

BANK OF ALBANIA

**ECONOMIC DEVELOPMENTS
DURING THE SECOND SEMESTER OF 2004
AND EXPECTATIONS FOR YEAR 2005**

JANUARY 2005

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I. GOVERNOR STATEMENT

The second part of 2004 has generated a larger economic activity, marking a certain general impulse, especially after a relatively quiet start of the year. The acceleration of production growth is reflected almost in all the economy sectors, while the major objectives of the economy have been achieved in conformity with the overall programme of the country's economic and financial development.

At international level, this semester coincided with an acceleration of the confirmed tendencies in the first part of the year, especially with regard to US dollar performance and oil price rise. The Fed monetary policy has changed the monetary policy tendency, during this period, through some successive increases of the core interest rate, in attempting to prevent the inflationary pressures in the economy. On the other side, the European Central Bank, considering the inflation performance and the strong pressure against the Euro has deemed unreasonable to change the core interest rate, keeping it at the level of 2 percent for almost a year and half.

Annual inflation in December resulted 2.2 percent, while the average annual inflation was only 2.9 percent. The maintenance of inflation within the targeted range was mainly attributed to the stable macroeconomic situation, the control of domestic demand of the economy and monetary indicators stability.

Year 2004 was characterized by the achievement of fiscal objectives in terms of budget expenditures and budget deficit, and also by a more uniform allocation of fiscal expenditures. Government demand for loans has been distinguished by a rising level during the second semester, however remaining within the projected levels. Also, the annual rate of the change of current budget expenditures was stable. The implementation of a prudential fiscal policy has provided the appropriate conditions to better control inflation rate.

During the second half of 2004, the Bank of Albania monetary policy has kept an easing tendency, aiming above all at reducing the borrowing cost in the economy. Bank of Albania has twice cut the core interest rate, in July and November, by 0.25 percentage points. These cuts have brought the core interest rate to the lowest historical rate, by 5.25 percent.

The banking system was characterized by an accelerated lending activity to the economy during 2004. The credit balance increased by LEK 9.2 billion during June-November 2004, being 51 percent higher than the balance growth in the first semester of the year. Lending to the economy is given an ever-increasing importance in the assets structure of the banking system, constituting a considerable source of the demand for monetary assets. The credit/deposit ratio increases on a continuous basis, an indication that positively introduces the function of the intermediation role of the banking system in supporting the economic development. The

balance credit rise marked during the eleven-month period of the year the value of LEK 15.3 billion, reflecting a rise of 30 percent relative to the yearend of 2003.

The easing monetary policy of the Bank of Albania has helped smooth the appreciation pressure of the Lek exchange rate. The differences between interest rates in foreign currency and those in domestic currency incurred a decline during 2004. However, the rising foreign currency inflows on one hand, and the reduction of imports volume on the other one, have created a temporary difference between the foreign currency supply and demand during the summer period. This misbalance has exerted a significant pressure on the appreciation of the Lek exchange rate, fostering the foreign market volatility. The exchange rate volatility through this temporary rise of foreign currency supply has imposed the necessity of the Bank of Albania intermediation to the foreign market during the summer period, towards purchasing the foreign currency.

Though trade deficit increased, the current deficit in the third quarter has been lower than in the previous quarters, thanks to increased and positive balances of income, services, and particularly current transfers. The current transfers balance is estimated at USD 295 million, being higher than the one of the first two quarters, and nearly 44 percent higher than the one of the third quarter of the previous year. Overall, the balance of payments performance during 2004 was positive. The gross foreign reserve level, at the end of this period, was estimated at USD 1 billion and 244 million, adequate to cover 5.1 months of imports of goods and services.

Based on the aforementioned developments, we may conclude that year 2004 contributed generally in further consolidating the country's macroeconomic equilibrium. Although full data for the yearend of 2004 are not yet available, there is a crystallization of the idea that the primary targets projected in the medium-term plan on the country's development have been met satisfactorily. According to the latest estimations, the Albanian economy grew by 6 percent under the conditions of a low inflation rate, far closer to the bottom level of the targeted band. The structural reforms, through their problematic concerns, have progressed during 2004.

All this consolidating process has created the premises for a better stability in the future. The development program of the country for year 2005 already exists, part of which are the primary targets of monetary policy.

The primary target of monetary policy for 2005, projected in the monetary program, remains the maintenance of the annual inflation rate within the two-to-four percent targeted range. This target is supposed to be met through the control of the monetary supply growth at an approximate level with the nominal growth of GDP, presuming that the velocity of currency circulation in the economy is stable. In this light, the annual growth rate of money supply for year 2005, projected in the monetary program, is 9.4 percent. This rate is in compliance with the provided demand of the economy for money, coming from its real growth by 6 percent.

The Bank of Albania monetary program is designed in line with other policies of the economy, where its harmonisation with the government fiscal policy is highlighted. The Bank of Albania estimates that like in the past years, even in 2005, the country's economic development will be in

conformity with the overall development program objectives. The last developments of the banking system consolidate the optimism that it will fulfil to the best of its knowledge the role of financial intermediation in the economy. We deem that its consolidation will continue with accelerated rhythms throughout this year, providing to the large public more credits, more services and more security in the savings conduct.

II. ECONOMIC PERFORMANCE DURING THE SECOND SEMESTER OF 2004

II.1 WORLD ECONOMY

World economy entered the stage of a mature development cycle during the second semester of 2004. The high growth rates at the end of 2003 and in the beginning of 2004 are followed by a moderate growth during this period. Oil price rise was a factor that negatively impacted the economy growth rates. Oil price reached the highest point in October, but since that moment it marked a fall, being followed by an increase of optimism and stock exchange indexes. World trade increased by 8.5 percent during 2004¹, being both a supporting factor and sign of economy growth. On the other hand, the economic growth is assisted also by macroeconomic policies, which maintain promoting trends at international level. Thus, the low borrowing rates and the high investment level have positively impacted the development of world economy. Independently of the high oil price, inflationary pressures have been low. The secondary effects of price rise waned because of the high competitiveness.

Table 1. Main indicators of world economy (in percentage)

	GDP – 3rd Q	Unemployment	CPI
United Kingdom	3.0	4.6 (September)	+1.2 (October)
France	2.0	9.9 (October)	+2.1 (October)
Germany	1.3	10.8 (November)	+1.8 (November)
Italy	1.3	8.1 (April)	+2.0 (November)
Japan	3.9	4.7 (October)	+0.5 (October)
USA	4.0	5.5 (October)	+3.2 (October)
Euro area	1.8	8.9 (October)	+2.2 (November)

*Source: "The Economist" magazine, December 4-10, 2004

In the United States, the economic activity performance resulted positive during this semester. Based on the most recent estimations, the growth being translated in annual terms of GDP was 4 percent in the third quarter, from 3.3 percent it was in the second one. The base of growth during this period was the increase of personal consumption. Employment increase during this year was one of the reasons of personal consumption increase. Evaluating that economic growth of the United States appears of stable bases, FOMC decided to rise by 0.25 percentage points the core interest rate on December 14, reaching the level of 2.25 percent. This was the fifth rise of core interest rate from Federal Reserve during this year. However, financial markets continue to be worried about the structural problems of the American economy. USA monthly deficit trade reached the record of USD 60.3 billion in November, due to the demand at record levels for oil and consumer goods. Also, budget deficit for the fiscal year 2004, closing on September 30, marked the value of USD 412.6 million, about 3.6 percent of GDP and about 9.4 percent more than the previous year. These deficits have oscillated the confidence of investors in the long run value of USD, being reflected in the reduction of foreign exchange rate against strong foreign currencies.

Real GDP growth rate for the euro area was only 0.3 percent during the third quarter. The performance of this economy, during the second half of the year, did not follow the same rhythms as in the first half. Net exports contribution during the third quarter resulted to be

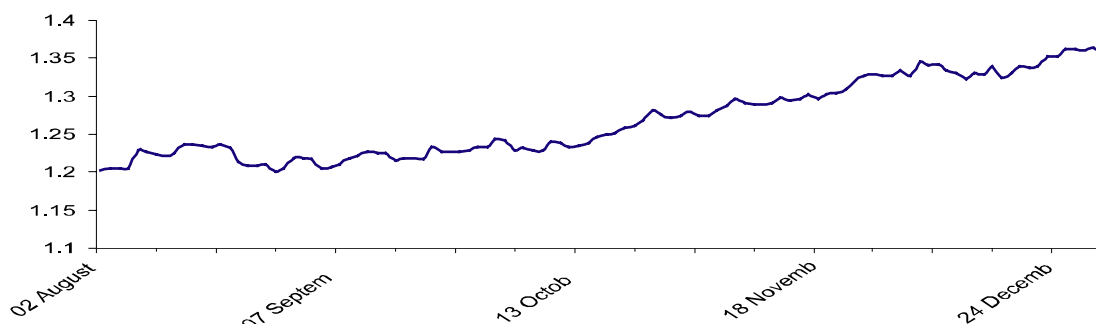
¹ Data of the World Trade Organization.

negative due to considerable increase of imports. Exports represent nearly one fifth of the European economy, a level about 2 times higher than the one of USA. Thus, the euro zone economy is more sensitive to Euro appreciation, which reached 7 percent during the last four months. The negative impact of euro appreciation in exports led to the decrease of confidence from the business. Another factor influencing the economic slowness is the decrease of private consumption, which is believed to be the consequence of high price of oil and unemployment rate, being evaluated at about 8.9 percent. The euro area countries have started to cut taxes, promote personal consumption, but further aggravating their fiscal position. The budget deficit ratio to GDP for 2004 is estimated to reach the level of 2.9 percent, from 2.7 percent it was in 2003. Inflation in the euro area was 2.2 percent in November, from 2.4 percent in October, reflecting the oil price movements. Annual rate of energy group index increase from 6.4 percent in September 2004 to 9.8 percent in October 2004. Data from the labour market show that the increase of annual wages in the euro area has been moderate during the third quarter of 2004, a fact that will help the control of inflationary pressures over the mid-term period.

EXCHANGE RATES

US dollar has continued to be depreciated at accelerated rhythms against all the foreign currencies, during the last two months of 2004. In the last days of December, one Euro was exchanged with US\$1.36. Till now this is the highest historical rate of the Euro exchange against US dollar.

Chart 1. Exchange rate of euro and US dollar, August – December 2004



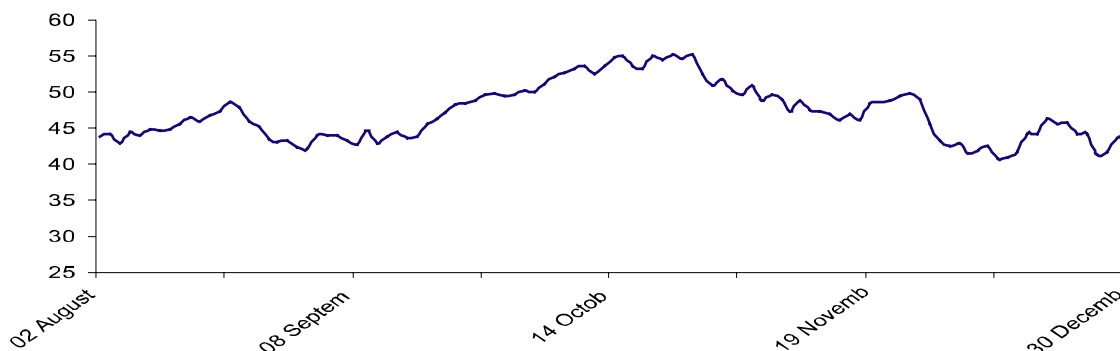
Source: Bloomberg.

Current account deficit in United States was the main factor impacting the US dollar depreciation. American exporters welcome US dollar weakness; meanwhile the leaders of European countries became worried, as European producers started to feel the Euro strengthening. US dollar has reached the lowest levels of exchange against the other foreign currencies as well, during the month of December. One dollar is exchanged even with 104.5 Japanese yen and with 1.9 British pound.

OIL PRICE

After reaching a culmination of USD 55 per barrel in October, oil price recorded a fall, but always remaining at high historical levels. The world supply of crude oil is 1 percent higher than the daily consumption; such a difference makes the markets nervous in the event of production interruption. The main geopolitical issues over the last months are related with the events taking place in Iraq and with the disagreements in Russia between Yuko Company – the highest Russian company of oil production – and Russian Government.

Chart 2. Crude oil price, August – September 2004



Source: Bloomberg.

OPEC Member States, in the meeting of December, decided to reduce the production to 1 million barrels per day. However, the decision did not have strong effects on the price, as it shall not immediately enter into force. OPEC produced 28 million barrels per day, about 1 million more than the ceiling production. The decision to turn the production at ceiling levels was made to avoid giving opportunities to oil consumer countries to create stocks, which would lead to price cut.

II.2 ALBANIAN ECONOMY

The available statistical information for purposes of real economy analysis continued to be rare even during this semester, thus making considerably difficult the analysing ability of the Bank of Albania. Available information results to be poor and disclosure period is furthermore of delay from the closure of the surveyed period. We are obliged, under these circumstances, to make use of that small quantity of information we may own, which mainly consists in the sales index and in some general estimations related to agricultural production.

Economic activity in the country has been distinguished by a significant growth during the third quarter of the year. The sales volume of non-agricultural sector, relative to both the previous quarter and the same quarter of the last year, increased considerably. Hence sales index, during the 9-month period of 2004 increased by 4.7 percent, compared to the same period of the previous year, compensating the fall noticed in the first quarter. The slowness of industry sector is balanced by the good performance of services sector (trade, hotels and restaurants) and that of construction. Positive developments are noted particularly in the services and construction sectors whose sales increased by 6.2 percent and 7.1 percent respectively during the 9 months of year. Albanian economy is eased by appropriate weather conditions, which have positively impacted the agricultural production and energy situation. Agricultural sector production is expected to be higher than the one forecasted at the beginning of the year, making that the contribution of this sector on GDP growth rises from 0.7 percentage point to 1 percentage point.

Table 2. Real growth of GDP

	2002	2003	2004*
Economy	4.7	6.0	6.0
- Industry	1.8	2.7	3.1

- Agriculture	2.1	3.0	3.0 (3.8 revised)
- Construction	8.7	11.3	10.6

- Transport	9.7	10.8	10.1
- Services	5.1	6.4	6.4

Source: Ministry of Finance.

Economic growth, from macroeconomic viewpoint, has been revitalized under the conditions of a relative stability of internal and external equilibriums. Inflation results 2.9 percent at average level, closely to the middle limit of the Bank of Albania targeted band. Monetary developments have moved within the established equilibriums. Credit balance of the economy increased by about 30 percent during the eleven-month period of the year, being simultaneously oriented toward longer maturity terms. This development attests to a higher support of the banking system towards increasing producing capacities of the Albanian economy.

Lek was generally characterised by a depreciating tendency, being facilitated by the increase of confidence in the domestic currency, by positive interest rates, and the decline of imports in energy and agricultural products. However, the balance of payments marked positive developments, being followed by a growth of foreign reserve of the Bank of Albania. Trade balance deficit in nominal terms has continued to increase, being impacted by USD depreciation against Euro. Nevertheless, exports during 2004 marked a growth almost two times higher than imports, reflecting a better performance of the external sector of the economy.

Unemployment progressively decreased, while budget expenditures up to November resulted to be within the expected limits, without infringing the supply increase. Oil price rise in international market, though being reflected in the oil and transport price in Albania, does not seem to have caused additional unbearable cost for the domestic business and consumers.

Based on the so-far developments and waiting for the confirmation of fourth quarter data, we estimate that the target of growth by 6 percent of the Albanian economy during 2004 has been achieved.

II.2.1 ECONOMY SECTOR PERFORMANCE

Sales volume in the economy² has been distinguished by an increase during the third quarter of 2004. Sales index on economy has recorded an increase of 14.6 percent compared to the second quarter, and an increase of 9.1 percent compared to the third quarter of the last year. Sales during the 9-month period of 2004 resulted about 4.7 percent higher than those of the same period of the last year. The sector having the highest weight of economy sales, the one of trade, hotels and restaurants, is developed at satisfactory level, marking a growth for all the compared periods and impacting significantly the total sales performance.

Table 3. Sales performance per sectors (in percentage)

	Sales weight (% of total)	January – September 2004/2003	Q3 '04 / Q2 '04	Q3 '04 / Q3 '03
Total economy	100.0	4.7	14.6	9.1
Industry	26.0	-0.6	3.0	0.0
Construction	12.8	7.1	10.7	3.2

² Agricultural sector sales are not included in this estimation.

Trade, hotels, restaurants	44.0	6.2	23.7	18.0
Transport and telecommunication	11.8	5.0	17.8	1.8
Other services	5.5	15.1	3.3	14.7

*Source: Institute of Statistics.

Tracing the performance of the last year, it was noted even during 2004 a progressive increase of sales throughout the quarters for all the sectors of economy.

Chart 3. Sectors sales per quarters



*Source: Institute of Statistics.

INDUSTRY

Sales of the industry sector represented by the processing industry, extracting industry and energy, water and gas industry, resulted to be at the same level with the previous year during the 9-month period of the year. Electric energy production increased by 7.1 percent during the 9-month period of the year, while consumption of electric energy increased by 3.9 percent. The utilization of electric energy by the non-household consumers raised by 10.3 percent. Based on the good performance of electric energy production and distribution and for lack of full data, we estimate that the sales of this sector have resulted from the fall of water and oil sales.

CONSTRUCTION

During the third quarter of 2004 construction sales have marked an increase of about 11 percent compared to the previous quarter. The highest level of sales for this sector was achieved in August, a growth of 25.3 percent compared to the average monthly sales of the 9-month period of 2004. The sales growth in the third quarter led to construction sales growth by 7.1 percent during the 9-month period of the year compared to the same period of the last year.

TRANSPORT AND TELECOMMUNICATION

Transport and telecommunication sector has marked an increase of 5 percent in terms of sales volume, during the 9-month period of 2004, compared to the previous year. During the third quarter, sales of this sector grew by 18 percent respective to the last quarter. Work volume in ports for the above-mentioned period increased by 7 percent. Imports, constituting the highest weight of goods volume in ports, increased by 5 percent, while exports by 29 percent. However, it is noted that the work volume in railway transports, for January – November, 2004, has suffered a considerable fall to 20 percent in goods and 16 percent in travellers, compared to the same period of the previous year.

AGRICULTURAL SECTOR³

Year 2004 has been distinguished by positive developments regarding agricultural, animal and agro-industry products. According to the estimations of the Ministry of Food and Agriculture, agricultural branch is expected to increase by 3.8 percent during 2004 compared to the initial forecast of 2.9 percent. Thus, the contribution of agricultural sector production growth on GDP growth for year 2004 is estimated at about 1 percentage point compared to the initial estimation for a contribution of 0.74 percentage point.

Table 4. Agricultural product during 2004

	Weight on Gross Agricultural Product	Forecast July 2004/2003 (%)	Estimation December on 2004/2003 (%)
A. Agriculture	80	2.9	3.8
A.1. Animal	37	4.3	4.9
A.2. Crops	43	1.8	2.9
B. Agro-industry	19	10	12
C. Fishery	1	10.7	10.7
Total	100	4.1	4.9

*Source: Ministry of Food and Agriculture.

The highest growth of agricultural production is facilitated by the favourable weather conditions and based on the improvement of the technology employed by farmers and on the growth of investments (particularly in agro-industry sector). The abundant production of domestic vegetables and crops have competed the imports, compared to the previous year, and has also impacted the decline in prices of these goods during the major part of the year.

Agro-industrial production, representing nearly 20 percent of the domestic gross agricultural product, increased by 12 percent during 2004. According to agro-industry survey for the third quarter, the processing of agricultural products considerably increased. Thus, during the third quarter the production of fish conservation, fruit and vegetables, milk processing, as well as the production of olive oil, alcoholic beverages, ham, and of water and fresh beverages, considerably increased, too. Although the increase of these processed products during the third quarter is explained by the seasonal nature of their production, the agro-industrial production for the third quarter grew by 18.3 percent in annual terms, which reflects the good performance of this branch.

Table 5. Performance of agro- industry during 2004 (change in %)

	Q3'04 (in billions of LEK)	Q3/T3 2004/2003	Q3/T2 2004
Agro-industry production	9.9	18.3	44.5
Meat and its products	0.7	41.0	25.6
Conserved products	0.2	5.6	40.7
Milk and its products	1.4	15.3	-18.0
Wheat flour and bread	1.8	-5.5	4.9
Alcoholic beverages	1.1	59.6	51.5
Water and fresh beverages	2.4	126.6	179.5
Other	1.6	-25.0	141.1

*Source: Ministry of Food and Agriculture.

³ This sector includes branches of agriculture, agro-industry and fishery.

⁴ This contribution is computed by using the growth rate of 3 percent and the sector weight on GDP of 21.8 percent.

II.2.2 FISCAL SECTOR

Fiscal policy and indicators resulted in general within the projected frame for the period January – November of 2004. According to the Ministry of Finance 92.2 percent of revenues are collected up to the end of November and about 90 percent of the projected expenditures are performed for this period. Thus, budget deficit, by the end of November, amounts to about LEK 24.8 billion, from LEK 32 billion being forecasted. Compared to the same period of the last year (January – November), revenues increased by 11.3 percent, expenditures by 9.1 percent, while budget deficit declined to 3.3 percent. In GDP terms budget revenues have maintained almost the same level with that of the last year, approximately 21.7 percent, while expenditures have reached the level 24.8 percent of GDP, marking a fall of 0.7 percentage point compared to the same period of the last year. The control of both budget expenditures and budget deficit within the projected levels made that inflationary pressures become less vulnerable to the fiscal sector.

Table 6. Fiscal indicators (billions of LEK) and the relative difference (in percentage)

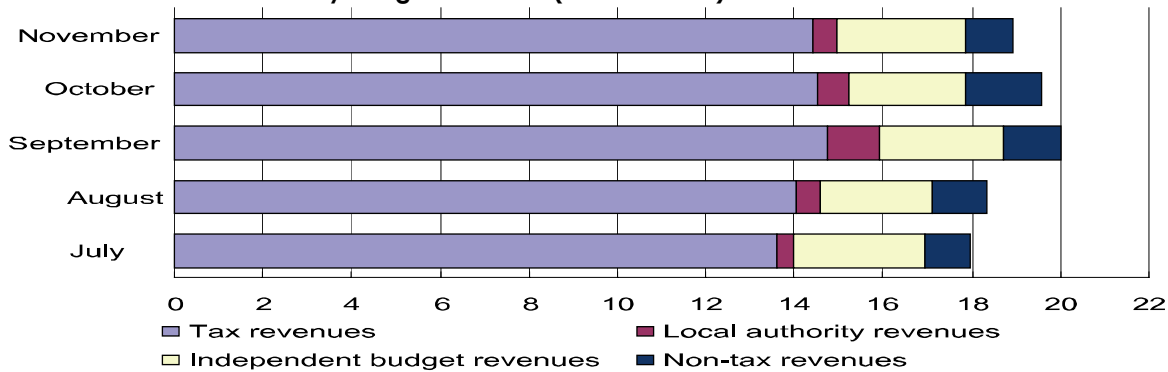
	July-November 2004	Difference with 2003	January – November 2004	Difference with me 2003
Revenues	79.4	15.7	165.4	11.3
Expenditures	95.7	12.0	190.2	9.1
Deficit	16.3	-2.9	24.8	-3.3

Source: Ministry of Finance.

BUDGET REVENUES

Budget revenues have marked an increase for all their components during the period January – November 2004. Tax revenues level, by the end of November, amounted to LEK 149.2 billion, while customs tax income resulted about LEK 111 billion, attaining the projected level of the annual budget by 97.7 percent and 96.4 percent, respectively.

Chart 4. Structure of monthly budget revenues (billions of LEK)



Source: Ministry of Finance.

Tax revenues remain the main source of budget revenues. They represent 85 percent of total revenues up to November. Unlike the previous periods, the value added tax exceeded the projected level, being performed at 103.2 percent. However, local government revenues are performed at 85.4 percent.

Table 7. Tax and customs revenues (in billions of LEK)

	November	Plan	Achievement (in %)	Annual plan
1. Tax revenues	149.2	154.9	96.4	170.6
1.1 Tax and Customs	111.0	113.6	97.7	125.6
- Value Added Tax	53.3	51.6	103.2	57.2
- Tax on income	14.7	13.8	106.2	15.2
2. Revenues from Local Government	9.1	10.7	85.4	11.3
3. Budgeted revenues. Independent	29.1	30.6	95.1	33.7
4. Non-tax revenues	13.8	18.7	73.7	20.8

Source: Ministry of Finance.

BUDGET EXPENSES

Budget expenditures have during 2004 the same features as in the previous year: during the 11-month period of the year current expenses are performed at 97.7 percent of the plan, while capital expenditures only at 67 percent. From the latter, expenditures covered by foreign financing are performed at 48.3 percent. However, capital expenditures performance is expected to considerably increase in December, and in the next year, due to the use of a part of revenues from the Savings Bank's privatisation for strategic investments.

Current expenses constitute 90 percent of total expenses (January – November 2004).

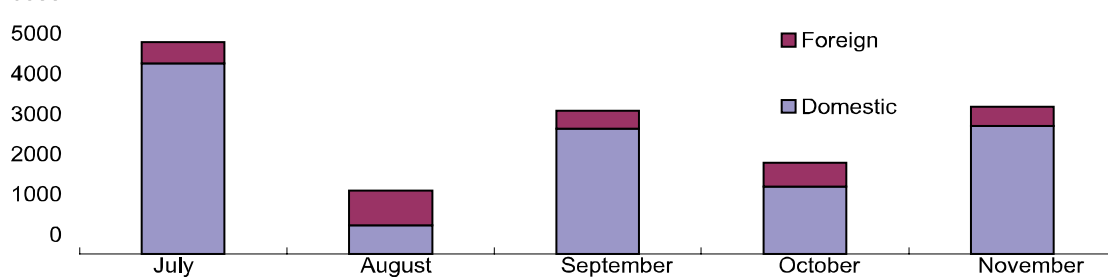
Chart 5. Budget expenditures structure (millions of LEK)

Source: Ministry of Finance.

FISCAL DEFICIT

Fiscal deficit, during January – November, resulted nearly 77.5 percent of the projected level. Compared to the same period of the last year, fiscal deficit declined at 3.3 percent. The major part of deficit is financed by internal source, mainly as domestic borrowing.

Chart 6. Budget deficit financing for 2004



Source: Ministry of Finance.

II.2.3 LABOUR MARKET

Labour market indicators speak for a positive performance of employment during the second part of 2004. Due to emigration, year 2004 is characterized by a fall of labour force number and of employment, particularly during the first quarter of the year, and dynamics of quarter's progress is positive. The number of employed persons during the third quarter is grown at 1 thousand other recorded persons. The number of unemployed persons has been declining as well; hence the unemployment rate is reduced from 15 percent at the beginning of the year to 14.6 percent during the third quarter. In other terms, this means that the number of unemployed persons decreased by 3 thousand persons during that period.

Table 8. Labor market indicators (in thousands of persons)

	2002				2003				2004		
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III
Total labor force (in thousands)	1096	1093	1094	1094	1096	1093	1092	1091	1080	1081	1080
A. Total employed (in thousands)	918	917	919	921	926	927	928	927	919	921	922
i) public sector	189	188	187	187	185	185	184	182	179	179	177
ii) private non-agricultural sector	6	203	206	208	207	208	210	211	206	208	211
iii) private agricultural sector	526	526	526	526	534	534	534	534	534	534	534
B. Unemployed (in thousands)											
i) total unemployed	178	176	175	173	170	166	164	164	161	160	158
ii) unemployment payment benefits	13	13	12	11	11	11	11	11	11.7	12.3	12
C. Unemployment rate (in %)	16.2	16.1	16.0	15.8	15.5	15.2	15.0	15.0	14.9	14.8	14.6

*Source: Institute of Statistics, Conjoncture, September 2004.

Employment structure per sectors reflects a continuous increase of employed persons in private non-agricultural sector during 2004, and a decrease of employed persons in public sector (mostly noted during the third quarter). The change of this ratio is due to public enterprises structuring process, which has diminished the number of their employed persons, and due to the Savings

Bank's privatisation, raising the number of employed persons in private non-agricultural sector. The number of employed persons in private agricultural sector has remained unchanged during the 9-month period of 2004. The total number of employed persons in this sector is 534 thousands persons.

The change of minimal salary approved in the third quarter of 2004, from LEK 10060 to LEK 10080, is reflected also in the average salary in public sector increased by 3 percent. The unemployment payment increased at the amount of LEK 4360.

II.2.4 EXTERNAL SECTOR OF ECONOMY

The balance of payments closed the third quarter by a positive balance. Foreign reserves increased by about USD 95 million during this quarter. The current deficit was about USD 26 million, while capital and financial account balance resulted to be a positive one (about USD 30 million). The trade deficit has been rising compared with the two first quarters of the year, as well as compared with the third quarter of the previous year. However, the current deficit in the third quarter was lower than the previous quarter of the year due to positive and increased balances of income, services and current transfers.

Table 9. Balance of payments (in millions of USD)

	Q1'04	Q2'04	Q3'04	Jan- Sep '04	Jan- Sep '03
A. Current account	-77.9	-108.4	-25.7	-212.1	-261.2
A.1. Goods	-317.9	-358.0	-405.8	-1081.7	-957.6
A.2. Services	-6.1	0.7	27.1	21.7	-44.1
A.3. Revenues	36.3	32.1	59.4	127.8	133.2
A.4. Current transfers	209.9	216.9	293.6	720.4	607.3
B. Capital account	34.0	25.7	33.6	93.3	113.1
C. Financial account	22.9	203.2	-4.3	221.8	124.8
D. Reserve assets	-14.9	-117.4	-95.3	-227.6	-78.5
E. Errors and omission	29.9	-3.0	85.9	112.8	90.7

Source: Bank of Albania.

CURRENT ACCOUNT

Current account revenues of Albania during the third quarter of 2004 amounted to USD 787 million, while expenditures to USD 813 million. About 38 percent of payments of the whole 9-month period of the year entered as current payments, while expenditures had a more uniform spread, representing 36 percent of the 9-month period expenditures. This quarter is characterised generally by higher imports of goods than the two previous quarters, lower goods exports, as well as higher inflows/outflows in services category. Current inflow transfers marked also an increase during the third quarter due to the growing number of emigrants turning back to homeland for vacations.

Travelling services continue to cover the major weight of services category. They have provided either for the third quarter or for the whole 9-month period of January – September about 70 percent of the total income and have represented 60 percent of services expenditures. Revenues from non-residents travelling in Albania for the third quarter (about USD 190 million) increased by 14 percent compared to the same period of the previous year, while expenditures of resident travellers abroad declined about 20 percent, remaining at the level of USD 130 million. Transport services, though being at lower levels than those of travelling, have marked an increase in both inflow and outflow directions compared with the third quarter of the last year.

An increase of income from other services is also noted while payments for these services remained at the level of the last year.

Positive balance of employment revenues (USD 60 million) increased by about USD 10 million compared to the third quarter of the last year. Income from employees' compensation has the highest weight in this category, which is estimated at USD 48 million for the third quarter. Income flows from portfolio investments, reserve and other investments have marked changes, compared to the third quarter of the previous year.

Balance in the current transfers category is estimated at about USD 294 million, being higher than the two previous quarters and about 44 percent higher than the one of the third quarter of the previous year. Emigrants' remittances (USD 282 million) are followed by transfers in the form of technical assistance (USD 7 million), of goods (USD 5 million) and of other transfers (USD 22 million).

CAPITAL AND FINANCIAL ACCOUNT

Net inflows of capital account amounted to USD 34 million during the third quarter of 2004, not reflecting any big difference in comparison with the previous quarters. Financial account balance shows that net financial inflows during the third quarter have been almost zero. Residents' claims to non-residents grew at the same level as residents' liabilities (USD 124 and 126 million, respectively). In terms of assets a holdings reduction of about USD 120 million was recorded as portfolio investments, while deposits of our banking system abroad increased by USD 234 million. In terms of liabilities, Albania has withdrawn about USD 72 million as direct investments and about USD 32 million as official and private debts. Residents' liabilities to non-residents increased due to borrowings as long-term credits and soft credits from abroad, which have raised the external debt of Albania at about USD 160 million. The new private loan for the 9-month period of 2004 is nearly 5.5 times higher in comparison with the same period of 2003. The new figures of private debt are provided also due to a closer cooperation with crediting institutions, which have supported over the years the Albanian business. Services of foreign debt as principal payments amounted to USD 31 million during this period. Net inflows of foreign assets as financial capital are reflected in the monetary authority foreign reserves, which increased by about USD 228 million. At the end of the period, gross reserve level is estimated at USD 1 billion and 224 million, sufficient to cover 5.1 months of imports in goods and services.

III. INFLATION DURING THE PERIOD OF JULY - DECEMBER

III.1 INFLATION PERFORMANCE AND COMPONENT GROUPS

Second part of 2004 was characterised by low inflation, within the 2-4 percent targeted range of the Bank of Albania. Annual inflation was 2.2 percent in December, while the average annual inflation was 2.9 percent. The achieving of inflation objective reflects, inter alia, the stable macroeconomic situation, the control of domestic demand of the economy and the monetary indicators stability.

Table 10. 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	3.1
August	-0.7	4.1	5.5	3.0	2.7
September	0.9	3.5	5.3	2.8	2.0
October	1.8	1.8	5.8	2.9	2.0
November	1.9	2.8	3.7	3.4	2.2
December	4.2	3.5	1.7	3.3	2.2
Average	0.1	3.1	5.2	2.2	2.9

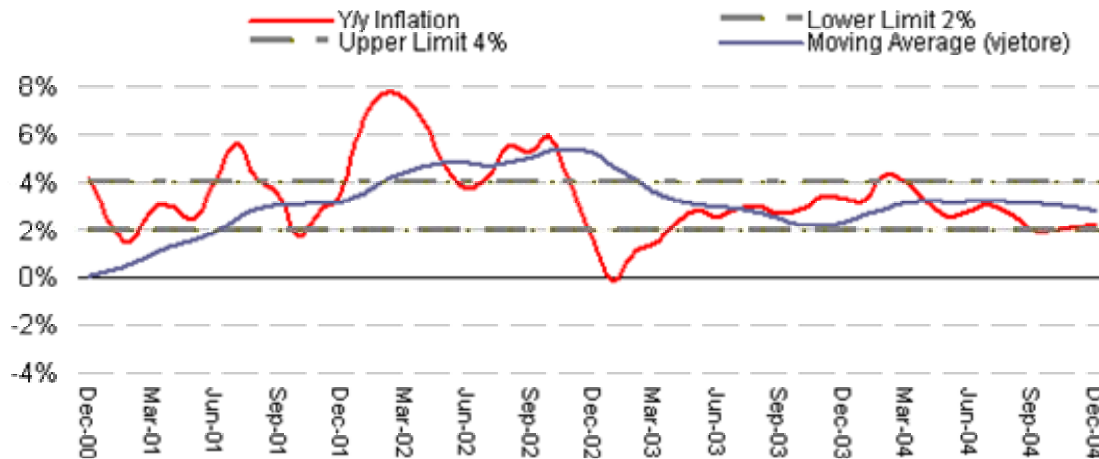
*Source: Institute of Statistics.

In accordance with the earlier warnings of the Bank of Albania, the falling performance of agricultural products prices is confirmed during the second half of the last year, thus further underpinning the confidence that domestic agricultural production of this year is higher in comparison with the previous years.

Regarding this impact, it remains to confirm in the future whether we have experienced a particular year, whose success was based on climatic conditions and on other casual circumstances, or we have to do with an increase of investments in green houses and agricultural techniques. If the second one will be verified as true, then there might be concluded the typical seasonal behaviour verified in the past will change somewhat, giving more opportunity to the levelling of monthly curved line of inflation.

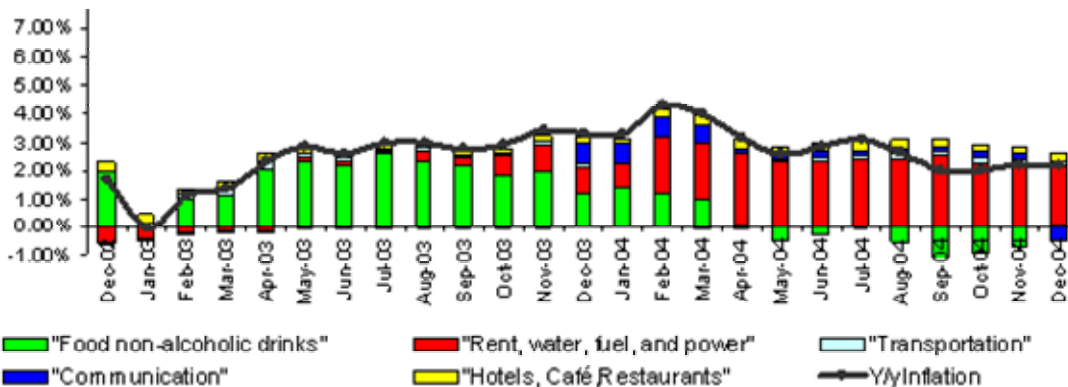
The continuous effect of the decline in agricultural price has been rather sufficient to absorb the upward impacts that accompanied the oil price rise and the delayed effects of the administered price changes (price rise of the electric energy and fixed telephony, respectively in January and April).

Chart 7. Annual inflation (in percentage)



Graph 8 reflects in a more detailed way the contribution that each group of price basket has provided to the annual inflation.

Chart 8. Contribution of the main groups of CPI basket (in percentage point)



Treating in more details the performance of the main items of the basket, we may highlight:

- "Food and non-alcoholic beverages" item marked negative annual rates for the period May – November 2004. This progress is diametrically opposite with the past. However, the one thing to be noted is that the contribution of this group has been continuously falling. The one thing interesting has to do with the fact that the high weight of this group continues giving its "face" to inflation. Due to the high weight (42.6 percent) of this group in the consumer price basket, it considerably affects the rate of total inflation. The high dynamics featuring the domestic economic development, during the last 3-4 years, has affected, among others, the behaviour of Albanian consumer; such an observation would impose changes in composing the price basket. Notwithstanding the fact that Albania is still considered a poor country, consumer behaviour is believed to be under an uninterrupted changing process, evidently towards a typical structure for consumer societies. A fall of the weight of this group would ease the high fluctuations of prices index from one month to the other, while the structure of this group might have gone through potential changes itself.

Table 11. Annual inflation rate and the contribution of “Food and non-alcoholic beverages” group on total inflation

	Annual inflation 2003	Contribution (pp)	Annual inflation 2004	Contribution (pp)
July	6.2	2.56	-0.1	-0.05
August	5.6	2.33	-1.4	-0.58
September	5.3	2.21	-2.9	-1.25
October	4.3	1.82	-2.2	-0.94
November	4.8	2.01	-1.6	-0.70
December	2.7	1.20	0.3	0.12

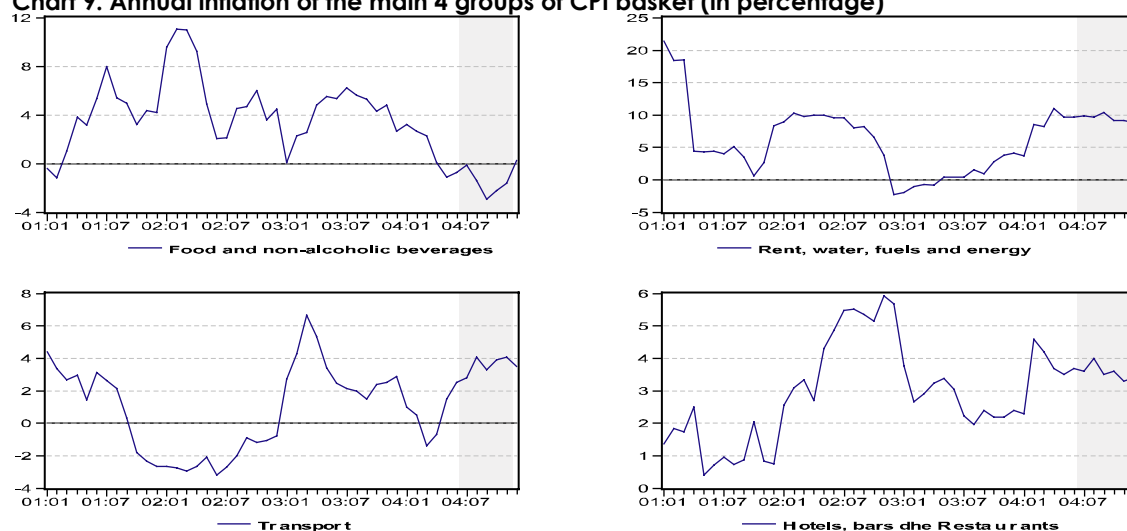
- Prices index of “Rent water, fuels and energy” group systematically increased throughout 2004. Electric energy price rise, in January 2004, had a direct impact on the rising direction, contributing at an average of 2.3 percentage points on the annual inflation rate (Table 12).

Table 12. Inflation annual rate and the contribution of “Rent, water, fuels, energy” group on total inflation

	Annual inflation 2003	Contribution (pp)	Annual inflation 2004	Contribution (pp)
July	0.4	0.10	9.9	2.39
August	1.6	0.39	9.7	2.37
September	1.0	0.23	10.4	2.49
October	2.8	0.68	9.2	2.24
November	3.8	0.91	9.2	2.22
December	4.1	0.95	8.8	2.08

- Decisions on the rise of the administered price of fix telephony at 68.8 percent in December 2003 and later the reduction at 28.5 percent in April 2004 affected the inflation of “Communication” group. Following this reduction, the group contribution on total annual inflation has been lowered from 0.7 percentage point during the period December 2003 – March 2004 to 0.2 percentage point during the period April – November 2004. The contribution of this group was in December negative at -0.46 percentage points, reflecting that the annual inflation rate is no longer impacted by the price rise of December 2003.

Chart 9. Annual inflation of the main 4 groups of CPI basket (in percentage)



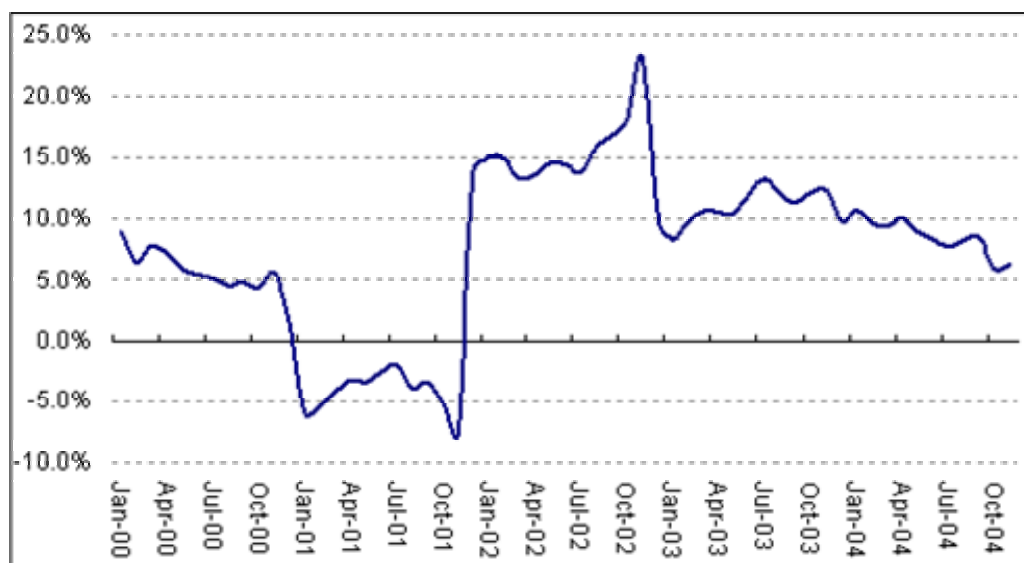
- Inflation of the other groups of CPI basket is moderately fluctuated during this semester. "Clothes and footwear" group marked a decline of annual inflation, while an increase was marked by "Hotels, bars and restaurants" and "Education service" groups.

III.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

Maintaining inflation at low level is undoubtedly a result of favourable macroeconomic conditions and of adequate and prudential monetary and fiscal policies, in addition to the favourable developments in both agricultural production and foodstuff prices.

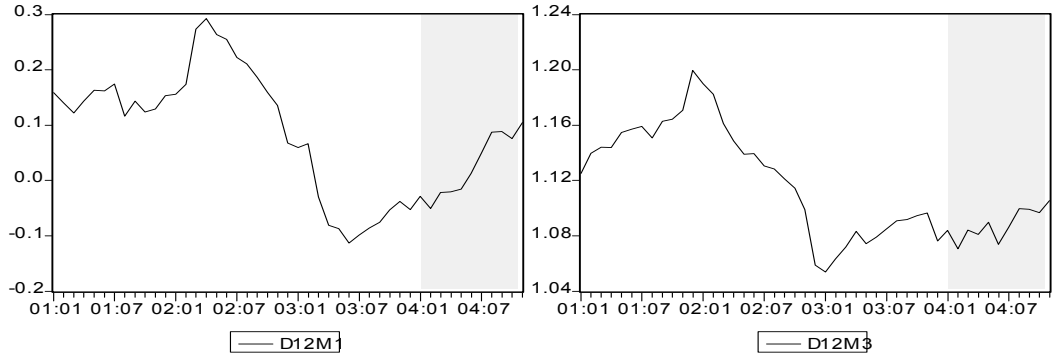
Year 2004 has been distinguished by the accomplishment of fiscal objectives in terms of budget expenses and budget deficit, as well as by a more uniform spread of budget expenses. Government demand for loan has been increasing during the second semester, but nevertheless remaining still within the forecasted levels. The annual rate of current budget expenses change has been stable. The implementation of a prudential fiscal policy has provided the conditions for a better control of inflation rate.

Chart 10. Annual change of current expenses



Monetary policy of the Bank of Albania has maintained the easing direction even during the second semester, aiming at reducing the borrowing cost in the economy. However, the low rate of inflation has provided a real positive interest rate, making possible the channelling of deposits in the banking system and preserving liquidity ratios in the system. The easing monetary policy is applied without infringing the monetary balances. The second semester of this year is characterised by higher growth rates of monetary aggregates, but without generating inflationary pressures on the economy.

Chart 11. Annual changes of M1 and M3 monetary aggregates (in percentage)



The continuous appreciation of Lek against Euro and US dollar has been an important factor in the moderate performance of inflation⁵. Lek appreciation during the summer period is due to some extent to the same factors impacting the low rate of inflation during this period: shifting of imports in the market due to domestic product growth. Lek appreciation, being also combined with low rates of inflation in partner countries, has equilibrated the inflationary impulses that are generated by imported inflation⁶.

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

	May	June	July	August	September	October	November
Greece	3.1	3.0	3.1	2.8	2.9	3.3	3.2
Italy	2.3	2.4	2.2	2.4	2.1	2.1	2.0

Source: Eurostat News Release.

On the other hand, supply factors have not generated considerable pressures on consumer price rise. The impact of oil price rise was moderated in the domestic market. Oil price rise in the foreign markets at about 29.7 percent, during the period August – October 2004, was reflected in the inflation increase for “Transport” group at 4.1 percent. Nevertheless, the continuous appreciation of Lek against US dollar has smoothed the oil price rise impact on inflation in the international markets. On the other hand, the adaptability of internal demand for this product made that domestic price was not subject to full rise.

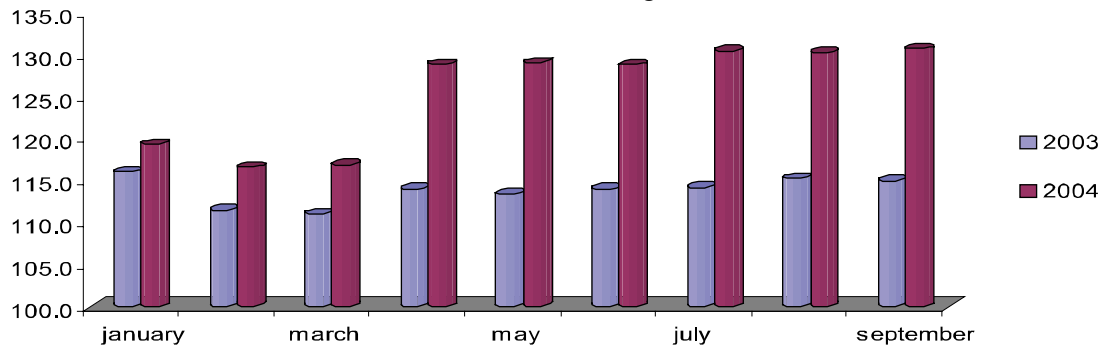
During the third quarter of 2004, Production Price Index marked an increase in annual and quarterly terms.⁷ Theoretically, the Production Price Index growth, in the framework of the increasing capacity usage, signals the risk of cost shifting into consumer prices. Nevertheless, such a phenomena is not confirmed yet, and as for the lack of empirical analyses in this respect, it cannot be concluded yet whether this shifting process shall be certified at a second time or not. A possible cause in the non-transmission of this effect to consumer prices shows that the Albanian economy still owns unexploited capacities. The increase of competitiveness in the economy has also exerted a restricted impact on consumer price rise.

⁵ Lek is appreciated at 13.2 percent against US dollar and 5.3 percent against Euro, at annual rate.

⁶ Such an inflationary pressure was oil price rise.

⁷ Source: Institute of Statistics, CPI. CPI increase was 1.26 percent relative to the previous quarter, and 13.53 percent relative to the previous year.

Chart 12. Performance of Production Price Index during 2003 and 2004



The slight increase of public sector salaries as well as the decrease of unemployment rate⁸ did not bring about significant changes in consumer dynamics and did not generate considerable inflationary pressures.

The accomplishment of Bank of Albania inflation objective for 2004 has given a positive contribution to the Albanian economy development, aiming at maintaining macroeconomic balances.

⁸ Data provided from Institute of Statistics for the third quarter of 2004.

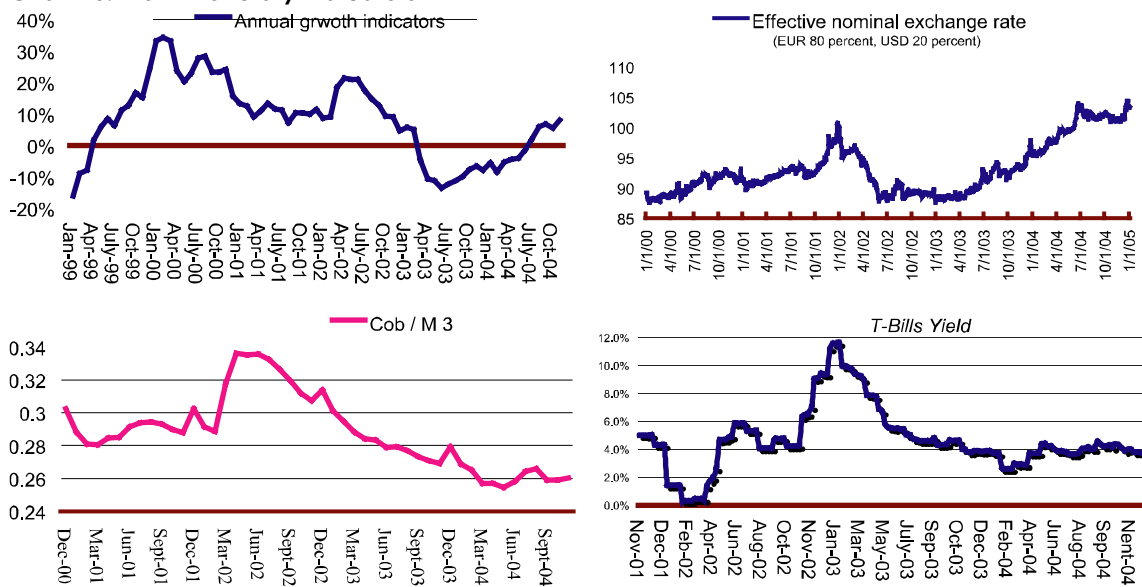
IV. MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

IV.1 MONETARY POLICY OF THE BANK OF ALBANIA

The Bank of Albania went on pursuing an easing monetary policy during the second half of 2004. This policy was conditioned by positive macroeconomic developments in inflation and monetary indicators. During the second half, the annual inflation rate fluctuated within the lower band of 2 - 4 per cent target, while expectations on inflation were stabilized in low levels.

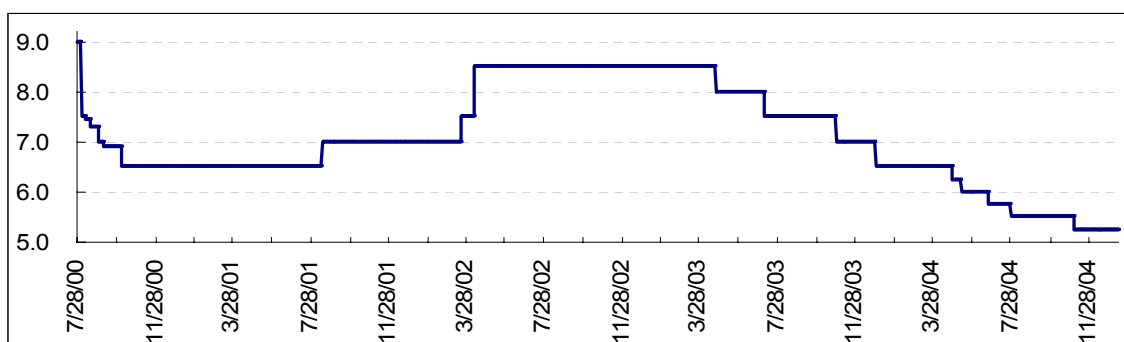
The satisfactory agricultural production and appreciating tendencies of domestic currency during 2004 limited inflationary pressures on the side of supply over the second half of the year. The low inflation resulting brought the real interest rate to previous levels even after the base interest rate cut. On the other hand, though the annual change of real M1 passed to positive direction, reflecting upward tendencies, its annual growth rate remained low compared to the historical mean. The ratio of currency outside banks to monetary supply was stabilized around the average of 26.1 per cent during the 11-month period. In the meantime, the ratio of demand and supply to monetary assets in lek, M2, was shifted to demand side, favoring the lek appreciation over this period and helping the control of inflationary pressures.

Chart 13. Main monetary indicators



Developments in monetary indicators and positive expectations on inflation performance created conditions for continuing the easing monetary policy even during the second half of 2004. The Bank of Albania cut the base interest rate twice, in July and November, by 0.25 percentage point. These cuts brought the base interest rate to its lowest historical levels, 5.25 per cent.

Chart 14. Base interest rate



Also, in the framework of the easing monetary policy, the Bank of Albania changed the type of auction for withdrawing excess liquidity of the system during the third quarter, to variable price auction. The banks' reaction to these monetary policy movements was satisfactory. Due to time difference of conveying the effect, the changes of T-bill interests include the reaction of banks even to base interest rate cuts taking place over the first half of the year.

Table 14. System reaction after two base interest rate cuts* (in percentage points)

	3-month	6-month	12-month
Deposits	(0.31)	(0.51)	(0.60)
Treasury bills	(0.73)	(0.96)	(0.90)

*The change includes the period of 28.07.2004 -31.12.2004.

The easing monetary policy of the Bank of Albania has helped even in smoothing the appreciating pressures of lek exchange rate. The spread between foreign currencies and lek interest rates declined over 2004. However, the increasing foreign currency inflows on the one hand, and the import reduction on the other created a temporary difference between supply and demand for foreign currency during summer months. This misbalance exerted obvious pressure on lek exchange rate appreciation, increasing even the fluctuation in foreign exchange markets. The exchange rate fluctuation due to this temporary growth of foreign exchange supply dictated the need of the Bank of Albania's intervention in foreign exchange market during summer months, in terms of purchasing foreign currency. During July – August, about Eur 35.3 million and Usd 17.5 million was withdrawn from the domestic foreign exchange market generating Lek 6.2 billion in the market. The upward demand for liquidity enabled the Bank of Albania not to sterilize these interventions through outright Treasury bill sales.

The policy pursued and operations undertaken by the Bank of Albania made possible the observance of its quantitative objectives.

Table 15. Meeting of quantitative objectives of the Bank of Albania

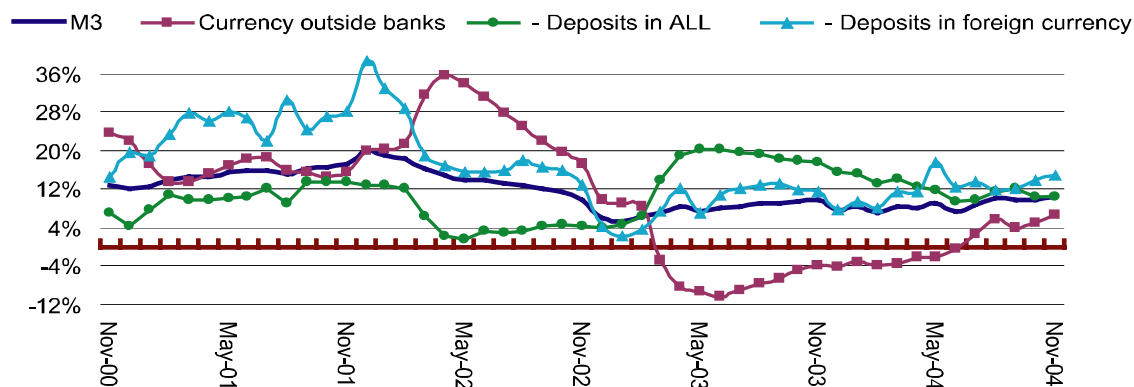
	December '03	March 04	June 04	September '04	November '04
Net international reserves (in million dollars)					
Objective	715.8	751.8	765.8	923.7	935.7
Actual	832.7	827.6	961.5	1043.6	1060.8
Difference	116.8	75.8	195.7	119.9	125.1
Net domestic assets (in billion leks)					
Objective	96.0	83.0	85.0	70.0	74.0
Actual	72.0	66.4	54.7	55.4	56.7
Difference	-24.0	-16.6	-30.3	-14.5	-17.2
Net domestic credit to government (in billion leks)					
Objective	280.9	272.8	270.1	279.1	282.4
Actual	266.8	272.6	263.6	272.0	276.2
Difference	0.0	-0.2	-6.5	-7.1	-6.3

IV.2 MONETARY AGGREGATES PERFORMANCE

Monetary developments during the second half of 2004 were generally performed according to the Bank of Albania monetary program. Reflecting even the positive performance of economy over this period, the monetary equilibriums established in the first half of the year are maintained,

while the economy demand for monetary assets and monetary aggregates have been increased. The annual growth rate of money supply in November reached to 10.5 per cent, from 7.4 per cent it was in June. The money supply growth during this period was based on the growth of two of its components, M2 aggregate and foreign currency deposits. Developments in the time and foreign currency structure of money supply indicate a stability tendency. During the period of June – November the ratio of currency outside banks to M3 fluctuated to almost constant levels, whereas the ratio of deposits in foreign currency to monetary supply was stabilized at high historical levels.

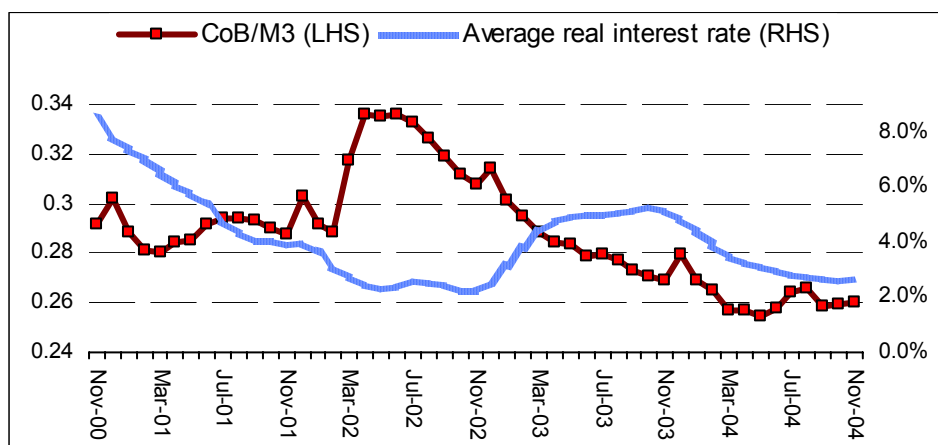
Chart 15. Annual rates performance of monetary aggregates



The performance according to forecasts of government and economy demand for money during this period, as well as the liquidity injection through Bank of Albania's foreign currency purchases in summer months are reflected in higher growth rates of M2 aggregate. This growth is reflected either in the growth of currency outside banks or in deposits in lek, stabilizing the annual growth of both components and their weight in monetary supply. The second half of the year marked the return of annual growth rates of currency outside banks to positive levels. In November, the annual growth rate of currency outside banks reached to 6.8 per cent, from -0.5 per cent it was in June, reflecting stabilization of time structure of money supply, after a long period of its shifting to long-term assets.

In November the ratio of currency outside banks to M3 marked the level of 26.0 per cent, remaining almost unchanged from its level at end of first six-month period. This sustainability reflects mainly the financial stability achieved and the presence of positive real interest rates continuing during two last years. In spite of the sequential base interest rate cuts, the interest rate of deposits in lek remained in acceptable levels, keeping stable the ratio of currency outside banks to M3.

Chart 16. Ratio of CoB to M3 and average real interest rate



Performance of deposits in lek during second half of the year had a stability trend, marking also a slight upward tendency. In November, deposits in lek marked an annual growth of 10.5 per cent. Their satisfactory performance is a result of growth of demand for monetary assets in lek and rise of confidence in domestic currency. Positive spread between real interest rates in lek and in foreign currency established a preference for lek investment instruments (deposits and Treasury bills). So, even the treasury bills portfolio of households in the second half of the year marked a rise of Lek 2.4 billion, which is about 43 per cent higher compared to the same period of the previous year.

The upward tendency of annual growth rates of currency outside banks and demand deposits in lek is reflected at higher growth rates of M1 aggregate. The annual growth rate of this indicator in November reached to 10.5 per cent⁹, from 1.3 per cent it was at end of first six-month period. Upon the stabilization of the time structure of money supply, the annual growth rate of M1 aggregate has been approached to its historical mean, in line with the growth rate of overall money supply.

Table 16. Performance of monetary indicators in November (in billion leks).

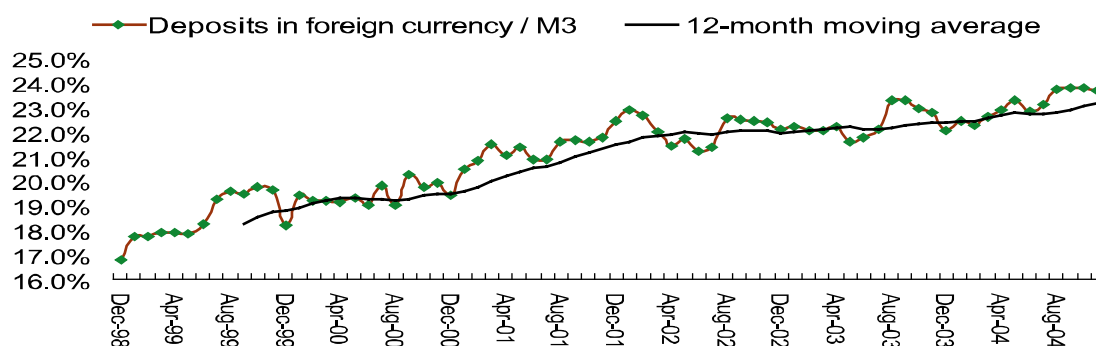
	November	5-month change		Annual change	
	2004	Absolute	Percentage	Absolute	Percentage
Currency outside banks	128.9	10.6	9.1	8.2	6.8
Total deposits	366.3	26.4	7.8	39.0	11.9
- in lek	249.1	13.6	5.8	23.7	10.5
- in foreign currency	117.2	12.8	12.4	15.3	15.0
Demand deposits	73.1	8.1	12.6	11.2	18.2
- in lek	28.3	6.0	25.3	6.7	30.8
- in foreign currency	44.7	2.1	5.1	4.6	11.4
Time deposits	293.2	18.3	6.7	27.8	10.5
- in lek	220.7	7.6	3.6	17.1	8.4

⁹ The alteration of the Raiffeisen Bank's regulation has brought about a shifting of deposits in lek from time deposits to demand ones, by about Lek 2.5 billion. In absence of this effect, the annual M1 growth rate in November would result to 8.7 per cent.

- in foreign currency	72.5	10.7	17.1	10.7	17.3
M1	157.2	16.6	11.8	14.9	10.5
M2	377.9	24.2	6.9	31.9	9.2
M3	495.1	37.0	8.1	47.2	10.5
Base money	169.6	9.5	6.1	13.3	8.5

The significant foreign currency inflows in summer season, in the presence of a stable exchange rate during the period of July-November¹⁰ have brought about higher annual growth of deposits in foreign currency. In November, the annual growth of deposits in foreign currency was 15 per cent against 12.6 per cent in June. On the other hand, the appreciation of the lek exchange rate continues to reduce the growth of deposits in foreign currency, expressed in terms of lek. In absence of this effect, the annual growth rate of deposits in foreign currency during 5 last months would be presented as stable, on an average level of 26 per cent. The high growth rate of deposits in foreign currency is associated with further growth of their weight in money supply. However, the acceleration of the annual growth of M2 aggregate during this period has made possible that the upward trend of the ratio of deposits in foreign currency to M3 be smoothed over.

Chart 17. Performance of deposits in foreign currency to M3 ratio



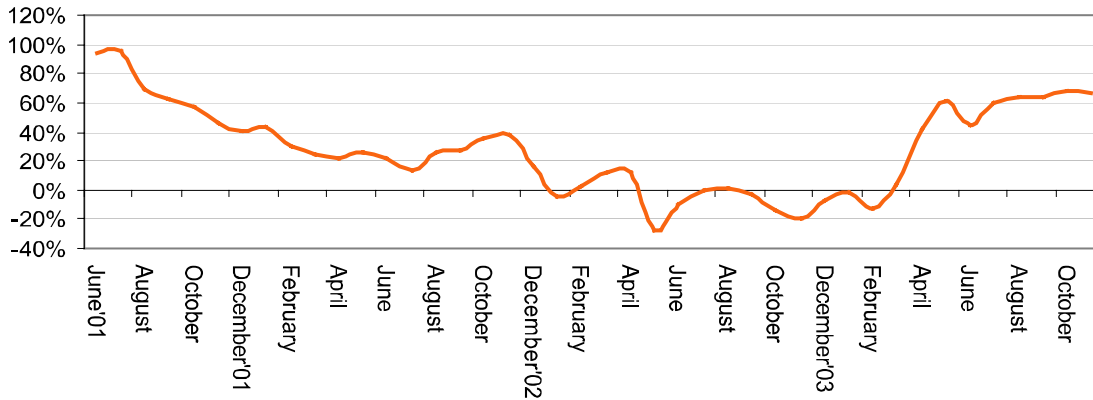
IV.3 DOMESTIC DEMAND

IV.3.1 Net foreign assets

Net foreign assets of the banking system during the second half of the year rendered a significant contribution to money supply growth. Their contribution to annual growth of M3 has been constantly rising during the second half of the year and in November it reached to 66.8 per cent. The Bank of Albania purchases in foreign exchange market, growth of foreign currency deposits with commercial banks, converting of Raiffeisen Bank's capital into foreign currency and the euro appreciation against the dollar have been primary factors impacting on foreign assets growth.

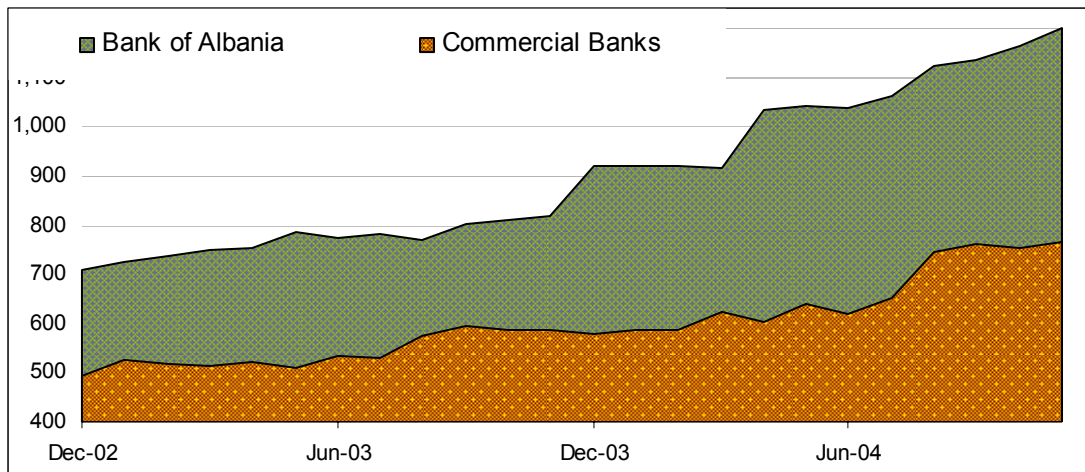
¹⁰ In November, the lek exchange rate against foreign currencies, Euro and usd, combined with the relevant weight of deposits in euro and usd to total, resulted at the same level with that of June.

Chart 18. Contribution of net foreign assets growth to M3 growth.



The net foreign assets of the banking system were increased by 304.9 million dollars¹¹ during the period of June-November. This growth was influenced by the growth of net foreign assets of the Bank of Albania and of commercial banks. So, the net foreign reserves of the Bank of Albania increased by 158.9 million dollars, whereas the net foreign assets of commercial banks increased by 146 million dollars. Excluding the exchange rate effect, the growth of foreign reserve of the Bank of Albania is 108.2 million dollars, whereas the net foreign assets growth of commercial banks is 121.4 million dollars.

Chart 19. Performance of banking system net foreign assets (in million dollars)



IV.3.2 Government demand for monetary assets

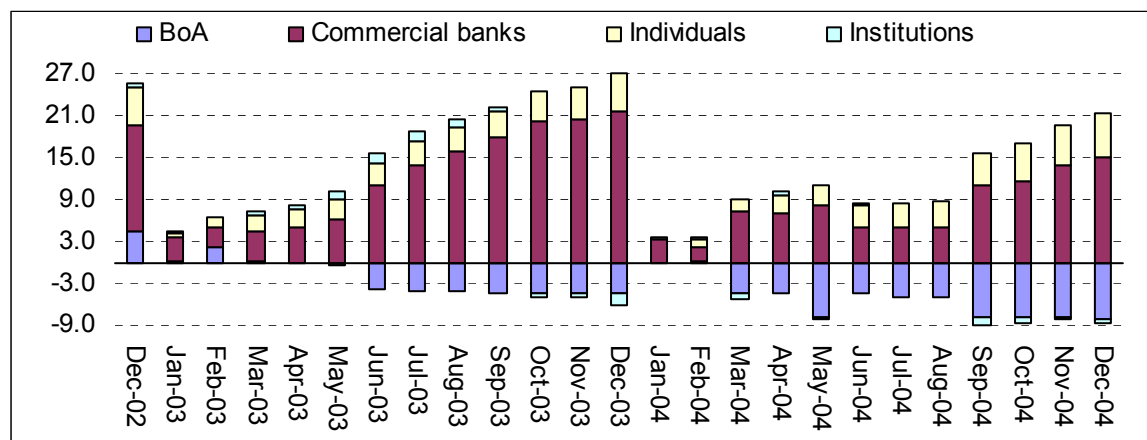
Government demand for monetary assets has been growing during the second half of the year. In November, the fiscal accounts mark a budget deficit of Lek 19.2 billion. The total financing of budget deficit in November reached to Lek 21.8 billion¹², from Lek 9.4 billion in June. Out of this financing, Lek 21.6 billion was in the form of domestic financing, mainly from the banking system. The issuing of treasury bills and two-year bonds were the main forms of financing. During July-November, the commercial banks increased the treasury bills portfolio by about Lek 3.9 billion.

¹¹ Estimated at fixed rate of December '03, the growth of these assets is 229.6 million dollars.

¹²The difference between budget deficit and domestic budget deficit financing represents statement of Government account with the Bank of Albania.

The households increased their portfolio by Lek 2.4 billion, whereas the institutions decreased it by Lek 0.5 billion. The Bank of Albania did not have any change in its treasury bills portfolio.

Chart 20. Cumulative performance of budget deficit financing (in billion lek)



The issuing of government bonds since June has ensured a financing of Lek 5 billion. Meantime, the deficit financing was covered even by revenues from privatization of the Savings Bank (presently Raiffeisen Bank), which for June – November were used at Lek 4.9 billion¹³.

IV.3.3 Credit to economy

Banking system is featured by high rates of lending to economy during 2004. Credit balance increased by Lek 9.2 billion during June – November 2004, being 51 per cent higher than the growth of balance in the first half of the year. Credit to economy is occupying an ever growing weight in the structure of banking system assets, constituting an important source of demand for monetary assets. The credit/deposit ratio is constantly growing, an indicator that positively presents the function of the intermediating role of the banking system on economy development sustainability.

Table 17. Performance of some main indicators¹⁴

	2002	2003	2004			
			Q-1	Q-2	Q-3	November
Money supply (in billion lek)	416.7	448.4	456.0	458.2	487.6	495.2
Domestic credit (in % to M3)	70.8	71.5	71.6	69.5	67.4	68.0
- Credit to government (in % to M3)	61.5	60.2	59.9	57.1	54.8	54.7
- Credit to economy (in % to M3)	9.3	11.3	11.7	12.4	12.6	13.3
Credit to economy (in % to total assets)	11.5	13.7	13.7	14.6	14.7	15.8
Credit to economy (in % to GDP)	5.7	6.8	7.0	7.4	7.3	8.1
Total deposits (in % to GDP)	42.2	43.4	44.1	44.1	44.4	44.8
Credit/deposit ratio (in %)	13.5	15.7	15.8	16.7	16.9	18

¹³ Out of the "Converting of SB's for external debt", an extra amount of Lek 1.5 billion has been used as domestic financing.

¹⁴ This ratio is established to annual GDP for 2004.

Growth of credit balance during 11 first months marked the value of lek 15.3 billion, constituting a growth of 30 per cent in comparison to year end 2003. Meantime, the foreign currency credit balance is under the exchange rate effect of the lek with two foreign currencies, USD and euro. The lek appreciation versus the usd and euro, at most part of 2004 has negatively impacted on credit balance growth. Speaking by figures, the exchange rate effect of currencies, Usd and euro on the reduction of credit balance for the whole 2004 is estimated at about Lek 3.6 billion. Excluding this effect, the balance of credit to economy would have been increased by about Lek 19 billion.

The credit balance structure by currencies is featured by high level of credit in foreign currency. At end of November 2004, the structure of lek-foreign currency credit balance resulted 18 by 82 per cent. Balance of credit in foreign currency, in euro and usd, constitutes respectively 69 per cent and 31 per cent of total of credit as of end of November. Compared with end of first half of the year (48 and 52), this structure has undergone an underlined shifting in favor of the euro.

Table 18. Performance of credit balance indicators, in percentage.

	2002	2003	Q-1 '04	Q-2' 04	Q-3'04	November'04
Credit balance (in billion lek)	38.7	50.7	53.4	56.8	60.9	66.0
Short-term credit	53.8	46.0	41.6	35.4	34.0	33.3
Mid-term credit	30.1	33.3	35.4	37.8	37.0	36.9
Long-term credit	16.1	20.7	23.0	26.8	29.0	29.8
Lek	21.3	19.6	17.0	17.0	17.0	18
Foreign currency	73.7	80.4	83.0	83.0	83.0	82

The new credit extended during July-November reached to Lek 32.5 billion. The gradual shifting of new credit towards longer maturity terms has been a positive development of lending during 2004. So, 40 per cent of the new credit extended in the second half of 2004 is mid-term and long-term credit against the value of 29 per cent marked by this indicator in the same period of the previous year. Also, one of the most striking features of bank lending market during 2004 is the growth of new credits in lek. New credit extended in lek is about Lek 30 billion or 33 per cent of total new credit. The new credits extended in lek constitute 37 per cent of the total new credit during July-November. In spite of an orientation and interest of banks to lend in lek, their effect on lek credit portfolio growth is slight. This is so because most credits in lek are extended in short-terms.

Table 19. Performance of new credit in years (in billion lek).

	2002	2003	Q-1 '04	Q-2'04	Q-3 '04	January- November'04
New credit (in billion lek)	62.6	92.6	27.9	28.5	18.0	88.8
Short-term credit	44.7	63.1	18.7	18.1	10.9	56.2
Mid-term credit	13.0	22.2	5.7	6.8	3.9	19.9

Long-term credit	4.8	7.4	3.5	3.6	3.1	12.7
Lek	20.8	30.8	8.80	8.9	6.0	29.6
Foreign currency	41.8	61.8	19.10	19.6	12.0	59.2

The banking credit during the second half of the year is assessed to have undergone changes even in terms of economy sectors. Upward tendencies are noticed in increasing lending to agricultural sector and processing industry. During 2004, it is estimated that trade sector has undergone a decline in terms of banking system financing. During three last years this sector has been the most credited economy sector.

Table 20. Balance of credit by economy branches (in percentage)

		2002	2003	Q-1 '04	Q-2'04	Q-3'04	November'04
1	Agriculture, hunting and silviculture	0.8	1	1.0	1.2	1.6	1.6
2	Fishing	0.2	0	0.1	0.1	0.1	0.1
3	Extracting industry	0.2	1	0.2	0.2	0.3	0.2
4	Processing industry	17.0	17	16.9	18.4	18.2	18.6
5	Production, electrical power distribution, gas, water	3.3	3	3.0	3.3	3.2	3.2
6	Construction	8.6	10	9.7	10.7	10.2	10.7
7	Trade, vehicles and house articles repairing	40.4	34	31.4	23.5	21.9	22.2
8	Hotels and restaurants	6.0	6	7.1	8.3	8.3	7.7
9	Transport and telecommunication	2.4	1	2.0	1.5	1.6	1.4
10	Financial activities	-	0	0.1	0.7	0.7	0.4
11	Real estate	9.1	13	13.7	14.8	15.6	9.1
12	Health and social activities	0.5	0	0.5	0.5	0.5	0.5
13	Collective, social and personal services	4.2	8	4.2	4.5	5.3	5.2
14	Other	7.3	4	10.1	12.2	12.7	19.0
	Total	100	100	100.0	100.0	100.0	100.0

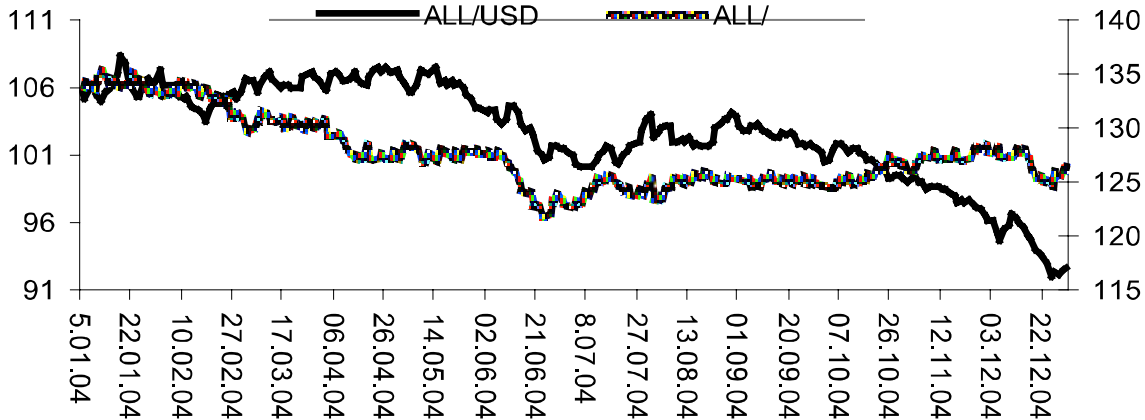
IV.4 EXCHANGE RATE

Even though some of the factors impacting on lek appreciation during early summer period (June) have been always weakening, the lek has been in strong positions against the euro and dollar even during the second half of the year. For June-December the lek was depreciated by 2.7 per cent against the euro, whereas it is appreciated by 8.7 per cent against the dollar. However, during this period the effects of some specific factors were weakened, such as increase of domestic production or increase of foreign currency supply from tourism and remittances, long term domestic factors maintained and reinforced the lek positions. Such factors constantly evidenced in the Bank of Albania surveys are:

- Constant consolidation of economic stability of the country. This stability has enhanced confidence in Albanian financial system and in lek monetary assets.
- Lek real interest rates higher than foreign currency interest rates. This difference has encouraged a high demand for lek. Even though lek interest rates have been declining, the low inflation rates have maintained high real interest rates in lek.

- Consolidation of public finances and budget deficit has dictated a low demand of government for monetary assets. Also, the credit in lek remains in low levels, limiting to a certain extent the generation of monetary assets in lek.

Chart 21. Exchange rate performance during 2004 (left scale lek/usd).



On the other hand, even the performance of the ratio of foreign currencies in international market has impacted on lek exchange rate, especially the exchange of the lek against the American dollar. So, the lek has been constantly appreciating against the dollar, whereas the exchange rate of the lek against the euro changed direction by mid of June. Since the beginning of the year, the lek appreciation against the euro and dollar is respectively 5.5 per cent and 12.3 per cent. The lek exchange levels at end of 2004 are 126.35 lek/euro and 92.64 lek/usd.

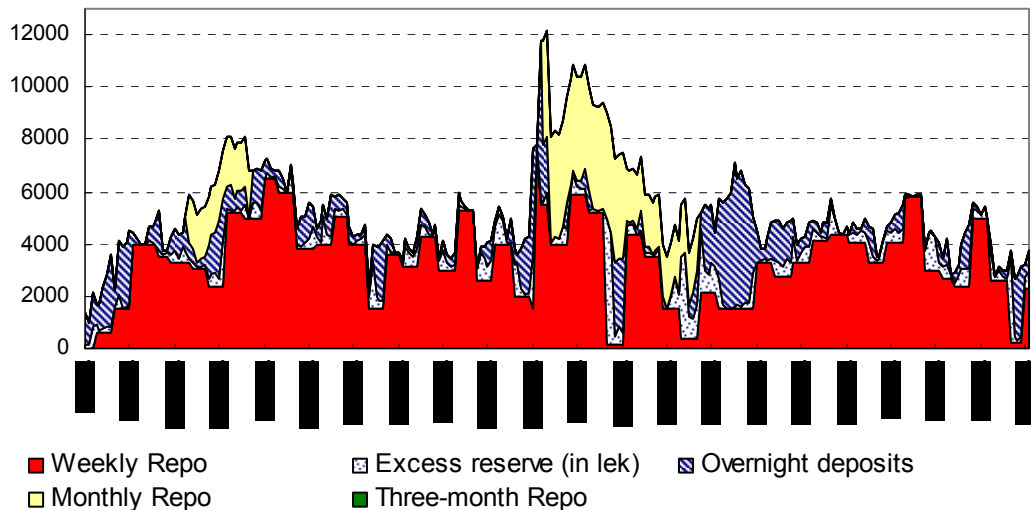
IV.5 CURRENCY MARKET AND INTEREST RATES

IV.5.1 Liquidity performance

Banking system has resulted with excess liquidity during the second half of the year. The average daily liquidity has been stable at lek 5.2 billion, close to Lek 5.1 billion it was in the first half of the year.

The main instrument used for withdrawing liquidity was that of one-week and one-month repo. The average volume of one-week repo has slightly declined over the second half of the year, whereas the average volume of one-month repo has increased. One-month repos have been used in July and August as a long-term form of withdrawing excess banking system liquidity. The repo auctions have taken place mainly according to the fixed-price type, but by mid of August to mid of September one-week variable price repos have also been employed. This auction type is used to facilitate the implementation of monetary policy decisions in terms of interest rate cut.

Chart 22. Banking system liquidity (in million leks)¹⁵.



Overnight credit facility has had a more significant use in comparison with first half of the year. Its average daily level reached to lek 265 million, from lek 36 million it was in the first half of the year. The increased use of this facility is also due to functioning of AIPS payment system by March of this year. The use of overnight deposits facility has fluctuated at the same levels with those of the first half of the year.

Interbank market has increased the level of transactions. Hence, the average level of overnight transactions reached to lek 0.48 billion, from lek 0.33 billion it was in the first half of the year. Also, one-month interbank transactions with an average level of lek 57 million have taken place.

The total supplied by the banking system and households for investment in Treasury bill auctions continued to be higher than the one requested from the Government, particularly for treasury bills of 6- and 12-month maturity. The increased competition for these investment alternatives impacted on the increased pressures for reducing interest rates in the primary market.

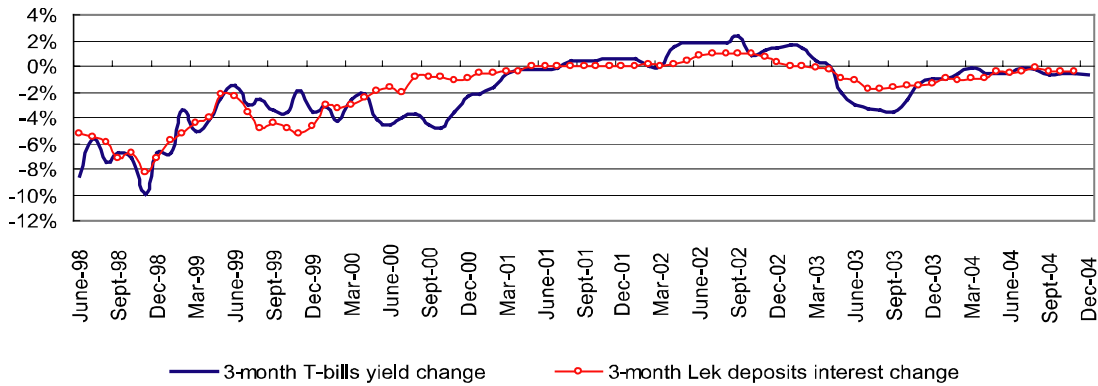
IV.5.2 Interest rate performance

Reaching lowest historical levels of treasury bills yield and interbank market interests was a feature of the second half of 2004. Meantime, the lek time deposits interests reached lowest levels in the 12 latest years¹⁶. The declining tendency of interests was due to easing monetary policy of the Bank of Albania. Lek deposits interest rate cut and foreign currency deposits interest rate rise have led to narrowing the spread between them. So, concerning time deposits, the Lek-usd interest spread declined from 4.7 percentage points it was at end of first half of the year to 3.8 percentage points at end of November. At the same time, the lek-euro interest spread dropped from 3.8 percentage points to 3.5 percentage points.

¹⁵ It includes: repo, overnight deposit and current account in lek minus overnight credit.

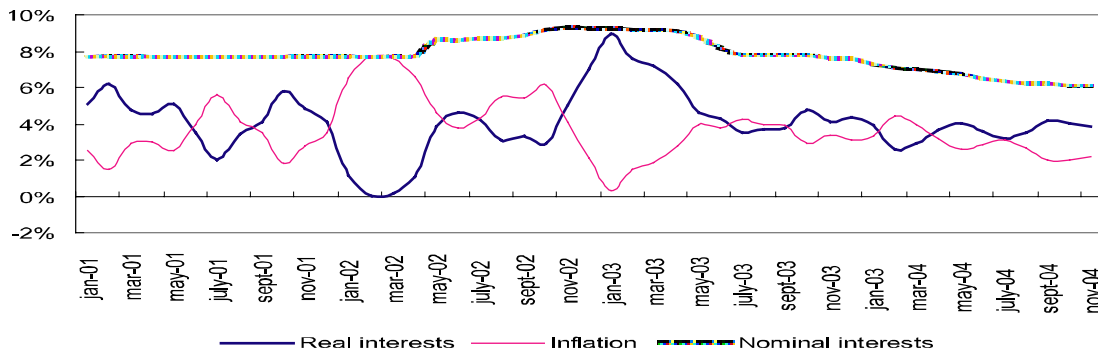
¹⁶ Since July 1992.

Chart 23. Six –month weighted average interest spread of three-month lek deposits and three-month treasury bills yield



In spite of nominal interest cuts, the low level of inflation impacted on maintaining real interest rate. Real interests of 12-month lek deposits fluctuated around an average level of 3.75 per cent from 3.44 per cent it was in the first six-month period.

Chart 24. Real and nominal interests of 12-month deposits in lek



Easing policy of the Bank of Albania is more reflected in interest rate cuts of 6- and 12-month deposits. Also, the average weighted yield of 3-, 6- and 12-month treasury bills dropped obviously during 2004, easing the cost of government debt. It should be stressed that time differences of conveying the reactions to Bank of Albania signals are various for the three maturity terms. This fact and the expectations on inflation may be translated into further interest changes by commercial banks for one or some of maturities.

Table 21. Banking system reaction to monetary policy during 2004 (in percentage points)

Period	6-m ¹⁷	6-m I	2004 (change)	2004 (level)
Base interest rate	1.00	-0.75	-1.75	5.25
Deposits in lek				
3-month	-0.77	-0.4	-1.17	4.5
6-month	-1.01	-0.61	-1.62	5.5

¹⁷ It includes even the end of 2003, since the effect of the decision made in this period is observed at start of 2004.

12-month	-1.13	-0.60	-1.73	5.9
Treasury bills yield				
3-month	-0.46	-0.79	-1.25	6.1
6-month	-0.59	-0.96	-1.55	7.2
12-month	-0.49	-0.90	-1.39	8.1

In general, during the second half of 2004¹⁸ downward changes are noticed in loan interest rates. The lek loan interest rates¹⁹ have reacted in line with monetary policy signals. This was associated even with rise in loans in lek at lek 2.5 billion in the second half of 2004.

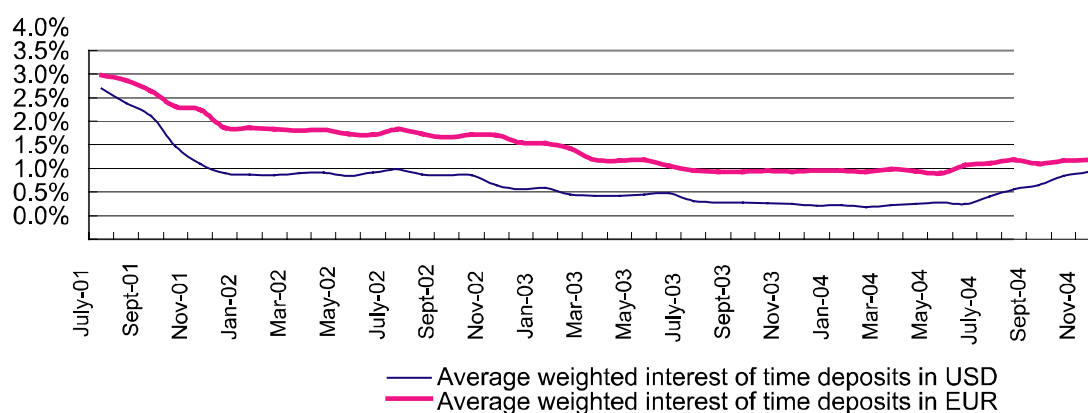
Table 22. Lek loan interest rates (in percentage)

	June -04	November -04	Change
	a	b	C = b-a
Credit of up to 6 months	11.94	11.98	0.04
Credit of 6 months – 1 year	17.33	15.05	-2.28
Credit of 1-3 years	19.37	19.02	-0.35
Credit over 3 years	15.23	12.72	-2.51

Meantime, interests of foreign currency credits have reflected downward tendencies due to increased competition in this market. Excluded are interest rates of six-month loans, which were slightly increased mainly as a result of approximations made to these rates. In November, the average weighted interests of loans in Usd reached to 8.45 per cent and of loans in euro to 8.49 per cent.

Second half of 2004 is featured by rise of interests of foreign currency deposit, particularly of those in dollars, respectively by 0.7 percentage points for time deposits in Usd and 0.12 percentage point for time deposits in euro.

Chart 25. Average weighted interests of deposits in foreign currency



¹⁸ Latest data are as of November 2004.

¹⁹ Excluding 6-month maturity loans.

At end of November, the average weighted interests of time deposits in Usd and euro reached respectively to 1.42 per cent and 1.68 per cent. The interest rates in Usd are raised for all maturities, influenced by rapid rise of libor interests, due to tightening policy of Fed. Also, there has been slight rise in all terms of euro deposit interests, impacted by fluctuations of euribor interests and competition in the market.

V. ALBANIAN ECONOMY IN 2005

Constant consolidation of macroeconomic stability during recent years constitutes a good basis for the development of Albanian economy over 2005. The budget deficit has had a downward tendency, while the domestic deficit financing has been maintained within the programmed values. On the other hand, the situation and monetary conditions have also been under control, contributing significantly to maintaining of inflation within the programmed levels. This situation, combined with positive developments in domestic agricultural and energy production during 2004 has resulted to inflation levels within the Bank of Albania target and has stabilized the inflationary pressures. Capitalizing on these developments, the Bank of Albania went on pursuing an easing monetary policy, bringing the economy borrowing cost to minimum historical levels.

Table 23. Main macroeconomic indicators

	2002	2003	2004	2005
Monetary indicators (in percentage)				
GDP growth	4.7	6.0	6.0	6.0
Annual CPI (average)	5.2	2.4	2.9	3.0
Nominal GDP (billion lek)	677.7	746.6	841.8	919.7
Fiscal indicators (in percentage to GDP)				
Fiscal deficit	-6.9	-4.7	-4.9	4.0
Domestic borrowing	3.2	2.7	1.9	3.1
Monetary indicators(in percentage)				
M3 growth	7.0	9.5	12.4	9.4
Growth of credit to economy	32.1	28.5	31.3	39.6
3-month T-bills interests	11.2	7.3	6.1	...

FISCAL SECTOR

General fiscal indicators presented in the budget of 2005 speak for a moderate fiscal policy stance, stressing its positive contribution to maintaining of macroeconomic stability in the country. During 2005 the budget spending in ratio to GDP is projected to mark a decline by about 0.7 percentage point, reaching to 26.3 per cent. This will be reflected in the reduction of capital expenditures from 5.1 per cent to 4.7 per cent of GDP. From a realistic viewpoint, budget revenues are projected almost unchanged, to 22.3 per cent of GDP.

In line with the policy of fiscal consolidation expressed in the Mid-term Draft-Budget for the three-year period, the budget deficit in 2005 is projected to be reduced to 4.0 per cent of GDP, from 4.9 per cent that is the expected realization for 2004. The main part of this deficit will be faced by domestic financing, which is planned to reach to Lek 28.3 billion or about 3.1 per cent of GDP, from 3.8 per cent it was in 2004. The decline of privatization revenues in 0.5 per cent of GDP, will make the domestic financing in 2005 be sustained mainly in domestic borrowing, which is projected to be lek 23.3 billion or 2.5 per cent of GDP. Financing of domestic borrowing of Government from banking system is projected to lek 17 billion or 1.8 per cent of GDP, whereas the rest is expected to be faced by households and other private subject.

MONETARY SECTOR

The primary target of monetary policy for 2005, included in the monetary program is the maintaining of annual inflation rate within the band of 2 – 4 per cent. This target will be intended to be reached through control of money supply growth at levels close to nominal GDP growth, under the assumption of stable performance of the velocity of money circulation in economy. On this basis, the annual growth rate of money supply for 2005 projected in the monetary program is 9.4 per cent. This rate is consistent with the meeting of economy demand for money that derives from its real growth by 6 per cent, serving as an intermediate instrument of monetary policy for achieving inflation target.

The monetary program provides a shifting of the structure of using financial resources by government in terms of the private sector of economy. Government demand for money is projected as low, about 1.8 per cent of GDP, while the growth rate of economy demand is expected to be accelerated significantly, with the growth of credit balance by 2.3 per cent of GDP. The reduction of the spread between interest rates of loans in lek and in foreign currency as a result of easing monetary policy pursued by the Bank of Albania is expected to be associated with a larger contribution of credit in lek to overall credit balance rise. The rise of overall credit balance by lek 27.2 billion will be due to the growth by lek 6.5 billion of credit balance in lek and lek 20.7 billion of credit balance in foreign currency.

The monetary program has projected shifting of time structure of money supply towards less liquid assets. This development will be reflected in further reduction of the ratio of currency outside banks to M3 aggregate, reflecting positive developments in the banking system and a set of measures planned in the framework of the program of cash reduction in economy during 2005. The ratio of currency outside banks to M3 is expected to mark a reduction by 0.7 percentage point, reaching at the level of 26.5 per cent at end of 2005. In consequence, a low growth rate is expected for indicators of currency outside banks and M1 aggregate, while the contribution of deposits in lek to money supply growth is expected to mark an obvious increase. The annual rate of growth of deposits in lek at end of 2005 is projected to reach to 10.7 per cent, representing the component with the highest growth rate in money supply. Upon stability of foreign currency inflows from emigrant's remittances, the ratio of deposits in foreign currency to M3 aggregate is expected to follow a stable performance, remaining unchanged at 22.2 per cent. Based on this assumption, the annual growth rate of deposits in foreign currency for 2005 is forecasted to be 9.9 per cent, remaining in line with annual growth rate of money supply.

Satisfactory growth of deposits in lek will enable the commercial banks to finance the whole government and economy demand, maintaining at the same time an excess liquidity position. The monetary program for 2005 does not foresee any participation of the Bank of Albania in primary market or direct crediting by it. However, depending on the performance of liquidity in the banking system, the Bank of Albania may deem necessary the undertaking of these operations at certain moments.