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

MONETARY POLICY REPORT
Q4 2010

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C O N T E N T S

B O X E S

T A B L E S

C H A R T S

V. MONETARY DEVELOPMENTS AND THE FINANCIAL MARKETS

OBJECTIVE

The Bank of Albania's primary objective is to achieve and maintain price stability. Promoting long-term investments, maintaining purchasing power of money, enhancing resource allocation efficiency in the economy and supporting financial stability are some of the benefits of an economic environment characterized by price stability, which is the greatest contribution that central banks can provide in support of a sustainable and long-term economic growth.

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

In order to accomplish that goal and enhance its transparency, the Bank of Albania compiles and publishes its Monetary Policy Report, which is the main instrument of monetary policy communication with the public. It makes a comprehensive presentation of recent macroeconomic developments, the factors that have affected and are expected to influence the performance of consumer prices at home.

The Monetary Policy Report on 2010 Q4 was approved on 26th of January 2011 by the Bank of Albania's Supervisory Council. The economic analysis incorporated in this report is based on the latest available statistical and qualitative data as of 14th of January 2011.

I. FOREWORD BY THE GOVERNOR

The Albanian economy recorded a positive development during 2010 H2. The economic activity continued to mark growth, while the main macroeconomic balances improved, whereas risk premium and interest rates in financial markets decreased. The 2010 economic growth was primarily driven by external demand for Albanian goods and services, whilst domestic consumption and investments remained at low levels, albeit positive developments. Inflationary pressures remained subdued, as a result of availability of spare capacity in the economy and anchored inflation expectations. Rapid expansion in exports and moderate increase in imports led to improved trade and current account deficits, contributing to balancing the foreign currency demand and supply and increasing the exchange rate stability.

Monetary and fiscal policies have conveyed a prudential macroeconomic stimulus. Withdrawal of the fiscal stimulus during the second half of the year led to a more stimulating monetary policy, by cutting the policy rate in July and enabling its pass-through into the financial markets during the following period.

Financial markets have been characterised by improved liquidity indicators and decreased interest rates in almost all financial instruments. Furthermore, a prudent fiscal policy has rendered budget deficit and public debt in line with 2010 forecasts.

Such developments are expected to be brought forward, in broad terms, in 2011 as well. Economic growth is expected to remain comparable to 2010 levels, with the domestic demand as the main driver. The banking system is in a much better position compared with two previous years in terms of supporting the increased domestic consumption and investments with funds.

Moreover, inflationary pressures are forecasted to remain subdued; budget deficit and public debt are expected to be further consolidated; and external position of the economy is expected to be more sustainable. Observance of this panorama has important implications, which I will later address in more details for policymakers and economic agents.

Recent developments in the global economy are featured by ongoing economic growth in most developed countries and emerging-market economies. In developed countries, economic growth was lower as a result of measures taken to consolidate public finances and withdrawal of fiscal stimulus. On the other hand, emerging-market economies maintained higher growth rates, expanding their demand for primary commodities and consumer goods, hence putting upward global inflationary pressures.

Economic growth is expected to continue in 2011, however, uncertainties remain elevated. Global macroeconomic imbalances, which appeared in high trade deficit levels of several developed countries, may materialise in shocks to major currencies' exchange rates and free trade exchanges worldwide.

Furthermore, concerns over the level of public debt and fiscal stability for some of the euro area countries continue to affect the sensitivity of financial markets and their tolerance to risk. Regardless of the latest upward tendencies, the balance of inflationary pressures is considered to be in check for the current year as well, as a result of availability of ongoing spare capacity.

Keeping free movement of people and capital worldwide, taking timely corrective measures on public debt position, and creating effective mechanisms to prevent and buffer out the financial crisis effects at local level, will be important challenges for policymakers. On the other hand, monetary policy of the main central banks will continue to be cautious, introducing an appropriate monetary stimulus into the economy, in order to promote economic activity without affecting the actual and projected inflation levels.

The Albanian economy recorded a positive growth during the third quarter. According to INSTAT's data, real annual GDP amounted to 4.9%, i.e., higher than the figures recorded over the first two quarters of the year. The economic activity improvement relied mostly on trade, tourism and other services. The industrial sector maintained the same contribution to economic growth, whilst construction sector continued to shrink for the fourth consecutive quarter. Developments in the demand components have followed the tendencies noted at year-start and are in line with our previous assessments. Available data suggest that economic growth continued to be stimulated, to a large extent, by external demand; meanwhile, fiscal consolidation during the second half of the year predictably yielded a slowing effect to the economic activity. Private consumption and investments remained sluggish during the second half as well, despite improved financing conditions of their activity. Private consumption continues to be subject to consumers' resilience to spend and a low support by banks. Increased wages, employment and remittances in the economy have not been fully factorised in optimising individuals for the future, as proven by low levels of consumer confidence indicator of 2010 Q3.

In addition, sluggish consumer demand and spare capacity in the economy did not encourage businesses for new investments. However, with the improvement of financing conditions and further increased demand, in contrast to the first two quarters, private investments are estimated to have provided a positive contribution in the third quarter.

Fiscal policy took a cautious approach during 2010, aiming to keep budget deficit and public debt in check. Budget deficit as of November 2010 was ALL 23.1 billion, down by 64% y-o-y. Budget deficit cut by 4 percentage points of GDP during 2010 demonstrated a fiscal consolidation in both public revenues that increased by 9.6% as at November, and budget spending that decreased by 4.8% over the same period. In particular, budget deficit reduction and public borrowing control in domestic financial market contributed to banking system liquidity improvement and interest rate cut in the financial market. Persistence of this tendency during 2011 would be a welcomed development for the Albanian economy. The Bank of Albania deems that the philosophy of prudence pursued in 2010 as concerns budget expenditure and public borrowing should also be present in the year ahead.

External demand continued to support economic growth during the third and fourth quarters as well. January - November 2010 recorded a trade deficit cut by about 9.2% y-o-y, as a consequence of increased exports by roughly 58%. On the other hand, imports increased more moderately - around 6.4 per cent - during the first eleven months. The depreciating exchange rate, the moderate growth of domestic demand, and the climate and global market structures, which sustained the Albanian exports, have been conductive to trade deficit improvement.

Nevertheless, contribution of net external demand to economic growth of the third quarter is considered to be lower than in the first half of the year. Annual improvement of trade deficit by 10.7% in the third quarter was lower than the one recorded over the first two quarters of 2010. Furthermore, merchandise trade in the first two months of the fourth quarter attested to a lower contribution of the external economy in 2010 Q4. The growing tendency of imports and an expected slowdown in the growth of exports may contain the process of correcting foreign trade balance and reduce its impact on 2011 economic growth. In terms of macroeconomic policies, these developments suggest that strong stimulating policies for the economy may be buffered out by a rapid increase in imports, which accompanies the increased domestic demand. In the structural aspect, these developments reiterate the need for ongoing structural reforms, which should orient the Albanian economy towards a more sustainable development model and a higher competitiveness in the global market. These reforms should, inter alia, aim at establishing a favourable climate to attract stable capital inflows, in the form of foreign direct investments or long-term capital inflows.

Further increase in aggregate demand enabled the Albanian economy to move closer to its potential output, yet remaining clearly under-utilized. Consequently, downward inflationary pressures persisted even during the second half of the year. Annual inflation rate averaged 3.1% in the first quarter of the year, 0.4 percentage point below its third-quarter average and close to Bank of Albania's target. During 2010, inflation was influenced by increased administered prices, rising trend of primary commodity prices, of food products and oil prices in international markets, and a depreciating exchange rate.

Annual inflation rise to 3.4% in December was driven by increased agricultural products prices, in response to their pickup in the global markets. Yet, anchored price stability expectations and disinflationary pressures from the real economy have balanced the impact of above-mentioned supply-side factors on inflation, restraining their transition to second-round effects and stable inflationary pressures.

The Bank of Albania considers that the inflation rate is expected to range within the 3% target throughout the next year. The rising effect on supply-induced inflation is offset by the negative output gap and existence of spare capacity in the economy.

Controlled inflationary pressures and fiscal policy made room for a gradually rising monetary stimulus in the economy during 2010. The Supervisory Council of the Bank of Albania decided to cut the policy rate by 0.25 percentage point in July, down to record low of 5.0%. Parallel to that, the Bank of Albania supplied the interbank market with the necessary liquidity for a smooth operation of financial markets.

In the operational aspect, a change in the form of our objective in June served to better orient the banking system supply with liquidity, resulting to a decreased liquidity premium in the system, and the interest rates in the interbank market. Financial markets were more relaxed with their gradually falling risk premium. Primary market interest rate continued its downward trend noted a year earlier, owing to the fiscal sector's moderate demand for funding and good liquidity condition in the banking system. Moreover, the policy rate cut was followed, to a sizeable degree, by falling interest rates in ALL-denominated deposits and loans, hence a good introduction of monetary policy decisions into the economy.

Beyond a better transmission of monetary policy decisions on financial market interest rates during the second half of the year, the Bank of Albania deems that their pass-through into the real economy remains incomplete. Referring to lending developments during the second half, loans to the private sector increased on average at the same pace as in the first half. Annual lending growth amounted to 10.1% in November, almost commensurate with the level noted at the end of the first half. Slower increase in loans to the private sector made a low contribution to money supply growth in the economy, reconfirming contained inflationary pressures by the domestic economy. M3, broad money growth approached its historical average rate during the fourth quarter of the year, marking 11.9% and taking mainly the form of banking system time deposits.

Although banks did not tighten their lending terms and conditions - on the contrary, during the second half of the year there were easing signs - the private sector's demand for bank loans remained low. It remained low due to persistent negative output gap by businesses and upward consumer tendency to save under a perceived added insecurity for the future and a more cautious behaviour towards actual consumption. Reduction of risk premium in financial markets, maintaining of positive growth rates in the economy, employment and wages, as well as a clearer short and medium-term economic outlook are expected to contribute to a higher demand for bank loans over the next period. The banking system meets the prerequisites in terms of liquidity, capitalisation and more favourable financing conditions in response to this demand.

Our outlook for the future supports the maintaining of a positive performance of the Albanian economy even for 2011. Growing demand is expected to be subject to a comparatively better progress of the domestic demand during this year. Private consumption and investments are expected to rise further, while the fiscal sector, after the 2010 slowdown, is expected to make a positive contribution to economic growth. Nonetheless, it is assessed that the demand growth will be below the potential of our economy in 2011 as well. This will put downward inflationary pressures on the domestic economy, which is expected to balance the impact of foreign and administered prices rise.

II.DEVELOPMENTS IN THE EXTERNAL ECONOMY

II.1 ECONOMIC GROWTH AND MACROECONOMIC BALANCES

II.1.1 THE GLOBAL ECONOMY

The global economy continued to show signs of improvement in the last quarter of the year, although at more moderate rates than in the first half. The slower growth is due to the winding down of the positive effect of monetary and fiscal stimulus put in place by many countries during the crisis. Different growth rates were noted worldwide between developed economies growing at slower rates and emerging-market economies recording high growth rates. Inflationary pressures also appear different across different countries. Therefore, developed countries have reflected slight inflationary pressures, albeit rising inflation rates, whilst emerging-market economies have reflected stronger inflationary pressures.

Table 1 Key macroeconomic indicators

	GDP change		Unemployment rate	Inflation rate	
	Q3-10/	Q3-10/		December -10/	December -10/
Country	Q3-09	Q2-10	November-10	November-10	December -09
USA	3.2	0.6	9.4[1]	0.5	1.5
Euro area	1.9	0.3	10.1	0.6	2.2
Germany	3.9	0.7	6.7	1.2	1.9
France	1.7	0.3	9.8	0.5	2.0
United Kingdom	2.7	0.7	7.9[2]	0.4[3]	3.3[3]
Japan	5.0	1.1	5.1	-0.3	0.1

Source: Eurostat, Respective Statistical Institutes

[1] Data for December 2010

[2] Moving average for August-September

[3] Data for November 2010

II.1.2 EURO AREA'S ECONOMY

The euro area's annualized economic growth was 1.9% in the third quarter of the year, compared with 0.3% in the previous quarter. Domestic demand is still the main driver to this development. Moreover, the improved global economic growth has sustained the growth of the demand for euro-area exports. The increased public debt in some countries of the euro area and the measures taken to adjust the budget deficits have made an insignificant impact, since so-far, the affected countries are small ones, with peripheral economies and with a little share to the euro area's economy. In November

2010, unemployment rate remained at 10.1%, commensurate with the level of October 2010, the first month that had marked a slight rise in this indicator, after being constant for about five months. Preliminary data from Eurostat suggest that the annual inflation rate reached 2.2% in December 2010. Rising foodstuff and energy prices were the main driver to this markedly higher rate than the past months' average.

II.1.3 U.S. ECONOMY

The U.S. economy showed signs of improvement, growing by 3.2% in 2010 Q3, from 0.6% q-o-q. Economic growth was based on consumer spending, government expenditure, exports and inventories. The U.S. economy is expected to grow in the period ahead, due to various measures taken by the Federal Reserve and the government, which aim to increase the external demand for American products and domestic citizens' disposable income. Following two months of rising U.S. unemployment rate, it dropped to 9.4% in December 2010. Annual inflation rate picked up slightly to 1.5% in December 2010, driven by high energy and food prices.

II.1.4 BRIC ECONOMIES

In 2010 Q3, the BRIC economies had positive economic growth, albeit somewhat slower than in the previous quarter. India, which succeeded in maintaining the high growth rate recorded over the second quarter, is excluded. More specifically, China's growth was sustained by high levels of consumption and investment, while India's growth was fuelled by industrial output growth. Adverse weather conditions have led to decreased agricultural output in Russia, which, coupled with the declining exports, have contributed adversely to the country's economic growth. Brazil's industrial output growth was the main driver to the economic growth. Inflation rates were upward in Brazil, Russia and China, and downward in India. Except the Bank of China, which raised its policy rate by 0.25 percentage point at its last meeting in December 2010, the central banks of other BRIC economies, in their respective last meetings, decided to keep their policy rates unchanged.

Table 2: Key macroeconomic indicators for BRIC economies

Countries	Annual Real GDP change			Annual inflation
	Q2:2010	Q3:2010	2011[1]	November-10
Brazil	8.7	6.7	4.2	5.9[2]
Russia	5.2	2.7	4.1	8.1
India	8.8	8.9	8.4	9.6[3]
China	11.1	10.6	9.6	5.1

Source: IMF, OECD, Respective Statistical Institutes

[1] *IMF's projections, October 2010*

[2] *Data for December*

[3] *Data for October*

II.1.5 REGIONAL ECONOMIES

The economic activity grew in the countries in the region, except in Greece.

- Italy's economic activity grew by 1.1% y-o-y, due to higher consumer spending and investments.
- Greek economy contracted, down by 4.6% y-o-y in 2010 Q4. Aggregate investments provided the most negative contribution to this growth. Consumer spending and government expenditure also dropped.
- Turkey's economy recorded an economic growth of 5.5% in 2010 Q3, below the average of the first 9 months of the year. All the sectors expanded, except agriculture. The slowed growth rate was due to sluggish industrial output growth, which increased only by 1.2%.
- In Former Yugoslav Republic of Macedonia (FYROM), the rise in exports and consumer spending made the economic activity reach the third quarter's 1.3% y-o-y growth.

Unemployment rate picked up slightly in Turkey, was constant in Italy and Greece, and was lower (than in the previous period) in FYROM.

Annual inflation followed an upward trend in Italy, Greece and FYROM, and a downward trend in Turkey.

Table 3 Economic indicators for countries in the region

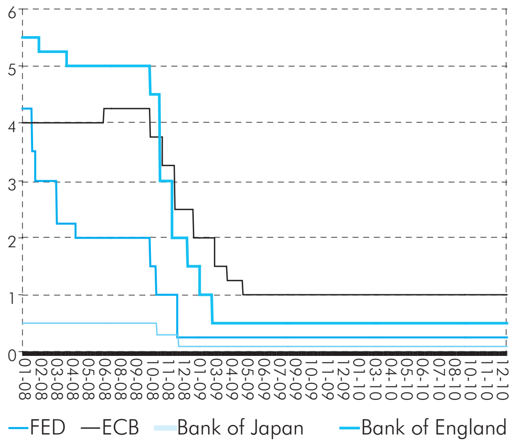
Countries	GDP change Q3:10	Annual inflation December -10	Unemployment rate December -10
Italy	1.1	2.1	8.7
Greece	-4.6	5.2	13.5[2]
FYROM	1.3	3.0	31.7[3]
Serbia	2.7	10.3	19.2[2]
Croatia	0.2	1.8	18.3
Turkey	5.5	6.4	11.2[2]
Kosovo	4.6[1]	6.6	:
Albania	4.9	3.4	13.5[3]

Source: Respective Statistical Institutes, EuroStat, EcoFin, IMF.
[1] IMF's 2010 forecasts. 2 Data for October
[3] Data for Q3 of the year
: Unavailable data

II.1.6 DECISIONS ON POLICY RATES

The major central banks have used for a long time the quantitative stimulus to promote their economies, while keeping the interest rates unchanged, considering them appropriate for stimulating the economies. Hence, in its last meeting, the ECB kept its policy rate at 1%; the Federal Reserve at 0-0.25% and the Bank of England at 0.5%. The Bank of Japan lowered its benchmark interest rate to 0 - 0.1% range. Except the Bank of Japan, which in October 2010 decided to include a 0% floor limit in its definition of the overnight rate, all the other banks have kept their policy rate unchanged for more than a year.

Chart 1 Policy rate

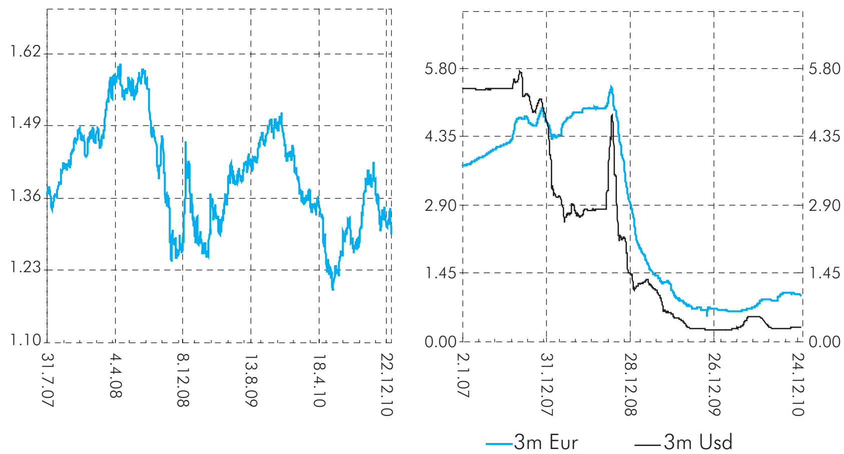


Source: ECB, FED, Bank of England, Bank of Japan

Financial markets showed a slight upward performance in 2010 Q4. In euro-area money markets, the winding down of the effects of certain facilities that were put in place by the European Central Bank during the crisis and the uncertainty induced from problems facing several euro-area member states have contributed to rising Euribor interest rates of all maturity terms. Government bond yields have shown an upward trend in most advanced economies. Optimistic signs of the global economic recovery have provided a positive contribution, while the emerging of public debt problems for a group of states within the euro area is another factor that has led to further pickup in respective debt security yields. In terms of equity markets, the effect of positive corporate earnings on quarter-over-quarter balance-sheets was reflected in a moderate growth of key indicators, whereas the impact of impaired sustainability of public balance sheets of the above-mentioned countries was reflected in increased volatility.

In December, the money market Euribor interest rates decreased slightly for all maturities, whereas in quarterly terms they moved up. Libor interest rate declined q-o-q. During 2010 Q4, Euribor interest rates of 1 -, 3-, 6-, and 12-month maturity term rose by 14 basis points, on average, while in December the level of these instruments was 0.81, 1.02, 1.25 and 1.53%, respectively. The 3-month Libor rate has dropped by 10 basis points, from 0.30% in the previous month. Related to foreign exchange markets, during the

Chart 2. Exchange rate of EUR/USD (left scale) and LIBOR USD, EURIBOR (right-hand)



Source: ECB, Reuters.

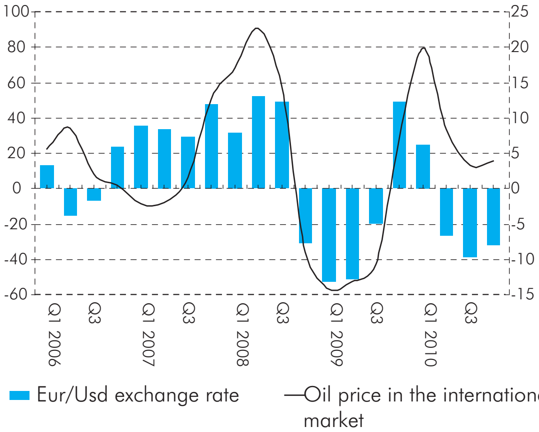
last months, the euro was depreciated vs. the U.S. dollar, Japanese yen and the British pound, though in quarterly terms, it appears to have appreciated vs. these currencies. At the beginning of January, 1 euro was traded at 1.32

U.S. dollar, or 2.3% less than at end-September. In 2010 Q4, the euro was appreciated by an average of 5.21% vs. the previous quarter.

II.1.5 PRIMARY COMMODITY PRICES IN GLOBAL MARKETS

During the second half of the year the global oil price per barrel showed an upward trend in both annual and semi-annual terms, as a result of high price rise in the last two months of the year. In 2010 H2, oil price per barrel rose by 14.5%, on average, compared to 2009 H2. The increased global demand for this product, in line with the positive economic performance in OECD countries and the high growth rates in advanced economies, has positively influenced the market price dynamics[1]. On the other hand, the annual appreciation of the U.S. dollar vs. some of the major international currencies helped subdue the upward pressures on oil price. The supply of this product increased during the observed period. The ongoing high rates of extraction and refining of this product in the main producing and exporting countries, such as Russia, U.S. and OPEC , impacted on the stabilization of the supply and demand ratios in the global markets.

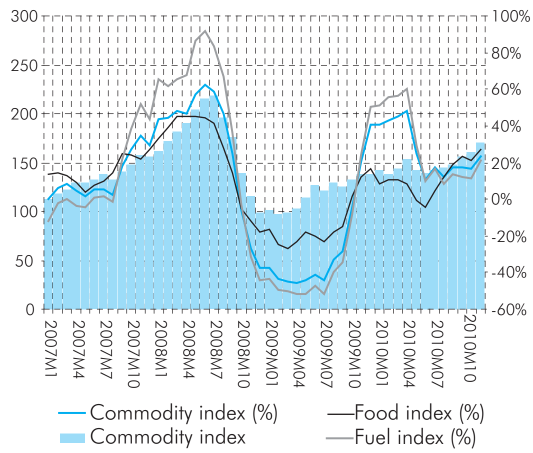
Chart 3 Year-over-year percentage change of global oil price and EUR/USD exchange rate



Source: Eurostat, Energy Information Administration..

The primary commodity indices have shown a similar performance, following an upward trend q-o-q and y-o-y. Food prices picked up mainly as a consequence of adverse weather conditions in Russia, which revised the world's 2011 expectations for the supply of grains. The global growth expectations have generated a higher demand for oil and primary commodities, which is also noted in increased indices. Hence, in 2010 Q4, the Commodity Price Index increased by 19.2% y-o-y and 11.8% q-o-q. Food Price Index increased by 23.7% y-o-y and 12.2% q-o-q. Fuel Price Index performed similarly, up 14.8% y-o-y and 12.2% q-o-q.

Chart 4. Price indices by primary commodities and their annual changes



Source: IMF, Primary Commodity Prices.

[1] The global oil demand increased approximately 2.1 % y-o-y during the third quarter of the year.

III. PRICE STABILITY AND BANK OF ALBANIA'S OBJEKTIVE

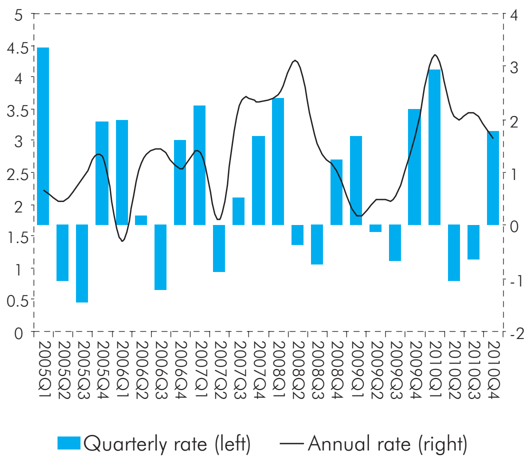
In 2010 Q4 inflation averaged 3.1%, staying within the tolerance band, around the Bank of Albania's 3.0% point target for consumer price stability. The Albanian economy performed upward even in Q4, narrowing but not eliminating the negative output gap. Subdued inflationary pressures from the real sector of the economy and the relative exchange rate stability have contributed to reducing the annual inflation rate.

Along the monetary policy span, inflationary pressures are expected to be contained, as also confirmed by the economic and monetary outlook. The economic agents' inflation expectations remain anchored around the central bank's target.

III.1 PERFORMANCE OF CPI BASKET

Average annual inflation rate fell by 0.4 percentage point to 3.1% in the fourth quarter, compared with the previous quarter, being close to the Bank of Albania's target. Performance of inflation rate over 2010 Q4 has reflected the high prices of food products and of primary energy commodities (mainly oil and gas) in the last month, as well as the cancellation of inflationary effect of several administered price increases at previous year-end. The direction and magnitude of rise was in line with the historical performance, but price volatility within the quarter was more pronounced than in the previous years' fourth quarters[2].

Chart 5 Annual inflation by quarters and quarterly inflation (in %)



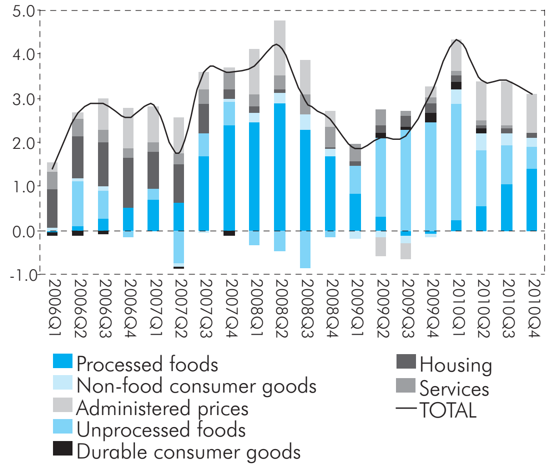
Source: INSTAT, Bank of Albania

Last twelve months, inflation fell due to subdued inflationary pressures from the real sector of the economy and relative exchange rate stability. Furthermore, inflation rate decline over the fourth quarter owes primarily to base effect. In 2009 Q4, some administered prices picked up, elevating the contribution of this category by 0.2 percentage point. Overall, the second half of the year highlighted a surge in the prices of unprocessed foods and non-food consumer goods relative to year-start, either directly or indirectly, making a strong comeback of upward price trend observed at year-start. In the meantime, such a tendency was observed not only in December. Observance of the seasonal behaviour of consumer

[2] *Over the last 5 years, the annual inflation standard deviation within the quarter was 0.8%, while over the past year it was 1.2%.*

price rise during this month was reflected in monthly inflation rate rise to about 2.2%. Consequently, annual inflation pointed to 3.4% at year-end, breaking its downward trend. Among specific factors, this month's inflation[3] was triggered by adverse weather conditions, which helped decrease the domestic supply of daily consumption agricultural products. Meeting the needs of our market with imported products, against the backdrop of exchange rate depreciation and increased consumer demand for them, resulted in higher consumer prices of these products than in the previous years.

Chart 6 Contribution of key items to annual inflation (in pp)



Source: INSTAT, Bank of Albania

Unprocessed foods recorded a significant reduction of positive annual inflation rates, marking the lowest annual inflation in November (1.5%). Unprocessed food inflation was characterised, as usually, by high monthly inflation rates fuelled by year-end holidays. Import of those products, against the backdrop of insufficient domestic product to meet the increased demand for them during this month, raised chances for a higher inflation owing to impact of import price inflation transmitted by relatively high prices of these products in Albania's main partner countries, as well as the lek's depreciation vs. the euro. However, this item's annual inflation during the second half dropped sharply compared to the first half of the year. Inflation rate was about 3 times lower than in the first half of the year. This item contributed by 1.3 percentage point less[4] to headline inflation compared to the first half of the year, impacting on gradually declining headline inflation throughout the year.

In 2010 H2, processed foods made a higher contribution to inflation rate. Processed food inflation rate approached 2008 values, when prices of these goods were extremely high, making a significant contribution to headline inflation rate. This reversal of inflation rate trend of these products after last summer is mostly attributed to the global conjuncture of prices of goods included in this item. In late-2010, according to latest data from World Food Organization, prices of goods included in this item rose sharply, remaining only a few percentage points below high values recorded in mid-2008. During the six-month period, there was a rise in all sub-items' prices, particularly in "Bread and cereals". Bread and cereal inflation was 5% in August-September, whereas in January-July it hit negative values, -2.2%.

[3] *December's 3.4% inflation rate increased the headline inflation by 0.2 percentage point, though being below the 3.7% rate recorded over a year earlier.*

[4] *During the first half of the year this item's contribution was 2 percentage points (3.9% headline inflation), dropping to 0.7% in the second half (3.3% headline inflation).*

Table 4 Items' contribution to annual inflation (in p.p.)

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

Source: INSTAT, Bank of Albania

Administered price items have made a relatively higher contribution to inflation throughout 2010, compared to their historical average. However, as anticipated, since October, the cancellation of the rising price effect of medical services, lessened the contribution to 0.8 percentage point, to marginally pick up (by 0.1 percentage point) in December due to gas price rise. This effect is expected to be cancelled out in 2011 Q1, in the absence of new price rise for electricity[5] and drinking water.

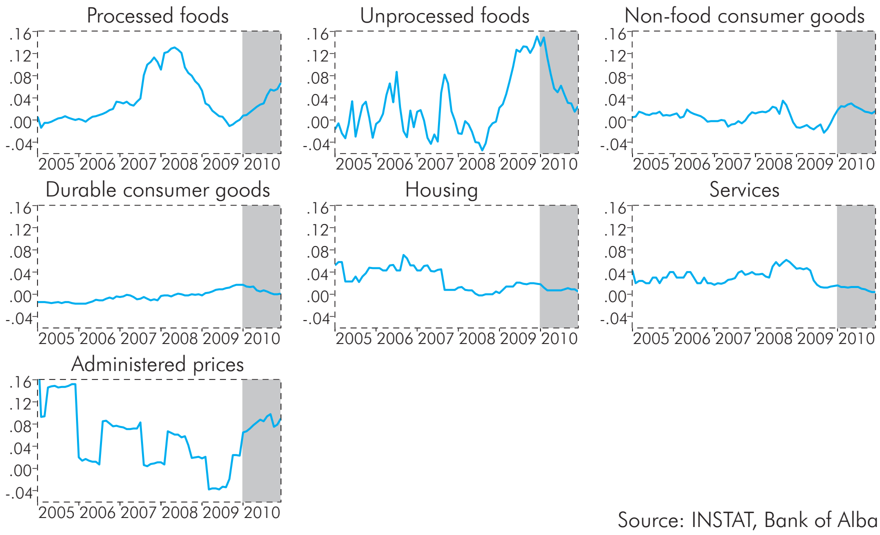
The prices of other CPI basket items were almost unchanged during the second half, attesting to their overall downward tendency as compared to the first half of the year.

During the second half of the year, the average oil price per litre in the domestic retail market performed similarly to its trend in the global market. Oil price per litre rose by around 15% y-o-y. Besides the escalating rise in this product's value in the international conjuncture during 2010 Q4, the lek's exchange rate has also provided a substantial impact on oil price performance at home. The y-o-y depreciation of the lek vs. the U.S. dollar by about 12.8% in the second half of the year contributed to increasing its average price. The analysis of the performance of the "Services to personal vehicles" sub-item in the CPI basket, which is closely linked to domestic oil market developments, shows a more moderate increase in this index vs. the oil price per litre. Hence, during the second half of the year, the index was up 7.3% y-o-y. Regardless of fuel price rise, particularly in December, the contribution of non-food consumer goods was insignificant to the fourth quarter's inflation. Such a price rise, along with upward prices of basic imported foods[6], may put additional supply-induced inflationary pressures over the period ahead.

[5] *The Energy Regulatory Authority decided, in its meeting dated 7 December 2010, not to raise the energy price in January 2011.*

[6] *These goods, whose prices are set in the world stock-exchanges, underwent a sharp rise during December 2010.*

Chart 7 Annual inflation by items of goods and services (in %)

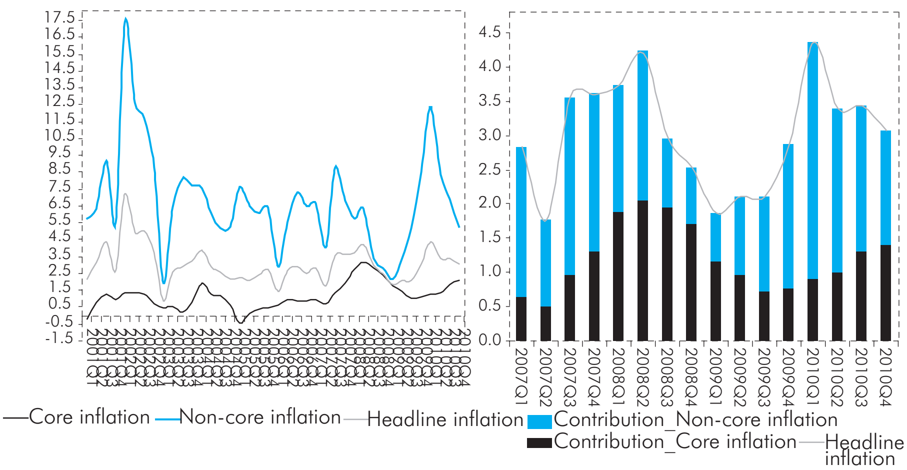


Source: INSTAT, Bank of Albania

III.2 THE MAIN TRENDS OF INFLATION

Annual core inflation[7] marked 2.1% in 2010 Q4, significantly impacted by its higher level in December (2.3%). Its rate averaged 1.7% for 2010, or 0.4 percentage point higher than in 2009. Such development owes mostly to price rise in "Bread and cereals" during 2010 H2. Consequently, annual contribution of long-term inflation components to headline inflation totalled 46%, remaining 6 percentage points higher than in the past four years, but 13 percentage points below the 2008 - 2009 H1's average.[8]

Chart 8 Core and non-core annual inflation (left-hand), respective contribution (right-hand)



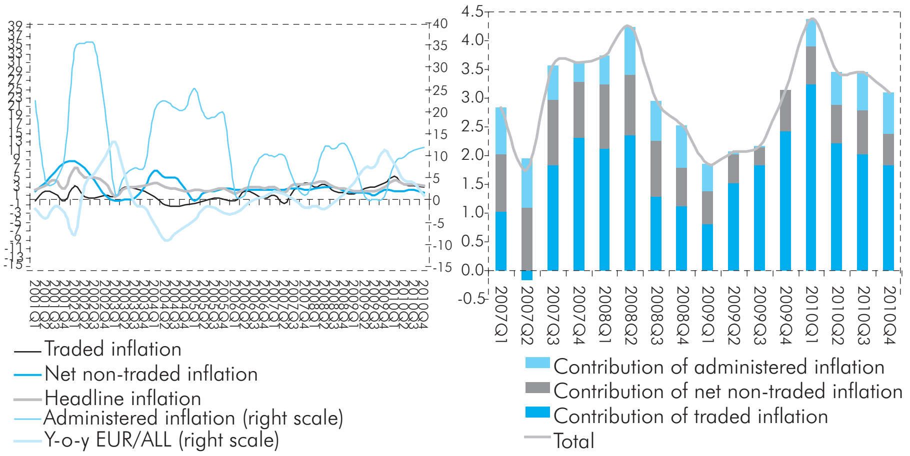
Source: INSTAT and Bank of Albania

[7] *The mean of both measures (permanent exclusion and trimmed mean).*

[8] *This period has recorded an upward trend and the maximum historical value of core inflation and its contribution to headline inflation.*

In the fourth quarter, non-core component, reflecting consumer prices' short-term volatility, continued to record downward values for respective annual inflation (5.3%) and respective contribution (54%) to headline inflation. That performance was affected markedly by the contained depreciation of the lek vs. the euro throughout the year.

Chart 9 Annual inflation by sectors (left-hand); Respective contribution and annual change of EUR/ALL exchange rate (right-hand)



Source: INSTAT and Bank of Albania

In 2010 Q4, annual inflation of traded and non-traded CPI basket goods resulted 3.0% and 3.3% respectively, whilst net inflation of non-traded goods and services was 1.7%.

Contribution profile continued to weigh on traded goods sector (59%), with a downward trend in 2010[9]. Albanian lek's diminished depreciating trend vs. the euro since May 2010 has determined such development. Net inflation of non-traded goods and services over the observed quarter was 0.5 percentage point below that of a year earlier, a development that was also materialized in the contribution to annual inflation (18%).

Core and net non-traded inflation rates underpin the presence of domestic demand-induced inflationary pressures in the economy. Shocks to prices are regarded as temporarily and volatile, tending to flatten, due to much more contained exchange rate depreciation.

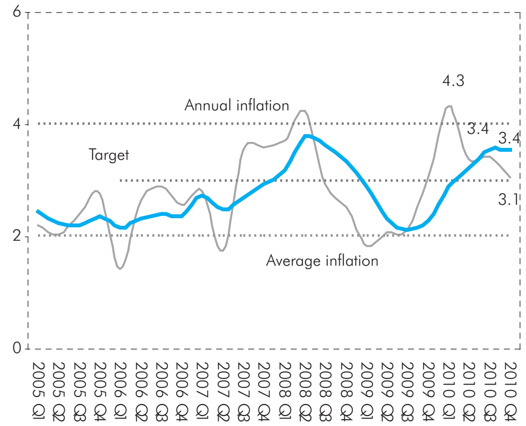
III.3 INFLATION AND MONETARY POLICY

In 2010 Q4, the average annual inflation fell to 3.1%, down by 0.3 percentage point from the level recorded over the past two quarters. High annual inflation rates of the first quarter, above Bank of Albania's upper ceiling, were driven mainly by administered price rise and the lek's ongoing

[9] *In 2010, the average annual inflation of this sector was 6 percentage points below the one a year earlier.*

strong depreciating trend. In line with the Bank's forecasts, the impact of disinflationary negative output gap[10] and lower rates of exchange rate depreciation in the quarters ahead resulted in a slower annual inflation rate rise and steady core inflation rate. Annual inflation has returned to 2-4% tolerance band since the second quarter of the year.

Chart 10 Average annual inflation by quarters (in %)



Source: INSTAT and Bank of Albania calculations

Monetary policy strengthened its expansionary stance in 2010 H1, cutting its policy rate in July. The policy rate cut by 25 basis points to 5.00% was put in place at a time when inflationary pressures were downward, driven primarily by slow domestic demand and well-anchored inflation expectations. Following this decision, the policy rate was kept unchanged. Its level is considered as appropriate to keep inflation rate in line with the central bank's definition on price stability along the time horizon of monetary policy action.

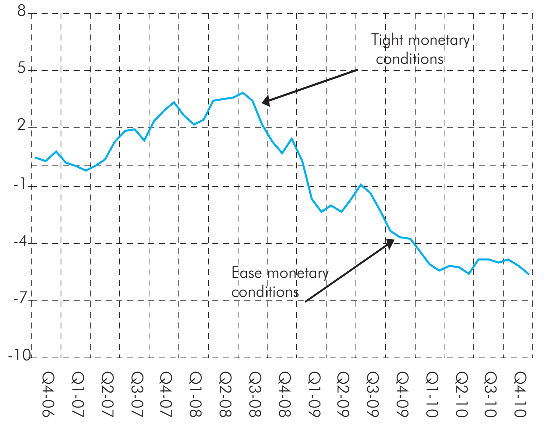
The winding down of fiscal stimulus over the course of 2010 provided room for monetary policy to boost domestic demand, against a backdrop of controlled inflationary pressures. Hence, confronted with weaker exchange rate depreciation, the Bank of Albania continued to inject monetary stimulus to the economy, in both quantitative and qualitative terms. Monetary conditions in the economy - based on the developments of composite monetary conditions index (MCI[11]) – remain accommodative by preserving significantly lower-than-neutral values. Improved liquidity conditions in the banking system and low public sector demand and moderate private sector demand for monetary assets have facilitated the transmission of accommodative policy into the financial markets over the fourth quarter. Consistent with the lags the monetary policy transmission mechanism involves, the latest monetary and financial data attest to ongoing downward interest rate trend in the financial markets, thus corroborating greater interest rate response to Bank of Albania's move.

Monetary conditions appear to have been eased, as a consequence of taking into account the interest rate cut at the beginning of 2010 Q3 and the relative exchange rate stability. The easing of exchange rate depreciating pressures has reflected, beyond seasonal factors, a recovered situation of the external sector and the fiscal consolidation tendencies. In 2010 Q4, the improved liquidity conditions in financial markets were coupled

[10] *Output gap is the difference between actual output of an economy and potential output (the output the economy would be at under full capacity and maximum efficiency).*

[11] *Monetary Conditions Index (MCI) is the weighted average of changes to key policy rate and the nominal effective exchange rate (NEER) of the lek against their respective values in a base period (December 2005). In Albania's case, the MCI ratio is 1.82:1, implying that the depreciation effect of the NEER by 1.82% on aggregate demand is offset by rise in key policy rate by 100 basis points. Worth noting is that a rise in the MCI means tightening in monetary conditions at home, but not necessarily of monetary policy stance.*

Chart 11 Monetary Conditions Index (MCI – change on the base period, December 2005)

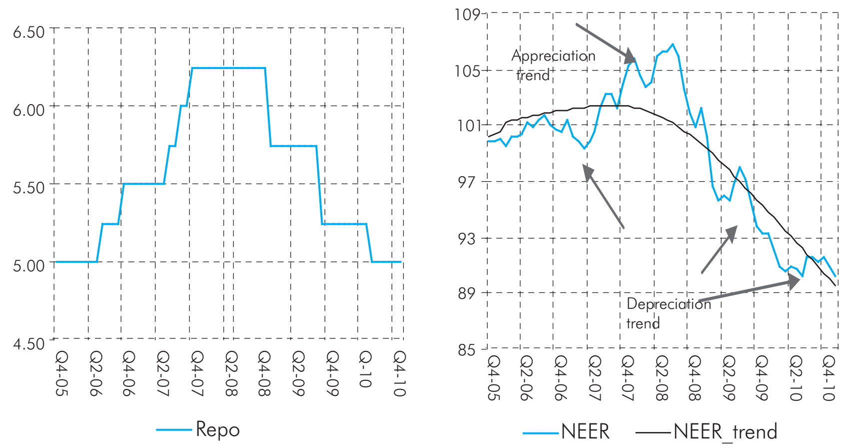


Source: Bank of Albania calculations

with depreciating exchange rate pressures, hence further decreased MCI over this quarter.

Overall, the monetary policy stance was accommodating, pushing the domestic demand of the economy higher, in line with its potential and medium-term price stability. Latest economic data support the upward economic activity trend, though its growth remains below its historical average. The economic and monetary analyses reveal that inflationary pressures will be contained throughout the time horizon of monetary policy action. However, the central bank will be prudent with regard to new developments. Anchoring stable inflation expectations within the Bank of Albania's quantitative targeted range on price stability is a guarantee for the attainment of this target.

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



Source: Bank of Albania calculations

IV. MACROECONOMIC DEVELOPMENTS AND IMPACT ON INFLATION

The Albanian economy remains on an upward trend, narrowing the negative output gap. According to INSTAT's data, GDP grew by 4.9% in the third quarter. The ongoing recovery worldwide encouraged economic growth at home. Moreover, the private sector's domestic demand has been upward, mainly supported by the pursuit of an ease monetary policy and other measures taken for the proper functioning of the banking system and by the increase in financial intermediation. The latest data suggest the persistence of positive growth rates in the period ahead. However, the adoption of a sustainable growth model in some sectors of the economy is expected to contribute to maintaining similar economic growth paces.

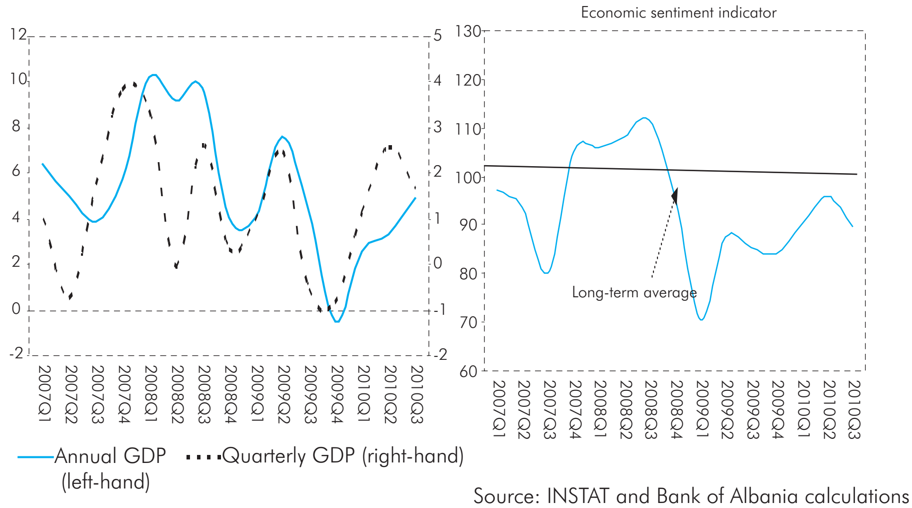
The combination of all observed factors, such as availability of spare capacity, increased monetary expansion in the economy in line with the real demand of the economy for money, along with the relative exchange rate stability and anchored inflation expectations have generated contained inflationary pressures.

IV.1 GROSS DOMESTIC PRODUCT AND AGGREGATE DEMAND

Based on preliminary data from INSTAT[12], Gross Domestic Product grew by 4.9% y-o-y in 2010 Q3, up 1.6 percentage point from 2010 Q2. Besides the positive contribution of external demand and rising contribution of the domestic demand, the base effect of comparison with the lowest annual growth of 2009 Q3[13] was materialized into a faster GDP growth in 2010 Q3. On the other hand, the quarterly GDP[14] flow has decelerated its growth rate. Slower quarterly performance of the economy is reflected in some indirect indices, such as the performance of lending to the private sector, business confidence and consumer confidence indicators over the third quarter of the year. Their development signals that regardless of their positive performance during 2010, economic growth resources are still non-consolidated. Fourth-quarter preliminary data suggest that domestic financial conditions continued to improve over that quarter[15], thereby supporting domestic demand and ongoing positive growth rates.

[12] December 2010 publication. GDP series for 2007 is revised.
[13] In 2009 Q3, the growth was 4.4% y-o-y, following the 7.6% growth in Q2.
[14] Seasonally adjusted value-added increased by 1.6%.
[15] Such assessment is reflected in higher credit growth rates compared to the first nine-month period, owing to low interest rates and ongoing easing lending standards compared to the third quarter.

Chart 13 Annual and quarterly GDP growth by quarters and business and consumer confidence indexe.



Source: INSTAT and Bank of Albania calculations

IV.1.1 OUTPUT BY SECTORS

The third-quarter economic activity expansion - from the viewpoint of value-added – has reflected ongoing good performance of industry and increasing value-added in several branches of the service sector mainly related to health, education and financial intermediation[16]. Such types of services accounted for 60% of annual GDP growth in the third quarter.

Table 5: Branch contribution (in p.p.) to annual GDP growth (in %).

Contribution (pp)	2007	2008	2009	Q1:2010	Q2:2010	Q3:2010
Agriculture, forestry, fishing	0.4	1.5	0.6	1.9	2.4	1.4
Industry	-1.3	1.2	0.2	2.0	1.8	1.8
Construction	1.7	1.7	0.0	-2.4	-4.6	-3.2
Services	4.4	4.0	3.1	1.0	3.7	5.0
GDP at basic prices	5.3	8.3	3.9	2.5	3.3	4.9

Source: INSTAT, Bank of Albania calculations

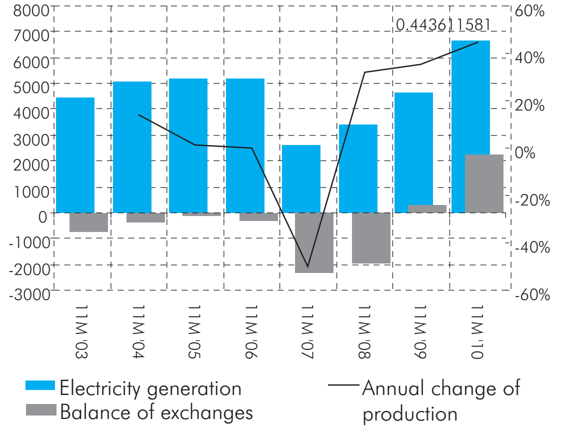
Industry value-added rose by 18.2% in 2010 Q3, down 1.3 percentage point from the previous quarter's growth rate. However, the increased in economic activity in this branch continues to remain above its historical average rates, mainly due to increased external demand for Albanian products, rising prices of primary commodities exported from Albania to international markets – against the backdrop of a still weak national currency - and the base effect of comparison with the low level of year 2009. The annual growth of value-added of this branch contributed by 1.8 percentage point to annual real GDP growth in the third quarter, continuing to be one of the major drivers to economic growth over the course of this year. Based on data from short-term statistics, which helped make detailed analysis of sub-branches, it comes out that industrial

[16] *These sub-branches are included in "Other services" to GDP. Other services have contributed by 2.9 percentage points to annual GDP growth.*

production has been upward in most sub-branches. The production of extractive industry, food, energy, gas and water showed decelerated trends.

Electricity[17] production rose by 44.4% in January - November 2010, compared to the same period a year earlier. Although the energy sector was characterized by new investments in power plants and small hydropower plants, on average 98.9% of electricity was generated by large hydro-powers. Moreover, the current level of electricity generated in Albania has been sufficient to meet the country's needs for electricity and be used for exports as well. Since 2009, the total balance of electricity exchanges has improved markedly.

Chart 14 Total balance of electricity exchanges and production (in KWh) and percentage of annualised production change in January – November 2010



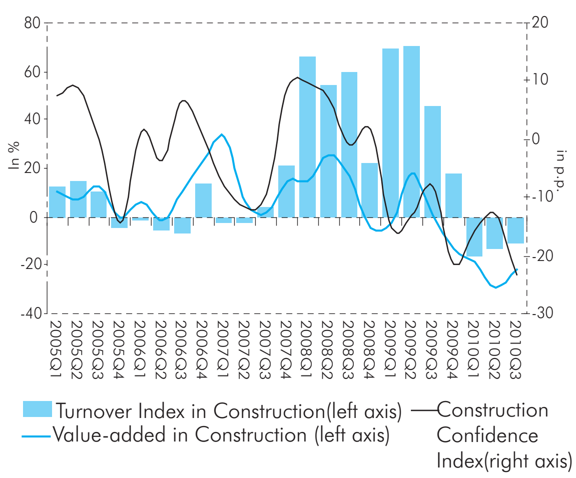
Source: AEC and staff estimates

Positive growth rates in industrial economic activity are expected to persist in the last quarter of the year, but at lower rates, as pointed out by confidence survey indicators. On the other hand, information on new orders in industry and the upward trend of credit to industrial sector support the assessment for recovery of its activity in the periods ahead.

Contraction of economic activity in construction was slower in the third quarter, both y-o-y and q-o-q. Value-added generated by this branch marked an annual decline of 22% in this quarter, contributing negatively by about 3.2 percentage points to annual GDP growth. Construction business confidence survey for 2010 Q3 signalled a severe deterioration in this branch.

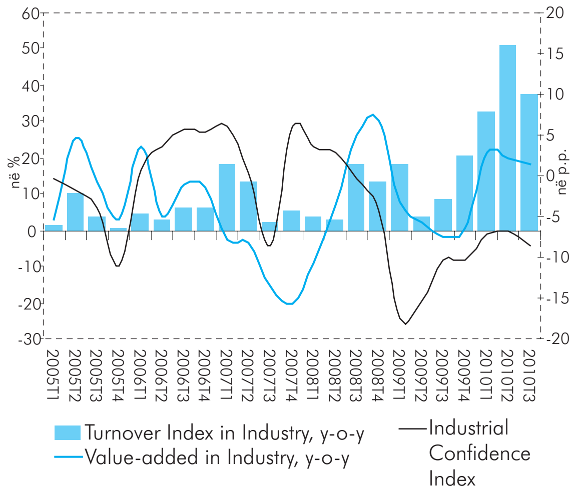
Slowing deterioration of construction activity is expected to persist in the periods ahead, as signalled by some indirect data, such as growth of

Chart 16 Value-added, Turnover Index and Construction Confidence Index



Source: INSTAT, Bank of Albania calculations

Chart 15 Value-added, Industrial Production Index and Industrial Confidence Indicator



Source: INSTAT and Bank of Albania

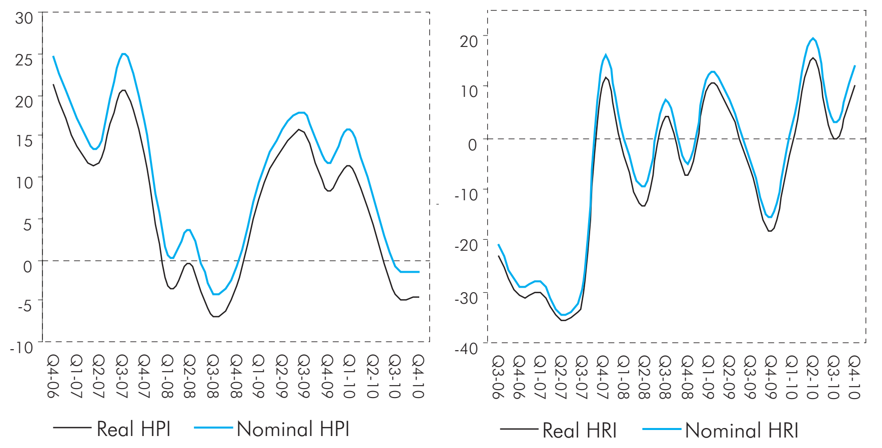
[17] Data on the balance of electricity are obtained from AEC and are available as at November 2010.

lending to this branch and the number of building permits issued mainly for house construction. Moreover, the number of permits issued for engineering constructions, carried out with public funds, was downward during the fourth quarter.

Box 1: Housing market prices in 2010 Q4

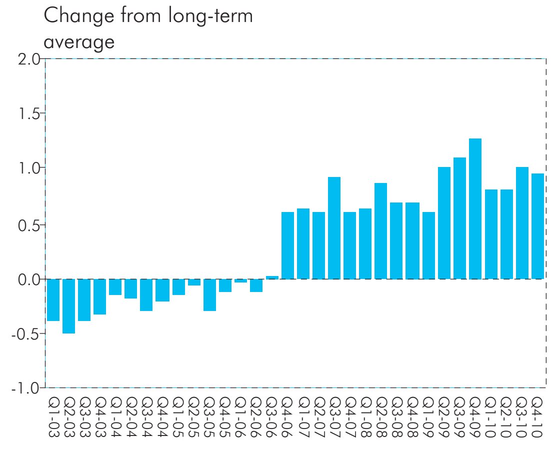
House Price Index followed a pronounced downward trend in 2010. The upward double-digit rates in 2009 are followed by slower growth rates in 2010 H1, turning downward in 2010 H2. Annual nominal change of house price index was -1.6% in 2010 Q4. Residential rental price index was featured by positive growth rates during 2010. The rental price index rose by 13.9% in 2010 Q4, from 11 in 2010 H1 and 3.2% in 2010 Q3. The real y-o-y rate of increase has been less pronounced; if adjusted for inflation, the rental price index has actually risen by 10.3%.*

Chart 17. House Price and Rental Price Indices (HPI and RPI)



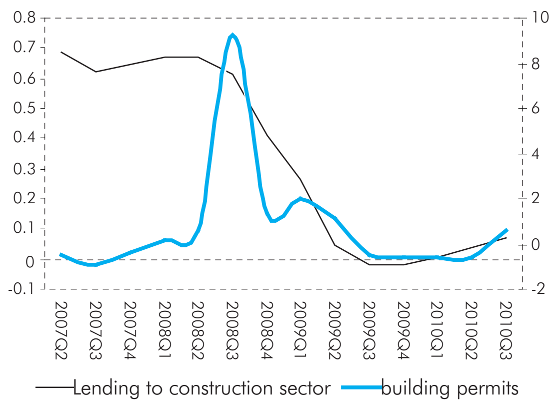
Source: Bank of Albani

Chart 18 Performance of HPI and RPI



Source: Bank of Albania

Chart 19 Lending to construction sector and building permits



Source: Bank of Albania

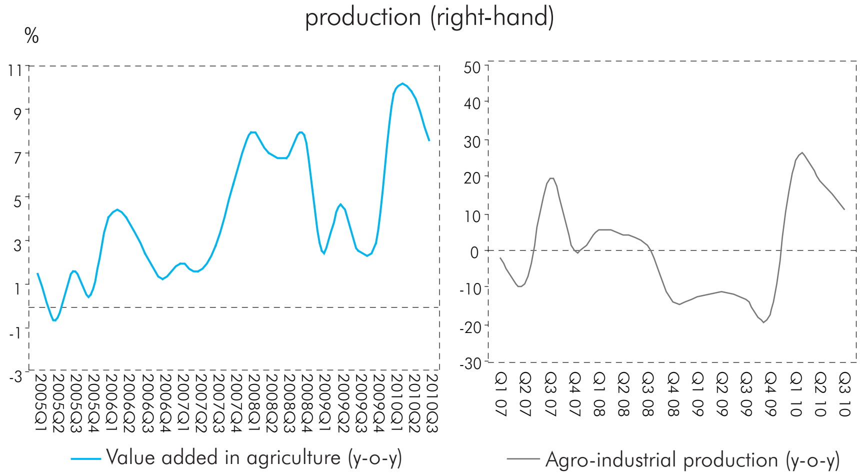
The latest developments in the housing market show that house prices are still higher than rental ones, as the analysis of price-to-rent ratio shows. Though recording lower values in 2010 than in 2009, this ratio is still above its long-term average. The quarterly dynamics shows that both house and rental prices rose in 2010 Q4. Rental prices account for a higher rise (+7.1%) than house prices (+3.1%), being reflected in a slight fall of price-to-rent ratio (by 0.1 percentage point).

In 2010, house prices were more influenced by a depressing demand rather than by a contracted house supply. On the supply side, indirect quantity and quality survey data suggest contracted output and investments in house construction sector. Building permits, which usually precede investments in dwellings with few months, rose by 57.8% in 2010 Q4, suggesting a more improved prospect of following investments. The demand for houses appears to have shown signs of recovery in 2010 Q4, compared with the first nine-month period, as proxied by the rise in house purchase loans to households. Latest Credit Conditions Survey showed that standards of house purchase loans to households were eased during 2010 H2.

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

Annual dynamics of value-added in agriculture to GDP slowed in the third quarter. Agricultural output increased by about 7.6%, down by 2.2 percentage points from Q2's annual growth. After three consecutive quarters of 2.7% growth[18], the agricultural sector output remained almost unchanged (0.8%) in the third quarter. Detailed data from the Ministry of Agriculture, Food and Consumer Protection also suggest slower annualized growth rates of agro-industrial production. Service sector accelerated the annualised growth

Chart 20 Value added in agricultural sector (left-hand) and agro-industrial production (right-hand)



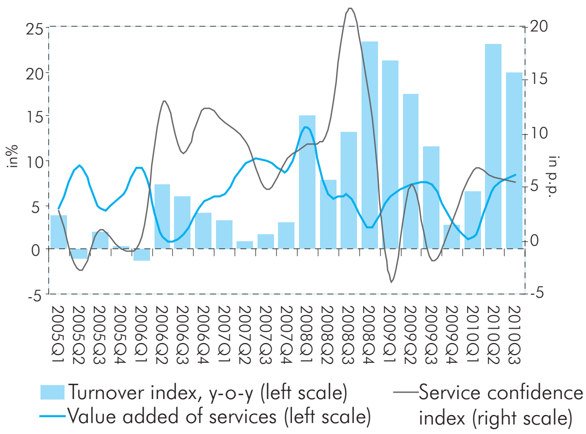
Source: INSTAT and the Ministry of Agriculture, Food and Consumer Protection

rates in 2010 Q3. The value-added in this sector grew by 8.3% in Q3, following the 7.0% rise in 2010 Q2. The quarterly changes of this sector's economic activity point to marginal slowdown over the third quarter[19]. Detailed data by main branches of the service sector suggest acceleration

18 Quarterly changes are seasonally-adjusted.
19 Value-added increased by 2.5%, compared to 2.8% in Q2.

of growth in "Transport" and "Other services". "Other services", which relate mainly to health, education and financial intermediation, have contributed by about 60% to economic growth over the third quarter. Administrative measures taken in terms of formalisation, alterations and amendments to the VAT[20] Law may have impacted on a higher value-added figure. In the meantime, the value-added of "Trade, hotels and restaurants" – which is closely related to consumer spending – recorded a decelerated growth rate y-o-y and q-o-q[21]. "Telecommunication" was the only branch that dropped y-o-y.

Chart 21 Value-added in services, turnover index and service confidence index



Source: INSTAT and the Bank of Albania

The third-quarter growth was not reflected in the service confidence indicator, which fell slightly over the course of this quarter. After having improved over the first and the second quarters, the service confidence indicator has recorded a slower growth, however, it is still above its long-term average.

IV.1.2 PERFORMANCE OF AGGREGATE DEMAND

In 2010 Q3, aggregate demand increased by 4.9% y-o-y, thus maintaining the upward trend that had commenced in the first quarter. In the meantime, in quarterly terms and excluding the seasonal effect, the third quarter's growth was 1.6%, from 2.6% in the second quarter of the year. The rebound in the global economy persisted over 2010 Q3, thus underpinning the country's aggregate demand growth. Partial data from official statistics and confidence surveys suggest a rising contribution of domestic demand, where the private sector's contribution to the economy has offset the public sector's diminished contribution. However, assessments related to the demand components through cross-sectoral indicators should be taken with reservation, because the economic slowdown observed over the past two years might have also been associated with changed contribution of different sectors to demand components.

While economic activity accelerated the growth rates in the third quarter, partial available data on private consumption suggest that it continues to make a low contribution to aggregate demand. Quantitative indicators, which are used to approximate private consumption in the economy, decelerated slightly their growth paces in Q2 and Q3, following the satisfactory growth paces noted over the first quarter. Consumer spending, as proxied by retail trade index, shrank by 0.7% in the third quarter, from up 5.7% in the first

[20] Among alterations and amendments made to the VAT Law, we mention the lowering of the minimum registration threshold from ALL 8 million (the existing figure) to ALL 5 million, and incorporation in the VAT scheme of liberal professions, such as: attorneys, notaries, specialized doctors, chartered accountants, as well as asset evaluation with a minimum threshold of ALL 2 million within a calendar year.

[21] Slower growth of this branch in Q3 is unexpected, due to its seasonality related to tourism season.

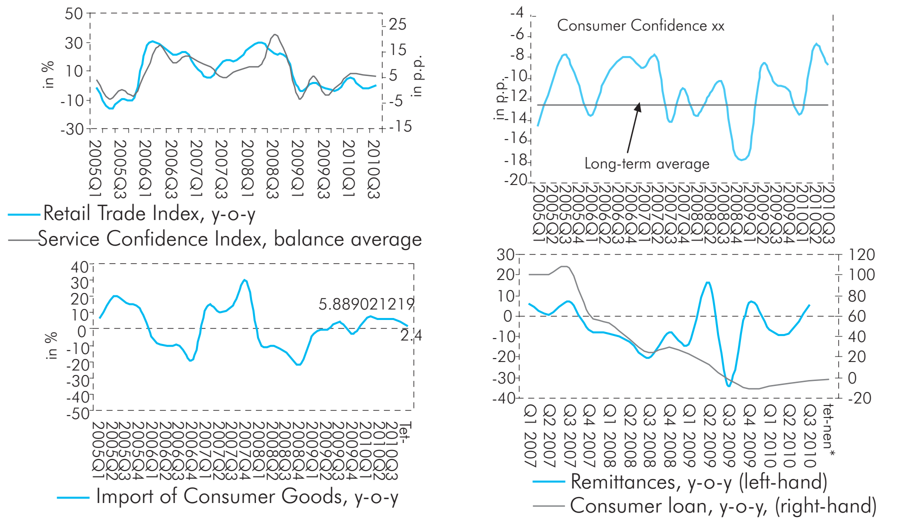
quarter. Consumer demand continued to mark increase in durable consumer goods and decrease in non-food consumer ones. Import of consumer goods, which from a growth of 7.3% in the first quarter, slowed down its annual dynamics to 5.9% in the third quarter, attests to a marginal increase in private consumption over the third quarter.

Uncertainty about the financial situation and employment prospects gave rise to a deteriorated consumer confidence indicator in 2010 Q3 and also boosted the propensity to save. The slightly decreased confidence indicator for this sector attested to a deceleration in the third quarter's gradually improving trend. However, in 2010 Q3, consumer confidence and service confidence indicators stood above their long-term average.

In 2010 Q3, private consumption funding was underpinned by 2.2% rise in real disposable income and 5.3% rise in remittances. The deceleration of real wage increase, regardless of positive interest rates and stable income tax rate, has resulted in the lower increase in real disposable income. As regards private consumption funding through consumer loans, its negative rates continued in 2010 Q3 (-2.7%, y-o-y), as well as during October and November (-1.7 and -1.9% respectively).

The persistent rising trend of household time deposits, coupled with increased savings indicator, as indicated by the consumer confidence survey, suggest higher household prudence with respect to their consumption-savings approach.

Chart 22 Indirect private consumption index



Source: INSTAT, Bank of Albania calculations

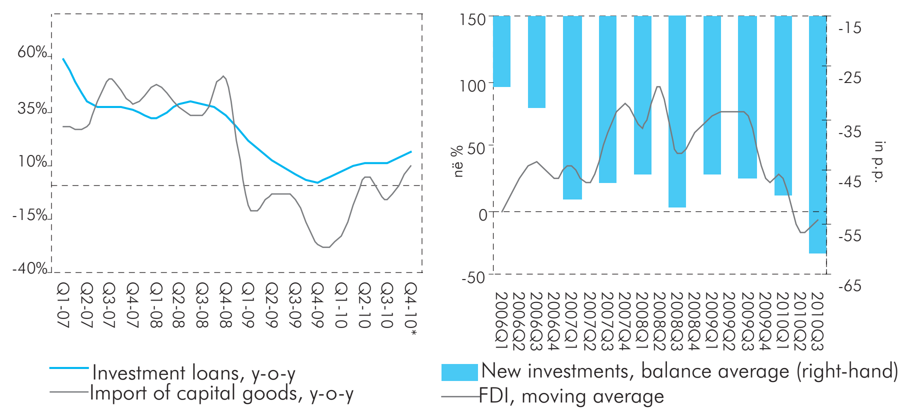
Private investment is estimated to have provided a small contribution to aggregate demand in 2010 Q3. Indirect data used as a proxy for investments show that it rebound at a slower pace than the Albanian economy resurgence over the course of 2010. Investment performance was positively influenced by external demand and slightly improved business confidence. However, still low capacity utilization levels, slow easing of lending standards and sluggish recovery of the domestic demand have negatively impacted on investments performance. Moreover, building permits issued for residential and engineering constructions, which usually precede the increase in construction investments with a several-month lag, dropped sharply in 2010 H1. Their increase by 16.3% in 2010 Q3 signals investment recovery over the quarters ahead.

After the positive signs shown in the second quarter, the import of capital goods fell by about 6.1% in the third quarter. Capacity utilization in the economy was downward in this quarter, dropping to 69.4%, restraining the improvement trend observed in the first half of the year. On the other hand, FDI inflows grew by 20.5% in 2010 Q3, following the 42.6% drop in the previous quarter.

The latest data suggest that the annual growth of capital goods import and investment loans is 9.2% and 16% respectively, over the period of October-November 2010. These developments signal ongoing recovery in private investments even for 2010 Q4.

It is assessed that the negative contribution of inventories to economic growth will continue in 2010 Q3. Based on business confidence survey data, inventories continued to drop in the third quarter.

Chart 23. Indirect data on private investments and FDI inflows

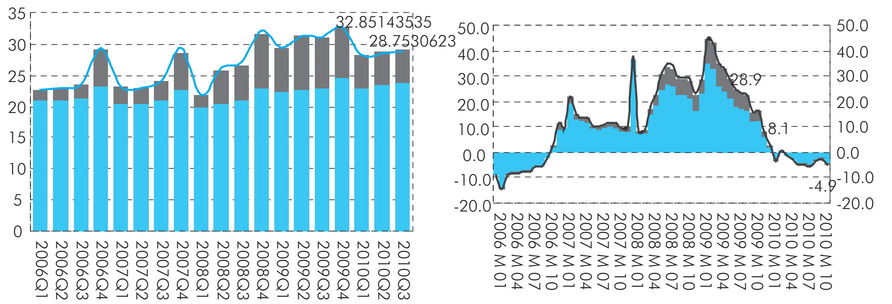


Source: INSTAT, Bank of Albania calculations.

FISCAL POLICY, FISCAL INDICATORS AND AGGREGATE DEMAND

Budget expenditures for the first 11 months of 2010 are estimated to have contributed less to aggregate demand, compared with a year earlier. This component's lower contribution to aggregate demand is reflected by the behaviour of budget expenditures, which experienced a negative rate of increase during the whole 11-month period. More specifically, total expenditure incurred as at the end of the 11-month period fell by about 4.9%[22] y-o-y. The total expenditure cut reflects simultaneously the decelerated annual increase in current expenditure to 7.7% [23]and the shrinkage of capital expenditure by 35.8% y-o-y.

Chart 24 Budget (current and capital) expenditures as a percentage of GDP (left-hand) and respective contribution of current and capital expenditures (in pp.) to annual change of total expenditures (in %), (right-hand)



Source: Ministry of Finance, INSTAT and IMF (World Economic Outlook, October 2010).

Budget expenditure has performed in line with the revised plan of the Ministry of Finance, which, inter alia, projected embarking on a process of fiscal consolidation to maintain fiscal sustainability in the medium term. Fiscal consolidation recorded in 2010 was translated into lower levels of budget expenditure and fiscal deficit, compared with a year earlier, thus contributing to observing the public debt threshold (below 60% of GDP) set out in the organic Budget Law.

Budget revenues, especially during the last two months, recorded higher annualised growth rates than in the previous period. The accumulated revenues as at end-November 2010 grew by about 9.4%[24] y-o-y. Higher rates of budget revenue realization in the last two months, in addition to base effect[25], also reflect the measures taken by the fiscal authority, which aimed at raising taxes directly or indirectly. Such measures consisted in expanding the VAT scope for businesses (by lowering the annual turnover threshold from 8 million to 5 million, as well as by setting a lower threshold for liberal

[22] *The "loan repayment by AEC" item is included with a negative sign in the total budget spending, according to consolidated budget table published by the Ministry of Finance. Annual change of total expenditure as at the end of the 11-month period, along with the effect caused by inclusion of this item, results -4.9%. If we exclude the "loan repayment by AEC" item, the annual change of total expenditures for the 11-month period of 2010 will result – 3.5%.*

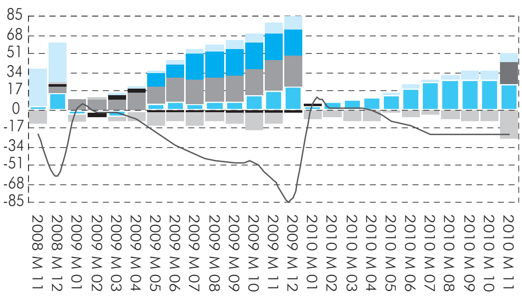
[23] *During two previous years current expenditures recorded a double-digit annual growth.*

[24] *Total revenues for 2010 include also the privatisation receipts, which do not constitute a permanent revenue improvement. If we excluded the privatisation receipts (ALL 8.4 billion) from total revenues, then the annual growth of revenues for the 11-month period would result about 6.3%.*

[25] *The annualised growth rate of budget revenues decelerated after 2009 Q1, to hit 2.2% in November, the lowest level for 2009.*

professions[26] to ALL 2 million); reviewing the national tax law and the law on excise tax, thus expanding the scope of goods subject to excise tax[27]. VAT income continues to record a higher contribution to annual income growth (by about 3.3 percentage points), for the effect of high share of this item to total revenues. Moreover, non-tax revenues have provided an upward contribution to annual change of revenues in recent months, because of the incorporation of a portion of revenues from privatization receipts to non-tax revenues.

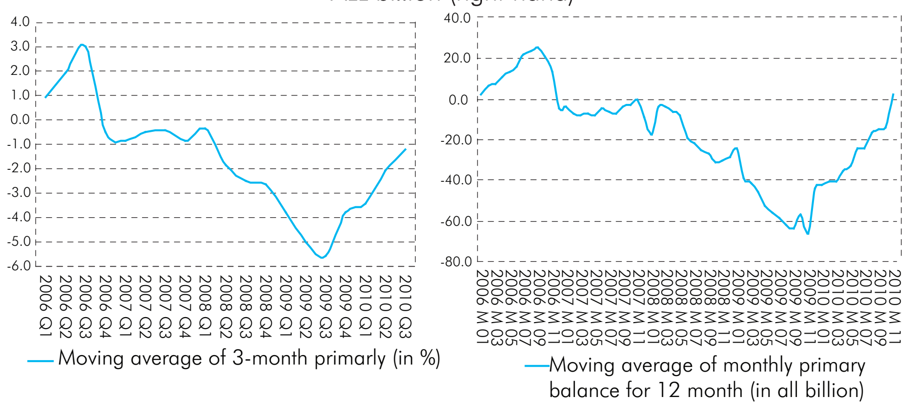
Chart 25. Budget balance and its financing instruments (in ALL billion) for M1'08-M11'10*



*"Others" item represents government's account position and is therefore recorded with the sign (-) in budget deficit financing-
Source: Ministry of Finance

Budget deficit resulted about ALL 23.1 billion[28] as at the end of the 11-month period, remaining almost unchanged for four consecutive months. The budget deficit as at end-November 2010 recorded a contraction of about 64% from the previous year's figure. Budget deficit financing in the first 10 months of the year was carried out mainly through domestic resources, implying government-issued treasury bills and bonds of all maturity terms. In the meantime, in November, the budget deficit structure financing altered from the one observed in the first 10 months of the year, as a consequence of EUR 300 million Eurobond issue. Of this amount, about EUR 192.6 million was transferred to repay the syndicated loan granted in 2008, whilst the rest was used for an ongoing reduction of domestic debt stock.

Chart 26 Primary balance as a share of GDP, (left-hand)* and primary balance in ALL billion (right-hand)*



*The left-hand chart represents the moving average of the primary 3-month balance (including the amount of 4 quarters) as a share of cumulative GDP, denominated in %.
**The right-hand chart is designed taking into consideration the moving average of the monthly primary balance (including 12 months) denominated in ALL billion.
Source: Ministry of Finance, INSTAT and IMF (World Economic Outlook, October 2010).

26 *Liberal professions included in the VAT scheme with an annual turnover of ALL 2 million are: lawyers, public notaries, specialized doctors, nurses, dentists, pharmacists, architects, engineers, economists, accounting experts, as well as real estate assessors.*

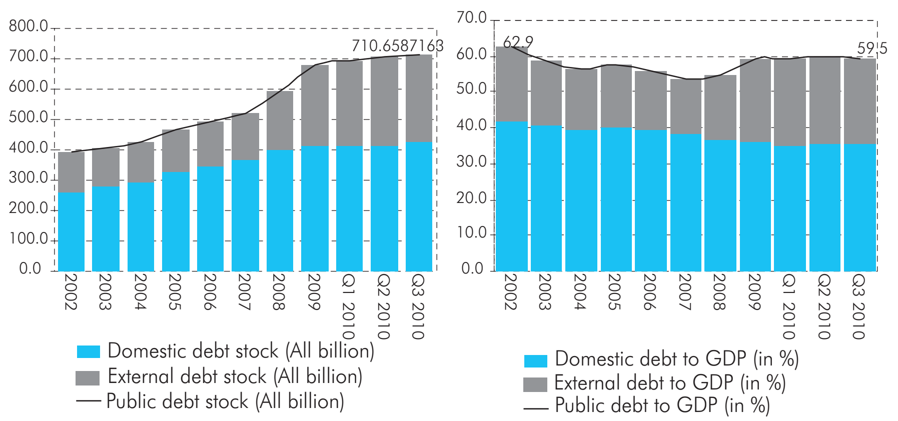
27 *Reviewing the excise law enabled removal of excise tax for perfumes and mineral water, but on the other hand it added the scope of goods subject to excise duty, like glass packaging, plastic packaging, incandescent lamps, new and used tires as well as fire-works.*

28 *The budget deficit figure results from inclusion of AEC's Loan repayment to total expenditures (with a negative sign by ALL 4.7 billion), and encompasses privatization receipts (by ALL 8.4 billion) to non-tax income.*

Fiscal consolidation process, which is simultaneously based on expenditure cut and tax rise (either directly or indirectly), is also highlighted through the primary balance performance throughout the year.

Primary balance in the first 11 months improved in comparison with the previous year. Its improvement has contributes positively to public debt dynamics. However, the public debt trajectory throughout 2010 remained virtually unchanged from that of end-2009[29], thereby attesting to the presence of fiscal vulnerabilities related to debt dynamics. Against this backdrop, it is essential to observe the budget deficit and maintain the public debt threshold stipulated under the organic 2011 Budget Law. In this way, fiscal policy would generate premises for decreased risk premium in the economy. It is worth mentioning that higher spread between the real interest rate paid on public debt and the real growth rate[30] compared to the previous years, did not favoure the public debt dynamics over the course of 2010.

Chart 27 Public debt in ALL billion (left-hand) and as a share of GDP (right-hand)



Source: Ministry of Finance, INSTAT and IMF (World Economic Outlook, October 2010).

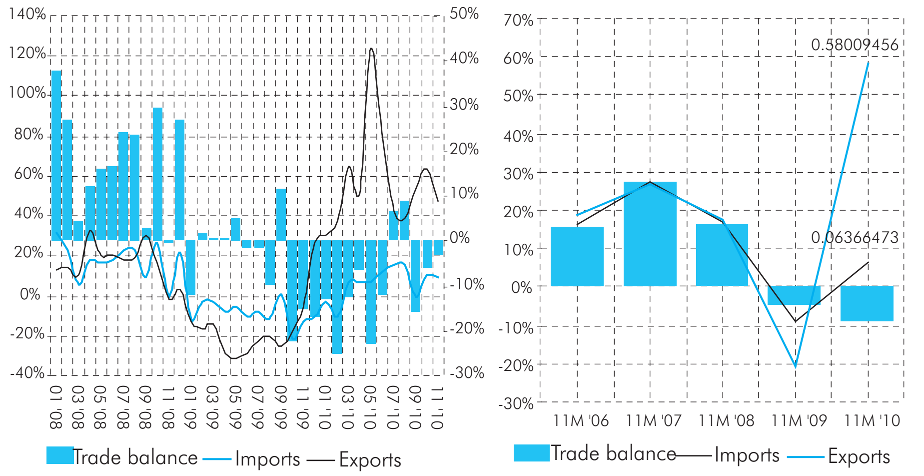
EXTERNAL SECTOR OF THE ECONOMY

The 2010 Q3's overall balance of payments highlighted an increase in foreign assets by about EUR 53.3 million. Over the course of this quarter, the current account deficit narrowed by about 45.3% y-o-y, following the trend having started in 2009 Q4. The rationale behind the narrowing of the current account deficit is: the net surplus increase in the trade-in-services account by 32.2%; the trade deficit cut by about 1.8%; and the change in the direction of the net income account. As a share of GDP, during the third quarter, this deficit was estimated at 9.1%. At the same time, the cumulative analysis on three quarters of 2010 shows a contraction of current account deficit by

[29] *Public debt as a share of GDP is estimated at abort 60% of GDP, for the fourth consecutive month, since 2009 Q4.*

[30] *Such a difference was deepened, as a consequence of slowed real growth rate and increased interest rates paid on public debt, driven by credit share growth in trading terms to total public debt, as compared to the previous years.*

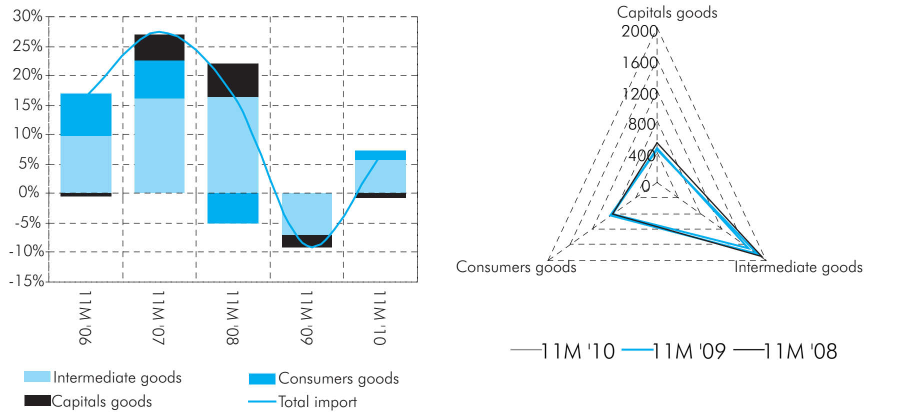
Chart 28 Performance of imports, exports and trade balance, annual changes in %



Source: Bank of Albania

5.1 percentage points vs. the same period in 2009. Financial and capital account surplus did not entirely offset the current account deficit for the fifth consecutive quarter, covering about 73% of it during 2010 Q3. Net foreign direct investments (foreign direct investment - privatizations), were up 43.1% y-o-y, accounting for 9.3% of GDP.

Chart 29. Imports by main categories, in EUR million, and their contribution to import growth, as well as the total import growth rate (in %);



Source: Bank of Albania

EXTERNAL DEMAND AND FOREIGN TRADE[31]

The latest foreign trade data show that from January to November 2010, the flow of trade exchanges was up 16.1% from the same period of the previous year. Increased exports by about 58.0% and more moderate growth of imports by about 6.4% over this period led to improved flow of trade exchanges in that period. The ratio of import coverage by exports resulted to about 34.4%, up

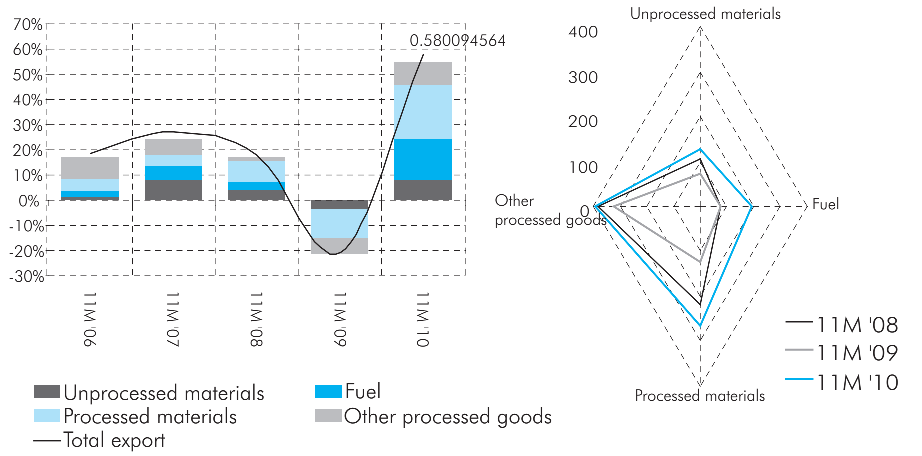
[31] *The latest foreign trade data cover the period of January – November 2010.*

about 11.2 percentage points vs. the same period a year earlier. During January to November 2010, a trade deficit narrowing by about 9.2% y-o-y was recorded, mainly due to increased exports and moderate growth of imports.

Import dynamics during the first eleven months of the year was more contained than that of exports. During January-November 2010, total imports increased their value by 6.4% compared to the same period in 2009.

Import analysis by final use highlighted a pronounced concentration towards intermediate goods, accounting for about 59.1%, whilst capital goods and consumer ones shared 13.4% and 27.4% respectively to total imports.

Chart 30. Exports by main categories, in EUR million and their contribution to import growth and the total import growth rate (in %);



Source: Bank of Albania

During January-November 2010, exports grew by 58.0% compared to the same period of the previous year. Exports of primary commodities, fuels and electrical energy experienced rising double-digit paces during that period. Moreover, the processed metal export experienced rapid growth rates during that period, while re-export of textiles showed stable growth rates.

Albania's trade activity remains EU countries focused, accounting for about 67.8% of trade exchanges during the period of January to November 2010. Thus, exports to countries like Italy, Greece, Spain and Germany, and also to the region, mainly to Turkey, posted positive growth rates. On the other hand, imports from member states of the Central European Free Trade Agreement (CEFTA), as well as from Italy, China, Turkey and Austria, registered an accelerated growth, about 91% y-o-y.

IV.2 LABOUR MARKET, WAGES AND LABOUR COST

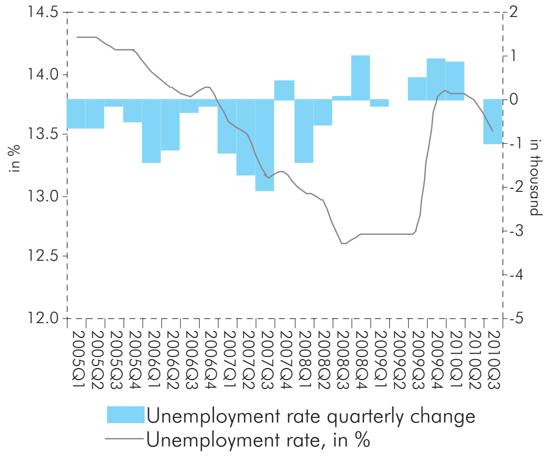
After marking a turning point in 2010 Q1, the performance of labour market confirmed the trend change in the next two quarters. Employment was rising and unemployment rate fell slightly in the third quarter. However, it is till *elevated, suggesting the existence of spare capacity in this market. Moderate growth of wages in the economy, against a backdrop of a sluggish consumer demand, appears to have not put upward pressures over wage - inflation spiral.*

After end-2009, labour market slack, the slow-but-steady employment growth attested to stable market conditions in 2010. According to INSTAT, the share of people working in the non-agricultural private sector of the economy[32] increased y-o-y by 2.6% in the third quarter. The share of people working in the public sector levelled out in 2010 Q3 compared to the same period of the previous year. The results of business survey sustain quarterly employment dynamics in the economy. The total number of people employed picked up by 1.23% in 2010 Q3. Such a perfomance is observed in all sectors of the economy.

Chart 31 Changes in employment and employment index by sectors (in %, y-o-y)

Source: INSTAT and Bank of Albania

Chart 32. Unemployment rate and quarterly change in the number of unemployed persons (%)



Source: INSTAT, short-term statistics

A detailed analysis on the sector, based on short-term statistical data, shows that the increased number of people employed in non-agricultural sector owes mainly to better performance of branches in the economy. Hence, in industry and services sectors, employment index was elevated by 10.6% and 7.3% y-o-y in 2010 Q3. In construction branch, employment continued the downward trend that had started since the previous quarter.

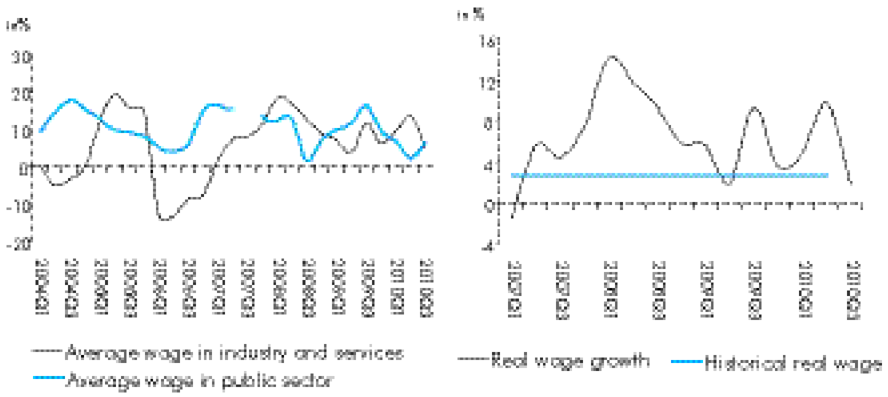
[32] *The number of people employed to total figure dropped by 5.7% in 2010 Q3. This continuous decline owes mainly to employment decline in agriculture private sector, reflecting the statistical effect of their measure. For the period of 2008 Q2 – 2009 Q3, that indicator is estimated according to the 2007 Labour Force Survey, while from 2009 Q4 and onward it is estimated according to the 2008 Labour Force Survey (Source: INSTAT, "Conjecture – Key economic indicator – March 2010). This effect will be cancelled out in the last quarter of the year.*

Reflecting developments in the number of people unemployed and the labour force, unemployment rate is downward, at 13.52%, down by 0.28 percentage point from the first half's figure.

WAGES

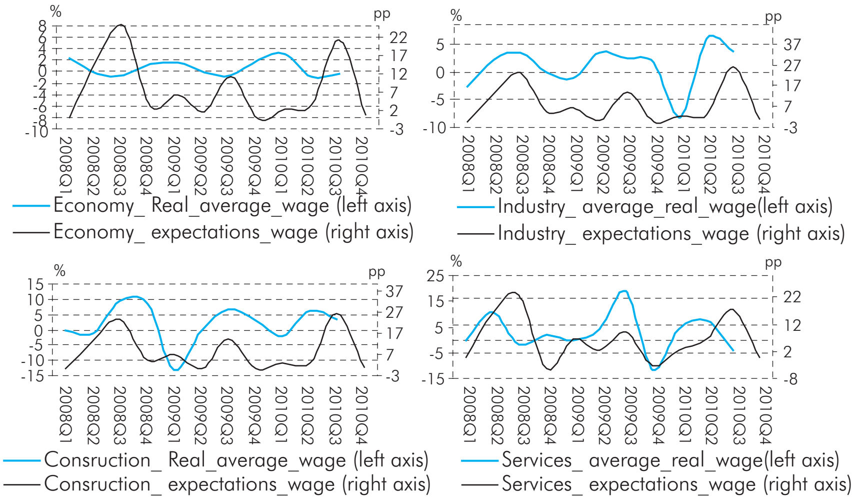
Following the downward trend in 2010 Q1 and Q2, average wage in the economy slowed its y-o-y and q-o-q growth rate over the course of Q3. According to INSTAT, average nominal wage[33] picked up 5.25% y-o-y and 0.62% q-o-q. In 2010 Q2, those rates were 13.34 and 5.53% respectively. The pickup in real wage, deflated by CPI, was modest, 1.85% in the third quarter.

Chart 33. Annual wage growth by sectors and the public sector wage (%).



Source: INSTAT and Bank of Albania

Chart 34. Wage performance and estimates on the economy and its sectors



Source: INSTAT and Bank of Albania calculations

[33] *Wage index in the economy, often referred to as "average wage", is calculated as the ratio of wage fund index to the number of employed index. Source: INSTAT, Short-Term Statistics, quarterly, excluding agriculture.*

At sectoral level, average wage growth slowed in all major sectors of the economy, excluding the service sector, in which average wage decreased in both nominal and real terms. Average real wage index in the service sector, following an upward trend observed over the course of three consecutive quarters, fell to 5.24% in 2010 Q3. Within this sector, a marked decline appeared in "Transport" and "Post and Telecommunication" branches.

Manufacturing sector wages slowed down their growth rates, recording 4.86% in real terms and 8.48% in nominal terms. In the light of the public sector, average wage picked up by 6.43% y-o-y, and 4.44% q-o-q.

INSTAT's general data have also been confirmed by the results of the business confidence survey on construction, industry, services and overall economy.

BOX 2: Wage-induced inflationary pressures

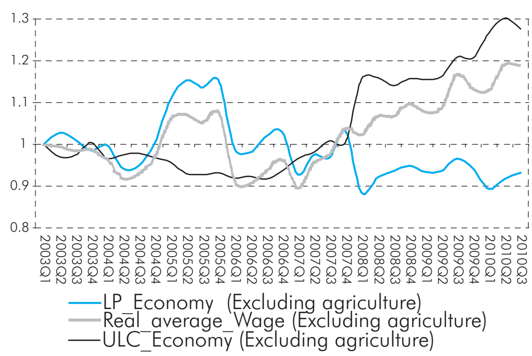
One of the main drivers to upward inflationary pressures in the economy is wage hike pushed by production cost. This factor will carry over pro-inflationary risk in the long run, if wage increase is not sustained by boosted labour productivity.

The increased cost per unit of output would be more sensitive to this factor's rise and the probability of upward price transmission of goods and services would be high. Inflationary pressures might also be much more induced by wage pickup, if the "wage" item had a considerable share to business cost structures. The risk of inflationary spiral to the economy would be inevitable. Businesses would raise prices of products and services in response to higher wages. However, such a wage increase would not result to the benefit of employees/customers, burdening the unit costs and product prices in the market. If the prices continued to pick up, employees would persistently push for higher wages to offset rising costs of living and hence inflation spiral would be amplified.

In contrast, if wages in the economy did not respond to overall price rise, inflationary pressures would diminish and wages would still be their source. Such a situation would be explained by the slowdown in consumer spending, a phenomenon that would weaken the aggregate demand.

In this context, the discussion about increasing the wage level in general and the minimum wage in particular, remains a sharp debate in economic policy. The argument against raising the minimum wage often refers to additional risks from inflationary higher cost-induced pressures caused by this factor. If workers' minimum wage increased, entrepreneurs would be forced to transmit such an increase to higher consumer prices. However, if the minimum wage pickup did not impact on employee's higher-than-minimum wages, the purchasing power of this category of consumers would fall as a result of price

Chart 35 Labour productivity and unit labour cost, and the real wage *



*An ongoing growth of labour productivity would substantially help create competitive advantage in the economy in terms of labour cost, contributing simultaneously to keeping on track the inflationary pressures induced by increased wages and unit labour cost.
Source: Bank of Albania calculations.

adjustment process. Although the theory on cost-induced inflationary pressures suggests likelihood of this scenario, the history of minimum and administrative wage increase in the Albanian economy does not result in significant inflation rise in the long run. This phenomenon has not occurred, because: first, the minimum wage increase is not reflected in wage rise for all categories; secondly, "personnel expenses" in business activity have a relatively low share to total expenditure. According to INSTAT, the average share of the respective item over the period of 2006-2008 for both production and services is about 8%.*

Since 2008, attention has been focused on extended gap between indicators such as unit labour cost (ULC), labour productivity (LP) and real wage index (W) in the national economy (excluding agriculture). It is assessed that it has been created mostly from several imbalances in the performance of labour market, wages and economic activity. The analysis of indicators reveals that (upward) shocks to unit labour costs have stemmed mostly from pickup in wages, without managing to be absorbed from rise in labour productivity. In 2011 Q3, there were slight improvement signs in both indicators, reflected in relative narrowing of the gap between them.

An ongoing growth of labour productivity would substantially help create competitive advantage in the economy in terms of labour cost, contributing simultaneously to keeping on track the inflationary pressures induced by increased wages and unit labour cost.

** INSTAT "Corporate economic activity". Table "Key data on income, expenditure and investments related to producers of goods and services, 2006 – 2008".*

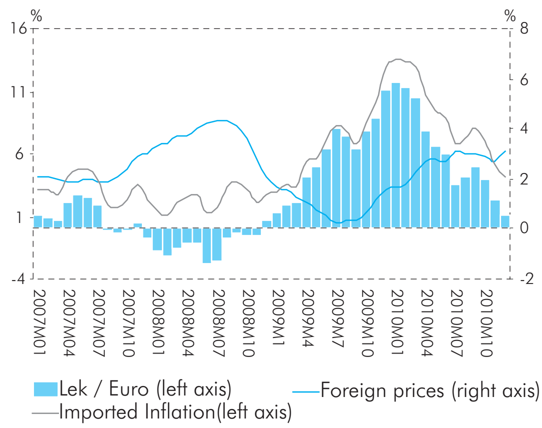
IV.3 IMPORTED INFLATION

Imported inflation in 2010 Q4 deepened the slowed trend, diminishing inflationary pressures on overall consumer prices at home. Relative exchange rate stability was the main driver to this development.

Notwithstanding the high pressure from foreign price hike, imported inflation[34] decreased further in 2010 Q4. It posted an annual growth of 5.4% in that quarter, half of the double-digit annual rate of 13.3% recorded in the first quarter. The lowest rates of annual exchange rate depreciation have somewhat offset the primary commodity price rise and the consumer price rise in global markets.

During the fourth quarter, consumer prices in Greece and Italy increased with an average of 5.1 and 1.7% respectively. Aggregate index of those

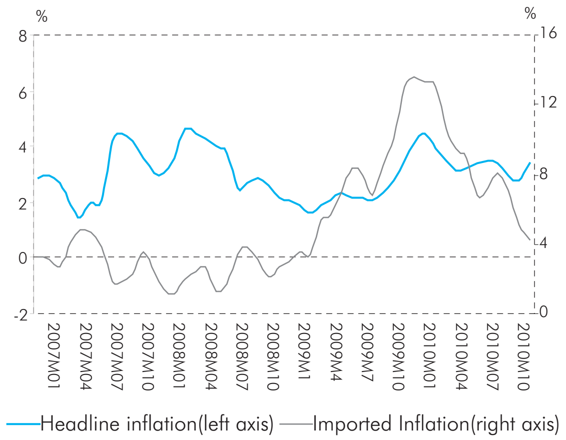
Chart 36 Annual change of consumer prices, imported inflation and EUR/ALL exchange rate



Source: Bank of Albania and the National Institutes of Statistics (Italy and Greece).

[34] *A proxy indicator estimated by the MPD, which results from combined information on the CPI of Greece and Italy, for the EUR/LEK exchange rate (with a lag of two months) and on Albania's share of imports with those countries.*

Chart 37. Headline and imported inflation rates (%)



Source: Bank of Albania calculations

prices (HPI)[35] - as a proxy of performance of import prices incorporated in the domestic CPI basket formation – posted an annualised fourth-quarter growth rate of 2.9%, about 0.3 percentage point above its historical average.

On the other hand, exchange rate developments have mitigated the upward pressures over the domestic consumer prices. The lek slowed progressively its annual dynamics of depreciation vs. the euro, from 8.3% in the first quarter to about 1% in the last quarter. Favourable exchange rate developments led to imported inflation slowdown, thus mitigating foreign inflationary pressures on the domestic consumer prices.

IV.4 INFLATION EXPECTATIONS IN THE ECONOMY

The economic agents' inflation expectations were anchored within the Bank of Albania's tolerance band, hence mitigating the upward pressures on domestic consumer prices.

During 2010, different economic agents' expectations[36] of annual inflation rate were anchored within the 2-4% tolerance band. After recording a slight increase in 2010 Q1 and Q2, performing similarly to current official inflation, agents' expectations were stabilized at lower rates over the rest of 2010. Based on data from 2010 Q4 survey, professional forecasters' expectation of annual inflation one year ahead is +3.3%. This expected rate is similar to the one expected a quarter earlier. Based on latest data from 2010 Q3 business and consumer confidence survey, companies' expectation of inflation one year ahead is +2.4%, whilst consumers' one is +2.2%.

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

The Albanian economy showed an upward trend during the first nine months of 2010. Annual Gross Domestic Product grew progressively until 2010 Q3 and labour market developments confirmed the turning point observed over the first quarter. On the other hand, the quarterly dynamics of main macroeconomic indicators suggests a more modest development over the third quarter. Quarterly real GDP growth, seasonally adjusted, slowed by 1 percentage point

[35] *HPI is measured as a weighted average of consumer prices in Italy and Greece at their respective market shares.*

[36] *Analysis of inflation expectations is based on 2010 Q3 business and consumer confidence survey and the monthly experts' survey conducted over the third quarter, and in October and November 2010.*

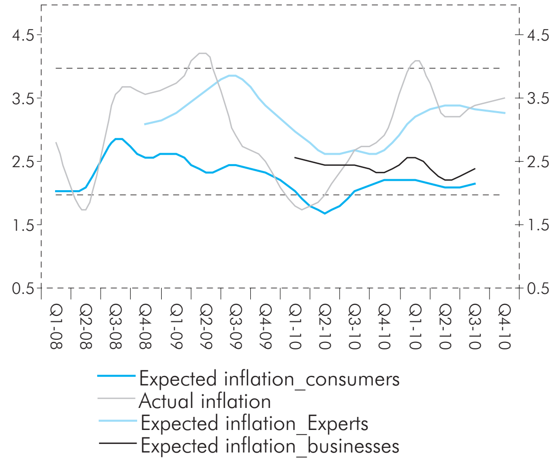
compared to the second quarter. Non-agricultural private sector employment, having picked up by 1.7% in the second quarter, remained almost unchanged in the third quarter. Unemployment rate fell slightly by about 0.26 percentage point.

Partial data on 2010 Q4 suggest relatively improved financial conditions, underpinning the assessment for ongoing positive growth rates.

Positive economic growth rates have mitigated slightly the actual and potential output gap, but have not eliminated it. The aggregate demand growth is driven mostly by the significant contribution of external demand, while private consumption and investments, although supported by monetary stimulus, have provided a low contribution to economic growth. Despite its decline, unemployment rate is still high, reflecting the mismatch between the supply of and the demand for, in the labour market. After a significant improvement in the second quarter of the year, capacity utilization rate fell again in the third quarter. High rate of unemployment and capacity utilization suggests the existence of spare capacity in the economy, which put disinflationary pressures on overall consumer price level in the country. Annual inflation rate fell to 3.1% in the fourth quarter, from 4.1% in the first quarter and 3.4% in the next two quarters. Relative exchange rate stability following the first quarter of this year mitigated inflationary pressures from external economy and disinflationary impact of the negative output gap.

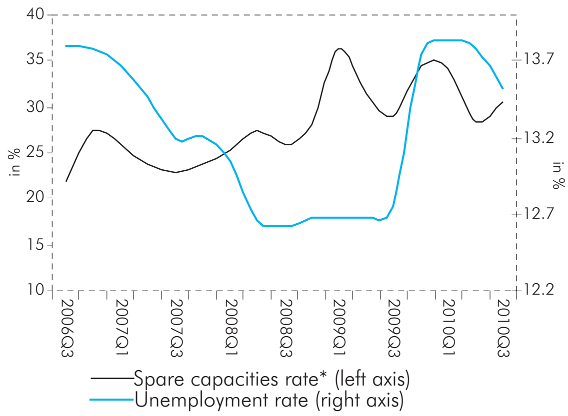
In the absence of unexpected shocks beyond the scope of monetary policy influence, future developments in consumer prices are expected to be in line with the Bank of Albania's inflation target. This assessment is based on persistence of the negative output gap and economic agents' anchored inflation expectations.

Chart 38 Economic agents' inflation expectations one year ahead (in %)



Source: Confidence survey and monthly experts' survey

Chart 39 Unemployment rate and spare capacities (%)*



*Note: Spare capacity rate is estimated as the difference between the maximum capacity utilization rate (100%) and the capacity utilization rate reported by business surveys.
Source: Bank of Albania, INSTAT

V. MONETARY DEVELOPMENTS AND THE FINANCIAL MARKETS

V.1 MONETARY INDICATORS

The demand for monetary assets in the second half of 2010[37] was higher than in the first half. Foreign currency constituent of money supply made the major contribution to base money growth. Foreign monetary position of the banking system has reflected the seasonal development of money creation in foreign currency, as a result of foreign-currency inflows during summer and their channelling into the banking system, thanks to restored confidence in the system. The public sector's contribution to monetary expansion maintained stable levels, except in November, which evidenced a deviation from this trend. In the meantime, the private sector's contribution to money creation continued to be relatively small. Moderate credit growth rates until October have confirmed the private sector's low demand for money and the summer seasonality. November highlighted a significant increase in loan portfolio, whose contribution to monetary expansion balanced the pronounced decline in public sector's demand for domestic funding. Overall, low annual rates of domestic credit growth and sustainable base money growth confirm low inflationary pressures in the economy.

V.1.1 MONETARY DEVELOPMENTS

Money growth showed an upward trend in the second half of the year. The monetary aggregate, M3, grew on average 11.7% y-o-y, compared to 9.4% in 2010 H1. The performance of the broad money reflected the external sector's positive developments and the moderate credit to the economy during 2010. Foreign-currency remittances during summer provided the highest contribution to broad money growth. The M2 aggregate growth averaged 4.3% in the second quarter, reflecting primarily the steady contribution from the public sector[38].

Public sector's domestic borrowing rates are generally associated with a seasonal volatility in the demand for cash, which is reflected in the performance of base money in the economy and M2 aggregate. The currency outside banks index has declined steadily, impacting on the decrease of its share to ALL aggregate to 31.9% at end-November, from 35.4% in the previous year. Strengthened confidence in the banking system and low intermediation in the public sector at the end of the period have been the key drivers to low demand for liquid monetary assets.

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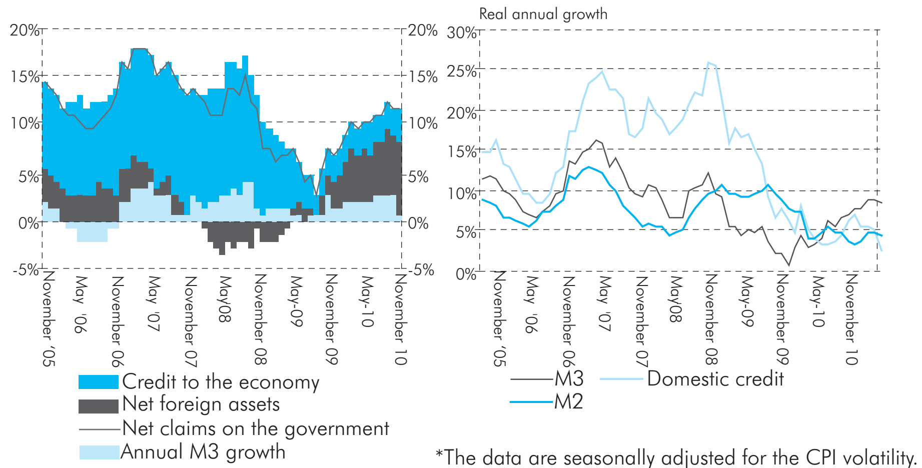
37 *The analysis refers to the period of July-November 2010.*

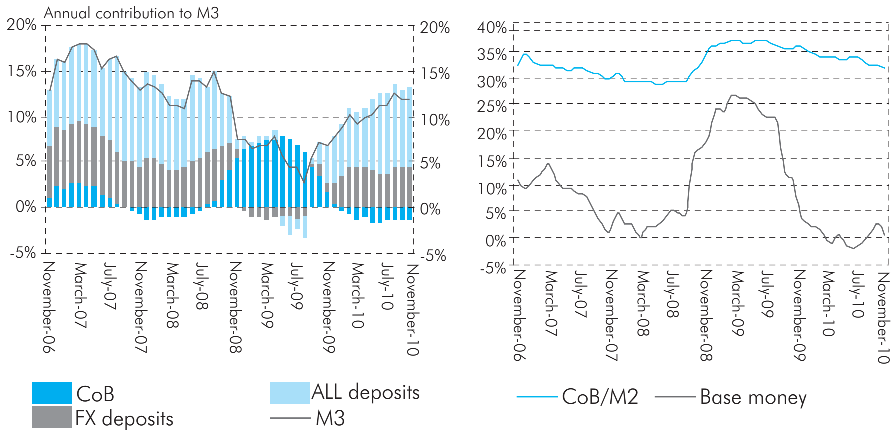
38 *Public sector activity during November provided a significantly lower contribution than in the rest of the year.*

Chart 40 Contribution of M3 components and money indicators in real terms*



*The data are seasonally adjusted for the CPI volatility.
Source: Bank of Albania

Chart 41 Contribution of money components and monetary aggregates

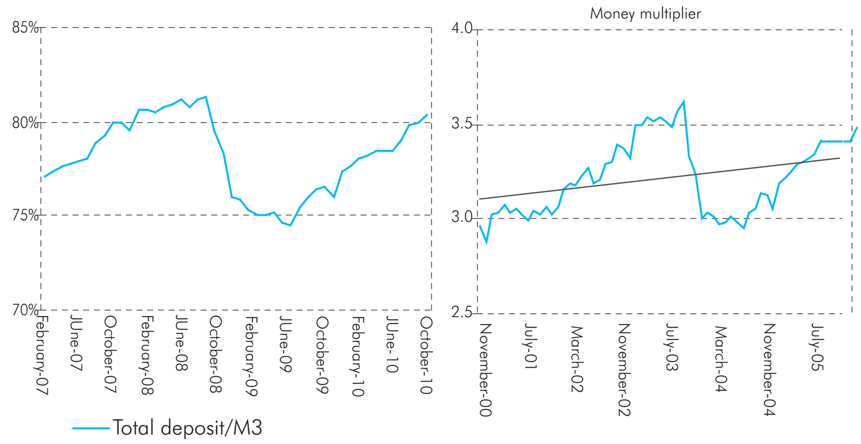


Source: Bank of Albania

Moreover, money circulation in the economy has led to creation of new deposits in the banking system and increased the money multiplier to 3.49 as at end-November. The annualized average deposit growth in the second half of the year reached almost the pre-withdrawal[39] growth rates. So, the total stock of deposits is estimated at about 17.4% higher than over the same period of the previous year, up by 15.6% from September 2008. Economic agents' tendency to save, strengthened confidence in banking institutions and favourable interest rates in the banking market have influenced the channelling of deposits into the banking system. In November, there was a monthly increase in deposits beyond the historical monthly average, owing mainly to faster money velocity, thanks to increased volume of bank lending to the economy. In line with those developments, the Bank of Albania's surveys show a rising propensity to save in the economy.

39 *In the framework of effects of the global financial crisis.*

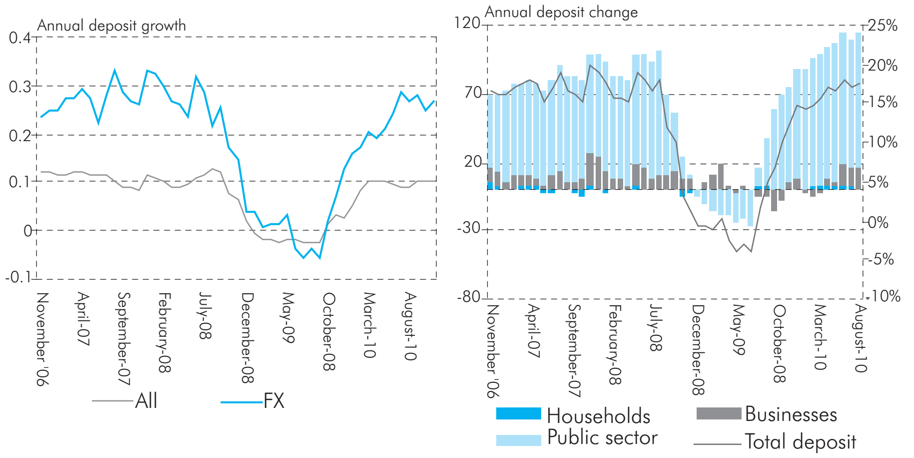
Chart 42 Annual pace of M3 aggregate and annual inflation, broad money multiplier



Source: Bank of Albania

Foreign currency composition of base money creation has reflected the increased share of foreign currency deposits to total deposits, by 47.7% compared with 45.1% as at the end of the first half of the year. Hence, foreign currency deposits increased more than ALL ones, in both annual[40] and monthly terms, impacting on rising contribution of foreign currency component to money creation in the economy. The growth rate of ALL deposits averaged 9.8%, resulting higher than in the first half of the year (9.1%, on average). Money creation in national currency is sustained more by higher public sector activity and less by ALL lending to the economy.

Chart 43 Annual changes of deposits by currency and economic agents



Source: Bank of Albania

Time structure of base money creation attested to a shift towards time deposits, the share of which amounted to about 79% of total stock of deposits. The shift of monetary assets to longer maturities has reflected the faster growth

40 *Foreign currency deposits increased on average 26.8% in July-November, compared to 19% in the first half of the year.*

of time deposits in the banking system, primarily those of households. In the meantime, business deposits reached record highs in August to September 2010, a period which coincides with high seasonal activity in tourism.

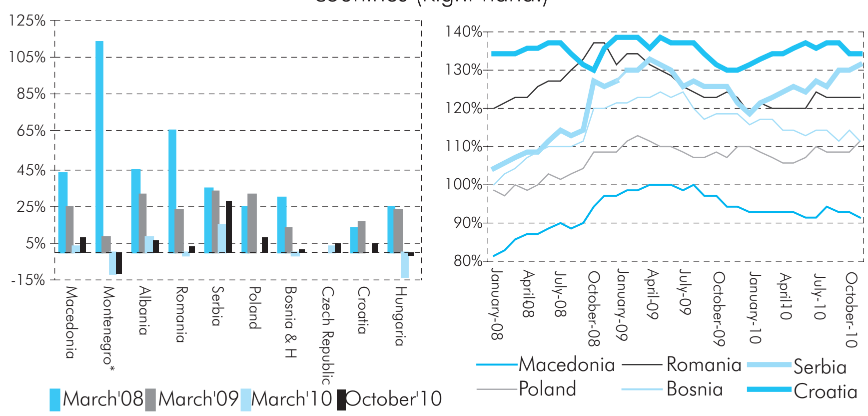
*BOX 3 Bank intermediation in the region**

The effects of the global financial crisis in the countries of Central and Eastern Europe (CEE) were felt in all sectors of the economy, leading initially to the slowdown and collapse of financial intermediation and later on to decrease in trade volume worldwide and to reflection of these effects in the real economy. The financial crisis hit the CEE countries at a time when the credit cycle marked high and constant growth rates. However, year 2010 witnessed signs of recovery in financial markets and various monetary and financial indicators, thanks to central banks' intervention and the pursuit of accommodating fiscal policies. All CEE countries are recovering from the crisis consequences by officially phasing the recession out.

Monetary expansion in these countries continues to remain low. According to a survey by Central Bank of Germany, the data on 2010 Q2 and onward show a slow improvement in lending rates, which after hitting low record in the first quarter, have already begun to show signs of recovery. Though, in real terms, we can not yet talk about a significant annual growth of lending to the private sector, there is observed a turning point in the overall lending trend. Availability of domestic or foreign financing sources, the performance of non-performing loans and the risks stemming from equity and banking system profitability will continue to remain among the main causes of this slow recovery in the lending rates.

*Intermediation rates** were generally downward throughout the global financial crisis, reflecting the significant slowdown in lending rates vs. more rapid expansion in deposits. Most CEE countries highlight increased intermediation rates primarily during 2010 H1, thus maintaining almost the same rates in the third quarter. Meanwhile, stimulating the economy by expanding lending to the private sector is reflected in the credit impulse indicator***, which has shown significant improvement during 2010 H1 compared to 2009, recording simultaneously positive values for countries, such as Ukraine, Hungary, and Rumania.*

Chart 44. Annual credit growth (left-hand) and intermediation rate in the region countries (Right-hand.)*



* Latest data of annual credit growth for Croatia belong to September '10
Burimi: Bankat qendrore përkatëse, Nëntor 2010.

Credit slowdown in most CEE countries was more pronounced for business loans. In countries, such as Rumania, Macedonia, or Croatia, household loans recorded a steeper decline, thus dictating the performance of loan portfolio.

In view of recovery from the crisis, the banking sector has mainly sustained short-term lending to businesses, first of all for meeting the liquidity needs, and then for short-term investment purposes. In Serbia's case, there has been an increase in loans for investment in important sectors, such as trade, industry and transport.

*Foreign financing of the CEE countries continues to remain sluggish. Moreover, capital outflows for most of those countries were lower than expected. This situation has reflected the entry of CEE countries into a phase of rapid reduction in the amount of financial leverage**** usage, suggesting that banks can also benefit from ECB's eased monetary policy rates and ample liquidity in the market. In line with poor economic performance and high unemployment rates, non-performing loans increased in 2009, preserving such levels even during 2010. Deteriorated rates of non-performing loans are registered in countries like Rumania, Bulgaria and Hungary, which have remained at high levels since the crisis onset. Non-performing loans in this region are expected to follow an upward trajectory and hit high records in the next 3-6 months.*

In the context of high unemployment rates and low consumption level, the sectors of the economy will continue to operate below their economic potential by generating a slow economic growth. Low positive economic growth rates that were observed during the first half of the year in a number of countries in the region are not expected to be stimulated by lending to the economy. This stimulus is expected to be restored only after the recovery of the private sector's demand, primarily from businesses.

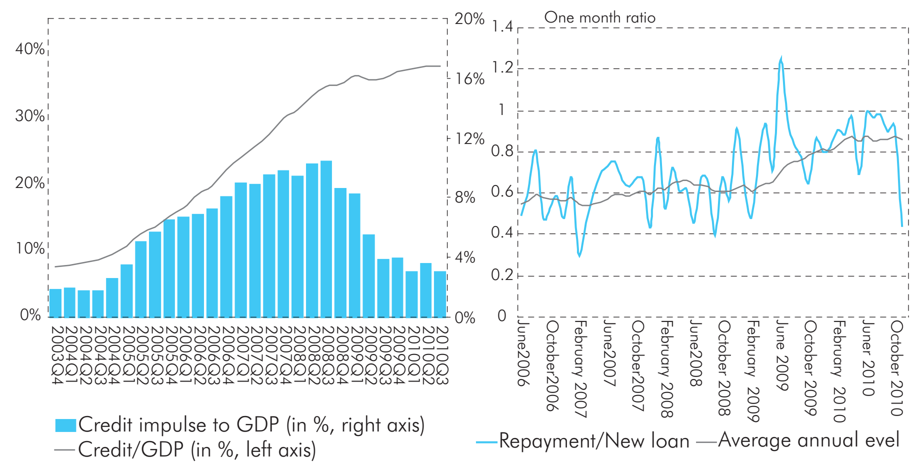
* For more information, refer to the working paper on "Financial Intermediation Analysis", incorporated in the Bank of Albania's bulletin, 2010 H2.
** As proxcied the ratio of total lending to the economy to total deposit stock.
*** Measured as the net percentage of change in loan portfolio as a share of GDP.
****Reduction of foreign banks' claims as a percentage of GDP of recipient countries.

V.1.2 LENDING TO THE PRIVATE SECTOR

The growth of economic activity below the potential and still high uncertainties about future prospects affected the contraction of agents' demand for money/borrowing[41] until the end of 2010 Q3. Consequently, during that period the private sector loan portfolio growth was moderate, due to banks' cautious stance to preserve credit quality[42]. In September 2010, loan to GDP ratio accounted for 38%, up by 2 percentage points from the previous year. In the meantime, the 3.1% credit impulse[43] to GDP is still at historical lows.

[41] This result is also supported by credit survey conducted with banks active in the credit market.
[42] Against the backdrop of loan quality deterioration, the ratio of non-performing loans to total loans reached 14.4% at end-November, from 12.2% in June-2010.
[43] Credit impulse is measured as a ratio of net credit flow to GDP. In the Global Market Research, December 2009, Biggs & Mayer proved empirically that this ratio is a suitable indicator that tends to capture swiftly the turning points compared to the ratio of credit to GDP.

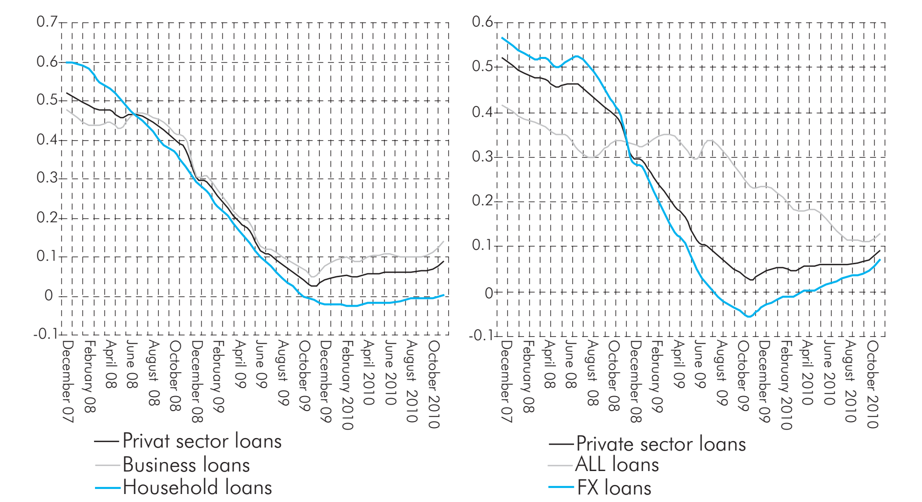
Chart 45 Credit to GDP and loan repayment to new loan (in %)



Source: Bank of Albania

Nonetheless, for November[44], private sector loan portfolio increased markedly by ALL 11 billion, from an average growth of ALL 2 billion for 2010. Private sector loan grew by 9% y-o-y vs. the moderate growth of the portfolio by an average of 5.5% in 2010 H1. Rapid credit growth in November appears to have been supported by: seasonal behaviour of lending activity in response to a higher business demand for creating year-end inventories; output gap narrowing in the real economy over the first three quarters of 2010; and higher bank credit availability, as also shown in the 2010 Q4's credit survey. The decreased repaid loan to new loan ratio, which in November had recorded the lowest level over the past two years, has also provided a significant influence. That ratio has reflected higher investment loans in 2010. Credit growth in November was dominated by foreign-currency business loans, extended to several sectors of the economy. However, whether such development constitutes a turning point to the loan portfolio performance has to be confirmed in the coming months.

Chart 46. Key indicators of the loan portfolio

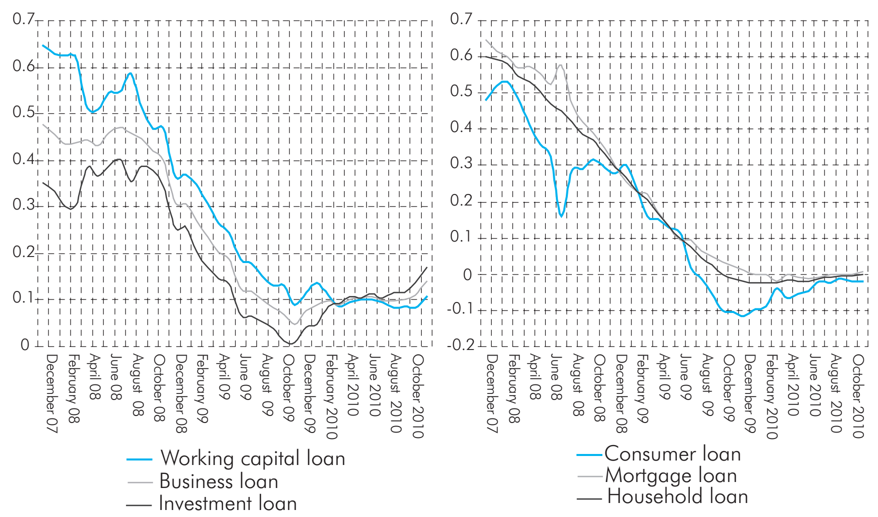


Source: Bank of Albania

44 Adjusted for the exchange rate volatility

Foreign-currency private sector loans increased on average by 4.1% y-o-y over the period of July to November 2010. Significant improvement in foreign-currency lending, compared to the first half[45] of the year, has also reflected better foreign-currency liquidity conditions in the banking system over the same period. Increased foreign-currency lending to the private sector has served primarily to finance corporate investment projects. Foreign-currency household loans continued to be tightened, reflecting a cautious stance in terms of foreign-currency borrowing, from both banks and households.

Chart 47 Loan portfolio by customers (in %)



Source: Bank of Albania

Lek-denominated loans increased on average 12.5% y-o-y, featuring slower growth rates as compared to the first half (18.6%, on average). Even though ALL lending cost has been downward during the period, it continues to be higher than EUR lending price, hence preference for foreign-currency mortgage loans.

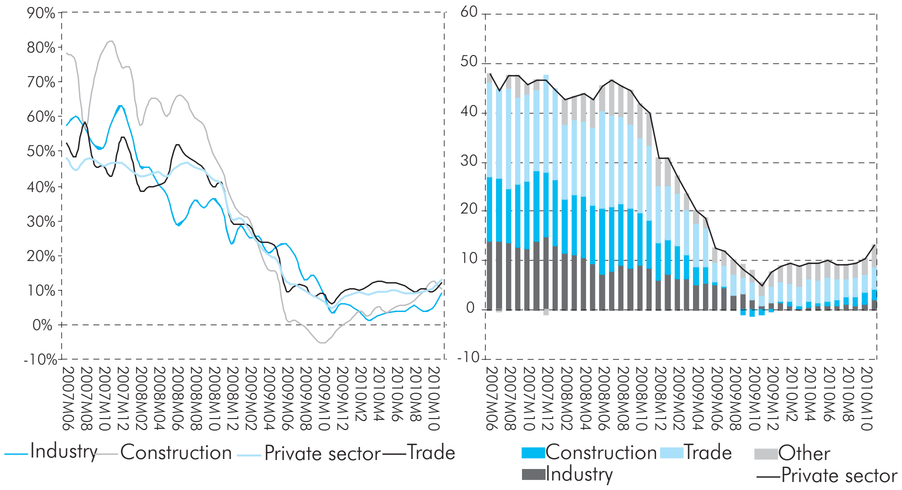
Business loan continued to be the main source of loan portfolio growth by the banking system in 2010 H2, increasing by 11%, on average, marginally higher than in 2010 H1. Business loan was used primarily for investment purposes, the contribution of which amounted to 7.5 percentage points at end-November. Working capital loan reflected decelerated growth rates, averaging 8.9%, from 10.6% in the first half of the year. Loan portfolio sectoral distribution shows that trade continues to receive the largest portion of lending, in line with its largest contribution to GDP. Likewise, industry and construction underwent improved growth rates during July to November 2010, with an annual growth rate of 4% and 7%, on average, respectively.

Despite the loan recovery in November, it is assessed that its contribution to monetary expansion is still at historic lows. Household lending continues to shrink (-0.6%, on average, y-o-y), particularly loan for consumption (-

[45] *During that period, foreign-currency loan portfolio was contracted with an average of about - 0.3% y-o-y.*

2.3%), which is the component that puts direct inflationary pressures. In the meantime, housing loan has presented a positive performance for several months, also driven by some promotional bank offers applying preferential mortgage loan terms.

Chart 48 Loan portfolio by sectors of the economy (in %)

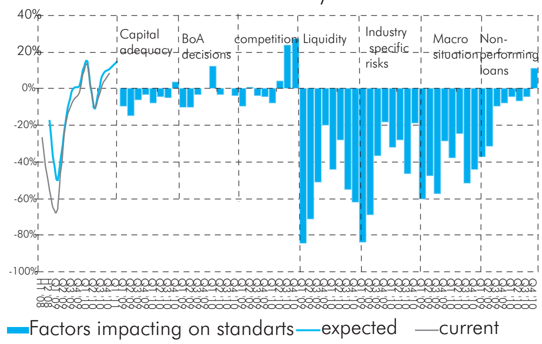


Source: Bank of Albania

Concerning the outlook, the Bank of Albania judges that the pace of recovery for the loan portfolio, particularly for business loans, will be affected by the pace at which Albania's economic activity will recover, as well as by banks' response to perceived credit risk. In the meantime, household demand for loans will depend, to a great extent, on continuation of positive economic growth and further improvement of employment and remittance indicators, which should lead to reduction of households' uncertainties and restore more positive expectations for the future. Other countries' experience has shown that the pace of credit recovery is reflected with some-quarter lag in the real economy[46].

[46] P. Kannan, "Credit Conditions and Recoveries from Recessions Associated with Financial Crisis", WP/IMF/2010.

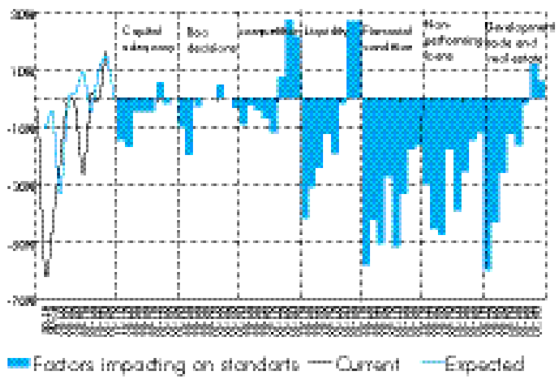
Chart 49. Changes in standards applied to business loans and contribution of different factors (net balance*, net percentage of banks having eased the standards)



*Positive balance means easing of standards or that the factor has influenced the easing of lending standards; negative balance means tightening of standards or that the factor has influenced the tightening of lending standards.

Source: Bank of Albania

Chart 50. Changes in the standards applied to housing and consumer loans and contribution of different factors (net balance*, net percentage of banks having eased the standards)



*) See note 1

Source: Bank of Albania

*BOX 4 The results of the 2010 Q4 Credit Conditions Survey**

2010 Q4 highlighted easing of lending standards for both businesses and households. The eased standards for business loans confirm the turning point having started since 2010 Q3. The eased standards for household loans follow their tightening having started since the previous quarter. Such developments are consistent with banks' expectations reflected in the previous survey.

The easing of lending standards in 2010 Q4 owes mainly to positive contribution of specific factors, such as liquidity condition and bank capital adequacy. Competitiveness has also provided a positive contribution in this regard.

Banks eased their lending standards for businesses chiefly by increasing the loan size, whereas, with regard to households, they eased their lending standards chiefly by narrowing the average margin, raising the maximum loan maturity and increasing the loan size.
According to bank experts, bank loan demand grew in 2010 Q4. Net percentage of banks having reported an increased demand by businesses is up, but still at negative levels. In the meantime, such percentage is upward and positive for households.

In 2011 Q1, banks expect continuation of easing standards for business loans. In contrast, expectations for further easing of household loans are pessimistic. Regardless of expectations for future changes in the lending standards, businesses expect a higher demand for business and household loans.

** A complete analysis on credit survey outcome is found on Bank of Albania's website,.http://www.bankofalbania.org/web/Vrojtimet_e_aktivitetit_kreditues_5311_1.php.*

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

During 2010 H2, the Bank of Albania pursued a prudent monetary policy of a loose approach, observing the implementation of inflation target. The injection of monetary stimulus in the economy continued in both quantitative and qualitative terms. Against this setting, the improved liquidity condition in the banking system and the presence of a moderate demand for monetary assets from both public and private sectors, allowed the pass-through of the accommodating policy to all financial market segments. T-bill and government bond yields dropped throughout the observed period, whereas All-denominated deposit and loan interest rates followed that trend, albeit at more moderate rates. Moreover, the performance of the nominal effective exchange rate continued to confirm reduction of depreciating paces during 2010 H2.

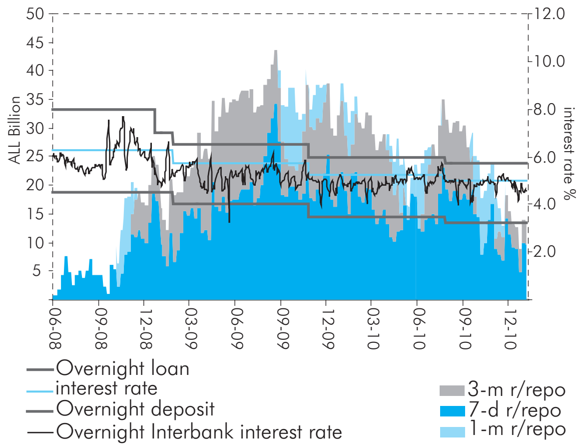
V.2.1 INTERBANK MARKET

During the 6-month period, the interbank market was characterized by a slight upward trend in interest rates and in the volume traded among banks. Interest rate rise was primarily observed in daily exchanges, while those of a weekly maturity term were downward throughout the major part of the 6-month period. With respect to the volume traded among banks, the weekly exchanges continued to have the major share, while the number of effected transactions was higher for daily exchanges. Along that period, the Bank of Albania injected liquidity by means of its open market operations through weekly reverse repurchase agreements. Besides this instrument, the Bank of Albania also used the reverse repurchase agreements of a longer maturity, such as the one-month and three-month ones.

Improved liquidity conditions at banks and the satisfactory level of their funding from deposits has created the possibility for reducing the liquidity injected by the Bank of Albania in its refinancing auctions over the course of these months. In the light of interbank market, lending among banks hit record highs in September and October, to fall back in the next months. Performance of monthly and quarterly transactions during that period has confirmed the improved liquidity condition and the decreased risk premium by banks, and has also offset the reduction in the traded volume of a daily maturity term. Interest rates of these transactions have exhibited high volatility throughout these months, having been affected mainly by temporary supply and demand-induced factors, often accompanied by non-efficient management of bank liquidity in the period of meeting the required reserve. Interest rate on weekly transactions preserved a steadier performance, being close to policy rate throughout most of the period. The performance of the volume of transactions in the interbank market appeared different between both principal maturities preferred by banks, where daily borrowing showed moderate reduction, while the weekly volume presented high levels, confirming the behaviour observed in the previous quarters.

The last quarter posted a total traded volume of ALL 3.529 billion, on average, or about 0.1 billion more than in the third quarter, where the positive contribution of weekly volume has offset lower daily values. In terms of 6-month period, the volume exchanged in the interbank market was higher for both daily and weekly exchanges. During that quarter, the interest rate on daily transactions was cut by 0.06%, to 4.91%, affected mainly by the low values recorded over October and December. Interest rate on weekly transactions was cut by 0.06% to 5.05%, though it is worth mentioning that the third quarter's rates carry over the average of July, when the policy rate was 0.25% higher. Overall, monthly average rates of that maturity have taken into account the policy rate cut, to 5.03% in December.

Chart 51. Volume of liquidity provided by the Bank of Albania and daily interest rate in the interbank market

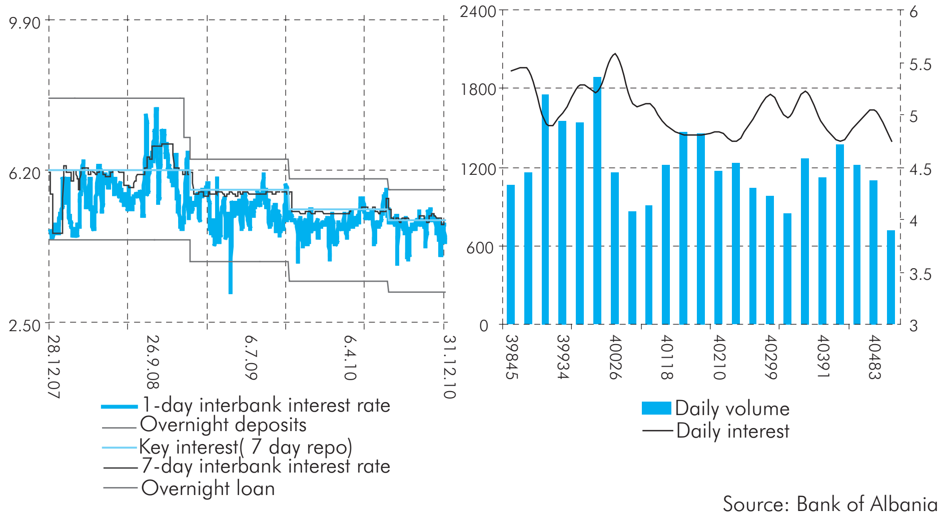


Source: Bank of Albania

V.2.2 PRIMARY MARKET

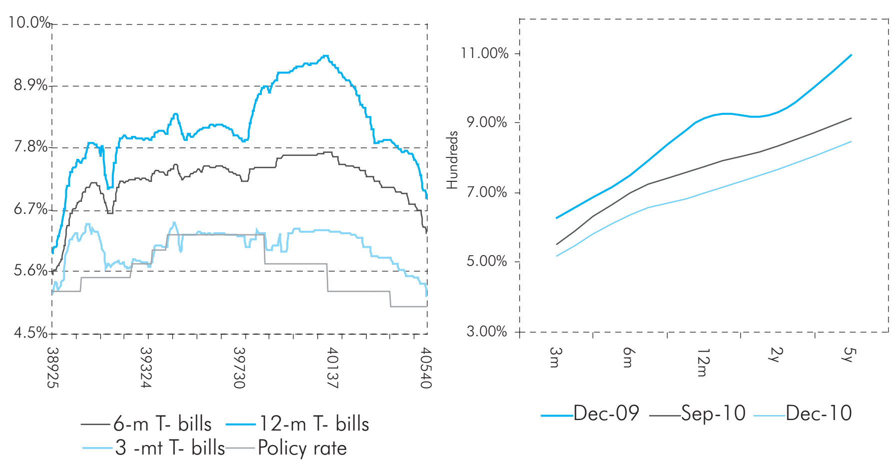
Primary market yield performance continued to follow the downward trend observed throughout 2010. Decreased risk premium, stabilized liquidity condition in the banking system and reduced government demand have exerted ongoing downward pressure on yields over the quarter. Downward T-bill yields were observed for all maturity terms, being more pronounced for the 12-month ones, which has favoured decline in the yield asked by other instruments parameterized with it. During the observed period, banks' participation in government security auctions was high and helped strengthen the downward pressures, also evidencing an improved risk premium by them. Banks'bid in the primary market auctions was for all types of maturity terms and exceeded the asked amounts, thereby enhancing the competitiveness and underpinning the downward yield trend. The policy interest rate cut at end-July reinforced such a downward trend and contributed to overall yield cut.

Chart 52 Interbank market interest rates (left-hand) and the average daily volume in the interbank market (right-hand)



Source: Bank of Albania

Chart 53 T-bill yield (left-hand) and yield curve (right-hand)



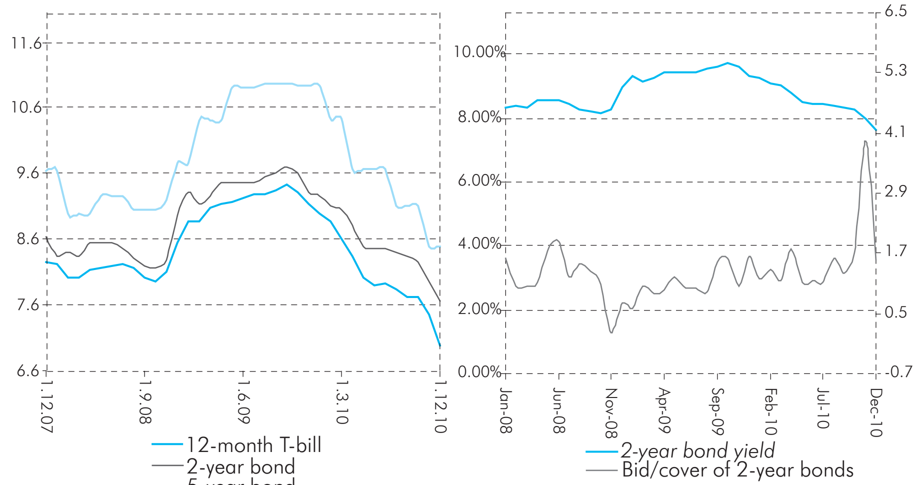
Source: Bank of Albania

At end-December, the 12-month T-bill yield was 6.91%, down by 0.97 percentage point from end-July. Security yields of 3 and 6-month maturity term performed similarly, albeit at a more restrained amount. T-bill yield asked in December dropped to 5.17% or 0.37 p.p. and 6.35 or 0.70 p.p. respectively from the end of the past quarter. On average, T-bill yield has reached markedly lower values than in the previous periods, positively affecting the government financing cost. Yield spread between different maturities fell, mainly related to short-term and medium-term ones, making the yield curve slope be slightly flattened at its start. The flattening yield curve slope indicates controlled inflationary tendencies and reduced liquidity premium.

The performance of yields in the primary bond market was similar to the T-bills'. Bond yields fell over the last quarter, affected by overall improvement of risk perception by banks, at a time when the above-mentioned T-bill-related factors have also influenced these long-term debt instruments. The combination of the downward trend of 12-month T-bill premium that is used as a base value in parameterization of many bonds, with the reduced government demand, has driven to downward yield performance throughout the period.

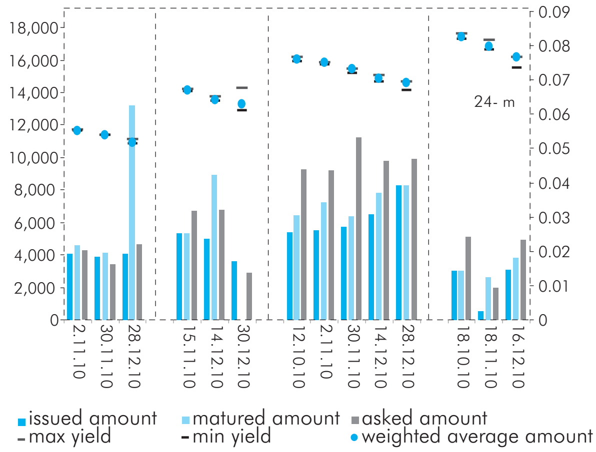
Similarly, in bond auctions, bank participation was high and the bid has exceeded the amount asked, exerting further pressure for yield reduction. In auctions held over the observed quarter, the 2 -, 3 - and 5-year-bond yield dropped, following the overall T-bill yield cut. As at quarter-end, 2-year bond yield was 7.65% or 0.70 p.p. lower than a quarter earlier, whilst spread on a year earlier was -1.65 percentage point. A similar performance was followed by 3 - and 5-year bond yields (of a variable interest). So, at year-end, they recorded 9.19 and 8.48 respectively, or down 0.41 and 0.64% p.p. from September. It is worth mentioning that variable-interest bond yield cut was affected by the performance of the instruments it is parameterized with, as well as by the reduction in accepted margin, which followed a downward trend during that period. The yield curve, with its markedly smoothed level and slope, has also reflected the low yield rates.

Chart 54 Bond yields (left-hand) and bid/cover ratio of 2-year bonds (right-hand)



Source Bank of Albania

Chart 55. Results of latest T-bill and bond auctions



Source: Bank of Albania

V.2.3 INTEREST RATES ON NEW DEPOSITS

The downward interest rate trend of both major currencies, the euro and the lek, continued in 2010 H2. The banking system has applied slight and consecutive interest rate cut for all maturity terms. Despite some promotional offers applied mainly in the short-term during summer, the weighted average interest rates on ALL deposits have followed a downward trend, in line with the monetary policy signals. Even so, competition among banks to maintain their market share has still held margins at relatively high levels, compared with policy rates and European market interest rates[47].

The average interest rate on ALL deposits was 5.13% in July to November 2010, or down 0.13 percentage point from the first half of the year. The policy rate was cut by 0.25 percentage point over the observed period. The weighted interest rate cut took place consecutively throughout the second half of the year[48] and for all maturity terms. Relative to 2010 H1, interest rates on 3-, 6-, 12-, and 24-month deposits dropped by 0.31, 0.22, 0.31, and 0.45 percentage point, respectively. Moreover, banks did not apply any promotional offers on deposit interest rates at year-end, reflecting the system's stabilized liquidity conditions and declining risk premium. Preliminary data suggest that deposit interest rate cut continued even in December.

Interest rates on EUR deposits pursued a similar dynamics to ALL deposits. On average, they accounted for 2.16% in July to November, down 0.17 percentage point from 2010 H1. Interest rate cut took place for all maturity terms. In concrete terms, the interest rate on 3-, 6-, and 12-month deposits fell by 0.54, 0.10 and 0.40 percentage point, respectively. Even so, the high level of competition across those banks that use the EUR deposit interest rates as cost of funds, has encouraged other banks to maintain high interest rates on EUR deposits, compared to the European market rates.

V.2.4 INTEREST RATES ON NEW LOANS

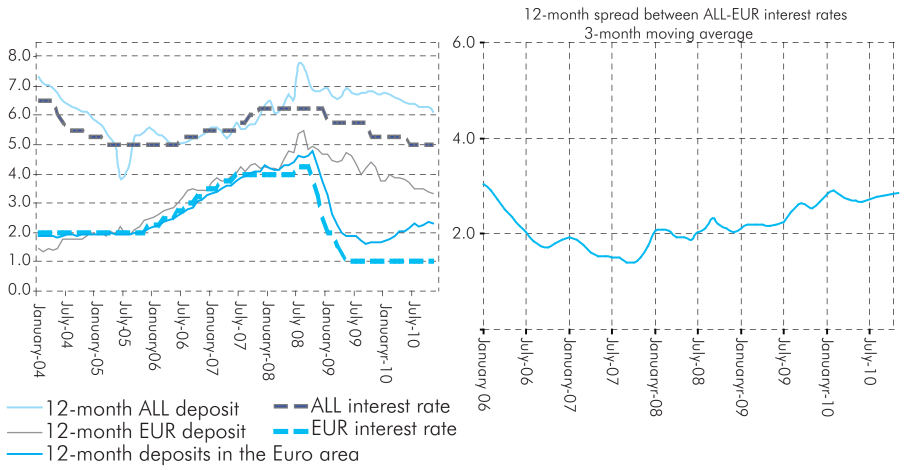
The period of July - November 2010 was characterized by lower average interest rates on ALL loans and EUR loan interest rate volatility. Such development was driven by the seasonal effect of business demand for ALL-denominated working capital and increased year-end inventories. They were associated by diversification in offers and preferential terms applied by several banks for particular clients in both major currencies. On the other hand, strict

[47] *Also, it should be stressed that the spread between interest rate on euro deposits in the country and foreign interest rates continues to be narrowed, upon rise in interest rates in Europe.*

[48] *Except in August, when the weighted average interest rate on deposits increased, as a consequence of high inflows of 12-month deposits (only as a consequence of weighting).*

monitoring and exchange rate risk were the factors that have contributed to keeping high margins for short-term EUR loans.

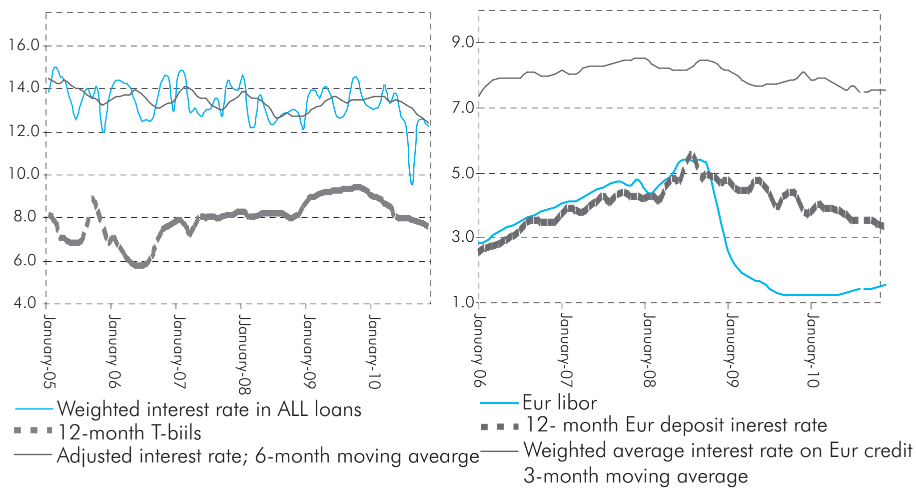
Chart 56. 12-month deposit interest rate and interest rates (in Albania and the Euro area)



Source: Bank of Albania

In 2010 H2, the average interest rate on ALL loans was down 1.11[49]p.p. from 2010 H1. Over the same period, the 12-month T-bill yield fell by 0.81 p.p., on average. In November, the weighted interest rate average was 12.25%, markedly lower than a year earlier. Though such decrease was favoured by preferential interest rates of individual banks on overdrafts and business investment loans, it also reflects the easing trend for ALL-denominated lending over that period. By maturity term, the greatest interest rate cut was applied to short-term (0-1 year) business loans. Moreover, banks continued to favour ALL-real estate loans to households.

Chart 57. Interest rate on new ALL and EUR loans



Source: Bank of Albania.

[49] *The actual decrease is 1.65 p.p., but it is adjusted excluding a short-term bank loan at a considerable amount and an interest rate well below the average of the system, without which the interest rate was 12.26% in August.*

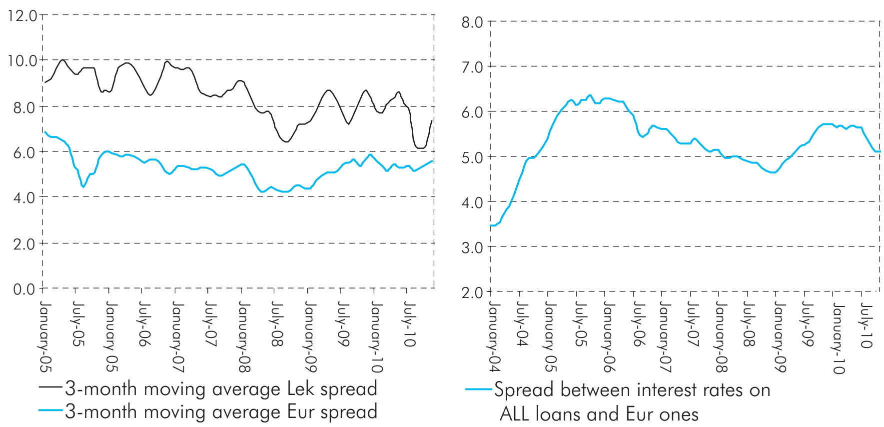
The interest rate on EUR loans was characterized by high volatility in July to November, averaging 7.53%, down by 0.02 percentage point relative to the past six-month period. In the meantime, reference rates have continued to fall. In the short-term, interest rates on working capital ALL-denominated loans to businesses have performed similarly, lowering their average rate. Meanwhile, banks have remained reluctant to make new EUR loans of over 5-year maturity term (for real estate and investments). Interest rate on those loans increased 0.34 p.p., on average, in July to November compared with the first half of the year.

Intermediation cost in ALL fell during July-November 2010, as a reflection of the downward interest rate on loans. It averaged 6.67 p.p. vs. 8.12 p.p. in the first half of the year. The intermediation cost in euro averaged 5.37 p.p. in July to November, or 0.15 basis points higher than in the first half. The spread between interest rates on ALL loans and EUR ones, though highly volatile, has decreased by 1.56 p.p. on average, relative to 2010 H1.

Box 5: Market response to Bank of Albania's new operational framework

As we have also stated in the previous box, the Bank of Albania decided to apply its operational objective for orienting the short-term interest rates in the interbank market to policy rate and restraining their volatility. To clearly reflect the effects and impact of this change on the domestic interbank market, we have measured and analysed the market rate volatility against the policy rate. The observed period encompasses the past two quarters of the year featuring similar regulatory and financial conditions. Interbank interest rate spreads have been different for both maturity terms, recording higher values for daily transactions.

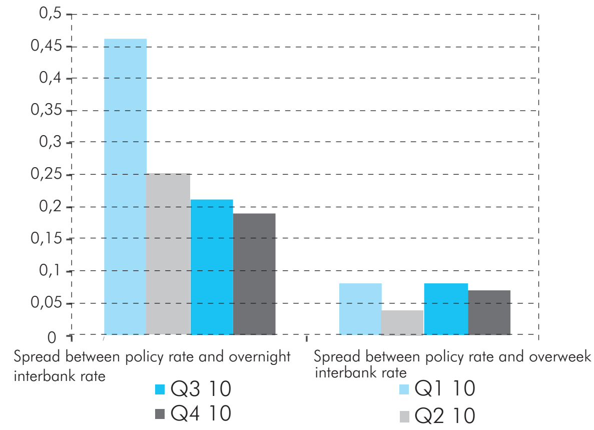
Chart 58. Average intermediation rates for ALL and EUR (Left-hand) and spread between average interest rate on ALL and EUR loans (right-hand)



Source: Bank of Albania

During the fourth quarter, daily rates decreased their absolute spread over the key rate from 21 to 19 basis points, whilst the weekly ones decreased by 1 unit to 7 basis points. This spread has followed the downward performance compared to the previous quarters of the year. Standard deviation highlights that over the *fourth quarter these values have been lower for both maturities, respectively, 0.24 from 0.34 for the overnight one, and 0.06 from 0.29 for the weekly one. Overall, the decreased spread between the daily interest rate and the policy rate supports the initial idea of reduced swings against the policy rate and of interbank market stabilization. Other factors of influence are improved liquidity position of banks under the conditions of a satisfactory funding from deposits as well as from the creation of free spaces in banks' assets, by lowering the demand for government securities. All these factors have contributed to achieving a more sustainable activity of banks in the interbank market during the quarter. So, the intraday interbank interest rate has remained below the policy rate, exceeding it only during certain days. The analysis of monthly performance has confirmed the interbank market volatility mitigation, which is reflected in the standard deviation values, and also in the periodic fluctuations of daily rates, mainly concentrated in the days for meeting the required reserve. As we have also stated in previous reports, bank liquidity management at efficiency limits makes this time of the month more exposed to daily interest rate volatility. Interest rates for weekly transactions have reflected a modest volatility and a minimum difference from the policy rate. Factors mentioned with respect to overnight maturity, apply to weekly transactions as well, adding also the lower number of operations carried out and the same maturity of these transactions with the Repo agreement used by the Bank in its main open market operations.*

Chart 59 Spread between policy rate and interbank interest rates of a daily and monthly maturity term



Source: Bank of Albania

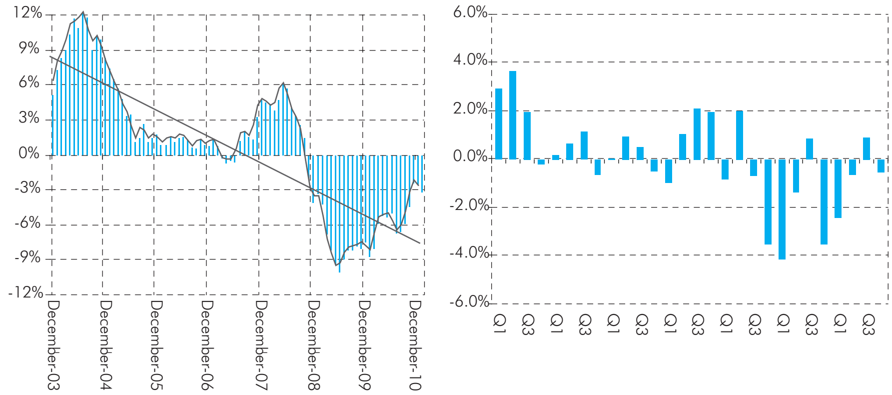
V.2.5 EXCHANGE RATE PERFORMANCE

The nominal effective exchange rate continued to confirm downward depreciating trends during 2010 H2. The annual change in the NEER index fluctuated around a narrow band of -3.2% and -2.39%, reaching record lows of the last quarter of 2008, when the effects of the global financial crisis were for the first time materialized in depreciating pressures over the Albanian foreign exchange market. Analysing developments in the NEER index on a quarterly basis has also confirmed the ongoing depreciating rates. More specifically, the lek's depreciation vs. the major currencies resulted 0.54% in the last quarter of the year, markedly lower than in the same quarter of 2008 and 2009 (3.57% and 3.54%, respectively). Exchange rate stability over the observed period has reflected the positive developments in the financial sector, and in the external sector of the economy. Against this backdrop, the developments of key determinants to exchange rate appear to have created premises for putting it to a new equilibrium.

Developments of individual major currencies in the Albanian foreign exchange market over the fourth quarter have reflected the lek's depreciation vs. the dollar (9.73%) and the euro (1.03%), compared with the same period a year earlier. On the other hand, the lek's quarterly dynamics has reflected its strengthened positions against the U.S. dollar, being appreciated by 3.35%, on average. In contrast, it has continued to present downward trend vs. the European currency, being depreciated by 1.61%, on average.

During the observed period, the USD/ALL dynamics appeared consistent with the performance of the USD in the international markets. Based on volatility index, the USD/ALL developments resulted significantly smoother than in the previous quarter, whereas, compared with the same period a year earlier it reflected a somewhat more pronounced volatility.

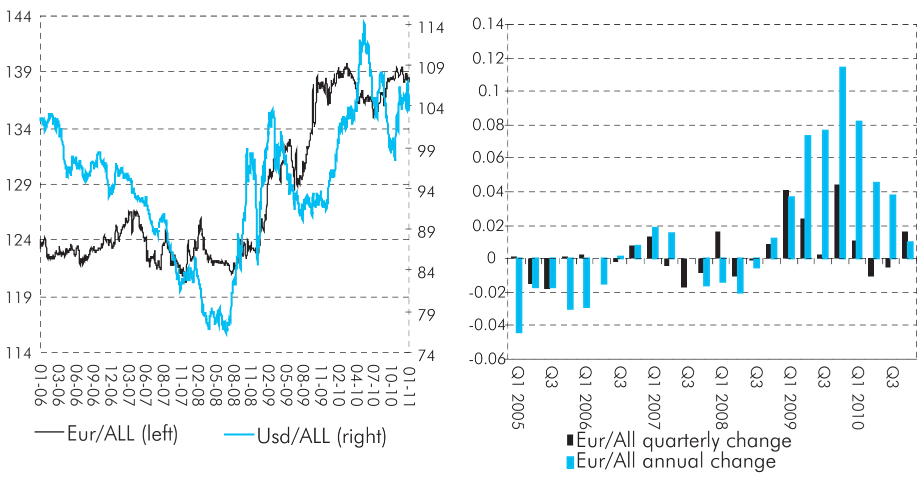
Chart 60. The lek's annual (left-hand) and quarterly (right-hand) change in nominal effective terms (NEER*)



*NEER – Nominal effective exchange rate, measured relative to both major currencies, according to an approximate weight they have when traded broad, EUR (80 %) and USD (20 %). A rise in the NEER implies the lek's appreciation.
Source: Bank of Albania calculations

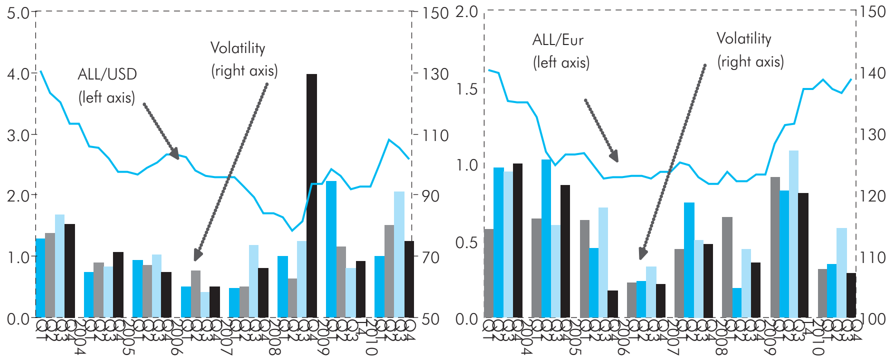
On the other hand, the performance of the lek vs. the euro has reflected diminishing seasonal effects. Market agents' cautious stance related to seasonal volatility, observed throughout 2010, has been intensified over the quarters, leading to a stable exchange rate in 2010 Q4, approaching the levels of year 2005 and 2006. This tendency is also supported by the monthly dynamics of the lek vs. the euro (a slight appreciation of the lek by an average of 0.01%, at a time when foreign-currency deposits with the banks, based on operational data, appear to have increased). In this context, it should also be noted that the EUR/ALL depreciating rates in both annual and monthly terms, have moderated relative to 2009 and approached to 2008 Q4's values.

Chart 61. Daily EUR/ALL and USD/ALL exchange rate (left-hand) and EUR/ALL ratio in years (right)



Source: Bank of Albania calculations

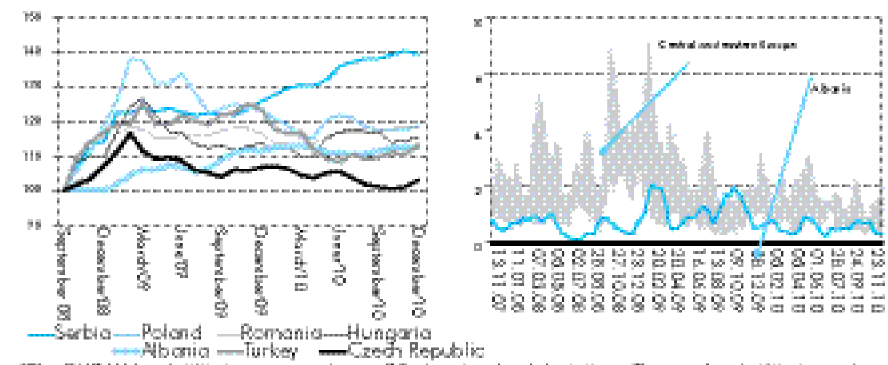
Chart 62 Exchange rate volatility* of ALL/USD (left-hand) and ALL/EUR (right-hand), q-o-q



*Measured as a quarterly average of the exchange rate volatility. The exchange rate volatility is measured by the standard deviation.
Source: Bank of Albania calculations

In a regional context, the performance of the lek vs. the euro is satisfactory in marginal terms, compared with most countries of the Central and East Europe and the Balkans. The dynamics of the EUR/ALL ratio appears markedly smoother in 2010 Q4, reaching, by the end of the period, the lower limit in the extreme values range of the EUR/ALL volatility.

Chart 63. EUR/ALL performance (Base period: October 2008) and volatility* in comparison with Central-Eastern Europe and Balkans**



*The EUR/ALL volatility is measured as a 30-day standard deviation. The peak volatility in each period represents the maximum and minimum standard deviation of these ratios. The selected countries are Poland, Czech Republic, Hungary, Romania, Turkey and Serbia.
**The index reference period of this ratio is October 2008. The selected countries are Poland, Czech Republic, Hungary, Romania, Turkey and Serbia. These countries apply an exchange rate regime similar to Albania's (free-floating exchange rate regime).
Source: Bank of Albania calculations .

BOX 6: Estimating Exchange Market Pressure in Albania

In small and open economies, which apply a free-floating exchange rate regime and inflation targeting, the determination of the domestic exchange market conditions presents a particular interest in monetary policy decision-making. According to Kara et al. (2005), central banks that target inflation are mostly inflation forecasters, thus highlighting the importance of current developments of underlying indicators to decision-making process. In the light of that outlook, the Bank of Albania attends* *cautiously the lek's exchange rate developments, as one of the most important channels to explain inflation developments. According to literature, the Exchange Market Pressure (EMP) index is one of the most useful tools to define foreign exchange market conditions.*

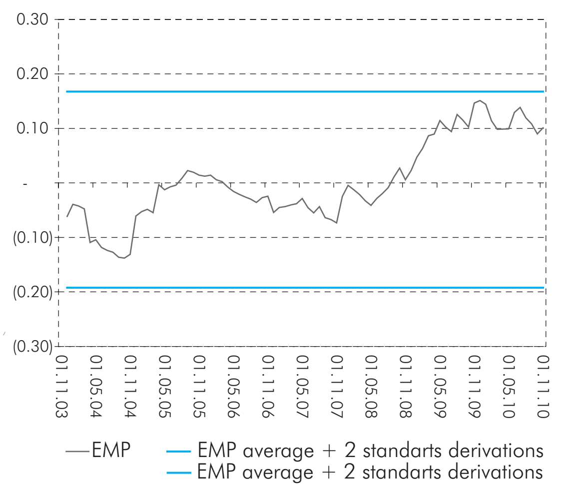
The term "exchange market pressure" was used for the first time by Girton and Roper (1977)[**] to describe changes in key indicators of external sector of the economy – foreign reserve and exchange rate, aiming at identifying the demand-supply imbalance in exchange market. According to Weymark[***] (1995), the foreign currency demand-supply imbalance occurs when, at a certain exchange rate level, the residents' demand for goods, services and foreign assets equalizes the demand for goods, services and domestic assets from foreign markets. In practice, the determination of this imbalance is difficult to be directly identified, and what can be observed is the change of endogenous indicators which tend to restore equilibrium in the foreign exchange market. In this context, and since the measurement of changes to foreign reserve and/or to interest rates may not be in direct proportion to exchange rate changes, there is used a methodology, which combines the changes of variables into a composite variable that expresses the external sector's imbalance, the index of exchange market pressures.

Further developments of this concept by Eichengreen et al (1995)[****] and later by Sachs et al. (1996) conclude with a formula for creating the operational EMP index. This formula is not generated from a model and its weights (σ) are defined as the inverse variance of the respective component. It tends to balance the weights of the three components, in order to eliminate the dominance of the most volatile component in EMP's formation.

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

In the EMP formula, Δ_e and Δ_r express respectively the annual exchange rate change (NEER[*****]) and the foreign reserve denominated in EUR million (at a fixed exchange rate). Based on country-specific financial market[******] and on the study by Kaminsky and Reinhart (1999), the interest rate spread $\Delta(i_t - i_t^*)$ is represented by interest rate spread in t period. That spread is estimated as the deviation of the weighted average rate of new ALL deposits from an index which combines the weighted average interest rates on EUR and USD deposits, weighted by their share to total deposits of the system. Finally, σ_e, σ_r and σ_i represent the variations in each component.

Chart 64. EMP in the Albanian economy



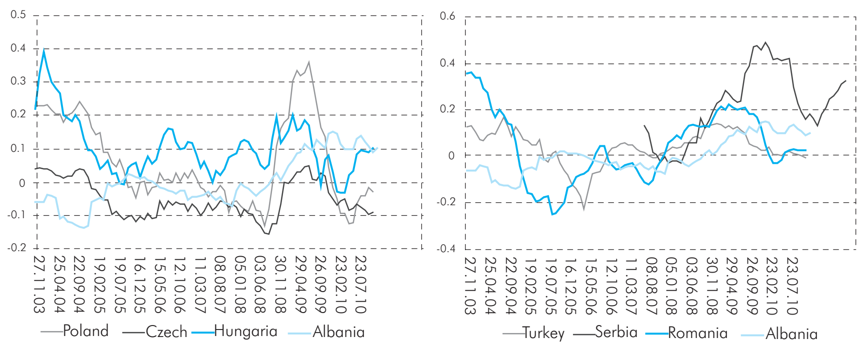
Source: Bank of Albania calculations.

In this context, (according to this index), the exchange market pressures are absorbed by depreciation/appreciation of the nominal exchange rate[******], or by decrease/increase in international reserve -ΔRt, under the assumption that the central bank tries to mitigate exchange market pressures, as well as by eased/tight monetary policy, which expands/reduces interest rate spread, which encourages/discourages capital inflows (under the assumption of free capital mobility), affecting the EMP.

The chart of the exchange market pressure index for the past two years does not show any extreme values. By dividing it into periods according to exchange rate developments, we can say that the index reflects the exchange rate stability over 2004 – 2008 Q3, fluctuating slightly around zero. In the meantime, regarding the next period, the impact of global crisis effects on the domestic market come out clearly. During that period, exchange market pressures appear upward, but without exceeding the extreme values. During 2010, though the index values have resulted at relatively high levels, the acceleration of pressures has been downward, reflecting a slight downward trend at the end of the period.

From a region-wide approach, the exchange market pressure index in Albania appears well-positioned over the period of 2003-2008, in relative terms, reflecting stability around neutral values. In Albania's case, the period after 2008 Q3 also highlights new pronounced pressures facing exchange markets in the region.

Chart 65 EMP in Albania, the CEE countries and the Balkan*



*The components included in the EMP index for Czech Republic, Hungary, Romany, and Serbia, are: Euro/national currency exchange rate, foreign reserves denominated in EUR and spread between the policy rate of the respective country and that of ECB. In Turkey's case, the exchange rate is represented by an index that reflects the developments of the euro/lire and USD/LIRE ratios weighted by the share those currencies occupy in the major currencies basket (50% euro and 50% USD, according to Inflation Reported by the Bank of Turkey for 2009 Q1, website), the international reserve is denominated in USD millions and the interest rate spread is presented as a combined index of the spread between Turkey's policy rate and those of the ECB and the FED weighted by the above-mentioned weights.

Source: Bank of Albania and staff estimates

** As a consequence of lags presented by monetary policy transmission mechanism.*

***GIRTON, L. – ROPER, D. (1977): A Monetary Model of Exchange Market Pressure Applied to the Postwar Canadian Experience. American Economic Review, vol. 67, no.4*

****WEYMARK, D.N. (1995): Estimating Exchange Market Pressure and the Degree of Exchange Market Intervention for Canada. Journal of International Economics, vol.39, no.3-4.*

*****EICHENGREEN, B. – ROSE, A.K. – WYPLOSZ, C. (1995): Exchange Market Mayhem: The Antecedents and Aftermath of Speculative Attacks. Economic Policy, vol. 10, no. 21, pp. 249-312*

******NEER – NEER – Nominal effective exchange rate, measured relative to both major currencies, according to an approximate weight they have when traded broad, EUR (80 %) and USD (20 %). A rise in the NEER implies the lek's appreciation*

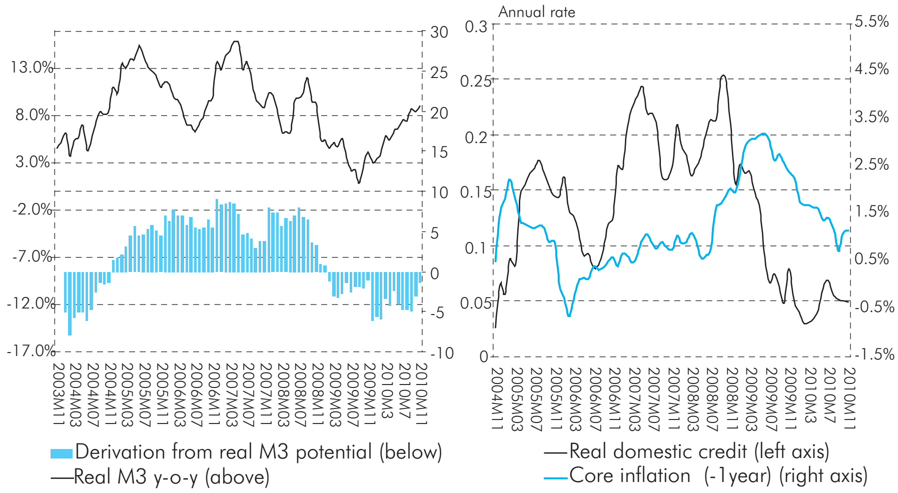
*******Since in Albania's case the capital mobility may be considered as imperfect because of yet undeveloped financial markets as well as restricted likelihood for savings and investments, the policy interest rate rise would favour the preferences for ALL-denominated deposits to the foreign-currency ones.*

********The exchange rate is estimated as the national currency cost price per foreign currency unit and a rise/fall in the ratio indicates appreciation/depreciation*

V.3 ESTIMATING MONETARY INFLATION PRESSURES

In 2010 H2, money growth in the economy accommodated the economic agents' increased money demand, without exerting pressure on price performance. On average, throughout the year, the real money supply growth by about 7% y-o-y has continued to be lower than over the past five-year historical average. The second half of 2010 has highlighted a narrowing of the monetary gap in the economy, reflecting also the country's economic recovery. Despite the monetary gap narrowing[50], during the second half of the year, the monetary expansion in the economy is taking place gradually and does not signal any added pressures on price performance. Moreover, this growth continues to be supported by the increase in foreign currency component of the money demand. In the meantime, the contribution of domestic credit remains moderate, close to historic lows. In real terms, domestic credit grew by 4.7%, on average, in 2010, markedly lower than the 12.6% historical average. Despite the rapid growth of lending activity in November, the level of domestic credit has remained almost unchanged compared with 2010 H1. Shifting funds from the public sector to the private one can help more efficient

Chart 66. Annual performance of monetary indicators in real terms & core inflation



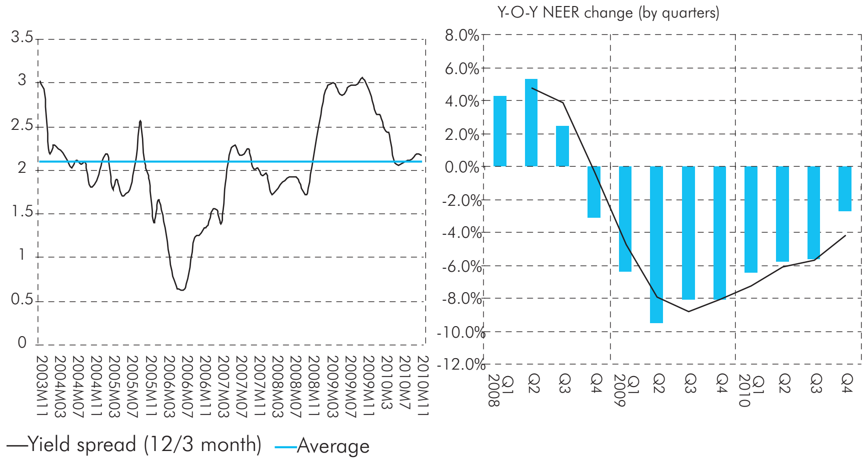
Source: Bank of Albania

use of funds, exerting less pressure on price rise in the economy.

Throughout the second half of the year financial markets were characterized by decreased interest rates and exchange rate volatility. The market interest rates performed in line with the signs given by the monetary authority. Also, the stabilized liquidity condition and fiscal consolidation have contributed to transmitting the Bank of Albania's accommodating policy more efficiently and swiftly. In the meantime, the performance of spread between long-term and short-term yields close to historical average levels shows that financial market agents do not expect added inflationary pressures on the economy. The eased monetary conditions and their pass-through into the whole maturity corridor of currency market price,

[50] *The change between the real actual M3 and the potential level.*

Chart 67. Spread between interest rates and exchange rates*



*Year-over-year changes by quarters of the NEER index.
Source: Bank of Albania

confirm a lower risk premium on long-term instruments, as well.

In 2010 H2, foreign exchange market was characterized by a sustainable stability. The gradual termination of the lek's depreciating trend vis-à-vis the major currencies, has helped further strengthen and consolidate the banking system's financial activity. Moreover, the exchange market developments have not transmitted any increased pressure of the foreign goods prices on the domestic CPI basket, and considering the lags of the exchange rate transmission channel, they do not signal any increased pressure for the next 3 quarters.

VI. ECONOMIC AND MONETARY OUTLOOK FOR 2010

Macroeconomic developments in 2010 were broadly more positive compared to the previous year. Following its slowdown in 2009 and annual contraction in the last quarter of the same year, the Albanian economy has progressively posted positive growth rates in 2010. Trade and current account deficit adjustment persisted in 2010, thus allowing for a more balanced demand and supply in the foreign exchange market and a relatively more stable domestic currency. Inflation has been kept in check despite the transitory supply-side shocks, and expectations thereupon have remained close to the Bank of Albania's target.

Economic growth in 2010 was largely underpinned by external demand for Albanian goods and services, particularly in the first half of the year. The acceleration of Albanian exports was relatively broad-based and it was favoured by the recovery of demand on a global level. At the same time, it was also affected by specific energy sector-related factors. On the other hand, domestic demand growth rates were slow, but they pursued an upward trajectory in the second half of the year. Initially, this performance of domestic demand reflected the mitigation, and later, the waning contribution of the fiscal sector, which was substantial in 2009 in view of sustaining the domestic economy. In addition to keeping the budget deficit and public debt in check, this fiscal authority approach in 2010 lowered the risk premium in the economy and provided more room for the development of the private sector. However, the latter's demand was sluggish. Consumer spending was low due to the slow income and, to a considerable extent, to the more cautious consumer approach to spending and their higher propensity to save. Private investment is reported to have been even slower than consumer spending. The existence of spare capacities in the economy and the low consumer demand discouraged businesses in undertaking new investments. The latter contracted in the first half of 2010, to later post positive growth rates in the second half once the economic activity rebound and the lending conditions improved.

Financing conditions were more favourable in 2010 than in 2009, however remaining below the levels observed prior to the global financial crisis, particularly foreign financing conditions. Net capital and financial account flows contracted for the second consecutive year as a reflection of still low risk tolerance on a global level and the concerns – the latter being sometimes materialized – raised over the fiscal sustainability in some Euro area countries. In the meantime, domestic financing conditions were less tight than in 2009. The improved banks' liquidity figures and balance sheets provided more room for private sector credit. Lending standards have been easing but the private sector demand for credit has been low.

Average annual inflation marked 3.4% in 2010, remaining within the Bank of Albania's target. Despite the progressive improvement of economic growth in 2010, it remains below potential, thus giving rise to a persistent negative output gap in the present year. Downward inflationary pressures arising from the domestic environment have offset the inflationary effects stemming from the rise in foreign and administered prices. The lek's depreciation effect was more moderate in 2010 to fully terminate at year-end. Though remaining within the target in average terms, annual inflation experienced higher levels of volatility in 2010 due to the administered price shocks. However, economic agents' expectations of inflation do not seem to have been affected by the elevated volatility in the annual inflation rates, and they keep being anchored around the Bank of Albania's target.

Judging upon the latest and expected performance of the main determinants of economic growth, the positive growth rates of economic activity will likely persist in 2011. However, its composition is expected to be dissimilar to the year we left behind. More precisely, the contribution of external demand may be lower than in 2010, not only due to the transitory nature of the acceleration of energy-related exports, but also to the comparative base effect. Economic growth in 2011 is expected to be underpinned more by domestic demand, with the private sector's contribution growing larger, which will, in turn, translate into a comparatively better consumption and private investment performance. Monetary developments in 2011 are expected to bring forward the growth of demand for money from both public and private economic agents. The annual growth of the broad monetary aggregate, M3, is expected to fluctuate to an average of 10%. Monetary and fiscal stimulus is expected to fuel aggregate demand and stimulate the resurgence of the economy. The fiscal sector's contribution to aggregate demand is expected to be positive, albeit small, in 2011. For the most part, deficit will be financed by the banking sector. The expected improvement of the macroeconomic climate, easier bank lending conditions and higher banking liquidity, coupled with the augmented economic activity, will likely fuel lending to the economy in 2011. Liquidity in the banking system will be stable, while non-performing loans will stabilize. On the other hand, demand for and supply of foreign currency ratios are expected to be broadly balanced. Private sector credit will grow by about 9%, out of which 17 billion in ALL and 25 billion in foreign currency. The positive external sector balance and the assumed higher foreign currency lending to the economy are expected to generate high foreign currency flows in 2011.

Despite the more positive expectations for 2011, the uncertainties surrounding the future prospects for the Albanian economy are not over yet. They particularly surround the developments in the external sector of the economy. Trade deficit adjustment trend may be only temporary against a background of lower trade exchanges on a global level and the possible acceleration of imports due to the further growth of consumer demand at home. In addition, the risk premiums for undertaking investments in South-East and Central European countries remains high, which will eventually condition the performance of foreign financing resources.

Within this context of economic development, the impact of the negative output gap on inflation is expected to persist, though to a lesser degree than in 2010. The positive growth rates of domestic demand will narrow the negative output gap further, but they will not fully eliminate it. Subsequently, the downward demand-side pressures will be present in 2011. On the other hand, the rise in foreign and administered prices will continue to provide its impact. The interaction of the foregoing factors will likely yield an environment of balanced inflationary pressures that ultimately will keep the annual inflation rates within the Bank of Albania's target throughout 2011.