

BANK OF ALBANIA

MONETARY POLICY MONTHLY REPORT

OCTOBER 2003

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1 MAIN HIGHLIGHTS OF OCTOBER.

- October 2003 marked an annual inflation of 2.9 per cent, remaining within the Bank of Albania targeted band of 2 – 4 per cent.
- Annual interest rate of inflation went on falling even during October, reaching the value of 2.27 per cent. October 2003 has not reflected any sharp deviation from its historical mean.
- During October the way of calculating the index of “Rent, water, fuels and power” group changed. The growth of this index brought about changes even in the total index, leading to annual inflation rate reduction by 0.6-1 percentage points along 2003.
- The slow increase of monetary indicators and the observance of inflation target have dictated the maintenance of the Bank of Albania easing side of monetary policy. The Bank of Albania reduced the repo interest rate by 0.5 percentage points in October.
- During November, the Bank of Albania changed some elements of the monetary policy instruments, adjusting them to the market needs and approaching to ECB standards.
- The Bank of Albania quantitative targets are maintained to satisfactory levels during September – October.
- During September, the monetary supply has followed up the tendency observed during the previous year. This month is characterized by a slow increase of deposits and by a reduction of the level of money outside banks.
- Budget deficit, at end of September, reached to Lek 13.9 billion, almost at the same levels with those of the previous year. The October income was realized to 95 per cent of the planned level whereas the spending was surpassed by 18 per cent. The budget deficit, according to the operative data resulted to be increased by Lek 2.8 billion and was fully financed by the Banking system and the households.
- The banking system credit portfolio at end of this month is estimated to have been increased by Lek 0.9 billion, compared to August. Unlike the previous month, during September, about 55.5 per cent of the banking system credit portfolio was derived from credit in lek.
- The banking system has continued to result with liquidity excess even during September – October. The increase of lek deposits during October due to the returning of money into the banking system and the completion of the local election campaign has impacted on the increasing tendency of liquidity after the first ten-day period of October.

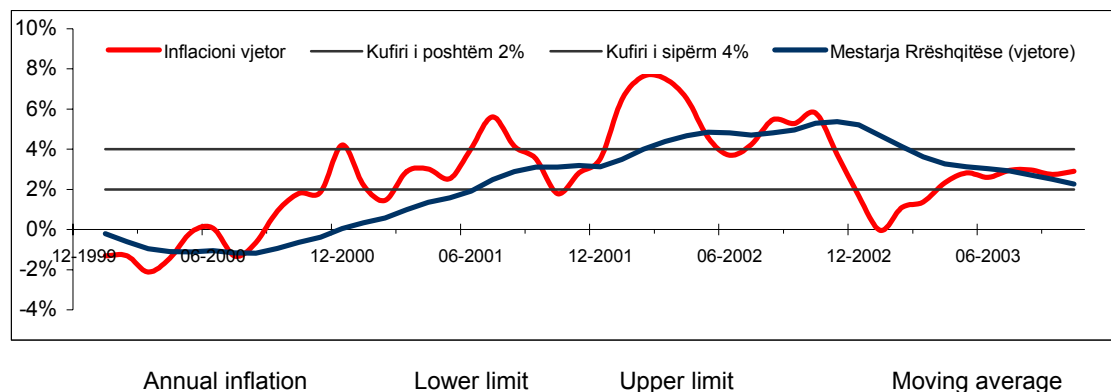
2 INFLATION PERFORMANCE IN OCTOBER 2003

October 2003 marked an annual inflation of 2.9 per cent, remaining within the Bank of Albania targeted band of 2 – 4 per cent. The annual average rate of inflation went on declining even during October, reaching to 2.27 per cent.

Table 1: ANNUAL INFLATION RATE (in percentage).

	1999	2000	2001	2002*	2003*
January	6.0	-1.3	2.2	6.5	0.0
February	3.5	-1.3	1.5	7.6	1.1
March	2.0	-2.1	2.9	7.5	1.3
April	0.4	-1.4	3.0	6.5	2.3
May	-0.1	-0.1	2.5	4.6	2.8
June	-0.6	0.1	4.0	3.7	2.6
July	0.1	-1.3	5.6	4.2	3.0
August	-0.6	-0.7	4.1	5.5	3.0
September	-1.9	0.9	3.5	5.3	2.8
October	-1.8	1.8	1.8	5.8	2.9
November	-1.2	1.9	2.8	3.7	
December	-1.0	4.2	3.5	1.7	

Chart 1: Annual inflation (in percentage).

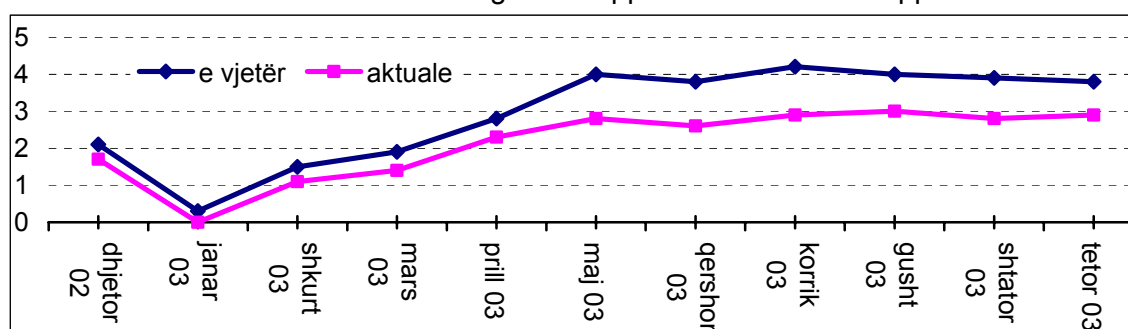


During October, the way of calculating the index of “Rent, water, fuels and power” group changed. Recalculation of this index brought about changes even in the total index, bringing about reduction of annual inflation rate by 0.6-1 percentage points along 2003 (see Box 1 for a detailed information).

The following chart shows inflation performance in 2003, with both ways of its calculation.

* Annual inflation rate for 2002-2003 is calculated according to new way.

Chart 2: Annual inflation rate according to old approach and current approach.



The annual inflation rate, calculated with the new approach has observed rigorously the Bank of Albania targeted band. **By means of the new calculation, deviation of artificial growth of the overall consumer price index value brought about a more accurate presentation of monthly and annual inflation rate.**

Box 1. Recalculation of “Rent, water, fuels and power” group index

In december 2001 the basket of goods and services, by means of which the consumer price index was measured changed. The change consisted both in the change of their weights and in adding new articles. One of the new articles added was the inputed rent, which occupied a considerable weight (about 17 per cent).

The price of this article was calculated as a weighted average of all articles of the group in which it was included, i.e., “Rent, water, fuels and power”. Then it was seen that the calculation of the index of this article brought about problems. It brought about artificial movement of the overall consumer price index value, and in consequence, even of the monthly and annual value of inflation rate. This fact is verified by the rate until May of this year. In May 2003, the raising of power price occurred, which by averaging the group prices, raised the inputed rent artificially, thus raising even the inflation rate.

To prevent this problem, it was agreed that the inputed rent price would be the price of only one of the articles of this subgroup, i.e., the **ususal rent**.

INSTAT disclosed the new consumer price index for October 2003, and recalculated the index for the whole year 2002 and 2003. Now there will be made a new calculation of “inputed rent” basket item index, which will have a much lower weight (1.5 per cent) than it had in its old calculation (17 per cent).

Annual inflation in October 2003 underwent a considerable reduction compared to annual inflation rate of the previous October of 5.8 per cent. The “Foodstuff and non-alcoholic beverages” group, whose annual inflation is 4.3 per cent, against 6.0 per cent in October 2002, has also rendered its contribution in this reduction.

Table2: Contribution of the main basket groups to total annual inflation (in percentage points).

	Jan.	Febr.	March	April	May	June	July	Aug.	Sept.	Octob.
1.Foodstuff and nonalcoholic beverages	0.05	0.99	1.11	2.09	2.34	2.23	2.56	2.33	2.21	1.82
2. Rent, water, fuels and power	-0.45	-0.24	-0.18	-0.18	0.10	0.11	0.10	0.39	0.23	0.68
Rent, water, fuels and power*	-0.15	0.19	0.33	0.32	1.31	1.31	1.33	1.41	1.35	
3.Hotels, café and restaurants	0.28	0.20	0.21	0.24	0.26	0.24	0.17	0.15	0.19	0.18
4. Transport	0.13	0.20	0.31	0.25	0.16	0.12	0.10	0.10	0.07	0.12
5. Others	-0.01	-0.05	-0.15	-0.10	-0.06	-0.10	0.07	0.03	0.1	0.10
Total	0.0	1.1	1.3	2.3	2.8	2.6	3.0	3.0	2.8	2.9

*According to old way of calculation

As shown by the following table, this group impacted on total inflation of October 2003 by 1.82 per cent, whereas in October 2002 this impact was 2.52 per cent. Monthly inflation has also declined. While in September the monthly inflation rate of this group was positive, in October we have a negative monthly inflation by -0.5 per cent. Among the subgroups having a more emphasized decline is the “Vegetables” subgroup with a monthly inflation - 6.1 per cent, marking a significant reduction in comparison to the previous year, where the inflation of this subgroup marked -0.4 per cent. Unlike the previous month, the monthly inflation of “Fruits” subgroup is increased by 3.1 per cent. The following table presents, in a summarized way, the impact of monthly and annual inflation of this group.

Table 3: Monthly and annual rate of “Food and alcoholic beverages” group.

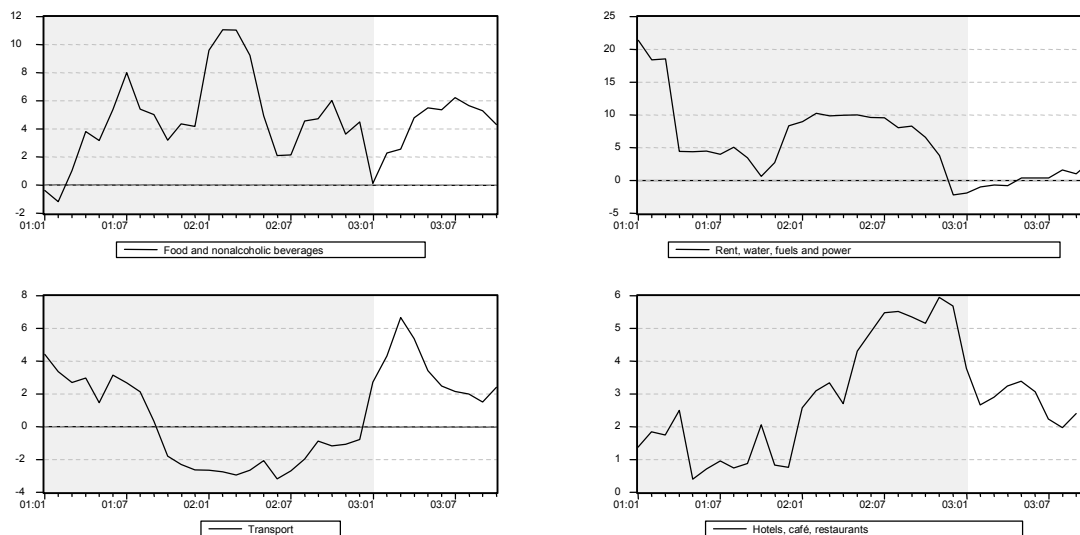
	“Foodstuff and nonalcoholic beverages” group		“Fruits” subgroup		“Vegetables” subgroup	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
Octob. '03	-0.5	4.3	3.1	24.8	-6.1	14.6
Octob. '02	0.5	6.0	1.2	6.6	-0.4	11.4

Among other developments of this month, the annual growth of “Medical care” group index by 5 per cent is highlighted. The increase of index of this group by 2.2 per cent is mainly due to the raising of payment charges on consulting a doctor by 5.5 per cent in October. Even the “Alcoholic beverages and tobacco” group has had an increase with an annual inflation of 4.4 per cent, where the “Tobacco” subgroup has had the highest annual growth by 5.5 per cent.

Just like in August, the monthly inflation rate of “Rent, water, fuels and power” group underwent once more an increase, due to the raising of the rent price

by 1.3 per cent. This value, along with other positive values of almost all other basket groups, broke the trend into negative values of the “Foodstuff and non-alcoholic beverages” group, resulting to a small positive value, of 0.2 per cent of inflation in October.

Chart 3: Annual inflation of 4 main groups of CPI basket (in percentage).



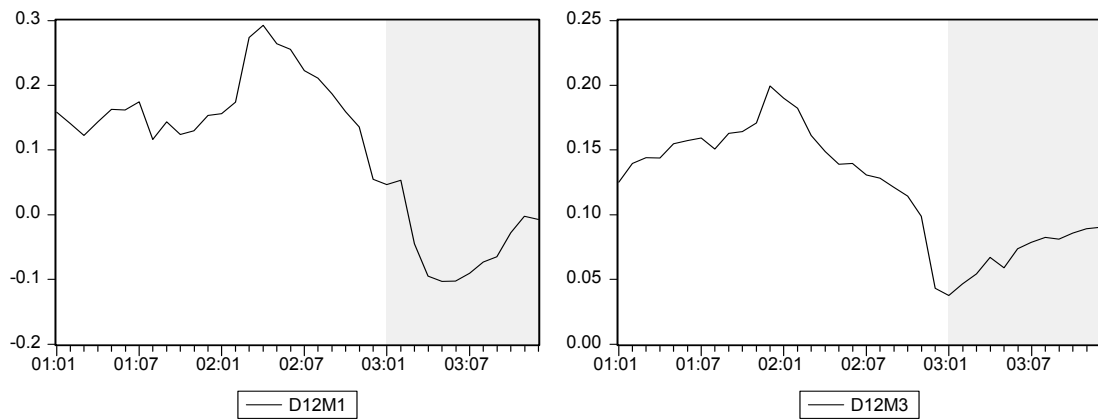
Inflation performance of Greece and Italy, the main partner countries of Albania, has generally marked high rates during this year. This fact, accompanied even with the depreciation of Lek against euro, is considered to have impacted on the increase of the value of imported inflation.

Table 3. Inflation performance in some partner countries (in percentage).

Countries	Annual inflation (in percentage)							
	Febr.	March	April	May	June	July	August	Sept.
Greece	4.2	3.9	3.3	3.5	3.6	3.5	3.3	
Italy	2.6	2.9	3.0	2.9	2.9	2.9	2.7	3.0
Germany	1.2	1.2	1.0	0.6	0.9	0.8	1.1	1.1

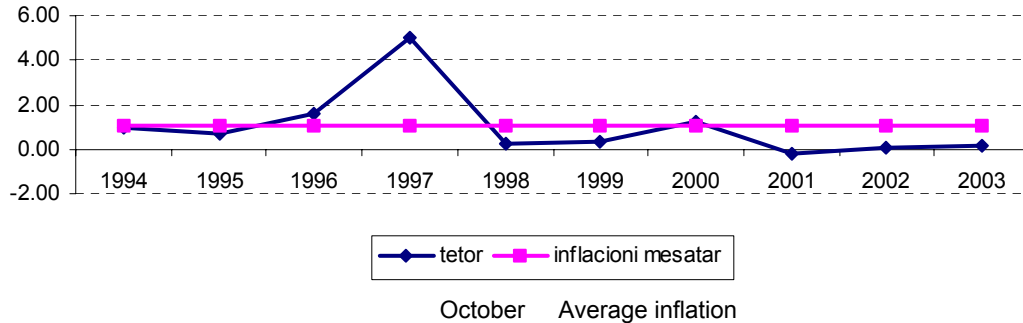
The Bank of Albania monetary policy has positively contributed to inflation performance, maintaining the liquidity level in economy within the programmed level. The positive performance of inflation and economy seem to have established an environment with expectations for a managed inflation. Such expectations are also a result of two surveys, "Consumer trust" and "Business trust" conducted by the Bank of Albania.

Chart 4: Annual changes of M1 and M3 monetary aggregates (in percentage).



October, in general, is featured by normal developments in terms of inflation. This is so because consumer demand during this month generally stands in normal levels, furthermore, there is decline against summer period. On the other hand, the domestic supply manages to face the demand, especially with food products of the season. Under these conditions, the monthly inflation rate, as noticed even from the following chart, is flat, with few fluctuations around the average. October 2003 has not reflected significant deviations from its historical mean.

Chart 5: Monthly inflation rate performance in October



October maintained the inflation rate of the previous months. Its movements were mainly due to more realistic calculation of consumer price index by INSTAT.

3 MONETARY DEVELOPMENTS

3.1 BANK OF ALBANIA MONETARY POLICY

The slow increase of monetary indicators and the maintenance of inflation target have dictated the maintaining of the easing side of the Bank of Albania monetary policy. The bank's reaction to repo rate change in July has continued even during September. Along this month the bankig system results with lower interest rates, both in deposits and credit in lek. The money supply is slightly increased, being influenced by a positive performance of demand for monetary assets. On the supply side, September witnessed an increase in lek deposits, while it is disguised by appreciation of Lek and increase of deposits in foreign currency.

Assessing the developments in inflation performance and monetary indicators, the Bank of Albania reduced the repo interest rate by 0.5 percentage points in October. This reduction is a response to past and expected developments of economic indicators within the targets, especially the inflation. The base interest rate reduction is expected to be associated with Banks' reactions on the same direction, thus reducing costs of money in economy. The so-far data indicate that the banks are reacting in the proper direction.

Responding to positive developments of monetary supply components, the Bank of Albania has continued to withdraw excess liquidity into the banking market. This liquidity is increased due to increase of deposits in lek and their non-investment in treasury bills or credit. This liquidity is also impacted by the Bank of Albania purchase of \$ 6 million in the foreign exchange market during September and October. A part of this liquidity, Lek 0.1 billion is withdrawn by the Bank of Albania by outright purchases during September. In the second week of November, the Bank of Albania has withdrawn about Lek 4.8 billion by the weekly and monthly repo auctions or Lek 0.8 billion more than end of October.

During November, the Bank of Albania changed some elements of monetary policy instruments, adjusting them to the market needs and approaching to the ECB standards.

During this period the Bank of Albania quantitative targets are maintained to satisfactory levels.

Table 4: Meeting the Bank of Albania quantitative targets ¹.

	Decemb. '02	March '03	June '03	Sept. '03	Octob. '03*
Meeting Net International Reserve target (in million dollars)					
Target	558.6	560.6	582.2	576.2	578.5
Actual	562.2	596.2	607.3	616.1	622.3
Difference	3.6	35.6	25.2	40.0	43.8
Meeting Net Domestic Assets target (billion leks)					
Target	95.1	97.1	98.1	89.1	90.5

¹ Reviewed according to most recent visit of the EU1 mission of October 2003.

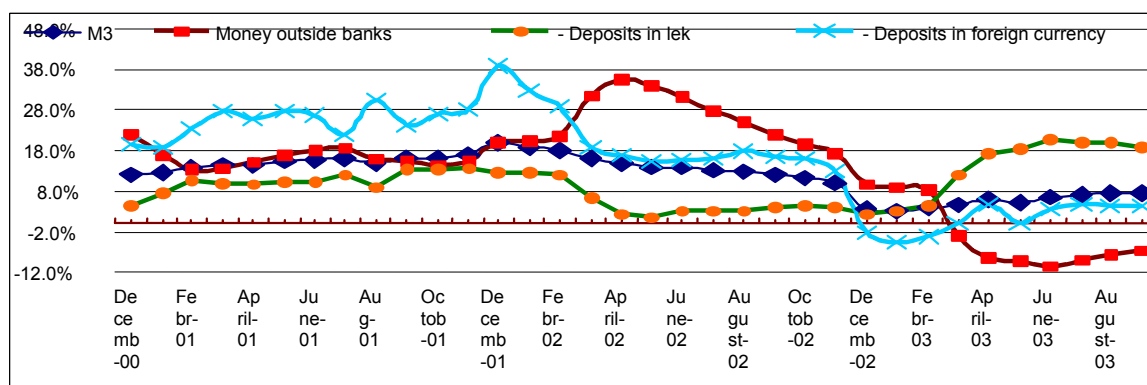
Actual	87.1	76.5	68.8	73.0	72.0
Difference	-8.0	-20.7	-29.4	-16.1	-18.5
Meeting the NDC to Government (billion leks)					
Target	258.7	264.6	267.7	274.7	276.4
Actual	259.6	263.1	263.1	270.8	-
Difference	0.9	-1.4	-4.6	-3.9	-

***Data on October are operative.*

3.2 MONETARY AGGREGATES PERFORMANCE

During September, the money supply has pursued the tendency observed during the past part of the year. Annual growth of this indicator is at the level of 7.5 per cent, being very close to that of two previous months.

Chart 6: Monetary aggregate annual rate performance



This month is featured by a slow increase of deposits and by a reduction of the level of money outside banks. Unlike the previous month, when the deposits in foreign currency were significantly increased (Lek 5.8 billion), in September their growth was merely 0.3 billion. The real foreign currency deposit growth is disguised by the combined appreciation of lek by 1.74 per cent against main currencies, euro and dollar. It is calculated that this effect has impacted negatively on the value of deposits in foreign currency, to about Lek 1.7 billion. In annual terms, the foreign currency deposit growth rate has been almost constant since the second quarter of the year, being below their historical trend.

Table 5. Monetary indicators performance in September (in billion leks).

	Sept. 2003	Monthly change		Annual change	
		Absolute	Percentage	Absolute	Percentage
Money outside banks	121.3	-0.8	-0.6	-8.4	-6.5
Total deposits	315.7	2.8	0.9	39.1	14.1
- Deposits in lek	220.2	2.5	1.2	35.0	18.9
- Deposits in foreign currency	95.5	0.3	0.3	4.1	4.5
Demand deposits	41.0	1,172	2.9	-18.5	-31.0
- in lek	17.2	624	3.8	-6.2	-26.6

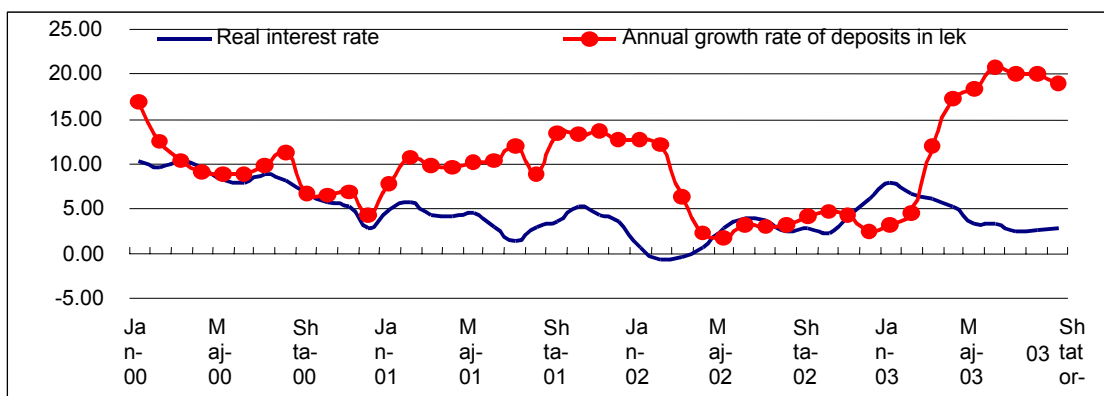
-- in foreign currency	23.9	549	2.4	-12.2	-33.9
Time deposits	274.7	1.6	0.6	57.5	26.5
- in lek	203.0	1.9	0.9	41.2	25.5
- in foreign currency	71.7	-0.3	-0.4	16.3	29.5
M1	138.5	-0.2	-0.1	-14.7	-9.6
M2	341.5	1.7	0.5	26.5	8.4
M3	437.0	2.0	0.5	30.6	7.5
Money base	157.2	0.8	0.5	-3.8	-2.3

The annual rates of Lek deposits and money outside banks seem to have started a period of approaching to their historical trends. Annual growth of deposits in Lek is slowing down due to stabilization of the ratio of money outside banks to M3. After summer months, the money outside banks continues to have negative performance both in monthly terms and annual terms, though the changes in absolute value are falling.

During September the process of returning money outside banks into the system has led to lek deposit growth. This growth has been higher than the economy demand for monetary assets, influencing on the increase of excess liquidity in the system. Compared to August, this liquidity is increased by lek 0.3 billion. The liquidity level has continued to grow further during October, reaching to Lek 5.5 billion from Lek 4.1 billion it was in the previous month. The Bank of Albania has been present in the market, continuously withdrawing such liquidity by means of weekly repo auctions.

The Lek deposit growth is favoured even by the positive performance of real interest rate. In spite of reduction of nominal interest rates on deposits in lek, the maintaining of inflation in low levels has kept a positive real interest rate.

Chart 7: Deposit interest and real interest



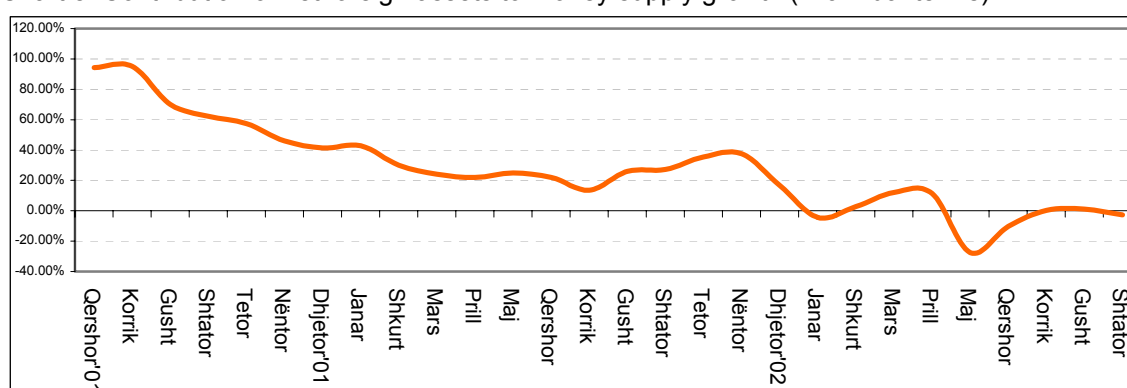
3.3 ECONOMY DEMAND FOR MONEY

Banking system net foreign assets

During September, the banking system has increased the net foreign assets by 52 million dollars. Denominated in Lek, they are presented as decreased by about Lek 1.6 billion. The decrease in Lek is due to appreciation of Lek against dollar. The clearance of exchange rate effect² on foreign assets indicated their real growth by Lek 6.2 billion.

The Lek reduction of foreign assets has decreased even the contribution rendered by this item to money supply growth. In this month this contribution is negative and is estimated at 2.6 per cent.

Chart 8. Contribution of net foreign assets to money supply growth (in annual terms).



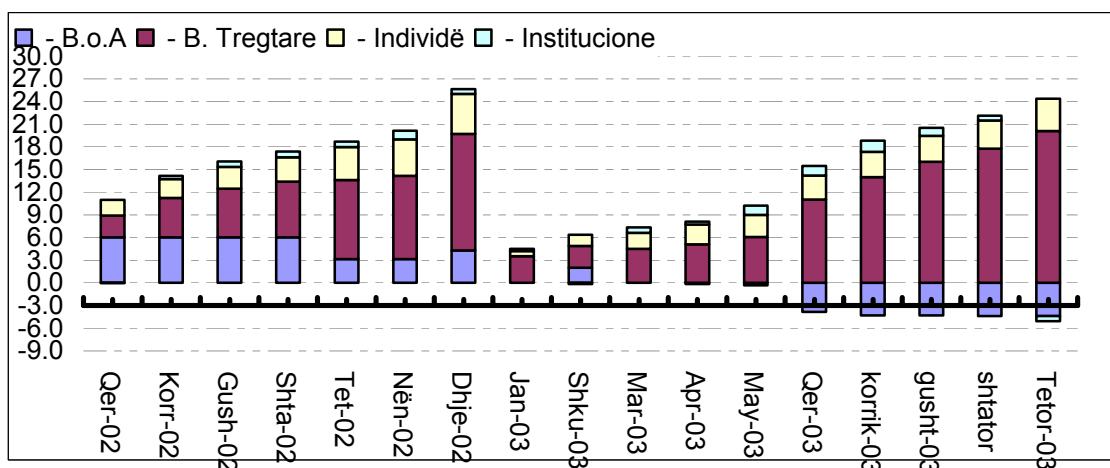
Estimated at the fixed exchange rate of usd/euro of December 01,= foreign assets of the system are increased only by USD 13 million. This increase is impacted by the Bank of Albania purchases, USD 3 million, and by the increase of foreign currency deposits of commercial banks. The increase of net foreign assets to 52 million dollars is dedicated to euro appreciation against dollar in the international market. The appreciation by 6.9 per cent of euro against usd in September has increased the euro investment value expressed in dollar.

Government demand for monetary assets

At end of September the budget deficit reached to Lek 13.9 billion, almost at the same levels with those of the previous year. Government demand for monetary assets during this period reached to total Lek 16.2 billion and was mainly covered by commercial banks. Until end of September, the Treasury bill portfolio of households is also increased, whereas the bank of Albania portfolio and the institutions' portfolio is decreased.

Chart 9: Gross financing cumulative performance of budget deficit along the year (in billion leks).

² At end of September lek resulted appreciated by about 4.7 per cent against dollar in comparison to the previous month.



The operative data indicate that during October the government demand for monetary assets is increased significantly against the previous month, leading the financing level for this month to Lek 18 billion. The monthly financing of deficit only by commercial banks is increased by Lek 2 billion against the previous month, and it is doubled against the same period of the previous year.

In October the monthly income is realized to 95 per cent of the planned level, whereas the expenditures are surpassed by about 18 per cent. Budget deficit according to operative data results to have been increased by Lek 2.8 billion and is fully financed by the banking system and the households.

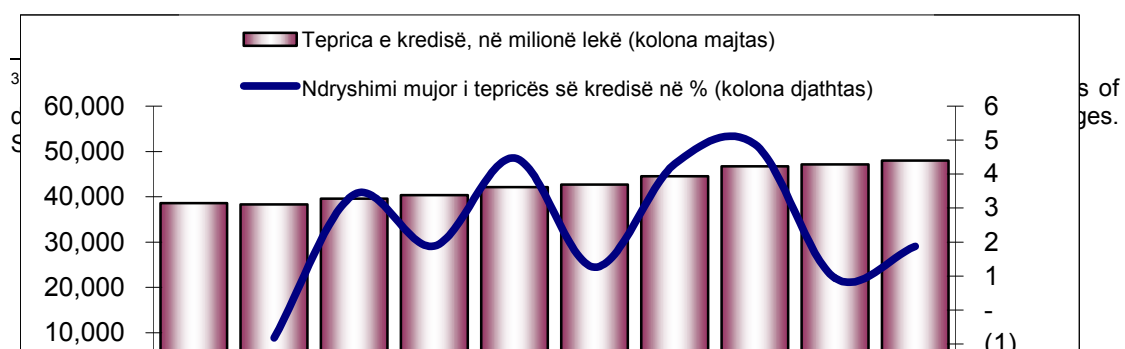
The current domestic financing level of budget deficit is very close to the limit allowed for it, which indicates that the government demand for monetary assets will not comprise an important element in the two coming months.

Credit to economy

Demand for money by the private sector and households in September reached to Lek 48 billion, constituting 11 per cent of the money supply³. The banking system credit portfolio at end of this month is estimated to have been increased by Lek 0.9 billion, compared to August. Unlike the previous month, during September almost 55.5 per cent of the increase of credit portfolio as a banking system is due to credit in lek. Even though an increase is noticed in September on the extension of loans in Lek, the foreign currency credit balance continues to dominate (81 per cent).

As a banking system, during September, there was totally extended 9.1 billion credit or 1,7 times more than in August. Also, the new credit had the following features: 73 per cent of it was short-term and 37 per cent was in Lek.

Chart 10. Monthly performance of credit to economy balance during 2003.



Credit balance, in million leks (left column)
 Monthly change of the credit balance in % (right column)

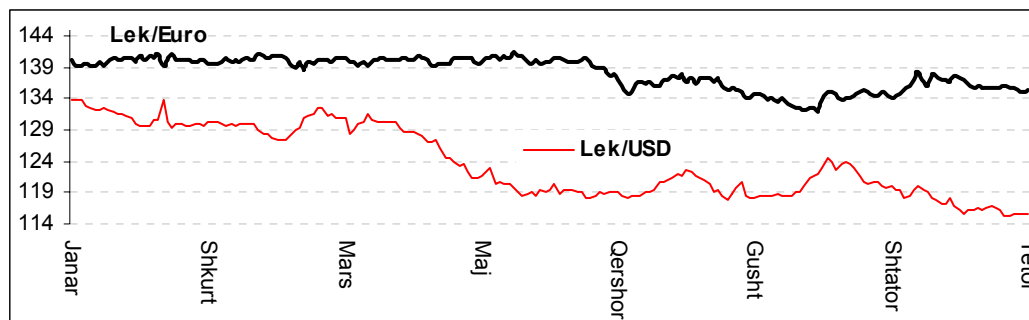
Credit to businesses for commercial purposes continues to dominate, though with a declining trend. It is reflected as being more focused on supporting branches such as processing industry, agriculture and fishing with credit.

The monetary program has foreseen that private sector and households will benefit from Lek 12.9 billion credit. The banking system for the period of January – September 2003 has financed these two sectors by Lek 9.3 billion or 72.1 per cent of the forecasting according to monetary program. Such a level of realization until end of September leaves room for claiming that the economy not only will be credited as much as programmed, but also the forecasting may be surpassed. This claiming is also supported by the tradition established in the three recent months, when the fourth quarter is associated with increase of demand for credit by the businesses and households.

3.4 EXCHANGE RATE

Since the year start until October, lek is appreciated against euro by about 13 per cent against dollar and it is appreciated by about 3.7 per cent against euro. Within October lek is fluctuated in close intervals against euro, to 136.2 lek/euro on average, whereas it is appreciated by 1.9 per cent against dollar.

Chart 11: Exchange rate along 2003.



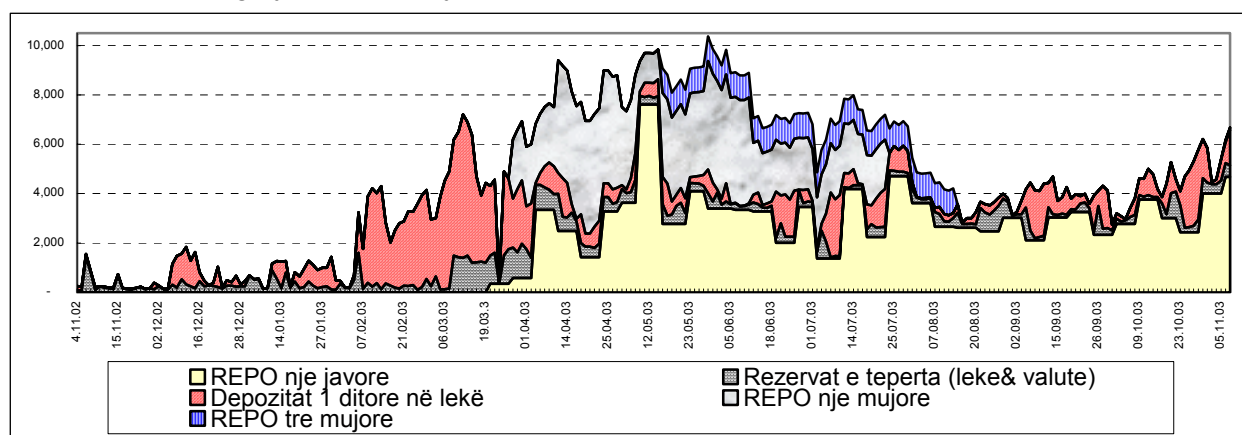
A backward –looking view in years (1999-2002) indicates that October, compared to September, has always witnessed appreciated lek both against dollar and against euro. October of this year witnesses once more the lek behaviour against dollar, while not the same thing can be said for its behaviour against euro. This deviation is mostly due to developments in international foreign exchange markets, which are also reflected even in Albanian market.

3.5 FINANCIAL MARKETS AND INTEREST RATE PERFORMANCE

3.5.1 FINANCIAL MARKETS

The banking system has continued to result with liquidity excess even during September – October. In the first week of November, the level of excess liquidity reached to Lek 6,7 billion, returning to the final level of July 2003.

Chart 12. Banking system liquidity at the Bank of Albania.



Weekly repo
Overnight deposits in lek
Quarterly repo

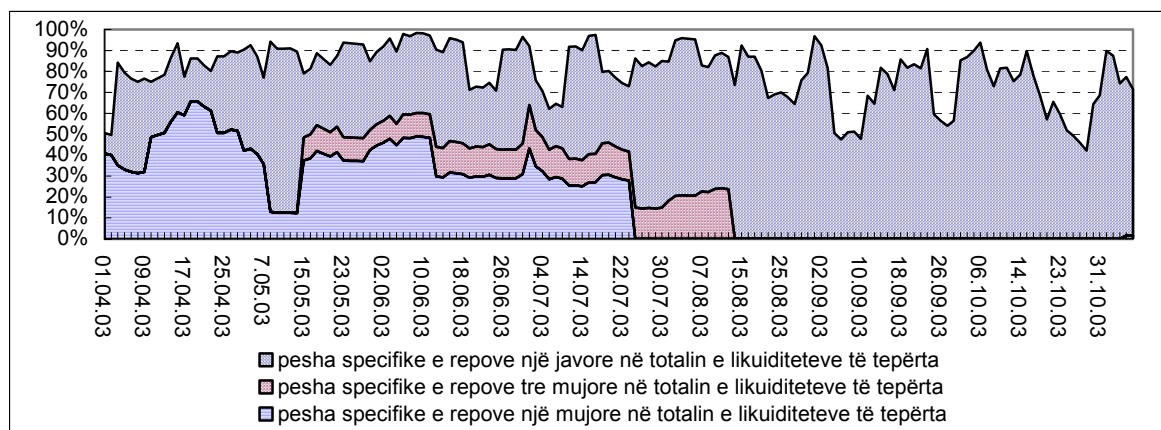
Excess reserves (in lek & foreign currency)
Monthly repo

The increasing tendency of liquidity after the first ten-day period of October is impacted by the increase of deposits in Lek during October due to the returning of money into the system, the end of local election campaign, etc.

The volume of overnight transactions in the interbank market has continued to stand in low levels, being impacted by the liquidity excess in all the banks of the system.

To withdraw the excess liquidity, the Bank of Albania has used the weekly repo auctions.

Chart 13. Specific repo weight in total commercial banks' liquidity at the Bank of Albania.



Specific weight of weekly repo in the total excess liquidity
 Specific weight of quarterly repo in the total excess liquidity
 Specific weight of monthly repo in the total excess liquidity

Under the conditions of excess liquidity, banks have continued to use the overnight deposit facility, while the overnight credit facility and the use of reserve requirement have been in low levels.

Meanwhile, we stress that in the future banks will have more space for the use of reserve requirement, since with the Bank of Albania Supervisory Council decision, starting from December, the limit allowed for the use of reserve requirement is increased from 5 per cent to 20 per cent of it. This is expected to further reduce the overnight credit use and the borrowing in the interbank market.

Besides this decision, the Supervisory Council decided even on the increase of remuneration of reserve requirement from 50 to 70 per cent of base interest rate in lek, of eurobor and libor, respectively for the reserve required in lek, euro and dollar. This change aims at approaching the remuneration of reserve requirement to market interest rate and at reducing the taxable element that is created by the holding of reserve requirement, which is expected to impact on bank intervention cost reduction.

In the framework of changes undertaken on reserve requirement instrument, the Supervisory Council also decided to extend the difference of overnight deposit rate and repo rate by 0.5 percentage points. This is expected to further promote the banks' activity in the money market, especially in the interbank market, since the borrowing cost in this market will be lower.

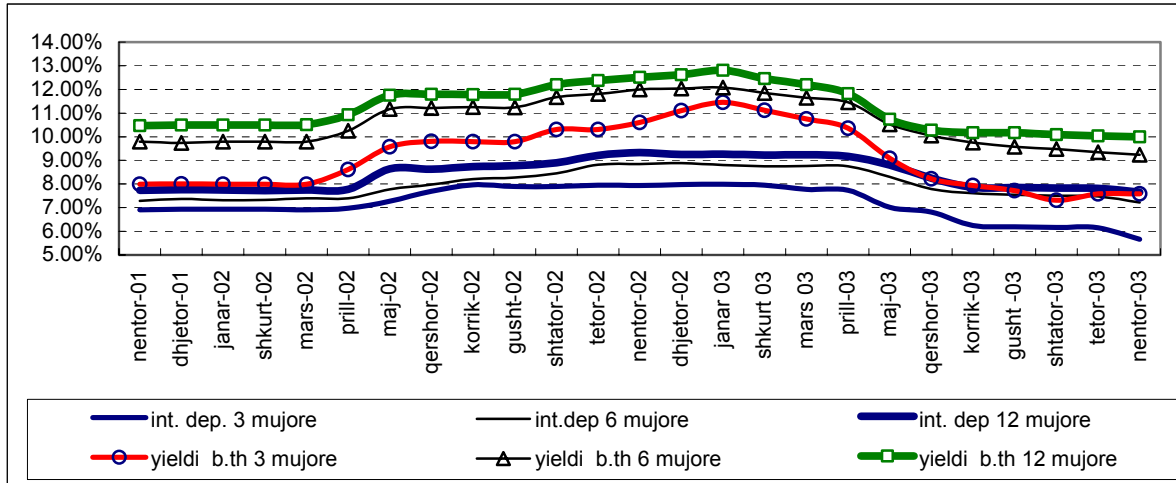
3.5.2 INTEREST RATE PERFORMANCE

Reduction of base interest rate by 0,5 percentage points made possible the reaching of the base interest rate before the 2002 crisis. This is expected to further influence reduction of money price in economy, thus further encouraging credit to business.

Chart 14. Policy pursued by the Bank of Albania through base interest rate

Banks' reaction in the deposit market and in the primary market has been more obvious at three- month terms. As it was expected, the reaction towards the reduction of interests in November resulted lower than the one after the first reduction of interests (in April).

Chart 14. Banks' reaction in the primary market and in deposit market according to terms



3-month deposits
3-month T.B. yield

6-month deposits
6-month T.B. yield

12-month deposits
12-month T.B. yield

We note that the banks' reaction has been fast in terms of lek deposit interest reduction. Eight banks have informed on the reduction of lek deposit interest since first week of November, immediately after the reduction signaled by the Bank of Albania.

Table 6. Change of average weighted interests in lek time deposits in the period after the signal by the Bank of Albania.

January-March	April-June	July-October	November	October
-0.14%	-0.87%	-0.55%	-0.36%	-1.92%

There has been reduction in the market of deposits in foreign currency both in euro and dollar, but the reduction of three-month USD deposit interests is more obvious.

Chart 15. Foreign currency deposit interest according to terms.

