

Monetary policy

Monthly report



June 2003

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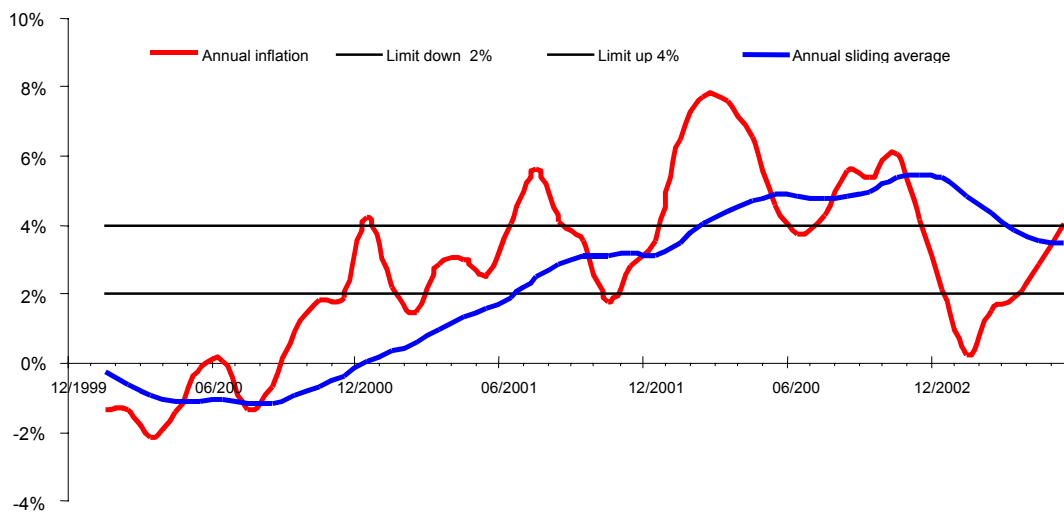
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I. Inflation performance during January-May 2003

I.1 Factors determining inflation performance.

Annual inflation rate for May resulted 4.03 percent, whereas the average one was 3.49 percent. During the first five months of 2003 the annual inflation has indicated an upward trend. The annual average, however, indicated a downward trend and is normalized within the targeted interval.

Graph 1: Annual inflation



The price performance of “ Foodstuff and nonalcoholic” group explains the most part of the inflation change during the first period of this year. The “Rent, water, fuel and power” group contribution has been more moderate during the first four months and it has increased considerably in May. The rise of the power price has affected the annual inflation rise over the above objective limit. Bank of Albania predicted an effect of 0.27-0.38 percentage point in the total inflation. The real data demonstrate that this subgroup gave an impact on the upward direction of about 0.3- percentage point of the monthly inflation. Without this factor, the monthly inflation would have resulted in lower levels (about -0.8 percent) whereas the annual one about 3.73 percent, that is within the above limit of the objective interval, expected for it.

The seasonal behavior, even for this year, for special groups seems totally confirmed. For example, the foodstuff group has the same performance as the previous the year. However, in totally, inflation was reduced less than it should have been reduced under the effect of seasonal factors for the above-mentioned reasons.

The considerable increase of the first group in May came as a result of the administered price rise of power. It should be emphasized that such inflation changes are not under the control of the monetary policy. They represent factors

in the supply direction, against which, as a rule, the monetary policy does not react.

Graph 2: Annual inflation of the four main groups of the CPI basket (in %).

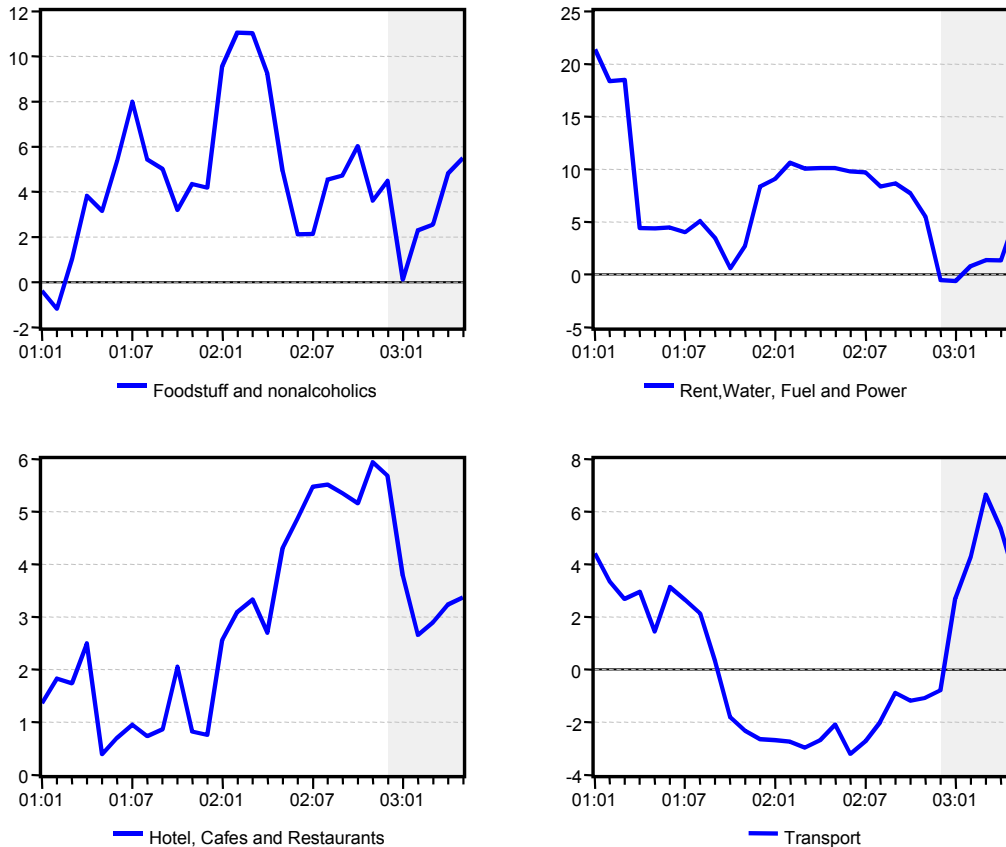


Table 1: The contribution of the main groups of the basket in the total annual inflation (%).

	January	February	March	April	May
1. Foodstuff and non-alcoholic	0.05	0.99	1.11	2.09	2.34
2. Rent, water, fuel, power	-0.15	0.19	0.33	0.32	1.31
2.1. Power and fuel					0.34
3. Hotels, cafeterias and restaurants	0.28	0.20	0.21	0.24	0.26
4. Transport	0.13	0.20	0.31	0.25	0.16
5. Other groups	-0.04	-0.04	-0.08	-0.07	-0.04
Total	0.28	1.54	1.89	2.82	4.03

As far as the “ Foodstuff and nonalcoholic” group is concerned, its contribution until May, in the total inflation, is increased by nearly 1 percentage point each month. The main reason for this increase could be mainly found in the developments of the foreign sector. The main countries from which Albania imports, Italy and Greece, are characterized by relatively high inflation rates

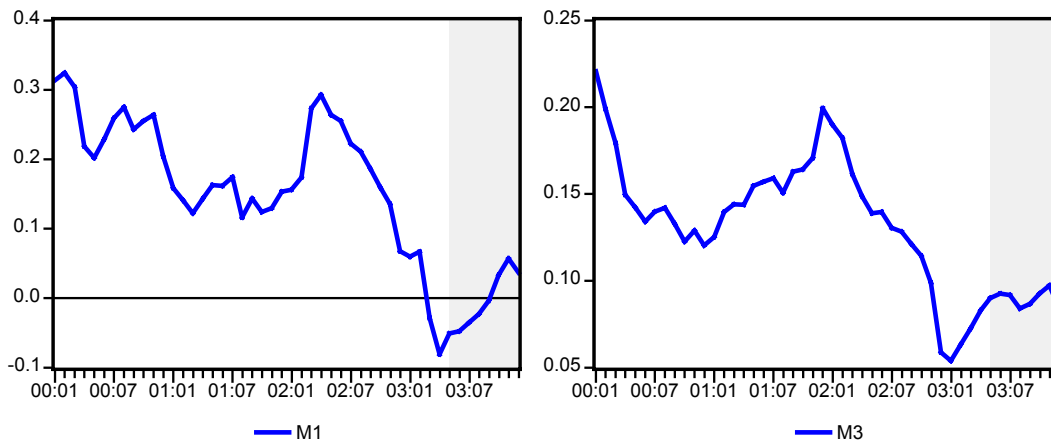
compared to the objective of 2% of European Central Bank, especially of fruits and vegetables. Similarly, this is a period when the national production is insignificant. On the other side, Lek is considerably depreciated (in annual level) against Euro, especially during the first quarter of 2003. Combining these two effects it can be argued that the imported inflation must have been considerable. The exact rate of this inflation depends from the weight occupied by different partners in the total imports, and the weight of this later in the total of the consumer basket. Regardless to these pressures, making a simple supposition that the quantity of imports occupies about 50 (30) percent of the basket, the potential imported inflation seems to be very high. Such a thing is partially confirmed also by annual inflation of agricultural products, which has been in a considerable way over 4 percent during all the period being analyzed. Though it seems that the potential imported inflation and that of the agricultural prices have moved in opposite direction, it could be argued that the first one is transmitted to the market price in an one or two month of delay. It exists also the probability of speculative price movements.

Table 2: Annual inflation of imported countries, annual exchange rate change Lek/Euro, and the annual change of agricultural price (in %).

	Italy	Greece	Germany	Turkey	Lek/Euro	The probable imported inflation		Agricultural price change
						Weigh 50%	Weigh 30%	
January 2003	2.73	3.15	0.09	26.40	14.67	8.50	5.0	4.69
February 2003	2.46	4.39	0.27	27.03	15.05	9.00	5.4	6.29
Mach 2003	2.71	4.06	0.27	29.42	12.06	7.50	4.5	8.17
April 2003	2.62	3.37	-0.18	29.73	7.55	5.50	3.0	9.34
May 2003	2.70	-	-	-	5.60	-	-	9.64

In a situation when the imported inflation is thought to have been considerable, the monetary policy followed by Bank of Albania, results effective if we consider that inflation has not deviated much from the expected interval of 2-4 percent. It should be said that the Bank of Albania applicable monetary policy instruments have been under control for most part of the period, considered having an impact during the first months of this year. To achieve this control, the moderated increase of the government deficit and the control of monetary aggregates` level have played an important role.

Graph 3: Annual monetary aggregate changes of M1 and M3 (%)



Note: The shaded part is the forecast.

II. Monetary developments and financial markets.

II. 1 Monetary policy of Bank of Albania

Monetary policy of Bank of Albania has had an alleviating direction during January-March. This alleviation is expressed by the change of the Repos auction form and the injection of liquidity in market as a result of the interference in the foreign exchange market. However, the continuous improvement of the monetary indicators, the high level of real interest rates, the positive performance of inflation and the forecasts for the observance of the objective of Bank of Albania at year-end, require necessarily a further alleviation of monetary circumstances in economy. Taking into account these factors, the Supervising Committee of the Bank of Albania, on the 23rd April, decided the reduction of 0.5 percentage point of Repos interest rate. The banking system reacted quickly, reducing the interest rates of the deposits in Lek. According to the operative data, the interest rate of the term deposits in Lek, are reduced to an average¹ of 0.8-0.9 percentage point level during 23rd April-20 June period. Meanwhile, the Treasury bond yield is reduced further more, also as a result of the low demand of the government during the first months of the year. The three and twelve months Treasury bills yields are reduced respectively by 1.98 and 1.95 percentage point during April-May period.

The alleviation of the monetary policy has not affected the observance of quantity objectives. These objectives have also been respected during the April-May months. The increase of the net foreign exchange reserves as the result of the purchase in the foreign exchange market, as well as the reduction of the

¹ The average of reduction of interest rates of the deposits in Lek is calculated as a simple arithmetic average.

monetary base level as an aftermath of the return of currency in the banking system, have influenced in deepening the differences of quantity indicators from their objectives. Meanwhile, the relatively low government borrowing in the domestic market has enabled, starting from March, to recognize observance also the domestic credit objective for the government.

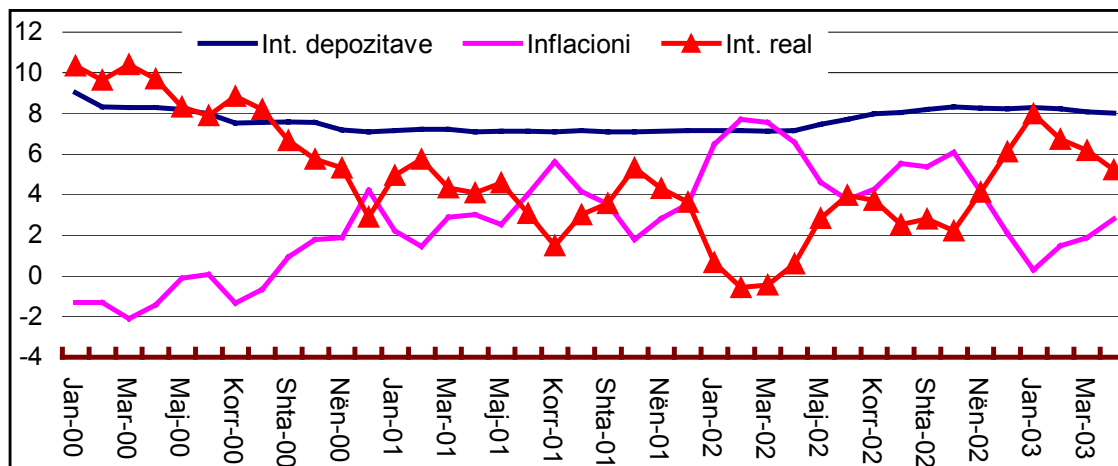
Table 3: The quantity objectives` achievement of Bank of Albania.

	January'03	February'03	March'03	April'03	May'03*	June*
Objective achievement of NIR (million dollar).						
Objective	559.3	559.9	560.6	560.6	560.6	582.2
Actual	571.1	586.2	596.2	597.5	606.5	608.9
Difference	11.8	26.3	35.6	36.9	45.9	26.7
Object achievement of NDA(billion Lek).						
Objective	95.8	95.9	97.1	97.4	97.8	98.1
Actual	80.1	81.2	77.1	73.5	69.7	68.2
Difference	-15.7	-14.7	-20.0	-23.9	-28.1	-29.9
Objective achievement of the domestic credit for the government(billion Lek).						
Objective	261.2	262.9	264.6	265.9	--	--
Actual	262.8	264.4	263.1	261.9	--	--
Difference	1.6	1.5	-1.4	-4.0	--	--

* Operative data

The Repos interest rate change was followed by the reduction of real interest rates. The real interest rate level, during the first four months of the year, recorded the highest level in the last two years. The monetary policy alleviation from Bank of Albania put back their level closer to the historical average.

Graph 4. Real and nominal interest rates of term deposits in Lek.



Although the level of currency outside banking system has continued to experience reduction also during April-May, its performance in May shows a

pace reduction of return of currency in the system. The currency ratio against M3 has approached the historical levels. Its present trend records a restraint of return of currency in the system. This return has been the main factor in the creation of excessive reserves from the banking system, exercising extra pressure on the reduction of deposits and treasury bills interest rates. The restraint of return of currency in the system and the approach of its ratio against money supply in an equilibrium level would play a stabilizing role in the interests' rates level.

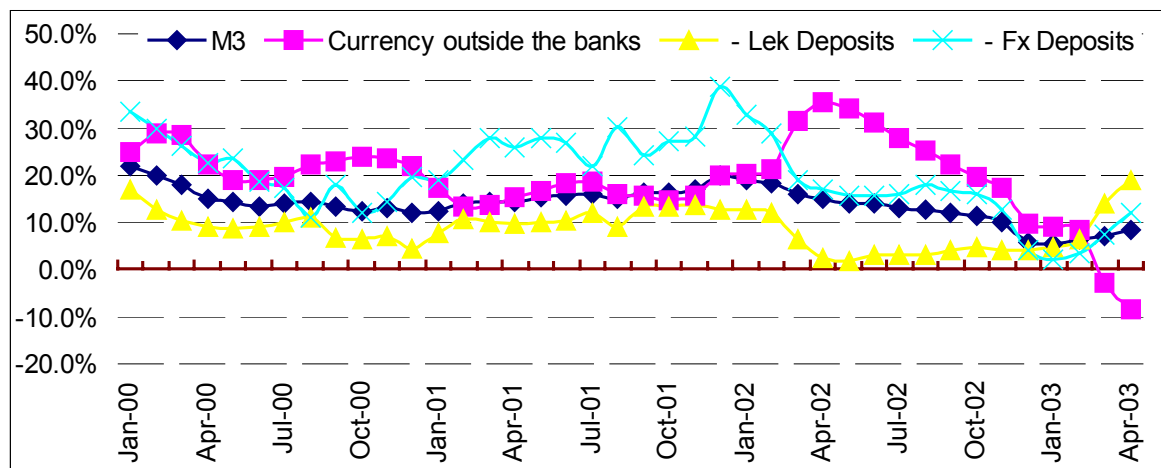
II. 2 Money aggregates performance

The money supply increase has been relatively weak as the result of the low demand of economy for monetary assets during April-May. Return of currency outside banks in the system, however, has achieved a satisfactory increase of the deposits in Lek. The increase of these deposits has enabled the banking system to create liquidity surplus.

The ratio of the currency outside banks against M3 in April, reached 28.4 percent, the lowest value of this ratio during this two last years. The currency included in the banking system has taken mainly the form of the fixed deposits in Lek, reducing the M1 aggregate level also in April. The annual interest increase of the M1 aggregate, as well as that of currency outside banks, continues to remain negative during the first part of the year. The reduction of M1 aggregate in April keeps low the inflationary pressures coming from monetary developments.

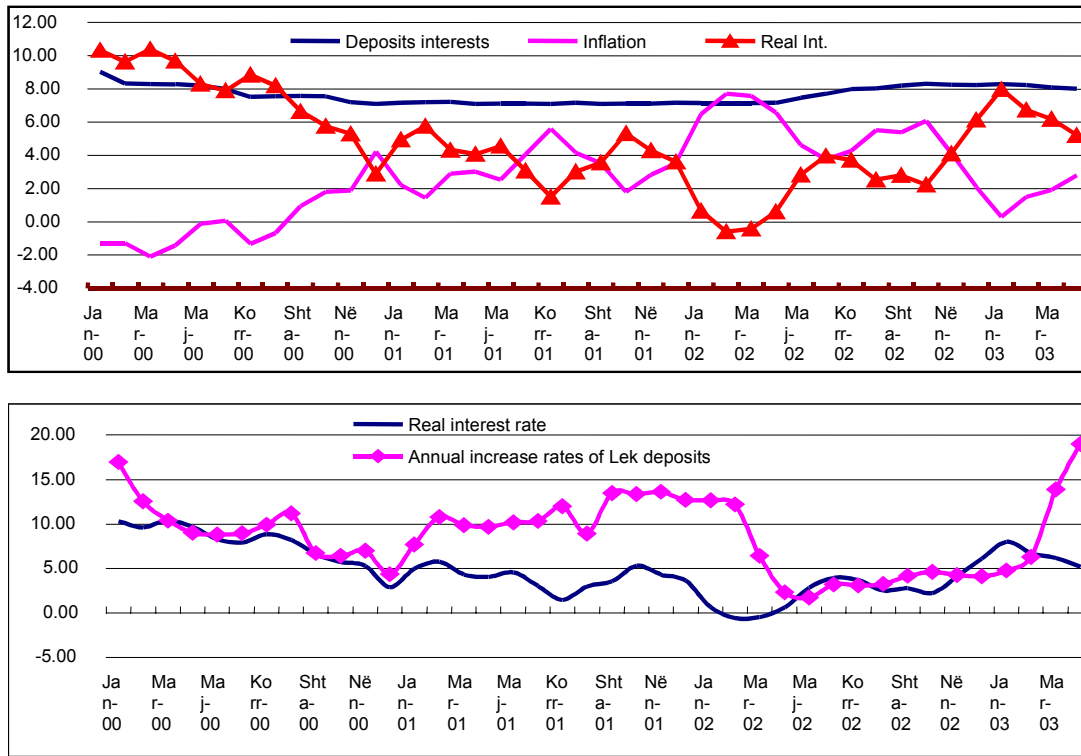
The growth rates of monetary aggregates, excluding the currency outside banks, have been growing. In particular the deposits in Lek present high rising rates, as the result of the return of currency in the system.

Graph 5. Annual rates of monetary aggregates rise



Operative data show a high growing pace of the deposits in Lek in May, too. During this month, the deposits in Lek are estimated to have grown by Lek 2.7 billion.

Graph 6: Deposits in Lek interest rates and their annual increase.



The deposits growth in Lek has brought the amelioration of the liquidity situation of the banks. Banks have passed from a liquidity deficiency situation of Lek 2.3 billion in December to an excessive liquidity of Lek 9.4 billion at the end of May. Knowing that high level of excessive liquidity exerts a pressure on the interest rates in the descending direction Bank of Albania intervened withdrawing Lek 3.5 billion liquidity from the market, during May-June.

In April, the annual growth of deposits in foreign exchange reached 12 percent, recording the highest rate since the beginning of the year. According to operative data, the low pace of the deposits growth in foreign exchange has continued in May as well. During this month, the deposits in foreign exchange are presented by nearly a 3 percent monthly decrease.

Table 4: Monetary aggregate performance.

	Absolute		Percent	
Currency outside banks	120.0	-1.3	-1.1	-8.4
Total Deposits	302.3	2.9	1.0	16.7
- Deposits in Lek	208.7	1.9	0.9	19.0
- Deposits in foreign exchange	93.6	1.0	1.1	12.0
Demand Deposits	58.7	1.2	2.0	5.7
- Deposits in Lek	22.5	-0.3	-1.1	-6.6

- Deposits in foreign exchange	36.2	1.4	4.1	4.8	15.1
Time Deposits	243.5	1.8	0.0	40.1	19.7
- Deposits in Lek	186.2	2.2	1.2	34.9	23.0
- Deposits in foreign exchange	57.3	-0.4	-0.7	5.2	10.1
M1	142.5	-1.6	-1.1	-12.6	-8.1
M2	328.7	0.6	0.2	22.2	7.3
M3	422.3	1.6	0.4	32.2	8.3
Monetary base	152.7	-5.2	-3.3	-10.3	-6.3

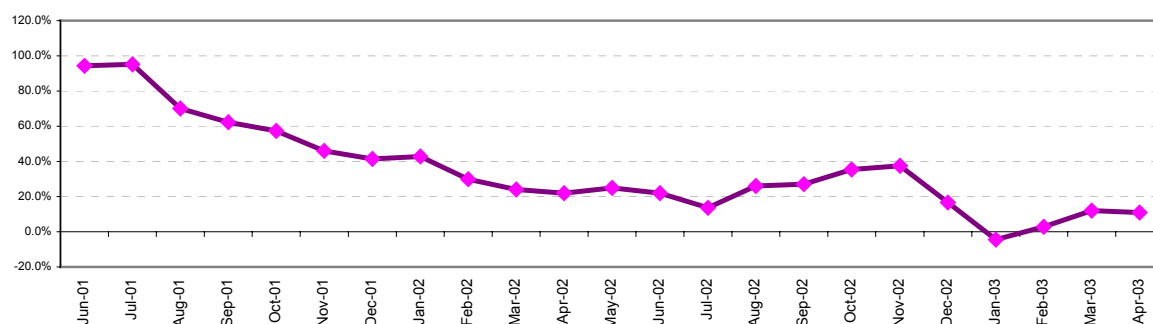
II.3 Economy demand for money.

II.3.1 Net foreign exchange assets of the banking system

Net foreign exchange means of the banking system, at the end of April 2003 compared to the end of 2002, record a reduction of about Lek1.6 billion or 0.96 percent. The reduction of net exchange means is totally a result of the over-evaluation by 5.6 percent of Lek against USD during 2003. Actually, the banking system has improved the level of net foreign exchange assets with about USD 76 million.

The contribution of growing foreign exchange assets in the money supply, in April 2003 is accounted to be about 11 percent. Compared to the historical performance, the contribution of growing foreign exchange assets in the money supply during 2003 has been small.

Graph 7. Contribution in annual terms of net foreign exchange assets in money supply.



II.3.2 The credit for the economy.

The banking system recorded high levels of economy credit for the January-May 2003 period. **The new credit** extended in this period reached Lek 24.4 billion, nearly 1.5 times higher than in the same period of 2002. The credit for the economy is holding a growing a place in the assets banking system, and it represents an important source of the demand for monetary assets. The credit/deposits ratio is in constant rise demonstrating a rise of the intermediating degree and role of the banking system.

Table 5: The performance of the main indicators.

	2000	2001	2002	T-1 '03	April'03
Money supply (in Lek billion)	328.1	394.3	416.7	420.6	422.4
Credit for the economy vercus M3	7.1	7.1	9.3	9.6	10
Credit for the economy vercus GDP	4.8	4.7	5.9	5.6 ²	5.9
Credit/Deposits ratio (in percentage)	10.1	10.2	13.5	13.5	14

The credit balance is increased by Lek 3.5 billion during January-May 2003, reaching 42.2 billion Lek at the end of April. Its growth is about 17 percent higher than the same period of 2002. April is highlighted by the highest monthly growth, Lek1.9 billion, of the credit balance.

An amelioration of the term structure credit is noticed during 2003. The medium-term and the long-term credit have presented rising tendencies during this period. The credit delivery in medium-term and long-term maturities during January-April 2003 reached about Lek 8 billion, consisting nearly 1/3 of the new extended credit. In relative terms, the growth of the medium-term and long-term credit surplus accounts for 43 percent of the growth of the credit surplus during the first months of 2003.

Foreign exchange credit is still holding a predominant feature in the economy credit. The new credit delivered in foreign currency occupies 64 percent of the new credit delivered until the end of April 2003. The foreign currency surplus

² This report is build up by GDP annual level of 2003.

continues to be predominant in the total credit surplus. This credit accounts for 78.5 percent of the total credit surplus. The stability of Lek exchange rate and the lowest interest level of foreign exchange credit justify the foreign exchange borrowing preference.

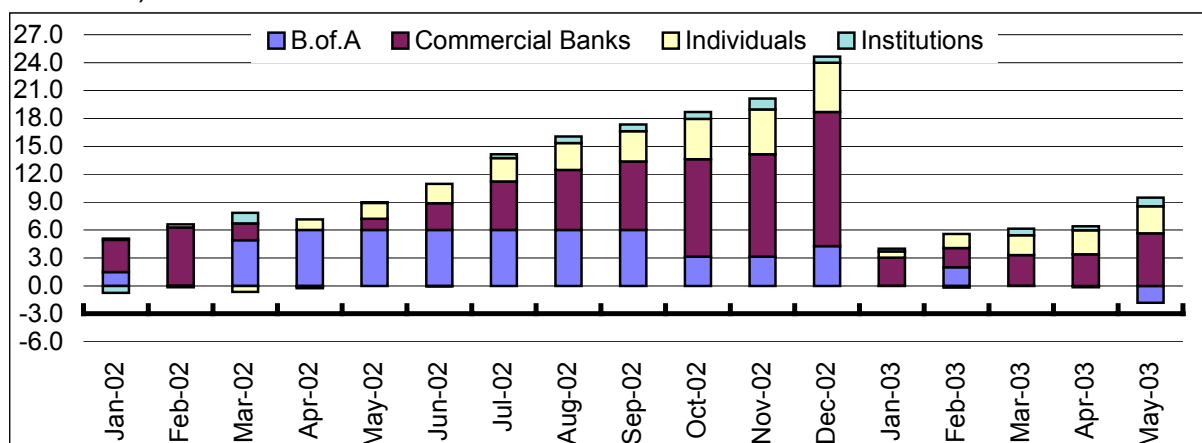
The trade sector continues to be the most preferred sector for credit. The credit in the trade sector holds 40.5 percent in the credit balance as banking system. A credit increase in the agricultural sector is noticed in this period. The preference for construction, however, has demonstrated a slight decrease compared to the end of 2002.

II.3.3 Government demand for monetary assets

The budget deficit financing by means of domestic borrowing has been low. This is due to the fact that the revenues acquisition at the end of April 2003 has been higher than expected at a time when the budget expenditures during this period were only 78 percent of the estimation.

Government demand for monetary assets does not constitute an important source in creating monetary assets. The budget deficit financing by means of treasury bills during January-April has been Lek 6.3 billion compared to Lek 6.7 billion of the same period in the previous year. The banking system has covered Lek 3.3 billion from this financing in 2003 compared to Lek 5.9 billion in 2002. The liquidity increase in the system has enabled the commercial banks cover totally government needs. Bank of Albania has not financed the budget deficit during this period. The high interest rates of the treasury bills have affected the growing participation of house holds in the primary treasury bills auction. Their financing until May was Lek 2.9 billion, comprising a 37 percent of their portfolio. The government demand has been low also during May. The budget deficit financing by means of treasury bills was Lek 1.4 billion during May. Meanwhile, the financing of the banking system during May has been only Lek 0.5 billion.

Graph 8. Cumulative performance of budget deficit financing during the year (in Lek billion)



III. Financial markets and interest rates.

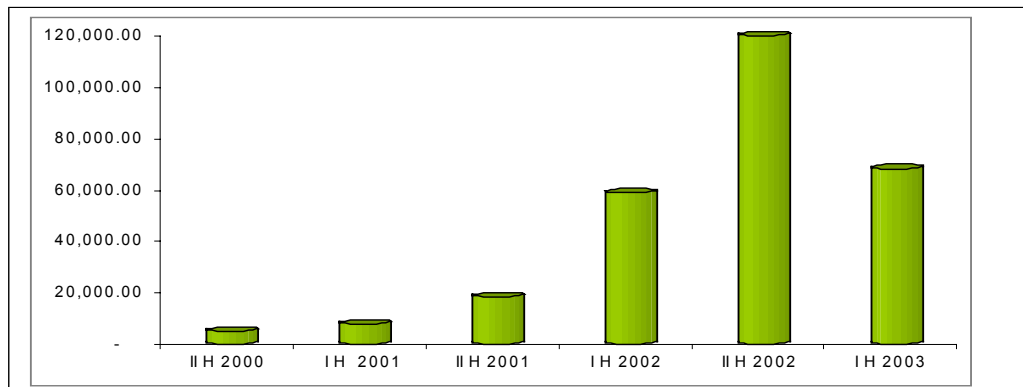
III.1 Financial markets.

III.1.1 Inter-bank system

The liquidity level in Lek has been constantly rising during January-May 2003. The change of market conditions from lack of liquidity absences to liquidity surpluses, was influenced by the gradual and constant rise of the deposits level as well as by the steady, with a falling trend, level of government needs in the securities market.

The liquidity surpluses growth in Lek, in the banking system, was followed also by the decreasing demand for borrowing in the inter-banks market. Banks` needs for liquidity have been short-term. Thus, 94.9 percent of the inter-bank transactions have aimed the fulfillment of the daily banks` needs for liquidity, whereas the remaining part has fulfilled the weekly needs.

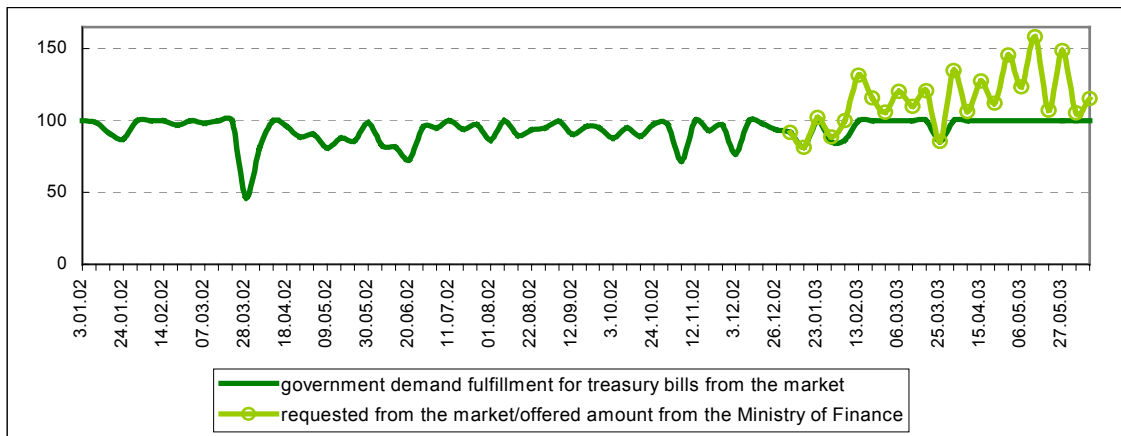
Graph 9. The six-month transaction volume in inter-bank market, in Lek million.



III 1.2 Government securities market

The state budget demand for funds has been in gradual decline during January-May 2003 period. Thus, the value of the new treasury bills issues is recorded to be lower than the maturities` value.

Graph 10. Government demand fulfillment for treasury bills from the market (in percent)

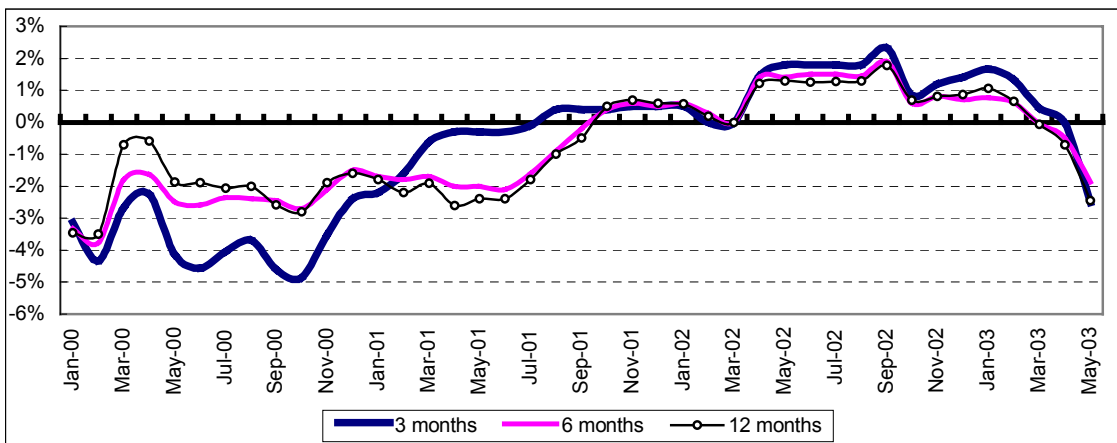


The commercial banks, various non-bank financial institutions and households have been the participant of the primary market. On 6th June 2003, the portfolio of commercial banks is reduced by 0.16 percentage point compared to the end of 2002.

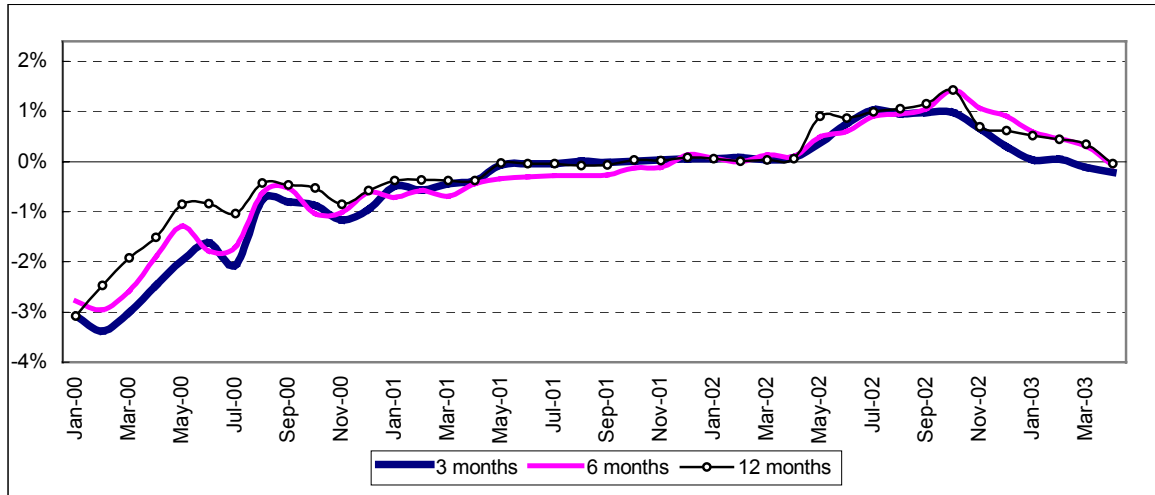
III.2 Interest rates performance

In the first half of 2003, the interest rates in various markets manifested declining trends, which were more emphasized after March.

Graph 11. The six-monthly change of average yield of the treasury bills in primary market (in percentage point).



Graph 12. The six-month change of the average interest of term deposits in Lek (in percentage point)

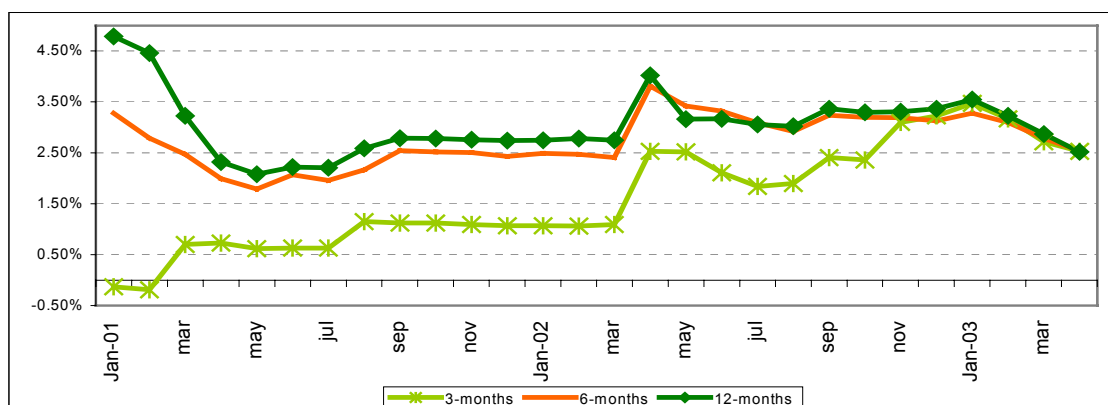


The interest rates in the deposits market and in that of the treasury bills, starting from the end of April, are reduced at more rapid paces than in the first months of 2003. The yield reduction in the treasury bills market has been more rapid compared to the reduction of the deposits interest for the three maturities.

Table 6: Interest rates change (in percentage point).

	Deposits interest rates change	Treasury bills yield change		Credit interest rates change
	January - April 2003	January - April 2003	January – 6 th June 2003	January - April 2003
3-month	-0.25	-1.19	- 3.16	
6- month	-0.05	-0.78	- 1.23	- 0.25
12- month	-0.09	-1.12	- 2.41	- 2.15
1-3 years				+0.92
Over 3 years				- 1.68
Average	-0.27	-1.03	- 2.27	- 1.64

Graph 13. The interest rate spread between treasury bills and deposits according to the maturities (in percentage point).



Consequently, even the spread between the treasury bills yield and the deposits interest according to the three maturities have acknowledged gradual and constant narrowing since January 2003.

The interest rates of the two main currencies have continued to be reduced in the foreign currency deposits market, following the manifested trend during 2002. Thus, compared to the end of 2002, it results that in April 2003, the average interest of the deposits in USD was reduced by 0.13percentage point, and the same type of interest for EURO was reduced by 0.38percentage point.

On the 5th 2003, the European Central Bank reduced the core interest rate by 0.5percentage point judging from the forecasts on the price stability in a medium-term period. This decision responds to the strategy on keeping the inflation at a low level of about 2.0 percent in a mid-term period. This move of the European Central Bank is expected to influence the reduction of EURO interest rates even in the domestic market.

In the credit market, it is noticed the narrowing of the six-monthly spread of interests. Despite this, the fluctuations of this spreads remain higher than in the other markets, and the transmission mechanism continues to remain weak. This happened, mainly as a result of the low level of competition in this market, where the Savings of Albania, the largest owner of liquidities in Lek, was not allowed to credit the economy, whereas other banks have preferred mainly foreign currency loans to the private sector.