

BANK OF ALBANIA

MONETARY POLICY REPORT FOR  
THE SECOND SEMESTER OF 2006

JANUARY 2007



## MONETARY POLICY REPORT FOR THE SECOND SEMESTER OF 2006

### 1 GOVERNOR'S SPEECH

The Albanian economy has been characterized by positive development tendencies over the last years, expressed in stable growth rates, in the constant improvement of macroeconomic stability and in the gradual approximation of our economy structure to the developed economies' ones. The structural reforms and the stability of macroeconomic indicators have sustained the economic potential of the private sector by generating stable economic growth rates at the level of 5-6 per cent.

This course of development was also maintained over the second semester of 2006. According to producer and consumer indices, the performance of economy was in line with the country's economic development. The improvement of the economic situation in the Euro area and the holding back of the oil price rise have favoured the performance of the Albanian economy. Considering the third quarter developments and the trends observed over the fourth quarter, it is concluded that the situation of production continued to be satisfactory and was generally in line with the projections. Unlike the first semester developments, the fiscal balance recorded a deficit over the second semester of 2006, as a consequence of the budget expenditure acceleration. The external sector of economy displayed signs of improvement, manifested in the slight reduction of current deficit. Foreign exchange market developments have pursued the international market performance, causing the domestic macroeconomic balance not to be jeopardized.

Domestic demand has remained in proper levels to sustain the economic growth, while the seasonal growth effect of demand over the consumer prices was more moderate in December compared to the previous years. The recurrent energy supply shortages over the second half of December makes up a new occurrence. The same shortages over the first month of 2007 lay down the necessity of a complete analysis, in order to reach into reliable conclusions on the possible negative effects, be they direct or indirect. The Bank of Albania deems as necessary the taking of concrete steps in finding alternative sources of energy, in order to minimise our country's great dependence on the atmospheric conditions. The Bank of Albania believes that the chronic recurrence of similar crises would convert this issue into a permanent factor, which would as a consequence affect the production or service costs.

As far as the previous year's economic activity is concerned, based on the available statistical information, it is assessed that the performance of

production over 2006, according to the economic enterprises' sales index, was satisfactory. In annual terms, the sales' growth rate was about 11 per cent over the first nine months, being close to the average growth rate of the last five years. The data on production signal that the sector of industry is displaying great signs of recovery, observed in particular in the processing industry. The latter grew under rapid rates over 2006, recording one of the highest rates of sectoral growth, by 27 per cent, in the third quarter of the year. Trade sector continues to grow rapidly. It has constantly recorded high annual growth rates, providing at the same time the highest contribution to the growth of sales in economy. Despite the annual positive growth in the third quarter, the sector of construction displayed signs of slowdown compared to the previous years. An economic slowdown was also observed in the sector of transport, while telecommunication services and other services have recorded growth over the second semester of 2006, both in annual and quarterly terms.

Labour market recorded the same figures as in the two previous quarters over the third quarter of 2006. Unemployment rate reached 13.8 per cent, while there has been a shift of employed from the public sector to the private non-agricultural sector.

Consumer prices inflation over the second semester of 2006 was close to the Bank of Albania objective, fluctuating to the low tolerance interval. On average, consumer prices rose by 2.7 per cent over the second semester, while the average annual inflation reached 2.4 per cent. The fact that the average annual inflation has fluctuated to around 2-3 per cent in the last four years indicates that inflation has now been stabilized in constant and relaxing levels for the performance of the Albanian economy. The profile of the rise of prices over the second semester was dominated by the energy price rise. Its annual rise by 13.7 per cent was also accompanied by the rise of rent prices, in particular over September and October. "Alcoholic beverages and tobacco" group also exerted pressure on the increase of inflation, as a result of the excises rise in September. The balancing effect over this period was provided by foodstuffs, the prices of which fell over September and October and recorded low positive rates in the other months. Worth emphasizing is that the consumer price rise remains under control and close to the targeted level of the Bank of Albania, even if we would exclude the administered prices' effect.

In general, the budget deficit financing through the domestic borrowing was low over the second semester of 2006. Government demand for monetary assets has provided a controlled influence on the expansion of monetary sources. The fiscal indicators have been within the projected amounts for this period, even under revised figures. In this context, the fiscal policy has not infringed the preservation of macroeconomic balances.

Current account developments until the third quarter of 2006 indicate an intensive activity of the external sector of economy. The volume of current account transactions reached EUR 5 billion over the first nine months, which is 17 per cent higher than the same period the previous year. Current transfers,

as in the previous years, were shaped by workers' remittances. The latter represent one of the main sources of deficit financing in the trade in goods and services. Over the first nine months of 2006, they were estimated at EUR 683 million or EUR 24 million more than the same period the previous year. This mitigating tendency requires a prudent monitoring and proper measures to be taken for the generation of more stable foreign currency sources in a longer term perspective.

In response to these economic developments, the Bank of Albania has pursued a prudent monetary policy, aiming at balancing the financial incentive of economy with the need of maintaining monetary stability and controlling the inflationary pressures on economy. The economic and financial developments generated focal challenges for the formulation and implementation of monetary policy over the second semester of 2006. The inflationary pressures over this period mainly originated from the shocks of supply; however, the component of demand began to constitute an important factor in the setting of inflation rate. The latter has been ever-increasingly influenced by the banking system boomed crediting over the last three years, sustaining the increase of business investment and consumption.

In order to precede the generation of inflationary pressures and their manifestation in the expectations of economy, the Bank of Albania raised the cost of money in economy. This raise occurred in July and November and brought about the increase of the core interest rate from 5.0 to 5.5 per cent. The increase of the cost of money aimed at keeping appropriate monetary conditions for guaranteeing price stability in the long-term. The re-dimensioning of incentives for consumption and saving in economy and the reassessment of the exchange rate sustaining factors will allow the maintenance of price stability over the coming months within the parameters set out by the Bank of Albania. Moreover, the tightening of monetary conditions is in line with the monetary policy pursued by large central banks and with the increase of interest rates in the international foreign currency markets. Following the tightening signals, the interest rates in the money market have been increasing over this period.

The monetary developments in the second semester of 2006 were conditioned by the gradual growth of Government demand for monetary assets. In response, money supply growth rate increased to 12.7 per cent in November, compared to 9.7 per cent in June. However, the current rates of monetary aggregates' annual expansion are evidently lower than the rate of 17-18 per cent of the last two years. Moreover, the gradual reduction of the share of currency in circulation favours the monetization of economy, the increase of the financial intermediation level and of the banking system role.

Credit to economy remains the main contributor to the growth of monetary assets in economy. It continued to record a rapid growth over the second semester of 2006. The banking system credit portfolio to economy amounted to ALL 179.5 billion in November 2006, accounting for 28.1 per cent of the economy monetary assets. In relation to the gross domestic production, this

portfolio stands in the highest historical level of the last ten years, - 20.1 per cent.

However, the annual expansion rate of credit to economy has decreased in relative terms, declining from 67.1 per cent in June to 57.8 per cent in November. The growth rate slowdown came as a result of the high credit level for a two-year period, of some market segments satisfaction and of the Bank of Albania signalling for the tightening of regulative measures which control the portfolio quality. The Bank of Albania expects the application of this regulative set over 2007 to contribute to the control of credit expansion rate, in line with the country's macroeconomic stability in the long run.

The Bank of Albania remains an accountable and transparent institution. The legal commitment for the maintenance of price stability and the institutional motivation for boosting and developing the financial markets are at the heart of the Bank of Albania tasks. In this context, the Bank of Albania has formulated and approved its policy and operational framework for 2007, finalized in the Monetary Policy Document and the Monetary Programme for 2007. Both these documents clearly outline our strategic objectives related to the economic and financial stability in the country.

The Bank of Albania deems that the country's economic and financial development objectives for 2007 are realistic. However, they impose their prudent pursue by the responsible institutions, in particular in the field of structural reforms in economy, and a sound coordination of the macroeconomic policies.

## 2 ECONOMIC DEVELOPMENTS OVER THE SECOND SEMESTER

### 2.1 WORLD ECONOMY

World economy continued to record positive developments over the second semester of 2006. The growth impulse generated by the Asian economies, in particular from China and India, continued to be strong, while the USA economy displayed signs of economic slowdown. The economic developments in the Euro area and Japan signal an improvement of the economic situation. In a general view, it is assessed that the world economy growth will somehow slow down in the coming period; however, the growth rates will continue to remain in satisfactory levels.

The rise of the oil and by-products price has increased the inflationary pressures on most economies. However, both the direct and secondary effects were limited. The effect of the high oil price on core inflation was moderate over 2006 in most countries. The tightening monetary policy pursued by many central banks has played a key role in the prices performance. The actualization of the monetary policy tightening effects and the dropping of oil

price over fall 2006 are expected to contribute to the reduction of inflationary pressures in the coming period.

|           | GDP annual growth, Q3 | Unemployment rate | Consumer prices inflation, November 2006 |
|-----------|-----------------------|-------------------|--|
| USA       | +3.0                  | 4.5 (December)    | 2.0                                      |
| Euro area | +2.7                  | 7.6 (November)    | 1.9                                      |
| Germany   | +2.3                  | 8 (November)      | 1.5                                      |
| France    | +1.9                  | 8.6 (November)    | 1.6                                      |
| Italy     | +1.9*                 | 6.9 (June)        | 2.0                                      |
| Japan     | +1.0                  | 4.0 (November)    | 0.3                                      |

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

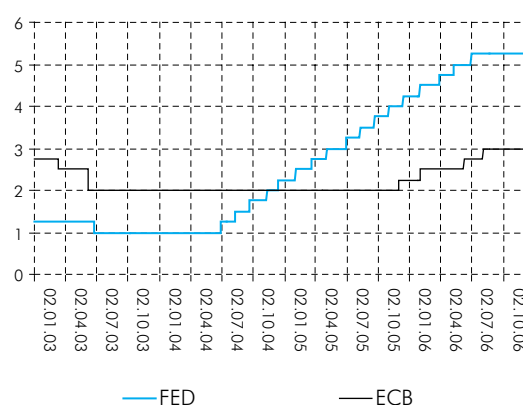
\* Second quarter

Source: Eurostat; Bureau of Economic Research; Bureau of Labour Statistics; ECB, Report for December

### Euro area Economy

According to the preliminary data provided by the Eurostat, the Euro area annual real growth for the third quarter of 2006 was 2.7 per cent. Although the growth rate was not as high as over the first semester of 2006, the economic developments are considered satisfactory and extensive. Domestic demand was the impelling force of the economic activity for the third quarter. Its contribution to annual growth marked 0.6 percentage points. The contribution of net exports, which reflects the developments in external demand, was negative. Various surveys and the industry and services confidence indices signal that the economic developments in the Euro area are assessed as stable. Despite the fact that not all the indicators have grown under the same rate, the growth rates are above their historical average.

Chart 1 Core interest rates (in percentage)



Source: European Central Bank and New York Federal Reserve, January 2007

The Euro area labour market has recorded positive developments throughout 2006. The increase of the employment rate continued to be high over the third quarter of 2006, while the unemployment rate stabilized over November to the lowest rate of the last ten years. There are positive expectations for the coming quarter, based on the projection for stable growth in employment in the short run.

Harmonized index of consumer prices inflation fluctuated to the average rate of 2.2 per cent over 2006. The developments in the oil and its by-products' price have defined the course of total inflation over most of the year. Meanwhile, production prices performance continues to show inflationary pressures, as a result of the past oil and other goods' price rise. Labour cost pressures remain limited.

In its meeting in December, the Governing Council of the ECB decided to increase the core interest rate by 0.25 percentage points to 3.5 per cent.

The Council took this decision in order to avoid upside risks to price stability over the medium term. According to the ECB, the Euro area monetary policy continues to be accommodative, with the interest rates remaining at low levels, strong credit growth and liquidity ample by all plausible measures.

### USA Economy

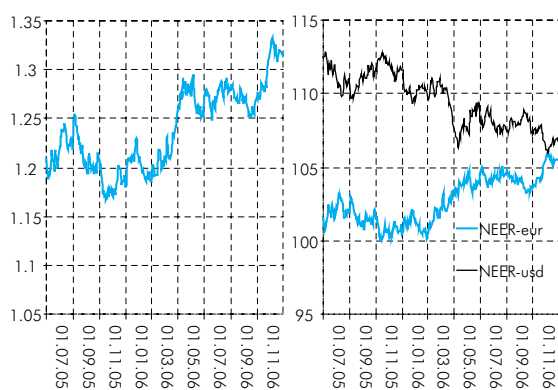
The high growth rate of the USA economy has displayed signs of slowdown over 2006. Annual real growth of gross domestic production was 3 per cent over the third quarter. This was the lowest rate recorded since the third quarter of 2003. The main reason behind this downward tendency relates to the dropping of residents' investment by about 8 per cent. The negative effect of the apartments' market is expected to be partly balanced by the growth of corporations' investment. The business situation remains sound, suggesting for a positive climate in the following periods.

After the continuous deepening over the first months of the year, trade balance deficit has been narrowing since September. In November, it amounted to USD 58.2 billion. The increase of exports and the decrease of imports supported by the oil price falling and by the limitation of the imported quantity, have contributed to the trade balance improvement.

The high level of the use of sources in the American economy may favour the inflationary pressures. However, the control of the oil price rise, the expectations for moderate inflation rates and the accumulated effect of monetary policy operations have held the domestic demand back, being reflected in a downward tendency of consumer prices inflation. After August, which recorded a peak inflation rate of 3.8 per cent in annual terms, this indicator has been marking

continuous decrease. In November, annual inflation marked 2.0 per cent. In its last meeting on 12 December 2006, the FOMC<sup>1</sup> decided to leave the core interest rate unchanged at 5.25 per cent.

Chart 2 EUR/USD exchange rate performance and nominal effective rate of the euro and the dollar for 2006



Source: European Central Bank, USA Federal Reserve

### Exchange Rate

In the last months of 2006, the Euro area currency appreciated against the USD, following some period of several months' stability in the spot exchange rate. The USD also depreciated against the British Pound and the Japanese Yen over the last months of 2006. The signals for a slowdown in the USA economic activity and for stable growth rates in the Euro area seem to have affected the international markets expectations, influencing on the depreciation of the USD against the EUR and the USA's main trade partner countries' currencies.

### Oil price

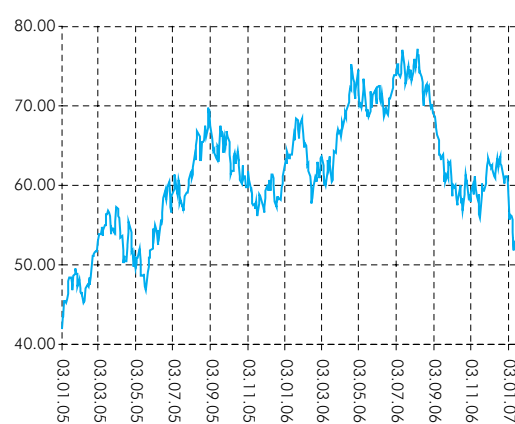
Oil price reached peak levels over summer 2006. At the beginning of August, oil price reached USD 78 per barrel. The considerable price rise came as a consequence of the panic deriving from the possible reduction of



production by the oil exporting countries following the intensified geopolitical tension over this period. Oil price has considerably fallen over the last months, mainly because some of the factors affecting the price rise over summer did neither actualize, nor had the expected effect. The high inventories level, the decrease of demand for oil and the slowdown of the American economic activity were all reflected in the decline of demand for this product. Oil price over the last two months of the year was also influenced by the favourable atmospheric conditions, leading to the reduction of demand for fuels.

However, OPEC countries have clearly indicated that they will try to keep the oil and its by-products' price in high levels. At the end of October, OPEC decided to reduce production by 1.2 million barrels per day. This is the first decision since 2003, which concludes for a reduction of production.

Chart 3 Price performance of crude oil, WTI, 2005-2006 (in USD per barrel)



Source: Bloomberg

## 2.2 ALBANIAN ECONOMY OVER THE SECOND SEMESTER OF 2006

The Albanian economy was generally characterized by positive developments over the second semester, both in the real sector and in the other sectors of economy. Economic growth is assessed to have marked satisfactory levels, while production and consumer prices have recorded a moderate growth. Unlike the first semester, fiscal balance recorded a deficit over October and November, as a result of the budget expenditure acceleration. Domestic foreign currency market recorded an appreciation of the lek against the American dollar and a stable performance of the lek against the euro. Oil price fall in the international market was reflected in the fall of domestic market oil price, though not under the same rates. The seasonal rise of consumer prices over December was manifested less than over the previous years. The influence of the aggravated energy situation over the performance of production over the end of 2006 and the beginning of 2007 is to be assessed in the future. The economic growth over 2006 was impelled by the performance of some key sectors of the economic activity, such as construction, industry and services.

Table 2 Economic growth by sectors of production for 2005-2006\*

|              | 2005       |          |                    | 2006       |           |                    |
|--------------|------------|----------|--------------------|------------|-----------|--------------------|
|              | Growth (%) | Share(%) | Contribution (p.p) | Growth (%) | Share (%) | Contribution (p.p) |
| Agriculture  | 2.6        | 21.9     | 0.6                | 3.0        | 21.5      | 0.6                |
| Industry     | 12.0       | 9.5      | 1.1                | 11.0       | 10.1      | 1.1                |
| Construction | 15.0       | 16.5     | 2.5                | 10.3       | 17.3      | 1.8                |
| Transport    | 7.0        | 7.8      | 0.5                | 7.0        | 8.0       | 0.6                |
| Services     | 1.9        | 44.3     | 0.8                | 2.1        | 43.1      | 0.9                |
| GDP          | 5.5        | 100.0    | 5.5                | 5.0        | 100.0     | 5.0                |

Source: Ministry of Finance and Bank of Albania estimates

\*Preliminary data

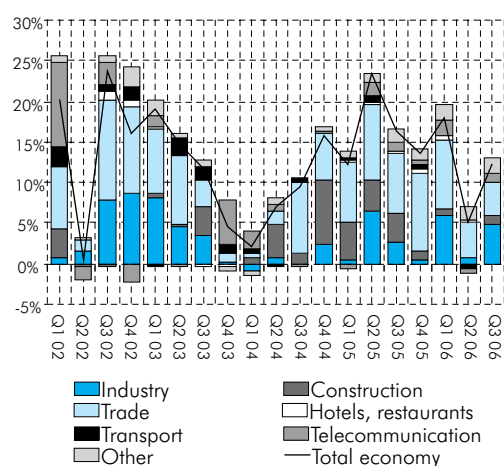
According to the sales index, the sector of industry, the sector of hotels and restaurants and other services have recorded the highest annual growth rates over the third quarter of 2006. The sector of construction and that of telecommunication have recorded positive annual growth rates over the same quarter, marking a return from the negative growth rates of the second quarter.

Table 3 Annual growth of sales in some sectors of economy<sup>3</sup> (in percentage)

|                            | Q1 - 06 | Q2 - 06 | Q3 - 06 | Share | Contribution |
|----------------------------|---------|---------|---------|-------|--------------|
| Industry                   | 22.9    | 3.4     | 19.9    | 24.5  | 4.6          |
| Extracting industry        | 34.2    | 5.8     | 28.4    | 2.1   | 0.5          |
| Processing industry        | 24.3    | 7.2     | 26.6    | 17.4  | 4.1          |
| Electricity, water and gas | 17.7    | -7.5    | -1.3    | 5.0   | -0.1         |
| Construction               | 5.8     | -1.1    | 6.8     | 14.2  | 1.0          |
| Trade                      | 17.4    | 9.5     | 9.5     | 44.5  | 4.3          |
| Hotels and restaurants     | 48.0    | 33.4    | 17.4    | 0.7   | 0.1          |
| Transport                  | -2.3    | -16.9   | -3.7    | 3.0   | -0.1         |
| Telecommunication          | 21.4    | -7.2    | 11.4    | 7.3   | 0.8          |
| Other services             | 31.7    | 26.3    | 33.6    | 5.7   | 1.6          |
| Total economy              | 17.9    | 5.1     | 12.4    | 100   | 12.4         |

Source: INSTAT, Economy sales index, Bank of Albania estimates

Chart 4 Contribution of sectors to the sales of economy (in percentage points)



Source: INSTAT, Sales index, Q1 2006

The general economic enterprises sales index had an annual growth of 12.4 per cent over the third quarter, which is higher than the previous quarter, but lower than the average annual growth level since the early 2005.

Based on the performance of some domestic demand and investment indicators, it is assessed that by the end of the third quarter of 2006, demand remained in satisfactory levels, while investment recorded low levels.

Table 4 Performance of some indicators of domestic demand and investment over the third quarter of 2006

| Item                              | Annual change (in %) | Quarterly change (in %) |
|-----------------------------------|----------------------|-------------------------|
| Fuels consumption                 | 57                   | 51                      |
| Import of vehicles                | 37                   | 77                      |
| Import of TVs                     | 131                  | 36                      |
| Import of washing machines        | 10                   | 27                      |
| Import of machinery and equipment | -15                  | -11                     |
| Cement consumption                | 3                    | 19                      |

Source: INSTAT, Conjecture, third quarter, 2006

### 2.2.1 Performance of economy by sectors

#### Sector of industry and electricity

Following the slowdown in the second quarter of 2006, the activity of the sector of industry grew by 20 per cent in the third quarter of the same

year, mainly as a result of the growth in the processing industry. The growth recorded in this sub-sector was pushed by the vitalization of the metallurgy and the materials processing activity over the third quarter. Processing industry has recorded the highest contribution of the last four years to the Albanian economy. The great performance of this industry was also accompanied by the increase in the number of employed. On the other hand, extracting industry has made a lower contribution to the general annual economic growth over the third quarter, despite the high annual growth compared to the previous quarter. The increase of sales in the sub-sector of energy, water and gas has been decreasing over 2006, making a negative contribution to the sales of economy over the third quarter by 0.3 percentage points.

Table 5 Main indicators of electricity balance sheet (in GWh)

|   | S1 '06 | July-November '05 | July-November '06 | Annual change (in %) |
|---|--------|-------------------|-------------------|----------------------|
| I. SOURCE (a+b+c-d)                     | 3,016  | 2,084             | 2,274             | 9.14                 |
| a. Domestic production                  | 3,056  | 1,759             | 1,900             | 8.00                 |
| b. Exchange balance                     | 12     | 372               | 404               | 8.43                 |
| c. Total production in distribution     | 67     | 38                | 50                | 30.24                |
| d. Loss and consumption in transmission | 120    | 86                | 79                | -7.90                |
| II. USES ( e + III )                    | 3,016  | 2,084             | 2,274             | 9.14                 |
| e. Invoiced consumption (f + g)         | 1,800  | 1,401             | 1,462             | 4.34                 |
| f. Household consumption                | 1,111  | 836               | 829               | -0.81                |
| g. Non-household consumption            | 689    | 566               | 633               | 11.94                |
| III. LOSSES (Uninvoiced consumption)    | 1,216  | 682               | 812               | 19.01                |

Source: Electricity Balance Sheet, Albanian Electro-Energy Corporation, 2006

Compared to the same period the previous year, domestic production of energy increased over July to November 2006, in contrast to the first semester of the year when it recorded a slight decrease. Invoiced consumption marked an annual increase of about 4 per cent, while the largest share of this increase is attributed to the increase of consumption by non-household consumer, by about 12 per cent. The ratio of losses to distributed energy was higher than the same quarter the previous year, but lower than the first semester of 2006. Energy exchange balance for the first five months of the second semester was positive and higher than over the first semester.

#### Sector of construction

Sales for the sector of construction were about 4 per cent higher over the first nine months of 2006 than the same period the previous year. There was a positive annual growth, although it was relatively low in the first and third quarters of 2006. The statistics on sales indicate that the performance of this sector is less positive than the one projected at the beginning of the year. The construction sales have provided only 4 per cent of the growth in the sales of economy for the nine-month period. Moreover, the cement consumption has increased under slow rates. The accomplishment of the projection for a growth of 10 per cent will strongly depend on the performance of this sector over the last quarter of 2006.

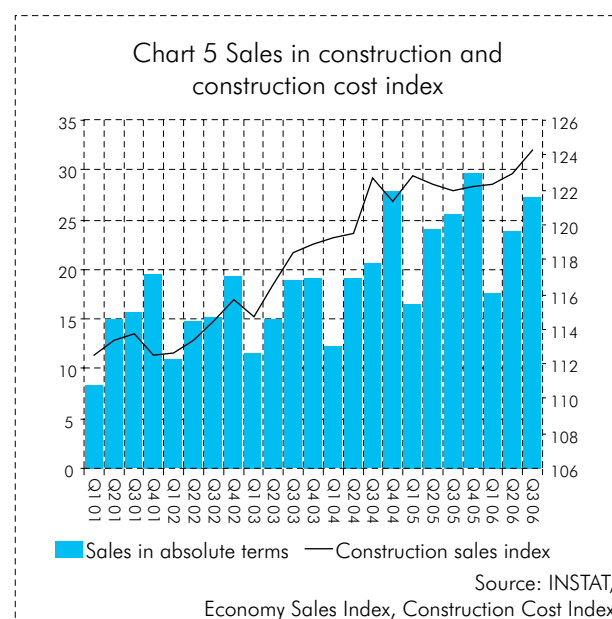


Chart 6 The projected amount of investment by construction permit

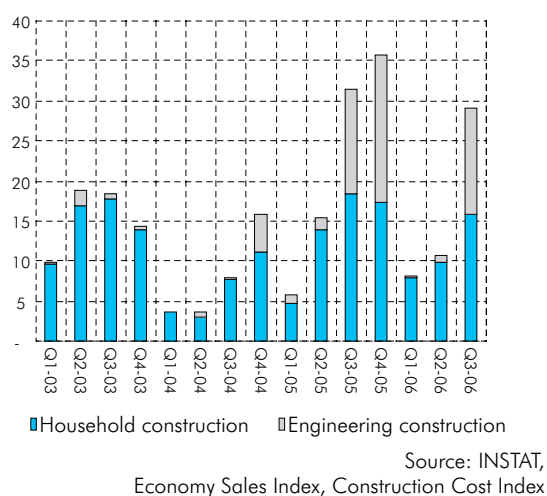


Chart 7 Annual growth of sales in the sectors of transport and telecommunication

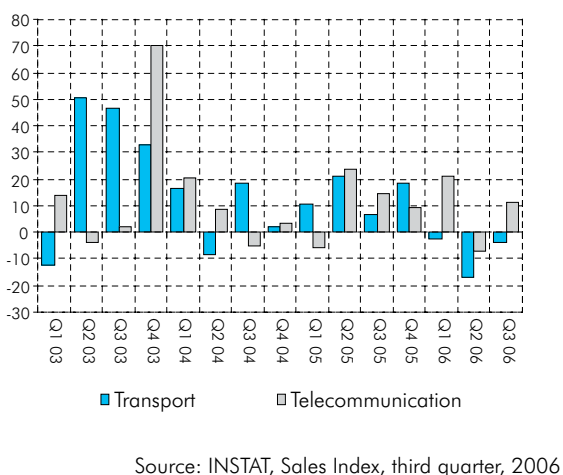
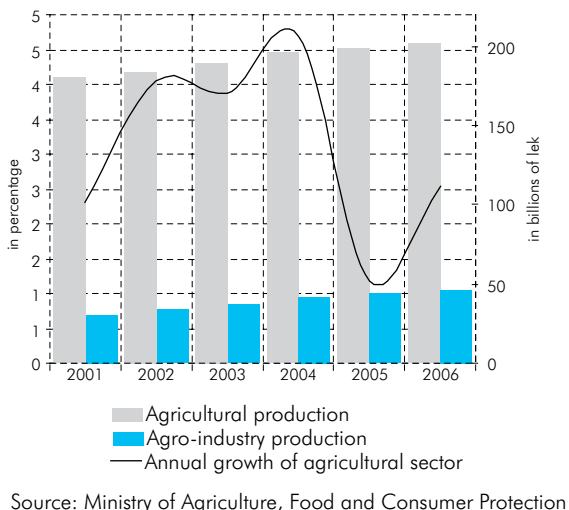


Chart 8 Performance of agricultural production and the projection of growth over 2006



With regard to the expected investment in the sector based on the construction permits statistics, over the first nine months of 2006 there has been a decrease by 3.6 per cent, in annual terms. This figure is a significant indicator for the projection of this sector's growth in the near future. There has been a considerable decrease in the number of residence construction permits by 14 per cent and an increase by 3.3 per cent in the projected amount for transport infrastructure.

*Other services*

Trade activity continued to provide a strong impetus to the performance of economy, contributing by about half of total sales over 2006. Following a considerable growth in the first semester of 2006, trade index grew by 9.5 per cent over the third quarter. The sales performance of hotels, café and restaurants was fairly positive for the third quarter of 2006. Transport and telecommunication recorded an annual growth of 6.5 per cent over the third quarter, following its economic slowdown over the second quarter. This growth is attributed to the positive performance of the sector of telecommunication, which contributed by 0.83 percentage points to the growth of sales index over the third quarter of 2006. On the other hand, the growth of this sector over 2006 was less considerable than the one recorded the previous year, despite the vitalization of transport over the third quarter.

*Sector of agriculture*

According to the projections of the Ministry of Agriculture, Food and Consumer Protection, production in the sector of agriculture is expected to grow by 2.55 per cent over 2006. The lack of final data on production impedes the analysis of its performance. Agro industrial production, which shares about 20 per cent of total agricultural production, is projected to grow by about 6 per cent, while agricultural production by about 1.8 per cent. Agro industry has marked positive developments over the first nine-month period of 2006, recording an annual growth of 9 per cent, despite the slowdown observed over the third quarter of the year. The performance of agricultural production remains to be assessed in the following months.

The growth of agro industrial production over the third quarter of 2006, in particular the processing of fruit and vegetables, has influenced on the increase

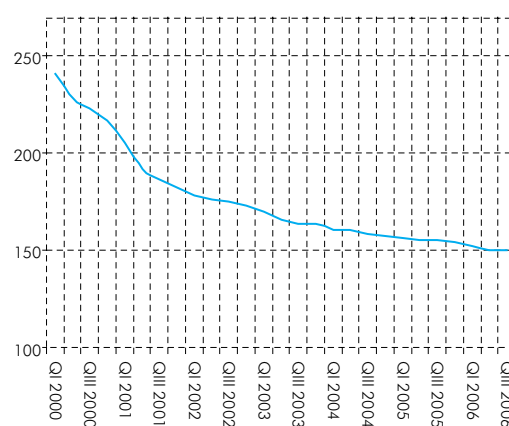
of their exports by 54 per cent, compared to the same quarter the previous year. On the other hand, the imports of this group have increased only by 15 per cent. The progress in the ratio of agricultural exports to imports over the third quarter reflects the growth of agricultural production over this part of the year.

### 2.2.2 Labour market

Labour market over the third quarter of 2006 confirms the revival of the economic activity for this period. The positive developments over this quarter, mainly observed in the sectors of trade, processing industry and construction, added to the mitigation of unemployment. The decrease in the number of unemployed over this period does not entirely correspond with the increase recorded in the number of employed, suggesting that part of the labour supply occurred out of the formal labour market.

The structure of employment over the first three quarters of 2006 was presented similar to the previous year structure. Unemployment rate has been decreasing over the quarters, recording 13.8 per cent in the third quarter, which is the lowest historical rate of the last nine years. At the end September 2006, labour force totalled about 2 thousand people fewer than at the end of the third quarter 2005. Moreover, the total number of employed increased by only about 3 thousand people, while the number of people recorded as unemployed has decreased by about 5 thousand. Over a time-span of a year, public sector labour force has decreased by about 5 thousand people, while the private non-agricultural sector has recorded an increase of the number of employed by about 8 thousand people.

Chart 9 Number of unemployed over the last five years (in thousand of people)



Source: INSTAT, Conjecture, third quarter 2006

According to the latest data provided by the Ministry of Labour, Social Affairs and Equal Opportunities, the number of unemployed registered in the labour offices by November 2006, was 149.6 thousand people or 2.8 per cent lower than the number recorded at the end 2005. An evident characteristic of the labour market is the fact that long-term unemployed share about 70 per cent of total unemployed in economy.

|  | 2005  |       |       |       | 2006  |       |       |
|--|-------|-------|-------|-------|-------|-------|-------|
|  | Q1    | Q2    | Q3    | Q4    | Q1    | Q2    | Q3    |
| Total labour force                     | 1,087 | 1,086 | 1,086 | 1,086 | 1,083 | 1,081 | 1,084 |
| A. Total employed                      | 931   | 931   | 931   | 932   | 931   | 931   | 934   |
| i) in the public sector                | 176   | 176   | 176   | 175   | 174   | 172   | 171   |
| ii) in private non-agricultural sector | 213   | 213   | 214   | 215   | 215   | 217   | 222   |
| iii) in private agricultural sector    | 542   | 542   | 542   | 542   | 542   | 542   | 542   |
| B. Unemployment                        |       |       |       |       |       |       |       |
| i) Total unemployed                    | 156   | 155   | 155   | 154   | 152   | 150   | 150   |
| ii) Unemployment rate (in percentage)  | 14.3  | 14.3  | 14.2  | 14.2  | 14.0  | 13.9  | 13.8  |

Source: INSTAT, September 2006

Table 6 Labour market indicators (in thousand of people)

## 2.2.3 Fiscal sector

Fiscal indicators have generally been close to the level projected in the supplementary budget over January to November 2006. The most considerable deviation in the fiscal indicators is observed in the budget deficit, resulting from the non-realization of expenditure plan. According to the data provided by the Ministry of Finance, over the first 11 months of 2006 were collected 97.8 per cent of projected revenues and carried out about 92.6 per cent of projected expenditure. As a consequence, budget deficit by the end November was about ALL 1.5 billion from the projected ALL 13.2 billion. Total revenues for January to November 2006, reached the highest level in the last seven years in relation to the Gross Domestic Production. Meanwhile, budget deficit has been characterized by a downward trend over the recent years, proceeded over 2006 as well.

Table 7 Main fiscal indicators as a share to GDP (in percentage)

|                     | 11M-99 | 11M-00 | 11M-01 | 11M-02 | 11M-03 | 11M-04 | 11M-05 | 11M-06 |
|---------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| Total revenues      | 20.2   | 20.7   | 19.7   | 21.2   | 22.0   | 21.8   | 21.7   | 24.4   |
| Tax revenues        | 12.6   | 14.5   | 13.3   | 14.8   | 19.5   | 19.7   | 19.6   | 22.2   |
| Total expenditure   | 29.5   | 27.7   | 25.5   | 26.3   | 25.8   | 25.1   | 23.7   | 24.5   |
| Current expenditure | 24.3   | 22.4   | 19.8   | 21.6   | 22.1   | 21.2   | 20.3   | 20.5   |
| Capital expenditure | 5.2    | 5.1    | 5.5    | 4.7    | 3.7    | 3.9    | 3.4    | 4.0    |
| Deficit             | (9.4)  | (6.9)  | (5.9)  | (5.1)  | (3.8)  | (3.3)  | (2.0)  | (0.2)  |
| Domestic financing  | 3.8    | 4.2    | 3.2    | 2.2    | 2.9    | 2.6    | 1.4    | (0.7)  |
| Foreign financing   | 5.6    | 2.7    | 2.6    | 2.9    | 0.9    | 0.7    | 0.5    | 0.9    |

Source: Ministry of Finance and Bank of Albania statistics

Compared to the same period the previous year, revenues and expenditure have increased by 12 and 3.5 per cent, respectively. Over the first months of 2006 was observed a considerable contraction of expenditure. This period was accompanied by their gradual acceleration over the following months. Budget deficit was until November mainly covered by foreign financing. The latter was carried out at 164 per cent of the projection<sup>4</sup>.

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

|                             | 11M-00 | 11M-01 | 11M-02 | 11M-03 | 11M-04 | 11M-05 | 11M-06  | Average 99-05 |
|-----------------------------|--------|--------|--------|--------|--------|--------|---------|---------------|
| Total revenues              | 14.3   | 5.7    | 15.7   | 12.8   | 11.3   | 9.3    | 12.0    | 12.1          |
| Tax revenues                | 28.8   | 1.8    | 19.7   | 43.2   | 13.2   | 9.0    | 14.4    | 18.5          |
| Local government revenues   | 57.9   | 39.7   | 32.0   | 252.1  | 13.3   | 16.0   | (6.5)   | 60.7          |
| Independent budget revenues | 10.7   | 3.3    | 23.1   | 11.5   | 12.7   | 10.6   | 10.2    | 12.4          |
| Non-tax revenues            | (26.2) | 29.5   | (9.3)  | (6.6)  | (10.4) | (6.7)  | (2.1)   | (1.5)         |
| Total expenditure           | 4.3    | 2.7    | 10.4   | 6.8    | 9.1    | 3.7    | 3.5     | 7.5           |
| Current expenditure         | 3.0    | (1.9)  | 17.1   | 11.5   | 7.4    | 5.0    | 1.3     | 7.4           |
| Capital expenditure         | 9.1    | 21.1   | (8.6)  | (15.1) | 19.9   | (3.7)  | 16.6    | 10.4          |
| Deficit                     | (17.4) | (6.0)  | (7.1)  | (18.6) | (3.3)  | (34.2) | (91.0)  | (10.1)        |
| Domestic financing          | 24.9   | (14.7) | (27.7) | 43.5   | 1.3    | (39.1) | (148.5) | (3.0)         |
| Foreign financing           | (45.9) | 7.5    | 18.1   | (65.3) | (17.8) | (15.6) | 68.5    | (10.8)        |

Source: Ministry of Finance

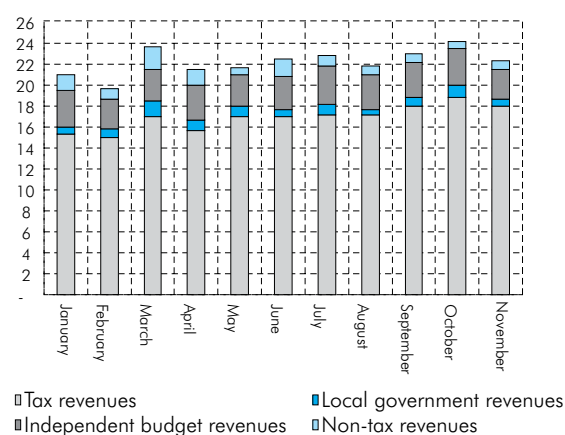
*Budget revenues*

Budget revenues, over January to November 2006, were about 12 per cent higher compared to the same period the previous year. The level of tax revenues at the end November amounted to about ALL 186 billion, out of

which tax collected by the customs totalled about ALL 12.9 billion, realizing the projected budget level by 99.2 and 99.6 per cent, respectively. Among the main indicators of tax revenues, it is observed that revenues from the independent budget have increased by 10.2 per cent compared to the same period over 2005, realizing the budget plan at 103.6 per cent. While, revenues from the local government and non-tax revenues decreased by 6.5 and 2.1 per cent, respectively, compared to the previous year.

Tax revenues continue to constitute the main source of budget revenues, accounting for about 92 per cent of total revenues. Tax on profit revenues, value added tax revenues and excises revenues provided the main contribution to the realization of tax plan. Compared to the same period the previous year, they increased by 20.4, 14.9 and 23.5 per cent, respectively. Tax on personal income and customs tax provided 13.9 and 6.2 per cent, respectively, more than over 2005. Meanwhile, non-tax revenues decreased by 2.1 per cent, realizing 86 per cent of the projection for this period.

Chart 10 Structure of budget revenues  
(in billions of ALL)



Source: Ministry of Finance, June 2006

Table 9 Main indicators of budget revenues (in billions of ALL, progressive data)

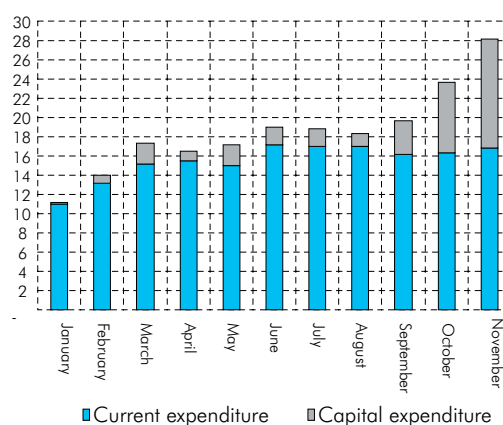
|                             | July  | August | September | October | November | 11 M Plan, in % | Annual plan, in % |
|-----------------------------|-------|--------|-----------|---------|----------|-----------------|-------------------|
| Total revenues              | 125.2 | 143.4  | 162.3     | 182.1   | 202.5    | 97.8            | 88.1              |
| Tax revenues                | 114.0 | 131.2  | 149.2     | 168.1   | 186.1    | 99.2            | 89.7              |
| Value added tax             | 39.3  | 45.7   | 52.4      | 59.6    | 67.1     | 98.5            | 88.3              |
| Tax on profit               | 13.2  | 14.9   | 16.7      | 18.6    | 20.5     | 106.0           | 97.8              |
| Excises                     | 11.8  | 14.2   | 16.5      | 18.7    | 20.9     | 97.5            | 86.5              |
| Tax on personal income      | 4.5   | 5.2    | 5.8       | 6.6     | 7.3      | 91.3            | 81.0              |
| Customs duties              | 8.2   | 9.3    | 10.5      | 11.7    | 12.9     | 99.6            | 91.1              |
| Local government revenues   | 6.7   | 7.2    | 8.1       | 9.2     | 9.9      | 96.7            | 89.2              |
| Independent budget revenues | 22.7  | 25.9   | 29.2      | 32.7    | 35.5     | 103.6           | 95.1              |
| Non-tax revenues            | 9.3   | 10.2   | 11.0      | 11.8    | 12.6     | 85.9            | 76.1              |

Source: Ministry of Finance, November 2006

### Budget expenditure

Budget expenditure for January to November 2006 amounted to ALL 203.9 billion, which is 3.5 per cent higher than over 2005. The growth rate of budget expenditure for this period was nearly half the average growth of the last seven years. Personnel expenditure, which account for about 29 per cent of current expenditure, were realized at 96 per cent. Current expenditures were concentrated in personnel expenditure, social insurance expenditure and local budget expenditure. These items have recorded an annual growth of 5.2, 7.7 and 4.4 per cent, respectively.

Chart 11 Structure of budget expenditure  
(in billions of ALL)



Source: Ministry of Finance, June 2006



Capital expenditure continues to be realized below the level projected in the revised budget. For the first 11 months of the year, they were realized at 86.9 per cent. About 66 per cent of capital investment, totalling ALL 33.4 billion, was carried out over the last three months of the period. As far as expenditure financing is concerned, those covered by foreign and domestic financing were carried out at 98.2 and 81.7 per cent, respectively.

Table 10 Composition of current expenditure (in billions of ALL)

|  | July | August | September | October | November | 11 M Plan, in % | Annual plan, in % |
|--|------|--------|-----------|---------|----------|-----------------|-------------------|
| TOTAL EXPENDITURE                              | 114  | 133    | 152       | 176     | 204      | 92.6            | 76.4              |
| Current expenditure                            | 104  | 121    | 137       | 154     | 171      | 94.1            | 83.5              |
| Personnel                                      | 30   | 35     | 39        | 44      | 49       | 96.1            | 83.0              |
| Interests                                      | 15   | 18     | 19        | 21      | 23       | 94.3            | 91.9              |
| Domestic                                       | 14   | 16     | 18        | 20      | 22       | 96.9            | 94.2              |
| Foreign  | 1    | 1      | 1         | 1       | 2        | 70.2            | 70.2              |
| Operative maintenance expenditure              | 11   | 12     | 13        | 15      | 17       | 89.6            | 80.2              |
| Social insurance expenditure and other related | 33   | 38     | 43        | 48      | 53       | 97.2            | 88.0              |
| Local budget expenditure                       | 9    | 11     | 13        | 15      | 17       | 92.2            | 73.7              |
| Other expenditure                              | 6    | 6      | 7         | 8       | 9        | 82.5            | 73.6              |
| Capital expenditure                            | 10   | 11     | 15        | 22      | 33       | 86.9            | 58.3              |
| Domestic financing                             | 7    | 8      | 11        | 18      | 21       | 81.7            | 57.8              |
| Foreign financing                              | 3    | 3      | 4         | 5       | 12       | 98.2            | 59.3              |

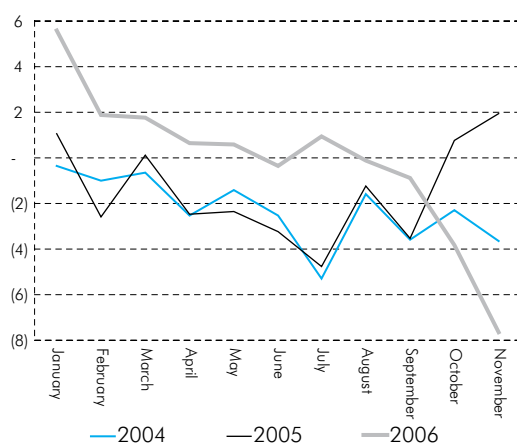
Source: Ministry of Finance, November 2006

### Fiscal balance

Fiscal deficit over January to November 2006 was nearly as much as 11.8 per cent of planned deficit. The sluggish performance of expenditure and the satisfactory growth of revenues caused the deficit to record the highest decrease in the last eight years. As far as distribution of deficit over 2006 is concerned, it is observed that the period over October and November recorded the highest level of deficit by ALL 11.5 billion, while the first quarter resulted in a surplus of ALL 9.2 billion. It is observed that the government

budget has by October resulted in a surplus of ALL 6.2 billion. This situation improved over November, causing the fiscal balance to result in a deficit of ALL 1.5 billion for the first time over 2006. The accomplishment of this objective was accompanied by the rapid increase of expenditure in the last two months of the year.

Chart 12 Monthly budget deficit in 2004, 2005, 2006 (in billions of ALL)



Source: Ministry of Finance, June 2006

### 2.2.4 External sector of economy

Current account developments until the third quarter 2006 indicate an intensive activity of the external sector of economy. The volume of current account transactions over the first nine months of the year amounted to EUR 5 billion, which is 17 per cent higher than the volume amounted over the

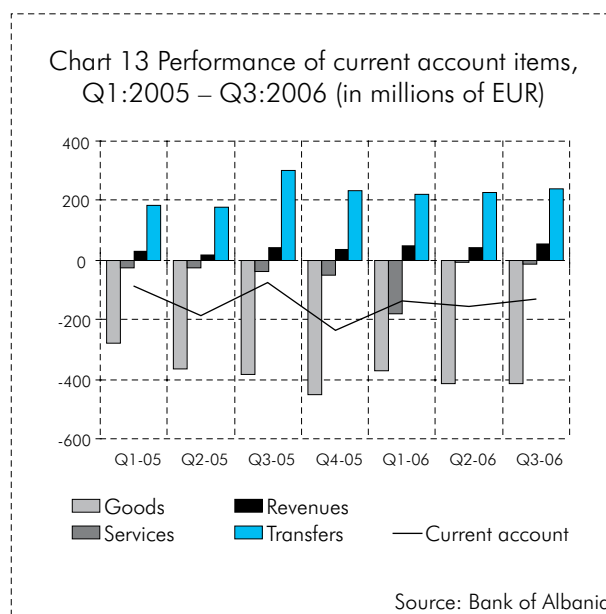


same period the previous year. Current account deficit deepened by about 15 per cent compared to the previous year. The deepening of deficit in the trade in goods, as a result of the higher increase of imports as opposed to the increase of exports, affected the aggravation of the current account balance. However, the negative influence of the trade balance was offset by the positive developments in all the other items of current account.

The third quarter of 2006, as opposed to the third quarter of 2005, recorded a current deficit of about 74 per cent higher. The decrease of the current transfers' inflows provided the main influence on the aggravation of current deficit. Goods, services and revenues' account recorded in the third quarter a deficit of almost as high as the one recorded in the third quarter of 2005, which equals EUR 375 million. Compared to the same period the previous year, the deficit on the trade in goods deepened by about 8.5 per cent; the deficit on the trade in services reduced by about 60 per cent; while the surplus recorded in the item of revenues was about 28 per cent higher.

Over the first nine months of 2006, the lek displayed a slight downward tendency against the three currencies of our five main trade partners<sup>5</sup>. The depreciation fluctuated around the level of 1-2 per cent. As a consequence, the influence on the performance of foreign trade is assessed to have been limited.

Over January to September 2006, the Albanian economy was developed dynamically. This performance was also observed in the advanced trade relationships with the rest of the world. By the end September, the exports of goods increased by 16 per cent, while the imports increased by 17 per cent compared to the previous year, causing the deficit on the account of goods to amount about EUR 1.2 billion. The high growth rate and the wide range of imported products reflect the orientation of the domestic market towards the foreign production.

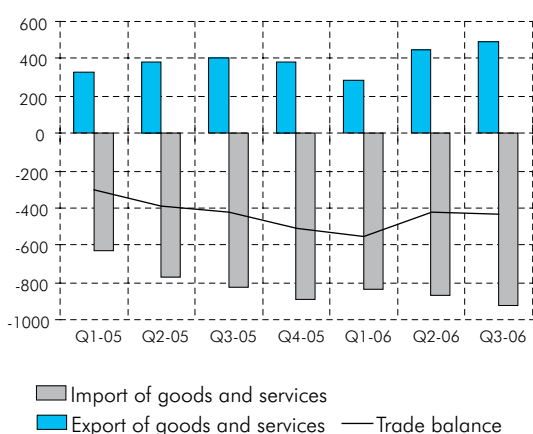


The most required commodity groups from the domestic market relate to the final consumption, foodstuffs, intermediate consumption, mineral products, chemical industry, plastic, base materials, as well as to the machinery and appliances item, which reflect the performance of capital investment in economy. The import of textiles and leather, which is related to the performance of re-export production, has increased under steady rates. This development has been reflected in the constant increase of exports upon orderer's material. Worth mentioning are the positive developments in vegetable products and prepared foodstuffs, in particular over the third quarter. This group has not only recorded a decrease in the import growth rate, but also an increase of exports by about 20 per cent, over the period

when domestic agricultural production recorded the highest levels. A stable growth has been also recorded in the exports of mineral products and of base metals.

Year 2006 did not mark evident changes in the distribution structure of imports and exports of goods by countries of origin and destination. European Union countries continue to constitute the most significant group of trade partners. Other important trade partners, apart for Italy and Greece, are Turkey, Ukraine, Russia, China and South Korea. Trade with the regional countries shares about 8 per cent of total volume of trade in goods for this period.

Chart 14 Trade balance of goods and services, Q1:2005 – Q3:2006 (in millions of EUR)



Source: Bank of Albania

Over the first nine months of 2006, the developments in the balance of services are considered as satisfactory, since they have had a positive influence on the reduction of current account deficit. Both the imports and exports of services have increased under high rates. At the end of the period, trade in services deficit was about EUR 64 million or 26 per cent lower than the first nine months' deficit of 2005. The higher growth rate of exports of transport services and other services, compared to the increase of imports, provided the main influence on the reduction of deficit on this account. Personal travels are one of the main items of services account, which to a large extent, displays the performance of tourism in and out of the country. The available data indicate that there has been a slowdown in the activity of tourism in the country for 2006. Over July to September, which represents the main period

of tourism in Albania, non-residents have spent about EUR 221 million or about 12 per cent more than over the previous year. Meanwhile, for the same period, residents have spent EUR 216 million abroad or 20 per cent more than the previous year.

Current revenues account continued to record a positive balance over the first three quarters of 2006. In September, this account recorded a surplus of about EUR 159 million, or about 73 per cent higher than the previous year. The increase in revenues has been a consequence of the increase of revenues from the compensation of seasonal workers, and of the increase of interests from the portfolio investment and the foreign reserve. In September, the surplus in current transfers account amounted to EUR 690 million, which is about 4 per cent higher than the net flow of transfers over the same period the previous year. Workers' remittances, the main item in this account, grew by 17 per cent, amounting to EUR 683 million. The decrease of remittances over the third quarter may be a temporary occurrence. They have covered about 54 per cent of trade in goods and services deficit.

Table 11 Main items in the current account (in millions of EUR)

|                              | July    | August  | September | Q3-06  | Q3-05  | 9M-06   | 9M-05   |
|------------------------------|---------|---------|-----------|--------|--------|---------|---------|
| Current account              | - 30.2  | - 28.6  | - 70.7    | -129.4 | -76.8  | -410.6  | -355.5  |
| Goods, services and revenues | -110.9  | - 109.3 | - 150.8   | -371.0 | -377.3 | -1100.0 | -1017.9 |
| Goods                        | - 133.5 | - 143.5 | - 138.2   | -415.3 | -382.3 | -1200.0 | -1022.7 |
| Exports                      | 59.3    | 37.0    | 56.9      | 153.2  | 133.7  | 463.3   | 398.5   |
| Imports                      | - 192.8 | - 180.5 | - 195.2   | -568.5 | -516.1 | -1663.2 | -1421.3 |
| Services                     | - 1.1   | 17.5    | - 31.4    | -15.1  | -39.0  | -60.7   | -87.0   |
| Exports                      | 112.3   | 135.5   | 89.1      | 337.0  | 270.8  | 895.5   | 714.1   |
| Imports                      | -113.5  | -118.1  | -120.5    | -352.0 | -309.9 | -956.2  | -801.1  |
| Revenues                     | 23.7    | 16.7    | 18.9      | 56.3   | 44.1   | 158.5   | 91.8    |
| Current transfers            | 80.8    | 80.7    | 80.1      | 241.6  | 300.5  | 689.5   | 662.4   |
| Remittances                  | 79.2    | 79.2    | 79.2      | 237.7  | 259.5  | 689.5   | 582.6   |

Source: Bank of Albania, Statistics Department

### 3 INFLATION PERFORMANCE

Annual inflation rate over the second semester of 2006 fluctuated around the Bank of Albania objective of 3 per cent. In December, inflation reached 2.5 per cent, being 0.5 percentage points higher than in December 2005. The average rate of 2.4 per cent of annual inflation over 2006 was similar to the average rate of 2005, which provides evidence for a stable inflation in periods longer than a year.

The dynamics of the monthly inflation performance for July to December 2006 is in line with the historical performance of the last years. The monthly inflation changes over the second semester in general display an upward tendency peaking in December with the speculative rise of prices over the end-year holidays. This phenomenon was quite moderate at the end 2006, being comparable to the two previous end-years. The monthly inflation of 1.7 per cent, recorded in December 2006, was the lowest rate in the last four years.

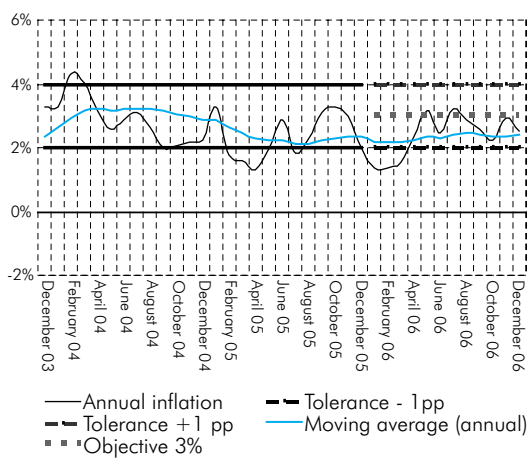
|           | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|-----------|------|------|------|------|------|------|
| January   | 2.2  | 6.5  | 0.0  | 3.3  | 3.3  | 1.4  |
| February  | 1.5  | 7.6  | 1.1  | 4.4  | 1.8  | 1.3  |
| March     | 2.9  | 7.5  | 1.3  | 4.0  | 1.6  | 1.5  |
| April     | 3.0  | 6.5  | 2.3  | 3.2  | 1.3  | 2.4  |
| May       | 2.5  | 4.6  | 2.8  | 2.6  | 2.0  | 3.1  |
| June      | 4.0  | 3.7  | 2.6  | 2.9  | 2.9  | 2.4  |
| July      | 5.6  | 4.2  | 3.0  | 3.1  | 1.8  | 3.2  |
| August    | 4.1  | 5.5  | 3.0  | 2.7  | 2.3  | 2.9  |
| September | 3.5  | 5.3  | 2.8  | 2.0  | 3.1  | 2.6  |
| October   | 1.8  | 5.8  | 2.9  | 2.0  | 3.3  | 2.3  |
| November  | 2.8  | 3.7  | 3.4  | 2.2  | 3.0  | 2.9  |
| December  | 3.5  | 1.7  | 3.3  | 2.2  | 2.0  | 2.5  |
| Average   | 3.1  | 5.2  | 2.2  | 3.0  | 2.4  | 2.4  |

Source: CPI, INSTAT, 2006

Table 12 Annual inflation rate (in percentage)

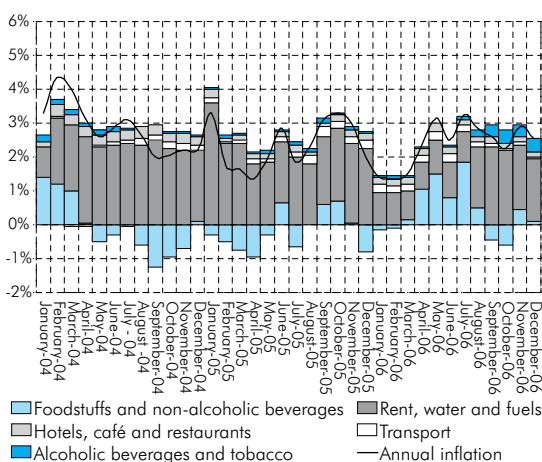
The developments in the general level of prices over the second semester of 2006 occurred within a balanced macroeconomic framework, in which the inflationary pressures, despite being present, have been kept under control. Both

Chart 15 Performance of annual inflation (in percentage)



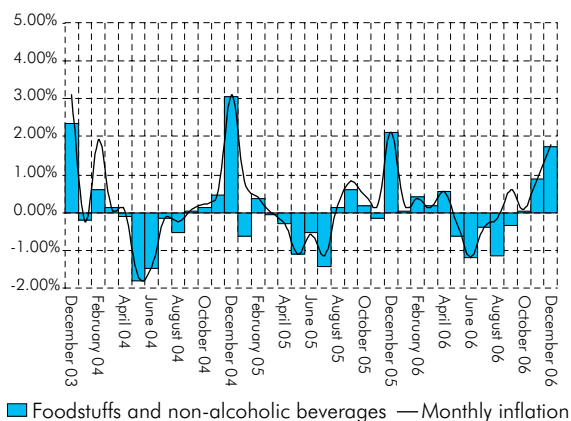
Source: Bank of Albania

Chart 16 Contribution of main groups to CPI basket (in percentage points)



Source: INSTAT and Bank of Albania estimates

Chart 17 Contribution of "Foodstuffs and non-alcoholic beverages" to monthly inflation (in percentage points)



Source: INSTAT and Bank of Albania estimates

the monetary and fiscal policies have controlled the demand and supply pressures in economy, allowing for the observance of the inflation objective. Annual inflation did not exceed the tolerance band of 1 percentage points around the 3.0 per cent objective over this period.

### 3.1 INFLATION PERFORMANCE BY MAIN GROUPS

Inflation performance over the second semester of 2006 was affected by the influence of a number of factors, such as the energy price rise in August, the deviation of domestic agricultural production from the seasonal framework, the rise in the prices of some excise goods and the oil price performance. Among these factors, "Foodstuffs and non-alcoholic beverages", "Rent, water, fuels and energy" and "Alcoholic beverages and tobacco" were the main groups which defined the inflation rate for this period.

Foodstuffs prices have played a pivotal role in the definition and performance of the general level of prices over this semester. This group's annual inflation has on average contributed by 0.3 percentage points to total inflation for this period. The increasing pressures were considerably higher than those of the previous year or of 2004, when the contribution of this group to total inflation rate was 0.0 and -0.6 percentage points, respectively. A number of internal and external factors have conditioned the change of this group's contribution. The unfavourable atmospheric conditions over spring had a negative impact over the supply of agricultural production, pushing the entry of import goods into the domestic market at high prices. The positive annual inflation rates of "Foodstuffs and non-alcoholic beverages" over most of the year reflect the presence and the share of import goods. September and October make up an exception, over which domestic agricultural production may have coped better with the domestic demand for agricultural products, causing the annual inflation for this group to be negative. The seasonal effect, despite being late and short, was reflected in the monthly inflation rates. Being in line with the seasonal performance, foodstuffs monthly inflation and total inflation recorded negative rates over May to August.

Foodstuffs prices were also influenced by the upward tendency of these goods' prices in the European markets. The favourable behaviour of the exchange rate between the lek and the euro toned down the influence of foreign prices until June, but did not manage to compensate the rise of foodstuffs prices over the second semester. Over this semester, the lek depreciated against the euro by 0.4 per cent, compared to the appreciation by 2.4 per cent and 2.2 per cent over the same period the previous year and over the first semester 2006.

Table 13 Annual inflation of "Foodstuffs and non-alcoholic beverages" (in the country and abroad) and its contribution to total inflation

|           | Annual inflation '05 | Contribution (pp) | Annual inflation '06 | Contribution (pp) | Italy <sup>6</sup> Annual inflation '06 | Greece <sup>7</sup> Annual inflation '06 | Euro area <sup>8</sup> (12 countries) |
|-----------|----------------------|-------------------|----------------------|-------------------|---|--|---------------------------------------|
| March     | -1.7                 | -0.7              | 0.4                  | 0.2               | 1.0                                     | 2.8                                      | 1.3                                   |
| June      | 1.6                  | 0.7               | 1.9                  | 0.8               | 1.3                                     | 3.0                                      | 2.0                                   |
| July      | -1.6                 | -0.7              | 4.7                  | 1.9               | 1.8                                     | 5.4                                      | 2.6                                   |
| August    | 0.0                  | 0.0               | 1.3                  | 0.5               | 2.2                                     | 4.6                                      | 2.9                                   |
| September | 1.5                  | 0.6               | -1.1                 | -0.5              | 2.5                                     | 4.6                                      | 3.3                                   |
| October   | 1.7                  | 0.7               | -1.5                 | -0.6              | 2.7                                     | 5.1                                      | 3.0                                   |
| November  | 0.2                  | 0.1               | 1.1                  | 0.5               | 2.9                                     | 4.5                                      | 3.0*                                  |
| December  | -1.9                 | -0.8              | 0.2                  | 0.1               | 2.7                                     | 4.3                                      | --                                    |

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

(\*) Preliminary rates

"Rent, water, fuels and energy" continued to provide the main influence on the definition of annual inflation rate over the second semester of 2006. The average contribution of this item to annual inflation rate for this period was 1.8 percentage points. Following the cessation of the energy price rise effect at the beginning of 2006, the annual inflation rates of this item increased moderately until August, when the energy price increased by 13.7 per cent, in annual terms. All this item's constituents marked positive growth rates. Apart from the energy price rise, rent and imputed rent market prices also increased. The highest annual inflation rates of this item over the second semester were recorded in September (8.5 per cent) and in October (8.0 per cent), reflecting the growth of demand for apartments at the beginning of the school academic year.

Table 14 Total annual inflation rate and annual rate of "Rent, water, fuels and energy", and its contribution to total inflation

|  | March | June | July | August | September | October | November | December |
|--|-------|------|------|--------|-----------|---------|----------|----------|
| Total annual inflation (in percentage)                       | 1.5   | 2.5  | 3.2  | 2.9    | 2.6       | 2.3     | 2.9      | 2.5      |
| Inflation of "Rent, water, fuels and energy" (in percentage) | 3.2   | 3.9  | 3.2  | 6.5    | 8.5       | 8.0     | 7.0      | 7.0      |
| Contribution to total inflation (in percentage points)       |       |      |      |        |           |         |          |          |
| Rent, water, fuels and energy                                | 0.9   | 1.0  | 0.9  | 1.8    | 2.3       | 2.2     | 1.9      | 1.9      |
| Rent   | 0.1   | 0.1  | 0.1  | 0.1    | 0.1       | 0.1     | 0.1      | 0.1      |
| Imputed rent   | 0.7   | 0.9  | 0.8  | 0.8    | 1.2       | 1.1     | 0.9      | 0.9      |
| Fuels and energy   | 0.0   | 0.0  | 0.0  | 0.9    | 0.9       | 0.9     | 0.9      | 0.9      |

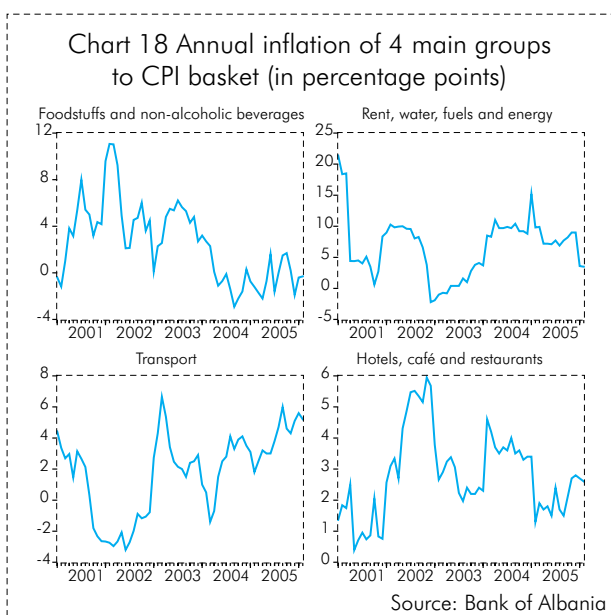
Source: Bank of Albania, INSTAT, 2006

Total prices level over the second semester was overwhelmingly influenced by the inflation of "Alcoholic beverages and tobacco". The information on the increase of the excises for these goods' prices was reflected in their sale

prices starting from August, preceding the entry into force of this decision in September 2006. This rise reflects the speculative features of the domestic market. Despite the small share by 3.1 per cent of “Alcoholic beverages and tobacco” in the consumer basket, its contribution to annual inflation rate was 0.3 percentage points, or as much as the contribution of “Foodstuffs and non-alcoholic beverages”.

The second semester of 2006 was characterized by low annual inflation growth rates of “Transport” and “Hotels, café and restaurants”. Their average contribution to annual inflation was 0.1 and 0.2 percentage points, respectively. The low inflation growth rates of “Transport” were mainly headed by the moderate rise of oil price. In annual terms, the oil price in the country rose by 0.1 per cent over this semester, which is lower than the rise of 0.3 per cent, recorded over the previous semester and over the same period the previous year. Apart from the more considerable appreciation of the domestic currency to the dollar over this period, the positive developments in the international markets oil price pushed the fall of oil price in the country.

Chart 18 Annual inflation of 4 main groups to CPI basket (in percentage points)



The goods’ prices of other basket groups displayed diverse tendencies over the second semester. The combined contribution of their inflation was almost insignificant, since the groups with a positive contribution balanced the groups which contributed negatively. The fall in the prices of tradable goods, which are part of “Clothes and footwear”, “Furniture, household and maintenance appliances”, is quite a long phenomenon, being present since 2000. Their decreasing contribution was offset by the rise of services prices, which are part of “Health service” and “Education Service”.

### 3.2 MACROECONOMIC ENVIRONMENT AND CONSUMER PRICES

Domestic macroeconomic developments over the second semester of 2006 have by and large provided a favourable environment for keeping the inflation rate under control. The inflationary pressures mainly derived from the supply-side, which at times, were intensified. Among them, the energy price rise in August, the excise goods price rise and the oil price rise until October 2006 were most evident. Under these conditions, the tightening monetary policy reaction at mid-July and end November is assessed to have begun to control the upward inflationary pressures in economy. In particular, the mitigation of these pressures was observed over the last month of the year, which has been historically perceived as a high inflation month. The stable lek in the foreign exchange market, the absence of inflationary pressures deriving from the external environment and the oil price fall in the domestic market are assessed to have provided their impact over this period. Budget expenditure and budget deficit have been in controlled levels, despite their concentration

in the last period of the year. This has caused the aggregate demand to remain within the projections, not transmitting inflationary pressures to the economy. However, part of the impact over demand and inflation will be carried out in the first quarter of 2007.

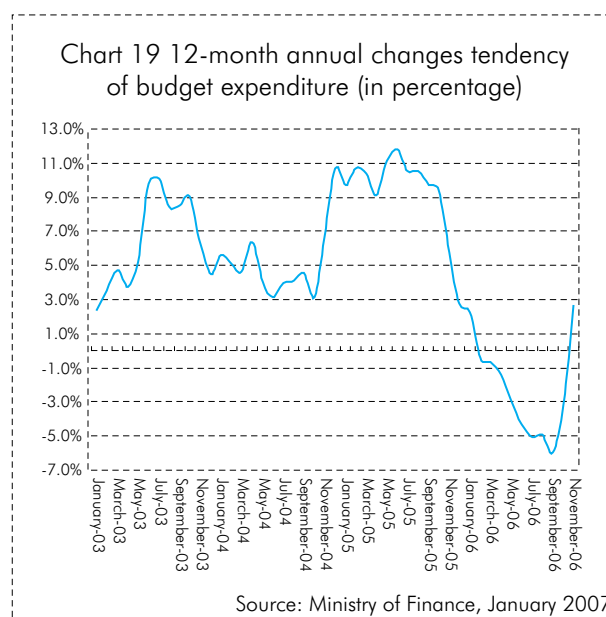
## FACTORS OF DEMAND

### Domestic demand indicators

The signals deriving from various indicators provide evidence for a growth in domestic demand over the second semester of the year. The sales index for the first nine-month period recorded an annual growth of 12.4 per cent. For the same period, foreign trade indices indicate a growth of exports and imports by 16 and 17 per cent, respectively, compared to the previous year. These indices, along with the rapid growth of lending activity, provide evidence for an expansion of consumption and investments. However, given the dynamics of inflation indices, this growth of domestic demand did not prove sufficient to transmit inflationary pressures to the economy.

### Fiscal policy

In general, budget deficit financing through domestic borrowing was low over the second semester. Government demand for monetary assets did not exert pressure for the growth of monetary sources. The fiscal indicators did not exceed the amounts projected for this period, even under the revised figures. In this context, the fiscal policy has not infringed the preservation of macroeconomic balances. On the other hand, the data on November provide evidence for a concentration of budget expenditure at the end of the year. Despite the accelerated growth rate of carrying out the expenditure, they are still far from the realization of plan. The concentration of expenditure over the fourth quarter increased the possibility of generating inflationary pressures in the short and medium-term.

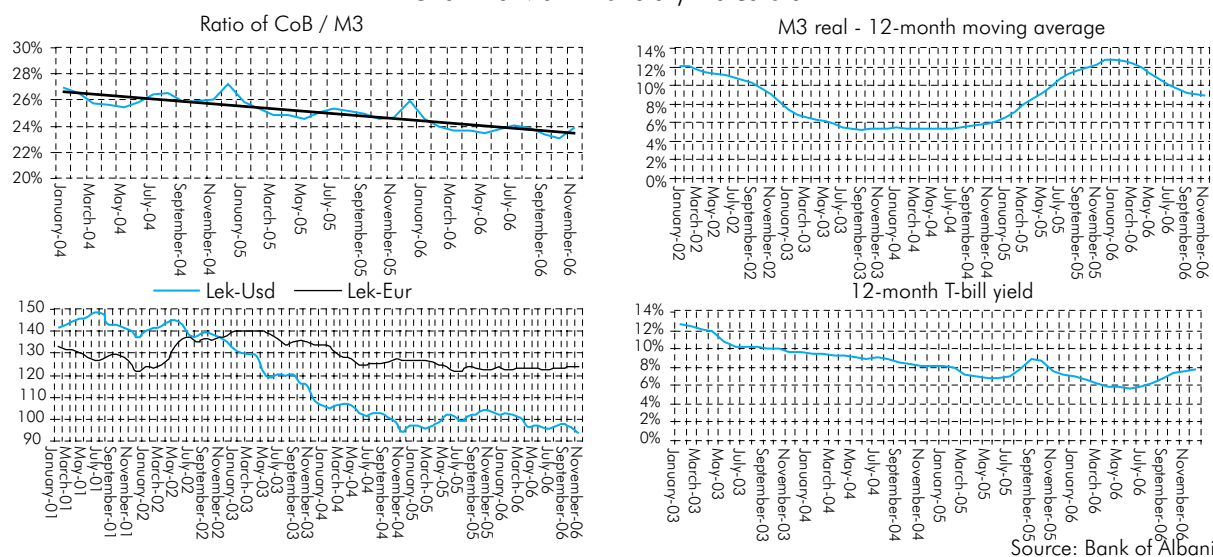


### Monetary policy and monetary conditions

Under the conditions when the supply-side inflationary pressures were more intensively present over the second semester of the year, monetary policy accommodated these developments by pursuing a tightening policy. The increase of the core interest rate aimed at creating adequate monetary conditions for the control of these pressures. Money supply grew gradually, meeting the increasing demand of both the public and the private sector. The Bank of Albania continued to be present in the money markets, aiming to provide the necessary liquidity and to minimize interest rate fluctuations. On the other hand, the ratio of currency outside banks to money supply fluctuated around the lowest historical levels. The meeting of market's demand for liquidity and the maintenance of low levels of currency outside banks aided the maintenance of price stability in the medium-term.



Chart 20 Main monetary indicators



Source: Bank of Albania

### FACTORS OF SUPPLY

#### External environment and exchange rate

Exchange rate developments enabled the mitigation of inflationary pressures over the second semester of 2006. Our domestic currency appreciated distinctly to the dollar, while remaining at stable levels to the euro. Such a performance of the exchange rate is assessed to have been one of the main factors to have controlled the strong supply-side pressures and to have influenced on the maintenance of the inflation rate within the Bank of Albania objective. On one hand, it influenced on the reduction of cost for import goods, and on the other, it provided a status quo of the oil price in the country, while in the international market there was an oil price rise (in particular over the third quarter).

Table 15 Annual inflation rates in Italy, Greece and the Euro area and the exchange rate annual change (in percentage)

|                         | Q1*-06* | Q2*-06* | Q3*-06* | Q4*-06* |
|-------------------------|---------|---------|---------|---------|
| Greece <sup>9</sup>     | 3.2     | 3.2     | 3.4     | 2.9     |
| Italy <sup>10</sup>     | 2.2     | 2.2     | 2.2     | 1.8     |
| Euro area <sup>11</sup> | 2.3     | 2.4     | 2.1     | 1.8     |
| Lek/Euro                | -2.9    | -1.4    | 0.1     | 0.7     |
| Lek/Usd                 | 5.7     | 0.1     | -4.1    | -7.0    |

Source: CPI, INSTAT

Note: (\*) The quarterly figures are the average monthly indicators.

#### Imported inflation

The performance of consumer prices in Albania's main trade partners was an important factor for the transmission of decreasing tendencies to the domestic consumer prices. As a result of the oil price fall, the inflation rate in our two main trade partners, Greece and Italy, and in the Euro area, recorded distinct lower rates at the end of 2006, compared to the previous year. Meanwhile, there was a fall in the prices of "Foodstuffs and non-alcoholic beverages",



resulting from the late entry of domestic production into the market over the end of summer 2006.

*Oil price and energy situation*

The downward oil price tendency starting from October pushed the fall of prices in the domestic market. As a result, the forewarned risk for inflationary pressures over summer and the first part of the second semester, pushed by the oil price rise, did not actualize. On the other hand, the oil price effects on the domestic market are reinforced by the situation of energy supply, which began to be displayed as problematic starting from December. The consequences of the interaction between both these factors, as well as the second round effects over prices, continue to remain among the priorities of monetary policy.

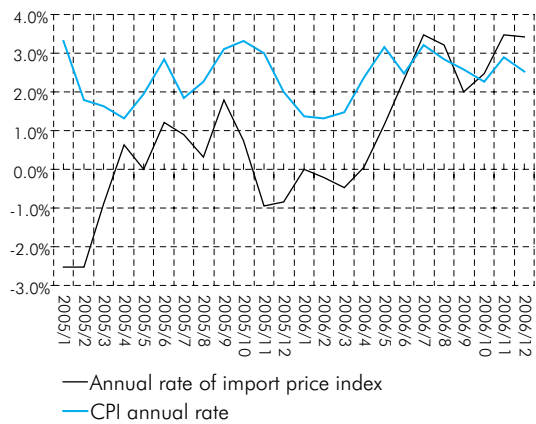
*Agricultural production*

The fluctuations in the prices of goods and services of consumer basket main groups compensated one another, causing the inflation rate to be kept below the objective of 3 per cent, but within the tolerance band. The energy price rise in August, the price rise of excise goods and of education service contributed to total inflation by 1 percentage points. On the other hand, the favourable behaviour of foodstuffs prices until the end 2006 balanced the high inflation rates of special goods and services. The dropping of this group's goods prices was favoured by the favourable climate conditions and the growth of agricultural production, almost until the end of the year.

*Unemployment and wages*

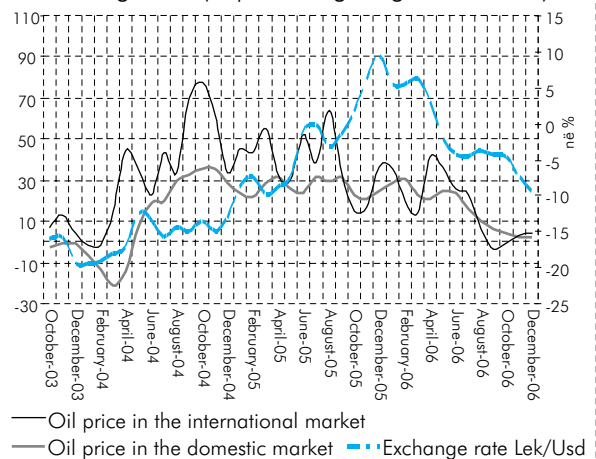
The labour market situation continued to improve. Moreover, the wages in the public sector, the minimal wage and pensions increased according to the budget programme. These elements did not transmit strong inflationary pressures to economy over July to December 2006; not even in the year end when the demand for goods and services grows overwhelmingly.

Chart 21 CPI and import price index annual change rate (in percentage)



Source: CPI, INSTAT, January 2007; Bank of Albania, January 2007

Chart 22 Annual change of oil price (in ALL/USD, left-hand side) and of the exchange rate (in percentage, right-hand side)



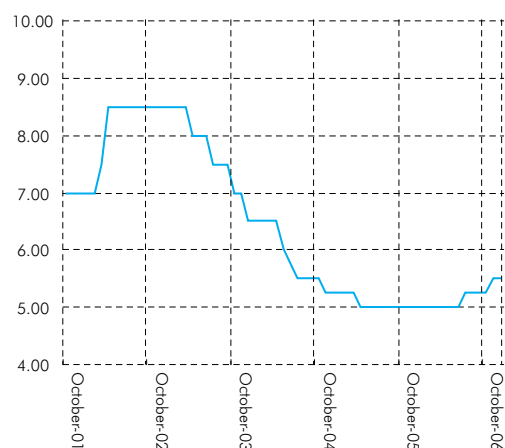
Source: Bank of Albania, INSTAT, Bloomberg, December, 2006

4 MONETARY DEVELOPMENTS AND FINANCIAL MARKETS

4.1 MONETARY POLICY OF THE BANK OF ALBANIA

The overall economic and financial environment introduced some important challenges for the formulation and implementation of monetary policy over the second semester of 2006. There were increasing inflationary pressures

Chart 23 Core interest rate performance



Source: Bank of Albania

over this period, mainly resulting from the influence of supply factors. The likelihood of high oil prices being transmitted to the costs of production and their effect on the economic agents' inflationary expectations was persistently monitored by the Bank of Albania, aiming at providing a rapid and complete reaction to it. On the other hand, the rapid growth of credit to economy and the concentration of budget expenditure in the last quarter provided evidence for a more complete inflationary pressures context, including in it the factors of demand as well. Under these conditions, the Bank of Albania reacted by increasing the core interest rate in July and November, from 5.0 per cent to 5.5 per cent over the second semester.

The raise of the cost of money aimed at keeping appropriate monetary conditions for guaranteeing price stability in the long-term. The tightening of monetary conditions is in line with the monetary policy pursued by large central banks and with the increase of interest rates in the international foreign currency markets. The Bank of Albania decision was reflected in the monetary markets' interest rates.

On the other hand, the increase of Government borrowing and the maintenance of high crediting rates in lek caused liquidity shortages in the system over the last quarter of the year. This situation was reflected in the increase of Treasury bills yield and in a higher fluctuation of the interbank market. Under these conditions, the Bank of Albania injected liquidity in the system, aiming at reducing the interest rates fluctuations and at meeting the market's short-term demand for liquidity. The injection of liquidity in the system was carried out through the use of reverse repos, totalling ALL 6.5 billion by the end of 2006. This injection affected the mitigation of pressures over the Treasury bills yield. Along with the money market operations, the interventions in the foreign currency market supported the meeting of economy's demand for liquids and the observance of the Bank of Albania quantitative objectives.

 Table 16 Realization of the Bank of Albania quantitative objectives<sup>12</sup>

|   | December'05 | March'06 | June'06 | September'06 | November'06 | December'06* |
|---|-------------|----------|---------|--------------|-------------|--------------|
| Net international reserve of the Bank of Albania (in millions of USD) |             |          |         |              |             |              |
| Objective   | 1,172       | 1,117    | 1,112   | 1,252        | 1,262       | 1,268        |
| Current   | 1,172       | 1,202    | 1,224   | 1,296        | 1,305       | 1,334        |
| Difference (C-Obj)  | --          | 85       | 112     | 44           | 43          | 66           |
| Net domestic assets of the Bank of Albania (in billions of ALL)       |             |          |         |              |             |              |
| Objective   | 82.0        | 85.0     | 90.0    | 82.9         | 85.6        | 86.9         |
| Current   | 76.9        | 61.9     | 67.8    | 71.2         | 72.7        | 79.5         |
| Difference (C-Obj)  | -5.1        | -23.1    | -22.2   | -11.7        | 12.9        | 7.4          |
| Net domestic credit to the Government (in billions of ALL)            |             |          |         |              |             |              |
| Objective   | 317.8       | 325.8    | 329.8   | 335.8        | 340         | 341.8        |
| Current   | 317.8       | 311.8    | 306.6   | 307.4        | 312         | --           |
| Difference (C-Obj)  | --          | -14.0    | -23.3   | -28.5        | -28         | --           |

\*Operative data

Source: Bank of Albania

## 4.2 PERFORMANCE OF MONETARY AGGREGATES

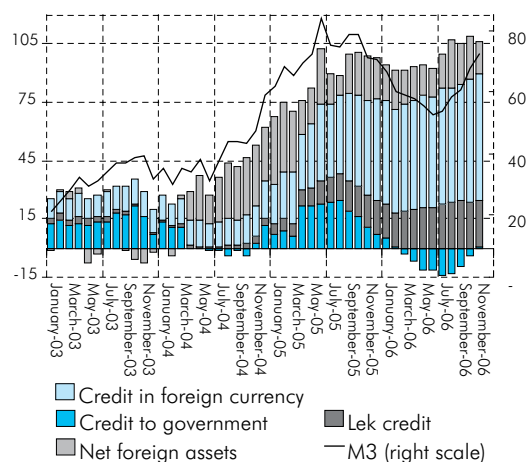
The monetary developments over the second semester of 2006 continued to reflect at large the dynamics observed in the private sector's economic activity, despite the gradual growth of Government's demand for monetary assets. Credit to economy remains the main contributor to the growth of monetary assets in economy. Moreover, workers' remittances made a positive contribution to the seasonal growth of deposits in foreign currency and of the system's net foreign assets. The growth of Government's demand for financing, in particular over the last quarter, influenced on a more rapid monetary expansion compared to the first semester. In November, money supply recorded an annual growth of 12.7 per cent, against an annual growth of 9.7 per cent in June.

However, the relatively low demand of the public sector over 2006 contributed to the shrink of monetary growth rates as opposed to the two previous years. The current annual expansion rates of monetary aggregates result distinctly lower than the last two years' rates of 17-18 per cent. Moreover, the slowdown of lending growth rate adds to the argument for a more sluggish monetary expansion and for the maintenance of macroeconomic balances. The gradual reduction of the share of currency in circulation tends to favour a more rapid circulation of money and the monetization of economy, being in line with the tendencies observed in more developed economies.

The creation of money in economy found an evident reflection in the growth of the level of deposits, while the share of currency outside banks to monetary aggregate M2 decreased to 32.5 per cent in November, compared to 32.9 per cent at end June. Moreover, the high level of deposits in foreign currency deepened further the decrease of the share of currency outside banks to broad money by about 0.8 percentage points over July to November 2006. Such a performance is in line with the positive tendency of the banking system development. The reduction in the use of cash in economy provides the grounds for the fall of the financial intermediation cost in economy.

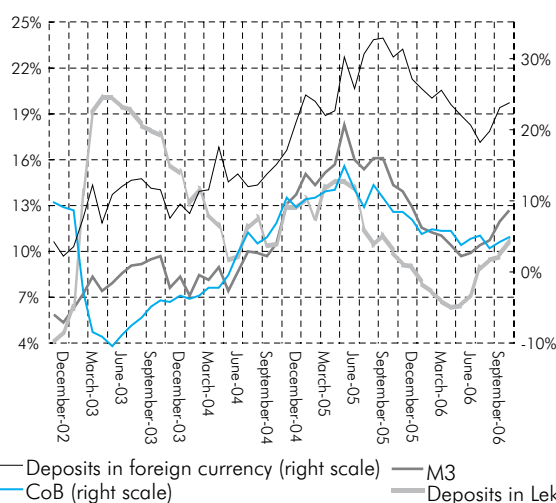
The banking system deposits recorded an annual growth of 15.3 per cent in November, compared to the annual growth by 11.7 per cent at the end of the

Chart 24 Contribution of demand factors to M3 annual growth (in billions of ALL)



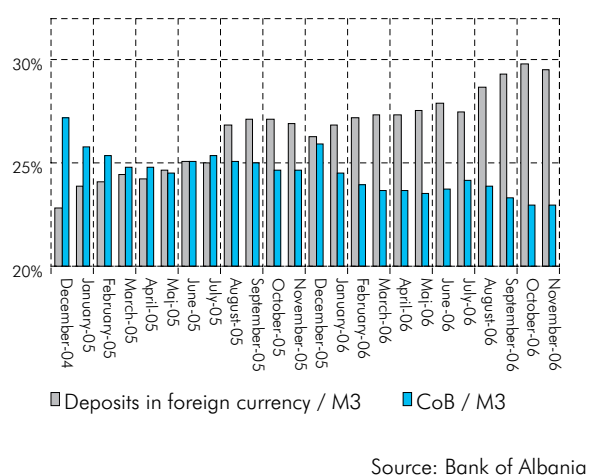
Source: Bank of Albania

Chart 25 M3 and its constituents annual growth



Source: Bank of Albania

Chart 26 The share of currency outside banks and of deposits in foreign currency to M3



first semester. ALL inflows have by and large been channelled in time deposits, while foreign currency inflows, mainly the share of the private sector, were in the form of both time and demand deposits. The more rapid growth of time deposits to demand deposits was reflected in the ratio of time deposits to M3, which marked 54.1 per cent in November or 0.7 percentage points more than in June and 1.9 percentage points more than the previous year. The level of deposits in foreign currency maintains the highest growth rates as opposed to the annual growth rate of deposits in lek. ALL deposits grew by 5.5 per cent compared to June, while foreign currency deposits grew by 13.6 per cent. Under these conditions, the foreign currency structure of broad money maintained the shifting tendency towards deposits in lek and in foreign currency.

The creation of money in the form of deposits in foreign currency was favoured by the high borrowing rates of the private sector in foreign currency and by the increasing rates of euro and dollar interests. The increase of the interest rates by the European Central Bank and the Federal Reserve had a pivotal influence on their upward tendency. Such an increase led to the narrowing of differences between ALL time deposits rates and time deposits in foreign currency. However, the increase of the lek core interest rate contributed to the maintenance of positive differences between the ALL and foreign currency interests.

Table 17 Performance of monetary indicators (in billions of ALL)

|                                       | November     | Monthly change |            | Annual change |            |
|---------------------------------------|--------------|----------------|------------|---------------|------------|
|                                       | 2006         | Absolute       | Percentage | Absolute      | Percentage |
| Currency outside banks                | 146.3        | 0.5            | 0.3        | 6.6           | 4.8        |
| Total deposits                        | 491.7        | 2.2            | 0.5        | 65.4          | 15.3       |
| - in lek                              | 303.3        | 3.2            | 1.1        | 29.4          | 10.7       |
| - in foreign currency                 | 188.4        | -1.0           | -0.5       | 36.0          | 23.6       |
| M1                                    | 226.9        | 1.3            | 0.6        | 11.2          | 5.2        |
| M2                                    | 449.6        | 3.7            | 0.8        | 36.0          | 8.7        |
| M3                                    | 638.0        | 2.7            | 0.4        | 72.0          | 12.7       |
| Monetary base                         | 209.3        | 3.6            | 1.7        | 20.4          | 10.8       |
| Shares to broad money (in percentage) |              |                |            |               |            |
|                                       | December '05 | June '06       |            | November '06  |            |
| Currency outside banks/M3             | 25.9         | 23.7           |            | 22.9          |            |
| Deposits in lek/M3                    | 47.8         | 48.4           |            | 47.5          |            |
| Deposits in foreign currency/M3       | 26.3         | 27.9           |            | 29.5          |            |

Source: Bank of Albania

### 4.3 DEMAND FOR MONETARY ASSETS

#### 4.3.1 Credit to economy

Credit to economy continued to record rapid growth rates over the second semester of 2006. The banking system credit portfolio amounted to ALL 179.5

billion in November 2006, accounting for 28.1 per cent of the economy monetary assets. As a share to the gross domestic product, it stands at its highest historical levels, accounting for 20.1 per cent. However, the annual growth rate of credit to economy marked a decrease over this semester, declining from 67.1 per cent in June to 57.8 per cent in November. The growth rate slowdown is a result of the high credit level for a two-year period. Moreover, the new market segments not covered with credit have been decreasing, not allowing the maintenance of such growth rates. The application of a set of rules in the beginning of 2007, which aims at controlling and maintaining the credit portfolio quality, is expected to affect the further reduction of credit growth. The continuous credit growth rates slowdown in the future will bring it to stable levels, in line with the macroeconomic stability in the country.

The extension of loans maturity terms of banks' portfolio and the increase of new extended loans are the main factors to support the stable growth of credit in the banking system. Over July of November 2006 was extended a total of ALL 13.4 billion of new credit per month or 20 per cent above the monthly average of the first semester. The positive developments over summer constituted the particular of the credit historical performance to date. Moreover, the new disbursed credit of ALL 15.9 billion in November marked the historical maximum extended credit within a month.

Credit in lek accounted for 29.7 per cent of credit portfolio in November, marking a slight growth in its share to total credit. The growth of credit in lek for more than a year was reflected in the reduction of the annual growth rate to 82.4 per cent in November, from 140 per cent the previous year. In August and September, the contribution of credit in lek reached to 40 per cent of credit growth, being later reduced to the rates featuring year 2006, to about 36 per cent. The supply of some large banks with low-cost consumer loan over summer seems to have pushed the acceleration of credit in lek over this period. Despite the rapid growth of credit in lek, credit in foreign currency dominates the banks' portfolio by 70.3 per cent. This type of credit displayed a positive performance over the second half of 2006. Its annual growth rate recorded 48 per cent in November, constituting the highest rate for July to November. Credit in foreign currency had an upward tendency in September, which is not only related to the increase of business crediting in foreign currency, but also to the financing of household purchases in foreign currency.

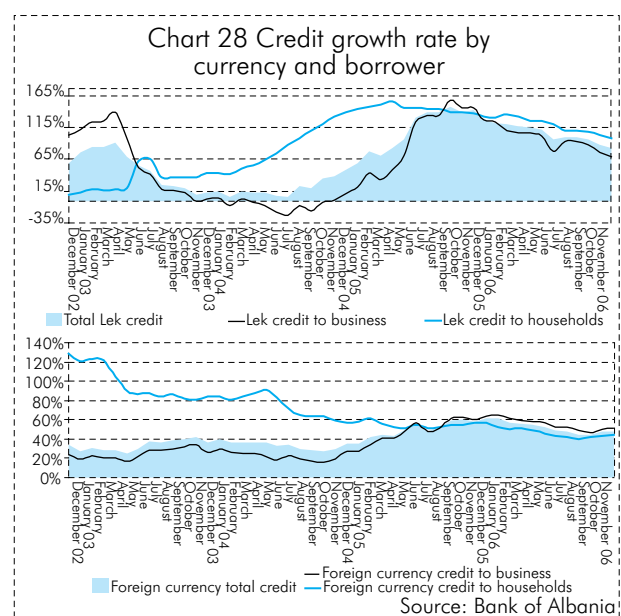
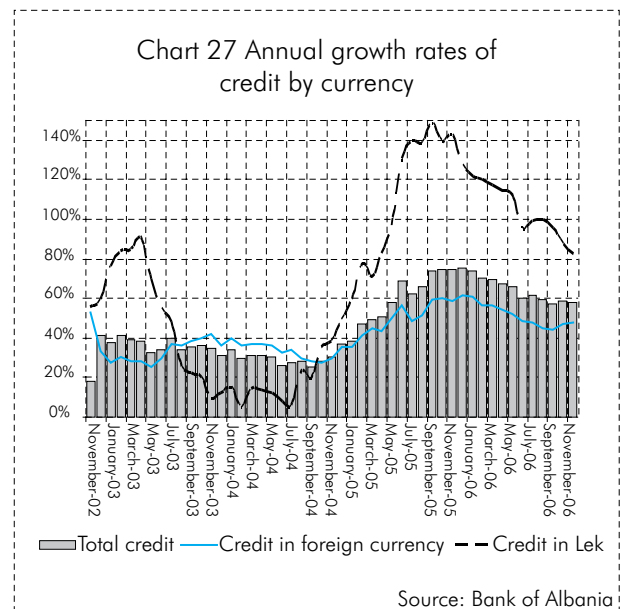
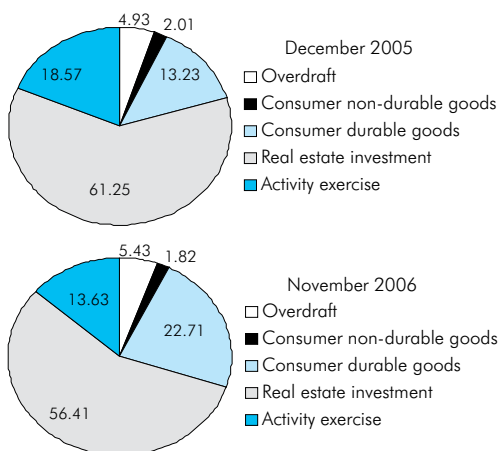
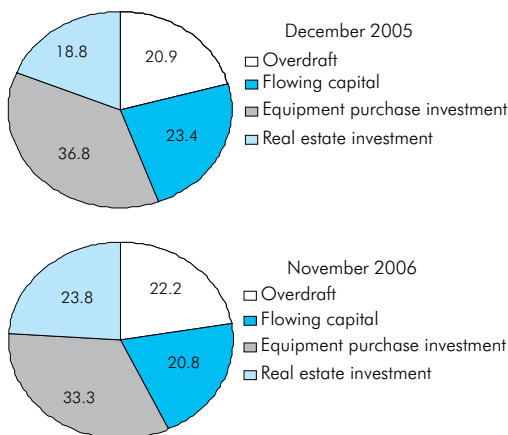


Chart 29 Credit to households by purpose of use



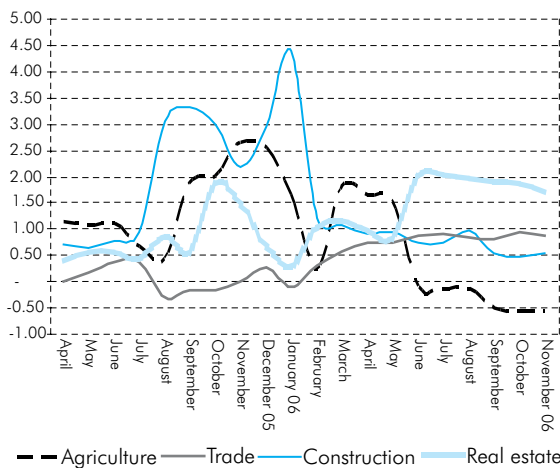
Source: Bank of Albania

Chart 30 Business loan by use



Source: Bank of Albania

Chart 31 Growth rate of loan index by sector, December 2004



Source: Bank of Albania

Credit to households accounted for 7 per cent of the GDP in November. Banks have almost maintained the share of this type of credit to total credit unchanged over the last months of 2006, around the level of 33 per cent. The annual growth rate of credit to households recorded 65 per cent in November, getting close to the lowest levels of the last three years. More than half of credit to households is extended for the financing of real estates acquisitions. However, there has been an increasing crediting of households for the financing of consumer goods purchases over 2006. The share of consumer loan to total households' portfolio accounted for 30 per cent in November, from 20 per cent the previous year.

Business loan maintained increasing annual rates over the second semester of 2006, accounting for about 55 per cent. The structure of its distribution by use attempted to be more harmonized compared to the previous year. The largest share of business loan is used for the purchase of appliances and machinery, accounting for 33.3 per cent. Meanwhile, the financing of business investments for the expansion of their activity had a remarkable performance over 2006, accounting for 24 per cent of business loan in November.

The sector of trade continued to constitute the most attractive sector for the banking system, accounting for 23.4 per cent of loans, and reflecting a slight increase from the end of the first semester. Meanwhile, the sector of agriculture continued to reduce its share to total to 0.7 per cent from 2.4 per cent the previous year<sup>13</sup>. The performance of loan index by sector indicates that real estates loan had the most remarkable performance for 2006, being stabilized in high growth rates. The positive borrowing performance in the apartments market is followed by the sector of trade. Meanwhile, the loan growth rates for this sector have been decreasing over the recent months.

#### 4.3.2 Net foreign assets

The banking system net foreign assets have increased considerably over the second semester, amounting to USD 260 million. This increase was



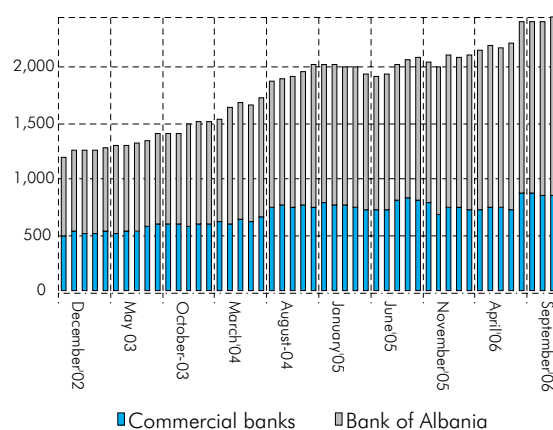
mostly influenced by the Bank of Albania foreign currency operations and by the growth of deposits in foreign currency held with commercial banks. On the other hand, a share of this growth is attributed to the appreciation of the euro against the dollar by about 3.8 per cent, increasing the amount of investment in euro, expressed in dollar. In the absence of this effect, the growth of the banking system net foreign assets for this period totals USD 198.8 million.

The developments in net foreign assets over this period have by and large been in line with their historical performance. The increase of deposits in foreign currency and the slowdown of credit over the third quarter have provided a positive influence on the level of commercial banks net foreign assets. Despite their decrease in the last quarter, their increase totalled USD 113.5 million over the second semester of 2006. In the absence of the exchange rate effect, the growth of these assets amounts USD 96.2 million.

The Bank of Albania net foreign reserve increased by USD 146.5 million over July to November. This increase came due to the continuous interventions of the Bank of Albania in the foreign currency market, in order to accomplish its objective related to the net international reserve and to lower the fluctuations in the foreign currency market. In the absence of the exchange rate effect, the increase of the Bank of Albania net foreign reserve amounts USD 102.5 million.

As far as the foreign currency structure of commercial banks' foreign assets is concerned, the USD shares most of this structure, accounting for about 50 per cent, over the second semester of 2006. Most of non-residents' securities held with banks and time deposits held with foreign banks are denominated in USD. Most of non-residents cash and credit are in EUR. On the other hand, about 70 per cent of foreign currency liabilities are denominated in EUR, most of which is shared by credit extended by foreign banks.

Chart 32 Net foreign assets of the banking system (in millions of USD)



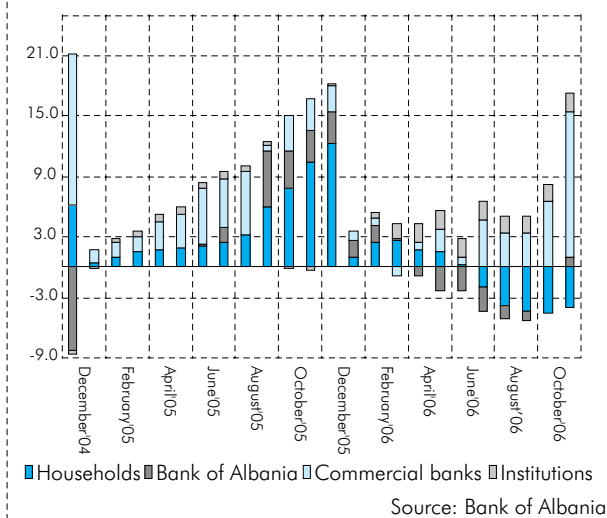
Source: Bank of Albania

#### 4.3.3 Government demand for money

The Government maintained the fiscal balance in positive levels for most of the second semester of 2006. Following June, budget surplus has been decreasing, recording negative levels in November. As a result of these developments, Government demand for money was concentrated in the last quarter of 2006. In this period, total financing recorded positive levels, marking a growth of ALL 16.6 billion. The fiscal projections for 2006 projected the level of domestic financing to reach to ALL 22.8 billion. By November, this financing resulted to about ALL 6.7 billion.

Over the second semester of 2006, the Government was oriented towards the issue of long-term debt and reduced the issue of Treasury bills. Domestic

Chart 33 Developments in budget deficit gross financing (in billions of ALL)

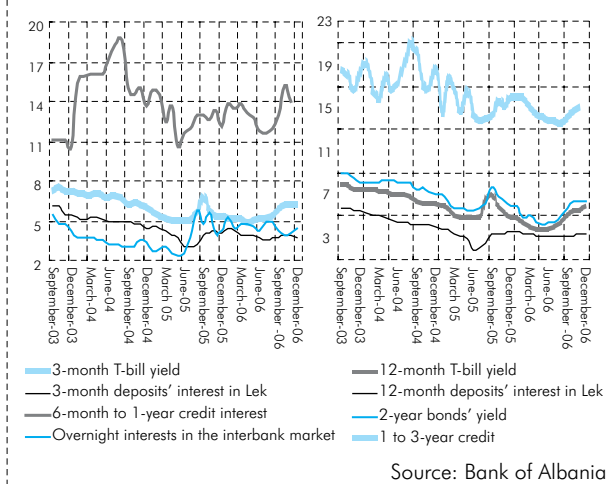


financing was mostly covered through the issue of bonds of 2, 3 and 5-year maturity. Bonds of 5-year maturity were issued for the first time in November, totalling ALL 6.36 billion. With regard to bonds of 2 and 3-year maturity, their portfolio for July to November<sup>14</sup> grew by ALL 9.8 and 6.5 billion, respectively.

Over the same period, the net level of Treasury bills purchased in the primary market decreased to the negative level of ALL 22 billion or about ALL 12.8 billion more than over the first semester of 2006. The Treasury bills' portfolio decreased by ALL 14.8 billion. About 90 per cent of this decrease is a consequence of the reduction of commercial banks Treasury bills' portfolio.

The Government continued to invest the surplus in the form of reverse repos to commercial banks over the second semester. However, over this period, the excess liquidity invested in reverse repos decreased, reaching ALL 5.8 billion or about ALL 5.2 billion less than in June. For the same period, the level of Government's deposits held with the Bank of Albania increased by ALL 7.3 billion.

Chart 34 Short-term (left-hand side) and long-term (right-hand side) interest rates in the markets



#### 4.4 PERFORMANCE OF FINANCIAL MARKETS

##### Money and securities market

The second semester was characterized by the tightening of the monetary policy. The Bank of Albania increased the core interest rate twice, in July and in November, by 25 basis points, respectively, causing it to reach 5.50 per cent. Following the tightening signals, the interest rates in the money market have been increasing over this period<sup>15</sup>.

While in the third quarter the Bank of Albania continued to withdraw the liquidity through the regular auctions of weekly repos (ALL 2.9 billion on average), in the fourth quarter the course of operations shifted. Under the absence of liquidity in the market, the Bank of Albania intervened by injecting liquidity through reverse repos. In order to provide for its stable level, there were auctions for reverse repos of one-month and three-month maturity, besides the weekly reverse repos. These kinds of structural operations totalled ALL 6.5 billion.

The average daily volume of transactions in the interbank market decreased to ALL 1.6 billion in the second semester, compared to ALL 1.7 billion in the first semester. The weekly transactions recorded ALL 0.9 billion, on average,



maintaining the same level as in the previous semester. The interest rate for these transactions increased by 9 basis points, reaching to 5.24 per cent by the end December. The overnight transactions interest rate was influenced by the change of demand/supply ratios. It decreased from 5.00 per cent in the third quarter to 4.52 per cent in the fourth quarter, when the volume of transactions was higher (ALL 0.9 billion on average, against ALL 0.6 billion).

The issues of Government securities in the primary market increased in the second semester, in particular for maturities of longer than one year. The banking system treasury bills' portfolio decreased by ALL 10.8 billion, while the bonds' portfolio of two- and three-year maturity<sup>16</sup> increased by ALL 19.5 billion. For the first time in November, were issued bonds of five-year maturity, whose yield resulted in 9.68 per cent.

The tightening of monetary policy and the occasional non-accomplishment of Government demand for liquidity from the banking system, caused the treasury bills yield to increase significantly compared to the first semester, when they decreased to historical minimum levels. By the end of December, the treasury bills yield of 12-month maturity increased to 7.88 per cent or 214 basis points above the yield in June<sup>17</sup>. For bonds of two- and three-year maturity, the yields increased to 8.40 per cent and 8.80 per cent from 6.38 per cent and 7.50 per cent, respectively, in June.

#### Banking system interest rates

According to the most recent data for November, there has been an increase of ALL deposits and loan interests of all maturities, except for interests of 2-year deposits and credit from 6 months to 1 year. The increase of interests was a reaction of these markets to the tightening policy pursued by the Bank of Albania, and to the increase of interests for loans and liquidities. As opposed to June, the increase of loan interests exceeded the increase signalled by the Bank of Albania, while ALL deposits interests did not pursue the same trend. The banks were more reserved in increasing the ALL deposits interests, since the system has in general resulted in excess of liquidity from June to November 2006. The more rapid increase of loan interests than deposits interests brought about the increase of intermediation cost<sup>18</sup>.

|                        | November-05 | June-06 | November-06 |
|------------------------|-------------|---------|-------------|
| 6-month loans-deposits | 8.47%       | 6.93%   | 11.1%↑      |
| 1-year loans-deposits  | 7.84%       | 6.75%   | 8.7%↑       |

Source: Bank of Albania

Chart 35 Borrowing interests in the interbank market and the Bank of Albania monetary policy

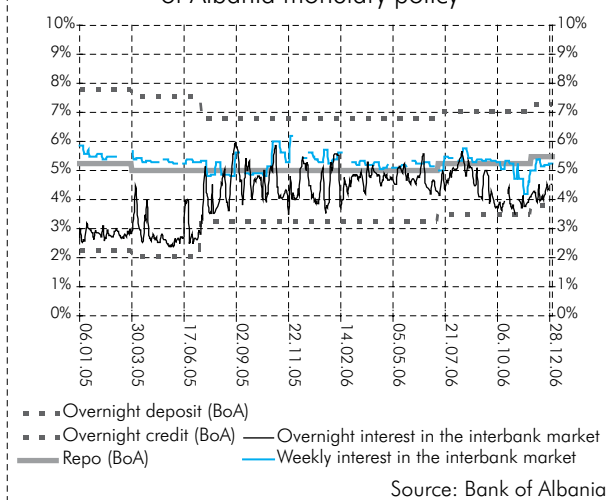


Chart 36 Yield of treasury bills and of bonds of two-year maturity

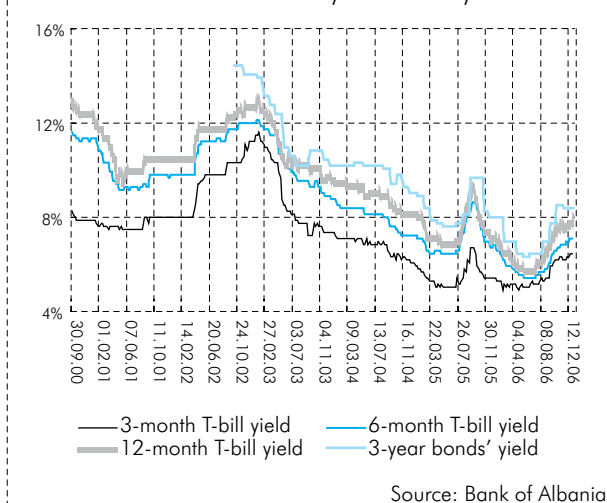


Table 18 Intermediation cost in lek

The tightening monetary policy pursued by the European Central Bank over the second semester 2006<sup>19</sup> influenced on the increase of loan and deposits interests in euro of all maturities<sup>20</sup>. In November, the average weighted interest of EUR loans reached 8.02 per cent from 7.75 per cent as of the end of the first semester.

As far as USD interests are concerned, under the conditions of a tightening monetary policy signalled by the Federal Reserve at the end of June 2006, the overall tendency was their increase both for deposits and loans. USD loan interests of all maturities increased from 9.85 per cent in June to 9.96 per cent in November 2006. Over the second semester of 2006, USD deposits interests increased in almost all maturities, exceeding, in most cases, the increase signalled by the Federal Reserve<sup>21</sup>. The expectations for the decrease of the core interest rate by the Federal Reserve in the following months, caused in November to be displayed cases of decrease in the interests of demand deposits, 1-month deposits, 2-year deposits, up to 6-month loans and loans from 6 months to 1 year.

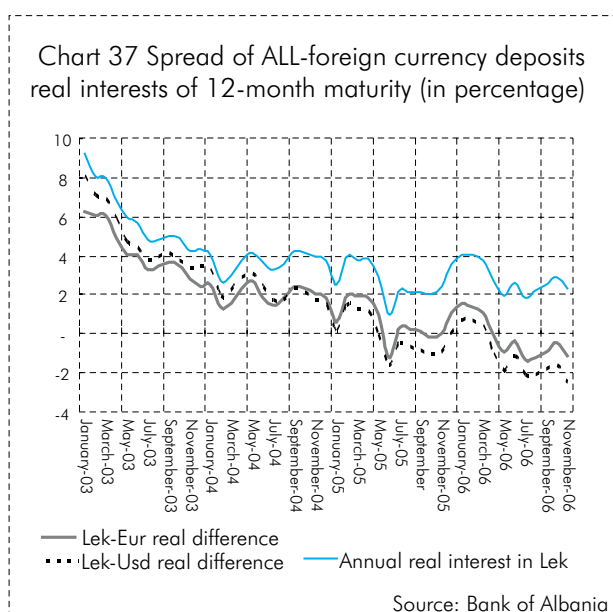
The difference of lek and foreign currency interests of deposits of 3-month, 6-month and 12-month maturity had, in general<sup>22</sup>, a downward tendency. The increase of the core interest rate by the Bank of Albania in November is expected to influence on the increase of this difference.

Table 19 Difference of ALL-foreign currency deposits interests

|          | December 2005 | June 2006 | November 2006 |
|----------|---------------|-----------|---------------|
| ALL-USD  |               |           |               |
| 3-month  | 1.6%          | 0.2%      | 0.3%          |
| 6-month  | 2.1%          | 0.9%      | 0.7%          |
| 12-month | 2.1%          | 1.2%      | 0.5%          |
| ALL-EUR  |               |           |               |
| 3-month  | 2.2%          | 1.3%      | 1.0%          |
| 6-month  | 2.8%          | 1.4%      | 1.4%          |
| 12-month | 3.1%          | 2.0%      | 1.9%          |

Source: Bank of Albania

The following chart displays the spread of ALL deposits real interests to foreign currency ones for deposits of 12-month maturities, which continues to have a downward tendency.



Exchange rate performance

The developments in the lek exchange rate over the second semester of 2006 confirmed the slowdown of its appreciating trend against the main currencies. In annual nominal effective terms, the lek appreciated by 1.1 per cent, on average, against the appreciation by 2.8 per cent over the previous year. The USD depreciation in the international foreign currency market continued to favour the appreciating trend of the lek against the dollar over the second semester. On the other hand, the lek was more stable against the EUR, displaying a slight depreciating tendency.

Over summer, the lek was confronted with a less moderate seasonal effect, compared to the previous years. Despite the higher fluctuation of the lek against the euro over the second semester, it followed the downward trend observed over the years. The lek stability was a result of the improvement in the functioning of the foreign currency market and of a number of macroeconomic developments, such as the stable economic growth, the low inflation, the transparency and the moderation of the lack of confidence related to the performance of these indices in the future.

## 5 EXPECTED PERFORMANCE OF ECONOMY OVER 2007

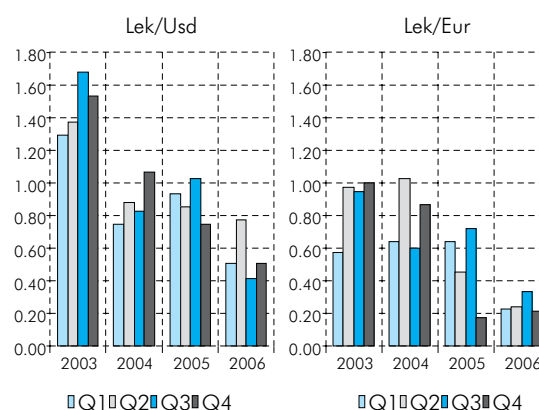
The economic activity has been displaying positive development tendencies over the recent years. The economy has grown by about 5-6 per cent in real terms, while the investment rate in economy has increased to more than 25 per cent of the GDP, against the 23-24 per cent rates over the previous years. The current macroeconomic framework takes into account the performance of both fiscal and monetary indicators, while the trends of external sector indicators have been in line with the projected economic growth. The macroeconomic situation as a whole remains favourable for 2007, while the accomplishment of the projected indicators for this year is projected to provide for an economic growth of about 6 per cent.

Chart 38 Lek performance in nominal effective terms (NEER<sup>23</sup>).



Source: Bank of Albania

Chart 39 Lek exchange fluctuation<sup>24</sup> over quarters



Source: Bank of Albania

|                                     | 2002                   | 2003   | 2004   | 2005   | 2006*  | 2007•  |
|-------------------------------------|------------------------|--------|--------|--------|--------|--------|
| <b>Real economy indicators</b>      | (in percentage points) |        |        |        |        |        |
| GDP growth                          | 2.9                    | 5.7    | 5.9    | 5.5    | 5.0    | 6.0    |
| Annual CPI (average)                | 5.2                    | 2.4    | 2.9    | 2.5    | 2.4    | 3.0    |
| Nominal GDP (in billions of ALL)    | 624.7                  | 682.7  | 766.1  | 836.6  | 896.3  | 978.9  |
| <b>Fiscal indicators</b>            | (as a share to GDP)    |        |        |        |        |        |
| Fiscal deficit (with grants)        | -6.6                   | -4.5   | -5.1   | -3.6   | -3.1   | -3.9   |
| Domestic borrowing                  | -3.3                   | -2.9   | -2.3   | -2.7   | -2.2   | -2.0   |
| Revenues                            | 24.7                   | 24.5   | 24.1   | 24.4   | 25.7   | 25.9   |
| Expenditure                         | 31.4                   | 29.0   | 29.2   | 28.0   | 28.9   | 29.8   |
| <b>External sector</b>              |                        |        |        |        |        |        |
| Trade deficit (in millions of EUR)  | -1,214                 | -1,248 | -1,307 | -1,617 | -1,707 | -1,853 |
| Current account deficit (% to GDP)  | -10.0                  | -8.1   | -5.5   | -7.5   | -7.2   | -7.5   |
| <b>Monetary indicators</b>          | (as a share to GDP)    |        |        |        |        |        |
| Monetary supply                     | 65.3                   | 65.0   | 65.7   | 68.4   | 73.3   | 75.0   |
| Credit to private sector            | 6.4                    | 7.7    | 9.4    | 14.9   | 20.8   | 25.5   |
| Interest of 12-month treasury bills | 12.0                   | 9.5    | 8.1    | 6.9    | 7.8    | --     |

\* Preliminary data, • Projections

\*\* Primary deficit excludes expenses of Government debt interests.

Source: Bank of Albania, Ministry of Finance, INSTAT

Table 20 Main macroeconomic indicators

*Macroeconomic balance and fiscal sector*

The macroeconomic framework for 2007 projects a slight increase of domestic savings in economy, accounting for about 19.9 per cent of the GDP, against 19.2 in the previous year, mainly from the private sector. This increase in savings is expected to be entirely channelled in the financing of supplementary investment. The average level of investments over the recent years varied to about 24 per cent of the GDP and their growth of 26 per cent in 2007 is projected to improve the performance of exports in economy for the upcoming periods. Under these conditions, the savings-investment balance is projected to about 6.2 per cent. This high ratio implies the aggravation of the current account (in the same level of 6.2 per cent), although the exports-imports balance varies to 23.3 per cent, as in 2006<sup>25</sup>.

Positive is the fact than the increase of the savings-investments macroeconomic balance and the aggravation of the current account are a result of the higher growth rate of investments, a tendency which promotes the economic and exports growth in the long run. Moreover, the higher level of savings is entirely based on the increase of the private sector's savings, while the level of public sector's savings is projected to account for about 2.5 per cent of the GDP, as in 2006.

The fiscal account contribution to the increase of savings-investments balance is projected to account for about 4.6 per cent of the GDP, while the rest makes up the private sector's deficit. The Government fiscal projections provide for the financing of the fiscal deficit through domestic borrowing to 2.5 per cent and external sources finances to about 2 per cent<sup>26</sup>.

*Monetary sector*

Based on the projections related to the growth of credit to the private sector and of Government borrowing, broad money is expected to grow by about 11.9 per cent in 2007. Moreover, the growth of M2 monetary aggregate is projected to about 11.4 per cent.

Money supply growth over 2007 will be a result of the growth of credit to economy by about ALL 63.3 billion and of the Government borrowing financing by the banking system, by about ALL 12 billion. The other share of domestic borrowing for the financing of deficit is projected to be covered by other financial institutions and households. The current projections concerning money supply and credit indicators are conditioned by the monetary policy stance related to inflation forecasts. The projected growth of money supply for 2007 is in line with an average inflation rate of about 3 per cent. The financial markets development and further deepening is expected to be positively influenced by the presence of Government securities of long-term maturity. The dynamics of demand for money requires the maintenance of an upward tendency of interest rates in the market. Moreover, the stable current account and the projections for an inflation rate being close to the objective are expected to provide a positive contribution to maintaining exchange rate stability.

## ENDNOTES

<sup>1</sup> FOMC - Federal Open Market Committee.

<sup>2</sup> Real effective exchange rate calculated as the weighted average of a country's currency relative to a basket of the country's main trade partners.

<sup>3</sup> Agriculture not included. Agro industry is included in 'Processing industry'.

<sup>4</sup> According to the supplementary budget.

<sup>5</sup> Referring to the nominal effective exchange rate calculated by the Bank of Albania.

<sup>6</sup> Source: ISTAT; web page: <http://www.istat.it>

<sup>7</sup> Source: National Statistical Service of Greece; web page: <http://www.statistics.gr>

<sup>8</sup> Source: Eurostat, web page: <http://epp.eurostat.ec.eu.int>

<sup>9</sup> Source: National Statistical Service of Greece; web page: <http://www.statistics.gr>

<sup>10</sup> Source: Italian National Statistics Institute; web page: <http://www.istat.it>

<sup>11</sup> Source: EUROSTAT; web page: <http://epp.eurostat.ec.eu.int>

<sup>12</sup> The Bank of Albania quantitative objectives are part of the new PRGF/ EFF 2006-2008 arrangement, signed between the Albanian Government, the IMF and the Bank of Albania in January 2006.

<sup>13</sup> The significant reduction of credit to agriculture observed from June 2006 mainly reflects the changes in reporting, according to the reassessment of one of the largest bank's credit portfolio in the banking system.

<sup>14</sup> The operative data for December indicate that the Government only issued bonds of 2-year maturity, amounting to ALL 3 billion.

<sup>15</sup> See: Statistical Annex; Financial Markets; Table 10 "End-month interest rates and their change to previous periods".

<sup>16</sup> Issued for the first time in April 2006.

<sup>17</sup> See: Statistical Annex; Financial Markets; Table 10 "End-month interest rates and their change to previous periods".

<sup>18</sup> Difference of ALL credit and deposits interests of 6- and 12-month maturity.

<sup>19</sup> The most recent data refer to November 2006.

<sup>20</sup> Excluding demand deposits interests and credit interests of 1-3 years maturity.

<sup>21</sup> See: Statistical Annex; Financial Markets; Table 12 "Interest rates of deposits in foreign currency".

<sup>22</sup> Excluding the ALL and EUR deposits interests of 3-month maturity, whose difference has increased compared to June.

<sup>23</sup> NEER – nominal effective exchange rate measured against two currencies according to an approximate share they have in trade with abroad, EUR (80 per cent) and USD (20 per cent). December 2001: NEER = 100. An increase of the NEER implies the lek appreciation.

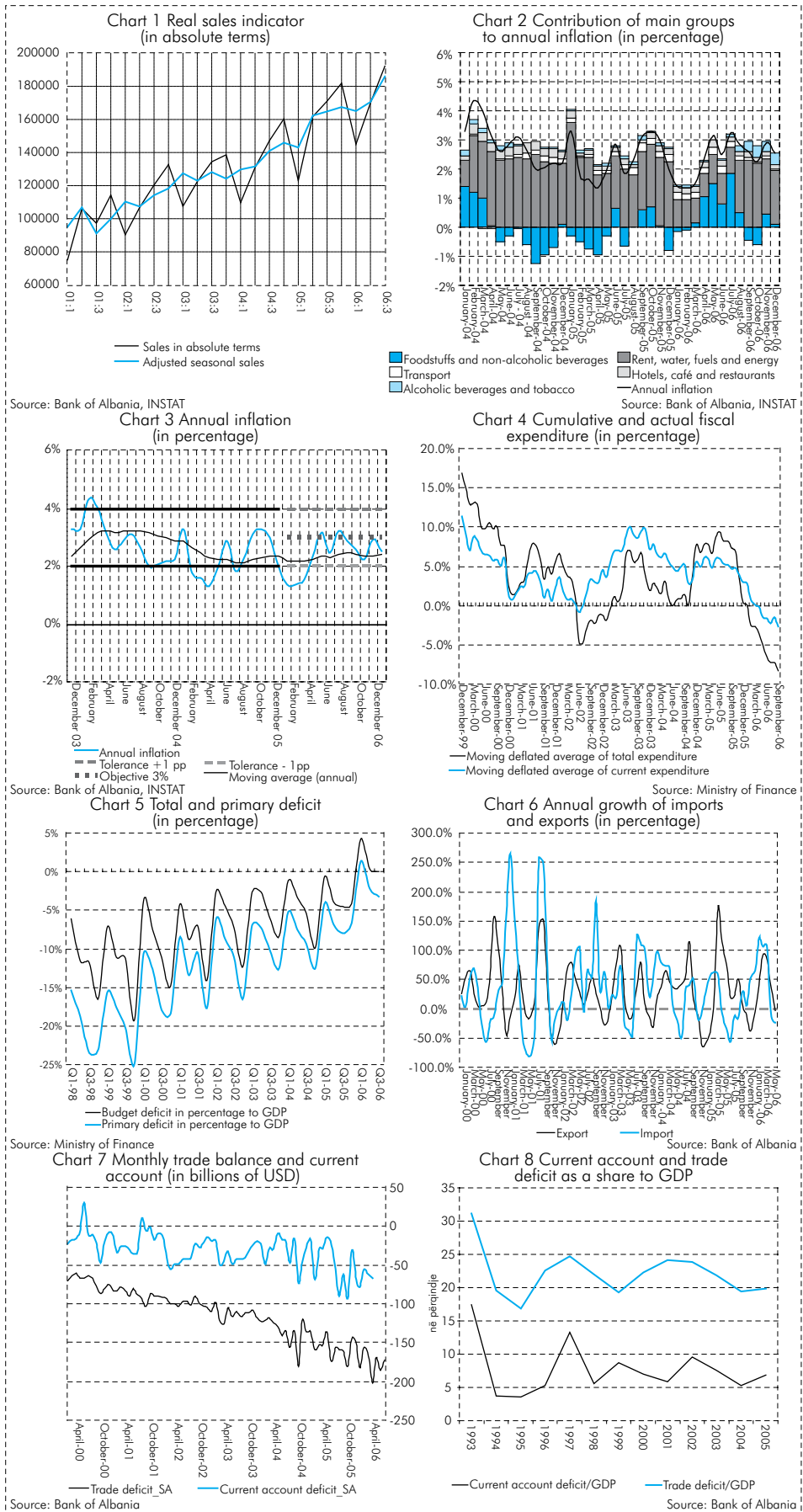
<sup>24</sup> Calculated as the quarterly average of the exchange rate volatility. Exchange rate volatility is measured as the standard deviation  $\sqrt{\frac{\sum (x_i - \bar{x})^2}{n-1}}$ ,  $x_i$  – exchange rate in period  $i$ ,  $\bar{x}$  – average of period  $i$  (for example, the exchange rate in a day of a given month in year  $i$  minus the average rate of

the month in year i).

<sup>25</sup> The difference corresponds with the aggravation of the balance of revenues from transfers from abroad.

<sup>26</sup> According to the Government budget data approved by the Parliament, which projects privatization revenues to account for 0.1 per cent of the GDP.

STATISTICAL ANNEX



## INFLATION

Table 1 Annual inflation rates (in percentage)

|           | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|-----------|------|------|------|------|------|------|
| January   | 2.2  | 6.5  | 0.0  | 3.3  | 3.3  | 1.4  |
| February  | 1.5  | 7.6  | 1.1  | 4.4  | 1.8  | 1.3  |
| March     | 2.9  | 7.5  | 1.3  | 4.0  | 1.6  | 1.5  |
| April     | 3.0  | 6.5  | 2.3  | 3.2  | 1.3  | 2.4  |
| May       | 2.5  | 4.6  | 2.8  | 2.6  | 2.0  | 3.1  |
| June      | 4.0  | 3.7  | 2.6  | 2.9  | 2.9  | 2.4  |
| July      | 5.6  | 4.2  | 3.0  | 3.1  | 1.8  | 3.2  |
| August    | 4.1  | 5.5  | 3.0  | 2.7  | 2.3  | 2.9  |
| September | 3.5  | 5.3  | 2.8  | 2.0  | 3.1  | 2.6  |
| October   | 1.8  | 5.8  | 2.9  | 2.0  | 3.3  | 2.3  |
| November  | 2.8  | 3.7  | 3.4  | 2.2  | 3.0  | 2.9  |
| December  | 3.5  | 1.7  | 3.3  | 2.2  | 2.0  | 2.5  |
| Average   | 3.1  | 5.2  | 2.2  | 3.0  | 2.4  | 2.4  |

Source: INSTAT

Table 2 Contribution of basket constituent groups to total inflation

|  | March<br>- 06 | April<br>- 06 | May<br>- 06 | June<br>- 06 | July<br>- 06 | August<br>- 06 | September<br>- 06 | October<br>- 06 | November<br>- 06 | December<br>- 06 |
|--|---------------|---------------|-------------|--------------|--------------|----------------|-------------------|-----------------|------------------|------------------|
| Foodstuffs and non-alcoholic beverages | 0.16          | 1.03          | 1.51        | 0.80         | 1.86         | 0.51           | -0.45             | -0.59           | 0.45             | 0.09             |
| Rent, water, fuels and energy          | 0.85          | 0.84          | 1.00        | 1.04         | 0.88         | 1.78           | 2.32              | 2.19            | 1.91             | 1.87             |
| Transport                              | 0.14          | 0.13          | 0.23        | 0.24         | 0.19         | 0.13           | 0.10              | 0.09            | 0.08             | 0.05             |
| Hotels, café and restaurant            | 0.20          | 0.22          | 0.22        | 0.22         | 0.16         | 0.18           | 0.18              | 0.15            | 0.15             | 0.14             |
| Other                                  | 0.11          | 0.12          | 0.10        | 0.15         | 0.15         | 0.24           | 0.40              | 0.40            | 0.32             | 0.40             |
| Total                                  | 1.48          | 2.35          | 3.1         | 2.45         | 3.24         | 2.84           | 2.55              | 2.24            | 2.91             | 2.55             |

Source: INSTAT, Bank of Albania

## MONETARY AGGREGATES

Table 3 Performance of monetary aggregates (in billions of ALL)

|                        | November-06 | Monthly change |            | Annual change |            |
|------------------------|-------------|----------------|------------|---------------|------------|
|                        |             | Absolute       | Percentage | Absolute      | Percentage |
| Currency outside banks | 146.3       | 0.5            | 0.3        | 6.6           | 4.8        |
| Total deposits         | 491.7       | 2.2            | 0.5        | 65.4          | 15.3       |
| - in lek               | 303.3       | 3.2            | 1.1        | 29.4          | 10.7       |
| - in foreign currency  | 188.4       | -1.0           | -0.5       | 36.0          | 23.6       |
| Demand deposits        | 146.9       | -3.4           | -2.3       | 15.9          | 12.2       |
| - in lek               | 80.5        | 0.8            | 1.1        | 4.6           | 6.0        |
| - in foreign currency  | 66.3        | -4.3           | -6.1       | 11.3          | 20.6       |
| Time deposits          | 344.9       | 5.7            | 1.7        | 49.5          | 16.7       |
| - in lek               | 222.7       | 2.4            | 1.1        | 24.8          | 12.5       |
| - in foreign currency  | 122.1       | 3.3            | 2.7        | 24.7          | 25.3       |
| M1                     | 226.9       | 1.3            | 0.6        | 11.2          | 5.2        |
| M2                     | 449.6       | 3.7            | 0.8        | 36.0          | 8.7        |
| M3                     | 638.0       | 2.7            | 0.4        | 72.0          | 12.7       |
| Monetary base          | 209.3       | 3.6            | 1.7        | 20.4          | 10.8       |

Source: Bank of Albania



Table 4 Performance of NFA indicators by main groups (in millions of USD)

|                     | November - 06 | Monthly change | Annual change |
|---------------------|---------------|----------------|---------------|
| Net foreign assets  | 2,440.7       | 35.7           | 393.4         |
| Foreign assets      |               |                |               |
| Bank of Albania     | 1,700.0       | 45.0           | 332.5         |
| ODC                 | 1,105.6       | 18.6           | 196.1         |
| Foreign liabilities |               |                |               |
| Bank of Albania     | 108.8         | 1.9            | 3.1           |
| ODC                 | 256.1         | 26.0           | 132.1         |

Source: Bank of Albania

Table 5 Net Claims on the Government by main groups (in millions of ALL)

|  | November - 06 | Monthly changes | Annual changes |
|--|---------------|-----------------|----------------|
| Net claims of the Government           | 275,738.3     | 1,258.5         | - 3,014.5      |
| Bank of Albania                        | 50,229.1      | - 2,203.2       | - 7,291.3      |
| ODC                                    | 225,509.2     | 3,461.7         | 4,276.8        |
| Deposits held with the Bank of Albania | 10,655.9      | 2,949.4         | 6,297.1        |
| Budget deficit                         | - 27.4        | - 3,448.2       | 11,845.6       |

Source: Bank of Albania

Table 6 Performance of some main indicators

|   | 2003  | 2004  | 2005  |        | 2006  |          |
|---|-------|-------|-------|--------|-------|----------|
|   |       |       | S1    | S2     | S1    | November |
| Money supply (in billions of ALL)                 | 448.4 | 507.2 | 541.8 | 578.04 | 594.5 | 638.0    |
| Domestic credit (in percentage to M3)             | 71.5  | 68.9  | 69.9  | 70.03  | 71.0  | 71.4     |
| Credit to Government (in percentage to M3)        | 60.2  | 55.1  | 52.2  | 48.94  | 45.3  | 43.2     |
| Credit to economy (in percentage to M3)           | 11.3  | 13.8  | 17.7  | 21.10  | 25.71 | 28.1     |
| Credit to economy (in percentage to total assets) | 13.7  | 16.9  | 20.8  | 25.11  | 28.7  | 31.0     |
| Credit to economy (in percentage to GDP)          | 6.8   | 9.0   | 11.2  | 14.57  | 17.6  | 20.1     |
| Credit/deposits ratio (in percentage)             | 15.7  | 19.0  | 23.6  | 28.47  | 33.7  | 36.5     |

Source: Bank of Albania

Table 7 Outstanding credit indicators as a share to total

|   | 2003 | 2004 | 2005  | Q1-06 | Q2- 06 | Q3 '06 | October '06 | November '06 |
|---|------|------|-------|-------|--------|--------|-------------|--------------|
| Outstanding credit (in billions of ALL) | 50.7 | 69.3 | 121.6 | 134.6 | 152.8  | 165.3  | 172.8       | 179.5        |
| Credit to households                    | 24.5 | 30.6 | 32.3  | 31.9  | 32.3   | 33.3   | 33.3        | 33.4         |
| Credit to private sector                | 75.5 | 69.4 | 67.7  | 68.1  | 67.6   | 66.7   | 66.7        | 66.6         |
| Short-term credit                       | 46.0 | 34.0 | 32.3  | 32.5  | 31.1   | 30.0   | 29.6        | 28.8         |
| Medium-term credit                      | 33.3 | 36.0 | 29.7  | 30.0  | 31.2   | 32.6   | 32.3        | 33.2         |
| Long-term credit                        | 20.7 | 30.0 | 37.9  | 37.5  | 37.7   | 37.4   | 38.1        | 37.9         |
| Lek                                     | 19.6 | 19.5 | 26.6  | 26.0  | 28.2   | 29.8   | 29.4        | 29.7         |
| Foreign currency                        | 80.4 | 80.5 | 73.4  | 74.0  | 71.8   | 70.2   | 70.6        | 70.3         |

Source: Bank of Albania

Table 8 New credit indicators as a share to total

|                                 | 2004  | 2005 |      |      |      | 2006 |      |      |          |
|---------------------------------|-------|------|------|------|------|------|------|------|----------|
|                                 | Total | Q1   | Q2   | Q3   | Q4   | Q1   | Q2   | Q3   | November |
| New credit (in billions of ALL) | 99.7  | 22.1 | 32.8 | 32.1 | 32.9 | 29.4 | 35.7 | 35.8 | 15.9     |
| Short-term credit               | 62.54 | 53.2 | 47   | 47.4 | 48.7 | 44.2 | 42   | 45.8 | 56.2     |
| Medium-term credit              | 22.53 | 22.4 | 31   | 30.3 | 25.6 | 30.1 | 33   | 31.2 | 22.6     |
| Long-term credit                | 14.93 | 24.4 | 22   | 22.2 | 25.7 | 25.7 | 26   | 23.0 | 22.2     |
| Credit in lek                   | 32.59 | 30.1 | 32.8 | 30.2 | 31.4 | 27.7 | 35   | 39.6 | 27.6     |
| Credit in foreign currency      | 67.41 | 70   | 67.2 | 69.8 | 68.6 | 72.3 | 65   | 61.4 | 73.4     |

Source: Bank of Albania

Table 9 Distribution of credit by sectors of economy (as a share to total)

|  | 2004  |      |      | 2005 |      |      |      |      | 2006    |          |
|--|-------|------|------|------|------|------|------|------|---------|----------|
|  | Total | Q1   | Q2   | Q3   | Q4   | Q1   | Q2   | Q3   | October | November |
| Agriculture, Hunting and Silviculture              | 1.5   | 1.3  | 1.5  | 2.4  | 2.7  | 2.2  | 0.9  | 0.7  | 0.7     | 0.7      |
| Fishing  | 0.1   | 0.01 | 0.1  | 0.1  | 0.1  | 0.1  | 0.1  | 0.11 | 0.1     | 0.1      |
| Extracting Industry                                | 0.3   | 2.35 | 0.6  | 0.5  | 0.5  | 1.4  | 2.3  | 1.0  | 0.9     | 0.9      |
| Processing Industry                                | 17.1  | 15.8 | 15.6 | 13.9 | 13.8 | 14.2 | 15.3 | 15.5 | 14.9    | 14.5     |
| Production, Distribution of Energy, Gas and Water  | 2.8   | 6.27 | 2.9  | 2.9  | 2.6  | 2.4  | 1.1  | 1.2  | 1.6     | 1.5      |
| Construction                                       | 9.8   | 10.6 | 11.2 | 12.8 | 13   | 13.0 | 12.2 | 12.6 | 12.2    | 12.1     |
| Trade, Repair of Vehicles and Household Appliances | 23.3  | 20.5 | 19.1 | 20   | 18.9 | 19.0 | 22.5 | 23.1 | 23.2    | 23.4     |
| Hotels and Restaurants                             | 8.3   | 2.5  | 4.7  | 4.4  | 4.3  | 4.8  | 4.1  | 3.9  | 3.7     | 3.6      |
| Transport and Telecommunication                    | 2     | 2.5  | 1.7  | 1.7  | 1.5  | 1.3  | 1.6  | 1.6  | 1.6     | 2.0      |
| Financial Activities                               | 0.2   | 0.2  | 1.1  | 0.7  | 0.8  | 0.7  | 1.3  | 0.7  | 1.4     | 1.3      |
| Health and Social Activities                       | 0.5   | 0.1  | 0.4  | 0.6  | 0.7  | 0.6  | 0.6  | 0.3  | 0.3     | 0.2      |
| Collective, Social and Personal Services           | 4.8   | 8.3  | 7.4  | 5.9  | 5.8  | 4.6  | 1.7  | 2.0  | 2.1     | 2.1      |
| Other*   | 29.1  | 29.6 | 33.7 | 34.1 | 35.4 | 35.7 | 36.2 | 35.1 | 37.5    | 37.7     |
| Total  | 100   | 100  | 100  | 100  | 100  | 100  | 100  | 100  | 100     | 100      |

Source: Bank of Albania

\* "Other" includes credit extended to some sectors sharing a small weight in the country's economic activity and credit to households. Upon the introduction of new credit forms was required to review the credit distribution by sectors, where the new classification was introduced.

## FINANCIAL MARKETS

Table 10 End-month interest rates and their change compared to previous periods (in percentage points)

|                               | December '06 | Change<br>December '06 - November '06 | Change<br>December '06 – June '06 |
|-------------------------------|--------------|---------------------------------------|-----------------------------------|
| Core interest rate*           | 5.50%        | +0.25                                 | +0.50                             |
| Interbank market              |              |                                       |                                   |
| Overnight interest            | 4.52         | +0.42                                 | +0.31                             |
| Weekly interest               | 5.24         | +0.26                                 | +0.09                             |
| Primary market                |              |                                       |                                   |
| 3-month Treasury bills yield  | 6.25%        | +0.01                                 | +1.02                             |
| 6-month Treasury bills yield  | 7.18%        | +0.31                                 | +1.76                             |
| 12-month Treasury bills yield | 7.88%        | +0.34                                 | +2.14                             |
| Bonds market                  |              |                                       |                                   |
| 2-year bonds yield            | 8.40%        | 0.00                                  | +2.01                             |
| 3-year bonds yield            | 8.80%        | -                                     | +1.30                             |
| 5-year bonds yield            | 9.68%        | -                                     | -                                 |

Source: Bank of Albania and commercial banks

\* Core interest rate throughout November was 5.25 per cent. On 30 November, it was increased to 5.50 per cent.

Table 11 Interest rates and their change in the lek deposits and credit market (in percentage points)

|                             | November '06 | Change<br>November '06 – October '06 | Change<br>November '06- June '06 |
|-----------------------------|--------------|--------------------------------------|----------------------------------|
| Core interest rate          | 5.25         | 0.00                                 | 0.25                             |
| Interest of deposits in lek |              |                                      |                                  |
| 3-month                     | 3.86%        | 0.01                                 | 0.12                             |
| 6-month                     | 4.51%        | 0.01                                 | 0.16                             |
| 12-month                    | 5.33%        | 0.13                                 | 0.28                             |
| 24-month                    | 5.59%        | -0.19                                | -0.31                            |
| Interest of credit in lek   |              |                                      |                                  |
| Up to 6-month credit        | 15.61%       | 0.41                                 | 4.33                             |
| 6-month to 1 year credit    | 13.99%       | -1.23                                | 2.19                             |
| 1-3 years credit            | 17.26%       | 0.42                                 | 1.37                             |
| Over 3-year credit          | 13.03%       | 0.68                                 | 1.61                             |

Source: Bank of Albania and commercial banks

Table 12 Interest rates of deposits in foreign currency (in percentage points)

|                             | November – '06 | Change<br>November '06 – October '06 | Change<br>November '06 – June '06 |
|-----------------------------|----------------|--------------------------------------|-----------------------------------|
| Fed – Core interest rate    | 5.25%          | +0.00                                | +0.25                             |
| Interest of deposits in USD |                |                                      |                                   |
| 1-month                     | 3.01%          | -0.07                                | 0.67                              |
| 3-month                     | 3.61%          | 0.09                                 | 0.08                              |
| 6-month                     | 3.81%          | 0.05                                 | 0.40                              |
| 12-month                    | 4.79%          | 0.20                                 | 0.97                              |
| 24-month                    | 4.72%          | -0.04                                | 0.34                              |
| ECB – Core interest rate    | 3.25%          | +0.25                                | +0.75                             |
| Interest of deposits in EUR |                |                                      |                                   |
| 1-month                     | 2.71%          | 0.24                                 | 0.58                              |
| 3-month                     | 2.85%          | 0.08                                 | 0.42                              |
| 6-month                     | 3.10%          | -0.07                                | 0.19                              |
| 12-month                    | 3.45%          | 0.03                                 | 0.41                              |
| 24-month                    | 4.13%          | 0.07                                 | 0.50                              |

Source: Bank of Albania and commercial banks

Table 13 Interest rate spread of deposit – credit in lek and in foreign currency

| Spread of deposit interest |          |              |          |              |
|----------------------------|----------|--------------|----------|--------------|
|                            | ALL-USD  |              | ALL-EUR  |              |
|                            | June '06 | November '06 | June '06 | November '06 |
| 3-month                    | 0.21%    | 0.25%        | 1.31%    | 1.01%        |
| 6-month                    | 0.94%    | 0.70%        | 1.44%    | 1.41%        |
| 12-month                   | 1.23%    | 0.54%        | 2.01%    | 1.88%        |
| Spread of credit interest  |          |              |          |              |
|                            | ALL-USD  |              | ALL-EUR  |              |
|                            | June '06 | November '06 | June '06 | November '06 |
| 6-month                    | 2.00%    | 6.82%        | 2.99%    | 6.83%        |
| 6-month – 1 year           | 0.58%    | 2.42%        | 4.45%    | 6.48%        |
| 1-3 years                  | 6.25%    | 7.25%        | 7.45%    | 9.88%        |
| Over 3 years               | 2.64%    | 3.87%        | 3.76%    | 4.76%        |

Source: Bank of Albania and commercial banks