

**BANK OF ALBANIA**

**QUARTERLY REVIEW OF ALBANIAN ECONOMY  
(JULY – SEPTEMBER 2004)**

**OCTOBER, 2004**

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## I. GOVERNOR'S SPEECH

After a first quarter somewhat "sluggish", the Albanian economy has experienced a recovered pulse of economic growth in the following months of 2004. The economic growth is performed in respect of maintaining and consolidating the country's macroeconomic stability. The nine-month period of the year was characterized by an inflation rate meeting the Bank of Albania target, creating the appropriate premises towards further adaptability of the monetary policy followed by the Bank of Albania. This policy is backed also by developments in the monetary indicators where it is worthy mentioning, inter alia, channeling of currency in the system, liquidity stability, interest rates, etc. Furthermore, even the fiscal indicators reflected generally a satisfactory performance within the programmed framework. Incomes, expenditures and budget deficit have been performed according to the schedule planned at the beginning of the year, whereas the balance of payments was stable and unemployment slightly declined.

Based on the data we dispose of, an economic invigoration was noticed mostly in the second quarter in the sectors such as industry, services, and particularly in the construction sector, after a slow performance of this sector in the first quarter. The volume of sales increased by 19.6 percent during the second quarter compared to the first quarter of the year and by 4.4 percent compared to the same period of the previous year.

In the meantime, even the agriculture sector experienced optimistic developments, reinforcing the confidence that the initial forecasts on the annual growth of this sector are possible to be realized. Likewise, transversal indicators suggest a growth in the economic activity. The electric energy consumption by non-familiar consumers increased by 15 percent during the first semester of the year compared to the same period of the previous year, whereas lending to the economy marked a rapid growth during 2004.

According to the economy sectors performed up to now we may say that in the following months of 2004 the economic growth of 6 percent shall be, as projected, an attainable goal.

During the first half of 2004, the volume of current transactions in Albania was higher than a year ago. The current account balance sheet recorded a value of USD 208 million or about -5.4 percent of GDP, remaining almost on the same levels as the previous year. The capital and financial account recorded net capital inflows estimated at USD 266.5 million, thus closing the first semester of the year by a capital inflow significantly higher than a year ago. The foreign currency inflows through current and capital transactions increased the net foreign reserve instruments by USD 132 million.

The third quarter was characterized by low inflationary pressures. The inflation rate has dropped gradually, within the two-to-four percent targeted range, at the end of the third quarter. The average annual inflation has declined as well, reaching 3.1 percent as of September. The increase of domestic agricultural products impacted significantly the consumer price performance during this period. This makes the rising demand during the summer period be supplied with domestic products, offering generally lower prices than

those of imports. As a consequence, unlike the previous years, the contribution of "Food and non-alcoholic beverages" group in total inflation was negative during the third quarter. The impact of oil price rise in the international markets has been relatively weak towards the inflation rate because of the insignificant weight this article has in the consumer price basket and Lek appreciation. The general macroeconomic conditions: monetary situation, economy demand and fiscal situation have been kept under control, contributing positively to the maintenance of price stability. Liquidity situation has been stable, interest rates, though being dropped, have continued to influence the increase of Lek deposits and channeling of currency in the banking system. On the other hand, the moderate increase of money supply has satisfied at best the rising demand for money, a seasonal specificity featuring this period.

Like the preceding part of the year, Bank of Albania monetary policy showed an easing trend during the third quarter. A moderate inflation rate and optimistic forecasts on it have suggested a further reduction of the base interest rate. In response to these developments, the Bank of Albania has cut the base interest rate by 0.25 percentage point as on July 28. The cut was made in compliance with the well-known policy of Bank of Albania to maintain the economy at lowest level of interest rates, being consistent with the target of price stability for a mid-term period. After this reduction, the base interest rate has reached 5.5 percent, the lowest one ever applied in the Albanian economy.

Though nominal interest rates were reduced, the low inflation rate and stability of inflationary expectations of the economy on it, made the real interest rate be rather higher, maintaining the savings deposit interest in the banking system. As a consequence, liquidity structure continued to move towards long-term monetary assets: deposits and Treasury bills. The deposits channeling in the system raises the economy potential for domestic investments, for lending to the economy and for financing of the budget deficit. The attractiveness of interest rates in Lek in comparison with those in foreign currency, alongside a rising supply of the foreign currency during the summer period, has exerted pressures on Lek appreciation. The third quarter marked a strengthening of the appreciation pressures against the Lek exchange rate, mainly due to big inflows of the foreign currency during that period. Under these conditions, the Bank of Albania has intermediated in the foreign market through purchasing the foreign currency, withdrawing its excess of supply and injecting Lek liquidity.

The Bank of Albania intermediation in the foreign market brought about the injection of liquidity in huge quantities in the economy and along with the foreign currency inflows have impacted a higher increase of money supply. This increase of supply has satisfied the demand of the economy for monetary assets. The demand of the government for monetary assets has continued to be covered almost totally by the domestic financing through Treasury bills and government bonds.

In the meantime, the financing of the production sector of the economy was characterized by a rapid growth during 2004. Lending to the economy against GDP has recorded a growth on a continuous basis, reflecting a higher commitment of savings to the financing of the economic activity. At the end of August 2004, the credit balance amounted to Lek 60.9 billion (7.3 percent of GDP). Also, an increase of the number of banks engaged in the lending market is particularly frequent. In the meantime, following the latest developments accomplished in the banking system, adequate conditions

were established for a significant invigoration of the crediting to the economy by the banking system.

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The developments accomplished up to now in the country's economy brought about rather positive expectations for 2004 and behind. The main targets on the development of the country for 2004 seem to be met in accordance with the provisions of the mid-term programme of the country's economic development. Under these conditions, estimating particularly the actual and expected developments on inflation, the Bank of Albania deems appropriate to ease on a continuous basis the monetary policy, that is to ensure a great support for fostering the economic activity.

## II. ECONOMIC DEVELOPMENTS

### II.1 WORLD ECONOMY DURING JULY-SEPTEMBER 2004

After a period of satisfactory economic growth in the second half of 2003 and in the first months of 2004, the world economy started to show signs of slowness and uncertainty. The oil price rise in the international markets is a factor which brought about a slow-down of the economic development. On the other side, the indicators, often contradictory, of the American economy, particularly those of employment, showed that the domestic demand has been fluctuated, while the European economy continues to rely mainly on the foreign demand as a source of economic growth. The United States of America and Asia continue to provide their main support in the development of world economy, while positive performance was experienced even by the Latin America countries and the new Member States which joined recently the European Union.

Inflationary pressures have recorded a growth in all economies replacing the deflation fear which was present in mid-2003. The increase of inflation was attributed to the oil price rise, but in many countries there was a growth of the base inflation too. This increase shows that inflation sources have a wider basis, including the demand factors.

**Table 1. Some essential indicators of the world economies (in percentage)**

	<b>GDP (second quarter)</b>	<b>Unemployment</b>	<b>CPI</b>	<b>Budget deficit (as a percentage of GDP)</b>
Britain	3.6	4.7 (July)	+1.3 (August)	-2.9
France	2.8	9.9 (August)	+2.4 (August)	-3.8
Germany	2.0	10.7 (September)	+1.8 (September)	-3.7
Italy	1.2	8.5 (April)	+2.1 (September)	-3.1
Japan	4.2	4.8 (August)	-0.2 (August)	-7.1
USA	3.3*	5.4 (August)	+2.7 (August)	-4.7
Euro area	2.0	9.0 (August)	+2.2 (September)	-2.8
China	9.2	-	+5.3 (August)	-

Source: "The Economist", September 2004.

The economic activity in the United States was somewhat slow in the recent months. The oil price rise and the real economic situation, characterized by a lower employment rate than expected, have had an important impact on the decline of individuals' consumption. Also, the considerable deficit of the current account in the United States constitutes a constant concern for the investors and policy-makers. During this quarter, FOMC<sup>1</sup> raised twice the base interest rate, bringing it from 1.25 percent to 1.75 percent. These decisions were influenced by the increase of inflationary pressures and the necessity to support the US dollar when it is exchanged against the other currencies. Also, the base interest rate in the United States has been on its lowest level over the last 40 years, a level which, evidently, could not resist the recorded rates of the economic growth.

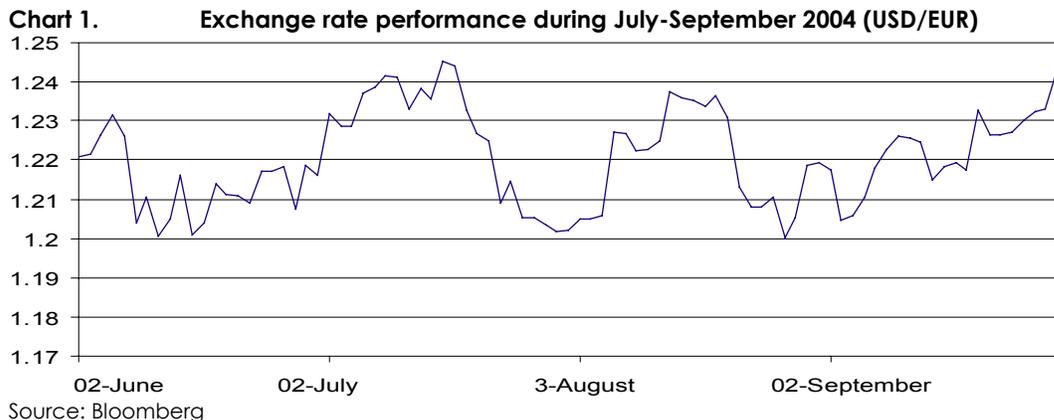
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<sup>1</sup> Federal Open Markets Committee.

The economic activity performance in the euro area has been more stabilized. The annual growth in the second quarter, according to the recent data, is believed to be 0.5 percent from 0.6 percent it was during the first quarter. The foreign demand continues to be the basis of economic growth, while the domestic demand plays rather a modest role. Net exports have continued to record positive values, although imports increased significantly compared to the previous periods, due to the oil price rise. The oil price had a negative impact even on the real income, reducing the private consumption. For the coming period, notwithstanding the developments in the oil market, the economy performance in the euro area is expected to be positive. Improvements in the labor market will lead to the increase of available revenues, which shall be reflected in the increase of the private consumption, thus rising the domestic demand.

### II.1.1 Exchange rate performance

During this quarter the exchange rate between US dollar and euro fluctuated in a narrow band. High oil price, short-term interest rates performance and expectations on the American economy and that of the euro area, have been some of the essential factors that have impacted on the exchange rate trend. At the beginning of August, the data originating from the American economy on the sharpening of the budget deficit and current account deficit, as well as non-positive signals from the American labor market, have impacted on the euro appreciation. While the announcement on the increase of capital investments in the United States for July, along with a growth in the American bonds yield, have supported the appreciation of US dollar during the second half of August. In September, euro is appreciated gradually against US dollar. The data on the moderate growth of inflation contributed to the decline of the American T-bills yield, thus raising the pressures against US dollar. Meanwhile, the data on the other indicators of the economy have been in the same line with the expectations, without having any impact on the exchange rate performance. Even the decision made on September 21 by FOMC to increase the base interest rate by 0.25 percent did not support the appreciation of the American currency.

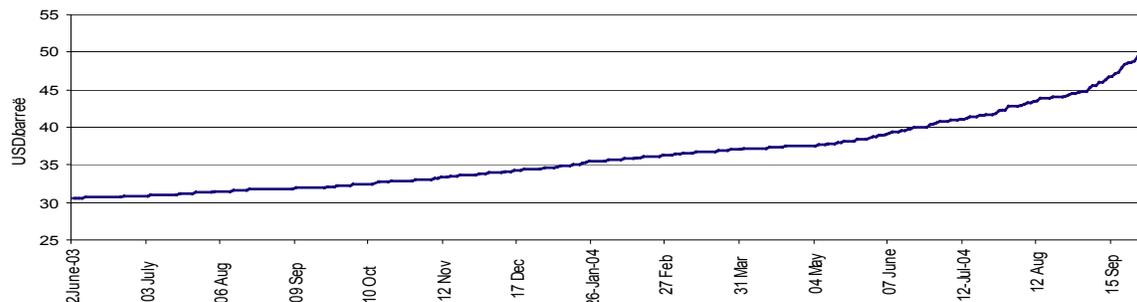


### II.1.2 Oil price

Oil market prices increased considerably. Oil price per barrel since the beginning of year rose by 44.4 percent. Both oil demand and supply factors have impacted the price rise. Oil demand resulted to be the highest one over the last years and this was attributed to the developments of the global economy, particularly the recovery of American

economy as well as the boom of Chinese economy. Price rise was also triggered by the events of some exporting oil countries. Security issue of Persian Gulf, the ongoing sabotages of oil wells in Iraq, the difficult situation of Yukos oil company in Russia and strikes in Nigeria, have had a special impact in increasing insecurity. The production does not entirely satisfy the supply although OPEC has reduced the reserve amount and plans to raise the supply by 400,000 barrels per day this year and by 700,000 barrel per day, in 2005. This phenomenon will have an impact on keeping high the price over the coming period. Oil price for 2005, based on IMF studies<sup>2</sup>, will be 8 USD higher than the price of 2003. Such a price rise would reduce the world GDP by 0.5 percent.

**Chart 2. Oil price during June'03 - September'04 (USD per barrel)**



Source: Bloomberg

## II.2 COUNTRY'S ECONOMIC DEVELOPMENTS

The Albanian economy has marked an economic growth over the first half of 2004. The operating data of the second quarter and those of the third quarter show that performance of various sectors of the economy, such as industry and services, have considerably been improved compared to the previous year, after a slow first quarter. Similarly, construction sector has marked a rather positive progress over the second quarter, also after a slow first quarter. Thus, sales volume over the second quarter increased by 19,6 percent compared to the first quarter and by 4.4 percent compared to the same period of the previous year.

Based on the performance of the economy sectors estimated so far, we can state that for the rest of 2004, the expectation for an economic growth of 6 percent is attainable. The intense development of the construction sector, the satisfactory performance of the processing and extracting industry branches, and the optimistic expectations on the performance of agriculture sector compared to the previous year, confirm the forecasts regarding the target achievement. Agricultural sector data show that the initial expectation on the annual growth of this sector is attainable. Indirect indicators speak also for a growth of the economic activity. Over the first half of 2004 the electric energy consumption by non-familiar consumers increased by 15 percent compared to the same period of the previous year, while credit to the economy had quickly grown over the year 2004. The portal services volume of exports increased at 81 percent over the second quarter of the year compared to the same period of 2003. The increase of capital

<sup>2</sup> IMF, World Economy Outlook, September 2004

budget expenditures by the use of revenues from the privatization of the Savings Bank will help the economic activity over the last quarter of the year.

**Table 2. Main economic indicators for 2004 (in percentage)**

	2002	2003	2004
Growth of real 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

## II.2.1. Domestic Production performance pursuant to the economy branches

### Agriculture

Production in the agriculture sector is expected to grow by 4 percent in 2004. Agro-industry sector is expected to have a more pronounced growth by 10 percent, while the other two sectors, agriculture and fishing, are expected to grow by 3 and 4 percent, respectively.

The ultimate estimations conducted by the Ministry of Food and Agriculture confirm the forecasts made at the beginning of the year on the growth<sup>3</sup> of the general agricultural production. The survey on the production of the agro-industry sector conducted by the Ministry of Food and Agriculture suggests that the agro-industrial production increased by 9 percent over the first half of 2004 compared to the same period of the previous year. There was also noticed a growth of meat products, conserved products and alcoholic beverages while corn processing has decreased. The development of agro-industry sector is expected to be positive for the rest of the year, since this production is of seasonal nature, with more pronounced concentration over the second half of the year.

**Table 3. Agro-industrial production during 2004**

	Q2 `04/Q1 `04 (in %)	Q2 `04/Q2 `03 (in %)	S1 04 <sup>3</sup> /S1 `03 (in %)
Agro-industrial production	8.4	0.2	9.0
Meat and its sub-products	10.6	16.6	16.4
Conserved products	36.1	20.0	-5.7
Milk and dairy products	40.6	7.0	6.8
Wheat flour and bread	-1.0	-6.1	1.0
Alcoholic beverages	38.4	45.0	34.8
Water and fresh beverages	-10.9	-14.4	12.1

Source: Ministry of Food and Agriculture.

Agricultural production performance seems to be positive although there is a lack of the final data on this sector. This estimation is supported by the price performance of the agricultural products in the domestic market whose price level has recorded a decline over the last semester. The domestic market supply increased due to the growth of

<sup>3</sup> Here, agriculture sector includes the agro-industry too.

domestic production, since the agricultural products imports have not recorded any particular growth compared to the previous year. The good atmospheric conditions at the beginning of the year and the extension of the areas with green houses have contributed to the domestic production.

Agricultural products imports (in Lek), over the half of 2004, resulted almost the same as those of the first half of 2003. Within this category, meat and vegetal oil imports have decreased, while cereals and vegetables imports increased in comparison with the first half of the previous year.

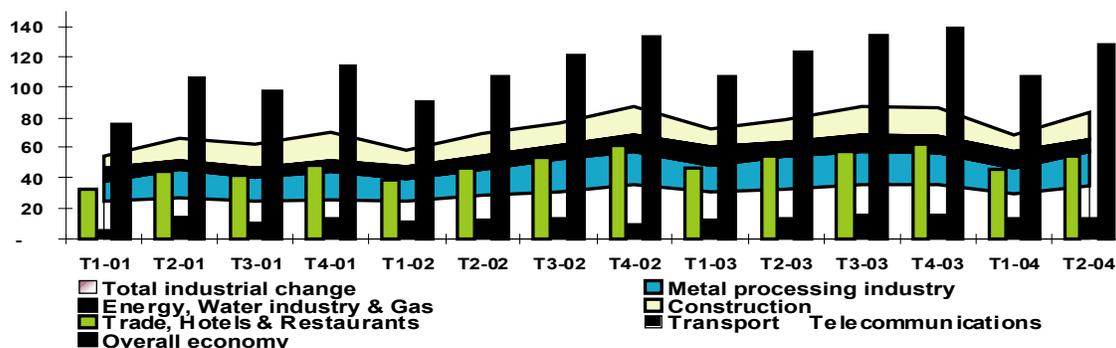
The Ministry of Food and Agriculture keeps on being engaged in a range of projects, which aim to improve the agriculture infrastructure. The second project of irrigation and draining rehabilitation is accomplished at 96 percent over the first six months of the year. Other projects, such as agricultural services project, fishing development program and mountainous regions development program continue to be implemented.

### Industry, construction, transport

Sales performance of industry, construction and transport<sup>4</sup> sectors speak for a satisfactory growth over the second quarter of 2004. A growth was also noted for both quarters compared respectively with the first and second quarters of the last year. The increase of the domestic production of electric energy by 9 percent as well as the increase of the use of electric energy by non-familiar consumers by 15 percent have supported the industrial activity.

The processing industry, a sub-branch carrying the highest weight in the industry sector, has performed in the second quarter 28 percent of sales more than in the first quarter of the current year. The construction sector has also marked a considerable increase of sales compared to both periods; respectively an increase by 52 percent compared to the first quarter of 2004 and by 17 percent compared to the second quarter of 2003. This performance shows the positive real progress of this sector, as the Construction Cost Index shows a slight increase. The analysis of Construction Cost Index shows an increase of 3.1 percent of direct expenditures for construction materials and an increase of 3.7 percent of salaries in the second quarter compared to the same period of the previous year. Also, the projected profit in this sector has restarted to demonstrate positive trends, increasing by 3.2 percent, while the cost of construction-site has declined by 5.6 percent.

**Chart 3. Performance of sales of some selected industry sectors (in billions of Leks)**



Source: Institute of Statistics.

<sup>4</sup> Industry, construction and transport sectors, in 2002 represented 14.5, 9.5 and 9.0 percent of GDP, respectively. Source: Institute of Statistics, Gross Domestic Product 1996-2002, September 2004.

Unlike the industry and construction sectors, sales in the transport sector have recorded a decline of 1.1 percent in the second quarter of this year, compared to the same period of the previous year. The partial performance of investments in this sector, from both budget and foreign sources, has contributed to this decline. These investments have been performed at 82 percent and 50 percent, respectively, during the second quarter. Meanwhile, the loading and unloading activity shows a positive performance. The exporting work volume in ports increased by 81 percent in the second quarter and 21 percent during July-August, in comparison with the same periods of the previous year.

**Table 4. Changes in the loading and unloading work volume (in percentage)**

	II Quarter -2004/2003	July – August 2004/2003
Total	+9	+5
Railways	+24	-38
Ports	+7	-7
- Imports	+2	+8
- Exports	+81	+21

Source: Ministry of Transports.

## Services

“Trade, hotels, restaurants” group represent 19 percent of GDP, while “Other services” group contributes by 22.5 percent in the General Domestic Product. Both these groups have recorded an increase of sales during the second quarter of 2004, compared to both estimated periods. “Trade, hotels, restaurants” group did not suggest any significant change from the same period of the previous year, while a growth of the activity by about 21 percent was recorded, compared to the first quarter of this year. Such a progress of services sector is satisfactory and seems to assist in achieving the target of the economic growth for 2004.

### II.2.2. Fiscal sector

Fiscal policy has been prudential during the first 9-month period of 2004, regarding the control of expenditures and budget deficit. The amount of Lek 132.5 billion has been deposited in the state budget, or 92 percent of the revenues projected for this period, while the expenditures performed from the Government were Lek 151.3 billion, or about 91 percent of the plan. Both revenues and expenditures, in absolute value, show an evident increase compared to the same period of the previous year. Fiscal indicators increased gradually during the quarterly periods, showing the highest values in the third quarter. The revenues, compared to the same period of the previous year, increased by 9.1 percent, while expenditures by 9.6 percent. Budget revenues maintained almost the same level as that of the previous year in percentage of GDP (21.3 percent from 21.7 percent), meanwhile the expenditures have declined from 25.2 percent to 24.3 percent, making the budget deficit be 3.0 percent of GDP by the end of September. The control of both the budget expenditures and deficit, within the projected targets, led to lower inflationary pressures from the fiscal sector.

**Table 5. Fiscal indicators of 2004 (in billions of Leks)**

In billions of LEK	Q1-04	Q2-04	Q3-04	9M - 2004	GDP (%)	Plan (%)	2003 (%)
A. Total revenues	41.4	44.6	46.5	132.5	21.3	91.9	109.8
1. Tax revenues	37.7	40.3	42.3	120.3	19.3	96.6	112.8
2. Non-tax revenues	3.4	4.0	4.2	12.1	2.0	68.6	90.6
B. Total expenditures	43.4	51.0	56.9	151.3	24.3	90.5	108.1
1. Current expenditures	38.9	44.8	46.7	130.3	20.9	98.9	108.8
2. Capital expenditures	4.5	6.2	10.3	21.0	3.4	63.1	104.2
C. Budget deficit	-2.0	-6.4	-10.4	-18.9	3.0	81.7	97.9

Both economic and tax base growth have impacted the increase of revenues. While current expenditures continue to be performed according to the plan, capital expenditures are performed only at 62.2 percent. Budget deficit is financed at 68 percent by domestic sources.

### **Budget revenues**

Total State budget revenues amounted to Lek 132.5 billion for the period January-September. These revenues, though lower than those projected at the beginning of the year, were 10 percent higher than the revenues of the same period of the previous year. Tax and customs revenues have provided on the average 91 percent of the total revenues during the first 9-month of the year. The revenues from value added tax (VAT), which provides about the half of revenues, cover the highest weight of this category. VAT has provided, as at August, 102 percent of the planned revenues of this category. Revenues from income tax on and excise have marked an increase particularly over the third quarter.

### **Budget expenditures**

Total expenditures amounted to Lek 131.5 billion during the period January-September 2004. Current expenditures continue to cover the highest weight of the total expenditures. However, a positive performance in the last months was reflected by the increase of capital expenditures, which gradually increased by 20 percent in August, from 9 percent of the total expenditures in January. More than half of current expenditures are covered by the wages and social insurances are, while interest payments, particularly the domestic ones, have declined during the first 9-month period of the year. Interest payments decline from 24 percent into 12 percent of the total expenditures, from January to August, is argued by the reduction of T-Bills interest rates, contributing to disburden the domestic government debt. While, capital expenditures are performed at 63 percent, and that is a fact which requires a greater attention from the Government in this direction.

### **Budget deficit**

Budget deficit amounted to Lek 18.9 billion as at the end of September. The major part of the budget (from 50 to 90 percent) is financed by the domestic sources, particularly during the second and third quarters of 2004. Budget deficit is estimated to be about 82 percent of the planned deficit, by the end of September.

### II.2.3. Foreign sector

Albania has performed in the first half of 2004 a higher volume of current transactions than in the respective period of 2003. Current account balance of this semester was USD 208 million, or about -5.4 percent of GDP. This ratio is fairly equal to the one of the previous year of -5.3 percent of GDP. The nominal growth of current deficit by 36 percent is not reflected in the growth ratio of this indicator against GDP, due to the GDP growth and dollar depreciation against the domestic currency. Similarly to the previous years, the highest weight of the current transactions is covered by the trade transactions in goods and current transfers. Capital and financial account has recorded a net inflow of USD 266.5 million, closing the first half of the year with a capital inflow, considerably higher than the one of the same period of the previous year. Capital inflows are considerably conditioned by the revenues from the Savings Bank privatization, which led to the increase of residents' liabilities in the form of foreign direct investments in the country. Foreign currency inflow through both the current and capital transactions contributed to the increase of gross foreign reserve instruments by USD 132 million.

**Table 6. Balance of payments for the first semesters (in millions of USD)**

	Inflows	Outflows	Balance-6-S1-04	Balance-S1-03
A. Current account	1,261.0	-1,469.3	-208.3	-152.9
A.1.Merchandise trade	289.8	-978.5	-688.7	-625.6
A.2.Services trade	434.8	-440.7	-5.9	-11.2
A.3.Revenues	82.0	-13.6	68.4	81.2
A.4.Current transfers	454.5	-36.6	417.9	402.7
B. Capital and financial account			266.5	179.0
B.1. Capital account			59.70	67.5
B.2.Financial account			206.8.0	111.5
D. Increase of reserve assets			132.3	61.2

#### Merchandise trade

When analyzing the merchandise trade and in general all the figures of the balance of payments, we have to take into consideration the exchange rate performance, specifically the rate of Lek against US dollar. US Dollar depreciation, particularly during December'02 – June'04, led to the growth of transactions volume measured in current dollar to result higher than the real growth. If Lek appreciation impact is not taken into consideration against American dollar during the above-mentioned period<sup>5</sup>, exports growth would result 9 percent from 30 percent estimated in current dollar, while imports growth from 15 percent turned down into 3.5 percent.

Foodstuffs keep on having the highest weight of total imports (17 percent), machineries and equipment (17 percent), textiles and textile articles (11 percent), etc. Imports of vegetal products grew at a modest degree compared to the first semester of the previous year, the textile ones, part of which is used as raw material for the active manufacturing industry, as well as imports of the base metals. In general, the relatively higher growth of imports of goods that are used as raw material for further processing in the country or for the machineries used in production, compared to the imports of consumer goods is a positive signal on the progress of the country's economy.

<sup>5</sup> This estimation is based on calculating exports by fixed exchange rate-December 2002.

Exports, alongside the nominal and real growth, have recorded positive developments towards the diversification of the exported goods basket. Thus, the first semester has marked a growth of exports of minerals and base metals products, apart from the growth of exports for the group of goods "textiles and textile articles" and "headwear, footwear, umbrellas, etc." Foreign trade has reflected as well an improvement of the economy performance in the second quarter. Second quarter exports resulted 12 percent higher than those of the first quarter, while imports were about 16 percent higher.

For import prices, which play an important role in fixing the final price of consumer goods (Consumer Price Index) and in the production materials (Produce Price Index), the changes have been almost insignificant for the major part of group of goods, as at the end of the first quarter of 2004. The general prices of import goods for the first quarter of 2004 have declined by 6 percent compared to the first quarter of 2003, and by 17 percent compared to the last quarter of 2003.

**Table 7. Changes of import good prices<sup>6</sup> (in percentage)**

	<b>Weight of import value, total (in %)</b>	<b>Q1 '04/Q4 '03 (in %)</b>	<b>Q1 '04/Q1 '03 (in %)</b>
Vegetable products	7.8	0.5	6.0
Prepared foodstuffs	7.8	-13.25	-11.0
Textiles and articles	11.1	-4.50	-5.0
Machinery and equipment	16.9	0.6	4.0
Mineral products	9.6	0.4	-14.0
Total	100	-17.0	-6.0

Considering the performance of import prices for the second half of 2003, we may say that the group of goods of higher weight in total imports is expected to know a significant decline of these prices. This means that import prices, excluding potential impacts due to oil price rise, are not expected to exert inflationary pressures on the consumer prices.

### **Services, income, Current transfers**

Services trade has recorded a growth in both directions, imports and exports, during the first half of 2004. Services account for this period seems slightly negative (- USD 6 million). Both services income and expenditures almost grew at the same degree compared to the same period of the previous year (about 40 percent). This growth is significant even if we ignore the exchange rate impact. Travel income, USD 300 million, represent 60 percent of inflows, while travel expenses, USD 265 million, represent 50 percent of total outflows in the services account. The number of visitors entering Albania from abroad, as well as the numbers of residents, spending the holidays abroad, result considerably higher than a year ago. Income in the communication category increased, reflecting the income growth from the services performed by the local radio-televisions, as well as from Altelecom.

Income category has not manifested any development different from the first half of 2003. Income balance was about USD 70 million. The major part of incomes (USD 44 million of USD 88 million) has come from employees' compensation, while the rest belongs to both portfolio investments and reserve income.

<sup>6</sup> Source: Institute of Statistics: Value Index unit for imports and exports.

Current transfers balance continues to be positive. Net current transfers inflow has covered about 60 percent of the trade deficit of USD 690 million. Private inflow transfers resulted about 8 percent higher than those of the first half of 2003. It might be argued that the highest financing source of current expenditures, considering the exchange rate, is ensuring lower foreign revenues for Albania. From some times now an emphasis was put on the necessity of providing alternative sources for the financing of expenses, to smooth the dependence on the unsafe and instable foreign exchange source.

### **Capital and financial account and reserve assets**

Net inflows in the capital and financial account were USD 267 million during the first half of the year. About 60 million of them were net inflows as capital, while USD 207 million, net inflows in the financial account. The financial account recorded during this period a considerable increase of residents liabilities as direct investments, due to the revenues from the Savings Bank privatization in April of the current year. The public and private borrowings marked also an increase of residents' liabilities by USD 42 and 35 million, respectively. Albania has repaid about USD 23 million from its foreign debt. In terms of assets it is worthy mentioning: growth of residents' deposits stock abroad by USD 38 million, growth of other assets by USD 32 million, as well as growth by USD 10 million of our assets abroad in the form of shareholder capital.

Reserve assets increased by USD 132 million, during the first half of 2004. The total growth was almost in foreign currency, while holdings in gold, SDR as well as the reserve position in the IMF have remained unchanged.

### **II.2.4. Labor market**

The labor market manifested stability signs during the second quarter of 2004. The decline of the labor force by 11 thousand persons during the first quarter was followed by an increase of 1 thousand persons in the second quarter. The logistic difficulties for the registration of the private entities in this period justify to some extent the developments of the first quarter. 1.081 million persons are enrolled in the labor force as at the end of the second quarter, 921 thousands of them were employed. About 20 percent of these persons are employed in the public sector, 23 percent in the non-agricultural private sector and 58 percent in the private agricultural sector. Unemployment rate has dropped from 14.9 percent by the end of the first quarter to 14.8 percent in the second quarter, due to the simultaneous increase of the number of labor forces and that of unemployed persons.

Employment level in the public sector has declined, while free labor forces seem to move towards the private non-agricultural sector. Although official data on labor market are published late, indications coming from regional labor office (particularly referring to Tirana district) show that employment is expected to grow for the rest of the year. At the same time, this year coincides with a campaign organized by the Ministry of Labor and Social Affairs regarding the registration of illegal work and the strengthening of control from tax authorities. It is expected these steps have their impact on labor market data.

**Table 8. Labor market indicators ( in thousands of persons)**

	2002				2003				2004	
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II
Labor force (thousands)	1096	1093	1094	1094	1096	1093	1092	1091	1080	1081
A. Employed persons (thousands)	918	917	919	921	926	927	928	927	919	921
i) public sector	189	188	187	187	185	185	184	182	179	179
ii) private sector, non-agricultural	6	203	206	208	207	208	210	211	206	208
iii) private agricultural sector	526	526	526	526	534	534	534	534	534	534
B. Unemployed persons (in thousands)										
i) total unemployed persons	178	176	175	173	170	166	164	164	161	160
ii) Receive an unemployment pay	13	13	12	11	11	11	11	11	11.5	12
C. Unemployment rate (in %)	16.2	16.1	16.0	15.8	15.5	15.2	15.0	15.0	14.9	14.8

Source: Institute of Statistic, Conjuncture - June, 2003.

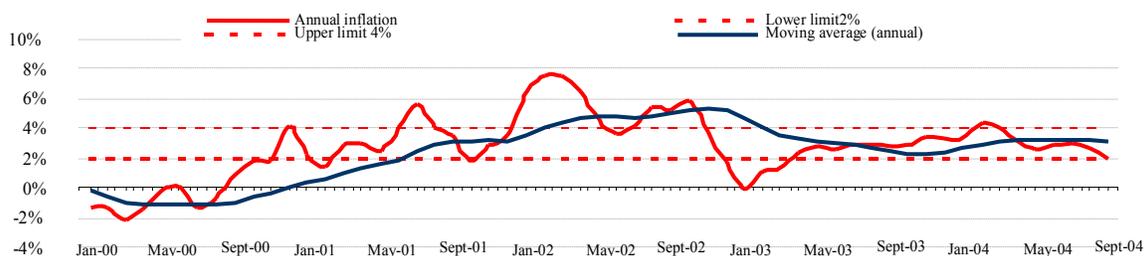
### III. INFLATION PERFORMANCE AND MONETARY POLICY

Inflationary pressures have been of low impact during the third quarter. Inflation rate has marked a gradual decline, attaining the lower limit of the 2 – 4 percent targeted range of the Bank of Albania, at the end of the third quarter. The average annual inflation have also declined, reaching 3.1 percent in September.

**Table 9. 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	2.6
June	0.1	4.0	3.7	2.6	2.9
July	-1.3	5.6	4.2	3.0	3.1
August	-0.7	4.1	5.5	3.0	2.7
September	0.9	3.5	5.3	2.8	2.0
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	
Average	0.05	3.13	5.22	2.37	3.13

**Chart 4. Annual inflation rate (in percentage)**



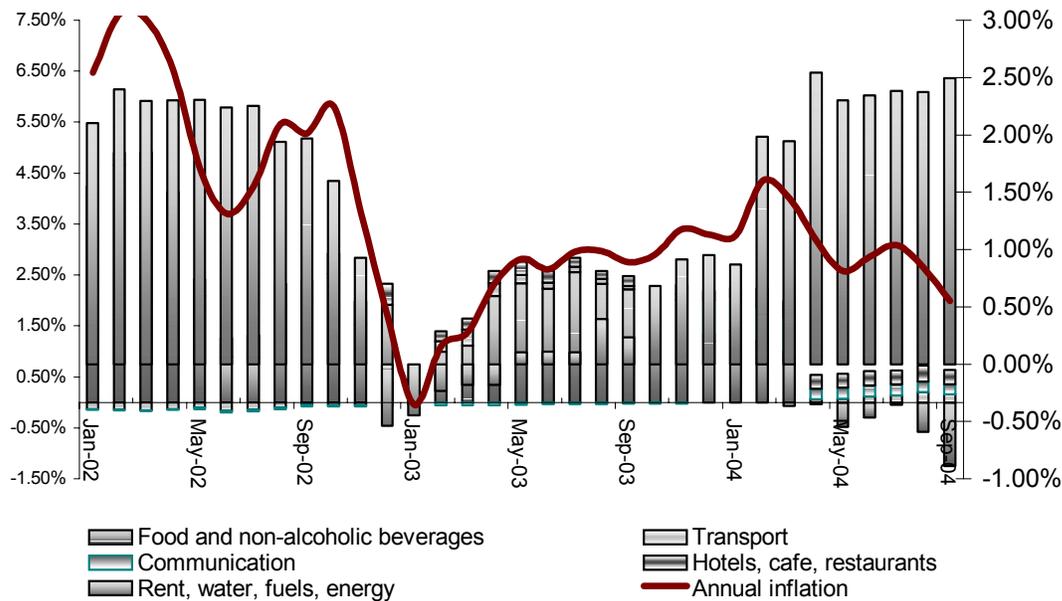
Source: institute of statistics.

Consumer prices performance was considerably conditioned by the domestic agricultural production growth over this period. This growth made the rising demand of the summer period be supplied by the domestic production, which in general offers lower prices than imports. Thus, unlike the previous years, (see Chart 5), the “Foodstuff and non-alcoholic beverages” group has contributed on the total inflation with a negative impact during the last quarter. Furthermore, the general macroeconomic conditions: monetary situation, economy demand and the fiscal situation have been kept under control, prioritizing the maintenance of price stability.

### III.1 Performance of constituent groups of consumer price basket

Annual inflation of the largest weight group - "Foodstuff and alcoholic drinks", has market negative values over the third quarter. "Clothes and footwear" group is highlighted by the same characteristic. Both groups "Rent, water, fuels and energy" and "Transport" have recorded positive annual rates of inflation in July, August and September.

**Chart 5. Contribution of main groups to inflation (in percentage point).**



Source: Institute of statistics; Bank of Albania

In September, the annual inflation for "Foodstuff and non-alcoholic drinks" recorded -2.9 per cent, contributing by -1.25 percentage points to total annual inflation rate. Over the third quarter of this year the seasonal effect of the reduction of agricultural product prices was felt stronger. The domestic agricultural product during May-September 2004 met the market demand largely. Also, production prices of food processing industry<sup>7</sup> have recorded an annual cut by 28.7 per cent. The monthly inflation performance of "Foodstuff and non-alcoholic drinks" and its components are presented in the following table.

<sup>7</sup> Data are received from the CPI of the second quarter 2004, INSTAT.

**Table 10. Monthly and annual inflation rate of "Foodstuff and alcoholic drinks "**

	"Foodstuff and non-alcoholic drinks"		"Fruits"		"Vegetables"	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
<b>July '04</b>	<b>-0.4</b>	<b>-0.1</b>	<b>3.7</b>	<b>10.9</b>	<b>-5.9</b>	<b>-15.4</b>
July '03	-1.0	6.2	-2.2	19.2	-3.9	30.1
<b>August '04</b>	<b>-1.2</b>	<b>-1.4</b>	<b>-5.5</b>	<b>7.8</b>	<b>-5.4</b>	<b>-21.3</b>
August '03	0.0	6.2	-2.7	17.4	1.7	26.1
<b>September</b>	<b>0.0</b>	<b>-2.9</b>	<b>-4.4</b>	<b>3.2</b>	<b>3.5</b>	<b>-25.6</b>
September '03	1.6	5.3	-0.1	22.5	9.4	21.4

Inflation of "rent, water, fuels and energy" has been relatively stable over the third quarter of the year. However, this group constitutes the main contribution to total inflation, contributing by about 2.5 percentage points to the final inflation rate of September. (See Chart 5). The abrupt rise of "Fuels and energy" annual inflation from 6.9 per cent in January to 35 per cent in February of this year made the inflation rate of the whole group remain in high level along the coming months (see Table 11).

**Table 11. "Rent, water, fuels, energy" monthly and annual rate**

	"Rent, water, fuels, energy"		"Rent"		"Fuels 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
May '04	0.0	9.7	0.0	5.6	0.0	27.2
June '04	0.0	9.7	0.0	5.6	-0.1	27.0
July '04	0.1	9.9	0.0	5.6	-0.1	26.9
August '04	0.8	9.7	1.1	5.5	0.0	26.7
September '04	0.0	10.4	0.0	6.4	-0.1	26.7

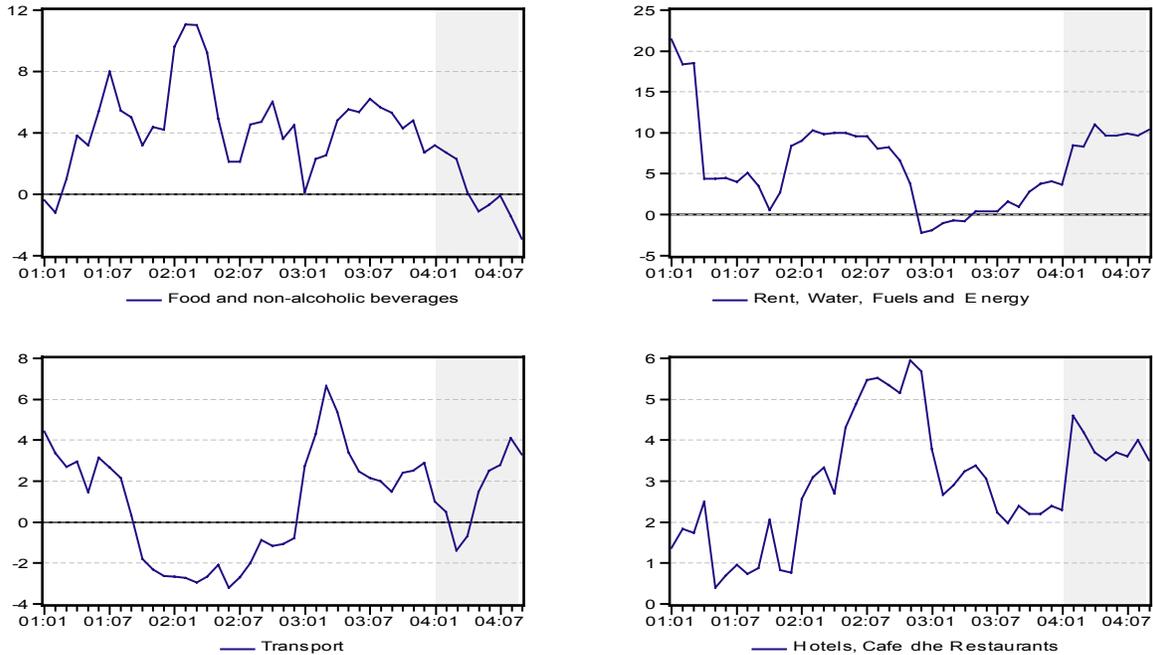
Oil price rise in the world markets risked to be translated into an inflation rise of "Transport" group over this quarter, having negative implications even on total inflation rate. But, the inflation of this group recorded only a slight raise in this period. August monthly inflation resulted to 1,4 per cent, due to price rise of transport services and services to personal vehicles. Meanwhile, the effect of oil price rise is deemed to have been balanced by the lek appreciation against the usd in the domestic market<sup>8</sup>.

The rise of tariffs managed by fixed telephony<sup>9</sup> has made the annual inflation of "Communication" group rest to 17 per cent over most of the year. Meanwhile, the contribution of other groups to total inflation rate has been modest.

<sup>8</sup> The dollar is depreciated by 3.5 per cent on average against the lek during the third quarter, compared to the second quarter of this year.

<sup>9</sup> The initial rise of tariffs managed by fixed telephony, in December 2003, was rectified to become lower in April.

**Chart 6. Annual inflation of the four main groups of the CPI basket (in per cent).**

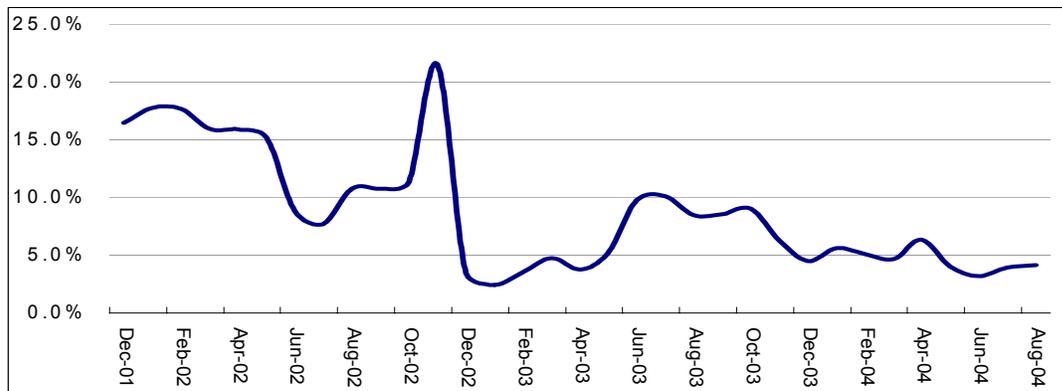


Source: Institute of statistics; Bank of Albania

### III.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

Excluding February, the annual inflation rate has been within the 2 – 4 per cent target of the Bank of Albania during 2004. This positive performance is undoubtedly conditioned even by macroeconomic equilibrium preserved during 2004. The prudent monetary and fiscal policies have established suitable conditions for maintaining inflation under control. During 2004 in general, and during the third quarter the programmed levels of expenditures and of budget deficit, made by the government, are observed.

**Chart 7. Annual growth of budgetary expenditures (in percentage).**

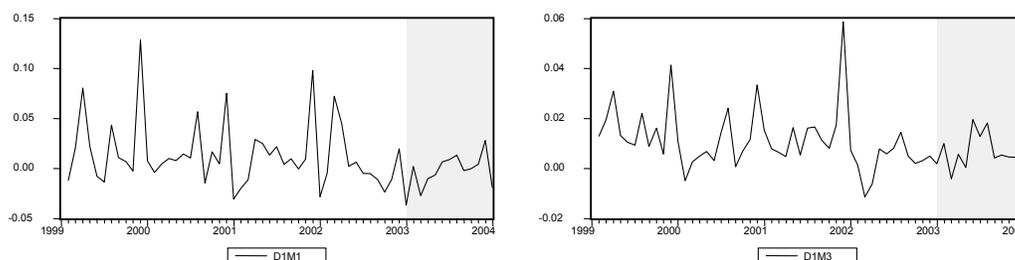


Source: Ministry of Finance; Bank of Albania

Until September 2004, the total expenditures were realized at 91 per cent, while the budget deficit at 82 per cent. The government demand for deficit financing has been relatively uniform during the year. It has not created any deformations in liquidity situation and therefore, it has not exerted inflationary pressures.

The Bank of Albania has been prudential in implementing its monetary policy. The liquidity situation has been stable. The interest rates, though downward, have continued to favour the rise of lek deposits and the return of money into the banking system. On the other hand, the moderate growth of money supply has well fulfilled the growth of demand for money, a seasonal characteristic of this period.

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



Source: Bank of Albania

The domestic demand for foodstuff during the first six-month of the year is easily met by the Albanian economy<sup>10</sup>. The growth of domestic production has led to substitution of imported agricultural goods with domestic goods, which have even lower prices. The low demand for imports of such nature has maintained low demand for foreign currency, which has caused further appreciation of the lek<sup>11</sup>. This factor, being combined with stable inflation rates in main partner countries of imported goods, has impacted on the dropping of imported inflation rate during 2004.

**Table 12. Annual inflation rate of the main partner countries (in percentage).**

	January '04	February	March	April	May	June	July	August
Greece	3.1	2.6	2.9	3.1	3.1	3.0	3.1	2.8
Italy	2.2	2.4	2.3	2.3	2.3	2.4	2.2	2.4

Source: Eurostat News Release.

Under these conditions, the growth of demand<sup>12</sup> and the retail market conditions<sup>13</sup> did not impact on the conveying of inflationary pressures to consumer prices. However, the possible impact of real estate price rise on the decline of domestic demand for consumer goods remains to be estimated in the future. This price rise may impact on shifting the consumption structure of a part of society towards real estate. On the other

<sup>10</sup> Imports of agricultural goods during this period have been almost the same in nominal terms with those of the same period of the previous year.

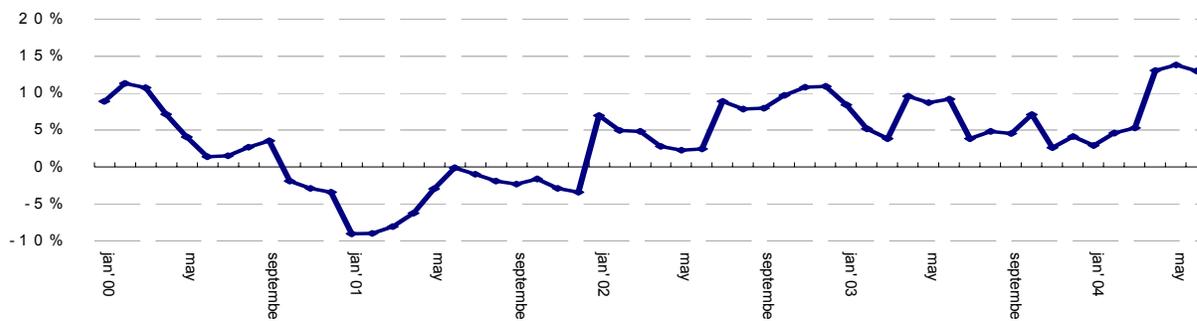
<sup>11</sup> In September 2004, the lek in annual terms is appreciated against the dollar and the euro by 15.1 per cent and 7.6 per cent respectively.

<sup>12</sup>The demand, viewed as the level of sales realized by all sectors of economy, has undergone a growth of 19.6 per cent in the second quarter of 2004 compared to the previous quarter. Source: Sales Index, INSTAT.

<sup>13</sup>Retail sales volume index in the second quarter of this year was 26.8 per cent compared to the first quarter and 28.2 per cent compared to the same period of the previous year. Source: Volume index, INSTAT.

hand, the production price index rise<sup>14</sup> over the second quarter of 2004 has not conveyed rising impulses to consumer prices.

**Chart 9. Annual Change of Production Price Index**



Source: Institute of statistics.

### III.3 MONETARY POLICY OF THE BANK OF ALBANIA

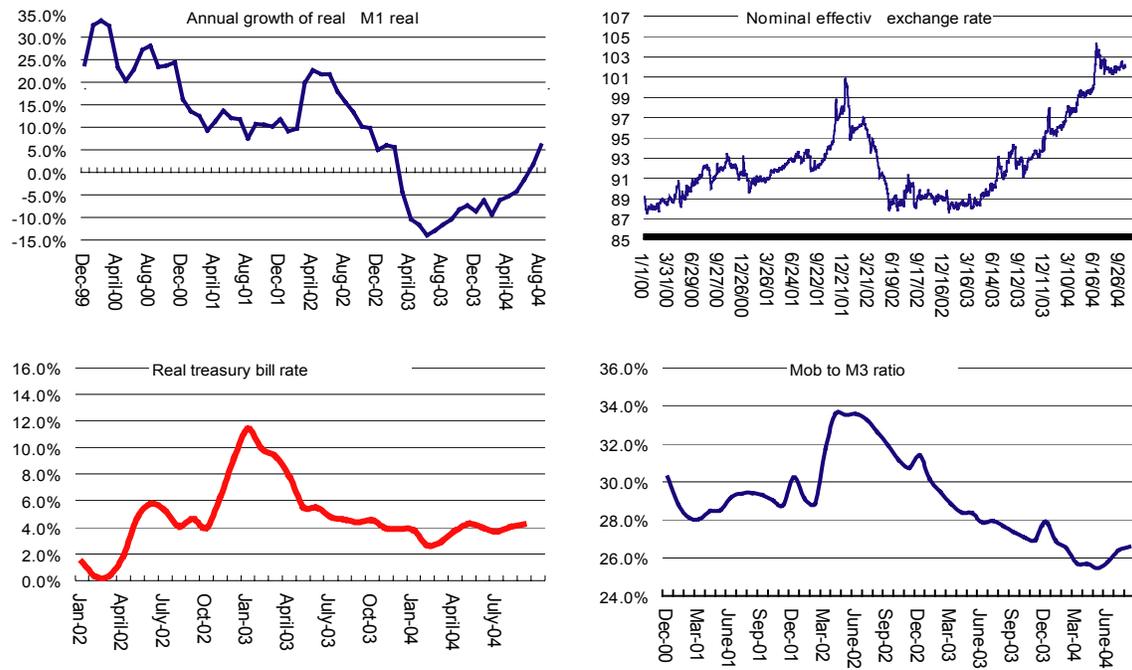
The Bank of Albania monetary policy has had a clear easing tendency during the third quarter of the year. The controlled level of inflation and the optimistic forecasts for meeting the Bank of Albania target have dictated the need of reviewing the monetary policy stance. The Bank of Albania has decreased the base interest rate, in three step, by 0.75 percentage points during the first half of the year. However, the analysis of monetary conditions and of factors impacting on inflation suggested that there was space for further decrease of base interest rate.

So, the annual growth rate of real M1 aggregate (the monetary aggregate which is proved to have the largest impact on inflation) continues to remain below some-year historical average. Also, the low inflation rate and the stabilization of inflationary pressures of economy<sup>15</sup> for this level, have made the real interest rate level be relatively high, even after the reductions of nominal interest rates. This has increased the interest in depositing the savings into the banking system, thus bringing about a shifting of liquidity structure towards long-term monetary assets, deposits and treasury-bills (Chart 10). The attraction of the lek interest rates in comparison with those in foreign currency, in the presence of an increased supply of foreign currency during summer, has exerted pressures on the lek appreciation.

<sup>14</sup> Data from INSTAT.

<sup>15</sup> The Bank of Albania surveys with consumers, businesses and the banking system generally indicate low inflationary expectations in economy.

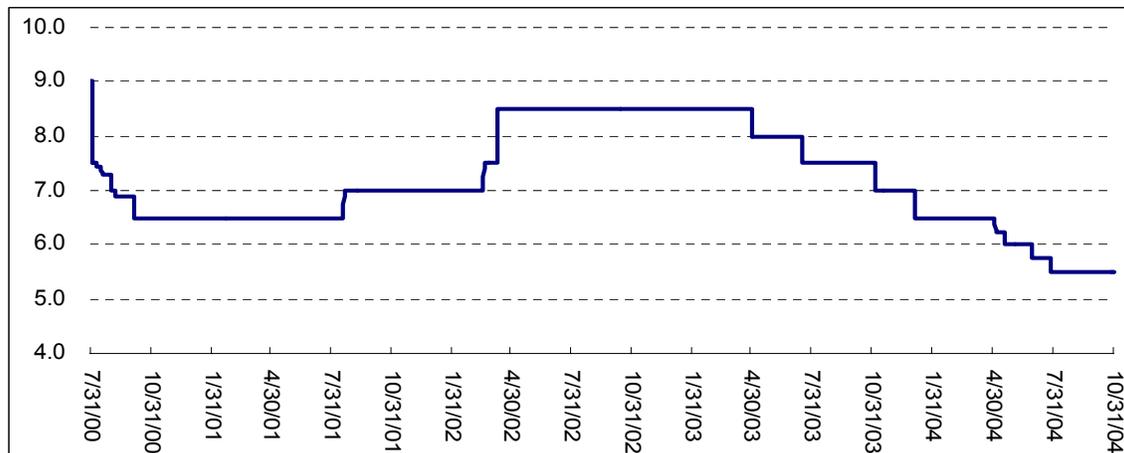
**Chart 10. Performance of monetary conditions in economy**



Source: Bank of Albania

In response to these developments, the Bank of Albania decreased the base interest rate by 0.25 percentage points on July 28. This decrease was made in compliance with the declared policy of the Bank of Albania to preserve an interest rate level as low as possible in economy, which must be consistent with the price stability target in a mid-term period. After this reduction, the base interest rate dropped to 5.5 per cent, its lowest level ever applied in Albania.

**Grafik 11. Base interest rate in Albania**



Source: Bank of Albania

The banking system reaction to the decline of base interest rate has been satisfactory. The interest rates of the lek deposits and treasury bills are decreased, reflecting even the previous reduction of the base interest rate<sup>16</sup>.

**Table 13. Banking system reaction to last smoothing of monetary policy**

	3 months	6 months	12 months
Deposits	-0.13	-0.49	-0.47
Treasury bills	-0.73	-0.61	-0.76

However, the banking system reaction has been slow and the Bank of Albania has supported the base interest rate reduction even with its operations in the interbank market. During July-August, the Bank of Albania applied repo auctions at limited amount to increase the pressure of interest rate reduction on commercial banks. Meanwhile, the data indicate that the interest rates of the loans in lek have not followed this smoothing of monetary policy of the Bank of Albania. This phenomenon is related more with the fragmentation of the lending market and the shifting of their structure towards longer-term loans. Meantime, over the passing of time even the interest rates in the lek lending market are expected to fall.

The third quarter marked a strengthening of the appreciating pressures on the lek exchange rate. These pressures are increased especially due to large foreign currency inflows during this period. So, the deposits in foreign currency are increased by Lek 10.5 billion or approximately usd 100 million during July-August. The increased foreign currency supply is faced with a weak demand, in consequence of import reduction and preference for the Lek due to interest rate spread. Under these conditions, the Bank of Albania has intervened in foreign exchange market in terms of purchasing foreign currency, withdrawing its excess supply and injecting lek liquidities. The Bank of Albania intervention into the foreign exchange market has been in compliance with the easing monetary policy. On the other hand, the base interest rate reduction during 2004 has mitigated the intensity of the operation of this factor, which has favoured the lek appreciation.

The Bank of Albania has observed even its quantitative targets during the third quarter

**Table 14. Quantitative objectives of the Bank of Albania**

	December '03	March '04	June '04	July '04	August '04
<b>Net foreign reserves of the Bank of Albania (in millions of US dollars ).</b>					
Objective	715.8	751.8	765.8	818.4	871.1
Actual	832.7	827.6	961.5	986.4	1041.9
Difference	116.8	75.8	195.7	168.0	170.9
<b>Net domestic assets of the Bank of Albania (in billions of Leks).</b>					
Objective	96.0	83.0	85.0	80.0	75.0
Actual	72.0	66.4	54.7	56.4	59.5
Difference	-24.0	-16.6	-30.3	-23.6	-15.5
<b>Net domestic credit to Government (in billions of Leks).</b>					
Objective	280.9	274.1	270.1	273.1	276.1
Actual	268.1	273.9	263.6	267.5	268.3
Difference	0.0	-0.2	-6.5	-5.6	-7.8

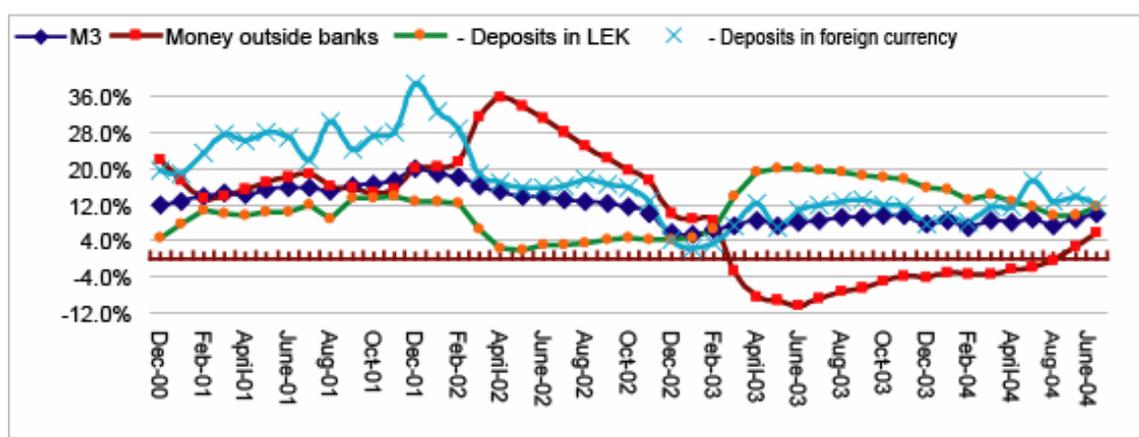
<sup>16</sup> The previous decrease, being the third in 2004, was made in June.

## IV. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

### IV.4 MONETARY SUPPLY AND MONETARY AGGREGATES

The annual growth rate of money supply has marked a significant growth over the period of June-August, reaching to 10 per cent, from 8.1 per cent its average level was in the first half of the year. The money supply rise in this period is impacted by the growth of its part in lek, whereas the annual growth of foreign currency deposits has continued to be high but at stable levels. The large foreign currency inflows and the growth of lek appreciating tendencies are associated with the intervention of the Bank of Albania into the foreign exchange market. This has brought about the injection, in considerable amounts, of liquidity in economy, impacting on the growth of M2 aggregate and on meeting the demand for monetary assets in lek. The performance of the ratios of money supply components has reflected mainly the seasonal impacts of the period, which have been reflected on the growth of the weight of money outside banks and of foreign currency deposits to broad money.

**Chart 12. Performance of annual rates of monetary aggregates**



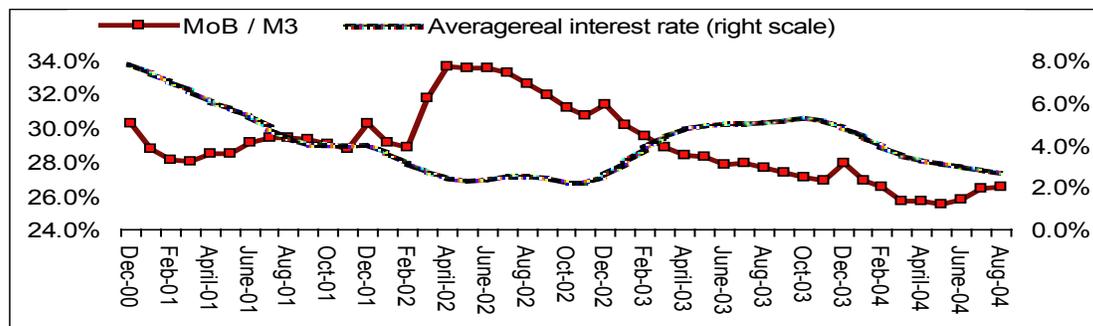
Source: Bank of Albania

Foreign currency inflows from tourism and emigrants' remittances are estimated to have marked a rise in comparison to the previous year. This is also indicated by higher annual growth rates of foreign currency deposits during three summer months of the current year than those of the previous year. In June-August 2004, the average growth rate of foreign currency deposits has fluctuated to 12.7 per cent while in the same period of the previous year this indicator was 11.9 per cent. Annual appreciation of the lek against the euro and the usd has impacted negatively on the level of deposits in foreign currency in August, by Lek 13.7 billion. In absence of this effect, their annual growth rate would result to 25.3 per cent.

Deposits in lek during June-August have manifested a growth. Their annual growth rate in August reached to 11.5 per cent, from 9.5 per cent in June. Growth of deposits in lek has reflected the attraction of highest interest rates in lek compared to those in foreign currency, making a part of foreign currency inflows from abroad be invested in financial assets in Lek (deposits and treasury bills). Also, another factor that is assessed to have impacted on the growth of deposits in lek and deposits in general, is even the improvement and increase of banking services to customers, which has increased their

tendency to use banks. The impact of this factor is noticed on performance of demand deposits of households and private sector, which have reflected a rising trend in the recent months.

**Chart 13. Ratio of money outside banks to M3.**



Source: Bank of Albania

The annual growth rate of money outside banks underwent a significant growth in July and August, due to liquidity injection into the market from the Bank of Albania foreign currency intervention. This situation has coincided with the seasonal growth of demand for cash, in consequence of high consumer expenditures during summer, making possible that the high level of money outside banks be stable. In August, the annual growth rate of money outside banks returned to positive levels, being increased to 5.5 per cent, from -0.6 per cent it was in June. The ratio of money outside banks to M3 reached to 26.6 per cent, marking a growth of 0.8 percentage points against the level of June.

**Table 15. Performance of monetary indicators in August (in billions of Leks).**

	August 2004	Two-month change		Annual change	
		Absolute	Percentage	Absolute	Percentage
Money outside banks	128.9	10.6	9.1	6.8	5.5
Total deposits	356.2	16.3	4.8	37.2	11.7
- in lek	241.2	5.8	2.5	24.9	11.5
- in foreign currency	115.0	10.5	10.2	12.3	11.9
Demand deposits	70.8	5.8	9.1	11.5	19.3
- in lek	25.1	2.7	11.6	5.6	28.6
- in foreign currency	45.7	3.1	7.6	5.9	14.8
Time deposits	285.4	10.5	3.8	25.7	9.9
- in lek	216.1	3.0	1.4	19.3	9.8
- in foreign currency	69.3	7.5	11.9	6.4	10.2
M1	154.0	13.4	9.5	12.4	8.7
M2	370.1	16.4	4.7	31.7	9.4
M3	485.1	26.9	5.9	43.9	10.0
Base money	170.3	13.3	8.6	13.8	8.8

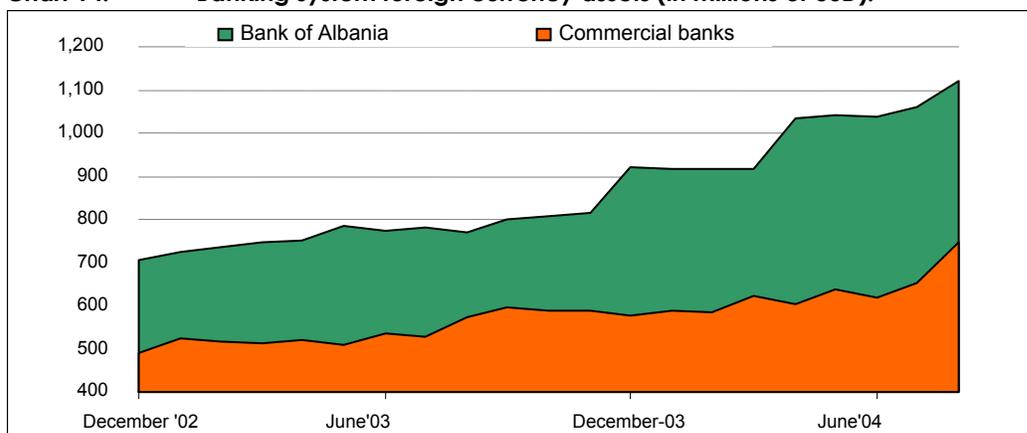
## IV.2 ECONOMY DEMAND FOR MONETARY ASSETS

### IV.2.1 Foreign currency position of the banking system

The foreign currency position of the banking system is improved over the 2004. The banking system resulted with a growth of USD 209.3 million<sup>17</sup> of net foreign assets during July-August. The growth of net foreign assets in August has rendered a contribution of 64 per cent to M3 growth, which is the highest contribution for 2004.

The largest contribution to this growth is given by commercial banks, by a growth of 127.4 million dollars of net foreign assets. The net foreign assets growth of commercial banks is mainly due to rise of foreign deposits during this period, in consequence of rise of emigrants' remittances. Also, this period is impacted by the conversion into euro of a part of capital of the Savings Bank. The Bank of Albania has also increased the level of net foreign reserve. For July – August, this growth is 81.8 million dollars. The presence of the Bank of Albania in the foreign exchange market in terms of foreign currency purchasing has impacted on the foreign reserve growth. The Bank of Albania has had the commercial banks as the main partner during foreign currency intervention.

**Chart 14. Banking system foreign currency assets (in millions of USD).**



Source: Bank of Albania

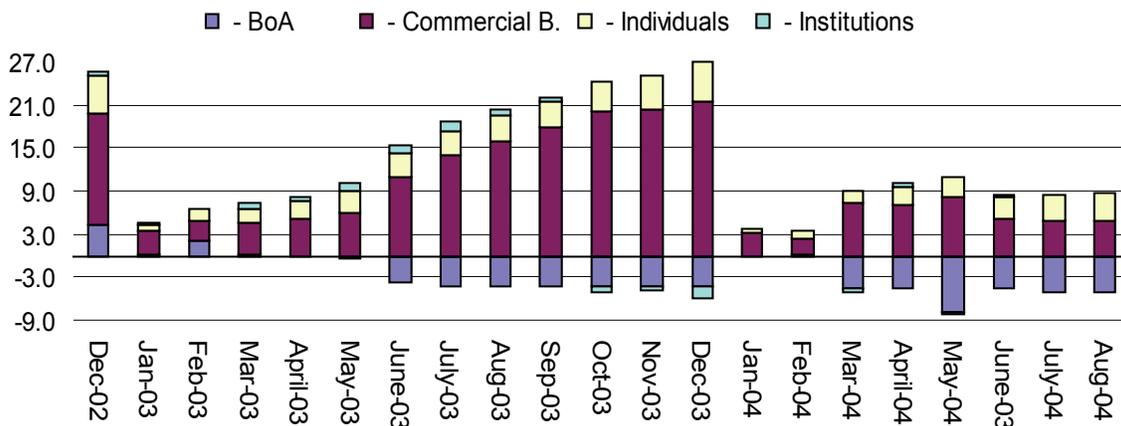
### IV.2.2 Government demand for money

July – August were associated by growth of government demand for monetary assets. The budget deficit reached to Lek 11.6 billion in August, being increased by 4.5 billion compared to second quarter of 2004. This government demand continued to be covered almost totally from domestic financing, which, during July-August was Lek 3.6 billion. The banking system has financed the government through purchases of treasury bills and government bonds. The commercial banks have reduced the treasury bill portfolio to Lek 1.6 billion. Also, the institutions have had a reduction of treasury bill portfolio, whereas the Bank of Albania and households have slightly increased their portfolio. The level of government bonds issued in July-August is Lek 1.6 billion.

<sup>17</sup> Setting aside the exchange rate effect, this growth is estimated at 218 million dollars.

The Bank of Albania, in implementing its monetary policy, has also used direct financing by Lek 0.5 billion during July-August to cover a part of the budget deficit. Also, a part of income from the Savings Bank's privatization, about Lek 0.6 billion, has passed for the government's account.

**Chart 15. Budget deficit financing (in billions of Leks).**



Source: Bank of Albania

#### IV.2.3 Credit to economy

Intermediation in the financing process of productive sector of economy is one of the main functions of the banking system. Though the banking system lending to economy remains still far from the level of developed economies, we should stress that credit to economy has marked a rapid growth during three last years. The credit to economy ratio to GDP has marked a constant growth, reflecting a larger commitment of savings to finance the economic activity. At end of August 2004, the credit balance reached to Lek 60.9 billion (7.3 per cent of GDP). Also, a rise in the number of banks committed to lending market is noticed.

The banking system, in January-August 2004, indicated high paces of credit to economy. The part occupied by credit to economy to demand for money has been increasing, at a time when credit to government has had a falling trend. At end of August 2004, the credit to economy constituted about 13 per cent of demand for money. The interest of banks for investing their assets in the lending market has been increasing constantly. This fact is supported even by the constant growth of credit to deposit ratio, which in August 2004 was increased by 1.4 percentage points compared to end of 2003.

**Table 15. Performance of some main indicators<sup>18</sup>.**

	2002	2003	Q-1'04	Q-2'04	July'04	August '04
Money supply (in billions of leks)	416.7	448.4	456.0	458.2	469.9	485.1
Domestic credit (in % to M3)	70.8	71.5	71.6	69.5	69.1	66.9
- Credit to government (in % to M3)	61.5	60.2	59.9	57.1	56.3	54.3
- Credit to economy (in % to M3)	9.3	11.3	11.7	12.4	12.8	12.6
Credit to economy (% to total assets)	11.5	13.7	13.7	14.6	15.1	15.0
Credit to economy (in % to GDP)	5.7	6.8	7.0	7.4	7.2	7.3
Total deposits (in % to GDP)	42.2	43.4	44.1	44.1	41.3	42.6
Credit/deposit ratio (in %)	13.5	15.7	15.8	16.7	17.4	17.1

Credit balance was increased by Lek 4.1 billion during July-August 2004. This growth resulted to 51 per cent higher than its growth during the same previous year period. The credit balance has increased by Lek 10.2 billion during 2004 or about 20 per cent more than in the same period of 2003.

The structure of credit balance by terms went on having changes in the direction of growth of mid-term and long-term credit during July-August 2004. The banking system is being oriented more and more to mid-term and long-term investment of funds, contributing more to economic development of the country. At end of August, mid-term and long-term credit balance constituted 65 per cent of the credit balance, from 54 per cent at end of 2003. The credit balance structure by currencies continues to be dominated by foreign currency credit. Meanwhile, a rise is noticed in the preference to receive credit in European currency. The credit in euro constituted 55 per cent of total credit at end of August 2004, from 50 per cent it was at end of 2003.

**Table 16. Performance of credit balance indicators, in percentage**

	2002	2003	Q-1 '04	Q-2' 04	July '04	August '04
<b>Credit balance (in billion lek)</b>	<b>38.7</b>	<b>50.7</b>	<b>53.4</b>	<b>56.8</b>	<b>60.0</b>	<b>60.9</b>
Short-term credit	53.8	46.0	41.6	35.4	35.6	35.0
Mid-term credit	30.1	33.3	35.4	37.8	37.4	38.0
Long-term credit	16.1	20.7	23.0	26.8	27.0	27.0
Lek	21.3	19.6	17	17	16	16
Foreign currency	73.7	80.4	83	83	84	84

The new credit extended during July-August 2004 is Lek 12.2 billion. The short-term credit constituted 62 per cent of the new credit extended over these two months. From the viewpoint of the structure of the extended credit by currencies, the new credit extended in lek occupies 45.2 per cent of its total. Meanwhile, Lek 68.6 billion credit or 26 per cent more than in the same previous year period was extended over the period of January – August 2004.

<sup>18</sup> This ratio is established to GDP in annual level for 2004.

**Table 17. New credit performance in years (in billions of Leks).**

	2002	2003	Q-1 '04	Q-2'04	July- August '04
New credit (in billions of Leks)	62.6	92.6	27.9	28.5	12.2
Short-term credit	44.7	63.1	18.7	18.1	7.6
Mid-term credit	13.0	22.2	5.7	6.8	2.6
Long-term credit	4.8	7.4	3.5	3.6	2.0
Lek	20.8	30.8	8.80	8.9	3.8
Foreign currency	41.8	61.8	19.10	19.6	8.4

Trade, processing industry, real estates and construction continue to be the branches most credited by the banking system. We highlight that during the period of January-August 2004 there is noticed a falling trend of banking financing for commercial activities, being oriented to such branches as processing industry, agriculture, hotels and restaurants, etc. On the other hand, the agriculture sector started to be more supported financially by bank loans. However, the nature of business activities operating with banks is generally more commercial than productive.

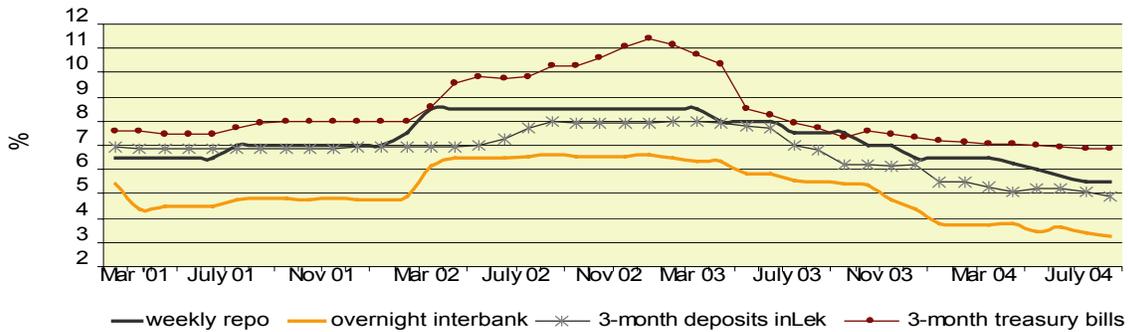
**Table 18. Credit balance by economy branches (in percentage).**

	2002	2003	Q-1 '04	Q-2'04	July '04	August '04
1 Agriculture, hunting and silviculture	0.8	1	1.0	1.2	1.4	1.4
2 Fishing	0.2	0	0.1	0.1	0.1	0.1
3 Extracting industry	0.2	1	0.2	0.2	0.2	0.2
4 Processing industry	17.0	17	16.9	18.4	17.5	18.6
5 Production, distribution of electric power, gas and water.	3.3	3	3.0	3.3	3.1	3.3
6 Construction	8.6	10	9.7	10.7	9.3	10.0
7 Trade, repairing of vehicles and home appliances	40.4	34	31.4	23.5	22.5	22.9
8 Hotels and restaurants	6.0	6	7.1	8.3	7.7	8.1
9 Transport and telecommunication	2.4	1	2.0	1.5	1.4	1.3
10 Financial activities	-	0	0.1	0.7	0.8	0.7
11 Real estates	9.1	13	13.7	14.8	15.5	16.0
12 Health and social activity	0.5	0	0.5	0.5	0.6	0.5
13 Collective, social and personal services	4.2	8	4.2	4.5	4.4	4.5
14 Other	7.3	4	10.1	12.2	15.4	12.3
Total	100	100	100.0	100.0	100.0	100.0

### IV.3 FINANCIAL MARKET DEVELOPMENT

The base interest rate decreased to 5.50 per cent during the third quarter of 2004. The money market interest rates generally pursued the same trend, resulting at end of the third quarter in their lower historical values. The interest rate decrease was supported even by an excess liquidity in stable levels during the whole period.

**Chart 16. Money market interest rates**

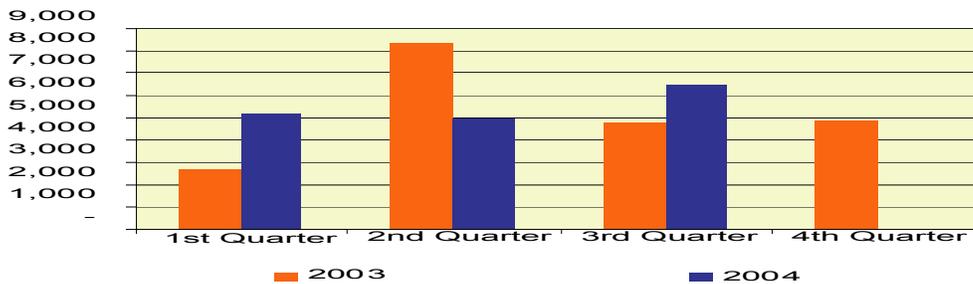


Source: Bank of Albania

### IV.3.1 Performance of market liquidity

The growth of deposits in lek and the use of direct credit to finance the government have raised the level of commercial banks' liquidity over the third quarter. The average liquidity level during this period reached to Lek 6.4 billion, from 4.9 billion it was in the second quarter and 5.2 billion it was in the first quarter of this year.

**Chart 17. Liquidity of commercial banks (in millions of Leks)<sup>19</sup>.**



Source: Bank of Albania

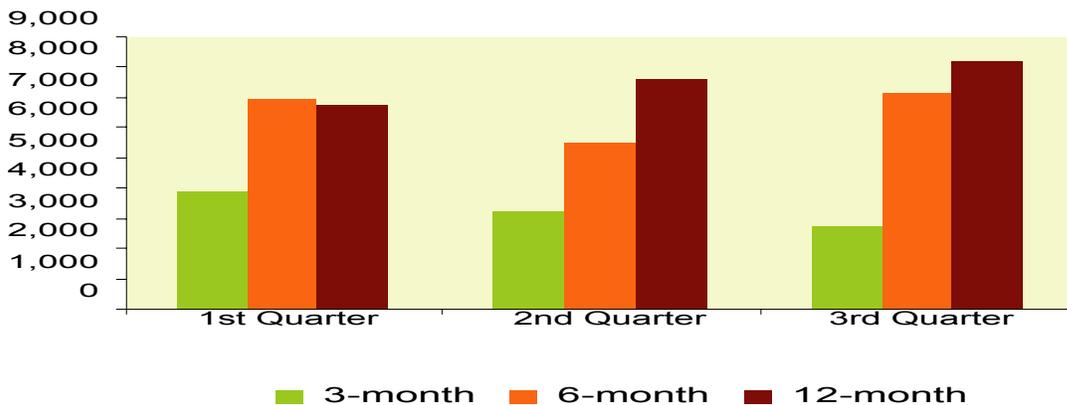
The Bank of Albania has continued to withdraw liquidity from the banking system through weekly repo auctions of one-week and one-month maturity. The average volume of commercial banks' funds invested in repo was increased to Lek 4.6 billion in the third quarter from 3.5 billion in the previous quarter.

The volume of overnight transactions in the interbank market has rested almost at the same levels with those of the previous quarter. The average level of overnight transactions reached to Lek 0.38 billion, from Lek 0.36 billion in the second quarter and Lek 0.3 billion in the first quarter. The average level of weekly transactions in the interbank market over the third quarter reached to Lek 0.36 billion from 0.46 billion in the second quarter and 0.18 billion in the first quarter.

<sup>19</sup> It includes the volume of repo, overnight deposits and excess reserves minus overnight credit.

In the primary market, there was a rising investment in treasury bills by banks and households during the third quarter. The average value invested in this instrument for each auction, during this period, reached to Lek 11 billion, from Lek 9 billion it was in the second quarter. However, in this period, the government demand for financing is covered even by direct credit, impacting on adding excess liquidity of banks.

**Chart 18. Investment in treasury bills during 2004 (in millions of Leks)**



Source: Bank of Albania

#### IV.3.2 Interest rate performance

Interest rates went on being decreased during 2004, reaching the lowest values at end of the third quarter. The easing policy followed over this period by the Bank of Albania is transmitted in the lek deposit market, primary market and interbank market, while the lending market has not reacted appropriately to monetary policy signals. The interest rate rise for savings in foreign currency has narrowed the spread between the domestic currency and foreign currency.

**Table 20. Average weighted interest change over 2004 (in percentage points).**

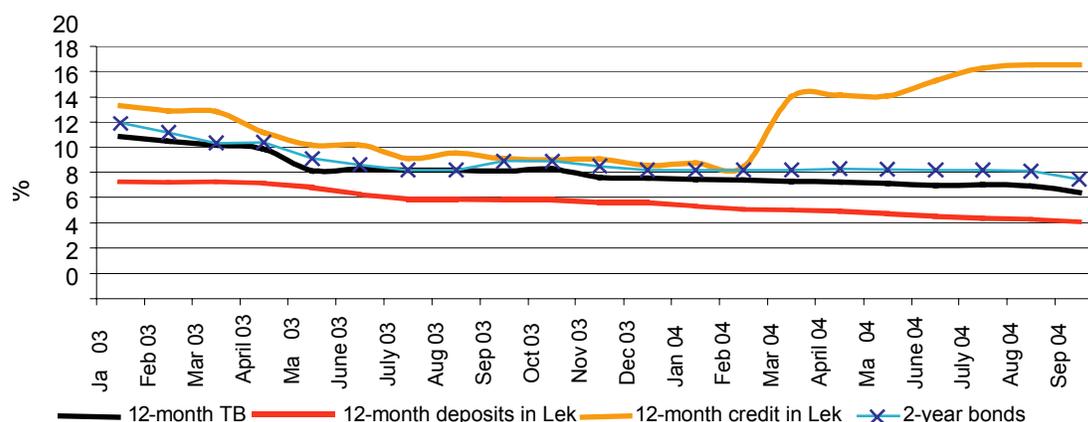
	Quarter I	Quarter II	Quarter III	Total for the nine-month period
Overnight interbank market	-0.61	-0.43	-0.20	-1.24
Weekly interbank market	-0.40	-0.30	-0.70	-1.40
Deposits in lek (3, 6 & 12-months)	-0.31	-0.37	-0.31*	-0.68
Treasury bills (3, 6 & 12 months)	-0.22	-0.15	-0.56	-0.93
Credit in lek	0.32	2.61	1.66**	2.93

\*data of interests of deposits in lek for September are according to operative data.

\*\*latest data of the third quarter for interests of loans in lek are as of August 2004.

The interest rate of overnight transactions in interbank market decreased to 3.07 per cent at end of the third quarter, from 5.4 per cent it was in the same period of the previous year. The level of 2.76 per cent recorded in September marked the lowest historical level of these interest rates in interbank market. The primary market also marked the lowest yield values in these ten last years. The average weighted three-, six-, 12-month treasury bill yields at end of the third quarter reached to 6.30 per cent, 7.56 per cent and 8.43 per cent respectively, leading to the narrowing of the spread between interest rates of investment in treasury bills and deposits.

**Chart 19. Long-term market interest rates**



Source: Bank of Albania

Lek time deposit interest rates during July-September have been decreased for all the terms. However, this reduction has not presented any problems for the real interest rates of deposits, which have remained positive due to low inflation. Since May 2003, the real interest rate of 12-month deposits in lek has fluctuated about an average level of 3.8 per cent.

**Table 21. Average weighted interests of time deposits in lek (in percentage).**

	September-03	December-03	March-04	June-04	September-04*
3-month	6.17	5.49	5.21	4.89	4.73
6-month	7.50	7.07	6.57	6.10	5.85
12-month	7.83	7.62	7.03	6.52	6.27

\* Data of September are operative weighted with the new inflow of deposits of August.

The low levels of market interest rates have impacted on cost reduction of domestic government debt, cost reduction of interbank borrowing, on narrowing the spread between interest rates of deposits in lek and in foreign currency and on establishment of spaces for cost reduction of credit to economy. However, the average interest rate of loans in lek is raised from 14.3 per cent in June to 15.9 per cent in August (the average interest rate for all terms). The fluctuations of these rates from month to month relate to reluctance of banks to decrease them immediately, as well as to the weight certain banks occupy in lending over certain periods.

As concerns to deposits and loans in foreign currency, usd and euro interest rate rise was marked during the third quarter, almost for all the terms. This was impacted by the Libor interest rise in international markets, after the monetary policy tightening by Fed, as well as by the competition between banks. In August, the average weighted interest of time deposits in usd reached to 1.06 per cent, from 0.74 per cent in June and those in euro reached to 1.68 per cent from 1.56 per cent.

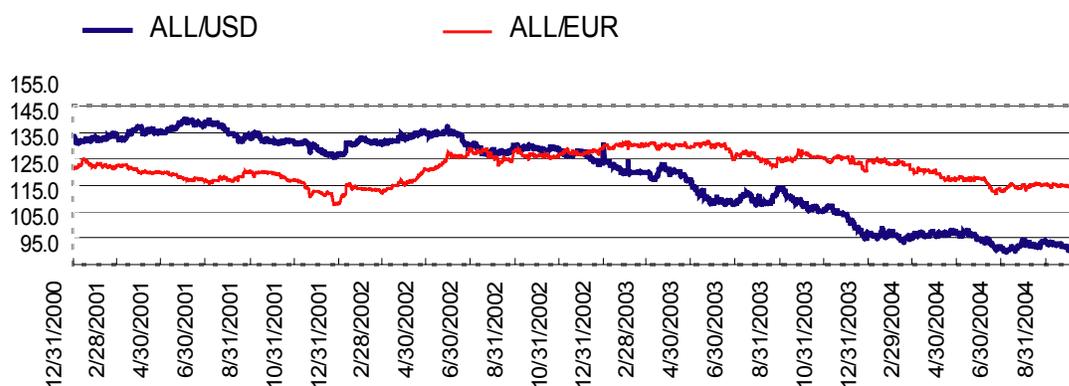
In response to interest rate rise of deposits in foreign currency, the commercial banks have also increased interest rates of loans in foreign currency, particularly those in euro, which in August reached to 9.13 per cent from 8.62 per cent in June. Meanwhile, interests of loans in usd, after the rise in June and July, were followed by a reduction by 0.24 percentage in August, to 7.81 per cent.

### IV.3.3 Exchange rate

The balance of the demand and supply factors continued to favour the appreciation of the lek even during the third quarter. Furthermore, the appreciating tendencies of the lek are reinforced more during this quarter, due to seasonal factors. The large inflows of foreign currency due to tourism in the summer season and the rise of the number of emigrants coming during this period have increased the foreign currency supply in the market. This growth of foreign currency inflow is reflected even in the growth of deposits in foreign currency during the third quarter, almost twice higher than their growth in the second quarter.

The increased supply of foreign currency in this period has been faced by a low demand for it. Such a demand has resulted partially due to growth of domestic agricultural product and reduction of import of these products, and partially due to interest rate spread, which continues to favour the demand for monetary assets in lek against those in foreign currency.

**Chart 20. Exchange rate in domestic foreign exchange market**



Source: Bank of Albania

Due to these pressures, at end of the third quarter, the usd was exchanged with 101.2 lek, while the euro with 124.8 lek, compared to respectively 101.5 lek and 123.1 lek at end of the second quarter. Even the development in the international foreign exchange market, where the dollar is depreciated against the euro has impacted on the constant appreciation of the lek against the American dollar. So, the exchange rate of the lek/usd in the domestic foreign exchange market marked the lowest levels in eight last years – in July 8, 2004 the exchange rate reached to 100.11 lek/usd.

The exchange rate of the lek against the euro has fluctuated to more stable levels, on average 125 lek/euro. Frequent interventions of the Bank of Albania into foreign exchange market have also impacted on its performance<sup>20</sup>.

<sup>20</sup> Mainly in the purchasing direction.