

**MONETARY POLICY REPORT FOR
THE FIRST HALF OF THE YEAR
JANUARY – JUNE 2003**



JUNE 2003

Speech Of The Governor

Economic developments during 2003 are expected to perform according to the program. The most important targets of this program are: 6 percent economic growth, keeping inflation in the 2-4 percent level, maintaining the budget deficit to 6.4 percent of the GDP, and keeping the balance of payments in a favorable position, expressed by the increase of foreign currency reserve of monetary authority.

Despite the lack of data for a complete analysis of economy performance during the first half of the year, Bank of Albania believes that economy growth objective seems attainable. The available data show a positive economy performance during the first half of the year. This performance is, particularly in the macro-economic aspect, represented in the observance of inflation objectivity, in the budget deficit maintenance within the predicted limits and in the strengthening of the domestic foreign currency position. In addition, the economy sectoral analysis, based on the available data, makes trustful the fulfillment of economic growth objectivity. The economic activity and the observance of economic growth objectivity will be positively influenced by the expected concentration of the government activity for the remaining part of the year, especially towards the capital expenditures and the invigoration of the private sector activity in the second half of the year.

The sales indicator for the first trimester of 2003 represents ameliorations compared to the first trimester of the previous year. Particularly, the sales index performance in the industry sector and in the services sector, show an invigoration of their economic activity. The agricultural sector continues to have a considerable contribution in economy. Agro-industry, one of its main branches, has recorded positive upward rates. On the other side, the foodstuff price performance in the market and the seasonal factor performance until June 2003, suggest that the agricultural production is expected to maintain the upward predicted levels. During the first four months of 2003, the import and export volume of goods is presented 24 percent higher compared to the same period in the previous year, whereas the direct foreign investments have recorded an increase of 23 percent.

Monetary developments analyzes seems to support the assessment of a positive economy performance during the first half of the year. The economy credit has had a positive performance during 2003. The new credit given during the first five months was Lek 33.1 billion or 1.4 times higher compared to the same period in the previous year. The credit degree increase, though it reflects the efficiency increase and the enlargement of the banking system, is also an indicator of the economy enlargement. The positive credit performance is predicted to continue during all the year 2003, supported by the interest rate overall reduction, the competition increase in the banking system as well as by the increasing number

of banks. On the other side, the credit increase offers premises for the enlargement of the banking sector.

The Albanian economy, even during the remaining part of the year, will be faced with challenges, which can influence its growing rate. Some of the main problems mentioned during 2002 and which influenced the slowing down of economy growth, like the problems in the power sector, world economy recession, the aggravated situation of liquidity in the banking system, etc, seem that will act in a more alleviated manner during 2003. Still problematic is the relatively non-satisfactory level of households and foreign investments, which do not create a basis for the support of long-term economic growth, the potential problems created by the local government election campaign in autumn of this year, the economic structural reforms performance and investments in the production technology. During the first five months of the year, only 63 percent of the planned capital expenditures are attained, which means that the economy is supported by less public investments. The Albanian economy was also influenced by the oil price fluctuations in the first part of the year, which reflected the conflict performance in Iraq, and from the completely different behavior of Euro-USD exchange rate in international markets and in the domestic market.

Inflation has been continuously within the objective of Bank of Albania. The average inflation has presented a downward trend, reflecting the amelioration of the basic factors, which have an impact on inflation, on monetary aggregates control, on the exchange rate depreciating performance and on the low pressures coming from the economy aggregate demand. Bank of Albania predicts the inflation to remain as such also at year-end, considering the up to date performance of these factors. However, the inflation level has been close to the limit up objectivity of Bank of Albania during May- June. The oil, water and power price rises, are assessed to have had an impact on the annual inflation increase in this period. Also, until April 2003, it is assessed that the highest imported inflation from the main trade partners, has had a considerable influence, which has consequently kept high the foodstuff group prices. These factors have generally acted from the supply direction, making thus the Bank of Albania intervention unnecessary.

The first months of 2003 were characterized by the reestablishment of monetary indicators` equilibrium. The money outside banks level has had a rapid decline, coming close to historical levels of its ratio against money supply. The monetary supply upward rate has been in continuous increase during 2003. Nevertheless, it remains relatively low, as a result of low economy demand for monetary assets. In May, the annual increasing rate of the M3 aggregate was 7.4 percent. The budget deficit financing from the banking system was Lek 4.5 billion until June, being nearly 50 percent lower compared to the same period in 2002.

Despite the low increasing rate of monetary assets in totality, Lek deposits have had a very rapid increase as a result of return of money outside banks in the

system. During the first five months of the year, Lek deposits increased by Lek17.5billion against an increase of only Lek7.7 billion during all 2002. Deposits increase has enabled the system to pass the liquidity lack, and now its liquidity situation is presented as stable. Because of the high real interest rates that resulted from a low inflation in the first half of the year, the money quickly returned in the system.

Bank of Albania has carefully followed its quantity objectives. The net international reserves and the net domestic assets of Bank of Albania have often been within their targets. By the end of June, the international reserves were USD 27 million over their objectivity. Bank of Albania interferences in the foreign currency market have influenced its foreign currency reserves increase. Bank of Albania has been present in the foreign currency market during the first months of the year buying nearly USD 43 million during the first five months of the year. Also, the net domestic assets were Lek 27 billion below their objective in May. Their high difference from their objective is as a result of the non-financed budget deficit from Bank of Albania and the money outside banks rapid return into the system. Meanwhile, the net government domestic credit level is surpassed in the first two months of the year, but later even this objective was achieved. The net domestic credit in May was Lek 5.3 billion below the objective, as a result of the low government borrowing.

The amelioration of liquidity situation and the monetary aggregates return to the historical levels, the domestic currency performance, the real interest rates performance and other factors led to the conclusion that the monetary policy alleviation was an adequate attitude. This alleviation was attained by means of some measures:

- Base interest rate reduction in April and July, respectively by 0.5 percentage points, reducing the interest rates by 1.0 percentage points. In response to the interest rate reduction by Bank of Albania, the banking system has reacted by reducing somewhat more the deposits and credits interest rates in Lek as well as the interest rates required for investments in treasury bills. Such a reaction from the banks was in compliance with the Bank of Albania policy;
- foreign currency purchase in the market.

The further attitude of Bank of Albania depends on the inflation performance and on the intensity of some factors, which have an impact on it:

- budget expenditures concentrations in the second part of the year;
- speculative elements which accompany the elections campaign and the year-end holidays;
- preoccupations connected with the power situation, etc.

These factors are predicted to act very soon from the supply direction. However, Bank of Albania will continue to monitor their activity intensity in order to evaluate the monetary policy suitability and its future attitude.

Thank you

Shkëlqim Cani
Governor

I. ECONOMIC DEVELOPMENTS DURING THE FIRST HALF OF THE YEAR

I.1 WORLD ECONOMY

World economy was greatly exposed to the war in Iraq during the first half of the year 2003. This war was accompanied by the reduction of the share prices, by belief/confidence weakening of the business and of the consumer, by the oil price rise and by the depreciation of the USD against the European currency. Due to the up-to date performance of the largest economies, the predictions on the world economic growth for the 2003 are reduced to 0.5 percent, compared to 3.7 percent initial prediction.

Table 1: Indicators on some of the world economies for the first half of 2003¹

	GDP	CPI	Unemployment (rate %)		
Britain	0.3	3.0	May	5.1	April
Germany	-0.9	1.0	June	10.7	April
Italy	-0.4	2.6	June	8.8	April
France	1.0	1.8	May	9.3	May
Euro-zone	0.0	2.0	June	8.8	May
USA	1.4	2.1	May	6.1	May
Japan	0.6	-0.2	May	5.4	May

Politicians all over the world have been worried about the inflation risk. The president of the USA Federal Reserve, Greenspan, has acknowledged the potential risk of a considerable decline in goods and services prices. Developments in the Euro-zone prices are expected to be affected by developments of prices in Germany, which is experiencing a difficult and blurred economic situation.

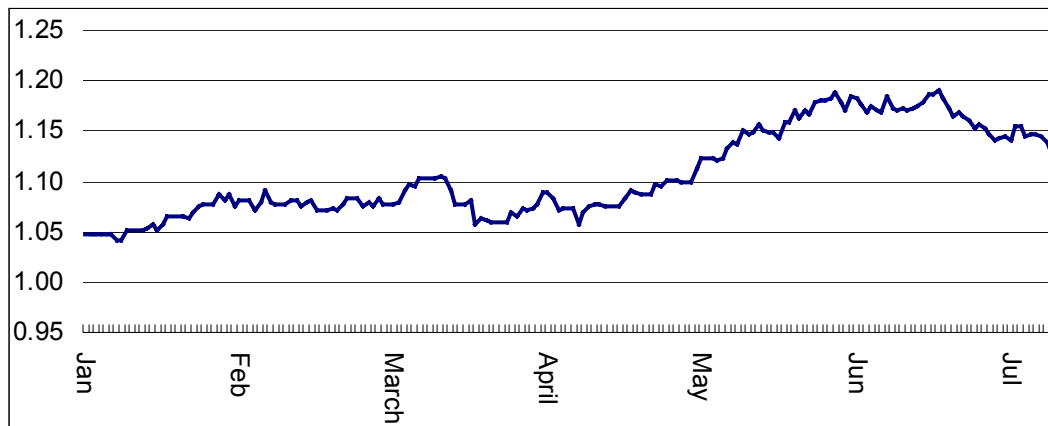
On 5th June 2003, European Central Bank reduced interest rates by 0.50 percentage points bringing them to the level of 2.0 percent. The decision reflects the assessment that the price stability in the medium-term period is considerably ameliorated since the last reduction of interest rates in March of this year. The Fed, in the meeting of 25th June, decide the reduction of interest rates by 25 percentage points bringing them to the level of 1.0 percent. The committee assessed that a more alleviating monetary policy would support the economy further on under the circumstances of low inflation expectations.

After an unstable period in March and in the beginning of April, being connected to the war developments in Iraq, the foreign currency exchange rate markets in

¹ Data source: "The economist", 27.06 - 03.07. 2003.

the following period were more influenced by the macro-economic factors, as for example the deficits increase in the United States and the small economic activity in Japan. The not pleasant signals that came during this period from the United States economy, the continuous deficit in current accounts and fiscal deficit, followed by the small activity in the production sector and the weak job market, seem to have strengthened the position of Euro.

Graph1: USD/Euro exchange rate during the first half of 2003*.



* Data source: Reuters.

1.1.1 OIL PRICES IN INTERNATIONAL MARKET

Oil prices had a noticeable rise in the eve of the American attack against Iraq; one the largest oil exporters in the world market (4 percent of the total before the war). Other factors were added to war in Iraq such as the strike of oil workers in Venezuela and the turmoil in Nigeria, which gave their effect in the further rise of oil price. OPEC members, determined to keep the oil price within the interval of 22-28 USD/barrel, have frequently met in order to discuss the probability of increasing, reducing or keeping unchangeable the oil production quotas. World production came to 27.4 million barrels a day in February and March, at a time when unused capacities producers, increased their production in order to put away the fear of oil-consuming states that the war in Iraq would reduce the oil supply and would rise significantly the oil price. These concerns were not materialized and the oil price fell from 40USD/barrel (before the war) to 24USD/barrel at the end of April. In June, again with the Iraq oil present in the market and with the quantities gathered from active producers, the oil reserves reached levels such as to fulfill the present world demand.

Graph 2: Oil price in USD/barrel for the January-June 2003.



I.2 DOMESTIC ECONOMY

The data on the real economy during the first trimester of 2003 can not cover important sectors of economy, yet. Therefore, it is difficult to make an analysis on economic developments and conclude whether the developments of this period support or not the above-mentioned target of 6 percent. Nevertheless, Bank of Albania believes that the predicted target of 6 percent, for 2003, is attainable.

Agriculture.

The production of the agro-industry branch, for the first trimester of 2003, has recorded an increase of about 7.7 percent compared to the same period in the previous year. It seems that production in agro-industry will continue to have satisfactory rates.

Table 2: Agricultural production forecast as to the branches for 2003 (in percentage)

Branches	Accomplishment for 2002	The increase for 2003
Agriculture	102.3	3
Agro-industry	113.1	10
Fishing	118.8	15.1
Total	103.9	4.2

Source: The Agriculture and Food Ministry, May 2003.

Other sectors of economy

The sales indicator for the first trimester of 2003, thanks to a rather more alleviated situation of the problems in the power sector, is presented more ameliorated compared to the first trimester in the previous year. Despite the limits included in the analyses made only by means of this indicator, it is believed that such sectors as industry, electricity and the services sector have had a higher activity compared to the previous year.

Table 3: The sales value performance (in percentage points).

Sectors	(T1-2003/T4-2002)100	T1-2003/T1-2002 (in %)
Industry in total	85.6	120.7
Power, water and gas	104.9	128.8
Construction	58.5	102.2
Trade, hotels and restaurants	75.1	117.8
Transport and telecommunication	97.1	83.9
Others	69.2	126.4
Economy in total	76.8	112.7

Services and tourism sectors are still strong points in supporting the economic growth of 2003. The support by financial sources from the banking system shows not only the interest of the banking system for these sectors, but also the ever-growing orientation of the Albanian business towards them. Thus, the hotel and restaurant sector, in the first trimester of 2003, is supported by nearly 46.5 percent banking credit more than the same period in the previous year.

Foreign trade activity is presented as satisfactory up to a certain point during the first four months of 2003. The trade volume increased by 26 percent² compared to the same period in the previous year. The increase of this indicator has come from the imports as well as from the exports direction.

The imports increase, for the comparative periods, was influenced considerably by:

- The highest level of imported machineries and equipments that increased by 29 percent. These were mainly equipment that will serve for the regeneration of the electric network in Albania. This is a positive signal for the performance of the energy- power situation in Albania.
- The high volume of imported fuel; 19.5 percent more than in the same period in the previous year. The ratio results much higher in value due to the oil price rises, especially during the first trimester of 2003.
- The highest level of imported power. The power import increased by about 330 million KWH, or 15 percent more in value, which alleviated the power supply difficulties.
- The increase of about 25 percent of core imported materials, which are considerably used in the construction process.
- The import of materials used in the production with ordered material, recorded a high increase of about 47.1 percent, which implies more production and more exports in the following periods.

To be specified is the that the concrete import has remained nearly in the same levels as in the previous year, which means that, the domestic production has continued to be stable in this sector.

² Imports and Exports estimated in f.o.b

The exports, only from the domestic production, have had an increase of about 26 percent for the comparative periods. The re-exports continue to keep their significant weight in the Albanian exports.

The considerable strengthening of the European currency, Euro, during the first part of 2003, compared to the previous year, has certainly given its influence on the value increase of the Albanian trade exchanges which are mostly done with the Euro-zone neighboring countries.

Factors which may put in difficulty the economic growth objective, are mainly connected with:

- The investment situation: the Albanian economy inherited a relatively non satisfactory level of direct and public foreign investments from the previous year;
- The industrial sector situation which is not expected to have fundamental changes this year. This is due to the fact that no such investments are noticed in technology in order to increase productivity and efficiency.
- The approach of the local authorities elections period, which is usually associated with growing politic tensions, a fact which does not stimulate the increase of the private activity of businesses or suspends the plans on investment and growing activity;
- The slowing down of the world economic growing rates.

Apart from these factors, the economic growth of 2003, as for 2001 and 2002, will be influenced also by the change of structure contribution of various sectors in GDP.

I.1.2 FISCAL SECTOR

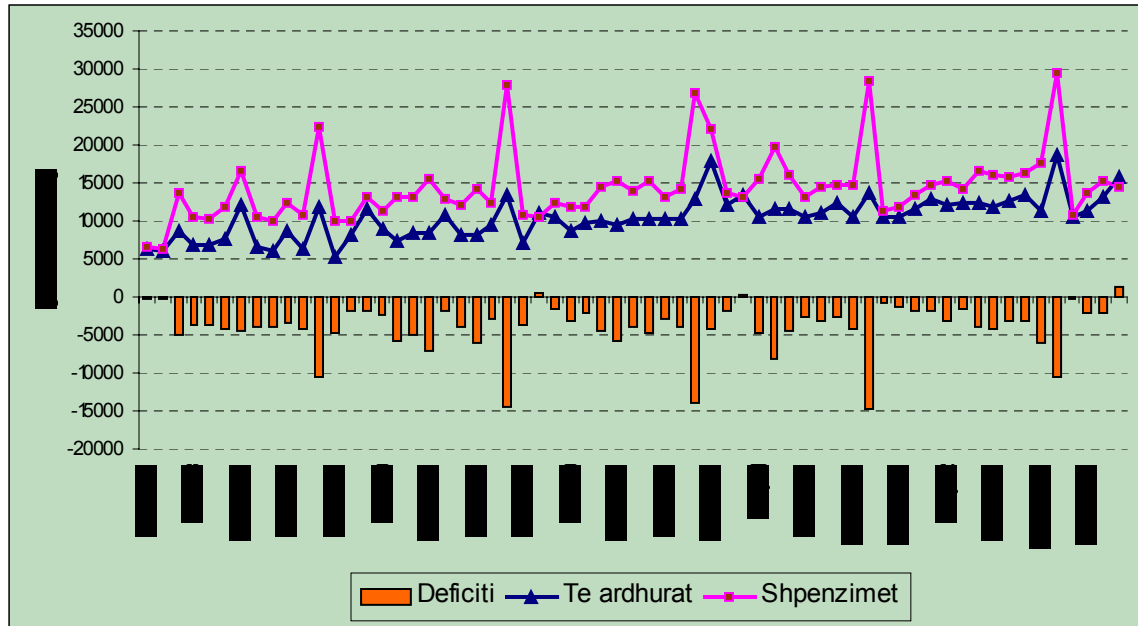
The fiscal indicators for the January-May 2003 have generally performed within the predictions made. According to the data of Ministry of Finance, until the end of May, there are collected 99 percent of the planned revenues, and nearly 82 percent of the programmed expenditures are attained. Consequently the budget deficit was nearly Lek 7.1 billion from Lek 22 billion predicted by the end of May. The domestic deficit financing until May came to Lek 3.6 billion versus the predicted level of Lek 14.6 billion. The foreign deficit financing came up to 49 percent of the predicted value.

Table 4: Fiscal indicators (in million Lek)

	January – May 2003	Difference in % with 2002	Plan accomplishment (%)
Revenues	65,0	13.1	99.0
Expenditures	72,1	8.2	82.0
Deficit	7,1	23.0	32.3

Source: Ministry of Finance

Graph 3: Fiscal indicators, January '98 – April '03



Budget revenues

During the first five months of the year, the budget revenues were nearly 13.1 percent higher compared to the same period in 2002. The tax revenues, by the end of May, reached about Lek 46.4 Lek or nearly 16.8 percent more than the same period in the previous year. The tax collected in the tax and customs system, during January-May 2003, resulted 97.1 percent of the plan in this period.

Graphic 4: The budget revenues structure



Source: Ministry of Finance

More than 71 percent of the budget revenues until April came from taxes, which were accomplished by 101.2 percent. The revenues increase from the Local Government influenced greatly the fiscal plan accomplishment, where the local tax collection and duties on the small business, were accomplished respectively by 198 and 146 percent. This is as a result of the increase of the taxpayers

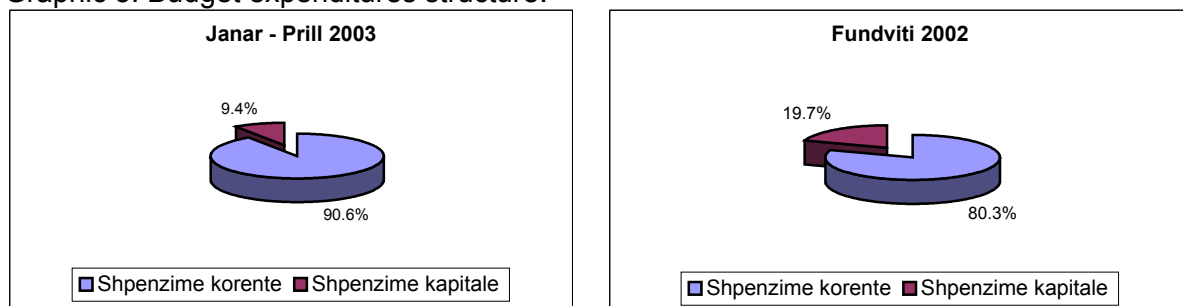
registration, when at the end of June it resulted nearly three thousand small business taxpayers more than at the end of 2002. An amelioration in the turnover control and an increase in the tax liabilities is also noticed, as a result of the revenues increase.

Budget expenditures

Budget expenditures during the first five months of the year were Lek 72.1 billion, that is 82 percent of the programmed level for that period. Staff expenditures were accomplished by 88 percent; social transfer expenditures were 78 percent and capital expenditures 63 percent. From these latter ones, expenses covered by foreign financing were accomplished by 51 percent. The capital expenditures performance does not support sufficiently the predicted economic growth for 2003 and on.

Some of the reasons of the low budget expenditures accomplishment are: the postponement of the implementation of the predicted reform in the civil service due to technical reasons; new public procurator rules, which have had an impact on the operative expenditures level as well as in the capital ones; the non-compliance in time between the treasury procedures and the real accomplishment of the investment plan, where the 60-day delays payments are also included, etc.

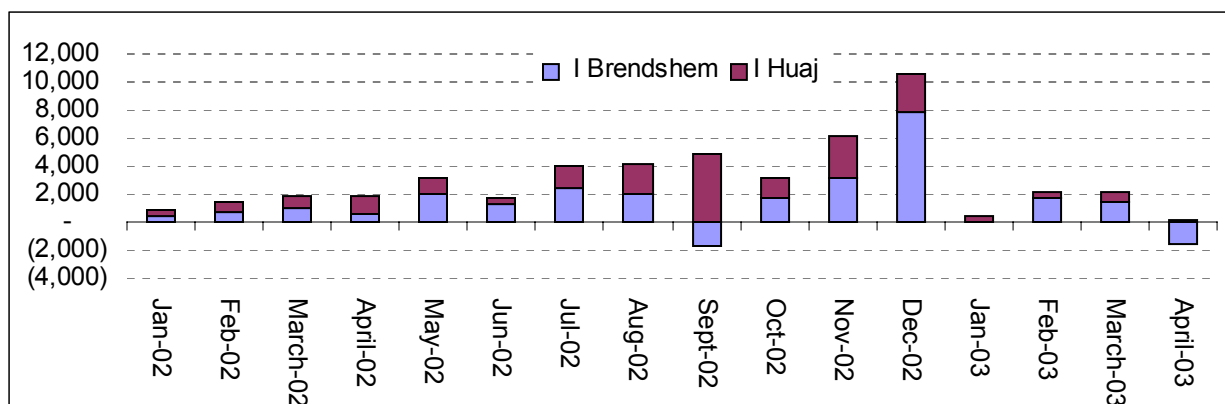
Graphic 5: Budget expenditures structure.



Fiscal deficit

Fiscal deficit for the first half of the year does not surpass 66 percent of the planned level, at a time when during January-April period it was 17.6 percent of the program. This fact gives information about an accelerated increase in the last months. The increase and concentration of budget expenditures in the following months is expected to be considerable, having thus an impact on the increase of inflationary pressures.

Graphic 6: Budget deficit financing form January 2002.



I.1.3 FOREIGN ECONOMY SECTOR

Current account.

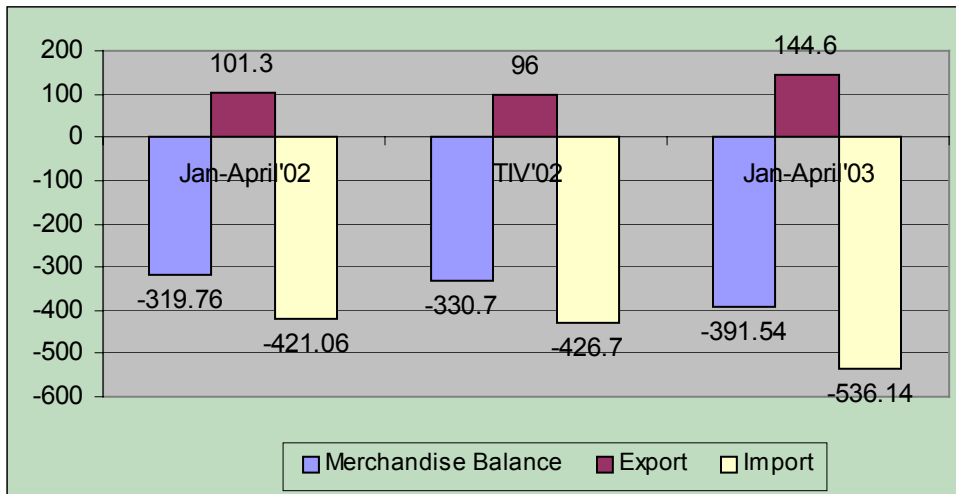
Developments in the current account are positive compared to the same period in the previous year. Total transactions of the current account were USD 1 billion for the first trimester of the year, from which USD 473.7 million were current incomes and USD 529.7 current expenses. The incomes increased by 16.6 percent, whereas the expenditures had an increase of 21.7 percent compared to the same period in the previous year. The goods imports held the greatest weight of the current account, which resulted higher compared to the first trimester of 2002.

– Foreign trade

During the first four months of 2003, the commercial activity is presented 24 percent higher compared to the same period in the previous year. The increase in the trade volume came as a result of both imports and exports increase. Compared to the same period in the previous year, exports increased by 30 percent, whereas imports by 23 percent.

As evident from the last year performance, imports are in continuous upward, worsening thus more the trade balance deficit. This year, the deficit increased by USD 536 million from USD 421.06 million that was during January-April period in the last year, recording thus an increase of about 21 percent.

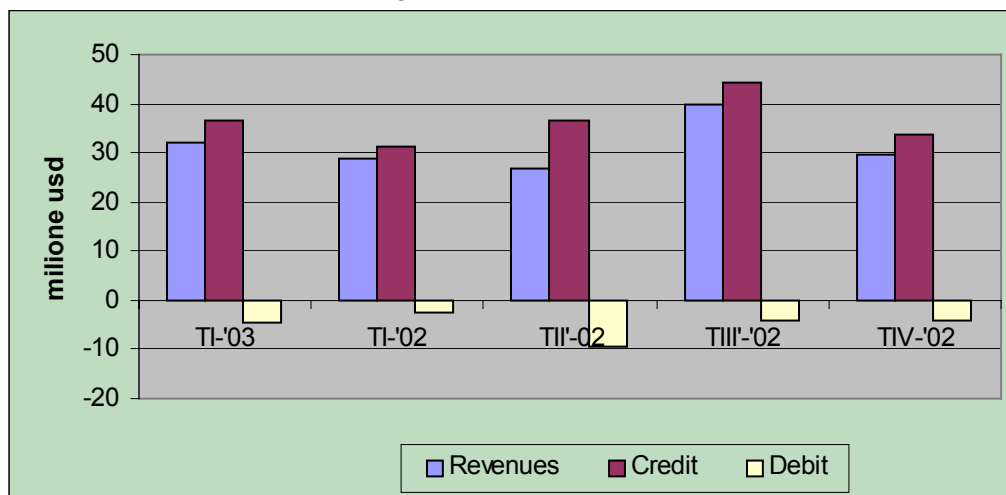
Graphic 7: Foreign trade balance (in USD million)



Revenues

The revenues balance resulted positive, USD 32.2 million for this trimester, or 11 percent more than in the first trimester of the previous year. This increase is due to the higher incomes coming from the seasonal and neighboring workers, as well as to the interests increase accumulated from the investments of foreign currency reserves of the banking system in the form of portfolio investments.

Graphic 8: Revenues according to trimesters.



- Transfers

During the first trimester of this year, the net transfers balance has had positive developments. The remittances from the emigrants have not changed much compared to the remittances of the respective trimester in 2002. However, these remittances were 17.5 percent higher compared to the previous trimester.

The remittances are estimated to have covered nearly 67 percent of the trade deficit. They represent the main part (92 percent) of the current transfers. The remittances from the emigrant recorded a level of USD 192.9 million during this trimester, compared to USD 181.8 million in the first trimester in the previous year, or 6 percent more.

CAPITAL AND FINANCIAL ACCOUNT

During the first trimester of the year, net flows in the capital and financial accounts are assessed as positive, at the USD 70.7 million level. Nearly 44 percent of these capital flows, during January - March, came from capital transfers which resulted 84.5 percent higher than the same period in the previous year, and 9.3 percent lower than the previous trimester.

The financial account of the first trimester is presented by a positive net capital flow of USD 39.7 million. The capital flow in this account is 23.6 percent higher compared to the last trimester in the previous year.

Net capital flows in the financial account, during January-March period of this year, resulted 41 percent less than the corresponding period in the previous year. Our financial liabilities during the first trimester, increased by USD 51 million from USD 32.5 million increased in January-March 2002.

Almost half of our financial liabilities in this trimester have been in the form of *foreign direct investments*, which resulted USD 27million. Compared to the same period in the previous year, the flow of these capitals is presented nearly 23 percent higher, at a time when a decline of 51 percent is noticed in the previous trimester. The year 2002 had a decline of 35 percent in the foreign direct investments compared to 2001 as a result of non -privatizations according to the predictions.

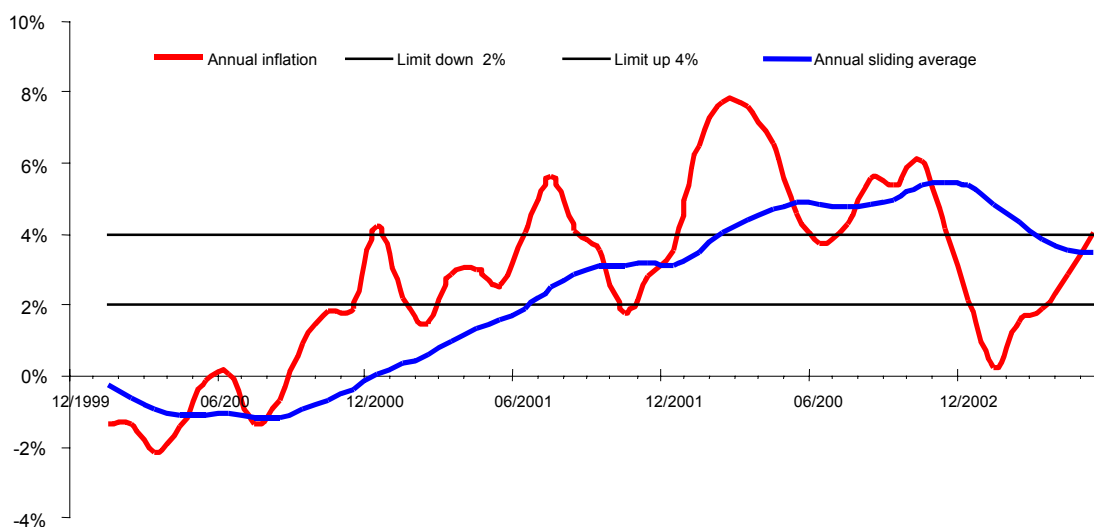
During January-March of this year, it was noticed an increase of our foreign assets which came as a result of the portfolio investment increase by USD 11.1 million. Though the portfolio increased more than the fourth trimester in the previous year, its investments are presented about 33 percent lower than the same period in the previous year. Bank deposits outside the country had a decline of USD 8.7 million in the first trimester of 2003, after an increase of nearly USD 59 million in the second half of the previous year.

II. INFLATION PERFORMANCE DURING JANUARY-MAY 2003

II.1 INFLATION PERFORMANCE DURING 2003.

Annual inflation rate in June resulted 3.8 percent, whereas the average one was 3.48 percent. During the first five months of 2003 the annual inflation indicated an upward trend until it reached the targeted limit up value set by Bank of Albania. In June, the annual inflation fell again below this limit. The annual average indicated a downward trend and is normalized within the objective interval.

Graphic 9: Annual inflation



The price performance of “Foodstuff and nonalcoholic” group explains most part of the inflation change during the first period of this year (table 5). The “Rent, water, fuel and power” group contribution has been more moderate during the first four months and it increased considerably in May. The increase of the power price has affected the annual inflation rise over the limit up objective in these months. Bank of Albania predicted an effect of 0.27-0.38 percentage points in the overall inflation. The real data show that this subgroup gave an impact on the upward direction of about 0.3 percentage points of the monthly inflation. Without this factor, the monthly inflation would have resulted at lower levels (about -0.8 percent) whereas the annual one about 3.73 percent, that is within the limit up of the objective interval targeted for it.

These data resulted after the acknowledged direct effect of the power price rise. In June, it was noticed that the direct effect on the inflation rate increase, of the

power price rise disappeared. This led the monthly inflation rate to record a negative low figure, and consequently even the annual rate to return within the objective interval. But, in the same time it is not to be excluded the fact that the power price rise will influence the increase of inflation rate for a longer period than a month, especially in autumn, when the problems in the power sector are more present in the domestic economy.

The seasonal behavior of the special groups seems totally confirmed, even for this year. For example, the foodstuff group has the same performance as in the previous year. However, inflation was reduced less than it should have been reduced under the effect of seasonal factors due to the above-mentioned reasons.

Table 5. Seasonal effect intensity during May-June of the last two years.

	Monthly inflation			
	2002		2003	
	May	June	May	June
"Foodstuff and nonalcoholics" group	-3.6	-3.7	-3.0	-3.9
"Rent, water, fuel and power" group	-0.1	0.1	4.0	0.0

We should concentrate on these two main groups in order to observe the factors influencing the inflation performance of this year. During the first trimester of 2003, the tensions and war in Iraq brought the increase of the oil price, which led to a considerable increase of the transportation prices. The overall influence of the "Rent, water, fuel and power" and "Transport" groups has not been more than 0.7 percentage points until May. The considerable increase of the first group in May came as a result of the administered price rise of power. Such inflation changes are not under the control of the monetary policy.

Graphic 10: Annual inflation of the 4 main groups in the CPI (in %)

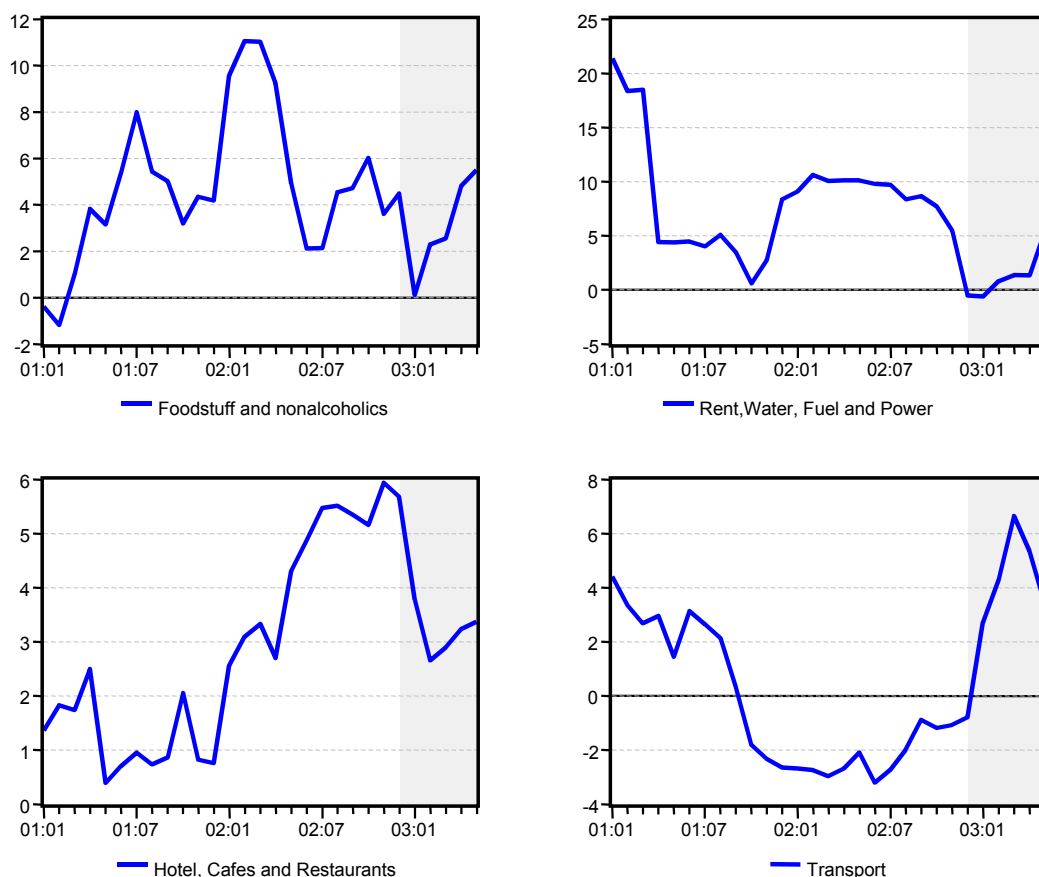


Table 6: The contribution of the main groups of the basket in the overall annual inflation (%)

	January	February	March	April	May	June
1. Foodstuff and non-alcoholic	0.05	0.99	1.11	2.09	2.34	2.23
2. Rent, water, fuel, power	-0.15	0.19	0.33	0.32	1.31	1.31
2.1. Power and fuel					0.34	
3. Hotels, cafeterias and restaurants	0.28	0.20	0.21	0.24	0.26	0.24
4. Transport	0.13	0.20	0.31	0.25	0.16	0.12
5. Other groups	-0.04	-0.04	-0.08	-0.07	-0.04	-0.90
Total	0.28	1.54	1.89	2.82	4.03	3.81

The “ Foodstuff and nonalcoholic” group contribution, in the overall inflation, increased by nearly 1 percentage points each month, until May. The main reason for this increase could be mainly found in the developments of the foreign sector. The main countries from which Albania imports, Italy and Greece, are characterized by relatively high inflation rates³, especially of fruits and vegetables. Similarly, this is a period when the national production is insignificant. On the other side, Lek is considerably depreciated (in annual level)

³ Compared to the objective of 2% of European Central Bank

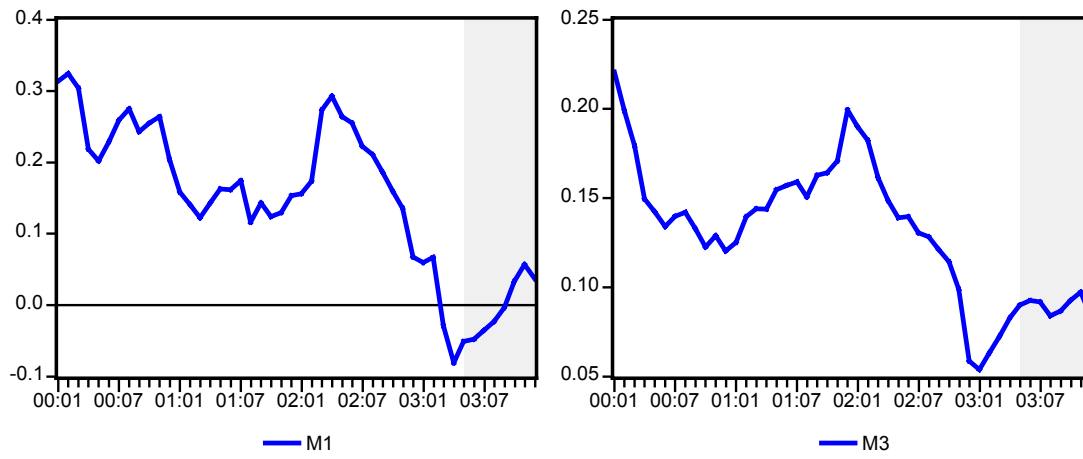
against Euro, especially during the first trimester of 2003. Combining these two effects it can be argued that the imported inflation must have been notable. The exact rate of this inflation depends on the weight occupied by different partners in the overall imports, and the weight of this later in the overall of the consumer basket. Regardless to these pressures, making a simple supposition that the quantity of imports occupies about 50 (30) percent of the basket, the potential imported inflation seems to be very high. Such a thing is partially confirmed also by annual inflation of agricultural products, which has been in a considerable way over 4 percent during all the period being analyzed. Though it seems that the potential imported inflation and that of the agricultural prices have moved in opposite direction, it could be argued that the first one is transmitted to the market price in one or two month delay. The probability of speculative price movements is always present, too.

Table 7: Annual inflation of imported countries, annual exchange rate change Lek/Euro, and the annual change of agricultural price (in %).

	Italy	Greece	Germany	Turkey	Lek/Euro	The potential imported inflation		Agricultural price change
						Weight 50%	Weight 30%	
Jan 2003	2.73	3.15	0.09	26.40	14.67	8.50	5.0	4.69
Feb 2003	2.46	4.39	0.27	27.03	15.05	9.00	5.4	6.29
Mach 2003	2.71	4.06	0.27	29.42	12.06	7.50	4.5	8.17
April 2003	2.62	3.37	-0.18	29.73	7.55	5.50	3.0	9.34
May 2003	2.90	3.5	0.6	-	5.60	4.20	2.5	9.64

In a situation when the imported inflation is thought to have been considerable, the monetary policy followed by Bank of Albania, results effective if we consider that inflation has not deviated much from the targeted interval of 2-4 percent. It should be said that the Bank of Albania applicable monetary policy instruments have been under control for most part of the period, considered having an impact during the first months of this year. The moderated increase of the government deficit has played an important role in achieving this control. The annual increase of the M1 and M3 monetary aggregates has been going downward, in order to compensate the influence of other factors, which exercised inflationary pressures, especially during 2002.

Graph 11: Annual changes of the monetary aggregate M1 and M3 (%)



Note: The shaded part is the forecast.

III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS.

III.1 MONETARY POLICY OF BANK OF ALBANIA

The first half of 2003 was characterized by the reestablishment of equilibriums in the monetary indicators. The money supply increase has been relatively weak as the result of the low demand of economy for monetary assets during this period. Nevertheless, the return of money outside banks in the system has achieved a satisfactory increase of the deposits in Lek, which has enabled the banking system to come out of the liquidity deficiency situation. Starting from February, the banking system is presented in liquidity surplus.

The low inflation levels in the first part of the year have given their contribution in the positive performance of the monetary developments. Inflation has been below the level of 4 percent during the first half of the year. This has had an impact on the high levels of real interest rates, which during the first four months of the year, have recorded their highest level of the last two years, stimulating the savings deposit in the banking system. The outstanding liquidity increase in the banking system has added pressures to the reduction of interest rates. During January-April period, the Lek deposits interest rates were reduced by 0.2 percentage points, whereas treasury bills yield interrupted the upward trend observed during the first two months of the year.

The Bank of Albania monetary policy, in response to the inflation and monetary aggregates amelioration, has had an alleviating direction during the first half of the year. The Bank of Albania Supervisory Board reduced by 0.5 percentage points the core interest rate on 23rd April. The banking system reacted quickly reducing the interest rates of Lek deposits and credits, as well as that of the treasury bills. The banking system reaction is considered as positive. Lek deposits interest rates were reduced by 0.55 percentage points in May, and the June-July data speak about a further reduction of them. Interest rates reduction from the banking system is also affected by the low inflationary expectations of banks. The reduction of the treasury bills yield after April was more rapid than that of the Lek deposits, reducing the banking system mediation cost.

Observing the continuous amelioration of the monetary situation and predictions on an inflation level within the objective, Bank of Albania reduced again the core interest rate by 0.5 percentage points in July. Thus, it brought interest rates close to their March 2002 level.

Bank of Albania has been present in the foreign currency market purchasing foreign currency during this period. This led to the liquidity launch in the market, and it has blocked up the Lek appreciation trends in this period. The Bank of Albania intervention in the foreign currency purchase has been another direction of monetary policy alleviation during the first half of the year.

The monetary conditions change in economy [dictated/ laid down](#) also the Bank of Albania operating framework suitability. Bank of Albania changed the direction of the Repo's operation in March, changing it from the liquidity injection to the absorption one. It has also withdrawn longer maturity terms liquidity from the market by means of monthly and three monthly Repo's auctions.

Bank of Albania monetary policy has enabled the observance of quantity objectives. The first part of 2003 has even had noticeable ameliorations in their observance.

Table 8: The quantity objectives' achievement of Bank of Albania.

	Dec'02	Jan'03	Feb'03	Mar'03	Apr'03	May'03	June'03 *
Objective achievement of BoA net international reserve (USD million)							
Objective	558.6	559.3	559.9	560.6	560.6	574.8	582.2
Actual	562.2	571.1	586.2	596.2	597.5	604.1	608.9
Diference	3.6	11.8	26.2	35.6	36.9	29.3	26.7
Object achievement of Net Domestic Assets of BoA (billion Lek).							
Objective	95.1	95.8	95.93	97.1	97.4	98.1	98.0
Actual	87.1	80.1	81.2	77.1	73.5	68.2	70.9
Diference	-8.0	-15.7	-14.8	-20.0	-23.9	-29.9	-27.2
Objective achievement of the domestic credit for the government(billion Lek).							
Objective	257.0	261.2	262.9	264.6	265.9	266.4	
Actual	259.6	262.8	264.4	263.1	261.9	261.1	
Diference	2.6	1.6	1.5	-1.4	-4.0	-5.3	

* Operative data

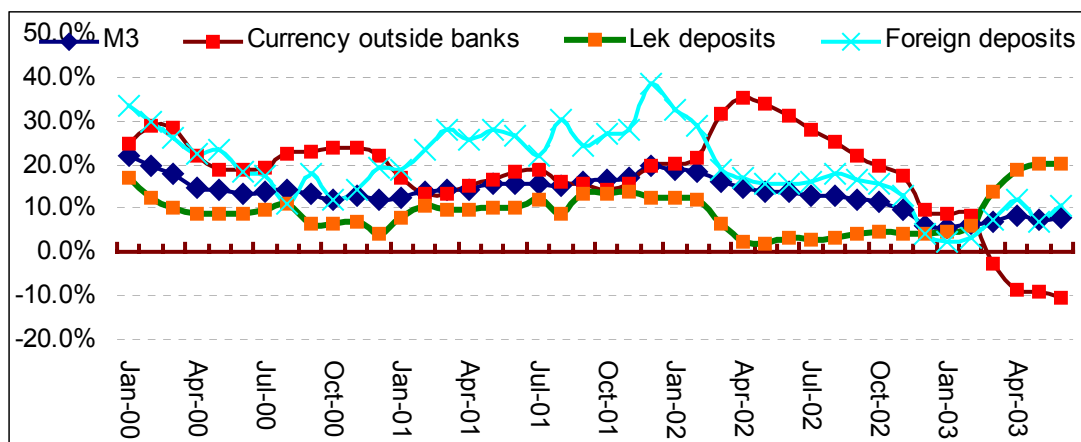
The increase of the net foreign exchange reserves as the result of the purchase in the foreign currency market, as well as the reduction of the monetary base level, as an aftermath of the return of money in the banking system, have influenced the growing of differences between quantity indicators and their objectives. Meanwhile, the relatively low government borrowing in the domestic market enabled, starting from March, the domestic credit objective for the government to recognize observance, too.

III.2 MONEY AGGREGATES PERFORMANCE

The first part of 2003 is characterized by the rapid return of money outside banks in the system. Its ratio against M3 came to 28.3 percent in May, being thus the lowest level of the last two months. Money put in the banking system has mainly taken the form of Lek term deposits, causing the decline of the M1 aggregate level. The annual increasing rate of the M1 aggregate, as the one of money outside banks, continues to remain negative during the first part of the year. The slow increase of the M1 aggregate maintains low the inflationary pressures coming from monetary developments.

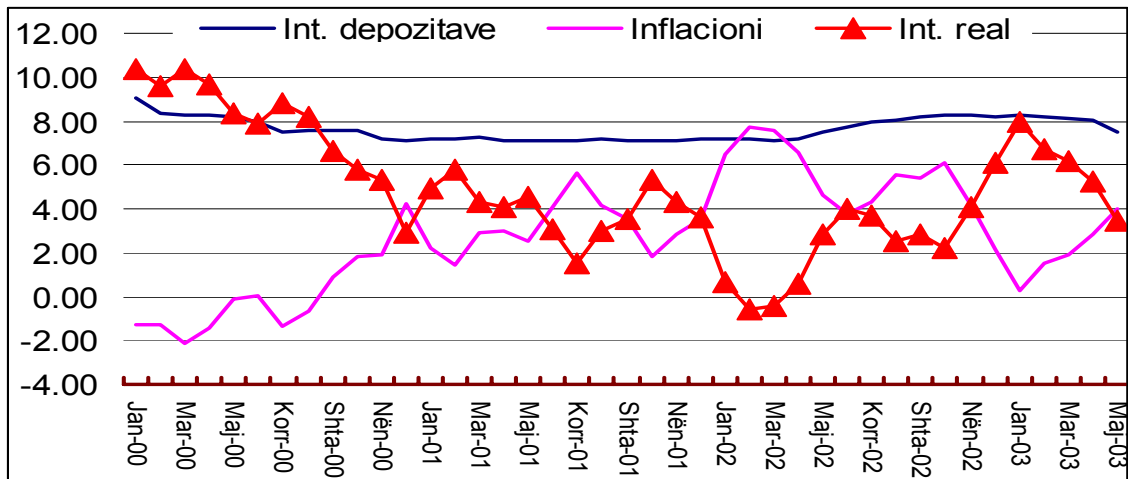
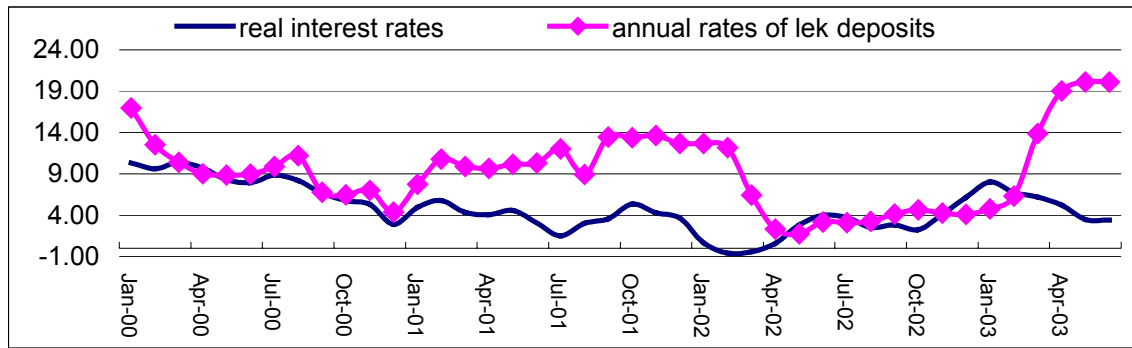
The increasing rates of monetary aggregates, except for the money outside banks, have been upward. In particular, Lek deposits present high increasing rates, as the result of the return of money in the system.

Graphic 12. Annual rates of monetary aggregates increase.



The return of money outside banks in the banking system is stimulated by the high level of real interest rates. The return of money in the system has brought a significant increase of Lek deposits. During the first five months of the year, Lek deposits increase was almost twice bigger than their annual increase in 2002. The June operative data speak about the continuing high rate of Lek deposits increase. Lek deposits are estimated to have increased by nearly Lek 19 billion during this month.

Graphic 13: Lek deposits interest rates and their annual increase.



The Lek deposits increase has brought the amelioration of the liquidity situation of banks. During the first half of the year, banks have passed from a liquidity deficiency situation of Lek 2.3 billion in December to an excessive liquidity of Lek 9.4 billion at the end of May. Starting from March, the month when the Repo's auction direction change, from the insertion to the liquidity withdrawal direction, was also decided, Repo's instrument has represented the main form of surplus reserves in the system. The high level of outstanding liquidity exerts a pressure on the reduction of interest rates. Bank of Albania intervened withdrawing Lek 3.5 billion liquidity from the market during May-June. Consequently, the outstanding liquidity of the banking system decreased at the level of Lek 7.2 billion, at the end of June.

The annual increasing rates of foreign currency deposits and M3, after the achievement of the several years minimum in January (respectively 2.2 and 5.4 percent), had a slight upward trend in February-May. The low increasing deposits rate in the first trimester was also stimulated by their continuous interest rates decline. The low increasing rate of foreign currency deposits proceeded in May, too. During this month, the foreign currency deposits were presented by a monthly decline of about 2.7 percent, although the annual increase continues to be positive.

Table 9: Monetary aggregate performance (in Lek billion)

	May 2003	Annual difference	
		Absolute	Percentage
Money outside banks	119.7	-12.1	-9.2
Total deposits	302.6	41.3	15.8
- Lek Deposits	211.4	35.4	20.1
- Foreign currency deposits	91.2	5.9	6.9
Required deposits	56.8	0.9	1.6
- in Lek	22.2	-1.5	-6.3
- in foreign currency	34.6	2.4	7.4
Term deposits	245.9	40.4	19.7
- in Lek	189.2	36.9	24.2
- in foreign currency	56.7	3.5	6.6
M1	141.9	-13.6	-8.7
M2	331.1	23.3	7.6
M3	422.3	29.3	7.4
Monetary base	152.4	-9.8	-6.1

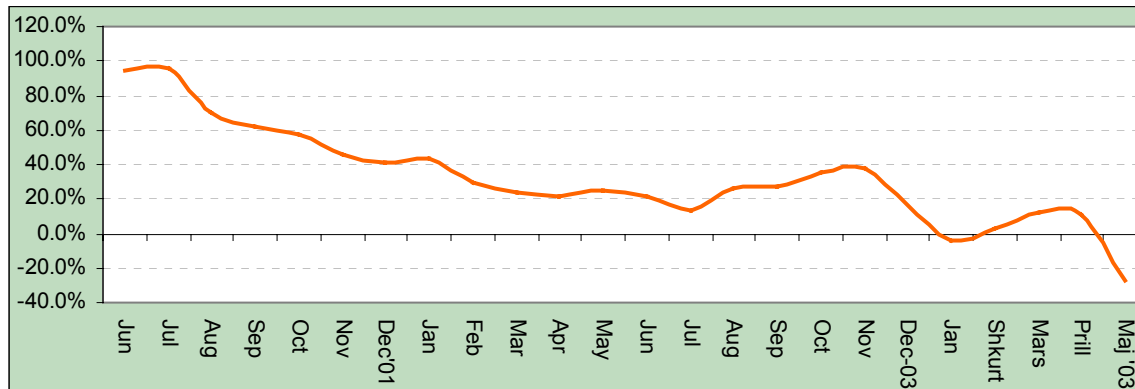
III.3 ECONOMY DEMAND FOR MONEY

III.3.1 NET FOREIGN EXCHANGE ASSETS OF THE BANKING SYSTEM

The net foreign exchange assets of the banking system until May 2003 were reduced by Lek 9.2 billion. The reduction of net exchange means in Lek came as a result of the over-evaluation by 11.5 percent of Lek against USD. The foreign exchange assets in USD increased by USD 88.8 million.

The increase of foreign exchange assets, expressed in USD, in this period is influenced by the purchase of nearly USD 43 million from Bank of Albania in the foreign exchange market. Moreover, the foreign exchange reserve increased also as a result of the Euro appreciation against Dollar by about 12.7 percent in international market during 2003. This latter has come up to the Euro investments value (converted in USD).

Graphic 14: Net foreign exchange assets contribution to the money supply (expressed in annual terms)



The foreign exchange purchase in the foreign exchange market influenced the liquidity launch in the system and the monetary supply increase. However, the contribution of the foreign exchange assets increase in the money supply is accounted to be negative, -27.6 percent in May 2003. Compared to the historical course, the contribution of the foreign exchange assets increase in the money supply growth during 2003 has been small. This is again due to the Lek exchange rate appreciation against USD, leading to lower net Lek currency assets.

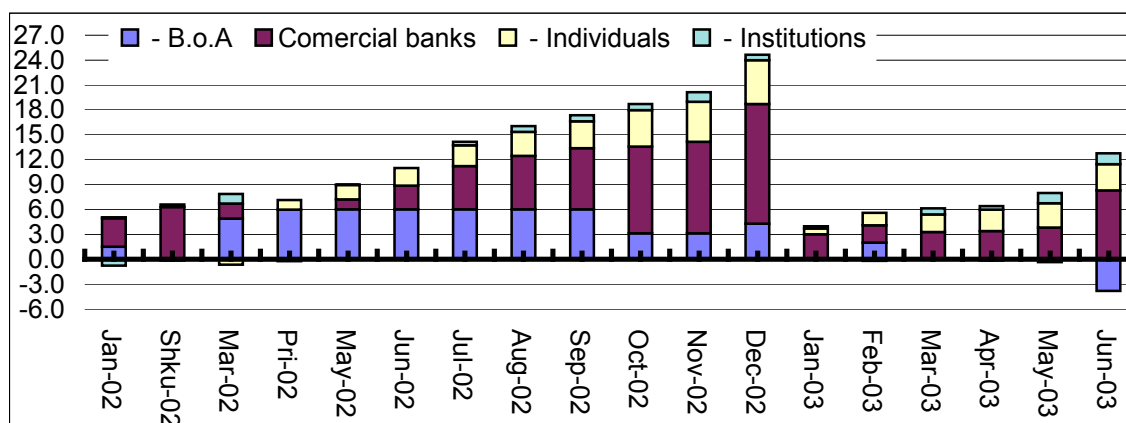
III.3.2 GOVERNMENT DEMAND FOR MONETARY ASSETS.

The budget deficit financing by means of domestic borrowing has been low. This is due to the limitations on the budget expenditures accomplishment, which were 82 percent of the planned ones during the first five months of the year, at a time when the budget expenditures accomplishment during this period was higher than expected.

Government demand for monetary assets does not constitute an important source in creating monetary assets. The budget deficit financing by means of treasury bills during January-May was Lek 8.9 billion compared to Lek 11.0 billion of the same period in the previous year. The banking system covered Lek 4.5 billion from this financing in the first half of 2003 compared to Lek 8.9 billion in the same period in 2002. Bank of Albania has not financed the budget deficit during this period. The liquidity increase in the system enabled the commercial banks cover totally government needs. The high interest rates of the treasury bills have affected the growing participation of households in the primary treasury bills auction. Their financing until June was Lek 3.2 billion, comprising an increase of 41 percent of their portfolio.

The budget deficit financing by means of treasury bills was Lek 1.2 billion during June. Meanwhile, the financing of the banking system during this month was only Lek 1.0 billion.

Graph 8. Cumulative performance of budget deficit financing during the year (in Lek billion)



III.3.3 CREDIT FOR THE ECONOMY

The credit activity of the banking system during 2003 is demonstrating a satisfactory performance. **The new credit** extended in the January-May 2003 period reached Lek 33.1 billion, nearly 43 times higher than in the same period in 2002. The credit for the economy is holding a growing weight in the structure of the banking system activities, and it represents an important source for the monetary assets demand.

Table 5: The performance of the main indicators.

	2000	2001	2002	T-1 2003	April 2003	May 2003
Money supply (in Lek billion)	328.1	394.3	416.7	420.6	422.4	422.3
Credit for the economy versus M3	7.1	7.1	9.3	9.6	10	10.1
Credit for the economy versus GDP	4.8	4.7	5.9	5.6 ⁴	5.9	5.9
Credit/Deposits ratio (in percentage)	10.1	10.2	13.5	13.5	14	14.1

The credit balance increased by Lek 4 billion during January-May 2003, coming up to Lek 42.7 billion at the end of May

⁴ This report is based on the estimated GDP of 2003.

An amelioration of the term structure credit was noticed during 2003. The medium-term and the long-term credit have presented upward trends during this period. The credit delivery in medium-term and long-term maturities during January-May 2003 reached about Lek 10.1 billion, consisting nearly 1/3 of the new extended credit. In relative terms, the growth of the medium-term and long-term credit surplus accounts for 56 percent of the credit surplus increase during the first five months of 2003.

Foreign exchange loans are still holding a predominant feature in the economy credit. The new credit delivered in foreign exchange occupies 63 percent of the new credit delivered during the five-month period. Although its ratio is in continuous downward, the foreign exchange surplus continues to be predominant in the loan structure. This credit accounts for 78.5 percent of the total credit balance. The stability of Lek exchange rate and the lowest interest level of foreign exchange credit justify the foreign exchange borrowing preference.

The trade sector continues to be the most preferred sector for loans. The loans in the trade sector constitute 40.5 percent in the credit balance. A credit increase in the agricultural sector was noticed in this period. The preference for construction sector, however, demonstrated a slight decrease compared to the end of 2002.

A positive development of the credit activity during the first months of 2003 was also the amelioration of the commercial banks credits portfolio. The non-performing loans level was constantly downward during the first five months of the year, falling from 10.1 percent of the loans total portfolio in December 2002 to 8.7 percent of the May 2003 portfolio.

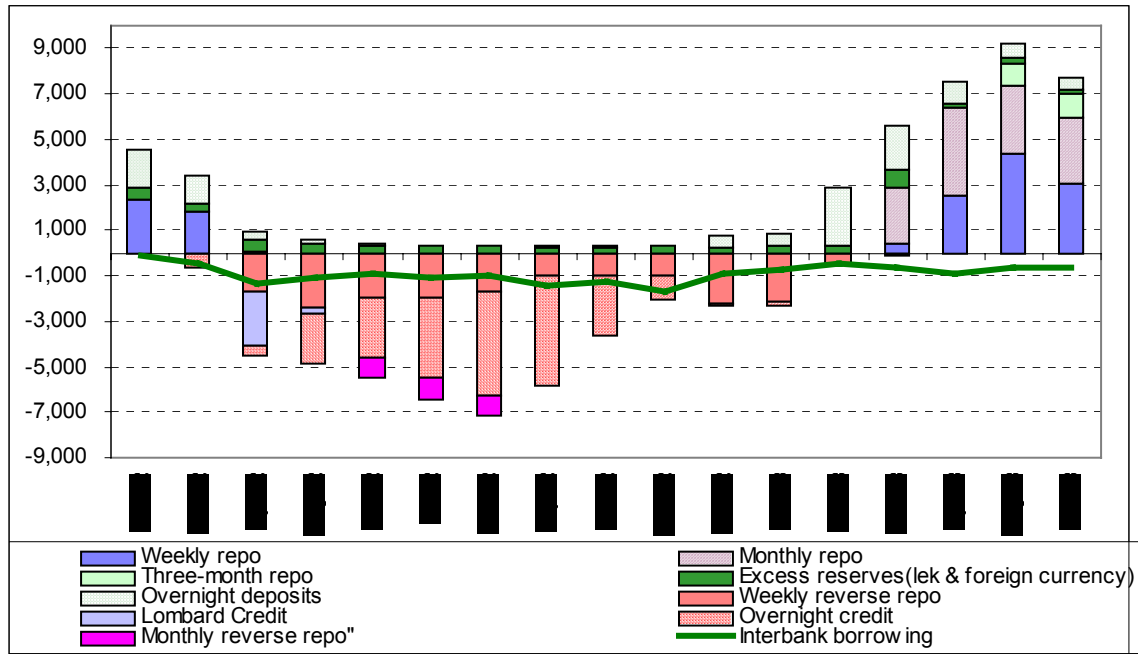
IV. FINANCIAL MARKETS AND INTEREST RATES.

IV.1 FINANCIAL MARKETS

IV.1.1 INTER-BANK MARKET

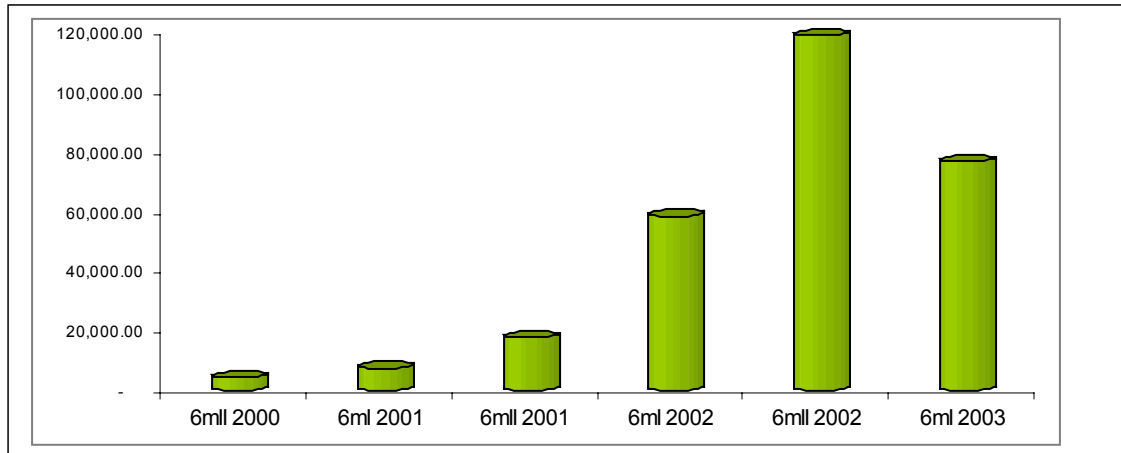
The liquidity level in Lek has been constantly rising and it reached the maximum level in May 2003, to be then reduced during June 2003 as a result of the structural intervention of Bank of Albania in the market by selling treasury bills in the quantity of Lek 3.5 billion. The change of market conditions from liquidity deficiency to liquidity surpluses, was influenced by the gradual and constant rise of the deposits level as well as by the steady, with a falling trend, level of government needs in the securities market.

Graphic 16: Liquidity change in the banking system (Lek billion).



The Lek liquidity surpluses growth in the banking system was followed also by the decreasing demand for borrowing in the inter-bank market. The volume of transactions performed in this market during the first half of 2003 constitutes only 64.6 percent of the transactions performed in the second half of 2002. Banks' needs for liquidity have been short-term. Thus, 94.9 percent of the inter-bank transactions have aimed the fulfillment of the daily banks' needs for liquidity, whereas the remaining part fulfilled the one-week needs.

Graphic 17: The six-month transaction volume in inter-bank market, in Lek million.



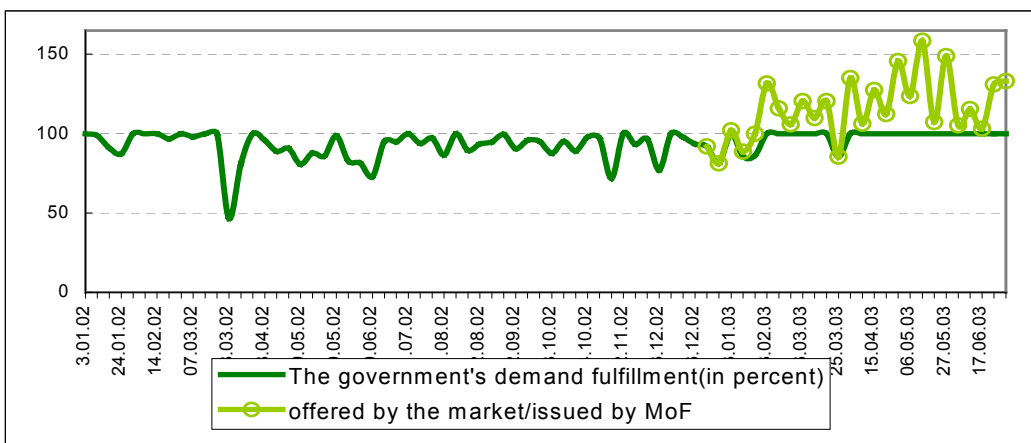
There were ten banks participating in this market. With some exceptions, all the participants were presented in ending as well as in borrowing position.

IV. 1.2 GOVERNMENT SECURITIES MARKET

The sale of treasury bills in the primary market has been the main form of fulfilling the government demand for internal financing. The state budget demand for funds has been in gradual decline. Thus, the value of the new treasury bills issues is recorded to be lower than the maturities' value in the last auctions.

This demand was faced with rapid amelioration of the liquidity situation in the banking system and with the households growing interest for these securities.

Graph 18. Government demand fulfillment for treasury bills from the market



The commercial banks, various non-bank financial institutions and households have been the participants in the primary market. On 10th July 2003, the portfolio of commercial banks increased by 0.62 percentage points compared to the end of 2002, whereas the households portfolio increased by 1.05 percentage points, which shows the interest these securities represent for the households. The main contribution in this increase by 0.95 percentage points belongs to the household's teller, opened in Bank of Albania and in its branches throughout the country.

Table 11: Households investments (in Lek million).

	2001	2002	10 July 2003
Banking system and Bank of Albania	2,505	7,810	11,141
Bank of Albania	373	5,065	8,009

Besides treasury bills trade in the primary market, the government has also issued two-year term bonds, in figures varying from Lek 300.0 million to Lek 500.0 million, in the course of regular monthly auctions.

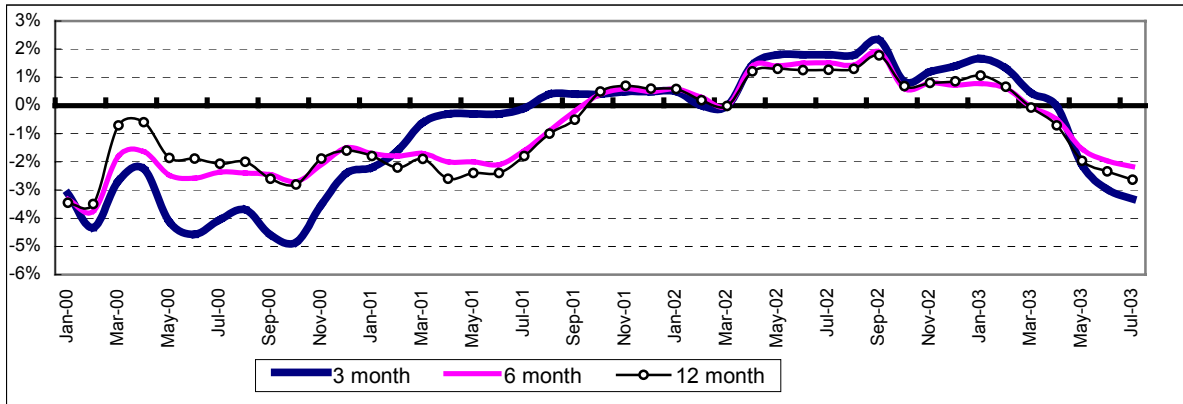
The market demand has been considerably higher than the amount declared by the Ministry of Finance, except for January 2003. This shows the growing interest of banks in these securities. As a result of the growing competition in these auctions, the uniform yield⁵ is noticeably presented below the coupon interest presented by the Ministry of Finance, recording a downward trend. Thus, this yield in June 2003 resulted 3.41 percentage points lower than the yield of December 2002.

IV.2 INTEREST RATES PERFORMANCE

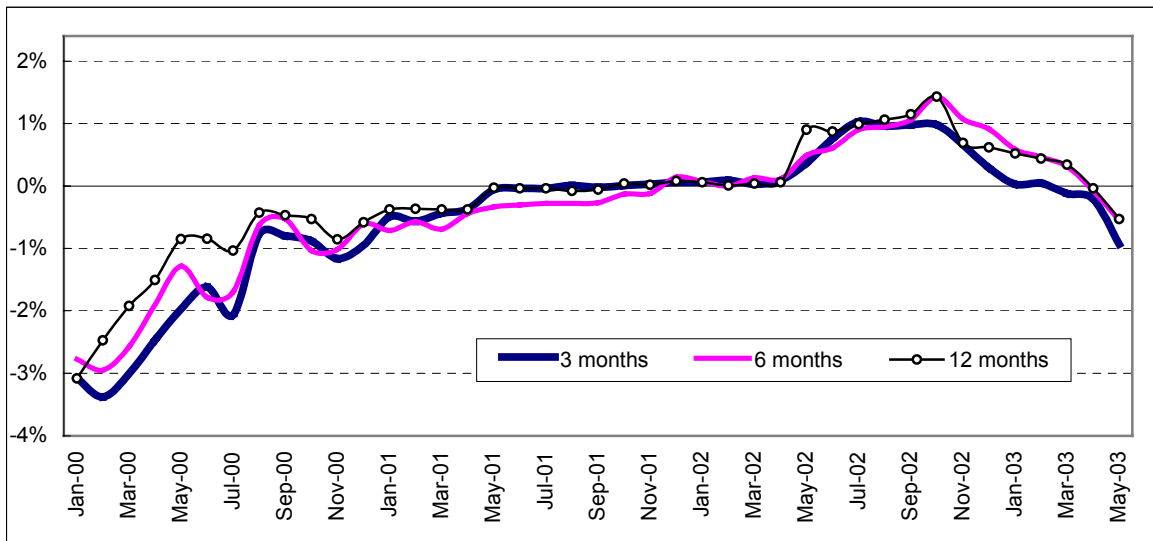
The Lek interest rates were reduced in all the markets during the first half of the year, manifesting different downward speeds in relation to the time span.

⁵ Uniform yield is called the maximal accepted yield in auction, by means of which all the winning demands of that auction are treated, albeit the yield of competitive offers.

Graphic 19 .The six-monthly change of average weighted yield of the treasury bills in primary market (in percentage points)



Graphic 20. The six-month change of the term Lek deposits average weighted interest (in percentage point)



The interest rates in markets were reduced to more modest levels until the end of April 2003 compared to the following period. Thus, until the end of April 2003, the interest rates reduction was affected by the pressure emerged in the market by such factors as the Lek liquidities increase in the banking system, especially in the Savings Bank, the holding of the refinancing position of Bank of Albania until 20th March 2003, or the stable level of government supply on treasury bills in the market.

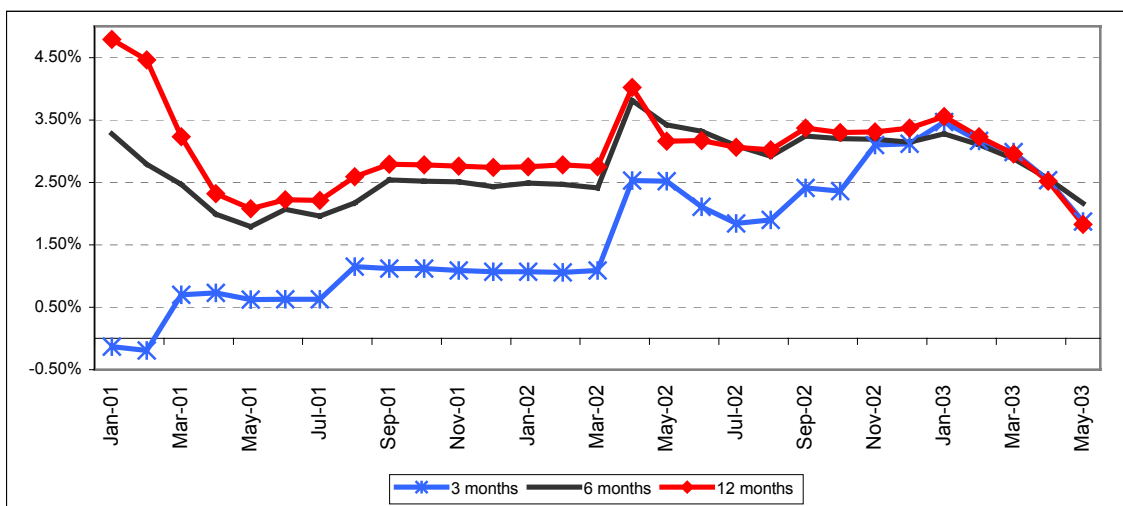
The reduction speed of the interest rates increased after the Bank of Albania decision on the reduction of the Repos` interest rate by 0.5 percentage points on the 23rd April 2003, which signaled the market on the monetary policy alleviation.

The first changes were noticed in the inter-bank transactions` interest, where the reduction by 0.5 percentage points was totally reflected. The yield reduction in the treasury bills market has been more rapid compared to the reduction of the deposits interest for the three maturities.

Table 12: Interest rates spread (in percentage points)

	Deposits interest rates spread	Treasury bills yield spread		Credit interest rates spread
	January- May 2003	January-May 2003	January-1 st July 2003	January-May 2003
3-month	-0.98	-2.96	- 3.32	
6- month	-0.50	-1.94	- 2.17	-1.50
12- month	-0.46	-2.66	- 2.63	- 3.20
1-3 years				+0.50
Over 3 years				- 5.40
Average weighted	0.68	-2.52	- 2.71	- 3.00

Graph 21: The interest rates spread between treasury bills and deposits according to the maturities (in percentage point)



Consequently, this influenced the spread narrowing between deposit's interests and credit ones, reflecting thus an inter-bank growing competition.

The Lek interest rates downward trends are expected to be more alleviated also during the second half of 2003, due to the decision on the reduction of the Repos` interest rate by 0.5 percentage points on the 23rd April 2003, which signaled the market on the monetary policy alleviation.

The interest rates of the two main currencies have been going downward in the foreign currency deposits market, following the manifested trends during 2002. Thus, compared to the end of 2002, it results that in May 2003, the average

interest of the USD deposits was reduced by 0.15percentage points, and the same type of interest for EURO was reduced by 0.35percentage points.

On the 5th 2003, the European Central Bank reduced the core interest rate by 0.5percentage point, and on the 24th June 2003, Fed reduced the core interest by 0.25 percentage points. These movements of the European Central Bank and Fed during June 2003 are expected to influence the reduction of EURO and USD interest rates even in our domestic market.

Before January-May 2003 period, it was noticed the narrowing of the six-monthly interests spread, except for the 1 – 3 year term loans in the credit market. Despite this, the fluctuations of these spreads remain higher than in other markets, and the transmission mechanism continues to remain weak. This happened, mainly as a result of the low competition level in this market, where the Savings of Albania, the largest owner of liquidities in Lek, was not allowed to credit the economy, whereas other banks preferred mainly foreign currency loans in the private sector.

V. ALBANIAN ECONOMY PERFORMANCE IN THE FOLLOWING YEAR.

V.1 ECONOMY INDICATORS OF THE REAL SECTOR

The medium-term program of the country's development, predicts keeping a growing economic annual level of 6.0 percent during 2003-2005. The problems that hit the Albanian economy during 2002 influencing the growing rate reduction by 4.7 percent in this year, will be acting in a more alleviating way during 2003. The exposure of the Albanian economy versus the power supply problems is expected to be low. Also, the monetary developments stabilization will help the consumption and investments stimulation, attaining a support for the growth of the credited businesses.

The fiscal policy will keep an unchanged attitude from the previous years. The budget expenditures compared to the GDP will fall nearly to the 29.6 percent GDP level. However, they will have an upward trend during this period, passing from 29.6 percent of the GDP in 2003 to 30.2 percent of the GDP in 2005. The budget expenditures are expected to have a greater orientation towards the capital expenditures. Their ratio against the GDP is predicted to increase from 6.1 percent in 2002, to 6.5 percent in 2003. The gradual increase of the budget expenditures will not have a negative effect on the budget deficit, as it will be cover by the government revenues increase. These latter ones are predicted to increase during the 2003-2005 time span, coming up to 25.3 percent of the GDP in 2005.

The trade balance deficit is predicted to narrow down in relative terms during 2003, falling form 8.9 percent of the GDP in 2002 to 8.5 percent in 2003. The emigrant's incomes will continue to be an important source in covering the deficit. They are estimated to cover nearly 50 percent of the trade deficit. However, the lack of the privatization revenues has affected the reduction of projections on the foreign exchange reserve growth compared to the previous years.

The budget deficit is estimated to come up to 6.4 percent of the GDP from 7.5 percent in 2002. The deficit will be mainly covered by the foreign financing, foreign budget support and by the credits for development. The foreign financing is estimated to cover nearly 45 percent of the overall deficit. The remaining part of the deficit will be covered by domestic sources, mainly from the internal borrowings. The revenues from the privatization are estimated to be only 0.1 percent of the GDP. The domestic borrowings will be 2.7 percent of the GDP, rather less than the level in 2002, which was 3.2 percent. In absolute figures, the domestic borrowing will be Lek 20 billion in 2003 against Lek 21.7 billion in 2002. The banking system financing is estimated to be 2.4 percent of the GDP or Lek

18 billion, from the domestic borrowings. The remaining part of the financing will be covered by households and institutions.

The Bank of Albania target of inflation during this period will be keeping the annual change of consumption prices within the level of 2-4 percent. Bank of Albania aims to control the monetary supply increase at the 8.4 level during 2003 with the intention of fulfilling that objective. The monetary supply increase will take mainly the form of increasing deposits, which will constitute 93 percent of the M3 increase. The high real interest rates will influence the return of money in the system in the first quarter, and they will help in keeping this ratio in the other quarters. The monetary program of 2003 predicts a more rapid relative increase of Lek deposits compared to the money outside banks.

Table 13. The monetary supply increase as to the quarters (in Lek billion).

	T1	T2	T3	T4	2003
Monetary supply	4.6	10.9	9.5	10.0	35.0
Money outside banks	-9.0	3.5	3.7	4.3	2.5
Lek deposits	12.4	2.8	3.7	2.6	21.5
Foreign exchange deposits	1.1	4.5	2.2	3.2	11.0

The Lek deposits increase during 2003 will cover the government demands for monetary assets and it will keep the excess reserves in the system at satisfactory levels. The banking system is predicted to be in excess liquidity situation for most part of the year.

The credit balance for the economy is estimated to increase by Lek 12.9 billion during 2003, which means an annual increase of 33.4 percent. The surplus increase of credit in Lek and in foreign exchange will reflect the structure offered by the new credit. In conformity with these predictions, the balance credit increase in Lek, in the following year is estimated to be Lek 5.1 billion or 40 percent of the balance credit increase.

The foreign exchange deposits are predicted to increase by 12.0 percent in 2003 compared to an annual increasing average of 30.1 percent during 1999-2001. The slow increase of the foreign exchange deposits was influenced by the high spread of foreign exchange and Lek deposits interest rates and by the Lek appreciation against USD, which is the currency of the majority of foreign exchange deposits.