

BANK OF ALBANIA

QUARTERLY REVIEW  
OF THE ALBANIAN  
ECONOMY OVER THE  
THIRD QUARTER OF 2007

SEPTEMBER 2007



## QUARTERLY REVIEW OF THE ALBANIAN ECONOMY OVER THE THIRD QUARTER OF 2007

### GOVERNOR'S SPEECH

The Albanian economy marked positive annual growth rates during the nine-month period of 2007, while consumer prices inflation was quite low for most of the period. Economic growth during the present year is expected to be around 6 per cent. Despite the upward trend, average annual inflation during January – September was 2.7 per cent, being quite close to the Bank of Albania target of 3 per cent. The growth of demand has been assessed to have been more rapid than the growth of supply. The consumption of companies and households continues to represent the most significant and dynamic part of aggregate demand. The contribution of the public sector has made a positive contribution to the growth of demand, though it was not in the projected levels. The external sector was characterized by current and trade deficit deepening, accounting for 10 and 27 per cent of the GDP respectively, for the first six months of 2007.

During January-September 2007, supply in the Albanian economy was put under the influence of some internal and external factors, which have decisively determined the movements in the overall level of consumer and production prices. Both the second and third quarter of the year were characterized by a dry and unfavourable weather for agricultural production, which has caused the reduction of supply of agricultural products, mainly in summer. The price rise of grains in the international markets began to affect the domestic market in July. The shortages in the supply with energy have been present throughout the nine-month period. The weather conditions, the problems related to the energy infrastructure, the shortages in the supply of energy by the partner countries and the price rise have caused both the domestic production and the import of energy to face hard times. The energy crisis has been more intensive during the third quarter. The expenses for the provision of alternative sources of energy are assessed to have exerted pressures on the cost of production and on the trade of goods and services.

Factors such as the growth of demand for some basic exports, the favourable monetary conditions and the price rise of real estates, which contribute to the increase of companies and individuals' wealth enhancing the opportunities for borrowing and investments, continued to contribute to the constant growth of demand. Credit to economy, which is the most direct indicator for the performance of demand, continued to grow rapidly during 2007. Credit to business grew by over 50 per cent in August, accounting for 16 per cent of the GDP. Although credit to households shares a smaller part in the total portfolio, it continued to grow annually by about 70 per cent. Exports were

evidenced to have grown significantly by about 28 per cent during January – August 2007. Trade deficit deepening by 4 percentage points as a share to GDP does not only reflect the increase of consumption but also the growth of investments. Both capital and intermediate goods imports have grown by about 30 per cent during the first semester. Foreign direct investments have also represented a great help for the economic activity.

The reliance of business on a better financial basis, through the banking system or on their personal resources, has been reflected in the growth of production in some of the most important sectors of the economy, such as industry and trade. For the fourth consecutive quarter, industrial production marked high annual growth rates and grew by about 20 per cent annually. At the same time, trade activity has maintained the high rates of the previous years, increasing by about 14 per cent during the first half of 2007. The contribution of the growth of construction sales to the total growth of economic enterprises' sales was almost insignificant during the first six months of 2007.

The Bank of Albania decided to increase the key interest rate twice until the end of September. The rapid growth rates of credit and the expectations for the ongoing growth after the first semester increased the concerns for the achievement of price stability objective in the future. In response to the increasing demand-side pressures, at the end of June the Supervisory Council of the Bank of Albania raised the key interest rate applied on the repurchase agreements by 25 basis points to 5.75 per cent. This raise aimed at controlling or relaxing the inflationary pressures generated by the rapid growth of demand through the increase of the cost of money in economy.

At the end of the third quarter 2007, the medium-term stability of consumer prices was jeopardized by the ever-increasing demand and by the production cost-related factors, whose duration was and still remains undefined. Under these conditions, the Bank of Albania stepped further in terms of tightening the monetary policy and raised the repurchase agreement rate by 25 points basis to 6 per cent at the end of September. By means of this raise, the Bank of Albania showed to the market its willingness to make the inflationary expectations stable in the medium term, in line with its inflation target of 3 per cent. The keeping of the balance between domestic demand for money and price stability is a condition for maintaining stable economic growth rates.

For the rest of the year, the Bank of Albania believes that the identified supply-side issues will remain present in the Albanian economy, and they will constantly exert pressure on the level of prices. It seems that there are few chances for the energy situation to have a quick and final solution in the medium term. Oil, grain and other foodstuffs' prices in the international markets may continue to rise or fluctuate, bringing destabilizing pressures on the domestic prices.

The Bank of Albania deems that time is ripe to set the domestic agricultural production, which nowadays is of prime importance, at the top of the structural reforms agenda. The establishment of an efficient collection and distribution

structure would be the starting point. Meanwhile, agricultural infrastructure, rural roads and the grain areas in particular remain very important issues.

The Bank of Albania believes that there is still room for further liberalization of the production market and the import of goods and raw materials, in order to enable a greater competition between the operators in these markets.

Beside the supply-side issues, the Bank of Albania believes that domestic demand will continue to grow in the future. In this context, beside the inflationary pressures-related concerns, the Bank of Albania is entirely committed in monitoring effectively the performance of lending in the country. The Supervisory Council of the Bank of Albania states that the loans' portfolio quality remains a priority. Financial stability represents another key objective of this institution. Consistently, the harmonization of monetary policy and banking supervision rules was and still remains our main focus.

The Bank of Albania is very close to the finalization of Credit Registry, whose main purpose is to help in carrying out sound lending transactions, by making available all the information that banks have on borrowers, pushing further the lending process. Moreover, the Credit Registry will help to reduce informality in economy and to increase the volume of loans; consequently reduce the cost and time of the lending process. Ultimately, it will affect the country's economic growth.

By making an overall assessment of the balance of risks which put consumer price stability at risk, it is to be emphasized that there is an increasing probability which requires the Bank of Albania to be very cautious.

The Bank of Albania considers the constant communication with the public as crucial. Continuous explanation of the balance of risks present in the short and long-term is required in order to make the public at large aware of the inflationary developments in the future. It also aims to anchor the inflationary expectations around the 3 per cent target.

In conclusion, I would like to underline that despite the full commitment of the Bank of Albania to achieve and maintain price stability, the constant coordination of monetary and fiscal policy is the key to success of all macroeconomic policies. All the economic agents and the public at large need to try and understand the motives laying behind the central bank's actions, the scope and the constraints of monetary and fiscal policy, and the fact that not all the objectives may be achieved at the same time. Long-term well-being may require a higher cost for all at present.

## 1 WORLD ECONOMY

World economy continued to have a positive performance during the first half of 2007. Despite the growth rate slowdown, the positive growth rates of developing countries have supported the global growth. The developments

in the Euro area and Japan have been stable while the US economic activity has recorded considerable growth following several months of slow growth. The international financial markets did not genuinely reflect the positive developments of the economic activity. During June-September there have been increasing fluctuations in the financial markets, caused by the aggravation of non-performing loans indicators in the US sub prime lending market<sup>1</sup>. The turbulences in the US financial markets brought about the increase of the risk prime at a global scale and caused the dropping of shares' price and the increase of fluctuations in the long-term Treasury bills yield. The situation was further aggravated by the absence of liquidity in the markets. The US and European central banks took measures by injecting liquidity in the market or by dropping the interest rate of overnight loans. During the last months, consumer prices inflation rate and cost-related inflationary pressures in industrialized countries have been decreasing. However, the oil price rise in September signals the revitalization of worldwide inflationary pressures for the following months.

Table 1 Some main economic indicators in annual terms (in percentage)

	GDP annual growth, Q2	Unemployment rate in August	CPI <sup>2</sup> for September
USA	+1.9	4.6	2.8
Euro area	+2.5	6.9	2.1
Germany	+2.5	6.3	2.7
France	+1.3	8.6	1.6
Italy	+1.8	5.9*	1.7
Greece	+4.1	8.4*	2.9
Japan	+1.7	3.8	0.0**

\* For June.

\*\*For July.

Source: Eurostat; ECB, Report for September; Bureau of Economic Analysis, USA

The growth of economic activity in the Euro area during the first half of 2007 was more modest compared with the previous year, fluctuating around the potential growth rates. There was a slowdown in the industrial production, growth in the services sector and improvement of labour market conditions. Since November 2006, the inflation rate has fluctuated around the target of 2 per cent. Meanwhile, in September inflation marked 2.1 per cent as a result of the energy price rise. The influence of the rise in the oil and foodstuffs prices is expected to continue to exert inflationary pressures in the following months, increasing the chances for the inflation to go beyond the targeted level.

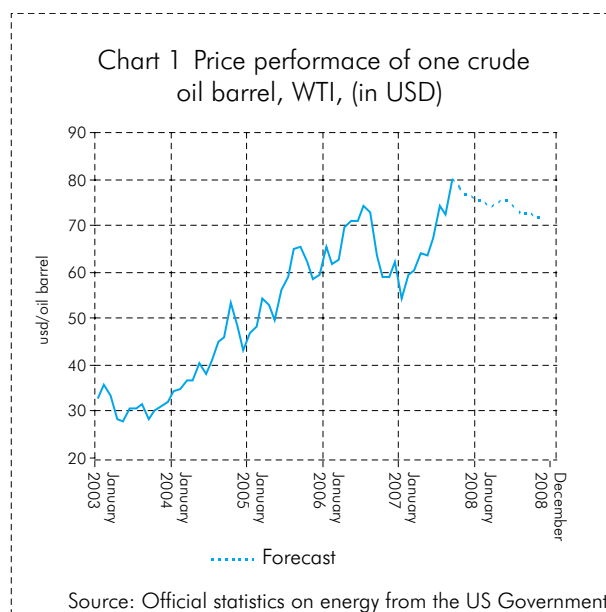
Following several months of growth under the potential, the US economy grew by 3.8 per cent in the second quarter of 2007. The growth of net exports, of the inventories and budget spending provided a positive contribution to this growth. Though the housing market continues to affect negatively the economic growth, it did not affect consumption and the other sectors of economy significantly. After the rapid rise of prices during the first months of the year consumer prices inflation moderated during June-August. The price dropping in the oil and its by-products price during this period provided the main contribution to the decrease of inflation. The increasing prices of agricultural products in the international markets also affected the price rise of foodstuffs in the US markets.

The monetary policy pursued by the ECB during 2007 continued to maintain an accommodating character. During January-September 2007, the Governing Council of the ECB raised the key interest rate three times to 4 per cent following the last rise. The US Open Market Federal Committee decided in its last meeting in September to drop the key interest rate by 50 basis points to 4.75 per cent. This decision aimed to prevent the negative effects the turbulences in the financial markets may bring to the economy and at the same time, to promote a moderate growth for the periods to follow. The key interest rate was last changed in June 2006.

### OIL PRICE

The oil price in the international markets was about 55 USD/barrel at the beginning of the year to reach the level of above 80 USD/barrel at the end of September. The price rise during 2007 did not only offset the dropping of the second half of 2006 but also took the oil price to high levels. Behind the constant oil price rise stands the reduction in the supply and the continuous growth of demand, in particular from China and the US. Although the global demand for oil remains high, its growth rate has displayed a downward trend. Apart from the high demand, the tensions and the geopolitical uncertainties in the oil production countries and the beginning of the cold season in the northern hemisphere the depreciation of the US dollar during September also influenced the oil price rise. The depreciation of the US dollar to many other international currencies affected the decrease in the purchasing power of oil producers' income and the increase of the purchasing power of consumers with income in other currencies.

Despite the constant rise, in real terms, the oil price arranged with the exchange rate and inflation is lower than the levels of the previous oil crises. At the same time, many countries are using alternative sources of energy, reducing their dependence on oil. As a consequence the influence of the high oil price on the global economic growth is assessed to remain limited. The oil price projections for 2008 move in a band of values, where the highest value is that of about 100 USD/barrel.



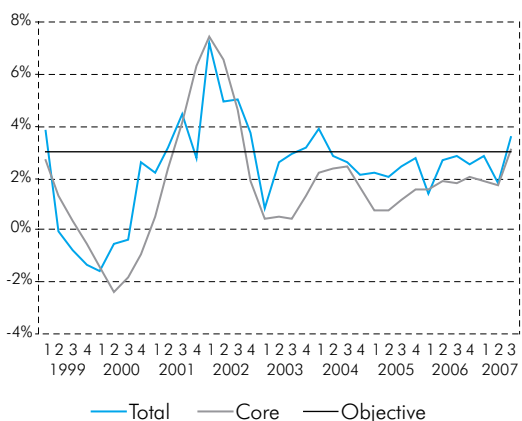
## 2 INFLATION

### 2.1 CONSUMER PRICES

Annual inflation rate was 3.6 per cent in the third quarter of 2007, while the annual core inflation rate marked 3.1 per cent. Annual inflation has been increasing since June this year<sup>3</sup>. The accelerating rise of prices during this period has been a result of the inflationary effect of both supply and demand-

side factors. The growth of demand was not followed by the same growth size of supply which exerted pressures on the level of prices and on the country's gross production.

Chart 2 Total inflation and core inflation (annual changes in percentage)



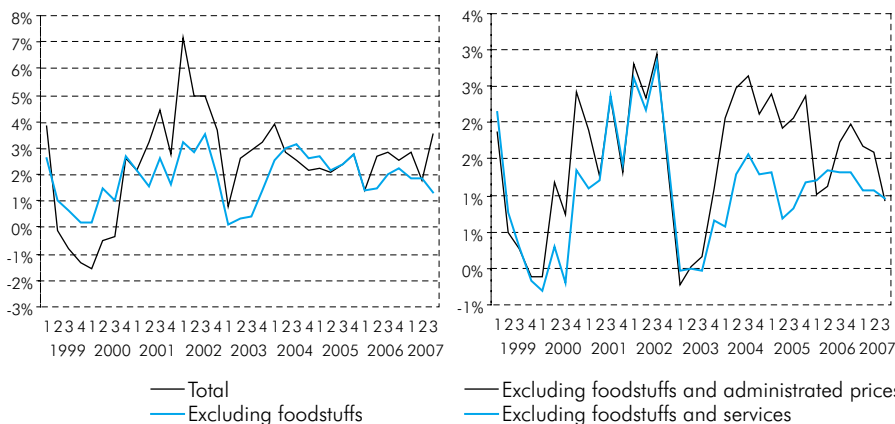
Source: INSTAT and Bank of Albania estimations

The influence of the supply-side factors on the overall level of prices was not uniform during January-September. The rise in the foodstuffs prices, partly affected by the reduction in the domestic agricultural production<sup>4</sup> and the price rise in grains and other foodstuffs in the global market were the main factors to affect the shift in the trend<sup>5</sup> of annual inflation rate. The price rise effect of energy and tobacco excises of the previous year was no longer present in the third quarter of 2007.

The alternative measures of net inflation<sup>6</sup> help to identify the combined or special effects of foodstuffs prices, administered prices and of services prices on the overall level of consumer prices. Net inflation, excluding foodstuffs, marked 1.3 per cent in the third quarter, recording the lowest rate in the last three years. The two other measures of net inflation, one excluding the administered prices and the other services prices, provide evidence for the annual decrease of these indicators during the nine-month period.

“Processed foodstuffs”, “Unprocessed foodstuffs”, “Housing” and “Services” formed about 92 per cent of the annual inflation rate in the third quarter of 2007.

Chart 3 Alternative measures of net inflation: inflation excluding foodstuffs (left-hand side) and inflation excluding foodstuffs and administered prices and excluding foodstuffs and services (right-hand side)

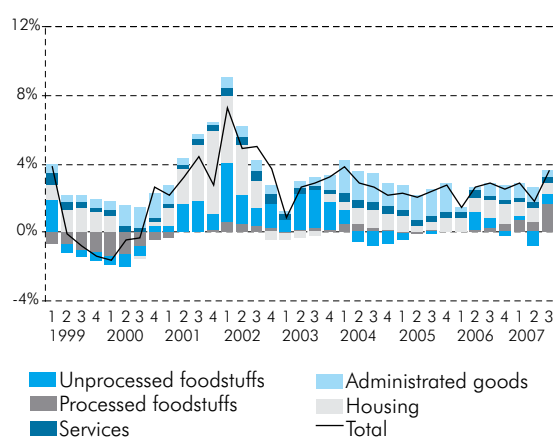


Source: INSTAT and Bank of Albania estimations



“Processed foodstuffs” provided the main contribution to the increase of annual inflation rate in the third quarter. The upward trend of this item’s annual inflation, quite evident starting from mid-2006, continued to be present in the first nine months of 2007. The high annual inflation rates of processed foodstuffs greatly exceed the eight-year historical average of 0.3 per cent for January-September 2007. The third quarter also marked the end of the price rise effect of tobacco<sup>7</sup> and the considerable price rise of bread and grains. The latter provided a contribution of 4.5 per cent to the annual rate of 7.3 per cent of the entire item. While during 1998-2006, bread and grains price index increased 3.4 per cent on average, during the nine-month period of 2007, it increased by about 21 per cent.

Chart 4 Contribution of items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania estimations

Along with the increase of processed foodstuffs inflation, “Unprocessed foodstuffs” inflation also increased by 3.1 per cent. This sub-item of prices is mainly influenced by the performance of domestic production of fruit and vegetables. During January-July ‘07, the price of fruit dropped by 11.7 per cent on an annual average, while during August-September it rose by 13.5 per cent. In annual terms, the price of vegetables rose throughout most of the nine-month period. Under the influence of dry weather conditions, the reduction of domestic agricultural supply and the price rise for these products in Greece and Italy (by 3.3 and 2.6 per cent respectively) exerted pressure for the price rise of these goods in the third quarter of 2007.

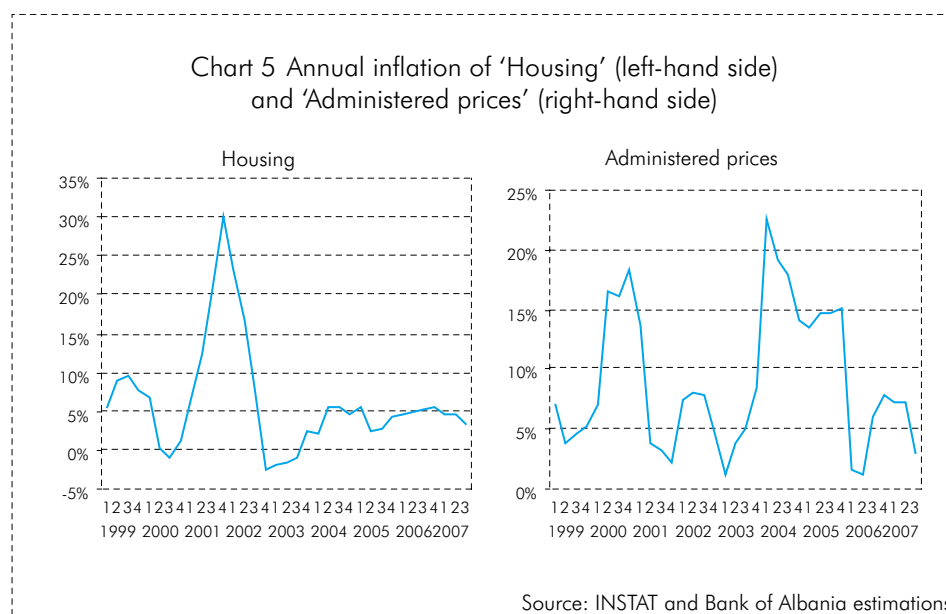
	Q3-06	Q4-06	Q1-07	Q2-07	Q3-07
Processed foodstuffs (pp)	0.3	0.5	0.7	0.6	1.6
Bread and grains* (pp)	0.1	0.1	0.0	0.3	4.5
Alcohol and tobacco* (pp)	1.0	1.6	1.7	1.9	1.3
Unprocessed foodstuffs (pp)	0.6	-0.2	0.2	-0.7	0.6
Fruit* (pp)	1.9	-1.4	-2.4	-3.1	1.1
Vegetables*(pp)	0.7	0.0	3.0	-0.6	1.7
Services (pp)	0.3	0.2	0.2	0.3	0.4
Administered prices (pp)	0.7	0.9	0.8	0.8	0.4
Fuels and energy* (pp)	5.5	7.8	7.6	7.8	2.7
Housing (pp)	1.0	1.1	0.9	0.9	0.6
Consumer Price Index (y/y, %)	2.9	2.6	2.8	1.8	3.6

Source: INSTAT and Bank of Albania estimations

Table 2 Contribution of items to annual inflation (in percentage points)

‘Services’ continued to record positive inflation rates, marking 4.2 per cent in September and getting close to the rates of the early 2005. This item’s inflation was mainly determined by the price rise in services, hotels and restaurants. During the last years, these services’ prices have risen by 2-3 per cent on average, while as of end the third quarter of 2007 this rise reached about 5 per cent. The price rise may have been caused by the cost of using alternative sources of energy and by the growing demand for such services.

Annual inflation of “Housing” fluctuated around the level of 5 per cent during 2006 and the first half of 2007. The stable price rise in annual terms is mainly a result of the growing demand for apartments for rent. Annual inflation of 3.3 per cent, marked in the third quarter, represented a shift from this rate caused by the almost inconsiderable increase of about 0.8 per cent of annual inflation in September<sup>8</sup>.



Administered prices fluctuated around the band of 6-8 per cent for 2006: Q3-2007:Q2. Following the energy price rise by 14 per cent in August 2006, this item’s average contribution to the annual inflation was about 0.8 per cent. The adjournment of the decision on the energy price rise projected for August 2007 caused the last year’s rise effect to be inconsiderable.

*Box: II. 1 On administered prices*

*The concept of administered prices: The statistical manuals define administered prices as products and services’ prices which are deliberately set by a producer or a group of producers and any price fixed or directly or indirectly influenced by the government economic policies, without keeping in consideration the demand and supply fluctuations in the market. ‘Regulated’ prices which are monitored and controlled by certain governmental policies are a specific part of administered prices. A policy of regulated prices causes them to change depending on the strategic objectives of the government. The decisions taken based on these strategies define the prices of different goods and services independently from the market forces.*

*Administered prices in the Albanian CPI basket: The transition process from an entirely centralized to a free market economy was initially followed by deep reforms in the privatization of different sectors of the economy. The first results were evidenced in the process of the establishment of products and services’ prices in these sectors. The continuation and deepening of privatization reforms caused the balance between administered prices and market prices to change considerably in favour of the latter. The assessments indicate that the share of goods and services with administered prices*

fell from 16 per cent in 1993 to about 9 per cent in the current basket (2001). 'Energy and fuels' shares more than half of this category while the rest of goods and prices with administered prices is shared by specific items of 'communication', 'health' and 'water supply'. The common thing of goods and services with administered prices is that they are generated by the economic activity in non-privatized or under privatization process sectors. Their gradual 'disconnection' from the public to the private sector has been followed by the application of pre-notified price rises, which was mostly evidenced in 'energy'. During January 2002 – September 2007 the average annual price rise of energy reached 30 per cent. Consequently, the price rise in energy was reflected in the total inflation rate. It has directly reflected the effect of this item whose share is relatively low in the current basket (4.6 per cent), and the indirect effect transmitted with relatively short time lags, mainly in services.

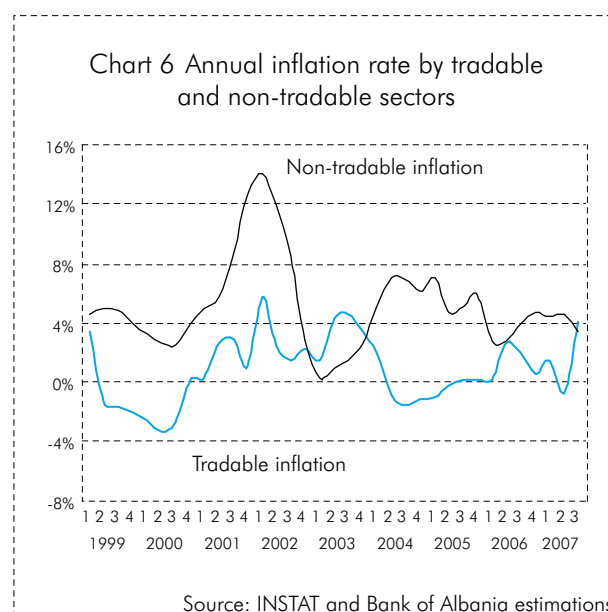
In general, the direct effects of the rise in administered prices to the total inflation rate are removed in a 12-month time period, unless other additional decisions are taken in the mean time. Being a product of administrative decisions the price rise effects cannot condition the monetary policy decision making, although the latter may not evade them completely. The main focus of monetary policy is the analysis of the influence of administrative prices changes on the demand and supply with other goods and services of consumer basket. This second round effect may cause the influence on total inflation to grow bigger, bringing indirect and longer-term implications to monetary policy.

## 2.2 PRICES OF TRADABLE AND NON-TRADABLE GOODS

Annual inflation of tradable and non-tradable goods and services was 4.1 and 3.4 per cent in the third quarter. Being more exposed to international competition in terms of prices because of the domination of imported products, the tradable sector continued to record high inflation rates reaching 7.1 per cent in September. This is one of the highest inflation rates of this item for the last four years. The evident rise of tradable inflation rates was mainly caused by the increased external inflationary pressures, expressed in the rising trends of prices of processed foodstuffs, oil and energy. Annual inflation of non-tradable goods and services displayed a slight downward trend during the third quarter, which may reflect downward demand growth rates. Nonetheless, the average rate of non-tradable inflation for January-September 2007<sup>9</sup> still remains high.

## 2.3 PRODUCER PRICES

Both producer costs and the specific markets conditions which relate to the demand-supply ratio and the perception of producers and merchants to have a certain profit rate affect the price formation process of goods and services. Producer prices measured by the PPI are important information for



analyzing the performance of some part of consumer prices. Producer prices may become 'good' orientations for the future short-term developments in consumer prices. From the PPI data it seems that the increasing inflationary pressures in the third quarter of 2007 were to a certain extent also pushed by the increase of producer costs in economy during the first half of the year. The annual change rate of the PPI was particularly high in the first half of 2007 reaching 3.3 per cent in the second quarter after the very low rates of last year. Processing industry, which shares more than 60 per cent of producer costs, recorded high annual growth during this year. Foodstuffs industry<sup>10</sup> grew most intensively from the third quarter 2006 to mid 2007. The price rise of raw material may have also affected the increase in the producer costs in this industry. The developments in the price index of 'Processed foodstuffs' during January-September 2007 indicate that the supply-side inflationary pressures on this item derived from both price rise of imports and the increase in the costs of domestic production. The annual increase rates of producer cost in the extracting industry were considerably contained in the second quarter of the present year<sup>11</sup>. The increase of sales in this industry during the first half of 2007, and in particular in the share of exports, reflects the growth of production and expansion of the extracting industry markets. Meanwhile, the costs have had a downward tendency.

Table 3 Annual change rates of some PPI and CPI components of 'Processed foodstuffs' (in %)

	PPI	PPI Total processing industry	PPI Foodstuffs processing industry	CPI Processed foodstuffs	CPI Extracting industry
Q1:06/Q1:05	0.9	0.7	-0.1	0.0	7.3
Q2:06/Q2:05	-0.1	-0.5	-4.4	0.5	10.8
Q3:06/Q3:05	0.4	1.2	-2.1	1.1	8.4
Q4:06/Q4:05	-0.7	1.5	1.4	2.4	8.3
Q1:07/Q1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/Q2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/Q3:06	-	-	-	7.3	-

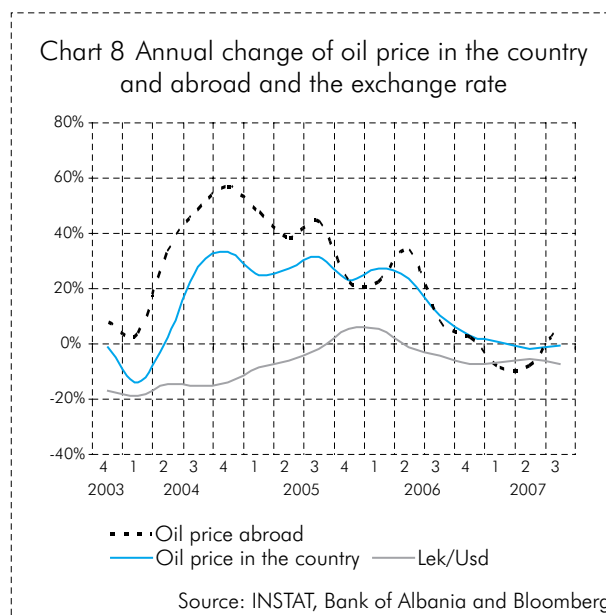
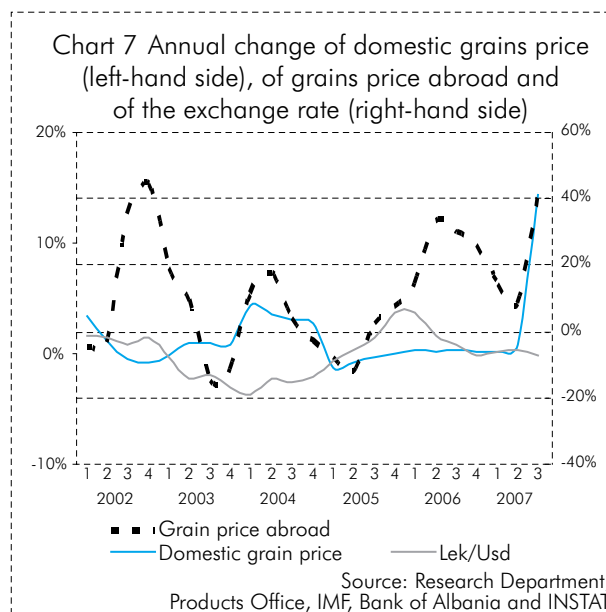
Source: INSTAT and Bank of Albania estimations

## 2.4 IMPORT PRICES

The developments in the import prices play a vital role in the performance of inflation. Domestic economy continues to be import-oriented, having imports four times as high as exports. The rapid price rise of wheat exerted strong inflationary pressures on domestic consumer prices in the third quarter. The price of wheat in the international markets rose by 40 per cent in the third quarter of the present year<sup>12</sup>. The unfavourable weather conditions, the drought and the floods in the large producer countries of grains<sup>13</sup> caused the reduction of world supply while the demand has grown as a result of the reduced supply. The grains stock in the world reached the lowest level in the last 26 years. The price rise of wheat in the international markets had a strong impact on consumer price performance in the country. The index of bread and grains increased by 14 per cent in the third quarter. This item was the main contributor to the annual inflation rate of 7.3 per cent of 'processed foodstuffs'<sup>14</sup>. The nominal appreciation of the lek to the US dollar by 7.2 per

cent in this quarter prevented the full rise of grains price in the country (it rose by as much as one third of its rise abroad). While in this quarter the price rise of bread was more considerable, the risk of a rise in the meat and dairy products price as a result of the transmission of the costs increased by the farmers to these products' final prices was also present. The indirect effect of the grains price rise has begun to be observed in the price rise of dairy products. In August and September 2007, 'milk, cheese and eggs' recorded an annual inflation of 2.4 and 6.1 per cent.

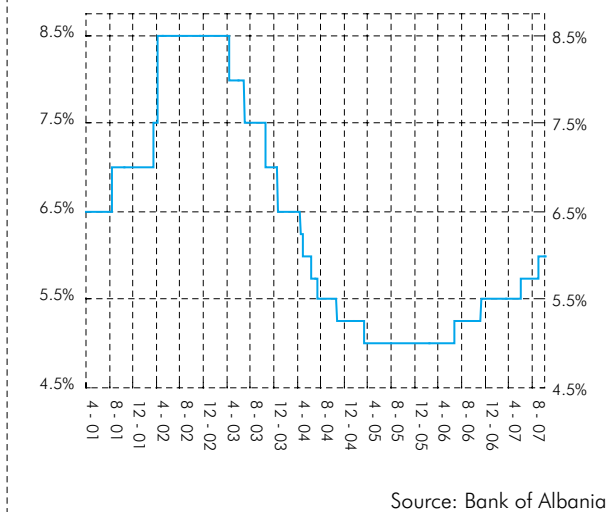
Oil price in the global market has fluctuated considerably during the last four years. The annual rise by about 40 per cent in the two-year period (2004:Q2 – 2006:Q2), was followed by the drop of 2 per cent in the following year (2006:Q3-2007:Q2). During the third quarter of 2007, the oil price recorded a new rise of about 6 per cent. The fluctuations of the oil price in the international markets were reflected in the performance of domestic oil price in a time lag of three months; however the size of the change was smaller at all periods. For 2004-2006 the oil price rise in the country was 25 per cent, while for 2007 the change is almost inconsiderable. The strong lek to the US dollar has contained the transmission of the price rise from the foreign to domestic market. In nominal terms, for the whole period of 2004-2007, the lek has appreciated by 7 per cent on average to the US dollar. However, under the energy crisis, the use of the oil and its sub-products as a basic matter for generating the energy may provide the grounds for the oil price rise in the future.



## 2.5 MONETARY POLICY DECISIONS

During the third quarter of 2007 money supply maintained the high growth rates observed in the first half of 2007. During this period it grew by about 17 per cent. This growth reflects the high demand for money, mostly from the private sector, in economy. The interest rates in the financial market have been mainly increasing in the first half of 2007. The rapid growth rates of credit and the expectations for the continuation of these rates beyond the first half of the present year increased the concerns for the achievement of price stability objective in the future. In response to the demand-side increasing pressures, at the end of June, the Supervisory Council of the Bank of Albania raised the key interest rate applied on the repurchase agreements by 25 basis points to 5.75

Chart 9 Performance of key interest rate



per cent. The rise of the interest rate aimed to contain and reduce the inflationary pressures by increasing the cost of money in economy. The upward tendency of the interest rates in the international markets was gradually transmitted to the domestic financial market. Consequently, the foreign currency interest rates have been increasing during 2007.

Although the increase of the key interest rate at the end of June was the third one within a period of 12-months, the high growth rates of credit continued during the third quarter of 2007. It has been continuously concluded that the low real interest rates have pushed the rapid growth of demand for money in economy. Along with the high monetary expansion rates the country recorded a deep current deficit during the first half and in particular during the first quarter of 2007. The external sector partly

coped with pressures of domestic demand in the form of trade balance and current account deepening. The increasing inflation of non-tradable goods prices is another indicator of the demand-side increasing pressures. During the third quarter there have been both demand and supply-side pressures on the level of consumer prices. The supply-side pressures reflected the increase of producer costs as a result of the energy situation, the grains price rise in the international markets, the fluctuations in the oil price and the reduction in the supply of domestic agricultural products.

At the end of the third quarter 2007, the medium-term stability of consumer prices was jeopardized by the ever-increasing demand and by the production cost-related factors, whose duration was and still remains undefined. Under these conditions, the Bank of Albania stepped further in terms of tightening the monetary policy and raised the repurchase agreement rate by 25 basis points to 6 per cent at the end of September. By means of this raise, the Bank of Albania showed to the market its willingness to make the inflationary expectations stable in the medium term, in line with its inflation target of 3 per cent. The keeping of the balance between domestic demand for money and price stability is a condition for maintaining stable economic growth rates.

The Bank of Albania has operated in the money markets through its operational instruments, being in line with the monetary policy decisions. The Bank of Albania met the system's needs for liquidity by injecting it mainly through the reverse repurchase agreements and the outright purchase interventions in the securities market. The liquidity injected during July to August was about ALL 9-10 billion, while the outright purchase interventions in the securities market resulted in the injection of about ALL 1.5 billion in August. The increase of liquidity in the system has met its needs following the seasonal growth of demand for money in circulation during summer. The return of cash to the system in September led to the decrease of the system's demand for liquidity to about ALL 6 billion. The monetary operations of the

third quarter facilitated the keeping of balance in the money market in line with the rise of the key interest rate in June and the reduction of seasonal fluctuations in the foreign currency markets.

The monetary operations aimed to meet the quantitative objectives of the Bank of Albania. The presence in the foreign currency market was consistent with the achievement of the quantitative objective of net international reserve, while the injection of liquidity in the system did not infringe the objective of net domestic assets of the Bank of Albania.

Table 4 Accomplishment of the Bank of Albania quantitative objectives<sup>15</sup>

	December '06	March '07	June '07	July '07	August '07	September '07
Net International Reserve of the Bank of Albania (in millions of USD)						
Objective	1,343	1,318	1,337	1,378	1,418	1,459
Current	1,484	1,487	1,486	1,527	1,523	1,650
Difference (C-Obj)	141.5	169.4	149	149	104	191
Net Domestic Assets of the Bank of Albania (in billions of ALL)						
Objective	79.1	80.6	81	86	90	95
Current	78.0	59.3	73	71	73	68
Difference (C-Obj)	-1.1	-21.3	-8	-15	-17	-27
Net Domestic Credit to the Government (in billions of ALL)						
Objective	342.4	338.6	346.6	348.6	350.6	352.6
Current	330.6	332.8	331.2	329.5	334.4	--
Difference (C-Obj)	-11.8	-5.8	-15.4	19.1	16.2	--

\* Net International Reserve increased in September due to the income derived from the privatization of the Altelekom.

Source: Bank of Albania

#### Box: II.2. Public expectations of inflation

The main and only objective of most central banks is to maintain price stability. There is a vast literature on the effect of various factors on the level of prices. In this context, the analysis of the role of consumers' expectations in the process of price formation is very important. There is now a wide consensus between the economists that the economic agents do not make continuous time errors during the forecasting process, since they are able to identify perception models in the past forecasting errors and base their behaviour in 'the best possible' forecasting of economic conditions.

Considering the importance of public expectations in achieving inflation objective the central banks are interested in attending the performance of inflation expectations and understanding the formation process of these expectations. The importance of a reliable measurement of expected inflation may be illustrated by two simple examples. First, since the expectations are considered as approximate indicators of future inflation rates the expectations indicators provide crucial information for the long term analysis of price performance. Second, if the employees think that prices will rise they will ask for higher wages and if this is also the general expectation of the economy then the companies/employers will raise the wages since they can transfer the cost changes into higher prices.

To assess and check the empirical characteristics of inflation expectations are required certain methodologies for collecting public expectations and processing and transforming them into time series. Consumer confidence survey is the most common

way to provide these expectations. The questions on inflation expectations are made in a way that the consumer does not indicate a numerical value but rather identifies the orientation and the expected extent of the change in prices. The basis for comparison is the change rate of prices during the survey period. Qualitative responses in numerical values are made possible through the probability methods. The expected inflation series provides more valuable information for future developments than the simple methods series based on the balance of consumer responses.

The measurement of expectations almost always requires further testing on the nature and characteristics which generally relate to the rationality scale of expectations. This is very important for the fact that the nature of expectations affects the reaction of agents to anti-inflationary measures of the decision-making institution, which in most cases is represented by the central bank. The concept of expectations rationality is related to the way they are created. The hypothesis of rational expectations presupposes that the agents consider all the available information providing as a result non-shifted forecasts (as close to the real rate as possible). While in the case of adoptive expectations hypothesis the economic agents rely only on the past variable information.

The Bank of Albania obtains information from consumers through the Consumer Confidence Survey. Every three months the consumers are asked whether they think: prices will rise at higher rates; at the same rates; at lower rates; will not rise or will fall. During the last two years the question time horizon has expanded from 3 to 12 months. From the tests applied on the results it seems that the consumers consider the average inflation rate of the last three months when they are asked to make an inflation forecast for the following quarter. If the average inflation rate increases the respondents expect even a larger price rise for the following period; the same holds true for the cases when prices are falling. The behaviour of Albanian consumers seems to be an adoptive one which relies on the past variable information. As a result the dynamics of expectations closely follows the dynamics of the current inflation rate. The consideration of adoptive expectations may often lead to non-accurate conclusions<sup>16</sup>. The improvement of consumers' perception of the macroeconomic indicators and inflation and the expansion of the database are expected to provide their contribution to the enhancement of the forecasting of expectation series.

### 3 INFLATION DETERMINANTS

#### 3.1 MONETARY CONDITIONS

##### 3.1.1 Interest rates and liquidity

The second and third quarter of the year were characterized by the growing tendency for tightening the monetary conditions in economy. The interest rates in the money market increased in line with the monetary policy signals. This tendency is being transmitted to the ALL deposits market as well, while the ALL loan interest rates stand at unchanged levels.

The real interest rates were relatively high in the first half of the present year as a result of the low inflation rate, which was also accompanied by an appreciating tendency of the national currency. The interest rates were accommodating for maintaining domestic demand, as also shown by the



above average growth of this indicator. On the other hand, the growth of demand for goods and services while the international prices were rising had implications for the increasing inflationary pressures and trade deficit deepening. The spread of interest rates between the lek and foreign currencies was narrowing after the central banks' signals for an increase of the interest rate in the international market.

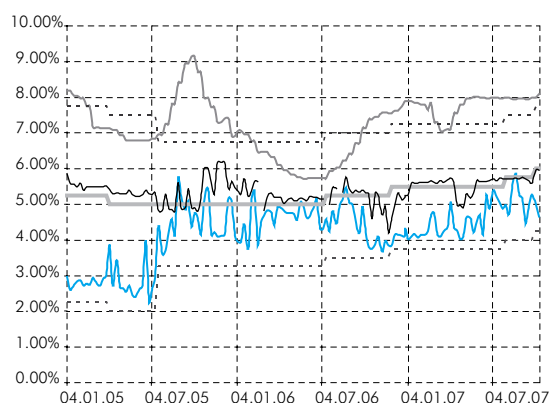
In order to contain inflation, at the end of June the Bank of Albania decided to raise the key interest rate by 25 basis points to 5.75 per cent. This decision was followed by the increase of the interest rates in both the interbank and deposits market. The third quarter evidenced the increase of supply-side inflationary pressures in economy. Domestic demand continued to maintain the high rates despite the increase of the interest rates. The exchange rate between the lek and euro recorded a slight appreciating tendency in the third quarter as a result of the seasonal supply while the lek continues to appreciate to the US dollar in line with the developments in the international market. The appreciation of the lek seems to have partly reduced the price rise effect of raw materials in the global market.

Following up the verbal signals of the Bank of Albania for tightening the monetary conditions in order to moderate the inflationary pressures, at the end of September the key interest rate was raised to 6.00 per cent, which is 75 basis points higher than the previous year. Currently, the interest rates in the interbank and deposits market are following the same trend.

The interbank market was used for meeting the short-term needs for liquidity, in particular when measuring the required reserve. The average lending volume amounted to ALL 2.2 billion from ALL 1.6 billion in the second quarter and ALL 1.4 billion the previous year. Most lending in the interbank market continues to be overnight and weekly.

The interest rates in the interbank market remained within the corridor defined by overnight facilities, but unlike the previous quarter they shifted upwards close to the key rate, affected by the growth of the banking system's demand for liquidity. The weighted average rate of overnight interests was 5.14 per cent in the third quarter or 59 basis points higher than the second quarter<sup>17</sup>. It fluctuated around the band of 4.39 - 6.12 per cent, while the previous year it fluctuated at around 77 basis points.

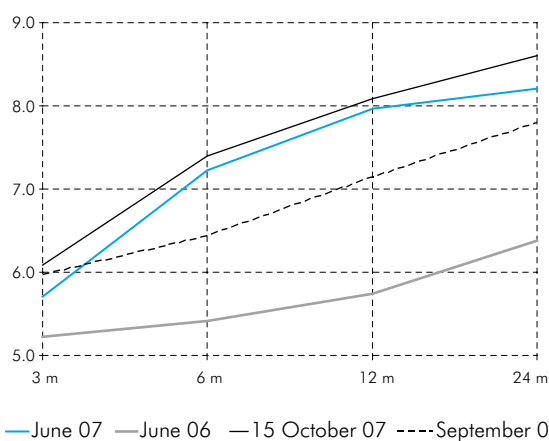
Chart 10 Interest rates in the money market



— Interbank weekly interest rate — 12-month T-bill yield  
— Interbank overnight interest rate — Weekly repo (core interest rate)

Source: Bank of Albania

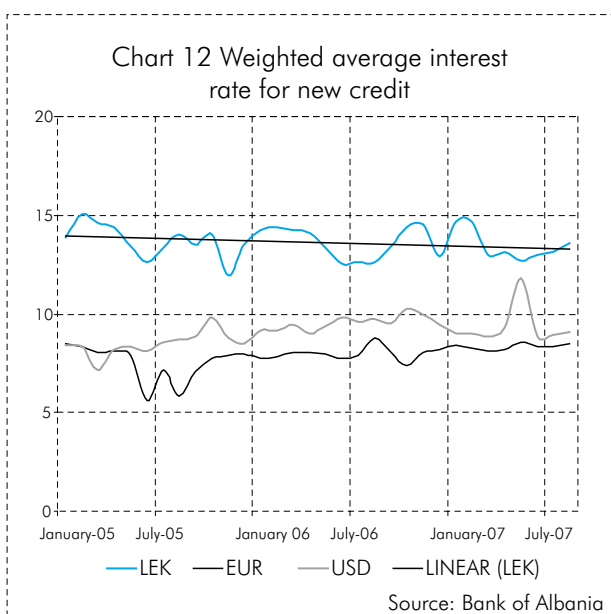
Chart 11 Government's securities yield in the primary market



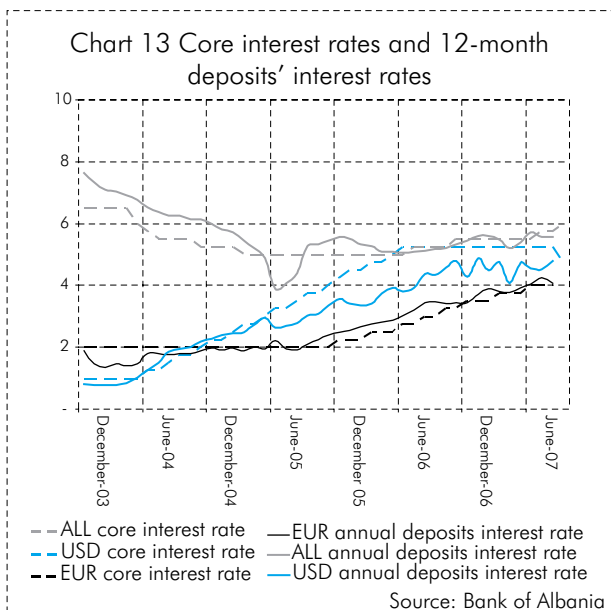
— June 07 — June 06 — 15 October 07 ---- September 06

Source: Bank of Albania

The coverage ratio of the Government demand for Treasury bills financing was positive (110 per cent), though the issued T-bills exceeded the matured ones (by ALL 11.0 billion). This caused the T-bills yields to be stable around the same levels throughout the third quarter. As of end September the 12-month yield of T-bills was 7.99 per cent from 7.96 per cent at end June. The increase of the key interest rate at the end of June was partly actualized earlier during the second quarter. As a result, the yields curve sloped compared with the previous year. The decision on the key interest rate rise by 25 basis points in September is being gradually reflected in the primary market for all maturities. The 12-month yield rose to 8.10 per cent or 0.14 per cent above the yield of June 2007 and 0.96 per cent above that of September 2006. The 2-year bonds yield increased by 0.10 per cent at the end of September to 8.30 per cent from 8.20 per cent in June.



ALL deposits continued to grow for all maturities. The weighted average interest of 12-month deposits reached 5.56 per cent in August or 0.44 per cent higher than the previous year. The key interest rate raise at the end of September 2007 and its transmission to the money market interest rates will orient the further increase of ALL deposits interests for the last quarter of the present year.

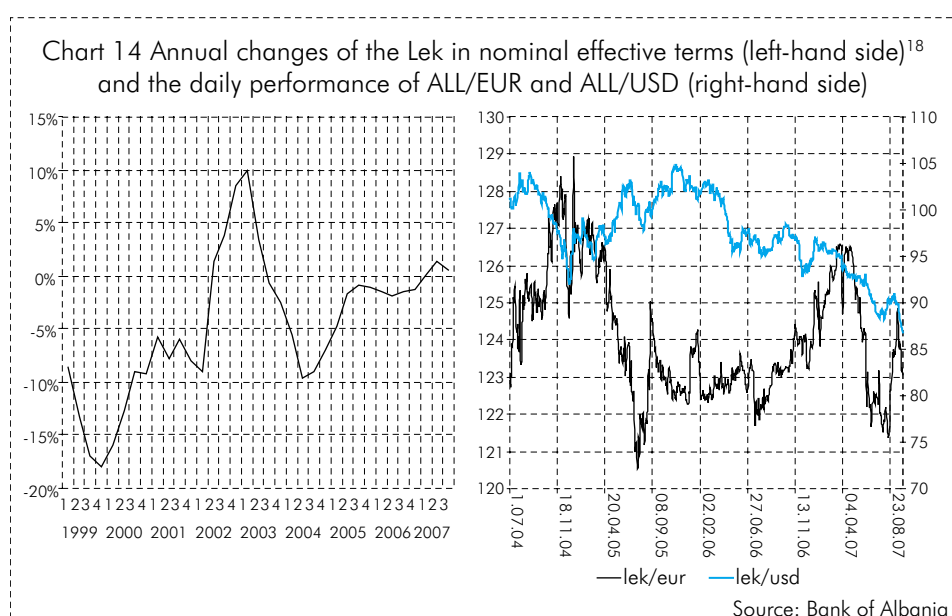


Their difference to the ALL credit interests fluctuates depending on the performance of ALL credit interests. In the second quarter this difference fell to 8.33 per cent (being under the average of 9.26 per cent) when because of the growth of supply for credit and the promotion of different packages the interest rates for ALL credit fell. In July and August the interest rates of credit returned to their historical average. At the end of August, the weighted average interest of credit increased to 13.50 per cent or 0.52 per cent higher than in June and 0.95 per cent higher than the previous year. Although the credit interest rates fluctuate from one period to another, being affected by changes in the structure of lending, in the last two years the short-term credit (0-6 months) interest rates have had an increasing trend while the medium-term ones (1-3 years) have been decreasing. The foreign currency interest rates have increased in line with the monetary conditions of other central banks. The interest rates of 12-months EUR deposits were 4.08 per cent or 0.64 per cent higher than the previous year. During this period the key interest rate for the EUR has changed by 1.00 per cent. The difference between the ALL and EUR interest rates remains positive at 1.5 per cent. EUR credit interest rates, like ALL credit ones, have been fluctuating, although

in the last two years they have shown a slight upward trend. The weighted average interest for the EUR credit was 8.48 per cent in August or 0.30 per cent higher than the annual average.

### 3.1.2 The exchange rate

In nominal effective terms, the exchange rate during the third quarter 2007 continued its depreciating tendency which was present starting from the beginning of the present year. In the second quarter, the annual depreciation of the lek was 1.4 per cent, while in the third quarter the annual change was almost inconsiderable (0.6 per cent). The depreciating behaviour of the lek to the NEER was mainly affected by the depreciation of the national currency to the European one. The decreasing depreciating rates during the third quarter are mainly a result of the substantial appreciation of the lek to the US dollar and the slighter depreciation of the lek to the euro for this period.



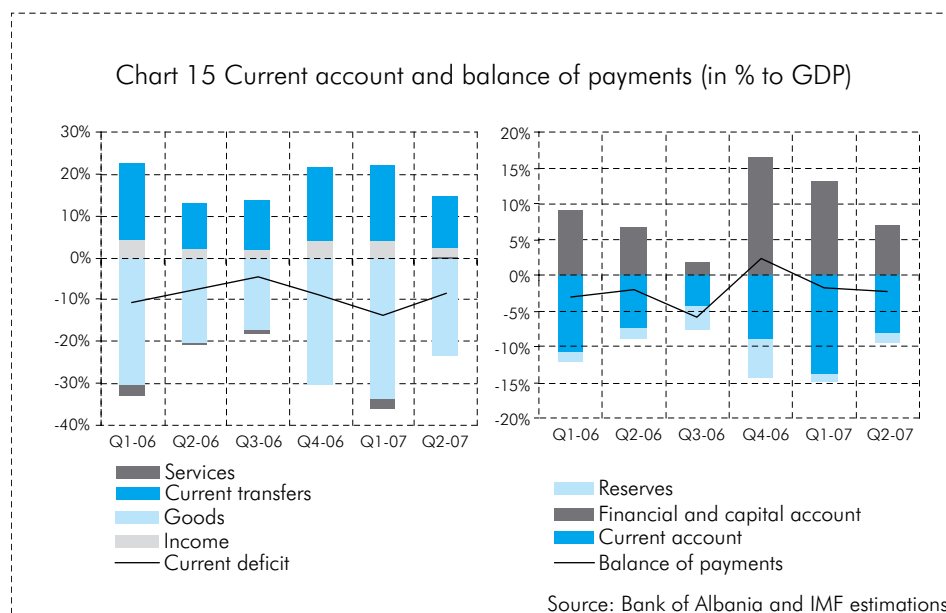
Compared with the previous year, the position of the lek to the euro has remained unchanged, while it has appreciated considerably to the US dollar. In the third quarter, the lek appreciated at constant rates to the US dollar (by 7.2 per cent on average), reaching 89.2 ALL/USD as of end period. The performance of the lek to the US dollar was highly influenced by the international markets, where the US dollar has been constantly depreciating to the euro, as a result of the financial issues signalled by the US markets. The average exchange rate of the lek to the euro for the third quarter was 123.2 ALL/EUR, which implies an annual depreciation of 0.4 per cent.

The depreciating behaviour of the lek in nominal effective terms and only to the euro reflects the pressures transmitted by the current deficit deepening for this period.

### 3.2 BALANCE OF PAYMENTS

The balance of payments for the first half of 2007 provides evidence for the increase of both Albania's current and financial transactions with the rest of the world. The volume of current transactions during this period was EUR 3.85 billion or 17 per cent higher than the same period the previous year. Both current income and expenses grew by about 17 per cent. The fact that both income and expenses had the same growth rates represents a positive development for Albania's external position. These rates need to be monitored constantly since higher expenses than current income would jeopardize the long-term stability of Albania's current account.

As of end semester, trade deficit was EUR 960 million or about 27 per cent of the GDP. Current trade deficit was not offset at the same extent by the improvement in the balance of payments and by the growth of excess income and current transfers. Hence, current deficit as of end semester accounted for 10 per cent of the GDP, while in the same period the previous year it accounted for 7 per cent. About 65 per cent of current expenses were used for the import of goods and 30 per cent for the import of services. In terms of income, the structure is less concentrated. The export of goods, services and incoming current transfers provided 22 per cent, 36 per cent and 30 per cent of total current transfers during the first half of the present year. The import of goods increased by about 24 per cent, while the export increased by 26 per cent. Although the growth rates of the import and export of goods have been quite similar for some consecutive years, their ratio remains almost unchanged. The imports coverage by the export of goods continues to fluctuate to around 28-29 per cent.



During January-August 2007 the import of goods grew by 23 per cent and the export by 28 per cent. 'Minerals, fuels and energy', 'construction materials and metals' and 'machinery, equipment and spare parts' recorded

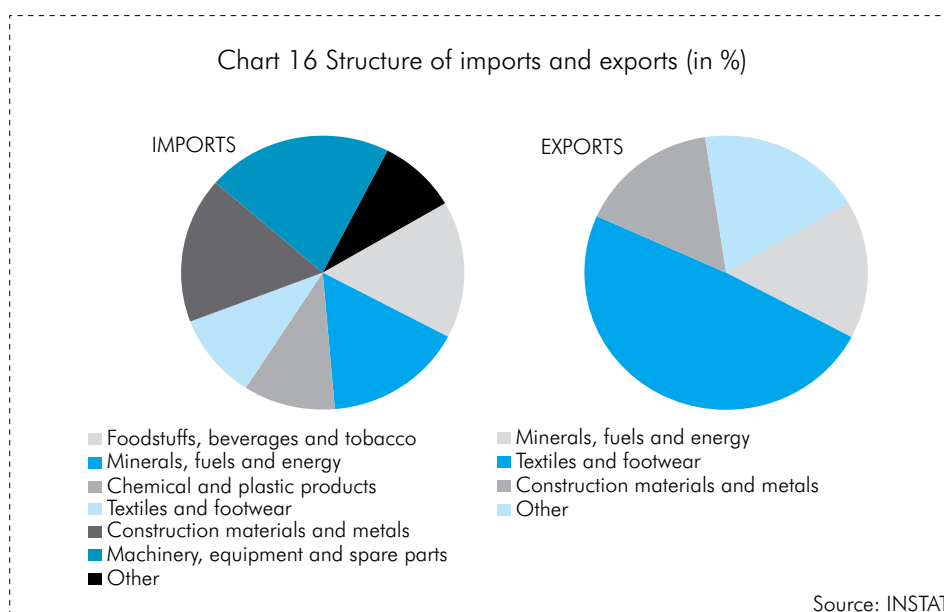
the highest growth in terms of import. The growth by about 45 per cent in the import of minerals, fuels and energy mainly reflects the growth of volume and price of imported energy. The growth in the import of capital goods has been a tendency for several quarters and it reflects the continuous expansion of investment in the country. The import of foodstuffs and beverages has almost remained around the same level as in the previous year. The price rise of these goods in our partner countries' markets may have held back the increase of their import.

Table 5 Imports and exports (in millions of EUR) and the annual increase by commodity groups

	IMPORTS		EXPORTS	
	January-August 2007	Increase	January-August 2007	Increase
Foodstuffs, beverages and tobacco	305	7%	35	12%
Minerals, fuels and energy	302	44%	84	189%
Chemical and plastic products	198	18%	4	-15%
Leather and articles thereof	41	17%	11	41%
Wood and paper	69	33%	15	23%
Textiles and footwear	194	8%	252	12%
Construction materials and metals	325	33%	84	22%
Machinery, equipment and spare parts	400	26%	19	26%
Miscellaneous	64	35%	14	20%
Total	1,900	23%	519	28%

Source: INSTAT

The structure of import and export by commodity groups did not undergo significant changes compared with the previous periods. The largest share of resident expenses is used for the import of machinery and equipment, construction materials, minerals and foodstuffs. The structure of exports continues to be overwhelmingly oriented to re-exports produced by orderer's material. Worth being underlined is the reduced share of re-exports to the total exports, while there is an increased share of the export of minerals and construction materials.



### CAPITAL AND FINANCIAL ACCOUNT

Capital and financial flows increased by 32 per cent during the first semester of 2007 compared with the same period the previous year. They managed to finance about 90 per cent of current deficit. Residents' financial claims on the rest of the world remained almost around the same levels as in the previous year. The stock of liabilities grew by about EUR 60 million. Foreign direct investments which totalled EUR 150 million during the first half of 2007 or 16 per cent higher than the previous year provided the main contribution to the growth of liabilities. This item played the main role in financing the current deficit. During this period public borrowing amounted to about EUR 55 million.

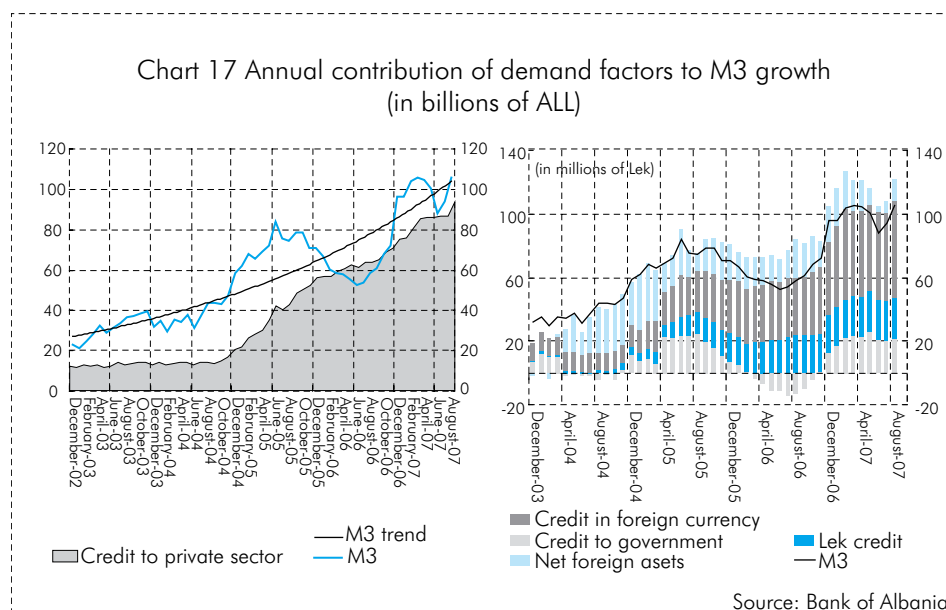
Foreign reserve as of end the first semester totalled EUR 1.4 billion, being fully sufficient to cover about 4.1 months of import of goods and services.

### 3.3 MONETARY DEVELOPMENTS

#### 3.3.1 Monetary aggregates

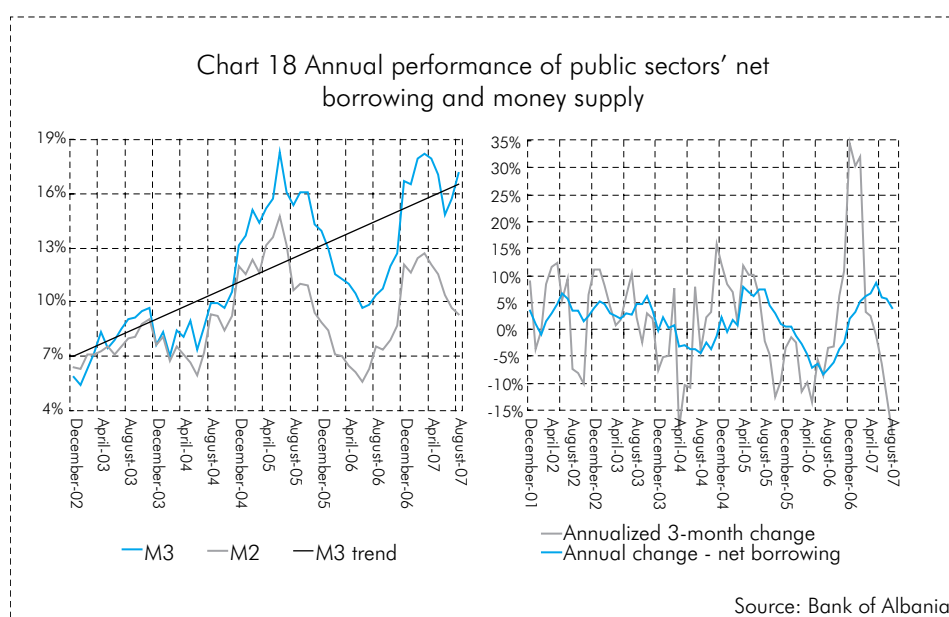
Money supply continued to grow rapidly during the nine-month period of 2007. The growth of money supply was dominated by the private sector's demand for money, followed by the growth of the banking system's net foreign assets. In the medium run, the tendency of money supply reflects the upward trend of credit, while the fluctuations around this tendency reflect the fiscal sector's monetary position and the seasonal foreign inflows in the form of remittances.

Money supply maintained the same growth rate in the third quarter as in the previous two ones (about 17 per cent). The growth of the banking system's lending provided the main contribution to the growth of money supply. Public sector continues to provide a relatively inconsiderable contribution to the



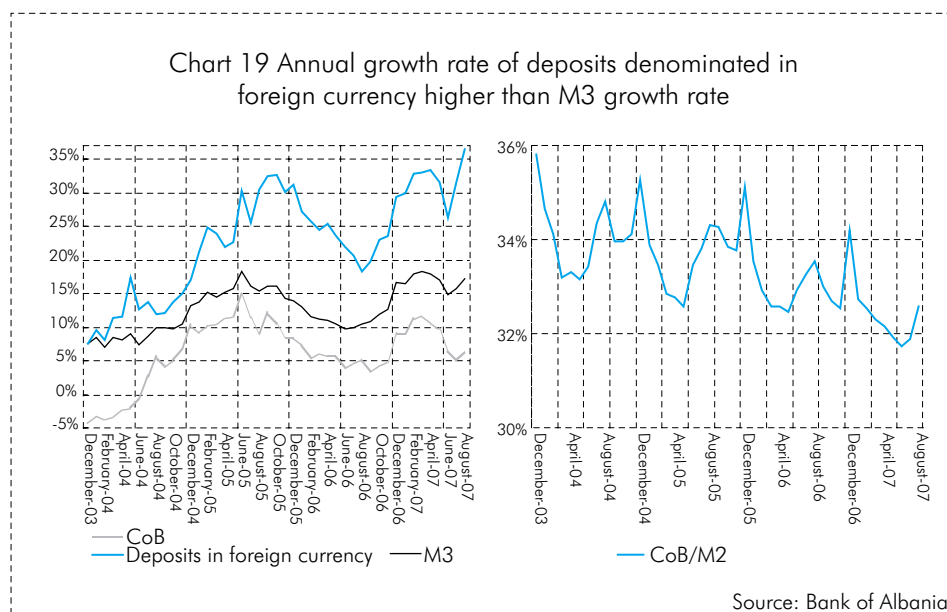
creation of money. Although in annual terms the net claims on the public sector have increased by about 8 per cent, the fiscal balance to the economy maintained the same level in the third quarter compared with June. The banking system's external position reflected the seasonal developments of money creation as a result of foreign inflows during summer.

The creation of ALL monetary assets, measured by the M2 aggregate slowed slightly down as a result of the positive balance on fiscal account, while the growth of ALL credit has a relatively small share in the M2 growth. M2 aggregate grew by 9.5 per cent on average in the third quarter, while it grew by about 10-11 per cent in the second quarter. The annual growth rate of money base had a downward tendency. As of end quarter, the annual growth rate of money base slowed down to about 4-5 per cent, decreasing considerably compared with March and June (14.5 and 9.4 per cent respectively). Public sector's domestic borrowing was followed by seasonal fluctuations of the demand for cash in circulation, reflected in the performance of money base in economy and M2 aggregate.



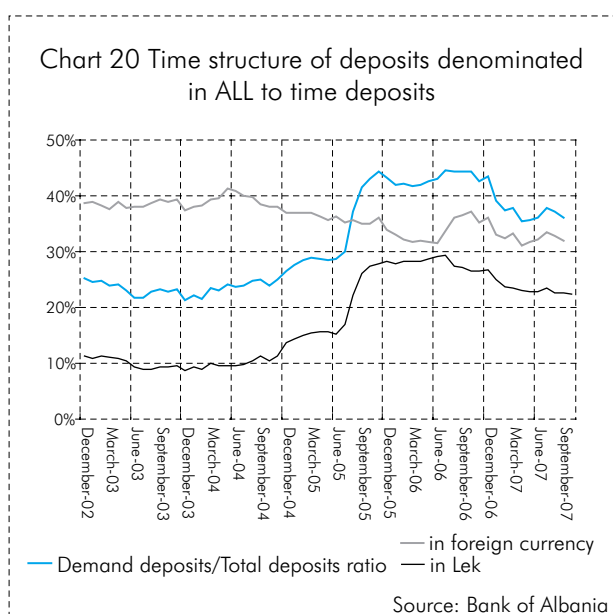
Foreign currency and time structure of money supply reflected the share of 70 per cent of lending in foreign currency and the positive balance of fiscal position to the system. The foreign currency component of M3, foreign currency deposit, grew by 36 per cent annually compared with the 17 per cent growth of M3. This growth rate is in line with the overall tendency observed in the last two years. The changes in the monetary structure of M3 aggregate were oriented to its foreign currency component. About 61 per cent of the money supply (M3) annual growth of ALL 105 billion in August is composed of the growth of foreign currency deposit. The share of the latter to M3 increased to 33.4 per cent from 30.7 per cent in June and about 29 per cent in August 2006. The share of M2 to money supply maintained its downward trend. Hence, the share of ALL denominated deposits to M3 dropped to about 45

per cent. The share of currency outside banks to M3 also dropped to 21.7 per cent.



The annual growth rate of ALL denominated deposits and currency outside banks maintained the downward tendency of M2 aggregate. While currency outside banks grew by about 6 per cent in the third quarter, ALL denominated deposits grew by about 12 per cent. However, M2 time structure was put under the influence of seasonal developments. While the share of currency outside banks to M2 decreased compared with the previous year, their share in August grew to 32.6 per cent from 31.7 per cent in June. The seasonality factor of this ratio tends to reflect the developments in the real sector of economy.

The time structure of the banking system's deposits during 2007 slightly shifted to time deposits. This tendency was mainly evidenced in the performance of ALL denominated deposits. In August, ALL demand deposits shared 22.7 per cent of total ALL denominated deposits from 27.4 per cent in August the previous year. During the last months this ratio results to be unchanged. The time structure of deposits denominated in foreign currency remained unchanged. During 2007, the share of demand deposits denominated in foreign currency to the total of foreign currency deposits was about 30-35 per cent. Compared with the last quarter the previous year this ratio results to be about 3.5 per cent lower.



In August, ALL demand deposits shared 22.7 per cent of total ALL denominated deposits from 27.4 per cent in August the previous year. During the last months this ratio results to be unchanged. The time structure of deposits denominated in foreign currency remained unchanged. During 2007, the share of demand deposits denominated in foreign currency to the total of foreign currency deposits was about 30-35 per cent. Compared with the last quarter the previous year this ratio results to be about 3.5 per cent lower.

In general, the performance of the banking system's total deposits was dominated by the changes in the structure of ALL denominated deposits<sup>19</sup>. Hence, the share of total demand deposits to total deposits in

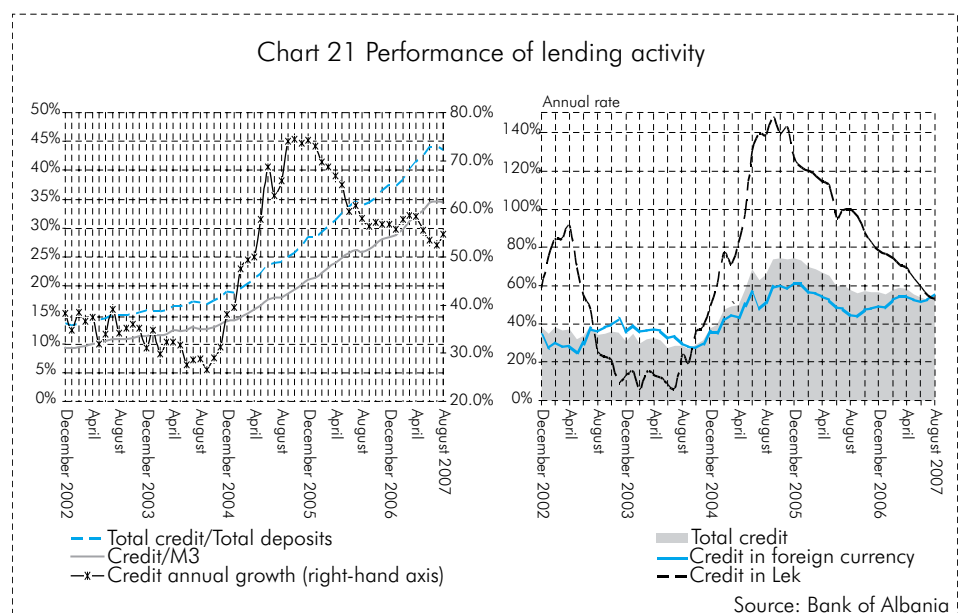


the third quarter the present year is about 33 per cent from 35 per cent the third quarter the previous year. This general trend tends to partly correct the growth of ALL denominated demand deposits two years ago.

### 3.3.2 Credit to the public and private sector

The high growth rates of demand for money, in particular of credit, continue to transmit risk for inflationary pressures in economy in the medium and long run. The share of credit denominated in foreign currency to the total credit portfolio remained almost unchanged in the third quarter compared with the first half of the present year, providing evidence for the ongoing high demand of businesses for foreign currency credit. Meanwhile, the higher lending to households, for both consumption and real estates, grew the credit portfolio to households.

Credit to economy grew by ALL 20 billion in the third quarter. As of end quarter the stock of credit was ALL 255 billion or as much as 27 per cent of the GDP. The share of credit to economy to money supply is presented stable at 34 per cent. Credit continued to grow in the third quarter with high growth rates of 54 per cent on average or ALL 89 billion in annual terms. The largest part of the growth of credit came as a result of the growth of businesses demand for credit. New credit of ALL 21 billion extended over the months remains at high monthly levels.



The structure of credit by foreign currency did not undergo significant changes during the third quarter. Credit in foreign currency continues to dominate the credit portfolio, accounting for 70.2 per cent. For more than two years credit portfolio in ALL is characterized by the moderation of growth rates which however continue to remain high. ALL denominated credit grew by 53 per cent on average in the third quarter, compared with 63 per cent

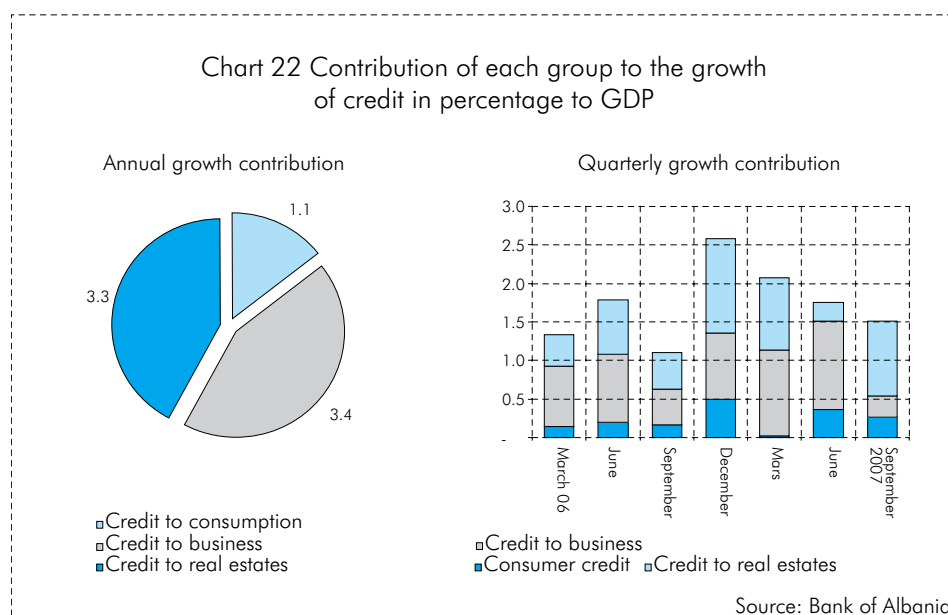
in the second quarter. Meanwhile, the growth rates of credit denominated in foreign currency are higher than the growth rates of the first half, being equal with the annual growth of ALL denominated credit. This positive performance is attributed to the high demand of the private sector, mainly of businesses, for credit denominated in foreign currency.

Table 6 Credit to businesses and households (average annual growth of quarters in %)

	Q1-07	Q2-07	Q3-07
Credit to businesses	54.0	50.6	46.6
For moving capital	47.8	64.2	62.0
For investment	59.0	40.9	36.0
Credit to households	68.4	68.6	67.1
For consumption	101.2	100.9	107.9
For real estates	91.5	53.9	60.0

Source: Bank of Albania

The portfolio of credit to businesses reached to 17 per cent of the GDP in the third quarter. There were no significant changes in the sectoral distribution of credit to businesses during this quarter. Trade, construction and processing industry remain the most credited sectors of the economy absorbing about 73 per cent of total credit to businesses. The dynamics of this portfolio evidences that unlike the first quarter of 2007, when credit to businesses was characterized by the growth of credit for investment in machinery and real estates, in the second and third quarter the growth of businesses' demand for credit was focused on covering their liquidity needs, included in overdraft and moving capital credit. The difficulties in the businesses' economic activity as a result of the shortages in the energy supply during summer are believed to have pushed the demand for short-term credit by businesses.



The portfolio of credit to households during the third quarter reflects further growth of the share to total credit to 36.5 per cent from 35.0 per cent in June

and 33.3 per cent the previous year. Credit to households is characterized by high annual growth rates at an average of 68 per cent for 2007. Real estates credit has the largest share in this portfolio, sharing 62.4 per cent. The growth of households' real estates credit in the last months of the quarter seems to have provided the main contribution to the growth of credit, which accounted for 9.6 per cent of the GDP. Meanwhile in July consumer credit was the type of credit to dominate the growth of households' credit portfolio. As a share to GDP consumer credit reached 2.6 per cent.

### 3.4 DEMAND AND SUPPLY FACTORS

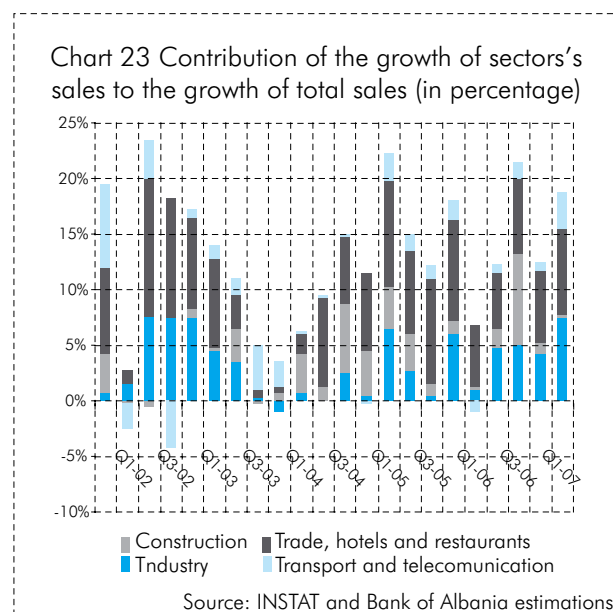
The growth of production during the first half of 2007 was slightly higher than the average growth rates of the previous year. The sectors of industry and trade provided the main contribution to the growth of sales, while construction continues to display slow growth rates. Economic growth has found strong support in the growth of domestic demand. Consumer demand is the main component of aggregate demand which recorded the most rapid growth. Investments have been increasing in almost all the sectors of economy. Economic growth was followed by the increase in the number of employed and the dropping of the unemployment rate. The constant improvement in the labour market was also reflected in the increase of nominal salaries and wages.

#### 3.4.1 Production by sectors

Industrial production recorded high annual growth rates and the trade activity has maintained the high rates of the previous years. The contribution of the growth of construction sales to the total growth of economic sales was almost inconsiderable during the first half of 2007.

Considering the effect of prices which rise constantly it may be concluded that the sales of constructed or in construction buildings were less than the same period the previous year.

Total sales increased by 14 per cent in the first quarter and by 20 per cent in the second quarter, compared with the same periods the previous year. The profile of annual growth of sales is much more similar to that of 2005, when the highest rates were recorded in the second and third quarter of the year. The performance of sales is consistent with a real growth rate of about 6 per cent<sup>20</sup>. The slowdown in construction may be an issue for maintaining the growth rates in the medium run. Transportation and telecommunication recorded a high sales growth in the second quarter (30 per cent).



**Box 4.1: Production and import of energy – Implications for the economy**

The problematic energy situation during the present year does no longer constitute an isolated and short-term occurrence. The dependence of this sector on the weather conditions and the imports is ever-increasingly becoming greater. The relatively high and stable economic growth rates are a source of continuous demand for energy sources while the electric energy remains the sole alternative.

Under the conditions when the potentials of domestic energy production have reduced considerably the increase of the import of energy is becoming a long-term way to partly meet the domestic demand.

The phenomenon of energy supply shortages has been now present for several months and it seems to continue to be present in the future. The recurrence of shortages at the end of the second quarter further intensified in the third quarter of 2007. The unusual situation for this season not only reflected the energy sector problems in Albania but also the consequences accumulated from the long drought in the country and throughout the region.

The energy sector indicators for January-August 2007 indicate a lower supply of energy compared with the same period the previous year. The decrease of supply by 9.3 per cent came as a result of the decrease in the domestic production while the increase of imported energy did not manage to meet the demand for energy.

The consumption of energy by the households and businesses has dropped by almost the same rate. Meanwhile the decrease of total losses and losses to sources constituted a positive development in the energy balance sheet.

This decrease was to a large extent a consequence of the increase of cashing. Despite the measures taken by the economic agents and the KESH to cope with the problems caused by the energy shortages the economic activity is largely dependant on the developments in this sector.

Table 7 Indicators of energy balance sheet

	January- August 2006 (in million GH)	January- August 2007 (in million KWH)	Annual change (In %)
Sources	3,898	3,536	-9
- Domestic production	3,760	1,943	-48
- Exchange with abroad	189	-1,834	
Uses	3,898	3,533	-9
-Household consumption	1,445	1,383	-4
-Non-household consumption	930	884	-5
-Total losses	1,523	1,267	-14
Losses as a percentage to Sources	39	36	-8

Source: KESH

The timely disproportion of the growing demand of economy for energy sources and its decreasing supply, actualized in the supply shortages did in several cases put in question the general confidence in achieving the main macroeconomic objectives, such as economic growth and price stability.

The periodical analyses of the Bank of Albania indicate that the grave energy situation in the country has generally limited the economic activity. In certain extreme cases the domestic and foreign businesses have suspended the activity, while the shaking of potential investors' trust is assessed to have a long-term negative effect on Albania's

economy. In response to the considerable limitations of the economic activity the reduction of new jobs and the falling wages have accompanied the near-collapse point of energy situation in the country.

The additional costs deriving from the use of alternative sources have affected both the businesses and the overall consumer prices level. The use of generators has constantly created additional costs. These costs have strongly affected the prices of products and services because of the oil price rise. Experience has indicated that the need to recover the economic activity in later periods has pushed a strained economic activity imposing unforeseen costs for businesses and in several cases shaking of their position in the market.

Borrowing businesses find it difficult to achieve the expected financial results due to the restraints in the economic activity. Experts of commercial banks state that credit risk becomes even greater in times of difficult energy situation. It would affect the quality of the return of borrowing in the banking system which the Bank of Albania monitors very prudently.

The cost of the import of energy is increasing as a result of the high price in the global markets and the increase of the imported quantity. The assessments indicate that the price of 1 KWh imported by KESH during January-June 2007 was about 60 times higher than the previous year. The high import costs and the impossibility to increase the domestic production seem to continue to affect Albania's trade balance negatively.

The high import does not manage to be compensated by the cashing, although the latter has increased considerably. This deficiency requires more support by the state budget in order to cope with the extra imports (Country Report, September 2007). In the long-term perspective the persistent occurrence of this phenomenon would reduce the potentials for efficient capital investments in economy.

There may be recurring exchange rate fluctuations in the domestic foreign currency market as a result of the high demand of KESH for foreign currency in order to carry out transactions for the purchase of energy (regardless of its price). Although these fluctuations may be temporary, their recurrence affects the domestic foreign currency market. As a result inflation is induced and the confidence in the stability of domestic currency is shaken.

### 3.4.2 Demand and consumption indicators

#### INDICATORS OF CONSUMER DEMAND

The indicators of domestic demand indicate that the level of households' spending as of end the second quarter was high. The positive developments in the labour market, the rise in salaries and wages and the stock of credit to households are consistent with the continuous growth of consumer demand. The rises in the key interest rate starting from July 2006 do not seem to have had a decelerating effect on the growth of consumer spending.

The most recent data for the second quarter of 2007 provide evidence for the growth of sales and imports. Sales in services<sup>21</sup> grew by 20 per cent. This is the highest growth rate of sales in services for the period covering 2006:Q2 – 2007:Q1, when the annual growth of this sector fluctuated

around 9-15 per cent. The volume of retail trade grew by 5 per cent during this period, while the employment index in this sector improved for the two consecutive quarters. Households channelled their spending mainly for the consumption of 'foodstuffs, beverages and tobacco', 'clothes, footwear and leather articles' and 'household appliances'. The sales of these commodity groups recorded an annual growth of 41, 53 and 15 per cent in the first half of 2007. Apart from the increase in the short-term consumption there is also an ever-increasing tendency in durable consumption. For the first time, the number of vehicles purchased in the second quarter more than doubled compared with the previous year. The increase in the import of goods both for final and intermediate consumption provides evidence for an increased consumer demand in the second quarter. The imports of consumer goods increased by about 11 per cent compared with the previous year.

Consumer spending was supported by income from labour, credit to households and workers' remittances. Along with the rise in the employees' salaries and wages in both the public and private sector there was an increase in the number of employed. Credit to households continues to record high growth rates. Although credit in the third quarter grew at slower rates compared with the previous two quarters, it was 56 per cent higher than the third quarter the previous year. The increase of the stock of credit to households is a result of their increased wealth. Housing prices are one of the main indicators of the performance of households' wealth. The rising housing prices increase the wealth of their owners; hence, it has a positive influence on the assessment banks make on the current and potential borrowers. Workers' remittances continue to be high and provide a considerable source of income for the Albanian consumers. In the second quarter remittances grew by about 16 per cent.

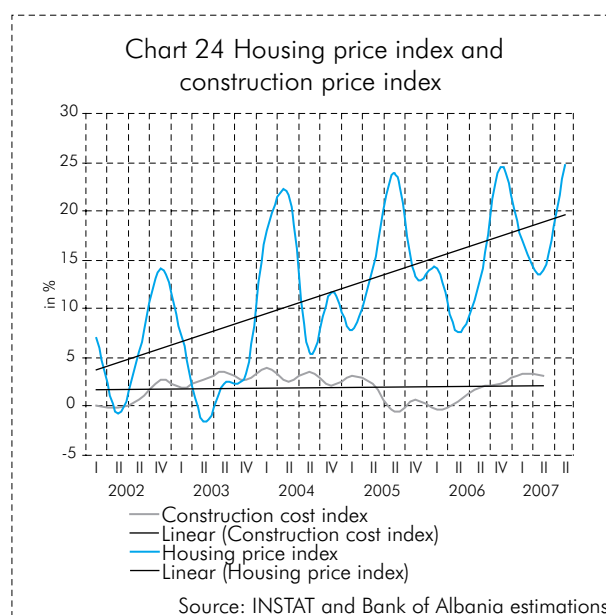
The information obtained from the consumer survey provides different signals related to consumer confidence. Although the survey data for the second quarter indicate that there has been an improvement of the consumer confidence index by 0.4 per cent compared with the previous quarter, it has been decreasing in annual terms. This year's energy crisis seems to have moderated the consumers' confidence causing the share of positive factors such as the increase of income or the favourable credit terms to be less.

#### INVESTMENT INDICATORS

Investment activity for the first half of 2007 increased compared with the previous year. Indirect indicators of investment in Albania suggest that this indicator has increased for all sectors of economy. Private non-financial sector provided a positive contribution to the performance of investment. The funding of investment projects was at a large extent supported through borrowing. Business borrowing for machinery, equipment and real estates has recorded high growth rates in the nine-month period of the present year increasing annually by 61, 36 and 34 per cent for the first, second and third quarter. The import of intermediate and capital goods increased by about 29 and 28 per cent on average in the first half of 2007 compared with the same period the previous year. The opinions expressed in the Business Confidence

Survey generally indicate a favourable investment climate and proper lending terms.

In annual terms, investment in houses, mainly by households, decreased. The volume of new buildings was about 8 per cent smaller than the first half of 2006. The limitations in the extension of construction permits reduced the growth of supply with house buildings. Meanwhile the demand for houses remains high and ever-increasing. The more rapid growth of demand than supply exerted pressure on the continuous rise of housing prices and the dropping of the sales growth rate in construction. In the third quarter the house price index for Tirana increased by 25 per cent compared with the previous year.



Capital spending of the public sector recorded high annual growth rates mainly in the first and third quarter. Foreign direct investment which increased considerably in the first quarter provided a positive contribution to the increase of investment in Albania. The reduced direct investment in the second quarter was partly offset by the increase of income from tourism by 16 per cent for this period.

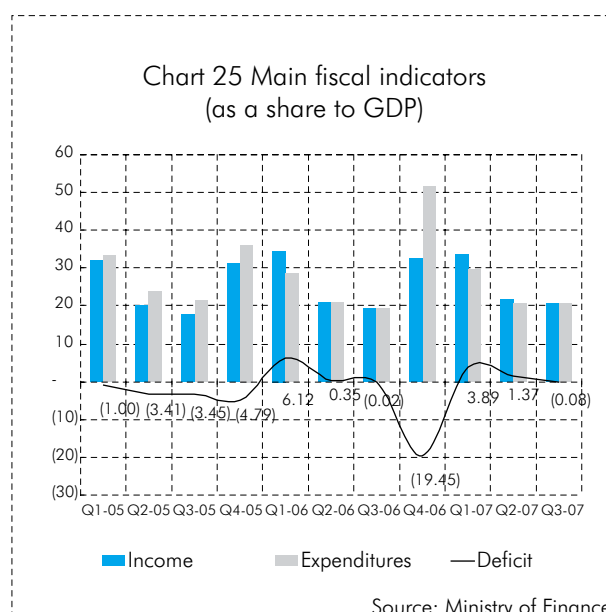
Table 8 Investment indicators

	Q1'06	Q2'06	Q3'06	Q4'06	Q1'07	Q2'07		
Import of intermediate goods (in millions of EUR)	273	301	296	345	347	396	27 %	31%
Import of capital goods (in millions of EUR)	68	76.9	66.5	83.6	87.3	98	28%	27%
Government capital spending (in billions of ALL)	3.2	5.1	6.6	32.6	5.7	5.5	79%	8%
Foreign direct investment (in millions of EUR)	57	69	75	58	86	51	51%	-26%

Source: Bank of Albania and Ministry of Finance

### 3.4.3 Fiscal sector

Fiscal policy for the nine-month period of 2007 may be described as tightening being quite rigorous in collecting income and prudent in carrying out spending. Fiscal balance for this period resulted in a surplus of ALL 10.3 billion from ALL 8.9 billion of the projected deficit. Budget income grew under satisfactory rates while spending followed the usual cyclic model, according to which it reduces during the first part of the year and increases in the last two quarters. This nonlinear distribution of budget spending over the year leads to the concentration of the fiscal stimulus in economy mainly in the last months of the year causing the inflationary pressures for this period to increase.



Budget income grew by 11.9 per cent and spending by 12.5 per cent in the nine-month period of 2007 compared with the same period the previous year. The share of fiscal surplus to the GDP dropped to 0.08 per cent in the third quarter.

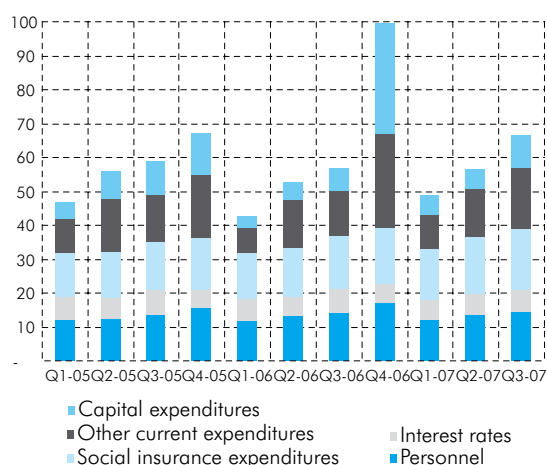
Value Added Tax represents the main source of tax income. It increased by 21 per cent compared with the nine-month period of 2006. The application of the change in the law on excises and tax on personal income (application of the flat tax) in the third quarter increased the tax on personal income and excises by 125.5 and 30.7 per cent respectively. The same performance is expected to continue in the period to come while the flat tax applied on business profit will be applied starting from 1 January 2008.

Table 9 Growth rates of income and spending (in percentage) and the fiscal balance

Annual growth in %	Q3-06	Q4-06	Q1-07	Q2-07	Q3-07
1. Total income	15.0	10.1	6.7	12.4	16.3
1.1 Tax income	13.8	6.2	7.5	10.3	12.1
1.1.1 Income from tax and customs	15.1	10.0	11.9	13.3	16.9
1.1.2 Other tax income	9.9	-4.7	-4.6	1.2	-2.9
1.2 Non-tax income	-15.1	35.7	-1.0	42.7	129.6
2. Spending	-3.4	53.0	14.7	7.2	16.6
2.1. Current spending	2.0	21.9	9.5	7.1	13.3
2.1.1 Personnel spending	4.9	10.7	1.1	1.3	2.2
2.1.2 Spending for interests	-2.0	2.1	-7.2	6.2	-12.7
2.1.3 Insurance and pension spending	7.5	8.6	14.2	17.3	17.7
2.2 Capital spending	-31.4	171.4	78.8	8.0	41.5
3. Fiscal balance (in millions of ALL)	(71.8)	(38,500.3)	6,400.9	3,749.2	(250.8)
3.1 Domestic financing	(152.3)	34,262.7	(6,416.0)	(4,028.8)	(433.2)
3.1.1 Income from privatization	1.1	(145.0)	30.1	13.6	13,093.1
3.1.2 Domestic borrowing	2,995.9	28,196.6	2,839.7	596.6	8,563.7
3.2 Foreign financing	224.1	4,238.7	15.0	279.6	684.0

Source: Ministry of Finance

Chart 26 Structure of budget spending (in percentage)



Source: Ministry of Finance

Current spending grew by 9.5 per cent and capital spending by 40.2 per cent in the nine-month period. Reform in public administration during the previous year caused the growth of spending on administration personnel to be modest by 1.5 per cent. Although investment had a satisfactory annual growth owing to several road projects undertaken over the year budget spending continues to be short-term oriented. This fact is evidenced by the small share of 27 per cent capital spending has in the budget.

### 3.5 LABOUR MARKET AND WAGES

Demand for labour continues to grow being reflected in the increase of employment and the decrease of



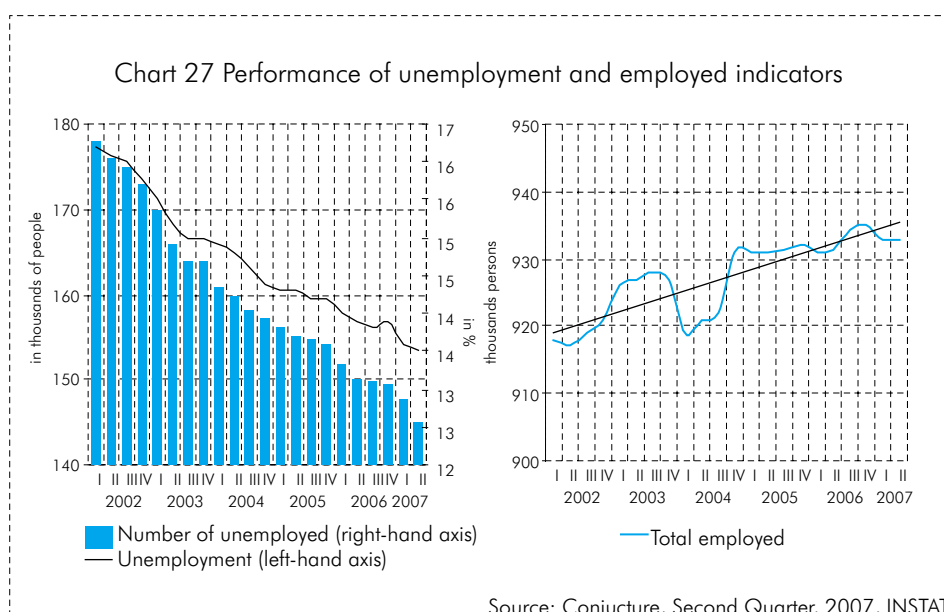
unemployment rate. The growth of domestic demand in industry and services was accompanied by the increase of employment in these sectors. The structural changes in the public sector had a negative impact on the employment indicator. The Government initiative to decrease the tax rate applied on businesses' profit and to determine the reference salary and wage for calculating the legal obligations of employees, accompanied by the strengthening of controls by the responsible public authorities, encouraged the businesses to register and declare the real salary and wage. The considerable rise of salaries and wages in the private sector during the second quarter mainly attributes to these developments. At the same time, it does not seem to have affected the number of employed since its growth rate has fluctuated around the historical average.

### EMPLOYMENT AND UNEMPLOYMENT

The data on employment for the second quarter of 2007 indicate an upward tendency starting from the last quarter of 2004. The number of employed in the second quarter was 933 thousand people or 1.7 per cent higher than the same period the previous year. This increase was mainly recorded in industry and services. Employment<sup>22</sup> in these sectors increased by 5 and 4 per cent annually. In retail trade the employment index increased by 19 per cent. The decrease in the number of employed in construction was in line with the slowdown in production and sales while transportation recorded a very high volume of sales with a small number of employees.

The structural changes in the public sector led to the decrease in the number of employed in this sector by about 5 thousand people. This decrease was somehow compensated by the increase by about 7 thousand people employed in the private sector. Unemployment rate fell by 0.4 per cent annually reaching 13.5 per cent as of end the second quarter. Unemployment rate has been dropping starting from 2002.

The more rapid falling rates in the number of unemployed than the increasing rates in the number of employed is translated into the decrease of the labour



force. According to official data provided by INSTAT labour force reduced by about 3 thousand people in the second quarter. This occurrence may be attributed to the informal nature of employment relationships, to emigration and to the non-compliance between supply and demand for labour related to the education and skills required by the job seekers.

#### PERFORMANCE OF SALARIES AND WAGES

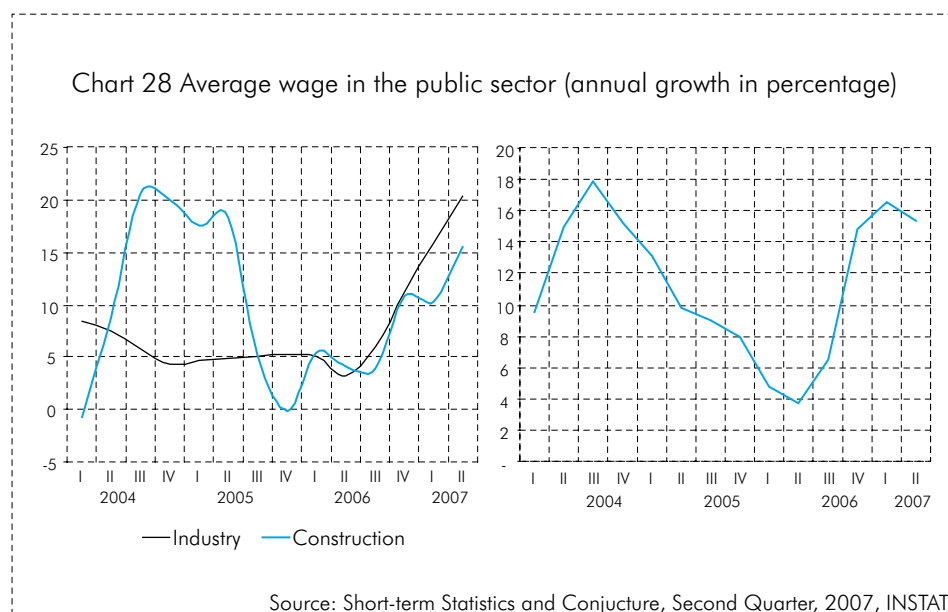
Salaries and wages rose in both the public and private sector in the second quarter of 2007. This rise differed among the two sectors. The average salary and wage rose at slower rates in the public sector compared with the previous two quarters.

The annual rise rate of average salary in this sector was 15 per cent or about 4 per cent higher than the average rise recorded in the last five years. The increase of wage index in the private sector varies from 15 per cent in construction to 40 per cent in services and hotel sector.

The encouragement of businesses to declare the real wages is assessed to have affected the considerable rise of wages in the private sector for the second quarter. Unlike the previous year the minimal approved wage and the unemployment payments did not undergo any changes during 2007.

Starting from May this year the contributions of social and health insurance and the tax on personal income from the employed in the private sector will be calculated on a monthly reference wage which has been determined upon the decision of the Council of Ministers.

“Reference” wage has been determined depending on the location of the business, the type of economic activity and the hierarchic level of employees so that the declared wages respond to the market value for the employment services.



## NOTES

<sup>1</sup> Sub prime lending is a type of lending that relies on risk-based pricing to serve borrowers who cannot obtain credit in the prime market, where higher degrees of risk for borrowers carry higher costs for loans.

<sup>2</sup> For the Euro area and its member countries the inflation rate is measured according to the Harmonized Consumer Prices Index methodology.

<sup>3</sup> Annual and core inflation over the months: May (1.4%; 1.5%) June (2%; 1.7%), July (2.1%; 2.1%), August (4.2%; 3.7%) and September (4.4%; 3.4%).

<sup>4</sup> Dry weather, the situation with the watering infrastructure, the absence of an efficient system collection and distribution of production and the energy crisis have affected negatively the domestic agricultural production.

<sup>5</sup> After a downward tendency in January-May annual inflation rate increased in the following months.

<sup>6</sup> We derive net inflation after excluding the effect of too volatile prices or administered prices from total inflation. In our case, the influence of foodstuffs prices and the simultaneous influence of foodstuffs prices and administered goods prices are excluded from total inflation. These two groups of prices have affected the overall level of prices in the country, causing inflation jumps beyond the targeted band in certain months.

<sup>7</sup> As a result of the rise in excises in September 2006.

<sup>8</sup> As a result of the measurement of this rate according to the very high index of the same month the previous year. This item's inflation was quite high in September 2006 due to the considerable increase of the dormitory tariffs paid by the students.

<sup>9</sup> Average annual inflation rate for the non-tradable sector was 4.1 per cent.

<sup>10</sup> The share of foodstuffs industry in the processing industry in the measurement of the PPI is about 17 per cent.

<sup>11</sup> The share of extracting industry in the measurement of the PPI is 9.6 per cent.

<sup>12</sup> Source: Research Department, Products Office, IMF.

<sup>13</sup> Canada and some European countries.

<sup>14</sup> Where bread and grains share 31 per cent.

<sup>15</sup> The quantitative objectives of the Bank of Albania are part of the new PRGF/EFF 2006-2008 arrangement, signed between the Albanian Government, the IMF and the Bank of Albania in January 2006, and lately reviewed in May 2007.

<sup>16</sup> The current average inflation of the second quarter of 2007 (when the Consumer Confidence Survey was carried out) was 1.8 per cent. It identified low expectations of inflation rate in the future from the consumers. Meanwhile inflation rate was in much higher rates, at least in the third quarter.

<sup>17</sup> The corridor of facilities shifted by +0.25 per cent in this period.

<sup>18</sup> The negative change rates of the NEER imply the appreciation of the lek to the currencies of the main trade partners. The positive rates imply its depreciation.

<sup>19</sup> Total deposits are composed of deposits denominated in ALL and deposits denominated in foreign currency (time and demand deposits).

<sup>20</sup> According to the IMF estimations of the GDP and the Bank of Albania estimations.

<sup>21</sup> Services include the sub-sector of trade, hotels and restaurants, transportation, telecommunication and other services where the financial intermediation is part of.

<sup>22</sup> Based on the Short-term Statistics for the second quarter of the year, published by the INSTAT.