

BANK OF ALBANIA

REVIEW OF MONETARY
POLICY IN THE FIRST
SEMESTER OF 2007

JULY 2007

REVIEW OF MONETARY POLICY IN THE FIRST SEMESTER OF 2007

1 GOVERNOR'S SPEECH

The first semester of 2007 marked a positive performance of the Albanian economy in terms of being in line with the projected economic growth rate, of further consolidating the macroeconomic stability and carrying on with the structural reforms in economy. The economic development has been along the lines of the projected framework in the country's economic development programme, observing the main objectives of the three-year programme and achieving a further milestone towards the economic and financial integration with the regional and international markets. Alongside, some specific developments over this period have raised the need for continuous attention to potential risks and for designing and implementing preventive policies in due time, in order to guarantee the country's economic balances and its long-term development.

Judging on the available information, the Bank of Albania observes that the economic development has been in line with the projections of the beginning of the year which projected an economic growth of 6 per cent. The economic growth has been driven by both domestic demand for goods and services and external demand. It reflects the expansion of economic activity in services, transportation and industry, while construction has recorded a relative slowdown, among others as a result of the reduction in extending construction permits. Despite the expected seasonal slowdown, the sales index increased by 14 per cent over the first quarter of 2007. Economic growth has been reflected in other indicators as well, such as the increase of retail sales in economy, the increase of tax income, the growth of exports, the increase of the level of capacities utilization in economy and of employment. The expansion of economic activity has been also perceived by the Albanian businesses and consumer, who have generally provided positive opinions on the performance of economy over the first quarter and are quite optimistic about the economic activity performance over the second quarter.

The economic activity over this period has been mainly driven by the increase of domestic demand which was reflected in the increase of consumption and investment in economy. The growth of demand for goods and services has been fuelled by the growth of credit to economy and by the monetary conditions, which remain stimulating for the economic activity. Moreover, the consolidation of macroeconomic stability has had a positive influence on the economic activity through the extension of the business plans time horizon and the mitigation of Albanian household consumption cycle. These factors have affected the maintenance of high credit rates to the private sector. At end of May, this type of credit amounted to ALL 228 billion or to 24.6 per cent of the GDP projected

for 2007, confirming as such its role as the main consumer of the Albanian economy funds. In addition, the external demand for Albanian products has grown, causing the Albanian exports to increase by 26 per cent over the first quarter of 2007. The overall world environment which was characterized by satisfactory growth rates in our main partners – the Euro area and the regional countries – has favoured the expansion of the Albanian exports.

Fiscal sector activity during the first semester is characterized by the increase of income and expenses, as well as the creation of fiscal excess as a result of unrealized capital expenses' execution. The main fiscal indicators continued to have positive trends, but with slower annual growth rates compared with the previous year. Based on the data provided by the Ministry of Finance, as of end May were collected 95.6 per cent of projected income and were executed 83 per cent of planned expenses. Fiscal activity did not exert any pressures on domestic demand over the first semester; however, the change of fiscal performance in the second semester of the year as a result of the concentration of budget expenses and public borrowing may push the presence of inflationary pressures and the possible fluctuations in the money market over this period.

The growth of domestic demand was followed by the deepening of current deficit over the first semester of 2007 in the presence of the rapid growth of exports and imports. Current deficit recorded an annual growth of about 40 per cent over the first quarter, mainly as a result of the increase of imports by 22 per cent and of the trade deficit in goods by about 25 per cent. Imports for intermediate consumption grew more compared with other categories, while the increase of investment-oriented imports continued to remain stable. Worth to be mentioned in terms of the external sector development is the increasing coverage of current expenses with capital income, which provides evidence that our country is being oriented towards the financing of current deficit with long-term capital inflows and foreign investments.

Despite the growing demand over the first semester, the pressures on the overall level of prices have been low, as a result of the favourable supply-side developments. The annual growth in the overall consumer prices level over the first semester fluctuated at around 2.3 per cent, while annual inflation marked 2 per cent in June 2007. The highest increasing rates in prices were displayed in processed foodstuffs, in housing services and in goods and services with administered prices. Consumer goods inflation was considerably affected by temporary seasonal factors which act downward and from a relative balance between supply and demand. On the supply-side, the positive influence of domestic agricultural production on inflation was more dominant than the high oil prices effect, while wages did not increase significantly and the inflationary expectations remained anchored around the Bank of Albania target. On the demand-side, the current monetary conditions have resulted to have been adequate to contain inflation in this period.

The performance of money supply indicators has displayed the high demand for monetary assets during 2007. Money supply recorded an

average annual growth of about 17.5 per cent during 2007. The annual growth of M2 aggregate fluctuated around 12 per cent compared with the average growth rates of about 7-8 per cent during the second semester of the previous year. In annual and foreign currency structure terms of money supply, the performance of M2 aggregate to M3 growth reflects the creation of foreign currency monetary assets in the private sector of economy. The annual expansion rates of monetary base in economy have had a stable performance of about 10-12 per cent.

Notwithstanding this setting, the analysis of the current and expected economic developments suggests that the inflationary pressures may increase in the medium run. The growth of domestic demand in economy, the current expansion tendency of imports and the current deficit deepening, the rapid growth of monetary assets in economy and the presence of potential risks in the expected dynamics of inflationary pressures pushed the Bank of Albania to tighten its monetary policy in June through the increase of the core interest rate by 25 basis points. Starting from 28 June the core interest rate applied on the repurchase agreements is 5.75 per cent. By means of this growth, the Bank of Albania aims to stabilize the inflationary expectations through the minimization of potential risks on the monetary and macroeconomic balance. The transmission of this signal to the financial markets will bring about the re-balancing of the current upward tendency of domestic demand in favour of financing the stable growth of economy in the long run.

Through the management of liquidity, the Bank of Albania monetary operations have aimed to minimize the interest rates fluctuations in the financial markets, in line with its long-term policy. In compliance with this policy and depending on the fluctuations of the banking system liquidity, the Bank of Albania has used the one-week repo operations, both by injecting and withdrawing the liquidity to signal its policy, and one- and three-month repos for the structural management of liquidity in the system. The excess liquidity and the downward tendency of interest rates caused the Bank of Albania to withdraw the liquidity in the second quarter. Meanwhile, the same logic but applied under the conditions of the absence of liquidity in the second quarter caused the Bank of Albania to inject liquidity in this period. These interventions allowed the reduction of interest rates fluctuations and the observation of the quantitative objectives of the Bank of Albania. In the foreign currency market, the exchange rate resulted to be relatively stable with a slight depreciating tendency in the first quarter. Meanwhile, the lek appreciated to the American dollar in the second quarter and it was relatively stable to the euro. The Bank of Albania was present in the foreign currency market in order to stabilize the short-term fluctuations in this market.

In conclusion, I would like to re-emphasize that the macroeconomic developments over 2007 had a positive performance in terms of economic growth and macroeconomic stability, mainly owing to the dynamics of the private sector. Moreover, this period identified a number of structural deficiencies in economy, among which the solution of the energy situation

and the provision of energy supply are of primary importance. The quick and final solution of this issue will spur the achievement of the projected economic growth rates. The good rate at the end of the country's risk assessment process assigned by the well-known Moody agency will lead Albania to the international financial markets and make it access funds which will support the country's needs for development. However, this borrowing requires the formulation of strategic and consistent development plans in order to guarantee the efficient and prioritized use of funds. Moreover, it requires the maintenance of domestic macroeconomic balances, which guarantee the foreign investors and drop Albania's borrowing cost. In the context of economic policies, the assurance of macroeconomic stability will be our future challenge, under the conditions of inflationary pressures expansion and current deficit deepening. This challenge will require the commitment of both core economic policies, the monetary and fiscal policy, and their co-ordination not only during the formulation stage, but also through the implementation over the financial year. The Bank of Albania remains committed to take the proper policy and regulatory measures, which will assure the observation of its legal objective and the maintenance of financial stability.

2 WORLD ECONOMY

Global economic activity is still in a fast developing momentum as recorded during 2007's first months. The high and constant growth of some developing economies has been the main engine to fuel world economic activity. Meanwhile, economic activity in some developed countries is expected to slow down, reflecting to a large extent the under capacity growth of the American economy. Euro area economies show to be an exception to this prospect, due to the fact that its economies continue to record positive developments based on foreign and domestic demand.

The constant economic growth on a global level during these last four years has triggered improvements in capacity utilization from the businesses and it has improved the advancement in the labour market. The high level of production capacity utilization for a relatively long period has triggered a general lift in core inflation resulting in the tightening of monetary policy in a number of central banks. The constant economic activity growth has influenced consumption and oil prices as well. The world price index for raw materials¹ has recorded an increasing trend for the month of May reaching the highest level recorded during the last nine months. Especially important for the increase in these products' prices is the high level of Chinese economic growth and its strong demand for natural resources.

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

	GDP annual growth, Q1	Unemployment rate, May	CPI, May
USA	+1.9	4.5	2.4
Euro area	+3.0	7.0	1.9
Germany	+3.6	6.6	2.0
France	+2.0	8.7	1.2

Italy	+2.3	6.2*	1.9
Japan	+2.2	3.8	- 0.2

*For March.

Source: Eurostat; ECB, Report for June; Bureau of Economic Research, Department of Commerce, USA

EURO AREA ECONOMY

Euro area economy recorded a 3 per cent growth in annual terms during the first quarter of 2007 and short-term indicators suggest stable growth for the remaining of the year. Economic growth has been strongly supported by domestic and foreign demand. The macroeconomic environment has triggered the continuous improvement of the labour market and conclusively has influenced private consumption. High investment returns, favourable financing terms and the high level of capacity utilization have supported corporate investments. Positive future expectations are based on different indicators resulting from different actors in the European economy.²

Starting from December 2006, the European Central Bank has started to pursue a tighter monetary policy with the intention to anchor the medium-term inflation expectations with price stability. Fluctuations in oil prices, the increased VAT in Germany and pressures resulting from the high economic activity have increased the mid-term risks associated with inflationary expectations. In their monetary policy meeting in June, the Governing Council of the ECB decided to raise the key interest by 0.25 per cent to 4 per cent.

USA ECONOMY

US economy finds itself in a transition period. After a long period of high economic growth, the American economy has shown a relative slowdown since the second half of 2006. During the first quarter, it recorded a 2 per cent annual GDP growth from 3 per cent recorded the previous period. The economic slowdown is related to the lack of investments, demand in the real estate market, net exports and inventories. The slowdown in construction and housing market has not been significantly reflected in the performance of the sectors of economy. Employment has recorded a continuous growth, since the dropping in the number of job opportunities in construction has been offset by the available job opportunities in other sectors of economy.

Core inflation continues to be over the desired level and unemployment is lower than the steady level. Under these conditions, the Federal Reserve has decided to keep the key interest rate unchanged at 5.25 per cent since June 2006. For the period to come analysis show that the high efficiency and the slowdown of economic activity will balance the inflationary pressures in the economy.

ECONOMIES IN THE REGIONAL COUNTRIES

Regional economic development has recorded satisfactory levels for 2006 at an average of 5.1 per cent. Foreign direct investments have played a major role in this growth, being reflected in the positive influence on the privatization

process and business climate. However, economic growth is expected to slightly slow down during 2007 at 5 per cent. Domestic demand, mainly private consumption and investments, still remain the main sources for development in the region and furthermore foreign demand is expected to play an increasing role in the future. Expectations for 2008 suggest for an improvement in the average annual growth rate at 0.2 per cent.

The beginning of 2007 found some of the West Balkans³ countries in geopolitical turmoil being reflected directly in their economic development. Overall the resolution of Kosovo’s final status has remained the major problem in the region. In the Former Yugoslav Republic of Macedonia the biggest Albanian ethnic party boycotted the parliament. Meanwhile the prolongation of the new government formation in Bosnia and Herzegovina and in Serbia, as well as the upcoming elections in Croatia, may influence these countries’ economic performance.

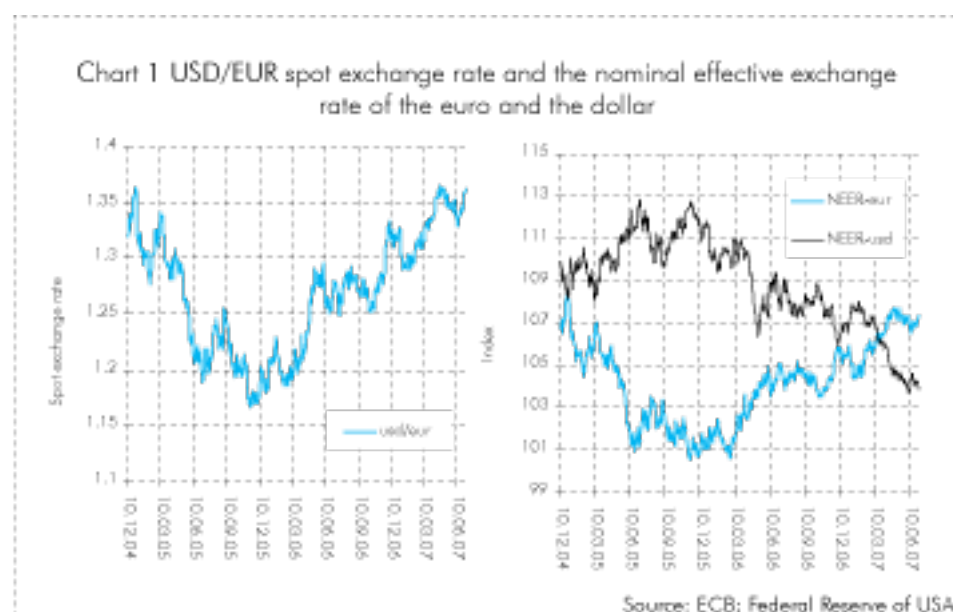
Table 2 Some main indicators of regional countries

Countries	GDP (in %) 2006	CPI (in %) (in %)	Exchange rate:		Interests (in % ⁴)	
			EUR	USD	Loans	Deposits
Kosovo	3	0.3 (April)	--	1.35	13.72	3.4
Greece	4.4	2.6 (May)	--	1.35	4.06	3.74
Italy	1.9	1.5 (May)	--	1.35	4.95	2.42
Macedonia	4.0	1.0 (April)	61.19 MKD	45.59 MKD	10.3	4.7
Kroatia	4.6	2.2 (May)	7.31 Kn	5.44 Kn	7.44	4.13
Serbia	5.4	4.4 (May)	80.73 CDS	59.18 CDS	13.01	4.60

Source: Central banks bulletins, IMF.

EXCHANGE RATE PERFORMANCE

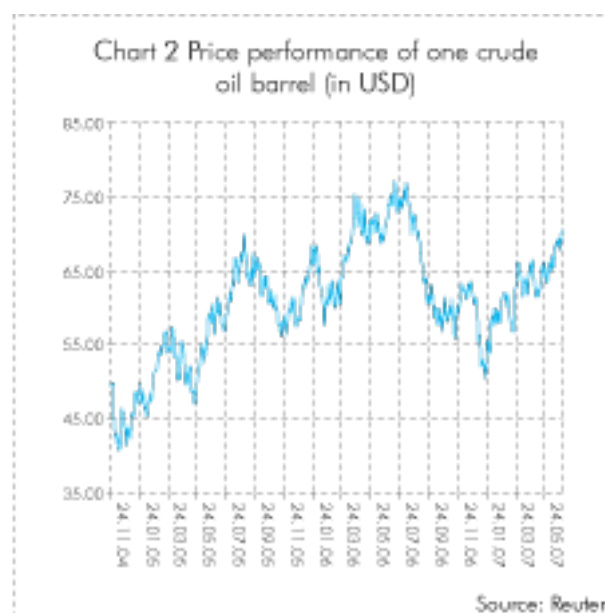
The effective exchange rate of the EUR⁵ has continuously appreciated during the first months of 2007. To a great extent the appreciation of the European currency has come as result of fluctuations in the USD market. The appreciation of the EUR to the USD has been gradual and has started since the last quarter of 2006. On 25 April 2007, EUR appreciated to 1.36 USD reaching the highest exchange value in the history of these two currencies.



Positive developments in the Euro area economy and the moderate economic activity in the USA have positioned exchange markets expectations and the main tendency of the exchange rate between these two currencies.

OIL PRICE

Oil price has recorded a gradual increase since the beginning of 2007 and reached peak levels in June, when one barrel was sold for USD 71. The lack of coordination of the increasing demand, production and overcapacity of inventories placed in an unsafe geopolitical environment explains the performance of oil prices during these last months. Global demand for oil is expected to increase by 2 per cent for 2007, where developing countries are expected to double their demand compared with 2006. On the other side, there is still uncertainty in oil production from both OPEC and other countries. The International Energy Agency (IEA) observes that non-OPEC production will still be not sufficient and demand will be mainly satisfied by OPEC. In these conditions oil prices are expected to be high and to fluctuate, due to the uncertainty in demand and supply equilibriums and geopolitical risks.



3 ALBANIAN ECONOMY IN THE FIRST SEMESTER

Albanian economy during the first semester of 2007 was characterized by a growing domestic demand which has been supported by the macroeconomic stability, economic growth, growth in salaries and wages and the favourable monetary conditions. This high demand is based on the credit expansion on both business and households, which is reflected in relatively low interest rates and the fast development of the banking system.

The increasing demand is reflected in a number of macroeconomic indicators such as, higher employment indicators, higher sales in different economic sectors and the deepening of trade deficit.

Based on the sales performance, production by sector is in comparative levels to those recorded during the first quarters of the last two years, where annual sales growth reached 14 per cent for the first quarter in 2007. Major contributions to sales' growth were provided by trade and services (hotels and restaurants), while industry has recorded higher sales levels compared with the last years. Demand for energy during the first semester in a limited production environment has been overcome with imported energy. Sales values recorded from the construction sector have remained relatively steady compared with the sales levels of last year. Annual growth in transportation and telecommunication remains modest. Analyses related to the agricultural sector suggest that annual growth will keep the same pace as that recorded during the last year.

Chart 3 Sales growth and contribution by sectors (in percentage)



Source: INSTAT and Bank of Albania estimations.

During the first quarter of 2007, employment recorded an annual growth of 2000 people, while the unemployment rate continued to record a slight decrease from quarter to quarter ending at 13.6 per cent at the end of March. Current deficit recorded an annual growth of about 40 per cent during the first quarter mainly as a result of an increase in imports and the trade deficit in goods by about 25 per cent. Imports for intermediate consumption have recorded a higher increase compared to other imports' categories, while investment-oriented imports have remained steady. A main development related to the external sector is the decrease in the trend of covering current expenses with current income. During 2006 this ratio was recorded at around 85 per cent whereas during the first quarter of 2007 this ratio has been recorded at 80 per cent. The country is

moving towards financing current deficit through long-term capital and foreign investments. Another indicator that signals an increase in consumption is the retail market, which has recorded an increase of about 10 per cent during the first quarter and employment in these businesses has recorded an increase of 20 per cent.

During the first semester the fiscal sector was characterized by slow developments in the public expenses, mainly in capital expenses, not exerting pressure on demand growth. Fiscal results during the first five months of 2007 recorded a surplus of 2 per cent of GDP. This fiscal profile is expected to change during the second semester, which comes as a result of the concentration of expenses in the last months of the year and bringing about increases in the fiscal stimulus in economy.

Despite demand growth during the first semester it is observed that pressures on the overall price level have been low due to the favourable developments on the supply side. Annual growth of consumers' price level during the first semester has been observed at around 2.3 per cent, where the average growth rate was faster during the first quarter rather than during the second. Higher level of price rise has been observed in processed foodstuffs, accommodation services and in goods and services with administered prices. Monetary policy has been neutral during the first semester of 2007. However, the Bank of Albania has constantly underlined the growing risk in price stability due to the growing domestic demand and its influence on the fast growth of monetary assets in the economy. In these conditions, at the end of June the Bank increased the key interest rate by 0.25 per cent, reaching 5.75 per cent.

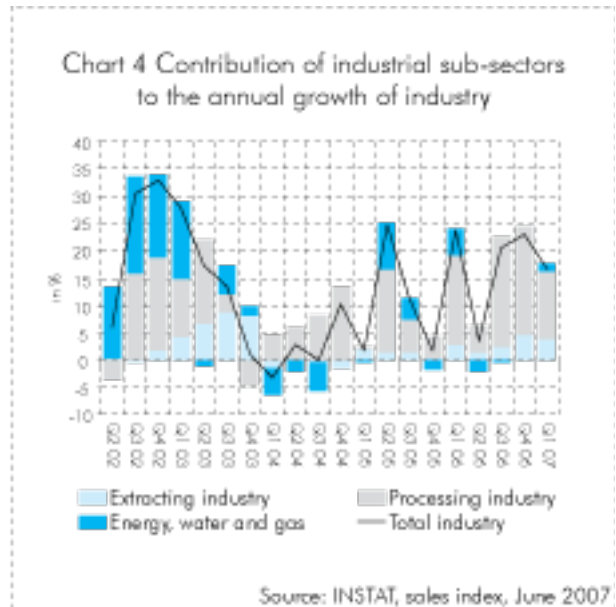
3.1 PRODUCTION BY SECTORS OF ECONOMY

INDUSTRY AND ENERGY

Sales in the industry sector recorded an annual growth of 17 per cent during

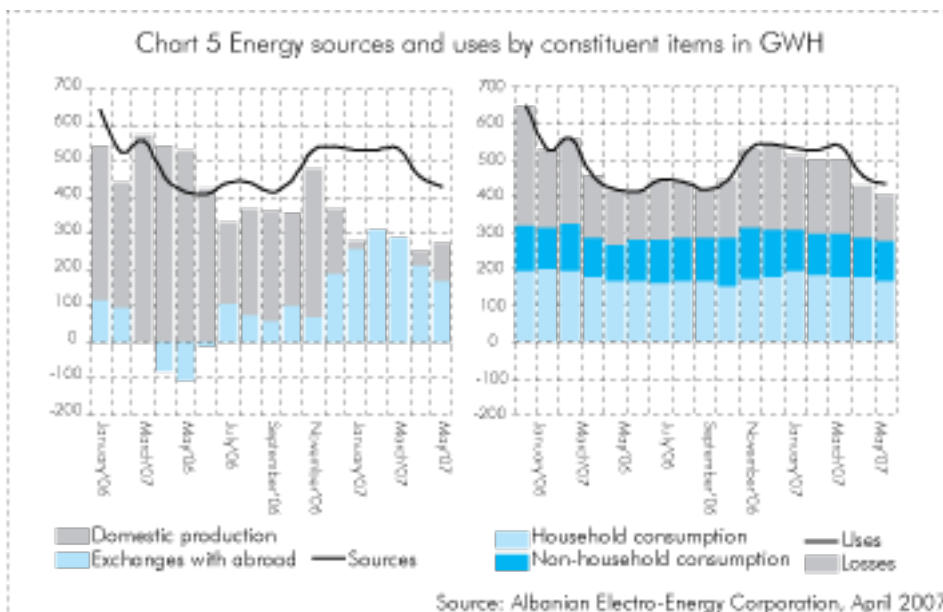
the first quarter of 2007, which is close to last year's average. The annual contribution of this sector to total sales in economy was positive reaching around 4.4 per cent. In terms of quarterly changes, seasonal adjusted sales of industry have increased by 2 per cent during the first quarter of 2007 showing steady developments in the economic activity of this sector.

These developments were supported from both the extracting and processing sub-industries at respectively 4.1 per cent and 12.5 per cent. As a result of the gradual revival of the extracting industry's activity it has recorded a positive contribution to total sales in economy. The growth of exports has provided a considerable contribution to the sales of extracting industry. In annual terms the exporting volumes of the extracting industry have nearly doubled. The processing industry dominates the performance of sales in industry, providing about 64 per cent of sales and contributing by 17 per cent to the total sales in economy. The exporting activity of processing industry remains in the same levels as in the previous year. Around 30 per cent of sales in this industry were realized in the foreign market and this positive environment during the first quarter expressed in growing exports, employment and improvements in their financial situation as well as the growing business confidence in the industrial production sector.



Source: INSTAT, sales index, June 2007

During the first quarter of 2007 nominal sales in energy, gas and water recorded a 4 per cent increase compared with the last year's figures. On the other side annual domestic energy production recorded a sharp decline (by 51.2 per cent during January-May 2007) mainly due to unfavourable hydric conditions. For these reasons, the Albanian Electro-Energy Corporation



Source: Albanian Electro-Energy Corporation, April 2007

(KESH) was obliged to increase power imports to five times the normal levels. Meanwhile power import levels have reached 1.4 billion kwh and it is expected that until the end of this year another 1 billion will be imported. The low production level and high import levels have negatively influenced the Albanian Electro-Energy Corporation's (KESH) financial balance.

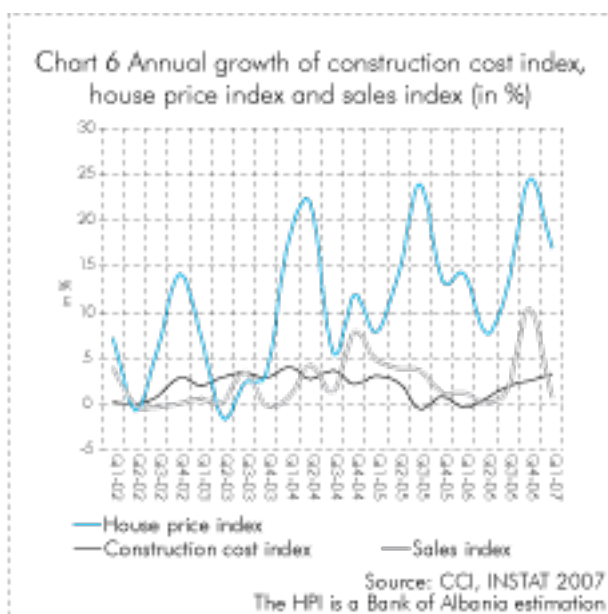
Household and non-household consumption has declined considerably during this period, being respectively 3.3 per cent and 1.9 per cent lower than the previous year. The administration measures taken by KESH influenced on the increase of collections, while the net losses recorded an annual decline by about 21 per cent. Despite the measures taken for the improvement of this situation, the Albanian Electro-Energy Corporation (KESH) informs that the limitations in power supply will still be present during the foreseeable future, stressing the importance of prioritizing direct intervention in power problems.

CONSTRUCTION

Official figures from sales volumes and the figures provided by the periodical surveys carried out by the Bank of Albania in cooperation with the construction firms show that construction activity in the country has experienced a sharp decline during the first quarter of this year, recording a 31 per cent decline in its contribution to total sales compared with the previous year. In terms of quarterly changes, the seasonally adjusted sales resulted about 40 per cent lower. It has been observed that the decline in granting construction permits

has strongly influenced the slowdown of this sector's activity, while demand on the other side is still high. This has been confirmed by the high positive figures in the balance for demand indicators resulting from construction companies' declarations during the business confidence survey.

The high demand level and the limited construction permits have resulted in high real estate prices. The annual growth rate of housing price index⁶ resulted at 17 per cent for the first quarter of 2007, otherwise expressed as some per cents higher than the last five years' average. On the other hand, annual growth rate of construction cost index was recoded at 3 per cent, a fact which shows that prices in construction are to a large extent led by the increase in the ratio of demand/supply rather than the increase in production costs.

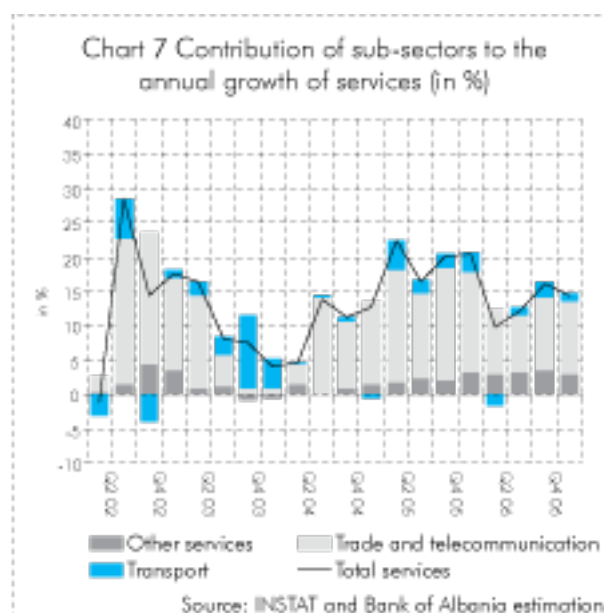


SERVICES

Trade activity of hotels and restaurants (considered as the most important for the services sector), recorded continuous annual growth rates of sales volume for the fifth consecutive year. Nearly half of the total sales growth in the economy is provided by this sub-sector, where during the first quarter of 2007 the annual sales growth rate recorded 14.7 per cent. Trade activity follows this sub-sector, sharing 44 per cent of total sales in the economy.

Work volume in the retail market, as based on the Retail Market Index (INSTAT, 2007), shows positive annual growth at 11 per cent. In terms of the number of employed, this sector has contributed by 20 per cent. The above developments are indications that support the growth in consumption and domestic demand in the country for the relative periods.

The transportation sector during the first semester of 2007 recorded an annual growth of 49 per cent, pointing towards a positive reorientation of its downward trend of the last four quarters. Even though the share of this sub-sector to the total sales volume is small, its high annual growth contributed by about 1.6 per cent to the annual growth of sales in economy. Positive achievements were recorded in the seasonally adjusted sales at 14 per cent compared with the previous quarter. These developments are based on the data collected from sea and air transportation.



Activity	Unit	Q1-06	Q1-07	Annual change (in %)
Air transport	Thousand passengers	466.7	405.3	26
Air transport	Thousand flights	18.2	22.4	23
Rail transport	Thousand tones	115	73	-37
Sea transport	Thousand passengers	138	165	20
Urban transport	Thousand passengers	5	4.8	-5.5

Table 3 Indicators of rail, sea and road transportation

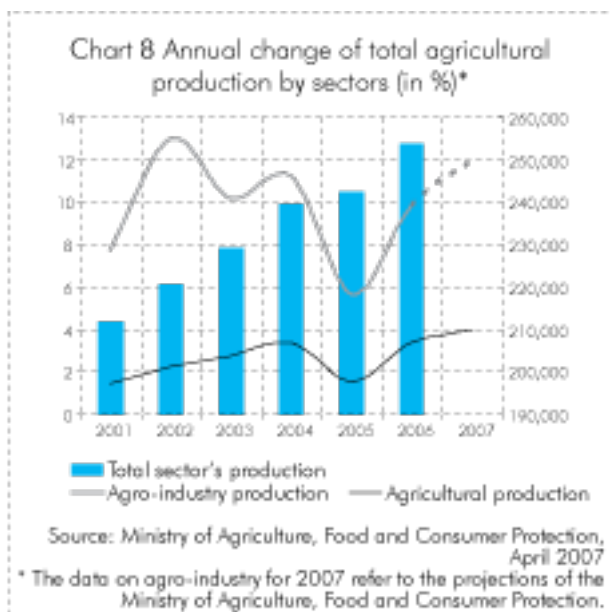
Source: Ministry of Public Works, Transport and Telecommunication, July 2007

During the first quarter of 2007, the telecommunication sector recorded a slowdown after a positive trend during the second semester of 2006. In real annual terms, the telecommunication sector sales index⁷ recorded a decrease of 3 per cent compared with the 27 per cent growth during the previous quarter.

Starting from the first quarter of 2005 other services have recorded positive developments as related to their influence on the total sales in economy. Their contribution to the annual growth of sales in economy was estimated at 2 per cent. In annual terms, the stable performance of services sector is based on the results of business confidence survey, where service companies' opinions were more positive than those expressed from other sectors.

AGRICULTURE

Developments in the agricultural sector for the first semester of 2007 are expected to follow the same trends as those recorded the previous year⁸. This assessment is based on the favourable weather conditions observed during January-June 2007. The most important factors that are expected to back agricultural production growth is the increase in efficiency are the increase in the glass-house areas and other factors that are related to potential changes



of production structure in the agricultural sector. In annual terms, total agricultural production grew by 3.4 per cent in 2006, mainly due to high fruit production.

Production in the agro-industrial sector is expected to grow by 12 per cent in 2007. Its positive performance during the first months of 2007 has been expressed in the slowdown of imports of agro-industrial products. A similar picture is observed in unprocessed agricultural imports as well, where annual growth rate has recorded a decline.

3.2 FISCAL SECTOR

Fiscal sector activity during the first semester is characterized by an increase of income and expenses, as well as the creation of fiscal excess as a result of non-executed capital expenses. The main fiscal indicators continued to have positive trends, but with slower annual growth rate compared with the previous year.

Table 4 Annual growth rates of fiscal indicators during the first 5-month period (in percentage)

	5M 2004	5M 2005	5M 2006	5M 2007	Average
Total income	8.5	8.2	13.0	7.5	8.7
Tax income	11.1	8.0	15.0	9.0	9.3
Income from local government	18.2	7.4	-8.8	-4.7	2.9
Income from independent budget	9.9	12.2	12.5	-0.4	10.7
Non-tax income	-11.8	-2.1	7.8	-9.0	4.5
Total expenses	6.6	7.9	-8.1	13.3	6.6
Current expenses	7.7	7.2	-4.6	10.0	6.3
Capital expenses	-1.1	14.0	-34.4	49.8	9.7
Deficit	-12.0	5.0	-266.8	-35.4	-66.9
Domestic	-10.6	25.2	-390.0	-35.7	-22.0
Foreign	-13.5	-18.2	-48.9	-38.3	2.9

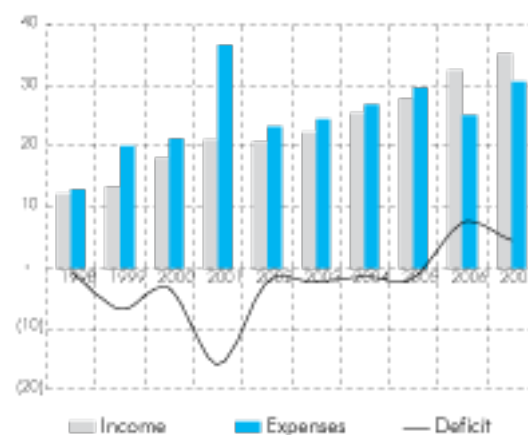
Source: Ministry of Finance

Based on the Ministry of Finance data, until the end of May was collected 95.6 per cent of projected income and were executed 83 per cent of planned expenses. Meanwhile, for the second consecutive year public finances ended the first five months of this year with a positive balance reaching a surplus of ALL 6.7 billion.

BUDGET INCOME

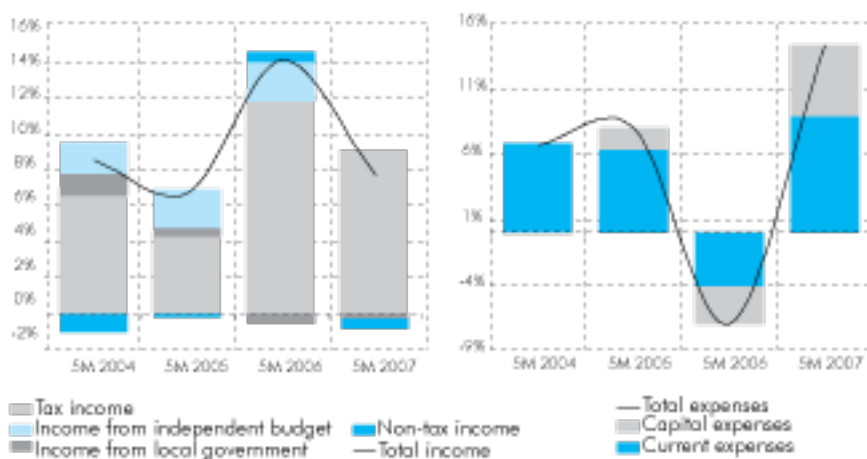
Budget income recorded an annual growth of 7.5 per cent during the first five months of 2007. The biggest contribution to this growth was provided by the collection of tax income, where the VAT, tax on personal income and excises had the best performance.

Chart 10 Main fiscal indicators for January-May (in billions of ALL)



Source: Ministry of Finance, June 2007

Chart 11 Contribution of main items to the annual growth of income (left) and of expenses (right) for the 5-month period (2004-2007) (in %)



Source: Ministry of Finance, June 2007

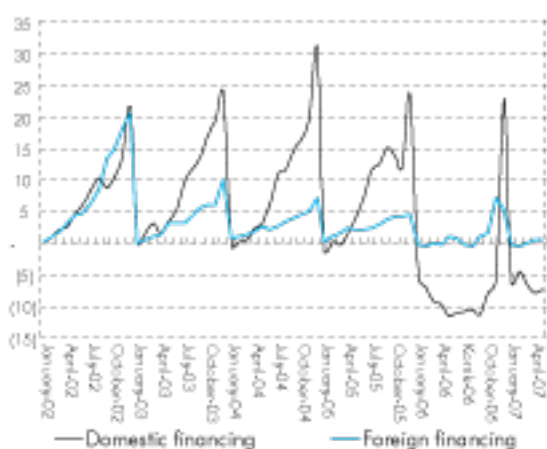
BUDGET EXPENSES

Budget expenses recorded an annual growth of about 13.3 per cent during the first five months of 2007. However, for this period only 83 per cent of expenses were executed according to the budget programme, otherwise expressed as 30 per cent of planned expenses for the entire year. Capital expenses' growth has been faster than current expenses' growth; however their realization remains far from the projected levels. On the other side, the positive balance of the first months and the low level of interest rates have resulted in a decrease in expenses for settling the debt interests by 0.4 per cent.

FISCAL RESULTS

The fiscal balance resulted in a surplus over the first five months of 2007, though in lower levels than the previous year. Its financing profile by sources

Chart 12 Cumulative financing of budget deficit, January 2002 - May 2007 (in billions of ALL)

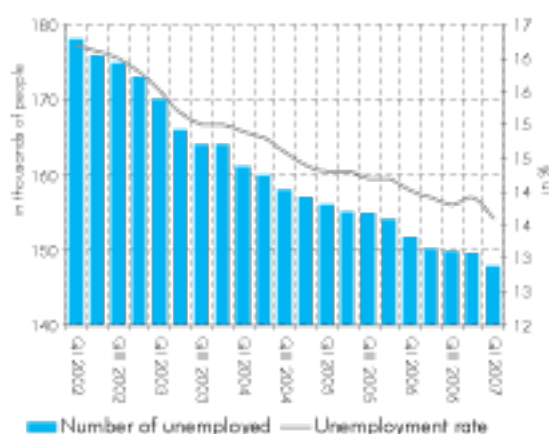


Source: Ministry of Finance, June 2007

is presented similar with the previous year's. In most of the previous year there was an accumulated surplus and in the last months the very rapid growth of expenses accelerated considerably the deepening of deficit which was mainly covered with domestic financing.

The up-to-now performance of the fiscal balance, almost alike with the previous year's, increases the possibility for the recurrence of public expenses and budget deficit concentration in the last months of the year. The Bank of Albania believes that the prevention of such a scenario would help the establishment of a more adequate climate in the financial market and the more efficient use of its sources.

Chart 13 Number of unemployed (left) and unemployment rate (right)



Source: INSTAT, Conjecture, Quarter 1, 2007.

3.3 LABOUR AND WAGES MARKET

The increase of domestic production led to improvements in the labour market. As a result of the annual increase in the employment levels and the dropping of the number of unemployed recorded in the Employment Offices, the annual unemployment rate dropped slightly during the first quarter of 2007.

Despite the seasonal dropping in the first quarter, total employment has increased in annual terms. The data provided by INSTAT indicate that the number of unemployed recorded in the Employment Offices is 147.7 thousand people, dropping by about 5 thousand compared with the previous year. Although the number of long-term unemployed has

been decreasing, they still constitute more than half of unemployed (57 per cent). The ratio of long-term unemployed to total unemployed is nearly 9 per cent less than in 2006. Long-term unemployment remains more present in the group of people with less education.

Table 5 Labour market indicators (in thousands of people)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
Total labour force	1,082	1081	1,084	1,084	1,080
A. Total employed	931	931	934	935	933
i) in the public sector	174	172	170	169	168
ii) in private non-agricultural sector	215	217	221	224	223
iii) in private agricultural sector	542	542	542	542	542
B. Unemployment					
i) Total unemployed	152	150	149	149	148
ii) Unemployment rate	14.0	13.9	13.8	13.9	13.6

Source: INSTAT, Conjecture, Quarter 1, 2007

The average wage in the public sector increased by about 17 per cent compared with the same period the previous year and by 1.4 per cent compared with the previous quarter.

Box 1 Opinions of businesses and consumers on salaries and wages and their re-evaluation.

In absence of a more recent official indicator of salaries and wages and of their policies in the private sector and in order to have a clearer view of future supply-side inflationary pressures, the Bank of Albania held a survey in the first quarter of 2007 and interviewed 670⁹ big companies and 1200¹⁰ consumers.

Around 45 per cent of the companies which were part of this survey answered that they review the salaries and wages in an average periodicity of 2 years, while the rest does not observe any time rule in their review. This is also confirmed by the answers of consumers employed in the private sector, most of who say that the review of salaries and wages is not regular. Around 48 per cent of employed consumers say that there are not any negotiating parties and moreover, they do not participate in this process. The time profile of salaries and wages review changes from one sector to another. Salaries and wages in construction are more volatile than in industry and services. Construction companies review the salaries and wages more often – about 60 per cent of businesses in this sector say that there is an annual review in salaries and wages. Average review frequency of salaries and wages in this sector is below the average of 1.7 years of total economy.

During 2006, 40 per cent of businesses and 31 per cent of consumers answered that there had not been a rise in salaries and wages. According to the answers of businesses and consumers who say that there has been a rise in salaries and wages, it results that the average rise is 8.5 per cent.

As far as businesses are concerned, construction has applied the highest average rise in salaries and wages, rising by 9 per cent. Companies review salaries and wages based on certain factors, among which the most important ones are: the company's financial result, the use of a rise in salaries and wages as motivation instruments, competition in the salaries and wages market within the sector and the seniority at work. Meanwhile, the rise in salaries and wages results to be less affected by factors, such as past and expected inflation in economy and the rise of salaries in the public sector. It results that the rise of salaries and wages in the public sector is higher than the one declared by businesses in this survey. The above results indicate that in determining the salaries and the wages, the companies consider the meeting of some micro conditions (within the sector), rather than the information in macro level (past and expected inflation). The Bank of Albania appreciates the positive signal for low inflationary expectations in the future, especially considering that this signal comes from businesses which are the main actors of economic activity in the country.

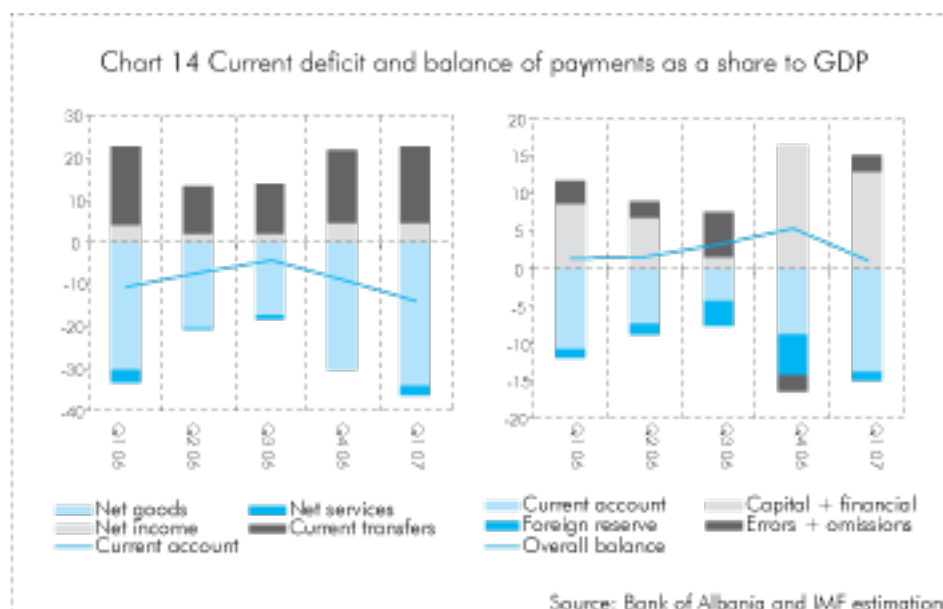
As of end 2007, about 85 per cent of interviewed companies are expected to review/rise the salaries and wages by 8.7 per cent on average. Production and construction companies are expected to apply the highest rise, by about 9 per cent. The reaction of the private sector to possible rises in salaries and wages in the public sector is expected to be balanced. About half of businesses would not be influenced (would not respond), while the rest would respond by rising the salaries and wages modestly, in response to their rise in the public sector.

Moreover, the consumers expect a rise in their salaries and wages by the end of 2007. They claim to have a rise of about 18 per cent or 10 per cent more than the one declared by businesses. This is a well-known phenomenon in the process of reviewing salaries and wages among parties, where the employers (businesses) set lower limits than the employees and their trade unions in order to come to a negotiable point at the end of the process. In determining the expected level of salaries and wages review, consumers consider as important factors not only at micro level, such as education and professional performance, but also macro factors, such as the performance of prices in the future, the exchange rate, in particular of the lek to the euro.

Based on these facts, the Bank of Albania considers prudently both the signals deriving from businesses and consumers. The Bank of Albania emphasizes that the preservation of balances in the salaries and wages market boosts economic growth and helps anchoring the public's inflation expectations to the central bank's objective.

3.4 EXTERNAL SECTOR OF ECONOMY

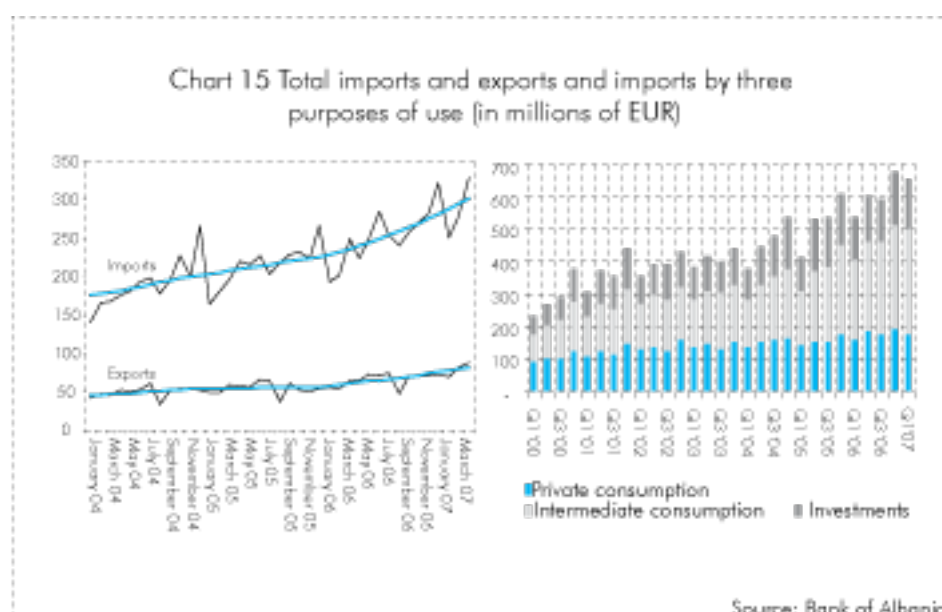
Current deficit deepened by about 40 per cent during the first quarter of 2007 compared with the first quarter of 2006. As a result of the current deficit deepening, its share to the GDP is assessed to have reached 14 per cent. The current deficit deepening for this quarter is mainly attributed to the increase of trade deficit in goods, which is estimated to share about 34 per cent of the GDP.



The volume of current transactions amounted to about EUR 1.8 billion in the first quarter, while current deficit reached EUR 180 million. About 70 per cent of overall current expenses (EUR 950 million) was used for the purchase of import goods, while the rest was used for the purchase of services by

residents. From the export of goods and services was generated 24 and 36 per cent of current income. The balance of current transfers, mainly private ones, continued to record positive figures. Net transfers financed about 50 per cent of trade deficit in goods and services.

Trade deficit in goods was about 8 per cent lower over the first quarter compared with the last quarter of the previous year, but about 20 per cent higher than the deficit of the same period the previous year. Imports and exports of goods amounted to about EUR 630 and 180 million and the coverage rate of imports by exports results to be about 30 per cent.



The import of goods recorded an annual growth of about 22 per cent, while exports were about 26 per cent higher than the first quarter the previous year. In terms of imports by use, it is concluded that the share of imports for private consumption has dropped slightly compared with the first quarter the previous year, while imports for intermediate consumption recorded the highest growth rate and the largest share to total imports (about 50 per cent). More than half of total exports are shared by the export of textiles and footwear, while the first quarter was characterized by a high increase in the export of minerals. The increase of export of chrome to China has provided a considerable contribution in this context.

Trade in services ended in a negative balance of EUR 30 million in the first quarter, while the balance of income ended positive with about EUR 60 million. Services account continues to be dominated by travel services, while other services have managed to end the deficit in travel. Income from travel services amounted to about EUR 170-180 million. The dropping in income from tourism is mainly attributed to the decrease in the number of non-resident travellers and to the reduced average duration of stay. Current transfers, which are mainly represented by workers' remittances, financed

about 50 per cent of trade deficit in goods. Net transfers totalled about EUR 240 million, while their share to the GDP has remained almost unchanged compared with the same period the previous year.

Capital and financial account net flow was about EUR 170 million over the first quarter, out of which EUR 30 million were in the form of capital transfers inflows and EUR 140 million were in the form of residents' financial liabilities. The increase of residents' financial liabilities to non-residents came as a result of the increase of foreign investments and of borrowing from abroad. For the first quarter, foreign direct investments were mostly concentrated in processing and manufacturing industry and in communication. External debt increased by about EUR 36 million over the first quarter. About 90 per cent of this debt is shared by state borrowing. As of end the first quarter, Albania's foreign reserves amounted to about EUR 1.376 billion. This amount of reserves is assessed to be sufficient for covering about 4.4 months of imports of goods and services.

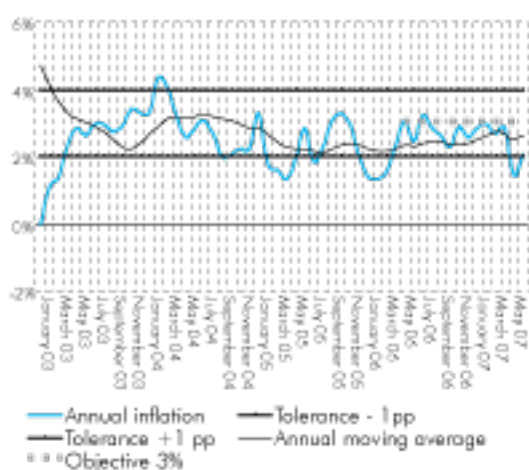
4 DEVELOPMENTS IN CONSUMER PRICES

Annual inflation rate was relatively low in the second quarter of 2007. In June 2007, it marked 2 per cent, while the second quarter resulted in an average annual rate of 1.8 per cent. Over this quarter, annual inflation displayed a downward trend, dropping by nearly 1 percentage point on average compared with the previous quarter. Inflation was considerably affected by temporary seasonal factors and by a relative balance between supply and demand. The current monetary conditions and the fiscal balance of the first five months have been adequate to keep inflation contained. Notwithstanding this setting, the expectations on the performance of some important monetary and fiscal indicators for the rest of the year suggest that the inflationary pressures may increase.

4.1 INFLATION BY CATEGORIES

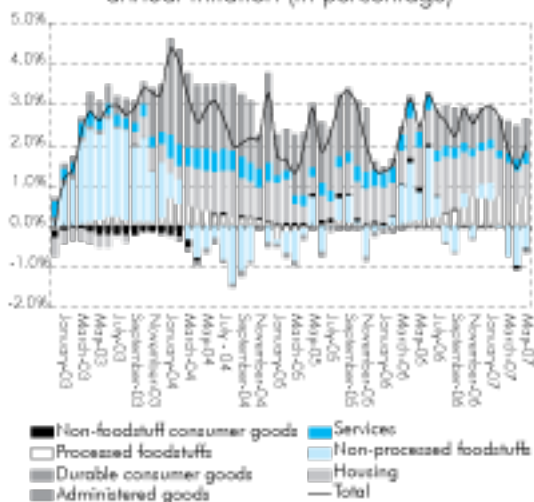
Annual inflation rate averaged 2.3 per cent for the first semester of 2007. The average rate marked in the first quarter was considerably higher than in the second quarter. The performance of inflation rates of special categories created according to economic function was relatively uniform throughout the period, except for 'unprocessed foodstuffs'. The other categories recorded positive annual inflation rates.

Chart 16 Annual inflation (in percentage)



Source: INSTAT and Bank of Albania

Chart 17 Contribution of main items to annual inflation (in percentage)



Source: INSTAT and Bank of Albania estimations

‘Processed foodstuffs’ recorded high annual inflation rates. In June, it marked the highest inflation rate of the year of 3.3 per cent. This increase is attributed to the price rise in ‘bread and corn’. This development reflected the price rise of bread in some cities in Albania. This item’s average inflation marked 3 per cent in the first six months, which is quite a few times higher than the inflation rate of 0.2 per cent marked in the same period the previous year.

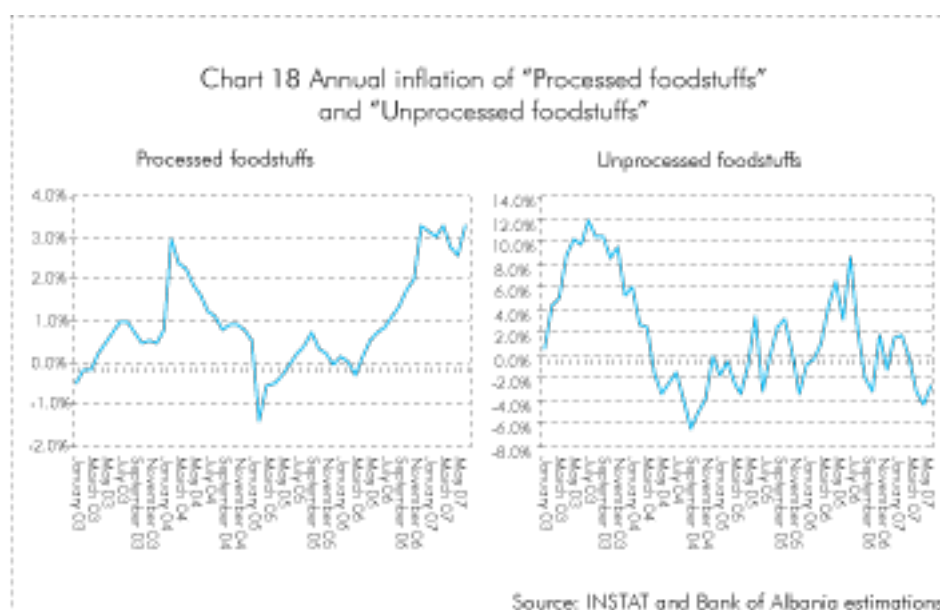
The rise in excise duty on some sub-items in September 2006 and the consumer price rise in partner countries also influenced on this category’s positive inflation rate.

	Alcoholic beverages and tobacco Annual inflation (%)			Foodstuffs and non-alcoholic beverages Annual inflation (%)		
	Albania	Italy	Greece	Albania	Italy	Greece
June '06	1.6	5.2	4.9	1.9	1.3	3.5
September '06	11.4	5.1	6.7	-1.1	2.5	4.7
December '06	12.1	5.0	10.7	0.2	2.7	4.3
March '07	12.2	5.7	10.8	-0.5	2.4	2.7
April '07	12.9	4.4	10.8	-1.2	2.7	1.7
May '07	13.6	4.4	8.8	-2.0	2.7	2.0
June '07	14.3		6.7	-0.7		2.2

Table 6 Annual inflation rates by main groups

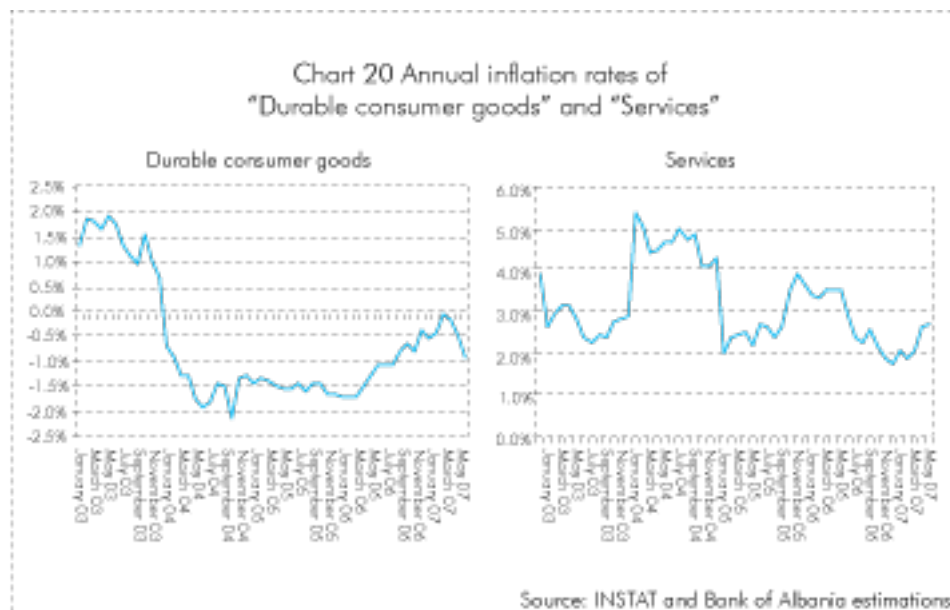
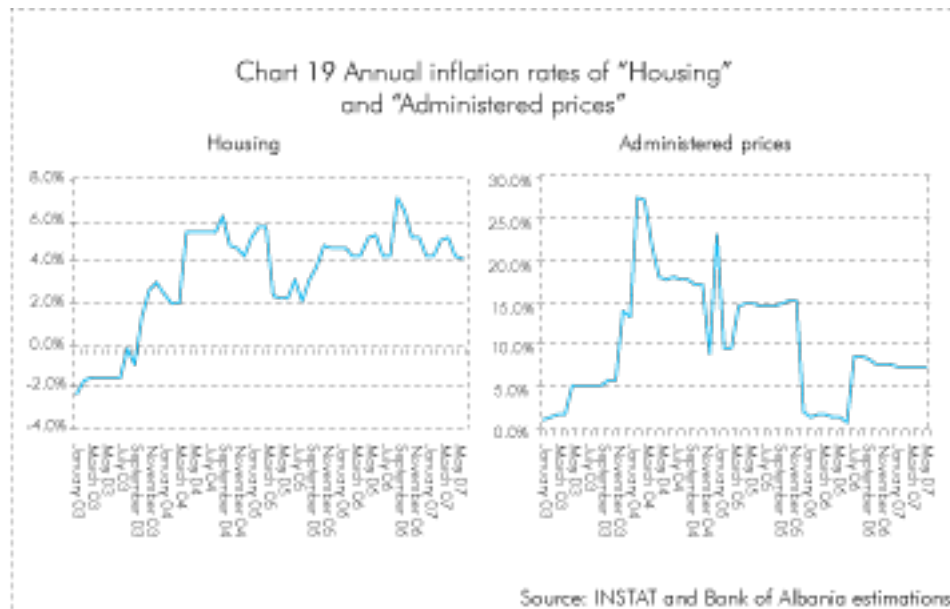
Source: ISTAT; <http://www.istat.it>; National Statistical Service of Greece; <http://www.statistics.gr>; INSTAT, CPI, June 2007

Annual inflation of ‘unprocessed foodstuffs’ marked -2.6 per cent in June, while in June the previous year it marked 3.2 per cent. This item’s average annual rate for the first semester was -1.1 per cent from 2.4 per cent the previous year. The dropping of this item’s prices mainly attributes to the considerable decrease in the prices of ‘fruit’ and ‘vegetables including potatoes’ which continued over June as well. In contrast to the previous year, the growth of supply for these productions as a result of the entry of domestic agricultural products in the domestic market brought about the drop in prices. Moreover, the decrease of these goods’ prices occurred earlier this year compared with the previous year.



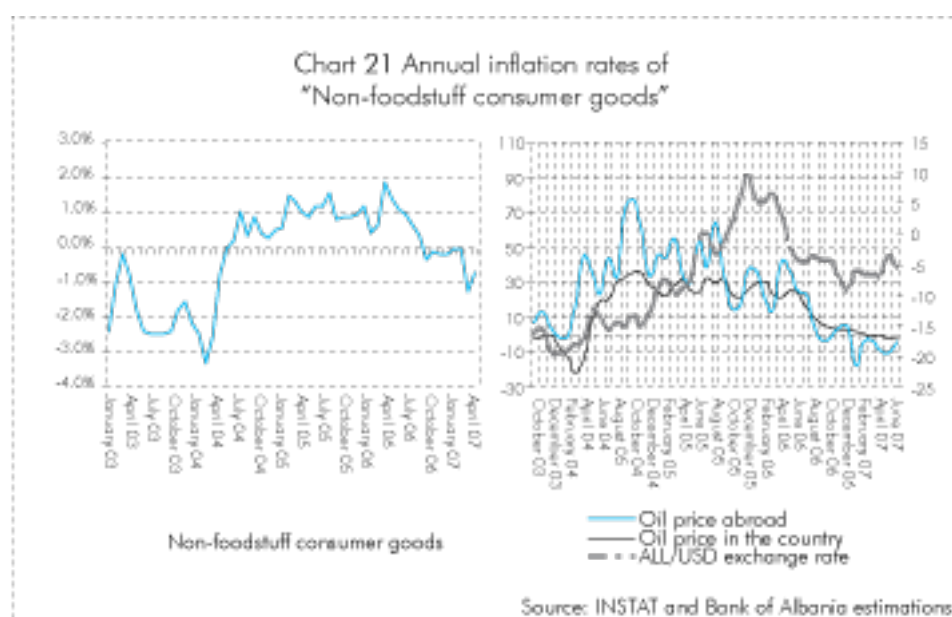
Annual inflation of 'housing' continued to record positive rates, though it dropped slightly in the first months of the year. In June, this item's annual rate marked 4.1 per cent, while the average inflation for the six-month period resulted in about 4.5 per cent. Compared with the first six-month period the previous year, it is observed that the price rise rates of housing services are lower. In general, this item has been characterized by seasonal price fluctuations being under the influence of domestic demand.

Annual inflation rate in administered prices of goods and services fluctuated at around 7 per cent over the first semester of 2007. Energy price has had a direct influence on inflation through the increase in the cost of energy consumed by households. The influence of the inflation in administered prices of goods and services on the total inflation rate is significant. This item has been contributing by about 0.8-1.0 percentage points each month starting from August 2006. Almost all services in this group have gone through slight fluctuations in the prices over the first semester of the year.



Annual inflation of 'durable consumer goods' and 'services' (-0.9 and 2.7 per cent) resulted to be quite close to the average annual rate of -0.7 and 2.4 per cent. The inflation performance of durable consumer goods is in line with the trend in other countries. As a result of the rapid technological development there is an ever-increasing quality improvement and dropping in prices. The price rise in services on the other hand provides evidence for the increasing demand and improved quality.

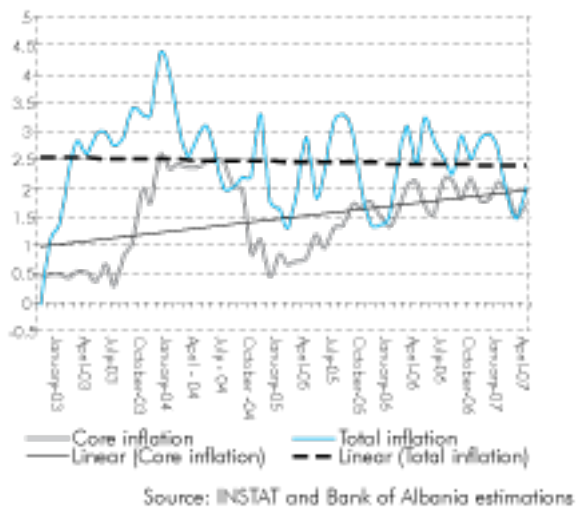
Annual inflation of 'non-foodstuff consumer goods' recorded the negative figure of -0.8 per cent in June 2007. The average rate for the first semester of 2007 was -0.4 per cent, while the previous year it marked 1.1 per cent on average. This decrease was manifested in both main items: 'clothes and footwear' and 'services to personal transport vehicles'. The phenomenon of the negative inflation in 'clothes and footwear' is quite a long one, starting from February 2000. The inflation of 'services to personal transport vehicles' is affected considerably by the oil price performance in the domestic market, which on the other hand is both influenced by the oil price performance in the international markets and by the exchange rate developments. The recent oil price rise, following the dropping for some months since last October, was offset by the appreciation of the lek to the US dollar.



4.2 INFLATION AND MACROECONOMIC ENVIRONMENT

The first semester of 2007 was characterized by the growth of domestic demand in the presence of the absent fiscal incentive, accommodating monetary conditions and of the by and large positive supply-side developments. The high domestic demand was reflected in the increase of sales and in the deepening of trade deficit. In the monetary area, the rapid growth of monetary assets and liquidity was followed by pressures on the decline of interest rates, while the exchange rate has shown a relative stability. The first quarter provided evidence for the growth of economic activity and the improved situation in the labour

Chart 22 Annual rate and linear trends of core and total inflation (in percentage)



market, despite the energy crisis early this year. The sales index increased by 14 per cent compared with the previous year and the unemployment rate continued to drop. On the supply-side, the positive influence of domestic agricultural production on inflation was more dominant than the high oil prices effect, while wages did not increase significantly and the inflationary expectations remained anchored around the Bank of Albania target.

The upward trend of the annual core inflation rate constitutes another signal for the monetary policy, providing evidence for the increasing inflationary pressures in economy. Annual core inflation rate marked 1.7 per cent in the second quarter of 2007, which is almost equal to total inflation rate. In April and May were recorded slightly higher core inflation rates compared to total inflation rate. In June annual core inflation marked 1.7 per cent, which is higher than the previous year. The price rise effect of bread¹¹ and some processed foodstuffs¹² affected this rate for June.

In June annual core inflation marked 1.7 per cent, which is higher than the previous year. The price rise effect of bread¹¹ and some processed foodstuffs¹² affected this rate for June.

The analysis of total inflation performance indicates that the latter is often subject to high fluctuations in the short-term. Therefore, the Bank of Albania assesses core inflation, or inflation “cleared” from temporary influences, as important and supplementary information because it informs the monetary policy and the public on the permanent inflation rates.

Box 2 More on core inflation and on its measurement

Core inflation is an important information for the analysis and monetary policy decision-making process in central banks. Literature defines core inflation as the long-term and durable part of total inflation. From the central bank point of view, core inflation is a component of total inflation, which is mainly caused by monetary factors. Based on these theoretical considerations, core inflation would result after the short-term or transitory fluctuations, which are usually caused by factors out of the monetary policy sphere, were excluded. The practice of measuring core inflation provides a wide spectrum of methods. The selection of a method, on the basis of which it is derived an adequate core inflation series, is quite debatable in both the academic and central banking circles (Silver, 2006). Theoretical and practical debates point out the advantages and disadvantages in applying different methods. Notwithstanding the difficulties and dilemma in selecting the method for the measurement of core inflation, the method to be selected should: first, exclude to a great extent the transitory volatilities from total inflation; second, have a high level of transparency, in order to be familiar and understandable to the public. The vast experience of different central banks and of the European Central Bank in particular, and the experience of the Bank of Albania indicates that the method of permanent exclusion of some items from the consumer basket is an alternative for the measurement of core inflation. From the comparison of different methods’ results of core inflation measurement in the case of Albania, it has been concluded

that the measurement of core inflation by using the method of permanent exclusion satisfactorily meets the statistical, transparency and public understandability criteria. Moreover, the total inflation may be forecasted more adequately. Notwithstanding the advantages of this method, some well-known researchers (Wynne, 2001; Cechetti, 2006) believe that the permanent exclusion of some items does not always imply that the remaining is only temporary or transitory inflation. Therefore, the results of core inflation should be carefully considered as additional information in deriving conclusions on inflation trends in the long run.

Based on the principles and experience in applying the method of permanent exclusion, from the Albanian consumer basket have been excluded: (a) highly seasonal goods and services, which cause high and temporary fluctuations in prices (usually some unprocessed foodstuffs); (b) goods with administered prices (energy and water); (c) goods, the prices of which are often subject to fiscal policy (excise goods); (d) goods, the prices of which are closely related to external conjunctures (oil). After the exclusion is made, the share of the sub-basket, upon which core inflation is measured, is about 78 per cent.

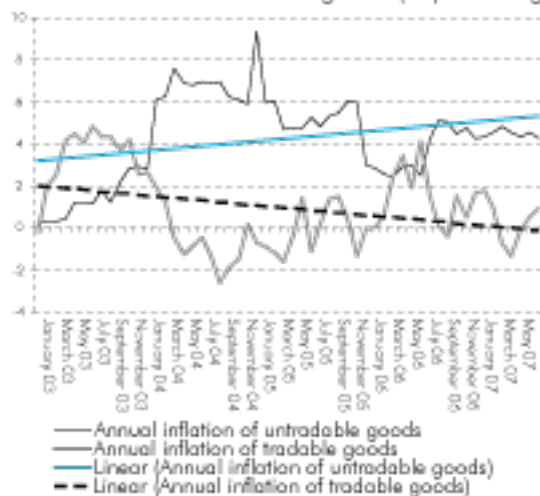
The presence of demand-side inflationary pressures is expressed in the prices of non-tradable goods and services¹³. Over the last four years this item's average annual inflation marked 4.2 per cent; however there is an upward trend from one quarter to another for 2007.

The highest inflation rate of non-tradable goods for the first semester was recorded in April (4.8 per cent). The high inflation rates of these types of goods have been partly neutralized by the low inflation of tradable goods which has been displaying a downward trend in the last months.

Monetary policy has continued to react through the increase of the core interest rate, remaining however accommodating to the economic growth. Under the conditions where the demand of economy for monetary assets has been growing, trade deficit has been deepening and the interest rates have been fluctuating around low levels, the Bank of Albania decided to increase the core interest rate at the end of June 2007. This increase aimed to keep the demand for monetary assets and the effects of its growth on the inflation perspective on check. On the other hand, the increase of the core inflation rate aims to balance the credit growth rates by better managing the level of liquidity in the market. It also seeks to harmonize the private sector's demand for money with that of the public sector's in the future, under the conditions where the latter is expected to grow. Consequently the increase of the core interest rate will establish a balanced macroeconomic environment and it will provide stable economic growth rates.

The public sector's fiscal position did not affect the increase of inflationary pressures over the first semester of 2007. Fiscal policy has been prudent in

Chart 23 Annual rates and inflation linear trends of tradable and untradable goods (in percentage)



Source: INSTAT and Bank of Albania estimations

implementing the fiscal programme in terms of income collection, while the execution of expenses resulted less than projected. Budget spending in the first semester of 2007 increased compared with the same period the previous year, while their execution level for this period was as much as 30 per cent of the amount projected for 2007.

The supply of goods, in particular of agricultural goods, and the economy's production capacities have managed the moderate growth of domestic demand by not generating inflationary pressures.

Exchange rate developments play a key role in the performance of inflation. Domestic market continues to be import-oriented. For the first semester imports resulted to be four times higher than exports. Imported inflation was positively influenced by price stability in partner countries and negatively affected by the continuous depreciation of the lek to the euro. The foreign prices rise effect on the total level of domestic consumer prices is assessed to have been neutral. As far as domestic production is concerned, the increase in the supply of foodstuffs, mainly over the second quarter managed to meet the largest part of demand for this type of goods. Considering that this is a seasonal phenomenon, the depreciating environment of the lek to the European currency would bring about serious problems to the inflation rate in case the domestic demand of the economy remains high in the medium run. Despite the positive performance over the first half of the year, oil price has begun to fluctuate again in high levels. In case of a potential energy crisis, this situation increases the risk of a rise in the production cost in economy.

5 MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

5.1 MONETARY POLICY OF THE BANK OF ALBANIA

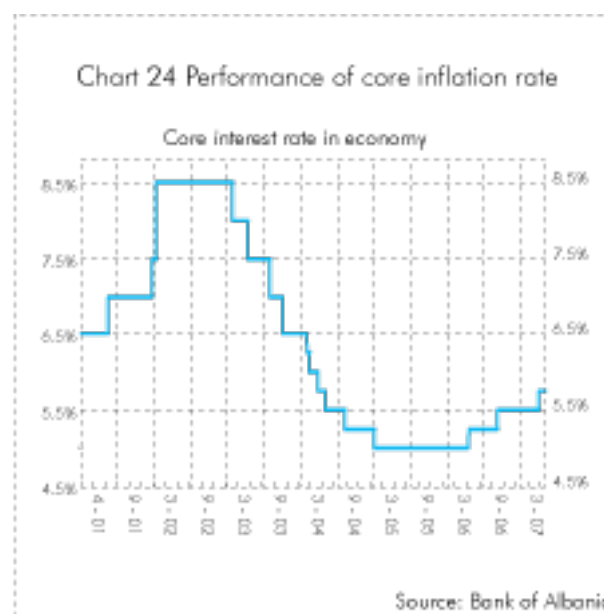
The analysis of monetary conditions evidences high expansion rates of money supply in economy, while the inflation rates forecasts confirm its upward trend from the current average rate. Annual money supply growth rate has averaged 17-18 per cent in the last six months compared to the average growth rates of 10-11 per cent in the second semester of 2006. The high growth rates of money supply have been supported by the high demand for credit from the private sector of the economy while the public sector's fiscal position contributed to the weakening of monetary expansion rates. At the same time, the presence of inflationary pressures was reflected in the price rise of non-tradable goods in the last quarters.

The effect of the increasing domestic demand for monetary assets has been partly amortized in the form of both trade and current deficit deepening. Over the first quarter of 2007, current account deficit deepened by about 39 per cent. The preliminary data on the trade balance for April and May confirm the deficit upward trend. Against the backdrop of the growth of domestic demand in economy, the current expansion trend of the economy external position over 2007 and the presence of potential risks in the expected dynamics of

inflationary pressures, on 27 June the Supervisory Council of the Bank of Albania decided to increase the core interest rate by 0.25 per cent. The core interest rate applied on the (reverse) repurchase agreements is 5.75 per cent.

By means of this growth, the Bank of Albania aims to stabilize the inflationary expectations through the minimization of potential risks on both the monetary and macroeconomic balance. The transmission of this signal to the financial markets will induce the re-balancing of the current upward trend of domestic demand in favour of financing the stable growth of economy in the long run.

In line with its long-term policy, the Bank of Albania has been operating in the financial markets in order to maintain the balance. The monetary operations for the first quarter operated through the short-term repurchase agreements and long-term reverse repurchase agreements, aiming to stabilize the liquidity situation in the market. The stable liquidity situation in the banking market was followed by the gradual increase of interest rates in the second quarter, being in line with the targeted monetary policy. The Bank of Albania was present in May by injecting liquidity and in June by withdrawing the liquidity. These operations aimed to minimize the interest rates fluctuations. In the foreign currency market, the exchange rate was relatively stable with a slight depreciating tendency in the first quarter. The Bank of Albania was present in the foreign currency market in order to stabilize the short-term fluctuations in this market.



The monetary operations were in line with the framework of accomplishing the quantitative objectives of the Bank of Albania for monetary policy purposes. Their accomplishment in the third quarter requires the design of a more prudent monetary operations framework by the Bank of Albania, in order to meet the net international reserve objective.

	December '06	March '07	April '07	May '07	June * '07	September '07 ¹⁵
Net International Reserve of the Bank of Albania (in millions of USD)						
Objective	1,343	1,318	1,324	1,331	1,337	1,459
Current	1,484	1,487	1,484	1,458	1,458	--
Difference (C-Obj)	141.5	169.4	159.5	127.6	121.1	--
Net Domestic Assets of the Bank of Albania (in billions of ALL)						
Objective	79.1	80.6	80.8	80.9	81.0	94.6
Current	78.0	59.3	57.8	64.6	68.8	--
Difference (C-Obj)	-1.1	-21.3	-23.0	-16.3	-12.2	--
Net Domestic Credit to the Government (in billions of ALL)						
Objective	342.4	338.6	341.2	343.9	346.6	352.6
Current	330.6	332.8	332.2	331.9	--	--
Difference (C-Obj)	-11.8	-5.8	-9.0	-12.1	--	--

*Operative data.

Source: Bank of Albania

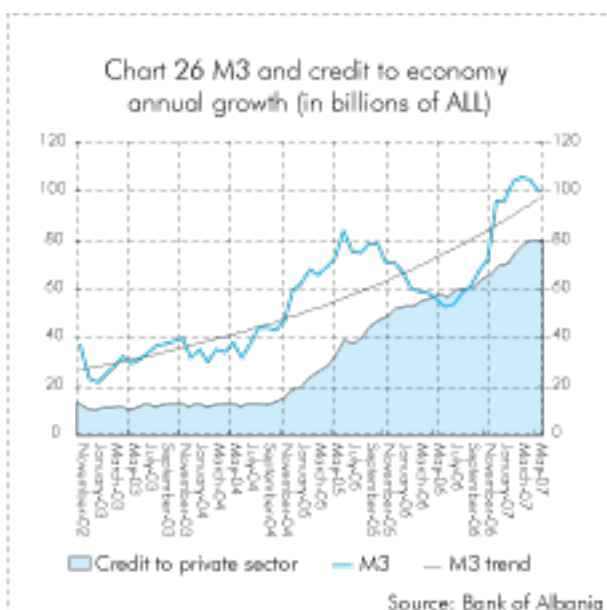
Table 7 Realization of the Bank of Albania quantitative objectives¹⁴.

5.2 MONETARY AGGREGATES DEVELOPMENTS

The performance of money supply indicators has evidenced the high demand for monetary assets during 2007. Money supply recorded an average annual growth of about 17.5 per cent during 2007. However, the expansion of money supply in economy, expressed by the narrowest monetary aggregates, results in lower rates. The annual growth of M2 aggregate fluctuated around 12 per cent compared with the average growth rates of about 7-8 per cent during the second semester of the previous year. In annual and foreign currency structure terms of money supply, the performance of M2 aggregate to M3 growth reflects the creation of foreign currency monetary assets in the private sector of economy. The annual expansion rates of monetary base in economy (reserve assets) have had a stable performance of about 10-12 per cent.

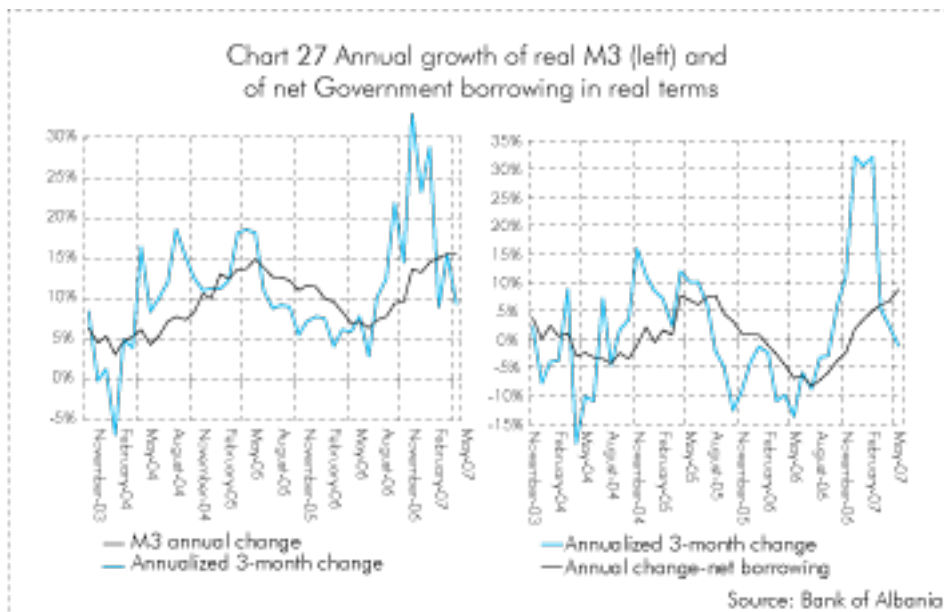


Both time and foreign currency structure of the economy demand for monetary assets have been balanced in the monetary aggregates structure. The long-term trend of M3 growth has been influenced by the creation of monetary assets in the form of credit to the private sector, while the fluctuations over the months have reflected the effect of domestic borrowing for the financing of deficit in generating money flows. The balanced performance of the fiscal position during 2007 contributed to the stabilization of money supply performance.

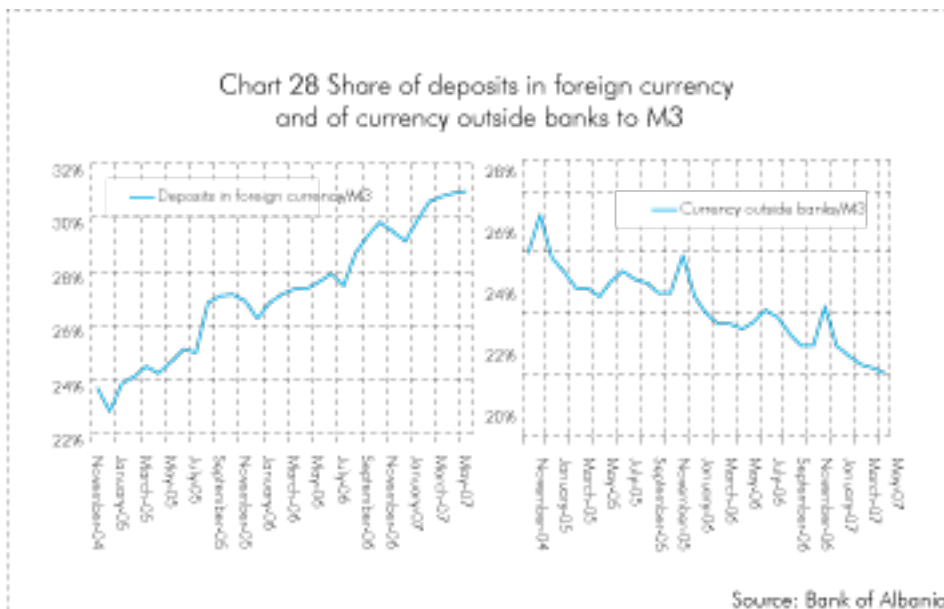


The creation of money flows was mainly in foreign currency. About half of annual money supply flow took the form of foreign currency deposits held with the banking system. As of end May 2007, the share of foreign currency deposits to M3 increased to about 31 per cent compared to 29 per cent as of end 2006. In annual terms, the performance of foreign currency deposits has followed the upward trend of the creation of foreign currency assets in economy, mainly because of foreign currency credit. Foreign currency workers' remittances also make a contribution to the annual growth of foreign currency deposits on seasonal basis.

The second main component of money creation in economy, domestic borrowing, has been a determining factor of the short-term behaviour of M2 aggregate and of the liquid component of money supply which is currency outside banks. The creation of ALL deposits held with the banking system was mainly supported by the generation of currency from ALL credit to the private sector. Meanwhile the share of currency outside banks to M3 dropped to



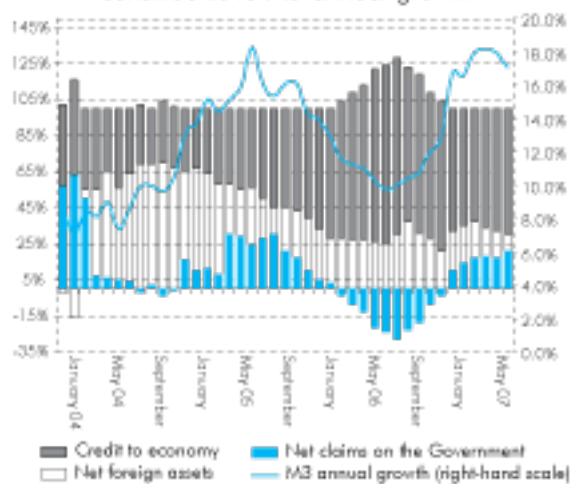
22.0 per cent in May compared to 24.2 per cent in December. The dropping of this ratio is partly seasonal. In May 2006, this ratio was 23.5 per cent or 1.5 per cent less than the current ratio. ALL deposits have grown annually by about 12.5 per cent, while their share to M3 accounts for about 47 per cent. In general, the structure of money supply is being oriented to less liquid assets. This orientation influences positively on the reduction of potential M3 growth effects on the creation of inflationary pressures.



5.3 PERFORMANCE OF DEMAND FOR MONEY AND CREDIT TO ECONOMY

Demand for money has grown under stable rates in April and May 2007. Being pushed by the higher demand of the private sector, its main

Chart 29 Contribution of demand for money constituents to M3 annual growth



component, domestic credit, continued to grow. The growth of credit to economy has provided the main contribution to the annual growth of demand for money by 71 per cent. This performance has offset the downward contribution provided by its foreign currency component. On the other hand, the public sector has had a moderate demand for money and the Government's fiscal position continues to be characterized by budget surplus. The focus of the banking system to crediting the private sector is affecting the constant dropping of the share banks' claims on the Government have on domestic credit to 54 per cent from 65 per cent it accounted for the previous year.

Credit to economy constituted the main impulse to the growth of demand for money in the second quarter. As of end May, this type of credit amounted to ALL 228 billion or 24.6 per cent of the GDP projected for 2007. In the last two months, the credit growth of ALL 14 billion has been more sluggish than the end of the first quarter, being close to the projection in the monetary programme of the Bank of Albania. In annual terms, credit growth rate reduced to 55.6 per cent from 58.7 per cent it peaked in March. Meanwhile, new credit extended during the second quarter maintained high levels (ALL 20 billion a month). The satisfactory performance of new credit was followed by high levels of settlements, which led to a more modest growth of outstanding credit. The first months of 2007 indicate a reduction in the average duration of new credit signalling a more sluggish growth of outstanding credit as a result of the high settlement levels for the following periods.

Box 3 Performance of credit in Central and South East Europe

Central and South East European countries have for many years been experiencing a boom in the credit to the private sector from commercial banks. The annual credit growth rates are high, being followed by a considerable increase in the ratio of credit to private sector to the country's GDP. However, this ratio is to a large extent below the average of many European countries with developed banking systems, where the ratio of credit to the GDP exceeds 100 per cent.

Credit boom in regional countries was pushed by the overall macroeconomic stability, the reforms in sectors of economy, the establishment of market economy institutions and the application of legal reforms (in particular, the legal obligation for the execution of contracts). The sound economic growth pushed further the expansion of lending activity, influencing on the expectation for the increase of individual income and earnings. This growth has encouraged the timely substitution of savings/consumption, pushing credit further.

Table 1 Performance of main indicators of lending activity in regional countries*.

Countries	Credit	Annual growth	Foreign currency credit/GDP	Credit to households/GDP	Real estates credit/GDP	Credit interest rates	Non-performing loans/total
	per cent GDP						
Bulgaria	49.1	30.7	22.8	17.7	7.6	8.4	2.2
Romania	26.3	59.3	12.5	11.8	2.3	13.9	8.5
FYROM	31.6	33	8.3	10.4	1.4	10.7	7.6
Albania**	23.4	58.9	16.9	7.9	4.6	14.1	3.3
Serbia	28.7	13.9	13.5	10.2	21.3	15.9	24
Croatia	74.4	22.4	60	39.5	na	9.1	2
Poland	33.3	31	na	18.4	5	7.8	6.6
Czech Republic	37	21.4	16.5	17	12	7.2	3.6
Average in the region	38.92	33.83	22.33	16.25	7.44	12.02	9.12

*Data for March 2007 (unless otherwise mentioned).

** Data for May 2007.

Source: "Southeastern Europe and Mediterranean Emerging Market Economies Bulletin", vol 8, Economic Bulletin NBG, and economic bulletins of central banks.

As shown in the table, lending activity in Albania displays high growth rates, boosting the country's economic development further. The annual growth rates of the last two years are the highest in Central and South East Europe. However, Albania has the lowest ratio of credit/GDP in the region. The low ratio of credit/GDP implies that there is room for further financial deepening and credit growth.

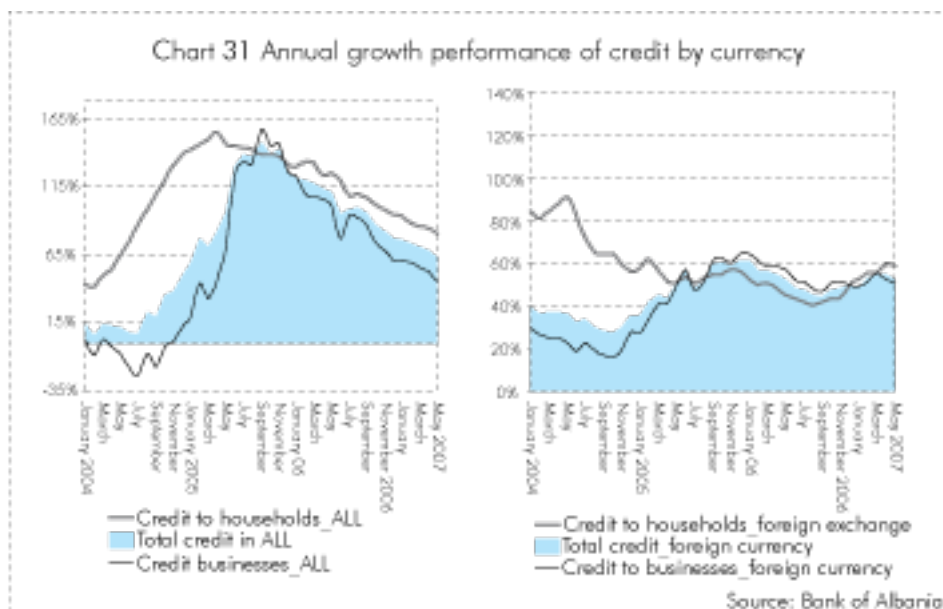
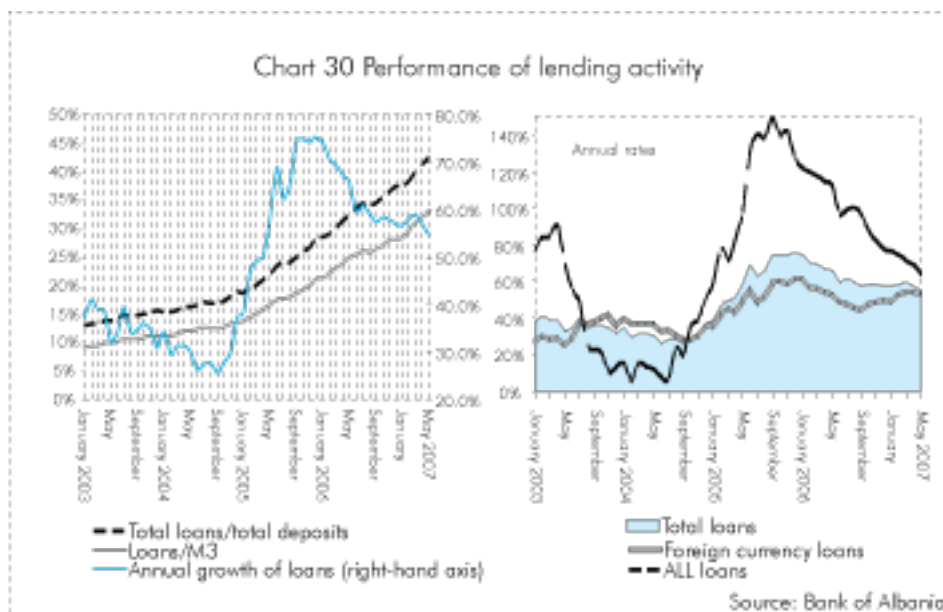
Lending developments in Central and South East Europe may be mainly interpreted as a manifestation of further financial intermediation deepening. But, in the same time, the rapid credit expansion implies increase of risk in many countries. Financial stability situation in these countries is positive; however, the rapid credit growth calls for special attention in terms of supervision, for the credit quality to be satisfactory. In macroeconomic terms, the credit boom has led to the growth of demand. As a result, in some countries with high and continuous credit growth, the deficit on current account has gone further the stable levels in a long period of time. The great risk of credit growth has been subject to measures taken by the decision-makers to keep it as close as possible to acceptable levels for the overall macroeconomic stability of the country.

Reference:

P. Backé, B. Égert & T. Zumer, 2006: "Fast credit expansion in Central and Eastern Europe: catching-up, sustainable financial deepening or bubble?"

P. Backé, & T. Zumer, 2005: "Focus on transition" OENB, Volume 2.

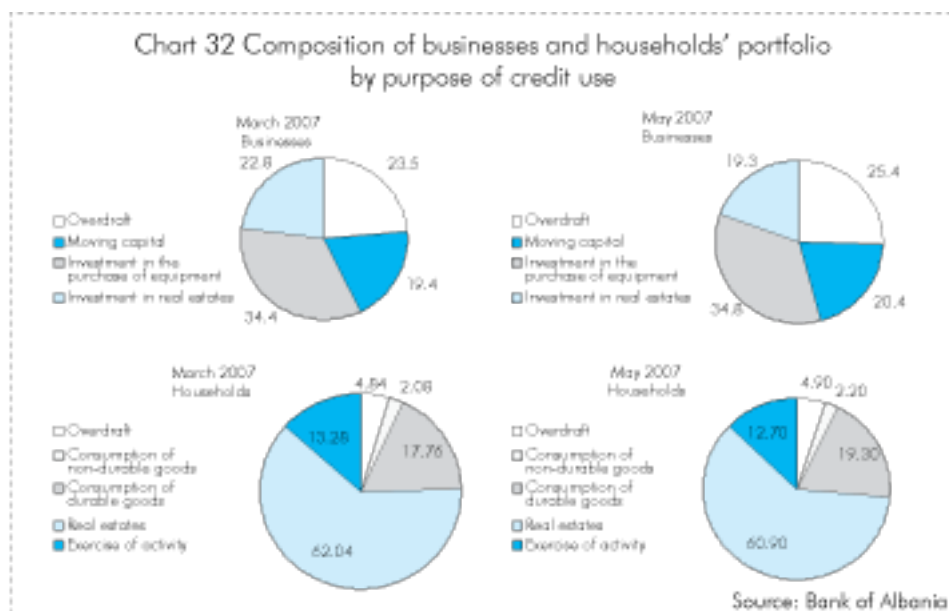
The structure of credit by currency is dominated by foreign currency denominated credit. This type of credit maintained the same growth rates during the second quarter as in the first months of the year, growing by 53 per cent in annual terms. Credit to businesses provided the main contribution to its growth, though credit to households denominated in foreign currency displays higher rates. Compared with the first quarter of 2007 there has been a slight improvement in the ALL denominated credit portfolio, which reached to 28.6 per cent in May. Annual growth rates of ALL denominated credit continue the downward trend to 63.1 per cent in May compared to 71.1 per cent in the first quarter. The growth of credit to households during the second quarter has favoured the performance of credit denominated in domestic currency.



Private companies' demand for credit is the main impulse of credit growth. As of end of May, credit to businesses reached to 16 per cent of the GDP. In annual terms, it was 48 per cent higher than the previous year. The growth rates of credit portfolio to businesses have been dropping, mainly as a result of the high credit settlement levels during this period. Credit to public sector also increased during the second quarter. This euro denominated credit became active following the use of the credit line by the state-owned company KESH in one of the banking systems. The largest increase of this credit was observed in April (ALL 1.8 billion).

In terms of purpose of use, credit to business extended by the banking system was mainly used for the purchase of equipment. However, compared with the previous quarter there is an increase in the credit for moving capital and overdraft which accounted for 45.8 per cent of credit portfolio to

businesses. In terms of sectors of economy, the second quarter displayed a moderate growth in credit to agriculture, construction and collective services. Although the trade sector has a more reduced credit portfolio it remains the most credited sector of economy sharing 20 per cent of credit portfolio.

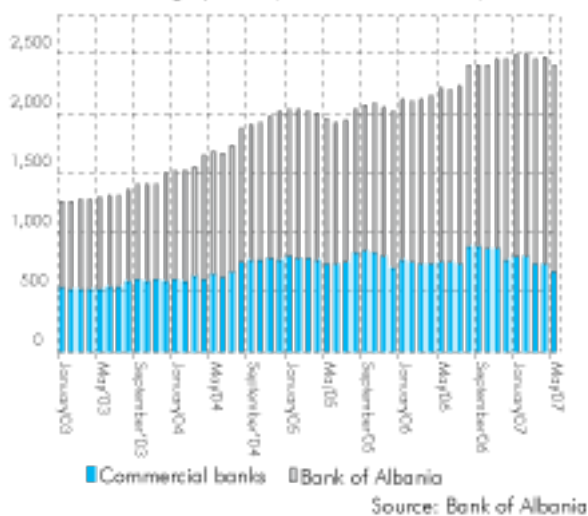


Compared with the previous quarter, there was an increase in credit to households in the second quarter of 2007. As of end May, it accounted for 34.5 per cent of total portfolio and its growth rate reached to 68.3 per cent. Credit portfolio to households provided evidence for an increase over the second quarter in the share of consumer loan for durable goods, which offset the reduction in the share of credit portfolio for real estates extended to households. However, real estates credit shares most of the weight in the households' portfolio by 61 per cent. Meanwhile, consumer loan grew over the second quarter, reaching the level of December 2006 and accounting for 9.1 per cent of the portfolio. The performance of consumer loan seems to be closely related to the holiday and vacations season.

The banking system net foreign assets amounted to about USD 2.4 billion as of end of May. The performance of commercial banks' net foreign assets has determined the performance of the foreign currency component of demand for money, which decreased compared with the previous quarter. The reduction of foreign assets is the net result of the higher financing of economy by banks, in the form of foreign currency credit and the growth of foreign currency deposits held with these commercial banks. Compared with the end 2006, commercial banks' foreign assets dropped by USD 95.5 million.

The developments in the net foreign reserve of the Bank of Albania have made a positive contribution to the banking system net foreign assets. The net foreign reserve of the Bank of Albania amounted to USD 1.72 billion in May, increasing by USD 34.7 million compared with the end of 2006. The changes in the EUR/USD exchange rate affected considerably the performance of these

Chart 33 Net foreign assets of the banking system (in millions of USD)

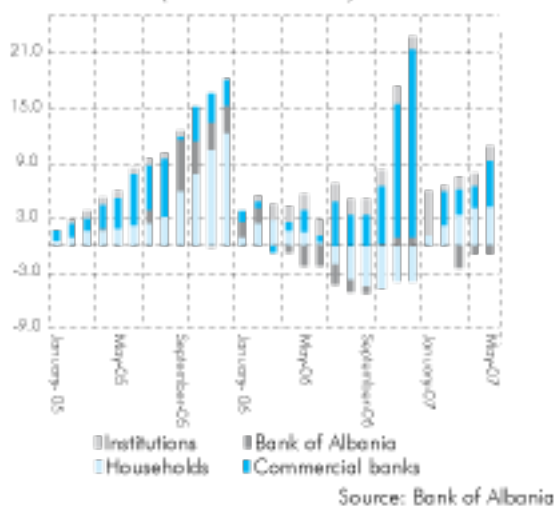


assets over this period. Excluding the appreciation effect of the euro to the American dollar, the net foreign reserve of the Bank of Albania results to have dropped by USD 4.9 million.

Fiscal balance for May continued to be characterized by a budget surplus¹⁶, which increased by ALL 1.9 billion compared with the end of the previous quarter. Fiscal surplus led to a moderate demand of the Government for monetary assets. The fiscal surplus and the issue of Government securities provided to the Government ALL 14.2 billion of surplus at the end of the first five months of 2007. Domestic financing totalled ALL 2.9 billion in May or only ALL 0.1 billion more than the end of the first quarter. The issue of ALL 5.8 billion of 2 and 5-year bonds helped to create Government

inflows. While the issue of Treasury bills of smaller amount than their matured amount and the ALL 6 billion investment in reverse repurchase agreements in the banking system helped the outflow of Government funds. The excess Government liquidity situation is also reflected in the Government's account balance held with the Bank of Albania which as of end of May resulted in a surplus of ALL 5.4 billion or ALL 2 billion more than as of end of March.

Chart 34 Gross financing of budget deficit (in billions of ALL)



The Government's gross financing during the first five months of 2007 was accomplished through the increase of households and institutions' securities' portfolio by about ALL 5.7 billion. Meanwhile, commercial banks continued to shift the portfolio to securities of longer maturity terms, that is Government bonds. Commercial banks increased their investment in Government bonds by ALL 19.2 billion; while on the other hand, they reduced the Treasury bills' portfolio by ALL 14.1 billion. In the light of these developments, as of end May the Treasury bills' portfolio accounted for 73.2 per cent of Government's securities portfolio from 85.7 per cent it accounted for the same period the previous year.

5.4 FINANCIAL MARKETS, INTEREST RATES AND THE EXCHANGE RATE

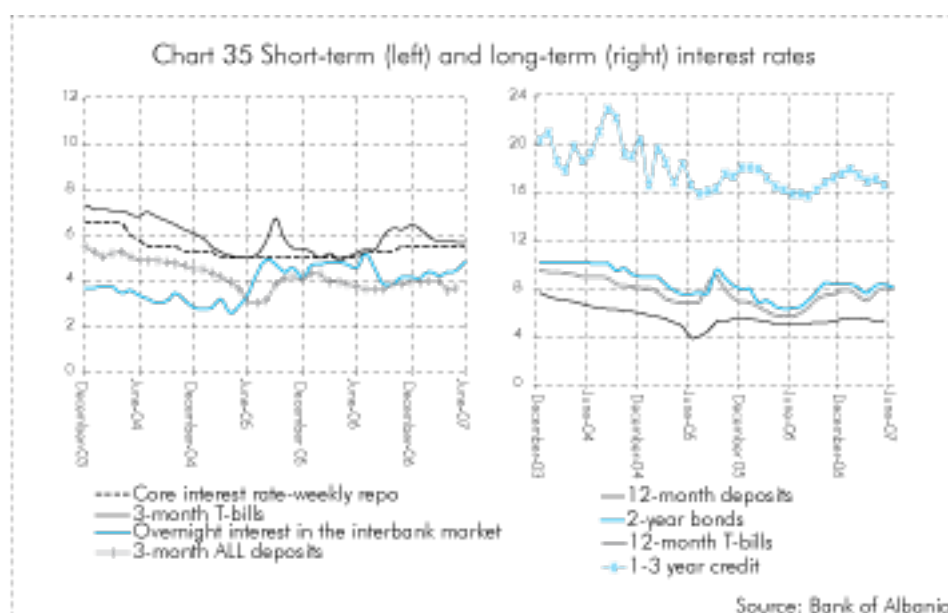
Trade activity in the markets has been more reduced and the interest rates have had an upward trend in the second quarter of 2007. The monetary policy stance remained unchanged for the period, maintaining the same core interest rate of 5.50 per cent since November 2006 when it was raised by 25 basis points. There was a signal for a raise in the core interest rate in the second quarter (which occurred at the end of June), which created

expectations partly reflected in the raise of interest rates in the money market at the end of the same quarter. The interest rates raise in this market over the second quarter was pushed by the decrease of the liquidity level in the banking system (to ALL 3.1 billion on average from ALL 4.9 billion in the first quarter).

LIQUIDITY PERFORMANCE AND ITS MANAGEMENT

The Bank of Albania intervened in the market through its main instrument, by withdrawing or injecting liquidity of one-week maturity term fixed at 5.50 per cent. As a result, the markets have generally operated with stable interest rates, in particular in the short-term maturity. The interest rate fluctuations were affected by the changes in the liquidity situation in the system. In light of these developments, in the second quarter, in addition to its main instrument, the Bank of Albania used the reverse repurchase agreements of three-month maturity, by injecting liquidity in the market. The average weighted yield of reverse repurchase agreements was 6.20 per cent in the second quarter. On the contrary, during the first quarter of 2007, the Bank of Albania intervened in the market by withdrawing the excess liquidity through the repurchase agreements of three-month maturity. Their average weighted yield was 6.00 per cent.

The interests which resulted from the use of the Bank of Albania's instruments oriented the interest rates in the market. Except for credit interests, interests of short maturity term fluctuated within a narrow range. Interests of long maturity term increased when the demand for liquidity grew in the second quarter of 2007.

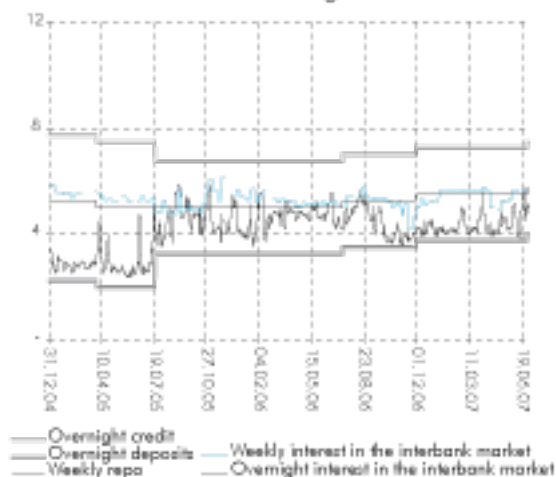


INTEREST RATES PERFORMANCE

The determining corridor of interbank market interests in the money market remained unchanged at minimal levels of 3.75 per cent (overnight deposits interest) and maximum levels of 7.25 per cent (overnight credit interest).

Within this corridor, overnight borrowing interests in the interbank market fluctuated between the lower limit and the core interest rate, while increasing in the second quarter. The average daily change between the core rate and the overnight interest dropped to 0.98 per cent from 1.24 per cent in the first quarter. Weekly borrowing interests fluctuated around the core interest rate, averaging 5.66 per cent. The average daily level of borrowing in the interbank market dropped to ALL 1.6 billion from ALL 1.8 billion in the first quarter and it mainly consists in overnight transactions.

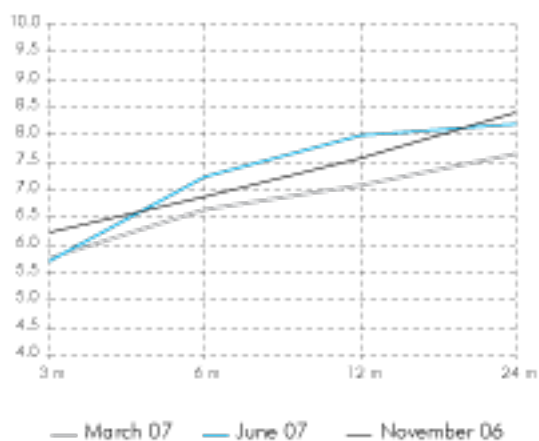
Chart 36 Interest rates in the interbank market and BoA's standing facilities



Source: Bank of Albania

The Treasury bills' yield in the primary market¹⁷ increased by almost 1 per cent in the second quarter. As of end June, the 12-month yield reached 7.99 per cent from 7.07 per cent as of end of March. In March, the yields decreased by about 0.50 per cent from the percentage of last November (the last time when the core interest rate changed) affected by the high excess of liquidity (as a result of the seasonal effect and the reduction of the Government demand for monetary assets). The opposite occurred in the second quarter. The ratio of Government demand for financing with Treasury bills and the system's supply for investing in them dropped to 1:1.2 from 1:1.9 in the first quarter.

Chart 37 Securities' yield in the primary market



Source: Bank of Albania

The expectations for an increase in the core interest rate (which was raised by 25 basis points on 28 June) partly affected the increase of the yield. As of end June, the 12-month yield was 0.40 per cent higher than as of November 2006.

The long-term interest rates in the bonds market fluctuated depending on the ratio of Government's needs for financing and the liquidity conditions. Two-year bonds fell to a minimum of 7.65 per cent in March, along the same line with the Treasury bills yield and increased the following period (by 0.50 per cent on average). Three-year bonds, which are issued on quarterly basis, resulted 8.05 per cent in April, when some banks' bids were refused.

The general trend in the ALL deposits¹⁸ market was the increase of interest rates for all maturity terms throughout the first five months. Calculated as a simple average, the interest rate of 12-month deposits reached 5.69 per cent in May or 0.14 per cent higher than in March and 0.28 per cent higher than in December 2006¹⁹. In the ALL credit market²⁰, the weighted average of loans' interest rates reached to 12.7 per cent in May which is 0.23 per cent less than as of end of the first quarter²¹. The interest rates of loans of 6 months to three years maturity term decreased during this

period, leading to the increase of demand for short-term and medium-term loans.

Intermediation cost, which is measured as the difference between ALL credit interests and ALL deposits interests, is presented in table 8.

	December '06	March '07	May '07
6-month credit-deposits	7.54%	7.73	10.32
1-year credit deposits	5.70%	6.18	4.73

Table 8 Intermediation cost in ALL

Source: Bank of Albania

Intermediation cost for 6-month maturity terms increased compared with the end of 2006 and the end of March 2007, as a result of the larger increase of ALL credit interest rates than ALL deposits interests rates. Meanwhile, the intermediation cost for one-year maturity term decreased as a result of the decrease in ALL credit interest rates.

EUR deposits interest rates fluctuated over the months; however, they have followed the upward tendency of interest rates in the Euro area. In May the weighted average rate of EUR deposits increased to 3.10 per cent or 0.13 per cent more than the first quarter and 0.30 per cent more than in December.

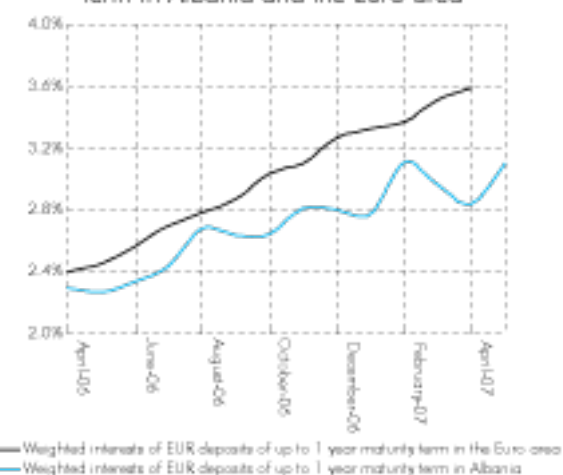
USD deposits interest rates²² dropped for all maturity terms, except for deposits of 1-month and 36-month maturity term. The expectations for the decrease of the core interest rate by the Federal Reserve affected the performance of USD deposits interest rates. The greatest decrease occurred in demand deposits interest rates, which dropped by 0.44 per cent during the second two months of 2007.

The interest rates of foreign currency loans increased in April and May, both for the EUR and the USD. In terms of weighted average, the interest rates of EUR and USD loans reached 8.53 per cent and 11.81 per cent in May. As of end the first quarter, they were 8.13 per cent and 8.86 per cent, respectively²³.

THE EXCHANGE RATE

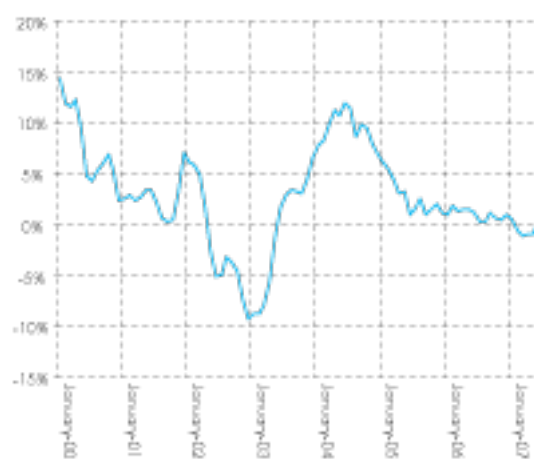
Lek performance in the second quarter of 2007 was different compared with the previous quarter. The depreciating tendency of the lek shifted, being reflected in the swift decrease of the EUR to the ALL in our foreign exchange market. This decrease was originally affected by the low demand for foreign currency in the foreign exchange market (mostly

Chart 38 Interest rates of up to 1 year maturity term in Albania and the Euro area



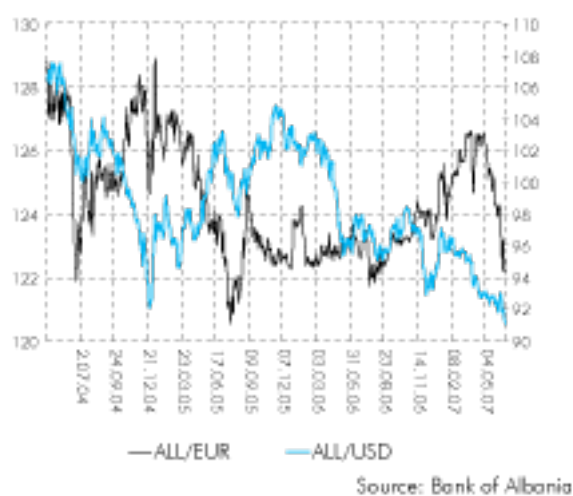
Source: Bank of Albania and ECB

Chart 39 Annual changes of ALL in nominal effective terms (NEER²⁴)



Source: Bank of Albania

Chart 40 Daily performance of ALL/EUR and ALL/USD



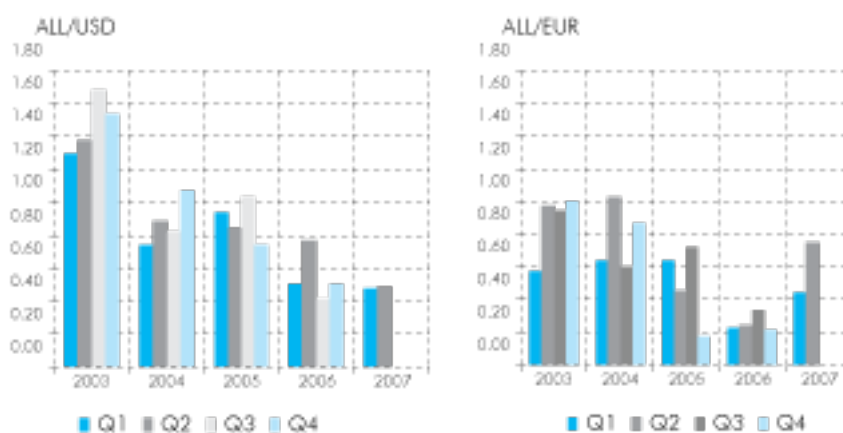
in May). Later, an increase in the supply of foreign currency in June deepened this decrease further, going against the appreciating pressures of the euro in the international market. Compared with the end of March, the lek appreciated by 3.7 and 4.7 per cent to the euro and the dollar.

The annual dynamics of the lek performance is presented stable, with moderate fluctuations, which has been a characteristic of the last two years. In June, the lek appreciated in annual nominal effective terms by 0.7 per cent. The stable performance of the lek during the first semester of 2007 was also affected by the macroeconomic environment. The growth of demand in economy, along with the increase in the deficit on current account brought about depreciating pressures on the lek. The narrowing of the spread between lek - foreign currency interest rates exerted pressure on the same direction.

On the other hand, the low inflation rates have supported the performance of the lek. The rise of the interest rate by the Bank of Albania is expected to increase the spread of interest rates, providing support for the position of the lek.

The seasonal supply in the foreign exchange market has also been exerting appreciating pressures on the lek. The exchange rate performance in the future will depend on the macroeconomic conditions and on the abovementioned factors' influence on the supply and demand for foreign currency.

Chart 41 ALL exchange volatility²⁵ in quarters



6 PERFORMANCE OF ECONOMY OVER 2007

The macroeconomic developments during 2007 provided evidence for a dynamic economic activity in the private sector. The growth of credit to the private sector projected for 2007 is expected to increase the annual money supply rate and aggravate the current account. While in the public sector, the annual framework of fiscal developments does not project any changes in the projections at the beginning of the year. However, the concentration of the public sector's domestic borrowing in the second half of the year will tighten the liquidity conditions in economy for 2007, by exerting pressures on the performance of interest rates. After an analytical assessment of the macroeconomic factors, this June the Bank of Albania tightened its monetary policy by raising the core interest rate to 5.75 per cent. This increase aims to maintain the inflationary expectations in order to achieve the inflation target. In line with these developments, the current projections for the economic growth and the inflation rate for 2007 remain unchanged.

	2002	2003	2004	2005	2006*	2007°	2008°
Real economy indicators	(in percentage)						
GDP growth	2.9	5.7	5.9	5.5	5.0	6.0	6.0
Annual CPI (average)	5.2	2.4	2.9	2.5	2.4	3.0	3.0
Nominal GDP (in billions of ALL)	624.7	682.7	766.1	836.6	896.3	980.0	1,075
Fiscal indicators	(as a share to GDP)						
Fiscal deficit (with grants)	-6.6	-4.5	-5.1	-3.6	-3.2	-3.9	-3.9
Domestic financing	-3.3	-2.9	-2.3	-2.7	-2.3	-2.0	-2.3
Income	24.7	24.5	24.1	24.4	25.2	25.9	26.4
Expenses	31.4	29.0	29.2	28.0	28.5	29.8	30.3
External sector							
Trade deficit (in millions of EUR)	-1,214	-1,248	-1,307	-1,617	-1,752	-1,985	-2,031
Current account deficit (%/GDP) ²⁶	-7.2	-5.3	-3.9	-6.5	-5.8	-7.4	-6.5
Monetary indicators	(as a share to GDP)						
Money supply (%/GDP)	65.3	65.0	65.7	68.4	74.4	79.0	83.3
Credit to private sector	6.4	7.7	9.4	14.9	21.8	28.7	35.0
12-month T-bills yield	12.0	9.5	8.1	6.9	7.8	--	--

* Preliminary data.

° Projections.

Source: Bank of Albania, Ministry of Finance, INSTAT

Table 9 Main macroeconomic indicators

MONETARY SECTOR AND MACROECONOMIC BALANCE

The growth of demand for money in economy during the first half of 2007 exceeded the initial projections. Lending rates have been higher as a result of the growth of demand by the private sector and the moderate domination of public sector borrowing. The Bank of Albania has revised the projection for the annual growth of credit to ALL 85 billion from the projections of ALL 63 billion at the beginning of the year. Following this review, as of end 2007 the share of credit stock extended to economy to the GDP is projected at about 29 per cent. Although the public sector's domestic borrowing remains unchanged, the money flows from domestic borrowing in the banking sector are expected to be higher²⁷. This projection is conditioned by the execution

of public expenses within the year. The higher demand for monetary assets, mainly from the private sector, led to the review of the projection for the annual growth of money supply to about 16.3 per cent from the projection of 11.9 per cent at the beginning of the year.

The expected performance of monetary indicators requires a prudent monetary policy which aims to maintain the level of interest rates in harmony with a balanced ratio between savings in economy and national income. The high credit rates have affected the savings-consumption balance and the external macroeconomic position. Hence, the savings rate in economy is projected to account for 18.3 per cent to the GDP in 2007 from the projection of 19.9 per cent at the beginning of the year. Under an unchanged level of investments which were projected to account for about 26 per cent of the GDP, the foreign financing rate increased to about 7.4 per cent of the GDP from the earlier projection of about 6.2 per cent²⁸. This rate implies an aggravation in the current deficit account. During this year, it is expected to be reflected in the increase of trade deficit.

The current lending rates in economy affect the upward tendency of consumption rate in economy. These factors – the high lending rates and the increase of consumption – tend to create inflationary pressures in economy in the medium-run. Moreover, they affect the dropping of savings rate opposed to national income, leading to the aggravation of current account and providing the grounds for misbalances in the foreign exchange market in the future. The accumulation of these factors and their further actualization would infringe the economic growth stability in the future. The Bank of Albania considers the pursue of a monetary policy oriented towards the increase of the current savings rate as a positive factor in the macroeconomic stability in the medium-term.

ENDNOTES

¹ Global PMI Input Price Index is calculated from JLMorgan and NTC Economics in cooperation with ISM and IFPSM.

² DG ECFIN regularly monitors the development of different industries in the economy in EU member countries and candidate countries. These surveys cover industry, services, retail, construction and consumption and through these key indicators business and consumer confidence indices. Another important indicator is the index of industry developments, PMI, where surveys are conducted in production, new orders, raw materials' prices and employment.

³ Bosnia and Herzegovina, Croatia, Montenegro, Macedonia, Serbia and Albania.

⁴ The interests for Bosnia and Herzegovina and Croatia are long-term average weighted; for Serbia total weighted average and for Macedonia weighted interests for credit and deposits in denars. For Greece and Italy is given the rate of deposits to households with up to 1 year maturity term, and the interest rate for new real estates credit. For Kosovo is given the interest of deposits to households with up to 1 year maturity term, and the interest rate of consumer credit.

⁵ Measured against 24 main trade partners in the Euro area.

⁶ Estimated and measured by the Bank of Albania.

⁷ The respective index in the CPI is used as deflator.

⁸ This consideration should not be taken for granted, considering the limited and fragmented information on agriculture. It is only based on preliminary assessments of experts in this area.

⁹ Respondents in this survey were 615 businesses of production, construction and services.

¹⁰ For this survey were considered only that part of respondents who declared to be employed in the private and public sector. The respondents were about 700 consumers.

¹¹ In the sub-basket of core Consumer Price Index, the normalized share of "bread and grains" is about 10 per cent.

¹² Milk, cheese and eggs.

¹³ The price performance of tradable goods is determined by the level of prices in trade partner countries and their effect is transmitted or amplified through the exchange rate.

¹⁴ The quantitative objectives of the Bank of Albania are part of the new PRGF/EFF 2006-2008 arrangement, signed between the Albanian Government, the IMF and the Bank of Albania in January 2006, and lately reviewed in May 2007.

¹⁵ The objectives in the third and fourth quarter are determined as the amount of monetary flows and the base of December 2006. For the first quarter, the calculation base is December 2005. The change of the base results in a higher level of quantitative objectives for September and December 2007.

¹⁶ See the part on fiscal sector for the budget surplus and its components.

¹⁷ See: Statistical annex, Financial Markets, Table "Interest rates as of end month and their change with previous periods".

¹⁸ The latest data refer to May 2007.

¹⁹ Weighted interest decreased in May and April, as a result of the change in structure by shares of new deposits.

²⁰ The latest data refer to May 2007.

²¹ See: Statistical annex, Financial Markets, Table "Interest rates and their change in the ALL deposits and credit market".

²² See: Statistical annex, Financial Markets, Table "Interest rates of deposits in foreign currency".

²³ See: Statistical annex, Financial Markets, Table "Interest rates of credit in foreign currency".

²⁴ NEER – nominal effective exchange rate measured against two currencies according to an approximate share they have in trade with abroad, EUR (80 per cent) and USD (20 per cent). An increase of the NEER implies an appreciation of the lek.

²⁵ Measured as the quarterly average of exchange rate volatility. Exchange rate volatility is measured by the standard deviation indicator.

²⁶ The data on the current account deficit have been revaluated since 2002.

²⁷ This increase results from the execution of projected expenses for January 2006.

²⁸ The projection of investments has slightly declined by 25.7 per cent compared with the projection of 26 per cent to the GDP at the beginning of this year. Foreign financing rate is the deficit on current account.

STATISTICAL ANNEX

INFLATION

Table 1 Annual inflation rate (in percentage)

	2001	2002	2003	2004	2005	2006	2007
January	2.2	6.5	0.0	3.3	3.3	1.4	2.9
February	1.5	7.6	1.1	4.4	1.8	1.3	2.9
March	2.9	7.5	1.3	4.0	1.6	1.5	2.7
April	3.0	6.5	2.3	3.2	1.3	2.4	1.9
May	2.5	4.6	2.8	2.6	2.0	3.1	1.4
June	4.0	3.7	2.6	2.9	2.9	2.4	2.0
July	5.6	4.2	3.0	3.1	1.8	3.2	
August	4.1	5.5	3.0	2.7	2.3	2.9	
September	3.5	5.3	2.8	2.0	3.1	2.6	
October	1.8	5.8	2.9	2.0	3.3	2.3	
November	2.8	3.7	3.4	2.2	3.0	2.9	
December	3.5	1.7	3.3	2.2	2.0	2.5	
Average	3.1	5.2	2.2	3.0	2.4	2.4	2.5

Source: INSTAT

Table 2 Contribution of basket constituent groups to total inflation

	June - 06	July - 06	Aug. - 06	Sep. - 06	Oct. - 06	Nov. - 06	Dec. - 06	Jan. - 07	Feb. - 07	March - 07	April - 07	May - 07	June - 07
Foodstuffs and non-alcoholic beverages	0.80	1.86	0.51	-0.45	-0.59	0.45	0.09	0.66	0.70	0.32	-0.51	-0.81	-0.27
Rent, water, fuels and energy	1.04	0.88	1.78	2.32	2.19	1.91	1.87	1.70	1.70	1.84	1.85	1.71	1.27
Transportation	0.24	0.19	0.13	0.10	0.09	0.08	0.05	0.02	0.01	0.04	0.04	-0.02	-0.55
Hotels, café and restaurants	0.22	0.16	0.18	0.18	0.15	0.15	0.14	0.14	0.17	0.14	0.15	0.23	0.25
Other	0.15	0.15	0.24	0.40	0.40	0.32	0.40	0.34	0.35	0.35	0.35	0.30	0.30
Total	2.45	3.24	2.84	2.55	2.24	2.91	2.55	2.86	2.93	2.69	1.88	1.41	2.00

Source: INSTAT, Bank of Albania

MONETARY INDICATORS

Table 3 Performance of monetary indicators (in billions of ALL)

	May - 07	Monthly change		Annual change	
		Absolute	Percentage	Absolute	Percentage
Currency outside banks	151.7	-1.2	-0.8	13.4	9.7
Total deposits	536.9	1.2	0.2	87.0	19.3
- in lek	323.6	0.8	0.2	35.9	12.5
- in foreign currency	213.3	0.4	0.2	51.1	31.5
Demand deposits	141.1	0.7	0.5	6.9	5.1
- in lek	73.5	-0.6	-0.7	-9.1	-11.0
- in foreign currency	67.5	1.2	1.8	15.9	30.8
Time deposits	395.8	0.5	0.1	80.1	25.4
- in lek	250.1	1.3	0.5	44.9	21.9
- in foreign currency	145.8	-0.8	-0.5	35.2	31.8
M1	225.2	-1.7	-0.8	4.4	2.0
M2	475.3	-0.4	-0.1	49.3	11.6
M3	688.6	0.0	0.0	100.4	17.1
Monetary base	209.5	-2.0	-0.9	18.8	9.9

Source: Bank of Albania

Table 4 Performance of NFA indicators by main groups, May 2007 (in millions of USD)

	May - 07	Monthly change	Annual change
Net foreign assets	2,390.0	- 70.8	192.4
Foreign assets			
Bank of Albania	1,826.7	- 19.0	257.1
ODC	1,147.1	- 33.3	218.2
Foreign liabilities			
Bank of Albania	103.2	- 0.9	- 4.2
ODC	480.6	19.4	287.1

Source: Bank of Albania

Table 5 Performance of Net Credit to the Government by main groups

	May - 07	Monthly change	Annual change
Net claims on the Government	291,753.4	- 22.25	23,733.6
Bank of Albania	48,407.9	3,627.5	- 2,545.2
ODC	243,345.5	-3,649.7	26,278.8
Deposits held with the Bank of Albania	6,190.6	- 3,313.4	- 638.6
Budget deficit			
	5,261.0	557.7	- 3,729.8

Source: Bank of Albania

Table 6 Performance of some main indicators

	2004	June - 05	December - 05	June - 06	December - 06	March - 07	April - 07	May - 07
Money supply (in billions of ALL)	507.2	541.8	578.04	594.5	674.3	686	688.6	688.6
Domestic credit (in percentage to M3)	68.9	69.9	70.03	71.0	71.8	73.9	74.6	75.5
Credit to the Government (in percentage to M3)	55.1	52.2	48.94	45.3	43.4	42.8	42.4	42.2
Credit to economy (in percentage to M3)	13.8	17.7	21.10	25.71	28.4	31.1	32.2	33.1
Credit to economy (in percentage to total assets)	16.9	20.8	25.11	28.7	31.3	33.6	34.5	35
Credit to economy (in percentage to GDP)	9.0	11.2	14.57	17.6	21.3	23.4	24.1	24.6
Credit/deposits ratio (in percentage)	19.0	23.6	28.47	33.7	37.4	40.1	41.4	42.4

Source: Bank of Albania

Table 7 Outstanding credit indicators as a share to total

	2003	2004	2005	Q1-06	Q2-06	Q3-06	Q4-06	March-07	April-07	May-07
Outstanding credit (in billions of ALL)	50.7	69.3	121.6	134.6	152.8	165.3	191.2	213.6	221.7	227.9
Credit to households	24.5	30.6	32.3	31.9	32.3	33.3	33.4	33.8	34.2	34.6
Credit to private sector	75.5	69.4	67.7	68.1	67.6	66.7	66.5	66.2	64.7	64.4
Short-term credit	46.0	34.0	32.3	32.5	31.1	30.0	29.6	30.5	30.7	31.1
Medium-term credit	33.3	36.0	29.7	30.0	31.2	32.6	31.6	30.6	30.2	29.7
Long-term credit	20.7	30.0	37.9	37.5	37.7	37.4	38.8	38.9	39.1	39.3
Lek	19.6	19.5	26.6	26.0	28.2	29.8	28.9	28.0	28.1	28.6
Foreign currency	80.4	80.5	73.4	74.0	71.8	70.2	71.1	72.0	71.9	71.4

Source: Bank of Albania

Table 8 New credit indicators as a share to total

	Total 2004	2005				2006				March-07	April-07	May-07
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
New credit (in billions of ALL)	99.7	22.1	32.8	32.1	32.9	29.4	35.7	35.8	53.9	18.9	20.2	20.2
Short-term credit	62.54	53.2	47	47.4	48.7	44.2	42	45.8	46.7	52.1	55.1	48.3
Medium-term credit	22.53	22.4	31	30.3	25.6	30.1	33	31.2	27.4	23.9	20.5	19.7
Long-term credit	14.93	24.4	22	22.2	25.7	25.7	26	23.0	25.9	24.0	24.4	32.0
Credit in lek	32.59	30.1	32.8	30.2	31.4	27.7	35	39.6	26.2	35.5	32.1	37.8
Credit in foreign currency	67.41	70	67.2	69.8	68.6	72.3	65	61.4	73.8	64.5	67.9	62.2

Source: Bank of Albania

Table 9 Distribution of credit by sectors of economy (in percentage to total)

	Q1-'05	Q2-'05	Q3-'05	Q4-'05	Q1-'06	Q2-'06	Q3-'06	Q4-'06	March-07	April-07	May-07
Agriculture, hunting and silviculture	1.3	1.5	2.4	2.7	2.2	0.9	0.7	0.7	0.6	0.7	0.8
Fishing	0.01	0.1	0.1	0.1	0.1	0.1	0.11	0.1	0.4	0.1	0.1
Extracting industry	2.35	0.6	0.5	0.5	1.4	2.3	1.0	1.0	1.4	1.5	1.5
Processing industry	15.8	15.6	13.9	13.8	14.2	15.3	15.5	14.3	13.4	13.2	13.0
Production and distribution of energy, gas and water	6.27	2.9	2.9	2.6	2.4	1.1	1.2	1.5	1.7	2.5	2.4
Construction	10.6	11.2	12.8	13	13.0	12.2	12.6	12.6	12.5	12.6	12.8
Trade, repair of vehicles and household appliances	20.5	19.1	20	18.9	19.0	22.5	23.1	22.4	22.0	21.5	20.9
Hotels and restaurants	2.5	4.7	4.4	4.3	4.8	4.1	3.9	3.5	3.4	3.5	3.5
Transportation and telecommunication	2.5	1.7	1.7	1.5	1.3	1.6	1.6	2.0	2.0	1.9	1.9
Financial activities	0.2	1.1	0.7	0.8	0.7	1.3	0.7	2.1	1.9	1.9	1.9
Health and social activities	0.1	0.4	0.6	0.7	0.6	0.6	0.3	0.0	0.3	0.3	0.4
Collective, social and personal services	8.3	7.4	5.9	5.8	4.6	1.7	2.0	0.6	2.5	2.1	2.5
Other*	29.6	33.7	34.1	35.4	35.7	36.2	35.1	39.2	37.8	38.2	38.3
Total	100	100	100	100	100	100	100	100	100	100	100

Source: Bank of Albania

*"Other" includes credit extended to some sectors sharing a small weight in the country's economic activity and credit to households. Upon the introduction of new credit forms it was required to review the credit distribution by sectors, where the new classification was introduced.

FINANCIAL MARKETS

Table 10 End-month interest rates and their change compared with previous periods (in percentage points)

	June '07	Change June '07-March '07	Change March '07-December '06
Core interest rate	5.50%*	+0.00	0.00
Interbank market			
Overnight interest	5.12	0.61	-0.01
Weekly interest	5.67	-0.01	0.44
Primary market			
3-month Treasury bills yield	5.83	-0.01	-0.75
6-month Treasury bills yield	7.23	0.59	-0.47
12-month Treasury bills yield	7.99	0.86	-0.64
Bonds market			
2-year bonds yield	8.20	0.55	-0.75
3-year bonds yield	8.05	-0.85	0.10
5-year bonds yield	9.83	-0.31	0.46

Source: Bank of Albania and commercial banks

* The Bank of Albania raised its key interest rate by 25 basis points, from 5.5 to 5.75 per cent on 27 June 2007.

Table 11 Interest rates and their change in the lek deposits and credit market (in percentage points)

	May '07	Change May '07- March '07	Change March '07 - December '06
Core interest rate	5.50	0.00	0.00
Interest of ALL-denominated deposits			
1-month	3.96%	0.57%	0.04%
3-month	3.68%	-0.34%	0.08%
6-month	4.55%	-0.09%	0.00%

12-month	5.39%	-0.09%	0.02%
24-month	5.64%	-0.35%	0.11%
36-month	7.00%	0.82%	-0.24%
Interest of ALL-denominated credit			
Up to 6-month credit	14.87%	2.50%	0.19%
6 month to 1-year credit	10.12%	-1.54%	0.50%
1-3 years credit	16.69%	-0.29%	-0.72%
Over 3-year credit	13.18%	0.67%	0.30%

Source: Bank of Albania and commercial banks

Table 12 Interest rates of deposits denominated in foreign currency (in percentage points)

	May '07	Change May '07 – March '07	Change March '07 – December '06
Fed – Core interest rate	5.25%	0.00	0.00
Interest of USD-denominated deposits			
1-month	3.32%	0.13%	0.16%
3-month	3.61%	-0.02%	0.19%
6-month	3.77%	-0.15%	0.05%
12-month	4.74%	-0.01%	0.46%
24-month	4.68%	-0.11%	-0.07%
ECB – Core interest rate	3.75%*	0.00	+0.25
Interest of EUR-denominated deposits			
1-month	3.02%	0.32%	0.16%
3-month	3.33%	0.17%	0.25%
6-month	3.37%	-0.06%	0.14%
12-month	3.92%	0.13%	0.34%
24-month	4.11%	-0.13%	0.08%

Source: Bank of Albania and commercial banks

* In June 2007 it was raised by 25 basis points to 4.00 per cent.

Table 13 Interest rates of credit denominated in foreign currency (in percentage points)

	May '07	Change May '07 – March '07	Change March '07 – December '06
Interest of USD-denominated credit			
Up to 6-month credit	12.25%	2.99%	-0.50%
6-month to 1-year credit	9.84%	0.75%	-0.02%
1-3 years credit	12.06%	5.97%	-3.91%
Over 3-year credit	11.00%	1.79%	0.15%
Average weighted interest	11.81%	2.95%	-0.56%
Interest of EUR-denominated credit			
Up to 6-month credit	7.96%	-0.01%	0.34%
6-month to 1-year credit	8.33%	0.61%	-0.73%
1-3 years credit	9.51%	1.41%	-0.35%
Over 3-year credit	8.50%	0.05%	0.11%
Average weighted interest	8.53%	0.40%	-0.05%

Source: Bank of Albania and commercial banks