Bank of Albania

MONETARY POLICY REPORT
2011 Q3

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C O N T E N T S

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C H A R T S

OBJECTIVE

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

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

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

Monetary Policy Report for 2011 Q3 was approved on 26 October 2011 by the Supervisory Council of the Bank of Albania. The economic analysis in this Report is based on the latest available statistical and qualitative data as at 18 October 2011.

I. FOREWORD BY THE GOVERNOR

The Albanian economy had an overall positive performance during 2011, in spite of an unfavourable external environment. Domestic economic activity posted growth and some of Albania's main macroeconomic and financial balances were controlled and further improved.

Nevertheless, the challenges we have been faced with have had their impact on the Albanian economy. More specifically, over the past two years, economic growth has been affected by a hesitating behaviour of economic agents towards consumption and investment. Similarly, risk reassessment in financial markets has been accompanied by added prudence and higher risk premia in domestic and foreign credit markets. Furthermore, high prices of oil, food and other products in world markets have led to increased import prices for the Albanian economy and subsequent strong inflationary pressures during the first half of the year. Finally, added attention of financial markets towards public finance has limited the opportunities for fiscal authorities to pursue stimulating policies. All these factors are reflected in economic growth rates, bringing them down to below the potential level and creating spare capacities in the economy. Moreover, these challenges we have been facing with have identified the need to continue with structural reforms and pursue prudent macroeconomic policies. Structural reforms at macro- and microeconomic level should be oriented towards enhancement of competitiveness of our labour force, products and services in the global markets. In addition, these reforms should aim at enhancing foreign interest in the Albanian economy as a business destination. Macroeconomic policies are facing a new reality at national, regional and international level. They should not, however, shift their focus away from safeguarding macroeconomic and financial stability. This stability controls long-term risk premia and is a prerequisite to promote sustainable investment in the economy.

The analysis of these problems and overcoming these challenges have been the focus of the work of the Bank of Albania throughout 2011.

Following, I will present a detailed overview of economic highlights focusing on the inflation performance and Bank of Albania's work to accomplish its mandate to maintain price stability.

Average annual inflation rate in 2011 Q3 was 3.2%, down by 0.9 percentage points compared to 2011 H1. Annual inflation pursued a declining trajectory even during the second quarter of the year, but it was stronger during the third quarter. This trajectory was mainly determined by the lower contribution of food inflation, as a result of price increase slowdown for these products in global markets. In addition to this factor, the increase of domestic agricultural products supply beyond the seasonality that characterises this period has led to reduced food inflation. Furthermore, this quarter evidenced the full elimination of the administered price increase effect recorded a year earlier.

In 2011, inflation was mainly affected by supply shocks, which are materialised in higher import prices. As expected, this effect was more moderate in the third quarter. Its downward dynamic was shaped mostly by more moderate growth rates of raw material and commodity prices in the global markets. Supply shocks were counterbalanced by downward pressures originating from aggregate demand. The Albanian economy continued to grow in the second and third quarters of the year; however, it continues to operate below its potential, which has conditioned the partial utilisation of production capacities and has prevented the creation of wage-inflation spirals. Furthermore, controlled expectations of economic agents on inflation have kept the second-round effects at minimum levels.

Public sector demand and external demand continued to support economic activity, although at a more moderate rate. Meanwhile, private sector demand had positive but slow growth rates. Private consumption growth rates remain contained, influenced by uncertainty about the future and hesitating consumer behaviour. Nonetheless, employment indicators improvement and increased aggregate disposable income suggest upward potential consumption during this period.

Private investments remain slow. Increasing external demand has supported the expansion of investment in the industry sector, but slow domestic demand has not favoured the increase of investment in services and construction sectors. Below-average capital utilisation rates, present almost across all the sectors of the economy, are expected to dictate low demand for investments in the near future as well.

Public sector demand stimulated economic growth this year, but its contribution has been declining after the first quarter. The performance of this component of aggregate demand has been dictated by the conduct of fiscal policy, which, although on the stimulating side for 2011, has been more prudent over the last two quarters. Budget deficit at the end of the first nine months of 2011 was ALL 30.7 billion, remaining almost unchanged for three consecutive months.

In GDP terms, it is estimated to be at 3.1%, or 0.5 percentage points higher than a year earlier. Budget deficit performance has been defined primarily by public spending slowdown, while public revenues retained their slow growth rates. Public spending and revenues growth rates at the end of 2011 Q3 were 3.5% and 1.0%, respectively.

External demand continued to support Albania's economic growth. In real terms, net export deficit in the second quarter narrowed compared to a year earlier, materialising in a positive contribution of this component to aggregate demand. The latest data on foreign trade suggest a similar trend for the third quarter as well. Average annual trade deficit in July and August narrowed by 0.8% as a result of higher exports and slight slowdown of imports' growth rate. Exports increased on average by 31.7% during July-August, triggered mainly by exports of processed goods and unprocessed raw material minerals. Imports marked an average annual growth rate of 8.2% in July-August 2011. Regardless of the positive developments, reduction of the current account deficit requires continued structural reforms to enhance domestic products competitiveness.

Monetary indicators confirm the assessments for contained inflationary pressures in the Albanian economy. Expansion of money supply is considered to comply with the economy's demand for real money. Annual M3 growth was 10.6% in July-August, retaining its rates noted during 2011. Private sector demand for monetary assets pursued the rising trend of the preceding months. Lending to the private sector was up by 12.6% in July and August, about 1.1 percentage points higher than the average rates recorded in the second quarter of the year. This growth relied primarily on private business demand for credit. Lending to households is also pursuing a rising trend. Annual growth rates of lending to households settled at 5.7% at end-August, from 1.5% at end-2010.

Bank of Albania analyses suggest that the moderate credit growth owes primarily to the lower demand by the economy. This position is confirmed by business surveys, which demonstrate a weak investment trend, as well as by the reduced number of credit applications to commercial banks. Against this setting, the banking system is liquid and well capitalised for financial intermediation activities. In response to the monetary policy of the Bank of Albania, credit interest rates have reached their all-time low. Nevertheless, the banking system has added its prudence as regards lending, with more critical assessment of business plans and tightened requirements for collateral.

This approach is a reaction to the insecurity about the economy in general or its specific sectors and reflects a more prudent development model of crediting and banking business. In the long run, it will yield a more sustainable growth for the Albanian economy and will guarantee a solid and reliable banking system.

Financial market developments in the third quarter reveal low liquidity and inflation premiums. Trade volume in the interbank market increased even further, while, in the presence of a good liquidity situation, interest rates in this market followed the lowering of the key interest rate and displayed low volatility. In respect of time lags in the monetary policy transmission mechanism, the lowering of interest rates is expected to be transmitted also in the deposit and credit markets. Treasury bond yields retained their rates during the second quarter, in the presence of moderate government demand for short-term funding.

Looking ahead, our estimations and projections suggest continued economic growth for the rest of the year. External demand is expected to support aggregate demand, although at slower rates compared to the first half of the year. Domestic demand performance remains pivotal to economic growth, while the contribution of public stimulus is expected to be even more moderate, as a result of the need to maintain fiscal indicators stability. Under these circumstances, private sector demand will condition the size and velocity of domestic demand recovery in the future. The performance of fundamental factors that define private sector demand suggests a potentially better performance of consumption and investments in the economy compared to what is estimated to have been materialised insofar.

Bank of Albania deems that, within the parameters of macro and microeconomic soundness, there is room for a more rapid growth of consumption and investments as well as for a more realistic behaviour of economic agents towards projections for the future. The Albanian economic outlook remains sound; development policies and further structural reforms will release new development potentials, which need to be explored attentively and far-sightedly by the private sector.

Analysing the factual and expected inflation performance, in September, the Bank of Albania eased further the monetary conditions, lowering the key interest rate by 0.25 percentage points to 5.00%. The easing of monetary conditions, in addition to maintaining price stability, enables a higher support to domestic demand.

In the absence of unexpected shocks, inflationary pressures appear to be downward in the medium-term horizon. The reduction of foreign price effects on inflation and the impact of the negative output gap make the inflationary pressures balance to remain controlled and downward over the monetary policy-relevant horizon. Inflation is expected to range at around our target in the medium run. It will be under the balanced influence of internal and external inflationary pressures. Aggregate demand is expected to remain below the economy's potential, thus carrying forward the negative output onto the upcoming period. Subsequently, demand-driven inflationary pressures will remain contained. Additionally, foreign price effect will continue to be present in consumer price performance and is expected to pursue its downward trend.

II. EXTERNAL ECONOMY

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

GLOBAL ECONOMY

The global economy grew at slower rates in the recent months. In industrialised countries, economic growth remained weak, due to lower aggregate demand expansion and high unemployment rate. Moreover, tensions created in financial markets related to the affordability of high public debt in many of these countries conditioned economic policies pursued by their governments leading to further economic recovery slowdown. In addition, temporary factors such as the natural disaster in Japan, price rise of some commodities at year-start and exports contraction in developing economies as a result of economic growth deceleration in advanced economies are reflected in the production cycles of these developing economies. Their economic performance is positive, but more contained. Inflationary pressures at global level are, overall, more pronounced in developing economies than in industrialised countries.

Table 1 Selected macroeconomic indicators (in %)

Countries	GDP change		Unemployment rate	Inflation rate	
	2011 Q2/ 2010 Q2	2011 Q2/ 2011 Q1	September 2011	September 2011/ August 2011	September 2011/ September 2010
USA	1.6	1.3	9.1[1]	0.4	3.8
Euro area	1.6	0.2	10.0	0.5	3.0
Germany	2.8	0.1	6.1	0.0	2.4
France	1.6	0.0	9.9	0.5	2.2
United Kingdom	0.7	0.2	8.11	0.6	4.5
Japan	-0.9	-0.3	4.7	0.0[2]	0.2[2]

Source: Eurostat, respective institutes of statistics
[1] Data for August.
[2] Data for July.

EURO AREA ECONOMY

Euro area economy continued to maintain positive growth rates during 2011 Q2, but its growth rate slowed down significantly compared to earlier periods. The y-o-y growth rate of about 1.6% in 2011 Q2 was lower than in 2011 Q1, mainly owing to declining private consumption and investments. Tightening fiscal measures by many euro area countries to cool off financial markets and restore the confidence of major economic agents about public debt affordability had a negative impact and economic growth is expected to slow down. Projections and indirect conjuncture indicators point to moderate growth rates over 2011 H2. These analyses reflect the economic growth slowdown in advanced economies, the downward trend of trade indicators, retail sales and confidence, as well as the concern of financial markets over the euro area countries sovereign debt. Inflationary pressures were up during these nine months, mainly due to higher energy products and raw material prices. Annual inflation in September 2011 reached 3.0%, or 0.5 percentage points higher than a month earlier. While stabilised, unemployment rate continued to be high during the first nine months of 2011. On the counterpart side, employment indicator for the second quarter was up 0.3% compared to the preceding period.

UNITED STATES ECONOMY

The latest available estimates on US economy for 2011 Q2 point to more positive values than 2011 Q1, although at slower rates compared to 2010. Gross Domestic Product in USA expanded 1.3%, compared to the first quarter and 1.6% compared to the corresponding period of a year earlier. The main contributors to this performance were increased consumer spending, investments and net exports. In a more detailed analysis, businesses, construction and foreign investments indicated growth during this quarter. Moreover, the overall continuity of unfavourable global economic conditions and the need to return to affordable values of government public debt, add to negative pressures on the US economy. Consumer confidence survey indices remain in low-rates territory, while the labour market does not show much optimism. Average unemployment rate for this quarter settled at 9.1%, or 0.5 percentage points lower y-o-y. Inflationary pressures were upward in these months, mainly subsequent to higher prices of food and energy products. Average annual inflation for the first eight months of 2011 was 3.0%, or about 1.4 percentage points higher, year-on-year.

BRIC ECONOMIES

BRIC economies continued their upward trend during 2011 Q2, albeit more moderately compared with 2011 Q1. According to the latest data published by the IMF in September this year, the annual growth rates for BRIC countries are revised downward, compared with the values published in June of the same year. Therefore, economic activity in the Chinese industrial sector in August was lower than in July. China is also undergoing slowdown of the labour force increase and added internal pressures to raise the average salary.

India continues to post high growth rates, second only to China in terms of economic growth among the Asian countries. In August, exports of goods recorded an annual growth of 44%.

The latest data from Russia indicate expansion of the economy in August, supported mostly by credit expansion, unemployment decline, average salary increase and expectations for the Russian rouble depreciation. Projections for economic growth in Brazil continue to remain threatened by the performance of advanced economies in Europe. The strengthening of the Brazilian real against the US dollar and consequent exports decline constitute the main causes of the weak performance of the Brazilian industry during the August-to-September period.

Inflationary pressures have remained high in BRIC countries and, as a result, their macroeconomic policies have focused on preventing overheating and reducing the inflation rates. Only in Brazil, in recent months, the central bank has raised the key interest rate five times. The inflation rate for September, compared with the previous month, was down 0.1 percentage points in India and China, whereas in Brazil it was equally higher.

Table 2 Selected macroeconomic indicators for BRIC countries (in %)

Countries	Annual GDP change			Annual inflation
	2011 Q1	2011 Q2	2011[1]	September 2011
Brazil	4.2	3.1	3.8	7.3
Russia	4.1	3.4	4.3	7.2
India	8.5	7.7	7.8	9.7
China	9.7	9.5	9.5	6.1

Source: IMF, OECD, respective institutes of statistics
1 IMF estimates, September 2011.

ECONOMIES IN THE REGION

In 2011 Q2, the economy of the countries in the region highlighted uneven annual growth rates. In Greece, the annual growth rates were negative. In Italy, growth was moderate, while the other countries posted positive growth rates. During 2011 Q2, the Greek economy narrowed by 7.3% y-o-y, driven mainly by downward consumer spending and aggregate investments. In Italy, in Q2, the economy expanded 0.8% y-o-y, driven by higher value added of the industry and services. On the other hand, Italy is facing with tensions in financial markets on weakened market confidence in its public debt affordability, which has led to overall higher borrowing costs for the government and businesses. In order to achieve a long-term stability for the country's debt, the Italian government introduced a fiscal package, which is expected to reduce its fiscal deficit by about EUR 45 billion by 2014. A different picture is in Turkey and the Former Yugoslav Republic of Macedonia, which recorded accelerated growth rates during 2011 Q2. Thus, Turkish economy grew about 8.8% y-o-y. Economic growth in this country relied on internal demand, industrial production and investments. In FYROM, the accelerated increase of consumer spending and aggregate investment led to an economic growth by about 5.3% y-o-y.

Unemployment rates were downward in Italy and Croatia. Annual inflation was up in Greece and Italy and down in Turkey and Former Yugoslav Republic of Macedonia.

Table 3 Economic data for countries in the region (in %)

Countries	GDP Change	Annual inflation	Unemployment rate
	2011 Q2	September 2011	August 2011
Italy	0.8	3.0	7.9
Greece	-7.3	3.1	16.6[3]
FYROM	5.3	3.4	31.2[1]
Serbia	2.2	9.3	22.2[4]
Croatia	0.8	2.2	13.7
Turkey	8.8	6.2	9.4[5]
Kosovo	5.5[2]	4.8	:
Albania	3.41	2.8	13.4[1]

Source: Respective institutes of statistics, Eurostat, EcoFin, IMF

[1] Data on 2011 Q1.

[2] IMF's projections for 2011.

[3] Data for May.

[4] Data for April.

[5] Data for 2011 Q2.

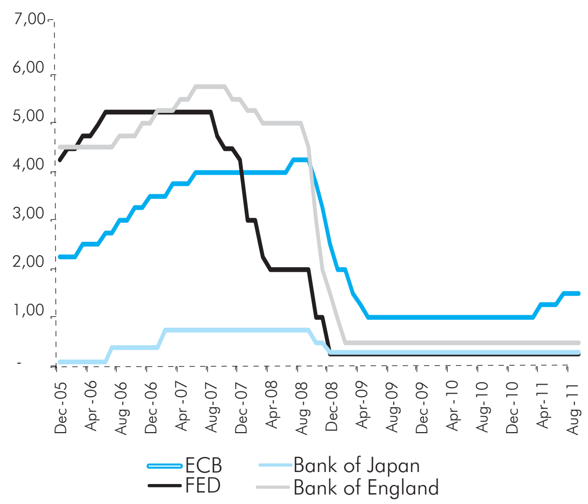
: Unavailable data.

II.2 INTEREST RATE DECISIONS AND FINANCIAL MARKETS

Major central banks left their key interest rates unchanged, except for the European Central Bank, which, in July, decided to raise the key interest rate by 0.25 percentage points, up to 1.5%. This decision was made to subdue inflationary pressures estimated as upward in the euro area countries and keep economic agents' expectations anchored around ECB's 2% target.

Central banks kept their key interest rates unchanged: ECB at 1.5%, Federal Reserve at 0-0.25%, Bank of England at 0.5% and Bank of Japan at 0-0.1%. Except for the European Central Bank, which raised the key interest rate twice during this year, the last rate change in major central banks was more than two years ago.

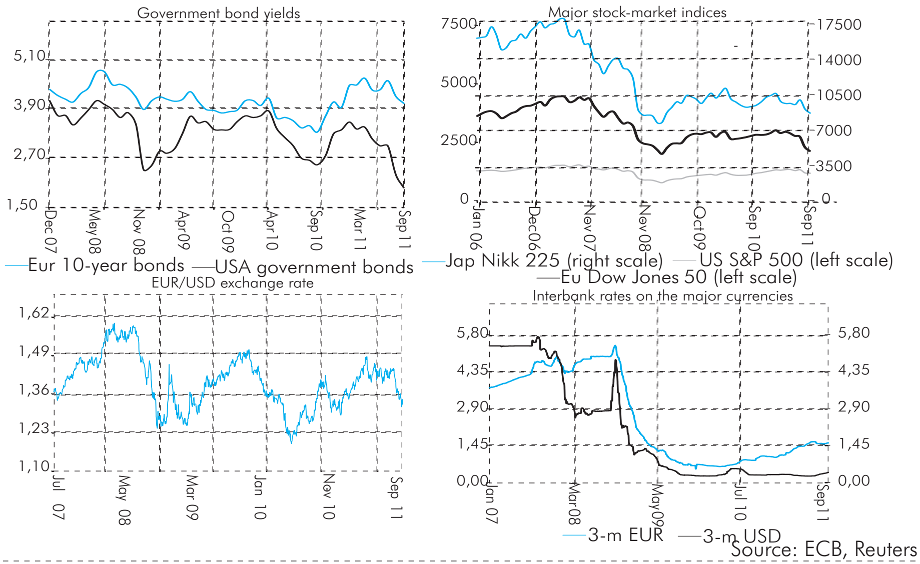
Chart 1 Key interest rates (in %)



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

Interest rates in international financial markets demonstrated moderate increase during this quarter. In euro area money markets, Euribor, after its upward rates in June and July, dropped slightly over the last months, mainly in 6- and 12-month rates. Libor rates on the US dollar pursued an upward trend. Financial markets have experienced heightened uncertainty by many agents affected by non-assuring data of the public balance sheets of many euro area countries. This climate has led to channelling the activity towards instruments deemed as more secure, consequently, leading to higher premia for low-rated securities by the rating agencies.

Chart 2 Exchange rate and selected financial indicators in international



Source: ECB, Reuters

In the bond markets, bond yields for US and other European governments rated as positive (Germany, France etc.) were downward while bond yields for countries rated as problematic with their public balance sheets (Greece, Italy, Spain, Portugal) continued their upward trend. The main indicators of stock markets were characterised by higher volatility during these months. The decline in these indicators was mainly influenced by the concern of market agents over the sovereign debt and potential implications on the financial sector situation and the overall business climate.

Euribor rates of 1- and 3-month maturity averaged in September 1.35% and 1.54%, up 0.07 and 0.06 percentage points from end-2011 Q2. Interest rates of 6- and 12-month maturity dropped 0.01 and 0.07 percentage points from this period down to 1.74% and 2.07%. Libor 3-month interest rate for the US dollar increased 0.10 percentage points up to 0.35%.

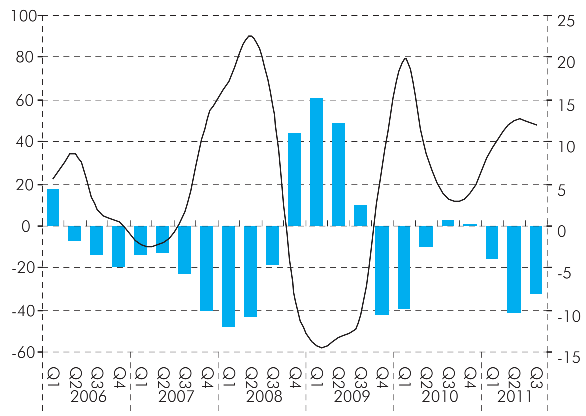
In foreign exchange markets, during 2011 Q3, the euro depreciated against the US dollar, although y-o-y it remains in positive territory. In addition to the US dollar, the euro during this period depreciated against the British pound and the Japanese yen. The average exchange rate in this quarter was 1 euro for 1.412 US dollars or 1.83% down from the second quarter. In September, 1 euro was exchanged for 1.377 US dollars, depreciating 4.0% from August 2011.

OIL AND PRIMARY COMMODITY PRICES

During 2011 Q3, the average oil price per barrel in the international market dropped lightly. Hence, one barrel was sold for USD 113 on average, down by about 3.4% compared to the previous quarter. Year-on-year, oil price continued to maintain its upward trend, increasing by 47.6%. While prices in the oil market increased in early September, prices were downward in the second part of this month, owing to the strengthening of the US dollar against the euro and some of the main currencies, as well as the downward revision of the economic growth for OECD and BRIC countries.

Global oil demand in 2011 Q3 year-on-year increased by 0.36%, driven mainly by increased demand in China and emerging economies. Global oil supply was estimated as increasing y-o-y during the period under review. In September, while oil production quota by OPEC[1] countries was estimated as downward, global oil supply was higher than in August, as a result of higher production in North America and Russia.

Chart 3 Annual change of international oil price and Nominal Major Currencies Dollar Index



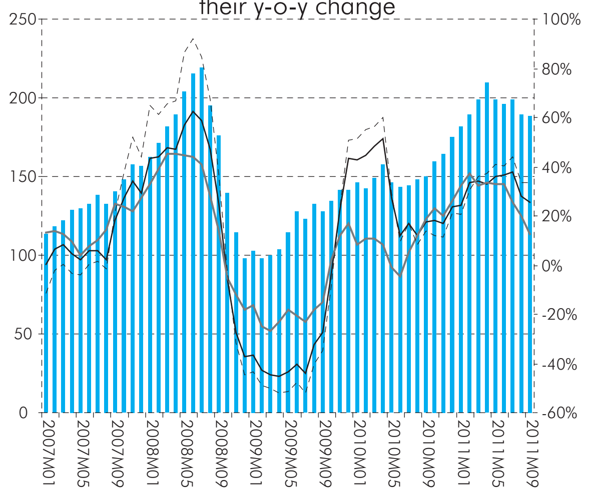
Source: Fed, EIA

PRIMARY COMMODITY PRICES

After the accelerated upward rates during 2011 H1, in the third quarter, major price indices recorded weaker growth rates. Price rise slowdown was driven by the economic outlook uncertainty under the circumstances of high sovereign debt in advanced economies, thus, leading to subdued demand for these commodities.

In the third quarter, the Commodity Price Index posted an annual growth of 30%, while, compared with the second quarter, it curbed by about 4%. During the period under review, Food Price Index annual growth was 19%, while on quarterly terms, it dropped by 3.9%. Fuel Price Index pursued the trend of the other two indices, increasing 37% annually and shrinking 4.8% quarterly.

Chart 4 Price indices by primary commodities and their y-o-y change



Source: IMF, EIA

[1] *Reduction of oil production by Nigeria and Saudi Arabia conditioned the reduction of total production quota by OPEC countries.*

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJECTIVE

In 2011 Q3, annual inflation was 3.2% with an accelerated downward trend compared with year-start projections. This trend was determined primarily by a more moderate contribution of imported inflation to headline inflation, as a result of slower commodity price increase in foreign markets and stable exchange rate. Domestic demand produced relatively weak inflationary pressures, due to the presence of the inherited negative output gap and modest utilisation of production capacities in the economy.

Based on medium-term analyses and projections, the Supervisory Council of the Bank of Albania, at end-September 2011, reduced the key interest rate by 0.25 percentage points, down to 5.0%, to stimulate demand and economic activity.

In the medium run, baseline inflation projections are expected to range around the Bank of Albania target, while they represent a high sensitivity to uncertainties on external developments and relevant implications on Albania's economy. Bank of Albania's timely monetary policy decisions, structural reforms' efficiency to promote domestic economic activity as well as market agents' readiness to correct their economic attitude will all contribute to subsiding consumer price volatility.

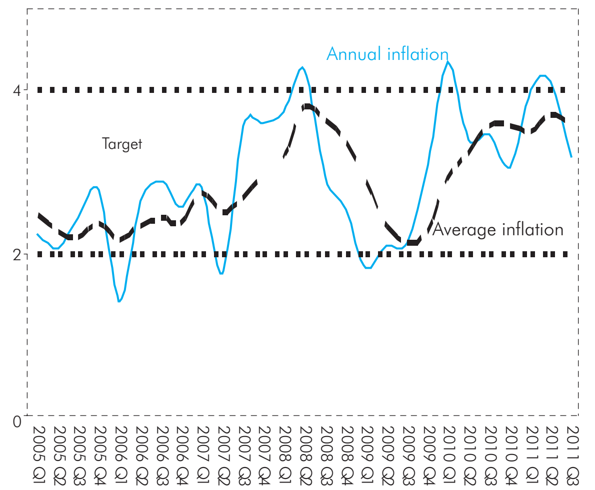
III.1 INFLATION AND MONETARY POLICY

Annual core inflation in 2011 Q3 was 3.2%, close to the medium-term target of the Bank of Albania. The downward trend of annual inflation, which had started in the second quarter, was more apparent in July-to-September 2011. Expected diminished contributions of goods and services with administered prices and the sub-item of Bread and cereals to headline inflation was accompanied by a change in the seasonal behaviour of fresh agricultural product prices, mainly in August and September[2]. These developments continued to balance the inflationary pressures generated by the relatively high raw material prices in the global markets. While still high during the third quarter, their rising rates weakened. Supported by medium-term exchange rate stability, pressures from imported inflation were more moderate compared with the first half of the year.

2 *Fruits and vegetables constitute about 9% of the CPI basket. Last year, this sub-item posted an average annual and quarterly inflation of 2.7% and -12.8%, in 2011 Q3, the respective inflation rates were 4.1% and 16.8%. Over the years, relevant inflation volatility for Q3 (especially for August and September) is estimated to be high, thus not representing a clear seasonality.*

On average, inflation remained above the central target, due to relatively high inflationary pressures extended over a one-year period[3]. Deceleration signals of inflationary pressures were also conveyed by developments in core inflation and non-tradable inflation during this quarter. In addition to mitigating longer-term inflationary pressures, higher market supply with domestic products and the exchange rate trend contributed to mitigating extra-economic and short-term inflationary pressures.

Chart 5 Annual inflation and moving average (in %)



Source: INSTAT and Bank of Albania

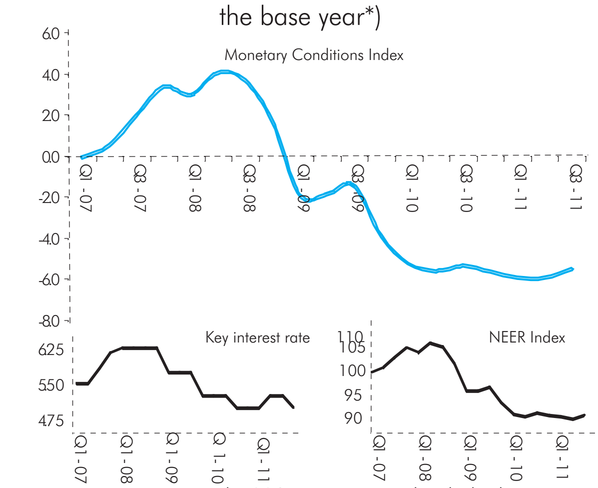
Inflationary pressures from the domestic demand-side are estimated to have been moderate during the first nine months of 2011. The following period is assessed not to have had added inflationary pressures from the domestic demand.

On average, the outlook is that the output gap will continue to be negative. In 2011 Q3, production capacity utilisation was below its historical average. These developments are expected to flatten potential inflationary pressures that may be produced by risks mainly related to misbalances in foreign economies, Albania's main trading partners as well as raw material prices in global markets. Exchange rate developments are related to the correction velocity of external sector balances. Moreover, decisions on administered prices and those that accompany fiscal adjustments are considered important for Albania's inflation outlook. While duly analysing risk signals, the monetary policy will aim to maintain the inflation stable in the medium run.

With achieving and maintaining price stability as its core objective, monetary policy has responded in order to maintain the inflationary expectations anchored around Bank of Albania's medium-term inflation target.

Although in the third quarter the Monetary Conditions Index shows a shift on the tightening side, overall it remains in easing territory, pointing out that monetary conditions accommodated economic activity during 2011. The Bank of Albania has been present in the interbank market by injecting the necessary liquidity through operations in the open market and ensuring low pressures for liquidity in the banking system. The key interest rate was kept unchanged in the third quarter[4]. The nominal

Chart 6 Monetary Conditions Index (MCI, change on the base year*)



*The MCI is constructed with the key interest rate and the nominal effective exchange rate as its components. In this series, an increase in NEER implies the appreciation of the exchange rate. An increase in the MCI implies a tightening of monetary conditions. monetare. Source: Bank of Albania

[3] *Average annual inflation for January-to-September 2011 was 3.8%. The moving average, a measurement that signals the trend of an index, flattening in part the short-term volatility, reached 3.6% in 2011 Q3, from 3.7% in the previous quarter.*

[4] *The key interest rate was last changed (reduced by 0.25 percentage points) on 29 September 2011.*

effective exchange rate appreciated slightly, thus affecting the trend of the Monetary Conditions Index.

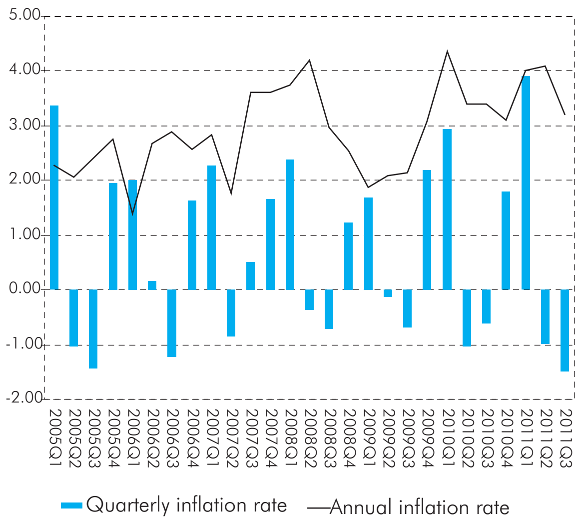
At the end of September, the Bank of Albania decided to reduce the key interest rate by 0.25 percentage points down to 5.00%. Under falling external inflationary pressures, this decision aimed at further easing lending standards to the economy and stimulating private consumption and investments. In concert with the tendency to tighten fiscal policy in the future, the monetary stimulus is expected to support domestic demand in the short term without affecting the range of our medium-term inflation target.

III.2 INFLATION BY ITEMS

Annual inflation, in 2011 Q3, was 3.2% or 0.9 percentage points down from 2011 H1. In June, it fell back to within the tolerance band of 2%-4%, while in the third quarter, it settled at lower rates than the central target. The downward inflation trend was verified chiefly over the last two months of this quarter, when it dropped to below the Bank of Albania target of 3%. In August and September, consumer prices in monthly terms increased 0.3% and 0.4%, clearly less than the increase of a year earlier[5], a development that led to pursuing a relatively rapid downward trend.

84% of the annual headline inflation in 2011 Q3 was formed by the contribution of Processed foods and Non-food consumer goods. Other significant items to the formation of inflation, such as Administered prices and Unprocessed foods did not contribute almost at all to 2011 Q3 headline inflation. This was primarily due to complete cancelling out of the sequential price rise effect for some administered price goods[6], as well as the fall, beyond the seasonal effect, of prices for some daily consumption goods. In line with forecasts, August 2011 marked the beginning of the downward contribution of Bread and cereals to headline inflation, while the contribution of other basket items remained almost unchanged.

Chart 7 Annual and quarterly inflation rates (in %)



Source: INSTAT and Bank of Albania

Inflation in Albania, albeit at more moderate rates than before, continued to be affected negatively by supply shocks, which were counterbalanced in part by the trend of some unprocessed foods prices and the cancelling out of the price rise effect of some goods and services during 2010.

In this quarter, the highest fall in the inflation rate was in Processed foods. The contribution of Processed foods to the headline inflation rate, in

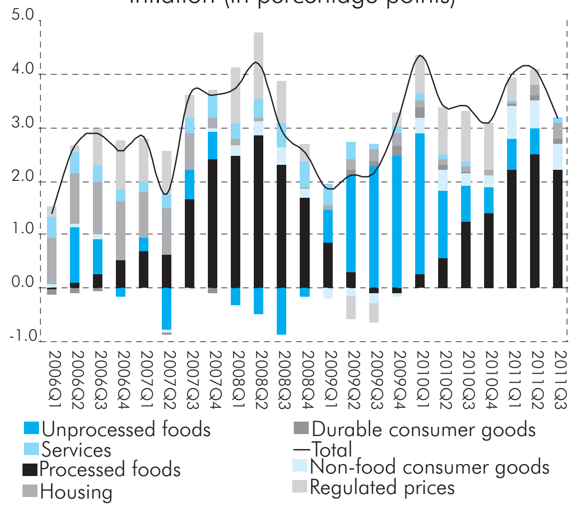
[5] *A year ago, during these two months, the monthly increase was 0.8% and 0.7%.*

[6] *This includes the cancelling out of the price rise effect of electricity, potable water and hospitalisation services in 2010.*

September 2011, reached the lowest level of the nine-month period (1.8 percentage points), while in the January-to-July period, it averaged 2.4 percentage points. The main contributor in August and September was the elimination of the first price rise of Bread and cereals, whose contribution to annual headline inflation was reduced by 0.3 percentage points. In spite of the above-mentioned developments, this item's inflation, given the conjuncture of basic product prices in global markets, is and will continue to determine[7] the annual inflation rates in the period ahead.

Moreover, Non-food consumer goods retained its high contribution to inflation. Determining factors of this phenomenon during this year for this item relate to oil price increase in global markets as well as medicine prices[8]. Subsequently, the contribution of this item during this quarter to the formation of headline inflation exceeded the contribution of Unprocessed foods. In addition, the prolongation of the action of oil price rise[9], as the summer ends, would increase the potential materialisation of second-round shocks on consumer prices over the subsequent period.

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



Source: INSTAT and Bank of Albania's estimates

*Table 4 Annual contribution of main items to annual inflation (in percentage points)**

	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11	Q2-11	Q3-11
Processed foods	-0.1	-0.1	0.3	0.6	1.1	1.4	2.2	2.5	2.2
Bread and cereals	-0.1	-0.3	-0.2	-0.1	0.1	0.4	0.7	1.0	0.7
Alcoholic beverages and tobacco	0.1	0.2	0.1	0.2	0.2	0.2	0.5	0.4	0.4
Unprocessed foods	2.3	2.5	2.6	1.3	0.9	0.5	0.6	0.5	0.0
Fruits	0.5	0.6	0.2	0.1	0.3	0.1	0.2	0.4	0.2
Vegetables	0.9	1.0	2.0	1.5	0.1	-0.7	0.1	-0.4	-0.6
Services	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1
Administered prices	-0.4	0.3	0.7	0.9	1.0	0.9	0.4	0.3	0.0
Fuels and energy	0.0	-0.1	0.4	0.4	0.4	0.4	0.2	0.3	0.2
Housing	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.3
Non-food consumer goods	-0.2	-0.1	0.3	0.4	0.3	0.2	0.6	0.5	0.5
Durable consumer goods	0.1	0.2	0.2	0.1	0.0	0.0	0.0	0.1	0.1
Consumer Price Index (y-o-y, %)	2.1	3.1	4.3	3.4	3.4	3.1	4.0	4.1	3.2

Source: INSTAT, Bank of Albania

Unprocessed foods prices dropped further annually, thus recording different inflation rates compared with a year earlier. Average inflation in this quarter

7 *The contribution of this category (2.2 percentage points) continues to form about 70% of headline inflation (3.2%).*

8 *While for most of the last 10 years, the average contribution of this item to headline inflation ranged 0.1-0.2 percentage points, during January-September 2011, it fluctuated around a higher range of 0.5-0.6 percentage points.*

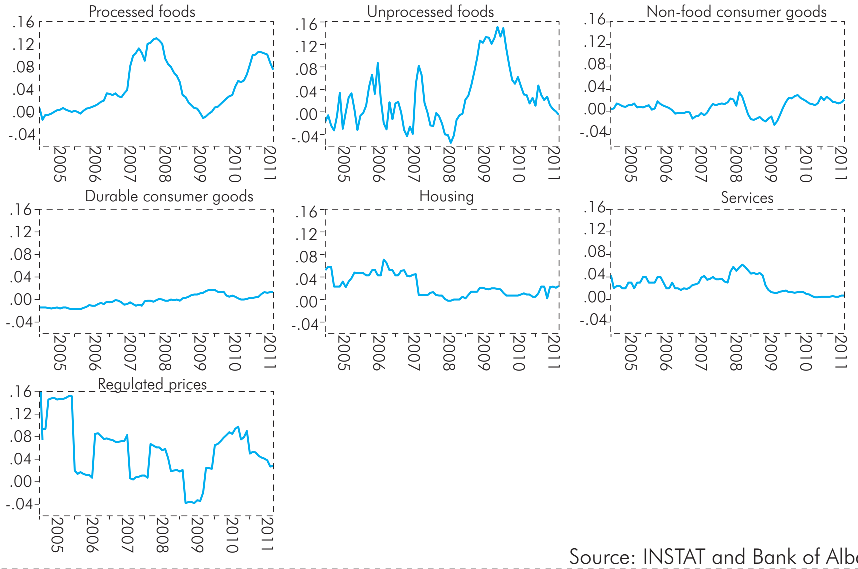
9 *In September, oil price rose following the introduction of added ALL 5 tax per litre.*

was 0.03%, from 4.6% a year earlier. In this last month, this item's annual inflation was negative (-0.5%) contributing to a decline in headline inflation by 0.1 percentage points. The strong downward seasonal behaviour of prices for these goods during the third quarter pushed the inflation trajectory downward by some percentage points. This item contributed to the headline inflation rate decline by 0.5 percentage points compared to the previous quarter, thus compensating for the high contribution of Processed foods prices.

Administered price goods had a quasi-inexistent contribution to headline inflation following the elimination of the latest price rise effects in this item during 2010 (potable water and some hospitalisation services prices). This category contributed to headline inflation curbing by 0.3 percentage points compared to the previous quarter.

Other items continue to have a low impact on headline inflation. In particular, Services contributed only to a small degree to inflation formation, although historically, during summer, its influence has been higher.

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



Source: INSTAT and Bank of Albania

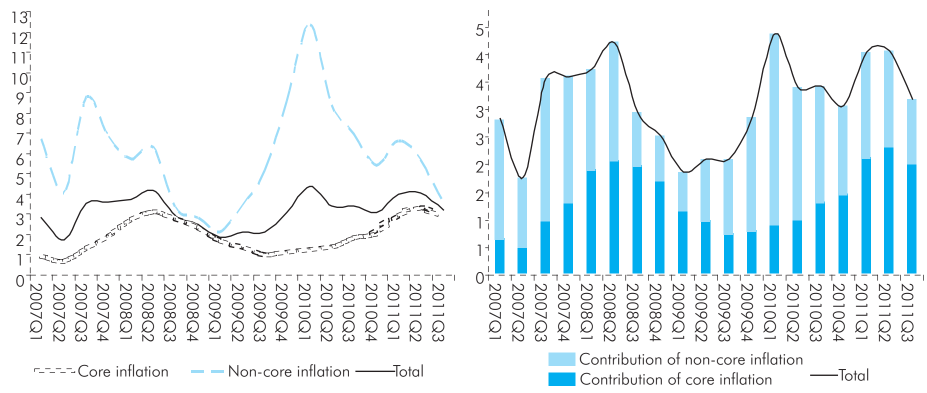
III.3 MAIN INFLATION TRENDS

Annual core inflation[10], in 2011 Q3 was 3%, which is lower than the all-time high reached in the preceding quarter[11]. The downward trend resulted more gradual than that of headline inflation, posting for each month of the quarter 3.3%, 2.9% and 2.9%, respectively. Core inflation was reduced as a result of the elimination of the first shock on of Bread and cereals prices in August of last year. Moreover, other price indices of the sub-basket on which core inflation is measured, remained high, almost at the same levels as in the first half of the year. Therefore, core inflation for the quarter under review was about 1.0 percentage points higher than a year earlier, forming about 63.3% of the annual headline inflation.

[10] *Average of two measurements (permanent exclusion and trimmed mean).*
[11] *In Q2, annual core inflation was 3.4%.*

Non-core inflation, which was 3.5% year-on-year, played an important role for the normalisation of headline inflation during 2011 Q3. Non-core inflation pursued a faster downward trend than core inflation, reaching, in September 2011, one of the lowest historical values of the series (2.6%). Short-term price fluctuations were smoothed significantly due to the stable exchange rate, full elimination of administered price rise effect and the agricultural products price trend beyond seasonality. Hence, non-core inflation contributed only by 1.2 percentage points to the formation of headline inflation.

Chart 10 Annual core and non-core inflation (left) and their respective contributions (right)



Source: INSTAT and Bank of Albania

The above structure of inflationary pressures formation in 2011 Q3 underlines a more persistent nature of the long-term component of inflation. Likewise, a relative convergence of core inflation towards the long-term average of headline inflation is evidenced[12].

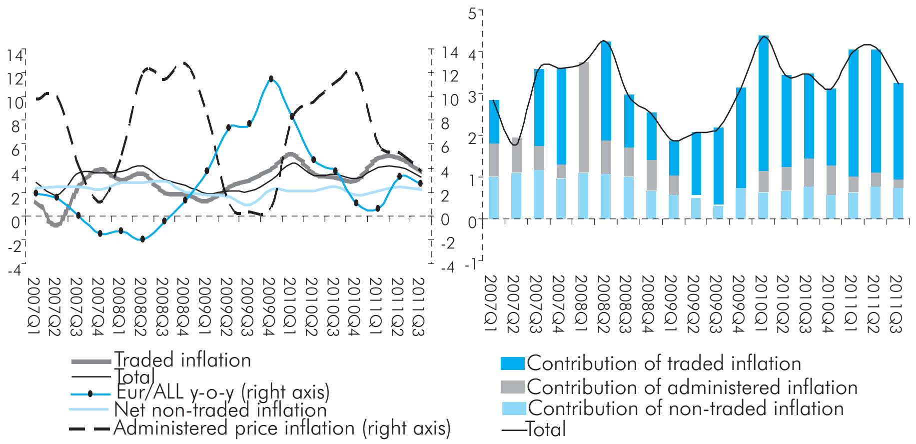
Inflationary pressures originating from inside and outside the economy during 2011 Q3 were downward. This behaviour materialised in more moderate values of annual inflation of tradable goods, net non-tradable and administered prices of the CPI basket.

Annual traded inflation of the CPI basked was 3.7% in the third quarter. Its downward trend was determined mostly by the more moderate price rise rates for raw materials and primary commodities in global markets. Although foreign prices remained high during July-September 2011, their rising rates were more contained than relevant projections made by international organisations in the spring of the current year (IMF). These developments were favoured by the stability of the exchange rate over time in the internal foreign exchange market and the added supply of the market with domestic products. The annual contribution of traded inflation to headline inflation was about 73%, comparable to that of the previous quarter.

12 *Headline inflation for September 2001-September 2011 was about 3%. The average of the long-term component is below this value, while for certain periods, including 2011 Q3, it ranges at around 3%. Above-described developments rely on actual measurements of core inflation.*

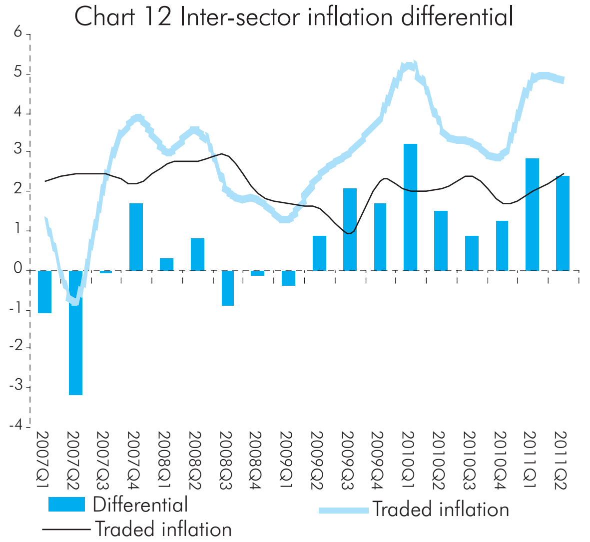
Annual net non-tradable inflation[13] of the CPI basket, for the quarter under review was 2.2%, close to that of the first half of the year and the average of the last five years. It contributed by about 23% to headline inflation formation in this quarter. On the other hand, its values do not indicate added first and second–round chain effects, on service prices. This conclusion is supported also by the deceleration of upward inflationary expectations of the market agents.

Chart 11 Annual inflation by sectors (left) and respective contributions (right)



Source: INSTAT and Bank of Albania

Chart 12 Inter-sector inflation differential



Source: INSTAT and Bank of Albania

In response to inter-sector consumer price developments, inflation differential between the tradable goods and service sectors narrowed in 2011 Q3, reaching 1.5 percentage points[14].

In the third quarter, the annual contribution of imported inflation to headline inflation is estimated at 50%, pointing to the establishment of a balance between inflationary pressures on consumer prices from outside and inside the economy.

13 *Excluding the effect of administered prices (electricity, water and hospital services) volatility.*

14 *The relevant differential indicator of inflation/contributions is a quantitative approximation of imported inflation/inflationary pressures intensity by this factor on the economy. It includes the combined effect of foreign inflation, generated by imports from main trading partners, with the exchange rate effect. This estimate is based on the meaning of the differential between prices of goods (more exposed to foreign competition and exchange rate volatility) and services (whose prices are set mainly in the domestic market). The latter do not exclude the chain effects transmitted from raw material prices to CPI basket services. The indicator of inflation differential and of relevant contributions assumes that the portion of non-traded inflation, net, is part of traded inflation. Calculating the difference, price-setting effects in the domestic market are excluded from traded inflation. As such, it informs on the foreign price impact, combined with that of the exchange rate, on headline inflation.*

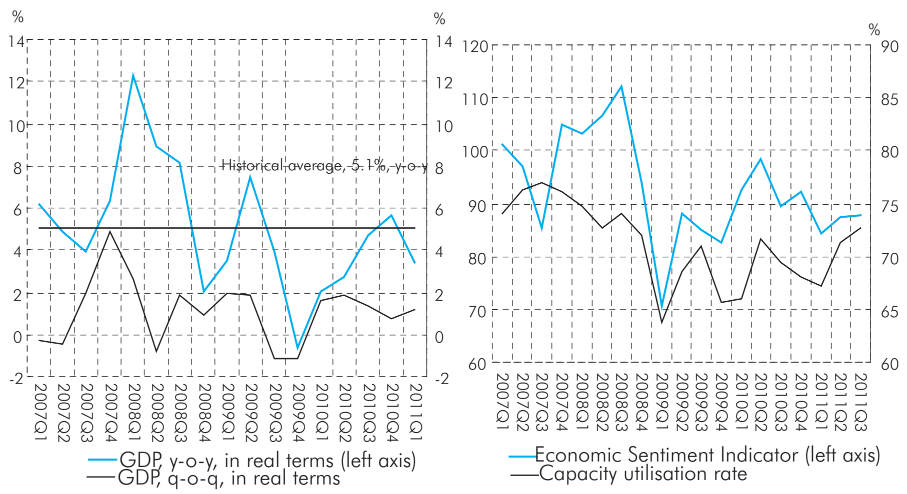
IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Gross Domestic Product for 2011 Q1 grew 3.4% year-on-year, supported primarily by the industry and, to a lesser extent, by services, construction, and agriculture sectors. On the demand side, economic growth was driven mainly by public spending and investment and foreign demand, while private sector investment and consumption remained slow. Although data on the gross domestic product for 2011 Q2 are not available, the dynamic of confidence indices signals a gradual improvement of economic activity in the second and third quarters.

Gross domestic product expanded 3.4% year-on-year in 2011 Q1, decelerating somehow the annual growth posted during the last two quarters of 2010. Confidence indices, as the latest available data for the economy, suggest the domestic economy improvement in the second and third quarters. However, economic growth is projected to be below its potential, conditioned by the sluggish increase of domestic and foreign demand and dampening of fiscal stimulus. In the upcoming periods, domestic demand is expected to play the main role in boosting aggregate demand.

Chart 13 GDP growth (annual and quarterly changes, left); Economic Sentiment Indicator and Capacity Utilization rate (right)

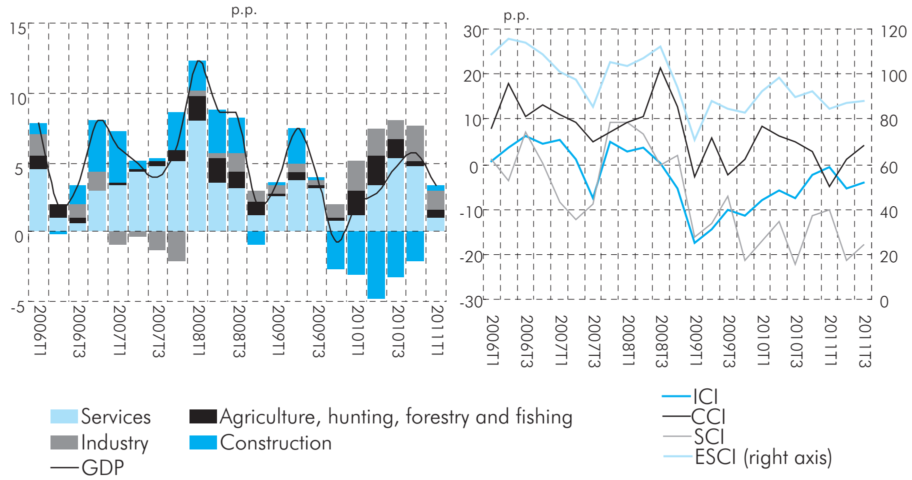


Source: INSTAT and Bank of Albania

OUTPUT BY SECTORS

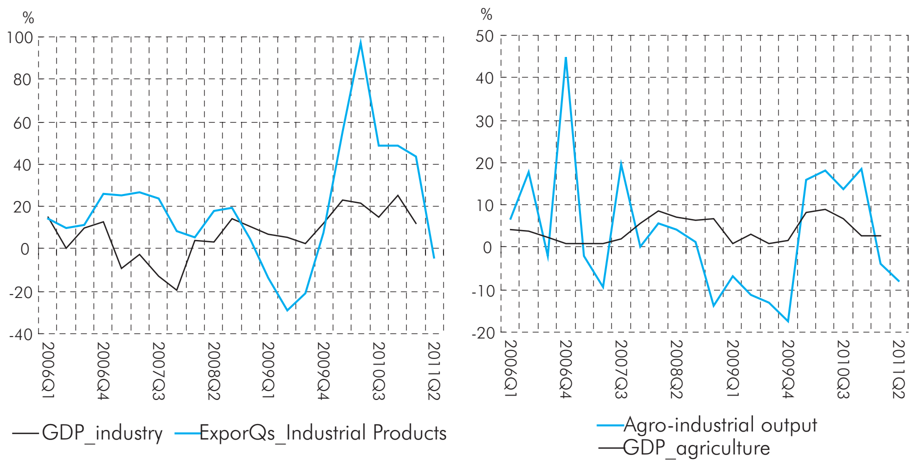
Domestic output by sectors in 2011 Q2 may not be fully analysed in the absence of detailed data on gross domestic product performance[15]. The Economic Sentiment Indicator signals a slight improvement of internal activity in the second and third quarters, q-o-q, albeit settling at around 8.6 percentage points, which is lower than the long-term historic average. Over these two quarters, survey data suggest that the activity generated by services had a positive impact on the performance of our economy.

Chart 14 Contribution of sectors to annual GDP performance (in percentage points, left); Economic Sentiment Indicator and Confidence Index of industry, construction and services (right)



Source: INSTAT and Bank of Albania

Chart 15 GDP for industry sector and exports for industrial products (annual change, left); GDP for agriculture and agro-industrial production (annual change, right)



Source: INSTAT, Bank of Albania, MAFCP

On the other hand, confidence indices in industry and construction did not reveal a consistent trend over the two quarters. In the second quarter, the production sector resulted with a slower performance than in the first quarter, with worse performance by the construction sector. Lower revenues from the

15 *A comprehensive analysis of gross domestic product by sectors in 2011 Q1 is reflected in the Monetary Policy Statement for 2011 H1.*

VAT collected from the construction activity in the first five months of the year[16] and shrinking of foreign demand[17] for industrial products, sustain somehow the signalled performance of the production sector in the second quarter.

In the third quarter, according to confidence indices, the industrial and construction sectors improved compared to the previous quarter. Indirect quantitative indicators – annual growth of industrial exports by 34% during July-August, annual growth of tax revenues of the production sector by 52% and, particularly, of VAT revenues by 3% for the first seven months of 2011[18] - confirm the trend of the overall qualitative data in the production sector.

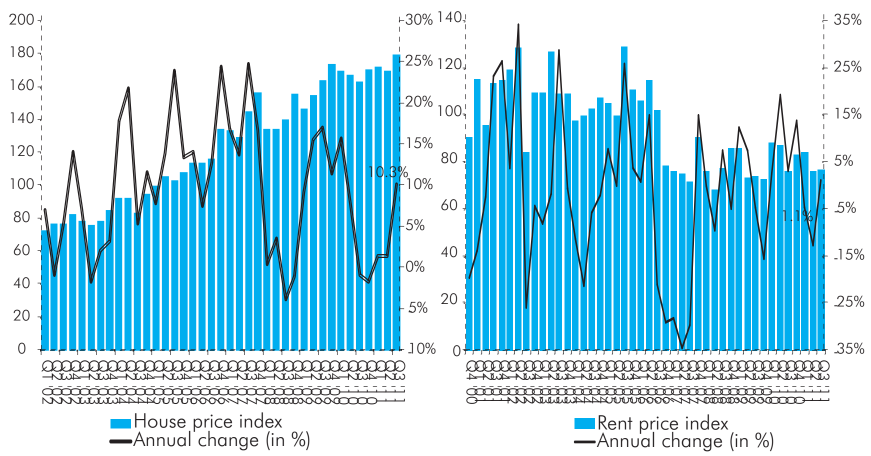
16 *Referring to publications of monthly fiscal reports by the Ministry of Finance.*
17 *Referring to exports performance on main industrial products in the local currency and deflated with the consumer price index.*
18 *Referring to publications of monthly fiscal reports by the Ministry of Finance.*

Box 1 House and rent prices in Tirana

House price index hiked notably in 2011. The annual nominal change of the house price index increased by about 10.3% in 2011 Q3, or 8.7 percentage points higher than in 2011 Q2. Deflated by the consumer price index, the real annual change in this quarter is 6.9%.*

House prices in 2011 Q3 were affected by the contracted supply in urban areas. In recent years, the number of construction permits in Tirana has been low. Nevertheless, the latest data on 2011 Q2 indicate that the number of housing construction permits has continued to grow. The improvement of this index for three consecutive quarters signals an increase of future house supply. On the other hand, the positive growth of house purchase lending during 2011 demonstrates increased demand, which may have affected the price rise in 2011 Q3. However, the latest results from the lending survey reveal that standards for house purchase lending to households, after an easing trend in 2011 H1, tightened again during 2011 Q3.

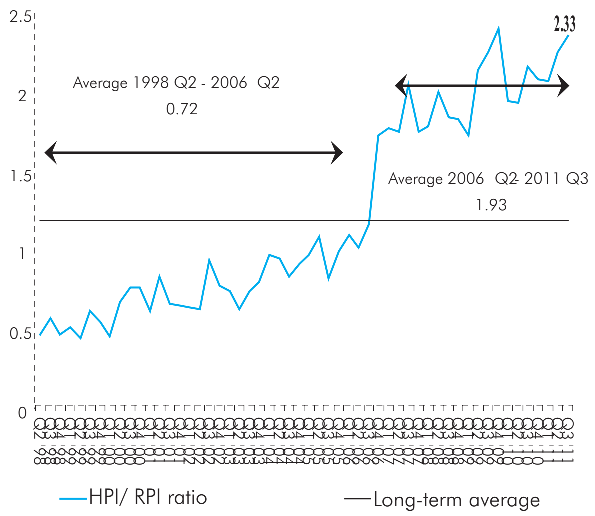
Chart 16 House price index and rent price index and annual changes in percentage



Source: Bank of Albania

During 2011 Q3, house rent index (HRI) for Tirana marked a slow increase by about 1.1% in annual nominal terms. This increase, albeit low, comes after the constant

Chart 17 Price-to-rent ratio



Source: Bank of Albania.

drop for two quarters in this index. In real annual terms, HRI dropped by about 2.1%. Compared to the previous quarter, the house rent index was up about 0.8% in nominal terms and about 2.3% in real terms.

The latest developments in the house market reveal that their selling price continues to be higher compared to renting prices, according to the analysis of the price-to-rent ratio. This ratio was 2.3, about 4.8%, higher compared to the previous quarter and about 9.1% higher than the same quarter a year earlier. During 2011 Q3, this ratio continued to remain above its historic trend.

**House and rent prices indices are built only for Tirana*

IV.2 AGGREGATE DEMAND COMPONENTS

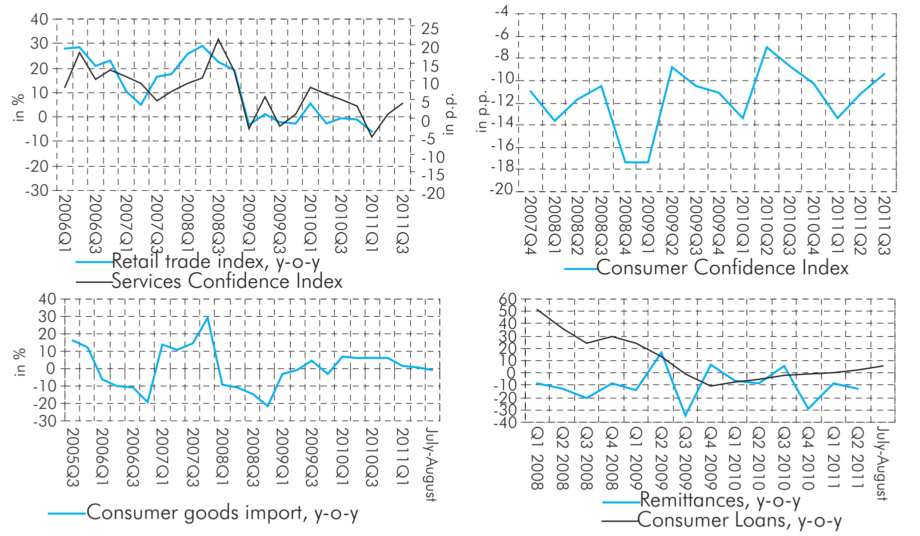
PRIVATE CONSUMPTION

Indirect available data on private consumption suggest that it continued to provide low contribution to aggregate demand growth. Quantitative indicators, used as proxies for private consumption in the economy, showed decelerated growth rates in the second quarter. More concretely, the import of consumer goods slowed its increase to 0.9% in 2011 Q2 following the 1.7% increase in 2011 Q1.

In 2011 Q2, private consumption financing was sustained by upward real disposable income. In the absence of the average wage index in the economy for 2011 Q2, data from personal income tax indicate an increase compared to the previous year. Along the same lines, consumer loans confirmed the improving trend that had started at end-2010, up year-on-year by about 2.5% in 2011 Q2. Consumption financing was sustained less by remittances, which, following their drop by 8.2% in 2011 Q1, fell 13.2% in 2011 Q2. Whilst consumer confidence improved during 2011 Q3, surveys data suggest that the uncertainty about the economic and financial situation has affected the existing high saving tendency in 2011 Q2. The high level of household time deposits suggests their continued added prudence as regards the consumption behaviour.

The signals received from partial data on 2011 Q3 are unclear and suggest a low contribution of consumption to aggregate demand growth. Thus, during July-August 2011, consumer goods' import value was down 0.84% compared to a year earlier. In the meantime, the outstanding consumer credit accelerated its growth by 6.1% year-on-year. The improvement of consumer and services confidence indices in 2011 Q3[19], signals private consumption recovery during this period.

Chart 18 Indirect private consumption indices

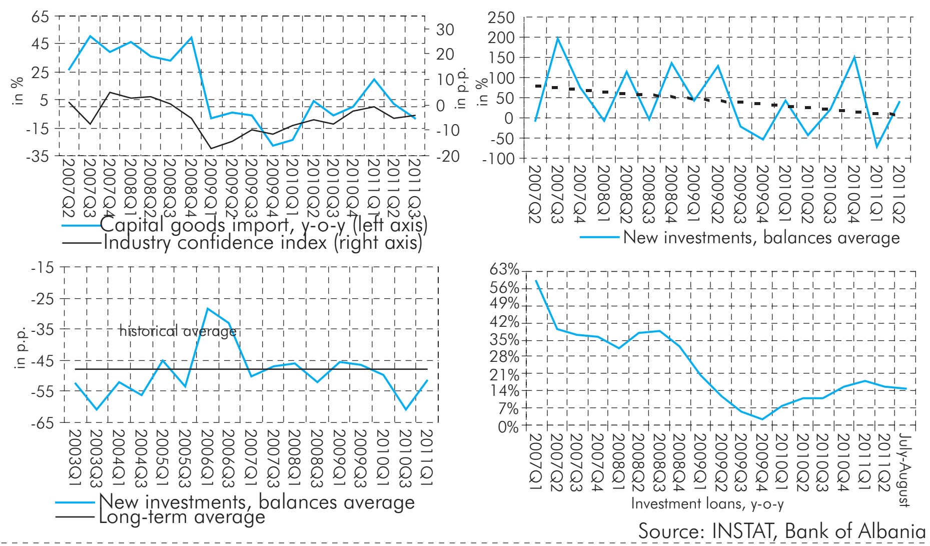


Source: INSTAT and Bank of Albania

PRIVATE INVESTMENT

Private investments are estimated to have slowed down in 2011 Q2. Capital goods import, after the salient growth in 2011 Q1 by 19.8%, decelerated its annual growth to 2.4%. On the other hand, foreign direct investments net inflow surged by 41.8% in 2011 Q2. Investment credit, albeit with a good performance in 2011 Q1 with an annual growth rate of 18.4%, slackened its growth rates in 2011 Q2 down to 15.4%.

Chart 19 Indirect private investments indices and foreign direct investment inflow



Source: INSTAT, Bank of Albania

[19] *Data on confidence indicators are qualitative data obtained from surveys on a certain number of enterprises. Due to frequent structural changes in the economy every now and then, their results may not fully reflect the volume of the relevant sector's activity.*

Investment performance was favoured by foreign demand and continuing export growth. The elimination of the fiscal multiplier effect led to slower rates in the second quarter compared to the first quarter. Demand for investment is estimated to be low taking into account the actual spare capacities in the industry. In addition, the banking system continues to adopt a prudent crediting behaviour and lending standards appear to be more tightened than in the preceding periods.

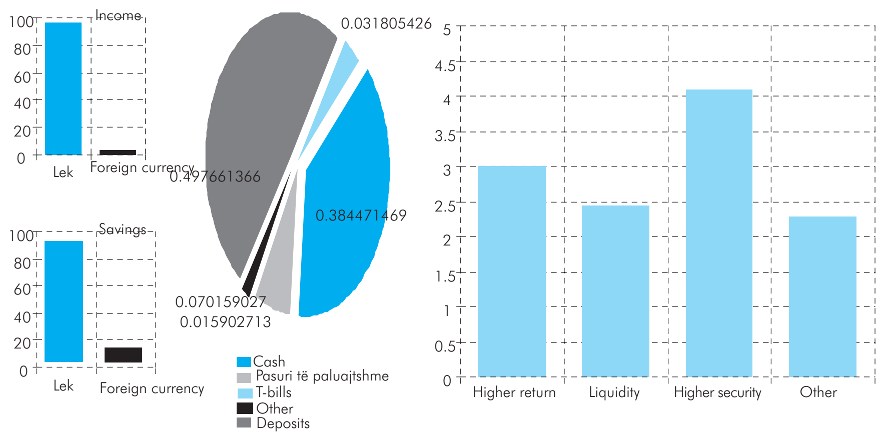
Indirect data on private investments in 2011 Q3 reveal a somewhat more pessimistic picture. Capital goods import during July-August 2011 was down by 8.6% year-on-year. Investment credit slowdown was 14.8% year-on-year, during July-August 2011. On the other hand, qualitative data obtained from business confidence surveys in 2011 Q3 suggest a gradual improvement of business confidence in the industry sector and a less negative assessment in the construction sector.

*Box 2 Consumer and business behaviour trends**

In business and consumer confidence survey in 2011 Q3, in addition to answers to standard questions, respondents provided information on some specific aspects. Consumers expressed their opinions on income, savings, their management and deposits interest rates. Businesses informed on restructuring processes over the past three years as well as future ones, motives for this choice and resulting income from these changes.

The aggregation of the responses revealed that 96.1% of respondent consumers received their income in the national currency. Only a small percentage, about 3.9%, received their income in foreign currency.

Chart 20 Income, savings by currency and savings instruments (left); factors determining the choice of investment instrument by importance (right)



Source: Consumer Confidence Survey, Bank of Albania

By currency, about 89.6% of consumers prefer to keep their savings in Albanian Lek and only 10.4% in foreign currency. By investment instrument, consumers' preferences were towards deposits (49.8%) and cash (38.4%). Compared to the same quarter of a year earlier, consumers' preferences for bank deposits are higher. In the previous year, about 57.9% of consumers preferred to keep their savings in cash and only 37.7% in deposits. According to 2011 Q3 estimates, investments in treasury bills and immovable properties are relatively smaller than the other two above-mentioned categories, but higher compared to a year earlier. Among the factors that determine the choice of instrument for savings investment, consumers rank security and highest offered interest rate as the most important ones. Although a majority of consumers prefer to keep their savings in bank deposits, about 59.5% state that interest rates for this instrument are low, a factor that may stimulate keeping savings in cash.

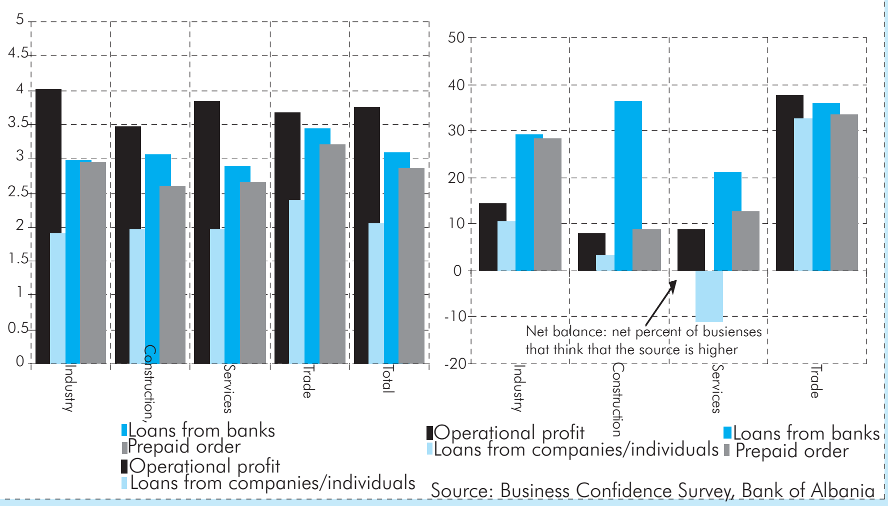
BUSINESSES

In the confidence survey for 2011 Q3, businesses were asked some questions about the funding of their activities. The same questions were asked to businesses in the same quarter of the previous year. On a scale from 1 to 5, with 5 being the most important, businesses ranked various funding sources for their activity. Overall, businesses have used internal and external financial sources to fund their activity. Businesses state almost the same preferences as a year earlier regarding the sources for their activities funding. Businesses that operate in the industry, construction, services and trade sectors affirmed profits from their activity as their primary funding source. In contrast to last year, the use of external sources such as bank loans and prepaid orders are estimated to be higher in the actual survey than in the one a year earlier. In the meantime, loans to households or other businesses are estimated as a factor of little significance in funding the business activity.

In addition to the assessment by importance of funding sources, businesses expressed their views on the performance of their use during 2011. Overall, the use of all sources under review is estimated to be up (positive net balance), in contrast to the estimation in 2010 by the same businesses. According to businesses operating in the trade sector, the use of the four funding sources increased during 2011.

In contrast to a year earlier, when all funding sources in the construction sector were estimated to be downward, in 2011 Q3 businesses operating in this sector assessed all of them positively, especially the use of bank loans. Moreover, prepaid orders are assessed positive, from negative, in the construction sector in the current survey. In the services sector, a positive assessment of bank loans and a significant decline of loans by households and other businesses to fund this sector are noted.

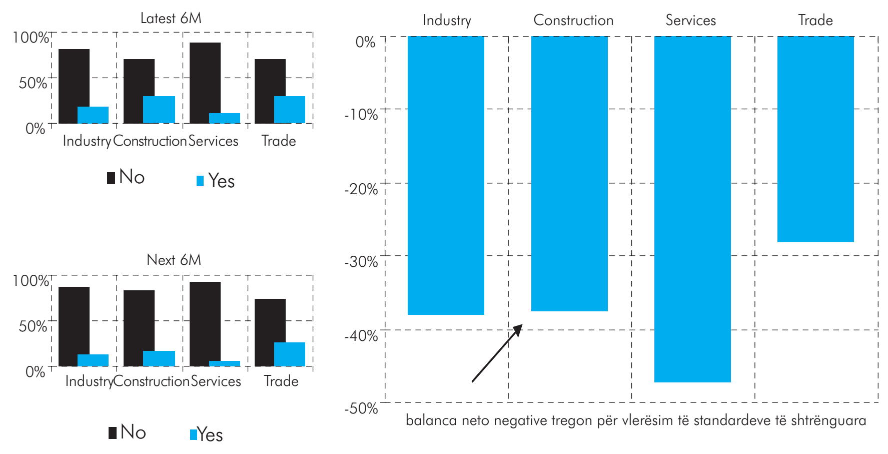
Chart 21 Business funding sources by importance (from 1 being the least to 5 being the most important, left) and their performance during 2011 (net balance in %, right)



Source: Business Confidence Survey, Bank of Albania

Regarding bank loans, on average, about 77.3% of respondent businesses had not received *a loan during the last six months. Similarly, about 84.4% of the businesses do not intend to receive a loan in the coming six months. According to businesses, the actual lending standards applied by the banks are tight, thus making borrowing less favourable. Lending standards were assessed negatively in all four sectors under consideration,*

Chart 22 Demand for loans in the past and next six months, and purpose for use

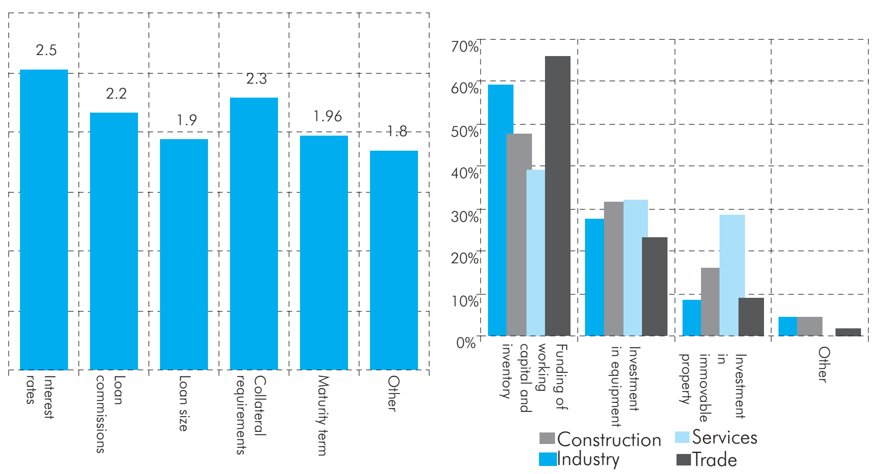


Source: Businesses Confidence Survey, Bank of Albania

especially the services sector. Their related net balances are negative. The main standards used by banks to implement their strategy more conservatively concerning lending to businesses are the applied interest rates and collateral requirements. These two factors are assessed as most restrictive by businesses in all four sectors under consideration.

About 22.7% of businesses that had received a loan during the last six months and about 15.6% of those that intend to receive a loan in the next six months, revealed their purposes on the loan use. On average, about 53.1% of businesses throughout the sectors under consideration responded that their intended loan use is to fund the working capital and inventory. This is more evident in trade businesses. The funding of investments in equipment was assessed as positive, but at a lower level.

Chart 23 Assessment of applied bank lending standards to businesses, ranking from 1 – did not restrict, to 3 – has highly restricted (left); purpose of loan use (right)



Source: Business Confidence Survey, Bank of Albania

**Box 2 written by Merita Boka*

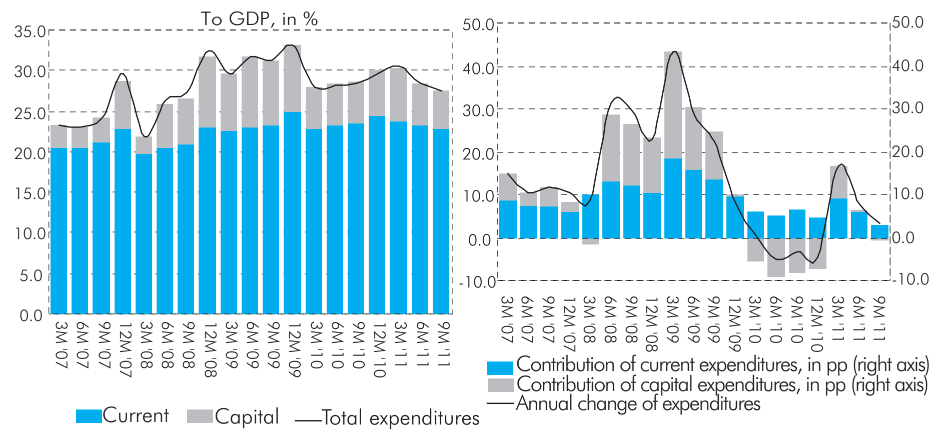
BUDGET SPENDING AND FISCAL POLICY

Fiscal policy during the first nine months of 2011 is assessed to have been stimulating, although less intensive after 2011 Q1. During 2011 Q3, with the budget review for 2011, a more prudent fiscal policy has been projected, translated into less spending than a year ago. Consequently, the growth rates of budget deficit slowed down in 2011 Q3 following a rapid growth in 2011 H1. Budget deficit during the first nine months of 2011 was financed, mostly, through issuing long-term securities.

Public sector contribution to aggregate demand is estimated to have been higher in 2011 Q1, as evidenced by the positive performance of spending that proxy government final consumption and spending for public investment. In the quarters ahead, a downward public sector contribution to aggregate demand is expected, chiefly due to negative capital spending growth rates.

Fiscal developments during this budget year reveal a slow performance of revenues, dictated in part by the performance of non-tax revenues. On the other hand, tax revenues demonstrated a weak growth, which is determined primarily by VAT revenues, suggesting, inter alia, slow consumption in the country.

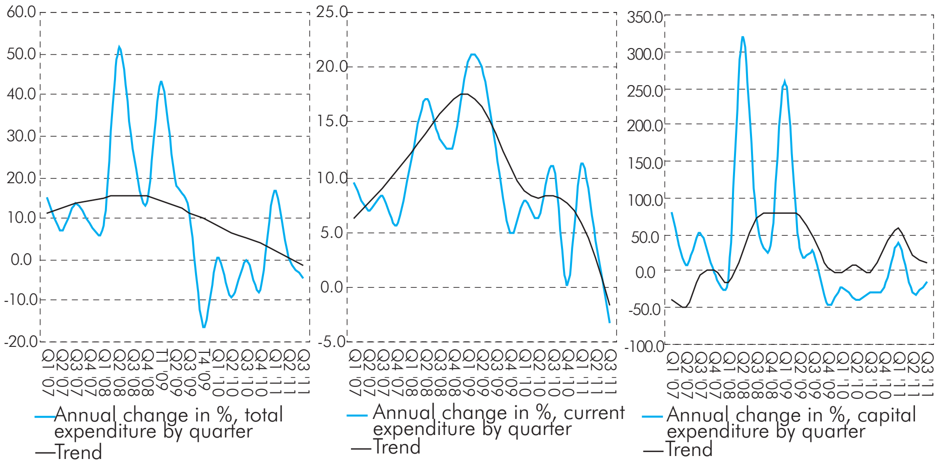
Chart 24 Cumulative budget expenditures (current and capital) to GDP, in % (left) and y-o-y change of budget expenditure in % and respective contributions of current and capital expenditures in p.p. (right)



Source: Ministry of Finance, INSTAT and Bank of Albania

Expenditure during the first nine months of 2011 totalled about ALL 270 billion, around 27.4% of GDP. Year-on-year, total expenditure was up 3.5% from the corresponding period a year earlier. Budget expenditure growth rates pursued a downward trajectory starting from 2011 Q2. This behaviour of expenditure owed mainly to capital expenditures, which, in the second and third quarters, were lower than a year earlier. Cumulatively, capital expenditures shrank 4.4%, while current expenditures during the same period were up 3.6% from the first nine months of 2010.

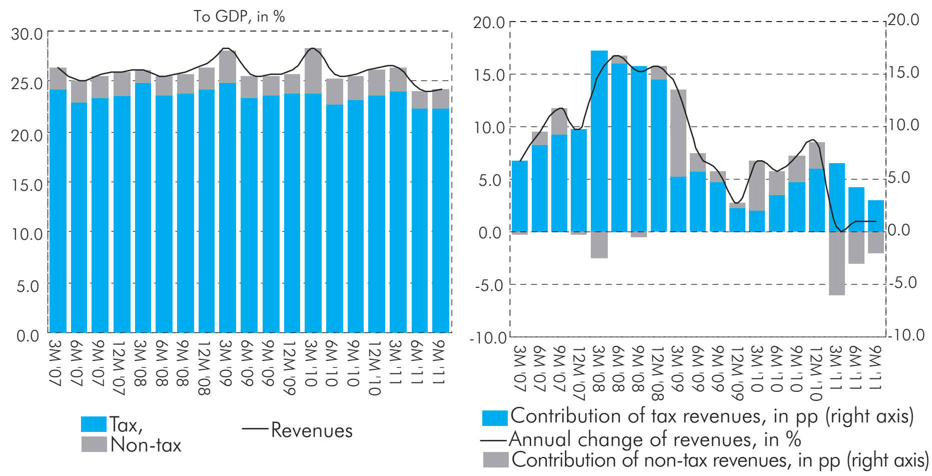
Chart 25 Y-o-y changes in % of quarterly expenditures by main items (from left to right: total expenditures, current expenditures, capital expenditures)*



*The annual changes trend for each expenditure item presented in the chart is built according to the Tramo/Seats adjustment method.
Source: Ministry of Finance, INSTAT and Bank of Albania

Fiscal expansion, proxied by the performance of current and capital expenditures, was apparently weaker in the third quarter, as a result of the negative annual growth rates recorded for the two above-mentioned items, by 3.3 and 17.1%, respectively. It is worth mentioning the fact that the only items that marked a positive contribution to expenditures growth over the three quarters of this year are expenditures for social and health insurance as well as economic assistance and unemployment benefits[20]. Regarding the other items, the trend of the effect on total expenses has not been consistent over the quarters.

Chart 26 Revenues as per two main items as a share of GDP (left) and y-o-y change of total revenues and contributions of the two main categories (right)



Source: Ministry of Finance, INSTAT and Bank of Albania

Budget revenues were characterised by sluggish growth rates during the first nine months of this year, remaining under the negative effect of non-tax revenues. Cumulatively, revenues were at ALL 239.3 billion, estimated to

[20] By quarter, expenditures for social insurance increased y-o-y by about 10.7%, 10.3% and 3.0%, while unemployment benefits and economic assistance increased y-o-y by about 7.9% , 21.8% and 5.2%, respectively in 2011 Q1 ,Q2 and Q3.

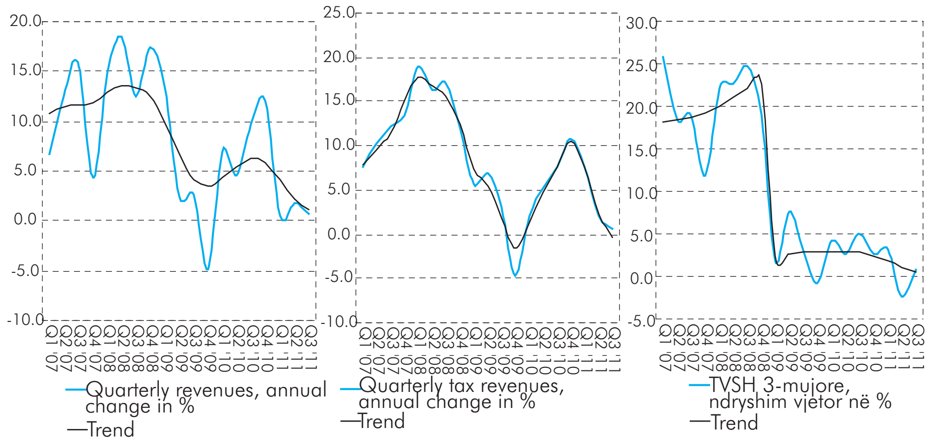
account for about 24.3% of the GDP. Regardless of the slight improvement (by about 0.06 percentage points) from the previous quarter, this level represents one of the lowest values since 2005 Q3.

On the other hand, tax revenue growth rates have pursued a downward trajectory after 2011 Q1. This performance of tax revenues was conditioned mostly by the performance of VAT and excise revenues. VAT revenues for the first nine months of the year recorded a nominal growth of 0.5%[21]. VAT revenues behaviour is related to the value of imports, performance of domestic goods production and services, exports as well as specific regulations on the methodology for VAT payment on capital goods import. The main underlying factor for the sluggish performance of VAT revenues relates to a lower level of VAT paid by domestic businesses operating in the services and construction sectors[22]. On the other hand, the number of VAT-paying businesses has significantly increased during 2011, thanks to fiscal measures incorporating freelancing into the VAT scheme as of 1 January 2011.

Among the items that have displayed a positive and stable performance during the first nine months of the year, we may mention revenues from profit tax and social insurance.

Developments in the main revenue categories during the third quarter depict a similar setting to budget expenditures. Hence, tax revenues in 2011 Q3 decelerated to 0.7%, from 2.1% in 2011 Q2.

Chart 27 Y-o-y change in % of quarterly revenues by main items (from left to right: total revenues, tax revenues and VAT revenues), 2006 Q1 – 2011 Q3



Source: Ministry of Finance, INSTAT and Bank of Albania

The improvement of excise revenue growth rate (to about 8.4% year-on-year, from 3.5% and -6.4%, respectively in Q1 and Q2) stands out amongst

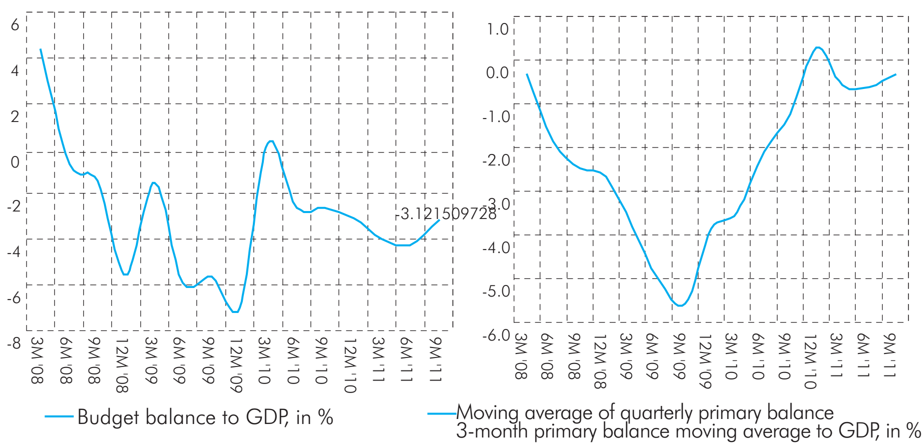
21 *Excluding the exports' VAT reimbursement effect, VAT revenues for the first nine months of the year are 1.3% higher than a year earlier.*

22 *By sector division of the VAT paid by local businesses, according to the monthly fiscal report of the MoF for July, the VAT paid by businesses for January-to-July period in the services and construction sectors is about 25% and 35%, respectively, lower than a year earlier.*

the main developments in revenues sub-items in 2011 Q3, primarily thanks to revenues collected by the tax administration[23].

Budget deficit at end-2011 Q3 was ALL 30.7 billion, estimated at about 3.1% of the GDP. While year-on-year the budget deficit at end-Q3 expanded by about 29%, the monthly deficit retained almost a constant level for three consecutive months.

Chart 28 Budget balance to GDP (left) and primary balance to GDP (right)*



*The right chart is built taking into account the moving amount of the 3-month primary balance (incl. 4 quarters) as a share to cumulative GDP for quarters.
Source: Ministry of Finance, INSTAT and Bank of Albania

Budget deficit, during these nine months, was funded mainly by issuing Treasury bills of over one-year maturity term. During this budget year, government borrowing policy continued to be oriented towards long-term debt instruments, being a key factor to reducing the cost of domestic borrowing[24]. The policy to extend the maturity term for the domestic debt was very present in the third quarter, as a consequence of which, a part of the government debt in six-month Treasury bill was replaced by bonds of various maturity terms[25].

The worsening of the primary balance in 2011 Q2 was reflected in a slight growth of the public debt stock from a quarter earlier. Public debt at end-2011 Q2, was estimated at around 59.2% of the GDP, from 58.8% at end-2011 Q1.

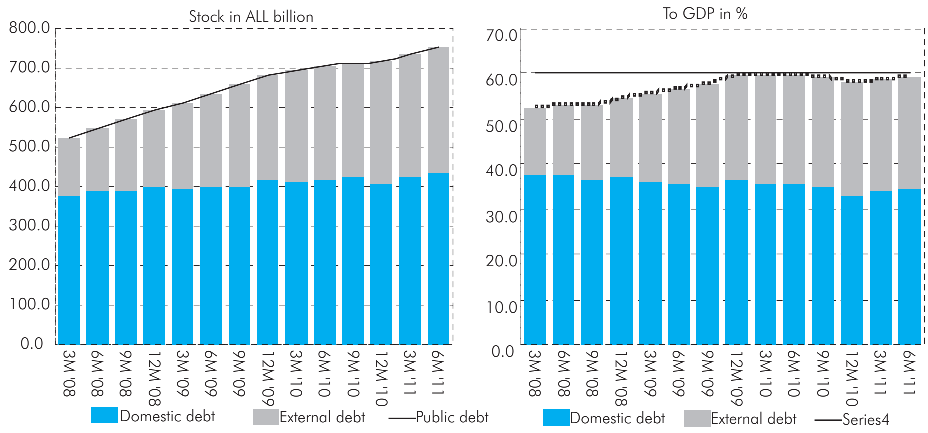
In the meantime, in the third quarter, the improvement of the primary balance suggests more favourable dynamics of the public debt for this period.

[23] *The performance of collected excise revenues may be related to the introduction of the vehicle circulation tax in September 2011, ALL 5 per litre.*

[24] *Interest payments on domestic debt at end-Q3 2011 are about 1% lower from the same period of a year earlier.*

[25] *In Q3 2011 were issued ALL 4.8 billion less than the 6-month maturity term Treasury bills and about ALL 6.8 billion more than the matured value of 2, 3 and 5-year bonds.*

Chart 29 Public debt as domestic and external debt in ALL billion (left) and as a share of GDP (right)



Source: Ministry of Finance, INSTAT and Bank of Albania

FOREIGN DEMAND AND FOREIGN TRADE

The latest available data[26] on the main indicators of the external sector reveal a narrowing in real terms of the net export deficit during 2011 Q2 from a year earlier. This narrowing came as a result of a decline in goods and services imports in real terms by 19.0%. Developments in the import and export balance of real goods and services are assessed to have been materialised in a positive contribution of this component to aggregate demand growth during this period. This development constitutes a change in the direction of impact, following a negative contribution during 2011 Q1.

[26] *The latest data on net exports cover 2011 Q2.*

Box 3 Balance of payments highlights, 2011 Q2

In 2011 Q2, the overall balance of payments registered a decline in foreign assets by about EUR 1.7 million. The current account net position registered a deficit of EUR 342.1 million. Year-on-year, the current deficit expanded by about 69.2%, thus reinforcing the tendency that had started in 2010 Q4. Consequently, this deficit was estimated at 14.0% of nominal GDP or about 5.5 percentage points higher than in 2010 Q2.*

Table 5 Balance of Payments main items

	Q1 '10	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11
Current account (% to GDP)	-12.0	-8.5	-10.4	-16.8	-11.6	-14.0
Current account (EUR mln)	-235.3	-202.2	-245.2	-373.6	-244.4	-342.1
Trade balance	-419.0	-482.9	-595.9	-584.9	-408.5	-581.4
Exports, f.o.b.	254.9	340.5	270.3	305.9	370.6	330.8
Impoers, f.o.b.	-673.9	-823.4	-866.2	-890.7	-779.1	-912.2
Balance of services	-13.1	9.5	180.0	5.2	-36.7	-17.5
Credit	259.3	369.5	661.0	412.5	299.2	362.7
Debit	-272.4	-360.0	-481.0	-407.2	-336.0	-380.2
Balance of income	-14.1	-11.2	-19.9	-31.6	4.4	11.0
Income from net FDI	-60.7	-51.5	-73.8	-73.7	-26.1	-20.7
Current transfers	210.9	282.5	190.6	237.7	196.4	245.9
Net remittances	170.1	219.5	135.1	165.1	153.1	189.4
Capital and current acc. (% to GDP)	6.0%	7.6%	8.2%	19.5%	9.4%	9.7%
Capital and current acc. (EUR mln)	117.3	180.6	193.7	433.1	197.0	237.9
Capital account	10.0	22.7	22.6	30.2	19.1	31.5
Financial account	107.3	157.9	171.1	402.8	177.9	206.5
FDI (net)	165.6	170.0	251.4	250.0	54.4	241.6
Portfolio investments (net)	-25.9	-25.0	-1.5	272.4	-20.9	5.4
Other capital (net)	-32.4	13.0	-78.9	-119.6	144.3	-40.5
Errors & Omissions	100.6	31.9	111.7	66.2	-29.7	102.5
Total balance	-17.4	10.3	60.2	125.7	-77.1	-1.7
Reserve assets	17.4	-10.3	-60.2	-125.7	77.1	1.7

Source: Balance of Payments, Bank of Albania

Current account dynamics during this quarter was impacted broadly by the trade balance and services account performance. The combined deterioration of their net position relative to the corresponding quarter of the previous year contributed to deepening the current account deficit. The expansion of merchandise trade deficit by about 20.4% year-on-year and the deepening of the negative net position of the services account conditioned the expansion of net export deficit by about 26.5% year-on-year. The net balance of revenue account was in surplus by EUR 11.0 million, primarily as a result of the downward outflow of revenues from foreign direct investments. The surplus of current transfer account narrowed 13.0% year-on-year. Remittances, the main sub-item in this account, continued their annual downward trend, for the third consecutive quarter. Their share to the trade deficit is estimated at 55.9% or 53.0 percentage points lower than in the same period a year earlier.

Net flows in the capital and financial account recorded a positive balance of EUR 237.9 million during 2011 Q2. This account's surplus was about 31.7% higher year-on-year and reaches about 9.7% of the GDP. Actually, the capital and financial account surplus financed about 69.5% of the current deficit of this period. Foreign direct investment inflow was up 41.8% year-on-year, mainly in the drilling and searching for hydrocarbon, banking sector, hydropower concessions and telecommunication. Foreign reserve stock at the end of the period was EUR 1.771,4 million. This level is estimated as sufficient to cover 4.2 months of goods and services import.

* *For 2003-2009, Nominal GDP published by INSTAT is used. For 2010-2011, projections of the Bank of Albania Monetary Policy Department are used*

FOREIGN TRADE, AUGUST 2011

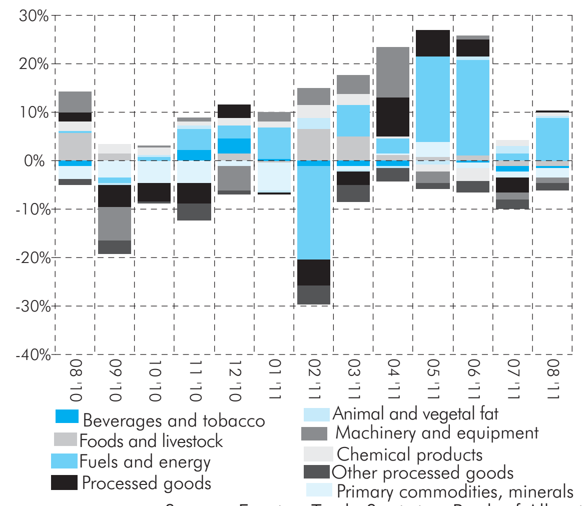
According to foreign trade data on merchandise for August 2011, trade deficit expanded by about 4.5% in annual nominal terms. The expansion of exports by about 34.6% year-on-year did not manage to compensate the effect of import growth by about 11.7% year-on-year. Similarly to the previous six months, Fuel and energy provided the most important contribution to the expansion of trade deficit year-on-year in August 2011.

Excluding trade inflows in electricity, the expansion of trade deficit in August 2011 was about 1.7% year-on-year. This was as a result of exports increase by about 38.2% and imports increase by about 10.6%, year-on-year.

Over the 8-month period, imports were up about 11.8% and exports about 20.8%. Hence, the trade deficit for the first eight months of the year was about 7.0% higher year-on-year.

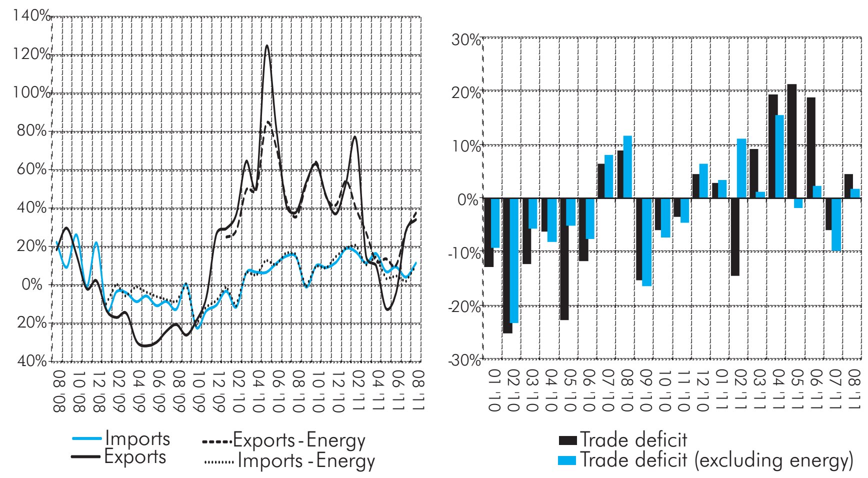
Imports to exports ratio in August 2011 was 29.0% or about 4.9 percentage points up from the previous year. Albania's trade activity, measured by trade exchanges with partner countries, expanded 16.2% year-on-year.

Chart 30 Contribution by items to trade deficit expansion/narrowing



Source: Foreign Trade Statistics, Bank of Albania

Chart 31 Annual change in percent of imports and exports and trade balance in total, excluding electricity

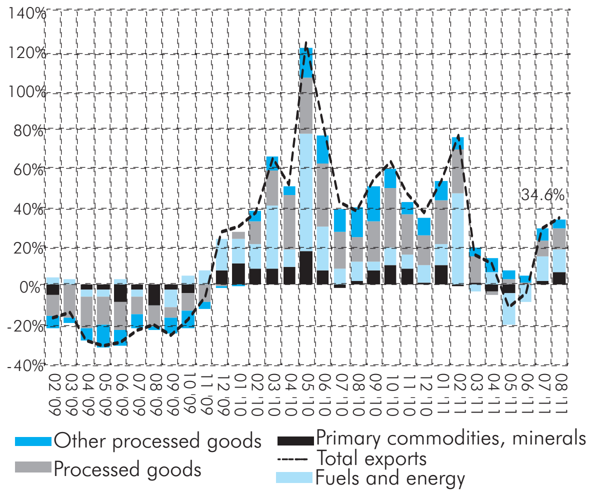


Source: Foreign Trade Statistics, Bank of Albania

Exports in value, following the positive developments in the previous month, during August 2011 were up about 34.6% year-on-year. The main contributor to the higher export growth rates during August 2011 was the export of goods under Fuel and energy, by about 11.9 percentage points. Within this item, a substantial contribution was given by exports of crude oil. Exports of this item were about 64.7% higher year-on-year. Exports of Processed goods[27] continued their positive growth trend.

In August, the export of goods under this item grew by 51.7% contributing by about 10.2 percentage points to the annual growth of total exports. Other processed goods, including mainly re-exported textile products, retained a steady growing trend and contributed positively to the annual performance of exports. In addition, Mineral raw materials contributed positively, albeit less. Year-on-year, exports of this item grew by about 44.6%.

Chart 32 Contribution of four key items of domestic exports to total annual export growth

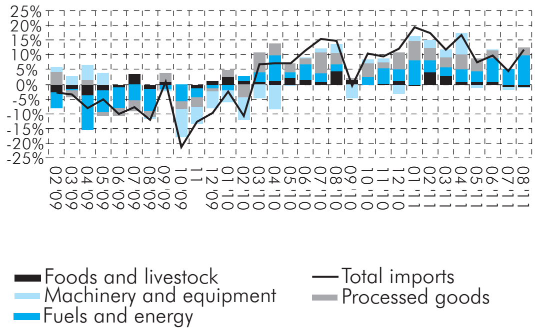


Source: Foreign Trade Statistics, Bank of Albania

Imports in value, during August 2011, continued to grow year-on-year with higher rates than the preceding three months. According to the division of imports by their ultimate use, import of products under Intermediate goods[28] expanded.

Import of goods in this item surged by about 21.8% year-on-year, contributing by about 13.1 percentage points to the annual growth rate of total imports. Meanwhile, import of Capital goods dropped 12.2% year-on-year. This downward trend of capital goods continues for the fourth consecutive month. After subduing during the last three months, imports of Consumer goods increased slightly by about 1.0% year-on-year.

Chart 33 Annual changes in import of goods and contribution to annual import growth rate by the items: capital, intermediate and consumer goods



Source: Foreign Trade Statistics, Bank of Albania

Trade exchanges by destination continue to be concentrated with EU countries, accounting for an average of 62.8% of the total trade activity. Year-on-year, imports from EU countries were up by about 12.4%. Albania's exports towards the EU pursued the same tendency, rising about 11.7% year-on-year. Imports from CEFTA countries, in August 2011, slumped about 31.1%, while exports increased about 30.4% year-on-year.

[27] *The main exported products of this item are basic processed metals such as steel, duct iron, iron and copper.*

[28] *This category includes unprocessed and processed foods and beverages for the industry, unprocessed and processed industrial products, fuels, oil, unprocessed and processed mineral wax, capital goods, spare parts and accessories.*

IV.3 LABOUR MARKET, WAGES AND COSTS

Developments in the labour market in 2011 Q2 confirmed its stabilisation for the third consecutive quarter. The increase of employment at a higher rate than the decrease of the unemployment rate was reflected in the increase of the labour force. Employment outlook is assessed as slightly deteriorating in the third quarter, to continue with an expected improvement in the fourth quarter. Businesses signal that wages remained almost unchanged in the second quarter, compared with the previous quarter, while for the rest of the year they are expected to rise.

LABOUR MARKET

According to data on labour balance, the employment rate improved in 2011 Q2. Concretely, the number of employed persons in the economy grew 2.7% year-on-year, continuing its upward trend since 2010 Q4. The good employment performance in the non-agricultural private sector contributed to the expansion of employment in Albania. Thus, the number of employed people in the non-agricultural private sector increased 6.5% year-on-year. On the contrary, a somewhat deteriorated situation was in the public sector with employment decreasing 1% year-on-year. As regards employment in the agricultural private sector, its annual growth was 2.1%, mainly as a result of the low comparative base.

Table 6 Employment performance (annual and quarterly changes in %)

		PersonS				
		Annual change		Quarterly change		
		2009	2010	2010 Q4	2011 Q1	2011 Q2
Total economy	Share *	-7.7	2.0	0.1	0.4	1.0
Non-agriculture private sector	24.7%	-0.9	3.1	0.6	1.7	3.8
Agriculture private sector	57.3%	-12.7	2.1	0.0	0.0	0.0
Public sector	18.0%	-0.2	-0.2	-0.4	-0.4	-0.2

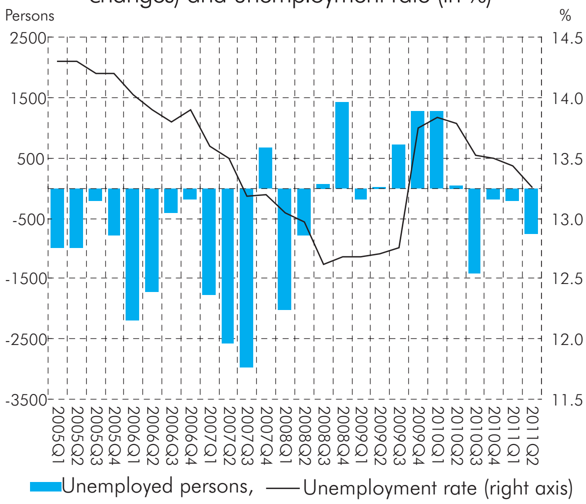
**Average employment share by sector to total employment, for 2005 Q1-2011 Q2.*
Source: INSTAT

Compared to the previous quarter, employment was slightly higher than in 2011 Q2. The quarterly increase by 3.8% of non-agricultural private sector employment, the quarterly decrease by 0.2% in the public sector and the estimate of the unchanged employment in the private agricultural sector in the first quarter led to an increase in employment by 1% in quarterly terms.

Unemployment rate continued its descent in the second quarter, settling at 13.26%, albeit 0.1 percentage points higher than its average of the last four years. While the number of unemployed persons continued to contract this quarter, the downward unemployment rate is attributed mainly to the employment index[29] improvement in the non-agricultural private sector.

[29] *Unemployment rate is calculated as a ratio of the number of unemployed individuals to total labour force. Thus, an increase in the labour force combined with the drop of unemployed individuals is reflected in lower unemployment rate. On the other hand, the labour force is calculated as the sum of the number of employed individuals and the number of unemployed individuals. Thus, if the increase of employment is higher than the decrease of unemployment, the labour force increases and, consequently, the unemployment rate decreases.*

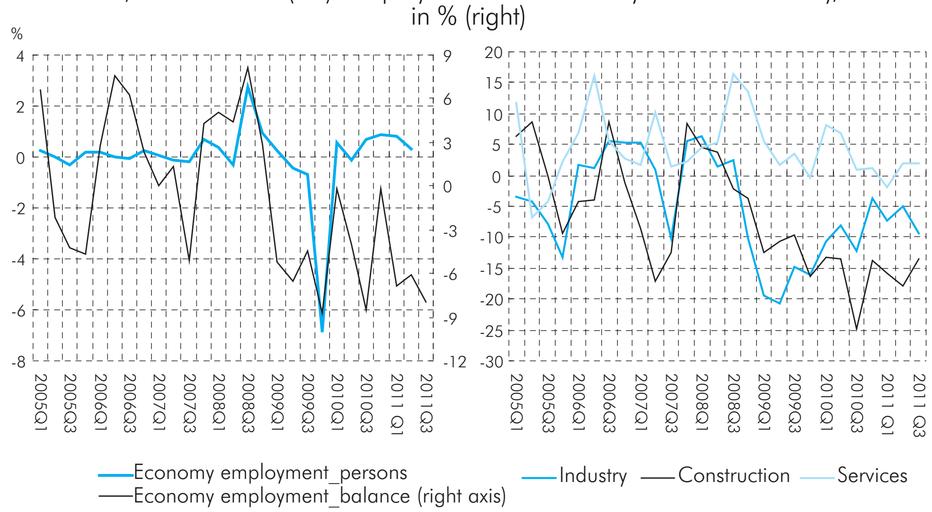
Chart 34 Number of unemployed persons (quarterly changes) and unemployment rate (in %)



Source: INSTAT

Qualitative data from the Business Confidence Survey for 2011 Q2 support the positive quarterly employment developments, while in 2011 Q3, businesses appear somewhat more pessimistic. In terms of economic activities, survey data signal a more pronounced deterioration of the employment situation in the industry sector and trade. On the other hand, employment in the construction sector is somewhat higher, while in the services sector it ranges almost at the same level as in the second quarter. In the fourth quarter, employment is expected to increase across all sectors of the economy compared with a quarter earlier.

Chart 35 Employment in the economy, seasonally adjusted, quarterly changes and assessment, balance in % (left). Employment assessment by economic activity, balance in % (right)



Source: INSTAT

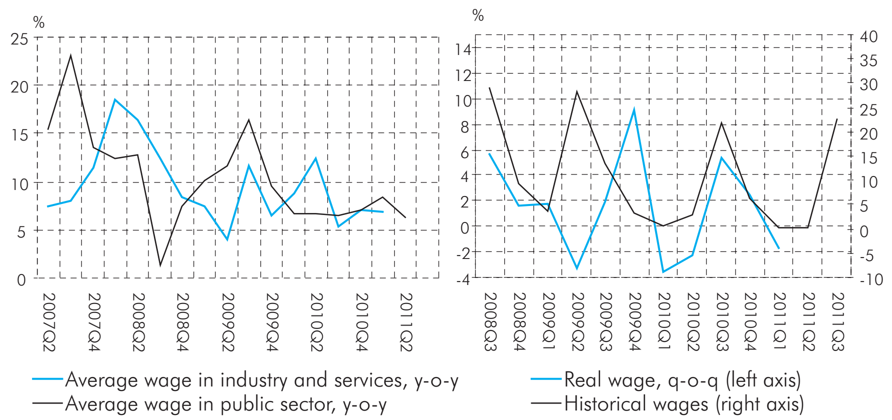
WAGES AND LABOUR COSTS[30]

In the absence of new and complete information, wages during 2011 Q2 and Q3 were addressed based on partial qualitative and quantitative data. Therefore, the latest available data from the second quarter show that the average wage in the public sector has remained unchanged compared with the previous quarter (at ALL 45,500). It marked an annual increase by 6.3%, which is 2 percentage points lower than in the previous quarter. In real terms, public sector wages were up 2.6%, from 3.8% in the previous quarter.

30 *A more detailed analysis of wages and labour costs for 2011 Q1 is reflected in the Monetary Policy Statement for 2011 H1. It is worth noting that in 2011 Q1, the average wage index in the economy was up 6.9% in annual terms and 0.26% in quarterly terms. As regards sectors, the average wage was up in both manufacturing and services sectors, by 5.5% and 13.9%, respectively. Real average wage marked an annual increase lower than the nominal wage in these sectors, 1.7% and 9.8%, respectively, due to inflation. On the other hand, labour cost per unit of output followed a downward annual trend.*

Data on the third quarter indicate an increase in the approved minimum wage of ALL 20,000. This indicator suggests for a potential increase in the level of wages in the economy[31]. Moreover, in business confidence surveys, wages were assessed as rising across all the sectors of the economy for the third quarter, thus confirming the wages trend signalled by indirect indicators.

Chart 36 Annual average wage by sector (left), quarterly wage performance and its assessment in the economy (right)



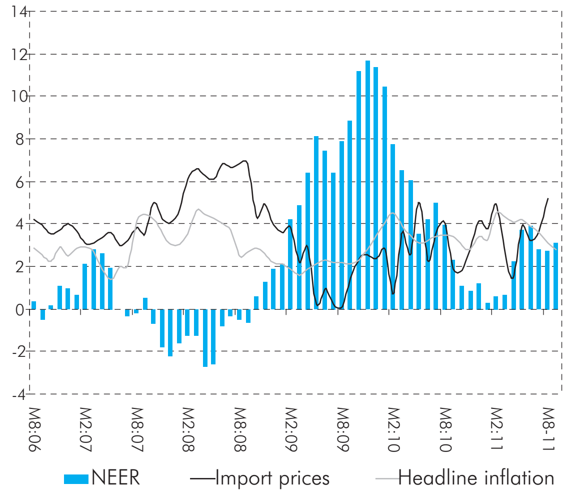
Source: INSTAT, Bank of Albania

IV.4 IMPORTED INFLATION

Inflationary pressures on prices in Albania, coming from price swings in our main international partners, were upward in January-August 2011.

Import price index[32], during the period under review, expanded on average 3.6% year-on-year, while during the corresponding period of 2010, the average annual increase of this index was 3%. Nevertheless, compared with the corresponding period of 2010, the relative stabilisation of the exchange rate, measured based on its annual performance, has contributed to keeping a moderate transmission of the import price rise into the domestic market. The annual depreciation of the national currency during the period under review against the common European currency was about 2%, while during the first eight months of 2010, it was 6%.

Chart 37 Annual import prices, inflation rate and ALL/EUR exchange rate.



Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

Imported inflationary pressures, disaggregated into various groups of the CPI basket, were upward

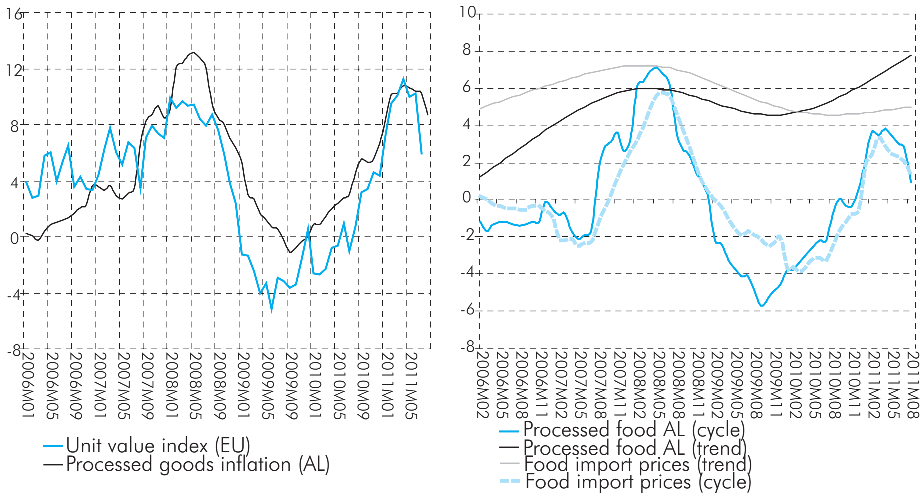
[31] *Taking into account the high level of informality in the declaration of wages by businesses, it is assessed that the minimum wage increase will urge businesses to increase wages, leading to an overall wage increase in the economy.*

[32] *This index is measured by weighing the share of imports of 21 countries by importance on foreign trade data with the relevant consumer price index according to a common base.*

for Processed foods during January-August 2011. This trend is confirmed by similar annual trends of indices, which show import price volatility such as: unit value index for processed food exports from European Union countries to Western Balkan countries and food import price index[33]. Thus, food import price index increased on average about 7% during the first eight months of this year. The average annual increase of this index for the corresponding period of 2010 was 3.5%. While the unit value index for processed food exports from European Union countries towards Western Balkan countries expanded on average 9% year-on-year, for January-July of the current year.

Nevertheless, it is worth evidencing that for the April-to-August period, both indices recorded a decrease in monthly terms, reflecting this trend in the cycle of Processed foods as well.

Chart 38 Cycle-long-term trend of annual inflation of processed foods and annual inflation of food import prices (left); import price index versus the annual change of unit value index of EU exports (right)



Source: Bank of Albania, INSTAT, IMF, OECD, EuroStat

IV.5 INFLATION EXPECTATIONS IN ECONOMY

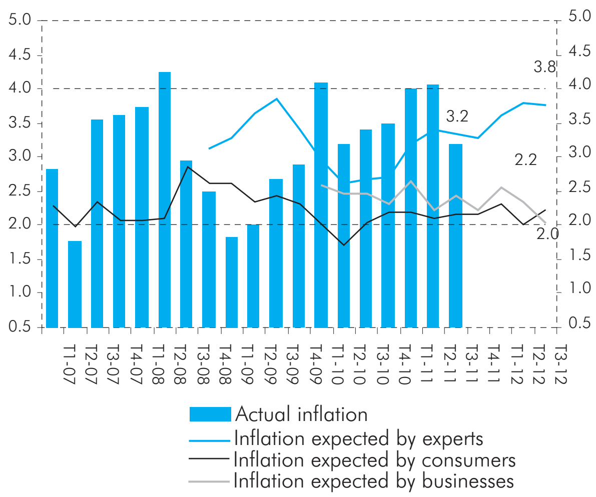
According to financial experts and business and consumer confidence survey, one-year-ahead inflation expectations remained at the same level as in the previous quarter. For 2012 Q3, economic experts' inflation expectations remain within the tolerance band of 2-4% of the Bank of Albania. Expected inflation rate for 2011 Q3, according to 2010 surveys, is at the official rate as published by INSTAT for the period under review.

[33] The first index is released monthly by the European Statistical Institute – Eurostat, and it includes Albania, Bosnia and Herzegovina, Serbia, Kosovo, and Former Yugoslav Republic of Macedonia. The second index is constructed by weighing the food price indices of 19 countries by their share to food imports into our country. Weights are updated for 2010, whereas the data on food import for 2011 by origin are not yet available.

One-year-ahead inflation expectations by finance experts continued to be high compared to business and consumer expectations. Finance experts expect the annual inflation rate for 2012 Q2 to average 3.8%, at the same level as the expected rate for the previous quarter and about 0.5 percentage points above the official inflation rate for 2011 Q3.

According to the latest data from business and consumer confidence surveys, for 2012 Q3 businesses expect one-year-ahead inflation rate to be about 2.0%, whereas consumers expect it to be 2.2%. One-year-ahead inflation expectations by consumers and businesses remain within the lower half of the 2-4% inflation target band.

Chart 39 One-year-ahead inflation expectations (in %)



Source: Business and Consumer Confidence surveys, Finance Experts Surveys

IV.6 ASSESSMENT OF INFLATION PRESSURES IN THE REAL SECTOR OF THE ECONOMY

Real economy pressures on inflation are assessed based on economic activity official data in the first quarter and on the judgment of potential dynamics of their development for the rest of the year, according to survey data, fiscal indices and the external sector. During 2011 Q1, the GDP increased 3.4% year-on-year, mainly sustained by the industry sector and, to a lesser degree, by the services and agriculture sectors. As regards components of aggregate demand, fiscal expenditures and external demand were the main factors that led to this increase, whilst consumption and private investment remained sluggish. In 2011 Q2, external demand is believed to have provided a positive contribution to GDP growth, while the room for the increase of the fiscal component was lower. Indirect available data for the second and third quarter, mainly those from the business and consumer surveys and external sector data, suggest a positive, albeit low, increase of economic activity. Concerning funding, banking system liquidity has created the premises for supporting the private sector; however, added businesses and consumers' prudence on spending is noted. The assessments reveal that economic growth continues to be below its potential, thus reducing demand-driven inflationary pressures. Capacity utilization rate reported by businesses remains below its historic level, while labour market data do not suggest upward inflationary pressures by wages as long as the unemployment rate remains historically high. Short-term expectations on consumption and investments continue to be conditioned by uncertainty for the realisation of expected profit, employment prospect and remittance flows. In terms of uncertainties surrounding the external environment, external demand impact may be more reduced. Moreover, the expansion of the trade deficit may pressure the exchange rate and it continues to be one of the upward inflation risks.

As regards imported inflation during January-August 2011, the effect of the increased inflation of food products in trading partner countries is dampened by the stabilisation of the exchange rate in relative terms and the composition of supply in the market in favour of the Albanian products. Reduction of the intensity of external shocks during this period, especially in the last months, has significantly dampened the second-round effects risk on inflation. This is noted also in the stabilisation of agents' inflation expectations within the tolerance band of the Bank of Albania. Inflation pressures on domestic prices, which arise from the volatility of foreign prices of oil and food products, are expected to continue to be present during the current year, though following a continuously downward trend.

In the absence of abrupt shocks beyond the scope of monetary policy impact, future consumer prices developments are expected to be within the Bank of Albania's inflation target. This assessment is based on the persistent negative output gap, dampened external shocks and anchored economic agents' expectations for inflation.

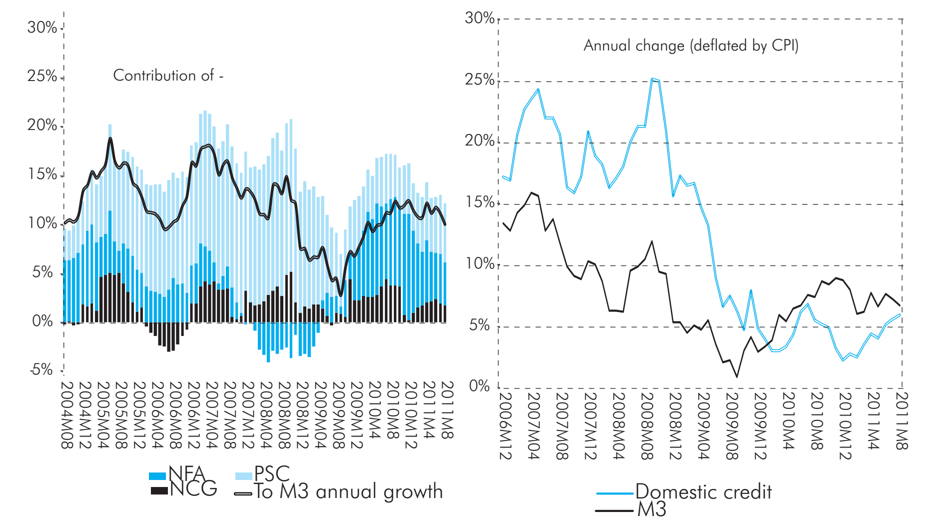
V. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

Monetary expansion decelerated in 2011 Q3 compared to 2011 H1, in response to the lower creation of money in the national currency. Broad money indicator, M3, was sustained by both private sector's demand for money and the external sector flows. Increase of lending to private sector remains conditioned both by the still high uncertainty for the future and banks' prudent lending policies. Moreover, the decline of remittances is reflected also in the lower contribution of the foreign currency component to monetary expansion. Similarly, during this period, public sector's demand for money has been downward, in response to the budget review in July 2011 for a more prudent fiscal policy. Lack of signals for an apparent recovery of the private sector demand for money supports the insofar assessments that pressures on inflation by monetary developments remain contained.

V.1 MONETARY INDICATORS

In July-to-August period, broad money indicator grew about 10.6% y-o-y from 11.4% in 2011 H1. The real demand for money decelerated further although the inflation rate underwent an obvious decline. In August, the annual growth rate of real demand for money reached 6.8%, compared to 7.7% at end-2011 Q2. Slowdown of monetary expansion growth in Albania reflects, most of all, the downward money demand contribution by the external and fiscal sectors, whereas the private sector continued to provide a positive and sustainable contribution. The lower contribution of the foreign currency component to money expansion reflected in the external sector performance,

Chart 40 Monetary developments on money demand side and in real terms.



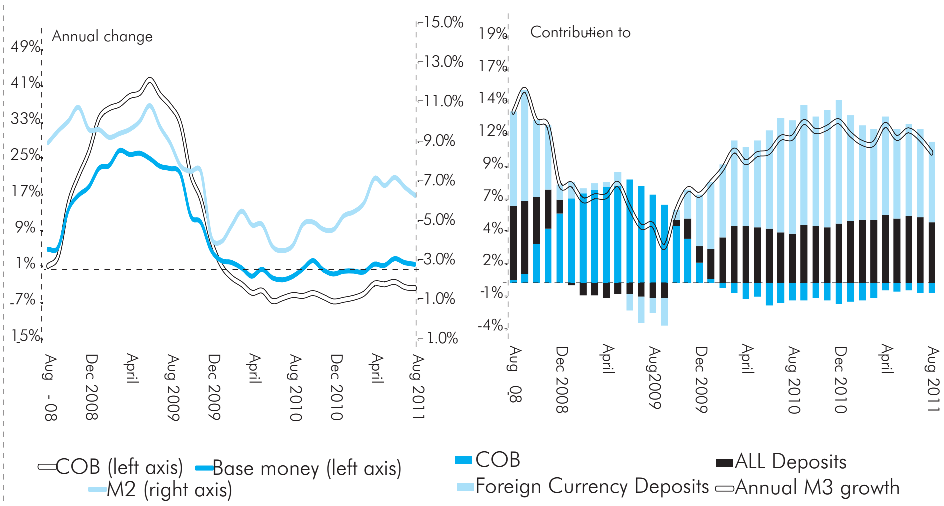
Source: Bank of Albania

with the deepening of the current account deficit followed by lower foreign currency inflows and, consequently, a slowdown of money creation in the economy. Nevertheless, during July-August 2011, net foreign currency flows were higher than in the second quarter, in line with the seasonality of these indicators during the summer.

The ALL monetary aggregate, M2, underwent a further slowdown in July-August, increasing on average by 6.5%, from 7.1% in 2011 Q2. This trend reflects the subdued need of the public sector for funding, following the mid-year budget review to reduce government spending for the remainder of the year, whereas private sector's demand for money grew insignificantly. A weaker ALL money creation over this period has contributed to a weaker performance in monthly terms of ALL deposits compared with a year earlier.

The most liquid money aggregate, M1, contracted on average 1.1% year-on-year in July-August 2011. This performance has mostly reflected the contraction of currency outside banks compared with the corresponding period of a year earlier. Currency outside banks to M2 ratio has settled almost at the same level throughout 2011, at about 30.3%.

Chart 41 Money supply indices

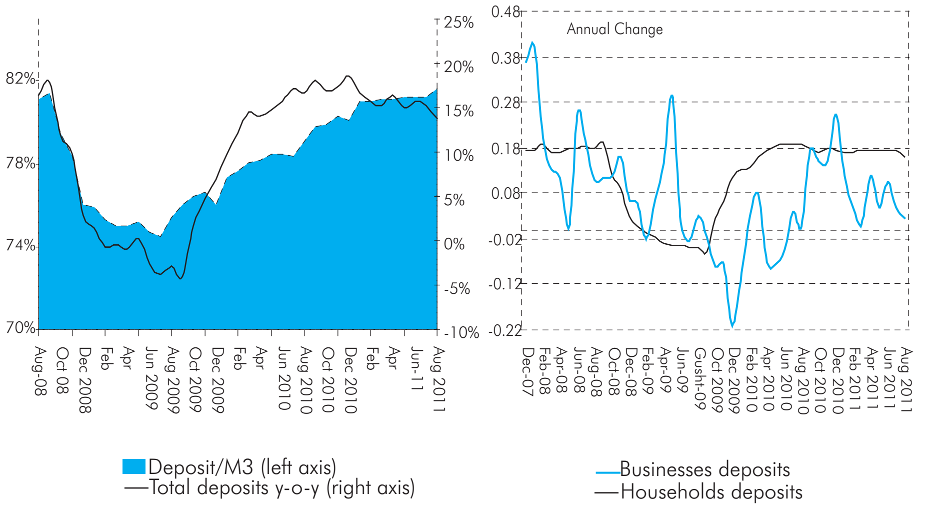


Source: Bank of Albania

Developments in the deposit stock during July-August pursued a positive trend characteristic throughout 2011. Year-on-year, total deposits were up by 14.5%, settling close to the average of the deposit growth in 2011 H1. The stable deposit growth has contributed to higher deposit-to-M3 ratio to 82%, compared with 80% at end-2010.

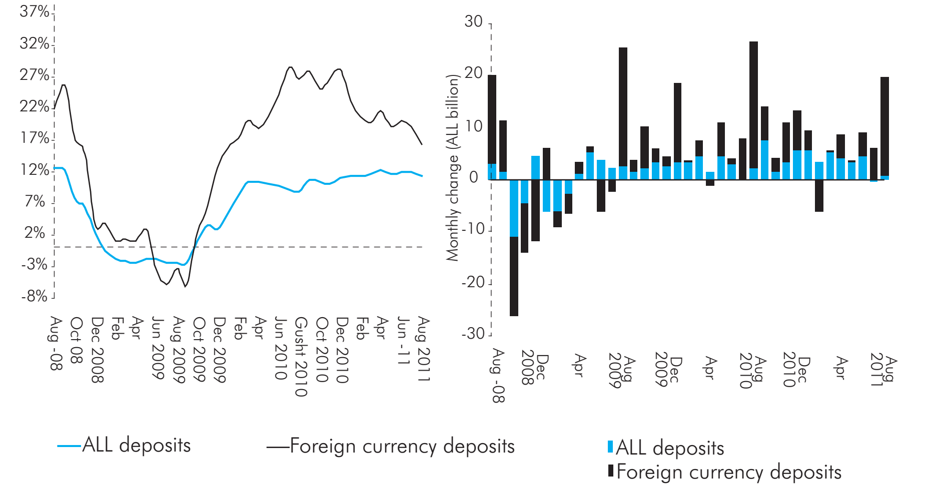
Deposits by currency show that deposits in the Albanian Lek retained a steady annual increase by about 11.6% throughout 2011, sustained mostly by the ALL money creation by the fiscal sector in the first half of the year. Furthermore, the annual growth rate of foreign currency deposits was downward, settling at 16.4% at the end of August. In 2011 H1, foreign currency deposits grew on average 20.3%. Nevertheless, in line with the seasonal behaviour in the summer months, net monthly flows of foreign currency deposits in July-August were higher than in 2011 Q2. Year-on-year, this seasonal increase is lower, signalling downward foreign currency flows channelled in the banking system.

Chart 42 Deposits in total and by economic agents.



Source: Bank of Albania

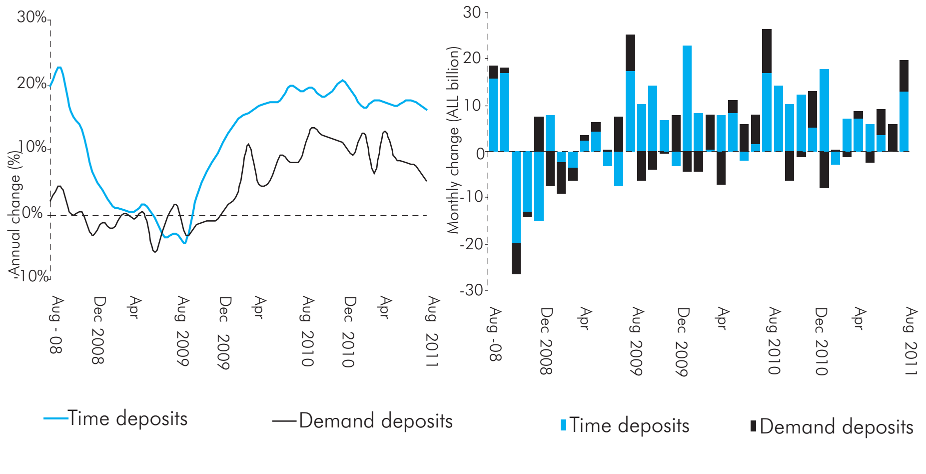
Chart 43 Deposits by currency



Source: Bank of Albania

By maturity term, in July-August, the ALL deposits growth was triggered mainly by the increase in demand deposits. Foreign currency deposit growth consisted mostly in the increase of time deposits. Demand deposits, especially in August, were in line with the seasonal behaviour of individuals to spend more during the summer months. Beyond the seasonal behaviour, it seems that time deposits are stable, retaining high annual growth rates, on average about 17%. Meanwhile, demand deposits continue their downward growth rates, which reached 5.2% year-on-year, in August. The shift of demand towards time deposits, especially for individuals, confirms the results obtained from the consumer confidence survey for a more prudent behaviour oriented towards savings over the last two years.

Chart 44 Deposits by maturity term

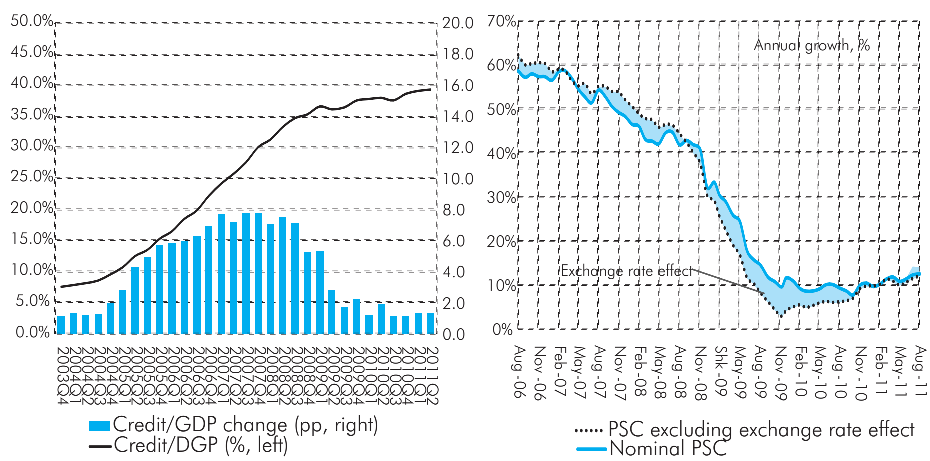


Source: Bank of Albania

V.2 PRIVATE SECTOR CREDIT

In July-to-August period, private sector credit retained its slight upward trend of the previous months. Year-on-year, it grew 12.6% at end-August or 1 percentage point higher than at end-2011 Q2. Excluding the exchange rate effect, the annual growth of lending to the private sector is 12.0%, from 10.6% at the end of June. Its share to GDP was estimated at 39.2% at end-2011 Q2 or 1.3 percentage points higher than a year earlier, retaining the impulse to the economic activity unchanged.

Chart 45 Private sector credit



Source: Bank of Albania

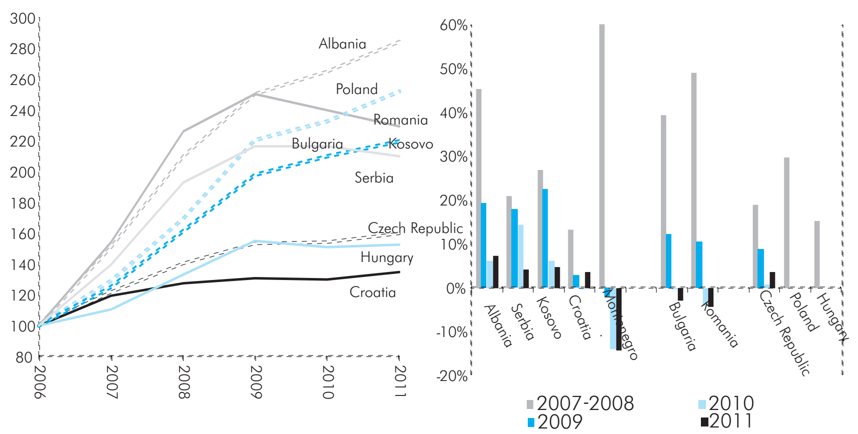
*Box 4 Private sector credit in CEE countries**

Over the past two years, crediting in Albania has been characterised by a moderate expansion of private sector credit. Average annual credit growth rate, excluding inflation, in 2011 is 8.0%, about 2.0 percentage points up from 2010. In addition, the credit impulse to GDP, measured as the annual difference of the private sector credit to GDP ratio, remained at low levels of about 1.3 percentage points.

*The comparative analysis of the credit portfolio performance for the countries of the region notes that the above description may serve very well to show the credit performance for each country of the Central and South-Eastern Europe (CEE). In all CEE countries, over the past two years, private sector credit has decelerated significantly, and in some cases even contracted. For CEE countries, the financial crisis emerged while the crediting cycle to the economy was going through a phase of high growth. The average credit growth rate for the private sector in CEE countries in 2007-2008 was 31%**. Currently, after more than two years, this growth is on average 1.0% for 2010-2011.*

Regardless of the size and intensity, lending slowdown in all these countries has resulted from similar factors, which refer both to the supply and demand for credit. Initially, banks were forced to tighten and ration their crediting due to difficulties in liquidity. Then, during the last two years, with the transformation of the financial crisis into a difficulty of the real sector of the economy, the dominating factor behind the slow lending rates is the sluggish demand of the economy for funding, in line also with the weak aggregate demand. Furthermore, banks continue to be prudent in lending, under the influence of the high NPL share in their portfolios.

Chart 46 Private sector credit in index and real annual growth

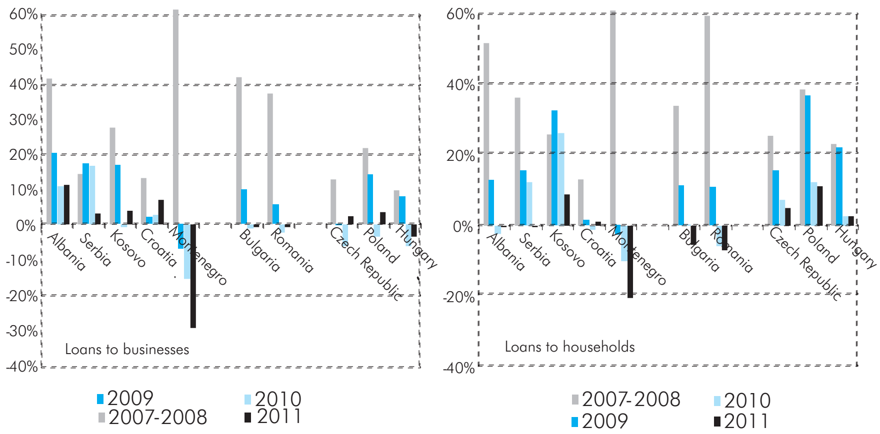


Source: Central banks web pages and IMF

By comparison, Albania is among the countries that has retained good lending rates, especially during the last year (see Chart 46, left). It is second to Poland, the only country that retained positive economic growth rates along with Albania. In relation to GDP, lending in Albania is comparable to the average trend of CEE countries. In a more detailed view of the credit portfolio, the countries' ranking varies according to two main segments, businesses and households. In Albania, lending to businesses was the leader of private sector credit growth. Albania was among those few countries where the portfolio kept its positive growth rates (see Chart 47, left). Meanwhile, lending to households (see Chart 47, right), in most CEE countries, including Albania, contracted during the last two years. Nevertheless, while in most of them this portfolio is shrinking also during 2011, in Albania, it is pursuing a clear

recovering trend. Overall, lending to households was the first to suffer from the downward demand, mostly affected by uncertainties for the future. An exception to this trend are the Czech Republic, Poland and Hungary, where, perhaps given their social and economic development, consumers have a different behaviour.
As regards future developments, they are under the influence of a number of factors, both supply and demand-related. The supply conditions will be determined by the performance of global financial markets and improvement of the NPL portfolio.

Chart 47 Average annual real credit growth for businesses (left) and households (right)



Source: Respective web pages of central banks and institutes of statistics

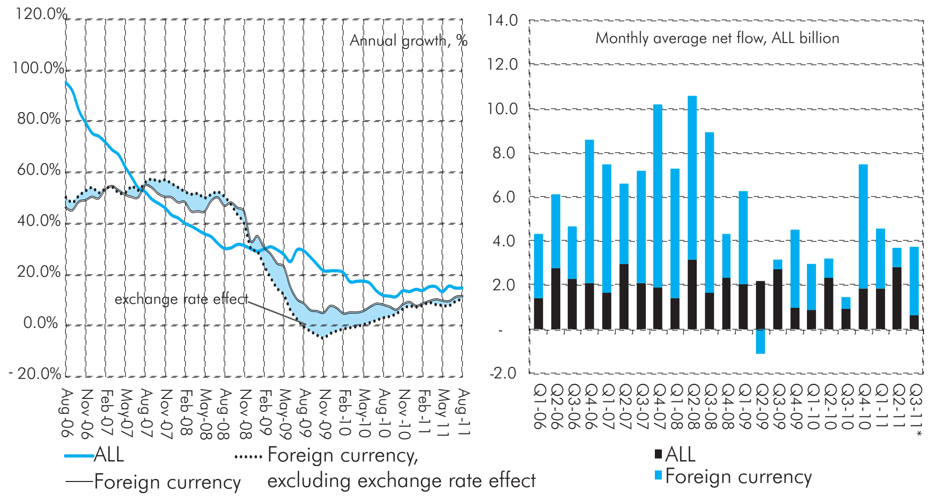
Moreover, credit demand developments will depend on the domestic economic activity and uncertainties for the future. Particularly for the countries of the region, as assessed by international institutions, their sustainable economic development and growth, and consequently, the participation of financial intermediaries in supporting the economy, will depend directly on structural and institutional reforms as well as on a more matured model of business organisation and consumer behaviour.

* *Written by Sofika Note*

** *Annual credit growth rates for all CEE countries are real (inflation is excluded)*

Private sector credit growth in July and August was supported by loans to businesses, while the recovery of loans to households has started to provide a growing contribution to crediting performance. Credit demand, however, is deemed as sluggish, affected by households inclination towards saving and overall private sector uncertainties to undertake investments or make large purchases. This is also reflected in the short-term nature of lending over the recent months, which is mainly destined to cover liquidity or consumption needs. However, in parallel with the action of a sluggish credit demand, its supply is also deemed to have affected private sector lending. Hence, the lending standards remain tightened and for certain market segments they are further tightened. This behaviour is dictated by banks' added prudence as a reflection of uncertainties that surround the global economic outlook and in response to economic activity performance for specific sectors of the Albanian economy.

Chart 48 Private sector credit by currency

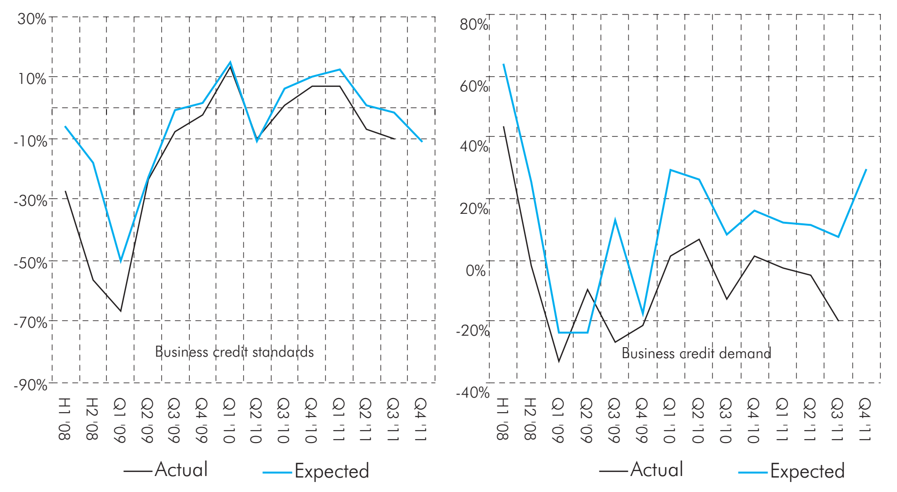


Source: Bank of Albania

*Box 5 Bank Lending Survey 2011 Q3**

During 2011 Q3, lending standards to businesses continued their tightening from the preceding quarter. This tightening is in line, but to a higher degree, with banks' expectations in the previous quarter. By business size, credit standards were tightened for both categories: small and medium-sized as well as big enterprises. By purpose of credit use, standards were tightened both for working capital and investment loans. Main drivers contributing to the tightening of business lending standards during 2011 Q3 were the NPLs situation in the banking system and the macroeconomic situation in Albania. For 2011 Q4, bank experts expect the business

Chart 49 Credit standards and credit demand (net balance, in %)



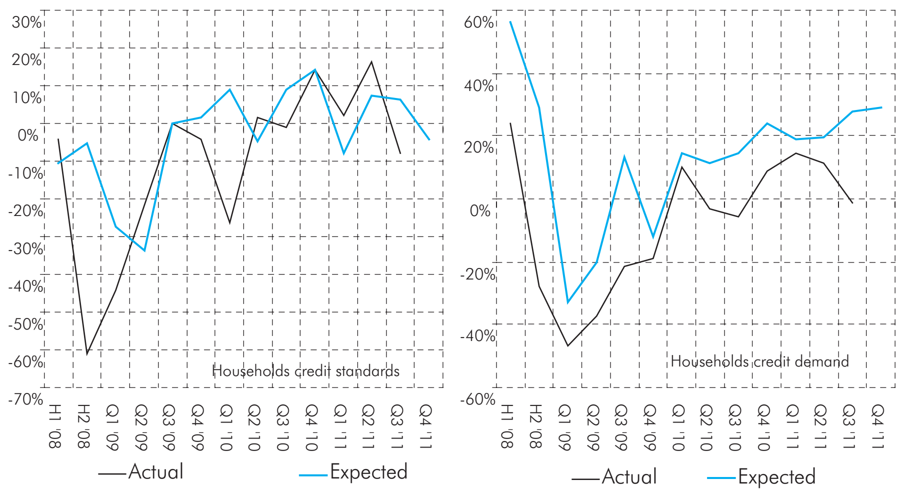
Source: Bank Lending Survey 2011 Q3, Bank of Albania

lending standards to continue to be tight. The relevant net balance was -10.5%. In 2011 Q3, bank experts continued to assess as negative the business demand for loans. The net percentage of banks that have perceived a lower demand for loans was -19.4% from -5.0% in the last survey. This development does not correspond to *banks' expectations for demand for loans in 2011 Q3, stated in the second quarter survey. The decline in the total business demand for loans was determined by the negative developments in the demand for loans, mainly from the big businesses. Demand for loans from big businesses continued to be downward in 2011 Q3, and its net balance was -23.0% from -7.2% in the previous quarter. The loan demand from small and medium-sized enterprises changed the direction from positive to negative; its net balance was -23.5% from +2.3% in the previous quarter. The need to fund fixed investments and the current and expected macroeconomic situation at home are the two factors providing a negative contribution to the demand for loans in 2011 Q3. Expectations for businesses demand for loans in 2011 Q4 are positive and significantly higher compared with the current balance of the demand for loans.*

Standards applied on loans to households tightened in 2011 Q3, following their easing in the past quarter. By purpose of use, standards for consumer loans were more tightened than those for house purchase.

* *The survey was conducted in October 2011 and it covers credit developments in 2011 Q3, as well as banks' expectations of potential changes to lending during 2011 Q4. A detailed analysis of the Lending Survey for 2011 Q3 results may be found at www.bankofalbania.org, under Publications section.*

Chart 50 Lending standards and loan demand by households (net balance, in %)



Source: Bank Lending Survey 2011 Q2, Bank of Albania

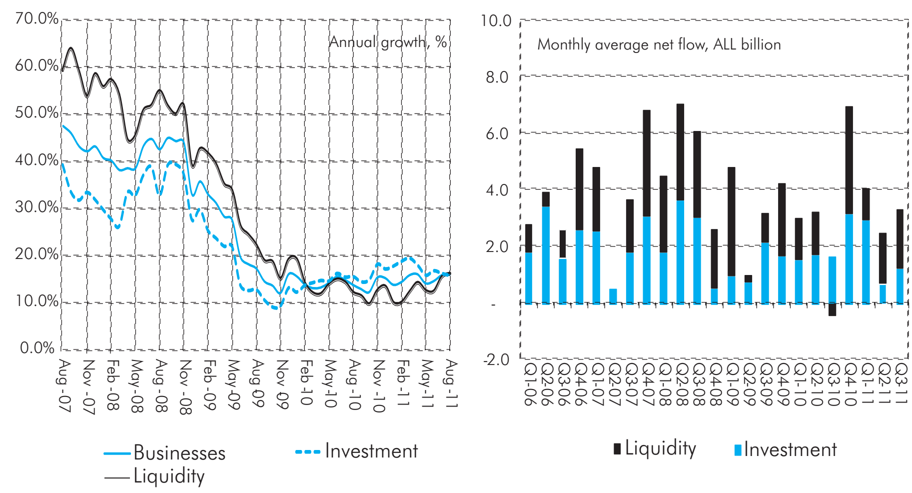
Banks' experts assessed that the financial position of households, situation of non-performing loans, and developments in the real estate market contributed to the tightening of lending standards on loans to households.

According to bank experts' assessments, lending standards applied on loans to households will continue to be tightened in 2011 Q4. The lending standards are expected to be somewhat less tightened than the actual level. This is applicable both on consumer and house purchase loans.

In 2011 Q3, in contrast to expectations from the previous month, household demand for loans was assessed as negative. The net balance was -1.0% from 11.3% in the previous quarter. The need to finance consumption and house purchase, as well as credit standards applied by banks continue to be driving factors of the demand for loans. On the other hand, developments in the real estate market and the use of alternative financing resources had a negative contribution to the household demand for loans. Bank experts' expectations regarding household demand for loans are positive for 2011 Q4.

In contrast to 2011 Q2, expansion of loans to the private sector in July-August was dominated significantly by loans in foreign currency. At the end of August, this portfolio increased 11.6%, or about 2 percentage points higher than at the end of the second quarter. The same dynamic is observed in the annual growth of loans in foreign currency, which, excluding the exchange rate effect, posted 10.5%. Lending in foreign currency continued to be stimulated by businesses demand and is more limited regarding households. Lending in Albanian Lek, although less in these two months, recorded annual growth of about 14.8%, retaining its average growth rates in this year.

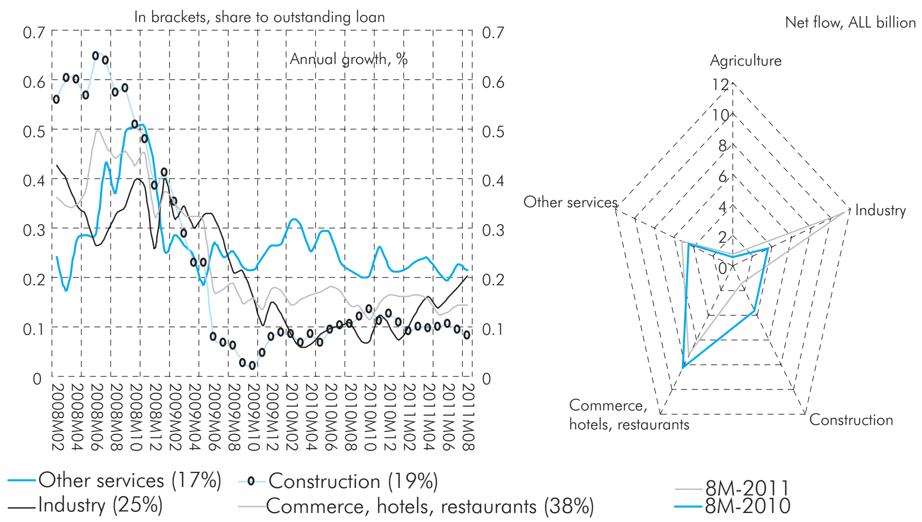
Chart 51 Developments in the business loans portfolio by purpose



Source: Bank of Albania

Year-on-year, the businesses loan portfolio was up 16.0% in August from 14.6% at the end of the second quarter. This increase of business loans was triggered mostly by the demand for funding liquidity needs. This portfolio expanded at higher rates, settling at 16.2% at the end of August from 12.4% at the end of 2011 Q2. Moreover, investment loans, since April, have been sluggish, as observed in the monthly net flow for this portfolio. Year-on-year, investment loans were down to 15.8% in August, compared with 19.6% at the end of the first quarter. This performance is in line with the assessment for the slowdown of private investments in the economy, as a result of the existence of free capacities conditioned by the below-potential performance of Albania's economic activity.

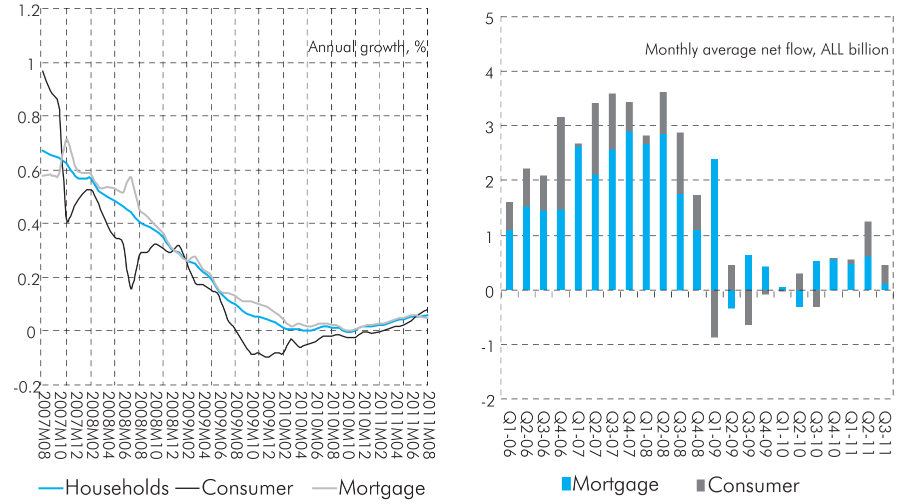
Chart 52 Businesses loan portfolio by sector



Source: Bank of Albania

Loans to businesses by industry sector followed the performance of economic activity in Albania during 2011. Hence, most loans were received by the industry and services sectors, which provided a larger contribution to economic growth during the current year. In July-August, rapid growth of lending to industry is evidenced absorbing about 60% of portfolio expansion of loans to businesses during this period. Net flow increase is noted also for loans to the agriculture sector, but its share in the credit stock is small, around 2%. Moreover, the weak performance of construction sector for more than three years continues to condition its low funding by the banking system.

Chart 53 Portfolio of loans to households by purpose of use



Source: Bank of Albania

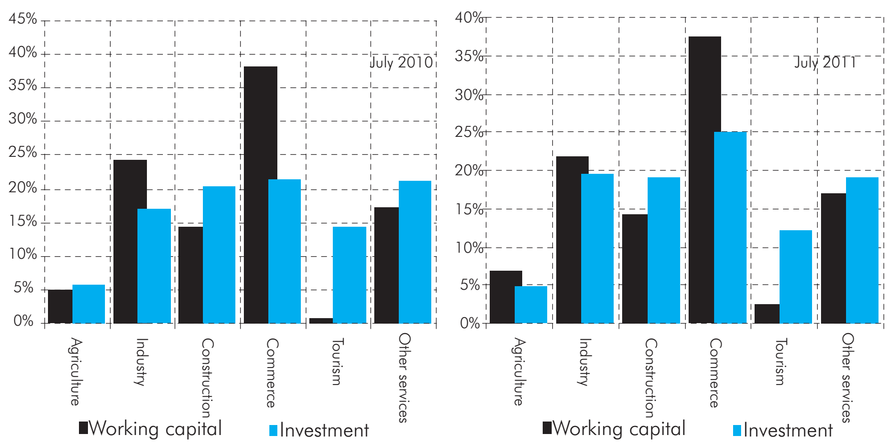
During July-to-August period, loans to households carried out the positive dynamic present since 2010 Q4. Monthly average net flow, though lower than in 2011 Q2, was significantly higher than the corresponding period of a year earlier. Similar to 2011 Q2, most of loans to households were granted to fund consumption. Year-on-year, consumer credit continued its rising trend, recording annual growth of 8.0% at end-August. Mortgage loan expansion was small during these two months and its annual growth rates were stable at 5.2%. Beyond developments in the short run, which carry positive signals, demand for loans to households is assessed as moderate. In line with household consumption, demand for loans to households continues to be affected by uncertainties for the future, postponement of large expenditures and added prudence to use bank funding.

*Box 6 Performance and restructuring of the credit portfolio by sector**

In the Bank Lending Survey conducted during 2011 Q3, bank experts stated their opinions about the distribution and performance of the credit portfolio by sectors of the economy, the restructuring of the credit portfolio and average duration of the credit approval process.

The distribution of the credit portfolio, an assessment for July 2010, points out a concentration of loans in the trade, industry and other services sectors. The same structure is also noticed in the assessments made or loans distribution by sector in July 2011. The sectors with the lowest share during the two periods in review are tourism (hotels and restaurants) and agriculture.

Chart 54 Distribution of loan use by sectors (in % of total group credit)



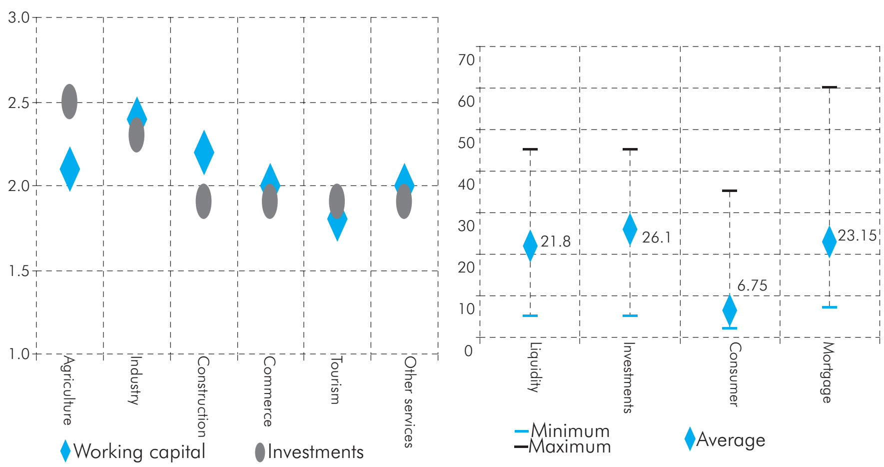
Source: Bank of Albania

Crediting to the sectors of the economy by purpose of use presents a specific picture for each sector. About 38.3% of the credit for working capital is granted to the trade sector and 24.3% to the industry sector. In this sector, over a one-year period, the investment loans portfolio grew by about 3.7 percentage points and loans to fund working capital fell slightly. The deceleration of economic activity in the construction sector led, over a one-year period, to a smaller share of the loan to the total portfolio in this sector both for investment and working capital loans.

In assessing the credit portfolio by sector of economy and purpose of use, bank experts have assessed the credit portfolio in the industry and agriculture sectors (although agriculture's share to the total portfolio is small). On the other hand, loans destined for such sectors as trade and tourism has remained unchanged.

Bank experts were asked also on the loan application review period. Their responses *show that the loan application review requires some amount of time in the case of loans to businesses, both for working capital and investments. Comparable duration is also noted in the application review for mortgage loans to households. Moreover,*

Chart 55 Credit portfolio by sectors (evaluation scale from 1 to 3, with 3 – increased, left); credit approval duration (in number of days, right)



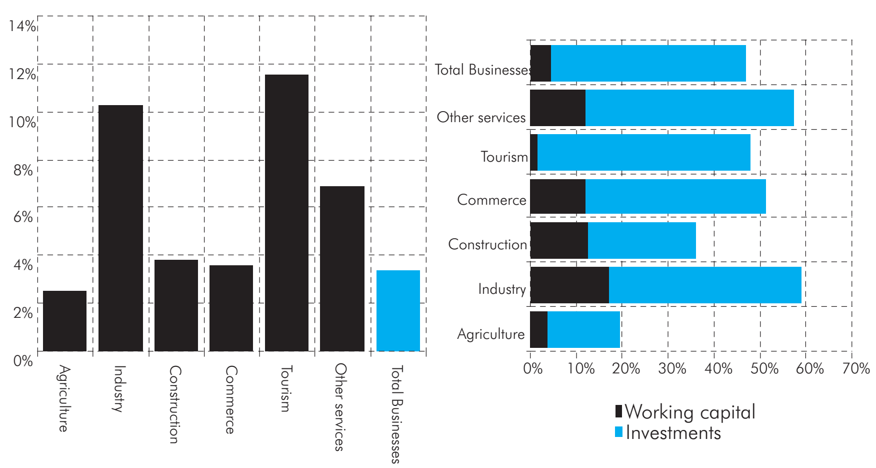
Source: Bank Lending Survey, Bank of Albania.

applications for consumer credit require on average a significantly shorter review period.

A factor that leads to longer scrutiny for credit application files, especially business and household mortgage loans, is also the completion of the required information subject to scrutiny, which is more extensive than the one required for a consumer credit. In addition, delays in credit disbursement after approval are also generated by the process of mortgaging collateral for the received loan, related to standards procedures at the immovable property registration office.

Taking into account the actual global situation and the overall economic situation at home, specific problems of the banking sector and especially non-performing loans developments, the banks affirmed their views on credit portfolio restructuring over the last 12 months. Bank experts assessed that restructuring is a process that has affected more or less the whole credit portfolio by sectors. On average, share

Chart 56 Credit portfolio restructuring by sector in total (in %, left); by sector and purpose of use (right)



Source: Bank Lending Survey, Bank of Albania *of restructured credit to total credit portfolio to businesses was about 3.4% in the last 12 months. Restructuring has affected mostly tourism sector regardless of its small share in the portfolio of loans to businesses. Furthermore, loans to businesses operating in the industry and services sectors have been subject to restructuring.*

Within the restructured credit portfolio, restructuring of investment loans across all the sectors in review have the biggest share. This phenomenon is acceptable, given that investment loans are based on medium-term projections of business performance. These projections had to be revised in line with the factual performance of the internal economy under global crisis shocks. Working capital loans have also been restructured but to a lesser degree, given its purpose of use and its short-term nature.

* *Written by Merita Boka*

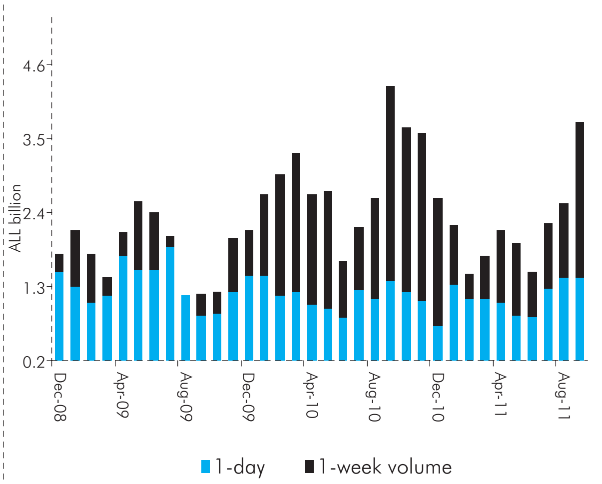
V.3 FINANCIAL MARKETS, INTEREST RATES AND EXCHANGE RATE

INTERBANK MARKET

In 2011 Q3, the interest rates in the money market were downward whereas the total volume exchanged between the banks recorded an apparent increase. The total liquidity level was steady, providing appropriate conditions for interbank market agents to boost their activity. Bank of Albania continued to conduct regular operations in an open market injecting liquidity of 7-day and 3-months maturity term. The value injected through reverse agreements during this period was higher than in the previous quarter, while the interest rate in these auctions was close to the key interest rate showing an improvement of banks' liquidity. At end-September, the Bank of Albania decided to cut the key interest rate by 0.25 percentage points down to 5.00%. Interest rates in the interbank market reflected this move and in the first weeks of October they declined even further in line with the signal of the monetary policy.

Transaction volume in the interbank market continued its growth month after month under the positive impact of the seasonal effect during this period. The conclusion of a number of monthly transactions during this period confirms the positive climate in market participants. One-week maturity loans had the biggest share in the interbank borrowing volume, although daily transactions highlighted a pronounced increase during the last two months. Thus, total borrowing in the interbank market was up to ALL 3.81 billion in September, which his higher than the average of quarters of the past two years. By traded maturity, daily volume increased by ALL 0.468 billion from the previous quarter to ALL 1.387 billion, whereas the weekly one reached ALL 1.515 billion from ALL 0.919

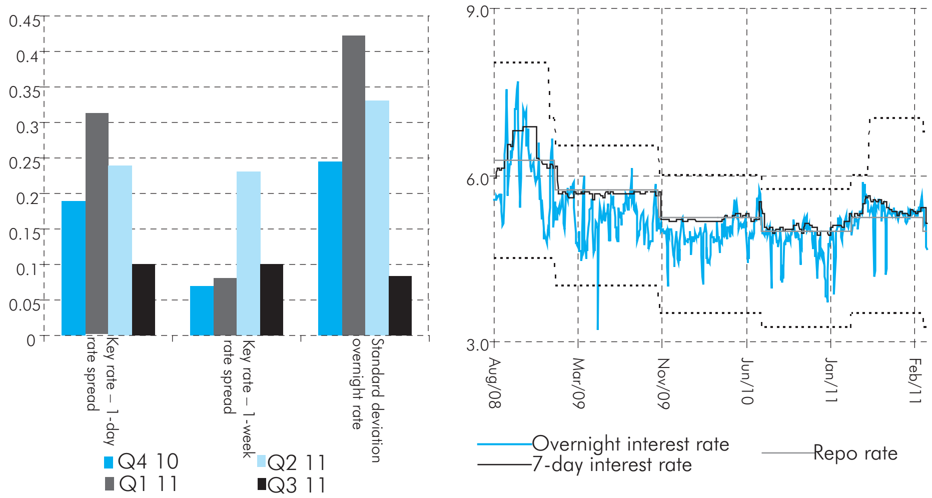
Chart 57 Volume of interbank borrowing



Source: Bank of Albania

billion in the previous quarter. Higher bank activity in the interbank market is also reflected on the interest rates, which, during these months, dropped for both maturities. Interest rate cut was more pronounced in July and August, while, overall, their volatility was lower than in previous quarters. On a quarterly average, the reduction was more pronounced on the weekly maturity with interest rates down to 5.34% from 5.48%, while reduction in overnight transactions was more contained down to 5.31% from 5.34% in the previous quarter.

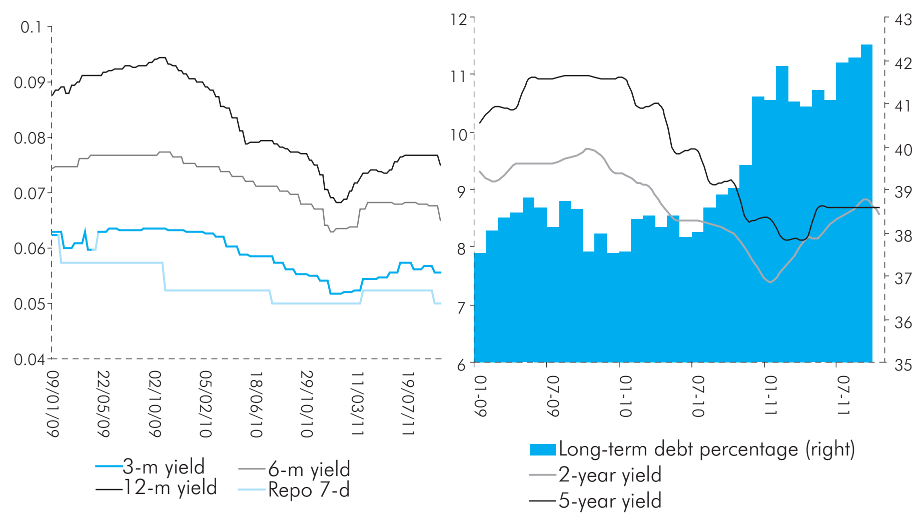
Chart 58 Interest rates in the interbank market (left) and the difference from the key interest rate and standard deviation (right)



Source: Bank of Albania

Interest rates ranged within the corridor established by the Bank of Albania and close to the key interest rate, demonstrating low volatility. The average spread between the overnight and the key interest rate in 2011 Q3 narrowed to 0.10 percentage points from 0.24 percentage points in 2011 Q2.

Chart 59 T-bill yields (left) and bonds yields in the primary market (right)



Source: Bank of Albania

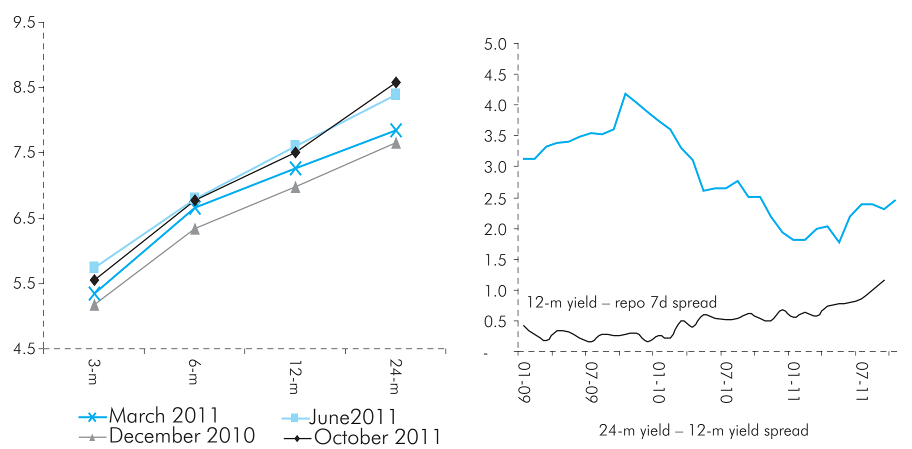
PRIMARY MARKET

Primary market yields were determined mainly by the strategy of budget deficit funding. In 2011 Q3, T-bill issuance decreased and the deficit was funded mainly by bonds. Moreover, pressures for liquidity were lower, reflected in the bid/cover ratio of over 100%. T-bill yields increased gradually until the end of June and settled at that level almost unchanged on to the third quarter, while bond ones continued to increase.

T-bill yield increase continued until June for all maturities. As of July, with the reduction of T-bill issuance, the yield level remained unchanged for the 12-month maturity term and was slightly down for the other two maturities. Sufficient liquidity and lower demand for this instrument did not contribute to downward pressures of the return rate. The 12-month yield was 7.67% at end-Q3, from 7.65% at end-Q2. The key interest rate cut by 25 percentage points at the end of September was transmitted to the succeeding T-bill auction, with the 12-month yield dropping 17 percentage points down to 7.50%.

Irrespective of the 12-month yield performance, the bond yield continued to rise. We point out that in the third quarter there were issued only 2-year bonds and the government securities portfolio in the banking system is expanded by investments in this instrument. Two-year bond yield rose to 8.84% in September or 0.44 percentage points from June, as a result of the low competition in this segment of the primary market.

Chart 60 Yields performance and their rates spread*



*7-day repo rate is the average weighted interest in 7-day maturity reverse, with variable price

Source: Bank of Albania

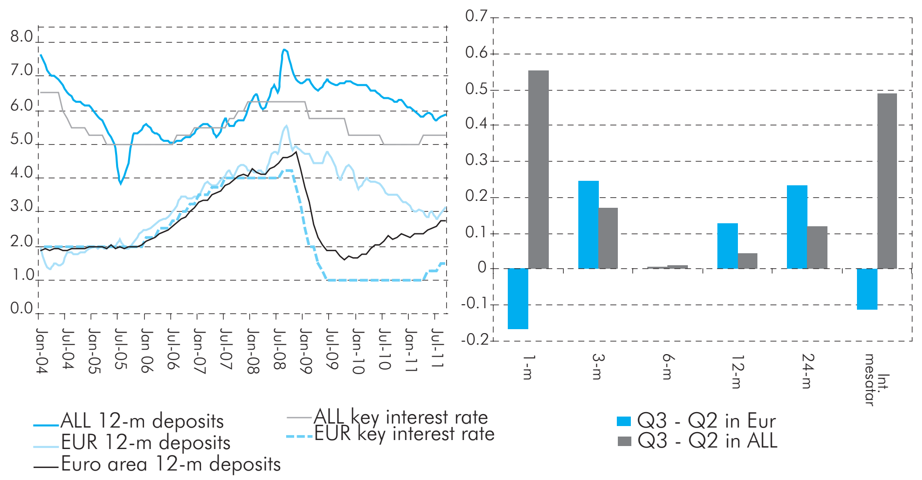
The yields in the primary market were up in September. The short-term end of the trajectory was down in response to increase of banking system liquidity in the third quarter and expectation for the reduction of the key interest rate. In contrast, the 2-year yield is higher, mainly impacted by the market configuration of this instrument.

INTEREST RATES ON NEW DEPOSITS

Upward interest rates on ALL new deposits, continued during July-August 2011. Following the rising trend at end-March[34], this trend was supported by the summer seasonal effect. Changes were minor, because banks were not very active during this season. The euro average weighted rate was up in these months as a result of the increase in reference rates.

The average weighted interest rate for ALL deposits in July-August registered 5.26% or 0.55 percentage points above the average of 2011 Q2. This increase came not only because of the summer promotional offers, but also due to new inflows of long-term deposits with higher interest rates (with an impact on the weighted value). Preliminary data show that deposits interest rates continued to remain at the same level even in September. Compared with the corresponding period of 2010, the deposits average interest rates in July-August 2011 was 0.04 percentage points lower (key interest rate at this period was 0.25 percentage points higher) showing a decline of margins[35].

Chart 61 12-month deposit interest rates and key interest rates in Albania and euro area (left); 3-month spread of ALL and EUR deposit interest rates by term (right).



Source: Bank of Albania

Interest rates for euro time deposits in July-August were line with the dynamics of Lek interest rates. Average weighted interest rate for new euro deposits during these two months was 2.73%, 0.43 percentage points higher than the average of 2011 Q1. Higher interest rates in the European market as well as the decision to increase the key interest rate by the ECB urged our banks to apply higher interest rates on euro-denominated deposits.

INTEREST RATES ON NEW LOANS

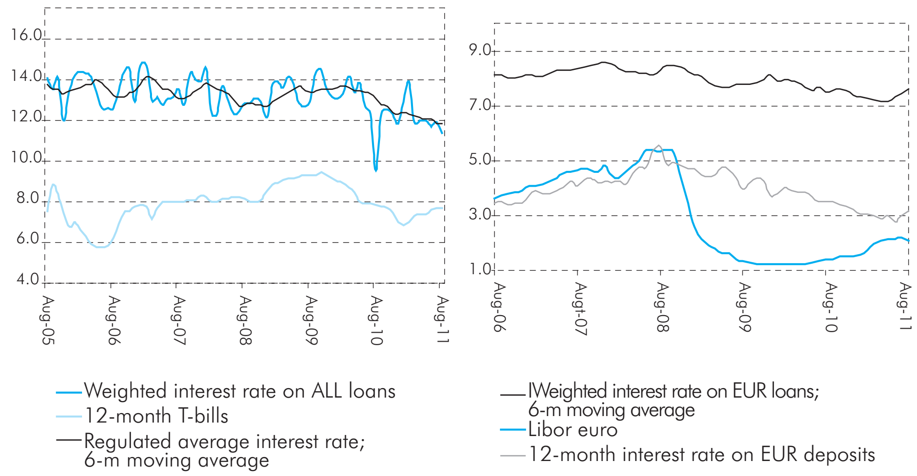
The last two months of the summer season continued to be characterised by easing credit premiums in the banking system. Interest rates on new Lek loans were stable at low levels during July-August. On the other hand, euro

34 *At the end of March, the key interest rate was up 0.25 percentage points.*

35 *In 2010 H2 and 2011 Q1 new deposits interest rates were down, thus cutting the margins, with the confirmation for the improvement of liquidity indicators.*

loans average interest rates were higher during this period. Average credit interest rates continue to be affected mainly by the diversification of offers and special terms by certain banks in the system for special clients, in both major currencies. In addition, increased reference rates and exchange rate risk were the factors that continue to contribute to high euro credit interest rates.

Chart 62 Interest rates on new loans ALL (left) and EUR (right).



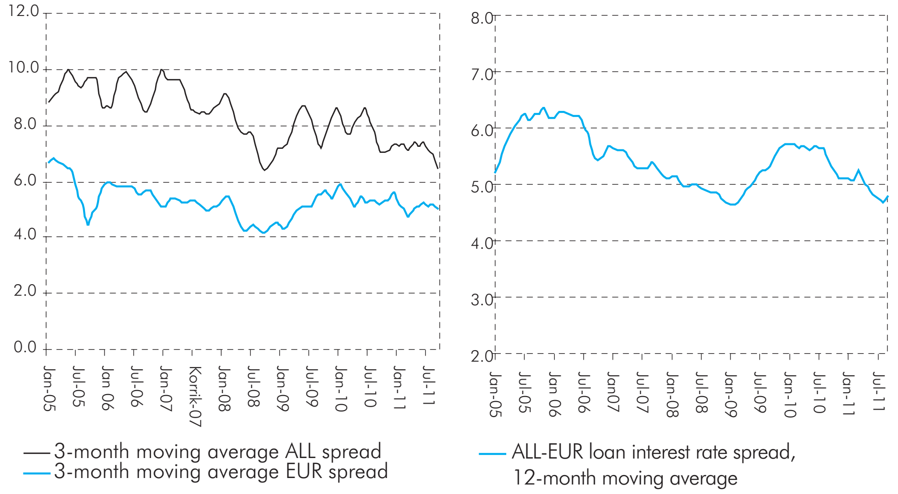
Source: Bank of Albania

In July-August, the ALL credit interest rate was cut again, narrowing thus its difference with the 12-month yield. It marked on average 11.66% in these months, 0.20 percentage points below the previous quarter and 1.24 percentage points below the first quarter[36]. Most of the new ALL credit was granted for short-term needs of businesses for investment, while in the last months, ALL-denominated mortgage loans to households have been more frequent. By maturity term, the highest cut on interest rates was applied to the short and medium maturity terms.

Interest rates on euro loans continued to grow in July-August. They averaged 7.76% or 0.35 percentage points above 2011 Q2. This trend stemmed primarily from reference rates that continue to go up as well as from the application of high premia on EUR working capital loans. Their interest rates were up 0.81 percentage points on average value from a quarter earlier. In the long-term maturity, over 5 years (mainly on real estate), banks continue to be sceptical on the premium of new foreign currency loans. The interest rate on these loans was up on average 0.18 percentage points in July-August from 2011 Q2.

[36] *It was on average 12.91% in Q1, but this high value was affected by a short-term loan for a considerable amount with the interest rate much higher than the average of the system. Excluding this loan, the interest rate was 12.19%, anyhow 0.53 percentage points above the July-August rates.*

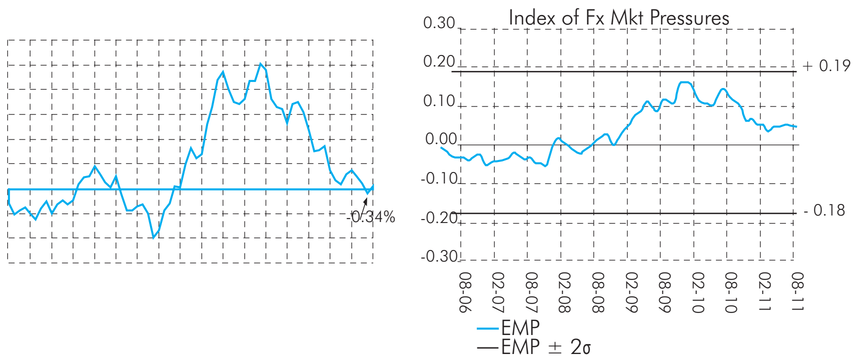
Chart 63 Average intermediation rates in ALL and EUR (left) and average interest rate spread between ALL and EUR loans (right)



Source: Bank of Albania

The ALL intermediation cost was significantly down during July-August, reflecting low interest rates for ALL loans, followed by higher deposits interest rates. This index registered an average value of 6.40 percentage points in these months from 7.15 percentage points in the previous quarter. Intermediation rate in euro averaged 5.03 percentage points, on average only 0.09 percentage points lower than the second quarter. The spread between interest rates on ALL and EUR loans remained highly volatile, although it continues to narrow on average values. It dropped 0.54 percentage points in July-August, compared with the second quarter.

Chart 64 Annual changes of the ALL to EUR and USD exchange rates (left) in nominal effective terms (NEER) and EMP Index* (right).



EMP index (exchange market pressure) is generated by the following formula

$$EMP_t = \left(\frac{1/\sigma_e}{((i/\sigma_e)+(1/\sigma_r)+(1/\sigma_i))}\right)\frac{\Delta e_t}{e_{t-1}} - \left(\frac{1/\sigma_r}{((1/\sigma_e)+(1/\sigma_r)(1/\sigma_i))}\right)\frac{\Delta r_t}{r_{t-1}} + \left(\frac{1/\sigma_i}{((1/\sigma_e)+(1/\sigma_r)+(1/\sigma_i))}\right)\left(\Delta\left(i_t - i_t^*\right)\right)$$

where e=NEER, r=NIR

and i= weighted interest rate for ALL and FX deposits. Higher index implies higher FX market pressure.

Source: Bank of Albania

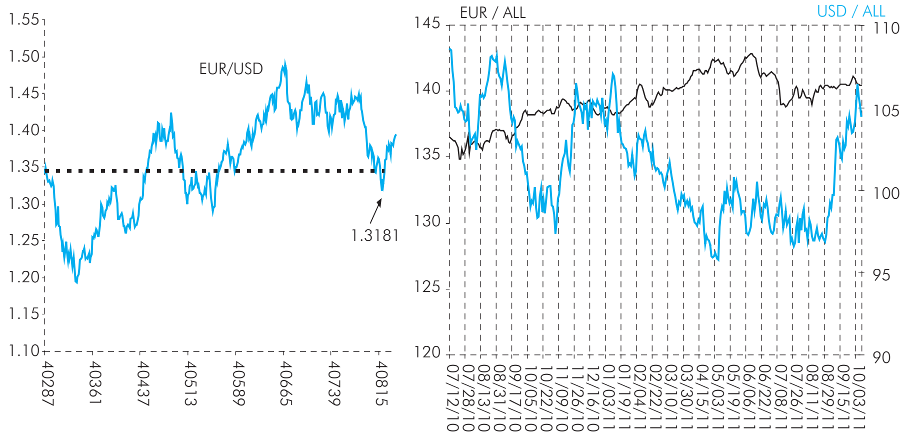
EXCHANGE RATE

The nominal effective exchange rate carried the depreciation trend of the national currency on to 2011 Q3. Annual changes to NEER[37], as of May 2011, registered slight changes on the depreciation side. In August, rates were up 0.34%, registering the first change of this trend since 2008. As regards average rates, 2011 Q3 recorded an annual depreciation of 0.13% from 6.0% in the corresponding quarter of 2010 and ALL appreciation of 1.7% compared with the preceding quarter.

Thus, the main contributor to NEER's annual appreciation was the external sector of the economy with exports of goods in July-August 2011 up by 31.7%, year-on-year. The above-mentioned developments are confirmed also by the EMP index, which has been stable since April 2011 reflecting its stabilisation around the level of 0.05 standard deviations from its historic average. The NEER index developments in quarterly terms reflects the Albanian Lek's appreciation versus the major currencies basket transmitting mainly seasonal effects that are characteristic for the summer.

During July-to-September period, the euro was exchanged on average for 140.09 Albanian Lek, while the US dollar for 99.15 Albanian Lek. The analysis of individual developments of major currencies versus the national currency shows that, year-on-year, Lek has lost ground to the euro 2.7% and has gained ground versus the US dollar 6.0%. Compared with the previous quarter, the euro has depreciated by 1.2% and the US dollar has strengthened its position by 0.72%.

Chart 65 Daily exchange rates of EUR/USD, USD/ALL and EUR/ALL



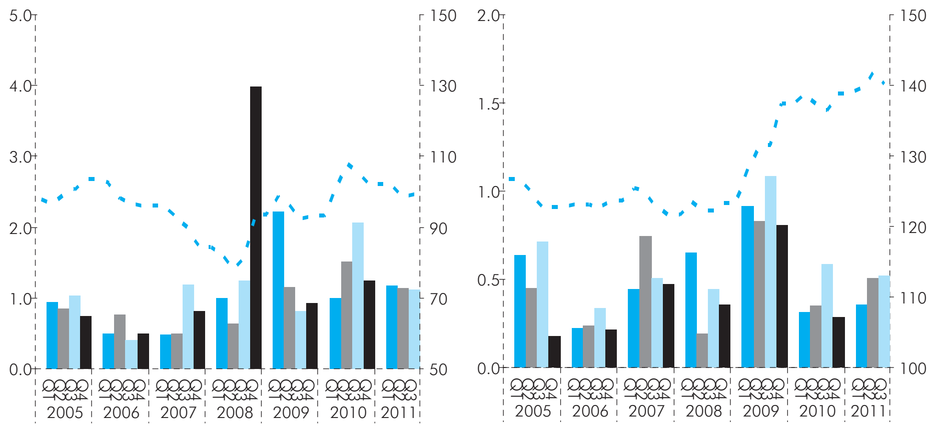
Source: Bank of Albania

37 As at September 2011, NEER – the nominal effective exchange rate shall be calculated against the currencies of our five main trade partners: Italy, Greece, Germany, Turkey and China. In contrast to the insofar index, higher NEER means ALL depreciation. For more, refer to the following box.

The appreciation of the national currency versus the euro is concentrated mainly in July, when the Albanian Lek appreciated on average monthly terms by 1.44%. The Lek's strong position was retained in the first days of August but this position was cancelled out in the second week of the same month. The Lek's position versus the euro has been stable throughout the quarter in review, significantly the lowest over the last four years.

The negative performance of the Albanian Lek versus the US dollar during this quarter has reflected mostly the EUR/USD developments in international markets. In September, due to uncertainty for the economic performance under the high sovereign debt levels in advanced economies and downward revising of growth rates in emerging economies, the US dollar reinforced its positions versus the major currencies (except for the Japanese yen).

Chart 66 Exchange rate volatility of EUR/ALL (left) and USD/ALL (right) q-o-q



Source: Bank of Albania

Therefore, on average, in the last month, 1 euro was exchanged for about 1.37 US dollars. This is close to the lowest exchange rate of 1.31 in February 2011. In the last quarter, the USD/ALL exchange rate was stable reaching levels similar to those of the previous quarters in 2011.

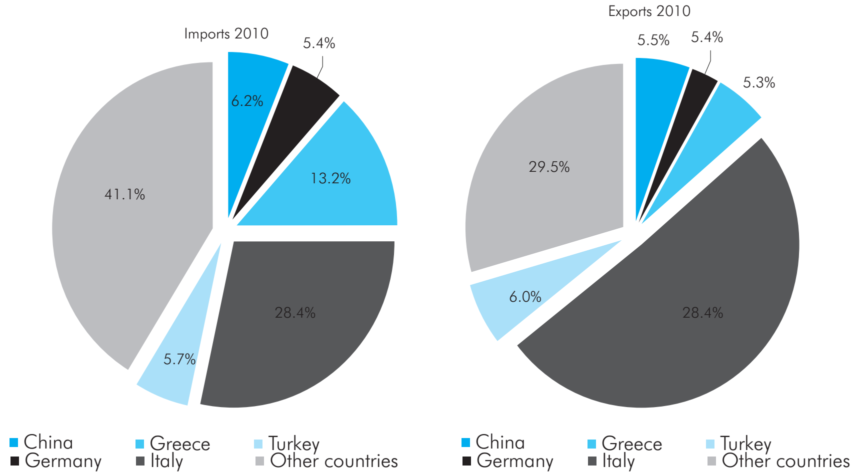
*Box 7 The new NEER**

NEER (Nominal Effective Exchange Rate) Index measures the value of the national currency versus major foreign currencies basket and is calculated by the weighted geometric average:

$$NEER_t = \prod_{n=1}^{N} K_n^{\,W_n}$$

Where K is the nominal exchange rate for the national currency and i of the trade partner country n and Wn is the share of the partner trade country in the trade activity of a country.

Chart 67 Imports and Exports by country



Source: Bank of Albania

This index may be seen as a "common" currency, weighted with certain shares according to their impact on international trade for each currency of Albania's trade partner countries.

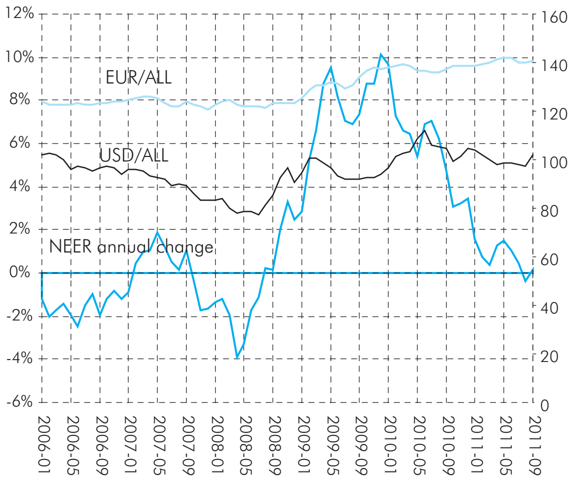
In our case, for the monthly NEER Index a basket of countries is selected including the country's five major partners: Germany, Greece, Italy (euro area countries) China and Turkey. Notably, Italy and Greece are primary trade actors for Albania and since 2006, China's and Turkey's share has increased.
Based on the bilateral trade flows model, the share of each partner country is calculated monthly according to this formula:

$$W_{ij} = \frac{M_i}{M_i + x_i} m_j^i + \frac{x_i}{M_i + x_i} x_i^j$$

Where Mi and Xi represent imports and exports of country i; mji is the share of imports of country i originating from country j and xji is the share of exports of country i sold in country j.

Another important issue in the calculation of shares is taking into consideration the changes in relative shares of bilateral trade, monthly. Lek's appreciation versus a certain currency would, in theory, lead to higher imports from that country. Subsequently, this country's corresponding share to the total imports would be different. Therefore, NEER calculation over time t is expressed as a product of

Chart 68 Average monthly FX rates EUR/ALL and USD/ALL and annual NEER spread



Source: Bank of Albania

NEER over the period prior to presentation of the new shares w(τ -B) to the ratio of real bilateral rates BRER for i countries, measures according to the geometric average for the base period B and current t, using current shares (Ellis 2001).

This index uses a monthly series of shares according to the above-mentioned model and average monthly rates of the nominal exchange rate of ALL/EUR nominal exchange rate (publication of the Bank of Albania), Turkish Lira (ALL/TRL exchange rate calculate by a cross-rate of TRL/USD exchange rate) and Chinese renminbi (ALL/CNY calculated by a cross-rate of the CNY/USD exchange rate). The average of 2006 is selected as the annual base for the construction of the NEER index and the annual spread of this indicator.

According to our model, higher NEER implies depreciation of the national currency and lower NEER implies appreciation of the Albanian Lek against foreign currencies.

* *Written by Jonida Bollano*

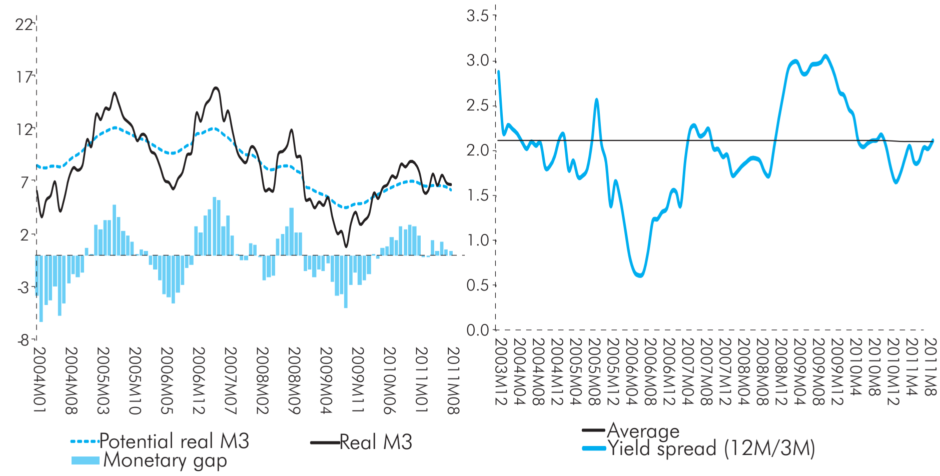
V.4 ASSESSMENT OF MONETARY INFLATION PRESSURES

Monetary developments in July-August 2011 confirmed a lower monetary expansion than in 2011 H1. In a long-term perspective, money expansion in the economy was in line with the real demand for money by economic agents. The withdrawal of the fiscal stimulus from the economy, which in the financial markets was reflected in downward demand for funding by the public sector, and decelerated growth of the M2 money aggregate and, consequently, broad money. Moreover, M3 growth slowdown was dictated also by foreign currency inflows by the external sector, which demonstrated a somewhat weaker seasonality than a year earlier. Furthermore, lending to the private sector continued its moderate growth, under high uncertainty about both domestic and international developments. Annual expansion of the real demand for money has been slowing down, settling in August at 6.8%. Nevertheless, overall, the annual domestic credit expansion during 2011 pursued a positive trend, from its historic low in December 2010. This indicator reflected, for most of the year, the positive impulse by the fiscal sector. At the end of August, the expansion of the real demand for money is in line with its long-term component, calculated conform to the statistical method[38]. The insofar dynamic of monetary indicators shows that monetary expansion recovery is slow and does not reveal added inflationary pressures from domestic monetary developments.

[38] *Potential growth of demand/supply for money is derived as an average of annual change of the series of potential M3 reached through a number of statistical methods such as HP with various coefficients and Tramo and SEAT.*

Chart 69 Real demand for money (in %) and interest rates gap (in percentage points)

Chart 69 Real demand for money (in %) and interest rates gap (in percentage points



Source: Bank of Albania.

Financial markets developments in the third quarter reveal contained conduct of financial agents, in line with seasonality. Overall, financial agents do not factorise added risk premia or liquidity to the price of their longer-term financial products. In addition, inflationary pressures expected from them over a one-year period remained stable, close to the historic average, as shown by the interest rates gap in the primary market of treasury bills. Keeping the yield of 12-month T-bills unchanged in the primary market, in addition to the lack of pressures for liquidity by banks to meet government demand, is a result also of lower demand for funding by the government during the third quarter. Total banking system funding of the government did not change, however, during this period, a shift was noted from funding through short-term instruments to longer-term debt instruments.

In addition to the money market, the foreign exchange market was stable. Volatilities in the third quarter were in line with the seasonal behaviour of the exchange rate at this period of the year. The eventless situation of the exchange rate contributed to partial prevention of pressures from higher prices in international markets on domestic markets. This performance of the national currency is expressed also on the lower contribution by imported inflation to headline inflation. Moreover, the stable exchange rate contributed to the strengthening and consolidation of the country's financial stability.