

## ECONOMIC DEVELOPMENTS DURING THE FIRST SEMESTER OF 2005

### I. GOVERNOR'S SPEECH

During the first half of 2005 the Albanian economy is characterized by positive developments within the expected parameters. The economic activity in Albania has been revitalized throughout a slight improvement of the world economy, which has continued to develop at a moderate pace during the first half of 2005. The American economy was one of the crucial driving forces of the world economy, while the economic situation in the euro area and Japan, even though it is improving, continues to remain fragile. The growth of the world economy is being accompanied by a growth with regard to the trade exchange volume. Moreover, the negative developments of oil price and the instability of exchange rate have not been reflected with their full amplitude in the internal economy.

Considering the developments in specific sectors, the fiscal indicators as well as the rapid growth of credit to the economy, it can be said that this period has been assessed as favourable for the country's economy and the achievement of development objectives. In general, the most vital sectors of the Albanian economy, at the beginning of 2005, have registered a satisfactory growth compared to the same period of the last year. The annual growth rates of these sectors have been increasing, thus showing a long-term trend of the development of the economy. The sectors that have marked the highest annual growth in terms of sales are construction, trade, services, agriculture and agro-industry, while the transport and industry sectors have performed almost the same volume of sales compared to the first quarter of the last year. The positive developments of the economic activity in the country are accompanied by a further improvement of labour market. This improvement has been shown in the increased number of the employed persons compared to the same period of the last year. The unemployment rate of the first quarter of this year has marked the lowest rate of the last seven years.

During January – March of this year, the current account resulted in a deficit of USD 56.2 million, thus indicating a slight worsening compared to the same period of the last year. While the rates of imports, exports of goods and services remained almost similar, the high volume of imports resulted in a deep current deficit. The trade deficit of USD 363 million as well as the deficit of USD 40 million in the service category is covered by the inflows of current transfers, mainly private ones. The inflows of the capital during the first quarter were sufficient to cover the current deficit, thus resulting in a positive level of the overall balance of payments of around USD 13 million. The appreciation of Lek against USD and Euro has led to the decline of price of goods and foreign services, while this appreciation has not threatened our

exports competitiveness, because of the structure of exports oriented towards re-exports.

Despite the electoral campaign of 2005, Bank of Albania estimates that the fiscal situation has been kept under control. The fiscal developments during the first half of 2005 were moderate and the indicators have not surpassed the projected level for this period. According to the Finance Ministry data, up to the end of June there are 98.3 per cent of the revenues collected and 97,7 per cent of the expenditures planned. As a result, the budget deficit by the end of June was about ALL 9.4 billion out of ALL 10.2 billion projected. The budget deficit for this period was mainly financed by domestic sources, while the foreign financing was 50 per cent of the projected amount.

The first half of 2005 is characterised by low inflation rates. The annual inflation has known a downward trend during the first half of the year, thus reaching the 1.3 per cent in April, while in May and June they evidenced an increase of inflation up to 2.9 per cent. The average annual inflation has been continuously within the targeted band of Bank of Albania, having stabilized at 2.25 per cent in June. The orientation of fiscal and monetary policies towards maintaining the macroeconomic stability as well as the positive developments in various groups of consumer goods, within a favourable macroeconomic environment, has made possible the inflation rate control. The balance of demand and supply factors has not resulted in inflationary pressures during this period. The modest rise of salaries, oil and administered prices is compensated by the effect of disinflation factors, such as the sustained level of domestic demand, the controlled monetary situation, the stable appreciation of Lek and the growth of domestic agricultural production.

The Bank of Albania monetary policy was generally a smoothing policy during the first half of the year. This tendency was more pronounced during the first quarter of the year, thus decreasing by 0.25 percentage point of the core interest rate at the end of March, while during the second quarter of the year the monetary policy has been gradually taking a neutral stance. The easing of the monetary policy has been reflected in the continuous decrease of interest rates in the financial markets. This decrease was more pronounced in relation to the medium-term maturities, thus affecting the curve of Lek interest rates towards its levelling. The easing monetary policy of Bank of Albania is followed by a decrease of demand for monetary assets. The main source of monetary expansion during this period was crediting to the economy, unlike the past years when this function was performed by the government loan or the foreign inflows. The credit balance increased by an average of ALL 3.7 billion per month, during January – March of 2005, thus indicating by the end of the period a total increase of ALL 18.7 billion. This level is the same as the credit growth during 2004. The positive developments of crediting to the economy from the banking system have considerably influenced the improvement of all macroeconomic indicators of credit.

The continuous consolidation of macroeconomic stability during the recent years constitutes a sound foundation for the development of the Albanian

economy for the rest of year 2005. The Albanian economy has all the premises for a development within the scheduled framework. However, during the last few weeks there has been noticed a movement of monetary funds from the banking channels in the economy, as a result of the seasonal factor, payment of the frozen funds in the pyramid schemes and the uncertainties that characterise in general the pre and post-electoral situation. Therefore, we are carefully following the latest developments of liquidity, especially those related to the financing of the budget deficit.

In favour of guaranteeing the stable development and the maintenance of the macroeconomic equilibrium, we believe that these developments will be temporary and the normal management of income will be recuperated very soon with the creation of the new Albanian government. Bank of Albania remains greatly committed towards observing the indicators of economic and financial development in the country for year 2005 and, in this context, we hope that there will be also the commitment of the competent authorities.

At the same time, Bank of Albania takes this opportunity to call on all the economic institutions for observing the fiscal obligations based on the applicable rules and regulations. On the other hand, Bank of Albania will aim at preserving the monetary conditions in the economy in line with the inflation targeted range of 2-4 per cent, thus aiming at the same time at developing the financial market, improving the payment infrastructure and increasing the financial intermediation in the economy. Bank of Albania estimates that to achieve the goal of developing the country, the cooperation and the support of all the responsible institutions in the field of economic policies is a crucial factor for preserving the progress of economic structural reforms.

## II. ECONOMIC DEVELOPMENTS DURING THE FIRST HALF OF 2005

### II.1 WORLD ECONOMY

The world economy has been growing with the same moderate pace even during the first half of 2005. The positive performance of the American economy has been one of the main factors giving the impulse to the world economy. The economies of the euro area and Japan have had a better performance compared to the previous period, but the economic situation in these countries continues to remain fragile. China's economy continues to grow with rapid pace, stimulating the economic activity even in the rest of Eastern Asia.

The world economic activity for this year has been based on the positive performance of the service sector compared to production sector. The increase of costs in the production sector due to oil price rise, has affected this asymmetry. The high oil price continues to be one of the crucial problems of the world economy.

Table 1 Some indicators of the first half of 2005

	GDP – 1Q	Unemployment rate	CPI
USA*	3.8	5.0 (June)	2.5 (June)
Euro area	1.3	8.8 (May)	1.9 (May)
France	1.8	10.2 (May)	1.5 (May)
Germany	1.1	11.7 (June)	1.9 (June)
Italy	-0.2	7.8 (March)	1.8 (June)
United Kingdom	2.1	4.6 (March)	1.9 (May)
Japan	0.8	4.4 (April)	0.2 (May)
China	9.5	-	2.7 (March)

Source: Monthly Bulletin of Central European Bank and Eurostat.  
\* The data for the American economy are taken from the American Department of Labour and American Department of Trade.

The American Economy. The American economic activity marked satisfactory growth rates even during the first half of 2005. The real growth rate of GDP during the first quarter was 3.8 per cent. The growth of the American economy indicates the growth of consumer expenditures, exports and investments. The consumer expenditures are supported by the improvements in the labour market conditions as well as by the positive developments in the housing market. Taking into consideration the revitalization of inflationary pressures, the USA central bank, the Federal Reserve, has continued to tighten the monetary policy "with diligence". In the meeting of 30 of June, FOMC increased for the ninth time in succession the core interest rate, leading it to 3,25 per cent.

The Euro area economy. The economic developments during 2005 are more positive for the economy of the euro area. According to the first estimations, the GDP growth in the euro area was 0,5 per cent during the first quarter, from 0,2 per cent it was during the fourth quarter of the last year<sup>1</sup>. The GDP growth has come as a result of the growth of exports, at a time when the domestic demand has not increased, while the investment growth has been lower than that of the previous period. In the euro area the core interest rate continues to be 2 per cent since June 2003. The low interest rates continued to have a driving impact on monetary expansion and credit. The level of inflation (according to Harmonised Consumer Price Index) in May dropped down by 1.9 per cent after a three-month period during which this indicator was at the level of 2.1 per cent. During this period the salary increase was moderate, without exerting any inflationary pressure.



#### Exchange Rate

The euro area currency is depreciated in nominal terms as well as in real terms during 2005. At the beginning of June, the ratio between euro and currencies of 23 main trade partners marked a decrease of 2.8 per cent against the average of 2004. The political debates on the EU constitution as well as the vote against it in France and Netherlands have negatively affected the performance of the currency in the euro area. The increase of interest rates in the USA has made

the investors be under the effect of the expected yield rather than the American economy deficits.

**Oil Price.** The oil price has continued to increase during the first half of 2005, thus exceeding the highest price reached in October last year. In April 2005 price for a barrel of crude oil<sup>2</sup> exceeded USD 57. Oil price rise during the past few years has come as a result of the growth of demand and the tightening of supply for oil. The rise is estimated to have had a moderate effect on the world economic activity as well as on inflation.

## II.2 ALBANIAN ECONOMY DURING FIRST HALF OF THE YEAR

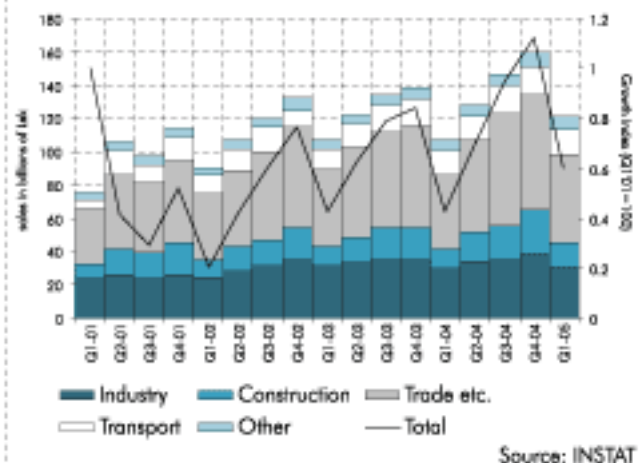
The Albanian economy is characterised in general by a good performance and estimated within the expected parameters during the first half of 2005. Considering the sales in the economy, the developments in the respective sectors, the performance of fiscal indicators as well as the rapid growth of credit to the economy, it can be said that this period has been favourable for the economy of the country. According to the data from VAT, which are considered as approximate indicators of the performance of the production in various sectors of the economy, the first quarter of 2005 has shown an increase in comparison with the first quarter of the last year. The first quarter of this year has experienced the highest percentage of sales for this quarter in the last four years. The sectors that have shown the highest percentage of sales, on an annual basis, are "Construction", "Trade", and "Other Services". Meanwhile, the sectors of transport and industry have performed almost the same volume of sales compared to the first quarter of the last year.

The income from VAT recorded an annual growth of 8.9 per cent during the first five-month period of the year, showing at the same time a growth in the trade exchanges in the country. The credit to economy has shown an annual growth of 50 per cent. Together with the shift of the loan structure towards the production sectors, this development shows a wider utilization of the financial potential of the country towards supporting the needs for the development of the country. The first quarter of the year has shown a higher competition of the Albanian exports, which is reflected in the annual growth of 16.1 per cent of the exports during this period. In addition, the total number of the employed persons grew by 12,000 compared to the first quarter of 2004. Based on these

Chart 2 Performance of crude oil price per barrel in USD



Chart 3 Performance of sales in the economy during 1Q '01 – 1Q '05



data and taking into consideration the limitations they show for giving a clear opinion about the development of the economy, especially the quantitative aspect, Bank of Albania believes that the Albanian economy has shown signs of growth during this period. However, the expected information during the months to come will help us create a reliable and clearer opinion on the development of the economic activity.

## II.2.1 Production performance according to the sectors of the economy

### *Agriculture*

According to the Ministry of Agriculture and Food, the agricultural production is expected to grow to the degree projected at the beginning of the year, by 4.7 per cent. The weather conditions are in general estimated as favourable for performing the expected production. Due to the late springtime the domestic production is introduced in the market later than the other years, but summertime has been favourable for the development of the agricultural production.

During the first half of 2005 it has been noticed a growth in the surfaces planted with vegetables, forage crops and cereals. According to the survey of the agro-industry, the agro-industrial production has increased by 11 per cent during the first quarter of 2005 compared to the first quarter of the previous year. During the first half of 2005, 40 new entities, of which 35 have started their activity, have been registered in the agro-industrial sector. The total number of the employed persons in agro-industry has not changed compared to the same period of the previous year.

Table 2 Agroindustrial production during the first quarter of 2005 (in billions of ALL)

	1Q '05	1Q '05/1Q '04 (in percentage)
Agroindustrial production	6.8	11
Meat and its by-products	0.6	23
Conserved products	0.2	82
Milk and its by-products	1.2	4
Flour and bread	2.2	25
Beverages	0.6	10
Water and refreshment drinks	0.7	-24
Other	0.7	28

Source: Ministry of Agriculture and Food

### *Energy*

The production of energy has been relatively at satisfactory levels during the first half of 2005. The quantity of the produced energy during this period has been 3.200 GWH or 4 per cent higher than the same period of the previous year. The exported quantity of electricity during this period is 2 times higher than the one exported in the same period of 2004. Non-household consumption has shown a growth of 7 per cent compared to the same period of the last year, while household consumption has dropped down by 3 per cent.



	6 M - 2004	6 M - 2005	Change	Consumption per KWH (in percentage) 2005
Production	3,133	3,259	4%	
Imports	314	412	31%	
Supply	3,447	3,671	7%	100%
Exports	264	512	94%	13.95%
Losses	1,263	1,221	-3%	33.26%
Household consumption	1,145	1,107	-3%	30.15%
Non-household consumption	765	822	7%	22.39%

Source: Ministry of Industry and Energy

Table 3 Data on electricity supply and consumption

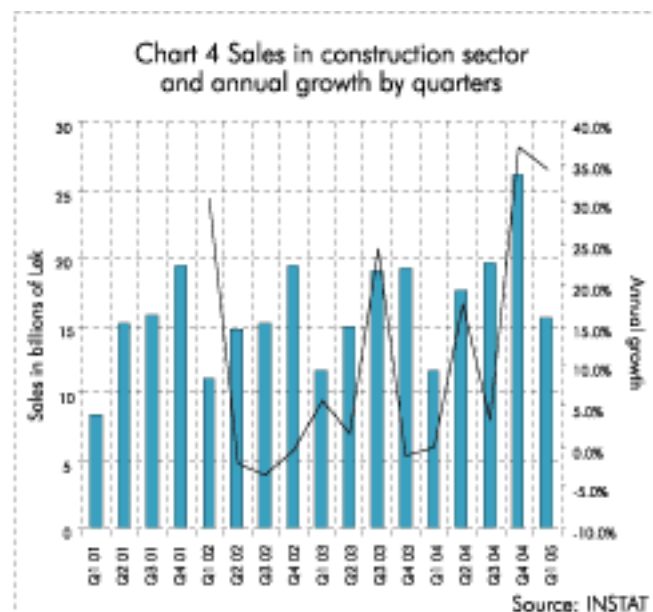
### Transport

The sales index in the transport and telecommunications sector showed an increase of 6.6 per cent during the first quarter of the year compared to the first quarter of the previous year. The sea transport marked an increase of 6 per cent during the first half of this year. Imports in the main ports of the country increased by 7 per cent, while the exports, which are 10 times lower than imports, decreased by 0,4 per cent. During the first half of 2005, the railway transport of goods decreased by 20 per cent, while the railway transport of passengers decreased by 24 per cent. The air transport marked an annual increase of 15 per cent during the last 10 years. During the first half of 2005, the air transport continued to increase, which is reflected in the increase of 27 per cent of number of flights as well as the increase of 22 per cent of the number of passengers.

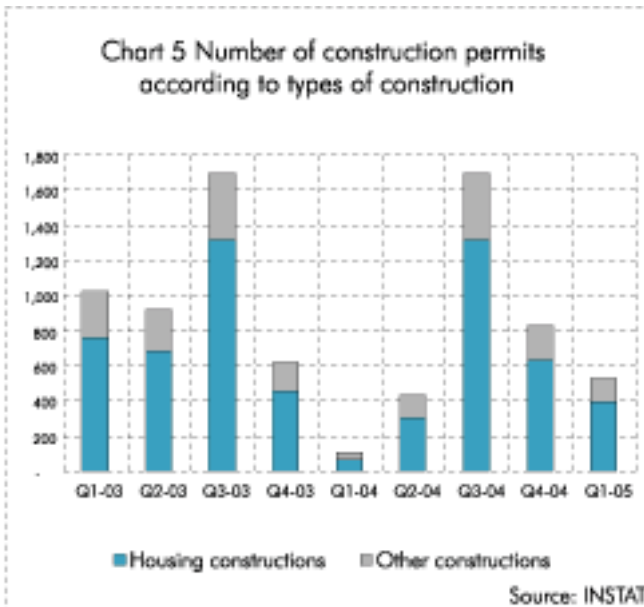
Investments in the transport sector decreased by 31 per cent during the first half of this year compared to the same period of the previous year. This decrease is due to the reduction of domestic investments, which were 33 per cent less than the same period of the previous year. Meanwhile, even the foreign investments decreased by nearly 27 per cent.

### Construction

During the first quarter of 2005, sales in construction sector were about 34 per cent higher than in the first quarter of 2004. The annual growth for the first quarter of this year represents a positive development for the construction sector, especially taking into consideration the lack of annual growth in the first quarters of the two previous years. Construction cost index increased by 3 per cent in the first quarter of this year. In this index it is noted an increase in the total direct expenditures. The items that have shown the highest annual increase, respectively 8.8 per cent and 9.7 per cent, are salaries and transport. Furthermore, it is noticed that the projected income has decreased by 1.5 per cent, thus reflecting the increase of construction costs.



The investments in construction sector, from both the private and government sources, have shown an increase during the first quarter of this year. Thus, the funds projected for investments during the first quarter increased by 55 per cent. Investments for housing construction, which increased by 30 per cent, take the main share in this increase. Furthermore, there is a considerable increase even in the engineered construction. The number of construction permits increased considerably during the first quarter of the last year and a major part of them is given for housing construction.



### II.2.2 Labour Market

According to statistics from INSTAT<sup>3</sup>, the labour force for the first quarter of 2005 has decreased by 1000 people, compared to the end of the last year. Meanwhile, compared to the first quarter of 2004, the labour force has increased by 7000 people. This increase has been reflected in the increase of the number of the employed persons by 12000 people, and in the decrease of the number of the unemployed persons by 5000 people, in annual terms.

Among all the employed persons, 19 per cent are employed in the government sector, 58 per cent in the agricultural sector and 23 per cent in the non-agricultural private sector. This distribution structure of the employed persons according to sectors remained unchanged during the last year and the first quarter of 2005. The number of unemployed persons, during the first quarter, has decreased by 1000 people. Compared to the first quarter of 2004, the number of unemployed persons has decreased by 5000 people. The unemployment rate by the end of the first quarter is estimated at 14.3 per cent, thus being the lowest rate registered during the last seven years.

Table 4 Indicators of labour market (in thousands of people)

	2004				2005
	Q I	Q II	Q III	Q IV	Q I
Total labour force	1080	1081	1080	1088	1087
A. Total employed persons	919	921	922	931	931
i) Government sector	179	179	177	176	176
ii) Non-agricultural private sector	206	208	211	213	213
iii) Agricultural private sector	534	534	534	542	542
B. Unemployment					
i) Total unemployed persons	161	160	158	157	156
ii) Beneficiaries of unemployment payment	11.7	12.3	12	11	14.3
C. Unemployment rate (in percentage)	14.9	14.8	14.6	14.4	14.3

Source: INSTAT, Coniuncture, June 2005.

The average public administration salary has increased by 3 per cent during the first quarter of 2005. This increase includes the salary increase in some groups of education employees. The minimum salary, the payments of the unemployed people and the average economic assistance per household have remained at the same level as at the end of the last year. In annual



terms, the average public administration salary has increased by 7 per cent and the payment to the unemployed people by 10 per cent.

### II.2.3 The fiscal sector

The fiscal indicators have in general been below the projected level during the first half of this year. According to the data from the Ministry of Finance, by the end of June, around 98.3 per cent of the revenues were collected and 97.7 per cent of the intended expenditures were performed. As a result, the budget deficit, by the end of June, has amounted to 9.4 billion out of 10.2 billion of Lek that it was planned. Compared to the same period of the last year, the revenues and budget expenditures have increased by 8.7 per cent and 9 per cent, respectively. The budget deficit for this period is being mainly financed by domestic sources (ALL 7.3 billion), while foreign financing was 43 per cent of the projected amount.

	6M '99	6M '00	6M '01	6M '02	6M '03	6M '04	6M '05	Average '99-'05
Total income	17.6	15.6	1.0	21.4	14.3	7.5	8.7	12.3
Tax revenues	9.8	30.8	-5.8	27.7	48.5	11.1	8.8	18.7
Revenues from local governments	4.3	61.0	36.4	32.5	242.3	18.0	5.2	57.1
Independent budget revenues	6.2	16.0	-2.5	31.7	14.9	8.5	11.1	12.3
Non-tax revenues	61.6	-25.2	37.9	-7.8	-9.9	-20.7	-0.6	5.1
Total expenditure	19.6	1.2	3.6	8.7	9.8	6.4	9.0	8.3
Current expenditure	12.9	0.0	-4.8	22.5	11.1	7.7	7.3	8.1
Capital expenditure	77.6	3.9	39.8	-31.4	1.1	-3.0	22.5	15.8
Deficit	24.5	-31.8	13.9	-34.9	-19.2	-4.2	12.0	-5.7
Domestic financing	26.6	-8.5	-16.7	-14.0	-10.2	14.6	17.7	1.3
Foreign financing	23.0	-49.3	55.5	-50.0	-30.4	-34.5	-4.0	-12.8

Source: Ministry of Finance

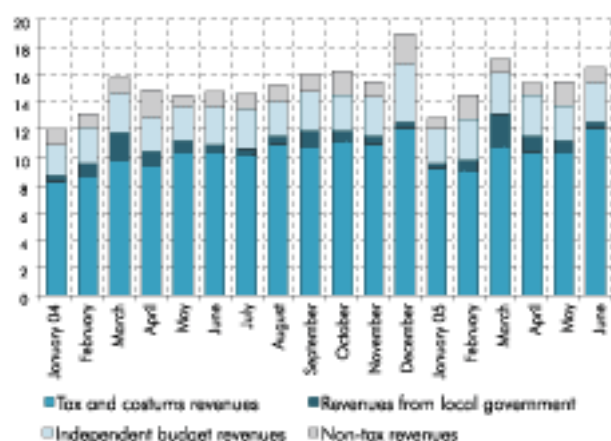
Table 5 Development of the main fiscal indicators (in percentage)

### Budget revenues

During the first half of this year, the budget revenues were about 8.7 per cent higher than the same period of the last year. The total revenues were ALL 93.4 billion, of which 61.8 billion have been collected from taxes and customs, 17 billion from the independent budget and the rest from the local governments and other sources.

With exception of the revenues from the local governments, the revenues of other categories have been below the projected level, however being close to that level. Revenues from VAT, excise and customs have been lower than the projected level, while the contrary has been observed with the revenues from income tax and from vehicles tax.

Chart 6 The structure of budget income (in billions of ALL – monthly data)



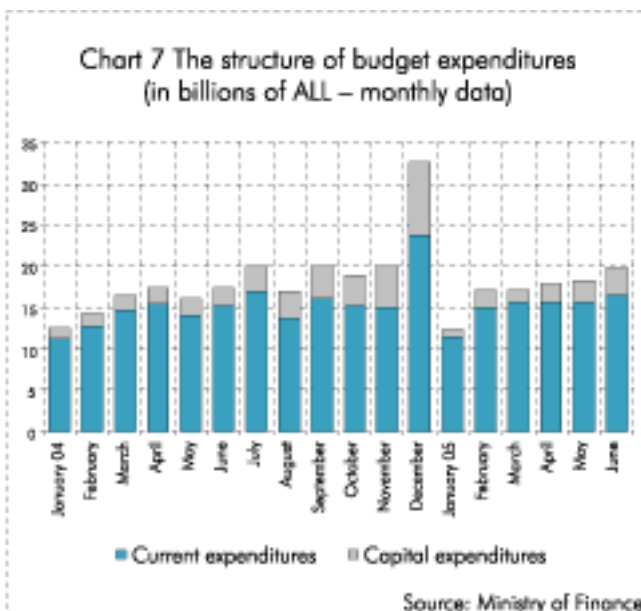
Source: Ministry of Finance

The income from the taxes continues to be the main source of budget income, thus representing around 91 per cent of total income. The structure of income has not showed significant changes compared to the same period of the last year.

Table 6 Income from taxes and customs (in billions of ALL – progressive data)

	June	6-month plan	Fact (in %)	To annual plan (in %)
Total	93.4	95.0	98	45
Tax revenues	84.8	85.2	99	47
VAT	28.5	29.4	97	45
Income tax	9.1	8.0	113	57
Excise tax	7.9	8.3	95	43
Personal income tax	3.3	3.4	98	43
National tax and others	4.9	6.3	78	40
Customs tax	5.9	6.1	96	38
Vehicles tax	2.1	1.0	206	98

Source: Ministry of Finance



### Budget expenditures

Budget expenditures, during the first half of 2005, were estimated at ALL 102.9 billion, thus performing the planned expenditures at 97.7 per cent. The current expenditures have been performed at 102.9 per cent and they represent 87 per cent of total expenditures for the first semester of 2005. Unlike the last three years, the performance of capital expenditures improved considerably during the first semester of 2005, being 22,5 per cent higher than the previous year.

However, these expenditures have been performed at 80.1 per cent. The concern in this regard seems to be the capital expenditures financed from foreign sources, which were performed only at 61 per cent of the plan, while the expenditures financed from domestic sources were performed at 100 per cent. Expenditures on interests and social security have remained within the projected level, so being performed at 92.8 per cent and 98.8 per cent, respectively.

Table 7 Composition of current expenditures (progressive data – in millions of ALL)

	March	June	6-month plan	Fact (in %)	To annual plan
Total expenditures	46.8	102.9	105.2	97.75	41.37
Current expenditures	42.0	89.7	87.2	102.86	46.52
Personnel	12.0	24.6	24.6	100.11	44.51
Interest	7.0	13.2	14.2	92.82	44.05
Domestic	6.8	12.3	12.9	94.93	45.01
Foreign	0.3	0.9	1.2	70.71	33.81
Maintenance - operative expenditures	4.5	11.0	9.5	115.62	50.25
Subventions	0.6	1.7	1.2	143.74	63.23
Expenditures on social security and others	12.7	26.2	26.5	98.76	47.46
Expenditures for local budget	3.0	8.0	6.5	124.20	45.57
Other expenditures	2.2	5.0	4.8	104.82	48.67

Source: Ministry of Finance

## II.2.4 External sector

The balance of payments closed with a positive balance during the first quarter of the year, thus being reflected in the growth of foreign reserves of Bank of Albania. Current account, during January – March of this year, resulted in a deficit of USD 56.2 million, revealing a slight worsening compared to the same period of the previous year, but with an evident tightening of deficit compared to the fourth quarter of 2004. The volume of current transactions increased by 26 per cent compared to the first quarter of the previous year. While the growth rates of imports and exports of goods have been almost similar, the high volume of imports has resulted in a deepened current deficit. The trade deficit of USD 363 million and the deficit of USD 40 million pertaining to the service item are covered in the largest part by the inflows of the current transfers, mainly private ones. The net capital inflows, during the first quarter, reached USD 60 million and were sufficient to cover the current deficit. At the same time, in our balance of payments it was recorded an increase of foreign reserves by USD 13 million.

### *Current account*

During the first quarter of this year, a volume of current transactions of about USD 1.7 billion was performed. The major activity in the category of current transactions continues to be that of merchandise trade, followed by the exchange of services. The current expenditures for this period were estimated at USD 860 million, of which 60 per cent were intended for the financing of imports of goods and 30 per cent for the financing of services purchased from the foreign residents. The exports of goods during the first quarter of this year were three times lower than the imports, while the exports of services financed about 90 per cent of the expenditures of the residents for services abroad. The current transfers have continued to register positive net flows, thus serving as balancing power for the high expenditures for purchasing goods and services. The current transfers account was USD 297 million by the end of the first quarter, or 33 per cent higher than the one in the first quarter of the previous month.

The trade exchanges in goods continue to be characterised by a high demand for imports and by limited exports, which, however, have registered continuous increase throughout the last quarters. Consumer's goods represent about one third of the imported goods, while the major part of imports comes as intermediary goods. The increase in the imports of capital goods is a good indicator for the performance of investments in the country. The exports have continued to be dominated by the re-exports, which during the first quarter of the year have represented about 80 per cent of total exports.

During the first quarter of the year, the residents have spent about USD 300 million for services insured by the non-residents and have earned about USD 260 million for providing these services to the non-residents. "Travel" or "Tourism" category continues to be the item that registers the highest inflows and outflows among the different types of services. During this period, the non-residents have spent in Albania about USD 200 million. A positive

development in this regard is the increase of the number of non-resident travellers by about 15 per cent compared to the same period of the last year. In line with the revenue growth from tourism, expenditures of the residents for travels abroad have increased as well. This phenomenon led to the tightening of the surplus of travel services.

Table 8 Balance of payments  
(in millions of USD)

	Q1-04	Q4-04	Q1-05
1. Current account (A+B+C+D)	-45.8	-167.3	-56.2
A. Trade of goods	-317.9	-509.8	-363.0
A.1 Imports of goods	-454.4	-671.5	-521.5
A.2. Exports of goods	136.5	161.7	158.5
B. Trade of services	12.2	-38.1	-37.0
B.1. Imports of services	-208.2	-299.2	-301.7
B.2. Exports of services	220.4	261.1	264.7
C. Income	37.5	42.4	46.4
C.1. Outflow	-5.3	-8.6	-5.0
C.2. Inflow	42.8	51	51.4
D. Current transfers	222.4	338.2	297.3
D.1. Outflow	-17.3	-30.3	-34.8
D.2. Inflow	239.7	368.5	332.1
2. Current account and financial account (E+F)	65.0	188.8	60.0
E. Capital account	34	37	46.6
F. Financial account	31	151.8	13.4
3. Net errors and omissions	-10.2	39.1	2.8
4. Overall balance	14.9	60.6	12.7
5. Growth of reserves	-14.9	-60.6	-12.7

#### *Capital and Financial account*

Like the capital account, the financial account also resulted in positive net flows during the first quarter. The common balance evidenced USD 66 million, of which USD 47 million have come as capital flows and USD 19 million as financial flows. The last ones were due to the increase of the financial obligations of the country to the world by USD 64 million and to the increase of the assets of residents abroad by USD 44 million. The increase of residents' obligations is mainly represented by the inflow of foreign direct investments in the country. The last ones, during this quarter, are estimated at USD 54 million, thus being higher than the investments of the same quarter during the last year. During this period, Albania has increased the stock of its external debt by about USD 22 million, meanwhile the cut of debt burden as a result of the principal and interest settlement, has been USD 10 million. During the first quarter of this year, the portfolio investment of residents abroad increased by USD 56 million, reaching the level of USD 200 million. The inflows of foreign assets as financial capital were reflected in the increase of foreign reserves of the monetary authority, by about USD 13 million. The level of foreign reserves by the end of the period was estimated at USD 1 billion and 350 million, which is sufficient to cover 4.9 months of imports of goods and services compared to 4.6 months in the first quarter of 2004.

### II.3 INFLATION PERFORMANCE DURING THE FIRST SEMESTER

The first quarter of 2005 is characterised by low inflation rates. The annual inflation decreased gradually during the first part of the year, thus reaching

the level of 1.3 per cent in April; meanwhile May and June registered a slight increase of inflation up to 2.9 per cent. While there are fluctuations in the annual rates, the average annual rate for each month of this period was maintained within the 2 – 4 per cent targeted range. The average inflation showed downward trends during the first four months of the year, thus remaining stable at 2.25 per cent during the two subsequent months.

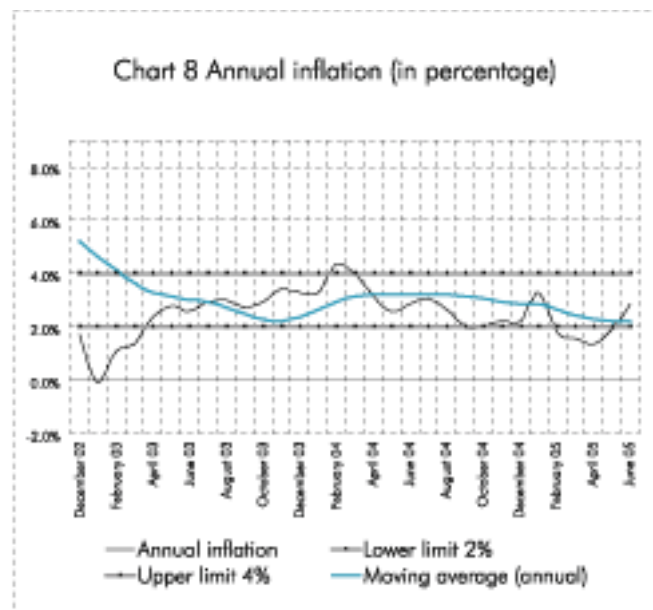
	2001	2002	2003	2004	2005
January	2.2	6.5	0.0	3.3	3.3
February	1.5	7.6	1.1	4.4	1.8
March	2.9	7.5	1.3	4.0	1.6
April	3.0	6.5	2.3	3.2	1.3
May	2.5	4.6	2.8	2.6	2.0
June	4.0	3.7	2.6	2.9	2.9
July	5.6	4.2	3.0	3.1	
August	4.1	5.5	3.0	2.7	
September	3.5	5.3	2.8	2.0	
October	1.8	5.8	2.9	2.0	
November	2.8	3.7	3.4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

Source: INSTAT

Table 9 Annual inflation (in percentage)

The good harmonisation of fiscal and monetary policies as well as the positive developments in various groups of consumer goods, within an appropriate macroeconomic environment, has made possible the control of inflation rate.

The interaction of the demand and supply factors has not resulted in inflationary pressures during this period. The modest increase of salaries and the rise of oil price and administered prices at the beginning of the year have exerted pressure on the increase of consumer prices. The effect of these factors has been balanced by the stable level of the domestic demand<sup>4</sup>, the stable performance of the Lek exchange rate and the domestic agricultural production.

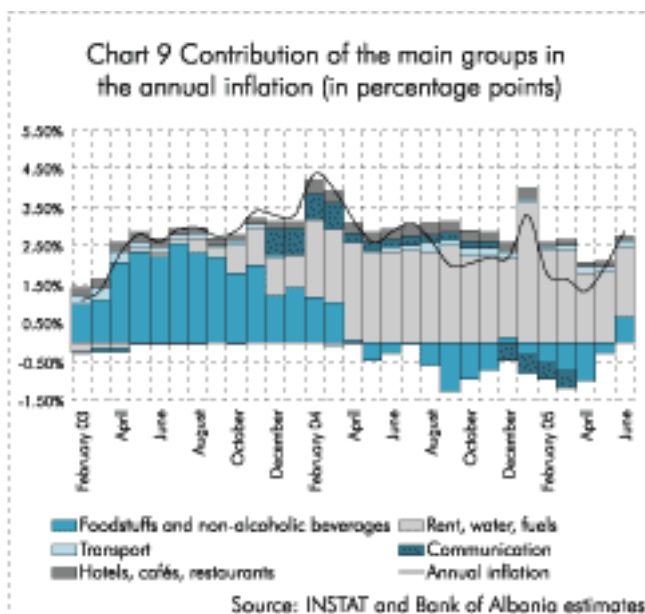


### II.3.1 Inflation performance and its constituent groups

The developments in the annual inflation rate during the first half of 2005 can be divided into two periods. During February – April, the consumer price index marked a downward tendency, dropping below the level of 2 per cent. After April, the annual inflation rate increased, thus reaching the level 2.9 per cent by the end of the first semester of the year.

The fall of foodstuff prices and especially the agricultural products have continued to exert pressure, like the last year, on the decline of consumer prices during the first five months of the year. The “Foodstuffs and non-alcoholic





beverages" item has marked negative inflation annual rates, except for the month of June. During the first five months of the year, the contribution of this group to the annual inflation rate was around – 0.6 percentage points, thus being lower than the contribution of 0.6 percentage points for the same period of the last year. Unlike the last year, the inflation of this group registered a turning point in June with a positive inflation rate of 1.6 per cent, thus contributing to the total inflation rate by 0.7 per cent. This development reflected a temporary deflation of the offer, as a result of the substitution of the greenhouse products with cornfield. The greenhouse agricultural product, which is present in the market over the whole year, the decline of foodstuff prices in the trading partner countries like Italy and Greece, as well as the appreciation of Lek against the euro have reduced the inflationary pressures of the goods included in this group.

Table 10 Annual inflation rate of item "Foodstuffs and non-alcoholic beverages" (in the country and abroad) and contribution of inflation of this group to overall inflation

	Annual Inflation '04	Annual Contribution (pp)	Annual Inflation '05	Annual Contribution (pp)	Italy* Annual Inflation '05	Greece** Annual Inflation '05
January	3.2	1.4	-0.7	-0.3	-0.5	0.6
February	2.7	1.2	-1.2	-0.5	-0.2	-0.9
March	2.3	1.0	-1.7	-0.7	-0.2	-1.4
April	0.1	0.1	-2.3	-1.0	-0.1	-0.1
May	-1.1	-0.5	-0.7	-0.3	-0.2	-0.4
June	-0.7	-0.3	1.6	0.7	-0.5	-0.5

\* Source: INSTAT; website: <http://www.instat.it>.  
\*\* Source: General Secretariat of National Statistical Service of Greece, <http://www.statistics.gr>.

Another important factor in estimating the annual inflation rate profile during the last two years is the performance of administered prices. This factor has been present even during the first half of the year. The rise of electricity price by 25.7 per cent in January was indeed an increase to the annual inflation of the "Rent, water, fuels, energy" item by 15.2 per cent. The average contribution (2.3 percentage points) of this item to the total figure of inflation during this semester was almost the same as the one of the first semester of the last year (2.0 percentage points).

During the second quarter of 2005, the annual inflation of the "Rent, water, fuels, energy" item has been decreasing, thus reflecting the decrease of rent prices and imputed rent. The subgroup "Rent" and "Imputed rent" has preserved its annual inflation norm of 2.3 per cent for the period April '05 – June '05.

Table 11 Annual inflation rate and contribution of the "Rent, water, fuels, energy" item to overall inflation

	Annual Inflation '04	Contribution (pp)	Annual Inflation '05	Contribution (pp)
January	3.7	0.9	15.2	3.6
February	8.5	2.0	9.8	2.4
March	8.3	1.9	9.9	2.4
April	11.0	2.5	7.2	1.8
May	10.0	2.3	7.2	1.8
June	9.7	2.3	7.1	1.8



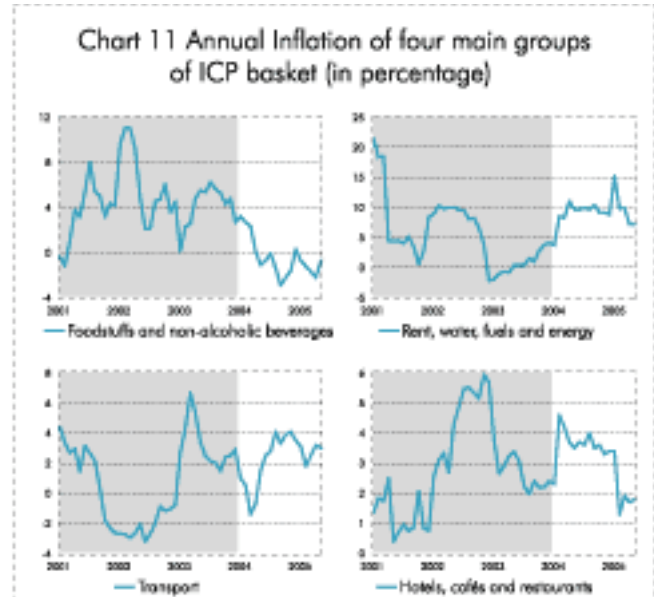
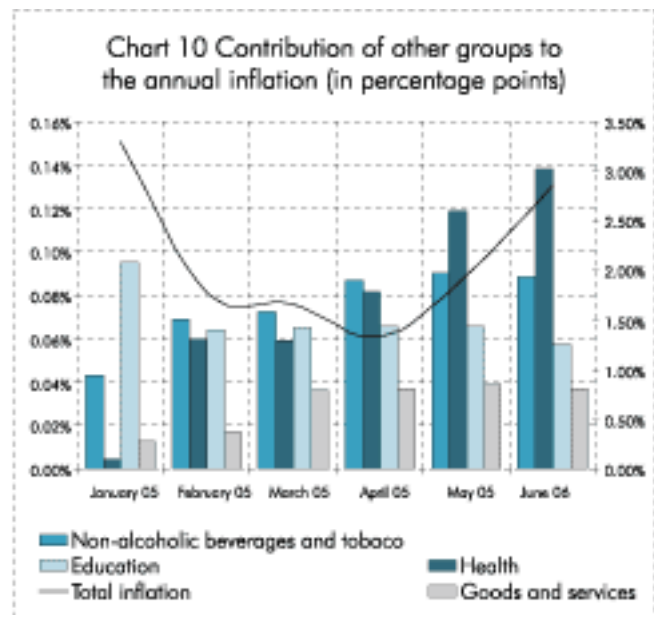
Another group, whose development is conditioned by the administered price fluctuations, is the “Communication” group. The changes made during the last year to the fixed telephony prices, have affected the annual inflation of the first half of this year. During the first quarter of this year, the “Communication” group contributed to the decrease of annual inflation rate by 0.5 percentage points, while during the second quarter the contribution of this group increased. April marked the end of the effect of the decrease of telephony prices a year ago<sup>5</sup>, so making the further contribution of this group to overall inflation be insignificant.

Oil price rise, though it constitutes a potential cost in the Albanian market, has transmitted weak inflationary pressures in the consumer price index. The inflation of “Transport” group, during this period, was lower than the rates registered over the most part of the last year. The annual inflation of this group, during the first semester, marked the highest rate in April (3.3 per cent). During January – June, this group has given an average contribution to the overall inflation rate by 0.13 percentage points.

During the first half of 2005, the other groups of basket are not in line with the price performance. Their effect on the inflation rate is small. The highest inflation was registered in the groups mainly composed of goods and services with administered prices, such as “Health” and “Education” but also in the other groups like “Alcoholics and tobacco”, “Goods and various services”. Groups like “Clothes and Footwear”, “Furnishing, equipment and maintenance”, “Entertainment and culture” have continued to register negative inflation rates. “Hotels, cafés and restaurants” have registered slower growth rates. These groups have contributed averagely to the annual inflation by 0.05 percentage points.

### II.3.2 Macroeconomic environment and consumer prices

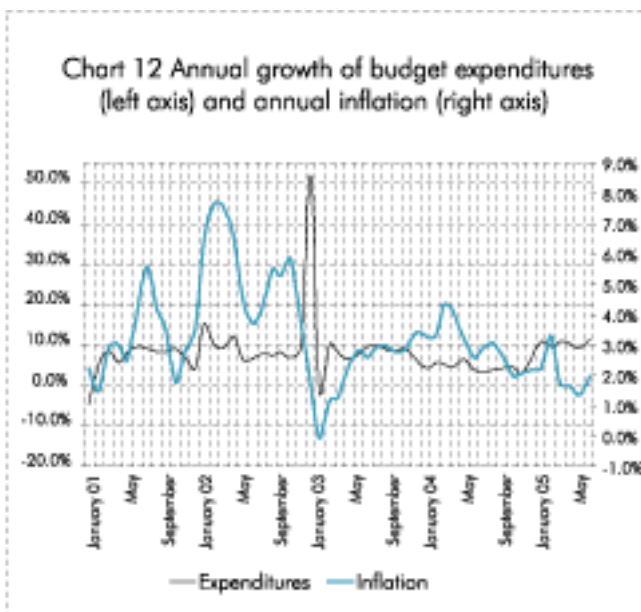
The macroeconomic environment has been in general stable during the first half of 2005. The prudential monetary policy and the lack of inflationary pressures from the supply and demand factors have made possible the control of the inflation rate. The inflationary impulses stemming from the increase of salaries, the rise of oil price and of administered prices, are balanced by the developments in the exchange rate and the better performance of the domestic production.



*Demand Factors*

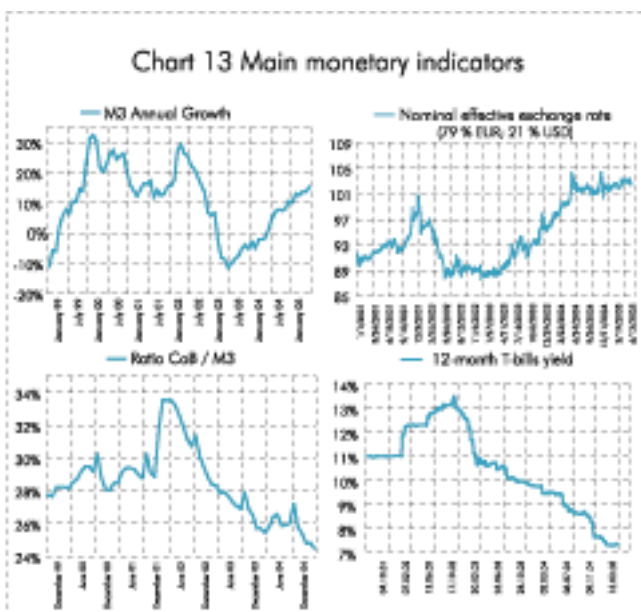
- *Fiscal policy and Fiscal indicators*

The fiscal policy and fiscal indicators did not have strong deviation from the approved budget. During the first five months of this year there has been noticed a tendency of increasing annually budget expenditures. However, the increase of current and capital expenditures has been within the projected level and in line with the other macroeconomic objectives. The increase of current expenditures has also been affected by the increase of salaries in the public sector, an increase that has not caused inflationary pressures during the first half of 2005.



- *Monetary policy and monetary indicators*

The monetary policy, through the control of monetary aggregates, has a long-term impact on inflation. It also has a medium-term impact on the economic activity through the control of interest rate. During the first half of 2005, Bank of Albania has cut the interest rate by 0,25 percentage points, thus bringing it to 5.0 per cent. The easing of the monetary policy has contributed to further stimulating the credit to economy. However, low inflation has maintained the real interest rate in positive terms. It has contributed to establishing an appropriate equilibrium between the increase of monetary aggregates (as a result of credit increase) and the required increase of liquidity in the economy, thus failing to inject uncontrolled impulses of inflation. In addition, the falling trend of the ratio between currency outside banks and monetary supply has been maintained during the first half of this year. In May this ratio resulted to be 24.5 per cent.



- *Other indicators*

Retail trade index<sup>6</sup>. During the first quarter of 2005, this index did not change considerably, thus following the seasonal model of the economy, which shows a slowdown during this period. The retail trade index decreased by 2.5 per cent compared to the same period of the previous year. The behaviour of this index can be interpreted as a stability of the domestic demand, thus affecting the demand to keep under control the inflationary pressures.

*Demand factors*

- *Domestic agricultural production*

During the last year the domestic agricultural production marked a strong increase. The growth of the production has come as a result not only of a

good harvesting year, but also due to the increase of investments in building greenhouses, whose products were present in the market even during this semester.

- *exchange rate and imported inflation*

One of the determining factors of inflation in the country is the exchange rate. Lek has shown an appreciation trend against the two main currencies – Euro and USD. During the first half of the year the same characteristic has been preserved, but at a smoothing pace of Lek appreciation. The tourist season and summertime are accompanied by high foreign currency flows (mainly Euro) and by the rising demand for Lek, meaning its appreciation. The favourable performance of the exchange rate has managed to amortize the inflationary pressures that are transmitted in the country by the imported inflation.

	January	February	March	April	May	June
Greece*	4.0	3.1	2.9	3.4	3.2	3.3
Italy**	1.8	1.8	1.7	1.9	1.7	
ALL/EUR	-5.3	-4.8	-3.1	-1.6	-2.3	-1.0
ALL/USD	-8.8	-7.4	-9.8	-8.9	-7.4	-1.2

\* Source: website of General Secretariat of National Statistical Service of Greece <http://www.statistics.gr>.  
\*\* Source: website of ISTAT, <http://www.istat.it>.

Table 12 Annual changes in inflation in the main trading partners and changes in the exchange rate (in percentage)

A small and open economy to the foreign market such as Albania is inevitably affected by the imported inflation. Imported inflation is a combination of the developments in the consumer prices of partner countries with the performance of the exchange rate. The main trading partners of our country, Italy and Greece, have registered low inflation rates. The low and stable annual changes of consumer prices in these countries, accompanied by the Lek appreciation against the Euro, have resulted in a decrease of imported prices denominated in Lek.

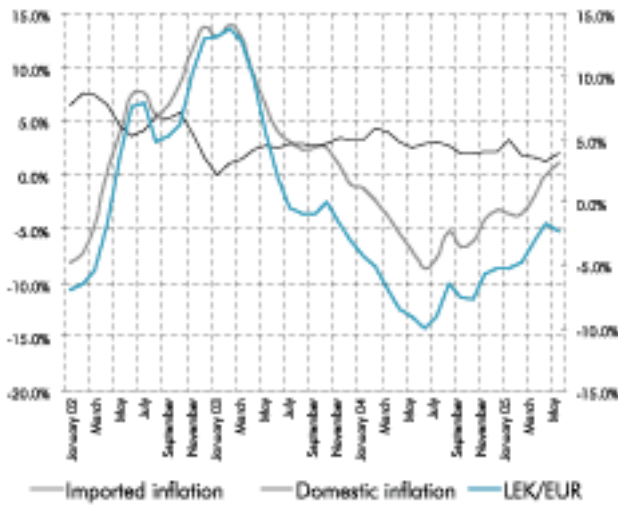
Imported inflation has not exerted strong inflationary pressures. Furthermore, the cheapest prices of imported goods have exerted a competitive downward pressure on the prices of goods in the country.

### *Box Imported inflation*

*As a result of lack of data on import prices, a simple calculation is made to evaluate the performance of imported inflation during January '02 – May '05.*

*The major share in the Albanian imports consists of imports from Italy and Greece, respectively by 31.6 per cent and 15.7 per cent of total imports. To evaluate the performance and impact of imported prices (in terms of local currency) on inflation in the country, the import price index was established, taking into consideration imports from Italy and Greece. The import price index was established in two steps:*

Performance of imported inflation in the country and the nominal exchange rate (right axis)



- A foreign price index was computed as a weighted average of consumer price indexes of Italy and Greece with the respective weights;
- This index was translated into Lek terms, by multiplying with the exchange rate Lek/Euro for January '02 – May '05.

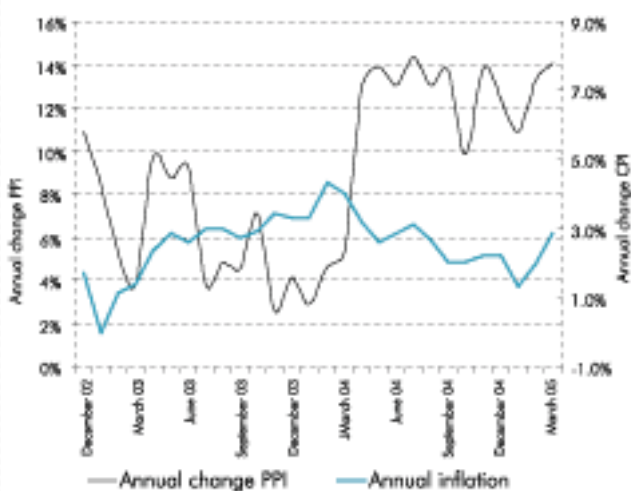
The chart below indicates the annual changes of imported inflation, of domestic inflation and the exchange rate of Lek against Euro.

Imported inflation has not exerted inflationary pressures in the country. Of course, this conclusion must also be corrected with the characteristics of the local market, especially with the degree of competition in it. However, it illustrates the fact that the combination of inflation in the partner countries and of the exchange rate performance has not encouraged inflationary pressures in the country. As stated in the periodical reports of Bank of Albania, the continuous appreciation of Lek versus the Euro has prevented the external inflationary pressures.

- *Producer price index<sup>7</sup>*

From the analysis of Producer Price Index, it results that production prices have recorded an increase for more than a year. However, the rising tendency in the first link of merchandise trade is not reflected in the final price, paid by the consumer. The lack of transmission of costs can be explained by the rising of competition in the retail trade segment.

Chart 14 Annual changes of PPI and CPI (in percentage)



- *Other Indicators*

Unemployment - salary. According to INSTAT data, the first quarter of this year did not bring about significant changes in terms of unemployment rate and the general level of salaries. The unemployment rate slightly decreased to 14.3 per cent, while the average salary level in the public sector increased by 3 per cent compared to the previous quarter. The increase of salaries in the public sector has come mainly as a result of the increase of salaries of some groups of employees in the health and education sector. On the other hand, the minimum salary, the payment for the unemployed people, as well as the average economic assistance per household, remained unchanged.

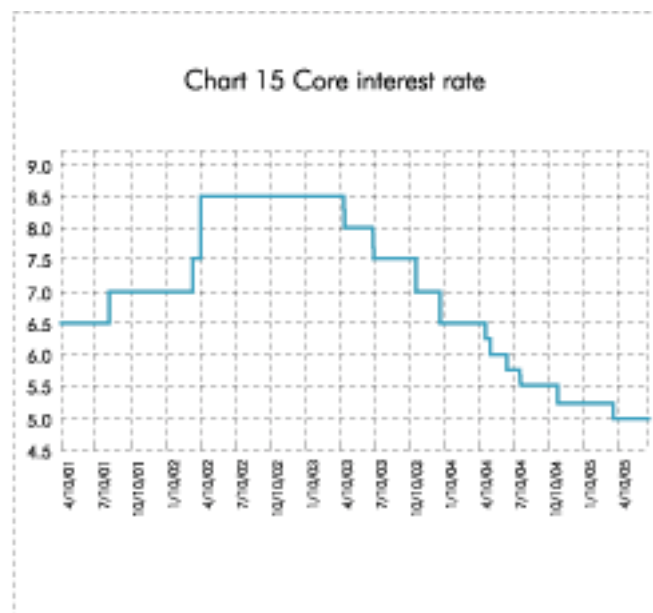
Oil price. Like in the previous year, this factor has not influenced the inflation in the country. Oil price rise in the international market has not been fully transmitted in the domestic market, because of a variety of factors such as: the appreciation of our currency against USD, the decrease of domestic demand (by 23.5 per cent<sup>8</sup> compared to the last quarter of 2004) and the small share<sup>9</sup> occupied by the "Transport" item in the consumer goods basket. On the other hand, oil price during the first quarter of 2005 increased by an average of 2.6 per cent compared to the same period of the previous year.

### III. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

#### III.1 MONETARY POLICY OF BANK OF ALBANIA

The monetary policy of Bank of Albania has been in general a smoothing policy during the first half of 2005. This tendency was more pronounced during the first quarter, thus finalising the cut by 0.25 percentage points of the core interest rate on 30<sup>th</sup> of March. Meanwhile, during the second quarter Bank of Albania has followed a more neutral monetary policy. This policy has been in line with the dynamics of inflationary pressures in the economy. The factual inflation rates were relatively low, while the monetary indicators have shown stability, thus contributing to give an optimistic picture on the inflation forecasting.

The effect of the cut of core interest rate is shown clearly in the deposits interest rates. Meanwhile, the reaction scale of Treasury bills rates has resulted to be close to the indicated cut. The cut of interest rate of deposits by commercial banks was more pronounced for the mid-term maturity, thus contributing to the levelling of the interest rate curve.



Maturity	Time deposits	Government security yield
3-month	(1.14)	(0.20)
6-month	(1.32)	(0.09)
12-month	(1.71)	(0.32)
24-month	(2.28) *	(0.30)

Operative data for the period 30 March – 8 July.  
\*Changes for the period 30 March – 1 July.

Table 13 Reaction of interest rates in the banking system (in percentage points)

The smoothing monetary policy of Bank of Albania is followed by the increase of demand for monetary assets. The main source of monetary expansion, during this period, is the crediting to economy, unlike the other years when this function was carried out by the government loan or the foreign inflows. Low inflation rates during this period have enabled high growth rates of monetary aggregates in real terms. The annual growth of real M3 has kept the same trends as the last two years.



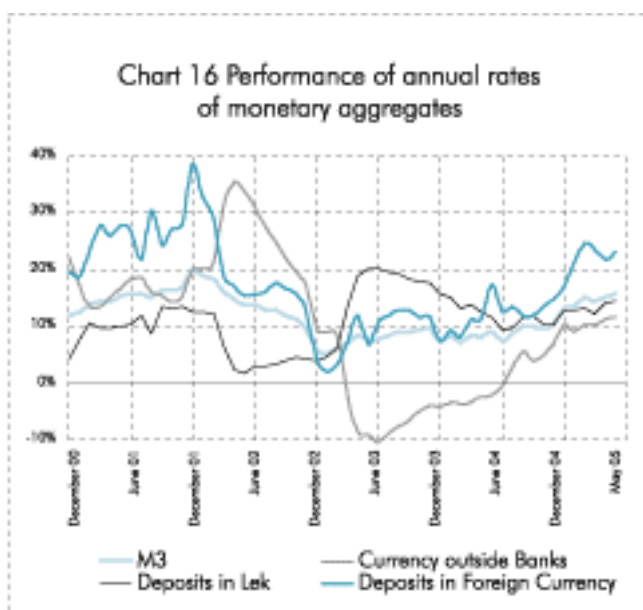
In the money market, the interventions of Bank of Albania have been limited in withdrawing liquidity through the repurchase agreements with a fixed and very unlimited price. Bank of Albania has eased the functioning of monetary markets through the supporting instruments, mainly the use of overnight deposits. The development of monetary operations has created the conditions for transmitting the monetary policy signal and it has been accompanied by the decline of interest rates in the monetary markets. The monetary policy of Bank of Albania has also enabled the meeting of its quantitative objectives.

Table 14 Meeting of quantitative targets of Bank of Albania

	December '04	January '05	February '05	March '05	April '05	May '05
Net international reserves of Bank of Albania (in millions of USD)						
Objective	941.7	985.3	1,029.0	1,072.7	1,077.3	1,082.0
Currently	1,105.2	1,108.8	1,108.7	1,107.4	1,109.0	1,104.6
Difference	163.5	123.5	79.7	34.8	31.7	22.6
Net domestic assets of Bank of Albania (in billions of ALL)						
Objective	79.0	73.1	67.2	61.3	61.6	61.9
Currently	61.0	56.3	56.5	53.3	56.1	57.0
Difference	-18.0	-16.7	-10.7	-7.9	-5.5	-4.9
Net domestic credit to government (in billions of ALL)						
Objective	286.4	288.2	289.9	291.7	293.7	295.7
Currently	285.7	286.9	288.9	287.8	290.4	291.3
Difference	-0.7	-1.3	-1.0	-3.9	-3.3	-4.3

### III.2 MONETARY AGGREGATES

The monetary developments, during the first half of the year, have been in line with the trends designed in the monetary programme. As expected, the growth rate of monetary supply increased, being consistent with the positive developments of the economic activity in the present period as well as with the increased volume of money retained by the economic agents for financing their transactions. In addition, the growth rate of monetary supply during this period has reflected also the positive developments towards the deepening of financial intermediation in the country and the consolidation of confidence in the banking system. As a result, there is a higher increase of less-liquidity monetary assets and especially that of time deposits in foreign currency.



The annual growth rate of monetary supply in May was 15.8 per cent, from 13.1 per cent in December. The growth of monetary supply during this period is being supported by the faster increase of foreign deposits and the maintenance of a moderate upward trend of M2 aggregate. The contribution of credit to the economy to generating monetary assets in Lek has been increasing, while the government demand for money has been almost at the same levels as the previous year. The developments in the time and currency structure of monetary assets suggest



that their trends have been maintained and consolidated as previously. During the five months of the year, the ratio of currency outside banks to M3 has registered a significant decline, dropping down to its minimum level. Meanwhile, the ratio of foreign deposits to monetary supply has always been increasing.

The indicator of currency outside banks was the component with the slowest increase in the monetary supply. Its annual growth rate, during January – May, increased slightly from 10.3 per cent to 11.6 per cent, thus following the same upward trend of M2 and M3 aggregates. The slowest rising tendency of currency outside banks compared to the other components of monetary supply is accompanied by the significant decrease of the ratio CoB/M3. By the end of May, this ratio dropped down to 24.4 per cent, thus marking a decrease of 2.7 percentage points compared to December, and of 0.9 percentage points compared to May of the last year.

The continuation of the falling trend of this index is mainly attributed to the positive developments in the payment infrastructure, which have been accompanied by the increase of banking services used by the public. At the same time, the maintenance of real interest rates at stable positive levels has supported investments in the financial assets in Lek, thus serving as premises to maintain the equilibrium of the liquidity infrastructure of monetary supply.

The rising trend of M2 aggregate and the continuation of channelling the currency outside banks in the banking system are reflected in the acceleration of growth rates of Lek deposits. The annual growth rate reached 14.6 per cent from 12.9 per cent it was in December. The upward performance of Lek deposits has shown mainly the higher contribution of time deposits from households, whose growth constitutes 67 per cent of the general growth of deposits during January – May. Moreover, the Lek deposits from the private sector and the demand deposits from households have evidenced high growth rates, thus impacting positively on the performance of Lek deposits.

The time structure of Lek deposits has known an increase of the share of demand deposits, which in turn is influenced by the shifting of the deposits of government sector, from time deposits into demand deposits<sup>10</sup>. This development has defined also the performance of M1 aggregate, whose annual growth rate reached 24 per cent in May from 19.4 per cent it was in December. As a result of lack of this shifting, the annual growth rate of M1 aggregate would result to be 20.1 per cent in May, thus representing a more moderate upward trend than the one of broader currency indicators.

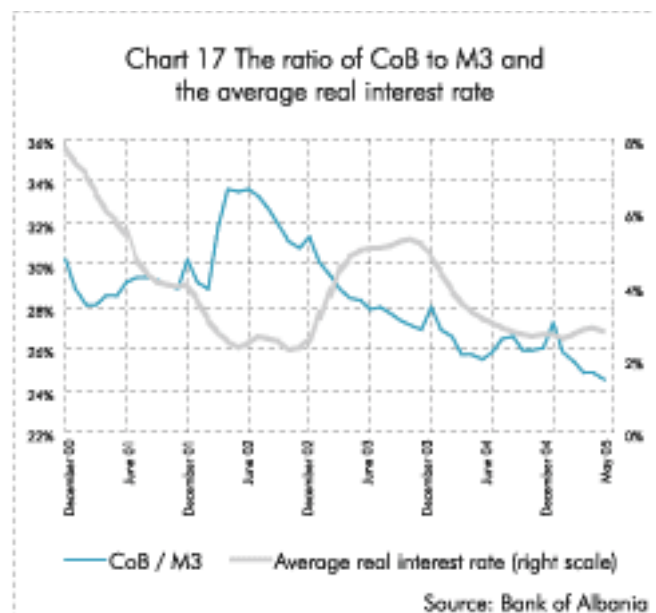
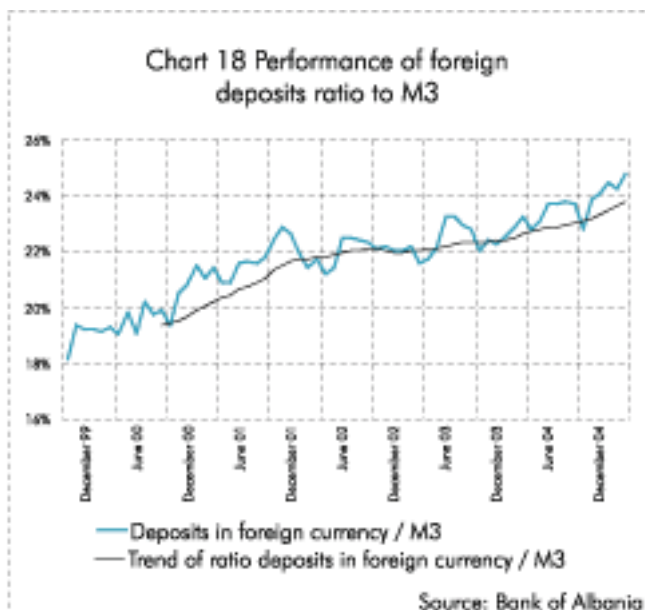


Table 15 Performance of monetary indicators in May (in billions of ALL)

	May 2005	Five month change		Annual change	
		Absolute	Percentage	Absolute	Percentage
Currency outside banks	130.7	-7.4	-5.4	13.6	11.6
Total deposits	402.5	33.4	9.0	59.4	17.3
- in lek	270.5	17.2	6.8	34.5	14.6
- in foreign currency	132.0	16.2	14.0	24.9	23.2
Demand deposits	89.2	11.6	15.0	22.5	33.7
- in lek	42.5	7.8	22.3	20.0	88.6
- in foreign currency	46.7	3.9	9.0	2.6	5.8
Time deposits	313.3	21.8	7.5	36.9	13.3
- in lek	228.0	9.4	4.3	14.5	6.8
- in foreign currency	85.3	12.3	16.9	22.3	35.5
M1	173.2	0.4	0.2	33.5	24.0
M2	401.2	9.8	2.5	48.1	13.6
M3	533.2	26.0	5.1	72.9	15.8
Monetary Base	174.5	-4.1	-2.3	20.9	13.6

The first half of the year has shown a significant increase of the contribution of foreign deposits to the increase of monetary supply. Their annual growth rate by the end of May reached 23.2 per cent from 17.1 per cent it was in December. This growth of deposits in foreign currency has indicated mainly the depreciation of the Lek exchange rate during January – May<sup>11</sup>, and as a result the negative effect of Lek appreciation decreased considerably from -9.2 per cent in December to -3.5 per cent in May. In real terms, the annual growth rate of foreign deposits has known a stable performance, thus recording a high level of 27.6 per cent in May.

The main contribution to the growth of foreign deposits has been given by the time deposits and those of households, which represent respectively 76 per cent and 73 per cent of the overall growth of foreign deposits during January – May. The highest growth of time deposits in foreign currency from households is assessed to have been influenced by the continuity of high foreign currency flows from the remittances, the increase of confidence in the banking system and the most favourable interest rates in US currency.



The fastest growth of foreign deposits compared to the component in Lek of monetary supply is accompanied by the increase of their share in the M3 aggregate. By the end of May, the ratio of foreign deposits to monetary supply reached 24.8 per cent, thus recording an increase of 1.5 percentage points compared to the same period of the previous year.

### III.3 DOMESTIC DEMAND

#### III.3.1 Net foreign assets

The banking system has preserved a stable position during the first part of the year. Under

the influence of depreciation of Euro against the USD, the level of net foreign assets registered a decrease of USD 76.5 million, while measured by fixed exchange rates they resulted to have increased by USD 12.8 million during the period of January – May.

The net foreign assets of Bank of Albania, during the first five months of the year, have registered a decrease of USD 46.5 million. In the absence of the interventions from the Bank of Albania in the foreign exchange market and in the presence of the low inflows and outflows from other sources, the decrease of net foreign assets during this period is totally affected by the depreciation of Euro against the USD. This depreciation has reduced the value of the foreign reserve portfolio in Euro denominated in USD, thus affecting negatively the net foreign assets of Bank of Albania by USD 60.5 million.

Net foreign assets of commercial banks have also decreased by USD 30 million. The significant acceleration of crediting in foreign currency during the first half of the year could not be entirely financed from the foreign deposits growth in commercial banks, thus posing the use of a part of their foreign assets as a necessity.

### III.3.2 Government demand for monetary assets

Government demand for money, during the first five months of 2005, had a similar performance with that of the last year. Its relative contribution to the increase of monetary supply has continued to remain low and below the projected level. The fiscal accounts of the government show an increase of budget deficit during this period, marking a cumulative level of ALL 4.7 billion by the end of May. This performance has reflected, on one hand, the financing by ALL 7.7 billion and the increase by ALL 3 billion of government deposits in Bank of Albania, on the other hand.

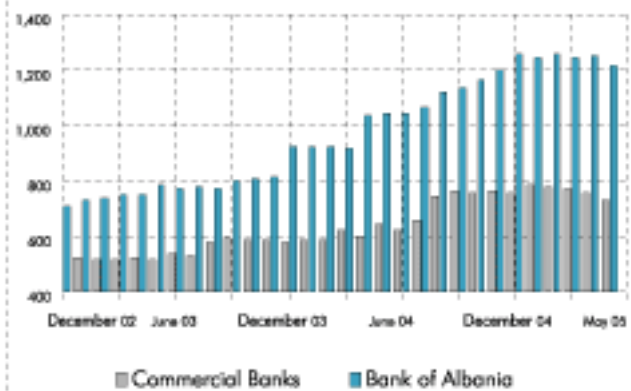
The banking system has satisfied nearly 56 per cent of the needs for the financing of the government until May, increasing the portfolio of securities by ALL 3.3 billion. This increase is entirely reflected in the increase of commercial banks portfolio, while Bank of Albania portfolio has remained unchanged from the last level of 2004. The structure of commercial banks portfolio is oriented towards the long-term issues of government, with the decrease of the portfolio of Treasury bills by ALL 6 billion and the increase of government

Chart 19 Annual contribution of NFA growth to M3 growth



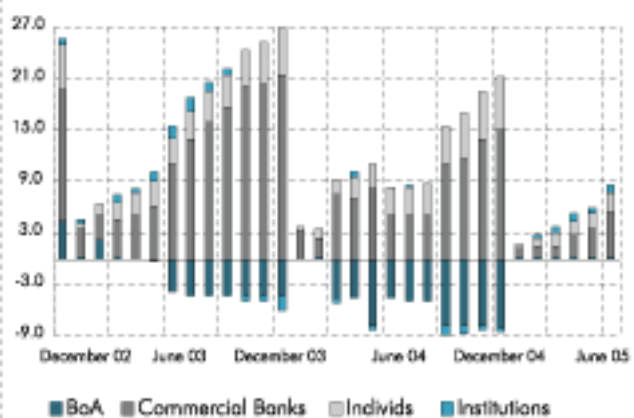
Source: Bank of Albania

Chart 20 Performance of net foreign assets of the banking system (in millions of USD)



Source: Bank of Albania

Chart 21 Performance of the cumulative financing of fiscal deficit (in billions of ALL)



Source: Bank of Albania

bonds portfolio by ALL 9.3 billion<sup>12</sup>. The other part of the loan of ALL 2.5 billion is financed by individuals and institutions, respectively 1.8 and 0.7 billion ALL.

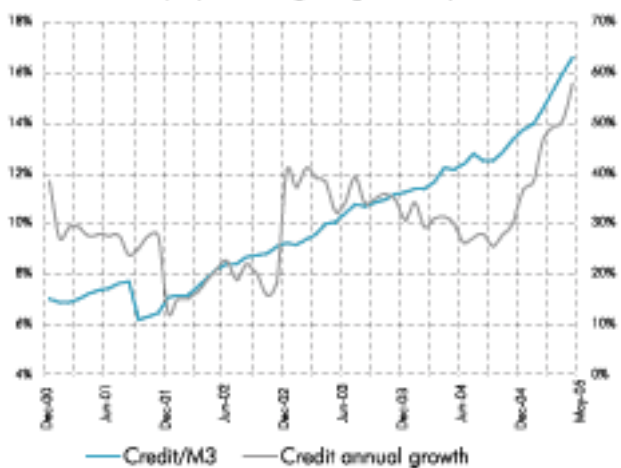
### III.3.3 Credit to economy

The credit balance has increased by about ALL 3.7 billion per month during January – May 2005, thus totalling by the end of the period to ALL 18.7 billion. This level is the same as the increase of credit during the 2004. The positive developments of crediting to the economy from the banking system have positively influenced the improvement of all macroeconomic indicators of credit.

Table 16 Performance of some main indicators

	2002	2003	6'M- I	2004 6'M- II	2005 May
Money supply (in billions of ALL)	416.7	448.4	458.2	507.2	533.2
Domestic credit (in % of M3)	70.8	71.5	69.5	68.9	69.4
- Credit to government (in % of M3)	61.5	60.2	57.1	55.1	52.7
- Credit to economy (in % of M3)	9.3	11.3	12.4	13.8	16.6
Credit to economy (in % of total assets)	11.5	13.7	14.6	16.9	19.5
Credit to economy (in % of GDP)	5.7	6.8	7.4	9.0	10.9
Ratio credit/deposits (in %)	13.5	15.7	16.7	19.0	22.0

Chart 22 Ratio of total credit to M3 (in percentage) and annual growth of total credit (in percentage, right scale)



Source: Bank of Albania

In annual terms the credit to economy marked an increase of 59 per cent by the end of May. This increase has come mainly as a result of the increase of credit with maturity over one year, which has contributed by about 79 per cent to the total increase. In addition, it has been noticed that the long-term loans have gained ground on a continuous basis compared to the medium-term ones, thus indicating an increasing commitment of banks towards long-term maturity investments.

The main contribution to the increase of the total credit continues to be given by the increase of credits in foreign currency (about 71 per cent), which also represents 79 per cent of the whole credit portfolio. As a result of Lek strengthening

against the Euro and its depreciation against the USD<sup>13</sup>, for January – May 2005, the credit in foreign currency has increased by ALL 1.1 billion.

However, during the first five months of 2005, it has been noticed a high annual growth of credit in Lek<sup>14</sup>, which contributes further to the increase of total credit. The positive rates of credit growth in Lek are dedicated to the

increasing commitment of banks to provide services for meeting the demands of the customers (57 per cent). This fact is shown in the high annual growth of credit for this group, around 72 per cent. In total the loan to individuals constitutes 30 per cent of the loan portfolio.

	2002	2003	Q-1 '04	Q-2 '04	Q-3 '04	Q-4 '04	May '05
Credit balance (in billions of ALL)	38.7	50.7	53.4	56.8	61.0	70.0	88.7
Short-term credit	53.8	46.0	41.6	35.4	33.9	34.0	32.2
Medium-term credit	30.1	33.3	35.4	37.8	37.2	36.0	34.5
Long-term credit	16.1	20.7	23.0	26.8	28.9	30.0	33.2
Credit to households	18.3	24.5	26.0	29.3	30.8	30.6	30.8
Credit to private sector	81.7	75.5	74	70.7	69.2	69.4	69.2
LEK	21.3	19.6	17	17	17	19.5	21.0
Foreign currency	73.7	80.4	83	83	83	80.5	79.0

Table 17 Indicators of the credit balance to total credit (in percentage)

The first five months of 2005 showed the decreasing preference of commercial banks to credit the trade sector, and their expectations to finance the construction sector and real estate business.

	2002	2003	2004				2005
			Q1	Q2	Q3	Q4	May
1 Agriculture, hunting and silviculture	0.8	1.0	0.9	1.2	1.6	1.5	1.5
2 Processing industry	17.0	17.0	16.9	18.4	18.2	17.1	16.2
3 Construction	8.6	10.0	9.7	10.7	10.2	9.8	11.3
4 Trade, vehicles repairing and household furniture	40.4	34.0	31.4	23.5	21.9	23.3	18.9
5 Hotels and restaurants	6.0	6.0	7.1	8.3	8.3	8.3	5.0
6 Real estate	9.1	13.0	13.7	14.8	15.6	9.8	14.3
7 Other	18.1	19.0	20.3	23.1	24.2	30.2	32.8
Total	100	100	100	100	100	100	100

Table 18 Performance of credit balance according to the main branches of the economy

During the period of January – May of 2005, it has been extended about 42.3 billion ALL or 13.4 per cent less than the same period of the previous year. This fact shows that the increase of credit balance comes mainly as a result of the orientation of banks towards long-term maturity investments. In addition, unlike the preceding year, banks have committed around 60 per cent more towards the credit with maturity over one year, thus decreasing considerably the financing of the economy with short-term credit.

Only 30 per cent of the new credit is extended in Lek, while the rest in foreign currency. This structure of crediting has remained unchanged compared to the previous year.

According to the sectoral distribution it has been noticed that the trade sector has absorbed about one-fourth of the new credit granted for the whole period. However, this level is less than half of the credit extended to this sector a year ago. The other part of credit is mainly absorbed by the production sectors (about 21 per cent), construction sector (8.2 per cent) and real estate (12.2 per cent).



### III.4 FINANCIAL MARKETS AND INTEREST RATES

#### III.4.1 Liquidity performance

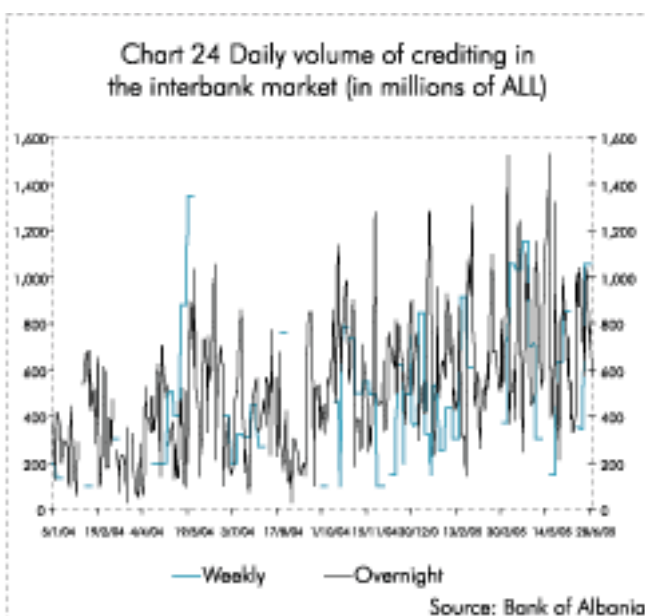
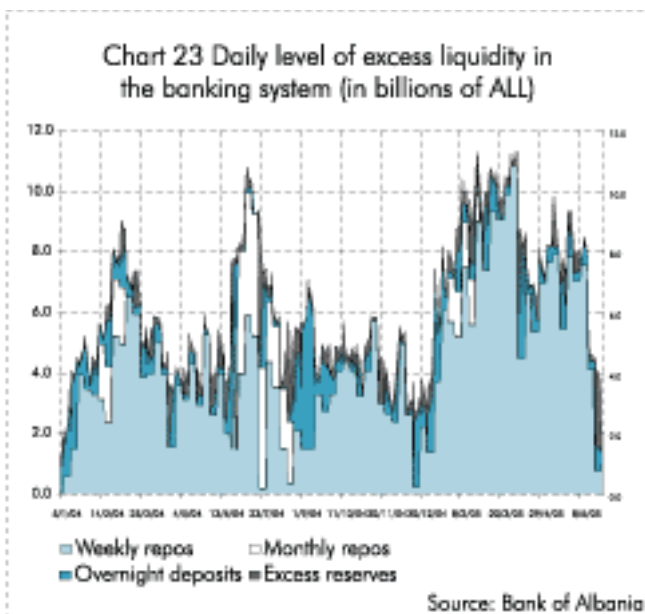
During the first half of 2005, a considerable level of excess liquidity has characterized the banking system, which was due to the growth of Lek deposits in the first months of the year. The average level of excess liquidity during the first half of the year amounted to ALL 7.9 billion, compared to ALL 5.0 billion in the same period of the previous year and to ALL 5.2 billion in the second half of 2004.

The increase of excess liquidity was noticed mainly in the first quarter of the year, when an increase of deposits in Lek is repeated as a result of the return of currency outside banks into the system. By the end of the second quarter, the level of liquidity decreased by around ALL 4.0 billion.

During the first quarter of this year, the excess liquidity withdrawal is made mainly by the weekly auctions of repo with a predetermined interest rate, in contrast to the previous year when, apart from this instrument, its withdrawal was performed with structural operations (outright purchase and weekly repo). The average level of investment in weekly repos has registered the amount of ALL 6.2 billion, compared to ALL 3.5 billion in the first half of 2004 and ALL 3.1 billion in the second half. Occasionally it has been applied also the weekly repo.

The overnight deposit facility is used regularly as a mean for investment of liquidity. The overnight deposit has registered on average the amount of ALL 0.67 billion during the first half of 2005 or ALL 0.17 billion and ALL 0.18 billion less than the second half of the last year. The overnight loan is used rarely and in small amounts.

The short-term needs for liquidity are supplied in the interbank market, which is dominated by overnight transactions. During the first half of the year, the volume of transactions in the market has increased, compared to the last year. The average level of overnight loans increased to ALL 0.69 billion, from ALL 0.48 billion in the first half of 2004 and ALL 0.37 billion in the second half of the same year. The average of weekly loans resulted in ALL 0.49 billion, from ALL 0.27 billion in the first half of 2004 and ALL 0.18 billion in the second half of the same year.





The primary market is characterised by the increase of demand from banks to invest in government securities. The supplied amounts from the banks in the primary market have surpassed at all cases the amounts demanded from the government. For the first time in April, three-year securities were issued, a demand that was afforded by the banking system. The Treasury bills market has resulted in a creation of liquidity, because the matured amounts were higher than the new investments, which has exerted pressure on the further decrease of interest rates in this market. However, the decrease of Treasury bills portfolio by ALL 5.3 billion during January – June is compensated with the increase of the two-year and three-year bonds portfolio by ALL 10.8 billion.

### III.4.2 Interest rates

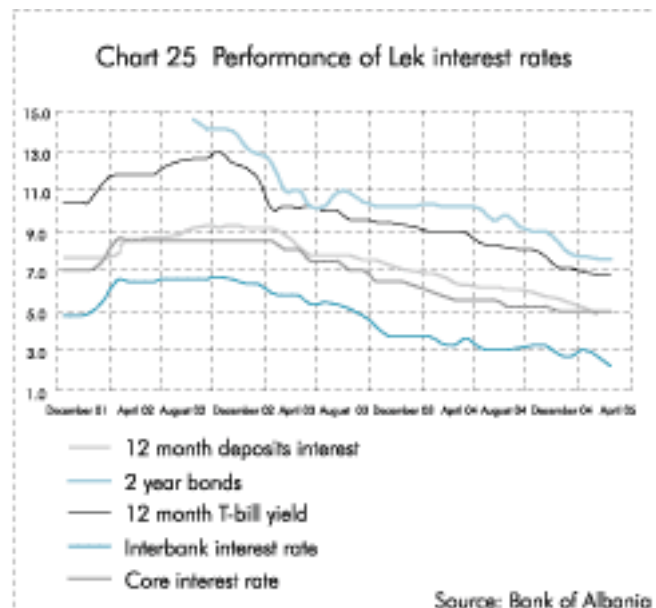
During the first half of 2005, the core interest rate reached the lowest historical levels, of 5.00 per cent. This interest rate, compared to the other countries, is shown below:

Albania	Euro area	USA
5.00	2.00	3.25

Table 19 Core interest rate, July 2005 (in percentage)

During the first half of 2005, the markets responded to the smoothing monetary policy of Bank of Albania by decreasing the interest rates in the interbank market, the Lek deposits market, Treasury bills market, government bonds market and the credit market.

By the end of the first half of the year, yield of Treasury bills and government bonds dropped to the lowest historical levels, while the interests of time deposits in Lek reached the lowest levels in the last 13 years. Despite the fluctuations of interests in the interbank market, especially during the period the required reserve is kept, during the first half of 2005 this market evidenced a significant decrease of interest rates reaching the lowest historical levels<sup>15</sup>.



In the credit market in Lek, which is characterised by huge fluctuations of interests from a month to another, the end of May resulted in a decrease of interest rates, except for the six-month maturity credits. In fact, the average weighted rate of credit has shown a downward trend from March 2005. The interest rates movement in this market was influenced by the cut of core interest rate, the enhancing of competition in the banking system, degree of credit risk, change of loan structure from a month to another, the huge differences between the minimum and maximum interests in the credit market, etc.

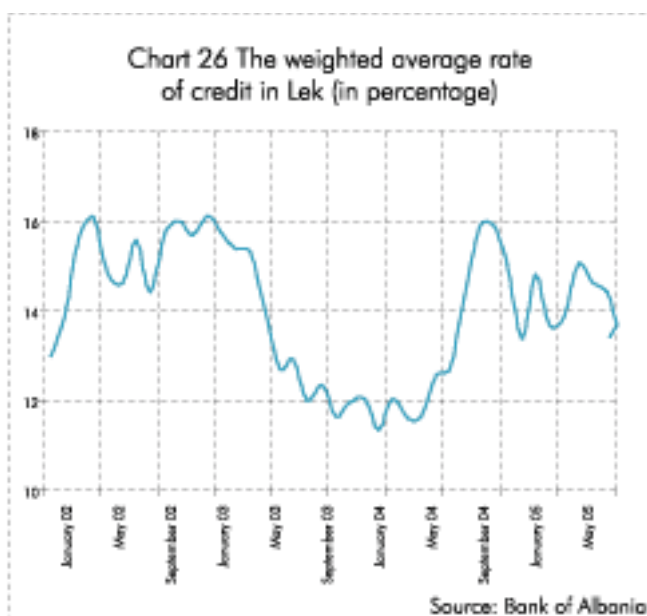
Table 20 Interest rates in Lek during May 2005, their six-month and annual change in percentage points

	June '05*	Change from December '04	Change from June '04
Core interest rate	5.00	-0.75	-1.00
Interbank market	2.50	-0.92	-0.77
3-month deposits	3.65	-0.83	-1.24
6-month deposits	4.41	-1.00	-1.69
12-month deposits	4.85	-1.14	-1.67
Yield of 3-month T-bills	5.06	-1.03	-1.76
Yield of 6-month T-bills	6.40	-0.82	-1.78
Yield of 12-month T-bills	6.79	-1.31	-2.21
2-year bonds	7.55	-1.45	-2.63
Credits in Lek (weighted average interest rate)	13.41	-0.30	-0.86

\* The data of deposits and credits in Lek refer to May 2005.

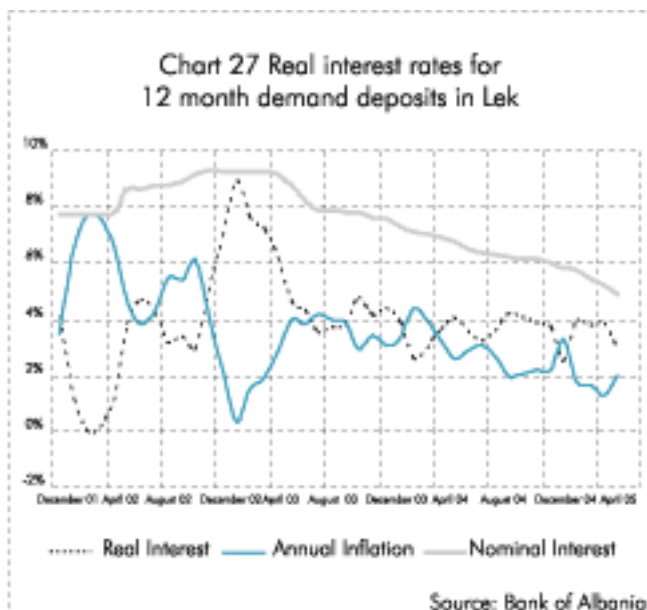
As it can be observed in the table below, the interest rates in Lek have decreased compared to the end of the last year and to the previous year.

During the first semester of 2005<sup>16</sup>, real interest rates of 12-month deposits in Lek fluctuated at an average level of 3.35 per cent from 3.75 per cent during the second semester of 2004. This level has been influenced by the continuous decrease of nominal rates and the low inflation rate during this period.



In the foreign deposits market, interest rates have been generally characterized by upward trends. During the first half of 2005<sup>17</sup>, nominal interest rates in USD increased remarkably at all maturities, while interest rates in Euro were, in overall, stable.

The performance of foreign interest rates has been affected by the developments of LIBOR and EURIBOR rates in the international markets, by a tightening monetary policy of FED and a neutral monetary policy of ECB, and by the competition in the banking system.



The decrease of interest rates in Lek and the increase of interest rates in foreign currency have contributed to narrowing the spread between them. The narrowing of spread has reflected the stability in the market, a reaction to the monetary policy signals, a low inflation rate, as well as the Lek strengthening during the first half of 2005.

Interest rates of credits in foreign currency have shown a different trend for the two main currencies. At the end of May, the weighted average interest rate of credits in USD increased by 8.39 per cent, compared to a 7.78 per cent increase in June 2004 and 7.79 per cent at the end of 2004. The weighted average interest rate of credits in Euro

	May '05	Change from December '04	Change from June '04
<b>USD</b>			
Interest rate, 3	2.07	+0.38	+1.32
Interest rate, 6	2.30	+0.42	+1.45
Interest rate, 12	2.95	+0.68	+1.69
<b>EUR</b>			
Interest rate, 3	1.77	+0.02	+0.13
Interest rate, 6	1.81	+0.03	+0.14
Interest rate, 12	1.94	-0.03	+0.14

Table 21 Interest rates of foreign deposits (in percentage points)

decreased to 7.89 per cent from 8.62 per cent in June 2004 and 8.17 per cent at the end of the year.

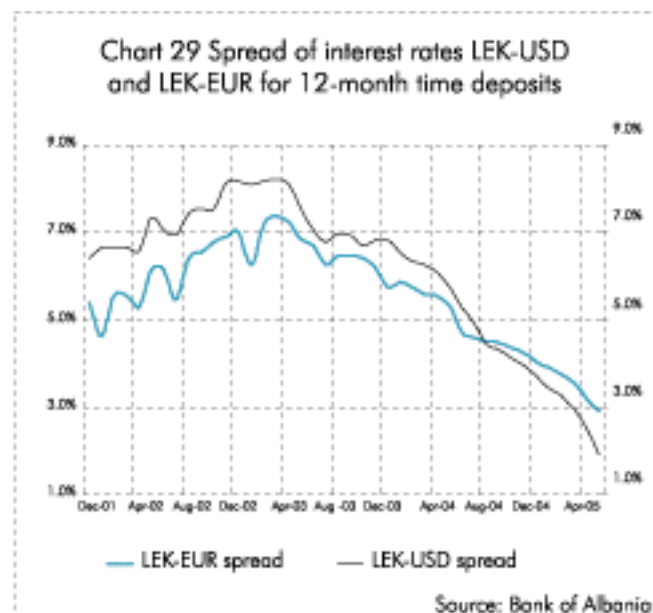
Interest rates of credits in foreign currency have been mainly affected by their performance in the international markets, however, the specifics of the lending market in the country (competition, concentration, risk, etc.) have brought about volatile rates from a month to another.

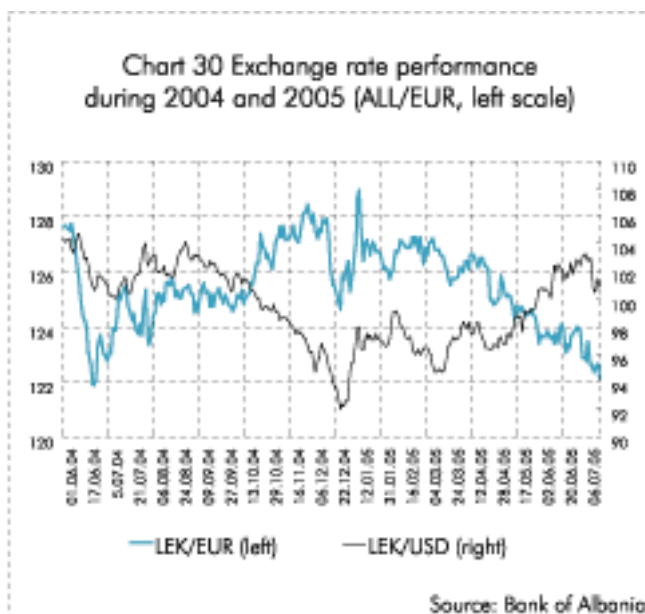
### III.5 EXCHANGE RATES

The value of the domestic currency against the Euro and USD has fluctuated at narrow levels. During January - June, Lek appreciated by 1.9 per cent against the Euro and depreciated by 10.9 per cent against the USD. Nevertheless, nominal effective exchange rate, which takes in account the relevant volume of foreign trade, shows a slight appreciation of Lek by 0.6 per cent during this period.

The main factors that affected the Lek appreciation during the last two years have showed a declining trend, while short-term factors influencing the exchange rate, like the growth of the foreign currency supply from tourism and remittances, have balanced the effect of demand for imported goods. Increases of foreign currency supply and introduction of domestic agricultural production, by the end of the first half of the year, had only temporary effects on the exchange rate performance.

Exchange rate performance of domestic currency versus foreign currencies has been subject of international exchange market developments as well. The performance of the ratio EUR/USD in the international market in favour of US dollar is mainly reflected as a depreciation of Lek against the US dollar and as a slight appreciation of





Lek against the Euro in the domestic market. This development was dictated by the domination of US dollar versus many currencies of the leading economies in the international markets. In overall, US dollar appreciated against the major part of the other currencies, included the European currency. Under these conditions, domestic exchange market developments are estimated as having positive effects on maintaining the equilibriums of trading conditions with partner countries, which use in their economies the Euro or another currency that has been subject of the USD appreciation. At the end of the first half of the year, Lek was exchanged at the levels of 123.9 ALL/EUR and 102.8 ALL/USD, against the respective levels of 126.4 ALL/EUR and 92.6 ALL/USD, at the beginning of the year.

#### IV. ECONOMIC DEVELOPMENTS DURING 2005

Economic developments during the first half of the year show that the main guidelines and basic forecasts of the economic development program have been materialized. The first indicators of the year suggest that the Albanian economy has grown and macroeconomic stability is further consolidated. The low inflation during the first part of the year, the positive trend of balance of payments, the monetary stability in terms of stable ratios of monetary aggregates and exchange rate, indicate that the main objectives of the program have been achieved. The continuous consolidation of macroeconomic stability over the last years is a good basis for the development of the Albanian economy during 2005. Also, the Albanian economy is being supported increasingly by credits from the banking system, making a better use of financial capitals.

Bank of Albania will aim at preserving the monetary conditions in consistency with the inflation targeting, aiming at the same time at developing the financial market and crediting to the economy.

Table 22 Main macroeconomic indicators

	2002	2003	2004	2005
<b>Monetary indicators (in percentage)</b>				
GDP growth	4.7	6.0	6.0	6.0
Annual CPI (average)	5.2	2.4	2.9	3.0
Nominal GDP (in billions of ALL)	630.0	695.1	780.1	857.3
<b>Foreign sector (as a percentage of GDP)</b>				
Trade balance	-25.8	-24.8	-22.9	-22.2
Current balance	-9.7	-8.2	-7.0	-7.0
<b>Fiscal indicators (as a percentage of GDP)</b>				
Fiscal deficit	-6.9	-4.7	-4.9	-4.9
Domestic borrowing	3.2	2.7	1.9	2.7
<b>Monetary indicators (in percentage)</b>				
M3 growth	7.0	9.5	12.4	9.8
Credit growth to economy	32.1	28.5	31.3	47.1
Interest rates of 3-month T-bills	11.2	7.3	6.1	...

Source: IMF, Ministry of Finance, and Bank of Albania.

In overall, the picture of macroeconomic projections for the rest of the year did not change from that part in the beginning of the year. Albanian economy is expected to grow by 6 per cent during 2005, with an inflation rate estimated within the 2-4 per cent targeted range.

#### *Fiscal sector*

The 2005-fiscal budget proposes a moderate performance of fiscal policy, with an emphasis on its positive contribution to maintaining macroeconomic stability in the country. During 2005 budget expenditures are projected to be 29 per cent of GDP, from which capital expenditures 5.9 per cent of GDP. The projected level of budget income is almost the same as the one of the last year, 24.1 per cent of GDP.

The contribution of the 2005 budget to fiscal consolidation consists in keeping the budget deficit at the level of 4.9 per cent of GDP. The domestic financing, which is projected to be about 2.7 per cent of GDP, will back up the main part of this deficit. The financing of domestic borrowing of the government from the banking system is projected to be ALL 15.7 billion or 1.8 per cent of GDP, while the rest is expected to be backed up by households and other private entities.

#### *Monetary sector*

The main objective of monetary policy for year 2005, included in the monetary program, remains maintaining annual inflation rate within the 2–4 per cent targeted range. This objective will be achieved through controlling the growth of money supply, bringing it close to the nominal GDP growth, under the assumption of a stable performance of the velocity of money circulation in the economy.

Controlling monetary aggregates serves as an intermediary instrument for controlling inflation. Bank of Albania will aim at maintaining the growth of money supply during 2005 at the level of 9.8 per cent. Despite the decrease of nominal interest rates in the economy, the low inflation has preserved real interest rates on stimulating levels for money channelling in the banking system. The low level of currency outside banks is a result of long-term declining tendency, a characteristic period in a stabilizing economy.

As a result, it is expected a lower growth rate for the indicator of currency outside banks, whose annual growth is expected to decrease to 4.8 per cent by the end of the year. The expected return of currency into the system will be reflected on the satisfactory growth of Lek deposits. The annual growth rate of Lek deposits is expected to be 10.8 per cent at the end of the year, compared with the initial projection of 10.6 per cent. The foreign currency structure of money supply is expected to shift towards the foreign component. The annual growth rate of foreign deposits is projected to be 13.7 per cent at the end of the year, supported by stable foreign currency inflows from remittances and the increasing trend of interest rates in US dollar.

Albanian economy is projected to benefit credits at the level of ALL 33.8 billion during 2005. In terms of GDP, credit balance to the economy is projected to increase by 3.9 percentage points, compared to 2.5 per cent of GDP in 2004. The credit balance in Lek is projected to grow by ALL 12.2 billion, being 36 per cent of the growth of total credit balance. The domestic financing of budget deficit for year 2005 is projected at the level of ALL 23.3 billion, from which the banking system will cover the amount of ALL 15.7 billion or 1.8 per cent of GDP. A lower growth of net claims of the banking system to the government, compared to crediting to the economy, shows that there is a better effectiveness in managing the funds of the banking system. For year 2005, annual growth of net foreign assets of the system is projected to be ALL 11.6 billion.



## NOTES

<sup>1</sup> The specialists of European Central Bank estimate that a part of this growth is a statistical effect. It is estimated that the effect of adjustment according to working days has affected the underestimation of GDP for the fourth quarter of 2004 and its overestimation for the first quarter of 2005.

<sup>2</sup> US light crude.

<sup>3</sup> The estimation of Ministry of Labour and Social Affairs on the number of the employed persons during the first half of 2005 is missing.

<sup>4</sup> Estimated based on the performance of sales and retail trade index, published by INSTAT.

<sup>5</sup> The decision taken in April '04 to reduce the price by 28.5 per cent after being increased in December '03.

<sup>6</sup> Source: INSTAT.

<sup>7</sup> Source: INSTAT, Producer Price Index.

<sup>8</sup> Source: INSTAT, Conjunction, January – March 2005.

<sup>9</sup> The weight of this group in consumer goods basket is 4.8 percent.

<sup>10</sup> The effect of this shift is about ALL 4 billion. It relates to the shifting of funds of pyramid schemes from the time deposits in Lek into current accounts, with the purpose of distributing them further to the creditors.

<sup>11</sup> Lek exchange rate against the Euro and USD, combined with the weight these currencies take in the foreign deposits, depreciated by around 2.6 per cent during December-May.

<sup>12</sup> The increase of government bonds portfolio is due to the increase of 2-year bonds by ALL 7.3 billion and to the issue for the first time of 3-year bonds at the level of ALL 2.0 billion in April.

<sup>13</sup> For the period of January – May 2005 Lek appreciated by 2 per cent against the euro and depreciated by 8 per cent against the USD.

<sup>14</sup> At the end of May, credit balance in Lek doubled compared to the same period of the previous year.

<sup>15</sup> The lowest historical levels have been 2.36 per cent for overnight loans (end of May) and 5.23 per cent for weekly loans (middle of June 2005).

<sup>16</sup> Data until May 2005.

<sup>17</sup> Data until May 2005.