumer Confidence Indices were consolidated, is an accomplishment of one of the medium-term development strategy objectives of our institution. The decision to publish these indicators passed through a prudent process and matured only after experts and decision-makers of the Bank of Albania were convinced that the confidence indicators, together with other indicators, revealed valuable additional information about the recent and future developments in the country’s real sector of the economy.

Allow me to briefly summarize some of the basic concepts on confidence, tendency and the foregoing indicators. They have been widely used in many advanced countries of the world, particularly over the last two decades. These indicators are constructed on the basis of information collected from surveys, which are technically referred to as Business and Consumer Confidence/Tendency Surveys. The Bank of Albania conducts these surveys in cooperation with INSTAT. Increasing demand of analysts, decision-makers, market agents and the broad public for timely economic information and the ability of these indicators to hint business cycle turning points, have made them very common and useful. The peculiarity of these indicators is that they reveal information on the tendency of various economic indicators, based on qualitative opinions of businesses and consumers.

The Bank of Albania has been working for several years to construct these indicators, based on the results from large-scale surveys conducted with 720 businesses and 1200 consumers. The cooperation with global leaders in this area has been very efficient. Experts from the German Institute of Economic Studies have supported the process of methodological and economic analysis of business confidence indicators. While working for this project, Bank of Albania’s experts have studied and applied important aspects of contemporary methodologies followed by the OECD countries and by the European Commission. Until coming to the decision to publish them, researches and tests have been constantly carried out on the developments, suggested by these indicators and later on verified by the statistics of the INSTAT. The compliance degree of the tendencies from both sources is assessed as statistically significant, thus making them useful. Various methodologies and empirical findings have been introduced in technical round tables, and in working papers and articles compiled by the Bank’s experts. For more than four years, the results revealed by these indicators have been ever-increasingly taken
into consideration by Bank of Albania’s decision-making, thus contributing to the building of inflation expectations indicator. They provide preliminary information on expected producer price performance, an important link for the price-setting process in the economy. Consumption and savings tendencies of the population are revealed through relevant indicators. In conclusion, the economic sentiment indicator combines the businesses’ and consumers’ opinions, giving hints of the economic prospects in the short run.

I would like to speak at length about the importance and informational utility of the confidence and the foregoing indicators. But, I would rather emphasize the respect the users should pay to such indicators, opting for being oriented to the large information flow through them. I regard this only as the beginning of a comprehensible and transparent cooperation. To this end, other special meetings and activities will follow, enriching various groups of interest with knowledge on business confidence or tendency indicators. I have confidence in the added values they will bring to users’ analyses. But, I advise and require from users, researchers, economic journalists of written and electronic media, students, businesses and consumers and the broad public, to rightly understand these indicators, before using them. These tendencies have resulted from businesses’ and consumers’ opinions and do not constitute the official stance of the Bank of Albania.

The Bank of Albania has built them on the basis of an advanced methodology. It has made use of the information obtained from interviewed businesses and consumers and it has confidence in their qualitative assessments and in those indicators. Their publication enhances the public transparency and makes the decision-making process more comprehensible. It is up to users to decide whether to use these indicators or not. I assure you that experts from the Bank of Albania will stand by the users, making them well-informed, highlighting that further improvements will be made in this area.

Thank you for your attention.
Dear participants,

It is my great pleasure to welcome at the Bank of Albania premises, so many honourable guests, whose contribution to ensuring stable growth rates of the country’s economic activity has been significant in the recent years. Your role has been vital in involving Albania to the globalization process and in attracting foreign investments.

Export industry is of great importance to the Albanian economy. During the transition period, our economy has recorded a negative trade balance, which, in turn, has caused a constant current deficit. Long-run macroeconomic stability requires that in the course of time, these balances are be paid from future trade surpluses. You realise that it has to do with a challenge you have to cope with at present and in the near and distant future. Naturally, I cannot avoid mentioning that a great role also belongs to decision-making institutions, which should create, by means of economic development policies, relevant incentives, the background and infrastructure on which your business will be based and promoted.

Macroeconomic developments in recent years and overall trends reflected in the standard of living indicators, show that the Albanian economy has succeeded in completing the transition stage and entering the group of the developing countries. Nevertheless, currently the Albanian economy is being influenced by second round effects that have affected the advanced economies of the world.

In general, first effects of the financial crisis outburst in American, Asian and European markets were: tightening of lending terms, reduced liquidity and decreased value of the national wealth of those economies. These phenomena triggered less consumption and investments, and eventually led to overall economic slowdown of all those regions.

Such developments have also affected the developing economies, since globalization process has turned them into factories of large economies. In consequence, this phenomenon has triggered the spread of crisis effects even in the developing economies.

Naturally, reduced demand has caused overall decreased investments of developed economies in traditional exporting markets. Currently, capital flows that have financed high current deficits, particularly into transition economies of the Central and Eastern Europe, are interrupted. Furthermore, financial
and manufacturing companies, as well as households from advanced economies, being faced with financial difficulties, are exercising pressures to withdraw their funds from the developing economies. All these developments have shaken the macroeconomic equilibrium of the developing economies, which are experiencing current deficit deepening and strong pressures on their currencies.

This contagion mechanism, through which the crisis ignited in most advanced economies of the world is spreading worldwide, has made the Albanian economy feel the effects. Even though the financial system was not influenced by the world financial crisis, second-round effects are being reflected and will be reflected even in the future. The Bank of Albania has assessed that, driven also by a large global market “drought”, 2008 has recorded reduced foreign currency inflows and increased current deficit.

During the last two months a moderate foreign exchange rate depreciation was noted. However, we should take into account that Albania is in a more favourable position than other economies of the Central and Eastern Europe. Our advantage stands on the fact that unlike other countries of the region, we have not financed our current and trade deficits with short-term foreign capital inflows, otherwise referred to as “hot money”. The Bank of Albania has prohibited lending to the economy with the so-called “exotic currency”, which once upon a time represented funds of a very low cost, ready to penetrate even into our economy. Let me remind you that many developing economies have fallen into the trap of those funds, suffering now gravely from their flight. Furthermore, we have adopted a flexible exchange rate, unlike fixed or managed exchange rates.

The Bank of Albania has assessed that current developments, particularly those of our main partners, will bring about tendencies which are generally different from those with which we have been working over the last ten years.

Actually, the euro area is in crisis. Economic growth is negative; the euro is losing ground versus the dollar; unemployment is increasing; and prices are going down. Important industries, such as the financial industry or that of machineries are undergoing the worst situation over the last 50 years and governments of these countries are obliged to approve aid packages, to guarantee their survival. According to the most optimistic assessment, this situation will not be improved, at least until the end of this year. Therefore, I emphasize that exporters should adopt new philosophies. They should be innovators, increase products and discover new markets, beyond the traditional ones, which have currently been hit from the economic and financial crisis.

Global developments impose adoption of new approaches. The country’s economic and financial development stage and passing into the group of the developing countries have created conditions for businesses in general and export industries in particular to adopt new standards in business management. Businesses should understand that the optimal regime of their activity requires new elements. Current developments of the world economy make necessary
the increase of prudence for managing the financial asset portfolio, overall risk and exchange rate risk in particular, as well as for identifying alternative financial methods and instruments. Businesses should invest in increasing analysing and forecasting capacities. They should build their development scenarios, including even the anticipation of their possible financial losses from non-operation. They should also employ capable human resources, specialised, educated, that is professional ones, in order to ensure an efficient activity. To this end, I invite you to cooperate more with the banking system, to stand by banks, but also by the Bank of Albania and be open with them. Make use of this communication for constructing preferential cooperation. This path will create to you the opportunity to find and promote appropriate financing instruments and possibilities to overcome difficulties of the moment and guarantee the future of this important branch of business.

Foreign currency income growth from all possible sources is translated into increase of macroeconomic stability in general and of financial stability in particular for the Albanian economy. At present, the geographic, demographic, economic and social characteristics of the Albanian economy present advantages, which if wisely utilized, may be materialised into economic benefits. Therefore, export sector constitutes an important source of profit and of foreign currency flows for financial intermediation in foreign currency. From this viewpoint, the support of exporters by the financial sector, not only with products and financial resources but also with financial consultancy, is an activity of mutual benefit. For this reason, I deem that the role of the banking system may be one of the main promoters to absorb some of advantages generated by the current international situation.

Availing myself of the presence of banking system participants, I would like to address an institutional appeal to them: Assess more prudentially the role and potentials of this industry, stand by it with advice and financial consultancy, review your policies on commissions applied to it and in this process, give priority to a larger funding for it. Recent crisis indicated that we all sail in the same waters and we may resist the waves, only if we confront these challenges together. Export is a generator of foreign currency flows needed so much for the currency stability, which is related to all other balances, financial system’s stability also included.

Under these conditions, we should be aware that a joint action, of national importance, deeply patriotic for the values and future of the country is needed. Make the market more lively, more competitive and more innovative. Now the financial infrastructure is complete and it is up to you to use it more efficiently.

It is the time to try to seek other balances in terms of foreign currency flows into the economy. Remittances have been important for a long time. They were the largest foreign currency serum in the economy. However, we should be aware that other indicators, such as exports and foreign direct investments will be prior items in the total foreign currency flows in the future. This should be realised by everyone and based on this ground, let us work together for the future.
Dear participants,

International initiatives are in process. The Berlin meeting was extremely important in this regard. There was broadly discussed and converged into the idea that there is room for more coordinated actions, and protectionism is not the answer to the crisis.

The London meeting will make new steps in this regard. Promoting investments for a cleverer future, setting new models for a new world, more structured and with renovated industry, will be in its focus. The crisis will have its own winners. Winners will be those that will develop new policies, products, services and markets of a non-cyclic nature.
LECTURE BY ARDIAN FULLANI, GOVERNOR OF THE BANK OF ALBANIA
At the Conference on “The Global Financial Crisis and Future Developments”, Organised by “Our Lady of Good Counsel” University and Bologna University
March 27, 2009, “Our Lady of Good Counsel” University

Dear participants,

It is a special pleasure for me to be among you in this conference syntonized with the sharpest recent problems and share with you some opinions about the Albanian economy performance and its confrontation with the international financial crisis. Though the origin of the global crisis is the same, its impact varies across countries, as the nature of problems and measures taken for solution to the crisis also vary.

Fortunately, the Albanian economy is in a more convenient position to face the crisis, compared with many countries of the region or with co-transition countries. I say fortunately, not to define the casual nature of the favourable economic and financial position we are in, but to highlight that the consolidated macroeconomic equilibrium of the country makes us less vulnerable and gives some more space for dealing with it. In reality, there is nothing casual in our headway towards sustainable economic development at home. In drafting and implementing the economic policies, the Bank of Albania, as one of the main stakeholders, has constantly paid attention to the achievement of this target. Our efforts in this direction have been associated with a sound framework for coordinating the macroeconomic policies, with a significant role being played by the IMF assistance and its financial support.

All these premises have made the Albanian economy grow at satisfactory rates during the last decade, recording an average GDP growth of 5-6 percent. Nominal income per capita has almost tripled during the last eight years and due to low inflation this growth has been directly translated into increased standard of living. On the other hand, fiscal policy has been relatively prudent. Its features have been shaped by the need to maintain fiscal discipline, which is reflected in the prudence for controlling the budget deficit, the public debt and the government’s impact on domestic financial markets. Like many other developing countries, our economic growth has been associated with high trade deficit levels, which have been financed from steady capital inflows in the form of remittances or foreign direct investments.

However, the economy’s performance in the last quarter of 2008 and first months of 2009 is indicating an ever larger impact of the global financial crisis on the country’s economy. In few words, this impact is illustrated with reduced flows of remittances and imports, reduced liquidity and tightening of credit market, as well as uncertainty of economic agents. All these developments have encouraged a public debate on appropriate measures to cope with
them and have highlighted the need for coordination of efforts of all economic stakeholders at home.

The financial system has been an important factor in sustaining the high economic growth of the country. It has reflected a constant growth of its activity, particularly over the latest years. This development has been supported by ongoing reforms, aiming to enhance competition and constantly improve the regulatory and supervisory infrastructure. The whole banking sector is currently dominated by private capital and most banks are owned by well-known European banking groups. Over the last 5 years, the annual growth of the banking sector assets is 15-20 percent, amounting to 87 per cent of GDP as at end 2008. As a result, in the last 4 years credit to the economy has increased on average by 7 percent of GDP, reaching around 37 percent of GDP.

The regulatory and supervisory infrastructure of the financial system has also improved. In the framework of regulatory and supervisory role of the banking activity, the Bank of Albania has aimed at implementing the best international standards, so that the banking activity and banks perform in a balanced way, with identified and controlled risks. To this end, the Bank of Albania has concluded that any developments, generally perceived as positive for the banking activity and for the economy in general are likely to be associated with numerous risks in terms of the financial stability of the system. Our objective is to be in the vanguard of identifying and taking appropriate measures to precede the materialization of such risks in the future. In more concrete terms I am referring to rapid credit growth by the banking system. We had to do with a positive performance, supportive to economic development of the country, but the Bank of Albania could in no case ignore the other side of the coin, i.e., the portfolio quality. The same holds even as concerns the loan portfolio composition by currencies. Domination of loans in foreign currency makes the loan portfolio sensitive to exchange rate performance of the national currency against the main foreign currencies. To ensure a better management of these risks by the banking sector, the Bank of Albania has recently undertaken different regulatory actions to better discipline the rapid credit growth and to better balance the loan portfolio composition by currencies.

Also during the last year the banking system performance was generally positive. The banking sector was well-capitalised and liquid. The capital adequacy ratio stood at 17.2 percent, whereas liquid assets to total assets, was at around 43 percent. However, due to international crisis developments over the last quarter of the year, the banking system was faced with an unstable situation of the public deposit performance, which during the last year increased only 2 percent. Low growth rates dictated a slowdown of the banking system asset annual growth to 12.3 percent, as well as a slowdown of the annual credit growth of around 35 per cent. The financial result of the banking sector for 2008 was positive but lower than in the previous year, due to a slowdown in profit-making activities and increased operation costs. The banking sector profit for 2008 was ALL 7.3 billion.
Under these conditions, the Bank of Albania took some measures, aiming to professionally and explicitly clarify to the public the international crisis effects, through its presence in the media and increased number of various publications; strengthening the banking activity surveillance through extended requirements in the framework of reporting of banks and on-site examinations, strengthening the dialogue with the banking industry; strengthening the cooperation with other supervisory authorities at home and in the region; improving the regulatory framework in certain aspects of the banking activity; preparing measures for maintaining public confidence in the banking sector, including the proposal for increasing the deposits insurance value.

The Bank of Albania, assessing its role objectively, has contributed to keeping liquidity at optimal levels, mainly through an effective combination of available operational instruments. The Bank of Albania has successfully alternated liquidity injection in interbank market, through weekly reverse repurchase agreements, at fixed price and longer-term injection options, including outright operations.

Year 2009 is expected to be harder for the banking activity growth. The banking sector will be stable, in terms of maintaining adequate capitalization and liquidity level. The Bank of Albania has requested from representatives of the banking industry maximum prudence and commitment to monitoring and coping with the developments over this year. We have required strengthened audits of managing structures of banks over the activity of their institutions. This should be done in accordance with the need for adapting to additional requirements of the Bank of Albania for timely information on banking activity performance. More specifically, the Bank of Albania has requested from banks’ stockholders to be willing to, if necessary, increase their capital and maintain financing lines for their subsidiaries operating in Albania. Within the parameters of a sound banking activity and in accordance with the regulatory and supervisory framework, the banking sector should utilize the existing possibilities to carry out its important role in the financial intermediation and in the sustaining of economic growth of the country.

Let me provide some aspects which orient the analysis and decision-making of the Bank of Albania in the current situation.

As it is clear for every researcher of economics, the development of every cell of the economic activity should be known and confronted with its budget deficit. It’s valid not only for corporate and household budget, but also for the whole economy. Challenges ahead have to do precisely with reduced possibilities for financing the economic activity. Due to problems deriving from abroad, the banking system financing possibilities are tighter than a year ago. Bank balance sheets, though sound and well-capitalised, are characterised by a lower liquidity level. Also, it is understandable that the banking system prudence for the loan portfolio quality has increased significantly, bringing about further drop of bank loan extension. In absence of foreign financial resources, it is normal for the Albanian economy to be aware of and accept these financial restrictions in the short run. Albanian business and consumers
should be more cautious in using the banking system funds. This is not an appeal for contracting the banking borrowing, but a signal for enhancing the efficiency in available funds utilization. This concern should be recognized and well understood by all economic, public and private agents.

The economic development is a constant confrontation of the desires for stimulating credit in support of consumption, investment and economic growth, with the needs for stability of macroeconomic balances. The latter condition the economy growth rate in the long-run. Strong stimulating policies may purchase an economic growth for a short period of time. But this strategy would damage long-term price stability, undermining the purchasing power of the economy and losing confidence in the national currency and in financial institutions. Also, these measures may result to a balance of payments deficit, causing strong second-round economic contractions. Obviously such an economic strategy would turn out negative. All this explication supports the Bank of Albania’s opinion that the maintainance of macroeconomic stability, reflected in low inflation, sound public and private balance sheets, stability of the fiscal debt and of the foreign currency external position of the economy and low volatility of the financial markets, is the proper key to orient and develop our economic policies.
SPEECH OF THE FIRST DEPUTY GOVERNOR OF THE BANK OF ALBANIA, MR. FATOS IBRAHIMI
At the Meeting of Launching the Program “On the Development of the Small and Medium-Sized Enterprises”
January 20, 2009, Tirana International Hotel

Your Excellency Mr. Ambassador,
Honourable Mr. Ministers,
Dear participants,

It is a great pleasure for me to attend this event and I avail myself of the opportunity to greet on behalf of the Bank of Albania this joint recent initiative, between the Ministry of Economy and the Italian Collaboration. The financial support of small and medium-sized enterprises has a particular importance for the development of this project and for the release of managing abilities of the economic units. The financing of small enterprises is a worthy opportunity for small developing economies to increase both the employment and the economic activity based on the initiative, ideas and producing capabilities of small groups or of distinguished individuals, who have the courage and knowledge to generate goods and to increase the welfare of the society. The small and medium-sized enterprises in Albania, over the transition period, have been growing quickly, hence displaying a distinguished characteristic of the whole Albanian transition, having survived to the domestic economic difficulties such as the fall of pyramid schemes or other problems related to the reforms and the process of completing the institutional and legal framework. The contribution of small enterprises to the growth of services, construction, trade and agriculture, where micro-enterprises compose the largest part of this group, has been obviously significant for the short-term and stable revitalization of the Albanian economy.

These enterprises have provided a substantial contribution to the decrease of unemployment and to the rise of productivity in the aforementioned economic activities, with a considerable impact over the rapid growth of the Albanian economy. The domestic economy has noticeably improved over the last decade and the progress made over the recent years reflects a positive and relatively stable macroeconomic environment. Real GDP growth rates are assessed as satisfactory and in general higher compared to the other countries of the region. The consumer price level as well, has resulted in compliance with the target of the central bank for the price stability. “The relaxation” of the external factors that hit the supply behaviour and the domestic macroeconomic stability, caused the inflation rate to be normalized to within the targeted limits. Exchange rate performance is stable compared to the high fluctuations characterizing the 90s. With respect to the performance of the Albanian Lek vis-à-vis its major counterparts, it has been appreciating for quite a considerable period of time, mitigating at the same time the imported inflation.
Estimations carried out at the Bank of Albania reveal that the relative high growth of real GDP during the period 2003-2007 attributes to the rise of labour productivity as well as to the increase of investments in the economy.

Simultaneously, the banking system has expanded substantially. The situation appears also satisfactory regarding banking credit to the private sector. Business loans have provided the main contribution to the growth of banking loan portfolio, by 66 percent. The augmentation of this portfolio is considered to have impacted positively the growth of economic activity for the main sectors. In September 2008, the loan portfolio was dominated by lending to trade sector (around 25 percent), construction (around 15 percent) and industry (over 15 percent). According to Bank of Albania estimations, loans to small and medium-sized enterprises as at November 2008 resulted 60 percent higher than the year end 2006, accounting for half of total loans to the business. Thus, the banking system’s lending activity has supported the growth in the main sectors of economy and has assisted to the further deepening of the financial intermediation. This support has been identified in their larger geographic coverage as well as in the range of services and the improvement of products supplied by the financial system.

Today’s initiative is an important event to sustain the growth of financing to this vital part of the economy and it will help to mitigate the negative impacts of the world economy slowdown. I encourage the banking system and other market players to undertake similar initiatives in order not to impede the financing of small projects, which may be transformed into profitable undertakings. At the same time, in order to maintain a stable and long-term progress of the country, in line with its European aspirations, the banking system should make steps ahead toward the perfection of customer services, public communication and education.

The Bank of Albania believes that the stable growth sources for the mid- and long-term period consist not only in the encouragement of the labour productivity increase or investments in industry and construction, but also in other strategic sectors. For the Albanian economy as a developing one, domestic and foreign direct investments in strategic sectors such as tourism and infrastructure would constitute a real resource for the economic growth. The positive chain effects are expected to be reflected in the preservation of the steady growth rates. Hence, the overall macroeconomic stability would be a precondition for motivating the further intensification of domestic and foreign investments. The ongoing reforms and the required structural improvements would provide positive and long-term effects on the establishment of a more secure climate for the domestic and foreign business investments.

Thanking you once again for the invitation, I wish you good proceedings of this important event for the development of the business in Albania.
THE ALBANIAN BANKING SYSTEM IN FRONT OF THE INTERNATIONAL FINANCIAL CRISIS

Dear participants,

Let me start by thanking the organizers of this meeting, for enabling this joint discussion regarding the status of our financial sectors and the measures which are necessary to sustain its resistance to the negative effects of this unprecedented global crisis. Indeed, what started as financial crisis in the US, has transformed itself into an economic crisis, that is having dire consequences in real sectors of the world economy. The hope is that, like earthquake bands, the magnitude of the crisis effects will fade out as it widens and is confronted with measures taken by countries to resist it.

I will start by describing the main macroeconomic developments of our economy and the characteristics of our financial system. Then I will mention some of the related measures taken by the Bank of Albania, in its role as the monetary and supervisory authority of the country, and our expectations for the foreseeable future.

Our economy has been in a solid path of growth for the last decade, with an average annual growth of around 6 percent. It has benefited from economic reforms that have provided development opportunities for our business sector, have opened markets, have increased competition, have stimulated flexible labor markets and have increased social revenues. Both fiscal and monetary policies have been cautious in providing the necessary stimulus to the economic growth, by being consistent and disciplined in the pursuit of their objectives to achieve fiscal consolidation and ensure a low-inflation environment. The size of the annual budget deficit in relation to GDP has been between 3 percent, leaping to 5.7 percent for 2008, while the public debt has been stable, reaching up to around 55.6 percent for 2008. The annual inflation growth rate has been for a long time within the corridor defined by the Bank of Albania of 2-4 percent (and close to the Bank of Albania target of 3 percent), indicating success in anchoring market participants expectations for price developments in the economy. This steady good economic performance has been supported by a flexible exchange rate that has been instrumental in supporting and maintaining a balanced growth, by maintaining the right incentives for interaction between domestic and foreign counterparties.

Fundamental changes have occurred in the financial sector too, thanks to consistent and successful reforms in the last decade. Nowadays the banking
sector in Albania counts 16 banks, all in private hands, where the foreign capital dominates. During this period, the banking sector has increased the number of branches, has improved its products to the public and has increased its intermediating role to provide an important contribution to the economic development of the country. At the same time, the entrance of well-known European banking groups from Austria, Greece, Italy and France, has been associated with consolidation in the banking industry. As it is the case in the entire region, the banking sector dominates the financial sector in our country.

Our supervisory work aims at adopting the best international standards in the field. As a result, our legal and regulatory framework is considered to be consistent in achieving our objective of a stable and sound development of the banking activity, and is continuously improved. From the practical aspect, we combine both regulatory and risk based supervision. The data reported from the banking sector are analyzed off-site and verified on-site. We also try to stay in close contacts and cooperate with foreign supervisory authorities, as an important instrument in improving the effectiveness of the supervisory work.

Nowadays, the assets of the banking sector represent around 87 percent of the country’s GDP. Loan portfolio has reached around 37 percent of GDP. Due to increasing competition after the privatization, its growth has been very strong in the last 4 years, albeit starting from a low base. Deposits represent around 80 percent of the banking sector liabilities, and the loan/deposit ratio stood at around 62 percent. Hence, the banking sector relies heavily in domestic deposits, both in national and foreign currencies, to perform its lending activity. The foreign currency position of the banking sector is quite balanced, as assets and liabilities in foreign currency stand respectively at around 49 percent of total assets, and liabilities of the banking sector to nonresidents (almost entirely in foreign currency) is only 10 percent of total liabilities. The banking sector is well-capitalized and liquid. The capital adequacy ratio stands at around 17 percent, compared to the required minimum of 12 percent. Liquid assets to total assets, is at around 43 percent. In the last 4 years, the average return on equity has been above 20 percent while the average return on assets has been around 1.5 percent. The branch network of the sector counts around 350 branches all over the country. In the last three years mainly, the banking sector has also introduced modern payment infrastructure and products, to allow for increasing usage of electronic payment cards and internet banking.

Despite solid performance in the last years the Bank of Albania has been vigilant to point out areas of the banking activity, related with domestic developments that required attention from the banking industry. Until before the appearance of this international financial crisis, we have expressed our concern regarding the rapid increase in lending which, until 2007 reached up to 8-9 percentage points in terms of annual growth to GDP. The composition of the loan portfolio, which is dominated by the euro dominated loans, is also a point of concern, although this position is supported by a strong presence of
foreign currency denominated liabilities in banks balance sheets, a generally supportive environment of exchange rates and interest rates over time and very close trade links to Euro-area countries like Italy and Greece. In this regard, the Bank of Albania has been consistent in its approach to introduce regulatory measures that would discourage rapid increase in lending, encourage banks to lend more in domestic currency and increase transparency toward clients on banking products and services.

Since the middle of last year, the Bank of Albania has been vocal in its concern regarding the indirect impact of the financial crisis, in particular regarding the performance of the real economy. We pointed out risks to economic growth related with a potential decline in credit from the banking sector, an increasing trade deficit (due to a slowdown in exports), a sharp contraction of remittances (due to perception of lower wealth and increasing unemployment in the developed countries). We stated that at these times, there is a much stronger need for a careful monetary policy and responsible fiscal policy. When it comes to the monetary policy, we have been careful in maintaining incentives for promoting savings in local currency assets and anchoring expectations for low and stable inflation rates. From an operational perspective, over the second half of last year, the Bank of Albania took a number of measures:

- Strengthening the surveillance of financial market developments, and in particular of the banking sector;
- Strengthening bilateral and multilateral meetings with bank representatives, asking them for increased vigilance due to current international market conditions;
- Increasing contacts with other domestic institutions that regulate and monitor the financial markets, in particular with the Albanian Financial Supervisory Authority;
- Increasing the number of publications, including the Financial Stability Report 2007 (Sept.) and the Statement on Financial Stability (Oct.), which try to analyze the elements of the crisis and its potential effects on the Albanian banking sector and the economy;
- Increasing the presence in the media, to explain the crisis, to clarify the position of our banking sector toward the potential crisis effects, and to maintain public confidence in the banking sector;
- Changing and improving the reporting framework of banks, in particular regarding their exposure to international markets (and the parent banks) and their liabilities (deposits and exposure to credit lines) from parent banks);
- Reviewing our “back-up” plans to assess the possibility of new actions, should we encounter a worsening scenario;
- Changing the form of our open market operations and starting to execute “open amount/fixed price” weekly reverse repurchase transactions and longer maturity ones, to better suit the liquidity needs of the banks.

When it comes to cooperation with the home countries, we have very much appreciated their measures to enhance the safety of their banks, as
this provides a sense of financial infrastructure security in our host-countries as well. We believe that these measures will be adjusted to a developing environment, and will be instrumental to also target some of the concerns of the host countries related with: a) the importance of maintaining reasonable flow of funds in euro from the headquarters of the banking groups toward their foreign subsidiaries, both for liquidity and lending support; b) the importance of gradually steering the lending portfolio of their foreign subsidiaries toward local currency of the host countries.

Events of the second half of 2008 have shown us the importance of having a balanced economy and a solid financial and banking sector. Despite the increasing effects of the international crisis, the economy showed a solid growth, in an environment of declining inflationary pressure. Impact of the international crisis started to materialize in the last quarter of the year, as shown in developments of the balance of payments and in the banking sector balance sheet. Indeed, a fall in external demand and a rise in unemployment rates in some of the EU neighbor countries caused a decline in the remittances and in exports. In addition, public sensitivity to (sometimes unbalanced) news on international crisis developments, increased the uncertainty about the safety of their savings in the banking sector, and caused some deposits withdrawal. In spite of this, due to satisfactory levels of capitalization and liquidity, the banking sector coped well with such developments. In terms of general developments, the banking sector assets annual growth slowed to 12 percent, compared to 19 percent of the previous year. In addition to a decline in loan growth, the loan quality also worsened and non-performing loans reached 6.6 percent of total loans. But the comfortable ratio of loans to deposits still supported a solid annual credit growth of around 35 percent. The financial result of the banking sector for 2008 was positive but lower than the previous year due to a slowdown in profit-making activities. The exchange rate of the domestic currency was stable over the year and with depreciating tendencies versus the euro and the American dollar over the first quarter.

In relation to expected domestic developments for 2009, we expect economy to face greater challenges. Economic growth will be positive, but almost half of what was in 2008. The planned fiscal stimulus will be harder to reach, due to potentially higher difficulties in realizing revenues and in providing other sources for financing the expenditures. Hence, there might be a need to prioritize fiscal expenditures over the year. Financial intermediation of the banking sector, to the public and the private sector, could be lower and potentially with higher cost, due to supply and demand factors. Due to tighter financing conditions, businesses and households are expected to undergo a painful but necessary adjustment process in the short term. This might prove to be beneficial in terms of efficiency gain in the medium term. Inflation may temporarily go under the corridor of the Bank of Albania, but is expected to be within the corridor for most of the year. Monetary policy will make sure that proper incentives to hold local currency denominated assets are maintained and that inflation expectations are kept anchored at the target of Bank of Albania. This is expected to also be important in maintaining adequate financial intermediation capacity in the medium term. The profitability of the
banking sector is expected to be lower this year, due to lower volume of the profit-making activities (lower credit supply/demand), potentially higher financing costs and increasing provisions for non-performing loans. But this is not expected to have a substantial effect on capital adequacy and liquidity indicators. More than sufficient capitalization and liquidity parameter of the banking activity will protect the stability of the banking sector and of the financial system going forward.

While the international crisis is impacting every country, the magnitude of the impact will depend on the duration of the international crisis and the state of that country’s economy. Expectations for the recovery of the world economy, somewhere between end of this year – beginning of next year, if materialized, will remove the uncertainty and the psychological boost will likely support the sense of earlier and stronger economic benefits. In spite of the difficulties ahead, it is deemed that the position of the Albanian economy and of our financial system is balanced and capable of withstanding the impact of this international crisis. In this effort, our economy will find support in factors related with the flexibility of the real sectors and of businesses, the appropriate level of some macroeconomic indicators related with fiscal and monetary areas, the stability of the banking sector and the very limited exposure to nonresidents’ assets and liabilities, the ability of the public authorities to maintain fiscal and monetary discipline and to act in a decisive and harmonized way to support economic growth.

Thank you.
March 2008

A DISCIPLINED APPROACH TO PORTFOLIO MANAGEMENT AND TRADING
Rezart Molla

This paper aims to give a short description of the trading process in general and the steps through which a disciplined trader and/or portfolio manager should go in particular. Its content comes on the top of a previous document, which was a feedback for the internship the author attended in the World Bank Treasury in Washington D.C. during the months of October 2007 on reserve management. The back-bone of the approach is the one World Bank currently uses, therefore the author fully recognizes the authorship of the World Bank staff on the core concepts behind this paper. However, the three-year experience the author has had as a portfolio manager at the Bank of Albania surely helps in providing a meaningful description.

The document is titled T.R.A.D.E.M.A.P., where every character stands for the first letter of each of the stages of portfolio management process from inception to execution and the follow-through. The paper describes the following stages:


After going through the eight stages of portfolio management process, the author concludes that this process involves strong human emotions and that market gyrations can cause similar and almost one to one gyrations to these feelings, which might have consequences on portfolio’s performance.

June 2008

INDEX OF FOREIGN PRICES/UNIT VALUES OF ALBANIAN IMPORTS
Risan Shllaku

The scope of this discussion paper is to propose an approach for an index of Foreign Unit Values/Prices of Albanian Imports. It also offers a brief review of index number theory, which unveils important aspects that need to be kept in mind by economists and policymakers while performing economic analyses and recommending or implementing economic policies. The proposed approach is based on this review of index number theory.

The paper is organized in the following sections. Section 1 introduces while section 2 offers a brief discussion of index number theory and of the main
issues related to price indices. Section 3 presents an approach based on the indices of export unit values/prices of the main countries from where Albania imports. Because of data availability reasons, the indices of export unit values are used for some of the foreign countries and the indices of export prices are used for other foreign countries. The advantages and disadvantages of this approach are obviously elaborated. Finally, section 4 offers a brief conclusion.

EXCHANGE RATE PASS-THROUGH IN ALBANIA
Klodiana Istrefi, Valentina Semi

This paper assesses the extent and the speed of exchange rate pass-through to consumers prices in Albania, using vector autoregressions models, VAR. Evidence shows that exchange rate pass-through for the period 1996-2006 is complete within a year. Meanwhile, a sub-sample analysis shows the incompleteness and the decline of pass-through to consumer prices after the year 2000. Developments in market structures, the stability of our currency, ALL, the low inflation environment and higher credibility in the Bank of Albania, rank as good justifiers to such behavior. Nevertheless, this does not mean that exchange rate developments have no longer an importance on consumer price formation. This paper shows that the effect of exchange rate on prices is not easily captured by direct analyses of data on exchange rate and consumer prices. Therefore, the monetary authority should be cautious, and choose the right reaction toward exchange rate movements. If the volatility of exchange rate increases in the future, there is no guarantee that the reaction of the economy and especially consumer prices will not change.

NEW CORE INFLATION MEASURES: THEIR USAGE IN FORECASTS AND ANALYSIS
Evelina Çeliku, Rajna Hoxholli

The practice of core inflation measures provides various approaches. Is there any perfect and universal method to measure it? Until now, no such thing has been concluded. Selecting a method on whose basis a proper core inflation series is constructed is a debatable issue in academic circles and in those of central bankers. Central banks employ different core inflation measures based on the fact: (i) whether their ultimate target is the core or the headline inflation; (ii) whether they use it or not to forecast the headline inflation. In all cases, it is aimed at selecting those methods that inform more clearly the decision-makers, economic agents and the broad public on the long-term inflation trends. This research brings about arguments related to on-going discussions at the Bank of Albania on forecasting inflation in general and core inflation in particular. This paper examines several measures of core inflation. A summary of methods, of corresponding priorities and problems is made with regard to each measure. Then, based on the outcome of some statistical criteria, on tests about the degree of basic component persistency,
on the predictive abilities of core inflation measures for the headline inflation, efforts are made to evidence the optimal measure to be used under Albania’s case. Based on a complete estimation process, this paper presents forecasting models of various core inflation measures, exploring the possibility to obtain through them the most accurate headline inflation forecast. Making a balance between priorities and problems of the alternatives of various core inflation measures, it is drawn the conclusion that the most appropriate measure – which simultaneously meets the statistical criteria and enables the headline inflation forecasting – is the one that permanently excludes some items from the basket. This model is preferred to be applied largely by different central banks, because of the high degree of transparency and better understanding by the public. The research concludes by providing concrete proposals for encompassing information on core inflation measures to Bank of Albania’s periodical analyses on the developments of the economy in general and of prices in particular.

September 2008

MEASURING IMPORT AND EXPORT FUNCTIONS IN ALBANIA
Ilir Vika

This paper uses an error correction model to measure the elasticity of merchandise import (export) flows to (from) Albania with respect to domestic (foreign) real demand, developments in relative prices abroad and at home, and local currency market fluctuations. The model specification is intended to find out whether trade flows respond differently to the explanatory variables in the long and short run. The estimated trade elasticities are useful for forecasting future trade flows as well as to policymakers who need to evaluate commercial policies or exchange rate devaluation options to improve the merchandise trade balance.

The empirical findings reveal that real income (as proxied by real GDP) is the main determinant of trade flows in the long run, particularly for exports. This suggests that Albania could potentially benefit from export promotion policies. Furthermore, changes in relative prices appear to have a larger impact than exchange rate fluctuations have on the volume of merchandise imports. The opposite is true for the export supply, which seems to react greater and faster to changes in the Lek/Euro exchange rate than to relative prices. Apart from estimating the elasticity of merchandise imports and exports for prediction purposes, the paper also sheds light upon domestic economic policies aiming at curbing the trade deficit with the rest of the world.

December 2008

FOREIGN DIRECT INVESTMENT IN ALBANIA FOR THE YEAR 2007
Endrita Xhaferaj

This paper provides an analysis of the performance of foreign direct investment in Albania over the year 2007, based on the data collected from the survey of foreign and joint venture enterprises, which was conducted in July 2008.
BUSINESS AND CONSUMER CONFIDENCE SURVEY
Methodological Explanatory Notes

Starting from the year 2002, the Bank of Albania has, in collaboration with the Statistics Institute, conducted the Business Confidence Survey (BCS) and the Consumer Confidence Survey (CCS). BCSs and CCSs are conducted on a quarterly basis. The main purpose of BCS and CCS surveys is to collect complete and timely information on different aspects of businesses and households’ economic activity. The increasing tendency of the central banks’ serious commitment to this ‘undertaking’ has been particularly shown in the last two decades. It is motivated by the preceding nature of monetary policy decision-making.

The purpose of the methodological explanatory notes to the Business and Consumer Confidence Survey is to explain the technical aspects of the construction of the index, in order to make it understandable by the public and enhance institutional transparency.

The surveying methodology is in line with the methodologies applied in many OECD and non-OECD member countries, the European Commission methodology and with one of the most reputable methodologies in this area - the German Ifo Institute for Economic Research.

The surveying process takes place in two stages. The first stage involves the field surveying of businesses and consumers and the collection of questionnaires by the INSTAT. The questionnaires contain quantitative questions. In the second stage, the Bank of Albania checks the process, enters the data, processes the survey results and releases them.

Based on the detailed results -balances of each question- are calculated a set of composite indicators. First, for each of the surveyed sector (industry, construction and services) are produced confidence indicators (CIs), which combine the balance of questions for each individual sector. CIs are calculated as the simple average of seasonally adjusted balances, which have the highest correlation with the reference series, quarterly GDP or the sales index. Economic Tendency Indicator (ETI) aggregates all the balances used in the calculation of CIs for the four surveyed sectors. The purpose of the Economic Tendency Indicator (ETI) is to track the performance of economic activity through a single indicator instead of two indicators obtained from the two main economic groups, businesses and consumers.

The results of BCS and CCS surveys are only a reflection of the tendency of indicators as perceived by producers and households. They do not reflect the Bank of Albania opinions. The aggregate indicators do not substitute for the official quantitative statistics.

* Opinions expressed in these papers are those of the authors and do not necessarily reflect the official opinion of the Bank of Albania.
DETERMINANTS OF NET INTEREST MARGIN IN THE ALBANIAN BANKING SYSTEM*

INTRODUCTION

Research on banking system efficiency has always been an argued and interesting issue. This material analyses the net interest margin as a measure of efficiency for the banks that operate in the Albanian banking system and the main focus is on the identification of factors that may affect this indicator. Net interest margin can be calculated as the proportion of net interest income to total assets or interest bearing assets. Nevertheless, a reduction of this indicator does not signal in all cases an improvement of efficiency. Under these circumstances, the study of factors that could bring about changes to the intermediation costs, compose an interesting field and broadly discussed by the foreign literature.

The banking system is the most important element of the Albanian financial system, whose assets stand for 97 per cent of the financial system assets. For Albania, banks function as the main players in channelling funds from lenders to borrowers, therefore it is important that their intermediary role provides a higher welfare for the society, possibly at lower costs. This study was inspired upon this context, aiming to identify the factors that impact the net interest margin for the Albanian banking system and wishing that it will contribute in the written literature dealing with this issue; as such a study is firstly accomplished for the case of Albania.

Different stakeholders, but especially the policy-makers are interested on the establishment and functioning of stabilized and efficient banking systems. The stability requires adequate profits, while the economic efficiency requires margins at acceptable levels, applied from banks. The results derived from the analysis of factors that impact the net interest margin may be useful for the compilation of specific measures of economic policies.

I. ACCOUNTING ANALYSIS OF NET INTEREST MARGIN

There exists various forms for analysing the interest margin, and the accounting analysis is one of them, firstly developed from Hanson and Rocha (1986). Considering the profit and loss statement (considering as well the model of the financial statements of commercial banks that operate in Albania), the following equation is derived:
where, NI (Net Income) represents the net result of banks (after taxes), NII stands for Net Interest Income, OE corresponds to the Operating Expenses, NNII represents the Net Non-Interest Income, NEI stands for the Net Extraordinary Income, LLP represents the Loan Loss Provisions and T stands for Taxes.

If we make a rearrangement of the equation (1) and express them as percentage against total assets (TA), there can be noticed the items that mostly impact the determination of Net Interest Margin (NIM), which here is calculated as net interest income to total assets.

\[
NIM = \frac{(OE - NII - NEI)}{TA} + \frac{LLP}{TA} + \frac{T}{TA} + \frac{NI}{TA}
\] (2)

The equation (2) clearly shows that upon to the accounting analysis, the net interest margin is impacted from operating expenses that are not covered from other incomes (non-interest incomes), the level of provisioning expenses that banks estimate for credit portfolio, the taxes paid to taxation authorities and the profit level they provide from operating in market.

II. THE THEORETICAL ANALYSIS OF FACTORS THAT IMPACT THE NET INTEREST MARGIN

The theoretical analysis of the determinant factors of net interest margin is another approach used, developed for the first time by Ho and Saunders (1981) and called the dealer model. According to these authors, banks are seen as risk-averse agents that accept deposits and make loans, which arrive randomly and where the probability of arrival depends on the margins banks fix and from the elasticity of the demand for credit/supply of deposits.

Ho and Saunders (1981) have argued in their study that the mark up that banks set out on the market interest rate for both deposits and credits depends on four factors: (I) bank’s risk aversion; (II) the structure of market where banks operate; (III) the average size of bank transactions and (IV) interest rates volatility. According to these authors, even if banks act in a market with high competition, the margins will continue to be positive.

Hence, it could be said that the interest margin (s) is calculated: \( s = r_l - r_D = a + b \), where \( r_D \) and \( r_l \) are the interest rates of deposits and credits that the bank sets out.

According to Ho and Saunders (1981)\(^1\), following a range of transformations of this basic equation, results that:

\[ s = r_l - r_D = \alpha/\beta + \frac{1}{2} \times \sigma^2_Q \]
where, $\alpha/\beta$ shows the risk neutral spread, or $\alpha$ and $\beta$ itself express respectively the intercept and the slope of symmetric function of the deposits and credits. Thus, this ratio measures somewhat the level of bank’s market power. The other part of the formula encompasses the elements of a risk premium. $R$ stands for the coefficient of risk aversion, $\sigma_i^2$ for the interest rates variance and $Q$ for the size of bank’s transactions.

III. RESULTS DERIVED FROM EMPIRICAL STUDIES ABOUT THE DETERMINANTS ON NET INTEREST MARGIN

There are carried out many empirical studies to identify the determinant factors of net interest margin, for groups of countries, as well as for specific economies; for individual banks or for aggregated data at systemic levels. Various results are derived from the performed studies (in some cases contradictory ones) regarding the relation of net interest margin with different factors that impact it. Some of the determinant factors of interest margin that have resulted from econometric analyses are as follows:

Capitalisation – Demirgüç-Kunt and Huizinga (1998), Saunders and Schumacher (2000), Afanasieff et al. (2002), Liebeg and Schwaiger (2006), have found a positive relationship between the net interest margin and banks capitalisation. But on the other hand, Brock and Franken (2002) have found a negative correlation among these variables, providing the explanation that the well capitalised banks tend to be more conservative in making loans (resulting in lower margins) as more shareholder equity is at risk. While less capitalised banks are more encouraged to take more risk (resulting in higher margins) to provide more profits.

Operating expenses – It is considered that the higher the operating costs, the higher the margins that banks set out to cover these costs. Even in the absence of market power and of any type of risk, banks need a positive margin to cover at least the operating costs. Liebeg and Schwaiger (2006), Estrada et.al (2006), Naceur (2003), Affanasief et al.(2002), Maudos and Fernández de Guevara (2004) have concluded in a positive relation between the interest margin and the operating expenses.

Market share of deposits and loans – Different studies have led to various results. If the relationship results a positive one, it means that a bank with a large market share of deposits, has more power thus it might impose higher margins. A negative coefficient shows efficiency on the use of the economies of scale, by transferring some of the profits to the bank customers, in the form of lower margins.

Credit risk – non-performing loans are a measure of credit risk. Hence, the higher the level of non-performing loans, the higher the credit risk and consequently the higher will be the interest margin as the bank seeks to cover the losses from these kinds of loans by passing the additional costs to its clients through higher interest rates for loans or lower rates for deposits, or a
combination of both. Maudos and Fernández de Guevara (2004), Brock and Franken (2002) and Demirgüç-Kunt and Huizinga (1998) have concluded to a positive relation of interest margins with the credit risk.

From the studies accomplished in some countries of Latin America has resulted a negative relation between two variables (Brock and Rojas-Suárez 2000). This may be explained by the decrease of loan interest rates or by the increase of deposit interest rates. The decrease of loan interest rates may be followed by banks that, notwithstanding the high level of non-performing loans, they risk their incomes by aiming the market share increase. On the other hand, deposit interest rates increase comes due to the increase of non-performing loans, at the industry level.

Non-interest incomes – usually have a negative impact on interest margins². Banks tend to lower the margins if they compensate the lower interest incomes by the higher commission or non-interest incomes. There are disclosed two types of relations between these variables in literature. In a high competitive banking market, where banks can not have a complete impact, commission incomes are expected to function as substitutes of interest incomes. In this case, the relation between net interest margin and net commission incomes will be a negative one. If banks enjoy a certain market power (due to specialisation in special products and services), they can influence the determination of the interest rate causing in this case the commission and interest incomes to be complementary of each other and the correlation to be a positive one (Estrada et al. 2006).

Management quality - Angbanzo (1997) and Maudos e Fernández de Guevara (2004) state that a qualitative management implies the selection of high quality assets (with low risk and high return) and low cost liabilities. As the management quality is measured from cost/income ratio, an increase of this ratio means a deterioration of management quality and thus a decrease of net interest margin.

Opportunity costs – As it is known, banks must deposit to the Bank of Albania, the mandatory reserve³. The opportunity cost of keeping reserves should be compensated by setting higher interest rates for loans. In their research, Estrada et al. (2006) and Gelos (2006) have found a positive coefficient for this variable.

GDP growth - Bernanke and Gertler (1989) have concluded that the solvency of borrowers is countercyclical. The relation should be a negative one, as during the recessions, the solvency decreases and thus, the borrowers can borrow only with higher interest rates, thus increasing the interest margin.

Considering the results derived from all the above mentioned authors on the relation of these factors with the net interest margin, it seems reasonable that some of these variables are encompassed in the equations that will be estimated for the case of the Albanian banking system. On the other hand, taking also into account the financial or macroeconomic conditions of Albania
and some particular characteristics in the banks’ behaviour of the Albanian banking system, also other variables will be added to adopt them with these circumstances.

IV. ECONOMETRICAL OUTCOMES DERIVING FROM THE ANALYSIS ON NET INTEREST MARGIN FOR THE ALBANIAN BANKING SYSTEM

Banking systems in economies that are in the process of liberalizing and reforming of their financial systems are not in a long-run equilibrium (Brock and Rojas-Suárez, 2000). For that reason, the interpretation of the results should be done attentively as these are not as straightforward as those for the industrialized economies.

IV.1 DATA AND SPECIFICATION OF THE MODEL

The dealer model of Ho and Saunders (1981) assesses the determinant factors of net interests’ margin by following two stages, but it requires long time series. Other authors (McShane and Sharpe 1985, Angbazo 1997 and Maudos e Fernández de Guevara 2004) have applied a single-stage model for the identification of the factors that impact net interest margin. As in the case of Albania the data belong to a short-term series, it is impossible to apply the first model. Thus, the equations will be estimated using the single-stage model applied by Maudos and Fernández de Guevara (2004). Differently from these authors, who have identified the factors that impact net interest margin for 5 countries of European Union, in my paper I have identified the determinant factors of net interest margin for the case of a single country, Albania. In this study, it is used the information mainly taken from the Bank of Albania, but also from other international institutions. The data are quarterly and for individual banks during the period March 2002-December 2007.

The dependent variable (net interest margin) in my work is being calculated in two forms: once as the ratio of net interest incomes to total assets and then as the ratio of net interest incomes to interest bearing assets.

For the banks of the Albanian banking system, the equations estimation will be done by employing the least squares method (OLS) in the Panel Data with fixed effects, enabling the identification of the individual effects of every bank.

Total number of observations used in the study amounts 273 and the data are unbalanced. The data are filtered according to two criteria: first, for new banks established during the analysed period, the data of the first year of the activity are removed, to avoid the effect of any non-normal value in the data. Second, related to the banks that have gone through structural changes during this period, the data for some quarters are eliminated.
Balance sheet items are calculated as average values between the beginning and end of the quarters, to smooth the fluctuations from one quarter to the other. Meanwhile for the items of profit and loss statement that are used in calculations, it is considered only the added value during the quarter in question.

In my model, there are used 8 explanatory variables that are thought to impact the net interest margin, considering the theoretical model or empirical studies of the same nature.

The equation to be estimated can be presented as follows:

$$NIM_i = \alpha + \beta_1 \cdot OE_i + \beta_2 \cdot RAV_i + \beta_3 \cdot CR_i + \beta_4 \cdot MQ_i + \beta_5 \cdot RES_i + \beta_6 \cdot COM_i + \beta_7 \cdot HHI_i + \beta_8 \cdot MR_i + \epsilon_i (3)$$

where:

- $i = 1, 2, \ldots, N$ is the $i$- bank;
- $t = 4, 5, \ldots, T$ corresponds to the quarter $t$;
- $\alpha, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7, \beta_8$ is a vector of parameters and $\alpha$ represents Fixed Effects.

NIM is the dependent variable (Net Interest Margin) respectively calculated, $NIM_1 = \text{Net interest incomes / total assets}$ and $NIM_2 = \text{Net interest incomes / Interest bearing assets}$; OE stands for Operating expenses to total assets; RAV represents the Risk aversion measured as the ratio of shareholder equity to total assets; CR expresses the credit risk measured from the non-performing loans ratio against total outstanding loans; MQ is the management quality expressed as the Operating expenses / Gross operating incomes ratio; RES represents the opportunity cost of reserves (Reserves with the Central Bank / Total assets); COM means other incomes measured by Net commission incomes / (Net interest incomes + Net other incomes); HHI is the concentration Herfindahl-Hirschman index in loan terms; and MR stands for the Market Risk measured in three ways: from the standard deviation of quarterly interests rates respectively for the treasury bills, euribor and libor.

IV.2 RESULTS FROM THE ANALYSIS OF NET INTEREST MARGIN FOR THE ALBANIAN BANKING SYSTEM

Table 1 provides the results of three equations that analyse the relation of the dependent variable $NIM_2$ with all the independent variables. The last variable (market risk) is expressed in three ways, respectively from the standard deviation of the treasury-bills (equation 4), Euribor (equation 5) and Libor interest rates (equation 6). This is the reason why three equations are presented for each form of NIM measurement, estimating six equations in total.

Comparing the results for both forms of NIM, it may be stated that there is a high similarity, as both forms of efficiency measurement do not change considerably in their value. Even if we compare the results for the equations
of the same dependent variable, it is noted they are similar and change only for the last variable (Market risk), as the latter is measured in different ways (while the other seven variables are measured at the same way in each of the three equations).

The adjusted $R^2$ results at satisfactory levels, showing that, approximately 70 per cent of fluctuations in net interest margin are explained by the fluctuation of independent variables included in the equation.

<table>
<thead>
<tr>
<th></th>
<th>Equation 4</th>
<th>The dependent variable ($NIM_2$)</th>
<th>Equation 5</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Coefficient</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coefficient</td>
<td>t-statistic</td>
<td>Coefficient</td>
<td>t-statistic</td>
<td>Coefficient</td>
<td>t-statistic</td>
<td></td>
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</tr>
<tr>
<td>C</td>
<td>0.0132</td>
<td>7.8390</td>
<td>0.0124</td>
<td>7.5501</td>
<td>0.0123</td>
<td>7.1842</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>OE</td>
<td>0.0897</td>
<td>2.6988</td>
<td>0.1021</td>
<td>3.1458</td>
<td>0.0928</td>
<td>2.7837</td>
<td></td>
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</tr>
<tr>
<td>RAV</td>
<td>-0.0111</td>
<td>-2.7569</td>
<td>-0.0095</td>
<td>-2.4379</td>
<td>-0.0099</td>
<td>-2.4671</td>
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<tr>
<td>CR(-4)</td>
<td>0.0017</td>
<td>2.2700</td>
<td>0.0111</td>
<td>2.4304</td>
<td>0.0122</td>
<td>2.5698</td>
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</tr>
<tr>
<td>MQ</td>
<td>-0.0010</td>
<td>-5.0650</td>
<td>-0.0011</td>
<td>-5.8513</td>
<td>-0.0011</td>
<td>-5.5008</td>
<td></td>
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<tr>
<td>RES(-2)</td>
<td>0.0366</td>
<td>2.0588</td>
<td>0.0376</td>
<td>2.1742</td>
<td>0.0368</td>
<td>2.0688</td>
<td></td>
<td></td>
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<tr>
<td>COM(-1)</td>
<td>0.0066</td>
<td>-3.8940</td>
<td>-0.0066</td>
<td>-3.9878</td>
<td>-0.0062</td>
<td>-3.6687</td>
<td></td>
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<tr>
<td>HHI</td>
<td>-0.0176</td>
<td>-2.1262</td>
<td>-0.0158</td>
<td>-2.0569</td>
<td>-0.0100</td>
<td>-1.2602</td>
<td></td>
<td></td>
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<tr>
<td>MR</td>
<td>0.1448</td>
<td>2.0981</td>
<td>0.9156</td>
<td>4.3777</td>
<td>0.1078</td>
<td>1.9221</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Adjusted $R^2$</td>
<td>0.6865</td>
<td>0.7038</td>
<td>0.6856</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>F-statistic</td>
<td>26.8978</td>
<td>29.0955</td>
<td>26.7924</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prob(F-statistic)</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

The coefficient of the operating expenses variable displays (as expected) a positive sign and is statistically significant. This means that the net interest margin increases when the operating expenses increase, to cover the additional cost. This result is consistent with the ones derived by the accounting analysis of net interest margin.

While a positive correlation between net interest margin and the level of bank capitalization was expected, for the banks that operate in the Albanian banking sector this correlation is negative. The explanation of this phenomenon is related to the fact that banks with higher capital levels (which are risk averse) are more cautious towards lending because more shareholder equity is at risk.

In the case of Albania, the margin reacts negatively to the increase of the nonperforming loans after one year. The results show that Albanian banks have aimed the market share increase during the time period taken into consideration, causing the high level of nonperforming loans to affect negatively the margins.

The correlation between net interest margins with the management quality for the banks that operate in Albania is negative and significant, as it was expected according to the results derived from similar studies. If the amount of operating expenses needed for generating one unit of income increases, it means that the management quality will deteriorate and the margins will decrease.
The net interest margin is positively related to the level of mandatory reserves settled in the Bank of Albania and this correlation is statistically significant. The banks tend to increase the margins for the purposes of compensating the omitted incomes deriving from the depositing of the mandatory reserves (remunerated with lower interest rates). In this view the results reveal that banks react nearly six months later in changing the margins, against the changes occurring in the reserve level.

In the case of the Albanian banking system, the coefficient of non interest incomes is negative and significant for all the three equations. This means that the banks that provide higher commission incomes, after one quarter will tend to lower the loan interest rates because they consider both sources of income as substitutes of each-other.

The correlation between the concentration level in loan terms with the net interest margin results significantly negative. According to theoretical and empirical results, a positive correlation was expected. What can be seen for the Albanian banking sector is that the Efficient Structure Hypothesis is confirmed. This means that the banks that operate in Albania make use of the higher level of concentration to be specialised towards different services or margin reduction.

The market risk is measured in three ways for the Albanian banking sector, because it is affected by the presence of foreign currency deposits and loans. From the first equation results that the net interest margin is positively correlated with the volatility of quarterly treasury bills interest rates. A weakly significant and positive correlation resulted with the standard deviation of libor rate too. But the strongest positive correlation was noticed in the equation where the euribor rate was included. For every 10 percentage points change in the volatility of euribor rate, a change of more than 9 percentage points in the net interest margin will be noticed. These results were expected as the major part of foreign currency loans are denominated in euro.

V. CONCLUSIONS

The data of individual banks that operate in the Albanian banking system were analysed in this study, through the period 2002-2007.

The results derived from the equations estimated, in some cases were consistent with what were expected and sometimes different from what was predicted. The net interest margin for banks that operate in Albania depends considerably on the interest rates volatility, of euribor, libor and treasury bills. Recently, the Albanian banking system is characterized by a rapid credit growth and by a large part of loans denominated in foreign currency (particularly in Euro), while on the other side of the balance-sheet the funds sources (deposits) are mainly denominated in the domestic currency.

The banks of the Albanian banking system tend to increase the intermediation margins while they go through higher operating expenses. Recently, the
banks have been more aggressive toward the enlargement with new branches throughout the territory or the country and this has lead to the increase of the operating expenses, resulting in an increase of interest margins.

Although the mandatory reserve rate has remained unchangeable during the analysed period, the increase in the volume of deposits itself (due also to the promotional offers of banks, particularly recently) has led to a raise of reserves volume placed with the Bank of Albania. The omitted incomes from the investment of these reserves in more profitable activities have made banks transfer a part of these costs to their clients.

Even though they still cover a small part of total incomes, the commission incomes, impact negatively the net interest margin. Albanian banks lower the interest incomes every time they provide higher commission incomes, because they consider these sources of incomes as substitutes of each other.

In the case of Albania the margin reacts negatively against the increase of non-performing loans degree (after four periods). Hence, the Albanian system banks over the considered period have paid more attention to the increase of loan market share, which is expressed as well in the recent aggressive promotional offers. During this period, the banks have increased the variety of loan products that offer, but have shortened the processing time, deriving from the increasing competition in loan market. When the competition becomes stronger and the nonperforming loans level has been low (although it is increasing), the banks have been more comfortable in setting the margins and not affecting them positively by the credit risk.

But the banks are more conservative when it comes to capital protection. Even though they have been more aggressive in increasing market share, they still have been cautious for the quality of loans made. The more capital they have added (as a result of supervisory requirements or activity augmentation according to the level of licence taken), the more careful have been in choosing their loan customers, which is also witnessed by the good loan quality.

The results derived from this study may serve to policymakers for orienting towards issues that are more related to net interest margin determinants. Greater attention must be paid to interest rates fluctuations, the mandatory reserves amount, bank capitalization, etc. This research paper aimed the identification of the factors that may affect more the net interest margin for the Albanian banking sector. Other possible directions where efforts may be directed in the future may be the incorporation of longer time series and other macroeconomic factors in the study.
LITERATURE

ENDNOTES

* Irini Kalluci, Research Department, Bank of Albania. The views expressed in this paper are exclusively those of the author and not necessarily those of the Bank of Albania. I thank Mr. Altin Tanku, Ms. Elona Dushku and Ms. Elsida Orhan for the opinions given during the preparation of this study.

1 For the way of deriving the equation, please refer to Ho and Saunders (1981).

2 Liebeg and Schwaiger have concluded a negative relation to the Austrian banking system.

3 The applied rate for the Albanian banking system is 10 per cent.

4 Later this model is used from Saunders and Schumacher (2000), Estrada et al. (2006), etc.

5 Various papers about the interest margins have been using one form of calculation or the other one, but the reason why I have encompassed as well the second form of calculation in this study, relates to the frequent use of this form in the analysis for the Albanian banking system.

6 The method of least squares is used by the majority of authors that have studied the determinants of net interest margin.

7 The number of banks encompassed in this research paper varies from 12 banks in 2002 to 17 banks in 2007.

8 Mainly denominated in Euro and Usd.
NET INTERNATIONAL RESERVES IN ALBANIA: LEVEL AND MEASUREMENT COMPARATIVE ANALYSIS WITH THE REGIONAL COUNTRIES*

The monetary authority is entitled to hold the international reserves of a country, which include the reserves in gold, cash-register of coins and banknotes in foreign currency, deposits held in foreign banks, various types of securities and foreign currency position at the IMF. Reserves’ holding mainly aims at withstanding any sudden events caused by liquidity constraints in the international markets. The other face of the coin is the opportunity cost of holding reserves instead of using them as a different form of investment. The level and adequacy of reserves have continuously been a matter of concern and debates among analysts and researchers. Quite often, various countries have been blamed for holding reserves at high levels. Though, in a globalizing world, the high level of reserves are often motivated as an insurance against high capital mobility.

The strategy of the Bank of Albania in managing international reserves has foreseen a continuous growth of reserves in accordance with the continuous growth of external trade activity and financial system expansion. The operational framework of reserve management pursued by the Bank of Albania has been subject to certain agreements of the Albanian Government with IMF such as PRGF/EFF in the recent years. In the light of these agreements, the monetary authority has been holding a minimum level of international reserves equal to at least three months of imports. As the agreement with the IMF came to an end in January 2009, international reserves will continuously be subject to close monitoring by the Bank of Albania.

The estimation of the optimal level of international reserves depends on a range of factors, which vary accordingly with economic growth as well as the level of the country’s progress. Albania is a country characterized by a small, open and developing economy, which is further detailed below.

Firstly, the Albanian economy is typically characterized by a high and growing current account deficit as a result of further deepening of trade deficit. The amount of total imported goods exceeds some fold the amount of exported goods, while the residuals in the balance of income and current transfers’ account are not sufficient to fully finance the trade deficit.

Thus, a country overall should provide enough liquidity to support several months of imports even without any other foreign currency inflows. An import-based benchmark of reserves is a criterion usually recommended in cases when countries are concerned about their current account deficit, which

![Chart 1 Trade balance and current account as a share of GDP (on quarterly basis)](chart1.png)
might become a source of instability for the economy. Holding a minimum level of foreign currency reserves in sufficient level to cover several months of imports serves as a guarantee that the country will be able to support the immediate demand for consumption in case of limited or no access to international financial resources. In addition, import-based criteria have been also used to assess developing countries, which face difficulties in coping with external shocks or foreign exchange shocks. The import-based benchmark that is frequently used by the IMF is usually the support with reserves of at least three to six months of imports (Movchan 2002).

Secondly, the Albanian economy has recorded a fast growth of short-term foreign debt in the recent years. Debt-based criteria monitor those risks arising from an “external drain”, that is a contraction of external financial resources. The growing use of international financial markets on one hand and the limitations of various countries ability to borrow on the other, have stimulated the need of monitoring the level of reserves against short-term debt. The observation of this criterion is important to address the fast growth of short-term foreign debt (debt with up to one year maturity) as well as confirming economy’s payback capacity even in situations of financial crisis. In general, this indicator includes all sorts of debt like loans, securities, business loans and other types of borrowing.

According to researchers Greenspan and Guidotti, the critical value of reserves to short-term foreign debt by remaining maturity ratio is equal to one. The rationale behind it suggests that a country should be able to pay its short-term (up to one year) due obligations. Hence, a country should have an adequate level of reserves to support short-term liabilities – especially when they are growing – even in cases when other foreign currency inflows and outflows cease.

Finally, in the last three-four years, it has been noticed a considerable shift of broad money towards its foreign currency component. The long-term weight of foreign currency deposits in monetary aggregate M3 has been growing. This ratio has moved from 31.3 percent on average in year 2007 to above 34 percent in 2008.

Highly euroised/dollarised broad money could become threatening for the well functioning of the financial system or money markets. Foreign debt based indicator of reserves monitors those risk factors originating from an “external
drain”, while money based indicator monitor those risks coming from an “internal drain”, thus an internal capital flight by residents. In the cases when foreign currency deposits weigh considerably as a share of GDP, a sudden withdrawal of foreign currency deposits would create foreign currency liquidity problems for the financial system. Thus, in the light of partial euroisation of the economy, it is required that reserves be monitored in terms of monetary aggregates as well. Money-based indicators can provide a better assessment of the euroisation process in the past as well its future developments.

According to researchers Wijnholds and Kapteyn, the share of broad money covered by reserves should be between 5 and 20 percent depending on the exchange rate regime. Hence, foreign currency reserves should cover 10 to 20 percent of broad money in case a country has adopted a fixed or managed exchange rate regime and 5 to 10 percent in case of floating exchange rate regime. As the share of reserves to broad money increases, the probability of foreign currency afflicted crisis is reduced (Movchan, 2002).

Holding reserves in terms of the aforementioned indicators promotes better understanding of potential risk factors that might impede macroeconomic stability of the Albanian economy. Such indicators that characterize a small open economy in terms of balance of payments, with a highly dollarized financial system as in the case of Albania, render it suitable to draw on one or several conventional benchmarks for foreign currency reserves. In order to identify an optimal level of reserve holdings, conventional criteria such as import-based, short-term foreign debt based, money-based criteria or a combination of them should be used.

COMPARATIVE ANALYSIS WITH REGIONAL COUNTRIES

The recent global financial crisis has once more drawn attention to the debate on the adequacy of foreign currency reserves. Several countries have been more exposed to risks such as further deepening of trade deficit, contraction of external financial resources or confidence crisis of the banking system followed by sudden withdrawal of deposits. In the light of these developments, cost related issues of holding reserves are less concerning towards the need to maintain reserves at high levels in order to withstand situations of emergency.

Reserve adequacy indicators of Central East European (CEE) countries confirm an overall reduction in the reserve level since 2002 (table 1). Nonetheless, indicators of countries such as Serbia, Bulgaria, Croatia and Romania confirm to be above the average level of the CEE countries group. Overall, Serbia has the highest level of reserves as a share of most of the indicators, while Slovenia stands on the opposite side with the lowest level. Most of the countries have met the traditional minimum criteria of reserves as they cover more than three months of imports (25 percent of the annual imports worth). In general, CEE countries seem to have spent part of their foreign currency reserves in 2008, except Hungary and Czech Republic. Hungary’s reserves increased considerably by almost 10 billion US dollars
(as a result of an IMF loan disbursement), while Czech Republic reserves increased by 2 billion USD.

As of 2008, import coverage of reserves for Albania is above the average of CEE countries. At the end of the year, foreign currency reserve level can cover the value of around four months of imports of goods and services. Despite a slight reduction as compared to 2002, debt-based adequacy benchmark has been also met, and seems to be at satisfactory levels as compared with the region countries. Reserve adequacy criterion as a share of GDP has fallen down to 15.4 percent in 2008 from 16.3 percent in 2002, almost 2 percentage points below the average rate of CEE countries. Albanian foreign currency reserves as a share of broad money stand above the conventional benchmark of 20 percent. However, as compared to the rest of the CEE countries, this indicator stands below the average. As such, maintaining an adequate level of reserves will continue to be in the focus of monetary policies of the Bank of Albania, even in absence of formal agreements with the IMF.

<table>
<thead>
<tr>
<th>Table 1 Foreign exchange reserves and measures of adequacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange reserves</td>
</tr>
<tr>
<td>As a percentage of:</td>
</tr>
<tr>
<td>GDP</td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td>Albania</td>
</tr>
<tr>
<td>Czech Republic</td>
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<tr>
<td>Hungary</td>
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<td>Poland</td>
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<td>Slovakia</td>
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<td>Slovenia</td>
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<td>Estonia</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Bulgaria</td>
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<td>Croatia</td>
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<tr>
<td>Romania</td>
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<tr>
<td>Turkey</td>
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<tr>
<td>Bosnia-Herzegovina</td>
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<tr>
<td>Macedonia</td>
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<tr>
<td>Serbia</td>
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<tr>
<td>Average</td>
</tr>
</tbody>
</table>

1 Short-term external debt as defined by Bank of International Settlements (BIS) with a maturity up to and including one year. 2 From end-2007. 3 Simple average of the above, excluding Albania in 2002.

Sources: IMF; national data; BIS

CONCLUSION

Given the features of Albanian economy, the application of reserve adequacy criteria based on conventional benchmarks is useful in the case of Albania. Adequacy benchmark of reserves covering 3-4 months of imports, covering one or up to one year of short-term foreign debt or 5-20 percent of broad money are required to forerun potential risk factors that might impinge on Albanian economy. Despite being widely used, conventional criteria are highly credible and provide good basis for comparison between different countries.
ENDNOTES

* Oltar Manjani, Monetary Policy Department.
1 International Monetary Fund.
2 Poverty Reduction and Growth Facility/Extended Fund Facility.
As a follow-up to its tradition and in order to maintain an ongoing dialogue with the media, the Bank of Albania organized in October 2008 to February 2009 the fifth round of training seminars for journalists covering economy-related issues in the print and electronic media. The Bank of Albania considers the media as an important partner that transmits its policies and decisions to the market players and to the public at large. Accordingly, these training seminars help to inform the public accurately and at the same time enhance the monetary policy transmission mechanism efficiency in economy.

At the focus of this training seminar were general topics related to the Bank of Albania activity and other specific issues of interest to the media concerning the recent developments in the world and in the Albanian economy. These training seminars are held at the Bank of Albania premises and they are in the form of lectures combined with conversations between the journalists and the central bank experts.

On 2 February, the Governor of the Bank of Albania, Ardian Fullani, held in a special session of this training seminar the lecture ‘Global Financial Crisis’. At the end of the fifth training seminar round, the Governor distributed certificates to the participant journalists and thanked them for the interest and the attention paid to the entire training seminar and for their good work in providing accurate and correct information and news to the public at large.

Training Seminar Schedule for journalists covering economy-related issues in the print and electronic media, October 2008 – February 2009

<table>
<thead>
<tr>
<th>No.</th>
<th>Topic</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>The banking system: Banking supervision and transparency Credit Registry – Figures and facts</td>
<td>14 November 2008</td>
</tr>
<tr>
<td>4.</td>
<td>The central bank – primary objective: Maintaining price stability Monetary policy: From economic analysis to the decision-making The exchange rate and its regimes; The exchange rate regime in Albania</td>
<td>26 December 2008</td>
</tr>
<tr>
<td>5.</td>
<td>Monetary Policy Reports</td>
<td>10 February 2009</td>
</tr>
<tr>
<td>6.</td>
<td>Consumer and Business Confidence Indices</td>
<td>27 February 2009</td>
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</table>
On February 5, 2009, the Governor of the Bank of Albania, Ardian Fullani, met at the Bank of Albania premises with representatives of foreign exchange bureaus. At the focus of this meeting were the latest trends and developments in the Albanian economy and other topics related to the better functioning of the financial market.

In an outline of the swift economic and financial developments at home, the Governor underscored the role of this segment in increasing the financial intermediation and moving the free funds to meeting the financial needs of the economy. The Bank of Albania has been constantly ranking the foreign exchange market as the most developed market, attesting to the free market initiative and the existence of a more competitive environment in it. Notwithstanding the increased share of the interbank market and the ever-increasing role the commercial banks play in generating the liquidity and determining the price in this market, the Bank of Albania continues to consider the role of foreign exchange bureaus as crucial in enhancing efficiency in the functioning of the foreign exchange market.

It is for many years now that the foreign exchange activity has been transferred from informal to formal channels. The number of entities conducting foreign exchange activity has increased ten-fold since the year 2000. The Bank of Albania has issued 227 operation licences for foreign exchange bureaus which have extended throughout Albania. Only during June 2007 to December 2008, when the Bank of Albania adopted a number of more liberal rules in particular in terms of minimum required capital, 16 foreign exchange bureaus have applied for and were licensed to operate in the foreign exchange market.

“Education is expensive but priceless”! This is the latest finding of the Bank of Albania in the framework of the economic and financial education of the public. Considering the role of professors in the transfer of knowledge to the students as very important and given the fact that the high school students will soon become active players in the Albanian economy and as such they need to be prepared, Ardian Fullani, Governor of the Bank of Albania, visited a number of high schools across Albania.

On 9 February 2009, Ardian Fullani, Governor of the Bank of Albania, met with students and professors of Petro Nini Luarasi High School in Tirana. On 12 February, the Governor visited Raqi Qirinxhi High School in Korça and Fuat Babani High School in Bilisht. Partizani High School in Tirana was another school to welcome the Governor on 9 March.

As shown by the slogan, discussions with the students focused primarily on the importance of economic and financial education to the new generation, the concrete role of financial literacy to everyone’s life and to the role of schools and professors in establishing the knowledge in this area. Other topics of discussion were the present situation in the Albanian economy and the crisis in the global markets; the necessity to reduce cash in economy and
the use of electronic payments; the principles and rules of banking system transparency; the usefulness of savings; the various financial institutions and their products.

A day before the regional meeting in Korça district, the Governor had a meeting at the National Commercial Bank branch of Elbasan and ProCredit Bank branch of Pogradec, where he discussed with various stakeholders, students, business people, commercial bank employees etc.

The Governor noted that the latest international developments call for an objective assessment of the overall economic and financial situation at home. Assuring the participants that the Albanian economy operates in optimal conditions and that the banking system in lucrative, capitalized and liquid, the Governor underscored that these meetings aim at ensuring better communication with the public in order to make them aware of the Bank of Albania role in consolidating the macroeconomic and financial balances further. These meetings also help to collect ideas, assessments and opinions on the public expectations for the economy and the performance of the financial system, hence becoming part of the dialogue in finding the ways and the optimal options for minimizing the negative effects the global economy transmits. The meeting next continued with open discussions between the Governor and the participants on present economic and financial matters.

As a follow-up to the other similar meetings organized in Gjirokastra, Shkodra, Saranda and Kukës, the Bank of Albania organized a regional meeting in the Korça district on 12 February 2009. The purpose of these meetings is to come into contact with the economic and financial development of the region and to identify the banking system’s role in supporting this development. They also help to educate the public on the role of the Bank of Albania, the economy and finance in general.

The open forum with representatives of the local government, banking and financial institutions, business representatives and academics of the Economic Faculty of Fan Noli University was the central part of the Governor’s visit to Korça. In his speech, the Governor dwelled on the recent economic and financial situation at home and the Bank of Albania endeavours to minimize the negative effects yielded by the global crisis. Among others, the Governor noted that although the world economy is facing the deepest downturn since World War II, the Albanian banking system remains lucrative, capitalized and liquid hence making the Albanian economy operate under optimal conditions. Going over the main highlights in the global economy, the Governor noted that the economic activity at home and the banking system in particular has been dynamic and effective in channelling savings in economy into the financing of production or household consumption. The meeting next proceeded with free discussions with stakeholders who presented their concerns and perspectives on the current economic and financial situation. On behalf of the Bank of Albania, the Governor expressed the Bank of Albania commitment to
monitoring cautiously all the economic and financial developments at home and its willingness to take the proper actions.

During his visit to Korça, the Governor met with the Mayor Niko Peleshi and with other stakeholders. The Governor noted that Korça represents an important and potential region for the economic development at home. The meeting next proceeded with the speeches delivered by the Mayor of Korça and the Chairman of the Chamber of Commerce, Ilir Selenica, who discussed projects and the potentials this region provides to the economic development in Albania.

As a follow-up to the dialogue initiated by the Bank of Albania with all the economic stakeholders and given the recent developments at home and in the global markets, the Governor of the Bank of Albania, Ardian Fullani, held on 23 February 2009 a meeting with representatives of the Albanian exporting companies and the Albanian Association of Banks at the Bank of Albania premises. The purpose of this meeting was also to encourage partnership between the banking and business community.

This meeting aimed to promote a constructive debate among the participants on the perspectives of multilateral development and the banking intermediation role in these developments, in order to converge the interests of all economic stakeholders. After discussing the most recent developments in the global and the Albanian economy, Governor Fullani called for more support from the representatives of the Albanian Association of Banks to the exporting industry, which has provided considerable contribution to a sustainable economic growth at home. The Governor required from the banking system to assess more prudentially the role and potentials of the exporting industry, provide more advice and financial consultancy, review the banking policies on commissions and give priority to a larger funding to this industry. The Albanian Association of Banks, on behalf of the banking system, expressed its willingness to provide more support to this strategic sector.

Under the framework of the economic and financial educational programme ‘Central Bank in Everyday Life’, the Bank of Albania organized in February to March 2009 a number of training seminars for high school professors teaching Applied Economics in Korça, Tirana, Shkodra and Gjirokastra.

While being previously held in Tirana and Vlora, these training seminars involved for the first time the high school professors of Korça on 10-13 February and of Gjirokastra on 24-27 March 2009. These training seminars have been organized by the Bank of Albania in co-operation with the respective Regional Educational Directories of these cities and they were attentively attended by around 60 professors teaching Applied Economics in public and private high schools in these regions. The participant professors were given the opportunity to be presented with the central bank functions, its role in economy and how it impacts our everyday life. Other topics of interest included the economy,
finance and commercial banking. In addition to providing the professors with the opportunity to discuss with central bank experts various issues and unclear aspects encountered during the teaching process, these training seminars also served as a preparatory step to the competition ‘The Real Value of Money’.

On 23-27 February 2009, 33 professors teaching Applied Economics in public and private high schools in Tirana attended the third round of the training seminar ‘The Central Bank in Everyday Life’. The topics addressed in this round were quite different from the previous two rounds. They mainly related to the main functions of the Bank of Albania and to some important topics the Applied Economics schoolbook also addresses.

Upon the invitation of the Governor of the Bank of Albania, Ardian Fullani, the Governor of the Central Bank of Luxembourg, Yves Mersch, paid an official visit to the Bank of Albania on 26 March 2009. This meeting took place in the framework of increasing and deepening the co-operation in the economic and banking area between the two countries. Consequently, the macroeconomic developments occurring at a national and global level were at the focus of this visit.

Governor Fullani introduced Mr. Mersch to the endeavours of the Bank of Albania to safeguarding financial stability at home and to the measures taken by the central bank to prevent the spreading of the global financial crisis to Albania. These measures have been guided by the philosophy of orienting the banking system towards the conduct of sound financial operations. On his behalf, Mr. Mersch assessed the work of the Bank of Albania, which with prudent policies has contributed to safeguarding financial stability in Albania, hence creating the proper grounds for ensuring a sustainable economic growth. The further deepening of the institutional co-operation in the area of monetary policy, monetary operations, financial stability and public communication were other important topics of discussion between the two governors. At the conclusion of the meeting, Governor Mersch held a lecture entitled ‘The Origin of the Crisis and the Role of Central Banks’.

The Governor of the Bank of Albania, Ardian Fullani, held on 27 March 2009 a lecture at the premises of Our Lady of Good Counsel University entitled ‘The Albanian Economy Facing the Present Challenges’. This lecture was delivered in the framework of the Conference ‘The Global Financial Crisis and Future Developments’ organized by Our Lady of Good Counsel University and Bologna University. The lecture was attended by the Italian Ambassador in Tirana, His Excellency Mr. Saba D’Elia, professors, media representatives, students, directors and specialists of the Bank of Albania.

In his lecture, Governor Fullani provided an outline of the main highlights in the Albanian economy, placing an emphasis on the contribution of the Bank of Albania to ensuring macroeconomic and financial stability. The Governor introduced the participants to the measures taken by the Bank of Albania and
its perspectives on near and more distant future. In conclusion, Mr. Fullani noted that the Albanian banking system is presented sound and capable to accomplish its mission.

**Friday Seminar**

Friday Seminar has now become a tradition for the Bank of Albania. It is now for two years that the Research Department at the central bank holds it every two Fridays. The main purpose of this seminar is to present and discuss theoretical and empirical research work having at its main focus the case of Albania and the application of the most recent research methods.

The first paper, presented in January by Irini Kalluci (Research Department, Bank of Albania), was entitled ‘Determinants of Net Interest Margin in the Albanian Banking System’. This paper analyses the net interest margin as a measure of efficiency for the banks operating in the Albanian banking system and the main focus is the identification of the factors that may affect this indicator. According to the estimations made for the Albanian banking system, the results show that the net interest margin is positively affected by the interest rate volatility (mainly of EURIBOR, domestic currency’s and slightly of the LIBOR rate), by the level of operating expenses which have had an increasing tendency and by the amount of banks’ reserves in the Central Bank.

February was opened with the paper of Holger Kächelein, Drini Imami and Endrit Lami entitled ‘A New View into Political Business Cycles: Household Expenditures in Albania’. Political business cycles relate to the use of fiscal and monetary instruments to stimulate economic growth before elections to impress the voters. Following other researches for political business cycles in Albania, in which there was found clear evidence of fiscal expansion before elections, the authors analyze the public expectations related to election outcomes and the way these expectations affect their spending decisions and consequently the macroeconomic variables.

The other paper was entitled ‘DEVINPRO – Consortium Members with key-findings and headline figures related to the quantitative surveys of migrants and migrants’ households’ and it was prepared by Nicolaas de Zwager, NEXUS and Dr. Ilir Gëdeshi, CESS. The survey consisted in 4500 field interviewing carried out between mid-December 2008 and early 2009 in Albania and Kosovo. The purpose of this survey was to identify the migrants and the people benefiting from remittances as a special market segment. The analysis showed that the contribution of migration-related financial initiatives may be further developed if savings and investments are encouraged and that they could support Albania’s economic development better.

The second paper for the month of February was presented by Elona Dushku (Research Department, Bank of Albania) and it was entitled ‘Financial Development and Economic Growth. The Albanian Case’. The main purpose of this paper is to examine the causality relations between financial development and economic growth for the Albanian economy using the Granger causality test for five different indicators of financial development based on data.
covering the 1996-2007 period. The empirical findings of the study showed that there is a positive relation between all indicators measuring the financial development and economic growth in the long term. While in the short term this relation is quite vague since different indicators provide different results.

Altin Tanku and Risan Shllaku (Research Department, Bank of Albania) presented in March the paper entitled ‘Feasibility of Inflation Targeting in the Case of Albania’. Given that theoretical considerations over the characteristics and regime preconditions have been covered by previous works of the Bank of Albania, the authors try to address this issue based on the empirical investigation of the monetary policy transmission. The main purpose is to identify the optimal intermediate target for the monetary policy set-up of the Bank of Albania.

The last paper for this quarter was presented by Ilir Vika (Research Department, Bank of Albania) entitled ‘Assessing Motives Behind Bank of Albania’s Purchase Interventions in the Foreign Exchange Market’. In countries with floating exchange rates, central banks generally intervene to reduce high market volatility or put a stop to exchange rate overshooting, but not to influence the exchange rate trend. Using a Probit model, the study tries to figure out what has prompted the Bank of Albania’s interventions during the 2000-2007 period. The final aim of the study is to assess whether the central bank’s interventions have been effective in stabilizing the exchange rate by reducing undesired market volatility and smoothening or returning it towards an underlying direction.
LEGAL EVENTS OVER JANUARY-MARCH 2009

MONETARY OPERATIONS

On 14 January 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 2 some amendments to the Decision No. 46, dated 17 May 2008 ‘On the approval of the remuneration rate on required reserve’. The amendment to paragraph 4 of the Decision No. 46 establishes the mid-interval point as the reference interest rate for the remuneration of the required reserve in the cases when the key interest rates of the central banks as specified in paragraphs 1, 2 and 3 are established as an interval.

MONETARY POLICY

On 28 January 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 3 ‘The monetary policy statement for the second half of 2008’. According to this Statement, economic activity performed generally in line with the early year projections both in terms of economic growth and maintenance of macroeconomic balances, despite its slight slowdown in the last quarter. Annual inflation rate for the second half of 2008 was close to the Bank of Albania target, 3.0 percent and 2.5 percent in the last two quarters, respectively. Unemployment rate marked 12.62 percent, down by 1.5 percent in annual terms, owing mainly to the increase in the average number of employed persons in the private non-agricultural sector.

On 28 January 2009, the Supervisory Council of the Bank of Albania approved the Decision No. 4 ‘On the decrease of the interest rate on repurchase and reverse repurchase agreements’. By cutting the key interest rate by 50 basis points to 5.75, the Bank of Albania aims to facilitate lending to economy and minimize the negative effects of the international financial crisis, hence supporting the economic activity at home.

BANKING SUPERVISION

On 11 February 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 5 the Regulation ‘On consumer loan and mortgage loan to households’. The purpose of this Regulation is to set out the requirements on the contents and the way of providing pre-contractual and contractual information as well as to regulate the consumer loan. This Regulation aims to protect the borrowers’ interests through the provision of transparency and necessary information related to the loan contract and its execution.
On 11 February 2009, the Supervisory Council of the Bank of Albania approved the Decision No. 6 ‘On harmonizing the documentation on the banking and financial activity of banks operating in the Republic of Albania with the requirements of the Law No. 9662, dated 18 December 2006 ‘On Banks in the Republic of Albania’. The purpose of this Decision is to harmonize the documentation specifying the activity of banks conducting banking operations in the territory of the Republic of Albania with the requirements of the Law No. 9662 and to update the existing annexes on licences. This Decision authorizes the Governor of the Bank of Albania to sign the updated licences of banks and branches of foreign banks.

On 11 February 2009, the Supervisory Council of the Bank of Albania approved the Decision No. 7 ‘On granting preliminary approval for the capital reduction of Italian Bank of Development’. Upon this Decision, the Supervisory Council of the Bank of Albania grants preliminary approval for the capital reduction of Italian Bank of Development in the amount of ALL 106,000,000, through the annulment of 1,060 shares without voting rights, at a nominal value of ALL 100,000 per share.

On 25 February 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 11 the Regulation ‘On the licensing and activity of non-bank financial entities’. The purpose of this Regulation is to set out the conditions, requirements, deadlines, documentation and procedures to be followed for the licensing and conduct of activity of non-bank entities and micro-credit institutions within the territory of the Republic of Albania.

On 25 February 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 12 the Document ‘The licensing policy of bank entities’. The purpose of this Document is to promote the entry into market of sound and stable bank entities which support Albania’s economic development and provide qualitative banking products and services to the Albanian public. This Document sets out the principles guiding the licensing process and the priorities this process should be oriented to.

On 11 March 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 14 the Regulation ‘On the licensing and activity of banks and branches of foreign banks in the Republic of Albania’. This Regulation applies to all persons applying to be licensed to conduct banking and financial activity in the Republic of Albania and to banks and branches of foreign banks. This Regulation sets out the conditions and requirements to be met by the entities to be licensed for conducting additional activity, opening branches, subsidiaries or representative offices within and outside the Albanian territory, changing the qualifying holding etc. This Regulation also provides for the various reorganization forms (merger and separation) of a bank.

On 25 March 2009, the Supervisory Council of the Bank of Albania approved the Decision No. 28 ‘On the suspension of the profit allocation from banks and branches of foreign banks’. Upon this Decision, the Supervisory
Council of the Bank of Albania suspends the allocation of retained profit from previous periods, 2008 profit and 2009 profit from banks or branches of foreign banks for an indefinite period of time.

FINANCIAL STABILITY

On 25 March 2009, the Supervisory Council of the Bank of Albania approved upon Decision No. 24 the Statement ‘On the financial system stability in Albania for the second half of 2008”. The Statement notes that despite the increasing impact of the global economy contraction in the last quarter the Albanian economic activity during the year 2008 performed generally in line with the early-year projections in terms of economic growth and preservation of macroeconomic balances. The banking sector remained well-capitalized and liquid over this period. The annual growth rate of the banking sector’s assets was lower than in the previous year owing to the unstable growth of deposits. The Albanian Lek exchange rate has by and large been stable over this period.

ECONOMIC POLICY

On 7 January 2009, the Council of Ministers approved the Decision No. 5 ‘On some amendments to Decision No. 96, dated 3 February 2008 of the Council of Ministers ‘On establishing the assets covering the technical and mathematical provisions and the maximal allowed limits of their investment by insurance companies”. Upon this Decision, the allowed percentage changes from 20 percent to 0 percent of the investment of gross technical and mathematical provisions in lands and buildings as specified in letter b of paragraph 4.

On 14 January 2009, the Council of Ministers approved the Decision No. 21 ‘On the approval of the macroeconomic framework and fiscal indicators for the 2010-2012 period’. This Document is part of the Integrated Planning System and its purpose is to provide information on strategic priorities, aggregate expenditures and targets related to revenues and deficit. The first part provides an assessment of the economic and fiscal performance over the year 2008, while the second part provides projections on the main macroeconomic indicators, the resources available to the Government and their allocation over the 2010-2012 period.

On 22 January 2009, the Parliament of the Republic of Albania approved upon Law No. 10055 the ratification of ‘The loan agreement between the Council of Ministers of the Republic of Albania and the Islamic Development Bank for the participation in the financing of the water supply and sanitation services project in Orikum’. The Islamic Development Bank will extend a loan of USD 1.51 million. The purpose of this project is to provide an uninterrupted supply of drinking water for Orikum residents and improve the environmental conditions through the establishment of a water supply and
The sewerage network in the project area. The principal amount will be paid in 25 years, including a grace period of 7 years starting from the day this agreement is signed, with consecutive semi-annual instalments.

On 27 January 2009, the Council of Ministers approved the Decision No. 81 ‘On declaring the economic area in Lezha and establishing the contracting authority in order to give the status of area developer’. Upon this Decision, the territory of the cadastral area No. 2660 in Lezha is declared an economic area and holds the status of ‘Industrial Park’ for a period of 35 years. Production, industrial and agro-processing activities and other commercial, import and export and services activities will be developed in this area.

On 29 January 2009, the Parliament of the Republic of Albania approved upon Law No. 10064 the ratification of ‘The agreement between the Council of Ministers of the Republic of Albania, represented by the Ministry of Finance, and the Bank of Greece’. According to this agreement, the Council of Ministers of the Republic of Albania, represented by the Ministry of Finance of the Republic of Albania, and the Bank of Greece agree to pay the debt arising from the Agreement between the Bank of Greece and the Albanian State Bank dated 19 November 1987. As of 30 April 2008, the total debt of the Albanian party to the Bank of Greece amounts to USD 7,574,550.97 and it is projected to be paid within the next five years.

On 29 January 2009, the Ministry of Economy, Trade and Energy approved upon Decision No. 69 the Instruction ‘On the liquidation procedures of state-owned companies’. This instruction sets out the conditions and procedures of announcing the company into liquidation, the operations to be carried out for the liquidation and the way of allocating the revenues from the sale of assets, lease revenues or other.

On 5 February 2009, the Ministry of Finance approved the Instruction No. 12 ‘On the reporting methods and procedures of reporting entities under the Law No. 9917, dated 19 May 2008 ‘On the prevention of money laundering and terrorism financing’. The purpose of this instruction is to prevent the use of reporting entities for money laundering and terrorism financing purposes by meeting the reporting requirements of financial transactions or dubious activities to ‘the responsible authority’.

On 5 February 2009, the Parliament of the Republic of Albania approved upon Law No. 10069 the ratification of ‘The framework agreement between the Council of Ministers of the Republic of Albania and the Government of the Republic of Italy on development cooperation’. The framework cooperation agreement sets out the terms and conditions through which the Italian Government, via the Italian Cooperation and other entities financed by this office, commits to assist the Albanian Government. The parties commit to promote joint development cooperation programs and projects. This agreement will be applied in all supporting activities provided by the Italian Cooperation through the adoption of financial instruments, namely donations, assistance loans or conditioned loans in the case of joint ventures.
On 11 February 2009, the Council of Ministers approved the Decision No. 145 ‘On the transferring of the state-owned stake of 16,7683661% shares in ‘Albtelecom’ sha Tirana through auction’. This transfer will be realized by the assistance of the international consulting company. The expenses of the execution of the selection procedures of the consultant, for the services that the consultant will perform, as well as other necessary expenses to realize the transfer of stake will be covered by the Ministry of Economy, Trade and Energy and will be reimbursed from the income realized from the sale of the stake of state shares.

On 12 February 2009, the Parliament of the Republic of Albania approved upon Law No. 10074 the ratification of ‘The agreement on military grant between the Council of Ministers of the Republic of Albania and the Government of the Republic of Turkey’. The purpose of this agreement is to strengthen the military cooperation between the two countries and to provide the contribution of the Republic of Turkey to the restructuring of the Armed Forces of the Republic of Albania. To this purpose, the Government of the Republic of Turkey will extend to the Council of Ministers of the Republic of Albania a grant of 969 000 Turkish Lira (equivalent to U.S. dollars). According to this agreement, 897 750 Turkish Lira (equivalent to U.S. dollars) from the grant will be provided through materials and services and the rest through monetary values.

On 16 February 2009, the Parliament of the Republic of Albania approved upon Law No. 10077 the adherence of the Republic of Albania to the Convention on temporary admission, concluded in Istanbul on 26 June 1990. This convention combines within one international instrument all existing conventions on temporary admission and provides simplified and harmonized procedures for economic, humanitarian, cultural, social and tourist objectives for temporary importation of goods (including means of transport) specified in the Annexes to this Convention.

On 23 February 2009, the Parliament of the Republic of Albania ratified upon Law No. 10079 ‘The financing agreement between the Republic of Albania and the International Fund for Agricultural Development for the financing of the Mountain to Markets Programme’. This is a package of poverty-reduction measures based on participatory and systematic identification of investment opportunities in poor mountain areas. The programme will improve opportunities for poor rural people in the northern part of Albania and will increase investment in small-scale, commercially justifiable rural infrastructure. The programme will work to improve access to markets, technical know-how and finance for poor rural people. To financially assist this programme, the International Fund for Agricultural Development will extend to the Republic of Albania a loan of SDR 5.86 million and a grant of SDR 0.26 million.

On 23 February 2009, the Parliament of the Republic of Albania approved upon Law No. 10080 the ratification of ‘The loan agreement between the Republic of Albania, represented by the Ministry of Finance, the Albanian Development Fund and the KfW, Frankfurt am Main, for the financing of the
second phase of ‘The rural water supply programme’. The loan extended by the KfW amounts to EUR 1.5 million and it will be used for the rehabilitation and reconstruction of the rural water supply systems and if applicable of the sewer systems.

BANK OF ALBANIA MANAGEMENT, 31 MARCH 2009

SUPervisory Council

ARDIAN FULLANI  Chairman
FATOS IBRAHIMI  Vice Chairman
TEFTA CUÇI    Member
LIMOS MALAJ    Member
KSENOFON KRIŞAFI  Member
ADRIAN CIVICI  Member
ARJAN KADAREJA  Member
HALIT XHABA    Member
BENET BECI     Member

GOVERNOR

ARDIAN FULLANI

GOVERNOR’S OFFICE

GENC MAMANI

DEPUTY GOVERNORS

FATOS IBRAHIMI    First Deputy Governor

GENERAL INSPECTOR

TEUTA BALET

DEPARTMENTS AND OTHER UNITS

HUMAN RESOURCES DEPARTMENT  Roden Pajaj
MONETARY POLICY DEPARTMENT  Erald Themeli
RESEARCH DEPARTMENT       Altin Tanku
MONETARY OPERATIONS DEPARTMENT  Marjan Gjermeni
SUPERVISION DEPARTMENT    Indrit Banka
FINANCIAL STABILITY DEPARTMENT  Klodion Shehu
INFORMATION TECHNOLOGY DEPARTMENT  Xhilda Kanini
STATISTICS DEPARTMENT      Diana Shylla
ISSUE DEPARTMENT            Valer Miho
ACCOUNTING AND FINANCE DEPARTMENT  Artan Toro
PAYMENT SYSTEMS DEPARTMENT  Dashmir Halilaj
LEGAL DEPARTMENT            Toni Gogu
AUDIT DEPARTMENT            Teuta Baleta
FOREIGN RELATIONS, EUROPEAN INTEGRATION
AND COMMUNICATION DEPARTMENT  Ina Kraja
ADMINISTRATION DEPARTMENT   Agron Škënderaga
SECURITY AND PROTECTION DEPARTMENT  Eduard Sinani

BRANCHES

SHKODRA     Ermina Istrefi
ELBASANI     Valentina Dedja
GJIROKAstra  Anila Thomaj
KORÇA       Liljana Zjarri
LUSHNJÀ     Shpresa Meço
LIST OF ALL ENTITIES LICENSED BY THE BANK OF ALBANIA*

BANKS AND BRANCHES OF FOREIGN BANKS

1. RAFFEISEN BANK (JOINT-STOCK COMPANY)
   Licence No. 2/1998, dated 11.01.1999
   Certificate No. 2 “On Deposit Insurance”.
   Director: Oliver WHITTLE
   Address: Bulevardi "Bajram Curri", European Trade Center, Tirana, Albania
   Tel.: 222 66 99, 222 45 40, 222 26 69, 222 54 16
   Fax.: 227 55 99, 222 35 87, 222 36 95, 222 40 51

2. 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: Rruga e Durrësit, Godina 14 katëshe Teknopjekjt, Tirana, Albania
   Tel.: 222 84 60, 222 84 60, 222 40 84
   Fax: 222 84 60, 222 84 60

3. ITALIAN BANK OF DEVELOPMENT (BANCA ITALIANA DI SVILUPPO)
   Licence No. 5/1998, dated 11.01.1999
   Director: Libero CATALANO
   Address: Bulevardi “Dëshmorët e Kombit”, Ndërtesa Kullat Binjake, Tirana
   Tel.: 228 05 11 / 2 / 3 / 4 / 5
   Fax: 228 05 56

4. 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.: 225 09 55
   Fax.: 225 09 56

5. TIRANA BANK (JOINT-STOCK COMPANY)
   Licence No. 7, dated 12.09.1996
   Certificate No. 6 “On Deposit Insurance”.
   Director: Bedri COLLAKU
   Address: Rruga “Dëshmorët e 4 Shkurtit”, Tirana, Albania
   Tel.: 226 96 16/7; 223 34 41/42/43/44/45/46/47
   Fax.: 223 34 17

* As of March 31, 2009.
6. NATIONAL BANK OF GREECE (JOINT-STOCK COMPANY) – TIRANA BRANCH
Licence No. 8, 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.: 227 48 02; 227 48 22
Fax.: 223 36 13

7. INTERNATIONAL COMMERCIAL BANK (JOINT-STOCK COMPANY)
Licence No. 9, dated 20.02.1997
Certificate No. 8 “On Deposit Insurance”.
Director: Mahendra Sing RAWAT
Address: Qendra e Biznesit, Rruga “Murat Toptani”, Tirana, Albania
Tel.: 225 43 72 / 225 62 54
Fax.: 225 43 68

8. ALPHA BANK (JOINT-STOCK COMPANY) – ALBANIA
Licence No. 10, dated 07.01.1998
Certificate No. 9 “On Deposit Insurance”.
Director: Andreas GALATOULAS
Address: Rruga e Kavajës, G – KAM Business Center, Kati II, Tirana, Albania
Tel.: 223 35 32; 223 33 59; 234 04 76/77
Fax.: 223 21 02

9. INTESA SANPAOLO BANK 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.: 224 87 53/4/5/6
Fax.: 224 87 62

10. 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”.
Deputy Director: Borislav KOSTADINOV
Address: Rruga “Sami Frashëri”, Tirana e Re, P.O. Box. 2395, Tirana, Albania
Tel.: 227 12 72/3/4/5
Fax.: 227 12 76

11. 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.: 225 87 55/ 56/ 57/ 58/ 59/ 60
Fax.: 225 87 52
12. 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 “Perlart Rexhepi”, Al-Kharafi Group Administration Building,
Kati 1 & 2“ Tirana, Albania
Tel.: 227 21 68, 227 21 62
Fax.: 227 21 62

13. 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.: 222 29 16, 223 40 96
Fax.: 222 29 16

14. 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.: 227 27 88 / 89 / 90 / 91
Fax.: 227 27 81; 228 04 41

15. UNION BANK (JOINT-STOCK COMPANY)
Licence No. 18, dated 09.01.2006
Certificate No.17 “On Deposit Insurance”.
Director: Gazmend KADRIU
Address: Bulevardi “Zogu I”, Pallati 13-katësh, përballë Stacionit të Trenit,
Tirana, Albania
Tel: 225 06 53; 225 80 81
Fax.: 225 06 54; 227 28 80

16. FIRST INVESTMENT BANK (JOINT-STOCK COMPANY)
Licence No. 19, dated 06.07.2007
Approved by the Supervisory Council Decision of the Bank of Albania No. 35, dated 27.06.2007.
Director: Bozhidar TODOROV
Address: Bulevardi “Dëshmorët e Kombit”, Kullat Binjake, Kulla 2, Kati 14,
Tirana, Albania
Tel: 225 64 23/4; 228 02 10
Fax.: 225 64 22
In addition to banks and branches of foreign banks, the Bank of Albania has as of 31 March 2009 licensed the following entities**:

<table>
<thead>
<tr>
<th>NO.</th>
<th>ENTITIES</th>
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<td>9</td>
<td>NON-BANK INSTITUTIONS</td>
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<td>FOREIGN EXCHANGE BUREAUS</td>
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<td>133</td>
<td>SAVINGS AND CREDIT ASSOCIATIONS</td>
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<td>1</td>
<td>REPRESENTATIVE OFFICES OF FOREIGN BANKS</td>
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</tbody>
</table>

** The full list of these entities may be found in section “Banking Supervision” of the official website of the Bank of Albania www.bankofalbania.org