

BANK OF ALBANIA

MONETARY POLICY  
REPORT FOR THE FIRST  
QUARTER OF 2009

2009



# MONETARY POLICY REPORT FOR THE FIRST QUARTER OF 2009

## 1. GOVERNOR'S SPEECH

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

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

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

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

our analyses, the risks for inflationary pressures in the medium run are to a large extent balanced.

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

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

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

Owing to the reduced amount of liquidity in the banking system, the annual growth rates of lending shrank considerably in the first two months of 2009. Excluding the exchange rate effect, the annual growth rate of loan portfolio slowed down further to 29 percent in February. Although the slump in lending activity leads to stable foreign currency position at home, the prolonged contraction of lending may affect the economic activity in the country. Accordingly, the Bank of Albania is supplying the banking system with the necessary liquidity and in co-operation with the latter is working on controlling the credit elements that are non-cost-related but which affect its performance.

The performance of loans by currency attests to the banks' tendency to shift from lending in foreign currency to lending in domestic currency. As of end February, Lek-denominated loans accounted for 29 percent of loan portfolio, up by 2 percentage points compared with the average share in 2008. This shift is considered a positive development for the Albanian banking system. Banks' greater inclination to lending in the Albanian Lek gives more room for greater monetary policy efficiency and for its impact over the behaviour of economic agents. In addition, the shift of the loan portfolio to the Albanian Lek would lower the exposure of the banking system's developments to the exchange rate movements and would contribute to strengthening and safeguarding financial stability at home.

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

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

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

The global events have attested to the high integration level and the chain effects of the crisis on the Albanian economy, hence calling for constant monitoring of the economic and financial activity at home and for co-ordinated measures to deal with the consequences of this crisis.

The Bank of Albania decided to cut the key interest rate by 50 basis points to 5.75 percent in January. This move attests to the persistence and commitment of the central bank to intervene timely and appropriately in order to meet its primary objective. The Bank of Albania will continue to work on anchoring the inflationary expectations to its 3 percent target, hence contributing to maintaining the macroeconomic balances and stimulating economic activity.

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

## 2. WORLD ECONOMY

### 2.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

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

#### EURO-ZONE ECONOMY

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

Table 1 Some main macroeconomic indicators

Country	Annual GDP growth		Unemployment rate	Annual inflation rate	
	Q4 2008/Q4 2007	Q4 2008/Q3 2008	February 2009	March 2009/ February 2009	March 2009/ March 2008
USA	-0.8	-6.3	8.5 <sup>1</sup>	-0.4	-0.1
Euro-zone	-1.2	-1.5	8.5	1.2	0.6
Germany	-1.6	-2.1	7.4	-0.1	0.5
Greece	2.6	0.3	7.8 <sup>2</sup>	2.0	1.5
Italy	-2.9	-1.9	6.9 <sup>2</sup>	1.2	1.1
Japan	-0.6	-3.2	4.4	-0.3 <sup>3</sup>	-0.1 <sup>3</sup>

Source: BEA, Eurostat, Respective statistical institutes

<sup>1</sup> Data for March.

<sup>2</sup> Data for Q4 2008.

<sup>3</sup> Data for February.

### U.S. ECONOMY

The U.S. economy continues to be characterized by a weak activity in its main sectors, although some important indicators have shown their first signs of recovery. Final assessments on economic growth for the last quarter of 2008 attest to more accelerated contraction of the economy, with the fall in consumer spending and aggregate investment<sup>1</sup> being the main contributors. Economic indicators over the first two months of 2009 show better performance in some sectors of the economy. Trade deficit narrowed in January and February as a result of more accelerated downward rates of imports compared with exports. Disposable income increased by an average of 2.5 percent over the same period owing to the decrease in the fiscal burden on U.S. households in order to recover the economy and underpin an increase in consumer spending. However, the latter continues to maintain a downward trend although at more moderate rates than the last quarter the previous year. The Fed has stated its commitment to purchase a large part of the Government debt in order to inject liquidity into the economy and enhance the lending capacity.

Consumer confidence index improved in January and February however remaining at low levels compared with the same months the previous year. According to the data on the performance of manufacturing industry, the business climate remains unfavourable<sup>2</sup>. However, the house market improved its sales in February by 4.7 percent in monthly terms. Unemployment rate attested to the further increase in the number of unemployed persons in March to 8.5 percent. Inflation rate rose by 0.2 percent compared with the same month the previous year reflecting primarily the rise in energy price in the domestic market.

### THE BRICs' ECONOMY

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

Chinese exports fell by 25.3 and 34.2 percent in January and February. Industrial production increased at moderate rates while construction

deteriorated in February. On the other side, the fiscal package approved by the Chinese Government at end 2008 has helped to maintain high investment and consumer spending growth rates.

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

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

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

Table 2 Some macroeconomic indicators for the BRIC countries

Country	February 2009	March 2009	Q3 2008	Q4 2008	2009 <sup>1</sup>
	Annual inflation rate		Real economic growth		
Brazil	5.9	5.6	6.8	1.3	-0.3
China	1.0 <sup>2</sup>	-1.6 <sup>3</sup>	9.0	6.2	6.3
India	10.4 <sup>2</sup>	9.6 <sup>3</sup>	7.5	5.3	4.3
Russia	13.9	14.0	6.0	1.2	-5.6

Source: IMF, OECD, Respective statistical institutes

<sup>1</sup> OECD Economic Outlook, Interim Report, assessments.

<sup>2</sup> Data for January.

<sup>3</sup> Data for February.

## REGIONAL COUNTRIES' ECONOMIES

### ITALY

The latest figures on the economic activity in Italy for the first two months of 2009 attest to the deterioration of some main economic indicators. Aggregate investment and industrial production fell further. In annual terms, the latter fell by 20 percent in February. Construction is also suffering sharp contractions, with investment falling below the average of the last decade. Exports to EU



countries and broader and imports decreased. On the other side, consumer spending has increased and the automobile industry has recovered over January following some fiscal measures taken by the Italian Government. Lending conditions remain tight. In February, loans to business and firms recorded an annual drop of 4.9 percent. Consumer price index increased by 1.1 percent in March compared with the same month the previous year.

#### GREECE

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

#### TURKEY

Turkey's economy shrank by 6.2 percent in the last quarter of 2008 compared with the same period the previous year, giving it an overall annual growth rate of 1.1 percent. The global economic and financial crisis gave rise to substantial contraction of exports and domestic demand. Although upward, public spending could not offset the drop in consumer spending and investment. Industry and construction recorded substantial fall. Growth prospects for the year 2009 remain uncertain. There has been a decrease in industrial production, increase in unemployment and contraction in lending. On the other side, confidence indices have improved although remaining at pessimistic levels. In February 2008, inflation fell by 0.3 percent in monthly terms, which is reflected in the annual inflation rate of 7.7 percent. This low rate compared with the inflation rate for 2008<sup>3</sup> owes to the continued downward trend of the food price rise.

#### MACEDONIA

Economic activity in Macedonia contracted sharply in the last quarter of 2008 to 2.1 percent from 5.7 percent in the first three quarters. Investment and industrial production recorded substantial drop surpassing the positive effect of the increase in consumer and public spending. The downward rates of industrial production in January and February 2009 attest to the further contraction in the first quarter of the present year. Unemployment increased in the last quarter of 2008; however this increase is similar to that in the last quarter of 2007 hence providing evidence for the seasonal effect rather than a reflection of the global crisis. Annual inflation in Macedonia maintained its downward trend and marked 0.2 percent in March. Average inflation for the first quarter marked 1 percent. In January 2008, annual

inflation reached 10 percent while in December 2008 it dropped to around 4 percent. The main driving forces were the rapid fall in the price of oil and its by-products as well as of food, which have a large share in the Macedonian consumer basket.

KOSOVO

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

Table 3 Economic indicators for the regional countries

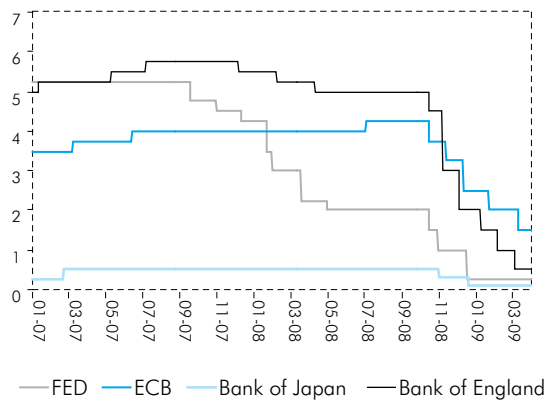
Country	Annual GDP growth Q4 2008	Annual inflation rate March 2009	Unemployment rate January 2009
Italy	-2.9	1.1	6.9 <sup>3</sup>
Greece	2.6	1.5	7.8 <sup>3</sup>
Macedonia	2.1	0.2	33.5 <sup>3</sup>
Serbia	2.8	9.9	14.0 <sup>4</sup>
Croatia	0.2	3.8	14.8 <sup>2</sup>
Turkey	-6.2	7.9	15.5
Kosovo	5.4 <sup>1</sup>	-1.2 <sup>2</sup>	43.0 <sup>5</sup>

Source: Respective statistical institutes, EuroStat, EcoFin

- <sup>1</sup> Data for 2008.
- <sup>2</sup> Data for February.
- <sup>3</sup> Data for the Q4 2008.
- <sup>4</sup> Data for October 2008.
- <sup>5</sup> Data for 2007.

2.2 MONETARY POLICY, FINANCIAL MARKETS AND THE EXCHANGE RATE

Chart 1. Changes in the key interest rate



Source: European Central Bank, Federal Reserve, Bank of Japan, Bank of England

The global financial markets continued to suffer pressures and volatility in the first months of 2009 generated by the prolonged crisis. The severe financial situation affected the economic performance of the main advanced and emerging and developing countries, being reflected in negative growth rates and lower global trade volume. The severe situation in the banking system led to tighter lending, higher uncertainty and deteriorated stock market indices. Foreign capital flows have declined in most emerging and developing countries bringing about deteriorated macroeconomic indicators. The inflationary pressures have slackened as a result

of lower raw material prices hence providing room for central banks to implement relaxed monetary policies in order to assist the banking system and fuel lending to economy.

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

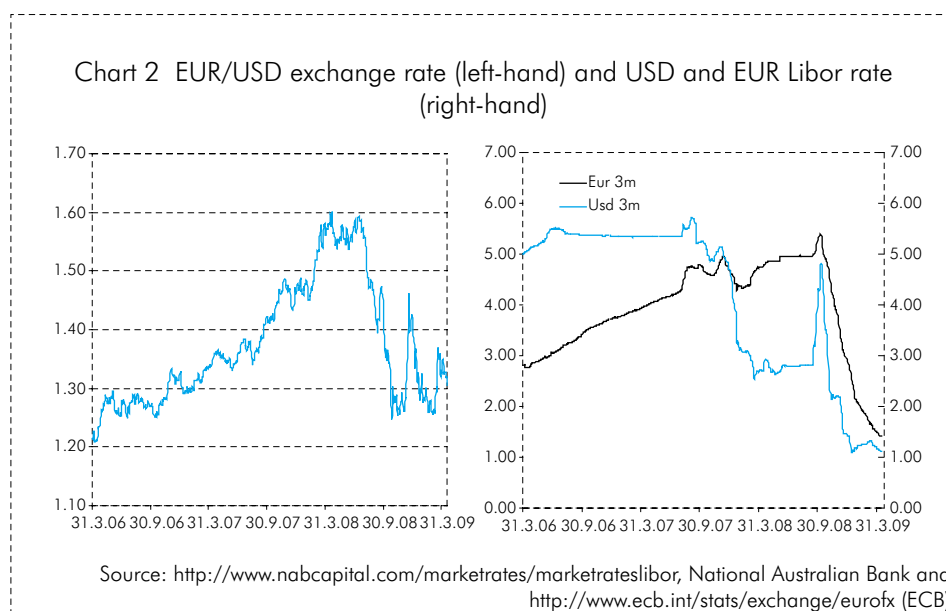
The ECB cut the key interest rate twice by 50 basis points in January and March to 1.5 percent, the lowest level in its 10-year history. The Federal Open Market Committee decided to keep the key interest rate unchanged at 0-0.25 percent, the record low in the U.S. The Bank of England slashed its key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

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

The bonds market in Europe and the USA was highly volatile and characterized by upward yields in the first months of 2008 to later relax and record downward yields in the months to follow. Worth noting is the increase of the business bond yields, in particular of those that received a non-positive assessment by the audit companies. The downward performance of the yields in the last period seems to have been triggered by the latest decisions of the U.S. Federal Reserve to pursue an easing monetary policy for a long period of time. In the Euro-zone, the central bank's decisions and the aiding policies of the governments have provided less impact over the yields' performance. The latter have shown higher volatility than in the other markets. In Japan, the yields have also maintained an upward tendency, however at lower levels than in the USA and the Euro-zone.

The main indices in the stock markets -Dow Jones, S&P and Nikkei- were characterized by a high volatility and considerable fall in the first months of the year 2009. The last weeks attest to an upward tendency and recovery owing mainly to the cut of the key interest rate in the major countries and the support plans the U.S. Government has committed to undertake to aid the businesses. The profits of a number of companies quoted in the global stock markets continued to record substantial fall over this quarter, deteriorating the market agents' perspective. The losses were considerable and mainly concentrated in the financial sector.

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



### 2.3 OIL AND RAW MATERIAL PRICES

Over the course of the first quarter of 2009, the international oil market continued to be characterized by the fall in the average price per barrel of

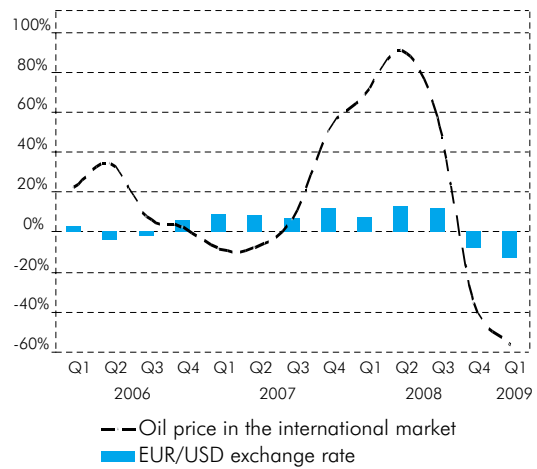
oil and the contraction of supply by some of the main oil producing countries. The price of one barrel of oil fell by about 57 percent in annual terms although in March it rose by nearly 19 percent in monthly terms<sup>4</sup>. The strong U.S. dollar vis-à-vis the Euro relative to the same quarter the previous year and the weakened demand and supply ratio led the oil price to remain at similar levels with the year 2004. Global annual demand for oil fell by 2.6 percent in the first quarter of 2009 owing to the contraction in advanced economies, which are the major consumers of oil and its by-products. In the meantime, the economic downturn in some of the major emerging countries such as Russia or China could not offset the fall of demand in advanced economies. Demand for oil fell in Russia while in China it recorded similar growth rates in absolute terms as in the same period the previous year. Against this backdrop, OPEC member countries continued to lower the daily oil production quota in order to recover demand for oil and raise the price per barrel.

Notwithstanding the concerns in some of the major North Sea oil refineries, supply in OECD countries has been upward. International oil market is expected to maintain the same performance for the next quarters although the recovery of U.S. demand in monthly terms in February was considered a positive signal and an expected effect of the current low price of oil in the market<sup>5</sup>.

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

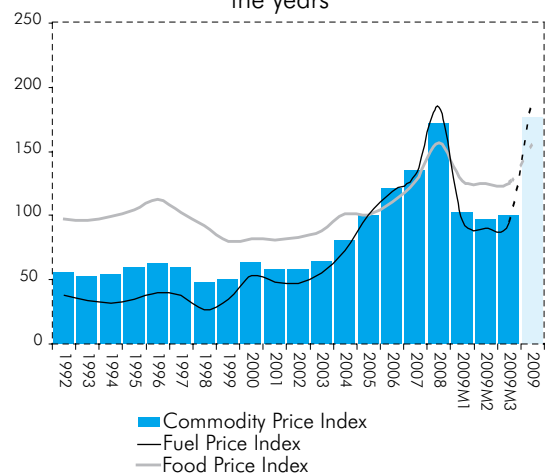
On the other side, the high annual fall rates are a result of the rapid price rise that began in the end of 2007 to the first months of 2008. The further fall in fuel and metal prices attests to the low demand for these goods as a result of the decelerated industrial production.

Chart 3 Annual change of oil price in the international market and the EUR/USD exchange rate



Source: Eurostat, Bloomberg

Chart 4 Performance of the main indices over the years

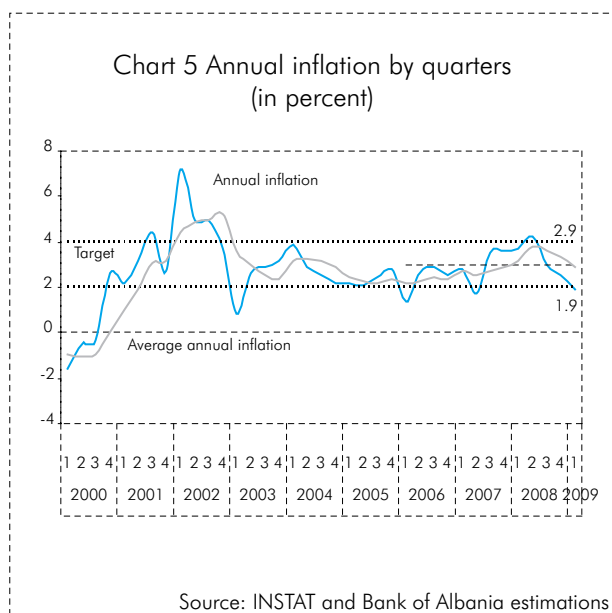


Source: International Monetary Fund

### 3. PRICE STABILITY AND THE BANK OF ALBANIA OBJECTIVE

Average annual inflation marked 1.9 percent in the first quarter of 2009, remaining close to the lower half of the tolerance band set by the Bank of Albania. In March, annual inflation declined further to 1.6 percent. The

downward trend of the annual inflation rate, shown since the mid-2008, attributes mainly to the fall of primary commodity prices in the international market, the lower domestic demand, the tighter financial conditions and the downward inflation prospects. The absence of inflationary pressures from both the internal and external environment is also reflected in the downward trend of traded and core inflation, which marked 1.4 and 1.7 percent, respectively, over this quarter.



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

#### BANK OF ALBANIA'S MONETARY POLICY

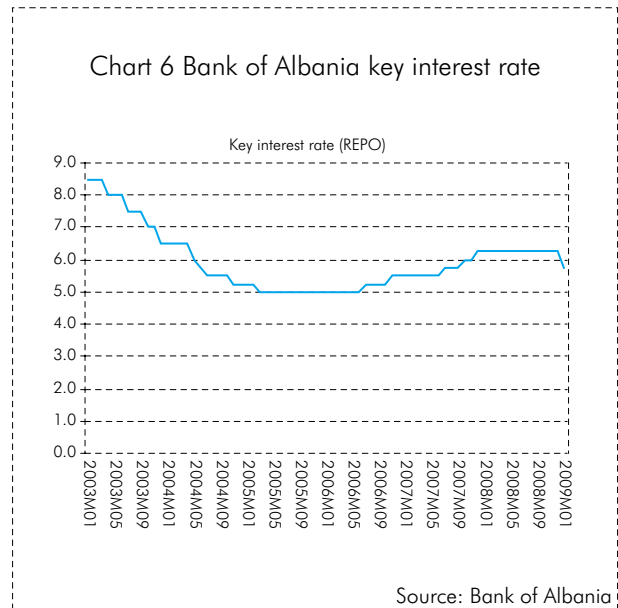
The implementation of the Bank of Albania's monetary policy is fully consistent with the primary target of achieving and maintaining price stability. This target implies pursuing low and stable inflation rates. The latter promotes economic growth, curbs the reduction in personal income and helps to moderate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

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

The Bank of Albania kept the key interest rate unchanged at 6.25 percent over the course of the year 2008. Given the lags in the transmission mechanism and the tight monetary policy pursued over the year 2007 it was assessed that the monetary conditions at home were appropriate for gradually restoring the macroeconomic balances and bringing inflation back to the tolerance band.

Average inflation marked 3.4 percent over the year 2008 resulting within the tolerance band. In absence of external supply-side shocks in the end of 2007 and early 2008, it would have been lower.

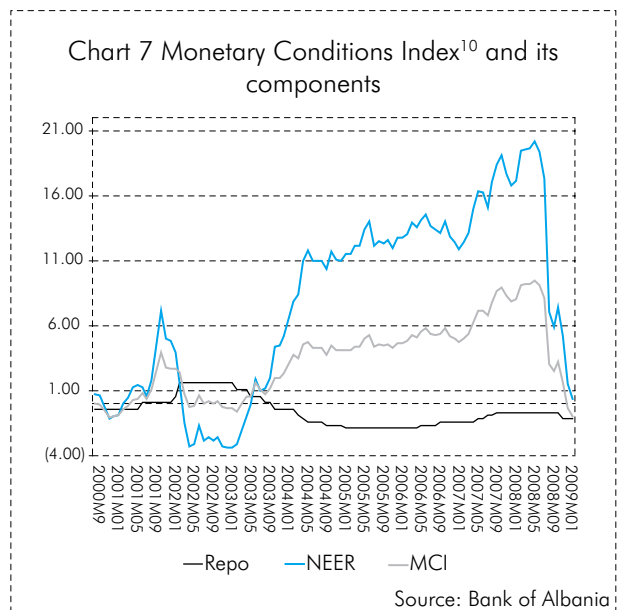
Notwithstanding the global crisis, the Albanian economy continued to maintain satisfactory economic growth rates, low inflation and stable banking system performance over the course of the year 2008. However, the pronounced and swift fall of inflation -in particular in the last quarter of 2008 and the first quarter of 2009-, the slower growth rates of credit to economy<sup>8</sup> and the worsened consumer and business expectations<sup>9</sup> for the future performance of economic activity and prices signal the possible shift in the economic situation at home. The decrease of inflation over the 2008:Q4 – 2009:Q1 period was mainly driven by the fall in global primary commodity prices. The low core and non-traded inflation rates attest to the plunge of inflationary pressures on the domestic demand side. As indicated by the current inflation rate, the Bank of Albania inflation forecasts for the period to follow and the economic agents’ (business and consumers) expectations for the inflation stand below the Bank of Albania target. Against this background, the Bank of Albania decided to cut the key interest rate in January by 50 basis points to 5.75 percent. The central bank’s response reflects its commitment to act timely and appropriately to risks that may jeopardize price stability, hence buttressing economic activity.



MONETARY CONDITIONS INDEX

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

For quite a number of years, short-term interest rates have been the main operational target for monetary policy. The ever-increasing importance of the interest rate and exchange rate channel in the monetary policy transmission required the construction of a new index. The Monetary Conditions Index (MCI) provides complete information on the monetary conditions setting and their impact on the economy. This fact



implies that there is an ever-increasing interest in determining the quantitative effects of monetary instruments on inflation and output. In addition, their use in monetary policy decision-making becomes greater.

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

### 3.1 PRICES OF MAIN CONSUMER BASKET ITEMS

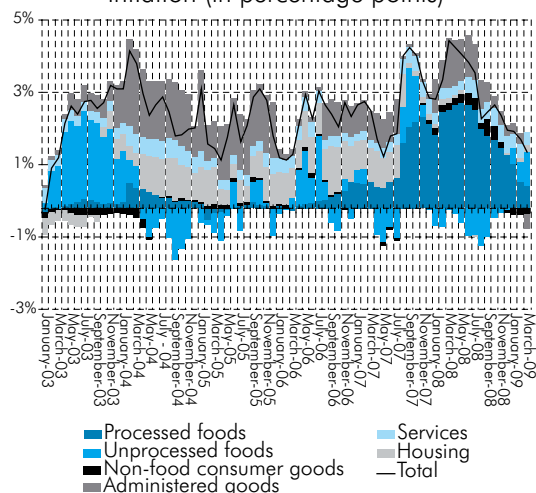
The annual change of the CPI in the first quarter of 2009 continued to maintain the same contribution pattern of goods and services' items as the end of 2008. The changes in 'processed foods', 'unprocessed foods' and 'services' provided the main influence on the consumer prices.

'Processed foods' and 'administered prices' recorded downward annual growth rates. The inflation rates of these two items are nearly three times lower than the same period the previous year. They contributed to the annual inflation rate for the first quarter by 0.9 and 0.1 percentage points, accounting for about 50 percent of the inflation rate. On the other side, 'services' which continues to contribute by an average of 0.4 percentage points to the inflation rate was complemented over the course of this quarter by the positive contribution of 'unprocessed foods' (0.6 percent). In terms

of inflation, this item had not provided a positive contribution since November 2007. Among other items, 'non-food consumer goods' provided a negative contribution of -0.2 percentage points hence offsetting the positive contribution rates of other basket items. Since January 2008, 'housing' has been providing negligible contribution to the inflation rate (0.1 percentage points).

The downward trend in the inflation rate of 'processed foods' shown over August to December 2008 peaked this year in March when it marked 2.6 percent. This item's inflation is recording similar rates to the ones prior to the price crisis in the second half of 2007. The terminated effect of the bread price rise over October 2007 to February 2008 -in addition to the more favourable global

Chart 8 Contribution of items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania estimations



conjuncture of this item's prices of goods- has triggered the decrease of inflation substantially. The same period the previous year 'bread and cereal' contributed by 1.7 percentage points to headline inflation to later fall to 0.6 percentage points in the first quarter of 2009.

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

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

	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08	Q1-09
Processed foods (pp)	2.4	2.5	2.9	2.3	1.7	0.9
Bread and cereal (pp)	1.2	1.4	1.7	1.3	1.0	0.6
Alcohol and tobacco (pp)	0.3	0.1	0.1	0.0	0.1	0.1
Unprocessed foods (pp)	0.5	-0.3	-0.4	-0.9	-0.1	0.6
Fruit* (pp)	0.4	0.5	0.3	-0.1	-0.1	0.0
Vegetables* (pp)	-0.1	-0.9	-0.2	-1.3	-0.7	-0.3
Services (pp)	0.4	0.3	0.3	0.5	0.5	0.4
Administered prices (pp)	0.1	0.3	0.7	0.8	0.3	0.1
Fuel and energy (pp)	0.0	0.2	0.6	0.6	0.7	0.4
Housing (pp)	0.2	0.1	0.1	0.0	0.0	0.1
Non-food consumer goods	0.1	0.2	0.3	0.3	0.2	-0.2
Durable consumer goods (pp)	-0.1	0.0	0.0	0.0	0.0	0.0
Consumer Price Index (y-o-y, %)	3.6	3.7	4.2	3.0	2.5	1.9

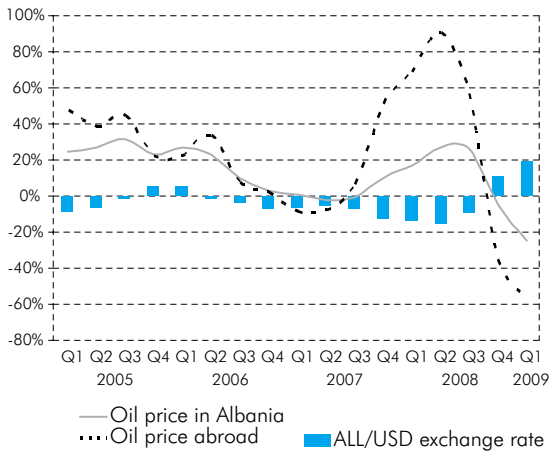
Source: INSTAT and Bank of Albania estimations

Table 4 Contribution of items to annual inflation (in percentage points)

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

The first quarter of 2009 attested to the continued fall of the oil price per litre in the retail market compared to the same period the previous year. Oil price per

Chart 9 Annual change of oil price in Albania and abroad and of the ALL/USD exchange rate

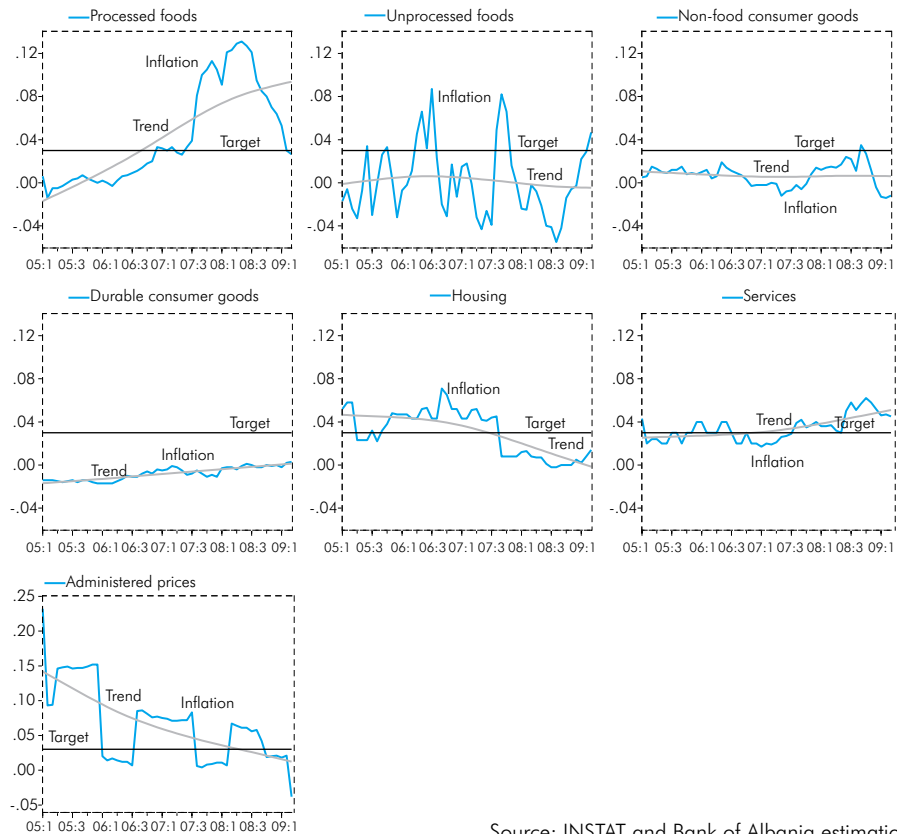


Source: INSTAT, Bank of Albania, Bloomberg

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

The main developments in the performance of prices over the first quarter of 2009 were noted in 'administered goods'. In March, the effect of the energy price rise last March was completely terminated, hence shifting the contribution of this item to negative rates. The falling price level affected the headline inflation rate markedly despite the volatile prices in other items. This item's contribution was 0.1 percentage points from 0.8 percentage points in mid-2008. Its annual inflation has been descending since October 2008 given that the increase in the inflation of 'fuels and energy' (inflation marked 15 percent in February) was offset by the falling prices in 'communication' by about 19 percent.

Chart 10 Annual inflation by items of goods and services (in percent)



Source: INSTAT and Bank of Albania estimations

‘Housing’ continued to record very low inflation rates in the first quarter of 2009 (0.1 percent) owing to the fall in rent prices. This item has by and large displayed seasonal fluctuations in prices triggered by the domestic demand in the market. The latter’s lower levels -in particular in late 2008 and the first quarter of 2009- led to a period of ‘relaxed’ prices in the house and rent market.

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

### 3.2 INFLATIONARY TRENDS BASED ON OTHER INFLATION MEASURES

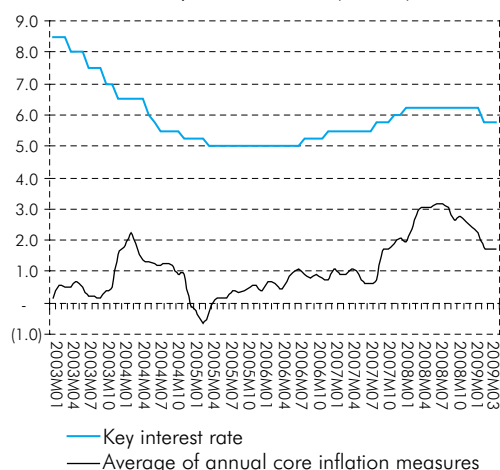
The curb on inflationary pressures in the Albanian economy was reflected in the downward tendency of different core inflation measures in the first quarter of 2009. In annual terms, the average of its measures marked 1.7 percent<sup>11</sup> for the reference period. For the first time since autumn 2007, the average of core inflation measures for the first quarter of 2009 marked rates below the lower half of the tolerance band<sup>12</sup> set by the Bank of Albania. Annual core inflation measured by permanent exclusion and trimmed mean marked 2.2 and 1.3 percent. The terminated effect of the price rise in ‘bread and cereal’ since 2008 has been gradually reflected over the first quarter in the permanent exclusion-based method. If the latter excluded this sub-item, core inflation would have marked about 1.5 percent, attesting to a relatively high convergence between the inflation rates as measured by these two measures.

Annual inflation by sectors of goods and services with traded and non-traded prices<sup>13</sup> marked 1.4 and 2.7 percent, respectively, in the first quarter of 2009. Traded inflation provided the main contribution<sup>14</sup> to the downward trend of headline inflation over September 2008 to March 2009. In the first quarter of 2009, it marked similar rates to its historical average over the last decade.

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

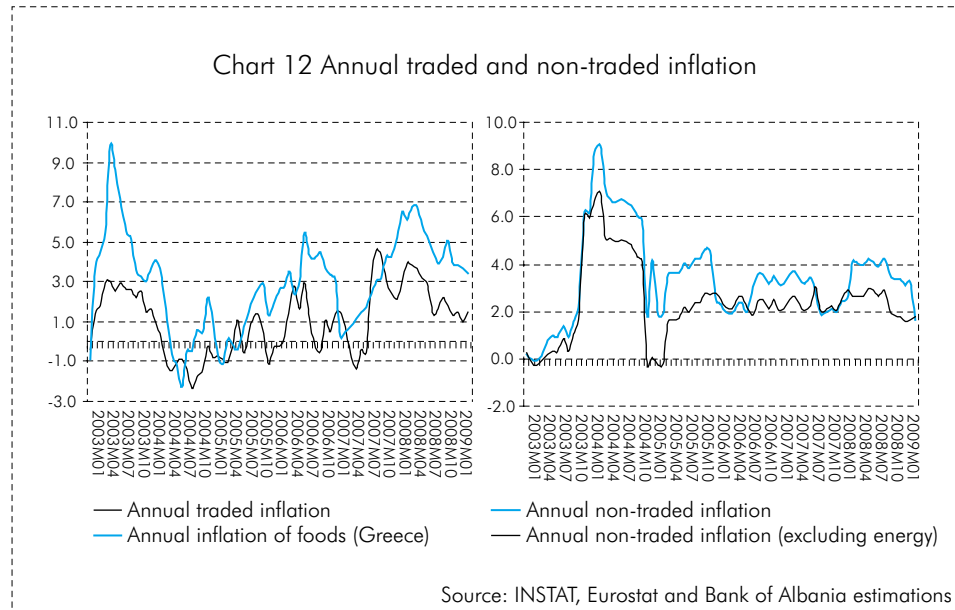
Annual non-traded inflation marked lower rates than the previous periods<sup>15</sup>, mainly owing to the

Chart 11 Average of core inflation measures and key interest rate (REPO)



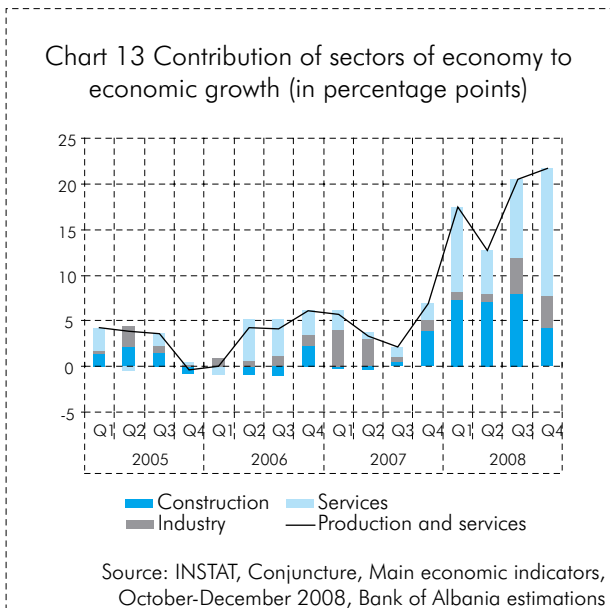
Source: INSTAT and Bank of Albania estimations

terminated effect of the administrative decision on the rise of the energy price last March.



The developments in inflation by the aforementioned components have been underpinning a uniform downward inflation, which has been characterizing the Albanian economy over the last three quarters<sup>16</sup>.

Average annual core inflation rate of the last four quarters (2.6 percent) is verging towards the average of annual headline inflation for this decade (2.7 percent). Traded and non-traded inflation stand at relatively low historical levels. These trends suggest the presence of the stabilizing role of domestic demand-side factors in the headline inflation, which have been adequately steered by the monetary policy decisions.



## 4. MACROECONOMIC DEVELOPMENTS AND THEIR IMPACT ON INFLATION

### 4.1 AGGREGATE DEMAND AND PRODUCTION

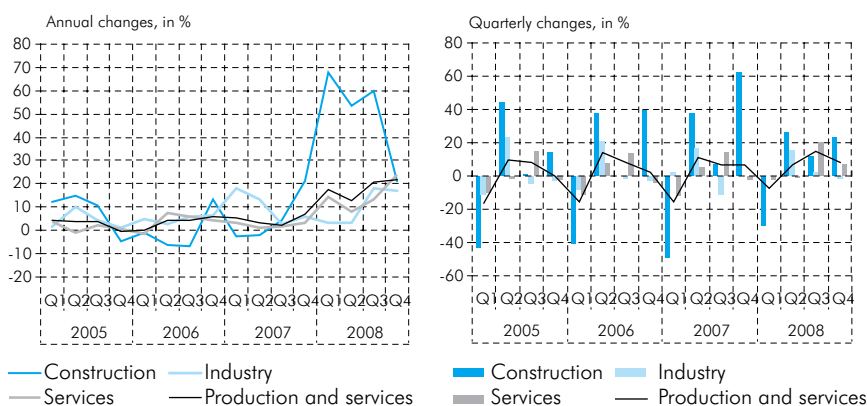
#### 4.1.1 Production by sectors

According to official data<sup>17</sup>, economic activity maintained high rates over the last quarter of 2008. Volume turnover generated from production and services increased by about 22 percent in annual terms. Relative to the previous period it increased by 8 percent. Services provided the main contribution to economic growth in the last quarter of 2009 being

mainly triggered by the increase in trading activity. Construction continued to share the main weight in production activity although twice lower than the preceding three quarters.

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

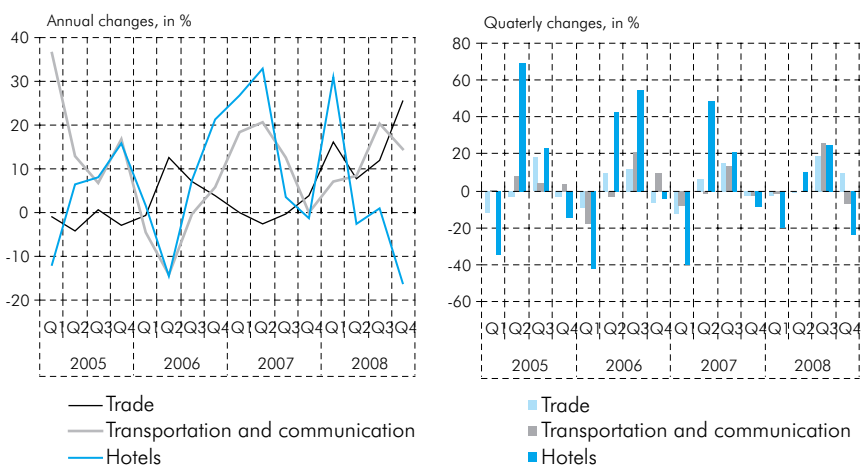
Chart 14 Volume turnover for the sectors of economy



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

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

Chart 15 Volume turnover in the services sector



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

the highest annual increase by 28.7 percent. The two other sub-branches, manufacturing and extracting industry, increased by 16.5 and -12.6 percent in annual terms. Relative to the previous quarter, volume turnover decreased by 1.2 and 25.7 percent, respectively.

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

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

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

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

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

Table 5 Energy balance sheet annual indicators (in GWh)

Indicator	January - February 2007	January - February 2008	January - February 2009	Annual change 2009/2008 (in %)
Net production	540	755	1,012	34.15
Import	541	523	222	(57.5)
Energy provided in distribution	1,013	1,172	1,184	1.08
Distribution losses	394	387	474	22.27
Distribution losses/Net production (in %*)	73.1	51.3	46.8	(8.85)
Energy shortages	219.5	37.4	1.7	(95.5)
Invoiced energy	1,060	1,208	1,218	0.88
- Invoiced consumption	637	771	745	(3.43)
- Un-invoiced consumption	422	436	474	8.51
- Household consumption	380	476	459	(3.60)
- Non-household consumption	257	295	286	(3.16)

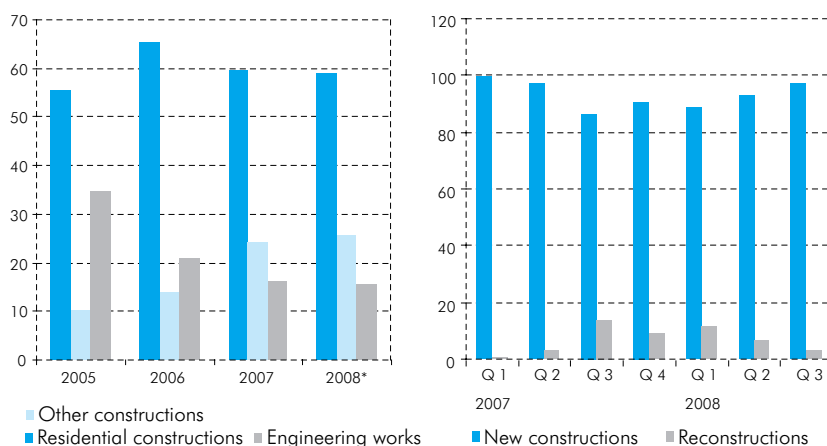
Source: KESH; \*) Bank of Albania estimations

**Box 1 Performance of construction and concerns related to its development**

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

Based on the data related to the number of construction permits approved<sup>18</sup>, construction for residential purposes has been sharing an ever-increasing weight (59 percent until the third quarter of 2008, compared to 55 percent in 2005). New constructions make up the highest share in the anticipated number of construction permits compared with reconstructions. Based on the anticipated number of construction permits<sup>19</sup>, in 2007 the private sector accounted for about 85 percent of construction activity, while in the first three quarters of 2008 it reached an average of 82 percent. With respect to the public sector, it has to a large extent concentrated on engineering works, which relates to the construction of roads and highways.

Chart 16 Types of constructions in Albania according to the anticipated number of construction permits (in percent)

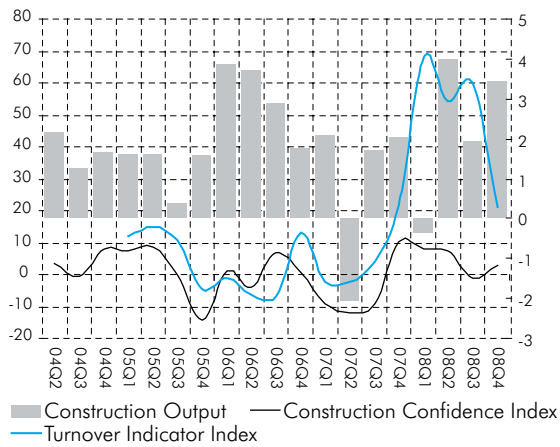


Source: INSTAT, Quarterly Statistical Bulletin

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

The positive performance and the sharp upward trend in the last quarter of 2007 and the first two quarters of 2008 slowed down in the last two quarters. Construction sector survey attests to this performance as well. According to construction firms' confidence survey, confidence in this sector has deteriorated due to the negative figures of the overall economic performance and the construction firms along with the downward output figures in construction. Construction firms' inventories increased

Chart 17 Construction Output, Turnover Indicator Index and the Confidence Index

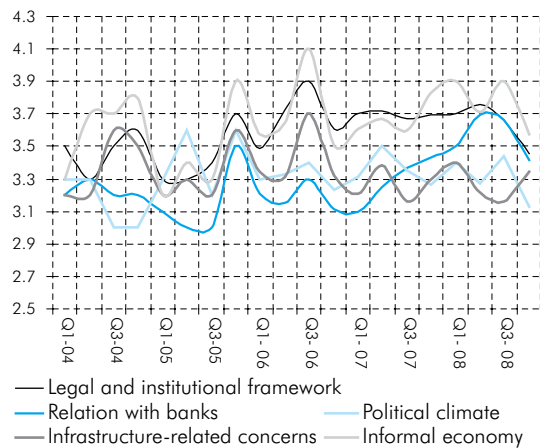


Source: INSTAT and Bank of Albania

in the last quarter of 2008, contributing to the slight fall of housing prices in Tirana over this period. House Price Index fell by 4.3 and 0.9 percent in the last two quarters of 2008.

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

Chart 18 Concerns\*) that have affected the normal activity of construction firms



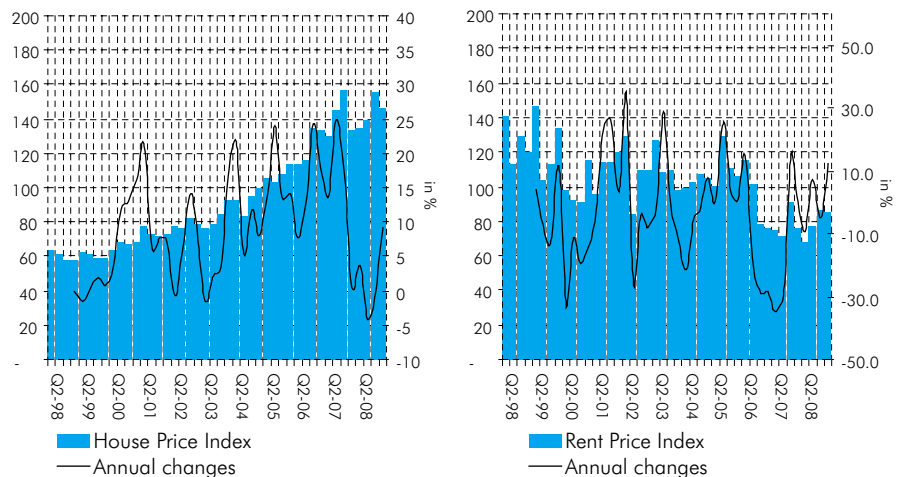
\*) The ranking of factors is 1 to 5, where 1 is the lowest important factor and 5 is the highest.

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

HOUSE PRICES<sup>21</sup>

Relative to the previous year, the House Price Index increased by 9.2 percent in the first quarter of 2009, while down by 5.7 percent compared to the previous quarter. The annual increase over this quarter marks a turning point in the downward trend of the House Price Index, which began in the last quarter of 2007. In the preceding two quarters, this index had fallen by 4.3 and 0.9 percent, respectively.

Chart 19 House Price Index and Rent Price Index



Source: Bank of Albania



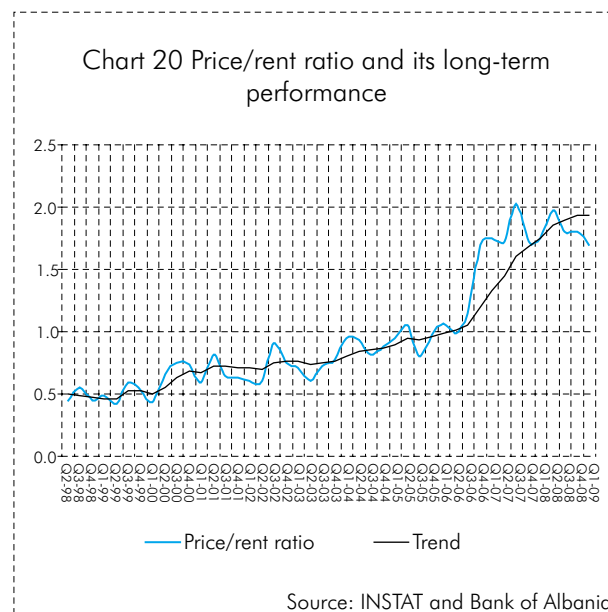
In annual terms, the House Rent Index increased by 12.3 percent in the first quarter of 2009, after having fallen by 4.9 percent in the last quarter of 2008. Relative to the previous quarter it decreased slightly by 0.4 percent. The price/rent ratio decreased further in the first quarter of 2009. The downward tendency of this indicator began in the third quarter of 2008.

#### 4.1.2 Developments in the external sector of the economy

##### FOREIGN TRADE

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

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



	January 2009	February 2009	January – February 2008	January – February 2009
Volume (in million euros)				
Exports	53.1	58.3	132.8	111.5
Imports	-223.0	-259.2	-520.2	-482.2
Trade balance	-169.9	-200.9	-387.4	-370.7
Change (in %)				
Exports		9.9		-16.1
Imports		16.3		-7.3
Trade balance (deficit)		18.3		-4.3

Source: INSTAT and Bank of Albania estimations

Table 6 Trade balance indicators for the 2008-2009 period

Trade with EU countries accounts for 68.3 percent of Albania's trade exchanges, up by 4.3 percentage points compared with the previous year. Despite the increasing share, the annual value of trade exchanges with Albania's main trading partners<sup>22</sup>, Italy and Greece, fell by 3 percent in January to February 2009. By contrast, trade exchanges with Great Britain and Germany<sup>23</sup> have increased. Albania's main non-EU trading partners by total trade volume include: Turkey, China, Ukraine, Macedonia and Russia<sup>24</sup>.

Excluding Russia and Macedonia, with which there has been a considerable annual decrease in terms of volume in trade exchanges<sup>25</sup>, trade with other countries has increased.

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

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

	Imports				Exports			
	February 2009	Monthly increase (in %)	January – February 2009	Annual change (in %)	February 2009	Monthly increase (in %)	January – February 2009	Annual change (in %)
Total	259.2	16.3	482.2	-7.3	58.3	9.9	111.5	-16.1
Food, beverages and tobacco	43.0	14.1	79.3	-14.2	4.4	-4.5	8.9	7.0
Minerals, fuels and energy	34.0	-8.7	69.5	-32.4	8.6	143.8	12.0	-15.0
Chemical and plastic products	29.8	26.3	52.4	10.3	0.7	-6.7	1.4	10.5
Leather and articles thereof	3.5	-0.4	6.9	-19.1	0.9	9.9	1.7	-38.1
Wood and paper products	8.7	-7.4	17.6	10.9	2.0	-3.6	4.0	-13.6
Textiles and footwear	23.0	6.4	43.5	-9.3	31.1	-6.0	62.6	-9.4
Construction materials and metal items	46.3	24.5	81.8	16.7	6.8	-3.5	13.5	-44.3
Machinery, appliances and spare parts	62.9	10.6	117.1	-0.4	2.7	6.8	5.2	-3.3
Miscellaneous	259.2	16.3	14.1	-18.8	1.0	-19.3	2.2	-27.5

Source: INSTAT and Bank of Albania estimations

#### 4.1.3 Fiscal indicators and fiscal policy

Unlike the previous three years, the first quarter of 2009 was characterized by the rapid increase of expenditure and budget deficit. In general, the maximum limit programmed for this period of time has been observed. Budget revenues and expenditure were estimated at ALL 72.3 and 76 billion, respectively, meeting the first quarter plan by 97 and 96 percent<sup>26</sup>.

Table 8 Main fiscal indicators according to the consolidated budget

	Actual level in billion of leks	Meeting of the plan (in %)	Annual change (in %)		
			Q1 2009	Q1 2007	Q1 2008
Revenue	72.3	96.8	6.7	14.9	13.7
1.1 Tax and customs	48.3	94.2	11.9	20.4	3.0
- VAT	24.4	91.8	25.8	22.0	1.8
- Tax on profit	5.5	94.9	(11.5)	12.9	(9.2)
- Excise duty	6.9	80.1	15.8	22.2	5.8
1.2 Local Government	3.0	64.3	(9.2)	(10.9)	24.3
1.3 Independent Budget	13.0	102.9	(3.1)	21.1	17.2
1.4 Non-tax revenue	7.7	153.2	(1.0)	(30.1)	147.0
1.5 Grants	0.2	23.0	(80.4)	173.3	462.6

Expenditure	76.0	95.8	14.7	8.5	43.2
2.1 Current expenditure	57.8	92.8	9.5	11.2	20.4
2.1.1 Personnel	14.1	109.2	1.1	16.7	(0.7)
2.1.2 Interests	8.4	99.5	(7.2)	16.6	21.5
2.1.3 Social insurance and pensions	21.0	92.5	14.2	8.9	26.2
2.1.4 Local Government expenditure	5.3	71.3	31.6	18.1	39.4
2.2 Capital expenditure	18.2	110.3	78.8	(11.8)	259.3
Fiscal balance	(3.7)	79.0	(30.5)	64.0	(135.6)
3.1 Domestic financing	2.9	78.8	(30.1)	65.0	(127.7)
3.2 Foreign financing	0.8	80.0	(147.4)	520.0	762.3

Source: Ministry of Finance and Bank of Albania estimations

### BUDGET REVENUES

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

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

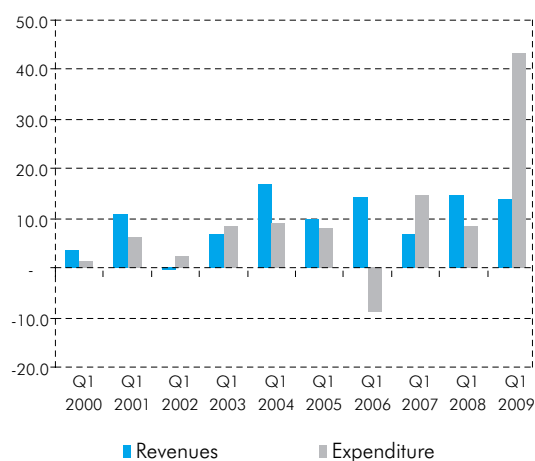
Revenues from tax on profit accumulated over the first quarter of 2009 recorded an annual negative change of 9 percent, although at a similar standard rate as the previous year (10 percent). The first quarter plan for this item was met at 95 percent.

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

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

The contribution of non-tax revenues to the annual increase of budget revenues was higher than the previous year. The 3-month plan for this item was exceeded by about 53 percent. The positive performance of this item owes partly to the restructuring of some budget items in early 2009<sup>27</sup>.

Chart 21 Annual change in budget revenues and expenditure, Q1 2000-Q1 2009



Source: Ministry of Finance and Bank of Albania estimations

### BUDGET EXPENDITURE

Budget expenditure amounted to around ALL 76 billion over the first quarter of 2009, 24 percent of which is shared by capital expenditure. This ratio represents the highest share of capital expenditure to total expenditure for the first quarter of the present year<sup>28</sup>. Capital expenditure is about 2.6 times higher than the same quarter the previous year. They were mainly domestically financed (90 percent). Expenditure on the Durrës-Kukës road accounts for about 44 percent of total capital expenditure carried out over this period.

In annual terms, total expenditure increased by about 43 percent in the first quarter of 2009, the highest annual increase in the last decade. Expenditure on social insurance, capital expenditure and personnel expenditure<sup>29</sup> provided the highest contribution to the increase of expenditure by 12, 10 and 8 percentage points, respectively.

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

### BUDGET DEFICIT

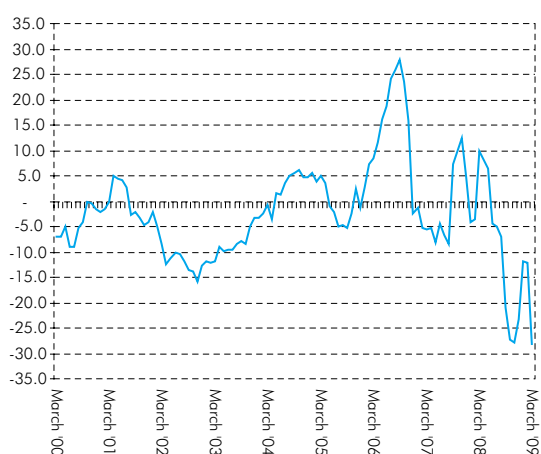
In contrast to the previous three years, the budget balance for the first quarter of 2009 recorded a negative value of ALL 3.7 billion from the planned ALL 4.7 billion. 80 percent of the budget deficit was financed through domestic financing. The main financing resource were the receipts from ARMO's privatization<sup>30</sup>.

Table 9 Budget deficit financing: Q1 2005 – Q1 2009

	Q1 2005	Q1 2006	Q1 2007	Q1 2008	Q1 2009
Budget balance	(1.4)	9.2	6.4	10.5	(3.7)
Domestic financing	(0.3)	(9.2)	(6.4)	(10.6)	2.9
- Privatization receipts	0.4	0.0	0.0	0.1	9.8
- Domestic borrowing	4.6	(0.8)	2.8	5.5	(3.1)
Foreign financing	1.7	(0.0)	0.0	0.1	0.8

Source: Ministry of Finance

Chart 22 Moving sum of primary deficit for the preceding 12 months, March 2000-March 2009<sup>31</sup>



Source: Ministry of Finance, Bank of Albania estimations

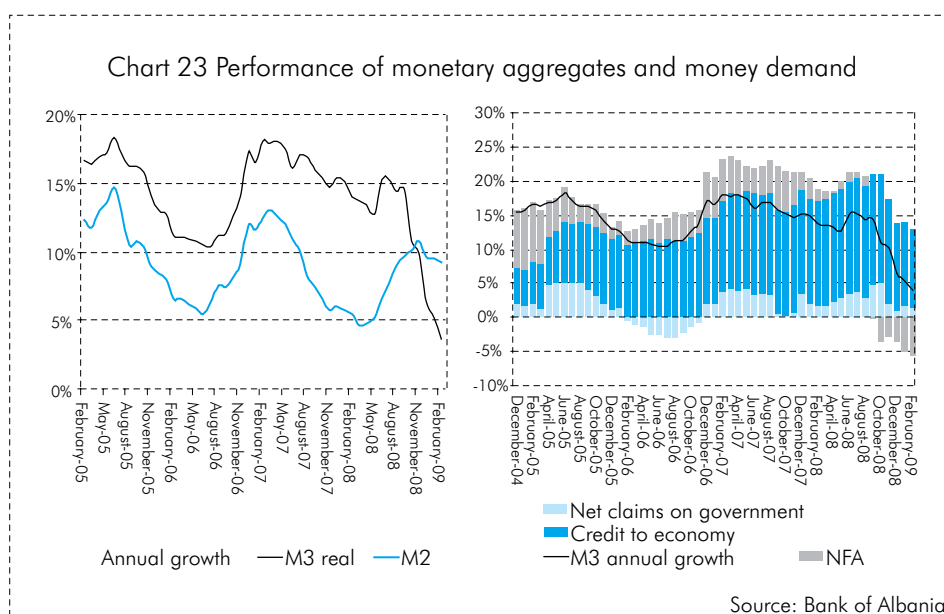
The Government's borrowing policy has aimed at increasing the amount of debt both for short and long-term instruments. The liquidity shortages in the Government securities' market (reflected in the low demand of market participants for this type of instruments) brought about the reduction of the Government's domestic debt stock and the increase in yields. Relative to year-end 2008, this stock reduced by about ALL 3.1 billion in the first quarter of 2009. In order to encourage the functioning of the financial markets and abate the pressures on the interest rates in the primary market, in March 2009 the Bank of Albania extended direct loans to the Albanian Government.

The primary deficit did not maintain a stable trend over the course of the first quarter of 2009, showing signs of deterioration solely in March 2009. Considering the effect that other macroeconomic variables (real interest rate on debt and economic growth) may have on public debt stock as unchanged from the year-end 2008, the primary deficit performance attests to the increase of the public debt stock only during March (mainly of foreign borrowing and long-term domestic borrowing).

#### 4.1.4 Monetary developments<sup>32</sup>

Over the course of the first quarter of 2009, monetary conditions indicators<sup>33</sup> improved considerably, while demand for money contracted owing to the slowdown in lending. The tightening of lending standards and terms from commercial banks triggered the fall of supply and demand for loans from the economic agents. These developments led to sluggish money supply growth rates compared with September 2008.

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

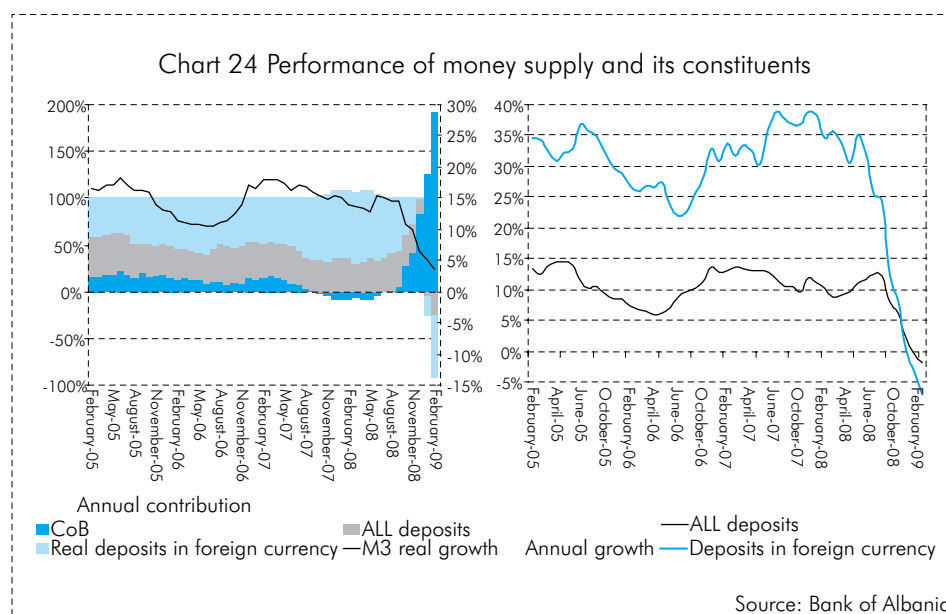


The monetary developments have been characterized by the tendency of shifting towards more liquid components, which in turn led to further growth of money base. The rapid growth of currency outside banks and the slower money growth rates exerted pressure over the contraction of the money multiplier to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

## DEVELOPMENTS IN MONETARY AGGREGATES

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

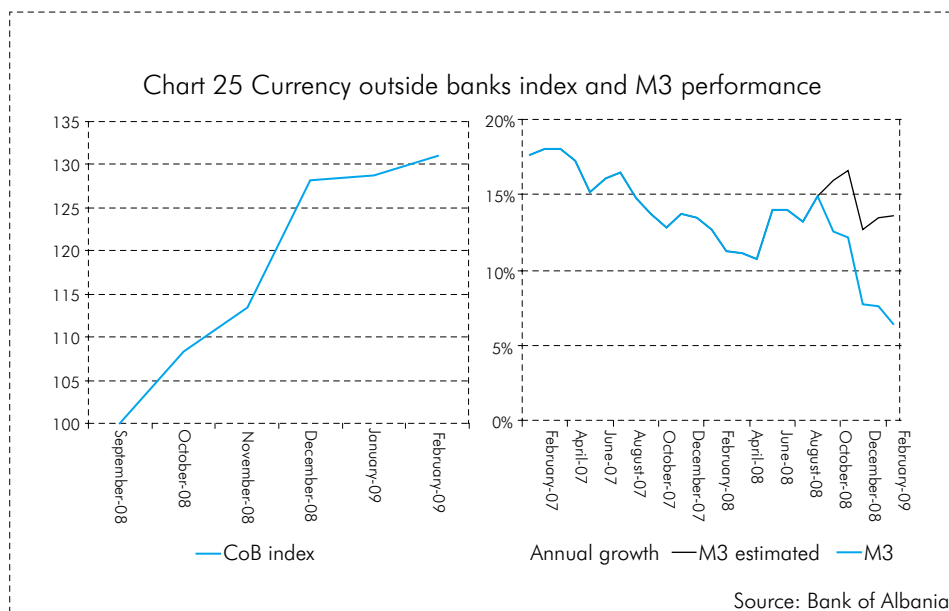
The creation of monetary flows on the deposits' side has been declining. In January and February, total deposits excluding the exchange rate effects reduced by an average of 3 percent in annual terms. However, the effects of the annual decline owe primarily to the last quarter's performance since the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



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

The uncertainty reigning on global financial systems was reflected in the withdrawal of a part of deposits from the system in the last quarter of 2008. The withdrawal of deposits was higher for foreign currency-denominated deposits than for ALL-denominated ones. Accordingly, currency outside banks in the Albanian Lek grew rapidly contributing markedly to the growth

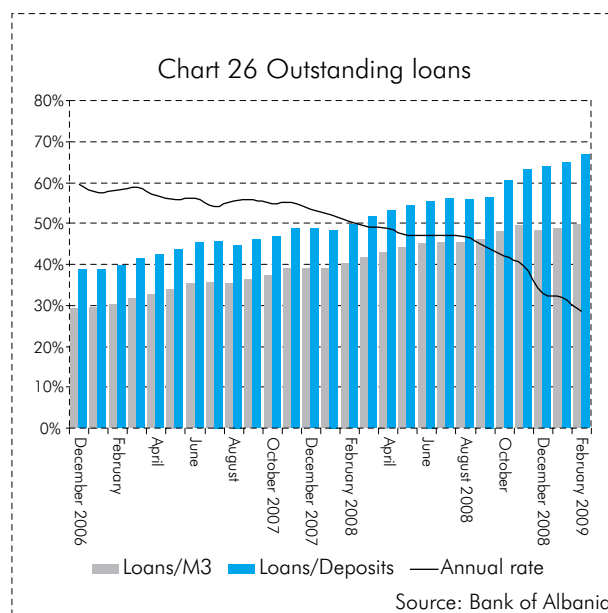
of monetary aggregates. Currency outside banks in foreign currency is not measured by the official data nor it is included in broad money. The change in this indicator can be measured through a proxy of the cumulative amount of foreign currency-denominated deposits out-flown by the banking system each month.



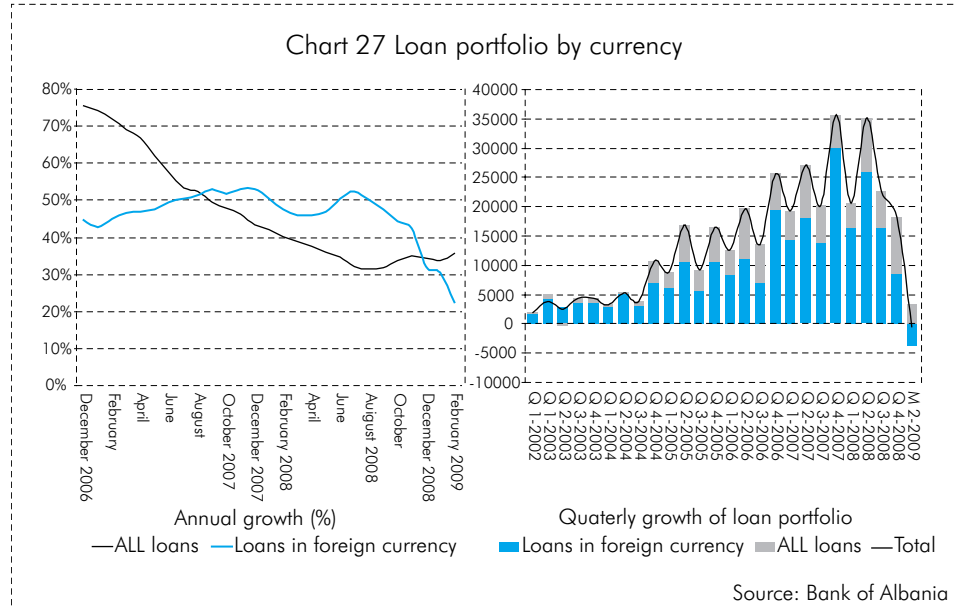
The inclusion of this indicator in the measurement of broad money results in the further growth of M3 aggregate compared with its growth rates when only currency outside banks in the Albanian Lek is included in it. The composition of M3 monetary aggregate suggests for the further shift of broad money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

**CREDIT TO THE PRIVATE SECTOR**

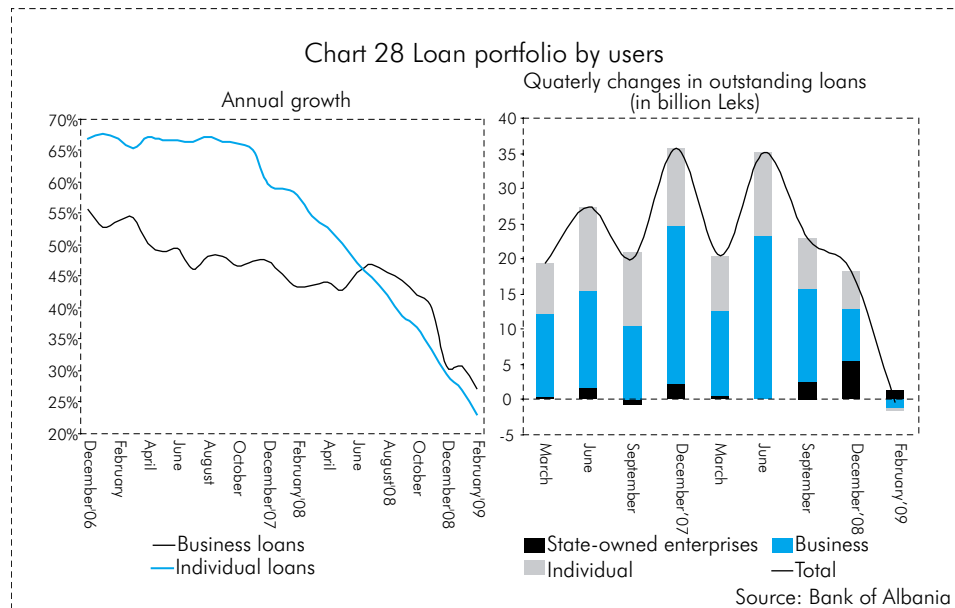
Lending growth rates have reduced substantially in the recent months. In February, the annual growth rate of the loan portfolio slowed down further to 28.5 percent compared with 44.2 percent in September 2008. Notwithstanding the positive effects on the external balance, this performance can negatively impact the economic development by affecting consumption and private investment. The performance of business loans plays a major role in this context. The contraction in lending to business investment projects exerts negative pressures on the economic growth rates. Moreover, the contraction in lending to households curbs consumption and wealth, which in turn exerts pressures on the further weakening of economic growth rates.



The latest developments in the loan portfolio attest to its reduction in quarterly terms by around ALL 0.3 billion. The moderate contraction in outstanding loans owes to the increase of lending to state-owned enterprises by around ALL 1.2 billion and the contraction in outstanding loans to the private sector in January and February the present year. Lending to state-owned enterprises was mainly in the Albanian Lek and of short maturity term.

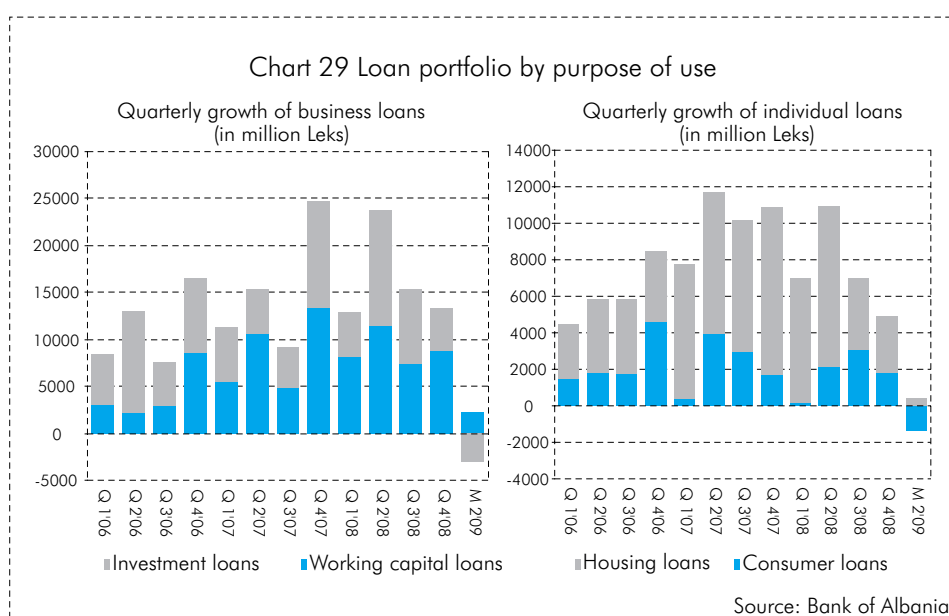


The performance of loans by currency attests to banks' inclination to shift the loan portfolio to the Albanian Lek. The preservation of lek-denominated loans growth rates by 36 percent compared with the constant decline in the growth rates of foreign currency-denominated loans (to 23 percent) shifted the portfolio to ALL loans. As of end February, ALL loans accounted for 29 percent relative to 27 percent it accounted for in September 2008.





The growth rates of business loans recorded a pronounced slowdown to 27 percent over the course of the first quarter. This performance reflects the slumping growth rates of working capital loans and the marked contraction in investment loans. The quarterly net change in investment loans shows a moderate decline attesting to the lower support to long-term projects from the banking system and to the weaker business demand for this type of loan. In light of the vague macroeconomic situation and the implications of the global financial crisis for the Albanian economy, a number of businesses have been reluctant to engage in investment undertakings. The bank lending survey for the first quarter of 2009 shows that banks have applied tighter standards on business loans as well. This approach has been triggered by the future economic uncertainties, the deteriorated conditions in individual economic sectors and the increase of non-performing loans.



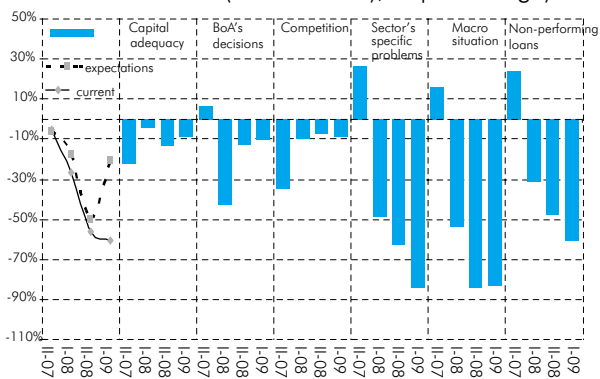
The homogeneous slowdown in the growth rate of household loans persisted in the first quarter of 2009. The uncertainties over the source of household income, be it from the labour market or from other alternative sources, have made banks more conservative for this group of users. Consequently, the share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

### Box 2 Results of the lending activity survey in the first quarter of 2009

The results of the lending activity survey conducted in April 2009 identifies the changes in lending activity over the first quarter of the present year compared with the previous quarter and the expectations for possible changes in lending in the second quarter of 2009 as opposed to the current<sup>34</sup>. The results obtained from this survey show that banks maintained the trend commenced in the second half of 2008, tightening the lending terms and standards further in the first quarter of 2009. In contrast to the previous survey, the tightening of lending standards has been sharper for enterprises than for individuals (net balance-net percentage of banks reporting looser lending standards is -66 percent for enterprises and -44 percent for individuals).

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

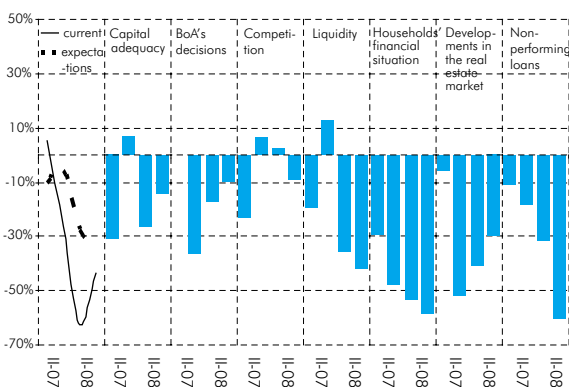
Chart 30 Changes in the lending standards applied on business loans and the impact of different factors (net balance<sup>1</sup>), in percentage



Source: Bank of Albania

Note 1. The positive balance indicates the alleviation of lending standards or that the factor has led to less tight lending standards. The negative balance indicates the tightening of lending standards or that the factor has led to tighter lending standards.

Chart 31 Changes in the lending standards applied on individual loans for residential and consumption purposes and the impact of different factors (net balance\*), in percentage



Source: Bank of Albania

\*) See Note 1.

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

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

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

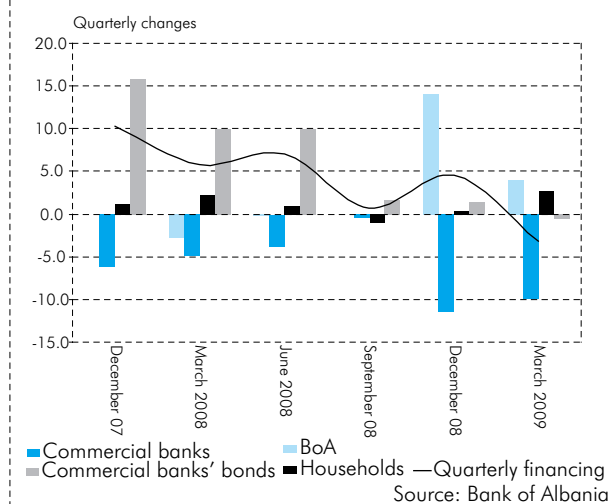
**Individual loans.** The data obtained from the banks' survey show less tightening of lending standards for individuals in the first quarter of 2009 compared with the second half of 2008 (the balance increased to -44 percent from -61 percent in the previous survey). Banks listed the households' financial situation and the situation in the real estate market as the main factors to have led to tight lending standards over the first quarter of 2009.

Banks report a negative net demand of individuals for loans in the first quarter, reflecting mainly the developments in the real estate market. Banks anticipate the lending standards for households to slightly alleviate in the second quarter of 2009 (the balance of expectations is about 10 percentage points higher than the current balance).

### FISCAL SECTOR FINANCING

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

Chart 32 Quarterly changes in the securities' portfolio and the Government financing

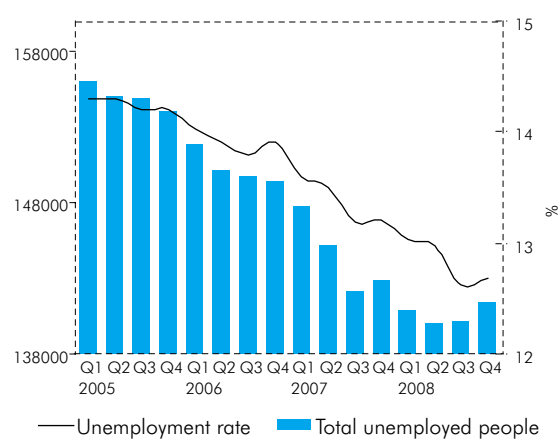


## 4.2 LABOUR MARKET AND WAGES

### 4.2.1 Labour market

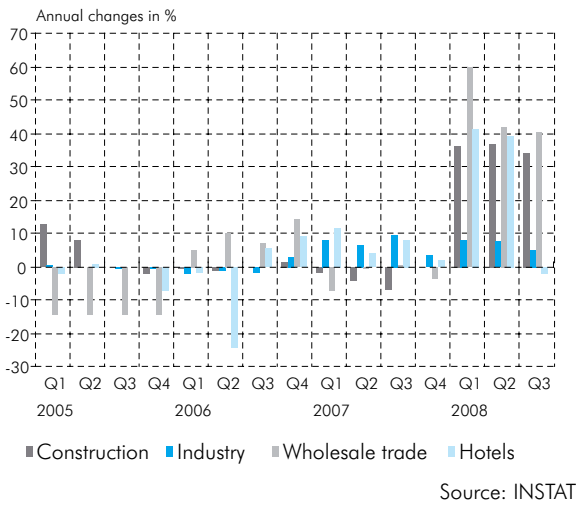
The labour market in the last quarter of 2008 recorded an increase in the labour forces, in the average number of employed people and an increase in the average number of unemployed people. Labour force totalled 1,115,562 persons, up by 5,594 persons compared with the previous quarter. In quarterly terms,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

Chart 33 Total number of unemployed people (left-hand) and unemployment rate (right-hand)



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

Chart 34 Number of employed people in some of the main economic activities



quarter. Unemployment rate reached 12.68 percent in the last quarter of 2008 compared with 12.62 percent in the previous quarter.

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

#### 4.2.2 Performance of wages

The latest data on the performance of wages in economy in the last quarter of 2008 attest to the increase of average monthly wage in the public

Chart 35 Average monthly wage in the public sector and in production and services

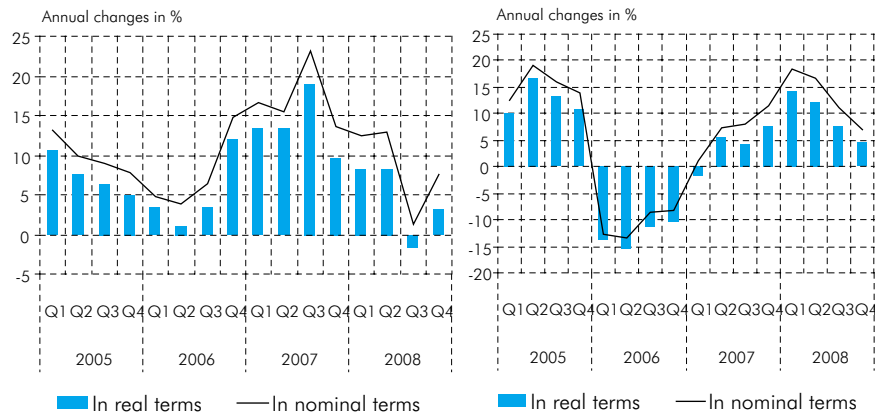
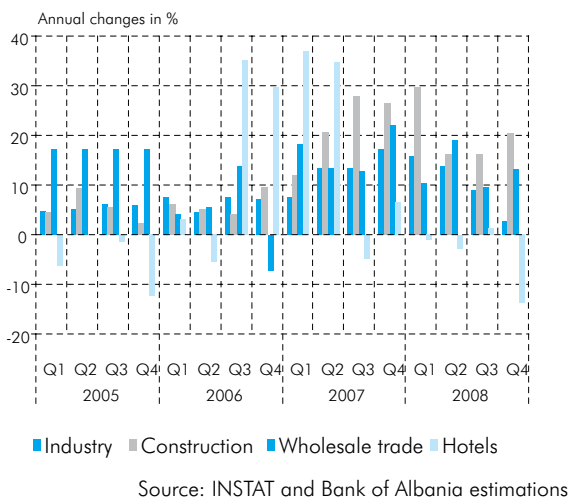


Chart 36 Average wage in some economic activities



sector<sup>35</sup> in nominal terms by about 7.5 and 6.1 percent in annual and quarterly terms. In nominal terms, average wage<sup>36</sup> in economic enterprises reduced the growth rates over the last quarter of 2008 to 7.1 percent compared with the highest annual growth by 18.4 percent in the first quarter. In the production sector, average wage in annual terms rose by about 20.3 percent in construction and 2.7 percent in industry. In the services sector, its average annual rise recorded high rates for the retail and wholesale trade by 28.6 and 13.2 percent, respectively.

Base minimal monthly wage stood at ALL 17,000 in the last quarter of 2008, up by 21 percent in

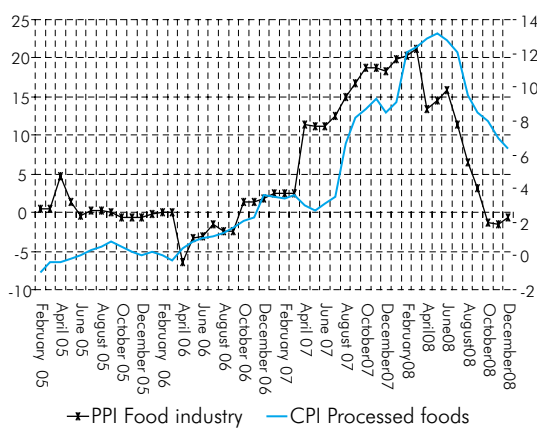
annual terms. As of end 2008, monthly unemployment benefit payment was ALL 5,980, up by 14 percent in annual terms.

#### 4.3 PRODUCER AND IMPORT PRICES

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

'Processing industry', which has the main share in the PPI, recorded an annual increase of 1.8 percent<sup>37</sup>. The increase in this index at more moderate rates attributes to 'food industry' and 'food and beverages industry', the two sub-items sharing the main weight in 'processing industry'. Their indices manifested a downward tendency in annual terms, attesting to the market correction following the high primary commodity prices in the second and third quarter of 2008. Producer prices in these industries seem to have provided their impact on 'processed foods' in the CPI basket as well. The latter showed lower increasing rates over the same period. Producer prices in 'extracting industry' continued to maintain upward rates over this quarter. Despite the low share to total basket components, its annual increase by an average of 9.2 percent contributed by 0.9 percent to headline PPI inflation.

Chart 37 Annual change in the indices of goods included in the PPI (right-hand axis) and the CPI (left-hand axis)



Source: INSTAT and Bank of Albania estimations

Table 10 Annual change rate of some PPI and CPI components of 'processed foods' (in percent)

	PPI	PPI Total processing industry	PPI Food processing industry	CPI- Processed foods	PPI Extracting industry
Q3:06/Q3:05	0.4	1.2	-2.1	1.1	8.4
Q4:06/Q4:05	-0.7	1.5	1.4	2.4	8.3
Q1:07/Q1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/Q2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/Q3:06	3.6	6.3	14.7	7.3	4.7
Q4:07/Q4:06	7.5	10.2	18.6	10.8	4.5
Q1:08/Q1:07	7.4	6.8	20.5	11.2	5.6
Q2:08/Q2:07	7.4	6.9	14.6	12.9	2.9
Q3:08/Q3:07	7.1	6.1	7.0	10.0	9.7
Q4:08/Q4:07	4.2	1.8	-1.1	7.1	9.2

Source: INSTAT and Bank of Albania estimations

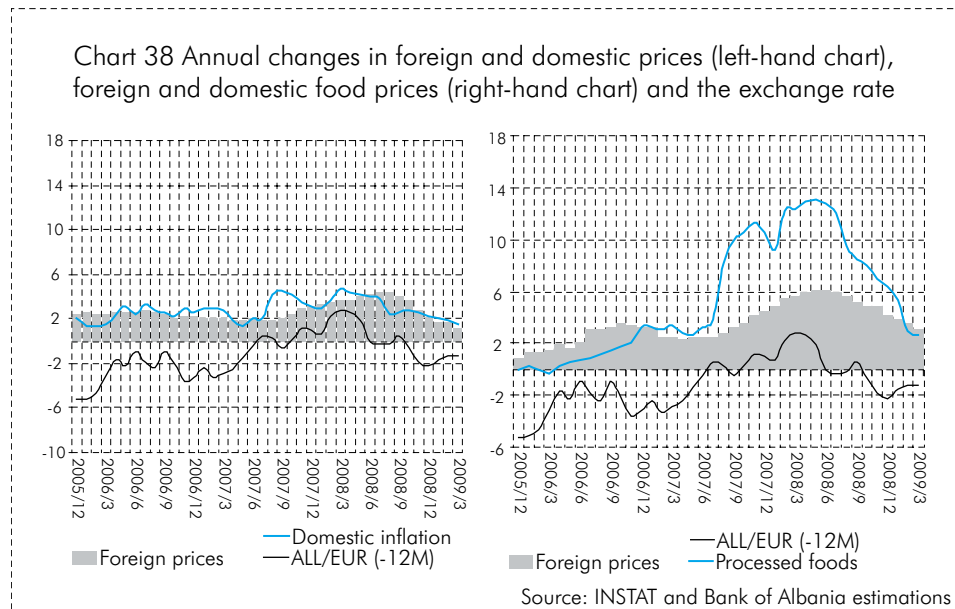
#### IMPORT PRICES

Imported inflation marked low growth rates in the first quarter of 2009 maintaining its performance of the last quarter of 2008. Annual imported

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

Foreign prices<sup>38</sup> were highly volatile throughout the year 2008 recording rates from 2.1 to 4.3 percent. In annual terms, they increased by an average of 3.6 percent in 2008, exceeding their historical average by 1 percentage point. The annual change in the foreign price index in the first quarter of 2009 was 1.5 percent, the lowest in the last nine years. The fall in primary commodity prices (food and oil)<sup>39</sup> and the economic growth downturn in Italy and Greece triggered the fall in consumer prices. Inflation in Albania manifested the same performance, attesting to the impact of foreign prices in the price formation process at home.

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

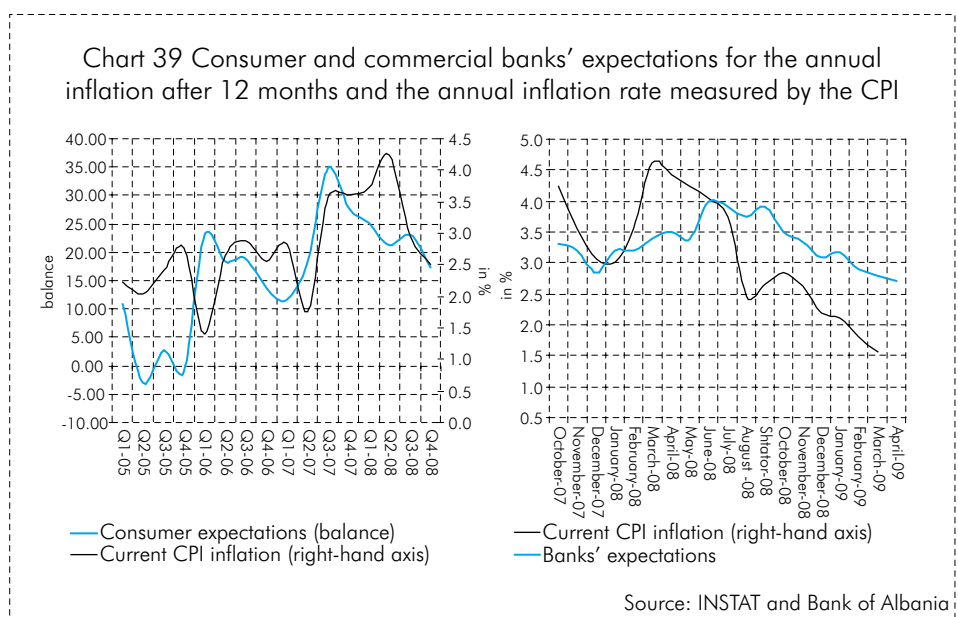


The inflationary pressures exerted by the imported inflation have been receding over the first quarter of 2009. The non-inflationary influence of this factor is believed to persist in the short-term, being mainly triggered by the fall in foreign prices. However, the depreciation of the Lek exchange rate vis-à-vis

its major currency counterparts<sup>40</sup> poses risks to this scenario. Empirical studies<sup>41</sup> attest to the asymmetry of the exchange rate pass-through to consumer prices. The extent of the pass-through is greater and the lag is shorter in the case of the Lek depreciation than in the opposite case. The depreciation of the Lek translates into higher import prices, exerting upward pressures on the overall level of prices in Albania.

#### 4.4 EXPECTATIONS FOR THE PERFORMANCE OF PRICES IN ECONOMY

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



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

According to banks' survey of March 2009, annual inflation after 12 months is anticipated to mark 2.7 percent, following a downward trend since October last year.

## 5. FINANCIAL MARKET, INTEREST RATES AND THE EXCHANGE RATE

### 5.1 INTEREST RATES

#### *THE INTER-BANK MARKET*

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

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

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

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



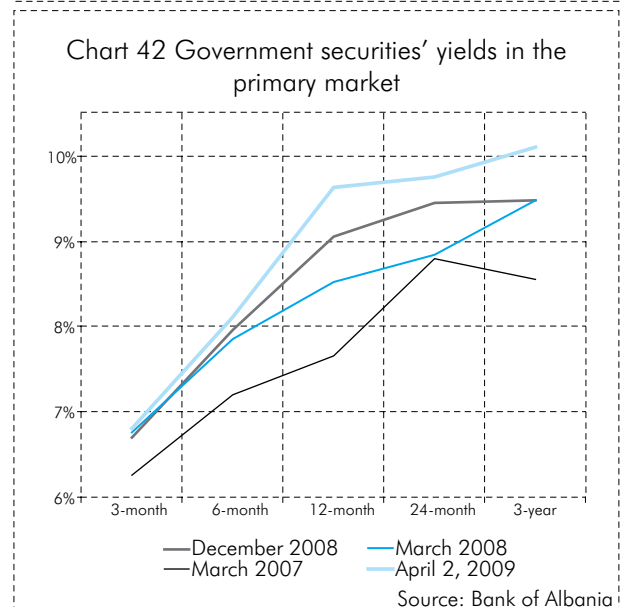
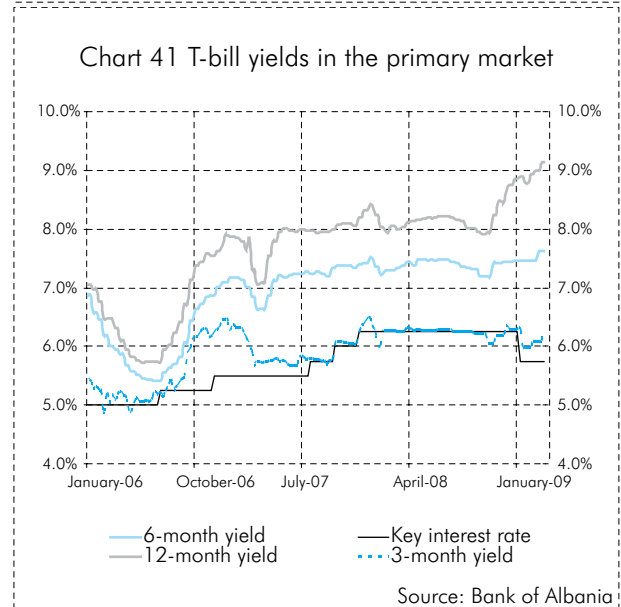
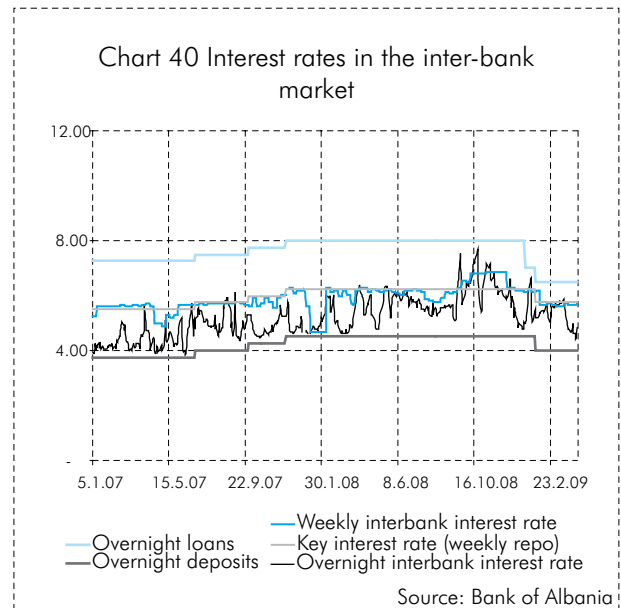
THE PRIMARY MARKET

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

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

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

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



early April. Their yield was 9.61 percent, up by 0.63 percentage points from the previous year.

Table 11 Interest rates on public debt instruments

Average yield rate	T-bills			Bonds	
	3-month	6-month	12-month	2-year	5-year
2007	5.92	7.17	7.87	8.30	9.80
2008	6.24	7.38	8.14	8.40	9.25
December 2008	6.19	7.45	8.56	8.95	9.75
January 2009	6.31	7.46	8.84	9.30	
February 2009	5.99	7.46	8.87	9.15	10.42 <sup>44</sup>
March 2009	6.08	7.61	9.07	9.25	

Source: Bank of Albania

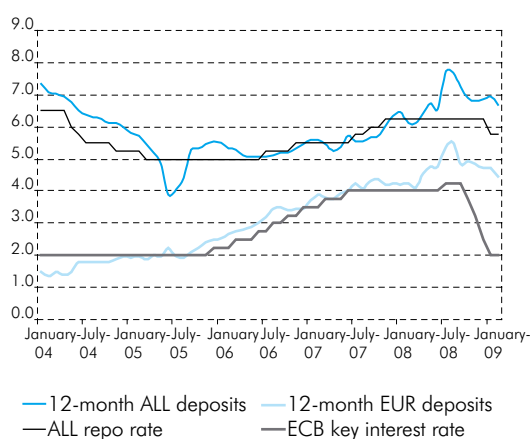
### INTEREST RATES ON DEPOSITS AND LOANS

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

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

The interest rates on Euro-denominated time deposits fell considerably in January and February the present year due to the cut of the ECB's key interest rate twice in December 2008 (-0.75 percent) and January 2009 (-0.50 percent).

Chart 43 Interest rates on 12-month deposits and the key interest rates



Source: Bank of Albania

The cut by 1.25 percentage points was not reflected equally in the interest rates on Euro-denominated deposits. In February, weighted average interest rate marked 2.56 percent from 2.92 percent in January, down by 0.58 percentage points from December 2008. In terms of maturity, the interest rates on 12-month deposits marked 4.47 percent in February, down by 0.24 percentage points from January the present year. The interest rates on 3-month deposits dropped by 0.84 percentage points in February, returning to the previous levels prior to the year-end promotional offers.

In February 2009, weighted average interest rate on ALL-denominated loans increased slightly -returning to the December level-, owing to the increase in the interest rate on long-term real estate

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

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

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

## 5.2 EXCHANGE RATE PERFORMANCE

The first quarter of 2009 reflected a persistent downward trend of the Lek vis-à-vis its major currency counterparts, shown since October 2008. The average change in the nominal effective exchange rate for this quarter is -4.14 percent compared with the last quarter of 2008

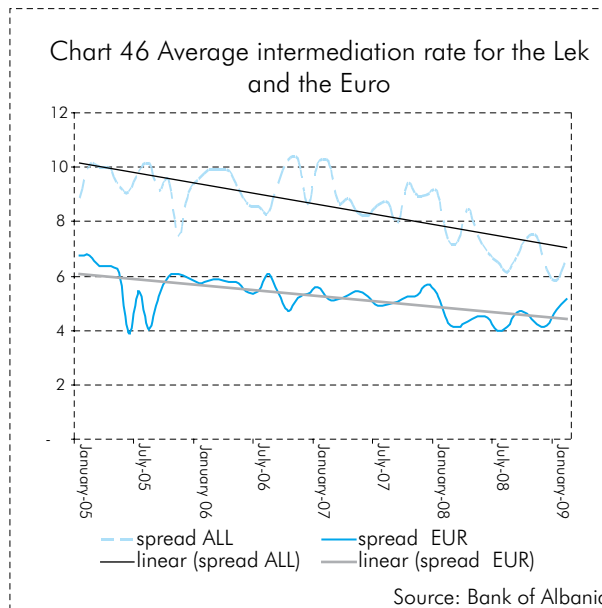
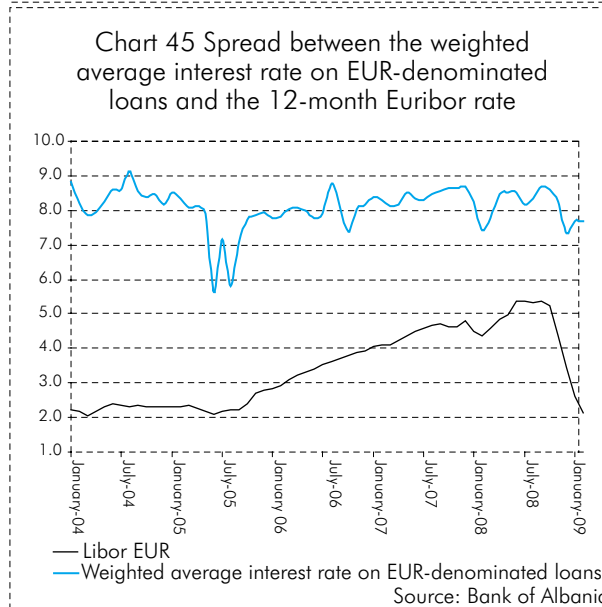
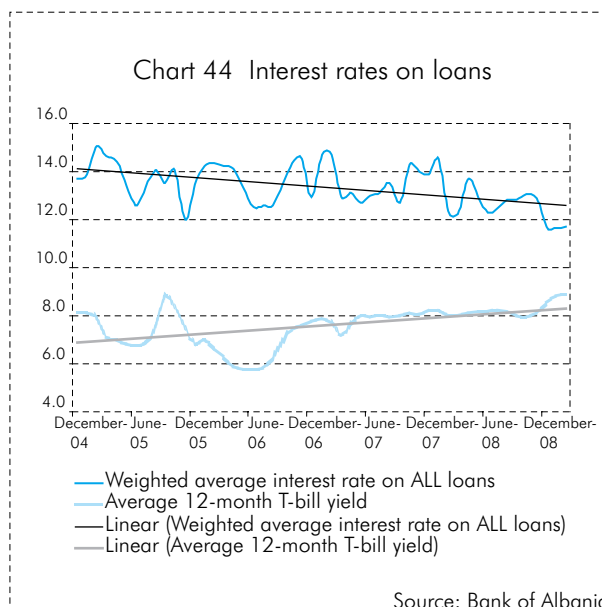
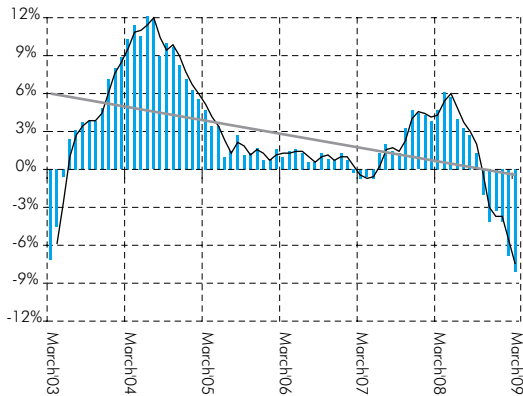
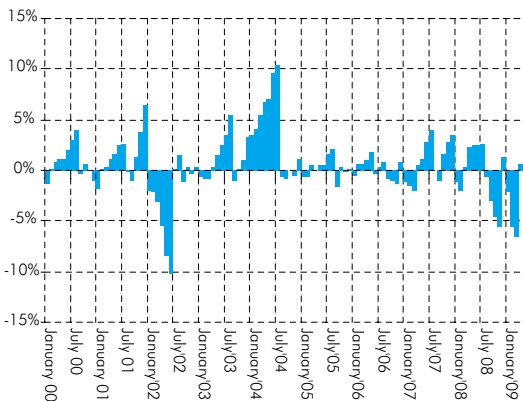


Chart 47 Annual changes of the Lek in NEER terms and their moving average



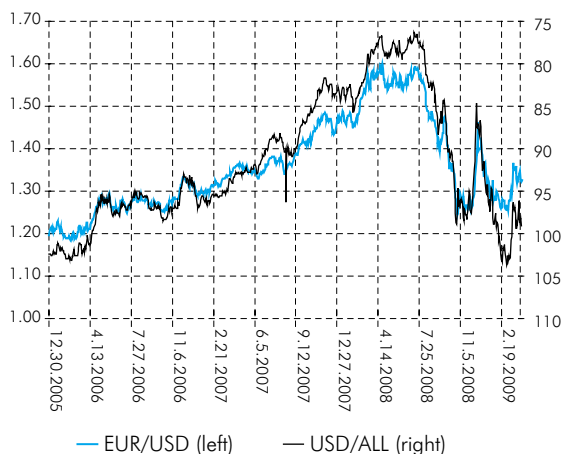
Source: Bank of Albania

Chart 48 Duration and extent of the NEER change - (monthly rates)



Source: Bank of Albania

Chart 49 Daily performance of EUR/USD and USD/ALL



Source: Bank of Albania

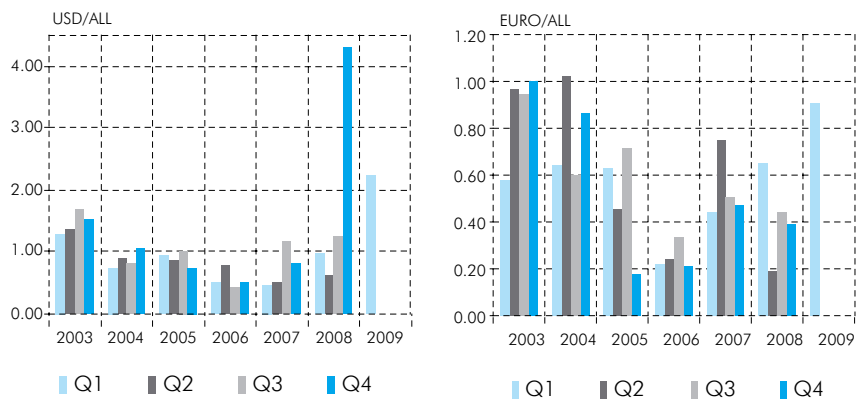
and -6.14 percent relative to the same period the previous year. Worth noting is that the contraction of foreign currency supply over the last months of 2008 as a result of lower workers' remittances and exports was followed in the early months of 2009 by the decrease in imports and trade deficit narrowing in annual terms. Although in monthly terms this indicator increased in February, it was moderate and did not maintain the same rates as in the previous years, which may have supported the exchange rate performance. In addition, the widening of the interest rate spread following the ECB's key interest rate cut by a total of 1.25 percent may generate the balancing of the demand and supply in the months to follow.

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

The performance of the Lek in the Albanian foreign exchange market during the first quarter of 2009 reflected the same depreciating behaviour vis-à-vis the U.S. dollar and the Euro. In quarterly and annual terms, the Lek depreciated vis-à-vis the U.S. dollar by 5.49 and 19.43 percent, respectively; the depreciation vis-à-vis the Euro was somehow more moderate to 4.0 and 3 percent, respectively.

The performance of the Lek vis-à-vis the U.S. dollar has mainly reflected the performance of the latter in the international markets. In January, the U.S. dollar lost ground vis-à-vis the Euro to later regain it in February. However, it could not halt a second depreciation in March. Worth to note however is that during the first quarter, the U.S. dollar reached the highest quotations in the recent years. Although at high levels, the USD/ALL volatility in Albania has been lower than the preceding quarter, reflecting the dynamics of this ratio in the international markets.

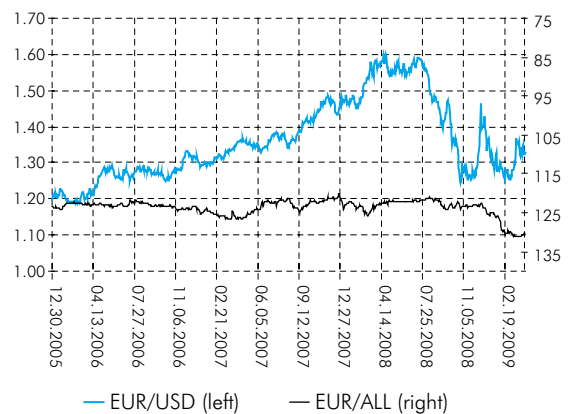
Chart 50 Lek exchange rate volatility<sup>45</sup> in quarters



Source: Bank of Albania

With respect to the performance of the Euro in the domestic market for the first quarter of 2009, the seasonal demand for foreign currency confronted with a more contracted supply owing to the poorer performance of workers' remittances and exports. Worth noting also is the psychological effect related to the exchange rate performance, which is the rationale behind the risk reflected in the market quotations and the high volatility of this ratio compared with the last quarter of 2008 and the same period the previous year. However, the performance of the Lek to the Euro was more stable near the end of the period.

Chart 51 Daily performance of EUR/USD and USD/ALL



Source: Bank of Albania

## ENDNOTES

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

<sup>2</sup> In February, manufacturing industry declined by 11.2 percent in annual terms.

<sup>3</sup> Annual inflation in Turkey for the year 2008 was 10.4 percent.

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

<sup>5</sup> In February, U.S. demand grew by 2.2 percent in monthly terms.

<sup>6</sup> Moving average of the last 12 months.

<sup>7</sup> Monetary Policy Document for the 2009-2011 Period, Bank of Albania.

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

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

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

<sup>11</sup> 1.1 percentage points lower than in the same period the previous year.

<sup>12</sup> For the first three months, it marked 1.8, 1.7 and 1.7 percent, respectively.

<sup>13</sup> Hereinafter referred to as traded inflation and non-traded inflation.

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

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

<sup>16</sup> Starting from the third quarter of 2008.

<sup>17</sup> INSTAT, *Conjuncture, Main Economic Indicators*, October-December 2008.

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

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

<sup>20</sup> For more information, refer to the quarterly results of the construction firms' confidence survey.

<sup>21</sup> House Price Index is measured only for Tirana.

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

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

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

<sup>25</sup> Trade exchanges with Russia and Macedonia have decreased by 62.2 and 20.9 percent.

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

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

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

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

<sup>30</sup> Although Armo's privatization receipts entered the budget at end 2008, they became active in the budget deficit financing for the year 2009.

<sup>31</sup> Primary deficit has been corrected for privatizations and grant revenues.

<sup>32</sup> Monetary data released by the Statistics Department at the Bank of Albania and in particular the data on the loan portfolio are strongly affected by exchange rate movements. Given the marked devaluation of the Albanian Lek in the first months of 2009, the official data are appreciated. Therefore, the monetary data analysis in this section of the Report refers to the data series which excludes the change effects in the Albanian Lek exchange rate vis-à-vis the Euro and the U.S. dollar.

<sup>33</sup> Key interest rate and the exchange rate performance.

<sup>34</sup> From the year 2002 to the second half of 2008, the Bank Lending Survey has been conducted every six months. Starting from Q1 2009, this survey will be conducted on a quarterly basis.

<sup>35</sup> Budget and non-budget (INSTAT, Conjunction, Main economic indicators, October-December 2008).

<sup>36</sup> Average wage is measured as the percentage of wages fund to the number of employed people – INSTAT's methodology.

<sup>37</sup> In annual terms, this index increased by 6.9 and 6.1 percent in the second and third quarter of 2008.

<sup>38</sup> Measured as the weighted average of consumer prices in Greece and Italy, Albania's main trading partners.

<sup>39</sup> In March 2009, primary commodity prices as published by the IMF fell by 45 percent in annual terms.

<sup>40</sup> In Q1 2009, the Lek depreciated vis-à-vis the Euro and the U.S. dollar by 3.7 and 19.4 percent, in annual terms.

<sup>41</sup> Marga Peeters (2005) "What about Monetary Transmission in Albania? Is the Exchange Rate Pass-through (still) the Main Channel?"

Gramoz Kolasi, Evelina Çeliku and Genti Hashorva, December 2001, "Inflation Trend in Albania during the Previous Decade: An Empirical Outlook", Economic Bulletin, pg. 36-47, Bank of Albania.

<sup>42</sup> Inflation expectations at the Bank of Albania are measured through the information obtained from confidence surveys and banks' survey.

<sup>43</sup> Consumer inflation expectations for inflation are quantified (qualitative information is transformed into quantitative form) based on the quantitative probability method.

<sup>44</sup> In this auction were issued only bonds of variable yield. The accepted spread was lower than the previous, however the reference interest rate – 12-month yield – increased over this period. 5-year variable yield in the preceding auction was 10.17 percent.

<sup>45</sup> Measured as the quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.

