Bank of Albania

MONETARY POLICY REPORT FOR THE SECOND QUARTER OF 2010

*This Report refers to the Monetary Policy Statement of the Bank of Albania for the First Half of 2010, approved by Decision No. 50 of the Supervisory Council, dated 28 July 2010.

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V. Financial markets, interest rates and the exchange rate

I. FOREWORD BY THE GOVERNOR

Economic and monetary developments of the first two quarters of 2010 were by and large in line with Bank of Albania's forecasts. Economic activity has slightly improved, inflation pressures have been downward and the external balances of the Albanian economy have recovered. In the meantime, the financial markets were provided a breathing space and featured lower risk premia, improved liquidity figures, downward interest rates and relative exchange rate tranquillity. The upcoming period is expected to feature similar characteristics.

The performance of the Albanian economy may be considered as positive, particularly when put in the context of the developments in global economy and the regional countries, and considering the challenges faced over this period. The latter represented a tough test for the sustainability of the Albanian economy, both at a macro and micro level, and in terms of the institutional and political capacities of economic management.

However, when viewed elaborately, economic and monetary developments in the first half of the present year provide numerous shadings for their interpretation. The Albanian economy still suffers the low domestic demand and activity financing-related concerns. Economic growth and economic development are not balanced yet for all the sectors of the economy. Economic growth has mainly relied on foreign demand rather than on domestic demand and it attests to a more dynamic performance of industry and services and slower performance of agriculture and construction. In addition, economic growth has been coupled with slower labour market and employment figures performance, hence increasing the non-utilized human and capital capacities of the Albanian economy. On the other hand, economic performance has confirmed the importance that the preservation of macroeconomic balances has to our country's stable and long-term development, as well as the need for the contribution of all economic players to guaranteeing them.

These messages, which constitute the main topics of this quarterly report, will be further elaborated below.

The global context that outlined Albania's economic development over this period has recovered, however the financial markets and investor sentiment remain highly volatile. Global economy continued to recover in the second quarter of 2010, being largely driven by the rapid economic growth in emerging economies and the fiscal and monetary stimulus in advanced economies. The Euro area is showing signs of stable growth but our main trading partners, Italy and Greece, are performing less positively. Despite the higher demand, the global negative output gap has yielded low inflationary pressures, which are expected to persist in the medium run as well. However, this positive setting is still incomplete as long as unemployment remains high in the majority of countries. Public debt figures are weighed down further by the fiscal burden contracted as a result of the high-cost government measures undertaken over the last two years to fuel the economy, while the fiscal room has narrowed down substantially. Concerns over fiscal sustainability, particularly in some Euro area countries, have been also reflected in the performance of financial markets, which featured higher risk premia and elevated profit margins.

Against this global background, official statistics show that the Albanian economy has experienced a rebound in growth. Following the decline of GDP in the last quarter of 2009 and the weak economic activity in the early months of 2010, the available data on the real and monetary sectors suggest that the Albanian economy posted positive growth rates in the first half of the present year. According to INSTAT's preliminary data, GDP grew 2% y-o-y in the first quarter of 2010. The growth in foreign demand was reflected positively in the performance of industry, which grew 27.5% for this period. On the other hand, the slower domestic demand was manifested in moderate growth rates of services and progressive contraction in the construction sector. The more positive performance of GDP in the first quarter of 2010 finds more support in the qualitative data. The Economic Tendency Indicator particularly increased 4.6 points versus the previous quarter, though remaining well below its long-term average. Along with other indirect indicators, like credit growth trend and the higher pace of budget revenue, business and consumer expectations for the second quarter of the present year suggest that the economic growth posted similar rates to the first quarter.

The below potential economic growth was coupled with slower labour market. Unemployment rate is 13.8%, slightly higher than the last five years' average. The decline in employed people has expanded the negative gap between supply and demand for labour, hence giving rise to slower wage rise and labour cost in economy.

In absence of timely data on the performance of demand components, our analyses based on quantitative and qualitative indirect indicators suggest that domestic demand has been affected by the decelerated consumption and decline in investments, as well as by the lower fiscal sector's contribution. On the other hand, the higher foreign demand has been reflected in considerably higher exports and their elevated contribution to aggregate demand.

Consumer spending was contained in the first half of 2010. The decline in consumer loans and remittances, the lower rise in wages, the lower growth in the imports of consumer goods, the low consumer confidence, and the higher household savings trend attest to lower growth rates of private consumption over the course of this period. The performance of the latter was affected by the slower growth rate of disposable income, the restrained financial resources, a more conservative consumer behaviour against a background of elevated uncertainties over the future, and the slower employment figures. In addition, private investments were downward in the first half of 2010; however their negative contribution was lower than in the second half the previous year. This performance owes to a large extent to the low capacity utilization in economy. In addition, the banks' tight lending terms have discouraged the demand for loans. However, the latest developments, like the growth of business demand for investment loans and the increase in the imports of intermediate and capital goods provide positive signals for the possible recovery of this demand component.

The public sector continued to contribute positively to the growth of aggregate demand in the first half of 2010. The government ran an expansionary fiscal policy, but rather more moderately relative to the previous year. Budget deficit, albeit narrowed 36% y-o-y, was pronouncedly higher than the projection. Budget expenditure is 4% lower than in the first half of 2009. The annual growth rates of current expenditure slowed down to 7.1%, whilst public investments declined 33.5%. Against a background of slow economic performance, fiscal revenue grew at low historical rates, 3.3%. In light of these developments, considering with priority the preservation of fiscal sustainability, public confidence and the associated risk premia, and welcoming a lower impact of fiscal policy on the financial markets, the Bank of Albania considers the downward revision of budget deficit and public expenditure as a positive and required step. By creating a more realistic setting for 2010 fiscal indicators, this revision will help maintain the medium-term macroeconomic balances. In addition, in order to maintain appropriate parameters of deficit and public debt figures, fiscal consolidation should progress beyond the actions undertaken in the short run. Fiscal sustainability needs to be addressed in the future through the adoption of a clear fiscal rule that should serve as a guide to and determinant of fiscal policy behaviour in the medium run and beyond.

The growth of foreign demand and the more favourable exchange rate position fuelled the Albanian exports, which grew 62% in the first five months of 2010. In parallel, the weak domestic demand has led to a low annual increase of imports, hence causing the balance of trade deficit to narrow 16.2%. Consequently, net exports provided a more positive contribution to aggregate demand. They also led to the continuous correction of the current account deficit, hence stabilizing the national currency further. The downward correction of the current account deficit by 2.7 p.p. of GDP provides an encouraging signal for the sustainability of Albania's external position. However, net financial inflows into the capital and financial account reduced 62.9% y-o-y in the first quarter of 2010. In addition, remittances, which make up a major source of trade deficit financing, are down 6.7% y-o-y. Both these concerns re-accentuate the fact that the external position of the Albanian economy remains a structural weakness that calls for further correction. Foreign direct investments, which grew 25.8% in the first quarter of 2010, represent the safest source of current account deficit financing. They need to be further boosted with attractive policies for foreign investors and structural reforms in the Albanian economy.

Annual inflation marked 3.2% in June. The slowdown in annual inflation, which commenced in March this year, was triggered by the low demand-side pressures, the lower prices in agricultural products and a more stable exchange rate. Against a background of non-utilized capacities in the labour and capital markets, the low core inflation rates attest to the low inflationary pressures balance. The contracted demand will determine the downward inflation pressures in the coming period, whilst the performance of monetary indicators shows weak inflationary pressures of a monetary kind. As expected, supply-side shocks on consumer prices were transitory and did not affect economic agents' expectations of inflation, which remain well-anchored around the Bank of Albania's target. Price stability has been achieved as a result of an adequate monetary policy decision-making, though amid substantial uncertainty over the future prospects and absence of timely statistical data.

Over the stated period of time, our monetary policy was stimulating, maintaining low interest rates and injecting the required liquidity and at well-suited maturity terms, in order to boost activity in the financial markets and lending to the economy.

In response to this policy, the interest rates in the interbank market were stable, reflecting largely the stable liquidity position in the system, while long-term interest rates maintained a downward trend as a result of lower risk premia. In the primary market, Government security yields of all maturity terms continued to decline in the second quarter. In addition, this period featured further growth of banking system deposits and their time-related shift to time deposits. Once household savings placed in the system increased, the interest rates on deposits showed a downward tendency. On the other hand, private sector credit continues to post low growth rates despite the improved liquidity figures and the lower activity financing costs. The annual growth of private sector credit averaged 9% in the second quarter of 2010. The credit market continues to feature volatile interest rates and tight lending conditions. However, the latest months' developments show positive signals, particularly in terms of the rather higher credit growth rates, its greater orientation towards supporting investments and the recovery of foreign currency lending to economic units whose income is in foreign currency. The Bank of Albania has been promoting this performance and will continue to do so, and encourages the banking system and borrowers to work harder in finding effective forms, instruments and practices that fuel credit.

The Bank of Albania considers that the monetary conditions and the demand-supply ratios in the major markets of the economy are well-suited to maintain price stability in the medium run. Our monetary policy will continue to be prudent in view of meeting the inflation target and maintaining macroeconomic stability.

II. DEVELOPMENTS IN EXTERNAL ECONOMY

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

Global economy showed signs of recovery in the first half of 2010. By and large, emerging countries experienced more rapid economic growth than advanced economies. Inflation in these countries performed along the same line, marking slightly higher rates in emerging countries and low rates in advanced economies. The concern of market agents over the impact of several Euro area countries' elevated sovereign debt has increased the demand for securities issued by countries with a more sound fiscal position.

Table 1 Key macroeconomic indicators

	GDP change		Unemployment rate	Inflation rate	
Country	Q1-10/ Q1-09	Q1-10/ Q4-09	May-10	June-10/ May-10	June-10/ June-09
USA	2.4	0.7	9.5[1]	-0.1	1.1
Euro area	0.6	0.2	10.0	0	1.4
Germany	1.5	0.2	7.0	0	0.8
France	1.2	0.1	9.9	0	1.7
United Kingdom	-0.2	0.3	7.9[3]	0.1	3.2
Japan	4.2	1.2	5.2	0.1[2]	-0.9[2]

Source: Eurostat, Respective statistical institutes

[1] Data for June 2010.

[2] Data for May 2010.

[3] Data for Q1 2010.

EURO AREA ECONOMY

In the first quarter of 2010, Euro area's economy grew 0.6% versus the same quarter the previous year, driven by the increase in inventories and government spending. Imports grew faster than exports, thereby widening the negative contribution of net exports to economic activity growth further, whilst domestic demand remains weak. Survey data suggest that the second quarter of 2010 will experience a slight economic growth, with industrial output expected to grow and business activity anticipated to recover in all sectors, except for construction. Unemployment, which remains high, posted slight growth rates in the early months of the second quarter relative to the previous quarter. Average annual inflation rate marked 1.5% in the second quarter, almost close to the previous month's rate. Transportation prices rose the highest, while communication prices recorded the lowest rise.

US ECONOMY

US economy grew 2.4% in the first quarter of 2010 versus the first quarter of 2009, fuelled by the increase in consumer spending, private investments and inventories. Public investments and net exports provided an adverse impact on economic growth, with imports growing faster than exports in the first quarter of 2010. In the second quarter, unemployment rate declined gradually to 9.5% in June. However, this decline owes largely to the opening of seasonal jobs by the government. Annual inflation rate averaged 1.8% in the second quarter of 2010, marking negative monthly growth rates in all the three months of this quarter.

BRIC ECONOMIES

BRIC economies, excluding Russia, posted high growth rates in the first quarter of 2010. Growth in China was underpinned by industrial output and fiscal stimulus that gave rise to higher domestic demand and aggregate investments. In India, economic growth was driven by the recovery in production and agriculture, the latter being affected by the improved weather conditions. In Brazil, the growth in industrial output led to higher economic activity.

Inflation in China increased slightly. In Brazil, it stood at similar levels, while in India it decreased marginally. In Russia, the inflationary pressures subsided considerably as a result of the national currency appreciation.

Table 2 Key macroeconomic indicators for BRIC economies

Country	Real GDP y-o-y change		Annual inflation
	2009	Q1 2010	June 2010
Brazil	-0.2	9.0	4.8
Russia	-7.9	1.5[1]	5.8
India	7.2	8.6	14.1[1]
China	8.7	11.1[2]	3.1[1]

Source: IMF, OECD, Respective statistical institutes

[1] May 2010 figure.

[2] Q2 2010 figure.

REGIONAL ECONOMIES

Italy's economy posted a slight growth of 0.5% in the first quarter of 2010 versus the same quarter the previous year. This growth was mainly underpinned by higher consumer spending and net exports, while aggregate investments recorded downward growth rates. The measures undertaken by the Greek economy following the financial turmoil affected economic activity as well. Greek economy contracted 2.5% y-o-y in the first quarter of 2010, due to the rapid decline of public spending and aggregate investments. The improved trade deficit is the sole indicator to have contributed positively to economic activity. Turkish economy grew 11.7% y-o-y in the first quarter of 2010, thereby recovering the economic contraction by 4.3% in 2009. All sectors experienced rapid growth except for agriculture. The high domestic demand triggered rapid growth of imports, which, coupled with the decline in exports, provided an adverse contribution to economic growth. In the first quarter of 2010, FYROM's economy contracted 0.9% versus the same quarter the previous year, owing to the decline in all domestic demand components and lower industrial output. The decline in imports and the rapid growth of exports helped to maintain the economic decline at moderate rates.

Unemployment recorded upward figures in Italy, Greece and FYROM, while maintaining downward rates in Turkey. Inflation rate increased y-o-y throughout the region.

Table 3 Economic indicators for regional countries

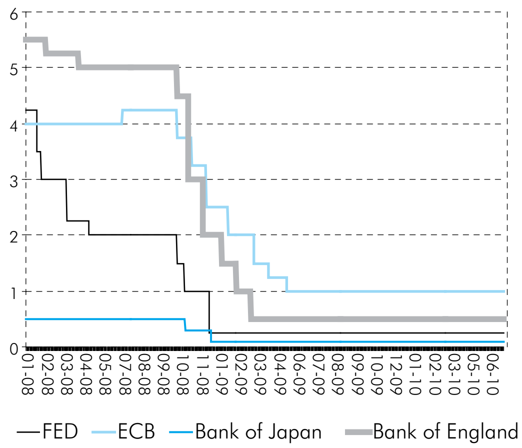
Country	GDP change	Annual inflation	Unemployment rate
	Q1:10	June-10	April-09
Italy	0.5	1.5	8.7[3]
Greece	-2.5	5.2	11.0[2]
Macedonia	0.9	1.8	33.5[1]
Serbia	0.6	4.2	19.5
Croatia	-2.5	1.8	17.2[3]
Turkey	11.7	8.4	12
Kosovo	4.6[4]	2.2	:
Albania	2	3.2	13.8[1]

Source: Respective Statistical Institutes, EuroStat, EcoFin, IMF
[1] Data for Q1 2010.
[2] Data for March 2010.
[3] Data for May 2010.
[4] IMF projection for 2010.
: Unavailable data.

II.2 MONETARY POLICY, FINANCIAL MARKETS AND THE EXCHANGE RATE

All the major central banks kept their respective key interest rate unchanged in the first half of 2010. In light of the positive projections for economic growth, the current rates were considered adequate to keep inflation under check and boost the economy. It is for more than a year that these central banks do not change their key interest rates, keeping them at historical low levels. In their meetings of June 2010, the ECB kept its key policy rate at 1%, the Fed at 0-0.25%, the Bank of England at 0.5% and the Bank of Japan at 0.1%.

Chart 1 Key interest rate



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

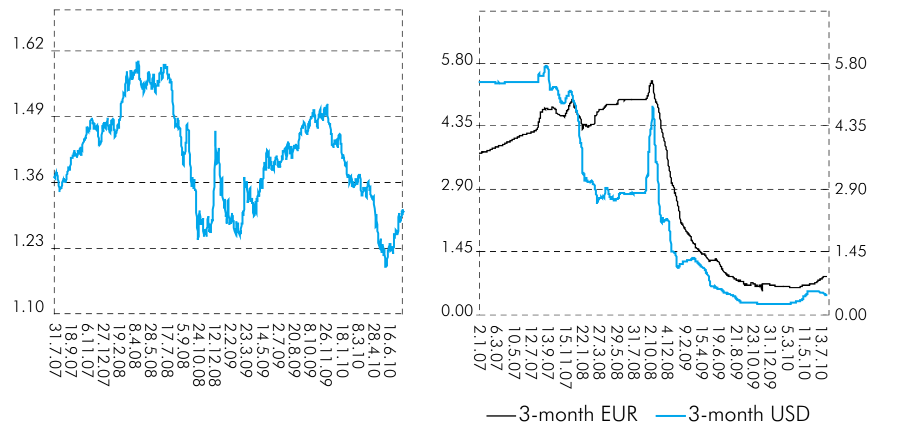
Financial markets featured an improved situation and higher interest rate volatility. The main market agents' concerns over public debt-related concerns of several Euro area countries were transmitted rapidly to many market segments, giving rise to higher risk premium and yield spreads. In the meantime, markets in advanced and emerging economies continued to confirm positive signals, thereby improving the market agents' expectations for a positive economic growth outlook. Interest rates in the markets continue to reflect the effects of the ample liquidity injected by the central banks' accommodating policies to withstand the crisis. Stock markets attested to a slight downward performance of prices as a result of the agents' concerns over the unfavourable public balances situation in some Euro area countries (Greece, Portugal and Spain). Dow Jones, S&P and Nikkei indices featured a downward trend over this quarter. The abovementioned financial concerns and the signs for an anaemic recovery[1] affected the major stock markets over this quarter.

In the second quarter of 2010, Euribor and Libor interest rates in the money market recorded moderate consecutive increase, shifting slightly from the key rates. In average terms, the 3-month Euribor interest rate increased 3 basis points from the previous quarter to 0.70% in June. The 3-month Libor interest rate increased 17 basis points this quarter to 0.54% in June.

Bond markets in Europe, USA and Japan showed a slight downward trend of the yields. The market agents' concerns over the unfavourable fiscal positions of some Euro area countries (Greece, Portugal and Spain) gave rise to higher demand for debt securities issued by more solid countries, thereby lowering the yields.

In the foreign exchange markets, the depreciation of the Euro against the major currencies, particularly against the US Dollar, the British Pound and the Japanese Yen, deepened further in the second quarter of 2010. The Euro lost ground to other European currencies as well. The more positive performance of the U.S. economy and the unfavourable situation in the Euro area over this period led to further depreciation of the Euro against the US dollar. In early July, 1 Euro traded at USD 1.25, down 6.8% from early April.

Chart 2 EUR/USD (left-hand) and USD, EUR Libor (right-hand)



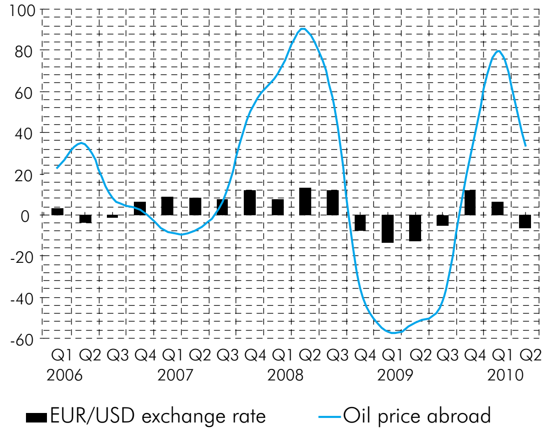
Source: ECB, Reuters

1 *Although the companies continue to report increase in their profits.*

II.3 OIL AND PRIMARY COMMODITY PRICES

In the second quarter of 2010, crude oil price was about 71-79 USD/barrel. After the persistent fall of the oil price in May, it rose slightly in June to the early 2010 levels. This rise owes to the higher demand from OECD countries as a result of the positive performance of their economic activity and optimistic future outlook. The supply-side also led to higher crude oil price. Supply of OPEC countries maintained a downward tendency in the last months of the second quarter. Although forecasts indicate a slightly higher supply in the following months, crude oil price is expected to reach 82.4 USD/barrel in December 2010, since the demand is expected to grow.

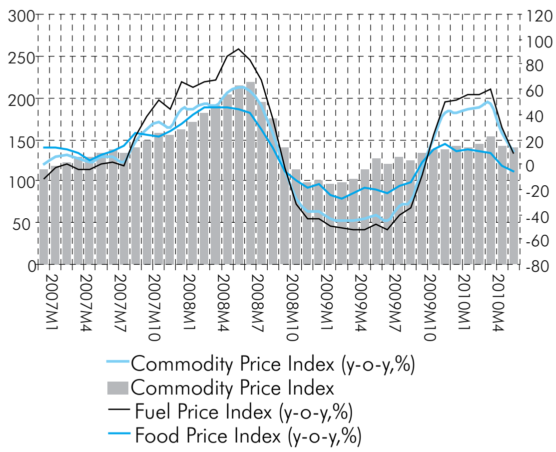
Chart 3 Annual change of oil price in the international market and EUR/USD exchange rate



Source: Eurostat, EIA

In the second quarter of 2010, the main commodity indices remained almost close to the previous quarter's levels. The monthly increases of these indices maintained a downward trend over this quarter. In the last two months, they recorded negative figures. Q-o-q, Commodity Price Index and Fuel Price Index increased 2% and 1.7%, respectively, in the first quarter, whilst the Food Price Index declined -0.2%. Relative to the same period the previous year, the Commodity Price Index and Fuel Price Index maintained a similar performance in the second quarter and increased 26.2 and 30.6%. The Food Price Index remained at similar levels and increased 0.8%.

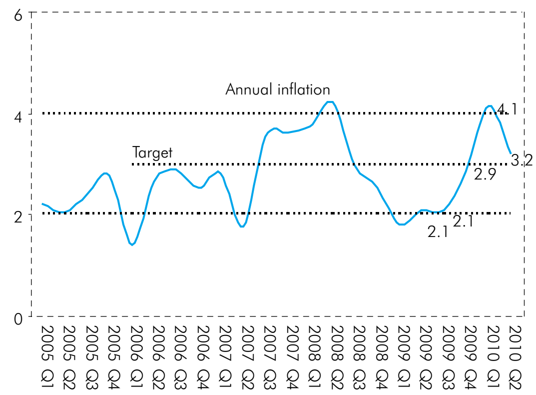
Chart 4 Price indices by main commodity groups and their annual changes



Source: IMF

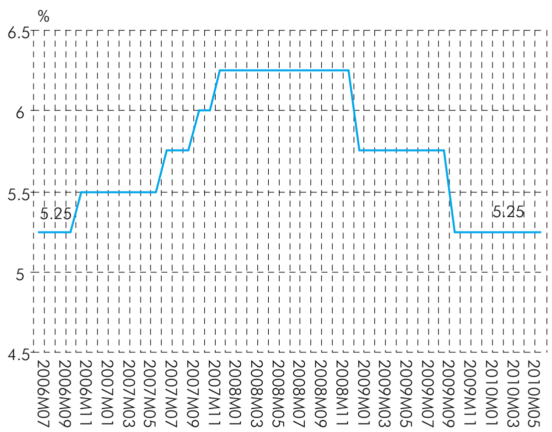
III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

Chart 5 Average annual inflation by quarters (in %)



Source: INSTAT and Bank of Albania estimates

Chart 6 Key interest rate (in %)



Source: Bank of Albania

After peaking in the first quarter of 2010, CPI annual inflation marked rates within the tolerance band and around the Bank of Albania's 3.0% target for inflation. Average annual inflation marked 3.2% in the second quarter. The low domestic demand-side pressures, the lower agricultural product prices and the relatively stable exchange rate triggered the decline of the annual inflation rate. Monetary and economic analysis confirms that the inflationary pressures will be contained against a background when the economic agents' expectations for inflation remain anchored around the central bank's target.

III.1 INFLATION AND MONETARY POLICY

Average annual inflation marked 3.2% in the second quarter of 2010, 0.2 p.p. above the Bank of Albania's inflation target and close to the central bank's forecast. After peaking in February 2010, 4.4%, annual inflation returned to the tolerance band of 2-4% in the upcoming months[2]. The slowdown in the annual inflation rate owes primarily to the low domestic demand-side inflationary pressures, the lower agricultural product prices and the stable exchange rate. The prevailing deflationary pressures amid free capital and labour market capacities were also reflected in the low core and net non-traded inflation rates.

The Bank of Albania continued to pursue an easy monetary policy in 2010. According to the Monetary Conditions Index, the monetary conditions are stimulating to the economy. Besides keeping the key interest rate unchanged at 5.25%, the Bank of Albania's monetary stimulus persisted in the economy through the injection of liquidity to sustain the banking system. Thereupon, the well-functioning banking system gave rise to higher financial intermediation and lending.

2 Annual inflation rate by month for the period March-June 2010 is 3.9, 3.5, 3.1, 3.2%.

Following the contraction in the last quarter of 2009, the Albanian economy posted weak growth rates in the first quarter of 2010. According to INSTAT's data, y-o-y GDP growth was 2.0% in the first quarter[3]. Economic growth in this quarter, albeit positive, shows a pronounced slowdown from the historical average[4] of 6%. The downward trend has been also shown in several indirect indicators of the economy[5], namely budget revenue, private sector lending and business and consumer confidence in the first quarter of 2010.

In a macroeconomic context, the slow economic growth reflects the weak domestic demand in the first half of 2010. The limited financial resources and the consumer and business perceived uncertainty dampen the increase of private spending for consumption and investment at levels comparable to the previous years. Although private sector credit showed signs of recovery in the second quarter of 2010, public spending declined[6], suggesting for weaker fiscal stimulus than in the previous quarter. The dampened domestic demand was somehow offset by the positive contribution of the growth in exports. Deficit in net exports narrowed 19% in the first quarter. External sector data for the second quarter of 2010 provide evidence for the further contraction of the trade deficit in this quarter.

Economic and monetary analysis confirms that the inflationary pressures will be contained in the medium run. In absence of unexpected supply-side shocks, the adequate monetary conditions and the anchoring of economic agents' expectations for consumer prices support the Bank of Albania's forecasts for safeguarding consumer price stability in the medium run, expressed in low and stable inflation rates.

III.2 MONETARY CONDITIONS

Bank of Albania's monetary policy continued to be oriented to the injection of monetary stimulus into the economy in view of meeting the central bank's primary objective – maintaining price stability – and safeguarding Albania's macroeconomic stability. Monetary policy decisions have taken into account the performance of fiscal policy in order for the stimulus to be absorbed timely and appropriately by the private sector. According to the Monetary Conditions Index, the key interest rate is at low historical levels and the exchange rate maintains a depreciating trend though more moderately than in 2009.

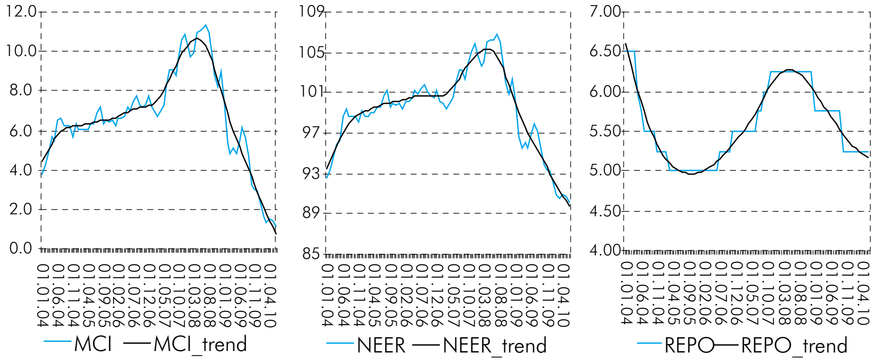
3 *According to INSTAT's publication, July 2010: Gross Domestic Product for the first quarter of 2010.*

4 *Economic growth in the first quarters of 2003-2009.*

5 *Fiscal revenue increased negligibly in the first quarter of 2010 versus the same period in 2009 (+0.5%). The annual growth of credit to the economy (excluding the exchange rate effect) was only 4.3% in the first quarter. Economic Tendency Indicator remains below its long-term average.*

6 *Budget spending increased 1.1% in the first quarter. In the second quarter, it contracted 8% y-o-y.*

Chart 7 Monetary Conditions Index (MCI)* and its components



*Monetary Conditions Index (MCI) is the weighted average of changes in the key interest rate and the nominal effective exchange rate (NEER) of the Lek against their respective values in a base period (December 2005). The MCI ratio in the case of Albania is 1.82:1, implying that the effect of the depreciation of the NEER by 1.82 p.p. on aggregate demand would be offset by the increase of the key interest rate by 1.00 p.p.. Worth noting is that the increase of the MCI may be viewed as a sign of monetary conditions tightening at home, rather than as the monetary policy stance.

Source: Bank of Albania

Despite the lower T-bill yields and ALL deposit interest rates, the interest rates on loans have not shown any clear downward tendency yet. The first two have generally responded rapidly to the monetary policy signals. However, some indicators suggest that the risk premia for long-term investments are lower and the system's lending capacity is upward. This performance will be favoured further by the latest fiscal policy measures to bring down budget deficit and reduce domestic borrowing. The available data show slower aggregate demand and contraction of fiscal stimulus, which in turn provides room for monetary conditions easing and their successful transmission into the economy. In addition, it is expected that the exchange rate will confirm the rebound in the second half of 2010, thereby lowering the risk.

III.3 PRICES OF CONSUMER BASKET ITEMS

Average annual inflation marked 3.7% in the first half of 2010, up 1.7 p.p. from the first half of 2009. The upward tendency of the inflation rate beginning from the last quarter of 2009 was mainly confirmed in the first two months of 2010 when its rate deviated from the Bank of Albania's 3% target. The inflation rate recovered to within the tolerance band of 2-4% in March, while in the second quarter it gradually stabilized to lower values around the 3% target.

Inflation of goods and services' items broken down according to their economic nature was triggered by supply-side factors, which shifted direction in the first two quarters of 2010. In the first quarter, the depreciating exchange rate, the higher prices of administered goods, the base effect[7] and the dampened domestic supply of agricultural products was translated into high

7 *Base effect increased the inflation 0.5 p.p. compared with last year's fall.*

inflation rates. In the second quarter of 2010, the positive performance of some of these factors and the weak demand prevailing in the market gave rise to lower inflation rates and alleviated inflationary pressures.

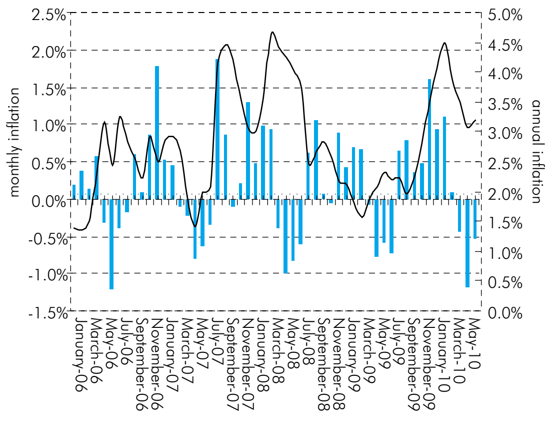
Annual headline inflation has been formed less by the contribution of "unprocessed foods" over the first half of 2010, while the contribution of other basket items mounted the pressures over the increase of the CPI compared with the relative low figure in 2009[8].

"Unprocessed foods" recorded consecutive price fall in the second quarter of 2010, showing a dissimilar performance relative to the early 2010. In June, this item's annual inflation fell 10 p.p. versus February the same year. The downward seasonal behaviour of this item's prices in the second quarter shifted the inflation curve downward by some percentage points. The relatively high deflationary intensity of these prices was also aided by the appreciation of the Lek to the Euro over this quarter as a result of the imported inflation.

The contribution of "unprocessed foods" to the inflation rate in the second quarter offset the upward positive contribution of two other major basket items, "administered prices" and "processed foods".

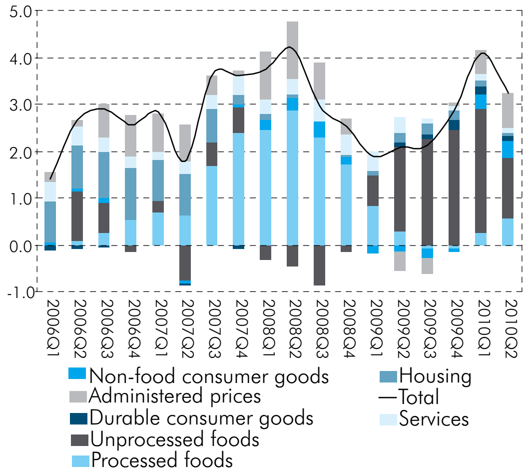
Following the price rise of electricity in January and of drinking water in March, "administered prices" is ever-increasingly increasing its contribution to determining the annual inflation rate in 2010 (this item's contributes by 0.9 p.p.). In addition to these price rises, tariffs for medical services rose over this quarter as well.

Chart 8 Monthly and annual inflation (in %)



Source: INSTAT, Bank of Albania

Chart 9 Contribution of main items to annual inflation (in p.p.)



Source: INSTAT, Bank of Albania

"Processed foods" recorded positive upward rates throughout the first half of 2010 due to the global conjuncture of this item's goods prices, which has maintained an upward trend since the year-end 2009. Its contribution to inflation increased by 2.6 p.p. versus the second half of 2009.

"Non-food consumer goods" contributed positively to headline inflation (0.3 p.p. on average) in the first half of 2010 due to the re-activation of the

8 *In June, "unprocessed foods" contributed 35% to headline inflation, versus 70% in February. The contribution of "administered prices" and "processed foods" to headline inflation increased versus December 2009 by 28 and 21%, respectively.*

oil price rise in the global and domestic market. This item's contribution to the inflation rate was negative throughout the year 2009.

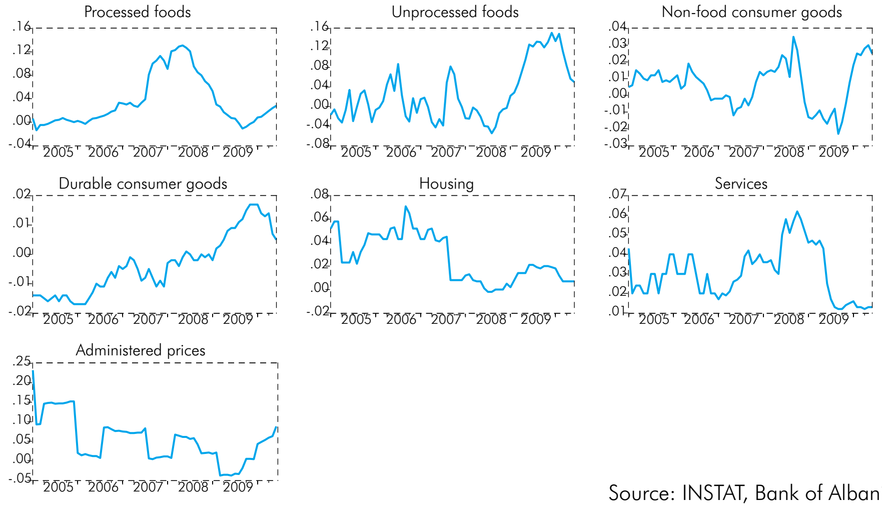
Table 4 Contribution of items to annual inflation (in p.p.)

	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10
Processed foods (pp)	0.9	0.3	-0.1	-0.1	0.3	0.6
Bread and cereal (pp)	0.6	0.2	-0.1	-0.3	-0.2	-0.1
Alcohol and tobacco (pp)	0.1	0.1	0.1	0.2	0.1	0.2
Unprocessed foods (pp)	0.6	1.8	2.3	2.5	2.6	1.3
Fruit (pp)	0.0	0.3	0.5	0.6	0.2	0.1
Vegetables (pp)	-0.3	1.4	0.9	1.0	2.0	1.5
Services (pp)	0.4	0.3	0.1	0.1	0.1	0.1
Administered prices (pp)	0.1	-0.4	-0.4	0.1	0.5	0.7
Fuels and electricity (pp)	0.4	0.0	0.0	-0.1	0.4	0.4
Housing (pp)	0.1	0.2	0.2	0.2	0.1	0.1
Non-food consumer goods	-0.2	-0.2	-0.2	-0.1	0.3	0.4
Durable consumer goods (pp)	0.0	0.1	0.1	0.2	0.2	0.1
Consumer Price Index (y-o-y, %)	1.9	2.1	2.1	2.9	4.1	3.2

Source: INSTAT, Bank of Albania

Against a background of low domestic demand, prices of goods and services of other inflation items remained almost unchanged, thereby providing a similar contribution as in the previous half.

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



Source: INSTAT, Bank of Albania

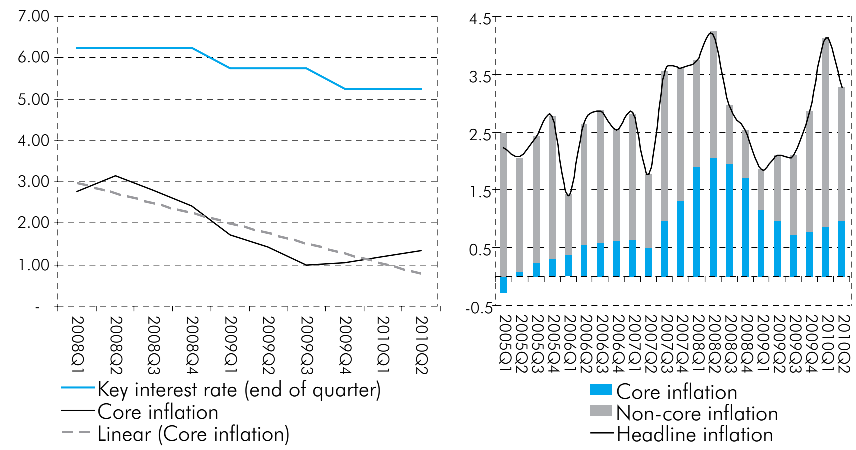
III.4 MAIN INFLATION TRENDS

Annual core inflation[9] marked 1.3% in the first half of 2010. Core inflation featured stable rates in the first and second quarter, 1.2 and 1.3%, respectively. Its rates confirm the downward trend of the long-term inflation component beginning from mid-2008[10].

9 Average of two measures (permanent exclusion and trimmed mean).
10 In June 2008, it hit the highest record, 3.2%.

In the first half of 2010, about 75% of annual inflation was formed by the short-term fluctuations in consumer prices. The annual contribution of non-core inflation was more moderate in the second quarter of 2010 than in the previous periods, attesting to the transitory nature of factors that contributed to its formation. Non-core inflation marked 8.2%[11] in the second quarter, higher than in the same period of 2009 but markedly lower than in the first quarter the present year (11.9%). Core and non-core inflation trends attest to the presence of low inflationary pressures on the domestic demand-side and to their gradual relief on the supply-side. These trends were more pronounced in the second quarter of 2010.

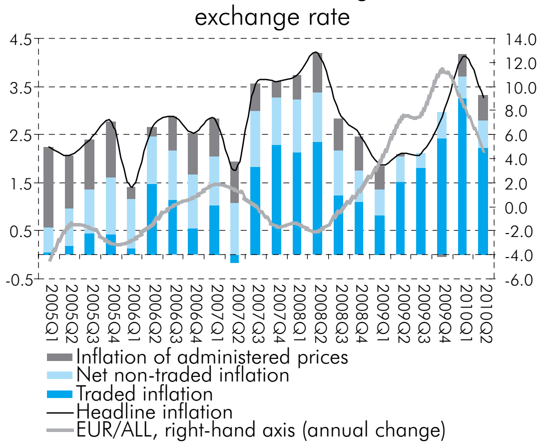
Chart 11 Annual core inflation and key interest rate (left-hand chart) and annual contribution of core and non-core inflation (right-hand chart)



Source: INSTAT and Bank of Albania

In average terms, annual inflation of traded and non-traded CPI basket goods marked 4.4 and 2.6%, respectively, in January to June 2010. After having increased until February 2010 (5.8%), traded inflation began to maintain a gradual downward trend in the second quarter to later become more pronounced in June (3.1%). Consequently, the annual contribution of traded inflation was lower in the second quarter than in the first one (67.8%), reflecting concurrently the fall of unprocessed product prices and the more complete transmission of signals for the curb in the depreciating rates of the Lek against the Euro in the market.

Chart 12 Annual contribution of inflation by sectors* and the annual change of EUR/ALL exchange rate



*Net non-traded inflation is measured by excluding only the sub-items of "water supply" and "electricity".
Source: INSTAT and Bank of Albania

On the other hand, non-traded inflation contributed by about 32.2% to the annual headline inflation in the second quarter of 2010, up 10 p.p. from the previous quarter. The rationale behind is

11 3.4% in average terms.

the rise in tariffs for medical and hospital services due to reforms in public health. This rise was reflected more pronouncedly in the inflation of June 2010. Annual non-traded inflation in June marked 3.5%, with medical and hospital services contributing by 0.8 p.p.. If we exclude the sub-items of “electricity”, “water supply” and “medical and hospital services”, inflation marks 1.4% in the second quarter of 2010, similar to the previous quarter and below the long-term historical average of non-traded inflation.

The analysis of the long-term inflation trend in the first half of 2010 confirms the presence of weak domestic demand-side inflationary pressures. Consumer price shocks were transitory and did not affect the well-anchored public expectations of inflation in the medium run. The Bank of Albania considers that the current consumer price stability has been also achieved as a result of the prudent monetary policy decision-making in at least the last 18 months.

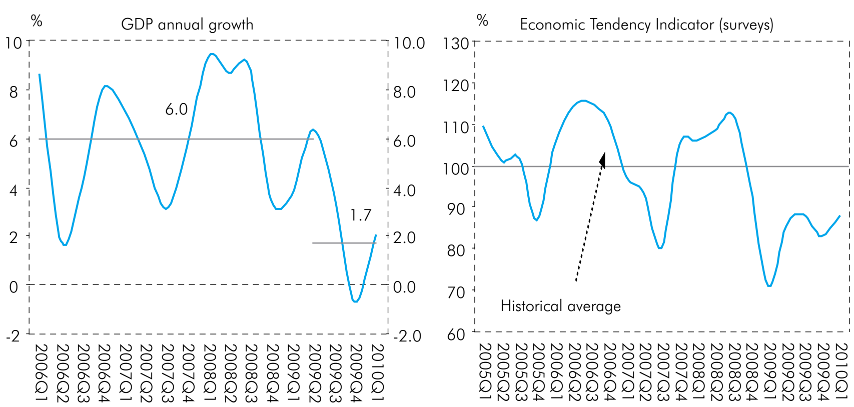
IV. MACROECONOMIC DEVELOPMENTS AND THEIR IMPACT ON INFLATION

After the contraction of the economy in the last quarter of 2009, economic activity posted low positive growth in the first quarter of 2010. According to INSTAT, the economy grew by 2% in the first quarter. However, economic growth remains below the historical rates and the potential of the Albanian economy. The latter features non-utilized capacities which, in addition to the slow expansion, have generated weak inflationary pressures. The sluggish economy is shown in several indirect indicators, namely budget revenue, private sector credit and business and consumer confidence in the first quarter of 2010.

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

After suffering a contraction in the last quarter of 2009, the Albanian economy posted positive growth rates in the first quarter of 2010. According to INSTAT's preliminary data, GDP grew by 2.0 and 1.8%, respectively, y-o-y and q-o-q. The first quarter's GDP is well below the historical average of 6.0% for this period. The sluggish economic activity is also shown in other economic indicators, namely budget revenue and private sector credit. Figures for business and consumer confidence in the first quarter are below the historical average, although slightly upward versus the last quarter of 2009.

Chart 13 Annual GDP growth by quarters and business and consumer confidence index



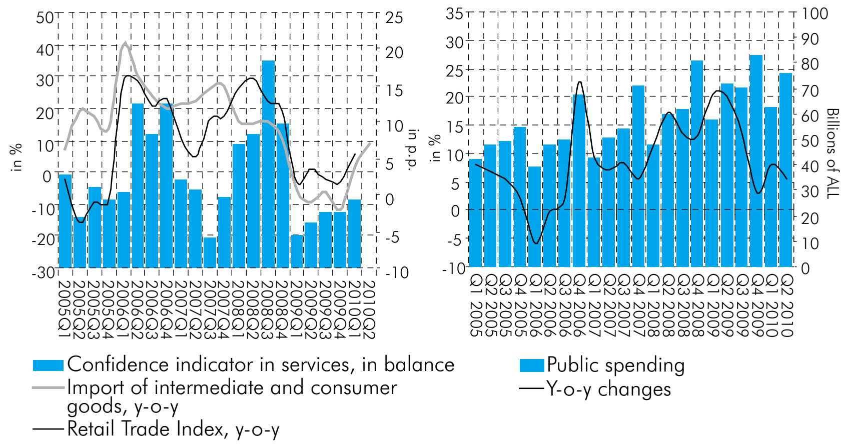
Source: INSTAT and Bank of Albania estimates

On the demand-side[12], the below potential economic growth in the first quarter of 2010 owes primarily to the weak domestic demand, whilst the negative contribution of net exports has moderated. Services continue to provide the major contribution to economic growth, while the positive performance of industry was offset by the contraction of construction.

IV.1.1 AGGREGATE DEMAND

The analysis of private consumption in the first half of 2010 features a high level of uncertainty due to the lack of data on this indicator. Retail sales volume index and the import of consumer goods suggest a rather more positive performance of this domestic demand indicator than the confidence indices and financing resources. Retail sales volume index rose 5.7% in the first quarter of 2010 versus the average annual increase of -1.8% in 2009. This increase may signal a turning point in private consumption[13]. The import of consumer goods has also provided positive signals for the performance of consumption. In the first and second quarter[14] of 2010, it increased by 7.3 and 5%, respectively. On the other hand, qualitative data obtained from business and consumer confidence surveys signal low growth rates of private consumption in the first half of 2010. Public sector consumption continued to contribute positively to aggregate demand in the first half of 2010, although slightly lower than in 2009. Current expenditure grew 7.1% y-o-y versus 14.3% in 2009.

Chart 14 Indirect indicators of private consumption and public spending



*Note: The figure for the second quarter has been approximated using the average of the two months available.

Source: INSTAT and Bank of Albania

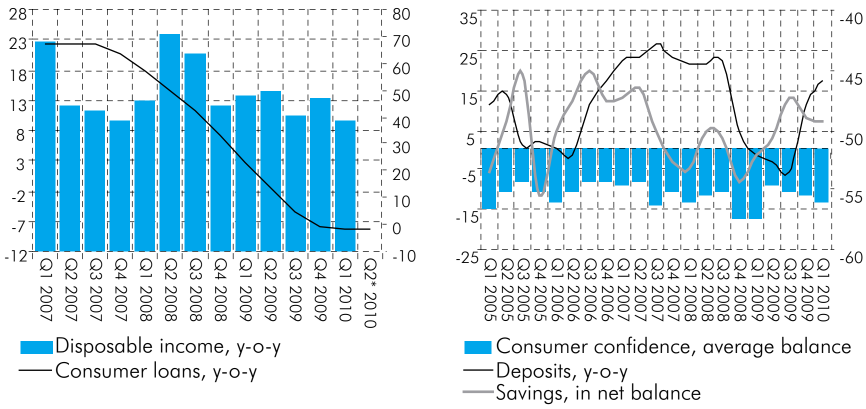
12 GDP by expenditure approach is measured by INSTAT on an annual basis. The last economic growth based on this approach was reported for 2008.

13 Its first quarter growth still remains far lower than the average historical growth rate, 11.3%, since 2000.

14 Approximated using the average growth of April and May.

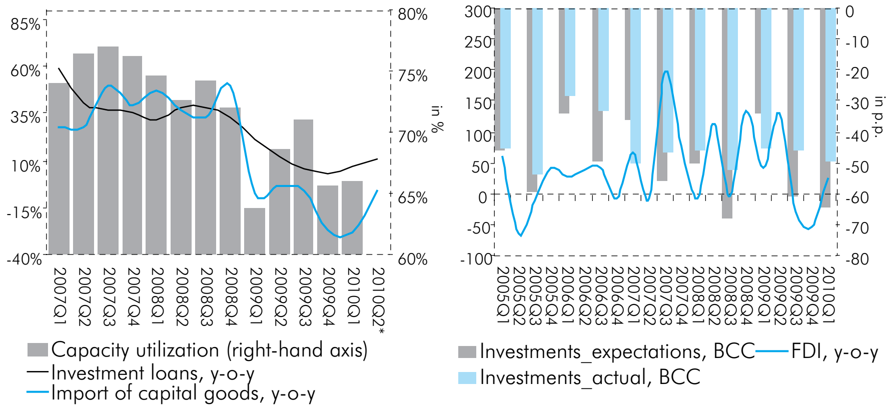
Private consumption was underpinned by the increase of disposable income[15] in the first quarter of 2010. However, the later is 3.4 p.p. below its average in early 2007. On the other hand, consumer confidence remains low due to the adverse performance of the labour market. Consumer loans posted negative growth rates in the first two quarters of 2010 due to demand and supply-side factors[16]. The uncertain real estate market situation and the enhanced prudence in consumption-savings behaviour are among the major reasons for the sluggish consumption and lower demand for credit. On the supply-side, banks continue to apply tight lending standards due to elevated uncertainty for the generation of income and non-performing loans situation.

Chart 15 Private consumption financing



*Note: Consumer loans include consumer and housing loans. The figure for the second quarter has been approximated using the average of the two months available.
Source: INSTAT and Bank of Albania

Chart 16 Private sector investment (left-hand) and foreign direct investment (right-hand)



*Note: The figure for the second quarter has been approximated using the average of the two months available.
Source: INSTAT and Bank of Albania

15 Disposable income is estimated by correcting the real GDP with the tax rate on personal income, adding further the Government's contribution (social insurance, economic aids, unemployment payment etc.).

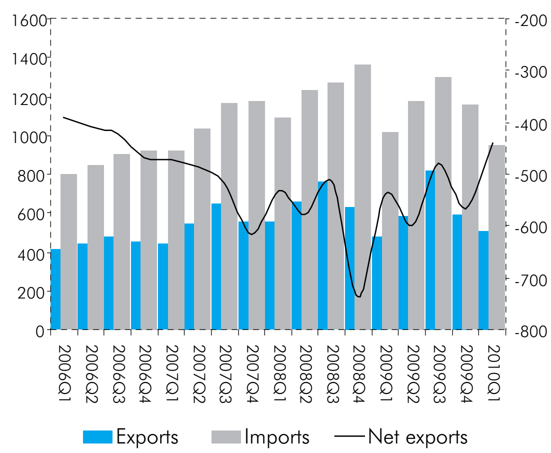
16 Lending Survey for the second quarter of 2010.

Private investments continued to provide an adverse contribution, albeit lower than in 2009, to the growth of aggregate demand in the first half of 2010. They were slightly underpinned by the more rapid growth in investment loans. The annual decline in the import of capital goods moderated in the second quarter of 2010. Their import dropped by 6.2% versus the annual decline by 12.7 and 28.5%, respectively, in 2009 and the first quarter of 2010. Public investments, which fell 33.5% y-o-y in the first half of 2010, continued to provide a downward contribution to aggregate demand.

New investments have been conditioned by the still dampened domestic demand and low capacity utilization and business confidence. Capacity utilization rate was 66% in the first quarter of 2010, 6.3 p.p. below the historical average. Excluding services sector, business assessments of investments in the last quarter of 2009 and their expectations for the first half of 2010 are downward. The higher uncertainty over the outlook for demand and the tight lending conditions have discouraged business investment expenditure. Foreign direct investments had a positive upward turn in the first quarter of 2010 following their sharp decline in 2009. They grew 25.6% y-o-y in the first quarter. FDI inflows[17] were used to finance investment in telecommunication and hydro-fuel.

The recovery of foreign demand from the main trading partners impacted positively on the trade balance in the first half of 2010. In the first quarter of 2010, exports of goods and services grew 6.1% y-o-y, while imports declined 6.9% owing to the low domestic demand and the exchange rate depreciation. Subsequently, the net export deficit narrowed 19%, thereby lowering the negative contribution to aggregate demand in the first quarter of 2010.

Chart 17 Net exports, in millions of EUR



Source: Bank of Albania

The latest data on foreign trade in April to May 2010 attest to the further correction of trade deficit. The considerable increase in the export of goods by 88.1% managed to offset the slight increase of imports by 7.1%. This performance signals the further decline of the negative contribution of net exports to aggregate demand in the second quarter of 2010.

17 In average terms, FDIs account for 7.7% of GDP for the period 2007-2010.

Box 1 Use of Confidence Indices to identify the business cycles in Albania

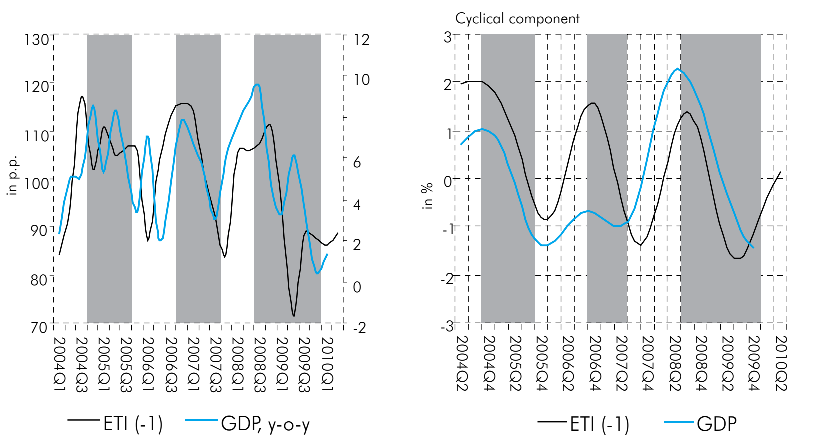
The Bank of Albania uses confidence indices as time series that summarize into a single indicator the business and consumer "confidence" and "expectations". Although it is practically impossible to measure the "confidence" quantitatively, it can be approximated through direct qualitative questions to business managers and households. The purpose of questions is to measure different aspects of business and consumer economic life. Theoretically, the questioned economic agents have already established an "opinion" or "confidence" prior to making decisions having economic consequences (like increasing production, hiring new employees, contracting an order etc.). Additionally, if consumers feel more "optimistic", they will consume more, thereby increasing aggregate demand. One of the reasons of using the information obtained from confidence surveys to determine the business cycle and the turning points, in addition to the faster time-related availability, is the definition of "confidence" or "tendency" as a special source of shocks on the economy; an alteration to the business or consumer confidence may lead to changes in their consumption and production-related decisions.

The answers to each question, aggregated in the form of a net balance[1], are analyzed to identify those aspects that display the strongest correlation with the official quantitative indicators. Hence, the following confidence indices are formed for each sector: industry confidence index (ICI), construction confidence index (CCI), services confidence index (SCI) and consumer confidence index (CCI). Economic Tendency Indicator (ETI) aggregates all the balances used for the construction of these indices.

The Bank of Albania uses confidence indices for three main reasons: first, they assist the periodical economic analysis by covering the delay in the release of official data; second, they are used in the short-term term forecast of quarterly GDP, and; third, they are used to define the phase of business cycle the economy is in. The following analysis focuses on the identification of these cycles.

The term "business cycle" refers to fluctuations in economic activity occurring around a long-term growth trend, characterized by periods of expansion, followed by deterioration, contraction and recovery, which are also noted in the majority of economic indicators. The coming phase of expansion marks the beginning of the following business cycle. Theoretically, business cycles last from one year and

Chart 18 Economic Tendency Indicator and annual changes in quarterly GDP (left-hand) and their cyclical component (right-hand)



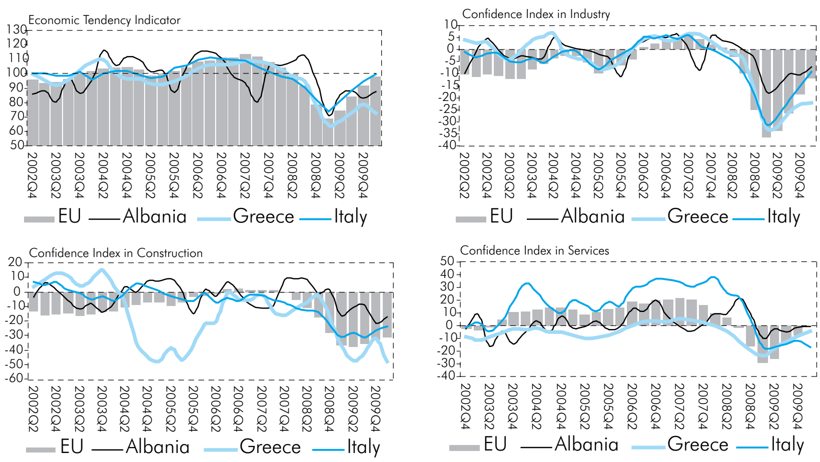
Source: Bank of Albania and INSTAT

a half to 10 years. Chart 18 (left-hand) provides an approximate identification of the business cycles the economy has been through during the 2004-2009 period. Worth noting is that short-term fluctuations of the series make it harder to identify the cycle. Therefore, the original series of quarterly GDP and Economic Tendency Indicator were subject to the filtering and normalization procedure[2], in order to obtain a clearer perspective of business cycles in the economy.

In Chart 19 (right-hand), the information obtained from the Economic Tendency Indicator and the y-o-y changes of GDP suggest two complete business cycles during the 2004-2010 period. The first cycle begins in the last quarter of 2004 and ends in the same quarter in 2006. The second cycle, which begins once the expansionary phase of the first cycle terminates, ends in the third quarter of 2008[3]. The last business cycle hit the lowest level in the last quarter of 2009 and marked its turning point in the first quarter of 2010. The Economic Tendency Indicator, which precedes the performance of the GDP one quarter ahead, shows that the first half of 2010 marked the beginning of the recovery phase. During this phase, the GDP is below the historical trend, but the quarterly changes are positive.

Confidence indices used at the Bank of Albania are highly concurrent with those in more advanced economies[4]. As shown by the following charts, the behaviour of confidence indices is particularly similar to the behaviour of Italian confidence indices, perhaps due to the closer economic relations and the higher trade exchanges. Industry confidence indices show greater synchronization relative to the other sectors.

Chart 19 Confidence indices in Albania and selected EU countries



Source: Bank of Albania and European Commission

Starting from the last quarter of 2009, all confidence indices in Albania reflected the uncertainty over the global financial crisis. As the Chart shows, confidence indices for EU countries preceded this performance starting from the third quarter of 2008[5] Confidence indices in Albania showed signs of improvement in the second and third quarter of 2009 after hitting the record low in the first quarter, to later fall again in the last quarter of 2009. Currently, all confidence indices stand below their historical average, this being more pronounced in the construction sector.

Notes

1 *The answers to each question are aggregated using the balance indicator, which is the difference between positive and negative answering options, measured as percentage points.*

2 The filtering process provides a series that is adjusted from the irregular component (very short-term fluctuations around the business cycle). The normalization process provides a series with a mean of 0 and a standard deviation of 1.
3 The grey part in the chart shows the period from the highest to the lowest point of the three cycles that includes the deterioration and contraction phase.
4 With the exception of consumer confidence index, whose performance has been dissimilar from one country to another owing to specific events occurring in each country.
5 A more detailed analysis of the correlation between confidence indices in Albania and in the EU shows that the developments in the EU countries precede the developments in confidence indices in Albania by one or two quarters.

IV.1.2 PRODUCTION BY SECTORS

According to INSTAT, economic activity at home, in terms of value added at basic prices, grew by 2% annually in the first quarter of 2010. GDP grew 1.8% quarterly. The improved foreign demand was primarily reflected in the increase of value added in industry, while the dampened domestic demand was mirrored in the contraction of construction and the poorer performance of services compared to the previous years. However, services continued to provide the main contribution (2 p.p.) to annual GDP growth in this quarter.

Table 5 Contribution of sectors (in p.p.) to annual GDP growth (in %)

Contribution	2007	2008	2009	Q1:2009	Q1:2010
Agriculture, hunting, forestry, fishing	0.4	1.5	0.4	0.5	0.5
Industry	-1.2	0.5	-0.2	0.3	2.4
Construction	1.7	1.7	0.0	0.0	-2.9
Services	4.4	4.0	3.1	2.9	2.0
GDP at basic prices	5.3	7.6	3.3	3.6	2.0

Source: INSTAT, Bank of Albania and its estimates

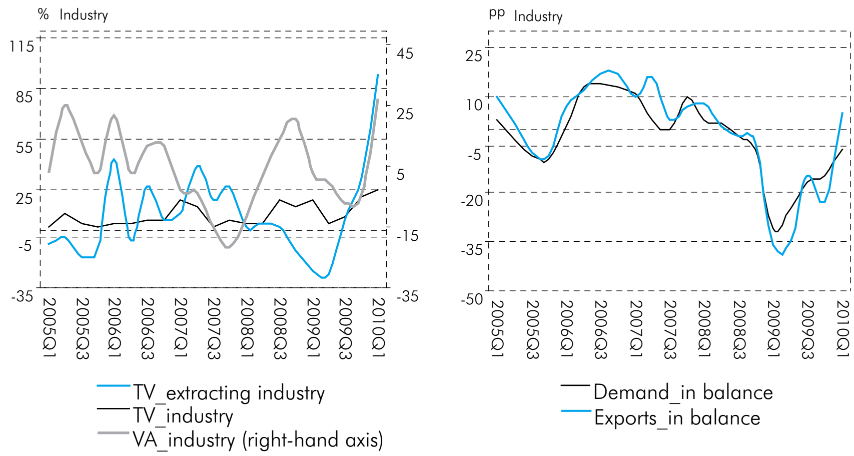
Following its contraction in the second half of 2009, the production sector is assessed to have provided an almost negligible impact on economic growth. The further deterioration of production generated from construction offset the positive contribution of industry.

In the first quarter of 2010, value added generated from industry was 27.5% higher versus the same period the previous year. It contributed by about 2.4 p.p. to the growth of economic activity in the first quarter of 2010. The structural analysis[18] of production in industry attests to the recovery of extracting industry and electricity and water supply. The higher foreign demand for extracting industry products was reflected in the annual increase of their exports and the turnover volume in this branch.

In terms of turnover volume, "electricity and water supply' grew by 41.3% y-o-y in the first quarter of 2010. The positive tendency that the energy sector's indicators featured almost throughout the year 2009 persisted in the first five

18 Based on the turnover figure for the first quarter of 2010, INSTAT, Short-term Statistics.

Chart 20 Total value added of industry and turnover volume of extracting industry (y-o-y, left-hand) and industry confidence indicators (right-hand)



Source: INSTAT, Bank of Albania

months of 2010 as well. Production of electricity increased by about 50.8% compared to the same period the previous year, however the curve was slightly downward. In monthly terms, the production of electricity increased by merely 0.5% in May. The beginning of summer, and therefore the more difficult hydro conditions, slightly curbed the double-digit increase of electricity production. However, compared to the previous year, the production of electricity increased considerably in May, about 58.2%.

The higher electricity production contributed to an improved net balance of the total exchange of electricity in the first five months of 2010. From January to May 2010, its net balance was 5.1 times higher than in the same period the previous year. The accelerated increase in the export of electricity and the lack of import led to a positive net balance (export - import) over this period and about 6 times higher than in 2009. For the same period, the exchange balance (given – received) of electricity was positive.

Table 6 Electricity balance indicators

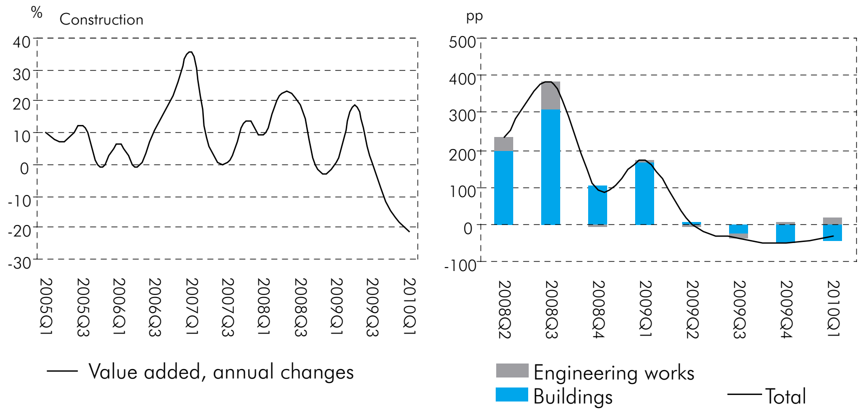
In Gwh	May 2009	May 2010	5M 2009	5M 2010
Production	505.6	800.1	2598.8	3919.3
Import (-)	0.0	0.0	10.1	0.0
Export (+)	128.1	465.6	304.5	1763.7
Balance (export - import)	128.1	465.6	294.5	1763.7
Received (-)	23.5	4.1	32.7	15.5
Given (+)	0.3	17.4	106.6	118.9
Balance (given-received)	-23.2	13.3	73.9	103.4
Net total exchange balance	104.9	478.9	368.3	1867.1

Source: KESH

In terms of value added, construction deepened the contraction commenced in the third quarter of 2009 further in the first quarter of 2010. Value added generated from construction dropped 21.1% y-o-y. The decline in construction volume[19] by 19.95 was mainly triggered by the contraction in private constructions. Other quantitative indicators, like the cement consumption and the number of construction permits, which declined by 3.3 and 15.7% y-o-y, respectively, were along the same worsened lines with private constructions. Construction permits approved for the item of "buildings" have been declining since the third quarter of 2009. In the first quarter of 2010, it posted a negative annual growth rate of 49.8%.

The persistent decline of production in construction reflects, *inter alia*, the business and consumer reluctance to invest in this sector, the still tight lending conditions, the accumulation of inventories (survey results) and the lower public investment projections. In the first quarter of 2010, the public sector's share in the approved construction permits[20] was 35.2%, of which 96.3% represent "engineering works". The following are included under this construction item: "transportation infrastructure", "water supply, electric and telecommunication network", "complex buildings in industrial plants" and "other engineering works".

Chart 21 Construction (value added, left-hand) and public and private sectors' contribution to the value of approved construction permits (right-hand)



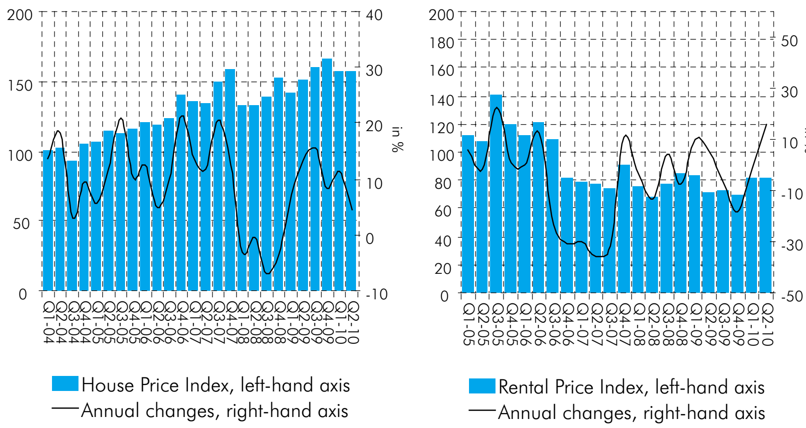
Source: INSTAT

19 Production Volume Index, INSTAT, Short-term Statistics, first quarter of 2010.
20 INSTAT "Quarterly Statistical Bulletin – First quarter of 2010".

Box 2 House Price Index and Rental Price Index

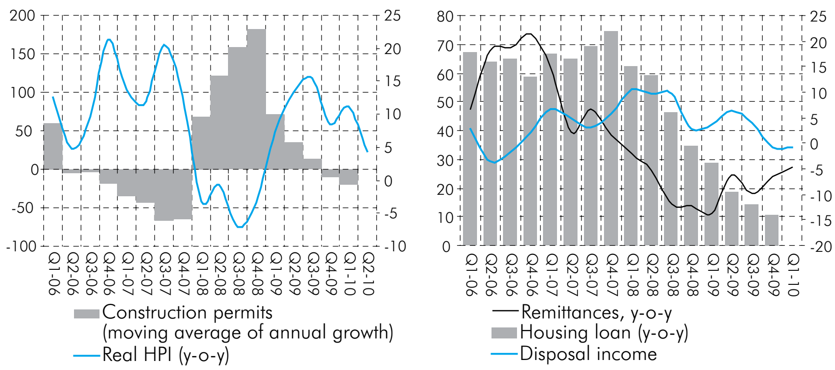
The y-o-y increase in house prices moderated in the second quarter of 2010 after the more pronounced increase in 2009 and the first quarter the present year. House Price Index[1], deflated by inflation, rose 4.3% y-o-y in the second quarter of 2010, versus the average of 11.1 and 11.2%, respectively, in 2009 and the first quarter of 2010. Q-o-q changes in the House Price Index provide evidence for its decline for the second consecutive quarter. Against a background of stable supply, the fall of demand gave rise to curbed price rise rates. Rental Price Index manifested a dissimilar performance to House Price Index. It posted a pronounced annual increase in the second quarter, hence confirming the turning point from the downward trend commenced in the second quarter of 2009.

Chart 22 House Price Index and Rental Price Index



Source: Bank of Albania

Chart 23 Construction permits and financing resources for house purchase



Source: INSTAT, Bank of Albania

Based on indirect indicators, house demand was low in the second quarter of 2010, affected by the performance of income in the labour market and inflows in the form of remittances. On the other hand, lending for residential purposes has been low;

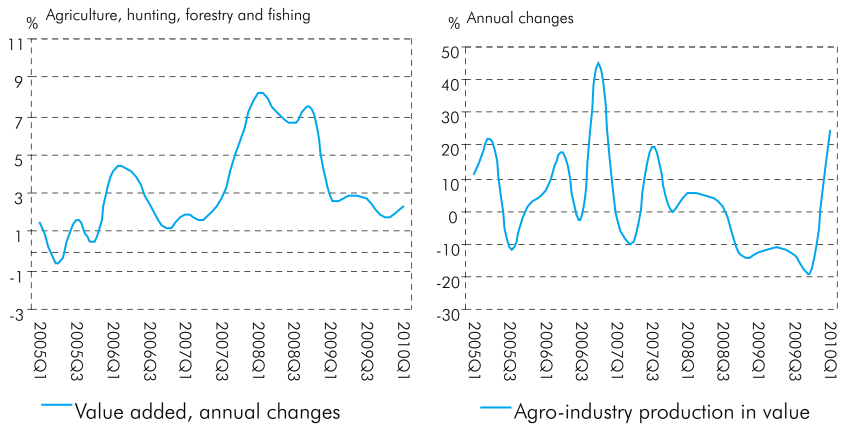
individual loans for residential purposes posted negative growth rates in the first and second quarter of 2010. Qualitative data from the banks' lending survey show that lending standards applied on individual loans for residential purposes have been tight in the last two years. On the other hand, the increase in the number of construction permits as at year-end 2009, coupled with the low number of transactions, provide evidence for stable house supply in the real estate market. Data from the construction business survey show the accumulation of inventories, which in turn leads to slower housing price rise.

Note

1 House Price Index and Rental Price Index are constructed only for Tirana, which is broken down into three main areas: the central area, the area within the city ring, but not the central part, and the area outside the city ring. These two indices are constructed based on Çelësi Newspaper announcements.

Value added generated from agriculture, hunting, forestry and fishing increased by 2.3% y-o-y in the first quarter of 2010, 0.3 p.p. below the average annual rate in 2009. Agro-industry production[21] increased 24.4% y-o-y, following its contraction since the last quarter of 2008.

Chart 24 Agriculture, hunting, forestry and fishing (value added, left-hand) and agro-industry production (right-hand)



Source: INSTAT and MAFCP

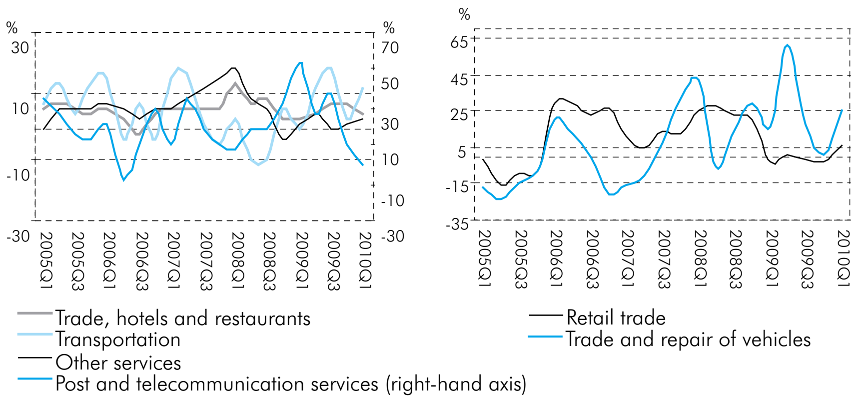
Value added of services to gross domestic product increased by 3.4% in the first quarter of 2010, hence maintaining the slowdown commenced in the second half of 2009. Transportation posted the highest y-o-y increase in terms of value added, 11.4%, up 3 p.p. from the average annual rate of 2009. However, "trade, hotels and restaurants"[22] provided the major contribution to annual GDP growth from the services' sector, about 1 p.p. The improved trade activity may be indirectly supported if we refer to the annual growth of

21 Agro-industry production is estimated based on the 2006 prices. Source: Ministry of Agriculture, Food and Consumer Protection.

22 The large contribution of this branch owes primarily to the high share. In the first quarter, it grew 4.8% y-o-y, while the average growth for the period 2005 – 2009 was 5.4%.

retail sales volume and repair of vehicles. More precisely, retail trade and repair of vehicles increased by 5.7% and 25.8%, respectively[23]. Post and communication services moderated substantially; their value added was 1% higher y-o-y. In the meantime, other services posted a modest annual growth rate of 1.7%.

Chart 25 Services (value added, y-o-y changes, left-hand) and retail sales volume and repair of vehicles (y-o-y changes, right-hand)



Source: INSTAT and Bank of Albania estimates

IV.1.3 EXTERNAL SECTOR OF THE ECONOMY

The correction of the current account deficit persisted in the first quarter of 2010 as a result of the improved trade balance and narrowing of services' account deficit against a background of low domestic demand and recovery of foreign demand. Net inflows into the capital and financial account declined allowing for partial financing of the current account deficit. The overall balance of payments for the first quarter of 2010 resulted in the reduction of foreign assets by about EUR 18.8 million.

Current account deficit maintained a similar trend in the first quarter of 2010 as in the previous one, narrowing by about 24.5% y-o-y. The accelerated increase of exports and the decline of imports were among the factors that contributed to the correction of the current account deficit over this period. The financing of the current account deficit was covered 41.2% by the surplus in capital and financial account. In addition to their 28.7% y-o-y increase, net foreign direct investments also recorded a higher level versus the previous quarter (43.1%). The overall balance of payments for the first quarter of 2010 resulted in the reduction of foreign assets by about EUR 18.8 million, which is more moderate than in the same period the previous year.

23 Compared to the average y-o-y rates of -1.8 and 9.2%, respectively, in 2009.

Table 7 Balance of payments indicators

Key items	In millions of EUR				
	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010
Current account	-326.5	-311.3	-383.1	-324.6	-246.6
Trade balance	-516.8	-579.0	-606.6	-601.3	-419.0
- Export	175.7	183.4	186.0	205.5	254.9
- Import	-692.5	-762.4	-792.6	-806.9	-673.9
Services (net)	-21.1	-18.6	126.2	34.5	-19.3
Revenue (net)	-5.0	-4.4	-60.7	-30.5	-19.2
Current transfers (net)	216.4	290.6	158.1	272.8	210.9
Capital and financial account	274.2	439.4	218.3	109.6	101.6
Capital account	19.6	16.2	32.1	17.0	10.0
Financial account	254.6	423.2	186.2	92.6	91.6
Foreign direct investments (inflows)	123.4	306.1	168.3	108.5	155.3
Public borrowing (withdrawals)	58.0	165.0	142.0	31.0	48.0
Private borrowing (withdrawals)	84.0	8.0	3.0	24.0	4.0
Errors and omissions	-78.5	13.6	208.7	128.3	126.2
Overall balance	-130.9	141.6	43.9	-86.7	-18.8

Source: Bank of Albania

CURRENT ACCOUNT

Current transactions amounted to about EUR 1.9 billion in the first quarter of 2010, down 2.1% from the same period the previous year. Current account recorded a deficit of EUR 246.6 million, about 12.7% of GDP[24]. The correction of the current account deficit by 24.5% in nominal terms versus the same quarter the previous year was favoured by the reduction of the trade deficit and services account deficit.

The reduction in the Albanian trade deficit in the first quarter of 2010, by about 18.9% y-o-y, attributes to the accelerated increase in the export of goods by 45.1% and the decline in imports by 2.7%. Trade deficit accounted for 21.6% of GDP in the first quarter of 2010, versus 26.4% in 2009. The net position of the revenue account continued to provide an adverse contribution to the performance of the current account for the fifth consecutive quarter. Although the current transfers balance – largely represented by workers' remittances – recorded a moderate reduction in annual terms, it financed about 50.3% of the trade deficit in this quarter.

FOREIGN TRADE[25]

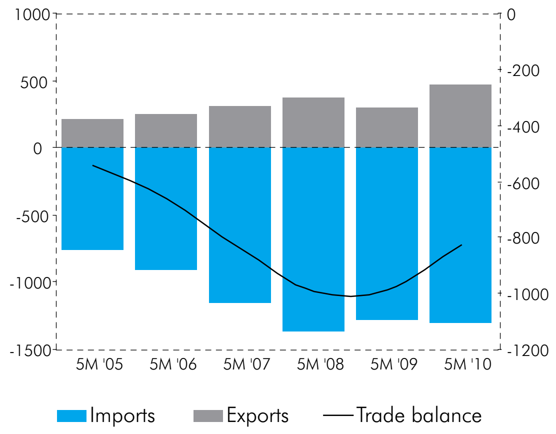
The flow of trade exchanges[26] for January to May 2010 increased by 12.9% compared with the same period the previous year. The higher trade exchanges over the first five months owe mainly to the increase in exports and imports by 62.0% and 1.7%, respectively. Imports' coverage by exports was 36.5%, up 13.6 p.p. from the same period the previous year. In the meantime, the correction trend of the trade deficit continued to persist. As at the end of the first five months, trade deficit amounted to EUR 825.7 million, down 16.2% from the same period in 2009.

24 IMF's projections for the GDP have been used for 2009 and 2010, "IMF Article IV Consultation, 2010", July 2010.

25 Foreign trade data are available until May 2010.

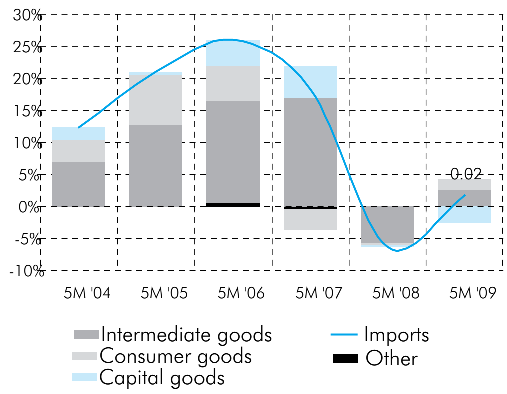
26 Imports and exports of goods are presented in the Balance of Payments on f.o.b. basis. They are presented on c.i.f. basis in the analysis of foreign trade by commodity group.

Chart 26 Imports (left-hand axis), exports and trade balance, in millions of EUR (right-hand axis)



Source: Bank of Albania

Chart 27 Total imports and contribution of key import items, January-May 2010, in %



Source: Bank of Albania

The dynamics of imports in the first months of 2010 remained more contained than that of exports. In May 2010, imports, albeit at lower rates than exports, increased by 7.0%, hence maintaining the upward trend shown since March.

The analysis of imports by their final use shows a pronounced concentration of intermediate goods (58.6% to total imports), while capital and consumer goods accounted for 13.3 and 28.0%, respectively, of total imports for January to May 2010. Compared to the first five months of 2009, the import of capital goods declined 16.1%. However, after a continuous decline in y-o-y terms in the first four months of 2010, the import of capital goods increased by 2.5% in May 2010. The import of intermediate goods and consumer goods increased by 4.5 and 6.3%, respectively, in January to May 2010 versus the same period in 2009.

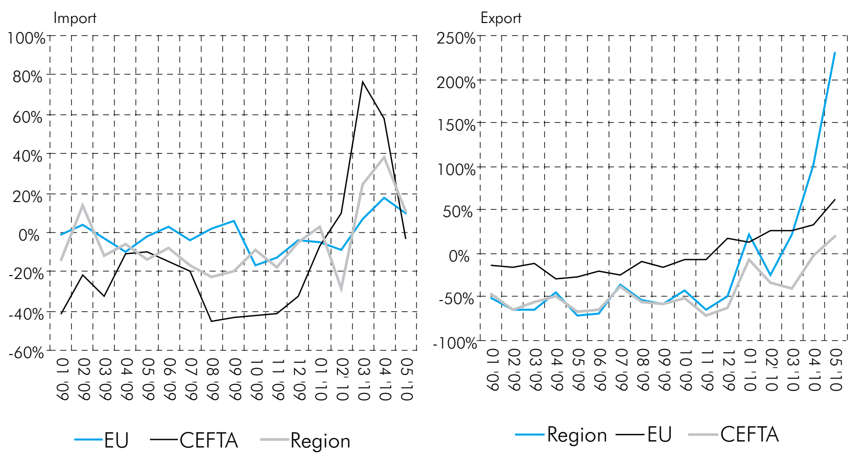
The continuous rise in primary commodity prices in the global markets[27], in addition to the depreciation of the domestic currency[28] and the statistical effect of the low-base comparison, contributed to the upward performance of primary commodity exports in the first five months of 2010. The exports of "fuels", "unprocessed goods and minerals" and "processed goods" recorded more rapid growth. These three commodity items continue to record three-digit annual growth rates. The export of metal and re-exports recorded high annual growth rates as well.

EU member states remain Albania's main trading partners accounting for about 65.7% of total trade exchange for January to May 2010. In the first five months of 2010, trade exchanges with these countries grew by 10.8% compared to the same period in 2009. Trade exchanges in the framework of the Free Trade Agreement with Central European and regional countries grew by 53.6 and 20.4% y-o-y. The latest available data show that Italy and Greece remain Albania's main trading partners in imports.

27 Primary Commodity Price Index is measured and published by the IMF at a monthly frequency. In May 2010, it increased by 24.6% y-o-y.

28 In January to May 2010, our domestic currency depreciated by an average of 6.8% compared to the same period in 2009.

Chart 28 Imports and exports by trading partners, annual changes, in %



Source: Bank of Albania

SERVICES, REVENUES AND CURRENT TRANSFERS

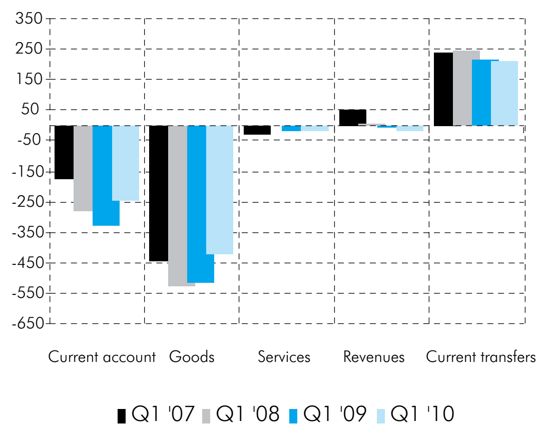
Net financial inflows from "services", "revenues" and "current transfers" declined 9.4% y-o-y in the first quarter of 2010. These accounts' net financial inflows managed to finance 41.1% of the trade deficit versus 36.8% in the same period in 2009.

Transactions in the services account amounted to EUR 525.5 million, down 16.2% y-o-y. After two quarters of surplus, this account's balance posted negative figures in the first quarter of 2010. Trade in services showed signs of deceleration in the first quarter, particularly in terms of exports' dynamics. Services account deficit totalled EUR 19.3 million, down 8.8% from the same period in 2009.

Revenues' account continued to post a negative balance for the fifth consecutive quarter owing to the negative net position of investment income. Its deficit totalled EUR 19.2 million in the first quarter of 2010 versus EUR 5 million the same period in 2009. Foreign currency inflows were almost similar to the previous year, while outflows increased by 19.6%.

The positive balance of net current transfers narrowed by 2.6% in the first quarter of 2010 compared to the same period in 2009. Its surplus amounted to EUR 210.9 million. Its main sub-item, "emigrant transfers", totalled EUR 170.8 million, down 6.7% from the same period in 2009. The decline of workers' remittances is assessed to have been impacted by the economic and financial crisis

Chart 29 Current account and key items, net, in millions of EUR



Source: Bank of Albania

and the increase in unemployment that has swept through the countries with higher presence of Albanian emigrants. Nonetheless, net inflows from workers' remittances managed to finance 40.6% of trade deficit in the first quarter of 2010 compared to 35.4% in the same period in 2009.

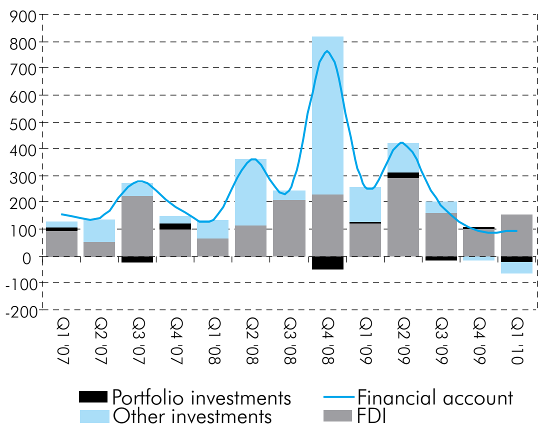
CAPITAL AND FINANCIAL ACCOUNT

Capital and financial account recorded a positive balance of EUR 101.6 million in the first quarter of 2010, contracting pronouncedly by 62.9% from the previous year, mainly as a result of the curbed capital transfers and net financial flows. Capital and financial account accounted for 5.2% of GDP in the first quarter of 2010 versus 14.0% in the same period in 2009. Capital and financial account surplus financed only 41.2% of the current account deficit compared to 84% in the first quarter of 2009.

Albania's financial liabilities to the world, albeit higher than in the previous quarter, declined 14.4% y-o-y. The decline of financial liabilities owes primarily to the decrease of non-resident deposits held with the Albanian banking system and the curbed banks' short-term borrowing for the fifth consecutive quarter. The Albanian banking system's short-term borrowing declined EUR 24.3 million in the first quarter of 2010 compared to the EUR 6.4 million decline in the same period in 2009. In addition, non-resident banks' deposits in Albania reduced substantially in this quarter compared to the previous year. Private and public borrowing amounted to EUR 43.7 million, down 27.1% from the same period in 2009.

About EUR 51.7 million of long-term and soft loans from abroad were disbursed during this period. Loans to the public sector and other sectors in the form of Government guaranteed debt have the largest share. External debt service reduced resident liabilities by about EUR 18.0 million.

Chart 30 Financial account and key items, net flows in millions of EUR



Source: Bank of Albania

Foreign direct investment inflows amounted to EUR 155.3 million in the first quarter of 2010, accounting for 8.0% of GDP[29], up 25.8% y-o-y. Half inflows in the form of foreign direct investments were benefitted by telecommunication sector, while 20% of them were benefitted by the sector engaged in the drilling and exploration of hydro-fuels. Foreign direct investment inflows into the Albanian economy remain a prevailing factor in the increase of Albania's financial liabilities to the rest of the world.

Our financial assets abroad grew to EUR 69.2 million in the first quarter of 2010 due to the sharp increase of portfolio investments abroad and other investment items. Portfolio investments grew sharply by EUR 27.7 million in the first quarter. Within other investments, short-term loans and deposits held

29 In the first quarter of 2009, they accounted for 6.3% of GDP.

by our banking system abroad posted increase. Albanian banking system's deposits held with non-resident financial institutions grew by EUR 19.1 million. On the other hand, the increase of short-term loans to non-residents, observed since the second half of 2009, contributed to the increase of our assets abroad by EUR 22.5 million in the first quarter of 2010.

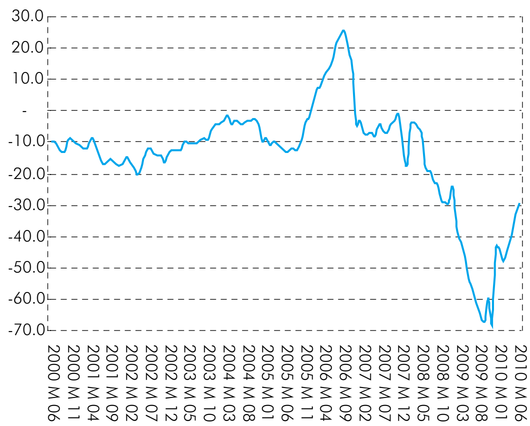
The overall balance of payments position resulted negative for the first quarter of 2010 causing the monetary authority's foreign reserve to reduce by EUR 18.8 million. As at end of March, foreign reserve stock amounted to EUR 1,683.6 million, sufficient to cover 4.4 months of imports of goods and services.

IV.1.4 FISCAL INDICATORS AND FISCAL POLICY[30]

Fiscal policy was stimulating in the first half of 2010, albeit at more moderate rates than in 2009. Against a background of downward total expenditure, the performance of budget indicators suggests for the curbed contribution of the public sector to aggregate demand, particularly in the second quarter of 2010. In the meantime, revenues recovered their growth rates slightly in the second quarter, following the weak growth in the first quarter.

Fiscal policy was more contained in the first half of 2010 compared to the previous year, reflecting prudence vis-à-vis the public debt performance. Budget revenues recorded a modest y-o-y increase in the first half of 2010, while expenditure contracted yielding a budget deficit of 36.2% lower than in the same period in 2009. The contraction of the primary deficit by 50% is a reflection of the lower fiscal growth rates in the first half of 2010 compared to the previous year. Its below-average historical rates attest to the more rapid growth rates of public debt in the recent years. Worth noting however is that, in addition to the primary balance, the performance of real interest rates on debt, real economic growth[31] and the exchange rate performance play a key role in this process.

Chart 31 12-month moving sum of primary balance, in billions of ALL



Source: Ministry of Finance, BoA estimates

Budget revenues amounted to ALL 150 billion in the first half of 2010, up by 3.3% y-o-y, among the lowest historical growth levels recorded in the first half of the year[32].

30 *Half-year data on the fiscal indicators are preliminary.*

31 *The deepening of the negative spread between real economic growth and real interest rates, despite an unchanged primary balance, leads to further deterioration of the debt dynamics.*

32 *Budget revenues increased by an average of 9.5% in the first half of the period 2000-2009.*

Table 8 Key fiscal indicators, as at the first half of 2010

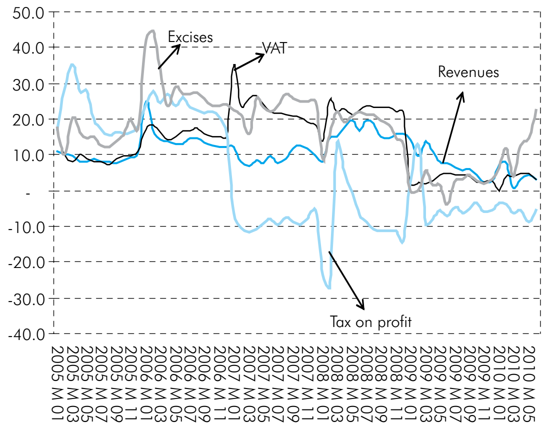
	Actual	As a share of GDP[1]	Annual change (in %)		
	S1 2010	S1 2010	S1 2008	S1 2009	S1 2010
Revenues	150.0	25.5	16.8	7.7	3.3
Tax and customs	103.9	17.6	18.3	4.8	3.2
VAT	53.8	9.1	22.3	4.8	3.3
Tax on profit	8.6	1.5	-6.8	-7.2	-5.4
Excises	17.6	3.0	22.2	-3.6	22.4
Local Government	6.4	1.1	3.0	26.1	-7.7
Social insurance contributions	26.5	4.5	18.5	13.2	3.7
Non-tax revenue	11.4	1.9	4.0	6.7	4.1
Grants	1.9	0.3	337.8	129.6	54.9
Expenditure	171.0	29.0	31.2	28.9	-4.0
Current expenditure	138.8	23.6	14.5	20.3	7.1
Personnel	31.9	5.4	17.2	-1.3	7.6
Interest	19.4	3.3	24.4	16.2	11.4
Social insurance and pensions	48.8	8.3	8.3	28.3	8.6
Local Government	14.1	2.4	32.4	44.1	-6.4
Capital expenditure	32.3	5.5	149.5	73.3	-33.6
Budget balance	-21.0	-3.6	-133.6	867.0	-36.2

1 The ratios to the GDP have been derived based on IMF's GDP data, Global Economic Outlook, April 2010.

Source: Ministry of Finance

The growth rate of budget revenue began to curb after the second quarter of 2009 to later hit a lower rate at the end of the first quarter of 2010. However, the setting of budget revenue in the second quarter of 2010 attests to accelerated growth rates compared to the previous quarter and the last two quarters of 2009[33]. Notwithstanding this positive performance, the end of the second quarter showed slower growth rates than the end of May[34]. This performance of budget revenue attributes to revenue through VAT, which provided moderate contribution to the growth of total revenue[35]. This item continues to hit below historical average annual growth rates despite the measures taken to increase the base tax on businesses subject to VAT[36]. Worth noting however is that the trend of VAT revenue reflects the effect of a number of factors concurrently: the performance of imports, sale of domestically produced goods, and services included in the VAT scheme. The positive but slow performance of VAT revenue is closely related to the performance of economic activity at home.

Chart 32 Annual growth of revenue collection, by key items, in %



Source: Ministry of Finance

33 As at end of the first quarter, budget revenues increased by merely 0.5%. In November and December 2009, they grew by 2.2 and 2.7%, respectively, y-o-y.

34 As at end of June, budget revenue increased by 3.3% versus 4.3% in May.

35 VAT's contribution to the total growth of budget revenue for the first half of 2010 was 1.2 p.p., versus the average of 3 p.p. in 2000-2009.

36 The changes and amendments to the Law No. 7928 dated 27 April 1995 "On VAT" became effective on 1 January 2010. Among the changes and amendments to the VAT Law, we note the lowering of the minimum registration threshold for VAT to ALL 5 million (from ALL 8 million), and the inclusion of free professions, like lawyers, notaries, specialized doctors, certified accountants and the property appraisers having a minimum threshold of ALL 2 million within a calendar year, into the VAT scheme.

Excise revenue showed a positive and stable growth over this year. The exchange rate depreciation, coupled with the amendments to Excise Law – which in addition to increasing some of the existing excises, expanded the range of products subject to excise –, determined the high growth rates of excise revenue[37]. As at end of the second quarter of 2010, excise revenue grew 22.4% y-o-y versus 3.8% as at end of the first quarter.

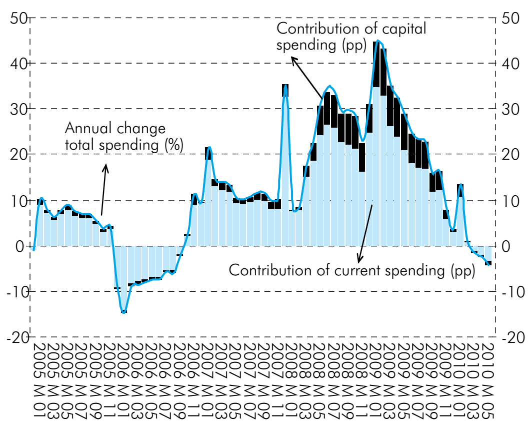
Tax on profit plays a key role in determining the performance of total revenue. They have recorded negative growth rates since mid-second quarter of 2008. Although the effect of the cut in the tax on profit from 20 to 10%[38] was expected to terminate in early 2009, tax on profit revenue maintained a downward trend throughout this period.

Budget expenditure showed a dissimilar performance from revenues in the second quarter of 2010. As at end of the first half of 2010, expenditure contracted 4% y-o-y, a trend that persisted in April and May 2010. Against a background of upward needs for fiscal correction, as a result of the deteriorated budget balance in 2009 arising from the fiscal stimulus for the economic recovery and the operation of automatic stabilizers, the budget for 2010 was revised in July 2010. According to the revised 2010 budget, which favours lower revenues than the initial 2010 budget and aims at bringing down the budget deficit by ALL 11.7 billion from the early-year projection, budget expenditure are projected to reduce by ALL 39 billion from the early-year projection. Given the slow growth of budget revenues in the first half of 2010, annual revenues projected for 2010 have reduced by ALL 27.3 billion from the early-year projection.

As at end of the first half of 2010, budget expenditure amounted to ALL 171 billion, contracting by 4% y-o-y. The contraction of capital spending and the slow growth rate of expenditure on social insurance and interests provided the largest contribution to the decline of budget expenditure.

Current expenditure grew by 7.1% y-o-y in the first half of 2010. Current expenditure by sub-items shows above historical average annual growth rates for interest payments and unemployment expenditure[39]. The high growth rates of external debt interest payments reflect the increase of the share of Government's foreign borrowing on trading terms and the exchange rate depreciation.

Chart 33 Annual growth of expenditure (in %), left-hand axis, and the contribution of current and capital expenditure (in p.p.), right-hand axis



Source: Ministry of Finance

37 Excise revenue grew by 12.6-22.4% y-o-y in the second quarter of 2010, quite high compared to the previous year, -3.6 – 5.8%.

38 As part of the fiscal package approved in July 2007, tax on profit was cut from 20% to 10%, effective from 1 January 2008.

39 The growth rate of interest payments was 45.2% versus 32% in the same period in 2000-2009. Unemployment expenditure increased by 26.2% compared to the average of -2% in the first half of 2000-2009.

The social insurance scheme has given rise to deeper fiscal deficit in the recent years; the social insurance scheme deficit has been one of the major determinants of overall budget deficit. On average for 2010, the negative spread between revenue and expenditure of the social insurance scheme and pensions is about 1.3 times higher than the overall budget deficit compared to 82% in the same period in 2009.

Long-term expenditure reduced by 33.6% y-o-y in the first half of 2010. The trend of capital spending is in line with the 2010 government budget, which projects that the intensity of investment spending will not be similar to the high rates of the previous year.

Budget deficit totalled ALL 21 billion in the first half of 2010 or twice as high as the projection, owing primarily to the lower revenues than the projection. Moreover, the spread between budget expenditure and the projection did not offset the spread between budget revenues and the projection. However, budget deficit contracted by about 36% compared to the same period in 2009.

Budget deficit financing in the first half of 2010 was mainly based on the issue of securities in the domestic market. In the meantime, foreign resources financed 15% of the budget deficit.

Table 9 Budget deficit and its financing, in billions of ALL

	S1 2006	S1 2007	S1 2008	S1 2009	S1 2010
Budget balance	10.1	10.2	-3.4	-33.0	-21.0
Domestic financing	-11.1	-10.4	-7.4	17.0	17.9
- Domestic borrowing	-10.5	3.4	12.7	5.0	19.6
- Privatization receipts	2.1	0.0	0.4	20.8	0.1
- Other[1]	-2.7	-13.9	-20.6	-8.8	-1.8
Syndicated loan	0.0	0.0	0.0	12.2	0.0
Foreign financing	1.0	0.3	10.9	3.7	3.1

1 It represents Government's liquidity held with the Bank of Albania, which explains its negative sign in financing the deficit.

Source: Ministry of Finance

The increase of new borrowing to finance the budget deficit of this period aimed at extending the maturity term of long-term borrowing (mainly 2 and 5-year bonds) and reducing borrowing in debt instruments of lower than one-year maturity term. In addition, in view of minimizing the fragmentation of securities' market, more room was given to other debt instruments instead of 3-year bonds. The issue in June of T-bills denominated in EUR, amounting to EUR 25 million and of 9-month maturity term, was a new instrument introduced in the Government securities' market to finance the budget deficit.

IV.1.5 MONETARY DEVELOPMENTS

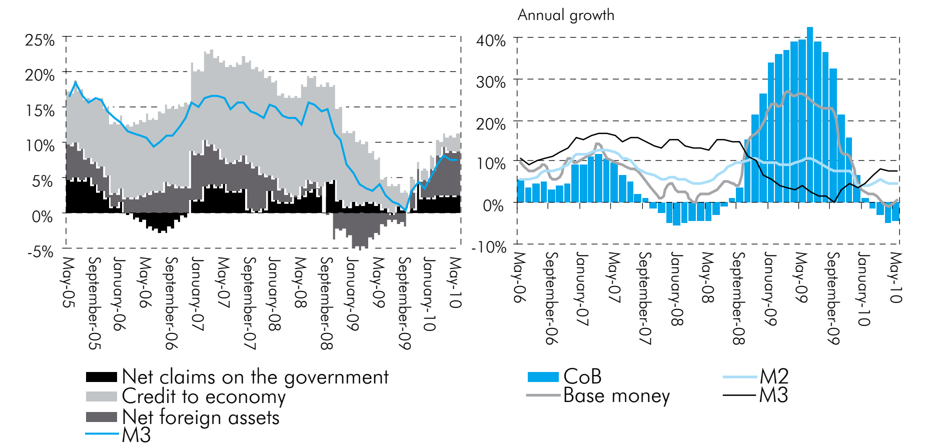
Monetary impulse on the economy increased in the second quarter of 2010 in response to the recovery of deposits into the system, the more rapid growth of credit and the positive signals from domestic demand against the year-end 2009 contraction. The growth of money was sustained by its foreign currency component, whose upward contribution offset the low contribution of credit to economy. Despite the improved liquidity figures, loan portfolio growth rates remain low. The long-term analysis of monetary developments confirms that the annual growth rates of money supply are substantially lower than their historical average of the pre-crisis period, hence providing evidence that the inflationary pressures in economy will be contained.

The performance of monetary indicators pursued an upward trajectory in the first part of 2010[40], a tendency that was pronounced in the second quarter. The creation of money in economy was mainly carried out through the foreign currency component of money supply. The moderate growth of the loan portfolio in foreign currency, coupled with the recovery of deposits into the system, gave rise to the accumulation of funds by the banking system and the growth of net foreign assets. The performance of the public sector's net domestic assets has reflected the low demand of the Government for monetary assets, hence providing a modest contribution to the creation of money in economy during this period. In the meantime, private sector demand for money remains low. Despite the positive short-term developments, the annual growth rates of credit were at low but positive levels.

PERFORMANCE OF MONETARY AGGREGATES

The average annual rate of the M3 aggregate reinforced its upward rate further in the second quarter[41] to 7.6% versus 6.6% in the first quarter. Money growth in January to May was also triggered by the growing demand of the private sector for monetary assets. The growth of base money has also reflected

Chart 34 Contribution of money supply components to M3 growth and the annual growth rates of monetary aggregates



Source: Bank of Albania

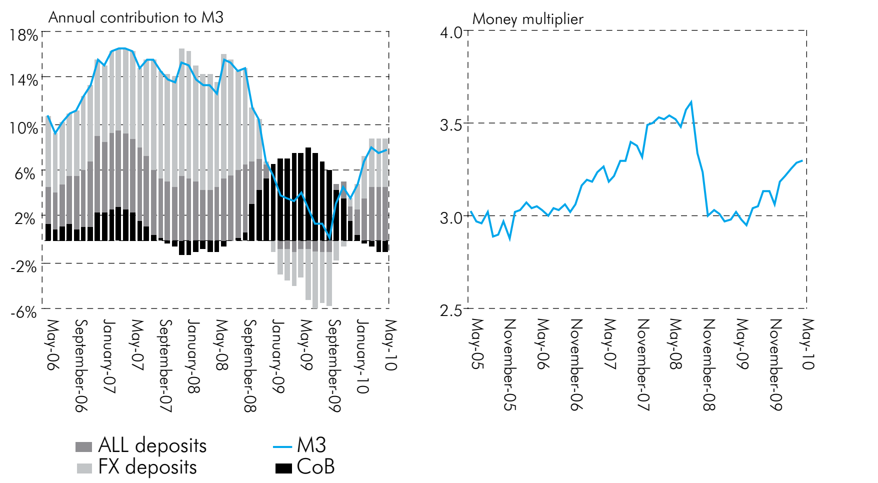
40 The analysis of the first part of the year covers the period from January to May 2010.

41 The analysis of the second quarter covers the period April to May 2010; the exchange rate effect is excluded from all indicators.

the gradual termination of the statistical effect of the low comparative base since April. The growth rates of Lek aggregate, M2, were more stable than those of broad money. In the second quarter, they stabilized at an average of 4.8% y-o-y.

Public sector's contribution to the creation of money in economy was relatively low. The increasing participation of individuals in financing public debt in the first half of 2010 gave rise to moderate growth rates of M2 aggregate. In addition, there was a shift in the time structure of money supply in ALL to longer-term assets. Currency outside banks declined 2.7% y-o-y in the first half of 2010. In the meantime, the upward rates of base money reduced substantially. Its growth averaged 1% y-o-y in the same period. Following the recovery of money supply and the decline of high-powered money, money multiplier grew further to 3.3 in May versus 3.02 in the same period in 2009.

Chart 35 Contribution of money supply components and money multiplier

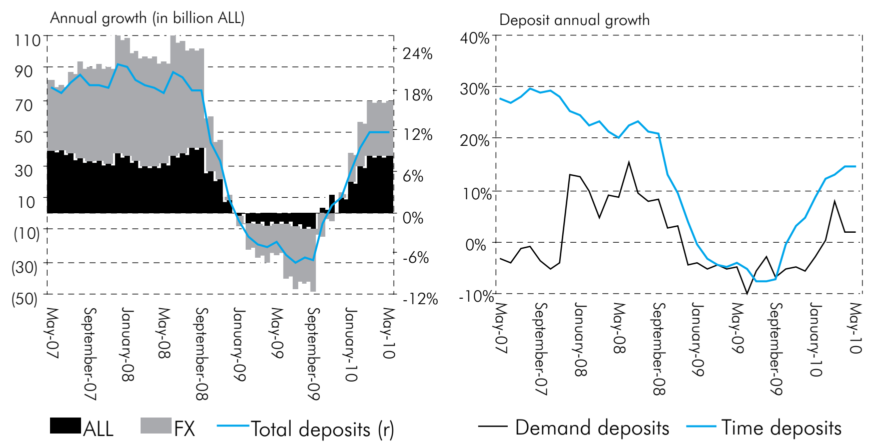


Source: Bank of Albania

PERFORMANCE OF DEPOSITS

The further growth of total deposit stock in January to May provided further evidence for the enhanced economic agents' confidence in the banking system and the higher circulation rate of currency in the economy. This tendency was more pronounced in the second quarter with the total stock of deposits growing by an average of 11.7% y-o-y. In terms of the time structure of deposits, there was a shift of demand deposits to time deposits as a result of the favourable interest rates, particularly the Lek ones. The share of time deposits to total deposits has been upward, moving around 78.5 – 79.5% in the second quarter of 2010.

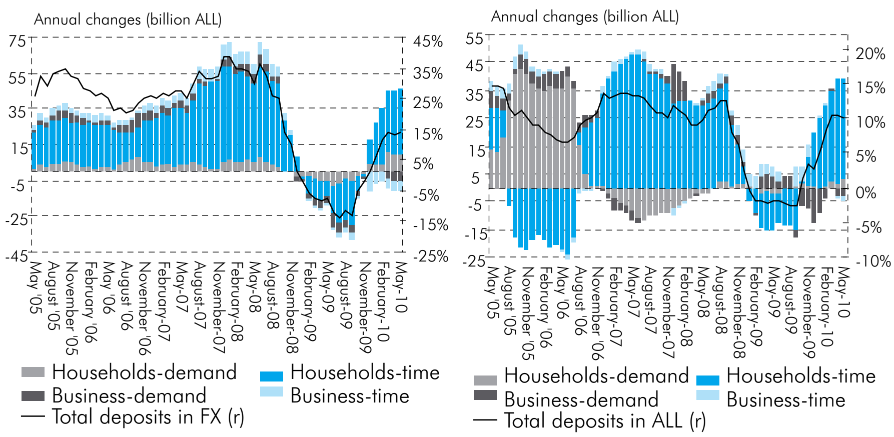
Chart 36 Y-o-y performance of deposits by foreign currency and time structure



Source: Bank of Albania

The currency structure of deposits shows a more rapid growth of foreign currency deposits versus Lek deposits. Deposits denominated in foreign currency grew by an average of 13.7% y-o-y. Lek deposits grew 10.2% in the second quarter. The recovery of currency outside banks into the system was reflected in the increase of deposits denominated in the Albanian Lek. Lek deposits contributed to the growth of total deposit stock by about ALL 3.1 billion in the second quarter, while foreign currency deposits contributed by ALL 2 billion[42].

Chart 37 Y-o-y change of Lek and foreign currency deposits by economic agent



Source: Bank of Albania

42 *ALL-denominated deposits grew by an average of ALL 3.7 billion a month in the first quarter. Foreign currency-denominated deposits grew by ALL 4 billion.*

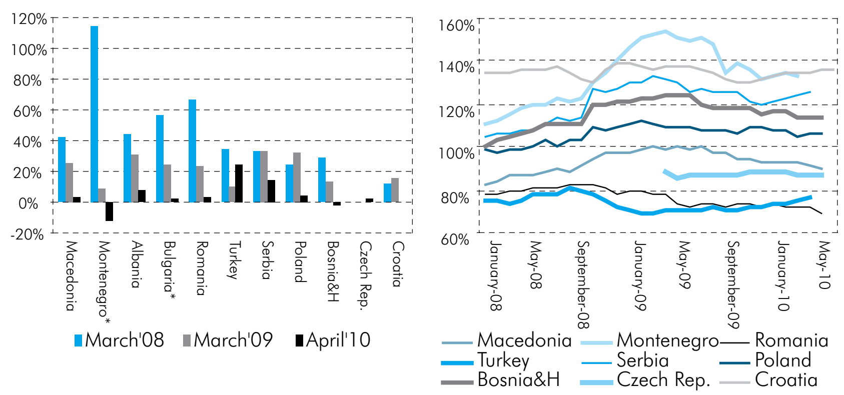
Household deposits dominated the growth of total deposit stock. In the second quarter of 2010, they grew by an average of 17.2% y-o-y versus the decline by 5.8% in the same period in 2009. Business deposits are lower than in 2009 owing to the performance of both time and demand deposits. On one hand, the decline of business deposits reflects their need for liquid monetary assets; and on the other, the performance of their economic activity during this period.

Box 3 Banking intermediation in the regional countries

The consequences of the global financial crisis, which peaked in September 2008[1], hit the Central and South-East Europe and consequently, Albania. Its effects spread throughout the sectors of the economy in 2009. It primarily began with the slowdown and decline of financial intermediation, the reduction in trading volume at a global level and later, the reflection of these effects in the growth of real economy.

However, in the early months of 2010, there were signs of recovery in the financial markets and financial and monetary indicators as a result of the coordinated interventions of central banks and the accommodating fiscal policies. The majority of Central and South-East European countries are recovering at satisfactory rates. Except for countries like Romania, Bulgaria and Hungary, which were hit the hardest from this crisis and were still under recession in the first quarter of 2010, the rest of countries posted positive economic growth rates that are projected to persist. Nonetheless, monetary growth in these countries remains low. According to a study conducted by Bundesbank, the recovery process and the low economic growth were not underpinned by banking system lending. In many of these countries[2], the lending rates are still pursuing a downward trajectory, hence anticipating slow progress in the following months. The availability of domestic or foreign financial resources, the performance of non-performing loans and the risks associated with the banking system's capital and profitability will remain among the major causes of the slow recovery in lending. In the majority of the regional countries[3], lending featured curbing downward rates in the early months of 2010; however, there were no signs of quick recovery. Intermediation rates[4] were also downward, reflecting the

Chart 38 Annual growth of credit (left-hand) and intermediation rates in the regional countries (right-hand)*



* The latest data on the annual credit rate for Montenegro and Bulgaria refer to March 2010.
Source: Respective central banks, May 2010

pronounced slowdown of lending versus the more rapid growth rates of deposits. The banking system has been generally supporting businesses with short-term loans, primarily to meet their liquidity needs and for short-term investment purposes.

In addition, CEE countries have entered a phase of rapid decline in the use of financial leverage. These developments are reflected in the lower ratio of foreign assets to total liabilities. According to a Bundesbank's study, the use of financial leverage will continue to remain low in the following months, suggesting that banks can take advantage of the ECB's easing policy rates and the ample liquidity in the market. Concurrently with the poor economic performance and the high unemployment rates, non-performing loans maintained an upward trend in some countries[5]. As a result of their weak economic growth compared with the rest of the regional countries[6], non-performing loans are expected to be upward and record peak rates in the following months. Hence, the allocation of banks' funds to settle the foreign debt and the upward non-performing loans rates are anticipated to give rise to low lending rates in the regional economies. The low and positive economic growth rates noted in a large number of regional countries in the first half of 2010 are not expected to be boosted by lending. This is expected to rebound only after the recovery of private sector demand, businesses mainly. Against a background of uncertainties over the future prospects, the decline in output, the low credit rates and the fall in domestic and foreign aggregate demand will determine the future performance of the economies in these countries.

Notes
1 *In September 2008, Lehman Brothers, the largest investment bank in USA, filed for bankruptcy.*
2 *Turkish economy has started to record upward lending rates.*
3 *Montenegro and Bosnia and Herzegovina continue to record negative growth rates.*
4 *Total credit to economy to total deposit stock.*
5 *Kazakhstan and Estonia recorded the highest rates of non-performing loans. Further growth in non-performing loans in Bulgaria and Romania is expected.*
6 *Economic growth rates in Lithuania and Romania continued to contract in the first quarter of 2010.*

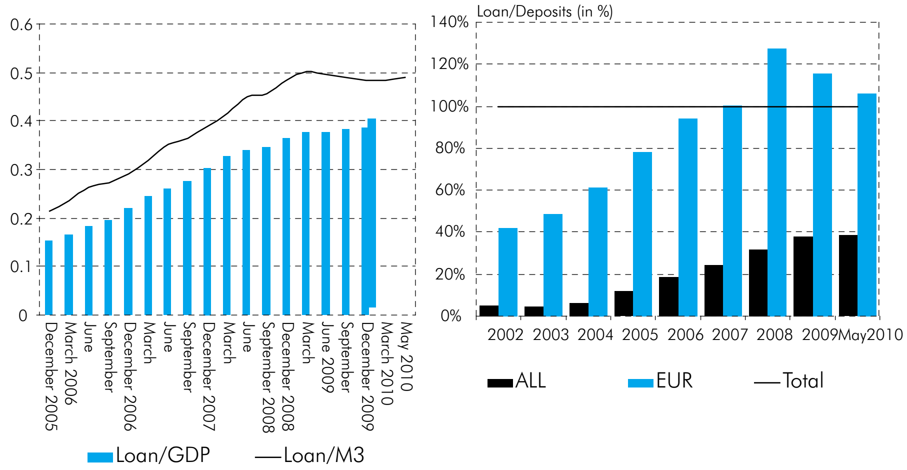
PRIVATE SECTOR CREDIT

Private sector credit grew further in the second quarter of 2010[43]. Its y-o-y growth reached 6.0%[44] in May versus 4.8% at the end of the first quarter. Private sector credit growth was determined by the growth in business loans, while household loans continued to contract at a constant rate in April to May. Despite the encouraging short-term developments in certain borrowing market segments, private sector credit has hit record lows. This performance owes to the contracted credit supply in response to the added prudence in banks' lending policies, and to the low demand for credit from the private economic agents as a result of the low aggregate demand and the high levels of unused capacities. In the meantime, the deteriorated loan portfolio quality and the uncertainties over the future economic developments gave rise to more conservative lending policies in the banking system. In the first half of 2010,

43 *The data on the second quarter cover only April and May.*
44 *The exchange rate effect is excluded from the figures in this analysis.*

intermediation indicator[45] in ALL remained at similar levels as in December 2009, while for the EUR it maintained the downward trend commenced since the year-end 2008.

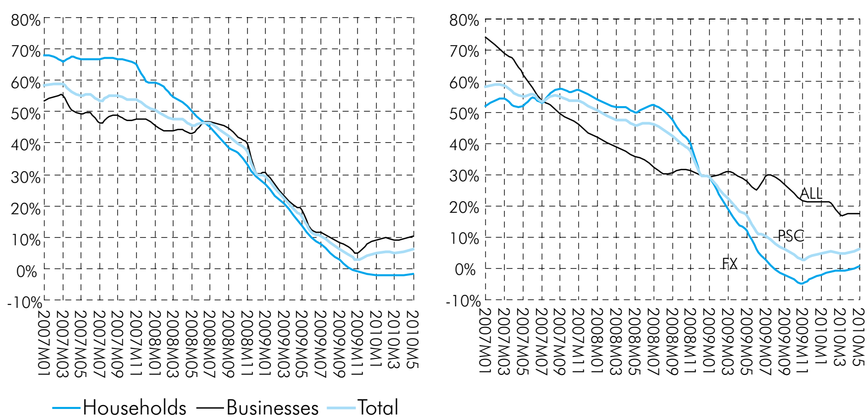
Chart 39 Loan performance and financial intermediation



Source: Bank of Albania

The banking system took advantage of the improved liquidity in foreign currency by lending more in foreign currency. After the y-o-y contraction since August the past year, foreign currency loans recorded a positive annual growth rate in May, 0.8%. Foreign currency loans were almost entirely oriented to businesses and they were generally granted for investment financing purposes. ALL loans grew by an average of 17.5% in the second quarter, down 2.4 p.p. from the first quarter of 2010.

Chart 40 Annual growth of private sector credit by borrower (left-hand, %) and currency (right-hand, %)

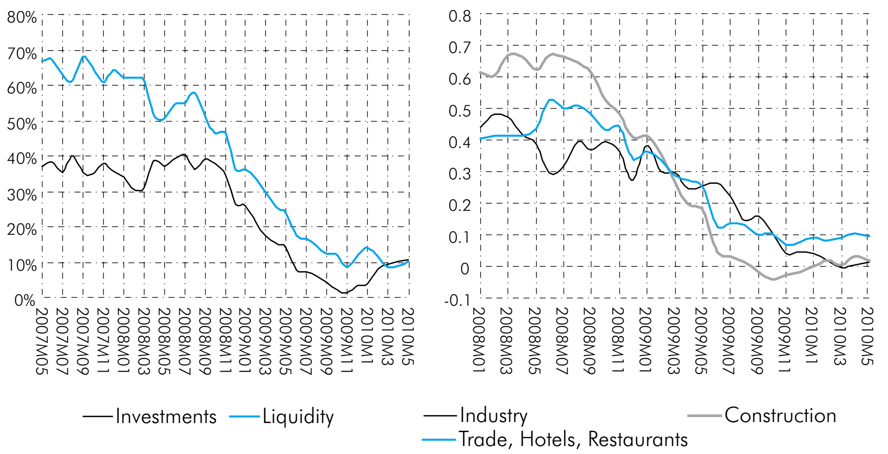


Source: Bank of Albania

45 *Intermediation is measured as the ratio of loans to deposits in Lek and Euro.*

Developments in the business loan portfolio in the second quarter of 2010 attested to its continuous positive performance that had commenced in the early 2010. Business loan portfolio posted a y-o-y growth of 10.5% in May versus 9.2% in March. The contribution of investment loans to this growth averaged 52% in the second quarter, about 1.3 times higher than in the first quarter. In May, it posted a y-o-y growth of 10.8% or 1.4 p.p. higher than in March. Although the main driving force of demand for loans is meeting the liquidity needs, business demand for investment loans grew substantially in 2010. On monthly average terms, new investment loans extended in 2010 were 50% higher than the 2009 average. In the meantime, new loans for liquidity purposes maintained similar levels as in the previous months. In the second quarter, their average y-o-y growth was 9.5%, slightly lower than in the first quarter.

Chart 41 Annual growth of business loans by purpose (left-hand) and sector (right-hand)

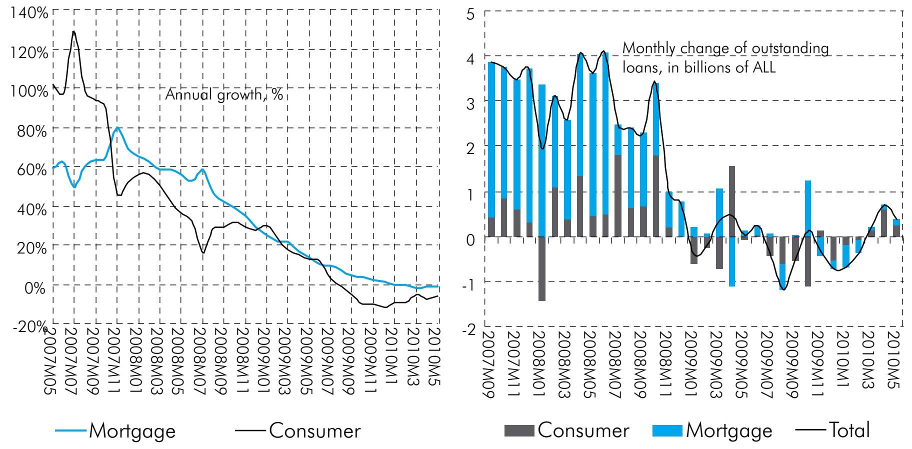


Source: Bank of Albania

In April and May 2010, trade sector absorbed the largest part of business credit growth, 50%. Average y-o-y growth of credit to trade sector was 10.1% or 1.2 p.p. higher than in the first quarter of 2010. Credit to construction sector, which resumed the positive annual growth rates in 2010, grew by 2.5% y-o-y on average in these two months. After slowing down constantly until March this year, credit to industry grew by 1.5% y-o-y in these two months. The distribution of business loan portfolio by sectors of economy continues to maintain similar relative ratios: trade 39%, industry 24% and construction 20% of the loan portfolio.

The y-o-y contraction in household loans continues to persist. In the second quarter of 2010, it contracted at similar rates as in the previous one, 2.0%. To a large extent, this performance owes to consumer loans, which contributed 65% to this rate. After peaking at 11.7% in December 2009, the y-o-y contraction rates of consumer loans declined to 5.9% in May. In the meantime, loans for the purchase of real estate continue to contract moderately by 1.1% y-o-y.

Chart 42 Household loan portfolio



Source: Bank of Albania

Short-term developments show a slight increase in household loan portfolio in the last three months. The largest part of loan portfolio growth in this period was for consumption purposes. As reported by banks, household demand for consumer loans grew in the first two quarters of 2010. On the other hand, household demand for housing loans, which makes up 77% of household loan portfolio, has been declining. This behaviour reflects households' more conservative approach to incurring large expenses against a background of high uncertainties in real estate investments and the tight lending terms for real estate financing.

Box 4 Bank lending survey results for the second quarter of 2010

Banks tightened the lending standards for businesses in the second quarter of 2010, in line with their expectations in the past survey. Standards tightened only for small and medium-sized enterprises (SMEs). For the second consecutive quarter, banks eased the lending standards applied on corporate loans. Standards were tighter for investment loans than for working capital. In the meantime, bank experts state that standards applied on household loans eased slightly compared to the tight lending standards in the last two quarters.

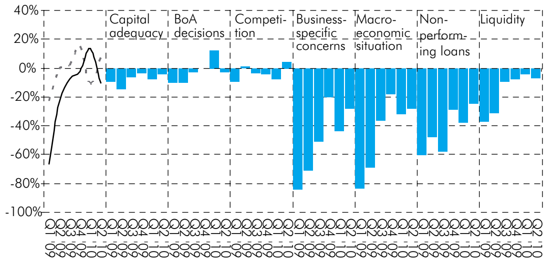
Business-specific concerns, the macroeconomic situation, non-performing loans and households' financial position remain the key factors contributing to the tightening of lending standards. Based on the opinion of bank experts, SMEs' and household demand for consumer loans has increased, while corporate demand and household demand for housing loans has reduced.

For the third quarter of 2010, banks expect easier lending standards for both business and households.

BUSINESS LOANS

Based on the survey data for the second quarter of 2010, banks tightened the lending standards on business loans. Net balance[1] was -9.9%. The tightening of lending standards is in line with banks' expectations in the first quarter of 2010. The tightening of lending standards was applied only on SMEs. The net percentage of banks reporting that they tightened the lending standards on SMEs is 10.9%. In the meantime, banks continued to slightly ease the lending standards on corporate loans but at lower extent than in the first quarter of 2010. The net balance of corporate lending standards was +16.7 and +4.5% in the first and second quarter of 2010, respectively. Bank experts reported that the lending standards were tight on investment and working capital loans.

Chart 43 Changes in business lending standards and contribution of different factors (net balance[1], net percentage of banks reporting easing standards)



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

Business-specific concerns, non-performing loans and the macroeconomic situation are the key factors contributing to the tightening of lending standards in the second quarter of 2010. The contribution of these factors declined moderately compared to the first quarter of 2010. Competition in the banking system is the only factor to have contributed slightly but positively to the easing of lending standards. Its net balance is +4.5%, for the first time since the second quarter of 2009 (see Chart 43).

Banks' tightening policy in the second quarter of 2010 was mainly applied by increasing the margins on high-risk loans and the collateral requirement. The increase of the approved amount of loan and the extension of the maximum maturity term of the loan have contributed to a looser lending policy.

SMEs' demand for loans increased, whereas corporate demand for loans fell slightly in the second quarter of 2010. The need to finance working capital remained the key factor contributing to pushing the demand for loans in this quarter. On the other hand, the balance of "investment financing" increased during this quarter.

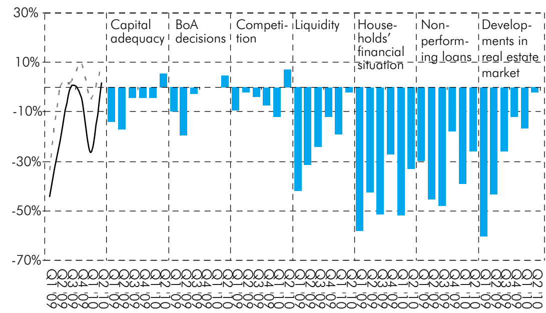
Banks expect easing of lending standards in the third quarter of 2010. In addition, they expect looser standards for working capital loans than for investment loans.

HOUSEHOLD LOANS

In the second quarter's survey, banks report looser lending standards for household loans than in the previous quarter. The net percentage of banks reporting easier lending standards increased to 1.5% versus -26.5% in the previous quarter. Lending standards eased for both consumer and housing loans. The net balance of standards for consumer loans was 2.8% and for housing loans 3.2%.

By and large, all considered factors lowered their contribution to tightening the lending standards in the second quarter of 2010. Competition in the banking system and the improved liquidity position contributed to easing the standards for household loans. Households'

Chart 44 Changes in lending standards applied on household loans (housing and consumer loans) and contribution of different factors (net balance*), net percentage of banks reporting easing lending standards)



* See Note 1.
Source: Bank of Albania

financial position and non-performing loans continued to provide the key contribution to the tightening of lending standards (see Chart 44).

Banks eased the lending standards in the second quarter of 2010, mainly by lowering the commissions and extending the maximum maturity term of the loans. The respective balances increased to 13.8 and 12.1%. The higher collateral requirement in relation to the loan amount continues to provide significant contribution to the application of a more conservative lending policy. The respective balance dropped to -14.3% from -10.7% in the previous quarter. The margin on high-risk loans contributed to tightening the lending standards, albeit at a lower rate than in the first quarter of 2010.

In contrast to banks' expectations for demand in the second quarter of 2010, household demand for loans was low. Its net balance was -3.2%. The negative net balance of demand for loans owes primarily to the fall of demand for housing loans. The net balance of demand for housing loans dropped to -17.8% versus 1.2% in the previous quarter. On the other hand, demand for consumer loans remains positive, albeit at a lower level than in the previous quarter. According to banks' opinion, the fall of demand was also triggered by the worsening of consumer confidence, real estate market performance and the perception for the tightening of lending standards applied by banks.

Banks expect further easing of lending standards in the third quarter of 2010. The extent of this easing is expected to be higher than in the second quarter. Banks also expect that standards applied on housing loans will be easier than those applied on consumer loans. In addition, household demand for loans is expected to be higher in the third quarter of 2010.

Note

1 *Banks' responses regarding the lending activity are aggregated through the "net balance" indicator. The net balance is calculated as a difference between the weighted responses of banks reporting an easing/increase of standards/demand and of those reporting tightening/decrease of standards/demand. The weight is calculated based on the loan portfolio ratio of each bank to total credit, for different market segments, according to type of question (business/household loans in Lek/foreign currency).*

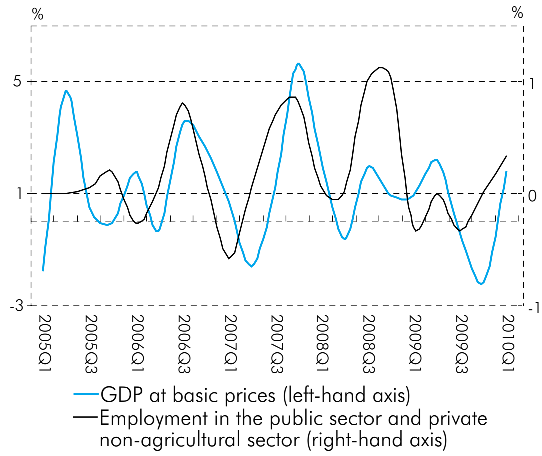
IV.2 LABOUR MARKET, WAGES AND PRODUCER PRICES

Imbalances in the labour market, shown in the last quarter of 2009, persisted in the first quarter of 2010 as well. Employment declined y-o-y; however it preserved similar levels in quarterly terms. Business survey results underpin the quarterly dynamics of this indicator for the second quarter as well. The below-potential economic growth and the low capacity utilization rate are translated into wider gap between supply and demand in the labour market. Subsequently, unemployment rate increased in the first quarter of 2010. It is assessed that the inflationary pressures arising from the rise in wages will be absorbed against a background of low domestic demand. Producer prices maintained similar levels in the first quarter as in the previous year.

IV.2.1 LABOUR MARKET

Labour market indicators continued to deteriorate in the first quarter of 2010. Employment in the Albanian economy[46] recorded similar levels as in the last quarter of 2009, increasing slightly by 0.2% q-o-y. Employment in the private non-agricultural sector and the public sector maintained a similar upward tendency as the GDP. The number of employed persons in these two sectors terminated the decline and remained almost similar as in the first quarter of 2009, at 404,463 persons.

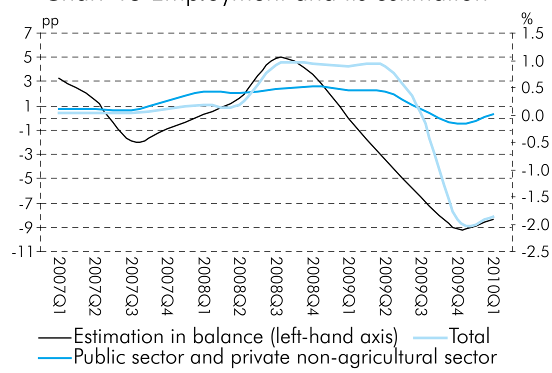
Chart 45 GDP at basic prices and employment in the public sector and private non-agricultural sector (q-o-q changes)



Source: INSTAT

Against a background of low historical growth rate of aggregate demand and capacity utilization rate, business demand for labour remained unchanged compared to the last quarter of 2009. Business confidence survey data on employment in economy (excluding agriculture[47]) support the last observation. The aggregated indicator estimating the employment situation is in line with the quarterly tendency of total employment and employment in the public sector and private non-agricultural sector.

Chart 46 Employment and its estimation*



*Employment is the moving average of quarterly changes in the number of employed persons in economy and in the public and private non-agricultural sector. Estimation of employment is also the moving average of respective balances, calculated as the arithmetic average of balances in the sectors of industry, construction and services.

Source: INSTAT, Bank of Albania and its estimates

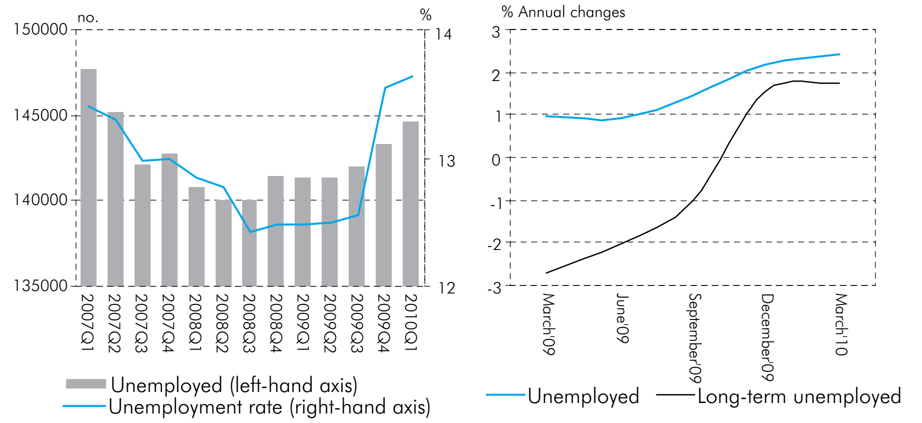
Given the lack of quantitative and qualitative data, the analysis of labour supply has a high level of uncertainty. Labour supply in economy depends on a number of factors like: the increase of population, labour force participation[48], long-term unemployment and emigration of population. The increase in the number of long-term unemployed persons exerts pressure on the decline of effective labour supply. Long-term unemployed persons find it hard to gain the skills required by the employer, hence exiting the labour market and yielding the decline in labour supply. The number of long-term unemployed persons increased pronouncedly in the last quarter of 2009 (+1.5% y-o-y). It maintained a similar level in the first quarter of 2010 as well (1.7%).

46 The y-o-y contraction of the number of employed by 7.4% for the second quarter in a row attributes primarily to the decline of employment in the private agricultural sector, reflecting the statistical effect of their estimation. This is because the average number of employed in the private agricultural sector from the second quarter of 2008 to the third quarter of 2009 has been estimated based on the 2007 Labour Force Survey, while for the last quarter of 2009 it has been estimated based on the 2008 Labour Force Survey (Source: INSTAT, "Conjuncture, Main Economic Indicators, January-March 2010". Employed in this sector are included in "Self-employed" and account for 57.7% (average of period Q1:2005-Q1:2010) of total employed.

47 Business Confidence Surveys do not provide figures on agriculture.

48 The number of employed or job-seekers as a percentage of labour force.

Chart 47 Performance of unemployment rate, the number of unemployed persons and long-term unemployed persons



Source: Unemployed persons and unemployment rate by quarters (INSTAT, Conjuncture, Key Economic Indicators).
Total unemployed persons and long-term unemployed persons by month (MLSAEO).

The average number of unemployed persons continues to maintain the upward tendency shown in early 2009. Unemployed persons increased by 2.3% y-o-y and 0.9% q-o-q in the first quarter of 2010. The number of unemployed persons reached 144,608. Unemployment rate was 13.83%, up 0.4 p.p. from the historical average of the last five years.

WAGES AND LABOUR COST

According to INSTAT, average wage[49] in economy rose in the first quarter of 2010. More precisely, average wage rose 9.6% y-o-y in nominal terms, up 2.2% from the average annual rise in 2009. In real terms[50], it rose 5.3%, 0.2 p.p. higher than the average annual rate in 2009.

The slowdown in the annual growth rates of average monthly wage in the public sector[51], which began in the third quarter of 2009, persisted. In nominal and real terms, it increased by 6.6% and 2.4%, respectively, in the first quarter of 2010. Average monthly wage in the public sector was ALL 42,000, similar as in the previous two quarters.

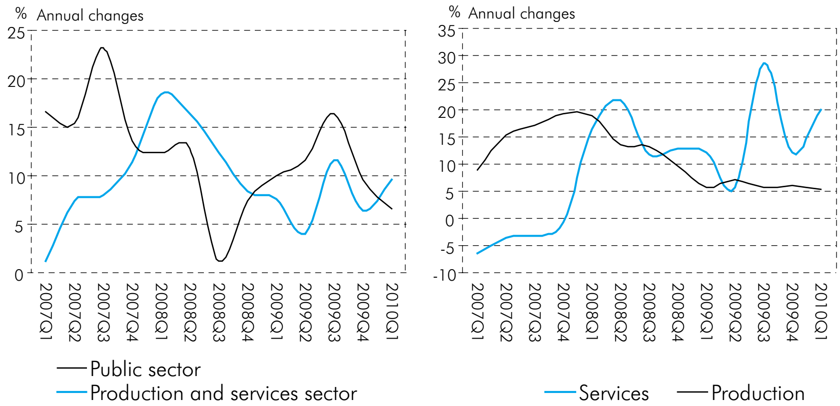
In terms of sectors of the economy, average wage slowed down its y-o-y rates in the production sector and accelerated the increase in the services sector. In production, average wage rose 5.4% y-o-y, lower than the average rise of 6.1% in 2009. In services, average wage was 19.9% higher than in the same quarter in 2009 and 5.2 p.p. higher than the average y-o-y rise in 2009.

49 Wages in economy, often referred to as "average wage", is calculated as the ratio of wage fund index to the number of employed index. Source: INSTAT, Short-term Statistics, quarterly periodicity, excluding agriculture.

50 Average wage index is deflated by inflation in order to obtain the wage index in real terms.

51 Budget and Non-budget Sector. Source: INSTAT, "Conjuncture, Main Economic Indicators, January-March 2010".

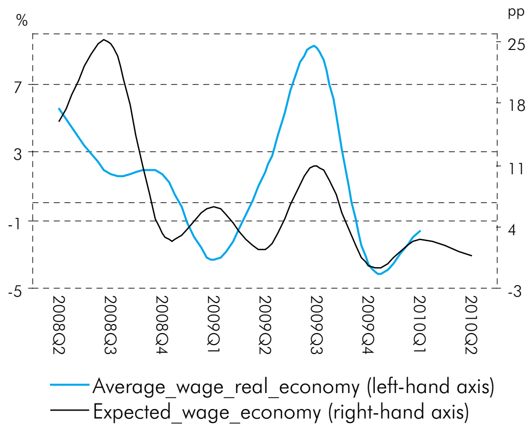
Chart 48 Average wage in production, services and the public sector (left-hand) and average wage by production and services activities (right-hand)



Source: INSTAT and Bank of Albania estimates

Business confidence survey results support the quarterly rise of average real wage in economy in the first quarter of 2010. However, expectations signal its curbing in the following quarter.

Chart 49 Average real wage and business expectations, quarterly



Source: INSTAT, Bank of Albania and its estimates

IV.2.2 LABOUR PRODUCTIVITY AND LABOUR COST PER UNIT OF OUTPUT[52]

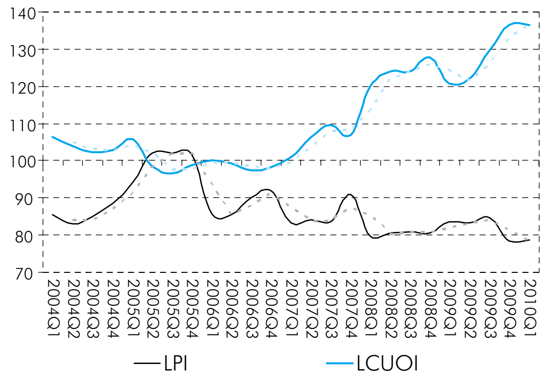
The annual change in Labour Productivity Index (LPI) was negative (-5.8%) in the first quarter of 2010. The negative performance of this index persists from the previous quarter. The rationale behind this performance is the imbalance between developments in economic activity and the labour market performance. However, the quarterly change in LPI rose slightly (0.3%) in the first quarter, hence providing signals for the curbing of this imbalance.

For the same quarter, Labour Cost per Unit of Output Index (LCUOI) posted relatively high annual growth rates (13%), although the quarterly change was almost negligible (0.06%).

The quarterly change rates of LPI and LCUOI underpin the narrowing of the gap between these two indices compared to the last quarter of 2009 when economic activity contracted. The vague tendency of LPI and LCUOI

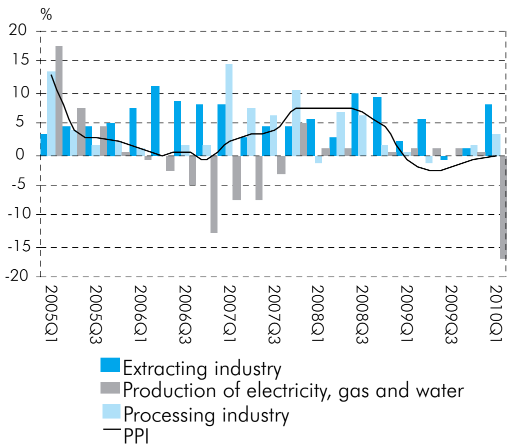
52 The estimation of these two indices is based on seasonally adjusted value added data, excluding agriculture (GDP for Q1 2010, INSTAT) and on employment and wage fund indices (Short-term Statistics, Q1 2010, INSTAT). The latter do not include agriculture, therefore these two indices, as estimated by Bank of Albania experts, represent the economy excluding agriculture.

Chart 50 LPI and LCUOI
(excluding agriculture)*



*Base year is 2005 (2005 is applied for the GDP and Short-Term Statistics.
Source: Bank of Albania estimates

Chart 51 Producer prices in respective industries and in total, y-o-y changes



Source: INSTAT

owes to the curbed increase of valued added in economy against a background of relatively higher employment rates.

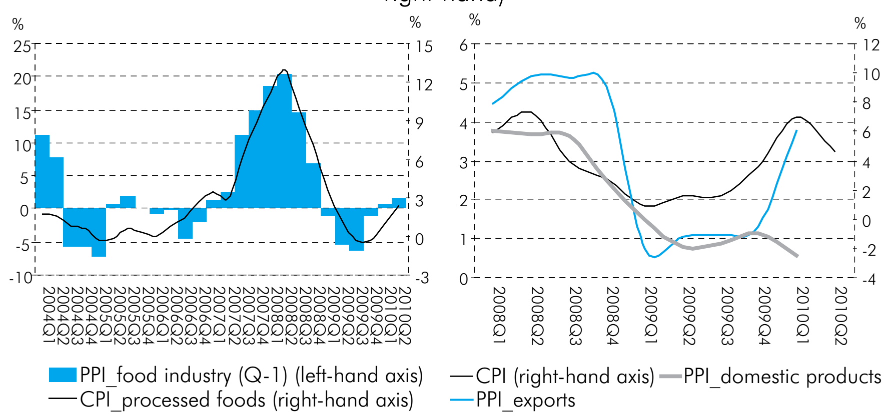
IV.2.3 PRODUCER PRICES

Producer prices fell 0.2% in the first quarter of 2010, more moderately than the average annual fall by 1.7% in 2009. In terms of type of industry, prices of "production, distribution of electricity, gas and water" posted the highest y-o-y fall, 17%, providing the largest impact on the overall index performance. By contrast, prices of extracting and processing industry increased the annual rise rates by 7.8 and 3.1%, respectively, compared to the average annual rates by 2 and 0.2% in 2009. The rise in these prices reflects the higher foreign demand for extracting and processing industry-related products.

Food industry products show higher linear correlation with consumer prices. Producer price index for this industry increased by 1.6% y-o-y, in line with the 4.1% average y-o-y increase of inflation in the first quarter. The positive upward rate of producer prices in food industry is assessed to have augmented the pressures on the rise of consumer prices for processed foods in the second quarter of 2010.

Against a background of still weak domestic demand, producer prices in the domestic market

Chart 52 Producer Price Index of food industry and Consumer Price Index of processed foods (annual changes, left-hand) and Producer Price Index of domestic products and exports and Consumer Price Index (annual changes, right-hand)

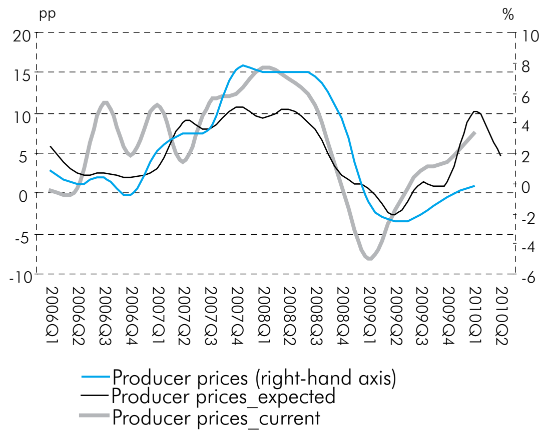


Source: INSTAT

were 2.5% lower in the first quarter of 2010 than in the same period in 2009. This index accelerated the fall recorded in 2009, over which producer prices of domestic products fell by an average of 1.1%. By contrast, producer prices of exports rose by 6.1% y-o-y, reflecting the high foreign demand, following the average y-o-y fall by 1.2% in 2009.

Business survey results of the first quarter of 2010 related to producer prices in economy support their annual upward trend. In the meantime, business expectations in the second quarter signal that producer prices will fall.

Chart 53 Producer prices (y-o-y changes), current balances and expectations for producer prices



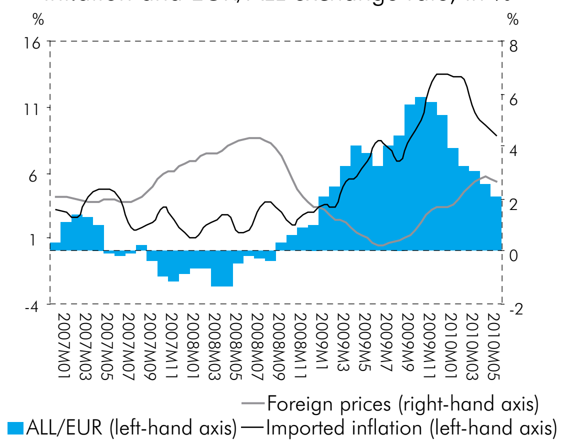
Source: INSTAT and Bank of Albania

IV.3 IMPORTED INFLATION

The inflationary pressures deriving from global economy on the overall level of consumer prices at home were present throughout the first half of 2010. However, the relative exchange rate sustainability in early 2010 relieved the upward pressures originating from the outside, hence favouring the curbing of inflation in the country.

The rise in raw material prices, the improved global economic activity and the statistical base effect have been translated into the recovery of inflationary pressures on the economies abroad in the first half of 2010. The same tendency has been also noted in the performance of inflation in our main trading partners, Italy and Greece. After hitting low inflation rates, about 1%, annual inflation in these two countries pursued a slight upward tendency in 2009. Average annual inflation rate in Italy and Greece marked 1.4 and 4.1%, respectively, in the first half of 2010. The Harmonized Index of Consumer Prices (HICP)[53] increased to 1.9 and 2.7%, respectively, in the first and second quarter of 2010.

Chart 54 Y-o-y change in the HICP, imported inflation and EUR/ALL exchange rate, in %



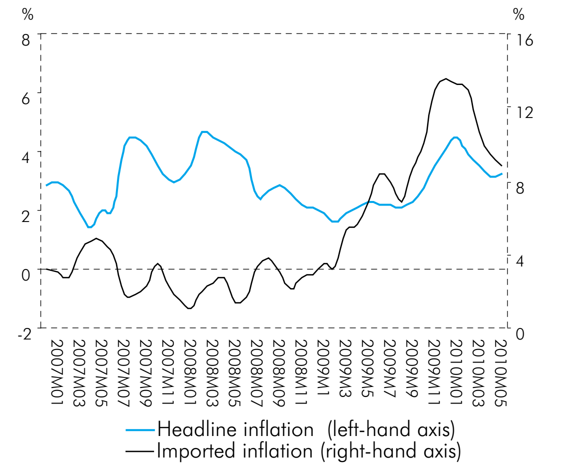
Source: Bank of Albania and National Statistical Institutes (Italy and Greece)

The low y-o-y depreciation rates of the Lek against the Euro, starting from January 2010, eased the external inflationary pressures on consumer prices at home. Imported inflation[54] slowed down significantly from 13.6% in January to 8.9% in June 2010. Subsequently, inflation at home maintained a downward tendency to 3.2% in June.

53 HICP is measured as the weighted average of consumer prices in Italy and Greece and their import share to total imports.

54 A proxy measured by Monetary Policy Department; it results from the combination of information on Greece's and Italy's CPI for the EUR/ALL exchange rate (three-month lag) and Albania's import share with these countries.

Chart 55 Imported and headline inflation, in %



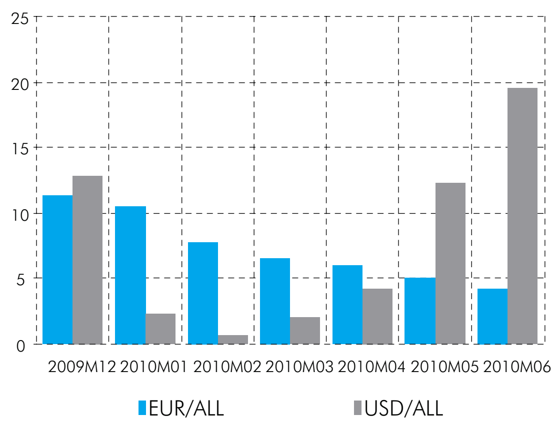
Source: Bank of Albania's estimates

Lek's exchange rate behaviour was dissimilar to the Euro and the U.S. dollar. The Albanian Lek slowed down progressively the annual dynamics of its depreciation against the Euro to 4.6% in the second quarter of 2010 versus 11.4% in the last quarter of 2009. On the other hand, the Lek depreciated significantly against the U.S. dollar in the second quarter of 2010, 11.9%, pronouncedly higher than in the previous quarters.

The depreciating tendency of the Lek versus the U.S. dollar underpinned the inflationary impact of the oil price rise in the international market. Oil price abroad slowed down its annual growth rate[55] to 9% in June from 83% in January 2010. According to statistical tests[56], the curb in the growth rate of oil price in the international market is expected to be reflected in oil price at home with a lag of 1 month. However, worth also considering is that the USD/ALL exchange rate is strongly correlated with oil price at home with a lag of 1 month.

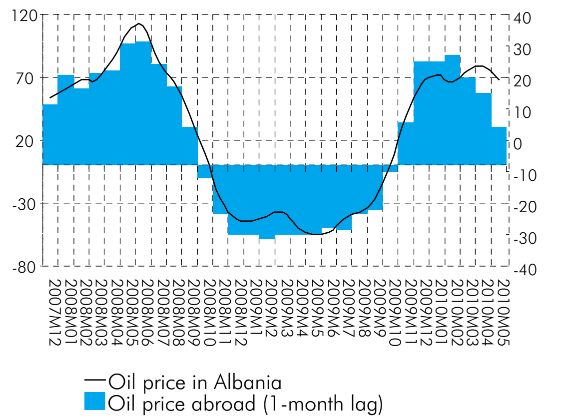
Oil price in the retail market averaged 131.6 ALL/litre in June 2010, up 0.2 and 19.2%, respectively, in monthly and annual terms. The lower annual growth rate of average oil price in the domestic market was also reflected in the performance of "service to personal vehicles" in the CPI basket[57] in June. This item's y-o-y inflation marked 9.9% from 12.2% in May. However, its

Chart 56 Exchange rate depreciation, y-o-y, in %



Source: Bank of Albania's estimates

Chart 57 Annual change of oil price in Albania and abroad (y-o-y, %)



Source: INSTAT and Bank of Albania's estimates

55 Reflecting the termination of the statistical effect of the very low-base comparison.

56 The correlation coefficient between the annual changes of oil price in Albania and oil price in the international market and the USD/ALL exchange rate with 1-month lag is 0.9 and -0.5, respectively, for the period 2003 M10 – 2010 M05.

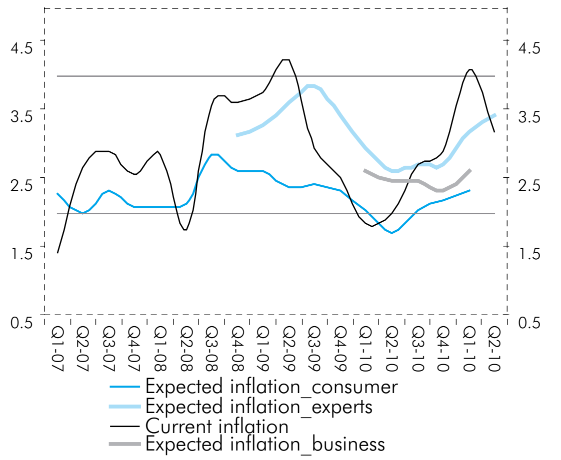
57 This index is more closely related to the performance of oil price in the retail market.

inflation is pronouncedly higher than the average historical rate of 2.9% for the period 1999 – 2009.

IV.4 INFLATIONARY EXPECTATIONS IN ECONOMY

Consumer, business and experts' expectations[58] for inflation after one year increased slightly in the first quarter of 2010, however, remaining within the tolerance band of 2-4%. In the first quarter of 2010, businesses and consumers expected inflation after one year to mark 2.7 and 2.3%, respectively. Experts' expectations for inflation after one year are higher than other economic agents'. The latest data on the second quarter of 2010 show that experts expect inflation after one year to be 3.4%. The performance of different economic agents' expectations for inflation after one year shows a high positive linear correlation with the current official inflation rates as measured by the CPI. This implies that the formation of their expectations relies heavily on the factual current inflation rates.

Chart 58 Economic agents' expectations for inflation after one year, in %

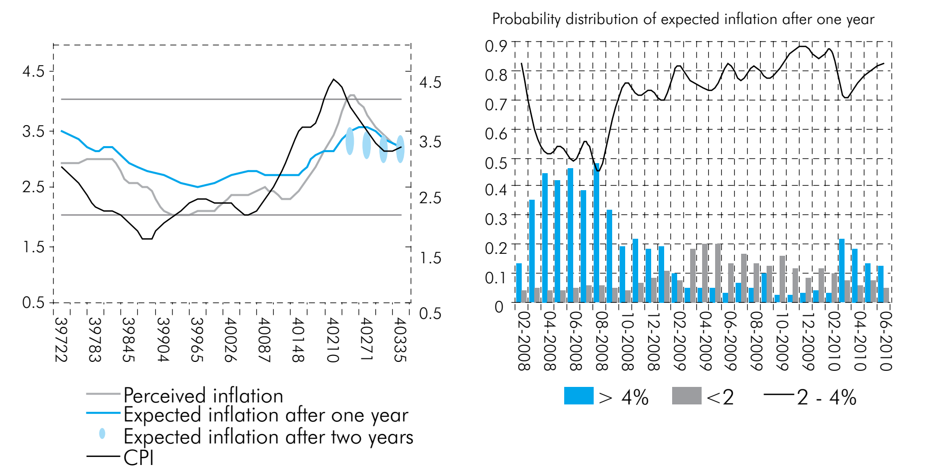


Source: Confidence Surveys and Expert Forecast Survey

IV.4.1 INFLATION EXPECTATIONS DERIVED FROM EXPERTS' MONTHLY SURVEY

In June 2010, experts expect that inflation after 12 months will be 3.2%, down 0.1 p.p. from the previous month. Their expectations for inflation after

Chart 59 Expected inflation after one and two years, perceived inflation (left-hand) and probability distribution of expected inflation after one year (righ-hand)



Source: Expert Forecast Survey, Bank of Albania

58 Consumer, business and bank experts' expectations are measured by the Bank of Albania through the following surveys: Consumer Confidence Survey, Business Confidence Survey and Bank Experts' Expectations Survey.

one year have been downward since April 2010, when the expected inflation rate marked 3.5%. In the meantime, expected inflation for a period longer than one year (two years) continued to mark a lower rate, +3.1%.

Probability distribution of experts' responses according to ranges of expected inflation rates shows that there is little perceived risk for inflation rates out of the 2-4% target range.

Probability distribution of expected inflation after two years is mostly concentrated in the 2-4% target range (83.3%). This distribution shows that experts' perceived risk of inflation in the long-term is lower than in the short-term. Lower risk perception reflects higher experts' confidence in the impact of monetary policy on price stability in the long run.

V. FINANCIAL MARKETS, INTEREST RATES AND THE EXCHANGE RATE

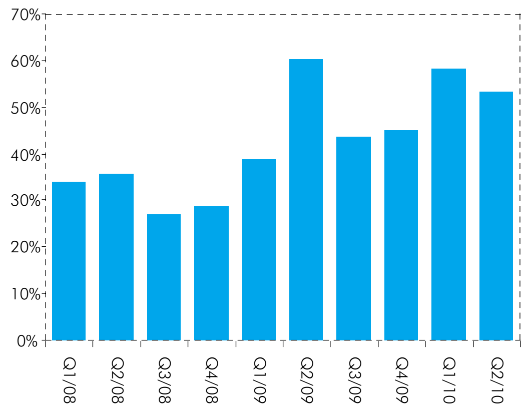
Financial markets attested to stable liquidity situation, stable interest rates, improved confidence of participants expressed in lower risk premia and decrease of long-term interest rates in certain market segments. The primary market continued to show reduced security yields and narrower maturity spreads of interest rates in the money market. Against a background of higher public savings, interest rates on deposits pursued a downward trend. In the meantime, the credit market featured high interest rate fluctuations and tight lending conditions.

V.1 INTERBANK MARKET

The interbank market attested to stable interest rates and their upward tendency in relation to the key interest rate. Following the key interest rate cut in October 2009, interest rates in the interbank market fluctuated in narrower intervals around this rate. The banking system was more active in the first quarter. The traded volumes in the interbank market increased compared to the previous year. Total volume traded between banks declined in the second quarter. Average interest rates increased slightly, particularly in periods of required reserve replenishment when the overnight interest rates exceeded the key rate. The lower traded volumes owe largely to the agents' positioning rather than to the liquidity pressures in the market. The use of free liquidity for trading purposes is slightly lower than in the previous quarter. The announcement of the new operational target by the Bank of Albania[59], which targets the interbank market, is expected to boost the latter's development and sophistication further in terms of higher volumes and maturity terms.

Liquidity pressures in the banking system have reduced substantially and the risk premia among banks are lower. The Bank of Albania continued to supply the market with liquidity in the national currency through regular reverse repo auctions of 7-day, 1-month and 3-month maturity. Liquidity injected into the system was lower in the second quarter than in the previous one (ALL 24 billion from ALL 31 billion) and shifted slightly to long-term

Chart 60 Average volume traded in the interbank market to the system's liquidity*

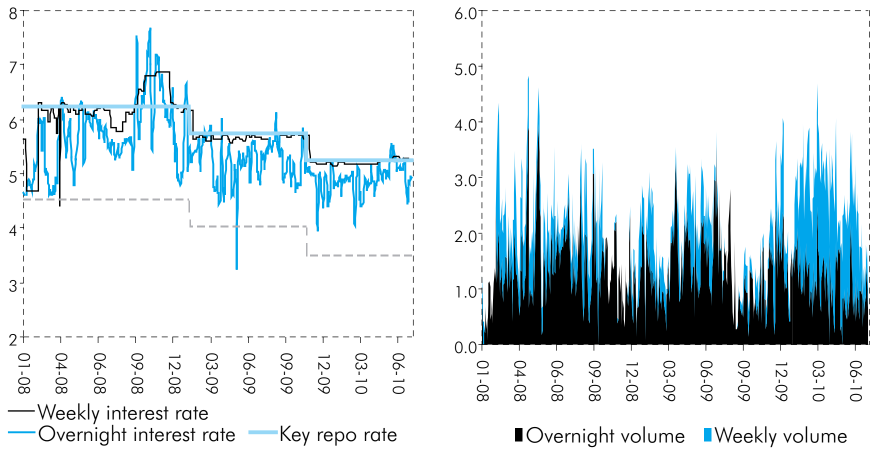


*Included here are overnight deposits, excess reserve and volume in the interbank market.
Source: Bank of Albania

59 For more information, please refer to Box 5 "Change of Bank of Albania operational targets".

maturities (totalling ALL 26 billion from ALL 16 billion in the first quarter). Although the Bank of Albania has since January resumed the regular reverse repurchase auctions by applying a fixed amount, the interest rates asked by participant banks were close to the key rate, hence not giving rise to elevated borrowing cost in the interbank market.

Chart 61 Interest rates (left-hand) and volume traded in the interbank market (right-hand)



Source: Bank of Albania

One-week maturity in liquidity trading prevailed in the last two quarters, hence reflecting enhanced confidence in the market. Average daily borrowing volume declined to ALL 0.97 billion in the second quarter from ALL 1.28 billion in the first quarter, a relatively low level compared to the last years' quarters. Average weekly volume declined to ALL 1.39 billion from ALL 1.68 billion, which is however high compared to previous periods. Interest rates in the interbank market have reflected this performance. On average terms, overnight interest rate increased to 5.03% or up 0.24 p.p. from the previous quarter, while one-week interest rate increased to 5.25% or up 0.08 p.p.

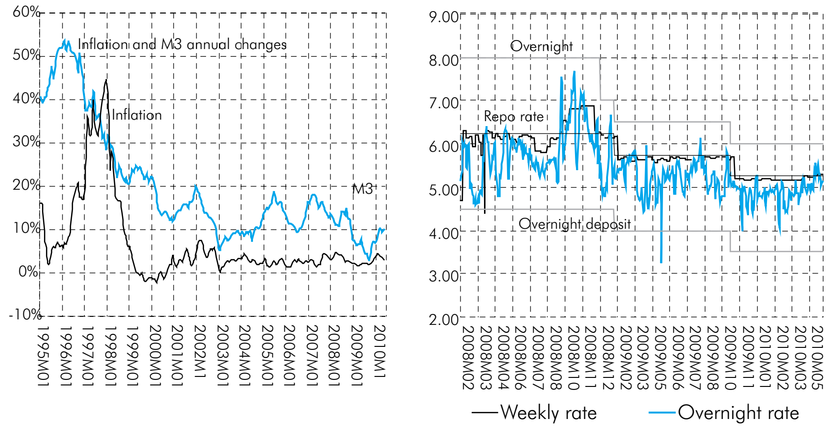
Box 5 Change of Bank of Albania operational targets

Operational targets play a key role in the formulation and implementation process of monetary policy. They serve as a link between the monetary authority's interventions in the money market and the intermediate target of monetary policy, thus serving as the starting point of monetary policy transmission mechanism. Since the beginnings of the Bank of Albania as a central bank in a market economy, monetary policy was designed based on the monetary targeting framework, in a free exchange rate regime, where the final objective – price stability – was achieved through an intermediate quantitative objective for money, M3. Net domestic assets (ceiling) and net foreign assets (floor) served as operational targets for achieving the intermediate target.

The Albanian economy has been very dynamic in the recent years. The development of monetary markets and financial innovation, the rapid growth of lending and dollarization in economy and the increasing role of real estate in investment alternatives are among the factors to have added the complexity of the Albanian economy functioning. Empirical studies at the Bank of Albania evidence that all these developments in the Albanian economy have been coupled with unstable velocity of money circulation, hence downgrading the short and medium-term linkage between monetary aggregates and inflation. These developments, inter alia, have generated a more complex process of the monetary authority's influence on the banking system's balance sheet, the latter being reflected in higher money multiplier volatility.

As shown by the chart (left-hand), inflation fluctuations have been low for several years, whilst money growth rates have fluctuated within a wide interval, hence making it difficult to determine the adequate quantitative targets in view of achieving the inflation target. This has been evidenced in a number of developed and emerging economies, in which monetary aggregates lose their informative function, and eventually their predicting function, at low levels of inflation[1].

Chart 62 Inflation and M3 (left-hand, %) and short-term interest rates in the interbank market (right-hand, %loan)



Source: Bank of Albania

In response to these developments, in the Monetary Policy Document for the 2009-2011 Period, the role of monetary aggregates as indicators of inflationary pressures in economy and as intermediate targets of monetary policy was complemented with a wide range of information provided by the real sector of the economy, which is systemized and finalized in the inflation forecast performance. Bank of Albania's monetary policy decision-making is now almost entirely guided by the forecast of inflation in the medium run and the balance of risks in achieving the target.

In parallel with these changes, the Bank of Albania has been constantly assessing the suitability of operational targets and the adoption of more advanced forms. The Bank of Albania's experience, albeit successful, shows that focusing on the quantitative control of net domestic assets and net foreign assets may bring about large fluctuations in the interbank market and it does not allow proper flexibility to weather unexpected situations. Thus, in response to the need for a more flexible and efficient operational framework in view of enhancing the monetary policy efficiency and transparency, the Bank of Albania decided to apply as its operational target the steering of short-term interest rates in the interbank market close to the key interest rate and keeping their fluctuations under check.

Targeting the interbank market interest rates seems a practical option that finds ample theoretical support and whose application has proved successful in a number of advanced economies. It serves better to keeping the short-term horizon of the interest rates' curve under check, making the conduct of monetary policy more transparent and providing clearer signals of the monetary policy stance. This operational framework, inter alia, allows for more flexibility in handling short and long-term shocks on the economy or the banking system. In addition, steering the Bank of Albania's operations towards stable interbank market interest rates serves to a more relaxed functioning of the interbank market, lowering of risk premia and to a better management of short and medium-term liquidity in the banking system.

Worth noting is that this change does not affect the monetary policy strategy pursued by the Bank of Albania, but only its operational framework[2]. In addition, this change does not imply that the central bank will exclude money from the monetary policy decision-making. Monetary aggregates will continue to serve as indicators that provide valuable information on inflationary pressures, particularly in the long-term, but without having the target status. In addition, the Bank of Albania will pay particular attention to net foreign assets in its monetary policy implementation process, but on a medium and long-term orientation.

Notes

1 *For a deeper analysis of the role of quantitative monetary objectives in monetary policy, see Estrella and Mishkin (1996): "Is there a role for monetary aggregates in the conduct of monetary policy?", NBER Working Paper 584.*

2 *For a deeper analysis of the Bank of Albania's monetary policy strategy, see "Monetary Policy Document for the 2009-2011 Period", revised by Decision No. 43, dated June 30, 2010, of the Supervisory Council of the Bank of Albania. The change of operational objectives has been reflected on page 10 of the Monetary Policy Document for the 2009-2011 Period.*

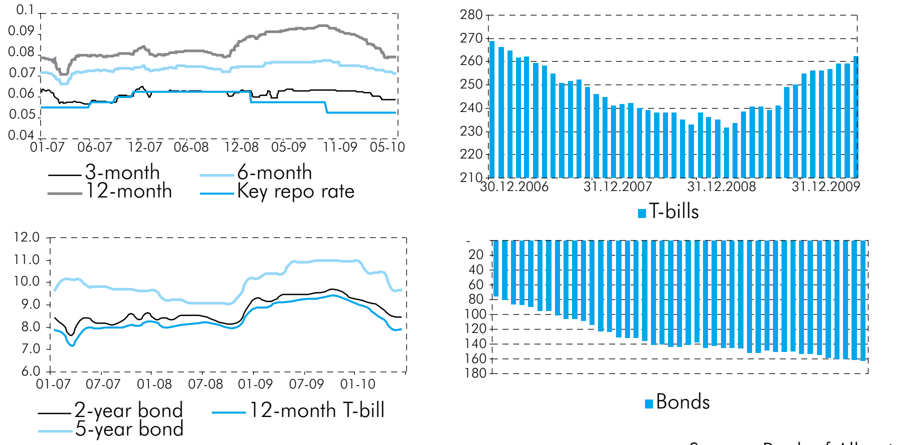
V.1.1 PRIMARY MARKET

The lowering of Government security yields for all maturities in the primary market persisted in the second quarter. The lower risk premia, the stable liquidity situation in the banking system and the lower Government demand for T-bills gave rise to lower T-bill premiums. Requests to participate in the primary market auctions were generally higher than the amounts issued hence increasing competition and exerting downward pressures on the yields.

As at end of June, 12-month yield was 7.91%, down 0.63 p.p. from March and 1.23 p.p. from the year-end 2009. It seems that 12-month T-bills as at end of the second quarter of 2010 stabilized at the pre-crisis period levels, although the key interest rate and short-term interest rates in the interbank market have dropped during this period.

Concurrent with the 12-month yield performance, 2-year and 5-year bond yields declined as well. As at end of the second quarter, 2-year bond yield dropped by 0.65 p.p. to 8.45%; 5-year bond yield dropped by 0.76 p.p. to 9.68%. Requests to participate in the bond auctions were higher than

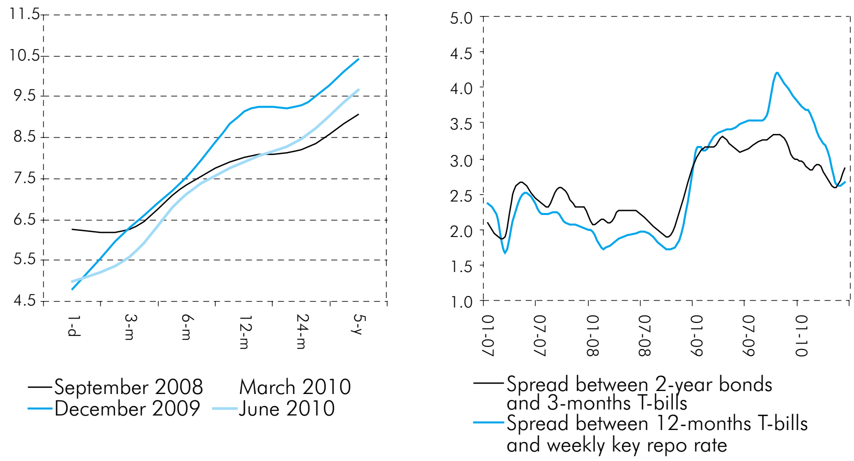
Chart 63 T-bill and bond yields (left-hand) amd T-bill and bond portfolio level (right-hand), in billions of ALL



Source: Bank of Albania

Government demand for funds, despite the latter's increase. This behaviour has given rise to lower long-term margins asked on 12-month T-bill yields, thus reflecting higher participants' confidence.

Chart 64 Interest rate slope and maturity spread



Source: Bank of Albania

The faster decline of medium and long-term yields compared to short-term ones has also reduced the slope of the yield curve as compared to the previous year. While the low curve point was oriented by the monetary policy signals, its high points reflected higher risk premium in 2009, giving also rise to a pronounced increase in the maturity spreads. The lowering of medium and long-term yields in the primary market is also a positive signal for the borrowing cost of economic agents by serving as a reference for setting interest rates on loans in the private sector.

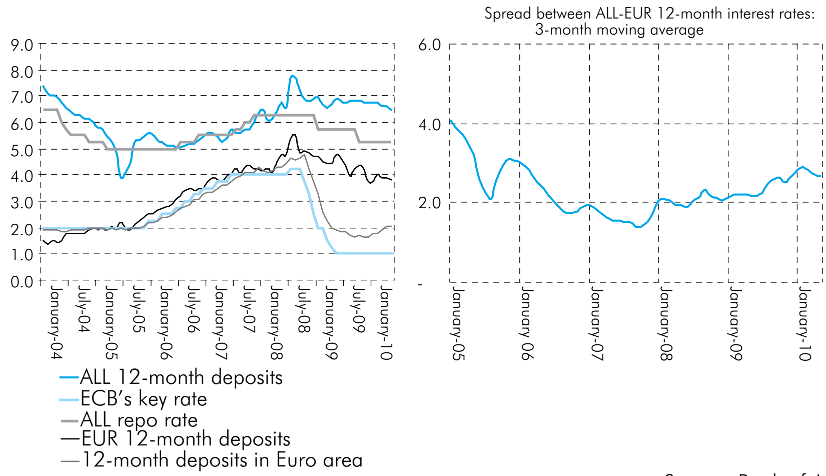
V.2 INTEREST RATES ON NEW DEPOSITS

The banking system has since January experienced slight and successive decreases of interest rates on deposits denominated in the two main currencies. Despite several promotional offers, mostly applied on short-term deposits, weighted average interest rates on ALL and EUR deposits maintained a downward trend. Yet, in marginal terms, they remain relatively high compared to the key interest rate as a result of the high competition among banks to maintain their market share.

In April and May, the weighted average interest rate on ALL deposits was 5.14% or 0.23 p.p. below the first quarter's average. This owes not only to the termination of the year-end promotional offers (which extended until February) but also to the stable liquidity figures in the system and the lower risk premia. Preliminary data show that the decrease in the deposit interest rates persisted in June, in line with their normal behaviour in response to monetary policy signals[60]. Regarding maturity, interest rates dropped in all maturity terms. Interest rate on 3-month deposits dropped by 0.15 p.p., while 6 and 12-month deposits dropped by 0.12 and 0.18 p.p. Relative to the same period in 2009, average interest rate on deposits in April and May was only 0.15 p.p. lower (the key interest rate has been cut by 0.50 p.p. during this period).

Interest rates on EUR time deposits pursued a downward trend in April and May. They were generally lower for all maturity terms, with 3, 6 and 24-month interest rates being affected the most. The high level of competition across

Chart 65 Interest rate on 12-month deposits and key rates (in Albania and Euro area)



Source: Bank of Albania

60 *Interest rates on ALL deposits have by and large responded to the change in the key interest rate. The cut of the key interest rate by 1.00 p.p. in 2009 was not followed by an immediate decrease of interest rates on ALL deposits due to banks' policies to continue withdrawing liquidity from the public.*

those banks that use the interest rates on EUR deposits as cost of funds caused the other banks to continue to maintain high interest rates on EUR deposits compared to the European market. Weighted average interest rate on new EUR deposits was 2.28% in April and May, down 0.11 p.p. from the first quarter's average.

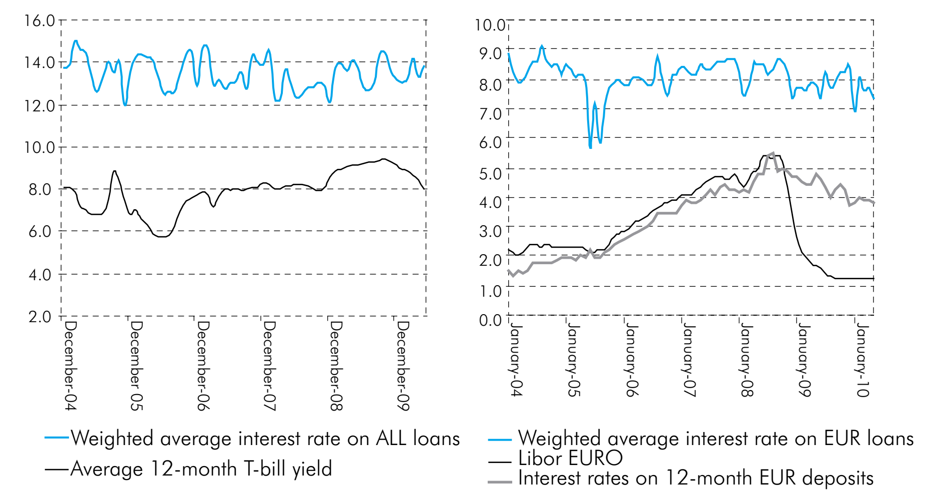
The interest rate spread between ALL and EUR deposits pursued a downward trend during this period. This performance owes to the faster decrease of interest rates on ALL deposits relative to the moderate decline in EUR interest rates.

V.2.1 INTEREST RATES ON NEW LOANS

The first five months of 2010 featured high volatility of average interest rates on ALL loans. This owes basically to the diversification in promotional offers and the preferential terms that some banks applied on particular bank customers for both main currencies. On the other hand, the strict monitoring and the exchange rate risk kept the margins on EUR long-term loans high.

Interest rates on ALL loans shifted direction twice in April and May. In April, they dropped by 0.81 p.p. (versus the previous quarter) to 13.32%. Later in May, they rose again to 13.81%. These changes were generally affected by the promotional offers of some individual banks related to overdrafts and business investment loans. Weighted average interest rate on new ALL loans was 0.08 p.p. higher than in the first quarter of 2010 while the 12-month T-bill yield used as a reference dropped by 0.65 p.p. during this period. Banks continued to favour lending in Lek for household loans for housing purposes.

Chart 66 Interest rate on new ALL and EUR loans



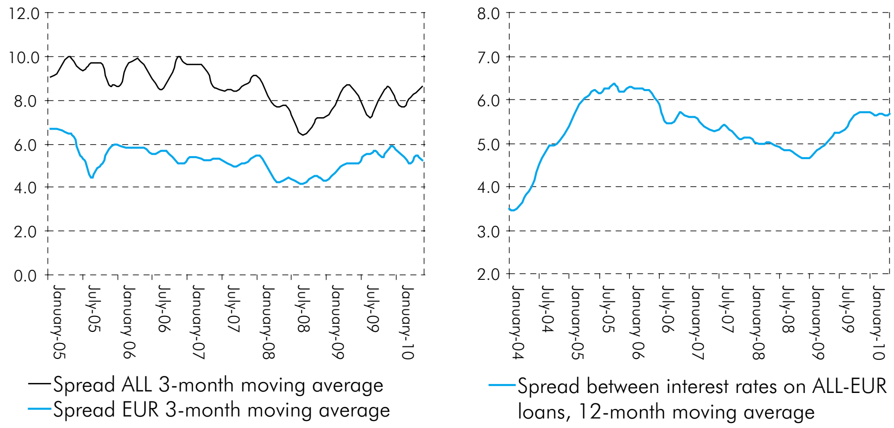
Source: Bank of Albania

Interest rates on EUR loans pursued a downward tendency starting from February. In April and May, they averaged 7.52%, similar to the first quarter

quarter's average. Interest rates on EUR loans performed alike in terms of maturity as well, with short-term EUR loans (for business working capital purposes) being affected the most. Banks remain reluctant to extending new EUR loans of over 5-year maturity term (real estate and investment purposes). Interest rates on this type of loans increased by 1.00 p.p. in the last two months compared to the first quarter.

Intermediation cost in Lek increased in April and May as a reflection of the divergent move between deposits and loans. In April and May it increased to 8.43 p.p. versus 8.11 p.p. in the first half of 2010. Average intermediation rate for the Euro averaged 5.24 p.p. in April and May, up 0.12 p.p. from the first quarter. The spread between interest rates on ALL and EUR loans was highly volatile. In April, it declined by 0.89 p.p. to later increase in May by 0.85 p.p.

Chart 67 Average intermediation rate for ALL and EUR (left-hand) and spread between average interest rate on ALL and EUR loans (right-hand)



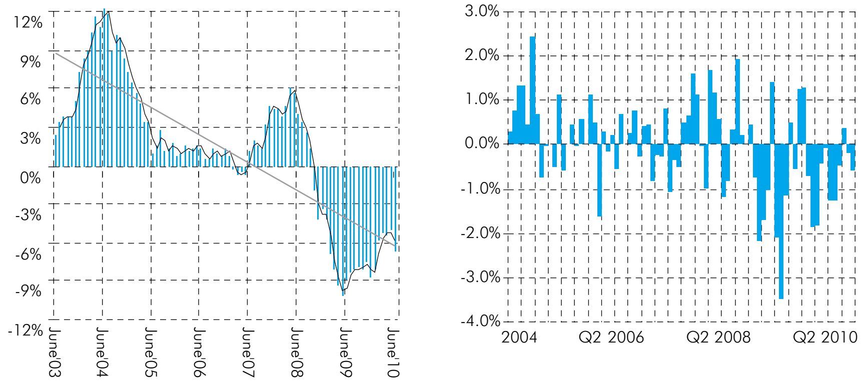
Source: Bank of Albania

V.3 EXCHANGE RATE

Nominal effective exchange rate featured moderate downward rates in the second quarter of 2010. The fluctuation interval of NEER changes, both in annual and monthly terms, narrowed in the second quarter. In addition, their downward rates curbed further. From the macroeconomic viewpoint, this performance is a reflection of the positive effect of the trade balance[61] and the termination of some negative developments that hit the foreign exchange market in 2009. Worth noting is that these effects were of psychological nature following the withdrawal of deposits from the banking system at year-end 2008 and the shaking of public confidence in the national currency, hence affecting the supply and demand in the foreign exchange market.

61 In the first five months of 2010, the import of goods increased by only 1.7% y-o-y, while the export of goods increased by 62.0%.

Chart 68 ALL annual (left-hand) and monthly (right-hand) changes in nominal effective terms (NEER*)

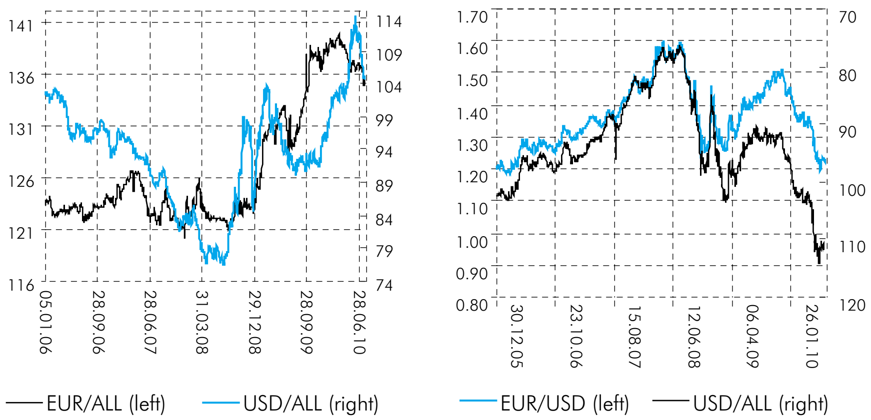


*NEER – Nominal Effective Exchange Rate, measured against two currencies according to an approximate share they have in trade with abroad, EUR (80 per cent) and USD (20 per cent). A positive change of the NEER implies the appreciation of the lek.

Source: Bank of Albania

In terms of individual performance by major currencies, the Albanian Lek depreciated both against the USD (11.9%) and the EUR (4.6%) in the second quarter of 2010 versus the same period in 2009. Q-o-q, the ALL gained ground against the EUR and appreciated by an average of 1.1%. By contrast, the ALL maintained downward rates against the USD and depreciated by an average of 5.5%.

Chart 69 Daily EUR/ALL and USD/ALL (left-hand) and EUR/USD and USD/ALL exchange rate (right-hand)

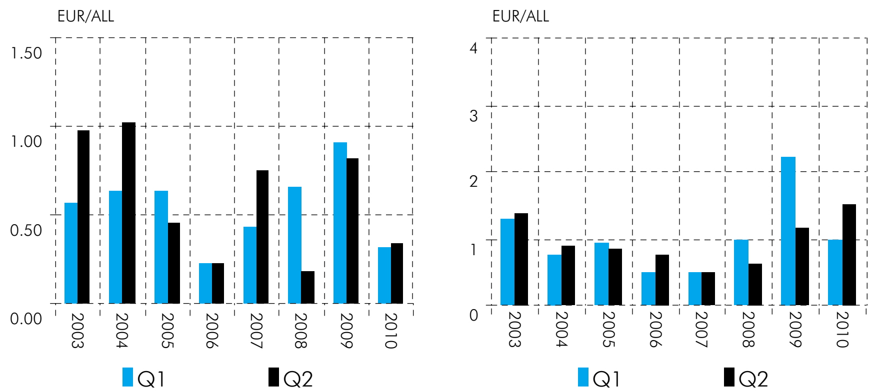


Source: Bank of Albania

After showing stability in the first quarter of 2010, the Albanian Lek gained ground against the EUR in the second quarter as a result of the termination of the seasonal effect. The beginning of seasonal inflows that generally characterize the summer season seems to have contributed to the positive performance of the Lek in June. The moderated supply and demand fluctuations were slightly higher than in the previous quarter but lower than in the first quarter of 2009.

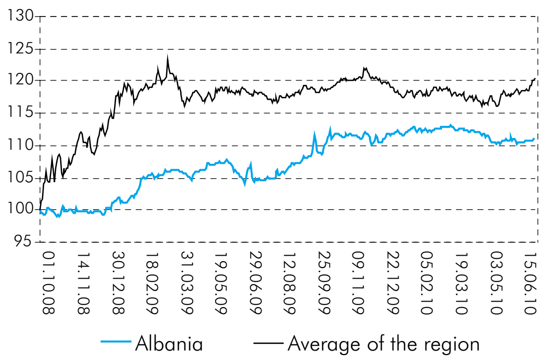
The pronounced depreciation of the ALL versus the USD, as in the formation of the EUR/ALL ratio, reflects the strong position of the USD in the international markets. The higher sovereign risk in some Euro area countries was expressed in pronounced EUR/USD volatility, which affected the Albanian market as well. Volatility was considerably higher in the second quarter of 2010 compared to the previous quarter and the same quarter in 2009.

Chart 70 ALL exchange rate volatility* in Q1 and Q2 during 2003-2010



*Measured as the quarterly average of exchange rate volatility. The latter is measured by the standard deviation indicator.
Source: Bank of Albania

Chart 71 EUR/ALL exchange rate in comparison to region's average*



*The index reference period of this ratio is October 1, 2008. The regional countries include Romania, Serbia and Turkey. These countries apply an exchange rate regime similar to Albania's (free-floating exchange rate regime).
Source: Bank of Albania

In a regional context, the performance of the Albanian Lek against the Euro is positive compared to the other countries' average. Developments in the Euro area's fiscal sector were at the focus of investors' decision-making. The higher public debt and the deteriorated solvency in some European countries hit the short-term expectations of the Euro and curbed the investors' wish to expose to risk. These developments, albeit at different extent, seem to have affected the performance of national currencies in the Balkans against the Euro.

VI. ECONOMIC AND MONETARY OUTLOOK FOR 2010

Macroeconomic developments in the first half of 2010 attested to a slow domestic demand due to limited financial resources and high uncertainty about the future economic outlook. Indirect indicators of domestic aggregate demand evidence that it maintained weak rates in the first half of 2010, being expressed in slow consumption and lower private and public investments. The curbed financial resources in private consumption and investments, due to the more conservative lending policies and the decline in foreign financing, gave rise to contracted consumption and investments. Additionally, the lack of funds was coupled with individual and business' reluctance to make long-term investments against a background of high uncertainty about the near-term economic outlook. On the other hand, net exports have improved and fiscal policy remains stimulating. Economic growth in Albania, albeit positive, is markedly lower than its potential. The latter is also evidenced by the low capacity utilization rates in businesses, which are quite reluctant to engage in long-term undertakings. The first half of 2010 provides evidence that the crisis of confidence in the financial institutions is now over and the channelling of savings into the banking system has increased substantially, hence contributing to strengthening the banking system's soundness and safeguarding financial stability in Albania. The improved liquidity figures and the further consolidation of financial and macroeconomic stability create the conditions for the recovery of private sector lending in the rest of 2010, which will in turn gradually improve consumption and investments.

The gradual recovery of global economy has provided a positive contribution to the external sector of the economy. In response to the higher foreign demand – being favoured by the exchange rate –, exports grew higher than imports. As a result, the negative contribution of net exports to the formation of the GDP was lower. The slow domestic demand, coupled with the depreciating exchange rate, seems to have aided the correction of foreign balance. The optimistic forecasts regarding the performance of global economy for the remaining of 2010 will help further correct the current account. Once the trade balance narrows, the external sector pressures will reduce. The expected positive performance of the balance of payments is expected to underpin a more stable exchange rate in the second half of 2010.

The decline in remittances, one of the key foreign financial resources, coupled with low foreign direct investments at home, calls for efficient measures to attract foreign capital. Gaining competitive economic advantages for the absorption of foreign direct investments represents a stable source of foreign financing. The comparative analysis of regional countries provides evidence that Albania is one of the countries absorbing the lowest foreign direct investments in economy, accounting for less than 10% of GDP.

On the other hand, the public sector is expected to feature a more cautious stance in the remaining of 2010 as far as Government spending is concerned. This will in turn lead to lower public investments and reduced fiscal stimulus in economy. The performance of the interest rate curve shows that economic agents have reduced their investment risk, which nonetheless is higher than the pre-crisis level. This behaviour is believed to have also reflected the latest Government decision for bringing down the budget deficit and the needs for its financing. The performance of financial and monetary markets is expected to be affected by the Government demand for money in the domestic market. The prudent public debt management will have an effect on the performance of the interest rate curve, hence preventing additional pressures on the financial markets. Further fiscal consolidation, as projected, will exert less pressure on the formation of prices in the financial markets and will provide more room to orienting the financial funds towards the private sector. In this regard, finding new alternative resources to finance fiscal activity in the international market plays a key role. It will in turn also contribute to increasing financial intermediation in the private sector.

Close-to-target inflation provides evidence for the lack of inflationary pressures in economy in the short run. However, inflationary pressures will be largely affected by the velocity of the recovery of economic activity close to its potential. The recovery is not expected to be quick and the inflationary pressures will continue to feature slow aggregate demand and under-potential economic growth, against a background of free capital capacity utilization. For the remaining part of the year, inflation is forecast to fluctuate close to the Bank of Albania's target.

The performance of monetary indicators in January to May attested to positive developments in banking system deposits. Meanwhile, lending continued to record moderate growth rates. Money supply has shifted to long-term assets. Time and foreign currency structure of money supply is not expected to undergo significant changes, hence maintaining the current ratios. Money creation in economy has been generally underpinned by the upward contribution of the foreign currency component of money supply. The channelling of funds towards the private sector is expected to provide greater contribution of private sector lending to money growth in economy for the remaining part of 2010. In the meantime, business and household demand for loans grew slightly in the first half of 2010 and the recovery of economic activity is expected to affect the loan portfolio performance positively. Current monetary developments attest to improved financial intermediation for the private sector. Lending is expected to show stable growth rates in both national and foreign currency lending. Considering the latest and expected developments in the fiscal sector, balance of payments and monetary and financial performance, the growth of broad money in economy is expected to be moderate. Its annual rate is anticipated to be about 9.2 - 11.6% in the second half of 2010, in line with Bank of Albania's price stability target in the medium run.