

## MONETARY POLICY STATEMENT FOR THE FIRST HALF OF 2009

### I. GOVERNOR'S SPEECH

The economic developments in the first half of 2009 posed strong challenges to the Albania economy. The global crisis affected our economy, swinging the factors and balances that have sustained the economic growth, thus testing the immunity and self-adjusting mechanisms of the economy and raising certain complex questions to economic agents and macroeconomic policies.

The economic recession hitting a major part of our trading partners is associated with a decline in trade exchanges and foreign currency inflows. The increased uncertainty in global financial markets has shaken the confidence in the financial system, exerting pressure on tightening of the financial conditions in Albania. Both these factors are reflected in the reduction of consumption, exports and investments, thus leading to economic activity slowdown and exerting pressure on fiscal indicators of budget revenues and budget deficit. On the other hand, the reduction of foreign currency inflows is accompanied by deterioration of the balance of payments indicators and arising of depreciating pressures on exchange rate, underscoring the role of current account stability on macroeconomic and financial balances at home and the need for taking precautions to guarantee it.

World economic environment is characterised by further deepening of economic and financial crises. Curtailing of consumption and investments, in the presence of high public and private debt levels and underlined macroeconomic imbalances, has made the world economy experience the sharpest economic downturn in last 50 years. The developed countries, USA, Euro-zone, United Kingdom and Japan have followed easing monetary and fiscal policies, aiming to hamper the economic downturn and improve the financial and capital market situation. Under their impact, the latest data have signalled relative improvement signs of some macroeconomic indicators. Tensions induced in the previous periods have relaxed and the main financial indicators have shown recovery signs. In the meantime, the world inflation rates have been falling, owing to low raw materials prices and low use of productive capacities, in the presence of a low aggregate demand and increasing unemployment.

The economic activity downturn worldwide was associated with contraction of world trade, tightening of financial conditions and dropping of economic agents' confidence. The direct impact on emerging countries, such as Albania, is the fall of demand for their exports, decline of foreign direct investments and tightening of lending terms in world markets. Thereupon, these countries

have been increasingly affected by the crisis. According to IMF, the emerging countries of Eastern Europe are estimated to incur a contraction of about 5 percent during this year.

The Albanian economy, in the face of this unfavourable environment, has recorded a comparatively positive performance. There are few data on the real economy. The Bank of Albania estimates that a positive economic growth has characterised the first half of the year. On the other hand, low growth of credit and money supply, worsened business and consumer confidence indices, slow-down of budget revenues and specific indicators of certain economy sectors, suggest that the economic growth rate has decelerated. It is still early to draw conclusions on the economic performance over the course of 2009 and onwards. The Bank of Albania deems that the premises to keep positive economic growth rates in the country are present, among which the macroeconomic and financial stability of the country is of primary importance.

The economic activity at home is carried out in the presence of favourable consumer price stability. It is sustained by easing monetary conditions and an expansionary fiscal policy over this period. The Bank of Albania cut the base interest rate in January and undertook liquidity-injecting operations, raising its quantity in the market. Simultaneously, we have lengthened the maturity span of liquidity injection operations, in order to lower the upward slope of interest rate curve. We have also expanded the eligible collateral base, in order to facilitate the financial institution's access to liquid funds. These operations of the Bank of Albania have helped controlling the interest rate level. The Bank of Albania's intervention has been more effective in controlling the short-term interest rates. The long-term interest rates of Government securities and loans displayed rising tendencies, owing to Government's demand for financing and increased sensitiveness of the banking system towards liquidity indicators. In parallel, the depreciating exchange rate trends have complemented the easier monetary conditions framework, providing advantage to exports and trade deficit improvement. However, as we have constantly emphasised in our statements, the Bank of Albania has paid attention to momentary stimulus management, aiming, above all, to achieve its objective for maintaining macroeconomic stability, by preserving internal and external balances.

As of the first half of 2009, the annual inflation rate was 2.0 percent, edging down from inflation rates of the last year, but remaining within the Bank of Albania's target range. Low inflation rates are due to the weakening of inflationary pressures on the demand and supply side, consequent to raw materials price cut in the international market and the economic activity slowdown at home. Inflationary pressure stabilization is clearly illustrated by low rates of core inflation and of non-tradable goods during this period, being reflected also in checked expectations of economic agents of the market. Meanwhile, after a long disinflationary period and confirming the Bank of Albania's forecasts, the annual consumer price change displayed a slightly increasing trend over the second quarter of 2009. Annual inflation marked 2.3 percent in June, reflecting a pass-through of exchange rate depreciation

effect on consumer goods prices. The Bank of Albania estimates that this factor may play a higher role in future price setting, thus creating premises for short-term and medium-term shocks on price level.

In the face of these developments, the Albanian economy continued to be featured by low public and private savings rates even during the first half of 2009, associated with further enlargement of current account deficit and upward pressures on exchange rate performance. Simultaneous reduction of exports and imports, respectively by 19.6 and 6.3 percent on annual level, made the trade deficit contract by 1.3 percent during the first five months of the year. However, reduction of emigrants' remittances by about 8 percent during the first quarter and the services account deterioration, made the current account deficit record an annual growth of 5 percentage points of GDP during this quarter. Though this deficit goes mostly for financing the capital and intermediate goods of import, its sustainability deserves a greater attention. Particularly concerning is the low degree of export to import coverage, signalling structural problems of this deficit due to still-low competitiveness in our economy.

In this direction, a special attention should be paid to checking costs and productivity growth in the economy, by raising investments in education and attracting most advanced technologies in production. Also, in the medium run, the macroeconomic policies should be prudent in terms of public and private savings level, in order to control the need for using foreign financing resources.

The fiscal policy during the first half of 2009 had an expansionary stance, being featured by a rapid growth of expenditures and budget deficit. Budget revenues have recorded a more moderate growth, partially reflecting even the economic slowdown effects. Though remaining within the projected level for 2009, the budget deficit by about ALL 30 billion constitutes a much higher amount than in the same period of the previous year. Under these conditions, the Bank of Albania would appreciate measures for keeping budget deficit levels and public borrowing in check, helping the maintaining of internal and external balances in the economy. The maintaining of projected budget parameters will positively impact on macroeconomic stability, by controlling the fiscal stimulus on aggregate demand and dampening the monetary market pressures.

The demand for monetary assets increased during the last months. Money supply rise by about 8 percent was based on money creation in the economy from the public sector and from private sector borrowing, mainly in ALL. Loan portfolio grew moderately, by ALL 7.5 billion or about 5 times less than as of the same period of the previous year. Reduction of bank funds source and increase of uncertainty in the country influenced the significant deceleration of credit growth rates. However, credit to economy increased along the first months of the year, while the banking system signalled no further tightening of the lending terms in the third quarter of the current year. The private sector's demand for Lek-denominated loans met an increasing willingness from banks,

thanks to stabilization of liquidity situation and easing of monetary conditions at start-2009. Restraint of foreign currency money supply has resulted to contraction of the foreign currency component of money structure, even on the demand for money side, bringing about a shifting of money supply structure towards the Lek.

In the first half of 2009, the financial market situation was influenced by increased uncertainty and revaluation of risk premiums that associated the liquidity constraint, consequent to deposit outflows and lending activity reduction. Ongoing intervention of the Bank of Albania in the money market, combined with measures that aimed at relaxing the market and encouraging the interbank market activity, as well as the maintaining of sound financial system indicators, made the end of the period record stabilized liquidity positions and interest rates. The latter displayed different behaviour, according to maturity term. Short-term interest rates in the money market decreased, consequent to base rate cut and improved liquidity positions. Long-term interest rates rose under the conditions of a high demand for long-term funds and increased risk premium. Primary market interest rate rise was transmitted to interest rates of new Lek-denominated loans of more than 1-year maturity term, influenced even by the overall lending tightening tendency.

The Bank of Albania deems that the issues of liquidity, internal and external balances in the economy and the financial soundness constitute direct challenges on macroeconomic stability and long-term development of the Albanian economy. Their treatment should be constantly oriented towards the need for observing the necessary macroeconomic balances of the country. The price stability, smoothing of monetary indicators volatility, a robust and efficient financial system, as well as sound public and private sectors' balance sheets, impact on reducing the risk premium in the economy. Also, they open the way to attract foreign investments and cut the cost of borrowing from international markets. In this way, they provide an irreplaceable contribution to the country's long-term growth.

Further promotion of this growth requires constant structural reforms in the economy, which should not only address the deficiencies of our economy but also precede future development trends. Investing in infrastructure should be a priority of funds use in the economy. Also, further development and consolidation of financial market segments, completion and expansion of pension system in the favour of private incentives, investment with priority in education and medical fields deserve the attention of all actors of the economy. We also deem that it is just the time for the private sector to reflect the new development stage of the country, by enhancing and fostering its management. This requires a better management of business and financial risk, signifying also a closer cooperation with specialised agents in the market, extension of business plan horizons and their better orientation towards the global reality and the country's development priorities.

In light of this, the financial system should respond more prudentially to these requirements, enhancing the transparency and efficiency of its products. Now

that the banking system has overcome the delicate moments it was faced with at end-2008, it should raise its contribution to financing the private sector's activity of the economy. However, I avail myself of the occasion to once more emphasise that the financial stability of the banking system is another major objective, to which the Bank of Albania remains deeply committed. This system will be constantly subject to Bank of Albania's supervision and stress-test analyses.

## II. DEVELOPMENTS IN THE WORLD ECONOMY

During the first six months of 2009, the global economy was characterized by an economic contraction stemming from the recession in the developed world and lower growth rates in the emerging economies. Global inflation rates have been on the downside, caused primarily from the rise in excess capacities and from the statistical effect brought about by comparison to the last year. Throughout the same period of the last year, commodity prices, particularly energy and foods, reflected a rapid growth.

Some main economic indicators	Annual GDP Change	Unemployment Rate	Annual Inflation
Countries	H1-09	H1-09	H1-09
USA	-2.5	8.7	-0.6
Euro-zone	-4.8	8.9 <sup>1</sup>	0.6
Germany	-6.9	7.5 <sup>1</sup>	0.5
Greece	0.3	8.9 <sup>2</sup>	1.3
Italy	-6.0	7.4 <sup>3</sup>	1.1
Japan	-8.4	4.7	-0.3 <sup>1</sup>

<sup>1</sup> Average for the January-May 2009 period

<sup>2</sup> Average for the January-May 2009 period

<sup>3</sup> Data for the first quarter of 2009

### II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

In the first quarter of 2009, the economic activity in the Euro-zone followed a downward trend and contracted by nearly 2.5 percentage points in annual terms. The main reason behind this negative progress is investment shrinkage by 4.2 percent on annual basis. Similarly, domestic demand and foreign demand recorded a decline, being reflected in a fall of exports. The indicators on the economic progress for the second quarter point toward a monthly growth in the sales index of 0.2 percent in April and a slight improvement of confidence indices in May. These results implicitly indicate continuity in GDP contraction, but at a lower rate. According to the European Central Bank forecasts, the recession is expected to continue at a more moderate pace until mid-2010, time when the first signs of economic growth are expected to occur.

Preliminary estimates on the Euro-zone inflation rate for June 2009, point to fall in aggregate prices by 0.1 percent in annual terms, whereas April and May values were respectively 0.6 and 0.0 percent. These low values are attributed to the fading statistical effect of last year's higher energy prices.

Economic activity in the USA during the first half of 2009, similar to year-end 2008, remained weak. Therefore, final estimates on the economic performance during the first quarter of 2009, delivered an economic contraction of 5.5 percent in quarterly terms. The GDP drop reflected an accelerated contraction of exports and investments. In the meantime, the encouraging performance of consumer spending and the rapid fall of imports could not reverse the above mentioned negative effect<sup>1</sup>. Data for the second quarter of 2009 show a slight improvement of economic conditions in the country primarily derived from the positive signals in the industrial sector. For the first six months of the year, unemployment rate grew considerably, reaching an average of 8.7 percent. Consumer price index registered an average annual fall of 0.4 percent during the January-May period.

The BRIC<sup>2</sup> countries experienced dissimilar growth scenarios during the first half of the year. In Brazil and Russia, the economies registered contraction during the first quarter of 2009. In both countries, the fall of exports was the main contributor to the weakening of the economic climate.

In contrast, the Chinese and Indian economies maintained their rapid growth rates during the first quarter of the year. In China, exports volume dropped at an accelerated pace, but the rise in government spending, investments and consumer expenditure has more than counter-balanced the former effect. In their latest meeting the Central Banks of China and Russia lowered their base interest rate, whilst those of Brazil and India left them unchanged.

Table 1 Some macroeconomic indicators for the BRIC countries.

Countries	Annual change of real GDP			Annual inflation
	Q1-09	2009 <sup>1</sup>	2010 <sup>1</sup>	H1-09
Brazil	-1.8	-1.3	2.2	5.6
China	6.1	6.5	7.5	-0.9 <sup>2</sup>
India	6.7	4.5	5.6	9.5 <sup>3</sup>
Russia	-7.0	-6.0	0.5	13.7 <sup>2</sup>

Source: IMF, OECD, Respective statistical institutes

<sup>1</sup> IMF estimates

<sup>2</sup> Average for the January-May 2009 period

<sup>3</sup> Average for the January-May 2009 period

The economic environment in Italy during the first six months of 2009 continued to be frail even though some economic indicators showed some signs of revival. During this period the reduction in trade exchanges at a global level has been a crucial cause for the deterioration of economic activity. Thus, the first quarter of 2009 registered a 6 percent fall in annual GDP, mainly due to a reduction in aggregate investments and exports<sup>3</sup>. Latest data on the second quarter of this year, present a protracted fall of economic activity in the country. Average annual inflation rate for the first half of 2009 was 1.1 percent.

Economic activity in Greece gave the first signs of deterioration during the first half of 2009. Subsequently, although Gross Domestic Product grew by nearly 0.3 percent in annual terms, compared to the previous quarter it contracted by 1.2 percent. The primary impact came from the accelerated fall in exports and investments. On the contrary the growth in consumer

spending, the extended public expenditures and the fall in imports gave a positive contribution to the county's GDP. Latest data on the performance of main macroeconomic indicators for the second quarter point to continuity of the economy's deteriorating trend. The average unemployment rate was 9.3 percent in first four months of the year, whereas the harmonized consumer price index, during the first half of the year, grew by 1.3 percent.

Throughout the first quarter of 2009, the economy in Turkey shrank at a rate of 13.8 percent in annual terms. This was caused by a rapid fall of personal consumption and private investments, both of which considerably surpassed the evident growth of public investments. A fall was also registered in the trade activity whereby imports and exports fell by 32.5 and 15 percent respectively. Data for the second quarter illustrate an amelioration of the economic environment. Industrial production declining rates resulted subdued and the confidence indices in May continued their recovery, which had started nearly six months ago. June inflation rate was 5.7 per cent, nearly 0.1 percentage points higher than in the previous month, whilst the average inflation rate for the second quarter of 2009 was 5.6 percent.

The Former Yugoslav Republic of Macedonia's economy registered a contraction of 0.9 percent in annual terms. The main reasons behind the fall in the economic activity were the uninterrupted decline of industrial production and exports, as well as the slowing down of consumer spending, which could not be nullified by the growth in investments. Higher public investments provided more employment opportunities in the public service, mirrored in a fall of unemployment rate by 1.1 percent. The inflation rate was negative in June, at -1.7 percent on annual basis.

According to IMF estimates the Kosovo's economy grew by 5.4 percent in 2008. The economic growth over this period was supported by financial resources from international institutions, by expanding consumer spending subject to higher remittances and doubling public investments. Inflation rates have registered negative values during 2009, thus conserving the downward tendency from the end-year 2009. The annual inflation rate in May was -4.4 percent.

Countries	Annual GDP change		Annual inflation rate	Unemployment rate
	Q1:09	2009 <sup>1</sup>	H1-09	H1-09
Italy	-6.0	-4.4	1.1	7.4 <sup>3</sup>
Greece	0.3	-0.2	1.3	8.9 <sup>4</sup>
FYROM	-0.9	-2.0	0.3	32.7 <sup>1</sup>
Serbia	-3.5	-2.0	9.0	15.0 <sup>3</sup>
Croatia	-6.7	-3.5	3.5	14.6 <sup>3</sup>
Turkey	-13.8	-5.1	7.32	15.8 <sup>4</sup>
Kosovo	:	:	-2.4	:
Albania	:	0.4	2.0	12.7 <sup>5</sup>

Table 2 Some economic indicators for the regional economies

Source: National Statistics Offices, EuroStat, EcoFin, IMF

<sup>1</sup> IMF estimates. <sup>2</sup> Data for the first quarter of 2009

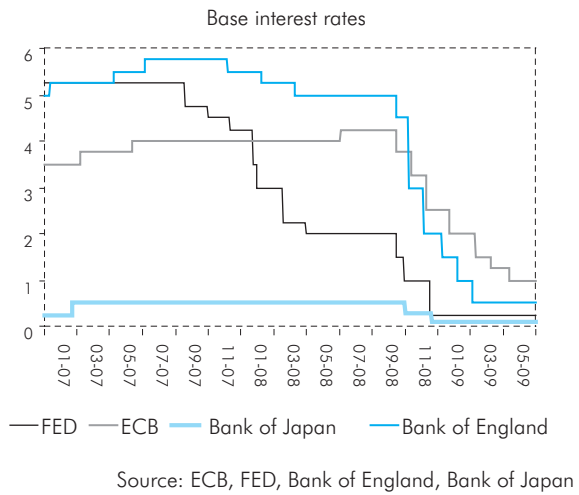
<sup>3</sup> Average value for January-May 2009

<sup>4</sup> Average value for the January-April 2009 period

<sup>5</sup> Data for the last quarter of 2008

: Data not available

Chart 1 Base interest rates of some main central banks



## 1.1 MONETARY POLICY, FINANCIAL MARKETS AND THE EXCHANGE RATE

Through the first half of the year, the European Central Bank lowered four times the base interest rate, down to 1 percent, from 2.5 percent on the turn of the year. The Federal Reserve Open Market Committee kept the base interest rate unchanged at 0-0.25 percent throughout the first six months of 2009, implicitly indicating that the base rate will not change in the months to come. The Bank of England changed thrice the base interest rate during the same period, lowering it to 0.5 percentage point, from 2 percentage points prevalent in January. The Bank of Japan did not change its reference interest rate (the over-night interbank interest rate), thus leaving it at the 0.1 percent level in the first half of 2009.

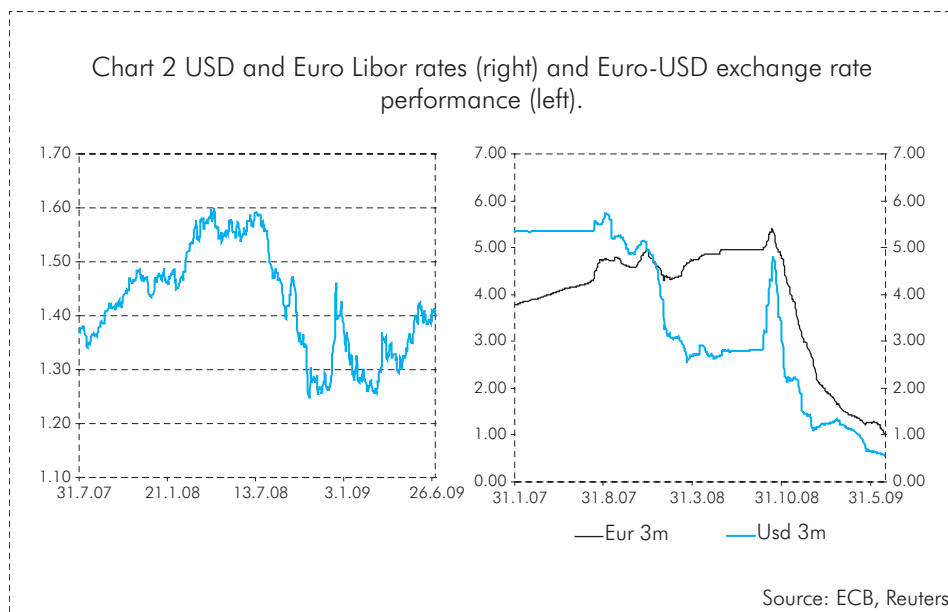
During the first half of the year global financial markets were characterized by falling interest rates and mild normalization of turbulence caused by the financial crisis. Positive signals passed on from the latest data indicate a subdued deceleration rate of several main economic and trade indicators in the global markets. During the first half of the year, Libor and Euribor interest rates in the money market fell considerably, reflecting the lowering of base interest rates from the ECB and the FED. In the beginning of July, 1-month, 3-month and 6-month Euribor interest rates fell on average by 2.92, 2.96 and 2.94 percentage points compared to the preceding six months, whereas the 3-month Libor rate diminished with 1.80 percentage points.

The bond market, during these months, was marred by constant fluctuations and higher yields. This upward trend was mostly pronounced in April, whereas recent developments show a moderate downward tendency. In Japan, yields were more stable during the same period. The stock markets were characterized by an acute bearish sentiment and frequent fluctuations. Better future prospects from businesses' economic indicators as well as traders' expectations have recently induced an upward trend in the stock market quotations.

In foreign exchange markets, the Euro has been characterized by frequent fluctuations and an appreciating tendency against the US dollar. After a considerable appreciation at the end of 2008, the Euro has followed a falling path accompanied with instability towards the US dollar, to re-gain momentum in May and June. The Euro was also valued with respect to the main basket of international currencies. Its appreciation vis-à-vis the Japanese yen and the Swiss franc more than compensated for the devaluation against other currencies. The negative performance of the US economy and unfavourable data on the Euro-zone macroeconomic indicators, have led the fluctuations and frequent appreciation of one currency against the other<sup>4</sup>. In the first half of the year, on average, the Euro depreciated by 5.47 percentage points compared to the previous six months. At the start of July, the Euro would be



equal to 1.40 US dollars, a comparable level to the value of end-December 2008.



## 1.1 OIL AND COMMODITY PRICE DEVELOPMENTS

The international oil market, during the first half of the year, was hit by the effects of deteriorating economic activity in the industrialized economies and in some main emerging economies. The average value of an oil barrel was 54 percent lower compared to the first half of 2008. After reaching its lowest point in February of this year, the oil price per barrel followed an upward tendency, despite the US dollar's appreciation vis-à-vis some main international currencies<sup>5</sup>. The global oil demand registered a 3.2 percent fall in annual terms during this period. Precipitating demand in some OECD countries and some emerging economies were of primary influence to the former development. A closer look to the monthly performance of this market highlights a pick-up in US demand during the May-June period. The oil supply, on the other hand, has shown a slender growth rate. The Organization for Petroleum Exporting Countries (OPEC) lowered its membership's reference production quotes for several months in a row, in a drive to reach a higher equilibrium oil price level. Nevertheless, the increase in production and refinery capacity in other world oil exporting regions, helped maintain an upward trend for the oil supply. Medium-term forecasts estimate higher oil prices in the second half of the year.

The main indices on commodity prices published by the IMF indicate a fall in their value in annual

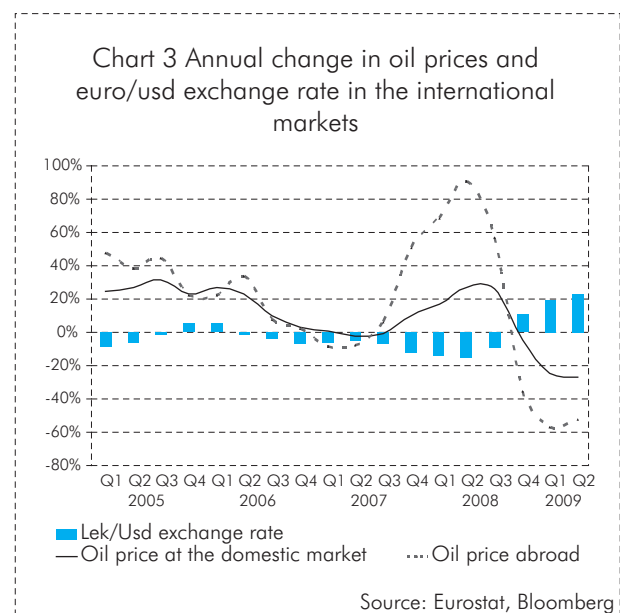
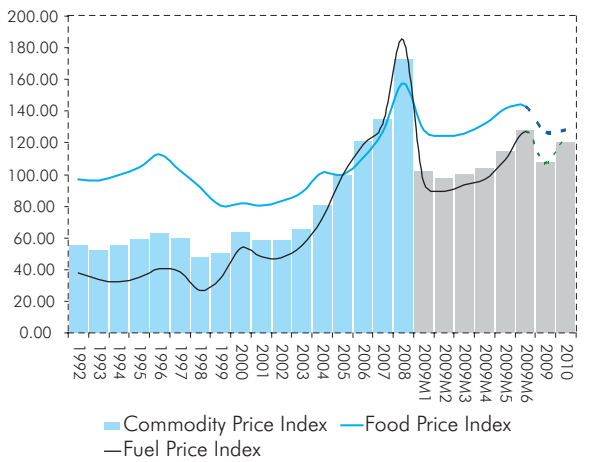


Chart 4 World market commodity price performance



Source: IMF

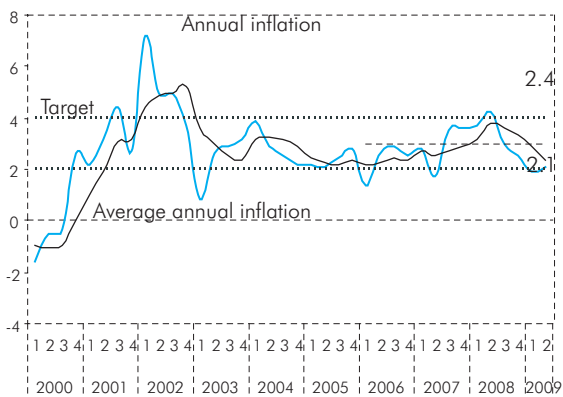
terms. However, in quarterly terms, commodity prices increased during the second quarter of the year<sup>6</sup>. Thus, the overall Commodity Price Index as of the first half of the year, dropped by 42.6 percent in annual terms. Whereas the second quarter of this year compared to the first quarter marked a 15.7 per cent increase in value. A similar trend has distinguished the Food Price Index, which marked a 21.7 fall in yearly terms during the first half of the year. During the second quarter of the year compared to the previous quarter this index grew by 10.2 percent. Similarly, the Fuel Price Index fell by 49.3 percent annually during the first six months of the year. In quarterly terms, in the second quarter it grew by 20.1 percentage points.

### III. PRICE STABILITY AND BANK OF ALBANIA'S TARGET

The achievement and maintaining of price stability is the main objective of the Bank of Albania. This is the major contribution the central bank can give to stimulating savings and attracting productive investments to sustain a consistent economic growth. In line with its strategy, the Bank of Albania is committed to achieving and maintaining an annual inflation of 3.0 percent, with a +/- 1 percentage point tolerance band. The publication of the quantitative objective on inflation aims at anchoring the economic agents' expectations and reflecting the Bank of Albania's continuous determination to achieve the main objective, despite the temporary fluctuations caused by factors beyond the control of monetary policy.

Annual inflation for the first half of 2009 marked an average of 2.0 percent, about 2 percentage points lower than in the first half of 2008. The annual inflation rate during this period<sup>7</sup> fluctuated around the lower limit of the 3.0 percent Bank of Albania's targeted band. After a disinflationary period (Q2:2008 – Q1:2009), inflation displayed a slightly increasing tendency in the second quarter of 2009, marking 2.3 percent in June. The average annual inflation was marked 2.4 percent in this month.

Chart 5 Annual inflation by quarters (in percentage)



Source: INSTAT and Bank of Albania estimates

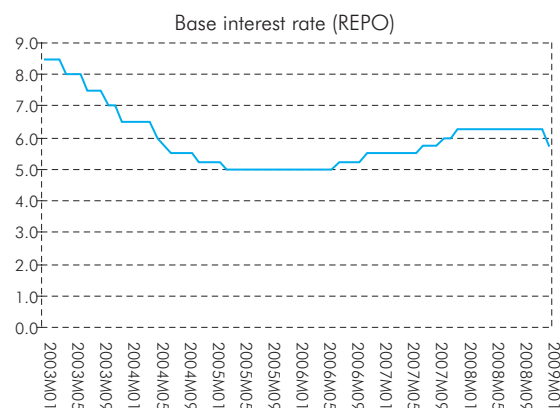
Low inflation rates in the first half of this year were caused by weakening of inflationary pressures on cost and demand side. Raw materials price cut in the global market was reflected in lower production costs and import prices. Expectations for slowdown in domestic demand growth, tight financial conditions and the downward inflation expectations influenced

the behaviour of core inflation and non-tradable goods, which displayed lower growth rates compared to June 2008.

The end of 2008 and the beginning of the current year were characterized by a falling trend of inflation, a notable weakening of inflationary pressures, low economic growth and domestic demand expectations, and falling future inflation expectations. Under these conditions, in January the Bank of Albania decided to lower the base rate by 50 basis points, to 5.75.

Under the conditions of an amplification of the global financial crisis in September 2008, the Bank of Albania was committed to using new monetary policy instruments to subdue the pressures triggered by liquidity constraint. Compared to end-2008, it injected liquidity through reverse repurchase agreement auctions, changing their type from fixed-amount repo auctions to those of unlimited-amount and fixed interest rate, the base rate. To meet the long-term market demand for liquidity, along with the main operations of 7-day maturity term, the bank carried out operations of a longer maturity term, i.e, of 3 months, and outright purchases of securities. In December 2008, overnight loan rate was cut by 100 basis points, in order to ease the borrowing ability of the banking system. In March 2009, given the improved liquidity conditions and striving for promoting the interbank market activity, the employment of overnight deposit was temporarily forbidden. This was reflected in increasing the trading levels in the interbank market over the second quarter of the year. The liquidity-injecting operations continued, but by the end of this period liquidity conditions improved and interest rates stabilized in the money market.

Chart 6 Base interest rate of the Bank of Albania



Source: Bank of Albania

Due to timely measures taken by the Bank of Albania, inflation rate in Albania was not only the lowest in the region but also within the announced price stability targeted range. Furthermore, all the operational and regulatory measures prevented contagion that the deterioration of the global financial conditions would have caused if induced in the domestic financial system and the real sector.

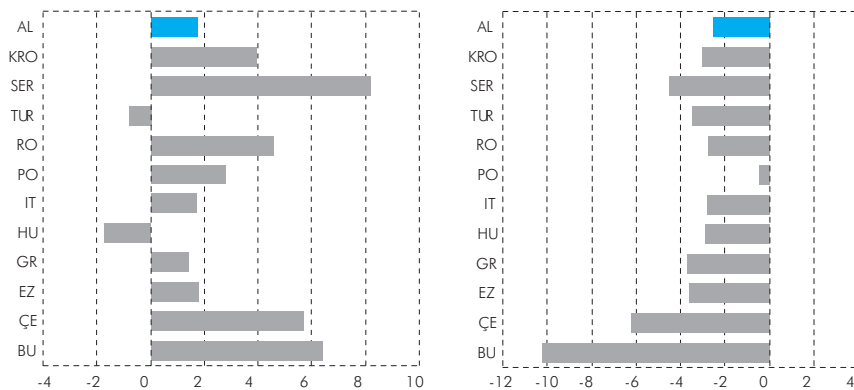
*Box 1 Regional central banks' reaction to the global crisis*

*The financial crisis in the global markets was strongly intensified in the third quarter of 2008 and transferred to the real sector of the economy. The economic situation in the world during the last 12 months is characterized by imbalances of the macroeconomic indicators, fall of production, rise of unemployment, depreciation of domestic currencies, tightening of lending and liquidity conditions in domestic markets. Facing this situation, the central banks are making use of every eligible instrument to stabilize the financial system and stimulate the economic activity.*

Monetary policy implementation depends on two main instruments: (i) the base rate, which is usually a short-term mediation rate and (ii) open market operations, which usually include the terms and conditions under which liquidity is acquired from the central bank. Under normal conditions, open market operations are composed and implemented in such a way as to affect a market interest rate determined by the monetary policy. They can be used in spite of the level of the base interest rate at that period. As such, they play a supportive role and do not contain any significant information on the future monetary policy stance.

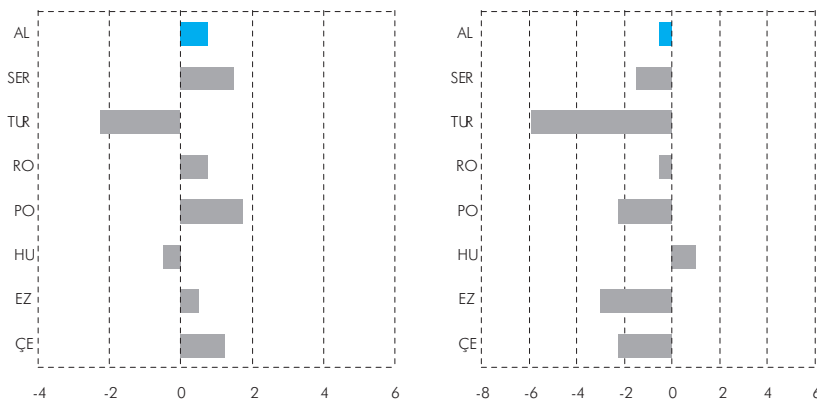
In some special situations, open market operations take an important role and are used to affect specific elements of transmission mechanism. This complementary approach of monetary policy aims at using this instrument, to raise the effect the base rate has on asset prices and yields and financing costs. In these situations, open market operations result in essential changes to central bank balance sheets and the monetary policy implementation through them can be regarded as balance sheet policy.

Chart 7 Differences in inflation for 2008M3 – 2007M1 (left) and 2009M5-2008M3 (right)



Source: Data obtained from respective central banks.

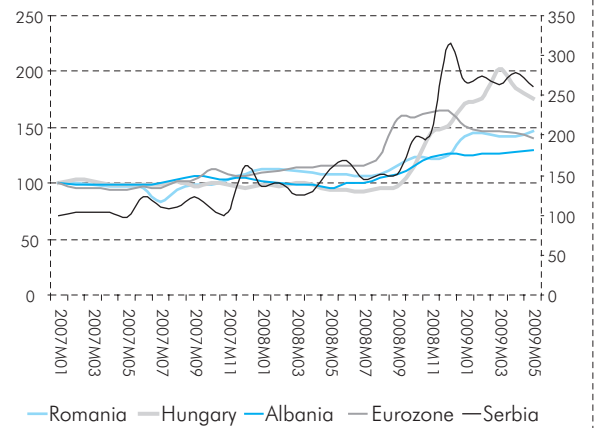
Chart 8 Interest rate difference for 2008M3 – 2007 M1 (left) and 2009M5 - 2008M3 (right)



Source: Data obtained from respective central banks.

In the face of the global crisis, the monetary authorities of different countries affected by the crisis have reacted in similar ways, by lowering their base rate, injecting liquidity in the market and creating easing conditions for refinancing operations. The central banks' reaction magnitude differs according to specific economic conditions of each country prior to the crisis – the inflation rate, economic growth, unemployment level, size of current account and fiscal deficits, etc. Therefore, some of these economies are more restricted in applying measures to counter the crisis.

Chart 9 Central banks' balances  
(2007 M1 based index)

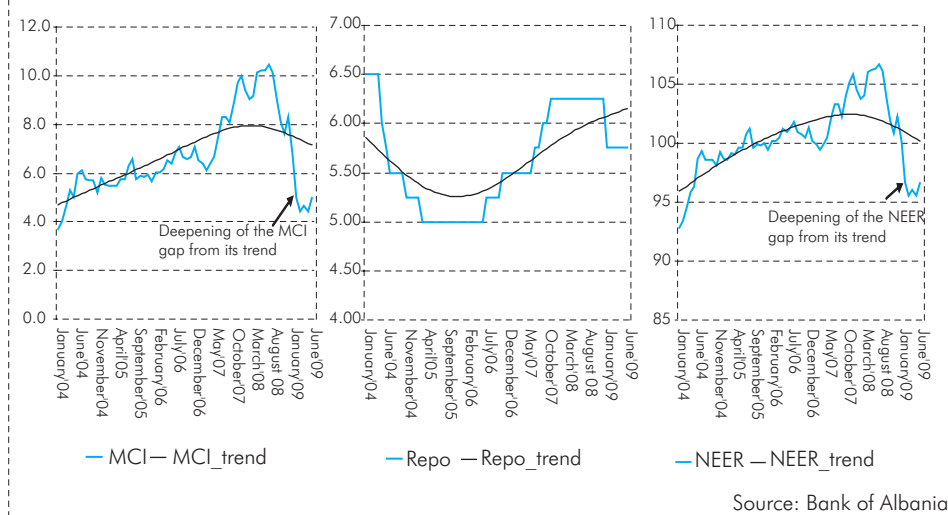


Source: Data obtained from respective central banks

### III.1 MONETARY CONDITIONS

The monetary policy pursued by the Bank of Albania during the first months of 2009 displayed an expansionary nature, as noted in the Monetary Condition Index. The base rate cut at year-start, underlined the decreasing trend of this index, which had started in the third quarter of 2008.

Chart 10 Monetary Condition Index<sup>8</sup> and its components

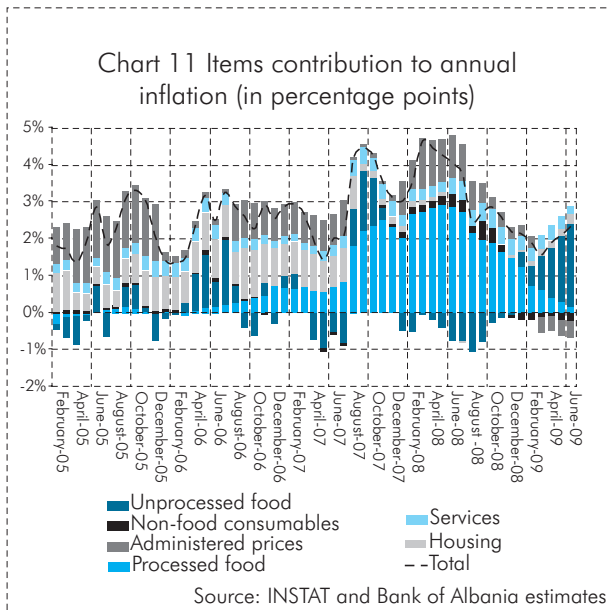


Source: Bank of Albania

Easing monetary conditions reflect the combined pace of index components, the exchange rate and the base interest rate. In the second quarter of 2009 this index continued its decreasing tendency, driven chiefly by exchange rate depreciation. The later is the component that has an important weight in

determining the economic conditions in small open economies, as is the case of Albania. In June, the seasonal effect of local currency appreciation was reflected in the monetary conditions of that month, which showed a slight contraction.

### III.1 PRICE TREND OF THE MAIN CPI BASKET ITEMS



The inflation rate trend in the first six months of 2009 reflected the smoothing of inflationary pressures stemming from inside and outside the country. The consumer goods (mainly food and fuel) price cut in international markets and better conjunctures of goods and services in the domestic economy facilitated the decrease of the inflation rate. Especially, the cancelling out of the energy price rise in March 2009 led to fall of inflation rate below the lower limit of Bank of Albania's target, to return above this limit in May and June. The inflation rate for the first half of 2009 was significantly affected by the inflation of items, the foodstuffs and administered prices.

It results out of the analysis of constituent consumer basket items that there is a notable increased contribution of the "unprocessed food" item, whereas almost all the other basket items recorded a decline related to the same previous year period. Contribution of processed and unprocessed food items determined to 90 percent the average annual headline inflation (2%) for the first half of 2009. In June, the annual headline inflation (2.3 %) was almost entirely determined by the contribution of the "unprocessed food" item (2.2 percentage points).

Table 3 Items contribution to headline inflation rate (in p.p)

	Q1-08	Q2-08	Q3-08	Q4-08	Q1-09	Q2-09
Processed food (pp)	2.5	2.9	2.3	1.7	0.9	0.3
bread and cereal (pp)	1.4	1.7	1.3	1.0	0.6	0.2
alcohol and tobacco (pp)	0.1	0.1	0.0	0.1	0.1	0.1
Unprocessed food (pp)	-0.3	-0.4	-0.9	-0.1	0.6	1.8
fruits* (pp)	0.5	0.3	-0.1	-0.1	0.0	0.3
vegetables*(pp)	-0.9	-0.2	-1.3	-0.7	-0.3	1.4
Services (pp)	0.3	0.3	0.5	0.5	0.4	0.3
Administered prices (pp)	0.3	0.7	0.8	0.3	0.1	-0.4
fuel and power (pp)	0.2	0.6	0.6	0.7	0.4	0.0
Housing (pp)	0.1	0.1	0.0	0.0	0.1	0.2
Non-food consumables	0.2	0.3	0.3	0.2	-0.2	-0.2
Durables (pp)	0.0	0.0	0.0	0.0	0.0	0.1
Consumer Price Index (year on year, %)	3.7	4.2	3.0	2.5	1.9	2.1

Source: INSTAT and Bank of Albania estimates

The "unprocessed food" item contributed an average of 1.2 percentage points to the annual headline inflation rate during January-June, while it

rendered a negative contribution throughout the whole 2008. The annual inflation rate of this category was -2.1 per cent in the previous year, compared to 6.5 per cent in the first half of 2009. The domestic demand for these products was met by both, the domestic and foreign production. High inflation rate in the first quarter of the year was triggered by the delayed seasonal effect (due to unstable weather conditions) of spring as well as the entry of season's foodstuffs at higher prices than usual. In the remaining three months, the depreciation of the domestic currency against two main hard currencies was translated into higher import prices (in lek), generating high prices in this item.

The "processed food" items performed on the reverse side. Annual headline inflation rate for this item dropped from 5.3 percent in January, to 0.7 percent in June. The contribution of this item to headline inflation stabilized around low positive values (0.6 percentage points in the first half of 2009 and 0.2 percentage points in June). Such values have not been recorded since the second half of 2006. Apart from the favourable global conjuncture related to prices of this item, the cancelling out of bread price rise in February, 2008 was a major factor behind the inflation fall.

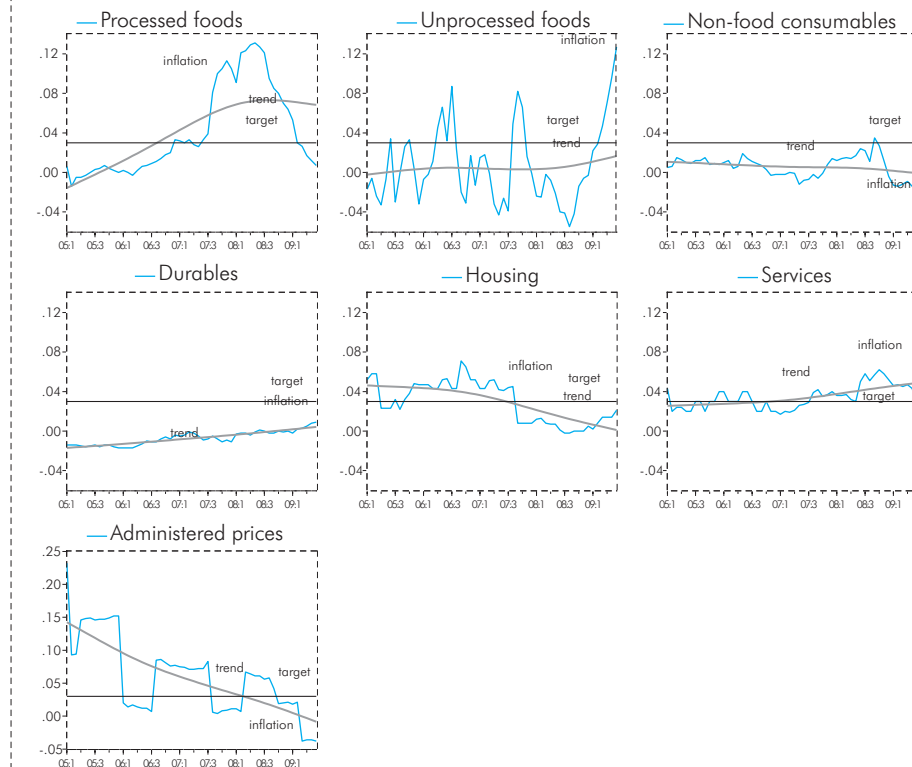
Annual inflation rate of "administered prices" has fluctuated around -3.7 percent in the last four months reflecting the cancelling out of energy price rise in March 2008. During March 2008 - February 2009, the contribution of this particular category to the headline inflation averaged 0.7 percentage points. After the cancelling out of the energy price rise, this figure turned negative (-0.4 percentage points), driven also by the annual decrease of communication tariffs - on average by 19.4 per cent in the last quarter.

Inflation of "non-food consumables" is affected by oil price performance in the country, which is determined by international oil price and exchange rate developments. The falling international oil price in annual terms is reflected in the domestic market as well (headline inflation rate fell to -1.3 per cent in the first half of the year). Nevertheless, since March, the oil price has been increasing in monthly terms, returning the risk of the presence of inflationary pressures from oil price rise.

The "services", "housing", and "durables" prices stayed almost unchanged, reflecting a period of 'tranquillity' as a result of the global economic crisis impacts on the cost of living, and on a decreased demand for such goods and services.

The price cut in "processed food" and "administered prices" has contributed to keeping much lower annual headline inflation rates in the first half of 2009 than in the same period of the previous year. In the meantime, a fuelling of inflationary pressures mainly as a result of exchange rate depreciation will play a determinant role in consumer price performance in the following months.

Chart 12 Annual inflation rate by goods and services items (in percent)

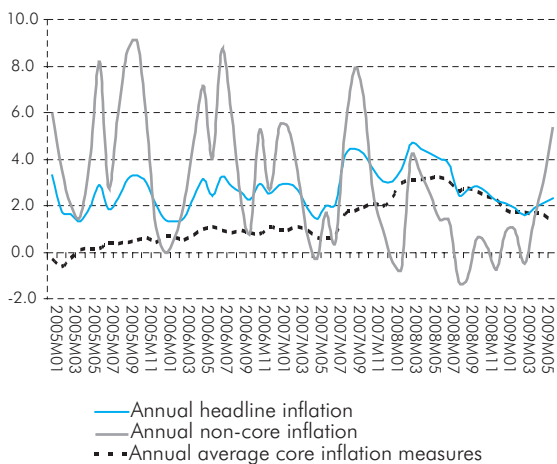


Source: INSTAT and Bank of Albania estimates

### III.1 INFLATIONARY TRENDS BASED ON OTHER INFLATION MEASURES

The annual core<sup>9</sup> inflation began to gradually decline during the first half of 2009, reaching its lowest level in June (1.2 percent), similar to the average of this indicator in last eight years. The downward trend of core inflation component was significantly affected by the overall dampening of global inflationary pressures since the fall of last year. Annual core inflation rate for January – June 2009, averaged 1.5 percent compared to 3.0 percent of the previous year. Returning of core inflation rates to historical levels for several months in a row, testifies an easing of inflationary pressures at home. High headline inflation rates, mainly over the last two months, are an outcome of the impact of factors not directly related to monetary policy, reflected in non-core<sup>10</sup> annual inflation indicator. Since August 2007 its profile has changed, as a result of the global developments in consumer prices.

Chart 13 Average of core, non-core and annual headline inflation (in percentage)



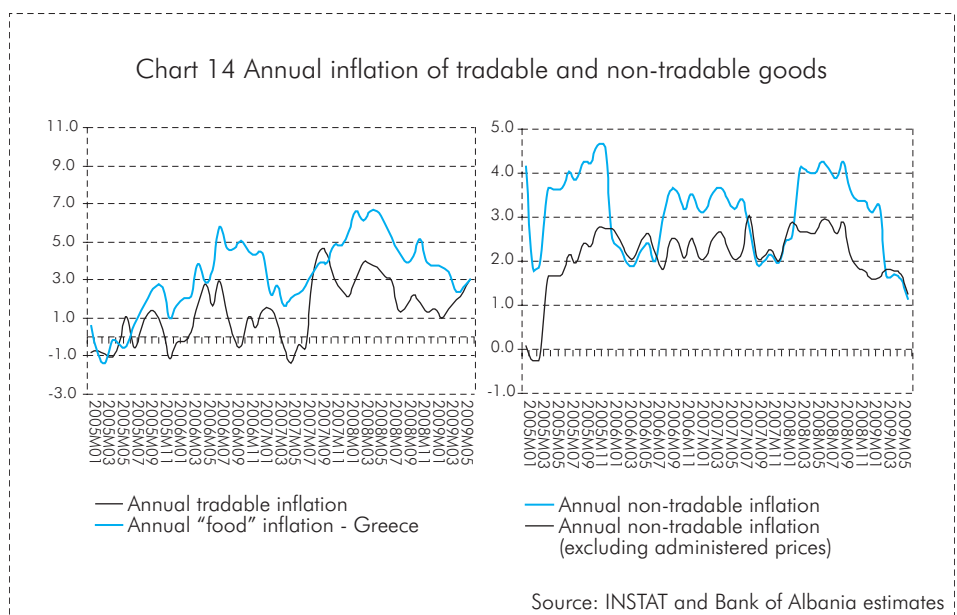
Source: INSTAT, Bank of Albania and Bank of Albania estimates



Contributions of tradable and non-tradable goods sectors to headline inflation were relatively balanced during the first half of 2009. The annual sectoral inflation averaged respectively 1.9 and 2.2 percent, down from the rates recorded in the same period of the previous year.

The upward trend of headline inflation during the second quarter of 2009 was affected mainly by the developments in tradable and non-tradable goods sectors. During June inflation in this sector rose by 3 percent, recording its highest rate in the last 12 months.

The tradable goods sector was affected by both, the relatively favourable prices in international markets and in main exporting countries for Albania, and the depreciating trend of the domestic currency vis-à-vis foreign currencies. It is estimated that the first factor contributed to the subduing of inflationary pressures, whereas the second influenced more thoroughly the tradable goods price rise during the last months of the first half of this year.



In the meanwhile, the cancelling out of administrative energy price rise (March '09) and urban transport services (June '09), resulted in a significant drop of inflation in non-tradable sector during March-June 2009.

Stable developments in core inflation and in non-tradables, around low historical levels reveal the presence of controlled demand-induced inflationary pressures during the first half of 2009. In the meantime, it is assessed that monetary policy decisions have contributed to balancing the overall inflationary pressures in the economy.

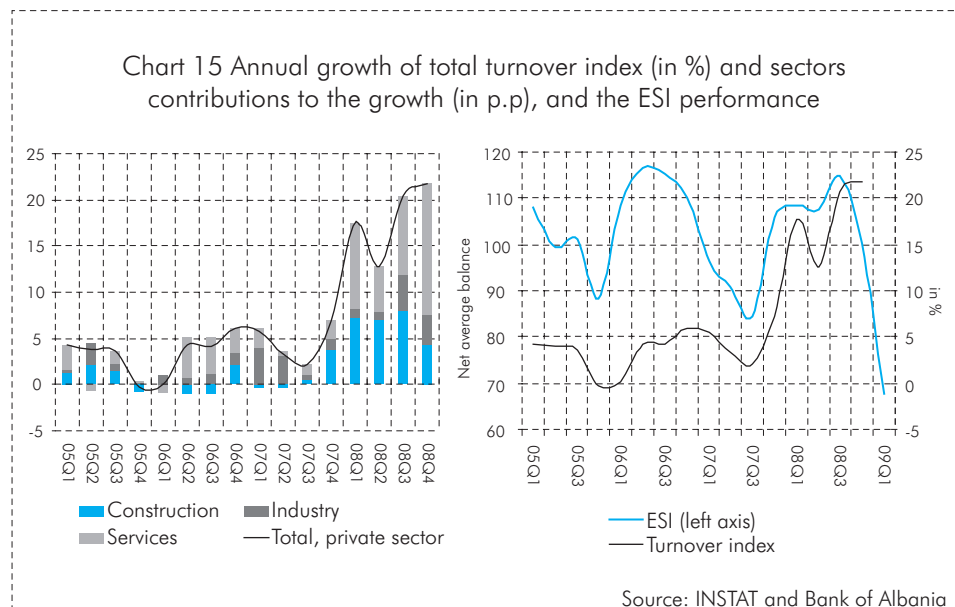
### III. MACROECONOMIC DEVELOPMENTS AND THEIR EFFECTS ON INFLATION

#### IV.1 AGGREGATE DEMAND

##### III.1.1 Production performance by sectors

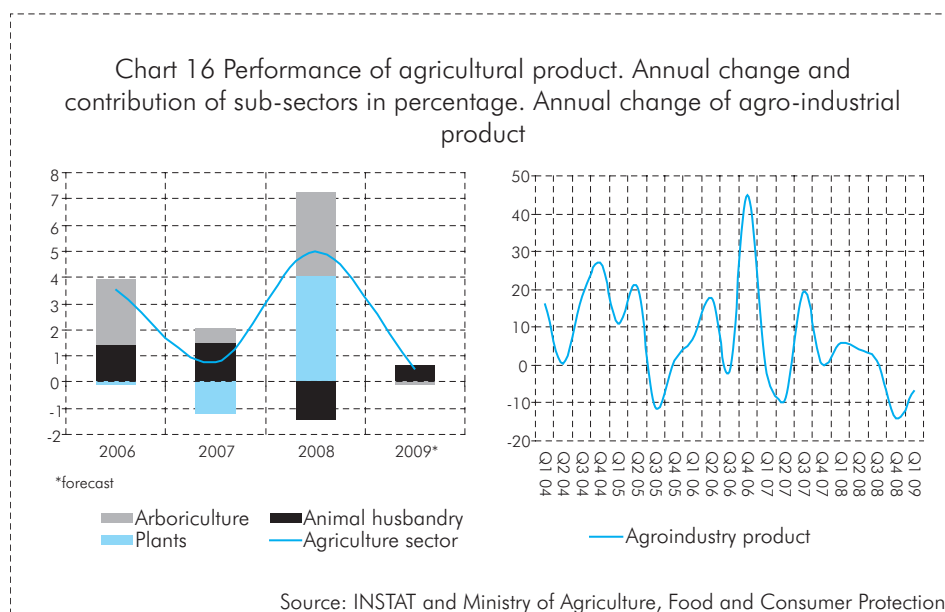
The statistical and indirect data available at the Bank of Albania indicate a slowdown of the economic activity in the first and second quarter of this year. The decline in the growth rate of credit and money supply, the depletion of exports, of remittances and fiscal revenue, low growth of energy consumption – especially by businesses, as well as the increased uncertainty induced from deposit withdrawals from the banking system, reveal a slowdown in the overall economic activity of the country. This observation is supported by the results from business confidence surveys, which show signs of a weakening domestic demand and a decline in production as of the first quarter. The interviewed businesses provided hints for further slowdown in industrial production even for the second quarter of the year, affected by decreased domestic and foreign demand. At the same time, industrial businesses will continue to diminish their inventories. Using these surveys as future-orienting indicators suggests that these paces might have continued even during the second quarter of 2009.

The latest INSTAT data on quarterly GDP indicate that the domestic economy during the first quarter of 2009 recorded an annual growth rate of 6.0 percent. The services and construction sectors rendered the largest contribution to positive developments over this quarter. Agriculture provided a moderate contribution to the economic growth. Industrial production recorded a significant drop (13.2 percent) during the first quarter of the year. However, given that available data are still preliminary and cover a short period of time, the Bank of Albania believes that the data on the economic developments for the second quarter of 2009 that base on various macroeconomic indicators and on market agents' assessments will be determinant for future paces of the country's economic activity.



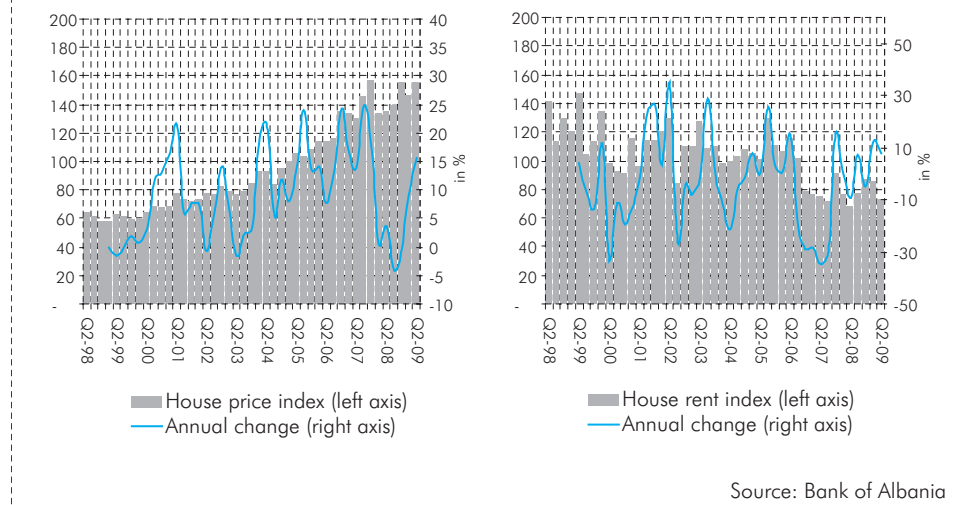
The data assembled from surveys suggest that production will continue to contract during the second quarter of 2009. During the first quarter of 2009, the utilization of capacities declined to lowest levels recorded. This decline is highlighted especially in the industrial sector (62 percent, compared to 64 percent of utilization of capacities in the economy). The data from the Agriculture Ministry show a restraint of production growth in this sector during 2009.

Production in agriculture sector is estimated to have dropped in 2009. Based on data from the Ministry of Agriculture, Food and Consumer Protection, agricultural product will grow by 0.5 percent, 4.5 percentage points lower than in 2008, mostly due to negative contribution of arboriculture product, which had an annual growth of -0.6 percent. The agro-industrial product, which had started a declining trend since the third quarter of 2007, fell by 7 percent compared with the same period of the previous year.



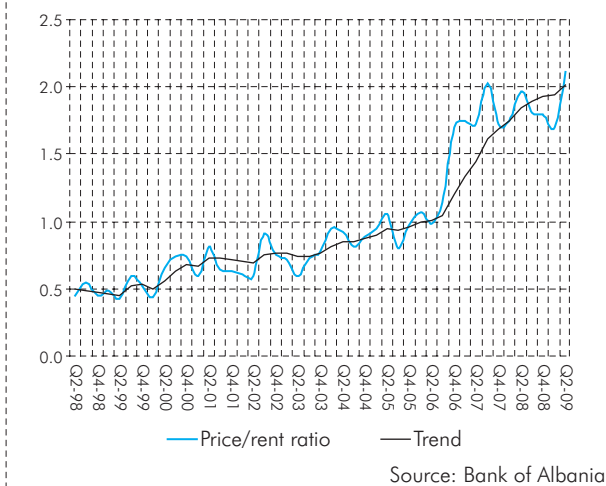
Housing prices climbed during the first half of 2009. The annual growth of housing price index of 15.6 percent in the second quarter of the year confirmed the positive turnaround that started in the first quarter after a sluggish growth in the previous year. In order to make possible the measurement of the growth in property prices as a result of the dynamic relationship between supply and demand, the index of housing prices built in a 7 percent depreciation as a result of FX changes in lek and euro in the second quarter<sup>11</sup>. Based on the measurements of the index without the effect of the FX in lek/euro, the annual growth of the housing price index was only 8 percent. Compared with the first quarter of 2009, this index is up by 6 percent. Using the same exchange rate of euro and lek in the second quarter of 2009 and in the same quarter of 2008, we would have a negative growth of -1 percent.

Chart 17 House price and rent price indices



According to the data assembled from business confidence survey, the real growth in housing price index for the second quarter of 2009 was anticipated by assessments the construction businesses had for producer price rise. Following the rise in producer prices in the first quarter of the year, businesses expected that the same trend would continue in the second quarter as well. Price rise expectations of construction businesses are in line with their anticipation to lower their inventories, which were very high in the last quarter of 2008. This suggests that real estate market supply will remain stable. On the other hand, the credit tightening during 2009, based on lending activity survey (see the information pages) suggests shrinkage of the demand. The supply and demand dynamics in the real estate market, under the conditions of a contracted demand and a steady supply, suggests curbing further price rise beyond the current level.

Chart 18 Price to rent ratio and its long-term trend



House rent index in the capital city increased by 7.5 percent in the second quarter of 2009 (5.9 percent excluding the Lek/Euro exchange rate effect). Compared to the previous quarter, the house rent index dropped by 14.7 percent (16 percent excluding the Lek/Euro exchange rate effect). The change in the opposite direction of housing price and rent for the second quarter compared with the first quarter led to rise in price/rent<sup>12</sup> ratio. This ratio is higher than its historical average for the current quarter, after being lower than the historical average for one year.

The main indicators of energy sector showed a positive trend in the first five months of the year. Further improvement in rainfall during this time led to increase of domestic production by 53 percent.

It is also encouraging to notice that the distribution and transmission of the produced energy has been improving, diminishing further the technical and non-technical losses.

Although historically the country has been a net importer of energy, the data from Albanian Power Corporation show that during the first 5 months of this year, the net exchange balance of energy was for the first time positive. Thus, the exported energy was 82.4 GWh higher than the imported one.

Meanwhile, the energy consumption profile has not deviated from historical levels. Households remain the largest users of electricity, accounting for 60 percent of the total demand. The private sector and state-owned institutions accounted for 25 and 15 percent, respectively. The energy consumption continues to have the same seasonality as in the previous years. The 2 percent growth is largely due to increased household consumption and unbilled one, whereas the non-household consumption dropped by 5 percent in annual terms.

	5M-07	5M-08	5M-09	Annual Change 5M-09 /5M-08 (in %)
Net production	1,307.7	1,685.1	2,584.8	53%
Imports	1,170.1	1,242.8	222.1	-82%
Exports	0	0	304.5	100%
Losses in distribution	860.6	830.5	1,000.0	20%
Losses/Production	66%	49%	39%	10.6 (pp)
Load Shedding	390.9	158.0	21.9	-86%
Consumed Energy	2,484.3	2,694.5	2,747.3	2%
Billed consumption	1,555.3	1,764.6	1,747.3	-1%
Unbilled consumption	929.1	929.9	1,000.0	8%
Household consumption	911.1	1,025.7	1,045.4	2%
Non-household consumption	644.2	738.8	701.9	-5%

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

Source: Albanian Power Corporation and Bank of Albania estimates

### III.1.1 Developments in the external sector of the economy

The overall balance of payments resulted with a reduction of monetary assets by Eur -131 million in the first quarter of 2009. Current account deficit deepened compared to the previous year, accounting for 16.6 per cent<sup>13</sup> of GDP<sup>14</sup>. Trade deficit (in goods) to GDP is 29 per cent, or 1.5 percentage points higher than in the last year.

During the first quarter of 2009, remittances fell by 7.7 per cent in annual terms, contributing to financing 38 per cent of trade deficit. The first quarter was characterized by a considerable annual growth of foreign direct investments inflows (19 per cent), affected mostly by privatization proceeds. Foreign direct investments are 8.1 per cent of GDP, up from 6.2 per cent in the previous year. The first quarter recorded net inflow of EUR 246.6 million in the capital and financial account. This indicator is estimated to 19.3 per cent of GDP, up by 8.8 percentage points compared to the previous year.

Table 5 Balance of payments indicators.

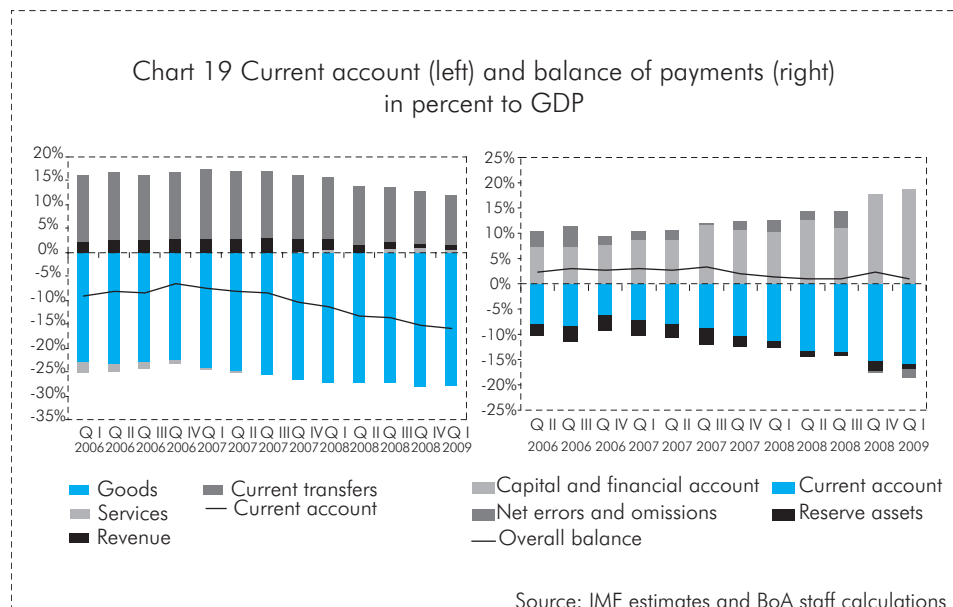
	In EUR million			
	Q1'06	Q1'07	Q1'08	Q1'09
Current account	-117.9	-178.0	-267.3	-334.2
Trade balance	-364.2	-443.0	-527.3	-516.4
-Exports	144.4	182.0	206.5	176.1
-Imports	-508.6	-625.0	-733.9	-692.5
Services (net)	-25.9	-28.0	-3.3	-26.8
Income (net)	48.3	53.0	20.5	-4.4
Current transfers (net)	223.9	240.0	242.9	213.4
Capital & financial account	117.7	180.9	167.1	246.6
Balance of payments	16.0	15.0	-27.0	-130.9

	Cumulative in % to GDP			
	Q1'06	Q1'07	Q1'08	Q1'09
Current account	-9.0	-7.2	-11.6	-16.6
Trade balance	-22.7	-23.5	-27.6	-29.0
-Exports	8.1	9.1	10.2	10.6
-Imports	-30.8	-32.6	-37.8	-39.6
Services (net)	-2.1	-0.5	0.5	0.5
Income (net)	2.2	2.9	2.3	1.0
Current transfers (net)	13.6	13.9	13.2	10.9
Capital & financial account	7.2	8.4	10.5	19.3
Balance of payments	1.9	2.9	1.3	1.0

Source: IMF estimates and BoA staff calculations

In the first quarter of 2009, current account deficit amounted to EUR 334.2 million, or 25 per cent higher than in the first quarter 2008. The main factors contributing to widening of current account are: relatively high values of trade deficit to GDP (29%), declining current transfers by 12 per cent in annual terms; a reversal from EUR 20.5 million surplus of income account in the first quarter 2008 to EUR 4.4 million deficit in the first quarter of 2009; and considerable worsening of service account deficit, - 27 million euros from - 3.4 million euros in the first quarter 2008.

Trade deficit (in goods) narrowed by 2 percentage points in annual terms, while current transfers fell by 7.3 per cent in the first quarter. Current transfers



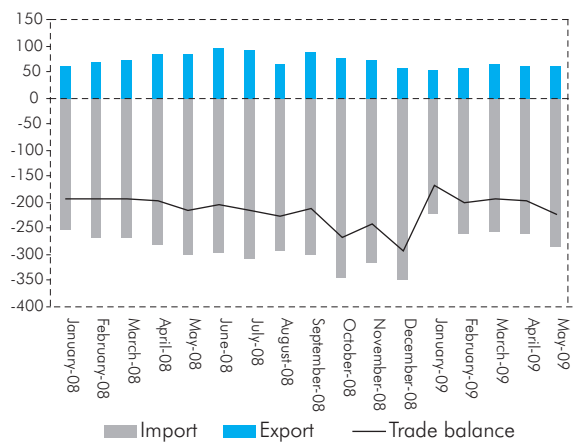
were mostly used to finance merchandise imports (61%), while foreign currency inflows came from export of services and goods (60%) and current transfers (32%).

Trade exchanges<sup>15</sup> of Albania with the rest of the world in the first five months of 2009 amounted to EUR 1577.7 million, falling by 9.1 per cent in annual terms. Due to the decline of foreign and domestic aggregate demand, exports and imports denominated in euro fell by 19.6 and 6.3 per cent respectively in annual terms. Consequently, trade deficit narrowed by 1.3 per cent on average during January – May 2009. The export to import ratio is 23.4 per cent, down by 3.8 percentage points compared to the same period of the last year.

The analysis of imports according to their final destination shows a yearly decline of imports of all types of goods during January-May 2009. Hence, capital goods fell by 2 per cent on average; intermediate goods fell by 9.5 per cent and consumer goods fell by 1.8 per cent. The reduction of imports in all categories, along with the slow-down in lending for investments and negative assessments from businesses with regard to production, demand and sales, point out a shrinkage in consumer demand and deceleration in production and investment.

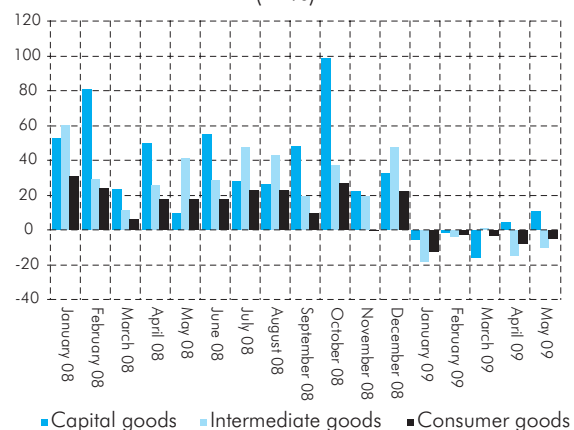
Currently, imports and exports stand below their respective historical trend.

Chart 20 Import, export and trade balance (in Eur mln)



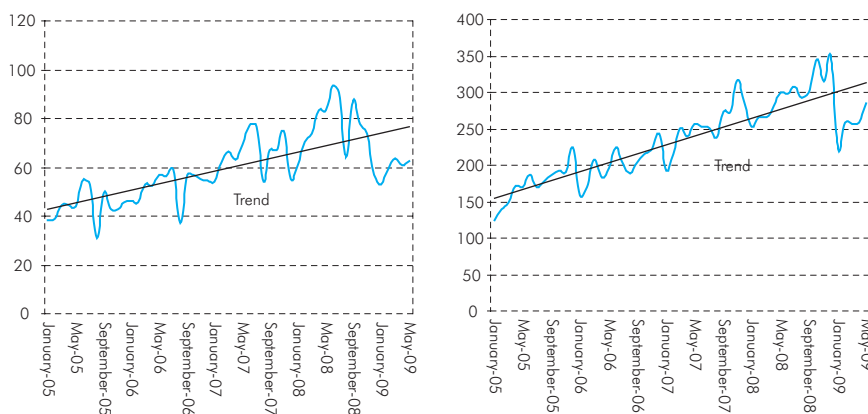
Source: Bank of Albania

Chart 21 Annual changes in import of capital, intermediate and consumer goods (in %)



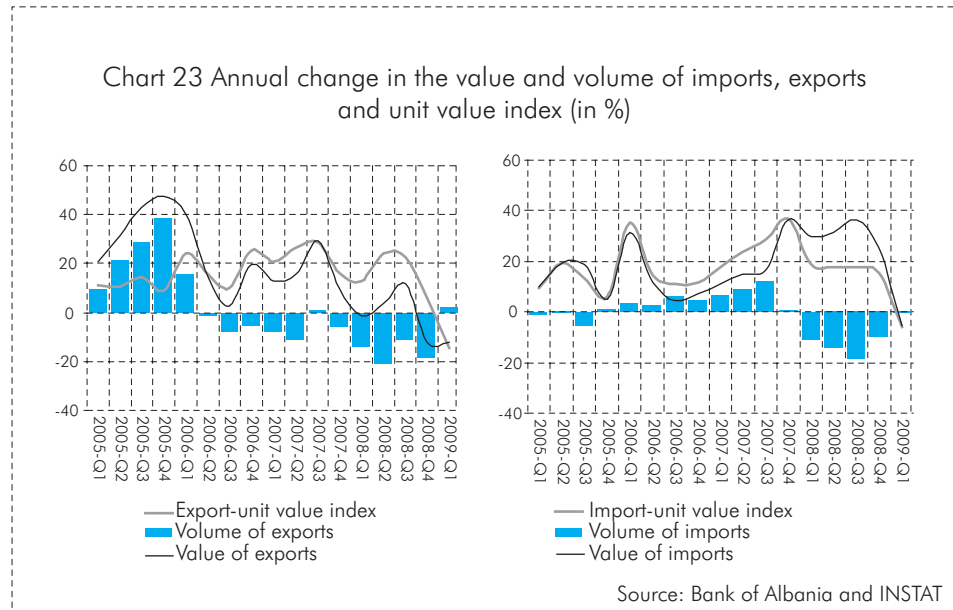
Source: Bank of Albania

Chart 22 Export and import values and the historical trend (in Eur million)



Source: Bank of Albania

The analysis of foreign trade by volume and price<sup>16</sup> for the first quarter shows that the falling trend of annual changes in export and import values for the third quarter of 2008 was triggered by price cut, in particular of commodities, as well as a decreased traded volume. The decline in the volume of exports reflected the contracted foreign demand and the importance of competitiveness in the country (see Box 2). The fall in imports reflected the commodity price cut and the contracted domestic aggregate demand (noted in the volume of imports).



The geographical span of trade exchanges shows that the European Union countries continue to be important trading partners. Trade volume with EU countries accounts for 64 per cent of total trade. Italy and Greece continue to be our main trading partners. Exports to Italy account for 60 per cent of total exports, while imports from this country account for 28 per cent of total imports. Exports to Greece account for 8 per cent, while imports account for 13 per cent. Some of the trading partners that have increased their relative importance in trading with Albania are: Austria, Germany, China, Croatia and Spain (exports); and Germany, Greece, Italy, Croatia, Switzerland (imports).

*Box 2 Comparing unit labor costs*

*Information on unit labor cost and labor productivity allow understanding how the performance of labor market and wages can affect, among other things, changes in comparative advantages of a given economy. Depending on development level of a country, different strategies can be followed to shape a certain competitive profile of an economy. Halting growing rates of ULC via a non expansionary policy in wages, increase of LP through technological and organizational improvements as well as implementation of other intermediary approaches, would help to consolidate and improve the competitiveness of an economy externally.*



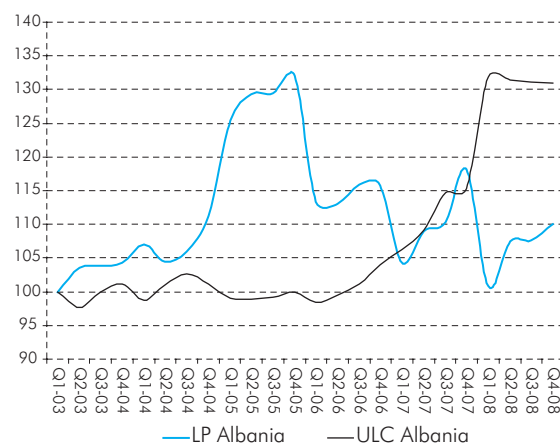
Indicators of LP and ULC in the Albanian economy are measured based on the value added indicator and on the employment and wage indices (INSTAT). The indicator of the value added is seasonally adjusted<sup>17</sup>. All indicators used to calculate LP and ULC do not include agriculture. The LP index is calculated as a ratio of value added (index) to employment index. The ULC index is calculated as a ratio of wages to value added index. The latter, for comparative purposes, is converted to euro based on nominal eur/lek exchange rates. All indicators of LP and ULC are referenced to a base period Q1:2003, in order to maintain a clear comparative basis of their trend.

The LP and ULC have followed relatively different trends during 2003-2008. The LP index shows a higher volatility, while the ULC is relatively stable, around 100 until end of the first half of 2006. Afterwards it has increased considerably, even above the LP value. This increase reflects the administrative measures taken to formalize the labor market by establishing reference wages for businesses. Starting from Q2, 2008, the ULC is again stable. The improvements in the quarterly performance of LP support the narrowing of the gap between these two indicators. Further narrowing of this gap would dampen the supply-side inflationary pressures in the economy.

Comparing ULC of Albania and other economies, it appears that the index built for Albania converges to that of the main trading partners and Euro-zone countries. Baltic economies show progressive loss in their competitive advantage towards other economies. The rapid increasing trend of ULC suggests the presence of strong shocks in the cost of labor, especially after 2006. The profile of ULC in the case of Bulgaria and Romania is similar to that of Baltic countries, but smoother. The ULC index for CSEE countries converges almost perfectly with that of Euro-zone. It shows a relatively high degree of approximation among labor markets and of the production based on high competitive advantages of CSEE countries. Albania appears to stand in between, in comparison to the three groups.

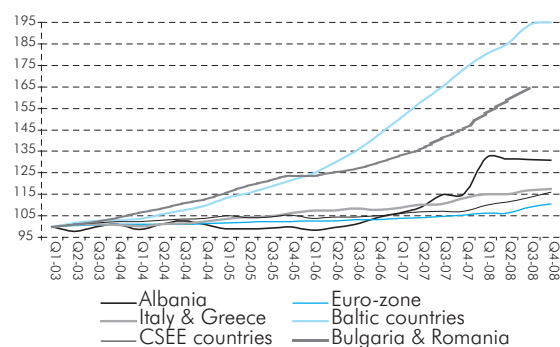
These conclusions are economically acceptable because they support the dynamic convergence process which characterizes the developing economies. On the other hand, the results reflect the low degree of efficiency of mobility in the labor and wages market or other deficiencies related to regulatory framework in these economies, compared to the experience of developed economies.

Chart 24 Labour productivity, ULC for Albania (excluding agriculture)



Source: INSTAT and Bank of Albania estimates

Chart 25 ULC's for different EU member states & for Albania\*



Source: OECD (Seasonal adjusted of ULC Index, Business Activity, excluding Agriculture); rebased in Q1:2003; BoA calculations.  
\*For group-countries, ULC is calculated as a simple average of individual country data. In Q4:08, data for Bulgaria are not available. CSEE – central and south-eastern European countries, including: Czech Republic, Slovakia, Hungary, Slovenia. Baltic countries include: Lithuania, Lithuania, Estonia.

## PERFORMANCE OF OTHER CURRENT ACCOUNT ITEMS

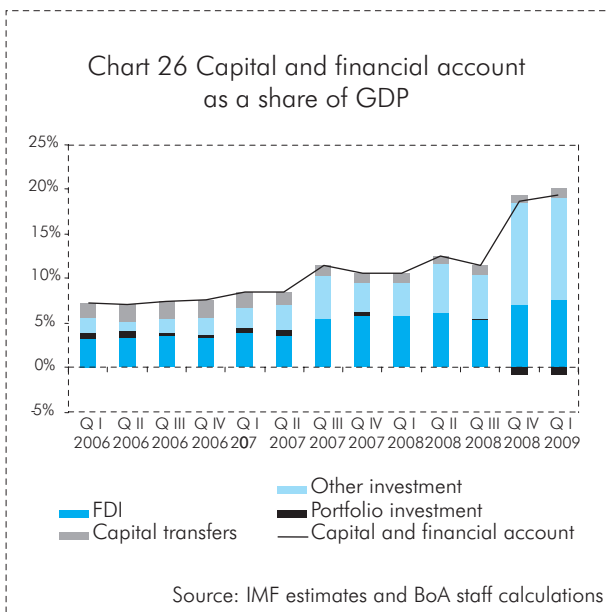
Services registered a decline in both revenues and expenditures during the first quarter of 2009,<sup>18</sup> giving a net result of - 26.8 million euros. Services trade exchanges amounted to EUR 633.2 million, or down by 10.5 per cent

in annual terms. The item “travel services” marked a net deficit of Eur 10.3 million and constituted the most important share in revenues and expenditures from services, respectively by 70 and 67 percent. Foreign currency inflows from travel services (exports) reached Eur 211.6 million, or down by 4.3 per cent from the previous year. Albanian tourists spent around Eur 221.9 million travelling abroad, up by 3.6 per cent in annual terms.

Net balance of income account registered a negative result by Eur 4.4 million. This effect was an outcome of declining net investment portfolio by 3 times in annual terms, while net income from employment increased by 14 per cent. Net current transfers are reckoned 12 per cent lower compared to the same period of the last year<sup>19</sup>. Around Eur 196 million entered in the form of remittances. The latter decreased by 7.7 per cent in annual terms, financing around 38 per cent of the goods trade deficit.

### CAPITAL AND FINANCIAL ACCOUNT

Net inflows recorded Eur 246.6 million in capital and financial account for the first quarter of 2009. Around EUR 20 million has entered as transfers for capital investments and around Eur 227 million are net financial flows. Capital inflows have financed around 74 per cent of current account deficit and its ratio to GDP is 19.3 per cent<sup>20</sup>.



Financial liabilities of Albania to the rest of the world increased by EUR 153.5 million, while residents’ assets abroad decreased by EUR 74 million. The main contribution from inflows in financial account came from foreign direct investments, EUR 123.6 million. These investments accounted for 8.1 per cent of GDP<sup>21</sup> and are related mostly to privatization proceeds. Financial assets decline was caused mainly from reduced banking system deposits at non-resident institutions (by EUR 62 million). Reserve assets fell by EUR 130.9 million. Foreign reserves amounted to EUR 1,595 million at first quarter-end of 2009. This level is considered sufficient to cover 4.7 months of imports of goods and services.

#### III.1.1 Fiscal indicators and fiscal policy

During the first half of 2009 fiscal policy was more expansionary than in prior years, when such a feature appeared. The difference between the projection and the realised level was prominent on budget revenue side, while expenditures were realised almost at the projected level. In consequence, the budget deficit has exceeded the projection by ALL 10.6 billion, to ALL 31.6 billion. As a share of GDP<sup>22</sup>, the budget deficit is estimated at 6.2 percent.

	Actual level	As a share of GDP <sup>23</sup>	Annual change (in %)		
	§ 1-09	§ 1-09	§ 1-07	§ 1-08	§ 1-09
Total revenue	144.8	28.5	9.6	16.8	7.2
Tax and customs duties	100.7	19.8	12.6	18.3	4.8
- VAT	52.1	10.3	21.9	22.3	4.8
- Tax on profit	9.1	1.8	(7.9)	(6.8)	(7.2)
- Excise tax	14.4	2.8	22.2	22.2	(3.6)
Local government	6.9	1.4	(7.2)	3.0	26.1
Independent budget	25.5	5.0	(0.0)	18.1	13.7
Non-tax income	11.0	2.2	18.9	5.9	4.8
Grants	0.7	0.1	(57.1)	337.8	30.4
Expenditure	176.3	34.7	10.5	30.3	28.4
Current expenditure	129.6	25.5	8.1	14.5	20.2
- Personnel	29.6	5.8	1.2	17.2	(1.3)
- Interests	17.4	3.4	(0.9)	24.6	16.0
- Social insurance	44.9	8.8	15.8	8.3	28.3
- Local government	15.1	3.0	11.9	32.4	44.1
Capital expenditure	46.6	9.2	35.5	149.5	66.5
Budget balance	(31.6)	(6.2)	0.6	(123.0)	1,254.4

Table 6 Fiscal indicators as of the first semester of 2007-2009

Source: Ministry of Finance, IMF PRGF program.

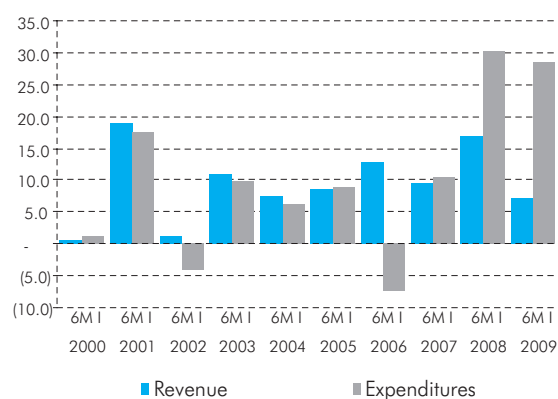
Budget revenues as of the first half of the year were realised by about ALL 144.8 billion, realizing the projection by 93 percent. As a share of GDP, revenues as of the first half of 2009 were estimated to about 28.5 percent, against 28% in the previous year<sup>24</sup>.

In annual terms, budget revenues increased by about 7.2 percent, but compared to previous years their growth decelerated. The items rendering the largest contribution to the difference from the projection are the proceeds from VAT, excise tax and local government.

As of the first half of the year, though the value added tax was maintained at the same levels as in the previous years, the growth rate of proceeds collected from this item recorded a significant deceleration. Revenues from profit tax, likewise in last two years, recorded negative growth rates. The projection was realised at 86 percent. The proceeds from excise tax, unlike in the previous years, recorded negative growth rates. Revenue contraction from excise tax in annual terms was primarily due to reduction of imported goods subject to excise tax. Local government revenues, though recording a high annual growth rate, have resulted under the projection for this period, down by about ALL 2.7 billion (28%).

Revenue items that realised the projection for this period were personal income tax revenues; non-tax revenues; customs duty revenues. However, the contraction of the latter is attributed to different agreements aiming at free mobility of goods, of which Albania is a party.

Chart 27 Annual change (in %) of revenue and expenditure as of the first half of 2000-2009

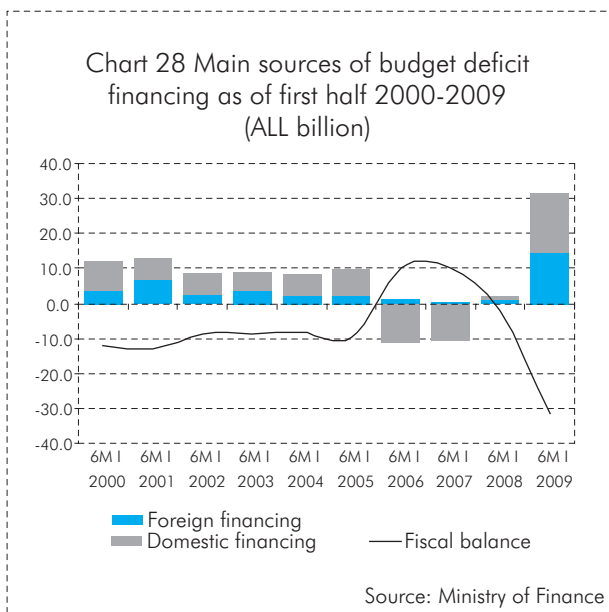


Source: Ministry of Finance, BoA staff estimates

Budget expenditure carried out during the first half of the year amounted to ALL 176.3 billion, realising almost fully the related projection. In annual term, they picked up by about 28 percent. They account for 34.7 percent as a share of GDP, against 28.5 percent realised in the first half of 2008. High rates of carrying out budget expenditure during this period were driven primarily by capital expenditure and by implementation of the project for constructing Rrëshen-Kalimash road. More concretely, capital expenditures, social and health insurance expenditures and personnel expenses contributed 7.5, 7.2 and 4.8 percentage points, respectively to total expenditure growth as of the first half of the year.

Another item highlighted in terms of high growth rate (in annual terms) is that of operating and maintenance expenses, which recorded about 33 percent more than in the previous year. Interest expenses, likewise all expenditure sub-items, increased in annual terms.

### BUDGET DEFICIT AND ITS FINANCING



During the first half of the year, growth of expenditures exceeded that of revenues. In consequence, the budget deficit increased significantly, recording ALL 31.6 billion in nominal value, about 6.2 percent of GDP, against 0.5 percent in the same period of the previous year.

Distribution of deficit financing almost equally to domestic and foreign sources is a specifics different from the previous years, which had highlighted the importance of domestic sources.

Deficit financing relied primarily on proceeds from privatization<sup>25</sup> and foreign borrowing. Syndicated foreign-currency loan received from resident and non-resident banks in Albania shares the major part of foreign borrowing.

Table 7 Budget deficit and its financing during the first half of 2005-2009 in ALL billion

	H 1-05	H 1-06	H 1-07	H 1-08	H 1-09
Budget balance	(9.5)	10.1	10.2	(2.3)	(31.6)
Domestic financing	7.3	(11.1)	(10.4)	1.2	17.0
- Privatization	0.6	2.1	0.0	0.4	20.8
- Domestic borrowing	10.5	(10.5)	3.4	11.5	5.0
- Other	(3.7)	(2.7)	(13.9)	(9.7)	(8.8)
Foreign financing	2.1	1.0	0.3	1.1	14.6

Source: Ministry of Finance

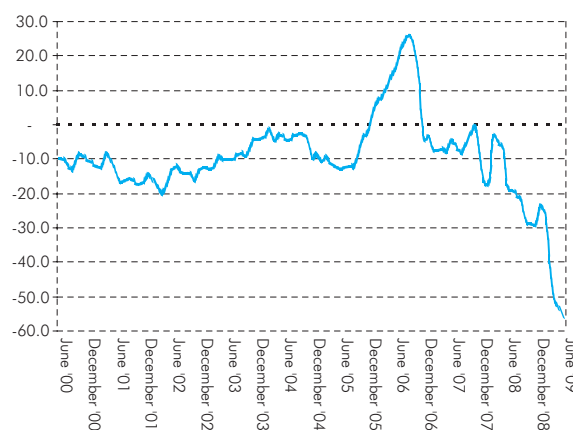
Government debt policy has aimed at raising the domestic debt size for all types of securities, particularly for instruments of one-year and longer-than-

one-year maturity term. However, lack of demand at securities auctions<sup>26</sup>, particularly at the first quarter of the year, made domestic debt stock rise only during the second quarter of the year. In total, the domestic debt outstanding in financial instruments increased by about ALL 5 billion during the first half of the year, owed primarily to debt in securities of longer maturity term. At end-June, in nominal value, the government debt outstanding in securities recorded about ALL 391.9 billion versus ALL 380.8 billion in the previous year.

### PRIMARY DEFICIT

Primary deficit continued further deepening even during the second quarter of the year, recording about ALL 55.7 billion at end-June<sup>27</sup>. The primary deficit performance reflected the rise of domestic and foreign debt over this period. Also, the deepening of the gap between the economic growth and the interest rate on public debt caused further budget deficit growth.

Chart 29 Primary balance moving sum, as of June 2000-June 2009 (in ALL billion)



Source: Ministry of Finance, BoA staff estimates

#### Box 3 Twin deficits

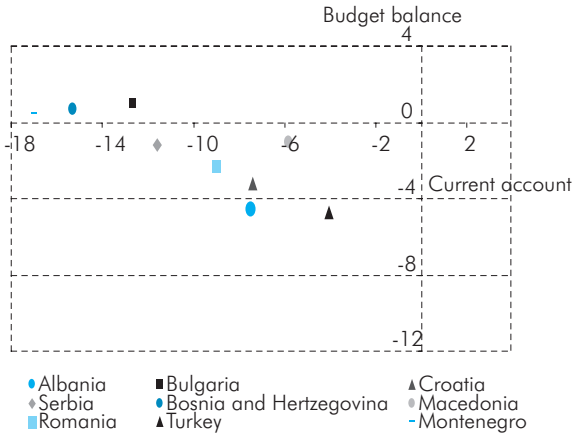
*Twin deficit hypothesis suggested that a large budget deficit leads to a large current account deficit. This hypothesis is viewed from the standpoint of the gap between national savings and investments: a rise in fiscal deficit causes a rise in the needs for foreign borrowing, which in turn leads to deepening of current account deficit. The above argument is inherent when savings and investments do not reflect any correlation with each-other, signifying that the budget deficit and the current account deficit can move together (Feldstein and Horioka, 1980).*

*The role of fiscal policy in external regulations is evident from the national income equation<sup>28</sup>. Tightening/expansionary fiscal policies directly improve (exacerbate) the external balance. The argument according to which the budget deficit causes simultaneously a current account deficit is supported even by the fact that budget deficit growth leads to interest rate rise. Interest rate rise attracts foreign capital, which is directly related to deepening of current account deficit.*

*Though theoretically the arguments on twin deficit hypothesis converge, the so-far empirical researches have provided mixed results. Some researches reviewed by Funke and Nickel (2006), have drawn the conclusion that a large fiscal deficit leads to a large current account deficit; whereas some others have not evidenced any significant impact.*

*Twin deficit theory was not verified in the European Union countries. According to Maastricht Agreement, they were liable to curtail budget deficit before launching their common currency in 1999. Though they were successful in decreasing the budget deficit gradually from 5.4 to 0.8 percent of GDP during 1995-1999, the current account surplus remained almost unchanged, around an average of 0.9*

Chart 30 Performance of budget balance and current account, on average to GDP for 2002-2008

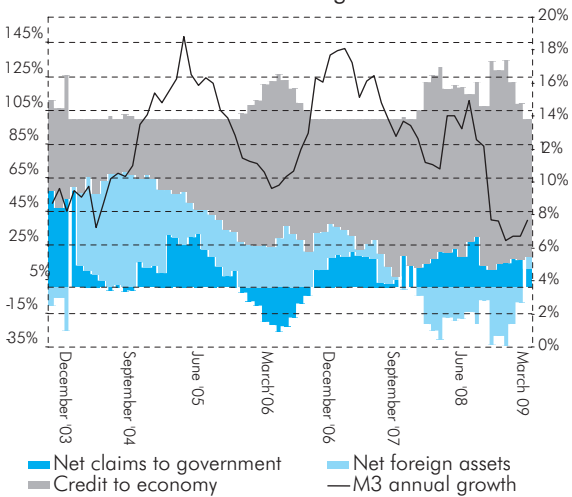


percent of GDP. In a research conducted for South-east European countries<sup>29</sup>, twin deficit identity is verified only in cases when budget deficit has been high (above 3% of GDP).

Albania, along with other countries of the South-east Europe, started the transition period with plenty of needs for investments. Under the conditions of limited resources for financing, the higher need for borrowing has led to deepening of current account deficit. Though the pursued policies have aimed to, inter alia, reduce fiscal vulnerability, external imbalances of the economy are deepened, particularly in last two years. Of a comparison with region countries, it results that simultaneous deepening of budget deficit and current account, particularly during last two years, has ranked Albania along countries where this hypothesis is confirmed. Verification of this correlation in the long run would require fiscal correction and current deficit correction. The latter would give implications on exchange rate performance in the short run.

#### IV.1.4 Monetary developments

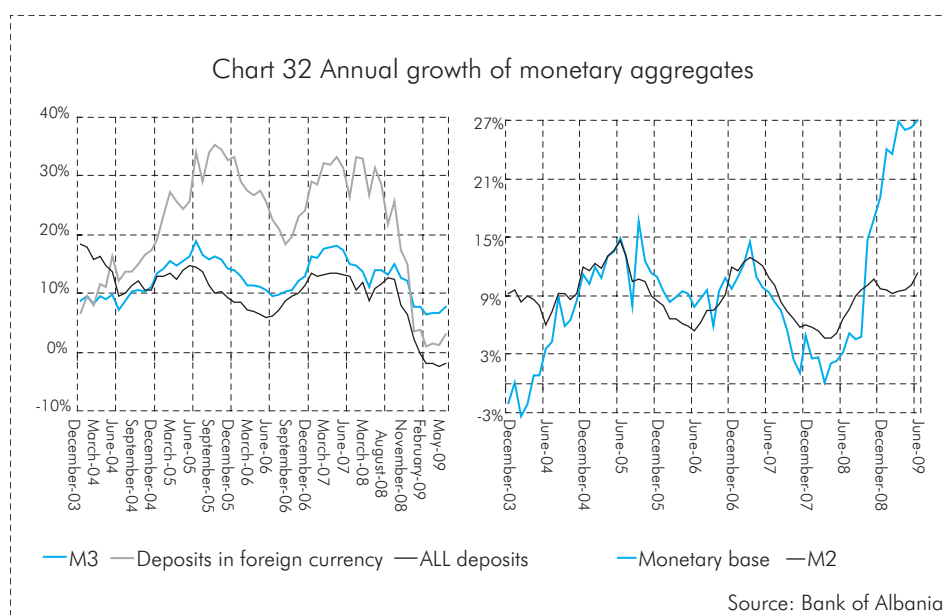
Chart 31 Components of money demand and annual M3 growth



The demand for monetary assets had a positive growth in the recent months. Money-supply growth was based on money created in the economy from the public sector and from the private sector's borrowing, mainly in ALL. The private sector's demand for Lek loans has found banks' willingness, thanks to stabilization of liquidity situation and easing of monetary conditions at the start of 2009. Restraint of foreign currency supply has resulted to contraction of foreign currency component of money structure, even on the demand for money side. Under these conditions the money supply structure has shifted towards the Lek. However, lower growth rates of the demand for money versus 2008 are also reflected in lower real M3 growth rates.

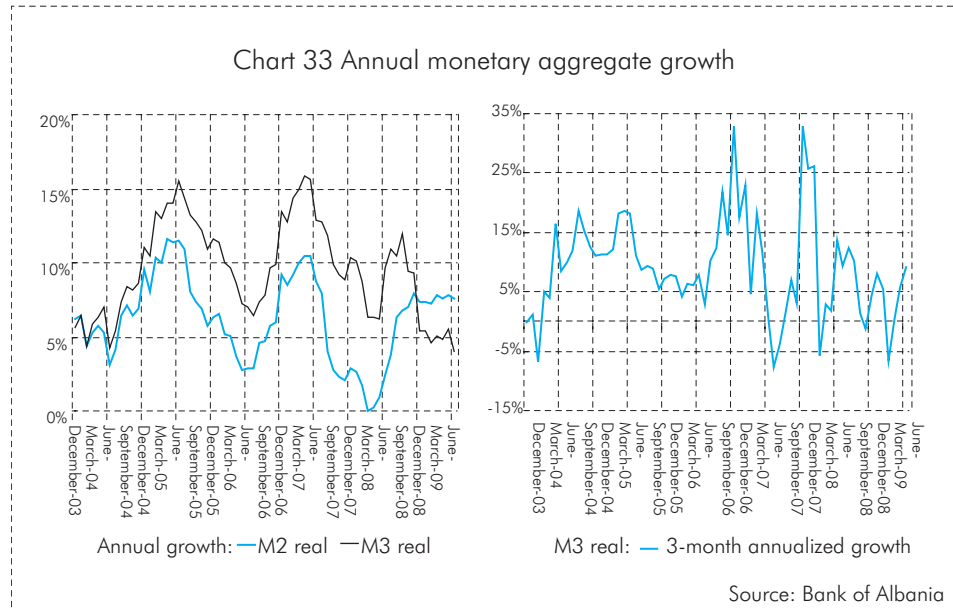
The first half of 2009 reflected a different dynamics of money creation in the economy. Since the last quarter of 2008 bank deposits withdrawals reduced the foreign-currency money supply and provided a double effect on monetary developments. First, deposit withdrawal has decreased the currency stock, which will be reflected in lower annual growth rates of M3 until September of the current year. Hence, as of end-May the M3 level was ALL 816 billion, versus ALL 820 billion as of September 2008, prior to deposit withdrawals. Second, withdrawal of foreign-currency denominated deposits has decelerated the money expansion pace, influencing the process of money creation in foreign

currency. Decelerated paces of foreign-currency lending to the private sector were associated with further reduction of M3 growth rate. As of May the annual M3 growth rate accounted for 7.7 percent, equivalent to that of end 2008, versus 14.9 percent as of September 2008. However, financial market stability and meeting of the system's needs for Lek-denominated liquidity has contributed to stabilization of money stock performance. The Lek component of the broad money, i.e., the M2 aggregate, has recorded stable annual growth rates, to about 10 percent versus about 9.6 percent as of September of the last year.



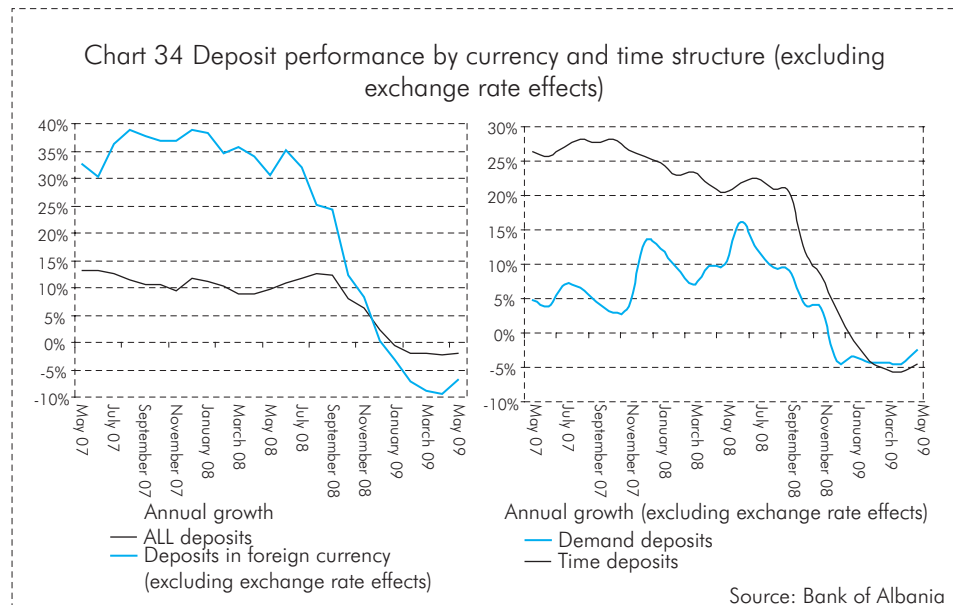
The long-term monetary developments were also influenced by performance of macroeconomic developments dynamics. In the recent years, the external sector of the economy has been a source of money creation, owing to foreign-currency remittances and credit supply. Latest developments in the economy of neighbouring countries have affected the performance of remittances. The slowdown of their rate in the long-run tends to be associated with lower rates of foreign-currency deposits compared to other years. Under these conditions, the meeting of the demand for money is conditioned by domestic sources of generating savings in the economy. However, in the first half of 2009, capital inflows of the balance of payments have somewhat mitigated the imbalance in the demand for money, which is reflected in monetary aggregate performance.

The dynamics of the aggregate demand in the economy and of the overall private sector's activity is reflected in the demand for money in real terms. Hence, while in the first quarter the real M3 recorded a slight reduction also due to deposit withdrawals, in the second quarter the demand for money reflected stabilization, recording a seasonal growth by 9 percent<sup>30</sup>. Notwithstanding the restraint of foreign-currency money supply, the M2 growth rate stood at end-2008 levels.



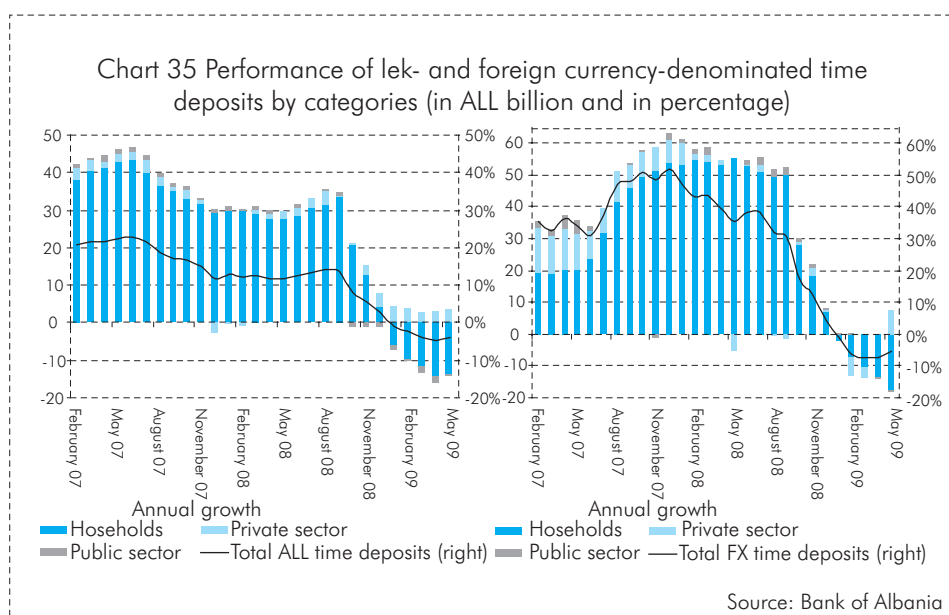
Total deposits as of end of May resulted lower in relative terms than as of year-end 2008. Deposit outflows from the banking sector were triggered by increased public sensitiveness related to safety of their savings, induced from developments in international financial markets. This unfavourable situation reflected its first slight improvement in December 2008. Deposit withdrawals continued with slower paces during the first half of 2009. As at the first quarter of this year the total deposits decreased on average by 3.6 percent in annual terms<sup>31</sup>. The ratio of total deposits to broad money is estimated at about 75 percent as at end of May, down by about 7 percentage points, related to end-September 2008.

In the second quarter of this year there was noticed a slight refraining of deposit withdrawals. Total stock of deposits rose in April, following a constant reduction in monthly terms. The main contribution to this rise was rendered



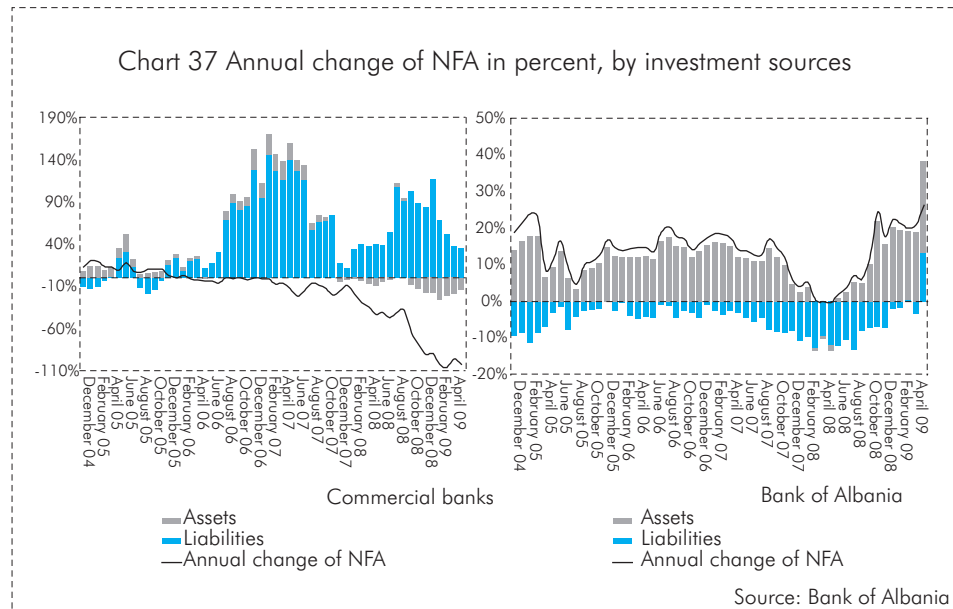
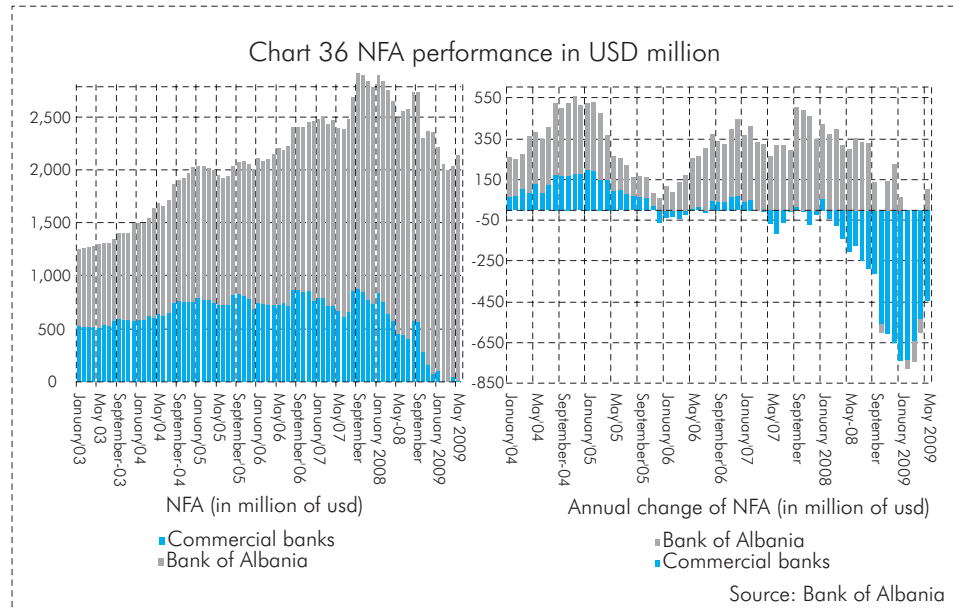


by business time deposits, mainly those in foreign currency, concentrated in a sole bank of the banking system. Household deposits continued to reflect a slight reduction, in spite of the prominent slowdown of its downward pace featuring the previous periods. Monthly deposit performance in the coming month also reflected improvement. Approval of the law on insuring deposits up to ALL 2.5 million in March was effective in managing this situation. Total stock of deposits in April-May was increased by about ALL 11 billion, excluding exchange rate effect. ALL-denominated deposits were the ones that dominated the rise of total stock, whereas concerning the time structure, time deposits resulted with a larger concentration to total deposits of the system.



#### PERFORMANCE OF FOREIGN CURRENCY COMPONENT

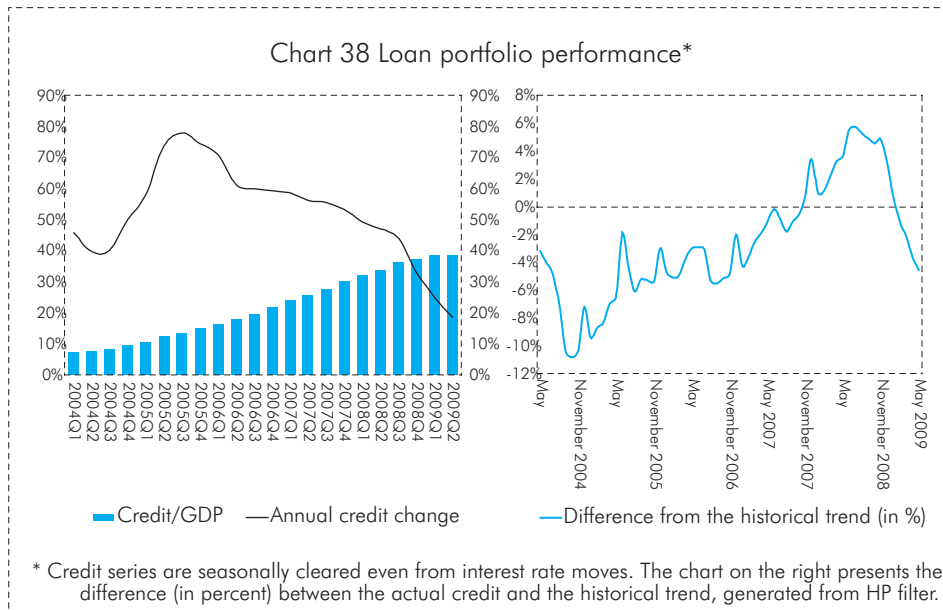
Constraint of banks' liquidity, particularly in foreign currency, due to deposit withdrawals in the fourth quarter of 2008 is reflected in the deterioration of foreign exchange position of the banking system. This deterioration was due to reduction of assets invested abroad and rapid growth of liabilities consequent to credit lines of parent banks backing up branches to cope with the situation. However, the positive growth of foreign currency loan portfolio against negative annual paces of foreign currency deposits, has greatly disfavoured the foreign exchange position in the system until March 2009. At end-May, the turning of deposits back to the system and the obvious slowdown in foreign currency credit brought about improvement of this position, which, however, is still negative.



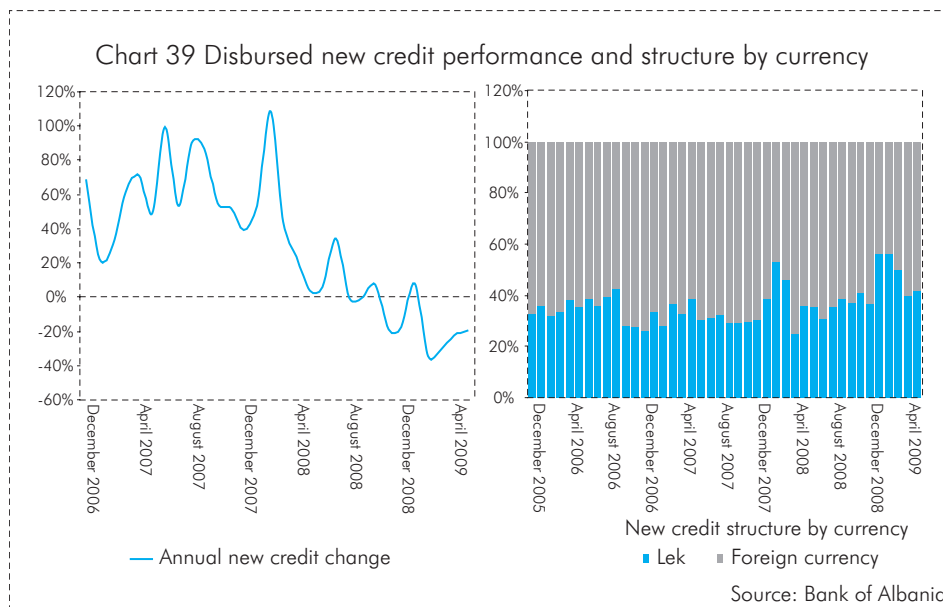
*PRIVATE SECTOR FINANCING<sup>32</sup>*

During five last years, the Albanian banking system has reflected increased financial intermediation in the country. High levels of loan portfolio growth have impacted on the rise of credit as a share of GDP, which in May 2009 reached 39 percent. For the major part of 2008 the high loan portfolio rates created a positive gap<sup>33</sup> compared to historical trend. Reduction of funds sources of banks and increase of uncertainty at home affected the significant slowdown of credit growth rates. In May the real annual growth of credit<sup>34</sup> recorded 19 percent, compared to 33 percent in December 2008. Compared to year-end 2008, the credit portfolio increased by ALL 7.5 billion or about 5 times less than in the same period of the previous year. This performance was influenced by banks' constraints in generating the liquidity needed for

lending, increased non-performing loans and the effect of the fiscal sector, which during this period was characterised by a high demand for financing, due to a significant rise in fiscal expenses. In the meantime, the annual nominal growth of loan portfolio reached 27 percent<sup>35</sup>. The credit slowdown in nominal terms was more moderate than the real rate, due to the positive impact on the portfolio by the lek's depreciation against the main foreign currencies, compared to the previous year.

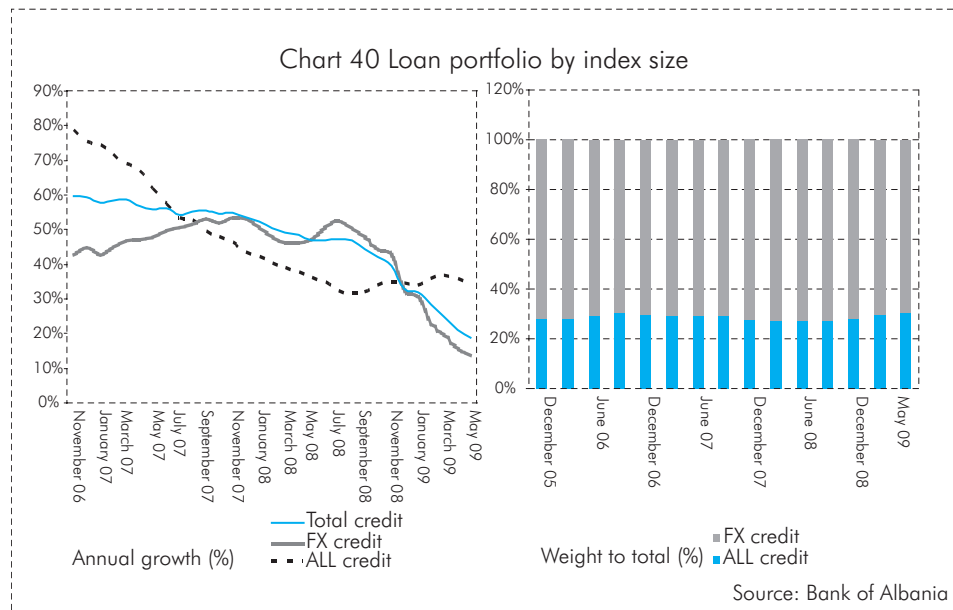


Deceleration of loan portfolio growth rates reflects primarily the contraction of credit supply from banks, which for more than six months are applying tightening lending standards, which have influenced the drop of the demand for credit. In the meantime, the contracted demand has reflected even the slowdown of economic activity in the first months of 2009, and market agents' uncertainty to undertake investments or finance their consumption by means

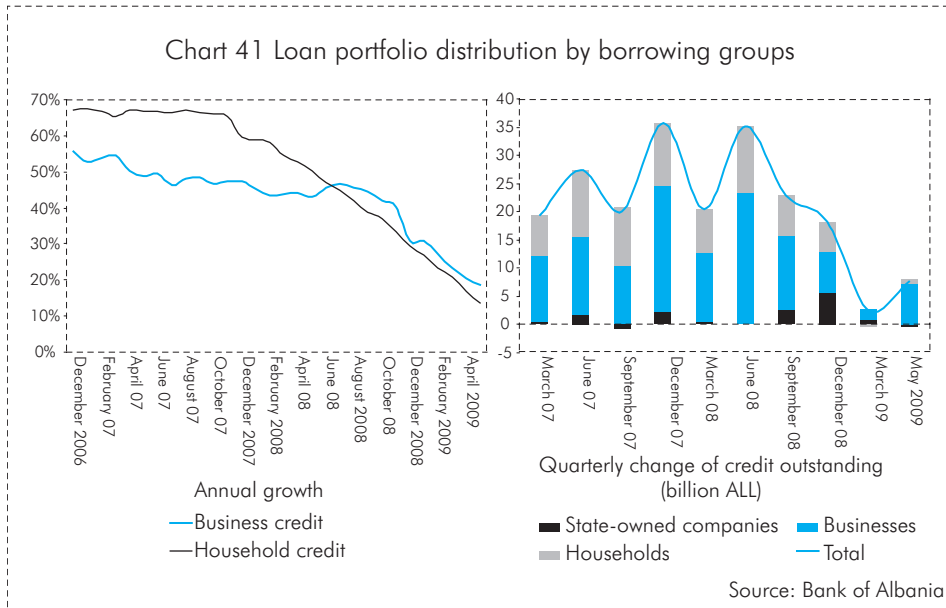


of credit. Also, during this period the new credit disbursed appears at lower levels than in the previous year, recording a negative annual change. A higher decline is noticed during first two months of 2009. Starting from March, an improved situation is highlighted. More positive developments over latest months are in line with the seasonal performance of credit over this period, which coincides with the seasonality of economic activity in the country. Also, the lending survey results for the second quarter of 2009 indicate that the lending terms have remained almost unchanged, with a relative easing tendency.

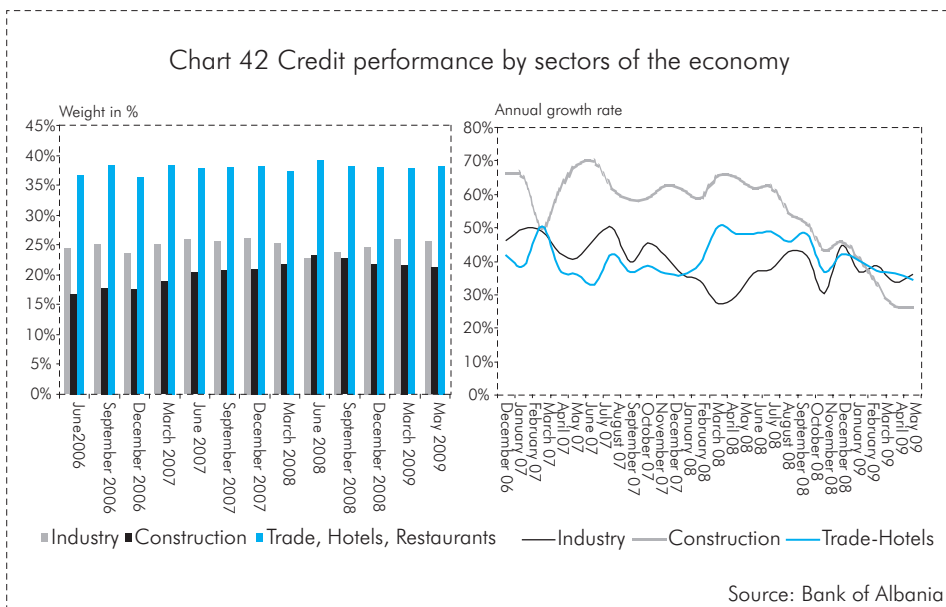
Concerning loan portfolio developments by currency, a deceleration of annual growth rates of foreign currency-denominated lending, reaching 13 percent, is noticed. In the meantime, lending in ALL has maintained the growth rates of the second half of 2008, with an annual growth of 33 percent. Difficulties in generating liquidity in foreign currency, along with perception for a higher risk for this portfolio<sup>36</sup>, have dictated this behaviour of banks. On the other hand, the lower degree of intermediation in domestic currency and the Bank of Albania's accommodating policy have created the necessary room for ALL lending to the economy. In May, the ALL loans to total loan portfolio amounted to 31 percent, against 27 percent in the previous year.



Business loan portfolio dominated the loan portfolio of the banking system, by 66 percent. In the first half of 2009, annual changes of this portfolio were downward, reaching 19 percent. However, the deceleration of business loan paces was lower than that of household loans. As noticed from the lending survey, banks were more conservative in retail loans. During most of this period, banks extended loans to businesses to supply them with liquidity. Working capital loan recorded an annual growth of 37 percent, compared to the 20 percent annual growth of investment loan.

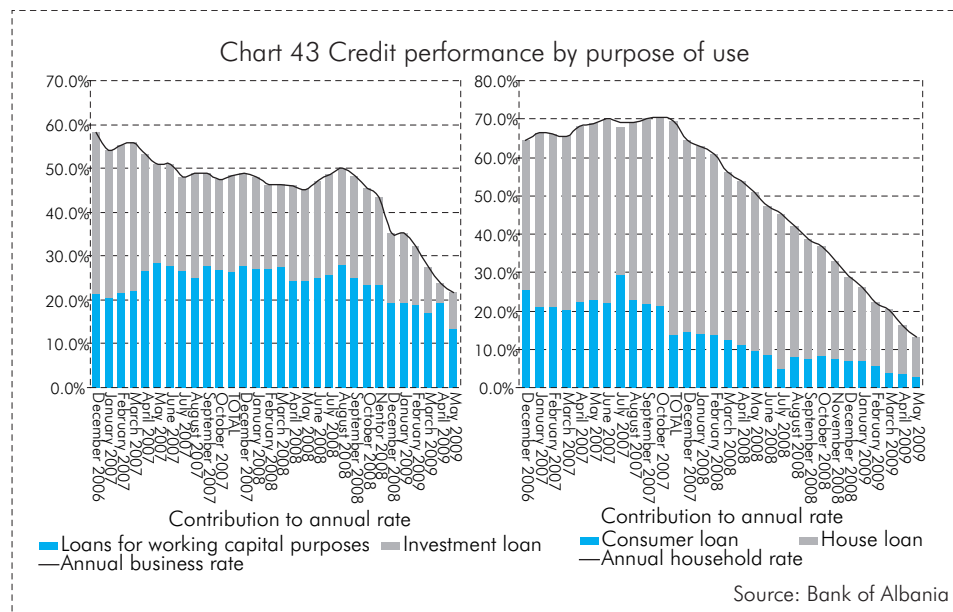


During last six months, credit to economy sectors displayed an obvious slowdown of lending to construction and to processing industry. The other sectors maintained almost the same pace as earlier. In May, trade loan portfolio reached 38 percent, construction one reached 21 percent and industrial one reached 26 percent of the business credit portfolio. Compared to the same period of the previous year, the overall industrial loan portfolio presented an obvious improvement, by about 3 percentage points. Growth of credit to electricity generation and distribution offset the contraction of lending to other sub-sectors. Loan portfolio by sub-sectors displays reduced share of credit to processing industry and increased share of credit to electricity generation. The banks state that during the last year they have preferred to credit those businesses that exercise their activity in those sectors of the economy that relate to basic commodities of consumption. Processing industry



displayed decelerated growth rates, due to encompassing in this sub-sector the businesses that relate to exports or supply construction with raw materials. Deterioration of international trade terms<sup>37</sup> and the uncertainty induced in real estate market have made many banks restrict significantly their lending to businesses of this sub-sector.

Household loan portfolio during 2009 has been characterised by uniform slowdown in annual growth rates, to 14 percent. This performance has reflected the prominent contraction of real estate loans. During first 5 months household loan outstanding increased only by ALL 1.5 billion, compared to ALL 12 billion in the previous year. The annual growth rate of housing loan portfolio has contracted obviously, accounting for 13.4 percent, similar to consumer credit. This slowdown of loans for house purchase has been in response to more conservative policies of banks for this product, but also to less demand. Commercial banks' policies for tightening the lending standards are noticed in raising the loan collateral coverage ratio, increasing the coverage level of credit instalment with personal income, selecting the collateral quality and reducing loan maturity term in some banks. Also, the demand for this product is influenced not only by the uncertainty related to steady income and job position, but also by expectations for a fall in the housing price.



Consumer credit has also reflected decelerated growth rates. As highlighted also by the lending surveys, this credit has reflected higher tightening of lending standards by the banking system since start of 2008. In May 2009, consumer credit accounted for 24 percent of household credit portfolio or by 6 percentage points lower than the highest historical level of July 2007. Compared to the previous year, the loan portfolio structure of household credit by usage has remained unchanged.

Box 4 Lending activity survey results for the second quarter of 2009

This box summarises the results from bank lending survey conducted with bank credit officers during July 2009 and refers to changes that occurred in lending during the second quarter of 2009, as well as bank expectations for the third quarter of the year. The results of this survey reveal that the net percentage of banks reporting a tightening of lending standards, though still high, has decreased as compared to the first quarter. The main factors stimulating the tightening policy of banks relate to assessment of the macroeconomic situation, the industry or firm specific problems and the financial position of households. Net demand for loans (net percentage of banks reporting a higher demand), though still at negative levels, has recorded a turning point, tending to rise in the second quarter 2009, whereas corporate demand has, for the first time, recorded positive values.

Bank's expectations for the third quarter of 2009 point to further easing of lending standards for both categories, business and household loans. With regards to demand for loans, banks have assessed that it will continue the upward trend by households and by corporations, as well as by small and medium enterprises.

**Business Loans:** During the second quarter of 2009 the tightening of business loan standards eased in comparison with the previous quarter. The net balance, being on the tightening side, escalated to -23.4 percent, compared to -66.3 percent in the previous survey. The negative balance reflects mainly banks that have answered "standards are tightened somewhat", since no bank has chosen to answer "standards are tightened considerably".

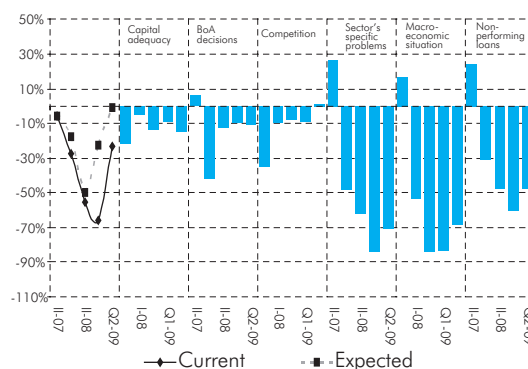
Industry or business specific problems, macroeconomic situation at home and non-performing loans remain the main factors behind the standards tightening in the second quarter of 2009. However, during the survey round, the impact of these factors somewhat eased compared to the second half of 2008 and the first quarter of 2009 (chart 1). Banks' tightening policy over the second quarter was implemented primarily by widening the average margin for riskier loans and increasing collateral requirement in relation to loan amount.

Net demand for loans by businesses, according to bank experts' assessments, has somewhat increased in comparison to the previous quarter; however, the demand of small- and medium-sized enterprises has remained at negative levels. The main factors behind the business demand for loans, according to bank experts' opinion, were: the need for financing the working capital, decreased use of alternative financing resources and Bank of Albania's decisions. According loan usage, the net demand for investment loans increased, while the demand for working capital was positive.

Banks expect further easing of business credit standards in the third quarter of 2009. Expectations point to positive turning point for the demand in the forthcoming quarter. The expectations balance is positive either for the demand from small-and medium-sized enterprises or from corporations.

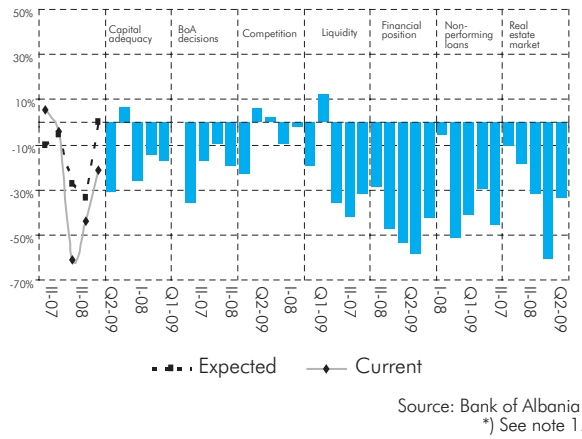
**Individual loans.** Lending standards applied on individual loans tightened in the second quarter of 2009, although at more moderated rates compared to the high

Chart 44 Lending standard changes applied to business loans and the factors impacting on them (net balance), in percentage



Source: Bank of Albania  
Note 1: The positive balance indicates easing of lending standards or that the factor has impacted the easing of lending standards; whereas the negative balance indicates tightening of lending standards or that the factor has impacted on the tightening of lending standards.

Chart 45 Changes on lending standards applied on individual housing and consumer loans and the impact of various factors (net balance\*), in percent



level in the first quarter: the net percentage of banks reporting easing lending standards has increased to -21.6 from -44.3 percent in the first quarter. The lending standards have been more tightened for consumer loans than for housing loan. The net balance of non-performing loans, pointing to -45.2 percent relative to -29.8 percent in the preceding quarter is the main factor imposing the tightening of lending standards in the second quarter of 2009.

In addition to non-performing loans, individual financial situation and the developments in the real estate market continue to provide the main impact on the bank's tightening lending standards.

Banks report a slight growth of individual demand for loans relative to the fall in the previous quarter. Consumer loan demand has been lower than demand for housing loans.

Banks do not expect further tightening of lending standards for households in the third quarter of 2009. Banks' expectations show a positive demand for the third quarter of the year.

*Lending activity by currency.* For the third quarter of 2009, banks expect higher ALL-denominated lending and lower foreign currency-denominated lending. This tendency has been shown since the second half of 2008. Banks expect higher interest rates on foreign currency loans in the following quarter. The net percentage of banks expecting higher interest rates on foreign currency-denominated loans is 12.3 percent relative to 4.7 percent of banks expecting higher interest rates on ALL-denominated loans.

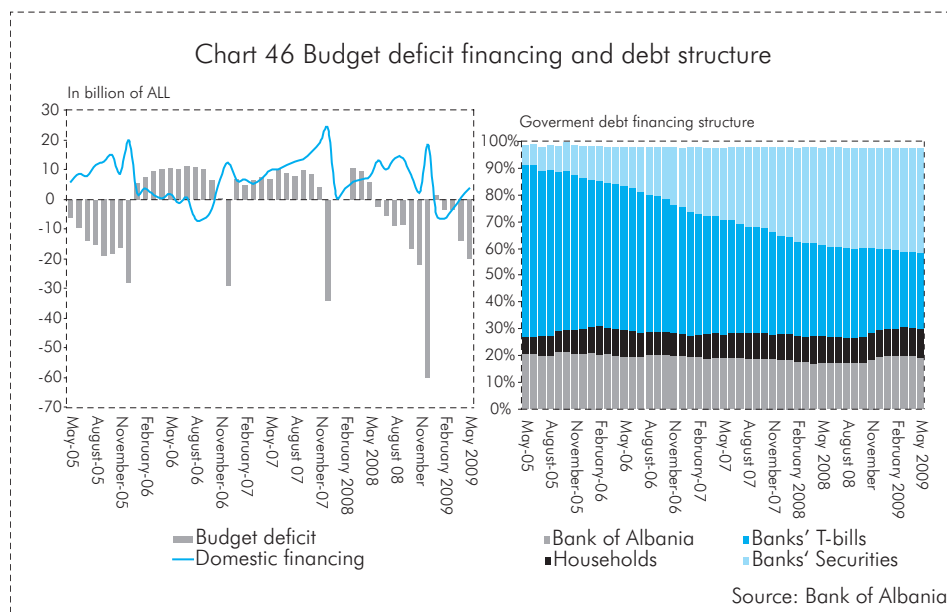
*Banks' experts have also assessed the factors encouraging businesses and consumers to apply for foreign currency-denominated loans.* The interest rate spread and the source of income in foreign currency appears the key driving force boosting businesses' demand in the second quarter. The interest rate spread and the goods' prices purchased in foreign currency remain the key driving force encouraging households' demand for foreign currency-denominated loan.

### FISCAL SECTOR FINANCING

Banks' participation in the Government securities' primary market has increased owing to the improved liquidity situation in response to the positive developments in deposits and the ongoing presence of the Bank of Albania in the money market. In the meantime, the further widening of the budget deficit in May kept the demand for funds high. However, certain privatisation receipts in May and June have sustained the decline of liquidity pressures in the money market. In turn, this led to stable interest rates in securities market during these months.



Government securities portfolio of the banking system grew by about ALL 8.3 billion in May, owing mainly to the monthly increase of long-term securities investments amounting to ALL 5.2 billion and of one-year securities by about ALL 3.1 billion. The shifting tendency of short-term securities portfolio of up to one year to long-term securities, mainly of 5-year maturity term, persisted in the early part of 2009. Compared to the end of December, banks' T-Bill portfolio reduced by ALL 5.4 billion, while it increased by ALL 7.5 billion in 5-year bonds.



A higher participation of households financing Government needs is observed during the first 5 months of 2009. Households' portfolio in the primary market grew by about ALL 5 billion, financing about 11 percent of Government domestic debt. A portion (about 1/5) of savings withdrawn from banks in the last quarter of 2008 is believed to have been partially channelled into the Government securities market.

## IV.2 LABOUR MARKET AND WAGE PERFORMANCE

### LABOUR MARKET

Unemployment rate was 12.68 percent in the last quarter of 2008, while in the preceding quarter it was 12.62 percent. The increase of unemployment rate was mainly triggered by the increase in the number of unemployed persons compared to the third quarter of 2008.

According to the data on the first quarter of 2009<sup>38</sup>, total employment indicator and the number of unemployed persons declined relative to the previous quarter.

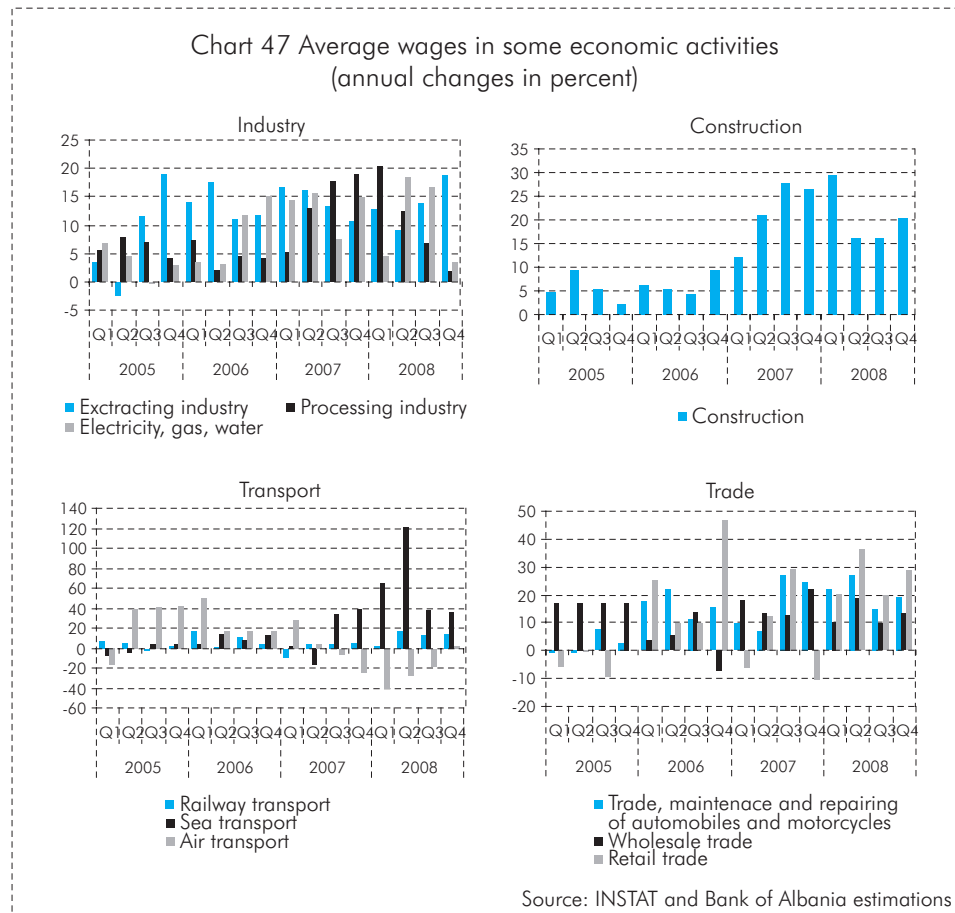
Table 8 Employment and unemployment indicators

	Q1-08		Q2-08		Q3-08		Q4-08		Q1-09	
	Sector		Sector		Sector		Sector		Sector	
	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private
Employed persons	165,427	230,548	165,266	230,777	164,019	234,795	164,052	238,975	163,767	237,379
Number of unemployed persons <sup>39</sup>		140,008		139,985		140,140		141,700		141,382
Unemployment rate		13.04		12.97194786		12.62		12.68		

Source: Ministry of Labour, Social Affairs and Equal Opportunities

PERFORMANCE OF WAGES

The annual change rates of average wage in the public sector and economic enterprises were about 7 percent in the last quarter of 2008. In quarterly terms, average wage rose in both public and private sector.



The approval and entry into force of the Government decision on the rise of wages starting from 1 May 2009 is assessed to have provided its effect on the increase of average wage, initially in the public sector<sup>40</sup>. The increase of monthly minimum wage<sup>41</sup> per employee nation-wide to ALL 18,000, about 13 percent higher on annual basis and 6 percent on quarterly basis, is expected

to affect the performance of wages in the private sector for the forthcoming quarters of 2009.

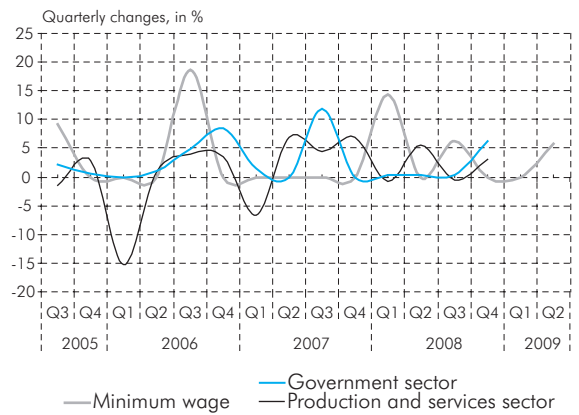
#### IV.3 PRODUCER AND IMPORT PRICES

Producer and import prices in the first half of 2009 were mainly affected by the favourable conjuncture in the international markets with respect to raw materials prices. The annual rise of import prices dropped from 3.7 percent in 2008 to 1.1 percent in the first half of 2009, while producer prices fell from 6.5 to -1.2 percent in the first quarter of 2009. Inflationary pressures generated by producer and import prices on the overall level of consumer prices have been declining; however, the depreciation of the Albanian Lek vis-à-vis the U.S. dollar and Euro is assessed to have provided an inflationary impact on the performance of imported inflation.

Producer prices fell by -1.2 in the first quarter of 2009 compared with the first quarter of the previous year. Starting from mid-2008, their downward trend was mainly triggered by the favourable economic climate in the international conjunctures.

The analysis of cost performance by sectors shows lower rising rates of producer prices in the main production sectors at home. Processing industry, sharing the main weight in the PPI basket, increased slightly by 0.6 percent y-o-y. "Food industry", the main sub-item in this item, recorded a negative annual change of -5.4 percent for the second quarter in a row. The decline of producer prices in this industry has eased the fall of processed foods' consumer prices. Production prices in "extracting industry" moderated their growth rates. In the first quarter of 2009, the annual increase of producer prices in this industry was 5 percentage points lower than the average annual growth of 7 percent in 2008. The lower demand and prices in this industry in the international markets and the re-exporting nature of domestic companies operating in this industry are assessed to have mainly triggered the lower growth rates.

Chart 48 Performance of minimum wage and average wage in production and services and in the public sector



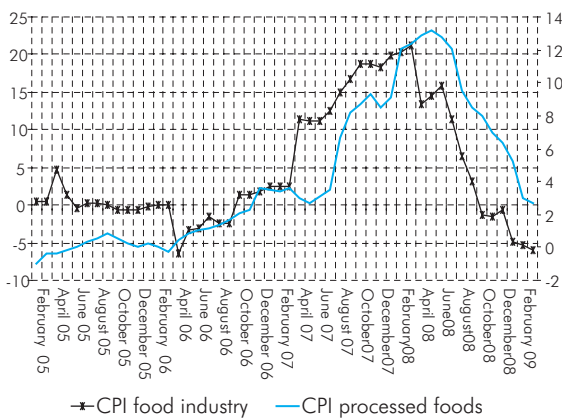
Source: INSTAT, Conjuncture: Main economic indicators, October-December 2008 and Bank of Albania estimations

	PPI	PPI Total processing industry	PPI Food industry	CPI Processed foods	PPI Extracting Industry
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	2.9
Q3:08/Q3:07	7.1	6.1	7.0	10	9.7
Q4:08/Q4:07	4.2	1.8	-1.1	7.1	9.2
Q1:09/Q1:08	-1.2	0.6	-5.4	3.6	2.3

Source: INSTAT and Bank of Albania estimations

Table 9 Annual change rates of some PPI and CPI components (in percent)

Chart 49 Annual change in PPI (right-hand axis) and CPI (left-hand axis) commodity indices



Source: INSTAT and Bank of Albania estimations

Export-related producer price index<sup>42</sup> fell by 2 percent in the first quarter of 2009. The average annual increased of this index was 9.3 percent in 2008. "Processing industry", the main branch in industry, recorded an annual growth of 2.5 percent during this quarter. Global demand weakening seems to have exerted pressures over the domestic exporting companies, which opting for lower profit margins have reduced the prices of their export-related products.

Producer price index for the domestic market has also declined. Producer prices at home fell by 0.1 percent in the first quarter from the average annual rise by 5.1 percent in 2008. The fall of producer prices in food industry by 4.7 percent in annual terms provided the main contribution. The downward tendency of producer prices for the domestic market

has been also reflected in the low rising rates of consumer prices at home in the first quarter.

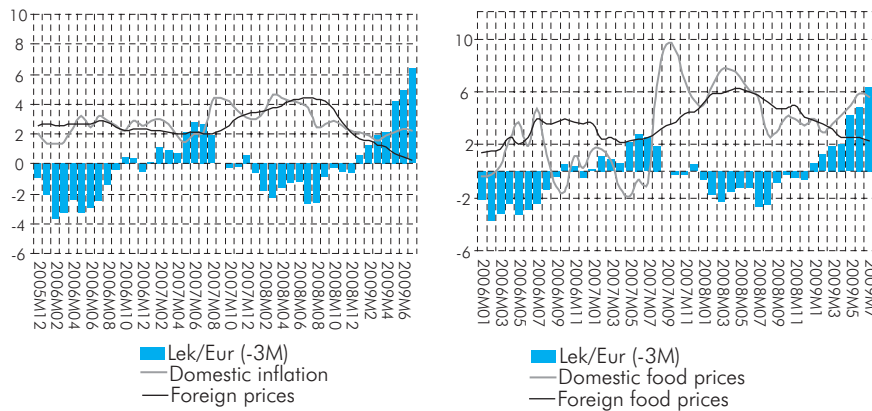
Foreign prices have followed a declining spiral starting from the third quarter of 2008. In the first half of 2009, foreign consumer price index<sup>43</sup> increased by an average of 1.1 percent y-o-y, 2.6 percentage points less than the previous year average. Consumer prices in Italy and Greece recorded the lowest annual rise of the last 10 years in June - by 0.5 percent, respectively. The decline of consumer prices in these countries owed to the fall of raw materials prices and the economic growth slowdown.

Despite the low foreign prices, imported inflation has been increasing due to the depreciation of the Albanian Lek in the recent months. In annual terms, the Albanian Lek has depreciated by 21.3 and 5.5 percent vis-à-vis the USD and EUR in the first half of 2009. Notwithstanding the sharper fall of foreign prices in the second quarter, annual inflation at home has maintained an upward trend for this period, from 1.9 percent in March to 2.3 percent in June. The higher headline inflation was mainly triggered by the increase of traded inflation, while non-traded inflation maintained the previous months' similar rates.

Foreign prices are directly and instantly reflected in performance of food prices at home. Average annual inflation of "food and non-alcoholic beverages" in Albania and abroad (Italy and Greece) increased by 3.5 percent in the first quarter of 2009. In the second quarter, the average annual rise of food prices at home (5.0%) was twice higher, attesting to the role of the exchange rate role in the increase of food price inflation.

Import prices continued to be strongly affected by oil price fluctuations in the international markets. In the first half of 2009, the Albanian oil market attested to an ever-increasing integration with the international market,

Chart 50 Annual changes in foreign and domestic prices (left-hand chart), foreign and domestic food prices (right-hand chart) and the exchange rate

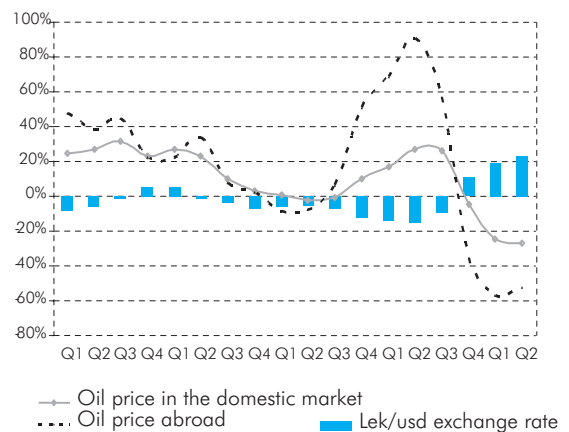


Source: Bank of Albania estimates and Italian and Greek Statistics Institutes

reflecting the fluctuations in prices without the one-month lag as in 2008. Average oil price in the retail market was ALL 104 per litre, down by about 26 percent from the same period of the previous year. Following the strong fall of oil price in February 2009, the preceding period manifested an upward trend in monthly terms, which peaked in June. This performance is in line with the oil performance in the international market, which is to a large extent transmitted to the performance of oil price in the domestic market against a background of ALL depreciation vis-à-vis the U.S. dollar.

Indices of CPI basket items, which directly or indirectly rely on the oil price fluctuations in the market, have followed the dynamics of changes of this product in annual and monthly terms. Prices of “Service to personal transportation vehicles” recorded an average annual fall by 12.3 percent and a rise in monthly terms. By contrast, prices of “transportation services” showed an upward trend, owing mainly to the rise in urban transportation prices in 2008. In June, these prices were declining, due to statistical effect.

Chart 51 Annual change of oil price in Albania and abroad and ALL/USD exchange rate

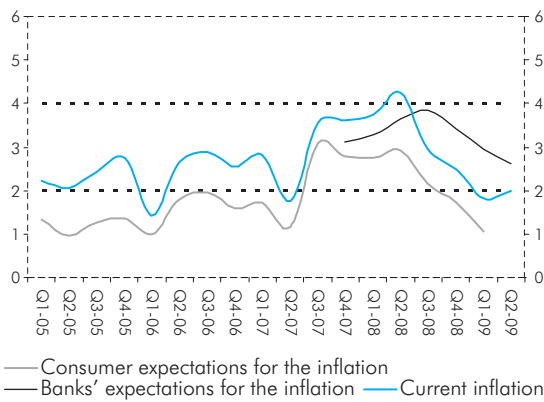


Source: INSTAT, Bank of Albania, EIA

#### IV.4 EXPECTATIONS FOR THE PERFORMANCE OF PRICES IN ECONOMY

Expectations for inflation<sup>44</sup> in the short and medium-term period have been declining in first half of 2009, remaining however within the Bank of Albania 2-4 target. Consumer expectations for the annual inflation after one year are lower than other economic agents’ (businesses and banks). Annual inflation after one year, as expected by consumers,<sup>45</sup> is +1.1 percent compared to 2.6 percent, as expected by banks and businesses.

Chart 52 Consumer and banks' expectations for the annual inflation and current inflation (in percent)



Source: INSTAT and Bank of Albania

After increasing sharply in the second quarter of 2008, expected producer prices manifested a downward trend in the first quarter of 2009, increasing slightly in the second quarter (see Chart 2). However, they remained lower than their historical average.

Industry-related businesses expect producer prices to drop further in the second quarter of 2009, with the balance of expectations reaching negative values. Expectations for producer prices in this sector are 6.5 percentage points below the historical trend. By contrast, construction and services-related businesses reported higher producer prices in the second quarter. Services-related businesses appear more optimistic, expecting producer prices to rise above the historical average. Although construction-

related businesses expect producer prices to increase, they expect them to remain below their historical average.

Chart 53 Business expectations for the performance of producer prices after one quarter (net percentage)



Source: INSTAT and the Bank of Albania

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

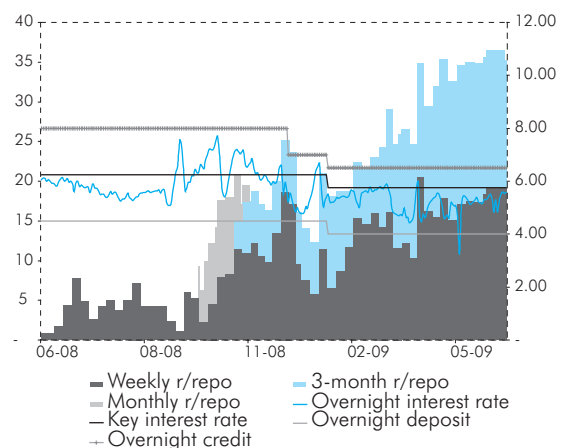
Monetary conditions components - interest rates and the exchange rate – have been affected by the uncertainty in the financial market and the heightened liquidity shortages in the first half of 2009. Short-term interest rates in the money market dropped owing to the positive effect of the central bank's intervention and the easing of monetary policy. By contrast, long-term interest rates increased due to risk re-evaluation. Moreover, the exchange rate has fluctuated dramatically and has maintained a depreciating trend.

### MONEY MARKET

The liquidity needs arising from the withdrawal of deposits from the banking system in the last quarter of 2008 persisted in the first half of 2009 as well. This situation triggered upward pressures over the interest rates in the money market, reflected in higher risk premium for longer-term interest rates. In view of containing these pressures, boosting lending activity in the money market and calming the market participants down, the Bank of Albania intervened by injecting temporary and unlimited liquidity through the open market operations. In November 2008, the form of reverse repurchase agreement auctions changed from determined to undetermined amount and fixed with the base interest rates. In addition, in order to create favourable conditions for banks' lending activity, the Bank of Albania has also employed the reverse repurchase agreement of 3-month maturity term. At the end of the first half, lending to the banking system through open market operations amounted to ALL 31.1 billion from ALL 15.3 billion in October. The base interest rate cut from 6.25 to 5.75 percent at end January, along with the narrowing of the corridor for the central bank's lending (December 2008) led to lower banking system's financing cost. Worth noting is that these measures were taken against a background of downward inflationary pressures; hence, the achievement of the main Bank of Albania targets was not jeopardized.

The improved liquidity situation, along with the contained withdrawal of deposits in the last months, fuelled the growth of lending activity in the money market. The volatility of interest rates moderated while the base interest rate cut by 50 basis points at end January was completely transmitted to the interbank market. The measure taken by the Bank of Albania in March, on non-usage of overnight deposits by lending institutions, seems to have been reflected in the growth of the volume exchanged in the interbank market and in lower interest rates.

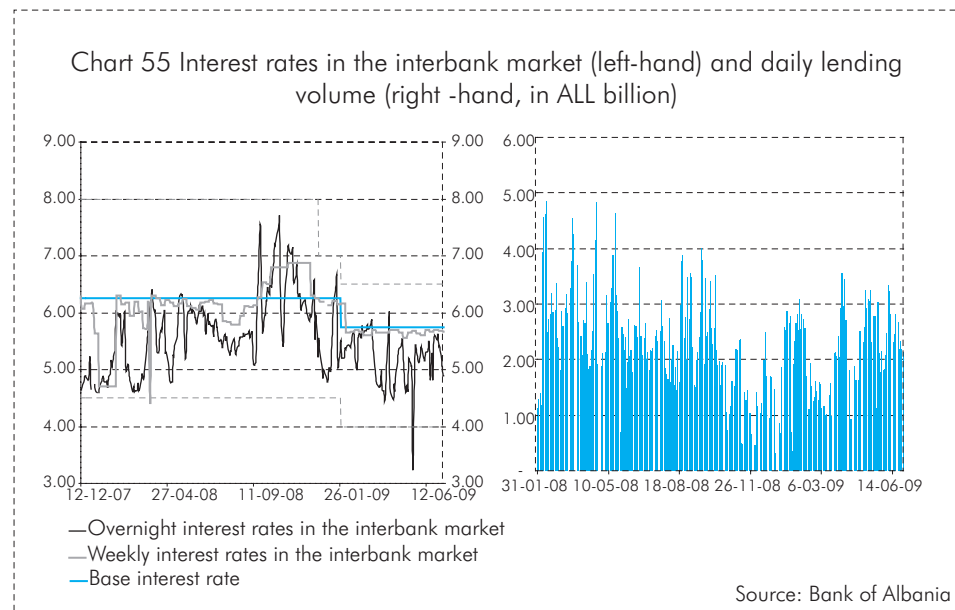
Chart 54 Bank of Albania interventions in the money market and key interest rate



Source: Bank of Albania

In response to the easing monetary conditions and improved liquidity situation following the open market operations, the interest rates in the interbank market decreased in the first quarter of 2009. The latter remained close to the base interest rate during this period. The second quarter attested to stable liquidity conditions and improved security in the market, fuelled by the first signs of deposits return to system. After the low figures recorded in the first two months of 2009, the traded volume in the interbank market grew. The temporary absence of overnight deposit facility seems to have been another factor to have encouraged the trading of funds in the interbank market, hence attesting to more efficient agents' behaviour in this market. The allocation of liquidity in the system has been uniform, leading to lower interest rates volatility.

Average daily lending grew by ALL 0.6 billion in the second quarter from ALL 1.8 billion in the previous quarter and ALL 1.5 billion in the last quarter of 2008. Banks continue to prefer daily transactions, while one-week transactions have grown moderately in the recent months. In average terms, overnight interest rate dropped to 5.08 percent from 5.42 percent in the first quarter and 6.33 percent in the last three months of 2008. In September and October, overnight interest rate exceeded the base interest rate, while remaining below it over the course of the current year. Interest rates of one-week transactions fluctuated close to the REPO rate of the same maturity term averaging 5.74 percent, down by 94 basis points from the last quarter of 2008.

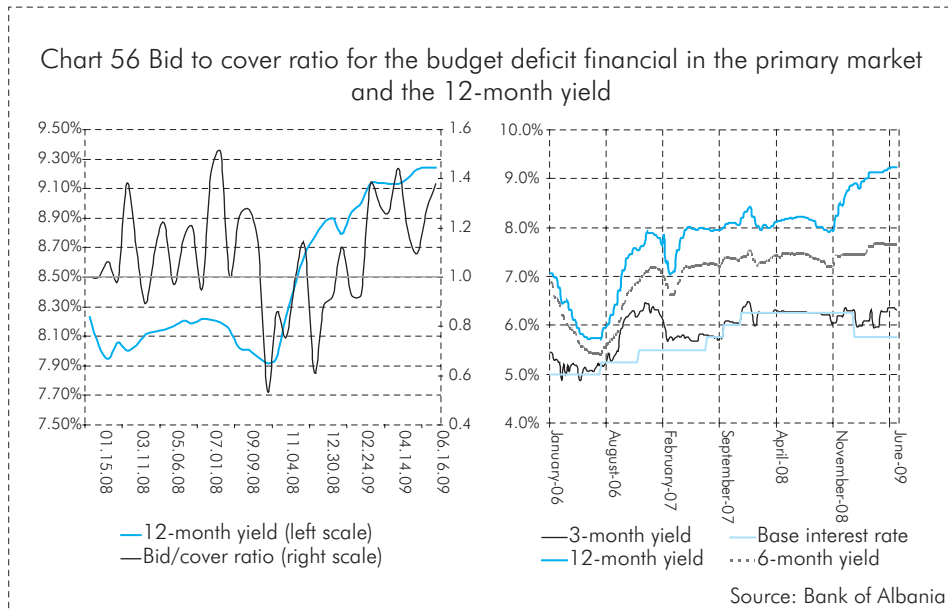


### PRIMARY MARKET

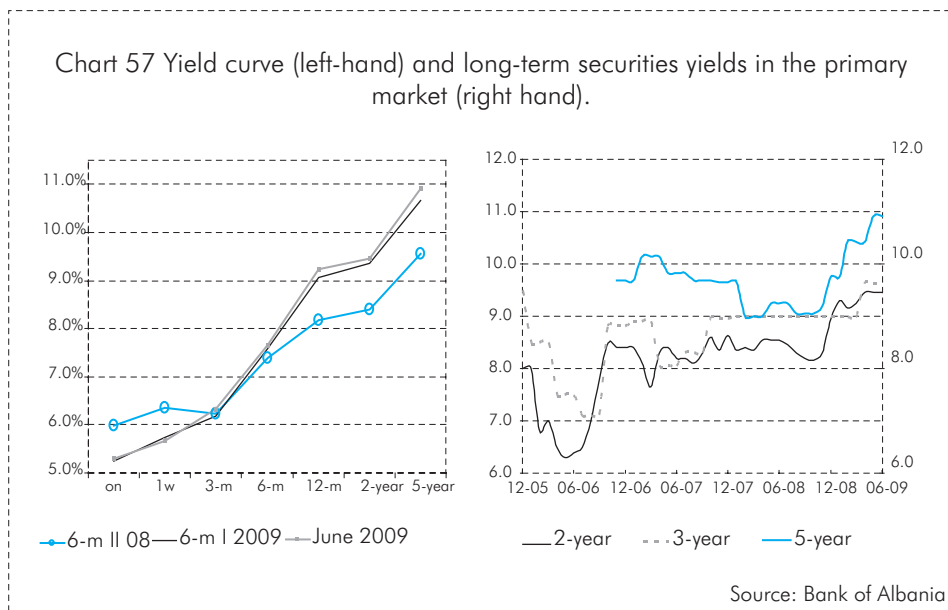
Government securities yields in the primary market have maintained an upward trend, which began in the late 2008. To a certain extent, the higher yields in the early months of 2009 seem to have reflected the low participation of banks in Government securities auctions. Despite the increasing banks'



participation in the following period, it did not moderate the upward pressures. Higher yields for all maturities, at a time when the base interest rate was cut by 50 basis points and banks' participation was high, attests to the higher risk perception from banks. This performance has been also encouraged by the increase in securities issue.



12-month T-bill yield experienced the sharpest increase. As at end the first half of 2009, 12-month T-bill interest rates reached 9.24 percent, up by 0.48 percentage points from the end of December and 0.93 percentage points from the same period of the previous year. 6 and 3-month yields manifested the same performance, although at more contained rates. At end-May, 6-month yields recorded 7.67 percent, up by 0.22 percentage points from end-December. In the meantime, 3-month yields maintained similar levels as in the previous periods.

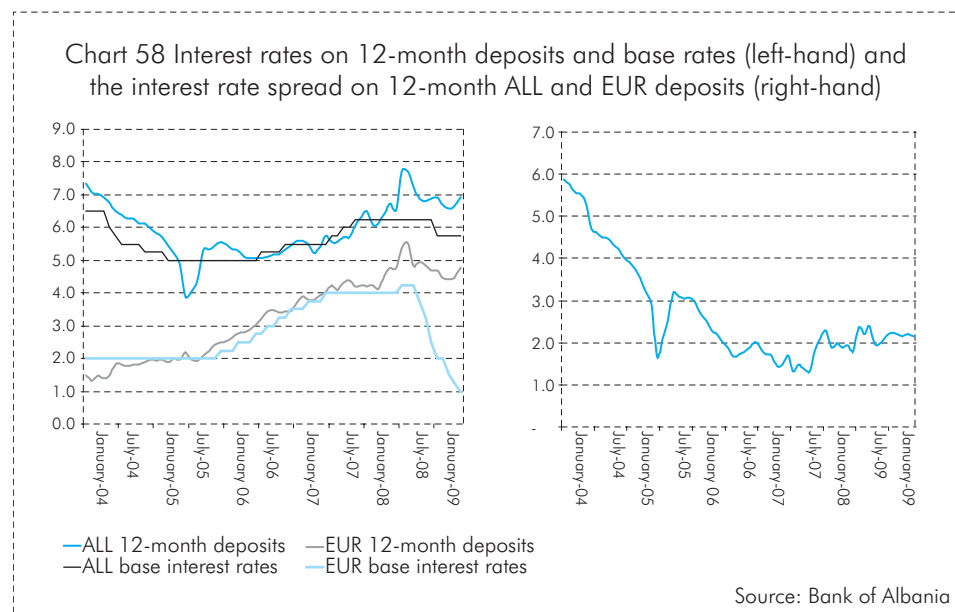


Bonds in the primary market manifested similar trends to T-bills. Bond yields increased owing to the higher perceived risk, while participation in auctions was satisfactory in the last months<sup>46</sup>. In June, 2 and 5-year bond yield (of variable interest rate) marked 9.45 and 10.92 percent, respectively, up by 50 and 75 basis points from the preceding half. Higher yields of these instruments have reflected the increase of 12-month T-bill yields and the higher margin. In the April auction, 3-year bond yield increased by 0.63 percentage points, to 9.61 percent.

### INTEREST RATES ON NEW DEPOSITS AND LOANS

In the first half of 2009, interest rates for both main currencies, the ALL and the EUR, were relatively high compared with the base rates. These rates have reflected the liquidity shortages and the higher risk premium.

Average interest rate on new ALL time deposits was 5.36 percent in the first 5-month period, down by 16 percentage points from the last quarter of 2008. The downward trend of ALL deposit interest rates after January 2009 reflected the termination of early-year banks' promotional offers and the base interest rate cut. This trend seems to have shifted in the early summer when the interest rates on deposits reached 5.45 percent in May.



Euro-denominated time deposit interest rates have maintained the same tendency as ALL interest rates, being conditioned by the liquidity situation and the risk re-evaluation in the domestic market rather than by the respective interest rate tendency in the international market. Even after the cut of base interest rate by the European Central Bank by 1.25 percentage points from December 2008 (2.50 percent) to May 2009 (1.25 percent), average interest rate on Euro-denominated time deposits continued to maintain high values. For the same period, average interest rate on new Euro deposits dropped by

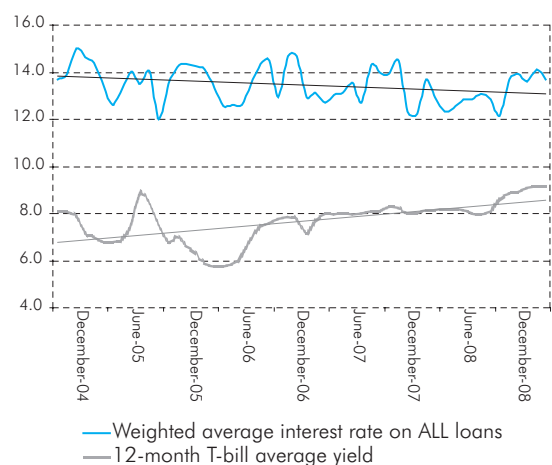
0.55 percentage points to 2.58 percent. The decline was mostly applicable on short-term maturities, while the interest rates on one-year deposits increased in May, hence maintaining high margins at home in order to attract foreign currency from the seasonal inflows.

The interest rate spread of ALL and EUR 12-month deposits maintained the same level as in early 2009, owing to almost similar policies applied on both currencies.

In the first five months of 2009, the banking system tightened lending in both currencies, reflecting it in higher interest rates as well. Their spreads with the benchmark rates have widened owing to higher perceived risk by banks and/or the maintenance of spreads with the respective deposit interest rates.

The weighted average interest rate on new ALL-denominated loans increased by 0.96 percentage points, to 13.81 percent in the first 5-month period. In addition to higher reference rates these loans are indexed to (mainly T-bill yields), this performance reflects the tightening lending conditions during this period as well. In terms of maturity, higher weighted average interest rate reflects the increase of interest rates on ALL-denominated medium-term loans. This tendency is in line with the banks' preference to tighten the long-term and investment-related loans more, in response to banks' perception of higher uncertainty in the country. By contrast, short-term interest rates (0-6 months) were downward and were mainly extended to meet businesses' working capital needs.

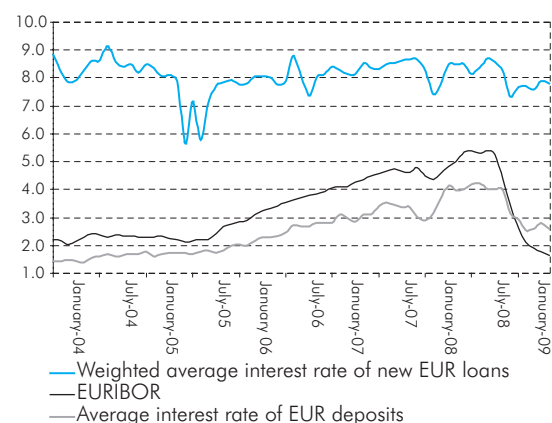
Chart 59 Weighted average interest rate on new ALL loans



Source: Bank of Albania

Average interest rate of Euro-denominated loans decreased in this period, but not at the same rate as the reference rates in the international market (EURIBOR and LIBOR). They were characterized by the preservation of high spreads with the deposit interest rates in the same currency and the general perception for more tightened lending in foreign currency. Average interest rate on Euro-denominated loans was 7.74 percent in January to May, down by 0.45 percentage points from the previous year. In the meantime, EURIBOR in the international markets has dropped by 2.79 percentage points. The opposite direction of ALL and EUR loan interest rates led to higher spread between both currencies. Against this background, the tightening of other criteria, in addition to the price, has triggered the decline of lending in foreign currency and the fall of

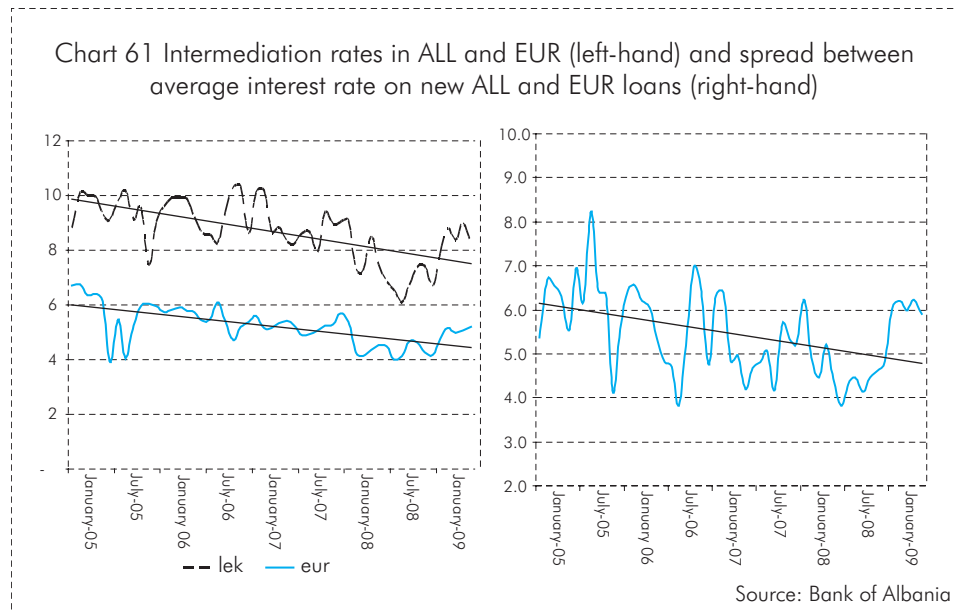
Chart 60 Weighted average interest rate of new EUR loans, EUR deposits and 12-month EURIBOR interest rate



Source: Bank of Albania, Reuters

demand for the latter. In the first half of 2009, the spread between new ALL and EUR-denominated loan interest rates was about 6.07 percentage points, widening by 1.40 percentage points from the previous year.

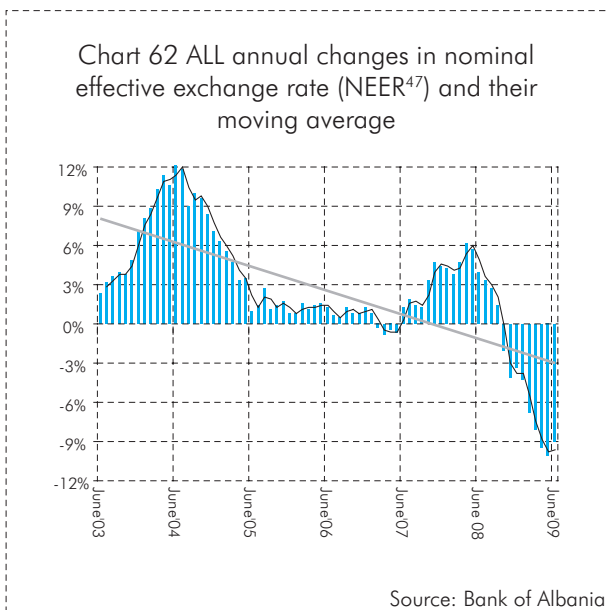
Intermediation cost (loan/deposit spread) was high throughout 2009 for both currencies. After the upward trend in January, this spread was higher than in 2008. In May, this indicator stood at 8.26 percent for ALL and 5.12 for EUR.



### EXCHANGE RATE

In average terms, the performance of the ALL in the first half of 2009 vis-à-vis its major foreign currencies basket maintained the same depreciating tendency as shown since last October, when the crisis that swept the international

financial markets hit the domestic foreign exchange market for the first time. In annual terms, the changes in the NEER moved within a band of -4.2 percent to -10.2 percent (7.95 percent on average) during this period. Notwithstanding the escalating depreciation of the NEER in June, which corresponds to the beginning of the summer (tourism) season and entry into the foreign exchange market of a portion of contracted funds from the international market, the downward rates have been more moderate. This is also witnessed by the positive change (1.14 percent) of this indicator in monthly terms.



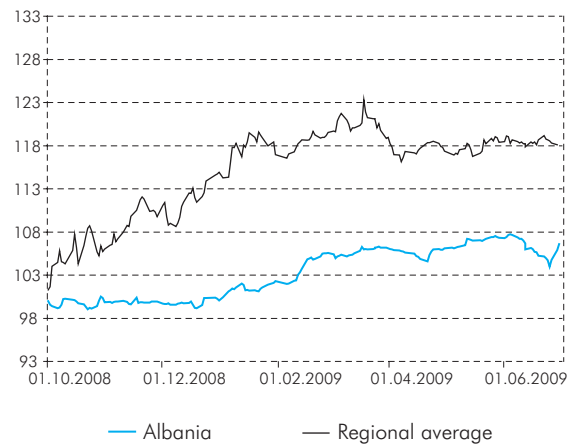
From a regional viewpoint, the analysis of the EUR/ALL ratio attests to the return of the depreciating tendency. This has not been noticed in Albania yet, although in marginal terms the ALL seems well-positioned.

The factors affecting the performance of the exchange rate in the first half of the year are linked to the global crisis and its impact over the domestic market. Here, we can mention the decline in remittances, exports, in foreign currency loans and the shaken economic agents' confidence. In addition to these factors, the seasonal effect, which characterizes the growth of demand for foreign currency in the early months of the year, seems to have led to an imbalanced demand-supply ratio.

In the first half of 2009, ALL depreciated against both main currencies in the domestic foreign exchange market. The ALL depreciated vis-à-vis the U.S. dollar by 21.3 percent in annual terms, and 11.6 percent relative to the second half of 2008. ALL vis-à-vis the U.S. dollar has entirely reflected the EUR/USD performance in the international markets. This is also attested by the relatively moderate volatility in the USD/ALL during this period compared with the last quarter of 2008 when the U.S. dollar was strongly hit by the financial crisis.

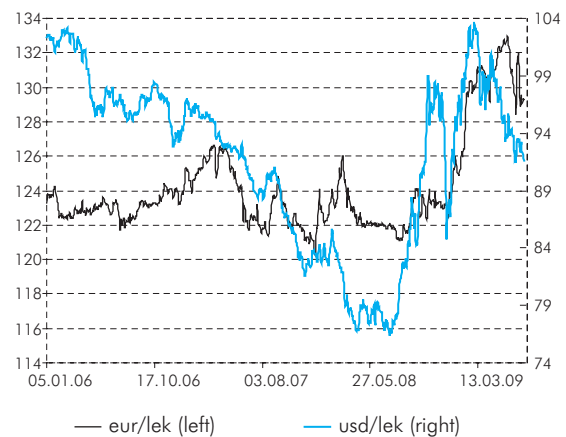
During the first half of the year, the ALL depreciated vis-à-vis the EUR by 5.54 percent relative to the same period of 2008 and 5.79 percent to the second half of 2008. Although in the first quarter of 2009, the euro seemed to gain ground against the ALL at an escalating rate, this trend was reined back in April and June in favour of the domestic currency, showing a slight appreciation by 0.16 and 0.57 percent, respectively. The appreciation of

Chart 63 EUR/ALL ratio compared to the regional average



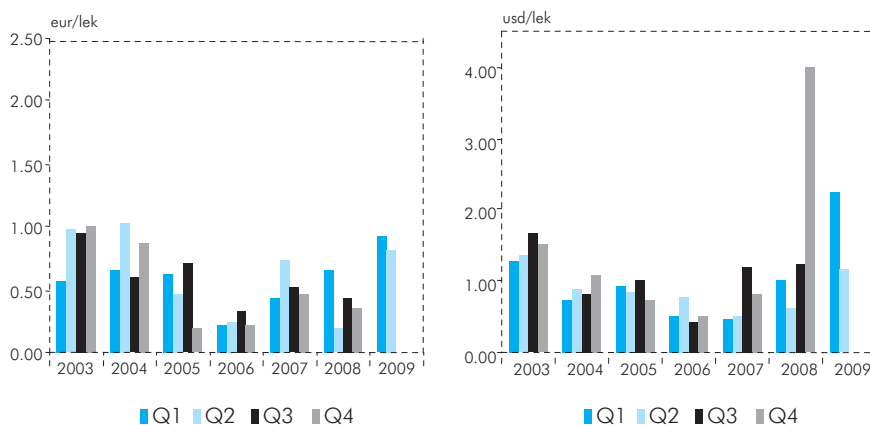
Source: Bank of Albania

Chart 64 Daily performance of EUR/ALL and USD/ALL ratio



Source: Bank of Albania

Chart 65 ALL exchange rate volatility in quarters<sup>48</sup>



Source: Bank of Albania

the ALL is mainly a result of the seasonal supply. The analysis dynamics in this ratio shows that the volatility was higher in the first quarter of 2009 than in the entire 2008. In the second quarter of the present year, this indicator dropped moderately, reflecting partially the presence of monetary authorities in the market.

The depreciation of the ALL nominal effective exchange rate (NEER) and the more rapid rise of prices at home than the foreign prices led to the depreciation of real effective exchange rate by 6.64 percent y-o-y in the first half of 2009. In the medium and long-term period, real effective exchange rate of the ALL is determined by the underlying economic factors such as the balance of payments, the competitive position of domestic goods and the interest rate spread. Based on the balance of payments' performance, in January to April 2009, the trade balance contracted moderately, which in turn may to a certain extent, have reflected the decline of remittances and the lower credit growth rates. Nevertheless, the upward tendency of unit labour cost in the last two years, may lead to wider trade deficit and higher demand for foreign currency. Along the same line, current account performance in the first quarter of 2009 attested to the fact that the performance of this balance sheet item will strongly depend on the recovery duration of the economies the Albanian emigrants reside the most (seasonal and temporary emigration) and on the performance and share<sup>49</sup> of capital and financial account items financing the current account. On the other hand, the further improvement of the liquidity situation in the market will create conditions for more effective transmission of monetary policies, reflecting the increased base rates in the market, which will sustain the positive exchange rate performance.

#### IV. EXPECTED ECONOMIC AND MONETARY DEVELOPMENTS DURING 2009-2010

Albanian economy was obviously affected by the world macroeconomic developments, along with changes in internal factors. Decelerated economic growth rates in the world economy and particularly the recession in many Euro-zone member states are transmitted to the slow-down of Albanian economic activity. The contracted aggregate demand in trading partners, employment reduction and deceleration of private foreign capital circulation among countries have provided their impact through external sector indicators of economy. Parallel to that, deposit withdrawal from the banking system, tightening of monetary supply and the rise of uncertainty in the market slowed down the economy demand. The overall economic activity was faced with more limited financing resources, converted into aggregate demand slowdown.

Economic downturn and the contracted aggregate demand in trading partners affected the export performance and hence, the encouragement of demand in Albanian economy. During last years, exports have had a growing tendency, amounting to about 30 percent of GDP in 2008. Data on current account in the first quarter of the year reveal their drop relative to first quarter of 2008. The confirmation, in general, of the falling tendency in exports during

2009, would contribute to downward aggregate demand performance in the economy.

Further progress of economic activity carries over additional uncertainty in terms of financing the economic growth in the long run. Beyond the growth factors of production and technological progress, remittances were a stable source of economic growth in the recent years. As a share of GDP, remittances account for 10-15 percent. However, in the last three years, they have followed a clear declining trend from 14.6 percent of GDP in 2005, down to 10.6 percent in 2008. In annual terms, remittances marked a fall of about 6 percent in 2008 relative to 2007, while for the first quarter of 2009 the annual drop was 7.7 percent. The ongoing downward trend of remittances makes difficult the consumer financing and increases opportunity cost of investments. In absence of the balancing of this factor, mainly through the rise of productivity and foreign direct investments, economic growth would tend to slowdown.

Developments in international capital markets and the uncertainty in undertaking initiatives are expected to affect the performance of real economy at home. In the presence of liquidity constraint in international markets and increased risk, the volatility of foreign direct investments and of capital ones from abroad require higher return rates. In terms of an emerging economy, this uncertainty of access to foreign capital markets is translated into more difficulties for preserving previous investment levels. Financial inflows, in the form of capital and foreign direct investments, have financed an increasing share of the demand in economy. Thus, in 2008 they accounted for 17 percent of GDP, against 9 percent in 2007 and 5 percent in the previous years. In terms of slowdown of alternative financing resources, the preserving of this level of financial inflows poses a challenge for achieving an economic growth at the levels of the previous years. Current financial and macroeconomic developments make difficult the finding of domestic resources for financing the economic growth. Finally, deposit withdrawal from the banking system in the last quarter of 2008 and at start of the current year, tightened the monetary supply and slowed down the financial intermediation process. Interventions in money market to meet liquidity needs in ALL and the relaxation of financial situation have met the demand for ALL-denominated monetary assets.

Also, beyond the factors induced from the global environment, in the presence of trade terms deterioration, the economy is expected to be faced with increasing needs for liquidity. Improvement of trade terms provides an equilibrated alternative for maintaining the economic growth rates in the long run and the macroeconomic balance. The undeveloped capital markets at home do not help the self-adjustment of trade terms and of the overall economy.

Under these conditions, the compilation and implementation of macroeconomic policies should sustain the economic stability in the medium and long run. Their coordinated compilation should aim at controlling the aggregate demand and increasing the savings rates in line with a stable long-term level of support to investments and the economic growth.

## ENDNOTES

<sup>1</sup> Exports and investments fell by respectively 30.6 and 48.9 percent in quarterly terms. At the same time, imports fell by 36.4 percent whereas consumer spending grew by 1.4 percent on a quarterly basis.

<sup>2</sup> BRIC countries are Brazil, Russia, India and China.

<sup>3</sup> The fall in both categories was respectively 12.6 and 21.7 percent.

<sup>4</sup> In this context, the Euro and the US Dollar.

<sup>5</sup> The US dollar appreciated by approximately 13 percent against the Euro during the first half of the year in annual terms.

<sup>6</sup> The higher base effect, given that the primary commodities underwent a considerable price hike during the first half of 2008.

<sup>7</sup> Inflation distribution by months: 2.1, 1.8, 1.6, 1.9, 2.1, 2.3 (%)

<sup>8</sup> In Albania's case the Monetary Condition Index (MCI) is a weighted average of the difference of the base rate and the nominal effective exchange rate (NEER) against their corresponding values in a base period. Starting from the second quarter of 2009, the base period is December 2005. The MCI ratio is 1.82:1, i.e. the effect on demand of a 1.82 per cent depreciation of exchange rate can be offset by 1 percentage point increase in the interest rate. It's worth noting 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.

<sup>9</sup> The average of two measures (permanent exclusion and trimmed average).

<sup>10</sup> As of June and the second quarter of 2009 it was 6 and 3.7 percent respectively.

<sup>11</sup> The methodology of estimating the housing process index is based on the assumption that the prices that are listed on sale are the final transaction prices. The majority of the houses listed for sale are denominated in European currency. To estimate the index for the second quarter, two methods were followed. According to the first method, the prices in Euro are denominated in lek with the current exchange rate. The second method has the prices listed in Euro converted to the exchange rate of a year ago. This assumes that the seller has not taken into account the devaluation of lek in listing the house in Euros. We would like to emphasize that the survey covers only the city of Tirana.

<sup>12</sup> House selling price to rent ratio is the simplest indicator used to assess whether housing is overpriced, comparing the current to historical values of this ratio.

<sup>13</sup> Values in percent to GDP are calculated as ratios of cumulative data for the period Q2:2008-Q1:2009 to GDP.

<sup>14</sup> Nominal GDP refers to IMF estimates for nominal GDP in 2009: 1,129,000 million lek (PRGF, 6th review).

<sup>15</sup> Data on foreign trade for May 2009 are preliminary. The Bank of Albania reserves the right to review them, i.e. to reflect changes in these values at a later period.

<sup>16</sup> Unit value index for exports and imports, INSTAT.

<sup>17</sup> The other indicators do not have seasonality and are considered in their original form.

<sup>18</sup> Compared to the first quarter 2008, income fell by 13.9 percent and expenditures by 7.1 percent.

<sup>19</sup> These transfers amounted to EUR 213.4 million in Q1:2009 compared to EUR 242.9 million in the previous year.

<sup>20</sup> Their relative indicator in Q1:2009 is 10.5 percent. The value of the above mentioned ratio refers to cumulative data for the period Q2:2008- Q1:2009.

<sup>21</sup> FDI increased by 1.9 percentage point compared to the first quarter 2008.

<sup>22</sup> Six-month GDP according to IMF estimates.

<sup>23</sup> Values are obtained from the ratio of 6-month realization to 6-month GDP posted by the IMF in PRGF program.

<sup>24</sup> Ratios are built according to 6-month realization of each year, as a share of 6-month GDP of the respective year.

<sup>25</sup> Including a part of privatization proceeds of ARMO, OSSH and a part of AMC stocks, totalling ALL 20.8 billion.

<sup>26</sup> The bid to cover ratio came in at less than 1 for the first quarter of the year. Upon increased demand of second-tier banks for instruments issued by the government, this ratio resulted above



1 for the second quarter of the year.

<sup>27</sup> This figure refers to primary budget moving sum for July '08 - June '09.

<sup>28</sup>  $Y = GNP = C_d + I_d + G_d + EX$ ; where  $C_d$ : domestic consumption;  $I_d$ : domestic investment;  $G_d$ : government expenditure;  $EX$ : Exports – Imports

<sup>29</sup> Bulgaria, Rumania, Croatia, Montenegro, Serbia, Macedonia, Albania, Bosnia-Herzegovina

<sup>30</sup> Seasonal growth measures the quarterly growth of monetary indicator adjusted to annual terms.

<sup>31</sup> Excluding exchange rate effects.

<sup>32</sup> Loan portfolio analysis is based on the series excluding exchange rate effect, except when otherwise stated.

<sup>33</sup> Difference of actual credit balance from equilibrium level.

<sup>34</sup> Series of credit cleared seasonally from exchange rate movements.

<sup>35</sup> Compared to 35% in December 2008

<sup>36</sup> Mainly consequent to depreciation of the national currency against the main currencies.

<sup>37</sup> The reduction of foreign demand, the protectionist policies of many countries in response to global financial crisis, etc.

<sup>38</sup> Source: Ministry of Labor, Social Affairs and Equal Opportunities, May 2009.

<sup>39</sup> At the end of each quarter.

<sup>40</sup> The decision on the rise of wages applies to public sector employed persons.

<sup>41</sup> The Council of Ministers' decisions on the minimum wage became effected starting from 1 May 2009.

<sup>42</sup> Export price index analyzes the performance of producer prices of goods exclusively designated for export purposes.

<sup>43</sup> Calculated as the weighted average of consumer prices in Italy and Greece.

<sup>44</sup> Expectations of inflation and producer prices used by the Bank of Albania are measured based on the information provided by the surveys held with businesses, consumers and banks.

<sup>45</sup> Consumer inflation expectations are estimated by the Bank of Albania by quantifying qualitative expectations. The qualitative responses obtained from the consumer confidence survey are converted into quantitative measures of inflation expectations by using the adjusted probability method.

<sup>46</sup> Bid/cover ratio in bond auctions was higher than 1 on average.

<sup>47</sup> NEER – Nominal Effective Exchange rate, measured against both currencies according to an approximate share they have in foreign trade, EUR (80 per cent) and USD (20 per cent). A positive change of the NEER implies the appreciation of the lek.

<sup>48</sup> Measured as the quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.

<sup>49</sup> The financing of current account through foreign direct investment sustains the exchange rate stability.