

B a n k o f A l b a n i a

MONETARY POLICY
STATEMENT FOR THE THIRD
QUARTER OF 2009

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C O N T E N T S

Monetary Policy Statement for the Third Quarter of 2009

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MONETARY POLICY STATEMENT FOR THE THIRD QUARTER OF 2009

I. GOVERNOR'S SPEECH

The third quarter of 2009 witnessed positive signs in the Albanian economy and financial markets. It particularly marked a turning point in terms of restoring confidence in the Albanian banking system. The stable liquidity situation, the preservation of financial stability and the banking system's capitalization parameters constitute a solid platform for restoring its intermediation and financial role in economy. In tandem with the latest positive tendencies of the global economy, which still remain frail in terms of their nature and permanence, these developments prompt us to consider the future Albanian economic activity under the optics of a prudent optimism.

Over the course of the year 2009, the Albanian economy has been affected by the global economic and financial crisis primarily through the decline of foreign demand and remittances, higher risk premiums and reduced and high-cost financial support. However, our economy continued to record positive economic growth rates during this period, while the domestic inflationary pressures remain contained. Economic activity at home has been sustained by the fiscal stimulus and the preservation of relatively high consumer demand rates. In the meantime, investments and export demand have recorded lower growth rates in the first nine-month period.

At a global level, the second quarter of 2009 and the following period witnessed stable economic activity. Although the world economy continued to contract in annual terms, the consumed stock cycle replacement set a floor on the downturn of Euro area and US economies. Moreover, this cycle served as a short-term catalyser for the reactivation of their industry and production sectors. In a longer-term perspective, the stable economic activity of the Asian countries -China in particular-, and the global trade growth will fuel the global economic growth. However, the world economy path to a sound and stable growth is a long one. The existing model of global economy has relied on the high consumption and the severe debt situation of the USA, against an Asian countries' strategy that favours exports and savings. Coupled with below potential economic growth and downward inflationary pressures for a relatively long period of time, the addressing of these imbalances at a global level requires time.

The global financial system, the capital markets, the banking sector and other financial intermediaries seem to be recovering. The monetary and fiscal stimulus has provided its effect at a global level, helping first the recapitalization of the financial system and restoring the lending system. Despite the high risk

perception and low risk readiness across the financial agents, the resumption of global financial flows will provide assistance to emerging countries through higher available funds.

Amidst the global development challenges, the Albanian economy recorded positive economic growth during the first half of 2009. According to preliminary data reported by the INSTAT, the GDP grew at an annual rate of 5.3 percent in the second quarter, maintaining similar growth rates as in the preceding quarter. Activity in services provided the main contribution to the GDP growth. The production sector provided additional contribution to the annual GDP growth, mainly owing to the performance of the construction sector. By contrast, industry deepened the downward growth rates that began in early 2009.

The economic growth tendency, albeit at lower magnitude, is also present in several indirect indicators of the economy, namely the higher budget revenues, higher lending to the economy and more stable labour market indicators. However, these indicators, particularly monetary and business and consumer confidence indicators, reflect slower economic growth rates relative to the previous year.

In a macroeconomic context, the slowdown is mostly a reflection of the fall in investment and foreign demand, while consumption and public expenditure have led to higher economic activity.

The economic performance of the first half of 2009, albeit positive, attests to a slowdown of about 1.4 percentage points compared with the same period in 2008. In addition to the general slackening of global inflationary pressures, this situation has been translated into the gradual reduction of inflationary pressures on the Albanian economy. Average inflation marked 2.0 percent in January to September 2009, fully reflecting the termination of the first round effects generated from the rise in raw material prices during 2007-2008 and the cessation of effects arising from the latest administrative rise in the energy price. The downward trend of core and non-tradable goods' and services' inflation attest to the fact that the inflationary pressures generated from the domestic demand-side are subsiding. On the other hand, the relatively strong depreciating movements of the domestic currency, the ALL, during 2009 have pushed the tradable goods' inflation higher to about 3.1 percent in the third quarter. Developments in the labour market and wages do not signal higher future inflationary pressures on the supply-side. Unemployment rate was 12.7 percent in the first half of 2009, similar to the year-end 2008 level. For the same periods, the growth rates of average real wage in economy have been more contained.

The Bank of Albania forecasts and the anchoring of economic agents' expectations for consumer prices support the preservation and firming up of consumer price stability in the medium run, expressed in low and stable inflation rates.

Current account deficit narrowed slightly by 1 percentage point y-o-y in the second quarter of 2009, reflecting slower imports and exports in the Albanian economy. In the meantime, workers' remittances have reduced at relatively lower rates than in the preceding quarters. However, the current account deficit remains high, reflecting the high levels of consumption in the Albanian economy and the unfeasibility of the production capacities at home to meet it. Privatization receipts and the public sector's foreign currency borrowing led to a positive balance of payments; however, its future stability should rely on longer-term factors.

The government ran an expansionary fiscal policy in the first eight months of 2009. In annual terms, budget expenditure increased by 23 percent, reflecting primarily the rapid increase of capital expenditure. Budget revenues maintained a slower rate than expenditure due to the slower economic growth rate during this period. Consequently, the additional budget expenditure was financed through the use of privatization receipts and the higher public borrowing. This policy has exerted pressure over the increase of Government debt securities' interest rates of long maturity term.

The influence of fiscal policy on the domestic monetary markets was more moderate during this period since the public debt was to a large extent borrowed from the international capital markets. However, the future persistence of this policy will face less funding potentials of both the Albanian and the international market. This fact calls for the quick return to the consolidating trajectory that the fiscal policy pursued in the pre-crisis years.

The monetary indicators of the third quarter of 2009 attested to the slow money growth tendency. Money supply, M3, recorded an annual growth of 4.5 percent in August vis-à-vis the average growth rate of about 7 percent in the first half of 2009, owing mainly to the lower credit flows to the private sector. Deposits grew substantially in August – about ALL 25.4 billion in monthly terms – in line with their seasonal performance during this period of the year. As at end of period, about 70 percent of the total deposits' stock growth was time deposits, hence signalling the higher confidence in the banking system.

Private sector credit maintained its slower growth rates in July and August 2009, reflecting both the tightening of credit supply and the contraction of credit demand. Coupled with the reduced use of capacities as reported by businesses in the Bank of Albania survey, this performance signals that the private sector's investments in economy are downward. Banks continue to apply tight lending standards, while consumer demand and private sector investments have fallen.

In nominal terms, private sector credit grew by an annual average of 16 percent in June to August, markedly lower than the first five months' average (29 percent). Despite the low growth rates, business credit provided the main contribution to the private sector credit growth, accounting for about 65 percent. The downward trend of credit attributes to the deceleration of foreign currency lending, whose growth rate was zero in August. In the meantime, ALL lending

continued to maintain its average growth rate of 30 percent throughout the year 2009. As a result, the share of foreign currency credit in the private sector's loan portfolio dropped to 67 percent. The understanding of the consequences of exchange rate movements and the greater tightening of lending for loans denominated in a currency other than that of the borrower's income caused the individuals to borrow less foreign currency credit than businesses.

The financial markets attested to an improved liquidity situation and the recovery of the agents' confidence in these markets. The persistent Bank of Albania's liquidity supply to the money market helped to calm the market participants down and to supply the market with funds, which served to the private sector's domestic currency intermediation. The liquidity needs in the interbank market have been declining, hence exerting no pressure over the short-term interest rates. By contrast, the Government securities' primary market experienced a reverse situation, with the T-bill yields of long-term maturity going up despite the ample liquidity. In September's last auction, the 12-month yield was 9.40 percent, up by 0.64 percentage points from the year-end 2008.

The high risk premium on long maturity terms and the existence of a shallow financial market were the rationale behind the high Government securities' long-term yields. On the other hand, the high yields attracted the individuals' investment in this market, hence providing them with an alternative instrument to keep their savings and at the same time, increasing the share of budget deficit financing from this item. The individuals' deposits held in the banking system have had a satisfactory return. Weighted average interest rate on ALL deposits marked 5.94 percent in August or up by 0.48 percentage points from the end of the second quarter. This increase led to lower intermediation cost for the ALL during the recent months. Interest rates on new ALL loans declined to an average of 12.86 percent in July and August, down by 0.79 percentage points from the average rate of the first half of 2009. The banking system's inclination to relieve the cost of ALL loans is attested by the narrowing of its margin and the corresponding reference rate, the T-bills. The spread declined to an average of 3.6 percentage points in summer, from 4.8 percentage points in early 2009.

The long-term development perspective of the Albanian economy is positive. Macroeconomic stability and confidence in the Albanian financial system are the product of our responsible macroeconomic and financial policies undertaken continuously over the course of the recent years. Macro financial stability is a solid foundation for boosting the country's development in the future.

This development will to a large extent depend on the capacity of the Albanian economy to attract funds, which will buttress its growth. The monetary conditions are relaxed in line with the dynamics of economic and financial developments in Albania, in our main trading partners and broader in the global economy. This decision represents a new incentive for the economic developments at home, aiming at reducing the financing cost of the economy further.

The performance of lending to economy will be of prime importance in the medium run. The Bank of Albania considers that the stabilization of the banking system's liquidity and balance sheet indicators will pave the way for the lending process. In this context, the Bank of Albania has been engaged in an active role in terms of stimulating demand and supply with funds. The relaxation of monetary conditions will fuel the growth of business and consumer demand for funds, while the Bank of Albania's injection of liquidity will assist the banking system in meeting the demand for funds in quantitative terms. The Albanian banking system should understand its role rightly and transmit the relaxation of monetary policy in economy completely and rapidly. On the other hand, a lower pressure of the fiscal sector over the domestic financial markets will in the future lower the risk premium in economy, will create more room for private sector lending and will facilitate the smoothing out of the interest rate curb in favour of lowering the cost of credit further. The efficiency of the monetary policy decision will depend on the market and its participants' behaviour, wherein fiscal policy plays a key role.

In the long run, the attraction of foreign direct investments and other forms of stable capital inflows should be at the core of our development policies. These funds will not only improve the external position in terms of its stability, but also sustain the country's long-term growth. Time is ripe for all the actors to carefully analyze the country's economic growth model in the decade we are approaching. The future economic growth model should in particular consider the competitive advantages of the Albanian economy more, mitigating its reliance on short-term capital inflows and expanding the economic basis, which generates stable and long-term capital flows. In this context, the Bank of Albania remains committed to playing a key role in the periods to follow.

In compliance with our legal and institutional commitment, the Bank of Albania's monetary policy will aim at creating the proper conditions for a balanced development, characterized by low consumer price inflation environment, moderate fluctuations of monetary indicators and sound macroeconomic agents' balance sheets.

II. DEVELOPMENTS IN THE WORLD ECONOMY

The most recent data show that the global economic conditions improved during the first nine months of 2009. This assessment is underpinned by the pronounced deceleration of economic contraction in the largest advanced and emerging economies. Despite the more positive recent developments, economic growth is forecast to be relatively slow and reach positive figures in 2010. The economic downturn pushed the unemployment rates up to peak levels in some of the main economies. The inflationary pressures have been low, in many cases resulting in negative annual inflation rates owing also to the high comparative basis.

Table 1 Some main macroeconomic indicators

Country	GDP change (in %)		Unemployment rate (in %)	Inflation (in %)	
	Q2 2009/ Q2 2008	Q2 2009/ Q1 2009	August 2009	September 2009/ August 2009	September 2009/ September 2008
USA	-3.8	-0.7	9.8 ¹	0.2	-1.3
Euro Area	-4.8	-0.2	9.6	0.0	-0.3
Germany	-5.9	0.3	7.7	-0.5	-0.5
Greece	-0.3	0.2	9.6 ²	1.9	0.7
Italy	-6.0	-0.5	7.4 ³	0.6	0.3
Japan	-7.2	0.6	5.5 ⁴	-0.3 ⁴	-2.2 ⁴

Source: Eurostat, Respective Statistical Institutes

¹ Data for September. ² Data for July.

³ Data for the second quarter of 2009. ⁴ Data for August.

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

After two quarters of rapid contraction, the economic activity in the Euro area decelerated its downward rates by only -0.2 percent in the second quarter of 2009 vis-à-vis the previous quarter. The Euro area GDP contracted 4.8 percent in annual terms, comparable to the first quarter's figure. The deceleration of economic activity downturn has been pushed by the positive contribution of commercial activity, where exports have declined less than imports. The slight increase of consumer spending curbed the downward trend of domestic demand, which fell slightly. The latter, coupled with the contraction of investments and industrial production, curbed the positive effect of commercial activity growth. Unemployment rate maintained its upward rates, which began in the second quarter of 2008, and reached 9.6 percent in August 2009, the peak rate of the last decade. The upward unemployment trend, which continues to hit demand, has been associated with the gradual decrease of annual inflation, which marked -0.2 and -0.3 percent in August and September.

The first signs of recovery have emerged in the macroeconomic situation in the USA, although it still remains weak. The US economy shrank at a 0.7 percent pace in quarterly terms in the second quarter of 2009, considerably lower than in the previous quarters. The poor performance of aggregate investments, consumer spending and exports are the main rationale behind this trend. Some economic developments in the third quarter of 2009 suggest for the further improvement of the economy. Industrial production, exports and consumer spending manifested an upward tendency in July and August. The labour market remains weak. Unemployment rate marked 9.8 percent in August, while the annual inflation marked -1.3 percent in September.

The BRIC¹ countries showed signs of recovery in their economic activity. In annual terms, the economies of India and China grew by 6.7 and 8.1 percent, respectively, in the second quarter of 2009, higher than in the previous quarter. In the meantime, the economies of Brazil and Russia experienced a decline in annual terms. In contrast to the economic contraction of Brazil, which has been moderating, the Russian economy has recorded continuous decline to

its lowest level. However, the data for July and August show signs of recovery in Russia's economic activity. The inflationary pressures have been subsiding in Russia and China. In Brazil and India, the slight rise of raw material prices during the recent months has been translated into added inflationary pressures over these economies. In their respective meetings in September, the central banks of China and Russia cut the key interest rates, while the central banks of Brazil and India left them unchanged.

The regional countries' macroeconomic situation deteriorated further in the second quarter of 2009. Their economies declined at more accelerated rates compared with the first quarter of 2009. According to the latest data on the performance of the main macroeconomic indicators, the same trend is expected to persist in the third quarter. In the meantime, the inflationary pressures have subsided in the majority of these countries.

The Italian economic activity continued to decline for the fifth consecutive quarter in the second quarter of 2009. The GDP contracted 6 percent in annual terms, with the fall of aggregate investment and exports² providing the main contribution. The latest data on the economic performance for the third quarter of 2009 attest to a slight improvement of the economy. For the first time since April 2008, industrial production grew about 7 percent in August, in monthly terms. However, exports maintained their downward trend in annual terms, about 25 percent. Unemployment rate marked 7.4 percent and annual inflation 0.3 percent.

Until the first quarter of 2009, the Greek economy was the least affected by the financial crisis that swept the other European Union countries. However, the Greek economy recorded the first contraction in the second quarter of 2009 owing to the accelerated fall of domestic investments and exports. The latest data on the economic performance for the third quarter of 2009 attest to the deepening of economic downturn. Construction industry and retail sales recorded further annual decline in July³. In August, industrial production and exports fell by 8.8 and 29.6 percent, respectively, in annual terms. Unemployment rate marked 9.6 percent in July. In August, annual inflation marked 0.7 percent.

The Turkish economic activity contracted -7 percent in the second quarter of 2009, following the contraction by -14.3 percent in the first quarter the present year. The improved foreign demand did not manage to recover the accelerated fall of domestic demand. Despite the improvements in investments, industrial production and consumer spending, they remained at negative figures. The improved confidence indices signal a turning point in the economic conditions in the country for the periods to follow. Inflation maintained its downward trend in September and marked 5.3 percent. In September 2008, it marked 10.4 percent.

According to the IMF assessments, Kosovo's economy grew 5.4 percent in 2008. The forecasts for 2009 show that it will shrink to 3.8 percent to later pick up again in 2010. The growth will be sustained by consumer spending

and investments. Annual inflation continued to record negative rates to -2.7 percent in September 2009. The rationale behind this figure is the fall of food and transportation prices.

Table 2 Economic indicators for the regional economies

Country	GDP change Q2 2009	Annual inflation September 2009	Unemployment rate August 2009
Italy	-6.0	0.3	7.4 ¹
Greece	-0.3	0.7	9.6 ²
Macedonia	-1.4	-1.4	31.9 ¹
Serbia	-4.0	9.5	15.5
Croatia	-6.3	1.0	14.2
Turkey	-7.0	5.3	12.8 ²
Kosovo	:	-2.7	:
Albania	5.3	2.0	12.7 ³

Source: Respective Statistical Institutes, EuroStat, EcoFin, IMF

¹ Data for the second quarter of 2009.

² Data for July. ³ Data for the first quarter of 2009.

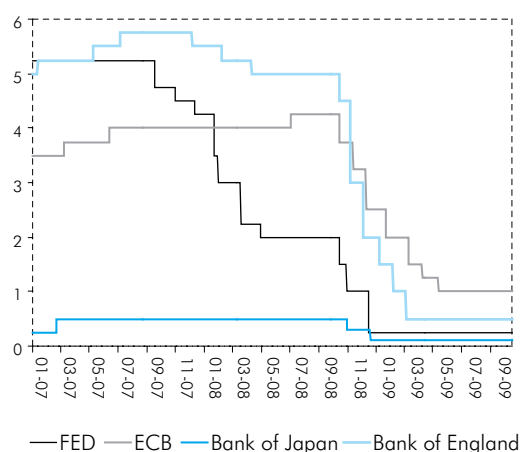
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Former Yugoslav Republic of Macedonia's economy contracted 1.4 percent in the second quarter of 2009 vis-à-vis the same period the previous year, hence deepening the decline shown in the first quarter the present year. Investments and industrial production recorded substantial fall, while imports and consumer and public spending recorded a more moderate decline. Inflation marked -1.4 percent in September 2009 due to the fall in food and transportation prices, while the energy price rose.

II.2 MONETARY POLICY, FINANCIAL MARKETS AND EXCHANGE RATE

The European Central Bank (ECB) cut the key interest rate four times in the first nine months of 2009 to 1 percent from 2.5 percent in January the present year. The key interest rate remained unchanged in the third quarter. The ECB considers that the current rate is adequate since inflation is moving towards the target and economic activity is showing positive performance. The US Federal Open Market Committee kept the key interest rate unchanged in the first nine months of 2009 at 0.0.25 percent. The key interest rate was last changed in December 2008. The Bank of England changed the key interest rate three times in the first nine months of 2009 reducing it to 0.5 percent from 2 percent in the early year. The last key interest rate cut was made in March 2009. The Bank of Japan kept its benchmark interest rate unchanged at 0.1 percent throughout the year 2009. The last benchmark interest rate change was made in December 2008.

Chart 1 Key interest rate performance



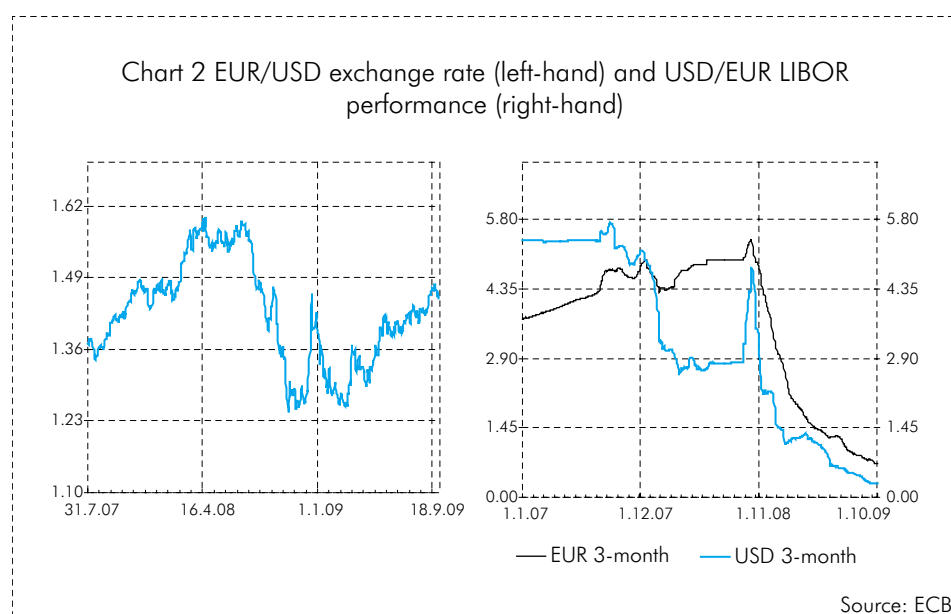
Source: ECB, FED, Bank of England, Bank of Japan

The financial markets attested to downward interest rates trend and improved confidence indices. Stock markets have also experienced a better performance. Starting from April 2009, the stock prices have risen for most items and volatility in this market has been more moderate. The improved economic and financial indicators have recovered the markets and fuelled the exchange activity, although the risk premiums show a cautious behaviour for long-term maturities⁴.

LIBOR and EURIBOR interest rates in the money market maintained their downward trend during the third quarter of 2009, transmitting the flattening of liquidity pressures and the decrease of risk premiums. In early October, EURIBOR interest rates of 1, 3 and 12-month maturity term were 0.43, 0.74 and 1.23 percent, respectively, down by 31, 34 and 27 basis points vis-à-vis the early July. LIBOR interest rate of 3-month maturity term dropped by 30 basis points from June 2009.

Bond markets in Europe, Japan and the US attested to a downward performance. The US bond market experienced more pronounced volatilities during this period. Dow Jones, S&P and Nikkei indices were characterized by satisfactory growth and lower volatility in the recent months. The more positive outlook on business economic indicators and the market agents' more optimistic expectations led to higher stock quotes.

As from the end of June, the Euro appreciated against the US dollar, in particular during September. The market agents' assumptions, some of which confirmed by the poorer performance of some US economy sectors led to the depreciation of the US dollar. The Euro has also appreciated against the British pound and other European currencies. In quarterly terms, the Euro appreciated 4.93 percent against the US dollar. In early October 2009, one euro exchanged against the US dollar at 1.46.



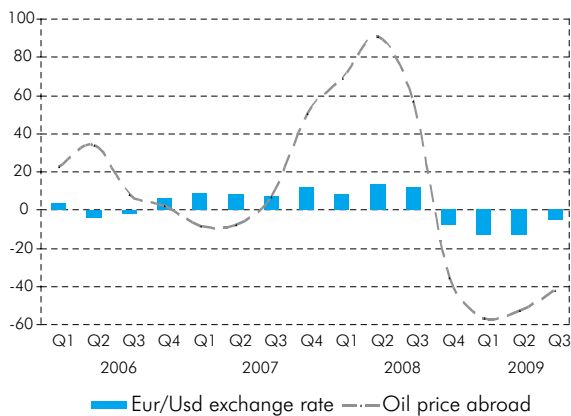
II.3 OIL AND PRIMARY COMMODITY PRICES

Conditions in the international oil market improved in the third quarter of 2009. The combination of the positive performance of global oil demand and supply, and the weak US dollar in the international foreign exchange markets helped to recover the oil market. Average oil price per barrel, albeit lower than the same period the previous year, rose by 16 percent in quarterly terms in the third quarter of 2009. The positive performance of economic activity in emerging countries, the exit of the main advanced economies from the economic crisis and the recovery of manufacturing industry at a global level preceded and fuelled the global demand for oil. The latter, although still below the average level of 2008, grew 1.6 percent in quarterly terms in the third quarter of 2009. Given the favourable economic conditions,

oil producing and exporting countries decided to increase the amount of oil produced in the second quarter. Global supply grew 0.7 percent in quarterly terms, with the OPEC countries, Russia and some of former Soviet Republics providing the main contribution.

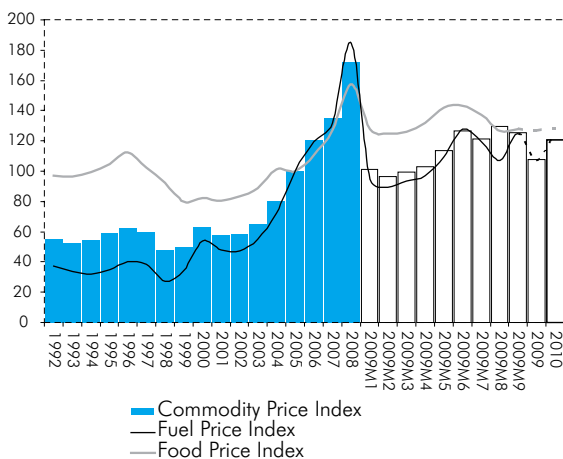
Commodity Price Index increased 9.6 percent in quarterly terms in the third quarter of 2009. In annual terms, it recorded a severe drop of 36.2 percent. The main rationale behind the latter is the statistical effect of the very high comparative basis. Fuel Price Index maintained a similar tendency and rose 11.9 percent in quarterly terms and fell 43.1 percent in annual terms. Food Price Index attested to a dissimilar performance, dropping in quarterly and annual terms by 3.2 and 18.8 percent, respectively.

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



Source: Eurostat, EIA

Chart 4 Performance of price indices by main commodity groups



Source: IMF

III. PRICE STABILITY AND BANK OF ALBANIA OBJECTIVE

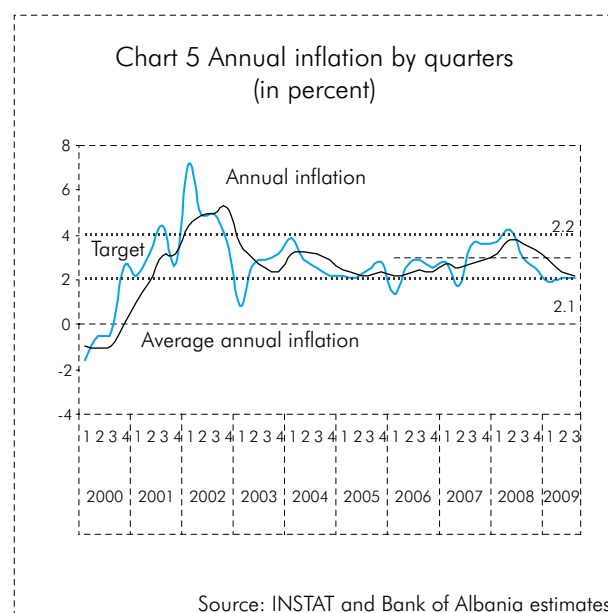
The primary objective of the Bank of Albania is to achieve and maintain price stability. This is the greatest contribution the central bank can provide to boost savings, sustain productive investments and promote a stable economic growth. In accordance with its strategy, the Bank of Albania is committed to achieving and maintaining inflation at 3.0 percent in annual terms, with a symmetrical tolerance band of +/- 1 percentage point. The announcement of the inflation quantitative objective aims at anchoring the economic agents' expectations, reducing the inflation premiums and promoting long-term investments in economy.

Annual inflation marked 2.1 percent in the third quarter of 2009, similar to the previous quarter. Following a pronounced downward trend⁵ until March (1.6 percent), the annual inflation rate stabilized at the lower limit of the 3.0 percent inflation target of the Bank of Albania. Average annual inflation⁶ marked 2.2 percent over this quarter, 0.2 percentage points below its historical average. This figure stands very close to its annual rate, attesting to the complete cessation of the first round effects of the primary commodity (food and oil) and energy price rise over the course of the previous year.

The inflationary pressures over the Albanian economy have been moderate during the last 12 months. In addition to the substantial fall of primary commodity prices in the international market, the disinflation process was also triggered by the weakening of inflationary pressures arising from the domestic demand against a background of global economic recession. Core and non-tradable inflation marked 1.0 and 0.8 percent, respectively, in the third quarter of 2009, attesting to a non-inflationary domestic macroeconomic environment. Starting from early 2009, tradable inflation increased by 1.6 percentage points owing to the exchange rate depreciating trend.

The Bank of Albania pursued a prudent monetary policy, aiming at creating the proper monetary conditions for a stable macroeconomic environment and mitigating the global crisis effects on the Albanian economy. Although the economic developments were affected by the global economic recession via the foreign trade and financial channel, they attest to positive economic activity growth rates in the first half of 2009. However, the slower growth rates of credit and money supply, budget revenues, trade exchanges and other indirect indicators of various economic sectors suggest that the economic activity in the country has slowed down. The latest data on global economy signal stable growth rates and primary commodity prices in the international market. The available data on the Albanian economy show a similar performance, although the figures are below the previous year's. Confidence survey results show that economic activity has weakened, although the indicators improved slightly in the second quarter. The economic agents' expectations remain anchored around the central bank's inflation target.

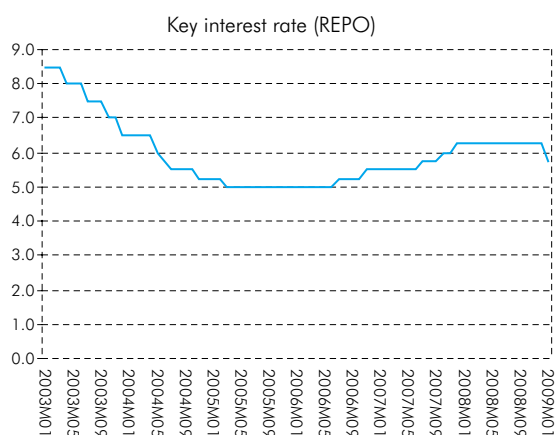
The Bank of Albania has been prudent in applying the monetary stimulus, aiming first and foremost at meeting its primary objective, which is conducive to safeguarding the overall macroeconomic stability.



III.1 MONETARY CONDITIONS

Against a backdrop of weak inflationary pressures and expectations

Chart 6 Key interest rate of the Bank of Albania

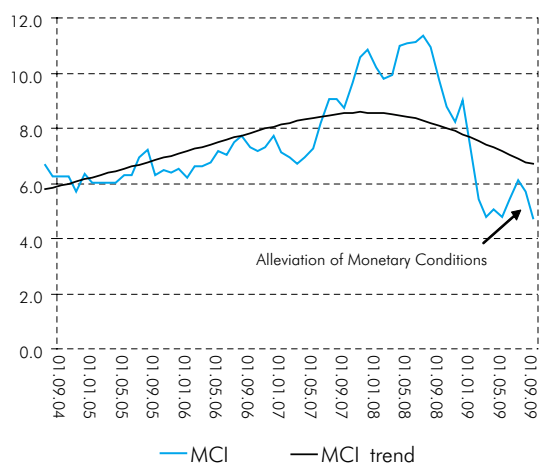


Source: Bank of Albania

anchored around the 3.0 percent target, the Bank of Albania continued to generate stimulating monetary impulses to the economy. In addition to lowering the key interest rate to 5.75 percent in January 2009, it injected ample liquidity. By increasing the amount of injected liquidity, extending the maturity term and expanding the collateral base, better conditions were created for stabilizing the liquidity and interest rates situation in the banking system and meeting the economy's needs for liquid funds.

Monetary policy maintained a neutral stand during this quarter as in the previous one. In spite of this, the Monetary Conditions Index (MCI) has alleviated and fluctuated below its historical tendency.

Chart 7 Monetary Conditions Index



Source: Bank of Albania

During this period, the MCI seems to have been entirely oriented by the performance of the exchange rate, one of the most significant components in small open economies. Reflecting the exchange rate performance, the MCI manifested a slight alleviating tendency in July. However, this tendency abated in August and September as a result of the depreciation of the ALL in the foreign exchange domestic market.

III.2 PRICE PERFORMANCE OF MAIN CPI BASKET ITEMS

Inflation of goods and services by their economic function maintained almost a similar profile during July to September 2009. The third quarter of 2009 attested to the higher inflation rate of foodstuffs, particularly of vegetables and fruit. Annual headline inflation was almost entirely formed by the contribution of "unprocessed foods", while the negative contribution of "administered prices", "processed foods" and "non-food consumer goods" eased the headline inflation for this period to lower positive rates.

The performance of the inflation rate of "unprocessed foods" is particularly significant in explaining and forecasting the short-term inflation fluctuations. This item's negative contribution to headline inflation over the course of the year 2008 helped to alleviate the strong inflationary pressures that were mainly generated by the supply-side. This item's contribution increased progressively during 2009 peaking in September with 2.4 percentage points. Its inflation marked double-digit rates in the last three months, peaking in August and September when it marked about 13.3 percent. The high monthly inflation (2.8 percent) in the two respective months owed primarily to the depreciation of

the Albanian Lek vis-à-vis the Euro, which led to the price rise of consumer goods mainly imported from the neighbouring countries. Prices of “vegetables” and “fruit” in particular contributed by 67 percent to the formation of the overall inflation figure during this quarter⁷.

Prices of “processed foods” fell during this period manifesting an entirely dissimilar performance from the previous year. This item’s annual inflation marked -0.2 percent while the previous year it stood at 10 percent. The imported share of these products has undergone a period of relaxation as a result of the marked fall of their prices in the global market the previous year. The downward inflation trend seems to have been determined by a gradual “shift” of prices below their level of August 2007 to February 2009 period, owing to the almost complete cessation of the price rise effect of “bread and cereal” sub-item since autumn 2007.

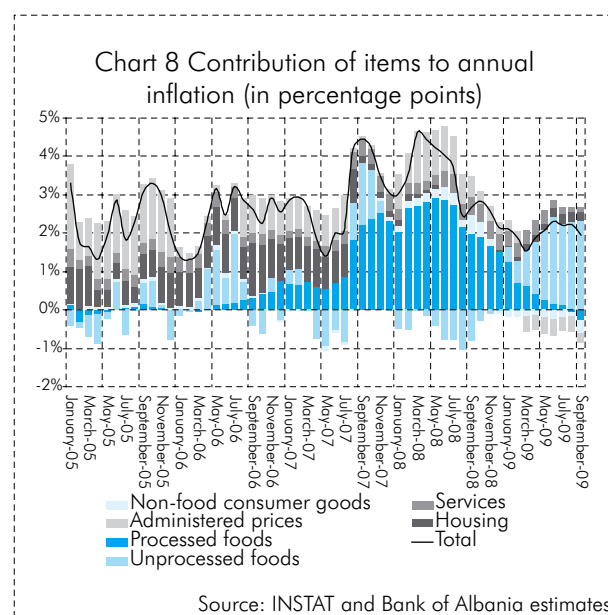


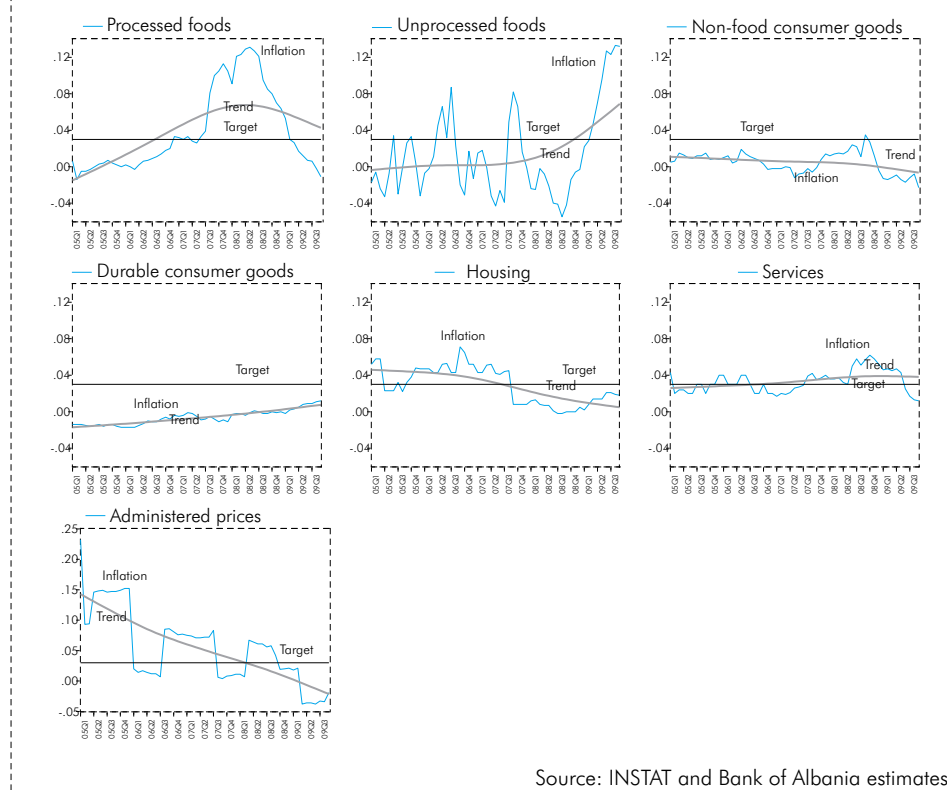
Table 3 Contribution of items to annual inflation (in percentage points)

	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009
Processed foods (pp)	2.9	2.3	1.7	0.9	0.3	-0.1
Bread and cereal (pp)	1.7	1.3	1.0	0.6	0.2	-0.1
Alcohol and tobacco (pp)	0.1	0.0	0.1	0.1	0.1	0.1
Unprocessed foods (pp)	-0.4	-0.9	-0.1	0.6	1.8	2.3
Fruit (pp)	0.3	-0.1	-0.1	0.0	0.3	0.5
Vegetables (pp)	-0.2	-1.3	-0.7	-0.3	1.4	0.9
Services (pp)	0.3	0.5	0.5	0.4	0.3	0.1
Administered prices (pp)	0.7	0.8	0.3	0.1	-0.4	-0.4
Fuels and energy (pp)	0.6	0.6	0.7	0.4	0.0	0.0
Housing (pp)	0.1	0.0	0.0	0.1	0.2	0.2
Non-food consumer goods	0.3	0.3	0.2	-0.2	-0.2	-0.2
Durable consumer goods (pp)	0.0	0.0	0.0	0.0	0.1	0.1
Consumer Price Index (y-o-y, %)	4.2	3.0	2.5	1.9	2.1	2.1

Source: INSTAT and Bank of Albania estimates

The annual inflation rate of “services” dropped for the third consecutive month in September 2009, marking 1.4 percent in the third quarter of the present year compared with 5.5 percent in 2008. The decrease of this item’s inflation rate mainly attributes to the cessation of the public transportation price rise effect in June 2008. In addition, within this item, the price of hotel and restaurant services⁸ fell during this quarter, which also represents a period of high demand for this type of services. The downward trend of prices in this item attests to the more complete satisfaction of the growing demand during the summer season⁹ by the domestic supply.

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



“Administered prices” item, which has historically determined the inflation trend, provided a downward contribution to the annual inflation during the last two quarters. The cessation of the administrative energy price rise in March and the maintenance of the energy price at an unchanged level for the following period, reduced the inflation and this item’s contribution to a figure close to zero. This item’s average annual inflation has marked about -3.5 percent since March the present year. The negative rates owe primarily to the fall of prices in “communication”. The low inflation in other basket items caused this downward effect to be more pronounced on headline inflation during March to September 2009. The contribution of other items underwent minor changes during this quarter. Worth noting is the rise of oil price in monthly terms, which bears the risk of inflationary shocks arising from supply-side factors originating from outside the Albanian economy.

III.3 MAIN INFLATION TRENDS

Annual core inflation¹⁰ marked 1 percent in the third quarter of 2009, deepening the downward trend, which began at year-end 2008, further. In September 2009, core inflation marked 0.7 percent converging to its long-term average¹¹. The period from January to September 2009 attested to lower core inflation rates and fluctuating non-core inflation. The low core inflation

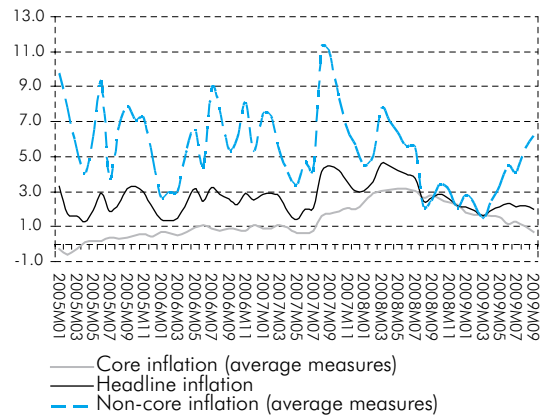
rates owed to the continuous dampening of relatively long-term inflationary pressures on the Albanian economy. In addition, the transitory movements in the consumer prices were more moderate. The rationale behind this behaviour is the contained nature of inflationary pressures at a global level.

Annual tradable and non-tradable inflation of the CPI basket marked 3 and 0.8 percent, respectively, in the third quarter of 2009. Tradable inflation marked 3.1 percent in September, similar as in August. Its relatively high rate was mostly determined by the depreciation of the Albanian Lek vis-à-vis the Euro and the presence of strong fluctuations in the foreign exchange market since the early 2009. In the meantime, the global conjuncture of primary commodity and raw material prices continued to play a favourable role in dampening the inflationary pressures originating from outside the Albanian economy.

Non-tradable inflation maintained its downward trend. In September 2009, it marked 0.4 percent, one of the lowest historical rates since the early 2003. As a result of the combination between the cessation of administrative factors' effects and those generated from the economic activity slowdown, the performance of non-tradable inflation dampened the inflationary pressures over the first nine months substantially.

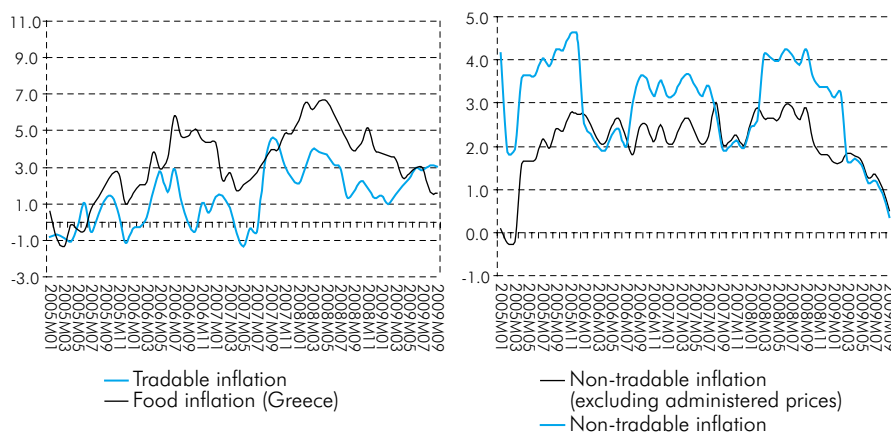
The above analysis attests to a balanced domestic demand in economy, expressed in low core and non-tradable inflation rates. They were important determinants of the headline inflation, which stood at the lower half of the tolerance band (2 percent) in January to September 2009.

Chart 10 Annual headline inflation and average measures of annual core and non-core inflation (in percent)



Source: INSTAT, Bank of Albania and Bank of Albania estimates

Chart 11 Annual tradable and non-tradable inflation



Source: INSTAT and Bank of Albania estimates

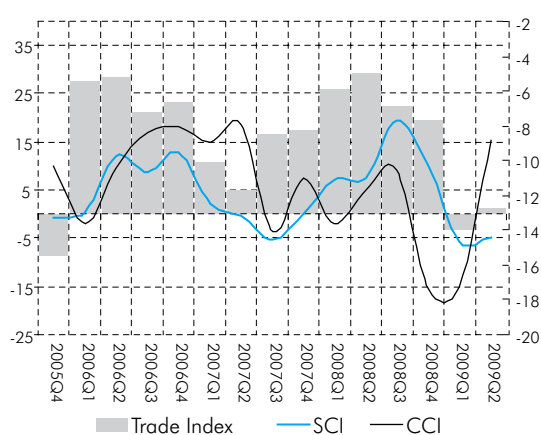
IV. MACROECONOMIC DEVELOPMENTS AND THEIR IMPACT ON INFLATION

Indirect indicators of aggregate demand in the Albanian economy attest to its contraction in the second quarter of 2009 and the period to follow. Consumption, private investments and export-related indicators continue to record lower rates than in the previous year. The expansionary fiscal policy pursued during January-August 2009 on short-term expenditure and public investments is assessed to have provided the main incentive to aggregate demand in economy. The contracted demand has slowed down the economic activity growth rates further during the first half of 2009 relative to the previous year.

IV.1 AGGREGATE DEMAND COMPONENTS

Indirect indicators show that consumer demand declined at more moderated rates in the second quarter of 2009 compared with the sharp decline in the first quarter of the present year. After recording the sharpest historical fall in the first quarter of 2009, services and consumer confidence indices showed signs of improvement in the second quarter. Based on quantitative data on consumer expenditure, the latest developments in the retail sector attest to the positive shift of this indicator compared to its downward trend since the third quarter of 2008. In annual terms, the Retail Trade Index (RTI) increased by 1.3 percent in the second quarter, following the decline by 3 percent in the first quarter. Its average rate for the first half of 2009 was -0.9 percent, which is far below the rate of the same period the previous year (+27.5 percent) and its average historical rate (+11 percent). With respect to private consumption, the downward trend of wages in the private sector, the labour market performance, the decline of remittances throughout the year 2009 and the pronounced reining in of household credit growth rates led to lower consumption rates during the first three quarters.

Chart 12 Retail Trade Index and Services and Consumer Confidence Indices



Source: INSTAT and Bank of Albania

Indirect indicators attest to the contraction of private investments during the first half of 2009. Based on quantitative data, the import of “capital goods” has declined 19 percent y-o-y in the second quarter. The fall of private investments is also confirmed by the confidence survey results. The contraction of investments owed to the undermined confidence in the industry and construction sectors, to the very low use of their production capacities and the curbing of lending for investment-related purposes. The annual drop of electrical energy consumption by non-households -mainly by businesses (-15 percent in annual terms)- signals the contraction of economic activity, reflected in the fall of demand by the private sector of economy during January to August 2009.

The fall of private investments has been followed by high growth rates of public investments, materialized in budget expenditure. Judging on the carrying out rates and level of budget expenditure for the period January to August 2009, public finances attested to an expansionary nature. Their annual increase by 23 percent marked one of the peak historical levels of the last four years' average. The increase in short-term expenditure and investment-related expenditure provided the main contribution to the higher expenditure rates. In the meantime, short-term investments continue to provide the highest contribution.

Foreign trade developments attest to the annual narrowing of trade deficit or net exports for the period January to August 2009. The 4 percent narrowing reflected the drop in both imports and exports, the latter being about 19 percent lower than in 2008. The performance of this aggregate demand component, which is mainly created by the private sector of the economy, suggests its general contraction during the first eight months of the present year.

IV.1.1 Production by Sectors of Economy

According to the data provided by the INSTAT, the GDP grew by an average annual growth rate of 5.35 percent in the first half of 2009, relative to about 6.8 percent the previous year. In the first and second quarter of 2009, the GDP grew 5.4 and 5.3 percent, respectively, in annual terms, down by 1.3 and 1.6 percentage points from the same period the previous year. Quarterly growth rates featured a similar tendency, attesting to the slower economic activity during January to June 2009.

Activity in services sectors¹² provided the main positive contribution to the GDP growth in the first half of 2009. Production sector increased its contribution to the GDP annual growth, mainly as a result of the improved activity in construction. In the meantime, industry deepened the downward rates that commenced in the first quarter of the present year.

PRODUCTION SECTORS IN ECONOMY

Following the contraction in the first quarter of 2009, activity in agriculture¹³ showed signs of improvement in the second quarter. GDP of agriculture grew 2.7 percent relative to the previous year, contributing by 0.55 percentage points to the annual GDP growth. In terms of quarterly changes, activity in this sector increased by 0.3 percent in the second quarter, following the decline by 0.3 percent in the first quarter the present year. In the meantime, agro-industry continued to decline during the first half of 2009, despite the

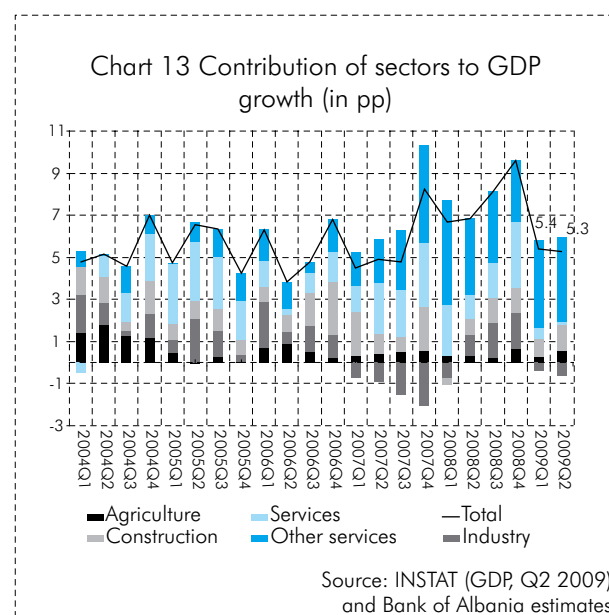
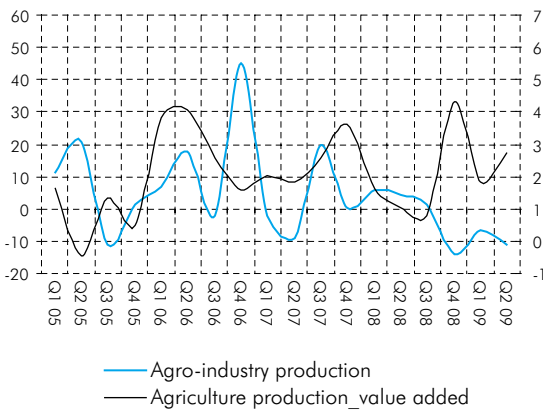


Chart 14 GDP annual changes in agriculture and agro-industry



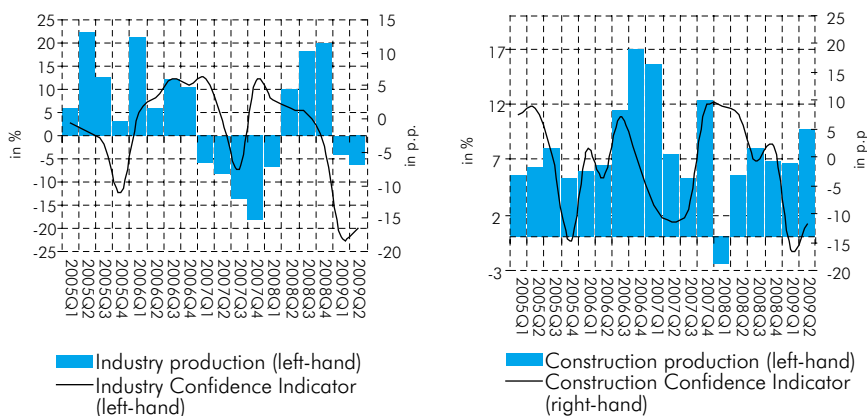
Source: INSTAT, Ministry of Agriculture, Food and Consumer Protection

relative improvement in the agriculture production sector’s GDP growth rates.

For the second consecutive quarter, activity in industry declined in annual terms during the second quarter of 2009, providing a negative contribution to the GDP growth. Industry’s GDP fell 6.3 percent in the second quarter relative to the same period the previous year. This fall deepened by 2 percentage points vis-à-vis the first quarter the present year. Despite the slight signs of improvement in the second quarter of 2009, the use of production capacities¹⁴ in industry remains below the average level. The survey data signal the contraction in industry activity during the first half of 2009. Industry confidence indicator remains at low levels compared with its long-term average, in spite of the slight improvement marked in the second quarter of the present year.

In the second quarter of 2009, construction’s GDP recorded the highest annual growth (9.8 percent) since the last quarter of 2007, hence reflecting into positive contribution to the GDP growth of the quarter. Starting from the second quarter of 2008, production in construction has recorded positive growth rates. Construction confidence indicator marked a turning point in the second quarter of 2009, following the deteriorated figures in the first quarter of 2009.

Chart 15 GDP annual change and Industry Confidence Indicator (left-hand); GDP annual change and Construction Confidence Indicator (right-hand)



Source: INSTAT and Bank of Albania

The positive tendency of energy sector indicators during the first half of 2009 persisted in July and August. Despite the poorer hydro conditions during this period of the year, energy production grew 3 percent in August

and September compared with the same period the previous year. Electrical energy production grew substantially in the first eight months of 2009, about 26.5 percent. The management of the energy distribution network has also manifested a positive performance. The ratio of losses in distribution to production dropped 4.5 percentage points in annual terms.

Despite the commencement of the electrical energy export in the first half of 2009, the volume of its export curbed in July and August owing to the lower production rates. The balance of the energy exchange recorded positive figures for the first time in 2009. The exported energy was 275.6 GWh higher than the imported energy. Households remain the main user of energy accounting for 57 percent of the market. Energy consumption by non-households, wherein business has the main share, dropped in annual terms.

	8M 2007	8M 2008	8M 2009	Annual change 8M 2009/8M 2008 (in %)
Net production	2,103	2,837	3,590	26.5
Import	1,990	1,842	54	-97.1
Export	0	0	352	100.0
Losses in distribution	1,260	1,260	1,433	13.7
Losses/Production*	59.9%	44.4%	39.9%	-4.5 (pp)
Consumed energy	4,046	4,478	4,192	-6.4
Billed consumption	2,675	3,080	2,759	-10.4
Unbilled consumption	1,371	1,397	1,433	2.6
Household consumption	1,532	1,710	1,590	-7.0
Non-household consumption	1,143	1,371	1,169	-14.7

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

Source: KESH; *) Bank of Albania estimates

Losses in the distribution system remained a concern during the early third quarter of 2009. The 13.7 percent annual increase of this indicator owes mainly to the higher non-technical losses.

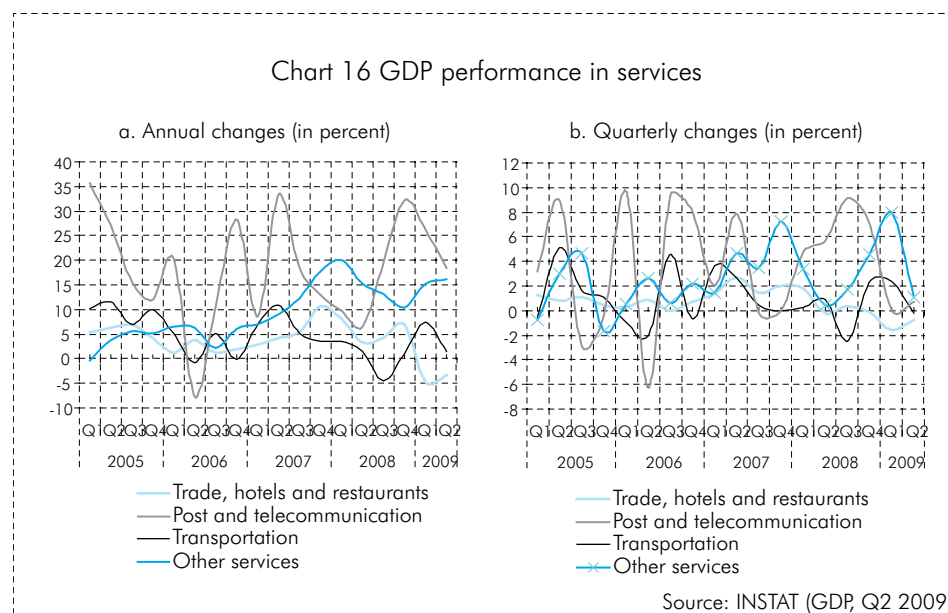
SERVICES SECTOR

The services sector contributed 4.1 percentage points to the annual GDP growth in the second quarter of 2009. As in the first quarter, "other services" provided the main contribution. According to the latest quarterly GDP data, this item has recorded substantial growth in the last two years compared with previous periods. The annual growth rate of "other services" is comparable to the previous quarter's figure, about 16 percent.

The activity of services in "trade, hotels and restaurants", "transportation", "post and telecommunication" provided a slight contribution by about 0.1 percentage points to the annual GDP growth, relatively lower than in the first quarter of 2009.

Among these items, services of "transportation" and "post and telecommunication" recorded positive annual growth rates, although markedly

lower than in the previous quarter (1.7 and 18.1 percent, respectively). By contrast, activity in “trade, hotels and restaurants” dropped during the first two quarters of 2009 (by -4.7 and -3.2 percent, respectively). The five-year series of the annual change rates of these services’ items recorded for the first time negative figures. In quarterly terms, services in “trade, hotels and restaurants” and “transportation” recorded negative growth rates, as well.



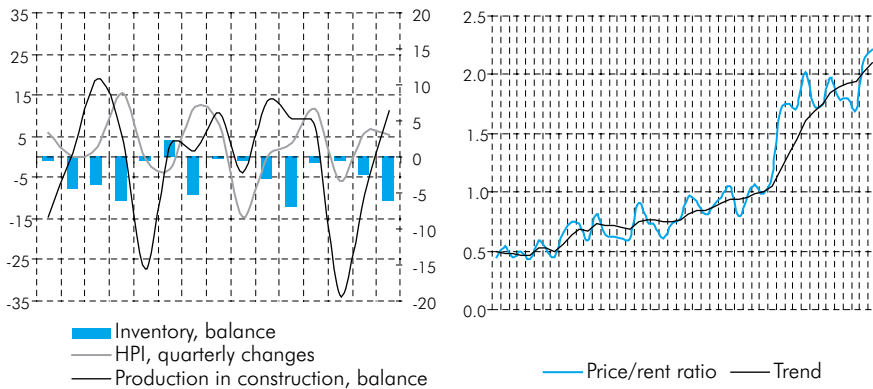
The relatively curbed growth rates in services were also signalled by businesses in the Services Confidence Survey. However, their expectations are relatively more positive than in the previous quarter.

HOUSE AND RENT PRICES¹⁵

House Price Index (HPI) rose 18 percent in the third quarter of 2009 vis-à-vis the same quarter the previous year. This performance confirmed the shift to its gradual rise that commenced in the first quarter of the present year. The data obtained from the construction business confidence surveys attest to the downward tendency of producer prices, which however have not been reflected in the transaction prices of the last two quarters¹⁶. Excluding the annual depreciation effect of the Lek vis-à-vis the Euro, the annual price rise of houses is only 10 percent (18 percent including the annual depreciation effect).

Indirect data show that the house price performance will largely depend on the expected growth of supply, expressed in the more optimistic expectations of construction, and on the decline of construction-related business inventories in the last two quarters (see Chart 18).

Chart 17 Performance of production and inventories in construction¹⁷ and HPI quarterly changes (left-hand). HPI/HRI ratio and its long-term trend (right-hand)

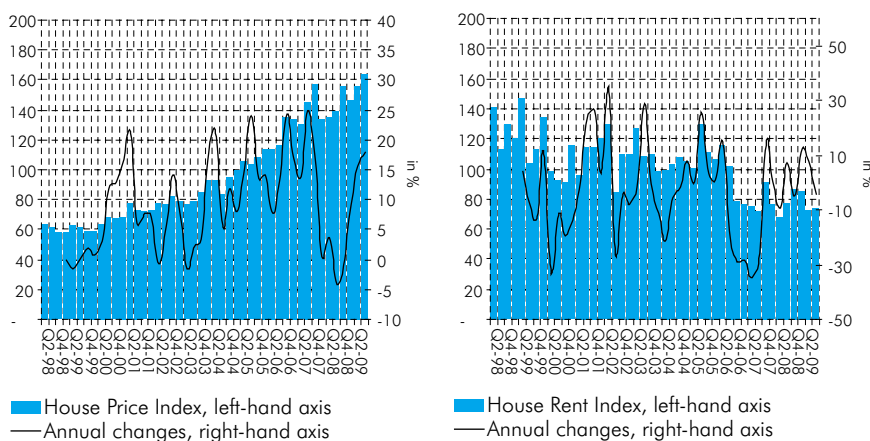


Source: Bank of Albania

House Rent Index (HRI) dropped 4.5 percent in the third quarter of 2009 compared with the same period the previous year.

The HRI remained at almost similar levels as in the previous quarter. House price/rent ratio¹⁸ (see Chart 19) rose in the third quarter of 2009. It currently stands above the historical trend of this ratio owing to the higher house prices and the lower rental prices in the third quarter of 2009.

Chart 18 House Price Index and House Rent Index performance

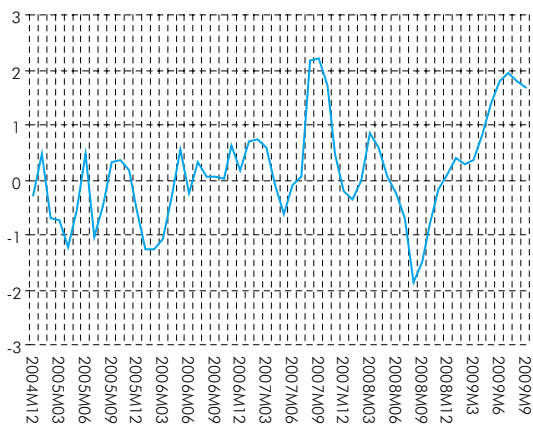


Source: Bank of Albania

PERFORMANCE OF IMPORT PRICES IN ECONOMY

The performance of import prices attests to low inflationary pressures deriving from the external economy and contracted aggregate demand in the Albanian economy. Import prices were a result of the counterbalance between the

Chart 19 Spread of domestic inflation and foreign inflation (in percentage points)



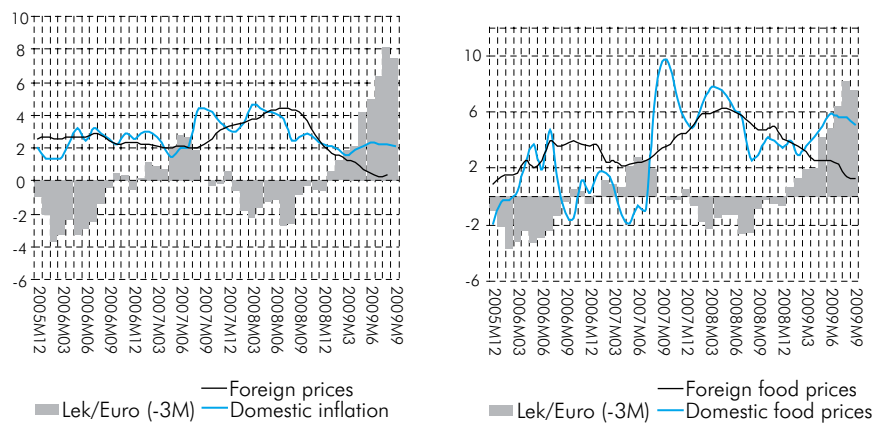
Source: Bank of Albania estimates and Statistical Institutes (Italy and Greece)

inflationary impact of the exchange rate devaluation on consumer prices and the favourable conjuncture of raw material prices in the international market, the global economic contraction and the statistical effect of the comparison. Foreign prices¹⁹ rose on average 0.4 percent, while the Lek depreciated 7.7 and 13.1 percent vis-à-vis the Euro and the U.S. dollar in the third quarter, relative to the same period the previous year.

The spread between inflation at home and the average inflation of Italy and Greece increased substantially in the last two quarters. It peaked in the third quarter (1.8 percentage points) while during the period 2005-2008 it was almost zero. The higher gap and the depreciating exchange rate may give rise to inflationary pressures in the future.

Despite the low foreign prices, imported inflation has been going up owing to the devaluation of the Lek over the course of the year 2009. The latter has mainly affected the inflation of “food and non-alcoholic beverages” and the tradable inflation component²⁰. Although food prices in Italy and Greece rose at low rates in the third quarter, about 1.1 and 2.0 percent, the annual depreciation of the Lek vis-à-vis the Euro curbed the transmission of the lower import prices to the Albanian economy.

Chart 20 Annual changes of foreign and domestic prices and the exchange rate (total – left-hand and only food prices – right-hand)



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

IV.1.2 Performance of the External Sector of the Economy

The overall balance of payments attested to the increase of foreign assets by EUR 142 million in the second quarter of 2009. The current account deficit totalled EUR 360 million, narrowing by EUR 3 million relative to the same

period the previous year. Trade deficit in goods amounted to EUR 567 million compared with EUR 561 million the second quarter in 2008. Capital inflows totalled EUR 434 million, thereby financing the current account deficit entirely.

The overall balance of payments attested to the increase of foreign assets by EUR 142 million in the second quarter of 2009. The current account deficit narrowed slightly in nominal annual terms, accounting for 16.7 percent of GDP²¹. Trade deficit in goods amounted to EUR 567 million, accounting for 29.5 percent of GDP.

Remittances declined 4.4 percent in annual terms, financing 35 percent of the trade deficit in goods. Foreign direct investments increased substantially during this quarter (by 2.6 times in annual terms) owing primarily to the privatization receipts.

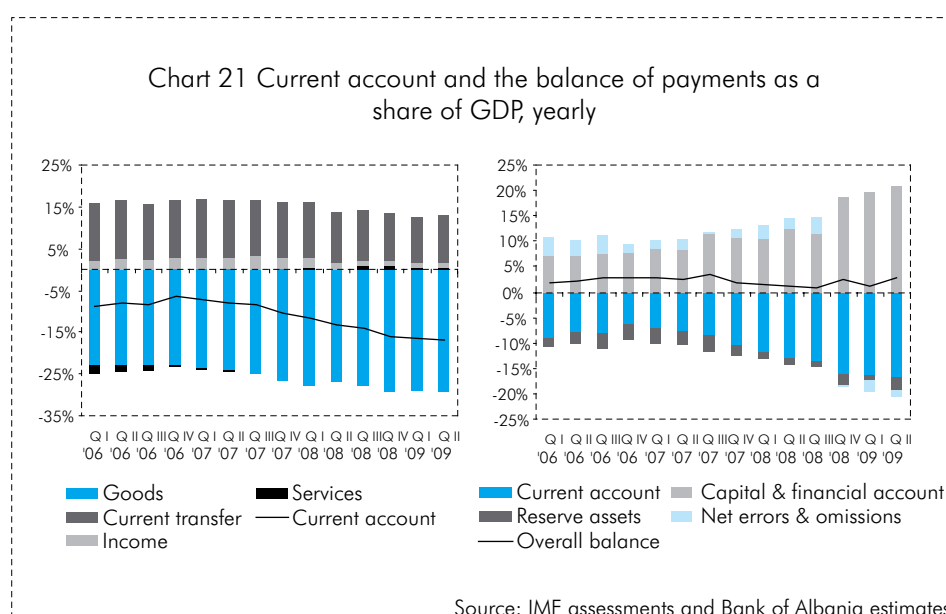
Table 5 Balance of Payments indicators, in annual terms

	In million Euros				As a share of GDP ²²			
	Q2 2006	Q2 2007	Q2 2008	Q2 2009	Q2 2006	Q2 2007	Q2 2008	Q2 2009
Current account	-153.2	-187.4	-363.5	-359.8	-7.9	-7.9	-13.2	-16.7
Trade balance	-413.8	-500.7	-561.2	-567.4	-22.9	-24.3	-27.0	-29.5
-Exports	165.7	209.8	260.4	195.0	8.2	9.5	10.3	10.0
-Imports	-579.5	-710.5	-821.6	-762.4	-31.1	-33.7	-37.3	-39.5
Services (net)	-9.5	13.3	-17.9	-18.4	-1.7	-0.3	0.1	0.6
Revenue (net)	41.1	43.5	-17.5	-10.6	2.4	2.8	1.5	1.1
Current transfers (net)	229.0	256.5	233.1	236.5	14.2	13.8	12.3	11.2
Capital and financial account	138.4	161.4	372.4	433.7	7.1	8.5	12.6	20.7
Overall balance	29.5	23.1	9.9	141.6	2.3	2.6	1.1	2.7

Source: IMF assessments and Bank of Albania estimates

CURRENT ACCOUNT

Current transactions amounted to EUR 2,203 million in the second quarter of 2009, down by 7.3 percent in annual terms. The largest portion of current expenditure financed the import of goods (above 60 percent), while foreign



inflows entered mainly in the form of the export of goods and services (64 percent) and current transfers (30 percent). Current account deficit narrowed slightly by 1.0 percent in annual terms and amounted to EUR 360 million. Its slight narrowing was mainly triggered by the substantial lowering of the deficit in the revenue account balance²³ and the higher surplus in the current transfers' account²⁴.

FOREIGN TRADE

The analysis of the foreign trade developments for the period January to August 2009 attests to the decline of trade exchanges by approximately 10 percent in annual terms. Subsequently, the trade deficit narrowed 4 percent relative to the same period in 2008. Imports' coverage by exports reached 24 percent. In total, imports and exports declined during this period 7.7 and 19.2 percent, respectively, in annual terms.

The short-term dynamics of trade in goods' indicators attest to a similar setting. Albania's trade activity with the rest of the world contracted in August 2009. Trade exchanges have maintained a downward trend since January the present year²⁵. Trade deficit narrowed further by about 11 percent in annual terms and 3 percent in monthly terms. Imports' coverage by exports is 21.4 percent or down by 2.4 percentage points from the same period the previous year.

Table 6 Exports and imports (in millions of Euro) and the annual and monthly change by commodity groups (in %) for August 2009

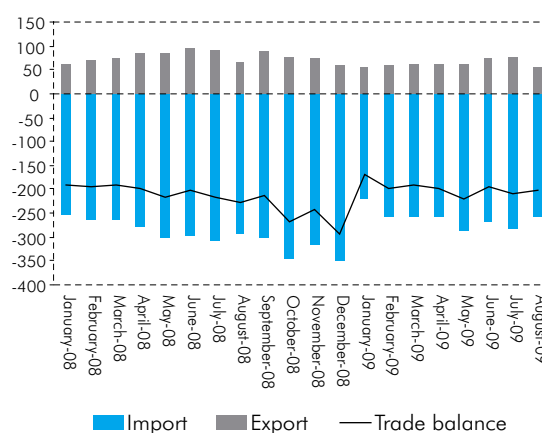
	Exports (in millions of EUR)	Annual change (in %)	Monthly change (in %)	Imports (in millions of EUR)	Annual change (in %)	Monthly change (in %)
Food and live animals	2.6	65.8	-7.1	32.2	-12.9	-13.8
Beverages and tobacco	0.1	-85.0	-82.3	18.1	31.0	40.5
Raw materials	9.6	-41.6	-17.7	9.6	80.1	9.2
Fuels	8.2	-1.1	55.3	45.6	-32.2	38.3
Vegetable and animal fats and oils	0.0	174.3	7527.2	2.9	-27.2	6.5
Chemical products	1.4	73.7	65.1	25.7	-11.1	-16.4
Processed goods	7.7	-44.5	-35.3	56.8	-9.8	-18.8
Machinery and appliances	3.7	47.9	-2.5	47.9	-3.4	-22.8
Other processed goods	21.8	7.5	-43.1	18.4	-21.1	-27.0
Miscellaneous	-	-	-	-	-	-
Total	55.1	-14.1	-26.4	257.2	-12.0	-9.0

Source: Bank of Albania

The performance of exports attests to the persistent downward trend in August, although slightly more moderate since April the present year. Exports declined 14 percent in annual terms, while in monthly terms they declined sharply by 26 percent.

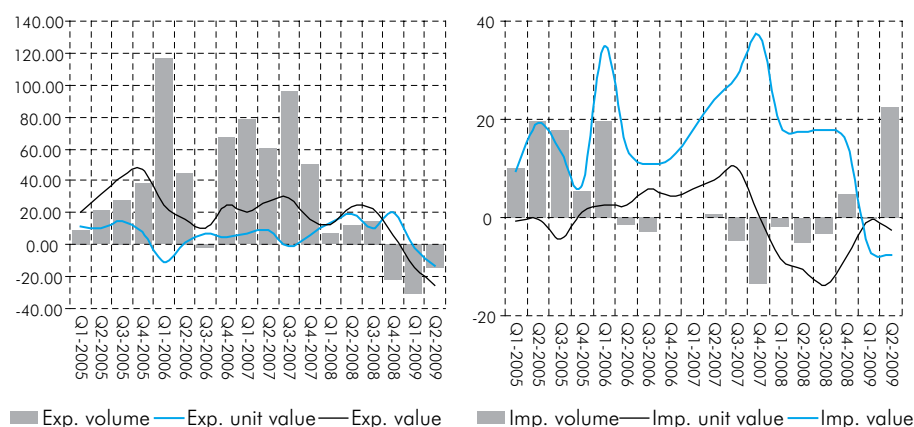
Imports show a similar performance as well. In August, they declined 12 and 9 percent in annual and monthly terms, respectively. In terms of commodity groups, the imports of “fuels” and “food and live animals” recorded double-digit decline in annual terms. In the meantime, “machinery and appliances” and “raw materials”, which have the largest share to total imports, recorded more moderate annual decline. The short-term dynamics of these items attests to more accelerated monthly growth rates of “fuels” and more accelerated monthly decline rates of the other three items. The performance of prices in the international markets has also triggered the annual fall of the unit value index of imports by 3 percent in annual terms. The unit value index of exports has maintained the downward trend shown

Chart 22 Imports, exports and trade balance (in million Euros)



Source: Bank of Albania

Chart 23 Annual change of imports' and exports' value and the unit value index (in percent)



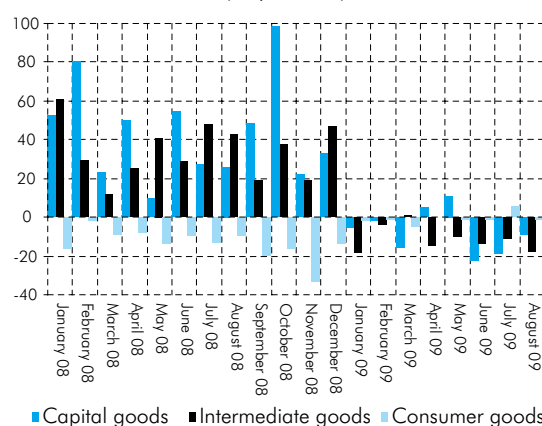
Source: General Customs Directory, INSTAT and Bank of Albania

since the third quarter of 2008, a period during which the demand from Albania’s main trading partners began to slacken.

In terms of purpose of use, imports of “capital goods” and “intermediate goods” posted a decline. In annual terms, their imports’ value declined 9 and 17.6 percent, respectively, in August. By contrast, the imports’ volume of “consumer goods” was less volatile, recording an average annual change of 0.7 percent. In August, this item’s imports declined 1 percent relative to the same month the previous year.

In terms of geographical distribution, the EU countries -mainly Italy and Greece- remain

Chart 24 Annual changes in the imports of capital, intermediate and consumer goods (in percent)



Source: Bank of Albania

Albania's main trading partners. Exports to EU countries accounted for 67 percent of total exports' volume, with Italy sharing the main weight, about 48 percent. With respect to imports' origin, the diversity is less concentrated. Imports from Italy declined their share to total to 20 percent in August 2009 from 27 percent in July, which is explained by seasonal-related factors. In the meantime, there has been an increase in the trade exchanges with China, Russia and Turkey.

PERFORMANCE OF OTHER CURRENT ACCOUNT ITEMS

Services posted a negative balance for the second consecutive quarter. Its deficit stood at an almost similar level as in the second quarter of 2008, while in quarterly terms, it improved by 14 percent. Revenue and expenditure remained at an almost similar level in annual terms. In quarterly terms, they grew 31.3 and 28.3 percent, respectively. Albania remains a net importer of freight and insurance services. Travel services posted a positive figure of EUR 2.7 million, shifting from deficit to surplus²⁶. Travel services account for the largest share in services' revenue and expenditure, sharing 75 and 71 percent, respectively, of the total. Foreign currency inflows from travel services totalled EUR 299.4 million, up by 19.8 percent from 2008. Albanian tourists spent abroad EUR 296.7 million or 6.0 percent more than in 2008.

Net revenue posted a negative figure of EUR 10.6 million. Relative to the previous year, the situation is more positive for income from labour and investment income. Income from labour is slightly higher than in 2008, while down by 11.6 percent from the previous quarter. Net investment income posted a reduction in its deficit of 12 percent in annual terms.

Net current transfers are 1.5 percent higher than in the same quarter the previous year²⁷. The considerable growth in official inflows²⁸ provided the main contribution to this increase. Around EUR 198 million entered Albania in the form of remittances, which declined 4.4 percent in annual terms.

CAPITAL AND FINANCIAL ACCOUNT

Net foreign inflows in the capital and financial account amounted to EUR 434 million in the second quarter of 2009. Around EUR 16 million entered Albania in the form of capital investment transfers and EUR 418 million in the form of net financial flows. Capital inflows financed the current account deficit entirely and accounted for 20.7 percent of GDP²⁹.

Albania's financial liabilities to the rest of the world grew EUR 285.3 million, while residents' assets abroad declined EUR 132.1 million. The considerable increase of foreign direct investments' inflows by EUR 312.8 million³⁰ provided the main contribution to the increase of liabilities to non-residents. Extensions of long-term and soft loans from abroad amounted to EUR 161.4 million during this quarter. The increase of this type of liabilities leads to higher future external debt-service payments. In the second quarter of 2009, external debt service lowered the residents' liabilities by EUR 37 million.

The decline of foreign currency assets invested abroad is mainly manifested in investments in the form of banking system's deposits held with non-resident financial institutions (EUR 126.3 million). Financial assets in the form of portfolio investments posted a decline as well (EUR 14.7 million).

Reserve assets increased by EUR 141.6 million. As at end of the second quarter, the reserve stock was EUR 1,711 million, sufficient to cover 4.2 months of imports of goods and services.

Box 1 Performance of Foreign Direct Investments – A Comparative Approach

Emerging countries consider the absorption of Foreign Direct Investments (FDI) to their economies a key priority. Economic theory underlines several economic and financial benefits arising from the increase of FDI in emerging countries. The entry of non-resident companies for business-related purposes – in addition to creating financial inflows and opening new jobs – increases productivity and competition in the respective industries (Jun & Singh 1995).

The level of the FDI in an emerging economy depends on several main factors. Some of them are directly related to the home authorities and the others to the domestic market profile. More specifically, the market size, wage costs, interregional competition, and slightly less the exchange rate stability, mainly relate to the domestic market profile. On the other hand, political and financial stability are two major determinants, which mainly relate to the home authorities. In addition, FDIs are flexible to the fiscal framework -temporary and permanent facilities- such as the measures applied on financial inflows and other administrative incentives.

After several years of positive performance, FDI inflows to South-East Europe declined in 2008. The majority of countries recorded negative growth rates of the FDI, while only a few of them (including Albania) recorded more moderate FDI growth rates relative to the previous year. Since the largest portion of FDI in the region originates from the advanced Euro area countries, the financial and economic turmoil in these countries provided their impact on the decline of the FDI, which began once the crisis was first shown in Europe.

Albania is the only country in the region to have recorded a double-digit figure of the FDI growth in 2008. The performance of the FDI in 2005 to 2008 attests to its double-digit growth in annual terms³¹. Relative to other regional countries, excluding Montenegro which does not record any changes in the FDI inflows, all the other countries recorded double-digit decline figures in 2008.

Table 7 FDI inflows, in millions of EUR

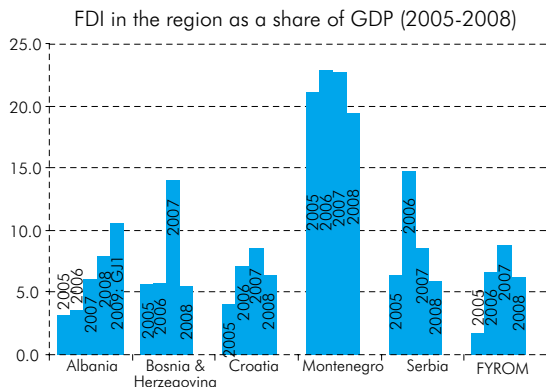
	2007	2008	Q1:2008	Q2:2008	Q3:2008	Q4:2008	Q1:2009
Albania	481	653	103.8	120.4	178.1	250.9	123.6
Bosnia and Herzegovina	1,543	686	80.3	142.2	259.9	200.0	30.7
Croatia	3,634	2,982	-	-	-	-	-
Montenegro	639	639	166.0	198.6	150.3	124.5	110.5
Serbia	2,525	2,037	853.7	728.6	225.2	229.9	635.5
Macedonia	510	407	117.0	136.7	90.5	63.3	54.5

Source: World Investment Report 2009 (UNCTAD) and Bank of Albania estimates

The same trend persisted in the first quarter of 2009. The FDI inflows to Albania grew 20 percent relative to the same quarter the previous year. In the meantime, regional countries recorded substantial decline in the FDI growth rates; subsequently

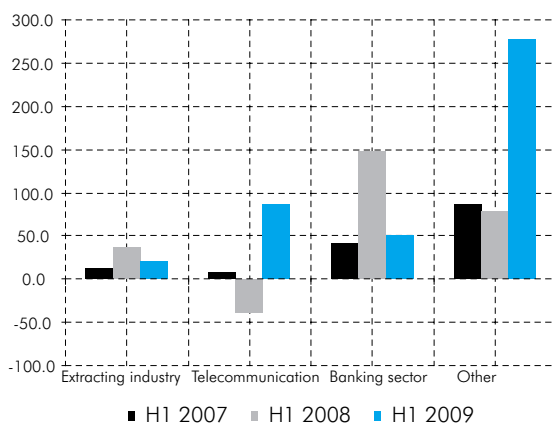
the FDI share as a percent of GDP declined as well. In the case of Albania, the upward trend of the FDI persisted in the second quarter of 2009, owing primarily to the increase of privatization receipts.

Chart 25 Performance of the FDI as a share of GDP, in years



Source: World Investment Report 2009 (UNCTAD) and Bank of Albania estimates

Chart 26 Distribution of FDI by sector, in years and millions of EUR



Source: Bank of Albania

The distribution of the FDI by sectors attests to their lack of uniformity and diversity during 2005 to 2009. The period 2005-2007 shows higher FDI inflows to telecommunication. However, the period from 2008 to the first half of 2009 shows lower FDI inflows to this sector. The year 2008 proved to be a successful one for the FDI to extracting industry and the banking sector. It also marked the peak year of FDI inflows to these sectors for the period 2005-2009. Given the remarkable performance in 2008, these two industries were less attractive to foreign investors during the first half of 2009. Manufacture of textiles and wood, classified under the item "other", has attracted a large portion of FDI inflows. This industry, mainly a re-exporting one, has enjoyed progressive growth rates of the FDI since 2005. The favourable labour conditions in the Albanian market and the fiscal facilities provided to the business sector are the two main incentives for the positive performance in this industry. The growth of the FDI inflows to this industry has been also spurred by the need to increase the Albanian exports to the international and interregional markets, in order to cope with the risks arising from the trade deficit deepening.

FDI inflows to Albania have been also affected by significant reforms aiming at improving the conditions of "doing business" in the country. More specifically, the creation of the National Registration and Licensing Centre reduced and eased the procedures for the business registration and licensing. Another incentive for foreign businesses that decide to invest in Albania relates to the reduction of the fiscal burden: the reduction by half of the profit tax to 10 percent, the reduction of the flat tax to 10 percent, the reduction by half of the tax on small-sized businesses to 1.5 percent and the reduction by half of the employer's contribution to 15 percent. In 2008, the Corporate Law was amended with the purpose of enhancing the corporate transparency further. The reforms in this Law ranked Albania among the first 20 countries in the Investor Protection index in the World Bank "Doing Business" report.

IV.1.3 Fiscal Indicators and Fiscal Policy Performance

The government ran an expansionary fiscal policy throughout the year 2009, however its intensity moderated in August. Mid-first quarter marked the beginning of the expansionary fiscal policy peaking in May and June. As at end of August, budget revenue amounted to ALL 195 billion, meeting 92 percent of the projection³². Budget expenditure totalled ALL 242.5 billion,

meeting 93.3 percent of the projection. As at end August, the budget deficit was at almost the same level as the projection.

Table 8 Main fiscal items for the first eight months relative to the previous years

	Actual (in billions of ALL)	Projection versus plan* (in %)	Annual change (in %)		
			8-month 2007	8-month 2008	8-month 2009
Revenue	195.0	91.8	8.7	18.6	5.4
- Tax and customs	138.1	94.2	13.1	18.9	4.7
VAT	71.1	94.8	21.1	23.2	4.3
Tax on profit	11.5	84.0	-7.6	-10.7	-6.4
Excises	22.5	78.6	27.1	21.1	3.2
- Local government	8.6	69.6	-7.7	16.2	11.3
- Independent budget	33.7	94.0	0.1	17.7	10.5
- Non-tax revenue	12.9	92.2	12.6	22.9	-8.9
- Grants	1.7	49.2	-56.3	-21.3	142.3
Expenditure	242.5	93.3	10.8	34.0	23.3
- Current expenditure	177.3	92.7	7.0	15.6	18.4
Personnel	40.2	95.4	0.6	17.2	-1.7
Interests	23.8	96.5	-3.5	24.6	13.0
Social insurance and pensions	62.4	96.4	15.7	9.7	27.9
Local government expenditure	20.8	89.6	0.9	36.6	40.3
- Capital expenditure	65.1	94.9	50.9	142.4	55.7
Budget balance	-47.5	99.9	-16.3	-228.7	304.7

Source: Ministry of Finance

Note: According to the early 2009 projection.

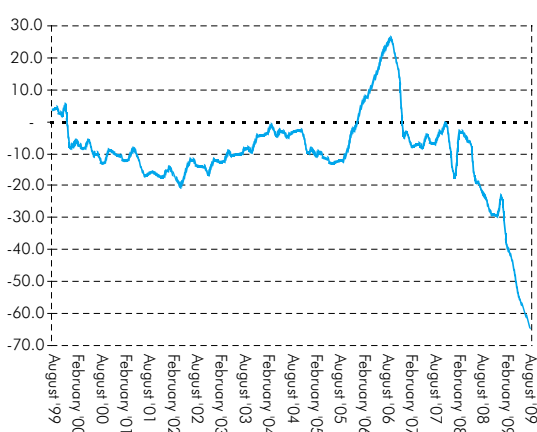
Primary deficit deepened further during the year 2009. As at end August³³, it amounted to ALL 64.7 billion.

The performance of the primary deficit reflects the concurrent increase of the domestic and external debt over the course of this period. In addition, the widening of the primary deficit mirrors the widening of the negative difference between economic growth and the interest rate on public debt.

PERFORMANCE OF BUDGET REVENUE AND EXPENDITURE

As at end of August 2009, budget revenue posted an annual increase of 5.4 percent, the lowest increase since 2002. Relative to the previous years, VAT revenue, which makes up the main source of budget revenue (about 36 percent of the total),³⁴ posted a downward contribution to total revenue. Other items, namely tax on profit, social and health insurance and non-tax revenue have also lowered their contribution to the annual increase of revenue relative to the previous years. The performance of the main revenue items attests to the contraction of economic activity at home.

Chart 27 Moving sum of primary deficit, August 1999-August 2009, in billions of ALL



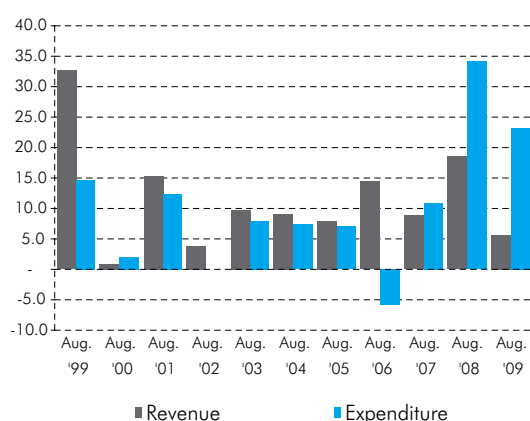
Source: Ministry of Finance and Bank of Albania's staff estimates

Budget revenue projection for the first eight months of 2009 was not met by ALL 17.3 billion, which primarily owes to the non-meeting of tax revenue projection.

Revenue from VAT amounted to ALL 71.1 billion, up by 4 percent in annual terms. Although the VAT rate was kept unchanged from the previous years, revenue from VAT posted the lowest increase in annual terms since August 2001. As in the previous two years, revenue from *tax on profit* posted negative growth rates during the first half of 2009, despite the termination of the tax rate reduction effect by 10 percent³⁵. The projection for this period was met 84 percent. *Excise duty* revenue recorded a substantial slowdown in terms of the growth rate relative to the previous years.

Independent budget revenue (social and health insurance contributions) increased by 10 percent relative to the first eight months of 2008. However, this item failed to meet the projection for this period by ALL 2.2 billion³⁶.

Chart 28 Annual changes of revenue and expenditure (January-August, in percent)



Source: Ministry of Finance

Revenue from tax on personal income, customs duties and budget institutions met the eight-month projection. However, in annual terms, revenue from customs duties continued to contract owing to the various agreements promoting the free movement of goods.

As at end of August, budget expenditure amounted to ALL 242.5 billion, meeting 93.3 percent of the plan. Unlike revenue, budget expenditure grew at higher growth rates during the year. In annual terms, total expenditure grew 23 percent, about 12 percentage points higher than the average growth rate for the period August 2005-August 2008.

Short-term expenditure provided the main contribution (17 percentage points) to the annual growth of total expenditure. The rest of contribution (6 percentage points) was provided by investment expenditure. All current expenditure items have grown in annual terms, among them local government expenditure, social and health insurance expenditure and operation and maintenance expenditure³⁷ having grown at the highest rate. Despite their high growth rates, the same items share the main weight in terms of non-meeting the 8-month projection of short-term expenditure.

Capital expenditure amounted to ALL 65.1 billion, meeting 95 percent of the projection. In annual terms, long-term expenditure grew 56 percent during the 8-month period. The increase of investment expenditure during the last two years, owing primarily to the Durrës-Kukës road, brought about the increase of this item's share in total expenditure. Although in the short-term the increase of this item gives rise to higher budget deficit, in the long run, the upgrade of infrastructure will be key to bolstering economic growth.

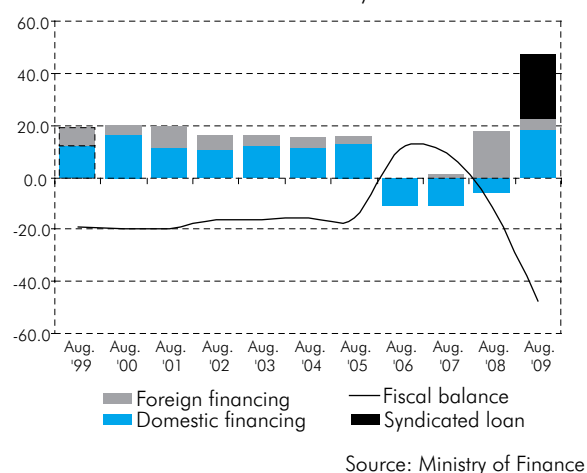
BUDGET DEFICIT AND ITS FINANCING

As a result of the more active fiscal policy on the expenditure side, the budget deficit has been going upward starting from February this year. The performance of budget revenue and expenditure, in terms of growth rates and meeting of projection, gave rise to higher budget deficit, which remained above the Ministry of Finance's projection throughout the largest part of the year.³⁸ In August, the budget deficit met the 8-month projection, owing to the relatively lower expenditure than in the previous three months³⁹.

In addition to the "conventional" instruments employed to finance the budget deficit, the Government employed another new instrument called the "syndicated loan"⁴⁰. The latter financed 50 percent of this period's budget deficit. About 75 percent of the syndicated loan was extended by non-resident banks and the rest by resident banks and institutions operating in Albania.

Privatization receipts provide substantial contribution to financing the budget deficit. As at end period, they amounted to ALL 22.9 billion⁴¹.

Chart 29 Budget deficit performance and main financing sources (January-August, in billions of ALL)



Source: Ministry of Finance

	8-month 2006	8-month 2007	8-month 2008	8-month 2009
Budget balance	10.9	9.1	-11.7	-47.5
Financing	-10.9	-9.1	11.7	47.4
Domestic financing	-10.5	-10.5	-6.0	24.5
Domestic borrowing	-8.7	11.7	13.4	3.0
T-bills	-26.6	-18.9	-8.2	-0.4
Bonds	17.9	30.7	21.6	6.4
Direct loans ⁴²	0.0	0.0	0.0	-3.0
Privatization receipts	2.1	0.1	0.7	22.9
Other ⁴³	-3.9	-22.3	-20.1	-7.6
Syndicated loan	0.0	0.0	0.0	24.6
Foreign financing	-0.4	1.3	17.8	4.5

Source: Ministry of Finance

Table 9 Budget deficit and its financing during the 8-month period, 2006-2009, in billions of ALL

Government's borrowing policy through financial instruments was more oriented to long-term instruments, which is consistent with the securities' market development principles. Domestic debt stock with financial instruments grew ALL 6 billion during January to August 2009, which is ascribable to long-term debt securities. Long-term debt as a share of total domestic debt increased by 0.9 percentage points from the same period the previous year to 38.5 percent.

As at end of the first half, external debt stock accounted for 20.8 percent of GDP, up by 2.4 percentage points from the previous year. As at end the same period, public debt accounted for 56.3 percent from 56 percent as at end 2008.

Box 2 Role of Fiscal Policy during the Crisis and the Future Challenges*

The crisis that hit the global economy in September 2008 required the immediate intervention of the monetary and fiscal authorities in order to curb the extent of its consequences on the real sector of different economies. The global crisis called for a number of measures that were mainly focused on two directions: first, the recovery of the financial system, and second, the stimulation of aggregate demand. In addition, these measures aimed at restoring the economic agents' confidence in the financial system. While some of these measures overlap and given the limited room for monetary policy, the focus of these measures was on fiscal policy. A survey of the countries that have experienced severe systemic financial crises shows that the successful resolution of the financial crisis is a precondition for achieving sustained growth. The government's intervention in economy consisted in two directions: the recapitalization of the financial system and the design and implementation of countercyclical fiscal policies. If the central banks and governments had not acted timely and appropriately, the financial crisis would have been even more intense and the recession deeper.

The fiscal costs of the crisis were significant, with substantial impacts of the contraction in economic activity on public finances. Based on the Euro area data, the fiscal costs of the economic and financial crisis are expected to be considerable. In 2007, Euro area general government borrowing amounted to around half a percent of GDP. In its Spring 2009 forecast, the European Commission projected that government borrowing in the Euro area would rise to 5.3 percent of GDP this year and 6.5 percent in 2010. The Euro area government debt ratio, which stood at 66 percent of GDP in 2007, is projected to rise to 88 percent of GDP in 2010. In addition, 13 of Euro area governments are projected to breach the 3 percent of GDP deficit reference value of the Maastricht Treaty. The latter is expected to persist in the following years as well.

The deterioration of fiscal figures compared to pre-crisis periods also reflects the costs of discretionary fiscal stimulus measures adopted in many countries. Against this backdrop, the regional countries have taken measures to improve the negative effects of the global crisis on their domestic economy. Almost all the regional countries (Croatia, Bosnia, Serbia, Macedonia and Montenegro) have revised their initial budget based on new economic growth projections (which is expected to be lower than the early-year projection). Against this background and in order to avoid unsustainable budget deficit or public debt in the future, the regional countries have reduced the early year budget expenditure projections, although these measures have relatively been of an "anti-social" nature.

The scale of the challenge for fiscal policy is considerable. Over the past 12 months, governments, like central banks, have taken unprecedented action to restore stability to the financial system and to tackle the largest recession in post-war history. Although this action was largely "justified", most governments will come out of this crisis with the highest debt levels, as a proportion of GDP, ever to have been experienced in modern history. And this at a time when the fiscal burden associated with the population ageing looms ever larger over the horizon. If confidence in future stability is to be ensured, now is the time to set out an effective fiscal exit strategy.

Faced with the prospect of large deficits in the coming years, the priority for fiscal policy must be to set out a clear and credible plan for restoring order to the public finances over the medium term. Just as central banks are mulling their exit strategy from non-standard monetary policy measures, governments need to develop their exit strategy too. Beyond this, there is a risk that the increase in government borrowing

during the crisis is viewed as being purely the consequence of the operation of the automatic stabilisers and fiscal stimulus packages. Cyclical effects should cancel out over time. Stimulus measures are supposed to be largely temporary. So once the crisis is over and the stimulus measures unwind, the economic indicators should be more or less back to long-term equilibrium or pre-crisis levels.

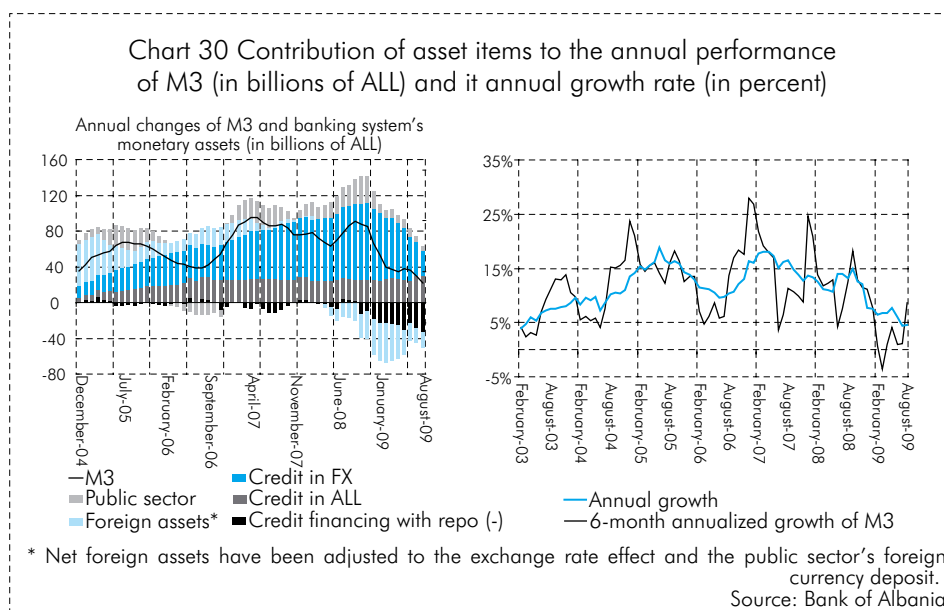
Note*) The references for Box 2 are as follows: "Fiscal policy and the financial crisis: the need for an effective exit strategy", CFS Conference, September 2009; "Fiscal policy for the crisis", A Spilimbergo, A., Symansky, S., Blanchard, O., Cottarelli, C., December 2008; World Economic and Financial surveys: Regional Economic Outlook, October 2009.

IV.1.4 Monetary developments

Third quarter's monetary indicators attested to the downward trend of money growth, which materialized into the decline of money circulation in economy. In annual terms, broad money (M3) grew 4-4.5 percent during the third quarter. Money growth in economy was mainly sustained by the stable growth of ALL lending to the private sector. The seasonal developments attest to the positive performance of net foreign inflows in the form of remittances. The banking system backed the growth of ALL financial assets through the borrowing instrument of repurchase agreements, while foreign currency inflows partly improved its foreign currency position.

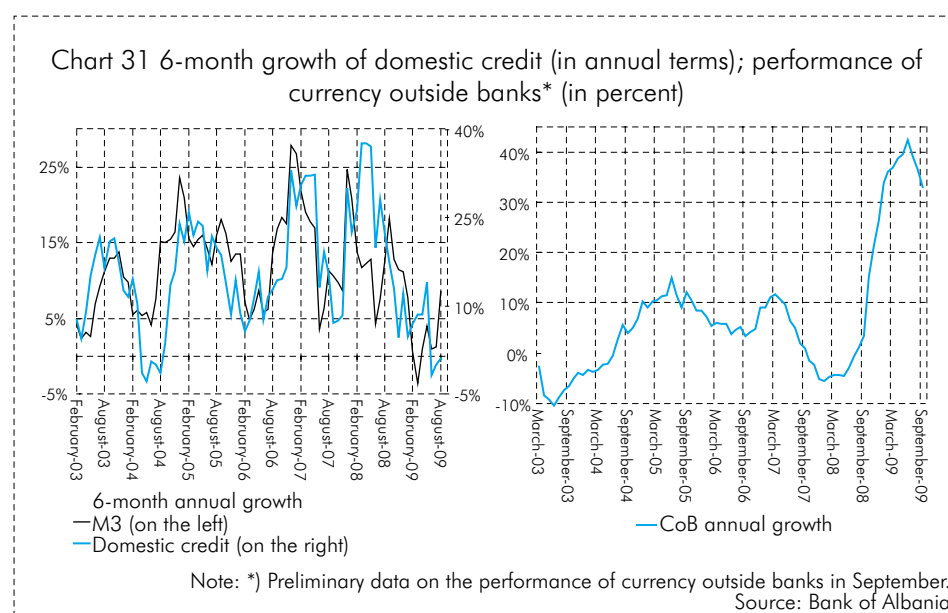
PERFORMANCE OF MONETARY AGGREGATES

The performance of monetary aggregates reflected the slowdown of money supply to the economy during July and August 2009. Money supply (M3) grew 4.5 percent in annual terms relative to the average growth rate of 7 percent during the first half of 2009. The statistical effect of deposits' withdrawal at year-end 2008 continues to be reflected in the annual growth rate of M3.



However, the withdrawal of foreign currency-denominated deposits and the decline of commercial banks' net foreign currency assets during the first half of 2009 gave rise to lower foreign currency lending. Against this backdrop, money circulation declined vis-à-vis 2008, while the money growth in economy was primarily sustained by the ALL lending.

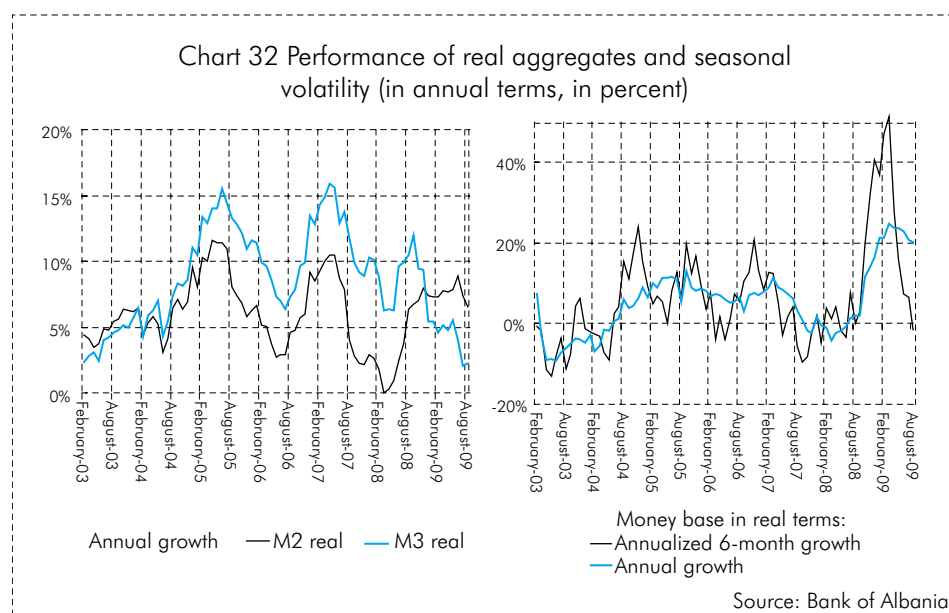
Non-banking sector's presence in financing the budget deficit led to lower domestic borrowing contribution to the annual growth rate of M3. Non-banking sector's role in financing the budget deficit grew at more rapid rates vis-à-vis the previous years. For the period January to September 2009, non-banking sector's financing totalled ALL 11 billion against the commercial banks' financing of ALL 2.2 billion. Non-banking sector's direct participation in financing the deficit has approximately totalled ALL 7-9 billion over the course of the recent years. The increase of individuals' direct participation in financing the deficit led the public sector to contribute by only 1.1 percent to the annual change of M3⁴⁴.



The relatively higher participation of individuals in financing the Government debt has reflected the return of currency outside banks to meet the demand for money in economy. According to preliminary data on September, currency outside banks declined vis-à-vis this year's peak of ALL 210 billion in July. In terms of M2 aggregate, the ratio of currency outside banks is 35.8 percent from 37 percent in July. In September, the annual growth rate slowed down to 33 percent from 36.5 percent in August⁴⁵.

In real terms, the performance of monetary aggregates has reflected the deposits' withdrawal effect on the money creation process⁴⁶. The more accelerated decline in M3 annual growth rate vis-à-vis M2 aggregate attributes to the slower foreign currency lending by the banking system. In real terms, money supply (M3) grew 2.3 percent against M2's annual growth rate by 6.6 percent. ALL private sector credit was not affected by the deposits' withdrawal, while the lower M3 growth rates attribute to the statistical effect

of the withdrawal of foreign currency-denominated deposits and the lower foreign currency lending by the banking system. The liquid money aggregate, money base, was affected by the gradual decline of the share of currency outside banks in money aggregates. The annual growth rate slowed to 20 percent in August vis-à-vis 25 percent in March.



Short-term developments of M3 are dominated by the performance of domestic credit to the public and private sector. The slowdown in private sector credit during 2009 was also reflected in the deceleration of M3 growth rates. In annual terms, M3's 6-month growth in August was 8.6 percent, following the decline in the M3 growth in the first quarter as a result of the deposits' withdrawal. M3's 6-month growth during this period reflects the foreign currency inflows in the form of remittances, which concentrated in the third quarter. Foreign currency flows improved commercial banks' external position. Banks' net foreign assets grew ALL 24 billion vis-à-vis ALL 2.5 billion in July.

Table 10 Performance of domestic credit and the banking system's foreign currency position (August 2009)

	Level	Monthly change		Annual change		Contribution to M3** In percent
		In billions of ALL	In percent	In billions of ALL	In percent	
Net foreign assets	241	19	8.7%	14	6.2%	-2.4%
Bank of Albania	214	-5	-2.3%	34	18.8%	
Commercial banks	26.5	24	1134%	-20	-43.0%	
Domestic credit	738	11	1.5%	67	10.0%	
Public sector borrowing*	315	7	2.2%	9	2.9%	1.1%
Credit to economy	423	4	1.0%	58	16.0%	7.2%
- State-owned enterprises and financial institutions	13	0	--	6	--	0.8%
- Private sector	410	4	0.9%	52	14.6%	
-in ALL	130	2	1.4%	29	29.3%	3.6%
-in foreign currency	280	2	0.8%	23	8.8%	2.8%

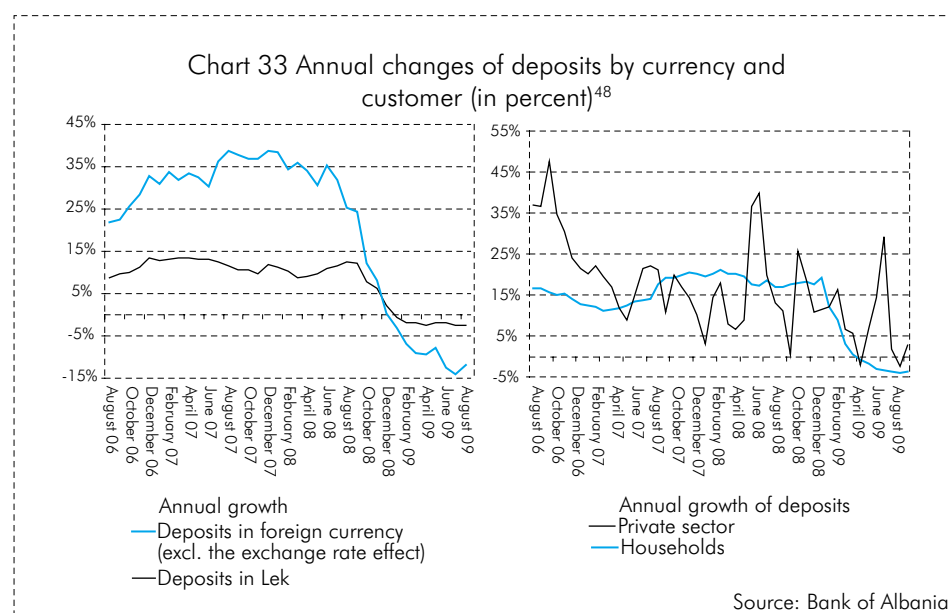
* The public sector's net borrowing (net to deposits) is also affected by the money flows in the form of privatization receipts held with the Bank of Albania. The change in the government deposit level, which also includes other unspent revenue, generates money flows that affect the performance of the M3. **The contribution to the annual M3 growth does not consider the exchange rate changes or the changes in the capital account and other statistics not included in the measurement of monetary aggregate.

Source: Bank of Albania

DEPOSIT PERFORMANCE

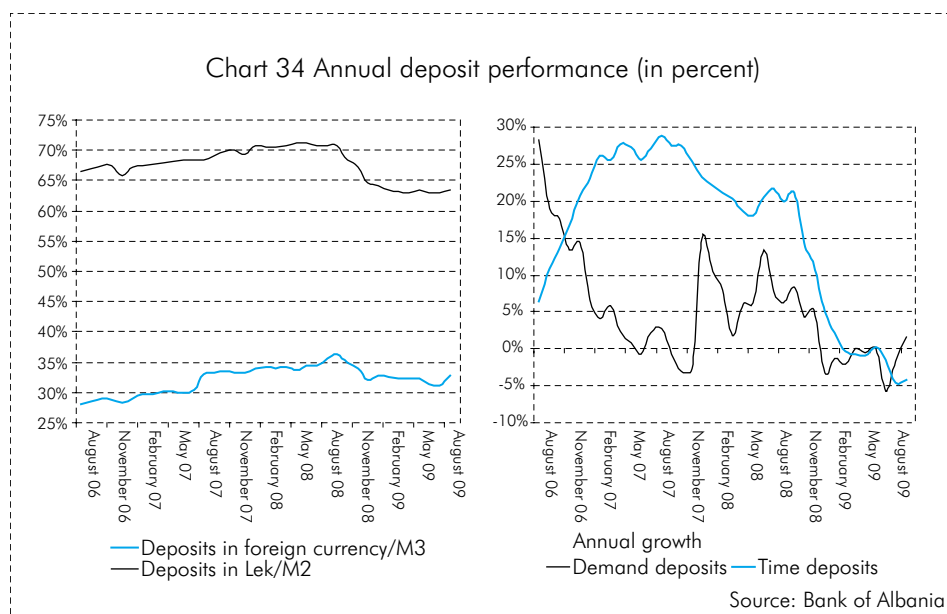
The wavering of confidence in the banking system that associated the global financial crisis was manifested in the withdrawal of a portion of deposits from the Albanian banking system. In response to the measures taken to improve the situation, savers' behaviour showed the first signs of shift in the beginning of the second quarter. This period was characterized by slower deposits' withdrawal rates, while in April the deposit stock grew in monthly terms. The latest developments' dynamics on the supply side attests to the further improvement of the deposit situation in July and August. In August, deposits grew substantially by ALL 25.4 billion in monthly terms, in line with their seasonal performance during this period of the year. Despite the positive deposit developments in August, the total deposit stock is 3 percent lower than in 2008.

The growth of deposits in August primarily reflected the growth of household deposits denominated in foreign currency. Foreign inflows in the form of remittances and tourism income in foreign currency during the summer season are the rationale behind the recovery and growth of deposits in foreign currency. The withdrawal of deposits at the end of 2008 led to lower foreign currency deposit stock in annual terms starting from April. Although as at end of August the deposits denominated in foreign currency were 3.4 percent lower than in the same period the previous year, the foreign currency deposit stock grew ALL 23 billion in nominal terms only in August. Excluding the exchange rate effects, this growth was more moderate, ALL 18.4 billion⁴⁷.



As at end of period, about 70 percent of total deposits' stock growth was in time deposits, signalling the recovery of confidence in the banking system. This is also attested by the slower growth rates of household demand deposits, while the business demand deposits grew at faster paces. In August, time deposits grew 3.7 percent in nominal monthly terms from the monthly average

of 0.3 percent in the previous quarter. Bank deposits in foreign currency as a share of broad money manifested an upward trend growing to about 33 percent at end August from 31.4 percent at the end of the second quarter.

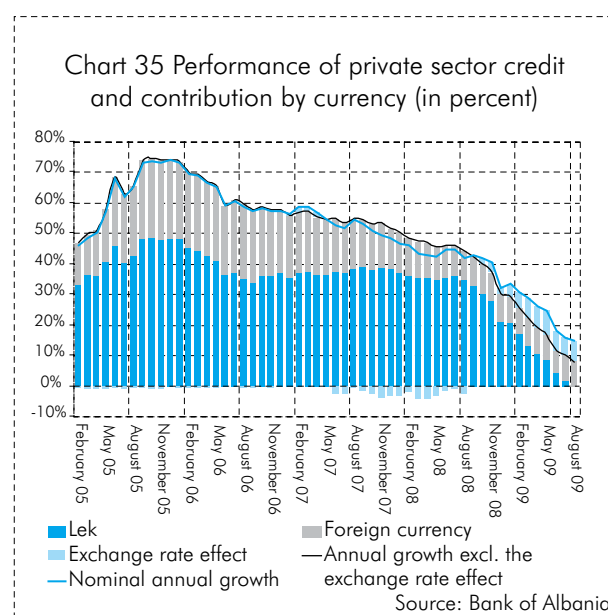


The growth of ALL deposits was stable in July and August but lower than the previous quarter's monthly growth. Despite the lower level of deposit withdrawal and the constant improvement, ALL deposit stock was 2.5 percent lower as at end August than in the same period the previous year. The growth of ALL deposit stock in July and August mainly reflects the growth of household deposits. ALL deposits as a share of M2 aggregate have remained stable at 63 percent since February the present year.

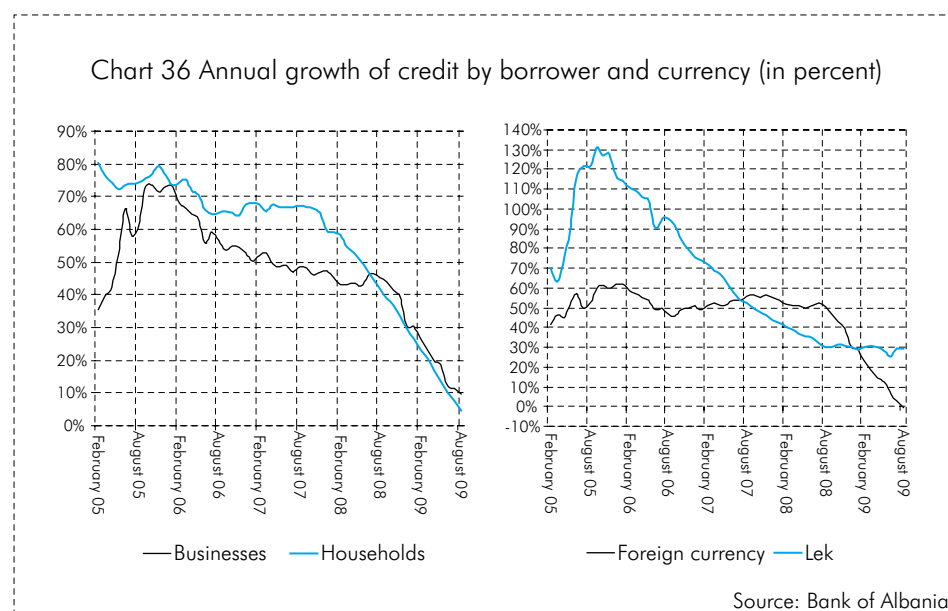
PRIVATE SECTOR LENDING

Private sector lending maintained the downward growth rates during July and August 2009, reflecting both demand and supply-side factors. On the supply-side, banks continued to apply tight lending standards, while the liquidity -in particular in Euro-remained at reduced levels. The Bank of Albania pursued an accommodating policy by injecting liquidity in order to support the higher intermediation in ALL in the banking system. Demand-side factors mainly originate from the fall of consumption and investments, which has also been shown in the imports of this type of goods throughout the year.

Average annual growth of private sector credit was 16 percent in nominal terms in June to August 2009, markedly lower than the first five months' average (29 percent). Excluding the ALL devaluation



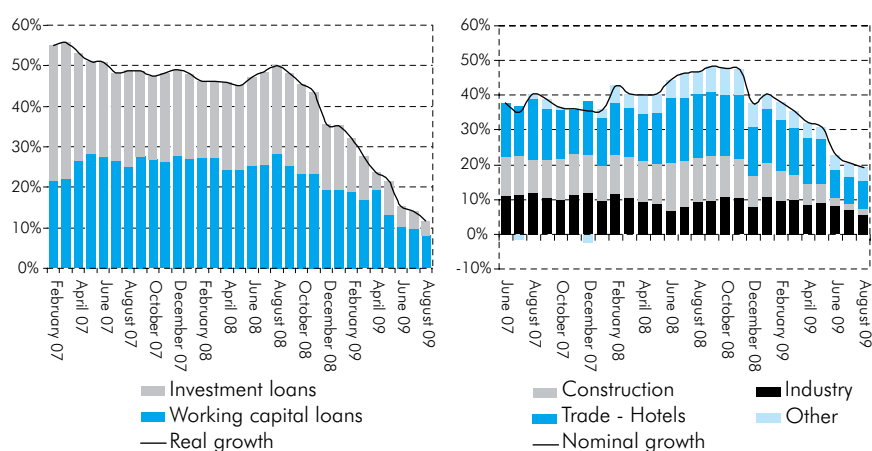
effect, the average annual growth is only 10 percent⁴⁹. The downward trend of credit attributes to the deceleration of foreign currency lending, whose growth rate was zero in August. ALL credit continued to maintain its average growth rate of 30 percent throughout the year 2009. As a result, the share of foreign currency credit in the private sector's loan portfolio dropped to 67 percent. In addition to the banks' tightening of lending conditions, these developments primarily reflect their prudence in foreign currency lending and the higher Government's demand for foreign currency credit from banks. The contained foreign currency lending was more pronounced in household credit than in business credit, which attributes to the understanding of the consequences of exchange rate movements and the greater tightening of lending conditions for loans denominated in a currency other than that of the borrower's income.



New private sector credit extended during summer was at similar levels as in the previous year. The largest portion of new credit is of short maturity term, reflecting the uncertainty of the economic agents to commit to long-term lending.

In average annual terms, business credit grew 11 percent in June to August 2009. Despite its low growth rates, business credit provided the main contribution to the growth of private sector credit accounting for about 65 percent of its total. New business credit for this quarter was mainly of short maturity term in the form of overdrafts and working capital. About 70 percent of the business credit growth in June and August attributes to credit for working capital purposes, whose share has been increasing particularly since February the present year. This performance, in addition to providing evidence for the business needs for liquidity, reflects the curbing of investments by the economic agents, which may materialize in the contraction of economic growth in the following year.

Chart 37 Contribution of business loans, by purpose and main sectors to the annual growth (in percent)

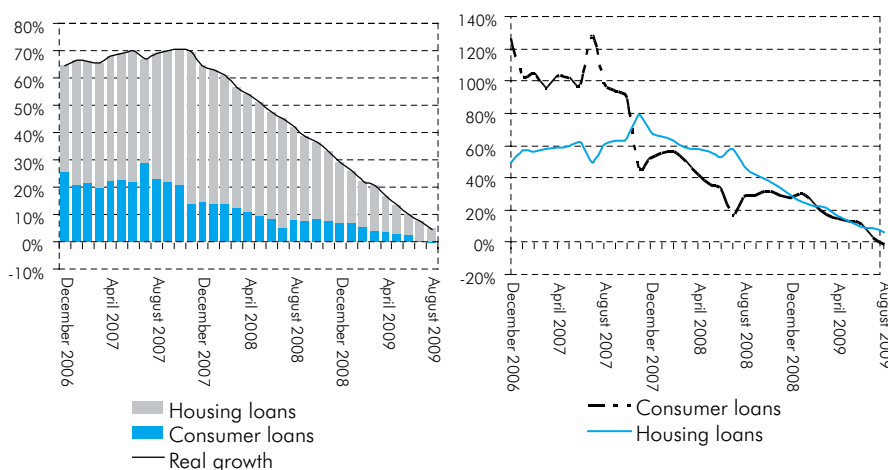


Source: Bank of Albania

The contraction of lending has been reflected in all the sectors of the economy, however the construction sector has been affected the most by its contraction. This sector's contribution to the loan portfolio growth was 2 percentage points from 13 percentage points the previous year. The annual growth of credit to the construction sector reduced to 8 percent in August vis-à-vis the average of 31 percent in the first half of 2009. Credit to the trade sector and hotel and tourism maintained high annual growth rates (20 percent) throughout summer.

Household loans grew at an average annual rate of 8 percent in June to August, contracting at more accelerated paces than business loans. The growth of consumer loans has contracted, while housing loans have provided the main contribution to the growth of household loans. In annual terms, housing loans grew 9 percent in summer, compared with 20 percent in the first half of 2009. For the same period, consumer loans grew 4 percent from 20 percent in the first five months of 2009.

Chart 38 Performance of household loans' portfolio (in percent)



Source: Bank of Albania

Box 3 Bank Lending Survey Results for the Third Quarter of 2009

Bank lending survey results show that the lending standards remained tight in the third quarter of 2009, although at a lower level than in the previous quarter. The majority of surveyed banks report that they kept their lending standards unchanged -both for business and household loans- from the second quarter of 2009. This performance attests to the turning point in the lending standards' tightening trend of the previous survey.

The tightening of lending standards was higher for businesses than for households. In terms of business size, small and medium-sized enterprises were subject to tighter lending standards than large enterprises. While in terms of purpose of use, investment-related loans were subject to tighter lending standards than working capital-related loans.

All the considered factors kept the lending standards tight in the third quarter of 2009, both for business and household loans. In general, the impact of factors on the net tightening was lower than in the second quarter of 2009, excluding the factors related to non-performing loans -both for business and households-, and the households' financial situation.

Based on banks' responses, business demand for loans fell again in the third quarter of 2009 after a slight improvement in the second quarter the present year. By contrast, household demand for loans improved slightly in the third quarter of 2009 vis-à-vis the very low and negative level of the previous quarter.

Expectations for the last quarter of 2009 show that banks will apply similar lending standards as in the third quarter of 2009, both for business and household loans.

Business Loans. The net tightening of lending standards was lower in the third quarter of 2009: the net balance increased to -7.6 percent compared with -23.4 percent in the second quarter of 2009. The majority of banks' experts state that they kept the lending standards unchanged from the previous quarter. All the factors have led to less tight lending standards, excluding the one related to non-performing loans, whose contribution has increased.

Banks have applied tighter lending policy mainly through the application of higher commissions, the reduction of the loan amount and that of the maximum loan maturity. The average loan margin and the collateral requirement, albeit still tight, have slightly loosened in the third quarter of 2009. In general, the tightening is higher for credit cost-related conditions rather than for non-cost related conditions and it is particularly higher for credit that banks rate as high risk loans.

The less tight lending standards in the third quarter of 2009 were reflected in loans to small and medium-sized enterprises (SMEs) and corporate loans. In contrast to previous surveys, the lending standards applied on SME loans were slightly tighter than those applied on corporate loans. In terms of purpose of use, the lending standards applied on loans for working capital purposes loosened for the first time this quarter (balance: +3 percent). The net percentage of banks reporting looser lending standards for investment-related purposes remains negative (-11 percent), although at lower levels compared with -30 percent in the second quarter of 2009.

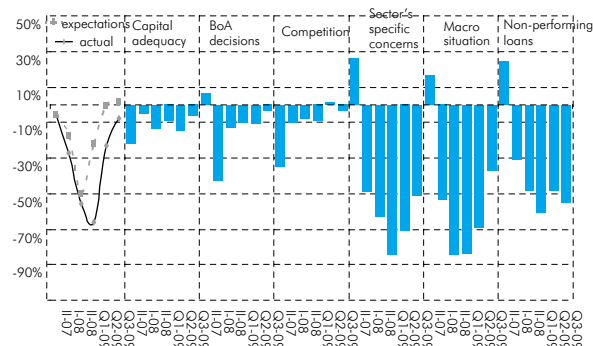
After experiencing some slight growth in the second quarter of 2009, the net demand for business (SME and corporate) loans fell in the third quarter of the current year. The fall owes mainly to the lower business demand for investment-related loans, whose net balance dropped to -33 percent versus -23 percent in the previous quarter.

Household Loans. The lending standards applied on household loans did not undergo any changes in the third quarter of 2009 relative to the previous one. Therefore, the net balance recorded the neutral value of zero. This represents an increase by 21.6 percentage points compared with the previous quarter's balance. Banks report that the lending standards applied in the third quarter of 2009 remained almost similar to the ones applied in the second quarter for housing loans and consumer loans.

The main factors to have determined the maintenance of lending standards' tightening at almost the same level during the third quarter of 2009 remain similar to those of the second quarter. More concretely, the household's financial situation is ranked the most significant factor in this regard. Its net balance for the third quarter was -51.2 percent versus -42.6 percent in the previous quarter. Other factors relate to non-performing loans and the developments in the real estate market.

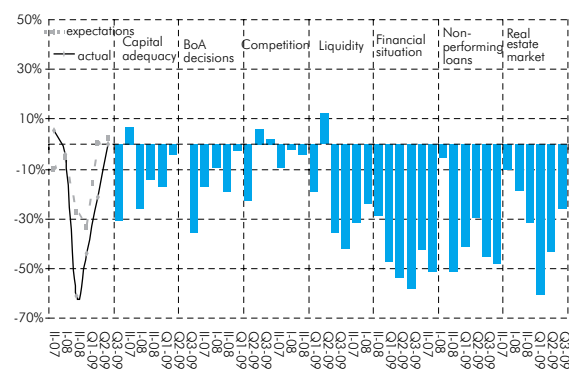
Household demand for loans has been less negative during the current quarter. Households' needs to finance consumption and the house purchase are the main factors to have provided a positive contribution to the growth of household demand for loans. On the other hand, the developments in the real estate market continue to represent the main driving force behind the fall of household demand for loans.

Chart 39 Changes in lending standards applied on business loans and the impact of different factors (net balance, in percent)



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

Chart 40 Changes in the lending standards applied on household loans (housing and consumer loans) and the impact of different factors (net balance*, in percent)



Source: Bank of Albania
 *) See Note 1.

IV.2 LABOUR MARKET PERFORMANCE

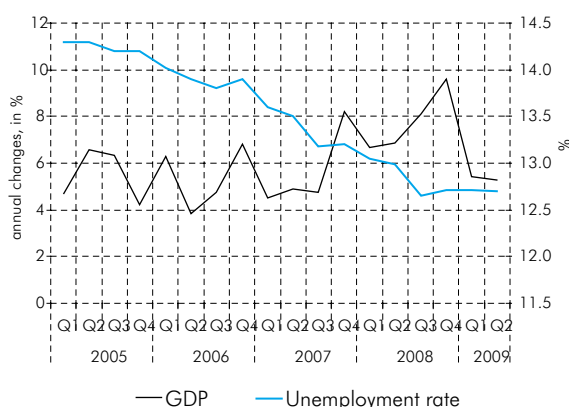
The data on the main labour market indicators for the second quarter of 2009 (INSTAT) attest to the annual increase in the total number of employed persons by 0.7 percent and in the average number of registered unemployed persons by 0.9 percent. The higher rate in the increase of the number of employed persons in the private non-agricultural sector provided the main contribution to the performance of total employed persons and labour force during this quarter. The dynamics in these indicators have maintained the unemployment rate for the second quarter of 2009 almost at the same rate (12.70 percent).

Table 11 Performance of labour market indicators

Labour market indicators	2008				2009		Annual change, Q2:2009/Q2:2008, in %
	Q1	Q2	Q3	Q4	Q1	Q2	
Labour force	1,080,107	1,105,932	1,109,968	1,115,562	1,114,161	1,114,166	0.74
Total employed persons	939,298	965,915	969,893	974,067	972,851	972,831	0.72
Number of employed persons in the public sector	166,750	166,589	166,549	166,543	166,563	166,453	-0.08
Number of employed persons in the agriculture sector	542,000	568,549	568,549	568,549	568,549	568,549	0.00
Number of employed persons in the private non-agriculture sector	230,548	230,777	234,795	238,975	237,739	237,829	3.06
Average number of total registered unemployed persons	140,809	140,017	140,075	141,495	141,310	141,335	0.94
Unemployment rate, in %	13.04	12.66	12.62	12.68	12.68	12.70	0.04 pp

Source: INSTAT

Chart 41 Annual growth rate of GDP (left-hand axis) and unemployment rate (right-hand axis) (in percent)

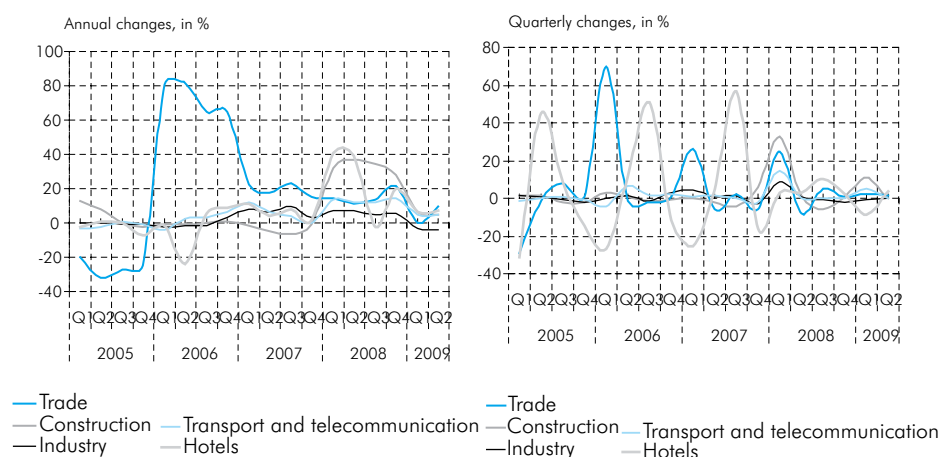


Source: INSTAT

Official data⁵¹ on the number of employed persons in non-agriculture economic enterprises show that the Employment Index has increased at lower rates during the first two quarters of 2009 following the slowdown of the Albanian economic activity during the first half of 2009.

In terms of sectors, services sector provided the main contribution to the annual increase in the number of employed persons during the second quarter. In the production sector, the number of employed persons in industry declined 4.2 percent, hence maintaining the downward trend commenced in early 2009. In construction, this indicator increased 5 percent, markedly lower than the average annual growth rate of 33 percent in 2008.

Chart 42 Employment Index performance by economic activity



Source: INSTAT

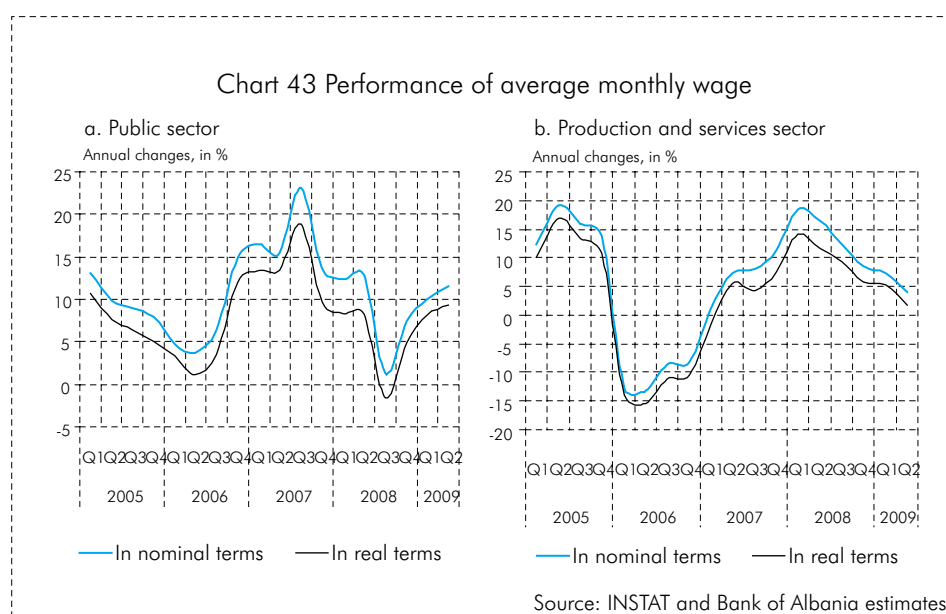
IV.3 PERFORMANCE OF PRODUCER PRICES

WAGES IN ECONOMY

Wages indicator in economy⁵² for the first two quarters of 2009 shows lower annual growth rates of average nominal wage⁵³ by 7.3 and 4 percent, respectively. In the first half of the year, it increased by an average of 5.6 percent, down by 12 percentage points from the same period the previous year.

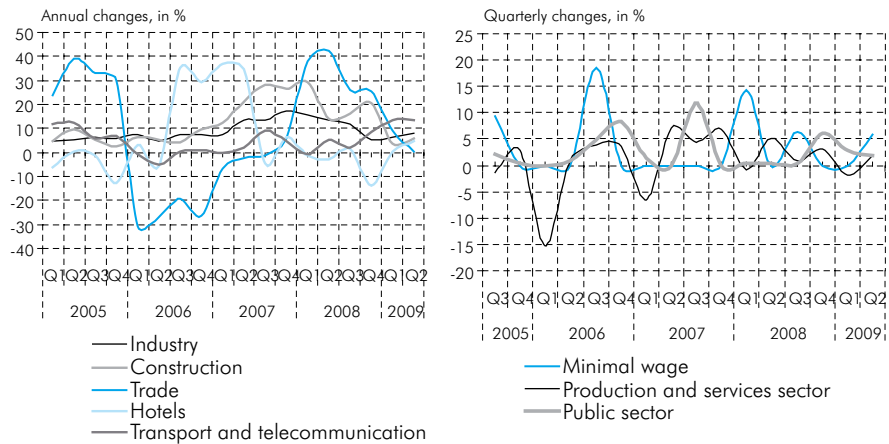
Deflated by the consumer prices, the annual increase of the real average wage index is 3.6 percent for the first half of 2009 or approximately 9.3 percent lower than the same period the previous year's increase.

According to the latest data provided by the INSTAT for the second quarter of 2009, public sector's⁵⁴ average monthly wage accelerated its annual growth rates by about 11.6 percent in nominal terms and 9.3 percent in real terms. Government's decisions on the increase of the monthly minimum base salary and the differentiated increase of the salary for some categories of professions may affect the growth rates of the public sector's average monthly wage in the following quarters. In the second quarter of 2009, monthly minimum base salary increased by 12.5 percent in annual terms to ALL 18,000, remaining at the same levels in the third quarter of 2009.



In terms of sectors, the highest annual growth rate of average wage in the second quarter of 2009 was recorded in transportation and telecommunication (13.6 percent). In industry and construction, the same indicator increased by 7.9 and 5.6 percent, respectively, 1.5 times higher than in the first quarter. In annual terms, average wage in the trade sector increased by 0.6 percent, compared with 9.3 percent in the first quarter of the current year.

Chart 44 Performance of average wage in some branches of economy (left-hand chart) and minimum and average wage by sectors (right-hand chart)

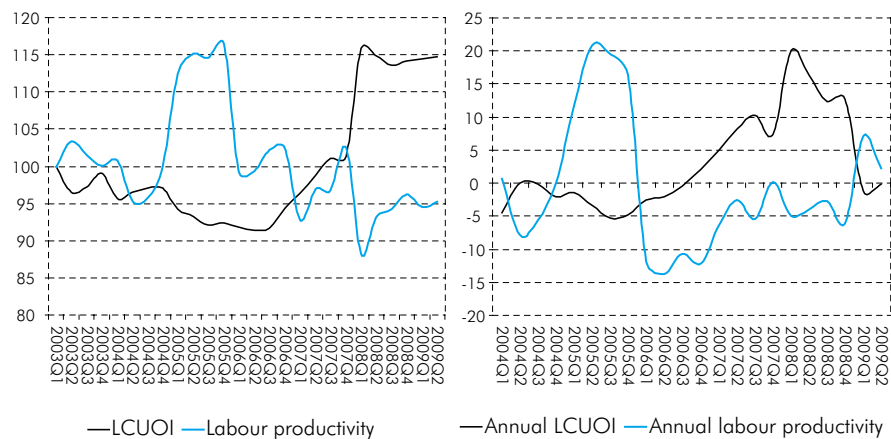


Source: INSTAT, Short-term Statistics

PERFORMANCE OF LABOUR PRODUCTIVITY AND THE LABOUR COST PER UNIT OF OUTPUT

According to the latest data, Labour Productivity Index (LPI) and the Labour Cost per Unit of Output Index (LCUOI) in economy⁵⁵ maintained more evident trends starting from the second quarter of 2008. LPI trend has increased slightly, while the LCUOI has maintained a smooth fall until the second quarter of 2009. The annual change rates of the LPI were positive in the first half of the current year. In the meantime, the LCUOI's annual change rates have reflected the relative cessation of effects of the administrative measures taken in view of declaring wages in the business sector.

Chart 45 Performance of LPI and LCUOI indices (above); annual changes of LPI and LCUOI indices (below)



Source: INSTAT (Quarterly GDP, Short-term Statistics) and Bank of Albania estimates

PRODUCER AND OIL PRICES

The inflationary pressures generated by producer prices on the overall level of consumer prices at home have been declining. The downward trend of the Producer Price Index (PPI) persisted in the second quarter of 2009 for the second consecutive quarter. Impacted by the fall of prices in the international conjunctures, business producer prices were 2.6 percent lower than in the same quarter the previous year.

	PPI	PPI Total processing industry	PPI Food industry	CPI – Processed foods	PPI Extracting industry
Q1:07/Q1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/Q2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/Q3:06	3.6	6.3	14.7	7.3	4.7
Q4:07/Q4:06	7.5	10.2	18.6	10.8	4.5
Q1:08/Q1:07	7.4	-1.5	20.5	11.2	5.6
Q2:08/Q2:07	7.4	6.9	14.6	12.9	2.9
Q3:08/Q3:07	7.1	6.1	7	10	9.7
Q4:08/Q4:07	4.2	1.8	-1.1	7.1	9.2
Q1:09/Q1:08	-1.2	0.6	-5.4	3.6	2.3
Q2:09/Q2:08	-2.6	-1.2	-6.4	1.2	5.8

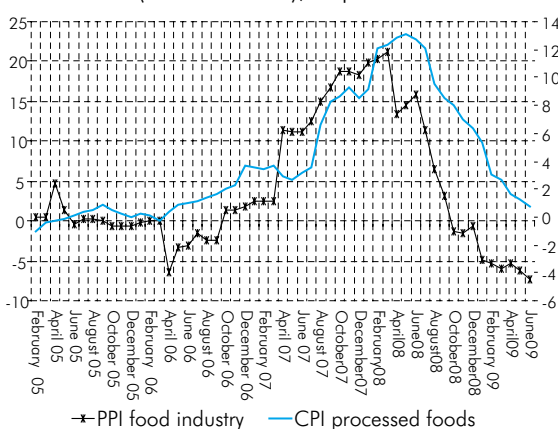
Source: INSTAT and Bank of Albania estimates

Table 12 Annual change rates of some PPI and CPI components of “processed foods” (in percent)

In terms of sectors, the PPI declined in the industrial components sharing the main weight. The PPI in “processing industry”⁵⁶ declined in annual terms for the first time following the recurrent increase for four consecutive quarters. “Food industry” provided the main contribution to the decline of this index. Its index was 6.4 percent lower than in the same quarter the previous year. This trend curbed the increase in “processed foods”, which recorded more moderate growth rates than in the previous quarter. The upward trend of producer prices in “extracting industry” persisted in the second quarter of 2009, although at more contained rates than in the second half of 2008.

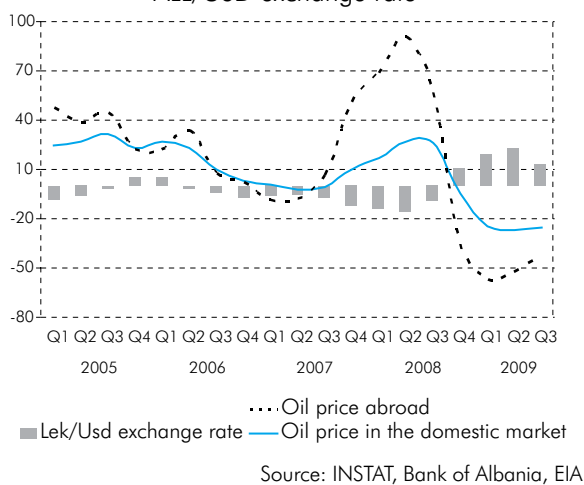
The oil price movements in the international markets were passed through to the domestic oil market and later to the Albanian consumers and business activity, though at more contained rates. After reaching the lowest average price per litre in the first quarter of 2009, oil price began to increase. In the third quarter of 2009, average oil price per litre in the retail market was ALL 114.4, approximately 7 percent higher than the previous quarter’s average. Owing to the appreciation of the Albanian Lek against the USD by 5 percent in quarterly terms, the oil price increase is markedly lower than in the international markets. Although the oil price has been upward, the last year’s high comparative base causes the oil price annual rates to record negative values.

Chart 46 Annual change of the indices of goods included in the PPI (right-hand axis) and CPI (left-hand axis), in percent



Source: INSTAT and Bank of Albania estimates

Chart 47 Annual change of oil price, domestically and internationally, and the ALL/USD exchange rate



The index of “service to personal vehicles”, which is closely related to the oil price movements in the market, increased by 3.7 percent in quarterly terms during the third quarter of 2009. In annual terms, it dropped by 12.5 percent, providing a negative contribution to the performance of average annual inflation rate in the third quarter of 2009. By contrast, the indices of “services” and “transportation services”, which are less related to the performance of oil price in the retail market, have undergone minor changes.

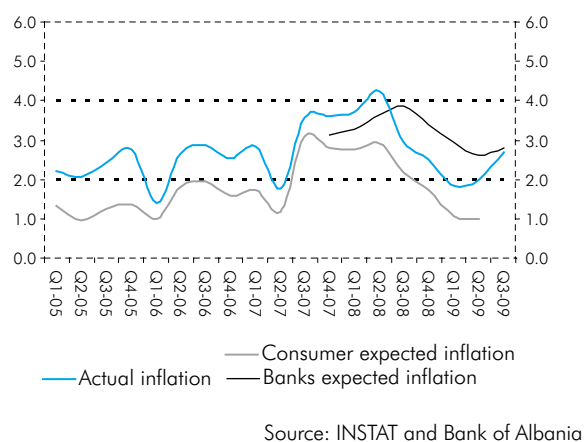
IV.4 EXPECTATIONS FOR THE PERFORMANCE OF PRICES IN ECONOMY

EXPECTATIONS FOR INFLATION

Expectations for inflation over the short and medium term as measured by different market agents are anchored around 1-3 percent band⁵⁷. Consumer expectations for inflation after 12 months remain lower than the other economic agents’ expectations.

Consumer expectations in the second quarter of 2009 show that inflation after 12 months will be about 1 percent, deepening the downward trend commenced in the last quarter of 2008. The rationale behind this figure is the low inflation rates during January to September 2009. In the confidence survey of the second quarter of 2009, businesses expect the inflation after 12 months to be about 2.6 percent. The last survey held with bank experts in October 2009 shows that they expect the inflation after 12 months to be about 2.7 percent.

Chart 48 Consumer and banks’ experts expectations of annual inflation after 12 months and the annual inflation rate measured by the CPI (in %)

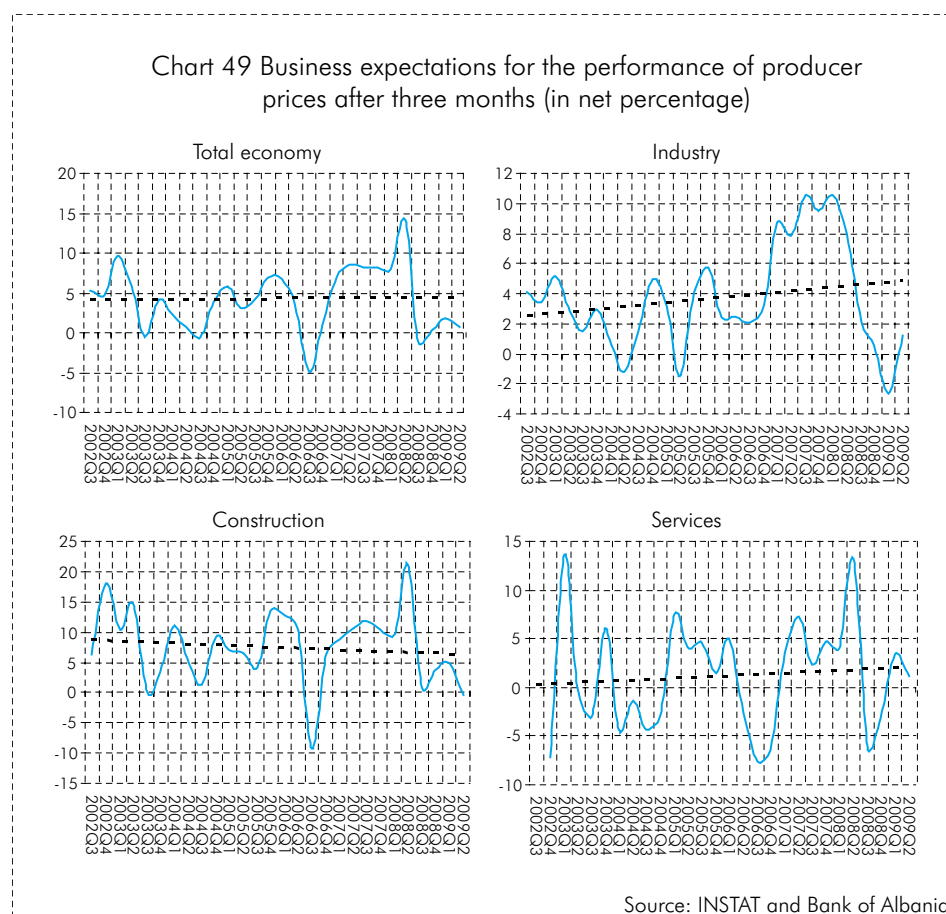


Banks’ expectations have generally been higher than consumer and business expectations. These expectations manifested a slight upward tendency in the third quarter of 2009 after three consecutive quarters of downward trend.

EXPECTATIONS FOR PRODUCER PRICES

According to the confidence survey results of the second quarter of 2009, businesses expect the producer prices after three months to slightly fall. However, the expectations were reverse in terms of sectors: in construction and services, businesses expect the producer prices to fall in the third quarter of 2009, while industry-related businesses expect them to increase.

Expectations for producer prices are for all sectors lower than in the previous year and lower than their historical average.



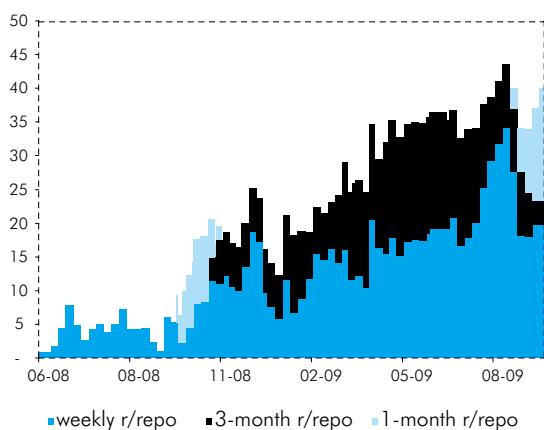
V. FINANCIAL MARKETS, INTEREST RATES AND THE EXCHANGE RATE

In September, the markets signalled the recovery of confidence in the financial institutions one year after the deepening of the global crisis. Against the backdrop of improved liquidity conditions, the volume of borrowing in the interbank market was lower, hence exerting no pressure over the short-term interest rates. Long-term interest rates in the government securities' primary market remained high as a result of the low financial market development, continuous demand to finance the budget deficit and the relatively high risk premiums. Interest rates on new ALL deposits have been relatively high, hence attracting considerable savings. In the meantime, the intermediation cost has lowered. These developments were coupled with high exchange rate volatility in September and October, giving rise to uncertainty in the market.

INTERBANK MARKET

The third quarter of 2009 attested to an improved liquidity situation as a result of the return of deposits to the system, the relatively lower instability of

Chart 50 Bank of Albania's open market operations (in billions of ALL)



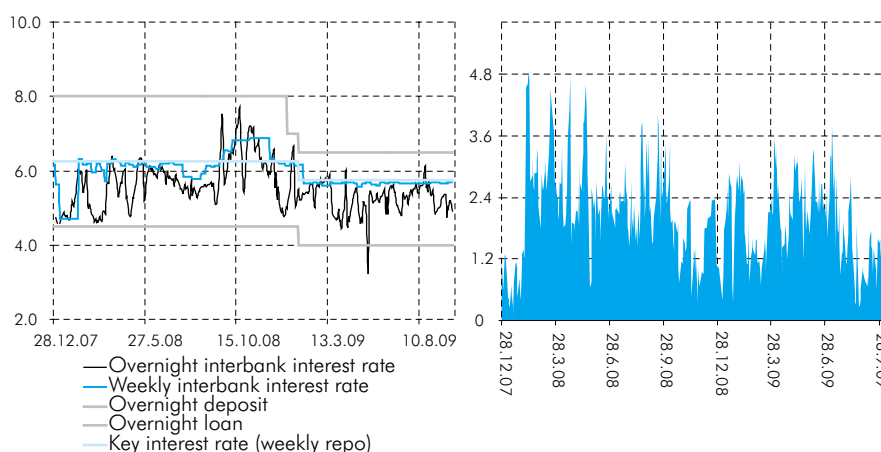
Source: Bank of Albania

currency outside banks and the continuous injection of liquidity by the Bank of Albania through the open market operations. The Bank of Albania provided liquidity through its main instrument, one-week repo agreements, which averaged ALL 23 billion in the third quarter vis-à-vis ALL 17 billion in the second quarter. In addition to one-week repo agreements, the Bank of Albania has, until September, intervened using the fine tuning operations of 3-month maturity term. After September, the 3-month maturity shifted to 1-month maturity reflecting the system's structural need for liquidity.

Banks' operations in the interbank market attested to lower traded volumes over the course of the third quarter of 2009. The operations in this market mainly aimed at meeting the short-term liquidity needs. The

volume of one-week transactions reduced leading to lower total borrowing volume. Interest rates were more volatile owing to the replenishment of the required reserve in given periods and to factors related to the supply and demand of individual banks against a background of frequently inefficient liquidity management. The use of the reserve and other deposit instruments as an option to the interbank market have often had an impact over the performance of traded volumes in this market.

Chart 51 Interest rates in the interbank market, in percent (left-hand) and the interbank market volume, in billions of ALL (right-hand)



Source: Bank of Albania

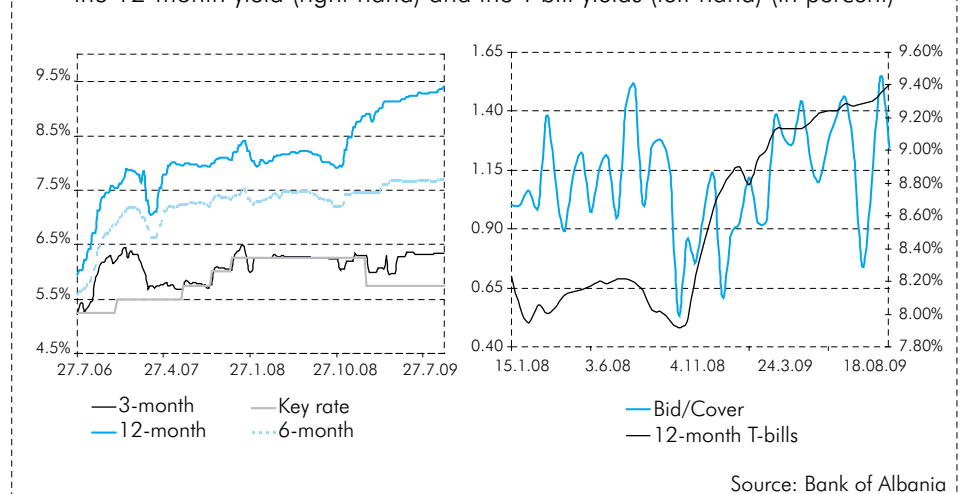
Starting from July 2009, the total traded volume in the interbank market has been downward. The interest rates have gone up, particularly the overnight interest rates, which have increased at more rapid paces in days of low transaction volumes. This performance shifted in September when the interest rates and the interbank transactions' volume began to go downward. The

flattening of liquidity pressures and the more uniform distribution of liquidity in the system was reflected in mitigated interest rates volatility⁵⁸. Liquidity in the system increased during this period owing primarily to the banks' performance in the primary market and the mitigated seasonal effects that generally characterize these months. In average terms, overnight interest rate in the interbank market rose to 5.30 percent in the third quarter vis-à-vis 5.08 percent in the second quarter. One-week interest rate rose to 5.67 percent, up by 0.02 percentage points. In 2008, they were respectively 5.67 and 6.07 percent. Total borrowing volume reduced to ALL 1.49 billion or 0.85 billion less than in the previous quarter. Overnight and one-week borrowing reduced by ALL 0.3 and 0.5 billion to ALL 1.32 and 0.23 billion.

PRIMARY MARKET

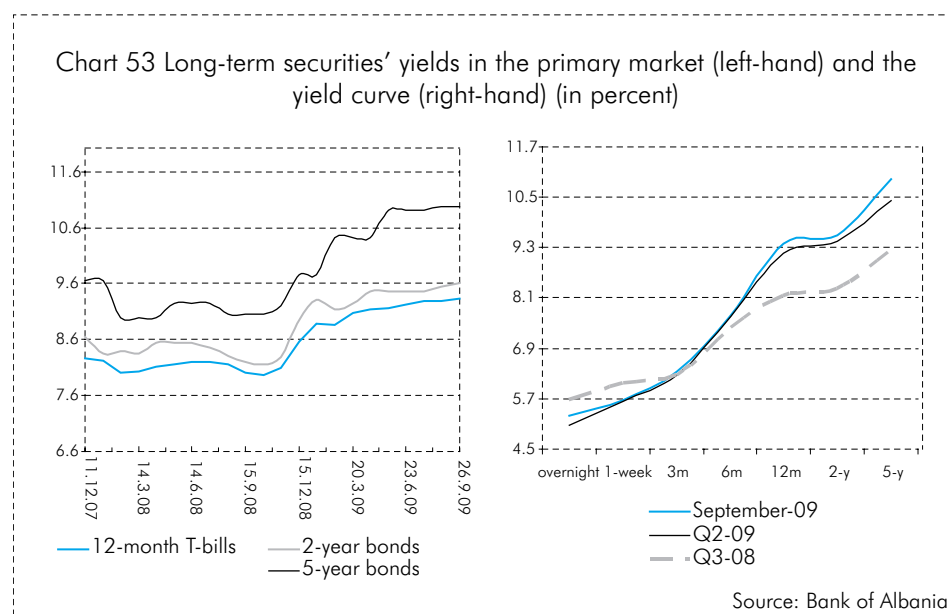
Primary market yields maintained the upward trend commenced in the year-end 2008. Government securities' yields increased and the maturity spreads remained higher than in 2008. The pressures for their increase have been fuelled by the higher risk perception of banks at a time when their high participation in auctions has not provided any contribution to abate the pressures. The increase of the yields for all maturities persisted during these months being also affected by the higher issues over this period. The more pronounced increase of 12-month T-bill yields was also transmitted to 12-month bond yields, giving rise to upward yield curve slope. As at end the third quarter, the yield on 12-month T-bills was 9.40 percent, up by 0.16 percentage points from the end of June. In average terms, the yield on 12-month T-bills was 0.14 percentage points higher than in the previous quarter and 1.18 percentage points higher than in 2008. The yields on 6 and 3-month maturity T-bills maintained the same performance, though at more contained rates. As at end of September, 6-month T-bill yield was 7.69 percent, up by 0.02 percentage points from the end of June. For the same period, 3-month T-bill yield increased 0.04 percentage points to 6.35 percent.

Chart 52 Bid to cover ratio for the deficit financing in the primary market and the 12-month yield (right-hand) and the T-bill yields (left-hand) (in percent)



Source: Bank of Albania

The yields in the bond market attested to a similar performance as the T-bill yields. Bond yields increased owing primarily to the higher risk perception of the instruments employed in the securities' market. Banks' participation in auctions was high⁵⁹, however, as in the case of T-bills, it did not have any effect on the upward performance of this market. In September, the yield on 2-year bonds was 9.60 percent and the yield on 5-year bonds (of variable interest rate) was 10.97 percent, up by 15 and 5 basis points, respectively, from the previous quarter. The higher yields on these instruments have primarily reflected the increase of the yields on 12-month T-bills at a time when the accepted margins have reduced. In the auction held in October 2009, the yield on 3-year bonds rose 0.29 percentage points to 9.90 percent.



INTEREST RATES ON NEW DEPOSITS

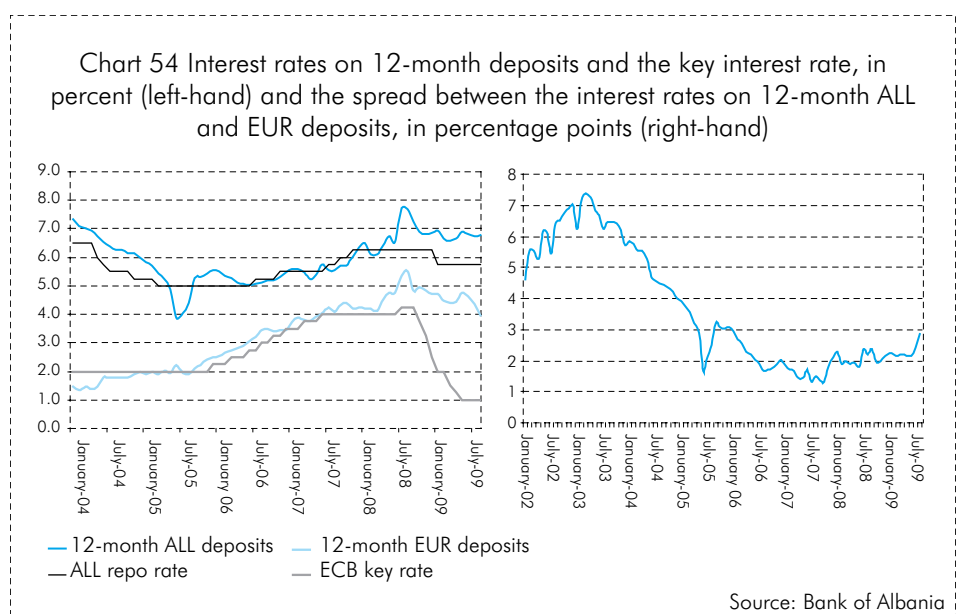
In July and August 2009, the interest rates for the two main currencies, the ALL and the EUR, were relatively high maintaining the first half trend. These interest rates reflected the banking system's inclination to attracting new deposits.

Average interest rate on ALL deposits was 5.94 percent in August, up by 0.48 percentage points from the end of the second quarter of 2009. The summer season promotional offers began in the end of the second quarter and persisted for the coming period as well. In terms of maturity, there is a larger concentration of promotional offers for short-term deposits. Relative to the previous year, the interest rates on deposits in August 2009 were 0.77 percentage points lower. The interest rates on deposits in the same period in 2008 rose considerably as a result of the aggressive short-term policies adopted by several banks to increase their market share.

The interest rates on EUR time deposits dropped slightly in the third quarter of 2009. This drop has a greater effect on long-term (12-month) interest rates.

The beginning of the recovery of deposits in the system made a few banks less aggressive in their efforts to attract funds and match the EUR interest rates with the cost of borrowing in this currency. Weighted average interest rate on new EUR deposits was 2.27 percent in August, down by 0.01 percentage point from the end of the second quarter. Interest rates on 12-month deposits were 3.95 percent, down by 1.56 percentage points from August 2008 (ECB's key interest rate has reduced by 3.5 percentage points during this period).

The spread between the interest rates on 12-month ALL and EUR deposits increased markedly in August owing to the reverse shift of the interest rates on new ALL and EUR deposits.



INTEREST RATES ON NEW LOANS

The bank lending standards eased slightly in the third quarter of 2009 driven by the more stable economic situation at home. In order to avoid the exchange rate risk, banks have mainly promoted lending in the national currency, the ALL.

In contrast to the first half of 2009, the interest rates on ALL loans were lower in the last two months of summer. In July and August, the weighted average interest rate on new ALL loans averaged 12.86 percent or 0.79 percentage points lower than in the first half of 2009. This pronounced drop owes partly to special preferential terms lending to individual bank customers. Broadly speaking, the margin to reference interest rates has narrowed. Banks applied eased lending terms on new short-term loans of up to 12-month maturity, which have the largest share of new loans for meeting business liquidity needs.

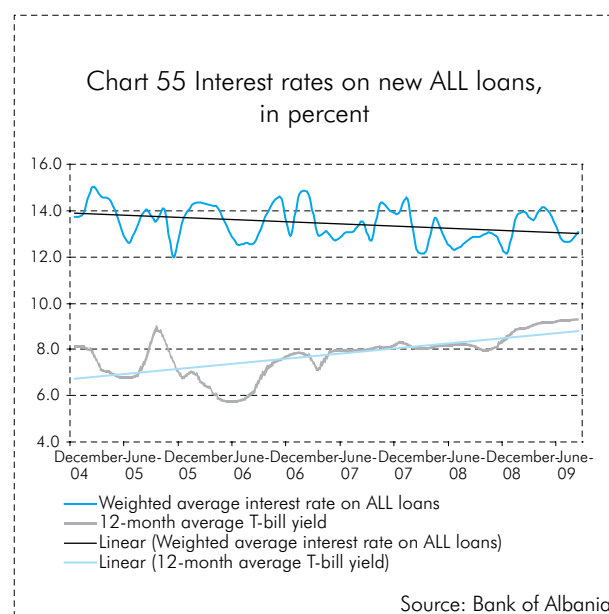
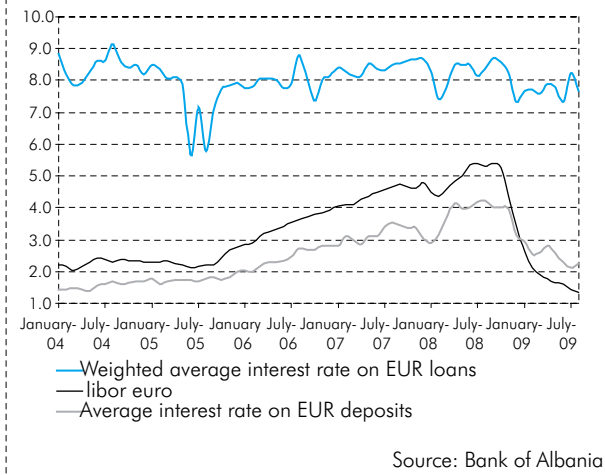


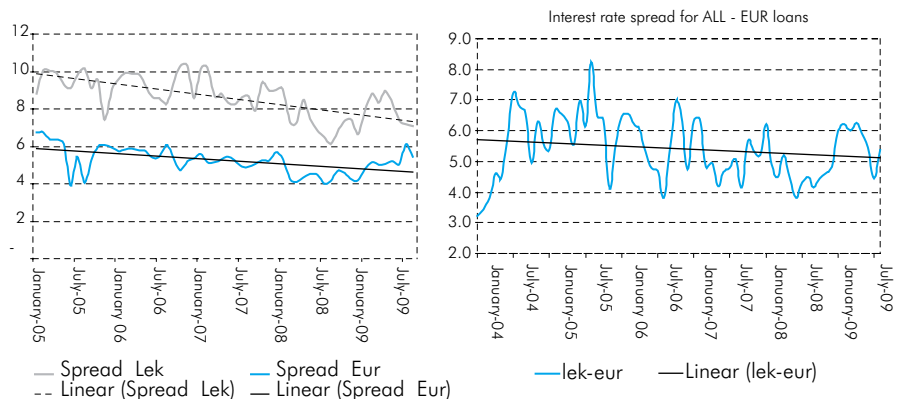
Chart 56 Weighted average interest rate on 12-month EUR, EURIBOR deposits and loans (in percent)



Interest rates on EUR loans were relatively high in July and August. Average interest rate on new EUR loans was 7.96 percent, up by 0.29 percentage points from the first half of 2009 and down by 0.30 percentage points from the previous year. Despite the lower LIBOR rates in EUR and EURIBOR in the international markets, the fluctuation of interest rates on new EUR loans was related to the cost of funds in this currency in the domestic market and the banks' tight policies for lending in foreign currency.

Intermediation cost in ALL declined in August 2009 to 7.11 percentage points from 8.27 percentage points in the first half. Average intermediation rate for the EUR increased markedly in July to later decline again in August. It averaged 5.77 percentage points, up by 0.73 percentage points from the average in the first half of 2009.

Chart 57 Average intermediation margin in ALL and EUR (left-hand) and the spread between average interest rate on ALL and EUR loans (right-hand), in percentage points



EXCHANGE RATE

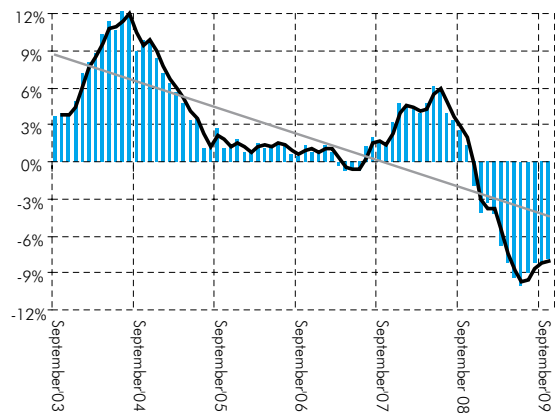
In the third quarter of 2009, the nominal effective exchange rate of the ALL relative to the main foreign currencies attested to a slight shift from the depreciation trend shown in three consecutive quarters since the beginning of the global financial crisis' effects on the domestic foreign currency market. After the high depreciation by -10.2 percent in May, the NEER manifested more moderate downward rates which move from -8.3 percent to -7.9 percent in annual terms. This performance seems to owe mainly to the partial termination of the comparative basis' statistical effect. In 2008, the USD to the ALL showed an upward trend, converging toward the current ratio in the market, and reducing the NEER in that period.

In the domestic foreign currency market, the ALL depreciated in the third quarter of 2009 both against the USD and the EUR. In quarterly and annual terms, the ALL depreciated 0.2 and 7.7 percent against the EUR. Against the USD, it appreciated 4.7 percent in quarterly terms while depreciating 13.1 percent in annual terms⁶¹. EUR to ALL has manifested reverse trends during this quarter. In July, the ALL was strong against the EUR as a result of the foreign currency inflows characterizing the summer season. In the following months, this effect terminated early owing to the market positioning towards the end of seasonal supply, hence depreciating the ALL against the EUR. In September, this trend was more pronounced reflecting the swinging supply-demand ratio effect.

The devaluation of the exchange rate has been triggered by the swinging foreign exchange supply-demand ratio, owing to the high current account deficit and the expected slowdown in the capital account inflows. To a large extent, the devaluation of the ALL owes to the market agents' lack of confidence in the national currency, expressed in higher EUR to ALL exchange rate volatility compared with the previous quarter and the same period the previous year.

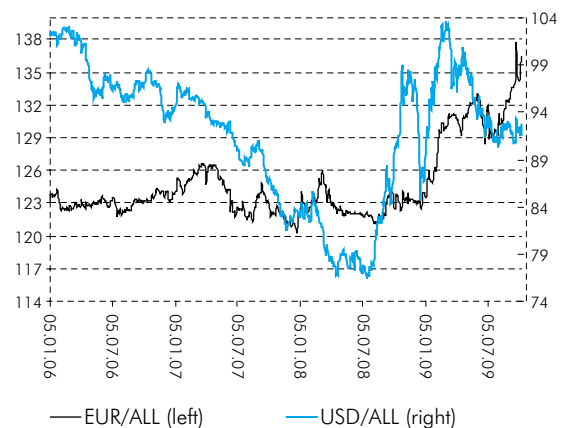
On the other hand, the USD/ALL exchange rate reflects to a large extent the performance of the USD in the international markets. In annual terms, the USD appreciated 5.3 percent against the EUR,

Chart 58 ALL annual changes in nominal effective terms (NEER⁶⁰)



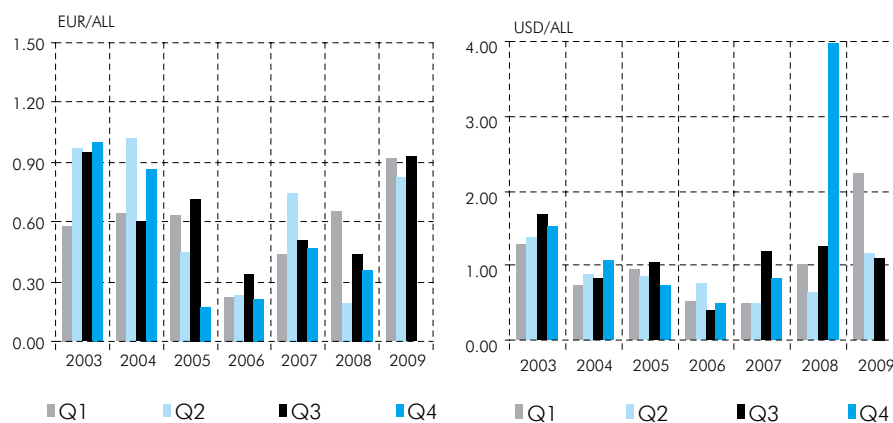
Source: Bank of Albania

Chart 59 Daily performance of EUR/ALL and USD/ALL exchange rate



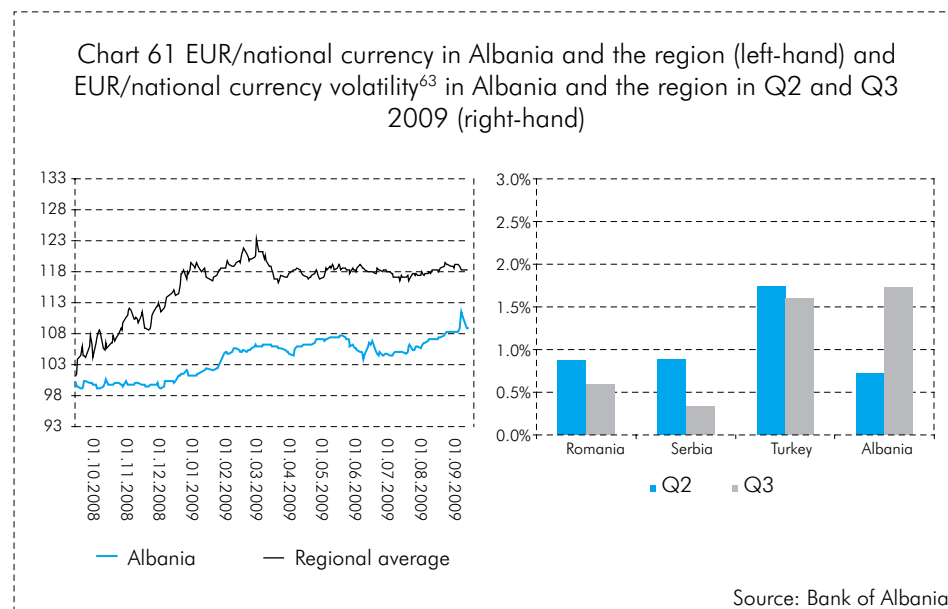
Source: Bank of Albania

Chart 60 ALL exchange rate volatility⁶² in quarters



Source: Bank of Albania

while relative to the previous quarter it depreciated 5.0 percent. Worth noting however, is that the volatility of this ratio, albeit at high historical levels, has been more moderate than in the previous quarters since the financial crisis emergence.



In a regional context, despite the relatively satisfactory position of the EUR/ALL exchange rate in marginal terms, the ALL seems to have depreciated at more accelerated paces during the last quarter relative to the other currencies in the region. This performance is also attested by the relatively high volatility of EUR/ALL during this period.

Box 4 Use of Unconventional Monetary Policy Measures

In order to achieve their objective and depending on the operational regime they apply, central banks employ a number of instruments in view of implementing the monetary policy. In many countries, the key interest rate is the main instrument applied. The level and changes in the key interest rate affect the economy via two main transmission channels: the interest rate channel and the credit channel. The description of the above mechanisms refers to a “conventional monetary policy”. However, in specific cases, in the event the conventional monetary policy measures do no longer function satisfactorily, central banks use alternative measures called “unconventional monetary policy measures”.

The need for unconventional monetary policy measures arises in periods of “crunch” when the transmission mechanism does not function properly. In this case, the interest rate channel becomes ineffective when the key interest rate reaches the zero bound and when it cannot be lowered further or when it would not affect the economy as a result of the “liquidity trap”⁶⁴. On the other hand, the credit channel becomes ineffective when banks’ ability to lend reduces. This situation may arise not only as a result of the reduction in the financing funds but also as a result of

the sharp deterioration of the economic conditions and economic uncertainty. These cases were evidenced upon the emergence of the global financial crisis. Although conceptually this situation is not unfamiliar -as is the case of recession in Japan- the massive and more sophisticated implementation of these measures took place only after the pressure exerted by the financial markets. In order to cope with the new challenges triggered by the non-functioning of the main transmission channels, central banks created some measures that were beyond the conventional operations. These unconventional monetary policy measures can be summarized in three categories and they aim respectively to:

Increase massively the quantity of money in circulation, known as “quantitative easing”. Massive money creation aims to circumvent the obstacle of a blocked interest rate channel. In these cases, the central bank attempts to “satisfy” economic agents’ demand for money, in the hope that these agents will directly spend their excess cash holdings. In some ways, this is tantamount to creating a new monetary policy transmission channel that does not depend on the interest rate. However, the efficiency of this channel, to a large extent, depends on the stability of economic agents’ short-term demand for money and on the purposes the absorbed liquidity is used for. Very often, the supply of money is channelled to only one economic agent, the “government”. The purchase of government bonds by central banks is therefore one of the most widely used forms of quantitative easing.

Influence the slope of the yield curve in order to guide economic agents’ expectations. To do this, the central bank can commit explicitly to keeping its key interest rate at a very low level for a considerable period. Under this policy, the central bank may also extend the maturity of its open market operations. This strategy is even more effective if the central bank’s monetary policy framework includes a quantified definition of price stability, in order for the economic agents to be prepared for deviations from the easing policy in case the objective is infringed.

Unfreeze the credit markets by directly purchasing the securities on these markets in order to exert downward pressure on risk premia, known as “credit easing”. In more concrete terms, the central bank can broaden the range of eligible assets for its main open market operations and directly purchase the debt securities from the economic agents. These operations have a two-fold impact: they revive the markets for these credit instruments and they directly provide financing to the economy. However, credit easing measures are more effective in economies with advanced financial markets, where companies primarily obtain financing by issuing securities and where loans to households are largely securitised through these instruments. The economies with undeveloped financial markets and where bank intermediation plays a key role, “quantitative easing” measures and those that influence the yield curve appear to be more relevant.

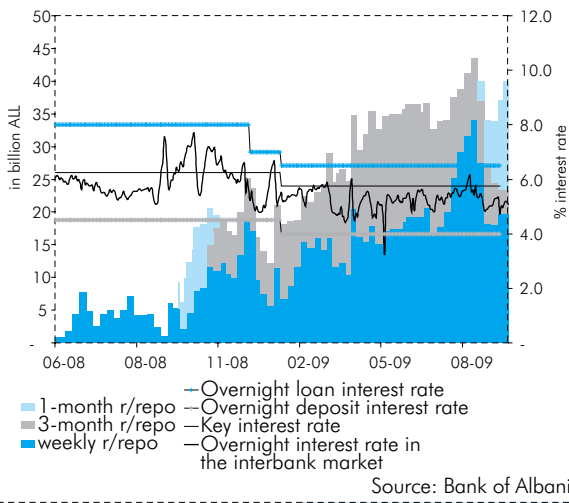
Table 13 Measures taken by central banks to impact the interbank market

	Broadening of the range of acceptable counterparty	Broadening of the range of quality of acceptable collateral	Extension of maturity
Federal Reserve	√	√	√
Bank of England	√	√	√
European Central Bank	√	√	√

Source: Central banks

In the case of Albania, the use of unconventional monetary policy measures was conditioned by the level of development of the domestic financial market, the same factor that prevented the complete and instant pass-through of the global crisis to

Chart 62 Bank of Albania interventions in the money market



Albania. But on the other hand, the psychological effect was often coupled with situations of panic, primarily reflected in the form of withdrawal of deposits by the public and the tightening and curbing of lending by the financial institutions. When the use of the key interest rate was conditional, the unconventional monetary policy measures mainly focused on creating easing liquidity conditions and boosting lending activity. Against this background, the Bank of Albania provided ample fixed-price (key rate) liquidity and the maturity of the main open market operations shifted to the 3-month maturity. The range of the collateral used in these operations was expanded and the use of the required reserve increased. On the other hand, the symmetric corridor of overnight deposit and loan interest rates narrowed to an asymmetric one. These measures brought about the increase in the central bank's balance sheet and have helped to overcome the last year's critical phase.

ENDNOTES

- ¹ BRIC stands for Brazil, Russia, India and China.
- ² Aggregate investments and exports fell 15.4 and 23.9 percent, respectively, in annual terms.
- ³ Activity in construction industry fell about 26 percent in annual terms, while retail sales dropped 9.1 percent.
- ⁴ The spread between 12-month and 1-month EURIBOR interest rates in the money market has increased by 13 basis points during these three months.
- ⁵ From the peak of 4.6 percent in March 2008.
- ⁶ Measured as the moving average.
- ⁷ "Vegetables including potatoes" and "fruit" contributed by 0.9 and 0.5 percentage points, while annual inflation marked 2.1 percent. These two sub-items' share in total CPI is 9 percent.
- ⁸ This sub-item has the largest share (51 percent) within this item.
- ⁹ The number of tourists has increased in the coming period.
- ¹⁰ The average of two measures (permanent exclusion and trimmed-mean).
- ¹¹ Average of January 2000 – September 2009 is 0.8 percent.
- ¹² They include: "trade, hotels and restaurants", "transportation", "post and telecommunication". "Other services" include: financial services, education, health, public administration, protection and mandatory social insurance etc..
- ¹³ According to the GDP for Q2 2009 (INSTAT), agriculture includes the value added in the economic activities in agriculture, hunting and forestry.
- ¹⁴ The use of production capacities is measured by the industry, construction and services business confidence surveys through direct questions.
- ¹⁵ The performance of house and rent prices is analyzed based on their respective indices and they are measured by the Bank of Albania. They cover only the city of Tirana.
- ¹⁶ Data used for the construction of the House Price Index. The largest portion of house prices is expressed in EUR, which appreciated 7.7 percent against the ALL.
- ¹⁷ Data obtained from the Construction Confidence Survey.
- ¹⁸ House price/rent ratio is one of the simplest indicators used to assess whether the price of houses has appreciated, comparing the current values of the ratio to its historical values.
- ¹⁹ Measured as the weighted average of CPI in Italy and Greece.
- ²⁰ Tradable inflation was 3.0 percent in Q3, up by 1.6 percentage points from the early-year level. Inflation of "food and non-alcoholic beverages" marked the peak annual increase rate in Q3 (5.4 percent) compared with the previous five quarters.
- ²¹ Nominal GDP for 2009 is based on the IMF estimation of nominal GDP: ALL 1,129,000 million (IMF's Sixth Review under PRGF Arrangement). The values of different indicators expressed as a share of GDP refer to cumulative data for Q3 2008-Q2 2009.
- ²² The values of these ratios refer to cumulative data from Q3 of the previous year to Q2 of the reference year.
- ²³ This item's balance posted a deficit of EUR 10.6 million or 40 percent narrower than the deficit posted in Q2 2008.
- ²⁴ This account's surplus amounted to EUR 236.5 million, up by 1.5 percent in annual terms.
- ²⁵ Trade exchanges reduced 12.7 percent in monthly terms and 12.3 percent in annual terms.
- ²⁶ In both annual and quarterly terms. Travel services' account balance had a deficit of EUR 30 and 10 million, respectively.
- ²⁷ Net current transfers totalled EUR 236.5 million in Q2 2009 compared to EUR 233.1 million the previous year.
- ²⁸ Official inflows amounted to EUR 11 million from EUR 6 million and 2 million in the previous year and the previous quarter.
- ²⁹ As a share of GDP, they accounted for 12.6 percent in Q2 2008. The figure provided in the text refers to cumulative data for the period Q3 2008-Q2 2009.
- ³⁰ FDI in Albania increased by 2.6 times compared with Q2 2008.
- ³¹ In 2006, 2007 and 2008, they grew 21.6, 86.0 and 35.7 percent, respectively, in annual terms.
- ³² Early 2009 projection.
- ³³ This figure refers to the moving sum of the primary deficit for the period September 2008-

August 2009.

³⁴ VAT revenue's contribution to the increase of total revenue for the first eight months of 2009 was about 2 percentage points. In 2008, its contribution was 7 percentage points.

³⁵ As part of the fiscal package approved in July 2007, tax on profit reduced from 20 to 10 percent starting from 1 January 2008.

³⁶ This may have also been triggered by the decrease of the employer's contribution by 5 percentage points starting from 1 May 2009.

³⁷ Their increase in annual terms is 40, 28 and 28 percent, respectively.

³⁸ Excluding January and March.

³⁹ Monthly nominal increase of expenditure.

⁴⁰ Syndicated loan is a loan borrowed by the government from a group of resident and non-resident banks in Albania. Its full settlement will take place in 2012. The disbursed syndicated loan totalled EUR 192.6 million compared with the early-year projection of EUR 250 million.

⁴¹ They refer to the receipts obtained from the privatization of ARMO (a portion of which were transferred to the 2009 account), OSSH, a part of AMC and the United Bank of Albania stocks, and the licence granted to the fourth mobile telephony.

⁴² Direct loan is negative since it refers to the direct loan extended to the government in February 2009 but effective in the 2008 account.

⁴³ "Other" is negative (-) since it reflects the change in the government account.

⁴⁴ The statistical effect of individuals' financing of ALL 11 billion to the annual M3 is about 1 percentage point relative to the current annual M3.

⁴⁵ Preliminary data for September.

⁴⁶ Monetary aggregates' data excluding the price change effect.

⁴⁷ As a result of the ALL devaluation against the EUR in August.

⁴⁸ Excluding the exchange rate effect.

⁴⁹ The figures shows in the lending analysis refer to data that exclude the exchange rate effect.

⁵⁰ The chart on business loans by sectors of economy shows nominal values.

⁵¹ Short-term Statistics (INSTAT).

⁵² According to Short-term Statistics, INSTAT, excluding "agriculture".

⁵³ Average Wage Index is measured as the ratio of wage fund index to the number of employees' index.

⁵⁴ Budget and non-budget.

⁵⁵ Excluding "agriculture" since it is not covered by Short-term Statistics (INSTAT).

⁵⁶ The sub-items of this industry cover 67.5 percent of the PPI basket.

⁵⁷ Information obtained from the periodical surveys held by the Bank of Albania.

⁵⁸ The standard deviation of overnight interest rate in the interbank market was 0.29 percent in this quarter compared with 0.43 percent in the previous quarter.

⁵⁹ Bid to cover ratio in the bond auction was above 1 on average.

⁶⁰ 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 ALL.

⁶¹ In Q2 2009, the USD appreciated 18.8 percent against the ALL.

⁶² Measured as the quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.

⁶³ EUR/ALL and USD/ALL volatility is measured as the standard deviation in monthly terms.

⁶⁴ The term "liquidity trap" is used in Keynesian economics to refer to a situation where the demand for money becomes infinitely elastic, i.e. where the demand curve is horizontal, so that further injections of money into the economy will not serve to further lower interest rates.