## CONTENTS

Monetary Policy Statement for the First Half of 2009  
**Page 7**

Speech of the Governor of the Bank of Albania, Mr. Ardian Fullani  
At the Joint Press Conference with the IMF Mission Chief for Albania, Mr. Gerwin Bell  
and the Minister of Finance, Mr. Ridvan Bode  
April 7, 2009  
**Page 64**

Speech of the Governor of the Bank of Albania, Mr. Ardian Fullani  
At the Presentation of the 2008 Annual Report before the Parliamentary Commission  
of Economy and Finance  
April 8, 2009  
**Page 66**

Speech of the Governor of the Bank of Albania, Mr. Ardian Fullani  
At the Presentation of the Annual Report 2008 to the Albanian Parliament  
April 16, 2009  
**Page 77**

Speech of the Governor of the Bank of Albania, Mr. Ardian Fullani  
At the Presentation of Economic Developments in Albania and Future Challenges,  
organized by Citigroup London, International Financial Services and the Albanian  
Embassy in United Kingdom  
May 18, 2009  
**Page 90**

Speech of the Governor of the Bank of Albania, Mr. Ardian Fullani  
At the Regional Meeting of Governors and Bankers  
June 20, 2009  
**Page 95**

Papers Published in the Economic Bulletin of 2009  
**Page 101**

Papers  
**Page 103**

Measuring Inflation Expectations  
**Page 103**

The International Financial Crisis and the Regional Countries  
**Page 121**

Bank of Albania News over April-June 2009  
**Page 129**

Chronology of Monetary Policy Decisions  
**Page 134**

Legal Events over April-June 2009  
**Page 136**

Bank of Albania Management, 30 June 2009  
**Page 142**

List of all Entities Licensed by the Bank of Albania  
**Page 143**

Publications Issued by the Bank of Albania since 2008  
**Page 147**
Monetary Policy Statement for the First Half of 2009
Table 1 Some macroeconomic indicators for the BRIC countries. 12
Table 2 Some economic indicators for the regional economies 13
Table 3 Items contribution to headline inflation rate (in p.p). 20
Table 4 Annual indicators of electrical energy balance sheet (in GWh) 27
Table 5 Balance of payments indicators. 28
Table 6 Fiscal indicators as of the first semester of 2007-2009 33
Table 7 Budget deficit and its financing during the first half of 2005-2009 in ALL billion 34
Table 8 Employment and unemployment indicators 48
Table 9 Annual change rates of some PPI and CPI components (in percent) 49

Measuring Inflation Expectations
Table 1 RMSE of expected inflation as measured by probability methods 111
Table 1 Frequency of responses to the question “How do you think prices will change in the next three months?” 113

The International Financial Crisis and the Regional Countries
Table 1 Annual real GDP percentage change in several world regions 117
Table 2 Annual changes in some macroeconomic indicators for 2008 120
Monetary Policy Statement for the First Half of 2009

Chart 1  Base interest rates of some main central banks
Chart 2  USD and Euro Libor rates (right) and Euro-USD exchange rate performance (left).
Chart 3  Annual change in oil prices and euro/usd exchange rate in the international markets.
Chart 4  World market commodity price performance.
Chart 5  Annual inflation by quarters (in percentage)
Chart 6  Base interest rate of the Bank of Albania.
Chart 7  Differences in inflation for 2008M3 – 2007M1 (left) and 2009M5 - 2008M3 (right).
Chart 8  Interest rate difference for 2008M3 – 2007 M1 (left) and 2009M5 - 2008M3 (right).
Chart 9  Central banks’ balances (2007 M1 based index)
Chart 10  Monetary Condition Index8 and its components
Chart 11  Items contribution to annual inflation (in percentage points)
Chart 12  Annual inflation rate by goods and services items (in percent)
Chart 13  Average of core, non-core and annual headline inflation (in percentage)
Chart 14  Annual inflation of tradable and non-tradable goods
Chart 15  Annual growth of total turnover index (in %) and sectors contributions to the growth (in p.p.), and the ESI performance
Chart 16  Performance of agricultural product. Annual change and contribution of sub-sectors in percentage. Annual change of agro-industrial product.
Chart 17  House price and rent price indices
Chart 18  Price to rent ratio and its long-term trend
Chart 19  Current account (left) and balance of payments (right) in percent to GDP.
Chart 20  Import, export and trade balance (in Eur mln)
Chart 21  Annual changes in import of capital, intermediate and consumer goods (in %)
Chart 22  Export and import values and the historical trend (in Eur million)
Chart 23  Annual change in the value and volume of imports, exports and unit value index (in %)
Chart 24  Labour productivity, ULC for Albania (excluding agriculture)
Chart 25  ULC’s for different EU member states & for Albania
Chart 26  Capital and financial account as a share of GDP.
Chart 27  Annual change (in %) of income and expenditure as of the first half of 2000-2009
Chart 28  Main sources of budget deficit financing as of first half 2000-2009 (ALL billion)
Chart 29  Primary balance moving sum, as of June 2000-June 2009 (in ALL billion)
Chart 30  Performance of budget balance and current account, on average to GDP for 2002-2008
Chart 31  Components of money demand and annual M3 growth
Chart 32  Annual growth of monetary aggregates
Chart 33  Annual monetary aggregate growth
Chart 34  Deposit performance by currency and time structure (excluding exchange rate effects)
Chart 35  Performance of lek- and foreign currency-denominated time deposits by categories (in ALL billion and in percentage)
Chart 36  NFA performance in USD million
Chart 37  Annual change of NFA in percent, by investment sources
Chart 38  Loan portfolio performance
Chart 39  Disbursed new credit performance and structure by currency
Chart 40  Loan portfolio by index size
Chart 41  Loan portfolio distribution by borrowing groups
Chart 42  Credit performance by sectors of the economy
Chart 43  Credit performance by purpose of use
Chart 44  Lending standard changes applied to business loans and the factors impacting on them (net balance), in percentage
Chart 45  Changes on lending standards applied on individual housing and consumer loans and the impact of various factors (net balance), in percent
Chart 46  Budget deficit financing and debt structure
Chart 47  Average wages in some economic activities (annual changes in percent)
Chart 48  Performance of minimum wage and average wage in production and services and in the public sector
Chart 49  Annual change in PPI (right-hand axis) and CPI (left-hand axis) commodity indices
Chart 50  Annual changes in foreign and domestic prices (left-hand chart), foreign and domestic food prices (right-hand chart) and the exchange rate
Chart 51  Annual change of oil price in Albania and abroad and ALL/USD exchange rate
Chart 52  Consumer and banks’ expectations for the annual inflation and current inflation (in percent)
Chart 53  Business expectations for the performance of producer prices after one quarter (net percentage)
Chart 54 Bank of Albania interventions in the money market and key interest rate 53
Chart 55 Interest rates in the interbank market (left-hand) and daily lending volume
(right-hand, in ALL billion) 54
Chart 56 Bid to cover ratio for the budget deficit financial in the primary market and the
12-month yield 55
Chart 57 Yield curve (left-hand) and long-term securities’ yields in the primary market
(right-hand). 55
Chart 58 Interest rates on 12-month deposits and base rates (left-hand) and the interest
rate spread on 12-month ALL and EUR deposits (right-hand) 56
Chart 59 Weighted average interest rate on new ALL loans 57
Chart 60 Weighted average interest rate of new EUR loans, EUR deposits and 12-month
EURIBOR interest rate 57
Chart 61 Intermediation rates in ALL and EUR (left-hand) and spread between average
interest rate on new ALL and EUR loans (right-hand) 58
Chart 62 ALL annual changes in nominal effective terms (NEER) and their moving average
58
Chart 63 EUR/ALL ratio compared to the regional average 59
Chart 64 Daily performance of EUR/ALL and USD/ALL ratio 59
Chart 65 ALL exchange rate volatility in quarters 59

Measuring Inflation Expectations
Chart 1 Responses of the CCI survey on the expected change in prices 103
Chart 2 Adjusted Carlson and Parkin (1975) method 104
Chart 3 Expected inflation as measured by average actual quarterly inflation and the
respective probability distributions 108
Chart 4 Expected inflation as measured by actual quarterly inflation and the respective
probability distributions 108
Chart 5 Expected inflation for period t + 1 and actual inflation (simple or average) 109
Chart 6 Expected inflation of period t based on the normal and central t-distribution
and the actual inflation of period t (simple or average) 109
Chart 7 Expected inflation of period t + 1 and actual inflation (simple or average) 110

The International Financial Crisis and the Regional Countries
Chart 1 Change in the value of respective currencies indexed to October 2008 119
MONETARY POLICY STATEMENT FOR THE FIRST HALF OF 2009

I. GOVERNOR’S SPEECH

The economic developments in the first half of 2009 posed strong challenges to the Albania economy. The global crisis affected our economy, swinging the factors and balances that have sustained the economic growth, thus testing the immunity and self-adjusting mechanisms of the economy and raising certain complex questions to economic agents and macroeconomic policies.

The economic recession hitting a major part of our trading partners is associated with a decline in trade exchanges and foreign currency inflows. The increased uncertainty in global financial markets has shaken the confidence in the financial system, exerting pressure on tightening of the financial conditions in Albania. Both these factors are reflected in the reduction of consumption, exports and investments, thus leading to economic activity slowdown and exerting pressure on fiscal indicators of budget revenues and budget deficit. On the other hand, the reduction of foreign currency inflows is accompanied by deterioration of the balance of payments indicators and arising of depreciating pressures on exchange rate, underscoring the role of current account stability on macroeconomic and financial balances at home and the need for taking precautions to guarantee it.

World economic environment is characterised by further deepening of economic and financial crises. Curtailing of consumption and investments, in the presence of high public and private debt levels and underlined macroeconomic imbalances, has made the world economy experience the sharpest economic downturn in last 50 years. The developed countries, USA, Euro-zone, United Kingdom and Japan have followed easing monetary and fiscal policies, aiming to hamper the economic downturn and improve the financial and capital market situation. Under their impact, the latest data have signalled relative improvement signs of some macroeconomic indicators. Tensions induced in the previous periods have relaxed and the main financial indicators have shown recovery signs. In the meantime, the world inflation rates have been falling, owing to low raw materials prices and low use of productive capacities, in the presence of a low aggregate demand and increasing unemployment.

The economic activity downturn worldwide was associated with contraction of world trade, tightening of financial conditions and dropping of economic agents’ confidence. The direct impact on emerging countries, such as Albania, is the fall of demand for their exports, decline of foreign direct investments and tightening of lending terms in world markets. Thereupon, these countries
have been increasingly affected by the crisis. According to IMF, the emerging countries of Eastern Europe are estimated to incur a contraction of about 5 percent during this year.

The Albanian economy, in the face of this unfavourable environment, has recorded a comparatively positive performance. There are few data on the real economy. The Bank of Albania estimates that a positive economic growth has characterised the first half of the year. On the others hand, low growth of credit and money supply, worsened business and consumer confidence indices, slow-down of budget revenues and specific indicators of certain economy sectors, suggest that the economic growth rate has decelerated. It is still early to draw conclusions on the economic performance over the course of 2009 and onwards. The Bank of Albania deems that the premises to keep positive economic growth rates in the country are present, among which the macroeconomic and financial stability of the country is of primary importance.

The economic activity at home is carried out in the presence of favourable consumer price stability. It is sustained by easing monetary conditions and an expansionary fiscal policy over this period. The Bank of Albania cut the base interest rate in January and undertook liquidity-injecting operations, raising its quantity in the market. Simultaneously, we have lengthened the maturity span of liquidity injection operations, in order to lower the upward slope of interest rate curve. We have also expanded the eligible collateral base, in order to facilitate the financial institution’s access to liquid funds. These operations of the Bank of Albania have helped controlling the interest rate level. The Bank of Albania’s intervention has been more effective in controlling the short-term interest rates. The long-term interest rates of Government securities and loans displayed rising tendencies, owing to Government’s demand for financing and increased sensitiveness of the banking system towards liquidity indicators. In parallel, the depreciating exchange rate trends have complemented the easier monetary conditions framework, providing advantage to exports and trade deficit improvement. However, as we have constantly emphasised in our statements, the Bank of Albania has paid attention to momentary stimulus management, aiming, above all, to achieve its objective for maintaining macroeconomic stability, by preserving internal and external balances.

As of the first half of 2009, the annual inflation rate was 2.0 percent, edging down from inflation rates of the last year, but remaining within the Bank of Albania’s target range. Low inflation rates are due to the weakening of inflationary pressures on the demand and supply side, consequent to raw materials price cut in the international market and the economic activity slowdown at home. Inflationary pressure stabilization is clearly illustrated by low rates of core inflation and of non-tradable goods during this period, being reflected also in checked expectations of economic agents of the market. Meanwhile, after a long disinflationary period and confirming the Bank of Albania’s forecasts, the annual consumer price change displayed a slightly increasing trend over the second quarter of 2009. Annual inflation marked 2.3 percent in June, reflecting a pass-through of exchange rate depreciation.
effect on consumer goods prices. The Bank of Albania estimates that this factor may play a higher role in future price setting, thus creating premises for short-term and medium-term shocks on price level.

In the face of these developments, the Albanian economy continued to be featured by low public and private savings rates even during the first half of 2009, associated with further enlargement of current account deficit and upward pressures on exchange rate performance. Simultaneous reduction of exports and imports, respectively by 19.6 and 6.3 percent on annual level, made the trade deficit contract by 1.3 percent during the first five months of the year. However, reduction of emigrants’ remittances by about 8 percent during the first quarter and the services account deterioration, made the current account deficit record an annual growth of 5 percentage points of GDP during this quarter. Though this deficit goes mostly for financing the capital and intermediate goods of import, its sustainability deserves a greater attention. Particularly concerning is the low degree of export to import coverage, signalling structural problems of this deficit due to still-low competitiveness in our economy.

In this direction, a special attention should be paid to checking costs and productivity growth in the economy, by raising investments in education and attracting most advanced technologies in production. Also, in the medium run, the macroeconomic policies should be prudent in terms of public and private savings level, in order to control the need for using foreign financing resources.

The fiscal policy during the first half of 2009 had an expansionary stance, being featured by a rapid growth of expenditures and budget deficit. Budget revenues have recorded a more moderate growth, partially reflecting even the economic slowdown effects. Though remaining within the projected level for 2009, the budget deficit by about ALL 30 billion constitutes a much higher amount than in the same period of the previous year. Under these conditions, the Bank of Albania would appreciate measures for keeping budget deficit levels and public borrowing in check, helping the maintaining of internal and external balances in the economy. The maintaining of projected budget parameters will positively impact on macroeconomic stability, by controlling the fiscal stimulus on aggregate demand and dampening the monetary market pressures.

The demand for monetary assets increased during the last months. Money supply rise by about 8 percent was based on money creation in the economy from the public sector and from private sector borrowing, mainly in ALL. Loan portfolio grew moderately, by ALL 7.5 billion or about 5 times less than as of the same period of the previous year. Reduction of bank funds source and increase of uncertainty in the country influenced the significant deceleration of credit growth rates. However, credit to economy increased along the first months of the year, while the banking system signalled no further tightening of the lending terms in the third quarter of the current year. The private sector’s demand for Lek-denominated loans met an increasing willingness from banks,
thanks to stabilization of liquidity situation and easing of monetary conditions at start-2009. Restraint of foreign currency money supply has resulted to contraction of the foreign currency component of money structure, even on the demand for money side, bringing about a shifting of money supply structure towards the Lek.

In the first half of 2009, the financial market situation was influenced by increased uncertainty and revaluation of risk premiums that associated the liquidity constraint, consequent to deposit outflows and lending activity reduction. Ongoing intervention of the Bank of Albania in the money market, combined with measures that aimed at relaxing the market and encouraging the interbank market activity, as well as the maintaining of sound financial system indicators, made the end of the period record stabilized liquidity positions and interest rates. The latter displayed different behaviour, according to maturity term. Short-term interest rates in the money market decreased, consequent to base rate cut and improved liquidity positions. Long-term interest rates rose under the conditions of a high demand for long-term funds and increased risk premium. Primary market interest rate rise was transmitted to interest rates of new Lek-denominated loans of more than 1-year maturity term, influenced even by the overall lending tightening tendency.

The Bank of Albania deems that the issues of liquidity, internal and external balances in the economy and the financial soundness constitute direct challenges on macroeconomic stability and long-term development of the Albanian economy. Their treatment should be constantly oriented towards the need for observing the necessary macroeconomic balances of the country. The price stability, smoothing of monetary indicators volatility, a robust and efficient financial system, as well as sound public and private sectors’ balance sheets, impact on reducing the risk premium in the economy. Also, they open the way to attract foreign investments and cut the cost of borrowing from international markets. In this way, they provide an irreplaceable contribution to the country’s long-term growth.

Further promotion of this growth requires constant structural reforms in the economy, which should not only address the deficiencies of our economy but also precede future development trends. Investing in infrastructure should be a priority of funds use in the economy. Also, further development and consolidation of financial market segments, completion and expansion of pension system in the favour of private incentives, investment with priority in education and medical fields deserve the attention of all actors of the economy. We also deem that it is just the time for the private sector to reflect the new development stage of the country, by enhancing and fostering its management. This requires a better management of business and financial risk, signifying also a closer cooperation with specialised agents in the market, extension of business plan horizons and their better orientation towards the global reality and the country’s development priorities.

In light of this, the financial system should respond more prudentially to these requirements, enhancing the transparency and efficiency of its products. Now
that the banking system has overcome the delicate moments it was faced with at end-2008, it should raise its contribution to financing the private sector’s activity of the economy. However, I avail myself of the occasion to once more emphasise that the financial stability of the banking system is another major objective, to which the Bank of Albania remains deeply committed. This system will be constantly subject to Bank of Albania’s supervision and stress-test analyses.

II. DEVELOPMENTS IN THE WORLD ECONOMY

During the first six months of 2009, the global economy was characterized by an economic contraction stemming from the recession in the developed world and lower growth rates in the emerging economies. Global inflation rates have been on the downside, caused primarily from the rise in excess capacities and from the statistical effect brought about by comparison to the last year. Throughout the same period of the last year, commodity prices, particularly energy and foods, reflected a rapid growth.

<table>
<thead>
<tr>
<th>Some main economic indicators</th>
<th>Annual GDP Change</th>
<th>Unemployment Rate</th>
<th>Annual Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countries</td>
<td>H1-09</td>
<td>H1-09</td>
<td>H1-09</td>
</tr>
<tr>
<td>USA</td>
<td>-2.5</td>
<td>8.7</td>
<td>-0.6</td>
</tr>
<tr>
<td>Euro-zone</td>
<td>-4.8</td>
<td>8.9(^1)</td>
<td>0.6</td>
</tr>
<tr>
<td>Germany</td>
<td>-6.9</td>
<td>7.5(^1)</td>
<td>0.5</td>
</tr>
<tr>
<td>Greece</td>
<td>0.3</td>
<td>8.9(^2)</td>
<td>1.3</td>
</tr>
<tr>
<td>Italy</td>
<td>-6.0</td>
<td>7.4(^3)</td>
<td>1.1</td>
</tr>
<tr>
<td>Japan</td>
<td>-8.4</td>
<td>4.7</td>
<td>-0.3(^4)</td>
</tr>
</tbody>
</table>

\(^1\) Average for the January-May 2009 period
\(^2\) Average for the January-May 2009 period
\(^3\) Data for the first quarter of 2009

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

In the first quarter of 2009, the economic activity in the Euro-zone followed a downward trend and contracted by nearly 2.5 percentage points in annual terms. The main reason behind this negative progress is investment shrinkage by 4.2 percent on annual basis. Similarly, domestic demand and foreign demand recorded a decline, being reflected in a fall of exports. The indicators on the economic progress for the second quarter point toward a monthly growth in the sales index of 0.2 percent in April and a slight improvement of confidence indices in May. These results implicitly indicate continuity in GDP contraction, but at a lower rate. According to the European Central Bank forecasts, the recession is expected to continue at a more moderate pace until mid-2010, time when the first signs of economic growth are expected to occur.

Preliminary estimates on the Euro-zone inflation rate for June 2009, point to fall in aggregate prices by 0.1 percent in annual terms, whereas April and May values were respectively 0.6 and 0.0 percent. These low values are attributed to the fading statistical effect of last year’s higher energy prices.
Economic activity in the USA during the first half of 2009, similar to year-end 2008, remained weak. Therefore, final estimates on the economic performance during the first quarter of 2009, delivered an economic contraction of 5.5 percent in quarterly terms. The GDP drop reflected an accelerated contraction of exports and investments. In the meantime, the encouraging performance of consumer spending and the rapid fall of imports could not reverse the above mentioned negative effect. Data for the second quarter of 2009 show a slight improvement of economic conditions in the country primarily derived from the positive signals in the industrial sector. For the first six months of the year, unemployment rate grew considerably, reaching an average of 8.7 percent. Consumer price index registered an average annual fall of 0.4 percent during the January-May period.

The BRIC countries experienced dissimilar growth scenarios during the first half of the year. In Brazil and Russia, the economies registered contraction during the first quarter of 2009. In both countries, the fall of exports was the main contributor to the weakening of the economic climate.

In contrast, the Chinese and Indian economies maintained their rapid growth rates during the first quarter of the year. In China, exports volume dropped at an accelerated pace, but the rise in government spending, investments and consumer expenditure has more than counter-balanced the former effect. In their latest meeting the Central Banks of China and Russia lowered their base interest rate, whilst those of Brazil and India left them unchanged.

The economic environment in Italy during the first six months of 2009 continued to be frail even though some economic indicators showed some signs of revival. During this period the reduction in trade exchanges at a global level has been a crucial cause for the deterioration of economic activity. Thus, the first quarter of 2009 registered a 6 percent fall in annual GDP, mainly due to a reduction in aggregate investments and exports. Latest data on the second quarter of this year, present a protracted fall of economic activity in the country. Average annual inflation rate for the first half of 2009 was 1.1 percent.

Economic activity in Greece gave the first signs of deterioration during the first half of 2009. Subsequently, although Gross Domestic Product grew by nearly 0.3 percent in annual terms, compared to the previous quarter it contracted by 1.2 percent. The primary impact came from the accelerated fall in exports and investments. On the contrary the growth in consumer

Table 1 Some macroeconomic indicators for the BRIC countries.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Annual change of real GDP</th>
<th>Annual inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1-09</td>
<td>2009(^1)</td>
</tr>
<tr>
<td>Brazil</td>
<td>-1.8</td>
<td>-1.3</td>
</tr>
<tr>
<td>China</td>
<td>6.1</td>
<td>6.5</td>
</tr>
<tr>
<td>India</td>
<td>6.7</td>
<td>4.5</td>
</tr>
<tr>
<td>Russia</td>
<td>-7.0</td>
<td>-6.0</td>
</tr>
</tbody>
</table>

Source: IMF, OECD, Respective statistical institutes

\(^1\) IMF estimates
\(^2\) Average for the January-May 2009 period
\(^3\) Average for the January-May 2009 period
spending, the extended public expenditures and the fall in imports gave a positive contribution to the county’s GDP. Latest data on the performance of main macroeconomic indicators for the second quarter point to continuity of the economy’s deteriorating trend. The average unemployment rate was 9.3 percent in first four months of the year, whereas the harmonized consumer price index, during the first half of the year, grew by 1.3 percent.

Throughout the first quarter of 2009, the economy in Turkey shrank at a rate of 13.8 percent in annual terms. This was caused by a rapid fall of personal consumption and private investments, both of which considerably surpassed the evident growth of public investments. A fall was also registered in the trade activity whereby imports and exports fell by 32.5 and 15 percent respectively. Data for the second quarter illustrate an amelioration of the economic environment. Industrial production declining rates resulted subdued and the confidence indices in May continued their recovery, which had started nearly six months ago. June inflation rate was 5.7 per cent, nearly 0.1 percentage points higher than in the previous month, whilst the average inflation rate for the second quarter of 2009 was 5.6 percent.

The Former Yugoslav Republic of Macedonia’s economy registered a contraction of 0.9 percent in annual terms. The main reasons behind the fall in the economic activity were the uninterrupted decline of industrial production and exports, as well as the slowing down of consumer spending, which could not be nullified by the growth in investments. Higher public investments provided more employment opportunities in the public service, mirrored in a fall of unemployment rate by 1.1 percent. The inflation rate was negative in June, at -1.7 percent on annual basis.

According to IMF estimates the Kosovo’s economy grew by 5.4 percent in 2008. The economic growth over this period was supported by financial resources from international institutions, by expanding consumer spending subject to higher remittances and doubling public investments. Inflation rates have registered negative values during 2009, thus conserving the downward tendency from the end-year 2009. The annual inflation rate in May was -4.4 percent.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Annual GDP change</th>
<th>Annual inflation rate</th>
<th>Unemployment rate</th>
</tr>
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<td>Q1:09</td>
<td>2009</td>
<td>H1:09</td>
</tr>
<tr>
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<td>-2.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Serbia</td>
<td>-3.5</td>
<td>-2.0</td>
<td>9.0</td>
</tr>
<tr>
<td>Croatia</td>
<td>-6.7</td>
<td>-3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Turkey</td>
<td>-13.8</td>
<td>-5.1</td>
<td>7.32</td>
</tr>
<tr>
<td>Kosovo</td>
<td>:</td>
<td>:</td>
<td>-2.4</td>
</tr>
<tr>
<td>Albania</td>
<td>:</td>
<td>0.4</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: National Statistics Offices, EuroStat, EcoFin, IMF

1 IMF estimates.  2 Data for the first quarter of 2009
3 Average value for January-May 2009
4 Average value for the January-April 2009 period
5 Data for the last quarter of 2008
: Data not available

Table 2 Some economic indicators for the regional economies
I.1 MONETARY POLICY, FINANCIAL MARKETS AND THE EXCHANGE RATE

Through the first half of the year, the European Central Bank lowered four times the base interest rate, down to 1 percent, from 2.5 percent on the turn of the year. The Federal Reserve Open Market Committee kept the base interest rate unchanged at 0-0.25 percent throughout the first six months of 2009, implicitly indicating that the base rate will not change in the months to come. The Bank of England changed thrice the base interest rate during the same period, lowering it to 0.5 percentage point, from 2 percentage points prevalent in January. The Bank of Japan did not change its reference interest rate (the over-night interbank interest rate), thus leaving it at the 0.1 percent level in the first half of 2009.

During the first half of the year, global financial markets were characterized by falling interest rates and mild normalization of turbulence caused by the financial crisis. Positive signals passed on from the latest data indicate a subdued deceleration rate of several main economic and trade indicators in the global markets. During the first half of the year, Libor and Euribor interest rates in the money market fell considerably, reflecting the lowering of base interest rates from the ECB and the FED. In the beginning of July, 1-month, 3-month and 6-month Euribor interest rates fell on average by 2.92, 2.96 and 2.94 percentage points compared to the preceding six months, whereas the 3-month Libor rate diminished with 1.80 percentage points.

The bond market, during these months, was marred by constant fluctuations and higher yields. This upward trend was mostly pronounced in April, whereas recent developments show a moderate downward tendency. In Japan, yields were more stable during the same period. The stock markets were characterized by an acute bearish sentiment and frequent fluctuations. Better future prospects from businesses’ economic indicators as well as traders’ expectations have recently induced an upward trend in the stock market quotations.

In foreign exchange markets, the Euro has been characterized by frequent fluctuations and an appreciating tendency against the US dollar. After a considerable appreciation at the end of 2008, the Euro has followed a falling path accompanied with instability towards the US dollar, to re-gain momentum in May and June. The Euro was also valued with respect to the main basket of international currencies. Its appreciation vis-à-vis the Japanese yen and the Swiss franc more than compensated for the devaluation against other currencies. The negative performance of the US economy and unfavourable data on the Euro-zone macroeconomic indicators, have led the fluctuations and frequent appreciation of one currency against the other4. In the first half of the year, on average, the Euro depreciated by 5.47 percentage points compared to the previous six months. At the start of July, the Euro would be
equal to 1.40 US dollars, a comparable level to the value of end-December 2008.

I. OIL AND COMMODITY PRICE DEVELOPMENTS

The international oil market, during the first half of the year, was hit by the effects of deteriorating economic activity in the industrialized economies and in some main emerging economies. The average value of an oil barrel was 54 percent lower compared to the first half of 2008. After reaching its lowest point in February of this year, the oil price per barrel followed an upward tendency, despite the US dollar’s appreciation vis-à-vis some main international currencies. The global oil demand registered a 3.2 percent fall in annual terms during this period. Precipitating demand in some OECD countries and some emerging economies were of primary influence to the former development. A closer look to the monthly performance of this market highlights a pick-up in US demand during the May-June period. The oil supply, on the other hand, has shown a slender growth rate. The Organization for Petroleum Exporting Countries (OPEC) lowered its membership’s reference production quotes for several months in a row, in a drive to reach a higher equilibrium oil price level. Nevertheless, the increase in production and refinery capacity in other world oil exporting regions, helped maintain an upward trend for the oil supply. Medium-term forecasts estimate higher oil prices in the second half of the year.

The main indices on commodity prices published by the IMF indicate a fall in their value in annual
terms. However, in quarterly terms, commodity prices increased during the second quarter of the year. Thus, the overall Commodity Price Index as of the first half of the year, dropped by 42.6 percent in annual terms. Whereas the second quarter of this year compared to the first quarter marked a 15.7 per cent increase in value. A similar trend has distinguished the Food Price Index, which marked a 21.7 fall in yearly terms during the first half of the year. During the second quarter of the year compared to the previous quarter this index grew by 10.2 percent. Similarly, the Fuel Price Index fell by 49.3 percent annually during the first six months of the year. In quarterly terms, in the second quarter it grew by 20.1 percentage points.

### III. PRICE STABILITY AND BANK OF ALBANIA’ S TARGET

The achievement and maintaining of price stability is the main objective of the Bank of Albania. This is the major contribution the central bank can give to stimulating savings and attracting productive investments to sustain a consistent economic growth. In line with its strategy, the Bank of Albania is committed to achieving and maintaining an annual inflation of 3.0 percent, with a +/- 1 percentage point tolerance band. The publication of the quantitative objective on inflation aims at anchoring the economic agents’ expectations and reflecting the Bank of Albania’s continuous determination to achieve the main objective, despite the temporary fluctuations caused by factors beyond the control of monetary policy.

Annual inflation for the fist half of 2009 marked an average of 2.0 percent, about 2 percentage points lower than in the first half of 2008. The annual inflation rate during this period fluctuated around the lower limit of the 3.0 percent Bank of Albania’s targeted band. After a disinflationary period (Q2:2008 – Q1:2009), inflation displayed a slightly increasing tendency in the second quarter of 2009, marking 2.3 percent in June. The average annual inflation was marked 2.4 percent in this month.

Low inflation rates in the first half of this year were caused by weakening of inflationary pressures on cost and demand side. Raw materials price cut in the global market was reflected in lower production costs and import prices. Expectations for slowdown in domestic demand growth, tight financial conditions and the downward inflation expectations influenced...
the behaviour of core inflation and non-tradable goods, which displayed lower growth rates compared to June 2008.

The end of 2008 and the beginning of the current year were characterized by a falling trend of inflation, a notable weakening of inflationary pressures, low economic growth and domestic demand expectations, and falling future inflation expectations. Under these conditions, in January the Bank of Albania decided to lower the base rate by 50 basis points, to 5.75.

Under the conditions of an amplification of the global financial crisis in September 2008, the Bank of Albania was committed to using new monetary policy instruments to subdue the pressures triggered by liquidity constraint. Compared to end-2008, it injected liquidity through reverse repurchase agreement auctions, changing their type from fixed-amount repo auctions to those of unlimited-amount and fixed interest rate, the base rate. To meet the long-term market demand for liquidity, along with the main operations of 7-day maturity term, the bank carried out operations of a longer maturity term, i.e., of 3 months, and outright purchases of securities. In December 2008, overnight loan rate was cut by 100 basis points, in order to ease the borrowing ability of the banking system. In March 2009, given the improved liquidity conditions and striving for promoting the interbank market activity, the employment of overnight deposit was temporarily forbidden. This was reflected in increasing the trading levels in the interbank market over the second quarter of the year. The liquidity-injecting operations continued, but by the end of this period liquidity conditions improved and interest rates stabilized in the money market.

Due to timely measures taken by the Bank of Albania, inflation rate in Albania was not only the lowest in the region but also within the announced price stability targeted range. Furthermore, all the operational and regulatory measures prevented contagion that the deterioration of the global financial conditions would have caused if induced in the domestic financial system and the real sector.

**Box 1 Regional central banks’ reaction to the global crisis**

The financial crisis in the global markets was strongly intensified in the third quarter of 2008 and transferred to the real sector of the economy. The economic situation in the world during the last 12 months is characterized by imbalances of the macroeconomic indicators, fall of production, rise of unemployment, depreciation of domestic currencies, tightening of lending and liquidity conditions in domestic markets. Facing this situation, the central banks are making use of every eligible instrument to stabilize the financial system and stimulate the economic activity.
Monetary policy implementation depends on two main instruments: (i) the base rate, which is usually a short-term mediation rate and (ii) open market operations, which usually include the terms and conditions under which liquidity is acquired from the central bank. Under normal conditions, open market operations are composed and implemented in such a way as to affect a market interest rate determined by the monetary policy. They can be used in spite of the level of the base interest rate at that period. As such, they play a supportive role and do not contain any significant information on the future monetary policy stance.

In some special situations, open market operations take an important role and are used to affect specific elements of transmission mechanism. This complementary approach of monetary policy aims at using this instrument, to raise the effect the base rate has on asset prices and yields and financing costs. In these situations, open market operations result in essential changes to central bank balance sheets and the monetary policy implementation through them can be regarded as balance sheet policy.
In the face of the global crisis, the monetary authorities of different countries affected by the crisis have reacted in similar ways, by lowering their base rate, injecting liquidity in the market and creating easing conditions for refinancing operations. The central banks’ reaction magnitude differs according to specific economic conditions of each country prior to the crisis – the inflation rate, economic growth, unemployment level, size of current account and fiscal deficits, etc. Therefore, some of these economies are more restricted in applying measures to counter the crisis.

III.1 MONETARY CONDITIONS

The monetary policy pursued by the Bank of Albania during the first months of 2009 displayed an expansionary nature, as noted in the Monetary Condition Index. The base rate cut at year-start, underlined the decreasing trend of this index, which had started in the third quarter of 2008.

Easing monetary conditions reflect the combined pace of index components, the exchange rate and the base interest rate. In the second quarter of 2009 this index continued its decreasing tendency, driven chiefly by exchange rate depreciation. The later is the component that has an important weight in
determining the economic conditions in small open economies, as is the case of Albania. In June, the seasonal effect of local currency appreciation was reflected in the monetary conditions of that month, which showed a slight contraction.

III.1 PRICE TREND OF THE MAIN CPI BASKET ITEMS

The inflation rate trend in the first six months of 2009 reflected the smoothing of inflationary pressures stemming from inside and outside the country. The consumer goods (mainly food and fuel) price cut in international markets and better conjunctures of goods and services in the domestic economy facilitated the decrease of the inflation rate. Especially, the cancelling out of the energy price rise in March 2009 led to fall of inflation rate below the lower limit of Bank of Albania’s target, to return above this limit in May and June. The inflation rate for the first half of 2009 was significantly affected by the inflation of items, the foodstuffs and administered prices.

It results out of the analysis of constituent consumer basket items that there is a notable increased contribution of the “unprocessed food” item, whereas almost all the other basket items recorded a decline related to the same previous year period. Contribution of processed and unprocessed food items determined to 90 percent the average annual headline inflation (2%) for the first half of 2009. In June, the annual headline inflation (2.2 %) was almost entirely determined by the contribution of the “unprocessed food” item (2.2 percentage points).

<table>
<thead>
<tr>
<th>Table 3 Items contribution to headline inflation rate (in p.p)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processed food (pp)</td>
</tr>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td>bread and cereal (pp)</td>
</tr>
<tr>
<td>alcohol and tobacco (pp)</td>
</tr>
<tr>
<td>Unprocessed food (pp)</td>
</tr>
<tr>
<td>fruits* (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 power (pp)</td>
</tr>
<tr>
<td>Housing (pp)</td>
</tr>
<tr>
<td>Non-food consumables</td>
</tr>
<tr>
<td>Durables (pp)</td>
</tr>
<tr>
<td>Consumer Price Index (year on year, %)</td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania estimates

The “unprocessed food” item contributed an average of 1.2 percentage points to the annual headline inflation rate during January-June, while it
rendered a negative contribution throughout the whole 2008. The annual inflation rate of this category was -2.1 per cent in the previous year, compared to 6.5 per cent in the first half of 2009. The domestic demand for these products was met by both, the domestic and foreign production. High inflation rate in the first quarter of the year was triggered by the delayed seasonal effect (due to unstable weather conditions) of spring as well as the entry of season’s foodstuffs at higher prices than usual. In the remaining three months, the depreciation of the domestic currency against two main hard currencies was translated into higher import prices (in lek), generating high prices in this item.

The “processed food” items performed on the reverse side. Annual headline inflation rate for this item dropped from 5.3 percent in January, to 0.7 percent in June. The contribution of this item to headline inflation stabilized around low positive values (0.6 percentage points in the first half of 2009 and 0.2 percentage points in June). Such values have not been recorded since the second half of 2006. Apart from the favourable global conjuncture related to prices of this item, the cancelling out of bread price rise in February, 2008 was a major factor behind the inflation fall.

Annual inflation rate of “administered prices” has fluctuated around -3.7 percent in the last four months reflecting the cancelling out of energy price rise in March 2008. During March 2008 - February 2009, the contribution of this particular category to the headline inflation averaged 0.7 percentage points. After the cancelling out of the energy price rise, this figure turned negative (-0.4 percentage points), driven also by the annual decrease of communication tariffs - on average by 19.4 per cent in the last quarter.

Inflation of “non-food consumables” is affected by oil price performance in the country, which is determined by international oil price and exchange rate developments. The falling international oil price in annual terms is reflected in the domestic market as well (headline inflation rate fell to -1.3 per cent in the first half of the year). Nevertheless, since March, the oil price has been increasing in monthly terms, returning the risk of the presence of inflationary pressures from oil price rise.

The “services”, “housing”, and “durables” prices stayed almost unchanged, reflecting a period of ‘tranquillity’ as a result of the global economic crisis impacts on the cost of living, and on a decreased demand for such goods and services.

The price cut in “processed food” and “administered prices” has contributed to keeping much lower annual headline inflation rates in the first half of 2009 than in the same period of the previous year. In the meantime, a fuelling of inflationary pressures mainly as a result of exchange rate depreciation will play a determinant role in consumer price performance in the following months.
### III.1 INFLATIONARY TRENDS BASED ON OTHER INFLATION MEASURES

The annual core\(^9\) inflation began to gradually decline during the first half of 2009, reaching its lowest level in June (1.2 percent), similar to the average of this indicator in last eight years. The downward trend of core inflation component was significantly affected by the overall dampening of global inflationary pressures since the fall of last year. Annual core inflation rate for January – June 2009, averaged 1.5 percent compared to 3.0 percent of the previous year. Returning of core inflation rates to historical levels for several months in a row, testifies an easing of inflationary pressures at home. High headline inflation rates, mainly over the last two months, are an outcome of the impact of factors not directly related to monetary policy, reflected in non-core\(^{10}\) annual inflation indicator. Since August 2007 its profile has changed, as a result of the global developments in consumer prices.
Contributions of tradable and non-tradable goods sectors to headline inflation were relatively balanced during the first half of 2009. The annual sectoral inflation averaged respectively 1.9 and 2.2 percent, down from the rates recorded in the same period of the previous year.

The upward trend of headline inflation during the second quarter of 2009 was affected mainly by the developments in tradable and non-tradable goods sectors. During June inflation in this sector rose by 3 percent, recording its highest rate in the last 12 months.

The tradable goods sector was affected by both, the relatively favourable prices in international markets and in main exporting countries for Albania, and the depreciating trend of the domestic currency vis-à-vis foreign currencies. It is estimated that the first factor contributed to the subduing of inflationary pressures, whereas the second influenced more thoroughly the tradable goods price rise during the last months of the first half of this year.

In the meanwhile, the cancelling out of administrative energy price rise (March ‘09) and urban transport services (June ‘09), resulted in a significant drop of inflation in non-tradable sector during March-June 2009.

Stable developments in core inflation and in non-tradables, around low historical levels reveal the presence of controlled demand-induced inflationary pressures during the first half of 2009. In the meantime, it is assessed that monetary policy decisions have contributed to balancing the overall inflationary pressures in the economy.
III. MACROECONOMIC DEVELOPMENTS AND THEIR EFFECTS ON INFLATION

IV.1 AGGREGATE DEMAND

III.1.1 Production performance by sectors

The statistical and indirect data available at the Bank of Albania indicate a slowdown of the economic activity in the first and second quarter of this year. The decline in the growth rate of credit and money supply, the depletion of exports, of remittances and fiscal revenue, low growth of energy consumption – especially by businesses, as well as the increased uncertainty induced from deposit withdrawals from the banking system, reveal a slowdown in the overall economic activity of the country. This observation is supported by the results from business confidence surveys, which show signs of a weakening domestic demand and a decline in production as of the first quarter. The interviewed businesses provided hints for further slowdown in industrial production even for the second quarter of the year, affected by decreased domestic and foreign demand. At the same time, industrial businesses will continue to diminish their inventories. Using these surveys as future-orienting indicators suggests that these paces might have continued even during the second quarter of 2009.

The latest INSTAT data on quarterly GDP indicate that the domestic economy during the first quarter of 2009 recorded an annual growth rate of 6.0 percent. The services and construction sectors rendered the largest contribution to positive developments over this quarter. Agriculture provided a moderate contribution to the economic growth. Industrial production recorded a significant drop (13.2 percent) during the first quarter of the year. However, given that available data are still preliminary and cover a short period of time, the Bank of Albania believes that the data on the economic developments for the second quarter of 2009 that base on various macroeconomic indicators and on market agents’ assessments will be determinant for future paces of the country’s economic activity.

<table>
<thead>
<tr>
<th>Chart 15 Annual growth of total turnover index (in %) and sectors contributions to the growth (in p.p), and the ESI performance</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="chart.png" alt="Chart Image" /></td>
</tr>
</tbody>
</table>

Source: INSTAT and Bank of Albania
The data assembled from surveys suggest that production will continue to contract during the second quarter of 2009. During the first quarter of 2009, the utilization of capacities declined to lowest levels recorded. This decline is highlighted especially in the industrial sector (62 percent, compared to 64 percent of utilization of capacities in the economy). The data from the Agriculture Ministry show a restraint of production growth in this sector during 2009.

Production in agriculture sector is estimated to have dropped in 2009. Based on data from the Ministry of Agriculture, Food and Consumer Protection, agricultural product will grow by 0.5 percent, 4.5 percentage points lower than in 2008, mostly due to negative contribution of arboriculture product, which had an annual growth of -0.6 percent. The agro-industrial product, which had started a declining trend since the third quarter of 2007, fell by 7 percent compared with the same period of the previous year.

Housing prices climbed during the first half of 2009. The annual growth of housing price index of 15.6 percent in the second quarter of the year confirmed the positive turnaround that started in the first quarter after a sluggish growth in the previous year. In order to make possible the measurement of the growth in property prices as a result of the dynamic relationship between supply and demand, the index of housing prices built in a 7 percent depreciation as a result of FX changes in lek and euro in the second quarter\(^1\). Based on the measurements of the index without the effect of the FX in lek/euro, the annual growth of the housing price index was only 8 percent. Compared with the first quarter of 2009, this index is up by 6 percent. Using the same exchange rate of euro and lek in the second quarter of 2009 and in the same quarter of 2008, we would have a negative growth of -1 percent.
According to the data assembled from business confidence survey, the real growth in housing price index for the second quarter of 2009 was anticipated by assessments the construction businesses had for producer price rise. Following the rise in producer prices in the first quarter of the year, businesses expected that the same trend would continue in the second quarter as well. Price rise expectations of construction businesses are in line with their anticipation to lower their inventories, which were very high in the last quarter of 2008. This suggests that real estate market supply will remain stable. On the other hand, the credit tightening during 2009, based on lending activity survey (see the information pages) suggests shrinkage of the demand. The supply and demand dynamics in the real estate market, under the conditions of a contracted demand and a steady supply, suggests curbing further price rise beyond the current level.

House rent index in the capital city increased by 7.5 percent in the second quarter of 2009 (5.9 percent excluding the Lek/Euro exchange rate effect). Compared to the previous quarter, the house rent index dropped by 14.7 percent (16 percent excluding the Lek/Euro exchange rate effect). The change in the opposite direction of housing price and rent for the second quarter compared with the first quarter led to rise in price/rent ratio. This ratio is higher than its historical average for the current quarter, after being lower than the historical average for one year.

The main indicators of energy sector showed a positive trend in the first five months of the year. Further improvement in rainfall during this time led to increase of domestic production by 53 percent.
It is also encouraging to notice that the distribution and transmission of the produced energy has been improving, diminishing further the technical and non-technical losses.

Although historically the country has been a net importer of energy, the data from Albanian Power Corporation show that during the first 5 months of this year, the net exchange balance of energy was for the first time positive. Thus, the exported energy was 82.4 GWh higher than the imported one.

Meanwhile, the energy consumption profile has not deviated from historical levels. Households remain the largest users of electricity, accounting for 60 percent of the total demand. The private sector and state-owned institutions accounted for 25 and 15 percent, respectively. The energy consumption continues to have the same seasonality as in the previous years. The 2 percent growth is largely due to increased household consumption and unbilled one, whereas the non-household consumption dropped by 5 percent in annual terms.

<table>
<thead>
<tr>
<th></th>
<th>5M-07</th>
<th>5M-08</th>
<th>5M-09</th>
<th>Annual Change 5M-09 /5M-08 (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net production</td>
<td>1,307.7</td>
<td>1,685.1</td>
<td>2,584.8</td>
<td>53%</td>
</tr>
<tr>
<td>Imports</td>
<td>1,170.1</td>
<td>1,242.8</td>
<td>222.1</td>
<td>-82%</td>
</tr>
<tr>
<td>Exports</td>
<td>0</td>
<td>0</td>
<td>304.5</td>
<td>100%</td>
</tr>
<tr>
<td>Losses in distribution</td>
<td>860.6</td>
<td>830.5</td>
<td>1,000.0</td>
<td>20%</td>
</tr>
<tr>
<td>Losses/Production</td>
<td>66%</td>
<td>49%</td>
<td>39%</td>
<td>10.6 (pp)</td>
</tr>
<tr>
<td>Load Shedding</td>
<td>390.9</td>
<td>158.0</td>
<td>21.9</td>
<td>-86%</td>
</tr>
<tr>
<td>Consumed Energy</td>
<td>2,484.3</td>
<td>2,694.5</td>
<td>2,747.3</td>
<td>2%</td>
</tr>
<tr>
<td>Billed consumption</td>
<td>1,555.3</td>
<td>1,764.6</td>
<td>1,747.3</td>
<td>-1%</td>
</tr>
<tr>
<td>Unbilled consumption</td>
<td>929.1</td>
<td>929.9</td>
<td>1,000.0</td>
<td>8%</td>
</tr>
<tr>
<td>Household consumption</td>
<td>911.1</td>
<td>1,025.7</td>
<td>1,045.4</td>
<td>2%</td>
</tr>
<tr>
<td>Non-household consump</td>
<td>644.2</td>
<td>738.8</td>
<td>701.9</td>
<td>-5%</td>
</tr>
</tbody>
</table>

Source: Albanian Power Corporation and Bank of Albania estimates

Table 4 Annual indicators of electrical energy balance sheet (in GWh)

III.1.1 Developments in the external sector of the economy

The overall balance of payments resulted with a reduction of monetary assets by Eur -131 million in the first quarter of 2009. Current account deficit deepened compared to the previous year, accounting for 16.6 per cent of GDP. Trade deficit (in goods) to GDP is 29 per cent, or 1.5 percentage points higher than in the last year.

During the first quarter of 2009, remittances fell by 7.7 per cent in annual terms, contributing to financing 38 per cent of trade deficit. The first quarter was characterized by a considerable annual growth of foreign direct investments inflows (19 per cent), affected mostly by privatization proceeds. Foreign direct investments are 8.1 per cent of GDP, up from 6.2 per cent in the previous year. The first quarter recorded net inflow of EUR 246.6 million in the capital and financial account. This indicator is estimated to 19.3 per cent of GDP, up by 8.8 percentage points compared to the previous year.
Table 5 Balance of payments indicators.

<table>
<thead>
<tr>
<th></th>
<th>Q1’06</th>
<th>Q1’07</th>
<th>Q1’08</th>
<th>Q1’09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td>-117.9</td>
<td>-178.0</td>
<td>-267.3</td>
<td>-334.2</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-364.2</td>
<td>-443.0</td>
<td>-527.3</td>
<td>-516.4</td>
</tr>
<tr>
<td>-Exports</td>
<td>144.4</td>
<td>182.0</td>
<td>206.5</td>
<td>176.1</td>
</tr>
<tr>
<td>-Imports</td>
<td>-508.6</td>
<td>-625.0</td>
<td>-733.9</td>
<td>-692.5</td>
</tr>
<tr>
<td>Services (net)</td>
<td>-25.9</td>
<td>-28.0</td>
<td>-3.3</td>
<td>-26.8</td>
</tr>
<tr>
<td>Income (net)</td>
<td>48.3</td>
<td>53.0</td>
<td>20.5</td>
<td>-4.4</td>
</tr>
<tr>
<td>Current transfers (net)</td>
<td>223.9</td>
<td>240.0</td>
<td>242.9</td>
<td>213.4</td>
</tr>
<tr>
<td>Capital &amp; financial account</td>
<td>117.7</td>
<td>180.9</td>
<td>167.1</td>
<td>246.6</td>
</tr>
<tr>
<td>Balance of payments</td>
<td>16.0</td>
<td>15.0</td>
<td>-27.0</td>
<td>-130.9</td>
</tr>
</tbody>
</table>

Cumulative in % to GDP

<table>
<thead>
<tr>
<th></th>
<th>Q1’06</th>
<th>Q1’07</th>
<th>Q1’08</th>
<th>Q1’09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td>-9.0</td>
<td>-7.2</td>
<td>-11.6</td>
<td>-16.6</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-22.7</td>
<td>-23.5</td>
<td>-27.6</td>
<td>-29.0</td>
</tr>
<tr>
<td>-Exports</td>
<td>8.1</td>
<td>9.1</td>
<td>10.2</td>
<td>10.6</td>
</tr>
<tr>
<td>-Imports</td>
<td>-30.8</td>
<td>-32.6</td>
<td>-37.8</td>
<td>-39.6</td>
</tr>
<tr>
<td>Services (net)</td>
<td>-2.1</td>
<td>-0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Income (net)</td>
<td>2.2</td>
<td>2.9</td>
<td>2.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Current transfers (net)</td>
<td>13.6</td>
<td>13.9</td>
<td>13.2</td>
<td>10.9</td>
</tr>
<tr>
<td>Capital &amp; financial account</td>
<td>7.2</td>
<td>8.4</td>
<td>10.5</td>
<td>19.3</td>
</tr>
<tr>
<td>Balance of payments</td>
<td>1.9</td>
<td>2.9</td>
<td>1.3</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Source: IMF estimates and BoA staff calculations

In the first quarter of 2009, current account deficit amounted to EUR 334.2 million, or 25 per cent higher than in the first quarter 2008. The main factors contributing to widening of current account are: relatively high values of trade deficit to GDP (29%), declining current transfers by 12 per cent in annual terms; a reversal from EUR 20.5 million surplus of income account in the first quarter 2008 to EUR 4.4 million deficit in the first quarter of 2009; and considerable worsening of service account deficit, - 27 million euros from - 3.4 million euros in the first quarter 2008.

Trade deficit (in goods) narrowed by 2 percentage points in annual terms, while current transfers fell by 7.3 per cent in the first quarter. Current transfers
were mostly used to finance merchandise imports (61%), while foreign currency inflows came from export of services and goods (60%) and current transfers (32%).

Trade exchanges\textsuperscript{15} of Albania with the rest of the world in the first five months of 2009 amounted to EUR 1577.7 million, falling by 9.1 per cent in annual terms. Due to the decline of foreign and domestic aggregate demand, exports and imports denominated in euro fell by 19.6 and 6.3 per cent respectively in annual terms. Consequently, trade deficit narrowed by 1.3 per cent on average during January – May 2009. The export to import ratio is 23.4 per cent, down by 3.8 percentage points compared to the same period of the last year.

The analysis of imports according to their final destination shows a yearly decline of imports of all types of goods during January-May 2009. Hence, capital goods fell by 2 per cent on average; intermediate goods fell by 9.5 per cent and consumer goods fell by 1.8 per cent. The reduction of imports in all categories, along with the slow-down in lending for investments and negative assessments from businesses with regard to production, demand and sales, point out a shrinkage in consumer demand and deceleration in production and investment.

Currently, imports and exports stand below their respective historical trend.
The analysis of foreign trade by volume and price\textsuperscript{6} for the first quarter shows that the falling trend of annual changes in export and import values for the third quarter of 2008 was triggered by price cut, in particular of commodities, as well as a decreased traded volume. The decline in the volume of exports reflected the contracted foreign demand and the importance of competitiveness in the country (see Box 2). The fall in imports reflected the commodity price cut and the contracted domestic aggregate demand (noted in the volume of imports).

The geographical span of trade exchanges shows that the European Union countries continue to be important trading partners. Trade volume with EU countries accounts for 64 per cent of total trade. Italy and Greece continue to be our main trading partners. Exports to Italy account for 60 per cent of total exports, while imports from this country account for 28 per cent of total imports. Exports to Greece account for 8 per cent, while imports account for 13 per cent. Some of the trading partners that have increased their relative importance in trading with Albania are: Austria, Germany, China, Croatia and Spain (exports); and Germany, Greece, Italy, Croatia, Switzerland (imports).

Box 2 Comparing unit labor costs

Information on unit labor cost and labor productivity allow understanding how the performance of labor market and wages can affect, among other things, changes in comparative advantages of a given economy. Depending on development level of a country, different strategies can be followed to shape a certain competitive profile of an economy. Halting growing rates of ULC via a non expansionary policy in wages, increase of LP through technological and organizational improvements as well as implementation of other intermediary approaches, would help to consolidate and improve the competitiveness of an economy externally.
Indicators of LP and ULC in the Albanian economy are measured based on the value added indicator and on the employment and wage indices (INSTAT). The indicator of the value added is seasonally adjusted.17 All indicators used to calculate LP and ULC do not include agriculture. The LP index is calculated as a ratio of value added (index) to employment index. The ULC index is calculated as a ratio of wages to value added index. The latter, for comparative purposes, is converted to euro based on nominal eur/lek exchange rates. All indicators of LP and ULC are referenced to a base period Q1:2003, in order to maintain a clear comparative basis of their trend.

The LP and ULC have followed relatively different trends during 2003-2008. The LP index shows a higher volatility, while the ULC is relatively stable, around 100 until end of the first half of 2006. Afterwards it has increased considerably, even above the LP value. This increase reflects the administrative measures taken to formalize the labor market by establishing reference wages for businesses. Starting from Q2, 2008, the ULC is again stable. The improvements in the quarterly performance of LP support the narrowing of the gap between these two indicators. Further narrowing of this gap would dampen the supply-side inflationary pressures in the economy.

Comparing ULC of Albania and other economies, it appears that the index built for Albania converges to that of the main trading partners and Euro-zone countries. Baltic economies show progressive loss in their competitive advantage towards other economies. The rapid increasing trend of ULC suggests the presence of strong shocks in the cost of labor, especially after 2006. The profile of ULC in the case of Bulgaria and Romania is similar to that of Baltic countries, but smoother. The ULC index for CSEE countries converges almost perfectly with that of Euro-zone. It shows a relatively high degree of approximation among labor markets and of the production based on high competitive advantages of CSEE countries. Albania appears to stand in between, in comparison to the three groups.

These conclusions are economically acceptable because they support the dynamic convergence process which characterizes the developing economies. On the other hand, the results reflect the low degree of efficiency of mobility in the labor and wages market or other deficiencies related to regulatory framework in these economies, compared to the experience of developed economies.

**PERFORMANCE OF OTHER CURRENT ACCOUNT ITEMS**

Services registered a decline in both revenues and expenditures during the first quarter of 2009, giving a net result of - 26.8 million euros. Services trade exchanges amounted to EUR 633.2 million, or down by 10.5 per cent.
in annual terms. The item “travel services” marked a net deficit of Eur 10.3 million and constituted the most important share in revenues and expenditures from services, respectively by 70 and 67 percent. Foreign currency inflows from travel services (exports) reached Eur 211.6 million, or down by 4.3 per cent from the previous year. Albanian tourists spent around Eur 221.9 million travelling abroad, up by 3.6 per cent in annual terms.

Net balance of income account registered a negative result by Eur 4.4 million. This effect was an outcome of declining net investment portfolio by 3 times in annual terms, while net income from employment increased by 14 per cent. Net current transfers are reckoned 12 per cent lower compared to the same period of the last year\textsuperscript{19}. Around Eur 196 million entered in the form of remittances. The latter decreased by 7.7 per cent in annual terms, financing around 38 per cent of the goods trade deficit.

**CAPITAL AND FINANCIAL ACCOUNT**

Net inflows recorded Eur 246.6 million in capital and financial account for the first quarter of 2009. Around EUR 20 million has entered as transfers for capital investments and around Eur 227 million are net financial flows. Capital inflows have financed around 74 per cent of current account deficit and its ratio to GDP is 19.3 per cent\textsuperscript{20}.

Financial liabilities of Albania to the rest of the world increased by EUR 153.5 million, while residents’ assets abroad decreased by EUR 74 million. The main contribution from inflows in financial account came from foreign direct investments, EUR 123.6 million. These investments accounted for 8.1 percent of GDP\textsuperscript{21} and are related mostly to privatization proceeds. Financial assets decline was caused mainly from reduced banking system deposits at non-resident institutions (by EUR 62 million). Reserve assets fell by EUR 130.9 million. Foreign reserves amounted to EUR 1,595 million at first quarter-end of 2009. This level is considered sufficient to cover 4.7 months of imports of goods and services.

**III.1.1 Fiscal indicators and fiscal policy**

During the first half of 2009 fiscal policy was more expansionary than in prior years, when such a feature appeared. The difference between the projection and the realised level was prominent on budget revenue side, while expenditures were realised almost at the projected level. In consequence, the budget deficit has exceeded the projection by ALL 0.6 billion, to ALL 31.6 billion. As a share of GDP\textsuperscript{22}, the budget deficit is estimated at 6.2 percent.
Budget revenues as of the first half of the year were realised by about ALL 144.8 billion, realizing the projection by 93 percent. As a share of GDP, revenues as of the first half of 2009 were estimated to about 28.5 percent, against 28% in the previous year.

In annual terms, budget revenues increased by about 7.2 percent, but compared to previous years their growth decelerated. The items rendering the largest contribution to the difference from the projection are the proceeds from VAT, excise tax and local government.

As of the first half of the year, though the value added tax was maintained at the same levels as in the previous years, the growth rate of proceeds collected from this item recorded a significant deceleration. Revenues from profit tax, likewise in last two years, recorded negative growth rates. The projection was realised at 86 percent.

The proceeds from excise tax, unlike in the previous years, recorded negative growth rates. Revenue contraction from excise tax in annual terms was primarily due to reduction of imported goods subject to excise tax. Local government revenues, though recording a high annual growth rate, have resulted under the projection for this period, down by about ALL 2.7 billion (28%).

Revenue items that realised the projection for this period were personal income tax revenues; non-tax revenues; customs duty revenues. However, the contraction of the latter is attributed to different agreements aiming at free mobility of goods, of which Albania is a party.
Budget expenditure carried out during the first half of the year amounted to ALL 6.8 billion, realising almost fully the related projection. In annual terms, they picked up by about 28 percent. They account for 34.7 percent as a share of GDP, against 28.5 percent realised in the first half of 2008. High rates of carrying out budget expenditure during this period were driven primarily by capital expenditure and by implementation of the project for constructing Rërëshen-Kalimash road. More concretely, capital expenditures, social and health insurance expenditures and personnel expenses contributed 7.5, 7.2 and 4.8 percentage points, respectively to total expenditure growth as of the first half of the year.

Another item highlighted in terms of high growth rate (in annual terms) is that of operating and maintenance expenses, which recorded about 33 percent more than in the previous year. Interest expenses, likewise all expenditure sub-items, increased in annual terms.

**BUDGET DEFICIT AND ITS FINANCING**

During the first half of the year, growth of expenditures exceeded that of revenues. In consequence, the budget deficit increased significantly, recording ALL 31.6 billion in nominal value, about 6.2 percent of GDP, against 0.5 percent in the same period of the previous year.

Distribution of deficit financing almost equally to domestic and foreign sources is a specifics different from the previous years, which had highlighted the importance of domestic sources.

Deficit financing relied primarily on proceeds from privatization and foreign borrowing. Syndicated foreign-currency loan received from resident and non-resident banks in Albania shares the major part of foreign borrowing.

<table>
<thead>
<tr>
<th>Chart 28 Main sources of budget deficit financing as of first half 2000-2009 (ALL billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign financing</td>
</tr>
<tr>
<td>2000</td>
</tr>
<tr>
<td>2001</td>
</tr>
<tr>
<td>2002</td>
</tr>
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<td>2003</td>
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<td>2004</td>
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<td>2005</td>
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<td>2006</td>
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<td>2007</td>
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<tr>
<td>2008</td>
</tr>
<tr>
<td>2009</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

**Table 7 Budget deficit and its financing during the first half of 2005-2009 in ALL billion**

<table>
<thead>
<tr>
<th></th>
<th>H 1-05</th>
<th>H 1-06</th>
<th>H 1-07</th>
<th>H 1-08</th>
<th>H 1-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget balance</td>
<td>(9.5)</td>
<td>10.1</td>
<td>10.2</td>
<td>(2.3)</td>
<td>(31.6)</td>
</tr>
<tr>
<td>Domestic financing</td>
<td>7.3</td>
<td>(11.1)</td>
<td>(10.4)</td>
<td>1.2</td>
<td>17.0</td>
</tr>
<tr>
<td>- Privatization</td>
<td>0.6</td>
<td>2.1</td>
<td>0.0</td>
<td>0.4</td>
<td>20.8</td>
</tr>
<tr>
<td>- Domestic borrowing</td>
<td>10.5</td>
<td>(10.5)</td>
<td>3.4</td>
<td>11.5</td>
<td>5.0</td>
</tr>
<tr>
<td>- Other</td>
<td>(3.7)</td>
<td>(2.7)</td>
<td>(13.9)</td>
<td>(9.7)</td>
<td>(8.8)</td>
</tr>
<tr>
<td>Foreign financing</td>
<td>2.1</td>
<td>1.0</td>
<td>0.3</td>
<td>1.1</td>
<td>14.6</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

Government debt policy has aimed at raising the domestic debt size for all types of securities, particularly for instruments of one-year and longer-than-
one-year maturity term. However, lack of demand at securities auctions\textsuperscript{26}, particularly at the first quarter of the year, made domestic debt stock rise only during the second quarter of the year. In total, the domestic debt outstanding in financial instruments increased by about ALL 5 billion during the first half of the year, owed primarily to debt in securities of longer maturity term. At end-June, in nominal value, the government debt outstanding in securities recorded about ALL 9.9 billion versus ALL 80.8 billion in the previous year.

**PRIMARY DEFICIT**

Primary deficit continued further deepening even during the second quarter of the year, recording about ALL 55.7 billion at end-June\textsuperscript{27}. The primary deficit performance reflected the rise of domestic and foreign debt over this period. Also, the deepening of the gap between the economic growth and the interest rate on public debt caused further budget deficit growth.

Chart 29 Primary balance moving sum, as of June 2000-June 2009 (in ALL billion)

Source: Ministry of Finance, BoA staff estimates

Box 3 Twin deficits

Twin deficit hypothesis suggested that a large budget deficit leads to a large current account deficit. This hypothesis is viewed from the standpoint of the gap between national savings and investments: a rise in fiscal deficit causes a rise in the needs for foreign borrowing, which in turn leads to deepening of current account deficit. The above argument is inherent when savings and investments do not reflect any correlation with each other, signifying that the budget deficit and the current account deficit can move together (Feldstein and Horioka, 1980).

The role of fiscal policy in external regulations is evident from the national income equation\textsuperscript{28}. Tightening/expansionary fiscal policies directly improve (exacerbate) the external balance. The argument according to which the budget deficit causes simultaneously a current account deficit is supported even by the fact that budget deficit growth leads to interest rate rise. Interest rate rise attracts foreign capital, which is directly related to deepening of current account deficit.

Though theoretically the arguments on twin deficit hypothesis converge, the so-far empirical researches have provided mixed results. Some researches reviewed by Funke and Nickel (2006), have drawn the conclusion that a large fiscal deficit leads to a large current account deficit; whereas some others have not evidenced any significant impact.

Twin deficit theory was not verified in the European Union countries. According to Maastricht Agreement, they were liable to curtail budget deficit before launching their common currency in 1999. Though they were successful in decreasing the budget deficit gradually from 5.4 to 0.8 percent of GDP during 1995-1999, the current account surplus remained almost unchanged, around an average of 0.9
The demand for monetary assets had a positive growth in the recent months. Money-supply growth was based on money created in the economy from the public sector and from the private sector’s borrowing, mainly in ALL. The private sector’s demand for Lek loans has found banks’ willingness, thanks to stabilization of liquidity situation and easing of monetary conditions at the start of 2009. Restraint of foreign currency supply has resulted to contraction of foreign currency component of money structure, even on the demand for money side. Under these conditions the money supply structure has shifted towards the Lek. However, lower growth rates of the demand for money versus 2008 are also reflected in lower real M3 growth rates.

The first half of 2009 reflected a different dynamics of money creation in the economy. Since the last quarter of 2008 bank deposits withdrawals reduced the foreign-currency money supply and provided a double effect on monetary developments. First, deposit withdrawal has decreased the currency stock, which will be reflected in lower annual growth rates of M3 until September of the current year. Hence, as of end-May the M3 level was ALL 816 billion, versus ALL 820 billion as of September 2008, prior to deposit withdrawals. Second, withdrawal of foreign-currency denominated deposits has decelerated the money expansion pace, influencing the process of money creation in foreign
currency. Decelerated paces of foreign-currency lending to the private sector were associated with further reduction of M3 growth rate. As of May the annual M3 growth rate accounted for 7.7 percent, equivalent to that of end 2008, versus 14.9 percent as of September 2008. However, financial market stability and meeting of the system’s needs for Lek-denominated liquidity has contributed to stabilization of money stock performance. The Lek component of the broad money, i.e., the M2 aggregate, has recorded stable annual growth rates, to about 10 percent versus about 9.6 percent as of September of the last year.

The long-term monetary developments were also influenced by performance of macroeconomic developments dynamics. In the recent years, the external sector of the economy has been a source of money creation, owing to foreign-currency remittances and credit supply. Latest developments in the economy of neighbouring countries have affected the performance of remittances. The slowdown of their rate in the long-run tends to be associated with lower rates of foreign-currency deposits compared to other years. Under these conditions, the meeting of the demand for money is conditioned by domestic sources of generating savings in the economy. However, in the first half of 2009, capital inflows of the balance of payments have somewhat mitigated the imbalance in the demand for money, which is reflected in monetary aggregate performance.

The dynamics of the aggregate demand in the economy and of the overall private sector’s activity is reflected in the demand for money in real terms. Hence, while in the first quarter the real M3 recorded a slight reduction also due to deposit withdrawals, in the second quarter the demand for money reflected stabilization, recording a seasonal growth by 9 percent. Notwithstanding the restraint of foreign-currency money supply, the M2 growth rate stood at end-2008 levels.
Total deposits as of end of May resulted lower in relative terms than as of year-end 2008. Deposit outflows from the banking sector were triggered by increased public sensitiveness related to safety of their savings, induced from developments in international financial markets. This unfavourable situation reflected its first slight improvement in December 2008. Deposit withdrawals continued with slower paces during the first half of 2009. As at the first quarter of this year the total deposits decreased on average by 3.6 percent in annual terms. The ratio of total deposits to broad money is estimated at about 75 percent as at end of May, down by about 7 percentage points, related to end-September 2008.

In the second quarter of this year there was noticed a slight refraining of deposit withdrawals. Total stock of deposits rose in April, following a constant reduction in monthly terms. The main contribution to this rise was rendered
by business time deposits, mainly those in foreign currency, concentrated in a sole bank of the banking system. Household deposits continued to reflect a slight reduction, in spite of the prominent slowdown of its downward pace featuring the previous periods. Monthly deposit performance in the coming month also reflected improvement. Approval of the law on insuring deposits up to ALL 2.5 million in March was effective in managing this situation. Total stock of deposits in April-May was increased by about ALL 11 billion, excluding exchange rate effect. ALL-denominated deposits were the ones that dominated the rise of total stock, whereas concerning the time structure, time deposits resulted with a larger concentration to total deposits of the system.

**PERFORMANCE OF FOREIGN CURRENCY COMPONENT**

Constraint of banks’ liquidity, particularly in foreign currency, due to deposit withdrawals in the fourth quarter of 2008 is reflected in the deterioration of foreign exchange position of the banking system. This deterioration was due to reduction of assets invested abroad and rapid growth of liabilities consequent to credit lines of parent banks backing up branches to cope with the situation. However, the positive growth of foreign currency loan portfolio against negative annual paces of foreign currency deposits, has greatly disfavoured the foreign exchange position in the system until March 2009. At end-May, the turning of deposits back to the system and the obvious slowdown in foreign currency credit brought about improvement of this position, which, however, is still negative.
PRIVATE SECTOR FINANCING

During five last years, the Albanian banking system has reflected increased financial intermediation in the country. High levels of loan portfolio growth have impacted on the rise of credit as a share of GDP, which in May 2009 reached 9 percent. For the major part of 2008 the high loan portfolio rates created a positive gap compared to historical trend. Reduction of funds sources of banks and increase of uncertainty at home affected the significant slowdown of credit growth rates. In May the real annual growth of credit recorded 9 percent, compared to 0 percent in December 2008. Compared to year-end 2008, the credit portfolio increased by ALL 7.5 billion or about 5 times less than in the same period of the previous year. This performance was influenced by banks’ constraints in generating the liquidity needed for
lending, increased non-performing loans and the effect of the fiscal sector, which during this period was characterised by a high demand for financing, due to a significant rise in fiscal expenses. In the meantime, the annual nominal growth of loan portfolio reached 27 percent. The credit slowdown in nominal terms was more moderate than the real rate, due to the positive impact on the portfolio by the lek’s depreciation against the main foreign currencies, compared to the previous year.

Deceleration of loan portfolio growth rates reflects primarily the contraction of credit supply from banks, which for more than six months are applying tightening lending standards, which have influenced the drop of the demand for credit. In the meantime, the contracted demand has reflected even the slowdown of economic activity in the first months of 2009, and market agents’ uncertainty to undertake investments or finance their consumption by means...
of credit. Also, during this period the new credit disbursed appears at lower levels than in the previous year, recording a negative annual change. A higher decline is noticed during first two months of 2009. Starting from March, an improved situation is highlighted. More positive developments over latest months are in line with the seasonal performance of credit over this period, which coincides with the seasonality of economic activity in the country. Also, the lending survey results for the second quarter of 2009 indicate that the lending terms have remained almost unchanged, with a relative easing tendency.

Concerning loan portfolio developments by currency, a deceleration of annual growth rates of foreign currency-denominated lending, reaching 13 percent, is noticed. In the meantime, lending in ALL has maintained the growth rates of the second half of 2008, with an annual growth of 33 percent. Difficulties in generating liquidity in foreign currency, along with perception for a higher risk for this portfolio, have dictated this behaviour of banks. On the other hand, the lower degree of intermediation in domestic currency and the Bank of Albania’s accommodating policy have created the necessary room for ALL lending to the economy. In May, the ALL loans to total loan portfolio amounted to 31 percent, against 27 percent in the previous year.

![Chart 40 Loan portfolio by index size](chart.png)

Business loan portfolio dominated the loan portfolio of the banking system, by 66 percent. In the first half of 2009, annual changes of this portfolio were downward, reaching 19 percent. However, the deceleration of business loan paces was lower than that of household loans. As noticed from the lending survey, banks were more conservative in retail loans. During most of this period, banks extended loans to businesses to supply them with liquidity. Working capital loan recorded an annual growth of 37 percent, compared to the 20 percent annual growth of investment loan.
During last six months, credit to economy sectors displayed an obvious slowdown of lending to construction and to processing industry. The other sectors maintained almost the same pace as earlier. In May, trade loan portfolio reached 38 percent, construction one reached 21 percent and industrial one reached 26 percent of the business credit portfolio. Compared to the same period of the previous year, the overall industrial loan portfolio presented an obvious improvement, by about 3 percentage points. Growth of credit to electricity generation and distribution offset the contraction of lending to other sub-sectors. Loan portfolio by sub-sectors displays reduced share of credit to processing industry and increased share of credit to electricity generation. The banks state that during the last year they have preferred to credit those businesses that exercise their activity in those sectors of the economy that relate to basic commodities of consumption. Processing industry
displayed decelerated growth rates, due to encompassing in this sub-sector the businesses that relate to exports or supply construction with raw materials. Deterioration of international trade terms and the uncertainty induced in real estate market have made many banks restrict significantly their lending to businesses of this sub-sector.

Household loan portfolio during 2009 has been characterised by uniform slowdown in annual growth rates, to 14 percent. This performance has reflected the prominent contraction of real estate loans. During first 5 months household loan outstanding increased only by ALL 1.5 billion, compared to ALL 12 billion in the previous year. The annual growth rate of housing loan portfolio has contracted obviously, accounting for 13.4 percent, similar to consumer credit. This slowdown of loans for house purchase has been in response to more conservative policies of banks for this product, but also to less demand. Commercial banks’ policies for tightening the lending standards are noticed in raising the loan collateral coverage ratio, increasing the coverage level of credit instalment with personal income, selecting the collateral quality and reducing loan maturity term in some banks. Also, the demand for this product is influenced not only by the uncertainty related to steady income and job position, but also by expectations for a fall in the housing price.

Consumer credit has also reflected decelerated growth rates. As highlighted also by the lending surveys, this credit has reflected higher tightening of lending standards by the banking system since start of 2008. In May 2009, consumer credit accounted for 24 percent of household credit portfolio or by 6 percentage points lower than the highest historical level of July 2007. Compared to the previous year, the loan portfolio structure of household credit by usage has remained unchanged.
Box 4 Lending activity survey results for the second quarter of 2009

This box summarises the results from bank lending survey conducted with bank credit officers during July 2009 and refers to changes that occurred in lending during the second quarter of 2009, as well as bank expectations for the third quarter of the year. The results of this survey reveal that the net percentage of banks reporting a tightening of lending standards, though still high, has decreased as compared to the first quarter. The main factors stimulating the tightening policy of banks relate to assessment of the macroeconomic situation, the industry or firm specific problems and the financial position of households. Net demand for loans (net percentage of banks reporting a higher demand), though still at negative levels, has recorded a turning point, tending to rise in the second quarter 2009, whereas corporate demand has, for the first time, recorded positive values.

Bank’s expectations for the third quarter of 2009 point to further easing of lending standards for both categories, business and household loans. With regards to demand for loans, banks have assessed that it will continue the upward trend by households and by corporations, as well as by small and medium enterprises.

Business Loans: During the second quarter of 2009 the tightening of business loan standards eased in comparison with the previous quarter. The net balance, being on the tightening side, escalated to -23.4 percent, compared to -66.3 percent in the previous survey. The negative balance reflects mainly banks that have answered “standards are tightened somewhat”, since no bank has chosen to answer “standards are tightened considerably”.

Industry or business specific problems, macroeconomic situation at home and non-performing loans remain the main factors behind the standards tightening in the second quarter of 2009. However, during the survey round, the impact of these factors somewhat eased compared to the second half of 2008 and the first quarter of 2009 (chart 1). Banks’ tightening policy over the second quarter was implemented primarily by widening the average margin for riskier loans and increasing collateral requirement in relation to loan amount.

Net demand for loans by businesses, according to bank experts’ assessments, has somewhat increased in comparison to the previous quarter; however, the demand of small- and medium-sized enterprises has remained at negative levels. The main factors behind the business demand for loans, according to bank experts’ opinion, were: the need for financing the working capital, decreased use of alternative financing resources and Bank of Albania’s decisions. According loan usage, the net demand for investment loans increased, while the demand for working capital was positive.

Banks expect further easing of business credit standards in the third quarter of 2009. Expectations point to positive turning point for the demand in the forthcoming quarter. The expectations balance is positive either for the demand from small-and medium-sized enterprises or from corporations.

Individual loans. Lending standards applied on individual loans tightened in the second quarter of 2009, although at more moderated rates compared to the high
level in the first quarter: the net percentage of banks reporting easing lending standards has increased to -21.6 from -44.3 percent in the first quarter. The lending standards have been more tightened for consumer loans than for housing loan. The net balance of non-performing loans, pointing to -45.2 percent relative to -29.8 percent in the preceding quarter is the main factor imposing the tightening of lending standards in the second quarter of 2009.

In addition to non-performing loans, individual financial situation and the developments in the real estate market continue to provide the main impact on the bank’s tightening lending standards.

Banks report a slight growth of individual demand for loans relative to the fall in the previous quarter. Consumer loan demand has been lower than demand for housing loans.

Banks do not expect further tightening of lending standards for households in the third quarter of 2009. Banks’ expectations show a positive demand for the third quarter of the year.

Lending activity by currency. For the third quarter of 2009, banks expect higher ALL-denominated lending and lower foreign currency-denominated lending. This tendency has been shown since the second half of 2008. Banks expect higher interest rates on foreign currency loans in the following quarter. The net percentage of banks expecting higher interest rates on foreign currency-denominated loans is 12.3 percent relative to 4.7 percent of banks expecting higher interest rates on ALL-denominated loans.

Banks’ experts have also assessed the factors encouraging businesses and consumers to apply for foreign currency-denominated loans. The interest rate spread and the source of income in foreign currency appears the key driving force boosting businesses’ demand in the second quarter. The interest rate spread and the goods’ prices purchased in foreign currency remain the key driving force encouraging households’ demand for foreign currency-denominated loan.

**FISCAL SECTOR FINANCING**

Banks’ participation in the Government securities’ primary market has increased owing to the improved liquidity situation in response to the positive developments in deposits and the ongoing presence of the Bank of Albania in the money market. In the meantime, the further widening of the budget deficit in May kept the demand for funds high. However, certain privatisation receipts in May and June have sustained the decline of liquidity pressures in the money market. In turn, this led to stable interest rates in securities market during these months.
Government securities portfolio of the banking system grew by about ALL 8.3 billion in May, owing mainly to the monthly increase of long-term securities investments amounting to ALL 5.2 billion and of one-year securities by about ALL 3.1 billion. The shifting tendency of short-term securities portfolio of up to one year to long-term securities, mainly of 5-year maturity term, persisted in the early part of 2009. Compared to the end of December, banks’ T-Bill portfolio reduced by ALL 5.4 billion, while it increased by ALL 7.5 billion in 5-year bonds.

A higher participation of households financing Government needs is observed during the first 5 months of 2009. Households’ portfolio in the primary market grew by about ALL 5 billion, financing about 11 percent of Government domestic debt. A portion (about 1/5) of savings withdrawn from banks in the last quarter of 2008 is believed to have been partially channelled into the Government securities market.

IV.2 LABOUR MARKET AND WAGE PERFORMANCE

LABOUR MARKET

Unemployment rate was 12.68 percent in the last quarter of 2008, while in the preceding quarter it was 12.62 percent. The increase of unemployment rate was mainly triggered by the increase in the number of unemployed persons compared to the third quarter of 2008.

According to the data on the first quarter of 2009\(^{38}\), total employment indicator and the number of unemployed persons declined relative to the previous quarter.
PERFORMANCE OF WAGES

The annual change rates of average wage in the public sector and economic enterprises were about 7 percent in the last quarter of 2008. In quarterly terms, average wage rose in both public and private sector.

### Table 8 Employment and unemployment indicators

<table>
<thead>
<tr>
<th></th>
<th>Q1-08</th>
<th>Q2-08</th>
<th>Q3-08</th>
<th>Q4-08</th>
<th>Q1-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employed persons</td>
<td>165,427</td>
<td>230,548</td>
<td>164,019</td>
<td>234,795</td>
<td>163,767</td>
</tr>
<tr>
<td>Number of unemployed persons</td>
<td>140,008</td>
<td>139,985</td>
<td>140,140</td>
<td>141,700</td>
<td>141,382</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>13.04</td>
<td>12.9794786</td>
<td>12.62</td>
<td>12.68</td>
<td></td>
</tr>
</tbody>
</table>

Source: Ministry of Labour, Social Affairs and Equal Opportunities

### PERFORMANCE OF WAGES

The approval and entry into force of the Government decision on the rise of wages starting from 1 May 2009 is assessed to have provided its effect on the increase of average wage, initially in the public sector. The increase of monthly minimum wage per employee nation-wide to ALL 18,000, about 13 percent higher on annual basis and 6 percent on quarterly basis, is expected.
to affect the performance of wages in the private sector for the forthcoming quarters of 2009.

IV.3 PRODUCER AND IMPORT PRICES

Producer and import prices in the first half of 2009 were mainly affected by the favourable conjuncture in the international markets with respect to raw materials prices. The annual rise of import prices dropped from 3.7 percent in 2008 to 1.1 percent in the first half of 2009, while producer prices fell from 6.5 to -1.2 percent in the first quarter of 2009. Inflationary pressures generated by producer and import prices on the overall level of consumer prices have been declining; however, the depreciation of the Albanian Lek vis-à-vis the U.S. dollar and Euro is assessed to have provided an inflationary impact on the performance of imported inflation.

Producer prices fell by -1.2 in the first quarter of 2009 compared with the first quarter of the previous year. Starting from mid-2008, their downward trend was mainly triggered by the favourable economic climate in the international conjunctures.

The analysis of cost performance by sectors shows lower rising rates of producer prices in the main production sectors at home. Processing industry, sharing the main weight in the PPI basket, increased slightly by 0.6 percent y-o-y. “Food industry”, the main sub-item in this item, recorded a negative annual change of -5.4 percent for the second quarter in a row. The decline of producer prices in this industry has eased the fall of processed foods’ consumer prices. Production prices in “extracting industry” moderated their growth rates. In the first quarter of 2009, the annual increase of producer prices in this industry was 5 percentage points lower than the average annual growth of 7 percent in 2008. The lower demand and prices in this industry in the international markets and the re-exporting nature of domestic companies operating in this industry are assessed to have mainly triggered the lower growth rates.

<table>
<thead>
<tr>
<th>Quarter</th>
<th>PPI Total processing industry</th>
<th>PPI Food industry</th>
<th>CPI Processed foods</th>
<th>PPI Extracting Industry</th>
</tr>
</thead>
<tbody>
<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</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>
<tr>
<td>Q1:09/Q1:08</td>
<td>-1.2</td>
<td>0.6</td>
<td>-5.4</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Table 9: Annual change rates of some PPI and CPI components (in percent)

Source: INSTAT and Bank of Albania estimations
Export-related producer price index fell by 2 percent in the first quarter of 2009. The average annual increase of this index was 9.3 percent in 2008. “Processing industry”, the main branch in industry, recorded an annual growth of 2.5 percent during this quarter. Global demand weakening seems to have exerted pressures over the domestic exporting companies, which opting for lower profit margins have reduced the prices of their export-related products.

Producer price index for the domestic market has also declined. Producer prices at home fell by 0.1 percent in the first quarter from the average annual rise by 5.1 percent in 2008. The fall of producer prices in food industry by 4.7 percent in annual terms provided the main contribution. The downward tendency of producer prices for the domestic market has been also reflected in the low rising rates of consumer prices at home in the first quarter.

Foreign prices have followed a declining spiral starting from the third quarter of 2008. In the first half of 2009, foreign consumer price index increased by an average of 1.1 percent y-o-y, 2.6 percentage points less than the previous year average. Consumer prices in Italy and Greece recorded the lowest annual rise of the last 10 years in June - by 0.5 percent, respectively. The decline of consumer prices in these countries owed to the fall of raw materials prices and the economic growth slowdown.

Despite the low foreign prices, imported inflation has been increasing due to the depreciation of the Albanian Lek in the recent months. In annual terms, the Albanian Lek has depreciated by 21.3 and 5.5 percent vis-à-vis the USD and EUR in the first half of 2009. Notwithstanding the sharper fall of foreign prices in the second quarter, annual inflation at home has maintained an upward trend for this period, from 1.9 percent in March to 2.3 percent in June. The higher headline inflation was mainly triggered by the increase of traded inflation, while non-traded inflation maintained the previous months’ similar rates.

Foreign prices are directly and instantly reflected in performance of food prices at home. Average annual inflation of “food and non-alcoholic beverages” in Albania and abroad (Italy and Greece) increased by 3.5 percent in the first quarter of 2009. In the second quarter, the average annual rise of food prices at home (5.0%) was twice higher, attesting to the role of the exchange rate role in the increase of food price inflation.

Import prices continued to be strongly affected by oil price fluctuations in the international markets. In the first half of 2009, the Albanian oil market attested to an ever-increasing integration with the international market,
reflected the fluctuations in prices without the one-month lag as in 2008. Average oil price in the retail market was ALL 04 per litre, down by about 26 percent from the same period of the previous year. Following the strong fall of oil price in February 2009, the preceding period manifested an upward trend in monthly terms, which peaked in June. This performance is in line with the oil performance in the international market, which is to a large extent transmitted to the performance of oil price in the domestic market against a background of ALL depreciation vis-à-vis the U.S. dollar.

Indices of CPI basket items, which directly or indirectly rely on the oil price fluctuations in the market, have followed the dynamics of changes of this product in annual and monthly terms. Prices of “Service to personal transportation vehicles” recorded an average annual fall by 12.3 percent and a rise in monthly terms. By contrast, prices of “transportation services” showed an upward trend, owing mainly to the rise in urban transportation prices in 2008. In June, these prices were declining, due to statistical effect.

### IV.4 EXPECTATIONS FOR THE PERFORMANCE OF PRICES IN ECONOMY

Expectations for inflation in the short and medium-term period have been declining in first half of 2009, remaining however within the Bank of Albania 2-4 target. Consumer expectations for the annual inflation after one year are lower than other economic agents’ (businesses and banks). Annual inflation after one year, as expected by consumers, is +1.1 percent compared to 2.6 percent, as expected by banks and businesses.
After increasing sharply in the second quarter of 2008, expected producer prices manifested a downward trend in the first quarter of 2009, increasing slightly in the second quarter (see Chart 2). However, they remained lower than their historical average.

Industry-related businesses expect producer prices to drop further in the second quarter of 2009, with the balance of expectations reaching negative values. Expectations for producer prices in this sector are 6.5 percentage points below the historical trend. By contrast, construction and services-related businesses reported higher producer prices in the second quarter. Services-related businesses appear more optimistic, expecting producer prices to rise above the historical average. Although construction-related businesses expect producer prices to increase, they expect them to remain below their historical average.
V. FINANCIAL MARKETS, INTEREST RATES AND THE EXCHANGE RATE

Monetary conditions components - interest rates and the exchange rate – have been affected by the uncertainty in the financial market and the heightened liquidity shortages in the first half of 2009. Short-term interest rates in the money market dropped owing to the positive effect of the central bank’s intervention and the easing of monetary policy. By contrast, long-term interest rates increased due to risk re-evaluation. Moreover, the exchange rate has fluctuated dramatically and has maintained a depreciating trend.

MONEY MARKET

The liquidity needs arising from the withdrawal of deposits from the banking system in the last quarter of 2008 persisted in the first half of 2009 as well. This situation triggered upward pressures over the interest rates in the money market, reflected in higher risk premium for longer-term interest rates. In view of containing these pressures, boosting lending activity in the money market and calming the market participants down, the Bank of Albania intervened by injecting temporary and unlimited liquidity through the open market operations. In November 2008, the form of reverse repurchase agreement auctions changed from determined to undetermined amount and fixed with the base interest rates. In addition, in order to create favourable conditions for banks’ lending activity, the Bank of Albania has also employed the reverse repurchase agreement of 3-month maturity term. At the end of the first half, lending to the banking system through open market operations amounted to ALL 15.3 billion in October. The base interest rate cut from 6.25 to 5.75 percent at end January, along with the narrowing of the corridor for the central bank’s lending (December 2008) led to lower banking system’s financing cost. Worth noting is that these measures were taken against a background of downward inflationary pressures; hence, the achievement of the main Bank of Albania targets was not jeopardized.

The improved liquidity situation, along with the contained withdrawal of deposits in the last months, fuelled the growth of lending activity in the money market. The volatility of interest rates moderated while the base interest rate cut by 50 basis points at end January was completely transmitted to the interbank market. The measure taken by the Bank of Albania in March, on non-usage of overnight deposits by lending institutions, seems to have been reflected in the growth of the volume exchanged in the interbank market and in lower interest rates.
In response to the easing monetary conditions and improved liquidity situation following the open market operations, the interest rates in the interbank market decreased in the first quarter of 2009. The latter remained close to the base interest rate during this period. The second quarter attested to stable liquidity conditions and improved security in the market, fuelled by the first signs of deposits return to system. After the low figures recorded in the first two months of 2009, the traded volume in the interbank market grew. The temporary absence of overnight deposit facility seems to have been another factor to have encouraged the trading of funds in the interbank market, hence attesting to more efficient agents’ behaviour in this market. The allocation of liquidity in the system has been uniform, leading to lower interest rates volatility.

Average daily lending grew by ALL 0.6 billion in the second quarter from ALL 1.8 billion in the previous quarter and ALL 1.5 billion in the last quarter of 2008. Banks continue to prefer daily transactions, while one-week transactions have grown moderately in the recent months. In average terms, overnight interest rate dropped to 5.08 percent from 5.42 percent in the first quarter and 6.33 percent in the last three months of 2008. In September and October, overnight interest rate exceeded the base interest rate, while remaining below it over the course of the current year. Interest rates of one-week transactions fluctuated close to the REPO rate of the same maturity term averaging 5.74 percent, down by 94 basis points from the last quarter of 2008.

**PRIMARY MARKET**

Government securities yields in the primary market have maintained an upward trend, which began in the late 2008. To a certain extent, the higher yields in the early months of 2009 seem to have reflected the low participation of banks in Government securities auctions. Despite the increasing banks’
participation in the following period, it did not moderate the upward pressures. Higher yields for all maturities, at a time when the base interest rate was cut by 50 basis points and banks’ participation was high, attests to the higher risk perception from banks. This performance has been also encouraged by the increase in securities issue.

12-month T-bill yield experienced the sharpest increase. As at end the first half of 2009, 12-month T-bill interest rates reached 9.24 percent, up by 0.48 percentage points from the end of December and 0.93 percentage points from the same period of the previous year. 6 and 3-month yields manifested the same performance, although at more contained rates. At end-May, 6-month yields recorded 7.67 percent, up by 0.22 percentage points from end-December. In the meantime, 3-month yields maintained similar levels as in the previous periods.

Bank of Albania
Bonds in the primary market manifested similar trends to T-bills. Bond yields increased owing to the higher perceived risk, while participation in auctions was satisfactory in the last months. In June, 2 and 5-year bond yield (of variable interest rate) marked 9.45 and 10.92 percent, respectively, up by 50 and 75 basis points from the preceding half. Higher yields of these instruments have reflected the increase of 12-month T-bill yields and the higher margin. In the April auction, 3-year bond yield increased by 0.63 percentage points, to 9.61 percent.

**INTEREST RATES ON NEW DEPOSITS AND LOANS**

In the first half of 2009, interest rates for both main currencies, the ALL and the EUR, were relatively high compared with the base rates. These rates have reflected the liquidity shortages and the higher risk premium.

Average interest rate on new ALL time deposits was 5.36 percent in the first 5-month period, down by 16 percentage points from the last quarter of 2008. The downward trend of ALL deposit interest rates after January 2009 reflected the termination of early-year banks’ promotional offers and the base interest rate cut. This trend seems to have shifted in the early summer when the interest rates on deposits reached 5.45 percent in May.

Euro-denominated time deposit interest rates have maintained the same tendency as ALL interest rates, being conditioned by the liquidity situation and the risk re-evaluation in the domestic market rather than by the respective interest rate tendency in the international market. Even after the cut of base interest rate by the European Central Bank by 1.25 percentage points from December 2008 (2.50 percent) to May 2009 (1.25 percent), average interest rate on Euro-denominated time deposits continued to maintain high values. For the same period, average interest rate on new Euro deposits dropped by...
0.55 percentage points to 2.58 percent. The decline was mostly applicable on short-term maturities, while the interest rates on one-year deposits increased in May, hence maintaining high margins at home in order to attract foreign currency from the seasonal inflows.

The interest rate spread of ALL and EUR 12-month deposits maintained the same level as in early 2009, owing to almost similar policies applied on both currencies.

In the first five months of 2009, the banking system tightened lending in both currencies, reflecting it in higher interest rates as well. Their spreads with the benchmark rates have widened owing to higher perceived risk by banks and/or the maintenance of spreads with the respective deposit interest rates.

The weighted average interest rate on new ALL-denominated loans increased by 0.96 percentage points, to 13.81 percent in the first 5-month period. In addition to higher reference rates these loans are indexed to (mainly T-bill yields), this performance reflects the tightening lending conditions during this period as well. In terms of maturity, higher weighted average interest rate reflects the increase of interest rates on ALL-denominated medium-term loans. This tendency is in line with the banks’ preference to tighten the long-term and investment-related loans more, in response to banks’ perception of higher uncertainty in the country. By contrast, short-term interest rates (0-6 months) were downward and were mainly extended to meet businesses’ working capital needs.

Average interest rate of Euro-denominated loans decreased in this period, but not at the same rate as the reference rates in the international market (EURIBOR and LIBOR). They were characterized by the preservation of high spreads with the deposit interest rates in the same currency and the general perception for more tightened lending in foreign currency. Average interest rate on Euro-denominated loans was 7.74 percent in January to May, down by 0.45 percentage points from the previous year. In the meantime, EURIBOR in the international markets has dropped by 2.79 percentage points. The opposite direction of ALL and EUR loan interest rates led to higher spread between both currencies. Against this background, the tightening of other criteria, in addition to the price, has triggered the decline of lending in foreign currency and the fall of
demand for the latter. In the first half of 2009, the spread between new ALL and EUR-denominated loan interest rates was about 6.07 percentage points, widening by 1.40 percentage points from the previous year.

Intermediation cost (loan/deposit spread) was high throughout 2009 for both currencies. After the upward trend in January, this spread was higher than in 2008. In May, this indicator stood at 8.26 percent for ALL and 5.12 for EUR.

EXCHANGE RATE

In average terms, the performance of the ALL in the first half of 2009 vis-à-vis its major foreign currencies basket maintained the same depreciating tendency as shown since last October, when the crisis that swept the international financial markets hit the domestic foreign exchange market for the first time. In annual terms, the changes in the NEER moved within a band of -4.2 percent to -10.2 percent (7.95 percent on average) during this period. Notwithstanding the escalating deprecation of the NEER in June, which corresponds to the beginning of the summer (tourism) season and entry into the foreign exchange market of a portion of contracted funds from the international market, the downward rates have been more moderate. This is also witnessed by the positive change (1.14 percent) of this indicator in monthly terms.

From a regional viewpoint, the analysis of the EUR/ALL ratio attests to the return of the depreciating tendency. This has not been noticed in Albania yet, although in marginal terms the ALL seems well-positioned.
The factors affecting the performance of the exchange rate in the first half of the year are linked to the global crisis and its impact over the domestic market. Here, we can mention the decline in remittances, exports, in foreign currency loans and the shaked economic agents’ confidence. In addition to these factors, the seasonal effect, which characterizes the growth of demand for foreign currency in the early months of the year, seems to have led to an imbalanced demand-supply ratio.

In the first half of 2009, ALL depreciated against both main currencies in the domestic foreign exchange market. The ALL depreciated vis-à-vis the U.S. dollar by 21.3 percent in annual terms, and 11.6 percent relative to the second half of 2008. ALL vis-à-vis the U.S. dollar has entirely reflected the EUR/USD performance in the international markets. This is also attested by the relatively moderate volatility in the USD/ALL during this period compared with the last quarter of 2008 when the U.S. dollar was strongly hit by the financial crisis.

During the first half of the year, the ALL depreciated vis-à-vis the EUR by 5.54 percent relative to the same period of 2008 and 5.79 percent to the second half of 2008. Although in the first quarter of 2009, the euro seemed to gain ground against the ALL at an escalating rate, this trend was reined back in April and June in favour of the domestic currency, showing a slight appreciation by 0.16 and 0.57 percent, respectively. The appreciation of...
the ALL is mainly a result of the seasonal supply. The analysis dynamics in this ratio shows that the volatility was higher in the first quarter of 2009 than in the entire 2008. In the second quarter of the present year, this indicator dropped moderately, reflecting partially the presence of monetary authorities in the market.

The depreciation of the ALL nominal effective exchange rate (NEER) and the more rapid rise of prices at home than the foreign prices led to the depreciation of real effective exchange rate by 6.64 percent y-o-y in the first half of 2009. In the medium and long-term period, real effective exchange rate of the ALL is determined by the underlying economic factors such as the balance of payments, the competitive position of domestic goods and the interest rate spread. Based on the balance of payments’ performance, in January to April 2009, the trade balance contracted moderately, which in turn may to a certain extent, have reflected the decline of remittances and the lower credit growth rates. Nevertheless, the upward tendency of unit labour cost in the last two years, may lead to wider trade deficit and higher demand for foreign currency. Along the same line, current account performance in the first quarter of 2009 attested to the fact that the performance of this balance sheet item will strongly depend on the recovery duration of the economies the Albanian emigrants reside the most (seasonal and temporary emigration) and on the performance and share of capital and financial account items financing the current account. On the other hand, the further improvement of the liquidity situation in the market will allow the effective transmission of monetary policies, reflecting the increased base rates in the market, which will sustain the positive exchange rate performance.

IV. EXPECTED ECONOMIC AND MONETARY DEVELOPMENTS DURING 2009-2010

Albanian economy was obviously affected by the world macroeconomic developments, along with changes in internal factors. Decelerated economic growth rates in the world economy and particularly the recession in many Euro-zone member states are transmitted to the slow-down of Albanian economic activity. The contracted aggregate demand in trading partners, employment reduction and deceleration of private foreign capital circulation among countries have provided their impact through external sector indicators of economy. Parallel to that, deposit withdrawal from the banking system, tightening of monetary supply and the rise of uncertainty in the market slowed down the economy demand. The overall economic activity was faced with more limited financing resources, converted into aggregate demand slowdown.

Economic downturn and the contracted aggregate demand in trading partners affected the export performance and hence, the encouragement of demand in Albanian economy. During last years, exports have had a growing tendency, amounting to about 30 percent of GDP in 2008. Data on current account in the first quarter of the year reveal their drop relative to first quarter of 2008. The confirmation, in general, of the falling tendency in exports during
2009, would contribute to downward aggregate demand performance in the economy.

Further progress of economic activity carries over additional uncertainty in terms of financing the economic growth in the long run. Beyond the growth factors of production and technological progress, remittances were a stable source of economic growth in the recent years. As a share of GDP, remittances account for 10.15 percent. However, in the last three years, they have followed a clear declining trend from 14.6 percent of GDP in 2005, down to 10.6 percent in 2008. In annual terms, remittances marked a fall of about 6 percent in 2008 relative to 2007, while for the first quarter of 2009 the annual drop was 7.7 percent. The ongoing downward trend of remittances makes difficult the consumer financing and increases opportunity cost of investments. In absence of the balancing of this factor, mainly through the rise of productivity and foreign direct investments, economic growth would tend to slowdown.

Developments in international capital markets and the uncertainty in undertaking initiatives are expected to affect the performance of real economy at home. In the presence of liquidity constraint in international markets and increased risk, the volatility of foreign direct investments and of capital ones from abroad require higher return rates. In terms of an emerging economy, this uncertainty of access to foreign capital markets is translated into more difficulties for preserving previous investment levels. Financial inflows, in the form of capital and foreign direct investments, have financed an increasing share of the demand in economy. Thus, in 2008 they accounted for 17 percent of GDP, against 9 percent in 2007 and 5 percent in the previous years. In terms of slowdown of alternative financing resources, the preserving of this level of financial inflows poses a challenge for achieving an economic growth at the levels of the previous years. Current financial and macroeconomic developments make difficult the finding of domestic resources for financing the economic growth. Finally, deposit withdrawal from the banking system in the last quarter of 2008 and at start of the current year, tightened the monetary supply and slowed down the financial intermediation process. Interventions in money market to meet liquidity needs in ALL and the relaxation of financial situation have met the demand for ALL-denominated monetary assets.

Also, beyond the factors induced from the global environment, in the presence of trade terms deterioration, the economy is expected to be faced with increasing needs for liquidity. Improvement of trade terms provides an equilibrated alternative for maintaining the economic growth rates in the long run and the macroeconomic balance. The undeveloped capital markets at home do not help the self-adjustment of trade terms and of the overall economy.

Under these conditions, the compilation and implementation of macroeconomic policies should sustain the economic stability in the medium and long run. Their coordinated compilation should aim at controlling the aggregate demand and increasing the savings rates in line with a stable long-term level of support to investments and the economic growth.
ENDNOTES

1 Exports and investments fell by respectively 30.6 and 48.9 percent in quarterly terms. At the same time, imports fell by 36.4 percent whereas consumer spending grew by 1.4 percent on a quarterly basis.

2 BRIC countries are Brazil, Russia, India and China.

3 The fall in both categories was respectively 12.6 and 21.7 percent.

4 In this context, the Euro and the US Dollar.

5 The US dollar appreciated by approximately 13 percent against the Euro during the first half of the year in annual terms.

6 The higher base effect, given that the primary commodities underwent a considerable price hike during the first half of 2008.

7 Inflation distribution by months: 2.1, 1.8, 1.6, 1.9, 2.1, 2.3 (%)

8 In Albania’s case the Monetary Condition Index (MCI) is a weighted average of the difference of the base rate and the nominal effective exchange rate (NEER) against their corresponding values in a base period. Starting from the second quarter of 2009, the base period is December 2005. The MCI ratio is 1.82:1, i.e. the effect on demand of a 1.82 per cent depreciation of exchange rate can be offset by 1 percentage point increase in the interest rate. It’s worth noting that an increase of the MCI would be viewed as a sign of monetary policy tightening at home, but not as the monetary policy stance.

9 The average of two measures (permanent exclusion and trimmed average).

10 As of June and the second quarter of 2009 it was 6 and 3.7 percent respectively.

11 The methodology of estimating the housing process index is based on the assumption that the prices that are listed on sale are the final transaction prices. The majority of the houses listed for sale are denominated in European currency. To estimate the index for the second quarter, two methods were followed. According to the first method, the prices in Euro are denominated in lek with the current exchange rate. The second method has the prices listed in Euro converted to the exchange rate of a year ago. This assumes that the seller has not taken into account the devaluation of lek in listing the house in Euros. We would like to emphasize that the survey covers only the city of Tirana.

12 House selling price to rent ratio is the simplest indicator used to assess whether housing is overpriced, comparing the current to historical values of this ratio.

13 Values in percent to GDP are calculated as ratios of cumulative data for the period Q2:2008- Q1:2009 to GDP.

14 Nominal GDP refers to IMF estimates for nominal GDP in 2009: 1,129,000 million lek (PRGF, 6th review).

15 Data on foreign trade for May 2009 are preliminary. The Bank of Albania reserves the right to review them, i.e. to reflect changes in these values at a later period.

16 Unit value index for exports and imports, INSTAT.

17 The other indicators do not have seasonality and are considered in their original form.

18 Compared to the first quarter 2008, income fell by 13.9 percent and expenditures by 7.1 percent.

19 These transfers amounted to EUR 213.4 million in Q1:2009 compared to EUR 242.9 million in the previous year.

20 Their relative indicator in Q1:2009 is 10.5 percent. The value of the above mentioned ratio refers to cumulative data for the period Q2:2008- Q1:2009.

21 FDI increased by 1.9 percentage point compared to the first quarter 2008.

22 Six-month GDP according to IMF estimates.

23 Values are obtained from the ratio of 6-month realization to 6-month GDP posted by the IMF in PRGF program.

24 Ratios are built according to 6-month realization of each year, as a share of 6-month GDP of the respective year.

25 Including a part of privatization proceeds of ARMO, OSSH and a part of AMC stocks, totalling ALL 20.8 billion.

26 The bid to cover ratio came in at less than 1 for the first quarter of the year. Upon increased demand of second-tier banks for instruments issued by the government, this ratio resulted above
1 for the second quarter of the year.

27 This figure refers to primary budget moving sum for July ’08 - June ’09.

28 \( Y = GNP = C_d + I_d + G_d + EX \); where \( C_d \): domestic consumption; \( I_d \): domestic investment; \( G_d \): government expenditure; \( EX \): Exports – Imports

29 Bulgaria, Rumania, Croatia, Montenegro, Serbia, Macedonia, Albania, Bosnia-Herzegovina

30 Seasonal growth measures the quarterly growth of monetary indicator adjusted to annual terms.

31 Excluding exchange rate effects.

32 Loan portfolio analysis is based on the series excluding exchange rate effect, except when otherwise stated.

33 Difference of actual credit balance from equilibrium level.

34 Series of credit cleared seasonally from exchange rate movements.

35 Compared to 35% in December 2008

36 Mainly consequent to depreciation of the national currency against the main currencies.

37 The reduction of foreign demand, the protectionist policies of many countries in response to global financial crisis, etc.

38 Source: Ministry of Labor, Social Affairs and Equal Opportunities, May 2009.

39 At the end of each quarter.

40 The decision on the rise of wages applies to public sector employed persons.

41 The Council of Ministers’ decisions on the minimum wage became effected starting from 1 May 2009.

42 Export price index analyzes the performance of producer prices of goods exclusively designated for export purposes.

43 Calculated as the weighted average of consumer prices in Italy and Greece.

44 Expectations of inflation and producer prices used by the Bank of Albania are measured based on the information provided by the surveys held with businesses, consumers and banks.

45 Consumer inflation expectations are estimated by the Bank of Albania by quantifying qualitative expectations. The qualitative responses obtained from the consumer confidence survey are converted into quantitative measures of inflation expectations by using the adjusted probability method.

46 Bid/cover ratio in bond auctions was higher than 1 on average.

47 NEER – Nominal Effective Exchange rate, measured against both currencies according to an approximate share they have in foreign trade, EUR (80 per cent) and USD (20 per cent). A positive change of the NEER implies the appreciation of the lek.

48 Measured as the quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.

49 The financing of current account through foreign direct investment sustains the exchange rate stability.
SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI
At the Joint Press Conference with the IMF Mission Chief for Albania, Mr. Gerwin Bell and the Minister of Finance, Mr. Ridvan Bode
April 7, 2009

The Bank of Albania’s Supervisory Council has pronounced directly and transparently on risks our country’s financial stability will be faced with over the current year. In its latest statement on “Financial Stability over the second half of 2008”, and meeting the obligations deriving from the Law “On the Bank of Albania”, an explicit rating of risks has been made, which I would like, availing myself of this opportunity, to once more point out to the public:

• First, the economic growth rate slowdown over 2009 makes the achievement of fiscal policy indicators in line with 2008 year-end forecasts difficult. External trade developments will impact on reduced collection of budget revenues, while the tightening of financial conditions in the economy negatively affects the banking sector’s ability to finance the budget deficit. Therefore, in order to achieve the target on budget deficit level, reallocation of public expenditures according to importance, at the needed quantity and throughout the financial year is necessary. In practical terms this means that whenever possible, all the efforts should be made to maintain the sources of revenues, to find alternative financing sources, to postpone non-urgent expenditures, to re-define projected expenditures for this year, which are not yet contracted or effected.

• Second, external sector’s performance in the economy, mainly in the form of export slowdown, reduced remittances and increased imports, affected the foreign exchange market equilibrium, exercising pressure on the national currency’s exchange rate at the beginning of the current year. The flexible exchange rate is a correcting instrument, which automatically helps preventing external sector misbalances in the economy. However, over a shorter run, fast and uncontrolled exchange rate fluctuations negatively affect the psychology of the public, thus concealing speculative operations of different subjects. Hence, premises are created for contagion, with negative effects on operators’ confidence in the national currency and in the capability of foreign currency borrowers to timely repay their debts. Expected reduction of economic growth rate for 2009 will reflect the reduced domestic demand and therefore, it is likely to be associated with a drop of its share in terms of foreign commodities. As a result, the overall trade volume may decline, effecting a necessary correction of current account deficit of the country’s economy and putting foreign currency supply/demand factors in a more stable balance.

• Third, it is necessary to recover the stable paces of public deposit
growth in the banking sector. Only in this way, the coverage of an increasing clientele with banking products and at more beneficial costs will be enabled. I repeat, the banking sector’s position concerning liquidity indicators and business capitalization is good and its constant surveillance is a priority of the Bank of Albania. We are confident that the last decision of the Albanian Parliament, which adopted an increase of the whole value of deposit insurance to ALL 2.5 million, will impact on a faster return of withdrawn deposits to the banking system. The current level of deposit insurance, likewise that of the European countries, fully and forever guarantees the savings of the major part of Albanian households. At present there are no objective reasons for the people to be concerned about the insurance of their savings held at banks. Every reluctance on putting savings in banks would unnecessarily increase the value of the missing income, due to non-benefiting of interests and other banking services. I underline that the Albanian banking sector is the best place, where our households should place their savings, thus increasing their values.

• Fourth, the returning of deposits to the system is necessary also for enabling a better financial performance of the banking sector, in terms of financial soundness. During the current year, the banking activity is expected to be less profitable, as a result of reduced lending and increased costs, in order to add deposits and provisioning for covering non-performing loans. It is important that the Albanian banking sector, after some years of a satisfactory profit, has mostly utilized it for firming up the banking sector’s capital. Moreover, through a specific regulatory act, the Bank of Albania has requested from the banking sector not to allocate the 2008 profit, in the form of dividend. In this way, banking activity capitalization is further strengthened, providing more guarantees for the financial soundness of the banking sector. Recently the Bank of Albania has been carrying out consecutive tests, to find out how the banking sector would react, if faced with ever more pessimistic scenarios. Analyses obtained from numerous stress-tests made on the whole system and on individual banks reveal that neither the banking system in general, nor any banks of systemic importance in particular have been affected in terms of liquidity and capitalization level. In spite of the expansion of risks spectrum and a more difficult year for the extension of the banking activity, the financial system and the banking sector will remain stable.
Honourable Mr. Chairman of the Commission,
Dear Ladies and Gentlemen,

It is my pleasure to be among you again in this annual meeting. The Bank of Albania considers this forum not merely as a fulfilment of its legal obligation, but also as an opportunity for enhancing its transparency and accountability.

I will present in my speech an analysis of the Albanian economy over the past year and a summary of the Bank of Albania’s work on the fulfilment of its legal mission and other commitments in view of strengthening the safety and raising the efficiency of the Albanian banking system. Also, availing myself of the opportunity of this public communication, I would like to share with you our views on the challenges the Albanian economy is faced with and the right path for their solution. The Bank of Albania deems that the addressing of these challenges should be in the centre of attention and a top priority for economic policies.

Preceding the conclusions of Bank of Albania’s analyses, I would like to emphasise right from the beginning that the country’s economic activity has performed on sound bases. The Albanian economy has fulfilled a number of prerequisites for having a stable and long-term economic growth, giving primary importance to macroeconomic stability of the country. However, in the presence of current challenges the Albanian economy is being faced with, these bases should be safeguarded and further strengthened, through the formulation of appropriate economic policies by the relevant authorities and the review of economic agents’ development plans.

1. PERFORMANCE OF ALBANIAN ECONOMY DURING 2008

Allow me to make in the following a brief retrospective analysis on the performance of the Albanian economy during 2008.

GLOBAL BACKGROUND

The world economy experienced a constant deterioration throughout 2008. The world economic growth moderated to 3.4 percent in 2008, from 5 percent in the preceding four-year period.

The most striking 2008 highlight was the financial turmoil and its spread to the real economy. The complex nature of derivative financial instruments,
employed at most in the latest years, raised uncertainties about the assessment of certain institutions’ exposure to financial instruments qualified as toxic. This uncertainty shifted to the lack of confidence and termination of financial market operation, impeding the smooth operation of the lending system to the economy. Under these circumstances, the real economy was instantly affected by the lack of funding for consumption and loans, leading developed countries to recession. The high inflationary pressures over the first half of the year, conditioned by strong economic growth and reflected in price hikes of oil and raw materials, were significantly dampened during the second half of the year. Monetary and financial markets have experienced a great volatility. Risk re-evaluation in financial markets was associated with securities price cut. Also, interest rates, exchange rates, stock prices and trade volume were obviously volatile, depending on market news and on the perceived risk of the situation.

ECONOMIC GROWTH

Against this turbulent global background, the Albanian economy has had a comparably positive performance. Expecting confirmations from official statistics, the Bank of Albania deems that the country’s economy has grown in line with the year-start projections. This growth has reflected the dynamic development of some sectors of the economy, supported by increased consumption and investments and constant structural and infrastructural improvements in the economy.

The country’s economic growth has been sustained mainly by the strong domestic demand, which remains the main generator of economic growth. Consumption, investments and government spending increased over 2008. External demand in the form of exports increased rapidly during the last years, but it still remains at low levels for sustaining the country’s economic growth. The country’s economic activity has been financed mainly from domestic sources. Due to its high liquidity during 2008, the banking system has been able to respond to the economy demand for funds through increased financial intermediation. The banking loan portfolio increased by 7.3 percentage points of GDP during 2008.

The economic activity at home was presented in two different pictures during 2008, significantly affected by international market developments.

Official statistics indicate a significant growth in the economic activity volume during the first nine months of the year, reflected in a higher turnover indicator and an increase in credit volume, in budget revenues and in external trade volume. The overall turnover indicator, which is a proxy of the value added in the economy, increased on average by 17 percent during the first nine months of the year. The highest annual growth rates were noted in construction and trade, while industry, transport and communication present a slowdown of the growth rate compared to the previous year. The last quarter presented a qualitatively different picture of economic developments. Under the influence of the global economic and financial turmoil, the economic
activity showed signs of slowdown, while monetary indicators underwent considerable volatility.

The country’s economic activity slowdown during the fourth quarter of the year was signalled by a number of indirect indicators, such as: deterioration of the economic trend indicator, resulting from the processing of business and consumer opinions about the current situation of the economy and their expectations; decreased remittances and export slowdown during the second half of the year; and curbing of lending activity during the last quarter.

**CONSUMER PRICE INFLATION**

During 2008 the Bank of Albania fulfilled its legal obligation for maintaining price stability in the economy. Consumer price inflation has fluctuated within the Bank of Albania’s targeted rate. Annual average inflation rate settled at around 3.4 per cent for 2008, being close to the Bank of Albania’s target of 3 per cent and within the 2-4 per cent tolerance band of the Bank of Albania. The controlled inflation rate reflected the Bank of Albania’s appropriate monetary stance and policy. The right monetary policy led to balancing of the demand and supply factors and anchoring of inflationary expectations to around the Bank of Albania’s target.

Inflation behaviour has not been uniform during 2008. High domestic demand and the shocks from the global economy, in the form of high primary commodity prices, were reflected in high inflationary pressures during the first half of the year. The annual inflation peaked at 4.6 percent in May, recording the highest inflation rate over the last 5 years. These high inflationary pressures were clearly reflected in the increase of core inflation and of non-tradable goods, which are also synthetic indicators of inflationary balances in the economy. The easing of supply shocks and the slowdown of the domestic demand during the last quarter of the year were accompanied by a gradual fall of inflation rate to 2.2 per cent in December. This fall reflects a better balancing of the domestic demand and supply, and lower imported inflation rates.

**BALANCE OF PAYMENTS AND EXTERNAL SECTOR OF THE ECONOMY**

Year 2008 was characterized by a significant growth of economic and trade exchanges. Domestic demand is reflected in the growth of both, the trade deficit and the current account deficit during 2008. The current account deficit is estimated at 14.9 per cent of GDP, mainly affected by the rapid growth of imports and a decline of remittances during the second half of the year, due to increased spill-over effects of the economic and financial crisis on the neighbouring countries’ economies. The trade deficit amounted to EUR 2.4 billion, being 13.1 percent higher than in 2007. However, foreign currency capital inflows have been sufficient to contribute to closing the balance of payments with a positive result for 2008. Foreign reserves of the Bank of Albania increased by about EUR 192 million or by 0.9 percentage points of GDP.
In macroeconomic terms, the high deficit on trade account signals high levels of consumption and investments in the economy, financed from foreign savings in the form of capital inflows. In a longer-term analysis, Albania’s current account deficit is a normal phenomenon in the context of the country’s development level. Especially positive is the fact that the major share of the country’s imports is represented by the imports of machinery and equipments and that of intermediate consumer goods. However, the current account deficit widening is an element that should be constantly monitored, since its financing sources are not always steady and necessary corrections for the current deficit compliance with the available funds for its financing are frequently difficult. Macroeconomic policies should be prudent to ensure long-term sustainability of the balance of payments, as one of the principal aspects of the macroeconomic stability and long-term growth of the country.

**FISCAL POLICY AND INDICATORS**

Fiscal policy is one of the main instruments for stimulating and controlling the economic activity. Due to its weight, the public sector is a significant generator of the economic activity and a determinant of the financial conditions of the economy, interest rates, the exchange rate, and its liquidity.

Fiscal policy was more expansionary in 2008, thus being reflected in the widening of the budget deficit and public debt.

During 2008, budget deficit to GDP reached 5.7 percent, deepening by about 2.2 percentage points in a per annum basis. Public debt level amounted to 55.6 per cent of GDP, from 52.2 per cent in the previous year. Budget revenues and expenditures increased respectively by 15.3 and 22.6 percent during 2008, accounting for 27.3 and 32.9 percent of GDP.

The improvement of public debt management in terms of extending the maturity time-length and diversifying the financing sources is a positive highlight, which has helped to refinance the debt and control its cost impact on debt indicators. However, the Bank of Albania deems that the fiscal policy should not distract attention from maintaining the long-term stability of fiscal indicators and minimizing their impact on financial markets. The fall of budget deficit during 2009 and the commitment for the lowering of public debt in the long run should be constant priorities of the fiscal bodies. In line with that, the Bank of Albania deems that more endeavours should be made in order to improve the expenditures structure, in view of decreasing the share of current expenses and increasing the capital investments.

**MONETARY PERFORMANCE**

Due to the slowdown noted in the last quarter, the money growth rate decelerated slightly relative to the previous year. The average annual growth rate of M3 eased to 12.3 per cent, from 15.8 per cent in 2007. The growth of monetary assets of the economy is attributed mainly to the banking system’s credit growth. The degree of financial intermediation in the economy increased
further. Banking system deposits to GDP increased to 80 percent during 2008, compared to 78 percent in 2007. Credit to GDP increased to 37 percent, recording an annual growth of 7.3 percentage points.

During 2008 deposit developments were characterized by seasonal volatilities. Deposits’ level recorded high growth rates mainly in summer and a marked slowdown in the last quarter of 2008. On the asset side, the banking system’s loan portfolio increased by about 35 per cent during 2008. The credit structure performance revealed a slight shifting of the loan portfolio towards foreign currency-denominated loans. The preference for foreign currency-denominated loans is attributed to their lower interest rates. This consideration would have been accurate in the presence of a stable exchange rate.

It is wrong under Albania’s conditions, where the exchange rate is flexible and the possibility for its depreciating movements can not and should not be excluded. Therefore, the Bank of Albania has concluded that commercial banks’ customers do not pay due attention to the exchange rate risk, when they choose a foreign currency-denominated loan.

Credit growth rate has been decelerating along the year, reflecting both the tightening of lending standards in response to the Bank of Albania’s regulatory measures and the tightening of the system’s liquidity position. The banks’ difficulties in generating adequate liquidity and their more prudential policy in terms of lending, were reflected in the slowdown of credit to the economy growth and of fiscal sector’s financing.

FINANCIAL MARKETS

Albanian financial markets have reflected not only the performance of economic developments at home, but also those of international financial markets. Under these conditions, their indicators, such as liquidity, interest rates, trade volume and exchange rate, have been characterized by higher volatility, however, remaining within the normal parameters of operation.

In a general view, deposit interest rates indicated upward trends for deposits in the national currency and those in Euro. On the contrary, credit interest rates reflected a downward trend during 2008, bringing about reduced intermediation cost of the banking system. In particular, positive is the latest evidence for drawing attention towards ALL credit and raising the competition through interest rates in this market.

In view of meeting its objective for price stability, the Bank of Albania applies a flexible exchange rate regime. It implies that the exchange rate price is freely determined in the market, reflecting the balancing of foreign currency demand and supply forces. During the major part of 2008, the lek’s exchange rate vis-à-vis the foreign currencies was steady, but it started to slightly depreciate by the end of the period. The positive performance of the national currency during 2008 was supported by a number of factors, such as: macroeconomic stability of the country, positive result of the balance of
payments, anchoring of inflation close to the Bank of Albania’s target and approaching of this indicator to that of the Euro area, as well as the positive interest rate spread.

THE BANKING SYSTEM

Year 2008 was characterized by intensive developments in the Albanian banking system. The banking activity grew further throughout the year, both in the quantitative aspect - geographic coverage of the country and intermediation degree -, and in the qualitative aspect - the variety of services provided and the intermediation cost. In the meantime, deposit withdrawals taking place during the last quarter, tested the system’s stability significantly. The developments over this period attested to the fact that the Albanian banking system passed successfully its first test of stability.

This system continues to be committed mainly to collecting deposits and increasing lending activity. Though at moderate paces, the system’s assets and liabilities increased further during 2008. The analysis of the system’s indicators reveals an upward risk level and its downward financial capacity along the year. The banking system performance recorded a downturn over 2008, from the viewpoint of net result performance. This reflected both the enhanced competition in the system and the rapid increase of expenditures for provisioning, particularly during the second half of the year. However, the volatility and the unsatisfactory performance of some of the main indicators has not put at risk the regulatory capital level needed for covering risks deriving from the system. The performance of the above indicators is not regarded as critical, but the dynamics and intensity of development require a more prudent monitoring on an ongoing basis.

2. BANK OF ALBANIA’S ACTIVITY DURING 2008

As the monetary authority of the country, the Bank of Albania’s mission is to ensure price stability in the economy. In order to fulfil its mission, it formulates and implements independently the monetary policy and monitors and regulates the financial market activity in general and that of the banking system in particular. Also, the Bank of Albania is an important and active actor in the country’s efforts for European integration. Let me further make a brief presentation of the Bank of Albania’s work throughout 2008.

BANK OF ALBANIA’S MONETARY POLICY AND OPERATIONS

The Bank of Albania’s monetary policy is formulated and implemented exclusively in view of fulfilling its primary objective, i.e., achieving and maintaining price stability.

Inflationary pressures present during the first half of the year and the shaking of agents’ confidence dictated the pursuit of a prudent monetary policy during
2008. The key interest rate was held unchanged throughout the period, aiming at a better balancing of the demand and supply ratio, and contributing to controlling the inflation expectations in the economy. Along with the strengthening of some banking supervision prudential measures for credit risk management, this policy has brought about a more balanced credit growth and has transmitted proper encouragement for consumption and savings.

The international confidence crisis in early fourth quarter of 2008 encouraged the withdrawal of a portion of deposits from commercial banks in Albania, hence highlighting the lack of liquidity in the banking system. It was reflected in higher interest rates and slower banking activity in the money market. The Bank of Albania intervened in the monetary market by injecting liquidity, in order to meet the banking system needs for liquidity.

The dynamics of 2008 events required the usage of all open market instruments and modification of some of them. The Bank of Albania has injected liquidity of weekly, monthly and quarterly terms. It has increased securities’ basis that may be used as collateral and has reduced the upper limit of the interest rate corridor of its operations. Also, in order to better satisfy the banks’ needs for liquidity, the Bank of Albania changed the main auction type from fixed-amount auctions into fixed-price auctions. Also, the Bank of Albania has induced more flexibility to banks for short-term liquidity management, by raising the quantity of the daily required reserve usage. All these operations have served for settling down the liquidity situation and attenuating its impact on interest rate rise. They have also prevented balance sheets of commercial banks from contraction and have been reflected in the enlargement of Bank of Albania’s balance sheet.

BANKING REGULATION AND SUPERVISION

Year 2008 coincided with an upward prudence of supervisory policies of the Bank of Albania. The passing of the new Banking Law gave way to the adoption of a new package of measures, among which the following are the most important:

- In compliance with the new Law, new criteria were adopted for calculating and reporting large exposures of banks to parent banks and connected entities, aiming at the management of risk arising 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.
- Taking into consideration previous problems, special importance was given to the transparency of banking and financial products and services. This is another aspect where the Bank of Albania intervened during 2008. The new requirements standardize the way and form of providing information about banking products and services to customers.
- Part of the new package was also the standardization of the required information that banks and branches of foreign banks should make
public, related to the banks’ main activity, their organisation and management, their financial performance and position, the risk management and the accounting policies.

- Aiming at a better diversification of risk arising 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.

- The Bank of Albania has prohibited lending to the economy with “exotic money”, implying 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, currently suffering gravely from their flight.

In view of enhancing the transparency, these measures were discussed in advance with the banking system, through an open forum held with representatives of the system. Financial market developments during 2008 highlighted the appropriateness of measures taken by the Bank of Albania. Its actions for absorbing the spill-over effects of the international crisis at the lowest cost possible, have continued to take place even during the first months of 2009.

LEGAL AND REGULATORY INITIATIVES

During 2008, upon the passing of the Law “On title repurchase contract”, the Bank of Albania’s efforts to create a proper legal infrastructure for the development of the repurchase agreements market among commercial banks were finalized, creating the possibility for the use of these agreements as flexible instruments to ensure and invest interbank market liquidities, in view also of enhancing the efficiency of the monetary policy transmission.

Also, another important highlight of the effective legal framework during 2008 was the approval of some amendments to the Civil Code Procedure of the Republic of Albania, which are expected to provide positive effects in terms of easing and shortening the time frames of collateral execution procedures for loans extended by banks and branches of foreign banks.

Also, in view of improving the existing regulatory framework in the banking supervision area, intending its adjustment to the requirements of the new Law “On Banks in the Republic of Albania” (which entered into force on 1 June 2007) and to the Acquis Communautaire in this area, and in accordance with the commitments under the Stabilization and Association Agreement, the Bank of Albania adopted some regulations on internal audit system and transparency of banks to the public, which are expected to positively impact the overall management and administration of banks.

EUROPEAN INTEGRATION

In the framework of European Integration, the Bank of Albania has paid special attention to the meeting of Bank of Albania’s obligations stemming
from the SAA related to meeting the Copenhagen economic criteria for EU membership, guaranteeing the right of decision-making and the freedom to provide financial services to EC banks and other financial institutions, liberalization of capital flows and of payments between Albania and the EU, as well as approximating the Albanian legislation with that of the European Community (Acquis Communautaire) in these areas.

During 2008 the Bank of Albania kept regular contacts with the Ministry of European Integration and posted there monthly progress reports, which reflect the progress achieved in terms of the implementation of legal and applicable measures, in accordance with the terms specified under the National Plan for the implementation of the SAA, as well as a description of the degree of compliance of the legal acts adopted by the Bank of Albania with the Acquis.

In the framework of the National Plan for the Implementation of the SAA (2007-2012), the Bank of Albania continued working for legal issues and applicable measures it should adopt. Hence, pursuant to the Law “On Banks in the Republic of Albania” which entered into force on June 2007, the banking supervision regulatory framework was reviewed, particularly in terms of the management, transparency and internal auditing of banks.

TRANSPARENCY OF THE BANK OF ALBANIA AND ITS COMMUNICATION WITH THE PUBLIC

A special importance in the day-to-day activity of the Bank of Albania is given to public relations and communication, since an open and transparent communication with the public helps to raise confidence in and efficiency of its decision-making. The Bank of Albania has carried out a number of activities and meetings with banking and financial system stakeholders, with different representatives of the media and academia, lectures at high schools and universities, regional meetings with representatives of the banking system, local government, business and the public.

The Bank of Albania has carried out its work in two main directions: first, enhancing the transparency and communication with the public on its decision-making; and second, enhancing the banking system’s transparency. During 2008 the Bank of Albania tried to enhance the transparency about decision-making and its effects on the economy, adding not only the contacts with the public and the number of publications, but also investing in public education, in order to improve the economic understanding in general and the financial one in particular. It has aimed at ensuring a compliance of the rational decision-making at a micro level with the Bank of Albania’s decisions.

Only during 2008:

- There were published more than 4500 pages in Albanian and above 2100 pages in English;
- There were distributed about 80,000 educational brochures;
- There were carried out training workshops for about 100 teachers of
economics in Tirana and Vlora;
• There was organized a competition on “The Real Value of Money” in Tirana and Vlora;
• There were organized 44 conferences, workshops, seminars, forums and round tables;
• There were organized 5 training workshops with journalists from visual and written media in the field of economics.

“Transparency in Decision-making” was enhanced through the provision of signals on future tendencies of monetary policy decisions, thus creating a standard form of communication that enables the public to perceive the direction of future monetary policy decisions.

“Transparency in Economic Developments” was enhanced through the publication of inflationary expectations trends generated from forecasts and analyses based on empirical models of the Bank of Albania and from the extension of the forecasting period from 12 to 24 coming months. It is also worth noting that in the framework of the banking system transparency, a set of regulatory measures has been prepared, aiming at enhancing transparency to customers, and protect them in consequence.

**FINANCIAL RESULT**

The Bank of Albania has carried out its economic and financial activity pursuant to effective laws. Its balance sheets have been constantly monitored and have been audited by the KPMG, which has certified their truth in compliance with the accounting policies adopted by the Bank of Albania’s Supervisory Council.

During 2008, the Bank of Albania’s balance sheet assets increased by ALL 60.1 billion, or about 23 percent. This growth is attributed mainly to the increased foreign reserve of the Bank of Albania and its operations for injecting liquidity in ALL. During 2008, the Bank of Albania had a net profit of about All 9.3 billion.

**3 CURRENT AND FUTURE CHALLENGES**

As I emphasized many times earlier in my speech, the Albanian economy is being ever-increasingly affected by the global crisis impact. The uncertainty induced by the global financial system shock was reflected in the withdrawal of a portion of deposits from the banking system, thus generating liquidity problems in the system and upward interest rate tendencies. This situation has naturally decreased the possibilities and willingness of the system to credit the economy.

On the other hand, the global economy developments suggest that during 2009 the Albanian economy may be faced with a decreased level of remittances and capital inflows. These developments, in turn, would further
decrease the possibilities for financing the economic activity and would
damage the foreign currency demand and supply balances. They give rise to
depreciating pressures on the exchange rate, as in many other economies of
Eastern Europe. This depreciation is in itself a corrective behaviour, under the
conditions of a flexible exchange rate regime applied in Albania.

From the Bank of Albania’s viewpoint, the main problem the Albanian
economy will encounter during the current year is the lack of liquidity, and
related to it, the tightening of conditions for financing activities. As we have
emphasised even in our public presentations, this restriction should be
recognized and considered in the business plans of all economic agents. The
Albanian economy will access less credit during 2009. The lack of liquidity
would also reduce the possibilities of the fiscal and monetary policy for reaction.
Under these circumstances, broader efficiency is required in making use of the
banking system funds, via a priority ranking of expenditures in view of their
impact on the economic growth.

Furthermore, the Bank of Albania deems that the current account deficit
behaviour should be constantly monitored. The equalization of this deficit to
the reduced capital account inflows should be another priority of the economic
policies’ development. As I emphasized earlier, this moment significantly
conditions the financial and macroeconomic balances at home. Therefore, it
will be constantly held at the focus of the Bank of Albania’s monetary policy.

Honourable Mr. Chairman of the Commission,
Dear Ladies and Gentlemen,

The current problems the Albanian economy is faced with have not originated
in Albania; therefore, their solution will mostly depend on the improvement of
the global economic activity.

The country’s macroeconomic stability has alleviated the economic and
financial global crisis’ impact on the country’s economic activity. This stability,
reflected in low consumer price inflation, stability of the balance of payments
and public debt, sound balance sheets of economic agents, low financial market
volatility, and public confidence in financial institutions, is a great capital of the
Albanian economy. It has been achieved through work and sacrifice throughout
the past years, therefore the Bank of Albania deems that even during these
challenging moments for all of us, we should pay full attention to its further
safeguarding and consolidation. The private sector’s dynamics of the Albanian
economy needs long-term and favourable economic and financial conditions,
and transparent competitive market structures to fully release its potential.

Only countries knowing how to rise and respond to these shocks have
managed to grow and prosper in the long run. Learning this lesson requires
an explicit ranking of development priorities, separation of long-term interest
of the country’s development from short-term intentions and the political
willpower for their accomplishment.
Honourable Ms. Chairwoman,
Dear deputies,

Pursuant to the legal requirement, it is a great honour and privilege to present before you the Bank of Albania Report for the year 2008. I avail myself of this opportunity to extend my gratitude to the Albanian Parliament for the support and understanding provided to the central bank.

The year 2008 confronted us with an intricate situation which swept the economy worldwide. In particular starting from September, a number of newly experienced events hit the U.S. financial infrastructure. The high integration of the financial market had allowed the spread of toxic products to the advanced economies, including the Asian growing economies as well. Within a short period of time, the global economy found itself amidst an all-embracing upheaval yielding slumping public confidence in the financial system. Prices in all main stock markets began to fall swiftly while the largest banks reported substantial losses.

Many reputable financial institutions collapsed which forced the authorities to take a number of rescue actions. The governments and central banks of advanced economies, including the specialized international institutions, adopted a number of emergent measures. In order to restore public confidence in the banking system capital was injected in addition to liquidity and toxic assets were purchased through public funds.

World trade was severely hit by the global crisis which spread swiftly to the emerging and low-income countries as well.

Emerging countries are experiencing a downturn in their financial conditions, tightening of lending, pressures over the exchange rate and considerable slump of demand in vital sectors of economic activity. As of end 2008 and beginning of 2009, some of the emerging countries – new European Union member states – were severely hit. In the face of a general balance of payments crisis, Hungary, Romania, Bulgaria, the Baltic States and other countries like Ukraine, Serbia, Belarus etc., addressed to the International Monetary Fund for emergency assistance.

The end of 2008 and January 2009 attested to the contraction of economic activity in the U.S., Germany, Italy, Great Britain and Japan. The international markets remain highly volatile and have added the uncertainties and vagueness among the participants. Notwithstanding the numerous efforts at a global level,
question marks hang over the future. The meeting in London represents one of these efforts, where the G-20 leaders agreed to commit USD 1.1 trillion to fuel economic activity at a global level, including the assistance to poor countries through the strengthening of the International Monetary Fund role.

The above situation provides evidence for the upward pressure the world economy in general and Albania’s partner countries in particular are generating over the yet frail Albanian economy. The international developments and the implications on the Albanian economic activity have been constantly addressed in my public speeches, press statements of the Bank of Albania Supervisory Council and other official documents of the central bank.

The Albanian economy has by and large shown high resilience to the phenomena characterizing the global economy in the last quarter of 2008. The Albanian banking system displayed high levels of immunity and did not manifest any signs of panic or perplexity. A few experts have considered Albania a fortunate country while others recognize the reduced integration of the Albanian economy into the global economy as the main cause.

The Bank of Albania considers that the rationale behind is the ever-increasing attention the banking system’s financial stability has been paid to in the recent years. The Albanian economy is as integrated as the other Balkan countries, some of which have already thrown in the towel. Allow me please to dwell further.

The Albanian banking system may be considered an extension of more developed European countries’ banking system. The banking groups with their headquarters located in the Euro Zone countries and extended throughout the region and broader hold 80 percent of the Albanian banking system’s assets.

The extension of the same banking groups to a number of countries caused the lending and deposit collection policies to be similar for all countries. Consequently, the exposure to risks these policies posed was similar for Albania, Bulgaria, Romania or Serbia for instance. According to this line of reasoning, it may be concluded that Albania’s financial integration has been similar to the levels of the regional countries in terms of the number of operators, types and products provided.

As in the majority of other countries, Albania had the regular sovereign rating being assigned B1 in 2006 and in 2008 as well. Other regional countries were assigned similar sovereign ratings causing the foreign investors’ perception of risk to be more or less similar. This fact is also confirmed by the purchase of domestic debt by international financial institutions. I would also like to underline that the capital account operations, in particular from the foreign investors’ viewpoint, are entirely liberalized, implying the absence of obstacles in the capital inflows and outflows.

The increased transactions with abroad is another indicator attesting to Albania’s opening to the rest of the world. Exports and imports have recorded
high growth rates over the course of the recent years causing Albania’s trade activity to increase substantially. Around 80 percent of trade activity is carried out with the Euro Zone countries, with Italy and Greece dominating as the main partner countries. The strong trade deficit deepening was a typical sign of the so-called rapid approximation process.

This phenomenon was the main development characteristic of all East European countries which became EU members in the recent years, including the majority of the South-West Balkans Albania is part of.

I believe these arguments are sufficient to understand that we have been neither fortunate nor undeveloped or on the periphery of global developments. What has distinguished the Albanian financial system from a number of counterparts in the region are its performance and soundness indicators which to a large extent owe to the commitment and measures taken by the Bank of Albania. The policies and decisions approved over the past years have taken the form of various platforms drafted with a view to better and prudently manage the situations we have been confronted with over the passing of time.

I would like to highlight that the decisions made from the year 2006 to August 2008 in the area of monetary policy and banking supervision have constituted the immunity platform. The decisions adopted from autumn 2008 to the present constitute the crisis absorption platform. The Bank of Albania is currently working intensively on the third platform: The recovery platform.

Please allow me to dwell briefly on each of these three platforms.

THE IMMUNITY PLATFORM

In a general context, the immunity of the Albanian economy relates to the large savings of the Albanian people materialized in the form of deposits and the Bank of Albania firmness to ban through an administrative act the penetration of some products which to other countries have resulted catastrophic.

In a more analytical context, it relates to our past actions which have built the immunity up further and served as a therapy to present events.

First, I would like to bring to your attention the monetary policy decisions from July 2006 to November 2007, when the key interest rate increased five times to 6.25 percent. This level was maintained unchanged throughout the year 2008. Our main motivation related to the overheating of the economy which primarily mirrored the high level of domestic demand owing to the growth of credit to economy. At present, the Bank of Albania considers that the monetary policy tightening has proved to be effective in curbing domestic demand in economy and having a direct impact over the credit channel in economy.
By and large, the Bank of Albania assesses that the overall macroeconomic environment has been sound in the last four years. Although official statistics are yet required to confirm, the central bank considers that the Albanian economy has performed and grown in line with the early-year projections.

This growth has mirrored the dynamic development in some sectors of the economy induced by the growth of consumption and investment in economy and the continued structural and infrastructure-related upgrades in economy.

Economic growth at home has been primarily sustained by the rapid growth of domestic demand which remains the main driver of economic growth. Consumption, investment and governmental spending recorded growth over the course of the year 2008. Foreign demand in the form of exports has grown steadily in the recent years although it remains at low levels to sustain economic growth. Economic activity has been mainly financed by domestic resources. Given its high liquidity levels over the year 2008, the Albanian banking system has managed to meet the upward demand of the economy for funds hence increasing the financial intermediation. The banking loan portfolio grew by 7.3 percentage points of the GDP.

The Bank of Albania has met its primary and mandated objective: achieving and maintaining price stability in economy. Average annual inflation rate marked 3.4 percent in 2008, quite close to the 3 percent target of the Bank of Albania and within the tolerance band of 2-4 percent. The controlled inflation rate mirrors the adequate monetary conditions and the appropriate monetary policy of the Bank of Albania. The latter has balanced the demand and supply-side factors and allowed the anchoring of inflationary expectations to the Bank of Albania target.

The government pursued a more expansionary fiscal policy over the course of the year 2008. Budget deficit is assessed to account for 5.7 percent of the GDP, deepening by 2.2 percentage points in annual terms. Public debt grew to 55.6 percent of the GDP from 52.2 percent the previous year. The improved public debt management in terms of maturity term extension and diversification of financial resources represents a positive development assisting the refinancing of debt and the control of its cost impact on budget indicators.

The year 2008 was characterized by a significant growth of economic and trade exchanges with abroad. Domestic demand has been reflected in the deepening of trade and current account deficit during 2008. The latter accounts for 14.9 per cent of the GDP, being mainly affected by the rapid growth of imports and the slump of remittances over the second half of the year. However, foreign currency capital inflows have been sufficient to contribute to closing the balance of payments with a positive result for 2008. Foreign reserves of the Bank of Albania increased by about EUR 192 million or by 0.9 percentage points as a share of GDP.
The growth of money moderated relative to the previous year owing to its slowdown in the last quarter. The average annual growth rate of M3 eased to 12.3 percent compared with 15.8 percent in 2007. The increase of monetary assets in economy attributes mainly to the growth of banking loans. The degree of financial intermediation in economy increased further over the course of the year 2008.

As a share of GDP, the banking system deposits grew to 80 percent compared with 78 percent in 2007. The performance of deposits was characterized by pronounced seasonal movements displaying high growth rates in summer and marked contraction in the last quarter. On the assets side, the banking system’s loan portfolio grew by about 35 percent in 2008. In terms of foreign currency structure, the loans indicated a slight shift of the loan portfolio to foreign currency. The growth rate of loans has been receding over the year reflecting both the tightening of lending standards in response to the regulatory measures of the Bank of Albania and the tightening liquidity conditions in the system.

In addition to the economic developments at home, the Albanian financial markets have also reflected the swift developments in the international financial markets. Against this background, their indicators, namely the liquidity, interest rates, trade volume and exchange rate, have been characterised by higher volatility, however, remaining within the normal functioning parameters.

The interest rates on deposits have been upward for both deposits denominated in the national currency and the euro. By contrast, the interest rates on loans have displayed a downward tendency over the course of the year 2008, bringing about reduced intermediation cost for the banking system. Worth to note is the increased attention to lending in the national currency and the enhanced competition by promoting the interest rates in this market.

Throughout the major part of 2008, the exchange rate of the Albanian Lek vis-à-vis the main foreign currencies was steady; however, it started to slightly depreciate by the end of the period. The positive performance owes to a number of factors, namely the macroeconomic stability at home, the positive balance of payments, the anchoring of inflation close to the Bank of Albania’s target and the approximation of this indicator to that of the Euro Zone, as well as the positive interest rate spread.

Second, worth to note is the relatively long period of continued consolidation of the banking system, characterized by its sustained financial soundness. The year 2008 was characterized by intensive developments in the Albanian banking system. The banking activity grew further throughout the year, both in quantitative terms - geographic coverage of the country and intermediation level - and qualitative terms - the great variety of services provided and the intermediation cost. In the meantime, the withdrawal of deposits in the last quarter put the banking system’s sustainability to the test. The developments over this period attested to the fact that the Albanian banking system passed its first sustainability test successfully.
Although at more moderate rates, the banking system’s assets and liabilities increased further during the year 2008. The analysis of the system’s indicators attests to an upward risk level and to its downward financial aptitude along the year. In terms of net result, the banking system’s performance recorded a downturn over the year 2008. This reflected both the enhanced competition in the system and the rapid increase of provision cost, particularly during the second half of the year.

However, the volatility and the non-satisfactory performance of some of the main indicators have not jeopardized the regulatory capital level required for covering the risks undertaken by the banking system. The performance of these indicators is not regarded as critical; however the dynamics and intensity of developments require a more prudent monitoring on an ongoing basis.

Third, I would like to place an emphasis on the prudence shown and the regulations made in the banking supervision area. For the first time in 2006, the annual conference of the Bank of Albania was entirely focused on financial stability issues seen from the regional point of view. The governors of the regional countries altogether concluded that a small number of banks were expanding swiftly throughout the region regardless of the yet incomplete supervisory framework regulating the banks in the country of origin and their subsidiaries.

On 1 June 2007, the Law On Banks in the Republic of Albania entered into force. This Law represents the first attempt to approximate the Albanian legislation with the Acquis Communautaire and in line with the commitments under the Stabilization and Association Agreement. This Law sets out clearer principles and rules on the management of risks banks may be faced with during their activity, aiming at protecting the depositors, investors and fostering the banking system’s stability.

On 31 December 2007, the Credit Registry was established representing a vital infrastructure-related development. It is an additional and useful instrument which will help to further deepen the analysis in terms of loan quality, identification of the concentration of loans by banks and borrowing entities, thorough evaluation of the latter’s financing by currency, detailed analysis of the type of collateral and guarantees used and the identification of the relations between the different borrowing entities.

For the first time in the Annual Report of the Bank of Albania for the year 2007 it is quoted: “The Bank of Albania argues that the intricate situation in the international financial markets represents a new type of risk for the Albanian financial system. However, as long as it does not transform into a global financial crisis with ramifications on the real economy worldwide, and particularly in Europe, this situation will relatively be of little effect to the domestic market.”.

Accordingly, in spring 2008 the Bank of Albania had open discussions with the banking system and addressed a package of regulatory amendments
which were generally oriented to adopting more conservatory policies in several main directions of day-to-day commercial banking running. The need for amendments arose from the implementation of the new Law On Banks in the Republic of Albania, the performance of credit to economy, in particular of foreign currency-denominated credit, and the developments in the international financial markets in the mid-year 2007 and the first quarter of 2008.

The launch of this initiative in April stimulated an open debate between the central bank and the banking system. The proper assimilation of these amendments by banks was considered as highly important. This consultation process finalized in August 2008 with the approval of a package of regulations by the Supervisory Council of the Bank of Albania.

In more concrete terms, this package provided for the amendments to the following existing regulations:

- “On the risk management in branches of foreign banks”.
- “On capital adequacy ratio”.
- “On credit risk management”.

The following new regulations were approved:

- “On the minimum requirements for the disclosure of information from banks and branches of foreign banks”.
- “On some basic criteria for the governance of banks and branches of foreign banks and their administrators”.
- “On the internal control system in banks and branches of foreign banks”.
- “On the transparency of banking and financial products and services”.

HOW WOULD THIS THERAPY BE TRANSLATED INTO MORE PLAIN WORDS?

- In compliance with the new Law On Banks in the Republic of Albania, new quantitative thresholds were set for the calculation, supervision and reporting of banks’ large exposures to parent banks and related entities. More specifically, in order to minimize the risk arising from the concentrated exposure to their parent banks, commercial banks operating in Albania must not exceed a given threshold of the paid-in capital.
- In order to better diversify the risk arising from the concentration in banks’ investments in the international financial markets, lower thresholds were set for banks’ large exposures. The calculation techniques of these exposures and the classification of financial assets used as collateral were also improved.
- With the purpose of promoting a more effective banking business running, the legal infrastructure for an active and accountable internal control in banks and branches of foreign banks operating in Albania
was put in place. Internal control is considered an integral part of banks’ governance. Hence, this regulation sanctions the key principles for an independent, unbiased and accountable internal control. Internal control should cover each section of the bank in order to prevent the origination and development of undesired phenomena.

- Accountable governance is one of the key principles to ensure a sustainable business growth. This becomes even more indispensable for financial institutions, whose success is, among others, largely dependant on public confidence in them. Accordingly, the Bank of Albania considers the quality of human capacities - implying the hiring of experts in the decision-making process and risk management - as fundamental. The de facto concentration of the decision-making in very few hands is a harmful practice. The new regulation sets out the responsibilities and duties of the managing structures of banking institutions. These structures are accountable for and guarantee the safe and sound functioning of the institutions they manage.

- The transparency related to the banking and financial products and services provided was also paid a special attention. The new legal requirements standardize the manner and form of providing information to the clients on the banking products and services banks provide. Special emphasis has been placed on the mandatory disclosure of effective interest rates on deposits and loans, the constituent elements to be specified in the loan and deposit contract, the marketing of products and services, the confidentiality of client information, the handling of clients’ complaints and the establishment of special structures dealing with these complaints.

- Part of this new package was also the standardization of the required information that banks and branches of foreign banks should disclose, related to the banks’ main activity, their organisation and management, their financial performance and position, the risk management and the accounting policies.

Fourth, I would like to call your attention that the approval of a regulatory act does not automatically imply its implementation in practice. To this end, the specialized human resources at the Bank of Albania, including the management, have been in constant contact with the banking system’s management, banks’ boards of directors, top management at headquarters and supervisory institutions in the parent banks’ countries of origin.

Communication bridges with the relevant authorities in the regional countries have been established in the last 3 to 4 years in order to identify:

- The magnitude of our system relative to the neighbouring countries’;
- The banks dominating the markets and their geographical coverage;
- The products provided, the level of service and the commissioning policies;
- The monetary policies and the supervision schemes;
- The relationships with the supervisory authorities of parent banks;
- The status of relationships and the co-operation perspectives with the international institutions.
At the end of this ceaseless process of co-operation and exploration we have come to conclusions which have often confronted us with ideas and practices which take a reverse course to ours. Our perseverance to administratively halt the lending to economy with the so-called ‘exotic currencies’ was the fruit of this entire process.

The recent years attested to the steadfast popularity of lending in the Swiss franc and Japanese yen owing to their very low cost and readiness to access the Albanian economy as well. Since the risk of lending in these two currencies was perceived to be high and the borrowers or banks could not provide the proper protection, the Bank of Albania banned through an administrative act the lending in these two currencies by the banking system. I believe this has also provided a direct contribution to reducing the short-term capital inflows from parent banks to their subsidiaries in the form of credit lines.

Allow me to remind you that a considerable number of emerging countries, which are now in serious need of refinancing debt in these currencies, have been trapped by these funds.

**CRISIS ABSORPTION PLATFORM**

The outburst of the financial crisis in autumn 2008 - which in a number of countries was displayed in the form of a confidence crisis - extended its reach to the Albanian banking system as well. The latter was confronted with the withdrawal of deposits during October to December 2008 period owing to the justifiable reluctance of households. However, the very good capitalisation level and the satisfactory liquidity situation allowed the banking system to overcome the situation.

At present, the Albanian economy is ever-increasingly finding itself under the pressure of the global crisis.

The uncertainty reigning on global financial systems was reflected in the withdrawal of a part of deposits from the system which in turn generated liquidity issues and upward interest rates. This situation has notably lowered the aptitude and willingness of banks to lend the economy.

On the other side, world economy developments suggest that the Albanian economy may be faced with a contraction of foreign currency inflows over the course of the year 2009. These developments would further lower the aptitude of financing the economic activity and distort the balances of foreign currency demand and supply. As in many other East European countries, they lead to downward pressures on the exchange rate. Under a flexible exchange rate regime as in the Albanian case, the downward pressures are a corrective behaviour in terms of consumption, savings and investment at a micro and macro level.

From the Bank of Albania’s viewpoint, the main issue the Albanian economy will be faced with over the course of the year 2009 is the liquidity shortages and
consequently, the tightening of lending conditions. As pronounced in earlier public addresses, this limitation should be acknowledged and considered in the formulation of business plans of all economic agents. The Albanian economy will access less credit during the year 2009. The liquidity shortages will also lead to weaker monetary and fiscal policy response.

Against this background, greater efficiency is required in using the banking system’s funds by making priority ranking of expenditures based on their impact on economic growth.

Furthermore, the Bank of Albania considers that the current account deficit behaviour should be constantly monitored.

The equalization of deficit to the reduced capital account inflows should be another key priority of economic policies development. As emphasized earlier, this moment conditions the macroeconomic and financial balances at home significantly. Therefore, it will constantly be at the focus of the Bank of Albania analysis.

In full acknowledgement of its role as an institution mandated to manage the money market, the liquidity situation, the banking system’s stability and act as lender of last resort, the Bank of Albania announced in the first days of October its intent to furnish the banking system with the required liquidity ceaselessly.

With the passing of time and while constantly monitoring the situation, the Bank of Albania amended its operational framework in order to better meet the market’s liquidity needs. We initially changed the form of auctions from fixed-amount to fixed price auctions, implying the supply of the market with the liquidity as required by banks at a fixed price of the key interest rate.

In addition, the Bank of Albania made some important regulatory amendments. In more concrete terms:

- The base of securities serving as collateral for reverse repurchase agreements extended with the bonds issued by the Government that have a remaining term to maturity of no longer than 65 days.
- The use of required reserve increased from 20 percent to 40 percent.
- The spread between the Bank of Albania key interest rate and overnight credit reduced from .5 percentage points to only 0.5 percentage points.
- Through a special regulatory act, the Bank of Albania has requested from the banking sector not to allocate the 2008 profit in the form of dividend. In this way, the banking activity capitalization is further strengthened, hence providing more guarantees for the banking sector’s financial soundness in the period to follow.

These decisions helped to relax the liquidity situation and they are in line with the operational policy of the ECB in response to the crisis.
The prudent monitoring of the situation required the creation of an ad hoc task force, whose main responsibility would be the daily monitoring of the situation in each individual bank. Our straight conclusion is that the aggregate indicators do not necessarily point out the truth. The idiom ‘devil is in the detail’ called for micro analysis, focusing on individual indicators of the system and individual banks.

The Bank of Albania has been conducting numerous and successive stress tests in order to identify the banking system’s response to possible pessimistic scenarios. The analysis obtained from the numerous stress tests – for the banking system-wide and individual banks – indicate that neither the banking system on the whole nor any of the systemically important banks in particular have been affected in their liquidity and capitalization indicators. Notwithstanding the enhanced spectrum of risks and a more severe year in terms of expanding their banking activity, the financial system and the banking sector will remain stable.

We believe that the latest decision of the Albanian Parliament which approved the increase of the deposit insurance to ALL 2.5 million creates the grounds and removes any negative psychological barriers for the return of withdrawn deposits to the banking system. The current deposit insurance level, similar to that in the European countries, provides full and permanent guarantee for the savings of the majority of Albanian households. There is no objective reason why people should worry about the safety of their savings in banks. Any reluctance to place savings in banks increases the amount of lacked income owing to the loss of interest rates and other banking services.

**RECOVERY PLATFORM**

The current issues the Albanian economy is faced with have not originated in Albania; therefore, their solution will to a large extent depend on the improvement of the economic activity at a global level.

The future development strategy will continue to depend on the essential factors elaborated in the first platform. Macroeconomic stability remains a fundamental precondition for ensuring a sustainable and long-term growth. Based on the lessons derived from the global crisis, the Bank of Albania considers that we need to be forward-looking and deepen structural reforms further. This constitutes the main condition for the stable convergence of Albania with the European Union.

Given the complexity of challenges we will be encountering in the period to follow, we consider the reformulation of current macroeconomic and financial policies, with a view to adapting them with the new settings, as imperative. Clear mechanisms need to be established in the future in order to co-ordinate the macroeconomic policies and the country’s development programs. The Bank of Albania calls for the adoption of a quantitative and transparent fiscal rule, which serves as a condition for fiscal policies in the medium and long-run.
The tightened financial conditions in economy, the insufficiency of domestic resources and the turmoil in the international financial market call for new foreign financing resources. To this aim, any possible option, including the support programs from specialized international institutions, need to be considered. The Bank of Albania considers that Albania should benefit from the international fund created from the G20 summit, since it meets all the terms and conditions.

On behalf of the institution I represent, I would like to assure the Albanian Parliament, the banking system and all stakeholders that the Bank of Albania will meet the banking system’s needs for liquidity. On the other side, we require from the banking system more independence from their parent banks in terms of the policies applied in the money market and investment portfolio. The Bank of Albania will further intensify the communication with the parent banks for the latter to financially support the subsidiaries operating in Albania.

Banks operating in Albania have been licensed to manage the savings of Albanian people. Consequently, the fundamental obligation of each banking system is the financial intermediation in the country it operates. To this aim, we will call for the recovery of credit to economy bringing to the system’s attention the specific branches of production that are worthy of being financially supported.

The banking system should be more active in terms of restoring public confidence through constant communication and launch of new products to address the public reluctance.

The business community should be more open to the banking system. Enhanced openness and the necessity to be more forward-looking in the formulation of future business plans are two important conditions for restoring credit.

I would also like to address to the public at large. The way you behave each day determines the dynamics of the crisis’ effects. The public should return to banks. If your behaviour is rational, the impact of the crisis will be only peripheral. By contrast, if your everyday behaviour displays any forms of unjustifiable panic, lack of confidence and withdrawal of deposits, then the possibility to be affected by the financial crisis becomes higher. Moreover, there is higher possibility that it turns into a real economic crisis. The financial system is the only specialized ‘machinery’ in possession of the information, know-how and human capacities to ensure the optimal allocation of financial resources in economy. Furthermore, the banking system is a regulated and supervised segment by the Bank of Albania, the authority whose main and exclusive objective is the preservation of macroeconomic and financial balances at home. To this aim, I believe time is ripe to respond rationally and with pronounced patriotism.

I would also like to extend my thanks to the media for the careful coverage of news in the recent months and encourage them to continue to do so.
I avail myself of the opportunity to address to the political class and call for increased attention to the challenges Albania will be faced with. The pursuit of a political understanding to address these challenges would reduce the negative impact on economy both in terms of time and intensity. We owe this to ourselves and to the future generations who deserve a more appropriate business environment, macroeconomic stability, a sound financial system and a clear convergence perspective with the Euro Zone.

The global crisis has now given us the first lessons. It teaches us that more discipline, communication, co-ordination, transparency and culture are required.

Dear deputies,

Macroeconomic stability at home has curbed the impact of the global economic and financial crisis on the Albanian economic activity. The stability expressed in the low consumer price inflation, balance of payments and public debt sustainability, sound economic agents’ balance sheets, reduced financial market fluctuations and public confidence in the financial institutions is a great asset of the Albanian economy. It has been gained through work and sacrifice throughout the past years, therefore the Bank of Albania deems that we should pay utmost attention to its further safeguarding and consolidation even during these challenging times. The private sector’s enthusiasm requires long-term and favourable economic and financial conditions as well as transparent competitive market structures. Only the countries knowing how to rise and respond to these shocks have managed to grow and prosper in the long run. Learning this lesson requires an explicit ranking of development priorities, the separation of long-term goals from short-term ones and the political willpower for their accomplishment. The energetic confrontation with the crisis’ effects implies earlier recovery and fewer consequences. This would provide Albania with comparative advantages relative to the other economies in the region in the pursuit of fast integration and convergence with the European family.
SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI

At the Presentation of Economic Developments in Albania and Future Challenges, organized by Citigroup London, International Financial Services and the Albanian Embassy in United Kingdom

May 18, 2009

Dear Ladies and Gentlemen!

Let me please begin by giving my thanks to the Albanian Embassy here in London for organizing this event. It is a pleasure to brief you today on the current Albanian trends and developments. Occasions of this kind are important events to match the opportunities offered by an emerging economy with the desire for higher returns of the leading developed countries.

Our macroeconomic progress during the recent years, the sound banking system and our commitment to increase its efficiency are the strengths we bring you today. The sound economic and stable financial situation is achieved via a modern, forward looking approach to monetary management and a responsible fiscal policy.

The macroeconomic success shows the ability of the Albanian authorities to identify priorities in a timely manner and choose to implement sound economic and social reforms. As an outcome, for the first time in 2007, Albania received an independent evaluation of the sovereign risk profile of the country. Moody’s sovereign rating assigned Albania B+, which remained unchanged for the year 2008.

In the last couple of years the country has achieved remarkable progress with regard to the business environment. Several data support this conclusion. However I would like to refer to the World Bank Cost of Doing Business Survey which indicates a significant improvement from a rank of 135 to a rank of 86.

At the end of 2007, the Albanian public debt denominated in national currency was for the first time traded in international financial markets.

In the recent years Albania has achieved considerable improvement in the fiscal and monetary management of the country. The application of the 10% flat tax was followed by an impressive boost in tax collection.

Recent legislative improvements have contributed to a better business environment. Some of the most distinguished developments can be listed as follows: simplified taxation system; easier and less expensive tax procedures; better infrastructure for settling tax disputes; introduction of e-tax procedures, reduction of the contribution of social insurance.

It is worth mentioning that a new draft law on the resolution of administrative disputes in the Republic of Albania is in discussion. The law will set up
administrative courts that will have substantial competence to adjudicate on decisions issued by the Albanian fiscal authorities.

The integration process has moved forward with two very important events. Albania officially became a NATO member in early April 2009, in the Strasbourg summit, and a few weeks later the official application for the EU candidate status was submitted to the Czech Presidency.

Placed in a very strategic geographical position, recently Albania has become a principal economic, political, and stability factor in the region. Defined by these geo-political considerations we are the linking bridge to the South-East Europe.

The Albanian economy has achieved robust non-inflationary growth during the last decade. Growth is supported by the domestic demand and fuelled by credit expansion.

In general, the country has managed to keep prices under control without sacrificing the growth or its financial stability. The annual economic growth during the last years has been around 6%. Economic activity has increased sufficiently to meet rapidly the growing demand. This has helped to keep price developments under control and inflation expectations well anchored around the Bank of Albania inflation objective. Our target for headline inflation specified as 3% ±1 has been achieved successfully.

Headline CPI inflation has fluctuated around 3% at the end of 2008. Despite a moderate depreciation of the exchange rate during the first months of 2009, inflation pressures have subsided in response to the recent developments in the international markets and economic contraction in our main trade partners as well as a slowdown of economic activity in the country. However, our estimations indicate that inflation broadly will remain within the tolerance zone during the next 12 months.

Our country has achieved constant fiscal consolidation in the past years. The IMF presence has been an important external anchor imposing financial discipline. However due to current ambitious plans to revitalize the road infrastructure, capital expenditures grew contributing to the enlargement of the fiscal deficit in 2008.

The recent increase in infrastructure projects has been financed among other by the incomes realized from the privatization of institutional sectors. This has contributed to keeping the size of government public debt at around 55% of GDP, reasonable by Maastricht criteria’s point of view.

The exchange rate of domestic currency is decided freely in the foreign exchange market. The Bank of Albania believes that the free floating regime is an important element of the adjustment process of the potential macroeconomic imbalances.
The Lek has been stable since early 2000s. Moreover it has exhibited a slight and persistent trend of appreciation due to productivity gains and persistent increasing remittances. The exchange rate volatility has decreased continuously since 1998.

However recent development trends, mainly in the foreign sector (reduced remittances and temporary widening of the current account deficit), contributed to the depreciation of Lek. Nominal effective exchange rate lost around 6 percent of its value until the end of April 2009. This depreciation is moderate compared to experiences of other CEE or SEE countries.

Balance of payments data confirm increased confidence in the Albanian economy, mainly reflected in the boom of Foreign Direct Investments which reached to 6 percent of GDP in 2008.

Current monetary policy framework can be considered as an implicit inflation targeting setup and is managed by indirect instruments of monetary policy. Monetary policy signals are transmitted via the decisions of the Supervisory Council of the Bank of Albania for the base rate of the weekly repurchase agreements and continuous communication.

Our natural resources and cheap but qualified labour force continue to be attractive for all European entrepreneurs who want to explore the benefits of globalization. The base of exports ranges from agricultural products to minerals. Albania offers investment opportunities in mining, agriculture, energy, infrastructure and tourism. At the same time, the food processing industry is already experiencing a satisfactory development and provides plenty of room for increased activity. Opportunities in the energy sector range from building new sources to improving the distribution network.

Meanwhile, Albania’s strategic focus towards the improvement of its transportation infrastructure calls for an increased public-private participation in building new roads and ports. Of course, as I mentioned above, Albania offers outstanding opportunities for investing in coastal, alpine, historical and cultural tourism due to its Mediterranean location, rich ethnographic heritage as well as its variable climate and geology.

The business culture is very adaptive. English is a well spoken language among young generation. Albanians like to invest in their education. There is a fresh supply of bright qualified young professionals educated in UK and other European universities. They have developed western style working habits with their education and are viable factors in your quest to expand in the Balkan region.

I mentioned the region on purpose. Albania is not the lonely and isolated island of ridiculous economic experiments anymore. During the last two decades it has transformed itself into a flexible and competitive free market, open to the modern developments of globalization. It has learned to position itself accordingly, and benefit from international
developments in the region. Albania is geographically located in a key east-west intersection.

Speaking of the financial system our goal is to maintain a sound, liquid and profitable one. At the end of 2008, the Albanian banking system consisted of 16 private banks. Privatization of the banking system ended 5 years ago with the privatization of the Savings Bank by Raiffeisen Bank. After the privatization of Savings Bank in 2004, the percentage of private-owned banks increased to 100% and over 90% of the shareholder capital is foreign-owned.

During the recent years, the credit extended by the banks to the private sector and individuals has increased substantially. This of course has been a factor in support of the economic growth and investments in the country.

The banking sector stands at the forefront of the foreign direct investment and integration process. It represents one of the most successful investment opportunities in Albania and has greatly benefited from the presence of some of the biggest financial groups in Europe. My reference to integration does not refer only to the presence of foreign capital, but also to the capacity of the banking system to intermediate and complement European initiatives and investments in the Albanian economy. These banks have the necessary reputation, ability and infrastructure to serve as partners for foreign investors.

Yet, the banking system alone is necessary but not a sufficient condition to promote economic prosperity and distribute resources to the best possible uses.

The distribution of the financial market in Albania is skewed toward universal commercial banks. The likes of mutual funds, hedge funds, pension funds and investment banks are inexistent.

The Bank of Albania and other financial market authorities are pushing to create the right incentives to promote investments in these segments. We believe that our financial system market has not yet exceeded all opportunities. Taking advantage of this event, I would like to invite the British companies to include Albania into their investment map.

Dear ladies and gentlemen,

Global developments have dominated the agenda of the decision-makers worldwide. So far our economy has shown admirable resilience. Both macro and financial stability are in place and the banking system remains liquid.

However the effects of the international financial crisis have appeared in the Albanian economy since the last quarter of 2008. The first consequence was the deposit withdrawal reflecting the free fall of public confidence in the banking system. Limited understanding of the real problems, reinforced by calls from emigrant relatives in Italy and Greece which instigated some degree of panic among the public are believed to be the main causes behind the deposit withdrawals in mid-October 2008.
Another apparent consequence has to do with the reduction of foreign exchange inflows, in the form of remittances and exports of goods and services tightening the overall financial conditions in economy and consequently putting pressures on foreign exchange rate.

At this point the Bank of Albania started to evaluate the situation in order to prepare for second round effects that would come as a consequence of liquidity constraints and the world while in economic recession. The Bank of Albania has been communicating its concerns regarding the indirect impact of the financial crisis, pointing out potential second round effects that will become stronger during 2009:

- We expect that liquidity constraints will slow down credit growth and economic growth.
- The expected slowdown of our exports as well as a decrease in the prices of commodities will widen the trade deficit. In addition, further contraction of remittances will also contribute to an increase in the current account deficit.
- However we believe the free floating exchange rate regime will provide an effective tool for adjusting consumption and therefore imports.
- The Bank of Albania will not intervene to fix any price in the market. As always, the central bank will try to avoid any sharp and significant market distortion.
- The fiscal deficit is expected to increase due to an expected negative impact of economic activity on government revenues and their financing due to limited liquidity in domestic and international markets.
- Our analyses indicate that economic activity will slow down significantly, however it will remain positive.
- Stress tests show that due to a slowdown in economic activity and the observed exchange rate depreciation, as well as the statistical effect of slower credit expansion, further deterioration of the loan portfolio quality is expected. However, this will remain within manageable limits and is not expected to pose serious threats to financial stability.

As a main conclusion, the Bank of Albania short-term objective clearly shifted toward preserving stability and minimizing second round effects without completely losing sight of inflation developments, which were however on the lower side.

Dear participants,

The year ahead will be a difficult one. Many challenges lie ahead. The mixture of the financial crisis with the world while in economic recession is an unprecedented event. My country, Albania, is part of this global picture as well. So far we have managed to maintain both macroeconomic and financial stability. We will remain committed to preserving these achievements.

Thank you for your attention. I will be happy to take questions.
Distinguished Governors,
Dear participants,

I want to start by thanking the organizers of this meeting, for promoting 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 USA, has transformed itself into an economic crisis, that is having dire consequences in the real sectors of the world economy. I will start by describing the main macroeconomic developments of our economy and the characteristics of our financial system, which is similar to other countries in our region. Then I will proceed with some of the measures taken by the Bank of Albania to alleviate the impact of the international financial crisis on our banking sector and the economy. I will finish by mentioning some thoughts on future policies, which I consider important to strengthen the economic environment and the financial stability in our region and in Albania.

The Albanian economy has been growing steadily over the last decade.

Our economy has been in a solid path of growth for the last decade, with an average annual growth rate of around 6 percent. It has benefited from economic reforms that have provided development opportunities for our private business sector, have sustained markets development, have promoted competition, have stimulated flexible labor markets and have increased social revenues. Supported by an IMF assistance program, 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. 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.

As in other countries in our region, the banking sector dominates the financial system in Albania.

The assets of the banking sector make around 95 percent of the total financial assets in Albania, or around 80 percent of GDP. Nowadays, the banking...
sector counts 16 banks with around 500 branches, all in private hands, where the foreign capital dominates. Over time, the sector has increased the number of branches, has improved its products to the public and has increased its intermediation role. At the same time, the entrance of well-known European banking groups from Greece, Austria, Italy and France, has been associated with episodes of consolidation in the banking industry. Financial performance indicators have been very good. 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. Undoubtedly, the banking sector has been a very important contributor to the economic growth, while preserving solid business development and financial soundness indicators.

Despite the solid performance in the last years, the Bank of Albania, in its role as the monetary authority and the exclusive supervisor of the banking sector, was vigilant to point out areas of the banking activity that required increasing attention from the industry.

We have continuously expressed our concern regarding the rapid increase in lending, which at some time reached up to 8-9 percentage points in terms of annual growth to GDP. We were aware of the risk it would bring to the credit quality, even though this was not expected to be relevant. The composition of the loan portfolio, which is dominated by the euro-denominated loans, has always been a point of concern. Despite the fact that this position is supported by a strong presence of retail foreign currency denominated liabilities in banks balance sheets, a generally supportive environment of exchange rates and interest rates over time and very close economic links to Euro-area countries like Italy and Greece, the Bank of Albania has been consistent in its approach to introduce gradually regulatory measures that would discourage the rapid increase in lending, encourage banks to lend more in domestic currency and increase transparency toward clients on banks’ products and services.

**IMPACT OF THE CRISIS ON OUR ECONOMY AND THE FINANCIAL SECTOR HAS BEEN INCREASING AND…**

In the last quarter of 2008, the financial sector in Albania started to feel the impact of the international financial crisis. The main development was an increasing sensitivity of the public for their savings in the banking sector. People started to withdraw their deposits regardless of the currency of denomination. At the beginning, there was no pressure on the exchange rate but it started to mount at the beginning of this year, when it was noticed a contraction in the foreign currency inflows, due to a decline in exports and remittances. The quality of the loan portfolio started to deteriorate, and the nonperforming loans reached 8 percent of the entire outstanding loan portfolio at the end of April 2009. We expect this figure to edge higher, as data from the economy and surveys of business expectations and a marked slowdown in the credit availability, suggest that the economic growth is going to be much lower than the previous year. Due to a decline in interest income
margins and an increasing amount of provisions, some of the banks have started to accumulate negative financial results.

On a brighter note, almost all the banks have increasingly supported loans in domestic currency. At the same time, the banking sector remains well capitalized and liquid. The capital adequacy ratio was 17.1 percent in March 2009, compared to the required minimum level of 12 percent. Liquid assets to total assets, is at around 42 percent.

The capital adequacy of the banking sector is sufficient to cover for a worst scenario that combines no economic growth, a higher level of depreciation for the exchange rate, and a higher level of non-performing loans. I want to mention also that banks’ shareholders have quickly and sufficiently responded to our calls for capital injection. Obviously, we remain in very close contacts with bank representatives, to identify further needs in this direction.

...MEASURES HAVE BEEN TAKEN TO COPE WITH THE CHANGING ENVIRONMENT.

Since the last quarter of 2008, the Bank of Albania has intensified its work on various directions to carefully monitor the developments and preempt them where possible. For this reason we have:

- strengthened bilateral and multilateral contacts with bank representatives, asking them for increased vigilance due to current international market conditions;
- increased contacts with other domestic institutions that regulate and monitor the financial markets, in particular with the Albanian Financial Supervisory Authority that supervises the insurance sector;
- increased the number of publications, including the Financial Stability Report 2007 (Sept.) and the Financial Stability Statement (Oct. 2008, April 2009), which try to analyze the elements of the crisis and its potential effects on the Albanian banking sector and the economy;
- increased 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;
- changed and improved the reporting framework of banks, in terms of timeliness and quality of data, in particular regarding their exposure to international markets (and the mother-banks), their liabilities (deposits and exposure to credit lines) from mother-banks, and their loan portfolio developments. These data are being closely monitored.
- intensified the on-site supervision of banks, to closely monitor their process of risk management and the way they have been responding to the new developments;
- improved our stress-test analysis, in terms of introducing more conservative assumptions, and technicalities that allow for a combination of adverse scenarios;
- started to execute fixed-price (unlimited amount) weekly reverse repo
transactions and longer term reverse-repo transactions, and extended the list of eligible collateral for these transactions, to better suit the liquidity needs of the banks;

- doubled the usage rate of the required reserves in order for banks to use more of their reserves with the central banks, should they need it during the maintenance period;
- prepared and submitted to the Albanian Parliament changes to the deposit insurance legislation. The approval of these changes has provided our depositors with a significant and permanent increase in the maximum amount of their deposits that is fully insured;
- lowered in January 2009 our policy interest rate by 50 basis points, to 5.75 percent, on the back of declining inflationary pressures. Since then, concerns about the exchange rate developments and potential impact on inflationary expectations and financial stability have been dominating the discussions;

In addition, in an improved framework of the internal discussions and decision-making, we are reviewing our “back-up” plans, to assess the possibility of new actions, should we encounter a worsening scenario.

**TIME IS RIPE TO INTRODUCE POLICIES THAT WILL STRENGTHEN THE ECONOMIC ENVIRONMENT AND THE FINANCIAL STABILITY IN OUR REGION...**

In a global level, it has now become clear that the recent crisis was a consequence of wrong incentives that supported unbalanced financial activity development and misconception of risk assessment, pricing and management. The supervisory institutions, trapped sometimes in situations of complicated structures, insufficiency of resources, inability to follow and understand market financial innovations and risk location, were not able to correct the situation in due time. The need to restore and maintain financial stability during this unprecedented crisis, has called for swift, coordinated and extraordinary measures by the public authorities, both in the area of monetary and fiscal policies. Central banks have abandoned almost any restriction and have even adopted unconventional measures in providing liquidity to the financial markets. Governments have shown a very strong commitment to reduce systemic risk by saving important financial institutions, provide guarantees for inter-bank lending, raise the level of deposit guarantees for the public etc..

This crisis is providing the public authorities and markets wherever in the world with the best opportunity to identify deficiencies and correct them in order to prevent a similar crisis in the future. Such task requires strong and visionary measures, which in the medium term will enable the strengthening of the supervisory architecture in different levels, but will also create conditions, including macroeconomic and fiscal ones, to avoid excesses in the financial activity, not only in the financial industry but also in the balance sheet of households and businesses. Such measures will require strong coordination
and responsibility by the public authorities at a national level, and a commitment to push ahead with the necessary steps to reform and improve the supervisory superstructure at a regional, European and global level. At the European level, such measures will be supported by the findings and recommendations of the “De Larosiere Report”, but of course their implementation will not be easy. As it is expected to be a more centralized model for globally systemic banks and, to an extent, a more decentralized one for smaller financial institutions, we hope that supervisory authorities in small countries will have a better determined position that would allow for clearer responsibilities and stronger voice in communication with the supervisors in the home countries.

More or less, all the countries in our region have resisted the initial direct impact of the international crisis, by enjoying some natural protection from less developed and integrated financial markets and a much lower level of indebtedness from the households and businesses, compared to developed countries. However, it is now clear that at the time of continuing financial integration and economic globalization, this may not be enough to compensate for potential risks coming from less diversified economic growth, overreliance on remittances, insufficient culture of risk management in financial institutions and other economic agents - in particular for the exchange rate and liquidity risk, and very limited space from the public authorities to introduce financial measures similar to those in the developed countries. Hence, policy measures should address these and other deficiencies to find a proper solution in the medium-term. Such measures should reflect the preference for preventive approaches.

AND IN ALBANIA

The Bank of Albania has been vocal in its concern regarding the impact of the international financial crisis, in particular regarding the performance of the Albanian economy.

Risks to economic growth have increased and they are related in particular with a further 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 believe that at these times, there is a much stronger need for a careful monetary policy and responsible fiscal policy.

Regarding the financial sector, we believe that there is also a need to establish certain rules, that would support a more balanced and safe development of the financial industry in general and of the banking sector in particular in the future. First, on general measures, I would support any such one that will contribute to: the establishment of a strong legal framework for property title and property rights in Albania, which in return will be instrumental in developing a non-financial asset market and increase price transparency and ultimately, strengthen the process of risk assessment. Second, efforts should be made to develop the non-bank financial market and the capital market in general.
This will help to better support the economic development of the country and of various economic agents, increase their opportunities to finance their needs in a more diversified and competitive way (thus improve their skills in managing risks) and release some pressure from the banking sector. Third, the public authorities in the country (the supervisory authorities and the Government) must have sound contingency plans for possible financial crisis management. Recent events in other countries have shown the importance of having a well-coordinated plan of actions, which is discussed, agreed on and tested in advance. Fourth, when it comes to the regulatory and supervisory framework of the banking sector, I am in favor of introducing the necessary changes to make it less pro-cyclical. In the case of Albania – where the minimum required capital levels are already high, I would be more in favor of introducing the model of dynamic provisioning adapted to the business structure and to the level of technical sophistication of the banking sector. In addition and in a more general position, I would support a revision of the regulatory framework toward clearance and simplicity, even though it might be interpreted like I am supporting more a rule-based approach in supervision.

I think that a regulatory framework is really effective and successful when it combines both the simplicity and transparency of a rule-based approach with the flexibility and forward looking characteristics of a principle-based approach. In any case, I believe it is necessary to make banks responsible for convincing the supervisor on the risk and return characteristics of various new products, before they exceed a certain threshold in size and exposure. This is achievable if the supervisory framework is always built with the main focus on assessing and managing the risk in different directions of the banking activity. Fifth, when it comes to choosing between lending in domestic currency or foreign currency, one should have various considerations in mind related with the nature of currency flows in the country, the concerns of the transmission mechanism of the monetary policy, the nature of the exchange rate regime, the currency composition of the asset-liabilities of the banking sector etc.. In this regard, we shall support a stronger role of the domestic currency in the lending activity of banks, and will make lending in foreign currency more costly for banks if it is not supported by retail savings in foreign currency. Thus, the over-reliance of banks in wholesale financial resources in foreign currency to support rapid lending should be addressed and managed in due time.

I find this meeting as very useful to discuss these issues and others that you have identified. I believe that the ultimate goal should be to establish a genuine and effective cooperation and to support a coordinated approach where possible.

Thank you very much for your attention.
PAPERS PUBLISHED IN THE ECONOMIC BULLETIN OF 2009

DETERMINANTS OF NET INTEREST MARGIN IN THE ALBANIAN BANKING SYSTEM
Irini Kalluci

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 represent an interesting topic and broadly discussed by the foreign literature.

The banking system is the most important element of the Albanian financial system, whose assets account 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 intermediation role provides 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, since it represents the first attempt for the case of Albania.

Different stakeholders, but especially the policy-makers, are interested in the establishment and functioning of stabilized and efficient banking systems. 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.

NET INTERNATIONAL RESERVES IN ALBANIA: LEVEL AND MEASUREMENT, A COMPARATIVE ANALYSIS WITH THE REGIONAL COUNTRIES
Olta Manjani

The purpose of this material is to make a general description of the international reserves held by the monetary authority. The strategy of the Bank of Albania in managing international reserves has foreseen a continuous growth of reserves in accordance with the main features of the Albanian
economy: a high and growing current account deficit, a fast growth of short-term foreign debt and a considerable shift of broad money to its foreign currency component. Given the features of the 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 the Albanian economy. Despite being widely used, conventional criteria are highly credible and provide good basis for comparison between different countries.
ABSTRACT
This paper attempts to apply some approaches in order to quantify the responses collected via the Consumer Confidence Survey conducted by the Bank of Albania. Moreover, it attempts to better understand the nature of consumer inflation expectations in Albania, which result to be adaptive. Accordingly, if the inflation rate increases, consumers expect an even greater increase of inflation in the subsequent period.

MEASURING INFLATION EXPECTATIONS*

1. INTRODUCTION

The main objective of most central banks is to maintain price stability; therefore, there exists a vast literature on the factors affecting inflation. The analysis of the role of consumer expectations in the price formation process is of paramount importance. The rational expectations theory dates back in the early 1960s when John F. Muth was the first to formulate the rational expectations hypothesis in a precise way and used it in a number of economic phenomena in which the result depends on what people expect to happen seen from a single market in partial equilibrium viewpoint. The importance of the rational expectations hypothesis became apparent only after a few decades when the Nobel Prize winner in 1995, Robert Lucas, extended the hypothesis to macroeconomic models and to the analysis of economic policy. There is now a broad consensus among the economists that economic actors do not persist in making foolish mistakes in forecasting over time. People are presumed to be able to both detect past patterns in their prediction errors and base their behaviour on the “best possible” forecast of future economic conditions (Bullard 1991). The current wide acceptability of this notion is testament to the success of the rational expectations revolution.

There is evidence that the level of expected inflation and the rational inflation are cointegrated. During the expectations formation process, the economic actors try to forecast what will happen and they are urged to use rules that work well, since if they manage to make accurate forecasts, they will have higher “gains”. The accuracy of forecasting is useful to people trading in the stock exchange or to people considering buying a new car. When people need to constantly forecast the price of a product or a basket of products, they tend to adapt the forecast rules in order to avoid possible errors; that is, there is a constant flow of past results and actual expectations.

The importance of inflation expectations – inflation based on consumer expectations – results from the fact that expectations exert influence on the
behaviour of economic agents, i.e., in terms of consumption, savings and investment decisions (Lyziak 2003). Expected inflation may also constitute an important information variable taken into account in forward-looking considerations. Its quantitative measurement may be used as a variable in the inflation forecasting analysis since inflation expectations affect the decisions related to price and wage-setting (Forsells and Kenny, 2002). Moreover, central banks need to assess the credibility of their monetary policy in order to know how the inflation expectations of the general public compare with the price stability objective pursued by the monetary authority (Berk 2000).

Inflation expectations play an important role in price formation. By affecting real interest rates, changes in inflation expectations may lead to changes in aggregate demand, which may then influence prices. On the other hand, an increase in the expected rate of inflation may make employees demand higher wage settlements. Companies, anticipating higher costs to be faced in the future, may see incentives to increase prices.

The paper is organized as follows: Section 2 describes the importance of expectations in the inflation control process and the method of their measurement. Section 3 continues with the methodology of data conversion from qualitative to quantitative, using a number of functions of the probability approach to quantification of inflation expectations. Moreover, this section analyzes the testing of expected inflation indicator in order to derive conclusions related to the nature of consumer inflation expectations. Section 4 applies the methodology and testing in the case of Albania. The last section provides some preliminary conclusions.

2. THEORETICAL CONSIDERATIONS

2.1 INFLATION EXPECTATIONS AND MONETARY POLICY

The Bank of Albania has for quite a long time formulated an action plan,
which aims at enhancing the efficiency of the communication channel with the public. The objective of enhancing the communication efficiency implies the achievement of a higher level of transparency and accountability to the public, which help to improve the latter’s credibility in the monetary authority decisions. Communication is a crucial aspect of monetary policy decisions’ transmission. Monetary policy transparency and central bank credibility – key elements in direct inflation targeting – allow monetary policy to meet its ultimate objective of price stability (Lyziak 2003).

Given the importance of consumer expectations in meeting the inflation objective, central banks are ever-increasingly interested in monitoring the nature of inflation expectations and understanding the consumer expectations’ formation process. By means of two simple examples, we emphasize the importance of having a reliable measure of expected inflation. First, to the extent that expectations provide an unbiased predictor of future inflation, quantitative measures of expected inflation may constitute an important information variable taken into account in forward-looking considerations. Second, in the event employees anticipate an increase in prices they will demand higher wage settlements. If this is the general trend of the economy, companies/employers will be more willing to pay higher wages since they may see incentives to transfer the higher costs into higher prices (Diagram 1).

**Diagram 1 Inflation formation process**

2.2 FORMATION OF EXPECTATIONS AND THEIR ESTIMATION APPROACHES

We argued that inflation expectations may be very useful in assessing the monetary policy credibility and the judgements on their empirical rationality are becoming ever-increasingly useful in the monetary policy conduct process. In order to assess and control the empirical features of inflation expectations, it is important to find methodologies that can collect the expectations from the public and transform them into time series. This process is frequently
considered as difficult given the errors associating the aggregation and generation procedures.

Figure 1: Formation of inflation expectations

Inflation expectations

\[
\begin{align*}
\pi^e & \rightarrow \pi_t^e & \pi_{t+12}^e & \pi_{t+24}^e \\
\text{Perceived actual inflation} & & \pi_{t-12}^p & \pi_t^p & \pi_{t+12}^p \\
\text{Actual (published) inflation} & & \pi_{t-12}^a & \pi_t^a & \pi_{t+12}^a
\end{align*}
\]

Figure 1 shows the formation of inflation perceptions during the 12-month periods, using the information on published inflation. The inflation expectations series is composed of expected rates of inflation \(\pi^e\) for the period ahead, while the agents contain information on the actual published inflation \(\pi^a\). It is also important to distinguish between actual \(\pi^a\) and perceived actual inflation \(\pi^p\). Consumer perception of inflation in time \(t\) may not be equal with the actual published inflation rate.

If we have a given time \(t\), then assuming that we have information on the actual inflation \(\pi^a\), the agents form their inflation expectations \(\pi_{t+12}^e\) for the period ahead, in this case for the next 12 months. The selection of the length of the period generally depends on the motivation to make the expectations comparable with the annual inflation objectives. However, in what follows we will see that in the case of Albania, the expectations consider the 3-month period, not the 12-month one, and that the advantages of choosing one over the other remain questionable given the lack of adequate 12-month data to make comparisons.

Consumer responses are quantified in order to derive the expectations series, which is expressed as: \([\pi^e, \pi^e_{t+12}, \pi^e_{t+24}...\].

The literature identifies three approaches that allow the collection of information on consumer expectations of inflation.

The first approach is to construct an economic model that includes expectations as variables and certain assumptions about how these expectations are formed. In order to estimate the equations, the expectations are proxied with the past or lagged inflation rates, based on preliminary assumptions on the way they are formed. In several cases, the model uses expectations generated from the
quantification of survey data. The estimation of equations provides information on the way expectations are formed - whether they are forward-looking —, and on their rationality level. However, the analysis of inflation expectations is in this case indirect and conditioned by the selection of the behaviour model.

The second approach is to try to infer the expected inflation rate from the prices of financial instruments. One way would be if, for example, both nominal and index linked bonds with identical risk, liquidity and maturity characteristics are traded, it is in principle possible to obtain a very accurate measure of expected inflation (Berk 2000). However, there are certain drawbacks which relate to the practical application of this approach. The limited number of index-linked bonds requires making strong auxiliary assumptions to infer expected inflation from the prices of these nominal assets, thereby clouding the information content of the expected inflation series that has been derived. Other problems include the unreliability of financial market indicators in general. Financial markets tend to over-react to shocks and are susceptible to herding and speculative phenomena, leading to time-varying risk premia that hinder the use of such measures for monetary policy purposes (Mylonas and Schich 1999).

The most common approach to measuring the expectations is the information obtained via surveys. This approach is widely used by many central banks and it has many advantages as compared to other approaches. Worth noting is the possibility to model the expectations and the simple way of measuring them. Moreover, this approach does not require any auxiliary assumptions that may affect the accuracy of indicators. However, it is often difficult to get the real opinion of the respondent, since there are no incentives to report. Even when the respondent provides the real opinion on the expectations, there are no urges to behave similarly to the opinion provided, as in the case of the financial markets, owing to the frequent non-rational behaviours. Moreover, the results of sample surveys are overly sensitive to sampling errors and to the precise formulation of the questions posed.

The measurement of inflation expectations via surveys is a widely used approach. However, deciding whether these expectations are good representatives of the real public confidence is quite a debatable issue. Nonetheless, for the purpose of this proposal, we will rely on the consumer confidence survey. In order to convert the qualitative responses into quantitative indicators of expectations, we will apply the adjusted probability method developed by Carlson and Parkin (1975).

3. METHODOLOGY

3.1 CONSUMERS’ ESTIMATION OF THE EXPECTED RATE OF INFLATION VIA THE CONSUMER CONFIDENCE SURVEY

In order to measure the inflation expectations, we have used qualitative data obtained from the Consumer Confidence Survey. This survey collects
information from about 1200 consumers and it is conducted on a quarterly basis. The survey questions on the inflation expectations do not require a numerical answer from the respondent. They indicate the expected direction and the rate of price change, comparing their expectation with the rate of price change in the quarterly period when the survey is conducted. They respond to the following question: “How do you think prices will change in the next three months? They will…: 1) rise more rapidly, 2) rise at the same rate, 3) rise at a slower rate, 4) stay about the same, 5) fall slightly”. For the fifteen surveys conducted so far, the percentages of each category in this question are given in Chart 1.

Chart 1 shows that the respondents acknowledge the downward seasonal trend of prices in the summer months (the percentage of the answer “fall slightly” increases) and their rise at the end of the season.

3.2 QUANTIFICATION APPROACH – PROBABILITY METHODS

The quantitative probability method was first employed by Theil (1952) in order to measure the inflation expectations. This method represented an alternative to simple “balance statistics”, defined as the difference between the percentage of respondents reporting an increase in prices and the percentage of respondents reporting a decrease.

There are two central assumptions in probability methods. Firstly, each individual is supposed to have a probability function over the expected price change. Secondly, it is assumed that, if the expected price change falls within a certain interval (-s,+s), the respondents will report that prices are going to stay the same. This interval is termed “sensibility interval” or “indifference interval”.

This material uses the normal probability method to describe the respondents’ responses on expected prices, since the number of respondents is sufficiently large (around 1200 respondents).

In the following part of this material, the following notations apply:

- percentage of respondents expecting prices to rise faster;
- percentage of respondents expecting prices to rise at the same rate;
- percentage of respondents expecting prices to rise more slowly;
- percentage of respondents expecting prices to stay at their present level;
- percentage of respondents expecting prices to go down;
\[ \Pi_{t+4} \] - expected rate of price change over the next quarter, assumed to be normally distributed \((m, \sigma^2)\);

\[ \Pi_b \] - perceived rate of price change over the previous quarter;

\( f \) - density function of expected rate of inflation;

\( F \) - cumulative distribution function of expected rate of inflation;

\( N_z \) - cumulative standardised normal distribution function.

Chart 2 makes a graphical presentation of the adjusted Carlson and Parkin (1975), applied with the consumer confidence survey results.

After making some algebraic transformations and using the standard normal cumulative distribution function, we derive the following result for the expected rate of inflation:

\[ m = \Pi_y (C+D)/ C+D-(A+B) \]

\[ \sigma = -2 \Pi_y / C+D-(A+B) \]

where \( A = N_z^{-1}(1-a) \); \( B = N_z^{-1}(1-a-b) \); \( C = N_z^{-1}(1-a-b-c) \); \( D = N_z^{-1}(1-a-b-c-d) \); \( E = N_z^{-1}(e) \).

and \( m \) is the mean of the expected inflation rate.

The responses on the change in future prices in the case of Albania are presented in Table 1 of the Statistical Annex.

3.3 DISTRIBUTION FUNCTIONS

The choice of the distribution function is not a simple task. Carlson and Parkin (1975) propose to use a normal distribution and justify this assumption by appeal to the Central Limit Theorem. Many empirical studies follow this suggestion also out of convenience, because the normal distribution is easy to handle and extensively explored and tabulated.

3.3.1 Assuming a normal distribution, we have:

General form:

\[ e_{t+1} = \Phi^{-1}(E_{t+1}) \]

\[ d_{t+1} = \Phi^{-1}(E_{t+1} + T_{t+1}) \]

\[ c_{t+1} = \Phi^{-1}(E_{t+1} + D_{t+1} + T_{t+1}) \]

\[ b_{t+1} = \Phi^{-1}(E_{t+1} + D_{t+1} + C_{t+1} + T_{t+1}) \]

where \( \Phi \) is the cumulative standard normal distribution function.
Despite these advantages the normal distribution might not cope with the empirical findings. There are theoretical and empirical reasons to reject the assumption of normality. One deviation observed by Carlson (1975) and Lahiri and Teigland (1987) while analyzing inflation forecasts and correspondingly by Vining and Elwertowski (1976), for the actual price changes is the peakedness which is not in line with the normal distribution. To account for this deviation, we have employed the logistic and the central t-distribution. They are both more peaked than the normal distribution.

3.3.2 The logistic distribution function is defined as:

General form:
$$H(x_{t+1} / \Omega) = \frac{1}{1 + e^{-x_{t+1} - m_{t+1}}}$$

where $\beta_1$ is the scaling parameter and $\sigma_{t+1} = \frac{m_{t+1}}{\sqrt{3}}$. Using this definition the mean is calculated as in the case of normal distribution and standard deviation$^2$:

$$\sigma_{t+1} = -m_{t+1} \cdot \frac{2\pi}{\sqrt{3}}, q_{t+1}$$

As a result:

$$e_{t+1} = \ln \left( \frac{E_{t+1}}{1 - E_{t+1}} \right)$$
$$d_{t+1} = \ln \left( \frac{E_{t+1} + D_{t+1}}{(1 - E_{t+1}) + D_{t+1}} \right)$$
$$c_{t+1} = \ln \left( \frac{E_{t+1} + C_{t+1}}{(1 - E_{t+1}) + C_{t+1}} \right)$$
$$b_{t+1} = \ln \left( \frac{E_{t+1} + B_{t+1}}{(1 - E_{t+1}) + B_{t+1}} \right)$$

3.3.3 The central t-distribution is defined as:

General form:
$$T_\nu = \frac{Y_1}{\sqrt{Y_2 / n}}$$

where $Y_1$ follows the standard normal distribution and $Y_2$ is independently distributed as $\chi^2$ with $n$ degrees of freedom. The variance of the central t-distribution is given by $\frac{n}{n-2}, n > 2.$

Praetz (1972) shows that to model the distribution of share price changes best a central t-distribution, scaled with its standard deviation, is used.

The standardized variable is scaled with $\theta^1 = \sqrt{\frac{n}{n-2}}$ and equations change to:

$$e'_{t+1} = \theta^1 e'_{t+1} = T_\nu \left( E_{t+1} \right)$$
$$d'_{t+1} = \theta^1 d'_{t+1} = T_\nu \left( E_{t+1} + D_{t+1} \right)$$
$$c'_{t+1} = \theta^1 c'_{t+1} = T_\nu \left( E_{t+1} + C_{t+1} \right)$$
$$b'_{t+1} = \theta^1 b'_{t+1} = T_\nu \left( E_{t+1} + B_{t+1} \right)$$
and:

\[ m_{t+1} = m_t, \quad e^{t+1}_t = d^{t+1}_t, q_{t+1} \]

\[ \sigma_{t+1} = -m_t, \quad 20^{(1)} q_{t+1} \]

where: \( q^{t+1}_i = e^{t+1}_i + d^{t+1}_i - c^{t+1}_i - s^{t+1}_i \)

Uniform distribution

In this case, the following relationships may be recorded:

\[ a = 1/2q \cdot (m_0 - \pi_0 - s) \]

\[ b = s/q \]

\[ c = 1/2q \cdot (\pi_0 - s - t) \]

\[ d = t/q \]

\[ e = 1/2q \cdot (-t - m_0 - q) \]

Where the set of dependent variables comprises \( m \) (mean of the expected rate of price change), \( q \) (half of the range between the minimum and maximum expected inflation) and also \( s \) and \( t \) (sensibility intervals). There are six explanatory variables, namely \( a, b, c, d, e \) (fractions of respondents choosing the respective replies to the survey question) and \( \pi_0 \) (current rate of inflation). The solution of equations may be expressed as:
where the last equation defines the expected rate of inflation based on this distribution.

3.4 BASIC TESTING FOR RATIONALITY

The methods that measure the expected inflation as described in the previous section provide useful information on the future consumer price developments compared with some other simple methods, which are based on the balance of respondents’ responses. In this section, we try to test the indicators of expected inflation in order to derive conclusions related to the nature of Albanian consumer inflation expectations.

The measuring of expectations requires almost always further testing on the nature and properties, which generally relate to the rationality level of expectations. This is because the nature of expectations affects the response of economic agents to the actions of the policy-making institution, in our case of the Bank of Albania. The rationality of expectations is strongly related to their formation. In the case of rational expectations hypothesis, it is assumed that the agents consider all the available information to make unbiased forecasts. While in the case of adaptive expectations hypothesis, the economic agents consider only the past information of the variable.

There are a number of interpretations related to the properties of the expectations series that make them rational or irrational; however, the main tests include the testing for bias, the periodic revision of errors and macroeconomic efficiency.

Testing for bias helps us to establish whether the consumers, on average, systemically under or overpredict inflation over the long run. A formal test for bias can be carried out using the following equation:

$$\pi = \alpha + \beta \pi^e + \epsilon$$

If the null hypothesis $H_0: (\alpha, \beta) = (0, 1)$ cannot be rejected, it can be concluded that the expectations are unbiased in a statistical sense (See Foresells & Kenny...
2 Bank of Albania

In general, the test results show that the respondents have poorly predicted the expected inflation in the next three months. In statistical terms, for the entire surveyed period (Q3 2003 – Q4 2006), the null hypothesis is rejected in the majority of cases.

The short data series of the Consumer Confidence Survey affects the above result significantly. The series of inflation expectations is insufficient to carry out further testing, in order to derive the dynamic properties of expectations that provide more information on the evolution of expectations than the above tests.

4. APPLICATION OF PROBABILITY METHODS IN THE CASE OF ALBANIA

The following charts show the expected quarterly inflation rate, measured based on the respective probability distribution functions. In the first chart, the average inflation rate of the last quarter has been considered for measuring the expected inflation. In the second chart, the quarterly inflation rate is used. The time length of data covers the period from the second quarter of 2003 to the first quarter of 2009. In Charts 1, 2 and 4, the average actual rate or the simple quarterly inflation rate is positioned in the same period as the average or simple expected inflation, but predicted in the previous period.

The charts show that the expected rate of inflation for the normal, logistic and uniform distributions is similar to both the actual rate of quarterly and average quarterly inflation with a lag of one period of time. This is shown more markedly in Chart 3 where the actual rate of inflation is positioned in the chart in the same period of time with the expected rate of inflation, for period \( t+1 \) predicted in period \( t \). Hence, if the actual inflation increases, the expectations for the period ahead indicate a higher increase of inflation and vice versa. The normal distribution function shows a greater shift from actual inflation compared with the other two functions, which reduces with the passing of time. The rationale behind is the enhanced education of the public or the familiarity of respondents with the consumer questionnaire.
The chart of the central t-distribution function is presented overturned compared with the other three charts of probability distribution functions. The highest points of inflation predicted based on the central t-distribution function correspond with the lowest points of inflation predicted based on the normal distribution and vice versa.

If we look at the chart in which the actual inflation rate is positioned with the expected inflation rate of period $t+1$, we note that it is overturned compared with the average or simple actual inflation.
These conclusions are also supported by the results of statistical equations applied in each case of the probability distribution function (see the results in the Annex) and by the estimation of forecast errors. From the application of equations, it is clear that the correlation between actual and expected inflation is stronger in the case when the inflation of period t is in regression with the expected inflation of period t+1. In addition, the results derived from the equations, more specifically the $R^2$ coefficient and the Root Mean Square Error, show that the respondents form their expectations of the quarterly inflation of period $t$ based on the average inflation of the preceding quarter $(t-1)^8$. The adaptive behaviour of consumers is also reflected in the test results of expectations rationality, where $H: (\alpha, \beta) = (0,1)$ is rejected.

### 4.1 ESTIMATION OF THE FORECAST ERROR

In order to assess the quality of inflation forecasts and compare the various methods applied for measuring the inflation expectations we have used the Root Mean Square Error (RMSE), which is calculated using the following formula:

$$RMSE = \left\{ \sum_{t=1}^{T} (F_t - A_t)^2 \right\}^{1/2}$$

where T is the number of inflation forecasts, F is the expected (or forecast) inflation and A is the actual inflation.

The estimation of this statistical indicator based on the survey data is presented in the following table:
The results show that average quarterly inflation is mostly considered by consumers when forming their inflation expectations for the quarter ahead. Moreover, the value of the indicator suggests that the closest figures for consumer expectations in the short-term are better modelled when applying the probability method, which considers the logistic or uniform distribution functions. This is clearly evidenced in Chart 2 in the present material.

5. CONCLUSIONS

In order to measure the expected inflation, we have used in this material qualitative quarterly data obtained from the (BoA) Consumer Confidence Index survey, which covers the period from September 2003 to March 2009. In absence of considerable data series\(^9\) on an annual basis, the inflation expectations are estimated on a quarterly basis. In order to convert the qualitative responses into quantitative indicators of expectations, we have applied the probability method. We have also applied a number of probability distribution functions in order to avoid bias (distortion and peakedness).

The results of the tests show that the consumers consider the average inflation rates of the last quarter if they need to make an inflation forecast for the quarter ahead. If the average inflation rate increases, the respondents expect an even greater increase of inflation in the subsequent period and vice versa. This provides evidence that the Albanian consumers have adopted an adaptive behaviour, which is based on the past inflation of the variable.

However, this issue requires further analysis, since the improvement in consumer perceptions of macroeconomic indicators – in our case of inflation – and the improved data base would enhance the forecasting process. The use of longer time series and the establishment of annual inflation expectations series in particular, will be important tools for improving the measurement of inflation expectations and forecast based on the Consumer Confidence Survey.

<table>
<thead>
<tr>
<th>Distribution function</th>
<th>Based on average quarterly inflation</th>
<th>Based on quarterly inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Logistic</td>
<td>9.5</td>
<td>12.9</td>
</tr>
<tr>
<td>Normal</td>
<td>33.1</td>
<td>38.3</td>
</tr>
<tr>
<td>Central t</td>
<td>13.9</td>
<td>10.3</td>
</tr>
<tr>
<td>Uniform</td>
<td>9.3</td>
<td>12.7</td>
</tr>
</tbody>
</table>

Source: Authors’ own estimations
LITERATURE


Nielsen, H, 2003, “Inflation expectations in the EU- Results from survey data”, Institute fur Statistik und Okonometrie


6. STATISTICAL ANNEX

Table 1: Frequency of responses to the question “How do you think prices will change in the next three months?”

<table>
<thead>
<tr>
<th></th>
<th>Q2/03</th>
<th>Q3/03</th>
<th>Q4/03</th>
<th>Q1/04</th>
<th>Q2/04</th>
<th>Q3/04</th>
<th>Q4/04</th>
<th>Q1/05</th>
<th>Q2/05</th>
<th>Q3/05</th>
<th>Q4/05</th>
<th>Q1/06</th>
<th>Q2/06</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>11.2</td>
<td>19.5</td>
<td>18.0</td>
<td>17.2</td>
<td>2.0</td>
<td>21.8</td>
<td>19.3</td>
<td>10.3</td>
<td>3.2</td>
<td>10.9</td>
<td>8.3</td>
<td>12.5</td>
<td>9.1</td>
</tr>
<tr>
<td>b</td>
<td>28.5</td>
<td>37.6</td>
<td>35.4</td>
<td>32.8</td>
<td>19.0</td>
<td>27.0</td>
<td>37.3</td>
<td>32.2</td>
<td>14.2</td>
<td>29.4</td>
<td>29.1</td>
<td>29.7</td>
<td>30.7</td>
</tr>
<tr>
<td>c</td>
<td>24.0</td>
<td>22.8</td>
<td>25.0</td>
<td>21.0</td>
<td>23.6</td>
<td>28.2</td>
<td>22.3</td>
<td>30.6</td>
<td>22.0</td>
<td>31.8</td>
<td>24.9</td>
<td>22.5</td>
<td>26.1</td>
</tr>
<tr>
<td>d</td>
<td>22.0</td>
<td>17.8</td>
<td>19.8</td>
<td>25.1</td>
<td>30.5</td>
<td>21.2</td>
<td>18.6</td>
<td>22.3</td>
<td>33.9</td>
<td>23.3</td>
<td>34.1</td>
<td>22.5</td>
<td>20.7</td>
</tr>
<tr>
<td>e</td>
<td>14.3</td>
<td>2.4</td>
<td>1.8</td>
<td>3.9</td>
<td>24.9</td>
<td>1.8</td>
<td>2.5</td>
<td>4.5</td>
<td>26.7</td>
<td>4.6</td>
<td>7.7</td>
<td>12.8</td>
<td>13.4</td>
</tr>
</tbody>
</table>

- **a** - percentage of respondents expecting prices to rise faster;
- **b** - percentage of respondents expecting prices to rise at the same rate;
- **c** - percentage of respondents expecting prices to rise more slowly;
- **d** - percentage of respondents expecting prices to stay at their present level;
- **e** - percentage of respondents expecting prices to go down;

Figure 1: Methods of calculating the expected inflation

\[ \pi_t = \alpha + \beta \pi_{t-1}^e + \varepsilon_t \]

where \( \pi_t^e \) is the expected inflation for period \( t \) forecasted in period \( t-1 \).

\[
\begin{align*}
\alpha & = 0.79 \\
\beta & = -0.01 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 31.91 \\
\end{align*}
\]

Central limit 

\[
\begin{align*}
\alpha & = 0.86 \\
\beta & = -0.09 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 5.85* \\
\end{align*}
\]

Logistic

\[
\begin{align*}
\alpha & = 0.79 \\
\beta & = 0.01 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 278 \\
\end{align*}
\]

Normal

\[
\begin{align*}
\alpha & = 0.84 \\
\beta & = -0.07 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 5.34* \\
\end{align*}
\]

Uniform

\[
\begin{align*}
\alpha & = 0.79 \\
\beta & = 0.01 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 278 \\
\end{align*}
\]

\[
\begin{align*}
\alpha & = 0.84 \\
\beta & = -0.07 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 5.34* \\
\end{align*}
\]

\[
\begin{align*}
\alpha & = 0.79 \\
\beta & = 0.01 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 278 \\
\end{align*}
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\alpha & = 0.84 \\
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\alpha & = 0.84 \\
\beta & = -0.07 \\
R^2 & = 0.00 \\
X^2 \text{ for } H & = 5.34* \\
\end{align*}
\]
\[ \pi_t = \alpha + \beta \pi_{t+1}^e + \varepsilon, \] where \( \pi_{t+1}^e \) is the expected inflation for period \( t+1 \).

\[ \begin{array}{cccc}
\alpha & \beta & R^2 & X^2 \text{ for } H \\
\hline
\text{Central limit } t & 0.69 & -0.01 & 0.00 & 26.19 \\
 & (1.32) & (0.04) & & [0.000] \\
\text{Logistic} & 0.74 & -0.11 & 0.01 & 7.01^* \\
 & (1.41) & (0.26) & & [0.03] \\
\text{Normal} & 0.68 & 0.01 & 0.00 & 204 \\
 & (1.31) & (0.11) & & [0.00] \\
\text{Uniform} & 0.73 & -0.11 & 0.00 & 6.24^* \\
 & (1.4) & (0.23) & & [0.044] \\
\end{array} \]

\[ \pi_t = \alpha + \beta \pi_{t+1}^e + \varepsilon, \] where \( \pi_{t+1}^e \) is the average expected inflation for period \( t+1 \).

\[ \begin{array}{cccc}
\alpha & \beta & R^2 & X^2 \text{ for } H \\
\hline
\text{Central limit } t & -0.02 & 0.43 & 0.9966 & 7308 \\
 & (0.45) & (61.73) & & [0.000] \\
\text{Logistic} & -0.39 & 1.61 & 0.85 & 10.74 \\
 & (1.59) & (8.68) & & [0.00] \\
\text{Normal} & 0.16 & 0.23 & 0.9929 & 21372 \\
 & (3.18) & (42.65) & & [0.00] \\
\text{Uniform} & -0.36 & 1.71 & 0.885 & 17.34 \\
 & (1.66) & (10.04) & & [0.00] \\
\end{array} \]

\[ \pi_t = \alpha + \beta \pi_{t+1}^e + \varepsilon, \] where \( \pi_{t+1}^e \) is the average expected inflation for period \( t+1 \).

\[ \begin{array}{cccc}
\alpha & \beta & R^2 & X^2 \text{ for } H \\
\hline
\text{Central limit } t & 0.012 & -0.81 & 0.990 & 7401.77 \\
 & (0.25) & (36.79) & & [0.000] \\
\text{Logistic} & 0.01 & 1.47 & 0.946 & 25.8 \\
 & (0.12) & (15.08) & & [0.000] \\
\text{Normal} & 0.03 & 0.25 & 0.992 & 19209.34 \\
 & (0.63) & (43.56) & & [0.000] \\
\text{Uniform} & (0.03) & 1.58 & 0.96 & 43.3 \\
 & (0.24) & (17.21) & & [0.000] \\
\end{array} \]
ENDNOTES

*Gent Hashorva, senior expert, Monetary Policy Department, Elona Bollano, expert, Monetary Policy Department, Elvana Troqe, expert, Monetary Policy Department, Bank of Albania.
The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Albania.

1 The data series on expected inflation in annual terms is still short to derive statistically significant conclusions.

2 See Roberts (1997), for instance.

3 Estrella and Fuhrer (1998) make a critique on the models assuming entirely rational expectations.

4 In our version, we have replaced the expected 12-month inflation rate with the expected 3-month inflation rate given the nature of questions in the Albanian Consumer Confidence Survey.

5 Where π is not connected with the inflation, but with the number 3.14.

6 The expected inflation rates are measured based on a series of only 24 terms.

7 These tests imply, on one hand, the testing of the periodic revision of forecasts from the economic agents, including their errors, in light of more updated information or the acceptance of the macroeconomic efficiency testing in order to test the expectations rationality.

8 This way of behaviour is referred to as adaptive, while the vice versa is termed rational.

9 In the questionnaire, the question on the annual prices was first applied in March 2005.
THE INTERNATIONAL FINANCIAL CRISIS AND THE REGIONAL COUNTRIES*

The global financial and economic system faced tumultuous times during 2008, which subject to the factual degree of globalization and financial integration had dissimilar effects in the majority of the world economies. The initial phase of this crisis swept through the financial markets of the most industrialized economies, whereas the subsequent phase affected the real economic indicators in both the developed and developing regions of the world. The purpose of this paper is not to closely scrutinize the origin or the consequences of the crisis but rather to provide a retrospective of its evolution from the developed to the developing world, the primary focus being some of the Central Eastern European Countries, some of the regional countries and Albania. Within this context, exceptional interest is paid to the manner the crisis is reflected in these countries’ real economic indicators as well as fiscal, monetary and respective institutional operational developments according to their quintessential economic profile.

The financial turmoil transition to an all-encompassing phase is considered to have occurred with the Lehman Brothers bankruptcy, one of the major banks in the U.S. market, in September 2008, and with the intervention of the U.S. government in some of the biggest financial institutions’ assets. The uncertainty prevailing during this period was transformed into a mutual loss of confidence of the markets’ main actors and changed the agents’ perception of the real financial outlook. In an attempt to minimize the transformation risk of the crisis into a contagion to the whole system, the central banks and governments of several leading economies intervened in a concerted and coordinated manner. Its starting point was the sub-prime mortgage market crisis in America which deteriorated further and was transmitted firstly to the domestic market, then into the main global financial markets. With the goal of stabilizing the system, the main central banks engaged in easing their monetary conditions, but which were offset by the widening of loan spreads and fall of asset prices.

Since the commencement of the crisis, it has largely inflicted hikes in the cost of financing and reduction of transactions in the financial markets. Liquidity constraints in the interbank market worsened further, hitting institutions obtaining their financing from the money market severely. During this crisis, the financial system was dramatically weakened from the losses incurred by banks in their balance sheets. Non-performing loans in the banks’ portfolios grew. The advancement of the crisis devalued the assets of financial institutions through lowering their liquidity and capital positions. Banks’ balance sheets change in the time structure and quality that had characterized these recent years helped in the spread and transmission of the consequences to some vital sectors of the economy. In the stock markets, the securities’ value registered a considerable fall, thus putting under risk the absorption of new capital for businesses. Banks’ tendency to lower their leverage through selling assets influenced their promptness in extending loans and lowered their market value.
Credit supply as a whole diminished and its cost went up due to higher credit risk. The consumers’ loss of confidence related to tensions in the financial markets contributed to the first signs of decelerating aggregate consumption and lower new loan rates.

The implications of the financial turmoil were transmitted with a short lag into the real economy. Industrialized economies faced negative shocks from both the demand and supply side. The constant depreciation of financial assets and house prices affected the propensity to consume and invest from households and businesses. Two of the main influenced channels are the wealth and credit channels. The former directly conditions the purchasing power of individuals and households, whereas the latter lowers the value of the collateral in the credit application process. As a result, consumption expenditures, which also have the highest share in the GDP in these countries, have followed a falling trend. Investments in the form of machinery or buildings, confronted with tight credit conditions, have also followed a falling tendency. Industrial production indicators and the prospect of manufacturing activities mirror a deep slowdown. The aggravated economic environment creates uncertainties in the market performance, which coupled with pressures in production capacities, forces firms to lower the number of employees. Developed countries such as the USA, the EU countries and Japan have experienced deteriorating labour market conditions during 2008 and the first half of 2009. In tandem, the effect of weakening demand and supply in the developed countries stirs moderation of economic growth rates and of forecasts in the short-term. According to the latest forecasts, global economic growth is projected to be lower in 2009.

### Table 1 Annual real GDP percentage change in several world regions

<table>
<thead>
<tr>
<th>Region</th>
<th>2006</th>
<th>2007</th>
<th>2008*</th>
<th>2009*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrialized economies</td>
<td>3.0</td>
<td>2.7</td>
<td>0.9</td>
<td>-3.8</td>
</tr>
<tr>
<td>Developing countries in Asia</td>
<td>9.8</td>
<td>10.6</td>
<td>7.7</td>
<td>4.8</td>
</tr>
<tr>
<td>South America and Mexico</td>
<td>5.7</td>
<td>5.7</td>
<td>4.2</td>
<td>-1.6</td>
</tr>
<tr>
<td>Developing countries in Europe</td>
<td>6.6</td>
<td>5.4</td>
<td>2.9</td>
<td>-3.7</td>
</tr>
<tr>
<td>The Middle East</td>
<td>5.7</td>
<td>6.3</td>
<td>5.9</td>
<td>2.5</td>
</tr>
</tbody>
</table>

*Estimates.

Source: IMF World Economic Outlook, April 2009

Economic growth rates followed similar trends in the emerging economies when compared to industrialized countries, but at different starting base levels. Retrospectively to previous financial crises, emerging economies have more sound fundamentals and as a result shocks to the economy have been less severe. Anyhow, risk levels are very sensitive to the typical economic profile of each country. Countries upholding the probability of a higher risk have the following traits: large current account deficit, domestic and foreign debt denominated in foreign currency and rapidly expanding consumer credits into levels hazardous to the financial stability. On the other hand, major commodity and oil exporting countries, despite a recent fall of prices in the international markets and weaker demand in developed countries, remain relatively less exposed. Foreign investors, primarily in some Asian countries but in other emerging economies as well, have withdrawn from the
domestic market forging a large financial and capital outflow. Similarly, the inability to secure fresh financing and the indecisiveness of foreign investors to penetrate into the emerging economies’ markets has diminished foreign direct investments. Consequently, after a time frame where financial and economic indicators displayed no pronounced structural alteration, during the first months of 2008, the first problems emerged in the Central and Eastern European Countries and in the regional economies. Quintessentially, countries with more integrated financial markets where hit hardest as opposed to countries with less developed markets. Simultaneously, countries operating under a currency board or under a fixed exchange rate regime experienced marked limitations in their scope of stabilising policies.

- **HUNGARY**

In Hungary, negative developments were manifested in the form of deterioration of available liquidity in all currencies in the money market, devaluation of the national currency, fall of credit growth, deposit withdrawals, higher interest rates on loans, higher government bond yields and in the form of foreign capital outflows as a result of a downgrade to the Hungarian economy’s credit rating issued from international grading agencies. In an endeavour to bring calm to the markets and to ameliorate monetary indicators, the Central Bank of Hungary focused on ensuring liquidity flows in domestic and foreign currency (mostly in Euro), in defending its currency from further depreciation and in following an appropriate monetary policy to keep inflation rates under control. In this respect, new instruments to pump liquidity into the system were used such as: special 2-week and 6-month credit lines with weekly periodicity offered under variable interest rates with collateral, more frequent tenders to buy up government bonds, narrower interest rate corridors for standing facilities, more diverse types of assets accepted as collateral as well as a lower ratio of reserve requirement held in the National Bank of Hungary. Similarly, Hungary raised its deposit insurance level reaching developed countries’ thresholds. At the end of 2008, Hungary reached a stand-by arrangement with the IMF for financial aid and assistance.

- **POLAND**

Similar developments were registered in the Polish economy. Accordingly, the inflation rate in Poland reached 3.3 per cent at the end of the year, slightly below the upper tier of the official objective. During the third and fourth quarter of 2008, the national currency picked a devaluing trend against the Euro and the U.S. dollar. Nevertheless, the devaluation of the national currency attributed to foreign capital outflow was a common characteristic of countries adopting a flexible exchange rate regime. Another phenomenon present in the Polish economy was a tightening of credit loans due to shortage of liquidity in the market. This brought about the risk of higher deposit interest rates, which would have gravely endangered commercial banks’ balance sheets. In order to avoid this situation, the National Bank of Poland lowered
its base interest rate by 25 basis points in November 2008 and March 2009 and by 75 basis points in December 2008 and January 2009. Apart from this, in accordance with the Ministry of Finance and the Financial Supervision Authority, the central bank enacted a set of measures called “Confidence Package” to restore confidence in the interbank market. This set of measures aiming at pumping liquidity consisted of REPO auctions of 3-month maturity, raise of foreign currency liquidity for the banks (swap) and alterations in the operational framework for Lombard loans through the extension of the range of assets to be used as collateral. Included assets were municipality bonds, domestic corporate bonds, bonds supported by the government and European Investment Bank’s bonds. Other measures taken by the central bank were the continuation in issuing securities of one-week maturity, to absorb surplus liquidity in the market, as well as if necessary, higher frequency of open market operations to ensure a more prompt response to liquidity fluctuations and to stabilize overnight deposits’ interest rates. In May of 2008, Poland was granted financial aid amounting to USD 20 billion from the IMF through a stand-by arrangement.

• ROMANIA

Romania was another country which suffered from the effects of the international financial crisis. The free-falling current personal transfers in the form of remittances, the low confidence of economic actors, the local currency devaluation, the tighter liquidity conditions and the inability of the government to secure loans in the international markets in order to step up public investments domestically were some of the determining traits of the economy. Therefore, in order to lower the risk incurred by commercial banks from new mortgage loans, the Central Bank of Romania adopted a regulation to strengthen the actual regulatory framework on risk management. Similarly, the CBR decided to lower the reserve requirement threshold for liabilities in foreign currency of over 2-year maturity to 0 per cent from 40 per cent. During this year’s subsequent meetings, the CBR Board left the base interest rate unchanged. In March, Romania applied for financial assistance in some major international institutions such as the IMF, the World Bank and the European Bank for Reconstruction and Development.

• CROATIA

Towards the end of 2008, affected by the continuously advancing regional economic integration, Croatia demonstrated the first signs of the effect on the domestic economy. A decrease in the foreign and domestic demand was
reflected in a fall of government revenue, which compelled the governing authorities to change the level of expenditure in the lately revised budget. The high foreign debt and the inability to obtain funds through the international organizations were among the other factors that caused pressures on the economy. Credit to individuals and small business decreased considerably while the interest rates on these loans increased markedly. The Croatian National Bank provided the market regularly with Euros in order to fulfil the commercial banks’ needs in the condition of an increase of the interest rates in the interbank market as well as to prevent the weakening of the domestic currency. At the same time, as a response to deposit withdrawals in October 2008 and the undermined public confidence in the banking system the CNB in accordance with the local government, quadruplicated the deposit insurance rate\(^3\). The CNB also eliminated the required reserve for the funds obtained in foreign currency by the commercial banks to facilitate these grants by their parent banks. Other measures were the lowering of the required reserve from 17 percent to 14 percent; the lowering of the mandatory ratio of the foreign currency liquidity down to 20 percent from 32 percent and the easing of the emergency loan approval to commercial banks.

• SERBIA

Similar developments occurred in the Serbian economy as well. The decrease of foreign direct investments and the weak supply of foreign currency in the market caused a quick devaluation of the domestic currency towards the Euro. The monetary indicators contracted in annual terms while the economy faced a decrease of both imports and exports. The inflow of foreign capital decreased, creating hardship in the financing of the economic and banking activity. The withdrawal of the foreign currency deposits added to the pressure on liquidity, requiring immediate intervention by the central bank. The inflation rate manifested upward tendencies, which in the last quarter of 2008, went over the central bank’s target. In order to improve the commercial banks’ foreign currency liquidity, the National Bank of Serbia lowered the required reserve rate and decided to eliminate it for the new financing that banks would get in the foreign market during 2009. The rate of insured deposits increased during this period. To accomplish its inflation target, the SNB lowered its key interest rate in January 2009, while the commercial banks provided their customers with the option of converting their foreign currency loans to loans denominated in domestic currency. In May 2009, Serbia was granted a financial aid of USD 4 billion by the International Monetary Fund.

<table>
<thead>
<tr>
<th>Countries</th>
<th>Change in GDP</th>
<th>Change in exports</th>
<th>Foreign direct investments (as a percentage of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>H:1 H:2</td>
<td>H:1 H:2</td>
<td>H:1 H:2</td>
</tr>
<tr>
<td>Croatia</td>
<td>3.9 0.9</td>
<td>7.0 2.1</td>
<td>8.1 6.5</td>
</tr>
<tr>
<td>FYROM</td>
<td>6.0 3.8</td>
<td>12.1 4.9</td>
<td>6.7 7.0</td>
</tr>
<tr>
<td>Serbia</td>
<td>7.3 3.9</td>
<td>40.3 11.6</td>
<td>9.0 3.9</td>
</tr>
<tr>
<td>Turkey</td>
<td>4.3 -2.9</td>
<td>20.8 10.4</td>
<td>2.2 2.1</td>
</tr>
<tr>
<td>Montenegro</td>
<td>8.1 8.1</td>
<td>-17.2 -23.0</td>
<td>17.7 16.9</td>
</tr>
</tbody>
</table>

Source: European Commission, Respective statistical institutions

Table 2 Annual changes in some macroeconomic indicators for 2008
• TURKEY

The third quarter of 2008 marked a turn in the progress of macroeconomic indicators in Turkey. Demand for Turkish exports, in line with falling demand in developed countries, started a strong decreasing trend creating negative pressures on private consumption and aggregate investment. The Turkish government increased expenditure and investment in order to jolt aggregate demand in the economy, to the expense of the budget deficit, which widened further. The current account deficit increased markedly as a result of the annual contraction of imports, which dropped by 44 percent in the first months of 2009. In the conditions of falling inflationary pressures and expectations, as well as a slowdown in economic activity, the Turkish Central Bank lowered its policy rate by 750 basis points since November 2008. The TCB also undertook continuous measures to prevent fluctuations in the interest rates in the interbank market, by increasing the frequency of its open market operations. Even though Turkey adopts a floating exchange rate regime, the devaluation of the local currency by 35 percent since mid-2008, required the TCB to be more active in supporting the Turkish currency in the exchange market. Meanwhile, given that exports make up a considerable part of the GDP and various manufacturing industries are directly dependent on them, the TCB decided to increase the level of its credit to exporting companies.

• MONTENEGRO

Montenegro has been characterized by a high economic growth in the last three years. This growth was sustained by investments and foreign capital inflows, increasing tourism activity and construction industry as well as successful privatizations. In the second half of 2008, the Montenegrin economy faced problems related to the economic slowdown and its reflection in the strategic sectors of the economy. During this period, there was an increase in the index of non-performing loans, a fall of foreign direct investments in the construction and real estate sectors and a weakening of domestic demand given that the foreign banks had difficulties in ensuring capital. There was a sharp decrease in the international reserves in the recent period. The phenomenon of deposit withdrawals aggravated the frail bank balance sheets, posing threats to the system. The Central Bank of Montenegro adopted a series of urgent measures in order to restore confidence in the financial institutions as well as to improve the capital adequacy indicators. The base and rate of the required reserve was increased and the time period of its availability was widened. A ceiling was applied to interbank crediting, deposit insurance for the private sector was expanded to all amounts and the time required for the compensation in case of bankruptcy was shortened. In order to increase liquidity, special credit lines for the banks were created and also one-month liquidity was offered to the troubled banks, as long as they had tried all the other available instruments in the operational framework. The risk management system in banks was subject to changes, which targeted the increase of preventive measures to risks in the system induced by the troubled global financial setting.
MACEDONIA

The Macedonian economy has proved to be relatively immune to the developments in the international conjunctures given that the economy grew by a satisfactory pace during the first nine months of 2008. Supported by the positive momentum of the main indicators and the quick dynamics of the economy, the government decided to operate under a budget surplus during that period. However, the pro-cyclic forms of the budget expenditure along with a decline in foreign demand, falling investment and industrial production exerted pressure on the domestic economy in the last quarter of the year. Simultaneously, the widening of the current account deficit by about 5 percent in 2008 compared to last year’s created extensive pressures on the domestic currency in the conditions of a fixed exchange rate regime. The National Bank of the Republic of Macedonia decided to contrast the rate of credit growth in the country to maintain financial stability. In this context, in addition to the restrictive monetary policy, the central bank also increased the required capital adequacy indicators for overdraft and credit card-type loans and forced the banks that pass the 40 percent threshold of credit to households to deposit funds in the central bank with low interest rates. The commitment to maintain the fixed exchange rate regime pushed the National Bank of the Republic of Macedonia to intervene regularly in the foreign exchange market to support the domestic currency.

ALBANIA

In the first signals of the slowing economic growth and the increase of demand for liquidity in the banking system as a result of the wavering confidence in the domestic financial institutions, the Bank of Albania undertook a wide package of measures to smoothen the negative effects of the global crisis in the domestic economy, further strengthen the financial system stability and to meet the market demand for liquidity. Among these measures were: the change of the type of the main auction for liquidity injection, from a fixed amount auction to a fixed price auction; the increase of the range of the securities that may be used as a collateral for the reverse repos; the increase of the time span for the use of the required reserve up to 40 percent from 20 percent per day; and the decrease of the difference between the policy rate and the overnight lending rate by 100 basis points. Also, some regulative acts were passed, aiming at the further capitalization of the commercial banks, the improvement of risk management and the prudential constraining of banks’ large exposure to the global markets. The Albanian government, as a response to deposit withdrawals in October 2008 and in order to bring the Albanian legislation close to that of the European Union, decided to increase the rate of insured deposits to ALL 2.5 million from the previous amount of ALL 00 thousand. These measures were accompanied by a wide explanatory and sensibilization campaign about the sound position of the Albanian economy, stressing the belief that the preservation of the macroeconomic balances is the best contribution to successfully dealing with the crisis. As a whole, these measures have helped face the problems brought up by the lack of liquidity and constrain their effects on the real economy during the first half of 2009.
ENDNOTES

* Eglent Kika, expert, Monetary Policy Department, Erblin Maçi, expert, Monetary Policy Department, Medvin Shehu, expert, Monetary Policy Department, Bank of Albania.

The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Albania.

1. IMF World Economic Outlook Update, November.
3. The deposit insurance rate increased from EUR 14,000 to EUR 56,000.
4. The ceiling of the TCB allocated credit increased to USD 2.5 billion from USD 0.5 billion.
“The Real Value of Money” competition is one of the most remarkable activities of the Bank of Albania educational programme “Central Bank in Everyday Life”. Held for the first time in April 2008 for high schools of Tirana, the competition challenges third-year students of high schools in each region to deepen knowledge and understanding of the Bank of Albania, its monetary policy, the instruments it employs and the impact of central bank’s decisions on the national economy.

On 9 April 2009, “The Real Value of Money” competition for high school students took place at Migjeni Theatre in Shkodra with 16 participant high schools competing against each other. The competition was attended by students, professors, representatives of the Educational Directory of Shkodra district and participant students’ family members. In his capacity as the Chairman of the Competition Jury, Governor Fullani accentuated the importance of economic and financial education to the development of the national economy and the prosperity of its citizens. The Governor congratulated the students and professors of participant high schools for their outstanding work and commitment and enthusiasm shown in this competition. At the conclusion of the two-round competition, “28 Nëntori” High School was announced winner for the Shkodra district.

Following Vlora and Shkodra, Korça was the third district to host “The Real Value of Money” competition for the academic year 2008-2009. On 24 April, 11 high schools of Korça district competed against each other at A. Z. Çajupi Theatre. 11 teams of 3 high school students each answered before the Bank of Albania Jury to a number of questions, including quizzes, missing terms completion and elaborative questions on the Bank of Albania, its objectives, functions and monetary policy. After several hours of competition, “Themistokli Gërmenji” High School, which scored the highest points, was announced winner of “The Real Value of Money” competition for the Korça district.

On 8 May 2009, 7 high schools of Gjirokastra district competed against each other in the Bank of Albania competition “The Real Value of Money”. The competition attracted the attention of participant competitors and of the audience that had filled up the Zihni Sako Theatre and warmly supported the competitors. In response to the interest of the audience, the Governor of the Bank of Albania and the Chairman of the Competition Jury, Ardian Fullani, explained the importance of public educational programmes that have been designed and implemented by the Bank of Albania in the last two years. At the
conclusion of the competition, the winners of different awards were delivered trophies, certificates and presents. The first prize went to “Siri Shaplllo” High School.

On 7 May 2009, in addition to “The Real Value of Money” competition for the high schools of Gjirokastra district, the Governor of the Bank of Albania, Ardian Fullani, attended the inauguration ceremony of the new premises of the Bank of Albania Branch in Gjirokastra. Following an extensive work for the construction of new premises according to all contemporary standards of most modern banks, the Bank of Albania Branch in Gjirokastra opened its doors to the public. At the end of the ceremony, the Supervisory Council held its regular meeting in Gjirokastra Branch.

On 14-16 May 2009, a delegation from the Central Bank of the Republic of Kosovo (CBK), composed of Driton Thaci, Head of Physical and Telecommunication Security Unit at the CBK, and Afërdita Uruqi, Head of Procurement at the CBK, had a working visit at the Bank of Albania. This visit was organized in the framework of the technical assistance the Bank of Albania provides to the CBK. The two CBK representatives held bilateral meetings with representatives of the Administration Department and Security and Protection Department at the Bank of Albania. The parties shared their respective experiences and discussed the organizational structures in order to ensure the well-functioning of work and the efficient distribution of duties and responsibilities within the respective departments.

At the conclusion of its tour in Vlora, Shkodra, Korça and Gjirokastra, “The Real Value of Money” competition returned to Tirana to challenge the capital city’s high school students with questions on the central bank, its functions, monetary policy and the instruments it employs. On 25–26 May 2009, at the Bank of Albania Hall, teams of 3 students each, representing 25 high schools in Tirana, competed against each other divided in 5 different panels. After a long and highly competitive competition, at the end of the second day, “Tirana Jonë” High School was announced winner of “The Real Value of Money” competition for Tirana district.

Through this competition, the Bank of Albania aims at broadening and developing the students’ understanding of the central bank and its monetary policy, presenting a real economic and financial culture to this age-group in an entertaining way. This competition allows the students to play the role of the Supervisory Council of the Central Bank, inviting them to get familiar to its work for achieving and maintaining price stability. It also helps to encourage the new generation to focus their university and post-university studies on economy, business and finance-related branches.

On 24-31 May 2009, Atilla Arda and Bossu Wouter, Legal Counsels for the International Monetary Fund (IMF), had a working visit at the Bank of
Albania. This visit was organized in the framework of the technical assistance the IMF provides to the Bank of Albania for the drafting of the new Law on the Bank of Albania. The purpose of this mission was to discuss the draft law on the payment systems, the best international practices in this area and the EU regulatory framework. The discussions of the IMF Legal Counsels with the Legal, Payment Systems and Monetary Operations Departments’ staff at the Bank of Albania were held in the form of a seminar, where the participants discussed the payment systems’ legislation, systems’ protection and surveillance and the central bank law (first chapter).

On 29 May 2009, the Payment Systems Department held at the Bank of Albania Library a working meeting with commercial banks’ coordinators focusing on the performance and further progress of the payment system in Albania. The topics discussed in this meeting related to the performance of the payment systems in 2008; the measures taken in view of implementing the Regulation “On the structure and use of IBAN in Albania” and the problems encountered; the restructuring of the treasury payment process from the Government account held with the Bank of Albania channelling it through the payment systems; problems encountered in the reporting of payment instruments’ statistical indicators; and other concerns raised by banks’ coordinators for the improvement of the payment systems’ regulatory basis or infrastructure.

On 9-20 June 2009, Goran Knežević, IMF Counsel, had a working visit at the Bank of Albania Supervision Department. This visit was organized in the framework of the IMF Technical Assistance Mission with the purpose of drafting the development plan of the Bank of Albania supervisory capacities. During his visit, Mr. Knežević met with Bank of Albania Administrators and heads of departments and representatives of other financial institutions in Albania.

On 15-19 June 2009, Cynthia McNulty, Chief Market Risk Officer at PNC Bank, Pittsburg, USA, had a working visit at the Bank of Albania Supervision Department. Contacted by the FSCV with the request of the Bank of Albania, Ms. McNulty is part of a project whose aim is to review and improve the current stress test methodology. The purpose of Ms. McNulty’s visit to the Bank of Albania, as the first phase of this project, was to get familiar to the Albanian banking system and the current stress test methodology. The FSVC expert met with Supervision Department representatives of Off-site Supervision Division and Credit Registry Office and with representatives of Financial Stability and Research Departments. At the conclusion of her visit, Ms. McNulty prepared some recommendations for the Supervision Department.

For more than two years, Research Department at the Bank of Albania has been organizing the Friday Seminar with the purpose of presenting and
discussing theoretical and empirical scientific works having at their main focus the case of Albania and the application of the most recent research methods. Friday Seminar invites all researchers at the Bank of Albania and broader to discuss their empirical and theoretical papers of a high scientific standard.

The first paper for the quarter April to June 2009 was presented by Vasil Zaho, winner of the 2008 Governor’s Award for the Best Diploma Thesis, and it was entitled “Efficiency and Productivity Growth of Albanian Banks”. This study uses data envelopment analysis to distinguish between cost, allocative, technical, pure technical and scale efficiency, and a distance function approach to derive Malmquist productivity indexes for 12 Albanian banks over the period 1999 to 2006.

In May, Prof. Murat Karagoz from Epoka University presented the paper entitled “Reflections on the Late 2000 Recession”. Although some casual comparisons between the late 2000s recession and the Great Depression in 1929 have been made, there remain large differences between the two events. Unlike the Great Depression, this recession was synchronized by global integration of markets, causing the synchronized recession to last longer than typical economic downturns and have slower recoveries.

The third study for this quarter was presented by Arjan Kadareja, Member of the Bank of Albania Supervisory Council entitled “Financial and Real Variables for Euro Area Countries with International Linkages. A Global VAR Approach.” The study provides a quantitative evaluation of the effects of shocks (country specific or global) on a number of economic variables for US, UK and Euro area countries. The latter are analyzed individually, which is vindicated by the asymmetric behaviour of the single economies in the current crisis.

The next study discussed at the Friday Seminar was presented by Elona Dushku, Bank of Albania Research Department, and it was entitled “Gap Model”. Ms. Dushku outlined the work to date for the construction of a new model for the Bank of Albania monetary policy called the Gap Model. This model contains 4 equations for the real GDP, real interest rate, real exchange rate and inflation rate. All variables are presented in the form of deviations from their equilibrium levels. This model provides a good merger of neo-Keynesian and real business cycle characteristics.

Irini Kalluci from the Research Department at the Bank of Albania presented another study entitled “Analysis of the Albanian Banking System from the Risk-Performance Viewpoint”. This study makes a theoretical and analytical analysis of risk and return indicators of the Albanian banking system. It introduces for the first time the estimation methodology of a risk index for the system. The purpose of this study is to analyze the risk and performance indicators and to suggest some indicators and an index that may be used by the supervisors during their work.

The last study for this quarter was presented by Ilir Vika from the Research Department at the Bank of Albania and it was entitled “Measuring the ALL
Exchange Rate Equilibrium”. The purpose of this study is to measure the exchange rate equilibrium in Albania using the ARDL model for the real exchange rate of the ALL versus the EUR. The determinants of the equilibrium real exchange rate considered in this study include the output gap, net foreign assets, government expenditure, interest rate spread and the economic openness.
CHRONOLOGY OF MONETARY POLICY DECISIONS

12 July 2006
The Supervisory Council of the Bank of Albania decides to increase the key interest rate by 0.25 percentage points, to 5.25 percent.

30 November 2006
The Supervisory Council of the Bank of Albania decides to increase the key interest rate by 0.25 percentage points, to 5.5 percent.

4 April, 2 May and 6 June 2007
The Supervisory Council of the Bank of Albania decides to keep the key interest rate unchanged at 5.5 percent.

27 June 2007
The Supervisory Council of the Bank of Albania decides to increase the key interest rate by 0.25 percentage points, to 5.75 percent.

19 July and 29 August 2007
The Supervisory Council of the Bank of Albania decides to keep the key interest rate unchanged at 5.75 percent.

26 September 2007
The Supervisory Council of the Bank of Albania decides to increase the key interest rate by 0.25 percentage points, to 6.00 percent.

31 October 2007
The Supervisory Council of the Bank of Albania decides to keep the key interest rate unchanged at 6.00 percent.

27 November 2007
The Supervisory Council of the Bank of Albania decides to increase the key interest rate by 0.25 percentage points, to 6.25 percent.
27 December 2007
The Supervisory Council of the Bank of Albania decides to keep the key interest rate unchanged at 6.25 percent.

The Supervisory Council of the Bank of Albania decides to keep the key interest rate unchanged at 6.25 percent, all through 2008.

28 January 2009
The Supervisory Council of the Bank of Albania decides to decrease the key interest rate by 0.50 percentage points, to 5.75 percent.

25 February, 25 March, 29 April, 17 May, 24 June, 29 July and 26 August 2009
The Supervisory Council of the Bank of Albania decides to keep the key interest rate unchanged at 5.75 percent.
LEGAL EVENTS OVER APRIL-JUNE 2009

MONETARY POLICY

On 29 April 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 35 “Monetary Policy Report for the first quarter of 2009”. According to this Report, the Albanian economy performed amidst stable consumer prices. The low core and non-traded inflation rates attest to the downward inflationary pressures on the domestic demand side. Imports and exports declined over this period in tandem with the trade deficit narrowing by 4.3 percent. 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.

SUPERVISION

On 27 May 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 40 the Regulation “On the basic management principles of banks and branches of foreign banks and the criteria for the approval of their administrators”. The purpose of this Regulation is to set out the basic rules and principles for a responsible and effective management of banks and branches of foreign banks, to specify the criteria their administrators should meet and the documentation required for their approval by the Bank of Albania. This Regulation also sets out the criteria for entering into agreement with the third parties in view of carrying out the functions and responsibilities for the bank’s management.

On 10 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 44 the Regulation “On the prevention of money laundering and terrorism financing”. The purpose of this Regulation is to prevent the use of entities licensed and supervised by the Bank of Albania for money laundering or terrorism financing-related purposes. This Regulation sets out the procedures and documentation for the customer identification, the rules for their registration, data maintenance and reporting to the responsible authority.

On 10 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 45 the Regulation “On reporting to the Bank of Albania according to the unified reporting system”. This Regulation sets out the rules, conditions and deadlines of reporting from banks and branches of foreign banks, non-bank financial entities, savings and loan associations and their unions to the Statistics Department at the Bank of Albania, as well as the rules for the management of reporting. The purpose
of unified reporting systems is to ensure standardized information from the abovementioned entities, allowing for their processing for banking supervision purposes and compilation of various financial and monetary statistics.

On 10 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 47 an amendment to the Regulation “On credit risk management”. Following this amendment, “borrowers exposed to the exchange rate risk” will be also considered those borrowers who are not protected against this risk through a derivative product (derivative instruments), which provides appropriate conditions for protection.

On 10 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 46 some amendments and changes to the Regulation “On the management of risk arising from large bank exposures”. The changes and amendments to Articles 7 and 8 of this Regulation set out the criteria the subsidiaries of a bank or parent bank should meet in order for the latter to be exempt from the maximum allowable large exposure. The changes also provide for the exclusion, from the bank’s exposure to a person or group of persons, of guarantees issued by banks and financial institutions operating in OECD countries, which guarantee rights or loans to customers operating in the Republic of Albania.

On 24 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 51 some amendments and changes to the Regulation “On the operation of Credit Registry at the Bank of Albania”. Following these changes, the data providers reporting to the Credit Registry should also report data and information on each Letter of Credit or Letter of Guarantee, approved and financed by them, within the next working day. The data providers also have the right to request information on the persons they consider related to the entity applying for a loan.

On 24 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 52 some amendments and changes to the Regulation “On the procedure for issuing the report on the borrower and reviewing the data kept at the Credit Registry”. The purpose of the changes and amendments to Articles 5, 11 and 15 of this Regulation is to improve the procedures to be followed and the conditions to be met for approving the borrower’s request for issuing the report with his/her data and reviewing them.

On 24 June 2009, the Supervisory Council of the Bank of Albania approved by Decision No. 50 “The Bank of Albania medium-term development strategy for the 2009-2011 period”. The purpose of the Bank of Albania medium-term development strategy is to set out a detailed programme of the work and duties of all Bank of Albania units and the way the commitments and initiatives taken by the institution will be achieved in the subsequent three years.
ECONOMIC POLICY

On 1 April 2009, the Council of Ministers approved the Instruction No. 1 “On the form, ways and reporting procedures of entities’ data to the Agency for the Legalization, Urbanization, and Integration of the Informal Zones/Buildings, and to the Central Real Estate Registry Office, in view of preventing money laundering and terrorism financing”. The purpose of this Instruction is to prevent the use of different entities for money laundering and terrorism financing purposes through a number of reporting, namely: “Cash transaction report”, “Self-control report”, “Asset transaction report” etc. The reporting entities suspecting that the transaction, property or business relationships are related to a criminal offence or are intended to be used for terrorism financing purposes, must within 72 hours submit to the responsible authority a report on the activity.

On 23 April 2009, the Parliament of the Republic of Albania ratified by Law No. 10115 “The agreement between the Council of Ministers of the Republic of Albania, represented by the Ministry of Finance, and the Ministry of Economy and Finance of the Republic of Greece and Export Credit Insurance Organization (ECIO)”. This agreement envisages the full debt settling arising from the agreement signed on 24 June 1991 between the Albanian State Bank and the Greek banks consortium, within a 10-year period through instalments to be paid every six months.

On 23 April 2009, the Parliament of the Republic of Albania approved the Law No. 10117 “On some amendments to the Law No. 9632, dated 30 October 2006, “On the national tax system”, as amended”. The Law envisages, inter alia, the changes to Articles 11 and 21 of the Law No. 9632. Accordingly, the upper limits, under which the municipal or communal councils decide on the level of the national tax on small-sized businesses (Article 11) and the tax on real estate (Article 21), change from plus 30 percent to plus 10 percent of the indicative tax level for the respective categories.

On 23 April 2009, the Parliament of the Republic of Albania approved the Law No. 10119 “On territory planning”. The purpose of this Law is to set out the key principles, rules and procedures for territory planning. This Law aims at ensuring stable territory development through the rational use of land and natural resources; creating adequate conditions and equal opportunities for housing, economic and social activities for all social categories. It also allows the regular compilation and updating of planning instruments by the national and local authorities depending on the market and social needs.

On 23 April 2009, the Parliament of the Republic of Albania approved the Law No. 10116 “On the approval of the contract for the sale of 76 percent of shares of the Electricity Distribution Company (OSSH) Jnt. Stk. between the Ministry of Economy, Trade and Energy of the Republic of Albania and CEZ A.S.”. In the framework of important reforms undertaken in the energy sector, which aim at the liberalization and development of the electrical energy market, upon this Law, the Ministry of Economy, Trade and Energy of the
Republic of Albania sells to CEZ A.S. 76 percent of the shares of OSSH. The value of the contract for the majority stake in OSSH is €102 million.

On 27 April 2009, the Council of Ministers approved the Decision No. 415 “On the pension raise”. This Decision envisages the raise of pensions by 8, 10 and 22 percent, according to the categories as set out in the Law “On social insurance in the Republic of Albania”.

On 6 May 2009, the Council of Ministers approved the Decision No. 487 “On establishing the rules and criteria for the allocation of the compensation fund to the land owners for the year 2009”. This Decision establishes the categories of expropriated entities subject to compensation, the land area the land owners will be compensated of according to the price established in the approved value map, the documentation required along with the application for compensation and the application examination procedures.

On 6 May 2009, the Council of Ministers approved the Decision No. 450 “On the approval of the ownership transfer of construction parcels of informal objects, detached, prior-1993 side building additions, and of unpermitted side building additions in permitted buildings, to their owners”. The purpose of this Decision is to approve the ownership transfer of construction parcels of informal objects to their owners, according to a list attached to the Decision and the respective building design plans for some districts in the Republic of Albania.

On 8 May 2009, the Council of Ministers approved the Instruction No. 16 “On establishing the rules for the allocation and reallocation of public funds to the election entities”. The purpose of this Instruction is to establish the rules for the allocation of public funds to the election entities taking part in the 2009 Albanian parliamentary elections, and the reallocation of public funds to the election entities winning mandates.

On 11 May 2009, the Parliament of the Republic of Albania ratified by Law No. 10123 “The loan framework agreement between the Republic of Albania and the Council of Europe Development Bank (CEB) for the financing of rural and mountainous areas stable development programme”. The purpose of this programme is to create and preserve the possible work places through lending to small entrepreneurs in rural areas to purchase livestock, tools and to make small rural investments and services. The fund of €5 million, approved by the CEB, will be used for “individual loans” (less than €1200) and “loans to small-sized enterprises” (more than €1200).

On 11 May 2009, the Parliament of the Republic of Albania ratified by Law No. 10125 “The loan agreement between the Republic of Albania, represented by the Council of Ministers acting through the Minister of Finance, and Alpha Bank A.E. of Deutsche Bank AG, London Branch, as arranger, the financial institutions listed as the original lenders and Alpha Bank A.E., London Branch as the agent, for the financing of 2009 capital expenditure, in accordance with Albania’s National Strategy for Development and Integration”. The loan,
envisaged not to exceed €250 million, will be used for capital expenditure purposes as projected by the Council of Ministers for the year 2009, in accordance with the priorities set out in Albania’s National Strategy for Development and Integration.

On 11 May 2009, the Parliament of the Republic of Albania approved the Law No. 10130 “On the Albanian Development Fund”. The purpose of this Law is to set out the organization form, the operation rules and the management of the Albanian Development Fund (ADF). The main objective of the ADF is to promote a sustainable and balanced economic and social development, at a regional and local level. To this aim, the ADF’s intermediate objectives are: the improvement of social and economic infrastructure, the improvement of local public services, the institutional strengthening of local government units and the promotion of good governance at a local level.

On 11 May 2009, the Parliament of the Republic of Albania approved the Law No. 00 “On the Albanian Development Fund”. The purpose of this Law is to set out the organization form, the operation rules and the management of the Albanian Development Fund (ADF). The main objective of the ADF is to promote a sustainable and balanced economic and social development, at a regional and local level. To this aim, the ADF’s intermediate objectives are: the improvement of social and economic infrastructure, the improvement of local public services, the institutional strengthening of local government units and the promotion of good governance at a local level.

On 13 May 2009, the Parliament of the Republic of Albania approved the Law No. 10137 “On some changes to the legislation in force on licences, authorizations and permits in the Republic of Albania”. Through this Law, the Albanian Parliament approved a number of changes to different laws, according to the areas of activity and use of goods. Some of the areas subject to changes in legislation are: national security, food and health, transportation, industry, services, etc.

On 13 May 2009, the Parliament of the Republic of Albania approved the Law No. 10140 “On the funding from the State Budget of religious communities that have entered into agreement with the Council of Ministers”. This Law envisages that the religious communities that have entered into agreement with the Council of Ministers, namely the Albanian Muslim Community, Orthodox Autocephalous Church of Albania, Catholic Church in Albania and the World Headquarters of Bektashians, may obtain partial funding for the construction and maintenance of cult objects and up to half of the minimum budget wage for the administration personnel and preschool, pre-university and university professors employed at institutions established and managed by these religious communities.

On 25 May 2009, the Council of Ministers approved the Decision No. 581 “On the additional fund to the 2009 budget, approved for the Central Election Commission for the financing of expenditure on the Albanian Parliamentary Elections of 28 June 2009”. According to this Decision, the Central Election Commission is allocated an additional fund of ALL 165 million to cover the expenditure on the Albanian Parliamentary Elections of 28 June 2009. This fund will be covered by the 2009 State Budget reserve fund.
On 28 May 2009, the Council of Ministers approved by Decision No. 595 “The commercial and economic co-operation agreement between the Council of Ministers of the Republic of Albania and the Government of the State of Qatar”. Through this agreement, the two governments commit to closely co-operate in economic, commercial and technical areas, namely industry, energy, agriculture, communication, transportation, labour and tourism.

On 11 June 2009, the Council of Ministers approved the Decision No. 681 “On the recovery of loans transferred from entirely state-owned commercial banks to the Loan Recovery Agency, the criteria and conditions for the change of the loan agreement and the ownership procedures of real estates pledged or unpledged by the borrowers, the management, sale and lease or emphyteutic lease of real estates”. The purpose of this Decision is to set out the recovery conditions of loans transferred from entirely state-owned commercial banks, the ownership procedures of pledged real estates and their management, and the terms and criteria to be met for the change of the loan agreement and the debtor or pledge replacement.

On 18 June 2009, the Council of Ministers approved the Decision No. 700 “On some changes to the Decision No. 1117, dated 30 July 2008 of the Council of Ministers “On some issues pursuant to Law No. 7703, dated 11 May 1993 “On social insurance in the Republic of Albania”, as amended; Law No. 9136, dated 11 September 2003 “On the collection of compulsory social and health insurance contributions in the Republic of Albania”, as amended; and Law No. 7870, dated 13 October 1994 “On health insurance in the Republic of Albania”, as amended””. The Decision envisages, inter alia, changes to the monthly minimum wage, for the effect of calculating the social and health insurance contributions, to not less than ALL 620, and to the monthly maximum wage, to not less than ALL 80600. As of 1 May 2009, the mandatory social and health insurance contribution for employed persons is 27.1 percent of the gross monthly wage, 16.7 percent of the contribution being covered by the employer and 11.2 percent by the employee.
BANK OF ALBANIA MANAGEMENT, 30 JUNE 2009

**SUPERVISORY COUNCIL**

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARDIAN FULLANI</td>
<td>Chairman</td>
</tr>
<tr>
<td>FATOS IBRAHIMI</td>
<td>Vice Chairman</td>
</tr>
<tr>
<td>TEFTA ÇUÇI</td>
<td>Member</td>
</tr>
<tr>
<td>LIMOS MALAJ</td>
<td>Member</td>
</tr>
<tr>
<td>KSÉNOFON KRISAFI</td>
<td>Member</td>
</tr>
<tr>
<td>ADRIAN CIVICI</td>
<td>Member</td>
</tr>
<tr>
<td>ARJAN KADAREJA</td>
<td>Member</td>
</tr>
<tr>
<td>HALIT XHAFA</td>
<td>Member</td>
</tr>
<tr>
<td>BENET BECI</td>
<td>Member</td>
</tr>
</tbody>
</table>

**GOVERNOR**

ARDIAN FULLANI

**GOVERNOR’S OFFICE**

GENC MAMANI

**DEPUTY GOVERNORS**

FATOS IBRAHIMI First Deputy Governor

**GENERAL INSPECTOR**

TEUTA BALETA

**DEPARTMENTS AND OTHER UNITS**

<table>
<thead>
<tr>
<th>Department</th>
<th>Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Human Resources Department</td>
<td>Roden Pajaj</td>
</tr>
<tr>
<td>Monetary Policy Department</td>
<td>Erald Themeli</td>
</tr>
<tr>
<td>Research Department</td>
<td>Altin Tanku</td>
</tr>
<tr>
<td>Monetary Operations Department</td>
<td>Marjan Gjermeni</td>
</tr>
<tr>
<td>Supervision Department</td>
<td>Indrit Banka</td>
</tr>
<tr>
<td>Financial Stability Department</td>
<td>Klodion Shehu</td>
</tr>
<tr>
<td>Information Technology Department</td>
<td>Xhilda Kanini</td>
</tr>
<tr>
<td>Statistics Department</td>
<td>Diana Shylla</td>
</tr>
<tr>
<td>Issue Department</td>
<td>Valer Miho</td>
</tr>
<tr>
<td>Accounting and Finance Department</td>
<td>Arton Toro</td>
</tr>
<tr>
<td>Payment Systems Department</td>
<td>Dashmir Halilaj</td>
</tr>
<tr>
<td>Legal Department</td>
<td>Toni Gagu</td>
</tr>
<tr>
<td>Audit Department</td>
<td>Teuta Baleta</td>
</tr>
<tr>
<td>Foreign Relations, European Integration</td>
<td>Ina Kraja</td>
</tr>
<tr>
<td>and Communication Department</td>
<td>Agron Skënderaga</td>
</tr>
<tr>
<td>Administration Department</td>
<td></td>
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<tr>
<td>Security and Protection Department</td>
<td>Eduard Sinani</td>
</tr>
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</table>

**BRANCHES**

<table>
<thead>
<tr>
<th>Branch</th>
<th>Name</th>
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<tbody>
<tr>
<td>Shkodra</td>
<td>Ermira Istreri</td>
</tr>
<tr>
<td>Elbasani</td>
<td>Valentina Dedja</td>
</tr>
<tr>
<td>Gjirokastra</td>
<td>Anila Thomaj</td>
</tr>
<tr>
<td>Korça</td>
<td>Liljana Zjarri</td>
</tr>
<tr>
<td>Lushnja</td>
<td>Shpresa Meço</td>
</tr>
</tbody>
</table>
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 Teknoprojekt, Tirana, Albania
Tel.: 222 84 60, 222 38 73, 222 74 08
Fax: 222 84 60, 222 83 87

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 03 51 / 2 / 3 / 4 / 5
Fax: 228 03 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. 07, dated 12.09.1996
Certificate No. 6 “On Deposit Insurance”.
Director: Dimitrias SANTIÐIS
Address: Rruga “Dëshmorët e 4 Shkurtit”, Tirana, Albania
Tel.: 226 96 16/7/8; 223 34 41/42/43/44/45/46/47
Fax.: 223 34 17

* As of June 30, 2009.
6. NATIONAL BANK OF GREECE (JOINT-STOCK COMPANY) – TIRANA BRANCH
Licence No. 08, dated 25.11.1996
Approved by the Supervisory Council Decision of the Bank of Albania No. 4, dated 14.03.1996.
Certificate No. 7 “On Deposit Insurance”.
Director: Ioannis KOUGIONAS
Address: Rruga “Durrës”, Godina Comfort, Tirana, Albania
Tel.: 227 48 02; 227 48 22
Fax.: 223 36 13

7. INTERNATIONAL COMMERCIAL BANK (JOINT-STOCK COMPANY)
Licence No.09, dated 20.02.1997
Certificate No. 8 “On Deposit Insurance”.
Director: Mahendra Sing RAWAT
Address: Qendra e Biznesit, Rruga “Murat Toptani”, Tirana, Albania
Tel.: 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 GALATOUS
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: Stefano FARABBI
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 “Perlat Rexhepi”, Al-Kharafi Group Administration Building, Kati 182” 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. 13, dated 16.04.1999
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 30 June 2009 licensed the following entities**:

<table>
<thead>
<tr>
<th>NO.</th>
<th>ENTITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>NON-BANK INSTITUTIONS</td>
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<tr>
<td>201</td>
<td>FOREIGN EXCHANGE BUREAUS</td>
</tr>
<tr>
<td>2</td>
<td>UNIONS OF SAVINGS AND CREDIT ASSOCIATIONS</td>
</tr>
<tr>
<td>135</td>
<td>SAVINGS AND CREDIT ASSOCIATIONS</td>
</tr>
<tr>
<td>1</td>
<td>REPRESENTATIVE OFFICES OF FOREIGN BANKS</td>
</tr>
</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
PUBLICATIONS ISSUED BY THE BANK OF ALBANIA SINCE 2008

This list was designed to inform readers about publications issued by the Bank of Albania since 2008. By visiting our website (www.bankofalbania.org) you can subscribe to our mailing list by submitting a written request either by e-mail at public@bankofalbania.org or sending a fax to (355 4) 223 558. You can also subscribe to updates by signing up to receive free e-mail notices when new series items are posted on the Bank of Albania website. You will receive e-mail notices each time we post new items of the series you selected. Listed below you can find all the publications issued by the Bank of Albania from January 2008 till August 2009. This list does not include periodical surveys carried out by the Bank of Albania as they are available only online (http://www.bankofalbania.org/web/survey_3405_2.php).

ANNUAL REPORT:
Annual Report 2007
Annual Report 2008

MONETARY POLICY PERIODICAL REPORTS:
Monetary Policy Report for the First Quarter of 2008
Monetary Policy Report for the Third Quarter of 2008
Monetary Policy Statement for the First Half of 2008
Monetary Policy Statement for the Second Half of 2008
Monetary Policy Report for the First Quarter of 2009
Monetary Policy Statement for the First Half of 2009
Monetary Policy Document for 2008
Monetary Policy Document for the 2009 - 2011 Period

PUBLICATIONS ON STATISTICS:
Statistical Report (Published monthly)
Balance of Payments Bulletin 2007
Balance of Payments Bulletin 2008

OFFICIAL BULLETIN:
Official Bulletin - Volume 10, no.1 Year 2008
Official Bulletin - Volume 10, no.2 Year 2008
Official Bulletin - Volume 10, no.3 Year 2008
Official Bulletin - Volume 10, no.4 Year 2008
Official Bulletin - Volume 10, no.5 Year 2008
Official Bulletin - Volume 10, no.6 Year 2008
Official Bulletin - Volume 10, no.7 Year 2008
Official Bulletin - Volume 10, no.8 Year 2008
Official Bulletin - Volume 10, no.9 Year 2008
Official Bulletin - Volume 10, no.10 Year 2008
Official Bulletin - Volume 10, no.11 Year 2008
Official Bulletin - Volume 11, no.1 Year 2009
Official Bulletin - Volume 11, no.2 Year 2009
Official Bulletin - Volume 11, no.3 Year 2009
Official Bulletin - Volume 11, no.4 Year 2009
Official Bulletin - Volume 11, no.5 Year 2009
Official Bulletin - Volume 11, no.6 Year 2009
Official Bulletin - Volume 11, no.7 Year 2009

ECONOMIC BULLETIN:
Economic Bulletin - Volume 11, no.1 Year 2008
Economic Bulletin - Volume 11, no.2 Year 2008
Economic Bulletin - Volume 11, no.3 Year 2008
Economic Bulletin - Volume 11, no.4 Year 2008
Economic Bulletin - Volume 12, no.1 Year 2009

FINANCIAL STABILITY REPORT:
Financial Stability Report 2007
Financial Stability Report 2008

SUPERVISION ANNUAL REPORT:
Supervision Annual Report 2007
Supervision Annual Report 2008

INFORMATIVE PUBLICATIONS:
Publications Catalogue:
Publications Catalogue 2007
Publications Catalogue 2008

WORKING PAPERS:
Articles Published throughout a Decade in the Economic Bulletin of the Bank of Albania.
Volume I, Period 1998-2000
Articles Published throughout a Decade in the Economic Bulletin of the Bank of Albania.
Volume II, Period 2001-2004
Articles Published throughout a Decade in the Economic Bulletin of the Bank of Albania.
Index of Foreign Prices/Unit Values of Albanian Imports
Exchange Rate Pass-Through in Albania
Measuring Import and Export Functions in Albania
New Core Inflation Measures: Their Usage in Forecasts and Analysis
The Role of Exchange Rate in an IT Framework, What do we do?
An Estimation of Balassa-Samuelson: Effect in Albania
Role of Banks in the Monetary Policy Transmission in Albania
Albanian Current Account Deficit: Does it Possess Mean Reverting Properties?
Monetary Policy Strategies for Small Economies - Editor, Ardian Fullani
Alternative Methods of Estimating Potential Output in Albania
SCIENTIFIC NOVELTIES AT THE BANK OF ALBANIA:
Scientific Novelties at the Bank of Albania No.1
Scientific Novelties at the Bank of Albania No.2

LEGAL PUBLICATIONS:

EDUCATIONAL PUBLICATIONS:
A Guide to Your First Bank Account*
Students’ Financial Guidebook*
Story of Ice-Cream (Reprint)*
Speaking Simply about Inflation (Reprint)*
Banknotes Withdrawal from Circulation (Leaflet)*
“The Real Value of Money”*
Bank of Albania - Our Central Bank
IBAN - The International Bank Account Number (Leaflet)*
Bank of Albania’s Monetary Policy Instruments and Procedures for their Execution
(Reprint)*
Payments System (Reprint)*
“The Real Value of Money”, Vlore, 2008*
Education - The New Challenge of the Bank of Albania

* Available only in Albanian.