



BANK OF ALBANIA

**QUARTERLY REVIEW OF ALBANIAN ECONOMY
(JANUARY - MARCH 2004)**

MAY 2004

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I. GOVERNOR'S SPEECH

The first quarter of 2004 seems to have reinforced the positive development of global economy, the positive signs of which were evidenced since the second half of 2003. Economic recovery is present, both in the United States and Euro area economy, though the economic growth in the latter one has been somewhat more modest, reflecting a larger inertia caused by labor market structure and legal regulations of these economies. Generally, it is estimated that the increased demand is the factor standing behind this economic recovery, though increased investments are also noticed recently in response to increased demand. Sustainability of the momentum of economic growth has led to increased speculations in the international financial markets for a change in the USA's monetary policy stance, while in its two last meetings the ECB put forward many arguments against further interest rate cuts. Such developments have reinforced the conviction that the period of a stimulating monetary policy is over, even though the change of its direction towards a more conservative approach seems still to be far away.

The world economy and international trade growth has provided a positive impact even on the region countries. Given the recent data, it is estimated that our region is featured by a relatively stable performance, reinforcing the expectations for a further macroeconomic consolidation of the regional economy.

The general objectives of the country's macroeconomic development for 2004 are summarized in the achievement of an economic growth rate of 6 per cent. Generally, economic indicators speak for a further strengthening of macroeconomic equilibrium. The economic growth is estimated to be achieved under the conditions of maintaining macroeconomic stability: a declining budget deficit; an inflation of 2-4 per cent; and a stable position of the balance of payments, expressed in the increased foreign exchange reserves and a relatively stable foreign exchange rate. Generally, it is estimated that the conditions that contributed to the same economy growth rates in the previous year, have remained unchanged even during 2004. Sustaining this growth, the Bank of Albania is committed to maintaining inflation within 2-4 per cent. To this end, it will aim at controlling money supply rise to the level of 11.8 per cent during 2004. This growth is forecasted to meet the economy demand for monetary assets and to guarantee the proper liquidity level in the interbank market.

More concretely, it is expected that the production growth in various economy sectors will be the same with that of the previous year, but the Ministry of Agriculture forecasts that the agricultural production growth during 2004 will be not 3 per cent, but 4 per cent. Also, it is estimated that energy sector performance will continue to be in the same level with that of the previous year, reducing the artificial obstacles with regard to overall production. It is forecasted that year 2004 will record a higher level of credit to economy. This estimation is confirmed by the performance of credit to economy during the first quarter, where

the new credit extended was 58 per cent higher than in the same period of the previous year. Also, the positive effect of free trade agreements with the region countries will be more complete during this year, gearing Albanian markets to those of the region.

End of 2003 and first signs of 2004 create the impression that the overall development of our economy during this year will proceed within the parameters forecasted. So, the main monetary and fiscal indicators are within the programmed framework. Following the movement caused by the controlled price change at year-end 2003 and the two first months of the current year, it seems that inflation performance is back within the Bank of Albania target, in similar levels with the previous year.

The combination of optimistic expectations on inflation with positive performance of monetary indicators and the current appreciation of the Lek, under the conditions of the existence of a still-large spread between the Lek and the foreign currency interest rates, made the Bank of Albania review once more the monetary policy stance in April-May, thus decreasing the key interest rate by 0.5 percentage point. With this action, the Bank of Albania aims at creating a better money market equilibrium and promoting banking system lending to economy.

Estimates of the first quarter of 2004 indicate positive developments of monetary indicators, which are deemed to support the Albanian economy growth by 6 per cent in 2004. Unlike the previous years, the lending to private sector of economy is forecasted to occupy the largest part of domestic economy demand for monetary assets. So, the balance of credit to economy is forecasted to grow by Lek 16.4 billion or 33.1 per cent during 2004. The increased lending to economy will sustain more and more the activity and economic growth during 2004 and onwards, by replacing the own equity and commercial credit as traditional financial sources of the Albanian firms. Furthermore, the continuous key interest rate cut by the Bank of Albania is assessed to increase the attraction for credit in Lek, as a valuable alternative for financing the Albanian business. Credit in Lek is forecasted to grow by Lek 4.2 billion during 2004, marking a rise of 39.4 per cent.

The consolidation of fiscal position and the privatization revenues in 2004 will decrease the needs of government for domestic financing against 2003. The domestically budget deficit financing during 2004 is forecasted to be Lek 13.9 billion or 1.9 per cent of GDP in comparison to 2.7 per cent that it was in 2003. The decreased borrowing of government will release more funds for extending credit to economy and will reduce interest rate pressures. On the other hand, the increase of capital expenditures financed from the revenues of the Savings Bank's privatization will provide a positive impact, not only on the economic activity of the current year but also on the improvement of infrastructure needed for the mid-term economic growth.

Regardless of the minimum historical levels of key interest rates, the Bank of Albania notices that the Albanian public is ever more addressing to banks for depositing the savings. Also, the automated payments systems, such as RTGS and ACH, and the public awareness of the advantages the banking system

supplies, will provide an incentive for reducing the quantity of money circulating outside the banking system. Therefore, the deposits in Lek are forecasted to rise obviously during 2004, being increased by Lek 21.9 billion or approximately 8 per cent.

Responding to the developments forecasted in the balance of payments and the monetary conditions in economy, the rest of 2004 would be characterized by balanced pressures on the exchange rate. The decline of interest rate spread between the Lek and the foreign currency will decrease pressures to Lek appreciation.

Notwithstanding the important macroeconomic achievements, the assurance of economic progress needs priority treatment and solution of a number of problems, having the establishment of an attracting framework for domestic and foreign investments in focus. Law reinforcement, establishment and implementation of a legal transparent framework, fair competition, remain fundamental conditions for promoting a welcomed environment to business. Also, the reforming and up-grading of public finance administration and taxation and customs administration, the performance of structural reforms, particularly with regards to privatizing the remained big state enterprises, constitute important challenges over the current period. In this respect, the reduction of political clashes would accelerate the pace of economic reforms and would decrease the impact of politics on economy.

Finally, I would like to emphasize that the drafting of fundamental economic policies, monetary and fiscal ones, has well taken into account the needs of encouraging the country's development for 2004, currently reflected even in the economic indicators of the first quarter. The maintaining of these policies within the programmed framework and the intensification of work for implementing structural reforms will provide a significant contribution to economic growth and to enhancement of the country's macroeconomic stability.

II. ECONOMIC ACTIVITY

II.1 WORLD ECONOMY

The world economy has rapidly perked up in these recent months. The American and Asian economy (except for Japan) influenced most in the world economy growth rates. The economic activity has been greatly stimulated by the overall increase of demand worldwide. The consumer's confidence and business confidence indexes were also higher. Thus, the world economy is considered to have enhanced in the recent months.

Table 1. Main indicators of world economy (in percentage)

	GDD (fourth quarter)	Unemployment	CPI (March)
Great Britain	3.0 *	4.8 (February)	1.1
France	0.6	9.8 (February)	1.7
Germany	0.2	10.4 (March)	1.7
Italy	0.1	8.5 (January)	2.3
Japan	3.4	5.0 (February)	0.0
USA	4.2*	5.7 (March)	1.7
Eurozone	0.6	8.8 (February)	1.7

The GDP data belong to the first quarter of 2004.

Source: "The economist" 1-7 May 2004.

The US economic growth was well-balanced and stable in the first quarter. The gross domestic product rose by 4.2 percent, reflecting thus an expansion in private and public expenditures and export's growth. Investments remained at good levels thanks to a favorable financing climate and a better economic situation of companies. The labor market – one of the factors putting at risk the economic growth – marked positive developments in march.

The Eurozone economy indicators of the first quarter of 2004 suggest that the economic growth – though a modest one – will go on in the short-term period. This growth is supported by the internal as well as the external environment. Investments are deemed to soar thanks to a favorable financing climate and current satisfactory financial results of European companies. Meanwhile, the economic growth of the global economy has provided a stable growth of the Eurozone exports' demand. Hence, exports are expected to rise throughout 2004, despite the Euro appreciation, which reduces completion of European exports.

However, the domestic demand remains one of the weaknesses of the European economies. Despite rather more stable employment indicators of this period compared to earlier ones, it is still at low levels. At a great extent, changes in the economy performance of the Eurozone countries reflect changes in their own

domestic demand; the lowest in Germany and then higher in Greece, Spain and Ireland.

The European Central Bank and the Fed did not change the core interest rate in this quarter. The Bank of England increased the core interest rate by 0.25 percentage points in February 2004, bringing it to the 4 per cent level.

II.2 ECONOMIC ACTIVITY

The Albanian economy has had quite a rapid growth in these recent years. The satisfactory growth rates are mainly due to the private sector development, which has been backed up by stabilizing economic policies and a relatively quiet political life.

The economic growth of 6 per cent in 2004 is considered to rely mostly on the growth of the service, construction and industry sectors. Agriculture and industry are forecasted to have lower growth rates.

Table 2. Forecasted economic growth in 2004 (in percentage)

	2002	2003	2004
Real growth of the GDP	4.7	6.0	6.0
- Industry	1.8	2.7	3.1
- Agriculture	2.1	3.0	3.0
- Construction	8.7	11.3	10.6
- Transport	9.7	10.8	10.1
- Services	5.1	6.4	6.4

The economic analysis of the first quarter shows that the Albanian economy is on-track in fulfilling the economic growth objective.

II.2.1 AGRICULTURE¹

Based on the initial assessments of the Ministry of Agriculture and Food, production is forecasted to increase by 4 per cent in 2004. The highest contribution will continue to be that of agriculture-animal farming sector. The forecasts suggest that the growth rate will be the same as in the previous year. In addition, implementation of projects on agriculture infrastructure will lay the foundations of a more sustainable development of this branch. The Ministry of Agriculture and Food is engaged in 13 projects, 4 of which are supposed to begin in 2004. Rehabilitation of irrigation and agriculture service project will have priority.

¹ Under the agriculture branch are included these sectors: agriculture-animal farming, agroindustry and fishing industry.

The agroindustry sector is expected to have a 10 per cent growth rate, or 1.2 percentage points less than in 2003. This lower pace is explained by the old technology, lack of raw material and serious (domestic or foreign) investments. Fishing industry will have a considerable growth. The production is going to boost twice as much if adequate steps are made to improve infrastructure in ports, as well as supporting policies are introduced from the government such as the price differentiation of the fuel used in the fishing industry.

Table 3. Forecasted performance of agricultural production in 2004

	Growth (in %)	Value (in Lek billion)
Agriculture	3.0	194.7
Agroindustry	10.0	41.5
Fishing industry	4.0	2.4
Total	4.0	238.6

Source: Ministry of Agriculture and Food

The detailed performance of the agricultural production – as to the main items – is given in the following table.

Table 4. Forecasted performance of agricultural and farming production in 2004

	Growth (in %)	Value (in Lek billion)
Field crops	0.5	83.8
Fruit-growing	5.9	20.3
Farming	4.3	90.6
Total	3.0	194.7

Source: Ministry of Agriculture and Food

II.2.2 ENERGY

The country's power consumption increased by 3.3 per cent in the first quarter of 2004 compared to the respective quarter of last year. The upward supply of the economy has fulfilled at best its needs, being thus a strong assumption on the growth of the economic activity. The drop of the domestic power production was compensated by import increase in this quarter.

The domestic power production rose by 223 GVVh compared to the first quarter of 2003; however, it was 364.2 GVVh higher than the previous quarter. Imports (transactions included) soared in this period, though compared to the previous quarter they fell by 20 per cent. Imports constitute 13.3 per cent of the power resources, from 19.9 per cent they were in the previous quarter.

Table 5. Power balance (in GWh)

	Q1 '02	Q1 '03	Q1 '04	Q1 '04 / Q1 '03 (in %)
Total sources	1360.2	1975.7	1853.0	-6.2
- Production	732.5	1829.1	1606.1	-12.2
- Import (transactions included)	627.7	146.6	246.9	68.4

Total uses	1360.2	1975.7	1853.0	-6.2
- Power station use	9.2	9.7	5.0	-48.3
- Export (exchanges included)	8.7	251.0	82.2	-67.3
- Losses in the network	516.0	730.2	748.9	2.6
- Domestic consumption use	826.3	984.7	1016.9	3.3
From which:				
- Families	516.5	616.2	635.7	3.2
- Others unspecified	309.8	368.5	381.2	3.4

Source: INSTAT.

II.2.3 FISCAL SECTOR

Fiscal indicators were at much lower levels than the forecasts made. According to the data issued by the Ministry of Finances, only 95 per cent of the planned revenues are collected and 93 per cent of the programmed expenditures. Hence, the budget deficit by the end of the first quarter was about Lek 1.5 billion less than the forecasted level.

Table 6. Fiscal indicators (in Lek billion)

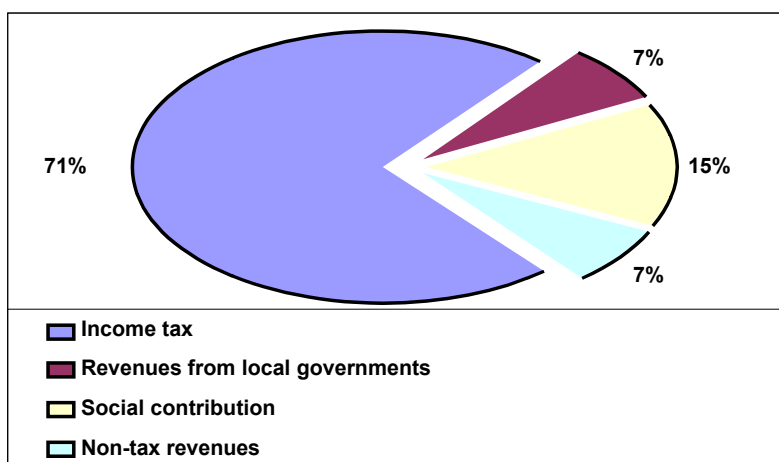
	Q1 '04	Realization(%)	Q1 '04 / Q1 '03 (in %)
Revenues	41.3	95	17
Expenditures	43.3	93	9
Deficit	-2	57	-53

Source: Ministry of Finances

▪ Budget revenues

Budget revenues were about 17 per cent higher than the respective quarter of 2003. Income tax reached the level of 37.7 Lek billion or about 13 per cent more than the same period last year. Income tax and customs tax together were about 98 per cent of the plan, marking thus an increase of 11 per cent compared to 2003.

Graphic 1. Budget revenues structure



Source: Ministry of Finances

Unlike past quarters, value added taxes were higher than what was forecasted – 12.5 Lek billion, a 105 per cent realization of the plan.

Table 7. Progressive fiscal indicators as to the consolidated budget (in Lek billion)

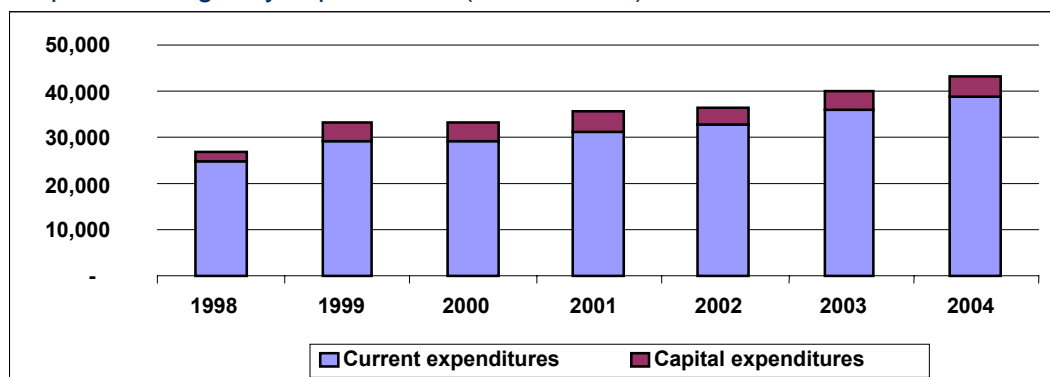
	Januar y	Februa ry	March	Plan	%	Annual plan
Total revenues	12.1	25.5	41.4	43.3	95.5	198.1
1. Tax revenues	11.0	23.1	37.7	37.9	99.6	170.6
- Value added tax	3.9	8.0	12.5	11.9	105.0	57.1
- Income tax	1.0	2.0	3.6	3.7	98.3	15.2
- Excise tax	1.0	1.9	2.9	3.4	84.0	16.2
- Customs tax	0.9	1.8	3.0	3.0	97.2	14.7
- Local government	0.6	1.5	3.5	2.8	122.4	11.3
- Social contribution	2.2	4.7	7.6	7.8	97.4	33.7
- Social insurance	2.0	4.3	7.0	7.2	97.2	30.9
- Health insurance	0.2	0.4	0.7	0.6	100.5	2.8
2. Non-tax revenues	1.2	2.2	3.4	4.3	78.7	20.8

Source: Ministry of Finances

▪ Budget expenditures

Budget expenditures were 43.3 Lek billion, or 93 per cent of the programmed level. From these, 55 per cent were covered by foreign financing and 95 per cent by domestic financing. The budget expenditures lag was, amongst other things, due to the long procedures when dealing with various projects.

Graphic 2. Budgetary expenditures (in Lek billion)



▪ Fiscal deficit

Fiscal deficit was lower than the forecasted level – 57 per cent. Expenditures remained at lower levels from what was already forecasted in the budget. On the other hand, contrary to the two last years trend when deficit was mainly covered by domestic sources, during the first quarter of 2004 it was covered by foreign sources.

III. INFLATION PERFORMANCE

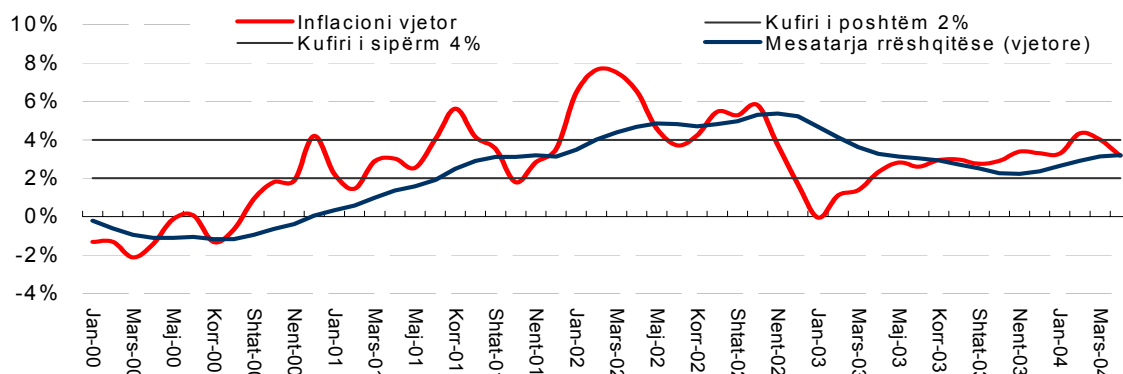
III.1 INFLATION PERFORMANCE AND COMPONENTS

The first quarter of 2004 was featured by high annual inflation rates. The highest rate was marked in February. It came due to the increase of the administered prices in December '03 – February '04. However, the positive balance of factors affecting inflation and the review of fixed line telephony prices in April brought down inflation rate during March – April. The annual rate fell to the upper-level of the target range in March, and in April it came close to the mid target range value. The inflation rate was 3.14 per cent by the end of the first quarter and 3.22 per cent in April.

TABLE 8. ANNUAL INFLATION RATE (IN PERCENTAGE)

	2000	2001	2002	2003	2004
January	-1.3	2.2	6.5	0.0	3.3
February	-1.3	1.5	7.6	1.1	4.4
March	-2.1	2.9	7.5	1.3	4.0
April	-1.4	3.0	6.5	2.3	3.2
May	-0.1	2.5	4.6	2.8	
June	0.1	4.0	3.7	2.6	
July	-1.3	5.6	4.2	3.0	
August	-0.7	4.1	5.5	3.0	
September	0.9	3.5	5.3	2.8	
October	1.8	1.8	5.8	2.9	
November	1.9	2.8	3.7	3.4	
December	4.2	3.5	1.7	3.3	

Graphic 3. Annual inflation (in percentage)



Inflation performance of the first quarter of 2004 reflected mainly the decisions taken on the increase of some of the administered prices, such as the fixed line

telephony, power and transport. All this lead to the rise of “Rent, water, fuel and energy” index.²

Table 9. Main groups’ contribution to the annual total inflation (in percentage points)

	March 03	April 03	Dec. '03	Jan. '04	Feb. 04	March 04	April. 04
Food and non-alcoholic drinks	1.11	2.09	1.20	1.41	1.19	1.00	0.06
Rent, water, fuel & energy	-0.18	-0.18	0.95	0.87	1.98	1.94	2.54
<i>Fuel and energy</i>			0.30	0.31	1.60	1.55	1.56
Hotels, Cafés, Restaurants	0.21	0.24	0.18	0.17	0.35	0.32	0.28
Transport	0.31	0.25	0.14	0.00	0.03	-0.07	-0.03
Communication	-0.06	-0.06	0.67	0.67	0.67	0.67	0.21
Other groups	-0.09	-0.04	0.16	0.18	0.18	0.18	0.14
Total	1.3	2.3	3.3	3.3	4.4	4.0	3.2

The increase of the power price by 31.2 per cent in January transformed into an increase to 8.5 per cent of this group annual inflation rate in February and to 8.3 per cent in March. The impact of the sub-group “Fuel and energy” on total inflation was 1.6 percentage points in February and 1.55 percentage points in March, from 0.31 percentage points it was in January. The 3.5 per cent rent rise caused annual inflation of the group “Rent, water, fuel, energy” jump to 11 per cent. This group influenced by 2.54 percentage points the annual inflation rate in April.

Table 10. Monthly and annual rate of the group “Rent, water, fuel and energy”

	"Rent, water, fuel and energy"		"Rent"		"Fuel and energy"	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
January '04	0.0	3.7	0.0	2.6	0.3	6.9
February '04	4.9	8.5	-0.5	2.1	26.4	35.0
March '04	0.0	8.3	0.0	2.1	-0.1	35.0
April '04	2.4	11.0	3.5	5.6	0.1	35.1

The contribution of “Food and non-alcoholic” group has been going downward in the first quarter of 2004. The reduction of the bread price and consequently the drop of inflation rate of “Bread and corn” group brought about the drop inflation rate in March. However, the contribution of this group during April was a modest one of about 0.06 percentage points, much lower than what it was in April 2003 – 2.09 percentage points.

Table 11. Monthly and annual rate of the group “Food and non-alcoholic”

	"Food and non-alcoholic"		"Fruits"		"Vegetables"	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
January '04	-0.2	3.2	-4.3	9.2	0.2	13.1

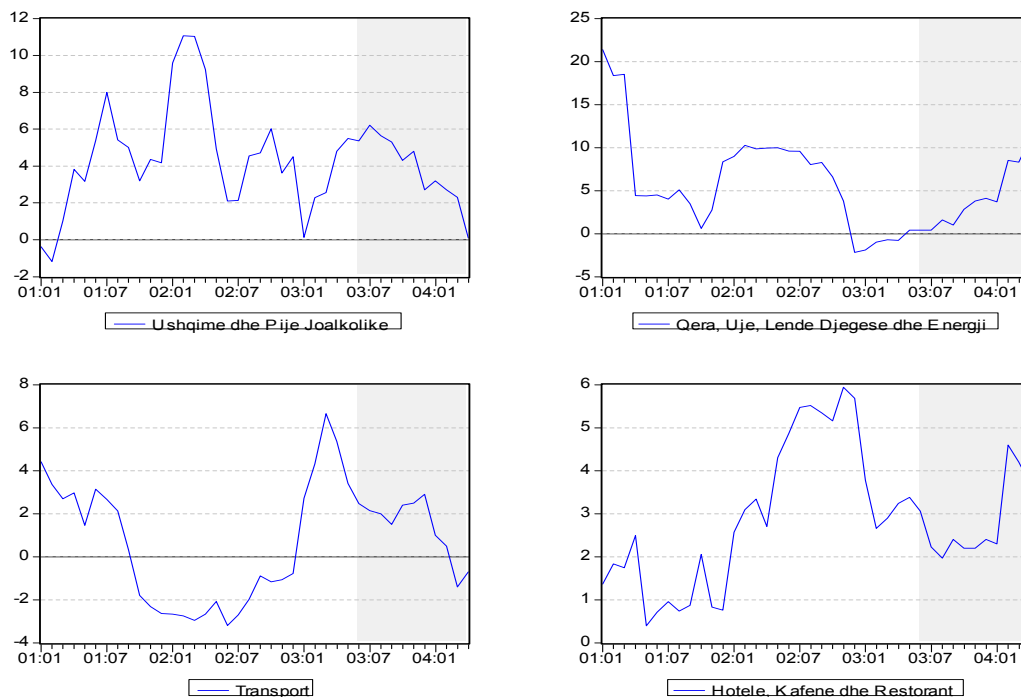
² The group “Rent, water, fuel, energy” comes second in the weight of the CPI basket. It comprises about 24 per cent.

February '04	1.4	2.7	1.4	6.6	1.7	4.7
March '04	0.3	2.3	13.3	16.9	-2.4	-1.3
April '04	-0.2	0.1	7.3	16.9	-5.1	-12.3

The increase by 32.2 per cent of transport prices was another factor that influenced inflation rate of this quarter. The monthly inflation rate of this group was 1.4 per cent in February.

Nevertheless, the rise by 68.8 per cent of fixed line telephony in December 2003 had a somehow stable influence on inflation. "Communication" group contributed by 0.67 percentage point until March. The reduction of fixed line telephony price by 28.5 per cent in April led to a drop of April inflation by 0.21 percentage point.

Graphic 4. Annual inflation of the main four items of CPI basket (in percent.)



III.2 FACTORS INFLUENCING INFLATION

The first quarter of 2004 – unlike 2003 – had an unusual rise of inflation rates. The rise of administered prices brought about a disorder of inflation performance. Most influential and worrisome one was the rise of power price, since it could lead to a chain-price rises in products and services where it serves as an input. Nevertheless, the price performance of the first quarter does not give any signs of such a phenomenon.

Imported inflation is one of the supply factors influencing constantly our inflation rate. However, it gave a mild influence in this quarter. Annual inflation rate in Italy

and Greece during January – March were lower than those by the end of 2003. Fluctuations in exchange rate have lessened the influence of imported inflation. On annual basis, Lek has appreciated by about 18.9 per cent against USD and 5.3 per cent against Euro during the first quarter of the year.

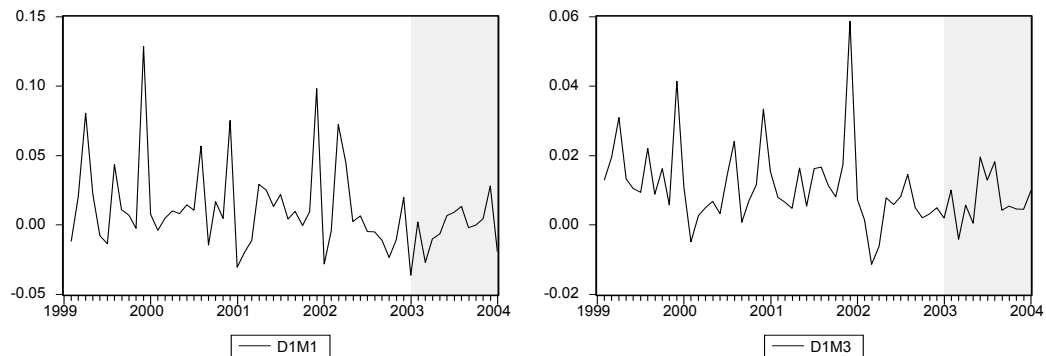
Table 12. Annual inflation of main trading partners (in per cent)

	September	October	November	December '03	January '04	February	March
Greece	3.3	3.2	3.4	3.1	3.1	2.6	2.9
Italy	3.0	2.8	2.8	2.5	2.2	2.4	2.3

Demand driven factors have generally performed as to the forecasts, having a positive influence on inflation.

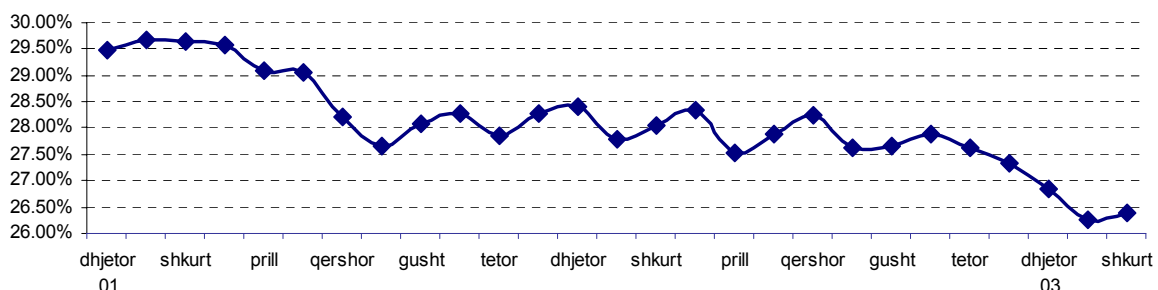
Monetary policy implemented by the Bank of Albania – despite the gradual core interest rate cut last year – continues to reduce inflationary pressures in economy. Thus, the difference between Lek interest rates and foreign exchange ones keeps Lek at high levels. Meanwhile, the money supply liquidity rates have improved significantly. Their annual growth rates are within the forecasts.

Graphic 5. Annual growth rate of M1 and M3 (in percent)



The moderate growth of budget expenditures and observance of their planned levels did not give rise to any inflationary impulses. Their uniform spread throughout the year provided non-inflationary trends in the first quarter of 2004. In addition, realization of these expenditures within the planned limits does not transmit inflationary impulses for the period ahead.

Graphic 6. Budgetary expenditure performance in 2003 (in percentage versus the GDP)



IV. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

IV.1 MONETARY POLICY AND QUANTITATIVE OBJECTIVES

The Bank of Albania has pursued a neutral monetary policy in the first quarter of 2004. This stance was forced by high inflation rates during this period. Monetary conditions in economy did not add up inflationary pressures. Money supply has been driven by less liquid monetary assets, reflected by the continuous decline of money outside banks ratio versus M3.

The neutral monetary policy has been carried out through Repo auctions at a fixed price of 6.5 per cent, by withdrawing the excess liquidity during this period. In order to lessen the downward pressures on interest rates, the Bank of Albania withdrew Lek 4.5 billion liquidity in March by means of outright sales of treasury bills of its portfolio. Interest rates had downward trends affected by the cut of core interest rates in December 2003. Except for the impact of this cut, the Lek interest rates have been relatively stable.

Inflation and inflationary pressures eased after February, and monetary indicators remained positive. The money outside banks ratio versus money supply was 25.7 per cent³ in March. This has been the lowest level of this ratio since 1992. Also, the annual growth of money supply was relatively low in this quarter. The Lek exchange rate showed appreciation trends against Euro. However, it was rather more stable against USD. Under these circumstances, the Bank of Albania cut the core interest rate twice by 0.25 percentage point in April and May. Hence, Repo rates fell from 6.5 per cent to 6 per cent. Second-tier banks are expected to reduce deposit and loan interest rates following the Bank of Albania's changes.

Monetary objectives set by the Bank of Albania have been guaranteeing the observance of quantitative objectives. The milder monetary conditions in April and May are not expected to threaten their fulfillment.

³ Calculated based on "International Financial Statistics" standards.

Table 13. Realization of quantitative objectives at the BoA

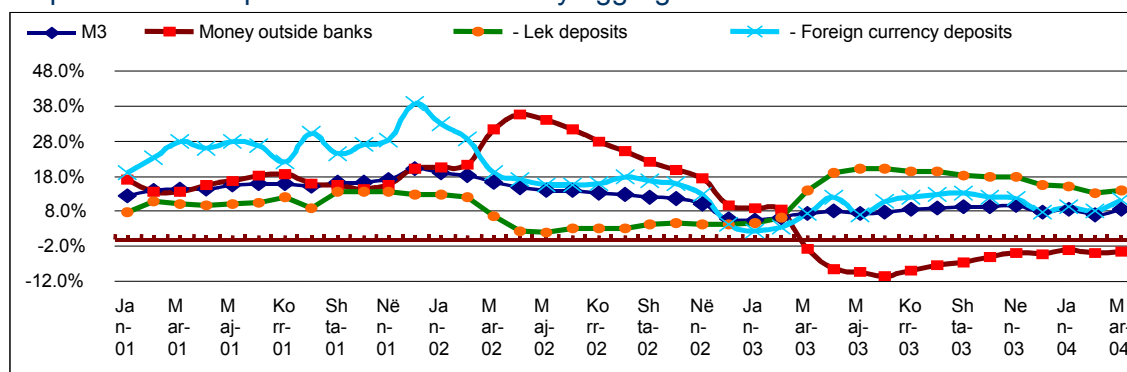
	June '03	September '03	December '03	March '04	April '04*
Net international reserve (in USD million)					
Objective	582.2	576.2	583.2	619.2	623.8
Actual	607.3	614.3	673.9	678.2	799.2
Difference	25.2	38.2	90.7	59.0	175.4
Net domestic assets (in Lek billion)					
Objective	98.1	89.1	93.1	80.1	80.8
Actual	68.8	73.3	68.5	61.7	44.8
Difference	-29.4	-15.9	-24.6	-18.4	-36.0
Net domestic credit to the government (in Lek billion)					
Objective	267.7	278.1	280.9	286.1	284.8
Actual	268.1	276.0	280.1	286.1	--
Difference	0.4	-2.1	-0.7	0.0	--

* April data are operative

IV.2 MONETARY AGGREGATES

Monetary indicators were below the average historical levels of these last years. The annual growth rate of the money supply was stable, fluctuating round the average level of about 8 per cent. The cut of Lek deposits interest rates did not affect the ratios of money supply constituents. The downward trend of money outside banks ratio against money supply maintained the same rate as before. This ratio came to 25.7 per cent⁴ in March. This is its lowest level in the last 5 years.

Graphic 7. Annual performance of monetary aggregates



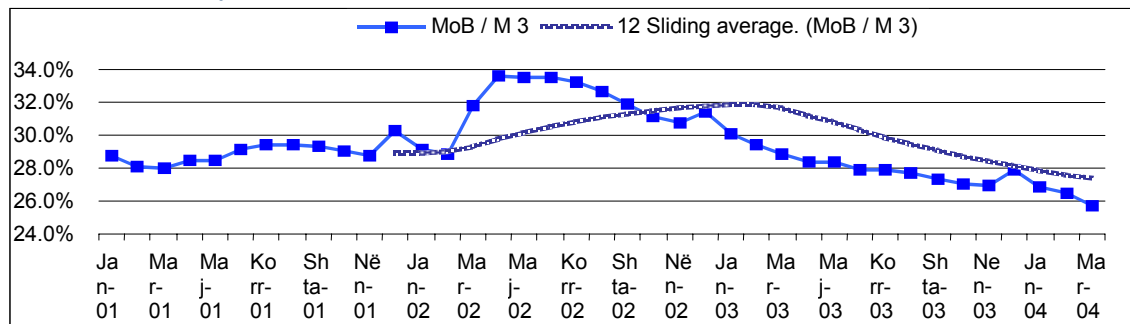
The annual growth rates of foreign exchange deposits are higher than the respective period in 2003. This is an outcome of the positive performance of foreign exchange demand deposits. However, the term deposits have been reflecting a downward trend even during this quarter. An underlying factor in the

⁴ Calculated based on "International Financial Statistics" standards.

performance of foreign exchange deposits was the exchange rate; the annual appreciation of Lek against Euro and USD brought down their level by 11.3 per cent. If putting apart the exchange rate impact, their growth is 25.5 per cent.

Lek deposits had the highest annual growth rate. However, they dropped from 15.7 per cent to 14.0 per cent. Such a performance complies with the trend to approach its normal levels. It reflects mainly the lowest rate of return of money into the system. Moreover, the demand of government and economy for monetary assets was lower, and this slowed even more the Lek deposits growth.

Graphic 8. Money outside banks ratio versus M3



The rise of inflation rate in this first quarter had negative impacts on real interest rates of term deposits in Lek. By the end of March, their level was 1.24 percentage point lower than three months ago. Nevertheless, the fact they remained in positive levels led to a further fall by 1.4 percentage point of money outside banks ratio against M3 during January – March. Negative annual rates were also noticed in this first quarter. The annual change rate of money outside banks was –3.4 per cent by the end of March.

Table 14. Monetary indicators (in Lek billion)

	March 2004	Quarterly change		Annual change	
		Absolute	Percentage	Absolute	Percentage
Money outside banks	117.2	-8.0	-6.4	-4.1	-3.4
Total deposits	338.8	15.5	4.8	39.4	13.2
- Lek	235.7	11.4	5.1	29.0	14.0
- Foreign currency	103.1	4.1	4.2	10.5	11.3
Demand deposits	64.2	7.7	13.5	6.6	11.5
- Lek	23.7	4.2	21.4	1.0	4.3
- Foreign currency	40.5	3.5	9.4	5.7	16.2
Term deposits	274.6	7.9	3.0	32.8	13.6
- Lek	212.0	7.2	3.5	28.0	15.2
- Foreign currency	62.6	0.7	1.1	4.8	8.3

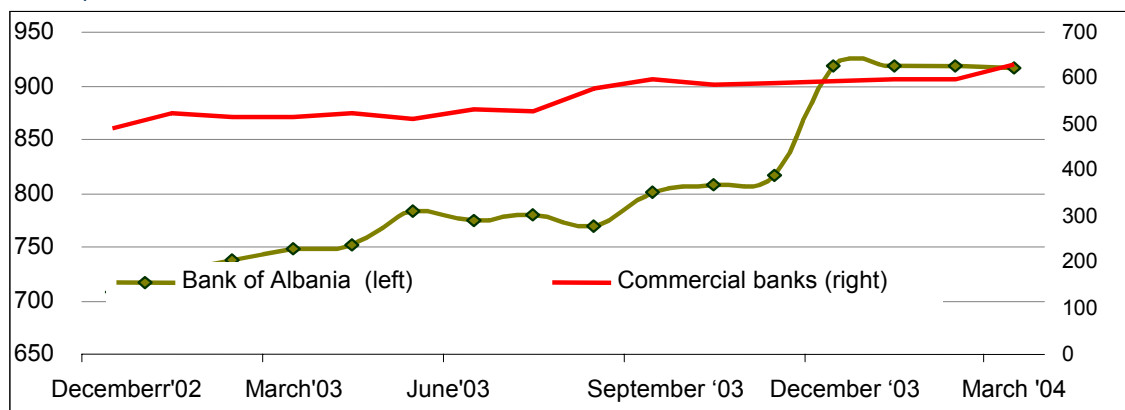
M1	140.9	-3.8	-2.6	-3.1	-2.2
M2	352.9	3.4	1.0	24.9	7.6
M3	456.0	7.5	1.7	35.3	8.4
Monetary base	154.4	-6.1	-3.8	-3.4	-2.2

IV.3 ECONOMY DEMAND

IV.3.1 FOREIGN EXCHANGE POSITION IN THE BANKING SYSTEM

Net foreign assets of second-tier banks increased by USD 37.8 million, an increase which brought about an increase of USD 34.6 million of net foreign assets in the whole banking system. The opposite happened to the Bank of Albania net foreign assets (denominated in USD) that fell by USD 3.2 million. Foreign currency deposits increased and this resulted in Lek 4.1 billion. Loans in foreign currency increased by Lek 1.3 billion.

Graphic 9. Performance of net foreign exchange assets of the banking system (in USD million)



The drop of net foreign assets of the Bank of Albania was partly a result of the depreciation of Euro against US dollar.

The Euro depreciation by 3.0 per cent against US dollar reduced the value of investments converted in US dollar. Excluding the exchange rate USD/Euro impact, the Bank of Albania's net foreign assets fell by USD 1.3 million. Negative impacts had also the foreign transactions with the Ministry of Finances. Denominated in Lek, they brought about a fall of Lek 0.5 billion.

IV.3.2 DOMESTIC CREDITING

Domestic crediting rose by Lek 5.9 billion. The increase of the government demand for monetary assets was about 54 per cent of the domestic crediting, whereas the rest came from the rise of economy crediting.

Table 15. Domestic credit structure (in Lek billion)

	December	March	Difference	
	2003	2004	Absolute	Relative
Domestic crediting	320.8	326.7	5.9	1.8%
1. Expectations from the government	270.1	273.3	3.2	1.2%
<i>Monetary Authority</i>	65.5	60.8	-4.7	-7.2%
<i>Commercial banks</i>	204.6	212.5	7.9	3.9%
2. Credit to economy	50.7	53.3	2.6	5.1%
Public sector	0.0	0.0	0.0	0.0%
Private sector	50.6	52.9	2.3	4.5%
Financial institution	0.1	0.4	0.3	300%

The economy crediting performance was higher than the one of government crediting, however in relative terms. Consequently, it has a larger size in the total domestic crediting. The credit to the economy ratio against domestic crediting came to 16.3 per cent in March from 15.8 per cent it was three months ago.

Table 16. Main indicators of the domestic credit (versus M3)

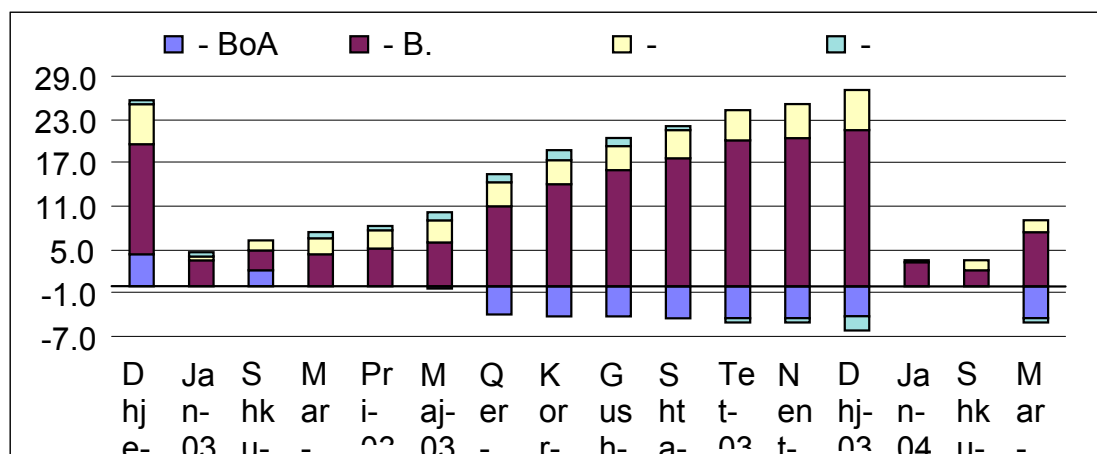
	2002	Q1 '03	Q2 '03	Q3 '03	Q4 '03	Q1 '04
Domestic crediting	70.8	71.2	71.4	70.9	71.5	71.6
-Credit to the government	61.5	61.6	61.0	60.1	60.2	59.9
-Credit to the economy	9.3	9.6	10.4	10.8	11.3	11.7

— CREDIT TO THE GOVERNMENT

Budget deficit was Lek 2.52 billion by the end of March, or 51.5 per cent lower than the respective period of 2003. Net claims of the banking system increased by Lek 3.2 billion.

Deficit was mainly financed from domestic sources with about Lek 5 billion (commercial banks only, since the Bank of Albania did not participate). Moreover, because of outright operations, the treasury bills portfolio dropped by Lek 4.5 billion. Households added about Lek 1.7 billion to treasury bills portfolio.

Graphic 10. Cumulative performance of budget deficit financing (in Lek billion)



The government issued about Lek 0.8 billion-government bills.

— **CREDIT TO THE ECONOMY FROM THE BANKING SYSTEM**

Credit balance increased by Lek 2.4 billion, or about 41.1 per cent higher than the first quarter of 2003.

Lek appreciation against Euro and USD brought about the fall of the value in Lek of foreign currency credit portfolio. Lek appreciation – respectively by 0.1 per cent and 3.0 per cent against USD and Euro – reduced credit to economy by Lek 0.9 billion. Excluding this impact, the real growth of credit balance is Lek 3.2 billion.

Table 17. Credit balance indicators, in percentage

	2002	Q1 '03	Q2 '03	Q3 '03	Q4 '03	Q1 '04
Short-term credit	53.8	53.2	53.4	51.4	45.5	44.4
Mid-term credit	30.1	30.4	30.7	30.5	37.0	34.4
Long-term credit	16.1	16.4	15.9	18.1	17.5	21.2
Private sector	99.8	99.8	100.0	100.0	100.0	100.0
State sector	0.2	0.2	0.0	0.00	0.0	0.0
Lek	21.3	21.5	21.2	19.3	19.6	20
Foreign currency	73.7	78.5	78.8	80.7	80.4	80
Credit balance (in Lek billion)	38.7	40.4	44.5	48.0	50.6	52.9

Positive trends of economy crediting are especially noticed in the new extended credit index. The new extended credit in this first quarter mounted to Lek 28 billion or 58 per cent more than the respective period of 2003. Although this was

a high level, it was not of any significant help to increase the credit balance, since credits in Albania are mostly short-term credits

Table 18 Credit performance (in Lek billion)

	2002	Q1 '03	Q2 '03	Q3 '03	Q4 '03	Q1 '04
Short-term credit	44.7	11.6	17.5	15.6	18.3	18.7
Mid-term credit	13.0	4.3	5.6	4.2	8.0	5.7
Long-term credit	4.8	1.5	1.5	1.8	2.6	3.5
State sector	0.06	0.05	0.0	0.0	0.0	0.0
Private sector	62.5	17.4	24.6	21.6	28.9	27.9
Lek	20.8	7.1	8.0	7.4	8.3	8.8
Foreign currency	41.8	10.4	16.6	14.2	20.6	19.1
New credit (in Lek billion)	62.6	17.5	24.6	21.6	28.9	27.9

Trade, processing industry and real estate are the branches that get the strongest support from the banking system. During January-March 2004, about Lek 144 million went to agriculture. The agro industry and animal farming sectors are not lagging behind with respect to the crediting process.

The Saving Bank privatization is deemed to increase crediting in agriculture, since it has a wide geographical spread throughout the country.

Table 19 Balance credit as to the branches of the economy (in percentage)

	2002	Q1 '03	Q2 '03	Q3 '03	Q4 '03	Q1 '04
1 Agriculture, hunting and silviculture	0.8	1.1	1.2	1.3	1.0	1.0
2 Fishing industry	0.2	0.2	0.2	0.2	0.0	0.1
3 Extraction industry	0.2	0.2	0.2	0.2	1.0	0.2
4 Processing industry	17.0	14.9	16.0	17.1	17	16.9
5 Production, distribution of power, gas and water	3.3	3.1	2.8	3.1	3	3.0
6 Construction	8.6	8.1	8.4	9.1	10	9.7
7 Trade, automobile repair and home appliances	40.4	40.5	38.4	35.9	34	31.4
8 Hotels and restaurants	6.0	6.3	6.2	6.2	6	7.1
9 Transport and telecommunication	2.4	2.1	1.8	1.8	1	2.0
10 Financial activities	-	0.0	0.0	0.0	0	0.1
11 Real estate	9.1	5.6	10.2	12.5	13	13.7
12 Health and social activities	0.5	0.5	0.5	0.5	0	0.5
13 Group, social and personal services	4.2	7.8	7.0	8.1	8	4.2
14 Others	7.3	9.5	7.1	6.1	4	10.1
Total	100	100	100	100	100	100.0

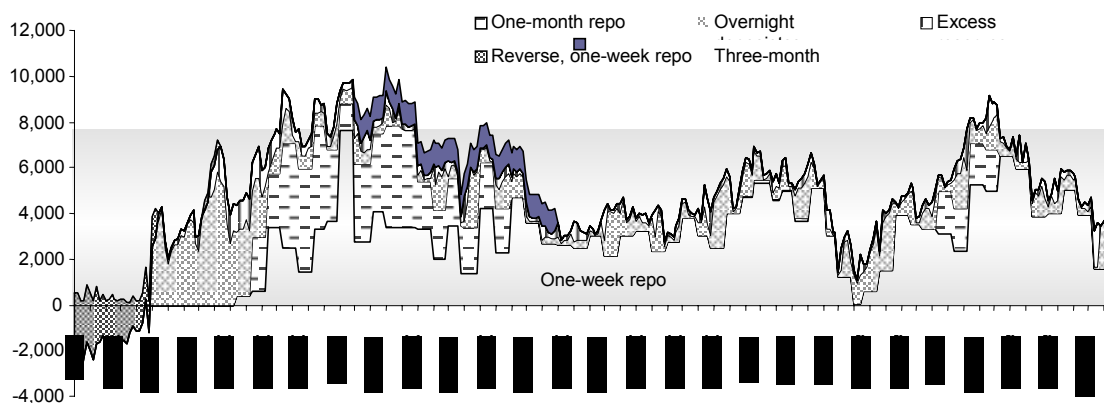
IV.4 FINANCIAL MARKETS AND INTEREST RATES

IV.4.1 FINANCIAL MARKETS

The banking system liquidity has been quite stable, fluctuating round the level of Lek 5.2 billion. This level is about Lek 1.2 billion higher than the first quarter of 2003⁵. This year's liquidity was influenced by satisfactory growth rates of Lek deposits, though government demand for deficit financing was relatively low.

One-week Repo instrument of fixed interest was used with the aim of drawing in liquidity. In addition, in order to reduce pressures on interest rates, the Bank of Albania announced one-month maturity auctions and outright government security auctions. Thus, liquidity was insured for quite a long time.

Graphic 11. Banking system reserves (in Lek billion)



Overnight deposit was one of the standing facilities provided by the Bank of Albania (the average volume was Lek 0.9 billion). Overnight loan has been rarely used.

Interbank market transactions have been mainly used to cover short-term needs thanks to a sufficient liquidity level. This volume has fluctuated mainly round the figure of Lek 0.3 billion a day, compared to Lek 0.5 billion it was in 2003.

⁵ During the first two months of 2003, the banking system was lacking liquidity. Bank of Albania operations consisted in reverse Repo auctions (liquidity injection into the system)

IV.4.2 INTEREST RATES

Banks reduced Lek deposits interest rates in the primary as well as in the interbank market, following the cut to 6.5 per cent of the core interest rate in December 2003.

The following table shows that the cut by 0.5 percentage point in the first quarter has not been entirely reflected in the primary market. The loan market, on the other hand, seems to have been quite not influenced by the Bank of Albania's signals. Actually, Lek loans interest rates dropped in all maturity terms, except for those of a 6 –12-month term. The average weighted interest for this group soared due to structural⁶ changes in March. The reduction of interest rates in other maturities did not compensate the impact of average weighted rate on increasing the total loan interest rate.

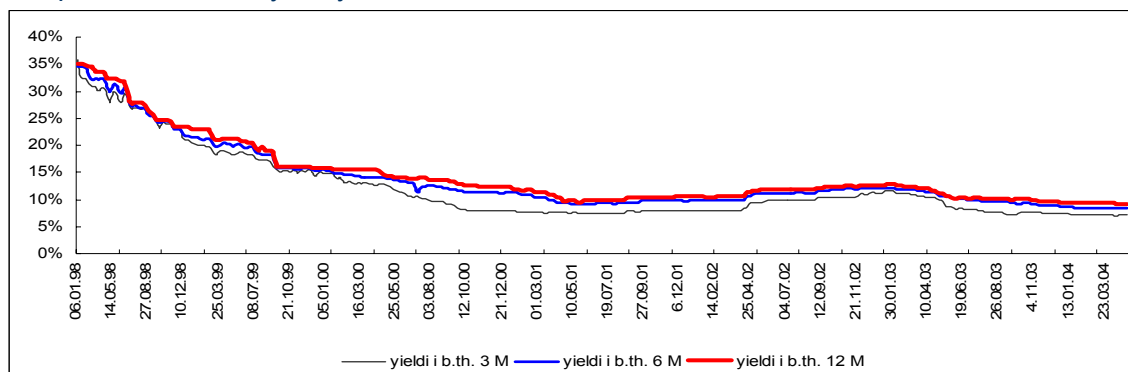
Table 20. Interest rates during the first quarter of 2004 (In percentage point)

Interbank market	Deposits	Treasury Bills*	Loans
-0.61	-0.54	-0.30	0.32

*The average yield rate for the three of maturities (3, 6 and 12-month)

There is a higher competition in the primary market due to a higher supply versus the government demand for liquidity. Consequently, treasury bills yield has had a downward trend from one auction to the other. Hence, the treasury bills yield reached the lowest level since 1998.

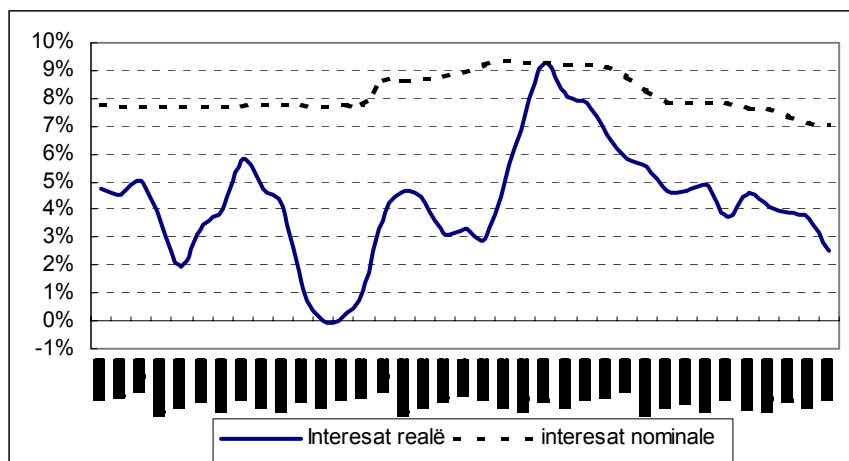
Graphic 12. Treasury bill yield



The average level of real interest rates of 12-month Lek deposits was 3.4 per cent

⁶ About 74 per cent of total loans – occupied by this group – were moved to up to 6 months loans.

Graphic 13. Real and nominal interest rates of 12-month Lek deposits



The further smoothing of monetary policy during April – May brought about a further drop of interests in markets, a drop which is expected to go on in the coming days. The interbank market reduced immediately the interest rates. Interest rates of Euro and USD deposits have reflected a slight downward trend in all maturities except for the three-month ones that went up. The average level was 0.48 per cent (USD) and 0.74 per cent (Euro). This does not leave space for a further reduction.

The foreign currency loans market has showed more fluctuation than the deposits one, though there has always been a downward trend. The average interest rate level dropped by 1.91 percentage point (loans in USD) and 0.56 percentage points for loans in Euro.

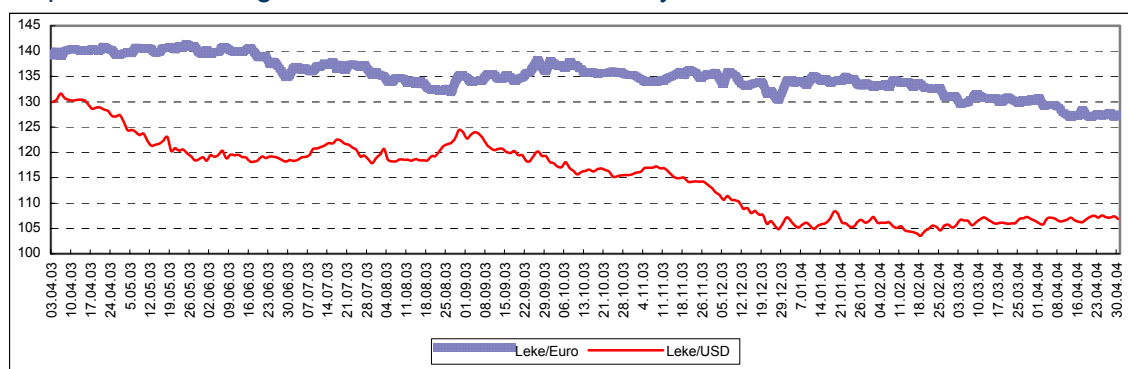
DOMESTIC FOREIGN EXCHANGE MARKET

Lek has appreciated during this quarter. It was almost stable against USD and appreciated by 3 per cent against Euro. The exchange rate Lek/Euro was 130.23 and Lek/USD was 106.51.

This appreciation came mostly due to the difference between Lek and foreign exchange interest rates. The interest rates cut by the Bank of Albania have lessened pressures of this factor on Lek exchange rate appreciation. Moreover, the downward trends of money outside banks and monetary base was another factor to Lek appreciation⁷.

⁷ Money outside banks dropped by 6.8 percent; monetary base dropped by 4 per cent.

Graphic 14. Exchange rate in the domestic currency market



The average exchange rate in this first quarter was 132.46 Lek/Euro and 106.02 Lek/USD

Table 21. Exchange rate in three months

	I-03	II-03	III-03	IV-03	I-04
Lek/Euro	0.9	-3.8	2.0	-2.6	-3.04
Lek/USD	-6.5	-9.6	-0.3	-9.8	-0.07

* * *