BANK OF ALBANIA

MONETARY POLICY REPORT
MARCH 2005

APRIL 2005

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I. MAIN HIGHLIGHTS

- Annual inflation rate of March was 1.7 percent, whereas monthly inflation rate was 0 percent. Annual inflation rate during first quarter of 2005 was 2.5 percent, close to lower limit of the targeted band of the Bank of Albania.
- March was characterized by a negative rate of foodstuff prices, and a relatively high annual inflation rate of "Rent, water, electrical power" group, whose inflation was impacted by electrical power price rise in January of this year.
- Growth of budget spending and exceeding of expenditure plan for February might have not exerted inflationary pressures until March.
- Monetary policy went on maintaining a smoothing direction, aiming at further cutting interest rates in the banking market and encouraging economy development through lending. Base interest rate cut by 0.25 percentage points at end of March was done under the conditions of low actual and expected inflation rates and in the presence of positive performance of monetary indicators.
- Monetary indicators performance during February was characterized by further shifting of money supply towards longer-term assets. The ratio of currency outside banks at end of February reached to 25.4 percent, marking its lowest historical level.
- Annual rate of money supply growth in February reached to 15.1 percent, against 13.7 percent of this indicator at end of January. Money supply growth was based mainly on growth of deposits in foreign currency, while annual rate of M2 aggregate reflected a slight growth due to moderate performance of Government demand for money.
- Credit to economy during two first months of 2005 had a positive performance. Credit balance was increased by about Lek 6 billion, reaching the level of Lek 76 billion. February of this year was presented as the period with the largest growth of credit balance, by about Lek 4 billion.
- During March, the Lek interest rates went on falling in the Treasury bill market and in lek deposits market.
- Developments in foreign exchange market indicated a stability of the lek value versus the main currencies, euro and usd. Appreciation of the lek on yearly basis against two main currencies has smoothed inflationary pressures from imported consumer goods and has served as an amortizer of oil price rise.

II. INFLATION IN MARCH

Annual average inflation rate during first quarter of 2005 was 2.5 percent, being close to lower limit of the Bank of Albania targeted band. The highest annual rate for this quarter was marked in January (3.3 percent) while February and March marked obvious reduction of annual inflation rate.

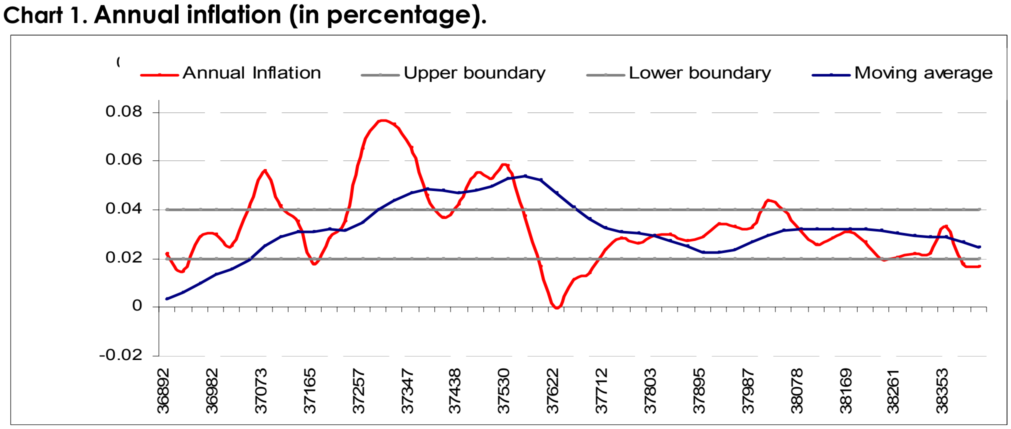
Table 1. Annual inflation rate (in percent).

	2001	2002	2003	2004	2005
January	2.2	6.5	0.0	3.3	3.3
February	1.5	7.6	1.1	4.4	1.8
March	2.9	7.5	1.3	4.0	1.7
April	3.0	6.5	2.3	3.2	
May	2.5	4.6	2.8	2.6	
June	4.0	3.7	2.6	2.9	
July	5.6	4.2	3.0	3.1	
August	4.1	5.5	3.0	2.7	
September	3.5	5.3	2.8	2.0	
October	1.8	5.8	2.9	2.0	
November	2.8	3.7	3.4	2.2	
December	3.5	1.7	3.3	2.2	
Average	**3.1**	**5.2**	**2.2**	**3.0**	**2.5**

Source: INSTAT.

Annual inflation rate of January got away from relatively low rates recorded over the second half of 2004, due to power price rise by 25.7 percent. February and March went on being featured by negative rates of foodstuff prices and by a smoothing of inflationary pressures caused by managed price movements. During the first quarter of the year fiscal policy did not exert inflationary pressures, while the base interest rate cut by 25 percentage points by the Bank of Albania, at end of March, was based on the performance and expectations for controlled levels of inflation and monetary indicators.

Chart 1. Annual inflation (in percentage).



The exchange rate, which went on scoring points in favor of the lek even during the first quarter of the year, was another factor that impacted positively on absorption of inflationary pressures by import prices.

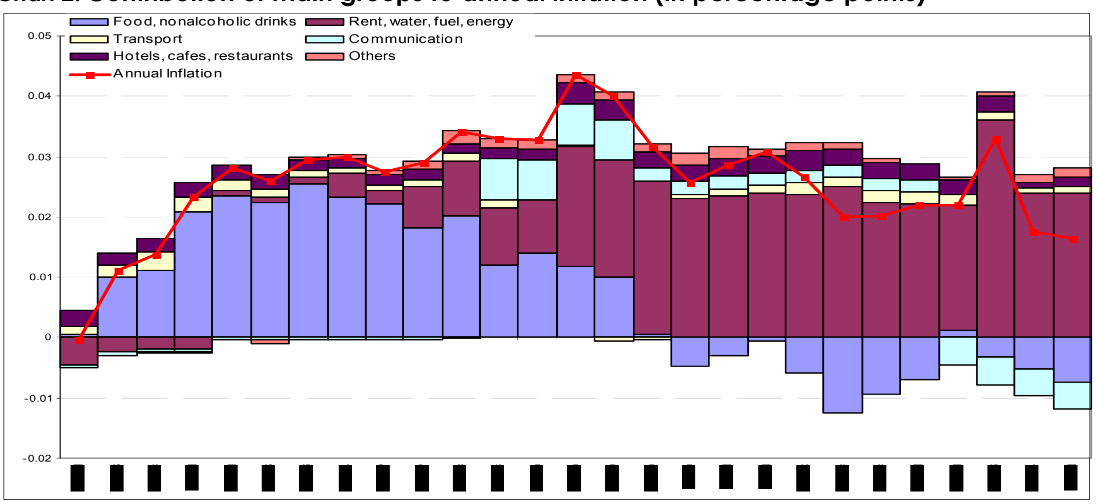
II.1 INFLATION AND CONSTITUENT GROUPS

March of 2005 was characterized by further reduction of annual inflation (1.7 percent), while on a monthly basis the consumer prices did not mark any change in comparison to February. Consumer price developments continue to be determined significantly by inflation performance of groups "Rent, water, fuels, energy", "Foodstuff and non-alcoholic beverages" and "Communication" (Chart 2).

For about ten months (May' 04 – March' 05), excluding December 2004, the group of "Foodstuff and non-alcoholic beverages" has recorded negative annual inflation rates, marking downward pressure on overall consumer price index. Lower foodstuff prices were due to better situation in agricultural market. On the other hand, exchange rate developments and lower prices of these products in partner markets have facilitated their reduction.

The group "Foodstuff and non-alcoholic beverages" contributed by – 0.7 percentage points to annual inflation of March, marking a turning point of the trend in comparison to previous March, when the contribution of this group to annual inflation rate was 2.3 percentage points.

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



While the group "Foodstuff and non-alcoholic beverages" exerted downward pressure on overall price level, the group "Rent, water, fuels, energy" went on increasing annual inflation rate even during the first quarter of 2005. The group "Rent, water, fuels, energy" contributed by 2.4 percentage points to formation of annual inflation rate over March. High annual growth rates were recorded almost in all sub-groups of this group (Table 2).

Table 2. Contribution to sub-groups inflation of the group "Rent, water, fuels, energy"

	Annual inflation	Contribution in (pp)
Rent, water, fuels, energy	9.9	2.4
1. Rent	5.9	0.1
2. Imputed rent	5.9	0.9
3. Fuels, energy	22.7	1.3

Inflationary pressures given by this group are counterbalanced not only by food price cuts on annual basis but also by negative inflation rate of the group "Communication". The "Communication" group has exerted a downward impact on inflation rate for the period of '04 – March'05, providing a stable negative contribution by – 0.5 percentage points.

The effect of fixed phone tariffs change is expected to diminish in April of this year, implying that after March, the contribution of inflation of this group will no longer be negative.

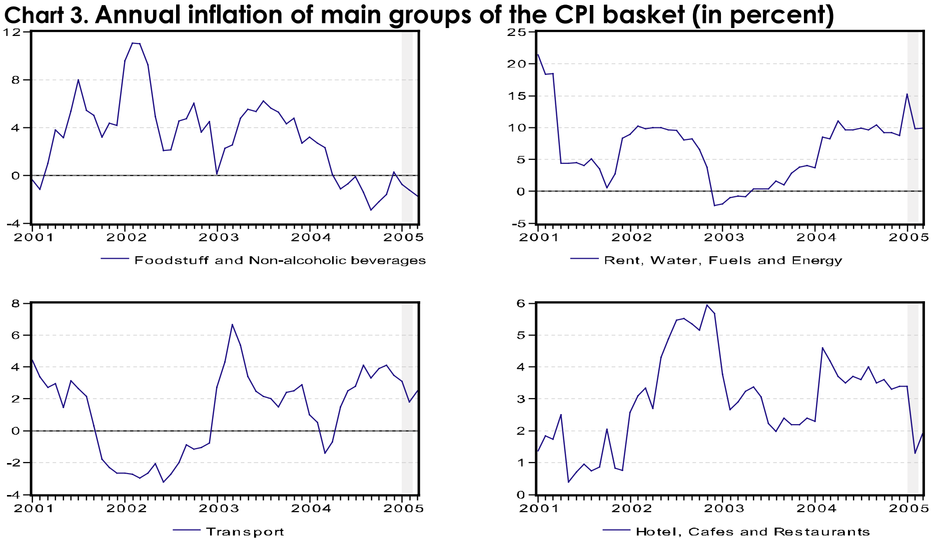
Prices of other groups of consumer basket fluctuated moderately, without causing changes in inflation structure. These groups provided a contribution of 0.3 percentage points to annual inflation of March (*Table 3)*.

Table 3. Annual inflation, monthly inflation and contribution of main groups

	Inflation in (%)		Contribution in (pp)	
	Monthly	**Annual**	**Monthly**	**Annual**
Foodstuff and non-alcoholic beverages	-0.2	-1.7	-0.1	-0.7
Rent, water, fuels, energy	0.0	9.9	0.0	2.4
Communication	0.0	-24.4	0.0	-0.5
Others			0.04	0.3
- Transport	0.8	2.5	0.04	0.1
- Hotels, cafes and restaurants	0.6	1.9	0.00	0.1
Total	4.0	1.6	4.0	1.6

Among these groups, it is worth mentioning the "Transport" and "Hotels, cafes and restaurants" groups. Annual inflation of "Transport" group was impacted by price rise of the subgroup "Services to personal vehicles"[1], which marked an annual and monthly inflation respectively of 7.3 percent and 1.6 percent. Oil price rise is assessed to have impacted on the inflation of this group.

Chart 3. Annual inflation of main groups of the CPI basket (in percent)



II.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

Annual inflation of March went on being below the lower limit of 2-4 percent targeted band for the second consecutive month. In general, during the first quarter of the year,

[1] This group includes even the oil price for vehicles.

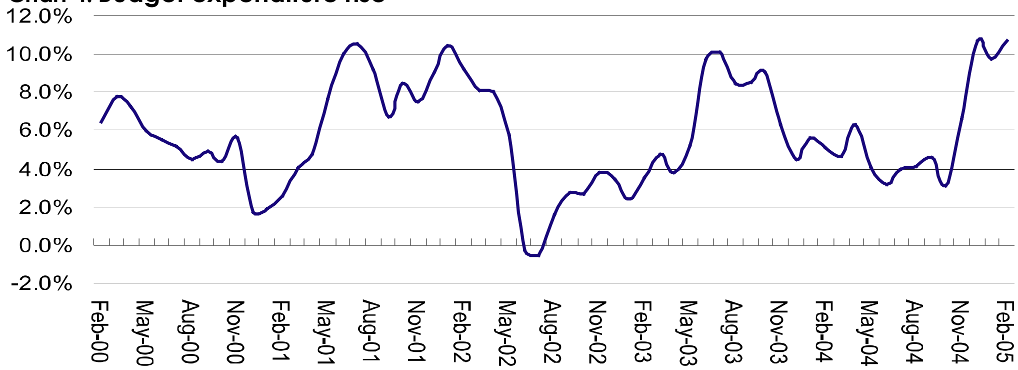
developments in demand and supply factors did not exert inflationary pressures. February and March, unlike January, were not characterized by important structural changes, which might have resulted in obvious consumer price fluctuations.

II.2.1 Demand factors

During March of this year, demand factors enabled the creation of a favorable climate for keeping inflation rate under control, without exerting inflationary pressures.

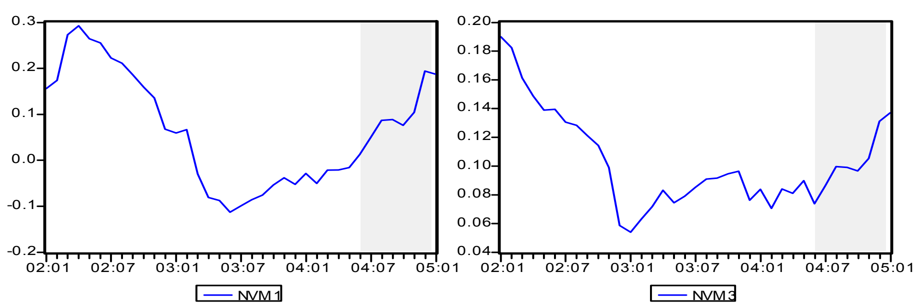
Fiscal policy and fiscal indicators Year 2004 was characterized by a mature fiscal policy. Overall expenditures did not exceed the annual plan and their growth in December was also within the projections. Also, further to the tradition created, year 2005 has started relatively as a tranquil one, leaving the place to February when a monthly rise was recorded in budget expenditures. Personnel expenses marked a monthly rise of 20 percent, while capital expenses also increased obviously during this month. This rise has made the total expenditures surpass the plan by 2.5 percent over two months. Even though it is estimated at the moment that this rise in expenditures has not exerted inflationary pressures, budget expenditures should be treated prudentially over the coming period, particularly in the framework of elections of this year.

Chart 4. Budget expenditure rise



Monetary policy and monetary indicators The Bank of Albania continues to pursue a smoothing monetary policy, which is reflected in controlled base interest rate cut. Though in its historical minimum, this rate, due to low inflation, meaning positive interest rates in real terms, continues to be an attractive means for absorbing free funds and for concentrating them in the banking system. This development is evidenced even by decline of currency outside banks to M3 ratio. Also, growth of money supply, though higher than at end of 2004, is estimated as non-problematic, without ruining macroeconomic equilibriums and without providing incentives for inflation rise.

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



Exchange rate. During March, developments in exchange rate maintained the same lek appreciation trend, though in slower paces. In this month, the lek was appreciated in annual level by 9.8 percent and by 3.1 percent in comparison to the dollar and euro. The lek appreciation operates as an anti-inflationary factor, reducing import goods prices in domestic currency.

Other indicators of domestic demand. Domestic demand rise[2], good situation in retail market[3], as well as wage rise in public sector did not generate inflationary pressures in the country.

II.2.2 Supply factors

During March of this year, the supply factors provided a stabilizing effect on consumer price performance, without misbalancing macroeconomic indicators stability.

Imported inflation. Low inflation rates in main partner countries of trading exchanges speak for an external economic-trading environment with non-inflationary tendencies. Given that our economy is import oriented, the lack of inflationary pressures conveyed through this channel, allows the formation of inflation rate as a consequence of operation of domestic factors.

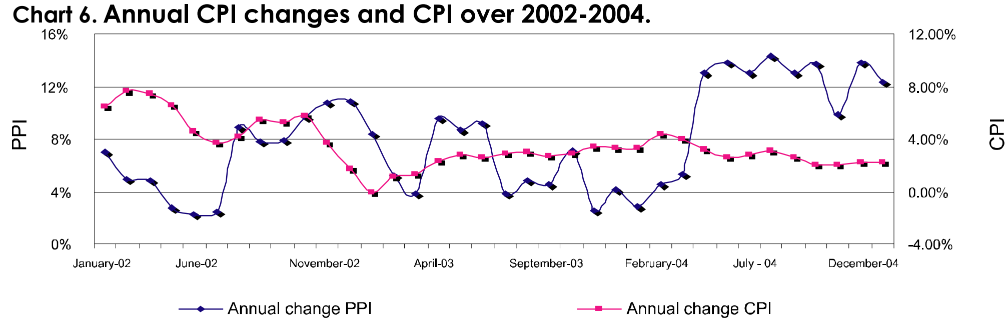
Table 4. Annual inflation of main trading partners (in percentage)

	June	Sept	Octob	Novemb	Decemb'04	Jan' 05	Febr
Greece	3.0	2.9	3.3	3.2	3.1	4.2	3.2
Italy	2.4	2.1	2.1	2.0	2.4	2.0	2.0

Source: Eurostat News Release.

Performance of domestic agricultural production. Good situation in agricultural produce market has favored food price cuts. The most plentiful agricultural produce of 2004, which was mainly due to rise of investments in greenhouses, constituted a domestic factor, which, combined with external factors such as the downward trend of food prices in foreign market and the lek appreciation versus the euro and dollar, led to reduction of food prices and of overall inflation in the country. Though even in March the annual inflation rate was conditioned mainly by high annual inflation of the group "Rent, water, fuels and energy", the food prices cut has served as an equilibrating factor, exerting falling pressure on total annual inflation rate.

Chart 6. Annual CPI changes and CPI over 2002-2004.



Oil prices. Oil price rise in international markets was a potential risk to the country's inflation, either during 2004 or during this quarter. As it has already been explained even in previous reports, a number of factors diminished the full reflection of this growth. The small weight this

[2] Estimated by retail sales index, which marked an annual growth of 14.6 per cent over the fourth quarter of 2004.
[3] Over the fourth quarter of 2004, the index of retail sales volume recorded an annual growth of 16.4 per cent.

product occupies[4] in consumer basket, the lek appreciation against the dollar and the adjustment of country's demand for this product[5], have hindered the full transmission of price rise of this product to domestic market. Annual inflation of the "Transport" group was 2.5 percent in March, being a little higher than the one recorded in February, but lower than the annual inflation of January.

III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

III.1 MONETARY POLICY AND QUANTITATIVE OBJECTIVES

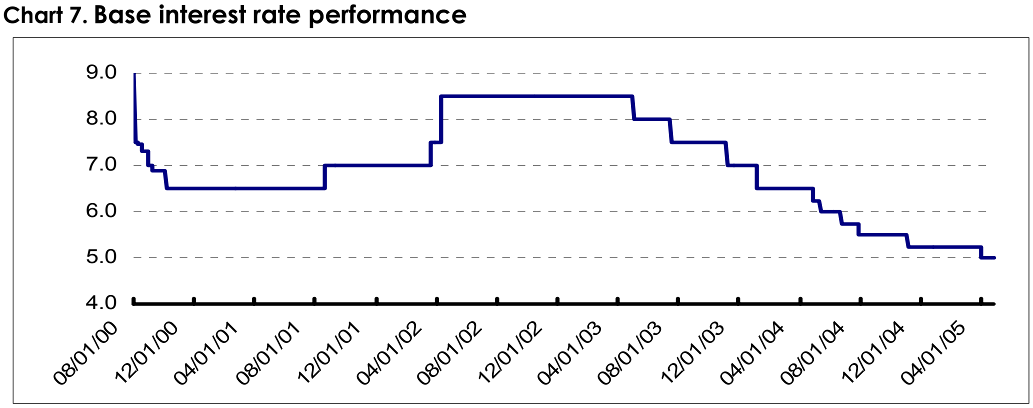
Further to easing monetary policy followed during the past year, the Bank of Albania impacted on further smoothing of monetary policy in February and March. This policy was based on low actual inflation levels and on optimistic forecasts for its performance in the future. Also, the monetary easing during this period was based on favorable reaction of monetary indicators, reflected in the controlled performance of equilibriums and growth rates of monetary aggregates.

Even during February – March of this year, the Bank of Albania transmitted its monetary policy through operations for managing liquidity in interbank market. Unlike the same period of the previous year, the Bank of Albania accommodated the seasonal growth of excess liquidity, making possible only its temporary withdrawal by means of weekly repo instrument.

Permit of high liquidity levels in the banking system was aimed at exerting pressure for interest rate cuts in money market. Responding to this policy, interest rates of treasury bills and deposits in lek of all maturities declined. Along liquidity pressures, interest rate cut reflected even the stabilization of inflationary expectations, as a result of price stability over the last months. This fact made interest rate cuts be particularly obvious for long term maturity instruments, bringing about the smoothing of interest rates time curve.

The latest data on inflation and current and expected economic developments indicate that inflationary pressures are low and oriented mainly to supply side. Based on this estimation, the Bank of Albania decided to undertake another easing step in monetary policy by cutting the base interest rate by 0.25 percentage point at end of March. The decision on base interest rate cut took into account the need of adjusting the current monetary conditions to inflation target in the presence of positive monetary indicators performance.

Chart 7. Base interest rate performance

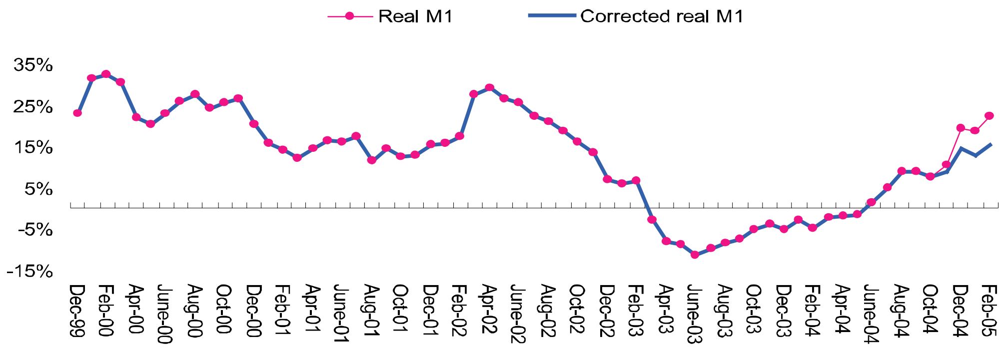


[4] The subgroup of "Services to personal means of transport", including the oil price, has a weight of 1.6 per cent in the CPI basket.
[5] During 2004 the oil import in the country declined by 2.4 per cent in comparison to 2003.

Performance of monetary indicators during February was characterized by further shifting of money supply towards longer term assets. The ratio of currency outside banks at end of February reached to 25.4 percent, marking its lowest historical level.

This development has enabled a controlled rise of liquidity in economy. Though the annual growth rate of M1 aggregate reflected a growing trend in real terms, the value of this indicator in February resulted slightly below the programmed level.

Chart 8. Annual growth of M1 aggregate in real terms*



*Series of M1 aggregate data is corrected with the deposits reclassification effect by Raiffeisen Bank.

Developments in foreign exchange market speak for a stability of the lek value against the main currencies, euro and usd. Therefore, the contribution of "exchange rate" factor to monetary indicators performance during February and March was almost neutral.

The latest base interest rate cut is expected to be reflected in interest rate cuts of Treasury bill market, lek deposit and lending market. The easing of monetary conditions will serve as a factor encouraging economic activity growth in the future.

Monetary policy pursued by the Bank of Albania made possible the meeting of its quantitative objectives until February.

Table 5. Meeting of quantitative objectives of the Bank of Albania

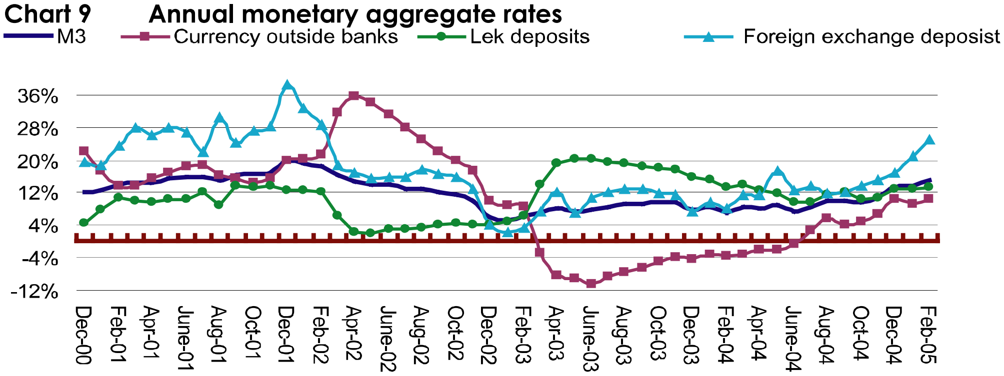
	June 04	Sept. '04	Dec. '04	Jan. '05	Feb. '05
Net international reserves of the Bank of Albania (in million dollars)					
Objective	765.8	923.7	941.7	985.3	1,029.0
Actual	961.5	1043.6	1,105.2	1,108.8	1,108.7
Difference	195.7	119.9	163.5	123.5	79.7
Net domestic assets of the Bank of Albania (in billion leks)					
Objective	85.0	70.0	79.0	73.1	67.2
Actual	54.7	55.4	61.0	56.3	56.5
Difference	-30.3	-14.5	-18.0	-16.7	-10.7
Net domestic credit to government (in billion leks)					
Objective	270.1	279.1	286.4	288.3	290.2
Actual	263.6	272.0	286.1	286.9	289.4*
Difference	-6.5	-7.1	-0.3	-1.4	-0.8

* Operative data

III.2 MONETARY AGGREGATES – MONEY SUPPLY

In February the monetary indicators marked higher growth rates compared to the previous month. The annual growth rate of money supply for February reached 15.1 percent, compared to 13.7 percent resulted at the end of January. The growth of money supply was mainly supported by the increase of foreign currency deposits, while the annual rate of M2 aggregate reflected a slight rise due to the moderate performance of Government demand for money. The developments in the time structure of money supply are characterized by its shifting toward less liquid assets, this being reflected in the further reduction of currency outside banks ratio to M3. On the other hand, the relatively faster increase of foreign currency deposits against the other components of M3 is followed by the rise of the foreign currency weight component of money supply.

Chart 9 Annual monetary aggregate rates



Money supply marked a monthly growth of about Lek 5.1 billion or 1.0 percent during February. Deposits in foreign currency have given the main contribution to this increase, resulting in a monthly rise of Lek 2.6 billion or 2.1 percent. The annual growth rate of foreign deposits, in February, raised significantly to 24.8 percent, from 21.1 percent resulted in the previous month.

Lek appreciation, compared with the same period of the previous year, has negatively impacted on the annual growth rate of foreign deposits. The performance of foreign deposits, due to the lack of exchange rate impact, is characterized by an upward trend, marking a high real annual growth of 32.3 percent.

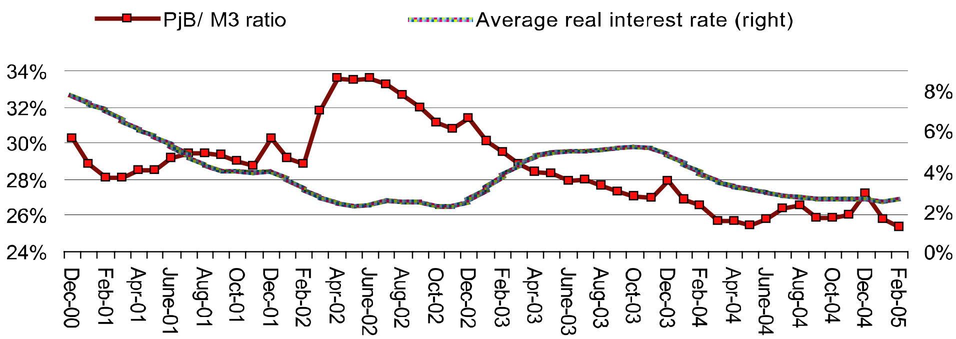
The high growth rate of foreign deposits has mainly reflected the faster increase of time deposits in foreign currency of individuals, which represent nearly 58 percent of total deposits in foreign currency. The high flow of foreign currency deposits from individuals is an evidence of the increase of public confidence in the banking system. The increasing interest rates in US dollar have encouraged the investment in foreign currency deposits.

The significant growth of demand deposits in foreign currency of the private sector is also highlighted as a particular development of February. These have contributed by 35 percent to the monthly increase of total deposits in foreign currency.

The indicator of currency outside banks marked a monthly decline of Lek 0.8 billion. However, the annual growth rate of currency outside banks in February slightly increased from 9.1 percent to 10.1 percent, mainly due to the highest annual rise of money supply in Lek, the M2 aggregate.

Currency outside banks has continued to be channeled in the banking system in a satisfactory way, supported by the stable performance of real interests in Lek. This trend is also encouraged by the channeling of public administration salaries in the banking system. The ratio of currency outside banks to M3, in February, declined to 25.4 percent, marking a fall of nearly 0.4 percentage points from the rate of the previous month.

Chart 10 Ratio of CoB to M3 and average real interest rates (right scale)

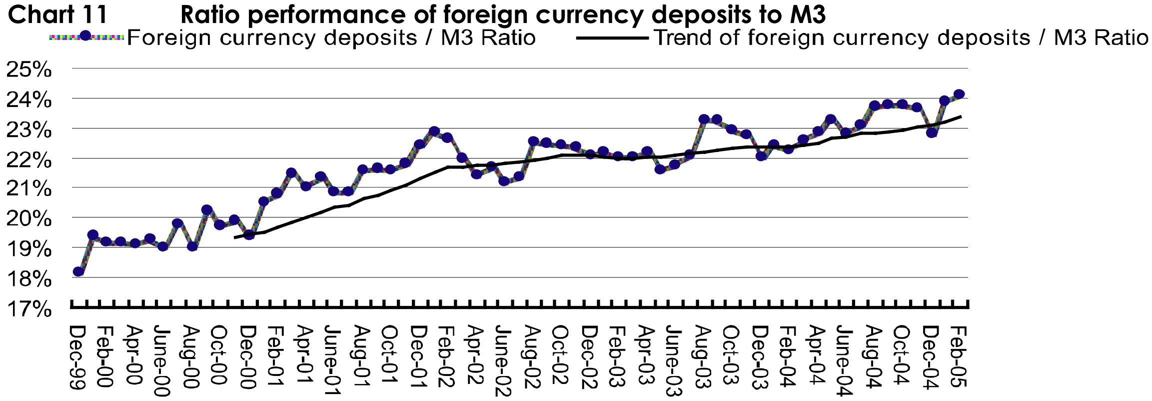


The growth of M2 aggregate and the channeling of currency outside banks in the banking system are reflected in the growth of Lek deposits. Their annual growth rate in February increased by 13.4 percent, from 12.9 percent resulted in the previous month. Lek deposits growth is particularly reflected in the positive performance of time deposits in Lek of individuals, which have recorded a rise of Lek 3.3 billion[6] or about 94 percent of the monthly increase of total deposits in Lek.

Notwithstanding the decline of nominal interest rates in Lek, the growth of deposits in Lek is estimated as satisfactory and reflects the increase of confidence in the domestic currency and in the real positive interest rates as well. The time structure of Lek deposits has known an unusual increase of demand deposits contribution, due to the shifting of the public sector deposits from time deposits to demand deposits, at about Lek 1.5 billion. This progress, along with the highest annual rate of currency outside banks, has affected the rise of annual rate of the most liquid aggregate – M1.

The annual growth rate of this indicator, in February, reached 22.3 percent or 3.5 percentage points higher than in the previous month[7]. The highest growth rate of foreign currency deposits against a normal performance of monetary assets in Lek is reflected in the growth of their weight in the money supply. Following the upward long-term trend, the ratio of foreign deposits to M3 rose by 24.1 percent in February.

Chart 11 Ratio performance of foreign currency deposits to M3



[6] Calculated excluding the effect of the shifting of time deposits in Lek to demand deposits from the "Raifffeisen"bank, in February, at about Lek 1 billion.

[7] M1 growth is affected by the reclassification, since November, of LEK deposits according to maturity from the "Raiffeisen" bank. In absence of this effect, the annual M1 rate would result 15.6 percent or 2.7 percentage points higher than in January.

Table 6 Performance of monetary indicators (in billions of Lek)

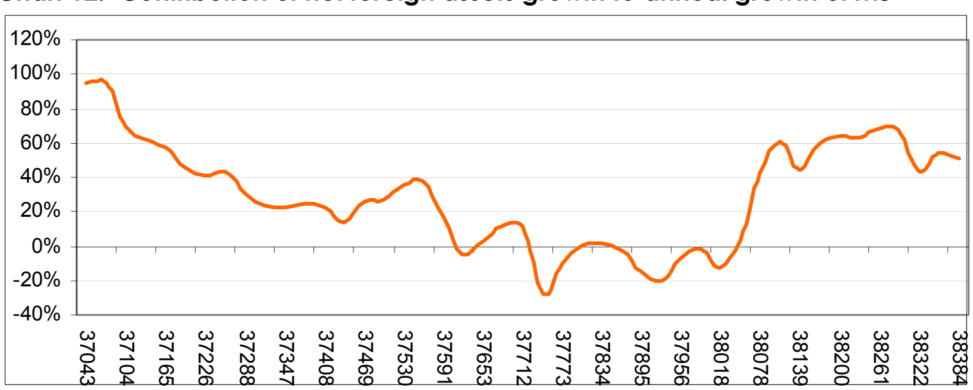
	February	Monthly change		Annual change	
	2005	Absolute	Percentage	Absolute	Percentage
Currency outside banks	132.0	-0.8	-0.6	12.3	10.2
Total deposits	388.0	6.0	1.6	55.9	16.8
- in Lek	262.5	3.4	1.3	31.0	13.4
- in foreign currency	125.5	2.6	2.1	24.9	24.8
Demand deposits	85.8	3.3	4.0	26.8	45.4
- in Lek	39.4	2.4	6.4	18.9	92.6
- in foreign currency	46.4	1.0	2.1	7.9	20.4
Time deposits	302.2	2.6	0.9	29.1	10.7
- in Lek	223.1	1.0	0.4	12.0	5.7
- in foreign currency	79.1	1.7	2.1	17.1	27.5
M1	171.4	1.5	0.9	31.2	22.3
M2	394.5	2.5	0.6	43.2	12.3
M3	520.0	5.1	1.0	68.2	15.1
Monetary base	174.5	0.1	0.1	18.7	12.0

III.3 ECONOMY DEMAND FOR ASSETS

III.3.1 Net Foreign Assets

The annual growth of net foreign assets in February has contributed by 50.8 percent to the annual growth of money supply. The contribution of foreign assets has fallen again in February following the rise of January.

Chart 12. Contribution of net foreign assets growth to annual growth of M3

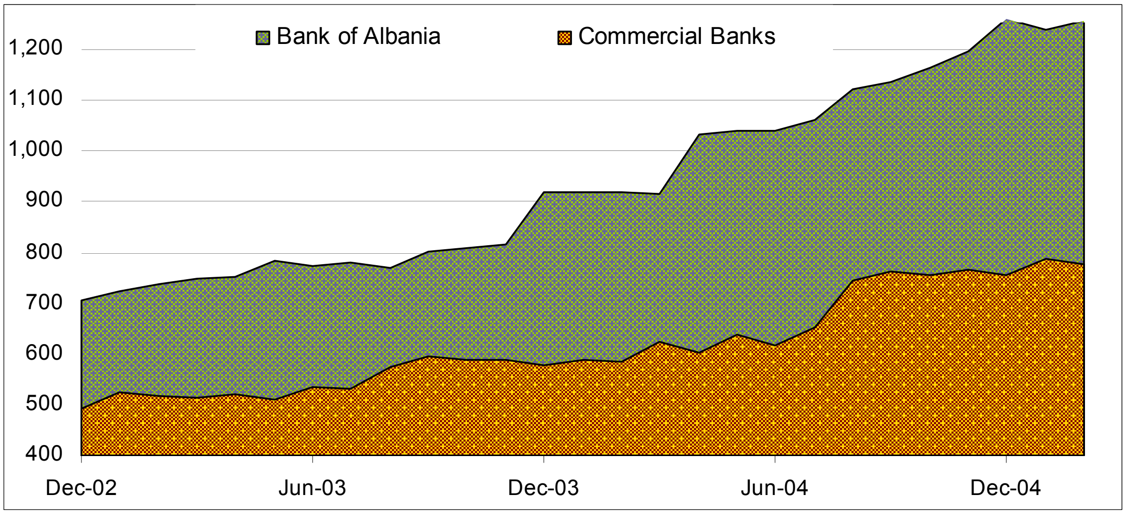


In total, the monthly growth of foreign currency assets of the banking system for February amounted to USD 4.4 million. The rise of USD 15.8 million of net foreign reserve of the Bank of Albania has covered the fall of USD 11.3 million in foreign currency assets of the commercial banks. The highest increase of net foreign currency reserve of the Bank of Albania is noted in the demand to foreign governments.

The Euro appreciation against US dollar, at about 1.6 percent, has impacted the foreign reserve of the Bank of Albania, increasing the value of Euro investments denominated in US dollar.

Foreign assets of the banking system resulted to drop to about USD 11.6 million, excluding the effect of exchange rate. This fall is due to the decline of net foreign assets of commercial banks by USD 15.3 million and to the rise of these assets for the Bank of Albania by USD 3.7 million.

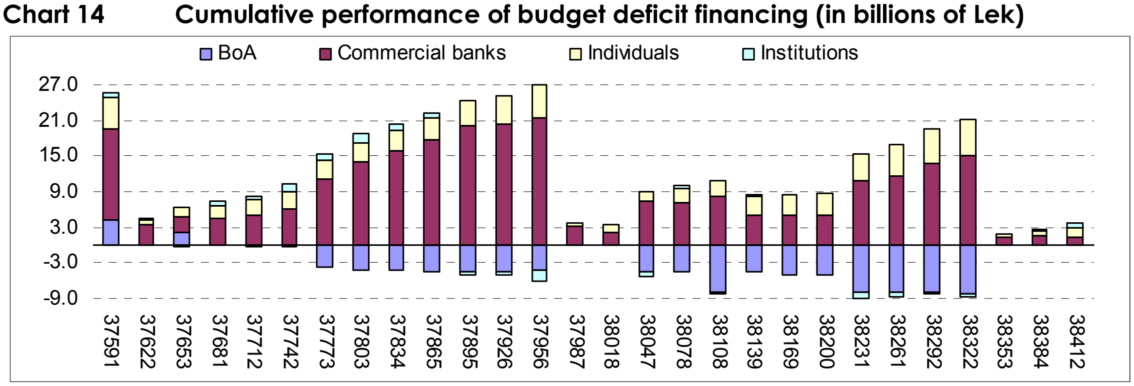
Chart 13 Net foreign assets rate of the banking system



III.3.2 Government Demand for Monetary Assets

Like in every beginning of the year, government demand for monetary assets appeared to be a moderate one. From a budget surplus resulted in January, February recorded a budget deficit estimated at Lek 2.4 billion. The total financing of budget deficit up to February amounted to Lek 1.3 billion[8]. The main way of financing, for this month, has been the issuance of two-year bonds estimated at Lek 1.2 billion. The issuing of Treasury bills resulted to be low and Treasury bills portfolio was characterized by a fall in February, of Lek 0.1 billion. The commercial banks reduced their Treasury bills portfolio by about Lek 1 billion, while households, institutions and the Bank of Albania have slightly increased their respective portfolios.

Chart 14 Cumulative performance of budget deficit financing (in billions of Lek)



[8] The difference between the budget deficit and the domestic financing of budget deficit represents the statement of account of the Governmnet with the Bank of Albania.

III.3.3 Credit to economy from the banking system

Credit to economy during the first two months of the year showed a positive progress. Balance of credit increased by about Lek 6 billion reaching the level of Lek 76 billion. February of this year was presented as the period of the highest growth of credit balance, of about Lek 4 billion. This change reflects not only reflect the tendency of banks to extend more credit, noted throughout 2004, but also shows the stability of the recent tendency to credit in long-term maturity. The balance of both medium-term and long-term credits, by the end of February, represents about 66 percent of total credit. The strengthening of bank-client relationships is growing the confidence of banks to further invest in the lending activity through increasing their role as financial mediators.

Table 7 Indicators of credit balance to the total (in percentage)

	2002	2003	2004	January '05	February '05
Credit balance in billions of Lek	38.7	50.7	70.0	72.0	76.0
Short-term credit	53.8	46.0	34.0	32.0	34.0
Medium-term credit	30.1	33.3	36.0	35.0	35.0
Long-term credit	16.1	20.7	30.0	33.0	31.0
Lek	21.3	19.6	20.0	20.0	20.0
Foreign currency	73.7	80.4	80.0	80.0	80.0

Sectoral distribution of credit to economy during the first two months of the year shows that banks' preference toward production sectors is being consolidated. During the last months it is noted the tendency to reduce credit portfolio for trade, while credit balance granted to less developed branches of the economy, as processing industry and agriculture, has been increasing. In total, about 25 percent of the new credit to economy is given to these two sectors.

Table 8 Credit balance by economy sectors (in percentage)

		2002	2003	2004	January '05	February '05
1	Agriculture, hunting and silviculture	0.8	1	1.5	1.4	1.5
2	Fishing	0.2	0	0.1	0.1	0.2
3	Extracting industry	0.2	1	0.3	0.2	0.8
4	Processing industry	17.0	17	17.1	15.5	16.1
5	Electricity, gas and water production and distribution	3.3	3	2.8	4.1	3.2
6	Construction	8.6	10	9.8	9.6	11.3
7	Trade, automobile and home items repairing	40.4	34	23.3	21.3	19.9
8	Hotels and restaurants	6.0	6	8.3	7.5	5.3
9	Transport and telecommunication	2.4	1	2.0	1.9	1.8
10	Financial activities	-	0	0.2	0.4	1.1
11	Real estate	9.1	13	9.8	16.7	14.8
12	Health and social activities	0.5	0	0.5	0.4	0.4
13	Social, personal and collective services	4.2	8	4.8	6.4	6.7
14	Other	7.3	4	19.3	14.4	17.1
	Total	100	100	100.0	100.0	100.0

III.4 MARKETS AND INTERST RATES PERFORMANCE

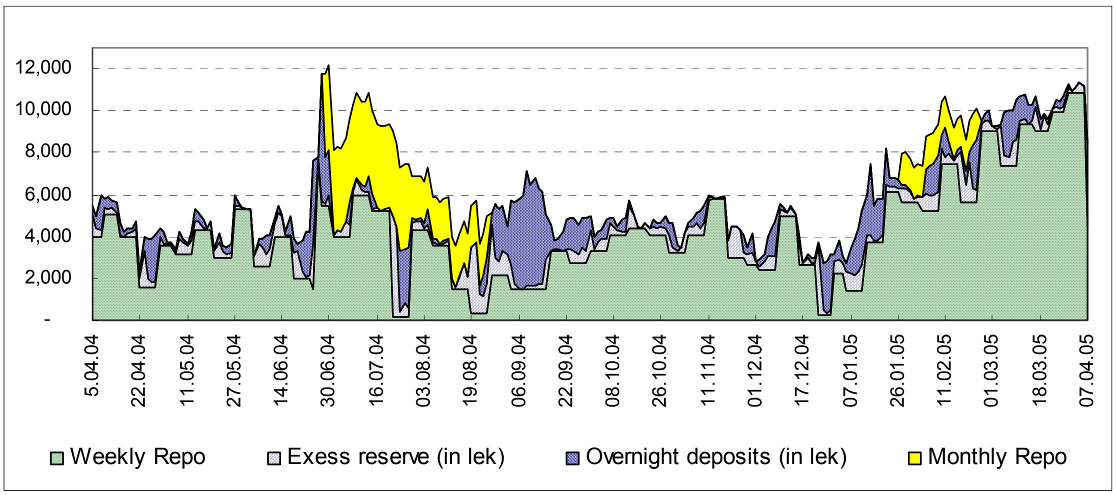
III.4.1 Liquidity performance

The first three months of the year are characterized by a considerable and increasing excess liquidity in the banking system. The reasons of this rise were the channeling of currency outside banks and the growth of Lek deposits in the banking system, as well as the low demand of Government for financing, these tendencies being observed in every beginning of the year. The daily average level of liquidity for March was estimated at Lek 10.2 billion, from Lek 9.3 billion resulted in February.

The most employed instrument to withdraw liquidity continued to be the one of weekly repos, with fixed price and unlimited amount. The daily average level of the weekly repo for March was Lek 8.9 billion, from Lek 6.5 billion resulted in February.

Overnight deposit has been less used during this month compared to the previous month. The average value invested in overnight deposits for March was Lek 0.72 billion, from Lek 0.79 billion. Under these conditions of excess liquidity, the facility of overnight deposits is rarely used. The daily average of overnight credit resulted to be Lek 3 million, from Lek 8 million in the previous month.

Chart 15 Banking system liquidity level (in millions of Lek)



The short-term needs for liquidity are supplied in the interbank market. The average level of transactions for March in this market recorded the value of Lek 0.69 billion or Lek 0.08 billion more than in the previous month.

The weekly average investment in government securities, Treasury bills and two-year bonds for the month of March amounted to Lek 11 billion, resulting Lek 3.47 billion more than in the previous month. Notwithstanding the growth of securities investment the average ratio of the earned amount to the total provided from the participants, in government securities' auctions, for the month of March, was 62.7 percent, from 67.7 percent resulted in February.

Excess liquidity growth in this market is also supported by the reduction of deficit financing with Treasury bills from commercial banks[9]. Meanwhile, the demand to invest in government securities has impacted the increase of competitiveness and the fall of their yields.

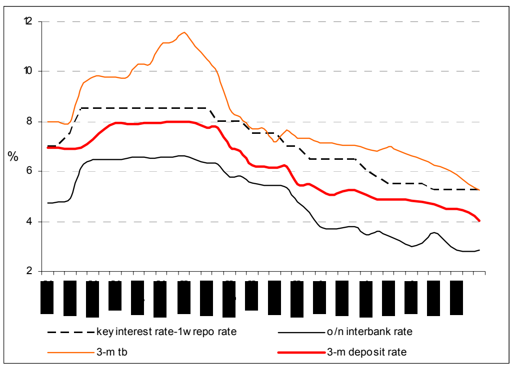
[9] Mature investments have exceeded the value of new investments.

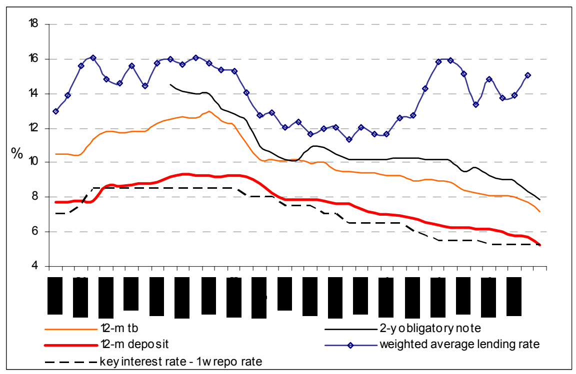
III.4.2 Interest rate performance

The interest rates in Lek have continued to decline in the money and deposits market during March, but not in that of credit. The fact that credit interest rates have moved to the opposite side with the general trend, might be an indicator of low competitiveness and of loan concentration in the hands of particular borrowers. Furthermore, the major part of credit is granted in foreign currency, which considerably weakens the efficiency of this important channel for the transmission of monetary policy. The expansion of credit market in Lek will naturally raise the degree of banking system reaction to credit interest rates in Lek. Presently, banks are likely still indifferent to the crediting alternative in Lek.

Under the conditions of a low inflation rate and of an excess liquidity in the market, the easing of monetary policy being reflected through the cut of the core interest rate by 0.25 percentage points (from 5.25 to 5.00 percent) was considered as a move that would not jeopardize the inflation target and the market position.

Chart 16 Interest rates in Lek





In the interbank market, the interest rates of overnight transactions that cover the main weight in this market fluctuated within the 2.70 – 3.00 percent range. These values have been close to those of February and January, while the further reduction of core interest rate is expected to impact the decline of the rates applied by this market.

Interest rates dropped more significantly in the primary market. The highest change is noted in the Treasury bills yield of twelve-month maturity, which by the end of March declined to 7.14 percent or 0.60 percentage points lower than the yield of the end of February. The value of twelve-month yield by the end of March is 0.97 percentage points lower, compared to December. The decline of yield is even deeper regarding the two-year bonds. In March, the yield lowered to 7.85 percent, from 9.00 percent in December.

The interest rates of deposits in Lek also reduced compared to Treasury bills yield. The interest rate of twelve-month deposits, at the end of February, was 5.72 percent or 0.09 percentage points lower than that of January and 0.27 percentage points lower than that of December. The cut of interest rates for Lek deposits has not depreciated the savings, as these last ones are supported by the low rate of inflation.

The real interest rate for twelve-month deposits in February reached 3.95 percent, while in January[10] this rate recorded 2.52 percent and 3.79 in December. The preliminary data of

[10] In January, the cut of real interest reflected the rise of the administered prices that led to the increase of inflation rate by 3.3 percent.

March show a further cut of interest rates for Lek deposits. According to these data, the annual interest rate has lowered to 5.24 percent and real interest rate to 3.58 percent.

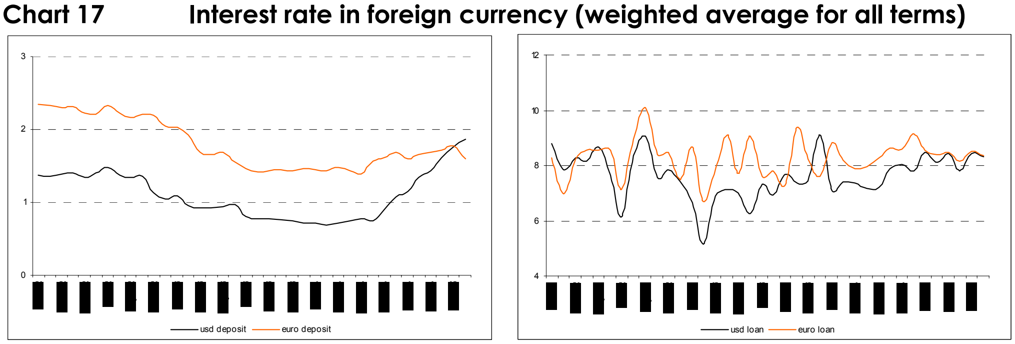
Table 9 Lek interest rates (in percentage)

	December' 04	January' 05	February' 05	March' 05
Interbank market				
Overnight	3.18	2.84	2.82	**2.84**
One-week	5.76	5.55	5.40	**5.40**
Primary market				
3-month	6.09	5.85	5.50	**5.24**
6-month	7.22	7.11	6.97	**6.51**
12-month	8.11	8.04	7.74	**7.14**
Two-year bonds	9.00	8.95	8.35	**7.85**
Deposits market				
1-month	3.39	3.55	3.68	
3-month	4.48	4.49	4.36	**4.02***
6-month	5.41	5.36	5.18	**4.79***
12-month	5.99	5.81	5.72	**5.24***
Weighted average	5.00	5.06	4.95	**4.75***
Credit market				
0-6 month	10.98	11.82	12.39	
6-12 month	13.73	14.91	14.45	
1-3 year	20.42	16.69	19.69	
Over 3 – year	12.89	13.57	12.87	
Weighted average	**13.71**	**13.88**	**15.03**	

* Preliminary data.

The average weighted rate of credit in Lek rose by 15.03 percentage points in February, resulting 1.15 percentage points higher than the rate of January. This indicator does not show any obvious trend, but it fluctuates from a month to another based on the weight that covers the portfolio of a certain bank or the maturity in the credit extended in the considered period. Regarding the foreign currency, the interest rates in our banking system follow the developments that occur in the international market and specifically, both LIBOR and EURIBOR interest rates. The average interest rate of deposits in USD increased by 1.86 percent or 0.10 percentage points more than in January and 0.25 percentage points more than in December. The opposite occurred with deposits rates in Euro. For them, the average weighted rate reduced by 0.19 percentage points compared to January and by 0.12 percentage points compared to December, coming down to 1.59 percent.

Chart 17 Interest rate in foreign currency (weighted average for all terms)



Interest rates for the credit extended in USD and Euro reached approximately equal values. The average weighted rate of credit in USD resulted to be 8.32 percent in February, or 0.12 percentage points lower than in the previous month. The Euro interest rate resulted to be 8.35 percent or 0.16 percentage points lower than in January.

III.4.3 Exchange rate

The foreign exchange market has been relatively quiet during the first months of the year. In these months it is noted a restriction of the tendencies being reflected on the exchange rate against both the foreign currencies, Euro and USD, up to the end of the year. Notwithstanding the fluctuations, Lek is exchanged at the same levels as those of the yearend 2004, thus avoiding to deepen the appreciation against USD and its depreciation against Euro. Since the beginning of the year Lek is slightly depreciated, by 0.43 percent against the Euro and by 2.55 percent against US dollar, respectively.

For the month of March it is noted a Lek appreciation against Euro estimated at about 0.9 percent. Lek is depreciated against US dollar by 1.07 percent. At the end of March, Lek is exchanged at the rate 125.81 ALL/EUR and 97.15 ALL/USD. Lek, compared to the previous year, continues to be appreciated against both the main foreign currencies. In March, the annual appreciation against US dollar is 9.82 percent, while against Euro is 3.11 percent.

Chart 18 Lek exchange rate performance