

BANK OF ALBANIA

REVIEW OF THE  
MONETARY POLICY OF  
THE BANK OF ALBANIA  
FOR THE SECOND  
HALF OF 2007



## REVIEW OF THE MONETARY POLICY OF THE BANK OF ALBANIA FOR THE SECOND HALF OF 2007

### GOVERNOR'S SPEECH

The Albanian economy recorded a positive performance during 2007 being characterized by a stable annual growth in line with the projections, contained inflation and further consolidation of financial stability. The preservation of optimal macroeconomic parameters during this year required high attention to developments in the global markets and in Albania, prudent analysis of these developments and the timely undertaking of preventive measures aiming at avoiding negative implications in the medium run. Preliminary projections provide evidence for the continuity of the current economic growth during 2008 while the Bank of Albania remains cautious of the domestic and foreign developments in order to ensure the achievement of the 3% inflation target.

The Albanian economy continues to grow at stable rates and in line with the projections. Real economic growth for 2007 is estimated to be about 6% or the same as the previous year. Transportation and telecommunication, trade, hotels and restaurants and industry were the main contributors to this growth. The more intensive activity in these sectors has offset the slowdown in construction. Despite the high demand for investments in real estates there has been an annual dropping of new constructions by 19%. The Bank of Albania re-emphasizes the need for undertaking structural reforms in agriculture, in order to enhance the efficiency and production in this sector and reduce the extent and effects of external shocks related with agricultural products in the medium run.

Average annual inflation rate marked 2.9% in 2007 being close to the Bank of Albania target of 3%. In average terms inflation target was reached despite the considerable fluctuations between the quarters as a result of supply-side factors' shocks which originated mainly from outside our economy and could not be forecasted earlier. Energy crisis, the rising oil and grain prices, and the import prices hike were the main supply factors to have led to higher inflation rates during August-September 2007. At the same time on the demand-side there has been a continuous growth of credit to the private sector. Although in the last two years it has grown at lower rates it remains a potential risk factor for achieving the inflation target.

In response to these developments and to the extent of their actualization in future inflation rates the Bank of Albania deemed it necessary to raise the key interest rate three times during 2007, by 75 basis points to 6.25%. By means of these decisions the Bank of Albania has aimed to mitigate expected inflationary pressures in economy in order to preserve the medium-term stability of consumer prices.

The developments in the external sector of economy provide evidence for the further growth of domestic demand. Despite the positive performance of exports, trade deficit increased by 27% in annual terms accounting for 28% of the GDP.

The second half of 2007 was characterized by a normal performance of budget spending and by the observance of new fiscal policy objectives announced at the beginning of the second half of the year in terms of income. According to the data made available by the Ministry of Finance the fiscal balance as of end November ended in a surplus of ALL 4.7 billion compared with the projected deficit of ALL 25.9 billion. The main reason behind this difference is the capital spending being only 3.4% higher than the same period the previous year.

The monetary developments in economy during the last quarter of 2007 were in line with the performance of real economic activity and observed the tendencies projected in the monetary programme. Broad money growth was characterized by a stable growth rate mainly supported by the maintenance of high lending rates to the private sector by the banking system.

The appreciating tendency of the lek to other foreign currencies observed in the third quarter of 2007 continued to be present in the last quarter both in nominal and real terms. It reflects the macroeconomic stability in the country, the increasing difference of interest rates between the lek and foreign currencies and the comparable inflation levels to our main trading partners. However, compared with the previous year, the lek fluctuated more during 2007 as a result of the developments in the international markets and the more active participation of domestic agents in the foreign currency market.

Although the credit growth rates have been continuously dropping in the last two years they remain high at about 48.5% as a result of the private sector's high demand for credit and the commercial banks' willingness to meet this demand. The share of credit to economy to the GDP grew considerably during 2007 by 8.8% accounting in December for 30%.

Worth considering is the fact that the high growth rates of credit portfolio represent a normal process for a developing economy like Albania, which is in need for further financial intermediation deepening. What is important in this process is that the credit growth is kept under control in order to prevent the jeopardy to price stability and at the same time ensure its soundness and avoid certain undesired implications to financial stability in the country. The commitment of the Bank of Albania in this context has been and remains at the maximum. Apart from the macro prudential measures taken at the beginning of 2007 for reducing the credit growth and maintaining its quality the beginning of 2008 marked remarkable progress in preserving financial stability with the establishment of Credit Registry.

In 2007 we were again witnesses of the vital importance to the entire economy of the financial system, of the extent and new formats the financial

crises may appear in as a result of the transformation of risk and the high velocity and level of their spreading due to the globalization of financial markets. Although our financial system does not seem to have been affected by these developments they have had our utmost attention in order to precede similar developments in the future when our markets become more sensitive to external shocks as a result of their integration and further deepening.

In conclusion I would like to re-emphasize the Bank of Albania commitment to achieving price stability. The Bank of Albania remains committed to timely and properly react to the added inflationary pressures or to the jump of inflationary expectations beyond our inflation target. I would also like to highlight that the anchoring of inflationary expectations is a duty and responsibility to be shared by all the decision-making institutions to the best of our work and joint success towards achieving long-term stability.

## I. WORLD ECONOMY

### I.1 WORLD ECONOMY

Global economic growth rate slowed down in the last quarter of 2007. US economy and some industrialized economies showed signs of economic slowdown while developing countries continued to play the main role in the global economic growth. The turbulences in the US credit market, which went through a hard time in summer 2007, and the rise in energy and foodstuffs prices have affected the performance of world economy and the international financial markets.

The accelerated increase of inflation, mainly because of the rise in the oil and some agricultural products' prices, may affect the demand as a result of the decreased purchasing power. Oil price in US dollar has risen<sup>1</sup> following the high demand of developing countries, the stagnation in the oil supply and the geopolitical tensions. Agro-foodstuffs prices have risen as a result of the temporary reduction of supply, after the drought and the additional use of some agricultural products in the bio fuel industry.

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

	GDP annual growth, Q4	Unemployment rate in December	Inflation in December
USA	2.5	5.0	4.1
Euro area	2.3	7.2	3.1
Italy	1.9 *	6.0**	2.8
Greece	3.6	8.2**	3.9
Japan	1.8	3.8	0.7

\* For the third quarter

\*\* For September

Source: Eurostat, Report for January, Eurostat estimations of the unemployment rate and the CPI, December

### US ECONOMY

US economy recorded high annual growth rates in the third quarter of 2007. Fixed investments of the companies and the increase of exports as a result of the US dollar depreciation provided the main contribution to the increase of the GDP. Consumption which has not been yet affected by the declining house prices played an important role in the growth of demand. Other indicators of the economy provide evidence for a slowdown in investments and an unsatisfactory performance of construction in the last quarter of 2007. The decreased sales of houses and the drop of investments in houses have aggravated the performance of real estates market. Unemployment rate increased in the last quarter. Inflation on the other hand continued to increase reaching 4% in the last quarter of 2007 from 2.4% the previous quarter. During September-December 2007, the Federal Open Market Committee lowered the key interest rate by 100 basis points. The aggravation of financial markets conditions and the unsatisfactory performance of house and labour market led to the further decrease of key interest rate by 1.25% to 3% in January 2008.

### *EURO AREA ECONOMY*

During the third quarter 2007 gross domestic product grew by 0.8% compared to the previous quarter. Household consumption increased by about 0.5%, while gross fixed investments grew by 1.2%, following an unsatisfactory performance in the previous quarter as a result of the drop in investments in construction. Business investments and exports have been also decreasing, in particular in the last months of the year as a result of the appreciation of the euro and the reduced US demand. Short-term economic indicators for the last quarter of 2007 indicate a slowdown in the economic activity. The turbulences in the financial markets may affect the Euro area economy and aggravate the performance in some countries' house market, construction and consumer spending. However the improvement of labour market conditions and the high profitability of companies lower the negative impact of turbulences on the gross domestic product.

Annual inflation rate reached 3.1% in December. The pressures in the global markets for energy and foodstuffs have led to the increase of inflation. According to the forecasts, the inflation rate will be 2.3% in 2008. ECB Governing Council changed twice the key interest rate during 2007 to 4%. Despite the further decline in the house market, the rise in the oil and foodstuffs prices and the continuous turbulences in the financial markets, the Governing Council has left the key interest rate unchanged for January and February 2008. ECB monetary policy continued to have as its main priority the anchoring of medium-term inflation expectations in line with the maintenance of price stability.

## *1.2 ECONOMY OF ALBANIA'S TRADING PARTNERS*

### *ECONOMY OF ITALY AND GREECE*

During the first half of 2007, gross domestic product of both countries recorded a high growth rate. The components of domestic demand, fixed capital investments and private consumption provided the main contribution to the economic growth. Employment grew as a result of the economic growth. During the second half of 2007 consumer spending and investments grew at slower rates. Consumer spending was mainly affected by the price rise of energy and foodstuffs as well as by the tightening of credit conditions. The appreciation of the euro and the slowdown in the markets led to the increase of exports at a lower rate than the imports. The main factors to have contributed to the deepening of Greek current account deficit are the higher trade deficit, the higher interest payments and the reduction in the current transfers' surplus. Current account deficit of Greece was financed by the capital inflows.

### *ECONOMY OF FORMER YUGOSLAV REPUBLIC OF MACEDONIA (FYROM)*

FYROM's economic activity remained stable throughout 2007. GDP for 2007 and 2008 is projected to grow by 5%. In annual terms, gross domestic

product grew by 4.2% in the third quarter of 2007. Transportation and telecommunication and wholesale and retail trade had a positive performance. During January-October, foreign trade increased by 26%. The import of energy and the export of iron and steel provided the main contribution to the increase of imports and exports. During this period, trade deficit increased by 20%. Despite the higher foodstuffs prices, average annual inflation rate is forecasted at 2% for 2007 and 3% for 2008. Fiscal position continues to improve, while foreign reserves have increased and key interest rate remains low.

## ECONOMY OF TURKEY

Turkey's economic activity continued to grow moderately in the last quarter of 2007, although the growth rate was higher than the previous quarter. Gross domestic product grew by 5.1% in 2007. The tightening monetary policy and the worldwide aggravated situation in terms of lending restrained the growth of domestic demand which was mostly supported by the increase of exports. Deficit on current account was pushed by the more rapid increase of imports compared with exports. The disinflation process slowed down as a result of the price rise of energy, foodstuffs and administered prices. The control of core inflation allowed the decrease of interest rates by 2% during September-January 2008. Inflation rate reached 8.4% in 2007 from 9.7% that was recorded in December the previous year.

Table 2 Some main indicators of countries in the region (in %)

Countries	GDP Annual Growth		Annual inflation		Unemployment		Fiscal balance (as a share to GDP)		Current account (as a share to GDP)	
	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Italy	1.7	1.3	1.9	1.9	6.5	6.5	-2.1	-2.3	-2.3	-2.2
Greece	3.9	3.6	3	3.2	8.5	8.5	-2.1	-2.9	-9.7	-9.6
Macedonia	5.0	5.0	2.0	3.0	..	..	..	..	-2.8	-5.9
Serbia	6.0	5.0	6.4	8.8	..	..	..	..	-14.7	-15.0
Croatia	5.6	4.7	2.3	2.8	..	..	..	..	-8.4	-8.8
Turkey	5.0	5.3	8.2	4.6	..	..	..	..	-7.5	-7.0

Source: IMF, assessments.

World Economic Outlook, October 2007.

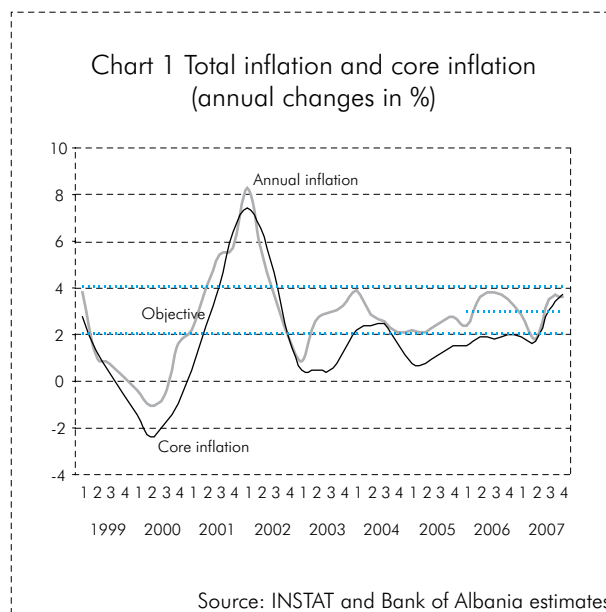
## II. INFLATION DEVELOPMENTS

### II.1 CONSUMER PRICES

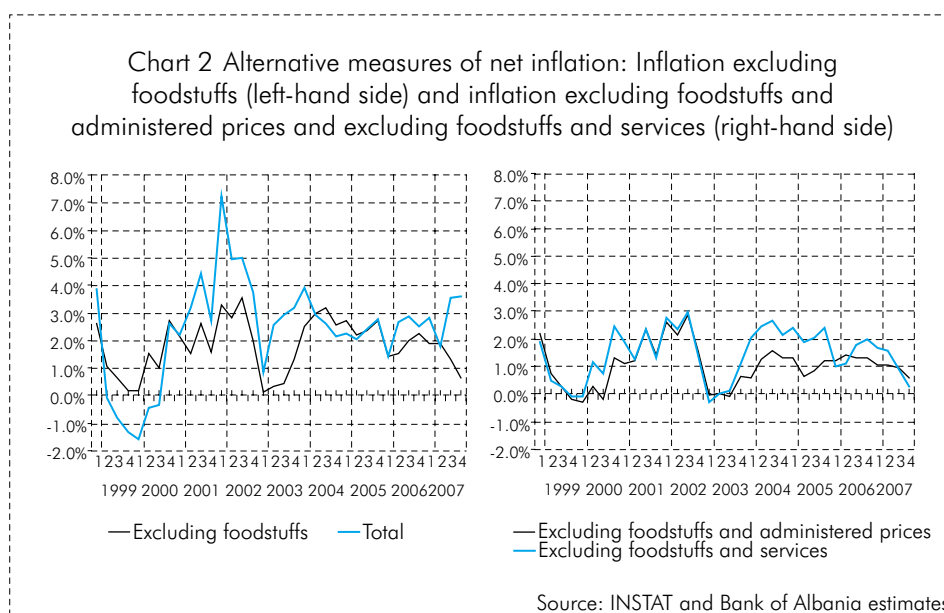
In the last quarter of 2007 annual inflation marked the same rate of 3.6% as in the previous quarter. Following the high rate in October (4.2%), inflation rate dropped in the last two months of the year being close to the Bank of Albania target<sup>2</sup>. This inflation trend was maintained in the first months of 2008 when inflation marked 3%<sup>3</sup>. Compared with the last quarter 2006, average inflation rate was about 1% higher. Supply and demand-side factors exerted pressure on the increase of inflation although more moderately relative to the third quarter of 2007.



The performance of inflation in the last quarter of 2007 reflected the high level of some basic foodstuffs prices and the further rise in the oil price. The improved weather conditions favoured the domestic supply by exerting pressure on the drop of some seasonal unprocessed foodstuffs' prices. On the other hand, the situation with the prices of some other foodstuffs, mainly processed ones (among which bread is the main product), remained unclear as a result of the dependence of these prices on import prices, which continued to record high inflation rates<sup>4</sup>. However, there was a temporary stabilization. In addition, the further price rise of fuels, along with the energy crisis, caused the producer cost to rise, exerting further pressure on the consumer price rise. In the third and last quarter of the year, the inflation curve shifted downward as a result of the no longer presence of energy price and tobacco excise rise effect undertaken during 2006. This effect offset the supply-side factor by some per cent.

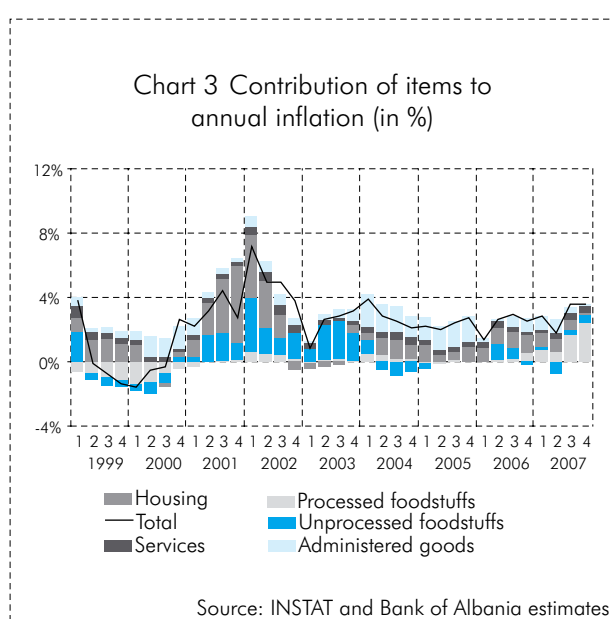


The alternative measures of net inflation indicate that the high inflation rate was mainly a result of the high contribution of processed foodstuffs' price rise. On the other hand, the energy price rise did not occur in mid-2007 as projected. Consequently, the contribution of administered prices to total inflation rate was almost inconsiderable. Net inflation, excluding foodstuffs and administered prices marked 0.7% and 3.5% in the third quarter, in a period when total inflation was 3.6%.



'Processed foodstuffs', 'unprocessed foodstuffs', 'housing' and 'services' formed about 97% of annual inflation rate in the last quarter of 2007. Annual inflation for this period was mainly determined by the inflation of 'processed

foodstuffs'. The latter recorded an annual inflation rate of 2.4% in this quarter while during the last eight years this item's annual inflation has almost recorded inconsiderable rates<sup>5</sup>. The high price rise in this item starting from August 2007 was mainly a result of the domestic price rise of bread. In addition there has been a rise in the prices of dairy products and oil, which reflect the higher producer costs following the energy crisis in the country and the price rise of these types of goods in Albania's main trade partners (Italy and Greece).



Annual inflation of 'unprocessed foodstuffs' was 0.5%, maintaining almost the same rate as in the previous quarter. Within this item the price of vegetables dropped by 0.4% in annual terms. This drop may have also been caused by the statistical effect of the high comparative base with the last quarter of the previous year when inflation marked positive rates at end-year. The developments in this item's prices are closely related to the agricultural domestic production which has influenced on the increase of domestic supply as a result of the favourable weather conditions. These favourable developments of domestic supply have reduced the inflationary pressures transmitted by the high demand characterizing this period of the year and by the high import prices.

Table 3 Contribution of items to annual inflation (in %)

	Q4-06	Q1-07	Q2-07	Q3-07	Q4-07
Processed foodstuffs	0.5	0.7	0.6	1.6	2.4
Bread and grains*	0.1	0.0	0.3	4.5	7.2
Alcohol and tobacco*	1.6	1.7	1.9	1.3	0.7
Unprocessed foodstuffs	-0.2	0.2	-0.7	0.4	0.5
Fruit*	-1.4	-2.4	-3.1	1.1	2.6
Vegetables*	0.0	3.0	-0.6	1.7	-0.4
Services	0.2	0.2	0.3	0.4	0.4
Administered prices	0.9	0.8	0.8	0.4	0.1
Fuels and energy*	7.8	7.6	7.8	2.7	0.3
Housing	1.1	0.9	0.9	0.6	0.2
Consumer Price Index (y/y, in %)	2.6	2.8	1.8	3.6	3.6

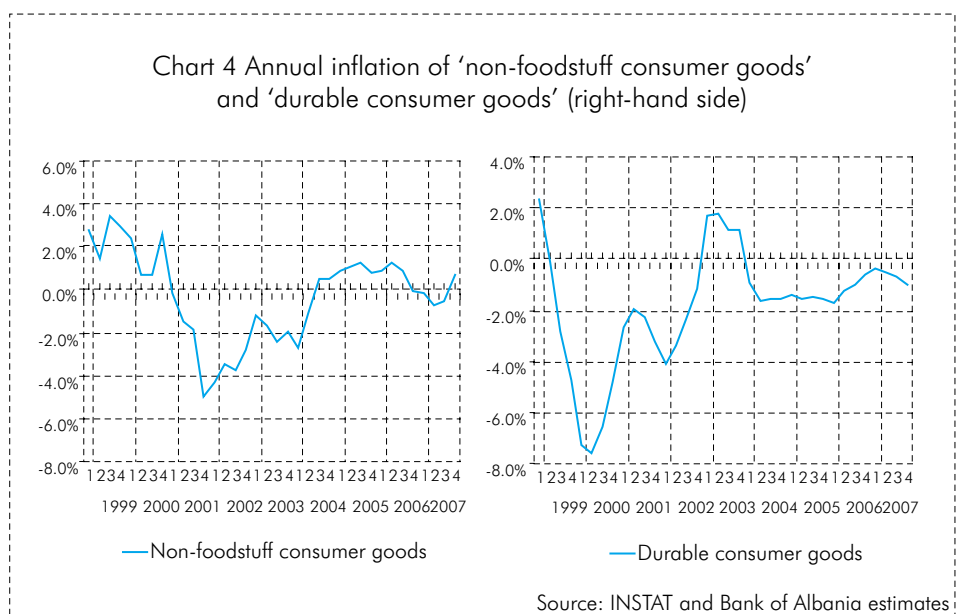
\*Contribution to the annual inflation.

Source: INSTAT and Bank of Albania estimations

The other items in the basket provided a moderate contribution to the 0.7% inflation in the last quarter. Annual inflation of 'housing' and 'administered goods' fluctuated around 4-5% until September while for the rest the average annual inflation was 0.8%. This decrease was also influenced by the statistical effect of the high comparative base with the last quarter of the previous year<sup>6</sup>. 'Services' inflation continues to record high upward rates. This item's annual inflation rate marked 4% in December. On average terms, inflation rate for the second half of 2007 increased by 1.5% compared with the first half of 2007 and the same period the previous year. This increase has to a large

extent reflected the price rise in hotels and restaurants, which had to face additional costs deriving from the use of alternative sources of energy.

Despite the price rise in fuels, the contribution of 'non-foodstuff consumer goods' to the last quarter inflation was inconsiderable. The same occurred with 'durable consumer goods' which have recorded negative inflation rates for a long period of time, most evident in the last quarter. The influence of these items' inflation fluctuations on the total inflation rate will be more significant in the new inflation basket where both these items have a larger share in the average consumer spending.

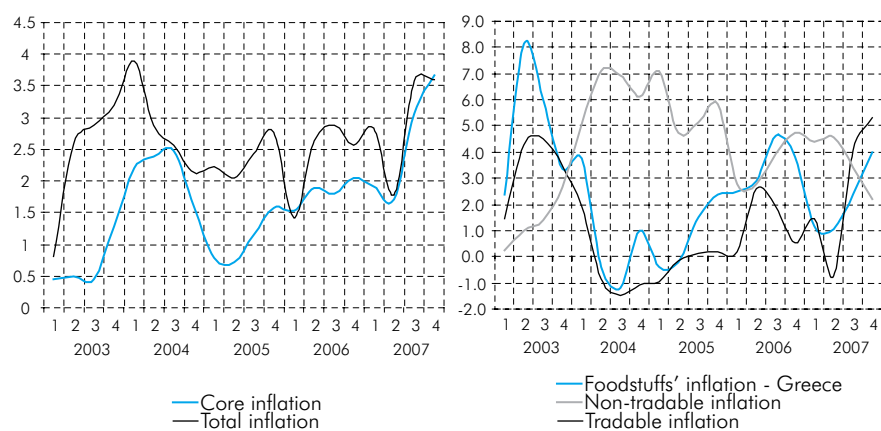


## II.2 OTHER INFLATION MEASURES

*Core inflation.* The increasing inflationary pressures in economy were reflected in high annual rates of core inflation in the second half of 2007. Core inflation marked 3.1% and 3.7% in the third and last quarter, reaching the highest rates in the last five years. Average core inflation rate was 2.6% in 2007 or 0.8% higher than the previous year. The constant price rise in some items<sup>7</sup> which share a considerable weight in the consumer basket are believed to have contributed to the high core inflation rates. This trend caused the permanent inflation component<sup>8</sup> to increase in the medium term while its average annual contribution to total inflation was about 2% in 2007<sup>9</sup>. The performance of core inflation provides evidence for the presence of non-temporary inflationary pressures which have exerted pressure on the total rise of domestic consumer prices in the second half of the previous year.

*Inflation of tradable and non-tradable goods.* The price rise of tradable goods which are more sensitive to changes in the foreign markets' prices played the main role in the increase of annual inflation during the second

Chart 5 Annual rates of core and total inflation (left-hand side), tradable and non-tradable (right-hand side) (in %)



Source: INSTAT and Bank of Albania estimates

half of 2007. Annual inflation of this item was 5.3% in the last quarter which is the highest rate from 2002. The increasing inflationary pressures deriving from outside our economy were reflected directly in the total inflation through the price rise of tradable goods. The volatile prices of this item largely depend on the prices of 'foodstuffs' in the consumer basket of Greece<sup>10</sup>. The rise in the prices of oil, gas and energy in the international markets have influenced on the prices of imported raw materials and intermediate goods, causing the domestic producer and services costs to increase. During the last quarter there was a continuous drop of the contribution of non-tradable inflation of goods and services to total inflation. Its annual rate reached 2.2%, while being 3.4% in the previous quarter. This performance of non-tradable inflation may reflect the control of upward demand rates. Although the average annual rate of non-tradable inflation for 2007 was relatively high (3.6%), the inflation of this item has shown a downward trend since the beginning of 2005, dropping from about 7% to 2%.

### II.3 PRODUCER PRICES

The changes in the Producer Price Index (PPI) are expected to provide their influence on the performance of consumer prices. However, based on the available data over the years there has not yet been identified a statistical relation between producer and consumer prices. The reason might be the fact that domestic production has not been a determinant in the supply of goods in the Albanian market, thus not having a direct impact on the consumer prices. On the other hand, the transmission of costs to the final consumption chain may have also been infringed by other factors such as the increase of competition in the retail trade and the lags caused by the transmission.

The increase of producer prices in 2007 was most evidently transmitted to the consumer prices. One reason is that the rise in the consumer prices has to a large extent derived from the price rise in goods (in particular of foodstuffs, oil,

gas and energy), while the price of services did not undergo significant changes. The unfavourable situation with the prices of goods in the global market had a direct impact over the prices of goods in the retail market (consumer prices) and over the domestic raw materials (producer prices). The aggravated situation with the energy in the second half of 2007 had a direct impact over the fall of productivity, by exerting pressure on the further increase of producer prices. Both the producer price and the import prices channels have exerted pressure on the increase of consumer prices. The fact that the production of processing industry is mainly supported by the imported raw materials caused this sector to record the largest annual rise of producer prices from 14.4% in the first quarter to 5.2% in the third quarter. On average, the producer prices for this sector have increased by about 9%<sup>11</sup>, while last year's increase was below 1%. Considerable increase in this industry was mainly recorded in foodstuffs, and textiles and clothing, which was also reflected in the performance of consumer prices. The annual change in the prices of production, distribution of energy, gas and water and extracting industry recorded downward rates.

Table 4 Annual change rates of some PPI and CPI components of 'processed foodstuffs' (in %)

	PPI	PPI Total processing industry	PPI Foodstuff processing industry	CPI Processed foodstuffs	PPI Extracting industry
Q1:06/Q1:05	0.9	0.7	-0.1	0.0	7.3
Q2:06/Q2:05	-0.1	-0.5	-4.4	0.5	10.8
Q3:06/Q3:05	0.4	1.2	-2.1	1.1	8.4
Q4:06/Q4:05	-0.7	1.5	1.4	2.4	8.3
Q1:07/Q1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/Q2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/Q3:06	3.8	5.2	12.8	7.3	0.9
Q4:07/Q4:06				10.8	

Source: INSTAT and Bank of Albania estimations

## II.4 IMPORT PRICES

Import prices may affect inflation in the country through the price of imported consumer goods and the influence on the business cost. The developments in the prices of consumer and producer goods' provide evidence for the inflationary influence of import prices during 2007. Import prices measured by the index of import unit values recorded an average annual increase of 8% during the first nine months of 2008. The historical average of this index's annual increase was 1.2% in 2001-2006.

The upward trend of the index of import unit values for January-September '07 was present in both the consumer goods and the producer raw materials. The consumer basket items of 'processed foodstuffs' and 'non-foodstuff consumer goods' recorded average annual changes of the unit price by 4.5 and -0.4% in the first nine-month period.

The price rise of raw materials' import was shown in the producer price index which increased by 3.1% for the same period. From the Business Confidence

Survey it results that the increase of producer cost was about 2 times higher this year than the historical average.

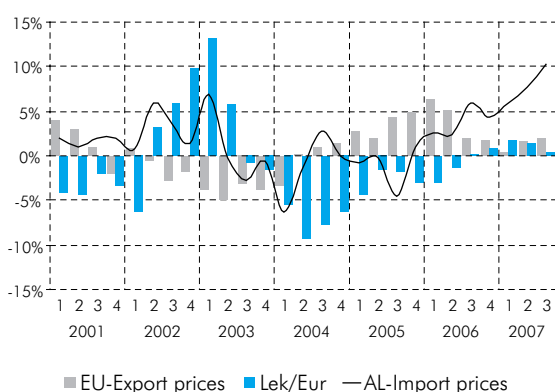
Table 5 Annual changes in the import prices by commodity groups

Commodity groups	Average				Average
	2001-2006	Q107	Q207	Q307	2007
<b>Consumer goods</b>					
Animal products	0.3	-3.9	-0.5	-0.2	-1.5
Vegetable products	-0.4	19.9	22.4	33.2	25.2
Animal and vegetable fats and oils	0.3	-4.4	3.1	23.2	7.3
Prepared foodstuffs, beverages and tobacco	0.0	12.1	5.3	6.3	7.9
Textiles and textile articles	0.6	2.8	5.5	6.7	5.0
Footwear, headgear etc.	3.7	-3.0	-3.8	-7.3	-4.7
<b>Raw materials</b>					
Mineral products	2.3	3.5	14.4	4.3	7.4
Products of chemical industry	1.7	-0.7	6.4	22.7	9.5
Wood and articles of wood	4.5	-2.7	-3.5	30.3	8
Base metals and articles thereof	2.0	14.5	17.7	1.0	11.1

Source: INSTAT

The developments in the lek import prices are a combination of the performance of foreign prices in the currency of the exporting country and the exchange rate. Albania's trade activity with abroad has been oriented to the EU countries<sup>12</sup>. Lek exchange rate to the euro has a definable influence. Starting from the second half of 2006 the slight depreciation of the lek to the euro has allowed the transmission of inflationary pressures from foreign prices.

Chart 6 Annual change in the index of import unit values, in the index of EU export unit values and the exchange rate



Source: INSTAT, Eurostat, Bank of Albania

The prices of basic goods in the global market, such as grains and oil, have risen rapidly during the last 2-3 years. The rise of these prices partly reflects the growth of demand of some developing countries such as China, India etc., and the influence of some factors which have limited the supply of these goods. The reduction in the supply of grain has been affected by the drop in production – as a result of the drought in the large production countries of grain – and the reduction of the stock.

Apart from the reduced stock, the reduced free production capacities and the geo-political risks have led to the price rise of oil. The price of wheat in the global market went up by 32% during this year<sup>13</sup>, compared with the average annual rise by 7% during 1999-2006. Given the absence of domestic

production and the difficult energy situation, this development influenced on the price rise of bread and its products in the country.

Annual inflation of bread and grains index increased by 10% in 2007 compared with the 8-year stable period<sup>14</sup>. This item contributed to the annual

rate of the second half by about 1.5% on average. The secondary effect of this increase was also shown in the prices of dairy products.

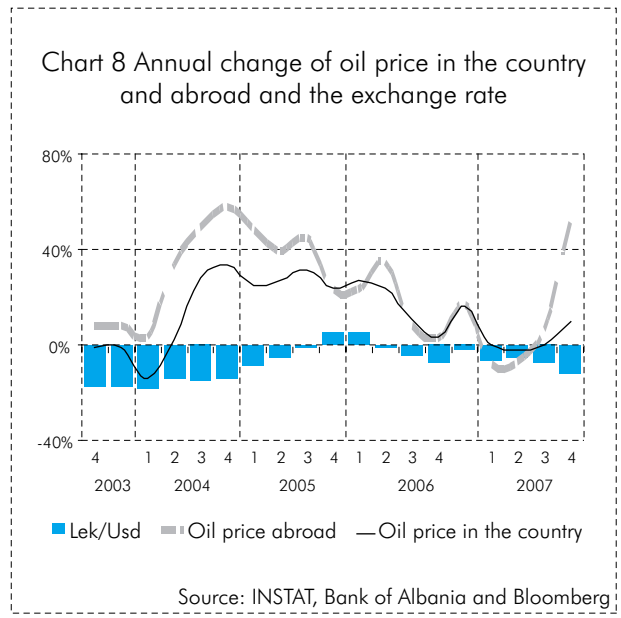
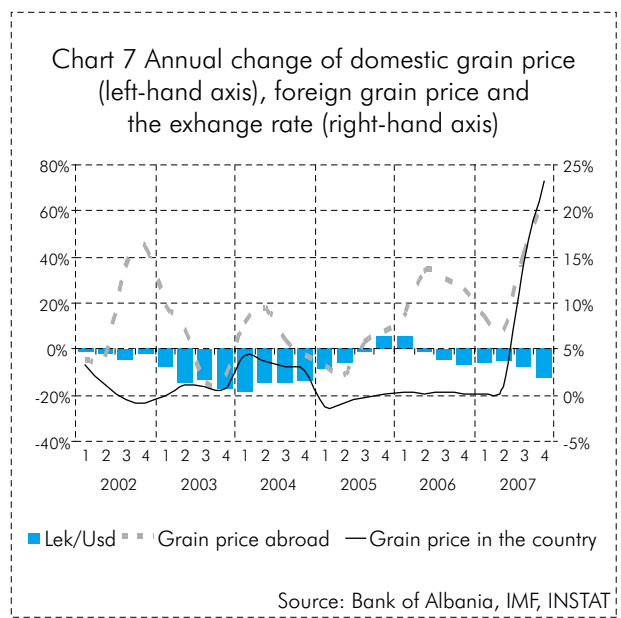
The appreciation in nominal terms of the lek to the US dollar by 8% has kept the full transmission of the price rise of grains in the country under control (the price at home raised by as much as 1/3 of the price abroad).

Oil price in the global market has been dropping on average terms; however there have been considerable fluctuations between the quarters. While in the first part of the year it recorded negative upward rates in the last quarter of 2007 the price rose by 51% annually. The dynamics of the oil price change in the global market was followed by the price of this product in the country. Oil price has remained almost unchanged in the first nine-month period and rose by 10% in the last quarter. As a result of the strong position of the lek to the US dollar the extent of this price change has been smaller than outside Albania. In nominal terms, the lek appreciated by 12% to the US dollar in the last quarter. However, the risk of further oil price rise remains present considering the uncertainty related with the performance of energy situation in the country.

## II.5 MONETARY POLICY DECISIONS AND INFLATION TARGET

Average annual inflation for 2007 marked 2.9%, which is almost close to the 3% target of the Bank of Albania. The inflation objective was reached in average terms, despite the considerable fluctuations between the quarters as a result of the supply-side shocks deriving mainly from outside our economy. The influence of the monetary policy in reaching the inflation target should be analyzed in retrospective. It is widely acknowledged that monetary policy decisions affect the overall level of prices within a time period of 12-24 months. Hence, in order to assess the monetary policy effect on inflation for 2007, we need to analyze at least last year's monetary policy stance.

In 2006 annual inflation of the following year was expected to increase and be within the upper half of the tolerance band (about 3-4%). In addition to the concerns related to the performance of domestic agricultural production, the energy crisis, the energy price rise and the oil price rise were assessed to continue to exert pressure on the increase of inflation during 2007. The





inflationary pressures deriving from the real economy could become significant under an accommodating monetary policy<sup>15</sup>.

In July and November 2006 the key interest rate increased by 25 basis points reaching 5.5% in November. Inflation was low at the beginning of 2006<sup>16</sup>. However, the Bank of Albania assessed that the demand-side inflationary pressures were getting stronger. Both core inflation and non-tradable goods' inflation displayed upward trend. Various economic indicators signalled the rapid growth of domestic demand. Banking loan continued to supply the demand of the economy, mainly the private sector's, for money. In 2006, M3 grew by 16.7%. The rise in wages, in almost all sectors of the economy, was another development that could trigger inflationary pressures. In 2006, the wages rose by 15% on average compared with 11% and 7% in the previous two years. In light of the energy crisis, the rise in the energy price was expected to generate possible secondary effects in the increase of producer costs. The reduced appreciation of the lek to the main foreign currencies, in addition to the increasing use of the production capital, were possible risks that could lead to the increase of inflation in 2007. The increase of the key interest rate in July and November 2006 aimed to contain the demand-side pressures, transmit the institutional commitment of the Bank of Albania to maintain price stability in the medium run and anchor the inflationary pressures that could increase further as a result of supply-side shocks.

Forecasts of year 2006 for annual inflation were to a large extent actualized in 2007. The divergence between forecast in 2006 and actual average inflation in 2007 resulted 0.5%. This divergence came as a result of the non-rise of expected energy price and the lower influence than expected of the oil price rise in the international markets. The upward annual inflation was caused by the influence of foodstuffs prices, mainly of the price rise in bread. The Bank of Albania is trying to assess the duration of factors which influence on the annual inflation rate. In more concrete terms, the Bank will assess whether these factors are temporary or will extend to an indefinite period of time.

Since monetary policy is forward-looking as a result of the transmission mechanism lag, the inflation forecast and the projections for the performance of economy in the future are fundamental. The current economic conditions provide evidence for the growth of economic activity which has been followed by a larger demand for money. The low real interest rates encouraged the growth of credit. The increase of the key interest rate in 2006 allowed the reduction of the credit growth rates. However credit grew by 50.4% in 2007.

In addition to demand-side factors, the increase of producer costs as a result of the energy situation, the price rise of grains in the international markets, the oil price fluctuations and the domestic agricultural production exert pressure on consumer prices. The increase of inflation has mainly derived from the supply-side factors. The high increasing rates of inflation which has reached total inflation<sup>17</sup> signal that the rapid growth of demand is leading to a pro-inflationary situation.



Considering these developments it becomes evident that the Albanian economy requires a more tightening monetary policy. During 2007, the Supervisory Council of the Bank of Albania raised the key interest rate three times by 75 basis points to 6.25%. These decisions aim to contain the expected demand-side inflationary pressures in economy in order to maintain the medium-term consumer price stability.

### III. INFLATION DETERMINANTS

#### III.1 FINANCIAL MARKETS AND MONETARY DEVELOPMENTS

##### III.1.1 Interest rates

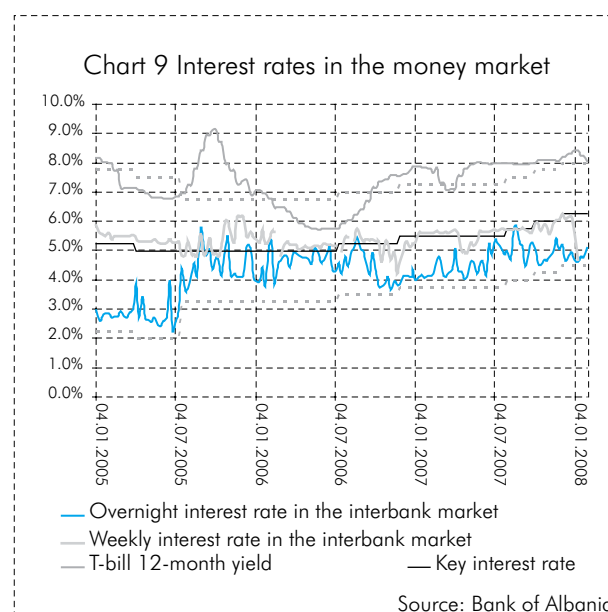
Following the tightening monetary policy signals the interest rates continued to increase in the last quarter. The interest rates of lek denominated deposits increased considerably leading to the broadening of their difference with the interest rates of foreign currency denominated deposits. The interest rates of lek denominated credit increased at slower rates than of deposits and they fluctuate around the same average in the last two years.

In the last quarter of 2007 the short-term interest rates continued to reflect the tightening policy of the central bank signalled at end September and November. Open market operations consisted in the injection of liquidity of one-week maturity<sup>18</sup>. The absence of liquidity was caused by autonomous factors.

These operations aimed to signal the orientation of the central bank monetary policy and they were held in the form of one-week reverse repo auctions with limited auction bid amount. The average interest rate in these operations was 6.35% in the last quarter from 5.81% the previous one. Lending interest rates in the interbank market fluctuated within the corridor re-set at end September and end-November after the increase of the key interest rate.

Unlike the previous quarter they showed lower fluctuation as a result of the more efficient provision of liquidity in the market. Weighted-average overnight loan rate marked 4.91% from 5.14% the previous quarter. In contrast the interest rates of one-week transactions increased to 5.92% from 5.70%. Total daily lending remained in the same levels of the previous quarter volume. It averaged ALL 2.2 billion being distributed almost equally between the overnight and weekly maturity term.

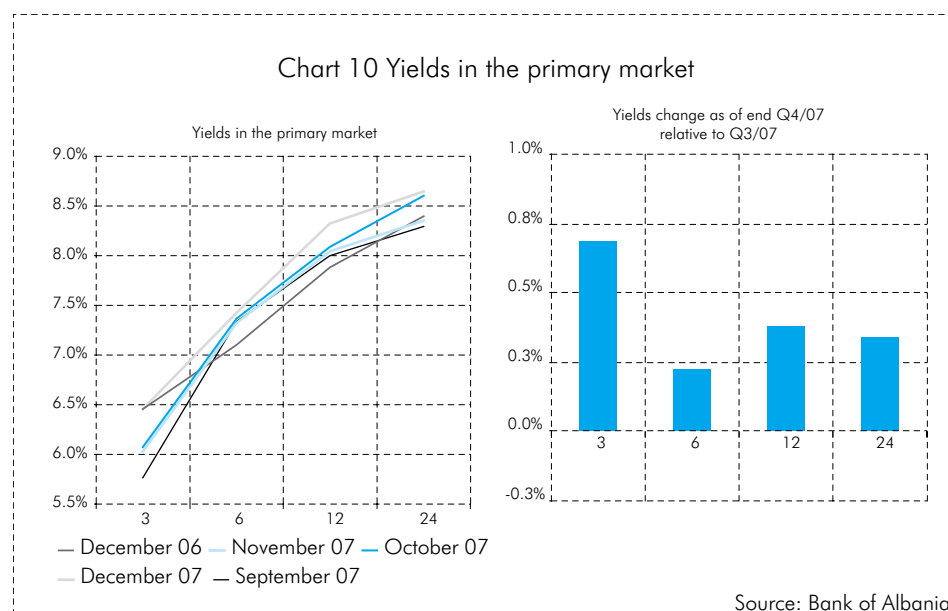
The results in the primary market were affected by both the interest rate changes and market factors. The primary market has swiftly reacted following



the increase of the key interest rate causing a parallel shift of T-bills' yields. However, the latter fell again at the beginning of the present year. T-bills' yields increased in October following the increase at end-September of the key interest rate by 25 points basis and fell slightly in November as a result of some unsuccessful bids with high yields.

Upon the second increase of the key interest rate at end November, the yields shifted further, this time with a higher magnitude than the monetary policy signal. In December the banks seemed to hesitate in investing in the T-bills' primary market.

On one hand it brought the injection of liquidity while on the other the increase of the yields as all the bids resulted successful in order to reach the deficit domestic financing. At end December the yields reached 6.49% for the 3-month maturity and 8.41% for the 12-month maturity or 0.46% and 0.36% above the yields of November (prior to the increase of the key interest rate).

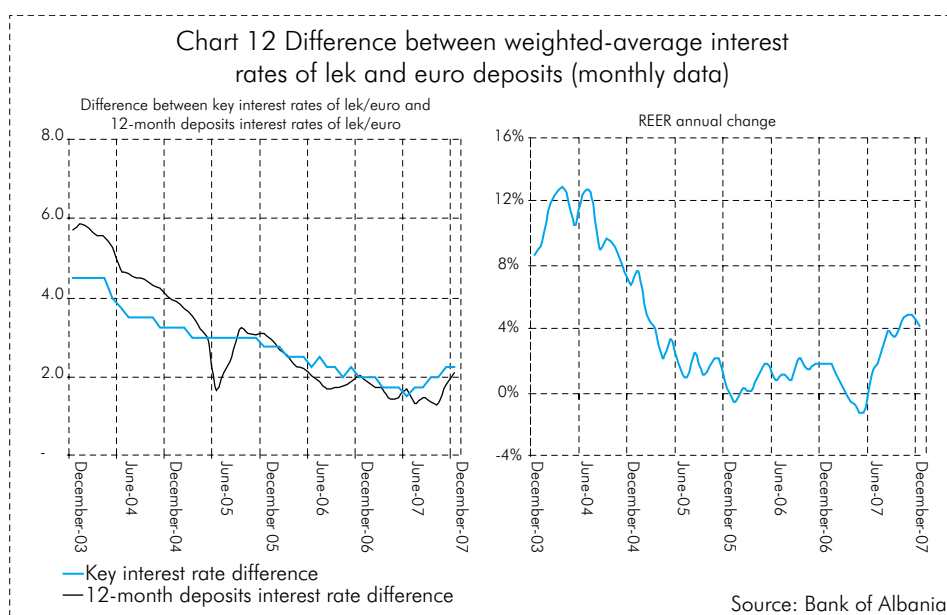
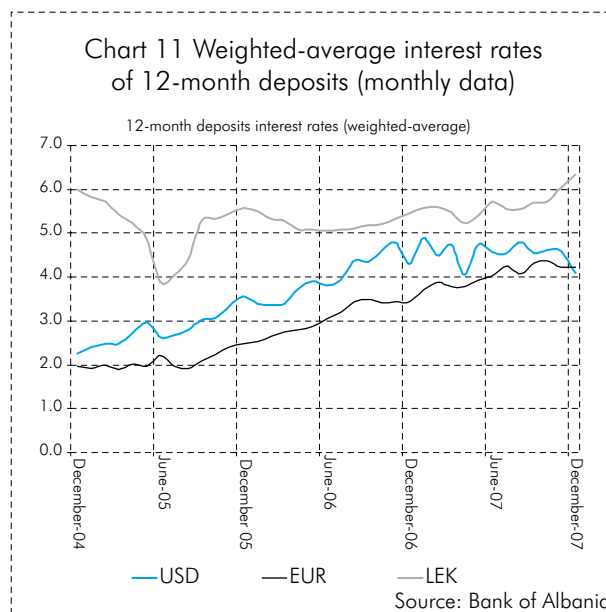


In the first two months of 2008, the T-bills' yields in the primary market became stable and were close to the yields in November. Compared with the previous year the 12-month yields increased more rapidly than the 3-month yields, causing their curve to slope in 2007.

In the last quarter of 2007 the banking system preference to shift the portfolio toward 2-year bonds by dropping the T-bills' preference was more evident. This tendency is in line with the domestic financing policy where the amount of issued bonds exceeds the matured ones. Considering the performance of domestic financing indicator at end year the participants in the auctions of 2-year bonds exerted pressure on its increase to 8.60%. This indicator fell again to the levels of November in January 2008 (8.35%). The yield of 3-year bonds increased by 0.65% in the last quarter; however this jump was mostly caused by the low participation in these auctions.

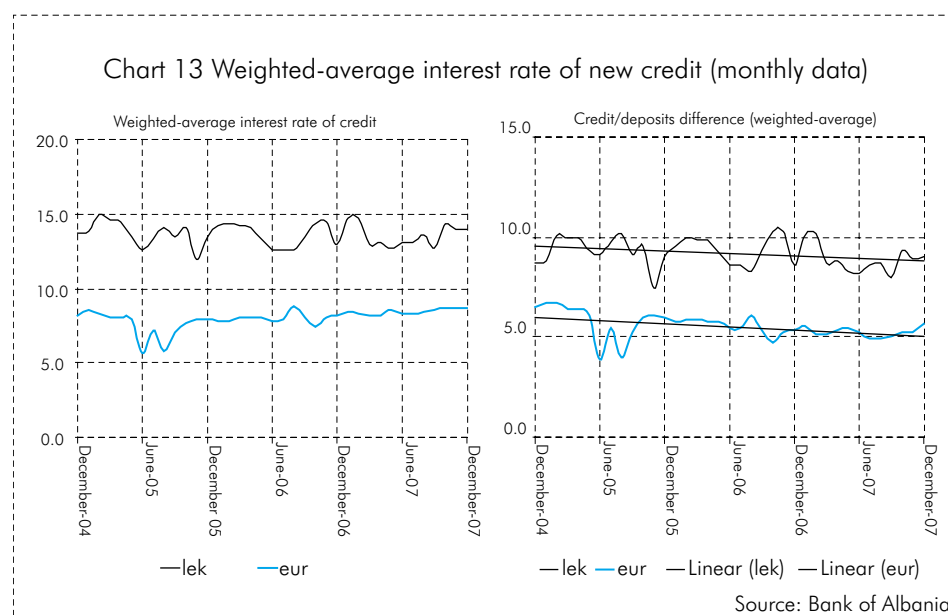
For the first time in December were issued bonds of 7-year maturity. What is to be highlighted in this development is not only the tendency of extending the debt terms, but also the participation of international financial institutions in the financing of public deficit. Albania's satisfactory rating in terms of country's risk by the relevant international institutions is expected to increase the interest of international institutions to invest in Albania<sup>19</sup>.

The interest rate of lek denominated deposits increased significantly in the last quarter, transmitting the increase of the key interest rate to the public savings'. However the lek denominated liabilities have increased considerably starting from the third quarter as a result of liquid accounts inflow in December while time deposits grew relatively in similar terms as in the previous year.



Weighted-average interest rate of 12-month deposits reached 6.33% in December which is 0.63% higher than in September and 0.87% higher than the previous year, exceeding the margin signalled by the monetary policy.

The end of the year is usually characterized by commercials advertising high deposit rates. These commercials also aim to attract the workers' remittances. Starting from the second half of the year the difference with the interest rates of euro denominated deposits (which share most of foreign currency denominated deposits) has increased and this fact is believed to have triggered the appreciation of domestic currency.

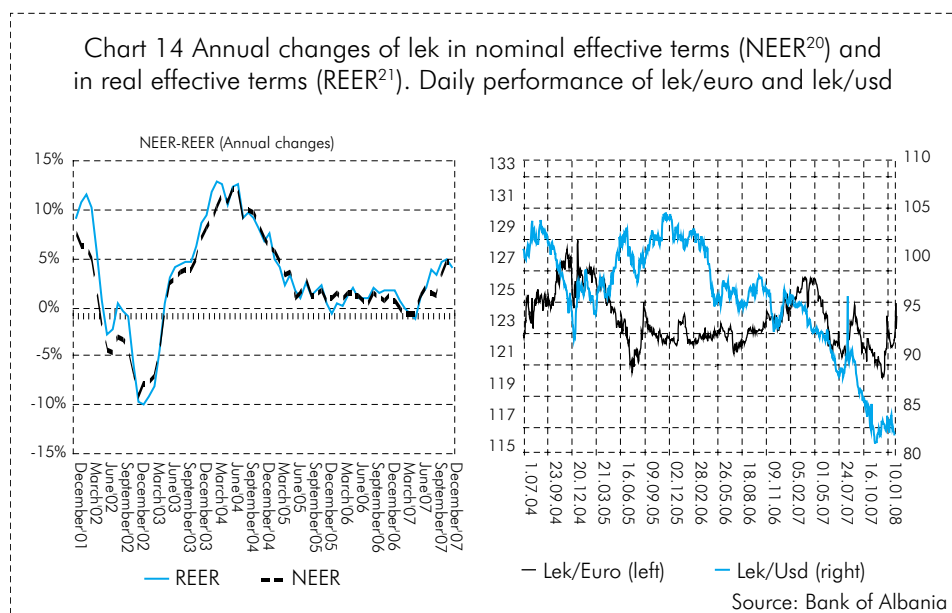


Following the growth of demand for lek denominated credit at the end of the year the interest rates increased to 14.1% in the last quarter from 13.1% in the previous one. The share of lek denominated credit remains low and the interest rates differ from one period to another depending on the lending distribution. On the other hand the enhanced competition in the banking system with respect to lending helped to maintain an average interest rate in lending regardless of the orientation of monetary policy. This performance has also brought a slight decrease of the difference between the interest rates of lek denominated deposits and credit during 2007. On average this indicator is estimated at 8.9% from 9.4% the previous year. This figure is lower for the euro. The interest rates of euro denominated credit increased during 2007 in line with the performance of euro interest rates in the international market, but their difference with the euro denominated deposits dropped to 5.25% from 5.50% in 2006.

### III.1.2 The Exchange Rate

The appreciating tendency of the lek to the basket of foreign currencies which was shown in the third quarter of 2007 was more pronounced in the last quarter. In annual nominal effective terms, in the last quarter the lek appreciated to the foreign currencies by 4.0% on average, which is overwhelmingly higher than 0.9% it appreciated by the previous year. In addition, during the same quarter the real effective exchange rate has increased annually by 4.6% on average. This appreciation implies the decreased competition in relation to the international markets and higher attractiveness for imports of foreign goods. The appreciating performance of the lek both in real and nominal terms reflects the macroeconomic stability at home, the deepening of the interest rates difference and the comparable inflation rates with the main partners.

Compared with the previous year the lek showed higher volatility in 2007. The increased dynamics reflects the developments in the international markets and the more active participation of domestic agents in the forex market. The lek has been constantly appreciating to the US dollar by 12.4% on average, reaching 83.38 lek per US dollar at the end of the period. The performance of the lek to the US dollar was mainly influenced by the developments in the international markets where the US dollar has been constantly depreciating to the euro reflecting the hard time in the US economy. The average exchange rate of the lek to the euro was 121.69 lek/euro in the last quarter, appreciating by 1.6% in annual terms. Apart from the seasonal factors, the appreciation of the lek also reflected the effect of demand and supply for the European currency at the end year. The data for January 2008 show the termination of the seasonal effect and the return of the lek quotation close to average annual levels.

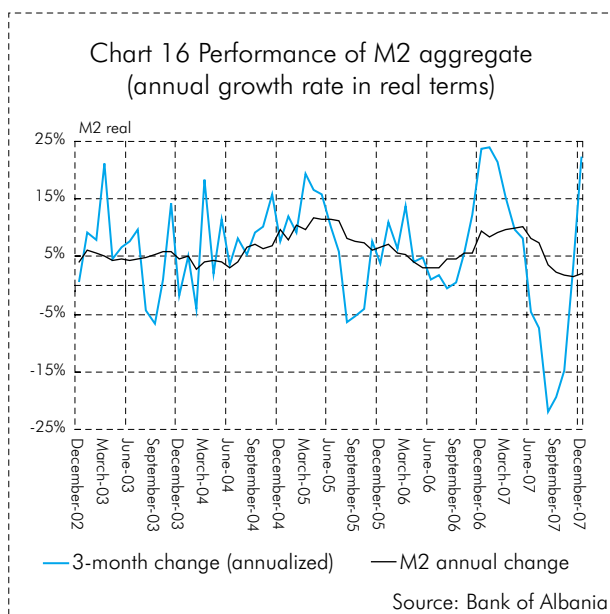
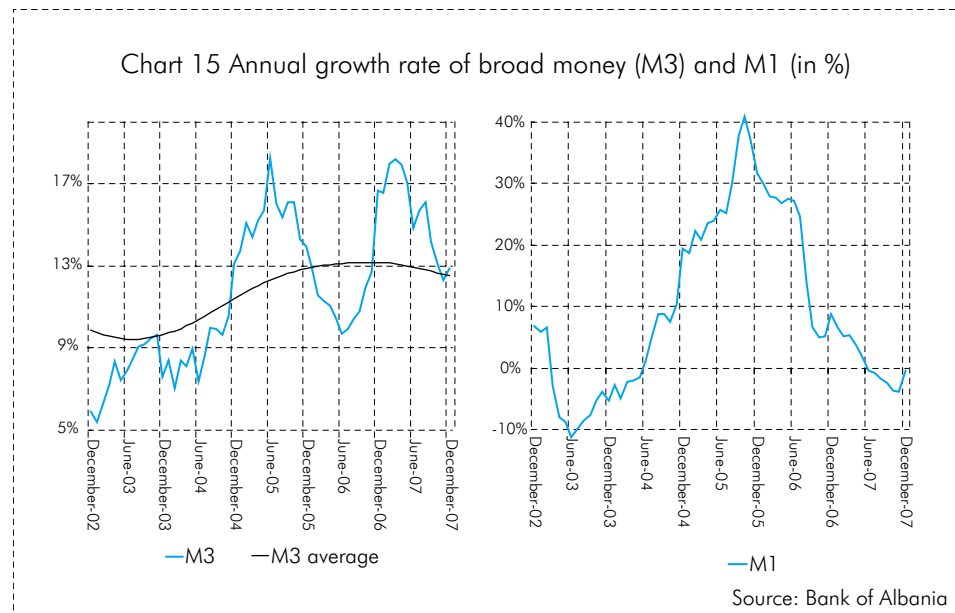


### III.1.3 Monetary developments

The monetary developments in the last quarter of 2007 followed the tendencies envisaged in the monetary programme while being in line with the performance of real economy. The expansion rate of broad money in economy was stable being supported by the maintenance of high lending rates to the private sector by the banking system. However, the creation of monetary flows in the form of credit to the private and public sector was followed by the reduction of the banking system's net foreign reserve which provided a negative contribution to the monetary expansion.

During the last quarter of 2007, annual growth of M3 aggregate slowed down to 13%, compared with 16.5% it grew by on average the first half of the same year. The moderate aggregates' rates provide evidence for the stable domestic demand for money. This tendency becomes evident in the dropping

rates of M2 aggregate to about 5%, from about 12% at the beginning of the year, and the unchanged M1 in annual terms. In seasonal terms, the economy absorbed in December the highest level of M3 projected for 2007.

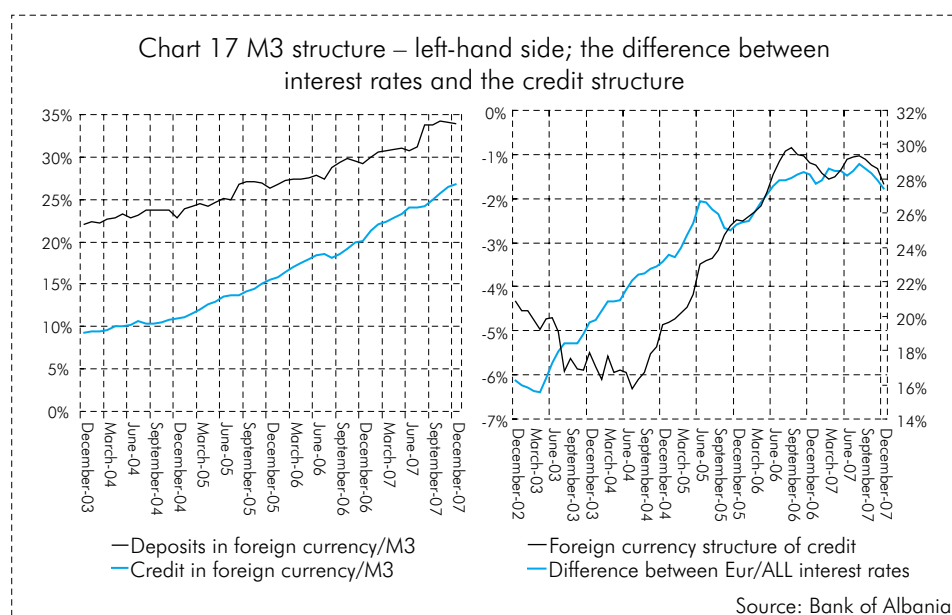


The downward trend of domestic money demand was also shown in the performance of monetary aggregates in real terms. Real M2 grew by about 2% in annual terms relative to the real M3 growth by 9.5%. The creation of lek monetary assets in the last quarter was triggered by the concentration of domestic borrowing by the public sector and the stable growth of lek denominated credit<sup>22</sup>. In addition, the current dynamics of monetary aggregates partly evidences the shift of M3 foreign currency structure to the foreign currency component.

Macroeconomic factors exerted the main influence on the rate of money creation and consequently of deposits. However the demand for money in economy and the structure of annual flows are under the influence of interest rates difference.

The foreign currency structure of M3 aggregate maintained the tendency toward the foreign currency component. The share of foreign currency denominated deposits to M3 in the last quarter accounted for about 34% to the average of 30.5% in the first half of 2007.

The performance of public sector's domestic borrowing in December provided the main influence on the return of currency to the banking system in the form of deposits. In monthly terms, lek denominated deposits grew by



about 5.5% while currency outside banks grew by only 8.4%. In annual terms, currency outside banks dropped by 5%.

In addition, the more rapid growth of non-liquid assets was followed by the dropping of the ratio of currency outside banks to M3 to 20.4% from about 24% at the end of 2006<sup>23</sup>. The implementation of the Bank of Albania monetary policy in 2007 took into consideration the accomplishment of quantitative objectives of the Bank of Albania.

Table 6 Accomplishment of quantitative objectives<sup>24</sup>

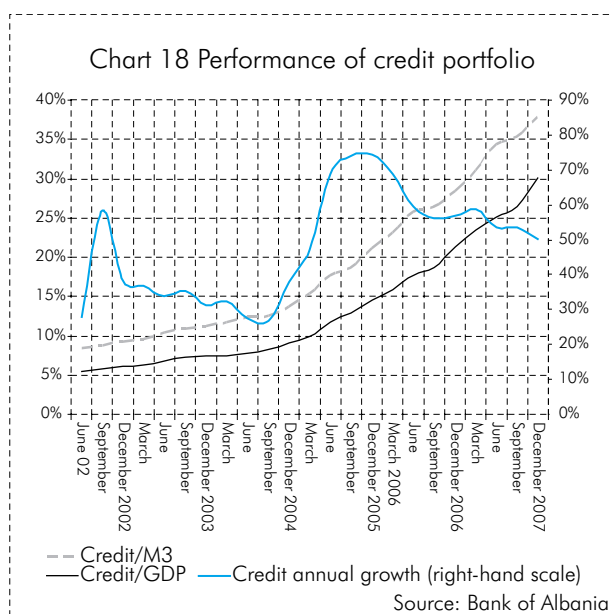
	December '06	March '07	June '07	September '07	December '07
Net International Reserve of the Bank of Albania (in millions of USD)					
Objective	1,343	1,318	1,337	1,459	1,593
Current	1,484	1,487	1,486	1,650	1,615
Difference (C-Obj)	141	169	149	191	22
Net Domestic Assets of the Bank of Albania (in billions of ALL)					
Objective	79	81	81	95	93
Current	78	74	73	59	76
Difference (C-Obj)	- 1	- 7	- 8	- 35	- 17
Net Domestic Credit to the Government (in billions of ALL)					
Objective	342	339	347	346	357
Current	331	333	331	318	352
Difference (C-Obj)	-11	-6	-16	-28	-5

Source: Bank of Albania

### III.1.4 Credit to the private sector

In the last quarter of 2007 the economy demand for money remained high. Although the credit growth rates slowed down it remains one of the main factors leading to the expansion of broad money in economy and becoming a potential factor which may generate inflationary pressures in the mid and long-term. Businesses provide the main contribution to the growth of credit, however during 2007 household credit maintained high growth rates contributing ever-increasingly to the growth of credit portfolio.

The growth rate of credit to economy continued to fall in the last quarter of 2007 to 50.3%. Although this figure represents the lowest growth rate of the last two years the growth of credit portfolio during October-December 2007 reached the peak level of ALL 32.8 billion in absolute terms. Over half of this amount was extended in December. Despite the slowdown in the credit growth rates, the private sector's demand for credit remains high. This fact is also evidenced by the commercial banks' credit officers<sup>25</sup>. In addition, the banks' willingness to extend credit is high although the Bank of Albania took some prudential measures at the beginning of the year for keeping the growth of credit under control. The main reason why the banks' policies with regard to lending may not have been duly affected by these measures stands in the fact that the Albanian banking sector provides relatively high return rates on equity. These returns maintain high levels even after the capital increases further in order to keep the adequacy ratio in the levels set by the Bank of Albania in case the credit growth exceeds the rate as defined in the regulation<sup>26</sup>.



In 2007 the share of credit to economy/GDP grew considerably by 8.8%, accounting for 30% in December. Despite the risks related with the rapid developments in the credit portfolio, the level of credit to economy is yet low and the high growth rate of credit portfolio is a normal process for a developing economy.

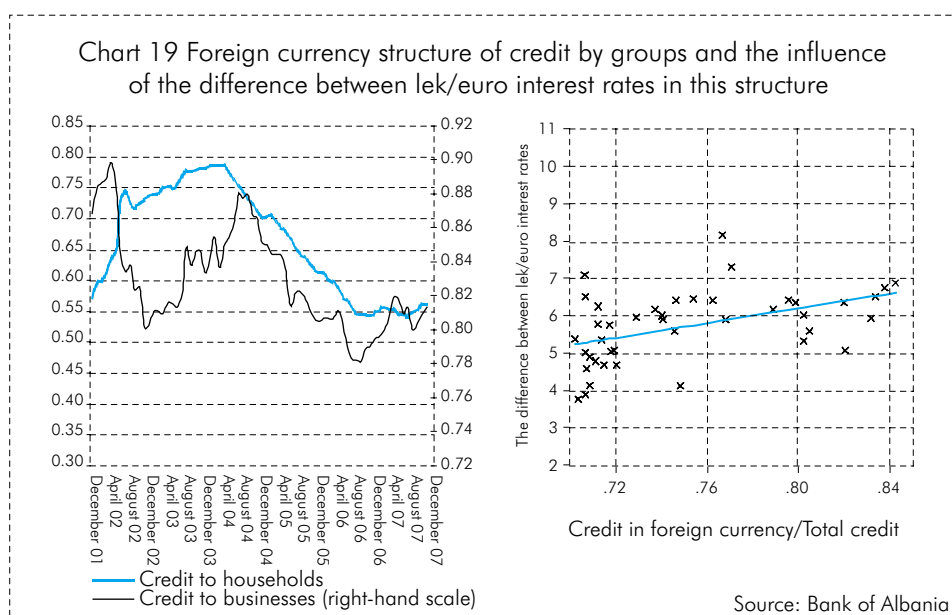
However, what is crucial in this process is that this growth is contained and sound in order to avoid undesired implications for the macroeconomic and financial stability in the country. The structure of credit by currency did not undergo significant changes.

Foreign currency credit dominates credit to economy. In the last quarter of 2007 it was characterized by higher growth rates (by 52.6% on average) than lek denominated credit (by 46.5% on average), contributing to the growth of credit to economy by 3 times higher. This type of credit distribution between the currencies was mainly favoured by the positive differences between the interest rate applied on the lek and the interest rate applied on the foreign currency, along with the stable appreciation of the lek in the last years.

The private sector remains the most credited, recording an annual growth of credit by 48.5%. Credit to business continues to provide the main contribution to this growth by 28.3%.

However, this contribution has been dropping under stable rates in the last two years as a result of higher growth rates of household credit to business credit. The lower growth of credit to business has been a result of the slower growth rates of credit for investment purposes and the more rapid growth of





credit for working capital. The latter is characterized by short maturity terms and consequently the high levels of credit settlement affected the lower growth of outstanding credit.

In the second half of 2007 the business demand for credit to cover the liquidity needs, as confirmed by commercial banks' officers, was higher than credit for investment purposes.

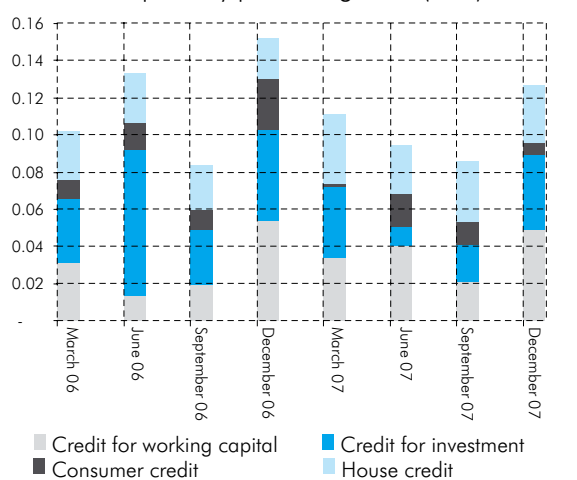
Table 7 Indicators of credit portfolio

		Average annual growth in quarters ( in %)				
		December '06	Q1'07	Q2'07	Q3'07	Q4'07
Credit portfolio (in billions of ALL)	287.5	56.3	57.8	56.2	53.6	50.9
Composition of credit portfolio in % (December '07)						
Credit to businesses	64.2	54.15	54.0	50.6	46.6	43.7
Working capital (+overdraft)	30.1	47.8	47.8	64.2	61.8	58.0
Investments	34.1	67.1	59.0	40.9	36.2	33.2
Credit to households	35.8	63.90	65.8	68.2	67.5	65.5
Consumption	9.1	121.78	101.2	100.9	106.7	61.5
Real estates	26.7	58.62	67.4	66.3	62.4	76.8

Source: Bank of Albania

The annual growth of credit to households was stable and remained in high levels, growing by 65% in 2007. This growth was supported by the high growth rates (by 77%) of the credit portfolio for real estates which dominates household credit. However, in the last quarter the growth of household credit portfolio was lower than the previous quarters. This reduction has resulted from the lower contribution provided by consumer credit. The survey carried out with credit officers indicates that although the demand for consumer credit is high the banks seem to be tightening the standards for extending this type of credit.

Chart 20 Contribution by purpose of credit use to the quarterly portfolio growth (in %)



Source: Bank of Albania

## III.2 FOREIGN TRADE

Relative to the previous quarter<sup>27</sup>, trade exchanges showed the trade deficit deepening by 20% in the last quarter, mainly triggered by the increase in the import of goods by 15%. The export of goods decreased by about 0.3%. The decrease of exports which has been characterizing the last two quarters of 2007 was lower than the previous quarter (5%). In annual terms, imports and exports grew by 29% and 18%. The level of imports' coverage by exports of goods was 23%. Although this is the lowest figure for 2007, it is comparable with the same period the previous year (24%). In the last quarter trade deficit accounted for 28% of the GDP while the previous year it accounted for 24%.

Table 8 Indicators of trade balance for 2006-2007

	Q4 2006	January – December '06	Q4 2007	January – December '07
Volume (in millions of EUR)				
Exports	167.32	630.74	196.87	782.52
Imports	679.14	2,410.91	874.82	3,036.90
Trade balance	-391.36	-1,780.17	-677.95	-2,254.38
Annual change (in %)				
Exports			18%	24%
Imports			29%	26%
Trade balance			32%	27%

Source: Bank of Albania

Albania's main trade partners from the EU remain Italy and Greece. Imports and exports of goods with these two countries account for 35% and 13% of total trade volume, which is about 2% lower than in 2006. Imports and exports of goods with Austria and Great Britain<sup>28</sup> have increased; however, their share to total trade exchanges did not undergo significant changes (2%). Turkey, Macedonia and Croatia remain Albania's main trade partners from the regional countries. Trade exchanges with Macedonia grew by 57% in 2007, mainly as a result of the growth of exports of goods (77%). The application of the free trade agreement with Macedonia is believed to have had a positive impact on the increase of exports. Croatia remains an important trade partner although the trade exchanges with this country recorded an annual drop by 17% in 2007. The volume of trade exchanges with China has also grown considerably in 2007 (46%).

Relative to the same period the previous year, during January-December 2007 the imports and exports of goods grew by 26% and 24%. 'Minerals, fuels and energy', 'machinery, equipment and spare parts' and 'construction materials and metals'<sup>29</sup> recorded the highest growth in terms of imports. The growth in the import of 'minerals, fuels and energy' by about 50% mainly

reflects the increase in the volume and price of imported energy. Excluding the import of energy, the annual growth of the import of goods is 22%. The increase in the imports of capital goods observed throughout 2007 reflects the continuous increase of investments in the country. The imports of 'foodstuffs, beverages and tobacco' grew by 17%.

Table 9 Imports and exports (in million of EUR) and the annual growth by commodity groups

	Imports		Exports	
	January-December 2007	Growth	January - December 2007	Growth
Foodstuffs, beverages, tobacco	506.00	17%	57.14	14%
Minerals, fuels, energy	508.04	51%	120.56	153%
Chemical and plastic products	318.39	18%	6.35	-5%
Leather and items thereof	62.79	18%	16.35	35%
Wood and paper	107.36	21%	24.37	20%
Textiles and footwear	315.79	11%	378.43	10%
Construction materials and metals	481.14	24%	123.83	17%
Machinery, equipment and spare parts	633.68	29%	31.38	28%
Miscellaneous	113.01	34%	23.27	24%
Total	3,046.20	26%	781.67	24%

Source: INSTAT

The growth rate of exports to EU and regional countries was 18% and 24%. The growth rate of exports to EU countries was similar to the previous year, while to the regional ones it grew by about 4%. 'Textiles and footwear' is the main item of the exporting industry (48.4%) however its export has decreased in the last years<sup>30</sup>. The exports of 'construction materials and metals' and 'machinery, equipment and spare parts' grew by 18% and 29%, although their share in the structure of exports has almost remained the same. The exports of 'fuels, minerals and energy' increased by 154%, reflecting the improvement of the hydro meteorological situation at home. This increase of exports helped to double the share of this item to total volume of exports relative to the previous year and reach 15% as of end 2007.

### III.3 SUPPLY AND DEMAND-SIDE FACTORS

#### III.3.1 Production by sectors

Economic growth for 2007 averaged 6%, which is equal to the previous year. The biggest difference in the growth profile of these two years is the falling contribution of construction by 1.1%, the increase of transportation and telecommunication, trade, hotels and restaurants and industry.

Considering the lack of official data the real growth of agriculture is questionable. The projections for 2008 have been based on assumptions of the relative performance of sectors from 2007 to 2008<sup>31</sup>.

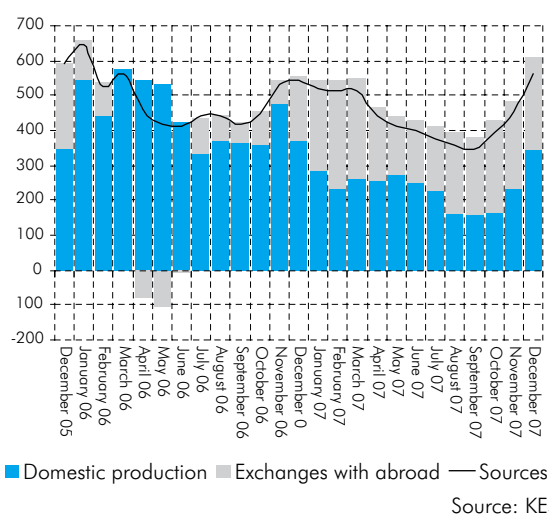
	2006	2007*	2007-2006	2008P
Agriculture	0.1	0.2	+ 0.1	0.5
Industry	0.9	1.1	+ 0.2	1.2
Construction	1.4	0.3	- 1.1	0.8

Table 10 Contribution of the production growth by sectors to the real GDP growth (in %)

Transportation & Telecommunication	0.4	1.0	+ 0.6	0.6
Trade, hotels, restaurants	1.1	1.4	+ 0.3	1.4
Other services	2.1	1.9	- 0.2	1.8
Economy (BoA assessment)	6.0	6.0	0.0	6.3

Source: INSTAT and Bank of Albania estimations

Chart 21 Indicators of energy balance sheet



Relative to 2006, domestic production of energy almost reduced by half in 2007. The imports of energy were about 3 times higher than the previous year. In 2007 the supply of energy (imports and production) was about 9% lower than the previous year. The businesses' demand for energy has been growing while their consumption of energy increased by about 20% in 2007. Household consumption continues to receive most of the energy supplied (about 60%). In 2007 the ratio of technical and non-technical losses to total amount of energy supplied has been falling. The most considerable drop was recorded in technical losses.

### III.3.2 Domestic demand and investments

#### DEMAND AND CONSUMPTION INDICATORS

The most recent data on the third quarter of 2007 provide evidence for the growth of domestic demand reflected in a number of economic indicators. Sales increased in all branches of services<sup>32</sup>, where 'trade, hotels and restaurants' provided the main contribution by 65%. Apart from the growth of sales by 16%<sup>33</sup> this branch also recorded an increase in the number of employed and rise in wages by 7.8% and 11.5%. Retail trade increased by 9% relative to the previous quarter and by 15% to the same period the previous year. Households spent mainly on 'foodstuffs, beverages and tobacco', 'clothes, footwear and leather' and 'household appliances'. The sales of these items grew by 3%, 17% and 18% respectively, relative to the previous quarter<sup>34</sup>. Consumer demand grew by 17% relative to the previous quarter. The imports of televisions and washing machines grew most considerably by 34% and 27%. On the other hand, for the first time after several quarters in a row, the import of purchased vehicles dropped by 24%. Unlike the quarterly developments, the annual developments showed a decrease in the durable consumer goods by 6%. The import of washing machines and televisions fell by 1% and 14%, while the import of vehicles grew by 3%. All in all, the growth of consumer demand provides an explanation for the intensive activity in foreign trade, where the growth rate of the import of consumer goods has been recording 30% for several quarters. The increased consumer spending was mainly covered by the increase of income from labour, by the rapid expansion of lending to households and partly by workers' remittances. Relative to the previous quarter, the rise of wages in both the public and private sector was followed by the increase in the number of employed by 0.2% and 1.1% respectively. In annual terms, credit to households grew by 62%. Its main items,

consumer credit and credit for real estates-purposes, grew by 50% and 75% annually. Workers' remittances represent a considerable source of income for the Albanian consumer. Although they have dropped by 17% compared with the second quarter their annual increase for January-September 2007 was 22%. Consumer confidence continues to record negative values despite a slight improvement by 1.2% relative to the third quarter 2007.

### INVESTMENT INDICATORS

Relative to the previous year, the performance of investment indicators for the third quarter of 2007 provides evidence for the increase of investments in all sectors of economy. Capital spending of the public sector almost doubled relative to the previous quarters' spending. Foreign direct investments are another important factor to have helped the increase of investments in Albania. These investments reached EUR 216 million being several times higher than the previous quarters. The imports of intermediate and capital goods grew by 35% and 50% relative to the same period the previous year.

Table 11 Performance of investment indicators

	Q2 '06	Q3 '06	Q4 '06	Q1 '07	Q2 '07	Q3 '07	Q3 '07 / Q3 '06
Import of intermediate goods (in millions of EUR)	301	296	345	347	396	399.96	35%
Import of capital goods (in millions of EUR)	76.9	66.5	83.6	87.3	98	99.94	50%
Government's capital spending (in billions of ALL)	5.1	6.6	32.6	5.7	5.5	10.13	53%
Foreign direct investment (in millions of EUR)	69	75	58	88.1	57.4	216	276%

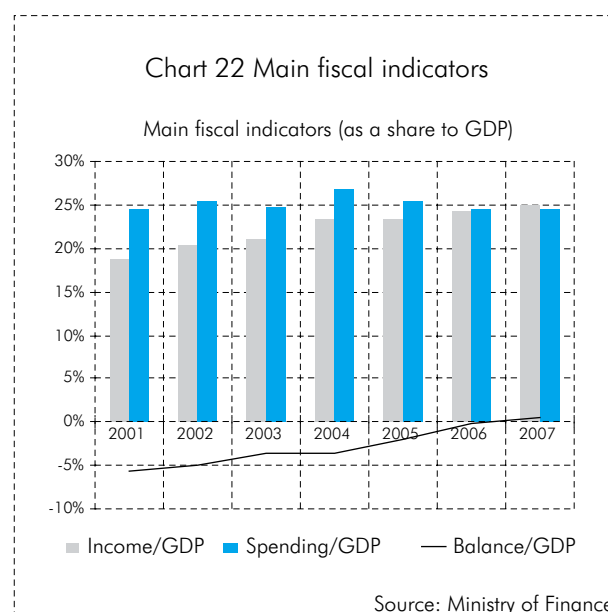
Source: Bank of Albania and Ministry of Finance

Banking system lending represents a considerable source for the financing of investments. In annual terms, credit extended to business for machinery and appliances and for real estates grew by 37% and 28%. The high demand of households and businesses to invest in real estates provides the explanation for the increase of banking system's credit portfolio for real estates-purposes by 54.4%<sup>35</sup>. Despite the high demand for investing in real estates, construction recorded an annual drop by 19%<sup>36</sup> in terms of new constructed buildings.

The pressure exerted by these two factors on the performance of House Price Index affected its increase by 24.8% relative to the previous quarter and by 16.7% to the previous year<sup>37</sup>. The information obtained from the Business Confidence Survey shows enhanced confidence in terms of investments and their financial situation.

### III.4 FISCAL SECTOR

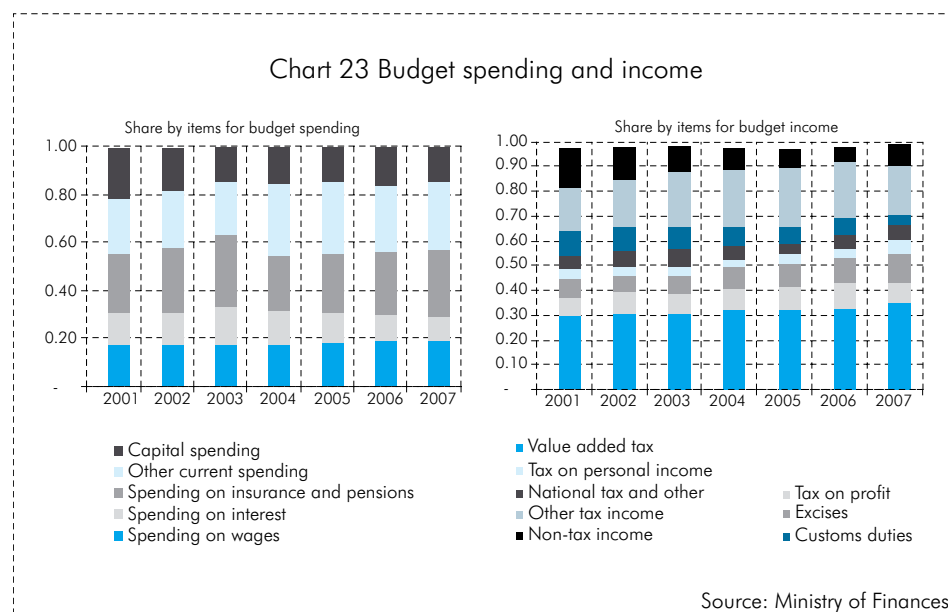
As of end November 2007, the performance of budget income was in the same line with the new fiscal policy objectives<sup>38</sup>, while budget spending has followed the usual realization trend.



In October and November 2007, there was a slowdown in the growth rate of budget income while spending increased moderately, thus not displaying significant change relative to the previous years. Unlike the projection of the Ministry of Finance, fiscal balance as of end November ended in a surplus of ALL 4.7 billion compared with the planned deficit of ALL 25.9 billion.

Relative to the previous year, budget income increased by 12%, being consistent with the average annual increase of the last seven years. Income from VAT provided the main contribution not only because of the weight it shares in total income but also because of the application of the additional 'package' that followed the new fiscal package which consisted in the removal of all facilities associated with the VAT previously. The application of the flat tax increased the amount of income collected from the tax on personal income by about 77% relative to the previous year<sup>39</sup>. In addition, this performance contributed to the total increase of income by 3%.

The rise in the excise duty for some goods was another element of the new fiscal package. The rise had a positive contribution to the annual growth of income. On the other hand, the reduction of customs duties deriving from the application of the SAA, the CEFTA and the Free Trade Agreement with Turkey provided a negative contribution to the increase of income.



Budget spending increased by 9% during the 11-month period, relative to the same period the previous year or by 3% above the annual average of the last 7 years. This increase attributes to short-term spending, mainly to spending on wages, insurance and pensions, being one of the main priorities of the new fiscal package. As of end November 2007 capital spending was far behind the projections of the Ministry of Finance, being only 3.4% higher than the same period the previous year.

In order to enable the efficient carrying out of unrealized spending during 2007, the Ministry of Finance issued in December a normative act which reallocates ALL 17.0 billion of budget spending. A considerable part of this amount has been channelled for the building of Durrës – Kukës motorway.

Table 12 Annual growth of income and spending, fiscal balance and deficit financing in nominal terms<sup>40</sup>

Annual growth in %	November 2001	November 2002	November 2003	November 2004	November 2005	November 2006	November 2007
Income	6%	16%	13%	11%	9%	12%	12%
1.1 Income from tax and customs	1%	19%	9%	13%	10%	15%	14%
1.2 Other tax income	6%	24%	33%	13%	12%	6%	0%
1.3 Non-tax income	30%	-9%	-7%	-10%	-7%	-2%	54%
Spending	3%	10%	7%	9%	4%	3%	9%
2.1. Current spending	-2%	17%	12%	7%	5%	1%	11%
2.1.1 Spending on wages	17%	8%	8%	10%	10%	6%	10%
2.1.2. Spending on interests	-28%	13%	22%	-4%	-9%	-3%	-1%
2.1.3 Spending on insurance and pensions	8%	25%	18%	-15%	10%	8%	17%
2.2 Capital spending	21%	-9%	-15%	20%	-4%	17%	-2%
3. Fiscal balance (cumulative in millions of ALL)	- 33,910	- 31,487	- 25,643	- 24,791	- 16,301	- 1,467	4,707
3.1 Domestic financing	18,701	13,530	19,414	19,675	11,982	(5,808)	(6,819)
3.2 Foreign financing	15,210	17,957	6,226	5,115	4,319	7,275	2,109

Source: Ministry of Finance

One of the main objectives of the Government's domestic borrowing policy for 2007 was the orientation to long-term debt instruments, which are represented by bonds of 2 to 7-year maturity. As of end November 2007, the Government debt stock in short-term instruments<sup>41</sup> reduced by about ALL 21 billion. The financing of deficit with foreign resources maintained very low levels, sharing only 15% of Government net borrowing.<sup>42</sup>

## IV. LABOUR MARKET

### IV.1 EMPLOYMENT AND UNEMPLOYMENT

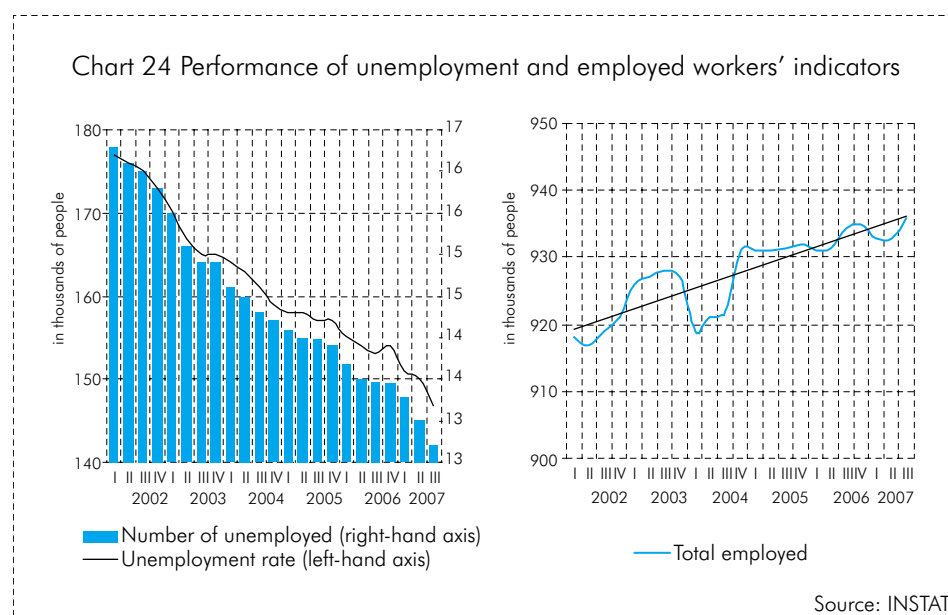
Employment increased in the third quarter of 2007 causing the number of employed to reach about 936 thousand. Employment increased highly in industry and services. In annual terms, employment in industry increased by 7% as a result of the increase by 10% in extracting and processing industry. Employment index increased by 8% in services (hotels). The number of employed in construction fell in the third quarter, in parallel with the slowdown in the annual production and sales. Transportation continues to record a higher volume of sales while having a smaller number of employed.

The number of employed workers in the public sector fell by about 3 thousand in the third quarter of 2007 relative to the previous year while this number increased by 5 thousand people in the private sector. Annual employment



was higher in the private sector (about 4,700 persons). Unemployment rate reached 13.18% as of end the third quarter of 2007. In annual terms, this rate fell by 0.6% recording the highest fall of unemployment since 2004.

The more rapid fall in the number of unemployed than the increase in the number of employed was reflected in the drop of labour force. In annual terms, labour force reduced by 6 thousand in the third quarter of 2007. The higher occurrence of this phenomenon may result from the informal employment relationships, emigration and the inconsistency between supply and demand for labour. The implementation of professional programs for the jobseekers and the consolidation of professional training centres outside the capital city are expected to grow the labour supply in the following periods.



#### IV.2 PERFORMANCE OF WAGES

Wages continued to rise in the third quarter of 2007. However the rise in wages was dissimilar for the public and private sector. Unlike the two previous quarters the rise in wages was higher in the private sector than the public one. In annual terms the rise of average wages in the public sector was about 23% in the third quarter and about 12% relative to the previous quarter.

As of end the third quarter the average annual rise of wages was about 18%, which is the highest since 2002. Average wage rise in the private sector did not follow the significant rise of the second quarter and recorded an average annual rise of about 13% in the third quarter.

The rise in wages of industry and construction was higher by 23% and 19% respectively. Wages rose less in services by about 12%, which is 28% less than in the second quarter. Minimal wage approved and the unemployment benefits have not changed since 2006, while the number of unemployed workers provided with unemployment benefits has been decreasing.

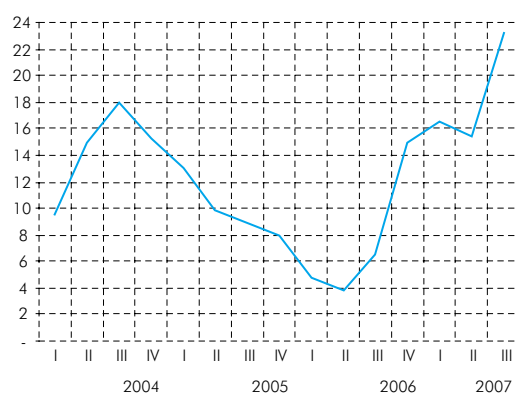


Chart 25 Performance of wages in industry and construction



Source: INSTAT

Chart 26 Performance of average wage in the public sector (annual growth in %)



Source: INSTAT

Table 13 Average wage, minimal wage and economic assistance (in thousands of ALL)

	Q1-06	Q2-06	Q3-06	Q4-06	Q1-07	Q2-07	Q3-07
Average monthly wage in the public sector	27,333	27,606	28,950	31,400	31,850	31,850	35,650
Monthly minimal base wage	11,800	11,800	14,000	14,000	14,000	14,000	14,000
Monthly average assistance to families							
full	2,442	2,455	2,477	2,883	2,621	2,536	2,482
partial	1,836	1,800	1,995	1,960	1,747	1,784	1,835

Source: INSTAT, Conjecture, third quarter 2007

## NOTES

- <sup>1</sup> Starting from the beginning of 2007 the price has risen by more than 80%.
- <sup>2</sup> Annual inflation over the months: July 2.1%; August 4.2%; September 4.4%; October 4.2%, November 3.5%, December 3.1%.
- <sup>3</sup> Inflation rate for January was measured based on the new consumer basket (INSTAT, Consumer Price Index, January 2008).
- <sup>4</sup> Inflation rates of foodstuffs for Italy and Greece in the last quarter were high and stood at 3.8% and 4.6%.
- <sup>5</sup> Average annual increase for January '99 – July '07 is close to 0.
- <sup>6</sup> The reason behind the high inflation for 'Housing' at end 2006 was the considerable rise in dormitory tariffs paid by students, while for 'Administered goods' was the energy price rise by 14% in August 2007.
- <sup>7</sup> The price rise of bread and grains, including some other processed products as well.
- <sup>8</sup> Core inflation may be its appropriate approach.
- <sup>9</sup> Annual total inflation for 2007 was 3%.
- <sup>10</sup> Foodstuffs in the price index basket of tradable goods share about 70%.
- <sup>11</sup> Almost equal to the producer price index for the last quarter 2007, according to the Business Confidence Survey.
- <sup>12</sup> Foreign trade with EU countries shares 68% of the total.
- <sup>13</sup> Source: IMF Research Department, Products Division.
- <sup>14</sup> Average annual inflation for this group was 0.6% in 1999 – 2006.
- <sup>15</sup> Starting from March '03 to June '05, key interest rate has had a downward rate and remained unchanged at 5% (the lowest historical rate) until June '06. Monetary aggregate M3 has been growing starting from 2003 and peaked in 2006.
- <sup>16</sup> It related with the fact that the energy price rise in 2005 did not affect the inflation rate as a result of its absence.
- <sup>17</sup> Annual core inflation and annual total inflation marked 3.6% in the last quarter of 2007.
- <sup>18</sup> In the third quarter there were also executed auctions of reverse repurchase agreements of one-month and three-month maturity.
- <sup>19</sup> In June, Moody Investors Service rated Albania B1 for the Government's ability to pay the debts.
- <sup>20</sup> NEER – Nominal Effective Exchange Rate measured against two currencies according to an approximate share they have in trade with abroad, EUR (80%) and USD (20%). An increase of the NEER implies an appreciation of the lek.
- <sup>21</sup> REER- Real Effective Exchange Rate, CPI-deflated with the main partners.
- <sup>22</sup> In addition, the low M2 rate in terms of the realization of public sector's domestic borrowing reflects the reallocation and the carrying out of the latter partly in foreign currency.
- <sup>23</sup> The performance of currency outside banks to M3 shows seasonality throughout the year.
- <sup>24</sup> The objective of Net Credit to the Government has been adjusted for the effect of 'income from privatization', and 'securities for covering the BoA re-evaluation'. In addition, the reallocation of spending in the first two weeks of January 2006 and 2007 has also been considered.
- <sup>25</sup> According to the preliminary results of the survey on the lending activity of commercial banks in the second half of 2007.
- <sup>26</sup> In December 2006 the Bank of Albania approved an amendment to the Regulation "On credit risk management" which became effective in March 2007. According to this amendment the required capital from banks increases in case credit grows beyond the set limit.
- <sup>27</sup> In annual terms, trade deficit deepened by 32% relative to the same period in 2006.
- <sup>28</sup> In annual terms, exports and imports of goods with Austria and Great Britain went up by 37% and 16%.
- <sup>29</sup> The annual increase in the import of 'machinery, equipment and spare parts' and 'construction materials and metals' was 29% and 24%.
- <sup>30</sup> This item shares 48% in the total exports for January-September 2007, from 54% it shared in 2006 and 58% in 2005.
- <sup>31</sup> In more concrete terms, it is assumed that agriculture will improve slightly relative to 2006-2007; industry will continue to grow at the same rates with 2007; construction will grow better

than in 2007, but less than in 2005 and 2006 as a result of market abundance; trade and other services are expected to grow at similar rates with 2007, and the increase in transportation and telecommunication may drop slightly as a result of the slowdown in telecommunication.

<sup>32</sup> This sector includes the sub-sector of trade, hotels and restaurants, transportation, telecommunication and other services such as financial intermediation.

<sup>33</sup> Relative to the second quarter of 2007.

<sup>34</sup> The sales of 'foodstuffs, beverages and tobacco' recorded an annual drop by 28%, while the two other items an annual increase by 51% and 48%.

<sup>35</sup> Expressed in annual terms, December 2006-December 2007.

<sup>36</sup> The reduction in the extension of new construction permits for a relatively long time may have led to the decrease in new constructions.

<sup>37</sup> This index refers to Tirana.

<sup>38</sup> Implemented in the second half of 2007.

<sup>39</sup> This item's average annual increase for the last 5 years is about 23%.

<sup>40</sup> Given the absence of data for December, the analysis is not on quarterly basis. Therefore, the cumulative data for November in the last 7 years have been used.

Domestic financing includes: Issue of securities (bonds and T-bills) (+)

Income from privatization (+)

Actual excess of Government liquidity as of end each period (-)

<sup>41</sup> 3, 6 and 12-month T-bills.

<sup>42</sup> As of end November Government debt increased by ALL 11.7 billion through the issue of securities, while foreign borrowing is ALL 2.1 billion in nominal terms.

