

**BANK OF ALBANIA**

**QUATERLY REVIEW  
OF ALBANIAN ECONOMY**

**FIRST QUARTER, 2005**

**JUNE 2005**

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## I. GOVERNOR'S SPEECH

First months of 2005, though under the conditions of incomplete data, seem to have maintained the paces observed recently. First quarter of 2005 is assessed as having maintained unchanged the main macroeconomic ratios present during the last quarter. This gives us the possibility to deem that Albanian economy is expected, for the rest of 2005, to continue further consolidation of the country's macroeconomic stability, in accordance with the objectives specified in the mid-term development program of the country for 2005 – 2007.

More concretely, during the year there is intended a stable economic growth at about 6 per cent, an annual inflation level within the 2 – 4 per cent band, an adequate level of foreign reserves, and a further narrowing of current account deficit. The economic growth for 2005 is expected to be sustained mainly by rise in the sectors of services, construction and further on by rise in the sectors of transport, agriculture and industry.

Budget revenues during 2005 are expected to mark an annual growth of about 12 per cent compared to 2004, maintaining the same relative level to GDP (22.5 per cent). On the other hand, while performing public spending, the increase of efficiency and better financing of sectors and priority programs is intended. Continuation of reforms in taxation and customs administration, as part of structural reforms of the country, associated with the efforts to restrict the informal economy extension, will increase the level of budget revenues and will create the possibility for raising the expenditures, particularly in the main sectors of economy.

The maintaining of inflation rate at low positive levels is the mid-term strategic objective of the monetary policy pursued by the Bank of Albania. Low positive inflation levels ensure market stability and support economic growth. Even for 2005, the inflation target is expressed in maintaining the annual growth rate of consumer price index, estimated and published by INSTAT, within the 2-4 per cent band. Given the economic growth forecasts for 2005, the Bank of Albania inflation rate target, and monetary development trends, the Bank of Albania will aim at controlling the money supply growth at 9.8 per cent for 2005. The Bank of Albania will continue to maintain a floating exchange rate. Macroeconomic developments and inflation rate performance have supported the further monetary policy smoothing, following the cut of core interest rate at the end of 2004. Demand pressures have been lessening, balancing almost totally the effects of oil price rises in international markets and of administered prices in the country. The smoothing of inflationary pressures is reflected in low inflation rates during the first months of the year. Also, inflation forecasting for the coming months indicate that inflationary pressures will remain weak in the first half of the year. Under these conditions, at the end of March, the Bank of Albania cut the core interest rate by 0.25 percentage points, leading it to the lowest historical level of 5 per cent. The banking system has reflected this reduction in cutting the interest rates of deposits, Treasury bills in Lek, and to a smaller extent, in decreasing the Lek credit interest rates.

The so-far achievements in consumer prices indicate that the general level of prices during 2004 and during the first quarter of 2005 is considerably conditioned on the foodstuff price performance, the administered price rise of electricity and the exchange rate developments. The falling prices of food products, caused by the rise of agricultural production supply, have exerted downward pressures on the annual inflation rate since May 2004. The fall of prices of these products on an annual basis is also evidenced in the first quarter of 2005, which is not typical for this period of the year. Electricity price rise in January allowed the inflation of the respective group, as well as total annual inflation, increase. Till the extinction time of price rise effect, so in January 2006, the contribution of electricity price rise is expected to remain within the level of 2.4-2.5 percentage points. On the other side, oil price rise failed causing a significant

increase of inflation due to the small share of "Transport" group in the consumer basket and to the positive effect of Lek strengthening versus American dollar. During 2005, the Bank of Albania monetary policy will aim at promoting the economic activity through investment support from the private sector, without infringing the objective of achieving inflation target and financial stability of the banking system in the future.

During 2005 macroeconomic policies will focus on the external sector developments, particularly on current account deficit performance, which during 2004 stood at 5.3 per cent of GDP. Current deficit to GDP has been decreasing over the last three years. Meeting the target of tightening the current deficit may be complicated during 2005 as a result of exchange rates volatility, while overall position of balance of payments will continue being closely linked with the financing from privatization revenues. A positive signal given from year 2004 was the relative stability of imports, despite the Lek strengthening against Euro and American dollar for the most part of the year. On the other side, Albanian exports grew at a faster pace than imports, showing a slight increase of competitiveness in the European market. Year 2005 has begun with a sound foreign reserve position, covering 5.2 months of imports of goods and services, a little more than our objective for the year-end.

In general, year 2005 is expected to be a different year in terms of the Albanian economy development. The growth of tax revenues, as well as the rise of crediting to the economy, speak for a positive performance of the economic activity. The monetary indicators stability, the favorable financial conditions in the economy and the continuous enlargement of the banking system will further encourage this activity during 2005, allowing a more comprehensive use of financial potential of the Albanian economy. The Bank of Albania deems that it's right time for the political authorities to capitalize over this moment, safeguarding the paces of structural reforms and designing concrete development policies and strategies. The Bank of Albania will continue to focus on designing and pursuing appropriate monetary policies to maintain price stability in the country and on providing the required conditions for the financial system development according to the most advanced standards.

## II. ECONOMIC ACTIVITY

### II.1 WORLD ECONOMY DURING FIRST QUARTER 2005

Year 2005 is expected to be characterized by positive developments, more or less similar to the developments highlighted during 2004. The supporting policies, the strengthening of corporations' financial condition and the financing facilities will positively affect the pace of economic growth. Notwithstanding the generally positive developments, the global economic growth is becoming further the less balanced. The world economy growth continues to be sustained by the growth of the United States and China, while the economic activity in the euro area and in Japan continues to be slow, away from the projected levels.

**Table 1 Data on the economies of some countries for 2004 and forecasts for 2005**

	GDP		Unemployment rate		CPI		Budget deficit (% of GDP)	
	2004	2005*	2004	2005*	2004	2005*	2004	2005*
USA	4.4	3.6	5.5	5.3	2.7	2.7	-4.3	-4.4
Euro area	2.0	1.6	8.8	8.7	2.2	1.9	-2.7	-2.6
France	2.3	2.0	9.7	9.5	2.3	2.0	-3.7	-3.1
Germany	1.7	0.8	9.2	9.4	1.8	1.5	-3.7	-3.5
Italy	1.2	1.2	8.3	8.0	2.3	1.8	-3.0	-3.5
Great Britain	3.1	2.6	4.8	4.7	1.3	1.7	-3.0	-3.1
Japan	2.6	0.8	4.7	4.5	-	-0.2	-7.1	-6.9
China	9.5	8.5	-	-	3.9	3.0	-	-

\*Forecasts of International Monetary Fund, World Economic Outlook, April 2005

Data on the beginning of 2005 indicate that the American economy will continue marking positive developments during this year, though the growth rate is expected to be lower than the one of 2004<sup>1</sup>. The real growth of gross domestic production is expected to range between 3.5-4.0 per cent, being more modest than the growth evidenced during 2004<sup>2</sup>. Price index of personal consumer goods, except for foodstuffs and energy, is expected to be about 1.5-1.75 per cent higher than the previous year. Labor market is expected to show improvement throughout 2005. Modest developments at the beginning of 2005 are noticed in the growth rate of industrial production, in consumer expending and in trade deficit, which, in January was around 5 per cent higher than in December 2005.

The United States monetary policy tightened further during the first months of 2005. FOMC, during the three meetings of this year, raised the core interest rate by 25 percentage points, leading it to the level of 3.0 per cent. The draft-budget for the fiscal year of 2006 highlighted the objective of halving the fiscal deficit in 2009. The basic assumption on which the deficit reduction is based is the interruption of further defense expending for military operations in Iraq and in Afghanistan.

The euro area economic growth was a modest one over 2004. Forecasts for year 2005 place the economic growth within the 1.2-2.0 per cent band or a little lower than the growth of 2004<sup>3</sup>. The average rate of the Harmonized Index of Consumer Price is expected to range between 1.6 and 2.2 per cent. The growth of exports, based on foreign demand strengthening, will continue being the basis of economic development. During this year the domestic demand and labor market are expected to gradually become stronger. The latest data and different surveys of the euro

<sup>1</sup> For the American economy estimations are conducted by the Federal Reserve staff, February 2005.

<sup>2</sup> GDP growth rate for 2004 was 4.4 per cent.

<sup>3</sup> For the euro area economy estimations are conducted by the European Central Bank staff.

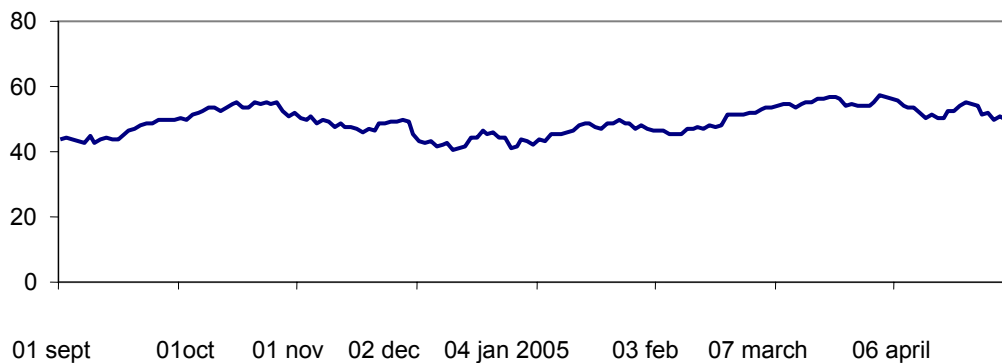
area economic activity suggest that the economic activity marked a modest growth during the first months of 2005. Confidence indexes give different signals. Industrial index and service sector index marked a decrease during the first months of the year, while consumer confidence index remained unchanged.

Low interest rates, set mainly according to the core interest rate which remained at the level of 2 per cent since June 2003, have contributed to the monetary expansion in the euro area. However, the latest monetary and credit data suggest a slowdown of this expansion during the first months of 2005. The fiscal situation continue being a concern. The fiscal perspective is worsened for some countries of the euro area, since fiscal deficits are not projected to decrease and there are expectations for a further increase in certain countries.

Oil price rise continued in the first months of 2005, exceeding the top level reached in October of the last year. In March 2005, an unprocessed oil barrel<sup>4</sup> costed above 57 USD. The so-far oil price rise effect on global growth and on inflation have been manageable, partially due to the strong growth of world demand, partially due to the improvement of central banks confidence in their anti-inflationary policies.

In March, Organization of Petroleum Exporting Countries decided to increase oil production by 500,000 barrels a day and the relevant agreement entered into force immediately. World oil consumption is expected to increase to 86.1 million barrels a day during the fourth quarter of 2005, a period during which is the top demand is recorded<sup>5</sup>.

**Chart 1 Performance of unprocessed oil price per barrel in USD**



\*Source: Bloomberg.com

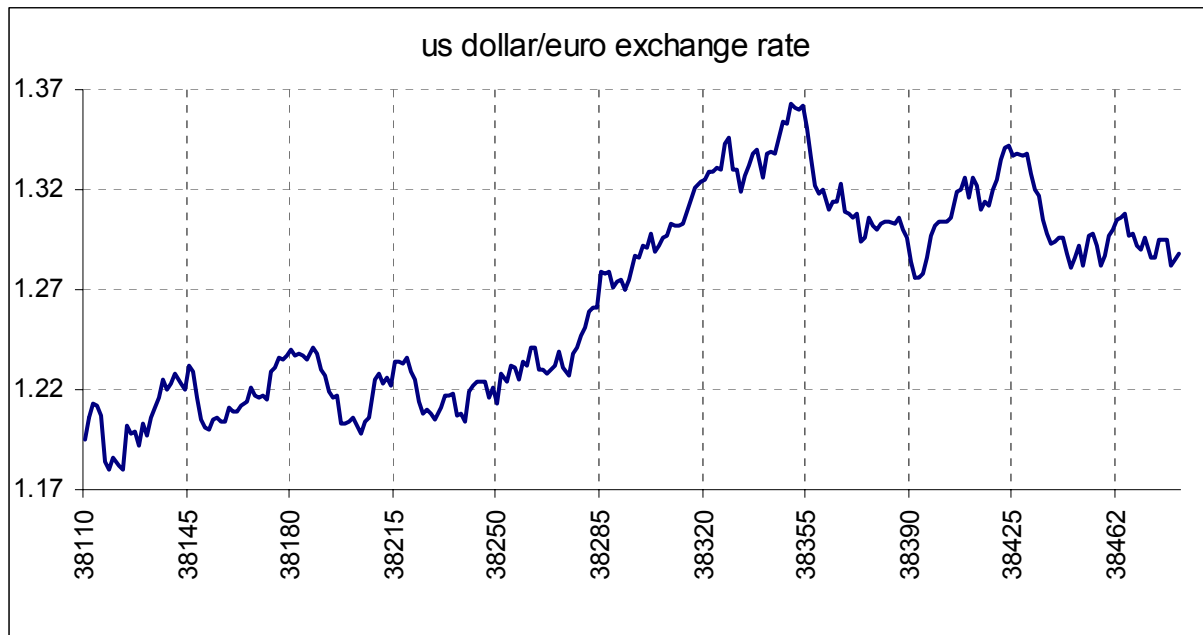
Exchange rate markets fluctuated during the first months of the year. Euro dhe American dollar were depreciated and revalued during the last months, reflecting the signals that have come from respective economies. The American dollar is appreciated versus the Euro during the month of March and at the beginning of April due to the continuous rise of the difference between interest rates in the euro area and in the United States. But, signals given by the American economy during the first half of April for a potential slowdown of the economic activity, led to the reduction of stock market yield and of long-term debt. This reduction is believed to have negatively affected, at least temporarily, the US dollar performance. In the second half of April, the US dollar regained its lost scores since expectations on the euro area economic growth were

<sup>4</sup> US light crude.

<sup>5</sup> International Energy Agency forecasts.

revalued as being lower than initial projections. At the beginning of May, 1 Euro was changed by 1.28 USD, being about 4 per cent lower than the value of Euro at the beginning of 2005.

**Chart 2 Performance of exchange rate USD/EUR**



\*Source: European Central Bank, May 2005

## II.2 ALBANIAN ECONOMY DURING FIRST QUARTER OF 2005

### II.2.1 Real sector

#### II.2.1.1 Agriculture branch

Agriculture branch grew by 4.4 per cent over 2004. This growth was higher than projections at the beginning of the year and higher than the growth of the previous three years. Year 2005 is expected to experience a much higher growth (4.7 per cent), approaching to the growth rate of year 1998. The agro-industry sector, which is assessed as having increased by 10.2 per cent during 2004, is expected to give once again the major contribution to this growth. In concrete terms, for year 2005 it is expected that agriculture sector grows by 3.1 per cent, agro-industry sector by 12 per cent and fishery sector by 10 per cent. This growth will be sustained by different stimulating policies. The help consisting in reducing fuel price that is used in agriculture will lead to the reduction of agricultural work cost, to the rise of mechanization degree and the increase of farmers' interest in the agricultural production. Also, the extension of plots of land, the improvement of seed quality and the rising interest of farmers in having a higher earning rate, adopting the most advanced technologies, confirm the expectations for a growing agricultural production. Based on these projections, the presence of domestic agricultural products in the market is expected to increase, which will exert downward pressures on agricultural product price level.

**Table 2 Evaluation of agricultural production over 2004 and expectations for 2005**

	<b>Growth 2004 (%)</b>	<b>Growth 2005 (%)</b>	<b>Weight (%)</b>
Agriculture	3.2	3.1	81.6
<i>Plants</i>	3.3	2.5	44.2
<i>Animal farming</i>	3.1	3.8	37.4
Agro-industry	10.2	12.0	17.3
Fishery	7.9	10.0	1.1
<b>Total</b>	<b>4.4</b>	<b>4.7</b>	<b>100.0</b>

\*Source: Ministry of Agriculture and Food

During the first quarter of 2005, the so-far estimations indicate that farmers are more oriented towards cultivating vegetables, mainly greenhouse vegetables, fruit-trees and producing animal products, while interest in the production of cereals is characterized by a falling trend. The bad weather conditions and low temperatures observed even throughout the spring postponed the sowing process of spring plants, a process which still continued during the month of May. However, the postponement of sowing time is believed to have no effects on the production level of 2005, since sowing is going ahead rapidly.

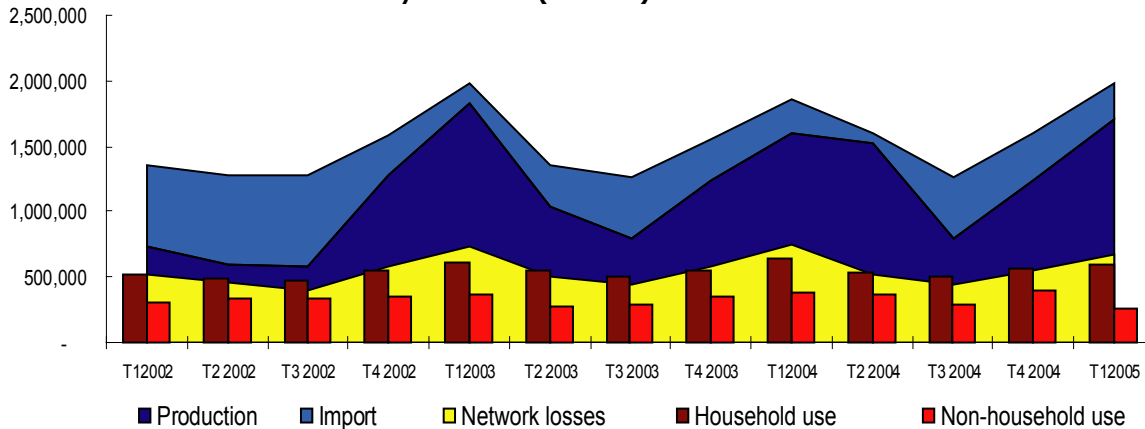
Agricultural production growth during 2004 consisted mainly in the growth of fruit production, the doubling of olive production and the growth of animal products. The growth of production in animal farming sector by 31 per cent has come as a result of high growth of egg and milk production, which enabled the market to supply its needs with these products. The rise of rentability remains the main factor influencing the growth of animal products.

The 2004 investments are sustained at 36 per cent by foreign investments, at 23 per cent from the State budget and at 41 per cent from farmers themselves. The farmers have used 90 per cent of their funds, while 10 per cent of these investments are financed through bank credits. The financing from banks has occupied a considerable place in the investments made in agro-industry sector. During 2004, for the first time the size occupied by the processing of agricultural and animal products from the farmers themselves was estimated at 75 per cent of the processing industry production.

### **II.2.1.2 Energy**

During the first quarter of 2005 the country was supplied with electricity at about 25 per cent more than the fourth quarter of the previous year, while the supplied quantity was about 7.4 per cent higher than in the first quarter of 2004. The domestic electricity production marked an increase of 6 per cent compared to production of the first quarter of 2004. The hydro-electric stations remain the largest domestic producers covering about 99 per cent of total production. Imports recorded an increase of 14 per cent during this quarter in comparison to the first quarter of 2004, while electricity exports marked a very high level, representing about 17 per cent of total production. The ratio of network losses to the used electricity quantity was lower than in the first quarter of 2004.



**Chart 3****Electricity Balance (in GWh)**

\*Source: Albanian Electro-Energetic Corporation

### II.2.1.3 Transport

Investments in transport sector amounted to ALL 2 billion during the first quarter of this year and marked a decrease of about 10 per cent compared to the investments made in the first quarter of the last year. The decrease has mainly come as a result of domestic investments decline by about 26 per cent, while foreign investments increased by 24 per cent, approaching to the level of domestic investments.

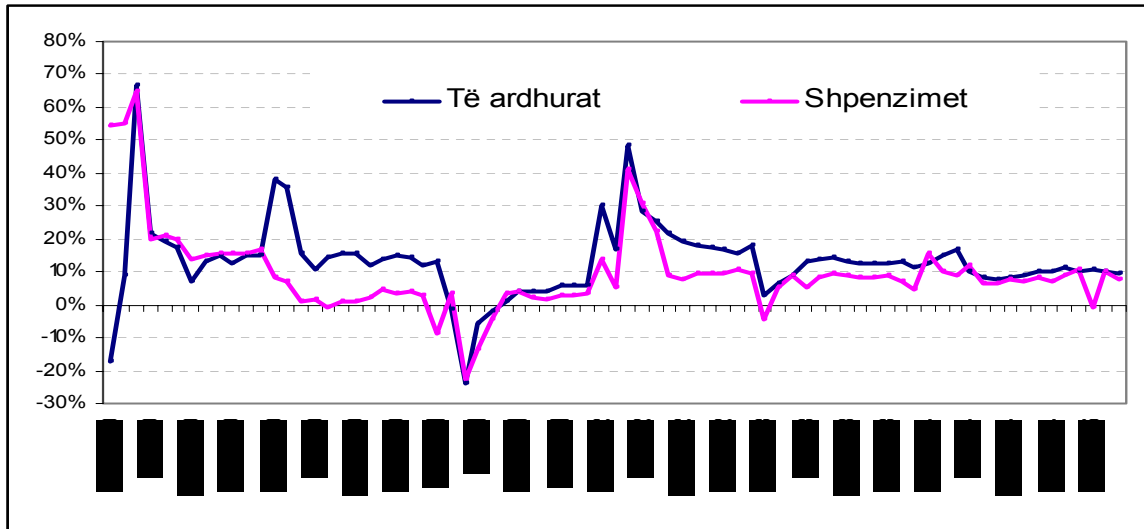
Air transport as well as sea transport marked an increase of the activity indicators during first quarter of the year. In this period, the number of passengers that have used the air transport increased by 15 per cent, while the number of flights increased by 23 per cent. Sea transport marked an increase of about 5 per cent during this quarter. According to the records in the main ports of the country, the volume of imports grew by 4 per cent and that of exports by 12 per cent. The volume of merchandise transport in Durrës Port, the main port in the country processing about 77 per cent of total merchandise volume in ports, decreased by 3 per cent. On the other side, transport in the ports of Vlora, Saranda and Shëngjin increased by 41, 79 and 41 per cent, respectively. Railway transport evidenced a slight decrease in merchandise transport and a sharper decrease in the number of passengers.

### II.2.2 Fiscal sector

During the first quarter of 2005, State budget received the sum of ALL 45.4 billion, about 1.2 per cent more than the plan, while expenditures are highly performed at about 98.4 per cent in comparison to the plan, or ALL 46.8 billion in absolute terms. In comparison with the same quarter of the last year, revenues as well as expenditures grew in absolute nominal terms.

Tax revenues, which provide about 90 per cent of the overall revenues, have recorded a growth of 9 per cent in comparison to the first quarter of the last year. In comparison with the same period of 2004, during the first quarter of this year more revenues from the highest tax categories, such as value-added tax, income tax and excise tax, were provided. Revenues from the independent budget, mainly due to the revenue growth from social insurance, were estimated at about 12 per cent higher than in the first quarter of 2004, while the level of non-tax revenues and of local government revenues marked significant changes.

**Chart 4 Annual growth of budget revenues and expenditures (cumulative data)**



During first quarter of 2005, overall expenses were about 8 per cent higher than expenses of the same period of the previous year. In annual terms, current and capital expenses marked the same growth rates. In current expenses category, the main items recording an annual growth during the first quarter are: personnel expenses (12 per cent), operative expenses (10 per cent) and social and health insurance expenses (12 per cent).

Total capital expenses, including foreign-financing and domestic-financing, totaled ALL 5 billion or about 3 times more than in the first quarter of 2004.

The financing of the deficit during the first quarter is covered mainly by long-term foreign sources. The growth of personnel expenses in the form of salaries and payments for social insurance due to the increase of minimum salary, of minimum pension, of unemployment payment, etc, during the third quarter of 2004, doesn't seem to have caused inflationary pressures during the second semester of 2004 and during the first quarter of 2005.

### III. INFLATION PERFORMANCE

In the first quarter of 2005, the annual rate of consumer price change was ranging to the lower limit of the targeted band of Bank of Albania. After marking a growth rate of 3.3 per cent in January, annual inflation rate lowered to 2 per cent in the subsequent months. Annual inflation rated at 1.6 per cent in March, while average annual inflation rate resulted 2.5 per cent during the first quarter.

**Table 3 Annual inflation rate (in percentage)**

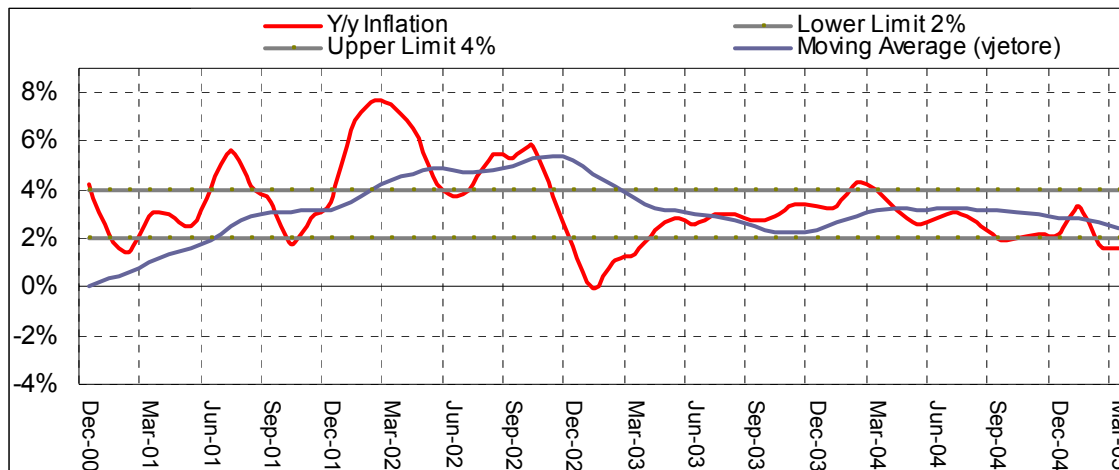
	2001	2002	2003	2004	2005
January	2.2	6.5	0.0	3.3	3.3
February	1.5	7.6	1.1	4.4	1.8
March	2.9	7.5	1.3	4.0	1.6

April	3.0	6.5	2.3	3.2	
May	2.5	4.6	2.8	2.6	
June	4.0	3.7	2.6	2.9	
July	5.6	4.2	3.0	3.1	
August	4.1	5.5	3.0	2.7	
September	3.5	5.3	2.8	2.0	
October	1.8	5.8	2.9	2.0	
November	2.8	3.7	3.4	2.2	
December	3.5	1.7	3.3	2.2	
<b>Average</b>	<b>3.1</b>	<b>5.2</b>	<b>2.2</b>	<b>3.0</b>	<b>2.5</b>

\*Source: Institute of Statistics

Low annual inflation rates started being observed in mid-2004. The decline in foodstuff prices, associated with the smoothing of inflationary pressures from administered prices, made the annual inflation rates in this period become lower than those recorded in the same period of the previous year. Inflation rate stability is being stimulated by a prudential fiscal policy, while periodic cuts of core interest rate are appropriately made in size and in time without infringing inflation target. Low inflation growth rates in the country are partly attributed to the favourable developments in the foreign exchange market. The continuous appreciation of domestic currency, the Lek, has helped absorb the inflationary pressures from import prices.

**Chart 5 Annual inflation (in percentage)**

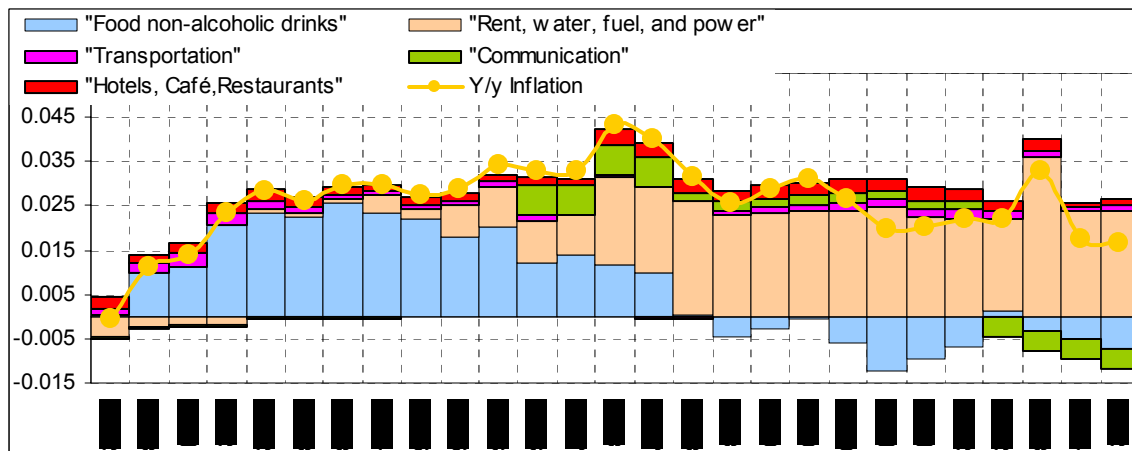


### III.1 INFLATION AND CONSTITUENT GROUPS

During first quarter of this year, the factors that have exerted pressures on consumer price level were similar, in kind and in size, with those that came into play in the same period of the previous year. Like in the first quarter of 2004, annual inflation rate evidenced in the first quarter of 2005 is considerably defined by the contribution of groups: "Rent, water, fuel and energy", "Foodstuffs and non-alcoholic beverages" and "Communication" (Chart 6). Unlike the previous year, the last two groups recorded negative annual rates, exerting downward pressures on the general level of prices.

Since more than ten months (May '04 – March '05), except for December 2004, "Foodstuffs and non-alcoholic beverages" group has recorded negative annual inflation rates. Lower foodstuff prices have come as a result of the good condition prevailing in the agricultural market. Year 2004 has been a particularly good year in terms of agricultural production, which is assessed as having increased by about 4.4 per cent in comparison to 2003. The abundant domestic production, the fall of foodstuff prices in the partner countries, as well as the favorable developments in the exchange rate, made the prices of food products, mainly of agricultural products, consumed in the country, mark a sharp fall over this period. During January – March 2005, "Foodstuffs and non-alcoholic beverages" group impacted on the annual inflation rate by an average of – 0.5 percentage points, while the contribution of this group was estimated at an average of 1.2 percentage points during the first quarter of 2004. This group has contributed in the annual inflation and monthly inflation of March 2005, respectively by – 0.7 and –0.1 percentage points.

**Chart 6 Contribution of main groups in the annual inflation (in percentage points)**



Since more than a year, "Rent, water, fuel and energy" group has given the main contribution to creating the annual inflation rate. The rise of electricity prices for households in January, made the annual inflation rate mount to 3.3 per cent. Electricity price rise made the contribution of inflation rate of this group in the general inflation rate be considerable and higher than the contribution given in the first quarter of 2004, during which an electricity price rise was observed too.

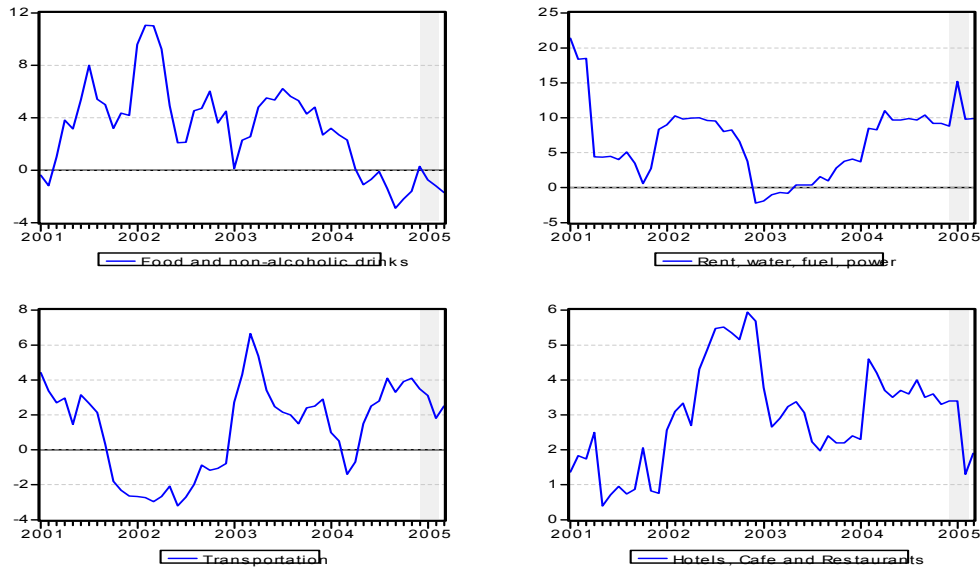
**Table 4 Annual inflation and contribution in inflation of "Rent, water, fuel and energy" group**

	Annual inflation (%)		Contribution in (pp)	
	2004	2005	2004	2005
"Rent, water, fuel and energy" group				
January	3.7	15.2	0.9	3.6
February	8.5	9.8	2.0	2.4
March	8.3	9.9	1.9	2.4

From May 2004 to March 2005, upward pressures exerted from "Rent, water, fuel and energy" group are counterbalanced by the negative inflation rates of "Foodstuffs and non-alcoholic beverages", while, since December 2004, "Communication" group has also exerted downward pressures. This group has given a constant negative contribution of – 0.5 percentage points in the annual inflation during December '04 – March '05. For the subsequent months, "Communication" group is expected to give a positive impact, since the effect of price rise (in December '03) disappears in April of this year.

During January – March '05, prices of other groups of consumer basket fluctuated in a moderate way, without causing changes in the inflation structure. "Clothes and footwear" group and "Furnishing, house equipment and maintenance" group followed their downward trend, while other groups of the basket marked positive low inflation rates.

**Chart 7 Annual inflation of four main groups of CPI (in percentage)**



To annual inflation of March, these groups<sup>6</sup> gave a contribution of 0.3 percentage points. In the developments highlighted during this month, apart from the above-mentioned group we may specify "Transport" group, which marked an annual inflation of 2.5 per cent. Within this group, "Services to personal vehicles" sub-group<sup>7</sup> recorded the highest growth, with an annual and monthly inflation of 7.3 and 1.6 per cent, respectively. The increase of price index of this group is due to oil price rise.

**Table 5 Annual and monthly (March) inflation and main groups contribution to inflation**

	Inflation in (%)		Contribution in (pp)	
	Monthly	Annual	Monthly	Annual
Foodstuffs and non-alcoholic beverages	-0.2	-1.7	-0.08	-0.7
Rent, water, fuel and energy	0.0	9.9	0.00	2.4
Communication	0.0	-24.4	0.00	-0.5
Other			0.04	0.3
Transport	<b>0.8</b>	<b>2.5</b>	<b>0.04</b>	<b>0.1</b>
Hotels, cafés and restaurants	<b>0.6</b>	<b>1.9</b>	<b>0.00</b>	<b>0.1</b>
<b>Total</b>	<b>4.0</b>	<b>1.6</b>	<b>4.0</b>	<b>1.6</b>

<sup>6</sup> Basket groups without the groups of "Foodstuffs and non-alcoholic beverages", "Rent, water, fuel and energy" and "Communication".

<sup>7</sup> This group includes oil price.

## III.2 FACTORS INFLUENCING THE CONSUMER PRICES

During first quarter of 2005, average inflation rate was 2.5 per cent. January marked the highest annual rate (3.3 per cent), while February and March were characterized by inflation rates lower than 2 per cent. Developments in demand and supply factors maintained generally the last year's features, meaning that this quarter was not characterized by important structural changes.

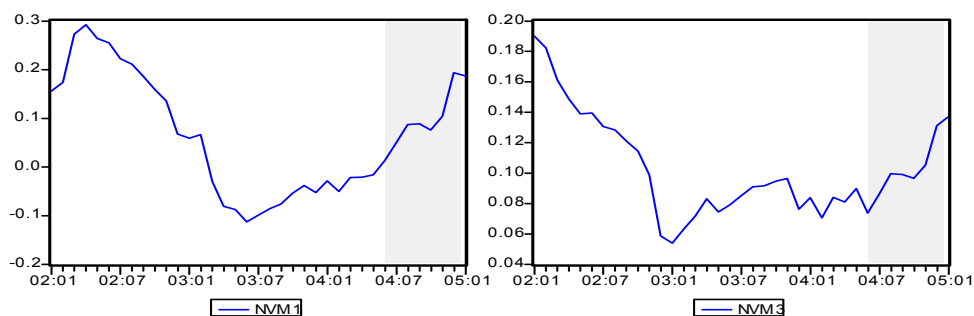
### III.2.1 Demand factors

Demand factors, like in the previous year, allowed to create a favorable environment for inflation rate control, without exerting inflationary pressures.

During 2004 the fiscal policy has been a prudential policy in terms of implementation of its fiscal program. The fiscal indicators have met the projected levels being performed uniformly, without leaving room for unexpected shocks. During the first quarter of the year, budget expenses marked an increase in comparison to the first quarter of the previous year, but this increase is mainly concentrated in February and in March. Expenses growth, which has come mainly as a result of current expenses growth, has not exerted inflationary pressures during the said period. The harmonization of monetary policy with fiscal policy has helped create a safe macroeconomic environment to control and maintain inflation rate stability.

The Bank of Albania has continued to follow an easing monetary policy, which is reflected in the controlled core interest rate cuts. Core interest rate is one of the main channels of transmission of monetary policy influence on real economy. Interest rate cuts aim at lowering the borrowing cost in the economy. Due to low inflation rate, real interest continues to be positive, turning into attractive instrument to absorb free funds and concentrate them in the banking system, which is reflected in the reduction of the ratio of currency outside banks to money supply. Also, monetary supply growth has been controlled, which allowed to maintain macroeconomic equilibriums and keep inflationary pressures under control.

**Chart 8 Annual changes of M1 and M3 aggregates (in percentage)**



Lek maintained strong positions versus foreign currencies – Euro and US dollar – even during first quarter of 2005. The Lek appreciation trend during this period was falling. Lek appreciation acts as an anti-inflationary factor, since it smooths down the inflationary pressures of imported inflation. In addition, Lek appreciation versus foreign currencies made the confidence in the domestic currency increase, which anchored inflation expectations at low levels.

The domestic demand<sup>8</sup> growth, the good condition of retail market<sup>9</sup>, and the increase of salaries in the public sector did not generate inflationary pressures in the country.

### III.2.2 Supply factors

Supply factors have exerted a stabilizing impact on the consumer price developments. During the whole quarter the Albanian economy is not characterized by internal or external shocks that might unbalance the stability of macroeconomic indicators.

Low inflation rates in the main partner trading countries speak for a external economic and trade environment of non-inflationary trends. The Albanian economy dependance on imports implies a significant dependance of this economy on foreign prices and exchange rate performance. The modest growth of consumer prices in the partner countries is weakened as a result of Lek strengthening against foreign currencies, meaning that the imported inflation pressures have been insignificant.

**Table 6 Annual inflation of main partner countries (in percentage)**

	June	September	October	November	December'04	January '05	February
Greece	3.0	2.9	3.3	3.2	3.1	4.2	3.2
Italy	2.4	2.1	2.1	2.0	2.4	2.0	2.0

\*Source: Eurostat News Release

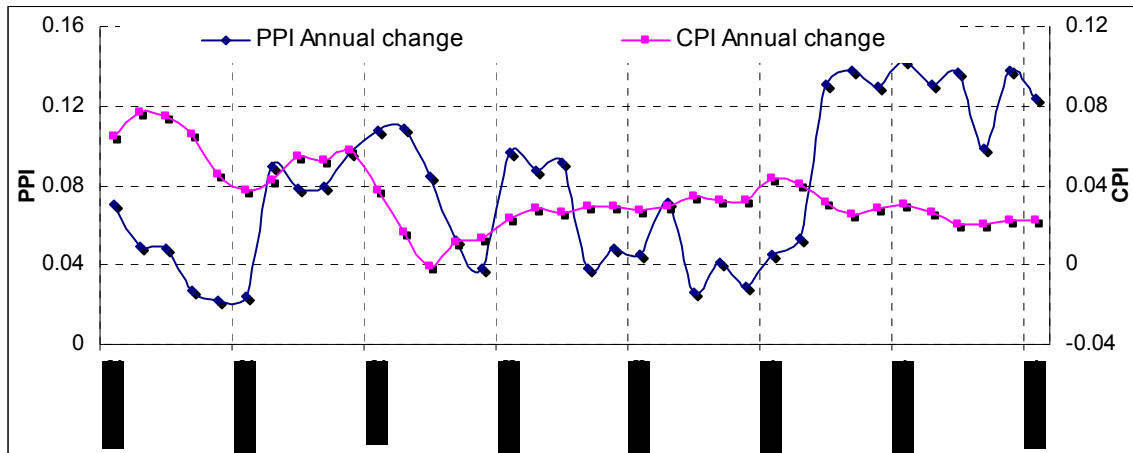
Domestic agricultural production played a determinant role in the foodstuff price performance. Thanks to the considerable weight in consumer basket, price performance of these goods has shaped, for the most part, the inflation rate profile even during the first quarter of this year. The extension of the planted surfaces and the investment growth in greenhouses have influenced and are expected to positively influence the agricultural production volume and the supply of these products in the domestic market. The annual decline in prices of these goods served as a balancing factor in the electricity price rise at the beginning of the year.

In 2004, production prices marked during the whole year high growth rates, which are not transmitted in the consumer prices. An explanation beyond the statistical discrepancies or inaccurate measurements, may be the argument that our economy operates below its potentiality. The growth and strengthening of competitiveness might have bound the producers to delay or smooth down the transfer of production cost rise in the final product prices.

<sup>8</sup> Estimated based on retail sale index, which recorded an annual growth of 14.6 per cent in the fourth quarter of 2004.

<sup>9</sup> Retail sale volume index recorded an annual growth of 16.4 per cent in the fourth quarter of 2004.

**Chart 9 Annual changes of PPI and CPI during 2002-2004**



A potential risk for inflation in the country, either during 2004 or during this quarter, was oil price rise in the international markets. As it has been explained in the previous reports, a series of factors have eased the full influence of this rise. The small share this product<sup>10</sup> occupies in consumer basket, the Lek appreciation against US dollar and the conformity of domestic demand for this product<sup>11</sup>, served as barriers for the complete transmission of oil price rise to the domestic market.

<sup>10</sup> "Services to personal vehicles" sub-group, which includes oil price, occupies a share of 1.6 per cent in the CPI basket.

<sup>11</sup> During 2004 oil imports lowered by 2.4 per cent in the country compared to 2003.



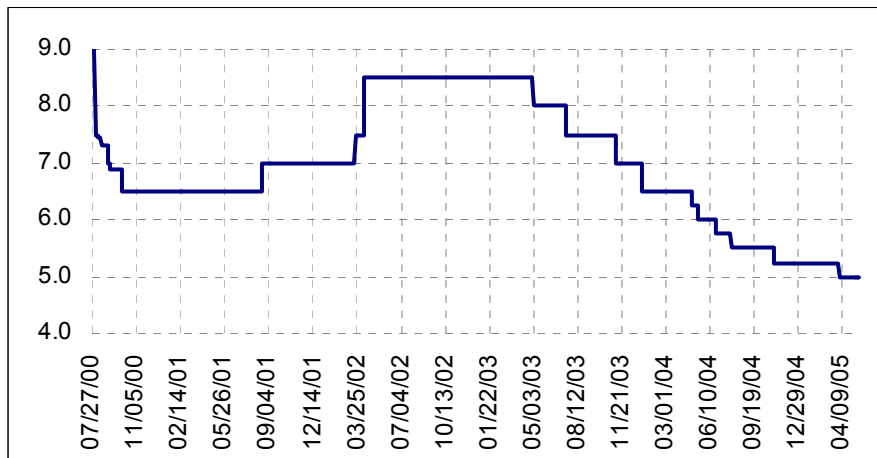
## IV. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

### IV.1 MONETARY POLICY AND QUANTITATIVE OBJECTIVES

The Bank of Albania followed an easing monetary policy throughout 2004, cutting several times the core interest rate. Annual inflation recorded during the first quarter of this year, despite the pressure caused by electricity price rise, failed exceeding the upper limit of 4 per cent of the targeted inflation. In the absence of inflationary pressures during this period, the Bank of Albania adopted a neutral stance, taking care of creating appropriate conditions for reducing interest rates in the banking market. The easing of monetary policy is sustained during this period by a favorable reaction of monetary indicators, reflected in the controlled performance of equilibriums and of monetary aggregates growth rates.

During the first quarter the interbank market is characterized by high levels of liquidity. Unlike the first quarter of the previous year, when inflationary pressures were higher, the Bank of Albania withdrew during this quarter, only temporarily, the seasonal excess liquidity, employing the weekly repos instrument. The permission of high liquidity levels in the interbank market aimed at creating downward pressures on interest rates. The latter ones have reacted in the expected direction. Interest rates decrease has been particularly evident for long-term instruments, leading to the leveling of time curve of interest rates.

**Chart 10** Core interest rate performance



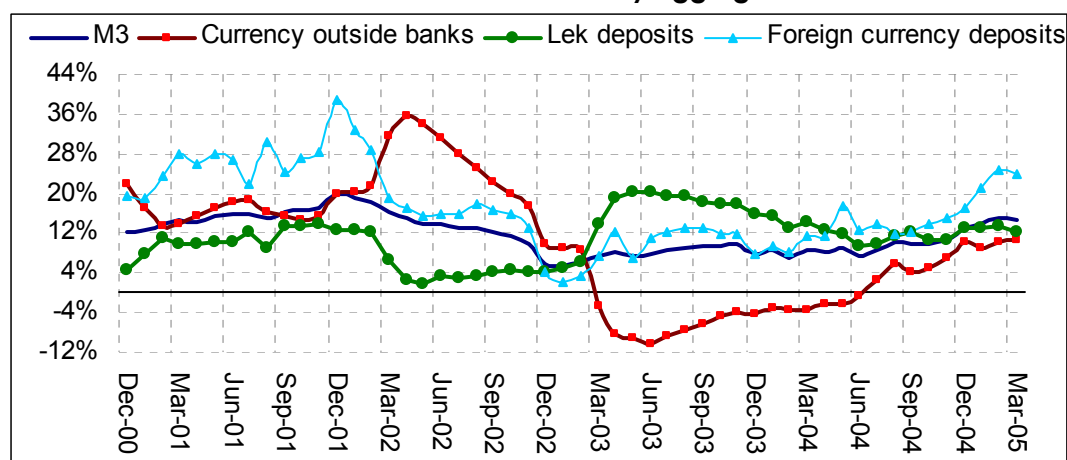
In the end of March, the Bank of Albania decided to cut core interest rate by 0.25 percentage points, leading it to the minimum historical level of 5 per cent. This decision was made based on the need to adjust the current monetary conditions with the inflation target under the conditions of positive performance of monetary indicators. The ratio of currency outside banks to M3 lowered to 24.8 per cent in March, highlighting the lowest historical level in the last twelve years. This indicator marked a significant decrease of 2.4 percentage points during the first months of the year. The last cut of core interest rate is expected to be reflected in the further fall of interest rates in Treasury bills market, of deposits and credits in Lek. The easing of monetary conditions will serve as a driving factor towards enhancing the economic activity for the rest of the year. The monetary policy followed by the Bank of Albania enabled to achieve its quantitative objectives till the month of March of this year.

**Table 7 Meeting the quantitative objectives of Bank of Albania**

	December '04	January '05	February '05	March '05
<b>Net international reserves of the Bank of Albania (in millions of USD)</b>				
Objective	941.7	985.3	1,029.0	1,072.7
Current	1,105.2	1,108.8	1,108.7	1,107.4
Difference	163.5	123.5	79.7	34.8
<b>Net domestic assets of the Bank of Albania (in billions of ALL)</b>				
Objective	79.0	72.3	67.2	61.3
Current	61.0	56.3	56.5	53.3
Difference	-18.0	-16.0	-10.7	-7.9
<b>Net domestic credit to government (in billions of ALL)</b>				
Objective	286.4	288.3	290.2	292.1
Current	286.1	286.9	288.9	287.8
Difference	-0.3	-1.4	-1.3	-4.3

## IV.2 MONETARY AGGREGATES PERFORMANCE

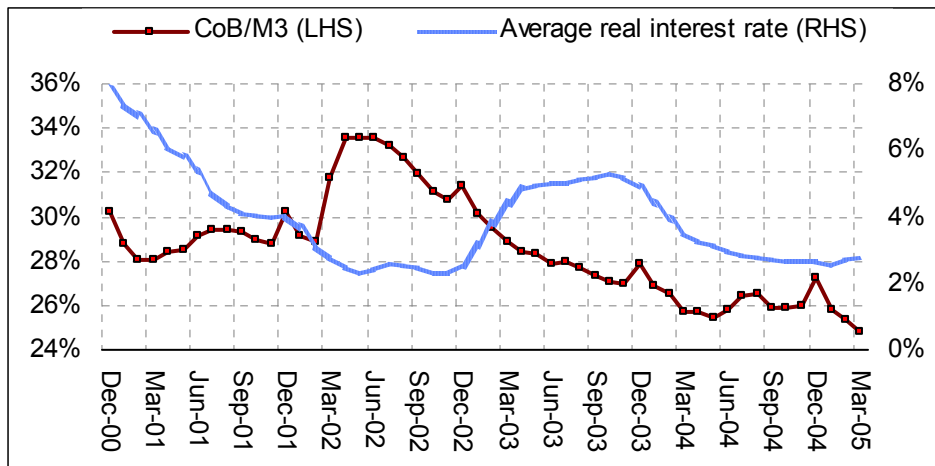
Annual growth rate of money supply showed an upward trend during the first quarter of the year. Annual growth rate of M3 aggregate reached 14.4 per cent in March, increasing by 1.3 percentage points compared to the level recorded in December. The accelerated growth rate of money supply is attributed to the higher growth of deposits in foreign currency. M2 aggregate, the Lek component of money supply, knew a stable growth, as a result of the accelerated growth of credit to the economy, which has compensated the low demand of government for monetary assets.

**Chart 11 Annual rates of monetary aggregates**

The time structure of money supply continued to be oriented towards longer maturity terms, reflecting the increase of confidence in the banking system and the rising attractiveness of financial instruments and services provided by the system. The ratio of currency outside banks to M3 lowered to 24.8 per cent in March, revealing the lowest historical level in the last twelve years. This indicator marked a significant fall of 2.4 percentage points during the first quarter of the year.

After its seasonal growth in the last months of the year, currency outside banks returned with velocity into the banking system. Its level decreased by ALL 8.7 billion or 6.3 per cent during the first quarter of the year. The return of currency outside banks into the system reflects the further channeling of financial transactions in the banking system. At the same time, maintenance of real interest rates on positive stable levels has been a determinant factor in keeping liquidity structure of money supply balanced.

**Chart 12 Ratio of CoB to M3 and average real interest rate (right scale)**



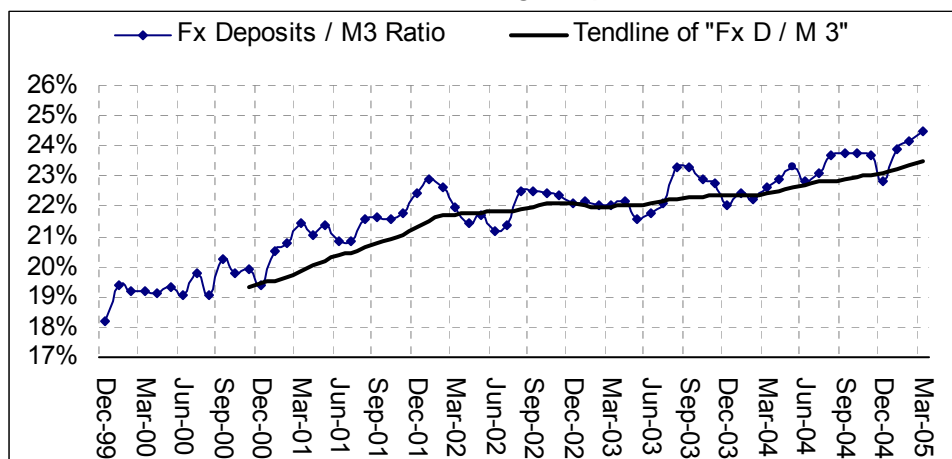
The return of currency into the banking system led to the increase of Lek deposits. Their level grew by about ALL 11.2 billion or 4.4 per cent during the first quarter of the year. Annual growth rates of Lek deposits have been stable over this period, fluctuating on an average level of 12.8 per cent. The stabilization of annual growth rates of Lek deposits reflects the stability of the return of currency outside banks into the system and the moderate demand for financial instruments in Lek (deposits and Treasury bills), a demand which was motivated by the differences of interest rates in Lek and in foreign currency.

Growth of Lek deposits has come mainly as a result of the growth of time deposits from individuals whose annual growth rate knew a slight upward trend during the first quarter. Also, demand deposits in Lek from individuals and the private sector have continued to grow with velocity, reflecting the positive developments in the banking payment means and the high degree of their utilization from the public. However, the low weight of these deposits to total deposits in Lek makes their contribution to increasing Lek deposits remain at modest levels.

The stable growth rates of currency outside banks and time deposits in resulted Lek in a stabilization of M1 performance, the most liquid monetary aggregate. The annual growth rate of M1 aggregate fluctuated around an average level of 20.6 per cent during the first quarter of the year. However, this high growth rate is not considered as a source of inflationary pressures, since it reflects a normal performance of growth rate of this aggregate and carries in itself some reclassification effects<sup>12</sup>.

<sup>12</sup> Exclusion of deposit reclassification effect from "Raiffeisen" bank lowered to 14.4 per cent the annual growth rate of M1 aggregate, placing it in line with the general growth of money supply.

**Chart 13 Ratio of foreign deposits to M3**



Foreign deposits have recorded the highest growth rate in comparison to other monetary indicators. Their annual growth rate at the end of March reached 23.9 per cent from 17.1 per cent it was at the end of December. The accelerated growth rate of foreign deposits may be considered partly as a return of their annual rates to historical levels of the previous years. It becomes clearer with the weakening of the negative effect of exchange rate of the last months<sup>13</sup>. However, even excluding from the analysis the exchange rate effect, foreign deposits showed a clear upward trend in the first quarter of 2005. Their annual growth rate with fixed exchange rates is estimated at about 31.2 per cent in March, against 28.0 per cent it was in December. This growing performance of foreign deposits indicates the high levels of foreign currency inflows in the country, having emigrants' remittances as a main source. Also, foreign deposits performance is influenced by the narrowing of interest rate spread of Lek versus foreign currency.

With accelerated growth rates of foreign deposits, foreign deposits ratio to M3 turned back to its upward trend. The level of this indicator increased to 24.5 per cent from 22.8 per cent it was at the end of the year. The high growth rates of foreign deposits are mainly sustained by the growth of time deposits in foreign currency (about 90% of them are owned by individuals). The contribution of time deposits growth in the annual growth of total foreign deposits was around 73 per cent in March, increasing by 8 percentage points in comparison with the previous quarter.

**Table 8 Performance of monetary indicators in November (in billions of ALL)**

	March	Quarterly change		Annual change	
	2005	Absolute	Percentage	Absolute	Percentage
Currency outside banks	129.4	-8.7	-6.3	12.2	10.4
Total deposits	392.2	23.1	6.3	53.4	15.8
- in Lek	264.5	11.2	4.4	28.8	12.2
- in foreign currency	127.7	11.9	10.3	24.6	23.9
Demand deposits	88.0	10.4	13.4	23.8	37.0
- in Lek	40.8	6.1	17.6	17.1	72.1
- in foreign currency	47.1	4.3	10.0	6.7	16.4

<sup>13</sup> Lek appreciation against US dollar and Euro decreased the level of foreign deposits denominated in Lek, resulting in low annual growth rates during the last two years.

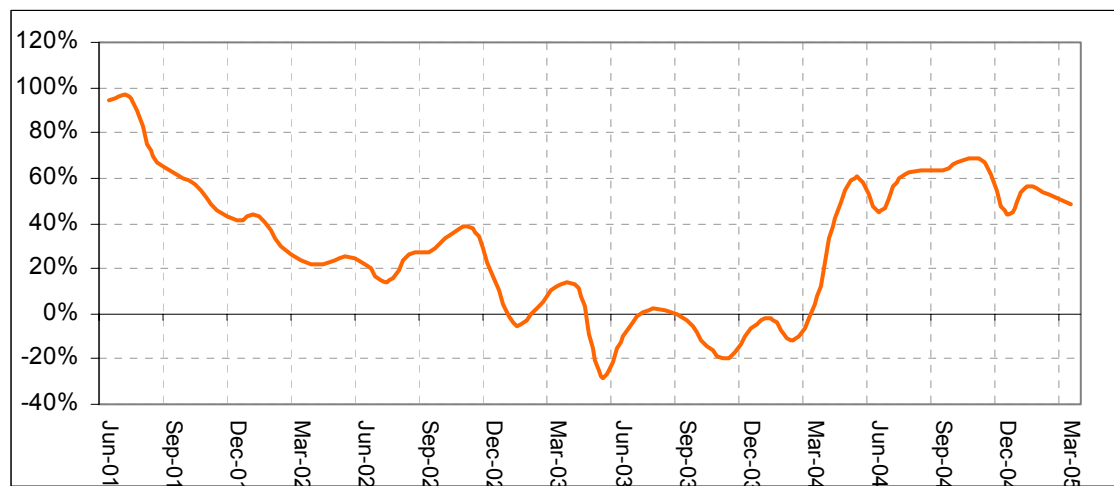
Time deposits	304.2	12.7	4.3	29.6	10.8
- in Lek	223.7	5.1	2.3	11.7	5.5
- in foreign currency	80.5	7.6	10.4	18.0	28.7
M1	170.2	-2.6	-1.5	29.3	20.8
M2	393.9	2.5	0.6	41.0	11.6
M3	521.6	14.4	2.8	65.6	14.4
Monetary base	171.2	-7.4	-4.2	16.7	10.8

## IV.3 ECONOMY DEMAND FOR MONEY

### IV.3.1 Foreign currency position of the banking system

The contribution of the annual growth of net foreign assets in the annual growth of money supply, though it resulted higher at the end of 2004, has been decreasing during first quarter of 2005. The contribution of foreign assets in the growth of money supply reached the level of 48.1 per cent in March.

**Chart 14 Contribution of net foreign assets growth to annual growth of M3**

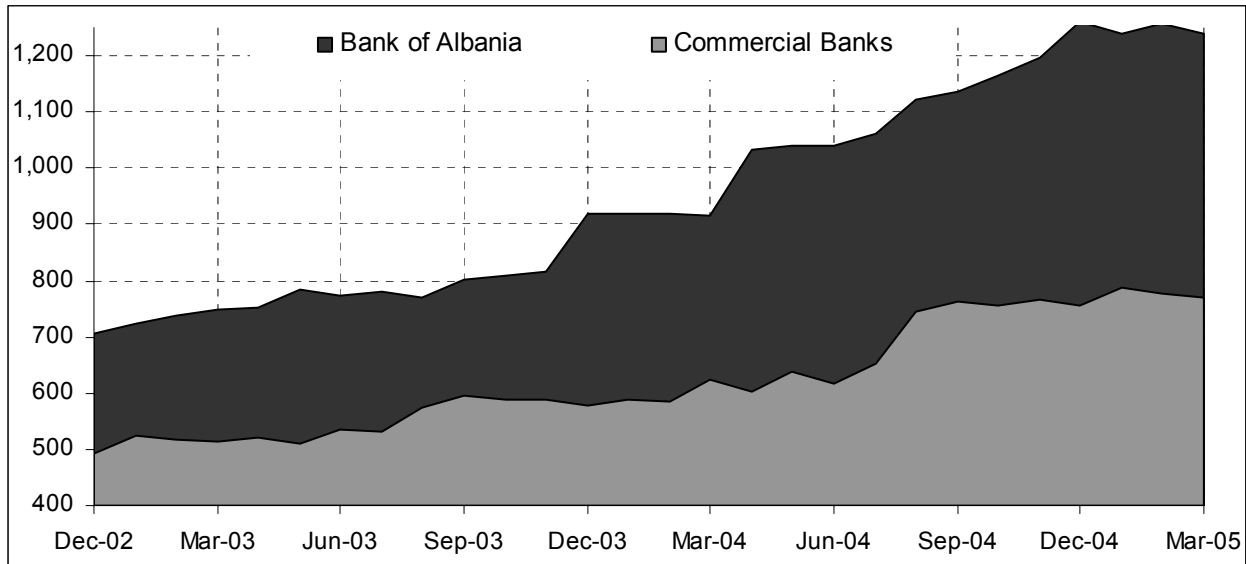


The level of foreign assets of the banking system increased during January and February, while in March, compared to December 2004, decreased by USD 3.4 million. Their decrease is the result of the reduction of net foreign reserve of Bank of Albania by USD 18.4 million. This reduction has come as a result of Euro depreciation against US dollar by 4.85 per cent during the first quarter, which lowered the investment value in Euro denominated in US dollar. During this quarter, intermediations in the foreign exchange market were conducted from Bank of Albania, but only at low levels. However, the growth of net foreign assets by USD 15 million has covered, for the most part, the reduction of foreign reserve of Bank of Albania. Commercial banks have recorded a growth of foreign deposits at higher levels than crediting in foreign currency, influencing the growth of their net foreign assets.

Excluding the exchange rate effect for the first quarter of 2005, foreign assets of the banking system resulted in a growth of about USD 43.3 million. This growth has come as a result of the

growth of net foreign assets of commercial banks, by USD 30.3 million, as well as from the growth of these assets for Bank of Albania, by USD 13 million.

**Chart 15** Level of net foreign assets of the banking system



### IV.3.2 Domestic crediting

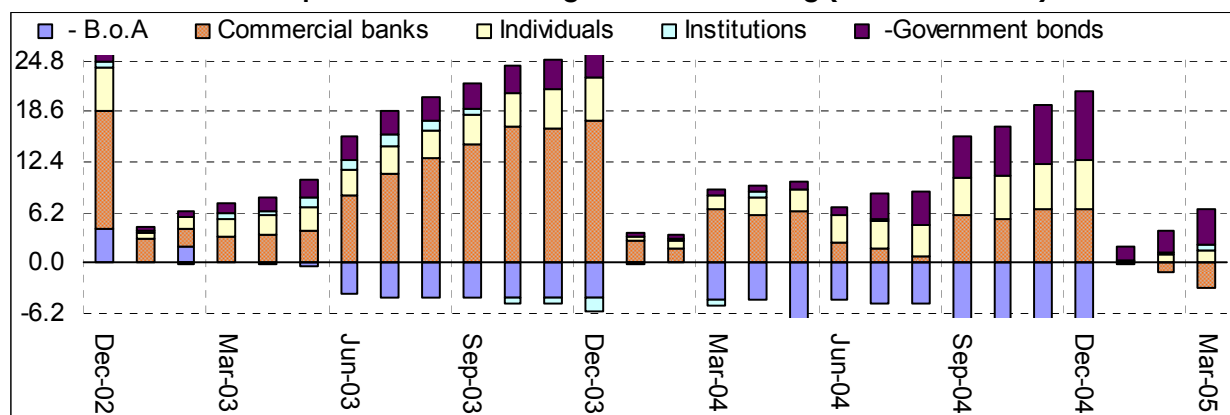
#### IV.3.2.1 Government demand for money

Government demand for monetary assets has been low during first quarter of 2005. According to Bank of Albania data<sup>14</sup>, budget deficit amounted to ALL 1.76 billion in March, while government borrowing reached the value of ALL 4.6 billion<sup>15</sup>. The issuing of two-year bonds constituted the main form of the financing of budget deficit, by ALL 4.3 billion. The issuing of Treasury bills has been at low levels, about ALL 0.3 billion. Commercial banks have reduced their Treasury bills portfolio compared to the end of 2004, by about ALL 2.9 billion. Households have raised their portfolio by about ALL 1.5 billion, while institutions and Bank of Albania increased their respective portfolio at low levels.

<sup>14</sup> These data differ from those of the Ministry of Finance, which keeps its balance sheet based on cash.

<sup>15</sup> The difference between the budget deficit and the domestic financing of budget deficit represents the account position of Government with Bank of Albania.

**Chart 16 Cumulative performance of budget deficit financing (in billions of ALL)**



#### IV.3.2.2 Credit to the economy from the banking system

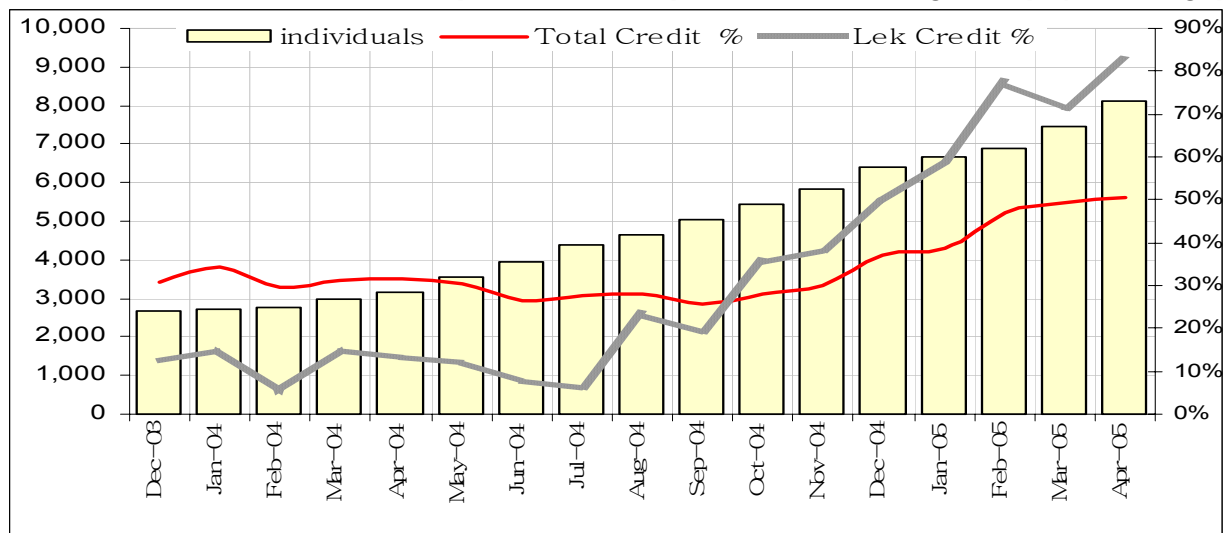
Credit to the economy experienced positive developments during the first quarter of the year. The credit balance increased by about ALL 10 billion during this period or about three times higher than the same period of the previous year. The boom observed over the last months in crediting to the economy is attributed to the changes in the credit time structure, particularly to the growth of credit with long maturity terms.

**Table 9 Indicators of credit balance to the total (in percentage)**

	2002	2003	2004				2005
			Q-1	Q-2	Q-3	Q-4	Q-1
Credit balance (in billions of ALL)	38.7	50.7	53.4	56.8	61.0	70.0	79.7
Shor-term credit	53.8	46.0	41.6	35.4	33.9	34.0	34.1
Mid-term credit	30.1	33.3	35.4	37.8	37.2	36.0	34.5
Long-term credit	16.1	20.7	23.0	26.8	28.9	30.0	31.4
ALL	21.3	19.6	17	17	17	20.0	20.0
Foreign currency	73.7	80.4	83	83	83	80.0	80.0

The entry of "Raiffeissen" bank in the lending market made banks become more active in the credit market, using new opportunities. The strengthening of relations between banks and their customers, between businesses and individuals, is believed to have played an important role in the growth of long-term credit volume. More attention is devoted from banks to individuals, as the continuous growth of credit portfolio for individuals proves it.

**Chart 17 Credit to individuals (in millions of ALL) and annual credit growth (in percentage)**



Besides the total credit, a positive growth rate was recorded by the credit performance in Lek, but without being able to gain ground against the credit extended in foreign currency, which continues to represent about 80 per cent of credit portfolio of the banking system.

The positive developments in the lending market are reflected in the improvement of the whole macroeconomic indicators, which speaks for a growing and improving commitment of banks to intermediation of funds.

**Table 10 Performance of some main indicators**

	2002	2003	2004				2005
			Q-1	Q-2	Q-3	Q-4	Q-1
Money supply (in billions of ALL)	416.7	448.4	456.0	458.2	487.6	507.2	521.6
Domestic credit (in % to M3)	70.8	71.5	71.6	69.5	67.4	68.9	68.3
- Credit to government (in % to M3)	61.5	60.2	59.9	57.1	54.8	55.1	53.4
- Credit to economy (in % to M3)	9.3	11.3	11.7	12.4	12.6	13.8	15.2
Credit to economy (in % to total assets)	11.5	13.7	13.7	14.6	14.7	16.9	17.7
Credit to economy (in % to GDP)	5.7	6.8	7.1	7.4	8.0	9.0	10.0
Total deposits (in % to GDP)	42.2	43.4	44.1	44.1	44.4	47.2	48.6
Credit/deposits ratio (in %)	13.5	15.7	15.8	16.7	16.9	19.0	20.3

The first quarter of 2005 has further consolidated the downward trend of credit to trade sector, which was observed in the second part of 2004. Also, a greater support given by the credits of production sectors and the purchase of real estate, is observed. Such a position reflects the tendency of banks to offer new products, in conformity with the demands of businesses and individuals.

**Table 11 Credit balance by economy sectors**

	2002	2003	2004				2005
			Q1	Q2	Q3	Q4	Q1
1 Agriculture, hunting and silviculture	0.8	1	0.9	1.2	1.6	1.5	1.5
2 Processing industry	17	17	16.9	18.4	18.2	17.1	16.7
3 Construction	8.6	10	9.7	10.7	10.2	9.8	11.2
4 Trade, automobile and house equipment repairing	40.4	34	31.4	23.5	21.9	23.3	20.6



5	Hotel and restaurants	6	6	7.1	8.3	8.3	8.3	5.2
6	Real estate	9.1	13	13.7	14.8	15.6	9.8	14.7
7	Other	18.1	19	20.3	23.1	24.2	30.2	30.1
	Total	100	100	100	100	100	100	100

During first quarter of 2005, a credit of about ALL 22 billion is extended in general at a level rather lower than the same period of the previous year. This fact highlights the idea that the high growth of credit balance has mainly come from the change in the structure of credit extended for longer maturity terms.

**Table 12 New credit indicators to the total (in percentage)**

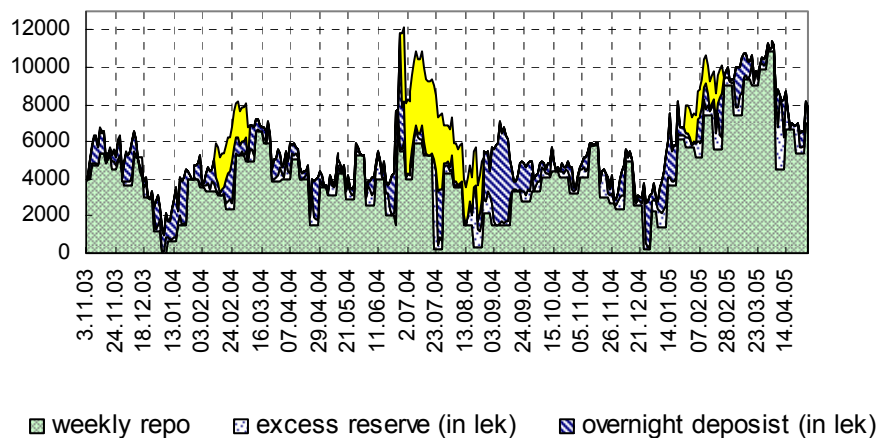
	2002	2003	2004				2005
			Q-1	Q-2	Q-3	Q-4	Q-1
New credit (in billions of ALL)	62.6	92.6	27.9	28.5	18.0	25.4	21.8
Short-term credit	44.7	63.1	67.1	63.6	61.1	57.5	53.3
Mid-term credit	13	22.2	20.3	23.9	21.7	24.0	22.4
Long-term credit	4.8	7.4	12.7	12.5	17.2	18.5	24.4
ALL	20.8	30.8	31.4	31.3	33.6	34.6	30.4
Foreign currency	41.8	61.8	68.6	68.7	66.4	65.4	69.6

## IV.4 FINANCIAL MARKETS AND INTEREST RATE PERFORMANCE

### IV.4.1 Financial markets

The daily average liquidity level, during the first quarter of 2005, is estimated at about ALL 8.5 billion or two times higher than the daily average liquidity of the fourth quarter of 2004. Excess liquidity during this quarter is due to the low level of currency outside banks and to the high level of Lek deposits. The liquidity level growth during the first months of the year constitutes a reiterated trend during these last years.

**Chart 18 Liquidity level of the banking system (in millions of ALL)**



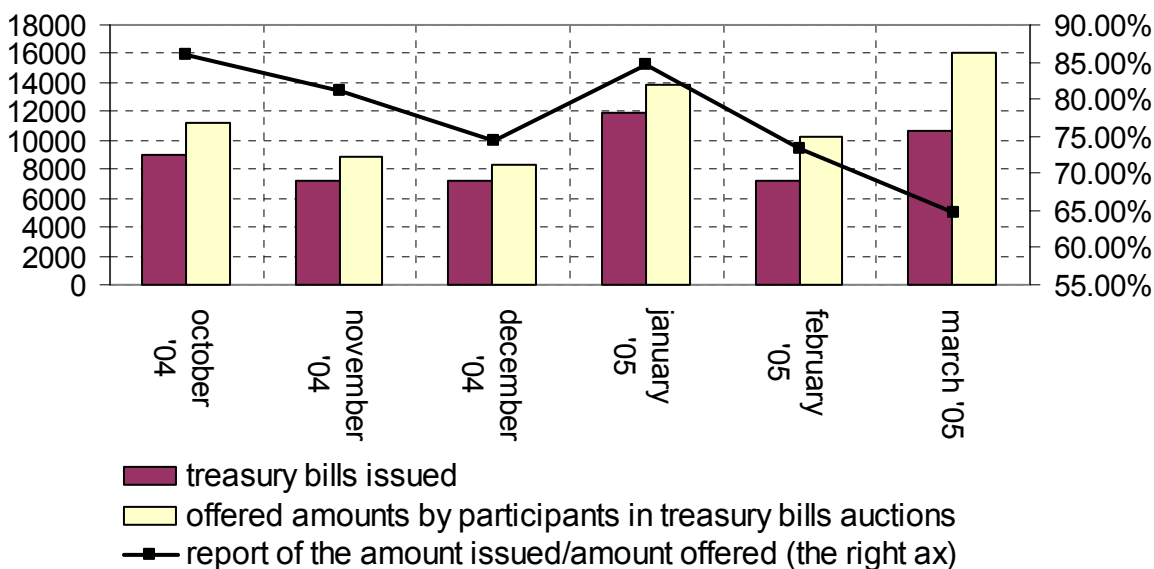
During this quarter weekly repos with fixed price, whose weekly average level amounted to ALL 6.5 billion from ALL 3.5 billion in the previous quarter, were employed to withdraw excess liquidity.

Overnight deposit facility, whose average level amounted to ALL 0.9 billion from ALL 0.4 billion in the last quarter of 2004, was broadly used. The temporary withdrawal of liquidity for a longer period of time is done with monthly repos, which smoothed down the high liquidity level in the interbank market, but failed eliminating it permanently, causing pressures for decreasing interest rate. Overnight credit is not used at all during this quarter.

In the interbank market, the daily average level of overnight transactions during this quarter was ALL 0.65 billion from ALL 0.59 billion in the previous quarter, while the daily average level of weekly transactions remained unchanged, estimated at ALL 86 million.

In the primary market, portfolio of commercial banks in government securities, Treasury bills and two-year bonds increased by ALL 1.4 billion compared to the previous quarter. Portfolio growth is caused by the financing growth to government with two-year bonds, while the financing with Treasury bills, decreased. Even during this quarter, the demand of market players to invest in government securities continued to be higher than the announced winning amount in these auctions, leading to the rise of competitiveness and the decrease of Treasury bills yields.

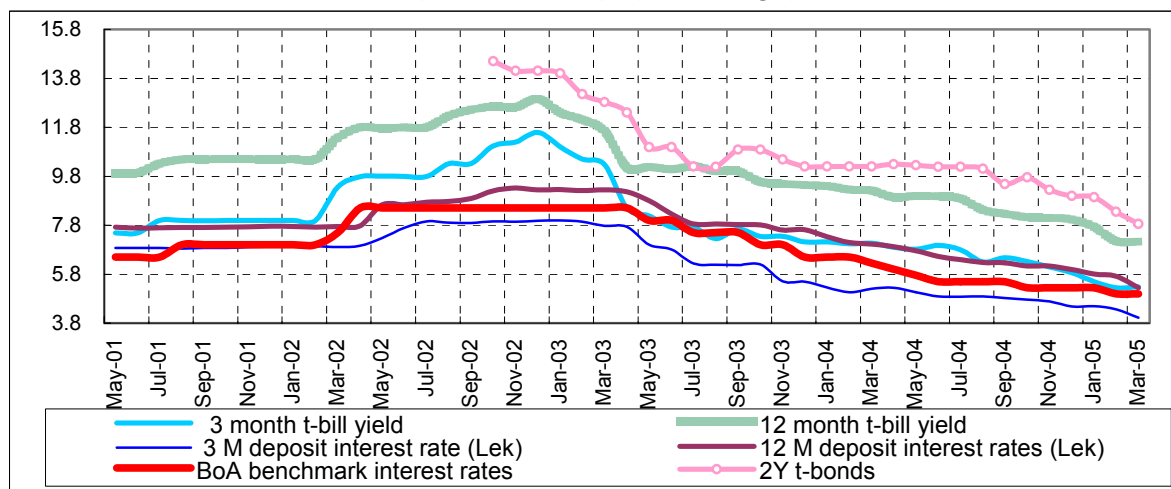
**Chart 19 Quantity required and offered in the primary market (in millions of ALL)**



#### IV.4.2 Interest rates

At the end of the first quarter of 2005, core interest rate was cut by 0.25 percentage point, reaching the lowest historical level of 5.0 per cent. Interest rates in the money market in general, followed the same trend, revealing at the end of third quarter their lowest historical values. The fall of interest rates was backed up by an excess liquidity being at stable levels over the whole period.

**Chart 20 Interest rate performance (in percentage)**



From one quarter to another, interest rate spread with core interest remained in general at constant level with a slight narrowing trend. The banking market has reacted either to the monetary policy signals or to the developments within the market, such as rise of competitiveness, controlled inflation level, financial stability of market agents, etc.

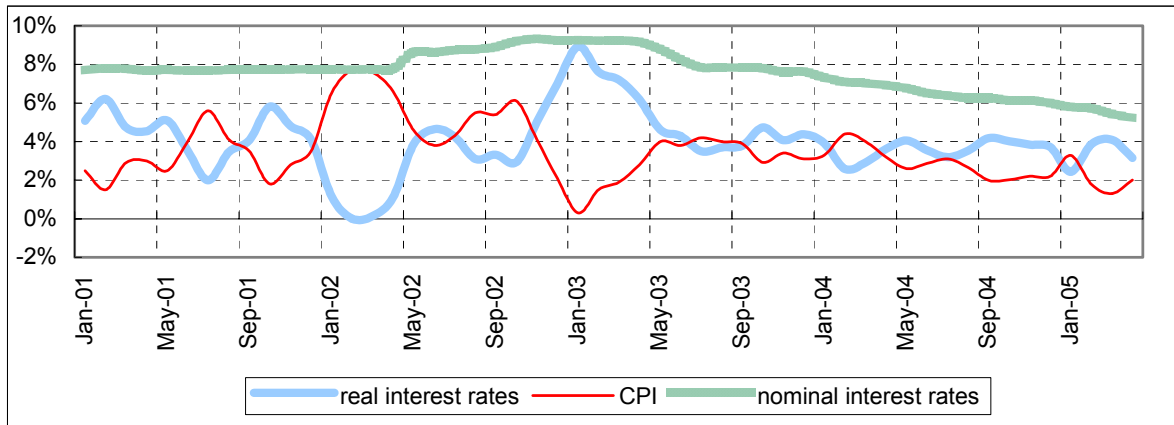
**Table 13 Interest level in markets at the end of each quarter (in percentage)**

	Core interest		Primary market		Deposits market (in ALL)			Interbank market
	REPO	3-month T-bills	6-month T-bills	12-month T-bills	3-month	6-month	12-month	Overnight
March-04	6.50	7.04	8.36	9.26	5.21	6.57	7.03	3.70
June-04	5.75	6.82	8.18	9.00	4.89	6.10	6.52	3.27
September-04	5.50	6.30	7.56	8.43	4.83	5.79	6.26	3.07
December-04	5.25	6.09	7.22	8.10	4.48	5.41	5.99	3.42
March-05	5.00*	5.24	6.51	7.14	4.16	4.85	5.44	2.95

\*Repo change from 5.25 per cent to 5.00 per cent was made at the end of the month.

Although nominal interest in Lek have shown the tendency to decrease, real interest rates during first quarter of 2005 increased due to the further decrease of inflation rate. At the end of the first quarter of 2005, real interest rate reached 4.1 per cent from 2.9 per cent it was in the same period of the previous year.

**Chart 21 12-month deposit interests in ALL and annual inflation**

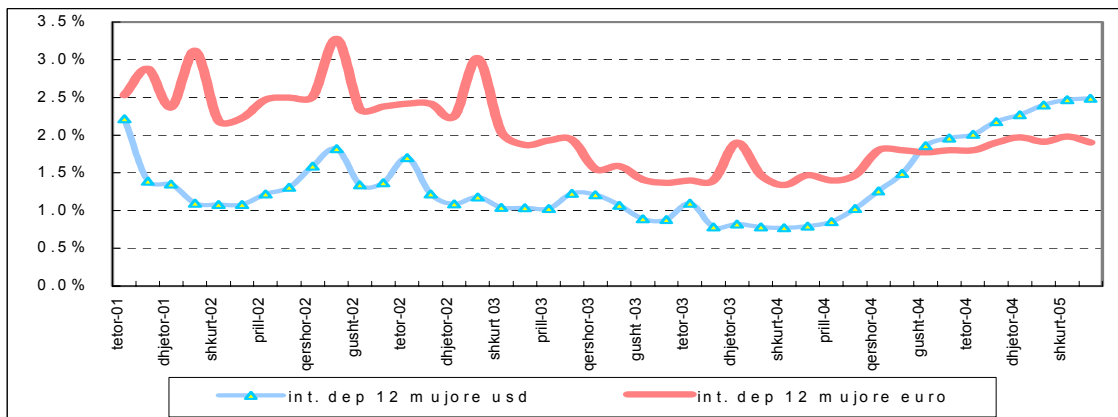


Lek credit market, unlike the other markets, is characterized by interest rates fluctuations. Such fluctuations are mainly caused by the change of the lending structure and the low level of competition. However, in March, there was noticed a tendency of the banking system towards the cut of interest rates for credits in Lek, lowering to 14.62 per cent, approximately 0.41 percentage points lower than February's rate.

Foreign deposits market was characterized by an upward tendency of interest rates in US dollar, which have been influenced by the Fed's tightening policies and by LIBOR interests growth in the international markets. The annual interest rate of deposits in US dollar reached 2.49 per cent, being 0.22 percentage points higher than the one recorded in December 2004.

Interest rates of deposits in Euro remained almost at the same levels, with few fluctuations according to terms, influenced by the EURIBOR interests performance in the international markets. The annual interest rate of deposits in Euro reached 1.90 per cent or 0.07 percentage points lower than in December.

**Chart 22 Average weighted interests of deposits in foreign currency**



The fall of interest rates in Lek led to the narrowing of the difference between the interest rates in Lek and those in foreign currency. At the end of March, there was an approximation between

interest rates of deposits in Lek and those in foreign currency, as well as a narrowing of spread between them.

During first quarter of 2005 there was noticed a downward trend of interest rates of credits in US dollar for all terms as well as of credits in Euro. At the end of March, the average weighted interest rate of credits in Euro reached 8.06 per cent from 8.17 per cent it was at the end of the previous year, while interest rate of credits in US dollar reached 7.18 per cent from 7.79 per cent.

#### IV.4.3 Exchange rates

Despite some fluctuations in the exchange rate, the foreign exchange market stabilized during the first months of the year. For the first quarter, the Lek was slightly depreciated, respectively by 0.43 per cent against Euro and by 2.55 per cent against US dollar. It is noticed that Lek has stabilized at the levels of year-end 2004, without sharpening the appreciation against US dollar and the depreciation against Euro. Although this period of the year knew a growth of the demand for foreign currency, a balanced demand and supply was observed during this year. In annual terms, Lek continued to be appreciated against the two main currencies, US dollar and Euro. In March the annual appreciation of Lek against US dollar is 9.82 per cent, while against Euro is 3.11 per cent.

**Chart 23 Lek exchange rate performance**

