

QUARTERLY REVIEW OF ALBANIAN ECONOMY, THIRD QUARTER 2005, JUNE 2005

I. GOVERNOR'S SPEECH

The nine-month period of 2005 was characterized by positive highlights with regard to economic growth and macroeconomic stability. The economic activity has generally moved in line with the directions projected by the country's development program. This estimation is based on a series of indicators such as: the evident growth of sales volume; growth of fiscal revenues; expansion of exports; reduction of unemployment rate and increase of employment. A significant development highlighted during 2005, which contributed to the consolidation of economic activity is the better support of economy by credits from the banking system. The major part of credit was extended for financing the production activities as well as trade. The economy was underpinned also by the neutral monetary policy followed by the Bank of Albania, which has contributed to maintaining interest rates at low historical levels.

Based on the available data, Bank of Albania estimates that the economy showed evident growth rates during the nine-month period. In particular, the economic activity marked an evident progress in the second quarter, showing a revitalization of production in all the sectors of economy. Further to the consolidated dynamics of the Albanian economy, the growth of production is mainly supported in the sectors like "Electricity, water and gas", "Transport and telecommunication" and "Construction". At the end of June, the unemployment rate reached 14.3 per cent, marking a decrease of 0.5 percentage points compared to the previous year. According to Institute of Statistics (INSTAT), the Albanian economy created, in the course of one year, 13.4 thousand of new job vacancies in the private sector, which continues to remain the engine of the economic growth.

Balance of payments showed a positive result of EUR 11 million till June. Capital flows have been sufficient to cover the current deficit, which amounted to EUR 145 million, during the first semester of the year. The deficit in trade of goods and services has been the primary source of current deficit. The capital and financial account has registered net inflows of about EUR 197 million, while the foreign reserves of monetary authority increased by about EUR 7 million during this period. Like previously, the high trade deficit is for the most part financed by the current inflows in the form of emigrants' remittances and by capital and financial inflows in the form of grants, public and private debts, and direct investments.

The economic growth is underpinned by the stable macroeconomic environment, expressed in the low inflation, the observance of monetary values projected in the budget deficit and a monetary situation maintained under control. At the end of September, annual inflation was 3.1 per cent,

practically the middle-point of Bank of Albania target, while average annual inflation was inclined to move to the lower limit of this target. In response to the economic and monetary developments, inflationary pressures and expectations remain under control even for the periods to come. During the third quarter, inflation rate is conditioned on the contribution of "Foodstuffs and non-alcoholic beverages" and "Transport" groups. The third quarter of the year was characterized by a considerable rise of oil price in the international markets, representing a real challenge to the economic activity worldwide. However, amortised by the exchange rate appreciation, the price rise in the domestic market, has been almost two times lower. Considering the low share of fuels in the consumer commodity basket in Albania, oil price impact on inflation was low, while no increase of commodity costs due to oil price rise was applied.

The consolidation of macroeconomic stability has contributed to controlling inflationary pressures. The main indicators of the budget program are met in general. According to the Finance Ministry data, till the end of September, 97.5 per cent of the projected revenues were collected and about 96.4 per cent of the projected expenditures were performed. In addition, the budget deficit and its domestic financing have generally resulted within their expectations. However, during the third quarter, a slowdown of income flows was attributed to the long post-electoral process. On the other hand, this period is being accompanied also by a concentration on government borrowing, which, though it has met the annual limits, has created difficulties in managing the liquidity situation. Bank of Albania estimates that strengthening the fiscal management as well as meeting the criteria of maintaining macroeconomic stability should remain a constant priority for the fiscal policy.

Macroeconomic developments and inflation maintenance at low levels are also favoured by monetary situation. After the last cut of core interest rate in March, Bank of Albania has followed a neutral monetary policy. During the third quarter, there was a slowdown of money supply growth rates compared to the rapid growth of money supply in the first half of the year. The annual growth rate of M3 in August dropped down to 15.4 per cent from 18.3 per cent it was at the end of June. Under the effect of the narrowing of interest rate differences between Lek and foreign currency, and of the seasonal growth of inflows from remittances, the money supply structure was shifted towards foreign deposits, while the time structure resulted relatively stable.

The performance of net foreign assets of the banking system in August was satisfactory, with a growth of USD 112.7 million compared to June. Till August, the credit balance increased by about ALL 31 billion; this growth was about 60 per cent higher than the credit balance growth over the whole year of 2004. The intense lending activity was accompanied by the improvement of all credit indicators; its ratio to the broad money reached the level of 18 per cent, while the credit share to GDP the level of 11.8 per cent.

The growth of credit to the economy, the concentrated financing of budget deficit and the slowdown of deposits flow, brought about the decrease of

banking system liquidity during the third quarter, contributing to increasing pressures on Treasury bills yield. Under the conditions of a privatised banking market and of a relatively undeveloped Treasury bills market, Treasury bills yield marked an increase, which was not in compliance with the situation and the basic macroeconomic factors. For managing this situation, Bank of Albania has carefully assessed its operational frame and its forecasted position in the foreign market, aiming at maintaining monetary equilibriums. In July, Bank of Albania changed the direction of monetary operations, with the purpose of meeting the short-term needs of the system for liquidity, by performing reverse repurchase agreements.

Meeting the temporary needs of the market with liquidity as well as financing the budget deficit from the Bank of Albania through short-term direct credits to government have aimed at smoothing the pressure on Treasury bills interest rates, with a special emphasis on preventing their further increase. Meanwhile, the second half of October was accompanied by a normal situation and a decline of Treasury bills yield. Due to the narrowing of the interest rate difference during this year, emigrants' remittances were channelled in the banking system mainly as foreign deposits. Under the conditions of a flexible exchange rate regime, this phenomenon has restricted the spaces for the seasonal presence of Bank of Albania in the foreign exchange market. The characteristic activity of Bank of Albania in the foreign exchange market, at the end of summertime, has been restricted over this year.

These factors led to the temporary deviation of some monetary indicators from the expected values. Generalising the monetary developments performed in the 2005 summer, we may conclude that the monetary situation management from Bank of Albania was efficient and this is proved by the improvement of liquidity situation during September-October and by the smoothing of pressures on interest rates.

In spite of the generally positive developments highlighted during the nine-month period, the Albanian economy has to face some challenges of structural nature, and their solution would constitute a significant contribution to the consolidation of economic growth rates. The exacerbated energy situation constitutes a constant concern for the Albanian economy. The intensity of this crisis and the sensitiveness of Albanian businesses to such a situation, would also condition the achievement of the economic growth target of 6 per cent for year 2005. The situation becomes more challenging under the conditions of price rise of oil and energy in the whole region. The combination of these factors may constitute a risk, which may extend its influence even in the next year.

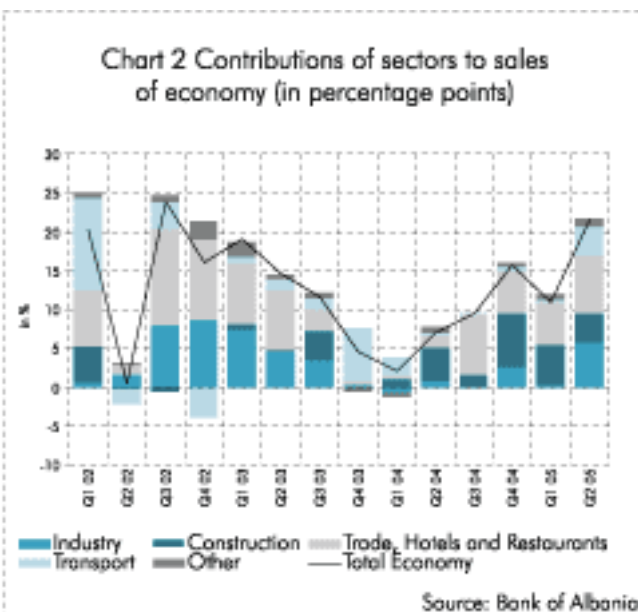
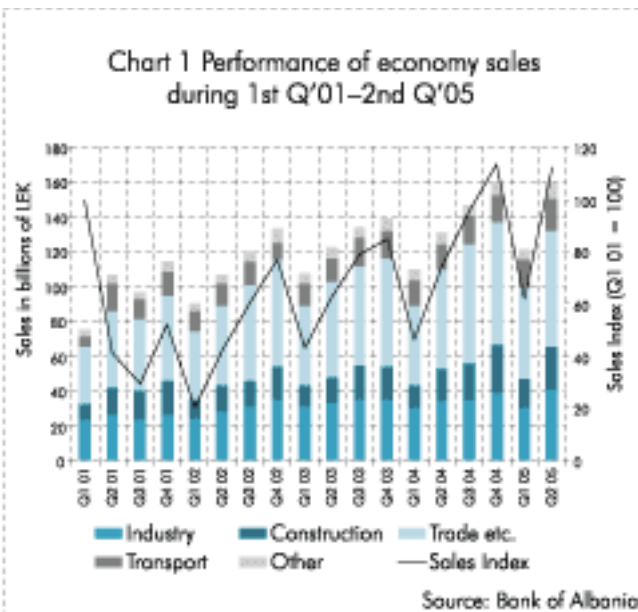
In this context, looking forward in the future, Bank of Albania estimates that we have to work for finding a sound solution to this problem, to extremely minimize the dependence of our economy on the subjective factors, including weather conditions. The improvement of business climate in the country requires, inter alia, the implementation of the projects relating to the increase of alternative energy resources in the country.

II. ECONOMIC DEVELOPMENTS AND INFLATION

II.1 ALBANIAN ECONOMY PERFORMANCE

The Albanian economy was characterised by a satisfactory performance throughout 2005. The growth of sales volume, of fiscal revenues and of credit to economy proves that there is an increase of economic activity in the country. Total sales of economy marked an annual increase of 21.54 per cent during the second quarter. In addition, sales increased by 30.9 per cent in comparison with the first quarter of the year, the highest increase of the last three years, indicating a production revitalization in all the sectors of economy.

The sectors that have marked higher growth rates, on an annual basis, are “Electricity, water and gas”, “Transport and telecommunication” and “Construction”. However, the highest share in economy sales is covered by trade and service sectors, estimated at 42 per cent of total sales, followed by industry sector, at 26 per cent. As a result, these sectors gave their major contribution to the annual growth of economy sales during the second quarter of the year, by 7.4 and 5.8 percentage points, respectively.



II.1.1 Production performance by economy sectors

Construction sector

Construction sector has been in one of the most active sectors of the Albanian economy over the last years. During the second quarter, sales of this sector increased by about 24.8 per cent compared to the same period of the previous year and by 44.2 per cent compared to the previous quarter. This growth rates show a high demand for extension and improvement of infrastructure, producing capacities, trade activities and housing. Sales of construction sector represent 14.4 per cent of total sales of economy during the first semester of 2005, contributing to their annual growth by 4.8 percentage points. The same contribution, during the last two years, was 2.5 and 0.5 percentage points, respectively.

As a developing sector, construction has known an increase of private and public investments. During the first semester of this year, the

projected investment funds increased three times compared to the same semester of the previous year. After the “the period of quiet” in the first quarter, the second quarter knew significant increases of the projected investment funds. Private investments continue to represent the main share and their primary destination remain housing constructions. Also, during this quarter the number of construction permits increased, where permits granted for housing constructions increased nearly three times compared to the previous year.

Trade, hotels and restaurants sector

Sales of “Trade, hotels and restaurants” sector represented about 43 per cent of total sales of economy, during the first semester of 2005. This sector has contributed to the annual growth of total sales of economy by 6.4 percentage points. Like the other sectors of economy, “Trade, hotels and restaurants” sector marked an evident improvement during the second part of the semester. Its sales increased by 17.6 per cent compared to the second quarter of 2004 and by 26 per cent compared to the previous quarter.

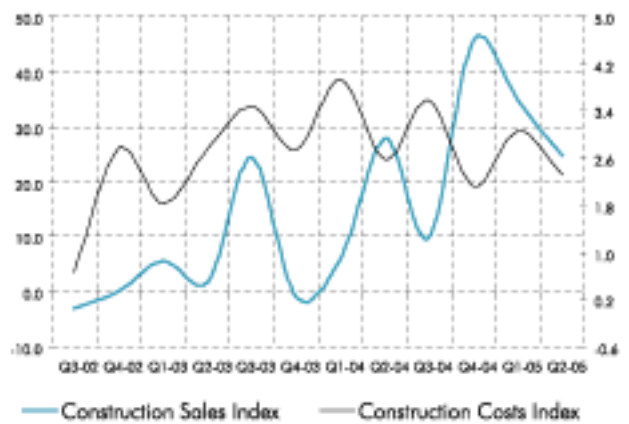
This performance has followed the seasonal behaviour of sales in this sector, according to which sales decline each first quarter of the year to record positive growth rates during the other quarters. However, in total, it is estimated that the performance of this sector contributed positively in the developments of the country’s economy during the first semester of 2005.

Agriculture sector

Agriculture sector¹ production is expected to increase by 4.7 per cent this year. In particular, agroindustry branch is expected to increase by about 12 per cent, the highest increase compared to the other branches of agriculture. Production in the agriculture branch is expected to increase by 3.1 per cent, this being supported by the positive weather conditions, the growth of investments in greenhouses and the extension of planted surfaces. Animal products are expected to mark the highest increase in agriculture branch, estimated at 3.8 per cent compared to the previous year. The production growth in this branch comes as result of rentability increase compared to the previous year.

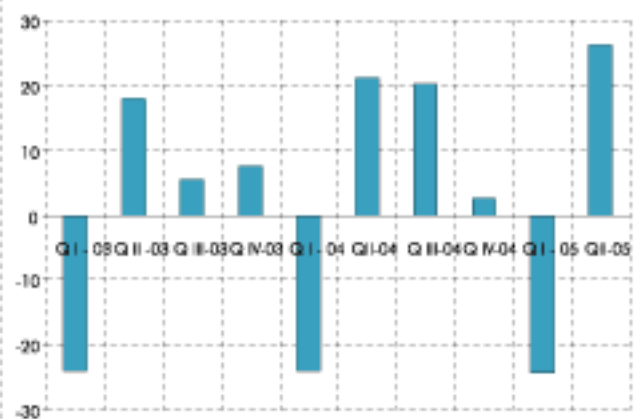
Based on the data of agroindustry survey conducted for the first semester of 2005, the agroindustrial production increased by 15.7 per cent compared to

Chart 3 Annual change of sales index for construction sector (right axis) and of construction cost index (right axis), in percentage



Source: Bank of Albania

Chart 4 Quarterly rate of sales change in “Trade, hotels and restaurants” sector (in percentage)



Source: Bank of Albania

the same period of the previous year. This is the highest increase (semester by semester) of the last four years.

Table 1 Agroindustrial production performance during the first semester

	First semester '04	First semester '05	Change (in %)
Total	13.0	15.0	15.7
Meat and by-products	1.3	1.5	17.32
Fish conservation	0.3	0.4	39.86
Fruits-vegetables processing	0.2	0.1	-17.86
Oil	1.1	1.1	-2.04
Milk and by-products	2.9	3.0	3.78
Flour and bread	4.0	4.6	15.97
Sweets	0.5	0.6	19.26
Alcoholics	1.3	1.5	12.30
Water and refreshment drinks	1.4	1.8	23.98
Tobacco	0.1	0.5	385.71
Other	0.0	0.0	66.67

Source: Ministry of Agriculture and Food

Investments in agroindustry sector during the first semester, increased 2.3 times in comparison with the first semester of the previous year. This was due to the growth of investments financed by foreign credits, about 29 times, and to the growth of investments financed by bank credits, about 2 times in comparison with year 2004. These investments are mainly concentrated in the districts of Tirana, Shkodra and Dibra. According to relevant activities, there was a growth of investments in flour industry, in production of a variety of juices, in processing meat and in conserving fruits and vegetables.

Table 2 Investments in agroindustry during the first semester (in millions of ALL)

	First semester '04	First semester '05
By owned capital	572.4	941.7
By foreign credits	8.1	229.9
By bank credits	78.7	163.0
Total	659.1	1334.6

Source: Ministry of Agriculture and Food

Industry sector

Industry sector was characterised by positive developments during the first semester of 2005, contributing positively to the performance of total sales of economy. Sales in this sector increased by 12.14 per cent during the first half of 2005, in comparison with the same period of 2004. More in detail, branches of extracting industry, processing industry and "Electricity, water and gas" marked an increase during the second quarter, after a decrease noted in the first quarter. Processing industry marked the highest annual growth during the first half of the year, but continues to represent a small share in total industrial sales. In the processing industry, sub-branches of plastic production, mineral manufacturing, metal processing and paper industry increased particularly. The extracting industry increased by 18.4 per cent during the first semester, influenced mainly by the growth in the extraction of energy products.

Table 3 Performance of industry sector in the first semester of 2005 (in percentage)

	Share to the total	Sales '05/'04
Total industry	100	12.14
Extracting industry	7.2	18.43
Processing industry	65.1	10.26
Electricity, water and gas	27.7	14.9

Source: INSTAT

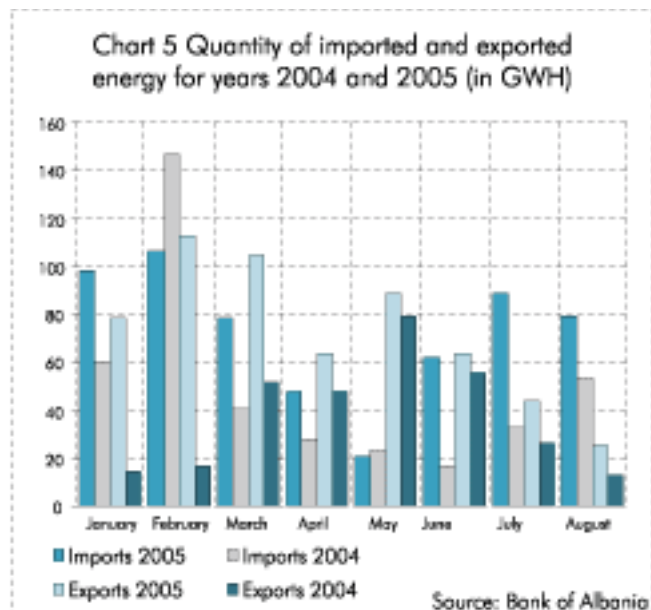
Energy sector

Energy sector developed in an equilibrated manner during the eight-month period of 2005. Household and non-household consumers were supplied with electricity by 1.2 per cent more, while energy imports and exports resulted practically equal. However, within this period, the second quarter knew a significant improvement of the situation. During the second quarter of the year, sales index of “Electricity, water and gas” marked an annual growth of 34.6 per cent and a growth of 9.5 per cent in comparison with the previous quarter.

	January – August'04 (GWH)	January – August'05 (GWH)	Annual change (%)
Total supply	4,353	4,641	6.6
Production	3,954	4,061	2.7
Imports	398	579	45.4
Total consumption	4,353	4,641	6.6
Exports	302	581	92.1
Household consumption	1,485	1,450	2.3
Non-household consumption	1,019	1,083	6.3

Table 4 Data on electricity supply and consumption

During January-August 2005, the supplied quantity of energy in the country increased by 6.6 per cent, in comparison with the same period of 2004. The domestic production covered 87.5 per cent of energy supply, unlike the eight-month period of the previous year, when this production covered 91 per cent. Meanwhile, the imported quantity of energy increased in comparison with the period of January-August 2004, ensuring 12.5 per cent of energy supply, instead of 9 per cent provided in the previous year. The same dynamics prevailed in terms of exports performance. During this period, 12.5 per cent of energy supply was utilized for exports in comparison with only 7 per cent of exported energy during the eight-month period of 2004.



Although the energy consumption by households declined on an annual level by 2.3 per cent, it continues to represent the main share (57 per cent) in energy consumption. On the other side, the energy consumption by non-households, for the eight-month period of this year, increased by about 6.3 per cent, in comparison with the previous year.

Transport sector

After the decrease of the sales index of transport during the first quarter of the year, this sector highlighted satisfactory developments during the second quarter, marking an increase of this index by 25.34 per cent. This is the highest

increase on a quarterly basis, since the fourth quarter of 2001. In comparison with the second quarter of the previous year, sales index increased by 30.57 per cent, contributing by 3.66 percentage points to the total increase of sales index of the entire economy.

The work volume in sea transport marked an increase of 9 per cent, during the eight-month period of this year. Imports in ports marked an increase of 5 per cent, while exports lowered to 2.1 per cent. Ports of Vlora and Saranda marked a more significant growth of work volume during the eight-month period of the year, but they represent only 13 per cent in terms of share in the work volume of four ports of the country. The work volume in Durres Port represented during this period about 80 per cent of work volume. Railway transport marked a decline of the passengers' number and of the volume of transported goods. Work volume decreased respectively by 13.2 per cent for goods and by 23.6 per cent for passengers, in comparison with the same period of the previous year.

During the first semester of this year, air transport increased by 27 per cent in terms of flights' number, in comparison with the same period of the previous year. Investments in transport sector during the first six months decreased by 31 per cent, compared to the first semester of 2004.

II.1.2 Fiscal sector

According to the Finance Ministry data, till the end of September, 97.5 per cent of the projected revenues were collected and about 96.4 per cent of the projected expenditures were performed. Budget deficit, till the end of September, was about ALL 18.9 billion, from ALL 21.4 billion being projected. The domestic financing of deficit till September amounted to ALL 15.2 billion, compared to the level of ALL 13.5 billion being projected, exceeding the plan by 12.5 per cent. While the foreign financing of deficit reached the level of 48.4 per cent of the projected value.

During the third quarter, there was a slowdown of income flows, bringing also a slowdown of budget expenditures. The main reason behind the decrease of fiscal revenue collection was the long post-electoral process. This period is being accompanied also by a concentration on government borrowing, which, though it has met the annual limits, has created difficulties in managing the liquidity situation. Bank of Albania estimates that strengthening the fiscal management as well as meeting the criteria of maintaining macroeconomic stability should remain a constant priority for the fiscal policy.

Table 5 Growth rates of fiscal indicators (in percentage)

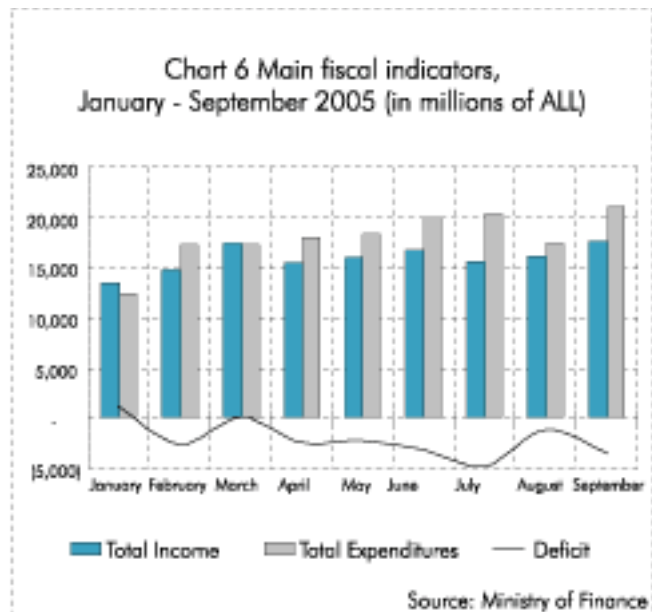
	Jan.-Sep. 00/99	Jan.-Sep. 01/00	Jan.-Sep. 02/01	Jan.-Sep. 03/02	Jan.-Sep. 04/03	Jan.-Sep. 05/04
Income	13.7	4.3	17.7	12.8	9.8	7.8
Expenditures	4.5	1.4	9.4	8.3	8.1	6.9
Capital expenditures	22.2	26.8	-18.5	(4.6)	4.2	8.8
Deficit	(15.7)	(6.9)	(18.2)	(13.1)	(2.4)	0.6

Source: Ministry of Finance

Budget revenues

Budget revenues were about 7.8 per cent higher during January-September 2005, compared to the same period of 2004. The level of fiscal revenues, at the end of September, reached about ALL 130.8 billion. Customs tax resulted about ALL 9.5 billion, achieving the expected level of the budget projected in the beginning of the year, respectively by 99.7 per cent.

Value Added Tax constitutes the main source of fiscal revenues. During the nine-month period there is noted that the growth velocity of VAT revenues is 8 percentage points lower than the average growth of this level in the last three years.



	Jul-Sept 02/01	Jul-Sept 03/02	Jul-Sept 04/03	Jul-Sept 05/04	Average 02-05	Factual plan Sep '05
Total income	11.3	9.9	14.3	6.1	10.4	97.5
Tax revenues	18.6	35.8	16.2	8.6	19.8	99.7
From tax and customs	18.2	4.0	16.8	8.0	11.7	99.4
Added value tax	14.3	5.3	17.4	10.4	11.8	99.6
Profit tax	21.0	0.8	31.5	9.7	15.7	113.9
Excise	4.8	21.0	42.8	11.7	20.1	98.9
Tax on personal income	35.0	4.2	4.7	10.5	13.6	95.6
Customs tax	7.2	1.6	[0.1]	1.4	2.5	89.3
Revenues from local government	40.1	284.5	1.2	22.4	87.0	108.2
Independent budget revenues (contributions)	12.2	9.5	18.3	7.3	11.8	98.2
Non-tax revenues	(23.2)	(7.6)	1.9	(10.8)	(10.0)	87.4

Source: Ministry of Finance

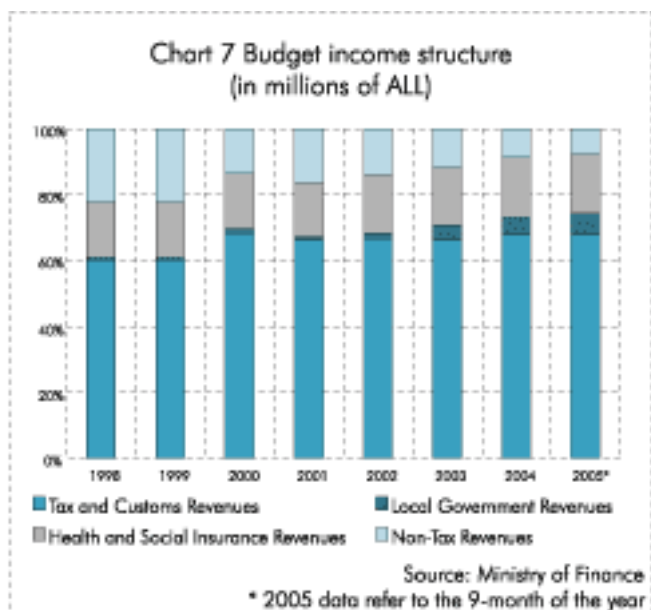
Table 6 Growth rates of income during 2002-2005 (in percentage)

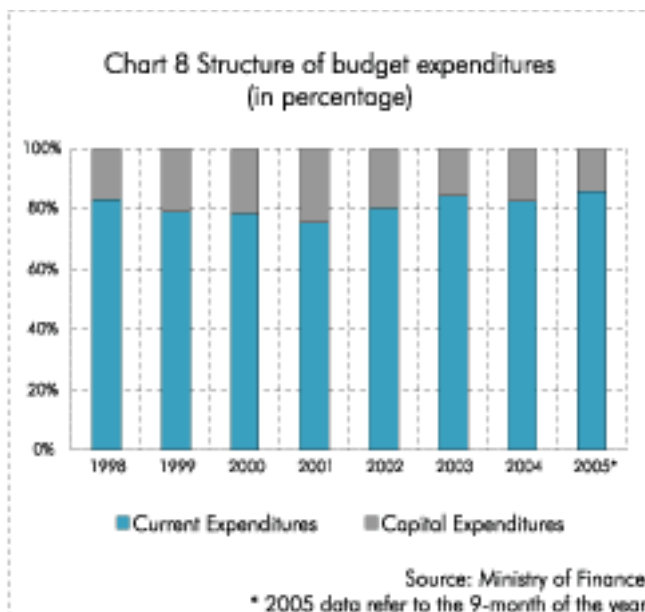
The period of July-September 2005 was characterized by a slowdown of velocity in the work of tax authorities. Total income increased by 6.1 per cent in comparison with the same period of the previous year, representing the lowest level of income growth in the last four years.

Excise revenues and revenues from local government have shown the best performance of income. Meanwhile, compared to the same period of the previous year, non-tax revenues decreased by 10.8 per cent.

Budget expenditures

Budget expenditures during the nine-month period of the year were ALL 161.8 billion, representing about 96.4 per cent of the level projected for this period. Personnel expenditures, which constitute





about 27 per cent of current expenditures and 24 per cent of total expenditures, were performed at 99.7 per cent. Capital expenditures, even though considerably increased during January-September of this year, continue to be below the projected level, reaching 80.4 per cent of the plan. From capital expenditures, expenditures covered by the domestic and foreign financing were performed at 99.3 and 57.6 per cent, respectively.

In comparison with the same period of the previous year, total expenditures increased by 3.4 per cent during the period of July-September 2005. During this quarter, expenditures of personnel and those of contributions for social insurance marked the highest growth in the current expenditures. Meanwhile, operative expenditures

for maintenance and those for interests reduced, being below the projected level. Capital expenditures marked a retrenchment during this period, but their behaviour over the years is irregular, which indicates that the performance of these expenditures is considerably influenced by the performance of specific projects. In the capital expenditures, the increasing share of the domestic financing against the foreign financing notably prevailed.

Table 7 Growth rates of expenditures during 2002-2005 (in percentage)

	Jul-Sept 02/01	Jul-Sept 03/02	Jul-Sept 04/03	Jul-Sept 05/04	Average 02-05	Factual plan Sep '05
Total expenditures	10.7	5.9	11.2	3.4	7.8	96.4
Current expenditures	13.3	10.3	10.8	5.4	10.0	101.4
Personnel	0.9	0.5	15.8	11.2	7.1	99.7
Payment	0.2	1.2	16.3	11.4	7.3	101.3
Social insurance contribution	3.6	(1.9)	13.7	10.7	6.5	96.2
Interests	11.7	24.5	4.9	(3.8)	9.3	89.7
Domestic	8.9	(23.5)	76.3	(4.4)	14.3	91.2
Foreign	72.3	(26.4)	(2.6)	9.4	13.2	70.3
Operative expenditures for maintenance	34.0	(0.8)	14.1	(5.8)	10.4	112.3
Expenditures for social security and other transfers	18.7	20.5	(16.9)	9.2	7.9	99.6
Capital expenditures	2.1	(10.6)	13.1	(5.7)	(0.3)	80.4
Domestic financing	(22.0)	12.7	34.9	(2.9)	5.7	99.3
Foreign financing	43.0	(32.2)	(20.6)	(12.8)	(5.7)	57.6

Source: Ministry of Finance

Fiscal deficit

Budget deficit, during the nine-month period of the year, was approximately 88.9 per cent of the projected level. The domestic financing, which represents the main share in the financing of deficit, was performed at 112.5 per cent of the plan, while the foreign financing was performed at only 48.4 per cent.

During the period of July-September 2005, the deficit marked a decrease of 8.6 per cent in comparison with the same period of the previous year.

	Jul-Sept 02/01	Jul-Sept 03/02	Jul-Sept 04/03	Jul-Sept 05/04	Average 02-05	Factual plan Sep '05
Deficit	8.7	(7.3)	(0.8)	(8.6)	(2.0)	88.9
Domestic financing	(61.5)	206.3	4.3	(8.5)	35.1	112.5
Foreign financing	149.9	(73.5)	(19.3)	(9.2)	12.0	48.4

Source: Ministry of Finance

Table 8 Growth rates of deficit during 2002-2005 (in percentage)

II.1.3 Labour market

During 2005 labour market continued to preserve the best performance demonstrated at the end of 2004, where labour indicators showed a strong upward trend. Thus, the number of employed persons increased by 10 thousand people, compared to the second quarter of the previous year. The employed persons in the non-agricultural private sector increased by 5400 people, being an important indicator for the revitalization of economic activity.

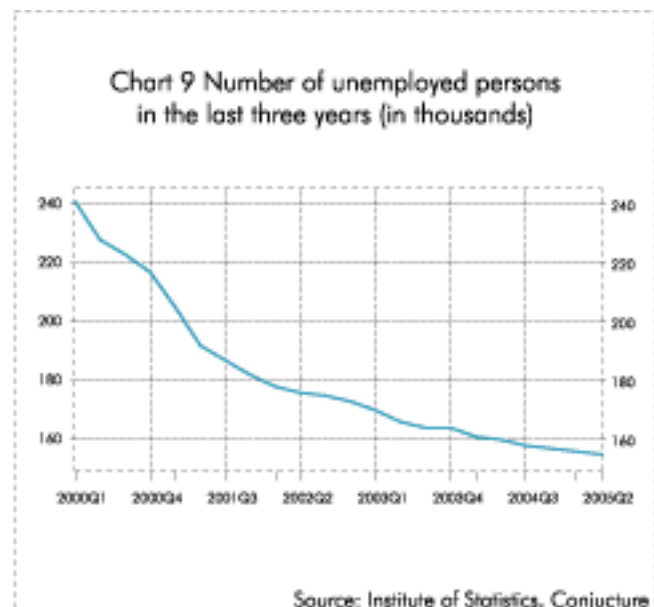
	2002	2003	Q.I	Q.II	Q.III	2004 Q.IV	2005 Q.I	2005 Q.II
Total labour forces (in thousands)	1167	1093	1080	1081	1080	1088	1087	1086
A. Total employed persons (in thousands)	991	927	919	921	922	931	931	931
i) public sector	188	184	179	179	177	176	176	175.6
ii) non-agricultural private sector	160	209	206	208	211	213	213	213.4
iii) agricultural private sector	644	534	534	534	534	542	542	542
B. Unemployment (in thousands)								
i) total unemployed persons	175.5	165.8	161	160	158	157	156	155
ii) beneficiaries of unemployment payment	12.3	11	11.7	12.3	12	11	11.5	11.5
C. Unemployment degree (in %)	15.1	15.2	14.9	14.8	14.6	14.4	14.4	14.3

Source: INSTAT, Conjuncture, September 2005

Table 9 Labour market indicators (in thousands of persons)

Labour market did not experience any change in its structure, during 2005. Thus, the public sector, though there was a reduction in the number of employed persons, continues to represent 19 per cent of the total number. The non-agricultural private sector represents 23 per cent and the agricultural private sector 58 per cent of all the labour forces². The most important changes during this quarter emerged in the unemployment figure. Unemployment declined by 0.5 percentage points in comparison with the previous year. In the second quarter, the number of unemployed persons decreased by one thousand people, leading the unemployment rate to 14.3 per cent. Another indicator showing this fact is also the number of the persons who benefit an unemployment payment. This number decreased further by 1.1 thousand persons in comparison with June of 2004.

The improvement of employment indicators seems to have been accompanied by the growth of revenues. Data on the salary structure in the



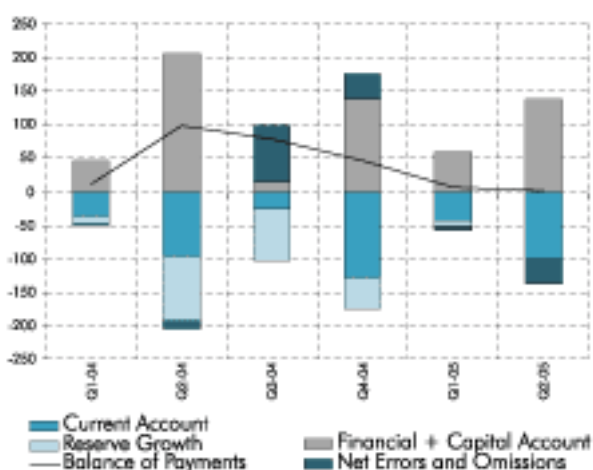
public sector, during the second quarter of 2005, indicate that the average public salary increased by 2 per cent, compared to the average of the first quarter of 2005. In annual terms (quarter by quarter), the average public salary increased by almost 10 per cent.

However, labour market data continue to have distortions in the indicators, which are due to the effect of certain phenomena such as: uncontrolled migration of population which brought about a continuous change of the ratio between rural and urban populations, as well as the continuous presence of a relatively large black market.

11.1.4 Foreign sector

Current and capital transactions of the country with the rest of the world were almost balanced during the first semester of 2005. During this period, an overall balance of payment of EUR 11 million was registered. The deficit in trade of goods and services has been the main source of current deficit. The latter amounted to about EUR 145 million during the first semester of the year. Capital and financial account recorded net inflows of about EUR 197 million, while foreign reserves of monetary authority increased by about EUR 7 million, during this period. The continuous deficit in trade of goods during the last years is compensated by the current inflows in the form of emigrants' remittances and by capital and financial inflows in the form of grants, public and private debts, and direct investments.

Chart 10 Balance of payments for the period of Q1'04-Q2'05 (in millions of EUR)



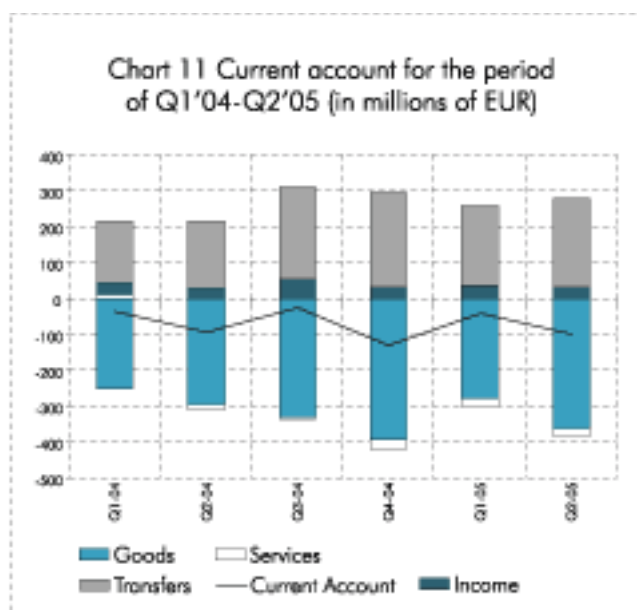
Current account

Current account of Albania during the first semester of 2005 was EUR 145 million or about 10 per cent higher than the deficit recorded in the first semester of the previous year. The major part of current payments have covered imports of goods (64 per cent) and those of services (34 per cent), while current revenues came mainly from the private transfers (37 per cent), services (35 per cent) and exports of goods (20 per cent).

Trade of goods represents the major part in the current transactions volume of the country with the world. The overall trade volume of the first semester of 2005 was about EUR 1.2 billion, from which about EUR 900 million were payments for imports and EUR 260 million revenues for exports. The annual growth of imports for the first semester was 14 per cent, while exports increased by 11 per cent. The coverage of imports by exports continues to be low. The major part of imports are represented by intermediate goods, while imports of capital goods marked a significant increase in comparison with the first semester of the previous year. These developments are an indication of good

performance of the processing industry and of investment performance in the country. The Albanian exports continue to demonstrate a low degree of diversification, being mainly represented by re-exports. The European Union countries continue to be the main source and destination of foreign trade.

Trade of services represents a smaller volume compared to trade of goods. The transactions volume in services, for the first semester of 2005, was about EUR 930 million or 20 per cent higher than the one of the same period of the preceding year. Services account is closed in a deficit of EUR 43 million. Tourism services represent the subgroup with the highest revenues and expenditures in the category of services. These services have provided about 70 per cent of revenues and have represented about 60 per cent of overall payments for services. Tourism activity represents not only one of the main sources of service revenues, but also one of the main sources of revenues in foreign currency for the Albanian economy. For the first semester of this year, the tourism revenues were 17 per cent higher than the revenues of the previous year, due to the increased number of foreign tourists and to the growth of their daily expenditures. However, during the last two years there was a growth of expenditures of the Albanian tourists outside the country, which led to a narrowing of the positive balance of this category.



Category of revenues has recorded a surplus of about EUR 66 million. Revenues from work of seasonal employees represent the main source of revenues, while expenditures for external debt interests are the main item in terms of expenditures. Current transfers have registered even for this semester a strong positive balance, serving as a counterbalance of trade deficit in goods and services. Emigrants' remittances have amounted to about EUR 420 million, representing about 76 per cent of overall volume of transfers, while the rest of transfers were ensured by government transfers as technical assistance.

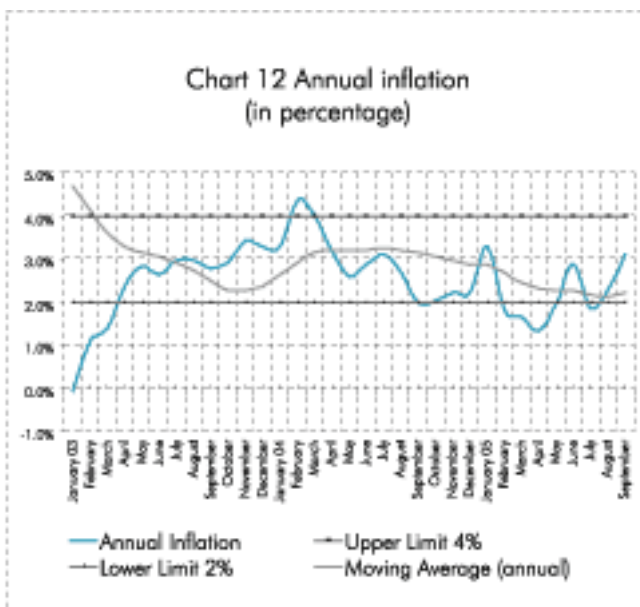
Capital and financial account

Net inflows in the capital and financial account, during the first semester of 2005, amounted to EUR 200 million. The surplus in the capital and financial account during the last years has financed the current deficit even in this period. Either the capital account or the financial account marked net positive inflows, respectively by EUR 50 and 150 million. Although positive capital inflows are translated into a growth of financial liabilities stock of the country against the rest of the world, the positive aspect of these developments consists in the fact that Albania relies rather on direct investments than on long-term foreign borrowing. Foreign direct investments for this semester amounted to about EUR 100 million, while foreign borrowing about EUR 80 million. Direct

investments of this period have been more oriented towards new investments in comparison with the previous year, when privatisation revenues ensured the major part of these investments. Financial claims of Albania to the world, represented mainly by portfolio investments and by deposits of resident banks with non-resident banks, marked an increase of about EUR 26 million. Financial assets stock in the form of portfolio investments, at the end of the period, amounted to EUR 164 million, with a semi-annual increasing flow of EUR 48 million. Foreign assets owned by the banking system in the form of deposits abroad, have decreased by about EUR 37 million. Also, cash foreign assets were estimated as decreasing. In the structural composition according to currencies, cash foreign assets in US dollar represented 39 per cent and those in Euro 53 per cent. Foreign assets inflows in the form of financial capital marked an increase of foreign reserves of the monetary authority by about EUR 11 million. The level of gross foreign reserves, at the end of the period, was estimated at EUR 1 billion and 72 million, being sufficient to cover 4.6 months of imports of goods and services.

Table 10 Performance of balance of payments (in millions of EUR)

	Sem.1-04	Sem.1-05
1. Current account	-131.8	-145.2
A. Goods	-551.5	-640.2
A.1. Imports	-790.5	-905.0
A.2. Exports	239.0	264.8
B. Services	-6.1	-42.8
B.1. Imports	-388.7	-484.0
B.2. Exports	382.6	441.2
C. Income	57.5	65.9
C.1. Outflows	-11.4	-14.5
C.2. Inflows	68.9	80.4
D. Current transfers	368.3	471.9
2. Capital account	48.5	50.1
3. Financial account	202.0	146.4
4. Growth of reserves	-109.7	-6.6
5. Net errors and omissions	-13.9	-44.7
6. Overall balance	109.7	6.6



II.2 INFLATION PERFORMANCE DURING THE THIRD QUARTER

Annual inflation marked a gradual growth during the third quarter, showing a different performance compared to the same period of the previous year. Annual inflation increased from 1.8 per cent in July to 3.1 per cent in September. However, inflationary pressures and expectations remained under control. Thus, inflation has been within the two-to-four per cent targeted range of Bank of Albania, during the third quarter. The average annual inflation rate did not experience any change during the third quarter, ranging between 2.2 and 2.3 per cent.

	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	3.1
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	2.2

Source: INSTAT

Table 11 Annual inflation rate (in percentage)

Inflation rise during the quarter came as a result of avoidance of the seasonal decline in prices of foodstuffs, this being combined as well by the inflationary pressures caused by oil price rise, particularly in August and in September.

II.3.1 Inflation performance and its constituent groups

During the third quarter of this year, annual inflation experienced some changes in both magnitude and direction, compared to the same period of the previous year. Compared to the previous year, annual inflation performance is determined by the contribution of “Foodstuffs and non-alcoholic beverages” and “Transport” groups. Unlike the last year, the first group has marked positive annual inflation rates, while the second group has almost doubled the annual inflation rate³.

“Foodstuffs and non-alcoholic beverages” group changed the behaviour during the third quarter of 2005, without contributing to the decline of annual inflation. Its contribution to the annual inflation during the third quarter is zero, while last year it contributed to the decline of annual inflation by 1.2 percentage points. The main reason of this behaviour is the presence of a weaker seasonal effect during summertime, being reflected in the gradual decrease of domestic foodstuff supply during the quarter. The inflation rise of this group has also reflected the imported inflation. Foodstuff prices in Greece, from where most of these products are imported, marked high prices, unusual for this period. In total, the inability of domestic supply to satisfy the market demands and the introduction of imported products with higher prices, have resulted in the general increase of prices.

“Rent, water, fuels and electricity” group was inclined to move to lower values than the previous year.

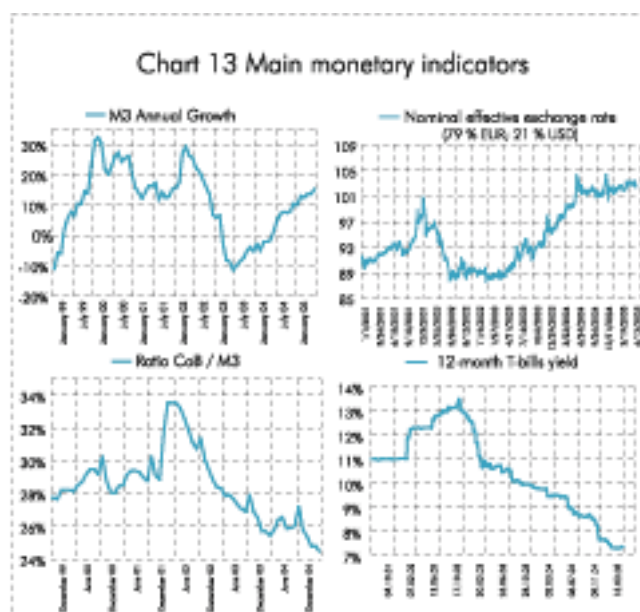


Table 12 Inflation of "Foodstuffs and non-alcoholic beverages" group and its share to total inflation

	Annual inflation '04	Contribution (pp)	Annual inflation '05	Contribution (pp)	Italy* Annual inflation '05	Greece** Annual inflation '05
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	1.3
September	-2.9	-1.2	1.5	0.6		

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

However, this group continues to give its main contribution to total inflation. Inflation of this group represents about 65 per cent of total annual inflation during the third quarter. In September, annual inflation of "Rent, water, fuels and electricity" group marked 7.7 per cent from 6.9 per cent it was in the previous month. The increase of the rent price and imputed rent to 3.3 per cent, has affected this figure, as a result of the new school year period, which brought about an increase of demand for housing and accommodation.

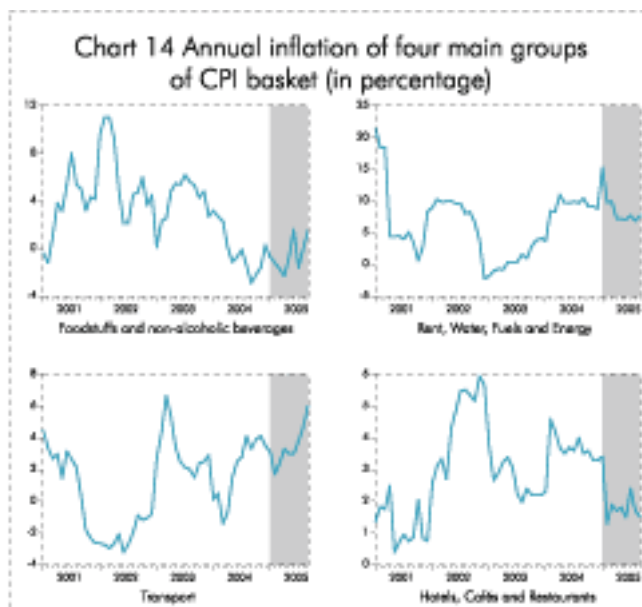
Table 13 Inflation of "Rent, water, fuels and electricity" group and its share to total inflation

	Annual inflation '04	Contribution (pp)	Annual inflation '05	Contribution (pp)
April	11.0	2.5	7.2	1.8
May	10.0	2.3	7.2	1.8
June	9.7	2.3	7.1	1.8
July	9.9	2.4	7.7	2.0
August	9.7	2.4	6.9	1.8
September	10.4	2.5	7.7	2.0

During the third quarter of this year, and in particular in August and in September, there was a significant oil price rise in the international market. This fact caused the increase of operators' sensitiveness to oil price rise worldwide, being demonstrated in subsequent increases of its price during August-September even in the domestic market. As a result, "Transport" group marked the highest growth since September of the previous year, while the "Services to personal assets" subgroup⁴ increased by 12.2 per cent. The

contribution of this group to inflation rate was 0.7 percentage points during this quarter. The low share of this group in Consumer Price Index is not big enough to become directly decisive for important changes in inflation rate. Also, the Lek appreciation versus the Euro and US dollar in annual terms has eased the transmission of this effect to inflation.

Contributions of other groups have been fluctuating in a moderate manner during this quarter. Despite their small share, the education payment increase affected the inflation increase during this quarter. The other groups of basket⁵ have influenced, in general, the decline of annual inflation rate, thus smoothing the price rise in the above-mentioned groups.



II.3.2 Macroeconomic environment and consumer prices

Macroeconomic environment in the country has by and large been favourable with regard to keeping inflation under control. It has been characterized by a satisfactory performance of sales in economy⁶, by a stable situation in the labour market and by the maintenance of the annual appreciation of Lek against Euro and US dollar. Moreover, the economy has not suffered a shock as regards the demand, while the oil price shock, which acts on the demand part, has considerably depreciated due to a strong Lek. Under such circumstances, this quarter was not characterized by significant structural changes in the fluctuation of different groups of consumer goods basket.

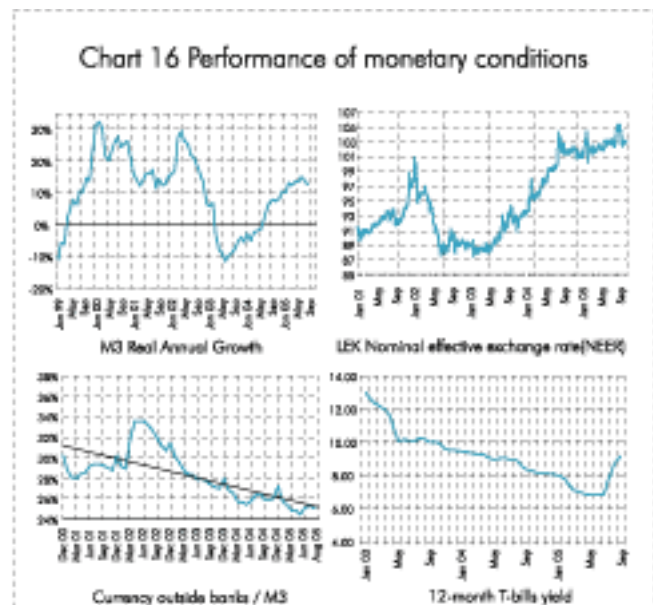
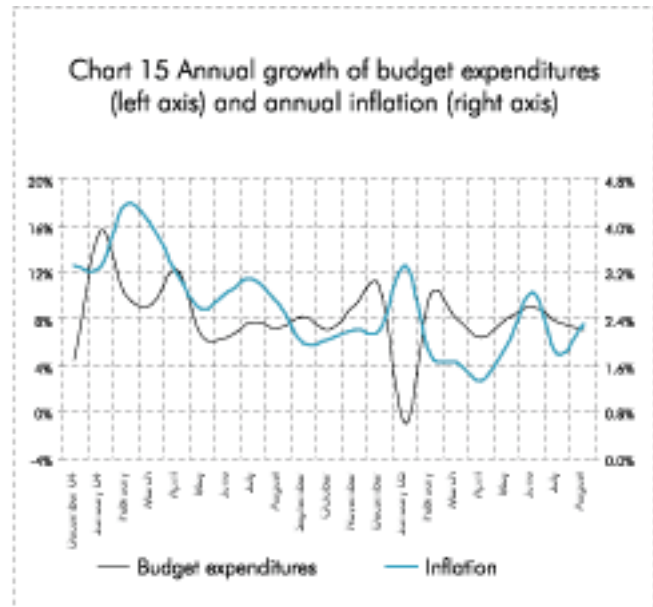
Demand factors

- *Fiscal policy and fiscal indicators*

During the first three quarters, fiscal indicators have been within the forecasted levels in the budget program. Budgetary revenues and expenditures have not exceeded the ceiling set for the period. Until September, they were respectively met to the extent of 97.5 per cent and 96.4 per cent of the plan, thus, causing the budget deficit be within the forecasted parameters. Hence, fiscal policy has given a significant contribution to the maintenance of macroeconomic equilibriums. However, the budget deficit concentration during the third quarter caused liquidity problems to the banking system and increased the interest rates fluctuation in the market. This fact highlights the importance of the comprehensive observance of forecasted budgetary indicators in the maintenance of macroeconomic equilibriums.

- *Monetary policy and monetary indicators*

During the third quarter, the monetary policy of the Bank of Albania has had a neutral direction. After a long easing period of the monetary conditions in the economy, the Bank of Albania has aimed at the stability of interest rates in the market. However, as a result of a sudden change in the liquidity situation, during the third quarter the interest rates have experienced noticeable fluctuations. Although the situation has caused difficulties with regard to the operation of the liquidity administration, the monetary indicators equilibriums have not displayed considerable deviations and were not reflected in inflation. The ratio of currency outside banks to M3 has been relatively stable, while the growth of monetary



supply has corresponded to the economy needs for monetary assets. In general, monetary policy has not given impulses to inflation increase.

- *Other indicators of domestic demand*

Domestic demand has marked a rise during the second quarter of the year. The sales index of the economy has had an annual growth of 21.6 per cent. Compared to the previous quarter this index grew considerably to 31 per cent, proving the revitalizing of the economic activity after the first quarter. Moreover, the Retail Trade Index has recorded a growth of 9.4 per cent compared to the previous quarter. Nonetheless, considering the performance and dynamics of the inflation indicators, it is assessed that the demand growth has not caused inflationary pressures to the economy.

Supply factors

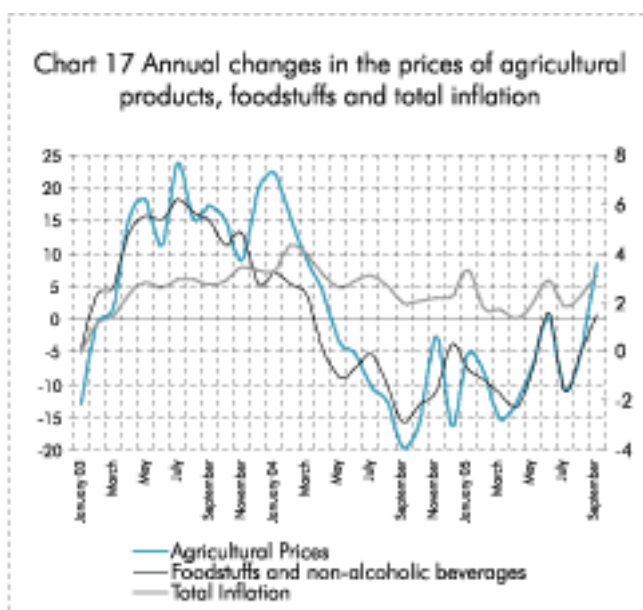
- *Exchange rate and the imported inflation*

The appreciating tendency of Lek against Euro and US dollar remained apparent even during the third quarter of 2005. Although with a more moderate annual dynamics, Lek marked an average annual appreciation of 1.4 and 1.0 per cent against the American dollar and Euro. The exchange rate appreciation is one of the main factors in easing and absorbing the inflationary pressures in the country, in particular those of the imported inflation. External stability, as well as the favourable developments in the exchange rate, has limited the external shocks over the price performance. On the other hand, the exchange rate stability states the confidence in the Lek value and indicates low inflationary expectations in the economy.

Table 14 Annual inflation in partner countries and changes in the exchange rate (in percentage) for 2005

	March	June	July	August	September
Greece*	2.9	3.3	3.9	3.7	3.9
Italy**	1.9	1.8	2.1	2.0	
LEK/EUR	-3.1	-1.0	-1.8	-2.4	-1.4
LEK/USD	-9.8	-1.2	0.0	-3.3	-1.0

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



- *Performance of domestic agricultural product*

The forecasts of the Ministry of Agriculture with regard to the domestic agricultural product for 2005 indicate an annual growth of 3.1 per cent. This growth is underpinned by the good weather conditions, spread of sown areas, growth of the yield and the increase in the number of greenhouses. The performance of domestic agricultural product is a significant factor in determining the inflation rate since the agricultural products constitute around 43 per cent of the consumer goods basket.

- *Production prices index*

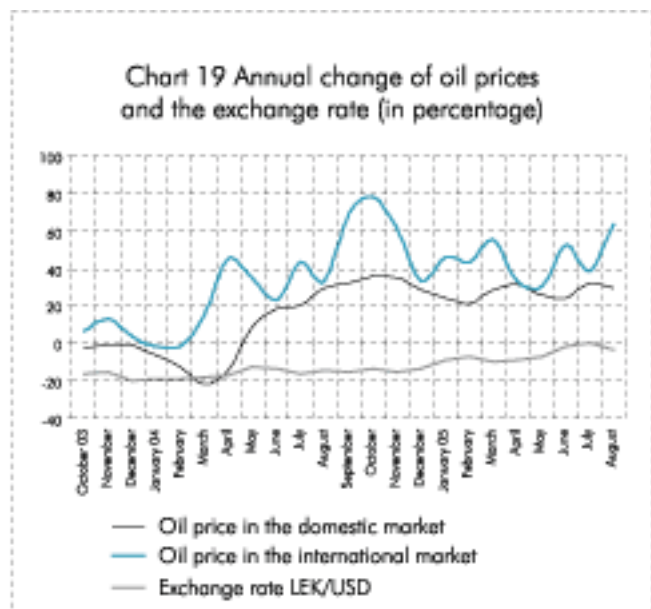
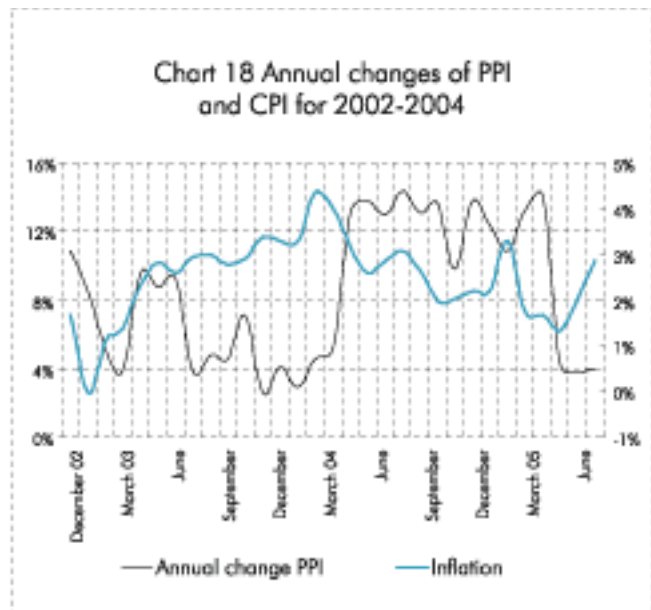
During the second quarter of 2005, the production prices have undergone less rapid growth paces, which were not reflected in the consumer prices. Compared to the second quarter of the previous year, the production prices increased by 4.0 per cent, while compared to the previous quarter they increased by 1.2 per cent. Growth was observed in all sectors of production⁷.

- *Oil prices*

The increase of oil prices in the international market is one of the main concerns for the importing economies, wherein our country is part of. However, the reflection of the direct effect over the inflation growth, or of the indirect effect, by increasing the cost of goods and services using this input – has been less considerable in our country. The small share this product⁸ holds in the consumer basket, as well as the appreciation of Lek against the US dollar, has hampered the full transmission of oil price rise in the domestic market. Nevertheless, along with the exacerbated energy supply situation, it remains a factor being continuously the focus of monetary policy.

- *Unemployment and salaries*

The stable situation in the labour market, along with the modest rise of salaries in the public sector, has not generated inflationary pressures in the economy. The labour market during the second quarter of 2005 did not experience significant changes. Unemployment rate remained unchanged, while the average salary in the public sector increased by 2 per cent compared to the first quarter of the year⁹. Minimum salary and unemployment salary remained unchanged.

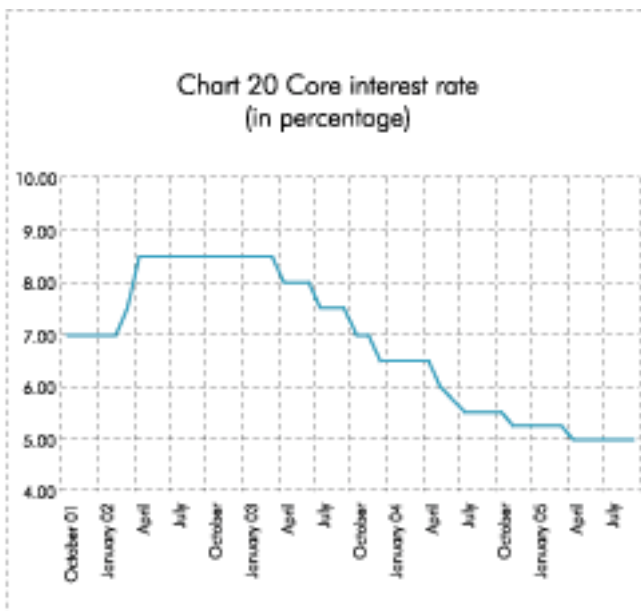


III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

III.1 MONETARY POLICY OF THE BANK OF ALBANIA

Macroeconomic developments and inflation rate expectations conditioned the maintenance of an unchanged core interest rate during the third quarter. Nonetheless, the monetary conditions have been under the influence of external factors, whose effect has led to the deviation of monetary indicators from the forecasted performance. Assessing the monetary situation and other factors influencing on inflation as being under control, the Bank of Albania

has maintained an unchanged monetary policy. After the last decrease of core interest rate in March, the Bank of Albania has followed a neutral monetary policy, by employing its operational instruments in managing liquidity and in reducing short-term fluctuations of interest rates in the markets.



The increase of cash in circulation, beyond expectations, and the concentration of government's domestic borrowing were followed by the aggravation of the liquidity situation in the system. Moreover, as a consequence of tightening the difference of interest rates during the year, workers' remittances have been channelled in the banking system, mainly as foreign currency deposits in commercial banks. Bank of Albania has been considerably active in the money markets by using both short-term and long-term instruments in order to maintain the monetary conditions equilibriums. In July, Bank of Albania changed the direction of monetary operations, with the purpose of meeting the short-term needs of the system for liquidity, by performing reverse repurchase agreements. Simultaneously, the

financing of the budget deficit by the Bank of Albania through short-term direct credits to the economy prevented the volatility of Treasury bills interest rates and it limited their increase as well. These factors led to the non-observance of the objective concerning the net domestic assets during the third quarter.

The average quantity of the injected liquidity into the system during the third quarter fluctuated to the level of ALL 1.5 billion. The continuous liquidity shortfall in the system and the growing tendency of the Treasury bills interest rates of all maturities, conditioned the intervention of the Bank of Albania through its long-term instruments. In the second half of September (at the end of the quarter), the Bank of Albania injected ALL 3.5 billion by means of outright purchase Treasury bills having commercial banks as partners.

The absence of Lek appreciation pressures during the summertime brought the need of reconsidering the forecasted position of the Bank of Albania in the foreign exchange market. The purchases in the foreign exchange market, which generally characterize the end of summertime, have been considerably limited over this year. The purchases of the Bank of Albania in the foreign exchange market have increased the money supply in Lek to the extent of ALL 3 billion, and have partly improved the system liquidity. Under these conditions, the liquidity situation turned quietened and the pressures of increasing the Treasury bills interests were lessened. Currently, the quantity of the injected liquidity through reverse repurchase agreements is ALL 1 billion.

Under the conditions of minimising the pressures against the bills interest rates and the risk the lack of liquidity in the system may cause, the performance of some monetary indicators has resulted beyond the projections

of the monetary program. Net domestic assets indicator (NDA) of the Bank of Albania has exceeded the objective level of ALL 59 billion, by about ALL 15.2 billion, while the level of net international reserves (NIR) at the end of September was USD 51.1 million below the objective level of the Bank of Albania. However, the forecasting excess of both indicators in total (with opposite directions) eases the potential influences on other macroeconomic indicators, in particular on inflation.

	December '04	March '05	June '05	July '05	August '05	September '05*
Net International Reserves (in millions of USD)						
Objective	942	1,073	1,087	1117	1148	1,178.7
Current	1,105	1,107	1,098	1105	1103	1127.5
Difference	163	35	11	-12	-45	-51.1
Net Domestic Assets (in billions of ALL)						
Objective	79	61	60	60	59	59.0
Current	61	53	64	65	66	74.1
Difference	-18	-8	4	5	7	15.2
Net Domestic Credit to the Government (in billions of ALL)						
Objective	286	292	298	299	301.0	
Current	285	288	294	298	299.2	
Difference	-1	-4	-4	-1	-1.8	

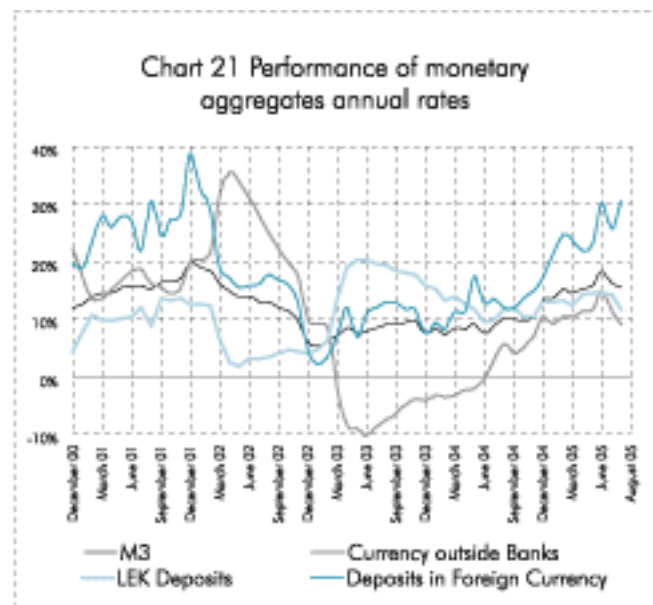
* Operative data

Table 15 Meeting the quantitative objectives by the Bank of Albania

III.2 PERFORMANCE OF MONETARY AGGREGATES

The third quarter was characterized by a significant slowdown of money supply growth rates compared to the rapid growth of money supply in the first half of the year. Annual growth rate of M3 aggregate fell to 15.4 per cent in August, compared to 18.3 per cent recorded at the end of June. The slowdown of the money supply pace was mainly reflected in its Lek component, M2 aggregate, whose demand reduced as a result of the fall of Lek deposits interest rates. On the other hand, the highest effect of Lek annual appreciation had a negative impact on the increase of foreign deposits, which, though at quite high levels, were in fact below their actual increase. Under the influence of low Lek interest rates and affected by the growth of seasonal inflows from remittances, the foreign currency structure of money supply shifted to foreign deposits, while the time structure has resulted as a relatively stable one.

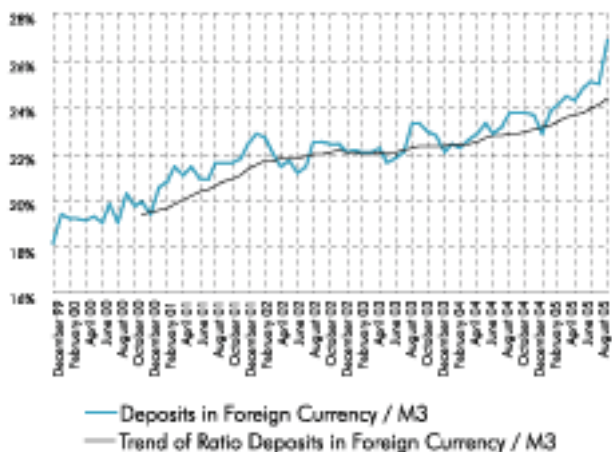
The monetary indicators with the most accelerated growth during July – August were foreign deposits, recording a growth of ALL 14.1 billion or 10.4 per cent. Their annual growth by 30.5 per cent in August represents the highest annual growth level of this indicator in the last three years. The annual effect of the exchange rate appreciation has weakened the growing tendency of foreign deposits annual rates.



Estimated in fixed exchange rates, the real annual growth of foreign deposits in August was about 33.6 per cent, in comparison to 29.0 per cent in June.

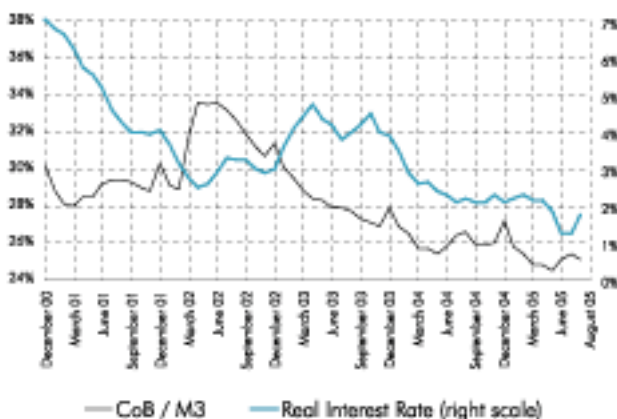
The growth of foreign deposits during July – August was mainly underpinned by the high growth of time deposits, which have represented about 71 per cent of total foreign deposits growth. Apart from the strengthening of foreign currency flows during the summertime, the positive performance of foreign deposits was also favoured by the reduction of Lek – foreign currency interest rates spread, which increased their attractiveness in relation to the savings instruments in Lek. The most accelerated growth of foreign deposits compared to other monetary indicators was reflected in the growth of their share in money supply. At the end of August, the ratio of foreign deposits to M3 aggregate reached its historical maximal level of 26.8 per cent, recording an increase of 1.7 percentage points compared to the level recorded in June.

Chart 22 The ratio performance of currency deposits to M3



Lek deposits contributed negatively to the growth of money supply during the period of July – August, recording a fall of ALL 1 billion or 0.4 per cent. The annual growth rate of Lek deposits also experienced a significant fall, decreasing to 11.5 per cent, compared to 14.7 per cent in June. This performance has reflected the considerable decrease of Lek household deposits by ALL 1.5 billion, while Lek deposits of other sectors have showed a normal performance. The withdrawal of Lek deposits by households has resulted as a consequence of a sudden decrease of interest rates by a number of banks in the system. The flow of deposits withdrawn by the banking system is estimated to have partly shifted towards investments in Treasury bills¹⁰ and the rest in foreign currency deposits.

Chart 23 Ratio of CoB to M3 and average real interest rate (right scale)



The structure of Lek deposits with regard to terms has had a significant growth as to the share of demand deposits. During July – August Lek demand deposits marked an increase of ALL 19.0 billion, compared to the decrease of ALL 20.0 billion of Lek time deposits. This increase has come as a result of changes in the classification of Lek deposits by Raiffeisen Bank¹¹. The growth of Lek demand deposits was reflected in the considerable growth of M1 aggregate. Annual growth rate of this indicator for the period July – August experienced an increase from 25.8 per cent to 30.1 per cent.

The fall of Lek deposits interest rates has not exerted a significant influence over the liquidity

equilibrium of money supply. The growth of currency outside banks by ALL 4.7 billion (3.4 per cent) for the period July – August, resulted in conformity with the seasonal performance of this indicator, as a response to the growing needs of the economy for liquid monetary assets. After its considerable growth in June, the annual growing rate of currency outside banks turned to the normal levels, decreasing to 9.0 per cent in August.

The ratio of currency outside banks to M3 in August resulted to be 25.1 per cent, marking an increase of 0.6 percentage points from the beginning of the seasonal effect at the end of May. It represents a slighter increase compared to the growth of this ratio in the same period over the previous years. It demonstrates the same continuous paces of the return of currency into the banking system, despite the low interest rates.

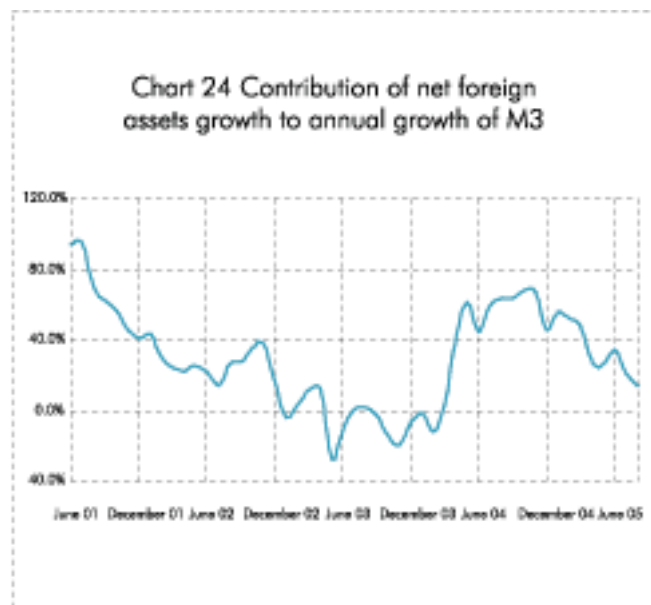
	August	2-month change		Annual change	
	2005	Absolute	Percentage	Absolute	Percentage
Currency outside banks	140.5	4.7	3.4	11.6	9.0
Total deposits	419.1	13.1	3.2	62.9	17.7
- in Lek	269.0	-1.0	-0.4	27.8	11.5
- in foreign currency	150.1	14.1	10.4	35.1	30.5
Demand deposits	113.5	23.0	25.4	42.7	60.3
- in Lek	59.9	18.9	46.0	34.8	138.7
- in foreign currency	53.6	4.1	8.3	7.9	17.3
Time deposits	305.7	-10.0	-3.1	20.2	7.1
- in Lek	209.1	-20.0	-8.7	-7.0	-3.2
- in foreign currency	96.5	10.0	11.6	27.2	39.3
M1	200.4	23.5	13.3	46.4	30.1
M2	409.5	3.7	0.9	39.4	10.6
M3	559.6	17.8	3.3	74.5	15.4
Monetary base	183.9	3.4	1.9	13.5	7.9

Table 16 Performance of monetary indicators in July-August (in billions of ALL)

III.3 DOMESTIC DEMAND

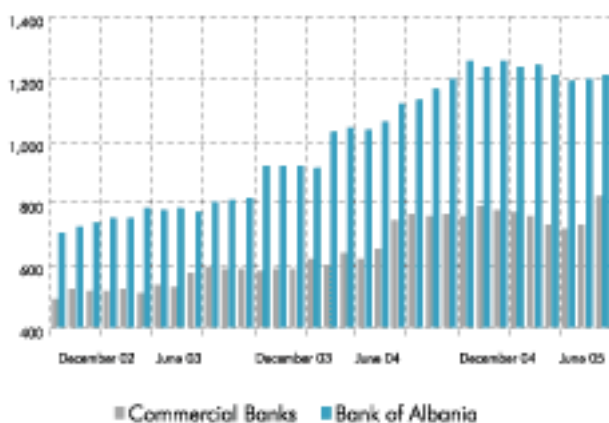
III.3.1 Net foreign assets

The performance of net foreign assets in the banking system during August has been satisfactory, with a growth of USD 112.7 million compared to the month of June. Excluding the exchange rate effect¹², the increase of these assets is USD 106.1 million. This period has been characterized by the lowest contribution of these assets to the annual growth of money supply from the beginning of the year, reaching 14 per cent in August. The decrease of this contribution is partly explained by the fall of annual growth rate of net foreign assets in Lek. The largest part of contribution to the annual growth of money supply has been given by the annual growth of net domestic assets during the third quarter.



Generally, the period July – August was characterized by a growth in foreign currency deposits; nevertheless, this year knew higher growth rates compared to the previous year. This performance of foreign currency deposits, influenced by foreign currency inflows, as well as by the fall of Lek interest

Chart 25 Level of net foreign assets of the banking system



rates, has created spaces for the growth of net foreign assets of commercial banks. Moreover, the decrease of foreign currency liabilities during this period influenced the net foreign assets to a larger extent. The growth of net foreign assets of commercial banks over the period is estimated at about USD 98.1 million. Calculated as a fixed rate, the growth of these assets is USD 97.1 million.

The growth of net foreign reserve of the Bank of Albania over the period July –August resulted to be USD 14.6 million. This is a result of the disbursement increase of foreign credits (IMF, IDA). Calculated as a fixed rate¹³, the net foreign reserve of the Bank of Albania has grown by USD 9.1 million.

III.3.2 Government demand for money

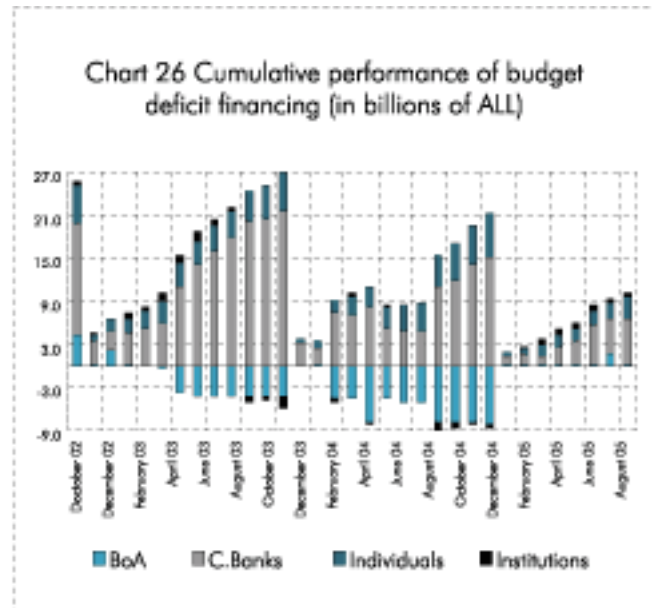
The budget deficit for the period July-August marked a considerable growth estimated at ALL 13.5 billion. Over this period, the deficit grew by ALL 6.7 billion, nearly ALL 2.2 billion more than the deficit increase during the same period in the previous year.

Overcoming the fiscal deficit was enabled through the new borrowing of about ALL 4.4 billion and the use of the government's deposit funds by ALL 2.3 billion. The Bank of Albania has financed the budget deficit by ALL 2.0 billion, in order to avoid the interest rate fluctuations in both the interbank and Treasury bills market. This financing was in the form short-term direct credit. The rest of the domestic financing has been provided by the issuance of two-year and three-year government bonds. This issuance during the period July – August was ALL 5 billion in two-year bonds and about ALL 2 billion in three-year bonds.

The growth of domestic borrowing by ALL 9 billion has compensated the decrease by ALL 4.6 billion of the Treasury bills level, purchased in the primary market. The Treasury bills portfolio of commercial banks has decreased by ALL 4.1 billion during July – August. A decrease of ALL 0.3 billion has also been noticed in the institutions' portfolio. On the other hand, individuals have increased their Treasury bills portfolio by ALL 0.9 billion. The Bank of Albania has not experienced movements in its portfolio over July-August, but has grown it by ALL 3.5 billion over September, as a result of operations in the secondary market.

III.3.3 Credit to the economy by the banking system

Year 2005 has been characterized by positive developments in crediting to the economy. The credit balance has grown by ALL 31 billion until the month of August; a growth of about 60 per cent higher than the growth of credit balance throughout 2004. The vigorous crediting activity has brought the growth of the share that the crediting to economy holds against M3, reaching the value of 18 per cent at the end of August. Moreover, the ratio of credit to GDP estimated at 11.8 per cent has recorded an evident growth, being reflected in the progress of all indicators related to crediting.

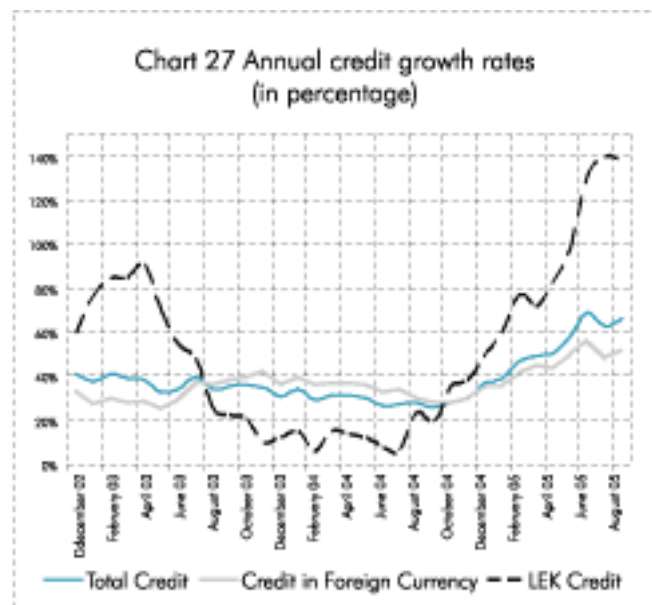


	2002	2003	2004	2005			
				Q1	Q2	July	August
Money supply (in billions of ALL)	416.7	448.4	507.2	521.6	541.8	545.3	559.6
Domestic credit (in % to M3)	70.8	71.5	68.9	68.3	69.9	70.4	69.2
Credit to government (in % to M3)	61.5	60.2	55.1	53.4	52.2	52.4	51.1
Credit to economy (in % to M3)	9.3	11.3	13.8	15.2	17.7	17.9	18.0
Credit to economy (% to total assets)	11.5	13.7	16.9	17.7	20.8	21.1	21.5
Credit to economy (% to GDP)	5.7	6.8	9.0	10.0	11.2	11.4	11.8
Total deposits (% to GDP)	42.2	43.4	47.2	48.6	47.4	47.5	48.9
Credit/deposits ratio (in %)	13.5	15.7	19.0	20.3	23.6	24	24.1

Table 17 Performance of some main credit indicators

The growth of credit balance over July-August is about ALL 5 billion, reflecting a decrease of credit growth rates, compared to the first half of 2005. This decrease has come partly as a result of seasonal factors and partly as a result of an unusual credit growth in June. In particular, the slowdown of credit balance growth is the outcome of the temporary growth that the short-term credit experienced during June. This fact is also based on the level of the new credit extended during these months, which has almost been at the same levels as the previous periods of the year. Moreover, the appreciation of Lek against Euro and US dollar has resulted in the decrease of foreign credit value by ALL 0.8 billion, so further decreasing the growth pace¹⁴.

Credit in Lek recorded an annual growth of 135 per cent at the end of August. Credit in Lek is experiencing a relatively better growth compared to the previous years, reflecting a more considerable commitment of banks to crediting in the domestic currency. Nonetheless, the monthly growths of such credit have known a significant fall compared to the second quarter.



The high growth rates of crediting in Lek have also resulted in the growth of its share in total credit. Credit to individuals continues to reflect the same growth rates as in the first quarters of 2005. This form of credit gets the main impulse by Lek credit to individuals; its annual growth rate is about 3 times higher than in the previous year.

Table 18 Credit balance indicators to the total (in percentage)

	2002	2003	2004		2005			
			Q3	Q4	Q1	Q2	July	August
Credit balance (in billions of ALL)	38.7	50.7	61.0	70.0	79.9	95.9	97.7	100.97
Short-term credit	53.8	46.0	33.9	34.0	34.1	33.7	34.4	32.8
Mid-term credit	30.1	33.3	37.2	36.0	34.5	33.1	31.6	31.7
Long-term credit	16.1	20.7	28.9	30.0	31.4	33.1	33.8	35.1
Credit to individuals	18.3	24.5	30.8	30.6	31.0	30.8	31.4	32.4
Credit to the private sector	81.7	75.5	69.2	69.4	69.0	69.2	68.6	68.0
ALL	21.3	19.6	17	20.0	20.0	22.9	23.2	23.4
Foreign currency	73.7	80.4	83	80.0	80.0	77.1	76.8	76.6

During the months of July and August there was granted a total of about ALL 20.7 billion of new credit. In monthly terms, the new credit is almost at the same level as in the other months of the year and about 70 per cent more than in the same period of the previous year. Around 50 per cent of the new credit granted during the month was short-term credit. 29 per cent of this form of credit was granted in Lek. Credit to individuals represents only 25 per cent of the total granted credit. Compared to the previous quarter, the same structure of granted credit has been maintained, with regard to both currency and maturity term.

Table 19 New credit indicators to the total (in percentage)

	2002	2003	2004		2005			
			Jan-Aug	Jan-Dec	Q-1	Q2	Aug	Jan-Aug
New credit (in billions of ALL)	62.6	92.6	68.6	99.7	21.8	32.8	10.6	73.4
Short-term credit	44.7	63.1	64.7	62.5	54.1	47.1	49.0	49.3
Mid-term credit	13	22.2	22.0	22.5	21.2	31.0	33.9	29.2
Long-term credit	4.8	7.4	13.3	14.9	24.7	21.9	17.1	21.5
ALL	20.8	30.8	31.3	32.6	30.4	32.8	26.0	30.9
Foreign currency	41.8	61.8	68.7	67.4	69.6	67.2	74.0	69.1

The months of July and August have not marked changes in the share of credit by sectors, compared to the two previous quarters. At the end of August, the trade sector continued to represent the major part of credit allocation, recording 19 per cent of the total. Meanwhile, the processing industry sector has reflected a decrease of its positions.

Table 20 Performance of credit balance indicators by sectors (in percentage to the total)

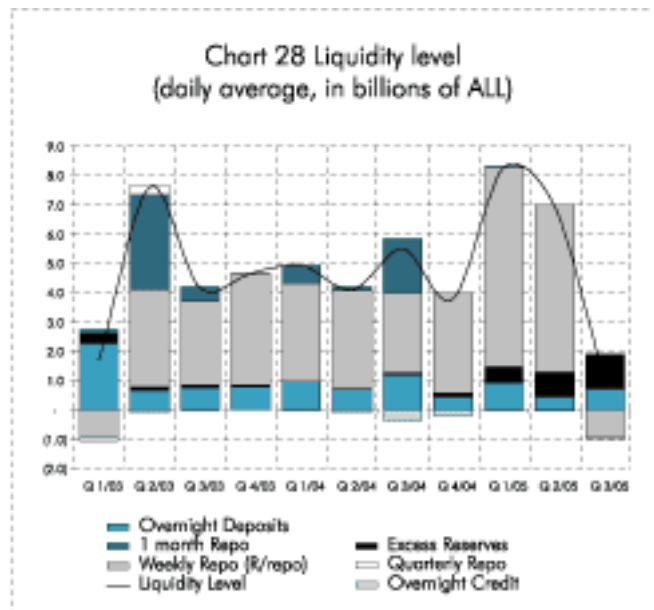
	2002	2003	2004		2005			
			T1	T2	July	August		
Agriculture, hunting and silviculture	0.8	1	1.5	1.5	1.5	1.5	1.4	
Processing industry	17	17	17.1	16.7	15.6	15.1	15.1	
Construction	8.6	10	9.8	11.2	11.2	11.2	11.0	
Trade, repairing of vehicles and household appliances	40.4	34	23.3	20.6	19.1	19.1	19.0	
Hotels and restaurants	6	6	8.3	5.2	4.7	4.7	4.4	
Real estate	9.1	13	9.8	14.7	13.5	13.4	13.0	
Other	18.1	19	30.2	30.1	34.3	35.1	36.1	
Total	100	100	100	100	100	100	100	

III.4 FINANCIAL MARKETS, INTEREST AND EXCHANGE RATES

III.4.1 Performance of liquidity

The growth of domestic credit, accompanied by the slowdown of bank deposits flow over the third quarter of the year, was reflected in the decrease of excess liquidity level in the banking system, in a few cases, recording negative values. On average, the daily liquidity level in this period resulted to be ALL 1.07 billion, while in the previous quarter the banking system calculated at an average ALL 7.05 billion of excess liquidity per day. In the previous year, this indicator recorded the value of ALL 5.49 billion or ALL 4.43 billion more than in the third quarter of this year.

The beginning of July resumed with the weekly organization of repo auctions for the liquidity withdrawal. In the sequel, in order to supply the liquidity needs, were mainly organized auctions of reverse repurchase agreements with weekly maturity, for the average value of ALL 1.44 billion. Apart from them, with the purpose of injecting liquidity permanently and regulating its structure in the market, were organized transactions for outright purchases of government securities. These operations, as well as the growth of Lek deposits during September¹⁵ have influenced the improvement of liquidity situation, and the beginning of October has marked positive values with regard to this indicator.



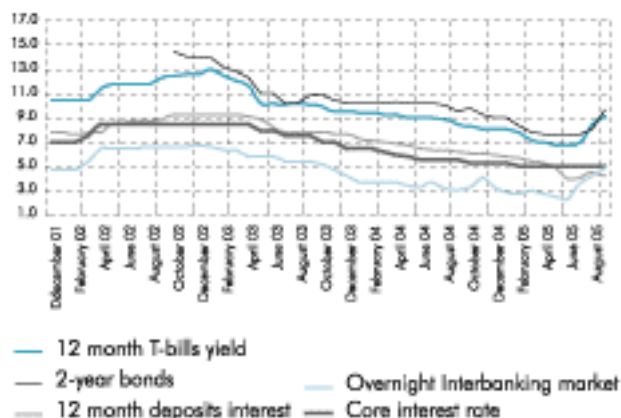
The average level of overnight deposit in the third quarter has amounted to ALL 0.72 billion or ALL 0.26 billion more than in the previous quarter and ALL 0.48 billion less than in the previous year. Overnight credit has been rarely used (by an average of ALL 0.04 billion) and daily needs for liquidity have been mainly met in the interbank market.

The daily average volume of total crediting in the interbank market, in the third quarter has resulted to be ALL 1.56 billion, from ALL 1.35 billion in the previous quarter and ALL 0.55 billion in the previous year. The average volume of crediting between banks stands over the average level of liquidity for the period, thus being an indicator of its non-symmetrical distribution. Crediting has been mainly in the form of overnight and weekly transactions. The average volume of overnight transactions has grown to ALL 0.84 billion from ALL 0.75 billion in the previous quarter and ALL 0.39 billion in the previous year.

III.4.2 Interest rate performance

During the third quarter of 2005, the monetary policy applied by the Bank of Albania has been neutral. The core interest rate has remained at the lowest

Chart 29 Core interest rate and interest performance in the markets (in percentage)



historical levels. Nonetheless, during this period, there were noticed pressures of interest rates increase in the interbank market, primary market, Lek deposits market, bonds market, credit market of less than a year term, etc.

The main factor that has influenced the interest increase in the markets was the change of the liquidity situation of banks. In the Treasury bills primary market it was observed a fall of liquidity offered by banks, which has also resulted in the increase of Treasury bills yield. In a few cases, government demand for the financing with Treasury bills has remained unaccomplished.

In the interbank market, overnight borrowing interests increased, following almost 4 years of their continuous decrease. The growth of liquidity demand in the market and the interest increase of overnight deposits by the Bank of Albania¹⁶ have influenced, inter alia, this increase. In contrast, the interests of weekly borrowings showed a downward trend, mainly owed to the interest cut of overnight credit by 0.75 percentage points¹⁷. The interests' corridor narrowing of supporting facilities has also caused the tightening of spread between overnight and weekly interests in the interbank market.

Table 21 Interest quarterly change in the markets (in percentage points)

	Sept 2005	Q1	Q2	Q3
Core interest rate	5.00	-0.25	0.00	0.00
Interbank market				
Interbank market overnight interest	4.37	-0.26	-0.74	+2.10
Interbank market weekly interest	4.90	-0.33	-0.24	-0.38
Primary market				
3-month T-bills yield	6.73	-0.85	-0.18	+1.67
6-month T-bills yield	8.64	-0.71	-0.11	+2.25
12-month T-bills yield	9.13	-0.96	-0.35	+2.34
Bonds market				
2-year bonds yield	9.70	-1.15	-0.25	+2.10

In the primary market, it was noticed an increase of Treasury bills yield, in all terms, where the largest increase was experienced in the 12- month terms. The increase of Treasury bills yield was a result of the reduction of banks' demand in the primary market¹⁸ and of the increase of government borrowing in this market. Considering that this volatility encourages the insecurity in the money market and the cost of government debt, the Bank of Albania has aimed at lessening the upward pressures through the injection of liquidity into the banking system by means of reverse repo¹⁹ auctions. Moreover, it has provided direct credit to the government by reducing the speculating operations in the market.

In the Lek deposits and credit²⁰ market there was an increase of deposit interest in all terms and an increase of credit interest for terms up to one year.

	August 2005	Q1 2005	Q2 2005	Q3* August '05-June '05
USD deposits				
1 - month	1.83	0.22	0.04	0.09
3 - month	2.13	0.26	0.09	0.09
6 - month	2.31	0.22	0.13	0.08
12 - month	2.79	0.22	0.13	0.17
24 - month	3.15	0.37	0.14	-0.01
Euro deposits				
1-month deposits	1.67	0.02	-0.01	0.01
3-month deposits	1.82	0.00	-0.01	0.08
6-month deposits	1.83	0.04	0.07	-0.06
12-month deposits	1.91	-0.07	0.31	-0.30

Table 22 Interest quarterly change (in percentage points)

The increase of deposit interests is expected to encourage depositors to put their savings in the banks, which would as a consequence bring about the deposits growth. According to operative data, the effects of this growth have been present in September.

In August 2005, the real interests of 12- month Lek time deposits reached 2.07 per cent, compared to 0.96 per cent at the end of the second quarter and 3.53 per cent in the previous year, influenced by inflation fluctuations and the change of nominal interests.

At the present, banks have also started to offer the acceptance of deposits up to 3 years. This would enable the investment of depositors' savings in longer terms, and it will provide a closer connection between these deposits' interests and the long-term credit and government bonds interests.

In Lek credit market, the average weighted interests have had an upward trend for credits less than a year and a downward trend for credits over a year²¹. The increase of Treasury bills yield, short-term and long-term expectations for the interest rates performance, the change of crediting structure, scale of risk, etc., have influenced the increase of short-term interests.

In the foreign deposits market, as in the Lek deposits market, it has been noticed an increase of interests in all terms, except for 24-month deposit interests in US dollar and 6- and 12-month deposit interests in Euro.

	August 2005	Q1 2005	Q2 2005	Q3* August '05-June '05
USD deposits				
1 - month	1.83	0.22	0.04	0.09
3 - month	2.13	0.26	0.09	0.09
6 - month	2.31	0.22	0.13	0.08
12 - month	2.79	0.22	0.13	0.17
24 - month	3.15	0.37	0.14	-0.01
Euro deposits				
1-month deposits	1.67	0.02	-0.01	0.01
3-month deposits	1.82	0.00	-0.01	0.08
6-month deposits	1.83	0.04	0.07	-0.06
12-month deposits	1.91	-0.07	0.31	-0.30
24-month deposits	3.06	0.75	-0.33	0.33

Table 23 Interest quarterly change (in percentage points)

What has influenced here was the increase of core interest rate for more than once by the Fed, within the third quarter; the increase of LIBOR and

Chart 30 Performance of average weighted deposit interest in foreign currency

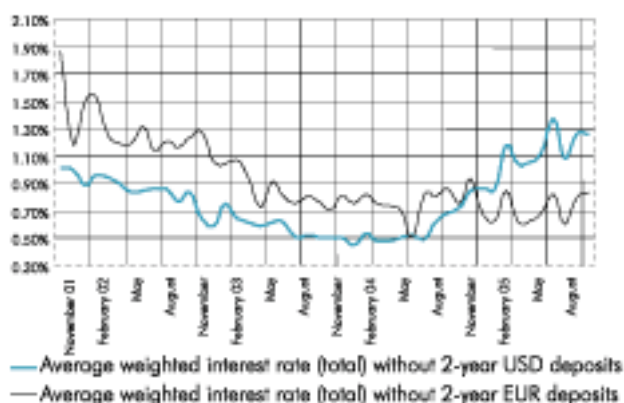


Chart 31 Performance of average weighted credit interests in foreign currency

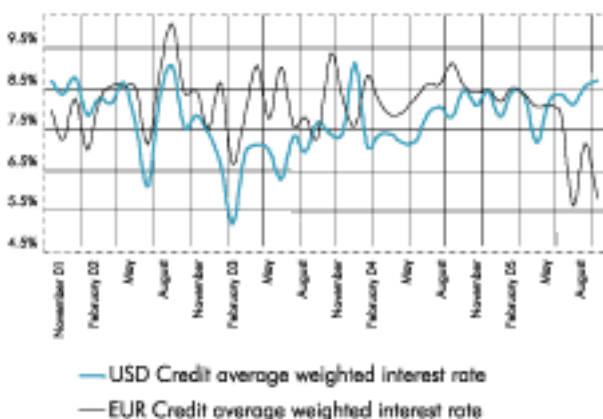


Table 24 Quarterly annual change average²² of Lek exchange rate

	Q3'2003	Q3'2004	Q3'2005
LEK/ USD	-13.10	-15.12	-1.56
LEK/ EUR	-0.79	-7.72	-1.75

Until mid-August, Lek has continued to present the same appreciation rates against the Euro, noticed since the beginning of the year. After this period, Lek was positioned in the depreciating direction. With regard to the US dollar, though there have been fluctuations, the Lek's depreciating trends, which continued over September, were outstanding. The higher demand for tourism outside Albania seems to have favoured the growing demand for foreign currency. Moreover, the pre- and post-election situation appears to have influenced on the public behaviour and its decisions for keeping foreign currency.

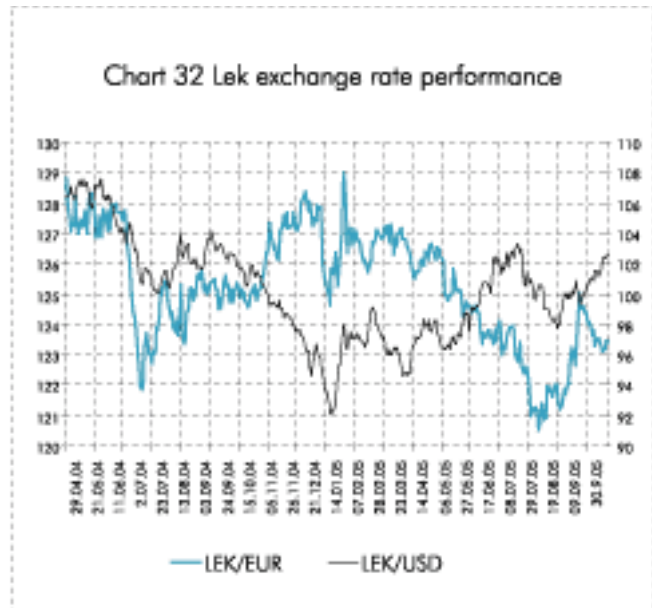
EURIBOR interests in the international markets, the increase of competitiveness in the markets, etc.

The foreign currency credit market has been characterized by the fluctuations of interest from one quarter to another. In August 2005, the average weighted interests of USD credits reached 8.71 per cent compared to 8.1 per cent at the end of the second quarter and the interests of euro credits reached 5.8 per cent compared to 5.63 per cent at the end of the second quarter. However, considering them separately, according to terms, in the USD and EUR credit market there were noticed cases of increase and decrease of these interests as a result of the policy applied by banks, the scale of risk according to the kind of credit, the change of creditors' share, competitiveness, etc.

III.4.3 Exchange rate

The beginning of the third quarter of 2005 presented Lek's appreciation trends and then continued with its depreciation against the main currencies. On average, during the quarter, Lek appreciated by 1.5 per cent against the US dollar and 1.7 per cent against the Euro, on an annual basis. The seasonal effect of summertime has not been considerably evident this year, resulting in a decrease of the Lek appreciation rates, in particular compared to last two years. Bringing the seasonal pressures under control mainly owes to the reduction of Lek - foreign currency interest rates difference.

On the other hand, the continuous tightening of the difference of Lek and foreign currency interest rates does not anymore constitute a sustainer to Lek appreciation, which has resulted in the growth of foreign deposits over the quarter. At the end of September the levels of Lek exchange rate marked 123.41 Lek/EUR and 102.6 Lek/USD.



NOTES

¹ Agriculture sector includes branches of agriculture, agroindustry and fishery. Agriculture branch includes subbranches of agriculture and animal farming.

² Unlike the first two sectors, on which data can be considered within statistical standards, for the third sector the figure should be taken with reserves. It does not express the moves that may happen during the quarters of the year (in fact the value remains unchanged throughout the year) being utilizable only at yearend, where results of Survey of Standard Living Measurement, on which it relies, are announced.

³ Annual inflation of this group increased from 3.3 per cent in September 2004 to 6 per cent in September of this year.

⁴ Annual inflation of this subgroup for July and August 2005 is respectively 8.8 and 10.3 per cent.

⁵ "Communication", "Hotels, cafés and restaurants", "Clothing and footwear", etc.

⁶ Index of Sales for all the economy recorded during the second quarter an annual growth of 21.6 per cent.

⁷ The price index of extracting industry grew by 4.8 per cent, the processing industry by 3.7 per cent, and the production, distribution of electricity, gas and water by 7.4 per cent.

⁸ Subgroup "Services to personal vehicles", where oil price has a share of 1.6 per cent in the CPI basket.

⁹ The rise of salaries followed the decision of the Council of Ministers for the salary increase in a few sectors of health and education.

¹⁰ The Treasury bills individual portfolio in July – August grew by about ALL 1 billion or twice as high as its growth over the same period in the previous year.

¹¹ The policy of non-extending the Lek time deposits of individual clients of Raiffeisen Bank at the end of the maturity term caused their re-classification as demand deposits. The influence of this re-classification for the months of July and August was about ALL 18.2 billion.

¹² Net foreign assets of the fixed EUR/USD exchange rate system.

¹³ The difference is an outcome of the appreciation of Euro against US dollar by 1.4 per cent for the period July – August, which implies a higher value of investments in Euro expressed in USD.

¹⁴ During the previous quarter, the depreciation of Lek against the USD influenced the growth of credit balance by about ALL 0.8 billion.

¹⁵ Operative data.

¹⁶ In July 2005, the Bank of Albania decided the overnight deposit interest to be 1.75 percentage points below the core interest rate, thus, causing the interest increase by 1.25 percentage points.

¹⁷ In July 2005, the Bank of Albania decided the overnight credit interest to be 1.75 per cent above the core interest rate.

¹⁸ During the third quarter, the government demand for liquidity in the primary market was met to the extent of 97 per cent compared to 131 per cent in the previous quarter.

¹⁹ The Bank of Albania used both kinds of repos (fixed and multi-rate) depending on the situation.

²⁰ See Q3* August '05-June '05 in the table.

²¹ See Q3* August '05-June '05 in the table.

²² Minus indicates the Lek appreciation against foreign currency.