Bank of Albania

MONETARY POLICY REPORT FOR THE FIRST QUARTER OF 2010

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INTRODUCTION

The main objective of the Bank of Albania is to achieve and maintain price stability. Promoting long-term investments, maintaining the purchasing power of money, increasing efficiency of funds allocation in the economy and supporting financial stability are some of the benefits of an economic environment featured by price stability. It is the greatest contribution central banks can make, in order to support a sustainable and long-term economic growth.

In line with its 2009-2011 strategy, the Bank of Albania is committed to achieving and maintaining annual inflation at 3.0%, with a tolerance band of + / - 1 percentage point. Announcement of the quantitative target for inflation aims at anchoring expectations of economic agents and reducing risk premium.

To attain this goal and to strengthen its transparency, the Bank of Albania compiles and publishes the Monetary Policy Report. This report is the main instrument of monetary policy communication with the public. It gives an accurate picture of recent macroeconomic developments and the factors that have affected and are expected to affect the country's consumer price performance.

Monetary Policy Report for the first quarter of 2010 was adopted on 28 April 2010 by the Supervisory Council of the Bank of Albania. The economic analysis in the report is based on the latest available statistical and qualitative data as at 20 April 2010.

I. FOREWORD BY THE GOVERNOR

Economic developments during the first quarter of 2010 were in line with those of the previous quarter. Although available data are scarce, our analyses conclude that the country's economic activity has been relatively slow. It was influenced by low level of private investments, uniform paces in consumer spending and mitigated fiscal stimulus effect. Albanian exports recorded a rapid growth during the first quarter of the year, influenced by ongoing improvement of the global economy. However, due to the relatively low share in GDP, their impact on economic growth is small.

Financial markets and monetary indicators experienced encouraging developments over this period. Bank of Albania's prudent monetary policy has led to easing inflationary expectations and a more balanced performance of external sector of the economy. The latest basic policy rate cut is already fully reflected in interbank market interest rates and in government securities. To some extent, it is also transmitted to lek-denominated deposit and loan interest rates. Ongoing liquidity injection has also helped alleviate the risk premium, supporting and implementing the loose monetary policy of the Bank of Albania.

The overall macroeconomic environment and monetary conditions did not favour the creation of steady inflationary pressures during this period. The relatively high consumer price inflation – above 4% during the first two months of the year - is triggered by administered price rise, higher prices in the world markets and lag of exchange rate pass-through. The Bank of Albania expects that the effect of these factors will be of a low-intensity and for a short period of time. Attesting to these expectations, inflation turned back below 4% in March and it is expected to remain within the Bank of Albania's target over the medium run.

I would like to dwell upon economic developments and the results of our analyses, supporting the conclusions I mentioned at the introduction of my speech.

The world economy continued to show signs of improvement during the first quarter of 2010. Hence, the economic activity, trade activity and capital flows are upward. Low capacity utilization has generated low but obviously upward inflationary pressures, due to demand recovery. Central banks have continued to pursue a loose monetary policy, while there has already started the work for withdrawing from unconventional policies undertaken at the onset of and during the global recession.

Financial markets have been characterized by falling interest rates, low risk levels and increased trade. However, expectations for a low lending activity for 2010, against the backdrop of withdrawing monetary and fiscal stimuli in most of the countries and high unemployment rates would condition the performance of global aggregate demand.

Statistical information, which provides figures on the Albanian economy performance, was partial during the first quarter of the year. However, the analysis of fiscal and monetary developments, inflation and external sector's performance and the quality of information obtained from the Bank of Albania through its surveys, create an overview of economic developments. According to INSTAT, the domestic economy recorded a positive growth of 3.3% in 2009. After the positive growth rates recorded during the first nine months, the economic activity contracted in the last quarter of 2009. Based on preliminary data, gross domestic product fell by 0.8% in annual terms during the quarter. This performance was determined by shrinkage of public and private investments, as well as significant slowdown of private consumption. Low growth rates of wages and employment, decreased remittances, contracted consumer credit, as well as greater tendency of consumers to save, triggered a slower pace of consumption in the last quarter of the past year. Private investments contracted during this quarter, against the backdrop of slowed domestic and external demand and low capacity utilization rate. Also, the reduction of fiscal stimulus during the last months of 2009 was reflected in a lower contribution from public investments to the economic growth over the last quarter. As shown by performance of fiscal and monetary indicators and consumer business expectations, the domestic economy performance is assessed as slow even during the first months of this year.

The average annual inflation settled at 4.1% for the first quarter of 2010, slightly above the upper tolerance band of the Bank of Albania's inflation target. During this quarter the rise in administered energy price has contributed by 0.5 percentage points to annual inflation, thus determining the exceeding of this limit. Meanwhile, inflation marked 3.9% in March, returning within the Bank of Albania's targeted band. During the first months of the year inflation was pushed up mostly by supply-side factors. Besides electricity price rise, the limited supply of domestic agricultural output and the upward trend of raw material prices in the world market, in the presence of the national currency's depreciation pass-through, have exerted upward inflation pressure. However, it is considered that these factors influence inflation only temporarily. Performance of core and non-traded inflation rates, which are close to their long-term historical average, attest to low demand-induced inflationary pressures. Over the medium run, the slowed domestic demand and below-the-potential economic growth are expected to impede creation of any sustainable inflationary pressures, thus balancing the direct effect of supply-side factors.

Developments in the external sector of the economy during the first two months of the year are characterized by a narrowing trade deficit at home. The trade deficit has narrowed by about 20% in annual terms, reflecting an annual increase in exports and annual decline in imports, respectively by 31% and 7%. This positive performance has also led to establishment of more balanced ratios between the demand and supply for foreign currency, resulting in steady exchange rate levels. Although trade deficit correction over this period is an encouraging development, its long-term sustainability requires ongoing structural reforms in the economy. In particular, the growth of savings in the economy should be encouraged through deepening and implementation of the pension system reform. It will support the long-term sustainability of this system and will create appropriate conditions for increasing domestic and long-term financial funds, serving the correction of current account deficit at home and supporting long-term investments in the economy. Also, further measures must be taken to attract foreign direct investments and enhance competitiveness of Albanian exports in the global markets.

During the first months of 2010, fiscal policy pursued a contained trend of fiscal expansion, which had appeared in the last quarter of 2009. Budget expenditures increased at a contained pace of about 4% in annual terms. On the other hand, the demand slowdown continues to dictate low growth paces of budget revenues. The Bank of Albania encourages the taking of measures that aim at strengthening the long-term sustainability of fiscal indicators, seeking their ongoing monitoring and correction over the year. The pursuit of a prudent fiscal policy would help consolidate fiscal indicators at sound levels, thus better serving the economic growth sustainability and the maintaining of macroeconomic balances in the long run.

The first two months of the year were featured by an ongoing positive performance of monetary indicators. Money supply grew on average by 8.3% in annual terms, supported mainly by the increase of foreign currency denominated deposits. The low intermediation of the banking system has created little room for growth of the broad money in the economy. Lending to the economy, though increased at higher rates than in the last quarter of 2009, remains at low record levels in recent years. Annual growth of lending to private sector, excluding exchange rate effect, resulted 5.4% in February. Business credit reflected a better performance over the first months of the year, thanks to improved foreign currency liquidity and easing lending terms. On the other hand, household credit continued to shrink at similar rates to those of the previous year-end. Despite these developments, credit demand has remained low, due to slowed economic activity in the country and more prudent stance of economic agents in terms of borrowing.

The Bank of Albania has pursued a prudent monetary policy, in support of meeting our inflation target and the needs of the economy for liquidity. It has been present in the interbank market, providing the necessary liquidity for a normal development of the financial markets. The latter have been characterized by reduced risk premium, increased volume of transactions and falling interest rates. Upon improvement of the banking system's liquidity position and normalization of risk premiums, in January of this year the Bank of Albania decided to reapply standardised repurchase agreement auctions: weekly injecting operations at a competitive interest rate. Performing these auctions at a fixed interest rate and unlimited amount in November to December 2008 was one of the measures taken by the Bank of Albania against the backdrop of a constrained liquidity position and rising risk premium and uncertainty during that period. Returning to standardised auctions of the main instrument of the Bank of Albania marks the beginning of withdrawal of these measures in response to normalized situation in financial markets at home.

The stable macroeconomic environment, improved liquidity indicators of the system, recovered global economy and eased lending terms by the banking system, encourage the progress of the Albanian economy for the rest of the year. In particular, we are expecting a greater contribution from the banking sector to lending to the economy for the rest of the year. In light of this, the Bank of Albania has created the proper regulatory, supervisory and monetary conditions to raise the intermediary activity of the banking system. These measures are communicated and will be consistently communicated through an open public dialogue with the banking system. On the other hand, the increased economic and trade activity in the global markets, domestic macroeconomic stability and reduced uncertainty at home, are expected to be reflected in a higher foreign demand and a steady domestic demand over the course of the year.

The Bank of Albania will continue to pursue a prudent monetary policy over this period, aiming at meeting its inflation target and creating appropriate economic conditions for a sustainable and long-term development of the country.

II. EXTERNAL ECONOMY DEVELOPMENTS

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

The global economy continued to show recovery signs in the first quarter of 2010, due to monetary and fiscal stimuli carried out during the past year by developed and emerging economies. The first months of this year experienced improved trade activity and confidence indices. Unemployment was rising in most of the developed countries. The inflationary pressures worldwide, though at low levels due to low capacity utilization rate, continued to be upward over this quarter.

Table 1 Some key macroeconomic indicators

	Changes of GDP		Unemployment rate	Inflation rate	
Countries	Q4-09/Q4-08	Q4-09/Q3-09	February-09	February -10/ Janar-10	February -10/ February -09
USA	0.1	5.6	9.7[1]	0.0	2.1
Euro zone	-2.2	0.0	10.0	0.3	1.5[1]
Germany	-2.4	0.0	7.5	0.5[1]	1.1[1]
France	-0.3	0.6	10.1	0.5[1]	1.6[1]
United Kingdom	-3.1	0.4	7.8[2]	0.4	3.0
Japan	-1.0	0.9	4.9	-0.1	-1.1

Source: Eurostat, Respective statistical institutes

[1] Data on March 2010. [2] Data on January 2010.

EURO-ZONE ECONOMY

Eurostat assesses that during the fourth quarter of 2009 the Euro zone economy settled at the same level as to the previous quarter. The stability in consumption expenditure provided the potential impact on this performance, whereas the positive impact of net export growth was offset by decreased total investments. During 2009, the Euro zone economy contracted by 4.1%, up from 0.6% growth in the previous year. In February 2010, unemployment peaked at 10%, hitting the high record since 1998. The 2010 forecasts indicate that the Euro zone economy will continue to grow at moderate rates. According to preliminary estimates, the Euro zone annual inflation edged up to 1.5% in March 2010, continuing the upward trend that had started in the last quarter of the past year. The upward impact on inflation was given by energy and food price rise, in consequence of bad weather that hit the region at the beginning of this year.

U.S. ECONOMY

Final estimate on U.S. economy show that real gross domestic product grew 5.6% (annualized, q-o-q, final) in the fourth quarter of 2009. Influenced by expansionary fiscal and monetary policies, consumer spending and investments have made a substantial contribution to GDP growth. The positive performance of key economic indicators on industrialized countries during this period led to export growth by 22.8% q-o-q. The data on the industrial sector for the first quarter of 2010 confirm an upward trend of activity in its main branches. Household lending rates remained low, due to risk perception by the banking sector on households' solvency, due to weakening labour market. Unemployment rate stayed flat at 9.7% in the first quarter of 2010, whereas annual inflation for February was 2.1%.

BRIC ECONOMIES[1]

BRIC economies were faced with upward inflationary pressures during the first months of 2010, induced by various fiscal stimuli aimed at improving the economic conditions. Excluding Russia, the annual inflation rate picked up in China and India during the period of January-February, and in Brazil during January-March. In Russia, the national currency's appreciation and the dampening of the domestic demand influenced the inflation rate fall, hitting low record levels in the last twelve years. The economic activity recorded positive annual growth rates in Brazil and India during the last quarter of 2009 and in China during the first quarter of 2010. Russia's GDP recorded growth rates q-o-q, whereas it decreased by 2% y-o-y.

Russia's central bank cut its basic policy rate by 0.25 percentage points in March, whereas India's central bank raised its basic policy rate by 0.25 percentage points. The central bank of Brazil and that of China kept their basic policy rates unchanged.

Table 2 Key macroeconomic indicators for BRIC economies

Countries	Annual change in real GDP			Annual inflation
	Q4, 09	2009	2010[1]	February-10
Brazil	4.3	-0.2	3.5	5.2[3]
Russia	-2.0	-7.9	1.5	6.5[3]
India	6.0	7.2	6.4	14.9
China	11.9[2]	8.7	9.0	2.7

Source: IMF, OECD, Respective statistical institutes

[1] IMF estimates, October 2009. [2] Data are for the first quarter of 2010.

[3] The data are for March.

ECONOMIES IN THE REGION

The economic data for the last quarter of 2009 show a downturn in the economic activity of Italy and Greece and an improvement in Turkey and Former Yugoslav Republic of Macedonia. In Italy and Greece, GDP contracted 3% and 2.5% respectively, in annual terms. The economic contraction in Italy was impacted by the decline in consumption expenditures and aggregate investments, whereas in Greece it was potentially influenced by the decline in government spending and aggregate investments. Greek government adopted three fiscal incentives during January-March 2010, aiming at reducing the budget deficit by 4 percentage points to 8.7% of GDP in 2010.

In the meantime, the euro area member states allocated a 30 billion euro bailout for Greece for a three-year period.

The economic activity in Turkey rose by 6% in annual terms in the last quarter, while the economic growth for 2009 was negative by 4.7%. The growth over the last quarter was fuelled by increased consumer spending, while net exports marked for the first time a negative rate. The economy of the Former Yugoslav Republic of Macedonia increased in annual terms by 1.2% in the fourth quarter of this year, after being contracted in the first nine months of it. The key factors that influenced growth in the last quarter were consumer spending and investments, while net exports and public spending have provided a negative impact.

Unemployment rate has declined in the Former Yugoslav Republic of Macedonia and in Greece, whereas it has remained at steady levels in Italy, while in Turkey the working conditions have deteriorated, leading to increased unemployment. Inflationary pressures have been high in all the countries of the region, continuing its upward trend in Greece, Italy and Turkey. Former Yugoslav Republic of Macedonia has experienced the end of annual inflation downward trend.

Table 3 Economic indicators for countries in the region

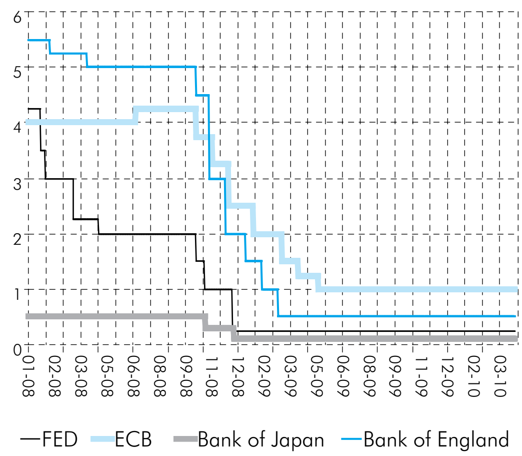
Countries	Change in GDP	Annual inflation	Unemployment rate
	Q4-09	March-10	January-09
Italy	-3.0	1.4	8.5[2]
Greece	-2.5	3.9	10.2[3]
Macedonia	1.2	0.7	32.4[4]
Serbia	-1.6	4.4	17.4[5]
Croatia	-4.5	0.9	18.3[2]
Turkey	6.0	9.6	13.5[3]
Kosovo	3.8[1]	1.1[2]	:
Albania	-0.8	3.9	12.8[5]

Source: Respective statistical institutes, EuroStat, EcoFin, IMF
[1] The figure stands for 2009. [2] Data are for February 2010.
[3] The data are for December 2009.
[4] The data are for the fourth quarter of 2009.
[5] The data are for the third quarter of 2009 .
: Unavailable data.

II.2 MONETARY POLICY, FINANCIAL MARKETS AND EXCHANGE RATE

The global economic recovery has supported the assessment that current interest rates are appropriate to help economic growth against a backdrop of a high uncertainty. In the first quarter of the year, none of the major central banks changed its interest rate. Except the European Central Bank, which finally changed its basic policy rate in May 2009, the other banks have not changed them for more than a year.

Chart 1 Performance of basic policy rates



Source: ECB, FED, Bank of England, Bank of Japan

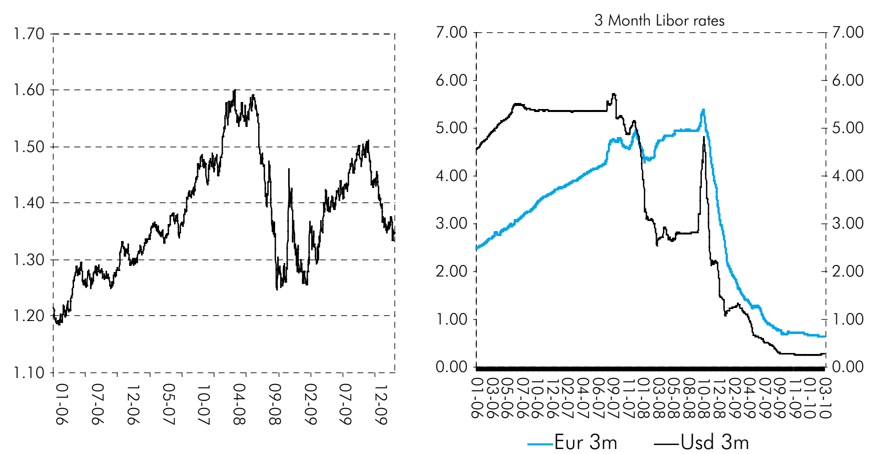
Financial markets were featured by downward interest rates and a contained volatility over this quarter. Interest rates have continued to fall, while trading activity has returned to pre-crisis levels. On one hand, interest rates have reflected the positive signals coming from the developed countries and emerging economies, which have ensured the market agents about positive economic growth performance and improvement of its prospects. On the other hand, these rates continue to carry over the effects of ample liquidity injected by supportive policies pursued by governments to withstand the crisis. A positive situation is noted even in stock markets, where stock price rise continued during this period for most categories.

During the first months of the year, Libor and EURIBOR rates continued to decline in the money market, reaching lower values than in previous periods. On average, one -, three - and six - month EURIBOR rate dropped by 6 basis points versus the end of the past year. In March they marked respectively 0.41, 0.64 and 0.95%. Three-month Libor rate increased marginally by 2 basis points only in the last month of this quarter, resulting 0.27%.

Yields on bonds fell marginally in Europe and Japan, while they increased marginally in the U.S. The more positive outlook of the U.S. economy has affected the market agents' expectations for a possible yield rise, close to the basic policy rate set by the American monetary authority, thus supporting the upward yield trend. During these months the major U.S. stock indices, Dow Jones, S&P and Nikkei registered a positive performance and a contained volatility.

Concerning foreign exchange markets, since early December, euro was depreciating against the major currencies and particularly against the U.S. dollar, the British pound and the Japanese Yen. The Euro also lost some ground against the group of other European currencies. Better performance in U.S. economy and debt problems in several countries within the euro area led to the euro's depreciation against the dollar. In early April, one euro was traded by 1.33 USD or 4.7% less than as at end-December.

Chart 2 Exchange rate performance of Eur / Usd (left) and Libor Usd, Eur (right)

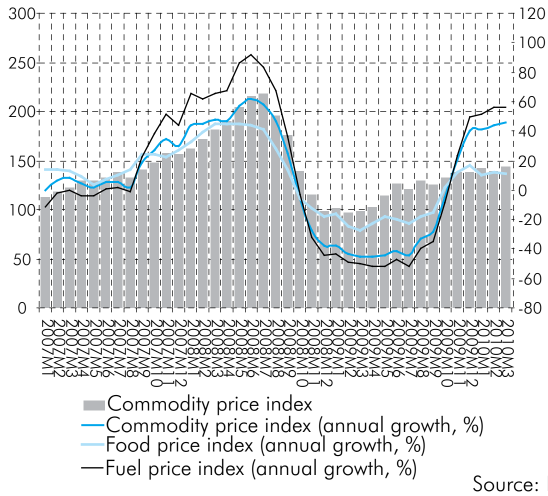


Source: ECB, Reuters

II.3 PERFORMANCE OF OIL AND RAW MATERIAL PRICES

The basic commodity prices continued their upward trend during the first quarter of 2010. Upward pressures were noted in all major categories. Aggregated index of these prices marked an annual growth of 43.8% for this quarter, driven primarily by double-digit rate of Fuel Price Index Rise (54.6%). In the meantime, Food Price Index recorded lower paces of increase, up by 11.8% in annual terms. Quarterly developments attest to slight rates of increase. Compared to the last quarter of the past year, Commodity Price Index, Food Price Index and Fuel Price Index increased marginally, by 4.5%, 3% and 4%.

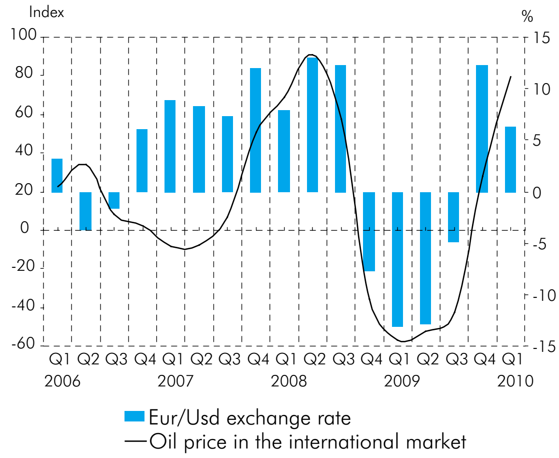
Chart 3 Price index performance by basic commodity items and their annual changes



Source: IMF

The first quarter of 2010 was featured by an ongoing low volatility in the average oil price per barrel in international markets. This price, which has stayed within the range of USD 72-79 a barrel in the last six months, reflects the stabilization of economic conditions in developed and emerging economies. Also, the appreciating trend of the dollar's exchange rate versus the euro influenced this performance. However, the average oil price was roughly 80% higher in annual terms, reflecting mainly the base effect from the comparison with low price of the previous year. Meanwhile, of the q-o-q comparison, there was a moderate rise of 2.1%.

Chart 4 Annual change of international oil price and EUR/USD exchange rate



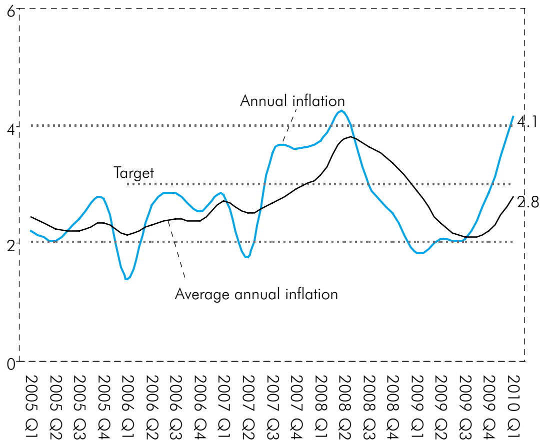
Source: Eurostat, EIA

The oil demand in international markets expanded in the first quarter of the year, primarily due to improved industrial activity and increased consumer spending in the U.S.A. and Asia. On the other hand, oil supply marked an upward trend in such countries as Brazil, U.S.A., Russia and OPEC. However, after several cuts in a row over the past year, OPEC's meeting in March decided to keep oil production quotas unchanged.

III. PRICE STABILITY AND BANK OF ALBANIA TARGET

Consumer prices showed an upward trend in the first quarter of 2010, pushed by temporary supply-side factors. Low core and non-traded inflation rates attest to weak demand-side inflationary pressures. Against a setting when economic agents' expectations for inflation remain anchored at Bank of Albania's target, the low capacity utilization rate in the economy, coupled with slow monetary expansion, are assessed to balance the temporary supply-side inflationary pressures.

Chart 5 Annual inflation by quarters
(in percent)



Source: INSTAT and Bank of Albania estimates

III.1 INFLATION TARGET AND MONETARY POLICY

Annual inflation for the first quarter of 2010 settled at 4.1%, i.e. 0.1 percentage point above the upper limit of Bank of Albania's targeted band. Temporary supply-side factors – rise in administered prices of electricity, limited domestic supply of agricultural production, exchange rate depreciation and upward raw material prices internationally – were the main determinants in the rising inflation rate even in the first months of the year. The low core and non-traded inflation rates attest to low domestic demand-induced inflationary pressures. Also, the slow monetary expansion during the past year supports the assessment for weak monetary inflationary pressures.

Average annual inflation[2] in this quarter was 8.2%, up by 0.6 percentage points against to that of end-2009. The upward trend of this indicator attests to the rising basic effect compared to the low price level in the previous year.

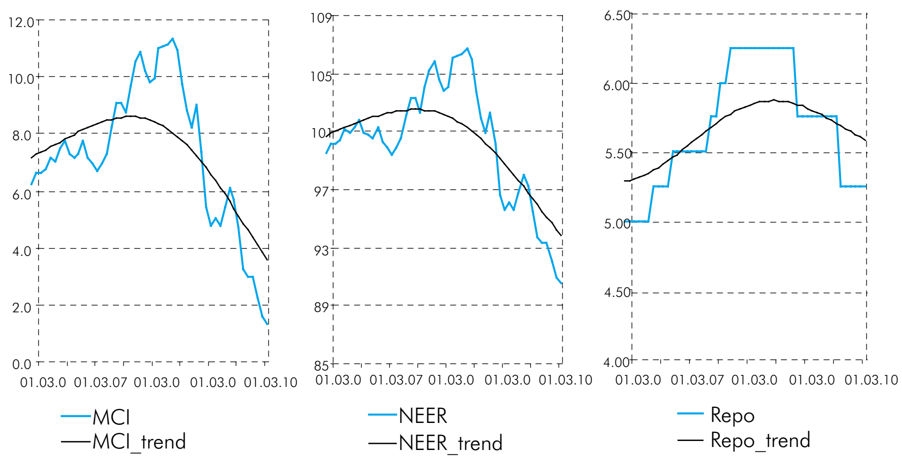
Macroeconomic fiscal and monetary stimulus, and other measures taken by the Bank of Albania to ensure the smooth functioning of the banking system and its liquidity backup, mitigated the effects of the global crisis on the domestic economy. Based on preliminary data from INSTAT, the economic growth for 2009 was 3.3%. This growth rate is significantly lower than the annual growth of 8.3% in 2008 and the average historical growth[3] of 6.1%. The decline in foreign demand, in the world trade volume and in capital flows due to the global crisis impact, was associated with slowed domestic demand. Private investments at home contracted, while consumer demand slowed against a background of limited financing resources and uncertainty about the future. Fiscal stimulus that was present mainly during the first half of 2009 decreased the contribution to domestic demand[4] over the fourth quarter. In response to dampened demand, the economic activity contracted at an annual level of 0.8% in the last quarter of 2009. The expanded gap between the downward demand and the labour market supply was reflected in slight unemployment rate rise, while real wage index for the economy marked a lower growth rate in this quarter.

The Bank of Albania's monetary policy was conditioned by inflationary pressures and economic activity developments. Since November 2009, the Supervisory Council of the Bank of Albania assessed that the basic policy rate is suitable for a balanced development against the backdrop of an uncertain situation. The repurchase agreement interest rate was kept unchanged at 5.25%, from its final cut in October 2009. This decision was motivated by the breaking of downward inflation trend[5] and forecasts for added inflationary pressures fuelled by supply-side factors in the short run. It comes out of the economic and monetary analysis that price stability will be achieved within the time horizon of Bank of Albania's monetary policy conduct. Economic agents' expectations and inflation expectations remain anchored close to the central bank's target. In terms of the absence of second-round effects, it is assessed that the expansion of negative output gap[6], reflected also in the low capacity utilization rate of capital, in facilitating labour market conditions and slow monetary expansion, will temporarily balance the supply-side inflationary pressures.

MONETARY CONDITIONS

The Bank of Albania, likewise in 2009, has been prudent in injecting the monetary stimulus, aiming primarily to attain its main objective. The monetary conditions in the first quarter of 2010, estimated by the Monetary Conditions Index, continued to reflect the easing monetary policy. This index has further deepened the falling trend, reflecting mainly the ongoing depreciation of the national currency, though at moderate paces. Also, the basic policy rate stands below its historical trend.

Chart 6 Monetary Conditions Index (MCI) and its components

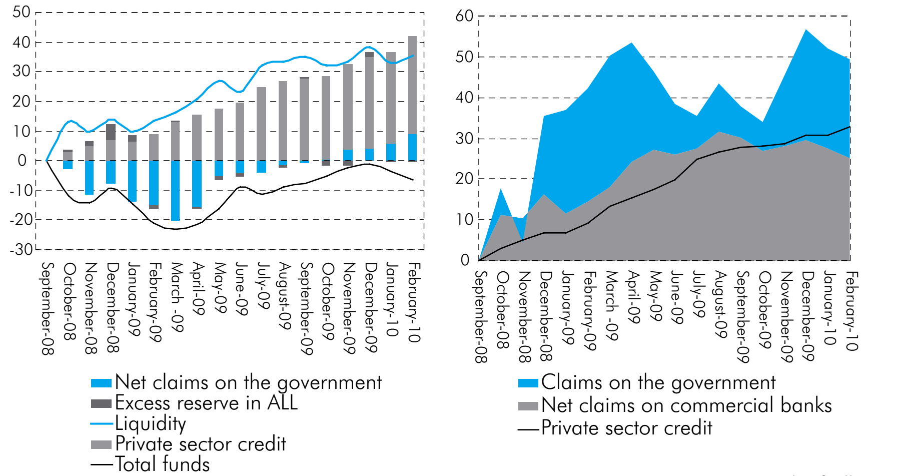


Source: Bank of Albania

The transmission of easing monetary conditions in the economy was limited, reflecting the high uncertainty about the future and the increased liquidity risk premiums. The exchange rate depreciation favoured the positive performance of exports, but the import-orientation of the Albanian economy, along with the low foreign demand, have hindered the correction for current account deficit to the extent noted in other countries in the region (*see box 3*). Current account deficit narrowed in annual terms by 3% in 2009. The latest data on the external sector of the economy show a narrowing of about 19.6% of trade deficit for the first two months of 2010. This development is estimated to ease pressures on the domestic currency for the next period.

Basic policy rate cut by 100 b. p. over the previous year was transmitted asymmetrically to interest rates in the financial markets. The signals given by the monetary authority have been reflected more in forming deposit rates than in credit ones. High uncertainty about future economic outlook and the loan portfolio quality performance have impeded the full transmission

Chart 7 Liquidity performance (banking system, left and central bank, right) in billion of leks



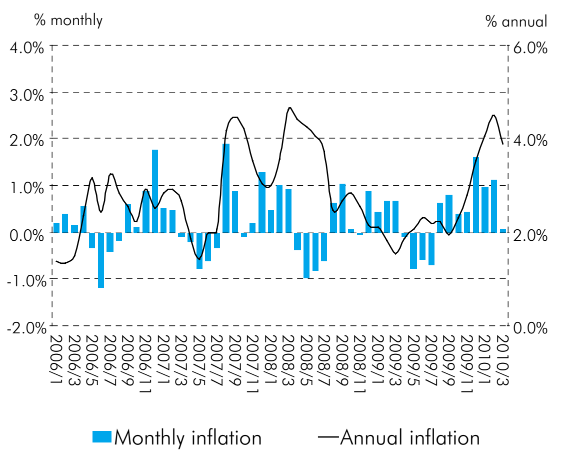
Source: Bank of Albania

of monetary policy decisions. On the other hand, the Bank of Albania has provided ongoing support to the banking system by injecting liquidity through open market operations. This policy has resulted in reduced risk premiums in the interbank market. Based on asset composition of the banking system, it is assessed that the liquidity injected into the banking system is channelled into lek-denominated credit to economy. Gradual improvement of banking system's financial position from the viewpoint of liquidity and increased confidence will contribute to complete transmission of central bank responses.

III.2 PRICES OF MAIN CPI BASKET ITEMS

Annual inflation in the first quarter of 2010 resulted 4.1 per cent, by 2.1 percentage points above the level of the last quarter of 2009. In the first two months of the year inflation overshot the Bank of Albania's target, to return to 2-4% targeted band in March (3.9%). The upward inflation rate trend, started since the last quarter of 2009, is driven mainly by supply-side factors – depreciating exchange rate behaviour, electricity price rise, base effects and the limited supply of domestic agricultural products.

Chart 8 Annual and monthly inflation (%)



Source: INSTAT, Bank of Albania

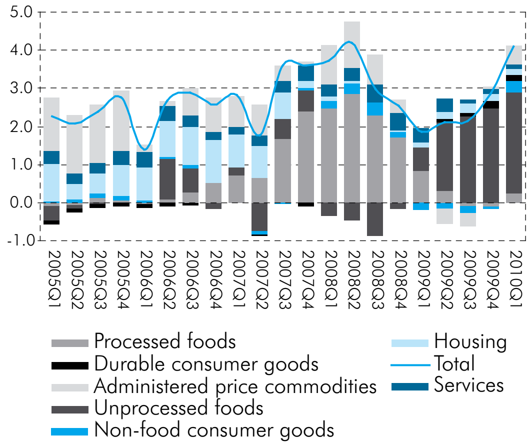
The behaviour of exchange rate depreciation against both major currencies, the euro and the dollar, and the raw material price rise in the global market, were translated into higher imported inflation rates (especially of food and fuels) during Q3 2009 – Q1 2010. The slowed depreciating paces in the first months of 2010 have mitigated the inflationary pressures; thus, in March inflation rate was downward.

The price rise of electricity by 13% in January, and of drinking water in March added the annual inflation rate of the first quarter of the year by 0.5 percentage point.

Base effect (*box 1*) added the annual inflation rate on average by 0.5 percentage point relative to the level recorded as at October of the previous year[8]. A year ago, the inflation rate was 1.9% or less than half the inflation rate of the current year.

Among the specific factors, bad weather led to a decline in domestic supply of agricultural products. Meeting the needs of our market with imported goods in terms of exchange rate depreciation resulted in increased consumer prices for these products.

Chart 9 Contribution of main items to annual inflation (in percentage points)



Source: INSTAT, Bank of Albania

"Unprocessed foods" and "Administered price commodities" contributed by 75% to annual inflation rate in the first quarter 2010, while other basket items have also given an upward contribution. The "Unprocessed foods" item was characterized by high double-digit annual inflation rates, peaking by 15% in February. In March, the annual inflation of these products fell by 4 percentage points compared with the preceding month. The high contribution (6.2 percentage points) made by this item to headline inflation rate over the first quarter of the year was triggered by insufficient domestic products to meet the demand and by import price rise denominated in leks – against the backdrop of exchange rate depreciation and the base effect.

Contribution of "Processed foods" and "Non-food consumer goods" to headline inflation was within the range of 0.2 - 0.3 percentage points. The inflation of these items went up compared to the previous year. Its upward trend is attributable mainly to global conjuncture of raw material prices for food and oils[9], which has been upward since mid-2009. During the first months of this year there is noted an acceleration of increase rate of these prices in the international market.

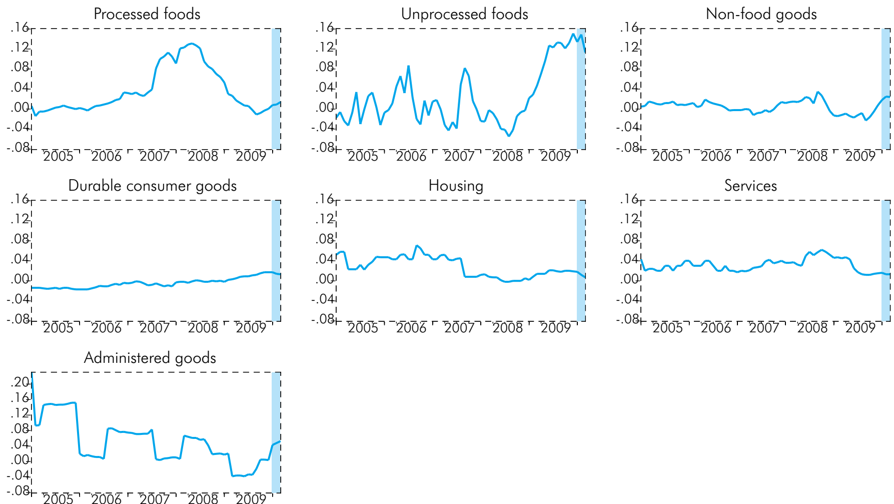
Table 4 Item's contribution to annual inflation (in percentage points)

	Q4-08	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10
Processed foods (pp)	1.7	0.9	0.3	-0.1	-0.1	0.3
Bread and cereal (pp)	1.0	0.6	0.2	-0.1	-0.3	-0.2
Alcohol and tobacco (pp)	0.1	0.1	0.1	0.1	0.2	0.1
Unprocessed foods (pp)	-0.1	0.6	1.8	2.3	2.5	2.6
Fruit (pp)	-0.1	0.0	0.3	0.5	0.6	0.2
Vegetables (pp)	-0.7	-0.3	1.4	0.9	1.0	2.0
Services (pp)	0.5	0.4	0.3	0.1	0.1	0.1
Administered prices (pp)	0.3	0.1	-0.4	-0.4	0.1	0.5
Fuel and energy (pp)	0.7	0.4	0.0	0.0	-0.1	0.4
Housing (pp)	0.0	0.1	0.2	0.2	0.2	0.1
Non-food consumer goods	0.2	-0.2	-0.2	-0.2	-0.1	0.3
Durable consumer goods (pp)	0.0	0.0	0.1	0.1	0.2	0.2
Consumer price index (y-o-y, %)	2.5	1.9	2.1	2.1	2.9	4.1

Source: INSTAT, Bank of Albania

The "Administered goods" contributed positively by 0.5 percentage point to the headline inflation of this period. A year ago, the annual inflation of this item did not contribute to the formation of inflation rate. The administered price rises for electricity in January and drinking water in March were materialized in the average annual inflation of the first quarter. In the absence of further increases, such price rise effect is expected to fade out in the first quarter of 2011.

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



Source: INSTAT, Bank of Albania

The prices of "Services" and "Housing" have contributed at minimum, respectively by 0.1 percentage point to the headline inflation of this quarter. The inflation of these items, though positive, has been downward since October of the previous year, due to a "quiet" market demand for such services.

Box 1 Base effect and its impact on inflation rate

During the past two years, inflation rate volatility was highly pronounced. After the high levels achieved in mid-2008, inflation started to drop sharply until end-2009. Compared with April 2008, in October 2009, i.e., for a 15-month period, inflation fell by 2.3 percentage points. Then, for four consecutive months, it increased gradually, to turn back to 4.4%. This inflation profile is largely determined by developments in the processed foods prices, especially that of grain. However, changes in the annual inflation rate in different months might have been caused not only by short-term developments (monthly changes), but also by price fluctuations over the past year - the so-called "base effect". Base effect may be defined as the contribution to annual inflation rate at a certain month, which is caused by monthly inflation deviation from its usual seasonal behaviour in the base year. Related to some items, this measure is accompanied by a high degree of uncertainty, given that their seasonal behaviour may be very volatile (for example, raw foods are influenced by weather) or may change because of the seasonal factors that affect their behaviour. This box will provide an analysis about the base effect's role during 2009 and the way it acts on formation of inflation rate for the current year.

Base effect calculation

Base effect is an important factor when analyzing changes in annual inflation rate. It occurs when changes in the annual inflation increase rate are influenced by some non-usual events, atypical ones that have influenced the rate of this indicator 12 months ago. Annual inflation represents an accurate reflection of changes in the consumer prices during the year, while the base effect helps explain changes in annual inflation or the extent to which it decreases or increases.

In our country, the most typical case to analyse the base effect is the moment when electricity price goes up. More specifically, in March 2008, once electricity price went up, the overall price level also rose sharply during this month, but when its impact cancelled out a year later, in March 2009, the annual inflation dropped back at the same extent - in the absence of a new electricity price rise.

The base effect is calculated as a deviation of monthly inflation rate in the base period from its common model.

$$\pi_t - \pi_{t-1} = (P_t/P_{t-1} - P_{t-12}/P_{t-13})\ x100$$

where

π_t	–	*the annual inflation rate in the current month*
π_{t-1}	–	*the annual inflation rate in the previous month*
P_t/P_{t-1}	–	*the monthly changes in prices of the current period*
P_{t-12}/P_{t-13}	–	*the monthly changes in prices of 12 months ago.*

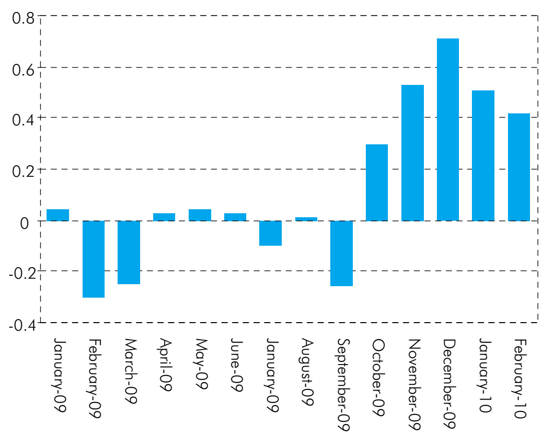
The above formula explains the fact that the change in the annual inflation rate between two subsequent months is equal to the difference between monthly changes in current period prices and those of 12 months ago. If the price index increases quite unusually in the period t-13 to t-12, then this will reduce the difference in annual inflation rates in the period t-1 and t. Hence, the base effect is nothing but the contribution of price changes of a year ago (P_{t-12}/P_{t-13}) to inflation change in the current period.

Sharp decline in annual inflation over the first half of 2009 reflected mainly the base effect. During the first half of 2008 raw material prices increased sharply. Also electricity price went up in March. Adverse direction of these developments starting from the second half of this year and the cancellation effect of electricity price rise in March contributed to annual inflation drop over the first half of 2009.

Although 2009 is regarded as the year when the base effect has significantly impacted on the overall inflation rate, identification and assessment of base effects in practice is not so straightforward, because there is no any specific way to make a distinction between usual and unusual causes that affect immediate fluctuations of inflation rate. Chart 11 presents the base effect in 2009 and in first two months of 2010. It comes out of the chart that the positive base effect on annual inflation rate started to be felt since October 2009 and has continued to be felt even during the first two months of 2010.

The annual inflation in 2010 may be affected by both the positive base effect (because of low inflation rates almost throughout 2009) and the electricity price rise in January. In the first quarter of the year, this effect shifted inflation curve upward by roughly 0.5% percentage point.

Chart 11 Base effect impact on inflation rate (in percentage points)



Source: Bank of Albania

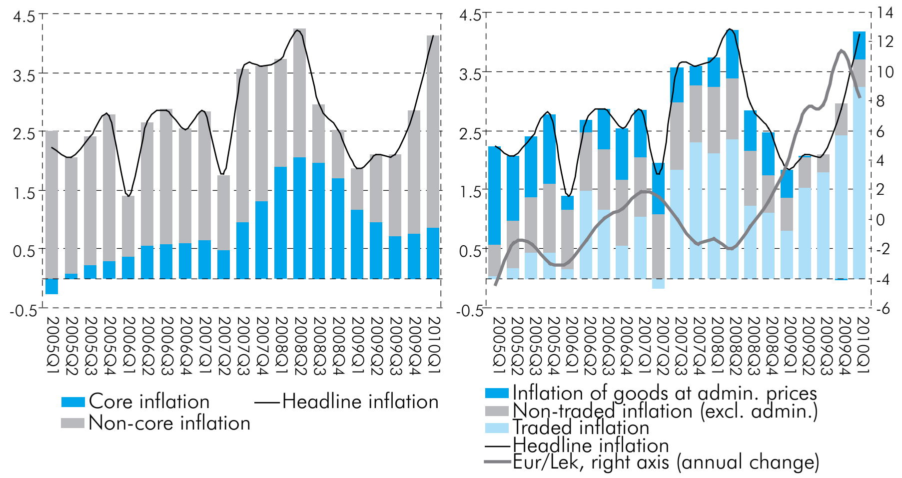
The above analysis highlights the contribution that the base effect has given to the performance of annual inflation rate until the first quarter of 2010. It also signals that this effect will continue to positively contribute to forming the inflation profile for the rest of the year, at least until the end of its third quarter. However, the extent of inflation rate rise is uncertain and can not be estimated mechanically by relying just on the base effects. The performance of annual inflation increase is determined mainly by macroeconomic developments at home.

III.3 MAIN INFLATION TRENDS

Core annual inflation[10] in the first quarter of 2010 resulted about 1.2%, about 0.5 percentage points lower than at the same period of the previous year. The low core inflation rate attests to weak inflationary pressures on the domestic demand-side.

Though headline inflation during the first quarter of 2010 was obviously upward, its long-term component displayed a steady behaviour and settled close to the historical average of the last decade[11]. Its contribution to total annual inflation was moderate, 0.9 percentage points relative to the previous quarter. Inflationary process in the economy was formed mostly from the contribution of short-term inflation component, which accounted for about 80% of the total inflation rate. Due to inflationary impact of the supply factors, the non-core inflation in February hit the highest record in ten years, 13.5%.

Chart 12 Annual contribution of main inflation items



Source: INSTAT, Bank of Albania

Annual traded and non-traded inflation of the CPI basket for the first quarter of this year were respectively 5.1% and 2.4%. The upward traded inflation of the CPI basket was fuelled mainly by price rise of unprocessed products. If their effect is excluded, this sector's net inflation in annual terms during the reference period would result about 1.6%. Contribution of traded inflation to headline inflation was comparable to that of non-core component (77%). The ongoing depreciating trend of the Lek against both major foreign currencies (euro and U.S. dollar) and unfavourable weather conditions hit the market demand, impacting on ongoing import price rise. Also, net non-traded inflation of the CPI[12] during the quarter resulted about 1.4%, continuing to remain below the average rate for this component over the last decade.

The steady trend of core inflation and of net non-traded one, and their rates close to long-term historical average, support the presence of contained inflationary pressures stemming from domestic demand in the economy. At a time when economic agents' expectations stand close to Bank of Albania's target and there exists a high uncertainty about the future, the performance of these indicators is in line with the prudent decision-making of the monetary policy pursued by the Bank of Albania during the preceding periods.

IV. MACROECONOMIC DEVELOPMENTS AND THEIR IMPACT ON INFLATION

The latest data on the country's economic growth in the fourth quarter of 2009 confirmed the contraction of aggregate demand. The contribution of fiscal stimulus to domestic demand was weakened and the decline in consumer demand, along with contraction of private investments contributed to the decline in GDP over this quarter. Performance of qualitative indicators suggests continuation of trends observed during the fourth quarter in the first quarter of 2010. The low level of capacity utilization rate and the slow monetary expansion support the assessment for weak demand-induced inflationary pressures in the following period.

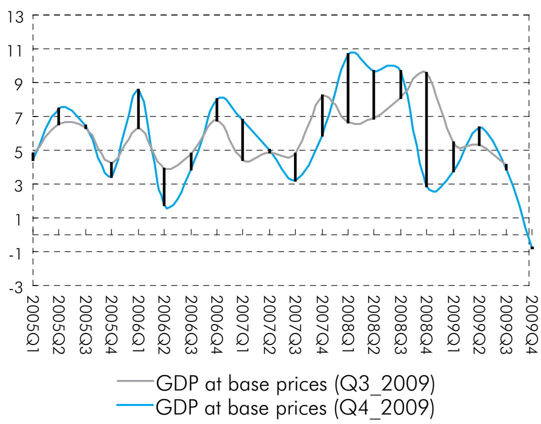
IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND PERFORMANCE

The Albanian economy, after positive growth rates in the first nine-month period of 2009[13], contracted in the last quarter. Based on preliminary data from INSTAT[14], gross domestic product fell by 0.8% in annual terms over this quarter. Economic growth for 2009 is 3.3%, down from 8.3% in 2008 and its potential level[15].

The latest data from business and consumer confidence surveys for the first quarter of 2010 signal ongoing downward trends.

Economic decline in the fourth quarter of the previous year reflects mainly the reduced domestic

Chart 13 Annual growth of GDP by quarters[16]

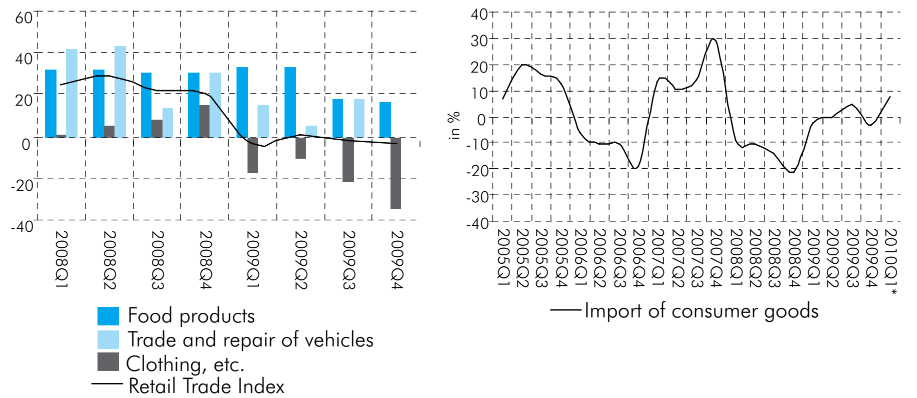


Source: INSTAT and Bank of Albania estimates demand at a time when net exports have decreased the negative contribution made over the period. Final consumption of population slowed down further during this quarter. This behaviour is reflected in its components, in both the private consumption and the public sector.

Private consumption decelerated during the fourth quarter of 2009. Various indicators available for this indicator suggest that its growth for the first months of 2010 continues to be weak.

Consumer spending, based on Retail Trade Index, decreased by 2.8% in the fourth quarter of 2009, reflecting further tightening of financial resources and the pessimistic expectations about their financial situation and future economic outlook. The low level of demand is mainly reflected in the decline of durable consumer goods (-1.1% in the fourth quarter). The low elasticity of the demand for foods has resulted in increased consumer spending for them[17] (16.6% in the fourth quarter). Import of consumer goods went up by 3.2% in annual average terms during the first two months of 2010.

Chart 14 Reduction of consumer demand in the fourth quarter of 2009, annual changes

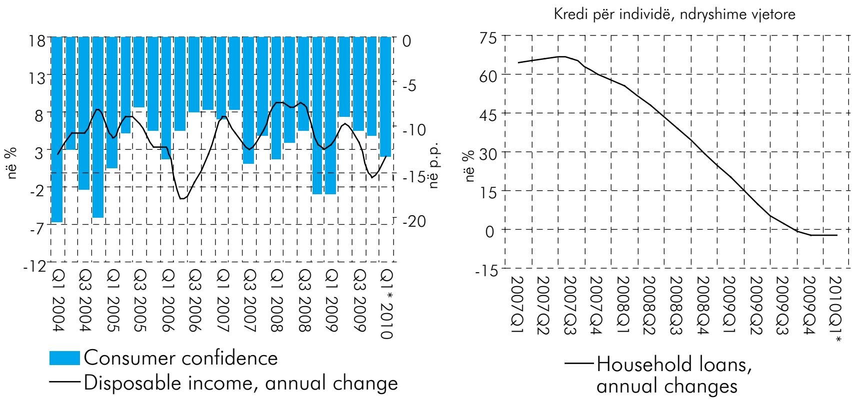


*Note: The import of consumer goods for the first quarter is estimated as an average of the first two months of 2010.
Source: INSTAT and Bank of Albania

The reverse in the upward trend of consumer spending during the fourth quarter was determined by slow rise in disposable income[18] indicator, the decline in consumer credit and uncertainty about future developments. The rise in disposable income during 2009 was positively influenced by positive nominal wage growth rates, though at lower paces than in the previous years. Low rates of inflation over the past year have supported the real income growth.

On the other hand, consumer credit, as an important source of financing the expenditures, was downward, standing at 2.2%. Based on lending activity survey for the first quarter of 2010, consumer credit standards were tougher than in the fourth quarter.

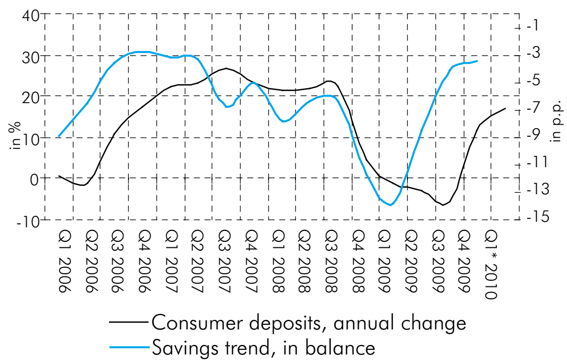
Chart 15 Financing the consumer demand



* Note: The annual consumer credit rate for the first quarter of 2010 is calculated as the arithmetic average of annual changes in January and February 2010.
Source: INSTAT and Bank of Albania

High uncertainty is reflected in the decline in consumer confidence indicator and in encouraging consumers to save. Consumer confidence index decreased in the third and fourth quarter of 2009, by respectively 1.8 and 0.5 percentage points. Their pessimistic expectations are also reflected in the negative assessments on employment rate in the first six months of 2010. In spite of deposit interest rate decline, household savings continued the upward trend that had started since the second half of 2009. Based on consumer survey data, savings balance grew significantly and is 5.6 percentage points above its historical average in the last quarter of 2009.

Chart 16 Upward trend of consumer savings

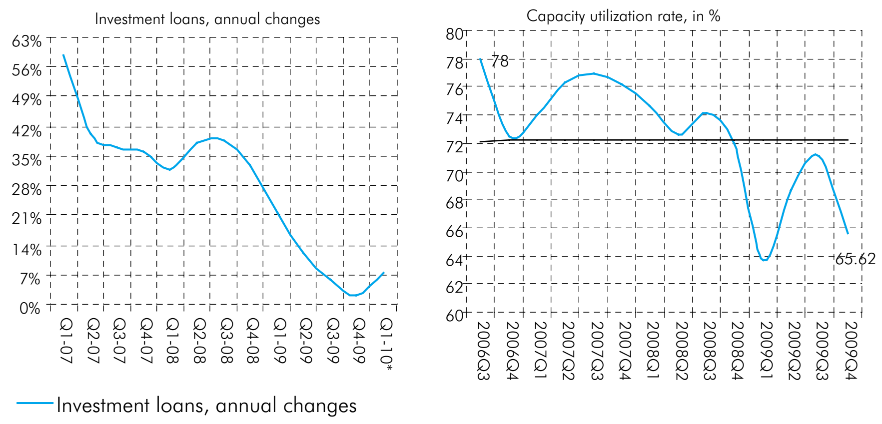


* Note: The annual rate of customer deposits for the first quarter of 2010 was calculated as the arithmetic average of annual changes in January and February 2010.
Source: Bank of Albania

Public sector consumption positively contributed to the growth of aggregate demand during the first half of 2009. Meanwhile, current public spending slowdown starting from the third quarter of the previous year continued in the first month of this year. Current expenditures increased by 5.3% in January 2010, compared with 13% in 2009.

Private investments contributed negatively to aggregate demand growth during the fourth quarter of 2009. The decelerated domestic and external demand, tightened investment loans and low levels of available capacity utilization, have negatively affected business decisions on carrying out new investments. New investment loans increased at very low paces. The latest data from banks' lending activity show that investment loan standards were somewhat relaxed in the first quarter of 2010.

Chart 17 Performance of investment loans and capacity utilization rate (in percentage)

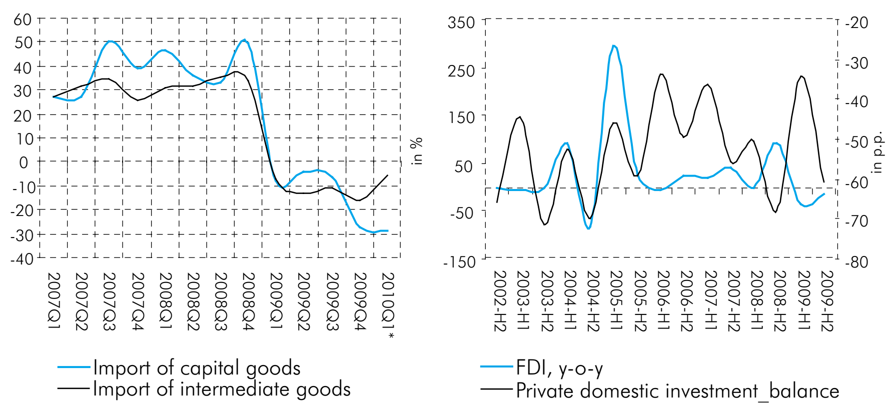


Source: INSTAT and Bank of Albania

Analysis of private investments in the economy for 2010 is also reflected in import of capital and intermediate goods, which continued its downward trend that started in the last year. The latest data for January-February 2010 presented further annual decline of these indicators, respectively by 28.5% and 5.5%. Foreign private investments, excluding privatization proceeds, have dropped by 61% as at the last quarter of 2009.

Public investments contracted by 27% in the fourth quarter of 2009 and by 2.2% in January 2010, decreasing the positive contribution of this component to aggregate demand for this period.

Chart 18 Investments contraction to the private sector

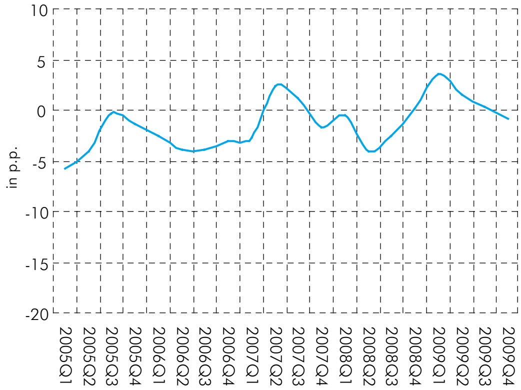


*Imports value for the first quarter of 2010 is estimated as the arithmetic average of annual changes of January and February 2010.
Source: INSTAT and Bank of Albania

Based on survey data, inventories position was upward during the first half of 2009, whereas businesses state that the inventory position slightly decreased in the last quarter of 2009.

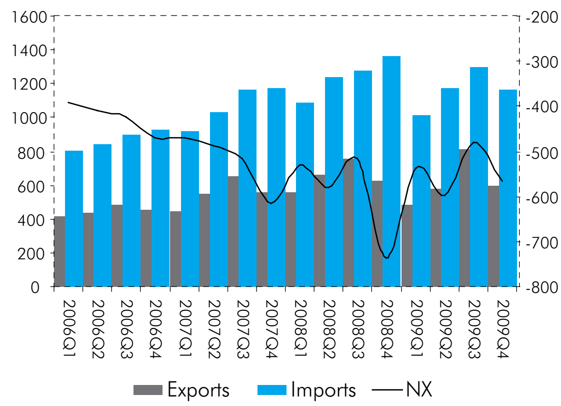
Net exports resulted negative in the fourth quarter of 2009, but at a smaller size than in the previous year. Imports and exports of goods and services decreased by 15% and 5% respectively, narrowing net exports by 23% in this quarter. The latest data on the first two months of 2010 attest to the continuation of the falling trend of imports (6.8%, in annual average terms) and to increase of merchandise exports (14.4% in annual average terms). Trade deficit narrowed during this period by 19.6% in annual terms, supporting the assessment to reduce the negative contribution of net exports on aggregate demand at early 2010.

Chart 19 Performance of inventories (in balance)



Source: Business confidence survey, Bank of Albania

Chart 20 Performance of exports and imports of goods and services and net exports, in million of Euros



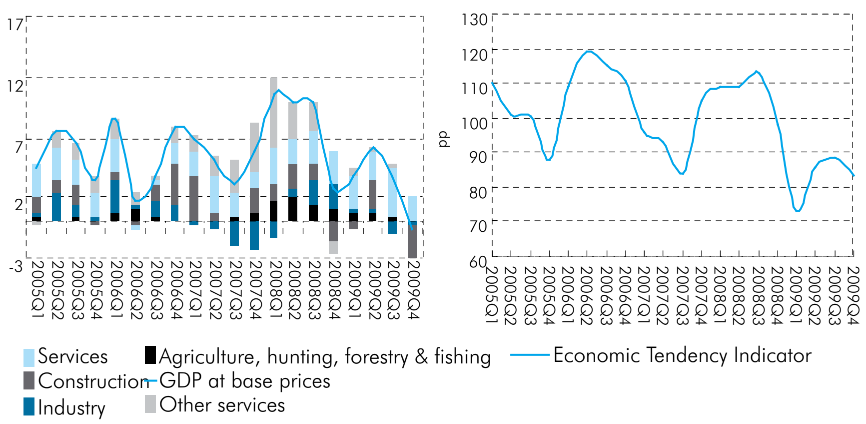
Source: Bank of Albania

IV.1.1 Output performance by sectors

During the fourth quarter of 2009, output underwent a downturn in annual and quarterly terms. Gross domestic product contracted by 2.4% at base prices compared with the third quarter.

Contraction of economic growth in this period was caused mainly by negative performance of manufacturing sector, which contributed negatively by 2.8 percentage points. Service sector, which made a positive contribution of

Chart 21 Gross domestic product at base prices and sectors' contribution to annual GDP growth (percentage point, left)



Source: INSTAT, Business Confidence Survey and Bank of Albania estimates about 2.0 percentage points, somehow offset the manufacturing sector's decline.

Industrial sector, in value-added terms, decelerated the annual decline over the fourth quarter of 2009, to 4.1%, down from 8.3% decline for the third quarter. The value-added from activities involved in it was reflected into a negative contribution to annual growth of GDP by 0.4 percentage points. The positive performance of domestic electricity generation[19] has contained somehow the falling trend displayed by industrial sector in the last quarter. The industrial confidence index continued to decline in the fourth quarter of 2009.

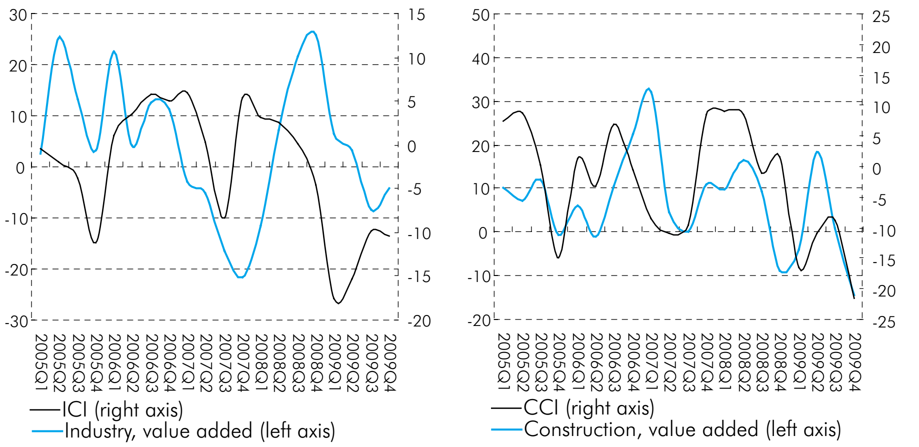
Statistics of energy balance sheet for the first quarter of 2010 are partial - they cover only the manufacturing side and not that of electricity consumption. Electricity generation during the first quarter of 2010 continued to record high growth rates in quarterly and annual terms (respectively 82.4% and 59.4%). The favourable hydro meteorological conditions impacted on the positive closure of export/import balance, and of the total balance of electricity net exchanges.

Table 5 Energy balance indicators

Energy balance indicators (in Gwh)	Q1 '06	Q1 '07	Q1 '08	Q1 '09	Q1 '10
Production	1612.9	811.8	1042.0	1457.7	2323.3
Import (-)	226.2	827.4	813.0	10.1	0.0
Export (+)	0.0	0.0	0.0	87.4	892.2
Balance (export-import)	-226.2	-827.4	-813.0	77.3	892.2
Received (-)	142.6	48.4	17.0	8.8	9.8
Given (+)	197.6	18.2	52.0	41.7	81.4
Balance (given - received)	54.9	-30.2	35.0	32.9	71.6
Total balance of net exchanges	-171.3	-857.6	-778.0	110.2	963.8

Source: AEC and staff estimates

Chart 22 Value-added (annual changes, in %) and the confidence index (in percentage point) respectively in the industry and construction sectors



Source: INSTAT and Bank of Albania

The energy balance (export – import) for the first quarter of 2010 resulted 892.2 Gwh, about 11.5 times higher compared to the first quarter of 2009. For the same period, the balance of electricity exchanges (given – received) was 71.6 Gwh. The net balance of total exchange of electricity for the first quarter 2010 was 963.8 Gwh, about 853.6 Gwh or 8.7 times higher compared with the same period of the previous year.

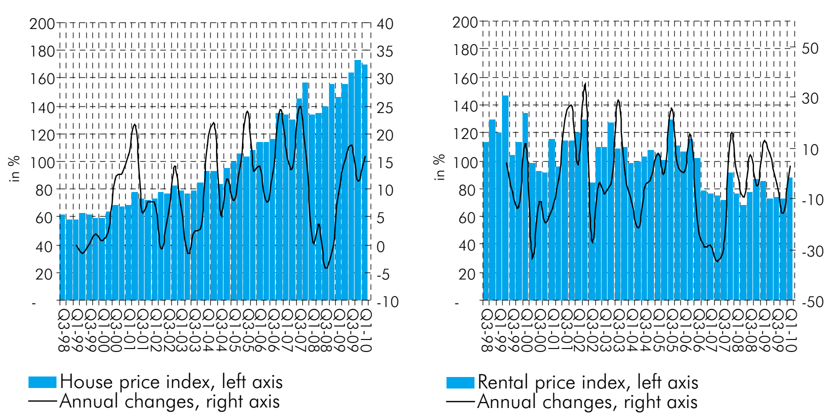
The value-added generated from construction sector recorded an annual decline of about 14.4% in the fourth quarter of 2009. The deterioration of construction activity, which was reflected into a negative contribution by 2.5 percentage points, represents the sector with the highest contraction in this quarter. The results of construction confidence survey and the annual decline in the lending to this sector are in line with its performance.

Box 2 House price performance[20]

House prices experienced an annual growth of 15.8 percent in the first quarter of 2010. House price index (HPI) increased annually, starting from the first quarter of 2009. A part of index rise (approximately 40%) reflects the pass-through of the lek's depreciation against the euro. Most of the prices collected to build the HPI are euro-denominated by builders or second-time house sellers. A detailed analysis of the performance of house prices and the factors that determine it is limited by the lack of data on the amount of transactions carried out in a quarter.

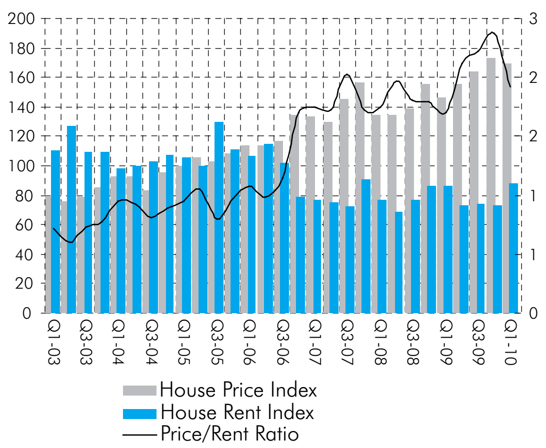
Developments in house prices in the first quarter of 2010 were impacted by a limited supply in the market. The number of building permits for new residential buildings decreased annually over the last three quarters of 2009. Tightening lending terms, the slowdown of the annual wage growth rate, coupled with the pessimistic expectations of customers for their financial situation, signal a low demand for housing. However, the supply to demand correlation in this market has not resulted in lower prices. On the other hand, the construction cost index followed a downward trend during the second half of the year.

Chart 23 House price index and rental price index



Source: Bank of Albania

Chart 24 Price/rent ratio

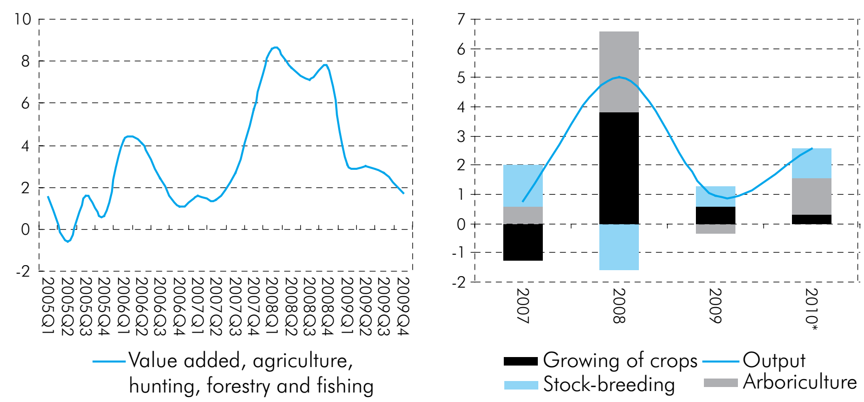


Source: Business and consumer surveys, Bank of Albania

Residential rental price index increased by 2.6% in the first quarter of 2010 compared to the same quarter of the previous year, following its decline over the third and the fourth quarter of 2009. Respective index changes over these periods were -4.4% and -15.6%. Rental price index grew by 21.1% in the first quarter of this year compared to the preceding quarter. House price to rent ratio dropped in the first quarter of 2010 due to reverse quarterly changes in house price and rent. This ratio is currently below its historical trend.

The value-added from agricultural sector in gross domestic product recorded an annual upward rate by about 1.7% and a positive contribution by 0.2 percentage points in the fourth quarter of 2009. More detailed information from the Ministry of Agriculture, Food and Consumer Protection attest to an annual growth of agricultural output[21] by about 1% in 2009. This rate was four percentage points lower than in the previous year. Stock-breeding is the branch that provided a significant contribution to this growth. For 2010, forecasts show an improvement in agricultural output, mainly from arboriculture output.

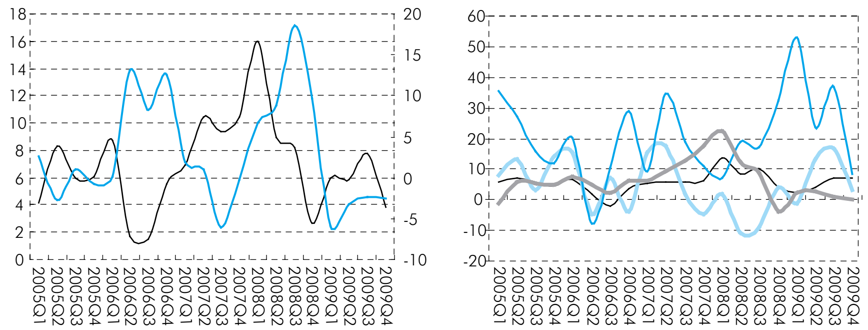
Chart 25 Value-added in agricultural sector (annual changes in %, left) and branch contributions to annual growth of agricultural output, right)



Source: INSTAT and Ministry of Agriculture, Food and Consumer Protection

In the fourth quarter the service sector continued to make the largest positive contribution to annual GDP growth, though at a smaller extent than over the previous three quarters. Activities included in services[22] contributed by 2.1 percentage points, offsetting the negative contribution of other services[23] by about 0.1 percentage points. Division "Trade, hotels and restaurants" scored the highest annual growth in terms of value added, 7.2 percent; its trend accelerated during the year. In terms of the confidence indicator in services, it has deepened the decline by 0.2 percentage points compared to the third quarter, signalling the slowing growth of the annual value added of this sector in gross domestic product.

Chart 26 Value added (annual changes, in %) and confidence index (in percentage point) in service sector (left) and the value added by service activity (annual changes in %, right)



Source: INSTAT, Bank of Albania estimates

IV.1.2 External sector developments

The overall balance of payments in the fourth quarter of 2009 resulted in reduced foreign assets. Capital and financial account surplus decreased, allowing for the partial funding, to 32%, of current account deficit. The latter showed a correction to the greatest extent in this quarter against the background of economic weakening at home and still low level of the demand and trade activity in the world.

Current account deficit was narrowed by about 23% annually in the fourth quarter, estimated at about 16.6 percent of GDP. The slowed domestic demand and the decreased global trade activity were manifested in the rapid decline of imports versus exports at home. Meanwhile, net income from direct investments resulted in a deficit for the fourth consecutive quarter. The financing of the current account deficit was covered to 32.1% by capital and financial account surplus. In view of enhancing prudence to perceived risk for investments, foreign direct investments, excluding privatizations, recorded an annual decline of around 60 percent in the fourth quarter of 2009. At the same time, there was also recorded a reduction of private and state borrowing during the same period. The overall balance of payments for the last quarter of 2009 resulted in decreased foreign assets of about Eur 86.7 million.

Table 6 Indicators of the balance of payments

Key items	In million of Euros				
	Q4 '08	Q1 '09	Q2 '09	Q3 '09	Q4 '09
Current account	-453.2	-319.8	-367.6	-291.7	-347.8
Trade balance	-740.9	-516.8	-579.0	-606.6	-601.3
- Export	208.6	175.7	183.4	186.0	205.5
- Import	-949.5	-692.5	-762.4	-792.6	-806.9
Services (net)	3.4	-21.1	-18.6	126.2	34.5
Revenues (net)	52.7	-11.5	-17.0	-25.3	-24.9

Current transfers (net)	231.6	229.6	246.9	214.0	244.0
Capital and financial account	785.2	271.1	434.1	201.5	111.6
Capital account	20.3	19.6	16.2	32.1	17.0
Financial account	764.9	251.5	417.8	169.4	94.6
Foreign direct investments (inflows)	239.3	123.4	306.1	156.1	112.4
Government borrowing (withdrawal)	151.0	58.0	165.0	142.0	31.0
Private borrowing (withdrawal)	49.0	8.0	3.0	24.0	4.0
Errors and omissions	-241.4	-82.1	75.2	134.2	149.5
Overall balance	-90.5	-130.9	141.6	43.9	-86.7

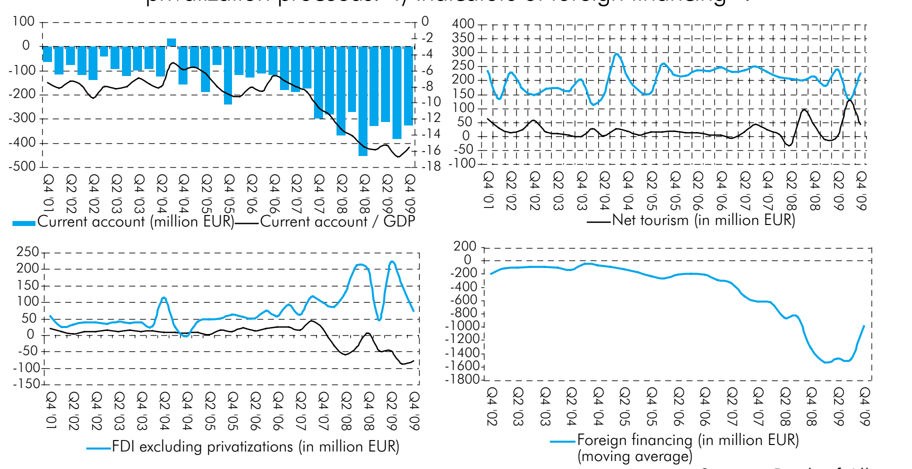
Source: Bank of Albania

CURRENT ACCOUNT

In the last quarter of 2009, current account recorded a deficit of Eur 347.8 million or 16.6 percent of GDP. Reduction of deficit by about 23.3% in annual terms was primarily due to decreased trade deficit and widened service account surplus against the fourth quarter of the previous year. Negative net position of revenues account continued to provide a negative impact on current account performance for the fourth consecutive quarter.

The deficit of net exports has been contracting over the last two quarters of the year, mitigating the negative impact on aggregate demand compared to the previous year. This development was due to increased financial flows from personal services, mainly from net income from tourism, as well as from reduced merchandise imports. Meanwhile, the revenues account, conditioned by the negative net position of investments revenues, recorded a deficit of Eur 24.9 million. In contrast, the positive balance of current transfers expanded by around 5.3% in this quarter compared to the same period of the previous year. This inflow of revenues financed about 41 percent of trade deficit. However, the main sub-item of this account, "remittances", continued the decline that had started since the last quarter of 2007. In annual terms, this sub-item decreased by 7.3%.

Chart 27 Current account (in million of Euros) to GDP (moving average). 2) Net income from remittances and tourism. 3) Income from direct investments and FDIs excluding net privatization proceeds. 4) Indicators of foreign financing[24].



Source: Bank of Albania

Box 3 Correction of current account deficit in countries in the region

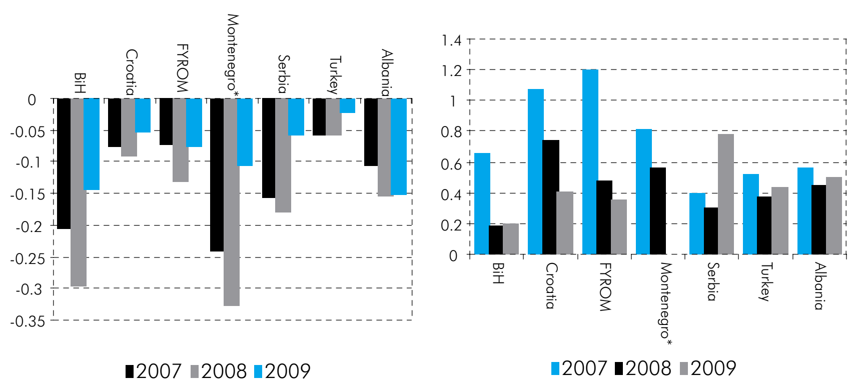
The balance of payments is a statistical statement which summarized systematically, for a certain period of time, a country's economic transactions with the surrounding world. These transactions, which in most cases take place between residents and non-residents, imply economic activities recorded in two main accounts: current account and financial and capital one. If the inflows into these accounts are lower than outflows, we say that the account results in deficit.

Current account deficit, as a measurer of flow of resources to an economy to finance the demand for investments can reflect on the one hand, the economic potential of a developing country and on the other hand, it reflects the imbalance between savings and domestic investments, leading to debt accumulation[25] (Roubini and Watchel, 1998)[26]. Financing of current account deficit requires capital inflows (new net borrowings) from the rest of the world. In this way, capital and financial account results positive and counter-balances the negative current account, indicating that the country is accumulating debt. The latter may be less problematic if these funds are used to finance investments rather than to finance consumption. Higher rates of investment would boost future productive capacity and potentially exports, which would serve to finance the external debt.

A country can have an ongoing current account deficit and continue to fulfil its obligations if the lenders expect that in future it will generate sufficient income. However, if the current account dynamics leads to unlimited growth of external debt as a share of GDP, then the current account may be considered as unsustainable. This occurs especially when the deficit is financed from short-term debt or decrease in foreign reserve, and when high growth of consumer spending is reflected. Here arises the discussion on current account (non-)sustainability. This occurs when financial markets get concerned about the country's willingness and ability to pay debts and react by limiting the amount of borrowing, thus leading to a foreign debt crisis.

In some countries in the region (chart 28) it is noted that current account for several years in a row has been characterized by a relatively high deficit, above 5% as a share of GDP. It means that for many years they have imported foreign savings to finance investments in the country, in view of economic integration and approximation to developed countries. Intensification of the global financial crisis caused further expansion, making these countries face the collapse of internal and

Chart 28 Current account deficit (left, in % to GDP) and foreign direct investments (right, in % to current account)



*The data include only the first three quarters of 2009.
Source: Central banks of respective countries

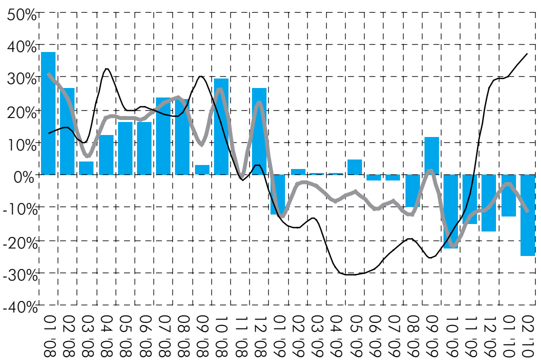
external macroeconomic balances. Thus, in 2007, as the pre-crisis period, current account deficit resulted above 10% of GDP in countries such as Serbia and Albania, whereas in countries such as Bosnia and Herzegovina and Montenegro the current account deficit was above 20% of GDP. Upon global crisis intensification in 2008, further expansion of deficits put into question the future performance of current account deficit and the possibility for financing it. Facing such a situation, the policy-makers of these countries took various measures to correct the current account deficit. The correction process occurred even in Macedonia, where the enhanced competitiveness thanks to structural reforms and prospects to become part of the EU, supported the attraction of foreign direct investments, thus moderating the current account deficit. In Serbia, the exchange rate depreciation was insufficient to correct the current account deficit, therefore, upon financial crisis onset, a number of somewhat protectionist measures were adopted, such as consumer lending for domestic products, reduction of wages and consumption. In Albania, a country with a free exchange rate regime, the effects of current account imbalances were somewhat buffered out by exchange rate depreciation and capital inflows.

The size and speed of current account correction in each of these countries seems related to the manner of financing the current account deficit prior to financial crisis onset. In contrast to the countries in which foreign direct investment accounted for the largest share in the financial account, such as Croatia and Montenegro, the other countries that have relied more on other investment flows, such as Bosnia and Herzegovina, Former Yugoslav Republic of Macedonia and Serbia generally had a more pronounced contraction of the current and capital account deficit. In countries such as Albania and Turkey, where the current account deficit was financed from inflows of foreign direct investments and other investments, the increased deficit and its ongoing correction was more moderate. High flows of other net investments in these countries during the financial crisis can be attributed partly to global deleveraging[27] that derived from significant increase of perceived risk by investors and capital orienting towards developing countries.

FOREIGN TRADE

The trading activity of our country increased during the first two months of 2010, driven mainly by increased exports. In line with improved world trade volume, trade exchanges (in value) rose by 0.7% percent in annual average terms for January to February of this year.

Chart 29 Annual changes of imports, exports and trade balance (in percentage)

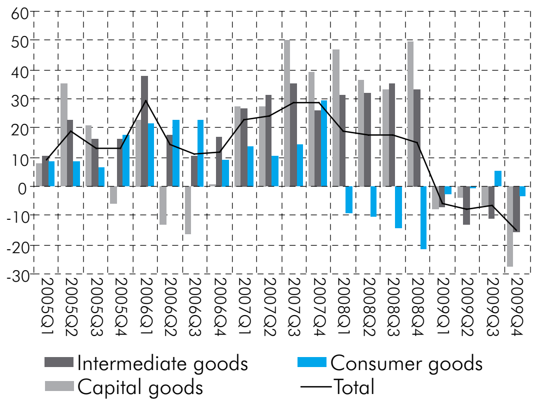


Source: Bank of Albania

Against the backdrop of slowed domestic demand, merchandise imports continued their downward trend. Meanwhile, the favourable conjuncture of raw material prices in the global market, along with exchange rate depreciation and statistical effect of comparison with the low base, have contributed to the upward performance of exports during these months. Trade account deficit for this period, estimated at Eur 295.8 million, was about 19.6% lower on an annual basis. The coverage ratio of imports by exports is estimated at 33.7%, roughly 10.2 percentage points higher than at the same period of the previous year.

The positive performance of exports in our country during December '09 – February '10 is caused mainly from increased raw material prices[28] and low comparative base of the previous year, against the setting of the decline in the world trade activity. Also, the increased presence of Albanian products in unconventional markets at competitive prices, as a consequence of the real exchange rate depreciation and the recovery of world economic activity helped increase exports. During the period under analysis, euro-denominated exports recognized an average annual growth of 31.4%. Their increase positively impacts on the extracting and processing industries in the country. Along with re-exporting products, exports of "Unprocessed and mineral goods"[29] and "Fuels" also recorded high growth rates. Electricity export increased by about Eur 7 million for the period.

Chart 30 Annual changes in the import of capital, intermediate and consumer goods (in %)



Source: Bank of Albania

Imports for the first two months of the year have shown a falling trend that appeared at the end of the previous year[30] reflecting the economic slowdown in the country. Almost all key import subgroups have also declined, except the group "Foods and live animals". The limited domestic supply of agricultural products and the low elasticity of the demand for food products have resulted in increased imports of this category, averaging 15% in annual terms. According to final use in the economy, the acceleration of downward rates of import of "Capital goods" is highlighted. The import of these commodities fell by about 28.5% in average terms for the first two months of 2010, while in 2009, they dropped by 12.7%. The imports of "Consumable goods" grew on average by 3.7% compared with the first two months of 2009. The value of imports of the third category, "intermediate goods", decreased at more moderate paces compared with the average of the previous year.

European Union member states remain the main trading partners of our country, accounting for about 67 percent of trade exchanges for the first two months of the year. Imports from Greece and Italy account for the largest share to total imports. As a result of signing the Free Trade Agreement with Central European countries[31], trade exchanges among member states[32] increased by about 12 percent in annual terms. Imports went up from countries such as Russia and the U.S.A and decreased from countries such as Turkey and China. On the other hand, exports to Italy, Switzerland, China and the U.S.A edged up, whereas to Greece they went down.

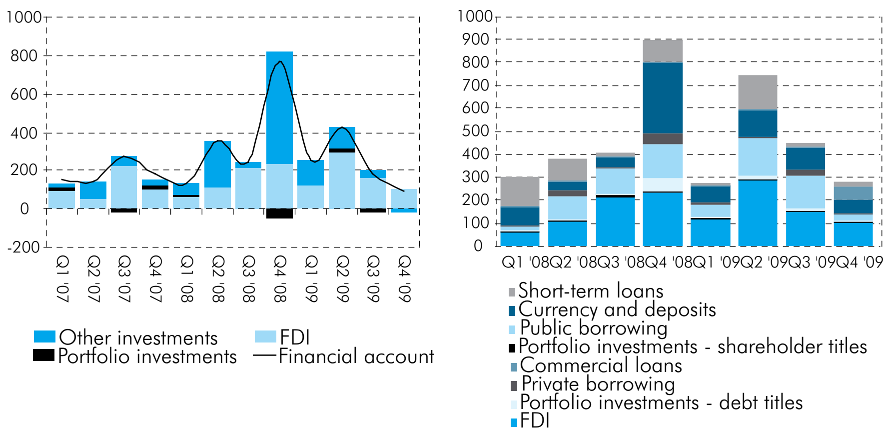
CAPITAL AND FINANCIAL ACCOUNT

Capital and financial account during 2009 resulted in reduced surplus by about 35.6% compared with the previous year. The impact of global financial and economic crisis and limited financial resources in international markets were reflected chiefly in decreased net flows of borrowing and reduced foreign direct investments. In the fourth quarter of the year, the net capital inflows were estimated at about Eur 111.6 million, about 85.8 percent less than in the fourth quarter of the previous year. Capital and financial account surplus managed to finance about one third of the current deficit for the last quarter of the year.

The country's financial dues to the world, mainly in borrowing and the banks' positions on short-term loans, were downward. The flow of borrowing during the fourth quarter was Eur 8.9 million, about 95.1% lower relative to the same period of the previous year. This decline was due to the decreased private borrowing and government one, respectively by 91.8% and 79.5% in annual terms. Short-term borrowing of the banking system also went down. In the fourth quarter of 2009, the banks' position for short-term loans was Eur -21.9 million, from Eur 93.7 million in the same period of the previous year.

Foreign direct investment inflows in the fourth quarter of the year recorded Eur 112.4 million, roughly 53.0% lower compared to the same period of the previous year. The low level of these inflows at the end of 2009 reflected mainly the lack of proceeds from privatization. However, inflows in the form of foreign direct investments to Albanian economy were a dominant factor in increasing the financial liabilities to the world.

Chart 31 Financial account (left) and main items (right)* by quarters – net flows in million of Euros



Note: * Reported in absolute value
Source: Bank of Albania

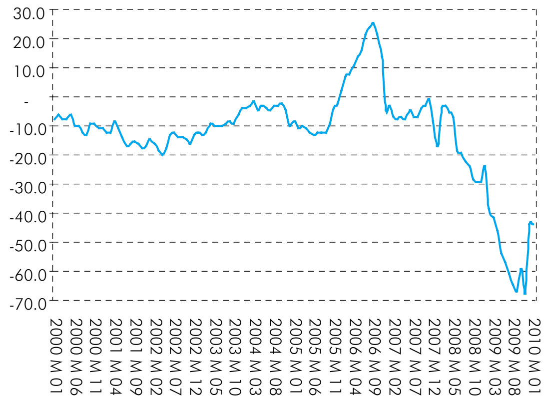
On the asset side, banking deposits with non-resident financial institutions went downward, except in the third quarter of 2009. For the fourth quarter of 2009, this amount was Eur 46.1 million, about 84.4% lower than in the previous year. On the other hand, a phenomenon observed during the second half of 2009 is the increase of short-term loan positions, which contributed by Eur 56.5 million to the growth of our assets abroad.

Foreign reserves in the fourth quarter of the year decreased by Eur 86.7 million. The stock of foreign reserves at end 2009 marked Eur 1.663 billion, sufficient to cover 4.2 months of import of goods and services.

IV.1.3 Developments in fiscal indicators and fiscal policy

The fiscal policy at the beginning of 2010[33] followed the trend of the last quarter of 2009, showing signs of fiscal expansion restraint. Budget revenues and expenditures increased very slowly, reflecting on the one hand the economic slowdown and on the other, the lessening of the contribution of this component to aggregate demand.

Chart 32 Moving sum of primary deficit for 12 months, M1, 2000 – M1, 2010 (billion of leks)



Source: Ministry of Finance, BoA staff estimates

Budget revenues in January were realized by about ALL 24.8 billion, while the expenditures by about ALL 22.5 billion. Budget balance resulted positive by about ALL 2.3 billion. Operational data[34] until the end of the first quarter 2010 show a slowdown in the revenues growth pace compared to the first month of this year. In contrast, budget expenditures have recorded higher growth rates than in the beginning of the year; therefore the budget balance has not followed the same trend with that of January 2010. According to operational data, fiscal performance indicators signal an expansionary fiscal policy, unlike that of January 2010.

The moving sum of primary deficit[35] at the end of January marked ALL 44.1 billion. This indicator was at relatively high levels over the past two years, reflecting *inter alia* the expansionary nature of fiscal policy, as well as increased public debt stock.

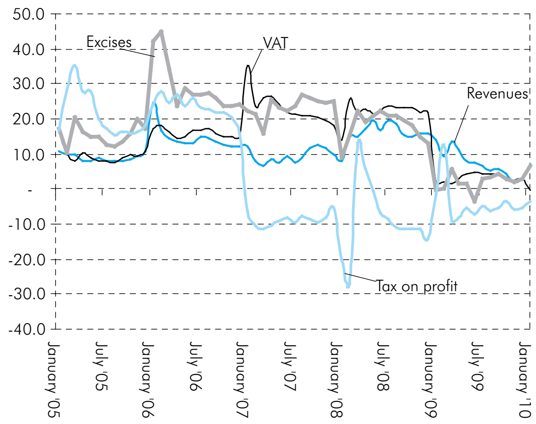
The increased public debt stock (which was 59.5% of GDP as at end 2009) has reflected the expansion of negative gap between economic growth and interest rates paid on the debt received over the previous periods.

Table 7 Performance of key fiscal items, January '09 – January '10

	Actual level (in ALL billion)		Against the plan (in %)	Annual change (in %)
	January '09	January '10	January '10	January '10
Revenues	23.2	24.8	99.7	7.2
- Tax and customs duties	15.4	15.6	91.5	1.3
VAT	8.24	8.23	91.0	-0.2
Profit tax	1.1	1.1	83.4	-3.6
Excise duty	2.2	2.3	87.5	6.6
- Local government	1.0	1.1	94.3	5.7
- Independent budget	5.0	5.1	95.7	2.0
- Non-tax revenues	1.8	3.0	227.1	68.1
- Grants	0.0	0.1	88.5	785.2
Expenditure	21.7	22.5	92.2	3.8
- Current expenditure	17.3	18.3	93.3	5.3
Personnel	5.0	5.3	98.5	7.6
Interests	3.5	2.1	93.9	-38.6
Social security and pensions	5.9	7.1	89.2	20.0
Local government spending	1.1	1.2	93.0	9.6
- Capital spending	4.4	4.3	92.5	-2.2
Budget balance	1.5	2.3	497.2	57.8

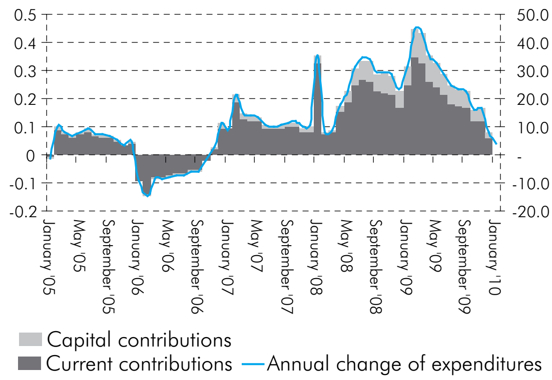
Source: Ministry of Finance

Chart 33 Annual changes in key revenues items, M1 2005 - M1 2010



Source: Ministry of Finance, staff estimates

Chart 34 Annual change of total expenditures (in percentage, left) and the upward contribution of current and capital expenditures (in percentage, right) for M1 2005- M1 2010



Source: Ministry of Finance, staff estimates

Revenues behaviour for January '10 followed the trend observed during the second half of 2009. Budget revenues marked an increase of about 7.2% in January, but however at a lower rate compared with 18% in the same month of the previous years[36]. The decelerated growth of revenues is driven primarily by lower contribution of VAT revenues relative to the previous years[37]. Other items that have contributed positively to this growth are revenues from social securities, non-tax and excise duties. Since import of goods subject to excise duty stood at the same levels or lower than in the previous year[38], part of the contribution of excise revenues to total revenues reflects the effect of amendments and alterations to the Law "On Excise Duty", in September 2009[39].

In January '10 budget spending increased by about 4% relative to the previous year. The main contribution is given by current expenditures, while capital expenditures contributed by about 1 percentage point to total expenditures. The contribution of long-term expenditures is expected to remain moderate during the current year, as investments are not projected to be at similar level with 2008-2009.

Budget spending realized in January carry over differences as concerns the level projected by the Ministry of Finance by about ALL 1.9 billion or 8 percent. The main difference from the projected level is caused by social security outlays and capital expenditures.

BUDGET DEFICIT AND ITS FINANCING[40]

Budget balance in late January resulted positive, due to a more active policy in terms of budget revenues. However, this behaviour is more related to the seasonality of this indicator, since year-start experiences almost only short-term expenditures.

New borrowing during January was evenly distributed between the issuing of short and long term instruments, respectively ALL 1 billion. During the first months of 2010, there was noted a change in the policy stance of government borrowing from the trend shown in the last quarter 2009. More specifically, the strategy of the Ministry of Finance to increase the domestic stock through the issuing of 12-month treasury bills and bonds of all maturities, against non-equivalent reduction of debt amount on treasury bills of a maturity term of under one year, found support by securities market actors. Thus, the demand of participants in all security auctions exceeded the amount announced by the Ministry of Finance during the first quarter of 2010. Also, the participation of individuals, especially in 12-month T-bill auctions was at fairly high levels during this period.

Box 4 Post-crisis period and challenges in the public sector

The global financial crisis spread rapidly in the real sector of the world economy. The latter was characterized by a contraction of global economic activity due to global economic downturn in the developed countries and significant economic slowdown in developing countries[41] during late 2008 and the first half of 2009. In response to this situation, most countries used fiscal stimulus to recover the economy. As a result, almost all countries were characterized by deterioration of fiscal positions, reflected in the expanded budget deficits and increased public debt stock.

Due to implementation of fiscal packages and operation of automatic stabilizers, budget revenues declined and public spending increased. The deterioration of public finances during the crisis, on the revenues side, was triggered by: (i) permanent or temporary reduction of some taxes on consumption, capital and wages or exclusion from taxes, either permanently or temporarily, (ii) lower level of meeting tax obligations than in the pre-crisis period[42], (iii) reduction of income tax at more accelerated rates than the economic activity contraction[43]. On the other hand, fiscal packages aimed at increasing public spending have provided a more measurable effect on increasing the budget deficit, compared with fiscal incentives oriented towards tax reduction or elimination. Fiscal stimulus is mainly focused on supporting the financial sector, but also spending on public investments and transfers to customers, businesses and local authorities have not lacked.

In most countries, fiscal stimulus is concentrated more in 2009. But, there are countries which plan to stimulate the economy even during 2010. However, for the current year, fiscal stimulus is expected to be reduced gradually and be applied rarely[44]. The deterioration of fiscal positions in both the developed and developing countries is not fully dedicated to the measures taken during the crisis. During the crisis onset, many developed countries were faced with relatively weak structural fiscal positions[45]. Great challenges are currently ahead of the public sector. Taking into account the deterioration of fiscal positions over the past two years, fiscal corrections are needed to return to a sustainable fiscal trajectory. Fiscal consolidation, which should be on focus of medium-term government budget programs, should target the balance improvement adjusted from business cycle effects[46]. In this way, it will contribute to reducing public debt stock. Attaining the pre-crisis level would be a simple criterion to deem the appropriate extent of public debt stock correction. At this level, it would be achieved (i) eliminating the risk of transferring crisis costs to later generations, (ii) reducing the crowding out effect for the private sector, thus prompting Ricardian behaviour[47], (iii) curbing upward pressures on interest rates, which though being stable at end-2009, they still carry over risk for any probable increase, in light of the market perception for probable fiscal risks, and (iv) creating larger fiscal room available to the governments to counter any possible recession in a later period.

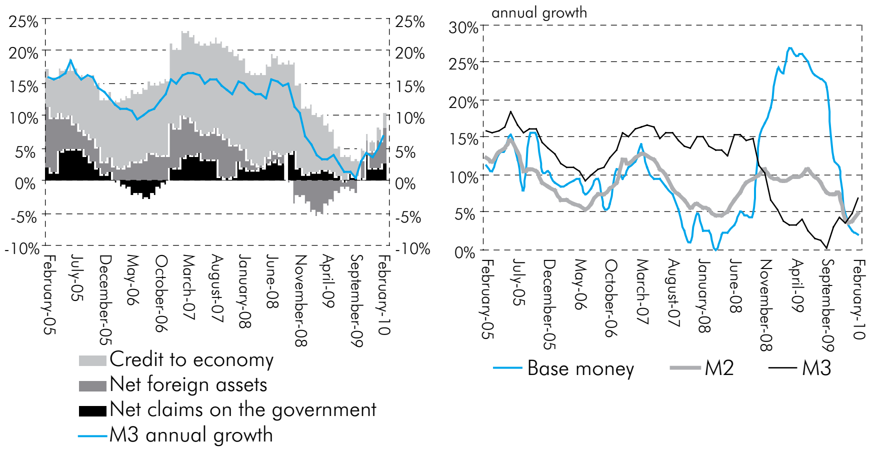
Depending on the level and structure of revenues, tax rate and type of expenditure, fiscal correction content may vary from one country to another. However, reforms and implementation of fiscal rule is a key factor that ensures the progress of fiscal correction, regardless of its content. The practice of countries that have applied major fiscal corrections[48] supports such a thing. Fiscal rules[49], in line with medium-term objectives of debt strategy, have proved to be effective in reducing the debt stock and improving the budget performance. However, it is worth mentioning that other additional criteria - the institutional coverage and the legal framework, along with the basic ones - which relate to the implementation, monitoring and transparency of fiscal rule, have contributed positively to achieving fiscal correction mostly over the medium run or even beyond.

IV.1.4 Monetary developments

Besides the positive performance over the recent months, monetary indicators continue to maintain moderate growth rates, supporting the assessment that inflationary pressures of monetary nature will remain at low levels during the following periods. The main contribution to monetary expansion since the fall of 2009 is given by its foreign exchange component. Meanwhile, the demand for currency by the public sector has contributed at moderate levels to annual M3 expansion. The low intermediation offered by the banking system in response to increased prudence in lending activity, coupled with the low demand by private agents as a result of the slowdown in the country's economic activity, has left little room for recovery of the growth rates of this broad money component.

Monetary developments during the first quarter of the year[50] have confirmed the positive performance of monetary expansion noted at the end of 2009. Money supply, M3, has recorded average annual growth of 8.3% during this period, compared with the average rate of 6.6% for the previous quarter. This expansion has reflected primarily the increased foreign currency deposits attributed to seasonal inflows from remittances, as well as the correcting effect of deposits withdrawal over the past year. The contraction of financial resources in 2009 impacted on low financial intermediation rates over the first quarter of this year, reflecting also the low demand of economic agents for monetary instruments. The money creation in the economy during this period was mainly supported by expanded net foreign assets of the system. In February, the contribution of this component to annual monetary expansion hit the highest levels in last three years, to 6 percentage points. The banking system has continued to support the expansion of lek-denominated financial assets through borrowing at the Bank of Albania, even though at lower levels than in the second half of 2009.

Chart 35 Contributions of money demand components to M3 and annual growth rate of monetary aggregates

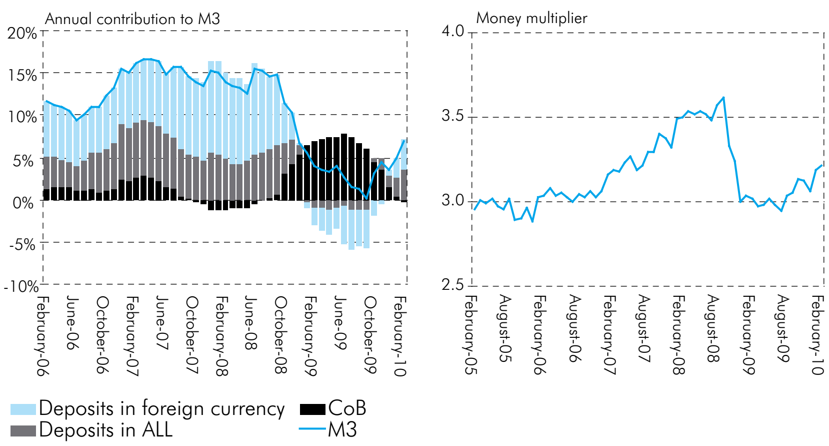


Source: Bank of Albania

BROAD MONEY INDICATOR

Money supply, M3, excluding the exchange rate effect[51], recorded an average annual growth of 6% versus 3.7% in the previous quarter. Monetary expansion resulted from the positive contribution of foreign currency deposit growth, against the setting that the M2 aggregate has slowed the annual growth rates and the M1 has decreased. The lek currency indicator, M2, expanded on average by 4.3% in annual terms, being decelerated by 2 percentage points compared with the previous quarter. The households' interest in investing in government debt securities, accentuated during 2009 and in the first months of 2010, has impacted on lessening the contribution of domestic borrowing to the annual pace of M2 aggregate growth. Moreover, its performance has also reflected a significant decline of the most liquid aggregate, currency outside banks during this period. Consequently, high-powered money, base money and narrow money indicator, M1, have carried over the effects of this decline. Thus, the annual rate of base money growth slowed to 2.3%, while the M1 aggregate decreased by 2.2% on average in annual terms during January to February. Reduction of currency outside banks and monetary expansion have influenced on the growth of broad money multipliers. This indicator has average around 3.2 in January and February, from 1.3 in the previous quarter, confirming its upward trend noted in the second half of 2009. However, the money multiplier continues to remain at lower levels than the pre-crisis ones.

Chart 36 Contributions of money supply components and money multiplier



Source: Bank of Albania

Box 5 Performance of money velocity in Albania

Box 2 of the Annual Report 2009 analysed the performance of money multiplier, which shows the relationship between the intermediate target (money supply) and operational objective (base money components). It came out of the analysis that this indicator is volatile in the short run, making the central bank's work more difficult in meeting an intermediate goal formulated in monetary terms. This box analyzes the performance of money velocity, which is a stable measurer of the demand for money.

The stability of the demand for money is an essential aspect of a successful monetary targeting regime. A stable demand for money implies a predictable relationship between inflation and expansion of monetary aggregates. Money velocity is known as the rate at which money circulates in the hands of economic agents to finance transactions in the economy at a certain period of time. One of the earliest monetary theories is the quantity theory of money. Otherwise known as the quantity equation, it is based on the relationship between money supply in the economy, M, and the market prices of products (py). The quantity theory of money is raised on the assumption that money velocity (V) is held constant over the time – or evolves predictably, assuming that economic agents do not change the inclination and the way of spending in the short-run[52]. Denominated as the velocity function, the equation takes the following form:

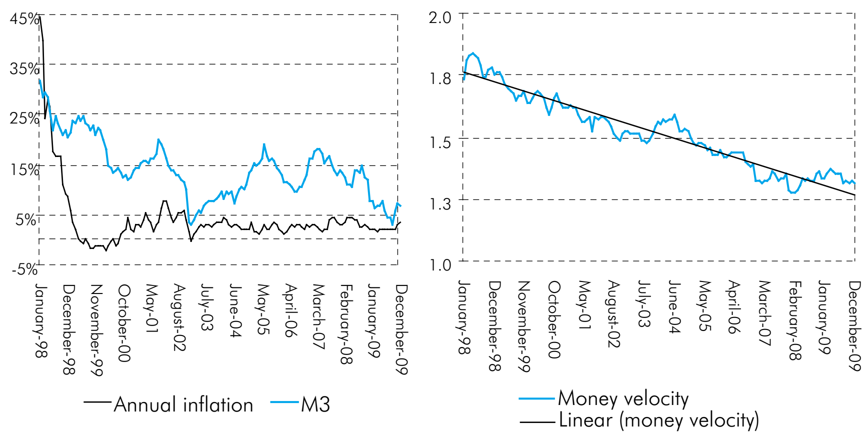
$$V_t = \frac{P_t \times y_t}{M_t}$$

This theory is based on the principle that prices respond proportionally to any changes in the money supply. From the monetarist viewpoint, the money-supply growth beyond the growth of real income will lead to an inflationary situation. On the other hand, the economic theory assumes that in the long run, there is a stable relationship between economic activity and monetary indicators. If the money velocity is determined clearly, the central bank would aim at a money stock level in line with the targeted price level and real economic growth forecasts. In reality, experience and observations of money velocity behaviour has shown that it is not stable, weakening the relationship between nominal income and money stock. If money velocity is volatile, the money demand is also unstable. Therefore, monetary authorities can not rely on the relationship between money supply and inflation for making decisions about monetary policy.

GDP indicators' performance and money supply in Albania in last 10 years confirms a more accelerated pace of money stock growth than that of nominal GDP. Also, in the presence of fluctuations and high money stock growth rates, inflation rates have turned out to be low and stable. The money velocity indicator has been volatile and downward during the same period. The decelerated velocity of money in circulation is attributed to boosted confidence in our financial system and financial innovations in terms of increasing the means of payments provided by this system. The boosted confidence in the financial system makes individuals and families proportionally hold a greater share of their savings in the form of financial savings. In particular, the increased uncertainty in the financial system was associated with an upward trend of the velocity of money in circulation in 2009, especially in the second half of the year. On the other hand, the introduction of new payment instruments leads to curtailed role of cash in carrying out transactions in the economy. Both these factors have motivated the downward trend of the velocity of money circulation. But, what is more important in compiling and implementing the monetary policy, this downward trend is not linear and uniform. In the short run, it reflects a pronounced volatility, weakening the relationship between monetary aggregates and inflation, as well as making more difficult the central bank's work in compiling a monetary policy solely based on monetary indicators.

If the central bank - under the monetary targeting regime - would have assumed a constant velocity at 1.32[53] during 2009, the average broad money growth rate would be aimed at 7.6%. In reality, due to fluctuations in the money velocity, the M3 growth rate resulted lower, averaging 6% in 2009. Thus, money supply growth by 1.6 percentage points would have created more room for inflationary pressures.

Chart 37 Inflation and money velocity



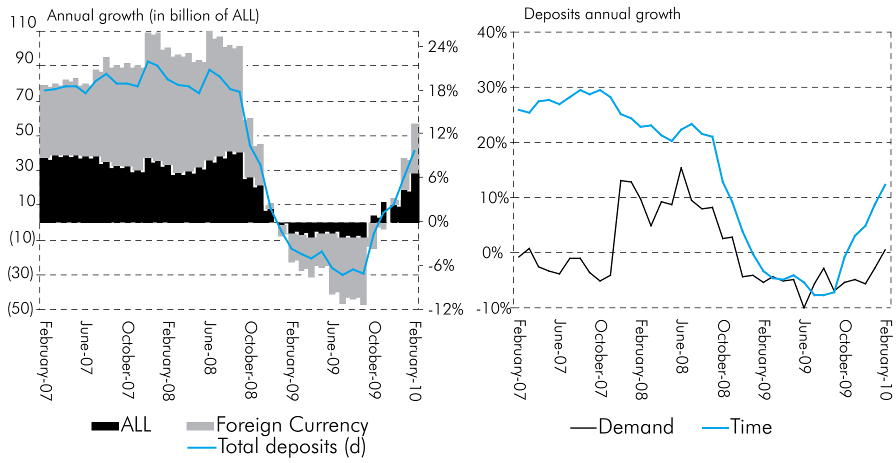
Source: Bank of Albania

These deficiencies of the monetary targeting regime, the volatility of money circulation velocity and volatility of its multiplier, have made many central banks not rely on the monetary targeting regime in compiling and implementing the monetary policy. Instead, the trend noted over the past two decades, is that of adopting inflation targeting regime. Under this regime, the central bank's monetary policy is informed via a wider framework of information. This framework includes not only monetary indicators, but also those of the real economy, systemizing them in econometric models designed to capture the behaviour of the whole economy. The central bank's monetary policy is guided by the final product of these models: the performance of forecasted inflation as an intermediate target, vis-à-vis the final objective of inflation targeting.

DEPOSIT PERFORMANCE

Developments on the supply side have confirmed ongoing improvement of deposit stock in January and February. Restoring the confidence in the banking system, in the aftermath of the global financial crisis, and promoting economic agents to save as a result of raised uncertainty is associated with a gradual rise in deposits. Deposit stock in February was about 9.6% higher than in the previous year. Total deposit share to M3 reached 76.8%, versus 75% at year-end. The deposit term structure has shifted from demand deposits to time ones, for both the national and foreign currencies. This performance has signalled an upward trend of savings, which is also sustained by maintaining high deposit interest rates. Consequently, at the end of the period, the share of time deposits to M3 expanded to 61%, up by 3 percentage points against last-quarter end. The deposit stock expansion has taken place mainly in household time deposits. Their share to M3 grew to 56.7% at the end of February 2010, versus 53% at the same period of the previous year.

Chart 38 Deposit performance by foreign currency and term structure

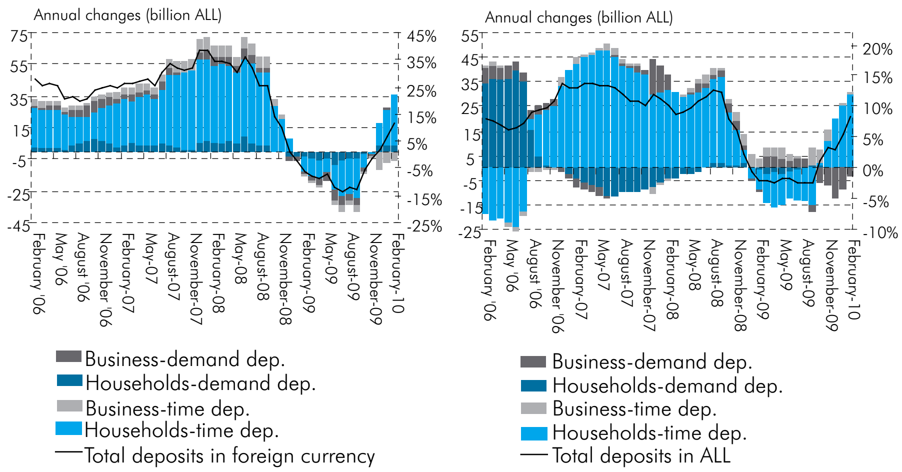


Source: Bank of Albania

According to foreign currency structure, foreign currency deposits marked an annual average growth of 9% during the period of January-February, relative to the annual average drop of around 4% at the same period of the previous year. The upward trend is noted in the performance of household deposits, which have shown ongoing positive rates in monthly and annual terms. The performance of business deposits was unstable, volatile, depending on their economic activity. Lek-denominated deposits remained stable, characterized by a monthly average increase of about ALL 3.3 billion. The total lek-denominated deposit stock has increased annually by 8.3% at the end of the period. Their sectoral structure is dominated by household deposits, which grew by about ALL 11 billion during January-February.

Total household deposits in February were about 14.5% higher than in the previous year. Household deposit stock expansion was partly depreciated by

Chart 39 Annual changes of deposits in lek and in foreign currency by sectors of the economy



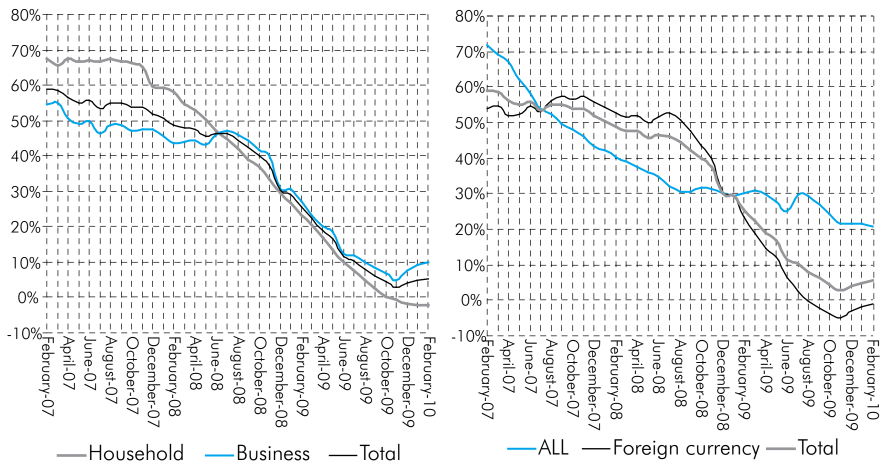
Source: Bank of Albania

the decline of business demand deposits in the national currency and time ones in foreign currency.

LENDING TO PRIVATE SECTOR

Though at low levels, the increase of lending to the private sector in the first two months of 2010 confirmed the positive performance that started since December of the last year. Annual growth rate of credit outstanding in February amounted to 5.4%[54], from the low record of 2.8% marked in November. This performance is driven by positive developments in business loan portfolio. Household loan continues to shrink at rates comparable to those of December last year. On the supply side, loan portfolio developments, especially in the latest months, were helped by improving liquidity of banks and easing of business lending standards. On the other hand, there is noted a rise in the credit demand by the private sector. However, the credit demand remains low, conditioned by uncertainties about future developments and the slowdown of the country's economic activity[55]. Even though these developments are encouraging and reflect improved banking intermediation, it still remains at low record levels in recent years.

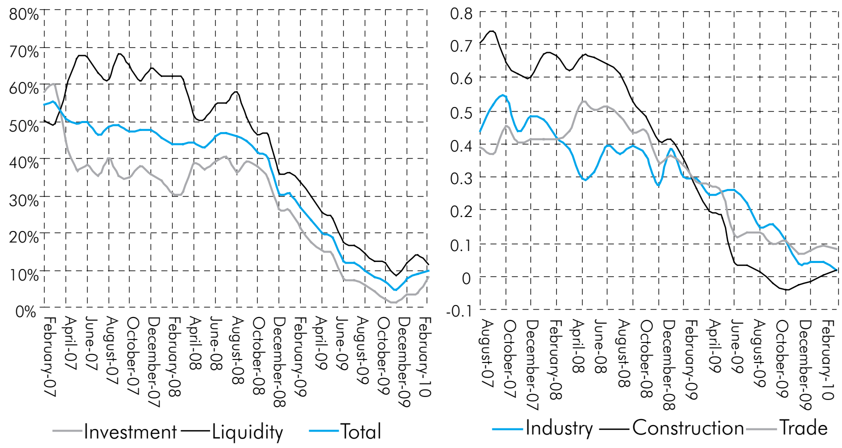
Chart 40 Annual private sector lending growth by borrowers and by currency, in percentage



Source: Bank of Albania

Business loan portfolio has grown uniformly since December last year. In February, the annual growth of this portfolio amounted to 10 percent. This performance is triggered by marginal increase in the business demand for credit, against the backdrop of easing credit standards applied by banks during the first quarter of the year. Business loan has maintained high growth rates in the lek component for financing liquidity needs and for investment purposes. Meanwhile, the significantly improved situation of foreign currency liquidity in the banking system in last months of 2009 was reflected in increased foreign currency lending, particularly for investment. Therefore, foreign currency business loan portfolio, after a period of annual contraction for about six months, increased marginally at the end of February, relative to the previous year.

Chart 41 Annual business loan growth by purpose and by main sectors of economy, in percentage



Source: Bank of Albania

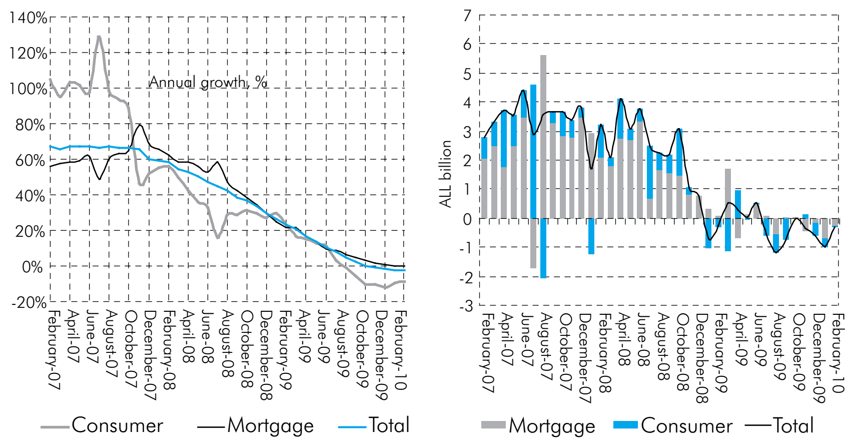
The working capital loan increased on average by 13% in January-February of the current year, or about two percentage points more than the average of the last quarter of the previous year. Although this loan continues to give the main contribution to annual business loan portfolio growth, this contribution is decreasing due to the positive performance of investment loan. In annual terms, investment loan growth reached 8.3% in February. Also, while the new working capital loan retains comparable seasonable levels, the new monthly investment loan was higher in January and February than the historical average for this period.

The data on business loans by sectors of the economy show a further slowdown in annual growth rates of industrial loan, reaching 2% in February. During January and February, trade loan maintained average annual rates comparable to those of the last quarter of the previous year. Meanwhile, construction loan returned to positive annual growth rates, reaching 2% in February. Business loan outstanding is dominated by trade loan, accounting for 38% in February. Loan portfolio for industry and construction accounts for 24% and 21% respectively to business loan outstanding. Since summer of the previous year, the sectoral distribution of loan portfolio appears to have remained largely unchanged.

Household credit has started to contract in annual terms since November of the past year. In the first two months of 2010, the annual decline of this portfolio has settled around 2%. Developments in household credit continue to be conditioned by further tightening of credit standards, particularly for consumer loan. On the other hand, wage rise slowdown and uncertainties about economic outlook have led to an upward trend of individuals to save, and a more prudent stance in terms of lending.

Household loan performance is mostly influenced by reduced foreign currency credit, which contracted on average by 5.7% in annual terms over these two months. Besides the slowed aggregate demand, a more discouraging behaviour of banks to foreign currency household loans[56] and the upward awareness of the borrowers of the exchange rate risk are materialized in historic low levels of new foreign currency loans.

Chart 42 Annual rate performance (in %) and the monthly change (in lek billion) of household loan by purpose



Source: Bank of Albania

The pace of consumer loan decline, after peaking by 11.7% in December 2009, appeared more moderate during the first two months of 2010, down to 9.1% in February. New consumer loan remains at low record, about 25% lower than the average of the previous year. Also, after the steady slowdown throughout the year, the real estate loan portfolio began to decrease in annual terms over the first two months of 2010. In late February, the loan portfolio was slightly lower than in the previous year.

Box 6 Bank lending survey for the first quarter of 2010

Lending standards, in general, are slightly eased on business loans and are further tightened on household ones in the first quarter of 2010. The performance of business loan standards is in line with banks' expectations stated in the fourth quarter of 2010, whereas the household ones are on the reverse side. Standards applied on business loans are eased in general only for corporations. In the meantime, they remain tightening for small and medium-sized enterprises. Specific problems of the sector where the business operates, the macroeconomic situation and the non-performing loans situation are the main factors impacting on the changing direction of standards on business loans. These factors are ranked higher by banks, compared with other factors and their assessment during the previous quarter. The financial situation of households, the situation of non-performing loans and the liquidity of the bank itself have affected the tightening of household loan standards. "Bank of

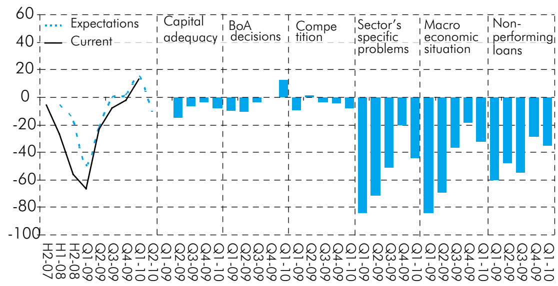
Albania Decisions" is the sole factor contributing to easing of lending standards, both for business and household loans.

According to banks' experts' opinions, business and household demand increased slightly in the first quarter of 2010. Banks' expectations signal that the current easing of new lending standards will be temporary and will not continue in the second quarter of 2010, though the future demand is expected to grow, for both businesses and households.

Business loans

On the basis of the survey data for the first quarter of 2010, it comes out that banks have slightly eased the standards they apply on business loans. Such a development is noted for the first time since the second half of 2007. Net balance[57] – which summarises all the weighted answers of banks on lending standards – recorded the positive value of 13.5%. This balance was -2.3% in the fourth quarter of 2009. The easing of lending standards in the first quarter of this year is applied only on big corporations. Lending standards are tightened on small- and medium – sized enterprises, but at a lower rate than in the previous quarter. According to purpose of loan usage, banks have eased the investment loans standards more than those for financing working capital loans. Respective balances edged up respectively by 27.9 and 4.6 percentage points.

Chart 43 Changes in lending standards applied on business loans and the impact of different factors (net balance[1], net percentage of banks that have loosened the standards)



Note 1: The positive balance indicates easing of lending standards or that the factor has contributed to the easing of lending standards. The negative balance indicates a tightening of lending standards or that the factor has contributed to the tightening of lending standards.
Source: Bank of Albania

In the first quarter of 2010, the specific problems of the sector in which the business carries out its activity is the factor rendering the main contribution to tightening of standards. Hence, the respective balance dropped by 24 percentage points, pointing to -44.2%. The macroeconomic situation and the non-performing loan position continue to be the factors affecting the tightening of standards. Factors related to competition rate in the banking system and banks' capital adequacy gave an insignificant contribution to determining the changed direction of standards. Bank of Albania decisions are pointed out as the sole factor providing an easing contribution to lending standards. The latter's balance recorded the positive value of 12.2% (Chart 43).

The easing policy of banks during the first quarter of 2010 was carried out mainly through application of lower commissions on the approved loan, against the setting that credit costs have been upward.

Net loan demand by businesses slightly increased in the first quarter of 2010, based on bank experts' opinion. The need for financing the working capital is the main factor driving to improved business demand for loans in the first quarter of the year.

The easing trend of standards noted over this quarter is not expected to continue in the next quarter. For the second quarter of 2010, bank experts expect tightening of lending standards.

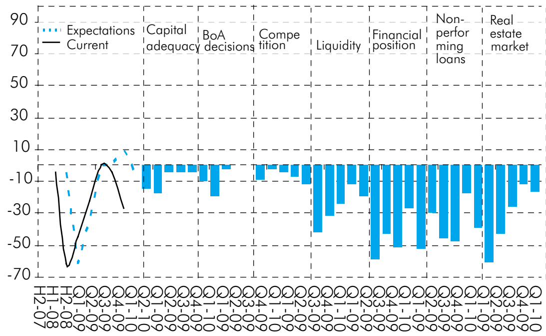
Household loans

Standards on household loans in the first quarter of 2010 were tightened more than in the previous quarter. Net percentage of banks reporting a tightening of standards *points to 26.5%, relative to 4% in the previous quarter. Standards continue to be tightened at a higher rate on consumer loan than on the housing loan. In general, all the considered factors have contributed to the intensified strengthening of lending standards during the first quarter of 2010.*

Banks strengthened the lending standards during the first quarter of 2010 by increasing the collateral requirements and the margins applied on both, loans in general and high-risk ones. A somewhat looser policy was pursued by rising the maximum maturity terms of loans.

The household demand for loans is perceived to have been upward in the first quarter of 2010. For the second quarter of 2010, banks expect to tighten the lending standards less than those applied over the first quarter of the year. This development is expected to be at the same level for both consumer loan and housing one.

Chart 44 Changes on the lending standards applied for house loans and consumer ones, and the impact of different factors (net balance*, net percentage of banks that have eased the standards)



* See note 1 in chart 43.
Source: Bank of Albania

IV.2 LABOUR MARKET, WAGES AND PRODUCER PRICES

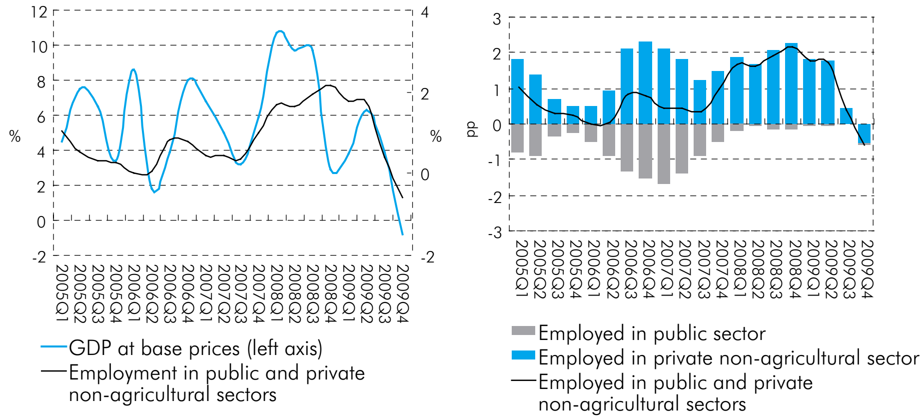
In the last quarter of the year, economic contraction was reflected in the declining employment. Reduction of aggregate demand and low capacity utilization rate led to reduced business demand for employment. The expanded gap between the supply and demand in the labour market is reflected in the upward unemployment trend, thus creating conditions for weak pressures for wage rise. As a result, the cost per produced unit decelerated, generating weak inflationary pressures. Producer prices in the domestic market stood at the same levels as in 2008, under the impact of the slowdown in the aggregate demand at home.

LABOUR MARKET

During the fourth quarter of 2009, employment went downward, reflecting the contraction of gross domestic product. The number of employed persons in the public sector and in the private non-agricultural sector[58] recorded an annual decline of around 0.6%. The number of public sector employees slightly fell by 0.2%. The average number of unemployed persons increased by 1.3% y-o-y and by 0.9% q-o-q. As a result, unemployment rate resulted 13.75% at the end of the previous year.

At a time when aggregate demand and capacity utilization rates have remained at low levels, the business demand for labour force has decreased. The data as at the fourth quarter of 2009[59] show that the number of private sector employees fell slightly y-o-y by about 0.9%. The extent at which the key sectors of the economy were influenced from output fall in the fourth quarter of the previous year were reflected also in the performance of employment in these sectors. Construction was the sector that was hit hard by the reduced

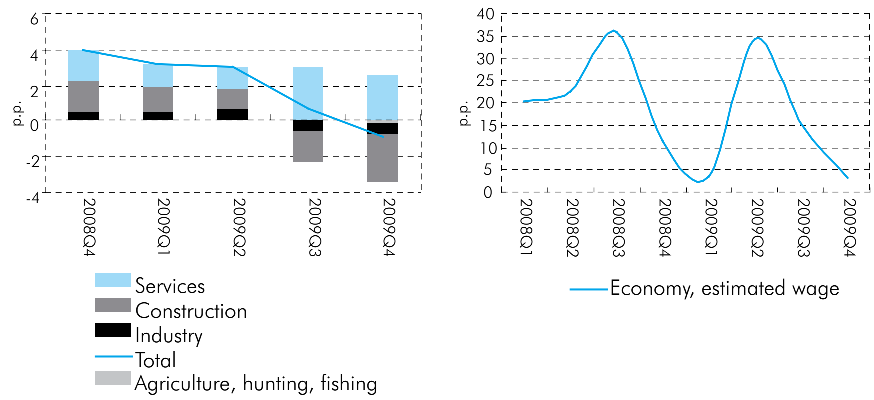
Chart 45 GDP at base prices and employment in the public and private non-agricultural sector (annual change, left) and sector's contributions to annual employment rise (right)



Source: INSTAT and BoA staff estimates

domestic demand in this quarter. The number of employees in this sector fell by 14.1% y-o-y, while the decreased foreign demand due to the global crisis was felt stronger in the industrial sector. In this sector, employment fell by 2.8%. The service sector continued to register positive growth rates, albeit at lower rates. This sector's employment rose by 4.6% in the fourth quarter.

Chart 46 Asset contribution to annual growth of private sector employees (left) and estimation of average wage in the economy (left)*



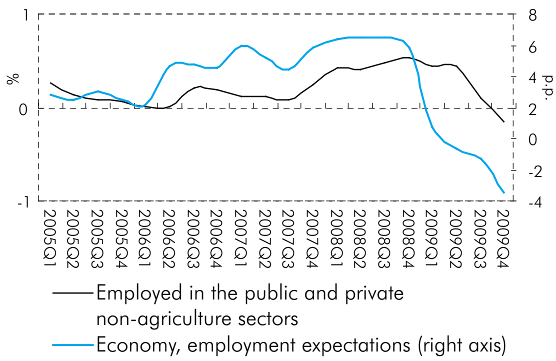
Note: * Average wage in the economy is calculated as the average of respective balances for evaluation of wages in industry, construction and services according to business confidence survey results.
Source: MLSAEO, Bank of Albania estimates

The data from business confidence surveys on employment in the economy (excluding agriculture[60]) are in line with the official figures (published by INSTAT). Business expectations for the first quarter of 2010 indicate further slowdown of employment indicators in the public and non-agricultural private sectors.

WAGES[61] AND LABOUR COSTS

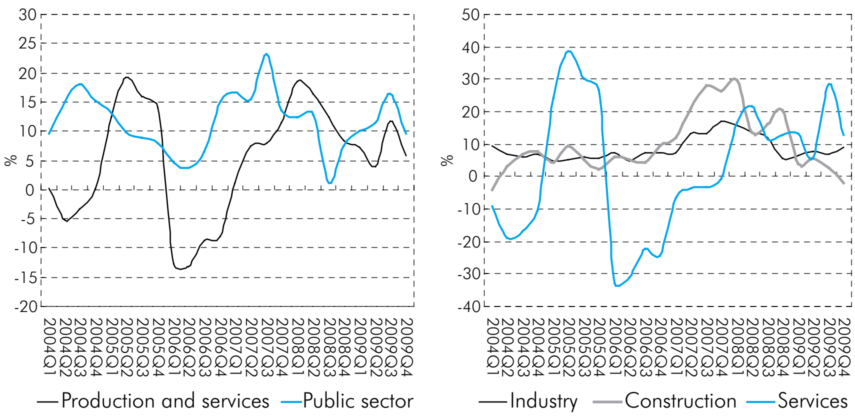
Average wage[62] in the economy recorded lower annual growth rates until the fourth quarter of 2009, relative to the previous year. Lower pressures for raising wages might have been affected by the weakening of domestic economic activity, the easier conditions in the labour market and low inflation rate over the past year. In the fourth quarter, the average wages in manufacturing and service sector slowed the annual growth rate to 5.9% in nominal terms and 3.0% in real terms[63]. In construction, the annual average wage declined by 2.0%, continuing the slowdown reflected in the third quarter. In industry, this index followed the contrary trend to the one noted in construction, recording an annual growth of 9.2%. Average wage index rose by 12.8% in annual terms in the service sector, a lower annual rate than in the previous quarter. Average monthly wage in the public sector[64] followed an upward trend during the first three quarters, decelerating in the fourth quarter of the year. During this period, this indicator increased by 6.9% y-o-y in nominal terms and by 6.6% in real terms.

Chart 47 Performance of employment in public and private non-agricultural sectors and employment expectations in the economy*



Note: * Employment in public and private non-agricultural sectors is the moving average of respective quarterly changes. Expectations for employment are also the moving average of the respective balances.
Source: Bank of Albania and INSTAT (business confidence survey)

Chart 48 Average wage in production and service sector and in the public sector (left, annual changes) and according to economic activity (right, annual changes)



Source: INSTAT and BoA estimates

The results coming out of business confidence surveys support the slowdown of wage performance over the fourth quarter of 2009 in construction, services and overall economy.

However, wage indicators rise as at the third quarter 2009[65] did not affect negatively on the ratio of wage cost to output per worker. In contrast, the annual growth of unit labour cost, as an indicator of potential inflationary pressures, was slower over the third quarter of this year.

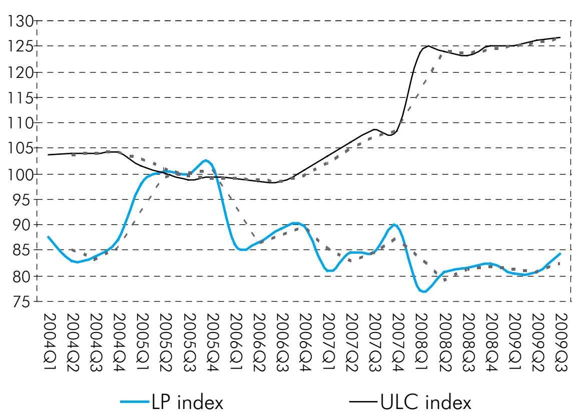
Chart 49 Wage performance and their estimation by sectors of the economy*

* Wage performance by sectors of the economy is reflected through quarterly changes of the average wage index. The wages estimated by sectors of the economy are the respective balances of business confidence survey.
Source: INSTAT, Bank of Albania estimates

On the other hand, the slowdown in the employment index[66] was not commensurate with the economic activity. As a result, the productivity indicator in the country's economy[67] increased slightly, respectively by 3.3% and 4.3%. This performance followed the positive growth rates noted in the first half of the year, after the relatively long behaviour under a negative pace of labour productivity in annual terms. GDP growth rates, in spite of their slowdown, were higher than those of employment, indicating full capacity utilization of existing human resources.

The aforementioned developments in labour productivity (LP) contributed to narrowing the gap between the paces of its change and those of unit labour cost (ULC). Labour productivity recorded an average increase in annual terms for each quarter by about 2.5%, whereas for the unit labour cost, it recorded 1.9%.

Chart 50 LP and ULC performance

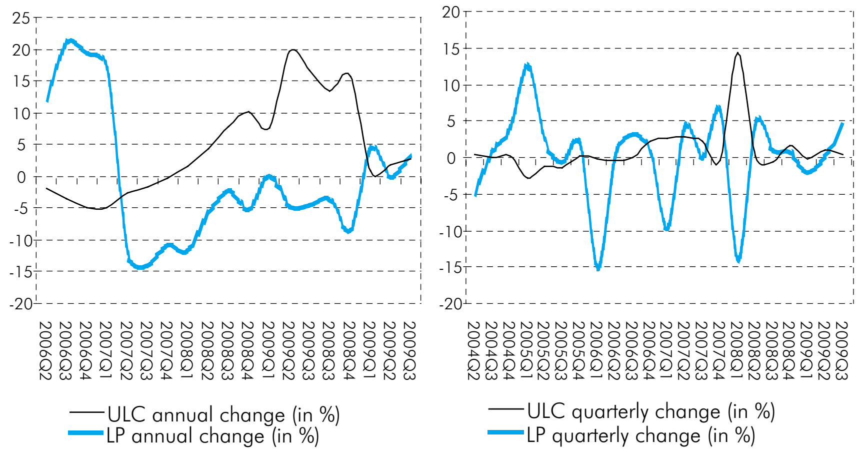


Note: The broken lines show the corresponding trends obtained from the moving average method.
Source: GDP and Short-term Statistics (INSTAT) and Bank of Albania estimates

ULC's annual growth is apparently slower than that of the previous year (16.6%), testifying complete cancelling out of the high base effect caused by administrative measures that aimed at private sector salary disclosure.

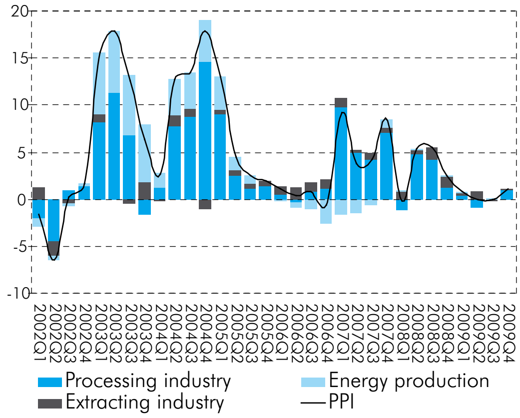
On the basis of latest developments, though more positive than the preceding ones, it can not be concluded yet for the creation of a clear profile in the field of productivity and labour cost in the country's economy. Some empirical results that attempt to capture the link between these indicators assume the existence of reverse correlation between them. Also, they show that labour productivity developments over the past five quarters give hints about future outlook of unit labour cost.

Chart 51 Annual and quarterly dynamics of LP and ULC



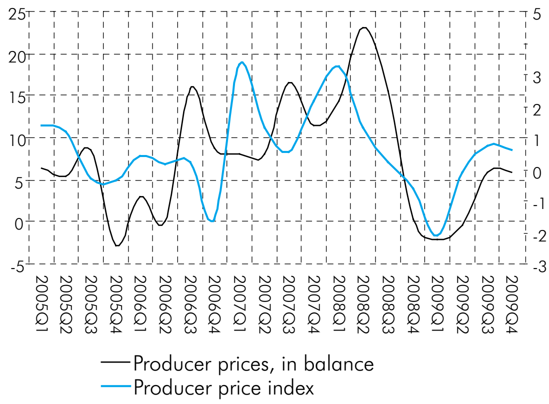
Source: GDP and Short-term Statistics (INSTAT) and BoA estimates

Chart 52 Annual change of producer price index and processing industry price index



Source: INSTAT and Bank of Albania estimates

Chart 53 Annual producer price index change (in percentage) and the qualitative producer price indicator from business confidence survey (in balance)



Source: Bank of Albania estimates

PRODUCER PRICE

Producer price index remained almost unchanged compared with 2008. After an average annual growth of around 6.9% during 2003-2008, these prices went downward during the first half of 2009 to slightly grow in the second half.

Producer prices in extracting and processing industry recorded slight growth rates, respectively 1.9% and 0.2%. However, they remain below their historical levels. Meanwhile, producer prices of food industry fell by 3.1%. Their aggregated contribution to annual change of producer price index for the first nine-month period of 2009 was negative.

Last quarter of the previous year was characterized by reverse price performance. The overall index rose by 1.2% y-o-y, where the main impact was given by the upward producer price performance in processing industry. Qualitative data obtained from business confidence surveys for the first quarter of 2010 signal that during this quarter producer prices will continue to maintain the slightly upward trend noted in the fourth quarter of 2009.

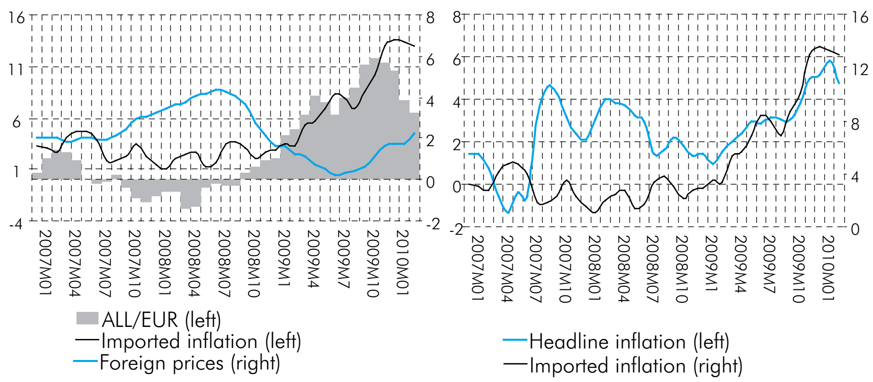
IV.3 IMPORTED INFLATION

Improvement of the global economic activity and stabilization of the forecasts for key economic indicators were reflected in slight upward raw materials and consumer prices in the world market, in the first quarter of 2010. Against the backdrop of continued exchange rate depreciating trend – though at lower paces at the beginning of this year - these developments were translated into increased pressure from imported inflation on consumer prices at home.

Inflationary pressures from external economy on the overall consumer prices were present in the first quarter of 2010. Improvement of the global economic situation and increased trade activity is associated with increased raw material and consumer prices. In terms of continuing the depreciating exchange rate behaviour, although at slower paces, these developments were translated into increased pressures from imported inflation on consumer prices at home.

Raw material prices recorded high annual growth rates, 43.8% on average for the first quarter of the year. Meanwhile, the average annual growth observed in foreign consumer price index[68] was more restrained, 1.9% for the same period, reflecting the still low level of consumer demand. The growth rate of this index, after showing a slight upward trend during the second half of the past year, settled at 1.7% in the first two months of 2010. In March, the pace was accelerated, recording an annual rate of 2.3%. The rise of foreign consumer price inflation over this month was impacted from the price rise of Greece (3.9%), whereas in Italy, the annual inflation for this month marked 1.4%.

Chart 54 Annual changes of imported and traded inflation rates (left) and annual changes of foreign prices and exchange rate (right)



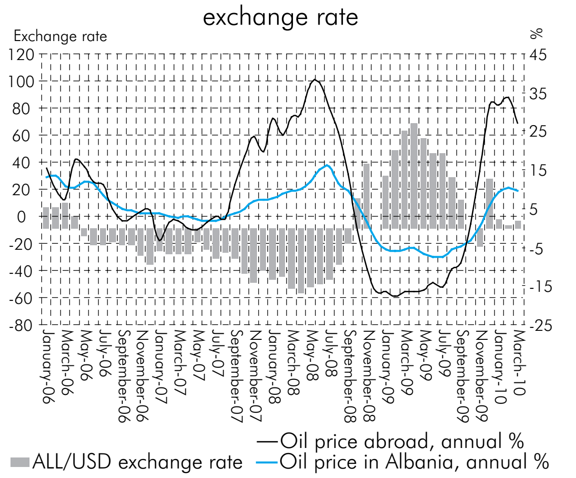
Source: Statistics Institutes of Italy, Greece and Albania; Bank of Albania estimates

In the first quarter of the year, imported inflation[69] recorded double-digit rates of annual increase, triggered mainly by the exchange rate depreciation of both hard currencies, the euro and dollar. The Lek continued to depreciate against the euro, but at a slower pace than in the fourth quarter of 2009. The Lek/Euro exchange rate depreciated by about 8.2% in annual terms, while for the last quarter 2009, the depreciation was 11.4%. The decelerated exchange rate depreciation rate was reflected in the slight decline in imported inflation increase rate, by 0.6 percentage points from the beginning of this year. This development was reflected in headline and tradable inflation rates in March.

Meanwhile, the performance of the lek's exchange rate against the U.S. dollar exerted upward pressures on oil prices during the first quarter of the year. The national currency is depreciated by more moderate rates in annual terms (about 1.6%), but it has deepened the depreciating trend in quarterly changes (by about 7.9%) for the first quarter.

The average oil price in the domestic market has followed the upward trend since October last year. During the first quarter of 2010, this price reached 119.9 leks per litre, about 19% higher compared to the same period of the previous year. Although in the international market, the price of this product fluctuated about the average of six last months, this development is not reflected in the performance of this indicator in the domestic market. The average monthly oil price movements were positive during November '09 - March '10, reflecting the ongoing depreciation of the domestic currency against the U.S. dollar. Concerning factors impacting this depreciation, the quarterly change of oil price rise in the domestic market, by 2.8%, was higher compared with the international one.

Chart 55 Annual change of oil price at home and abroad and the Lek/USD exchange rate



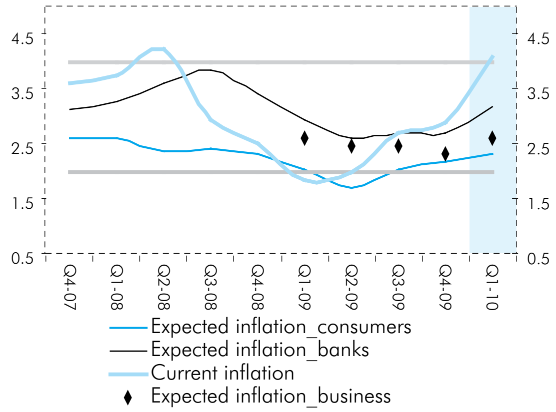
Source: INSTAT, Bank of Albania, EIA

The index of the subgroup "Services to personal vehicles" in the CPI basket showed the same trend with oil prices performance in the domestic retail market, albeit at more moderate upward rates. This index recorded an annual growth of around 9.7% and a quarterly increase of 1.4%. On the other hand, the index of the sub-group "Transport services" remained at comparable levels with its value over the first quarter of the previous year, up by 0.5%.

IV.4 INFLATION EXPECTATIONS IN THE ECONOMY

During 2009, overall inflation expectations recorded low positive rates within the range of 2-4%. As it appears in chart 56, during the last four years, changes in the expected consumer inflation were closely connected to current official inflation developments. Although in the last quarter 2009, the expected inflation recorded an upward trend, reflecting the official inflation rise, it remains at low rates. Inflation expected from businesses recorded higher rates than the one expected by consumers over 2009, but it remained close to the Bank's target range of +3%.

Chart 56 Consumers' and bank experts' expectations as to annual inflation after one year and the current annual inflation rate (in %)



Source: Confidence Surveys and banks' surveys, Bank of Albania

The latest information from bank experts' survey conducted during the first quarter of 2010 shows an upward trend for inflation expected after 12 months. The expected inflation was 3.2% in this quarter, up by 0.5 percentage points compared with the inflation expected in the fourth quarter of 2009.

V. FINANCIAL MARKETS, INTEREST RATES AND EXCHANGE RATE

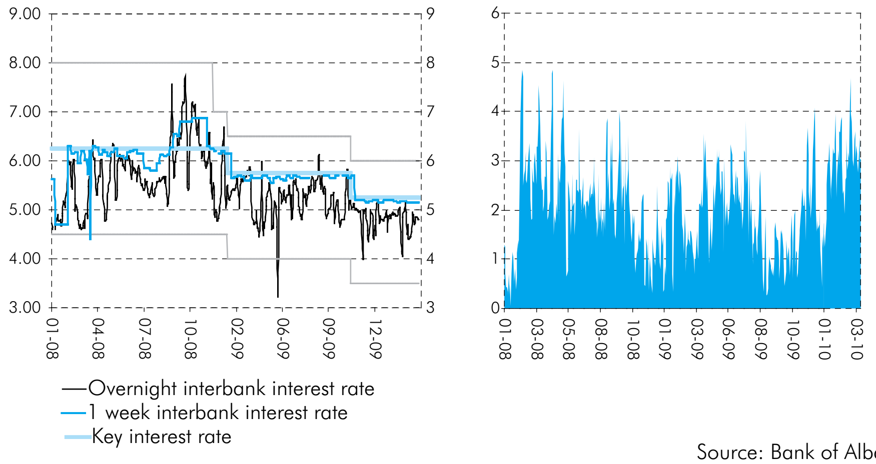
Unlike the general trend of the last year, financial markets are characterized by reduced liquidity risk premium, increased volume of transactions and downward interest rate trend in the first quarter of 2010. Interbank market borrowing has increased, accompanied also by reduced interest rates in this market. These developments are transmitted to the primary market of government security auctions, where participation has been high and the security yield has been progressively downward. The downward yield performance in the primary market is expected to facilitate the lending market, which, though continues to apply tightening standards, it has tended to apply interest rate smoothening. On the other hand, the restoring of confidence in the banking system, reflected also in the deposit growth, has prompted the lowering of their interest rates.

INTERBANK MARKET

The first quarter of this year was characterized by lowered interest rates and increased volumes exchanged in the interbank market. The overall volume exchanged in the currency market during the first months of this year increased significantly, mainly due to positive contribution of one-week transactions. Liquidity distribution in the system was more uniform, reflected to smoothening of interest rate volatility. Base interest rate cut by the Bank of Albania over the past year and the mitigated liquidity pressures, against the backdrop of improved confidence, are factors that have contributed to falling interest rates for overnight and one-week transactions. Interest rate volatility was noted mainly in certain periods of meeting the demand for maintaining the required reserve.

The liquidity provided by the Bank of Albania through weekly reverse auctions continued to be high. The Bank of Albania continued to inject liquidity through its main open market instrument, reverse repurchase agreement of one-week maturity. The volume offered through these auctions was roughly ALL 17 billion, about 2.0 billion lower than in the previous quarter. Besides this instrument, the Bank of Albania has also used the reverse repurchase agreement of one-month and one-quarter maturity term, by offering ALL 16 billion through them. Upon improvement of liquidity situation and return of deposits into the system, in January[70], the Bank of Albania decided to reapply standard-form repurchase agreement auctions, at a competitive interest rate. Conducting these fixed interest rate and unlimited-amount auctions since November 2008, contributed to reducing liquidity pressures in the market and risk perceived by agents. The changed form of weekly auctions has not affected the banks' stance in the currency market, where interest rates in these auctions have been close to the base rate.

Chart 57 Interest rates (left) and the volume exchanged in the interbank market (right, in ALL billion)



Source: Bank of Albania

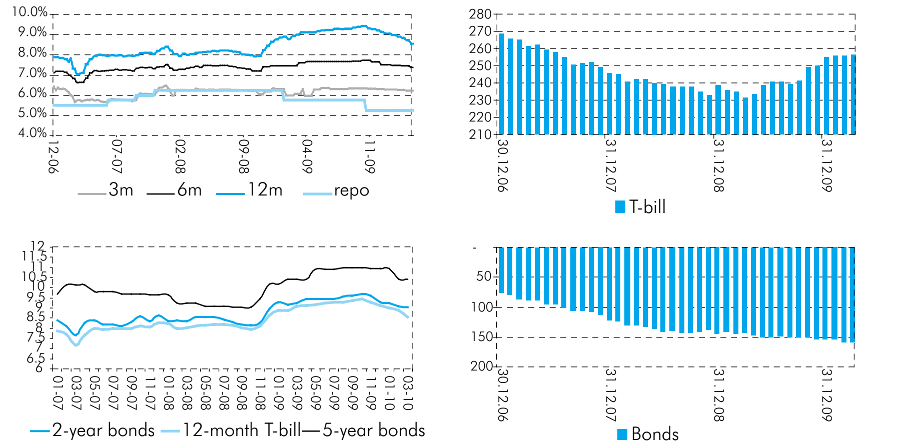
The rapid rise of weekly borrowing during the first week of the year has offset slower growth of overnight loan, by contributing to increased total volume exchanged in the interbank market. The increase of the latter speaks for a better management of liquidity added in the market and increased confidence among lenders. As a result, the total borrowing has increased not only in comparison with the previous quarter but with the average of the previous year. The volume of weekly borrowing has increased significantly by ALL 1.03 billion, reaching ALL 1.68 billion over this period. The daily borrowing went up slightly to ALL 1. 28 billion, up by ALL 0.07 billion from the previous quarter. Interbank market interest rates have reflected the following developments. In average terms, overnight interest rate was lowered during this quarter to 4.79%, from 4.93% in the previous quarter, whereas the one-week interest rate went down to 5.17% or less by 0.18 percentage point.

PRIMARY MARKET

After further easing of monetary conditions by the Bank of Albania in late October, the yield of government securities in the primary market continued to drop significantly. Improvement of liquidity situation, lowering of interest rates in the interbank market and the decline in the demand for financing by the government in the first quarter of this year against the last year-end have led to interest rate cut on these securities.

The yield rate has dropped for all maturity terms, especially for the 12-month one. The 12-month yield, after reaching in October 2009 the highest level in the last five years, dropped to 0.37 percentage points at the end of 2009. It went down in the first quarter of 2010, settling at 8.56% or 0.87 percentage point lower than at last year-end. Participation in security-purchase auctions continued to be high, while the demand for financing with them was contained, as compared to the last quarter of 2009, without exerting upward pressures on the yield.

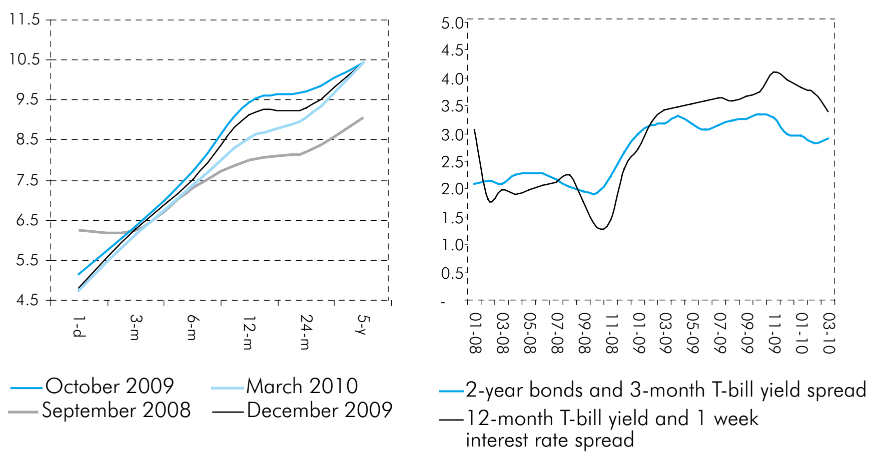
Chart 58 Yield on T-bills and bonds (left) and T-bill and bond portfolio level (right, in ALL billion)



Source: Bank of Albania

Upon the start to correct yields of 12-month maturity term, the yield spread between short, medium and long terms is narrowed, leading to reduced yield curve slope. Such a trend would confirm the reduction of risk premiums for long-term investments and steady inflationary expectation.

Chart 59 Interest rate curve and the spread between their maturity



Source: Bank of Albania

Yields on long-term securities, due to the way they are determined, have followed the performance of 12-month yield rate, marking further decline in the first quarter of 2010. As at end of March, the yield on two-year bond decreased to 9.05%, down by 0.25 percentage point from December. The same behaviour is noted even to five-year bonds, which represent the highest maturity term of government securities. Reference yield margin (12-month T-bill) continued to diminish, due to improved overall risk perception by banks. Participation in bond auctions was higher than the issues, though the latter increased over the first quarter. This move resulted in a shifting of government securities portfolio to higher-than-one-year maturity terms, a trend that had started in 2008 but that changed during the past year, due to agents' reluctance to invest in long-term maturities.

Box 7 An overview on the yield curve

Yield performance of government debt instruments has always been on focus not only of the major market stakeholders but also of the Albanian public. The not very developed financial market and the fact that yield performance is often used as an indicator of financial health of the overall economy, have added interest in yield performance. We are presenting an overview, in an effort to point out the factors that may affect yield performance, according to best world economic analyses.

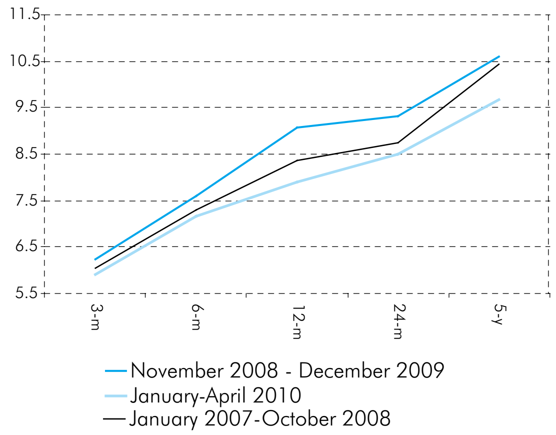
Yield curve is a graphic depiction at any given date, of the relationship between interest rates on similar debt instruments and the time to maturity of the debt for a given time, following a rule that ranks the short-term maturity ones first and then the long-term ones. Given this yield curve definition, a set of information can be obtained, including current prices of debt securities and economic agents' expectations for the future. The major part of economic literature has agreed on the terminology used when qualifying yield curve moves. Hence, we talk about variance at the level, slope and curvature respectively, when we have similar rise in all interest rates for the first case, higher rise in short-term ones in the second case, and in the third case the medium-term interest rates exceed short-term and long-term ones.

The main theories attempting to explain the yield curve shape are market expectations theory, market segmentation theory and liquidity preference or risk premium theory. Expectations hypothesis assumes that various maturities in yield curve are perfect substitutes and suggests that the shape of the yield curve depends on market participants' expectations of future interest rates. Thus, the yields on long-term instrument are equal to the geometric mean of the yields on a series of short-term instruments. This theory is based on the assumptions that: transaction costs are at minimum; arbitrage opportunities are minimal; and economic agents are risk-neutral and able to form in time clear expectations of short-term interest rate performance. The market segmentation theory is diametrically the opposite. In this theory, financial instruments of different terms are not perfect substitutes and every agent is faced with the supply and demand rule for each market segment. The third theory is liquidity preference or risk premium theory. According to this theory, the yields demanded for long-term instruments are an average of short-term yields expected for the future plus a risk premium, which may be risk of liquidity, issuer's default, maturity term or any other factor that is regularly raised upon rise in the maturity term of the issued instrument. This hypothesis tries to explain also why yield curve in normal situations has a positive slope. An offshoot of this theory underscores the idea of preferred space of economic agents, who, being risk-sensitive, would accept to move from their favourite space, only if the expected yield was worth taking.

One of the main aspects of economic study and research is related to potential factors influencing and determining the debt security interest rates that shape the yield curve. These factors encompass monetary policy, fiscal policy, inflation, economic growth and political and economic stability. The impact of these factors can be both direct and indirect, while their interaction is not excluded.

Important aspects of monetary policy impacting on yield curve are the effects that it gives on public expectations about the future interest rate moves, given the economic agents' expectations about inflation. Following the performance of inflation, market agents anticipate any possible base rate changes by the central bank. These cases point out that short-term maturity yields will go up or vice versa, depending on the possible change expected to be carried out by the central authority. In this respect, inflationary expectations and inflation performance itself constitute an important factor influencing the yield performance. Another factor is the economic growth, whose rate and outlook condition the preferences and performance of the overall financial system.

Chart 60 Yield curve at different periods of time*



* Yield curve calculated as an average of pre- and post-crisis periods.
Source: Bank of Albania

Public balance position and the fiscal policy constitute a very important factor impacting on yield performance. Currently, it is widely accepted that high fiscal deficit levels are mostly accompanied by higher yield levels for all maturity terms. Keeping public expenditure in check, ongoing quest for enhancing the efficiency in investments and receivable income are deemed as reliable guide to cancelling out the upward yield pressure. Dwelling further upon this argument we see that upward yield pressures in the case of disequilibrium in the public balances may occur due to unexpected fiscal deficit deterioration. Another situation refers to the case when a government fiscal deficit has shown most of the time an upward trend and economic agents estimate that it will continue to grow. In such a case, the long-term interest rates are the ones that present a higher rise, changing likewise in the previous case, the yield curve slope.

Turning to Albania's case, we have presented two moments of yield curve referring to two different periods. Along with obvious change in time, these curves carry over the effects of several factors mentioned in the above paragraphs.

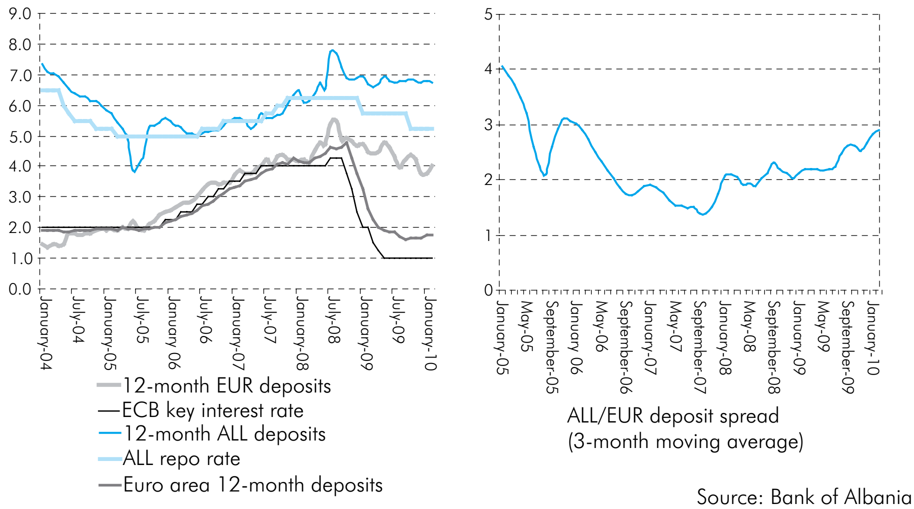
The curve for November 2008 - December 2009 points out clearly that it has increased in flexion and the last part of it shows faster increase than the beginning. The change against the previous period curve is formed mainly in the segment after that of short-term maturity. Actually, for November 2008 - December 2009, the monetary policy was easing, while inflation expectations were anchored close to Bank of Albania's target. Also, the results of surveys conducted at banks, businesses and consumers support such a fact. Yield rise in 2009 seems to have been influenced by increased liquidity risk following deposit withdrawal and the upward perception of government demand for financing. However, both these factors are mitigated in the course of 2010, thus bringing about slope reduction.

NEW DEPOSIT INTEREST RATES

In the first two months of 2010, the banking system recorded slight cut of Lek-denominated deposit interest rate, though they continue to keep relatively high levels compared with the pre-crisis period. The weighted average interest rate of Lek-denominated deposits in January-February was respectively 5.66% and 5.29%. The decrease by 0.38 percentage point in February was due to completion of year-end promotional offers, which continued until January. Three-month deposit interest rate declined by 0.12 percentage point in February, while 12-month deposit one declined only 0.04 percentage point. As compared to the same period of 2009, the average deposit interest rate in January-February 2010, is at the same level, though the base interest rate over this period is 0.50 percentage point lower.

Euro-denominated time deposit interest rates during the first two months of the year followed an upward move. The increase was applied to deposits of almost all maturity terms, but the highest impact was noted on 12- and 3-month interest rates. High competition among banks, which consider the euro-denominated interests as funds costs, has made other banks be more aggressive, in an effort to attract funds, thus leaving the international market interest rates. The weighted average interest rate for new euro-denominated time deposits in January-February was 2.46%, 0.12 percentage point higher than the average of the last six months of 2009. 12-month deposit interest rates were 4.0% in February 2010, up by 0.22 percentage point compared to January and by 0.25 percentage point compared to December 2009.

Chart 61 Performance of 12-month deposit interest rate and the base rate (in Albania and the EU)

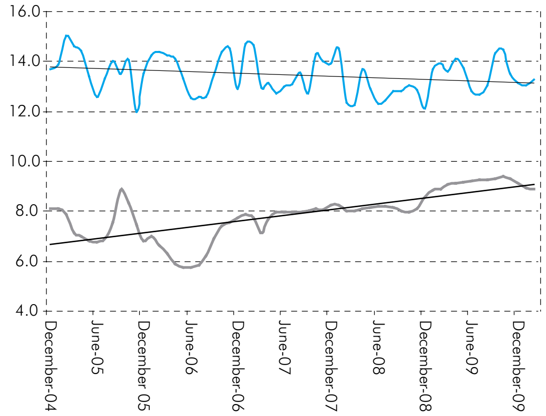


Source: Bank of Albania

INTEREST RATES ON NEW LOANS

In the first two months of 2010, loan interest rates were volatile, but on average somewhat lower than in the last quarter of the previous year. The high demand for working capital (overdrafts) by businesses, for both hard

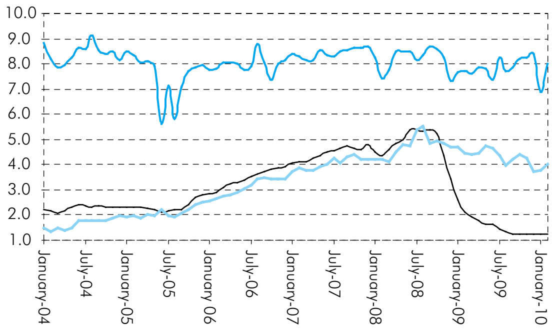
Chart 62 Performance of interest rates on new lek-denominated loans



Weighted average interest rate for ALL loans
Average 12-month T-bill yield

Source: Bank of Albania

Chart 63 Weighted average interest rate on euro-denominated loans, 12-month euro Libor and the weighted average interest rate on euro-denominated deposits



Weighted average interest rate for EUR loans
Libor eur
Interest rate on 12-month EUR deposits

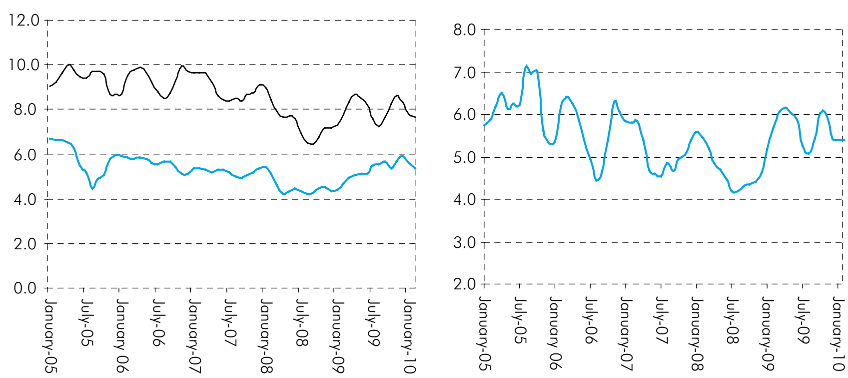
Source: Bank of Albania

currencies and the uncertainty about exchange rate performance were factors contributing to maintaining relatively high levels of loan interest rates. Banks continued to favour national currency lending to major businesses and household real estate.

The downward trend of lek-denominated loan interest rates in the last quarter of 2009 continued until January 2010. In February, lek-denominated loans were more expensive, influenced by several high overdraft rates to businesses. During January to February, the weighted average interest rate on new lek-denominated loans averaged 13.16%, down by 0.55 percentage point relative to the last quarter of 2009. Reduction of the weighted average interest rate in national currency was influenced by interest rate cut on long-term loans for purchasing real estate and equipment mainly to businesses.

The Euro-denominated loan interest rate was highly volatile in early 2010. In January they dropped considerably, averaging 6.90%, thanks to introduction of promotional products in several banks. This drop did not continue in February, with this rate marking 8.02%, shifting again from the 12-month Euribor rate. The interest rate of euro-denominated loans averaged 7.46% for January-February, down by 0.82 percentage point from the last quarter of 2009. They performed similarly by maturity terms, though the highest impact was given by long-term ones, above five years (for real estate) and short-term ones (for working capital to businesses).

Chart 64 Average rate of lek- and euro-intermediation (left) and interest rate spread between lek-denominated and euro-denominated loans



ALL spread 3-month moving average
EUR spread 3-month moving average

Spread between ALL-EUR interest rates on loans, 3-month moving average

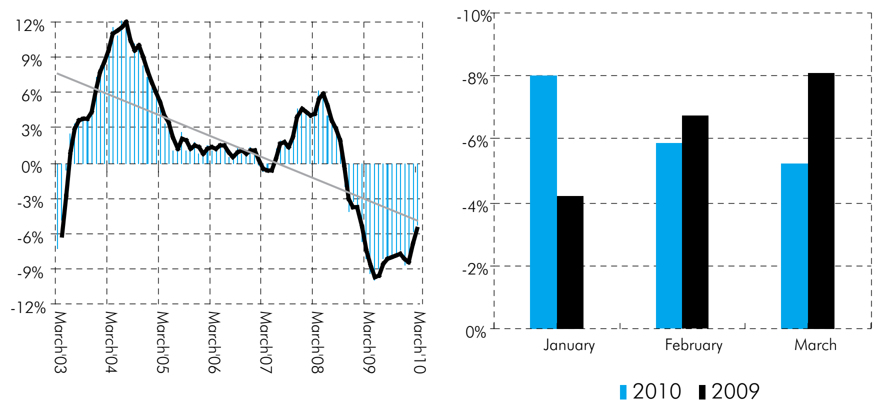
Source: Bank of Albania

Lek-intermediation cost decreased during January-February, averaging 7.68 percentage points, from 8.31 percentage points in the fourth quarter of 2009. The average rate of euro intermediation was 5.00 percentage points for January-February, down by 0.89 percentage points. The interest rate spread between lek-denominated loans and euro-denominated ones continued to be highly volatile. In January, it increased by roughly 0.27 percentage point, to later lower by 0.9 percentage point in February.

EXCHANGE RATE DEVELOPMENTS

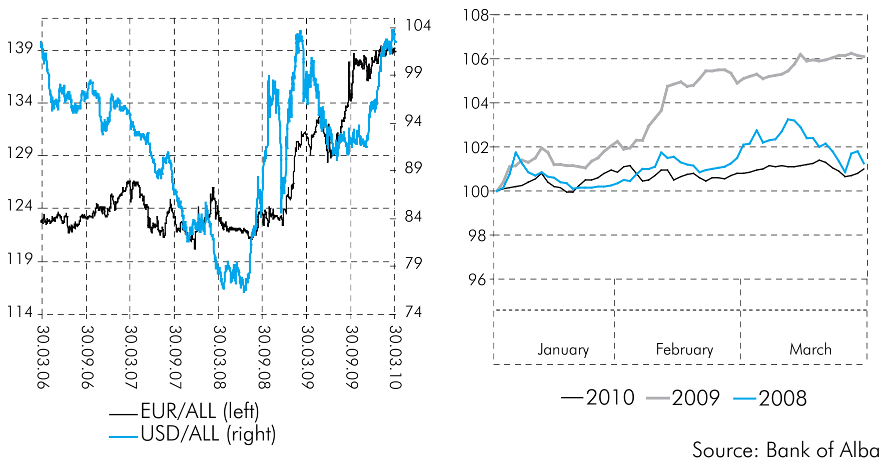
In the first quarter of 2010, the lek continued to depreciate but at a more moderate pace. In nominal effective terms, the lek depreciated on average by 6.4% compared with the same quarter of the previous year and by 2.4% compared with the preceding quarter. The decelerated depreciating rates of the Lek against main currencies basket is due to weakened seasonal effect[71]

Chart 65 Annual changes of the Lek nominal effective exchange rate (NEER[72]) and the moving average (left), annual changes for the first three months of 2009 and 2010 (right)



Source: Bank of Albania

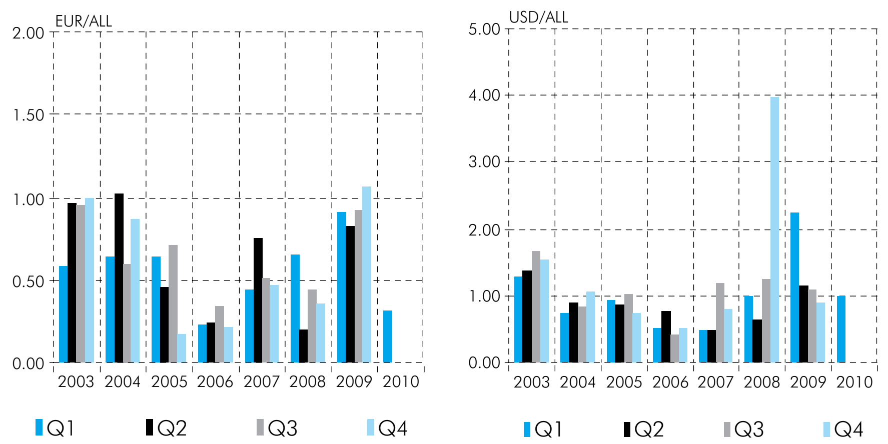
Chart 66 Daily performance of the Euro/Lek and Usd/Lek ratio (left) and daily performance of the Euro/Lek ratio in the first quarter of 2008-2010 (index as at the first day of the year) (right)



Source: Bank of Albania

that characterizes the first quarter of each year. The lessened impact of the seasonal factor is attributed to macroeconomic and technical factors. Trade deficit correction - as an outcome of decreased imports and increased exports – during the first two months of the year, has contributed to weakening the depreciating pressures on foreign exchange markets. Besides this economic factor, market agents' awareness of this seasonal effect has played an important role in reducing exchange rate volatility over the first quarter. Distribution of the needs for foreign currency has minimized the demand-side shocks. This behaviour of market agents is in line with the operation of more developed financial markets, which aims at a non-concentrated distribution of seasonal conversions.

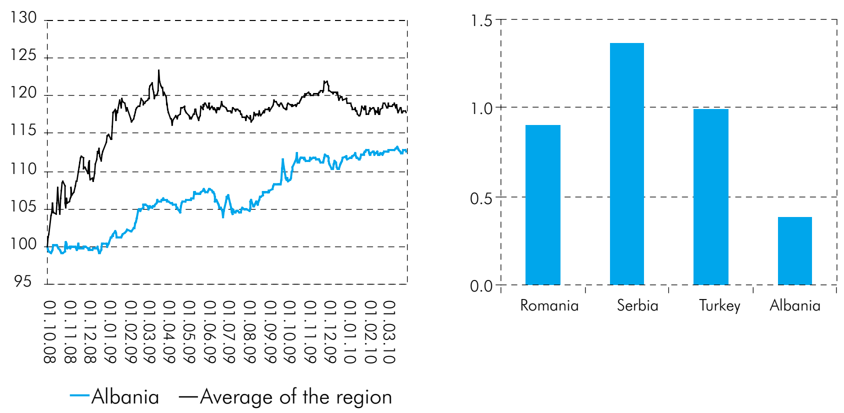
Chart 67 Volatility[73] of the Lek's exchange by quarters



Source: Bank of Albania

In the first quarter of the year, the position of the Lek against hard currencies, the euro and dollar, in the domestic foreign exchange market shows its depreciation in average annual terms, respectively with 8.22% and

Chart 68 Performance of euro/lek ratio relative to average in the region (index as at 1 October, 2010 (left). Euro/national currency volatility[74] for countries in the region as at Q1, 2010 (right)



Source: Bank of Albania

1.62%. On the other hand, quarterly developments reflect more decelerated depreciating rates of the Lek against the Euro (1.09%) and more accelerated rates against the U.S. dollar (7.89%).

From a regional perspective, the lek vis-à-vis the euro appears to have reflected a relatively similar performance to that of the average in the region. The trade deficit correction, the efforts for reducing fiscal deficits, foreign exchange inflows from debt issue, the stabilization of expectations for the future, and the reduction of perceived risk in general are factors that have influenced such behaviour. The lek to euro ratio in the first quarter of the current year reflected lower volatility compared with this ratio for currencies of the countries over the said period.

ENDNOTES

[1] Brazil, Russia, India and China.

[2] Measured as a moving sum for the preceding 12 months ended on March 2010.

[3] The historical mean for 2000-2008.

[4] Budget expenditures recorded negative growth rates, by –17.2% in the fourth quarter of 2009.

[5] Annual inflation pursued a downward trend until the third quarter of 2009.

[6] Output gap is the difference between the actual output of an economy and the potential output (the economy would be at under full capacity or maximum efficiency).

[7] The Monetary Conditions Index is a weighted average of changes in the basic policy rate and the effective exchange rate (NEER) of the lek vis-à-vis values in a base period (December 2005). The ratio of Monetary Conditions Index in Albania's case is estimated at 1.82:1, which means that the depreciation pass-through by 1.82 percentage point of the NEER to the aggregate demand may be offset by 1% interest rate rise. An increase of the MCI corresponds to tighter monetary conditions at home, but not as a monetary policy stance.

[8] When inflation started to edge up.

[9] Raw materials, mainly imported ones (cereal, rice, sugar and oils, etc.,) account for the greatest share in this item.

[10] The average of two measures (with permanent exclusion and trimmed mean).

[11] For the period of Q1 2001 – Q2 2010, the core annual inflation in average terms is about 1.1%.

[12] Here are excluded sub-items encompassing energy and water.

[13] During the first nine-month period, the economic growth averaged 4.7%. Annual growth rates by quarters are respectively 3.8, 6.3, and 3.9%.

[14] The domestic economy analysis in terms of gross domestic product is based on INSTAT publication "Quarterly Gross Domestic Product, publication of the fourth quarter for 2009, April 2010".

[15] The potential level is approached to real average growth of GDP by 6.1% for 2000 – 2008.

[16]The chart shows revised figures of publications for September and December 2009 on whose basis is built the GDP series at base prices. (Q3_ 2009) and the GDP series at base prices (Q4_2009) built on the basis of publications of April 2010. The reviewed GDP series shows that the economic growth for 2006 and 2008 is reviewed on the upward direction (respectively 0.14 and 0.44 percentage point), whereas for 2007 on the reverse side (-0.38 percentage point).

[17]As proxied by Retail Trade Index, "foods" sub-item.

[18] Disposable income is proxied by building a weighted index of wage indexes and government contributions (social ones, economic aids, employment pay, etc.) as well as remittances.

[19] Along with revival of foreign demand, reflected in rise in exports for these products.

[20] House price and rental price indices refer solely to Tirana. House price index is calculated by means of the hedonic method, which helps construct an index adjusted from the quality change effects. The index is based on data from advertisements on house sale prices in "Çelesi" newspaper. Most of advertisements are priced in the Euro. They refer to re-sale by owners (not first-time sales). Also, the index may not display in time the sale price change as an effect of its change from house builders.

[21]Agricultural output estimated at 2006 prices. The agricultural output for 2010 is a forecasted figure.

[22] Services include the following branches: "Trade, hotel and restaurants", "Transport", "Post-telecommunication".

[23] Other services include: "Financial activities", "Real estate", "Renting", "Business activities", "Administration and public protection", "Compulsory social security", "Education", "Health Care", "Other social and individual activities".

[24] Foreign financing indicator, calculated as the sum total of current account, capital account, and the item "Errors and omissions", serves to present the need to finance the economy from foreign sources. Foreign sources may be in the form of debt liabilities (treasury bills, loans, trade loans, etc.) or/and from capital liabilities (foreign and capital direct investments). If these forms of foreign financing do not manage to meet the demand for foreign financing, then a decline in

reserve assets will balance the necessary funds.

[25] One of the most well-known macroeconomic identities equals the current account balance and the difference between savings and domestic investments. In the case when current account results in deficit, the savings level is lower than the level of domestic investments, implying borrowing from the rest of the world.

[26] Nouriel Roubini, Paul Wachtel, "Current account sustainability in transition economies", Discussion paper of NBER No. 6468, March 1998.

[27]The process undertaken in an effort to decrease financial leverage by reducing the amount of outstanding debt.

[28] Raw material price index is measured at a monthly frequency by the IMF. It grew by 43.8% for the period under question.

[29] These products recorded three-digit figures of their annual growth for the first two months of the year.

[30] The average downward rate of imports for the first two months of the year was 6.8%.

[31] Albania is a member state of the Free Trade Agreement of the Central Europe since July 2007.

[32]Signatory countries of the Free Trade Agreement of the Central Europe since July 2007.

[33] Data on fiscal indicators for February and March 2010 are unavailable and their release is delayed, taking into consideration the date of their publication according to the budget instruction.

[34] Operational data refer to the data reported by commercial banks for the account of state budget at the account "Government deposit" with the Bank of Albania.

[35] Primary deficit indicator – which is the budget deficit corrected at the amount of interest payments – is built as the moving sum of monthly flows of primary deficit for 12 months.

[36] It is referred to 2006 – 2007, because monthly data for January 2008 are not available.

[37] In January `10, the VAT contribution to total revenues was about 2.4 percentage points, while in 2006 – 2007, this contribution resulted about 6.2 percentage points.

[38] The imported quantity of fuels at the beginning of 2010 is lower than at the same period of 2009.

[39] Amendments to the Law "On Excise Duty" were passed by the Parliament on 28. 09. 2009. Along with the increase of tax scale for several goods subject to excise duty (mainly tobacco), they consisted in adding the range of goods subject to excise duty with "Incandescent lamps" group (excluded until 2009).

[40] Budget balance at end of January resulted positive by ALL 2.3 billion. Domestic borrowing, including the direct credit, was about ALL 5.0. The counter-balancing item in financing the deficit is the government account position at the Bank of Albania, which is calculated with a negative sign in financing the deficit (ALL 7.3 billion).

[41] According to IMF data, the world economic growth for 2009 was – 0.8%; -3.2% for developed economies and 2.1% for the developing countries.

[42] The meeting of obligations for tax settlement during the crisis period may decrease also as a result of economy's shifting from the formal sector to the informal one, due to deviation from or non-accurate declaration of income.

[43] The decline in the global demand for goods and services is also associated with a real decline of the demand for imports, which for the government constitutes a reduction of revenues from excise or customs duties.

[44] OECD Economic Outlook, Chapter 3: "The effectiveness and scope of the fiscal stimulus" (2009).

[45] The structural position is proxied to the primary structural position, which is the budget balance corrected for interest expenses, cyclical factors and measures applied in sole and specific cases.

[46] The targeting of the balance corrected for the effects of the business cycle helps measure the fiscal policy effect on budget performance and on aggregate demand.

[47] Ricardian behaviour or Ricardian equivalence implies an increase in private savings at the same extent with the reduction of public savings, since economic agents perceive an unsustainable fiscal position thus raising their savings.

[48] According to IMF Staff Position Note "The State of Public Finances, Cross Country Fiscal Monitor" (November, 2009).

[49] The most widespread types of fiscal rules have targeted the level of expenditure or of the budget deficit.
[50] Monetary indicators analysis for the first quarter 2010 includes January and February.
[51] The following monetary indicators exclude the exchange rate effects, except when otherwise stated.
[52] GDP is aimed to be stable in the short run, since there is needed time to change the overall output level.
[53] The average broad money velocity for 2008.
[54] The figures presented in this analysis are adjusted for the exchange rate effect.
[55] Based on lending survey of the banking system over the first quarter of 2010.
[56] During 2009, banks applied tougher lending standards for households' loans granted in foreign currency, whose income is generated in leks, in response also to measures taken by the Bank of Albania.
[57] Banks' answers regarding lending activity are aggregated through the "net balance" indicator. The net balance is calculated as a difference between banks' weighted answers, which have reported easing/increase of standards/demand and the ones reporting tightening/decrease of standards/demand. The weights are calculated based on the loan portfolio ratio of each bank to total loans, for various market segments, according to question type (business loan/household loan, lek- or foreign currency-denominated).
[58] INSTAT, labour force as at the fourth quarter 2009.
[59] Source: Employment analysed in this paragraph refers to preliminary data obtained from the Ministry of Labour, Social Affairs and Equal Opportunities.
[60] Short-term Albanian Statistics and business confidence surveys lack indicators on agriculture.
[61] The latest data on wages are as at the third quarter of 2009. Their analysis is reflected also in the Annual Report of the Bank of Albania.
[62] Wage indicator in the economy, referred to as "average wage", is measured as a ratio of wages fund index to the employed index, whose source is the "Short-term Statistics" released by INSTAT, which exclude agriculture. The data are quarterly.
[63] Average wage index is deflated to inflation index to obtain the real wage index.
[64] Budget and non-budget.
[65] Lack of data for the absolute value of GDP for the fourth quarter of 2009 does not enable calculation of labour productivity and unit cost for this quarter.
[66] Referring to employment index, released by INSTAT, short-term statistics until the third quarter of 2009.
[67] The LP (Labour Productivity) indicator and the ULC are built on the basis of seasonally adjusted Value Added (GDP, INSTAT) and short-term statistics, which do not include the agriculture sector. INSTAT has released data on wage and employment performance, necessary series to produce LP and ULC.
[68] Foreign price index as a multiplication of the weighted average of consumer prices in Greece and Italy at the Eur/Lek exchange rate, with a 3-month lag.
[69] A proxy indicator estimated from corrected consumer Foreign Price Index.
[70] The change of the auction form of reverse repurchase agreements entered into force on 15 January of the current year.
[71] The exchange rate is generally depreciated during the first quarter of the year, due to high demand for foreign currency by importing companies and foreign ones, which send their profits to their home country upon closure of the financial year. Also, the exchange rate depreciation during this quarter is attributed to the correcting effect that follows the year-end appreciation from increased foreign currency inflows.
[72] NEER – Nominal effective exchange rate, calculated against both currencies by an approximate weight they occupy in foreign trade, euro (80%) and USD (20%). A rise in the NEER implies the lek's appreciation.
[73] Calculated as the quarterly average of exchange rate volatility. Exchange rate volatility is measured from monthly standard deviation indicator.
[74] It is calculated as a standard deviation of the daily rates of the euro/national currency ratios for the first quarter of 2010.