

# **The Assessment of Economy for the Third Trimester of 2003**

**September 2003**

## TABLE OF CONTENTS

1	Fjala e Guvernatorit.....	3
2	Ecuria e ekonomisë gjatë tremujorit të tretë... Error! Bookmark not defined.	
2.1	Ecuria e aktivitetit ekonomik..... Error! Bookmark not defined.	
2.1.1	Zhvillimet në sektorin real të ekonomisë.....	6
2.1.2	Sektori fiskal..... Error! Bookmark not defined.	
2.1.3	Sektori i jashtëm..... Error! Bookmark not defined.	
2.2	Ecuria e inflacionit..... Error! Bookmark not defined.	
3	Ecuria e politikës dhe e zhvillimeve monetare Error! Bookmark not defined.	
3.1	Politika monetare e Bankës së Shqipërisë Error! Bookmark not defined.	
3.2	Ecuria e agregatëve monetarë.....	24
3.3	Kërkesa e ekonomisë për para..... Error! Bookmark not defined.	
3.3.1	Mjetet valutore neto të sistemit bankar.....	26
3.3.2	Kërkesa e qeverisë për mjete monetare.....	27
3.3.3	Kreditimi i ekonomisë nga sistemi bankar. Error! Bookmark not defined.	
3.4	Tregjet financiare dhe ecuria e normave të interesit Error! Bookmark not defined.	
3.4.1	Tregjet financiare..... Error! Bookmark not defined.	
3.4.2	Ecuria e normave të interesit..... Error! Bookmark not defined.	

1. Governor's speech.

## 2 Performance of economy during the third trimester

### 2.1 Economic activity performance

#### 2.1.1 Developments in the real sector of the economy

2.1.2 Financial sector

2.1.3 Foreign sector

2.2 Inflation performance

## 3 Monetary policy performance

### 3.1 MONETARY POLICY OF THE BANK OF ALBANIA

### 3.2 MONETARY AGGREGATES PERFORMANCE

### 3.3 MONEY DEMAND IN THE ECONOMY

#### 3.3.1 NET FOREIGN ASSETS OF THE BANKING SYSTEM

3.3.2 GOVERNMENT DEMAND FOR MONETARY ASSETS

3.3.3 Economy crediting from the banking system

### 3.4 FINANCIAL MARKETS AND INTEREST RATES PERFORMANCE

3.4.1 Financial markets

### 3.4.2 Interest rate performance

## 1 GOVERNOR'S SPEECH.

Three months before the end of 2003, it could be concluded that the economy has been performing conform the objectives set in the development program of the country. Just like the previous years, the Albanian economy is likely to mark another satisfactory increase of the general production. According to the latest indicators, the real increase of the GDP is expected to be in the limit of 6 percent, as it was estimated in the economic development program of the country for 2003. The data available, albeit the fact they are again insufficient, make us believe that this important target is attainable, and therefore, considering their variety, we would depict:

- **Agricultural production**, according to the assessments for July, is estimated to have maintained, almost unchanged, the growing rate compared to what was planned. Evidences show that agro-industrial production in particular has had a positive performance, recording a 13 percent increase in the first half of 2003 as compared to the same period in the previous year.
- Signals coming from the **sales' volume index** suggest an upward trend of the economic activity of other areas of economy in general. The most evident economic boom in real and nominal terms was presented by the industry, service and transport-telecommunication sectors.
- Various indicators of the domestic demand, such as the fuel consumption one, the motorcars' import and home electric appliances have had a notable increase as compared to the previous year. The highest increase was in the import of machineries and equipments, which in the second trimester of 2003 increased by 15 percent compared to the same period in the previous year.
- **The total of foreign trade transactions** during the first half of 2003 has increased considerably as compared to the same period in the previous year, despite the exchange rate impact. What is worth mentioning is the high growth of the Albanian exports during the second trimester of 2003, though their weigh remains still low in the overall volume of the foreign trade.
- **The electric power situation** during 2003 has marked a notable amelioration, lessening thus at the uttermost an artificial barrier against production and commercial activities in the country. On the other side, this has led to the reduction of the inevitable import of the electric power, though we believe that efforts in minimising the damages in the network should increase.
- As in the previous years even during the first half of 2003, it is registered a high level of **foreign exchange inflows** in the form of remittances, a phenomenon that during all the previous period has been an important source of growth.

Inflation, the other final target of the development program for the country, seems to be in on track. More specifically, annual inflation at the end of September 2003 was within the targeted interval 2- 4 percent, as declared by the Bank of Albania. Factors influencing inflation performance during this year are the same traditional ones, perhaps with the only difference that the bigger number of tourists and the exports' increase has somehow influenced more pressures on the foodstuff prices. Meanwhile, other indicators as the monetary ones, the exchange rate, the budget deficit, etc, have affected the amortization of the pressures emerged as a result of the foreign demand increase. However, even during this period our economy, being an economy under transformation, continued to produce shocks on the supply side, where the most evident remains the increase of the administered price of the electric power as well as the increase of the excises and taxes in June. Relying on the forecasting models of the Bank of Albania and also on the steps to be undertaken by the Bank of Albania towards the public awareness on minimising speculations of year-end prices, there is a strong belief that this target could be achieved.

The two core economic policies, the monetary policy and the fiscal one, are assessed as being adequate and within the planned framework, bringing thus a greater contribution to strengthening the macroeconomic stability in the country.

. The reduction of the Repo's interest rate by 0.5 percent in July is not followed by any changes. Meanwhile the Bank of Albania, is carefully watching the interest rate fluctuations in the financial market and according to the developments in foreign exchange markets and to the expected developments in the monetary indicators, in inflation, production, etc, it believes that there is room for a further reduction of the core interest rate by 0.5 percent from the present level of 7.5 percent to 7 percent.

According to the year-end developments of 2002 and to the first nine months of 2003, monetary developments are characterized by a rapid return of the money into the system. Specialists believe that spring 2002 haemorrhage effect is surpassed, and the recent developments in extending the banking system and in improving the services offered constitute premises for a better situation of the liquidity in the system.

Even during this year as during the recent years, the economy has continued to draw in financing in the form of the banking credit. During January – August 2003 it has been extended a loan of 55 billion Lek, which means 1.4 times more than the same period in the previous year.

On the other side, developments in the foreign sector of the economy speak about a further growth of the foreign trade activity, where the most positive developments belong to the growth of exports and remittances. Though the tourism activity might seem upgraded, we are to wait for the third trimester of 2003 data, in order to have a clearer view of the whole 2003.

The exchange rate, reflecting developments in the interest rate in the American and European economy, developments in international markets as well as the country's developments, has presented a kind of appreciation versus the two main currencies. Under these circumstances the Bank of Albania has time after time intervened in the market to lessen the pressures of the foreign currency supply. Consequently, the foreign currency reserve of the Bank of Albania at the end of September reached the level USD 965 million, in absolute value, a figure this that corresponds to the Bank of Albania target in covering 4.5 months of imports.

Though it remains somehow less than three months from the end of the year, we believe that there is still room for greater attention, so that this year not only keeps the planned rate but also provide premises for a favourable performance in the short-term and mid-term future. The Bank of Albania considers that a greater attention should be paid to the upward trade deficit, which according to the six-month figures has reached the level of USD 615 million.

The Bank of Albania believes that the proceeding with the reforms scheduled for 2003 comprises a significant issue in attaining a sustainable growth in the follow-up periods. The Bank of Albania hopes to achieve a successful trade of the Savings Bank and also to find the new investor of the National Commercial Bank. The commitments taken in this direction are considered to be of the same importance: a more efficient management of power resources and distribution system (Grid), successful finalisation of the steps taken in the privatisation of Albtelekom, INSIG, etc.

At the end, the Bank of Albania hopes in the implementation of an accurate fiscal policy for the rest of the year, a policy that inevitably should reduce the negative effects caused by the non-realisation of the revenues at the intended level. Despite other facts, the Bank of Albania is of the opinion that an accurate policy would help to avoid the pressures on the liquidity at the end of the year, a phenomenon historically present adding thus unduly pressures on the monetary policy in the last month of the year.

## 2 PERFORMANCE OF ECONOMY DURING THE THIRD TRIMESTER

### 2.1 ECONOMIC ACTIVITY PERFORMANCE

#### 2.1.1 DEVELOPMENTS IN THE REAL SECTOR OF THE ECONOMY

A growth of 6 percent is expected for the year-end of 2003. Though the information cannot be considered adequate, most of the data available on the economic activity support the above given result.

#### DEVELOPMENTS IN VARIOUS FIELDS OF THE ECONOMY.

**Agriculture** remains one of the pillars of the economic growth. According to the latest estimations made by the Ministry of Agriculture and Food, the production growth in agriculture is estimated to be 2.8 percent. Table 5 shows the estimations made in April '03 and July '03, for all the sectors of agriculture.

**Table1: Performance of the agriculture sector estimations (in Lek million)**

Sectors	Estimation in April		Estimation in July	
	Value	(%)	Value	(%)
Agriculture	189,895	103.0	189,817	102.8
Agro industry	37,304	110.0	37304	110.0
Fishing	2,470	115.1	2470	115.1
Total	229,669	104.2	229,591	104.2

Source: Ministry of Agriculture and Food, September 2003.

As it is noticed, the expectation on the production growth in agriculture is reduced by 0.2 percentage point in July, as compared with April. This was due to the damaged plants from the low temperatures in April and high temperatures in June. Regarding the production in agro industry, even during the second trimester of 2003, it followed the upward trend, present since the first trimester of this year. The Bank of Albania expectation, that the production in agro industry would continue at satisfactory rates, due also to the seasonal effect increasing the domestic agricultural production, can also be proved by the data given in table (2). The agro industrial production, in general, had an increase of 30.3 percent compared to the previous trimester, while it increased by 12.7 percent in the first half of 2003, as compared to the same period in the previous year.

**Table 2: Growing rates in agro industry production (in %).<sup>1</sup>**

Name	T2-'02/ T1-'02	T2-'03/ T1-'03	T2-'03/T2-'02	6m-I '03/6m-I-'02
Agro industrial production	20.0%	30.3%	16.9%	12.7%

Source: Ministry of Agriculture and Food, September 2003.

**The other sectors of the economy** show an upward trend of their activity, in the second trimester as compared to the previous one. This fact is evident in the sales' indicator in each trimester and from one year to the other. Hence, the overall economic activity is estimated to have had a real growth of 7.7 percent compared to the same period in the previous year, and 18.1 per cent versus the previous trimester. The industry and service sectors gave the highest contribution in this growth, while the performance of transport-telecommunication and construction sectors has been positive.

**Table3: Sales' index developments (in real terms)**

Sectors	T2-2003 / T1-2003 in %	T2-2003 / T2-2002 in %
Industry <sup>2</sup>	7.9	9.5
Construction <sup>3</sup>	34.2	1.1
Trade, hotels, restaurants <sup>4</sup>	15.8	13.2
Transport-telecommunication <sup>5</sup>	43.9	4.1
Economy total <sup>6</sup>	18.1	7.7

Source: INSTAT, Sales' index 2003.

In the second trimester, revenues in the **industry sector** had a real increase of 9.5 percent compared to the same period in the previous year, and by 7.9 percent as to the previous trimester. This growth was influenced by the sales' growth of 22.7 percent in the process industry category; however, sales in the electric power, water and gas category, suffered by 24.7 percent as compared to the previous period, which manifests a quite normal seasonal influence.

**Services sector** (trade, hotels, restaurants). Sales in real terms in this sector were 13.2 percent higher than the same period in the previous year, and 15.8 percent more than the sales in the previous trimester. These figures are also based on the data of **retail sales' volume index**, which in real terms increased by 26 percent as compared to the respective period in the previous year.

<sup>1</sup> On the data of the main products, in million lek ( prices for 2000).

<sup>2</sup> Due to the GDP deflator absence, the CPI, consumption price index was used.

<sup>3</sup> Deflated with construction cost index.

<sup>4</sup> Deflated with th respective CPI basket group.

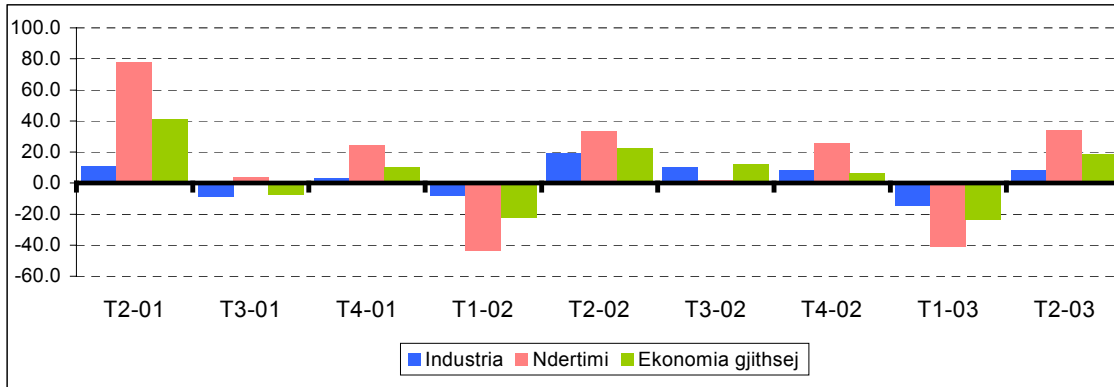
<sup>5</sup> Deflated with th respective CPI basket group.

<sup>6</sup> Deflated with CPI index.



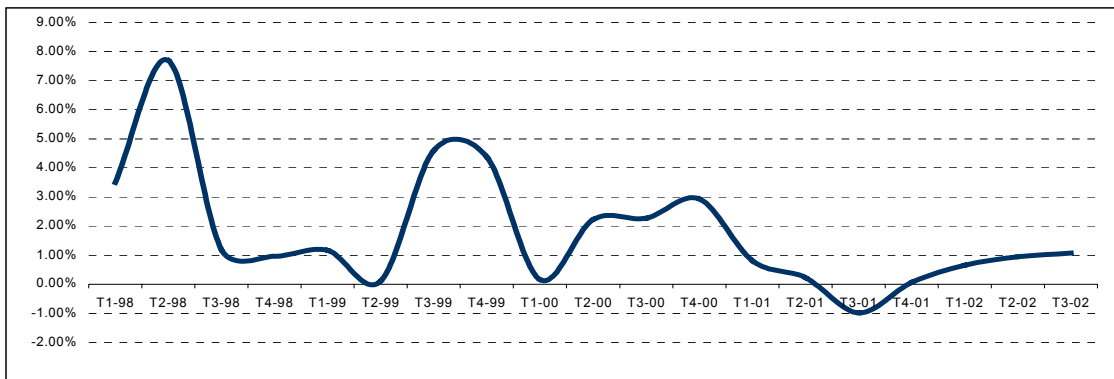
**Construction sector.** The performance of the sales' index in this sector reflects a positive trend of the growing rates during the last two trimesters, which promises a further amplification of this activity in the course of the year.

**Graphic 1. Difference in percentage of the sales' index (in real terms)**



As opposed to the second trimester of the previous year, the sales increased by 3.9 percent, whereas in real terms, the growth was only 1.1 percent. This difference came as a result of the annual increase of the **construction cost index** by 2.77 percent. This growth was mainly affected by the items of direct expenses and additional expenses, respectively 3.17 percent and 10.41 percent, whereas the items "forecasted profit" and "construction" recorded a decline of 2.91 percent and 2.94 percent.

**Graphic2: Trimester difference of the construction cost (in percentage)**



The situation in the **electric power sector** has notably improved as compared to the previous year. Energy resources for the first and second trimester resulted respectively 45 percent and 6 percent higher than in the last year. Production from the domestic resources mounted to 77 percent, occupying thus 76.8 percent of the overall supply from 46.1 percent it occupied in the same period of the previous year. The big slope of imports accompanied also by the losses in the network, caused the domestic consumption of the electric power to rise only by 1 percent as compared to the same period in the previous year. The considerable

losses<sup>7</sup> in the network are also reflected in the annual sales' fall by 16 percent for the group of electric power, water and gas, in real terms for the second trimester.

**Table4: Data on the electric power balance sheet.**

Balance sheet items	T1-2003 / T1-2002	T2-2003 / T2-2002
Sources total	45%	6%
- Production	150%	77%
- Import	-77%	-54%
Domestic consumption	19%	1%

Source: INSTAT, the electric power balance sheet, second trimester 2003.

**Transport sector.** The first trimester of this year, presented a negative performance of this sector, which was reflected in negative rates of the sales indexes and loading and unloading work volume index. The situation has greatly improved in the second trimester, where the sales' index recorded a real growth of 4.1 percent compared to the same period in the previous year, and 43.9 percent, as opposed to the previous trimester. It is difficult to come to right conclusions concerning growth in this sector, due to the high volatility in the sales' index. However, the growing rates in this sector have presented a positive trend, a fact, which makes us optimistic about its performance for the rest of the year.

Regarding **investments**, their performance during the first half of the year has been quite positive. Investments in transport were twice higher in the second trimester than in the respective period of the last year. The highest growth was that of the budget investments, which were tripled, whereas foreign investments increased by 45 percent.

**Table 5: Annual differences of investments (in %)**

INDICATOR	T2-2003/T2-2002	6M-I 2003/6M-I 2002
Investments total	100	118
From which:		
Budget investments	358	307
Foreign credit investments or economic aid	45	64

Source: Ministry of Transport, July 2003.

What is evident is the fact that albeit the high rise of investments as compared to the previous year, the present level is still lower than the one of 2000. Additionally, it is noticed the return of the budget investments weight to the total

<sup>7</sup> According to the "Electric power balance", the second trimester of 2003, INSTAT, losses in the network in the second trimester of 2003 were reckoned to be nearly 37 percent of the supply or nearly 40 percent of the domestic production during the trimester.

investments in its historical value. In the first six-month, it was 41 percent, opposed to 22 percent it was in the previous year.

Loading and unloading activity increased by 20 percent compared to the second trimester of the previous year. It is evident the annual increase of 26.2 percent of the railways process volume. As always, the harbours remain the most important pillar of the loading and unloading activity, though their weight fell to 91 percent, from 96 percent it was in the previous year.

**Table 6: Annual changes of the loading and unloading work volume (in percentage).**

	<b>T2-2003/T2-2002</b>	<b>6m-I 2003 / 6m-I 2002</b>
Total	20	7
Railways	262	197
Harbours	12	1

Source: Ministry of Transport, July 2003.

**Various indicators of the domestic demand**, like the one of fuel consumption, motorcars import and home appliances, have had a considerable increase compared to the previous year. The highest growth was noticed in the import of machineries and appliances, by 15 percent in this trimester, compared to the second one of 2002. An important element of the domestic demand is the one reflecting the retail activity, a growth of 26 percent<sup>8</sup> resulted in the second trimester of 2003, compared to the previous year.

**Foreign trade volume**, during the first half of 2003, increased significantly by nearly 33.3 percent, compared to the same period in the previous year (INSTAT, Conjuncture, September 2003.) What is more, this increase was noticed in the imports and exports trend, the like. The Albanian exports, during the second trimester of 2003, have shown even an unusual rise, though their weight remains still low in the overall volume of foreign trade.

In conclusion, generalising the present information on developments in the real sector of the economy, the economic growth target could be regarded as achievable. This assessment is based on:

- The positive performance in the sectors of industry, agro industry, transport and services;
- The notable increase of the foreign trade volume, depicting exports, mainly the agricultural products. On the other side, remittances, during the first half of 2003, reached the level of USD 336 million, which means nearly 18 more than the same period in the previous year;
- The evident lessening of problems in the electric power sector, minimizing thus an energetic crisis;
- The performance of the domestic demand indicators.

<sup>8</sup> INSTAT, Retail index, August 2003

Nevertheless, focus should also be given to some other factors, which could affect the expected economic growth rate, as:

- The public investment situation, which for the first eight months of 2003 were realised only at the level of 65 percent. From these, expenses covered by foreign finance, were 47 percent. Such a performance of this group, does not support sufficiently the expected economic growth for 2003 and on;
- The well-known governmental problems and the obscurity in coming political developments.

### **2.1.2 FINANCIAL SECTOR**

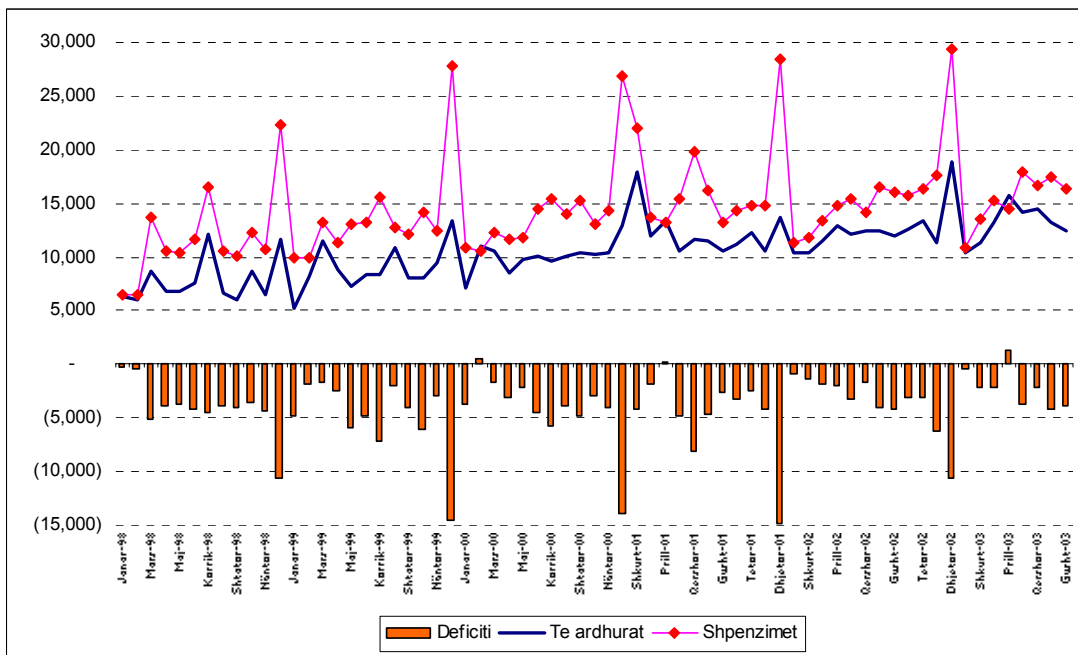
During July-August 2003, the financial indicators have generally not performed as to the expectations. According to the information provided by the Ministry of Finance, until the end of August, it was collected 95 percent of the planned incomes, and it is realised only 86 percent of the programmed expenses. Consequently, by the end of August, the budget deficit was Lek 17.2 billion from the estimated figure of 31.5 billion. However, as it can be noticed in the graphic, the budget expenditures rose considerably in December, making us think of a probable increase of the deficit by the end of the year.

**Table 7: Financial indicators (in Lek million).**

	<b>July – August 2003</b>	<b>Difference in % with the same period in 2002</b>	<b>Plan realisation (%)</b>
Incomes	25.7	5.6	95.1
Expenditures	33.8	3.8	86.2
Deficit	8,1	-1.8	54.9

Source: Ministry of Finances.

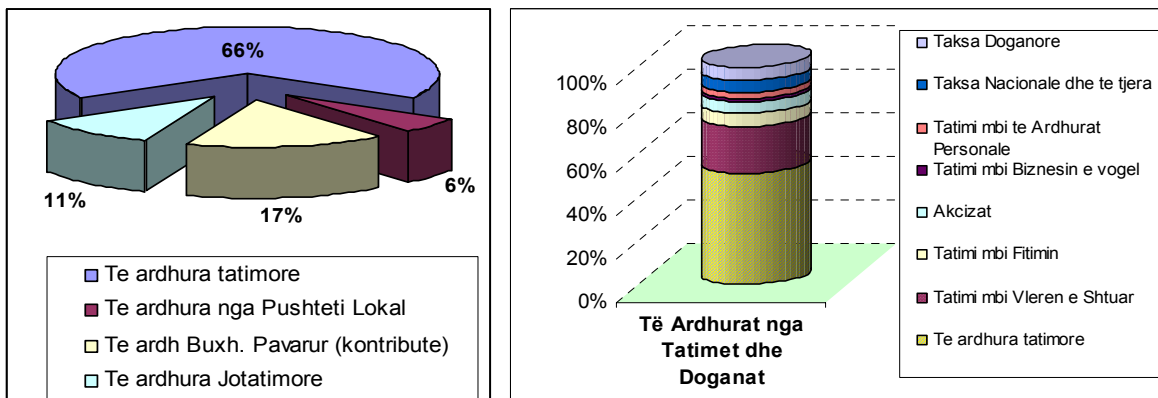
**Graphic 3. Financial indicators, January '98 – August '03 (in Lek billion).**



**Budget incomes**

During July – August of this year, the budget incomes were nearly 5.6 percent higher compared to the same period in 2002. Tax revenues at the end of August reached the level of about Lek 74.6 billion or nearly 14.8 percent more than the same period in the previous year. Whereas taxes collected in taxes and customs systems during July – August 2003 resulted nearly 94 percent of that period plan.

**Graphic 4: Structure of budget incomes**



Source: Ministry of Finances.

Nearly 70 percent of the budget revenues, until August, came from taxes, which were realised at the level of 95.8 percent. It is noticed that during January – August of this year, total revenues increased by 11 percent more than the same period in the previous year. However, the annual plan expected this increase to

be 17 percent until August. This suggests that during September – December a figure of Lek 1.3 billion should be generated per month more than what was forecasted in the plan in order to completely hit the target of Lek 175 billion by the end of 2003. One of the main items responsible for the unsatisfactory realisation of the plan could be regarded the value added tax, which has been realised only by 91 percent. Also, income tax and customs duties were realised by 78 and 96 percent respectively. Excises and revenues from the local government are realised by 11.3 and 12.1 percent respectively.

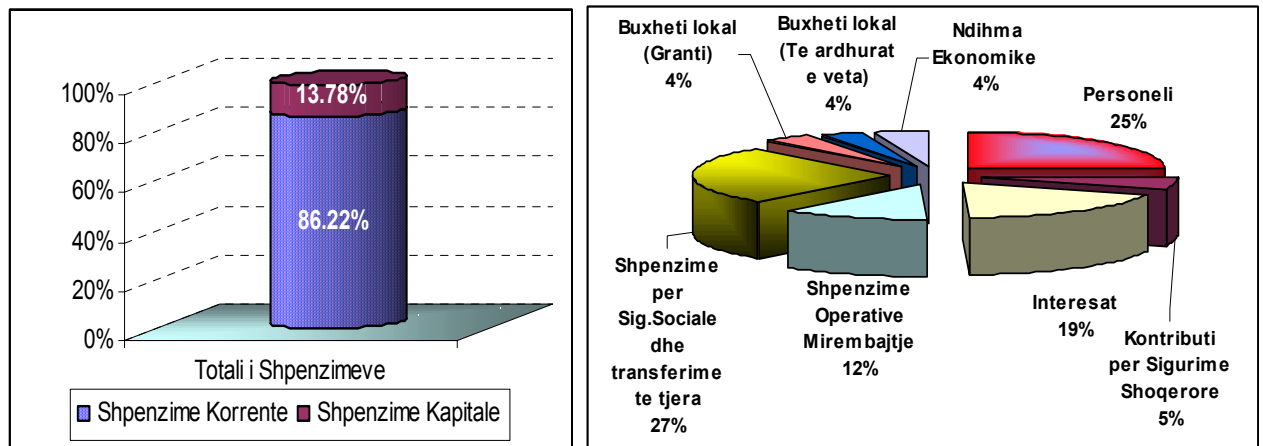
Generally speaking, incomes have had a considerable increase as compared to the same period in the previous year though this increase was expected to be higher.

### Budget expenditures

The budget expenditures during the first eight months of the year were Lek 123 billion, comprising 86.2 percent of the programmed level for this period. Current expenditures were realised by 93 percent and capital expenditures by 65 percent. Form the latter ones, expenses covered by foreign financing were realised at 47 percent. The capital expenditures performance does not sufficiently support the expected economic growth for 2003 and on. The employer's payroll expenses were also realised at 90 percent.

Some of the reasons for the fall of the budget expenditures are: the delay of the expenditures for more budget projects during the last months of the year; the new public procurement regulations, which have affected not only the level of operating expenses but also that of the capital ones; non-realisation as expected of programmed incomes in the budget, etc.

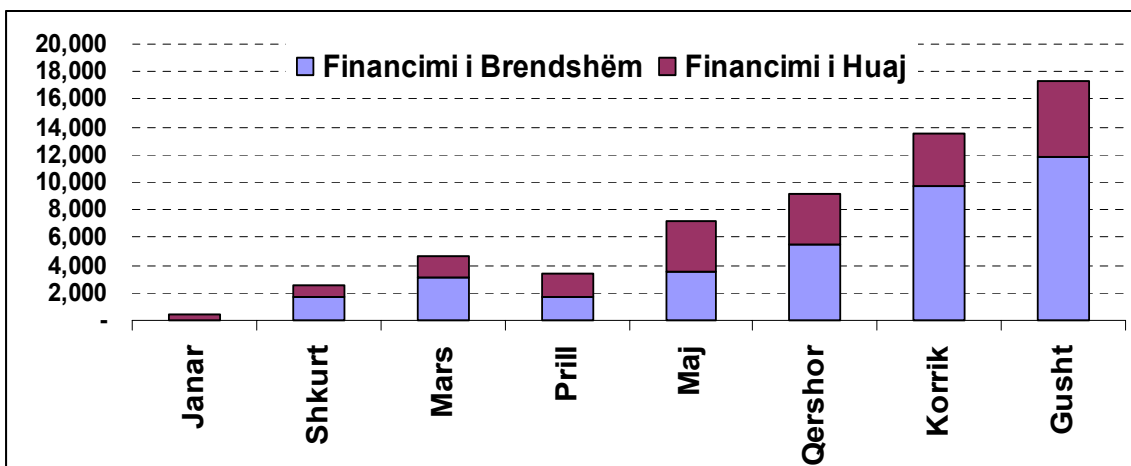
**Graphic 5: The budget expenses structure (left) and the current expenses structure (right)**



## Fiscal deficit

The fiscal deficit for the first eight months of the year is nearly 55 percent of the planned level. The low budget deficit during this year is a proof of a more appreciable stability of the fiscal policies. Although the incomes were not realised as to the annual program, expenses were still lower, which led to a more balanced budget than expected until August of this year.

Graphic 6: Budget deficit financing for 2003.



### 2.1.3 FOREIGN SECTOR<sup>9</sup>

The first half of 2003 was characterised by a considerable increase of current transactions. However, the Albanian economy is still characterised by the current account deficit, which mounted to USD 201.1 million in this period.

Historic developments show that the common deficit of foreign trade and services could not be covered by the surplus of the *labour incomes* and from the *current transfers*. The deficit of the trade balance, which mounted to USD 625.6 million, appreciated thus 18.5 percent higher than the first half of 2002, determined the current account deficit.

The continuous deterioration of the trade deficit is directly related to the upward growth of imports since the domestic product cannot yet cover the demand of the economy.

<sup>9</sup> The analytical table of the balance of payments performance during the first half of 2003 is in the annex attached to this report.

However, the capital and financial account inflows have enabled the balance of payments to result positive, reflecting a growth of USD 61.2 million of the foreign currency reserves of the monetary authority.

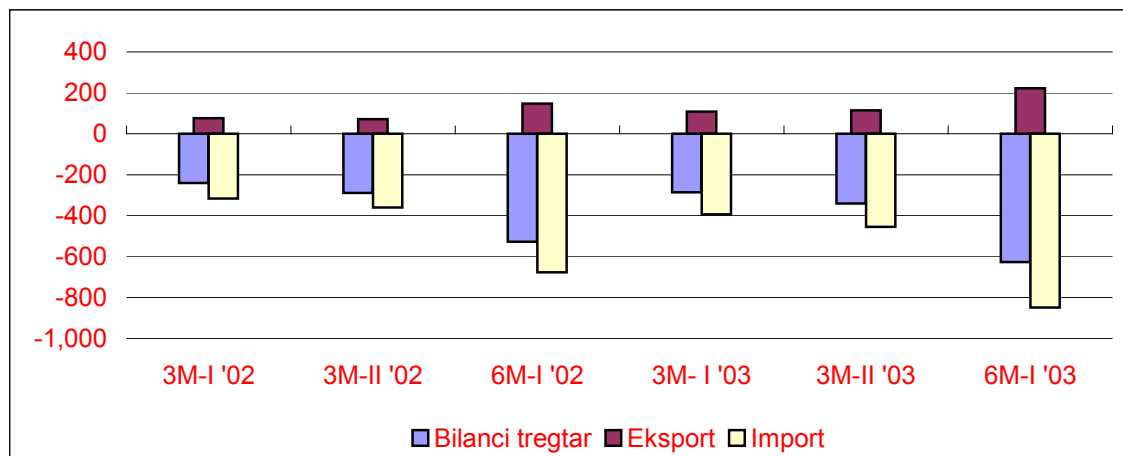
- **FOREIGN TRADE**

Registered transactions of goods during the first half of 2003, kept the upward tendency. The overall trade volume is reckoned to be over USD 1 billion, and it represents nearly 47 percent of the current transactions. The trade of goods is estimated to have increased nearly 11 percent as compared to the first half of 2002.

The greater weight in the trade volume (nearly 79 percent) is occupied by imports, which speaks of an economy and internal import-oriented market. Goods import registered USD 847 million, an increase of 25 percent more than the first half of 2002. The goods export was estimated USD 222.3 million, rising thus by 50 percent versus the first half of the previous year. However, the exports level has not responded to the imports growth in absolute value, causing thus the worsening of the trade deficit. The coefficient of import covering from export, for the first half of 2003, is estimated to be 26 percent.

The trade deficit, in absolute value, has been going upward. In the first half of the year, its value mounted to USD 625.6 million. This trade deficit is present in all the goods-group, except for the group “footwear”, in which the value added in re-exports causes this goods group remain always in surplus.

**Graphic 7: Trade balance performance**



- **SERVICES**

The services trade during the first half of 2003, marked a positive balance of about USD 300 million. The balance of payments developments, though



uncovered by official figures, show an increase of the number of tourists, which have visited Albania. This is a factor, which contributes to the positive balance of payments.

- **REVENUES**

The positive balance of revenues, by the end of the year, is estimated to be about USD 72.2 million. This surplus is due to the incomes from the labour of seasonal workers and those in the borders, incomes from investments in the form of interests accumulated from the investment of foreign currency reserves of the banking system, in non-resident financial institutions as well as those received by investments of our banking system in the form of portfolio investments.

- **TRANSFRES**

Current transfers, during the first half of 2003, marked the figure of USD 350.6 million. These transfers are estimate as 11 percent higher than the same six-month period of the previous year. This increase was mainly due to the increase of incoming transfers, especially that of remittances, which registered the figure of USD 366.5 million. This implies an increase of 15 percent above the one of the same period in the previous year. These transfers have financed nearly 50 percent of the goods and services deficit for the first six-month.

- **CAPITAL AND FINANCIAL ACCOUNT**

A net capital flow of USD 157.7 million was registered in the first half of 2003. Capital transfers registered about USD 67.5 million, whereas the financial account is presented by a net capital flow of USD 90.2 million.

- **FINANCIAL LIABILITIES**

The rise of these liabilities is mainly realised by borrowing foreign direct investments and portfolio investments as well as by other investments in the form of deposits of banks and non-resident financial institutions in our banking system. The positive balance of the financial account is mainly realised by the absorption of foreign direct investments and also by the credit disbursement from abroad. These movements led the upward of financial liabilities.

- **FINANCIAL ASSETS**

The foreign direct investment flows mounted to USD 64 million during the first half of 2003. Compared to the respective period in 2002, this shows an increase of about 21 percent of the foreign direct investment flows. It reflects mainly the activity of big foreign oil striking and oil-extracting companies, as well as the mobile communication companies in the country. Meanwhile, the foreign credit disbursement led to the rise of the foreign debt of Albania by USD 59 million.

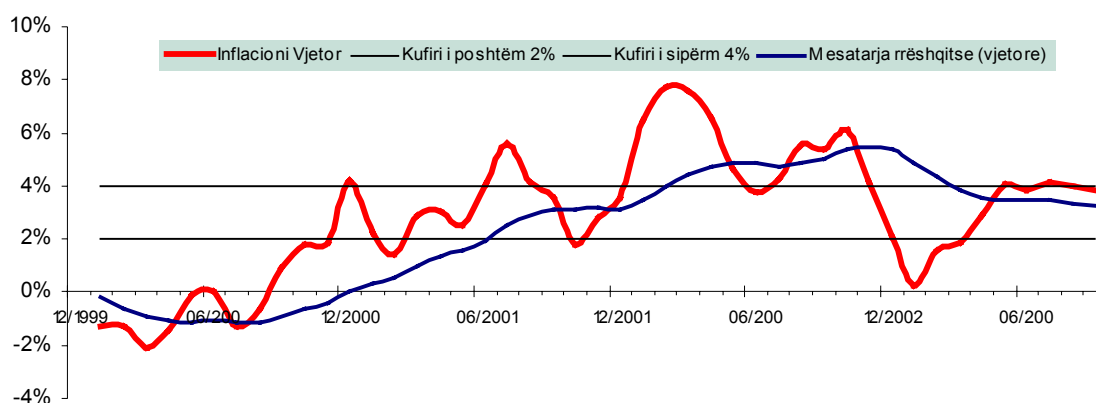
## 2.2 INFLATION PERFORMANCE

September 2003 marked an annual inflation of 3.86 percent, remaining thus within the target interval. However, although it continues to fluctuate near the upper limit target of the Bank of Albania, the average annual inflation rate marked other falls in September, coming to 3.22 percent, from 5.35 percent it was by the end of 2002.

**Table 8: Annual inflation rate (in percentage).**

	1999	2000	2001	2002	2003
January	6.0	-1.3	2.2	6.5	0.3
February	3.5	-1.3	1.5	7.7	1.5
March	2.0	-2.1	2.9	7.6	1.9
April	0.4	-1.4	3.0	6.6	2.8
May	-0.1	-0.1	2.5	4.6	4.0
June	-0.6	0.1	4.0	3.8	3.8
July	0.1	-1.3	5.6	4.3	4.2
August	-0.6	-0.7	4.1	5.5	4.0
September	-1.9	0.9	3.5	5.4	3.9
October	-1.8	1.8	1.8	6.1	
November	-1.2	1.9	2.8	4.1	
December	-1.0	4.2	3.5	2.1	

**Graphic 8: Annual inflation (in percentage)**



The inflation value during September has been within the expected interval. The greatest contribution in inflation was that of “Education service” group. During this month, this group marked an annual inflation of 6.2 percent. Rises in education fees such as foreign languages fee 2.3 percent, preschool education 2.1 percent

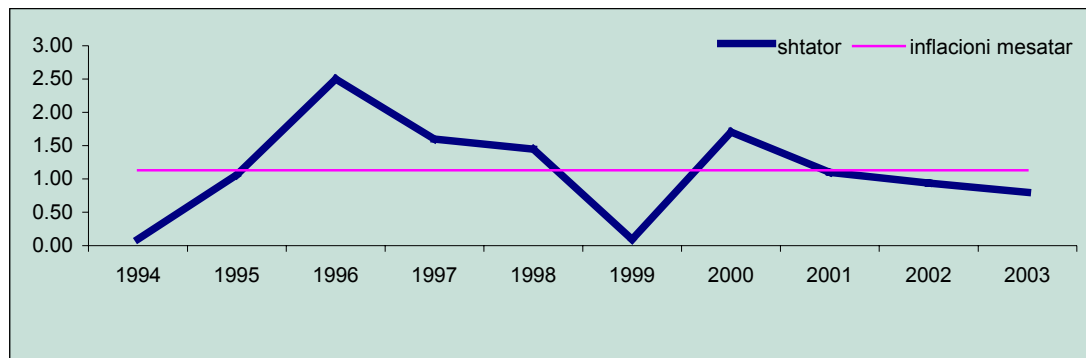
and middle school fee 1.3 percent, caused the rise of 2 percent in the monthly inflation of this group.

An annual increase of 5.3 percent marked also the “Foodstuff and non-alcoholics” group, at a time when the increase of last year was 4.7 percent. The seasonal effect faded as summer went past. This helped the inflation value for September be positive, while during the previous months inflation had been negative. The decline of the foodstuff domestic demand during September, led to demand insufficiency for these products, and consequently to price rises.

**Table 9: Monthly and annual rate of the “Foodstuff and non-alcoholics” group**

	“Foodstuff and non-alcoholics” group		Subgroup “Fruits”		Subgroup “Vegetables”	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
September '03	1.6	5.3	-0.1	22.5	9.4	21.4
September '02	1.9	4.7	-4.3	2.6	13.7	7.7

**Graphic 9: Performance of monthly inflation rate in Septembers**



The seasonal effect of the “Foodstuff and non-alcoholics” group explains inflation performance during the third trimester of this year. This year, this factor had its full impact during May – June. Although the inflation rate in July was negative, the impact of this factor was insignificant and far from the trend presented in years. The seasonal behaviour in August was totally proved. The impact of this factor is assessed to have emerged as follows:

- The rise of the domestic demand due to the growth of tourist activity, made it difficult fulfilling it, particularly for foodstuff. Hence, imports of this group<sup>10</sup> mounted to 24 percent in July and 31 percent in June as opposed to the respective months in the previous year.

<sup>10</sup> Source: Bank of Albania. Balance of Payments and Observations Sector.

- The increase of imports gives way to the influence of trade partner countries' inflation and exchange rate on the proper inflation of the country. Our trade partners had a higher inflation than the target, affecting thus the price rises of imported goods. On the other side, Lek appreciation in annual terms against Euro and USD, for this period, has helped the fall of upward pressures that imported inflation would have had in the country.

**Table 10. Annual inflation rate.**

Countries	February	March	April	May	June	July	August
Germany	1.2	1.2	1.0	0.6	0.9	0.8	1.1
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

- As it is often mentioned, there is a tendency to approximate the prices of domestic products with the foreigner ones.

Other important developments during the third trimester of this year, which gave their impact on the inflation rate performance, are the rise of excises in July and price rise of the electric power in May.

The rise of excises in July brought about a notable rise of the inflation rate in the "Alcoholic and tobacco" group. Thus, the annual inflation of this group marked the highest figure of 4.7 percent in September, while the highest monthly inflation was reached in July by 3.2 percent.

Despite the fact that the electric power price rise gave its impact on the inflation rate of May, raising thus the monthly inflation of "Rent, water and fuel" group to 4 percent, the impact of this factor did not follow on the other months. The annual and monthly rates of this group fell in June – September, except for August. The rise of rent price by 1. 2 percent in August brought about the inflation rise in this group.

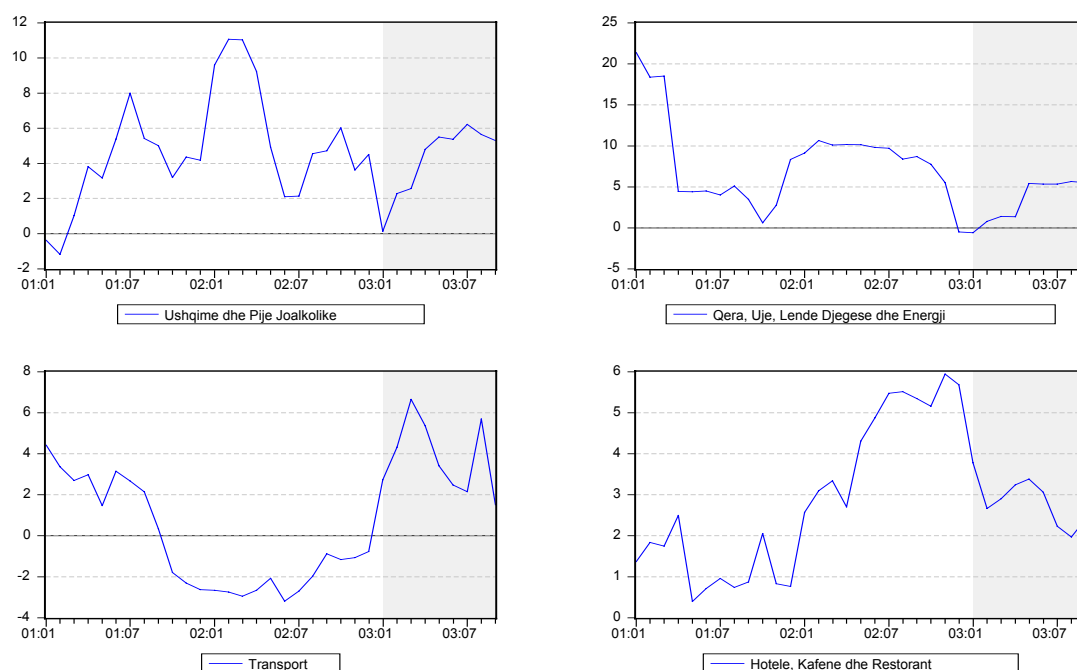
Below, it is concisely given the contribution of the main groups in the total annual inflation.

**Table 11: The contribution of the main groups of the basket in the overall annual inflation (in percentage)**

	January	February	March	April	May	June	July	August	September
1. Foodstuff and non-alcoholics	0.05	0.99	1.11	2.09	2.34	2.23	2.56	2.33	2.21
2. Rent, water, fuel and electric power	-0.15	0.19	0.33	0.32	1.31	1.31	1.33	1.41	1.35
3. Hotels, cafes, restaurants	0.28	0.20	0.21	0.24	0.26	0.24	0.17	0.15	0.19
4. Transport	0.13	0.20	0.31	0.25	0.16	0.12	0.10	0.10	0.07

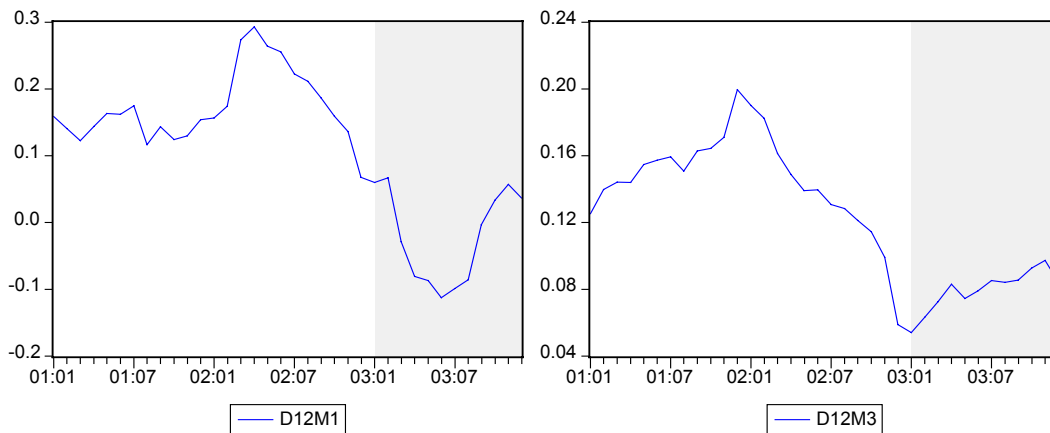
5. Other groups	-0.04	-0.04	-0.08	-0.07	-0.04	-0.90	0.00	0.01	0.04
<b>Total</b>	<b>0.28</b>	<b>1.54</b>	<b>1.89</b>	<b>2.82</b>	<b>4.03</b>	<b>3.81</b>	<b>4.16</b>	<b>4.00</b>	<b>3.86</b>

**Graphic 10: Annual inflation of the 4 main groups of the PCI basket (in percentage)**



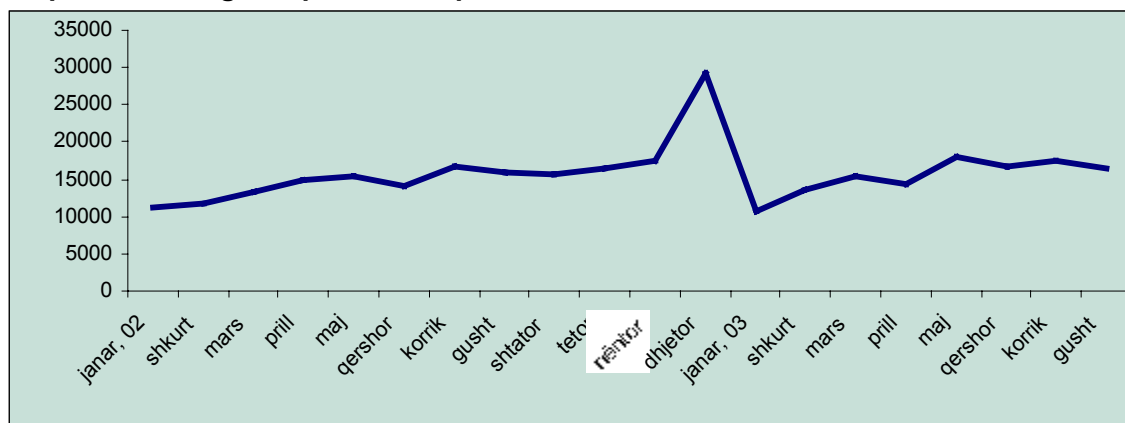
The slow growing rates of the M1 aggregate have helped the alleviation of inflationary pressures. As expected, the easing policy followed by the Bank of Albania has not led to significant inflation deviations from the targeted interval.

**Graphic 11: Annual spreads of the monetary aggregates M1 and M3 (in percentage).**



Additionally, the moderated increase of the budget expenditures and government deficit has helped slow down the operating intensity of factors exercising inflationary pressures.

**Graphic 12: Budget expenditures performance.**



In conclusion, monthly and annual inflation rates during the third trimester did not show any unusual fluctuations, with the seasonal features characterizing the inflation rates in this period.

## **3 MONETARY POLICY PERFORMANCE**

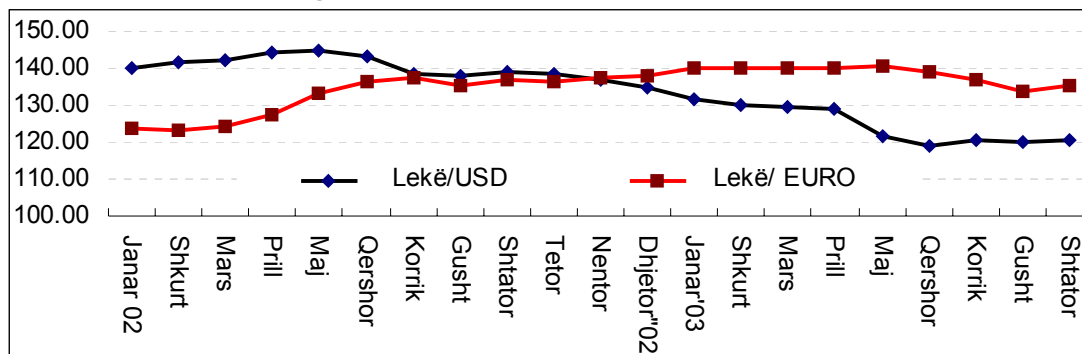
### **3.1 MONETARY POLICY OF THE BANK OF ALBANIA**

The Bank of Albania has been following an easing monetary policy during this trimester, too. This policy was conditioned by developments in real economy and monetary sector. Inflation performance has been within the target set by the Bank of Albania in the first half of the year. Except for July, inflation remained within the 2-4 percent interval even during the third trimester. Also, inflation expectancies have been within this target. The stability of monetary indicators was also maintained during the third trimester. The real interest rates remained at relatively high levels (graphic 15), whereas the money outside banks/M3 ratio was fixed at the level of 28 percent. Additionally, Lek has generally showed appreciating trends during 2003.

Considering these factors, the Bank of Albania reduced by 0.5 percentage point the core interest rate at the beginning of July. This reduction brought the total reduction of the core interest rate to 1.0 percentage point during 2003. The Bank of Albania move was soon reflected in financial markets. The inter-bank market and the treasury bills market reacted immediately, reflecting almost thoroughly the reduction made by the Bank of Albania. The reduction of the interest rate affected also the market of Lek deposits. However, the reduction of Lek deposits interest rates was smaller than the reduction of the core interest rate, since banks had somehow preceded to the move of the Bank of Albania.

Also, in compliance with the easing monetary policy, the Bank of Albania has been present in the foreign exchange market, on the side of foreign exchange purchase. The third trimester recognized an appreciation of Lek due to the high offer of the foreign currency during the tourist season. The foreign exchange purchase from the Bank of Albania has impeded the Lek appreciation, adding up the liquidity in the market during this period. Compared to three months before, Lek is depreciated by about 2.5 percent against Euro. However, in annual terms, Lek is appreciated against these two main currencies.

**Graphic13: Lek exchange rate performance as to various months.**



The quick return of money outside banks in the system led to the creation of surplus reserves in commercial banks. Moreover, the Bank of Albania activity in the foreign exchange market is assessed to have amplified the money supply by about Lek 1.8 billion, exercising pressures on the reduction of interest rates. Under these circumstances, the Bank of Albania has sterilized the effects of its foreign currency activity, withdrawing about Lek 0.6 billion liquidity through the outright sale of the treasury bills. Despite the reduction of interest rates, monetary indicators have been moving within the expectations of the monetary program. The increase of the monetary offer, performance of economy crediting, the timeline structure of the monetary assets in economy and internal financing of the deficit have performed positively. During July – August, a rapid increase of the money supply was noticed, which was basically supported by the rise of foreign exchange deposits due to the high foreign exchange inflows during vacations. In this period, the economy and government demand for monetary assets in Lek has been performing as to the historic trend.

An appreciable performance has also been shown by the quantitative objectives of the Bank of Albania, which were observed throughout the third trimester.

**Table 12. Realisation of the quantitative objectives of the Bank of Albania**

	December '02	March '03	June '03	September '03*
<b>Realisation of the INR objective (USD million)</b>				
Objective	558.6	560.6	582.2	572.6
Actual	562.2	596.2	607.3	625.7
Difference	3.6	35.6	25.2	53.1
<b>Realisation of the NDA objective (Lek billion)</b>				
Objective	95.1	97.1	98.1	97.1
Actual	87.1	76.5	68.8	71.8
Difference	-8.0	-20.7	-29.4	-25.3
<b>Realisation of the domestic credit to the government (Lek billion)</b>				
Objective	258.7	264.6	267.7	272.4
Actual	259.6	263.1	263.1	-
Difference	0.9	-1.4	-4.6	-

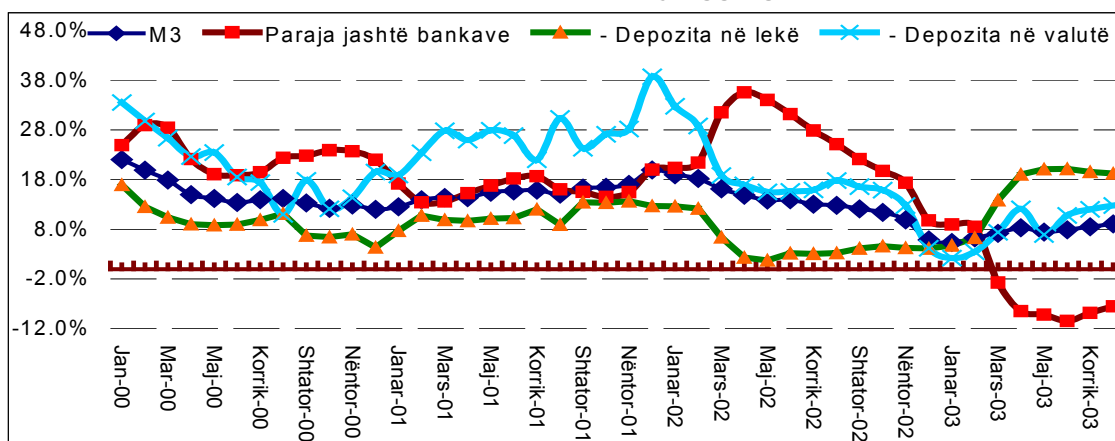
\*\*September data are operative.



### 3.2 MONETARY AGGREGATES PERFORMANCE

Monetary developments during the third trimester could be characterised as pursuing the historic trends. Foreign exchange deposits had a notable growth despite the appreciation pressures of Lek exchange rate, whereas money outside banks marked a slight rise of its level. The third trimester recorded a considerable rise in the monetary aggregates level. Money supply was characterised by higher annual growing rates during 2003. In August, the annual growing rate of the M3 indicator mounted to 9.1 percent, recording thus the highest value throughout the year.

**Graphic 14: Annual performance of the monetary aggregates**



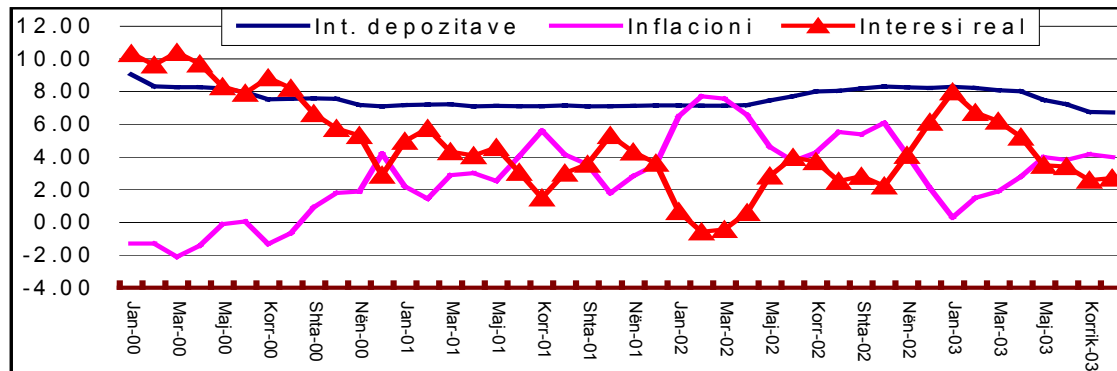
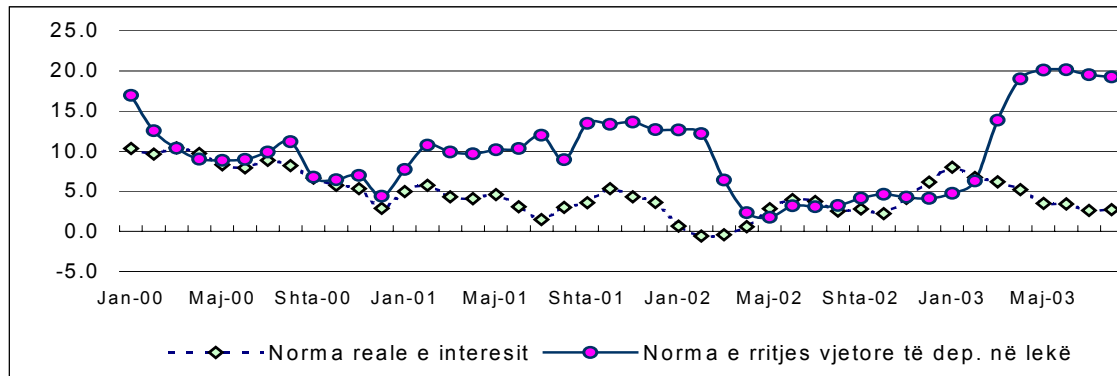
The annual growing rate of foreign exchange deposits mounted to 12.8 percent in August. However, it is still lower than the annual growing rate of Lek deposits. Meanwhile, the returns of money in the system during 2003 caused the money outside banks have negative rates of annual spread. Foreign exchange deposits, in general, presented an upward trend during this period due to the tourist season. The increase of Lek 9.9 billion of foreign exchange deposits, during July-August, is higher than the average of the past years<sup>11</sup>, while if there were no exchange rate impacts, this increase would have been Lek 7.4 billion.

Lek deposits increased slower than the second trimester. Their ratio versus M2 fell from 64.4 percent in June to 63.9 percent by the end of August. The slow increase of Lek deposits was affected by: the low demand of the government and economy for monetary assets in Lek, the return of money outside banks/M3 ratio near to the historic level and the fall of the real interest rate during July – August,

<sup>11</sup> Foreign exchange deposits have increased at an average of Lek 4.9 billion during July – August '99-'02.

due to the reduction of the core interest rate from the Bank of Albania, and also due to the little rise of inflation during this period.

**Graphic 15: Deposits interest rates and real interest rates**



The slowing down of Lek deposits and the rise of government borrowing during the third trimester have affected the reduction of the excessive liquidity in the system. By the end of September, the excessive liquidity of the banking system fell to nearly Lek 4.1 billion from Lek 7.2 billion it was by the end of June.

**Table 13. Performance of the monetary indicators in august (in Lek billion)**

	August 2003	Monthly spread		Annual spread	
		Absolute	Percentage	Absolute	Percentage
Money outside banks	122.1	1.2	1.0	-9.8	-7.5
Total deposits	319.1	7.4	2.4	46.6	17.1
- Lek deposits	216.3	0.2	0.1	34.9	19.3
- Foreign exchange deposits	102.7	7.2	7.6	11.7	12.8
Demand deposit	59.3	3.6	6.4	0.5	0.9
- In Lek	19.5	0.1	0.3	-3.5	-15.1
-- In foreign exchange	39.8	3.5	9.7	4.0	11.2

Term deposits	259.7	3.8	1.5	46.1	21.6
- In Lek	196.9	0.1	0.0	38.4	24.2
- In foreign exchange	62.9	3.7	6.3	7.6	13.8
M1	141.6	1.3	0.9	-13.3	-8.6
M2	338.4	1.4	0.4	25.1	8.0
M3	441.2	8.6	2.0	36.8	9.1
Monetary basis	156.4	1.7	1.1	-5.5	-3.4

Meanwhile, the level of money outside banks marked a rise in July and August, following thus the historic trend. The increase of consumers' expenses during August affects the rise of cash level circulating in economy. According to the operative data, the level of money outside banks fell slightly in September.

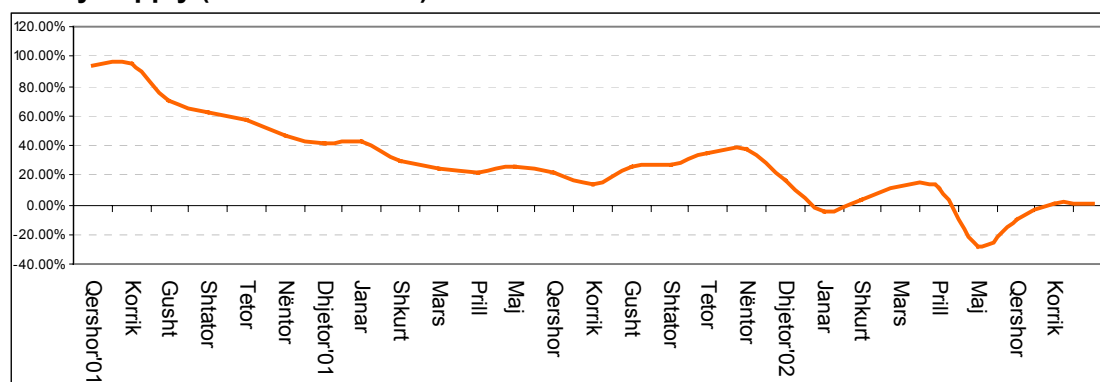
### 3.3 MONEY DEMAND IN THE ECONOMY

#### 3.3.1 NET FOREIGN ASSETS OF THE BANKING SYSTEM

Net foreign assets of the banking system have had an increase during the third trimester of 2003. These assets increased by USD 37 million during July-August. The increase of net foreign assets, denominated in Lek, is estimated Lek 11.7 billion, from which only Lek 4.6 billion comprise their real increase as Lek 7 billion are due to the foreign exchange influence. During July-August, Lek is depreciated by nearly 4.6 percent against USD.

During this trimester, it is noticed an increase of the net foreign assets contribution to the annual growth of the monetary offer. Unlike the previous trimester, these one net foreign assets have contributed positively to the monetary offer increase. In August, this contribution was estimated nearly 12 percent.

**Graphic 16. Contribution of the net foreign assets increase in the increase of the money supply (in annual terms)**



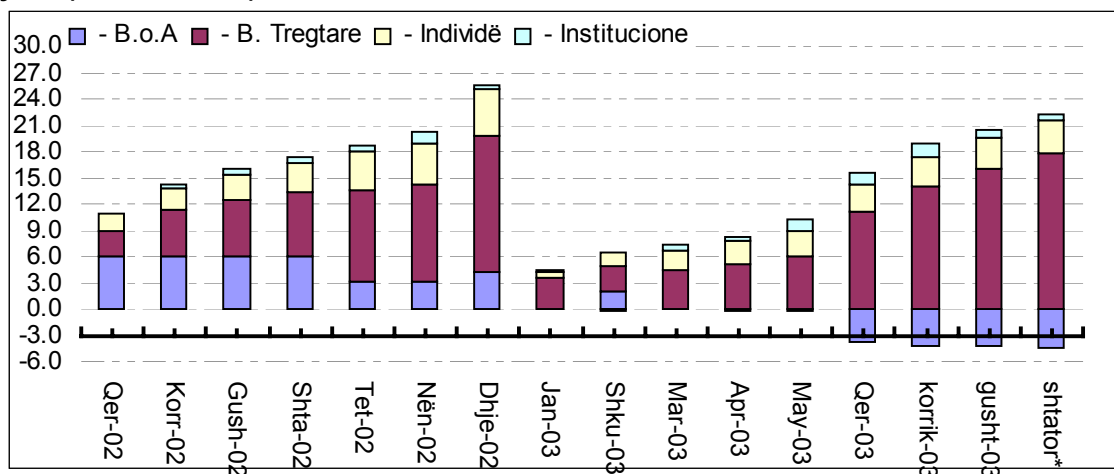
The growth of foreign assets of the banking system is due to the growth of about USD 41million of the foreign assets of the second tier banks, as a result of the increase of foreign exchange deposits. Meanwhile, the net foreign reserves of the Bank of Albania decreased by USD 4 million as a result of the depreciation of Euro against USD, which reduced investments in Euro denominated in USD.

### 3.3.2 GOVERNMENT DEMAND FOR MONETARY ASSETS

The budget deficit by the end of August mounted to Lek 12.1 billion, being almost at the same level of the previous year. On the other side, the budget deficit is presented lower than the expected value, due to the non-realisation of the budget expenditure plan.

The budget deficit during the first eight months is mainly financed by the banking system. This financing was about Lek 11.7 billion by the end of August, being thus 5 percent lower than the respective period in the previous year. According to the operative data of September, it is noticed that domestic financing mounted to Lek 16.6 billion, being almost at the same level with the respective period in the previous year. During September, the Bank of Albania portfolio recorded a further decrease, due to the outright sale during this months.

**Graphic 17: The cumulative performance of budget defect financing during the year (in Lek billion)**



The budget deficit financing through internal borrowing has been upward during the third trimester. It was almost completely covered by the banking system. During the third trimester of 2003, internal financing increased by nearly Lek 6.1 billion, recording thus an increase compared to the previous trimester, during which it was Lek 4.3 billion.

### 3.3.3 ECONOMY CREDITING FROM THE BANKING SYSTEM

Economy crediting from the banking system has recorded a continuous growth during 2003. The crediting market is characterised by an amelioration of the new credits indicators, being followed by also by an involvement of almost all banks.

**Table 14. Performance of some main indicators<sup>12</sup>**

	2000	2001	2002	T-1 2003	T-2 2003	July	August
Money supply (In Lek billion)	328.1	393.6	416.7	420.6	426. 7	432.5	441.2
Internal credit (In % versus M3)	75.5	67.5	70.8	71.2	71.4	71.6	70.7
- Credit to the government (In % versus M3)	68.4	60.4	61.5	61.6	61.0	60.8	60.0
- Credit to the economy (In % versus M3)	7.1	7.1	9.3	9.6	10.4	10.8	10.7
Credit to the economy (In % versus GDP) <sup>13</sup>	4.8	4.7	5.9	5.6	6.0	6.3	6.6
Credit to the economy (In % versus the overall assets)	8.6	8.9	11.5	11.6	12.5	13	12.8
Credit/Deposit ratio (in %)	10.1	10.2	13.5	13.5	14.5	15	15

During January – August, the level of new extended credit reached Lek 54.6 billion, being 1.4 higher than the same period of the previous year. During July – August 2003, it has been extended nearly 23 percent of the credit extended during 2003.

Credit surplus by the end of August 2003 mounted to Lek 47.1 billion. The performance of the credit surplus structure as to the maturities and currencies is presented in the following table.

**Table 15. Credit surplus structure (in percentage)**

	Year 2002				Year 2003			
	T-1'	T-2	July	August	T-1	T2	July	August
Short-term credit	59.5	57.0	56	55	53.2	53.4	52.2	51.6
Mid-term credit	27.5	29.5	30	30	30.4	30.7	31.6	29.7
Long-term credit	13.0	13.5	14	15	16.4	15.9	17.2	18.7
State sector	2.1	0.4	0.4	0.4	0.2	0.0	0.0	0.0
Private sector	97.9	99.6	99.6	99.6	99.8	100.0	100.0	100.0

<sup>12</sup> These indicators are reckoned by subtracting from the credit surplus the part transferred to the BART

<sup>13</sup> This ratio is set on versus the GDP at annual level for 2003.

Lek	16.1	17.2	18	19	21.5	21.2	20.4	18.6
Foreign Currency	83.9	82.8	82	81	78.5	78.8	79.6	81.4
Credit surplus (in Lek billion)	29.5	33.3	33.6	35.2	40.4	44.5	46.7	47.1

**Table 16. New credit (in Lek billion).**

Indicators	Year 2001	Year 2002	Year 2003			
			T-1	T-2	July	August
Short-term credit	27.6	44.8	11.6	17.5	5.3	3.5
Mid-term credit	10.4	13.0	4.3	5.6	1.2	1.4
Long-term credit	2.6	4.8	1.5	1.5	0.7	0.5
State sector	0.5	0.05	0.05	0.0	0.0	0.0
Private sector	40.1	62.59	17.4	24.6	7.2	5.4
Lek	10.0	20.9	7.1	8.0	2.4	1.7
Foreign Currency	30.6	41.7	10.4	16.6	4.7	3.7
New credit (in Lek billion)	40.6	62.6	17.5	24.6	7.2	5.4

During July – August 2003, the credit surplus as banking system compared to the second trimester of 2003 increased by Lek 2.6 billion. July 2003 is estimated as the month with the highest crediting level of Lek 2.2 billion, surpassing the 120 percent average monthly crediting level, forecasted in the monetary program of 2003.

Credit to the economy for 2003 in the monetary program is expected to rise by Lek 12.9 billion. Until the end of August 2003, it was realised 65 percent of the annual growth of the credit surplus as estimated in the monetary program. The greatest contribution in this growth was the increase of the credit surplus in foreign currency, which contributed 94 percent of the credit surplus increase. The rapid increase of the foreign currency credits is due to the interest spread of credits in foreign currency and in Lek, making thus credits in foreign currency more appreciable.

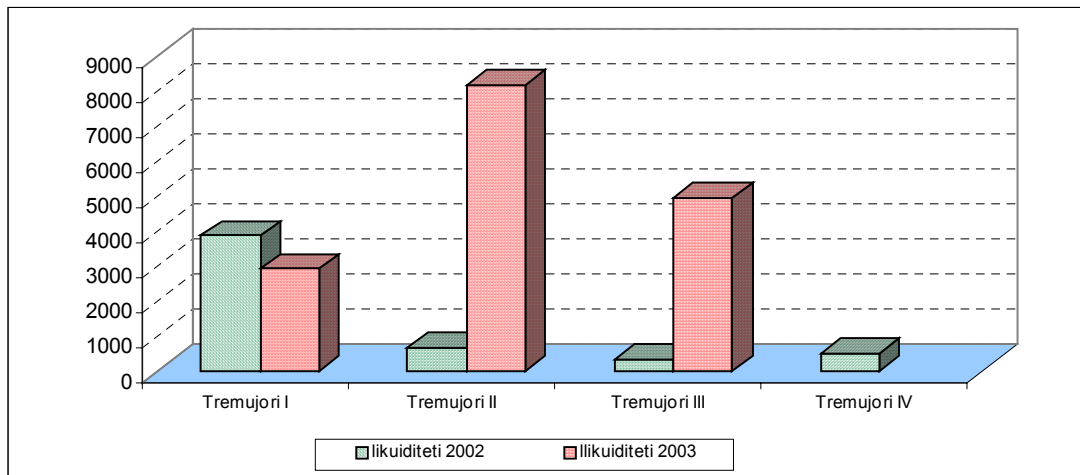
According to the data reported from businesses credited through the banking system, 34 percent of the credit surplus as banking system goes to the commercial activity financing, 17 percent to the processing industry and 12 percent to the real estate purchase financing. The increase of bank credit financing is also appreciated, although not at significant levels for such sectors as agriculture, fishing, transport, services, etc.

## 3.4 FINANCIAL MARKETS AND INTEREST RATES PERFORMANCE

### 3.4.1 FINANCIAL MARKETS

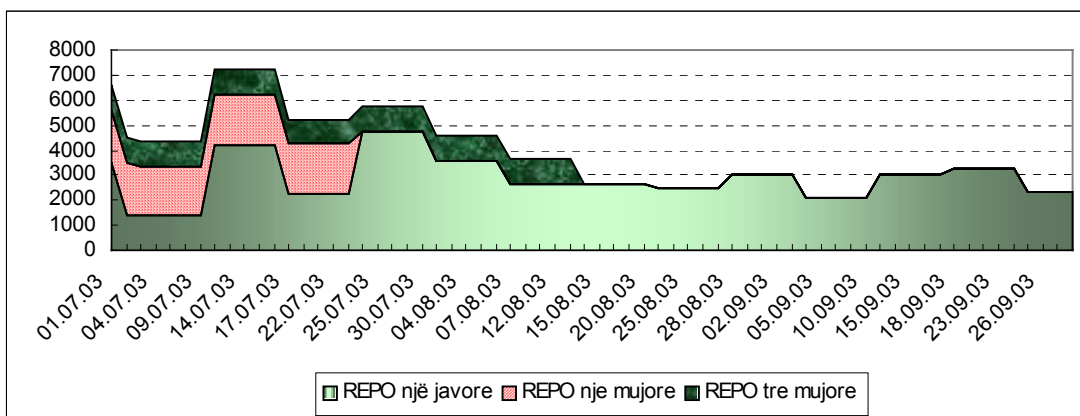
The banking system continued to have liquidity surplus during the third trimester of this year, though they had a downward trend.

**Graphic 18. The daily average liquidity of commercial banks by the Bank of Albania (in Lek million)**



The downward trend of liquidities in the system was affected by the increase of the government borrowing in the primary market and the slowing down of the growing rate of Lek deposits, due to the increase of consumption expenditures during vacations. In order to withdraw the excessive liquidity in the system, the Bank of Albania has followed on with the repos and outright sale auctions. The downward trend of the liquidity in the system brought about the low participation of banks in the auctions of three monthly repos, even their non-participation in the auctions of one-monthly repos.

**Graphic 19. Repos application in withdrawing the excessive liquidity of the banking system during the third trimester 2003 (in lek million)**

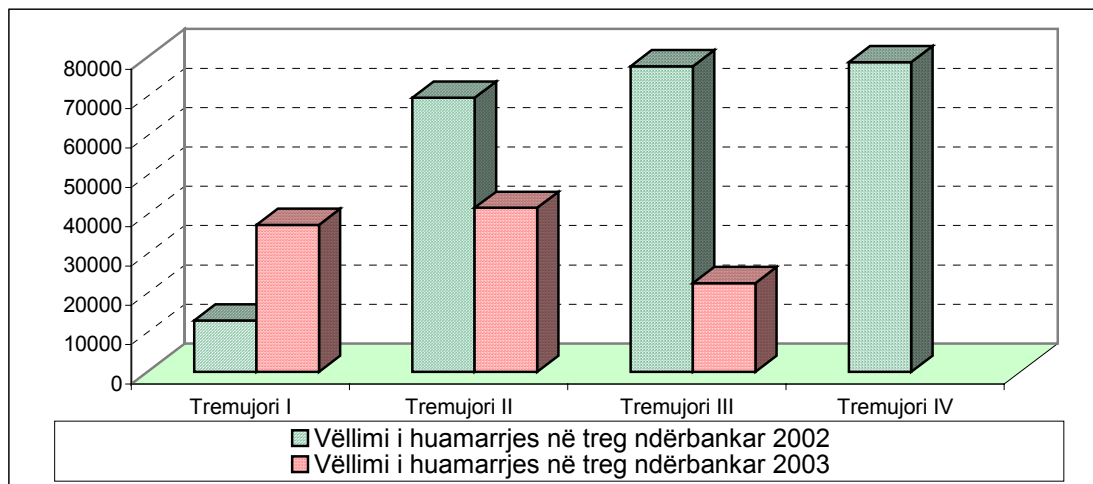


**Table 17. Sum of outright sales (in Lek million)**

	05.06.03	12.06.03	31.07.03	25.09.03
Sum	1 500	2 000	470	100

In the third trimester, the borrowing volume in the inter-bank market resulted lower than the second trimester. This borrowing has been mainly for overnight maturities.

**Graphic 20. The cumulative volume of the borrowing in inter-bank market (as to the trimesters)**



### **Permanent facilities offered by the Bank of Albania.**

Since the system has continuously had liquidity surplus, the facility applied was that of the overnight deposit, which during the third trimester has been at an average level of Lek 720million.

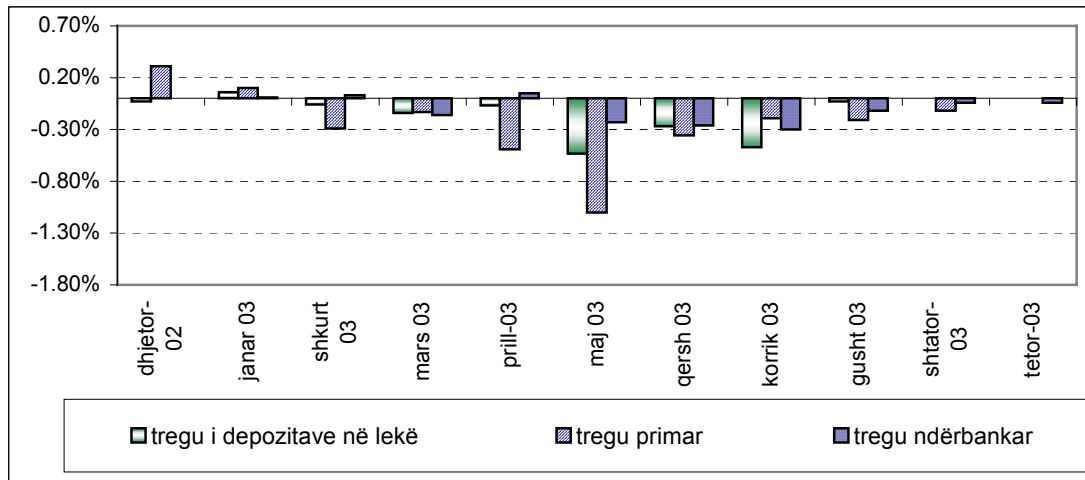
Banks have also used the reserve requirement, the use of which had even an upward trend in the third trimester.

### **3.4.2 INTEREST RATE PERFORMANCE**

The Bank of Albania continued to follow an easing monetary policy during the third trimester of 2003, reducing the core interest rate by 0.5 percentage point. The reaction of banks under these circumstances is reflected in all markets. The greatest reaction, however, was that in the Lek deposits market.



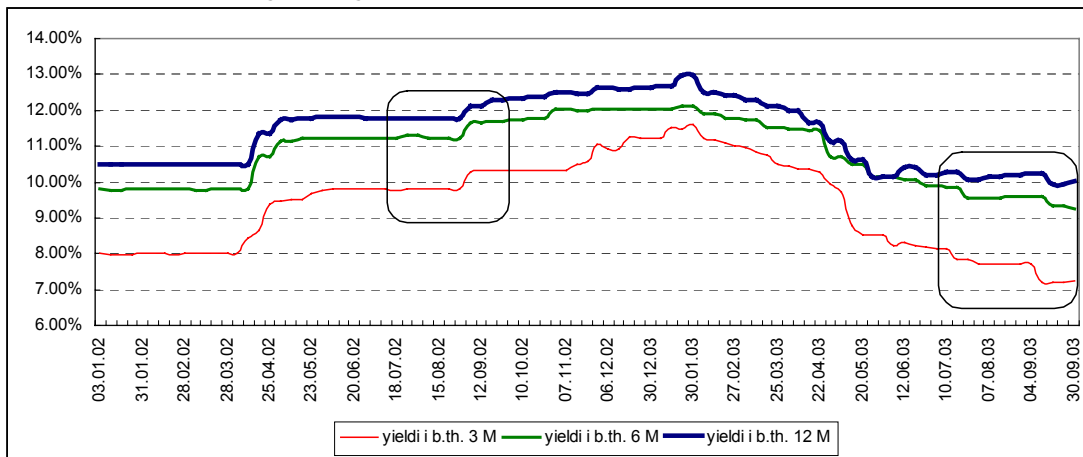
**Graphic 21: The market reaction towards the change of the core interest rate by the Bank of Albania.**



Once the core interest rate was reduced, changes were noticed in the credit market, too. However, the change of lending structure as to the banks, from one month to the other, causes fluctuations in the credit interest rates level, in Lek, and the examination of this indicator becomes more difficult.

The treasury bills yield followed the downward trend, but at lower rates than in the previous trimester. The treasury bills yield resulted at lower levels in the third trimester as compared to the same period in the previous year.

**Graphic 22. Treasury bills yield performance**

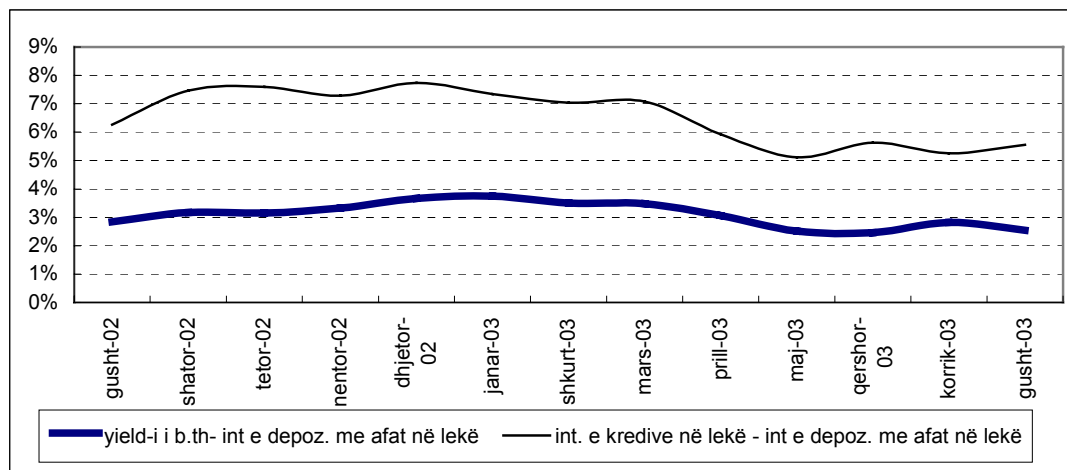


The previous reduction of the interest rates in the market of foreign currency deposits continued also in the third trimester, though at lower rates. This is pursuant to the reduction of core interest rate from the European Central Bank

and Fed in June, and to the increase of foreign currency offer<sup>14</sup>, mainly from emigration and tourism.

These developments resulted in the contraction of the spread between treasury bills interest rates and Lek deposits from one side, and the spread between Lek deposits and foreign currency deposits on the other. Both these indicators are close to their two-year minimums.

**Graphic 23. Interest rate spread.**



<sup>14</sup> There was a notable increase of foreign currency deposits, in August.

