

**BANK OF ALBANIA**

**MONETARY POLICY REPORT**

**NOVEMBER 2004**

**DECEMBER 2004**

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## I. MAIN HIGHLIGHTS

- Annual inflation marked 2.2 percent in November, thus being within the targeted range of the Bank of Albania. The average annual inflation was 3.0 percent, while the monthly inflation in November was 0.5 percent.
- The “Rent, water, fuels” group has given the major contribution to the annual inflation rate, while the “Foodstuff and non-alcoholic beverages” group index marked a certain decrease in comparison with the previous year, exerting pressures on the fall of the general level of prices.
- Oil price rise in the international markets, reflected as well in the annual inflation increase in the “Transport” group, has not influenced significantly the general inflation, mainly due to the annual appreciation of Lek against American dollar and Euro.
- Bank of Albania has maintained unchanged the base interest rate, being in expectancy of the banks’ reaction to the last cut made on November 11<sup>th</sup>. The Bank of Albania has employed continuously the repo’s auctions to withdraw the liquidity surplus of the banking system during this period.
- The annual growth rate of the monetary supply was 9.7 percent in October, marking a slight decrease in comparison with the previous month. M2 aggregate increased slowly and this was due to the low demand of Government for money.
- Foreign position of the banking system is improved during October. An increase of USD 20.1 million was recorded at the level of net foreign assets during this month.
- Budget deficit during October was almost totally covered by the domestic financing, which was estimated at about Lek 1.9 billion.
- Credit balance amounted, at the end of October 2004, to Lek 63.1, recording a monthly increase of Lek 2.2 billion. The Albanian economy was credited during the period December 2003 – October 2004 by Lek 12.4 billion, representing nearly 76 percent of the level projected in the Monetary Programme for 2004.
- Lek tendency toward depreciation against Euro and appreciation against American dollar was noticed even during the period October – November 2004. During this period Lek was depreciated, on the average, by 1.8 percent against Euro and appreciated, on the average, by 4.1 percent against American dollar.

## II. INFLATION IN NOVEMBER

### II.1 GENERAL DEVELOPMENTS OF INFLATION

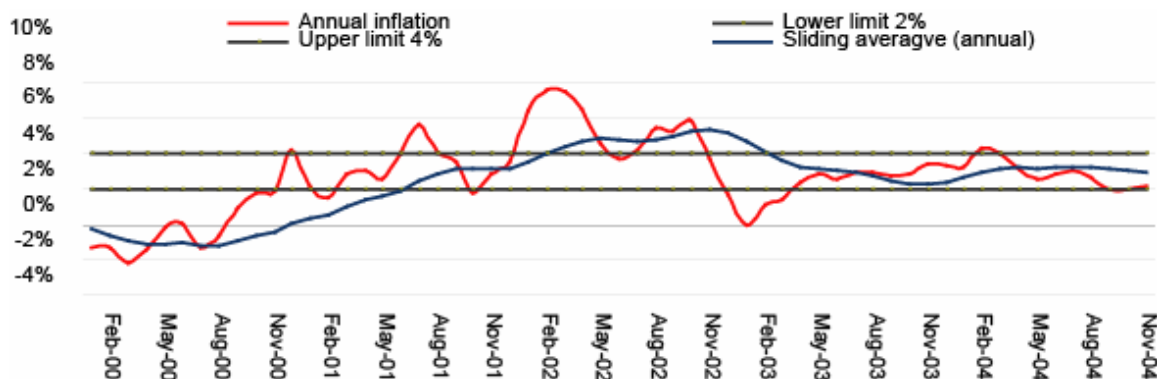
Annual inflation marked 2.2 percent in November 2004, while the average annual inflation remained unchanged, at 3.0 percent. The annual inflation rate resulted within the two-to-four percent targeted range of the Bank of Albania, being close to the lower limit of this band. The monthly inflation, since September, which puts an end to the negative monthly inflation rates<sup>1</sup>, marked a certain increase, in compliance with the season's performance of prices during the fourth quarter. Monthly inflation was 0.5 percent in November. This rate was under the average monthly inflation (0.7 percent) of all the months of November for the period 2000-2004.

**Table 1 Annual inflation rate (in percentage)**

	2000	2001	2002	2003	2004
January	-1.3	2.2	6.5	0.0	3.3
February	-1.3	1.5	7.6	1.1	4.4
March	-2.1	2.9	7.5	1.3	4.0
April	-1.4	3.0	6.5	2.3	3.2
May	-0.1	2.5	4.6	2.8	2.6
June	0.1	4.0	3.7	2.6	2.9
July	-1.3	5.6	4.2	3.0	3.1
August	-0.7	4.1	5.5	3.0	2.7
September	0.9	3.5	5.3	2.8	2.0
October	1.8	1.8	5.8	2.9	2.0
<b>November</b>	<b>1.9</b>	<b>2.8</b>	<b>3.7</b>	<b>3.4</b>	<b>2.2</b>
December	4.2	3.5	1.7	3.3	
<b>Average</b>	<b>0.1</b>	<b>3.1</b>	<b>5.2</b>	<b>2.2</b>	<b>3.0</b>

Source: INSTAT

**Chart 1. Annual inflation (in percent).**



Since April, annual inflation was on a stable basis within the range of 2 to 3 percent. This stability was mainly attributed to the favourable microeconomic situation, the control of demand constituents and the abundant agricultural production throughout 2004.

<sup>1</sup> Monthly inflation marked negative rates in May, June, July and August.

## II.2 MAIN CONSTITUENT GROUPS OF CONSUMER MARCHANDISE BASKET

During November no significant changes were noted in price indexes of constituent groups of consumer basket and in their contribution to the total annual inflation rate. However, a change in the size of contribution of the two main groups of consumer basket is noted, in comparison with the month of November of the previous year. Inflation of the rent group raised the annual inflation rate, while the foodstuff group exerted pressures on the fall of this rate, for the major part of the year.

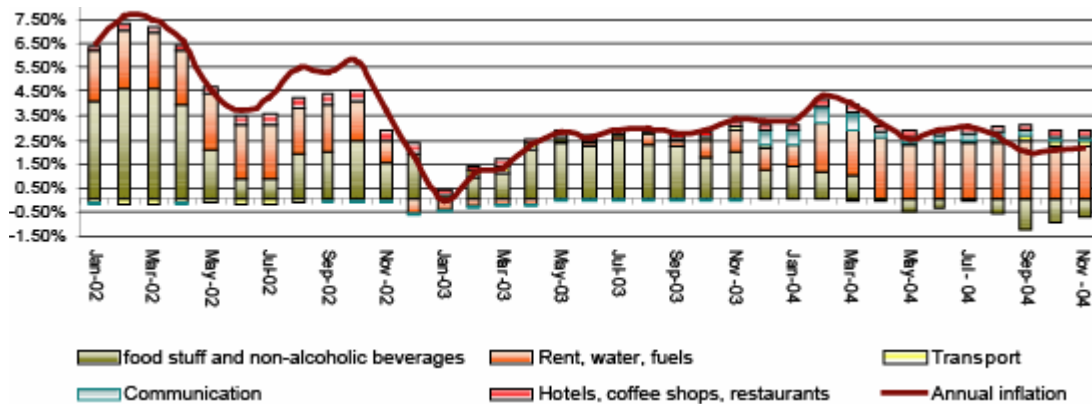
**Table 2 Annual inflation of basket groups (in percentage) and contribution to the total annual rate (in percentage point)**

	<b>November -03 (%)</b>	<b>November -04 (%)</b>	<b>Contribution- 03 (pp)</b>	<b>Contribution- 04 (pp)</b>
Foodstuff and non-alcoholic beverages	4.8	-1.6	2.0	-0.7
Alcoholic beverages and tobacco	5.1	1.8	0.2	0.1
Headwear and footwear	-2.9	-2.9	-0.1	-0.1
Rent, water, fuels and energy	3.8	9.2	0.9	2.2
Furniture, equipment and housekeeping	-0.3	-0.8	0.0	0.0
Health	5.1	0.0	0.1	0.0
Transport	2.5	4.1	0.1	0.2
Communication	-1.7	15.4	0.0	0.2
Entertainment and culture	0.5	1.4	0.0	0.0
Education service	8.3	6.7	0.1	0.1
Hotels, coffee shops and restaurants	2.2	3.3	0.2	0.3
Goods and diverse services	-2.2	-0.6	-0.1	0.0
<b>Total</b>	<b>3.4</b>	<b>2.2</b>	<b>3.4</b>	<b>2.2</b>

Source: INSTAT and Bank of Albania records.

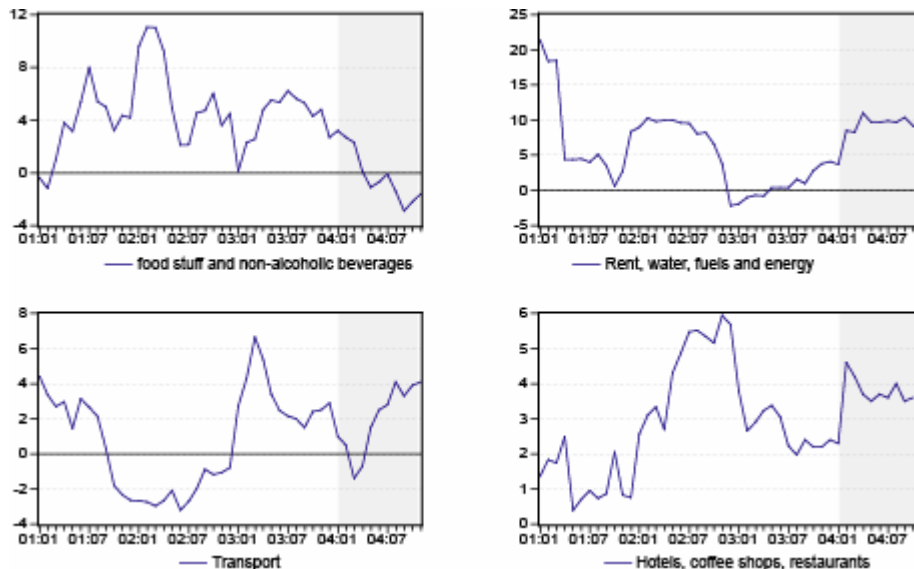
In concrete terms, the "Foodstuff and alcoholic beverages" group was characterized in November by a fall in prices on annual basis for the seventh month consecutively. Inflation contribution of this group to the total annual inflation was negative and significant: - 0.7 percentage point. As a comparison, in November of the last year, this group has contributed with 0.2 percentage point, ensuring more than the half of the annual inflation rate. On the other side, almost during all the year 2004, a significant upward contribution of the "Rent, water, fuels and energy" group was noted as a consequence of the energy price rise at the beginning of the year. Annual inflation of this group, in November (9.2 percent), has contributed with 2.2 percentage points to the annual inflation rate, while the total of contributions given from the other groups was zero.

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



Inflation of the “Transport” group was 4.1 percent in November, becoming close to the highest annual rate recorded during this year, that of August. The “Services to personal means of transport” subgroup marked an annual rate of 9.3 percent, reflecting the oil price rise in our country. Although the average oil price in the international market was in November 5 percent lower than in October, oil in the domestic market was characterized by a rise in prices. This rise, like in August, has followed the oil price rise in the international market, a month later. However, the increase by 4.1 percent of the annual inflation of the “Transport” group, because of the small weight in the consumer price basket (4.8 percent), has contributed only with 0.2 percentage point to the annual inflation rate in November.

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

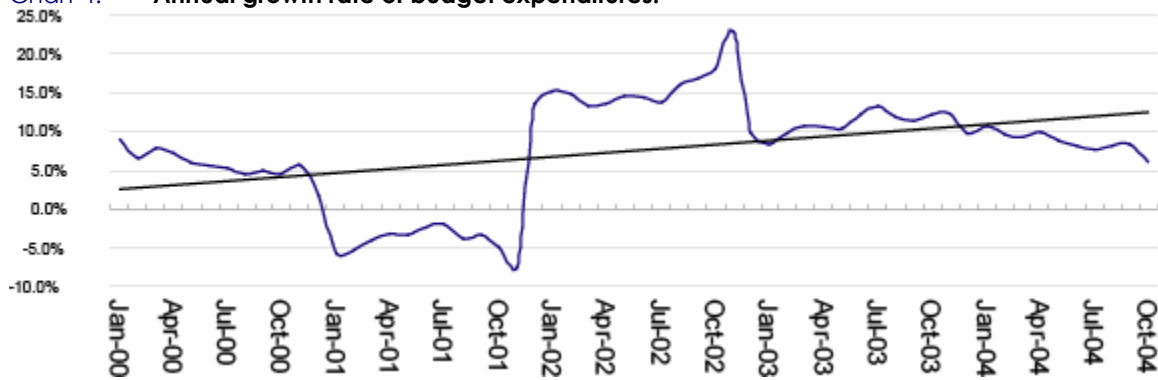


The “Communication” group marked an annual inflation rate of 15.4 percent, contributing to the total inflation with 0.2 percentage point. Inflation contribution of this group to the total inflation dropped significantly in comparison with the first quarter of this year (see Chart 2). The rise in prices of fixed telephony in December 2003 have influenced the increase of inflation of the “Communication” group, in spite of their subsequent fall in April.

## II.3 FACTORS INFLUENCING THE INFLATION

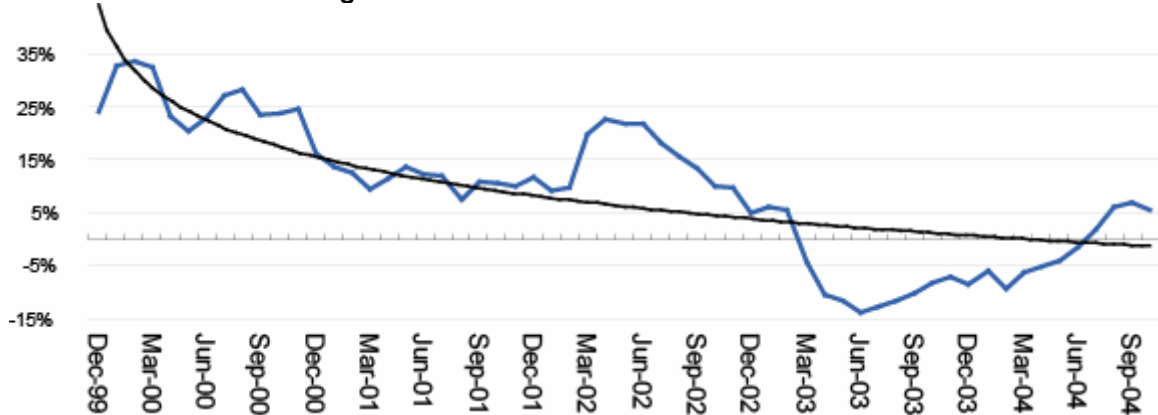
The favourable macroeconomic environment, either regarding the supply or the demand, as well as the lack of shock factors, have influenced the maintenance on a continuous basis of the annual inflation rate within the two-to-four percent targeted range. Budget expenditures have been lower than the expectations on the first nine-month period. Thus, till October, budget expenditures were performed at 90.1 percent in terms of monthly planning and 69.0 percent in terms of annual planning. Since being within the programmed framework of the economic policies for 2004, they did not exert inflationary pressures during November of this year either. Also, the annual growth rates of current expenditures have been generally stable throughout 2004.

Chart 4. Annual growth rate of budget expenditures.



Monetary policy of the Bank of Albania, notwithstanding the continuous reduction of inflation rate, has kept under control the monetary aggregates. The annual growth rates of M1 and M3 aggregates have resulted below the historical trend during October.

Chart 5. Real M1 annual growth.



From the viewpoint of supply, a number of factors have exerted pressures on the fall of the general level of prices in the economy. According to the Ministry of Agriculture and Food estimations, the agricultural production, agro-industrial production and fishery production have been in 2004 higher than the preceding year and, simultaneously, higher than expectations at

the beginning of the year. The reviewed annual growth rate of agricultural production resulted 3.8 percent, from 2.8 percent it was projected at the beginning of the year. The abundant agricultural production led to the increase of the domestic products supply in the market, which brought about the fall in prices of a range of food products, especially fruits and vegetables. The growth of agricultural production has been facilitated by the favourable weather conditions as well as the investments growth in agro-industry during 2003 and 2004. The seasonal effect of introduction of the domestic products in the market gave rise, from April to August, to monthly falls denominated in negative rates of inflation of the foodstuff group. This effect has been present every year but specifically in 2004 it emerged faster and lasted more than usually.

The annual appreciation of Lek against Euro and American dollar<sup>1</sup>, alongside the inflation stability in the partner countries, has impacted the smoothing of inflationary pressures arising from prices of the imported consumer goods and raw material. The strengthening of Lek has helped to amortize the pressures that oil price rise could possibly produce in the domestic market, either in the immediate price rise of this product or in the cost rise of the related services or goods.

**Table 3 Annual inflation of the main trading partners (in percentage)**

	March	April	May	June	July	August	September	October
Greece	2.9	3.1	3.1	3.0	3.1	2.8	2.9	3.3
Italy	2.3	2.3	2.3	2.4	2.2	2.4	2.1	2.1

Source: Eurostat News Release.

Also, the energetic situation already improved, denominated in the growth of energy production, in the decrease of imports and the increase of consumption from non-household users, has reduced the cost of replacing the continuous energy resources with alternative resources, like generators. The administered price rise of the electric energy at the beginning of this year did not led to the reduction of the quantity of electric energy consumed by producer companies. The quantity of electric energy, used by these consumers during the first nine-month period of this year, was about 20 percent higher than the previous year.

The analysis of the demand and supply factors shows that their performance, for lack of shock factors, will facilitate the inflation maintenance within the targeted range of the Bank of Albania even for the years to come.

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<sup>1</sup> The annual appreciation of Lek against American dollar and Euro was in November 14.9 percent and 5.7 percent, respectively.



### III. MONETARY DEVELOPMENTS AND DEMAND FOR MONEY

#### III.1 BANK OF ALBANIA MONETARY POLICY

The Bank of Albania has continued to maintain an easing tendency of monetary policy during the second half of 2004. This policy is subordinated by the macroeconomic indicators stability and positive developments in the inflation indicator. Since March, inflation has been within the targeted range of the Bank of Albania and expectations have been always optimistic in achieving the objective for 2004. At the same time, a noticeable development during 2004 was the increase of public confidence in the banking system, denominated in the increase of the confidence and demand for money. Both factors facilitated the process of adopting an easing monetary policy during 2004, without infringing the monetary equilibriums and ratios.

The Bank of Albania has cut five times its base interest rate<sup>2</sup>, this being followed by reductions of interest rates of the interbank market, of Lek deposits and Treasury bills. Also, even interest rates of credit in Lek incurred generally a fall with regard to maturity terms, but the orientation of their structure toward longer terms has influenced the increase of the weighted average interest rate. The level of real interest rates has contributed to the maintaining of monetary equilibriums and the guaranteeing of a stable liquidity situation in the banking system. The monetary aggregates have continued to be kept under control and their structure is oriented toward longer maturity terms (see Charts 7 and 8).

The exchange rate of Lek against US dollar and Euro has continued to be characterized by Lek appreciation during 2004, in spite of the general reduction of interest rates. This appreciation brought about especially the increase of the demand for Lek, as a consequence of the difference of interest rates between Lek and foreign currency. On the other hand, the growth of domestic agricultural production and the improved energetic situation have influenced the fall of imports, reducing the demand for foreign currency. The Bank of Albania has intermediated in the foreign exchange market during 2004, especially in summer, to balance the ratio demand/supply and to inject liquidity in the market. Meanwhile, Lek appreciation pressures marked a smoothing tendency after this period and the Bank of Albania activity in the foreign exchange market decreased significantly during the period October-November 2004.

The Bank of Albania has continued to withdraw liquidity from the banking system during the last two months and employed the instrument of repurchase agreements during this period. Also, the Bank of Albania has followed its quantitative objectives under the PRGF arrangement.

**Table 4 Meeting the quantitative objectives of the Bank of Albania**

	December '03	March '04	June '04	September '04	October '04
<b>Net international reserve (in millions of USD)</b>					
Objective	715.8	751.8	765.8	923.7	929.7
Currently	832.7	827.6	961.5	1043.6	1049.4
Difference	116.8	75.8	195.7	119.9	119.7
<b>Net domestic assets (in billions of Lek)</b>					
Objective	96.0	83.0	85.0	70.0	72.0
Currently	72.0	66.4	54.7	55.4	55.3
Difference	-24.0	-16.6	-30.3	-14.5	-16.6

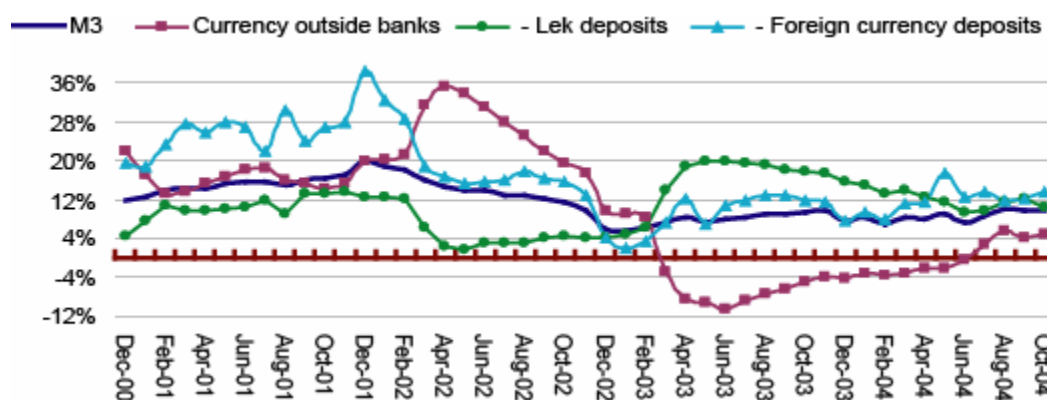
<sup>2</sup> The Bank of Albania has applied the last cut of base interest rate on November 4th.

Net domestic credit to the government (in billions of Lek)					
Objective	280.9	272.8	270.1	279.1	280.8
Currently	266.8	272.6	263.6	272.0	273.0
Difference	0.0	-0.2	-6.5	-7.1	-7.8

### III.2 MONETARY AGGREGATES PERFORMANCE

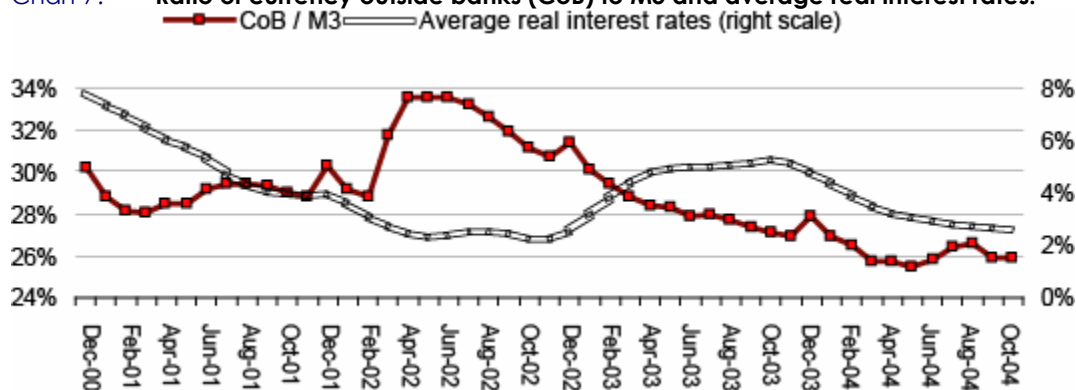
The annual growth rate of monetary supply in October was 9.7 percent, marking a slight fall in comparison with the previous month. This performance has reflected the slow growth of M2 aggregate as well as the lowest growth of foreign currency deposits due to the Lek appreciation during October. Relative growths of monetary supply components have been balanced, making that the time and foreign currency structure of monetary supply remains equilibrated.

Chart 6. Annual monetary aggregate rates.



The level of currency outside banks marked a monthly growth of Lek 0.4 billion or 0.3 percent in October. The annual growth rate of currency outside banks reached 4.9 percent, from 4.1 percent it was in the previous month, in compliance with its upward tendency in the second semester. This growth represents mainly a tendency of approximation with the annual growth rates of the other components of monetary supply, under the conditions of maintaining the time structure of monetary supply equilibrated. The ratio of currency outside banks to the monetary supply reached 25.9 percent, remaining unchanged if compared with the previous month. This ratio has manifested several months ago a tendency of stability.

Chart 7. Ratio of currency outside banks (CoB) to M3 and average real interest rates.



The contribution of Lek deposits to the increase of monetary supply resulted to be low in October. Their level marked a monthly growth of Lek 0.5 billion or 0.2 percent, while the annual growth rate of Lek deposits dropped to 10.4 percent in October, from 12.1 percent being in September. This performance reflected the slowness of the M2 aggregate growth due to the low demand of government for money, while Lek credit marked a satisfactory monthly growth. The time structure of Lek deposits is oriented toward time deposits, which marked a monthly growth of Lek 2.6 billion or 1.2 percent. The downward inflation performance has maintained satisfactory levels of real interest rates, facilitating the growth of time deposits in Lek.

The fall of demand deposits in Lek and the low growth of currency outside banks led to the fall of M1 aggregate. The annual growth rate of this indicator dropped to 7.6 percent in October, from 8.8 percent it was in the previous month. Also, the annual growth rate of monetary base marked 6.6 percent, remaining below the historical average of the past years.

The growth of foreign currency deposits was Lek 0.3 billion or 0.3 percent. The resulting Lek appreciation against foreign currencies Euro and US dollar is estimated to have negatively influenced their monthly increase by about Lek 0.26 billion. The annual growth rate of foreign currency deposits increased by 13.7 percent in October, from 12.1 percent it was in September, reflecting the reduction of negative impact of the annual appreciation of domestic currency in comparison with the previous month. For lack of this appreciation, the annual growth rate of foreign currency deposits appears to be stable, at 25.4 percent. The ratio of foreign currency deposits to M3 aggregate remained unchanged due to the approximate monthly growth of monetary supply components in Lek and in foreign currency.

**Table 5 Monetary indicators in October (in billions of Lek)**

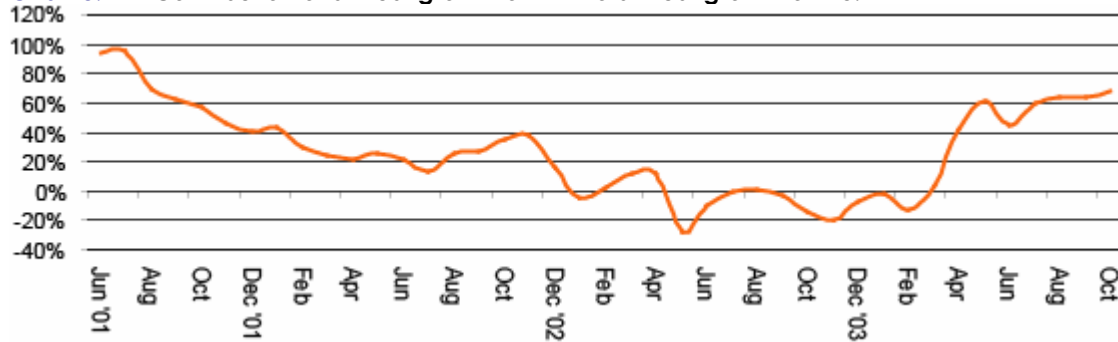
	October	Monthly difference		Annual difference	
	2004	Absolute	Percentage	Absolute	Percentage
Currency outside banks	126.6	0.4	0.3	6.0	4.9
Total deposits	362.2	0.9	0.2	37.1	11.4
- in Lek	246.1	0.5	0.2	23.1	10.4
- in foreign currency	116.1	0.3	0.3	14.0	13.7
Demand deposits	69.9	-2.5	-3.5	9.3	15.3
- in Lek	25.7	-2.1	-7.4	4.8	22.9
- in foreign currency	44.2	-0.5	-1.0	4.5	11.3
Time deposits	292.3	3.4	1.2	27.8	10.5
- in Lek	220.3	2.6	1.2	18.3	9.1
- in foreign currency	72.0	0.8	1.1	9.5	15.2
M1	152.4	-1.7	-1.1	10.8	7.6
M2	372.7	0.9	0.2	29.1	8.5
M3	488.8	1.3	0.3	43.1	9.7
Monetary base	167.0	0.5	0.3	10.3	6.6

### III.3 ECONOMY DEMAND FOR MONETARY ASSETS

#### III.3.1 Foreign currency position of banking system

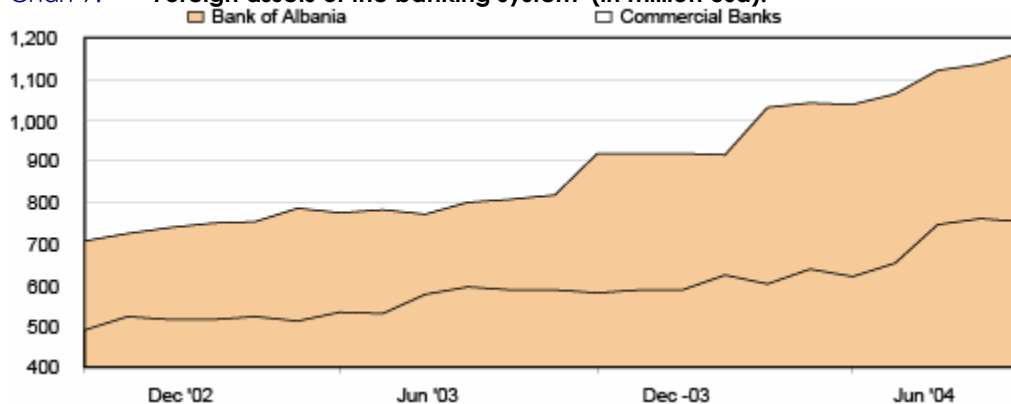
Net foreign assets of the banking system were increased by<sup>3</sup> 20.1 million dollars in October. The net foreign assets growth in annual terms provided a contribution of 68.3 per cent to annual growth of M3 in October, constituting the highest contribution rendered over 2004. Compared to the previous month, the net foreign assets expressed in Lek decreased by about 1.6 billion lek.

Chart 8. Contribution of annual growth of NFA to annual growth of M3.



The monthly growth of net foreign reserve of the Bank of Albania was 27.3 million dollars. The euro's appreciation against the dollar in international market was the main factor of this growth. This appreciation, which in monthly terms was 2.6 per cent, impacted on net foreign assets growth by 19.8 million dollars. The Bank of Albania did not intervene in foreign exchange market in October but some transactions with the government or for its account have impacted on the growth of the Bank of Albania reserve. Net foreign assets of commercial banks decreased by 7.2 million dollars in October.

Chart 9. Foreign assets of the banking system (in million Usd).

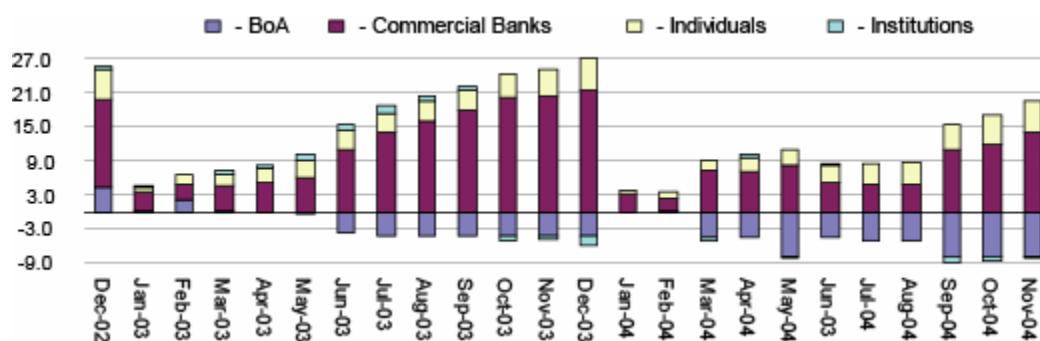


<sup>3</sup> In absence of the exchange rate effect, the foreign assets resulted downward by 10.4 million dollars.

### III.3.2 Government demand for monetary assets

The budget deficit marked a rise in October. In monthly terms, the budget deficit was increased by 1.6 billion lek, reaching to 15.3 billion lek. The government demand was covered almost totally by domestic financing, which was about 1.9 billion lek in November. The commercial banks contributed by 1.2 billion lek in this financing through purchasing government bonds. The financing of government demand by treasury bills, about 0.5 billion lek, was enabled by households' and institutions' purchases. The posting of a part of income from Savings Bank's privatization (0.1 billion lek) and the converting of Savings Bank's funds for foreign debt (0.1 billion lek), also were part of domestic financing.

Chart 10. Budget deficit domestic financing (in billion lek).



### III.3.3 Banking system credit to economy

Credit balance at end of October 2004 reached to 63.1 billion lek, marking a monthly growth of 2.2 billion lek. Unlike changes in bank lending market over the previous month, when credit balance did not mark any growth, October is estimated as a month of higher growth in monthly level during 2004. Albanian economy for December 2003 – October 2004 has been credited by 12.4 billion lek, constituting about 76 per cent of the level projected in the monetary program for 2004. The exchange rate effect on credit balance growth for the period under discussion should not be left aside. The lek appreciation against both currencies, the euro and usd, respectively by 6.8 per cent and 5.8 per cent, has negatively impacted on credit balance reduction by 3.5 billion lek. Given this effect, the real growth of credit balance is about 16 billion lek, almost equal to 16.4 billion lek that is the level projected in the monetary program of 2004.

The performance of many indicators of lending activity during October is estimated as positive. This fact is well made concrete by the ever growing of such ratios as economy credit to GDP, credit to deposit and credit to total assets.

**Table 6 Performance of some main indicators<sup>4</sup>.**

	2002	2003	2004			
			Q-1	Q-2	Q-3	October'04
Money supply (in billion lek)	416.7	448.4	456.0	458.2	487.6	488.8
Domestic credit (in % to M3)	70.8	71.5	71.6	69.5	67.4	67.7
- Credit to government (in % to M3)	61.5	60.2	59.9	57.1	54.8	54.8
- Credit to economy (in % to M3)	9.3	11.3	11.7	12.4	12.6	12.9
Credit to economy (in % to total assets)	11.5	13.7	13.7	14.6	14.7	15.3
Credit to economy (in % to GDP)	5.7	6.8	7.0	7.4	7.3	7.6
Total deposits (in % to GDP)	42.2	43.4	44.1	44.1	44.4	44.0
Credit /deposit (in %)	13.5	15.7	15.8	16.7	16.9	17.4

The credit structure by terms, even during October, continued to be more oriented to mid-term and long-term credit, responding ever more to the country's needs for growth and development of productive capacities. Also, even the credit balance structure by currencies (lek/foreign currency) is marking improvements in favour of rise of credit in lek, even though their ratio leaves much to be desired (18 per cent of credit balance is in lek and 82 per cent of it is in foreign currency).

**Table 7 Performance of credit balance indicators (in percentage).**

	2002	2003	Q-1 '04	Q-2' 04	Q-3 '04	October '04
Credit balance (in billion lek)	38.7	50.7	53.4	56.8	60.9	63.1
Short-term credit	53.8	46.0	41.6	35.4	34.0	33.0
Mid-term credit	30.1	33.3	35.4	37.8	37.0	38.0
Long-term credit	16.1	20.7	23.0	26.8	29.0	29.0
Lek	21.3	19.6	17.0	17.0	17.0	18
Foreign currency	73.7	80.4	83.0	83.0	83.0	82

Mid-term and long-term credit constituted 42 per cent of the new credit extended over September. September marked a positive development as concerns to foreign exchange structure of the new credit extended. During this month, the new credit in Lek constituted 39 per cent of total new credit, being 6 percentage points higher than in the previous month and much higher in comparison to historical levels of 25 per cent.

During October, 7.5 billion lek new credit or about 32 per cent more than in the previous month was extended. The new credit extended during ten first months of the year reached to 81.8 billion lek, being about 16 per cent higher in comparison with the same period of the previous year. The extension of new mid-term and long-term credits has marked a growth of 40 per cent compared to 2003. Improvements are marked in terms of the new credit extended in lek, which was about 50 per cent of the new credit extended in October in comparison to 32 per cent it was during nine first months.

<sup>4</sup> This ratio is established to annual GDP of 2004.

**Table 8 Performance of new credit in years (in billion lek).**

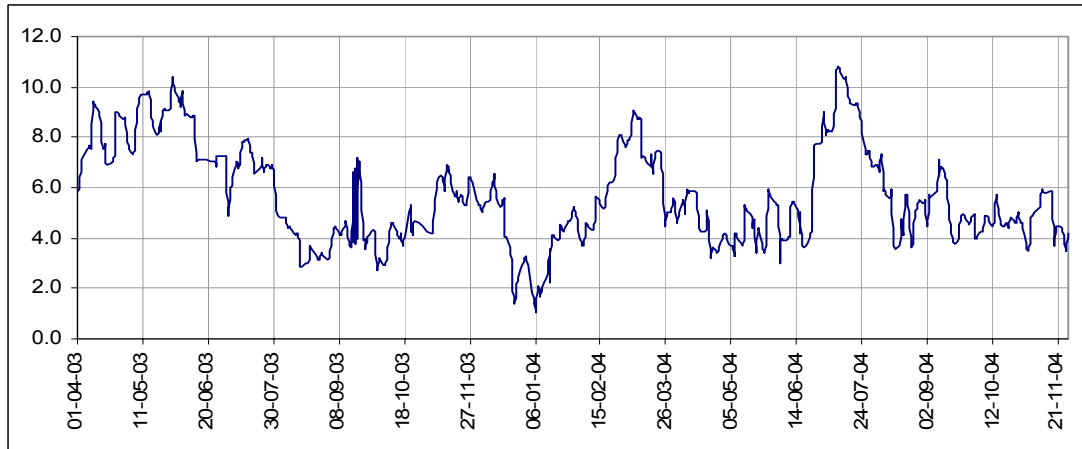
	2002	2003	Q-1 '04	Q-2'04	Q-3 '04	October '04
New credit (in billion lek)	62.6	92.6	27.9	28.5	18	7.4
Short-term credit	44.7	63.1	18.7	18.1	10.9	4.7
Mid-term credit	13	22.2	5.7	6.8	3.9	1.7
Long-term credit	4.8	7.4	3.5	3.6	3.1	1.1
Lek	20.8	30.8	8.8	8.9	6.0	3.6
Foreign currency	41.8	61.8	19.1	19.6	12	3.8

## IV. CURRENCY MARKET AND INTEREST RATES

### IV.1 LIQUIDITY PERFORMANCE

During November, the banking system resulted with a somewhat higher excess liquidity than in October. The average liquidity level in November was 4.5 billion lek. Its performance is dictated mainly by the performance of budget deficit financing in November.

Chart 11. Banking system liquidity at the Bank of Albania<sup>5</sup> (in billion lek).



To absorb excess liquidity, the Bank of Albania continued to use the weekly fixed-price repo instrument. The participation in repo auctions marked the same results with those of October and occupied the largest weight in liquidity. The liquidity withdrawn by overnight deposits was lower than in the previous month. On average 0.3 billion lek or 1.2 billion lek less were invested in overnight deposits.

Compared to the previous month, the interbank market maintained almost the same level. The average daily volume of transactions performed in October recorded 0.62 billion lek or 0.14 billion lek less than in the previous month.

Government demand for financing by the banking system was reduced in comparison to the previous month. In all cases, the supply of banks to invest in government treasury bills was higher than government demand and was concentrated on treasury bills of six-month and twelve-month maturity. This led to increased competition for them and respective yield reduction.

### IV.2 INTEREST RATES PERFORMANCE

Responding to monetary policy signals<sup>6</sup>, banks cut interest rates in lek deposits market, primary market, interbank market and lek credit market. Reaction of interests in interbank market was immediate but unstable. The interest rates fluctuated depending on demand-supply ratio. At end of October, the average weighted interests of three-, six- and twelve-month deposits in lek reached respectively to 4.76, 5.63 and 6.13 per cent.

<sup>5</sup> It includes the Repo agreements, overnight deposits and excess reserves at the bank of Albania.

<sup>6</sup> The last base interest rate cut was done on November 4, 2004.



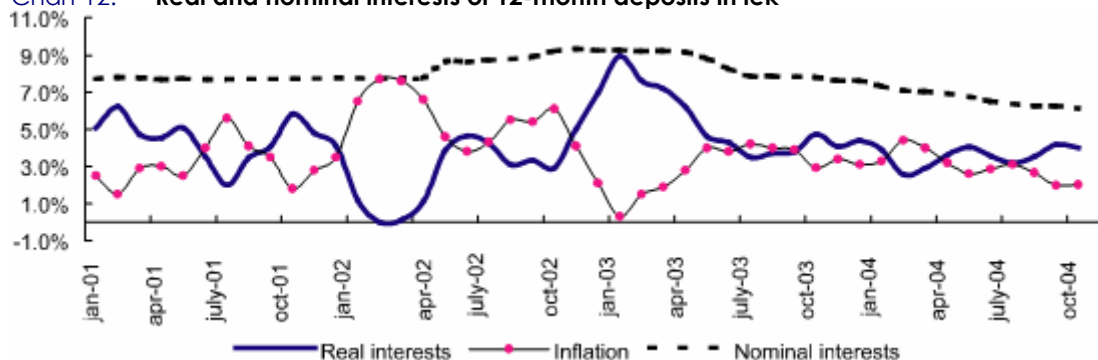
**Table 9 Banking system response to monetary policy over 2004 (in percentage points).**

Period <sup>7</sup>	30/12/03- 28/04/04	28/04/- 12/05/	12/05/- 23/06/	23/06/- 28/07/	28/07/- 4/11/	04/11/ 03/12/	Total
<b>Base interest rate</b>	<b>-0.5</b>	<b>-0.25</b>	<b>-0.25</b>	<b>-0.25</b>	<b>-0.25</b>	<b>-0.25</b>	<b>-1.75</b>
<b>Deposits in lek</b>							
3-month	(0.45)	(0.03)	(0.29)	(0.07)	(0.13)	(0.17)	<b>(1.14)</b>
6-month	(0.52)	(0.15)	(0.34)	(0.08)	(0.49)	(0.02)	<b>(1.60)</b>
12-month	(0.54)	(0.14)	(0.45)	0.04	(0.47)	(0.13)	<b>(1.69)</b>
<b>T-bills yield</b>							
3-month	(0.28)	0.03	(0.21)	0.10	(0.61)	(0.17)	<b>(1.14)</b>
6-month	(0.42)	0.05	(0.22)	(0.08)	(0.79)	(0.05)	<b>(1.50)</b>
12-month	(0.27)	0.02	(0.24)	(0.02)	(0.71)	(0.18)	<b>(1.40)</b>

According to operative data, not all banks have responded to lek deposits market. This is impacted by the fact that in total, the cut of deposit interests of six-month and twelve-month maturity has approached to the reduction signalled for 2004. Also, the banking market competition increased due to opening of new banks and privatization of the Savings Bank.

During October, real interests of 12-month deposits in lek continued to fluctuate around an average of 3.6 per cent, with a slight downward trend. This was impacted by slight inflation pick up and lek deposit interest reduction by narrowing the spread between them.

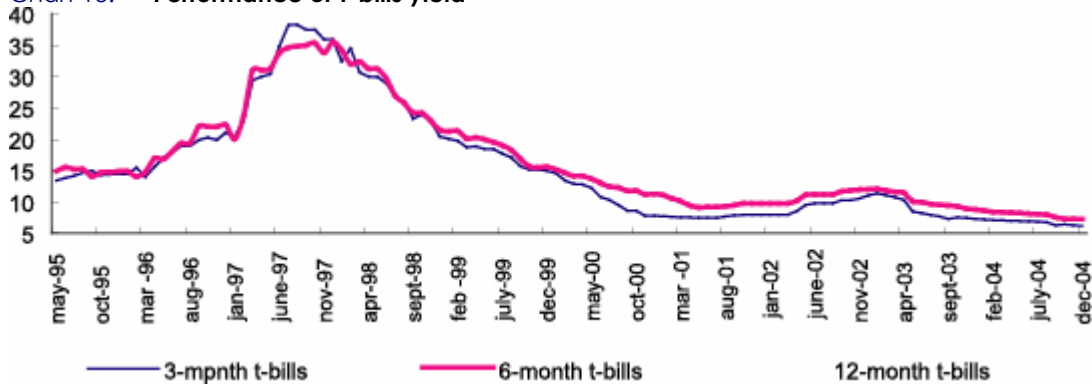
**Chart 12. Real and nominal interests of 12-month deposits in lek**



Over the first week of December, the average weighted T-bills yield in the primary market dropped respectively to 6.20, 7.26 and 8.09 per cent for three-, six- and twelve-month maturity. These are the lowest historical levels of T-bills yield reached over 10 years of the functioning of this market. Reduction of T-bills yield has decreased the government domestic debt cost. On the other hand, the spread between T-bills yield and lek deposit interest was stable, impacting on the stability of banking system incomes.

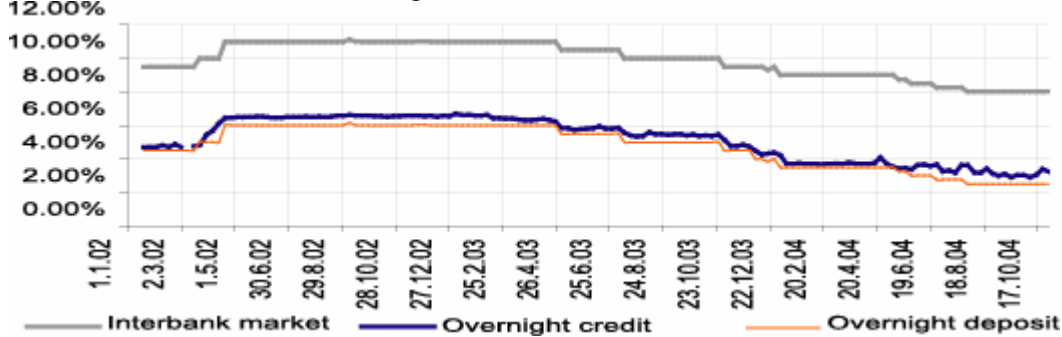
<sup>7</sup> It shows the period between two decisions on changing the base interest rate. It includes even the end of 2003, since the effect of the decisions made in this period was seen at the beginning of 2004.

Chart 13. Performance of T-bills yield



Interbank market is featured by interest rate swings within the band of overnight standing facilities, reflecting the market demand-supply ratios. In the first week of December, the interests of overnight and weekly transactions reached respectively to 3.26 and 5.9 per cent.

Chart 14. Interest rates of overnight transactions



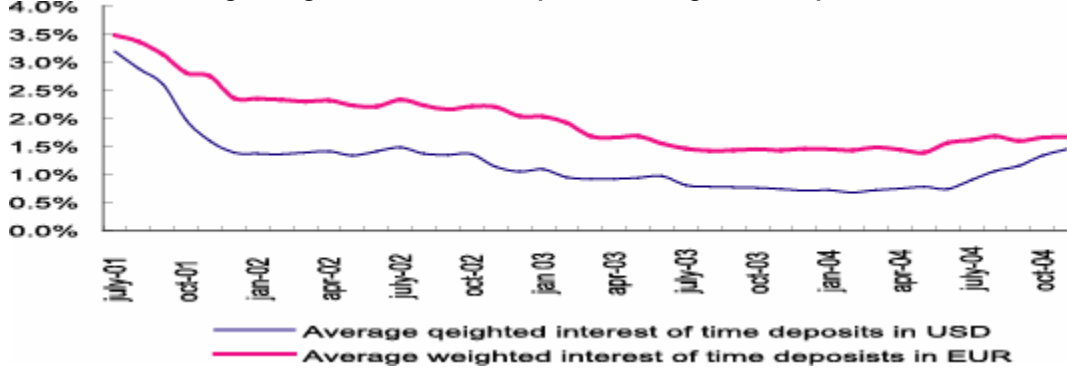
In October, the lek credit interests of all maturities were cut, reacting in the same direction with the monetary policy signals.

Table 10 Interest rates of loans in lek (in percentage).

	September-04	October-04	Difference (in pp)
Credit of up to six-months	11.20	10.97	-0.23
Credit of 6 months to 1 year	15.02	14.43	-0.58
Credit of 1 - 3 years	22.29	19.24	-3.05
Credit over 3 years	14.56	11.69	-2.87

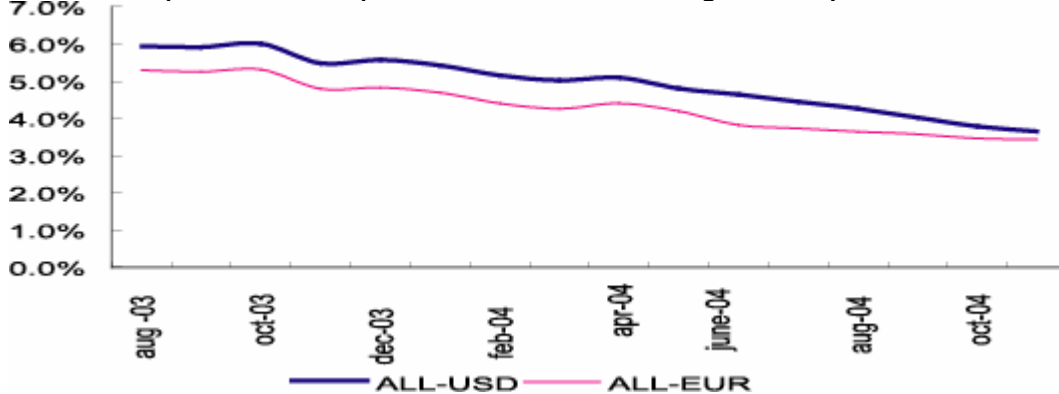
During October, eight banks cut lek credit interests of various maturity but there were also cases of rise of these interests.

Chart 15. Average weighted interests of deposits in foreign currency



In foreign currency deposit market, the average weighted interests of time deposits in Usd and Euro reached respectively to 1.34 and 1.66 per cent at end of October. One month ago these interests had resulted to 1.15 per cent for deposits in Usd and 1.60 per cent for deposits in Euro. The interest rates in Usd have been increased for all maturities due to rapid rise of Libor interests and tightening policy of the Fed. Interests on three- and six-month deposits in Euro have been cut slightly, but those of one-month deposits have been raised, impacting on the weighted interest cut. This was impacted by Euribor interest fluctuations and by market competition.

Chart 16. Spread of time deposits in lek and those in foreign currency

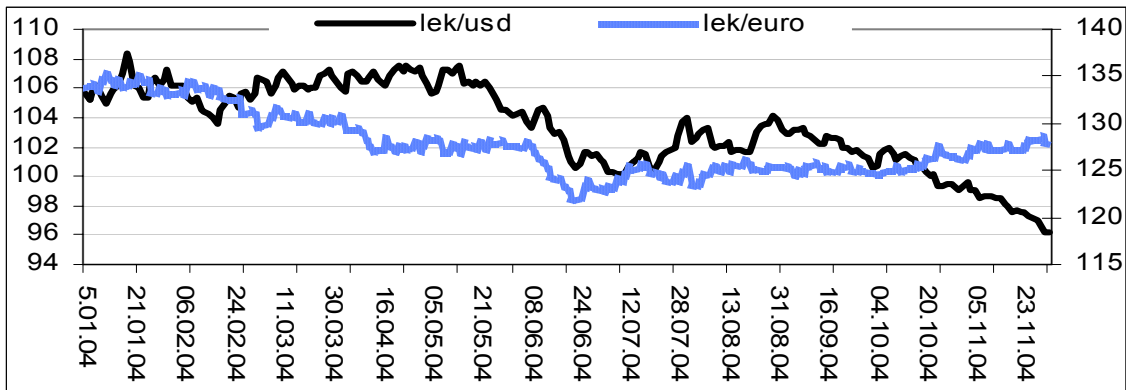


Interests spread of time deposits in lek with those in foreign currency has been narrowing, thus increasing preferences for lek. In October the Usd-Lek spread dropped to 3.8 per cent, and the Lek-Euro spread was 3.5 per cent. This tendency is supported even by low inflation and lek appreciation against the Euro and the dollar.

### IV.3 EXCHANGE RATE

The tendency of the lek's depreciation against the Euro and appreciation against the dollar was observed even during October – November 2004. At end of November, one Euro was exchanged with 128.19 lek, whereas one dollar was exchanged with 96.97 lek. For October – November, the lek was depreciated on average by 1.8 per cent against the Euro and was appreciated on average by 4.1 per cent against the dollar. In annual terms, the lek results appreciated against both currencies. In November, the appreciation was higher against the dollar, about 14.9 per cent, whereas against the Euro the appreciation was 5.7 per cent.

Chart 17. Exchange rate performance of the lek against the Usd and Euro



The Lek has not reflected strong fluctuations in its exchange against the Euro. Among domestic factors that continue to support the Lek performance are low inflation rate (close to lower limit of the Bank of Albania target) which has increased the confidence in preserving the domestic currency's value, positive spread between the lek interest rates and those in foreign currency and low government demand for money. On the other hand, the appreciation of the Euro against the dollar in the international market is reflected in the constant weakening of the dollar against lek. The exchange of the Euro above the level of 1.3 dollars is associated with the depreciation of the dollar against lek below the level of 96 lek.