

BANK OF ALBANIA

**SIX-MONTH REPORT
OF
MONETARY AND ECONOMIC DEVELOPMENTS
JANUARY - JUNE 2004**

JULY 2004

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GOVERNOR'S SPEECH

World economy over 2004 went on preserving the last year-end paces, recording positive developments of the main indicators. The driving fiscal policies and easing monetary policies of the two past years have provided obvious effects in the growth of the American economy, whereas the economy of the euro area has presented somewhat lower growth rates. The American dollar, after the historical depreciation at the level of 1 euro equivalent to 1.283 American dollar in February, went on fluctuating around the level of 1.2, based mainly on the positive data of employment in the following months.

While the driving policies in the developed countries are livening up the aggregate demand and the economic climate, the preliminary data, though limited, show that the Albanian economy went on keeping the previous growth rates, at the limit of about 6 per cent. The ensuring of macroeconomic stability, improvement of the energy situation in the country, the relatively satisfactory level of the agricultural production and the better support of economy needs for financing from the banking system contributed to the driving of economic activity over 2004.

The favourable climatic conditions during this period, the growth of the surfaces planted, especially in the greenhouses, and the improvements in the technology used by the farmers, reinforce the evaluation for a growth higher than the agricultural production forecasts during 2004. It is assessed that even sectors of industry, such as transport and services, present a growth. The estimations on the economy growth are supported even by the latest employment data, according to which the unemployment rate in the first quarter of the year declined to 14.9 per cent. However, not all economy sectors have confirmed the forecasted growth rates. The data of the first quarter suggest that the construction sector had an underlined decline in comparison to the same period of the preceding year. This decline is noticed in the number of construction permits, in the surface and fund projected for construction, leaving the way open for doubts concerning the performance of this sector.

Fiscal policy continued to be prudential, reflecting a satisfactory performance within the programmed framework. At the end of June the budget deficit resulted to Lek 8.4 billion, representing about 82 per cent of the forecasted level for this

period. This performance has reflected mainly the non-fulfillment of capital expenses of the government at the level projected for this period. However, these expenditures are forecasted to be accelerated for the rest of the year in consequence of the use of half of income from the Savings Bank's privatization for financing the public projects.

Developments in the external sector of economy during the first quarter of 2004 maintained almost unchanged the trends noticed during the recent years. The overall balance of payments for the first quarter of 2004 marked a positive level at USD 15 million, while the developments in the current account still do speak for an economy with a still small productive base and a low degree of competition in the region and further. The first quarter was closed with a current deficit over 2 times higher than the relevant quarter of the previous year. The deepening of the current deficit was due to trade deficit rise and a slight deterioration of the balance of services, while the balance of income and that of the current transfers remained almost unchanged.

Inflationary pressures were generally kept under control during the first half of 2004. The annual inflation rate indicated an upward trend during the first three months of the year, reflecting mainly inflationary pressures of the administered price rise, to be later on stabilized within the two-to-four per cent targeted range during the second quarter of 2004. The demand factors have provided a positive impact in the inflation performance during this period. The stable liquidity situation, the keeping under control of the monetary aggregates and the maintaining of domestic financing of the government within the permitted limit have created a suitable monetary environment to control inflation. The fiscal policy, in turn, has reflected a controlled performance of the budgetary expenditures without exerting inflationary pressures during this six-month period. The impact of the supply factors has been dual. During the first quarter of the year, inflation is negatively impacted by the supply factors, such as price rise of energy, bread and transport. The downward correction of the fixed phone tariffs in April and the bread price cut due to competition, as well as the entry of the domestic production in the domestic market impacted on the reduction of the inflation rate during the second quarter of the year. Also, the lek appreciation against the euro and the US dollar during this period has significantly smoothed the imported inflation effect.

The lek exchange rate is appreciated respectively by 6.4 per cent and 5.4 per cent against the euro and the US dollar. In the long run, this performance mirrors the consolidation of the economic stability in the country and the growing

confidence in the domestic currency. Meanwhile, this period is featured even by some specific factors, which have all operated in line with lek appreciation. Without going into details, I would mention that the season's effect of the entry of the domestic agricultural production has been more rapid and stronger during 2004. Also, the commencing of tourism earlier than in the previous years has impacted on the foreign currency supply rise from the tourists and emigrants, helping in the lek appreciation. Meanwhile, the demand for lek has remained strong due to interest rate spread between the lek and the foreign currency; a spread which, though low, has triggered the interest of economic agents for monetary assets in lek: deposits and treasury bills.

The monetary policy during the first six-month period has continued to be eased. The inflation target stability and its positive experience have made necessary the adjustment of monetary policy in terms of easing the monetary conditions in the economy. The Bank of Albania has cut three times the base interest rate within April-June 2004. Given that each cut has led the base interest rate towards new historical minimums, the Bank of Albania has acted prudentially, cutting it by 0.25 percentage point each time. The Bank of Albania policy with the base interest rate has led to the reduction of interest rates in the financial markets. The commercial banks' reaction to these operations is estimated as satisfactory. The money cost reduction will serve to encourage lek credit to economy, so as to reduce the government debt cost and smooth the lek appreciating pressures noticed in the recent periods.

Credit to economy during this six-month period has maintained the growth rates already noticed in the recent years. During this period the credit balance has increased by Lek 5.5 billion, about 25 per cent higher than the one recorded in the same period of the previous year. The structure of the credit balance by terms is presented with a rise of the mid-term and long-term credit balance, whose weight is raised by 61.5 per cent of the credit balance from 54 per cent it was at the end of 2003.

Current developments in economy and expectations for the rest of 2004, speak for a stability period. More concretely, this macroeconomic framework implies the maintaining of economy growth rate at about 6 per cent in the mid-term period, under the conditions of an annual inflation rate within the targeted band. The economic growth will make the current deficit level, as a relative expression to gross general product, remain more or less in the same levels with those of the previous year.

Both basic policies, either fiscal or monetary, will continue to be prudential in accordance with the financial program of the development of the country. It is estimated that the Savings Bank's privatization incomes have created a more convenient position for the state budget, though more attention should be paid to the quantitative fulfilment of capital expenditures.

On the other hand, the monetary policy will continue to follow prudentially the inflationary developments in the economy, considering them from a more complete viewpoint, including even developments in the other main indicators of economy. Given the above, the Bank of Albania will be prudential in its political decision-making, reflecting month in month out not only the economic developments inside the country but even events happening in the international market, having the maintaining of price stability as its main objective.

The Bank of Albania will intend to preserve easier monetary conditions in the economy, which are consistent with the maintaining of price stability. This policy drives the country's economic development. It tends to maintain low interest rates in support of credit to economy as well as an acceptable level of the exchange rate in support of long-term stability of the foreign currency position in Albania. Viewing in this light the latest developments in the economy, especially the positive perspective of inflation performance, monetary indicators stability and exchange rate behaviour, the Bank of Albania deems suitable to make another step in the cycle of easing the monetary policy. A moderate reduction of the base interest rate would serve to encourage crediting and economic development, without infringing the macroeconomic equilibrium of the country.

I. ECONOMIC DEVELOPMENTS DURING THE FIRST HALF OF 2004

I.1 WORLD ECONOMY

The world economic growth started to consolidate during the third quarter of the previous year, continuing to have the same tendency even during the first half of 2004. The driving macroeconomic policies have undoubtedly provided their impact on this growth, influencing the encouragement of investments and consumption, business climate improvement, this being testified even by improvement of the confidence index and the world trade growth. The geopolitical risks related to terrorist attacks have impacted mainly on oil price rise, being reflected even in the rise of inflationary pressures during the recent months, but they do not seem to have put into question the economic growth stability.

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

	GDP (First quarter)	Unemployment	CPI	Budget deficit (% of GDP)
Britain	3.0	4.7 (Feb)	+1.5 (May)	-2.9
France	1.7	9.8 (Apr)	+2.6 (May)	-3.8
Germany	1.5	10.5 (May)	+2.0 (May)	-3.7
Italy	0.8	8.5 (Jan)	+2.3 (May)	-3.1
Japan	5.6	4.7 (Apr)	-0.4 (April)	-7.1
USA	5.0	5.6 (May)	+3.1 (May)	-4.7
Euro Area	1.3	9.0 (Apr)	2.5 (May)	-2.7

Source: Magazine "The economist", 26 June – 2 July 2004.

In spite of the positive direction of the developments of world economy, the growth rate has not been the same in all the regions of the world. The American economy is distinguished for a higher dynamism, marking even the best indicators of the economic growth. The high domestic demand, constant growth of industrial production and growth of private investments in businesses due to favourable financing conditions are the factors that determined the rapid growth of American economy. However, this growth has not cured the big problem that the American economy has with the current account deficit. On the contrary, the growth of domestic demand and the high budget deficit have made the trade deficit go on increasing. For the first quarter of the year, this deficit is estimated to be about 14 per cent higher than in the same period of the previous year, constituting a constant concern for the stability of macroeconomic indicators of the USA, particularly of the USD exchange rate.

At the end of June, FOMC decided to raise, for the first time after four years, the key interest rate of USD. The decision was taken since inflationary pressures increased in the American economy due to the economic growth and oil price

rise. The key interest rate rise was modest, 0.25 percentage points, leading it to 1.25 per cent, but it is expected to be followed by other rises over the year.

The economy growth rate of the euro area has been somewhat more slow. According to the latest data, it is estimated that the growth rate of GDP for the first quarter of the year in comparison with the same period of the previous year is 0.6 per cent. The low domestic demand is one of the main factors that impacted on this moderate growth rate. The euro area economy growth during the first half of the year is based mainly on the external demand and exports.

Box 1 European Union enlargement

On 1 May 2004 ten new Member States joined the European Union: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia, leading to 25 the number of the Member States of this Union. This is the largest enlargement as far as concerns the number of countries but not in terms of the economic weight. The total number of population increased by about 20 per cent, whereas GDP raised by 5 per cent.

Some economy indicators of the European Union, United States of America and Japan

		Unit	EU 15	EU 25	USA	Japan
Population	2004	Mln	380.8	454.9	291.4	127.7
GDP (% of worldwide GDP)	2002	%	26.8	28.1	32.5	12.3
GDP	2002	Euro-Billion	9.172	9.615	10.980	4.235
GDP per capita	2002	Thousand Euro	24.0	21.1	37.7	33.2
Exports	2002	% of GDP	10.9	9.5	6.5	9.9
Imports	2002	% of GDP	10.8	9.8	11.1	7.6
Unemployment rate	2003	%	8.0	9.0	6.0	5.3
Budget deficit	2002	% of GDP	-2.0	-2.1	-3.4	-6.1

Source: Monthly report of the European Central Bank, May 2004.

The European Union enlargement implies also the expansion of the Joint European Market, bringing about a raising competition in it. Under the conditions of scale economies and the raising of competition, it is expected to have lower prices and higher productivity, impacting on economic growth. The membership of new countries has brought about the change of the weights of economy sectors. So, the weight occupied by the agricultural sector in the structure of the production of the new Member States is larger in comparison with the weight that these sectors occupy in the production structure of the European Union.

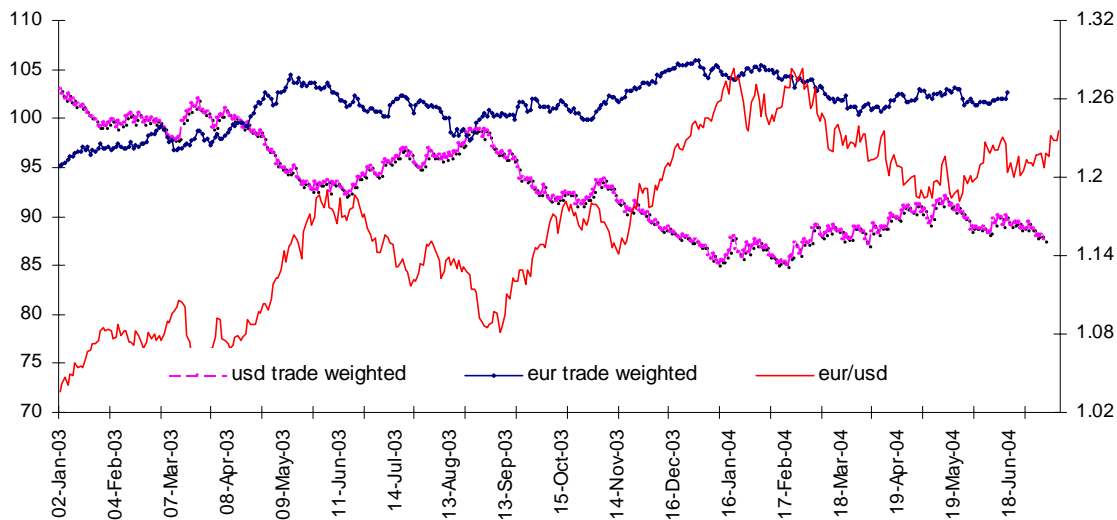
In the long-run, the union will contribute to the growth of economy and the welfare of the European Union, since it will serve for enhancing the “four freedoms” – free movement of goods, services, capital and work. The development pace of this great community will depend on the harmonization of new and old policies and on the structural forms to be undertaken for increasing the flexibility of the joint market.

In spite of the overvaluation of the euro, the euro area exports continue to grow and the current account continues to mark surplus since June 2003. Meanwhile, the weak economy situation has worsened the performance of public finances. The average rate of the budget deficit to GDP continues to be at 2.7 per cent. Furthermore, six countries - Germany, Greece, France, Italy, Netherlands and Portugal – have this rate above the 3 per cent allowed by the Maastricht Treaty. This surpassing reduces considerably their room for an upward fiscal policy.

International exchange rate

During the first half of 2004 the euro continued to be appreciated in nominal effective terms, reflecting appreciation against all other currencies. At the beginning of the year one euro was exchanged with 1.26 US dollars, reaching the six-month period peak in February 17, when one euro was exchanged with 1.2833 US dollars. The positive signals coming from the American economy during May, especially with regard to good conditions of the labour market made the US dollar gain ground, reaching the lowest level of this period when one euro was exchanged with 1.181 US dollars. The data released in the second half of May on the deterioration of the American current account deficit made the Euro re-gain all the lost points.

Chart 1 Effective nominal exchange rate of the euro against the US dollar and the spot exchange rate of the EUR/USD over January 2003 – June 2004



Source: Bloomberg.

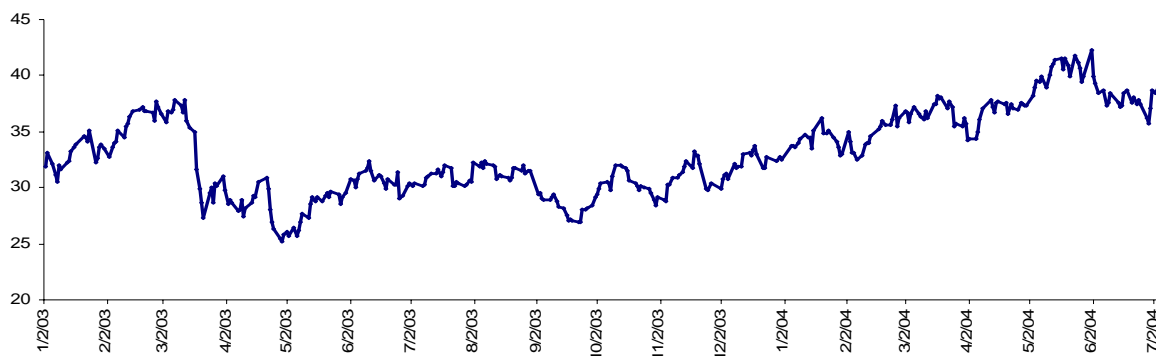
According to procedures and mutual agreements, it was decided on June 27 2004 to include the currencies of Estonia, Lithuania and Slovenia in the ERM II¹.

¹ ERM II is the preliminary stage of adopting the euro.

Oil prices

Oil prices raised significantly during the first half of the year, causing concerns for all the economies of the importing countries, since they have increased the inflation rate in these countries and have impacted negatively on the economy. The large increase of the demand for oil and the grave situation in the Middle East impacted on the oil price rise. It is estimated that the demand for oil is currently in its highest levels in the last 16 years. The development of the American economy and the expansion of the Chinese economy has increased significantly the demand for oil. At the same time the oil companies try to be more efficient, reducing the stock level with which they operate in the market. Thus in the event the production is interrupted, the markets have less reserves.

Chart 2 Crude oil prices, January 2003 – June 2004



Source: Bloomberg.

It was agreed in the meeting of the OPEC ministers in Beirut on the 3rd of June 2004 to boost the oil production. This decision was reflected immediately in the oil price cut both in the American market and the British market (Brent crude).

1.2 COUNTRY'S ECONOMY

The stabilizing economic policies, the dynamic development of the private sector and a relatively peaceful political period have made the economy mark a rapid growth during the recent years. The Albanian economy has grown, on average, by 6.1 per cent during the past three years and is forecasted to grow by about 6 per cent during 2004. The year 2004 presents an overall favourable situation for the economic development. Based on the macroeconomic stability, the reduction of the energy problems, the satisfactory agricultural production and the largest support of the economy needs for financing from the banking system will drive the economic activity. Also, the use of a number of incomes from the Savings Bank's privatization for financing the public projects will provide a development impulse to economy for 2004, establishing simultaneously a better infrastructure for the economic growth in the medium and long run.

Table 2 Real GDP growth

	2002	2003	2004*
Economy	4.7	6.0	6.2
- Industry	1.8	2.7	3.1
- Agriculture	2.1	3.0	3.0
- Construction	8.7	11.3	10.6
-Transport	9.7	10.8	10.1
-Services	5.1	6.4	6.4

*2004 forecast

Source: Ministry of Finance

The analysis of the economic indicators available to the Bank of Albania shows that the Albanian economy, in spite of some weaknesses noticed in certain sectors, could meet its economic growth target by about 6 per cent projected for 2004. The domestic demand has generally reflected upward trends. So, in the first quarter of this year, the import of vehicles, television sets and washing machines is raised by 24 per cent, 89 per cent and 48 per cent respectively in comparison with the same period of the previous year. The obvious consumption of fuels is 9 per cent lower than the first quarter of 2003 and 29 per cent lower than the last quarter of the previous year. Particularly the sectors of agriculture, industry and transport are presented with quite improved indicators in comparison to the previous year, at a time when a deterioration was marked in the construction sector. Also, foreign investments were estimated at 35 million US dollars for the first quarter of the year, recording a decline of 8 per cent from the first quarter of the previous year.

I.2.1 PERFORMANCE OF THE ECONOMY SECTORS

AGRICULTURE

The data of the Ministry of Food and Agriculture indicate a good performance of the agricultural production during the first half of the year. The favourable climatic conditions during this period, the enlargement of the planted surfaces and especially the increase by about 12 per cent of the surface used for greenhouses, as well as improvements in the technology used by farmers reinforce the assessment that the agricultural production during 2004 has increased according to the projections, in all its sectors.

Table 3 Agricultural production forecasting by sectors over 2004

	Growth (in %)	Value (in billions of Lek)
Agriculture	3.0	194.7
Agroindustry	10.0	41.5
Fishing	4.0	2.4
Total	4.0	238.6

Source: Ministry of Food and Agriculture

The agroindustrial production for the first quarter of 2004 is estimated at Lek 6.3 billion, being increased by 20.4 per cent in comparison with the first quarter of 2003. The experience of the previous years suggests that the processing of agricultural products reaches its peak during the second half of the year.

Table 4 Industrial production during the first quarter of 2002-2004

Q1 2002 (in millions of Lek)	Q1 2003 (in millions of Lek)	Q1 03/T1 02 (in%)	Q1 2004 (in millions of Lek)	Q1 04/T1 03 (in %)
4.9	5.3	7.7	6.3	20.4

Source: Ministry of Food and Agriculture

Though the data on the whole six-month period are missing, the accomplishment of agroindustrial production during the first three months of this year contains optimistic signals in terms of meeting the year-start forecasting on the production in this sector.

Table 5 Forecasting of the agricultural and animal production over 2004

	Growth (in %)	Value (in billions of Lek)
Crops	0.5	83.8
Fruit growing	5.9	20.3
Animal breeding	4.3	90.6
Total	3.0	194.7

Source: Ministry of Food and Agriculture

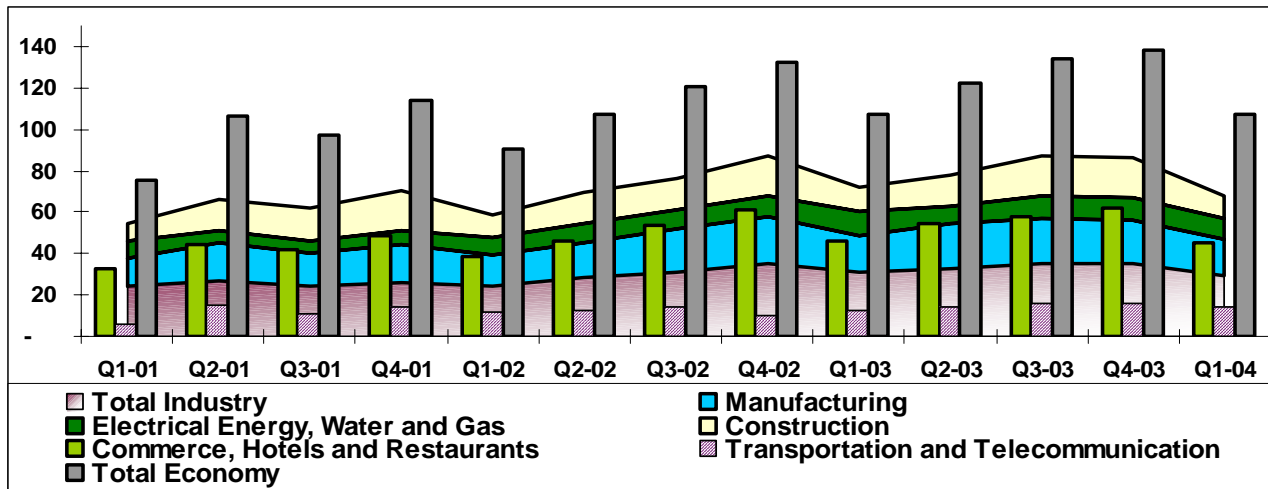
Investments covered by foreign funds are fulfilled at 30 per cent during the first half of the year. The rest of foreign fund projects are expected to start implementation in the coming months. Some of the most important projects were: the project of rehabilitation of the watering and draining systems (It should be stressed that in this year watering indicators are better than in the previous years), the project of agricultural services, the project of fishing, the project of registering real estates, the project of increasing the foodstuff production and the program for the development of mountaneous areas.

INDUSTRY

The sector of industry was characterised by positive indicators during the first half of the year. The sold commodity production was raised to 25.9 per cent during the first five months of the year, compared to the same period of the preceding year.

The largest growth, to 43.5 per cent, is marked in the energy sector. Also, the chemical industry and the wood and paper processing industry increased to 16.5 and 3.3 per cent, respectively, in comparison with a year ago. The fuels production in this five-month period increased by 22.4 per cent in comparison with the same period of the previous year. The price rise in the international market has driven the production in the country and the launching into the market of a part of oil reserves.

Chart 3 Performance of sales in some industry sectors (in billions of Lek)

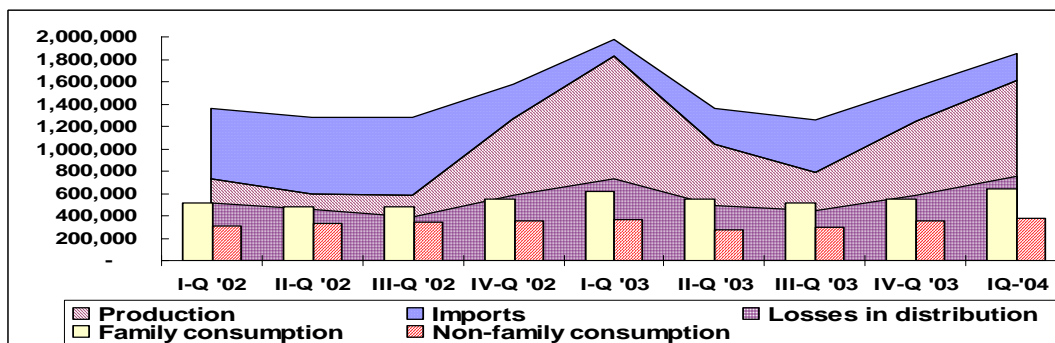


ENERGY

The electric power production marked a growth by about 3.51 per cent in the first five-month period of 2004. The domestic production rise has reduced the need to import energy during this period. The import of electric power fell by 15.6 per cent over the first five months of this year. Hydroelectric stations remain the greatest producers in the country, covering about 98.8 per cent of total production, while the weight of thermal-powers continues to be downward, recording the lowest level of production compared to 2003.

On the other hand, exports fell to 22 per cent. This made the energy production in the country be raised by 3.5 per cent compared to the same period of the previous year.

Chart 4 Electric power balance sheet (in MVVh)



Source: INSTAT.

CONSTRUCTION

The construction sector is expected to provide an important contribution to the Albanian economy during 2004. This sector is expected to grow by about 10.6 per cent over this year, providing 9.5 per cent of the total added value of economy.

The data of the first quarter indicate that this sector has known an underlined reduction in comparison with the same period of a year ago, leaving the way open for doubts to the performance of these forecasts. The weak performance of the sector is noticed in the main parameters of measuring the performance of this sector: construction permits, construction areas and the fund projected for constructions. This situation is presented in the following table.

Table 6 Main parameters of construction sector

	Q1 '03	Q1 '04
Construction permits	757	68
Construction areas (thousand m ²)	445.7	154
Construction fund (in billion of Lek)	21.3	4.3

At the same time, the costing index in construction recorded an increase of 3.94 per cent compared with the same period of the previous year. Direct expenditures were raised by 0.39 per cent in comparison with the previous quarter and 5.51 per cent in comparison with the first quarter of 2003. Also, material expenditures increased by 6.07 per cent in comparison with the same period of 2003.

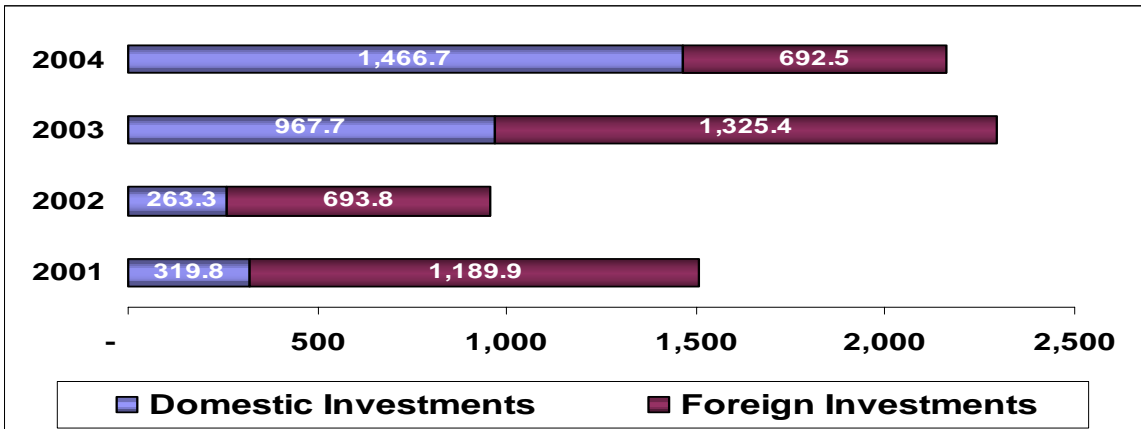
Presently, these indicators do not constitute a sufficient argument to put into doubt the accomplishment of the forecasted annual growth of the sector, knowing its seasonal character and the focus of work for the rest of the year. However, these indicators highlight the need for a greater attention to be given to the performance of this vital sector of economy.

TRANSPORT

Volume of work of loading-unloading during the first five-month period of 2004 increased by 15 per cent in comparison with the same period of a year ago, reaching to 1.55 million tons. Among the sectors having the largest growth are the railway services and seaports, which increased by 22 and 14.4 per cent, respectively. The work volume of loading-unloading in ports occupies about 91 per cent of the overall total volume. The growth of the work volume of loading-unloading, particularly in ports, is due to the improvement of conditions and infrastructure, better supplying of electric energy, as well as the rise of the foreign trade volume.

Total investments in the transport sector fell to 5.9 per cent compared to the first quarter of 2003. Although the domestic budgetary investments were raised by 51.6 per cent, the foreign investments in this sector lowered to 47.8 per cent.

Chart 5 Investments and their sources in transport sector



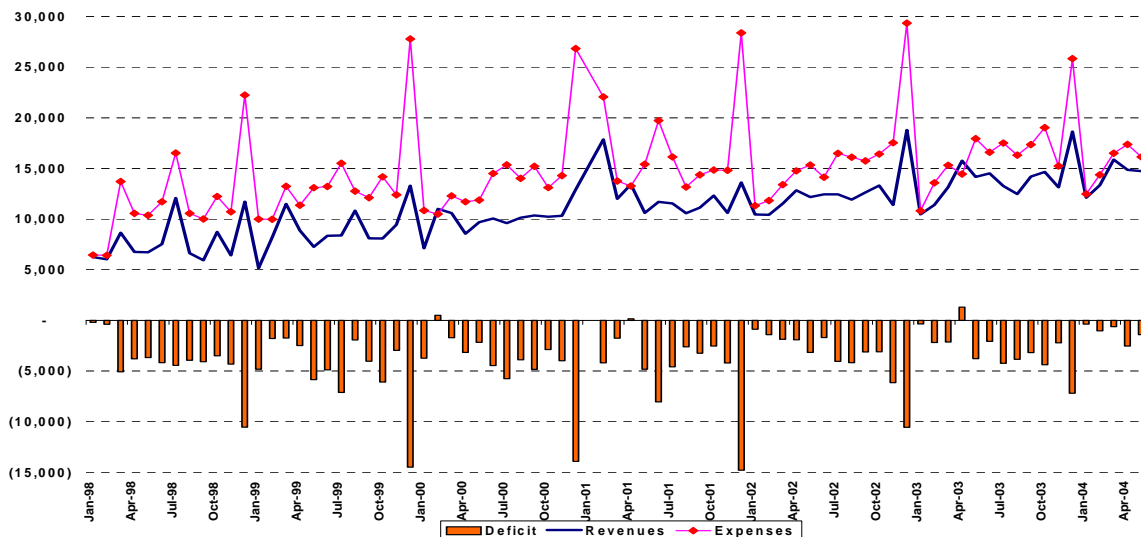
Source: Ministry of Transport and Telecommunication

As far as concerns air transport, a rise of 10 per cent of the number of passengers and a rise of 13.6 per cent of the number of airplanes and fly-overs is marked, while a decline by 27.1 per cent of goods and mail was noticed.

I.2.2 FISCAL SECTOR

In general, fiscal policy and fiscal indicators are performed within the framework scheduled for this period. Pursuant to data of the Ministry of Finance, until the end of May, 93 per cent of the planned incomes are collected and 91 per cent of the programmed expenditures are fulfilled. This has made the budget deficit at the end of May be about 5.9 billion from 7.9 billion Lek forecasted. The domestic deficit financing reached to 3.2 billion Lek versus the level of 3.4 billion Lek forecasted, while the deficit foreign financing reached to 2.7 billion Lek or 62 per cent of the forecasted value.

Chart 6 Fiscal indicators, January '98 – May '04 (in millions of Lek)



Source: Ministry of Finance.

Table 7 Fiscal indicators (in billions of Lek)

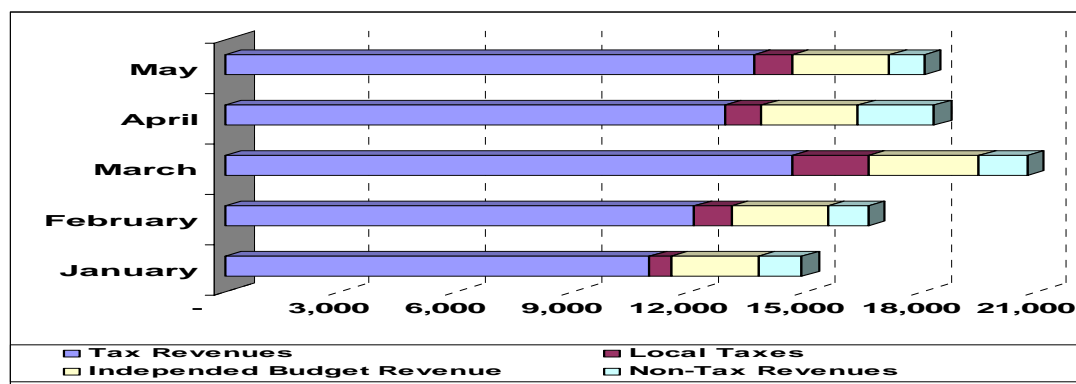
	January – May 2004	Change in percentage against the same period of 2003	Meeting of the plan (%)
Income	25.7	9.2	92.6
Expenditure	33.8	6.6	91
Deficit	8,1	-16.2	75.3

Source: Ministry of Finance.

BUDGET INCOME

During January – May of this year, the budget incomes were about 9.2 per cent higher than the same period of 2003. The level of taxation incomes at the end of May reached about 64.3 billion Lek, while the customs duties collected resulted about 5.1 billion Lek, achieving the level forecasted in the draft budget of the year-start by 97 per cent and 95 per cent, respectively.

Chart 7 Budget income structure



Source: Ministry of Finance.

Taxes remain the main source of budget income. They constitute 71.3 per cent of total income until May. Unlike the previous periods, the value added tax exceeded the forecasted level, being fulfilled at 103 per cent. Also, it is noticed that income from local authorities continues to exceed the plan, being fulfilled at 101.76 per cent.

Table 8 Income from taxes and customs duties (in billions of Lek)

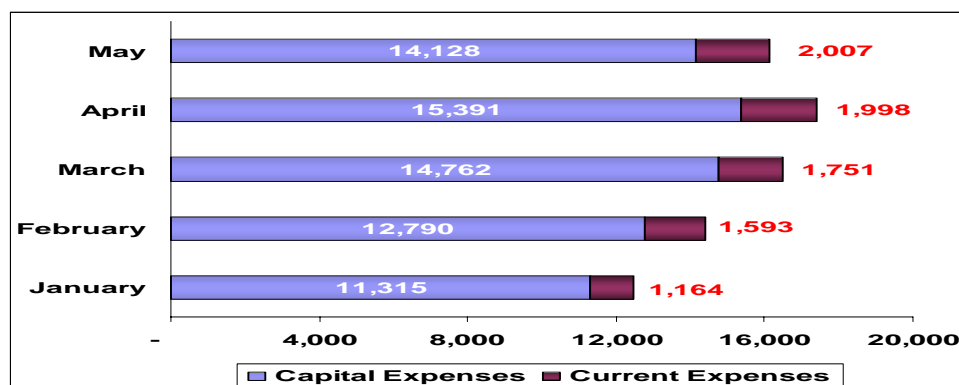
	March	May	Plan	%	Annual plan	%
Taxes and customs duties	26.6	46.2	47.7	97	125.6	37
Value added tax	12.5	21.6	21.0	103	57.1	38
Income tax	3.6	6.1	6.3	96	15.2	40
Excises	2.9	5.5	6.0	91	16.2	34
Personal income tax	1.6	2.6	3.0	87	8.2	32
National tax and others	2.8	4.4	5.2	85	12.6	35
Customs duties	3.0	5.1	5.4	95	14.7	35

Source: Ministry of Finance

BUDGET EXPENDITURES

During the first five months of the year, budget expenditures were 76.9 billion Lek, constituting 91 per cent of the level scheduled for this period. Personnel expenditures were fulfilled at 101 per cent, while capital expenditures continue to be fulfilled to a level less than the plan, reaching 68 per cent. From these, the expenditures covered by foreign financing were fulfilled at 52 per cent. The performance of capital expenses is expected to grow considerably in the forthcoming months due to the government decision to use a part of income from the Savings Banks' privatization for strategic investments.

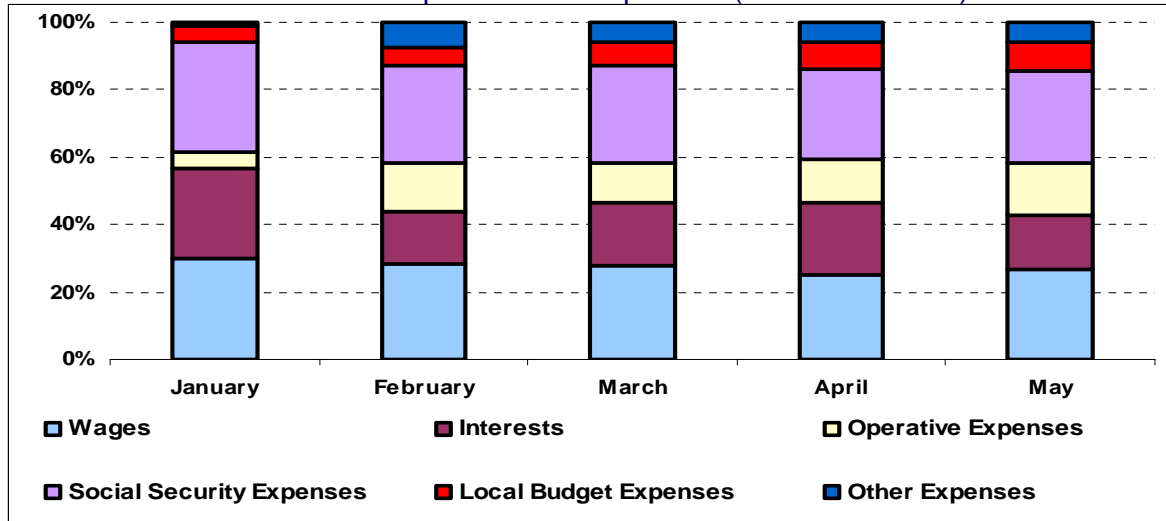
Chart 8 Budget expenditure structure (in millions of Lek)



Source: Ministry of Finance.

Current expenditures constitute (for January – May 2004) 87.6 per cent of total expenditures, thus taking a priority in the process of government decision-making.

Chart 9 Current expenditures composition (in millions of Lek)

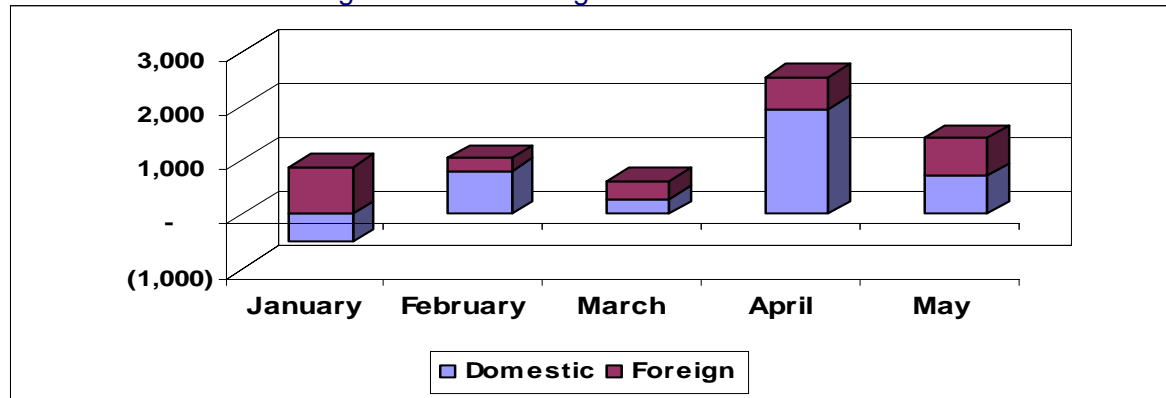


Source: Ministry of Finance.

FISCAL DEFICIT

For the first five months of the year, the fiscal deficit is, on average, 75 per cent of the planned level. The keeping under control of the expenditures has impacted on the fiscal deficit control.

Chart 10 Budget deficit financing for 2004



Source: Ministry of Finance.

1.2.3 LABOUR MARKET

During the first half of 2004 the labour market was featured by a pronounced reduction of the number of labour forces and employees. The labour forces marked a reduction by about 11 thousand persons, mainly due to decline in the number of employees by 8 thousand persons. The decline by 3 thousand persons of employment in the state sector was due to the continuation of reforms in the state administration and particularly in large state-owned enterprises still unprivatized. On the other hand, we have a reduction by 5 thousand persons of

employment in the non-agricultural private sector. The first quarter of the year is not usually distinguished for the rise in such indicators of labour. However, the reduction in the employment indicators is deemed to be related to the period when measuring has taken place with regard to these indicators. So, during January – March, the private entities perform the registration of their businesses and the statistics may be reflected as deformed and not realistic, since the time to collect them is not sufficient. Not accidentally the number of 5 thousand persons belongs to Tirana, where the largest part of industry and services are concentrated. Therefore, the employment data in this sector should be taken in reserve. A more explicit view will be taken after the data on the second quarter of this year are published. The signals show that this indicator is upward for this quarter. This mistake in measurement does not exclude the possibility that labour forces were reduced during this quarter as a consequence of the phenomenon of emigration or black market.

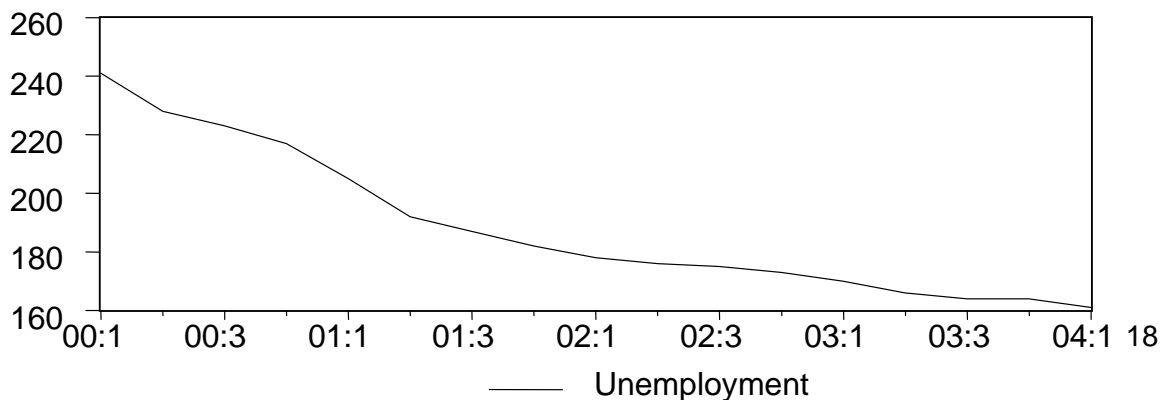
Table 9 Labour market indicators (in thousand persons)

	2002				2003				2004
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III	Q.IV	Q.I
Total labour forces (in thousand)	1096	1093	1094	1094	1096	1093	1092	1091	1080
A. Total employed (in thousand)	918	917	919	921	926	927	928	927	919
i) in state sector	189	188	187	187	185	185	184	182	179
ii) in non-agricultural private sector	6	203	206	208	207	208	210	211	206
iii) in agricultural private sector	526	526	526	526	534	534	534	534	534
B. Unemployment (in thousand)									
i) total unemployed	178	176	175	173	170	166	164	164	161
ii) earning unemployment compensation	13	13	12	11	11	11	11	11	11.7
C. Unemployment degree (in %)	16.2	16.1	16.0	15.8	15.5	15.2	15.0	15.0	14.9

Source: INSTAT, June Conjecture, 2003.

The unemployment indicators continue to be positive even in this quarter. The number of the unemployed has dropped by three thousand persons, leading the unemployment rate to 14.9 per cent.

Chart 11 The unemployed number in three recent years (in thousand persons)



I.2.4 FOREIGN SECTOR OF ECONOMY

The economy development during the first half of the year is associated with a further strengthening of its foreign position. The balance of payments for the first quarter of 2004 was positive. It marked USD 15 million, a sum equal to the growth of foreign reserves of the monetary authority. The first quarter was closed with a current deficit above 2 times higher than the first quarter of the previous year. The deepening of the current deficit was due to the rise of the trade deficit and a slight deterioration of the balance of services, while the balance of incomes and that of current transfers have remained almost unchanged. This quarter marked a decline of capital transfers and foreign investments. The capital and financial account inflows financed about 80 per cent of the current deficit. Though full data for the second quarter are missing, the foreign reserve continued to grow even during this period, suggesting a positive resultant performance of the balance of payments.

Table 10 Balance of payments accounts (in millions of USD)

	Q1-2004	Q1-2003	Q1-04/Q1-03 (%)
A. Current Account	-74.2	-32.3	130
A.1. Trade balance	-314.8	-285.5	10
A.1.1. Merchandise imports	-451.3	-394	15
A.1.2 Merchandise exports	136.5	108.5	26
A.2. Balance of services	-6.0	4.1	
A.3. Balance of income	36.3	38.9	-7
A.4. Current transfers	209.9	210.2	0
B. Capital account (net)	34.0	31.0	10
C. Financial account (net)	25.1	55.5	-55
C.1 Growth in liabilities	87.6	67.0	31
C.2.Growth in assets	-62.5	-11.5	443
D. Growth in reserve assets	-14.9	-57.0	-74
E. Net faults and omissions	30.3	2.8	982

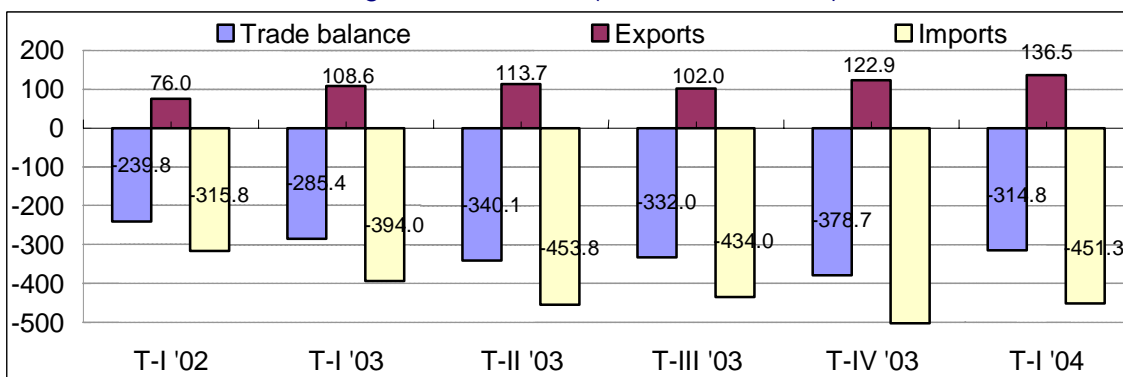
Current account

During the first quarter of the year the current transfers of Albania with the world are estimated at 1.3 billion USD (600 million USD exports and 676 million USD imports). Trade transactions in goods have the largest share in current transactions (46 per cent). Current transfers account is the one that has balanced the trade deficit, just like in many previous quarters. The services account, in spite of the considerable volume of inflows (about 1.4 times higher than merchandise exports) and the outflows (approximately 45 per cent of merchandise imports), has not played any important role in the current account performance due to the small balance sheet.

Foreign trade

During the first quarter the general trade volume was estimated at 590 million USD or about 85 million USD higher than it was in the same period of 2003. The growth of exports at a rate higher than imports did not come with a narrowing in the trade deficit. The latter was estimated for the first quarter at 315 million USD or 10 per cent higher than it was in the first quarter of 2003. However, it's worth mentioning that merchandise exports marked for this quarter the highest level of quarterly exports over the years. Whereas imports increased continuously, in particular capital merchandise imports and active processing merchandise imports. Also, the demand for foodstuff remains still high. The main contribution to the Albanian exports growth was given by re-exports, which dominate the Albanian exports, occupying presently 81 per cent of their general volume. Re-exports increased by 32 per cent compared to the first quarter of the previous year, while exports from domestic production showed a rather slow performance. In the total exports, this production is estimated at 19 per cent.

Chart 12 Foreign trade balance (in millions of USD)



Services, income and current transfers

The deficit of USD 6 million in the balance of services was attributed to the sharpening of the deficit in transport services and the narrowing of surplus in travel services. Service imports were estimated at USD 197 million, while exports at USD 203 million. The largest weight, in both categories, belongs to the services of tourism and transport (79 per cent of inflows and 82 per cent of outflows). Service exports are 45 per cent higher than merchandise exports.

Income category for the first quarter was closed with a positive balance similar to that of the first quarter of the previous year (36 million USD). Work income (22 million USD) compared to the first quarter of the last year has remained unchanged. Portfolio investments income (8 million USD) and reserve investments income (10.5 million USD) have recorded a slight growth in comparison with the first quarter of the previous year.

Current transfers account for the first quarter was closed with a positive balance of USD 210 million, without marking any significant change in comparison with the first quarter of 2003. The main weight of income (about 85 per cent) in this

category is still represented by Albanian emigrants' remittances. During this period, these remittances were evaluated at USD 194 million. The positive balance of current transfers has covered 72 per cent of the deficit in goods and services for the first quarter of the year.

Capital and financial account and reserve assets

During the first quarter of the year, net flows in the capital and financial account were estimated at about 59 million USD. From these flows, 34 million USD were in the capital account while 25 million USD, net flows in the financial account. The latter has recorded an increase either in terms of liabilities or in terms of pretensions towards non-residents. About 40 per cent of financial liabilities growth, during this quarter, was attributed to the flows of foreign direct investments, which reached the amount of USD 35 million, recording a slight decline in comparison with the first quarter of the previous year. Resident liabilities increased too, as a consequence of the official foreign debt growth (by USD 27.5 million) and the non-residents' deposits growth in the country (by USD 10 million). On the other hand, residents' pretensions towards non-residents were raised by USD 62.5 million during the first quarter of the year. The growth of assets (by USD 41 million) is mainly determined by the movement of deposits in the resident units abroad and by the net growth of other assets. Monetary authority reserves increased during the first quarter of the year by about 15 million USD, an increase partly attributed to the foreign assets growth and partly to the growth of property in SDR. The stock of reserves is evaluated at USD 1028 million and covers 4.7 months of import of goods and services.

II. INFLATION PERFORMANCE OVER JANUARY – JUNE 2004

II.1 PERFORMANCE OF INFLATION AND CONSTITUENT GROUPS

During the first half of 2004, inflationary pressures have been generally kept under control. The Bank of Albania monetary policy along with other permanent factors that affect the price performance have smoothed the negative impact on the rise of some administered prices. This balanced impact made that annual inflation, except in February, remain within the Bank of Albania targeted range.

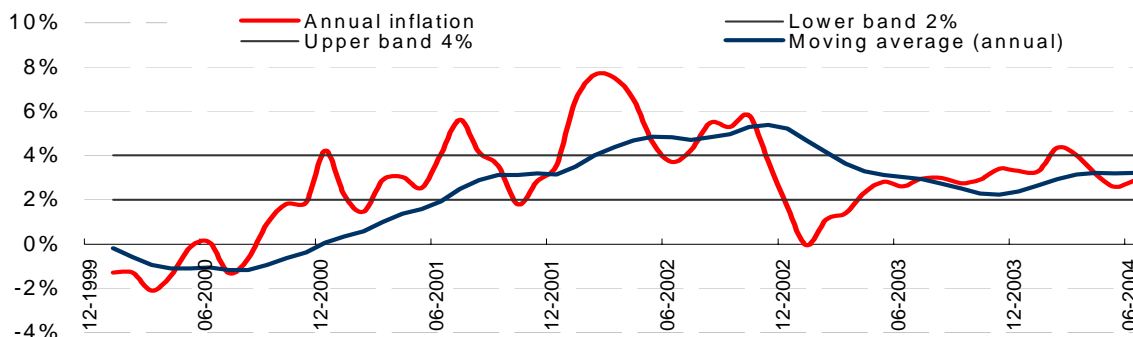
During the first quarter of this year, the inflation annual rate showed a growing trend, reflecting the inflationary pressures of the price rise in energy, bread and transport, as well as the fixed phone price rise in December 2003. The annual inflation rate maintenance within the two-to-four per cent targeted range, during the second quarter of 2004, was the result of the positive cooperation of demand factors, including monetary and supply factors, mainly the revision of fixed phone and bread price, as well as the downward effect of introducing the domestic agricultural production.

Table 11 Annual inflation rate (in percentage)

	2000	2001	2002	2003	2004
January	-1.3	2.2	6.5	0.0	3.3
February	-1.3	1.5	7.6	1.1	4.4
March	-2.1	2.9	7.5	1.3	4.0
April	-1.4	3.0	6.5	2.3	3.2
May	-0.1	2.5	4.6	2.8	2.6
June	0.1	4.0	3.7	2.6	2.9
July	-1.3	5.6	4.2	3.0	
August	-0.7	4.1	5.5	3.0	
September	0.9	3.5	5.3	2.8	
October	1.8	1.8	5.8	2.9	
November	1.9	2.8	3.7	3.4	
December	4.2	3.5	1.7	3.3	
Average	0.05	3.13	5.22	2.37	

The inflation increase was dictated during the first quarter by the rise of electric energy price by 31.2 per cent in January 2004. Besides the effect of the electric energy price rise, inflation in the month of April reflected also the rent price rise by 3.5 percentage points. Consequently, the “Rent, water, fuels” group marked the highest inflation rate of 11.0 per cent in April.

Chart 13 Annual inflation (in percentage)



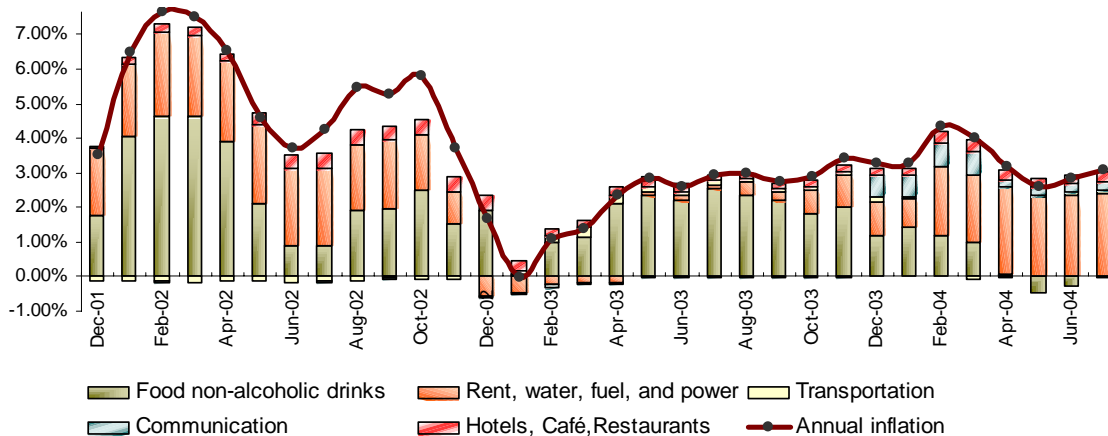
The contribution of “Rent, water, fuels” group in the total inflation went on declining during May-June, due to the reduction of inflation of gas price by 7.9 percentage points.

Table 12 Monthly and annual rates of “Rent, water, fuels, energy” group

	“Rent, water, fuels, energy”		“Rent”		“Fuels and energy”	
	Monthly	Annual	Monthly	Annual	Monthly	Annual
Jan’04	0.0	3.7	0.0	2.6	0.3	6.9
Feb’04	4.9	8.5	-0.5	2.1	26.4	35.0
Mar’04	0.0	8.3	0.0	2.1	-0.1	35.0
Apr’04	2.4	11.0	3.5	5.6	0.1	35.1
May’ 04	0.0	9.7	0.0	5.6	0.0	27.2
June’04	0.0	9.7	0.0	5.6	-0.1	27.0

Unlike the ordinary structure of inflation, the influence of “Rent, water, fuels” group in the inflation performance has been stronger than the influence of “Foodstuff and non-alcoholic beverages” group, during the first half of the year.

Chart 14 Contribution of the main groups in the total annual inflation (in percentage points)

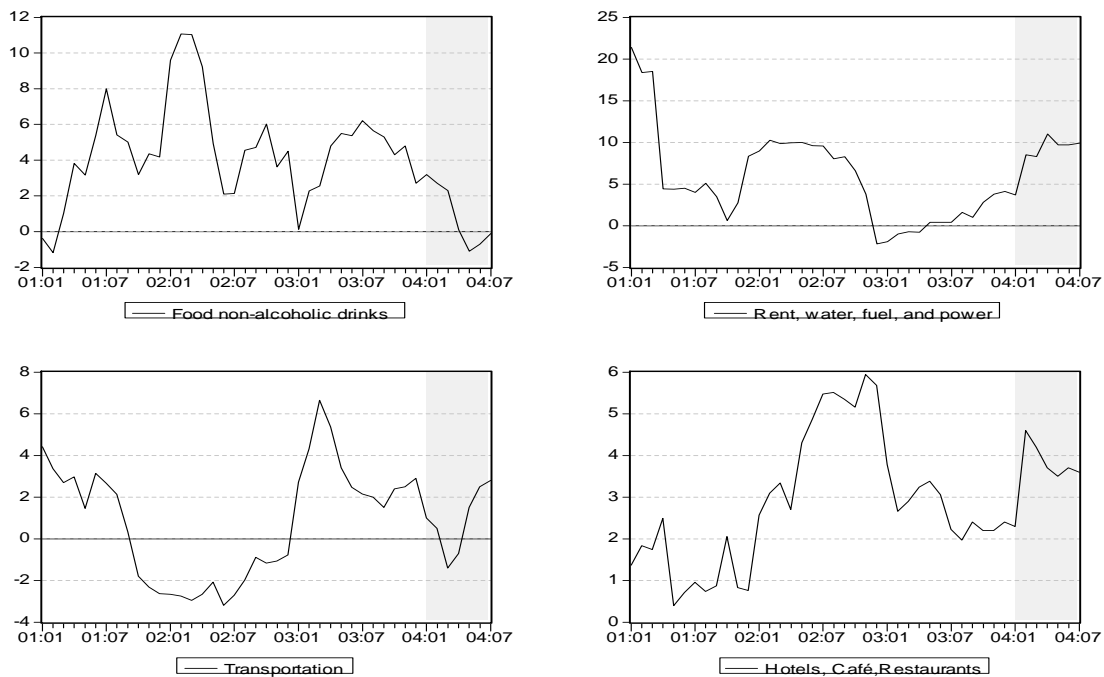


The influence of “Foodstuff and non-alcoholic beverages” group on inflation has been too low during the first half of the year, reaching a significant negative value in May. This performance was dictated by the price reduction of items of this group due to the entry of the domestic agricultural production. In comparison with the previous year, the domestic agricultural production was abundant, making that the seasonal effect² during 2004 be earlier and stronger. Whereas in 2003, only during the month of June the market was significantly dominated by domestic products and later the seasonal effect disappeared earlier. During 2004, the months of May and June were significantly affected by this effect.

The contribution of “Transport” group in annual inflation of June was 0.12 percentage points. The oil price rise in the international market, reaching the maximum level in May, 40.3 USD per barrel, brought about the price rise of this product even in our market. The annual inflation of this group continued to increase by 1.5 per cent in May and 2.5 per cent in June.

“Communication” group has provided a stable contribution by 0.67 percentage points to the annual inflation since December 2003. The reduction of fixed phone prices brought about the reduction of inflation of “Communication” group by 37.5 percentage points from March to April. Hence, the contribution of this group to inflation dropped by 0.21 percentage points in April 2004.

Chart 15 Annual inflation.

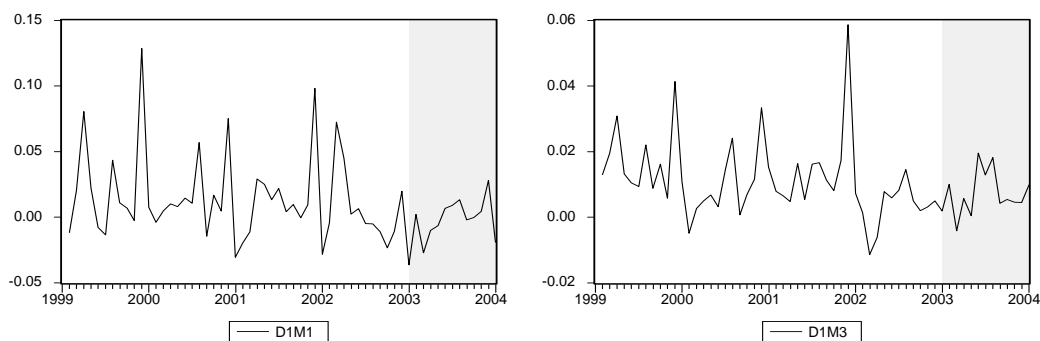


² Domestic supply dominates the internal market of our country during the summer time, substituting the imported foodstuff and bringing about the reduction of foodstuff price.

II.1.1 FACTORS IMPACTING ON INFLATION PERFORMANCE

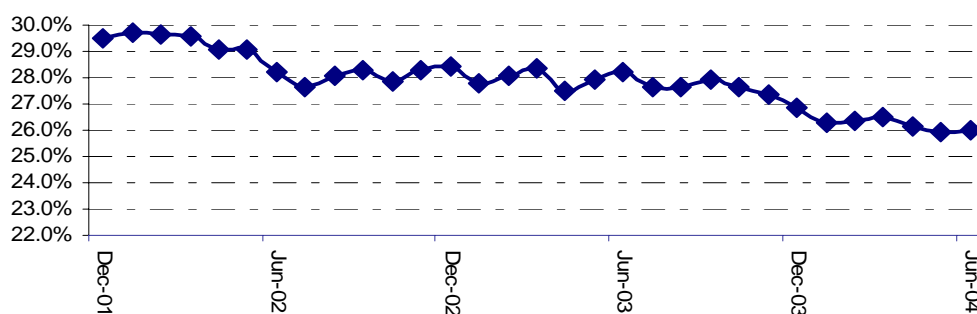
Demand factors have had a positive impact on the inflation developments during the first half of 2004. Just like in the previous year, the stable situation of liquidity, keeping under control of the monetary aggregates, maintaining of the internal financing within the permitted limits and the most uniform allocation throughout the year, have provided an adequate monetary environment for controlling inflation.

Chart 16 Annual changes of M1 and M3 monetary aggregates (in percentage)



The fiscal policy did not exert inflationary pressures during the first half of the year. The budgetary expenditures increased on a controlled basis, remaining within the planned levels. They contributed to the stability of the economy's demand.

Chart 17 Budgetary expenditures performance of 2004 (in percentage of GDP)

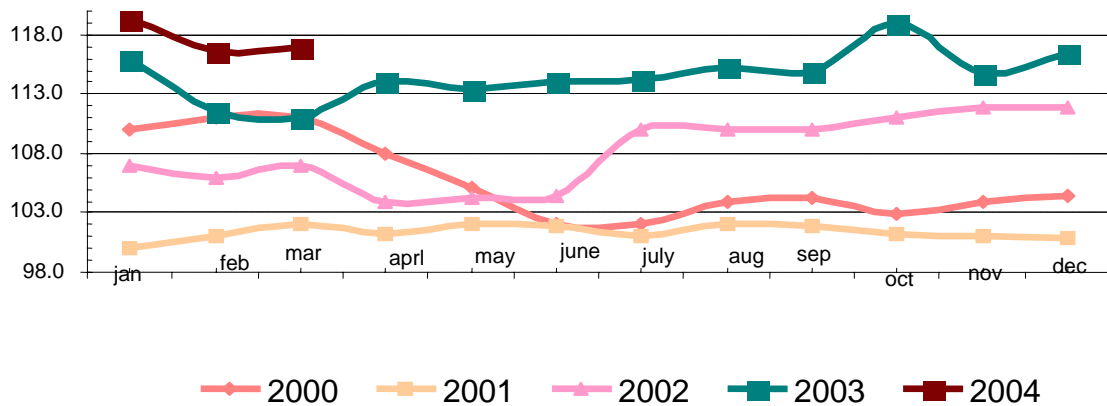


On the other hand, the influence of supply factors has been well-oriented in both directions. During the first quarter of the year, inflation was negatively affected by the supply factors, such as the energy, bread and transport price rise. Likewise, the production price index showed a rise by 4.12³ per cent in comparison with the first quarter of 2003, leading to the increase of inflationary pressures. During the

³ Source: INSTAT.

second quarter, the rectification on reducing the fixed phone and bread price, in April, and the entry of the domestic products in the internal market have contributed to the reduction of inflation rate.

Chart 18 Production price index performance over 2000 – 2004



Source: INSTAT.

The imported inflation has provided a slight impact on the country's inflation during the first half of 2004. Low inflation rates⁴ recorded in the trade exchange partner countries, combined with the appreciation, on annual basis, of Lek against euro and US dollar by 10 per cent and 13.6 per cent, respectively, have smoothed the impact of this factor.

Table 13 Annual inflation of main partner countries (in percentage)

	Sep	Oct	Nov	Dec '03	Jan '04	Feb	Mar	Apr	May
Greece	3.3	3.3	3.4	3.1	3.1	2.6	2.9	3.1	3.1
Italy	3.0	2.8	2.8	2.5	2.2	2.4	2.3	2.3	2.3

Source: Infobase European Resource.

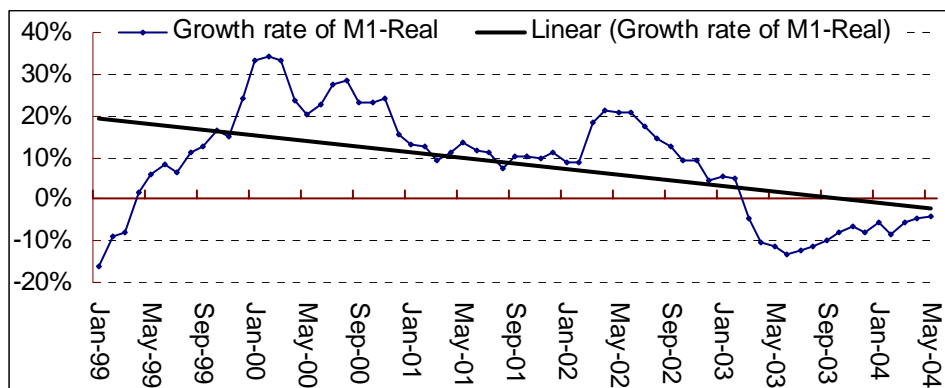
⁴ Rates recorded during the first half of 2004 are lower compared to the inflation performance of these countries during the second half of 2003.

III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

III.1 BANK OF ALBANIA MONETARY POLICY

The growth of production cost, as a consequence of the rise of administered prices of energy and fixed phone, was not accompanied with a significant price rise of final goods. The monetary conditions in the economy favoured the maintenance of inflation at low levels, making that the rise of administered prices be transmitted into inflation only in the form of direct impact. The currency continued to rapidly return in the system through banks, while the Lek exchange rate has been generally stable, even with slight appreciation trends. The return of currency in the system improved the liquidity indicators of the banking system and led to the reduction of M1 aggregate, which has an essential impact on inflation.

Chart 19 Real M1 annual growth



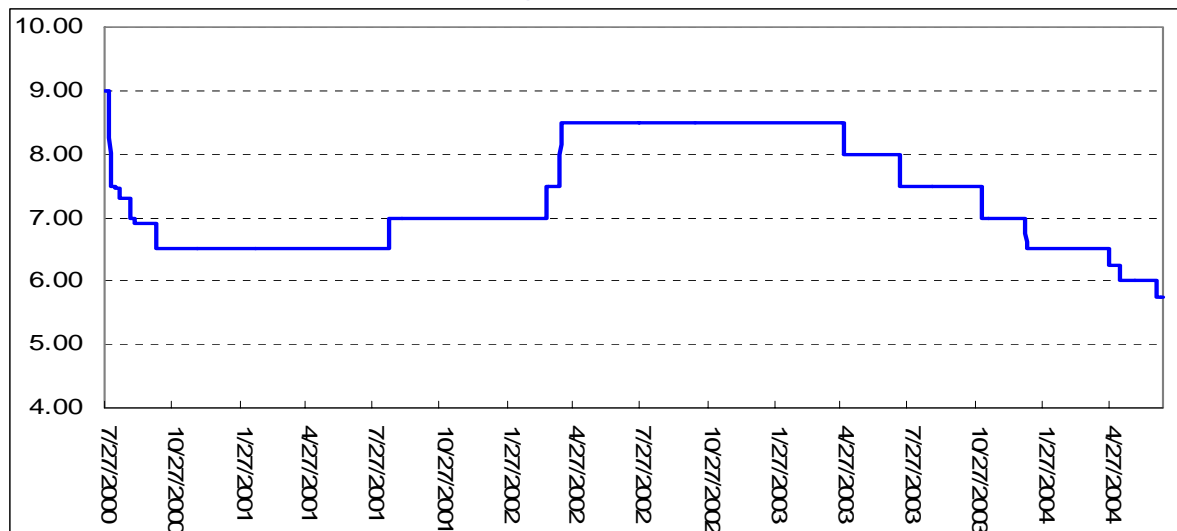
In response to these developments the Bank of Albania adopted a neutral monetary policy during the first quarter of the year. The Bank maintained unchanged the base interest rate and employed the repo's auctions at a fixed price to withdraw the liquidity surplus of the banking system during this period. Also, with the purpose of smoothing the downward pressures on the interest rates, the Bank of Albania withdrew 4.5 billion Lek of liquidity in March, by performing full sales of treasury bills of its portfolio.

The Bank of Albania monetary policy took on a significant smoothing trend during the second quarter. The revision on reducing some administered prices and the entry of domestic agricultural products in the market made that inflation return within the two-to-four per cent targeted range, approaching after the month of May to its lower limit. The fall of inflation rate brought about an increase of the real interest rate. The ratio between currency outside banks and M3 reached the

minimum historical level in May, at 25.4 per cent. Meanwhile, the stability of monetary conditions and the controlled inflation rate have impacted on increasing the confidence in the Lek. These factors, along with the domestic agricultural production growth in the second quarter, have impacted on the Lek appreciation during this period.

Inflation stability within the targeted range and its positive prospects made that the Bank of Albania facilitate on a continuous basis the monetary conditions, cutting the base interest rate. The cut of the base interest rate was performed in three phases: on 28 April, 12 May and 23 June. Given that every cut has led the base interest rate to new minimum historical levels, the Bank of Albania has acted with diligence by reducing the base interest rate by 0.25 percentage points in each case. At the end of this cycle, the base interest rate has lowered by 5.75 per cent.

Chart 20 Base interest rate performance



The reduction of the Lek cost will serve to encourage the lending to economy in Lek, so as to decrease the cost of government's debt and smooth the Lek appreciation pressures. The impact of this decrease was initially observed in the banking market. Commercial banks have reduced the interest rates of deposits, treasury bills and credits in Lek.

The easing monetary policy is based on the change of the repo instrument form, from a fixed price auction into a fluctuated price auction. This has contributed in increasing pressure on the reduction of interest rates applied by commercial banks. Also, the Bank of Albania was present in the foreign market, mainly in a waiting position, aiming at fulfilling the foreign currency supply in the market. However, its real activity in the foreign market was insignificant during the first half of the year.

The Bank of Albania has continued to observe its quantitative objectives. The easing monetary conditions are not expected to harm the further achievement of these objectives.

Table 14 Meeting the Bank of Albania quantitative targets

	Dec '03	Mar '04	Apr '04	May '04	Jun '04**
Net international reserves* (in millions of USD)					
Target	715.8	751.8	756.5	761.2	765.8
Current	832.7	827.6	965.2	962.1	914.0
Difference	116.8	75.8	208.7	201.0	148.2
Net domestic assets (in billions of Lek)					
Target	96.0	83.0	83.6	84.3	85.0
Current	72.0	66.4	51.3	51.3	59.7
Difference	-24.0	-16.6	-32.3	-33.0	-25.2
Net domestic credit to government (in billions of Lek)					
Target	268.1	274.1	274.1	271.4	-
Current	268.1	273.9	273.9	271.6	-
Difference	0.0	-0.2	-0.2	0.2	-

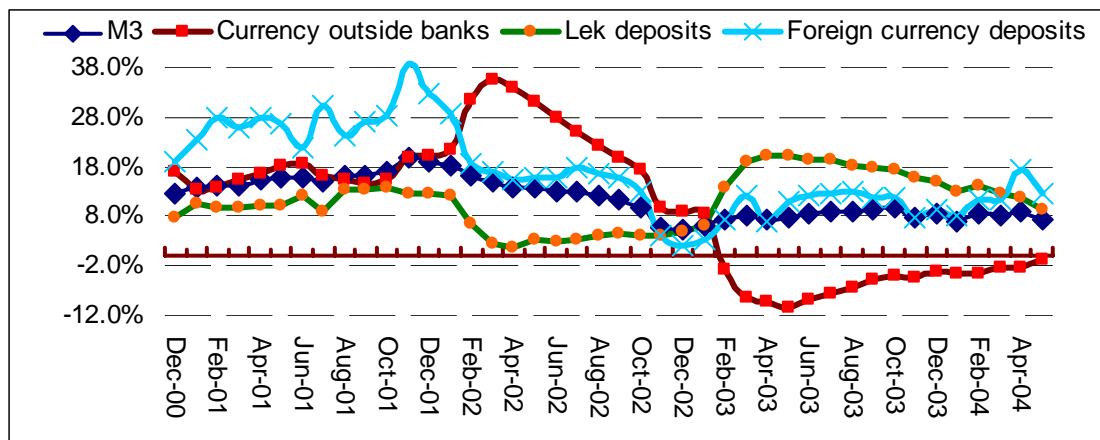
*Since March 2004, this target is computed according to a new standard.

** Operative data.

III.2 MONETARY AGGREGATES PERFORMANCE

The first half of the year was featured by a stable growth of monetary supply. On average, the annual rate of the M3 aggregate growth was 8.2 per cent during this period, a level below the historical average of the past years. The monetary supply in Lek showed a slowdown in performance, reflecting partly the very low demand of government for money in the first half of the year. The time structure of monetary supply continued to move towards less liquid assets, while the significant growth of foreign currency deposits resulted in the growing weight of the foreign component in the total currency.

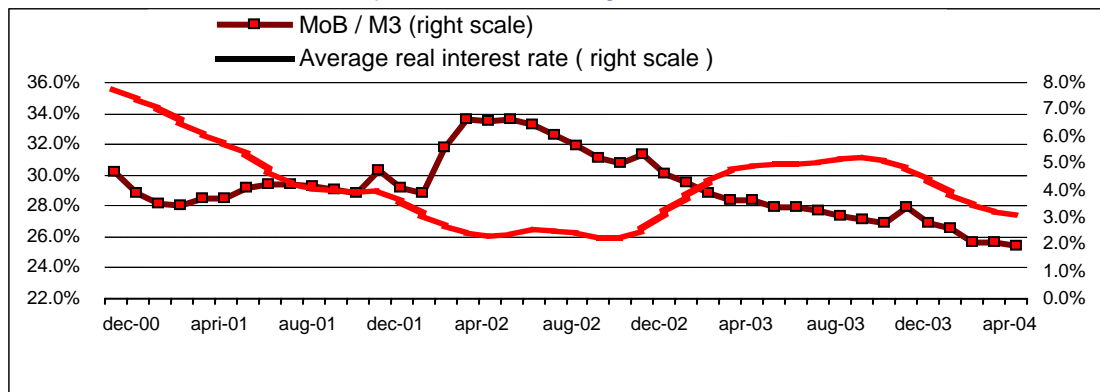
Chart 21 Performance of annual monetary aggregate rates



At the end of May, the monetary supply marked an annual growth rate of 9.0 per cent. The largest contribution in this growth has been provided by the foreign currency deposits whose annual rates have been growing during all the period. The annual growth rate of foreign currency deposits reached at the end of May 17.4 per cent. For lack of negative effect of the Lek appreciation, which in annual terms is evaluated at about 11.1 billion Lek, this rate would result 29.6 per cent. Their growth has been mainly in the form of foreign currency demand deposits, which in the last five months increased by 7.1 billion Lek from 8.2 billion Lek of total growth. The foreign currency time deposits performance have been low during this period as a consequence of the very low interest rates offered on them.

The performance of the ratio between money outside banks and the total of currency shows its continuous decline towards lower historical levels. The level of this ratio in May reached 25.4 per cent, recording a decline of 2.5 percentage points since December. This performance has reflected the constant increase of confidence in the banking system and the growing number of banking services for customers, under the conditions when positive real interest rates have maintained the tendency towards encouraging savings investment in time deposits in Lek. However, the performance of interest rates decline seems to have influenced the stabilization of the ratio of money outside banks, which is noticed in the slowness of its downward trend in the last months.

Chart 22 Ratio of money outside banks against M3 and real interest rates



The annual growth rates of deposits in Lek have been decreasing during all the period, reinforcing their trend of approximation to annual rates of M2 aggregate. At the end of May, the annual growth rate of deposits in Lek has lowered by 11.6 per cent from 15.7 per cent it was at the end of 2003. Meanwhile, the process of returning money in the system continued even during the first half of the year, making that annual rates of the change of money outside banks remain to negative levels. In May this rate resulted -2.1 per cent.

Table 15 Performance of monetary indicators in May (in billions of Lek)

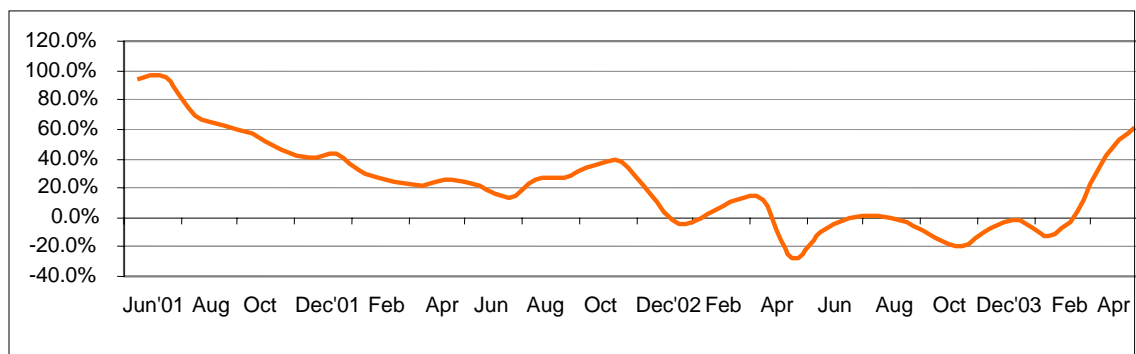
	May 2004	Five-month change		Annual change	
		Absolute	Percentage	Absolute	Percentage
Currency outside banks	117.1	-8.1	-6.4	-2.6	-2.1
Total deposits	343.1	19.9	6.2	40.5	13.4
- in Lek	236.0	11.7	5.2	24.6	11.6
- in foreign currency	107.1	8.2	8.3	15.9	17.4
Demand deposits	66.7	10.1	17.9	9.9	17.5
- in Lek	22.5	3.0	15.3	0.3	1.5
- in foreign currency	44.2	7.1	19.3	9.6	27.8
Time deposits	276.4	9.7	3.7	30.6	12.4
- in Lek	213.5	8.7	4.3	24.3	12.8
- in foreign currency	62.9	1.0	1.7	6.3	11.1
M1	139.7	-5.1	-3.5	-2.2	-1.6
M2	353.2	3.6	1.0	22.0	6.7
M3	460.3	11.8	2.6	37.9	9.0
Monetary base	153.7	-6.9	-4.3	1.2	0.8

III.3 DOMESTIC DEMAND

III.3.1 FOREIGN CURRENCY POSITION OF THE BANKING SYSTEM

Foreign currency deposits growth and privatization revenues inflow have impacted the improvement of the foreign currency position of the banking system during the first part of the year. Net foreign assets of the banking system are raised by USD 183,5 million during the first five months of the year. This performance led to a high contribution of these assets on the growth of monetary assets in the economy.

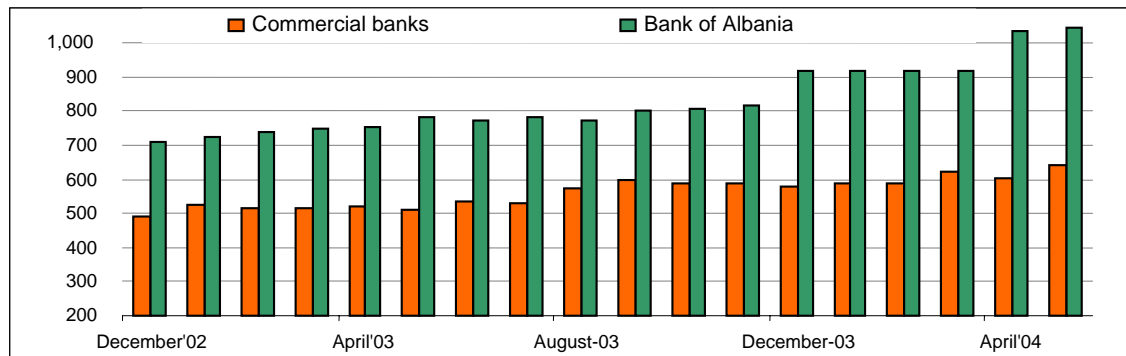
Chart 23 Net foreign assets contribution on M3 growth



During the period January – May 2004, the Bank of Albania marked an increase of net foreign assets by about USD 122.8 million. This increase is attributed to

the privatization revenues inflow in the net foreign assets of the Savings Bank, of USD 126 million. During this period the Bank of Albania has been present also in the foreign market, mainly in a passive position, the Ministry of Finance being its main partner.

Chart 24 Net foreign assets performance of the banking system



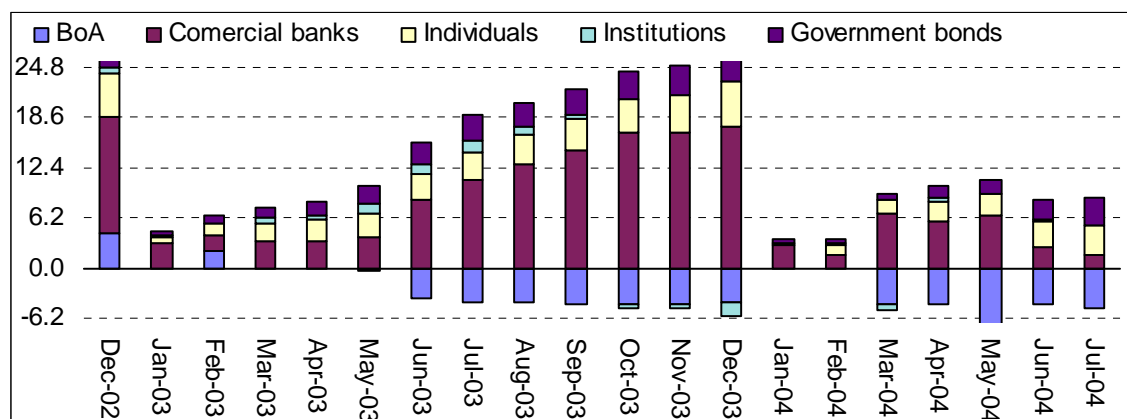
Foreign assets of commercial banks, for the same period of year 2004, increased by USD 60 million. The period January – May was followed by a growth of foreign currency deposits, by Lek 8.2 billion, while foreign credit balance was raised by Lek 5.0 billion.

III.3.2 BUDGET DEFICIT FINANCING

Fiscal accounts of May mark a budget deficit of Lek 5.2 billion. The deepening of this budget is mainly observed in April and May. The total financing for the period January – May amounted to Lek 7.6 billion, and was almost an entirely domestic financing, from the banking system as well.

The T-bills issuance and two-year obligations were the financing ways during this six-month period. Part of the domestic financing in May were also the revenues from the privatization of the Savings Bank, estimated at Lek 3.5 billion. This financing source, at about Lek 3.1 billion, will be used even for the remaining part of the year leading to reduction of the government demand for financing from the banking system. During the first five months of 2004, commercial banks and households have raised the T-Bills portfolio by Lek 6.4 billion and Lek 2.7 billion, respectively. Non-banking financial institutions and the Bank of Albania have reduced the portfolios by Lek 1.2 billion and Lek 8 billion, respectively. Through the issuance of government's obligations, a financing of Lek 1.8 billion is provided since the beginning of the year.

Chart 25 Cumulative Performance of budget deficit financing (in billions of Lek)



III.3.3 CREDIT TO ECONOMY

The first five months of year 2004 revealed rapid rhythms of development for the crediting to economy. The economy, for the five-month period, is credited by Lek 5.5 billion or 25 per cent higher than the same period of 2003. Credit balance amounted to Lek 56.2 billion by the end of May 2004. During January – May 2004 period, just like the same period of 2003, the part that credit to economy covers in the demand for money has been growing, while credit to government has manifested a downward trend. Credit to economy represents 12.2 per cent of the demand for money by the end of May 2004.

Table 16 Performance of some main indicators

	2000	2001	2002	2003	T1'04	April '04	May '04
Money supply (in billions of Lek)	328.1	393.6	416.7	448.4	456.0	456.7	460.3
Domestic credit (in % against M3)	75.5	67.5	70.8	71.5	71.6	69.0	68.9
- Loan to government (in % against M3)	68.4	60.4	61.5	60.2	59.9	56.7	56.6
- Credit to economy (in % against M3)	7.1	7.1	9.3	11.3	11.7	12.2	12.2
Credit to economy (% against total assets)	8.6	8.9	11.5	13.7	13.7	14.3	14.3
Credit/deposits ratio (in %)	10.1	10.2	13.5	15.6	15.8	16.5	16.4

Ongoing improvements are marked as for the extension of the banking service network and for the institutional lender–borrower relationships as well. Thus, clients' awareness of the correctness that follows the borrowing relationships between the business and the banking system has been growing. Such a fact becomes concretized by the high level of new credit extension that has been grown from one period to the other. Also, the indicators of lending quality confirm the improvement of bank – business relationships. Thus, the percentage of bad loans fell by 0.2 percentage points during the first five months of the year, reaching 4.4 per cent by the end of May.

Credit balance performance, according to the terms, presents a growth of the medium – term and long – term credit balance, which by the end of May reached in total 61.5 per cent of the credit balance. During 2004 it is noticed an ongoing fall of short – term credit balance. This credit has declined by 7.5 percentage points compared to the year-end of 2003.

Credit balance structure as per currencies continues to be dominated by the foreign credit. By the end of May 2004, foreign credit constituted about 83 per cent of the overall credit. The Lek appreciation against both main currencies, euro and US dollar, during the first five months of 2004, respectively by 2 per cent and 5 per cent, has reduced the Lek value of foreign credit balance by Lek 1.7 billion. By eliminating this impact, it results that the real growth of credit balance amounts to Lek 7.2 billion.

Table 17 Credit balance indicators, in percentage

	2002	2003	T-1 '04	April '04	May '04
Short – term loan	53.8	46.0	41.6	40.8	38.5
Medium – term loan	30.1	33.3	35.4	35.9	37.1
Long – term loan	16.1	20.7	23.0	23.4	24.4
Private sector ⁵	99.8	100.0	100.0	100	100
State sector	0.2	0.0	0.0	0.0	0.0
Lek	21.3	19.6	17	17	17 ⁶
Foreign currency	73.7	80.4	83	83	83
Credit balance (in billions of Lek)	38.7	50.7	53.4	55.97	56.2

New credits granted in the period of January – May 2004, amounted to Lek 48.7 billion or 47 per cent higher than the level of credits granted in the same period of the previous year. About 50 per cent of credits are granted for trading purposes, 9 per cent for the processing industry and 10 per cent for the purchasing of real estates. The other part belongs to the branches of construction, hotels and restaurants, transport and telecommunication, and rather low to the agriculture. However, the level of credits granted to the agricultural sector during January – May 2004 results 78 per cent higher than the same period of 2003.

⁵ In this classification, 99 per cent belong to the private sector and households and 1 per cent to the financial institutions.

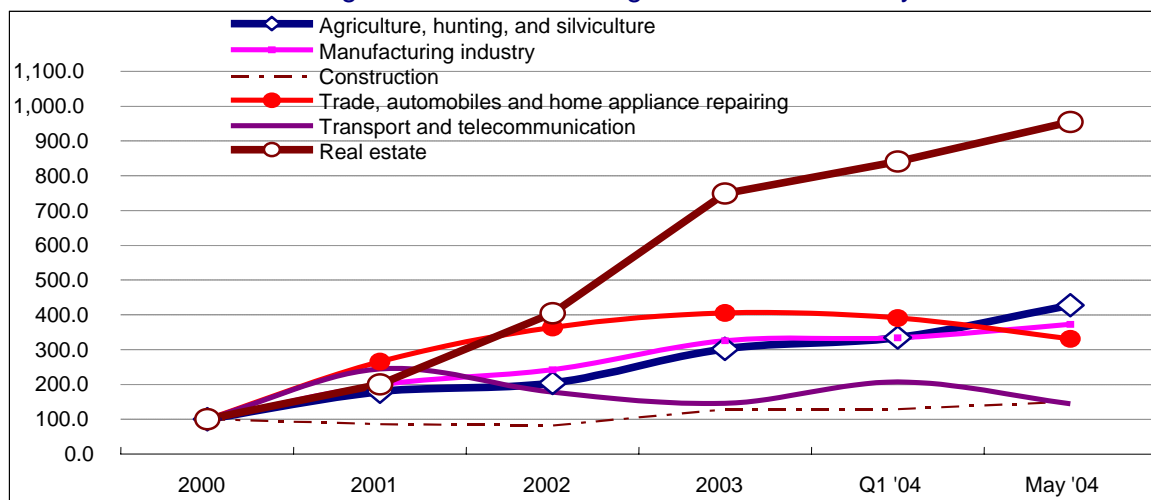
⁶ In May 2004, the American Bank of Albania in its reports on the lending activity has performed some systematisations in the credit balance structure according to the terms and currencies. These systematisations are carried out since December 2003.

Table 18 New credit performance over the years (in billions of Lek)

	2001	2002	2003	T-1 '04	April'04	May'04
Short-term loan	27.6	44.7	63.1	18.7	6.9	6.5
Medium – term loan	10.4	13.0	22.2	5.7	2.3	2.5
Long – term loan	2.6	4.8	7.4	3.5	1.4	1.2
State sector	0.5	0.06	0.04	0.0	0.0	0.0
Private sector	40.1	62.5	92.6	27.9	10.6	10.2
Lek	10.0	20.8	30.8	8.80	2.4	3.9
Foreign currency	30.6	41.8	61.8	19.10	8.2	6.3
New credit (in billions of Lek)	40.6	62.6	92.6	27.9	10.6	10.2

During the first half of 2004, a downward trend of the weight that credit occupies for the trade sector and an ongoing growth of credit for real estates is observed in the structure according to the economy branches of total credit balance. On the other hand, the agricultural sector has started to be financially supported by banking credits. This becomes obvious, if we compare the growing rate of lending to this sector with year 2000 (see Chart below). The credit balance for agricultural sector results, by the end of May 2004, 4 times higher than it was in 2000.

Chart 26 Credit balance growth index according to some of economy sectors



The monetary program of 2004 forecasts that the crediting growth to the private sector amount to Lek 16.5 billion. The expected level, by the end of May 2004, is fulfilled at 33.3 per cent. Considering the fact that during the second half of the year banks will grow the credit portfolio level, and also the presence of the Savings Bank in the credit market, we deem that the level of crediting to

economy from the banking system, projected in the monetary program, will be succeeded.

Table 19 Credit balance with regard to economy branches (in percentage)

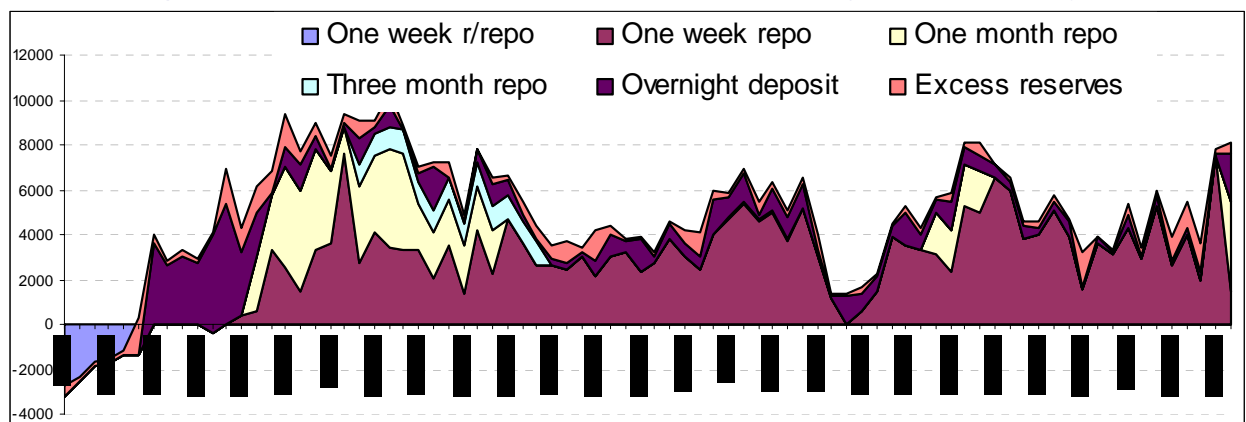
	2001	2002	2003	T-1 '04	May '04
1 Agriculture, hunting and silviculture	1.0	0.8	1	1.0	1.1
2 Fishing	0.1	0.2	0	0.1	0.1
3 Extracting industry	1.6	0.2	1	0.2	0.2
4 Processing industry	19.5	17.0	17	16.9	18.0
5 Production, distribution of electric power, gas and water	3.0	3.3	3	3.0	3.2
6 Construction	12.5	8.6	10	9.7	10.8
7 Trade, repairing of vehicles and home appliances	41.3	40.4	34	31.4	25.3
8 Hotels and restaurants	4.3	6.0	6	7.1	7.8
9 Transport and telecommunication	4.6	2.4	1	2.0	1.3
10 Financial activities	0.1	-	0	0.1	0.2
11 Real estate	6.3	9.1	13	13.7	14.7
12 Health and social activities	1.2	0.5	0	0.5	0.5
13 Collective, social and personal services	3.3	4.2	8	4.2	4.5
14 Other	1.2	7.3	4	10.1	12.2
Total	100	100	100	100.0	100.0

III.4 FINANCIAL MARKETS AND INTEREST RATES

III.4.1 MAIN DEVELOPMENTS IN THE FINANCIAL MARKETS

Even during the first half of 2004, the banking system has resulted in excess of liquidity. The liquidity level during this period, in general, has presented a stability fluctuating at an average of Lek 5.1 billion.

Chart 27 Liquidities of commercial banks at the Bank of Albania (in millions of Lek)



Liquidity withdrawing is performed mainly through weekly Repo auctions at unlimited amount. Meanwhile, the end of June and beginning of July are followed by signs of a growing liquidity level, leading to the need of intervention through quick and monthly Repo auctions. Overnight deposits were one of the favorite facilities for commercial banks, while overnight loan was rarely used.

Alongside the introduction of the new payment system RTGS, in March, the intraday loan has started to be applied as well. This facility has been used by a range of banks, mainly by those being the most active in the interbank market.

Excess liquidity has not encouraged the transactions in the interbank market. On average, transactions volume amounted to Lek 0.4 billion compared to Lek 0.7 billion in the first half of 2003, when the banking system faced liquidity shortage periods.

In the primary market, the government demand for funds has been met by banks. Their supply to invest on securities for the government has been higher than the stated amount, particularly for the one-year maturity T-Bills, thus increasing the competitiveness of banks in the market. Yield decline following the easing monetary policy of the Bank of Albania and competitiveness growth led to a negative display of the net impact of the government securities issuance and immaturity. This brought about the disbursement of the system funds and liquidity growth, while for the budget deficit coverage the direct credit and privatization revenues were used as well.

III.4.2 INTEREST RATES

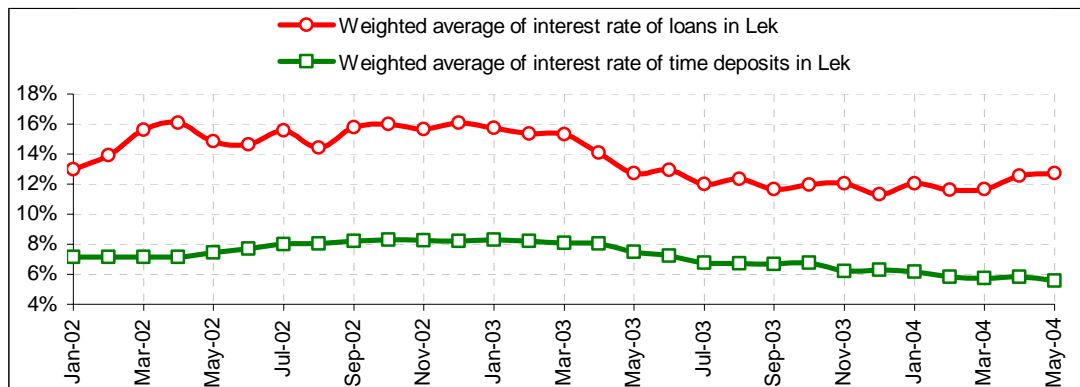
Throughout the first half of 2004, the Bank of Albania has signaled the facilitation of the monetary policy, reducing subsequently three times the Repo rate by 0.25 percentage points. By the end of June, Repo rate reached 5.75 per cent. It appears that these signals have traversed all markets, except the credit market.

Table 20 Weighted average interest rates of the new deposits flow; the new granted credits and T-Bills, during 2004

	December-03	March-04	May-04	Cumulative Change
Repo	6.50	6.50	6.00	-0.50
Lek time deposits	6.29	5.75	5.59	-0.70
T-Bills	8.57	8.25	8.1	-0.47
Lek credits	11.34	11.66	12.72	+1.38

It appears that banks have preferred to reduce the deposits interest rates in Lek more than the T-Bills yield, thus providing a higher profit. Furthermore, the reduction of deposits interest rates in Lek was higher than the one signaled from the Bank of Albania. This reaction was supported by the fact that Lek deposits had a growing tendency. Meanwhile, interest rates in the credit market have had a slight upward trend, as a consequence of the credit structure shifting to long-term loans.

Chart 28 Lek deposits and credit interest rates performance

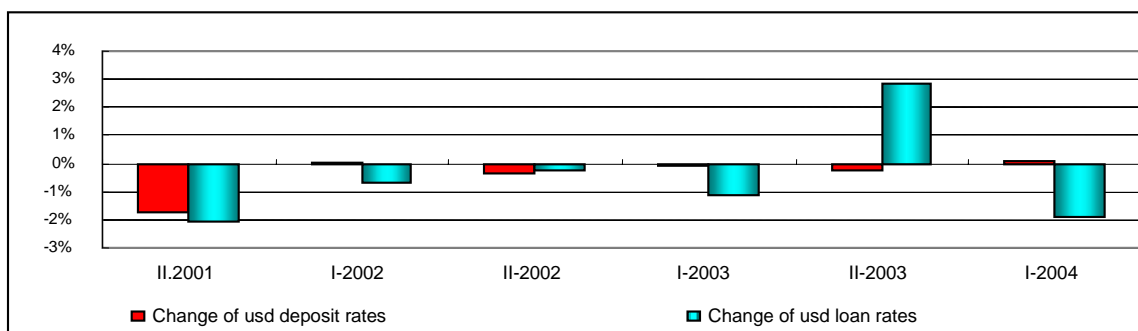


During the first half of 2004, the average interest trends of foreign currency deposits⁷ appear of opposite directions: growing for the US dollar and dropping for the euro.

USD deposits interests' growth has reflected the expectations of international markets towards a tightened policy from the Fed that became a reality by the end of June.

Euro deposits' falling has reflected the expectations of markets for a further facility of the monetary policy from the European Central Bank. To this one it is added the growth of Euro deposits near banks (almost three times higher than the growth of dollar deposits⁸), the higher cost of Euro deposits acceptance and the preference of banks to decrease it, dollar appreciation in the international markets, growing banks interest for it, etc.

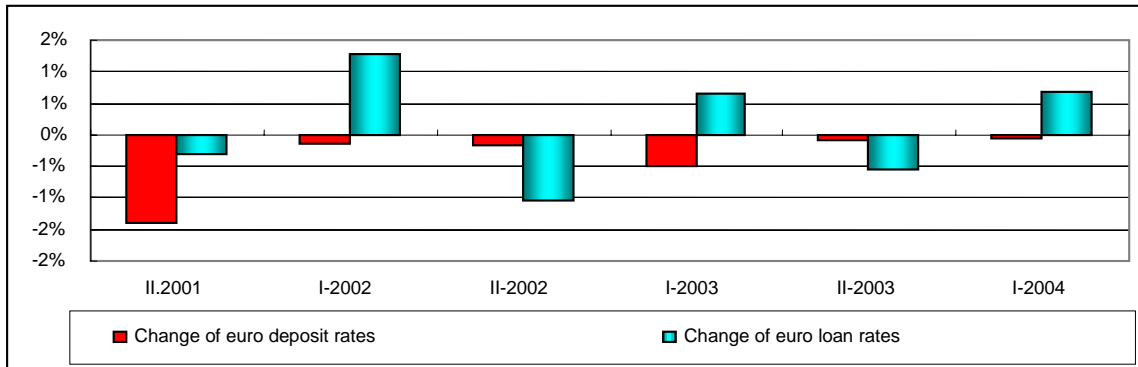
Chart 29 Six-month change of USD deposits and credits weighted average interests



⁷ The average weighted interest rate of time deposits.

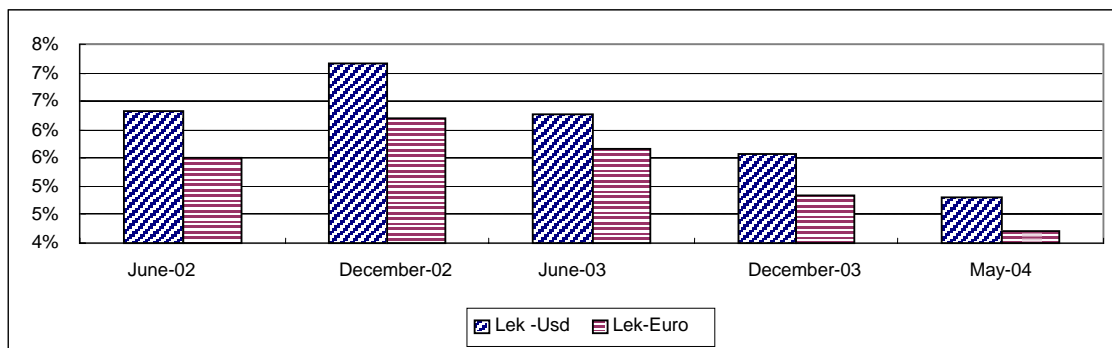
⁸ According to the operative data in US dollar and euro.

Chart 30 Six-month change of EUR deposits and credits weighted average interests



Through an easing policy followed by the Bank of Albania, the spread between Lek-foreign currency deposits interests has become tightened in the first half of 2004.

Chart 31 Spread between time deposits in Lek and those in foreign currency



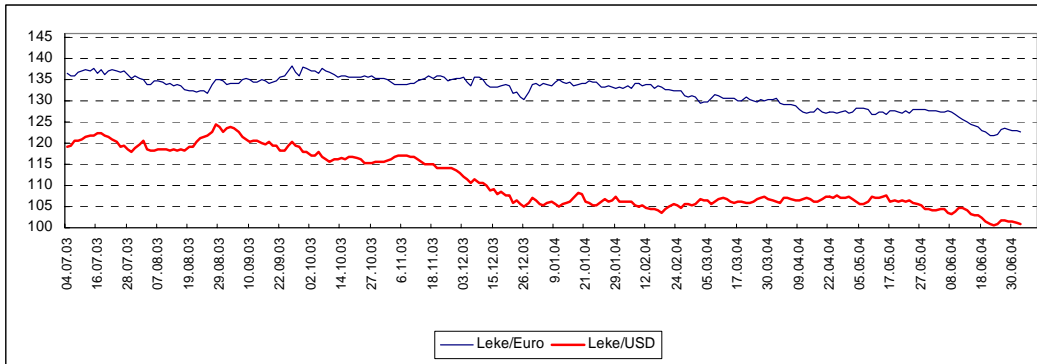
However, under the conditions when foreign currency deposits interests have resulted on low levels, Lek preferences have not diminished.

III.4.3 DEVELOPMENTS OF FOREIGN EXCHANGE MARKET

Under the conditions of economic stability, increase of confidence in the domestic currency and seasonal impact, in the first half of 2004 Lek is appreciated against both euro and US dollar by 6.4 per cent and 5.4 per cent, respectively.

Chart 32

Exchange rate in the domestic foreign exchange market



The commencing of tourism earlier than the previous years has impacted the growth of foreign currency supply from tourists and emigrants, thus helping the Lek appreciation. The growth of the domestic output and the falling of the demand for agricultural goods imports have prompted the low demand for foreign currency. In respect of Lek demand, during this six-month period the government has manifested a low demand for the financing of the deficit, being assisted by the revenues originating from the Savings Bank's privatization.

On the other hand, though interest rates in Lek have been declining on a continuous basis during the first half of the year, the low inflation rates have maintained the real interest rates in Lek higher than the foreign interest rates. Foreign interest rates were decreased due to the easing policies implied from both Fed and ECB. All these seem to have supported the Lek strengthening. Lek preference is observed either in the Lek deposits increase or in the growth of public's interest for the T-Bills in this currency.

Lek appreciation has not reflected any significant impact on the exports decline, since they consist, to the vast majority, of re-exports. Besides the growth of imports, data of the first quarter of 2004 suggest a growth of exports as well.

The Bank of Albania has intervened in the market by purchasing foreign currency, in order to maintain the exchange rate stability, alongside the reduction of the base of interest rate.

V. EXPECTED ECONOMIC PERFORMANCE DURING 2004

The general targets of the country's macroeconomic development for 2004 are summarized by the achievement of the economy growth rate at about 6 per cent, that is forecasted to be fulfilled under the conditions of maintaining the macroeconomic stability, an inflation within the two-to-four per cent targeted range, a falling budget deficit, a stable position of the overall payment balance, expressed in the growth of foreign currency reserves and in a relatively stable exchange rate. The most dynamic sectors of the Albanian economy, such as construction, transport and services, continue to give their main contribution on the economic growth.

Table 21 Forecasted growth of the economy sectors (in percentage)

	2002	2003	2004
Real growth of GDP	4.7	6.0	6.2
-industry	1.8	2.7	3.1
-agriculture	2.1	3	3.0
-construction	8.7	11.3	10.6
-transport	9.7	10.8	10.1
-services	5.1	6.4	6.4

The data of the last years, in general, suggest a consolidation of the macroeconomic balance. Inflation is maintained within the targeted band and on modest levels compared to the standards of the developing countries, the domestic currency has been stable, ultimately manifesting appreciating trends; fiscal policy has been implemented within the forecasted parameters, while the monetary indicators appear to be stabilized. Lending to economy appears to have taken a new run up, marking an annual average growth of 30 per cent during the last three years, while banking system appears to be sound, with satisfactory indicators of liquidity and profitability.

The Albanian economy is expected to move forward in consistence with this stability even during 2004. The fiscal and monetary policies are oriented towards this target, establishing an adequate environment for the economic growth.

Table 22

Main macroeconomic indicators

	2001	2002	2003	2004
Monetary indicators (in percentage)				
GDP growth	7.6	4.7	6.0	6.2
Annual CPI (average)	3.1	5.2	2.4	3.0
Nominal GDP (in billions of Lek)	610.4	677.7	744.6	836.9
Fiscal indicators (as a percentage of GDP)				
Fiscal deficit	-8.2	-6.9	-4.7	-6.5
Domestic borrowing	3.0	3.2	2.7	1.9
Domestic public debt	39.5	38.8	38.0	35.9
Foreign sector (in million of USD)				
Trade deficit	-1027	-1155	- 1336	-1602
Private transfers	543	597	782	939
Gross foreign reserves	737	860	1026	1133
Monetary indicators (in percentage)				
M3 growth	19.9	7.0	9.5	11.8
Credit growth to the economy	43.1	32.1	28.5	31.54
Quarterly T-Bills interest rates	8.0	11.2	7.3	...

Foreign sector

The foreign sector of the economy will continue to be characterized by high trade deficits. This fact shows the high consumption of the Albanian economy, a consumption being considerably financed by the emigrants' remittances. These incomes are expected to increase by 20 per cent during 2004, amounting to USD 939 million. On the other hand, this deficit shows also the competitiveness that appears in the difficulties the Albanian exports afford in the foreign markets, and in their impossibility to effectively replace a part of imported goods. Trade deficit is expected to be at 20.4 per cent of GDP for 2004, from 21.8 per cent it was in 2003.

The high trade deficit leads Albania to have current account deficits, though the presence of considerable private transfers. However, the reduction of trade deficit in relative terms makes that current account deficit also be expected to lower to 5.5 per cent of GDP during 2004, from 6.5 per cent it was in 2003. This deficit will be financed by the foreign direct investments and foreign financing. The balance of payments, in overall, is forecasted to be positive for this year, causing that the gross foreign reserves of the Bank of Albania increase by USD 107 million.

Fiscal sector

The fiscal policy of government will continue to maintain the macroeconomic stability, keeping the budget deficit on low values. Budget revenues are expected to reach 23.1 per cent of GDP, increasing by 0.7 percentage points in comparison with year 2003. Tax revenues are expected to be 20.8 per cent of GDP, from 19.5 per cent they were in 2003. The budget deficit is expected to be 6.5 per cent of GDP. Revenues from the Savings Bank's privatization will grow the capital expenses, from 5.9 per cent of GDP initially forecasted to 6.3 per cent. The domestic borrowing also will fall from 2.8 per cent of GDP to 1.9 per cent, recording the lowest level over the past years.

Monetary developments

The Bank of Albania, for the year 2004, aims to maintain inflation within the two-to-four per cent targeted range. To achieve this target, the Bank of Albania aims to control the growth of the monetary assets in the economy at a level of 11.8 per cent. This growth is deemed to better meet the economy demands for monetary assets, supervising at the same time the inflationary pressures. The monetary program of the Bank of Albania for the year 2004 forecasts a growth of net foreign exchange assets of the banking system by 14.9 per cent or about Lek 24.1 billion, of which Lek 9.7 billion belongs to the growth of net foreign exchange assets of the Bank of Albania. Foreign revenues from privatization and the increase of foreign currency deposits are the main sources of their growth. Privatization revenues suggest a forecast of the budget deficit financing lower than in 2003. Government's deficit financing from the banking system during 2004 is projected to be 1.9 per cent of GDP or Lek 13.7 billion, of which Lek 12.5 billion is expected to be financed from commercial banks. The Bank of Albania previews, in the monetary program of 2004, a growth of credit balance for the private sector by Lek 16.4 billion, of which Lek 4.2 billion will be the growth of credit balance in Lek, while the remaining part of Lek 12.2 billion belongs to the growth of foreign currency credit.

Ratio of currency outside banks against monetary supply by the end of 2004 is forecasted to be 27.2 per cent. The reduction of projection on the ratio of currency outside banks against monetary supply from 28.6 per cent to 27.2 per cent is conditioned by the growing tendency of the public to maintain the monetary assets in less liquid forms. The reduction of the ratio of currency outside banks against M3 will favour the growth of Lek deposits, which are projected to grow by 9.7 per cent or Lek 21.9 billion during 2004. Foreign currency deposits ratio against monetary supply is expected to be 22.8 per cent by the end of 2004, from 20.8 per cent this ratio was at the end of 2003. Based on this projection, growth of foreign currency deposits, expressed in Lek, will be 20.8 billion Lek or 22.6 per cent during 2004.