

BANK OF ALBANIA

MONETARY POLICY MONTHLY REPORT

JULY 2004

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I. MAIN HIGHLIGHTS

- Monthly inflation in July was estimated at – 0.15 per cent, leading the annual inflation to 3.1 per cent. This rate and the average annual inflation rate of 3.22 per cent resulted within the targeted band of the Bank of Albania.
- Month of July 2004 has followed the historical tendency of negative monthly inflation rates. Developments recorded in the consume prices for this month have been within the projected parameters.
- Even during July, demand factors did not exert pressures to increase the inflation rate. The weakening of the seasonal effect of the domestic production entry brought about the increase of the inflation rate figure for the month of July. However, inflationary pressures remained controlled and inflation continues to be with the targeted band of the Bank of Albania.
- Consume prices developments and monetary indicators stability enabled the Bank of Albania to adopt a rather smoothing monetary policy. The Bank of Albania cut the base interest rate on 23 June and on 28 July. The base interest rate was cut by 0.25 percentage points in both cases, reaching the level of 5.5 per cent.
- The reaction to the Bank of Albania easing monetary policy is observed in the Lek deposits market, in the primary market and in the interbank market. The more significant reduction of the interest rate occurred for one-month and three-month deposits.
- The annual growth rate of monetary supply marked a slight decrease in June, due to the low government demand and the Lek appreciation in this month. By the reduction of interest rates and the maintenance of inflation close to the average of the targeted band, the real interest rate marked a decline, being followed by a gradual softening of the falling trend of the money outside banks ratio against M3.
- Credit balance during June 2004 marked a monthly increase of Lek 0.6 billion. It was raised by Lek 6.1 billion, compared to the year-end of 2003. Lending to economy from the banking system on an average monthly level results close to the projections of the monetary program for 2004.
- Previous tendency of the Lek appreciation has continued being significant even during July. Foreign currency growth in the tourism season and domestic agricultural production growth have contributed to the maintenance of Lek appreciating trends.

II. INFLATION IN JULY 2004

II.1 INFLATION AND CONSTITUENT GROUPS

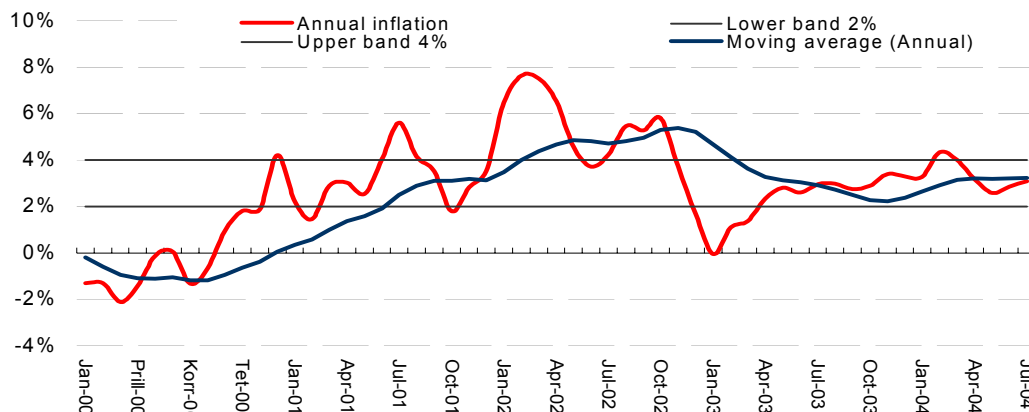
Annual inflation in July was estimated at 3.1 per cent. This rate and the average annual inflation rate of 3.22 per cent resulted within the targeted band of the Banka of Albania.

The downward effect of the domestic agricultural production entry provided a soft impact on the inflation of July, reflecting its earlier entry in the market during 2004. This factor, followed by the concentration of the tourist activity and the demand growth in July-August, led to a slight increase of the monthly inflation rate in comparison with the months of May-June.

Table 1 Annual inflation rate (in percentage)

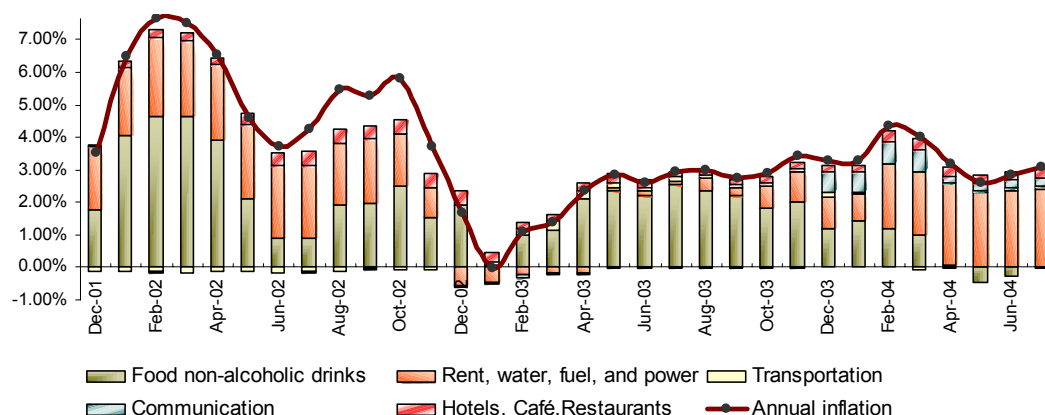
	2000	2001	2002	2003	2004
January	-1.3	2.2	6.5	0.0	3.3
February	-1.3	1.5	7.6	1.1	4.4
March	-2.1	2.9	7.5	1.3	4.0
April	-1.4	3.0	6.5	2.3	3.2
May	-0.1	2.5	4.6	2.8	2.6
June	0.1	4.0	3.7	2.6	2.9
July	-1.3	5.6	4.2	3.0	3.1
August	-0.7	4.1	5.5	3.0	
September	0.9	3.5	5.3	2.8	
October	1.8	1.8	5.8	2.9	
November	1.9	2.8	3.7	3.4	
December	4.2	3.5	1.7	3.3	
Average	0.05	3.13	5.22	2.37	

Chart 1 Annual inflation (in percentage)



Notwithstanding the influence provided by the agricultural products price performance in the monthly inflation rate in July, the main influence in the annual inflation rate performance continues to be given by the “Rent, water, fuels, energy” group, for this month too.

Chart 2 Contribution of main groups to annual inflation (in percentage points)



The contribution of the “Rent, water, fuels, energy” group to the annual inflation in July was 2.4 percentage points. The annual inflation rate of 9.9 per cent of this group was due to the inflation growth by 5.3 percentage points of the “Water supply” subgroup, in July.

Table 2 Monthly and annual rate of the “Rent, water, fuels, energy” group

	“Rent, water, fuels, energy” group		“Rent” sub-group		“Fuels and energy” subgroup	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
July '04	0.1	9.9	0.0	5.6	-0.1	26.9
July '03	0.0	0.4	0.0	-1.7	-0.1	6.7

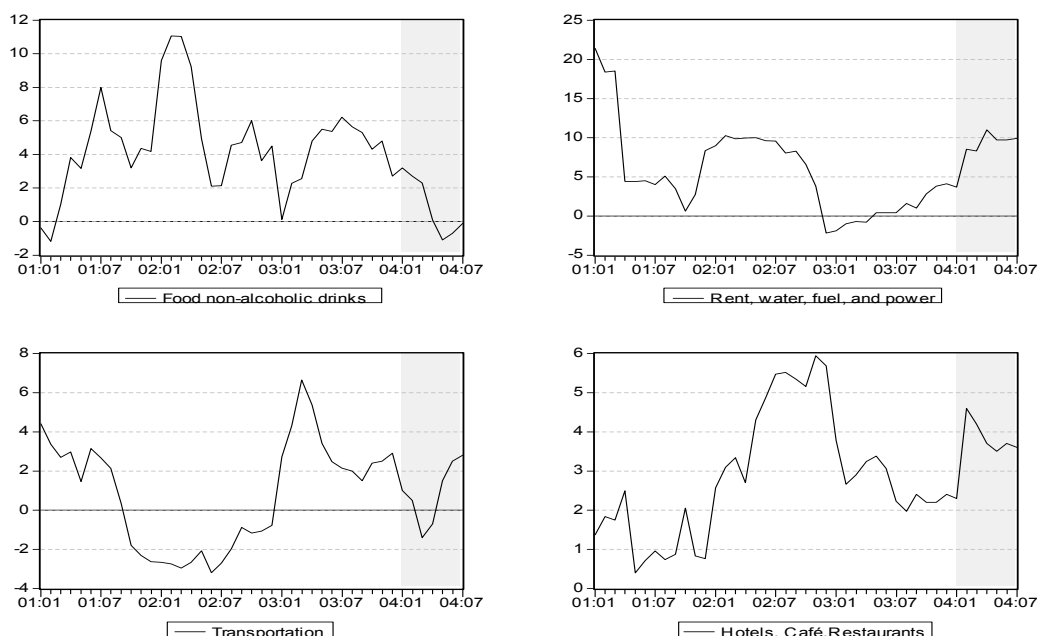
The “Food and non-alcoholics” group, like over the past months, has provided a rather non-considerable influence in the annual inflation of the month of July (see Chart 2). The contribution of this group to the annual inflation of the month of July was negative, -0.05 percentage points. The monthly inflation rate of -0.4 per cent of the “Food and non-alcoholics” group showed the weakest action of the falling seasonal effect caused by the fulfilment of domestic demand through domestic supply. The more abundant agricultural production during this year, backed by the greenhouses production growth, started its downward influence since April 2004. Due to technology improvements, expansion of greenhouses surfaces and domestic agricultural production growth, the effect of this factor becomes ever closer in time during the recent years. Thus, for year 2004, the downward seasonal effect was observed since May.

Table 3 Monthly and annual rate of the “Food and non-alcoholics” group

	"Food and non-alcoholics"		"Fruits"		"Vegetables"	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
July'04	-0.4	-0.1	3.7	10.9	-5.9	-15.4
July'03	-1.0	6.2	-2.2	19.2	-3.9	30.1

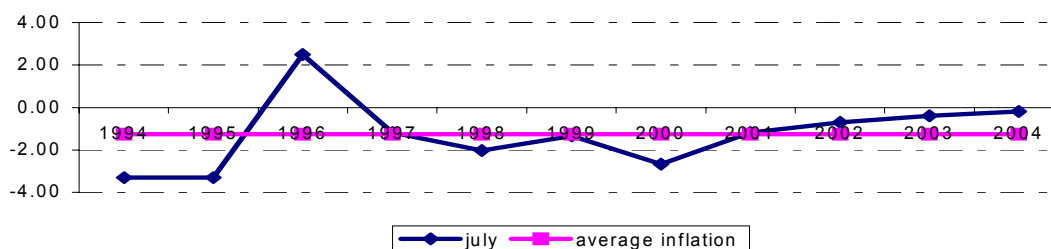
Even the “Transport” group recorded an increase of the annual inflation rate during the month of July. The annual inflation rate of this group reached 2.8 per cent from 2.5 per cent it was in June.

Chart 3 Annual inflation of the four main groups of the CPI basket (in percentage)



Notwithstanding the above developments, the month of July 2004 has followed the historical tendency of negative monthly inflation rates. Developments recorded in the consume prices for this month have been within the projected parameters.

Chart 4 July-Inflation rate performance

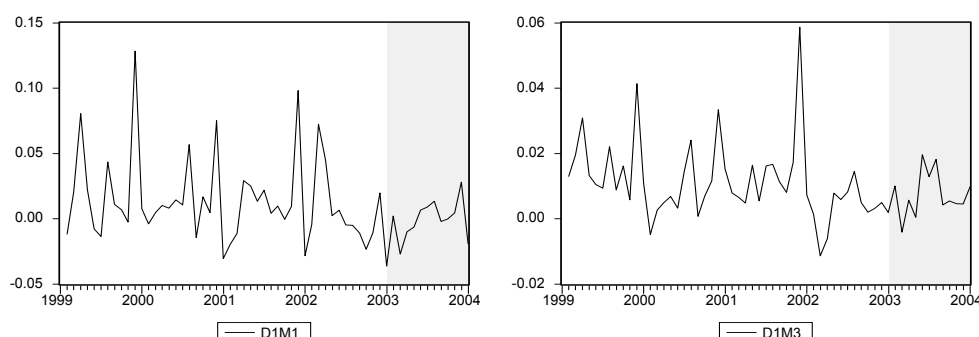


II.2 MACROECONOMIC SITUATION AND CONSUME PRICES

Demand factors have not marked any particular development during July, while the monetary policy and the fiscal one have continued to give a positive influence in the inflation developments.

The Bank of Albania has followed a smooth monetary policy during 2003 and further in 2004. However, the liquidity situation have been stable, the monetary aggregates have moved within the expectations, while domestic financing of the budget deficit was maintained within the permitted limit. Annual change rates of the M1 and M3 monetary aggregates appear close to the average historical values.

Chart 5 Annual changes of the M1 and M3 monetary aggregates (in percentage)



The Lek appreciation during 2004, followed by stable inflation rates recorded in the trading partner countries, has smoothed the effect that imported inflation gives on the country's inflation.

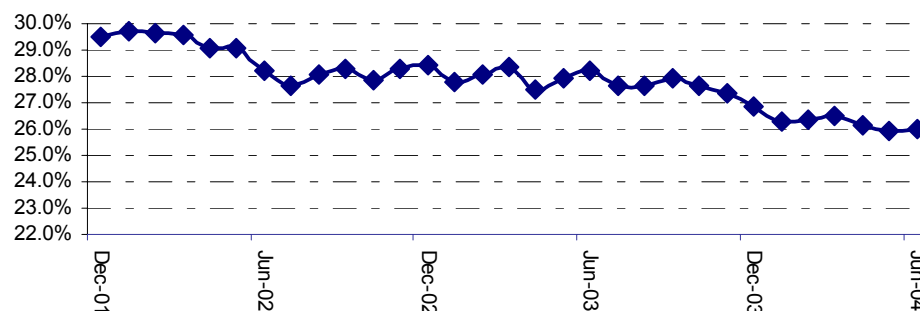
Table 4 Annual inflation of the main trading partners (in percentage)

	Dec'03	Jan'04	February	March	April	May	June
Greece	3.1	3.1	2.6	2.9	3.1	3.1	3.0
Italy	2.5	2.2	2.4	2.3	2.3	2.3	2.4

Source: Eurostat News Release.

The maintenance of budget expenditures within the expected limits has impacted on the demand control, supervising the inflationary pressures this factor may cause.

Chart 6 Annual budget expenditures (as a percentage of GDP)



All these have created an adequate monetary environment to control inflation. The negative impact on inflation given by some supply factors such as the administered prices rise or the domestic demand growth due to the commencing of the tourist season were balanced to a certain extent by the domestic production entry during May and June.

Even during July, demand factors did not exert pressures to increase the inflation rate. The weakening of the seasonal effect of the domestic production entry brought about the increase of the inflation rate figure for the month of July. However, inflationary pressures remained controlled and inflation was with the targeted band of the Bank of Albania.

The Bank of Albania, taking into consideration **the oil price rise in the international market that resumed at the beginning of August**, estimates that the risk to oil price in inflation is more serious than the growth undertaken in this market by the end of spring. This is due to the following factors:

- During autumn, a growth of imports is noticed, bringing about inflationary pressures growth stemming from main partner countries, where the effect of oil price rise is sensitive. This concern is expressed recently even by the European Central Bank.
- The high oil price at Lek 90-95 per liter suggests strong pressures on the price of goods and services being directly related to it. This effect is confirmed even by the fact that the majority of autumn's products come from greenhouses, increasing significantly the demand for oil. Another factor that is expected to grow the demand is the fact that over the years oil serves as a substitute of electric energy, which, though the improved situation of power supply, continues to still cause interruptions like those happened at the end of the year.

During the coming 2-3 months, the Bank of Albania will go on assessing with care the effect and intensity that the further oil price rise will provide on the inflation rate performance and the economic growth.

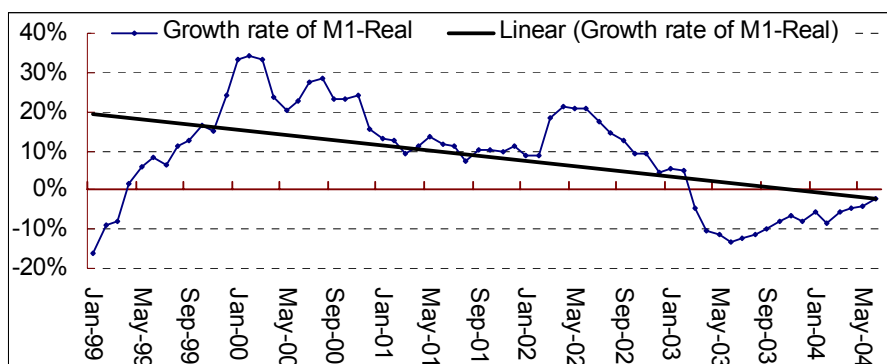
III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

III.1 BANK OF ALBANIA MONETARY POLICY

Consume price developments and monetary indicators stability enabled the Bank of Albania to follow a smoother monetary policy. Thus, forecasts show that inflation has been maintained within the targeted range while monetary indicators performance appear controlled. Liquidity level is presented under

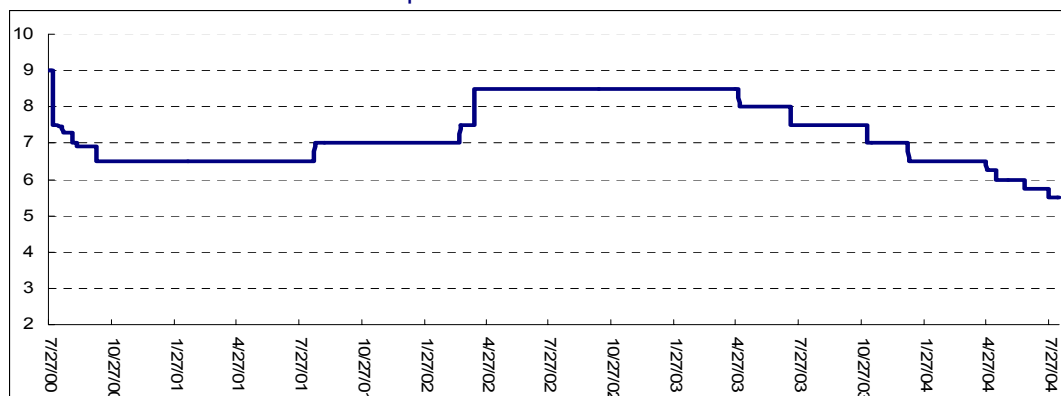
historical trend (see Chart 7) while exchange rate has had appreciating trends.

Chart 7 Real annual growth of the M1 monetary aggregate



Based on its stated policy, to maintain in the economy easier monetary conditions which are in compliance with the inflation targeting, the Bank of Albania cut the base interest rate on 23 June and on 28 July. The base interest rate was cut by 0.25 percentage points in both cases, reaching the level of 5.5 per cent.

Chart 8 Base interest rate performance



The Bank of Albania has financed during the month of June the budget deficit of government by Lek 3.4 billion in the form of direct credit. This move aimed at exerting pressures on banks to direct the interest rates reduction in the treasury bills market too.

The Bank of Albania has been withdrawing the excess liquidity from the banking market through repurchase agreements, using the two types of auctions. During July, the Bank of Albania has been present in the foreign currency market aiming to control the appreciation seasonal pressures on Lek. These withdrawals led to the launching of the sum of Lek 1.06 billion in the market.

The Bank of Albania has met its quantitative objectives during June and July.

Table 5 Meeting of the quantitative objectives of BoA

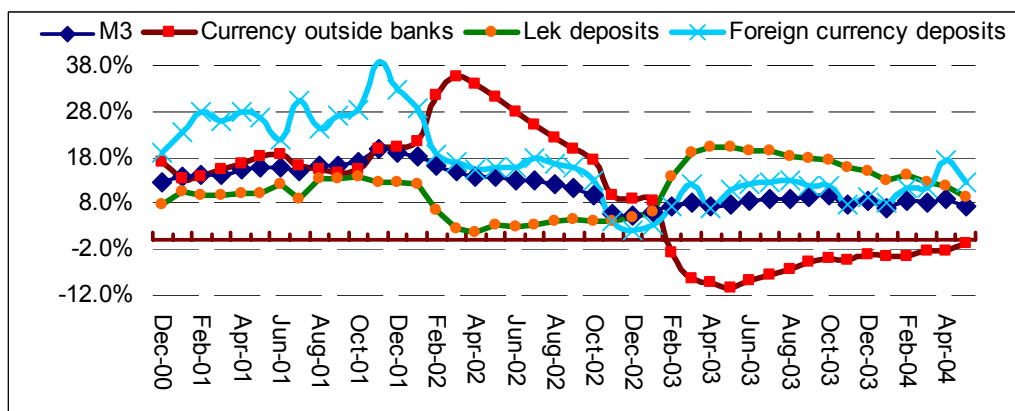
	Dec'03	March 04	May 04	June 04	July 04*
Net international reserve (in millions of USD)					
Target	715.8	751.8	761.2	765.8	818.4
Current	832.7	827.6	962.1	961.5	942.9
Difference	116.8	75.8	201.0	195.7	124.4
Net domestic assets (in billions of Lek)					
Target	96.0	83.0	84.3	85.0	80.0
Current	72.0	66.4	51.3	54.7	61.6
Difference	-24.0	-16.6	-33.0	-30.3	-18.4
Net domestic credit to government (in billions of Lek)					
Target	280.9	272.8	270.1	268.8	284.5
Current	266.8	272.6	260.3	262.1	--
Difference	0.0	-0.2	-9.9	-6.7	--

* The data on July are operative.

III.2 MONETARY AGGREGATES PERFORMANCE

During June, monetary indicators performance has been consistent with the tendencies already observed during the last twelve months. The annual growth rate of money supply dropped slightly in June, due to the low demand of government and appreciation of Lek in this month.

Chart 9 Annual monetary aggregate rates

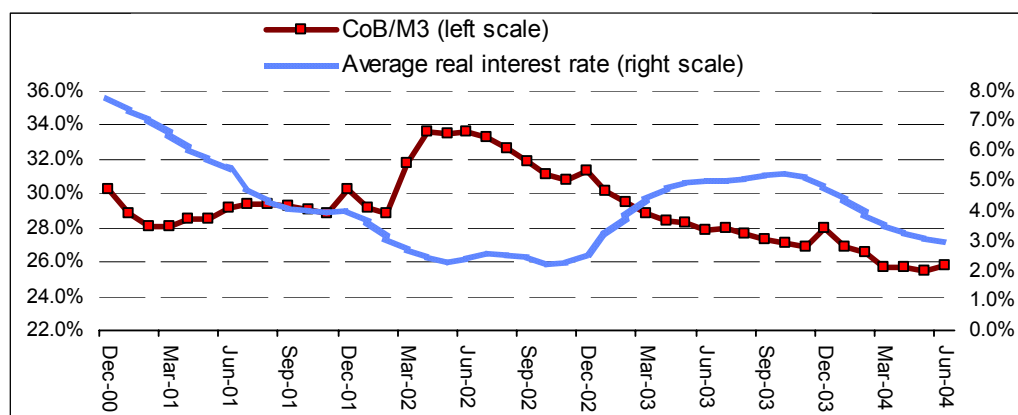


After a long period of decline, the ratio of money outside banks against M3 has manifested signs of stability during the last months. In June this ratio

increased by 0.3 percentage points, marking the level of 25.8 per cent. However, it remains close to the historical minimum of 25.5 per cent recorded in May. The channeling of money into the banking system and the banking deposits growth under the conditions of easing monetary conditions are attributed to the increase of public confidence in the banking system. Due to the reduction of interest rates and the maintenance of inflation closer to the average targeted band, the real interest rate dropped, followed by a gradual softening of the falling trend of the money outside banks against M3.

Also, based on the recent historical performance of consumer expenditures growth during summer time, the Bank of Albania forecasts a growth of money outside bank, as well as the ratio of this indicator against M3. However, this ratio will remain within the expectations of the Bank of Albania's program, without infringing the performance of other monetary indicators and inflation targeting.

Chart 10 Ratio of money outside banks against M3 and average real interest rate



The annual growth rate of Lek deposits in June reached 9.5 per cent. In monthly terms, the level of Lek deposits dropped slightly by Lek 0.6 billion (0.2 per cent), while money outside banks increased only by 0.9 per cent, or by Lek 1.1 billion. The slow rhythms of monthly changes of these two indicators, money outside banks and Lek deposits, have not supported the M2 aggregate growth in the last months. The annual growth rate of M2 reached 5.9 per cent in June, remaining in line with the downward trend of this indicator evidenced during the last three months. This performance of M2 has reflected, in general, the low demand of government and private sector of economy for domestic monetary assets.

The annual growth rate of foreign currency deposits is consistent with its historical trend, reaching 12.6 per cent. The foreign currency deposits drop by Lek 2.6 billion over the month of June, or by 2.4 per cent in monthly terms, is due to the appreciation of Lek against the US dollar and euro, thus reducing the value of foreign currency deposits expressed in Lek. Since the exchange rate of Lek against the two main currencies remained unchanged in June, the

level of foreign currency deposits would be Lek 3.4 billion, or 3.2 per cent higher.

Table 6 Monetary aggregates in June (in billions of Lek)

	June	Monthly change		Annual change	
	2004	Absolute	Percentage	Absolute	Percentage
Money outside banks	118.2	1.1	0.9	-0.6	-0.5
Total deposits	339.9	-3.2	-0.9	32.2	10.4
- in Lek	235.5	-0.6	-0.2	20.5	9.5
- in foreign currency	104.5	-2.6	-2.4	11.7	12.6
Demand deposits	65.0	-1.7	-2.6	9.9	17.9
- in Lek	22.3	-0.2	-0.9	2.4	12.2
- in foreign currency	42.6	-1.5	-3.4	7.4	21.1
Time deposits	275.0	-1.5	-0.5	22.3	8.8
- in Lek	213.1	-0.4	-0.2	18.0	9.3
- in foreign currency	61.8	-1.1	-1.7	4.2	7.4
M1	140.6	0.9	0.6	1.8	1.3
M2	353.7	0.5	0.2	19.8	5.9
M3	458.2	-2.1	-0.5	31.5	7.4
Monetary base	157.0	3.3	2.2	5.3	3.5