

BANK OF ALBANIA

MONETARY POLICY
STATEMENT FOR THE
FIRST HALF OF 2008

2008

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I. GOVERNOR'S SPEECH

The recent developments attest to further deepening of the U.S. financial crisis, peaking in the last weeks with the collapse of one of the largest investment banks Lehman Brothers. Prior to this startling failure, the two U.S. mortgage giants, Freddie Mac and Fannie Mae, were subject to an unprecedented and costly rescue plan designed by the U.S. Treasury Department. In fact, this has only been one of the U.S. authorities' interventions, followed by a number of other actions, involving the AIG insurance company, Merrill Lynch and in particular the plan announced on 21 September 2008 for the creation of a 700 billion dollars fund for the purchase of mortgage-related assets.

This crisis which is characterizing the global economy for more than a year has caused many reputable international financial institutions to experience large financial losses. The situation remains vague and the spreading process of its undesired effects may also be present in the months to follow.

U.S. crisis and its combination with a number of other global developments have caused the economic situation in developed countries to be characterized by numerous uncertainties. Inflation has now turned into a concern for most international economies, mainly reflecting the surge in prices of raw materials, oil and food. Economic growth in developed economies has shown distinct signs of slowdown. Economic growth for the Euro area shrank by 0.2 percent in the second quarter of 2008 relative to the first quarter of the same year. Meantime, the U.S. economy is expected to continue to grow at slow rates during the second half of the year.

Under these circumstances, there has been high tension in the markets being mainly reflected in the dropping value of financial assets, changes in the prices of raw material and commodities, contracted house prices and the increase in the interest rates spread. In response to this situation, the largest global central banks have taken co-ordinated measures to relieve the markets by mainly injecting large amounts of liquidity. However, in their last meetings, both the Federal Reserve and the ECB kept the key interest rate unchanged at 2 percent and 4.25 percent, respectively.

With respect to internal developments, annual inflation dropped to 2.5 percent in August 2008, being in line with the previous projections of the Bank of Albania. The eighth-month period of January – August 2008 was characterized by considerable fluctuations of the annual inflation rate which marked an average of 3.8 percent. Since August 2007 to June 2008 there

have been negative developments in this respect, causing the inflation rate to remain above the upper tolerance band of 4 percent. The price rise of food and oil in the global market, the performance of agricultural production in 2007 and the price rise of energy in March 2008 represent some of the main causes to explain the inflation increase during this period.

Headline inflation and other measures of core inflation have shown a downward tendency in the last two months. Supply-side factors which pushed the increase of inflation in the previous period reduced their effect in July and August. Weather conditions during the present year have been encouraging, causing the domestic supply of agricultural production to grow. Seasonal effect generated by the entry of domestic agricultural production was more considerable relative to the previous year. Oil and grain prices in the global market have been falling in the last two months. The projections of the Bank of Albania staff indicate that the inflation rate will remain in the following 12 months at around 3 percent, which is also our quantitative objective.

Despite this, worth to note is that the risks for its upward deviation are still present and they mostly relate to the international developments. However, plausible risks are present in the internal developments and they will be constantly subject to analyses of the Supervisory Council of the Bank of Albania. Any unwelcome developments in the energy situation in the months to follow, the rapid growth of credit to economy and other possible fiscal implications in the future represent the main risks in this context.

Statistical monitoring of the Albanian economic activity continues to reflect difficulties. Based on the data made available for the first quarter of 2008 and some other indirect indicators covering the 6 and 9-month period (growth of exports, growth of budget revenues, hydro energy situation and some other consumer indicators) it may be concluded that gross domestic product will grow in line with the previous projections by 6 percent. However, more statistical information is required to make a more detailed and comprehensive sectoral analysis.

In contrast to the previous two years, budget revenues followed a different trend in the first half of 2008, being mainly manifested in a more rhythmical spending. Unlike the last two years, budget balance ended negative, 2.3 billion leks, which is far behind the projected level of 18 billion leks. Budget revenues continued the previous months' trend, exceeding the planned target by about 3 percent in the first half of 2008. Expenditures accelerated their meeting rates, in particular in the end of the six-month period, and met 92 percent of planned target. Domestic borrowing represents the main instrument of budget deficit financing, sharing 90 percent of total borrowing.

The first half of 2008 recorded a 60 percent growth of current deficit in annual terms, which amounted to 591 million euros. Consequently, it accounts for about 13 percent of the GDP. The high trade deficit, which has provided the main contribution to current deficit deepening during this period, was also followed by the deficit on trade in services and the narrowing of net

current transfers' surplus. The Bank of Albania is monitoring prudently the developments in the external sector of the economy, which for the moment remain a concern in terms of long-term developments in economy. The main implications relate among others with the financial stability in the country, while their source relates with the imposed correction of long-term ratios within a short period of time.

Demand for money in economy has grown at a stable rate by an average of 12 percent in annual terms during 2008. Credit to the private sector dominates the money growth in economy, while credit to the public sector still remains at modest levels, accounting for only about 2.5 percentage points of M3 annual growth. In terms of constituent components of money supply, its most liquid part, currency outside banks, continues to grow at slow rates, while deposits show high growth rates. Being mainly pushed by the marketing strategies of the banking system applied during summer 2008, annual growth of lek and foreign currency-denominated deposits was 11.2 percent and 30 percent, respectively. During the last two months, their time structure has shifted to time deposits, being mainly reflected in the growth of households' time deposits.

During the seven-month period of 2008, credit to economy continued to grow at an average annual rate of 45.5 percent, accounting for 34 percent of the GDP and 45.3 percent of (M3) broad money. Credit growth rates have generally followed the downward trend of the last two years, except for June and July which recorded higher growth rates relative to the previous months.

Composition by currency continues to maintain the same structure, with foreign currency-denominated credit sharing the main weight. In average terms, during the first seven months of 2008, credit denominated in foreign currency accounted for about 72 percent of credit portfolio or about 2 percentage points more than the 2007 average.

Credit to the private sector recorded an average annual growth by 41 percent in the first seven months. Business loans provided the main contribution, out of which the sectors of trade, construction and industry shared 77 percent of loans extended to businesses. In annual terms, household loans grew by an average of 51 percent during January – July 2008. Despite this figure, the two-month period, June – July, showed a slowdown for this type of loan. On the other side, real estates loans, which account for about 66 percent of household loans, maintained the high growth rates providing the main contribution to the growth of this portfolio.

During 2008, the interest rates in the money market increased in line with the monetary policy orientation. In average terms, overnight interest rate in the interbank market increased by 80 basis points relative to the previous year, to 5.6 percent.

The oscillations of interest rates in the interbank market related to the change of liquidity conditions in the market and to its asymmetrical distribution. The beginning of the third quarter was followed by the relief of the liquidity

situation and a more balanced distribution being reflected in the downward performance of overnight interest rates to 5.6 percent at the end of August.

The primary market showed low oscillations of the yields during 2008. They have gradually transmitted the tightening of monetary conditions signalled in the second half of 2007 while the spread between the maturities has narrowed.

Long-term yields in the bonds' market show a narrowing trend of spreads between maturity terms in the last two years. 2-year bonds which have a higher (monthly) frequency in average terms have increased slightly during 2008 relative to the previous year, while the yields for other maturity terms have been decreasing. As of end August, 2-year bonds' yield stood at 8.3 percent or 0.06 percentage points higher than last year's average, while 5-year bonds' yield dropped by 0.76 percentage points to 9.06 percent.

The interest rates for credit denominated in foreign currency have been in line with the developments in the global markets and in proportion to the changes in LIBOR and EURIBOR. The interest rate of euro-denominated credit was 8.15 percent in July, dropping by 0.35 percentage points relative to June 2008.

Intermediation rate in the banking system has dropped in average terms. With respect to lek, it is shown that the spread between the weighted average interest rate of lek-denominated deposits and lek-denominated credit has dropped to 7.56 percent in the first seven months from 9 percent the same period the previous year. In addition, average intermediation rate for the euro has dropped by 0.82 percentage points to 4.44 percent relative to the first half of 2007.

The appreciating tendency of the lek against the main foreign currencies shown in the first two quarters of 2008 continued in the third quarter although at more moderate rates. In nominal effective annual terms, the lek has appreciated against the euro and the U.S. dollar by an average of 2.63 percentage points. In annual terms, nominal exchange rate of the lek against the euro and the dollar has appreciated by an average of 0.75 percent and 9 percent.

Monetary developments should not be analyzed separately from the factors establishing the financial system's stability. With regard to the latter, I would like to underline that the financial system in Albania has developed at stable rates in the first half of 2008. Capitalization indicators of business, liquidity and profitability are at satisfactory levels. Given the increased importance of these indicators and in light of the recent developments in the international financial markets, the Bank of Albania has expanded the information sources in terms of deepening the analysis of the stability of the financial system and in particular of the banking sector, endeavouring to identify in advance the possible risks and propose measures to prevent them.

In general, the abovementioned situation contains, in addition to positive developments, some old and new risk factors which affect both the monetary developments and the financial stability. In case of materialization, they may compromise the achievement of the Bank of Albania objective mandated by law. This setting imposes the need for greater prudence in assessing and analyzing these factors and in the decision-making process.

In conclusion, I would like to highlight that the Bank of Albania has preceded the latest developments in the Albanian banking system by taking a number of structural reforms which aim at ensuring its smooth functioning and maintaining the financial balances. During the last year, the Bank of Albania has focused on improving the technical and legal infrastructure of the banking system. The establishment and functioning of Credit Registry, the review of credit regulations in view of enforcing the prudence norms for foreign currency-denominated loans and the review of regulations on interbank loans in view of itemizing the ownership titles, are important reforms which sustain the stable development of the financial system.

On the other side, the establishment of specialized structures, namely the Committee for the Implementation of Monetary Policy and the decisions made by the Supervisory Council of the Bank of Albania, have provided a direct contribution to maintaining macroeconomic balances and the financial system's stability. The effects of the increase in the cost of money have driven more contained credit growth rates and more appropriate proportions of its foreign currency structure. Lately, the Bank of Albania has established a fruitful co-operational relationship with the supervisory authorities of the international financial system and other central banks, in terms of exchanging information and analyses on the latest developments in the global financial system and on their implications.

Even though the maintenance of macro-financial balances is ever-increasingly becoming challenging, on behalf of the Supervisory Council of the Bank of Albania I would like to clarify to the public at large that the maintenance of price stability and the strengthening of financial stability remain the Bank of Albania's priority objectives and that we will be fully committed and willing to achieve them.

II. WORLD ECONOMY

The second quarter of 2008 saw a slowdown in global economic growth and continuous inflationary pressures. The turbulences in the financial markets, the overall price rise and the changes in the house prices have aggravated the economic activity. On the other side, the growing demand of emerging economies has led to a stable growth in these countries, hence contributing to the growth of global economy. Inflation rate increased in the second quarter, being mainly pushed by the price rise of oil and food. Inflation in OECD countries increased by 1.8 percentage points in the second quarter relative to the previous quarter and by 3.9 percentage points relative to the same period the previous year.

II.1 U.S. ECONOMY

U.S. economic activity recorded considerable growth in the second quarter relative to the previous one¹. The depreciation of the U.S. dollar led to the growth of external demand for U.S. goods and to the decrease in imports. The contribution of the trade balance to the GDP growth in the second quarter was the highest since 1980. Substantial contribution was also provided by the increase of personal expenditures which were affected by certain temporary fiscal facilities. The downward tendency of house prices led to the fall of investments in residential buildings; however, this fall was lower than the following quarter. The turbulences in some of the large U.S. financial institutions generated the further reduction of banking lending. Economic growth is expected to grow at slow rates in the second half of 2008, while unemployment and the financial turbulences are expected to continue to jeopardize the U.S. economy. In the second quarter, Consumer Price Index was 4.4 percent or 2.2 percentage points higher relative to the previous quarter. In addition, Producer Prices recorded an annual increase of 9.6 percent, which is one of the highest rates of the last 27 years.

II.2 EURO ZONE ECONOMY

The Euro zone economy shrank 0.2 percent in the second quarter compared with the first quarter of 2008, partly due to the error correction in estimating the growth in the first quarter (0.7 percent). The decline of the economic growth is assessed to have stemmed from the high prices, which have led to the decrease of consumer sentiment and fall in domestic demand. Exports and imports recorded a drop of 0.4 percent in the second quarter, while the influence of trade balance on the economic growth has almost been inconsiderable. Investments dropped by about 1.2 percent compared with the previous quarter. Inflation in the Euro zone continued to mark high rates, remaining well above the ECB's 2 percent target. The high inflation has resulted due to the rising prices of base foods in the international markets and to the increasing labour cost per unit². According to ECB projections, inflation will remain at high rates during 2008 to later reduce significantly in 2009.

Table 1 Macroeconomic indicators of main economies

Country	Annual GDP growth	Annual inflation	Unemployment rate
	Q2:08	Q2:08	Q2:08
USA	2.2	4.4	5.3
Euro area	1.4	3.6	7.3
Germany	1.7	3.0	7.4
Italy	0.0	3.8	6.5 ¹
Greece	3.5	4.7	7.8 ¹
Japan	1.0	1.4	3.8

Source: Eurostat, ECB³, Bank of Japan

Note: ¹⁾ Rate for Q1:08.

II.3 ECONOMIES IN THE REGION

II.3.1 Economy of Turkey and FYROM

After a moderate growth at the end of 2007, the Turkish economy recorded considerable growth in the beginning of 2008 driven by the private sector's high demand. The growth of private investments and consumption of transportation and telecommunication services provided the main contribution to these developments. Public investments, on the other hand, shrank. Agriculture grew as well, following the low growth rates of the previous year. Trade deficit as a share to GDP improved by about 0.1 percentage points. Consumer Price Index recorded 8.8 percent in the first quarter, which is equal to the average rate of 2007. The high inflation rates were driven by the high prices in the international markets and the increased price of energy at home.

FYROM's economy continued to record stable annual growth rates during the second quarter of 2008 propelled by the ongoing growth of domestic demand and investments in the private sector. In the first quarter of 2008, imports grew by 27.6 percent or about 3 times as much as exports, causing the trade deficit to deepen further. The latter accounted for 21 percent of the GDP in the last quarter of 2007. Inflation marked high rates in the first half of 2008. Annual inflation reached about 10 percent in the second quarter, while its average rate for 2007 was 2.3 percent. The sharp price hike of food prices, being also affected by the unfavourable weather conditions, fuelled inflation to record high rates.

II.3.2 Economies of Italy and Greece

Italy's economy grew by 0.3 percent in the first quarter of 2008, while it did not undergo any changes in the second quarter. Industrial production grew higher than projected in the early 2008; however, it fell substantially in May. Annual CPI increased by 3.1 percent in the first quarter and 3.6 percent in the second.

The economy of Greece grew in the first two quarters of 2008; however, the growth in the second quarter was somewhat lower than in the first one. The growth of overall demand in the economy, driven by the higher consumer expenditures, provided the main contribution. The growth of demand in economy was also pushed by the increase of exports and the fall of imports in the first quarter of the present year. On the other side, investments have reduced. Inflation in Greece continued to increase, marking 4.3 percent and 4.8 percent in the first and second quarter, respectively, fuelled by the price rise of energy and food.

Country	Annual GDP growth	Annual inflation	Unemployment rate	Fiscal balance (share to GDP)	Current account (share to GDP)
	Q1:08	Q1:08	Q1:08	2007	Q1:08
Italy	0.0 ¹	3.6 ¹	6.5	-1.9	-2.7 ²

Table 2 Macroeconomic indicators of economies in the regional and trading partner countries

Greece	3.5 ¹	4.8 ¹	7.8	-2.8	-14.8 ¹
Macedonia	5.2	9.9 ¹	34.8	0.6	-3.0 ²
Serbia	8.2	11.3	18.6	0.4	-17
Croatia	4.3	5.9	14.7	-1.6	-9.6
Turkey	6.6	8.8	11.6	-1.2	-5.6

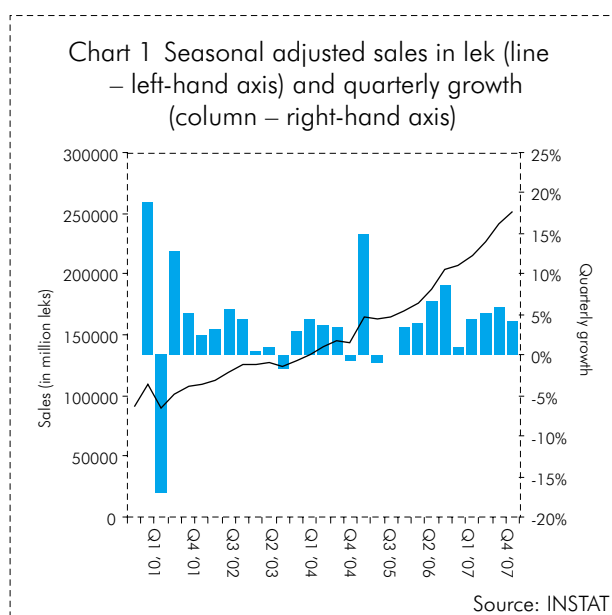
Source: Eurostat, European Commission, respective central banks, OECD

Notes: ¹⁾ Rate for Q2:08; ²⁾ Fourth quarter of 2007.

III. DOMESTIC ECONOMY

III.1 PRODUCTION SECTORS

According to the data for the first quarter of 2008, domestic production has recorded high annual growth rates. Sales indicator⁴ increased by about 4 percent relative to the last quarter of 2007 and by about 20 percent to the same period the previous year. Compared with the historical growth rates, this quarter has recorded one of the highest annual growth rates, while the lowest rates were recorded in 2004-2005.



Services recorded the highest annual growth rate. The increase of sales by about 40 percent in the first quarter of 2008 was similar to the annual increase of sales for the entire year 2007, while the annual increase has been accelerating during the last four years. This outline shows a very rapid growth of services and suggests that it is currently the most dynamic sector of the Albanian economy. Worth to note is that some types of services have recorded relatively high rates of price rise (about 4 percent in annual terms), which have been reflected in the growth rate of the sales' value. Industry and construction continued to record high growth in terms of sales. According to the figures published as of end September, construction shows gradual improvement compared to the unsatisfactory situation in 2007. The sector of trade, hotels and

restaurants continued to grow by about 20 percent being close to the annual growth rates of the last three or four years.

Table 3 Annual growth of sales by sectors (in percent)

	2002	2003	2004	2005	2006	2007	Q1-08
Industry	18	14	3	10	17	25	17
Construction	2	7	24	20	21	11	32
Trade	19	10	10	19	14	21	19
Services	21	10	5	23	33	40	41
Transportation and Telecommunication	4	19	6	11	6	14	12
Economy	14	12	9	16	16	21	21

Source: INSTAT

III.1.1 Construction

The number of new constructions' permits increased substantially during the first quarter of 2008 compared with the same period the previous year. However, this indicator remained during the same period about 50 percent lower than the historical average of the first quarter of 2003 - 2007. The permits granted for the construction of residential buildings, which shared about 64 percent of total number of construction permits, provided the main contribution to the annual increase of new construction permits in the first quarter of 2008.

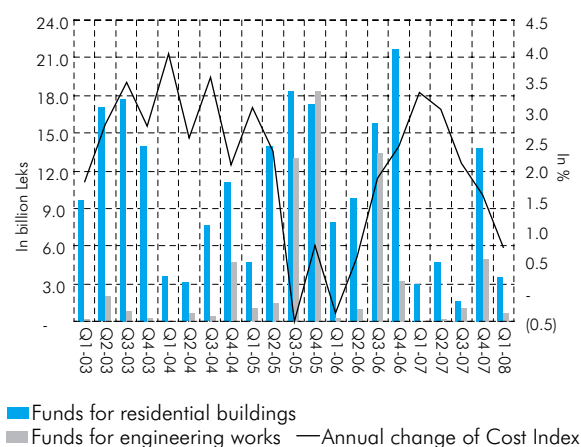
Table 4 Number of approved construction permits during the first quarters in years

	Q1-03	Q1-04	Q1-05	Q1-06	Q1-07	Q1-08	Q1-07 / Q1-08 (in times)
Constructions	751	64	389	300	40	146	2.7
- Residential buildings	481	28	255	194	17	93	4.5
- Non-residential buildings	270	36	134	106	23	53	1.3
a.Hotels	117	-	1	1	-	0	-
b.Commercial buildings	85	23	83	44	10	29	1.9
c. Industrial buildings	16	6	5	16	2	4	1.0
d.Other buildings	52	7	45	48	11	20	0.8

Source: INSTAT

During the first quarter of 2008, the projected value of new constructions by construction permits recorded an annual increase of about 50 percent. About 90 percent of these funds will be used for the construction of residential buildings and the rest (10 percent) for other non-residential buildings, namely commercial buildings, industrial buildings and other. Construction Cost Index increased by 1.3 percent in the second quarter of 2008 compared with the same period the previous year. The increase of this indicator was mainly driven by the rise of direct expenditures by 2.2 percent, where expenditures for electrical equipment, wages and transportation rose by 7.5, 5 and 2.5 percent, respectively, in annual terms. In the meantime, projected earnings dropped by 1 percent.

Chart 2 Projected funds for construction and annual change of Construction Cost Index



Source: INSTAT

III.1.2 Agriculture

During the first half of 2008, the sector of agriculture attested to a high trade activity of agricultural and agro-industry products. Trade exchanges amounted to about 52 billion leks compared to about 28 billion leks totalled during the same period the previous year⁵. In more concrete terms, the exports of agricultural and agro-industry products were reported to have amounted to 4.2 billion leks, while imports totalled 48.2 billion leks⁶. Exports and imports account for 8 percent and 92 percent, respectively, of total trade exchanges of these products.

Table 5 Performance of trade exchanges

Value (in million leks)	S1-2007	S1-2008
Exports	3,552	4,191
- Agricultural products	1,072	1,730
- Agro-industry products	2,480	2,461
Imports	24,431	48,159
- Agricultural products	8,871	17,616
- Agro-industry products	15,560	30,543
Total	27,983	52,349

Source: Ministry of Agriculture, Food and Consumer Protection

During the first half of 2008, agro-industry production grew by 12 percent compared with the previous year⁷. The following agricultural products recorded the figures as below⁸:

- Wheat* (annual production)	312000 tons
- Total vegetables	267000 tons
- Early potatoes	80000 tons
- Fruit	32000 tons

During January-June 2008, the greenhouse areas grew to 695 hectares compared with 683 hectares in 2007.

III.1.3 Energy

During the first half of 2008 there were marked improvements in the main indicators of energy sector in Albania. The improvement of hydro conditions during this period led to the annual increase of domestic production by 25 percent. The fall in technical and non-technical losses is another positive development which has improved the transmission of produced energy.

Despite the increase in domestic production during the first half of the present year compared with the same period the previous year, annual production remains about 37 percent lower than the average production during 2004 – 2006. In the meantime, the balance between the growth of supply of energy (9 percent) and demand for its consumption (13 percent) was offset by the growth of imports by 7 percent.

Table 6 Energy balance sheet indicators

	S1 – 06 (GWh)	S1 – 07 (GWh)	S1 – 08 (GWh)	Annual change S1 – 07/ S1 – 06 (in percent)	Annual change S1 – 08/ S1 – 07 (in percent)
Net production	3,056	1,557	1,944	-49	24.9
Import	226	1,341	1,442	493	7.5
Energy provided in distribution	2,949	2,741	2,975	-7	8.5
Distribution losses	1,216	1,053	1,051	-13	- 0.2
Distribution losses/net production (in percent) ^(*)	39.8 percent	67.6 percent	54.1 percent	70.0 percent	-20.1 percent
Consumed energy	1,743	1,850	2,077	6	12.3
- Invoiced consumption	527	797	1,025	51	28.7
- Un-invoiced consumption	1,216	1,053	1,051	-13	- 0.2
- Household consumption	1,111	1,074	1,192	-3	10.9
- Non-household consumption	632	775	885	23	14.1

Source: KESH; ^(*) Bank of Albania estimations

The increase of financial collection by 24.2 percent in the first half of 2008 has not only reflected the improved invoicing level, given that invoiced consumption grew by 28.7 percent, but also the price rise of energy in the market during the same period. It is noted in particular that while household consumption of energy has grown moderately in the first six months compared with the same period in 2006, the collection has grown markedly by about 3.5 times. The improvement of KESH's financial position helps to upgrade its capacity to import energy, in order to complete the insufficient domestic production and meet the growing demand for energy.

Table 7 Indicators of KESH's financial balance sheet for the six-month period over the years

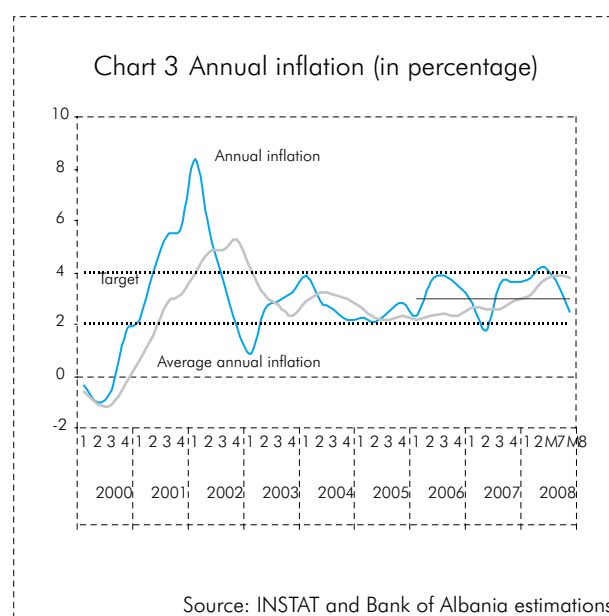
	Invoiced (in million leks)			Collections (in million leks)			Collections (in percent)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Household	1,743	9,080	10,961	1,850	6,772	8,294	106.14	74.57	75.67
Private	1,216	3,981	5,529	1,053	3,701	4,985	86.60	92.98	90.16
Budgetary	1,111	926	1,155	1,074	843	970	96.71	91.11	84.00
Non-budgetary	0.382	1,403	1,558	0.348	1,328	1,444	91.08	94.67	92.64
Total	4,070	15,390	19,203	3,978	12,644	15,693	97.73	82.16	81.72

Source: KESH

III.2 PRICES

III.2.1 Consumer prices

For the first eight months of 2008, average annual inflation marked 3.8 percent. During 2007 and the first four months of 2008, average annual inflation rate remained unchanged at 3 percent, which is the Bank of Albania target with respect to price stability. As a result of the cumulative effects of price rise in food and fuels in the global market, inflation peaked in July at 3.9 percent to later drop in August by 0.1 percentage points. Annual inflation fluctuated markedly during this period. In the first quarter, it showed an upward tendency, peaking 4.6 percent in March, which is the highest in the last 5 years. After remaining above the 4 percent level in the second quarter, annual inflation returned to the tolerance band of 2-4 percent of inflation target. In July and August, annual inflation rate marked 3.7 percent and 2.5 percent, respectively.



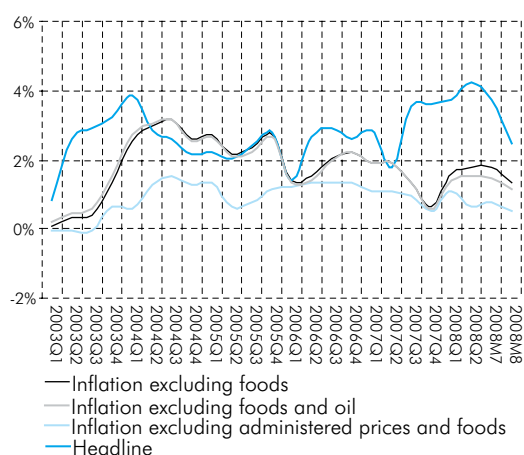
The high inflation rates during August 2007 to June 2008 were driven by the direct and indirect impact of the price rise in food and fuels in the global market. In addition to external inflationary pressures, prices in Albania were affected by last year's curtailed domestic supply of agricultural production and the price rise of energy in March 2008. Supply-side shocks were entirely reflected in the consumer prices, given the ongoing growth of aggregate

demand. The growth of household income, the growth of credit to the private sector and the concentration of budget expenditures at end of 2007 were among the factors which fuelled the growth of domestic demand during this period.

In response to the increasing inflationary pressures, the Bank of Albania increased the key interest rate three times in 2007. The tight monetary policy was followed by the implementation of a prudent fiscal policy in terms of meeting the budgetary programme for 2008. These policies have

created favourable conditions for safeguarding price stability, in particular in terms of weakening the supply-side inflationary pressures and the continuous appreciation of the lek. In the last two months, headline inflation and other measures of core inflation have shown a downward tendency. Supply-side factors, which fuelled the increase of inflation in the previous period, reduced their effect in July and August. Weather conditions during the present year have been encouraging, causing the domestic supply of agricultural production to grow. Seasonal effect generated by the entry of domestic agricultural production was more considerable compared to the previous year. Oil and grain prices in the global market⁹ have been falling in the last two months. However, it is yet too soon to acknowledge that the tendency of these prices is making a turning point.

Chart 4 Annual rates of different measures of net inflation



Source: INSTAT and Bank of Albania estimations

Average annual inflation (3.8 percent) for the first eight months of 2008 was approx. 1.4 percentage points higher than for the same period the previous two years. Excluding the prices of unprocessed foods, all other items provided a positive contribution to this increase. Annual inflation for this period has been entirely determined (100 percent) by the high annual rising rates of processed food prices and the price rise in services and goods with administered prices.

Inflation of processed foods continued to record high annual increasing rates. The high prices of primary foods in the global markets, combined with the higher producer and transportation costs continued to drive the increase of this item's inflation, which reached the highest historic rate in May (13 percent). After almost a year (September 2007 – July 2008) of double-digit inflation, this item's inflation dropped to 9 percent in August. In absence of other shocks on global food prices, annual inflation of processed foods is expected to fall, although prices are expected to remain high. The main sub-groups of this item¹⁰ have recorded positive growth rates and have contributed by around 2.6 percentage points to headline inflation.

In contrast to processed foods, the prices of unprocessed foods have provided an average negative contribution of -0.5 percentage points to the

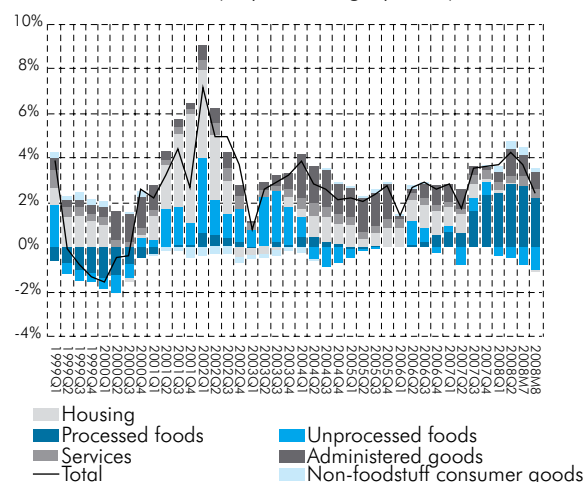
inflation of the first eight months. Annual inflation of this item has recorded negative increasing rates during this period, dipping in August to -5.5 percent. The downward inflation trend has been driven by the more favourable supply conditions relative to the previous year, in particular in the vegetables market. Vegetables' negative inflation (-24 percent in August) managed to offset the positive annual changes of other sub-groups. The growth of agricultural supply, the appreciation of the lek and the downward tendency of these goods' prices in the countries they are imported from¹¹, have reduced the inflationary pressures on food prices at home.

In January to August 2008, the annual price change of food and services with administered prices reached another high level owing to the price rise of energy by 23.7 percent in March. In the second half of 2007 and the first two months of the present year, this item's inflation oscillated around 1 percent in annual terms, as a result of the terminated effect of the previous price rise of energy. Average annual inflation rate in March to August marked 6 percent, providing an average contribution to headline inflation by 1 percentage point.

Inflation of services has increased further during the present year. Average annual inflation of services jumped the 3.2 percent rate, around which it has oscillated since 2002, by 1 percentage point. As a result of the tourist season, annual inflation increased at accelerated rates, in particular in June (5 percent), July (5.8 percent) and August (5.1 percent). Beyond these short-term oscillations, some particular services attest to the pass-through of increased costs' pressures stemming from the food, oil and energy prices. Average annual inflation of transportation services marked 11 percent and hotel and restaurant services 4 percent, which is 8 and 1 percentage points, respectively, above their average for 1999 – 2007.

Non-food consumer goods recorded positive growth rates, contributing by 0.2 percentage points to the average annual inflation of this period of the year. Oil price rise contributed to the increase of this item's inflation by about 2 percentage points compared with the average annual inflation of the same period the previous year. Oil price¹² has risen sharply during 2008, reaching 18 percent in June and July, the highest since January 2001. The moderated rising rates of this item in the global market in the last two months were reflected in the inflation of August which dropped to 13 percent.

Chart 5 Contribution of items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania estimations

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

	S1-07	Q3-07	Q4-07	S1-08	M7-08	M8-08
Processed foods (pp)	0.6	1.6	2.4	2.7	2.7	2.2
Bread and grains* (pp)	0.2	4.5	5.9	7.1	7.1	5.0
Alcohol and tobacco* (pp)	1.8	1.3	0.7	0.4	0.1	0.1
Unprocessed foods (pp)	-0.3	0.4	0.5	-0.4	-0.8	-1.0
Fruit* (pp)	-2.9	1.1	2.6	1.8	-0.2	-1.0
Vegetables*(pp)	1.2	1.7	-0.4	-4.6	-4.9	-6.2
Services (pp)	0.3	0.4	0.4	0.3	0.5	0.4
Administered prices (pp)	0.8	0.4	0.1	1.0	1.0	0.8
Fuels and energy* (pp)	7.7	2.7	0.3	3.8	5.4	5.6
Housing (pp)	0.9	0.6	0.2	0.1	0.0	0.0
Consumer Price Index (YoY, in percent)	2.3	3.6	3.6	4.0	3.7	2.5

Source: INSTAT and Bank of Albania estimations

Box 1 Inflation in Central, Eastern and Southeastern European (CESEE) region opposite global price rise

The rising tendency of agricultural products and energy prices during the last two years has pushed economists to consider the high inflation a global phenomenon. The contribution of the price rise of raw materials and base products to inflation has changed depending on the level of development and the economic structure in different countries. The economies in which the item of 'foodstuffs' has had a high share in the consumer basket, have suffered more from the high price rise of basic agricultural products (wheat, corn, soy, etc) or from 'agflation'¹³. The inflation of industrialized countries has reflected more notably the price rise of energy and oil products and sub-products. At any case, these contributions and the second round effects have generated high core or headline inflation rates in almost all economies.

The CESEE region was hit even more strongly by the unfavourable developments in the global market prices, given that the share of energy and food in the consumer goods basket is still high. Thus, in the period October 2007 to July 2008, the food and energy components added more to inflation than they did in the previous period. In most of CESEE EU Member States the weights of energy and food come to around 40 percent¹⁴, while the corresponding weight in the euro area is just around 30 percent. The imbalances between domestic supply and demand supported the added inflationary pressures in CESEE countries' economies. Output gap became more positive in most countries in 2007 compared with 2006, signalling the increase of inflation in 2008. Some CESEE countries were severely hit by crop failure in 2007, which put additional pressure on food prices.

Apart from these developments, country-specific factors pushed up inflation, as well. In some countries (Bulgaria, Poland and Romania) were featured strong consumption growth and accelerating real unit labour cost, hence pushing the increase of future inflationary pressures. In other countries (Croatia and Turkey), real unit labour cost remained almost unchanged in 2007 compared with 2006, while in Slovakia it declined strongly. Accelerating wages in 2007 call for attention with regard to the increase of inflation in CESEE countries over 2008. Higher administered prices and VAT increases are further factors behind the pickup in inflation (Bulgaria and the Czech Republic in 2007; Poland and Albania in 2008). Due to the administrative reforms in prices was featured higher contribution of 'services' to the respective inflation of countries.

Table 9 Annual inflation for CESEE countries (2005-2008) and the inflation target*

CESEE region	2005	2006	2007	Q1-2008	Q2-2008	August 2008	Inflation target
Bulgaria ⁴	6.0	7.4	7.6	12.4	14.0	11.8	No inflation target
Czech Republic ⁴	1.6	2.1	3.0	7.5	6.7	6.2	3 percent \pm 1 pp as of end 2009 (measured by the CPI)
Hungary ⁴	3.5	4.0	7.9	6.9	6.8	6.4	3 percent \pm 1 pp over the medium term
Poland ⁴	2.2	1.3	2.6	4.5	4.3	4.4	2.5 percent \pm 1 pp (measured by the CPI)
Romania ⁴	9.1	6.6	4.9	8.0	8.6	8.1	4 percent \pm 1 pp as of end 2008
Slovakia ⁴	2.8	4.3	1.9	3.4	4.0	4.4	0-2 percent as of end 2008
Slovenia ⁴	2.5	2.5	3.8	6.5	6.4	6.0	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Italy ¹	2.0	2.1	1.8	3.3	3.8	4.2	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Greece ¹	3.5	3.2	2.9	4.3	4.7	4.8	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Euro area ⁴	2.2	2.2	2.1	3.4	3.7	3.8 (preliminary)	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Croatia ³	3.3	3.2	2.9	5.9	6.5	8.4	No inflation target
Kosovo ³	-1.3	0.6	4.4	11.8	13.9	7.8	No inflation target
Macedonia ^{3.1}	0.5	3.2	2.3	9.5	9.9	8.6	Maintain price stability (measured by the CPI). No defined (quantitative) target
Montenegro ³	-	2.1	2.1	6.6	8.0	-	No inflation target
Serbia ^{3.2}	14.5	5.9	5.4	6.4	9.0	10.3	2.5 percent-5.5 percent as of end 2009 (measured by the base CPI)
Turkey ⁴	8.1	9.3	8.8	9.1	10.2	11.8	4 percent \pm 2 pp, but increased to 7.5 percent for 2009 (measured by the CPI)
Albania ³	2.4	2.4	2.9	3.7	4.2	2.5	3 percent \pm 1 pp over the medium-term period (measured by the CPI)

Source: Webpages of: Eurostat; national statistics institutions; central banks

Notes: (1) Albania's main trading partners; (3) according to the CPI; (3.1) according to retail consumer prices; (3.2) according to the base CPI; (4) according to the HCPI.

*CESEE non-EU Member States listed in the darker part of the table.

In almost all CESEE member or non-EU Member States, annual inflation has marked the highest rates of the last decade. The years 2007-2008 were characterized by inflation rates which were two to three times higher than the quantitative target. The analyses and assessments of economists and central bankers on the high inflation converge to the conclusion that the status of price stability in these economies has deteriorated. This has occurred despite the fact whether there has been a quantitative inflation target or not. However, in the cases when the primary monetary policy objective of a central bank is different from that of maintaining price stability in economy, the risk for increasing inflationary pressures in a medium-term period is assessed to be high. This risk is considered at moderate to average levels in countries with medium-term quantitative inflation targets. The quantitative targets help to put the domestic inflationary pressures at an early control.

The undertaking of structural measures in developing trade and agricultural production and the anti-speculative measures in the food and energy market, the special fiscal policies and the financial support and application of temporary subsidies' schemes for agricultural products' prices in developed countries are among the possible ways to help countries face the global price rise at moderate economic and social costs.

III.2.2 Other inflation measures

Annual core inflation¹⁵ reached the highest figure of the last decade in the second quarter of 2008 (4.6 percent). The higher prices of some processed primary food products¹⁶ provided the main contribution to the sharp upward tendency. The first signs of relatively lower rates of core inflation were shown in August when the sub-group 'bread and grains' experienced a partial fall in prices. Despite this expected positive development, average core inflation for January to August remained high (4.2 percent) or about 1.5 percentage points above its long-term average¹⁷. Core inflation, which also excludes the effect of 'bread and grains', stood close to 2 percent in the eighth-month period attesting to the high effect on inflation caused by the volatile prices of this significant sub-group in the consumer basket. Other inflation measures, which exclude the change effects of certain specific goods and services' prices¹⁸, provide more detailed information on its performance. The average of these measures was 2.9 percent in the second quarter. The first two months of the third quarter showed decreasing rates, hence, average net inflation measures stood at about 2.6 percent for the eighth-month period. Core inflation, measured by the trimmed mean and by excluding processed food products, recorded the lowest rates of all measures.

The higher supply of domestic production in June to August 2008 helped to reduce the inflationary pressures originating from outside the Albanian economy. This good performance was reflected in the decreased rates of annual inflation in the traded prices. In August, the respective inflation marked 1.9 percent, reflecting at the same time the partial termination of last year's price rise in bread and grains. Average traded inflation remained high in January to August (3.7 percent), which is even higher than the same period the previous year (0.3 percent). The high share of traded prices in the consumer basket implies the exposure of headline inflation to the risk of imported inflation. The impact of the price rise of primary goods (food and energy products) in the international markets has been transmitted directly and indirectly to this sector's inflation. In traded prices, inflation which excludes the effect of the energy price rise, stood at 2.9 percent during the period January to August 2008 or very close to the historic average of the last four years (2.8 percent). The slight fluctuations in this sector's inflation at end the second quarter and in the period to follow mainly attributed to the application of higher tariffs in transportation services¹⁹ and to the ongoing transmission of the price rise in food products, fuels and energy to services prices.

Table 10 Alternative measures of annual inflation (in percent)

YEARS	2006	2007	2008				
Annual changes of price index:			Q1	Q2	July	August	Eighth-month average
Total (CPI)	2.4	2.9	3.7	4.2	3.7	2.5	3.8
Core (permanent exclusion)	1.2	1.9	4.1	4.6	4.4	3.7	4.2
Core (permanent exclusion, excluding 'bread and grains')	1.3	1.2	2.0	2.2	2.2	2.1	2.1
Core (trimmed mean)	0.7	0.7	1.7	1.8	1.7	1.4	1.7
Headline, excluding processed foods	2.3	1.5	1.4	2.1	1.8	1.2	1.7
Headline, excluding 'bread and grains'	2.4	1.9	2.0	2.9	2.7	2.0	2.4
Headline, excluding energy	1.7	2.0	3.6	3.9	3.6	2.3	3.4
Average net inflation measures	1.6	1.5	2.5	2.9	2.7	2.1	2.6

By prices:							
Traded	1.7	2.3	3.9	4.2	3.5	1.9	3.7
Non-traded	3.7	3.9	3.4	4.5	4.3	4	4.1
Non-traded, excluding administered prices	3	2.7	2.9	2.8	3.1	2.7	2.9

Source: INSTAT, Bank of Albania estimations

Note: (*) Exclusion of 30 percent of sub-items in both ends of monthly deviations of respective prices, weighted according to their share in the CPI basket, that is 15 percent from each end.

The information on these measures indicates that the Albanian economy continued to face high inflationary pressures. The impact of supply-side factors originating from the developments in the global markets has been assessed as the main cause for the high inflation rates in Albania. Given its relatively long presence, it has also been reflected in the prices of goods and services which until the end of 2007 were considered as fairly 'immune' to the influence of supply-side factors. Chain effects of the global price rise affected different indicators of core inflation at home. Its recent rates indicate that these effects have begun to moderate and that they are expected to moderate more markedly in the months to follow.

III.3 SUPPLY AND DEMAND-SIDE FACTORS

III.3.1 Supply

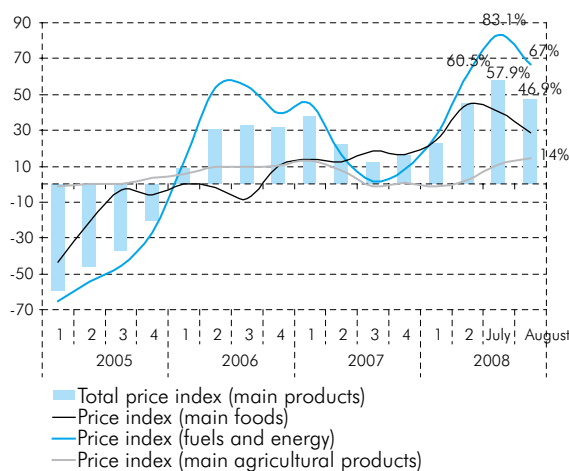
III.3.1.1 Prices of food products and raw materials

Overall inflation in Albania continued to be under the pressure of supply-side factors, mainly originating from the outside. The beginning of the third quarter attested to the moderation of these pressures. The structure of supply in the internal market of food products was encouraged by the entry of fresh Albanian products sold to the consumers at relatively lower prices. However, the impact of foreign prices on the Albanian inflation and the economy remains high despite this expected development. The significant dependence of the Albanian economy on imports in general and on food and energy (fuels) in particular²⁰ caused the global price rise to inevitably hit the producer prices in food processing industry, consumer prices and services prices in Albania.

The most recent statistical data and assessments of international institutions signal the persistent presence of global price rise of commodities in the world economy. This occurrence exceeded the projections of April 2008²¹. During the second quarter of 2008, total price index of commodities in the global markets continued its upward tendency with an annual rate of 45 percent. The period July to August 2008 experienced the highest growth rates (58 percent and 47 percent). In global terms, average annual change of total price index of commodities reached about 43 percent, hence, exceeding considerably the historic average of the last four years (34 percent).

The price rise in fuels and energy has played a key role in these rates. Annual price rise rate of these products, which are of prime importance for the countries' economic development, reached 60 percent in the second quarter.

Chart 6 Annual changes of commodities' price index (in percent)



Source: IMF²²

Its peak was recorded in July (83 percent). Although at more moderate rates, the price rise in August remained high (67 percent).

In global terms, food price index recorded the highest growth of the last years in the second quarter of 2008 (44 percent). The period from January to August 2008 recorded an average annual increase of food prices of 34 percent or 19 percentage points higher than in 2007. Although prices kept their rising rates in the first months of the third quarter, they were lower than before, hence, being in line with the projections of global economy experts.

The outlook of agricultural products' prices, in particular during the first two months of the third quarter, does not seem very promising for a decline in global food prices for at least in the short to medium-term period. Higher prices of agricultural prices augment the producer cost-side inflationary pressures. The largest share of agricultural products is used as raw material in food and non-food processing industry. In the second quarter, agricultural products' prices recorded a slight annual increase of 2 percent, while in July and August they rose by about 11 percent and 14 percent, respectively.

Chart 7 Annual changes in prices of some food products in the world and in Albania

Chart 7a. Annual changes of global prices of grains and of the CPI of 'bread and grains' in Albania (in percent)

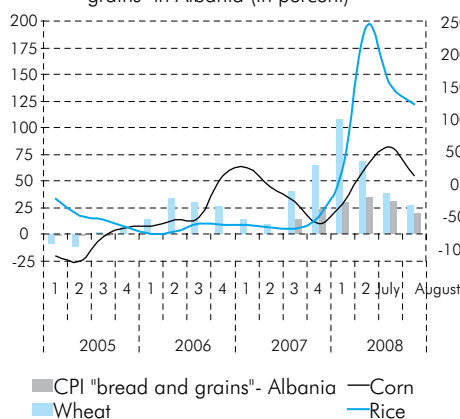
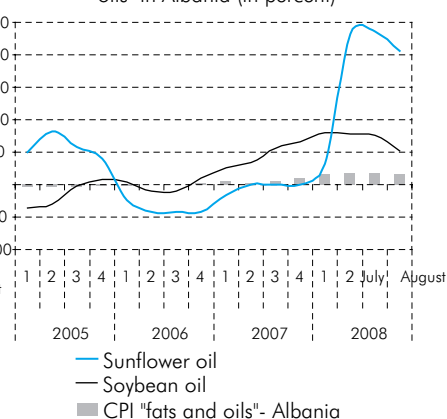


Chart 7b. Annual changes of global prices of vegetable oils and of the CPI of 'fats and oils' in Albania (in percent)



Source: IMF, INSTAT

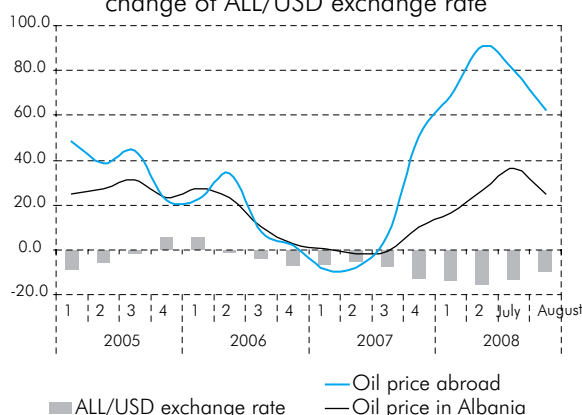
The developments in the global market of grains' prices attested to the persistent annual rising rates during the second quarter of 2008 and beyond. During this period, one of the main items in this category – rice – recorded the highest price (April 2008) of nearly the last four decades and the highest annual rising rates of grains' prices. In the second quarter, the price of rice

was twice higher than the same period the previous year. In the meantime, the annual rising rates of global wheat price after March the present year²³ were more contained and showed a marked downward tendency. In August 2008, its annual rising rate was about 27 percent. The same tendency was also shown in the global prices of corn. The figures suggest that the annual rising rates of the price index of 'bread and grain' in Albania have generally been in line with the developments in the global wheat prices. According to ECB assessments, grain prices are expected to fall at gradual rates during the second half of 2008 provided that there will be no shocks in the Euro area and global economy. This assessment is sustained by the performance of grain prices in the global market in the first two months of the third quarter. The high rising rates of global food prices have also been affected by the prices of vegetable oils. In more concrete terms, sunflower oil price rose by about twice as high in the second quarter and in the period to follow. Although at more moderate rates, annual inflation of this sub-group in the Albanian CPI basket saw high increasing rates²⁴.

The uncertainties that may be present in the future developments in global and internal food prices do not only relate to the weather conditions but also to the performance of global demand for these products, to substantial changes in the structure and nutrition of the Asian population, to the regulatory measures that the government may take to cope with the price rise in food products, etc. In case global demand keeps growing at higher rates than the supply in the market, the imbalances would augment the risks for oscillations or long-term rises in food prices in the world and hence, in the internal economy.

During the second quarter and the first months of the third quarter of 2008, crude oil price in the global market fluctuated around the high historic rates (from 113 to 134 USD/barrel). The highest annual rise occurred in the second quarter (90 percent) reaching a new record. In the period July to August 2008, monthly oil price changes in the global markets showed signs of slight falling, which may possibly mark the beginning of downward annual rates. Despite this positive signal, average annual rising rate for the period January to August 2008 remains high (75 percent) and several times higher than that of the last three years. Oscillations in the oil price continue to stem from the imbalances between the very high growth rates of demand relative to supply. The latter always depends on the decisions made by the largest global oil producers and exporters with regard to the quantity of production and processing of this highly strategically important item. Due to new geopolitical pressures, the risks which affect oil supply in the global markets have augmented in the recent months. The fire on a Turkish section of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which connects Azerbaijan to Turkey, and the Russian-Georgian conflict²⁵ are present issues. In their absence, the fall in the prices of crude oil would have been more considerable. At present, OPEC members are producing above assigned quotas which led the oil price to be very close to 100 USD/barrel in the first weeks of September. According to oil market analysts, future OPEC decisions on the oil price and quantity will depend on the geopolitical developments and to the performance of the U.S. economy following the presidential elections.

Chart 8 Annual change of the oil price in Albania and in the global market and annual change of ALL/USD exchange rate



Source: INSTAT, Bank of Albania, Bloomberg

In January to August 2008, the developments in the international market have been transmitted relatively rapidly to the internal market, hence, intensifying the supply-side inflationary pressures originating from outside our economy. The profile of the annual price rise of oil in the internal market was quite similar to the international one. Characteristic of the domestic market is that starting from end-year 2007 and on, the price rise rates have been markedly more moderated than in the international market. The favourable performance of the exchange rate of the lek vis á vis the U.S. dollar, in particular in the second quarter, has played a significant role in curbing the price rise rates.

Peak price of oil which hit the global market in June 2008 was transmitted to the Albanian market only a month later. The very rapid transmission model of signals coming from the international to the internal market shifted in the months to follow to the moderation of oil price rise rates in Albania. The subsequent performance of the oil price in the internal market will largely depend on the current and future geopolitical developments. Supply-side shocks that may generate from the Russian-Georgian conflict need to be kept under consideration given that these two countries have an overwhelming share in the import of oil²⁶.

Box 2 World Bank recommendations on how to cope with the high food prices' crisis

The considerable price rise of foods and fuels, which began in the second half of 2007, continues to keep the international markets under pressure, jeopardizing macroeconomic stability and economic growth in almost all developed and emerging countries.

With respect to the price of foods, the combination of certain factors led to their considerable price rise in the global market, among which:

- The growth of global demand, in particular from countries with high economic growth, such as China, Brazil or India.
- The high price of fuels affected mostly the price rise of raw materials for agriculture, processed food products and the increase of transportation costs.
- The increased bio-fuel production has contributed to the rise in food prices. This factor affected more sharply the U.S market, which is the greatest producer of these products. However, this factor is believed not to have been a determinant in the general price rise of foods.
- Lastly, the low growth rates in the production of these products, in particular of grains, due to the bad weather conditions, were also a specific factor.

This global crisis of food prices hit more severely the net importers of agricultural and energy products. Poor people, in particular those living in the urban areas, who spend a considerable share of their income for food, risk to have a lower purchasing power.

Food prices are expected to fall slightly in the short-term period compared with their peak this spring. This is due to the fact that there are still some imbalances between global demand and supply of these products and it will take some time to create necessary stocks for similar emergency situations, mainly in their exporting countries. The prices are expected to fall (in particular grain prices); however, not to be returned to the low levels of some years ago.

Given this situation, many international organizations have recommended the governments some necessary measures to face this critical situation with prices. The World Bank, being one of the main international organizations to recommend policies and ways to overcome this crisis, suggests three possible ways of intervention, to be adapted according to the economic developments of each country:

"First, the strengthening of social aid to assist directly the most affected groups from the crisis (assistance in income or directly in foods). Although this policy does not jeopardize domestic production, given that it depends on the development of the country applying it, it may be challenging to implement from the administrative point of view and it may have additional budget costs.

Second, short-term administrative measures (such as the cut of customs tariffs on basic agricultural products). These measures are recommended to be applied only temporarily given that they have high fiscal costs. Along with the strengthening of social aid, they may require the reallocation of budget funds. On the other side, experts do not support measures such as the increase of exports' tariffs from the biggest producers of base food products, which apart from not affecting the fall in domestic prices they harm severely agricultural production at home.

Third, measures to stimulate the growth of foods supply in the medium-run (the high prices of agricultural products may stimulate their production, hence, contributing to the development of agriculture in the medium-run). This year's high prices (in particular of grains) can also help to reverse a generally declining trend in government and private investments in agriculture. In 1980, 30 percent of annual World Bank lending went to agricultural projects, but this declined to 12 percent in 2007. This year the expectations for this type of lending show considerable increase compared with the past. The World Bank has committed itself to doubling lending for agriculture in Africa. To this purpose, it is important to expand investments in the watering system and in infrastructure in order to promote increased agricultural productivity"²⁷.

III.3.1.2 Wages

Wages rose in the first quarter of 2008 both in the public and private sector. Average wage in the public sector reached 35,800 leks or 0.4 percent higher compared with the last quarter of 2007 and 12.4 percent higher on annual basis. The administrative measures²⁸ continued to affect the rise in wages²⁹ in the private sector during the first quarter.

Table 11 Annual indicators of employment and wages – annual changes (in percent)

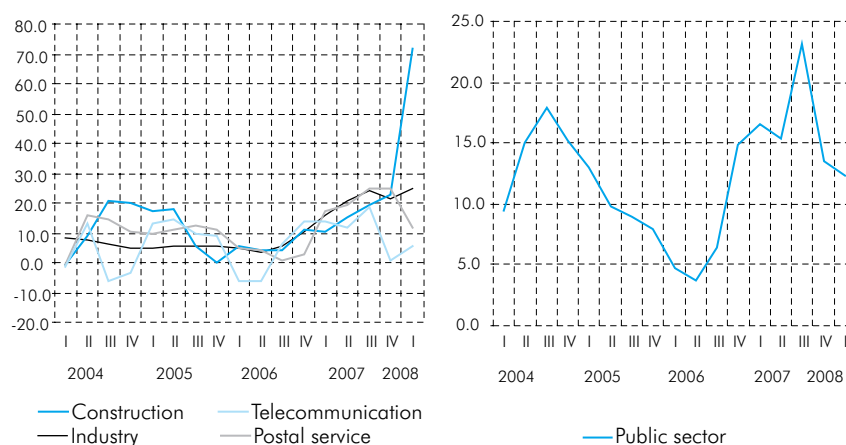
Sectors of economy	Employment			Wage		
	Q1 '07	Q4 '07	Q1 '08	Q1 '07	Q4 '07	Q1 '08
Industry	7.9	3.5	10	16	21.2	24.9
Construction	-1.7	-4.6	30.5	10.2	22.5	71.5
Postal service	18.1	12.8	7	17.4	25.1	11.9
Telecommunication	9.7	2.1	7.1	13.9	0.7	5.2

Source: INSTAT

In terms of employment and wages indicators, the sector of construction recorded the highest increase during the first quarter, in particular in the area of engineering works³⁰. Industry continued to maintain almost similar increasing rates during the same quarter. The administrative measures taken with regard to the declaration of the number of employees combined with the satisfactory performance of turnover indicator led to the improvement of the annual change of wages in the first quarter in trade activity and postal and telecommunication services.

Minimal monthly base wage rose in the first quarter of 2008 by about 14 percent to 16,000 leks compared with the previous quarter. Unemployment compensation rose in proportion to minimal wage and reached 5,980 leks.

Chart 9 Annual rise rate of wages by sectors of economy



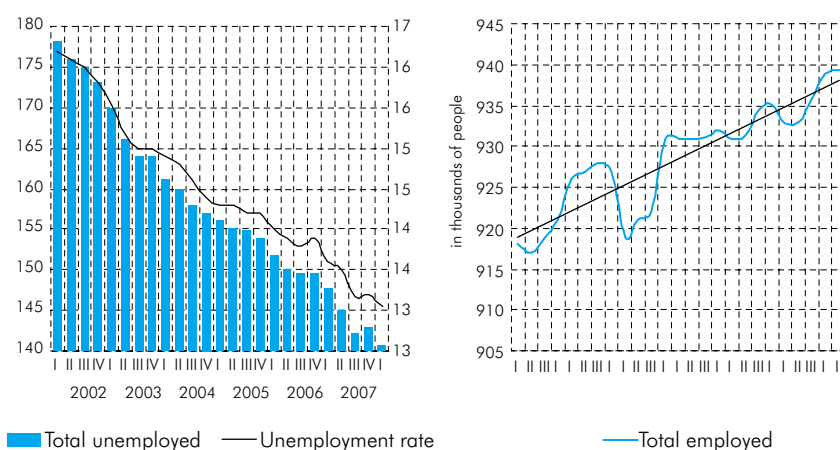
Source: INSTAT

III.3.1.3 Labour market

According to the most recent data, the number of people listed in labour forces totalled 1,080.1 thousand in the first quarter of 2008 or 1,714 people fewer compared with the previous quarter. This fall mainly attributes to the fewer number of jobseekers (about 2,012 people); hence, reflecting a more rapid drop in the number of unemployed people than the increase in the number of employed people.

As of end the first quarter of 2008, the number of employed people totalled 939.3 thousand. Employment in the private non-agricultural sector increased by about 648 people, while that in the public sector descended by about 350 people. Trade activity, construction and industry sectors provided the main contribution to the increase in the number of employed people in the private sector. The data on employment in the private agricultural sector remain unchanged. Unemployment rate reached 13.04 percent in the first quarter from 13.2 percent in the last quarter of 2007.

Chart 10 Performance of unemployment and employed people indicators



Source: INSTAT

In the second quarter of 2008, the number of unemployed people totalled 140 thousand, descending by 0.56 percent compared with the first quarter and by 3.53 percent with the same period the previous year. Relative to the previous quarter, the average number of unemployed people benefiting economic assistance has dropped by about 3.3 percent. In the meantime, the average number of unemployed people benefiting unemployment compensation increased by about 1.9 percent. The number of long-term jobseekers has been falling in the second quarter while the Albanian Employment Office records 2,595 people more than in the first quarter and 631 more than in the same period the previous year. Employment in the public sector continued to fall while quite on the contrary, the private sector recorded an increase in the number of employed people, mainly in industry and construction sectors.

III.3.1.4 Producer price

Producer Price Index maintained the same annual growth rate in the second quarter of 2008 as in the previous two quarters (7.4 percent). The PPI increased by 1.3 percent relative to the first quarter of the present year. It is evident that the increase of inflationary pressures starting from the third quarter of 2007 and on has to a certain extent also been driven by the increased producer costs in the Albanian economy.

The high figure of this index in the last two years is a result of temporary imbalances between demand and supply in the Albanian and global market. The needs of some emerging countries, in particular China, India, Brazil etc., for wider use of raw materials, the growth of imports and the speculative environment created as a result of the U.S. dollar depreciation, drove the rise of prices at a global level. The high prices were later transmitted to the prices of imported raw and intermediate materials, which in turn increased the business costs. Given that the Albanian economy develops at relatively high rates and that the same performance will plausibly persist in the future, recurrent supply and demand imbalances are absorbed by businesses within a short period of time. Consequently, the increase in producer prices does not risk to be fully transmitted to consumer prices – not even in the short term. The latest developments seem to confirm this fact, since consumer prices have been falling starting from July, although producer prices maintained their increasing rates in the second quarter. The rise in these prices does not seem to have dramatically affected the living cost of consumers in comparison to businesses. However, the latter consider them entirely recoverable³¹. On the other side, it is assessed that the share of domestic production is not yet a determining constituent of goods' supply in the internal market and in the sales' price to consumers.

With respect to individual sectors, worth to note is that the prices of processing industry rose further in the second quarter, given that this sector operates mostly with imported raw material. Within this sector, food industry continued to record the highest growth, although the double-digit positive rate is lower compared with previous year when the signs of the prices' crisis in this item were first shown. Industry cost index has increased by an average of 16 percent since the first quarter of 2007. The pass-through of producer price rise in this item was more moderate in consumer prices given that there has been an average increase of 9 percent in the index of 'processed foods' in the CPI basket.

The annual change in the prices of 'extracting industry' recorded declining rates compared with the previous year; however, with no significant impact on total producer prices. Prices in 'production and supply of energy, gas and water' remained almost unchanged compared with the previous quarter, although they recorded considerable fall compared with end-year 2007.

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

	PPI	PPI – Total Processing Industry	PPI – Food Processing Industry	CPI – Processed Food Products	PPI – Extracting Industry
Q1:06/Q1:05	0.9	0.7	-0.1	0	7.3
Q2:06/Q2:05	-0.1	-0.5	-4.4	0.5	10.8
Q3:06/Q3:05	0.4	1.2	-2.1	1.1	8.4
Q4:06/Q4:05	-0.7	1.5	1.4	2.4	8.3
Q1:07/Q1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/Q2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/Q3:06	3.6	6.3	14.7	7.3	4.7
Q4:07/Q4:06	7.5	10.2	18.6	10.8	4.5
Q1:08/Q1:07	7.4	6.8	20.5	11.2	5.6
Q2:08/Q2:07	7.4	6.9	14.6	12.9	3.0

Source: INSTAT

III.3.2 Demand

III.3.2.1 Fiscal sector

Budget balance recorded a deficit only in the last month of the first half of 2008. As of end June, fiscal deficit totalled 2.3 billion leks, which is several times lower than the projected deficit of 18 billion leks. Budget revenues have followed a similar tendency with the previous months, exceeding by about 3 percent the level projected for the first half of 2008. Expenditures were carried out at accelerated rates, mainly in the last months of the six-month period, meeting 92 percent of the projected plan for this period.

Table 13 Performance of main fiscal indicators

	Fact S1 2008 ¹	Plan S1 2008 ¹	Change in percent 2008 ²	Change in percent 2007 ²	July 2008	Annual plan ³
REVENUES	134.99	130.89	16.80	9.61	161.14	303.78
Tax and customs revenues	96.09	89.79	18.32	12.61	113.41	209.71
1.2 Other tax revenues	27.91	31.45	14.8	- 1.69	33.86	66.64
1.3 Non-tax revenues	10.47	7.97	5.42	19.41	13.24	22.76
EXPENDITURES	137.32	148.86	30.30	10.52	166.72	360.21
2.1 Current expenditures	107.79	113.62	14.47	8.15	129.75	257.41
2.1.1 Expenditures on personnel	29.99	30.23	17.20	1.22	35.65	67.96
2.1.2 Expenditures on interests	15.02	15.28	24.61	- 0.89	18.76	32.58
2.1.3 Expenditures on insurance and pensions	35.02	35.32	8.27	15.78	41.80	78.67
2.2 Capital expenditures	28.02	33.36	149.54	35.47	34.74	94.42
FISCAL BALANCE	- 2.33	- 17.97	- 122.86	1.00	- 5.59	- 56.42
3.1 Domestic borrowing	11.52	- 0.22	235.19	- 132.88	8.68	16.96
3.2 Foreign financing	1.13	16.82	283.05	- 69.59	1.75	35.33

Source: Ministry of Finance

Notes: ¹⁾ Progressive data, in billion leks; ²⁾ Annual change in percent for the first half of the year;

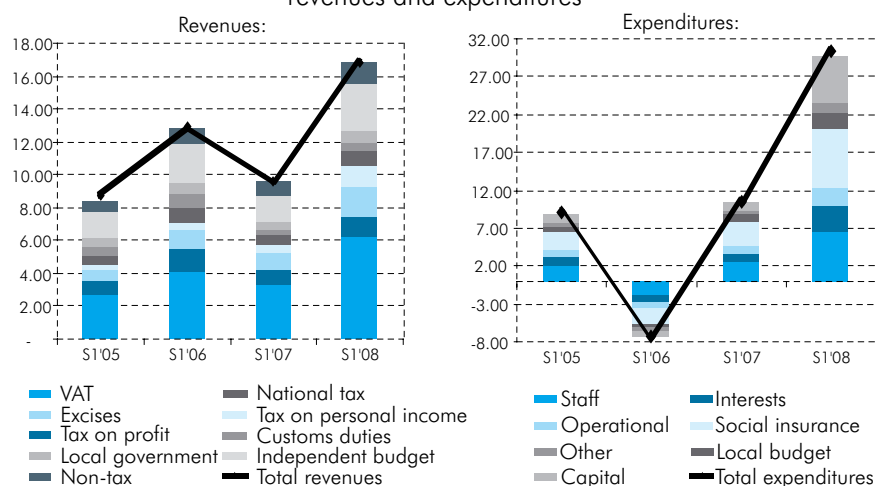
³⁾ Annual plan according to the revised budget in July 2008.

Collected income recorded an annual growth of 17 percent, the highest in the last five years. Income from VAT and personal income tax provided the main contribution to this growth. The ever-increasing contribution of the VAT is explained by the large share of this item in total revenues. It has maintained the same growth rates of the previous years, exceeding at the same time the projected plan for the first half of 2008 by about 8 percent. Starting from the second half of 2007, tax on personal income has increased its share to total revenues. The main factors to have affected the increase of the share are the change in the tax rate of personal income from progressive to simple tax, and the amendments made to the regulatory and legal framework³². Income from tax on profit have exceeded the six-month projection by 40 percent. Despite this positive performance, the annual change rate of this item was about -7 percent as of end the first six months. The main cause is the change in the tax on profit from 20 percent to 10 percent starting from 1 January 2008.

Similarly to revenues, budget expenditures have recorded the highest growth of the last five years with an annual growth of 30 percent. At the same time, expenditures have met 92.3 percent of the plan in the first half of 2008.

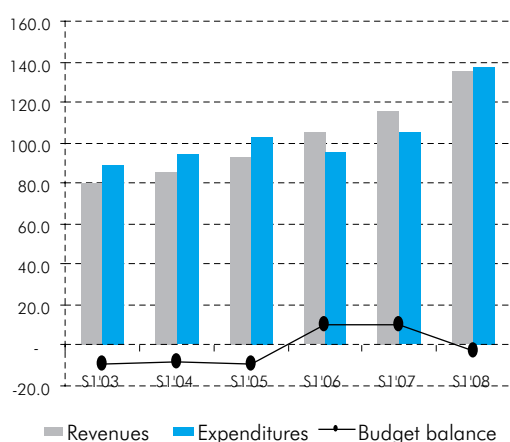
The annual increase of capital expenditures provided the main contribution to the total increase of expenditures. Worth to note is the fact that long-term expenditures carried out during the first six months have been met by about 84 percent of the plan for this period, while in the previous two years (the first half of the year) the plan was met by around 43-51 percent. The road Durrës-Kukës absorbed about 45 percent of capital expenditures, contributing dramatically to their annual growth by 150 percent. Personnel expenditures have grown by 18 percent in annual terms, which is the highest in the last three years. This growth attributes to the rise in the average monthly wage in the public sector by about 12.4%³³.

Chart 11 Contribution of items to the annual change of budget revenues and expenditures



Source: Ministry of Finance and Bank of Albania estimations

Chart 12 Performance of main fiscal indicators during the first half of 2003-2008



Source: Ministry of Finance

As of end July, revenues and expenditures amounted to 161 and 166 billion leks, meeting 53 and 46 percent of the annual plan approved in the revised budget in July the present year.

As of end the first half of 2008, budget balance has had a different performance compared with the previous two years and recorded a deficit of 2.3 billion leks. However, it is reported that it has met only 13 percent of the projection for this period.

As of end July, budget deficit totalled about 5.6 billion leks, deepening by about 3.2 billion leks compared with the previous month.

	§1 2003	§1 2004	§1 2005	§1 2006	§1 2007	§1 2008
BUDGET BALANCE	- 8.82	- 8.45	- 9.47	10.09	10.15	- 2.33
Deficit financing	8.82	8.45	9.47	- 10.09	- 10.15	2.33
Domestic	5.45	6.24	7.35	- 11.06	- 10.44	1.20
Privatization receipts	0.35	4.15	0.62	2.11	0.04	0.40
Domestic borrowing	9.75	5.50	10.48	- 10.45	3.44	11.52
Other	- 4.65	- 3.40	- 3.75	- 2.72	- 1.47	- 9.72
Foreign	3.37	2.21	2.12	0.97	0.29	1.13

Source: Ministry of Finance

Table 14 Budget deficit financing

Domestic borrowing represents the main instrument of budget deficit financing, accounting for 90 percent of total borrowing. Compared with the previous year, the Ministry of Finance reduced the amount of debt in T-bills by about 30 billion leks in the first half of 2008, increasing by about 46 billion leks the debt stock in bonds of different maturity terms. The shift of the amount of debt from short to long maturity terms is in the same line with the Ministry of Finance's policy on public debt management.

Box 3 Supplementary budget and a comparative analysis

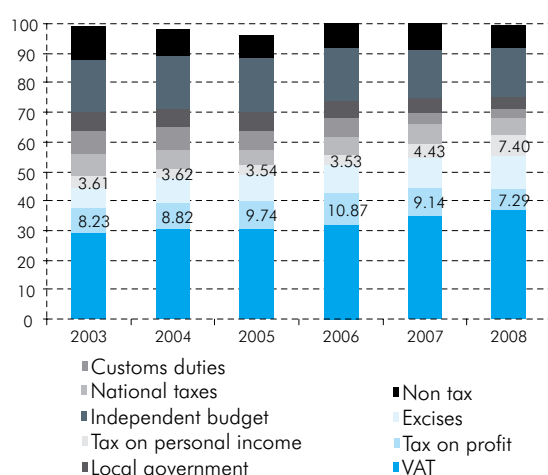
Table 15 Revenues and expenditures according to the early 2008 budget and the revised budget in July 2008

	Initial Budget (1)	Revised Budget (2)	Absolute Change (2-1)
TOTAL REVENUES	283.7	303.8	20.1
Value added tax	99.9	104.9	5.0
Tax on profit	14.4	18.4	4.0
Excises	38.5	37.5	(1.0)
Tax on personal income	16.3	23.3	7.0
National taxes and other	17.2	16.2	(1.0)
Dividend income	0.1	5.0	4.9
Other	1.0	1.7	0.7
TOTAL EXPENDITURES	369.0	360.2	(8.8)
Domestic interests	29.0	28.7	(0.3)
Foreign interests	4.3	3.9	(0.4)
Operational and maintenance expenditures	28.0	28.6	0.6
Subsidies	2.3	2.0	(0.3)
Expenditures on social insurance	76.0	78.7	2.7
Expenditures on local budget	29.6	31.6	2.1
Contingency reserve fund	10.4	9.9	(0.5)
Capital expenditures	105.6	94.4	(11.2)
With domestic funding	38.8	48.8	10.0
With foreign funding	66.7	45.6	(21.2)
BUDGET BALANCE	(85.3)	(56.4)	28.92
Domestic funding	29.4	21.1	(8.32)
Domestic borrowing	25.3	17.0	(8.32)
Foreign funding	55.9	35.3	(20.60)

Source: Ministry of Finance

According to the revised budget for 2008, budget revenues and expenditures are projected to amount to 303.8 and 360.2 billion leks. Revenues are projected to be about 20 billion leks higher and expenditures about 8.8 billion leks lower than the early 2008 projection. Until end 2008, deficit is projected to reduce to 56.4 billion leks or 5.2 percent of the GDP, from 85.3 billion (7.9 percent of the

Chart 13 Individual items by share to total revenues



Source: Ministry of Finance and Bank of Albania estimations

GDP) projected in early 2008. About 35 percent of total additional revenues are projected to be collected from tax on personal income. In the first half of 2008, this sub-item of revenues shared about 7.4 percent of the total, which is two times higher than its average share during the same period the years 2003-2007. About 20 percent or 4 billion leks of total additional revenues are expected to be collected from tax on profit. The share of this item in total revenues reduced by about 2 percentage points in the first half of 2008 compared with the same period the previous year.

The new fiscal package was approved in July 2007. Among others, it envisaged the change in the tax rate of personal income and tax on profit. As of July 2007, personal income tax rate was reduced to 10 percent. The 20 percent corporate tax rate was reduced from 20 to 10 percent in January 2008.

What figures do other countries that have had reforms in flat tax adoption present?

Keen et al. (IMF, 2006) in the working paper "The flat tax(es): Principles and Evidence", has analyzed the way and effects of flat tax adoption. The following table lists the countries by order of adoption.

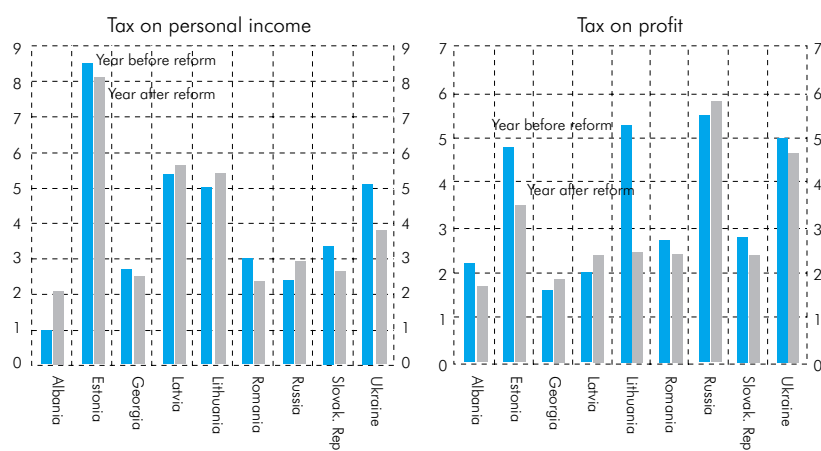
Table 16 Flat tax and tax on profit before and after reform

	Personal income tax rates			Tax on profit	
	Flat tax adopted	After reform	Change in basic allowance	Before reform	After reform
Estonia	1994	26	Modest increase	16-33	26
Lithuania	1994	33	Substantial increase	18-33	29
Latvia	1997	25	Slight reduction	25 and 10	25
Russia	2001	13	Modest increase	12-30	37
Ukraine	2004	13	Increase	10-40	25
Slovak Republic	2004	19	Substantial increase	10-38	19
Georgia	2005	12	Eliminated	12-20	20
Romania	2005	16	Increase	18-40	16
Albania	2007	10	Reduction	20	10

Source: Keen et al, *The flat tax(es): Principles and Evidence*. IMF Working Paper 2006 and Ministry of Finance

The adoption of the flat tax in these countries includes two waves. The first wave is characterized by tax rates set at moderately high levels – at or close to the highest marginal tax prior to the reform. The second wave was marked by tax rates that are closer to the lowest of the pre-reform rates. Except in Russia³⁴, the second wave of low-rate flat tax reforms has been associated with a reduction in revenues from the personal income tax. In the case of Albania, there has been an increase in revenues from personal income tax following the flat tax adoption. Compared with the previous years, revenues from tax on profit expected to accumulate until the end of 2008, are projected to reduce as a share to the GDP.

Chart 14 2008 Revenues from tax on personal income and tax on profit as a share to the GDP before and after reform.

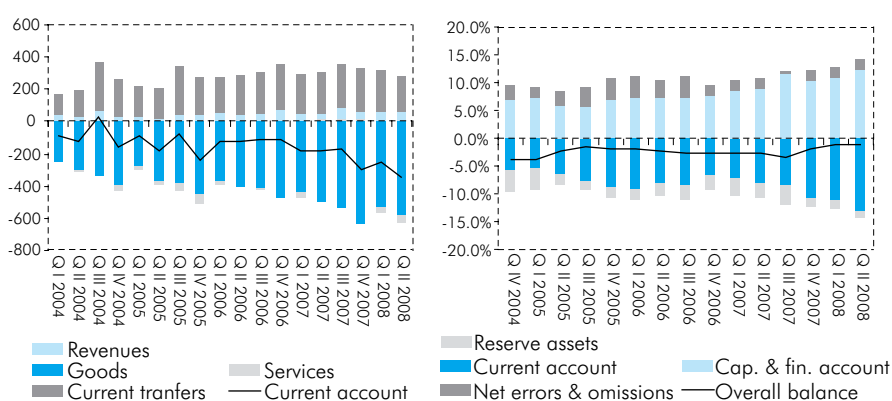


Source: IMF, August 2008³⁵.

III.3.2.2 External sector

Current deficit increased by about 60 percent in annual terms, amounting to 591 million euros and accounting for about 13 percent of the GDP at the end of the first half of 2008. The high trade deficit, the main contributor to the current deficit deepening during this period, was also followed by the deficit on trade in services and the contraction of surplus in net current transfers³⁶.

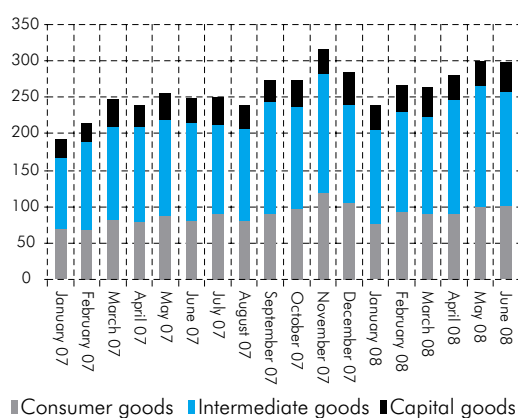
Chart 15 Current account (in million euros) and the balance of payments (as a share to GDP)



Source: Bank of Albania and IMF assessments

The volume of current transactions amounted to 4.2 billion euros, which is 10 percent higher in annual terms. 95 percent of current expenditures were used for the import of goods and services, while 60 percent of current revenues stems from the export of goods and services. The rest is obtained from current

Chart 16 Imports by purpose of use
(in million euros)



Source: Bank of Albania

transfers (30 percent) and income (10 percent). Deficit on trade in goods deepened by 17 percent in annual terms, accounting for about 28 percent of the GDP. Imports and exports of goods recorded an annual growth of 18 and 19 percent, respectively. Imports' coverage rate from exports was estimated at about 30 percent. In terms of imports by purpose of use, it is noted that imports for consumption purposes have been reducing as a share to total imports, although they have grown by 17 percent in annual terms. The import of 'capital goods' has grown by 18 percent and does not present any changes in terms of share. Imports for 'intermediate consumption' recorded the highest annual growth rate (18.3 percent) and the largest share to total imports (53.4 percent).

Total exports are mainly represented by the exports of textiles and footwear (45 percent); however, their share has been decreasing³⁷. Around 38 percent of total exports is shared by the exports of 'construction materials and metals' (22 percent) and 'minerals, fuels and energy' (16 percent). As of end period, the balance of services recorded a deficit of about 83 million euros, while the income balance ended in a surplus of 129.3 million euros. Services account is dominated by travel services, mainly personal ones, while 'other services' covered about 93 percent of deficit in services. Income from tourism have grown by 20 percent in annual terms, owing to the increase in the number of non-resident travellers. Net current transfers continue to record positive values, although at a downward tendency. Represented mainly by workers' remittances, net current transfers finance about 42 percent of trade deficit in goods and amount to about 470 million euros. Their share to the GDP is about 12 percent. During the period January to June 2008, the net flow in capital and financial account was about 500 million euros. Around 31 million euros have entered in the form of capital transfers and 435 million euros in the form of residents' financial liabilities. The net flow of this account funds about 85 percent of current deficit. The substantial increase of residents' financial liabilities attributes to the increase of foreign direct investments and borrowing from abroad which amounted to around 227 and 145 million euros. External debt has increased by about 41 million euros. As of end the first half of 2008, Albania's foreign reserve amounted to about 1.42 billion euros, sufficient to cover 3.7 months of imports of goods and services.

III.3.2.3 Public expectations of inflation

Public expectations of inflation have been higher in the last 18 months compared with the previous periods. Despite the upward tendency, they have converged close to 3 percent, attesting to their relatively satisfactory anchoring around the Bank of Albania quantitative inflation target of 3 percent \pm 1 percentage point. Evidences from the periodical survey conducted by the Bank of Albania indicate that the different market economic agents are

ever-increasingly becoming aware and rational in providing opinions and assessments on the future and possible developments in consumer and producer prices in the medium-run. The expectations formation process implies the combination of information on past and future events in consumer prices and the domestic and foreign economy and on the central bank inflation target. Each information has a specific share when analyzing the expectations. The Bank's monetary policy target is that the public forms the expectations based mostly on the future economic events and on the medium-term quantitative inflation target.

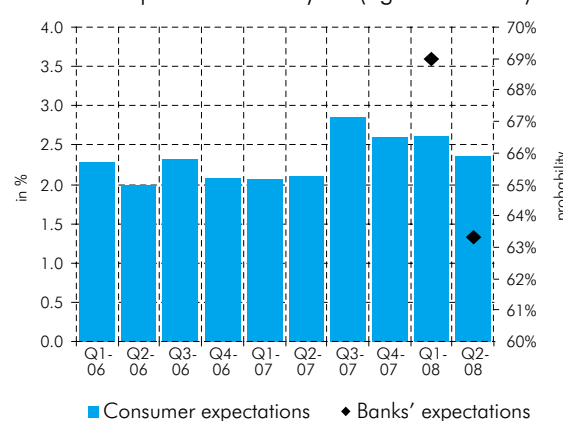
Box 4 Market agents' expectations of inflation – evidences from surveys

During the last years, the measures of different market agents' expectations of the change rate in the general level of prices have played a role in the Bank of Albania decision-making process, given that its main objective is to achieve and maintain price stability. This box aims to present the inflation expectations of consumers, businesses and commercial banks' experts.

Medium-term expectations. The measures of expectations in the long-term period are useful to measure the market agents' confidence in the Bank's announced target. During 2008, medium-term expectations have increased compared with the previous year, although they appear to be more contained or optimistic than short-term expectations. Consumer expectations of inflation over the next 12 months, after peaking in the third quarter of 2007 (2.9 percent), moved below but however close to 3 percent in the first two surveys conducted in 2008. The latest data of 'Monthly banks' survey' indicate that the expectations of commercial banks' experts of inflation over the next 12 months have registered a slight downward tendency during the last three months after having increased in February 2008. According to banks, however, there is a 64 percent probability that annual inflation marks above 3 percent after a year.

Short-term expectations. Inflation expectations in the short-term period are considered as indicators of short-term pressures on the level of consumer prices. Unlike long-term expectations, short-term expectations of commercial banks' experts have been aggravating during the first nine months of 2008. In their anticipations of the change of prices in the short-term period – annual inflation after a month – banks tend to be more pessimistic compared with long-term expectations. According to banks, there is a 42 percent probability that inflation jumps the upper tolerance band of 2-4 percent. Consumers on the other hand expect a more optimistic situation. According to Consumer Sentiment Survey, during the first half of 2008, consumers anticipated inflation to decrease in the next 3 months. On the other side, business expectations of producer prices for the next quarter have remained at high levels since 2007, signalling the presence of upward supply-side pressures.

Chart 17 Performance of consumer expectations of inflation after a year (left-hand axis) and the probability that banks expect inflation to mark above 3 percent after a year (right-hand axis)



Source: Consumer Sentiment Survey and Monthly Banks' Survey

III.3.2.4 Monetary policy

The main objective of the Bank of Albania's monetary policy³⁸ for 2008 remained the achievement and maintenance of price stability, translated into an annual inflation rate of consumer prices equal to 3 percent. The tolerance band around this central value is 2-4 percent. In order to achieve this objective, the Bank of Albania collects and uses all the possible economic and financial information that serves to the decision-making process. In addition, it implements some key features of the inflation targeting regime. Repurchase agreement rate, which is set by the Bank of Albania Supervisory Council every end of the month, is the main monetary policy instrument.

The key interest rate was 6.25 percent in the beginning of the year 2008. Until August, this rate was kept unchanged. During 2007, this rate rose three times by 25 basis points each. The three consecutive raises aimed to contain the credit growth rates, which during that period accounted for above 8 percent of the GDP, and to anchor the expectations around the 3 percent target. The raise of the key interest rate has also affected the increase of the real interest rate of lek denominated deposits. The maintenance of positive spreads between the deposits' real interest rates in lek and in foreign currency aimed to push the demand for money in lek in the form of deposits. The decisions on tightening the monetary policy by 75 basis points were expected to provide their effect during a time frame of 12 to 24 months. As expected, there was a slowdown in the growth rates of credit to economy in the first half of 2008 as a share to M3 aggregate and to the GDP.

The macroeconomic environment of the first half of the present year was very dissimilar to that of the previous year. Global and Albanian CPI inflation began to respond markedly to supply-side shocks and to the increased producer prices. The high annual inflation rates registered in the first two quarters were generated as a result of the rapid increase of food prices (in particular of processed foods), oil price rise and the increase of energy tariffs at end March. The shortages in the supply of energy at home – in particular during winter – have also exerted pressure on the increase of producer price, which pushed a considerable number of producers to increase the prices of goods and services. Even under the conditions of supply-side shocks, the Bank of Albania has monitored closely the demand-side developments and has assessed periodically the need of monetary policy intervention to manage money supply in economy. According to the Bank of Albania projections made in mid-2007, annual inflation rate was expected to return to the targeted band of 2-4 percent around the end of the first half of 2008, as a result of the absence of other strong supply-side shocks. In assessing and weighing the risk factors have been considered past and expected developments in the main goods' prices in the international market, exchange rate performance, meeting rates of budget plan, the possible deterioration of energy, credit growth rates and the performance of public, business and banks' short-term and long-term expectations of inflation. While the supply-side pressures persisted and their impact was assessed as being long-lasting, the other factors mentioned above have generally helped in lowering or containing the increase of inflation.

In more concrete terms, the fiscal stimulus has almost been inconsiderable during the first half of 2008, the appreciation of the lek against the euro and the U.S. dollar has amortized the impact of imported inflation increase, inflation expectations have not jumped markedly from the target and the growth rates of credit have been declining. The combination of monetary policy tightening with the relaxation of external pressures and the statistical effect of the termination of annual price rise of bread and grains starting from the second quarter of 2008 have caused the annual inflation rate to return to the targeted band of 2-4 percent. In addition, in August inflation fell to below the 3 percent target of the Bank of Albania. In the second half of 2008 and on, the monetary policy will monitor closely the internal and external macroeconomic developments and make a periodical assessment of the shifts in the balance of risks, which may jeopardize the price stability objective.

BoA Supervisory Council meeting date	Interest rate	Change
4 April 2007	5.50	---
2 May 2007	5.50	---
6 June 2007	5.50	---
27 June 2007	5.75	+ 0.25
19 July 2007	5.75	---
29 August 2007	5.75	---
26 September 2007	6.00	+ 0.25
31 October 2007	6.00	---
27 November 2007	6.25	+ 0.25
27 December 2007	6.25	---
30 January 2008	6.25	---
27 February 2008	6.25	---
26 March 2008	6.25	---
30 April 2008	6.25	---
27 May 2008	6.25	---
25 June 2008	6.25	---
30 July 2008	6.25	---
29 August 2008	6.25	---

Table 17 BoA Supervisory Council meeting dates and decisions during 2007 and 2008 (as of August 2008)

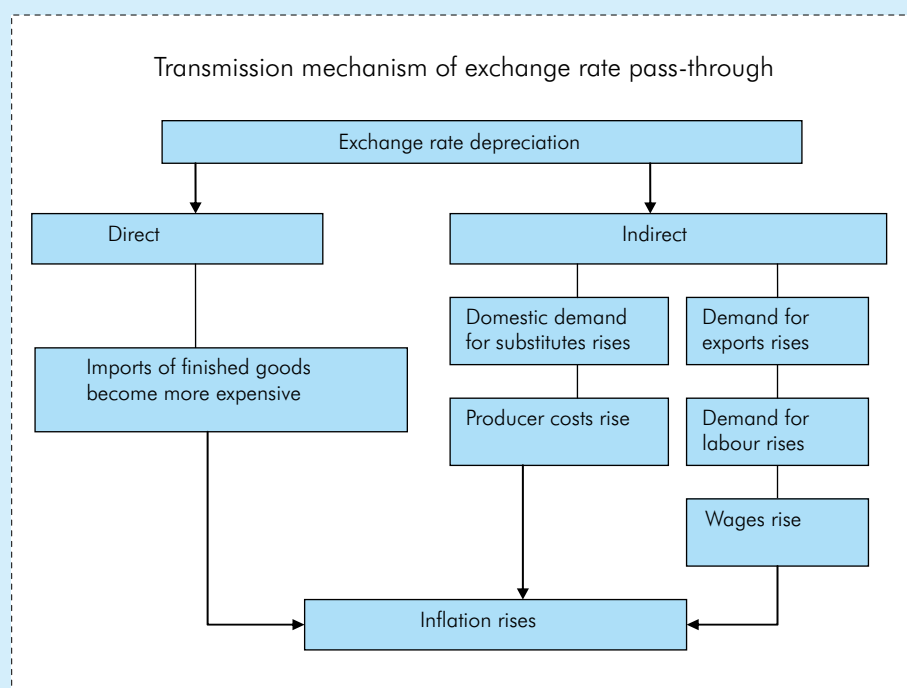
Source: Bank of Albania

Box 5 Exchange rate pass-through to consumer prices

In a small and open economy like Albania, the exchange rate has a considerable impact on the economic activity. The expression 'exchange rate pass-through' is generally used to refer to the effect of exchange rate changes on one of the following: import and export prices, consumer prices, investments and trade volumes. The primary focus of this box is on the effects of exchange rate changes on consumer prices, that is, the extent to which exchange rate changes alter relative prices. This interest stems from the fact that changes in the exchange rate pass-through to consumer prices are integral to the design of monetary and exchange rate policies.

Exchange rate changes affect inflation measured by the consumer price index through some channels (chart 1). They affect inflation directly on prices of imported final goods, and indirectly through prices of imported intermediate goods which affect

final prices of goods and services produced in the country. Exchange rate changes may also affect labour cost, affecting inflation through wage/inflation spiral.



Exchange rate pass-through to consumer prices may be complete or partial. The pass-through is complete when a one percent depreciation in the exchange rate leads to a 1 percent price rise. In case the price rise is less than 1 percent, the pass-through is defined as partial.

Empirical studies³⁹ have found some main factors that influence the degree of exchange rate pass-through to an economy: (i) openness and size of the economy. The degree of pass-through will decrease the more open the economy is. (ii) Relative elasticities of demand and supply⁴⁰ for traded goods. For exports, the degree of pass-through will increase the greater the elasticity of demand and the smaller the elasticity of supply. (iii) Macroeconomic conditions and the microeconomic environment. These studies conclude that the degree of exchange rate pass-through is higher in emerging than in developed economies.

Exchange rate and inflation in Albania

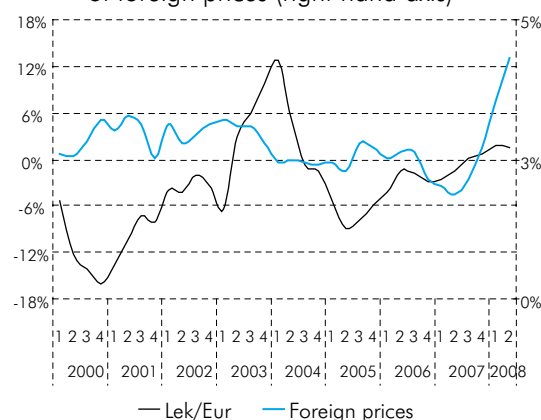
Albania implements a floating exchange rate regime which is determined by the supply and demand in the foreign exchange market. Foreign exchange market interventions aim to avoid strong and speculative short-term fluctuations and to create the foreign reserve. Exchange rate developments have an overwhelming impact on the CPI inflation. According to the survey conducted by the INSTAT in 2004, about 50 percent of the consumer basket is shared by imported consumer goods. Albania's main trading partners are EU countries. Italy and Greece share about 80 percent of our imports. These developments and the empirical results⁴¹ provide evidence that the role of the U.S. dollar in the Albanian economy has weakened in favour to the euro.

In addition to the price rise abroad, the depreciation periods of the lek against the euro (Q1 1999-Q1 2002 and Q4 2003-Q1 2006) were followed by the negative contribution of imported inflation to total inflation rate in Albania. The high global price rise during fall 2007 (galloping price rise in foods and energy) and the slight appreciation of the euro against the lek during this period has translated into positive increasing rates of imported inflation. The latter has contributed by 2.1 percentage points to the average inflation of 3.8 percent during Q3 2007 – Q2 2008.

Conclusions of the studies on transmission mechanism of exchange rate pass-through

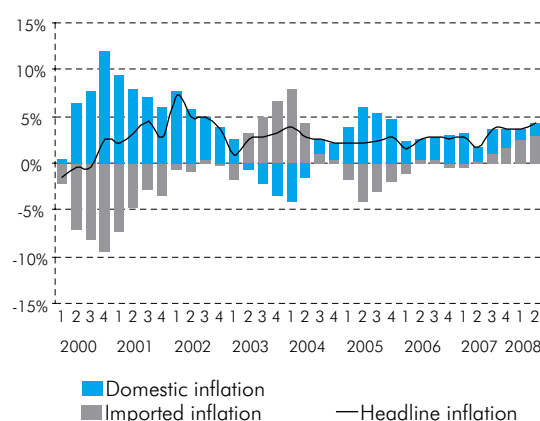
The latest empirical studies⁴² on the exchange rate pass-through to consumer prices in Albania indicate that it is almost complete, however falling. The pass-through of a shock to the exchange rate reaches 42 percent in the first four months after this shock. The transmission is complete within the year. The shocks on the exchange rate explain about 24.5 percent of the consumer price fluctuations. However, the pass-through intensity depends on the period under analysis. Results show that the exchange rate pass-through to consumer prices reduces during periods with low and stable inflation. Developments in the market structures, the lek stability, the inflationary environment and the confidence in the Bank of Albania, in particular after the inflation target has been made public, seem to be good 'justifiers' of a low exchange rate pass-through to consumer prices after 2000. These outcomes are in line with the findings of similar studies on countries that have been through such changes. However, these conclusions may not be confirmed during periods of high inflation and volatile exchange rates.

Chart 18 Annual changes of lek/euro exchange rate* (left-hand axis) and of foreign prices (right-hand axis)



Source: Bank of Albania
Notes: (*) The exchange rate affects with a time lag of 3-4 quarters; (-) appreciation (+) depreciation

Chart 19 Contribution of imported inflation and domestic inflation to the annual headline inflation rate (in percentage points)



Source: INSTAT and Bank of Albania estimations

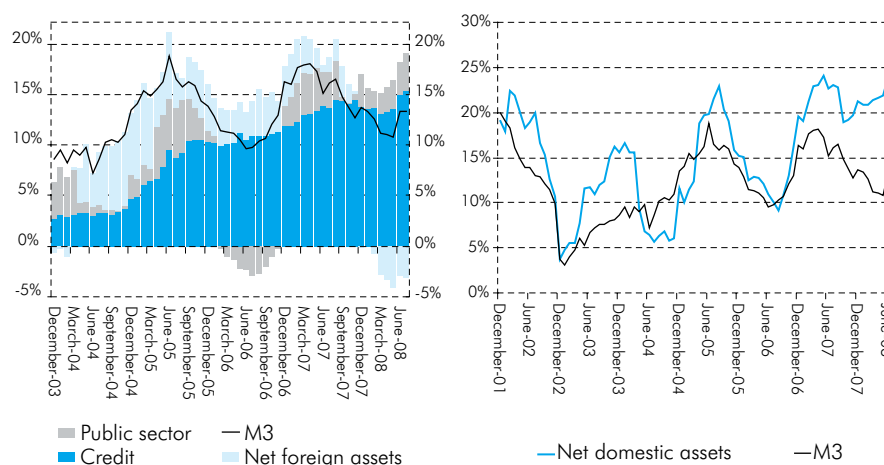
III.4 MONETARY DEVELOPMENTS

III.4.1 Monetary aggregates

Demand for money in economy has grown during 2008 at a stable rate by about 12 percent in annual terms⁴³. Money flows have been mainly created in the form of credit to economy. Annual flow of credit to the private sector dominates the money growth by about 15 percentage points in terms of M3. On the other hand, annual credit to the public sector has contributed by only about 2.5 percentage points to the M3 annual growth. In total, demand for net domestic assets has grown at more rapid rates to broad money stock. The reduction of net flow of the system's foreign currency assets has amortized the pressures in terms of further growth of money supply. The more accelerated

credit rate in June and July was followed by the annual growth of the M3 to 13.3 percent in July.

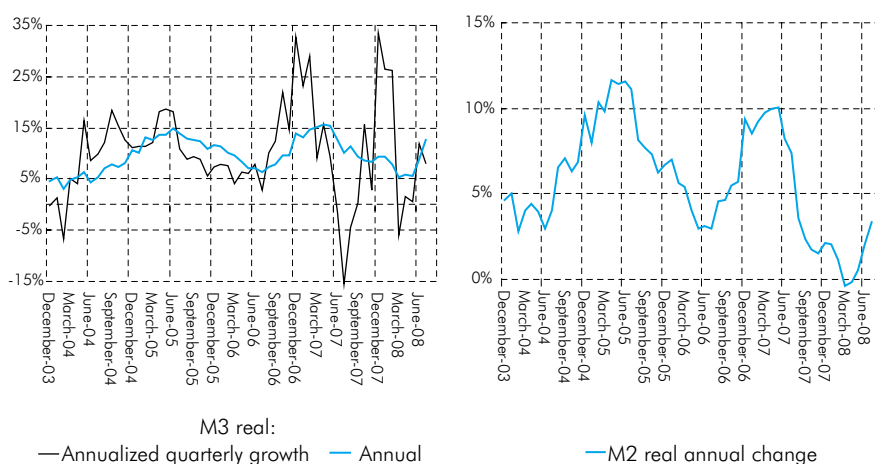
Chart 20 M3 annual growth and money demand elasticity



Source: Bank of Albania, Ministry of Finance and estimations

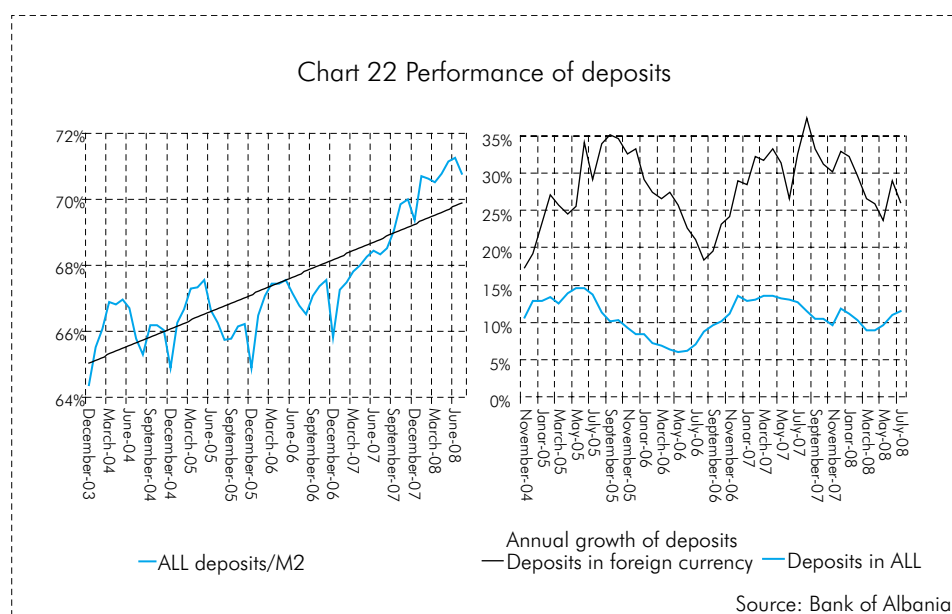
In real terms, money growth has been increasing during June-July. In the first half of 2008, real growth of M2 and M3 aggregates was 1 and 7 percent, respectively, in annual terms. The upward tendency of real M3 during the recent months to 12 percent moves around the average of this indicator in the last years. At the same time, money base has maintained its downward tendency which was shown during 2007. In annual nominal terms, it has grown by an average of 2.6 percent, while it has reduced by an average of 1.7 percent in real terms. In June to July, the annual rate of money base has reflected the growing demand for currency in circulation. In nominal terms, annual growth rate for July reached 5 percent, while in real terms it stood at 3.6 percent. This tendency was reflected in the more rapid growth of currency outside banks and in the foreign reserve accumulation in terms of assets.

Chart 21 Aggregates' annual growth in real terms



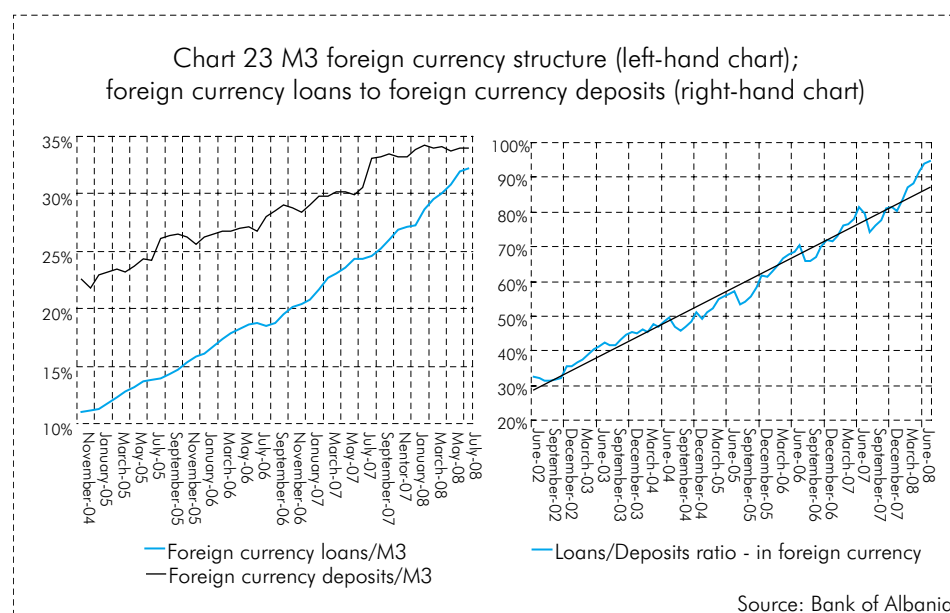
Source: Bank of Albania

The more moderate growth of the liquid component, currency outside banks, than the monetary aggregates was reflected in the higher growth rate of deposits in the banking system. During the first half of 2008, annual growth of total deposits was about 17 percent. In monthly terms, deposits recorded higher growth in June and July. Average annual rate of deposits denominated in lek and in foreign currency was 10 and 28 percent. During the last two months, their time structure shifted to time deposits, being mainly reflected in the growth of household time deposits. Given the growth of demand for domestic monetary assets, annual ALL deposits' rate increased to about 11.2 percent in July. The ratio of ALL deposits to M2 was above 71 percent compared with the average ratio of 69 percent in 2007.



Foreign currency inflows in the form of workers' remittances have affected the foreign currency structure of M3. The more accelerated growth rates of foreign currency-denominated deposits than ALL deposits continue to affect M3 foreign currency structure. In more concrete terms, the share of foreign currency deposits to M3 results stable at 34 percent during 2008, compared with the share of 33.2 percent at end 2007. The shift of broad money to foreign currency-denominated deposits was followed by the drop in the ratio of M2 to M3 to 66 percent from the average of 69 percent in 2007.

The shift of the M3 to the foreign currency component was also affected by the creation of money in the form of credit to economy and by its foreign currency composition. Hence, the increase of the intermediation through the channelling of the system's net foreign assets to foreign currency lending has led to a more accelerated creation rate of foreign currency. In July, the ratio of foreign currency loans to foreign currency deposits increased to 95 percent from 82 percent at end 2007. Being in line with the upward tendency of this ratio, the share of foreign currency loans to M3 has increased to 32 percent from 27 percent as of end the last year.



Foreign currency inflows and the prudent operational policy have allowed the increase of the Bank of Albania net foreign reserve during 2008. In order to meet its operational objectives, the Bank of Albania has met the liquidity needs in economy as a result of the seasonal growing demand and has managed to balance the foreign currency structure of money base in economy in line with its objectives. In August, net foreign reserve amounted to 1,219 million euros, compared with the objective of 1,143 million euros in September. The increase of the reserve has maintained the net domestic assets at low levels.

Table 18 Meeting of quantitative objectives⁴⁴

	March 2008	June 2008	July 2008	August 2008	September 2008
Net International Reserve of the Bank of Albania (in million euros)					
Objective	1,088	1,122	1,129	1,136	1,143
Current	1,127	1,137	1,163	1,219	--
Difference (C-Obj)	39	15	34	83	--
Net Domestic Assets of the Bank of Albania (in billion leks)					
Objective	88	96	95	94	93
Current	74	81	82	76	--
Difference (C-Obj)	-13.8	-15.7	-13.2	-18.1	--
Net Domestic Credit to the Government (in billion leks)					
Objective	383	389	--	--	--
Current	360	376	--	--	--
Difference (C-Obj)	-22.6	-13.1	--	--	--

Source: Bank of Albania

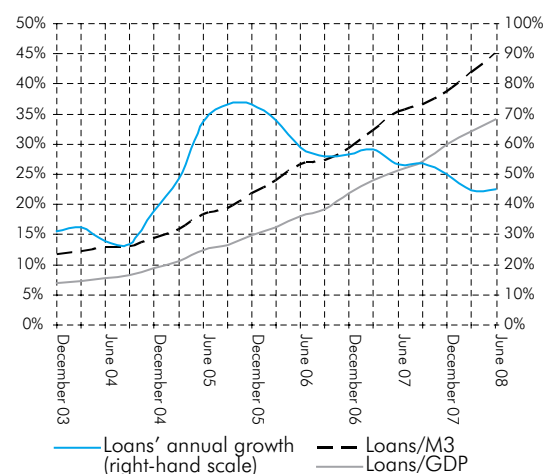
III.4.2 Credit to economy

During the first seven months of 2008, credit to economy continued to grow at an average annual rate of 45.5 percent, accounting for 34 percent of the GDP and 45.3 percent to M3 broad money. Credit growth rates have by and large followed the downward tendency of the last two years, except for June and July when the growth rates were higher than in the previous months.

This performance owes to the higher monthly lending, mainly to businesses, during June. In addition, monthly lending returned to the average annual level of about 8 billion leks in July.

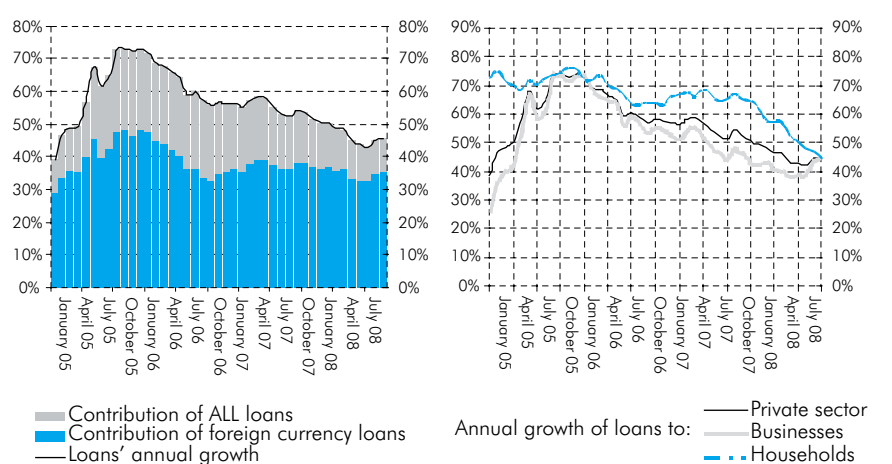
The foreign structure of credit has maintained the same tendency as in the previous year, being characterized by the moderate growth of the share of credit in foreign currency, both for business and household credit. At average levels, during the first seven months of 2008, credit denominated in foreign currency shared about 72 percent of loan portfolio or about 2 percentage points more than the average for 2007. This performance owes to higher growth rates of foreign currency lending compared to ALL lending which averaged 49 and 37 percent.

Chart 24 Performance of loan portfolio



Source: Bank of Albania

Chart 25 Performance of loan portfolio by foreign currency and borrowers



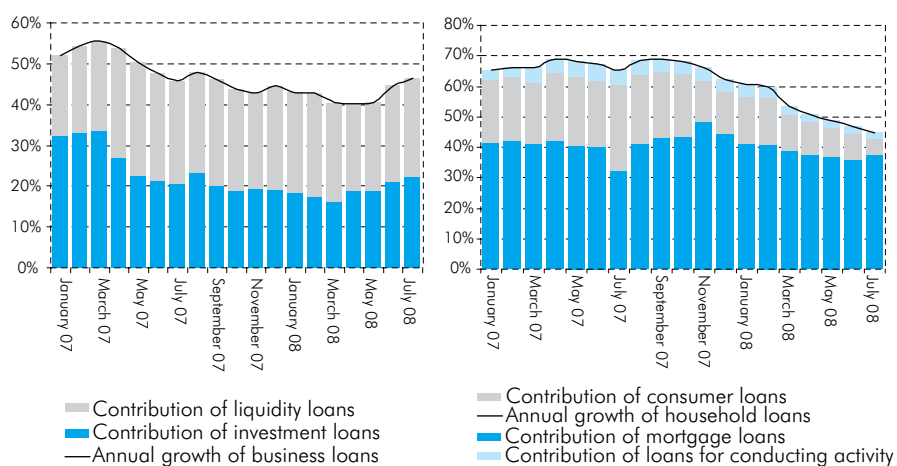
Source: Bank of Albania

Credit to the private sector recorded an average annual growth of 40.6 percent in the first seven months of 2008. Business credit provided the main contribution. Worth to note is that this type of credit has in the last months provided greater contribution than household credit. Trade, construction and industry absorb about 77 percent of business credit. Most of the credit is used by businesses to cover their liquidity needs (48 percent) and to finance investments in real estates (22 percent).

In annual terms, household credit grew by 51 percent on average in January to July 2008. The growth of this type of credit has been following a downward tendency to 44.3 percent in July from 57.5 percent as of end 2007. This considerable slowdown attributes to a large extent to the decline of consumer loans. On the other side, real estates loans, which account for

about 66 percent of household loans' portfolio, maintain high growth rates, providing the highest contribution to the growth of this portfolio. The high and stable rates of real estates loans to households and the growth of business loans have increased the share of this type of loan to 12.5 percent of the GDP which is 2 percentage points more than as of end 2007.

Chart 26 Performance of loan portfolio by main groups and purpose of use



Source: Bank of Albania

Table 19 Indicators of loan portfolio

		Average annual growth for the quarter (in percent)				
		Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007
Loan portfolio (in billion leks), July 2008	351	44.0	47.1	50.7	53.4	55.5
Composition of loan portfolio in percent (July 2008)						
Business loans	64.7	41.8	42.7	43.7	46.6	50.6
-working capital (+overdraft)	30.8	48.6	58.3	58.0	61.8	64.2
-investments	33.9	36.1	30.2	33.2	36.2	40.9
Household loans	35.3	48.7	58.0	65.5	67.5	68.2
-consumer	8.7	36.2	57.7	61.5	106.7	100.9
-real estates	23.2	60.4	64.8	76.8	62.4	66.3

Source: Bank of Albania

Box 6 Survey results of lending activity during the first half of 2008

According to the survey on lending activity during the first half of 2008, banks report the further tightening of loan standards compared with the second half of 2007, both to businesses and households. Banks have been more prudent in lending to large businesses and to consumers than to lending to small businesses and mortgage-related loans.

The factors with the highest contribution to the tightening of lending standards to businesses have been: the Bank of Albania decisions; the specific issues of the sector the business operates in and the expected macroeconomic situation. The main

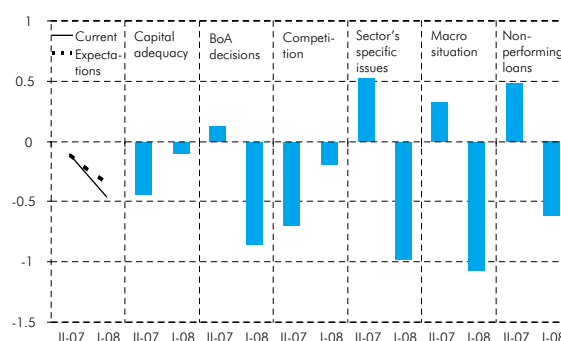
factors to have contributed to the tightening of lending standards to households in the first half of 2008 were the financial situation of households and the performance of non-performing loans.

With respect to banks' standards in lending to businesses, banks have strengthened the standards applied on loans through the increase of the margin for risk-bearing loans and the increase of the collateral as a ratio to the amount of loan. With respect to banks' standards in lending to households, their tightening policy was mainly applied through the increase of the margin for higher-risk loans. The margin for average loans has slightly reduced, hence allowing the implementation of a looser lending policy.

The business and household demand for loans has been assessed as positive in the first half of 2008, although there is a downward tendency compared with the second half of 2007. Business demand is expected to remain positive in the second half of the present year, while household demand is anticipated not to show considerable changes compared with its level of the first half of 2008.

With regard to foreign currency lending, the main factor to have fuelled the business demand was the interest rate spread. In addition, banks consider the low awareness on the future economic developments (such as the changes in the exchange rate or interest rate) as another important factor with a positive contribution to the growth of demand for foreign currency lending. With respect to the factors that have fuelled the household demand for foreign currency lending, they are the prices of goods which are expressed in foreign currency and the interest rate spread.

Chart 27 Changes in the lending standards applied in business loans and the influence of different factors (net balance*), in percent



Source: Bank of Albania

* A positive balance implies the relaxation of standards or that the factor has influenced on the relaxation of lending standards. A negative balance implies the tightening of lending standards or that the factor has influenced on the tightening of lending standards.

Chart 28 Changes in the lending standards applied in household loans for houses and consumption and the influence of different factors (net balance*), in percent



Source: Bank of Albania

* See note 1

III.5 MARKETS AND INTEREST RATES

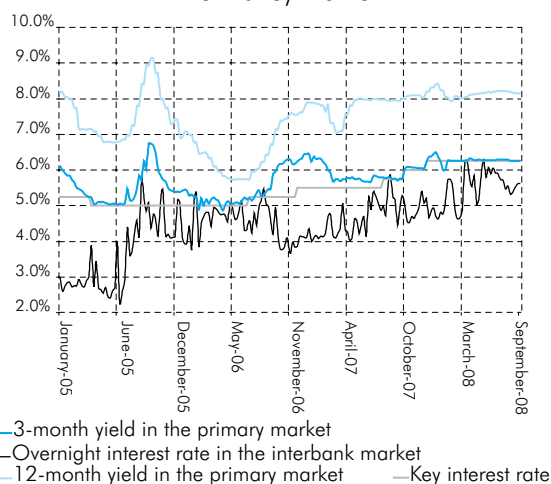
Key interest rate increased three times in the second half of 2007 (a cumulative change of 75 basis points) in response to the expectations for the increase of inflationary pressures in economy. Consequently, the interest rates in the markets increased during 2008 relative to the previous year. Interest rates in the money market have shown steady volatilities given the expectations for the maintenance of an unchanged key interest rate. The spread between the interest rates of deposits and loans denominated in lek and in euro has narrowed following the introduction of attractive summer offers for the collection of deposits. In addition, the average interest rates for the lek-denominated loans have shown a downward tendency starting from early 2008.

III.5.1 Money market

The interest rates in the money market have increased during the present year in line with the monetary policy orientation. Compared with the previous year, overnight interest rate in the interbank market has increased in average terms by 80 basis points to 5.60 percent, while the 12-month yield has risen by 27 basis points to 8.14 percent.

The oscillations of interest rates in the interbank market relate to the change of liquidity conditions in the market and to its asymmetrical distribution. The amount of liquidity shrank over the second quarter, leading to the increase of overnight interest rates and to their shift close to the key interest rate.

Chart 29 Performance of interest rates in the money market

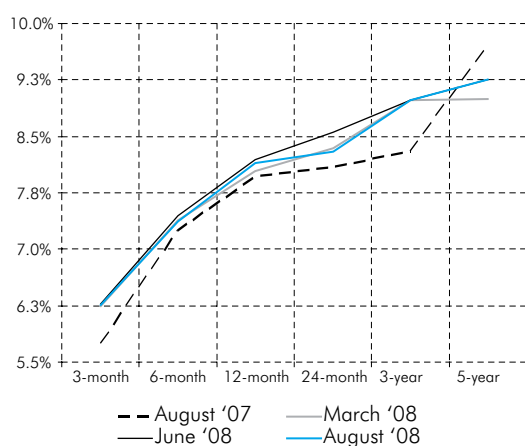


Source: Bank of Albania

Average overnight interest rate increased to about 6.00 percent in the second quarter from 5.20 percent in the previous one. Weekly interest rate stood at 6.17 percent or 0.31 percentage points higher. During this period, the Bank of Albania has conducted open market operations by injecting funds through reverse repurchase agreements of one-week maturity term. The majority of funds were concentrated in a limited number of banks which have met the market's needs, which in turn have led to oscillations in the interest rate. Transactions were mainly of overnight maturity term and their average volume grew compared to the first quarter. Average daily volume of lending recorded a total of 1.6 billion leks, while average weekly volume reduced by about 0.2 billion, showing a similar performance with the previous quarter.

The beginning of the third quarter was followed by the improvement of the liquidity situation and a more balanced distribution which was reflected in the downward performance of overnight interest rates to 5.6 percent as of end August.

Chart 30 Time structure of yields in the primary market



Source: Bank of Albania

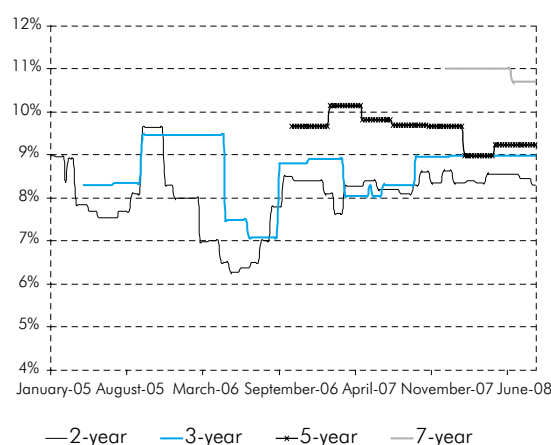
The primary market has shown low fluctuations of the yields during 2008. They have gradually transmitted the tightening of monetary conditions signalled in the second half of 2007, while the spread between the maturity terms has narrowed. Relative to the previous year when the key interest rate rose by 50 basis points, as of end August 3-month and 12-month yields increased by 51 and 0.18 percentage points, respectively.

While the yields maintained an upward tendency in the first two quarters of the present year, they dropped in the third quarter following the creation of larger excesses of liquidity in the market. In the

beginning of September, the 12-month yield was 8.02 percentage points, falling by 0.19 percentage points from its peak of 8.21 percent at end-June.

Long-term yields in the bonds' market show a narrowing tendency of the spreads between maturity terms in the last two years. In average terms, 2-year bonds, which are of higher frequency (monthly), have increased slightly during 2008, while other maturity terms' yields have been falling. As of end August, 2-year bonds' yield marked 8.3 percent or 0.06 percentage points higher than last year's average, while 5-year bonds' yield fell to 9.06 percent or 0.76 percentage points lower. The banking system's portfolio continues to shift to instruments of maturity term longer than one year⁴⁵, which has moderately affected the fall of bonds' yields and the consolidation of this market. Market participation has been high and the volume of issued bonds is increasing, reflecting the upward tendency of debt financing through long-term instruments. For the first time in November 2007 were issued bonds of 7-year maturity term. In the auction of June 2008, their yield was 10.71 percent or 0.29 percentage points lower. The secondary market remains almost inactive with a limited number of transactions and volumes. The trading of securities in this market would otherwise provide valuable information on the behaviour of participants and their expectations of financial and economic indicators.

Chart 31 Performance of bonds' yields in the primary market



Source: Bank of Albania

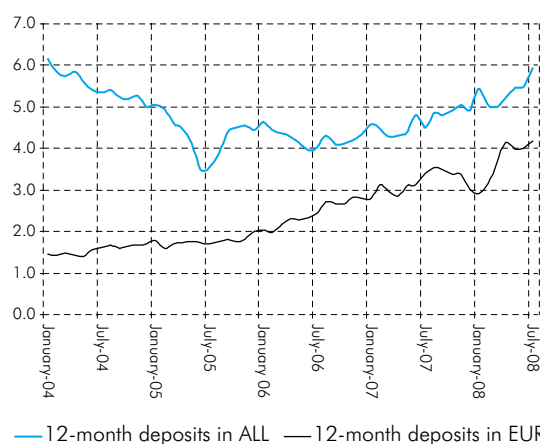
III.5.1.1 Performance of deposits' interest rates

Weighted average interest rate of deposits denominated in lek increased to 5.94 percent in July, up by 1.43 percentage points to the previous year and 0.95 percentage points to the previous quarter. The increase has persisted, except for in February and March when the offers made by the banking system in the end of 2007 were concluded.

With respect to maturity terms, worth to note is that the weighted interest rate for 12-month deposits recorded the highest increase by 1.12 percentage points to 7.72 percent. This considerable increase owes to the aggressive marketing strategy applied by the banking system to collect deposits through the application of promotional products during summer.

The interest rates of euro-denominated time deposits have generally had an upward tendency. The aggressive marketing strategies have been also applied for foreign currency-denominated deposits

Chart 32 Performance of weighted average interest rates of 12-month deposits denominated in lek and in euro



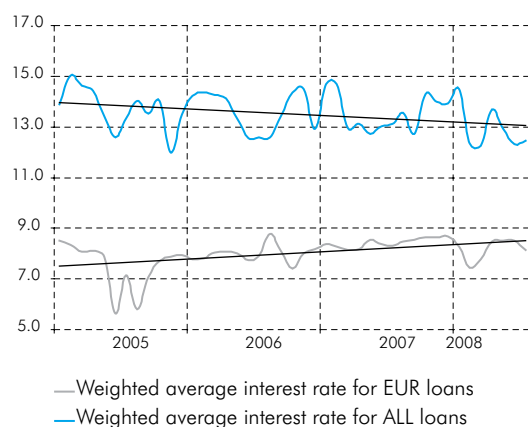
Source: Bank of Albania

of long maturity term. Average interest rate of 12-month deposits reached 5.36 percent in July from 4.74 percent in June, hence increasing by 0.62 percentage points. The spread between lek and euro 12-month deposits increased significantly in July from 1.81 to 2.36 percentage points, affecting positively competition for lek deposits and perhaps having some impact on the exchange rate.

III.5.1.2 Performance of loans' interest rates

The downward tendency of interest rates of new loans in lek shown in the beginning of 2008 persisted in the following months as well. Demand for lek-denominated loans continued to be high in particular in the beginning of summer. Weighted average interest rate of lek-denominated loans was 12.46 percent in July from 12.93 percent in March and 12.32 percent in June. The loans extended have been mainly used to fund the short-term needs of businesses for working capital, consumption and the purchase of real estates. The overwhelming enhancement of competition, the banks' eagerness to gain their market shares, the more conservatory policies in terms of foreign currency lending have affected the drop in the banks' margins for lek-denominated loans. The average spread of the interest rates of new loans and T-bills has shown a distinct downward tendency in the first half of 2008 to an average of 4.79 percentage points, which is 0.92 percentage points lower than in the same period the previous year.

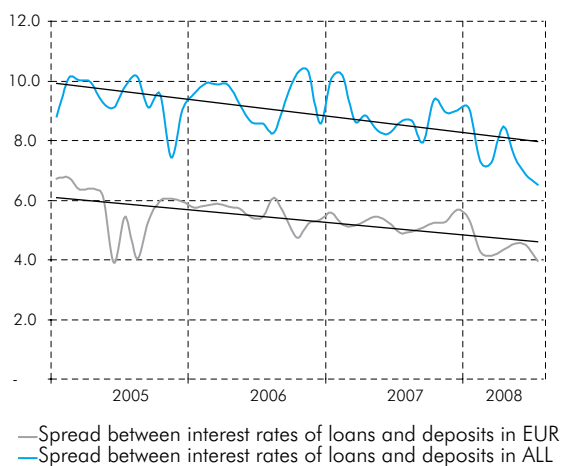
Chart 33 Performance of weighted average interest rate of loans denominated in lek and in euro



Source: Bank of Albania

The interest rates of foreign currency-denominated loans have performed in line with the developments in the global markets, observing the changes in LIBOR and EURIBOR. In July, the interest rate for euro-denominated loans was 8.15 percent, which is 0.35 percentage points lower than in June 2008. As in deposits, this fall mainly reflects the aggressive marketing policies of banks during this month. The demand for euro-denominated loans remained high for all purposes of use, in particular for real estates, hence keeping the spreads low and competition between banks high.

Chart 34 Intermediation rate for the lek and the euro



Source: Bank of Albania

Intermediation rate in the banking system has dropped in average terms. With respect to the lek, it is noted that the spread between the weighted average interest rate of deposits and loans denominated in lek dropped to 7.56 percent in the first seven months from 9 percent the same period the previous year. In addition, average intermediation rate for the euro

has dropped by 0.82 percentage points compared with the first half of 2007, to 4.44 percent.

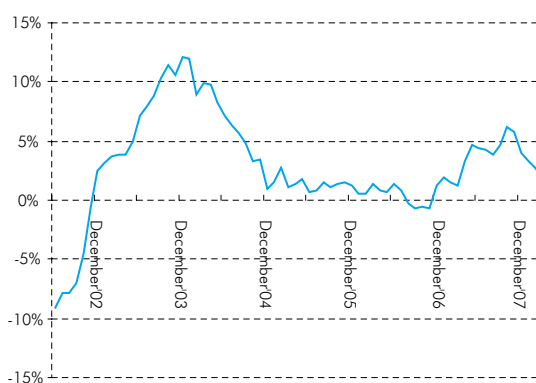
III.5.1.3 Exchange rate

The appreciating tendency of the lek against the main currencies in the first two quarters of 2008 persisted in the third quarter, although at more moderate rates. In annual nominal effective terms, the lek has appreciated against the main currencies, the euro and the U.S. dollar, by an average of 2.63 percentage points during this quarter – relatively higher than 1.58 percent the same period the previous year. In annual terms, the nominal exchange rate of the lek against the euro and the U.S. dollar has appreciated by an average of 0.75 and 9 percent, respectively.

The performance of the exchange rate has been affected by the behaviour of the main currencies – euro and U.S. dollar – in the international market and by the seasonal behaviour during summer. In the beginning of the third quarter, the EUR/USD exchange rate showed high volatilities in the international markets. The depreciating tendency of the U.S. dollar shown in the last three quarters (Q4 2007-Q2 2008) was also maintained in the beginning of the third quarter. The U.S. dollar depreciation against the euro has mainly reflected the uncertainty in finding a solution to the credit crisis and the non-satisfactory performance of the U.S. economy. On the other side, the figures published recently in the Euro area have indicated some deterioration of the economic situation even after the tightening of the monetary policy by the ECB in the beginning of July (raise of the key interest rate by 0.25 percentage points).

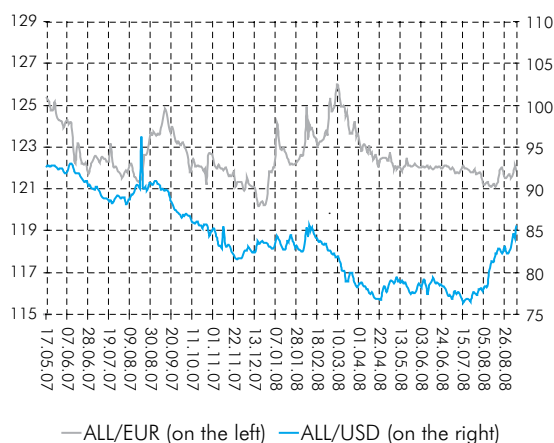
As of end this quarter, the U.S. dollar has gained considerable ground against the euro being exchanged at the highest rates since the early 2008 (1.39 EUR/USD), however, not exceeding the rates of the same period last year (1.42 EUR/USD at end September 2007). The fact that the other economies, and the European economy in particular, are being affected by the current economic crisis, support the appreciating behaviour of the U.S. dollar; however with no long-term effects if we consider the latest turbulences in the U.S. financial market.

Chart 35 Annual changes of the lek in nominal effective terms (NEER⁴⁶).



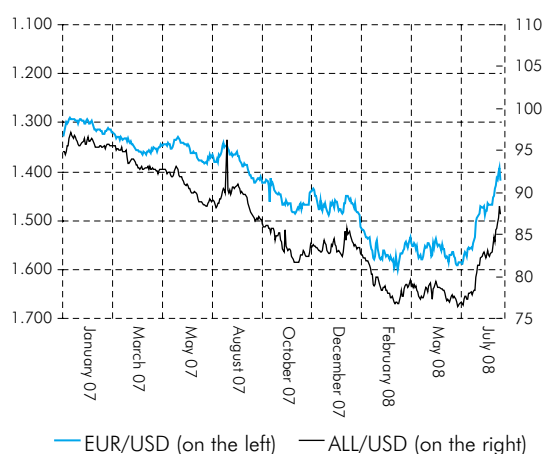
Source: Bank of Albania

Chart 36 Daily performance of ALL/EUR and ALL/USD exchange rate



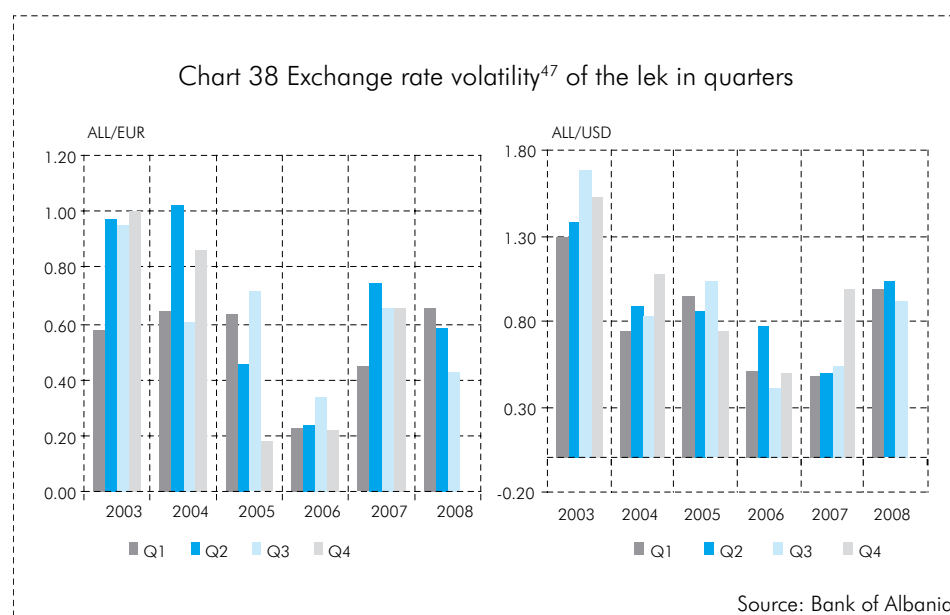
Source: Bank of Albania

Chart 37 Daily performance of EUR/USD and ALL/USD



Source: Bank of Albania

In the Albanian market, the lek has appreciated against the euro by 0.41 percentage points and has depreciated against the U.S. dollar by 4 percentage points relative to the second quarter of 2008. The appreciation of the lek against the euro owes to the seasonal effect characterizing this period of the year. However, this effect has been somehow more moderate due to the active presence of market agents which has offset the demand/supply ratio. The quarterly dynamics of the lek performance in relation to the euro is presented stable during this period, with lower volatilities compared with the first two quarters of 2008 and the same period the previous year. On the other side, the depreciation of the lek against the U.S. dollar reflects the developments of this currency in the international markets. The correlated performance between the U.S. dollar and the lek over the last years may represent a characteristic of the period to follow. As of end period, the lek exchanged against the euro and the U.S. dollar at 123.33 ALL/EUR and 78.20 ALL/USD, respectively.



Box 7 Understanding Monetary Conditions Index – The Albanian approach

Monetary Conditions Index (MCI) has become widely known during the last years as a way to interpret the monetary policy orientation and its impact on the economy. The central Bank of Canada was the first institution to use this index in the early 90s. Later, the central banks of Sweden and Norway began to use this index as a tool to interpret the changes in monetary policy. (Freedman (1994); Hansson and Lindberg (1994)).

Nowadays, central banks are ever-increasingly using the term 'monetary conditions' to evaluate the monetary policy settings. The monetary conditions represent the combined effect of interest rates and the exchange rates on the economy. These are the key variables through which monetary policy can affect economic activity,

which in turn influences inflation. In a period of easy monetary conditions, monetary policy has been set in a way as to support economic growth. If, conversely, monetary policy suppresses growth, we speak of a period of tight monetary conditions. Finally, in the case of neutral monetary policy settings, the monetary conditions are also termed neutral.

The components of the monetary conditions do not necessarily affect the economy in the same direction. The interest rate component may, for instance, be evaluated as relaxed and the exchange rate component as tight, or vice versa. The interest rate plays the primary role in determining the monetary conditions. The exchange rate, - along with numerous other effects, - adjusts to interest rates: low interest rates in a given period tend to lead to disinterest in the domestic currency and a weaker exchange rate, whereas high interest rates have the opposite effect.

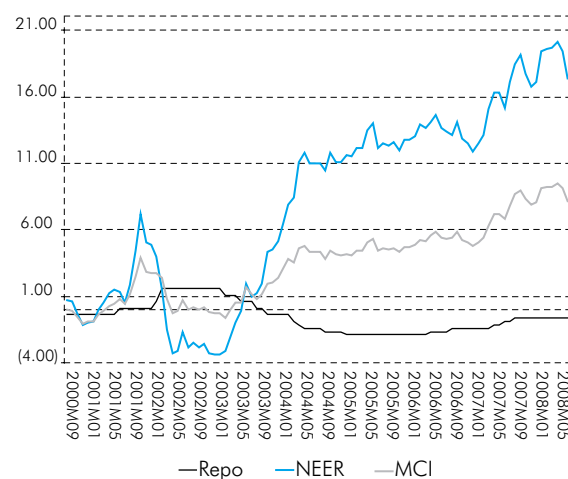
The selection of this index's components has aroused long debates over the years and has been influenced by different economic points of view. According to the Banque de France (1996) the use of short-term nominal rates in calculating the MCI in the short-term may be considered as a good approach of the real MCI. However, in the long-term, the variables need to be expressed in real terms in order to avoid their effect on inflation. In the same line, the Czech National Bank supports the fact that the interest rate component of the monetary conditions is made up not of short-term interest rates, which are subject to direct control by the central banks, but of long-term interest rates. Most firms, households and other economic agents work with long-term interest rates (one-year or longer) when making decisions about their level of consumption and investment. High interest rates generally increase the attractiveness of deferring consumption and investment and of depositing any free funds in the interim on an account to increase their value. This leads to weaker domestic demand, slower economic growth and a fall in inflation. By contrast, if interest rates are low it is generally better to realise one's consumption and investment plans now, be it using one's own money or borrowed funds. The result is upward pressure on economic growth and inflation.

The exchange rate component of the monetary conditions is represented by the relative price of domestic and foreign goods and services. Appreciation of the real exchange rate, i.e. an increase thereof, naturally leads to a shift in interest from domestic to foreign supply. The result is a decrease in domestic economic growth and downward pressure on prices of domestic goods. Depreciation of the exchange rate has the opposite effects.

Based on this concept and considering the particularity of the economic and financial structure, the use of the key interest rate and the nominal exchange rate lead to a better approach of the MCI in the case of Albania⁴⁸.

The MCI is a weighted average of changes in the key interest rate and the nominal effective exchange rate (NEER) of the lek against the respective values of these two indicators in a base period. In the case of Albania, the ratio of the MCI is 1.82:1. Interpreting it, it implies that the effect on the aggregate demand of an appreciation of the NEER to 1.82 percent would be offset by a drop in the key interest rate by 1 percentage point. Worth to note is that an increase of the MCI would be viewed as a sign of monetary policy tightening at home, but not as the monetary policy stance.

Chart 39 MCI and its components' performance



Source: Bank of Albania

The slight upward tendency of the MCI, shown since the second half of 2007, relates to the change of the key interest rate in economy during this period, which has reinforced the effect of the lek appreciation on these indicators. During the year 2008, the key interest rate has remained unchanged, while the lek has appreciated. The developments in the exchange rate in the recent months have reflected a slight slowdown of the appreciation rates of the lek against the foreign currencies. Despite this development, the information provided by the MCI indicates that the monetary conditions have continued to affect the relaxation of aggregate demand in economy.

ENDNOTES

¹ Preliminary data indicate a growth of 3.3% in the second quarter relative to the first quarter of 2008. Compared with the previous quarter, GDP growth in the first quarter was 0.9%.

² As a result of the more rapid rise of wages than the growth of productivity.

³ ECB, Statistics Pocket Book, 2008.

⁴ Adjusted to exclude the seasonal effect.

⁵ The data have been made available by the Ministry of Agriculture, Food and Consumer Protection. This is the first time for this institution to publish data on the first half of 2008, given that they have only been published in annual terms.

⁶ The exports and imports of agricultural and agro-industry production during the first half of 2007 amounted to about 3.55 and 24.4 billion leks, respectively.

⁷ The data have been made available by the Ministry of Agriculture, Food and Consumer Protection. They are expressed only in percent and not in value. The data on the first half of 2007 are not available.

⁸ Figures on the agricultural production for the period January to June 2008 are available only for these products.

⁹ According to IMF data, the price index of food and oil in August increased at lower growth rates in annual terms (29 and 63%, respectively). In the meantime, in monthly terms they have decreased by 7 and 14%.

¹⁰ Prices mainly increased in 'Fats and oils' (average annual growth is 17%), 'Milk, cheese and eggs' (8%) and particularly in 'Bread and grains' (30%).

¹¹ In Greece, annual inflation rates of 'Foods and alcoholic beverages' were 5.3 and 4.5% in July and August.

¹² Included in 'servicing personal transportation vehicles'.

¹³ Agflation is a term used during the last decade to describe the inflation originating from the rise in food and grain prices. In global markets, the extent of this phenomenon becomes international. In addition, agflation affects the price rise in agro-industry products or processed foods, given that food and grains are used in this industry as raw materials.

¹⁴ Excluding Romania (60 percent) and Slovenia (35 percent).

¹⁵ A measure of core inflation which excludes permanently certain items that face volatile price movements, administered prices, etc.

¹⁶ Rise of bread and grain prices.

¹⁷ Long-term period refers to the time period from January 1999 to August 2008.

¹⁸ These measures are also known as 'net inflation'.

¹⁹ Starting from June 2008.

²⁰ According to (BoA) Balance of Payments statistics, during the first half of 2008, food products and fuels shared about 30% of Albanian imports' volume, which is close to the share in 2007 (27%).

²¹ IMF, World Economic Outlook –UPDATE (an update of the key WEO projections) - July 2008.

²² The annual changes of the series in the database in <http://www.imf.org/external/np/res/commod/externaldata.csv> have been calculated, since the latter have been transformed into figures of quarterly frequency.

²³ In March 2008 was recorded the highest annual rise (121%) for the period January 1980 to March 2008.

²⁴ In April to August 2008, this sub-group marked an average annual inflation rate of about 18%.

²⁵ The oil resource in the Caspian Sea (Azerbaijan) is one of the few new and important resources of global oil supply from non-OPEC countries. Oil and pipeline-related (BTC) issues and those which relate to the Georgian-Russian conflict (in the Georgian part of the Black Sea where the port of Supsa is situated) have severely hindered the oil and gas transportation from the Caspian Sea to Georgia.

²⁶ According to ACIT 2007, the Russian Federation and Georgia are ranked the third and the sixth in the list of countries in which the import of the commodity group, wherein oil is part of, is of prime importance.

²⁷ Source: 'Rising food prices: Policy options and World Bank response', World Bank.

²⁸ The measures relate to the declaration of the number of employed people and their income. The application of the Council of Ministers' decision No. 285, dated 4 May 2007 'On the establishment of the referring monthly wage, for the effect of calculating the social and health insurance contributions and the tax on personal income according to the nomenclature of economic activity for private sector employees who carry out qualified or non-qualified work and for their managing and technical-economic personnel' by the private enterprises.

²⁹ According to INSTAT, wages refer to the wage fund paid to all employees during the reference period. During the first quarter of 2008, INSTAT updated the methodology on the calculation of short-term economic indicators.

³⁰ Engineering works involve the construction of roads and highways. The quarterly increase attributes to the works for the construction of Durrës-Kukës-Morinë road.

³¹ According to periodical surveys of the Bank of Albania with businesses.

³² Decision of the Council of Ministers, No. 285, dated 4 May 2007 'On the establishment of the referring monthly wage, for the effect of calculating the social and health insurance contributions and the tax on personal income' and the Law 9844, dated 17 December 2007, on some amendments and changes to the Law 'On tax on income'.

³³ This figure refers to the first quarter of 2008.

³⁴ In Russia, there is little evidence that the strong revenue performance after the reform was due to the flat tax itself; rather it appears to have reflected wider macroeconomic recovery.

³⁵ IMF, Country Report no. 08/267, August 2008.

³⁶ Deficit on trade in services amounted to 83 million euros, while the surplus in net current transfers account amounted to 467 million euros, about 6 percent lower in annual terms.

³⁷ The share of this item has dropped by about 6 percent over the period January to June 2008 compared with the same period the previous year.

³⁸ See: Monetary Policy Document for 2008, www.bankofalbania.org

³⁹ Ball, Laurence, 2006, 'Has globalization changed inflation?' NBER Working Paper 12687

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⁴⁰ C. Kent (1995), 'Exchange Rate Pass-through: Testing the Small Country Assumption for Australia', Econometrics Paper.

⁴¹ Peeters, M, 2005, 'What about monetary transmission in Albania? Is the exchange rate pass-through (still) the main channel?'

⁴² Tanku A, Vika I, Gjermani M, 2007, 'The role of exchange rate in an IT framework, what do we do?'

Istrefi K, Semi V (2007), 'Përçimi i kursit të këmbimit në Shqipëri: evidencë nga modelet me vektorë autoregresivë (VAR)'.

⁴³ The data on monetary indicators are based on 'Monetary Statistics' standard. This standard differs slightly from the International Financial Statistics standard in classifying deposits in M3 broad money. However, the differences between the two standards do not affect the thorough assessment of monetary indicators for monetary policy purposes. For more information, please refer to the monetary statistics methodology published in www.bankofalbania.org.

⁴⁴ The meeting of quantitative objectives is an obligation of the Bank of Albania in view of observing the EFF/PRGF arrangement with the IMF and the Albanian authorities.

⁴⁵ The share of bonds' portfolio has increased to 38 percent in August from 33 percent at end 2007.

⁴⁶ NEER – Nominal effective exchange rate, measured against two currencies according to an approximate share they have in trade with abroad, EUR (80 per cent) and USD (20 per cent). A positive change of the NEER implies the appreciation of the lek.

⁴⁷ Measured as quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.

⁴⁸ M. Tase, (2006), 'Matja e Indeksit të Kushteve Monetare/Financiare për Shqipërinë'.