

MONETARY january
POLICY REPORT 2005

on second semester of 2005

B a n k o f A l b a n i a

MONETARY POLICY REPORT ON SECOND SEMESTER OF 2005 JANUARY 2006

I. GOVERNOR'S SPEECH

The second semester of 2005 generally marked a favourable period for the country's economic development. The Albanian economy continued to be extended, as testified by the annual growth in the volume of sales, increased number of employees, rapid growth of the volume of lending to the economy, and growth of fiscal revenues. Moreover, the economic growth developed under the conditions of maintaining inflation control and budget deficit within the programmed values, without infringing the main macroeconomic ratios and balances. Also, the foreign position of the country was further improved and the exchange rate was steady.

The economic growth over 2005 was favoured by improvement of the economic climate on the global level. The world economy continued to grow at relatively high rates during the second semester of the year. According to recent forecasts of the International Monetary Fund, the world economy growth for 2005 was expected to be at about 4.3 per cent, influenced particularly by the economic growth in the USA, Asia, and Japan. Also, the financial conditions on world level were positive for financing the economic activity, regardless of the interest rate rise from two most important central banks, the FED and the ECB.

In retrospect, the second semester of the year may be regarded as a proof period for the sustainability of the economic growth and macroeconomic balances. The second semester was opened with a long post-electoral period, which effected a higher concentration of the budget deficit on this period and increased the market ambiguity. Partly due to the operation of the above factor, the banking system was faced with a lack of liquidity, bringing about upward trends of treasury bills yield in the presence of a high volatility. Furthermore, the economic activity encountered the impact of electricity shortages, which directly influenced production and brought about financial difficulties in the form of high costs to businesses. On the other hand, the oil price rise in the international market reinforced inflationary impulses, strengthening the negative effect caused by the grave electrical energy situation.

The long post-electoral situation and the decreased fiscal incentive of the second quarter have impacted on the slow down of the economic growth rate during the third quarter, while the grave electrical energy situation, which went to a climax during the fourth quarter, has further restrained the economic activity of this period. Under these conditions, the Bank of Albania estimates that even during 2005 the economy has grown in real terms, however, this growth is a little smaller than the 6 per cent forecasted level. Confirming the tendencies observed over the recent years, the economic growth has

been supported by the private sector dynamism, particularly in the sectors of construction and services. The actual developments of the semester and the current economic situation indicate that the impact of the external factors on the main macroeconomic indicators has resulted limited and transitory. This constitutes an encouraging factor for consolidating the economic growth factors and macroeconomic balances.

Fiscal developments have generally performed within the forecasted lines of 2005, continuing the fiscal consolidation tendencies. The budget spending and budget deficit have been within the parameters of the budget program, thus contributing to maintaining the macroeconomic stability and inflationary pressures control. According to the data from the Ministry of Finances, until November, about 97.8 per cent of the planned revenues were collected and about 93 per cent of the programmed expenditures were realized. The domestic budget deficit financing reached the lowest level of seven recent years in ratio to gross domestic product, easing the burden it presents to financial resources of the economy. However, taking into account even the experience of the current year, the Bank of Albania deems that more regularity is needed to timely disseminate and implement the fiscal program. Also, the needs for the country's development require more attention in observing the plan of capital expenditures, which, similar to the previous years, continue to record low level of realization. The economic growth has created premises for improving the labour market, which even during 2005 followed the positive performance of the preceding years. The unemployment rate marked 14.2 per cent over the third quarter, reaching the lowest level in the recent years.

The foreign sector of the economy is characterized by an intensive activity, reflected in the growth of current and capital transactions. The overall volume of exports and imports during July – September 2005 was about Euro 650 million or about 12 per cent higher than the same period of the previous year. Though the trade deficit recorded an annual growth of 16 per cent in the third quarter, amounting to US\$ 382 million, the capital inflows have covered all of it, enabling foreign reserve growth as well. The balance of payments was closed with a surplus of Euro 33.7 million during the third quarter of 2005, making the foreign reserve level cover 4.6 import months of goods and services.

The annual growth rate of consumer prices fluctuated around the lower half of the Bank of Albania target during the second semester, descending to the lower limit of the Bank of Albania target in December. Though the economy has been under the impact of some supply shocks, such as high oil prices and energy crisis, the monetary and fiscal policies have enabled the creation of a favourable macroeconomic environment for maintaining price stability. No emerging of secondary effects or growth of inflationary pressures is observed in the economy. The good harmonization of macroeconomic policies and the lek's strong position have depreciated the inflationary pressures.

In the presence of normal inflationary developments, the Bank of Albania has pursued a neutral monetary policy, leaving the key interest rate unchanged,

at the level of 5 per cent. Under these conditions, the monetary policy and its operational framework are focused on smoothing the fluctuations of the monetary indicators and treasury bills interest rates. The banking system underwent liquidity shortages during July-October, due to the unexpected cut of the lek deposits interest rate by some banks and the growth of the economy's and government's demand for monetary assets during the third quarter. This liquidity shortage was further transmitted to rapid treasury bills yield rise. These developments required a prudential monetary stance management, balancing the demand for liquidity injection with the need for controlling inflationary pressures to the economy. The average volume injected through the reverse repo instrument during July-September was Lek 1.7 billion. Also, the Bank of Albania has extended credit to the government at certain periods of time, thus smoothing excess pressures on the treasury bills yield rise. This policy resulted successful. At end of the semester, the treasury bills yield has returned to levels close to those of June, while the banking system has excess liquidity. The Bank of Albania has purchased foreign currency almost during the whole second semester, smoothing the appreciating pressures on the exchange rate and injecting liquidity into the market. These interventions have injected about Lek 12.4 billion liquidity, assisting the banking system in surpassing the situation and easing the non-inflationary expansion of money supply.

Year 2005 was associated with a rapid money supply growth. Money supply growth rate was estimated to 14.3 per cent in November. Lending to the economy was the main source of using funds and of monetary expansion, preventing for the first time the budget deficit financing from this role. At end of November, lending to the economy reached to Lek 114.6 billion, equal to 13.7 per cent of the GDP. Only during July-November the lending increased by 2.5 percentage points to GDP, while the annual growth rates of credit fluctuated around 70 per cent. The credit increased to all sectors of the economy, reflecting a closer relation of businesses and consumers with banks. The Bank of Albania estimates that the current monetary conditions and their trend are consistent with the maintaining of price stability in the mid-term period.

The year that went by indicated that the economy of our country has created a kind of invulnerability, which provides good premises for more qualified developments in the future. However, its further consolidation is an ongoing process, where, among others, the carrying out at rapid paces of numerous reforms required in the three-year mid-term program of the country's development remains a priority.

The Bank of Albania, estimating its role as one of the key institutions in successfully meeting its ambitious objectives of the mid-term program, has already drafted the monetary program for 2006. Based on basic assumptions of this program for an economic growth of 5 per cent under the conditions of an average inflation of 3 per cent, the Bank of Albania foresees that the supply growth will be at 11.8 per cent. This growth will be sufficient for meeting the needs of the economy for monetary assets and particularly for enabling credit extension at the limit of Lek 53 billion or about 45 per cent of the total.

Continuing the positive economic logic of 2005, the budget deficit financing by the banking system is forecasted to consume about Lek 12.8 billion or ¼ of funds forecasted for crediting. The Bank of Albania estimates that the increasing support of the Albanian business by domestic funds constitutes a positive premise for maintaining high economic growth rates even in the future.

II. WORLD ECONOMY

The world economy went on being increased at relatively rapid paces even during the second semester of the year. The main impulse in the world economic activity derived from the economic growth of the USA, Asia and Japan. According to recent forecasts¹ of the International Monetary Fund, the world economy growth for 2005 is expected to be at 4.3 per cent. The situation in the world financial markets is presented as positive for financing the economic activity, due to high prices of financial assets, low borrowing cost and positive corporate profits. On the other hand, a risk exists to the economic growth, present not only in high oil prices but also in fiscal imbalances in most developed countries, in balance of payments deficit growth in a number of countries as well as in the differences that exist in the economic development among the regions.

Table 1 Some main economic indicators (annual change in percentage)

	GDP-Q3	Unemployment rate	CPI
USA	+4.1	4.9 (November)	+3.5 (November)
Euro zone	+1.6	8.3 (October)	+2.3 (November)
Germany	+1.4	11.5 (November)	+2.3 (November)
France	+1.8	9.7 (October)	+1.6 (November)
Italy	+0.1	7.7 (June)	+2.2 (November)
Britain	+1.7	4.9 (October)	+2.1 (November)
Japan	+2.9	4.5 (October)	-0.7 (October)

Source: American Labour Department, American Department of Trade, "The Economist" magazine, December 24, 2005 – January 6, 2006.

Euro zone economy

Gross domestic product in the Euro zone marked a faster growth over the third quarter. According to preliminary data, the economic growth during this quarter was 0.6 per cent, against a growth of 0.3 per cent and 0.4 per cent in the first and second quarter of this year. The economic growth was mainly due to rise in investments, exports, individual expenditures for consumption and imports. The information on business confidence indicates an expected stability of the economic growth for the rest of the year. The continuous growth in the global demand is expected to assist the exports of the Euro zone, whereas investments are expected to benefit from favourable financial conditions and significant rise of corporate profits. On the other hand, the forecasting on economic activity remains subject to risks that relate mainly to high oil price, concerns on lack of global balances and weak confidence of consumers. The annual inflation rate for November in the Euro zone was 2.3

per cent, from 2.6 and 2.5 per cent in the two previous months. Inflation rate is expected to be higher than the targeted rate of less than 2 per cent even for a short-term period. The identification of some increasing pressures on price stability enabled the European Central Bank raise the key interest rate by 0.25 percentage point in December. This change is expected to be sufficient for maintaining mid-term and long-term expectations of inflation in line with price stability target.

American economy

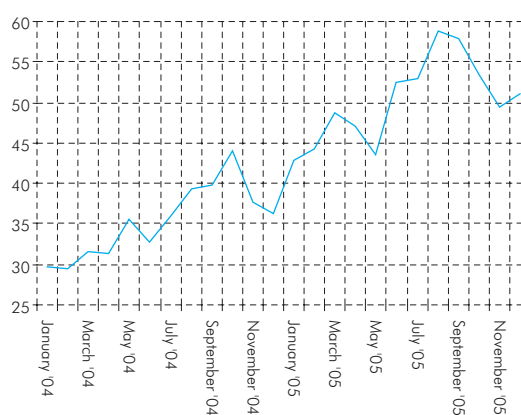
The economic activity of the United States of America marked a rapid growth during the third quarter of this year. According to the latest data, the annual GDP growth for the third quarter marked 4.1 per cent, from 3.3 per cent it was in the second quarter. Consumer expenses, fixed investments of residents and non-residents and government expenses are the main contributors to American economy growth. Economic development forecasts on the short run remain good. Inflationary pressures caused partly by negative effects of hurricanes are expected to smooth over, positively impacting on inflation expectations and on the continuation of high growth rates of productivity. Under such conditions, the American Federal Reserve (FED) is expected to moderate the aggressiveness for interest rate rise.

Oil price

The oil price fell during the recent months. However, it reflects a significant rise in annual terms.

Oil price fluctuations during the recent months have been mainly due to the difference between refined capacities and demand. According to the latest data on nine first months of the year and OPEC's forecasts about the last quarter of 2005, the world oil demand is expected to rise by 1.2 million barrels a day, amounting to a daily average of 83.3 million barrels a day. The supply of the countries outside OPEC is expected to reach an average of 54 million barrels a day, whereas the average output for OPEC countries is estimated to have reached an average of 30 million barrels a day in October.

Chart 1. Crude oil prices (in American dollars per barrel)



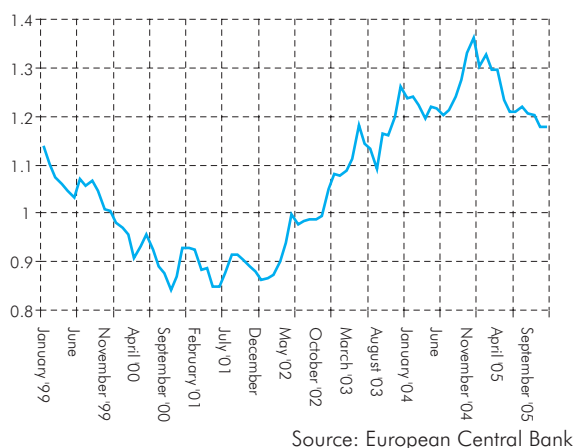
Source: Official energy statistics of the American Government

	2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005
a-Worldwide oil demand	82.09	83.65	82.09	82.42	84.93
b-Supply from countries outside OPEC	53.94	54.55	54.77	54.09	54.61
c- Supply from OPEC countries	29.06	29.48	29.92	30.21	
Balance (b+c-a)	0.91	0.38	2.61	1.87	30.32

Source: Organization of Petroleum Exporting Countries (OPEC)

Table 2 World oil demand and supply (in million bpd)

Chart 2. Usd/Euro exchange rate



Exchange rate

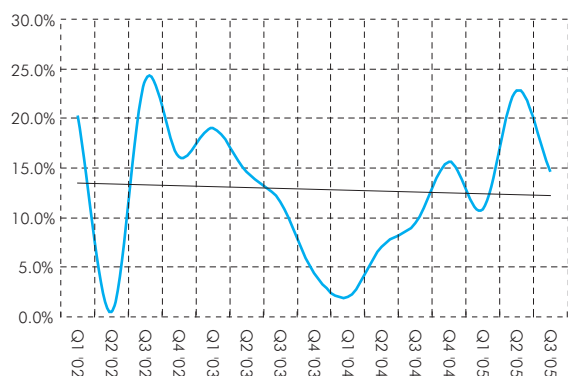
The Euro area currency has reflected depreciating trends against the American dollar during the latest months. The euro exchange rate has depreciated by 2.44 per cent during this period.

The exchange rate of the American dollar is positively impacted by relatively high interest rates in the United States of America. The key interest rate rise by the European Central Bank in December has impacted on stabilizing the exchange rate during this month. At end of December, one euro was exchanged with 1.179 Usd, being appreciated by 0.24 per cent in comparison to the previous month.

III. ALBANIAN ECONOMY OVER THE SECOND SEMESTER

The country's economic activity has continued its good performance during 2005. This positive opinion is based on some indicators, such as an increased volume of sales, a reduction in the unemployment rate, a rapid rise in the volume of lending to the economy and improvement of revenues from taxes. Hence the economy sales during the first nine months have been 16.2 per cent higher than in the same period of 2004. The total sales index has marked an annual growth of 14.7 per cent during the third quarter. However, the grave electrical energy situation of the fourth quarter has negatively impacted on the Albanian business activity.

Chart 3. Annual sales change by quarters (in percentage)



Based on the latest monetary data, lending to the economy underwent a sharp rise during 2005. The outstanding credit was increased by Lek 18.7 billion during July-November, marking a growth of 19.5 per cent of the outstanding credit. For the first time it seems that the ratios of credit to the economy to credit to the government are overturned into the favour of the first one, providing a positive sign that even in the future the banking system will continue to generate financial resources for growing and enlivening the economy.

According to the data from the foreign sector of the economy, the foreign currency remittances from emigrants during 2005 seem to have maintained the same trends with those of the recent years, constituting another important factor in ensuring stable economic growth rates.

Based on this view, the Bank of Albania estimates that the economy will grow even during 2005, but the growth will be somewhat lower than the forecasted 6 per cent level.

The third quarter of the year has marked a rapid growth of services and construction sectors. The sales of the services sector (“Trade, hotels, restaurants”) have had an annual growth of 15.1 per cent during the third quarter of the year, providing the best contribution to economic activity extension during this period. This contribution is estimated to be 7 percentage points, constituting almost half of the annual growth of the economy. The activity extension in this sector has brought about also a rise to 47 per cent of its weight to the economy, from 43 per cent it was in the second quarter of the year. The rise of the weight of the services sector has been associated with a reduction of the weight of the industry sector. Meanwhile, the weight of the other sectors of the economy has not had significant changes during this period.

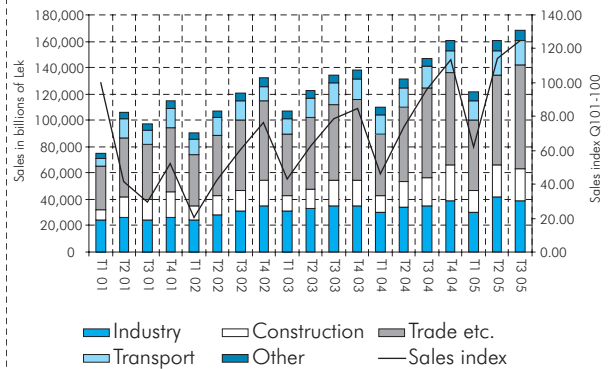
Trade, hotels and restaurants

After a significant growth over the second quarter of 2005, the developments of “Trade, hotels and restaurants” have been positive even during the third quarter. The sales of this sector have marked an annual growth of 15 per cent, whereas in comparison to the previous quarter, the sales are presented at 15.8 per cent higher. Similar to some other sectors, the sales growth rates of this sector decreased during the third quarter.

Agriculture

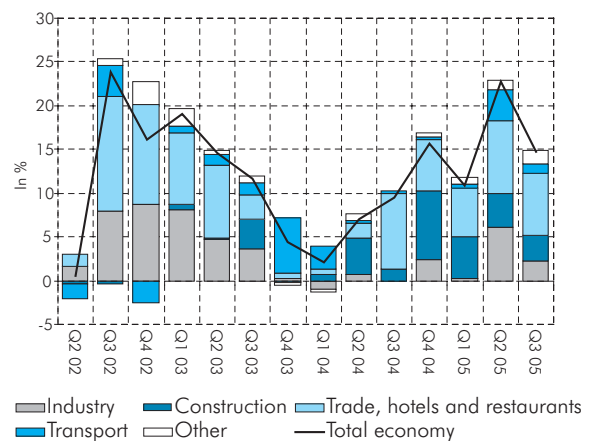
The agriculture output is expected to grow by 3.9 per cent during 2005, sustained by a growth by 2.5 per cent of the agricultural production and a growth by 10 per cent of agro-industry and fishery sectors. These expectations are more pessimistic if compared to 2004 year-start forecasts and its realization. The employment rate in agro-industry sector has increased by 1 percent compared to the previous year.

Chart 4. Economy sales performance during Q1 '01 – Q3 '05



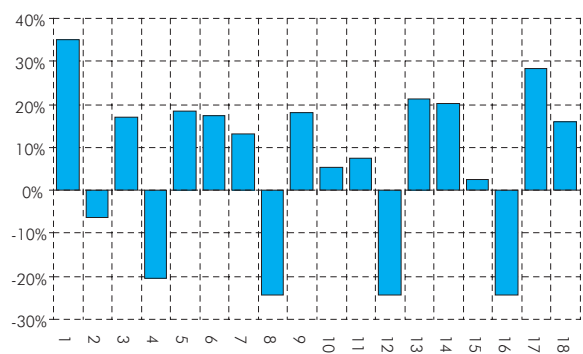
Source: INSTAT, Sales index, Q3 2005

Chart 5. Sectors contribution to the economy sales (in percentage)



Source: INSTAT, Sales index, Q3 2005

Chart 6. Quarterly sales change in “Trade, hotels and restaurants” (in percentage)



Source: INSTAT, Sales index, Q3 2005

Table 3 Agricultural production forecasts by sectors, in percentage

Name	'04 Realization	'05 Forecast
Agriculture	3.2	2.5
Agro-industry	10.2	10
Fishery	7.9	10
Total	4.7	3.9

Source: Ministry of Food and Agriculture

Agricultural production growth rate decreased by 0.7 percentage point during January – September 2005 as compared to the growth of the previous year, manifesting a type of spontaneous development and a considerable dependence on weather conditions. During 2005 numerous legal problems about land did not yet find the way out, thus continuing to hinder a quantitative and qualitative agricultural production growth.

According to estimations of agro-industry, the agro-industrial output has been raised by 4 percent during the first nine-month period of 2005, while the processing of the agricultural products has dropped by 11 per cent during the third quarter of this year. The reduction of processing capacities has directly impacted on reduction by 44 percent of agro-industry exports, influencing also the total export of agriculture sector. During the first nine-month period of 2005, the agricultural exports fell totally by 21.2 percent, while we should emphasize that imports were also reduced by 11.5 percent. In animal farming the export/import situation is overturned. Exports decreased by 12 percent during the nine-month period compared to the previous year and imports increased by 10.4 percent.

Industry and energy

Annual sales growth of industry sector reached to 10 per cent during the third quarter of the year, marking, however, a slow-down as compared to the growth of 23.6 percent recorded in the second quarter. Nevertheless, the industry sector continues to occupy the second place to the total economy sales even during the second semester of 2005.

Table 4 Industry performance over third quarter of 2005 (in percentage)

	Weight to total	Q3 '05/Q3 '04	9-month '05/9-month '04
Total industry	100	11.87	10.06
Extracting industry	8	16.05	14.3
Processing industry	67	10.04	7.5
Electrical energy, water, gas	25	15.3	16.0

Source: INSTAT, Sales index, Q3 2005

Sales in absolute value of “Electrical energy, water and gas” marked an annual growth of 16 percent during the third quarter of the year. During July–November 2005 a growth of 7 per cent was marked in the energy resources, as compared to the same previous year period. The domestic product was increased by 3.8 percent during this period, satisfying 76.3 percent of the consumer domestic demand. During the last quarter, Albania encountered an electrical energy crisis, due to low level of production and import. During October and November imports grew considerably as compared to July – September, so as to satisfy the domestic demand for electrical energy.

Households' consumption, which constitutes 57 per cent of the energy consumption, dropped by 5.1 percent during these months, as compared to the same previous year period.

Table 5 Main indicators of the electrical energy balance sheet (in GWh)

	July-05	August-05	September-05	October-05	November-05	Jul-Nov 05/ Jul-Nov 04	11m 05 / 11m 04
Total resources	495.6	474.6	471.7	507.8	449.3	7.0%	6.7%
Production	406.7	395.6	380.7	362.0	286.2	3.8%	4.0%
Import (including exchanges)	88.9	79.0	91.0	145.8	163.1	18.7%	23.7%
Export (including exchanges)	43.9	25.3	54.7	47.6	30.7	294.0%	126.3%
Network losses	145.0	149.8	116.4	165.0	162.4	8.9%	1.0%
Supply to consumers	306.6	299.4	300.5	295.2	256.3	-3.1%	-0.8%
Households' consumption	167.6	176.6	171.7	166.4	153.4	-5.1%	-4.1%
Non-households' consumption	139.0	122.8	128.8	128.8	102.9	-0.4%	3.9%

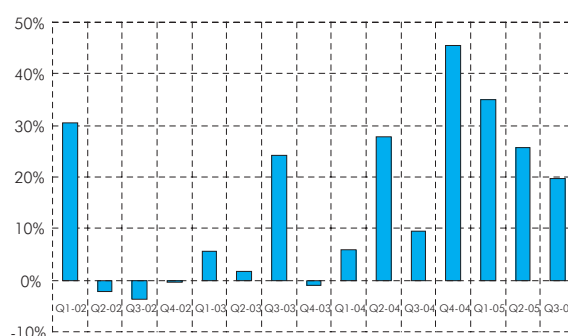
Source: Albanian Electro-energy Corporation

Construction

Sales in construction sector marked a significant growth by 19.7 per cent as compared to the same period of 2004. During the first nine-month period of the year, the sales in this sector have increased by 25.5 per cent.

Direct expenditures in construction fell by 0.31 percent compared to the previous quarter and 0.37 percent compared to third quarter of 2004. Material expenses also had a slight reduction by 0.36 percent compared to the previous quarter, while compared to the same previous year period they did not mark any change at all. The forecasted profit fell by 2.78 percent against the third quarter of the previous year.

Chart 7. Annual growth rates of sales in construction (in percentage)



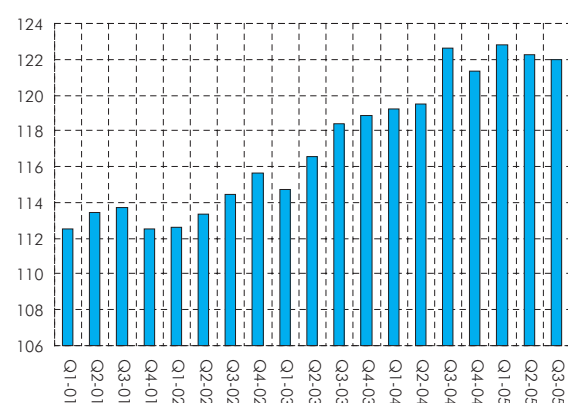
Source: INSTAT

Transport

Sales in the 'Transport and Telecommunication' sector were increased by 10.3 percent in the third quarter of 2005, as compared to the same period of the previous year.

Sea transport of goods had a growth of 16.6 percent during July – November of 2005 as compared to the same period of the previous year. So, imports increased by 7.7 percent, whereas exports fell by 28.8 percent, in the main ports of the country. The railway transport in Albania constitutes only 1 percent of the traffic of goods and passengers. During July – November of 2005 the

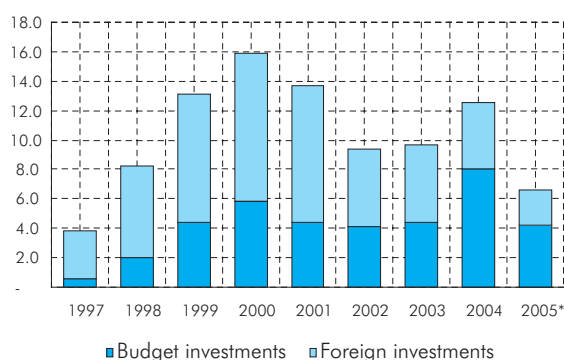
Chart 8. Construction costing index



Source: INSTAT

railway merchandise transport declined by 29 percent. The railway transport of passengers fell by 15 percent. The airline transport had an average annual growth by about 15 percent in 10 recent years. Hence, this trend continued during the 9 first months of 2005, when a rise by 24 percent was noticed in the number of flights and 22 percent in the number of passengers.

Chart 9. Transport investments in years* according to resources (in billion leks)



Source: Ministry of Transport and Telecommunication
*Data of 2005 are for its first nine months

Investments in this sector dropped by 28.8 percent during the third quarter of 2005 as compare to the same period of the previous year. This reduction is due to the low level of domestic and foreign investments, which were respectively by 21.6 and 43.9 percent less than the third quarter of the previous year.

III.1 LABOUR MARKET

During 2005, the labour market went on maintaining its good performance manifested at end of 2004, when the labour indicators reflected a sharp upward trend. Compared to the third quarter of the previous year, the employed number increased by 9200 people. Among them, only the number of the workers employed in the private non-agricultural sector increased by 3 thousand people.

Meanwhile, the labour market structure did not undergo changes during 2005. So the public sector continues to occupy about 19 per cent of the total number, the private non-agricultural sector occupies 23 per cent, and the private agricultural one occupies 58 percent of the whole labour forces².

Table 6 Labour market indicators (in thousand people).

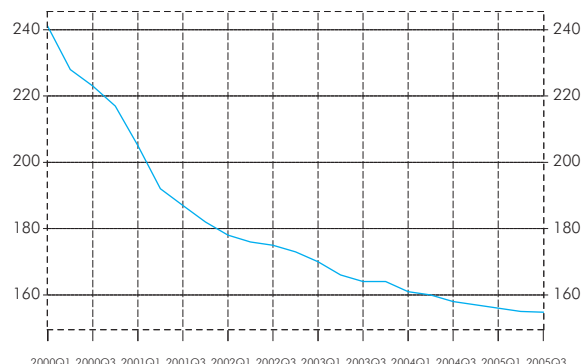
	Year	Year	2004				2005		
	2002	2003	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	Q.III
Total of labour forces	1167	1093	1080	1081	1080	1088	1087	1086	1086
A. Total of the employed	991	927	919	921	922	931	931	931	931.2
i) in the public sector	188	184	179	179	177	176	176	175.6	175.6
ii) in private non-agricultural sector	160	209	206	208	211	213	213	213.4	214
iii) in private agricultural sector	644	534	534	534	534	542	542	542	542
B. Unemployment (in thousand)									
i) Total of the unemployed	175.5	165.8	161	160	158	157	156	155	154.8
ii) benefit from unemployment compensation	12.3	11	11.7	12.3	12	11	11.5	11.5	11.5
C. Unemployment rate (%)	15.1	15.2	14.9	14.8	14.6	14.4	14.4	14.3	14.2

Source: INSTAT, *Conjuncture*, December 2005

The number of the unemployed decreased by 3200 people during the four last quarters and the unemployment rate decreased by 0.4 percentage point. During the third quarter the number of the unemployed fell by 200 people, leading the unemployment rate to 14.2 percent. The improvement of the employment indicators seems to be associated with income growth. Data on public sector's wages during the third quarter of 2005 indicate that the average wage in the public sector has increased by almost 9 percent in annual terms.

However, the labour market data continue to have deformations in the indicators, due to the happening of such phenomena as: unrecorded migration of population, continuously changing the ratio of rural population and urban one, and continuous existence of black labour market.

Chart 10. The unemployed number over three last years (in thousand people)



Source: INSTAT, Conjoncture, December 2005

III.2 FISCAL SECTOR

Fiscal indicators have generally been close to forecasted levels during 11 first months of 2005. According to the data from the Ministry of Finances, 97.8 percent of the planned revenues were collected until November and about 93 percent of the programmed expenditures for this period were realized. This has made the budget deficit at end of November be about Lek 16.3 billion, from Lek 27 billion forecasted. The budget spending and deficit in January – November 2005 reached the lowest levels in 7 last years in ratio to Gross Domestic Product. Capital expenses and domestic deficit financing had a significant reduction in ratio to GDP.

	11M 99	11M 00	11M 01	11M 02	11M 03	11M 04	11M 05
Total incomes	21.7	22.3	19.6	21.1	21.6	21.3	21.1
Income from taxes	13.5	15.6	13.2	14.7	19.2	19.3	19.0
Total expenditures	31.8	29.7	25.4	26.1	25.3	24.5	23.0
Current expenditures	26.1	24.1	19.7	21.4	21.7	20.7	19.7
Capital expenditures	5.6	5.5	5.5	4.7	3.6	3.8	3.3
Deficit	(10.1)	(7.5)	(5.8)	(5.0)	(3.7)	(3.2)	(1.9)
Domestic financing	4.0	4.5	3.2	2.2	2.8	2.5	1.4
Foreign financing	6.0	2.9	2.6	2.9	0.9	0.7	0.5

Source: Ministry of Finances

Table 7 Main fiscal indicators (in percentage to GDP)

Incomes and expenditures are increased respectively by 9.3 percent and 3.7 per cent compared to the same period of the previous year, marking a smaller growth than the average of 7 last years. The domestic financing deficit until November reached to Lek 11.9 billion, against Lek 16.2 billion forecasted. The foreign deficit financing reached to 40 percent of the forecasted value.

Table 8 Annual growth rates of main fiscal indicators (in percentage)

	11M 99	11M 00	11M 01	11M 02	11M 03	11M 04	11M 05	Aver. 99-05
Total income	15.2	14.3	5.7	15.7	12.8	11.3	9.3	12.0
Income from taxes	13.9	28.8	1.8	19.7	43.2	13.2	9.0	18.5
Income from local government	13.9	57.9	39.7	32.0	252.1	13.3	16.0	60.7
Income from independent budgets	14.7	10.7	3.3	23.1	11.5	12.7	10.6	12.4
Non-tax income	19.5	(26.2)	29.5	(9.3)	(6.6)	(10.4)	(6.7)	(1.5)
Total expenditures	15.5	4.3	2.7	10.4	6.8	9.1	3.7	7.5
Current expenditures	9.7	3.0	(1.9)	17.1	11.5	7.4	5.0	7.4
Capital expenditures	49.9	9.1	21.1	(8.6)	(15.1)	19.9	(3.7)	10.4
Deficit	16.3	(17.4)	(6.0)	(7.1)	(18.6)	(3.3)	(34.2)	(10.1)
Domestic financing	(9.3)	24.9	(14.7)	(27.7)	43.5	1.3	(39.1)	(3.0)
Foreign financing	43.5	(45.9)	7.5	18.1	(65.3)	(17.8)	(15.6)	(10.8)

Source: Ministry of Finances

Budget revenues

Budget revenues of the first nine-month period had an annual growth of about 9.3 per cent. Income from taxes is the main source of budget revenues, constituting about 90 per cent of total revenues. Their level reached to ALL 165.1 billion at end of November, realizing the forecasted budget level by 100.4 per cent.

The main contribution to realizing the income from taxes has been given by tax on profit, tax on vehicles circulation, value added tax, and excise taxes, which exceeded the plan by 16.5, 41.9, 2.0 and 1.7 per cent respectively. Taxes collected from customs resulted about Lek 12.2 billion, reaching to 87.8 per cent of the planned level. Other main tax indicators, such as: tax on personal income and customs duties were realized by 97.1 and 87.8 per cent, respectively.

Also, it is noticed that income from local government continues to exceed the plan, being realized to 110.8 percent, whereas incomes from independent budget and non-taxing ones were realized at 98.5 and 85.6 percent respectively.

Table 9 Main indicators (progressive data – in billion lek)

	July	August	Sept.	October	Nov.	11M plan %	Annual plan %
Total income	109.0	125.2	142.8	161.5	180.8	97.8	87.5
Income from taxes	99.6	114.4	130.8	147.4	165.2	100.4	90.6
Value added tax	33.6	38.9	45.2	51.8	58.4	102.1	92.2
Tax on profit	10.7	12.1	13.7	15.2	17.1	116.5	106.6
Excises	9.3	11.1	13.1	15.1	16.9	101.7	92.7
Tax on personal income	3.9	4.4	5.1	5.5	6.4	97.1	84.0
Customs duties	7.0	8.2	9.5	10.8	12.2	87.8	78.1
Tax on vehicles circulation	2.3	2.5	2.7	2.8	2.8	141.9	130.8
Income from local government	6.9	7.8	8.6	9.5	10.6	110.8	102.3
Income from independent budget	20.3	23.0	25.9	29.2	32.2	98.5	87.8
Non-taxing income	8.2	9.3	10.5	11.8	12.8	85.6	74.0

Source: Ministry of Finances

Budget expenditures

Budget expenditures reached the level of Lek 197.1 billion at end of November, constituting about 93 percent of the programmed level for this period. The level of rise of expenditures for this period was approximately as much as half of the average of growth in seven last years. The personnel expenditures, which constitute about 28 percent of current expenditures, were 97.9 percent. The current expenditures (for January – November 2005) constitute about 85 per cent of total expenditures. The public administration restructuring is expected to provide more underlined effects in 2006, with less expenditures particularly in the personnel expenditures indicator.

Meanwhile, the capital expenses continue to be realized less than the planned level. So, for the first 11 months of the year, they were realized at 71.9 per cent. The expenditures covered by foreign financing were realized only at 52.5 per cent of the plan.

	July	August	September	October	November	11M plan %	Annual plan %
Total expenditures	123.2	140.7	161.8	179.7	197.1	93	79
Current expenditures	107.3	121.7	138.9	153.6	168.5	99	87
Personnel	29.6	33.6	38.1	42.1	46.5	98	84
Interests	15.9	17.9	20.6	22.3	24.0	88	80
Domestic	14.9	16.8	19.4	20.9	22.5	90	82
Foreign	975.0	1.2	1.2	1.3	1.5	68	60
Operational maintenance expenses	13.5	14.5	16.7	18.6	20.4	108	93
Social insurance expenses, etc	30.9	35.9	40.6	45.0	49.3	98	89
Local budget expenses	9.6	11.0	12.9	14.5	16.3	116	92
Other expenses	5.8	6.6	7.4	8.2	9.1	101	89
Capital expenditures	15.9	18.9	22.8	26.1	28.6	72	57
Domestic financing	10.4	12.7	15.4	17.4	19.4	87	69
Foreign financing	5.6	6.3	7.4	8.7	9.3	52	41

Source: Ministry of Finances

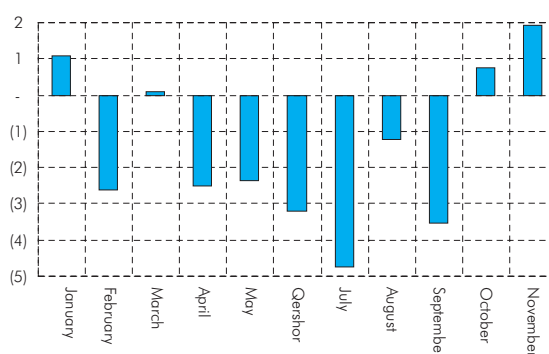
Table 10 Composition of current expenditures (in billion lek – progressive data)

Fiscal deficit

The fiscal deficit at end of November was at about 60.3 percent of the planned level. The keeping under control of expenditures and the realization of income have made the budget deficit record the highest decline over seven last years.

During this period, 4 months recorded a surplus budget, while 8 last years have had only one month per year with a surplus budget. The deficit was focused on the third quarter, whereas the fourth quarter until November resulted with a surplus of ALL 2.7 billion.

Chart 11. Monthly budget deficit for 2005 (in billion lek)



Source: Ministry of Finances

III.3 FOREIGN SECTOR OF THE ECONOMY

The overall balance of payments was closed with a surplus of Euro 33.7 million during the third quarter of 2005. The capital inflows have fully covered the current deficit and have enabled foreign reserve growth. During this period the foreign sector of the economy has been characterized by an intensive activity, which has been reflected in the growth of current income and expenditure. The third quarter has marked a current deficit of about 65 percent lower than that of the previous quarter, but about 2.8 times higher than the current deficit recorded in the same period of the previous year. The overall volume of imports and exports during July – September of this year was about Euro 650 million or about 12 per cent higher as compared to the same period of the previous year.

Table 11 Main balance of payments items by quarters (in million euro)

	Q-III'04	Q-IV'04	Q-III'05	Q-I&III'05
Current account	-25.0	-129.0	-67.0	-222.5
Trade balance	-329.3	-389.4	-382.2	-1022.4
Capital and financial account	13.9	339.2	34.5	248.0
Overall balance sheet	78.1	45.9	33.7	44.8

Source: Bank of Albania

III.3.1 Current account

During the third quarter of 2005 the current account recorded a general volume of transactions by about Euro 4.5 billion or 22 percent higher than that of the same period of 2004. Transactions in goods and services represented about 73 percent of current transactions.

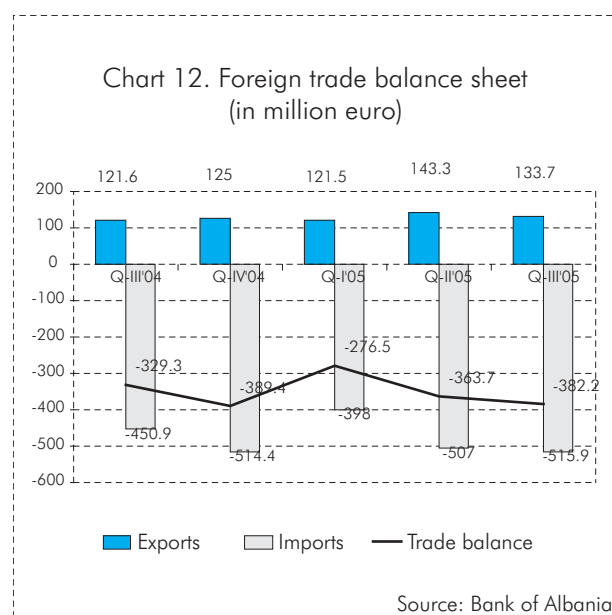
In comparison to the third quarter of the previous year, the said quarter marked some not very positive changes such as: the deepening of the trade deficit at 16 percent, underlined growth of services deficit (from about 5 million to about 45 million) and a slight decline of the surplus in income account. The rise in public current transfers and particularly in private ones has balanced the deepening of the deficit and has decreased the surplus in these items. Therefore, the quarter has been closed with a current deficit of about Euro 40 million higher than the third quarter of the previous year.

Foreign trade

During January – September of this year the merchandise trading activity with the world recorded a value of Euro 1.8 billion. Merchandise trading exchange over this period represented about 40 percent of the overall volume of current transfers carried out during this period. The country's economy and domestic market remained oriented to imports, which were about 3.85 times higher than exports during this period. During July – September the foreign trade volume increased by Euro 650 million or about 11.8 percent in comparison to the same period of the previous year. Either revenues from exports or expenses

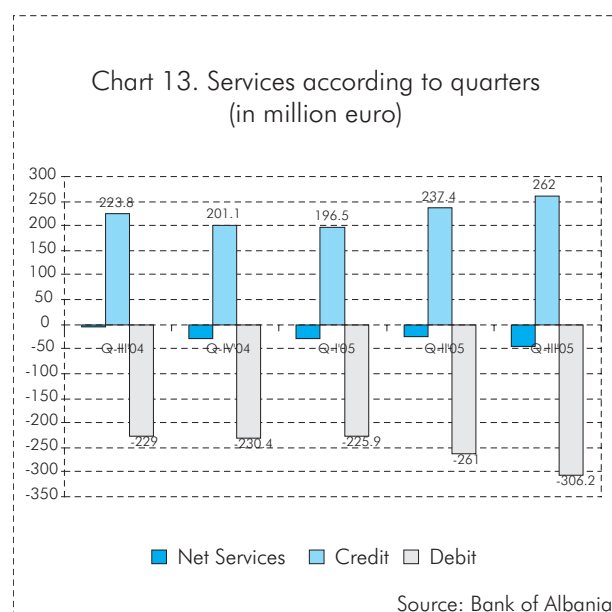
for imports have increased significantly. The rise in imports has been higher than that of exports, both in percentage and in absolute values. Therefore, the trade deficit of goods has been increased by 16 per cent or by Euro 50 million.

Export/Import ratio has fluctuated within the limits of 20-25 percent during all latest years. This ratio should attract attention towards policies of substituting imports and towards the need to diversify and support exports, which currently present a high degree of concentration and an underlined dependence on a limited number of countries that purchase domestically produced goods with imported raw materials (re-exports) from Albania. Current transfers that are largely represented by income from emigrants may not be regarded as an inexhaustible and permanent financing source for the ongoing trade deficit.



Services

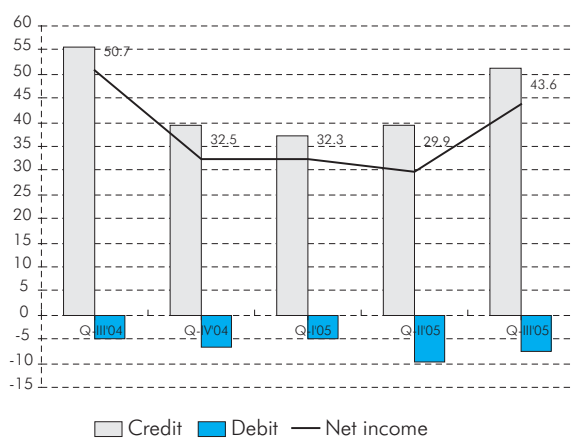
During July – September the services balance sheet marked a deficit of about Euro 44.2 million. This deficit was about 2 times deeper than the deficit recorded in the previous quarter and about 9 times larger than the deficit recorded in the same quarter of the previous year. Residents have spent about Euro 306 million to purchase services from non-residents, while the latter ones have spent about Euro 260 million to purchase services in the Albanian territory or services provided by resident units in Albania (for example telecommunication services). The largest weight of services either in income or expenditure is occupied by tourism services (63 percent of income and 54 percent of expenditure) as well as transport services, which have ensured 12 percent of income and 29 percent of expenditure. Currently, the tourism activity continues to represent one of the main sources of foreign currency income for our country's economy, and as such, it should be regarded as one of the Albanian economy growth vehicles. It is worth mentioning that the services export during the third quarter of this year was about 17.5 percent higher than the merchandise export.



Income

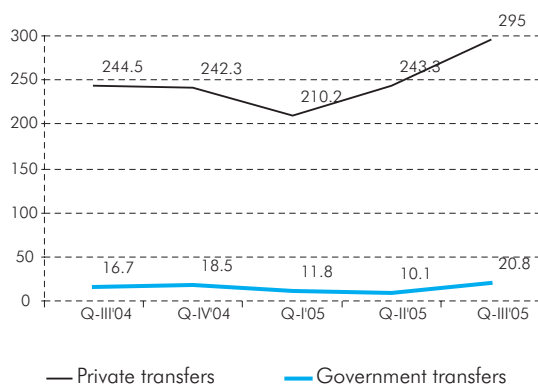
During this quarter the balance of income was positive. The surplus of about Euro 44 million has been about 2 times higher than the one recorded

Chart 14. Income by quarters
(in million euro)



Source: Bank of Albania

Chart 15. Transfers according to quarters
(in million euro)



Source: Bank of Albania

in the second quarter, but about 14 percent lower than the surplus recorded in the same period of the previous year. The income growth has derived from growth of income on seasonal and customs works, as well as on increased accumulated interests from foreign reserve investments of the banking system in the form of portfolio investments.

Transfers

During the third quarter of this year, positive developments have taken place in the current transfer account. Private transfers were about 20 percent higher either in comparison to the previous quarter or in comparison to the third quarter of the previous year. Incomes from emigrants or remittances are estimated to have covered about 77 per cent of the trade deficit. They constitute the main part (93 percent) of current transfers. During this quarter, income from emigrants has marked the level of Euro 295 million, while the government transfers, though higher than in the previous quarter, remain some times lower than the private ones.

III.3.2 Capital and financial account

Net inflows in capital and financial account are estimated to Euro 34.5 million during the third quarter of 2005. Almost 72 per cent of these inflows during July – September come from capital transfers. However, the capital account has been about 16 percent lower in comparison to the same period of the previous year. The financial account for the

third quarter is presented with a net capital inflow of Euro 9.4 million, unlike the same period of the previous year when this account marked a negative balance sheet. Foreign direct investments in this quarter were about Euro 53 million, being almost at the level of investments of the second quarter, but somewhat lower than the direct investments carried out in the same period of the previous year. The financial liabilities of Albania to the world have been increased by Euro 9 million.

III.3.3 Reserve assets

Foreign reserve assets have been increased by Euro 33.7 million, making the foreign reserve level reach to about Euro 1 billion and 72 million, a sufficient quantity to cover 4.6 months of import of goods and services.

	Q-III'04	Q-IV'04	Q-I'05	Q-II'05	Q-III'05
Current account	-25.0	-129.0	-51.6	-103.9	-67.0
Merchandise export	121.6	125.0	121.5	143.3	133.7
Merchandise import	-450.9	-514.4	-398.0	-507.0	-515.9
Trade balance	-329.3	-389.4	-276.5	-363.7	-382.2
Services: Credit	223.8	201.1	196.5	237.4	262.0
Services: Debit	-229.0	-230.4	-225.9	-261	-306.2
Services (net)	-5.2	-29.3	-29.4	-23.6	-44.2
Income: Credit	55.8	39.3	37.4	39.5	51.2
Income: Debit	-5.1	-6.8	-5.1	-9.6	-7.6
Income (net)	50.7	32.5	32.3	29.9	43.6
Private transfers	244.5	242.3	210.2	243.3	295
Government transfers	16.7	18.5	11.8	10.1	20.8
Capital account	29.1	28.5	35.5	14.6	25.0
Financial account	-15.2	110.7	29.0	134.4	9.4
Capital and financial account	13.9	339.2	64.5	149.0	34.5
Direct investments	58.7	42.6	45.3	50.3	53
Portfolio investments	98.2	-95.9	-42.9	-5.3	40.9
Other capitals	-172.2	164.0	21.9	89.4	-89.3
Net faults and omissions	84.9	35.6	-3.3	-43.7	66.2
Overall balance sheet	78.1	45.9	9.7	1.4	33.7
Reserves and related items					
Reserve assets	-78.1	-45	-9.7	-1.4	-33.7
Use of loans and credits from the IMF	4.8	0	4.6	0	4.8

Source: Bank of Albania

Table 12 Balance of payments according to quarters

III.4 INFLATION

The annual inflation has fluctuated in the lower half of the Bank of Albania target. After a slight rise during the first part of the semester, the annual inflation has been falling, reaching the value of 2 percent in December. Also, the average annual inflation rate has fluctuated within the narrow band of 2.1 – 2.4 per cent during July – December.

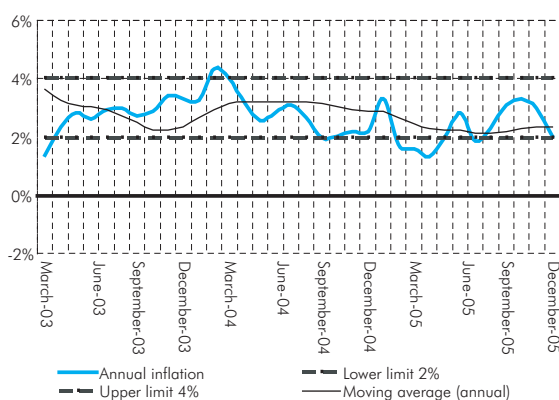
	2001	2002	2003	2004	2005
January	2.2	6.5	0.0	3.3	3.3
February	1.5	7.6	1.1	4.4	1.8
March	2.9	7.5	1.3	4.0	1.6
April	3.0	6.5	2.3	3.2	1.3
May	2.5	4.6	2.8	2.6	2.0
June	4.0	3.7	2.6	2.9	2.9
July	5.6	4.2	3.0	3.1	1.8
August	4.1	5.5	3.0	2.7	2.3
September	3.5	5.3	2.8	2.0	3.1
October	1.8	5.8	2.9	2.0	3.3
November	2.8	3.7	3.4	2.2	3.0
December	3.5	1.7	3.3	2.2	2.0
Average	3.1	5.2	2.2	3.0	2.4

Source: INSTAT

Table 13 Annual inflation (in percentage)

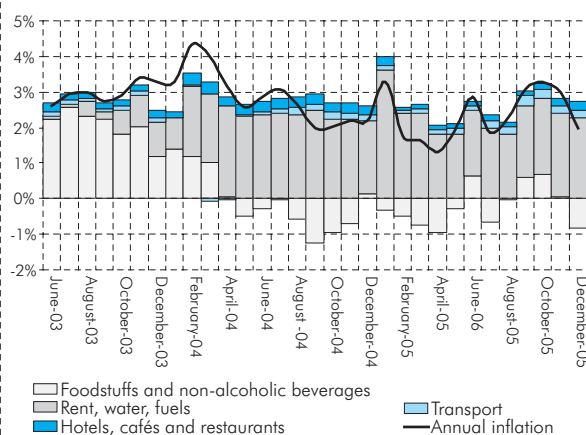
Macroeconomic developments have enabled the creation of a favourable macroeconomic environment for maintaining price stability. Good harmonization of macroeconomic policies, lack of inflationary pressures on

Chart 16. Annual inflation (in percentage)



Source: INSTAT, Bank of Albania

Chart 17. Contribution of main groups to annual inflation (in percentage point)



Source: Bank of Albania

Table 14 Annual inflation of "Foodstuffs and non-alcoholic beverages" (within the country and abroad) and the contribution of this group to total inflation

	Annual inflation '04	Contribution (pp)	Annual inflation '05	Contribution (pp)	Italy ³ Annual inflation '05	Greece ⁴ Annual inflation '05
July	-0.1	-0.05	-1.6	-0.7	-0.2	0.7
August	-1.4	-0.6	0.0	0.0	-0.2	1.3
September	-2.9	-1.2	1.5	0.6	0.1	2.1
October	-2.2	-0.9	1.7	0.7	0.2	2.7
November	-1.6	-0.7	0.2	0.1	0.6	2.6
December	0.3	0.1	-1.9	-0.8	-	-

Source: Bank of Albania; General Secretariat of National Statistical Service of Greece, ISTAT-Italy

the supply side and strong positions of the lek have depreciated the inflationary pressures.

III.4.1 Inflation and constituent groups

Annual inflation rose from 1.8 percent to 3.3 percent during July – October, and then it fell during the two following months. The main consumer basket groups, "Foodstuffs and non-alcoholic beverages", "Rent, water, fuels and energy", "Transports", and "Hotels, restaurants and cafés" have been the main determinants of inflation performance, maintaining the same contribution structure.

"Foodstuffs and non-alcoholic beverages". Consumer price developments have indicated that the overall price level during the second half of 2005 has pursued the dynamics of foodstuff prices. Unlike the first half of the year, during the second semester the contribution of this group to annual inflation has had opposite directions at certain months. The average contribution of "Foodstuffs and non – alcoholic beverages" to annual inflation rate of this period was zero. Unlike the previous years, the annual inflation of this group in December was negative (-1.9 percent). Lack of excess growth of the consumer demand has discouraged the artificial price rise during these celebrations. The inflation of this group decreased the annual inflation rate by -0.8 percentage point in December.

the contribution rendered during the first semester. Along with the electrical energy administered price rise, the free market price rise of fuels, rent and imported rent also impacted on the inflation performance of this group. Price rise of fuels, gas, and fire woods, was due to electrical energy crisis that our country underwent in October – November. The increased demand for these energy replacing alternatives brought about their price rise, which returned to higher inflation rates (23.1 -23.4 percent) for the subgroup “Fuels, electrical energy”, in October – December. Also, the rent price underwent the highest rise in December, marking an annual inflation of 4.9 percent.

	Annual inflation '04	Contribution (pp)	Annual inflation '05	Contribution (pp)
July	9.9	2.4	7.7	2.0
August	9.7	2.4	6.9	1.8
September	10.4	2.5	7.7	2.0
October	9.2	2.2	8.2	2.1
November	9.2	2.2	9.0	2.3
December	8.8	2.1	9.0	2.3

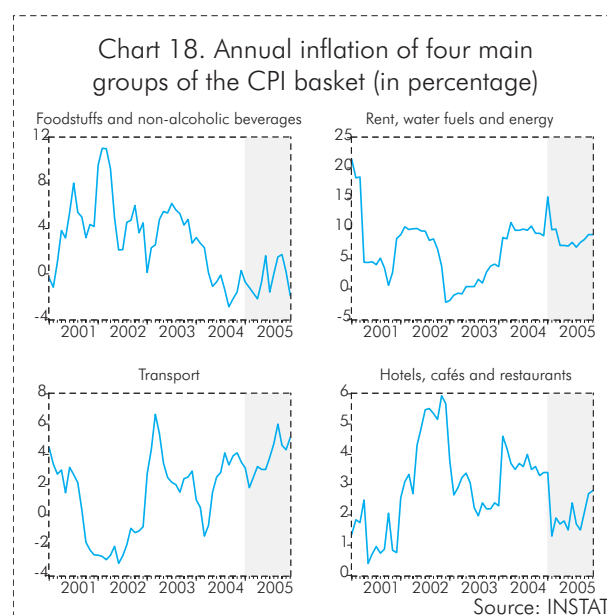
Source: INSTAT, Bank of Albania

Table 15 Annual inflation rate and contribution of “Rent, water, fuels, energy” to total inflation

“Transport”. Unlike the first semester of the year, the oil price has turned into a significant cost for Albanian consumers. Though having a small weight of 4.8 percent in the representative consumer basket, the “Transport” group has marked high annual inflation rates during July – December. It has contributed on average by 0.23 percentage point to the annual inflation of this period (compared to 0.13 percentage point during the previous period). The highest inflation rate of 6.1 percent was recorded in September. The oil price rise was accommodated even by the lek’s depreciation against the American dollar⁵ - a factor that facilitated a more fully transmission of this rise from the international market to the domestic one. Along with external pressures for price rise of this product, the domestic market was faced with a higher production cost. During the third quarter, the crude oil production price marked an annual rise of 3.2 percent. However, the Albanian economy might have not been affected by secondary effects of the oil price rise.

“Hotels, café, restaurants”. The second quarter of 2005 was characterized by price rise in the services sector. The “Hotels, cafes, restaurants” group has testified higher growth rates in comparison to the previous semester. This group has rendered an average contribution of 0.2 percentage point to the total figure of the annual inflation of this period. The most obvious growth has been marked mainly during three last months. The “Accommodation services” subgroup has marked an annual inflation rate of 28.7 percent from 28.3 percent.

During the second semester the other basket groups maintained the same trends observed during



the first semester of the year. “Alcoholic beverages and tobacco” and “Various goods and services” groups have marked positive growth rates, whereas “Clothes and footwear” and “House furniture, equipment and maintenance” have continued to record negative inflation rates. Totally these groups have contributed to the annual inflation on average by -0.1 percentage point. The administered energy price impact provided a constant influence along the year, whereas the other administered prices rose significantly during the second quarter of this year. “Health” and “Education service” groups have given an average contribution of respectively 0.14 and 0.1 percentage point to the annual inflation of the analyzing period.

III.4.2 Macroeconomic environment and consumer prices

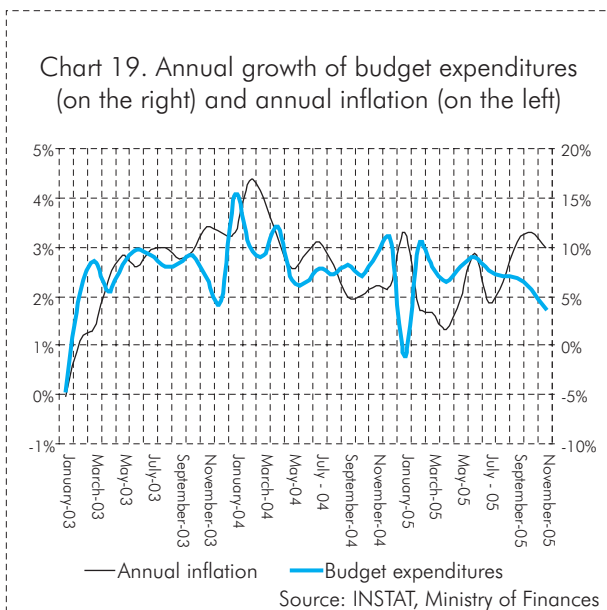
Macroeconomic conditions during the second semester have generally been favourable for maintaining price stability. Irrespective of the electrical energy crisis of October – November and high oil prices - factors that added inflationary pressures – the macroeconomic environment may be qualified as favourable. Important macroeconomic indicators testify a slower growth of the economic activity over the third quarter, a stable labour market situation and lek’s stability against the foreign currencies. Also, low inflation rates have been sustained by a good coordination of the fiscal policies with monetary one, under the conditions of an external trading environment with weak inflationary impact.

Demand factors

Fiscal policy and fiscal indicators. The fiscal policy has performed prudentially, paying attention to the approved budget implementation. The fiscal indicators have observed the forecasted levels. So, the budget expenditures and budget deficit are at lower levels than those forecasted for

the eleven previous months of the year. Also, the budget expenditures are increased at lower paces during the second half of 2005 compared to the first half and to the previous year. The implementation of prudential fiscal policies, regardless of the budget expenditures growth and modest rise in the public sector’s wages, has enabled conditions for controlling inflation rate.

Monetary policy and monetary indicators. In absence of inflationary pressures, the monetary policy has accommodated macroeconomic developments, following a neutral monetary policy. During the second semester of 2005, the money supply marked lower growth rates, but it satisfied the high demand of the economy for credit. On the other hand, the ratio of currency



outside banks to money supply, as well as long-term interest rates have been decreasing, reflecting reduction of inflation expectations and bringing about its timely stability, without genuine costs to the economy.

Domestic demand. The third quarter of 2005 marked a slower growth of the economic activity compared to the previous quarter. The sales index marked an annual growth of 14.7 percent and a quarterly growth of 4.9 percent versus the previous quarter. These rates were respectively 22.8 and 32.2 percent in the second quarter.

Meanwhile, the retail market index increased by 5.5 percent versus the previous quarter and decreased by 9.6 percent in annual level. This fact indicates that the domestic demand estimated by these indicators has not generated inflationary pressures for the analyzing period.

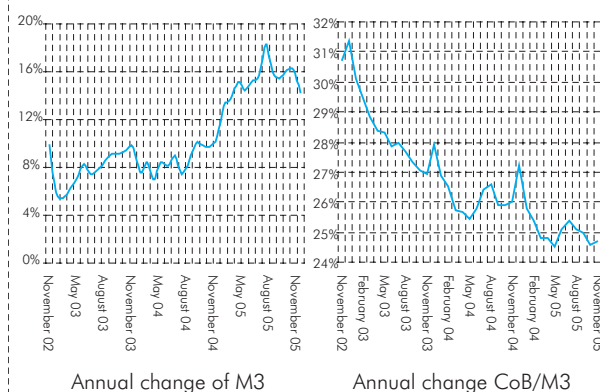
Supply factors

Inflation rate and imported inflation performance. Exchange rate developments play a fundamental role on inflation performance. The domestic market continues to be oriented to imports, which resulted 3.6 times higher than exports during the first nine-month period of 2005. The trade deficit has not brought about imbalances in the exchange rate, being totally financed by net capital inflows.

The exchange rate trends of the domestic currency against the euro and the American dollar have reflected the performance of the ratio of these two currencies in the international markets. After a long appreciating period, the annual appreciating dynamics of the lek went downward during 2005. After the fourth quarter of this year, the lek was depreciated against the American dollar, but it continued to be appreciated against the euro. Given that the main partner countries remain Italy and Greece – whose exports and imports represent respectively 83 percent and 47 percent of the overall volume – the lek appreciation against the euro continues to smooth the imported inflation impact.

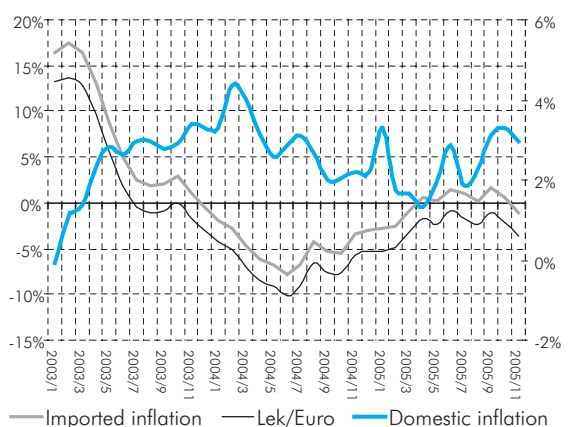
The foreign trading environment stability and the exchange rate appreciation against the euro have facilitated inflationary pressures conveyed by this factor.

Chart 20. Annual changes of money supply and of currency outside banks to M3



Source: Bank of Albania

Chart 21. Annual nominal lek/euro exchange rate spread, imported inflation (left axis) and the country's inflation (right axis)



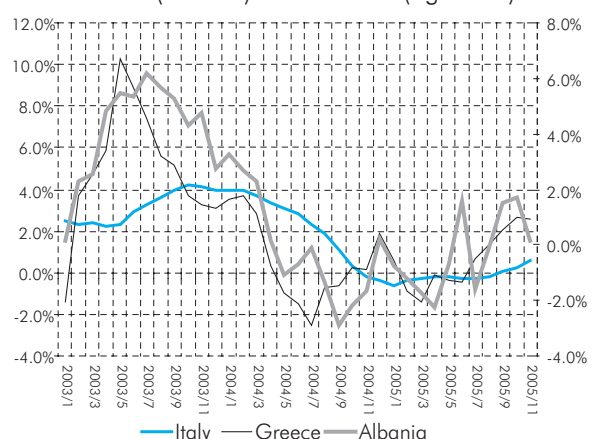
Source: Bank of Albania, General Secretariat of National Statistical Service of Greece, ISTAT-Italy

Table 16 Annual inflation of partner countries and exchange rate spread (in percentage)

	July	August	September	October	November	December
Greece ⁶	3.9	3.7	3.9	3.9	3.5	-
Italy ⁷	2.1	2.0	2.0	2.2	2.2	-
Lek/euro	-1.8	-2.4	-1.0	-2.1	-3.7	-3.2
Lek/usd	0.0	-3.3	-1.4	1.6	5.9	9.5

Source: INSTAT, General Secretariat of National Statistical Service of Greece, ISTAT-Italy

Chart 22. Annual inflation of "Foodstuffs and non-alcoholic beverages" in Italy and Greece (left axis) and Albania (right axis)

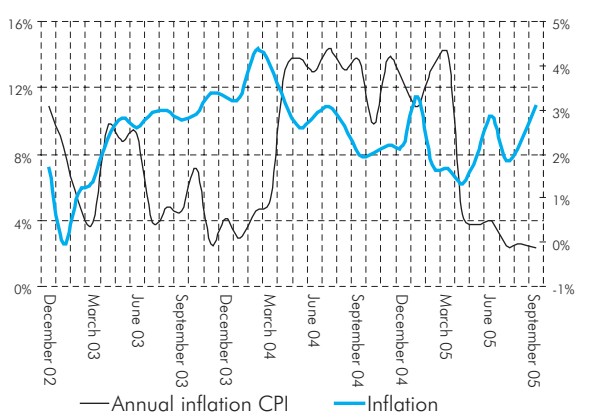


Source: INSTAT, General Secretariat of National Statistical Service of Greece, ISTAT-Italy

Domestic agricultural production. Foodstuffs prices rose during the second half of 2005, either in comparison to the previous year or to the first half of this year. The falling impact of this indicator is estimated to no longer operate with the same force during this semester. The latest data from the Ministry of Agriculture, Food and Consumers Protection support this viewpoint. During this year, the agricultural production increase is forecasted at 1.3 percent, compared to 2.5 percent forecasted at the beginning of the year and 3.3 percent realized in 2004.

Along with the lower growth of the domestic agricultural production, the price rise of agricultural products in partner markets, and the smoothing of the compensating effect of the lek's appreciation against the euro brought about, in consequence, an almost impartial average impact of the "Foodstuffs and non-alcoholic beverages" group (the average contribution of this group to annual inflation is 0.0 percentage point), to annual inflation rate for the second semester of 2005.

Chart 23 Annual change of production and consumer price index (in percentage)



Source: INSTAT

Production price index⁸. After a significant production price rise during April '04 – March '05, these prices recorded the lowest growth rates during the second and third quarters of this year. The sectors of "Silviculture, forestry, supplementary services" (10 %) and "Extraction of non-energetic products" (6.8%) marked the highest annual growth over the third quarter, whereas "Processing industry" and mainly the "Foodstuff industry" recorded lower rates, respectively 1.5 and 0.1 percent. Notwithstanding the production cost growth, they were not transmitted to consumer prices, mainly due to increased competition in retail market segments.

Oil prices. Unlike the first semester of this year, the oil prices are turned into a source of inflationary pressures. The price rise rates of this product in international markets have been translated into a rise of almost the same dynamics in the domestic market.

	Oil price in the country(Lek)	Annual change (%)	Oil price abroad (USD)	Annual change (%)
July	104.5	32	60.6	38
August	112.4	30	68.9	64
September	116.4	32	66.2	33
October	116.8	23	59.8	15
November	117.1	21	57.3	17
December	116.0	25	59.5	37

Source: INSTAT, Bloomberg

Table 17 Partner countries' inflation and exchange rate annual change (in percentage)

Oil price rise in the country, mainly during the third quarter of this year, was associated with a fall of demand for it by 21 percent in annual terms and 18 percent in quarterly terms ⁹. Regardless of the small weight¹⁰ of this product in the consumer products basket, it added the annual living cost on average by 0.24 percentage point in the third quarter of 2005 (compared to 0.17 percentage point in the third quarter of 2004). However, the oil price rise has not created effects of the second round.

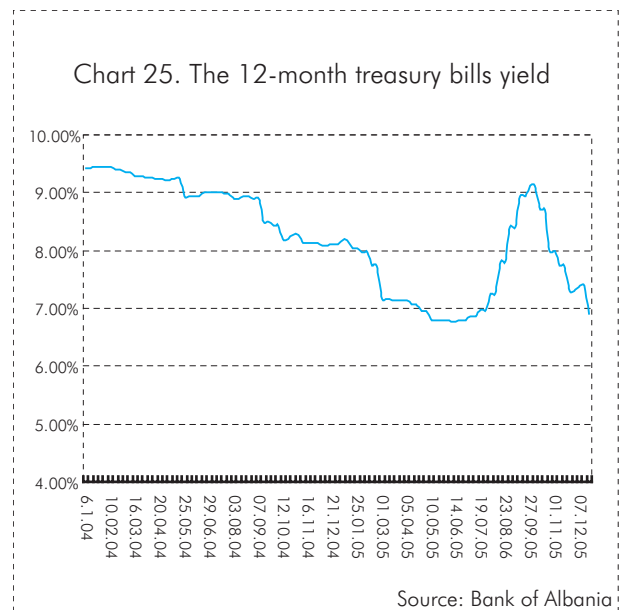
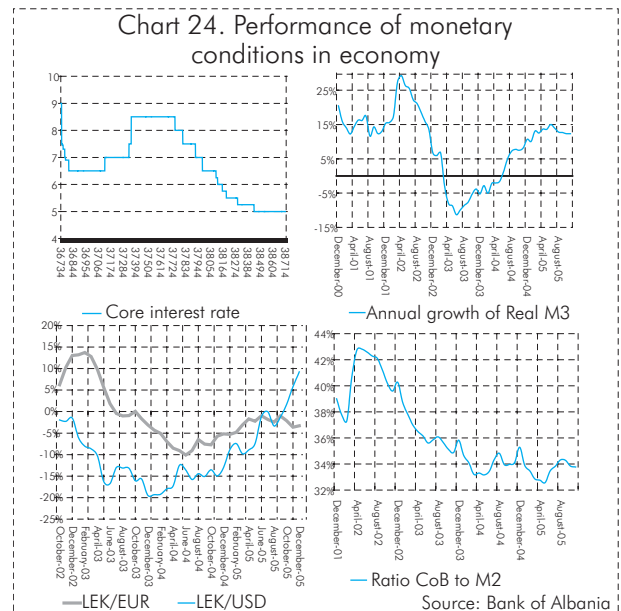
IV MONETARY POLICY AND MONETARY INDICATORS

IV.1 Monetary policy of the Bank of Albania

The Bank of Albania has pursued a neutral monetary policy during the second semester of 2005, holding the key interest rate unchanged, at 5 percent. This policy is limited by the stable performance of the consumer prices and low inflationary expectations for the coming period. In general, the monetary conditions are estimated as appropriate to maintain the price rise within the Bank of Albania target during the coming period.

Under these conditions, the monetary policy and its operational framework are focused on smoothing some fluctuations of monetary indicators during the semester. Due to the unexpected cut of the lek deposits interest rate by some banks and the increased demand of the economy and of the government for monetary assets during the third quarter, the banking system felt lack of liquidity during July – October. This lack of liquidity was further conveyed to fast rise of treasury bills yield during the third quarter of the year.

To confront this situation, the Bank of Albania changed the direction of its main operations, repo,



transforming them into injectors of liquidity into the system. The average volume injected through reverse repo instruments was Lek 1.7 billion during July – September. Also, it used direct credit to government in a selective way, aiming at preventing excessive pressures and speculations in increasing the yield. Due to this policy, the banking system surpassed the situation of the liquidity shortage, mostly by self-correcting the lek deposit interest rates.

Also, the Bank of Albania intervened in the foreign exchange market to surpass this situation. It purchased foreign currency almost throughout the whole second semester, smoothing the appreciating pressures on the exchange rate and injecting liquidity into the market. In its interventions into this market, a liquidity of about Lek 12.4 billion was injected, assisting the banking system to surpass this situation.

The second semester of 2005 was not covered by agreements between international financial bodies and Albania. However, the Bank of Albania fulfilled the indicative indicators set for this period.

Table 18 Realization of quantitative objectives of the Bank of Albania

	March '05	June '05	September '05	October '05	December
Net International Reserves (million dollars)					
Objective	1,073	1,086.7	1,094.6	1,108.5	1114.3
Actual	1,107	1,098.0	1,094.6	1,119.1	1116.9
Difference	35	11.3	0.0	10.6	2.6
Net Domestic Assets (billion leks)					
Objective	61	60.0	65.7	65.7	65.7
Actual	53	63.6	65.7	57.8	55.8
Difference	-8	3.6	0.0	-7.9	-9.8
Net Domestic Credit to Government (billion leks)					
Objective	292	297.7	302.7	304.7	306.7
Actual	288	294.4	301.6	299.5	296.9
Difference	-4	-3.2	-1.1	-5.2	-9.8

Source: Bank of Albania

* Operative data

IV.2 MONETARY AGGREGATES

Year 2005 was characterized by a high monetary expansion, reflecting the high economic activity and increased confidence in the country's financial system. The main effect on the money supply growth was given by the economy demand for credit, while the government borrowing from the banking system had a falling trend. The money supply growth rate had slow-down tendencies in the second half of the year. The growth rate of the M3 decreased to 14.3 percent in November, since it had reached its peak at 18.3 per cent in June. This development was forecasted by the Bank of Albania. The monetary aggregates performance in this period was also impacted by the stabilizing monetary policies followed by the Bank of Albania during the second semester of 2005, for smoothing the interest rate fluctuations and stabilizing the banking system liquidity situation during this period. The current monetary conditions and their expected trend are consistent with the maintaining of price stability in the mid-term period.

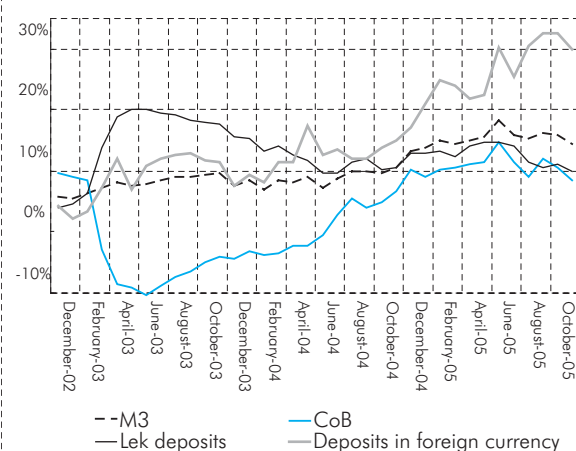
Annual growth rates of monetary aggregates have reflected similar trends in the second half of the year. The most liquid component of the M3 aggregate, currency outside banks, has reacted in the same way as the money supply to developments in economy. The annual growth of currency outside banks resulted to about 8 percent at end of the year, against 14.9 percent in June. The annual growth rate of currency outside banks resisted the accelerating tendency that re-appeared as a result of the demand of the government for liquidity focused in September and the low level of lek deposits interest rates during this period.

In spite of fluctuations of currency outside banks, their weight to M2 has been falling. The indicator of the ratio of currency outside banks to M2 recorded 33.8 percent in November, being reduced by 0.5 percentage point in comparison to September. The returning of this ratio to falling trend reflects the reduction of inflationary pressures on the side of demand for the economy. Reduction of currency outside banks is translated directly into lek deposits growth.

The positive impact of these developments is further transmitted in improving of capacities of the banking system for financing the productive activities in economy and enables the meeting of needs for budget deficit financing. The banking system deposits level has been sufficient for covering the economy demand for credit in lek. The upward participation of households in budget deficit financing has facilitated the allocation of financial resources of the banking system towards financing of the economy¹¹.

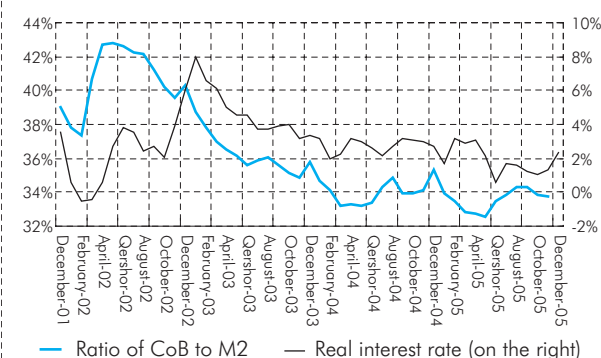
The annual growth of deposits in lek has reflected the growth rates of the M2 Aggregate. The deposits in lek marked an annual growth of 10.0 per cent in November, against the growth of 14.7 percent in June. The growth by Lek 3.9 billion of the level of deposits in lek during July – November is smaller than the growth of the outstanding credit in lek over the same period. The banking system has faced this situation by reducing the level of excess liquidity held by it. Time deposits in lek decreased during last twelve months¹², but it was compensated by growth of demand deposits. The increase of the lek demand deposits weight to total deposits from 15.2 percent in June to 27.7 percent in November impacted on reduction of cost of lek deposits of the system. Marginal cost of financial resources in lek of the banking system reached to 1.2 percent in November, from 1.3 per cent in June. However, the positive real interest rates of deposits in lek have maintained the demand for them, bringing about even the growth of

Chart 26 Annual monetary aggregate rates



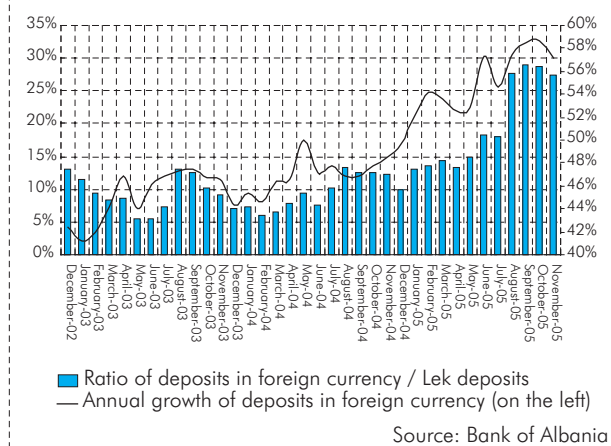
Source: Bank of Albania

Chart 27 Currency outside banks to M2 and real interest rate (on the right)



Source: Bank of Albania

Chart 28. Ratio of foreign currency deposits to lek deposits



total deposits in lek and reduction of the weight of currency outside banks to M2.

Along with the reflection of the domestic economy development dynamics, the monetary supply developments have reflected even the performance of foreign currency inflows from remittances. In absolute terms, foreign currency deposits increased by lek 16.4 billion during July – November, against the growth of lek 12.8 billion in the same period of the previous year¹³. Their performance was impacted by foreign currency inflows from emigrants and by narrowing the interest rates between the lek and the foreign currencies, euro and usd. Rise of interest rates of the euro and the usd by respective central banks has brought about the narrowing of interest rate spread, influencing the way of investing foreign currency inflows. However, under the conditions of

a balanced policy of the Bank of Albania to interventions in foreign exchange markets and the exchange rate stability, the growth of foreign currency deposits may be a reflection of a higher supply of remittances in this year, compared to the previous year. The ratio of foreign currency deposits to money supply reached to 26.9 percent in November, against 25.1 percent marked in June of this year. Also, the ratio of foreign currency deposits to lek deposits was increased from 50.4 percent in June to 55.7 percent in November. Growth of foreign currency deposits in the banking system influences positively in facing the economy needs for foreign currency credit.

Table 19 Monetary indicators performance in July-November (in billion lek)

	November	5-month spread		Annual spread	
	2005	Absolute	Percentage	Absolute	Percentage
Currency outside banks	139.7	3.8	2.8	10.8	8.4
Total deposits	426.3	20.3	5.0	60.1	16.4
- in lek	273.9	3.9	1.4	24.8	10.0
- in foreign currency	152.4	16.4	12.1	35.2	30.0
Demand deposits	113.5	23.0	25.4	42.7	60.3
- in lek	59.9	18.9	46.0	34.8	138.7
- in foreign currency	53.6	4.1	8.3	7.9	17.3
Time deposits	305.7	-10.0	-3.1	20.2	7.1
- in lek	209.1	-20.0	-8.7	-7.0	-3.2
- in foreign currency	96.5	10.0	11.6	27.2	39.3
M1	200.4	23.5	13.3	46.4	30.1
M2	409.5	3.7	0.9	39.4	10.6
M3	559.6	17.8	3.3	74.5	15.4
Base money	183.9	3.4	1.9	13.5	7.9

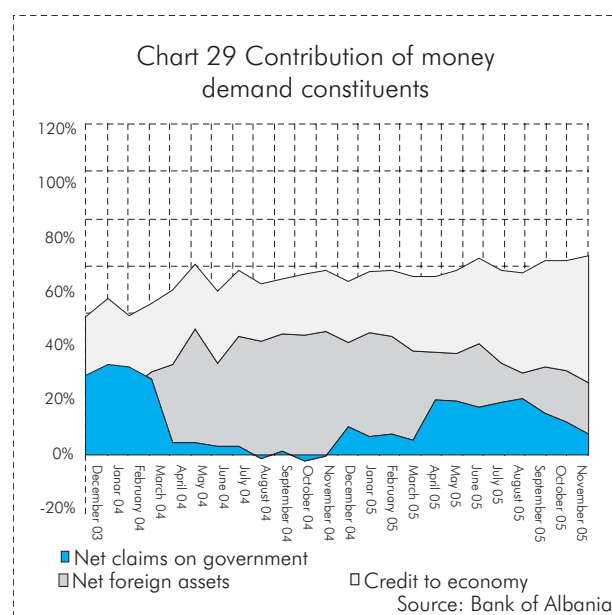
Source: Bank of Albania

IV.3 DEMAND FOR MONETARY ASSETS

Year 2005 has marked a positive moment for the performance of monetary indicators. During this period the credit to the economy has been the main

source of funds use and monetary expansion, preventing the budget deficit financing from this role. In the meantime, the foreign component of money supply growth, net foreign assets of the banking system, has maintained a steady level in relation to M3.

Banking system credit portfolio for the economy has been increased by Lek 18.7 billion during July – November 2005. At end of November, credit to the economy reached to Lek 114.6 billion, constituting 13.7 per cent of the 2005 GDP. Within 5 last months of the year, the ratio of credit to GDP has been increased by 2.5 percentage points¹⁴. During July – November 2005, credit has continued to present very high annual growth rates, with an average of 70 percent.



	2003	2004		2005		
		Semester I	Semester II	Semester I	October	November
Money supply (in billion lek)	448.4	458.2	507.2	541.8	567.4	566.0
Domestic demand (in % to M3)	71.5	69.5	68.9	69.9	69.0	69.5
Credit to government (in % to M3)	60.2	57.1	55.1	52.2	49.6	49.2
Credit to economy (in % to M3)	11.3	12.4	13.8	17.7	19.4	20.2
Credit to economy (% to total assets)	13.7	14.6	16.9	20.8	22.9	23.5
Credit to economy (in % to GDP)	6.8	7.4	9.0	11.2	13.2	13.7
Credit/deposit ratio (in %)	15.7	16.7	19.0	23.6	25.8	26.9

Source: Bank of Albania

Table 20 Performance of essential indicators

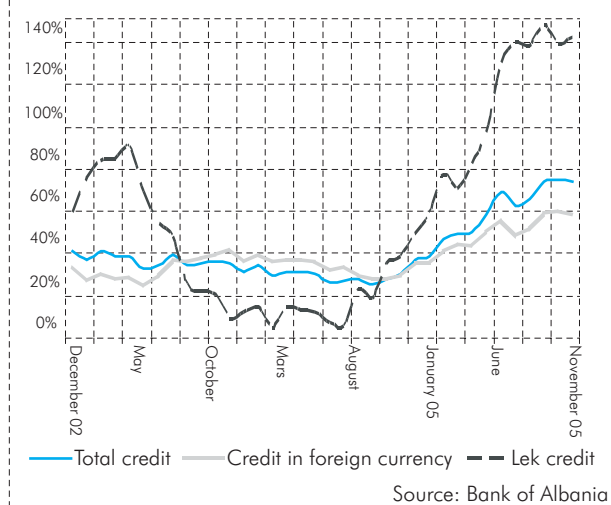
Banks' increasing commitment to long-term maturity credit has impacted on the reduction of the weight the short term credit occupies to total credit, compared to the first half of the year. This tendency has positively influenced on increasing the outstanding credit.

	2003	2004	Q-1 '05	Q-2 '05	Q-3 '05	October '05	November '05
Outstanding credit (in billion lek)	50.7	69.3	79.0	95.9	106.0	110.0	114.6
Short-term credit	46.0	34.0	34.1	33.7	31.6	31.8	32.0
Mid-term credit	33.3	36.0	34.5	33.1	31.2	31.3	31.2
Long term credit	20.7	30.0	31.4	33.1	36.9	36.9	36.8
Credit to households	24.5	30.6	31.0	30.8	31.4	31.7	32.0
Credit to private sector	75.5	69.4	69.0	69.2	68.6	68.3	68.0
In Lek	19.6	19.5	20.1	22.9	23.7	24.5	25.2
In foreign currency	80.4	80.5	79.9	77.1	76.3	75.5	74.8

Source: Bank of Albania

Table 21 Outstanding credit indicators in percentage to the total

Chart 30. Annual credit growth by currencies and in total



Growth of credit in lek has maintained the same paces as in the first half of the year, marking an average monthly growth of Lek 1.4 billion during July – November. In annual terms, the credit in lek has reflected an average growth of 142 percent during this period, compared to the average rate of 86 per cent of the first quarter. This positive development was influenced not only by the banks' increasing commitment to extend credit to households, but also by the credit in lek to businesses, which maintained high growth rates following the positive impulse of June.

Lending to the agriculture sector has had the most striking growth for July – November, indicating the biggest commitment of banks in this sector. Along the agriculture, lending to construction and real estates is also associated with a moderate growth. The growth in these sectors has balanced the reduction of the credit weight for the extracting industry and for hotels and restaurants. Meanwhile, trade continues to be the most credited sector of the economy, constituting 19.3 per cent of the total of credit at end of November.

Table 22 Credit by the economy sectors (in percentage to total)

	2003	2004		2005		
		Semester I	Semester II	Semester I	October '05	November '05
Agriculture, hunting and silviculture	1	1.5	1.5	1.5	2.51	2.44
Processing industry	17	17.1	17.1	15.6	13.8	14.58
Construction	10	9.8	9.8	11.2	12.9	12.27
Trade, repairing of vehicles and household equipments	34	23.3	23.3	19.1	18.9	19.34
Hotels and restaurants	6	8.3	8.3	4.7	4.4	4.35
Real estates	13	9.8	9.8	13.5	14.0	13.78
Other	19	30.2	30.2	34.3	33.5	33.24
Total	100	100	100	100	100	100

Source: Bank of Albania

During July – November 2005 there was extended about Lek 50 billion altogether or on average Lek 10 billion per month. Compared to the first part of the year, it is observed that banks are more committed to long-term maturity loans and to loans in lek. The new credit of November reflected a significant rise of the weight of credit to the total.

Table 23 New credit indicators (percentage to total)

	2004			2005		
	November	January-November	Total	January - June	July-November	November
New credit (in billion lek)	7.1	88.8	99.7	54.9	49.9	9.3
Short-term credit	54.0	63.3	62.5	49.6	46.6	45.8
Mid-term credit	26.9	22.4	22.5	27.5	30.1	29.5

Long-term credit	19.1	14.3	14.9	22.9	23.3	24.8
In Lek	32.6	33.3	32.6	31.7	31.9	36.0
In Foreign currency	67.4	66.7	67.4	68.3	68.1	64.0

Source: Bank of Albania

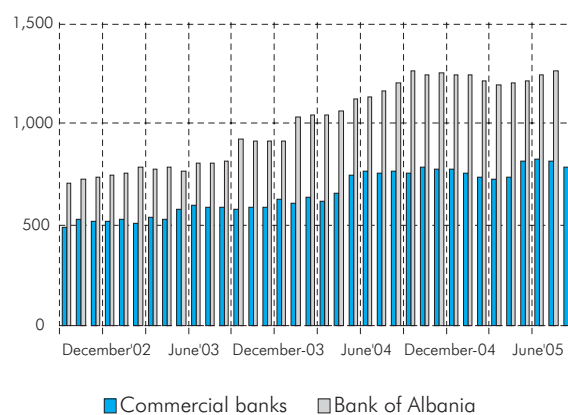
The foreign currency position of the banking system has marked further improvements during the second semester, in spite of the rapid growth of credit in foreign currency during this period. Net foreign assets of the banking system have been increased by Usd 131.7 million during July – November. Net foreign reserve of the Bank of Albania has been increased by Usd 67.0 million, whereas net foreign assets of the commercial banks have been increased by Usd 64.7 million.

Buying of foreign currency by the Bank of Albania in the foreign exchange market has been the main reason of Bank of Albania net foreign reserve growth. Reduction of foreign liabilities of commercial banks by USD 50.7 million, mainly due to reduction of demand deposits of foreign banks, has mostly assisted in the net foreign assets growth of these banks. Gross foreign assets of commercial banks have also increased, though the extension of foreign currency credit has been in higher levels than the foreign currency deposits of the banking system during the second part of the year.

Maintaining budget deficit under control has driven government's demand for money at moderate levels. During July- November 2005, the budget deficit resulted with a rise of Lek 5.1 billion, compared to Lek 12.1 billion its growth was in the same period of the previous year. A domestic financing level of Lek 15.9 billion was recorded until November, about Lek 5.4 billion more than in June. The difference of Lek 0.3 billion from the deficit financing has been entered as government's deposit with the Bank of Albania. In July and September the government was extended direct credit by the Bank of Albania, at the total amount of Lek 3.5 billion, with the purpose to prevent interest rates fluctuations to interbank market and treasury bills market. The improved banking system situation has enabled the government to return the whole amount.

The selling of two- and three- year government bonds has been the main form of domestic financing of the government's demand. Respectively Lek 8.1 billion and Lek 3.9 billion bonds have been issued during this period. On the other hand, the treasury bills portfolio has been reduced by Lek 4.3 billion during July – November. This situation is expressed in the reduction of treasury bills portfolio level. Commercial banks have decreased their portfolio by Lek 14.6 billion, whereas institutions by Lek 1 billion. Households and the Bank of Albania have marked a growth of treasury bills portfolio, respectively by Lek 8.2 billion and Lek 3.0 billion.

Chart 31. Banking system net foreign assets level



Source: Bank of Albania

IV.4 FINANCIAL MARKETS, INTEREST RATES AND EXCHANGE RATE

Chart 32 Cumulative performance of budget deficit financing (in billion lek)

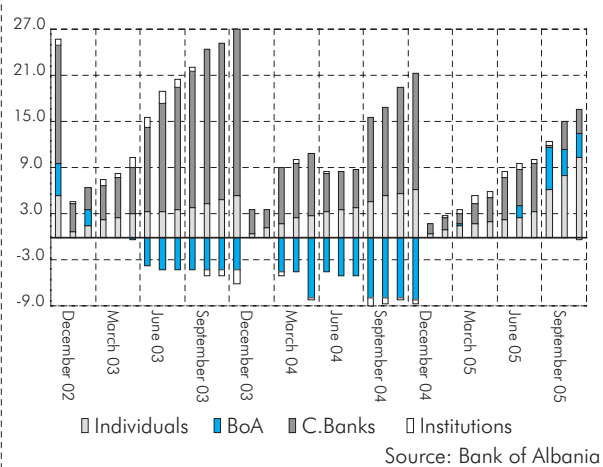
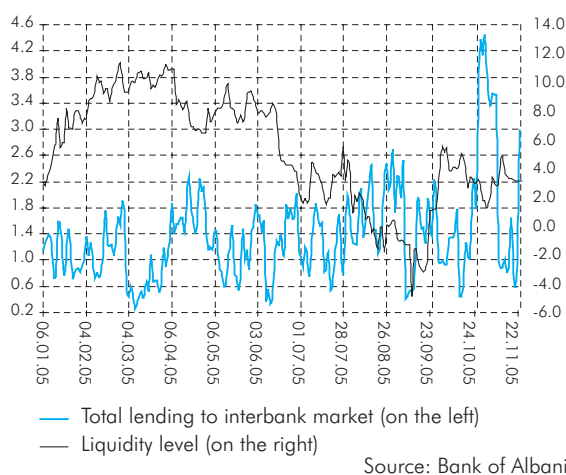


Chart 33 Daily lending to interbank market and liquidity level (in billion lek)



The average daily level of banking system liquidity marked the value of 2.3 billion in the second semester of 2005, from Lek 7.9 billion in the first semester of this year and Lek 5.2 billion in the previous year. The performance of liquidity indicator has been very fluctuating during this period. Due to growth of domestic credit, along with a slow down of the lek deposit inflow, the banking system indicated temporary lack of liquidity in the third quarter. Its daily average level decreased to Lek 1.1 billion, from Lek 7.1 billion in the previous quarter. This situation was improved and normalized in the last quarter of the year, after the Bank of Albania interventions, when the daily average level of liquidity was increased to Lek 3.7 billion.

Instruments of weekly repos and outright transactions have been used for liquidity management. Under the conditions of lack of liquidity, during the first part of the semester weekly reverse repo auctions were organized. Along with them, in order to permanently inject liquidity and regulate its structure in the market, transactions for outright purchases of the government's securities have been organized. Upon improvement of liquidity conditions in the banking system, since October, weekly repo auctions continued to be organised.

Currency market

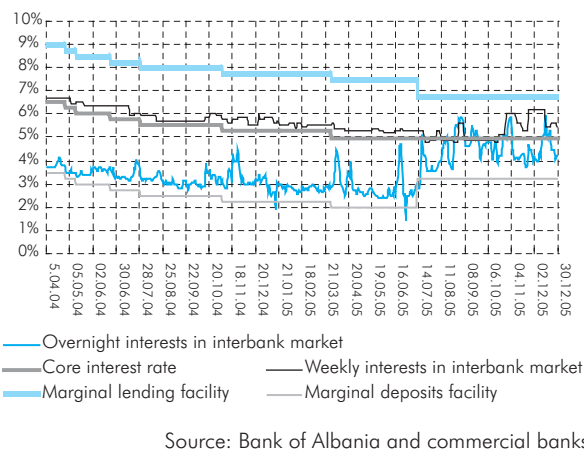
Liquidity fluctuations have been reflected in the interbank market activity and in the primary market, as well as in interest rates applied to them. The daily average volume of lending in the interbank market was increased to Lek 1.5 billion in the second semester of the year, from Lek 1.2 billion in the first semester. Extension of seven-day maturity loans has been increased, and it is almost doubled compared to first semester of the year (average daily level is increased to Lek 0.9 billion, from Lek 0.5 billion).

Average weighted interest rates of the interbank market are increased by 1.7 percentage point for overnight transactions and by 0.2 percentage point for seven-day transactions. Though a part of their growth was caused by increased demand for liquidity in the market during the third quarter, the interest rates rise in the interbank market was impacted by the defining of a symmetric and narrower corridor of interests of stand by facilities by the Bank of Albania, by ± 1.75 percent. The putting of this corridor since July 2005

brought about significant narrowing of the spread between seven-day loans interests and overnight ones and the fluctuation of overnight loan interests around key interest rate.

Lack of liquidity in the third quarter was the main factor that impacted on the interest rate rise in the primary market. The banks' supply for treasury bills, which until end of the first semester had exceeded the amount announced to be issued by the Government impacting on treasury bills reduction, did not manage to satisfy the government's demand. Treasury bills yield of a 12-month maturity reached to 9.1 percent in September, from 6.8 percent in June. Under these conditions, the Bank of Albania has supplied direct credit to the government, reducing pressures on primary market interest rates.

Chart 34 Key interest rate and response of interbank market interests



Source: Bank of Albania and commercial banks

	Interest rate December 2005	Spread Semester II, 2005	Spread Semester I, 2005
Key interest rate	5.00%	0.00	-0.25
Interbank market			
Overnight interbank market interest rate	4.20%	1.70	-0.90
Seven-day interbank market interest rate	5.46%	0.18	-0.62
Primary market			
3-month treasury bills yield	5.41%	0.35	-1.03
6-month treasury bills yield	6.90%	0.50	-0.82
12-month treasury bills yield	6.91%	0.12	-1.31
Bonds market			
2-year bonds yield	8.00%	0.40	-1.40

Table 24 Interest rates performance (in percentage point)

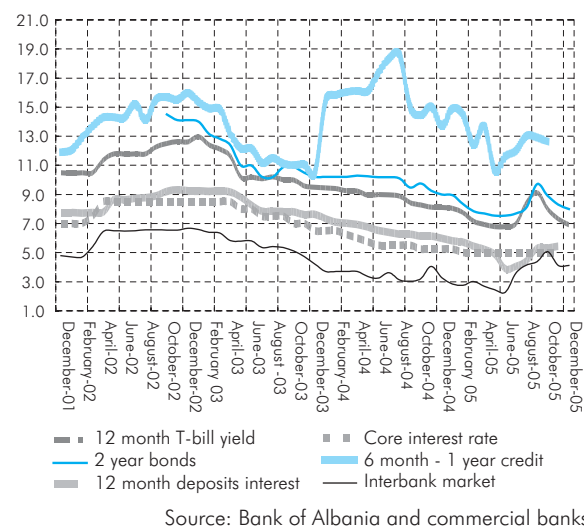
Source: Bank of Albania and commercial banks

Normalization of liquidity situation and keeping under control of the government demand brought about gradual reduction of yields during three last months. At end of December the spread between the treasury bills yield and lek deposits of one-year maturity dropped to 1.5 percentage point, from 3.8 percentage point in September.

Credit and deposit interest rates

The interest rates of lek deposits have increased, particularly in long-term maturities. This increase is mainly a correction of the large cutting of these interests during the first semester of the year. In November, the real interests of lek deposits were increased to 2.38 percent, recording the highest

Chart 35 Interest rate performance (in percentage)



Source: Bank of Albania and commercial banks

level of real interests since June of 2005. This level was influenced by the nominal interests rise and dropping of inflation. The interest rates of the foreign currency deposits market have continued to have upward trends, likewise in the first semester. During the second semester of 2005¹⁵, nominal interests of USD deposits are raised significantly for all the maturities, while the euro deposits interests, though with fluctuations, have had a moderate upward trend.

Table 25 Lek deposit interest rates (in percentage points)

	Interest rates November 2005	Spread Semester II 2005*	Spread Semester I 2005*
Key interest rate	5.00%	0.00	-0.25
Lek deposit interest rate			
1 - month	3.49%	0.38%	-0.28%
3 - month	4.17%	1.09%	-1.40%
6 - month	4.89%	1.12%	-1.64%
12 - month	5.45%	1.56%	-2.10%
24 - month	6.54%	1.93%	-2.37%

Source: Bank of Albania and commercial banks

* Latest data belong to November 2005

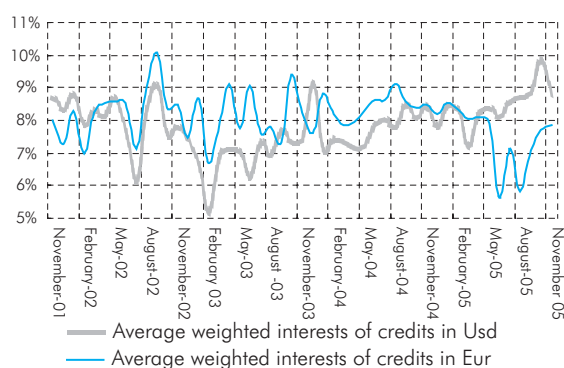
Interests have been raised in the lek credit market during the second semester of the year, excluding credits of a longer maturity than three years¹⁶. Lek credit rates are impacted by increase of the Lek deposit receipt cost and treasury bills yield rise. Simultaneously, they were impacted by the change of the lending structure from one period to another and the extension of preferential credits in some cases, with lower interests than those of the market.

Table 26 Lek credit interest rates (in percentage point)

	Interest rates November 2005	Spread Semester II 2005*	Spread Semester I 2005
Interests of credit in lek			
Up to 6-month credit	13.36%	2.74%	-0.36%
6 – 1 year credit	13.29%	1.67%	-2.11%
1-3 year credit	17.34%	0.68%	-3.76%
Over 3-year credit	8.54%	-3.82%	-0.53%

Source: Bank of Albania.

Chart 36 Average weighted interests of credits in foreign currency



Source: Bank of Albania and commercial banks
* Latest data belong to November 2005

Interest rates of credit in dollar and in euro have been increased during the second semester of 2005, in spite of fluctuations characterizing this market.

The libor and euribor interest rise in international markets, the increased cost of receiving foreign currency deposits, degree of credit risk, change of its structure from one month to another, etc, have impacted on the rise of foreign currency credit interest rates. In November the average weighted interests of credit in dollar and in euro reached respectively to 8.79 percent and 7.87 percent, with a rise of 0.69 percentage point for credits in usd and 2.24 percentage point for credits in euro.

Exchange rate

The Lek exchange rate has been relatively stable during the second semester, indicating a slow-down of the appreciating trends noticed during the first half of the year. Most of this performance is due to reduction of the lek-foreign currency interest rate spread, but also the higher demand for foreign currency intended for tourism abroad has strengthened this performance. Furthermore, the foreign currency interventions of the Bank of Albania, which are focused on the purchasing side, act in the direction of smoothing the lek appreciating trends.

Despite the Lek fluctuations during the second semester, at end of the period the lek was almost at the same levels with those of June. During this period, the lek has been appreciated by 1.1 percent against the euro and has been depreciated by 0.8 percent against the dollar. The lek exchange rates at end of December are 122.6 lek/euro and 103.6 lek/usd. In real terms, the lek continued to be appreciated against the euro, on average by 2.4 percent for the second semester. After a long appreciation period, the lek was depreciated against the dollar on average by 2.0 percent.

Chart 37 Lek exchange rate performance and NEER ¹⁷



V ALBANIAN ECONOMY IN 2006

Macroeconomic indicators of 2005 testify that the Albanian economy has had a positive performance and the macroeconomic stability has been maintained. The low and stable inflation rates during the last year, maintaining of a positive balance of payments, further financial consolidation reflected in the steady ratios of monetary aggregates, better intermediation of the economic activity by the banking system and the exchange rate, continue to ensure favourable conditions for promoting the enterprise activity in the economy.

However, macroeconomic developments during 2005 have been under the pressure of domestic factors and international ones. The electrical energy crisis the economy underwent during the last quarter of the previous year is estimated to have influenced the Albanian economy growth. The presence of these effects during this year and their magnitude are conditioned by the improvement of the electrical energy situation. Also, the oil price rise in international markets tends to have negative effects on the economic growth, transmitted even to our economy. The indirect effects of fuels price rise on production factors may be present even during 2006. Under the same conditions of the other factors, the increased production costs would be reflected in smoothing the economy demand and as a result in slowing down the economic growth rates in the future.

However, the factors that supported the economic growth will continue to exercise positive impacts. The ongoing consolidation of macroeconomic stability during recent years ensures a positive support for a sustained economic growth in 2006. Fiscal deficit reduction will enable the financing of the economy and of productive activities by the banking system. The financial intermediation of the Albanian banking system will enable the supporting of the economy with more credits, improving its financial potential. The Bank of Albania monetary policy will aim to maintain monetary conditions in economy, in compliance with its inflation target, as well as in supporting the development of financial market and in encouraging lending to the economy. The macroeconomic development trend and current conditions in financial markets support the economic growth forecast by 5 percent, in the presence of an inflation that fluctuates around the target of 3 percent for 2006.

Table 27 Main macroeconomic indicators

	2002	2003	2004	2005*	2006*
Real economy indicators (in percentage point)					
GDP growth	2.9	5.7	5.9	5.5	5.0
Annual CPI (average)	5.2	2.4	2.9	2.5	3.0
Nominal GDP (billion lek)	624.7	682.7	766.4	836.9	899.7
Fiscal indicators (in percentage to GDP)					
Primary deficit** (grants excluded)	-3.3	-0.5	-1.8	-1.7	-1.7
Fiscal deficit (grants included)	-6.7	-4.5	-5.1	-3.9	-4.1
Income	24.7	24.5	24.1	24.6	24.6
Expenditure	31.4	29.0	29.2	28.4	28.7
Foreign sector					
Trade deficit (million euros)	-1214	-1248	-1307	-1548	-1699
Current account deficit (% GDP)	-10.0	-8.1	-5.5	-7.0	-8.1

Source: Bank of Albania, Ministry of Finances, INSTAT.

* Figures about 2005 and 2006 are forecasts.

** Primary deficit excludes the expenditures on the government debt interest.

Fiscal sector

Fiscal indicators of 2006 testify a positive contribution of annual budget realization, in the function of maintaining macroeconomic stability of the economy. The budget expenditures are estimated at 28.7 percent of the GDP against the level of 28.4 percent in 2005. The growth of total expenditures to GDP favours the increase of capital expenditures in 5.5 percent of the GDP against the level of 5.3 percent in 2005, a development that contributes to improvement of the macroeconomic situation and the national income growth potential. The forecasting of 24.6 percent of the budget revenues to GDP for 2006 is the same with that of the previous year.

The positive impact of the 2006 budget in macroeconomic developments is reflected in maintaining the budget deficit financing to 4.1 percent of the GDP. About 65 percent of the budget deficit will be financed through the domestic borrowing. In GDP terms, the domestic financing of the deficit will be 2.6 percent. The participation of households and other private entities is forecasted to ensure the domestic borrowing financing at about Lek 11 billion, whereas the remaining part of Lek 12.8 billion will be financed by the banking system.

Monetary sector

The 2006 monetary policy and program are oriented to meeting the Bank of Albania target for maintaining inflation around 3 percent, with a tolerance band of + 1 percentage point. This will require the pursuing of a prudential monetary policy during 2006. The easing monetary policy of two last years resulted successful in maintaining inflation within the target. During nine recent months, the key interest rate in economy has remained unchanged at its historic minimum, whereas the inflation rate has tended towards the targeted band average of the previous year by 2-4 percent, since it touched the lower ceiling of this band in the first half of the year.

The Bank of Albania forecasts on the future inflation performance suggest that the annual change of consumer price index in economy is expected to fluctuate close to 3 percent. However, the influence of exogenous factors in economy and the impact of shock effects on the supply side, remain unforeseen elements, which come out in different time frames in economy. So, the direct effect of the oil price rise in two last years, has not infringed the meeting of the inflation target during this period.

The forecasted performance of money supply constitutes a sustainability factor of monetary inflows during 2006. The growth of Lek 67.6 billion of M3 in annual terms is forecasted to be concentrated mainly in the third quarter, as a result of foreign currency remittances from emigrants. The exogenous nature of foreign currency deposits growth, mainly on seasonal basis, does not reflect inflationary pressures to the economy. The effect of foreign currency remittances is expected to ensure foreign currency deposits growth by 16.5 per cent. The weight of foreign currency deposits to M3 is forecasted to grow to 27 percent. The constituents of money supply in lek, the currency outside banks and deposits in lek are expected to maintain their contribution to M2 aggregate growth. At end of 2006, the ratio of currency outside banks to M2 aggregate is forecasted to be 35.2 percent, whereas their annual growth is forecasted 9.2 percent. The moderate growth of currency outside banks enables growth of deposits in lek, by about Lek 29.1 billion or 10.6 percent in annual terms.

Credit in lek of banks to private sector will be the main source of growth of deposits in lek. Unlike historical trends, the credit in lek to private sector is forecasted to be higher than the banking system lek credit to the government. However, the growth of Lek 29.1 billion of deposits in lek, results insufficient for financing the credit in lek and the deficit by the banking system. During 2006 the Bank of Albania intervention through outright purchases of securities is forecasted at Lek 5 billion, mainly during the second half of the year. However, depending on monetary developments, the Bank of Albania will adjust the time of outright interventions in the function of maintaining the stability of liquidity position and interest rates in the banking market.

During 2006 the outstanding credit growth is forecasted to about Lek 53.0 billion or 5.9 percent of the GDP. Compared to credit performance in

2005, this forecast is about Lek 7 billion higher. Credit in domestic currency is inclined towards the growth during recent years. In absolute value the Lek credit outstanding growth is forecasted Lek 19.2 billion or 36.2 percent to total growth of credit outstanding. At end of 2006, the credit stock weight to GDP is forecasted 19.0 against the ratio of 14.1 percent at end of 2005. In ratio to money supply growth by Lek 67.6 billion, the credit outstanding growth to the economy constitutes 78 percent of this growth. This performance is in compliance with the Bank of Albania targets for further consolidation of the banking system, through increasing the commitments of financial resources of the banking system in financing the private sector of the economy.

The extension of foreign currency lending by commercial banks more than the growth of foreign currency deposits, decreases the net foreign assets of commercial banks. Credit in foreign currency to private sector is expected to grow by Lek 33.8 billion, against the growth of deposits in foreign currency by Lek 24.6 billion. Net position of foreign assets of commercial banks is forecasted to decrease by about Lek 11.6 billion. Net foreign assets of the Bank of Albania will grow by Lek 13.4 billion. Under these conditions, the net foreign assets of the banking system are forecasted to grow slightly by Lek 1.8 billion.

NOTES

¹ IMF, September 2005, World Economy Description.

² Unlike two first sectors, whose data may be regarded within the statistical standards, the figure of the third sector should be taken with some reservation because it does not express the movements that may occur during the quarters of the year (the value remains unchanged along the year). It becomes useful only at end of the year, when the results of the Questionnaire of Measuring the Standard of Living, on which it is based, come out.

³ Source: ISTAT; web site <http://www.istat.it>

⁴ Source: General Secretariat of National Statistical Service of Greece; web site: <http://www.statistics.gr>

⁵ A currency in which the importing of this input is effected.

⁶ Source: General Secretariat of National Statistical Service of Greece; <http://www.statistics.gr>

⁷ Source: ISTAT; <http://www.istat.it>

⁸ Source INSTAT, Production price index.

⁹ Source INSTAT, July Conjuncture – September 2005

¹⁰ Weight of the “Transport” group in the consumer products market is 4.8 percent.

¹¹ Treasury bills portfolio of households in July – November has been increased by about Lek 8.2 billion or about 3.5 times more than its growth in the same period of the previous year.

¹² Reduction of time deposits of the system in 2005 has been a result of automatic non-renovation of contracts of time deposits in lek from the Raiffeisen Bank, classifying them as demand deposits.

¹³ Exchange rate effect in the same period of both years is insignificant.

¹⁴ The downward reviewing of the GDP value for the year has had its own positive impact in this ratio along with credit growth.

¹⁵ More latest data are of the period until November 2005.

¹⁶ The applying of preferential credits has impacted on the cutting of interest rates of credits with a longer maturity than three years.

¹⁷ Nominal effective exchange rate of the lek. Rise of the exchange rate means strengthening of its value.