

BANK OF ALBANIA

MONETARY POLICY
REPORT FOR THE THIRD
QUARTER OF 2008

2008

MONETARY POLICY REPORT FOR THE THIRD QUARTER OF 2008

1. GOVERNOR'S SPEECH

Economic activity during the third quarter the present year has been carried out amidst strained settings in the developed countries' financial markets and economies. The turmoil the financial markets went through is being translated into the deceleration of consumption and investments, which in turn generate the slowdown in economic growth and the upsurge in unemployment in many developed countries. Despite the financial markets' strains and the first signs of global economic slowdown, the Albanian economy has been relatively resilient during the third quarter. According to the available data, economic growth at home has progressed in line with the projections and inflation remains at contained rates and within the Bank of Albania target. In addition, the Albanian banking system is presented sound and stable and adequately capable of carrying out its financial intermediation function. Taking note of the increasing public interest in the stability of the Albanian financial system, the Bank of Albania notes that the economic agents' confidence in our financial institutions and their products has been intact.

Under these global circumstances, the economic developments in the past months have been characterized by a vague situation in the monetary and financial markets and institutions. Global economy has been swept by an upward uncertainty during this period while the financial crisis has been extending further being reflected - through the contraction of lending and the reduction of consumption and investments - in the real economy as well. The end of the third quarter and the first months of the last quarter found the economies of developed countries – United States, Euro zone, England and Japan – in a deep economic crisis, which is anticipated to extend its effects to the following year as well. While the supervisory, monetary and fiscal authorities of affected countries have at a national or international level launched co-ordinated or one-sided emergency measures to cope with its immediate effects, the professional consensus converges to characterizing this crisis as one of the most severe of post-war period.

Sub-standard mortgage loans-related troubles during the past 12 months manifested their real extent during the third quarter. The collapse of one of the largest investment banks, Lehman Brothers, served as a signal for a chain reaction in the financial markets. The following events proved that many innovative financial products were invented and launched into the market skipping all the testing mechanisms and without being entirely acknowledged by the market agents. They were market priced based on a wrong perception of the risk, in particular of the counterparty risk. The awareness for the nature

of this type of risk increased the uncertainty in the financial markets, yielding large disruptions and the virtual cessation of the lending system, which is the backbone of a functional and free market economy. The resetting into operation of the lending system required massive fiscal interventions, high liquidity injections from the central banks, the partial nationalization of some financial institutions and the state guaranteeing of financial institutions' obligations. Although reactive and often uncoordinated, these measures proved successful in revitalizing the financial sector and re-establishing the public trust.

The challenge of coping with the economic growth contraction remains open. Euro area countries have now confirmed the economic growth slowdown and have revised downward the economic growth forecast for the last quarter and the year 2009. GDP continued to drop by 0.2 percent in the third quarter compared with the previous one, as a result of the fall in domestic demand, exports and investments. A similar setting, characterized by an economic decline and increase in unemployment during the quarter, was also noted in the economies of the United States and England. On the other side, the marked decline in food and raw materials' prices has helped to ease the inflationary pressures on these economies. In October, Euro zone inflation marked 3.2 percent from 3.6 percent the previous month. The fall in consumer prices is expected to persist in the following months as well, causing the monetary policy to shift its focus to preventing deflationary situations and boosting economic growth. In their efforts to ease the pressures on the markets and better fine-tune the monetary conditions with the moderated inflationary pressures, the main central banks, including the Federal Reserve, the ECB and the Bank of England, lowered the key interest rate on 8 October 2008. Following that, these banks lowered again their interest rates, the Federal Reserve and the ECB by 50 basis points, while the Bank of England was more aggressive lowering it by 150 basis points.

While developed countries were experiencing hard times, emerging countries have by and large shown resilience to this crisis' consequences. Their immunity attributes to their incomplete financial integration with the developed countries, and to the fact that their economic growth is ever-increasingly being supported by domestic factors. The same setting is also confirmed for neighbouring countries which have not been affected by the first wave of global financial crisis, while their domestic demand remains high.

The performance of the Albanian economy for this quarter has been characterized by features comparable with those of the emerging countries. Albania has shown resilience to the financial markets' turmoil and the pessimism that has accompanied the large economies, some of which Albania's trading partners. The available data show that economic activity for the first nine months of 2008 has been in line with the projections, macroeconomic balances remain stable and the banking system maintains its soundness. Economic activity at home maintained an upward trend during the second quarter of 2008, being evidenced in the high annual increase of turnover indicator. The positive indicators of credit and sentiment indices show that

the same performance was also maintained in the third quarter. Services and the trade sector in particular continued to provide the main contribution to the annual increase of turnover indicator. In addition, the high contribution of construction sector continues to dominate the expansion of production activity at home.

Following the increase in the first half of 2008 beyond the threshold of 4 percent, the annual consumer price increased by 3.0 per cent in the third quarter, which is fully in line with the Bank of Albania's price stability objective. CPI inflation dropped in October to 2.7 percent. The inflation rate drop for this period was fuelled by the moderated aggregate supply-side shocks, in the form of high food, oil and raw materials' prices in the international market. On the other side, more specific indicators of inflationary trends - core inflation for instance - show that macroeconomic balances at home and the monetary conditions have been adequate to warrant an inflation rate close to the Bank of Albania target. The inflationary expectations of economic agents, which have been anchored to around 3 percent, have also provided their positive contribution. These developments attest to the fact that the monetary policy tightening and the strengthening of supervisory measures by the Bank of Albania have been efficient steps in containing inflationary pressures. The assurance of a more contained credit growth rate, the generation of a more proportionate ratio of consumption and savings incentives and the support to demand for ALL-denominated financial assets have proved to be fundamental contributions of the Bank of Albania monetary policy to the country's economic development.

The positive performance of economic sectors and the economy in general has been propelled by the positive rates of domestic demand at home, while the latter has been favoured by the macroeconomic and financial stability of the Albanian economy. The low inflation rates and the anchored inflation expectations have expanded the decision-making horizon of economic agents and have generated a more efficient allocation of financial resources. On the other side, the expansion of the banking system network, the decline in the intermediation costs and the wider range of banking services have provided better support to the economy with credit. Outstanding loans grew by 29 billion leks in the third quarter of 2008, hence maintaining the high annual growth rates of 43 percent. As a share of GDP and the system's assets, loans have recorded further growth to 36 percent and 41 percent, respectively. Foreign currency-denominated loans continue to provide the main contribution to the growth of loans being pushed by the positive interest rate spread of ALL loans to foreign currency loans. Businesses were the main banking loans' users, accounting for 66 percent of loan portfolio growth. The distribution of lending by sectors of economy attests to the fact that the loan portfolio is dominated by lending to the sectors of trade (24.8 percent), construction (14.7 percent) and industry (15.5 percent). The growth rate of households' loan portfolio has reduced to 41.0 percent from 67.7 percent for 2007, owing to the contained annual growth rates of consumer loans. Households' portfolio has shifted to housing loans which accounted for 66 per cent of this portfolio in the third quarter.

Fiscal policy has provided a more uniform contribution during 2008 to buttressing domestic demand. Fiscal balance ended in a deficit during the first months of the present year, mainly as a result of the higher pace in capital expenditures, which is different from the previous two years' performance. Budget expenditures and revenues were met by 98 percent and 94 percent, respectively, of the first nine-month plan, recording high increasing rates. The fiscal policy pursued during the entire year 2008 has observed the targets set in the Medium-term Budget Programme for 2008-2010; consequently, it has not yielded any recessions in economy and performance of prices.

Foreign demand, materialized in the balance of goods and services trade exchanges with abroad, remains at negative levels. Trade deficit accounted for 22.7 percent of the GDP in the third quarter, increasing slightly compared to 21.6 per cent the previous year. Imports grew by 17.2 percent, while exports grew by 21.9 percent. The deepening of trade deficit owes to a large extent to temporary factors and to the deterioration of trading terms as a result of the risen price of energy and food products in the global markets. The import of 'minerals, fuels and energy' accounted for 20.6 percent of total imports. Excluding the imports of this item, the annual growth of the import of goods would have recorded 13.1 percent, while trade deficit as a share of GDP would have been 18.7 percent. However, the deep trade deficit remains an issue which requires special attention in the context of the stable economic development over the long term. While the trade and current account deficit is a normal phenomenon in emerging economies, the generation of stable foreign currency resources in the form of exports and foreign direct investment needs to be a priority of economic development policies. In addition, the structure of exports by trading partners attests to a high concentration of exports with EU countries (76.33 percent); hence, exposing our economy to oscillations of demand in these countries.

Demand for money in economy has maintained average rates in the third quarter – around 14 percent – being mainly pushed by private sector lending. The growth of M3 aggregate mainly attributes to foreign currency-denominated deposits which recorded an annual growth of 26 percent in September. Narrower money aggregates, M2 and money base, recorded in September an annual increase of 9.6 percent and 4.8 percent, respectively.

The financial markets have not been affected by the turmoil in global or European financial markets. This performance does not only attribute to the low integration level with the European markets and to the orientation of the Albanian banking system to financing the internal activity, but also to the prudent Bank of Albania supervision. Being the monetary and supervisory authority of the banking system, the Bank of Albania has been particularly prudent in terms of meeting the system's liquidity needs and constantly monitoring the performance of banks' financial indicators. To this purpose, it has conducted open market operations and injected liquidity for longer periods and beyond the banks' anticipated needs.

The interest rates in the interbank market increased in September and October, a period during which the change in the required reserve was met. On the other side, the interest rate fluctuations in the interbank market also relate to the features characterizing this market, such as the asymmetric market distribution and the hesitation to trade in maturities of longer than one week. Interbank market fluctuations have not been transmitted to other markets, which in contrast have been characterized by decrease in interest rates. T-bills' and bonds' yields in the primary market have confirmed their downward trend which commenced in the second half of the present year. The spread between maturities has narrowed, reflecting the improved market agents' expectations of inflation, the enhanced confidence in these debt instruments and the monetary policy efficiency. Following the considerable increase of deposits' interest rates in summer as a result of banks' aggressive market strategies, they dropped in September once the offers terminated. Interest rates of ALL loans have shown a downward tendency in 2008. Combined with the increase of ALL deposits' interest rates, this performance attests to the improvement of the intermediation rate. The spread between ALL and EUR interest rates has shown a narrowing trend since the latter have increased in line with the performance of foreign currencies' interest rates in the international markets. Despite the historical developments in foreign currency loans, lending in currencies other than in lek has been contained in the last two months as a result of the strengthening of supervisory measures.

Concluding, I would like to underline that the period to follow will present major challenges to the Albanian economy and the decision-makers.

Economic crisis recovery at a global level requires time. Revitalization of domestic demand, the increase in employment and the development of the economy at the level of its production capacities remain constant challenges to the political authorities. Its solution will materialize through the resetting of a number of internal and external economic balances, the re-arrangement of many supervisory institutions and the re-design of the regulatory framework on many financial market segments and on their managers' incentives systems.

The Albanian economy has not been affected by the financial turmoil or recession that has gripped the developed countries. The Albanian banking system has not invested in any toxic securities of developed markets, while its internal activity remains sound. The ongoing supervision conducted by the central Bank of Albania is an additional safety element that this system will continue to operate within normal parameters. Safeguarding financial stability is a permanent objective of the Bank of Albania, which carries out its mission through its traditional role as the lender of last resort and through the constant improvement of legal and institutional infrastructure of the interbank market functioning. The fiscal authorities' commitment to facing any plausible events in this context completes the safety network package.

In an economic context, Albania may be faced with more difficult conditions in terms of financing the economic activity. The fall in foreign demand, remittances and foreign direct investments may yield a lower growth rate during

2009; however, their levels will remain at acceptable figures. In addition to the not too high integration levels with the global markets, the resilience shown by the Albanian economy to foreign shocks attributes to the economic stability at home and to the anchored expectations of economic agents. Therefore, the Bank of Albania believes that the decision-makers' attention will focus on maintaining macroeconomic balances. Fiscal policy should be anchored to a fiscal rule, which will orient fiscal performance and set clear quantitative criteria for coping with the various shocks. The Bank of Albania will continue to have as its key priority the preservation of price stability in economy, close to our 3 percent target of annual consumer price increase. We believe this is the best contribution monetary policy could provide in terms of economic growth and wellbeing in the medium and long run.

2. DEVELOPMENTS IN WORLD ECONOMY

2.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

World economy was characterized by unfavourable economic developments in the third quarter of 2008, generated by the financial crisis which hit the United States and developed European countries. The inflationary pressures have been high, although recently they have eased as a result of the sharp fall in prices. Economic growth in emerging countries has continued to offset the economic slowdown in developed countries; however, the further deepening of the financial crisis has led to uncertain projections for the global economic growth. The latter has also been reflected in the accelerated fall of sentiment indices.

Table 1 Some main macroeconomic indicators

	GDP annual growth*	Unemployment rate	Inflation rate	
	Q3-08	September-08	Q3-08	October-08
USA	0.8	6.5 ¹	5.3	4.9 ³
Euro zone	0.7	7.5	3.8	3.2
Germany	0.8	7.1	3.1	2.5
Greece	3.1	7.5 ²	4.7	4.0
Italy	-0.9	6.8 ²	4.0	3.6
Japan	-0.1	4.0	2.2	2.1 ³

Source: OECD, Eurostat, ECB Statistics Pocket Book

* Preliminary data for GDP growth.

¹ Rate for October 2008.

² Rate for June 2008.

³ Rate for September 2008.

EURO ZONE ECONOMY

Euro zone economic growth continued to maintain downward rates in the third quarter, contracting by 0.2 basis points compared with the previous quarter. In annual terms, however, it has grown by 0.7 basis points. The economic decline stems from the turbulences in the U.S. financial markets that were transmitted to the European economy and to the cessation of temporary factors, which had provided considerable contribution in the first

quarter. The decline in economic growth was mainly materialized in the drop of investments during the third quarter.

Euro zone inflation maintained the downward trend which began in mid-2008 after reaching the record rate. In September, the CPI increased to 3.6 percent in annual terms, while in October it fell to 3.2 percent. The fall in raw materials' prices and the drop of demand is expected to affect the further fall in prices, to later stabilize in 2009.

U.S. ECONOMY

U.S. economy continues to endure the negative effects generated by the liquidity problems in the interbank market and the repricing of real estates' financial assets, which have already provided their impact on the real economy as well. According to preliminary assessments, GDP contracted by 0.3 basis points in the third quarter of 2008 compared with the previous quarter¹. The fall in consumption spending and aggregate investments as a result of reduced income and housing-related investments provided the main contribution to this performance. In the meantime, Federal Government's budget expenditure and the net exports maintained their positive contribution to GDP growth. Though the U.S. dollar appreciated against some main foreign currencies², imports maintained their downward trend, although at more moderate rates. Processing and construction industries have had a reduced activity which in turn has resulted in drop of production capacities. With respect to services sector, financial and business services have deteriorated sharply to below the average for 2008. Unemployment rate recorded 6.0 percent from 5.3 percent the previous quarter. Although the inflation rate marked about 5.3 percent in the third quarter, in September it manifested a downward trend accompanied with the improved inflationary expectations³.

MAIN EMERGING COUNTRIES' ECONOMIES

Economic growth rates of main emerging countries' economies, BRICs⁴, have been more moderate in the second quarter of the year 2008 compared with the average growth of 2007. Domestic demand and investments continued to provide the main contribution to GDP growth. Foreign demand has slightly reduced as a result of economic growth slowdown and the moderation of aggregate demand's growth rates in developed countries. Nonetheless, the high prices of oil and raw materials did not affect the deterioration of current account and the contribution of net exports to the GDP growth of mainly exporting countries⁵.

In August, inflation rate in China and Brazil fell to 4.9 percent and 6.2 percent, respectively⁶, while it remained unchanged in Russia relative to July (15 percent). In India, the rapid credit growth and the second round effects of raw materials' price rise triggered the increase of the inflation rate in August. In order to fuel the growth of domestic demand and under the conditions of a decreasing inflation rate, China decided to pursue an easy monetary policy. Meanwhile, the concern over possible inflationary spirals in Brazil and

the high inflation rate in Russia and India, propelled the relevant monetary authorities to raise the key interest rates.

Table 2 Economic indicators for the BRICs

Country	2007	2008 ¹	2009	2007	2008 (6M1) ²	2009 ¹
	Inflation			Real economic growth		
Brazil	3.6	5.7	5.1	5.4	6.1	3.5
China	4.8	6.4	4.3	11.9	10.4	9.3
India	6.4	7.9	6.7	9.3	8.4	6.9
Russia	9.0	14.0	12.0	8.1	8.0	5.5

Source: IMF, OECD and Statistical Institutes

¹Assessment.

²Economic growth for the first half of 2008.

SOME REGIONAL COUNTRIES' ECONOMIES

The turbulences in the interbank market and the highly volatile financial markets⁷ provided their impact on the economic growth in Italy. In the second quarter of 2008, the GDP contracted by 0.3 percent compared with the previous quarter. This performance attributes to the drop in aggregate exports and the fall in investments, mainly in construction sector. Domestic demand weakened further while services sector contracted. The weak foreign and domestic demand and the uncertainty over the short-term economic developments led to drop in production capacities. Periodical surveys on the economic situation attest to the fall in business and consumer sentiment. Industrial production reduced during the period June to September, wherein construction was mostly affected. Meanwhile, inflation rate seems to have followed a downward tendency⁸.

In annual terms, GDP in Greece grew by 3.5 percent in the second quarter. Aggregate demand grew by 1.8 percent relative to the same quarter the previous year, fuelled by the increased consumer expenditures. Investments continue to maintain a downward trend⁹, reflecting the uncertainties in the national and international markets and the fall in business sentiment. Aggregate exports, which increased by 4.6 percent in annual terms for this quarter, continue to mirror the stability in foreign demand. Meanwhile, imports maintained their downward trend which commenced in the first quarter of the present year. During the last two months, inflation rate has shifted downward¹⁰; however, it still remains high. In July and August, unemployment rate has been lower than the average recorded in the first half of 2008.

Turkish economic growth recorded an annual growth of 1.9 percent in the second quarter, which is the lowest figure for the last six years. In the first quarter the present year, economic growth recorded 6.7 percent. This overwhelming decline attributes to the reduced demand, which grew by 1.5 percent compared with 7.1 percent the previous quarter. Inflation marked 11.7 percent in the third quarter from 10.3 percent in the previous quarter. The financial sector has been relatively resilient to the first wave of the global financial crisis.

Economic activity in the Republic of Macedonia maintained its growing rates in the second quarter as well. Demand in the domestic market remained high and private investments recorded considerable increase as in the first quarter. Inflation decreased in the third quarter to 8.4 percent, while for the nine-month period inflation rate marked 9.3 percent compared to 1.4 percent the previous year. The first wave of the global financial crisis has not affected Macedonia as well.

Table 3 Economic indicators for the regional countries

Country	GDP annual growth	Annual inflation	Unemployment rate	Trade balance (as a share of GDP)	Current account (as a share of GDP)
	Q2:08	Q3:08	Q3:08	Q2:08	Q2:08
Italy	-0.1	4.0	6.8 ¹	-1.5	-3.7
Greece	3.5	4.8	7.1 ²	-5.9	-16.0
Macedonia	6.5	8.4	33.8 ¹	-26.3	-11.1
Serbia	6.2	10.7	12.6 ³	-23.2	-20.7
Croatia	3.4	7.4	12.4	-27.4	-10.6
Turkey	1.9	11.7	9.4 ³	-7.4	-6.1

Source: Statistical Institutes, EuroStat, OECD Statistics

¹ Second quarter of 2008.

² Data for August.

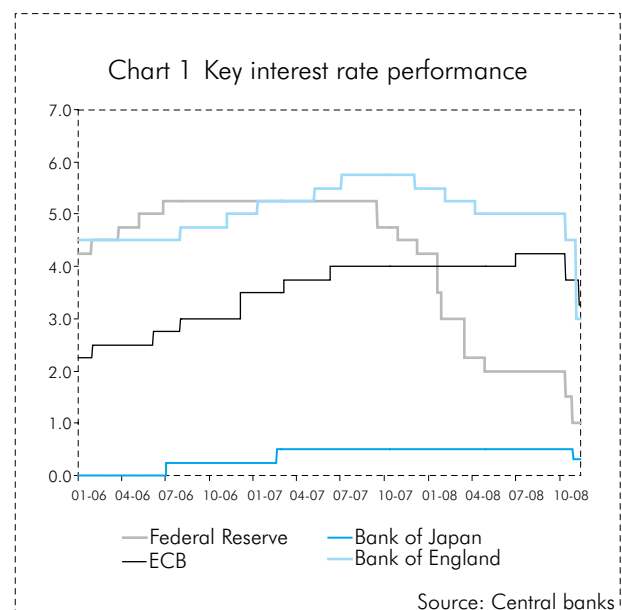
³ Data for July.

2.2 MONETARY POLICIES, FINANCIAL MARKETS AND THE EXCHANGE RATE

The month of October marked a truly historical event in central banking, when six major central banks cut the key interest rate in a coordinated move. The Federal Reserve, the ECB, Sveriges Riksbank, the Bank of England, the Bank of Canada and the Swiss National Bank announced the reduction in policy interest rates. The Bank of Japan expressed its strong support of these policy actions.

The ECB has cut the key interest rate twice by 50 basis points to 3.25 percent – the lowest rate in the last two years. This move aimed at coping with the financial turbulences that have hit the global economy. Given the current situation, the ECB may continue to cut the key interest rate in the future.

In order to stimulate the financial markets and the monetary market and to spur aggregate demand, the Federal Open Market Committee cut the key interest rate twice in October and November from 2.0 to 1.0 percent. Additionally, the Bank of England has cut the key interest rate twice by 50 and 150 basis points each to 3.0 percent. This decision was taken as a result of the marked deterioration in the outlook for economic activity at home and abroad



and the sharp fall in commodity prices. The Bank of Japan cut its key interest rate (overnight interest rate in the interbank market) to 0.3 percent from 0.5 percent, the first rate reduction for more than seven years. The central bank decided to lower the target rate as a result of the global financial crisis and following the cut of the interest rates by the major central banks.

Global financial markets entered a new phase in September. The U.S. largest financial institutions were faced again with liquidity problems. The two largest U.S. mortgage lenders recorded considerable losses in their balance sheets, which brought about the U.S. government intervention through a bailout plan. The dramatic collapse of Lehman Brothers, one of the largest U.S. investment banks, has shaken confidence among the main market agents and has constrained the absorption of capital and funds. This deteriorated outlook was reflected in the high intermediation rates in the money markets, where the main indicators - Eonia¹¹, Euribor¹² and Libor¹³ recorded high values. The main central banks coordinated their actions focusing on the provision of liquidity and the reduction in key interest rates, in order to moderate the cost of money for financial institutions. Easing measures were taken in terms of expanding the instruments accepted for the insurance of funds in the banking system and restoring confidence in order to avoid the deepening and spread of this crisis.

EUR and USD LIBOR reached high rates, reflecting the money market turbulences in the United States, Euro zone and England. The spread between quarterly USD LIBOR and the OIS¹⁴ was high in September and early October. At the same time, EONIA interest rate in the Euro zone interbank market reached 4.5 percent in early October, which is 0.21 percentage points more than the key interest rate. EURIBOR rates of one-week, one-month and one-year maturity term increased during this period. Following the cut in the key interest rate by the Fed¹⁵, the ECB¹⁶ and the Bank of England, money market interest rates have reduced; however, their spreads remain high as a result of the vague financial situation in the interbank markets.

Bond yields in Europe and the United States have shown significant fluctuations and a downward trend. This performance may relate to the shift of investors from the stock markets to these markets, fearing the persistence of the financial crisis and its implications for the real economy. The main indices in the stock markets - Dow Jones Euro Stoxx, S&P and Nikkei – experienced considerable fall and high oscillations. The losses were significant and they affected the titles of both financial and non-financial companies, transmitting the investors' uncertainty over the banks' situation and the financial system's stability.

In October, the foreign currency markets showed a depreciating behaviour of the euro, being also followed with high oscillations. The euro has depreciated against the main currencies, mainly owing to the appreciation of the U.S. dollar and the Japanese yen. The orientation of foreign direct investments to the U.S. market and the growing demand for the U.S. dollar in the money market, as a result of its use in financing the large financial

institutions, seem to be the main reasons behind the appreciation of the U.S. dollar against the euro. As of end September, the euro exchange rate against the U.S. dollar was 1.43 or 4.4 percent more than the average of 2007. In early November, the EUR/USD exchange rate dropped to 1.29 or 6.1 percent below this average.

2.3 OIL AND RAW MATERIALS' PRICES

The oil international market was highly affected by the extremely volatile financial markets. Starting from July, oil price has gained a downward tendency during the third quarter of 2008. In October, average oil price fell by 26 percent in monthly terms, reaching close to the price of September 2007. The appreciation of the U.S. dollar during the recent months has helped to reduce the oil price per barrel; however, it has represented only one of the several main factors. The negative projections for the economic growth in advanced economies have undermined confidence in the markets and weakened aggregate demand from these countries. In addition to the fall in industrial production indices, OECD member countries and the United States experienced the reduction in the demand for oil. Emerging countries continue to maintain high growth rates of the demand for oil, although at more moderate rates relative to the second quarter the present year.

Global oil supply has also suffered from several negative shocks. The disruptions in the supplying network in the Caucasian region, the fall in the oil production from OPEC countries¹⁷, the unfavourable weather conditions in the Gulf of Mexico and the low inventories in the United States and OECD countries have been the key supply-side pressures. High production has been reported in Russia and the North Sea; however, insufficient to mount the supply.

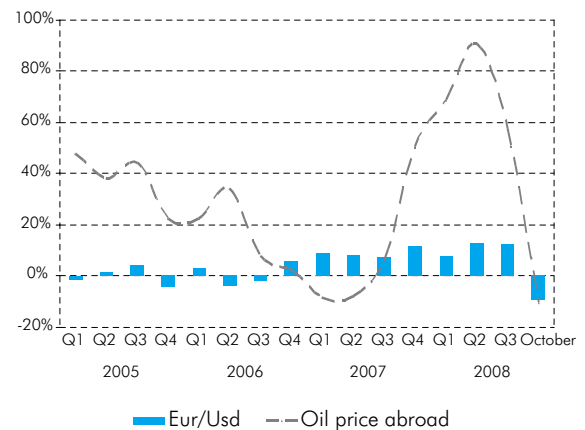
According to the IMF food price index, the annual price rise has maintained its downward tendency starting from mid-year. For the first time in the last two years, in October the food price index reached negative values – about 4.8 percent lower than the previous year. Wheat price has fallen sharply

Chart 2 EUR/USD exchange rate in the international market



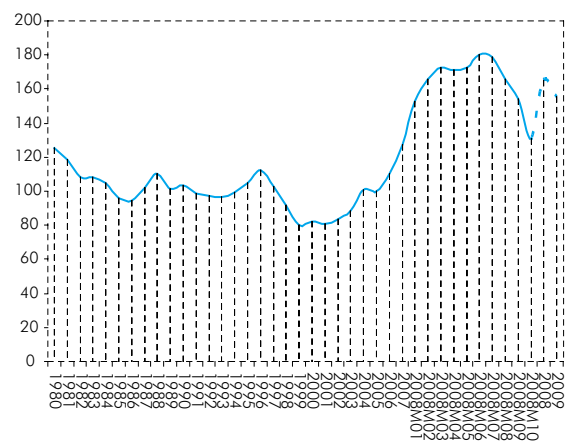
Source: Federal Reserve

Chart 3 Annual change of oil price in Albania and abroad and EUR/USD exchange rate



Source: Eurostat, Bloomberg

Chart 4 Basic commodity price index over the years



Source: IMF

by 26.9 percent compared with the previous year, owing to the favourable weather conditions. The fall in food prices is expected to persist in 2009 as well. In addition, the drop in metal prices, reflecting the weakening of industrial indicators, attributes to the slowing demand growth providing evidence for the reduction in economic activity.

Box 1 The financial crisis and the possible implications for global economy

The crisis the financial system has been faced with during the past year has entered a new phase in the last months. The collapse of Lehman Brothers, one of the largest U.S. investment banks, and the intervention of the U.S. Government to the capital of many financial institutions at home altered the perception of market agents of the real situation the financial institutions were in. The uncertainty prevailing during this period turned into a crisis of confidence of market agents in their counterparties. In order to prevent systemic events, the major central banks and governments took coordinated and duly measures. The financial crisis originated from the U.S. subprime mortgage crisis, which initially deepened and hit the U.S. market to later sweep the main global markets.

Since its inception, the crisis affected the increase in the financing cost and the tightening of exchanges in the financial markets. The liquidity problems in the banking market deepened and hit the institutions, which were mainly financed in the money market. The deterioration of the crisis shackled the assets' value of financial institutions by reducing their liquidity. The change in the time and quality structure that had occurred in the banks' balance sheets during the recent years triggered the spread of the crisis to vital sectors of the economy. The value of shares in the stock market has dropped significantly, hence deteriorating the absorption of new business capital. Banks' inclination to reducing their leverage¹⁸ through the sale of assets reduced their value and impacted their availability to extend loans. The shackled confidence was reflected in consumers, who finding themselves in front of a strained financial setting, lowered their consumption and reduced their demand for new loans.

The consequences of the financial turbulences have now been transmitted to the real economy as well. Advanced economies were confronted with both demand and supply-side negative shocks. The continuous fall in the financial assets' value and the house prices affected the households' purchasing and investing power. The two main channels to have been affected are the wealth and the credit channel. The first conditions directly the households' purchasing power, while the second reduces the collateral value in the borrowing process. Consequently, consumer spending, which has the main share in these countries' GDP, has followed a downward tendency. Being faced with tightened lending conditions, investments in the form of machinery or buildings began to follow a downward tendency. The indicators on industrial production and activity in processing industry have been contracting in the months to follow. The present economic setting has led to increased market uncertainty, which along with the production capacity constraints, compels firms to reduce the number of employed people. Labour market conditions in developed countries like the United States, the EU and Japan have weakened during the year 2008¹⁹. The weakening effect of both demand and supply reduces the economic growth rates and the short-term projections in developed countries.

The slow economic growth rates in emerging countries follow the same pace of economic growth in advanced economies, although at more moderate rates. Compared to the previous financial crises, the basic economic indicators of emerging countries are more sound and hence the shocks to the economy have been less pronounced. However, the risk level largely depends on the respective macroeconomic balances of each country. The countries facing a plausible higher risk are characterized by a high current account deficit, internal and external debt in foreign currency and the accelerated growth of consumer loans at levels which may threaten the financial stability. Despite the fall of prices in the international markets and the reduced demand in advanced economies, exporting countries of raw materials and oil remain less affected. The internal markets of some of the Asian countries and other emerging countries have attracted foreign investors, hence creating capital and financial outflows²⁰. In addition, the constraints in obtaining new loans and foreign investors' hesitation to risking in emerging countries have reduced the foreign direct investments.

According to the latest projections, global economic growth is expected to moderate in 2009.

Table 4 Economic growth in some global regions (annual percentage)

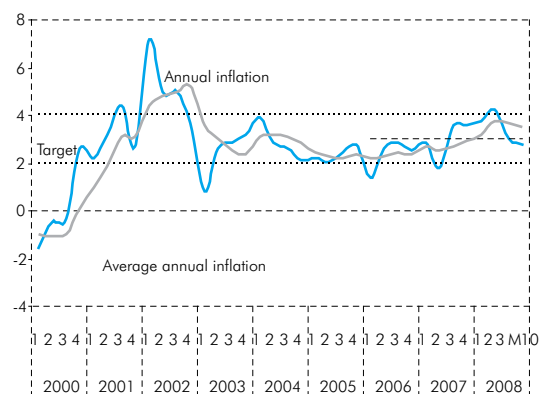
	Real GDP growth			
	2006	2007	2008	2009
Advanced economies	3	2.6	1.5	0.5
Newly industrialized Asian economies	9.2	9.3	7.7	7.1
South America and Mexico	5.4	5.6	4.6	3.1
Emerging economies in Europe	6.7	5.7	4.5	3.4
Middle East	5.7	5.9	6.4	5.9

Source: IMF, World Economic Outlook, October 2008

3. PRICE STABILITY AND BANK OF ALBANIA OBJECTIVE

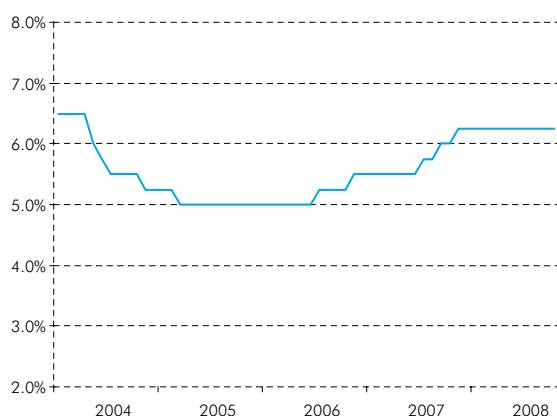
Average annual inflation marked 3.0 percent in the third quarter of 2008, which is fully in line with the Bank of Albania's price stability objective. CPI inflation has marked lower increasing rates during the last three months - 2.5, 2.7 and 2.8 percent. The fall in primary commodity prices in the global market and the presence of domestic supply of agricultural products in the market have helped to ease the inflationary pressures at home in the recent months. The "moderation" of supply-side shocks and the macroeconomic stability at home caused the inflation rate to stabilize within the target band. In addition, the tightening monetary conditions and the strengthening of banking supervision lending standards have led to a more contained growth of credit to the private sector. Budget expenditure have been carried out in line with the projections; hence, not signalling strong inflationary pressures for the following period.

Chart 5 Annual inflation by quarters (in percent)



Source: INSTAT and Bank of Albania estimations

Chart 6 Key interest rate of the Bank of Albania



Source: Bank of Albania

Monetary policy has been oriented towards meeting the Bank of Albania main target – maintaining price stability. Monetary policy-related decisions aim at keeping inflation close to the 3.0 percent target and they are based on the expectations and assessments for its forecast in the medium and long run. The return of inflation within the target band reflects the monetary conditions' adequacy as a result of the monetary policy pursued by the Bank of Albania. The raise of the key interest rate in November 2007 by 0.25 percentage points – the third raise in a year – preceded the inflationary pressures of the first half of the year and the need to firm up the inflationary expectations. The decision was taken in light of the presence of inflationary pressures, which could push the prices above the upper 3.0 percent target of the Bank of Albania.

The pressures stemmed from the strong domestic demand, shoved by the rapid growth of credit to the private sector and the announced wage rise, and the projections for the rise in raw materials' prices. These factors could provide a direct impact on domestic prices and on inflation expectations in the form of second round effects.

In the meantime, given the rebalancing of inflation risks and assessing that the supply-side pressures would be temporary, the Bank of Albania has kept the key interest rate unchanged during the year 2008. In addition, the stable growth of money base in the third quarter has allowed the meeting of the Bank of Albania quantitative objectives, without exerting any pressures on the market interest rates and on the exchange rate. In late September, which represents the performance criterion month for meeting the PRGF/EFF agreement with the IMF, the net international reserve totalled 1,231 million euros or 88 million euros above the target level. In addition, net domestic assets amounted to 76 billion leks or 18 billion leks below the target level.

Table 5 Meeting of quantitative objectives²¹

	March-08	June-08	July-08	August-08	September-08	October-08*
Net International Reserve of the Bank of Albania (in million euros)						
Objective	1,088	1,122	1,129	1,136	1,143	1,157
Current	1,127	1,137	1,163	1,219	1,231	1,208
Difference (C-Obj)	39	15	34	83	88	88
Net Domestic Assets of the Bank of Albania (in billion leks)						
Objective	88	96	95	94	93	91
Current	74	81	82	76	75	91
Difference (C-Obj)	-13.8	-15.7	-13	-18	-18	0
Net Domestic Credit to the Government (in billion leks) ²²						
Objective	377	383	381	378	376	--
Current	367	375	374	369	369	--
Difference (C-Obj)	-10	-8	-7	-9	-7	--

* Operational data for October.

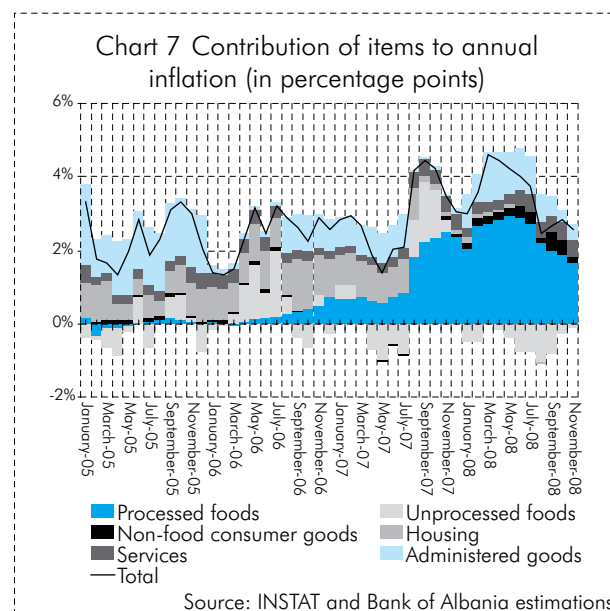
Source: Bank of Albania

3.1 PERFORMANCE OF MAIN ITEMS IN CONSUMER BASKET

Prices of goods and services have been falling for almost all main items in the last quarter. Prices of foods, in particular of processed ones, and the prices of 'non-food consumer goods' (wherein oil is included) and 'administered goods' accounted for about 80 percent of headline inflation. The fall in food prices - shored by the performance of domestic agricultural production and grain prices in the global market - and the decrease in fuel prices triggered the shift in the annual inflation rate. The shift of these goods' prices compared with several previous months, directly or indirectly, altered the strong rising tendency of prices during August 2007 - July 2008.

Starting from August the previous year, 'processed foods' have provided the main contribution to the increase of inflation. The upward trend of this item's annual inflation, shown since 2006, was more pronounced in the first seven months of the present year. The high annual inflation rates during this period exceeded drastically this item's historical average. Starting from August, processed foods' inflation has been constantly falling as a result of the partial termination of the bread price rise effect and of a more favourable performance of prices in the global market (most goods in this item are imported from abroad). Consequently, its contribution to the annual inflation reduced in the last quarter to about 2 percentage points, from 2.7 percentage points earlier this year.

Prices of 'unprocessed foods'²³ experienced the largest fall. Their prices are mainly affected by the performance of domestic agricultural production of fruit and vegetables. The growth of domestic agricultural supply, owing to the favourable weather conditions, is assessed to have led to the fall of these prices. From January to July 2008, this item's prices have offset the high prices recorded in almost all other basket items.



	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	M10-08
Processed foods (pp)	1.6	2.4	2.5	2.9	2.3	1.9
Bread and grain (pp)	0.7	1.2	1.4	1.7	1.3	1.1
Alcohol and tobacco (pp)	0.2	0.3	0.1	0.1	0.0	0.1
Unprocessed foods (pp)	0.6	0.5	-0.3	-0.4	-0.9	-0.3
Fruit* (pp)	0.2	0.4	0.5	0.3	-0.1	-0.1
Vegetables*(pp)	0.3	-0.1	-0.9	-0.2	-1.3	-0.8
Services (pp)	0.4	0.4	0.3	0.3	0.5	0.5
Administered prices (pp)	0.4	0.1	0.3	0.7	0.8	0.3
Fuels and energy (pp)	0.2	0.0	0.2	0.6	0.6	0.7
Housing (pp)	0.6	0.2	0.1	0.1	0.0	0.0
Non-food consumer goods	0.0	0.1	0.2	0.3	0.3	0.4
Durable consumer goods (pp)	0.0	-0.1	0.0	0.0	0.0	0.0
Consumer Price Index (y-o-y, %)	3.6	3.6	3.7	4.2	3.0	2.8

Source: INSTAT and Bank of Albania estimations

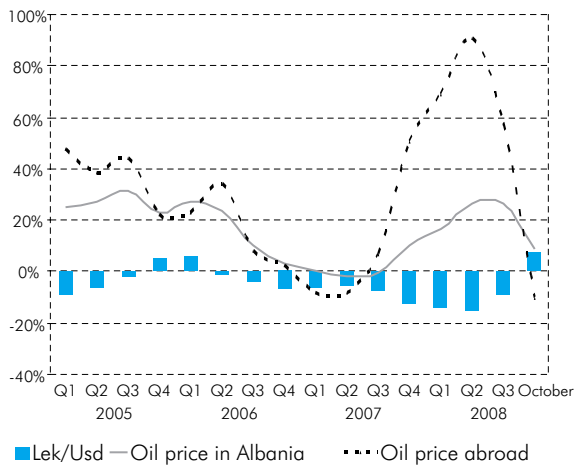
Table 6 Contribution of items to annual inflation (in percentage points)

Annual inflation rates of 'services' have also shown an upward tendency in the first ten months of 2008. In the last two months in particular, this item's annual inflation has experienced an accelerated increase - 5.7 and 6.2 percent. To a large extent, inflation of services is generated by the prices of 'hotels and restaurants'. From June to October 2008, their inflation increased by an average of 3.7 percent relative to the same period the previous year. This year's price increase has been pushed by the high costs, arising from the price rise in foods, fuel and energy, and in particular by the growing demand for these services.

Inflation of 'administered prices' has averaged 4-7 percent following the increase of energy price by 23.7 percent in March the present year, providing an average contribution by 1 percent to the increase of inflation rate. In October, this contribution reduced to 0.3 percent, owing mainly to the price fall in 'communication'. The latter's annual inflation dropped by 19.2 percent in October.

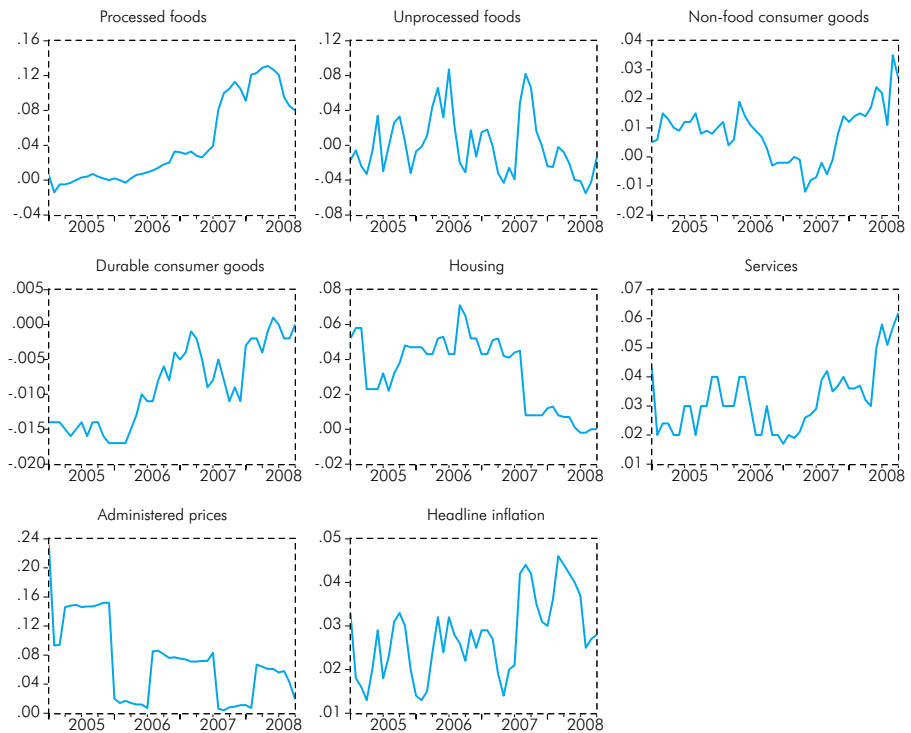
Among other items' inflation, worth to note is the downward tendency of the oil price which began during the month of August. Price volatility has been less pronounced; consequently, the average oil price change in Albania compared to the change in the

Chart 8 Annual change of oil price in Albania and abroad and of ALL/USD exchange rate



Source: INSTAT, Bank of Albania, Bloomberg

Chart 9 Annual inflation by items of goods and services (in percent)



Source: INSTAT and Bank of Albania estimations

international markets, in monthly or yearly terms, has been more moderate. Starting from the first quarter of the present year, the internal market has reflected the change in the oil price per barrel in the international market with a one-month lag.

The appreciation of the U.S. dollar against the lek during September-October has slightly decelerated the fall in the oil price per litre in the retail market. Although the average price rose further in the third quarter, it peaked in July. The price index of 'service to personal vehicles' has followed a similar downward trend to the oil price in the market, while 'services' price index continued to increase during the period July to October in monthly terms.

The fall in the oil price - along with the fall in food prices - is expected to provide a positive contribution to the long-term public expectations of inflation; hence creating a non-inflationary environment under the conditions when economic growth continues to preserve satisfactory rates.

3.2 INFLATIONARY TRENDS BASED ON OTHER INFLATION MEASURES

Alternative measures of net inflation²⁴ help to identify the (separate and concurrent) impact that food and administered goods' prices have on the overall price level. Net inflation, excluding foods, marked 1.2 percent in October, which is the lowest during the entire year. The other two net inflation measures, where one excludes the administered prices' effect and the other oil and food prices, attest to the annual decrease of this indicator during the last 10 months. In the third quarter, it reached 1 percent²⁵.

The tendency of stable inflation developments is also confirmed by the performance of core inflation²⁶, which has followed a downward trend during August-October 2008. The deceleration of inflationary pressures was more pronounced in October, a period during which annual core inflation²⁷ marked 3 percent - the lowest rate since the early 2008. The strong price rise in sub-items having a relatively high share in the consumer basket, and which until last fall were stable and almost 'intact' from foreign developments, provided a considerable impact on the core inflation for 2008 as well. Referring only to 'bread and grain' sub-item, the core inflation rate would have reduced by about 1.7 percentage points in the first 10 months if this measure excluded this sub-item's effect. Despite the positive signals for the reduced intensity of inflationary pressures at home, the average of the two main annual core inflation measures for the period January to October 2008 resulted 2.7 percent or 1.1 percentage points higher than the last three years'.

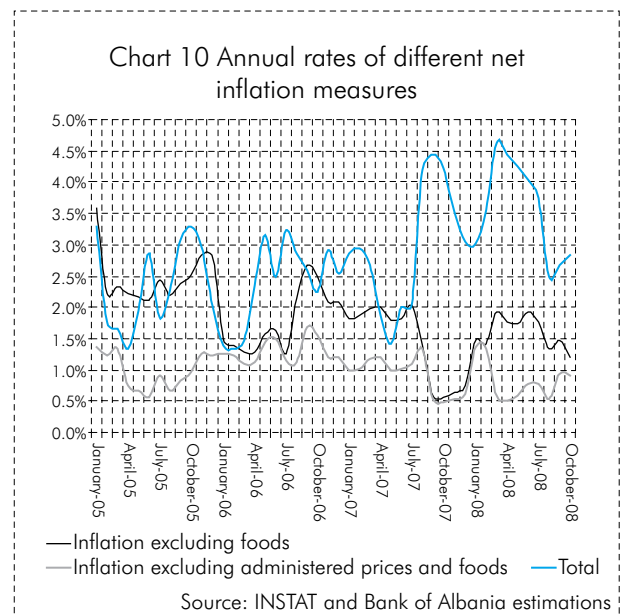


Table 7 Different measures of annual core inflation by price (in percent)²⁸

CPI annual change	Share in the CPI basket (in %)	2006	2007	2008				10-month average
				Q1	Q2	Q3	October	
Total (CPI)	100.0	2.4	2.9	3.7	4.2	3.0	2.8	3.6
a. Core (permanent exclusion)	77.0	1.1	1.7	3.7	4.1	3.7	3.0	3.7
- Core (permanent exclusion, excluding 'bread and grain')	70.0	1.1	1.1	1.9	2	2.2	1.7	2.0
b. Core (trimmed mean, 30%)	Average for 2008 60.0	0.7	0.7	1.7	1.8	1.6	1.8	1.7
By price								
Traded	62.0	1.7	2.3	3.9	4.1	2.4	2.3	3.4
Non-traded	38.0	3.7	3.9	3.4	4.4	4	3.6	3.9
- Non-traded, excluding administered prices	33.0	3	2.7	2.9	2.8	3	2.1	2.7

Source: INSTAT and Bank of Albania estimations

Annual inflation of traded goods marked 2.3 percent in October, hence maintaining the downward tendency of the third quarter. The performance of prices in this sector attests to the further moderation of inflationary pressures originating from outside the Albanian economy compared to the first semester of the present year. Notwithstanding the latest positive developments in traded consumer goods, average inflation for the first 10-month period resulted about 1.5 percentage points higher than its average in the last three years. This sector's inflation mirrored the overall price rise in the global markets of primary food and non-food commodities. The favourable behaviour of the lek exchange rate against the foreign currencies has halted the full transmission of the global price rise chain effects to headline inflation at home.

Annual inflation in the sector of non-traded consumer goods and services remains high, owing to the impact of administrative decisions on the price rise of energy (March 2008) and of public transportation services (June 2008). Other additional effects²⁹ have also kept the prices in this sector relatively high in the last two months. Excluding the administrative decisions' effects, inflation of non-traded goods and services would reflect more accurately the domestic demand-side pressures. In October it marked 2.1 percent, while for the first 10-month period it was 2.7 percent - close to its historical level.

The recent months' performance shows that core inflation and inflation by sectors have maintained more contained increasing rates compared to the first half of 2008. Their stable rates at around 2-3 percent reflect the balance of demand and supply factors and the adequate anchoring of inflationary expectations to the Bank of Albania medium-term inflation objective.

Box 2 Food and oil prices and second round effects

Primary commodities' prices have risen dramatically in the recent years. This phenomenon has affected energy, food and agricultural products. The price rise in primary commodities triggered the increase of inflation at a global level.

Being a small and open economy, Albania was affected by this shock on the supply-side. The level at which the rise in primary commodities' prices was transmitted to prices at home may be assessed by comparing their unusual hike during 2007:M9 – 2008:M10 with its average rise during 2000-2007. Bread and grain prices rose by 26 percent during a year period, while their historical average was 1 percent; vegetable oil prices rose by 13 percent compared to their average rise of -1 percent; prices of dairy products rose by 7 percent compared to the 0 percent historical change; oil price rose by 10 percent compared to its average historical rise of 5 percent.

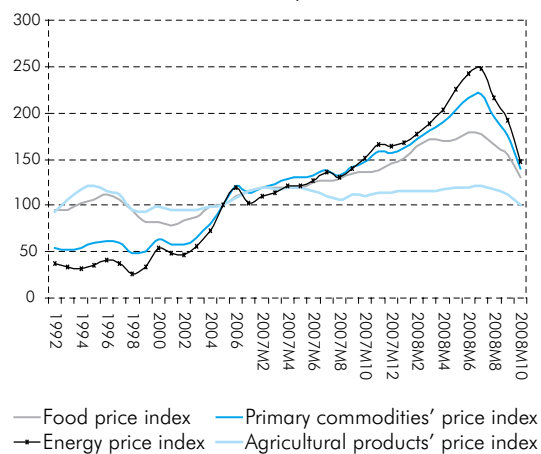
The price rise in primary commodities deteriorates the living standard by increasing consumer and business cost. In addition, it may affect directly or indirectly the cost of living and the inflation rate. The price rise in energy, bread, oil and in other goods that are purchased by the household consumer implies the increase of the cost of living and of the inflation rate. This is the direct effect.

However, the higher price of energy may also have an indirect effect on the inflation rate, as in the case when companies transmit the increase of their production cost to the final price of consumer goods or services that use energy as an input; or as in the case when the employees respond to the increase of the cost of living by demanding a rise in wages. In front of this situation of increased prices, the public may form expectations for the increase of inflation in the long run, hence generating strong inflationary pressures. The indirect effects of the price rise in primary commodities on the inflation rate are otherwise referred to as second round effects. The inflation rate manifests both first and second round effects.

Economic theory and empirical evidence show that high inflation harms economic growth. Consequently, the main contribution monetary policy could provide to one country's long-term economic growth is price stability. Economic theory suggests that monetary policy should not respond to short-term effects such as the price rise in primary commodities, given that their inflationary effects are transitory and inflation may very soon return to the prior crisis rates. However, in case these supply-side shocks materialize in the form of second round effects, long-term pressures on inflation would generate an overall rise in prices which undoubtedly requires the monetary policy intervention. The decision-makers' challenge is to allow the adjustments in relative prices in order to prevent unwelcome second round effects.

During the 12-month period (2007:Q3-2008:Q2), annual inflation in Albania reached the upper tolerance band of the Bank of Albania's 3 percent inflation target. The high inflation rates during this period were mainly generated by the price rise of primary commodities in the global market. The Bank of Albania has been cautious of the developments in the primary commodities' prices and it has been assessing the materialization of second round effects. Based on economic and monetary analyses, the central bank has assessed that the price volatilities generated by supply-side shocks would be temporary and would not harm the inflation rate over the medium and long term. Public expectations of future inflation remain anchored to around the Bank of Albania target. In addition, the crisis of food and primary commodities' prices was a global one and individual central banks could not do much to solve it.

Chart 11 Performance of primary commodities' indices, by item



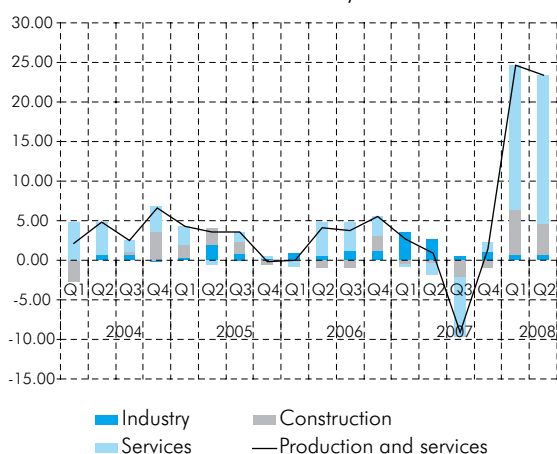
Source: IMF, Commodity Prices

4. MACROECONOMIC DEVELOPMENTS AND THEIR IMPACT ON INFLATION

4.1 ECONOMIC GROWTH AND AGGREGATE DEMAND

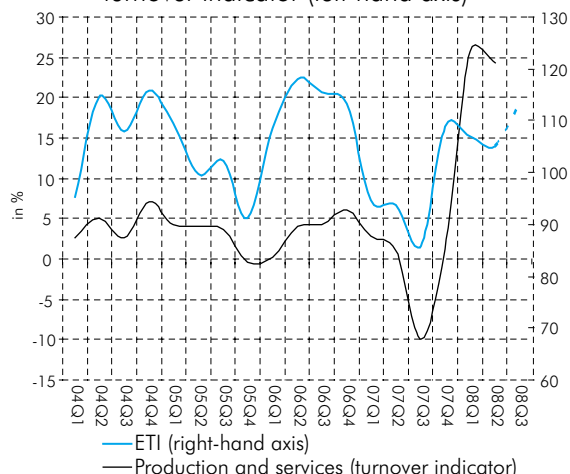
The Albanian economy has been characterized by positive developments during the year 2008, mainly driven by the high domestic demand. Economic activity at home continued to maintain an upward trend during the second quarter of 2008. The annual increase of deflated turnover indicator was among the highest in the last five years - about 24 percent. This performance of economic sectors and the economy in general is believed to have been propelled by the positive rates of domestic demand at home. Services and the trade sector in particular continued to provide the main contribution to the annual increase of turnover indicator in the second quarter of the present year. In addition, the high contribution of construction sector continues to dominate the expansion of production activity at home.

Chart 12 Contribution of economic sectors over the years



Source: INSTAT and Bank of Albania estimations.

Chart 13 Economic Tendency Indicator (right-hand axis) and annual change of turnover indicator (left-hand axis)



Source: INSTAT and Bank of Albania.

The latest data obtained from business and consumer sentiment surveys attest to the persistence of economic growth rates during the third quarter of 2008 as well. The Economic Tendency Indicator (ETI)³⁰ recorded a quarterly increase by 8 percentage points in the third quarter, although several individual sectors have shown signs of weakening.

Box 3 Short-term statistics – indicators that allow the assessment of economic activity

The analysis of economic activity at home is mainly based on the Short-term Statistics (STS) data, published by the INSTAT since end 2007. According to OECD, Eurostat and other national statistical institutions of countries with developed statistics, short-

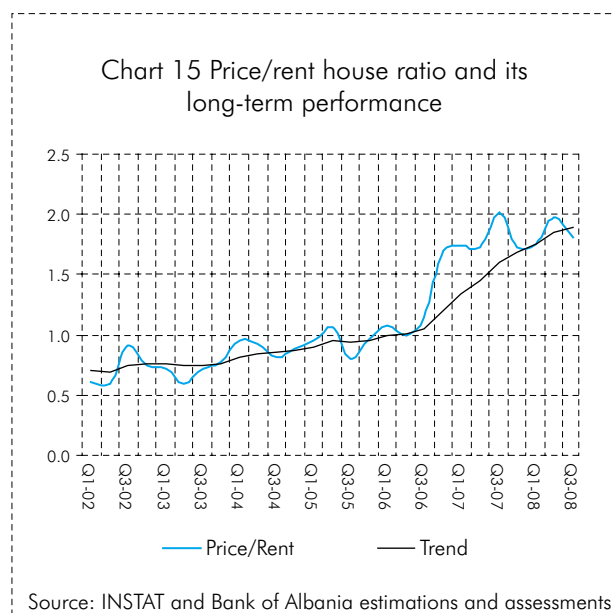
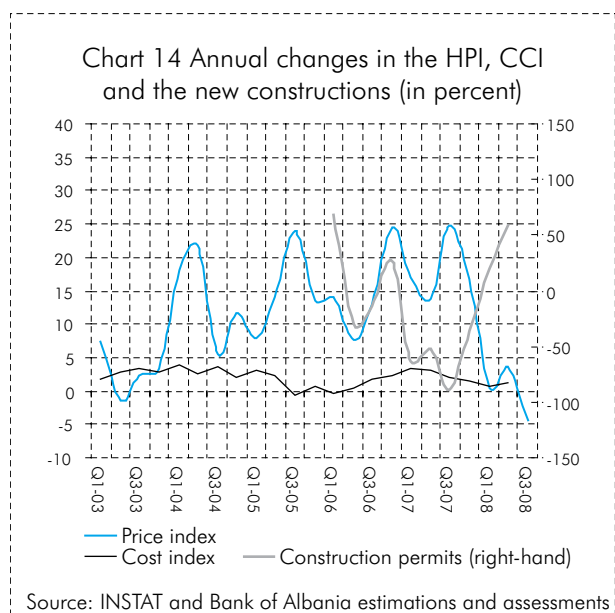
term statistics include many of the key short-term indicators that are vital for analysis of recent economic developments and the development of monetary and economic policy in different countries and regions.

The profile and use of short-term statistics is expanding rapidly. The majority of indicators are provided in the form of indices, which allow the rapid assessment of the economic climate within an economy or a group of economies. The STS published by the INSTAT cover the following indicators: turnover, number of persons employed, wages and salaries, production by sectors of economy etc. STS indices cover these major domains: industry, construction, retail trade, hotels, transportation, communication, postal service and other services. These activities are defined in relation to a classification of activities - NACE - which is the statistical classification of economic activities in the European Community (NACE Rev. 1.1). Basically, STS data are derived from surveys of businesses. The results of each STS indicator are aggregated to take account of the structure of the sector and the economy, by using the shares generated by the Structural Business Survey of 2005, which is the base year.

Among the STS indicators, the turnover index of the economy and given by sectors provides a lot of information which allow the assessment of the short-term performance of economic activity at home. It is deflated in order to provide more accurate information related to the volume of production, labour and services in economy. Starting from the second quarter 2008, turnover index by sectors and for the economy, published as an integral part of the STS, has replaced the respective sales index in economy.

Further improvement has been and will be made to consolidate the STS, in order to allow their wide use in the assessment of the economic climate within the economy.

House Price Index (HPI), which is measured by the Bank of Albania³¹, fell by 4.3 percent in the third quarter of 2008, compared to the same period the previous year. Although this was the highest annual fall since this indicator first began to be measured³², house prices rose by 3.6 percent compared to the previous quarter.



House Rent Index recorded an annual increase of 7.4 percent in the third quarter following its decrease in the previous quarter (-9.5 percent). The opposite performance of price and rent indices has led to the decrease in the price/rent ratio below its long-term trend. After peaking in the third quarter the previous year, this trend began to gradually reduce in the four following quarters. Despite this performance, price/rent ratio for the current quarter is about twice as high as its long-term average³³.

4.1.1 Performance of production by sectors

Services sector has recorded a high annual increase of the turnover indicator during the second quarter of 2008 (32 percent), which is comparable to the previous quarter. Trade activity - wholesale trade in particular - has increased highly by about 35.3 percent. In addition, the results obtained from the business sentiment surveys attest to the persistent positive performance of services sector in the third quarter of the present year.

Production sector recorded an annual increase of the turnover indicator by about 13 percent. According to this indicator, economic activity in industry increased slightly by 3.5 percent, while the annual increase in construction was relatively high - 29 percent. Industry and construction-related businesses confirm the increase in their activities during the third quarter, although at more contained rates - especially in the construction sector³⁴.

Energy sector. The main indicators in the energy sector improved during the year 2008, compared to the same period the previous year. The annual increase by about 35 percent in domestic production was followed by the drop in imports by 7.4 percent, while the relative indicator of losses to net production continues to fall in annual terms.

Domestic demand remained at almost the same rates as in the previous quarter, being triggered by the consumption needs of households and businesses. The data for the last six years attest to the stable trend of household consumption, while consumption in production activity has maintained average increasing annual rates of about 8.3 percent per year. This consumption trend provides evidence for the expansion of economic activity at home. The positive performance of energy balance sheet indicators was more pronounced in the third quarter of the year 2008. Net production, household and non-household consumption recorded an annual increase of 63.5, 13.2 and 32.3 percent, respectively.

Table 8 Energy balance sheet indicators (for the period January to September over the years, in GWh)

Indicators	2003	2004	2005	2006	2007	2008	Annual change 2008/2007 (in percent)
Net production	3,606	4,107	4,292	4,124	2,103	2,837	34.9
Import	708	305	0	412	1,990	1,842	-7.4
Distribution losses	1,223	1,388	1,485	1,652	1,260	1,260	0.0
Domestic demand	4,733	4,795	4,778	4,646	4,808	4,986	3.7
Invoiced consumption	2,591	2,738	2,693	2,558	2,675	3,080	15.2
Un-invoiced consumption	519	695	721	1,652	1,371	1,397	1.9
Household consumption	1,668	1,668	1,623	1,612	1,532	1,710	11.6
Non-household consumption	923	1,070	1,070	947	1,143	1,371	20.0
Distribution losses/Net Production (in percent)*	33.9	33.8	34.6	40.1	59.9	44.4	-26.0

Source: KESH; (*) Bank of Albania estimations

4.1.2 External sector of the economy

Trade exchanges amounted to 1.14 billion euros in the third quarter of 2008, which is 18.2 percent higher than the same period the previous year. Imports increased by 17.2 percent, while exports recorded an increase of 21.9 percent. Imports' coverage ratio stands at 26.8 percent. Despite the higher increase in exports, trade deficit deepened further. The latter is assessed to have accounted for 22.7 percent of the GDP in the third quarter of 2008, from 21.6 percent the previous year. The deepening of trade deficit has been characterizing several regional economies³⁵ during the recent years.

Trade with EU member states accounts for about 64.1 percent of Albania's total trade exchanges. Italy and Greece remain Albania's main trading partners³⁶. Our main non-EU trading partners by total trade volume are China, Turkey, Russia, Macedonia and Croatia. Excluding Turkey, with which there has been an annual decrease in terms of trade exchanges volume by 4.5 percent, trade with other countries has increased³⁷.

	Q3 2007	Q3 2008	January-September 2007	January-September 2008
Volume (in million euros)				
Exports	196.99	240.19	588.60	706.09
Imports	765.51	897.03	2,180.37	2,551.07
Trade balance (E - I)	-568.51	-656.84	-1,591.77	-1,844.98
Change (in percent)				
Exports		21.93		19.96
Imports		17.18		17.01
Trade balance		15.54		15.91

Source: INSTAT and Bank of Albania estimations

Table 9 Trade balance indicators for the period 2007 to 2008

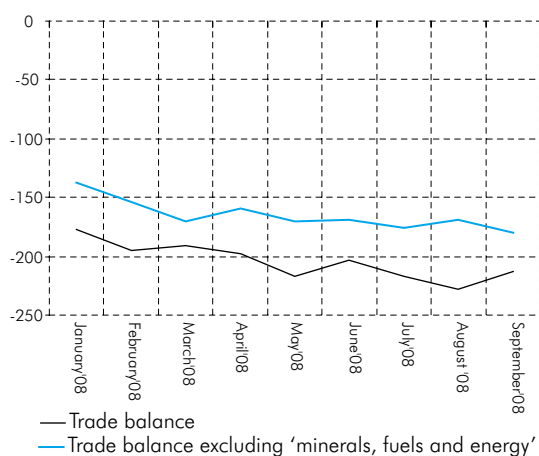
In terms of imports, the following items recorded the highest annual increase during this period: 'minerals, fuels and energy', 'chemical and plastic products', 'construction materials and metal items' and 'machinery, appliances and spare parts'. The imports of 'textiles and footwear' recorded an annual increase of only 3 percent.

Table 10 Imports and exports by commodity groups (in million euros) and the annual increase

	Q3 - 2008	Imports		Exports	
			Increase (in percent)	Q3 - 2008	Increase (in percent)
Total	897.03	17.18	240.19	21.93	
Food, beverages and tobacco	144.68	9.59	14.78	-1.10	
Minerals, fuels and energy	184.72	36.07	67.44	48.01	
Chemical and plastic products	98.44	24.69	2.46	38.86	
Leather and articles thereof	11.37	-0.62	2.31	-19.18	
Wood and paper products	32.33	9.20	7.36	34.45	
Textiles and footwear	73.44	3.00	92.04	6.42	
Construction materials and metal items	142.53	19.28	38.88	42.86	
Machinery, appliances and spare parts	180.23	13.30	8.99	32.81	
Miscellaneous	29.28	5.07	5.96	0.68	

Source: INSTAT

Chart 16 Trade balance including and excluding 'minerals, fuels and energy'



Source: INSTAT and Bank of Albania estimations

The import of 'minerals, fuels and energy' accounts for 20.6 percent of total imports. Excluding this item's imports, the annual increase of merchandise imports would be 13.1 percent, while the trade deficit as a share of GDP would reach 18.7 percent.

In terms of exports, 'textiles and footwear' have recorded an annual drop of about 19.2 percent. Its share to total exports accounts for 38.3 percent or 5.6 percentage points lower in annual terms. By contrast, the exports of 'minerals, fuels and energy', 'construction and materials and metal items', 'chemical and plastic products', 'wood and paper products' and 'machinery, appliances and spare parts' have recorded an annual increase. The structure of exports by trading partners attests to the high concentration of exports with EU member

states - 76.33 percent. Therefore, despite the high increasing rates of exports and the enlarged map of trading partners, a possible reduction of demand in these countries would affect the total volume of Albanian exports and consequently, the trade balance figures.

4.1.3 Fiscal indicators and fiscal policy

As of end the third quarter of 2008, fiscal policy has by and large observed the targets set in the Medium-term Budget Programme for 2008 – 2010. This period has been characterized by a positive performance of budget revenues, which met about 98 percent of the 9-month plan. In contrast to the previous two years, the third quarter of the year 2008 provided evidence for an active fiscal policy on the expenditures side, which brought about the deepening of budget deficit compared to the previous quarter. Starting from the second quarter, budget expenditures have been

carried out more rapidly. As of end the third quarter, they were met by about 94 percent. In contrast to the previous two years, the higher pace in expenditures has caused the budget balance to end in a deficit for the first nine-month period. According to the budget approved for 2008, budget deficit as a share of GDP is projected to account for 5.2 percent, implying a primary deficit of about 2.2 percent as a share of GDP. This figure is about 1.3 percentage points higher than the previous year and it implies a more rapid increase of public debt.

In nominal terms, budget revenues amounted to 208.9 billion leks as of end September. In annual terms, this is the highest figure in the last nine years. Excluding the sub-item of tax on profit, customs duties³⁸ and non-tax revenues³⁹, the other sub-items have increased in annual terms. Value added tax, tax on personal income and excises continue to provide the main contribution to the increase of total revenues. The contribution of tax on personal income to the total increase of revenues has increased substantially as a result of the change in the tax rate⁴⁰.

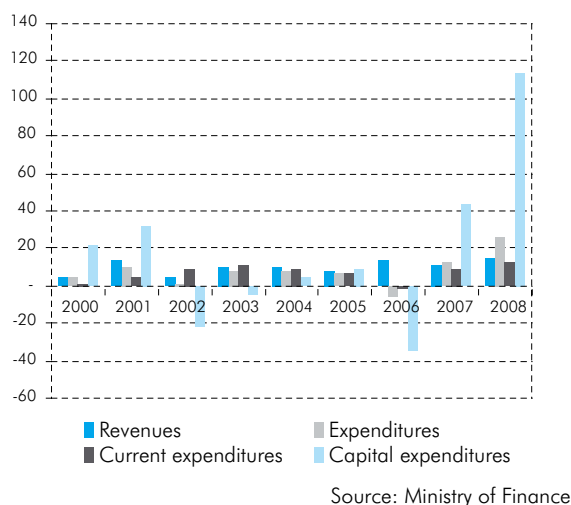
As of end September, budget expenditures totalled about 217.4 billion leks or as much as 94 percent of the projected plan for this nine-month period. Similarly to revenues, total expenditures recorded the highest increase in the last nine years. Capital expenditures, personnel expenditures and social insurance expenditures provided the main contribution to this increase. Investment expenditures were twice as much as the previous year, mainly owing to the financing of Durrës – Kukës road⁴¹. As of end the third quarter, despite the high increasing rate, capital expenditures have been met by about 83 percent of the projection. Interest expenditures have also increased substantially relative to the previous year (by about 25 percent). As of end the third quarter, their meeting level is in line with the projection.

Table 11 Main fiscal indicators for the period 2006 to 2008

	Performance during Q3 over the years (in billion leks)			Cumulative ⁴² (in billion leks)		Annual change (in percent)	
	Q3 2006	Q3 2007	Q3 2008	2007	2008	2007	2008
Total revenues	56.82	65.86	73.93	181.40	208.92	11.79	15.17
Tax and customs	39.69	46.40	53.85	127.61	149.94	14.13	17.50
Other tax	12.63	12.27	14.77	36.58	42.68	- 2.09	16.66
Non-tax	2.70	6.20	5.11	16.09	15.58	46.01	- 3.16
Total expenditures	56.88	66.34	80.05	171.73	217.37	12.80	26.58
Current expenditures	50.25	56.21	61.75	150.37	169.54	9.51	12.75
- Personnel	14.21	14.50	16.35	40.09	46.34	1.51	15.60
- Interest	7.28	6.35	7.97	18.41	22.99	- 5.31	24.93
- Social insurance	15.50	18.24	20.40	50.58	55.42	16.46	9.57
Capital expenditure	6.64	10.13	17.49	21.35	45.51	43.06	113.12
Budget balance	- 0.06	- 0.48	- 6.12	9.67	- 8.45	- 3.48	- 187.39
Domestic financing	- 0.15	- 1.18	- 11.46	- 11.62	- 10.26	3.61	- 11.74
- Privatization	0.00	13.09	0.43	13.14	0.83	520.80	- 93.67
- Domestic borrowing	3.00	3.01	1.88	6.45	13.40	- 186.52	107.69
Foreign financing	0.22	1.65	17.58	1.95	18.71	63.19	860.37

Source: Ministry of Finance and Bank of Albania estimations

Chart 17 Annual change of main fiscal indicators: September 2000 - September 2008



As of end September, budget balance recorded a negative figure of 8.5 billion leks, as opposed to 18.8 billion leks projected for this period. The year 2008 marks the shift in the budget balance behaviour relative to the previous two years. This is due to the fact that in the previous two years, the budget balance recorded negative figures only in the last months of the respective year, while starting from the second quarter 2008 this item has fluctuated within a band of negative values.

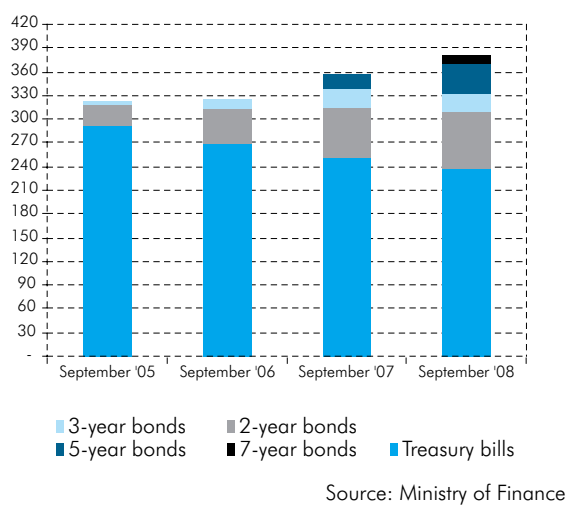
Budget deficit financing. In contrast to previous years, foreign financing has the largest share in deficit financing. Domestic borrowing amounted to 13.4 billion leks or about 3.6 billion leks below the projection for this year. Foreign financing has been met by 18.7 billion leks or about 76 percent of the nine-month plan.

Table 13 Budget deficit financing as of end Q3 for the period 2003 to 2008 (in billion leks)

	Sept. 2003	Sept. 2004	Sept. 2005	Sept. 2006	Sept. 2007	Sept. 2008
Budget balance	- 19.32	- 18.87	- 18.98	10.02	9.67	- 8.45
Domestic financing	13.66	14.81	15.19	- 11.21	- 11.62	- 10.26
Privatization receipts	0.48	8.28	0.83	2.12	13.14	0.83
Domestic borrowing	16.16	8.22	14.86	- 7.45	6.45	13.40
Foreign financing	5.66	4.05	3.80	1.19	1.95	18.71

Source: Ministry of Finance

Chart 18 Stock of domestic debt as of end Q3 for the period 2005 to 2008 (in billion leks)



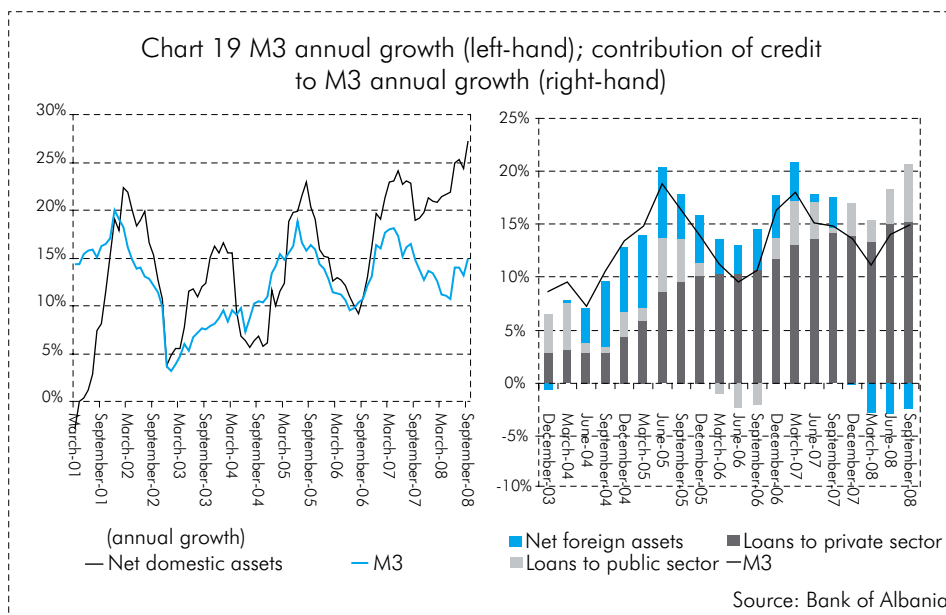
During the year 2008, domestic borrowing was more oriented towards long-term instruments. In the auctions held until the end of the third quarter, the Ministry of Finance has reduced the amount of debt in 3-month T-bills, while increasing slightly the stock of debt in 6 and 12-month T-bills. In the meantime, for all bonds' maturities it has been issued a larger amount of debt than the matured one.

Short-term domestic debt shares about 62 per cent of total domestic debt, dropping by 8 percentage points from the previous year.

4.1.4 Monetary developments

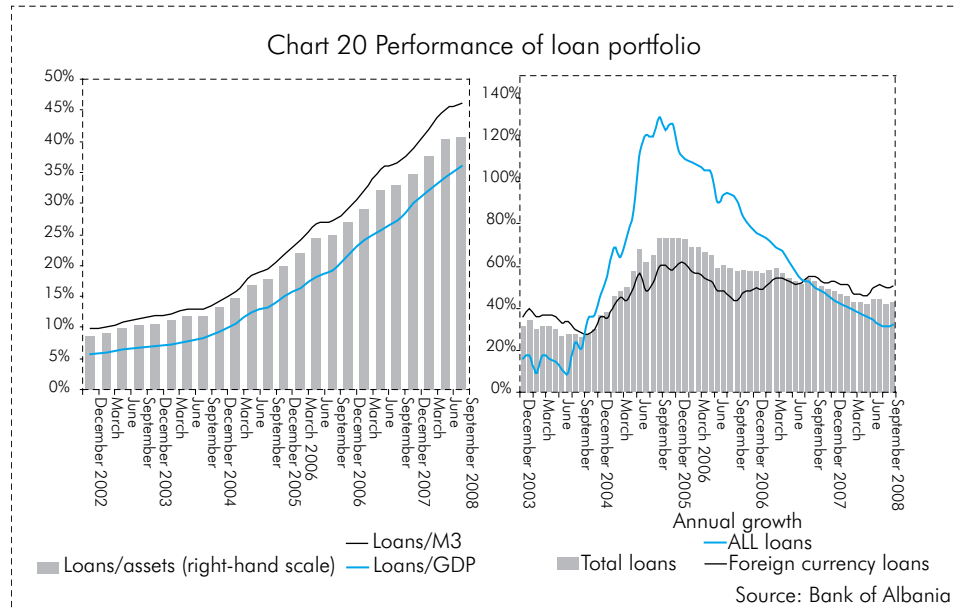
Monetary expansion in economy maintained the average growth rates by about 14 percent during the third quarter. Money growth has reflected the expansion of credit stock to

the private sector. Credit to the private sector has contributed to M3 annual growth by about 15 percentage points. In addition, in terms of contribution to M3, credit to the public sector has generated about 2 percentage points annual money flows. However, the annual reduction of net foreign assets has exerted an offsetting effect on the annual money growth rate⁴³. The current performance of demand for monetary assets reflects an upward tendency of demand for foreign monetary assets, which attributes to the developments in the external sector of the economy and to the growth in aggregate demand. This tendency is shown in the annual growth rate of the banking system's net domestic assets by about 27 percent in September from about 22 percent in September 2007.

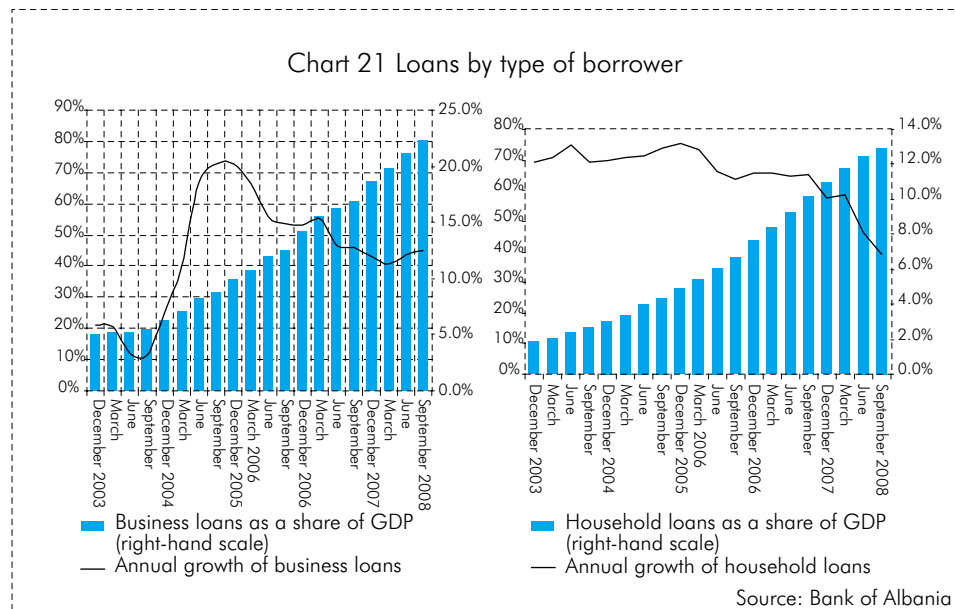


DEVELOPMENTS IN LOAN PORTFOLIO

Outstanding loans grew by 29 billion leks in the third quarter of 2008, hence maintaining the high growth rates of 43 percent. In annual terms, the growth of loans to the private sector did not experience any changes from the second quarter. The banking system's lending activity has sustained growth in the main sectors of the economy and has provided its contribution to the further deepening of financial intermediation. As a share of GDP and the system's assets, loans have recorded further growth to 36 and 41 percent, respectively. The growth of loans in the third quarter owes to the high level of new loans (68 billion) and to the extension of the loans' maturity term. In the last two years, the time structure of loans portfolio has shifted towards long-term loans (46.5 percent) and short-term loans (35 percent), while the medium-term maturity loans have reduced considerably (22 percent)⁴⁴.

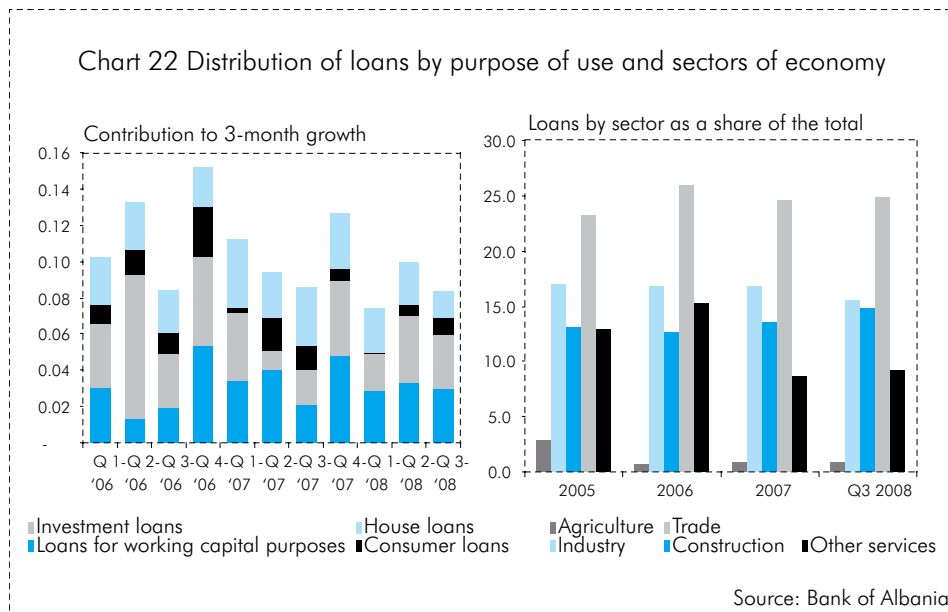


Foreign currency-denominated loans continue to provide the main contribution to the growth of loans, maintaining high annual growth rates (50 percent), compared to ALL-denominated loans which grew by 32 percent as of end the third quarter. The positive interest rate spread between ALL loans to foreign currency loans remains the key factor, which pushes people to borrow loans in foreign currency. This performance has also been favoured by the larger share of business loans and by the tendency of lending to households in foreign currency in response to the higher demand for mortgage loans.



Business loans provided the main contribution to the growth of loans' portfolio, accounting for 66 percent. In annual terms, business loans' portfolio grew by 44.2 percent compared to 40.2 percent the previous quarter. The growth of business loans owes to the higher demand for meeting the liquidity

needs and for investments in real estates. In average annual terms, liquidity loans grew by 56.3 percent in the third quarter, compared to 48.6 percent in the previous quarter. Loans for investment purposes grew by 40 percent, being mainly pushed by the increase of business investment in real estates. Loan portfolio growth during the year 2008 has sustained the positive growth of the main sectors' economic activity. In September 2008, the loan portfolio is dominated by lending to the sectors of trade (24.8 percent), construction (14.7 percent) and industry (15.5 percent). During the entire year 2008, trade and construction-related activity have been granted more financing from the banking system, hence growing their share of loans by 0.3 and 1.2 percentage points, respectively, compared to December 2007.

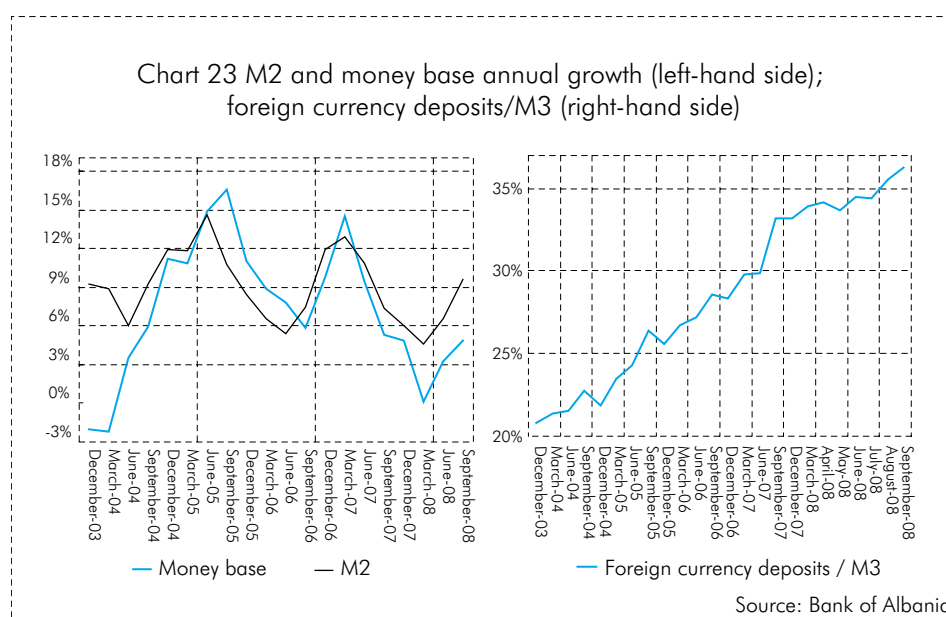


Households' loan portfolio growth rate has reduced to 41.0 percent from 67.7 percent in 2007. This performance owes to the substantial reduction in the annual growth rate of consumer loans (29.3 percent) and to the reduced growth rate of house loans (46.7 percent). Households' portfolio, however, has shifted towards lending for the purchase of houses throughout the year 2008. In September, house loans accounted for 66 percent of this portfolio. Despite the seasonal growth during summer, consumer loans provided a less considerable contribution compared to the previous year. In September, consumer loans accounted for 25 percent of household loans, compared to their peak of 31 percent in July 2007.

DEVELOPMENTS IN MONETARY AGGREGATES

The growth of money mainly attributes to growth of deposits held in foreign currency. In annual terms, the narrow monetary aggregates, M2 and money base, grew by 9.6 percent and 4.8 percent, respectively, in September. The creation of money flows in foreign currency, on the side of demand for deposits, has contributed to the more rapid growth of M3 aggregate. In

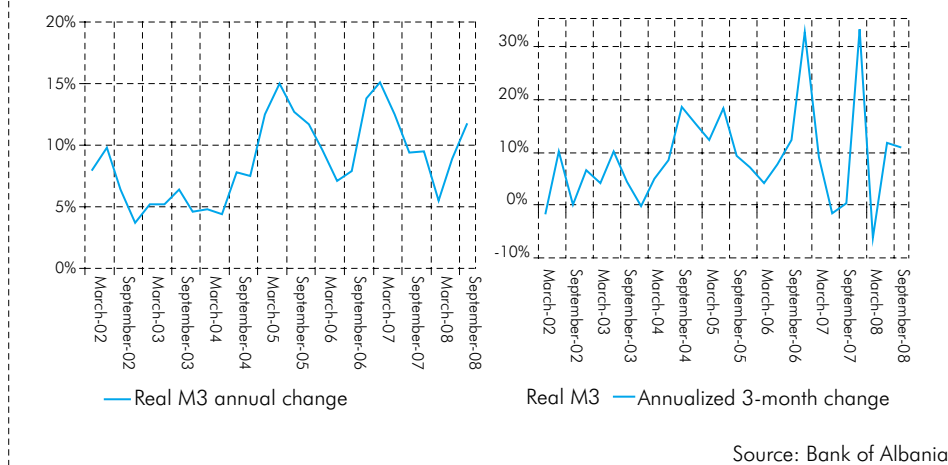
annual terms, foreign currency-denominated deposits grew by 26 percent in September relative to the more moderate growth of M2 aggregate. The high interest rates on foreign currency-denominated deposits attribute to the impact of foreign currency inflows in the form of remittances and to the creation of money in the form of foreign currency loans to the private sector. Foreign currency-denominated loans account for about 70 percent of credit to economy. As of September, foreign currency deposits accounted for about 36 percent of broad money (M3) compared to about 33 percent as of end year 2007.



In average terms, the annual growth of M2 and money base is assessed as being stable. The volatile annual rates reflect the behaviour of net loans to the public sector and the reduced use of currency in circulation. The growth of the banking system's net loans to the public sector in the second half of the year has triggered the acceleration in the growth of money base from 0 percent to about 5 percent, and of M2 aggregate relative to the average rate of 4 percent in the first quarter of the year.

In real terms, money supply (M3) has shown an upward tendency, mainly owing to the decrease in the average inflation rate in the third quarter of the present year. As of September, the real M3 grew by about 12 percent, compared to about 9 percent it grew by in the second quarter. An upward tendency in the annual growth of real M3 is likely to generate additional pressures on the aggregate demand and consumption. In seasonal terms, M3 real growth materialized in the second and third quarters. The decrease in the inflation rate, the more accelerated public expenditures and the foreign currency inflows in the form of remittances in the third quarter have provided the main contribution to the more accelerated growth of real M3 in seasonal terms.

Chart 24 Real M3 annual growth (left-hand side) and real M3 (annualized) quarterly growth (right-hand side)⁴⁵



Source: Bank of Albania

4.2 PERFORMANCE OF WAGES AND THE LABOUR MARKET

PERFORMANCE OF WAGES

In annual terms, the average wage rose during the second quarter of 2008, both in the public and private sector. Average monthly wage in the public sector⁴⁶ reached 35,943 leks, which is 0.4 percent higher compared to the previous quarter and 13 per cent higher than the previous year. The administrative measures⁴⁷ continued to affect the increase of reported wages⁴⁸ in the private sector during the first half of the year.

During the second quarter, wage in the private sector rose by about 15 percent in annual terms. Wage in production and services sectors rose at the same rates as in the previous periods. Within the sector of production, industry and construction recorded the highest rise in average wage.

The performance of wages during the first half of the present year was sustained by the positive annual growth rates in productivity⁴⁹. If this tendency persists in the future - and mainly in the production sectors of the economy - then the price rise effect on the cost per unit of production will be lower, hence not transmitting additional pressures in economy in the medium-run.

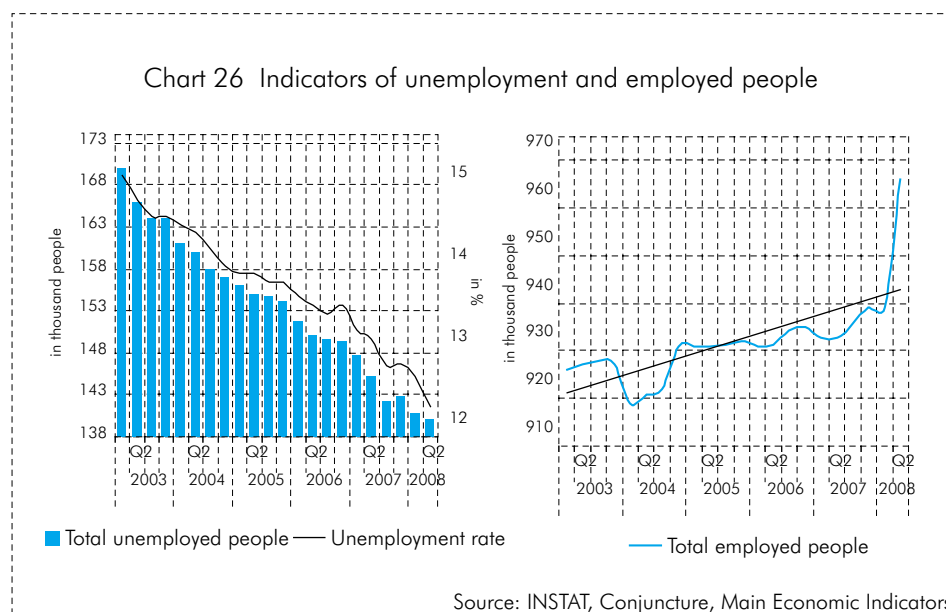
Chart 25 Annual changes in the average wage in the public and private sector



Source: INSTAT (Short-term Statistics and Conjuncture) and Bank of Albania estimations

LABOUR MARKET

The number of employed people⁵⁰ increased by about 26,617 in the second quarter or 2.83 percent compared to the previous quarter. The private agricultural sector provided the main contribution to the increase in the number of employed people in the second quarter by about 26,549, reflecting at the same time the improvement in registration. The private non-agricultural sector has recorded a slight increase by about 229 people, while the number of employed people in the public sector has reduced by about 161 people. Unemployment rate reached about 12.7 percent in the second quarter, hence keeping the historical downward trend for this indicator.

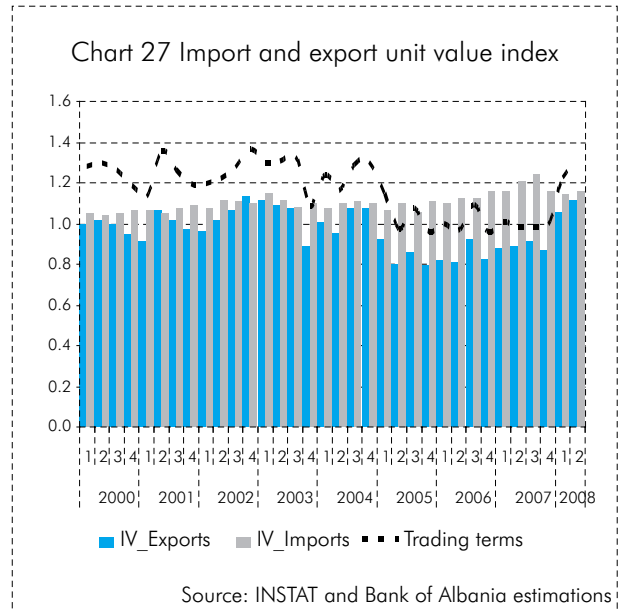


During the same quarter, the number of registered labour forces increased by about 25,825 people or 2.39 percent, implying that the number of registered unemployed has reduced by 792 people.

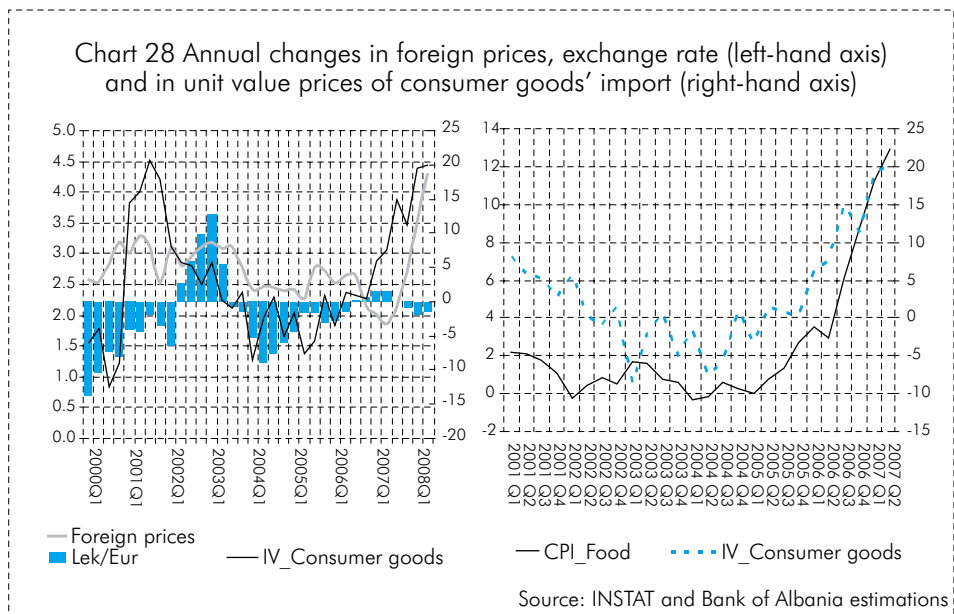
4.3 IMPORT PRICES

Import prices may affect inflation at home through the price of imported consumer goods and the impact on the business cost. After increasing in the last two years, import prices⁵¹ fell in the first half of 2008. During 2006-2007, import prices rose by an average of 5 percent, while in the first half of the present year they fell by 3 percent in annual terms. Raw materials' prices provided the main contribution to the annual fall in the import prices index. The corresponding items in the producer price index maintained the same downward tendency in prices. Export prices recorded high annual rising rates by 20 and 26 percent respectively, in the first and second quarter, hence improving the trading terms.

The Albanian economy continues to be import-oriented, mainly from the EU member states⁵². In addition to the developments in the overall level of prices in these countries, the lek exchange rate against the euro has a determining impact on imported inflation. Starting from the second half of 2007, inflation in Albania's main trading partners - Italy and Greece - has marked high increasing rates, owing mainly to the price rise in primary commodities of foods and oil. Given the downward tendency of the lek appreciation against the euro⁵³, the inflationary pressures generated by the price rise in these countries were stronger on prices at home. During the third quarter of 2008, the index comprising the consumer goods' prices of Italy and Greece maintained the increasing rates of the previous two quarters - 4 percent -, while the exchange rate remained unchanged.



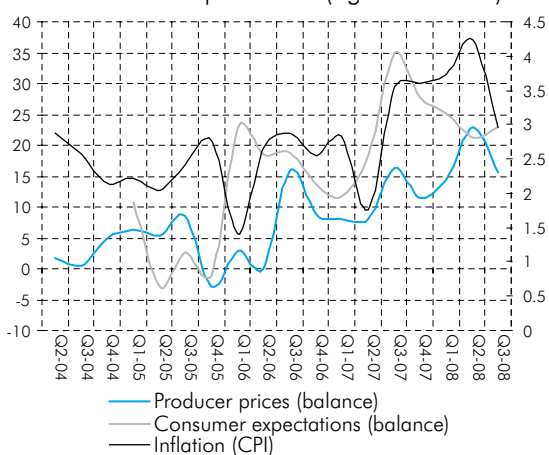
The high import prices of consumer goods combined with the downward tendency of the lek appreciation against the euro in the first half of 2008, have been exerted inflationary pressures on prices at home.



4.4 EXPECTATIONS FOR PRICES IN ECONOMY

Inflation expectations, which are based on the results of the surveys carried out by the Bank of Albania⁵⁴, have been in line with the actual upward tendency of this indicator starting from September 2007. After peaking in 2007, medium-term consumer expectations (1 year horizon) have fluctuated at around 3.0 percent or close to the central bank's inflation target. Their behaviour attests

Chart 29 Consumer expectations, business assessments of producer prices (left-hand axis) and banks' expectations (right-hand axis)



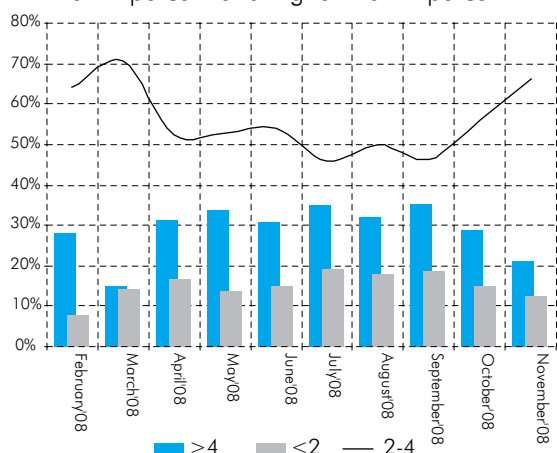
Source: INSTAT and Bank of Albania

to the fact that consumer expectations are closely related to their perception of current inflation. Thus, the recent months' contained increase of inflation has been also reflected in the behaviour of expectations, which in the third quarter of 2008 stand below 3.0 percent.

According to the business sentiment survey, producer prices show an upward tendency starting from the second half of 2007. However, during the last quarter the balance of producer prices has dropped by 7 percentage points⁵⁵.

During October - November 2008⁵⁶, median expectations of banks' experts for the inflation rate after 12 months, were close to 3.4 percent, compared to 3.9 percent in the second quarter of 2008. From the aggregation of responses on the probabiliary distribution of expectations for the inflation rate after 12 months, in the survey held in November the inflation rate stood at within the 2-4 percent range, with a 66 percent probability, up by 10 percentage points from a month earlier. In the short-run, expectations for annual inflation after a month are optimistic. Banks are more certain than a month ago that inflation for the coming month will be within the 2-4 percent range. The probability that annual inflation rate after a month will be above 4 percent has fallen slightly.

Chart 30 Probability that annual inflation after a year will be within the 2-4 percent rate, lower than 2 percent and higher than 4 percent



Source: Monthly Banks' Survey, Bank of Albania

5. FINANCIAL MARKETS, INTEREST RATES AND THE EXCHANGE RATE

The interest rates in the markets have by and large been stable during the third quarter, while the central bank has continued to supply the banking system with liquidity. As of end the third quarter and later in October, the short-term interest rates in the money market increased considerably, owing to the pressures for the liquidity shortage during the period when the required reserve was met and to its asymmetric distribution in the interbank market. These fluctuations in the short-term interest rates have not been transmitted to other markets. The Government securities' yields in the primary market lowered, while deposits and loans' interest rates have been stable.

The available data indicate that the domestic market remains on the fringes of the negative developments characterizing the international financial markets. This attributes to the yet too low financial intermediation at home and the lack of the Albanian banking system exposure to the financial instruments

that triggered the current crisis. However, the increase in the funding cost in the international market may lead to the tightening of lending, in particular of that in foreign currency. In addition, the supervisory measures in the lending process will strengthen. On the other side, despite the high intermediation margins, interest rates of ALL loans have shown a slight downward tendency in the last two years. Agents' expectations for the maintenance of inflation at stable rates and the preservation of domestic demand may shift the attention to lending in domestic currency, hence enhancing competition in this market.

5.1 MONEY MARKET

Since the first quarter, the banking system has been characterized by the shortage of liquidity and the open market operations have been oriented to its injection, mostly through one-week maturity reverse repo auctions with limited amount. On the other side, the trading activity in the interbank market has increased compared with the previous year. Borrowing continues to be limited to short-term maturity terms - mainly overnight. In the last 10 months, borrowing in the interbank market increased to an average of 1.5 billion leks from 1.0 billion leks, while the interest rates fluctuated at around the low corridor and very close to the key interest rate. A similar situation also characterized the third quarter of the present year; however the increasing need for liquidity at end September, when the required reserve was met, caused the overnight interest rate in the interbank market to jump substantially to 7.54 percent or 1.29 percentage points above the key interest rate. This move followed the increase in the interest rate bid in open market operations. The upward tendency was transmitted until the first two weeks of October.

The pressure on the interest rates arose from the inefficient management of liquidity and the asymmetry in the interbank market, rather than from its shortage in the open market operations. In order to 'calm down' market participants and trigger activity in the interbank market, the Bank of Albania has also made use of reverse repos of overnight (in September), one-month and three-month (in October and November) maturity term. In addition, the amounts announced to be purchased in the auctions were significantly higher than the banking system's needs. In November, the auctions took the form of reverse repo auctions, with a fixed price to the key interest rate (6.25 percent) and with undetermined amounts, hence allowing for the decrease of the borrowing cost in the market.

The interbank market has been active throughout the third quarter and has met the banking system's short liquidity needs. Median daily volume of borrowing in the interbank market stood at similar levels with the previous quarter - about 2.4 billion leks. In October, it reduced by about 0.6 billion leks,

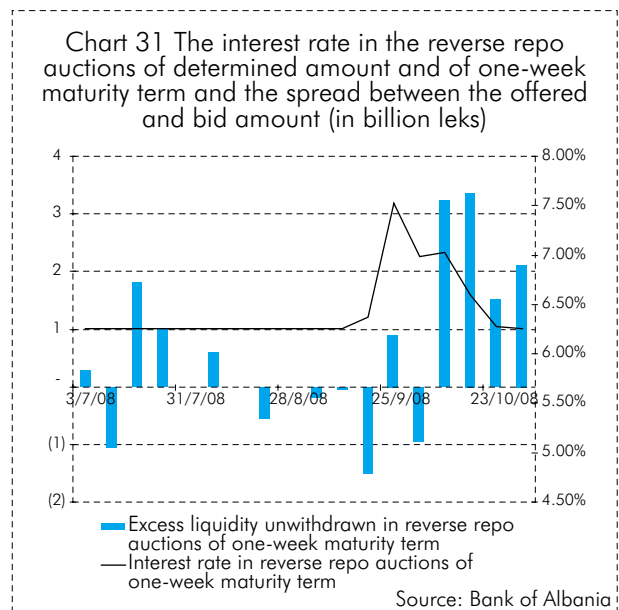
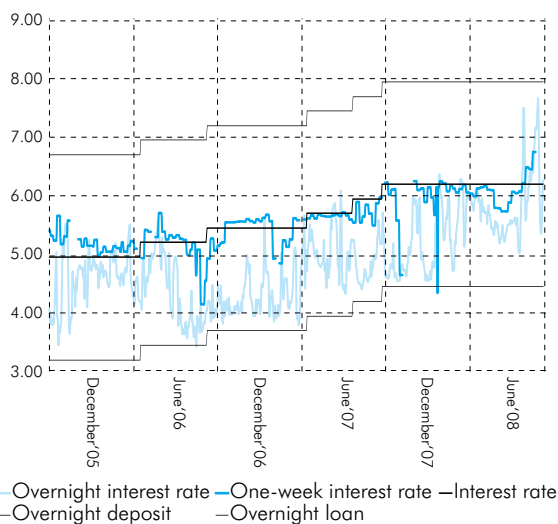


Chart 32 Interest rates in the interbank market



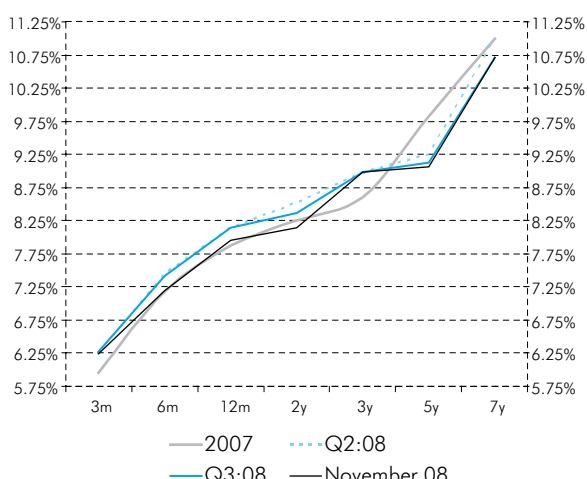
Source: Bank of Albania

owing to the decrease in the traded volume of one-week maturity term, while the overnight transactions remained at the same levels. Weighted-average interest rate of overnight transactions increased to 6.60 percent in October from 6.06 percent in September.

5.2 PRIMARY MARKET

T-bill yields in the primary market have shown a downward tendency in the third quarter. Following their response to the last change in the key interest rate in November 2007, they maintained a slight upward tendency in the first two quarters of the present year to later shift downward in the third quarter starting from August. The same performance also persisted in October, hence confirming the tendency of this period. Compared with the previous year when the key interest rate increased by 50 basis points, at end October the 3-month yields increased by 0.16 percentage points (6.23 percent) while the 12-month yields fell by 0.18 percentage points (7.92 percent). The downward tendency and the reduced spread between maturity terms were reflected in the yields' curve, whose sloping moderated. With respect to yields movements, they have shown slight volatilities. The issued volumes were higher than in the previous quarter and participation in the auctions has been at satisfactory levels. The drop of the yields persisted in the early November, when the 12-month yield stood at 7.95 percent, while the 3-month yield was 6.05 percent, which is close to the yield prior to the last increase of the key interest rate by 25 basis points (November 2007).

Chart 33 Government securities' yields in the primary market



Source: Bank of Albania

Table 13 Government securities' yields in the primary market

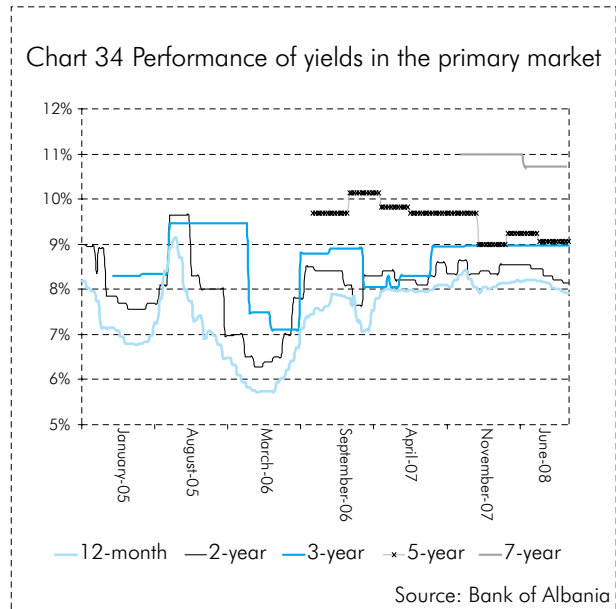
	T-bills			Bonds		
	3-month	6-month	12-month	2-year	3-year	5-year
Average 2007	5.96	7.17	7.87	8.25	8.54	9.83
Q3: 2007	5.78	7.25	7.97	8.19	8.30	9.76
Q1: 2008	6.24	7.34	8.11	8.41	8.98	9.40
Q2: 2008	6.28	7.44	8.151	8.52	8.98	9.25
Q3: 2008	6.26	7.41	8.146	8.37	8.98	9.13
November-08	6.05	7.20	7.95	8.15	8.98	9.20

Source: Bank of Albania

Bonds' yields in the primary market were stable and maintained a downward tendency in the third quarter. The performance of bonds' yields has reflected

the movements in the T-bills' market, hence shifting downward during this period. Compared with the previous year, the spread between 2-year bonds and 12-month T-bills has narrowed. In addition, the spread between other long-term instruments has kept the same performance. The reduced spread between all maturity terms has moderated the slope of the yields' curve of these instruments. The downward tendency of long-term yields attests to the improvement of market agents' expectations for inflation, the enhanced confidence in these debt instruments and the monetary policy efficiency.

In early November, 2-year bonds' yield dropped to 8.15 percent or 0.10 percentage points lower than the previous year's average. 5-year bonds' yield stood at 9.20 percent or 0.62 percentage points lower. The participation was high and the volume of bonds issued by the Ministry of Finance has been increasing, reflecting the shift of debt financing with long-term instruments. The banking system's portfolio continues to shift to instruments of longer than one year maturity term, which is believed to have impacted the decrease of bonds' yields. 3-year and 7-year bonds' yields remained unchanged at 8.98 and 10.71 percent, respectively.



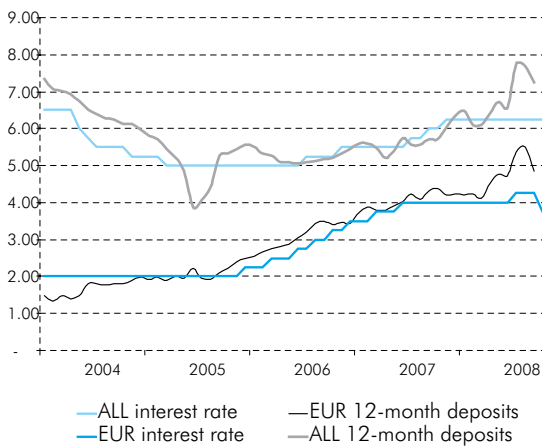
5.3 INTEREST RATES ON DEPOSITS AND LOANS

Weighted average interest rate of ALL deposits increased in the third quarter of the year, owing to the launch of promotional offers available for only a limited period of time and aiming at attracting the savings to the banking system during the visit of Albanian emigrants. The banking system promoted high interest rates on both ALL and EUR deposits, causing the shift in the ratio of deposits between these two currencies to become insignificant. These promotional offers terminated in September when the interest rates began to drop again close to (but above) the previous levels.

ALL interest rates peaked in August with an average of 6.72 percent, up by 1.24 percentage points from the second end-quarter of the present year. In September, the interest rates fell to 6.11 percent, up by 1.32 percentage points from the previous year. In real terms, this change is even higher considering that the annual inflation rate has been descending. With respect to maturity terms, worth to note is the fact that the interest rates on 12-month deposits increased substantially to 7.72 percent in July and August. In September, weighted average interest rate on 3-month deposits recorded the highest fall by 1.19 percentage points to 5.08 percent, while that on 12-month deposits fell by 0.46 percentage points to 7.25 percent.

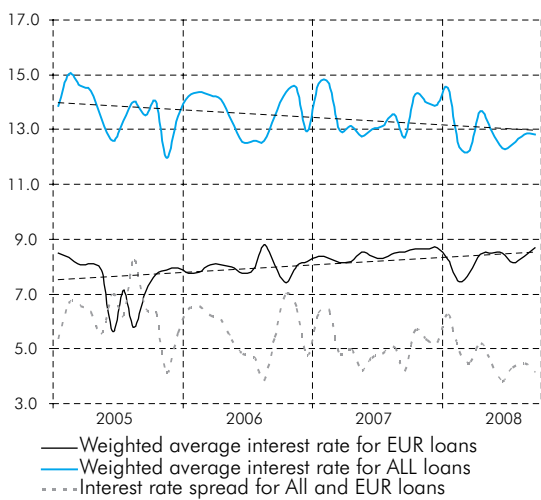
The interest rates on EUR time deposits have by and large maintained the same seasonal movement. After the launch of promotional offers, when the

Chart 35 Performance of ALL and EUR deposits interest rates



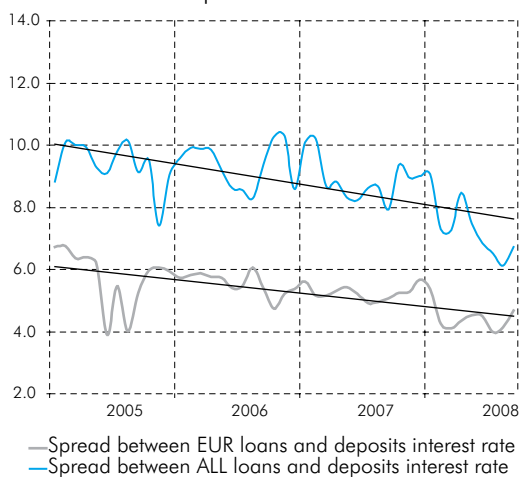
Source: Bank of Albania, ECB

Chart 36 Performance of weighted average interest rate for ALL and EUR loans



Source: Bank of Albania

Chart 37 Spread between ALL and EUR loans and deposits interest rate



Source: Bank of Albania

weighted average interest rate on these deposits reached the peak of 4.22 percent, in September it fell by 0.19 percentage points to 4.03 percent. The cut of the key interest rate by the European Central Bank in October is expected to be reflected in the domestic market as well, although not at the same margin given the banks' efforts to maintain their market positions. The ALL and EUR 12-month deposits' spread was 2.33 percentage points in September, which is close to that in July (2.36 percentage points), providing evidence for the ongoing competition in the banking system with respect to euro-denominated deposits.

Demand for ALL loans remained relatively high in the third quarter. In August, average interest rate on ALL and EUR loans had a slight upward tendency. Interest rates on EUR loans increased in September, partly reflecting the developments in the international financial markets.

Weighted average interest rate of ALL loans was 12.84 percent in September (almost the same as in August), up by 0.38 percentage points from July. The figures were mainly determined by the loans to meet short-term business needs and the real estate loans to households.

The interest rates on foreign currency loans were in line with the developments in the global markets. The interest rate on EUR loans increased to 8.70 percent in September, up by 0.34 percentage points from August 2008. This increase mainly attributes to the tightening policies pursued by the banking system during this month. On the other side, the conservatory policies in terms of foreign currency lending are expected to shift the attention to lending in the local currency and to the reduction in interest rate margins. Demand for EUR loans continued to be high for all purposes of use, in particular for real estate purposes, whose interest rates remain competitive and stable.

Intermediation rate for ALL interest rates increased by 0.6 percentage points in September, compared with the previous month. However, this increase owes to the drop in ALL deposits' interest rates during this period. Average intermediation rate for the euro increased by 0.5 percentage points. This

change provides evidence for the slight tightening tendency, resulting from the latest developments in the banking system with respect to lending in foreign currency.

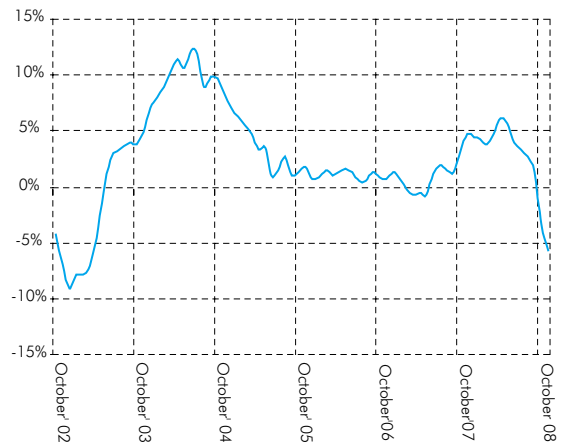
5.4 EXCHANGE RATE PERFORMANCE

The third quarter of 2008 saw the pronounced downward tendency of the lek exchange rate depreciation, which began in the beginning of the second quarter. In annual nominal effective terms, there was a 2.40 percent change in the index during the third quarter, from 1.60 percent the previous year. In October, this tendency shifted to the depreciation of the local currency when for the first time since May 2007, the NEER reached negative values to -2.0 percent.

The depreciation of the lek at end the third quarter and the beginning of the last quarter has mirrored the developments in the domestic market and the performance of the EUR/USD ratio in the international markets. The depreciation of the lek against the euro owes to the high demand for the latter. This demand was mostly concentrated in two periods of time: in September when the demand for foreign currency stemmed from the conversion of the foreign companies' profits; and in October owing to the high demand for foreign currency, mainly from outside the banking system. In October, the lek depreciated against the euro and the dollar in annual terms, by 0.6 and 7.6 percentage points, respectively.

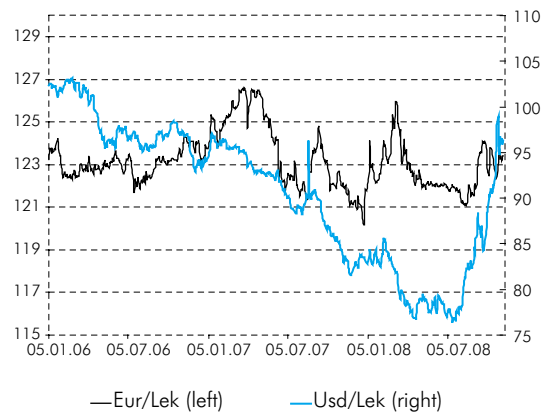
In addition, the depreciation of the lek against the euro in October, compared to the previous year, became more pronounced as a result of the positive performance - beyond the seasonal behaviour - of the lek in the same period the previous year, owing to the conversion of commercial banks' capital from foreign currency in lek in 2007. The appreciation of the U.S. dollar against the lek has fully reflected the developments in the EUR/USD in the international market, where this ratio reached 1.283 EUR/USD at end period, from 1.40 in September.

Chart 38 Lek annual changes in nominal effective terms (NEER⁵⁷)



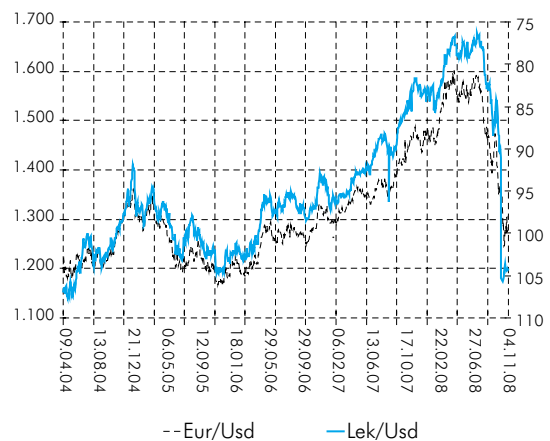
Source: Bank of Albania

Chart 39 Daily performance of ALL/EUR and ALL/USD exchange rate



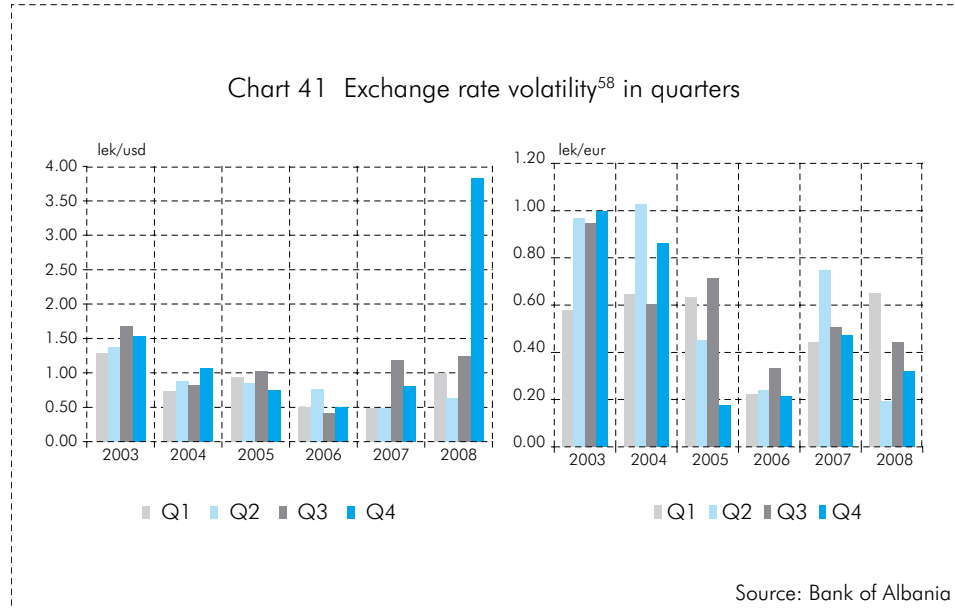
Source: Bank of Albania

Chart 40 Daily performance of EUR/USD and ALL/USD



Source: Bank of Albania

The volatility in the ALL/EUR ratio in the domestic market has been stable, unlike the volatility shown in the ALL/USD ratio, which was high due to the settings in the international markets. The correlated performance in EUR/USD and ALL/USD ratios suggests the importance of the euro in the exchange rate performance at home and the pronounced responsiveness of the ALL/USD ratio to the developments in the international markets.



As of end October, the lek exchanged against the euro at 123.92 ALL/EUR and against the dollar at 96.78 ALL/USD.

ENDNOTES

¹ In the second quarter of 2008, GDP grew by 2.8 percent in quarterly terms.

² In the third quarter, the U.S. dollar appreciated by about 3.7 percent against the euro compared with the previous quarter.

³ In August, inflation rate marked 5.4 percent, while in September it marked 4.9 percent.

⁴ Fast growing developing economies, Brazil, Russia, India and China.

⁵ The current accounts of China and Russia account for 9.5 percent and 6.5 percent of the GDP.

⁶ In April, inflation rate in China marked 8.5 percent.

⁷ Since the early 2008, Italian Stock Exchange has dropped by about 48 percent.

⁸ In August, inflation rate marked 4.2 percent, while in September it dropped to 3.9 percent.

⁹ Investments shifted downward during the last quarter of 2007, when they contracted by 4.7 percent.

¹⁰ In September and October, inflation rate marked 4.7 percent and 4.0 percent, respectively.

¹¹ Effective Overnight Interest Rate. It is computed as a weighted average of all overnight unsecured lending transactions in the interbank market between Euro zone banks.

¹² The Euro Interbank Offered Rate is a daily reference rate based on the averaged interest rates at which banks offer to lend unsecured funds to other banks in the euro wholesale money market.

¹³ The London Interbank Offered Rate is a daily reference rate based on the interest rates at which banks borrow unsecured funds from banks in the London wholesale money market.

¹⁴ OIS - An overnight indexed swap. It is an important measure of risk and liquidity in the money market.

¹⁵ The Central Bank of the United States.

¹⁶ European Central Bank.

¹⁷ OPEC countries reduced their supply by about 3 percent in September, compared to the previous month.

¹⁸ Borrowing money to supplement existing funds for investment.

¹⁹ IMF World Economic Outlook Update, November 2008.

²⁰ IMF, Global Financial Stability Report, October 2008.

²¹ The meeting of quantitative objectives is an obligation of the Bank of Albania in view of observing the EFF/PRGF arrangement with the IMF and the Albanian authorities.

²² Preliminary data.

²³ This item's inflation was -1.4 percent in October. Average inflation for August to October was -3.7 percent.

²⁴ Net inflation is derived after excluding the effect of very volatile prices or administered prices from headline inflation rate.

²⁵ Inflation excluding food prices and administered prices and the other excluding oil prices marked 0.9 and 0.8 percent, respectively, in a second

measure.

²⁶ One of the most sensitive indicators of inflationary pressures originating from demand side.

²⁷ Core inflation, computed using the permanent exclusion method of certain items.

²⁸ Due to improvements in the re-grouping of some basket items according to the measures referred to in the table, inflation rates have reflected slight and systemic changes which have not distorted the trends shown in the analyses to date.

²⁹ Price rise in 'newspapers, books and school items' (September 2008).

³⁰ ETI aggregates specific indicators of the main sectors of economic activity (industry, construction and services) and of consumers. The series of indicators used in the construction of the ETI are seasonally adjusted.

³¹ House Price Index is measured only for Tirana.

³² House Price Index has been measured since the second quarter of 1998.

³³ The average refers to the period from 1998 to 2008.

³⁴ The indicators are seasonally adjusted.

³⁵ During 2007, trade deficit as a share of GDP for some regional countries was: Serbia (22.0 percent); Bulgaria (25.3 percent); Macedonia (21.3 percent) and Romania (14.5 percent).

³⁶ Merchandise exports and imports with Italy and Greece account for 31.6 percent and 15.4 percent of total trade exchanges volume. In addition, there has been an annual increase in trade exchanges with Austria and Germany.

³⁷ The annual increase in trade exchanges with China, Russia, Macedonia and Croatia is 22.9, 43.1, 45.02 and 8.8 percent, respectively.

³⁸ The annual drop by about 11 percent in tax on profit is strongly related to the change in the tax on profit from 20 percent to 10 percent starting from 1 January 2008. In addition, while implementing the fiscal package for 2007, which among others brought about the reduction in customs duties, revenues from this category have dropped by about 14 percent relative to the previous year.

³⁹ The drop in non-tax revenues compared to the previous year owes to the Bank of Albania's transfer of profit, which upon the requirement of the Ministry of Finance it has been paid only for the period January to April 2008.

⁴⁰ From progressive to simple tax starting from 1 July 2007.

⁴¹ The financing of Durrës-Kukës road accounts for about 50 percent of total capital expenditures. This project is mainly funded by foreign financing (about 90 percent).

⁴² Cumulative realization of fiscal indicators as of end September each year.

⁴³ These estimations have excluded the exchange rate effect. However, in annual terms, the exchange rate effect is inconsiderable.

⁴⁴ As of September 2006, the loan portfolio time structure is as follows: short-term loans - 30 percent; medium-term loans - 32.6 percent; and long-term loans - 37.4 percent.

⁴⁵ Annualized quarterly growth measures the quarterly growth exponentially converted into an annual growth rate.

⁴⁶ Average wage in the public sector (budgetary and non-budgetary).

⁴⁷ Measures related to the declaration of the number of employed persons and their income by the private enterprises pursuant to the Council of Ministers Decision No. 285, dated 4 May 2007.

⁴⁸ According to INSTAT (Short-term Statistics), wages refer to the fund of wages paid to all employed persons during the period.

⁴⁹ The approximate indicator of production index is constructed by dividing the deflated turnover indicator by the number of employed persons index (constructed by Bank of Albania experts on the series of Short-term Statistics data (INSTAT, second quarter, 2008).

⁵⁰ According to the latest data published by the INSTAT (Conjuncture April - June 2008).

⁵¹ Measured by the unit value index, INSTAT.

⁵² Foreign trade with EU member states accounts for 68 percent of the total.

⁵³ In the first nine-month period of 2008, the lek appreciated against the euro by 1.3 percent.

⁵⁴ The analysis of inflation expectations is based on the results of the surveys carried out by the Bank of Albania: Business Sentiment Survey, Consumer Sentiment Survey and Monthly Banks' Survey.

⁵⁵ Quarterly difference of indicators in the form of balances.

⁵⁶ Monthly Banks' Survey is carried out on monthly basis.

⁵⁷ NEER – Nominal effective exchange rate, measured against two currencies according to an approximate share they have in trade with abroad, EUR (80 percent) and USD (20 percent). A positive change of the NEER implies the appreciation of the lek.

⁵⁸ Measured as quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.