

BANK OF ALBANIA

MONETARY POLICY REPORT

OCTOBER 2005

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I MAIN HIGHLIGHTS

- Annual inflation highlighted a slight increase in August, returning within the targeted band of Bank of Albania. Annual and monthly inflation rates were 2.3 per cent and 0.2 per cent, respectively.
- The main factor having impacted inflation in August is the price performance of “Rent, water, fuels and energy” group. The contribution of “Foodstuffs and non-alcoholic beverages” group to inflation of this month has been at minimum levels.
- The other groups of consumer basket have contributed with the same value as the previous month, 0.5 percentage points.
- Oil price rise in the international market is being accompanied by a moderate price rise of this product in the domestic market. The ongoing appreciation of Lek versus US dollar has prevented it from having a full impact in the country.
- Favourable developments in the exchange rate have enabled keeping imported inflationary pressures under control. In annual terms, Lek has appreciated at 2.4 per cent against USD and 3.3 per cent against Euro, in August.
- Demand and supply factors continue to give a balanced influence in the consumer price performance. Meeting the overall parameters of budget and monetary programs has already created favourable macroeconomic conditions for maintaining inflation under control.
- Remaining generally within the approved annual budget frame, the fiscal policy has not transmitted excessive inflationary pressures in the economy. However, the concentration of budget borrowing during the last three months has created liquidity problems in the system, increasing as well the fluctuations of interest rate.
- July is characterised by a slower increase of money supply, which is reflected in the decline of annual rate of M3 to 16.0 per cent, from 18.3 per cent it was in the previous month. This slowdown is reflected in both the foreign currency component and the Lek component of money supply.
- July has known a fiscal deficit deepening estimated at ALL 10.8 billion or ALL 4 billion more than the previous month. The fiscal deficit was mainly afforded through the reduction of government deposit at ALL 2.5 billion, while the new borrowing has been estimated at ALL 1.5 billion.
- July has marked a monthly increase of credit balance by ALL 1.8 billion, reaching the amount of ALL 97.7 billion. In GDP terms, credit balance attained the level of 11.4 per cent, highlighting an increase of 2.4 percentage points by the end of 2004. Credit balance evidenced a monthly increase of ALL 37.8 billion or 62.8 per cent, remaining at high levels throughout 2005.
- Banking system is characterised by a liquidity decrease during the summertime due to the increase of consumer expenditures, the credit in Lek to the economy and the internal borrowing of government.

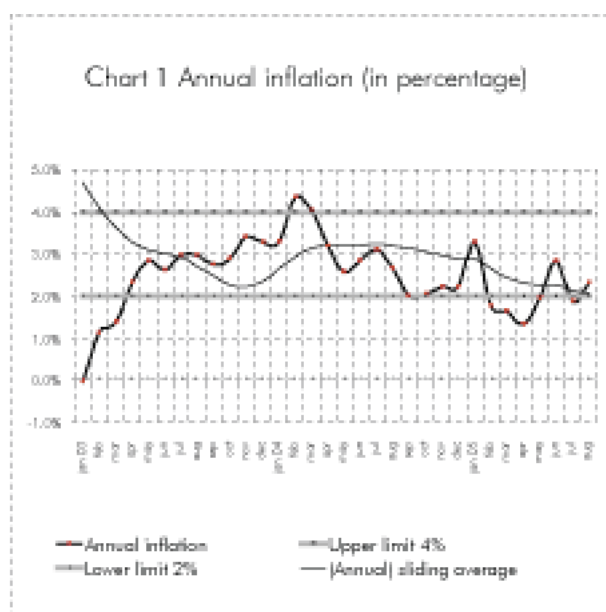
II INFLATION IN AUGUST

Annual inflation highlighted a slight increase in August, returning within the targeted band of Bank of Albania. Annual and monthly inflation rates were 2.3 per cent and 0.2 per cent, respectively. Meanwhile, the average annual inflation¹ remained unchanged during this month, at 2.1 per cent.

Table 1 Annual inflation rate (in percentage)

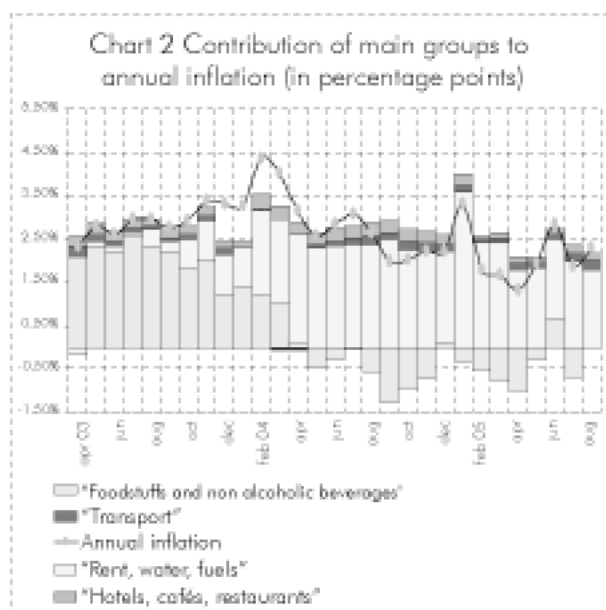
	2001	2002	2003	2004	2005
January	2.2	6.5	0.0	3.3	3.3
February	1.5	7.6	1.1	4.4	1.8
March	2.9	7.5	1.3	4.0	1.6
April	3.0	6.5	2.3	3.2	1.3
May	2.5	4.6	2.8	2.6	2.0
June	4.0	3.7	2.6	2.9	2.9
July	5.6	4.2	3.0	3.1	1.8
August	4.1	5.5	3.0	2.7	2.3
September	3.5	5.3	2.8	2.0	
October	1.8	5.8	2.9	2.0	
November	2.8	3.7	3.4	2.2	
December	3.5	1.7	3.3	2.2	
Average	3.1	5.2	2.2	3.0	2.1

Source: INSTAT



II.1 INFLATION AND CONSTITUENT GROUPS

The main factor having impacted inflation in August is the price performance of “Rent, water, fuels and energy” group. The contribution of this group to the annual inflation rate in August was 1.8 percentage points, while the contribution of “Foodstuffs and non-alcoholic beverages” group to inflation of this month has been at minimum levels. The other groups of consumer basket have contributed with the same value as the previous month, 0.5 percentage points.



After showing a significantly negative rate in July, annual inflation of “Foodstuffs and non-alcoholic beverages” group evidenced a level close to zero in August. The inflation increase of this group in August is attributable to a longer tourist season of this year, which brought about an increase of demand for foodstuffs at a time when the domestic market reached the peak supply in July. The level of prices of this group, even during this month, depended basically on the price performance of agricultural products². On the other side, the growth of imports of these products during this month did not generate strong inflationary pressures on their prices. This is due to the fact that exchange rate of Lek against the Euro has been relatively stable and foodstuff prices in the partner countries, like Italy and Greece, continue to remain within the normal seasonal fluctuations.

Table 2 Annual inflation rate of the group "Foodstuffs and non-alcoholic beverages" (in the country and outside) and the contribution of inflation of this group to the total inflation

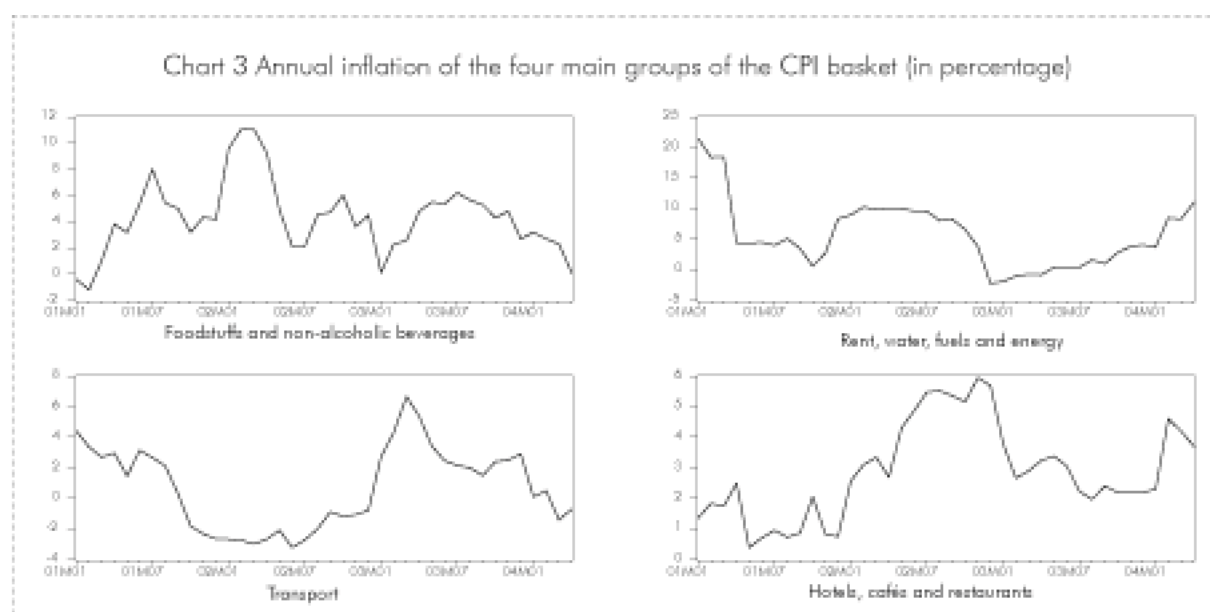
	Annual inflation '04	Contribution (pp)	Annual inflation '05	Contribution (pp)	Italy* Annual inflation '05	Greece** Annual Inflation '05
January	3.2	1.4	-0.7	-0.3	-0.7	0.6
February	2.7	1.2	-1.2	-0.5	-0.4	-0.9
March	2.3	1.0	-1.7	-0.7	-0.2	-1.4
April	0.1	0.1	-2.3	-1.0	-0.2	-0.1
May	-1.1	-0.5	-0.7	-0.3	-0.2	-0.4
June	-0.7	-0.3	1.6	0.7	-0.2	-0.5
July	-0.1	0.0	-1.6	-0.7	-0.2	0.7
August	-1.4	-0.6	0.0	0.0	-0.2	1.4

* Source: ISTAT; website: <http://www.istat.it>

** Source: General Secretariat of National Statistical Service of Greece; website: <http://www.statistics.gr>

The contribution of "Rent, water, fuels and energy" group decreased again at the levels of the first quarter of this year, after the increase observed in July. In August annual inflation of "Rent, water, fuels and energy" group was estimated at 6.9 per cent, from 7.7 per cent it was in the previous month. This figure of inflation was attributed to the influence given by the decline of rent price and of imputed rent to the average levels of the second quarter by 2.2 percent, after the increase evidenced in July due to the intensive tourist season period.

The other administered prices, such as healthcare and education fees, have continued to grow even during this month. Their contribution to the overall inflation rate continues to be insignificant due to the small share³ they take in the consumer basket. Oil price rise in the international market is being reflected as well in the fuel domestic market. As a result, "Transport" group has known the highest increase since August last year, while "Services to personal vehicles"⁴ subgroup increased by 10.3 per cent. Inflation of the other groups of basket had a lower impact in defining the inflation rate, due to the fact that price movement in these groups have been within the normal seasonal fluctuations.

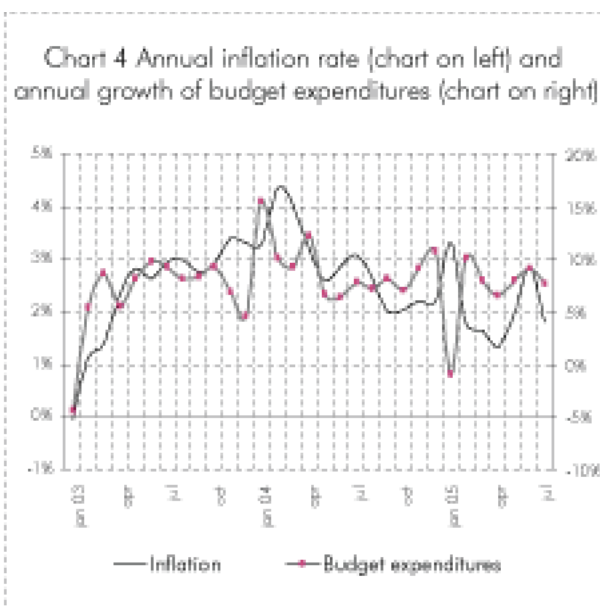


II.2 MICROECONOMIC ENVIRONMENT AND CONSUMER PRICES

The macroeconomic developments speak for a stable macroeconomic environment. The annual inflation (2.3 per cent) and the average annual inflation (2.1 per cent) remained within the 2-4 per cent targeted range in August 2005. Demand and supply factors continue to give a balanced impact on the price performance in the country. Meeting the overall parameters of budget and monetary programs has already created favourable macroeconomic conditions for maintaining inflation under control.

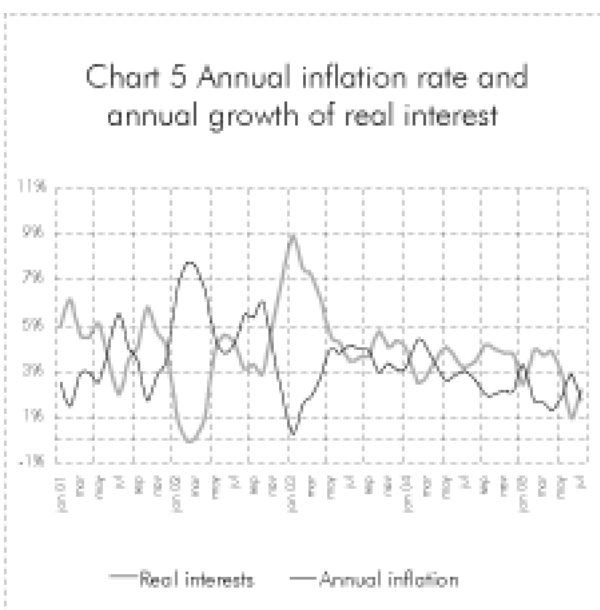
FISCAL POLICY

Remaining generally within the approved annual budget frame, the fiscal policy has not transmitted excessive inflationary pressures in the economy. However, the concentration of budget borrowing during the last three months has created liquidity problems in the system, increasing as well the fluctuations of interest rate. Although the period of January-July is characterised by a growth of budgetary, current and capital expenditures, total expenditures have been within the projected limits. In July, total revenues reached the level of 92.8 per cent of the plan, while total budget expenditures were performed at 96.4 per cent.



Although the period of January-July is characterised by a growth of budgetary, current and capital expenditures, total expenditures have been within the projected limits. In July, total revenues reached the level of 92.8 per cent of the plan, while total budget expenditures were performed at 96.4 per cent.

The budget deficit exceeded by 10.8 percentage points the projected level. Neither the targeted performance of current expenditures nor the prudential financing of budget deficit has exposed any risk to inflation rate.



MONETARY POLICY

The easing monetary policy of Bank of Albania has satisfactorily met the needs of the economy for monetary assets, without exerting inflationary pressures. Low interest rates have provided lower borrowing costs, encouraging the increase of crediting to the economy. On the other side, under an environment at low inflation rates, the positive real interest has succeeded to channel the free funds of economy in the banking system, without creating excess liquidity.

Both of the main components of macroeconomic policy have created the appropriate conditions for a moderate increase of inflation rate in the country.

EXCHANGE RATE AND IMPORTED INFLATION

Favourable developments in the exchange rate have enabled keeping imported inflationary pressures under control. In annual terms, Lek has appreciated at 2.4 per cent against USD and 3.3 per cent against Euro, in August. While during the last two months the main trading partners of our country knew a slight increase of domestic inflation, the ongoing appreciation of Lek versus the Euro has smoothed the inflationary pressures that may have been transmitted by the imported inflation.

Table 3 Annual changes in the inflation of partner countries and in the exchange rate (in percentage)

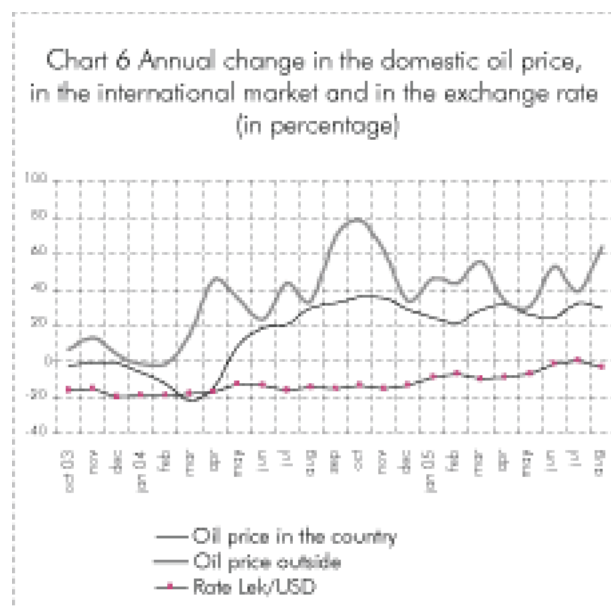
	January	February	March	April	May	June	July	August
Greece*	4.0	3.1	2.9	3.4	3.2	3.3	3.9	3.7
Italy**	1.9	1.9	1.9	1.9	1.9	1.8	2.1	2.0
LEK/EUR	-5.3	-4.8	-3.1	-1.6	-2.3	-1.0	-1.8	-2.4
LEK/USD	-8.8	-7.4	-9.8	-8.9	-7.4	-1.2	0.0	-3.3

* Source: General Secretariat of National Statistical Service of Greece; website: <http://www.statistics.gr>

**Source: ISTAT; website: <http://www.istat.it>

OIL PRICE

Oil price rise in the international market is being accompanied by a moderate price rise of this product in the domestic market. While the international market data⁵ indicate an annual oil price rise of 63.7 per cent, this rise of this product in the domestic market is only 29.6 per cent. The ongoing appreciation of Lek versus US dollar has prevented it from having a full impact in the country. The impact of this factor on the inflation performance measured by Consumer Price Index is much weaker. As mentioned in the previous reports, the small share this product takes in the CPI basket makes that oil price rise in the country is not reflected in a comprehensive manner. Thus, the annual increase of 29.6 per cent of oil price in the country was partly reflected in the increase of inflation of "Transport" group at 4.7 per cent, which added by 0.23 percentage points the total figure of inflation.



The good harmonisation of fiscal policy with monetary policy, the ongoing appreciation of Lek, as well as the smooth effect of oil price rise shock have helped in controlling inflationary pressures and in creating an appropriate environment for maintaining price stability even during the periods to come.

III. MONETARY POLICY AND MONETARY INDICATORS

III.1 MONETARY POLICY OF BANK OF ALBANIA

Monetary situation in the third quarter marked a visible deviation from the historical performance and our expectations. In contrast with the past 2-3 years, this period was characterized by a significant use of cash in circulation, by a concentration of internal government borrowing and by a worsening of liquidity situation of the banking system. Furthermore, seasonal appreciation

pressures of Lek exchange rate, observed during summertime due to emigrants' remittances, did not emerge in the expected time and intensity.

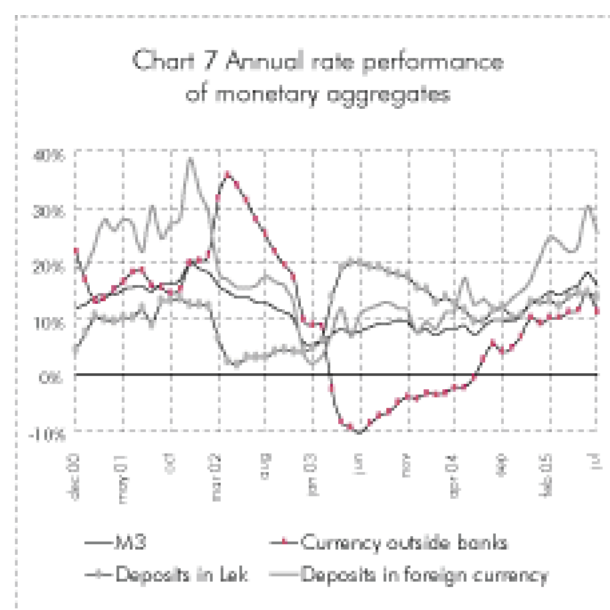
This situation required a greater attention for maintaining monetary equilibriums. In the operational plan, Bank of Albania has aimed at managing the liquidity situation and re-examining the foreign currency operations plan, with a view to re-establishing liquidity in the system and to maintaining exchange rate. Bank of Albania has changed the direction of its liquidity operations, supplying the banking system with liquidity through reverse repurchase agreements and has financed in the short-term periods the budget deficit to prevent the sharp fluctuations of interest in the interbank market and the Treasury bills market.

This policy has contributed to render the liquidity situation stable and to prevent upward pressures on Treasury bills yield, while inflation situation remains under control. However, due to the deviation from the expected rate of monetary indicators, the objectives of net domestic assets and net international reserve resulted as non-performed. Considering this non-performance as temporary, Bank of Albania estimates that monetary equilibriums and consumer price perspectives remain under control.

Table 4 Meeting the quantitative objectives of Bank of Albania

	December '04	March '05	May '05	June '05	July '05	August '05*
Net international reserves (in millions of USD)						
Objective	942	1,073	1,082	1,087	1117	1148
Currently	1,105	1,107	1,104	1,098	1105	1103
Difference	163	35	23	11	-12	-45
Net domestic assets (in billions of ALL)						
Objective	79	61	60	60	60	59
Currently	61	53	57	64	65	66
Difference	-18	-8	-3	4	5	7
Net domestic credit to Government (in billions of ALL)						
Objective	286	292	296	298	299	
Currently	285	288	291	294	298	
Difference	-1	-4	-5	-4	-1	

* Operative data



III.2 MONETARY AGGREGATES

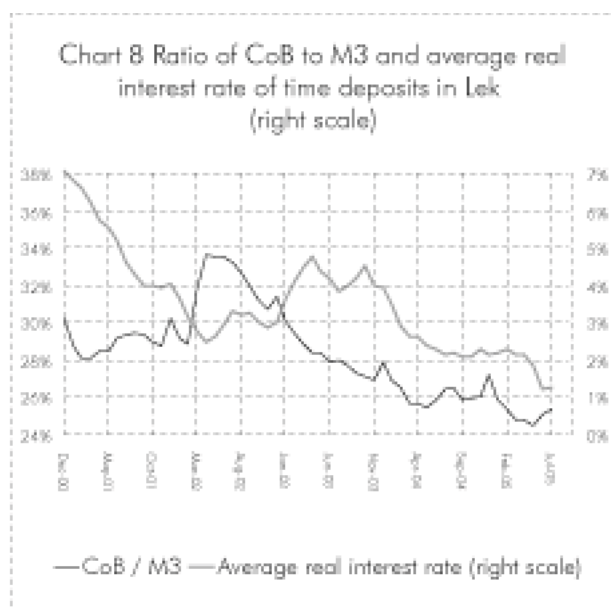
July is characterized by a lower increase of money supply, which is reflected in the decline of annual rate of M3 aggregate to 16.0 per cent, from 18.3 per cent it was in the previous month. This slowdown is reflected either in the foreign currency component or in the Lek component of money supply. The appreciation of Lek in July impacted negatively the growth of foreign deposits denominated in Lek, while the annual growth of M2 aggregate marked a significant decline. Unlike the last year, foreign inflows have not contributed to the growth of money supply in Lek, making the annual growth

rate of M2 aggregate comes down to its historical values⁶. In compliance with the seasonal trend, the time structure of money supply knew a further increase of share of its most liquid component.

Foreign deposits gave a small contribution to the money supply growth in July. Their level marked a monthly increase of ALL 0.3 billion or around 0.2 per cent, reflecting the negative effect of monthly appreciation of Lek (about ALL 3 billion). The annual growth rate of foreign deposits decreased to 25.6 per cent, from 30.2 per cent it was in the previous month. For lack of the annual exchange rate effect, the annual growth rate of foreign deposits is presented at high and stable levels, around 29.5 per cent. Although foreign currency flows have resulted below the last summer's level, the reduction of the difference between interest rates in Lek and in foreign currency has encouraged the placement of a greater part of these flows in foreign monetary assets, maintaining high annual rates of foreign deposits. The foreign deposits structure according to terms has known a significant growth of the time deposits share. This growth has come as a result of the shift of the private sector deposits with one of the banks of the system, from current account into time deposits, for an amount of approximately ALL 1.9 billion.

The slowdown of the M2 aggregate growth is reflected in lower growth rates of indicators of currency outside banks and of deposits in Lek. After its significant growth in the last month, currency outside banks turned back to normal growth rates. In compliance with the seasonal performance, its level has showed a monthly increase of ALL 2.5 billion or 1.8 per cent. Meanwhile, the annual growth rate of this indicator has recorded a significant decrease in July, marking the value of 11.4 per cent, from 14.9 per cent it was in June.

The ratio of currency outside banks to M3 aggregate, in July, reached 25.4 per cent, from 25.1 per cent it was in the previous month. The decrease of real interest rates to the minimum historical levels does not seem to have impacted the increase of this indicator beyond the expected seasonal effects. In addition, the normal performance of the ratio of currency outside banks to M3 indicates the end of the impact of some factors that brought about its temporary increase in June.



The contribution of Lek deposits to the annual growth of money supply has resulted also at low levels. The monthly growth of Lek deposits reached the amount of about ALL 0.7 billion, while their annual growth rate decreased from 14.7 per cent to 14.1 per cent in July. This decrease has reflected a slowdown of private sector deposits, while the annual growth rate of household deposits in Lek has recorded a slight decline. The slowdown of deposits in Lek is a sign of decline of their attractiveness among other alternatives of investment (Treasury bills and foreign currency deposits), due to the significant decrease of interest rates in Lek during the last months.

As a result of changes in the classification of Lek deposits⁷, the demand deposits in Lek have recorded a significant increase of ALL 5.0 billion, against the decrease of ALL 4.3 billion of time deposits in Lek. This increase of demand deposits

Table 5 Performance of monetary aggregates in July (in billions of ALL)

	July	Monthly change		Annual change	
	2005	Absolute	Percentage	Absolute	Percentage
Currency outside banks	138.3	2.5	1.8	14.2	11.4
Total deposits	407.0	1.0	0.2	61.2	17.7
- in Lek	270.6	0.7	0.2	33.4	14.1
- in foreign currency	136.3	0.3	0.2	27.8	25.6
Demand deposits	93.9	3.4	3.7	27.2	40.7
- in Lek	46.0	5.0	12.2	22.8	98.4
- in foreign currency	47.9	-1.6	-3.2	4.4	10.0
Time deposits	313.1	-2.4	-0.8	34.0	12.2
- in Lek	224.6	-4.3	-1.9	10.6	5.0
- in foreign currency	88.4	1.9	2.2	23.4	36.0
M1	184.3	7.5	4.2	37.0	25.1
M2	408.9	3.1	0.8	47.6	13.2
M3	545.3	3.4	0.6	75.4	16.0
Monetary base	182.3	1.8	1.0	21.0	13.0

Chart 9 Performance of foreign deposits ratio to M3

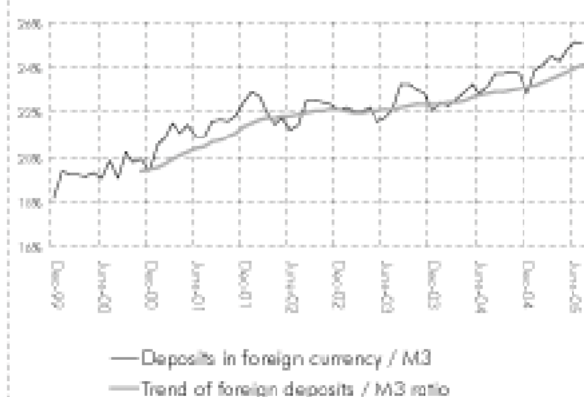
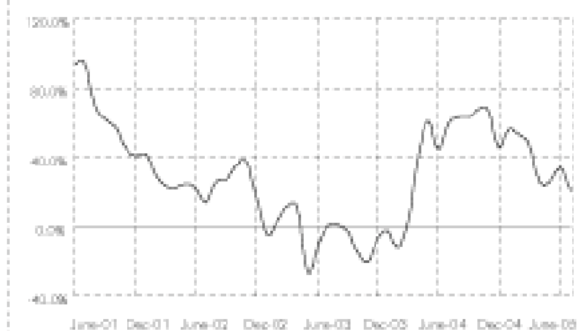


Chart 10 Contribution of net foreign assets growth to the annual growth of M3

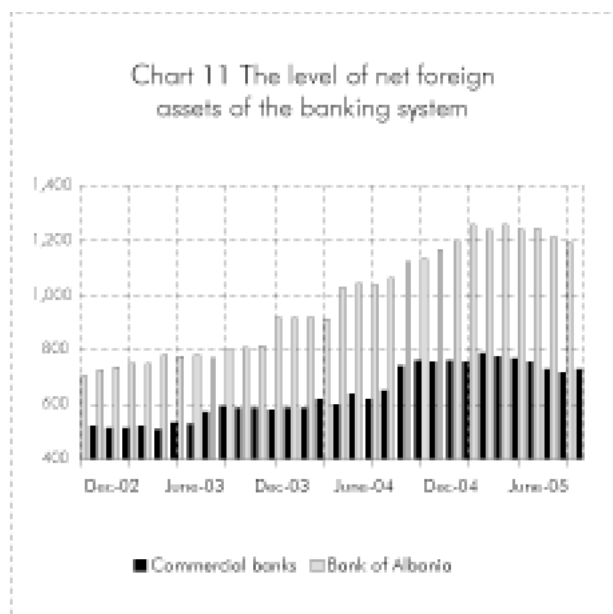


in Lek has weakened the slowdown effect of currency outside banks on the M1 aggregate performance. The annual growth rate of this aggregate recorded a slight decrease in July, dropping to 25.1 per cent, from 25.8 per cent it was in June. The foreign currency structure of money supply has remained almost unchanged compared to the previous month. Under the sensitive effect of exchange rate, the ratio of foreign deposits to M3 aggregate has put an end to its upward trend, marking a slight decrease to 25.0 per cent.

III.2.1 NET FOREIGN ASSETS

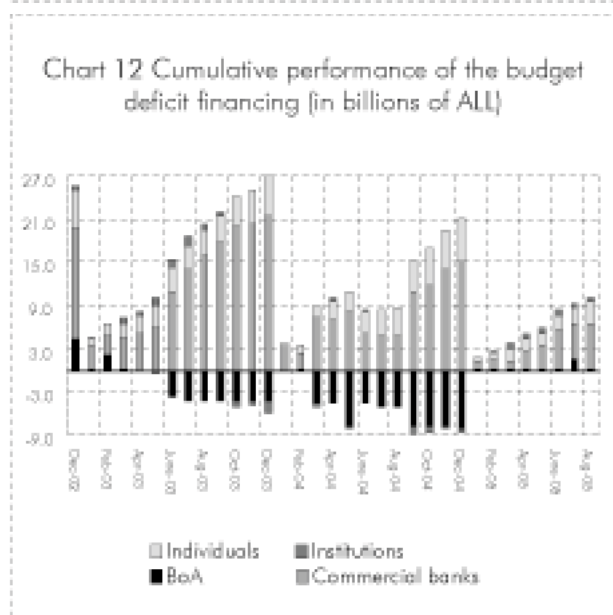
The annual growth of net foreign assets in July gave a contribution of 21.1 per cent to the annual growth of money supply, representing their lowest contribution since the beginning of the year. The growth rate of net foreign assets continued to be low even in July, although on absolute level they evidence an increase of USD 17.5 million compared to the previous month. Excluding the exchange rate effect, the growth of these assets is USD 20.8 million.

The major contribution to the growth of foreign assets of the system has been given by the net foreign assets of commercial banks, with a monthly growth of USD 13.5 million. During July, both foreign deposits and credits have recorded an increase, but the level of depositing in foreign



currency has been higher, creating spaces for the growth of net foreign assets of commercial banks. Estimated at a fixed rate, the growth of these assets is USD 14.1 million. Bank of Albania has increased the net foreign reserve by USD 4.2 million. Estimated at a fixed rate, the net foreign reserve of Bank of Albania has increased by USD 6.7 million. This result comes from the growth of deposits with foreign banks and from the decrease in "Due to the IMF" item.

III.2.2 GOVERNMENT DEMAND FOR MONETARY ASSETS



July has known a fiscal deficit deepening to the level of ALL 10.8 billion or 4 billion more than the previous month. The fiscal deficit is mainly afforded through the reduction of government deposit to ALL 2.5 billion, while the new borrowing has been amounted to ALL 1.5 billion. Bank of Albania has temporarily financed the deficit to the amount of ALL 1.5 billion. The monthly domestic financing has been provided by the issue of two-year and three-year government bonds. The growth of domestic borrowing of ALL 5.2 billion has compensated the decrease by ALL 3.7 billion of the level of Treasury bills purchased in the primary market. In July, there is noted a decrease of Treasury bills portfolio of commercial banks by ALL 4.4 billion. A slight decrease has also been noted in the institutions portfolio. On the other side, individuals and Bank of Albania have slightly increased their Treasury bills portfolio.

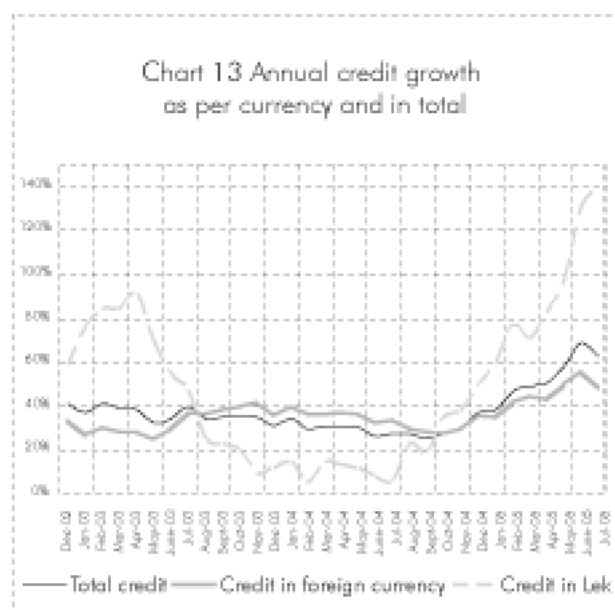
III.2.3 CREDIT TO ECONOMY

July marked a monthly increase of credit balance by ALL 1.8 billion, reaching the amount of ALL 97.7 billion. In GDP terms, credit balance reached the level of 11.4 per cent, highlighting an increase of 2.4 percentage points by the end of 2004.

Table 6 Performance of the main indicators

	2002	2003	2004	May '05	June '05	July '05
Money supply (in billions of ALL)	416.7	448.4	507.2	533.2	541.8	545.3
Domestic credit (in % to M3)	70.8	71.5	68.9	69.5%	69.9%	70.4%
- Credit to government (in % to M3)	61.5	60.2	55.1	52.8%	52.2%	52.4%
- Credit to economy (in % to M3)	9.3	11.3	13.8	16.6%	17.7%	17.9%
Credit to economy (in % to total assets)	11.5	13.7	16.9	19.5%	20.8%	21.1%
Credit to economy (in % to GDP)	5.7	6.8	9.0	10.4	11.2	11.4
Ratio credits / deposits (in %)	13.5	15.7	19.0	22.0	23.6	24.0

The credit balance marked an annual growth of ALL 37.8 billion or 62.8 per cent, remaining at high levels throughout 2005. Credit in Lek continues to grow; its contribution to the annual growth of total credit reached 35 per cent, from 32 per cent it was in June. During July the credit growth in Lek is believed to have had a new impulse from the positive performance of credit to households. The acceleration of credit in Lek has also favoured its position to the credit in foreign currency, representing 23.2 per cent of total credit balance at the end of July.



The credit by sectors has evidenced a slight increase of credit to households, which was about ALL 30.7 billion at the end of July. About 35 per cent of credit consists of credit in Lek. During July 2005 the credit for this group increased by ALL 1.5 billion and only the credit in Lek of this group marked an increase of ALL 1 billion. The decrease of the share of credit contribution to the private sector is believed to have come as a result of credit settlements at high levels.

Table 7 Indicators of credit balance as a percentage of the total

	2003	2004	T-1 '05	June '05	July '05
Credit balance (in billion of ALL)	50.7	69.3	79.0	95.9	97.7
Short-term credit	46.0	34.0	34.1	33.7	34.4
Medium-term credit	33.3	36.0	34.5	33.1	31.6
Long-term credit	20.7	30.0	31.4	33.1	33.8
Credit to households	24.5	30.6	31.0	30.8	31.4
Credit to the private sector	75.5	69.4	69.0	69.2	68.6
ALL	19.6	19.5	20.1	22.9	23.2
Foreign currency	80.4	80.5	79.9	77.1	76.8

The sectoral distribution of credit in July remained generally the same as that of June. The trade sector continues to represent the main sector attracting the major part of credit to the economy. However, during 2005 the credit to this sector showed downward trends, representing about 19 per cent of credit portfolio at the end of the month.

Table 8 Credit performance for the main branches of economy

	2002	2003	2004	Q1 '05	Q2 '05	July '05
Agriculture, hunting and silviculture	0.8	1	1.5	1.5	1.5	1.5
Processing industry	17	17	17.1	16.7	15.6	15.1
Construction	8.6	10	9.8	11.2	11.2	11.2
Trade, repairing of vehicles and house equipment	40.4	34	23.3	20.6	19.1	19.1
Hotels and restaurants	6	6	8.3	5.2	4.7	4.7
Real estate	9.1	13	9.8	14.7	13.5	13.4
Other	18.1	19	30.2	30.1	34.3	35.1
Total	100	100	100	100	100	100

In July the total amount of ALL 10.2 billion is extended as new credit or 34 per cent more than the same period of the previous year. Compared to June, the new credit extended reflects a decrease by 20 per cent; meanwhile it remains at the same levels as the best months of the first part of 2005. The new credit is mainly extended for a short-term period (48 per cent) and in foreign currency (68 per cent). However, compared to the previous year, there is observed a decrease of the short-term credit part (61 per cent) as well as an increase of the credit share in Lek to the total extended credit (30 per cent). This credit is for the most part extended to trade sector and to production sectors such as extracting and processing industry as well as construction. In addition, July highlighted a further increase of new credit to agriculture.

Table 9 Indicators to new credit as a percentage of the total

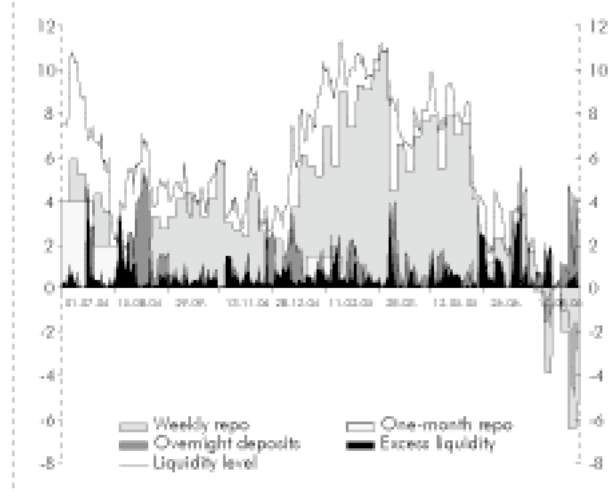
	2004		2005		May	June	July
	July	December	March	April			
New credit (in billions of ALL)	7.6	11.0	8.5	10.4	9.5	12.6	10.2
Short-term credit	60.7	56.4	51.3	50.3	39.8	49.9	48.5
Medium-term credit	21.5	23.4	24.3	28.0	37.8	28.3	33.2
Long-term credit	17.8	20.2	24.4	21.7	22.4	21.8	18.3
ALL	30.1	26.7	28.7	26.2	33.4	37.9	32.0
Foreign currency	70.0	73.3	71.3	73.8	66.6	62.1	68.0

III.3 MARKETS AND PERFORMANCE OF INTEREST RATES

III.3.1 LIQUIDITY PERFORMANCE

In August the banking system is characterised by a strong decrease of liquidity, which continued also in the beginning of September. On average, the daily liquidity level in August decreased to ALL 0.74 billion from ALL 3.00 billion in the previous month and ALL 4.71 billion in the previous year. Liquidity decrease is accompanied by the growth of currency outside banks at the end of July and during August and September. This movement is being influenced by the growth of consumer

Chart 14 Level of excess liquidity (in billions of ALL)



expenditures, of credit in Lek to the economy and the increase of borrowing for covering the budget deficit during this period.

Repurchase agreements with weekly maturity terms continued to be used for withdrawal of excess liquidity, in the beginning of August. Under the conditions of demand to liquidity from the banking system in the second part of the month, Bank of Albania conducted auctions of reverse repurchase agreements with weekly maturity terms, thus injecting on average the sum of ALL 1.95 billion. The average level of overnight deposit decreased from ALL 1.10 billion to ALL 0.39 billion, while the level of excess reserve lowered by ALL 0.07 billion, to the value of ALL 0.65 billion. The use of overnight

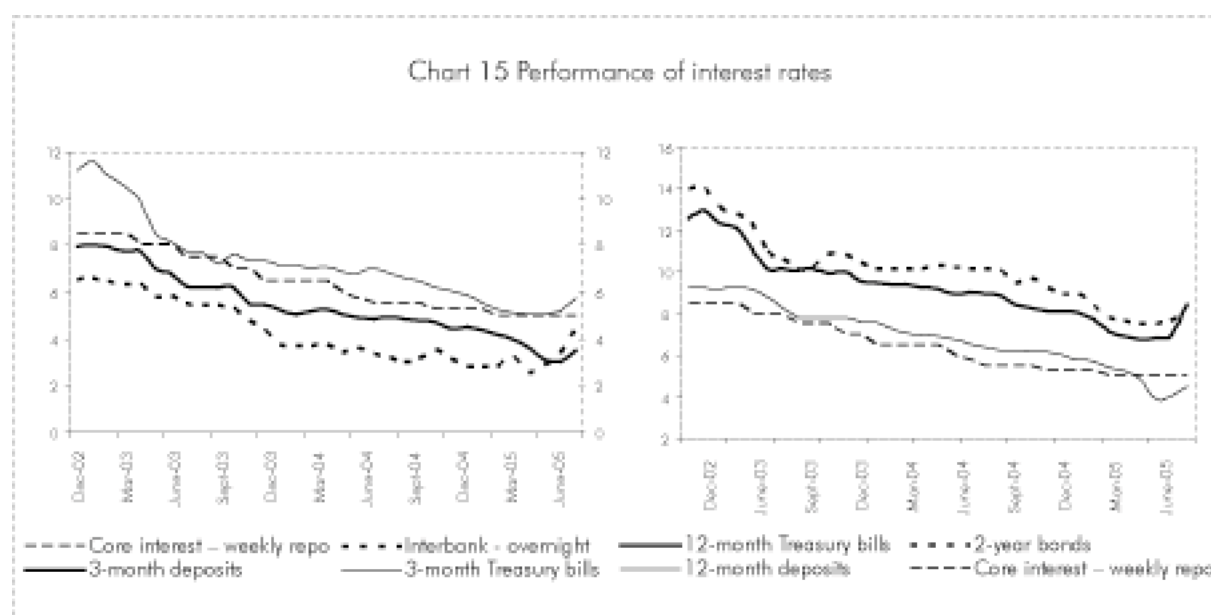
loan remained at the same levels as the previous month and the average value of overnight loan in August resulted to be ALL 0.04 billion.

Compared to the previous month, the interbank market evidenced an increase of transactions volume in August. The overnight loan in this market marked the average value of ALL 0.96 billion, or 0.29 billion more than in July. The average volume of overnight transactions increased to ALL 1.00 billion from ALL 0.48 billion.

A part of liquidity is invested in the primary market for the financing of budget deficit. Compared to July, the government securities portfolio of banks increased by ALL 1.50 billion in August.

III.3.2 PERFORMANCE OF INTEREST RATES

In contrast with the trend evidenced in the first semester of the year, interest rates of Lek in the markets showed upward trends in July and in August. Although the monetary policy followed by Bank of Albania remained unchanged, interest rates for Lek deposits, for primary market and interbank markets were influenced, for the most part, by liquidity reduction.



The average weighted interest for 12-month deposits in Lek increased to 4.06 per cent in July, from 3.89 in the previous month (or 2.33 percentage points below the level of the previous year). Under the effect of annual inflation rate cut in July, the real interest for these deposits increased reaching the level of 2.22 per cent, from 0.96 per cent in June.

A significant increase of interests is also noted in the primary market, where Treasury bills yield raised from 6.97 per cent in July to 8.41 per cent at the end of August (12-month maturity). The lack of liquidity brought about the reduction of banks supply for purchasing Treasury bills, in some cases even without completing the issued amount. The competition in auctions decreased exerting pressure on yield increase. The need for liquidity made that even in the interbank market, interests for transactions move from 3.80 per cent in July to 5.79 per cent in August (overnight transactions).

Table 10 Change of interests of deposits and credits in Lek

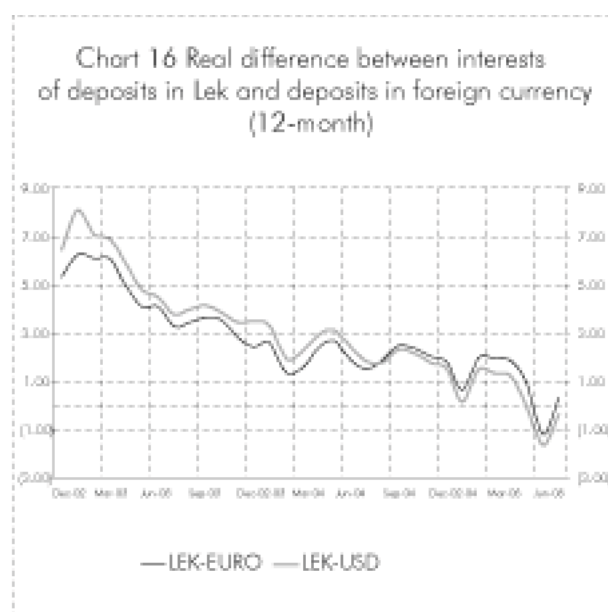
	July '05	Annual change July '05 - July '04	Monthly change
			July '05 - June '05
Deposits in Lek			
1-month	3.20	- 0.69	+ 0.09
3-month	3.02	- 1.86	- 0.06
6-month	3.72	- 2.29	- 0.05
12-month	4.06	- 2.33	+ 0.17
24-month deposits	6.41	n/a	+ 1.80
Credits in Lek			
up to 6-month	13.30	+ 1.07	+ 2.68
6 - 12-month	12.00	- 6.33	+ 0.39
1-3 years	15.95	- 5.17	- 0.71
over 3 years	11.77	- 3.60	- 0.59

In July average weighted interests for credits extended in Lek had the tendency to increase for the terms below one year and decreased for the credit over one year. They were influenced not only by the upward trend of interests of deposits in Lek, by the increase of Treasury bills yield, but also by the change of crediting structure according to specific banks. In July the average weighted rate of credit in Lek attained the figure of 13.33 per cent or 0.74 percentage points higher than in June.

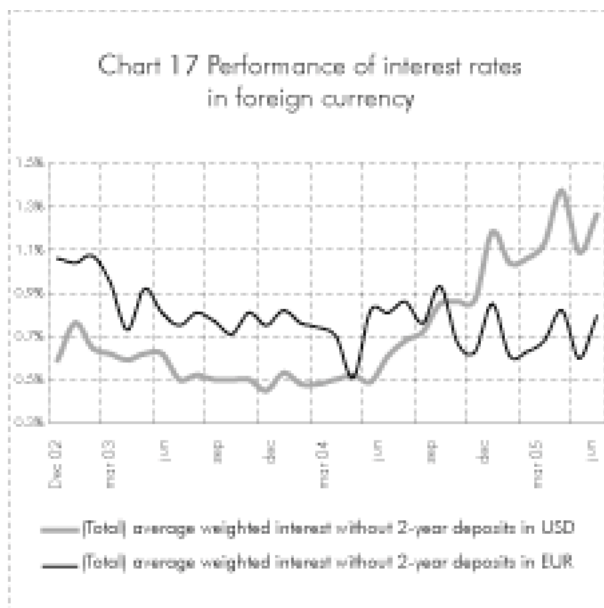
Table 11 Change of interests in the markets

	August '05	Annual change	Monthly change
		August '05 - August '04	August '05 - July '05
3-month Treasury bills yield	5.73	- 1.07	+ 0.57
6-month Treasury bills yield	7.94	- 0.06	+ 1.35
12-month Treasury bills yield	8.41	- 0.49	+ 1.44
2-year bond yield	8.10	- 2.00	+ 0.40
Overnight interbank market	5.79	+ 2.85	+ 1.99
Weekly interbank market	5.61	- 0.09	+ 0.77

The change of trend in the behaviour of interest rates in Lek started to be reflected also in the spread trend between interests of deposits in Lek and in foreign currency. There are already noted signs of spread broadening between these interests, unlike the previous downward trend, which lasted more than two years.



During July interest of deposits in foreign currency increased almost for all terms, except for interests of 1-month and 12-month deposits in Euro. The rise of LIBOR and EURIBOR interests, the tightening policy followed by Fed as well as the competitiveness in the foreign market, have impacted the increase of interests in foreign currency. The further tightening of monetary policy by Fed, in September⁸, is expected to have an impact on the rise of LIBOR interests in international markets as well as on the rise of interests of deposits and credits in USD.



In July interests of credits in USD and in Euro increased for all terms, except for interests of time credits up to 6 months. The average weighted rate of credits in foreign currency for all terms has resulted respectively 8.56 per cent for credits in USD and 7.15 per cent for credits in Euro, with a rise of 0.46 per cent for credit in USD and of 1.52 per cent for credits in Euro. The rise of interests of credits in foreign currency is being influenced by the rise of interests of deposits in foreign currency and by the change of crediting structure from one month to another, etc.

III.4 EXCHANGE RATE

US dollar. However, Lek appreciation rates were falling, especially when compared to the last two years. Unlike the other years, there was no seasonal effect of summertime, which resulted in a strong appreciation of Lek against the main currencies. In exchange against the Euro, Lek has continued to have the same appreciation rates, observed since the beginning of the year. With Lek exchange against USD it was quite differently, as there was noted a USD appreciation for the most part of July. During August Lek is positioned as a depreciation currency. This situation is being influenced

by the tourism performance inside and outside Albania, where net effect seemed to have been in the favour of demand increase for foreign currency. Also, the situation before and after the elections seemed to have influenced the public behaviour and his decisions of keeping foreign currencies.



Seen from a longer-term viewpoint, it seems that the continuous narrowing of the gap of interest rates in Lek and in foreign currency does not constitute a support for the Lek appreciation. At the end of August, the annual change of Lek exchange rate against the Euro is the Lek appreciation by 2.4 per cent and against the USD by 3.3 per cent. Lek exchange levels marked 123.15 Lek/Euro and 100.8 Lek/USD at the end of August.

NOTES

¹ Average annual inflation is the average value of the annual inflation of the last 12 months, including the month we are examining.

² Fruit prices declined to 10.3 per cent, while of vegetables prices increased by 2.9 per cent.

³ The groups take a share of 2.1 and 1.0 per cent respectively in the consumer basket.

⁴ Annual inflation of this subgroup for June and July 2005 is 6.2 and 8.8 per cent, respectively.

⁵ Source: Bloomberg

⁶ M2 aggregate marked a significant growth during July and August of the last year due to the very high foreign currency flows that followed the event of Olympic Games in Greece and to higher interest rates in Lek against those in foreign currency, which oriented these flows to monetary assets in Lek.

⁷ The policy of non-renewing the time deposits in Lek for individuals by Raiffeisen Bank on the termination of maturity term caused their reclassification as demand deposits. The effect of this reclassification for July is about ALL 4.5 billion.

⁸ On September 21, 2005, Federal Reserve (Fed) raised the core interest rate by 0.25 per cent.

