

BANK OF ALBANIA

**MONETARY POLICY
MONTHLY REPORT**

MAY 2004

CONTENT

I.	Main developments	2
II.	Inflation in may.....	3
II.1	Inflation and constituent groups	3
II.2	Factors influencing inflation performance	5
III.	Monetary developments and financial markets	8
III.1	Monetary policy	8
III.2	Monetary aggregates	9
III.3	Demand of the economy for money	10
III.3.1	Net foreign assets	10
III.3.2	Government demand for money	11
III.3.3	Credit to the economy	12
III.4	Financial markets and interest rates	13
III.4.1	Financial markets	13
III.4.2	Interest rates	14
III.5	Exchange rate	15

I. MAIN DEVELOPMENTS

- Annual inflation rate in May dropped to 2.6 per cent from 3.2 per cent it was a month ago. The average annual inflation rate was 3.19 per cent.
- The reason behind this fall was the earlier entry of the domestic agriculture production in the market than last year. In addition, the review of administered prices.
- The Bank of Albania eased monetary conditions in April and May. It cut the core interest rate by 0.5-percentage point. This was the result of positive expectations on inflation, which aims at stirring up crediting and the economy activity.
- Second-tier banks made the same move by reducing the core interest rates. During May- June they reduced interest rates of term deposits (Lek) and treasury bills yield
- The slow down of the M2 annual growth rate, which reflected a lower demand from the government and economy for monetary assets in Lek, caused the slight drop of the money supply growth rate in April. However, foreign currency deposits have shown an opposite direction and they have contributed more in the money supply growth.
- The credit balance to the economy increased by Lek 2.6 billion - a growth almost equal to the one of the first quarter. In April, about Lek 10.6 billion were extended or 54 per cent more compared to the same month in 2003.
- Liquidity situation was stable during April-May. It reflected the moderate growth of Lek deposits in Lek and the low demand of the government for funds.
- Lek has been in favorable positions versus usd and euro, underpinned by lower imports and low inflation rates.

II. INFLATION IN MAY

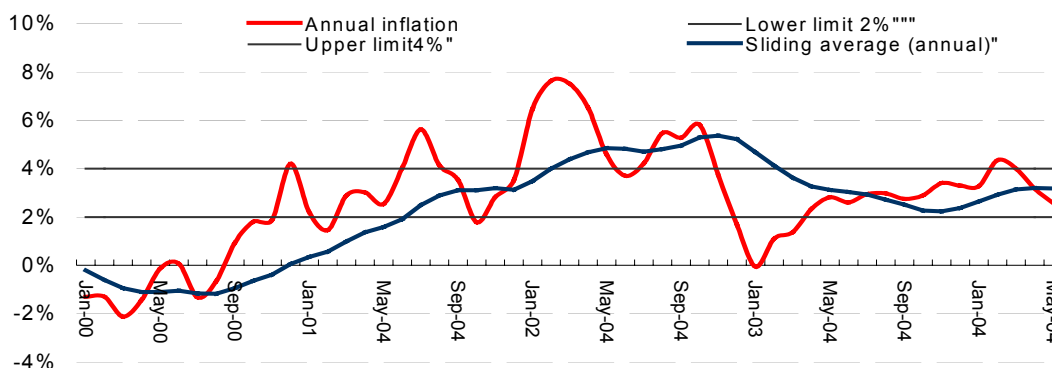
II.1 INFLATION AND CONSTITUENT GROUPS

Annual inflation rate in May dropped to 2.6 per cent from 3.2 per cent it was a month ago. The average annual inflation rate was 3.19 per cent, practically at the same level as in April. The reason behind this fall was the earlier entry of the domestic agriculture production in the market than last year. Consequently, the agriculture production prices fell, and reduced thus by 1.7 percent the monthly inflation (from one year to the other) as well as total inflation. In addition, the review of power and fixed telephony prices and the appreciation of the domestic currency were other factors that brought about the fall of the annual inflation rate.

Table 1. Annual inflation rate (in percentage).

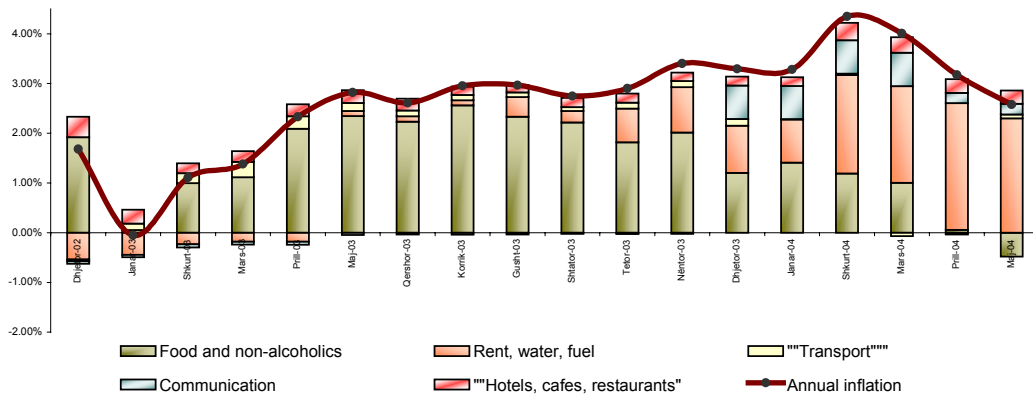
	2000	2001	2002	2003	2004
January	-1.3	2.2	6.5	0.0	3.3
February	-1.3	1.5	7.6	1.1	4.4
March	-2.1	2.9	7.5	1.3	4.0
April	-1.4	3.0	6.5	2.3	3.2
May	-0.1	2.5	4.6	2.8	2.6
June	0.1	4.0	3.7	2.6	
July	-1.3	5.6	4.2	3.0	
August	-0.7	4.1	5.5	3.0	
September	0.9	3.5	5.3	2.8	
October	1.8	1.8	5.8	2.9	
November	1.9	2.8	3.7	3.4	
December	4.2	3.5	1.7	3.3	
Average	0.05	3.1	5.2	2.4	

Graphic 1. Annual inflation (in percentage).



This month's inflation was influenced by the considerable reduction of "Food and non-alcoholics" inflation in May unlike previous months when it was affected by "Rent, water, fuel, energy" group.

Graphic 2. Contribution of main groups in the total annual inflation (in percentage points).



May marked the starting point during which the country’s inflation reflects the seasonal drive of lower food prices because of the domestic production entry. The higher supply of the domestic agricultural production brought down their prices in May. The annual inflation of “Food and non-alcoholics” was -1.1 percent compared to 5.5 per cent it was in May 2003. The contribution given by this group dropped from 2.34 percentage point in May 2003 to –0.48 percentage point in May 2004.

Table 2. Annual inflation of “Food and non-alcoholics”

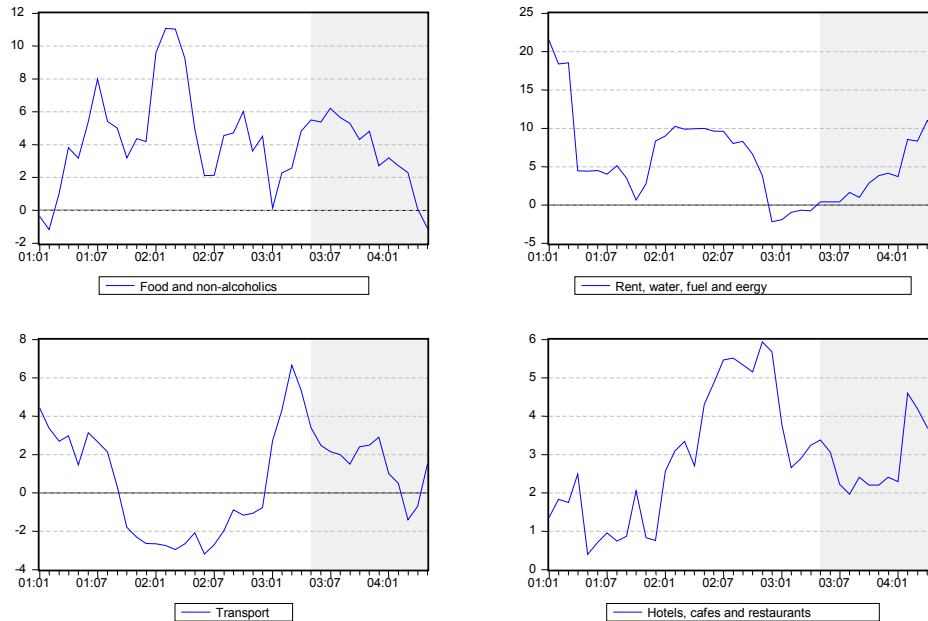
	"Food and non-alcoholics"		"Fruits"		"Vegetables"	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
May'04	-4.2	-1.1	-2.6	6.0	-21.0	-14.8
May'03	-3.0	5.5	7.3	13.1	-18.7	21.3

However, “Rent, water, fuel, energy” group contributed significantly in the annual inflation. Thus, its contribution was 2.3 percentage points. The annual inflation of this group in May was 9.7 per cent; 1.3 percentage point lower than its annual rate in April. The subgroup “Fuel and energy” marked an annual inflation rate of 27.2 per cent – lower than the one in April of 35.1 per cent, and the fall of gas price is deemed to be the cause. The measures taken by relevant state entities on proper standards and trading conditions of this product are believed to have bettered the quality and to have lowered extra costs, bringing thus down its price.

The rise of fuel price was reflected in the rise by 1.5 per cent of the annual inflation of “Transport”. The monthly rate of the subgroup “Services to private transportation vehicles” – including fuel – increased by 2.3 percentage point compared to April. The price of fuel soared in international markets because of the turmoil in the Middle East. Geopolitical tensions are still subject to many uncertainties regarding expected fuel prices and its impact on inflation.

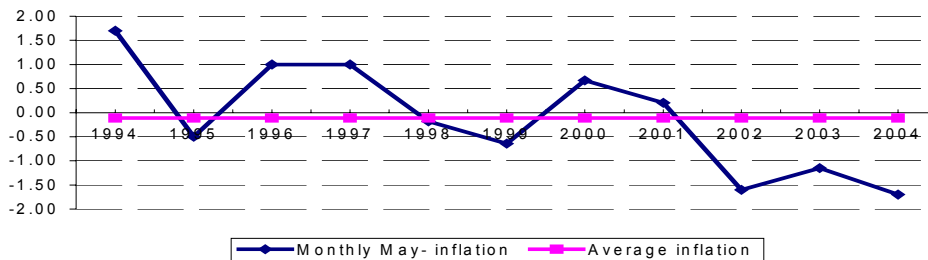
Other groups have been reflecting their seasonal behaviour, without any significant volatility.

Graphic 3. Annual inflation of the four main groups of the CPI basket (in per cent)



The monthly inflation rate of -1.7 per cent is keeping the same trend of these last three years, being thus lower than the historical average.

Graphic 4. May-inflation rates



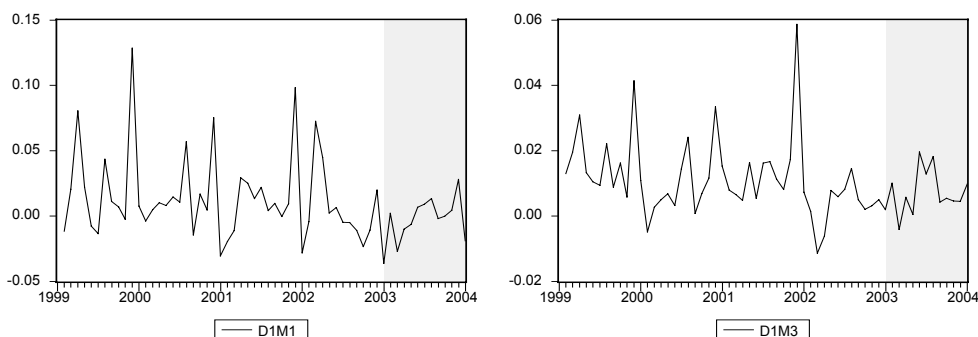
II.2 FACTORS INFLUENCING INFLATION PERFORMANCE

Demand factors have positively influenced in providing a suitable climate for inflation control, and void of negative pressures on it for a long time now.

The Bank of Albania has pursued a careful monetary policy, checking monetary indicators and inflationary pressures on economy. The low core interest rate and, consequently, the low opportunity cost of keeping the money, have raised deposits as to the money supply forecasts. The satisfactory growth of deposits in

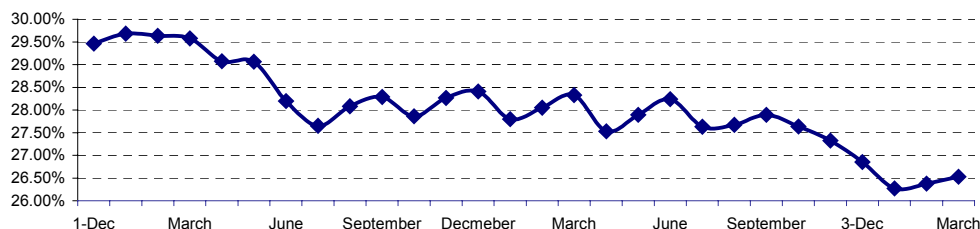
Lek and foreign currency has provided a stable liquidity situation, making thus interest more stable.

Graphic 5. Annual changes of M1 and M3 (in percentage)



Budget expenditures in March had a moderate growth, within expected levels in the first quarter. The adequate realization of these expenditures – in a relatively long run – provides strong assumptions that this factor will not increase inflationary pressures because of a higher demand in economy or because of a higher government demand for money.

Graphic 6. Budgetary expenses in 2003 (in percentage versus the GDP).



Supply factors had positive impact on inflation in May. Prices in economy – besides the above-mentioned reasons – were influenced by a milder effect of imported inflation.

Imported inflation cannot be avoided in any way in the country's inflation rate. Inflationary pressures stemming from such a factor were much lower recently. The lowest inflation rates registered in Italy and Greece as well as Lek appreciation - on an annual basis – versus euro and USD, respectively by 9.1 per cent and 12.5 per cent, have hold back the effects of imported inflation on our own inflation.

Table 3. Annual inflation of main trading partners (in per cent)

	October '03	November '03	December '03	January '04	February '04	March '04	April '04
Greece	3.2	3.4	3.1	3.1	2.6	2.9	3.1
Italy	2.8	2.8	2.5	2.2	2.4	2.3	2.3

The annual inflation rate in May fell mainly because of the downward seasonal effect of the domestic agricultural production. It showed up sooner in 2004 rather

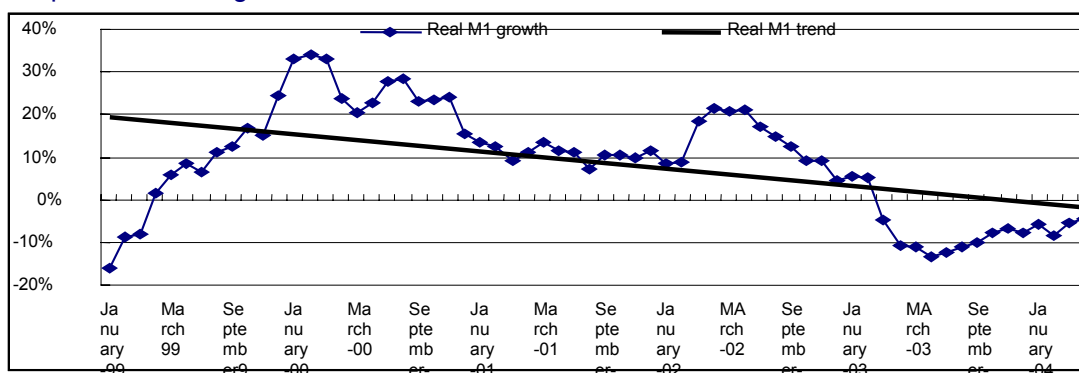
than in 2003. Therefore, its impact is expected to be weaker during summer. Nevertheless, inflation factors were under control. Hence, they offer a kind of comfort in observing the inflation target of 2004.

III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

III.1 MONETARY POLICY

Watching attentively monetary indicators in order to observe the inflation target, the Bank of Albania eased monetary conditions in April and May. It cut the core interest rate by 0.5-percentage point. This was the result of positive expectations on inflation. In addition, the analysis of monetary conditions in the economy – particularly the appreciation trends of Lek versus euro and usd, the fall of the money outside banks/money supply ratio down to the lowest historical level and the real M1 annual growth being still out of the trends show that the economy can absorb another money stimulus, without turning it into inflationary pressures. Under this light, cutting interest rates aims at stirring up crediting and economic activity.

Graphic 6. Annual growth of real M1



Second-tier banks made the same move – during May and in the first week of June they reduced interest rates for 3, 6 and 12 month-term deposits respectively by 0.34, 0.52 and 0.56-percentage point. Treasury bills interest rates for the same maturities were reduced respectively by 0.16, 0.2 and .027 percentage point. The cut of deposits interest rates is expected to lead to the cut of Lek loans interest rates.

The Bank of Albania has been withdrawing the surplus liquidity from the banking market through repurchase agreements on a fixed price and of unlimited amount. The Ministry of Finance was the sole partner in its foreign transactions having thus no impacts on the foreign currency market. During April, the government deposited about usd 126 million by the Bank of Albania. This amount was earned from the Savings Bank privatization. The government paid part of the internal debt by using half of the government's foreign exchange earnings during May. Consequently, the internal debt was reduced by Lek 3.5 billion in May. The Bank of Albania has observed its quantitative objectives during April and May.

Table 4. Realization of quantitative objectives at the BoA

	Sept. '03	Dec. '03	March 04	April 04	May 04*
Net international reserve (in USD million)					
Objective	576.2	583.2	619.2	623.8	628.5

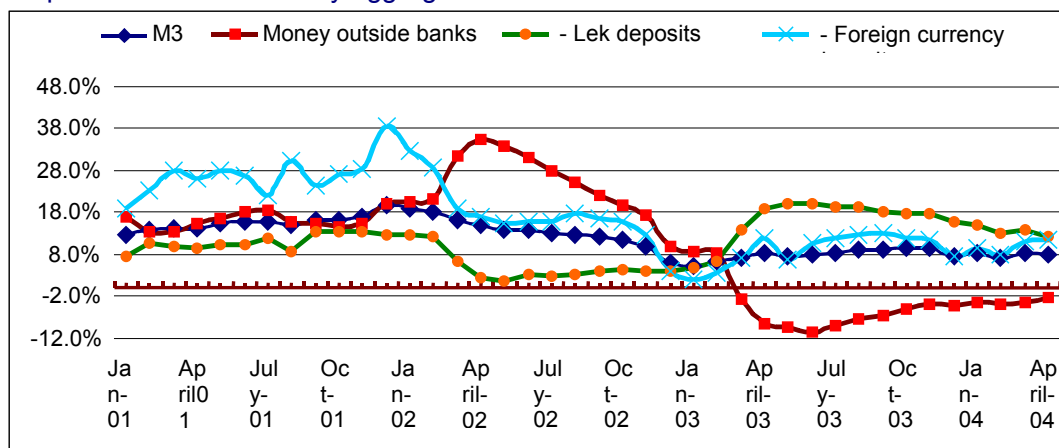
Actual	614.3	673.9	678.8	799.2	796.5
Difference	38.2	90.7	59.6	175.4	168.0
Net domestic assets (in Lek billion)					
Objective	89.1	93.1	80.1	80.8	81.5
Actual	73.3	68.5	61.7	44.8	44.9
Difference	-15.9	-24.6	-18.4	-35.9	-36.6
Net domestic credit to the government (in Lek billion)					
Objective	278.1	280.9	286.1	285.8	284.5
Actual	276.0	280.1	286.1	285.6	--
Difference	-2.1	-0.7	0.0	-0.2	--

* May data are operative

III.2 MONETARY AGGREGATES

The money supply growth rate dropped slightly down to 8.1 per cent in April. This came due to the slow down of the M2 annual growth rate. M2 reflected a lower demand from the government and the economy for monetary assets in Lek. However, foreign currency deposits showed an opposite direction and they contributed more in the money supply growth.

Graphic 7. Annual monetary aggregate rates



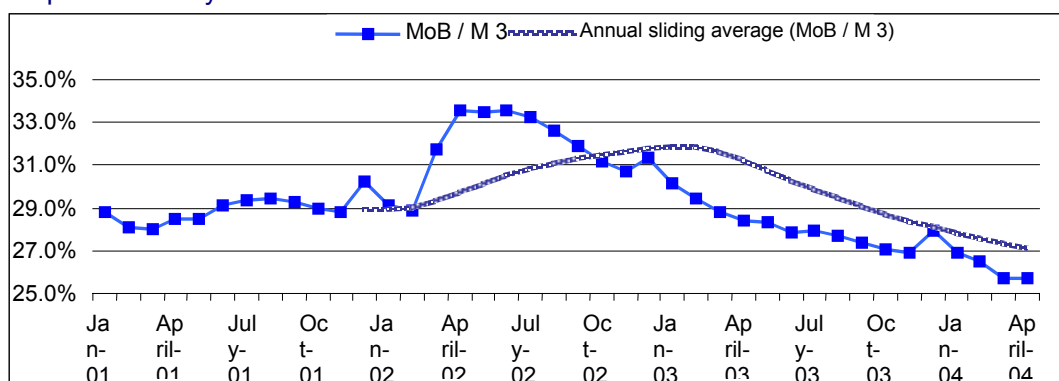
The money supply, in monthly terms, increased by 0.2 per cent. This was strongly underpinned by the Lek 1.4 billion growth of foreign currency deposits; however, Lek deposits had a monthly drop of Lek 0.8 billion. The money outside banks index increased slightly by Lek 0.16 billion.

The annual growth rate of foreign currency deposits is close to its historical levels. By the end of April, their annual growth was 11.5 per cent. Appreciation of Lek versus euro in April gave a negative impact of about Lek 0.8 billion. In annual terms, the negative impact of the exchange rate is lek 13 billion or about 12.5 per cent. Even during this month, demand deposits had the biggest growth in the foreign currency deposits, which is connected to the low interest rates of term deposits.

Lek deposits fell by 0.3 per cent in April because of the slower demand for monetary assets in Lek, associated this by the stable level of money outside

banks. Their annual growth has pursued its upward trend coming down to 12.5 per cent from 14 per cent it was a month ago.

Graphic 8. Money outside banks ratio versus M3.



The level of money outside banks was stable in April, after some of them were back into the system in the early months of the year. The level of money outside banks rose slightly this month; however, its ratio with the money supply did not change. The annual rate of money outside banks in April – though negative – reinforces its trend to go back to its normal levels.

Table 5. Monetary aggregates in April (In Lek billion)

	April 2004	Monthly difference		Annual difference	
		Absolute	Percentage	Absolute	Percentage
Money outside banks	117.3	0.2	0.1	-2.6	-2.2
Total deposits	339.4	0.6	0.2	36.9	12.2
- Lek	234.9	-0.8	-0.3	26.1	12.5
- Foreign currency	104.4	1.4	1.3	10.8	11.5
Demand deposits	63.6	-0.6	-1.0	4.6	7.9
- Lek	22.3	-1.4	-6.1	-0.3	-1.3
- Foreign currency	41.3	0.8	2.0	4.9	13.6
Term deposits	275.8	1.2	0.4	32.2	13.2
- Lek	212.6	0.6	0.3	26.4	14.2
- Foreign currency	63.1	0.6	0.9	5.8	10.1
M1	139.6	-1.3	-0.9	-2.9	-2.1
M2	352.2	-0.7	-0.2	23.5	7.1
M3	456.7	0.7	0.2	34.2	8.1
Monetary base	154.4	0.0	0.0	1.7	1.1

III.3 DEMAND OF THE ECONOMY FOR MONEY

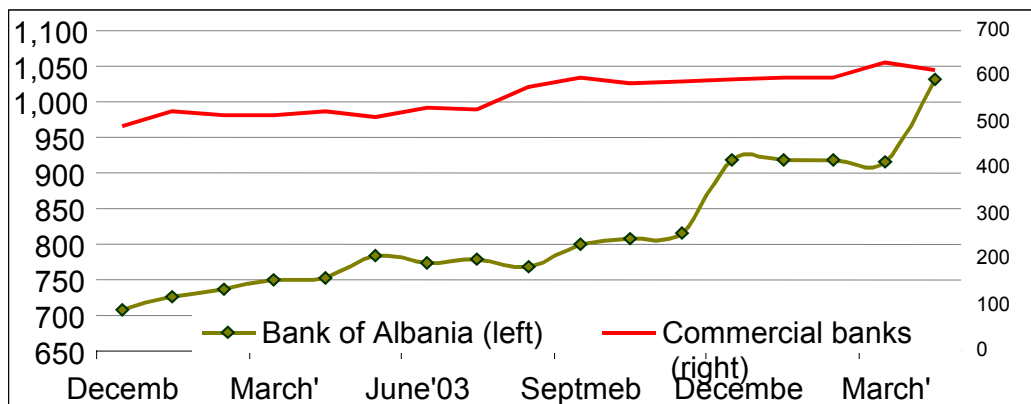
III.3.1 NET FOREIGN ASSETS

Net foreign assets of the banking system increased by usd 96.5 million. The foreign reserve gave a positive impact on this growth; however, the net foreign assets had an opposite effect. In April, net foreign assets increased by usd 116 million. This was the outcome of inflows at an amount of usd 126 million from the

Savings Bank privatization. In the mean time, euro depreciation versus usd by 2.6 per cent in April brought down reserve investments in euro, denominated in usd.

Net foreign assets of second-tier banks fell by usd 19.8 million. This is because the credit balance¹ in foreign currency increased by Lek 2.6 billion over April, although foreign currency deposits increased by Lek 1.4 billion this month.

Graphic 9. Performance of net foreign assets of the banking system



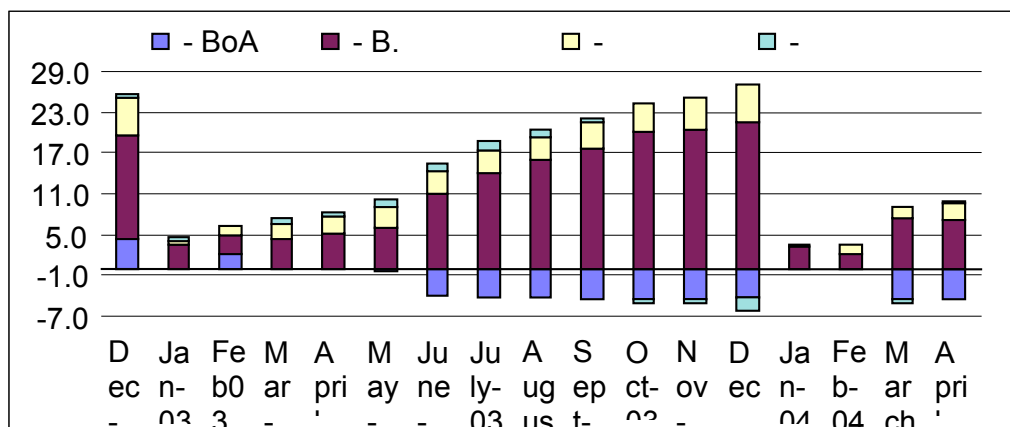
III.3.2 GOVERNMENT DEMAND FOR MONEY

Fiscal accounts marked a budget deficit of about Lek 3.7 billion in April. Its internal financing is still mainly from by the banking system. Annual financing of the budget deficit from the banking system was Lek 1.9 billion in April; the cumulative financing of the budget deficit came to Lek 6.9 billion by the end of April. Budget deficit has been mainly financed by treasury bills and two-year bonds. Second-tier banks reduced the treasury bills portfolio by about Lek 0.8 billion a month ago. Households and institutions increased their portfolio respectively by Lek 0.7 and 1.2 billion. The Bank of Albania portfolio has not changed.

The Government issued governmental bonds in April. They reached the level of Lek 1.3 billion at the very beginning of the year. However, Lek 0.5 billion of those were issued in April.

Graphic 10 Cumulative performance of budget deficit financing (in Lek billion)

¹ Loans in foreign currency to the private sector and financial institutions.

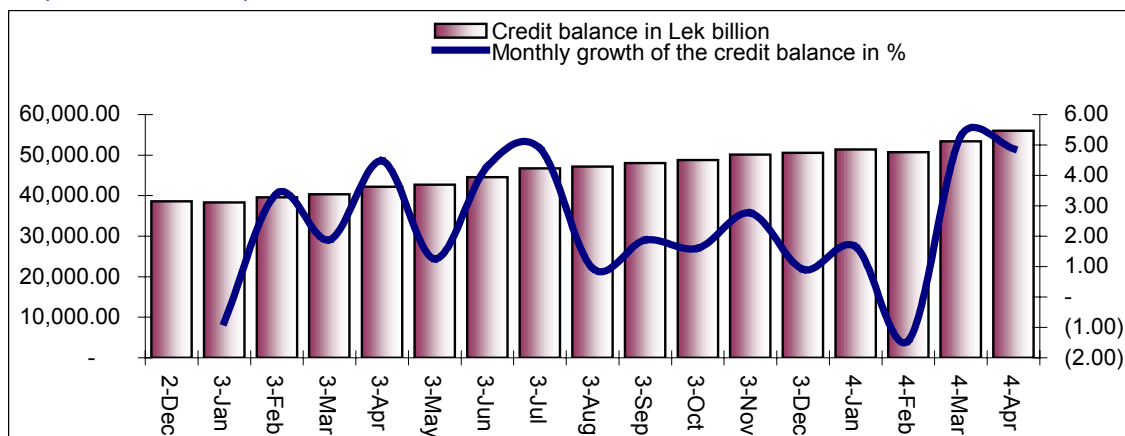


III.3.3 CREDIT TO THE ECONOMY

Credit to the economy increased quite fast in April. The credit balance to the economy increased by Lek 2.6 billion - a growth almost equal to the one of the first quarter, and at the same time 30 per cent higher than the one of April 2003. Compared to the end of 2003, it increased by Lek 5.3 billion or 47 per cent higher than the same period of last year.

The private sector and households were credited by Lek 1.4 billion a month. This level is almost equal to what was forecasted in the monetary program.

Graphic 11. Annual performance of the credit balance



By the end of April 2004, credit balance (mid-term and long-term credits) was 56 per cent of total credit, from 54.5 per cent it was by the end of 2003. Banks feel generally safer towards long-term crediting to the private sector, contributing thus in the economic growth. Credit balance in foreign currency still prevails in the Lek/foreign currency structure.

Table 6. Credit balance indicators, in percentage

	Year 2002	T-1'03	T-2'03	T-3'03	T-4'03	T-1 '04	Prill'04
Short-term credit	53.8	53.2	53.4	51.4	45.5	44.4	44

Mid-term credit	30.1	30.4	30.7	30.5	37.0	34.4	35
Long-term credit	16.1	16.4	15.9	18.1	17.5	21.2	21
Lek	21.3	21.5	21.2	19.3	19.6	20	20
Foreign currency	73.7	78.5	78.8	80.7	80.4	80	80
Credit balance (in Lek billion)	38.7	40.4	44.5	48.0	50.6	53.4	55.97

The credit balance structure has undergone some changes. Thus, there is a tendency for a lower weight in the trade branch and higher ones in branches such as processing industry, agriculture, construction, etc.

Table 7. New credit performance over the years in Lek billion

	2002	2003	T-1 '03	T-2 '03	T-3 '03	T-4 '03	T-1 '04	Prill '04
Short-term credit	44.7	63.1	11.6	17.5	15.6	18.3	18.7	6.9
Mid-term credit	13.0	22.2	4.3	5.6	4.2	8.0	5.7	2.3
Long-term credit	4.8	7.4	1.5	1.5	1.8	2.6	3.5	1.4
State sector	0.06	0.04	0.05	0.0	0.0	0.0	0.0	0
Private sector	62.5	92.6	17.4	24.6	21.6	28.9	27.9	10.6
Lek	20.8	30.8	7.1	8.0	7.4	8.3	8.80	2.4
Foreign currency	41.8	61.8	10.4	16.6	14.2	20.6	19.10	8.2
New credit (in Lek billion)	62.6	92.6	17.5	24.6	21.6	28.9	27.9	10.6

The new accorded credit in April – 41 per cent – was mainly aimed at commercial activities. Processing industry credited by 10 per cent, real estates by 15 per cent and construction by 6 per cent are the most credited branches. Crediting to the agriculture has shown a continuous growth. During the first four months of this year, about Lek 248 million were extended to the private sector.

III.4 FINANCIAL MARKETS AND INTEREST RATES

III.4.1 FINANCIAL MARKETS

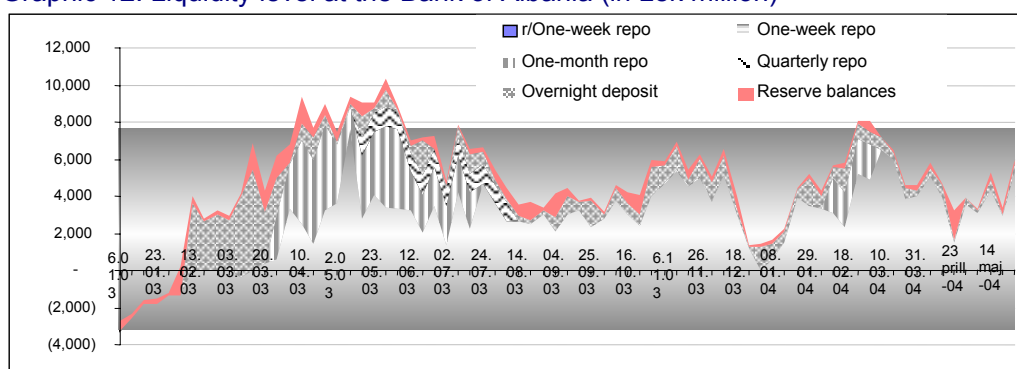
Liquidity situation was stable during April-May 2004. The average level of liquidity was Lek 4.3 billion, Lek 0.3 billion higher than April. Based on operative data, the liquidity level in May was affected by the moderate growth of Lek deposits and the lower deficit financing.

The surplus liquidity was withdrawn through one-week repos. The rate changed twice from 6.5 per cent to 6.0 per cent. The current repo interest rate – the core interest rate in the economy – is the lowest ever registered since the application of this instrument.

Overnight deposits facility was used about three times less in May than in April. The interbank market had a wider activity in volume and transactions the like.

The average level of transactions in May was Lek 0.58 billion from 0.43 billion it was in April.

Graphic 12. Liquidity level at the Bank of Albania (in Lek million)



III.4.2 INTEREST RATES

Interest rates in monetary markets did not stay the same for long. Banks reacted towards the two cuts of core interest rate from the Bank of Albania in April and early May. The interest rates changed as follows (April 28 – May 31).

Table 8. Market's reaction following the core interest rate cuts (April 28 – May 31)

Maturity	Lek deposits*	Treasury bills yield
3 – month	-0.34	-0.16
6 – month	-0.52	-0.20
12 – month	-0.56	-0.26

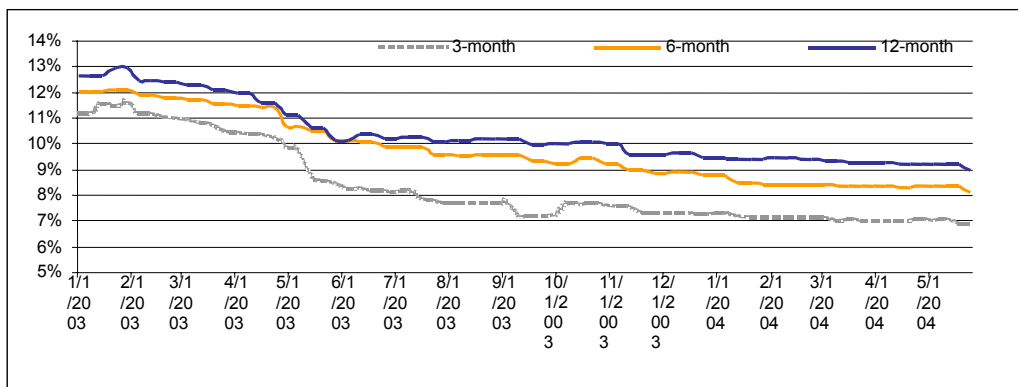
*The average weighted spread as to the deposit structure.

The interest rates in the interbank market dropped by 0.3 percentage point for the overnight and one-week transactions.

As far as the loans market are concerned, the latest data belong to end of April. The average weighted interest rate of loans increased by 0.9 percentage point. This because of a larger number of long-term loans extended in April. However, banks do not react with the same percentages and speed as in the deposits' market.

A higher competition is noticed in the primary market due to a higher supply versus the government demand for liquidity. In addition, nominal values of securities issued in this period were higher than the ones issued by the government, which has generally lowered its demand for financing from the banking system.

Graphic 13. Treasury bills yield



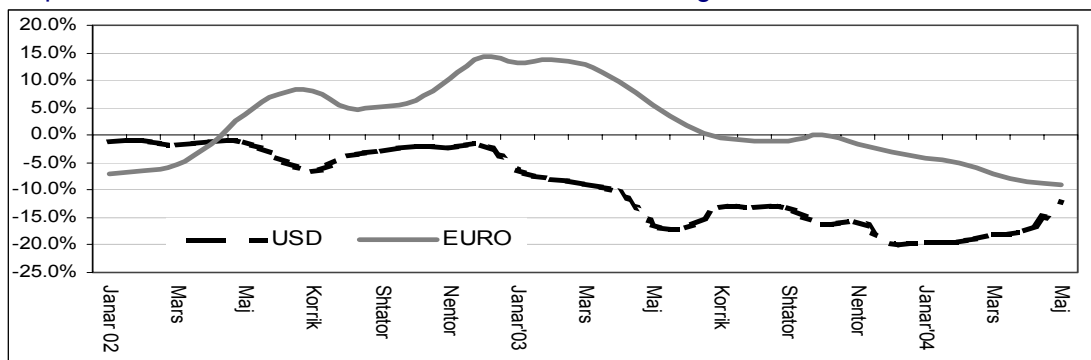
Compared to a month ago, interest rates of usd deposits had a slight upward trend in all maturities. The opposite happened to interest rates in euro, reflecting thus the general trend of international markets. The average weighted level of interest rates of foreign currency deposits is low: 0.75 per cent for the usd and 1.44 per cent for the euro.

The trend of interest rates differences in the loans' market is not the same for the euro and for the usd. The average weighted rate of loans in euro rose (+0.83 percentage point) and the one in usd dropped (-0.17 percentage point).

III.5 EXCHANGE RATE

Lek was quite strong during May. This period is featured by the entry of domestic agriculture production and lower imports, reducing thus the demand for foreign exchange and leading to Lek appreciation. Furthermore, Lek was favored also by the low level of inflation. Throughout the month, Lek ranged within a narrow band against the two main currencies. It appreciated by 2.2 per cent versus usd and depreciated by 0.1 per cent versus euro. Lek has held an appreciation position since the end of 2003. Appreciation is stronger versus euro by 4.9 per cent; appreciation versus usd is 1.9 per cent.

Graphic 14. Annual difference of the average interest rate of Lek



Summer period is generally featured by an appreciated Lek. The same is expected even this summer despite the impact of the last cut of the core interest rate from the Bank of Albania might have.