

BANK OF ALBANIA

MONETARY POLICY
MONTHLY REPORT

JULY 2006

MONTHLY POLICY MONETARY REPORT

CURRENT AND EXPECTED INFLATION PERFORMANCE AND MONETARY POLICY

SUMMARY

Inflation highlights

- Annual inflation rate of July 2006 recorded +3.2 percent, the highest upward trend of this year. Starting from April 2006, the annual inflation has recorded values belonging to the upper targeted band of 2-4 percent. The average annual inflation rate for the four-month period of April – July was 2.7 percent. The monthly inflation of July recorded -0.4 percent.
- The annual inflation rate is almost twice higher than in the same period of the previous year. The non-verification of the mitigating seasonal foodstuff price effects and the rise of excise tax have significantly contributed to CPI rise.
- Prices of “Foodstuffs and non-alcoholic beverages” group have contributed by +1.9 percentage point. The inflation of this group reflects an obvious rise of foodstuff prices, against the negative contribution of -0.7 percentage point in July of the past year. The unfavourable weather conditions in the spring of this year have impacted on significant decline in the agricultural production, reducing the domestic market supply. Also, the main countries from which agricultural goods are imported, Italy and Greece, have recorded high inflation rates of foodstuffs, transmitted to domestic inflation.

Monetary indicators

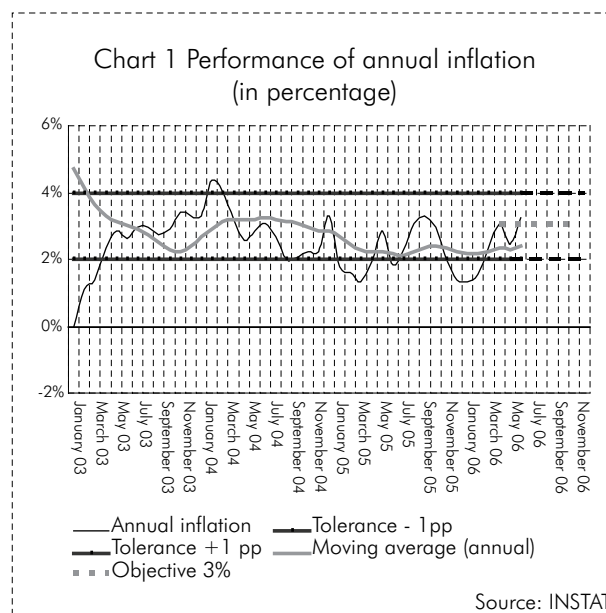
- In June the money supply grew by 1.1 percent in monthly terms. Monetary expansion resulted higher than in the other months of the semester, in accordance with the seasonal developments of the economy. In annual terms, the monetary supply growth by 9.7 percent is in line with the downward trend observed over the last twelve months.
- The M3 time structure and the foreign currency structure have maintained the upward trend of the foreign currency deposit weight and of the seasonal growth of the demand for currency in circulation. The ratio of currency outside banks to M3 was 23.7 percent, against 23.5 percent over the previous month. The foreign currency deposit weight to the stock of broad money has amounted to 27.9 percent, against 25.1 percent in June of the previous month.

- On the demand side, the money supply has increased due to private sector's demand for money. The increased volume of lending to the private sector of the economy has been the main contributor to money supply expansion during this year. The credit to money supply ratio, M3 is 25.7 percent against 16.1 percent in the same period of the previous year or 1.1 percentage point higher than in May.
- Market reaction to key interest rate rise of July has been partial. Rise of interests was initially reflected in the primary market, in the 2-year bonds market and in the 2-year lek deposit market. Also, fluctuations of 3-month, 6-month and 12-month deposit interest rates have been observed. The core interest rate rise effect is not yet reflected in the deposit market.
- On monthly terms, the lek has appreciated slightly against both currencies the euro and the usd, by about 1.1 and 1.4 percent respectively. At end of the first week of August, the lek exchange rates were respectively 95.7 lek/usd and 122.3 lek/euro.

I. INFLATION IN JULY

In annual rates, inflation of July 2006 recorded +3.2 percent, the highest upper rate over this year. The annual inflation has recorded values that belong to the upper limit of the targeted band of 2-4 percent, starting from April 2006. The average rate of annual inflation for April-July period was 2.7 percent, while over the first seven-month period of the year the annual average inflation rate was +2.2 percent. The monthly inflation of July resulted only -0.4 percent.

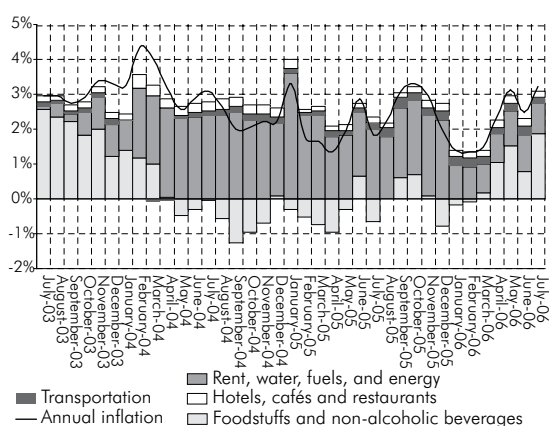
The twice higher annual inflation rate of July compared to the same period of the previous year is mainly due to non-verification of the mitigating seasonal effects of foodstuff prices and rise of excise tax. Since some months ago the domestic inflation is being negatively influenced by supply shocks, which have not managed to be balanced completely by the favourable developments of the demand over the first half of the year.



I.1 PERFORMANCE OF INFLATION AND CONSTITUENT GROUPS

The annual inflation of 3.2 percent in July 2006 is 1.4 percentage higher than in July 2005 and 0.8 percentage point higher than in the preceding month. Changes in the inflation structure during July 2006

Chart 2 CPI basket contribution to the main groups (in percentage points)



Source: INSTAT

reflect mainly the upward positive development of the inflation of the “Foodstuffs and non-alcoholic beverages” group, somewhat balanced by the smallest rise in the inflation of “Rent, water, fuels and energy” and “Transport” and “Hotels, café and restaurants” groups.

“Foodstuffs and non-alcoholic beverages” group prices contributed + 1.9 percentage point to inflation of July, maintaining the positive trend observed since March of 2006. The contribution of this group reflects a significant rise of foodstuff prices for July, against the negative contribution of -0.7 percentage point in July of the previous year. The annual rise of this group is caused by internal factors, along with unfavourable weather conditions during the spring of this year, leading to obvious reduction of the agricultural

production and of the domestic market supply. Inflation rose also due to external factors. Main countries from which agricultural goods are imported, Italy and Greece, have recorded high inflation rates of goods of this category. These developments are reflected mainly in the annual price rise of fruits and vegetables, respectively 20 percent and 18 percent. Together these sub-items have influenced the annual inflation of the foodstuff group by 90 percent.

Table 1 Annual inflation of “Foodstuffs and non-alcoholic beverages” group (at home and abroad) and the contribution of this group to total inflation

	Annual inflation '05	Contribution (pp)	Annual inflation '06	Contribution (pp)	Italy ¹ Annual inflation '06	Greece ² Annual inflation '06
January	-0.7	-0.3	-0.4	-0.2	1.1	1.6
February	-1.2	-0.5	-0.3	-0.1	0.9	2.1
March	-1.7	-0.7	0.4	0.2	1.0	2.1
April	-2.2	-1	2.5	1	1.0	3.8
May	-0.7	-0.3	3.7	1.5	0.9	2.9
June	1.6	0.7	1.9	0.8	1.3	3.5
July	-1.6	-0.7	4.7	1.9		5.8

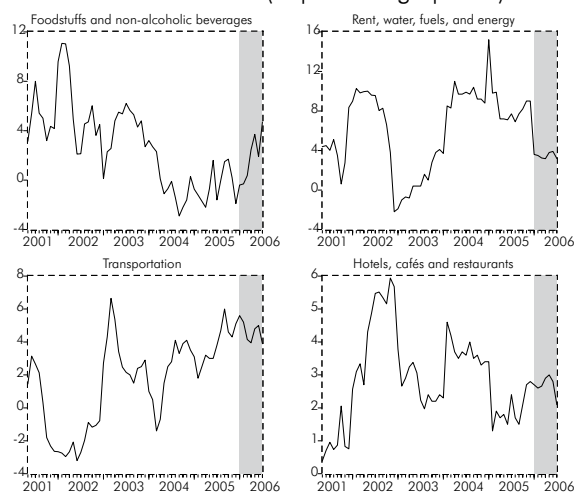
Source: Bank of Albania; General Secretariat of National Statistical Service of Greece, ISTAT-Italia

The lowest contribution of “Rent, water, fuels and energy” group to total inflation has somewhat balanced the upward positive impact of the foodstuff group. In July, the annual inflation of “Rent, water, fuels and energy” recorded a rise of 3.2 percent and contributed by +0.9 percentage point to annual inflation rate (against 7.7 percent and 2 percentage points in the previous year. The administered energy price remained unchanged even for July. After the rise undergone by the “Rent” and “Imputed rent” sub-items in June of this year, only a moderate rise by 4.5 percent was noticed in the annual inflation of this group in July. The rent price cut in this month is an outcome of a slower rise of the seasonal demand than the spring supply. This argument is

manifested in parallel with inflation of “Hotels, café, restaurants” group, which recorded an annual inflation of 2.1 percent, compared to 2.8 percent in the previous month and 2.4 percent in the previous year. The annual inflation of the “Transport” group fell by 1.1 percentage points compared to the previous year. This was an outcome of the lower rate of inflation rise of the “Services to personal vehicles” sub-item, oil price also included.

Other basket groups have maintained the same direction of movement versus the same period of the previous year. The “Clothes and footwear” group inflation declined by 0.7 percentage point, while the inflation of “Alcoholic beverages and tobacco” group increased by 1.4 percentage point. A significant reduction has been noticed in the “Health” group by 2.3 percentage points compared to the previous month, thus reducing the consumer cost for these services. The increased contribution of “Tobacco and alcoholic beverages” group is a highlight for this month. The inflation of this group contributed by 0.1 percentage point to the total annual inflation rate of July, in spite of the small weight it occupies in the consumer price index basket.

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



Source: INSTAT

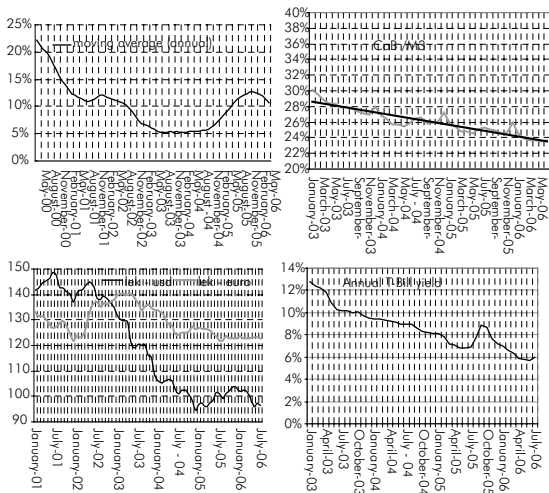
1.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

During July, the monetary policy signalled tightening of monetary conditions, in view of meeting the inflation target. The fiscal indicators until July have operated on the tightening direction of the aggregate demand. The supply factors have provided an upward impact on the inflation of this month, because of the reduced supply of agricultural products and increased size of agricultural products and increased transmission size of imported inflation. The transmission of the effects of imported inflation to the domestic inflation has been more complete against the previous periods, whereas the mitigating role of the exchange rate performance has been relatively smaller. The effect of concentration of budgetary expenditures is expected to be added to supply shocks during the rest of the year. This factor, combined also with the accumulated stimulus of credit growth, may bring about increasing pressures on the side of the demand.

Monetary policy

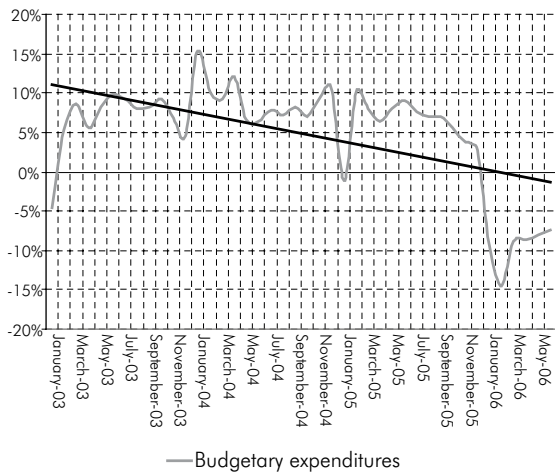
In July the Bank of Albania changed the monetary policy stance oriented to control of inflationary pressures with a slight increasing trend over the medium-term period. Based on the inflation performance and forecasts for the 12 coming months, the Supervisory Council of

Chart 4 Main monetary indicators



Source: Bank of Albania

Chart 5 Monthly budgetary expenditures performance



Source: Ministry of Finances

the Bank of Albania increased the key interest rate in July, by 0.25 percentage point. The (M3) money supply growth rate has been falling since the beginning of this year and during June it recorded +9.7 percent. Currency outside banks to money supply has maintained a slight falling trend, in compliance with the historical trend.

Fiscal policy

In June of 2006 total Government expenditures confirm the downward performance that had started since January. During the first half of the year, the realization of expenditures and revenues is respectively 90 percent and 103 percent against the plan. In the coming months the fiscal policy is expected to operate in the promoting direction of aggregate demand, becoming less easing in terms of inflationary pressures in the economy, due to acceleration of the realization of budgetary expenditures and financing through domestic borrowing.

Exchange rate, oil prices and imported inflation

The constant price rise of electricity products in international markets and the inflation rise in the neighbouring countries during two last months indicate an increasing external pressure on the domestic inflation. The change of the exchange rate performance of the lek and euro is important from the viewpoint of imported inflation transmission to home consumer prices. The monthly seasonal appreciation of the lek against the euro in July has not been as strong as in the same month of the previous year. The

lek has been depreciated in annual terms by 0.5 percent against the euro. The depreciation of the lek amplifies the transmission of higher prices of imported foodstuffs to the domestic inflation rate³.

Table 2 Annual changes in partner countries' inflation and in the exchange rate (in percentage)

	January	February	March	April	May	June	July
Greece ⁴	3.2	3.2	3.3	3.3	3.1	3.2	3.8
Italy ⁵	2.2	2.1	2.1	2.2	2.2	2.3	2.2
Lek/Euro	-2.5	-3.3	-2.9	-2.5	-1.4	-0.4	0.5
Lek/Usd	5.4	5.4	6.4	3.0	-2.1	-4.3	-4.5

Source: CPI, INSTAT

Though the oil price rise in the international markets during July tended towards stabilization, the present relatively high price is a potential risk for the European economies. The price rise under the

present conditions implies a cost impossible to be faced up by the consumer. The imported inflation transmission during this month, as in the previous months, was restrained only partially by the lek' s appreciation against the dollar.

Agricultural production

The annual growth rate of agricultural products, after dropping close to zero level during June 2006, still recorded positive values during July, registering the value of +15 percent. This was so mainly as a result of the lower supply of agricultural products. Though July is a period during which the agricultural production had to be felt in the market, this tendency was not noticed during this year. The following chart reflects the significant rise of the price index of fruits – vegetables during July 2006, compared to the negative values of the previous year⁶.

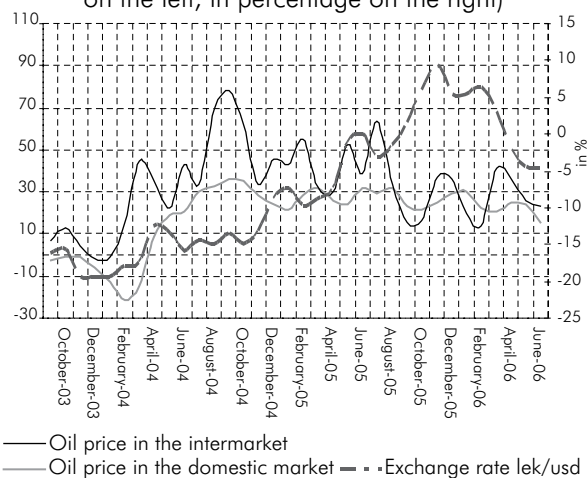
II. MONETARY DEVELOPMENTS AND MARKETS

II.1 MONETARY POLICY OF THE BANK OF ALBANIA

During the first half of the year, the Bank of Albania's monetary policy has maintained a neutral stance on monetary developments in the economy. The key interest rate of 5 percent has been applied in repurchase agreements since March of 2005. The inflation rate and its forecasts have fluctuated on average within the 2 - 4 percent targeted band. However, the presence of high monetary growth rates is estimated to have impacted on other macroeconomic indicators. In parallel, inflation has reacted with upward trends to monetary and macroeconomic developments.

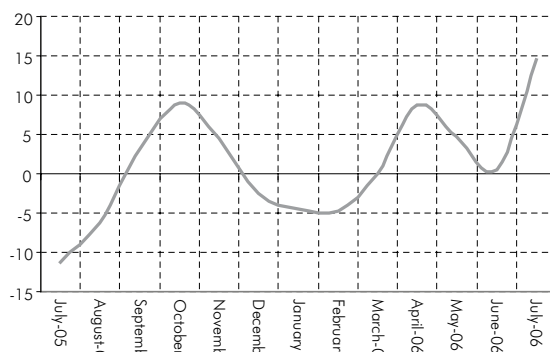
Inflationary pressures on the economy have formed an upward trend, clearly reflected in the inflation rate performance over first six months of the year, partially due to developments on the

Chart 6 Oil price performance and the lek exchange rate against the dollar (in the Usd on the left, in percentage on the right)



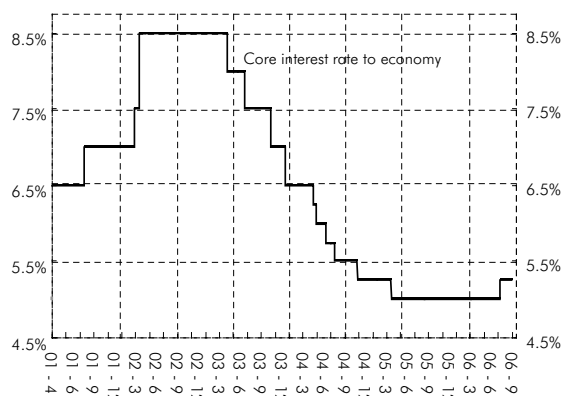
Source: Bank of Albania, INSTAT, Bloomberg

Chart 7 Annual change of fruit-vegetable index (in percentage)



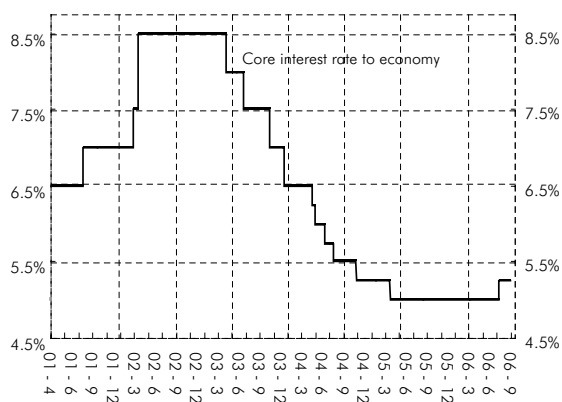
Source: Ministry of Agriculture, Food and Consumer Protection

Chart 8 Key interest rate



Source: Bank of Albania

Chart 8 Key interest rate



Source: Bank of Albania

aggregate demand side. The Bank of Albania forecasts confirmed that the upward trend may continue even in the future. The monetary policy reacted by changing its stance from the neutral direction to the tightening one. The stance was conditioned by inflation forecasts and expectations over the medium-term period. In accordance with this stance, the key repurchase agreement interest rate was raised by 0.25 percentage point, to 5.25 percent, with the Supervisory Council Decision of 12 July.

The banking system has responded by raising the interest rates of investing in government securities, while the overnight interest rate in the interbank market has been oriented to key interest rate. Though the data are preliminary, the banking system tends to react with delays in terms of increasing the deposits interest rates.

Table 3 Interest rate spread in the government security market (in percentage points)⁷.

	Spread
2-year bonds	+ 0.6 pp
12-month treasury bills	+ 0.5 pp
6-month treasury bills	+ 0.3 pp
3-month treasury bills	+ 0.1 pp
Interbank overnight market	+ 0.6 pp

Source: Bank of Albania

During July – August, the Bank of Albania intervened in the currency market through repurchase agreement operations for withdrawing the banking system liquidity at an unlimited amount and at a fixed price, as well as through overnight deposit instruments. Also, during July, the Bank of Albania intervened in the foreign exchange market, injecting liquidity to the system by ALL 1.4 billion. Due to these operations, the Bank of Albania has enabled the observance of quantitative objectives. While the meeting of these operational objectives constitutes a conditionality criterion for the three-year PRGF/EFF agreement, it guarantees a growth of the broad money that enables the keeping of inflationary pressures of money supply side under control.

Table 4 Meeting of the Bank of Albania quantitative objectives

	December '05	March '06	April '06	May '06	June '06	July '06*
Net International reserves (dollar million)						
Objective	1,184	1,117	1,115	1,113	1,112	1,163
Actual	1,184	1,215	1,219	1,243	1,237	1,250
Difference	-	98.0	104.0	129.7	125.1	87.6
Net domestic assets (lek billion)						
Objective	82	85.0	86.7	88.3	90.0	87.6
Actual	77	61.8	65.0	62.5	67.7	70.0
Difference	- 5	-23.2	-21.7	- 25.8	- 22.3	- 17.6

Net domestic credit to the government (lek billion)						
Objective	306.7	314.6	315.9	317.2	318.6	320.6
Actual	306.7	300.5	297.1	297.3	297.7	--
Difference	-	- 14.1	- 18.8	- 19.9	- 20.8	--

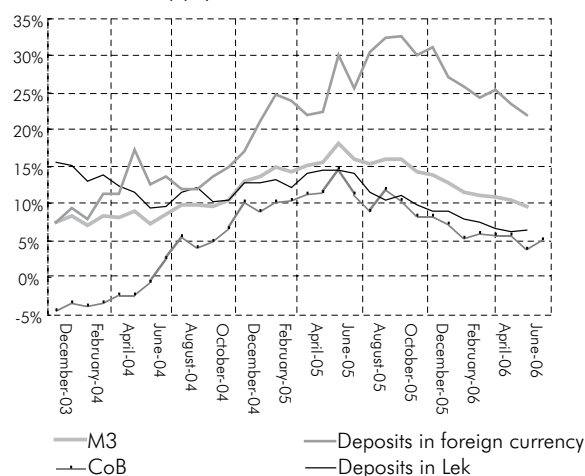
*Operative data for July
Source: Bank of Albania

II.2 MONETARY AGGREGATE PERFORMANCE

The money supply has increased by 1.1 percent in monthly terms⁸. The monetary expansion in June resulted higher than in the other months of the six-month period, in compliance with the seasonal developments of the economy. The increasing demand for monetary assets during spring motivates growth of the broad money. However, in annual terms, the money supply growth is in line with the tendency of monetary expansion observed over the twelve last months. In annual terms, the money supply growth of 9.7 percent is in compliance with its downward trend.

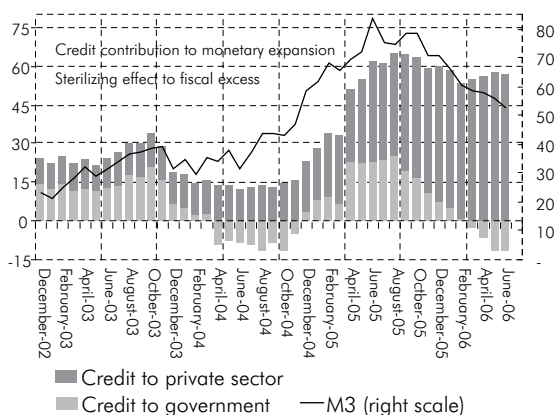
The M3 time structure and foreign currency structure have maintained the tendencies towards foreign currency deposit weight growth and seasonal growth of the demand for currency in circulation. The ratio of currency outside banks to M3 was 23.7 percent, against 23.5 percent in the previous month. The demand for currency in circulation leads to the seasonal growth of currency outside banks during the spring months. The foreign currency deposit weight to

Chart 9 Annual growth of the money supply and its constituents



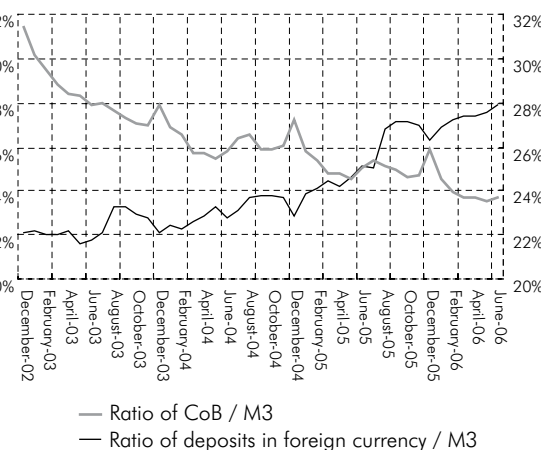
Source: Bank of Albania

Chart 11 Contribution of credit to the private sector and of the fiscal position to the M3 growth (12-month changes in lek billion)



Source: Bank of Albania

Chart 10 M3 time structure and foreign currency one



Source: Bank of Albania

the stock of the broad money has grown to 27.9 percent, against 25.1 percent in the previous year.

On the demand side, the money supply has grown due to the private sector demand for money. The growth of lending to the private sector of the economy has been the main contributor in extending the money supply. The ratio of credit to money supply, M3, is 25.7 percent against 16.1 percent in the same period of the previous year, at about 1.1 percentage point higher than in May. Also, the weight of credit to GDP has increased to about 17.8 percent or 6.0 percentage points higher than in June of 2005.

Table 5 Monetary aggregate performance

In lek billion	June 2006	Monthly change		Annual change	
		absolute	percentage	absolute	percentage
Currency outside banks	141.0	2.8	2.0	5.2	3.8
Total deposits	453.5	3.6	0.8	47.4	11.7
- ALL deposits	287.6	-0.1	0.0	17.6	6.5
- Foreign currency deposits	165.9	3.7	2.3	29.8	21.9
M1	225.0	4.1	1.9	48.1	27.2
M2	428.6	2.6	0.6	22.8	5.6
M3	594.5	6.3	1.1	52.7	9.7
Monetary base	194.6	3.9	2.1	14.1	7.8

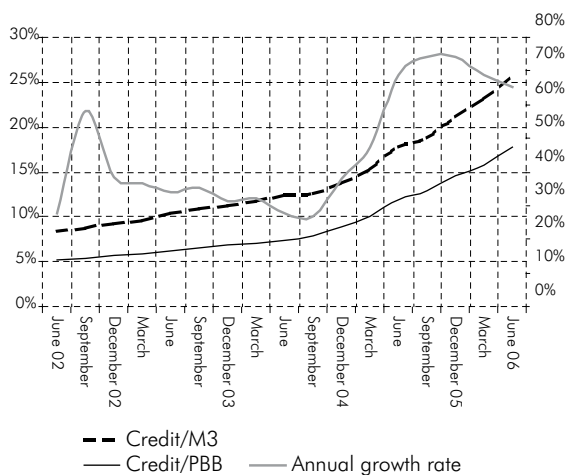
Source: Bank of Albania

II.3 DOMESTIC DEMAND

Credit to the economy

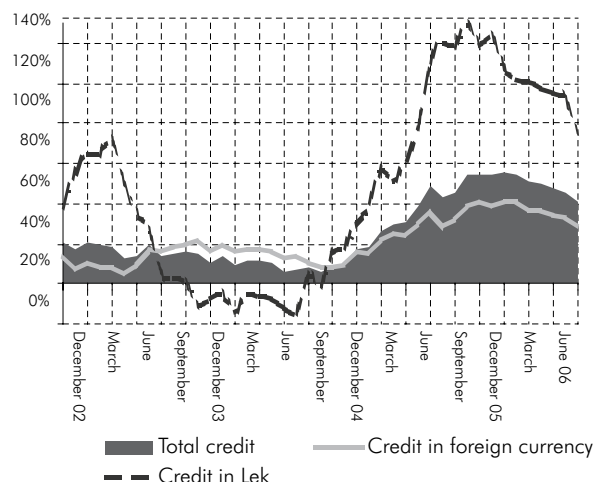
The credit to the economy grew by ALL 6.4 billion. Credit outstanding to the economy by ALL 152.8 billion is estimated at 59.3 percent higher than in the same period of the previous year. The annual credit

Chart 12 Credit to GDP and M3 (left scale) and the annual rate of total credit (right scale)



Source: Bank of Albania

Chart 13 Annual rate of credit growth



Source: Bank of Albania

growth rate has reflected mitigating tendencies, though it fluctuates in relatively high intervals versus the historical performance. During the first six months of the year, the credit outstanding to the economy has increased by ALL 30.8 billion, while the annual credit growth rate has been smoothed over to about 59 percent.

The foreign currency credit structure reflects the shifting tendency towards credit in ALL. Credit in ALL was increased by ALL 3.3 billion, against the growth by ALL 3.1 billion of the foreign currency credit. The credit in ALL to total credit ratio has increased to 28.2 percent. The historical trends confirm that the banks' orientation to credit in ALL is associated with interest rate cut of credit in ALL.

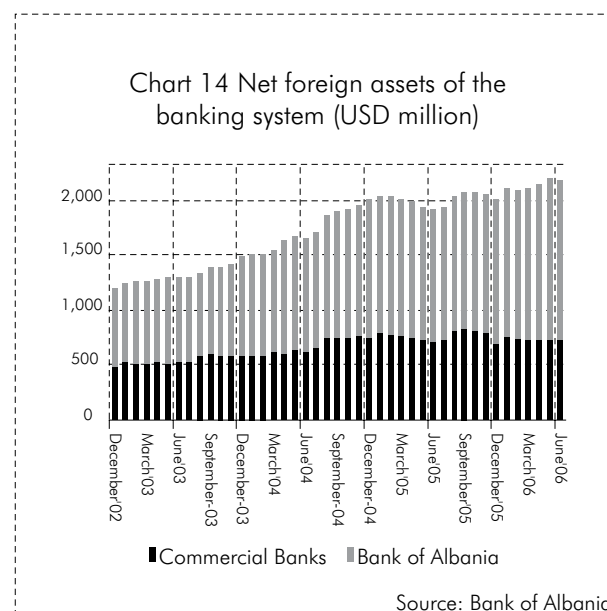
	2002	2003	2004	2005	2006		
					Q I	May	June
Credit /deposits ratio	13.5	15.7	19.0	28.5	30.4	32.6	33.7
Credit to the economy/ total assets (in % to M3)	11.5	13.7	16.6	25.0	26.3	28.0	28.7
Domestic credit	70.8	71.5	68.8	70.0	70.1	72.8	70.8
- Credit to the government	61.5	60.2	55.0	48.9	46.9	47.1	61.5
- Credit to the economy	9.3	11.3	13.8	21.1	23.2	24.9	25.7
(in % to GDP)							
Credit to the economy	6.2	7.4	9.1	14.6	15.9	17.1	17.7
Total deposits	45.8	47.3	48.2	51.2	52.3	52.5	52.5

Source: Bank of Albania

Table 6 Main credit and deposits indicators (in percentage)

Net foreign assets

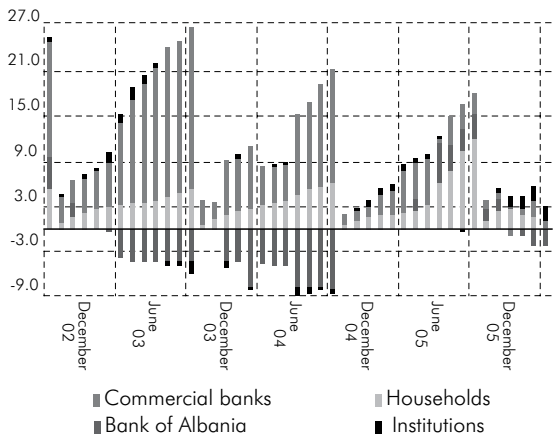
Banking system foreign assets have decreased by USD 17 million. Avoiding the exchange rate effect, these assets have increased by USD 2.6 million. The net foreign reserve of the Bank of Albania has declined by USD 17.5 million, mainly due to the Euro/Usd exchange rate effect (depreciation of the euro by 0.4 percent). While the foreign assets of commercial banks have increased slightly, by USD 0.4 million, the foreign assets growth has been associated in parallel with foreign liabilities growth, denominated in credit to non-residents, thus providing a lower net effect.



Government demand for money

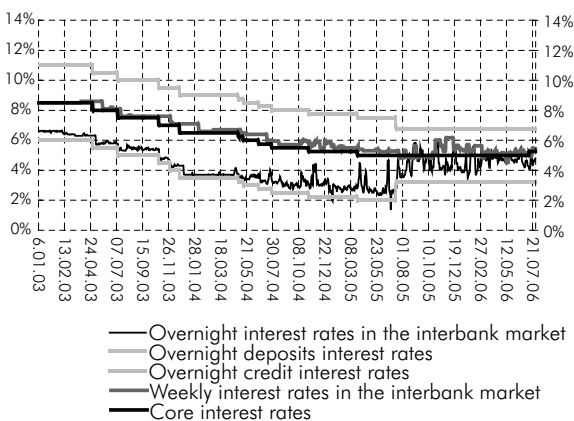
Budget surplus reached ALL 9.2 billion, further reducing the government demand for money. This development has deepened the negative level of the domestic financing, by about ALL 4.4 million compared with the previous month. Government deposits have decreased by about ALL 2.1 billion. The government went on

Chart 15 Deficit financing (cummulative) (in lek billion)



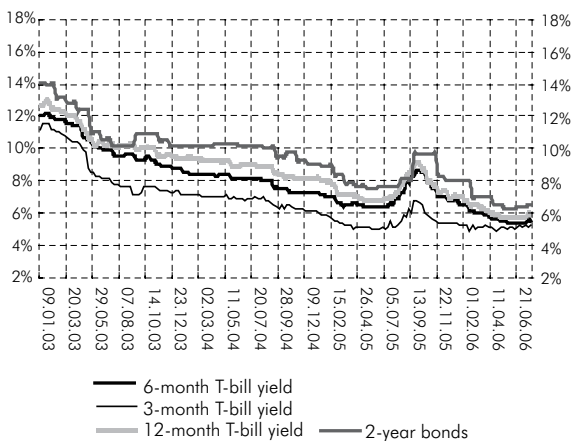
Source: Bank of Albania

Chart 16 Interest rates in interbank market and monetary policy



Source: Bank of Albania

Chart 17 Yield of treasury bills and two-year bonds



Source: Bank of Albania

increasing the long-term debt, issuing two-year bonds to about ALL 2 billion. The net treasury bills effect continues to be negative, thus marking the further deepening by ALL 4.4 billion for June. Also, the government has increased the quantity of reverse repos with commercial banks, by about ALL 2 billion.

II.4 FINANCIAL MARKETS AND INTEREST RATE PERFORMANCE

The market reaction to the tightening monetary policy has been partial. The interest rate rise is reflected first of all in the primary market, in two-year bonds market and in lek two-year deposits market. Also, there are observed interest fluctuations in three-month, six-month and twelve-month lek deposits. The high liquidity level in the system at ALL 7-9 billion and the limited possibility of investing in the primary market and in the lending market, have affected this market behaviour. The increasing effect of the key interest rate on the deposits market tends to be realised with delays.

The interbank market has been characterised by interest rate fluctuations around the key interest rate. The spread between overnight credit interest rates and key interest rate has been expanded by 0.4 percent in June to 0.7 percent in July. While the system has resulted with considerable liquidity excess, it is estimated that the interest rates in the interbank market have been influenced mainly by fluctuations of the quantity of liquidity in this market⁹. The security market has responded faster to monetary policy signals, raising treasury bills' and two-year bonds' yields.

The reaction of these markets has been to a smaller extend than the rise signalled by the Bank of Albania, while the three-month treasury bill yield is sensitive to the demand/supply ratio of the primary market in the short-term period. The banking system treasury bill portfolio has maintained the downward trend in July (ALL 0.9 billion less than in June), while the two-year and three-year bonds portfolio has increased by ALL 5.0 billion.

	3-month	6-month	12-month
Key interest rate change			0.25%
Treasury bill yield change	0.02%	0.15%	0.20%

Source: Bank of Albania

Table 7 Primary market response to the rise signalled by the Bank of Albania in July 2006 (in percentage points)

In spite of the rise in the security market yields, they continue to remain close to lowest historical levels. Upon rise of the government demand for liquidity, rise of these yields is expected in the coming months. In July, the financial intermediation cost increased as a result of interest rise in the primary market and interest cut of deposits in ALL.

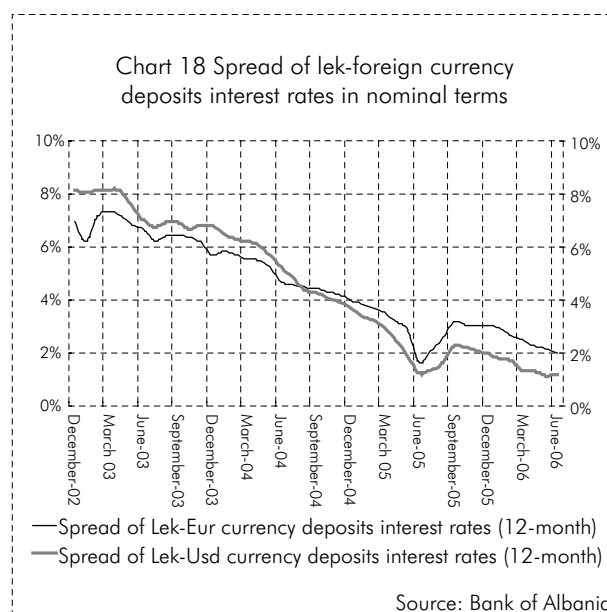
Maturity term	June 2006	July 2006
3-month	1.5 pp	1.6 pp
6-month	1.1 pp	1.4 pp
12-month	0.7 pp	1.0 pp

Source: Bank of Albania

Table 8 Intermediation cost (the spread between primary market and ALL deposit market interest rates in percentage points)

In June the interest rates of deposits in ALL of all maturities declined. According to operative data on July, the rise of interest rates in foreign currency has led to narrowing of the spread between the lek deposit interest rates and the foreign currency ones.

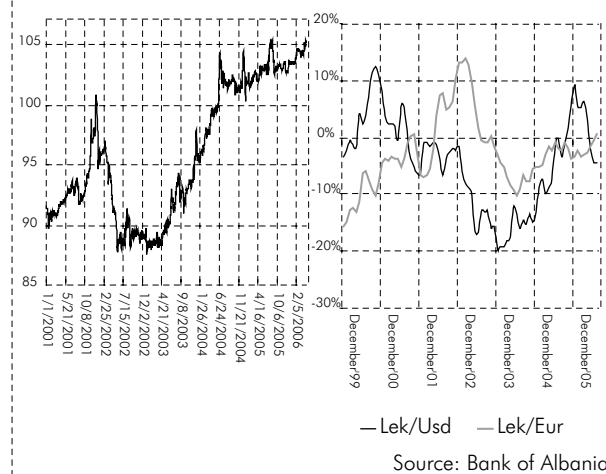
The monetary policy tightening by the Federal Reserve and the European Central Bank during 2006 has impacted on interest rate rise of deposits in euro and in dollar¹⁰. The upward trend of foreign currency deposit interest rate has continued for almost two years, reflecting the tightening monetary policy developments of the Federal Reserve and the European Central Bank. Also, in June, the interests of credits of 6-month to 1-year maturity in USD and in Euro, and the interests of credits of 1-3 year maturity in Euro have increased. For all other credits in Lek and in foreign currency, slight reductions of interest rates are noticed. The intermediation cost, as a difference of the credit interest and deposit interest of twelve-month maturity, is estimated at about 7.0 percentage points in All, above 6.0 percentage point in USD and above 4.0 percentage point in Euro.



Exchange rate

The lek's exchange against foreign currencies has been stable during first the months of spring. During this period the lek has not reflected the fluctuations characterizing it in the previous years. In monthly terms, the lek was appreciated slightly in July against both currencies the euro and the usd, by about 1.1 and 1.4 percent, respectively. In

Chart 19 Nominal effective exchange rate – NEER (on the left) and exchange rate (- /appreciation)



annual terms the lek is depreciated against the euro by 0.5 percent and is appreciated against the dollar by 4.5 percent. At end of the first week of August, the lek's exchange rate was respectively 95.7 lek/usd and 122.3 lek/euro.

NOTES

¹ Source: ISTAT; website <http://www.istat.it>

² Source: National Statistical Service of Greece, web site: <http://www.statistics.gr>

³ The inflation of the analogue group of foodstuffs in Greece recorded about +6 percent in July 2006.

⁴ Source: National Statistical Service of Greece; website: <http://www.statistics.gr>

⁵ Source: Institute of Statistics of Italy; website <http://www.istat.it>

⁶ The chart is made by using the preliminary data obtained from the Ministry of Agriculture, Food and Consumer Protection

⁷ Interest rate spread between auctions of July 04 and August 15

⁸ Data on monetary aggregates belong to June, unless otherwise specified.

⁹ The interbank market interest rise was carried out during the period of calculating the required reserve, which coincides with the period prior monetary policy signalling.

¹⁰ Here are excluded interests of one-month and twelve-month time deposits in dollar, which have undergone a slight reduction by 0.03 percentage point and 0.09 percentage point respectively.