

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

MONETARY POLICY REPORT FOR
THE THIRD QUARTER OF 2010

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Published by:

Bank of Albania, Sheshi "Avni Rustemi", Nr.24, Tirana, Albania

Tel.: 355-4-2222230; 2235568; 2235569

Fax.: 355-4-2223558

E-mail: public@bankofalbania.org

www.bankofalbania.org

Printed in: 850 copies

Printed by Adel PRINT

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OBJECTIVE

The primary objective of the Bank of Albania is to achieve and maintain price stability. Promoting long-term investments, maintaining the purchasing power of money, enhancing the efficiency of fund allocation in economy and safeguarding financial stability are some of the benefits that an economic environment characterized by stable prices provides. This is the greatest contribution that the central bank can make in order to sustain a stable and long-term economic growth.

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

In view of achieving this goal and strengthening its transparency, the Bank of Albania prepares and releases the Monetary Policy Report. This Report is the main instrument the Bank of Albania communicates its monetary policy to the public. It provides a thorough assessment of the latest macroeconomic developments and the factors that have affected and are expected to affect the performance of consumer prices at home.

Monetary Policy Report for the third quarter of 2010 was approved on 26 October 2010 by the Supervisory Council of the Bank of Albania. The economic analysis in this Report is based on the latest available statistical and qualitative data as at 15 October 2010.

I. FOREWORD BY THE GOVERNOR

The performance of the Albanian economy during the third quarter of 2010 reinforced the main developments in the first half of the present year, featuring gradual recovery of aggregate demand, lower risk premium and consolidation of macroeconomic stability. Broadly in line with our projections, economic growth has firmed up and its base seems to have broadened. CPI inflation and expectations have been anchored close to the Bank of Albania's target for inflation. The external position of the Albanian economy has recovered and the exchange rate is more stable. In addition, liquidity in the system has increased and the interest rates have generally been downward.

These highlights reflect, *inter alia*, the macroeconomic policies pursued over the course of this period. Monetary and fiscal policies have, in a concerted manner, aimed at fuelling aggregate demand and economic growth, ensuring at the same time the preservation of macroeconomic balances. State budget revision in July put emphasis on the measures required to be taken in view of maintaining medium and long-term fiscal sustainability, hence implying lower fiscal stimulus in the short-term. This revision paved the way for pursuing an easier monetary policy. The key interest rate lowered by 0.25 p.p., hence yielding the most stimulating monetary conditions during the last decade.

Nevertheless, complex challenges remain for the Albanian economy and the economic agents. Economic growth rate, albeit positive, seems insufficient to yield improvements in the labour market and to lower unemployment. In addition, the sustainability of economic growth remains frail in the short run. Its reliance on foreign demand and export growth may be insufficient against a background of a non-consolidated global economic outlook. Moreover, waning the fiscal stimulus requires greater contribution of the private sector to economic growth, hence bringing consumer and business behaviour to the forefront and accentuating the role of bank credit to their financing. Setting proper equilibrium between short-term stimulus and long-term stability requires courage and diligence from the policy-makers. Promoting long-term economic growth requires ongoing structural reforms, which should aim at broadening the potential growth rate of Albania and underpinning its macroeconomic sustainability.

In what follows I will elaborate on these issues, beginning first with a brief overview of the recent developments in global economy.

The recovery of global economic activity persisted in the second quarter of 2010, while indirect or preliminary data show more moderate growth rates in the third quarter. Economic outlook remains highly uncertain about the effects

of fiscal stimulus withdrawal and the private sector's soundness. Growth in advanced economies and in our main trading partners was moderate due to the correction of private sector's balance sheets, weak lending and labour market, and low consumer confidence. Inflationary pressures remain weak, while the financial markets continue to show high levels of volatility in response to the concerns over the economic outlook and the long-term sustainability of fiscal indicators. In political terms, maintaining macroeconomic co-ordination on a global level and keeping open channels of the movement of goods, capital and technology, are considered priority measures to avoid a second recession. This would certainly provide substantial contribution to the Albanian economy, which remains a net borrower in the global market and that has benefited largely from the growth of demand and global trade in the form of higher exports in 2010.

In light of these developments, and being largely affected by them, the Albanian economy has grown progressively over the year. According to INSTAT, GDP grew by 3.3% in the second quarter of 2010, considerably higher than 2.0% in the first quarter the same year. This growth was mainly driven by foreign demand, while domestic demand performed at more stable rates. This performance was reflected in improved figures in industry, particularly in its export-related sub-branches. Construction and services did not perform alike. The gradual recovery of domestic demand boosted the activity in services further. By contrast, the construction sector continues to suffer from the weak demand in the real estate market, limited financial resources and structural concerns related to its regulation. Indirect economic and financial indicators suggest that economic growth performed similarly in the third quarter as well. The weaker impact of the fiscal stimulus and the deeper trade deficit seem to have been offset by a better performance in tourism over this period.

The more positive economic outlook in the second quarter of 2010 was also reflected in the labour market. Although unemployment rate remained almost unchanged at 13.8%, the higher activity in industry and services increased employment by 1.8%. Nonetheless, the dynamics of these indicators is less promising than the pre-last quarter of 2008 period.

The analysis of economic activity by aggregate demand components allows for a more thorough assessment of the current and expected developments. Available indicators suggest that the economy grew in the second quarter in response to the higher foreign demand. The performance of domestic demand attests to a more positive private consumption, higher private investments and a more positive contribution of the public sector, albeit more moderately than in the previous year. Considering that fiscal stimulus waned further, these developments are believed to have persisted in the third quarter as well.

- Although private consumption indicators are often contradictory, the overall setting shows a better performance compared to the first quarter of 2010. The rise in average wage and employment, the increase in the import of consumer goods and the substantial improvement of the consumer confidence index reinforce and signal

the recovery of consumption in the second and third quarter of 2010. On the other hand, the further decline of remittances and the contraction of consumer loans, the drop in the retail trade index and the higher consumers' propensity to save suggest that the growth rates of consumption remain below the expectations.

- Private investments recorded positive growth rates as evidenced by the increase of capacity utilization, higher imports of capital goods and better performance of investment loans. The further increase of investments in economy is reciprocally related to banking system lending; but ultimately, it will depend on the performance of domestic and foreign demand for Albanian goods and services. The gradual increase of the capacity utilization rate in economy, as reported by business surveys, shows that there is more room for increasing private investments.
- Fiscal policy has been more prudent in 2010 owing to the narrower room for fiscal expansion and the public debt approaching the threshold of 60% of GDP. Despite the public sector's positive contribution to sustaining economic activity, the fiscal indicators point to its lesser impact on economic growth. On the other hand, the 2010 state budget revision in July, which established the reduction of expenditure and budget deficit by 10% and 23%, respectively, is an expression of the fiscal authority's commitment to safeguarding economic stability. The Government's prudent approach in the first eight months of 2010 actualized in the annual reduction of public expenditure and budget deficit. The latter amounts to ALL 23.2 billion, which is within the projected figure in the budget and about 51% lower than in 2009.
- The high growth rates of exports and the contained performance of imports determined a positive contribution of foreign demand to economic growth in the second quarter of 2010. Foreign trade data on July and August attest to moderate annual growth rates of exports and positive annual growth rates of imports, hence leading to higher trade deficit in this period. The growth of exports in 2010 was fuelled by the recovery of global economy and the favourable conjuncture of prices in the global markets, the depreciation of the exchange rate, the Albanian entrepreneurship efforts to expand the market and by some other factors of transitory nature. Therefore, promoting exports requires undertaking structural reforms which will in turn increase the competitiveness of the Albanian economy. This would ultimately serve to the transition to a more stable economic growth model and, at the same time, to curbing the reliance on foreign financial sources.

Our analyses of monetary indicators conclude that the growth of money in economy is concurrent with the economic agents' demand for monetary assets, hence creating no room for inflationary pressures in the future. Aggregate M3's average growth was 11.2% in July and August, being in line with the nominal economic growth and the enhanced confidence in

the banking system. Its growth during this period was mainly determined by the increase of the banking system's net foreign assets. Private sector credit grew by 9.8% y-o-y, close to the previous quarter's rate. Although the better liquidity figures and the improved banks' balance sheets led to higher supply of banks and provided greater room for lending, the latter has progressed at moderate rates. The concerns related to lending are elaborated at length in the present Report. They seem to mainly relate to the low demand and the lack of worthy projects to lend. On the other hand, the supply of lending and its conditions are tighter. The Bank of Albania is scrutinizing this concern in all its dimensions and, along with the banking system, is considering the required measures that may lead to the growth of lending in line with the cyclical and structural needs of the economy.

Economic and monetary developments elaborated above yielded an environment of contained inflationary pressures. Average annual inflation marked 3.4% in the third quarter. Against a background of below-potential economic growth, and given the absence of monetary-related inflationary pressures, inflation was largely affected by the rise in administered prices. The contribution of the latter's rise to headline inflation is 1 p.p. In the absence of second-round effects, the effect of the rise in administered prices is expected to be transitory, while the inflationary pressures arising from domestic demand remain well contained. On the other hand, the depreciation of the national currency has been declining, hence offsetting the rise of primary commodity prices in the world markets and the increase of inflation in Albania's main trading partners.

The absence of inflationary pressures in the medium run and the contained fiscal policy provided room for pursuing a stimulating monetary policy that sustains economic activity. In July, the Supervisory Council of the Bank of Albania cut the key interest rate by 0.25 p.p. bringing it to the historical low of 5.00%. In addition, the Bank of Albania continued to supply the banking system with the required liquidity in order to ensure the smooth operation of the money markets and to enhance financial intermediation in economy. The favourable liquidity situation facilitated the rapid transmission of the key interest rate cut to the interbank and the primary market, hence allowing for the reflection of this cut in other interest rates in the economy as well.

The Bank of Albania considers that the inflationary pressures remain well contained all through the time frame of the monetary policy effect. The effect of supply-side factors is expected to be offset by the downward pressures arising from the performance of demand in economy. Inflation projections and inflationary pressures remain well-anchored around the Bank of Albania's target. Therefore, the Bank of Albania considers that monetary conditions in economy are adequate to ensure safeguarding price stability in the medium-run and to boost economic development further. The Bank of Albania will, in response to actual and expected economic and monetary developments, continue to pursue a prudent monetary policy, thus providing the required monetary conditions for achieving the inflation target and safeguarding macroeconomic stability.

II. EXTERNAL ECONOMY

ECONOMIC GROWTH AND MACROECONOMIC BALANCES

Against a background of expansionary macroeconomic policies and increase in international trade, global economy showed the first signs of recovery in 2010. However, the sustainability of economic growth could be threatened by certain risks, like the increase of the interest rate on governments' debt and the high unemployment rate. The focus of economic growth has shifted to larger emerging countries.

The major advanced economies experienced positive GDP growth rates. Nevertheless, the priority given to fiscal stimulus is expected to shift to fiscal consolidation. On the other hand, the growth of domestic demand and investments are jeopardized by the devaluation of consumer wealth, increase in the savings rate and the tightening of lending. The focus of economic growth has shifted to larger emerging countries. These economies continue to grow at rapid rates, driven by a stable domestic demand and a positive performance of exports. The decision of their respective central banks to protect their national currencies against the appreciation relative to the major international currencies, by increasing foreign reserve, has contributed to maintaining the competitiveness of their exports. According to IMF's recent estimates¹, world GDP is forecast to expand by 4.8% in 2010.

Table 1 Key macroeconomic indicators

Country	GDP change		Unemployment rate August 2010	Inflation rate	
	Q2-10/ Q2-09	Q2-10/ Q1-10		September 2010/ August 2010	September 2010/ September 2009
USA	3.0	0.4	9.6 ¹	0.3 ²	1.1 ²
Euro area	1.9	1.0	10.1	0.2	1.8
Germany	3.7	2.2	6.8	-0.2	1.3
France	1.7	0.7	10.1	0.0	1.8
United Kingdom	1.7	1.2	7.7 ³	0.0	3.1
Japan	0.4	0.1	5.1	0.3 ²	-0.9 ²

Source: Eurostat, Respective Statistical Institutes

¹ Data for September 2010.

² Data for August 2010.

³ Moving average for the period June-August.

In the second quarter of 2010, Euro area's economy grew by 1.9%, driven by the increase of consumption expenditure and exports. However, the economic growth was not uniform across countries. Germany and France experienced fast growth at a time when the economies of Greece, Spain and Ireland contracted. The most recent data on the performance of economic

¹ World Economic Outlook, October 2010.

activity in the third quarter of 2010 confirm the upward rates of domestic demand although at more moderate rates than in the second quarter. On the other hand, the pressures over the appreciation of the Euro are expected to jeopardize the contribution of exports to economic performance. The agreement to establish a joint crisis management fund by the Euro area countries gave rise to higher borrowing cost for some of these countries in the international market. Hence, in September, the ECB decided to intervene in the market by purchasing government bonds to get the market interest rates down. Unemployment rate was 9.6% in August and annual inflation in September was 1.8%. The ECB forecasts the inflation rates to fluctuate around the current levels, while unemployment rate is expected to go down.

Final estimates for the U.S. economy in the second quarter of 2010 show that its GDP grew by 0.4% q-o-q², down 0.4 p.p. from the preliminary estimate in July. This revision was a result of the lower growth rates of consumer spending, which accounts for about 70% of GDP. The termination of the fiscal stimulus package undertaken by the U.S. Government in the second quarter of 2010 and the persistent decline in the number of employed are expected to affect consumer demand in the following months. In addition, the increase of the savings rate in economy, the decline of housing prices by about 25% in the last three years, combined with the tightening of consumer lending, could contract the purchasing power in economy further³. U.S. economy's incapacity to base its economic growth on the increase of the exports' base reinforced in the second quarter when the trade and current account deficit deepened further. For the third quarter in a row, unemployment rate in September was 9.6%. Annual inflation marked 1.1% in August.

BRIC economies, excluding India, grew at more moderate rates in the second quarter of 2010. Indirect data on China's economic performance show that industrial production and exports grew further despite the government's measures to reduce lending in order to prevent overheating. In Russia, the summer drought is expected to bring annual GDP growth down and increase the inflationary pressures on consumer prices. In India and Brazil, industrial production posted rapid growth rates, albeit lower than in the first half of the present year. At its last meeting, the Reserve Bank of India decided to raise the key interest rate, while the other central banks kept their respective key interest rates unchanged.

Country IV.	Real GDP y-o-y change V.			Annual inflation VI.
	Q1:2010	Q2:2010	2011 ¹	September 2010
Brazil	9.0	8.7	4.1	4.7 ²
Russia	4.9	2.4	4.3	6.1
India	8.6	8.8	8.4	11.5 ³
China	11.9	11.1	9.6	3.5

Source: IMF, OECD, Respective Statistical Institutes

¹ IMF's projections, October 2010.

² Data for September.

³ Data for July.

² 3.0% y-o-y.

³ According to IMF's estimates, World Economic Outlook, October 2010.

Table 2 Key macroeconomic indicators for BRIC economies

REGIONAL ECONOMIES

Economic activity in the regional economies did not progress uniformly. In countries experiencing economic growth, net exports provided the largest contribution. Italy's GDP grew by 1.3% y-o-y in the second quarter of 2010, driven largely by the contribution of exports and domestic demand. By contrast, Greece's GDP contracted owing primarily to the decline of consumer spending by about 5.1% y-o-y. The tight fiscal policy and the business incapacity to access foreign financial resources are expected to provide further adverse contribution to macroeconomic balances in the coming quarters. Turkish economy grew by 10.3% y-o-y in the second quarter of 2010. The rapid growth in aggregate investment, exports and consumer demand contributed to maintaining a similar growth rate as in the first quarter. FYROM's economy grew slightly by 0.4% in the second quarter following the contraction in 2009 and a similar tendency in the first quarter of the present year. The rapid increase of exports provided the major contribution to this positive performance.

Table 3 Economic figures for regional countries

Country	GDP change Q2:10	Annual inflation September 2010	Unemployment rate July 2010
Italy	1.3	1.6	8.2
Greece	-3.7	5.7	11.6 ⁴
Macedonia	0.4	2.0	32.1 ⁵
Serbia	2.0	7.7	19.2 ⁶
Croatia	-2.5	0.9 ²	16.4 ²
Turkey	10.3	9.2	10.5 ⁴
Kosovo	4.6 ¹	2.9 ³	:
Albania	3.3	3.4	13.8 ⁵

Source: Respective Statistical Institutes, EuroStat, EcoFin, IMF

¹ IMF's forecast for 2010.

² Data for August.

³ Data for July.

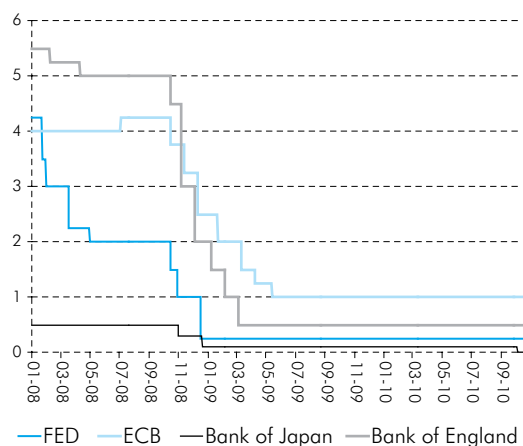
⁴ Data for June.

⁵ Data for Q2 2010.

⁶ Data for April.

: Unavailable data.

Chart 1 Key interest rates



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

Unemployment rate reduced in these selected economies. In the meantime, annual inflation increased in Turkey, FYROM and Greece.

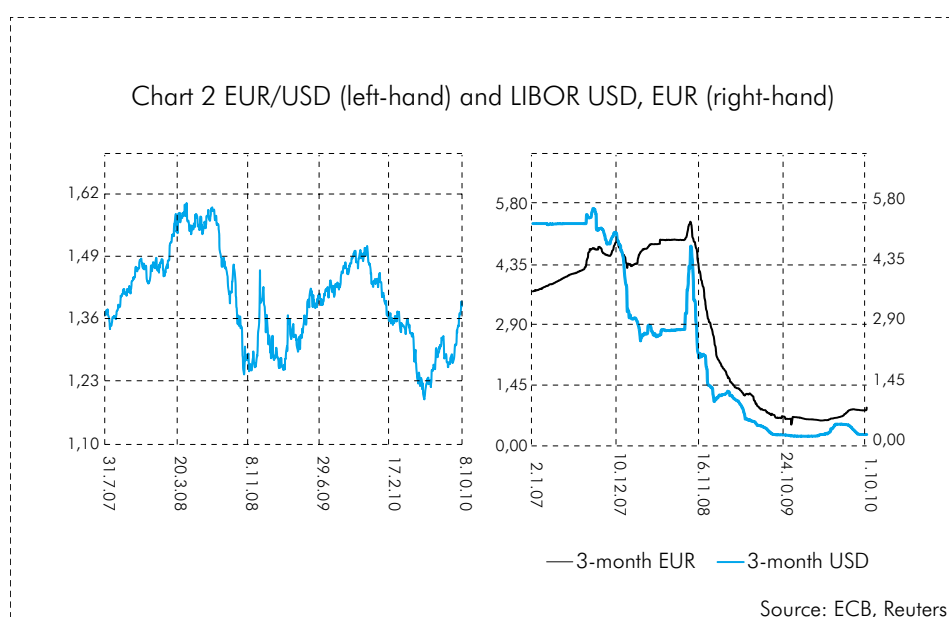
MONETARY POLICY, FINANCIAL MARKETS AND THE EXCHANGE RATE

All the major central banks kept their respective key interest rate unchanged in their September meetings. Keeping the interest rates at low record levels is considered adequate at a time when the macroeconomic stimulus of these economies is considered necessary and current economic growth is jeopardized by the combination of external factors and the weak domestic demand. The ECB kept its

key policy rate at 1%, the Fed at 0-0.25% and the Bank of England at 0.5%. The Bank of Japan lowered its benchmark interest rate to a range of 0 to 0.1%. In three of the major central banks, the last key policy rate changes were made more than a year ago.

Financial markets showed heightened volatility and featured a slight upward performance during this quarter. In Euro area's money markets, the termination of some facilities activated by the ECB during the crisis period was reflected in higher Euribor interest rates at all maturities. In the U.S., the LIBOR interest rate dropped further. The performance of the bond yields in the equity markets was affected by the prudent approach of the key market players. Preliminary data on the performance of economic growth in the major advanced economies, and of global economies in general, show that the growth rate slowed down, thereby yielding lower optimism across the largest portion of the market agents. Their inclination to safer debt securities of the major economies brought about the decline of the yields. In the stock markets, the effect of the positive results of businesses on the quarterly balance sheets diminished slightly due to these factors, being thus reflected in the moderate increase of the main indicators of these markets and heightened volatility. The interest rates in these markets continue to reflect the effect of the ample liquidity injected and the impact of stimulating policies undertaken by the governments to weather the crisis.

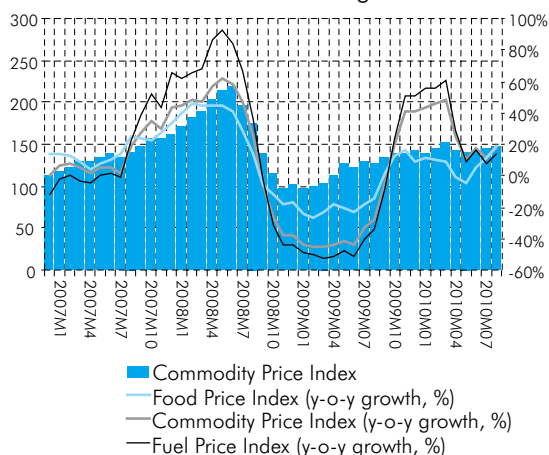
The Euro appreciated against the U.S. dollar, the Japanese Yen, the British Pound and the Swiss Franc during this quarter, hence shifting from the depreciating tendency shown in the first half of 2010. In the beginning of October, 1 Euro traded at USD 1.38, up 12% from the end of June. The Euro appreciated by an average of 1.60% versus the previous quarter.



OIL AND PRIMARY COMMODITY PRICES

The main commodity price indices showed an upward annual tendency in the third quarter of 2010. Only the Food Price Index recorded a considerable

Chart 3 Price indices by main commodities and annual changes

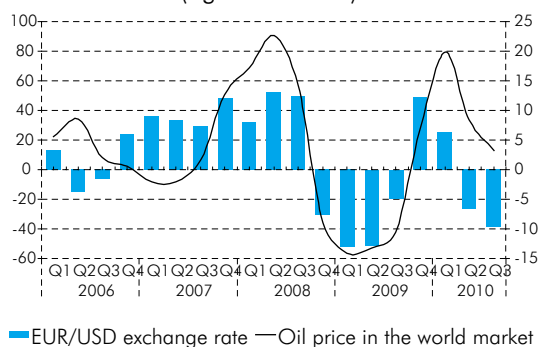


Source: IMF

q-o-q increase. Commodity Price Index increased by 15.5% compared with the previous year. Energy Price Index increased by 12.9% y-o-y. Food Price Index rose 11.6% due to adverse weather conditions in Russia and the expectations for the fall in supply in the short-term. Q-o-q, Commodity Price Index rose 0.1%, Food Price Index rose 7.2%, while Energy Price Index dropped 3.2%.

The rise of food prices was transmitted to the Albanian market as well, at a time when the depreciating tendency of the exchange rate persists, albeit at a more moderate rate. Inflation of “Processed foods” recorded the highest annual growth rate, 4.4%, in the third quarter.

Chart 4 Annual change of oil price in the world market and EUR/USD exchange rate (right-hand axis)*



*Below-zero values of the exchange rate variable in the chart show the depreciation of the Euro; above-zero values show its appreciation.

Source: Eurostat, EIA

Oil price per barrel in the world market has remained broadly in the USD 70 to 85 range. This tendency began to emerge in the third quarter of 2009 when global economic activity recovered. Average oil price per barrel was USD 76.8 in the third quarter of 2010, 12.9% higher than in the same period in 2009. The stable oil price per barrel in the world market was also reflected in the price of oil in the Albanian retail market. ALL/USD exchange rate played a key role in the price volatility.

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

Inflation marked 3.4% in the third quarter of 2010, remaining within the tolerance range and close to Bank of Albania's 3.0% target. The Albanian economy continued to post positive growth rates in the second quarter, albeit remaining below the potential. Weak domestic demand-side inflationary pressures, in addition to the relative exchange rate stability and the anchored inflationary expectations, helped tone down the inflation rate from the high rates in the previous quarter.

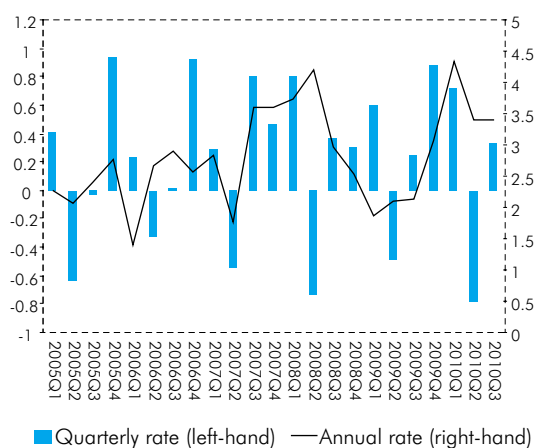
Monetary and economic analysis and inflation forecast models confirm that inflationary pressures will be contained.

III.1 PRICES OF CONSUMER BASKET ITEMS

Annual inflation averaged 3.4% in the third quarter, similar to the previous quarter's rate. After increasing slightly in the first two months of this quarter⁴, annual inflation rate marked 3.4% in September. The performance of the inflation rate reflected the high prices of some food products (mainly processed ones)⁵ and the further rise in some administered prices. Quarterly inflation rate was negative (-0.6%) but lower than in the second quarter. Although the seasonal behaviour was in line with the historical performance, the decrease was 0.5 p.p. lower than the average of the third quarters during the last decade⁶.

Beginning from the third quarter of 2009, the inflation curve has shifted upward in the last 12 months due to the price rise in some administered prices⁷. This effect caused headline inflation to rise by 1 p.p. as at the end of the third quarter. Prices of certain processed foods (bread in particular) rose in the second part of this quarter due to their reliance on import prices. The latter recovered the high levels recorded

Chart 5 Annual inflation by quarters and quarterly inflation, in %



Source: INSTAT, Bank of Albania

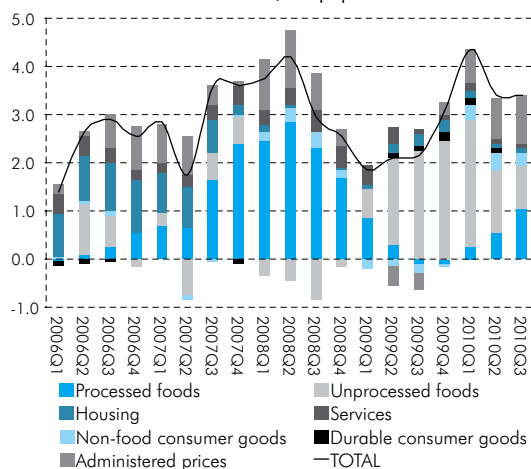
⁴ Annual inflation in July and August was 3.4 and 3.5%, respectively.

⁵ "Processed foods" contributed by 31% to the formation of headline inflation, while the two other items contributed by 29 (administered prices) and 26% (non-processed foods), respectively. The other four items contributed by 14%.

⁶ Based on CPI's seasonal behaviour, this quarter's seasonal factor was 1.4 p.p. versus the average rate of 1.9 p.p. in 2001-2010.

⁷ Worth noting within this item are the energy price rise in the beginning of 2010, the price rise of drinkable water and the rise in public medical service tariffs.

Chart 6 Contribution of key items to annual inflation, in p.p.



in 2008. On the other hand, the higher domestic supply and the relative exchange rate stability pushed the prices of a portion of unprocessed foods down.

“Processed foods” recorded the highest inflation rate in this quarter. The gradual price rise of processed foods, persistent throughout 2010, generally reflects the global conjuncture of food prices and the higher excise for some goods. Inflation of “Bread and cereal” was 3.3% in August and September, while in July 2009 to July 2010 it marked negative rates averaging at -3.0%. This item’s contribution to headline inflation was 1.3 p.p. in September, which is comparable to the average contribution by 1.4 p.p. in September 2007 to August 2008.

Annual inflation of “Unprocessed foods” eased in the third quarter. In September, it hit the lowest rate of 3.1%. After marking a high rate in the first quarter, 13.2%, annual inflation rate dropped to 4.6% in the third quarter. This item’s contribution to the third quarter’s annual inflation was 0.9 p.p., hence slightly offsetting the intensified contribution of processed goods’ prices. In spite of that, the seasonal behaviour of the fall of unprocessed goods’ prices was not as intensive as in the second quarter. Quarterly inflation was almost zero in the third quarter compared to the double-digit negative figure (-11%) in the previous quarter. Hence, the deflationary setting, which shifted the inflation curve of the second quarter downward (-1%), was almost insignificant.

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

	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10
Processed foods (pp)	0.9	0.3	-0.1	-0.1	0.3	0.6	1.1
Bread and cereal (pp)	0.6	0.2	-0.1	-0.3	-0.2	-0.1	0.1
Alcohol and tobacco (pp)	0.1	0.1	0.1	0.2	0.1	0.2	0.2
Unprocessed foods (pp)	0.6	1.8	2.3	2.5	2.6	1.3	0.9
Fruit (pp)	0.0	0.3	0.5	0.6	0.2	0.1	0.3
Vegetables (pp)	-0.3	1.4	0.9	1.0	2.0	1.5	0.1
Services (pp)	0.4	0.3	0.1	0.1	0.1	0.1	0.1
Administered prices (pp)	0.1	-0.4	-0.4	0.3	0.7	0.9	1.0
Fuels and energy (pp)	0.4	0.0	0.0	-0.1	0.4	0.4	0.1
Housing (pp)	0.1	0.2	0.2	0.2	0.1	0.1	0.1
Non-food consumer goods	-0.2	-0.2	-0.2	-0.1	0.3	0.4	0.3
Durable consumer goods (pp)	0.0	0.1	0.1	0.2	0.2	0.1	0.0
Consumer Price Index (y-o-y, %)	1.9	2.1	2.1	3.1	4.3	3.4	3.4

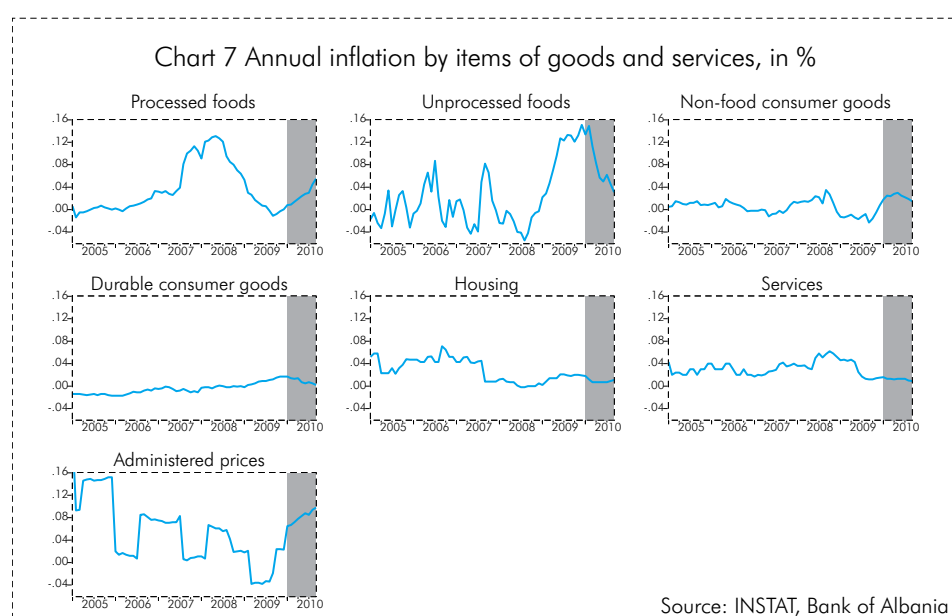
Source: INSTAT, Bank of Albania

“Administered prices” provided a relatively higher contribution to inflation in the third quarter of 2010 relative to their average historical contribution. This item’s upward inflation trend emerged in October 2009 when the tariffs

for hospital services were raised⁸. In addition, the price rise of energy by 13% and water by 28% in the current year increased this item's contribution to headline inflation to 1 p.p. as at the end of the third quarter of 2010. In the absence of further rise in administered prices, this contribution is expected to persist until the first quarter of 2011.

“Non-food consumer goods” provided a downward contribution to the formation of the inflation figure in this quarter due to the relative exchange rate stability, expressed in lower annual depreciation rates during this period.

The other items continue to provide a low contribution to headline inflation. “Services” and “Housing” in particular continue to contribute trivially to the formation of inflation, although they have generally provided higher contribution during summer. The weak domestic demand has led to lower pressures on their prices.



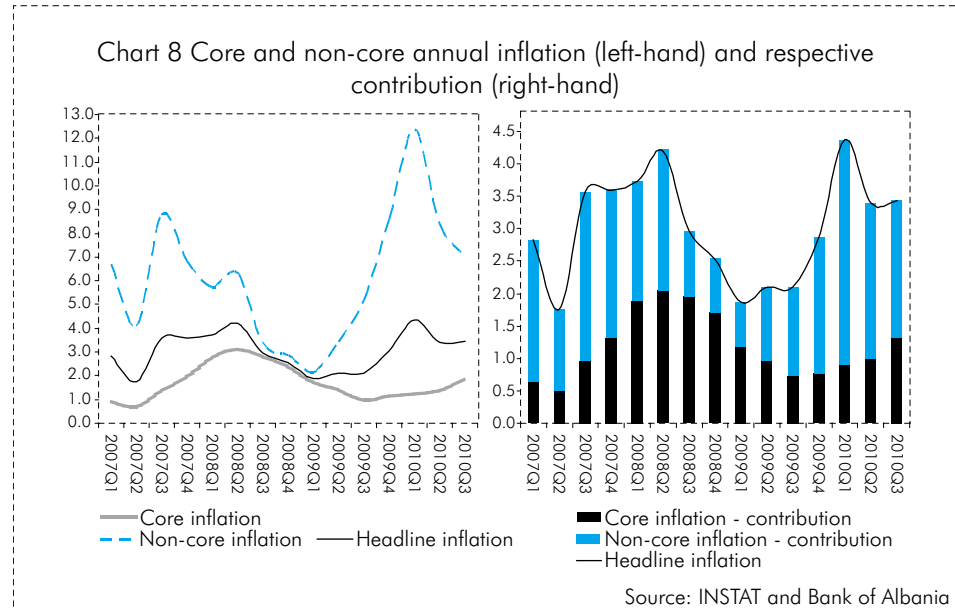
III.2 MAIN INFLATION TRENDS

Annual core inflation⁹ marked 1.9% in the third quarter of 2010. The annual increase of core inflation owes primarily to the rise in the prices of some key processed food items and medical, paramedical and dental services. Core

⁸ The inclusion of the rise in these prices was the main cause for the revision of inflation in August. In the release of Consumer Price Index, July 2010, INSTAT reported a revised series of consumer prices for the period October 2009 – May 2010. The revision of the series relates to the inclusion of the effect of the rise in medical service tariffs starting from October 2009 when the decision on the rise in these administered prices was taken. The inclusion of this effect has increased annual inflation rate by 0.2 p.p. each month.

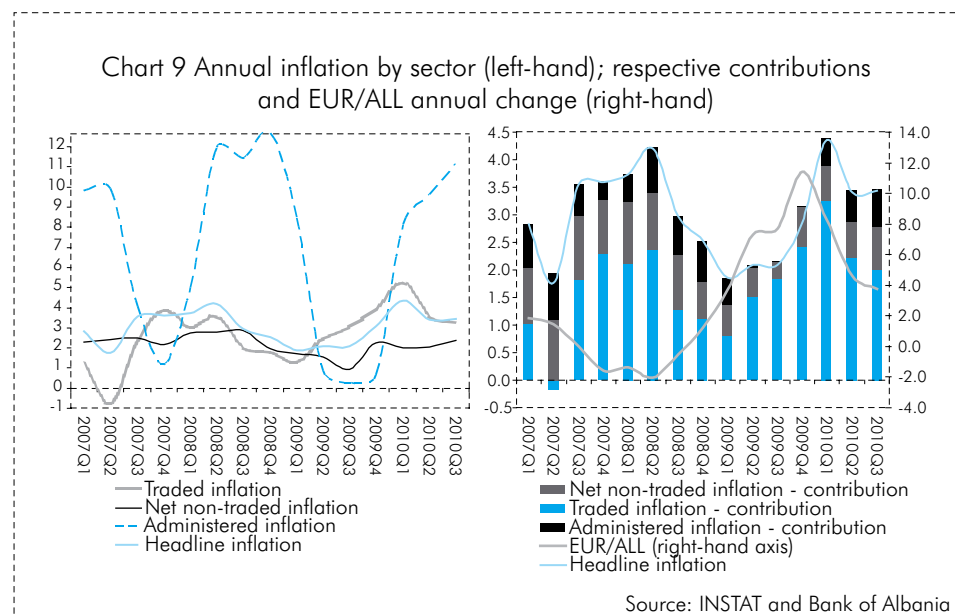
⁹ Average of two measures (permanent exclusion and trimmed mean). The inflation series based on the first measure has been revised aiming at its improvement. In administered price items, which are excluded from the basket, are also included hospital service tariffs in addition to energy and water.

inflation formed about 40% of this quarter's headline inflation, up 10 p.p. from the previous quarter's contribution. Non-core inflation marked more moderate rates, hence providing evidence for the mitigation of short-term volatilities in consumer prices during the third quarter of the present year.



Core inflation averaged 1.5% in January to September 2010, quite close to the same period in 2009 (1.4%).

Annual inflation of traded and non-traded CPI basket items marked 3.3 and 3.5%, respectively, in the third quarter of 2010. Net inflation of non-traded goods and services¹⁰ marked 2.4%. Inflation of traded goods formed 60% of annual headline inflation, hence contributing by 10 p.p. less than



¹⁰ Net non-traded inflation has been revised by excluding the following sub-items from the non-traded CPI basket: "Water supply"; "Electrical energy"; "Hospital services".

in the previous quarter. This downward contribution owes primarily to the curbing of the monthly depreciation rates of the Albanian Lek against the Euro in May to September 2010.

On the other hand, net inflation of non-traded goods and services was higher than in the first half of 2010¹¹, contributing by 20% to headline inflation. This performance owes to the recent price rises in some generally domestically-produced processed food items and in medical, paramedical and dental services.

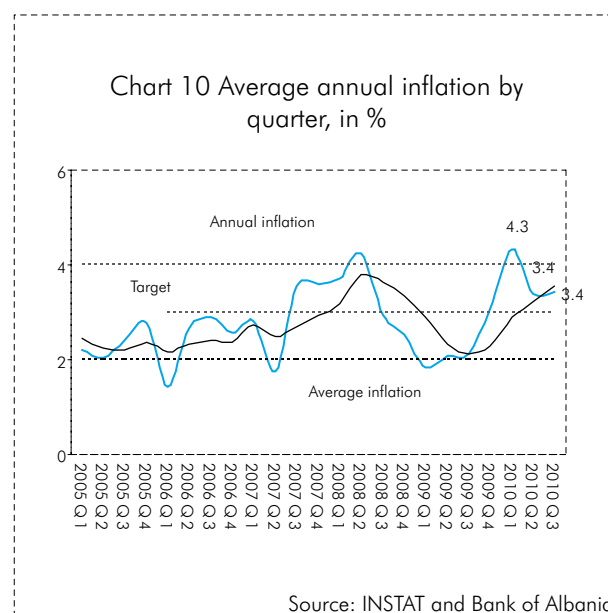
The stable and close-to-target core and net non-traded inflation provides evidence for contained demand-side inflationary pressures.

III.3 INFLATION AND MONETARY POLICY

Average annual inflation was about 0.4 p.p. above the Bank of Albania's target in the third quarter of 2010. After marking high rates in the first quarter, annual inflation rate remained within the tolerance range of 2-4% in the second and third quarter. The above target CPI owes primarily to the rise in administered prices. The inflationary effect of this factor was somehow offset by the slow growth of domestic demand, the free capacities in the economy and the relative exchange rate stability. These developments have been reflected in core and net non-traded inflation rates, which were close to their historical figures. The sluggish money and credit growth in particular attests to weak demand-side inflationary pressures.

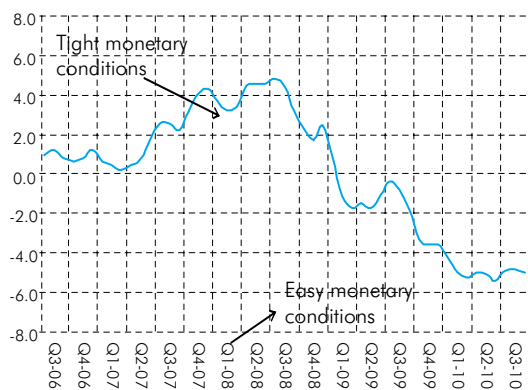
Based on the periodic economic and monetary analyses and on inflation forecasts, the Supervisory Council of the Bank of Albania decided to cut the key interest rate by 25 b.p. in July 2010. Following this cut, the interest rate on one-week repurchase agreements is brought at a record low of 5.00%. In the presence of the annual exchange rate depreciation, in addition to cutting the key rate, the Bank of Albania continued to inject liquidity into the banking system in order to ensure its smooth functioning and increase financial intermediation. Against a background of weak demand-side inflationary pressures and a more prudent fiscal setting, this monetary policy approach helps boost economic activity.

The last key interest rate cut was absorbed soon by the money and primary market. The most recent monetary and financial data show that the short-term interest rates in the interbank market went down and close to the key interest rate. In the Albanian government security market, the yield curve flattened as a reflection of the ample liquidity in the banking system and the moderate



¹¹ Net annual inflation of non-traded goods and services was 2% in the first half of 2010.

Chart 11 Monetary Conditions Index (MCI; change from base year)



Source: Bank of Albania and staff estimates

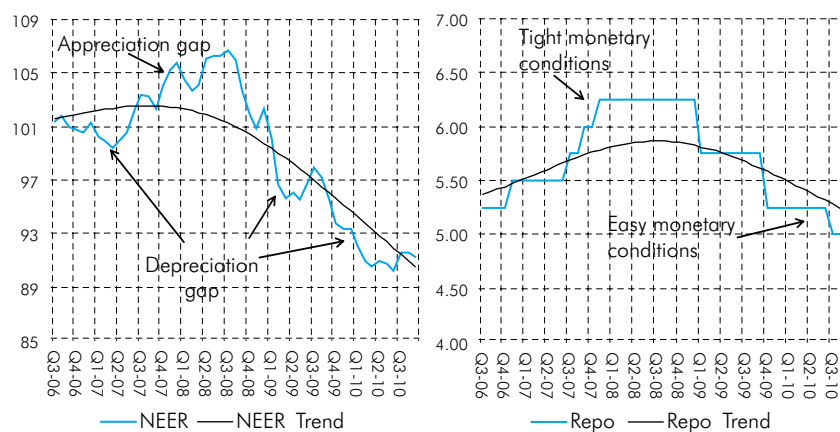
government demand for money as well. Interest rates on deposits and loans also declined. Their complete response to the Bank of Albania’s move is expected to extend longer considering the lags in the transmission mechanism of monetary policy.

The interest rate cut by the Bank of Albania has offset the stable exchange rate effect. As a result, the Monetary Conditions Index¹² preserved the previous quarter’s values in the third quarter and its stimulating contribution to economic activity.

The exchange rate, which provides substantial contribution to the formation of the MCI, pursued an upward tendency in the third quarter of 2010. In addition to its seasonal behaviour, it was also affected by the continuous correction of the current account, reflected in the contraction of its deficit.

Trading in the forex market was calm in the absence of psychological response to temporary shocks on demand or supply.

Chart 12 Performance of MCI, NEER (left-hand) and Repo (right-hand)



Source: Bank of Albania and staff estimates

¹² Monetary Conditions Index (MCI) is the weighted average of changes in the key interest rate and the nominal effective exchange rate (NEER) of the Lek against their respective values in a base period (December 2005). The MCI ratio in the case of Albania is 1.82:1, implying that the effect of the depreciation of the NEER by 1.82% on aggregate demand is offset by the increase of the key interest rate by 100 basis points. Worth noting is that the increase of the MCI may be viewed as a sign of monetary conditions tightening at home, rather than as the monetary policy stance.

Box 1 Projections and the role of their constituents in decision-making

Prompt and qualitatively reliable statistical information from the real and financial sector of the economy is particularly important in the process of macroeconomic analysis and monetary policy decision-making in a central bank. In periods of heightened uncertainties regarding the internal and external, actual and future economic and financial developments, the decision-making process becomes harder. "The degrees of freedom" are reduced and the expression: "The future cannot be as the past anymore!" gets greater value. Economists, forecast experts and policy-makers at central banks make it their motto in their judgment in order to make accurate projections of future processes towards the establishment of updated macroeconomic equilibriums. Against this setting, the accuracy in knowing the future of the economy during the monetary policy time frame effect, becomes an increasing function of the three basic constituents: statistical information, forecasting models and expert judgment.

The monetary policy objective for safeguarding price stability is achieved through an optimal decision-making, which consists in the projection of future economic conditions under a potential monetary policy stance. The purpose of the projection process is to select that option of monetary policy that is more useful to achieving its primary objective. This is the reason why the forecast is made in the short and medium-term, in the forecast horizon of 4-8 following quarters. Each forecast round includes, based on a given significance, each of the three foregoing key constituents, depending on the degree of updated information, the models' capacity to "imitate" one or several economic processes and the expert judgment intuition.

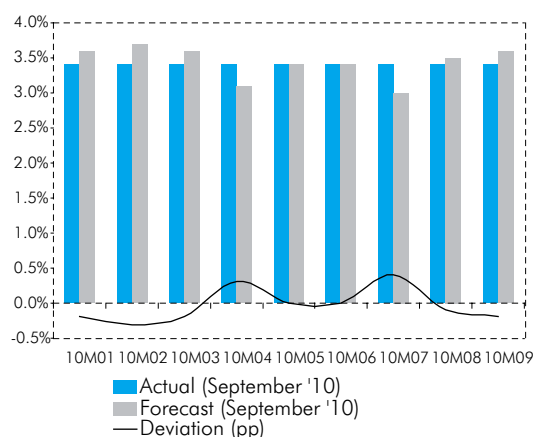
The database is the basis for each forecast. The science and art of forecasting aims at developing techniques that consider a broad range of reliable and updated data. This enhances the usefulness of models and forecast generated by them. In this process, the Bank of Albania aims that each simple or complicated forecasting model contributes to creating the future macro setting where the series function according to an economic logic. But as long as the models cannot capture every economic aspect and assumptions cannot be fully accurate, the process of numerical forecasting cannot and should not be considered "all-powerful". Against a background of higher asymmetric information and heightened uncertainties regarding the future prospects, the third column – judgment – gains particular importance in the projection process in the present day. Combining the information obtained from the history, captured from forecasting models, with that obtained from current and expected developments, through judgment, is a critical part of projection. Overlooking or over-estimating one or another aspect may lead to "wrong" projections. Lessons from the last financial crisis showed that forecast deviated largely from factual developments even in economies with advanced modelling and forecasting techniques.

Regarding the inflation forecast at the Bank of Albania, this process is based on the three foregoing basic constituents. The four main models function according to monthly and quarterly periodicity. Those of monthly periodicity are used to update the quarterly forecast, depending on more recent developments of explanatory variables. The forecasting process is carried out through the following models: headline inflation, the four main inflation items, core and non-core inflation, traded and net non-traded inflation of the CPI basket of goods and services. The information on administered prices is incorporated as an additional contribution to inflation. The inflation forecast is obtained from the average of results provided by the foregoing models.

The portfolio of models at the Bank of Albania* is maintained, enriched and improved periodically. The performance of the forecasting process shows that it has improved due to the higher information update from the real and financial sectors of the

economy and to the greater inclusion of expert judgment in the construction of base assumptions. Referring to the monthly forecast for September 2010, it resulted that they fluctuated around the interval of 3.0-3.7% during January to September 2010, hence averaging 3.5%. The deviations of the factual (3.4%) from the forecast rate for this month during 2010 converge towards the factual rate and fluctuate slightly below and above zero.

Chart 13 Forecast for September 2010 during January to September 2010



Source: Monetary Policy Department, Bank of Albania

The forecast made over the course of 2010 for each month has also encompassed the CPI revision and the administrative effects as of the last month of forecast**, and the updated expert judgment.

Complete information on the future performance of variables affecting inflation at the moment when the forecast is made for the following 12 months/4 quarters is highly important for a monetary policy that has an anticipatory decision-making profile. Therefore, the timely acknowledgment of future decisions on administered prices would contribute to a relatively accurate inflation forecast process. Let us refer to the actual and forecast inflation rates one year ago. In September 2010, inflation marked 3.4%; the monthly inflation forecast made 12 months ago was 2%. Quarterly, the forecast was 2.4%, hence deviating 1 p.p. from the actual inflation rate of the third quarter of 2010. In both forecast frequencies, the deviations are principally a result of the shocks from the rise in administrative prices of goods and services. This

phenomenon is autoregressively transmitted to the forecast of headline inflation. As shown above, the information on the rise and effect of administered prices began to be incorporated into the inflation forecast at the Bank of Albania since January 2010, while not being available 12 months ago. The test results on the distribution of deviations show that they continue to maintain a normal distribution with parameters $[N \sim (0; 1)]$.

* "Portfolio of econometric models for forecasting inflation at the Bank of Albania", Çeliku, E., Shtylla, D., Hashorva, G., Hoxholli, R., Kota, V., Discussion Paper, Inflation Targeting 2 - Roundtable, organized by the Bank of Albania, Tirana, 7-8 December 2006.

** As of September 2010, the accumulated effect of the rise in administered prices was 1 p.p.

Against a background of contained inflationary pressures, the easy policy of the Bank of Albania has aimed at boosting domestic demand in economy. After the economic contraction of the last quarter in 2009, the Albanian economy recorded positive growth rates in the first half of 2010.

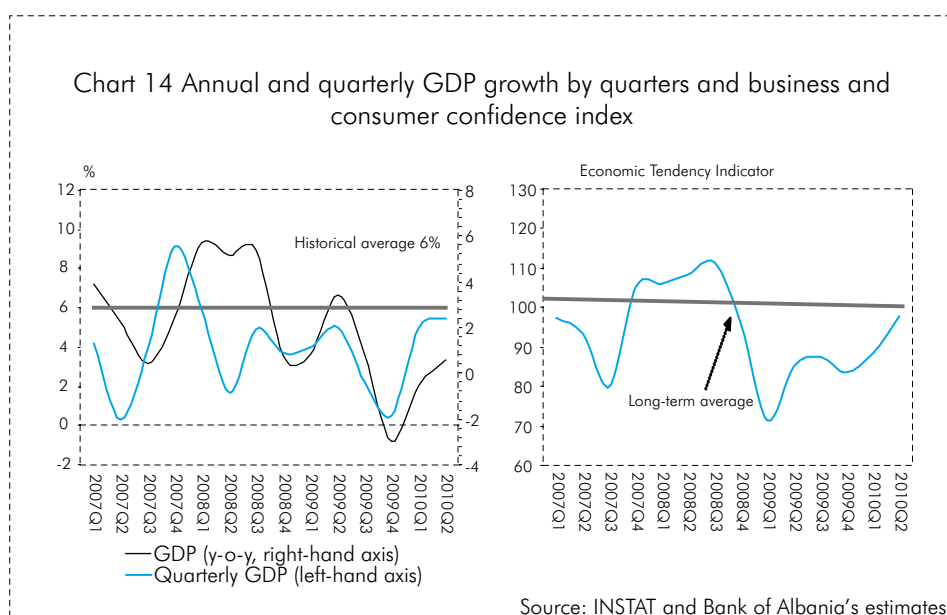
Economic growth rates are below the historical rates due to the low domestic demand and imbalances in the labour market. This analysis, in addition to the monetary policy credibility materialized in the anchored inflation expectations, reinforces the forecast that demand-side inflationary pressures will be contained. In the absence of abrupt supply-side shocks – rise in administered prices, developments in the exchange rate and prices in the world primary commodity market – consumer prices in Albania will, over the time frame of monetary policy effect, raise in line with the Bank of Albania's target.

IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

As the recovery of world economy progresses amid rising uncertainty, the Albanian economy continues to record positive GDP growth rates. According to INSTAT's data, GDP grew by 3.3% in the second quarter. The easy monetary policy and the ongoing fiscal stimulus in the first half of 2010, in addition to the significant contribution of foreign demand to the export growth, pushed domestic demand higher. However, there are still non-utilized capacities in the Albanian economy, which, in addition to the sluggish money growth, relative exchange rate stability and the anchored inflationary expectations, have generated contained inflationary pressures.

IV. 1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

The Albanian economy recorded a positive GDP growth rate for the second quarter in a row. Based on INSTAT's preliminary data, GDP grew by 3.3% y-o-y in the second quarter of 2010¹³, following the 2.0% growth in the previous quarter. The easy monetary policy and the ongoing fiscal stimulus, in addition to the significant contribution of foreign demand, pushed domestic demand higher. Partial data on the third quarter of 2010 suggest that domestic lending conditions improved further in this quarter¹⁴, hence fuelling domestic



¹³ Seasonal-adjusted value added increased by 2.4% from the first quarter of 2010.

¹⁴ The rationale behind this consideration is the higher growth rates of credit than in the first half of the present year, the low interest rates and the modest easing of lending standards.

demand and the positive economic growth rates. In the meantime, the positive contribution of exports to economic growth, albeit expected to persist in the remaining of 2010, is lower than in the first half of the present year.

IV.1.1 OUTPUT BY SECTORS

The quarterly dynamics of real GDP provided evidence for a more rapid growth of economic activity in the second quarter. The recovery of foreign demand was broadly reflected in the increase of industry value added, while the resurgence of domestic demand contributed to faster growth in services than in 2009.

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

Contribution	2007	2008	2009	Q1:2010	Q2:2010
Agriculture, forestry, fishing	0.4	1.5	0.4	1.0	1.2
Industry	-1.2	0.5	-0.2	2.5	2.8
Construction	1.7	1.7	0.0	-2.8	-4.6
Services	4.4	4.0	3.1	1.4	4.0
GDP at basic prices	5.3	7.6	3.3	2.0	3.3

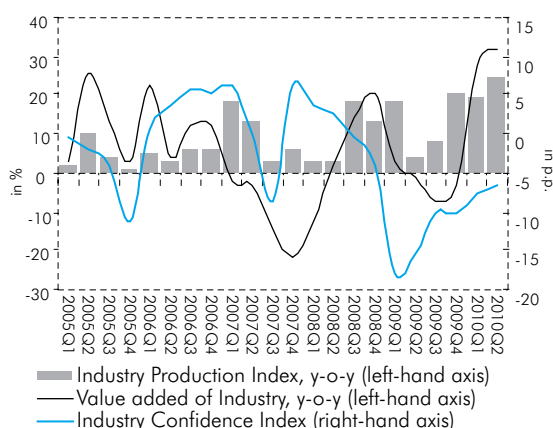
Source: INSTAT, Bank of Albania and its estimates

Value added of industry rose at a record high of 31.8% y-o-y in the second quarter of 2010. Its positive performance was one of the major determinants of GDP growth in the first two quarters of the present year. The recovery of foreign demand and its impact on the increase of Albanian industrial exports, coupled with the price rise of these products in the world market and the still weak domestic currency, yielded a high performance of industry in the first two quarters of 2010. Concerning the sub-branches, extracting industry and energy, gas and water recorded pronounced growth. The upward tendency of

new orders in industry, as indicated by the industry confidence survey, provides evidence for the persistence of growth in industry in the third quarter of 2010. In addition, industry confidence index improved further in the second quarter following the gradual increase commenced in the second half of 2009.

Production Index in energy, water and gas rose 40% y-o-y in the second quarter of 2010. There are more detailed data on the production of energy in the first eight months of 2010. Due to the favourable hydro conditions in Albania, domestic production met the country's needs for electrical energy and a portion of it was exported as well. Production of electrical energy rose by 41.4% in January to August relative to the same period in 2009.

Chart 15 Value added, Industry Production Index and Industry Confidence Index

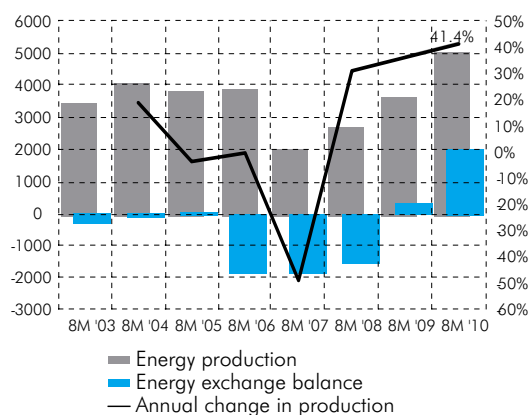


Source: INSTAT and Bank of Albania

Value added of construction dropped 29% y-o-y in the second quarter of 2010. The worsening of construction activity, which began in the second quarter of 2009, deepened further in this quarter, hence providing a negative contribution of 4.6 p.p. to economic growth. The decline in construction volume¹⁵ was mainly a result of the contraction in private constructions due to the unfavourable domestic demand, still tight real estate lending conditions¹⁶ and the low level of public investment projections.

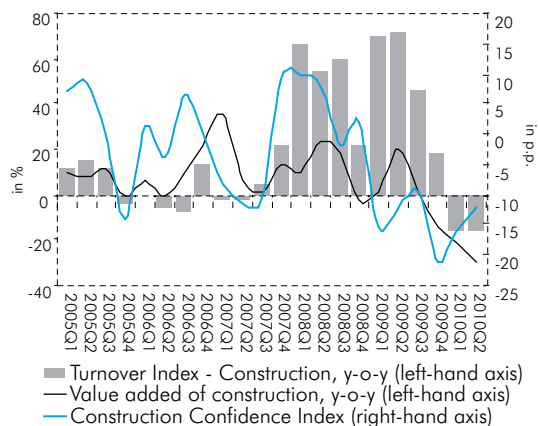
Quarterly growth in construction was however positive at 25.8% versus the first quarter. This positive performance was in line with the business confidence survey results in construction, which had anticipated a slight recovery in the second quarter of 2010. Business expectations for the recovery of construction volumes in the third quarter are not very optimistic. They also expect the decline in construction inventories to persist in the third quarter.

Chart 16 Production and total energy exchange balance (in GWh) and annual change in production (in %), January - August 2010



Source: KESH and staff estimates

Chart 17 Value added of construction, Turnover Index and Construction Confidence Index



Source: INSTAT, Bank of Albania and staff estimates

¹⁵ Production Volume Index, obtained from INSTAT, Short-Term Statistics, Q2 2010.

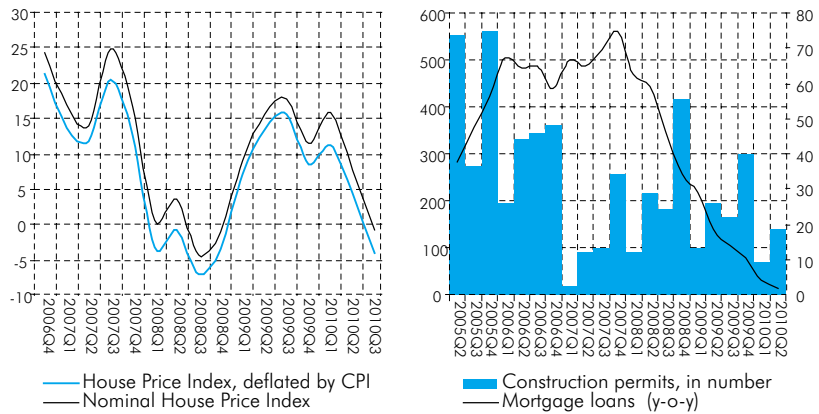
¹⁶ The last bank lending survey reported marginal easing of lending standards applied to the purchase of houses in the third quarter of 2010.

Box 2 House Price Index and Rental Price Index¹⁷

House Price Index dropped 0.8% in the third quarter of 2010, hence keeping up with the downward tendency of annual changes commenced in the third quarter of 2009. House Price Index, deflated by CPI, dropped 4.1% y-o-y.

The drop in house prices owes to the higher contraction of demand versus supply. Beginning from the third quarter of 2009, the slow private demand in economy has generally been also coupled with the fall of demand for houses. The use of remittances and mortgage loans to buy a house has also declined. House supply has been affected by the decline in the number of construction permits and the tight bank lending standards.

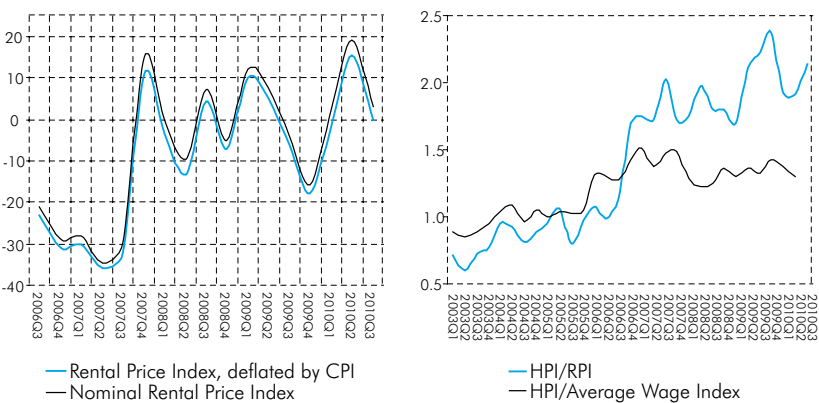
Chart 18 House Price Index, construction permits and mortgage loans



Source: Bank of Albania

Rental Price Index rose 3.2% in the third quarter of 2010 versus the same quarter in 2009. Deflated by CPI, it dropped 0.3% y-o-y. House and Rental Price Index dropped 2.8 and 13%, respectively, versus the second quarter, hence yielding higher price/rent ratio. The latter has been declining since the first quarter of 2010.

Chart 19 Rental Price Index, HPI/RPI and HPI/Average Wage Index

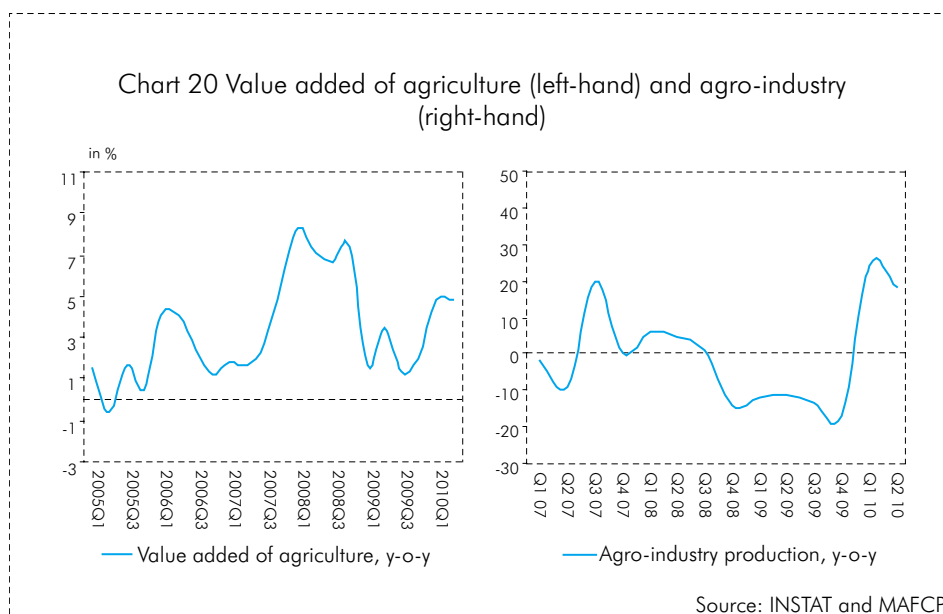


Source: Bank of Albania

¹⁷ House Price Index and Rental Price Index are constructed only for Tirana.

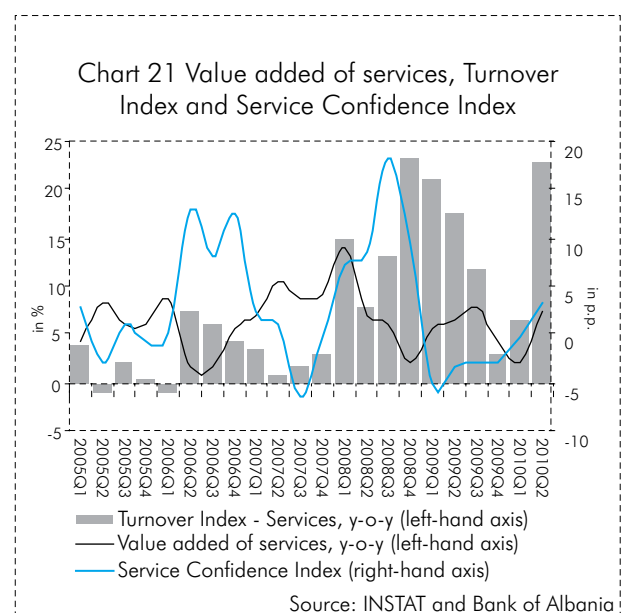
The downward tendency of house prices has been reflected in lower house price index to average wage index. This ratio is used to measure the capacity to purchase houses in the real estate market. House price index to average wage index dropped 1.1% q-o-q. It hit its record high in the last quarter of 2007.

Value added of agriculture rose 4.8% y-o-y in the second quarter of 2010. In contrast to the low contribution to GDP in 2009, agriculture contributed by 1.1 p.p. to GDP in the first half of 2010. According to detailed data provided by the Ministry of Agriculture, Food and Consumer Protection (MAFCP), stockbreeding has the largest share in growth. MAFCP's projections for 2010 suggest positive change rates of agriculture and stockbreeding.



Activity in the Albanian service sector improved further in the second quarter of 2010. After a 2.3% y-o-y rise in the first quarter, value added of services rose 7.5% in the second quarter. More detailed data suggest that all types of services increased except for post and telecommunication. Its value added dropped 2.6% in the second quarter of 2010. Within service sector, the value added of "trade, hotels and restaurants" recorded the highest increase. It also provided the largest contribution to the increase of total value added of service sector.

Confidence survey data show that confidence in services improved more pronouncedly in the second quarter of 2010 following the slight improvement in the first quarter. Services confidence index currently stands above its long-term average.

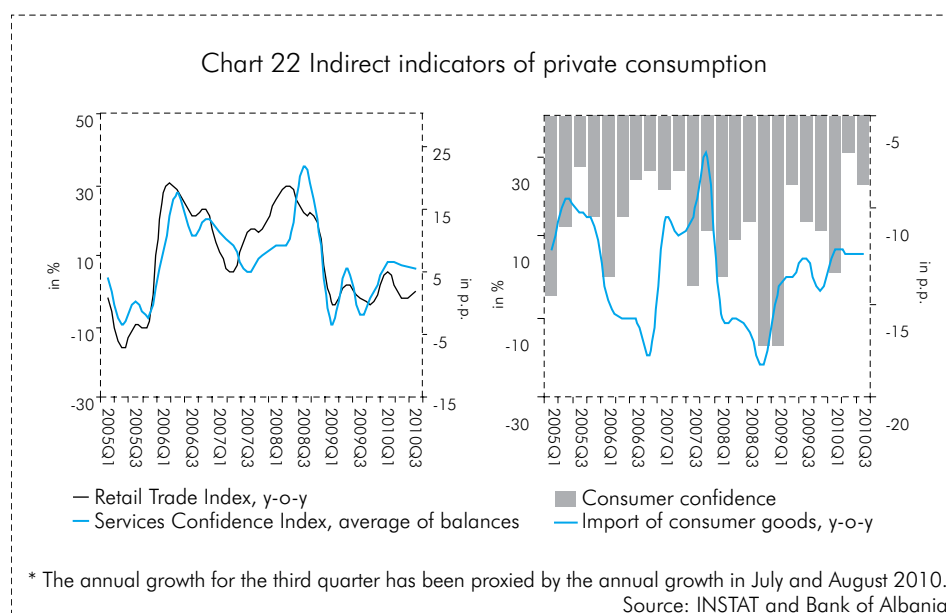


IV.1.2 PERFORMANCE OF AGGREGATE DEMAND COMPONENTS

Aggregate demand grew by 3.3% in the second quarter of 2010. Partial data on the third quarter suggest that its recovery persists, underpinned by global GDP, monetary stimulus and the improved confidence in the sectors of economy. However, in the absence of official data, there is heightened uncertainty regarding this outlook.

CONSUMER DEMAND

Consumer demand is the key component of aggregate demand in Albania. During 2000-2008, it accounted for 80% of GDP¹⁸. Indirect data suggest that private consumption had an upward tendency in the second quarter; however, its contribution to aggregate demand growth remains low. Information obtained from the import of consumer goods, retail trade volume and confidence surveys attests to positive developments in private consumption in the first half of 2010. The import of consumer goods increased by an average of 6.6% in the first half. In addition, consumer spending, proxied by retail trade data, rose 1.6% over the same period. However, this growth rate stands considerably below its historical growth average by 11% since 2001. The structural analysis indicates that the slowdown in trade was more pronounced in foods and clothing, while trade and repair of vehicles increased y-o-y. The import of consumer goods continued to record positive annual growth rates (7.7% on average) in July and August, hence signalling the persistence of positive developments in consumer demand during the third quarter of 2010.

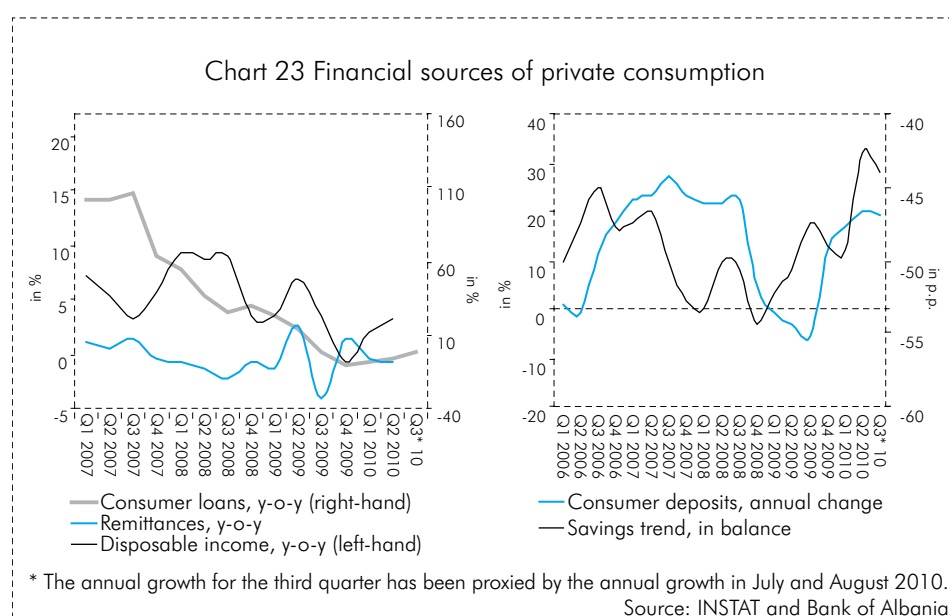


Consumer spending has been underpinned by the increase in real disposable income and the recovery of consumer confidence. After declining

¹⁸ GDP by expenditure approach is measured by INSTAT on an annual basis. The last economic growth based on this approach was reported for 2008.

in the last quarter of 2009, disposable income¹⁹ posted positive growth rates in the first half of 2010, albeit still below the historical average growth rate of 6%. The rise in average wage, in addition to the positive interest rates and the anchored inflation expectations, underpinned the increase in real disposable income, hence resurging consumption in the first half of 2010. On the other hand, there was less support to private consumption from remittances and consumer lending, which declined by 7.7 and 6.2%, respectively, in the first half of 2010. Bank lending standards to household loans tightened further (see Box 5), hence curtailing the opportunities for consumers to spend and invest in the purchase of houses. Lending to households continued to record a negative annual growth rate in July and August, 3.3%.

Consumers were more optimistic about their financial prospects and employment in the second quarter of 2010; however, their propensity to save and the increase of savings in the form of time deposits suggest that their consumer behaviour will remain cautious.



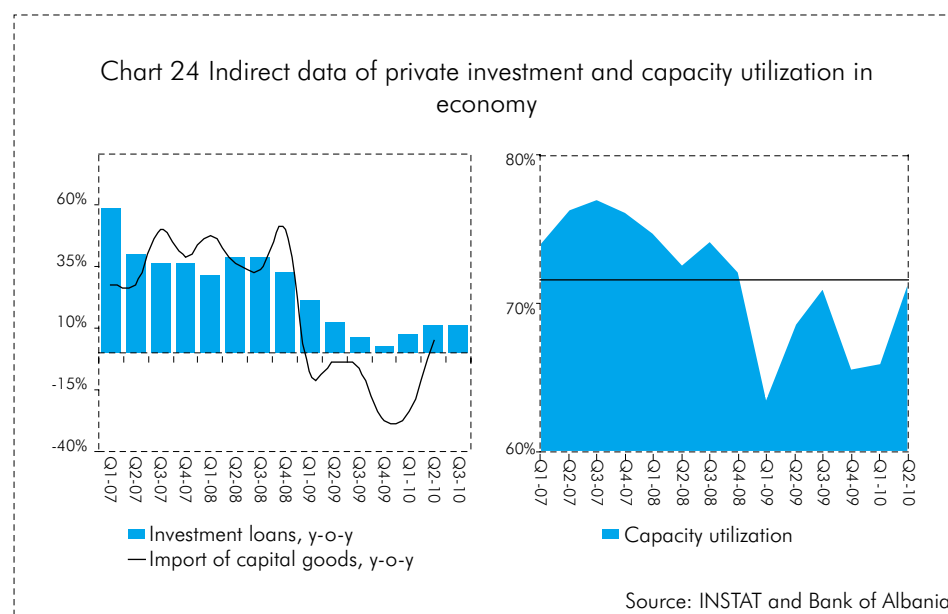
Public consumption continued to contribute positively to the growth of aggregate demand during January to August 2010, albeit at a lower extent than in the previous year. Current expenditure increased by 8.4% y-o-y, versus 19.3% in 2009.

PRIVATE INVESTMENT

The resurgence of economic activity in 2010 was reflected slightly later in the recovery in demand for private investment. Against a background of weak demand, low business confidence, record low capacity utilization rates and tight lending standards, private investment declined in 2009. Once the

¹⁹ Disposable income is estimated by correcting the real GDP with the tax rate on personal income, adding further the Government's contribution (social insurance, economic aids, unemployment payment etc.).

negative impact of these factors moderated, private investment recovered their previous year's decline slightly in the second quarter of 2010. Capacity utilization rate was 71.6% in the second quarter, down only 0.5 p.p. from the average historical rate. Indirect quantitative data that approximate the level of private investment in economy show signs of a positive upward turn of investment beginning from the second quarter of 2010. The import of capital goods, up 4.4% in the second quarter of 2010, increased further in the third quarter, yielding an annual change of 12.3%.



On the other hand, qualitative indicators derived from confidence surveys suggest that the recovery of private investment in economy will be more sluggish than as suggested by indirect quantitative data. According to the business confidence survey conducted in the second quarter of 2010, the balances that estimate the level of investment in industry and construction in the last six months stand below their long-term average. By contrast, the investment balance in service sector has improved.

Table 6 Business expectations for new investment, Q3, net balance

VII.	Values since Q3-2002			Expectations for Q3-2010	Situation	
	min.	av.	max.		VIII.	Conjunctural
Industry	-75.1	-50.5	-7.8	-75.1	↓	↓
Construction	-76.4	-53.4	-0.5	-73.3	↓	↓
Services	-82.0	-55.8	-31	-44.1	↓	↓

Source: Bank of Albania

Based on qualitative data derived from surveys, inventories are found out to have provided a negative contribution to aggregate demand in the second quarter of 2010.

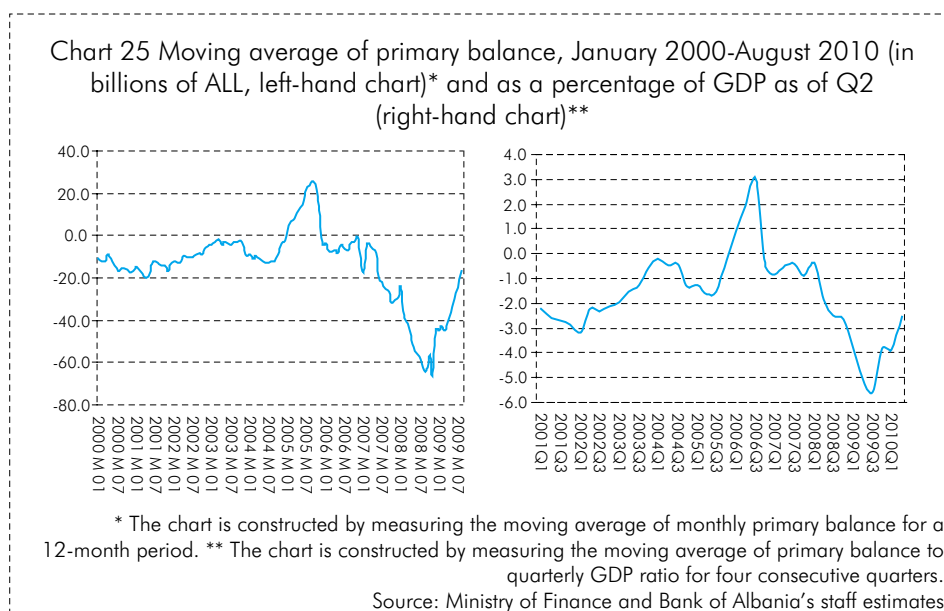
The positive developments in total investment have mainly reflected the performance of private investment, whilst public investment provided an

adverse contribution. During the first eight months of 2010, capital spending contracted by 38.2% y-o-y. The recovery of private investment was also reflected in the lending channels of this type of activity. Lending for investment purposes recorded positive growth rates in the second quarter (10.9%) and in July and August (11.2% on average). In the meantime, foreign direct investment declined by 23.2% in the first half.

FISCAL POLICY, FISCAL INDICATORS AND AGGREGATE DEMAND

Following the first quarter of 2010, fiscal policy has been oriented towards fiscal consolidation, with special focus on measures to cut budget spending and bring down the deficit. In addition to cutting spending compared to the previous year, fiscal policy has also projected various revenue-side correction measures that contribute to fiscal consolidation. These measures have aimed at expanding the business base included in the VAT scheme²⁰ and increasing the range of goods subject to excise²¹. Fiscal correction, sustained by the cut in spending and the increase in taxes, is expected to contract aggregate demand in the short-term. On the other hand, the reduction of the debt stock (which lies at the heart of fiscal consolidation) will lower the risk premium in economy and is expected to stimulate gross domestic product in the long run.

As a result of the fiscal authority's decisions related to fiscal correction, the primary balance²² improved further, particularly after the first quarter of the present year.

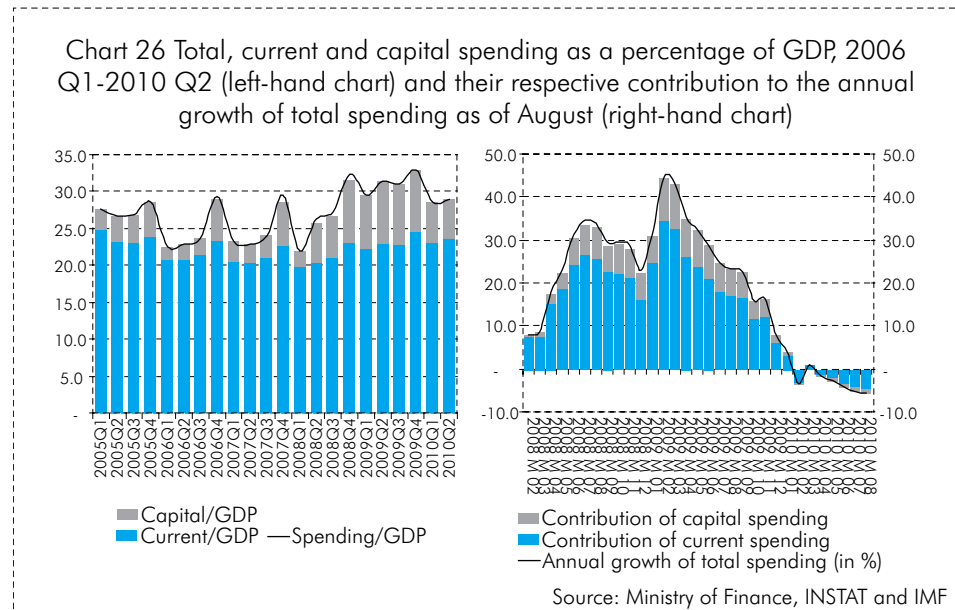


²⁰ Revenue-side correction measures relate, inter alia, to the lowering of the minimum registration threshold from ALL 8 to 5 million, through the changes and amendments to the Law No. 7928, dated 27 April 1995 "On VAT".

²¹ Fireworks, (new and used) tires, primary piles and batteries and glass and plastic packaging have been added to the existing list of excise taxable goods.

²² Primary balance represents the budget balance that excludes public debt interest payments.

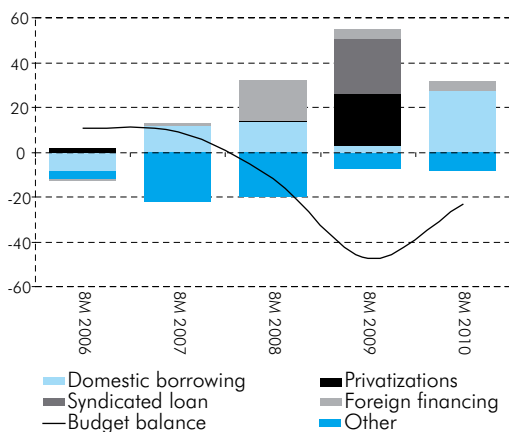
Fiscal policy's effect on aggregate demand has yielded lower ratios of budget spending to GDP compared to the previous year. Throughout most of the period, total spending has followed a downward trajectory due to the lower growth rate of current spending and the y-o-y reduction in capital spending. As of August, total spending and capital spending contracted by 5.5 and 38.2%, respectively, y-o-y. By contrast, current spending increased by 8.4% y-o-y.



The annual growth rates of budget revenue recovered compared to the first

7 months of the year²³. As a result of the changes and amendments to the Excise Law, No. 8976, dated 12.12.2002, revenue from excise had the most stable annual growth throughout most of the first 8 months. As of August, VAT revenue was 4.2% higher than in the same period in 2009. Although the personal income tax rate was similar as in the previous year²⁴, this type of revenue has recorded negative growth rates starting from the beginning of the second quarter.

Chart 27 Budget deficit and its financing (in billions of ALL) for the first 8 months of 2006 - 2010



The budget deficit of ALL 23.1 billion as of August resulted within the fiscal authority's projection in the 2010 revised budget. According to the 2010 budget revision, approved by the Albanian Parliament in July, budget revenue and spending reduced by ALL 27.3 and 39 billion, respectively, from their initial projection.

²³ As at end of the first 8 months, total revenue increased by 5.7% y-o-y. The annual growth rates ranged between 0.6-4.4% in the previous period.

²⁴ This phenomenon may be a result of the automatic stabilizers in economy: against a background of below-potential output, personal income decline despite the fact that the tax rate remains unchanged from the previous periods.

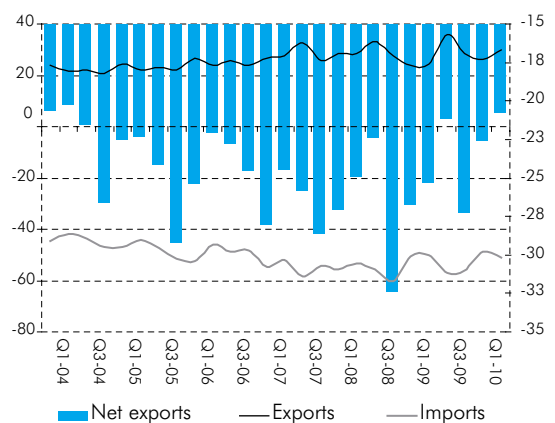
As of August, new borrowing to finance the budget deficit amounted to ALL 26.9 billion. The issue of T-bills (for the three maturity terms) accounted for 38% of this figure, while the rest represents the issue of long-term bonds. As at end of the second quarter of 2010, total debt stock accounted for 60% of GDP, out of which 59% is domestic debt. Over the course of one year, the share of foreign debt to total debt stock has increased by about 4 p.p.

NET EXPORTS AND ALBANIA'S EXTERNAL POSITION

The narrowing of the net export deficit trimmed the negative contribution to aggregate demand for the fourth quarter in a row, hence contributing positively to economic growth. Its narrowing persisted in the second quarter as well. Net export deficit accounted for 20.7% of GDP, 3.7 p.p. lower than its historical average. Thus, due to the growth in foreign demand and the slow domestic demand, the trade deficit in goods and services corrected²⁵ by 19.2% y-o-y. During Q4:2009-Q1:2010, the annual decline in imports played a key role in the foregoing contribution, whilst in the second quarter the increase in exports provided the major impact.

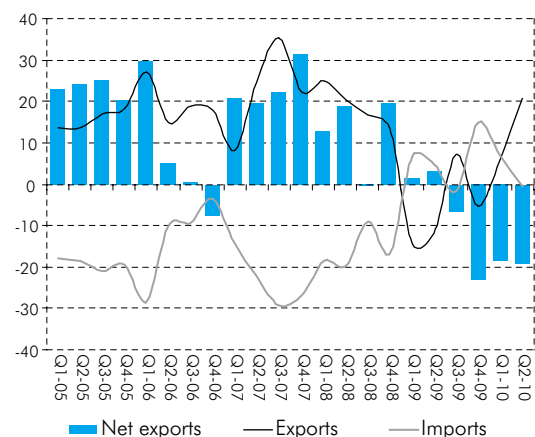
The value of Albanian exports of goods increased by 85% y-o-y in the second quarter. The previous year's low comparative base, the depreciation of the national currency and some other temporary factors contributed to the rapid increase in exports. The export of manufactured metals and re-export of textiles²⁶ provided the major contribution to the increase of export value. However, the statistical tests²⁷ prove that there is a strong correlation between the primary commodity prices in the world markets and the export of manufactured metals. Subsequently, this export item relies heavily on the constant volatilities in the world markets. In addition, the rapid increase in the export of electrical energy – due to the favourable hydric conditions – contributed substantially to the increase of export. On the other hand, although the balance of trade in services had a positive net position in the second quarter, it attributed to the decrease in the import of services at more accelerated rates.

Chart 28 Exports and imports of goods and services as a share of GDP (left-hand axis) and net export deficit as a share of GDP (right-hand axis)



Source: Bank of Albania, Customs Directory

Chart 29 Export and import of goods and services and net export deficit, y-o-y change



Source: Bank of Albania

²⁵ Correction is an economic term that implies the narrowing of an economic balance deficit at a level comparably more desirable for the economy, as a result of the market forces. In these cases, the authorities do not alter their stance on economic policies.

²⁶ Manufactured metals are the main exports of "Manufactured goods", while re-exports of textiles are the main exports of "Other manufactured goods".

²⁷ The correlation between the export of "Manufactured goods" and Metal Price Index published by the IMF with 3 months lag, is 0.76.

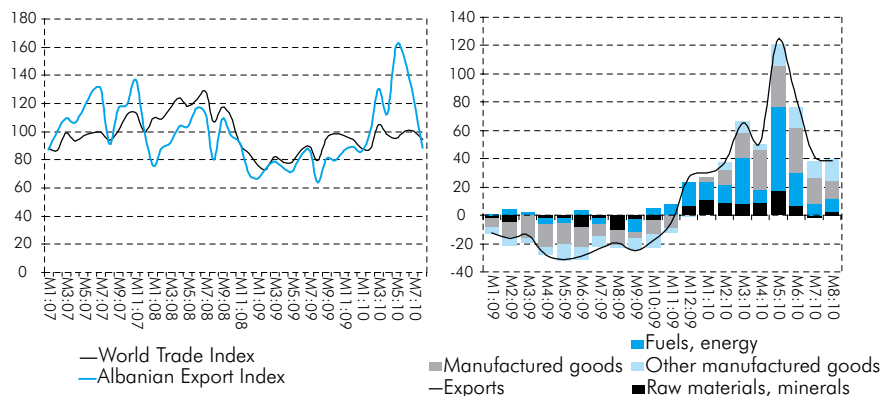
Following the consecutive decrease in the previous two quarters, the import of goods and services increased by 0.5% y-o-y in the second quarter of 2010. The positive performance of the import of goods provided the major contribution to this increase. The three main import items, “Consumer goods”, “Intermediate goods” and “Capital goods”, increased in annual terms. On the other hand, net service outflows were 13.8% lower than in the same period in 2009. The import of transportation services increased in annual terms. By contrast, travel-related foreign outflows contributed adversely to the annual performance of the import of services.

The most recent data on foreign trade in July and August show a more moderate increase in the export of goods than in the first half of the present year. The rapid increase in the import of capital goods and intermediate goods in July and August signal a more positive performance of aggregate investment in Albania. On the other hand, the persistent upward trend of the import of food products suggests for the sustainability of consumer demand.

Box 3 Export sustainability

During January to June 2010, the Albanian exports had a positive upward tendency, markedly higher than the last five years’ historical average. The rebound in global economic activity in 2010 and the increase in trading activity fuelled foreign demand for Albanian products. The export of manufactured products, re-export of textiles, electrical energy and metal raw materials provided the major contribution to the increase of export value. Although this positive performance helped reduce the trade deficit and subsequently correct the current account deficit, and lower the depreciating pressures on the national currency, the sustainability of this development in the medium run remains unclear.

Chart 30 World Trade Index and Albanian Export Index, base month December 2007 (left-hand) and contribution of the four main Albanian export items to the annual increase in export value (right-hand)



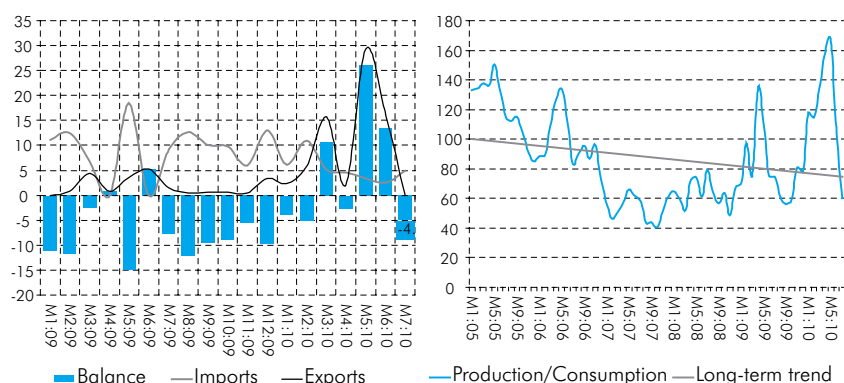
Source: Bank of Albania, Customs Directory, World Trade Organization

In addition to the upward tendency of world trade activity and the recovery of foreign demand, worth noting in the analysis of export sustainability are the temporary factors that depend on the developments in global conjunctures.

ENERGY SECTOR AND PRIMARY COMMODITY PRICES

The export of electrical energy intensified in the first half of 2010 due to the favourable hydric conditions and the operation of the main dams, on which domestic production relies almost entirely, at their full capacity. Another factor to have contributed to the increase of electrical energy export is the positive gap between the production and consumption of electrical energy.

Chart 31 Trade balance of electrical energy (left-hand) and production to consumption ratio (right-hand)

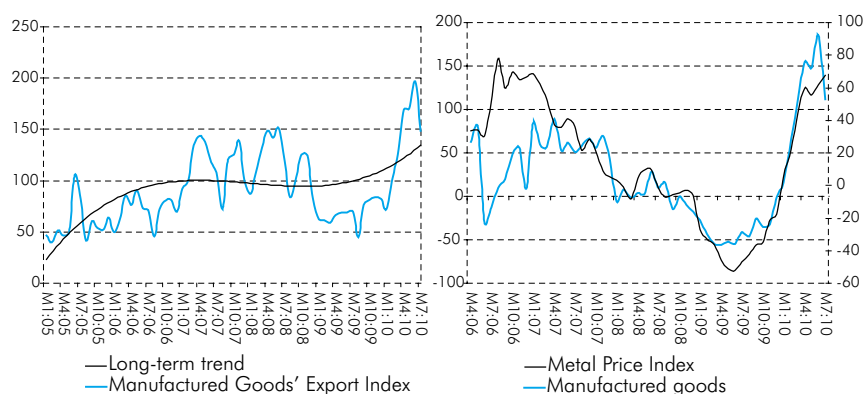


Source: Bank of Albania, Customs Directory, KESH

However, against a background of upward consumer demand for energy, the maintenance of the number of major production plants unchanged and the reliance on hydric conditions, the contribution of electrical energy export to total exports is considered only temporary. Excluding the first half of 2010, Albania has recorded a negative balance of the trade of electrical energy and, taking the foregoing factors into account, it is expected to resume its historical trend.

The export of manufactured metals, which has the main share in the export of “Manufactured goods”, maintained a rapid upward tendency in 2010. The rebound

Chart 32 Index of processed goods’ exports, base period: December 2007 (left-hand) and the annual change of processed goods’ export value (left-hand axis) and the annual change of metal price index, 3-month lag, (right-hand axis, left)



Source: Bank of Albania, Customs Directory, IMF

in foreign demand, as a result of the increase in industrial production in the countries this product is exported to, was one of the key factors to have led to this performance. The other was the upward tendency of metal and primary commodity prices in the world markets. Against a background of reliance on developments in the world markets, the export sustainability of this product becomes uncertain.

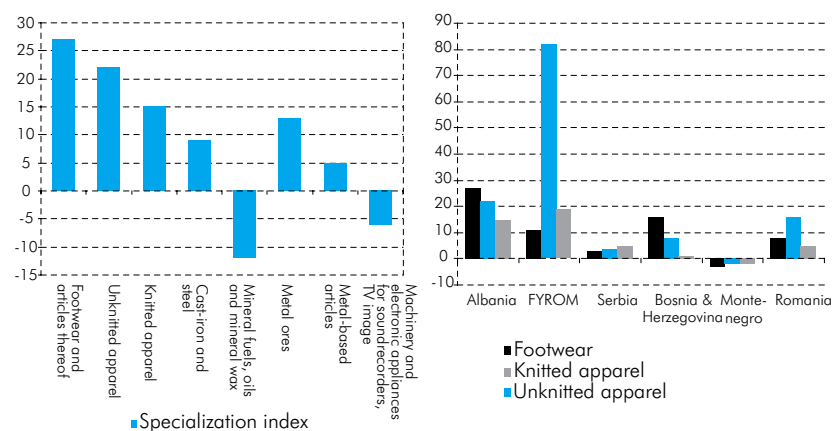
On the other hand, the export of textile industry articles, which accounts for about 43% of total exports and represented broadly by re-exports, is assessed to have provided a stable contribution to the performance of Albanian exports. Despite posting lower growth rates than the foregoing categories during 2010, its export growth remains close to the last five years' historical average. The following section elaborates further on textile industry competitiveness.

EXPORT SPECIALIZATION INDEX

One's country specialization in a given sector's export plays a key role in determining its international comparative advantages. One of the main techniques in determining a country's specialization in the items it exports, that is its comparative advantages in producing a given item, is Lafay's Index of Specialization proposed by Lafay (Lafay 1992, Jarreau, Poncet 2009). This method takes into account intra-industry imports in the process of producing a given item and eliminates export fluctuations influenced by cyclical factors and macroeconomic fluctuations. The first chart below shows Albania's specialization in the items having the largest share in total exports in 2008. Positive values indicate the existence of comparative advantages in a given item. Negative values point to de-specialization. The index's size shows the level of specialization.

We note the comparative advantage of textile industry export versus the other industries. Putting the Albanian textile industry into other regional countries' perspective, we note that Albania has the highest comparative advantage in the export of footwear, but lags behind the FYROM as far as the export of clothing items is concerned.

Chart 33 Lafay's specialization index for Albania for 2008 (left-hand) and Lafay's specialization indices in textile industry exports for the regional peers (right-hand)



Source: UN Comtrade, International Trade Centre

CURRENT ACCOUNT

Current account deficit narrowed to 9.2% of GDP in the second quarter of 2010 due to the correction of the net export deficit. Net current transfers financed about 59% of the trade deficit. On the other hand, the revenue account continued to record a negative balance for the sixth consecutive quarter, deepening by EUR 11 million versus the same quarter in 2009. This adverse performance owes to the ongoing repatriation of profits derived from FDI in Albania and the higher interest payments on public and private sector loans.

Net current transfers declined by 2% y-o-y, hence maintaining the previous quarter's trend. Within this current account item, worth noting is the annual decline of workers' remittances by 7.7%. Although the latter remain a key factor in financing consumer spending in Albania, their long-term trend is downward due to the time cycle.

CAPITAL ACCOUNT

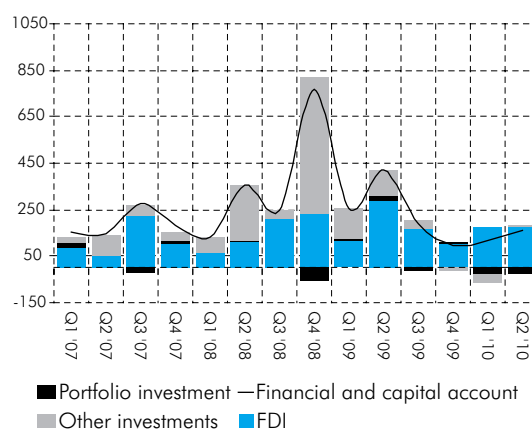
Inflows into the capital and financial account amounted to EUR 177.8 million, or 7.6% of GDP²⁸, in the second quarter of 2010, down 59.5% y-o-y. The surplus in the capital and financial account financed only 83.3% of the current account deficit versus 141.1% in the second quarter of 2009.

Albania's financial liabilities to the rest of the world, albeit upward from the previous quarter, declined 28.3% y-o-y. The latter is mainly a result of the annual decline of Government's long-term borrowing and the lower FDI. Public and private borrowing amounted to EUR 41.8 million during this quarter, 71.6% lower than in the same period in 2009.

FDI inflows were estimated at EUR 173.6 million in the second quarter of 2010, down by 43.3% y-o-y. The decline in privatization receipts²⁹ provided considerable impact on the decrease of the FDI. Net FDI (FDI inflows – privatizations) is estimated at 7.4% of GDP, 2.0 p.p. lower than in the same period in 2009.

As a result of the increase in portfolio investment abroad and in other investment, Albania's financial assets abroad increased to EUR 54.1 million in the second quarter of 2010 (Albania's assets invested abroad dropped by EUR 131.7 million in the same period in 2009). Portfolio investment grew

Chart 34 Financial account and key items – net flows, in millions of EUR



Source: Bank of Albania

²⁸ The GDP used for the 1996-2008 period is published by INSTAT. The GDP for 2009 and 2010 derives from the IMF's projections for the GDP, "IMF Article IV Consultation, 2010", July 2010.

²⁹ In the same period in 2009, privatization receipts (ARMO, OSSH, AMC and PLUS) contributed by EUR 83.5 million to the increase of the FDI in the Albanian economy. In the current quarter, privatization receipts contributed by only EUR 0.4 million.

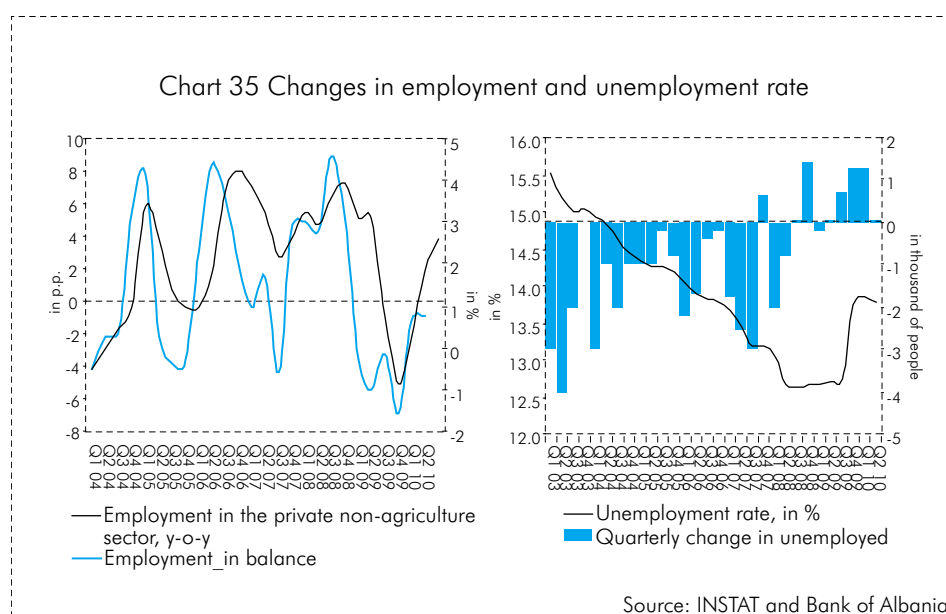
pronouncedly by EUR 27.9 million. Within “Other investment”, short-term loans and banking system’s deposits held abroad increased in annual terms.

The monetary authority’s foreign reserve increased by EUR 15.7 million in the second quarter. As at end of June, foreign reserve stock totalled EUR 1,787.0 million, sufficient to cover 4.7 months of imports of goods and services.

IV. 2 LABOUR MARKET, WAGES AND LABOUR COST

The labour market showed signs of stabilization in the second quarter of 2010. Unemployment rate, albeit high, increased slightly y-o-y and q-o-q. Business expectations for the performance of employment in the third quarter of 2010 are less optimistic than in the preceding quarter. Against a background of low domestic demand, the inflationary pressures arising from the rise in wages and labour cost are expected to be absorbed.

The labour market showed signs of stabilization in the second quarter of 2010, hence being in line with the first half’s economic growth. After increasing for six quarters in a row, unemployment rate remained almost unchanged in the second quarter at 13.78%. Employment in the private non-agricultural sector rose by 1.8% y-o-y in the second quarter, after remaining almost unchanged in the first quarter (+0.2%). This recovery owes primarily to the increase in the number of employed in industry and service sectors. Despite the increase in the number of employed, unemployment rate remained high reflecting the higher increase in the number of unemployed (2.3%).



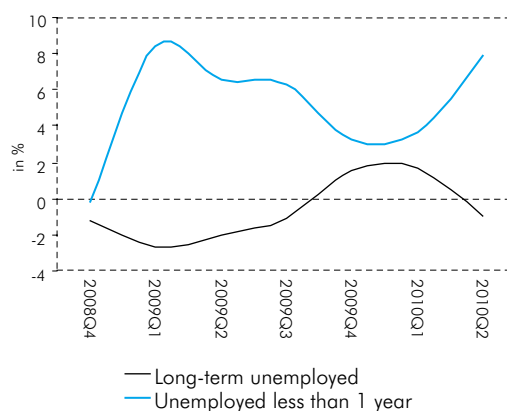
According to INSTAT’s data, the number of total employed in the private economic sectors (excluding agriculture) rose by 4380 in the second quarter

compared to the second quarter in 2009. The number of employed remained unchanged in the public sector. In the agriculture sector, it dropped markedly by 12.7% after an eight-year period over which it had increased according to INSTAT³⁰. The pronounced decline in the number of employed in agriculture led to lower total employed in economy in the second quarter of 2010. Their respective y-o-y changes are -7.0 and -5.8%.

The number of unemployed rose by 3305 in the second quarter compared to the same quarter in 2009. Although the number of employed has been increasing, the higher increase of labour force has resulted in a higher number of unemployed. It results that the increase in the number of unemployed has been mainly generated by the higher number of job seekers seeking a job for less than a year. Long-term unemployment, which increased by 1.5% y-o-y in the last quarter of 2009, has had a downward tendency in the last two quarters.

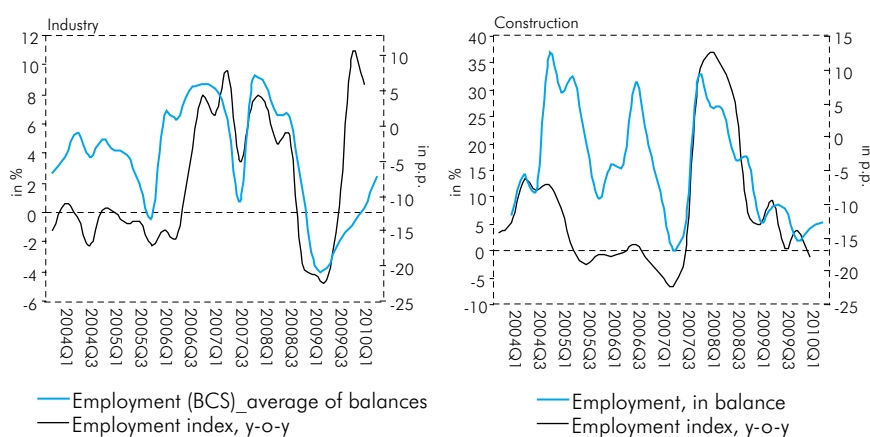
Qualitative data obtained from the confidence surveys confirm these trends for the private sectors of the economy. According to the second quarter's survey results, industry shows the highest level of optimism as far as employment is concerned. Its balance increased by 4.6 p.p. versus the previous quarter. In the meantime, construction indicates a contained recovery of its employment.

Chart 36 Annual changes of long and short-term unemployed



Source: Ministry of Labour, Social Affairs and Equal Opportunities

Chart 37 Annual changes of employment in industry and construction



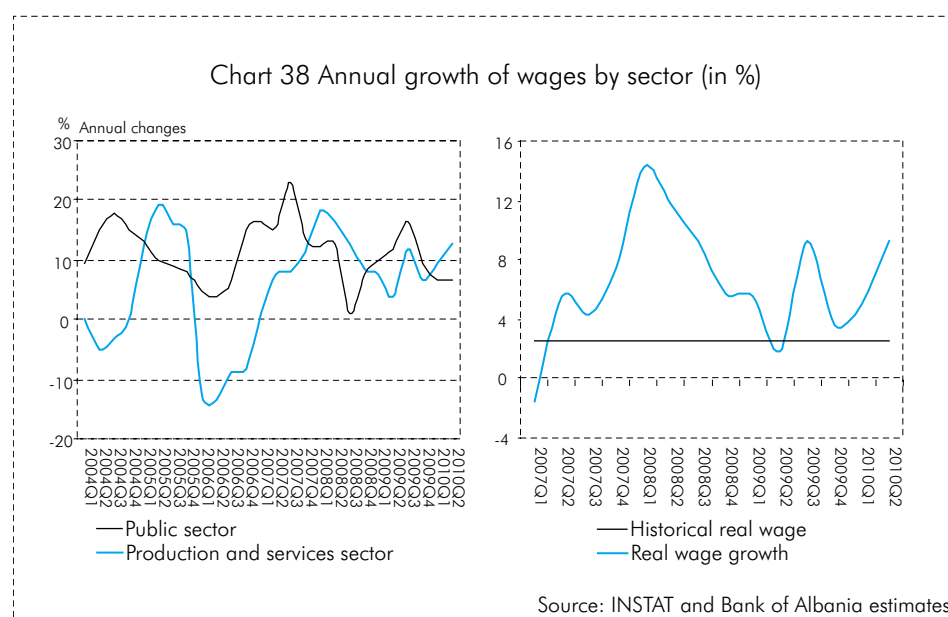
Source: INSTAT and Bank of Albania

³⁰ The annual contraction in the number of employed by 7% for the second quarter in a row attributes primarily to the decline of employment in the private agricultural sector, reflecting the statistical effect of their estimation. The average number of employed in the private agricultural sector from the second quarter of 2008 to the third quarter of 2009 has been estimated based on the 2007 Labour Force Survey, while for the last quarter of 2009 it has been estimated based on the 2008 Labour Force Survey (Source: INSTAT, "Conjuncture, Main Economic Indicators, January-March 2010"). Employed in this sector are included in "Self-employed" and account for 57.7% (average of period Q1:2005-Q1:2010) of total employed.

The balance between supply and demand in the labour market determines the magnitude of inflationary pressures in economy. The high unemployment rate and business non-optimistic expectations for the increase in the number of employed in the third quarter of 2010 suggest that labour market conditions remain tight, hence generating no inflationary pressures.

WAGES AND LABOUR COST

Average wage in economy posted the highest annual growth rate since the second quarter of 2008. According to INSTAT, average wage³¹ in economy accelerated its annual growth to 12.9% in the second quarter of 2010. Average wage rose by 5% versus the previous quarter. Real wage, deflated by CPI, rose by 9.4%, nearly 7 p.p. above the historical average, hence maintaining the growth rates emerged since the last quarter of 2009. Average monthly wage in the public sector pursued an upward tendency though at lower rates than the private sector's. In the second quarter of 2010, average wage in the public sector rose by 6.7%. According to qualitative data obtained from the confidence survey conducted in the second quarter of 2010, the majority of businesses review wages in July each year, a period that corresponds to the change in the minimum wage.



Indicators on the labour force use efficiency in the Albanian economy³² suggest relatively positive developments, but still in the short term. Labour Productivity Index (LPI) increased 4.3% q-o-q, following the previous two

³¹ Wages in economy, often referred to as “average wage”, is calculated as the ratio of wage fund index to the number of employed index. Source: INSTAT, Short-Term Statistics, quarterly periodicity, excluding agriculture.

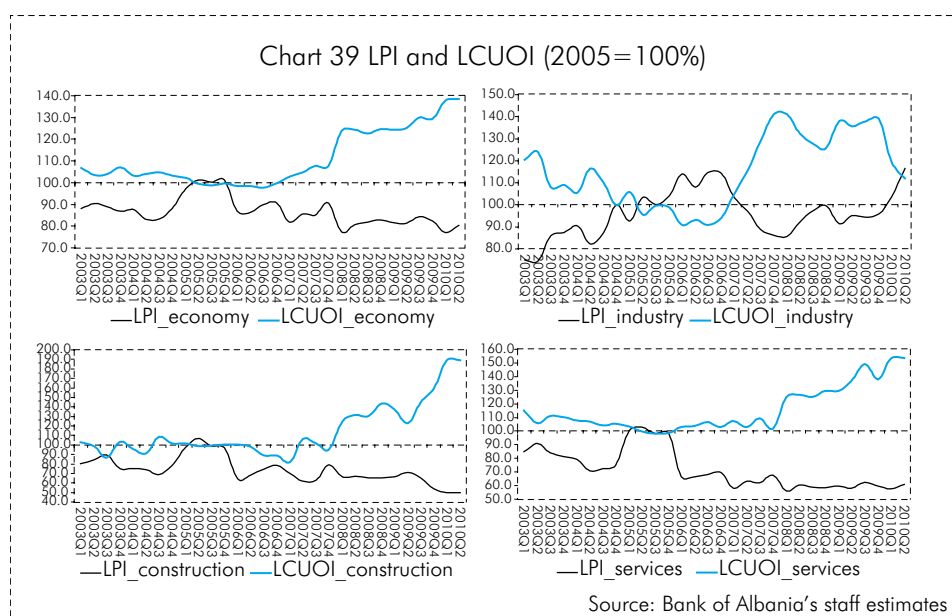
³² The estimations refer to Labour Productivity and Labour Cost per Unit of Output, excluding agriculture. They are based on seasonally-adjusted value added data (INSTAT, GDP, Q2 2010) and short-term statistics on employment and wages (INSTAT, Short-Term Statistics, Q2 2010). These indicators do not include agriculture, therefore the value added is considered excluding agriculture. The wage index is deflated by the seasonally-adjusted CPI.

quarters' negative rates. This performance was reflected in curbed annual downward rates of the LPI from -5.5 to -1.2%.

Industry contributed to the relative improvement of the LPI in economy. The value added growth rates were pronouncedly higher than those of employment. Industry productivity grew 22.4% y-o-y, comparable with the record high (25.5%) in the second quarter of 2005. Construction continued to decline though at more moderate rates (-29.4%). The LPI increased only slightly in services (5%).

As a result of the LPI performance, the Labour Cost per Unit of Output Index (LCUOI) curbed its growth rates. Its annual and quarterly change was 10.6 and 0.5%, respectively. Owing to the positive developments in production and a more balanced labour market and wage performance, only industrial activity³³ had a lower LCUOI in annual terms for the first half of the year (-15.5%). The other two branches, construction and services³⁴, continued to record very high annual growth rates of their LCUOI (54 and 12%) in this quarter.

Enhancing the labour force use efficiency, in addition to pursuing a prudent wage revision policy, is one of the premises for ensuring a positive dynamics of economic activity and price stability. This consideration is important for both traded and non-traded sectors. The emergence of industry³⁵ and services' (tourism)³⁶ competitive advantages is considered a high potential for preserving macroeconomic equilibrium in the medium and long run.



³³ Its share to value added, excluding agriculture, is 14%.

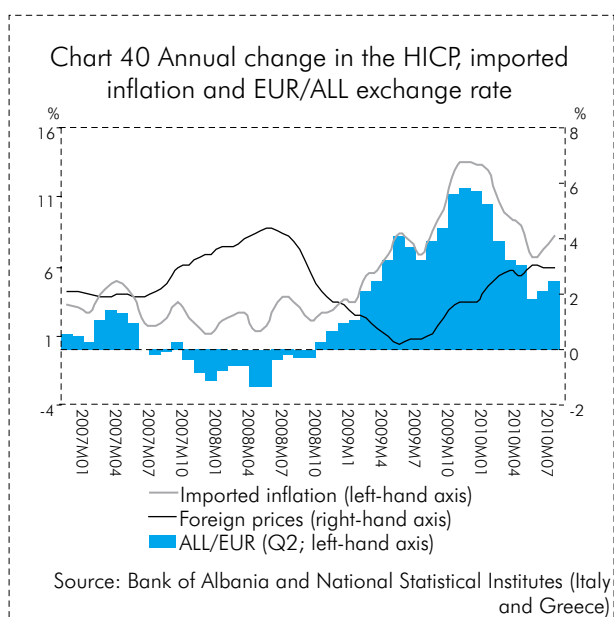
³⁴ These branches are included in the non-traded sector of the economy based on the share of exports from branches. Branches with considerable exports are considered traded since they face competition in the foreign markets. In the Albanian case, industry may be considered a traded sector. Subsequently, the increase in the LPI and decrease in the LCUOI in industry may create competitive advantages for the country's economy.

³⁵ A traded sector (given the high share in exports).

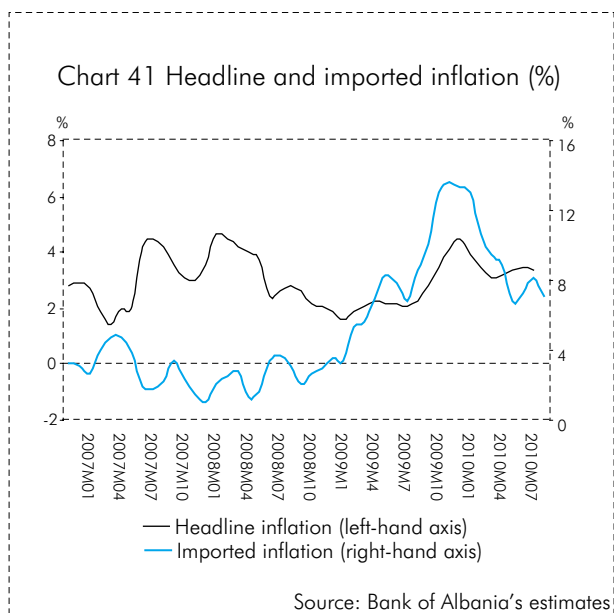
³⁶ Still a non-traded sector.

IV. 3 IMPORTED INFLATION

After marking high rates in the first quarter of 2010, imported inflation pursued a descending tendency in the following quarters, hence exerting downward inflationary pressures on the CPI. Despite the rise in foreign prices, the exchange rate stability was the key factor to have affected this performance.



External inflationary pressures on consumer prices in Albania subsided further in the third quarter of 2010. After peaking in the first quarter of 2010, 13.3%, imported inflation³⁷ slowed down to 9.7 and 7.4% in the subsequent two quarters. The lower annual depreciation rates of the exchange rate slightly offset the rise in primary commodity and consumer goods' prices in the world markets. In addition to the rising prices, the increase of inflation in Italy and Greece has also reflected the positive statistical effect of the low-base comparison. Consumer prices in Greece rose by an average of 5.5% in the third quarter, up 1.4 p.p. from the first half. The annual change was lower in Italy (1.7% from 1.4% in the first half). As a result, the Harmonized Index of Consumer Prices (HICP)³⁸ recorded an annual growth rate of 3.0%.



The exchange rate developments against the Euro have an effect on imported inflation with a time lag of two months. The Albanian Lek slowed down progressively its annual depreciation dynamics against the Euro until May 2010. During the last four months, June to September, the ALL has depreciated by 3.9% y-o-y. In September, it depreciated 2.3%. The favourable exchange rate developments gave rise to slower imported inflation, thereby alleviating the inflationary pressures originating from outside on consumer prices at home.

IV.4 INFLATIONARY EXPECTATIONS IN ECONOMY

Economic agents' expectations for inflation remained anchored within the Bank of Albania's inflation target range, thereby alleviating the upward pressures on the Albanian consumer prices.

³⁷ A proxy measured by Monetary Policy Department; it results from the combination of information on Greece's and Italy's CPI for the EUR/ALL exchange rate (two-month lag) and Albania's import share with these countries.

³⁸ HICP is measured as weighted average of consumer prices in Italy and Greece and their respective shares in trade.

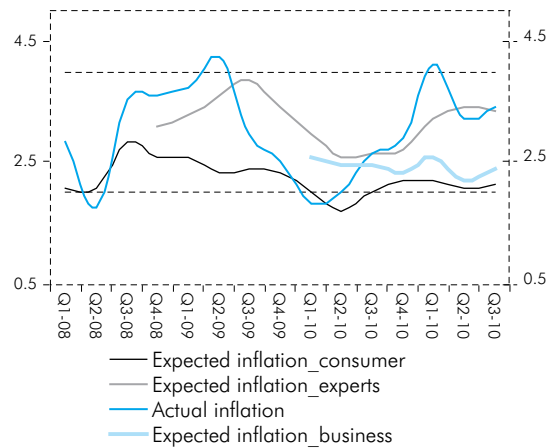
According to the surveys conducted in the second and third quarter of 2010, economic agents' expectations for the inflation rate after one year³⁹ remain within the tolerance range and around the 3% target of the Bank of Albania. The most recent data obtained from the bank experts' survey for the third quarter of 2010 show that they expect inflation after one year to be 3.3%, down 0.1 p.p. from their expectations in the second quarter. In the confidence surveys conducted in the second quarter of 2010, consumers and businesses expected y-o-y inflation to be 2.1 and 2.2%, respectively.

IV.5 ASSESSMENT OF INFLATIONARY PRESSURES IN THE REAL SECTOR OF ECONOMY

The first half of 2010 featured positive economic growth rates and showed signs of stabilized labour market conditions in response to the recovery of aggregate demand. After suffering a contraction in the last quarter of 2009, real GDP posted positive growth rates in the first and second quarter of 2010. The quarterly dynamics of GDP growth shows higher rates in the second quarter. In the meantime, partial data on the third quarter of 2010 suggest improved financing conditions, hence supporting the consideration for the persistence of positive growth rates. After remaining almost unchanged in the first quarter, employment increased in annual and quarterly terms in the second quarter, suggesting for positive developments in the labour market.

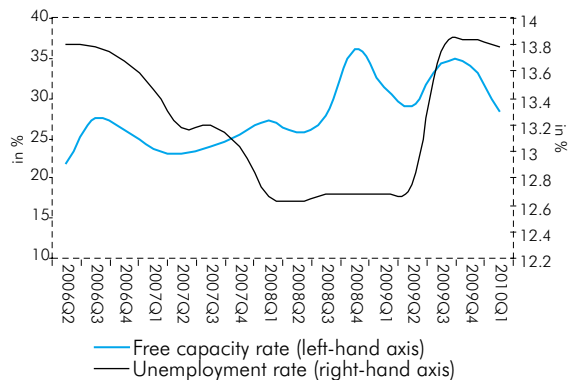
Despite the increase in employment, unemployment rate remains high reflecting the higher increase in the number of unemployed in economy. Business expectations for employment in the third quarter are less optimistic. The positive economic growth rates have slightly reduced the gap between actual and potential output, but they have not eliminated it fully. Aggregate demand has grown underpinned by the recovery of private consumption and the increase in private investment. However, the capacity utilization rate remains below its historical average. The high unemployment rate and the below-historical average capacity utilization rate suggests for the presence of non-utilized capacities in economy.

Chart 42 Economic agents' expectations for inflation after one year (%)



Source: Confidence Surveys and Monthly Bank Expert Survey

Chart 43 Unemployment and free capacity rate* (%)



* Free capacity rate is measured as the difference between the capacity utilization rate of 100% and the capacity utilization rate reported in the business surveys.
Source: Bank of Albania, INSTAT

³⁹ Consumer, business and bank experts' expectations are measured through the following surveys: Consumer Confidence Survey, Business Confidence Survey and Bank Experts' Expectations Survey.

While the sluggish performance of the labour market and the negative output gap have exerted downward pressures on inflation, the above-target rise in consumer prices during 2010 was mainly triggered by the rise in administered prices. Due to their transitory effect on the annual dynamics of consumer prices, annual inflation rate is forecast to remain close to the target in the coming period. The relative exchange rate stability during the first nine months of the present year has acted as curb on inflationary pressures deriving from the external economy on the Albanian consumer prices. As a result, imported inflation has curbed, hence generating downward pressures on the level of consumer prices. The absent materialization of the second-round effects on economic agents' expectations for inflation, which are within the target range, will facilitate the decrease of inflation in line with the central bank's target. This process will be also underpinned by the persistence of the negative output gap and the sluggish labour market, and the anchoring of economic agents' expectations for inflation.

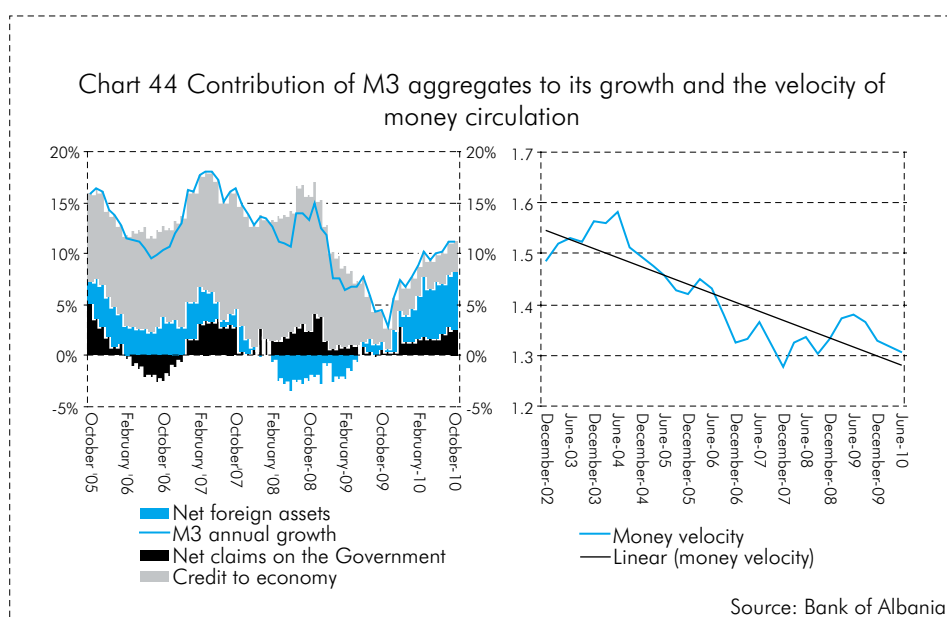
V. MONETARY DEVELOPMENTS AND THE FINANCIAL MARKETS

V.1 MONETARY DEVELOPMENTS

Money growth rates in economy were higher in the third quarter of 2010, triggered mainly by the increase in net foreign assets as a result of the foreign inflows. Banks' preferential interest rate seasonal offers fuelled the growth of deposits, thereby improving banking liquidity further, particularly that denominated in foreign currency. Households confirmed their propensity to investing their savings in time deposits, while businesses increased their preference for more liquid assets. Lending maintained the moderate growth levels of the second quarter. The public sector continued to contribute positively to the growth of money in the third quarter, while the private sector's contribution remains at low record levels.

V.1.1 DEVELOPMENTS IN CURRENCY AND DEPOSITS

The long-term analysis of monetary indicators confirms the assessment that money growth in economy remains at moderate levels, hence exerting no inflationary pressures in the medium run.

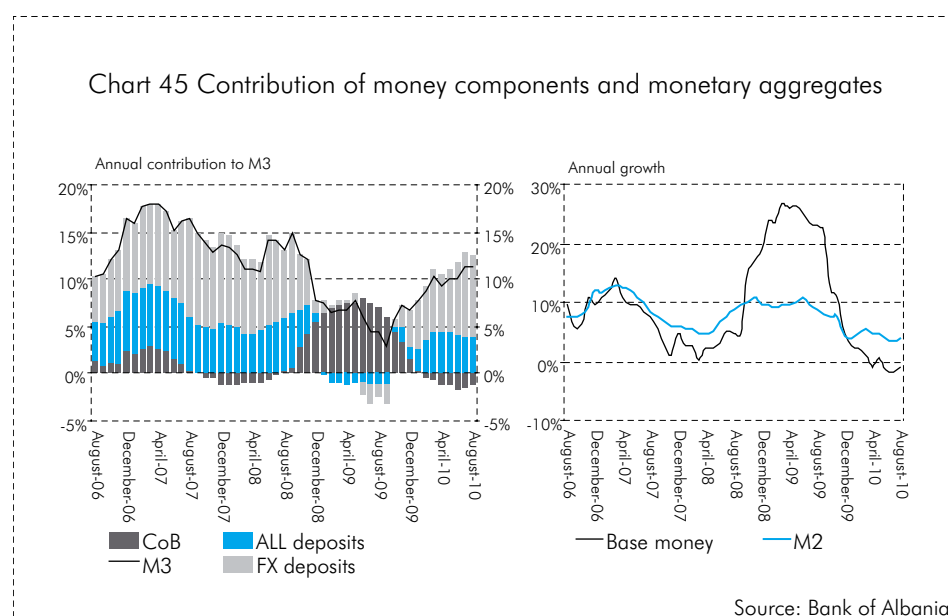


The latest monetary data⁴⁰ confirm the persistent growth of money, remaining however below the recent years' average. M3 aggregate grew by 11.2% y-

⁴⁰ The analysis of the third quarter includes data on July and August 2010.

o-y in July and August versus 9.8% in the second quarter. On the supply-side, it reflects the higher growth of deposits denominated in foreign currency and the moderate growth rates of M2 aggregate. Excluding the exchange rate effects, M3 annual growth rate is 8.6%. Seasonal foreign inflows have triggered the accumulation of foreign assets by commercial banks, thereby improving the banking system's liquidity denominated in foreign currency. The growth of deposits and M3 also underpins the downward tendency of the velocity of money circulation in economy⁴¹. This tendency reflects, *inter alia*, the improved economic agents' confidence in the financial system.

Demand for monetary assets in ALL slowed down its growth rates in the third quarter of 2010. M2 aggregate grew by 3.6% y-o-y versus 4.4% in the second quarter. This fall owes to the lower growth rates of ALL lending⁴². Currency outside banks continues to record lower rates in annual terms, being in line with the upward tendency of deposits in the banking system. Hence, money multiplier rose to 3.41 in August from 3.33 at the end of the first half.



PERFORMANCE OF DEPOSITS

The growth of total deposit stock was considerably higher than in the previous quarter, mainly due to the seasonal effect of foreign inflows during summer. As at end of August, total deposit stock was ALL 34.5 billion higher than in June⁴³. Its share to broad money is estimated at 79%⁴⁴.

In July and August, foreign currency deposits contributed by over 90% to total deposit growth or by over ALL 32 billion. Deposits denominated in foreign currency recorded the highest growth rate during this period, by an average of 27.4% y-o-y.

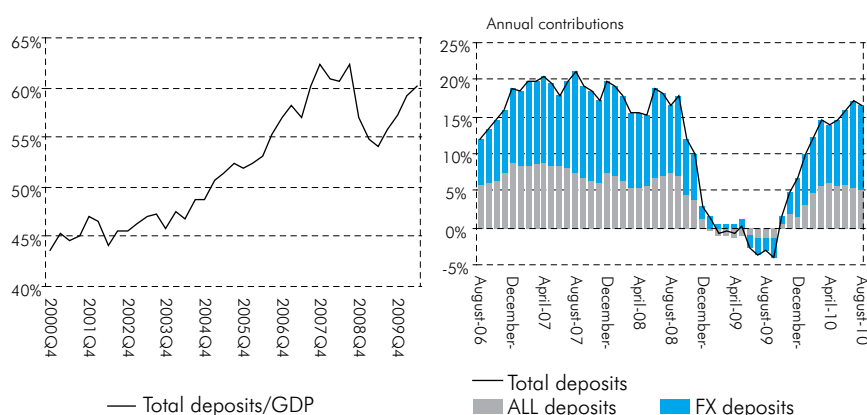
⁴¹ Data on the velocity of money cover the period until the end of the first half of 2010.

⁴² This rate also reflects partially the effect of the previous year's high comparative base.

⁴³ Excluding the exchange rate effect, this growth amounts to ALL 31.5 billion.

⁴⁴ Very close to the interval of 80-81% as of September 2008, prior to the withdrawal of deposits as a result of the shaking of confidence in the banking system.

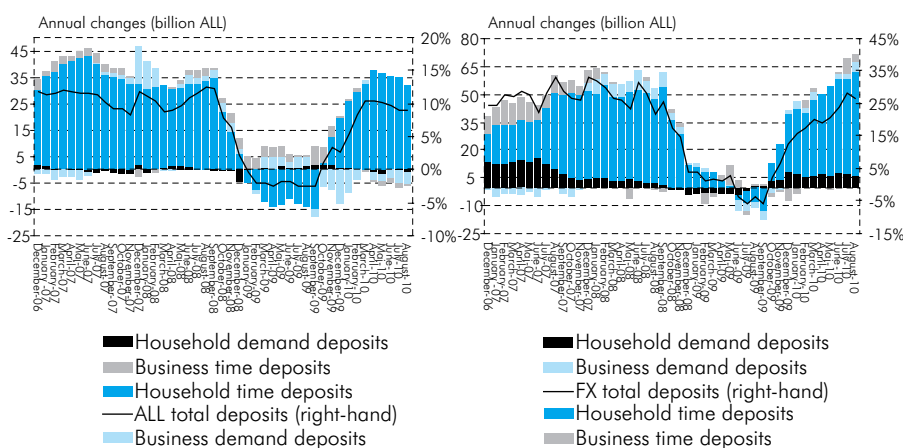
Chart 46 Deposits as a share of GDP and their annual performance by currency



Source: Bank of Albania

The annual growth rate of ALL deposits slowed down slightly to 9.0% versus 10.1% in the second quarter. In monthly terms, ALL deposit growth was lower than in the first half of 2010. The latter may reflect the consumers' seasonal propensity to keep more liquid assets during summer.

Chart 47 Annual deposit changes by currency and economic agents



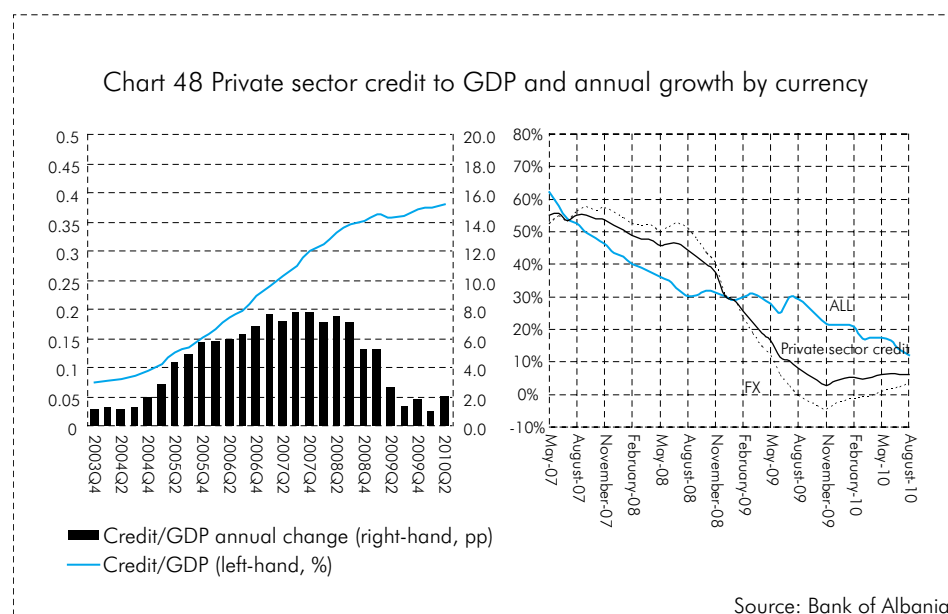
Source: Bank of Albania

The time structure of deposits shows further increase of the share of time deposits to total deposits to 78%, hence exceeding the September 2008 level. This performance confirms the improved confidence in the banking system and the higher consumer propensity to save. The growth rates of demand deposits improved in the third quarter (8.6% versus 6.4% in the second quarter), mainly due to the growth of business demand deposits.

The composition of deposits by economic agents confirms the continuous growth of household deposits, which have shown upward annual rates. Business deposits have also recovered their annual growth rate during this quarter. After posting a negative growth in the second quarter, they grew by an average of 6% in July and August. The growth of business deposits in summer reflects the recovery of their activity in line with the seasonal performance of economic activity at home.

V.1.2 PRIVATE SECTOR CREDIT

The most recent monetary data confirm the slow performance of lending and the low contribution of private sector credit to money growth. In July and August 2010⁴⁵, private sector credit grew by an average of 9.8% y-o-y. Excluding the exchange rate effect⁴⁶, it grew by 6.1%, only 0.2 p.p. higher than the average growth in the second quarter the present year. Private sector credit to GDP ratio is about 38%, up 2 p.p. from the previous year. The performance of private sector credit continues to be affected by the low private sector demand for credit and the cautious behaviour of banks as far as lending is concerned. Although the improved banks' balance sheets and liquidity figures have provided more room for private sector lending, the still high credit risk and the uncertainties regarding economic outlook continue to impose a conservatory bank lending approach, albeit more moderately than in 2009. On the other hand, the first positive signs of the recovery of credit demand, shown in the second and third quarter of 2010, are still frail against a background of high uncertainty regarding the future outlook, both in terms of the labour market, as far as households are concerned, and the undertaking of new investment by businesses.

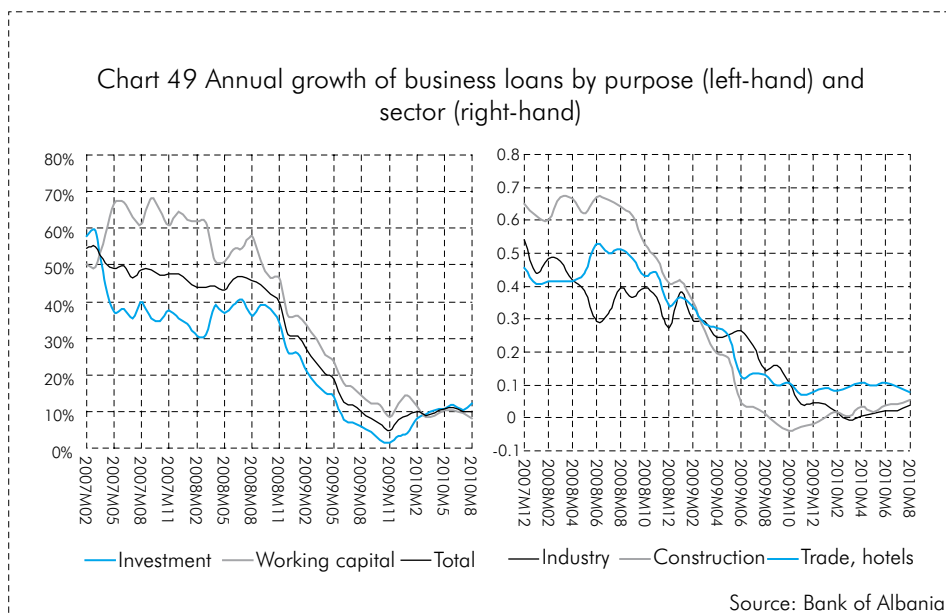


⁴⁵ The data on the third quarter cover only July and August.

⁴⁶ The exchange rate effect is excluded from the credit figures in the remaining of the analysis.

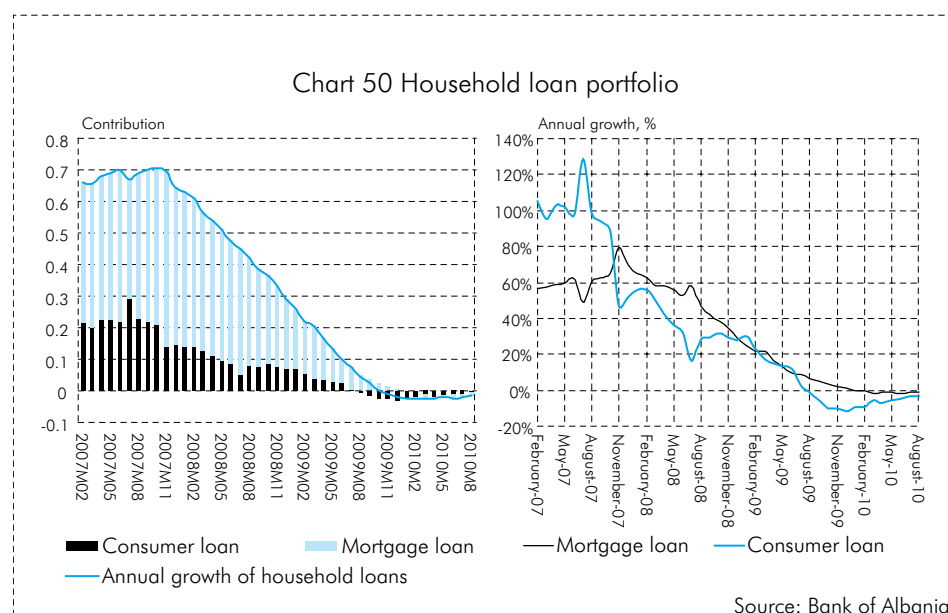
The positive foreign currency liquidity position in the banking system has been reflected in higher foreign currency lending over the course of the year. It grew uniformly and posted an annual growth of 3.3% in August. By contrast, lending in the national currency decelerated its growth rate further to 12.0% in August. Despite posting lower annual growth rates, ALL lending continues to provide the major contribution to the growth of private sector credit.

The growth of private sector credit portfolio continues to be underpinned by the higher business lending. The latter grew by 10.0% y-o-y in the third quarter of 2010, slightly below the average growth of 10.4% in the previous quarter. Services, particularly trade, continue to receive the largest portion of lending. This sector has also recorded the highest growth rates in terms of value added in economy. In the meantime, credit to industry and construction continued to show positive but moderate growth rates during the third quarter of 2010.



Credit for working capital purposes slowed down further while credit for investment purposes maintained its growth rates. Credit for working capital purposes posted an average annual growth of 8.8% in July and August, versus 9.8 and 11.4% in the second and first quarter the present year. Despite the lower annual growth of credit for working capital purposes, the necessity to meet the liquidity needs is the main driving force of business demand for loans. New loans for this purpose remained at high levels throughout 2010 and comparable to 2008 and 2009. Investment loans grew by an average of 11.2% in July and August versus 10.8 and 7.2% in the second and first quarter the present year. Despite the higher business demand for investment loans in the last two quarters, its growth is largely affected by the existence of non-utilized business capacities⁴⁷, hence giving rise to a moderate demand for new investment loans.

⁴⁷ According to the business confidence survey in the second quarter of 2010, capacity utilization rate increased, however standing below the average historical rate.



Household loans continue to be affected by the sluggish labour market, the higher consumers' propensity to save, the uncertainties surrounding real estate investment and the tight bank lending conditions to finance consumption. These factors materialized in a weak household demand for loans. Against this background, the performance of household loans was slow in the third quarter featuring a more contained contraction in annual terms. In July and August, household loan portfolio declined by an average of 0.9% y-o-y versus the decline by 1.9 and 2.1% in the second and first quarter the present year. This performance owes to a large extent to consumer loans. The latter's contraction rates were lower during this quarter, 3.3%. Mortgage loans exhibited a similar performance. After declining by an average of 1.3% y-o-y in July, mortgage loans posted a decline by 0.7% in August.

Box 4 Lending activity and related concerns

Economic literature provides extensive evidence for the importance of bank lending to a country's economy. Research literature highlights the strong correlation between the development of the banking system and economic growth, concluding that countries with developed banking systems have greater prospects to grow⁴⁸. These conclusions are particularly important for emerging countries, as is the case of Central and South-East European countries, where bank lending is the main financial source for businesses at a time when other sources, like the capital market, are very little or no developed.

The performance of bank lending is determined by factors that affect supply (banks' willingness and capacity to lend) and demand (business and household wish to

⁴⁸ There is vast research literature that supports the positive correlation between bank lending and economic growth. For more information, see Ross Levine, "Finance and Growth: Theory and Evidence" NBER Working Paper No. 10766, 2005.

increase their economic activity). It is difficult to identify and measure the specific effects of these factors since the loan portfolio developments are a consequence of their concurrent interaction.

Empirical evidence shows that the slowdown of economic activity is followed by a general fall of demand for loans triggered by household and business propensity to lower their borrowing. The uncertainty regarding the economic outlook pushes individuals to save more and spend less, to postpone their investment plans, like the purchase of a house, and show more prudence in financing consumption through loans. Against a background of reduced consumer demand, businesses are confronted with lower utilization of their production capacities. The existence of free capacities, coupled with the uncertainty regarding the performance of economic activity in the future, give rise to lower business needs and incentives to make new investments. In the absence of new investment plans, business demand for loans is dominated by loans to finance the short-term liquidity needs.

On the other hand, economic slowdown affects the soundness of banks' balance sheets, hence having an effect on the credit supply. The economic difficulties consumers and businesses are confronted with lead to delays in the settlement of their loans, hence increasing the level of non-performing loans and causing losses for banks. The deterioration of profitability indicators provides a direct impact on banks' capacity to lend and it is reflected in tight lending standards. In these periods, credit supply is also affected by a more conservative behaviour of banks in assessing risk compared to periods of economic boom when not only banks but all other economic agents are very optimistic about the future prospects.

The monetary and supervisory authority, the central bank, plays a key role in the interaction of the foregoing factors. Through its policies, it affects both demand and supply for credit. In particular in periods of economic slowdown, it is confronted with a difficult decision-making in view of meeting its two responsibilities: pursuing a stimulating monetary policy to boost economic activity and carrying out a prudent banking supervision in order to safeguard financial stability. Although these two objectives are reciprocally consistent in the long run, there may be a trade-off in the short run: on the one hand, there is the need for greater support to the real sector of the economy for banking loans; and on the other, there is the need to observe the soundness of lending parameters in accordance with the regulatory and supervisory framework. The central bank's approach is to make an appropriate combination of these policies in order to ensure a stable economic development and safeguard financial stability.

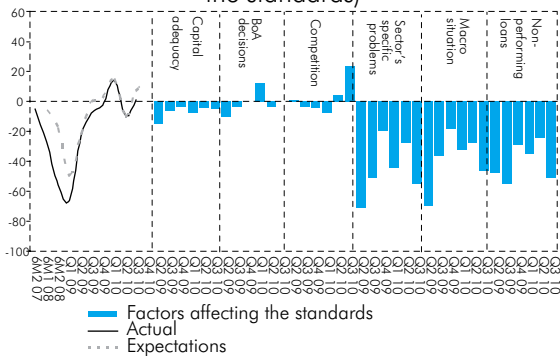
The economies of Central and South-East European countries are suffering a pronounced credit slowdown and, in several cases, credit contraction⁴⁹. Initially, this performance was considered to respond to the high uncertainty regarding the future prospects and the liquidity constraints that banks suffered as a result of the confidence crisis in the global financial system at year-end 2008. Despite the improved liquidity in the banking system and the markedly lower uncertainty, the performance of lending in these economies remained sluggish in 2010 and manifested almost all the foregoing concerns.

The performance of lending in Albania during 2009 and 2010 is similar to the experience of other Central and South-East European countries but at more moderate levels. The growth of private sector credit, albeit slowing down in

⁴⁹ The performance of lending in these countries' economies is elaborated at length in the periodic reports published by the respective central banks.

2009, did not plunge into a negative territory and resumed its growth rates in 2010 once the positive economic growth rates recovered. The Bank of Albania has over this period provided room for the banking system to lend. In addition, it has constantly worked on providing a modern and flexible regulatory and supervisory framework, hence ensuring an efficient banking supervision and a sound financial system. It is expected that once the demand in the Albanian economy recovers more rapidly, the banking system will increase lending to meet its financial needs.

Chart 51 Changes in lending standards to businesses and contribution of different factors (net balance*, net percentage of banks easing the standards)



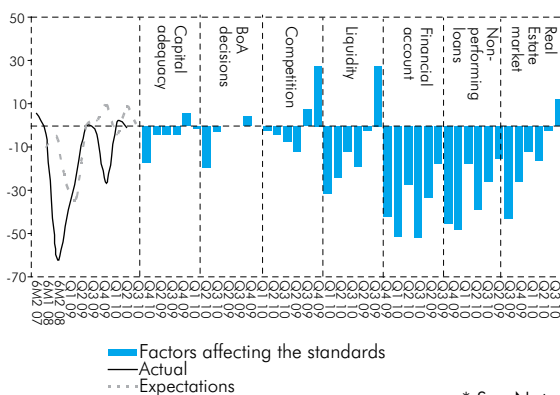
*The positive balance indicates easing lending standards or that the factor has contributed to easing the lending standards; the negative balance indicates tightening lending standards or that the factor has contributed to tightening the lending standards.
Source: Bank of Albania

Box 5 Bank lending survey results for the third quarter of 2010⁵⁰

Bank lending survey results show that the lending standards applied to businesses eased slightly in the third quarter of 2010, while tightening slightly to households compared to the previous quarter. The standards eased in the third quarter only for loans to SMEs and to households for housing loans. In terms of purpose of use by businesses, the standards eased more for working capital loans than for investment-related ones.

According to bank experts, business and consumer demand was downward in the third quarter of 2010. Macroeconomic situation is considered the key factor to have pushed the business demand down, while concerning households, bank lending conditions are considered the key factor.

Chart 52 Changes in the standards applied to housing loans and consumer loans and contribution of different factors (net balance*, net percentage of banks easing the standards)



* See Note 1.
Source: Bank of Albania

Banks' tight lending policies on business loans during the third quarter of 2010 were mainly applied through the increase of margins on high-risk loans and the increase of the collateral requirement. The easing policies were mainly applied through the increase of the maximum loan maturity. Banks' tight lending policies on household loans were applied through the increase of margins on high-risk loans, In the meantime, the lowering of the lending margin, contributed to applying an easier lending policy.

For the last quarter of 2010, banks expect easier lending standards applied to businesses and tighter lending standards to household loans. Banks expect higher demand in the last quarter of 2010, both for business and household loans. Banks also expect a more rapid growth of lending in foreign currency.

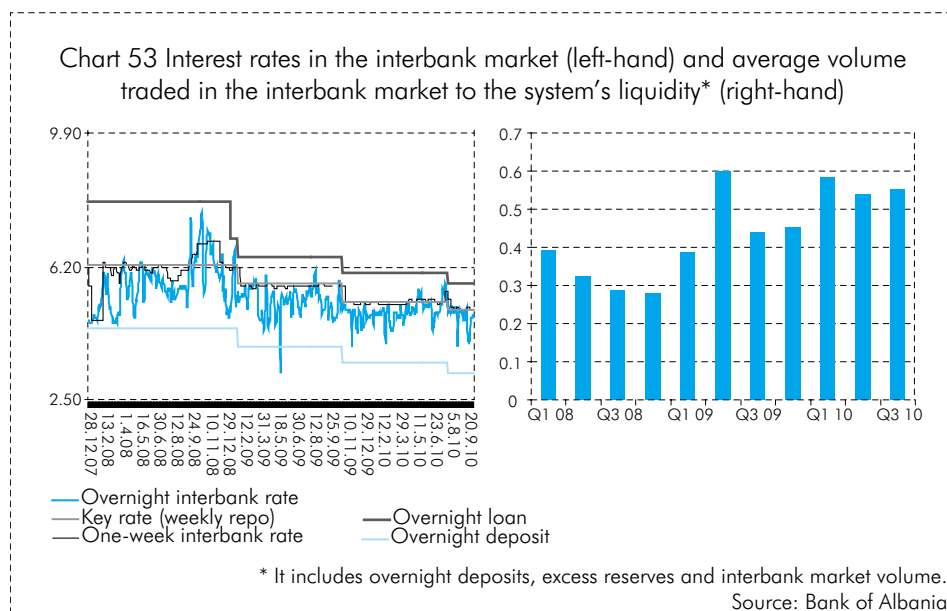
⁵⁰ You may find a complete analysis of the bank lending survey results at the Bank of Albania's website www.bankofalbania.org under the Surveys column.

V.2 FINANCIAL MARKETS, INTEREST RATES AND THE EXCHANGE RATE

Against a background of stable liquidity situation, the key interest rate cut by the monetary authority generated the expected response in the financial markets. The interest rates in the interbank and primary market went down in response to the key interest rate cut. The downward tendency of interest rates was also noted in the ALL loan and deposit market. However, the cut of the interest rates on loans denominated in the two major currencies is not uniform and is highly affected by banks' preferential policies for certain segments of the economy. For the fifth consecutive quarter, the nominal effective exchange rate featured a lower depreciation trend.

V.2.1 INTERBANK MARKET

Interest rates in the interbank market pursued a downward tendency during this quarter, whilst the traded volumes have been increasing to higher levels than in the previous quarter. Considering the performance of inflation within the target range and in order to fuel domestic demand by lowering the cost of lending, the Bank of Albania cut the key interest rate by 0.25 p.p. to 5.00% in July. The interest rate cut by the Bank of Albania was reflected almost instantly to the interest rates in the interbank market. The transactions volume in this market was dissimilar for the two most prevalent maturities; overnight borrowing grew moderately, while one-week borrowing remained at similar levels, hence confirming the previous quarters' performance.

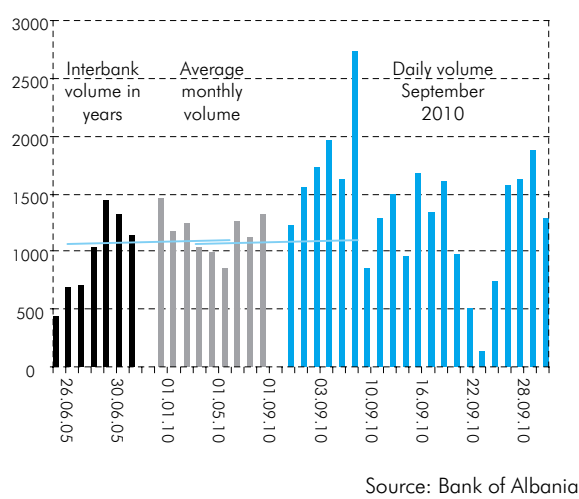


After the low levels in June, banks' activity in the interbank market expanded in the following months and exceeded the previous quarters' average. The decrease in interest rates was more evident in August and September, which relates to the change in the key interest rate. In general, interest rates were more volatile⁵¹ than

⁵¹ The standard deviation of overnight interest rate in the interbank market was 3.45% versus 2.2% in the previous quarter.

in the previous quarter. Average interest rate rose slightly in July, particularly at moments of required reserve replenishment when the overnight interest rates exceeded the key rate. Temporary supply and demand-side factors and the inefficient banks' management of liquidity at times gave rise to higher interest rates. The Bank of Albania continued to furnish the market with liquidity in the Albanian Lek through reverse repo auctions of one-week, 1-month and 3-month maturity. The liquidity injected into the system in the third quarter was higher than in the previous quarter (ALL 29 billion from ALL 24 billion) and shifted slightly to one-week maturity. The interest rate in these auctions was close to the key rate. At the end of June, the Bank of Albania announced the new operational target, which targets and monitors the performance of the interest rate in the interbank market. This change is expected to help increase and stimulate the activity of banks in the interbank market, being reflected in improved margins.

Chart 54 Daily volume traded in the interbank market



The rapid growth of one-week borrowing during these months has offset the slower growth of overnight borrowing, thus resulting in higher total volume traded in the interbank market. This performance provides evidence for a more improved confidence setting in the market. Hence, total borrowing increased versus the previous quarter and the first half's average. The interest rates in the interbank market reflected these developments in average terms as well; in September, overnight interest rate dropped to 4.71% and the one-week interest rate to 5.02%. Q-o-q, the interest rates have reflected the key interest cut and have been lower than in the previous quarter.

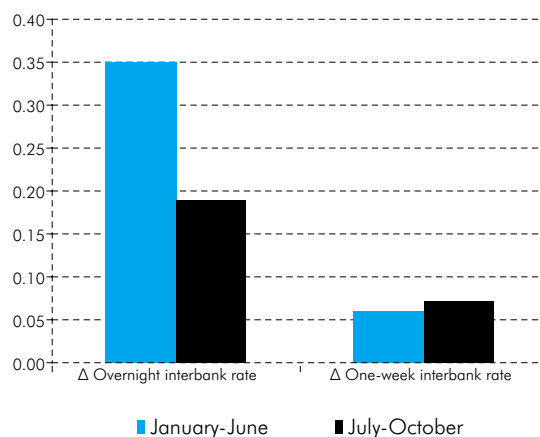
Box 6 The new operational framework and the interbank market response

Beginning from July 2010, the Bank of Albania decided to apply as its operational target the steering of short-term interest rates in the interbank market close to the key interest rate and keeping their fluctuations under check. This Box provides an outline of the performance of some indicators that are directly related to this new development in our practice. The quickest and most direct indicator to be obtained is the measurement and analysis of interest rates volatility in the interbank market versus the key interest rate. Although the selected period is short and there are factors related to the seasonal developments and structure-related concerns, the rates below provide preliminary information, which is useful for our analysis. Another indicator is the standard deviation level of these rates in given periods, under the rationale that an announced and transparent target, focused on the interest rates in this market, will stimulate banks to enhance the soundness of the interbank market activity.

The analysis of the spread between the interbank market rates and the key rate was made between two periods that are characterized by similar regulatory requirements and financial conditions. The time interval used as a reference for the “old” operational objective begins in January, when the repo auctions resumed their competitive limited amount form, and terminates at the end of June when the central bank’s operational target changed. The second period covers the months following the change and which contain the probable effects of the new operational target.

The changes between the interbank rates and the key rate were dissimilar for both maturities during these two periods. After the change of the operational target, overnight interbank rates lowered their absolute spread to the key rate from 35 to 21 b.p. One-week rates increased this spread slightly by 2 b.p. Concerning the standard deviation, we note that the pre-change period shows lower values for both maturities, 24 b.p. from 34 b.p. for overnight rates and 5 b.p. from 15 b.p. for one-week rates. The rationale behind this deviation is the seasonal effect of the selected months for the post-change period and the key rate cut. The lower spread between the overnight interest rate and the key rate supports the initial goal of convergence around the key rate and the interbank market stabilization. This spread is comparable to that in more developed financial markets. In Euro area’s interbank market, the spread between EONIA (overnight interbank rate in Europe) and the key rate has averaged 70 b.p. in the last 12 months. Worth noting in this case is that the supply of liquidity by the ECB is still carried out through a fixed-rate and open amount auction procedures. This factor contributed substantially to the level of banks’ liquidity and to the interbank rate positioning close to the overnight deposit rate.

Chart 55 Key rate and interbank market rates spread

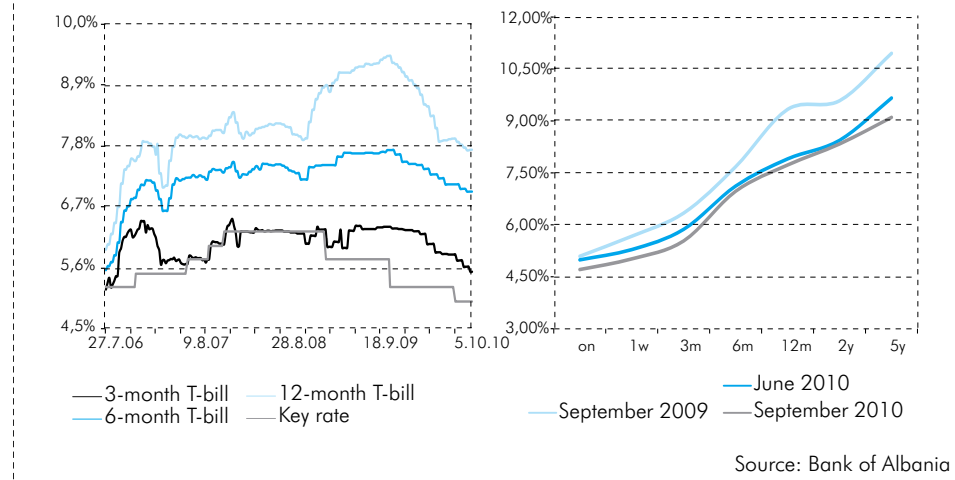


Source: Bank of Albania

V.2.2 PRIMARY MARKET

The lowering of Government security yields for all maturities in the primary market persisted in the third quarter, hence maintaining the downward tendency that emerged in the beginning of 2010. The lower risk perception, the more adequate supply-demand ratio for Government borrowing, the stable liquidity situation in the banking system and the last key interest rate cut by the Bank of Albania exerted downward pressures on the yields. Banks’ demand in the primary market auctions was for all types of maturity and higher than the issued amounts, thus increasing competition and underpinning the downward trend of the yields. The 12-month yield dropped continuously, while the change of the key rate by 0.25 p.p. at end-July reflected in the asked yields in the auctions held in the following period. The yield rates dropped markedly during this period to below the pre-crisis period. As at end of September, the 12-month yield was 7.74%, down 0.17 p.p. from the end of the previous quarter and 1.61 p.p. than the previous year. 3- and 6-month yields dropped by 0.35 and 0.24 p.p. versus June to 5.54 and 6.98%, respectively.

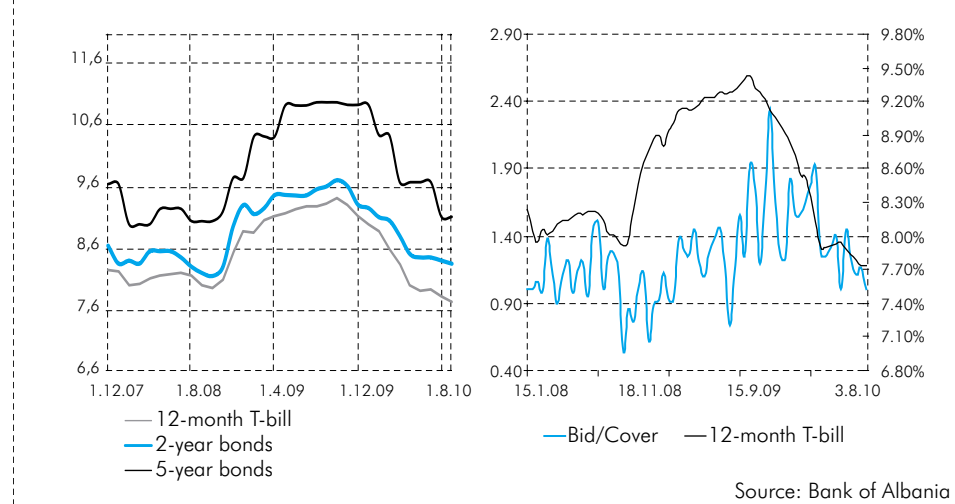
Chart 56 Government security yields (left-hand) and the yield curve (right-hand)



As at the end of the third quarter of 2010, the more rapid drop of short and medium-term yields than the long-term yields gave rise to a slight increase of the yield curve slope.

The performance of the yields in the primary bond market was similar to the T-bills'. As at end of the third quarter, 2-year bond yield dropped by 0.10 p.p. to 8.35%; 5-year bond yield dropped by 0.56 p.p. to 9.12%. The key rate cut was reflected in these instruments in the last auctions when the yields dropped again. The improved financial conditions and the high competition for these types of instruments intensified the downward pressures further, hence underpinning the downward performance of the yields.

Chart 57 Bond yields (left-hand) and bid/cover ratio (right-hand)



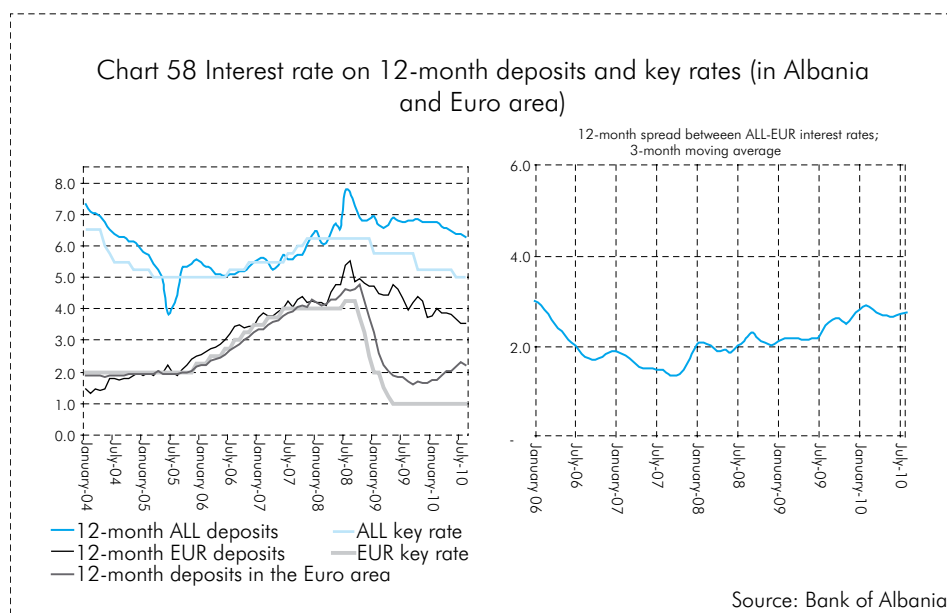
V.2.3 INTEREST RATES ON NEW DEPOSITS AND LOANS

In July and August, the banking system continued to record slight drops in the interest rates on deposits denominated in the two major currencies. Yet, in marginal terms, they remain relatively high compared to their respective key rates, due to the high competition among banks to maintain their market share.

The weighted average interest rate on ALL deposits was 5.30% in July and August, up 0.15 p.p. from the second quarter's average. This rise does not only owe to the summer offers, but also to the new inflows in long-term deposits of higher interest rate. Preliminary data show that the drop of interest rates on deposits persisted in September, hence being in line with their normal behaviour in response to the monetary policy signals⁵².

Regarding maturity, interest rates dropped for all maturity terms. The interest rate on 3-month deposits dropped by 0.21 p.p., while 6- and 12-month deposit interest rate dropped by 0.08 and 0.14 p.p. Relative to the same period in 2009, average interest rate on deposits is 0.41 p.p. lower in July and August (the key interest rate has been cut by 0.75 p.p. during this period).

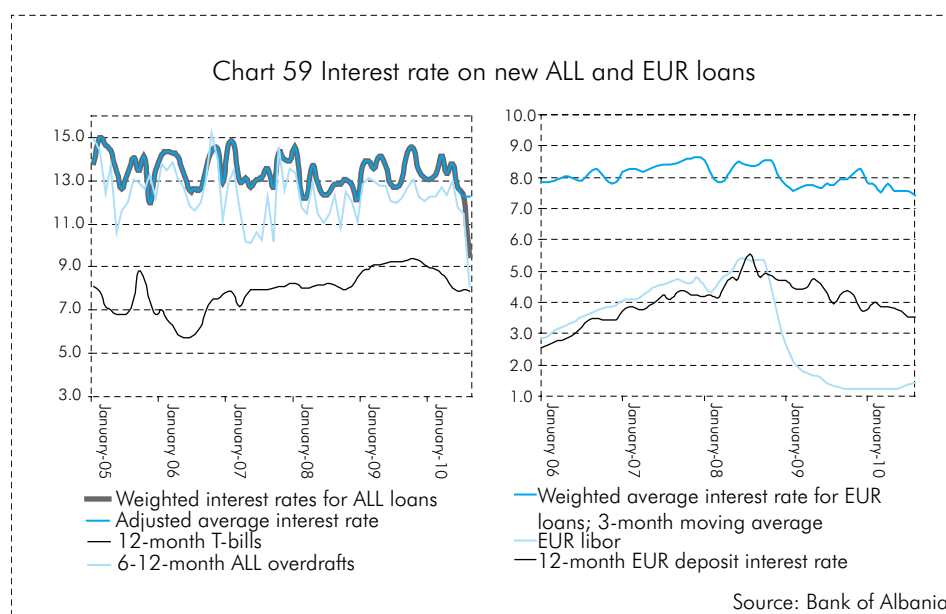
Interest rates on EUR time deposits pursued a similar dynamics as ALL time deposits in July and August. Weighted average interest rate on new EUR deposits was 2.29%, 0.02 p.p. higher than the second quarter's average. Concerning the maturity term, interest rates on 1-, 3-, 6- and 12-month deposits dropped by 0.10, 0.24, 0.01 and 0.28 p.p., respectively. The high level of competition across those banks that use the interest rates on EUR



⁵² Interest rates on ALL deposits have by and large responded faster this year to the change in the key interest rate. The cut of the key interest rate by 1.00 p.p. in 2009 was not followed by an immediate decrease of interest rates on ALL deposits due to banks' policies to continue withdrawing liquidity from the public.

deposits as cost of funds caused the other banks to continue to maintain high interest rates on EUR deposits compared to the European market⁵³.

The last two months of summer continued to feature easier lending standards and prices in the banking system. They continue to be mainly affected by the diversification in promotional offers and the preferential terms that some banks apply on particular customers for both major currencies. On the other hand, the more cautious monitoring and the exchange rate risk still keep the margins on EUR long-term loans high.



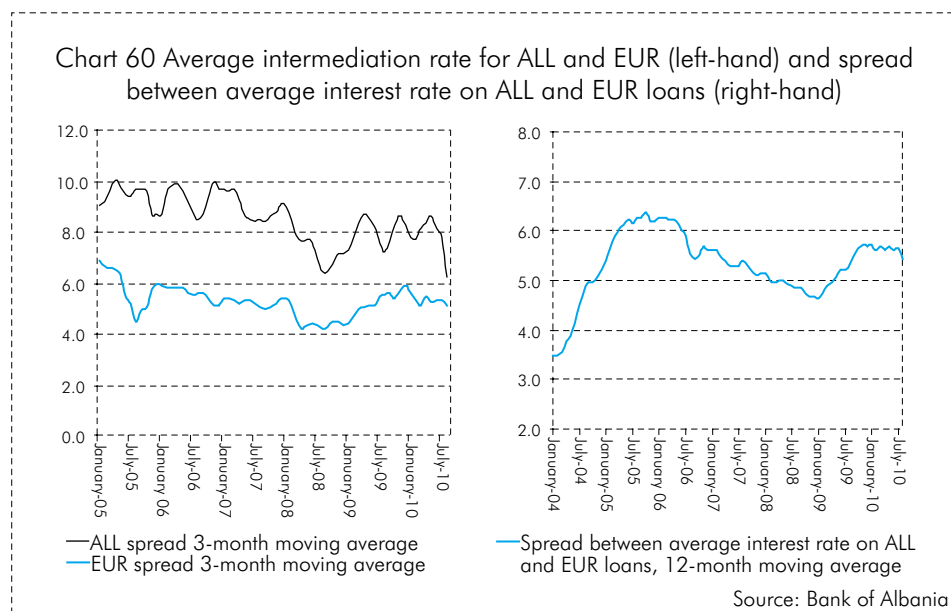
Interest rate on ALL loans dropped markedly in July and August, approaching the 12-month yield. It averaged 10.92% but this low value was affected by a considerable short-term loan amount and at an interest rate highly below the system's average. Excluding this loan, the interest rate was 12.26%, being however 1.02 p.p. below the previous quarter. The lower average owes primarily to the promotional interest rates of some individual banks, mainly on business overdrafts and mortgage loans.

Interest rates on EUR loans have pursued a downward trend since June. In June and August, they averaged 7.29% or 0.30 p.p. below the second quarter's average. Interest rates on EUR loans performed alike in terms of maturity as well, with short-term loans extended by some individual banks providing the major impact (lower interest rates on business working capital loans). In the meantime, banks remain reluctant to extend new loans of over 5-year maturity term (mortgage loans). Interest rates on these loans increased by an average of 0.16 p.p. in July and August compared to the second quarter.

Intermediation cost in ALL reduced markedly in July and August as a reflection of the downward interest rate on loans. In the third quarter, it pointed

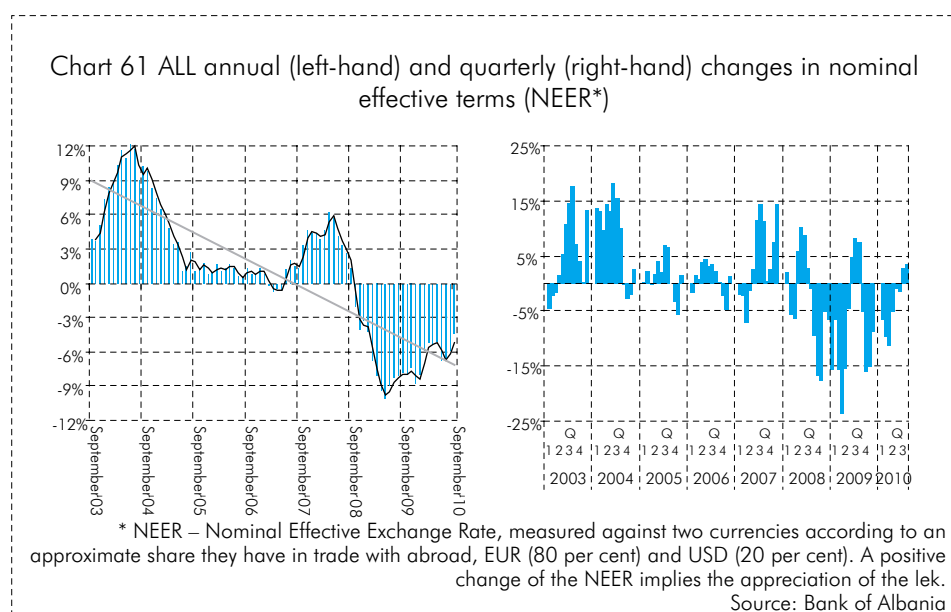
⁵³ Worth noting however is that the spread narrowed as a result of the higher interest rates in Europe.

to 5.62 p.p. versus 8.13 p.p. in the second quarter. Average intermediation rate for the EUR averaged 5.00 p.p. in July and August, down 0.31 p.p. from the second quarter. The spread between interest rates on ALL and EUR loans remained highly volatile. In August, it narrowed by 2.04 p.p.



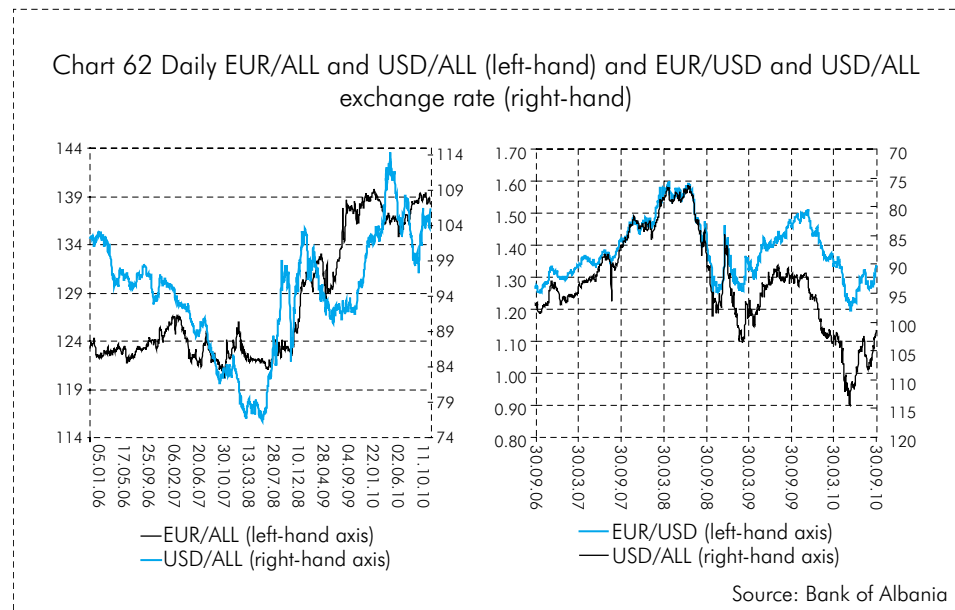
V.2.4 EXCHANGE RATE

Nominal effective exchange rate continued to attest to lower depreciation rates of the domestic currency in the third quarter of 2010. The annual changes in the NEER index fluctuated regressively on the depreciation side for the fifth quarter in a row. In September, they were estimated at -4.4%, the lowest depreciation rate since February 2009. The average rates declined by 5.64% y-o-y in the third quarter, versus 8.10 and 5.73% in the same

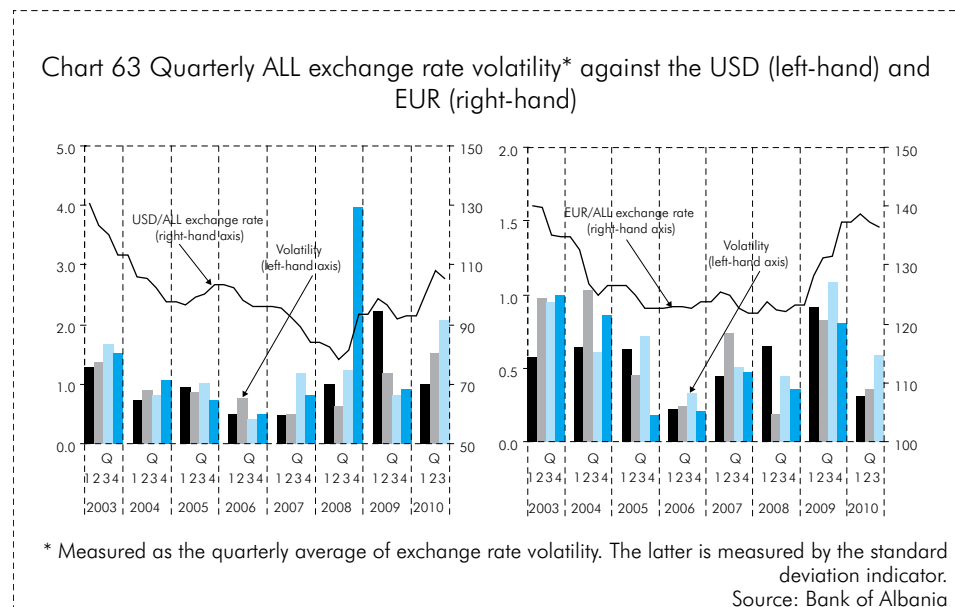


quarter in 2009 and the previous quarter. The considerable improvement in the external sector of the economy, the normalized liquidity conditions in the financial markets and the minimized psychological effects that characterized the Albanian market throughout 2009 provided the major contribution to the decline in the depreciation rates versus the previous year.

The analysis of quarterly NEER shows the appreciation of the ALL against the major currencies, owing primarily to the seasonal effects characterizing summer and the performance of foreign currencies in the world market. EUR/ALL and USD/ALL individual ratios showed the appreciation of the ALL by 0.57 and 2.23%, respectively.

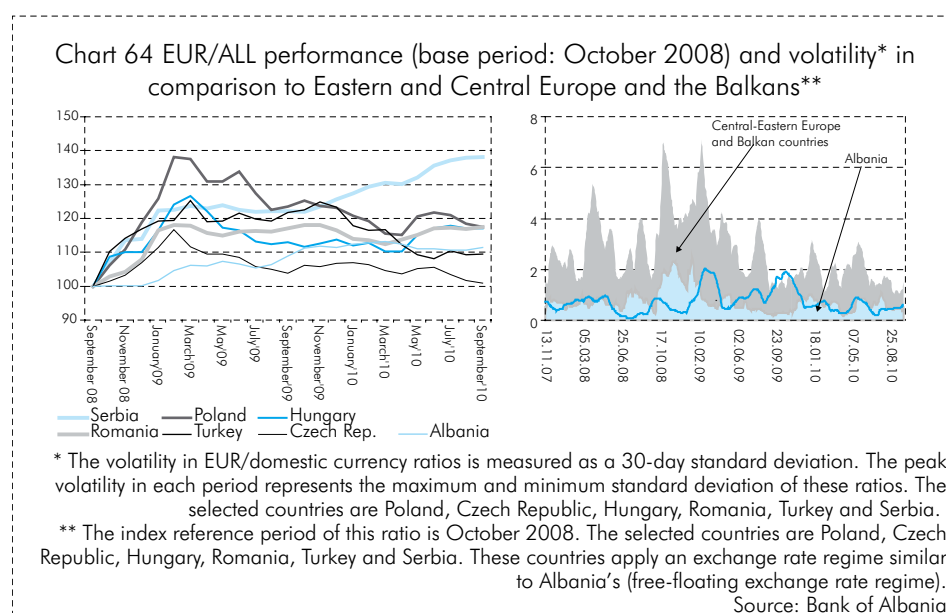


The positive performance of the ALL against the USD during this quarter reflects the performance of the EUR/USD in the world market. The depreciation of the USD against the EUR by an average of 1.6% q-o-q is a reflection of



the pessimistic outlook regarding the U.S. economic growth and the possible monetary policy response to this outlook. Against a similar setting, it seems that the international agents' concerns over the fiscal strains some Euro area member states are facing – which made up the key factor in the favouring of the USD trading in the first half of 2010 – have receded.

On the other hand, the seasonal appreciation of the ALL against the EUR concentrated in July when it appreciated by 0.4% on monthly average terms. For the first time since October 2009, 1 Euro traded at Lek 134.86⁵⁴. The strong Lek's position persisted in the first half of August, a period that marks the peak tourist season. In the meantime, the Lek depreciated in the second half of August once the seasonal offers terminated. The foregoing developments in the EUR/ALL exchange rate point to a relatively higher volatility than in the previous quarter but below the same quarter in 2009.



In a regional context, the EUR/ALL has been stable, featuring a slight appreciation tendency. The performance of the Lek is in line with that of other currencies of Central and Eastern European and Balkan countries against the Euro. It seems that the positive external sector developments and the fiscal measures undertaken in the majority of the foregoing countries have favoured the position of the domestic currencies.

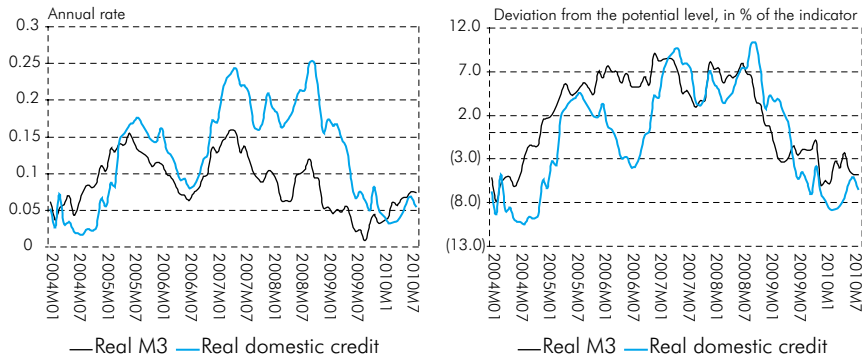
V.3 ASSESSMENT OF MONETARY INFLATIONARY PRESSURES

The annual growth rates of monetary indicators remain moderate despite the positive developments during summer. The long-term dynamics of monetary indicators shows that real demand for money is growing at lower rates than the historical average. In the last 12 months, M3 aggregate growth

⁵⁴ This figure refers to July 21, 2010.

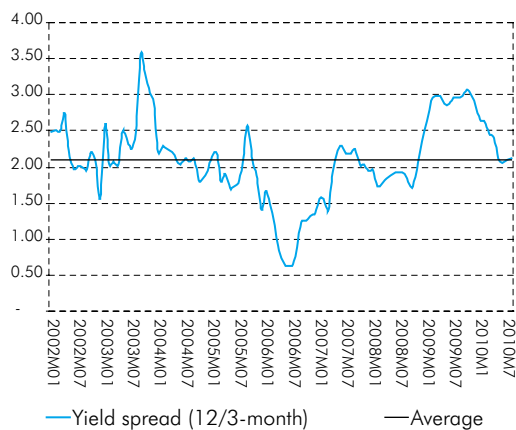
has averaged 4.8% in real terms⁵⁵. The moderate growth rates of real M3, and in particular the lower contribution of domestic demand for money to money growth⁵⁶, underpins the assessment that the money growth rate in economy is in line with the real demand of the economy for money and that the inflationary pressures arising from the monetary developments in the medium run are contained.

Chart 65 Annual performance of monetary indicators in real terms and real demand for money gap*



* As shown in the chart, the gap is measured as the deviation of current M3 and domestic credit from assumed potential level of 8.6 and 12.3% (which represent the historical average of 2004-2010, base year: 2004). Due to the uncertainty in the estimation of the potential, the performance of this indicator should be interpreted cautiously, particularly in the case of an emerging economy.
Source: Bank of Albania

Chart 66 Interest rates gap



Source: Bank of Albania

The performance of interest rates in the third quarter shows stable risk premium and lower factorization of the inflation premium in long-term interest rates. Hence, the gap between long and short-term interest rates⁵⁷ narrowed during this quarter. After the marked widening in the first half of 2009⁵⁸, this indicator narrowed in 2010 and stabilized around the recent years' average in the third quarter. This performance attests to the rebound in economic agents' inflationary expectations.

In addition, the stable exchange rate during summer and its slight monthly appreciation against the major currencies reinforce the conclusions for lower pressures of the forex market on inflation.

⁵⁵ The performance of M3 aggregate and domestic credit in real terms reflects the discount of growth in these indicators vis-à-vis the increase in the price index.

⁵⁶ As shown in Chart 65, unlike the historical behaviour, the annual growth of domestic credit is lower than real M3 growth throughout 2010.

⁵⁷ The gap is defined as the spread between 12-month and 3-month T-bill yield. The rationale behind the selection of the 12-month yield is that this instrument is part of a more competitive market and its market price reflects the key factors best.

⁵⁸ In addition to the reflection of the higher perceived uncertainty, this difference owes also to the liquidity shortages in banks and the high Government demand for money.

Moreover, the absence of shocks on the exchange rate relative to the previous year has contributed to safeguarding financial stability at home, providing room for larger banking system participation in financing the economy's needs and transmitting the monetary stimulus into the economy more fully.

