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MONETARY POLICY STATEMENT FOR THE FIRST HALF OF 2008

I. GOVERNOR'S SPEECH

The recent developments attest to further deepening of the U.S. financial crisis, peaking in the last weeks with the collapse of one of the largest investment banks Lehman Brothers. Prior to this startling failure, the two U.S. mortgage giants, Freddie Mac and Fannie Mae, were subject to an unprecedented and costly rescue plan designed by the U.S. Treasury Department. In fact, this has only been one of the U.S. authorities' interventions, followed by a number of other actions, involving the AIG insurance company, Merrill Lynch and in particular the plan announced on 21 September 2008 for the creation of a 700 billion dollars fund for the purchase of mortgage-related assets.

This crisis which is characterizing the global economy for more than a year has caused many reputable international financial institutions to experience large financial losses. The situation remains unclear and the spreading process of its undesired effects may also be present in the months to follow.

U.S. crisis and its combination with a number of other global developments have caused the economic situation in developed countries to be characterized by numerous uncertainties. Inflation has now turned into a concern for most international economies, mainly reflecting the surge in prices of raw materials, oil and food. Economic growth in developed economies has shown distinct signs of slowdown. Economic growth for the Euro area shrank by 0.2 percent in the second quarter of 2008 relative to the first quarter of the same year. Meantime, the U.S. economy is expected to continue to grow at slow rates during the second half of the year.

Under these circumstances, there has been high tension in the markets being mainly reflected in the dropping value of financial assets, changes in the prices of raw material and commodities, contracted house prices and the increase in the interest rates spread. In response to this situation, the largest global central banks have taken co-ordinated measures to relieve the markets by mainly injecting large amounts of liquidity. However, in their last meetings, both the Federal Reserve and the ECB kept the key interest rate unchanged at 2 percent and 4.25 percent, respectively.

With respect to internal developments, year-on-year inflation dropped to 2.5 percent in August 2008, being in line with the previous projections of the Bank of Albania. The eighth-month period of January – August 2008 was characterized by considerable fluctuations of the year-on-year inflation rate which marked an average of 3.8 percent. Since August 2007 to June 2008

there have been negative developments in this respect, causing the inflation rate to remain above the upper tolerance band of 4 percent. The price rise of food and oil in the global market, the performance of agricultural production in 2007 and the price rise of energy in March 2008 represent some of the main causes to explain the inflation increase during this period.

Headline inflation and other measures of core inflation have shown a downward tendency in the last two months. Supply-side factors which pushed the increase of inflation in the previous period reduced their effect in July and August. Weather conditions during the present year have been encouraging, causing the domestic supply of agricultural production to grow. Seasonal effect generated by the entry of domestic agricultural production was more considerable relative to the previous year. Oil and grain prices in the global market have been falling in the last two months. The projections of the Bank of Albania staff indicate that the inflation rate will remain in the following 12 months at around 3 percent, which is also our quantitative objective.

Despite this, worth to note is that the risks for its upward deviation are still present and they mostly relate to the international developments. However, plausible risks are present in the internal developments and they will be constantly subject to analyses of the Supervisory Council of the Bank of Albania. Any unwelcome developments in the energy situation in the months to follow, the rapid growth of credit to economy and other possible fiscal implications in the future represent the main risks in this context.

Statistical monitoring of the Albanian economic activity continues to reflect difficulties. According to the data made available for the first quarter of 2008 and some other indirect indicators covering the 6 and 9-month period (growth of exports, growth of budget revenues, hydro energy situation and some other consumer indicators) it may be concluded that gross domestic product will grow in line with the previous projections by 6 percent. However, more statistical information is required to make a more detailed and comprehensive sectoral analysis.

In contrast to the previous two years, budget revenues followed a different trend in the first half of 2008, being mainly manifested in a more rhythmical spending. Unlike the last two years, budget balance ended negative, 2.3 billion leks, which is far behind the projected level of 18 billion leks. Budget revenues continued the previous months' trend, exceeding the planned target by about 3 percent in the first half of 2008. Expenditures accelerated their meeting rates, in particular in the end of the six-month period, and met 92 percent of planned target. Domestic borrowing represents the main instrument of budget deficit financing, sharing 90 percent of total borrowing.

The first half of 2008 recorded a 60 percent growth of current deficit in annual terms, which amounted to 591 million euros. Consequently, it accounts for about 13 percent of the GDP. The high trade deficit, which has provided the main contribution to current deficit deepening during this period, was also followed by the deficit on trade in services and the narrowing of net

current transfers' surplus. The Bank of Albania is monitoring prudently the developments in the external sector of the economy, which for the moment remain a concern in terms of long-term developments in economy. The main implications relate among others with the financial stability in the country, while their source relates with the imposed correction of long-term ratios within a short period of time.

Demand for money in economy has grown at a stable rate by an average of 12 percent in annual terms during 2008. Credit to the private sector dominates the money growth in economy, while credit to the public sector still remains at modest levels, accounting for only about 2.5 percentage points of M3 annual growth. In terms of constituent components of money supply, its most liquid part, currency outside banks, continues to grow at slow rates, while deposits show high growth rates. Being mainly pushed by the marketing strategies of the banking system applied during summer 2008, annual growth of lek and foreign currency-denominated deposits was 11.2 percent and 30 percent, respectively. During the last two months, their time structure has shifted to time deposits, being mainly reflected in the growth of households' time deposits.

During the seven-month period of 2008, credit to economy continued to grow at an average annual rate of 45.5 percent, accounting for 34 percent of the GDP and 45.3 percent of (M3) broad money. Credit growth rates have generally followed the downward trend of the last two years, except for June and July which recorded higher growth rates relative to the previous months.

Composition by currency continues to maintain the same structure, with foreign currency-denominated credit sharing the main weight. In average terms, during the first seven months of 2008, credit denominated in foreign currency accounted for about 72 percent of credit portfolio or about 2 percentage points more than the 2007 average.

Credit to the private sector recorded an average annual growth by 41 percent in the first seven months. Business loans provided the main contribution, out of which the sectors of trade, construction and industry shared 77 percent of loans extended to businesses. In annual terms, household loans grew by an average of 51 percent during January – July 2008. Despite this figure, the two-month period, June – July, showed a slowdown for this type of loan. On the other side, real estates loans, which account for about 66 percent of household loans, maintained the high growth rates providing the main contribution to the growth of this portfolio.

During 2008, the interest rates in the money market increased in line with the monetary policy orientation. In average terms, overnight interest rate in the interbank market increased by 80 basis points relative to the previous year, to 5.6 percent.

The oscillations of interest rates in the interbank market related to the change of liquidity conditions in the market and to its asymmetrical distribution. The beginning of the third quarter was followed by the relief of the liquidity

situation and a more balanced distribution being reflected in the downward performance of overnight interest rates to 5.6 percent at the end of August.

The primary market showed low oscillations of the yields during 2008. They have gradually transmitted the tightening of monetary conditions signalled in the second half of 2007 while the spread between the maturities has narrowed.

Long-term yields in the bonds' market show a narrowing trend of spreads between maturity terms in the last two years. 2-year bonds which have a higher (monthly) frequency in average terms have increased slightly during 2008 relative to the previous year, while the yields for other maturity terms have been decreasing. As of end August, 2-year bonds' yield stood at 8.3 percent or 0.06 percentage points higher than last year's average, while 5-year bonds' yield dropped by 0.76 percentage points to 9.06 percent.

The interest rates for credit denominated in foreign currency have been in line with the developments in the global markets and in proportion to the changes in LIBOR and EURIBOR. The interest rate of euro-denominated credit was 8.15 percent in July, dropping by 0.35 percentage points relative to June 2008.

Intermediation rate in the banking system has dropped in average terms. With respect to lek, it is shown that the spread between the weighted-average interest rate of lek-denominated deposits and lek-denominated credit has dropped to 7.56 percent in the first seven months from 9 percent the same period the previous year. In addition, average intermediation rate for the euro has dropped by 0.82 percentage points to 4.44 percent relative to the first half of 2007.

The appreciating tendency of the lek against the main foreign currencies shown in the first two quarters of 2008 continued in the third quarter although at more moderate rates. In nominal effective annual terms, the lek has appreciated against the euro and the U.S. dollar by an average of 2.63 percentage points. In annual terms, nominal exchange rate of the lek against the euro and the dollar has appreciated by an average of 0.75 percent and 9 percent.

Monetary developments should not be analyzed separately from the factors establishing the financial system's stability. With regard to the latter, I would like to underline that the financial system in Albania has developed at stable rates in the first half of 2008. Capitalization indicators of business, liquidity and profitability are at satisfactory levels. Given the increased importance of these indicators and in light of the recent developments in the international financial markets, the Bank of Albania has expanded the information sources in terms of deepening the analysis of the stability of the financial system and in particular of the banking sector, endeavouring to identify in advance the possible risks and propose measures to prevent them.

In general, the abovementioned situation contains, in addition to positive developments, some old and new risk factors which affect both the monetary developments and the financial stability. In case of materialization, they may compromise the achievement of the Bank of Albania objective mandated by law. This setting imposes the need for greater prudence in assessing and analyzing these factors and in the decision-making process.

In conclusion, I would like to highlight that the Bank of Albania has preceded the latest developments in the Albanian banking system by taking a number of structural reforms which aim at ensuring its smooth functioning and maintaining the financial balances. During the last year, the Bank of Albania has focused on improving the technical and legal infrastructure of the banking system. The establishment and functioning of Credit Registry, the review of credit regulations in view of enforcing the prudence norms for foreign currency-denominated loans and the review of regulations on interbank loans in view of itemizing the ownership titles, are important reforms which sustain the stable development of the financial system.

On the other side, the establishment of specialized structures, namely the Committee for the Implementation of Monetary Policy and the decisions made by the Supervisory Council of the Bank of Albania, have provided a direct contribution to maintaining macroeconomic balances and the financial system's stability. The effects of the increase in the cost of money have driven more contained credit growth rates and more appropriate proportions of its foreign currency structure. Lately, the Bank of Albania has established a fruitful co-operational relationship with the supervisory authorities of the international financial system and other central banks, in terms of exchanging information and analyses on the latest developments in the global financial system and on their implications.

Even though the maintenance of macro-financial balances is ever-increasingly becoming challenging, on behalf of the Supervisory Council of the Bank of Albania I would like to clarify to the public at large that the maintenance of price stability and the strengthening of financial stability remain the Bank of Albania's priority objectives and that we will be fully committed and willing to achieve them.

II. WORLD ECONOMY

The second quarter of 2008 saw a slowdown in global economic growth and continuous inflationary pressures. The turbulences in the financial markets, the overall price rise and the changes in the house prices have aggravated the economic activity. On the other side, the growing demand of emerging economies has led to a stable growth in these countries, hence contributing to the growth of global economy. Inflation rate increased in the second quarter, being mainly pushed by the price rise of oil and food. Inflation in OECD countries increased by 1.8 percentage points in the second quarter relative to the previous quarter and by 3.9 percentage points relative to the same period the previous year.

II.1 U.S. ECONOMY

U.S. economic growth recorded considerable growth in the second quarter relative to the previous one¹. The depreciation of the U.S. dollar led to the growth of external demand for U.S. goods and to the decrease in imports. The contribution of the trade balance to the GDP growth in the second quarter was the highest since 1980. Substantial contribution was also provided by the increase of personal expenses which were affected by certain temporary fiscal facilities. The downward tendency of house prices led to the fall of investments in residential buildings; however, this fall was lower than the following quarter. The turbulences in some of the large U.S. financial institutions generated the further reduction of banking lending. Economic growth is expected to grow at slow rates in the second half of 2008, while unemployment and the financial turbulences are expected to continue to jeopardize the U.S. economy. In the second quarter, Consumer Price Index was 4.4 percent or 2.2 percentage points higher relative to the previous quarter. In addition, Producer Prices recorded an annual increase of 9.6 percent, which is one of the highest rates of the last 27 years.

II.2 EURO ZONE ECONOMY

The Euro zone economy shrank 0.2 percent in the second quarter compared with the first quarter of 2008, partly due to the error correction in estimating the growth in the first quarter (0.7 percent). The decline of the economic growth is assessed to have stemmed from the high prices, which have led to the decrease of consumer confidence and fall in domestic demand. Exports and imports recorded a drop of 0.4 percent in the second quarter, while the influence of trade balance on the economic growth has almost been inconsiderable. Investments dropped by about 1.2 percent compared with the previous quarter. Inflation in the Euro zone continued to mark high rates, remaining well above the ECB's 2 percent target. The high inflation has resulted due to the rising prices of base foods in the international markets and to the increasing labour cost per unit². According to ECB projections, inflation will remain at high rates during 2008 to later reduce significantly in 2009.

Table 1 Macroeconomic indicators of main economies

Country	Annual GDP growth	Annual inflation	Unemployment rate
	Q2:08	Q2:08	Q2:08
USA	2.2	4.4	5.3
Euro area	1.4	3.6	7.3
Germany	1.7	3.0	7.4
Italy	0.0	3.8	6.5 ¹
Greece	3.5	4.7	7.8 ¹
Japan	1.0	1.4	3.8

Source: Eurostat, ECB³, Bank of Japan

Note: ¹) Rate for Q1:08.

II.1 ECONOMIES IN THE REGION

II.1.1 Economy of turkey and fyrom

After a moderate growth at the end of 2007, the Turkish economy recorded considerable growth in the beginning of 2008 driven by the private sector's high demand. The growth of private investments and consumption of transportation and telecommunication provided the main contribution to these developments. Public investments, on the other hand, shrank. Agriculture grew as well, following the low growth rates of the previous year. Trade deficit as a share to GDP improved by about 0.1 percentage points. Consumer Price Index recorded 8.8 percent in the first quarter, which is equal to the average rate of 2007. The high inflation rates were driven by the high prices in the international markets and the increased price of energy at home.

FYROM's economy continued to record stable annual growth rates during the second quarter of 2008 propelled by the ongoing growth of domestic demand and investments in the private sector. In the first quarter of 2008, imports grew by 27.6 percent or about 3 times as much as exports, causing the trade deficit to deepen further. The latter accounted for 21 percent of the GDP in the last quarter of 2007. Inflation marked high rates in the first half of 2008. Annual inflation reached about 10 percent in the second quarter, while its average rate for 2007 was 2.3 percent. The sharp price hike of food prices, being also affected by the unfavourable weather conditions, fuelled inflation to record high rates.

II.1.2 economies of Italy and Greece

Italy's economy grew by 0.3 percent in the first quarter of 2008, while it did not undergo any changes in the second quarter. Industrial production grew higher than projected in the early 2008; however, it fell substantially in May. Year-on-year CPI increased by 3.1 percent in the first quarter and 3.6 percent in the second.

The economy of Greece grew in the first two quarters of 2008; however, the growth in the second quarter was somewhat lower than in the first one. The growth of overall demand in the economy, driven by the higher consumer spending, provided the main contribution. The growth of demand in economy was also pushed by the increase of exports and the fall of imports in the first quarter of the present year. On the other side, investments have reduced. Inflation in Greece continued to increase, marking 4.3 percent and 4.8 percent in the first and second quarter, respectively, fuelled by the price rise of energy and food.

Country	Annual GDP growth	Annual inflation	Unemployment rate	Fiscal balance (share to GDP)	Current account (share to GDP)
	Q1:08	Q1:08	Q1:08	2007	Q1:08
Italy	0.0 ¹	3.6 ¹	6.5	-1.9	-2.7 ²

Table 2 Macroeconomic indicators of economies in the regional and trading partner countries'

Greece	3.5 ¹	4.8 ¹	7.8	-2.8	-14.8 ¹
Macedonia	5.2	9.9 ¹	34.8	0.6	-3.0 ²
Serbia	8.2	11.3	18.6	0.4	-17
Croatia	4.3	5.9	14.7	-1.6	-9.6
Turkey	6.6	8.8	11.6	-1.2	-5.6

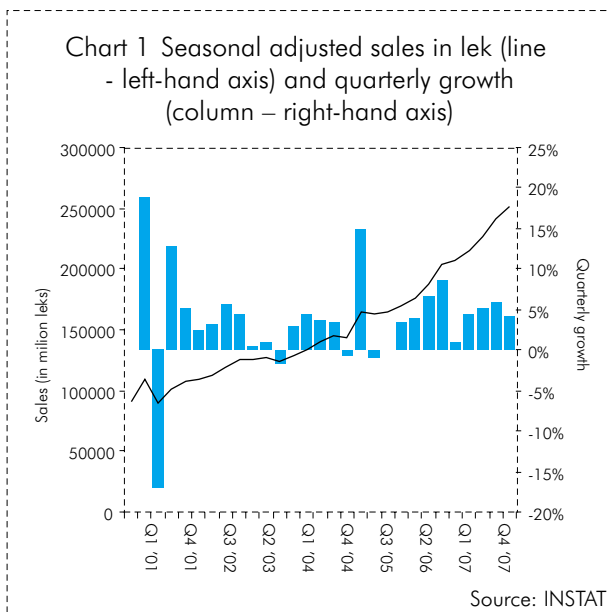
Source: Eurostat, European Commission, respective central banks, OECD

Notes: ¹) Rate for Q2:08; ²) Fourth quarter of 2007.

III. DOMESTIC ECONOMY

III.1 PRODUCTION SECTORS

According to the data for the first quarter of 2008, domestic production has recorded high year-on-year growth rates. Sales indicator⁴ increased by about 4 percent relative to the last quarter of 2007 and by about 20 percent to the same period the previous year. Compared with the historical growth rates, this quarter has recorded one of the highest year-on-year growth rates, while the lowest rates were recorded in 2004-2005.



Services recorded the highest annual growth rate. The increase of sales by about 40 percent in the first quarter of 2008 was similar to the annual increase of sales for the entire year 2007, while the annual increase has been accelerating during the last four years. This outline shows a very rapid growth of services and suggests that it is currently the most dynamic sector of the Albanian economy. Worth to note is that some types of services have recorded relatively high rates of price rise (about 4 percent in annual terms), which have been reflected in the growth rate of the sales' value. Industry and construction continued to record high growth in terms of sales. According to the figures published as of end September, construction shows gradual improvement compared to the unsatisfactory situation in 2007. The sector of trade, hotels and

restaurants continued to grow by about 20 percent being close to the annual growth rates of the last three or four years.

Table 3 Annual growth of sales by sectors (in percent)

	2002	2003	2004	2005	2006	2007	Q1-08
Industry	18	14	3	10	17	25	17
Construction	2	7	24	20	21	11	32
Trade	19	10	10	19	14	21	19
Services	21	10	5	23	33	40	41
Transportation and Telecommunication	4	19	6	11	6	14	12
Economy	14	12	9	16	16	21	21

Source: INSTAT

III.1.1 Construction

The number of new constructions' permits increased substantially during the first quarter of 2008 compared with the same period the previous year. However, this indicator remained during the same period about 50 percent lower than the historical average of the first quarter of 2003 - 2007. The permits granted for the construction of residential building, which shared about 64 percent of total number of construction permits, provided the main contribution to the annual increase of new constructions' permits in the first quarter of 2008.

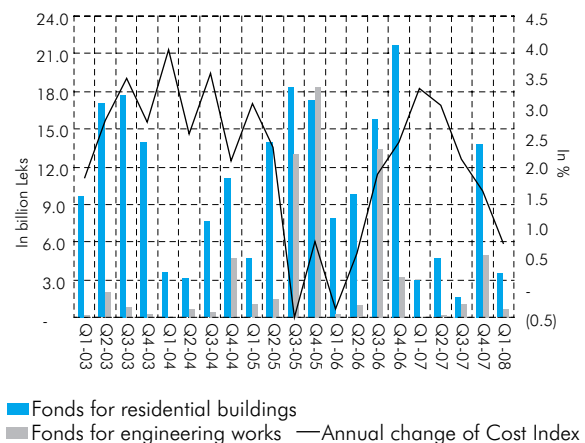
Table 4 Number of approved construction permits during the first quarters in years

	Q1-03	Q1-04	Q1-05	Q1-06	Q1-07	Q1-08	Q1-07 / Q1-08 (in times)
Constructions	751	64	389	300	40	146	2.7
- Residential buildings	481	28	255	194	17	93	4.5
- Non-residential buildings	270	36	134	106	23	53	1.3
a.Hotels	117	-	1	1	-	0	-
b.Commercial buildings	85	23	83	44	10	29	1.9
c. Industrial buildings	16	6	5	16	2	4	1.0
d.Other buildings	52	7	45	48	11	20	0.8

Source: INSTAT

During the first quarter of 2008, the projected value of new constructions by construction permits recorded an annual increase of about 50 percent. About 90 percent of these funds will be used for the construction of residential buildings and the rest (10 percent) for other non-residential buildings, namely commercial buildings, industrial buildings and other. Construction Cost Index increased by 1.3 percent in the second quarter of 2008 compared with the same period the previous year. The increase of this indicator was mainly driven by the rise of direct expenditures by 2.2 percent, where expenditures for electrical equipment, wages and transportation rose by 7.5, 5 and 2.5 percent, respectively, in annual terms. In the meantime, projected earnings dropped by 1 percent.

Chart 2 Projected funds for construction and annual change of Construction Cost Index



Source: INSTAT

III.1.1 Agriculture

During the first half of 2008, the sector of agriculture attested to a high trade activity of agricultural and agro-industry products. Trade exchanges amounted to about 52 billion leks compared to about 28 billion leks totalled during the same period the previous year⁵. In more concrete terms, the exports of agricultural and agro-industry products were reported to have amounted to 4.2 billion leks, while imports totalled 48.2 billion leks⁶. Exports and imports account for 8 percent and 92 percent, respectively, of total trade exchanges of these products.

Table 5 Performance of trade exchanges

Value (in million leks)	S1-2007	S1-2008
Exports	3,552	4,191
- Agricultural products	1,072	1,730
- Agro-industry products	2,480	2,461
Imports	24,431	48,159
- Agricultural products	8,871	17,616
- Agro-industry products	15,560	30,543
Total	27,983	52,349

Source: Ministry of Agriculture, Food and Consumer Protection

During the first half of 2008, agro-industry production grew by 12 percent compared with the previous year⁷. The following agricultural products recorded the figures as below⁸:

- Wheat* (annual production)	312000 tons
- Total vegetables	267000 tons
- Early potatoes	80000 tons
- Fruit	32000 tons

During January-June 2008, the greenhouse areas grew to 695 hectares compared with 683 hectares in 2007.

III.1.1 Energy

During the first half of 2008 there were marked improvements in the main indicators of energy sector in Albania. The improvement of hydro conditions during this period led to the annual increased of domestic production by 25 percent. The fall in technical and non-technical losses is another positive development which has improved the transmission of produced energy.

Despite the increase in domestic production during the first half of the present year compared with the same period the previous year, annual production remains about 37 percent lower than the average of production during 2004 – 2006. In the meantime, the balance between the growth of supply of energy (9 percent) and demand for its consumption (13 percent) was offset by the growth of imports by 7 percent.

Table 6 Energy balance sheet indicators

	S1 – 06 (GWh)	S1 – 07 (GWh)	S1 – 08 (GWh)	Annual change S1 – 07/ S1 – 06 (in percent)	Annual change S1 – 08/ S1 – 07 (in percent)
Net production	3,056	1,557	1,944	-49	24.9
Import	226	1,341	1,442	493	7.5
Energy provided in distribution	2,949	2,741	2,975	-7	8.5
Distribution losses	1,216	1,053	1,051	-13	- 0.2
Distribution losses/net production (in percent) ^(*)	39.8 percent	67.6 percent	54.1 percent	70.0 percent	-20.1 percent
Consumed energy	1,743	1,850	2,077	6	12.3
- Invoiced consumption	527	797	1,025	51	28.7
- Un-invoiced consumption	1,216	1,053	1,051	-13	- 0.2
- Household consumption	1,111	1,074	1,192	-3	10.9
- Non-household consumption	632	775	885	23	14.1

Source: KESH; ^(*) Bank of Albania estimations

The increase of financial collection by 24.2 percent in the first half of 2008 has not only reflected the improved invoicing level, given that invoiced consumption grew by 28.7 percent, but also the price rise of energy in the market during the same period. It is noted in particular that while household consumption of energy has grown moderately in the first six months compared with the same period in 2006, the collection has grown markedly by about 3.5 times. The improvement of KESH's financial position helps to upgrade its capacity to import energy, in order to complete the insufficient domestic production and meet the growing demand for energy.

Table 7 Indicators of KESH's financial balance sheet for the six-month period over the years

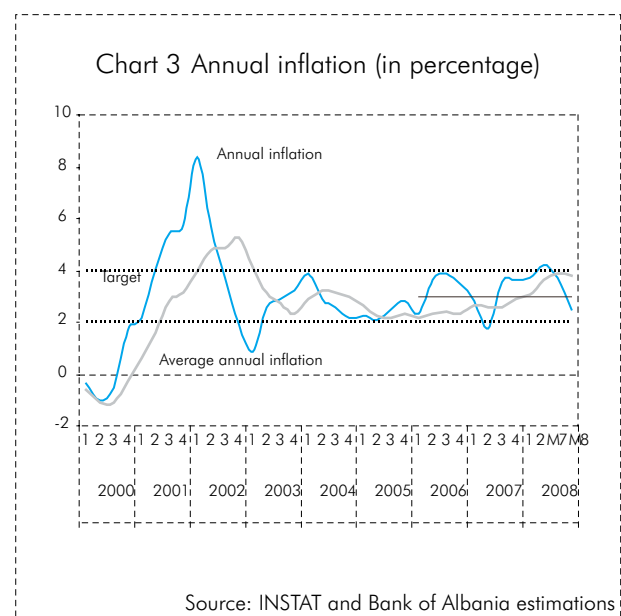
	Invoiced (in million leks)			Collections (in million leks)			Collections (in percent)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Household	1,743	9,080	10,961	1,850	6,772	8,294	106.14	74.57	75.67
Private	1,216	3,981	5,529	1,053	3,701	4,985	86.60	92.98	90.16
Budgetary	1,111	926	1,155	1,074	843	970	96.71	91.11	84.00
Non-budgetary	0.382	1,403	1,558	0.348	1,328	1,444	91.08	94.67	92.64
Total	4,070	15,390	19,203	3,978	12,644	15,693	97.73	82.16	81.72

Source: KESH

III.1 PRICES

III.1.1 Consumer prices

For the first eight months of 2008, average annual inflation marked 3.8 percent. During 2007 and the first four months of 2008, average annual inflation rate remained unchanged at 3 percent, which is the Bank of Albania target with regards to price stability. As a result of the cumulative effects of price rise in food and fuels in the global market, inflation peaked in July at 3.9 percent to later drop in August by 0.1 percentage points. Annual inflation fluctuated markedly during this period. In the first quarter, it showed an upward tendency, peaking 4.6 percent in March, which is the highest in the last 5 years. After remaining above the 4 percent level in the second quarter, annual inflation returned to the tolerance band of 2-4 percent of inflation target. In July and August, annual inflation rate marked 3.7 percent and 2.5 percent, respectively.



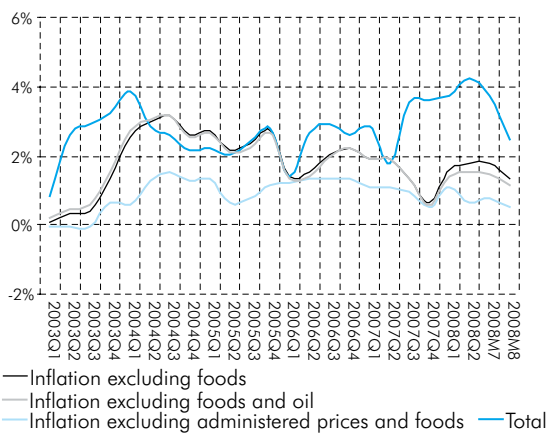
The high inflation rates during August 2007 to June 2008 were driven by the direct and indirect impact of the price rise in food and fuels in the global market. In addition to external inflationary pressures, prices in Albania were affected by last year's curtailed domestic supply of agricultural production and the price rise of energy in March 2008. Supply-side shocks were entirely reflected in the consumer prices, given the ongoing growth of aggregate

demand. The growth of household income, the growth of credit to the private sector and the concentration of budget expenditures at end of 2007 were among the factors which fuelled the growth of domestic demand during this period.

In response to the increasing inflationary pressures, the Bank of Albania increased the key interest rate three times in 2007. The tight monetary policy was followed by the implementation of a prudent fiscal policy in terms of meeting the budgetary programme for 2008. These policies have

created favourable conditions for safeguarding price stability, in particular in terms of weakening the supply-side inflationary pressures and the continuous appreciation of the lek. In the last two months, headline inflation and other measures of core inflation have shown a downward tendency. Supply-side factors, which fuelled the increase of inflation in the previous period, reduced their effect in July and August. Weather conditions during the present year have been encouraging, causing the domestic supply of agricultural production to grow. Seasonal effect generated by the entry of domestic agricultural production was more considerable compared to the previous year. Oil and grain prices in the global market⁹ have been falling in the last two months. However, it is yet too soon to acknowledge that the tendency of these prices is making a turning point.

Chart 4 Annual rates of different measures of net inflation



Source: INSTAT and Bank of Albania estimations

Average annual inflation (3.8 percent) for the first eight months of 2008 was approx. 1.4 percentage points higher than for the same period the previous two years. Excluding the prices of unprocessed food prices, all other items provided a positive contribution to this increase. Annual inflation for this period has been entirely determined (100 percent) by the high annual rising rates of processed food prices and the price rise in services and goods with administered prices.

Inflation of processed foods continued to record high annual increasing rates. The high prices of primary foods in the global markets, combined with the higher producer and transportation costs continued to drive the increase of this item's inflation, which reached the highest historic rate in May (13 percent). After almost a year (September 2007 – July 2008) of double-digit inflation, this item's inflation dropped to 9 percent in August. In absence of other shocks on global food prices, annual inflation of processed foods is expected fall, although prices are expected to remain high. The main sub-groups of this item¹⁰ have recorded positive growth rates and have contributed by around 2.6 percentage points to headline inflation.

In contrast to processed foods, the prices of unprocessed foods have provided an average negative contribution of -0.5 percentage points to the

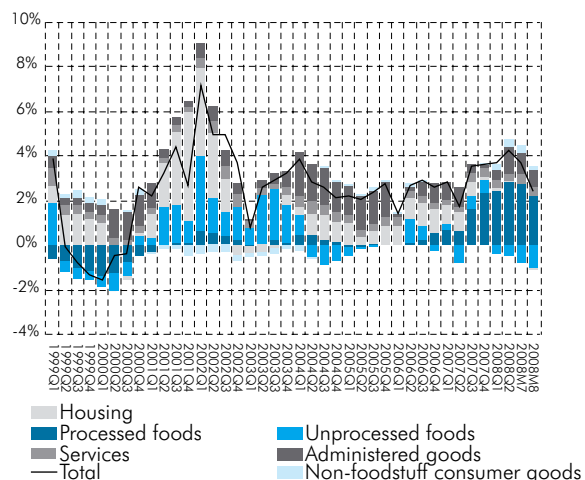
inflation of the first eight months. Annual inflation of this item has recorded negative increasing rates during this period, dipping in August to -5.5 percent. The downward inflation trend has been driven by the more favourable supply conditions relative to the previous year, in particular in the vegetables market. Vegetables' negative inflation (-24 percent in August) managed to offset the positive annual changes of other sub-groups. The growth of agricultural supply, the appreciation of the lek and the downward tendency of these goods' prices in the countries they are imported from¹¹, have reduced the inflationary pressures on food prices at home.

In January to August 2008, the annual price change of food and services with administered prices reached another high level owing to the price rise of energy by 23.7 percent in March. In the second half of 2007 and the first two months of the present year, this item's inflation oscillated around 1 percent in annual terms, as a result of the terminated effect of the previous price rise of energy. Average annual inflation rate in March to August marked 6 percent, providing an average contribution to headline inflation by 1 percentage point.

Inflation of services has increased further during the present year. Average annual inflation of services jumped the 3.2 percent rate, around which it has oscillated since 2002, by 1 percentage point. As a result of the tourist season, annual inflation increased at accelerated rates, in particular in June (5 percent), July (5.8 percent) and August (5.1 percent). Beyond these short-term oscillations, some particular services attest to the pass-through of increased costs' pressures stemming from the food, oil and energy prices. Average annual inflation of transportation services marked 11 percent and hotel and restaurant services 4 percent, which is 8 and 1 percentage points, respectively, above their average for 1999 – 2007.

Non-food consumer goods recorded positive growth rates, contributing by 0.2 percentage points to the average annual inflation of this period of the year. Oil price rise contributed to the increase of this item's inflation by about 2 percentage points compared with the average annual inflation of the same period the previous year. Oil price¹² has risen sharply during 2008, reaching 18 percent in June and July, the highest since January 2001. The moderated rising rates of this item in the global market in the last two months was reflected in the inflation of August which dropped to 13 percent.

Chart 5 Contribution of items to annual inflation (in percentage points)



Source: INSTAT and Bank of Albania estimations

Table 8 Contribution of items to annual inflation (in percentage points)

	S1-07	Q3-07	Q4-07	S1-08	M7-08	M8-08
Processed foods (pp)	0.6	1.6	2.4	2.7	2.7	2.2
Bread and grains* (pp)	0.2	4.5	5.9	7.1	7.1	5.0
Alcohol and tobacco* (pp)	1.8	1.3	0.7	0.4	0.1	0.1
Unprocessed foods (pp)	-0.3	0.4	0.5	-0.4	-0.8	-1.0
Fruit* (pp)	-2.9	1.1	2.6	1.8	-0.2	-1.0
Vegetables*(pp)	1.2	1.7	-0.4	-4.6	-4.9	-6.2
Services (pp)	0.3	0.4	0.4	0.3	0.5	0.4
Administered prices (pp)	0.8	0.4	0.1	1.0	1.0	0.8
Fuels and energy* (pp)	7.7	2.7	0.3	3.8	5.4	5.6
Housing (pp)	0.9	0.6	0.2	0.1	0.0	0.0
Consumer Price Index (YoY, in percent)	2.3	3.6	3.6	4.0	3.7	2.5

Source: INSTAT and Bank of Albania estimations

Box 1 Inflation in Central, Eastern and Southeastern European (CESEE) region opposite global price rise

The rising tendency of agricultural products and energy's prices during the last two years has made economists to consider the high inflation a global phenomenon. The contribution of the price rise of raw materials and base products on inflation has changed depending on the level of development and the economic structure in different countries. The economies in which the item of 'foodstuffs' has had a high share in the consumer basket, have suffered more from the high price rise of basic agricultural products (wheat, corn, soy, etc) or from 'agflation'¹³. The inflation of industrialized countries has reflected more notably the price rise of energy and oil products and sub-products. At any case, these contributions and the second round effects have generated high core or headline inflation rates in almost all economies.

The CESEE region was hit even more strongly by the unfavourable developments in the global market prices, given that the share of energy and food in the consumer goods basket is still high. Thus, in the period October 2007 to July 2008, the food and energy components added more to inflation than they did in the previous period. In most of CESEE EU Member States the weights of energy and food come to around 40 percent¹⁴, while the corresponding weight in the euro area is just around 30 percent. The imbalances between domestic supply and demand supported the added inflationary pressures in CESEE countries' economies. Output gap became more positive in most countries in 2007 compared with 2006, signalling the increase of inflation in 2008. Some CESEE countries were severely hit by crop failure in 2007, which put additional pressure on food prices.

Apart from these developments, country-specific factors pushed up inflation, as well. In some countries (Bulgaria, Poland and Romania) were featured strong consumption growth and accelerating real unit labour cost, hence pushing the increase of future inflationary pressures. In other countries (Croatia and Turkey), real unit labour cost remained almost unchanged in 2007 compared with 2006, while in Slovakia it declined strongly. Accelerating wages in 2007 call for attention with regard to the increase of inflation in CESEE countries over 2008. Higher administered prices and VAT increases are further factors behind the pickup in inflation (Bulgaria and the Czech Republic in 2007; Poland and Albania in 2008). Due to the administrative reforms in prices was featured higher contribution of 'services' to the respective inflation of countries.

Table 9 Annual inflation for CESEE countries (2005-2008) and the inflation target*

CESEE region	2005	2006	2007	Q1-2008	Q2-2008	August 2008	Inflation target
Bulgaria ⁴	6.0	7.4	7.6	12.4	14.0	11.8	No inflation target
Czech Republic ⁴	1.6	2.1	3.0	7.5	6.7	6.2	3 percent \pm 1 pp as of end 2009 (measured by the CPI)
Hungary ⁴	3.5	4.0	7.9	6.9	6.8	6.4	3 percent \pm 1 pp over the medium term
Poland ⁴	2.2	1.3	2.6	4.5	4.3	4.4	2.5 percent \pm 1 pp (measured by the CPI)
Romania ⁴	9.1	6.6	4.9	8.0	8.6	8.1	4 percent \pm 1 pp as of end 2008
Slovakia ⁴	2.8	4.3	1.9	3.4	4.0	4.4	0-2 percent as of end 2008
Slovenia ⁴	2.5	2.5	3.8	6.5	6.4	6.0	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Italy ¹	2.0	2.1	1.8	3.3	3.8	4.2	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Greece ¹	3.5	3.2	2.9	4.3	4.7	4.8	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Euro area ⁴	2.2	2.2	2.1	3.4	3.7	3.8 (preliminary)	According to ECB's monetary policy: below but close to 2 percent over the medium term (measured by the HICP)
Croatia ³	3.3	3.2	2.9	5.9	6.5	8.4	No inflation target
Kosovo ³	-1.3	0.6	4.4	11.8	13.9	7.8	No inflation target
Macedonia ^{3.1}	0.5	3.2	2.3	9.5	9.9	8.6	Maintain price stability (measured by the CPI). No defined (quantitative) target
Montenegro ³	-	2.1	2.1	6.6	8.0	-	No inflation target
Serbia ^{3.2}	14.5	5.9	5.4	6.4	9.0	10.3	2.5 percent-5.5 percent as of end 2009 (measured by the base CPI)
Turkey ⁴	8.1	9.3	8.8	9.1	10.2	11.8	4 percent \pm 2pp, but increased to 7.5 percent for 2009 (measured by the CPI)
Albania ³	2.4	2.4	2.9	3.7	4.2	2.5	3 percent \pm 1 pp over the medium-term period (measured by the CPI)

Source: Webpages of: Eurostat; national statistics institutions; central banks

Notes: (1) Albania's main trading partners; (3) according to the CPI; (3.1) according to retail consumer prices; (3.2) according to the base CPI; (4) according to the HCPI.

*CESEE non-EU Member States listed in the shaded part of the table.

In almost all CESEE member or non-EU Member States, annual inflation has marked the highest rates of the last decade. The years 2007-2008 were characterized by inflation rates which were two to three times higher than the quantitative target. The analyses and assessments of economists and central bankers on the high inflation converge to the conclusion that the status of price stability in these economies has deteriorated. This has occurred despite the fact whether there has been a quantitative inflation target or not. However, in the cases when the primary monetary policy objective of a central bank is different from that of maintaining price stability in economy, the risk for increasing inflationary pressures in a medium-term period is assessed to be high. This risk is considered at moderate to average levels in countries with medium-term quantitative inflation targets. The quantitative targets help to put the domestic inflationary pressures at an early control.

The undertaking of structural measures in developing trade and agricultural production and the anti-speculative measures in the food and energy market, the special fiscal policies and the financial support and application of temporary subsidies' schemes for agricultural products' prices in developed countries are among the possible ways to help countries face the global price rise at moderate economic and social costs.

III.1.1 Other inflation measures

Annual core inflation¹⁵ reached the highest figure of the last decade in the second quarter of 2008 (4.6 percent). The higher prices of some processed primary food products¹⁶ provided the main contribution to the sharp upward tendency. The first signs of relatively lower rates of core inflation were shown in August when the sub-group 'bread and grains' experienced a partial fall in prices. Despite this expected positive development, average core inflation for January to August remained high (4.2 percent) or about 1.5 percentage points above its long-term average¹⁷. Core inflation, which also excludes the effect of 'bread and grains', stood close to 2 percent in the eighth-month period attesting to the high effect on inflation caused by the volatile prices of this significant sub-group in the consumer basket. Other inflation measures, which exclude the change effects of certain specific goods and services' prices¹⁸, provide more detailed information on its performance. The average of these measures was 2.9 percent in the second quarter. The first two months of the third quarter showed decreasing rates, hence, average net inflation measures stood at about 2.6 percent for the eighth-month period. Core inflation, measured by the trimmed mean and by excluding processed food products, recorded the lowest rates of all measures.

The higher supply of domestic production in June to August 2008 helped to reduce the inflationary pressures originating from outside the Albanian economy. This good performance was reflected in the decreased rates of annual inflation in the traded prices. In August, the respective inflation marked 1.9 percent, reflecting at the same time the partial termination of last year's price rise in bread and grains. Average traded inflation remained high in January to August (3.7 percent), which is even higher than the same period the previous year (0.3 percent). The high share of traded prices in the consumer basket implies the exposure of headline inflation to the risk of imported inflation. The impact of the price rise of primary goods (food and energy products) in the international markets has been transmitted directly and indirectly to this sector's inflation. In traded prices, inflation which excludes the effect of the energy price rise, stood at 2.9 percent during the period January to August 2008 or very close to the historic average of the last four years (2.8 percent). The slight fluctuations in this sector's inflation at end the second quarter and in the period to follow mainly attributed to the application of higher tariffs in transportation services¹⁹ and to the ongoing transmission of the price rise in food products, fuels and energy on services prices.

Table 10 Alternative measures of annual inflation (in percent)

YEARS	2006	2007					2008
Annual changes of price index:			Q1	Q2	July	August	Eighth-month average
Total (CPI)	2.4	2.9	3.7	4.2	3.7	2.5	3.8
Core (permanent exclusion)	1.2	1.9	4.1	4.6	4.4	3.7	4.2
Core (permanent exclusion, excluding 'bread and grains')	1.3	1.2	2.0	2.2	2.2	2.1	2.1
Core (trimmed mean*)	0.7	0.7	1.7	1.8	1.7	1.4	1.7
Headline, excluding processed foods	2.3	1.5	1.4	2.1	1.8	1.2	1.7
Headline, excluding 'bread and grains'	2.4	1.9	2.0	2.9	2.7	2.0	2.4
Headline, excluding energy	1.7	2.0	3.6	3.9	3.6	2.3	3.4
Average net inflation measures	1.6	1.5	2.5	2.9	2.7	2.1	2.6

By prices:							
Traded	1.7	2.3	3.9	4.2	3.5	1.9	3.7
Non-traded	3.7	3.9	3.4	4.5	4.3	4	4.1
Non-traded, excluding administered prices	3	2.7	2.9	2.8	3.1	2.7	2.9

Source: INSTAT, Bank of Albania estimations

Note: (*) Exclusion of 30 percent of sub-items in both ends of monthly deviations of respective prices, weighted according to their share in the CPI basket, that is 15 percent from each end.

The information on these measures indicates that the Albanian economy continued to face high inflationary pressures. The impact of supply-side factors originating from the developments in the global markets has been assessed as the main cause for the high inflation rates in Albania. Given its relatively long presence, it has also been reflected in the prices of goods and services which until the end of 2007 were considered as fairly 'immune' to the influence of supply-side factors. Chain effects of the global price rise affected different indicators of core inflation at home. Its recent rates indicate that these effects have begun to moderate and that they are expected to moderate more markedly in the months to follow.

III.1 SUPPLY AND DEMAND-SIDE FACTORS

III.1.1 Supply

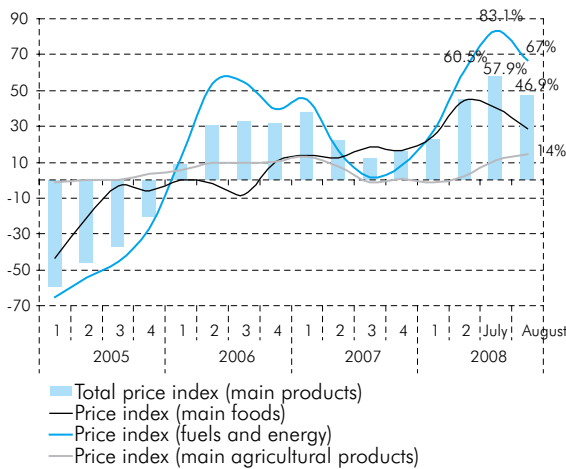
III.1.1.1 Prices of food products and raw materials

Overall inflation in Albania continued to be under the pressure of supply-side factors, mainly originating from the outside. The beginning of the third quarter attested to the moderation of these pressures. The structure of supply in the internal market of food products was encouraged by the entry of fresh Albanian products sold to the consumers at relatively lower prices. However, the impact of foreign prices on the Albanian inflation and the economy remains high despite this expected development. The significant dependence of the Albanian economy on imports in general and on food and energy (fuels) in particular²⁰ caused the global price rise to inevitably hit the producer prices in food processing industry, consumer prices and services prices in Albania.

The most recent statistical data and assessments of international institutions signal the persistent presence of global price rise of commodities in the world economy. This occurrence exceeded the projection of earlier this year in April²¹. During the second quarter of 2008, total price index of commodities in the global markets continued its upward tendency with an annual rate of 45 percent. The period July to August 2008 experienced the highest growth rates (58 percent and 47 percent). In global terms, average annual change of total price index of commodities reached about 43 percent, hence, exceeding considerably the historic average of the last four years (34 percent).

The price rise in fuels and energy has played a key role in these rates. Annual price rise rate of these products, which are of prime importance for the countries' economic development, reached 60 percent in the second quarter.

Chart 6 Annual changes of commodities' price index (in percent)



Source: IMF²²

Its peak was recorded in July (83 percent). Although at more moderate rates, the price rise in August remained high (67 percent).

In global terms, food price index recorded the highest growth of the last years in the second quarter of 2008 (44 percent). The period from January to August 2008 recorded an average annual increase of food prices of 34 percent or 19 percentage points higher than in 2007. Although prices kept their rising rates in the first months of the third quarter, they were lower than before, hence, being in line with the projections of global economy experts.

The outlook of agricultural products' prices, in particular during the first two months of the third quarter, do not seem very promising for a decline in global food prices for at least in the short to medium-

term period. Higher prices of agricultural prices augment the producer cost-side inflationary pressures. The largest share of agricultural products are used as raw material in food and non-food processing industry. In the second quarter, agricultural products' prices recorded a slight annual increase of 2 percent, while in July and August they rose by about 11 percent and 14 percent, respectively.

Chart 7 Annual changes in prices of some food products in the world and in Albania

Chart 7a. Annual changes of global prices of grains and of the CPI of 'bread and grains' in Albania (in percent)

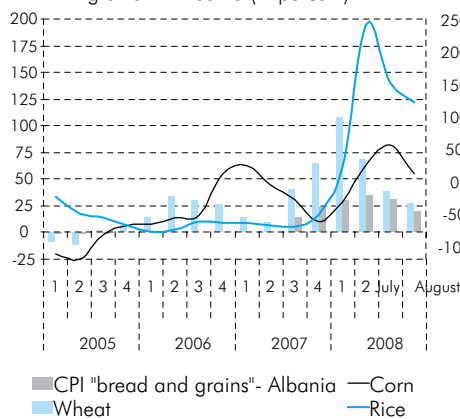
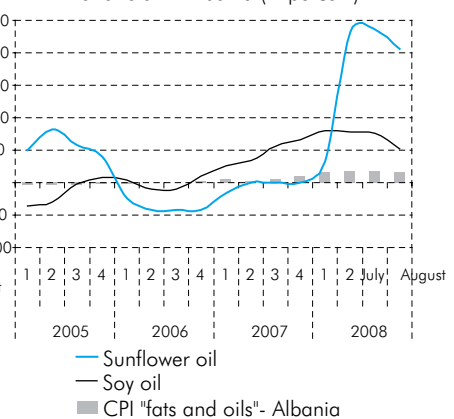


Chart 7b. Annual changes of global prices of vegetable oils and of the CPI of 'oils and fats' in Albania (in percent)



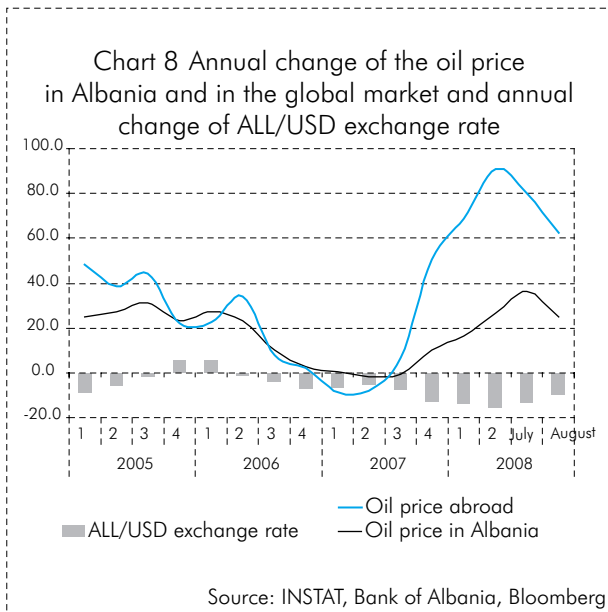
Source: IMF, INSTAT

The developments in the global market of grains' prices attested to the persistent annual rising rates during the second quarter of 2008 and beyond. During this period, one of the main items in this category – rice – recorded the highest price (April 2008) of nearly the last four decades and the highest annual rising rates of grains' prices. In the second quarter, the price of rice

was twice higher than the same period the previous year. In the meantime, the annual rising rates of global wheat price after March the present year²³ were more contained and showed a marked downward tendency. In August 2008, its annual rising rate was about 27 percent. The same tendency was also shown in the global prices of corn. The figures suggest that the annual rising rates of the price index of 'bread and grain' in Albania have generally been in line with the developments in the global wheat prices. According to ECB assessments, grain prices are expected to fall at gradual rates during the second half of 2008 provided that there will be no shocks in the Euro area and global economy. This assessment is sustained by the performance of grain prices in the global market in the first two months of the third quarter. The high rising rates of global food prices have also been affected by the prices of vegetable oils. In more concrete terms, sunflower oil price rose by about twice as high in the second quarter and in the period to follow. Although at more moderate rates, annual inflation of this sub-group in the Albanian CPI basket saw high increasing rates²⁴.

The uncertainties that may be present in the future developments in global and internal food prices do not only relate to the weather conditions but also to the performance of global demand for these products, to substantial changes in the structure and nutrition of the Asian population, to the regulatory measures that the government may take to cope with the price rise in food products, etc. In case global demand keeps growing at higher rates than the supply in the market, the imbalances would augment the risks for oscillations or long-term rises in food prices in the world and hence, in the internal economy.

During the second quarter and the first months of the third quarter of 2008, crude oil price in the global market fluctuated around the high historic rates (from 113 to 134 USD/barrel). The highest annual rise occurred in the second quarter (90 percent) reaching a new record. In the period July to August 2008, monthly oil price changes in the global markets showed signs of slight falling, which may possibly mark the beginning of downward annual rates. Despite this positive signal, average annual rising rate for the period January to August 2008 remains high (75 percent) and several times higher than that of the last three years. Oscillations in the oil price continue to stem from the imbalances between the very high growth rates of demand relative to supply. The latter always depends on the decisions made by the largest global oil producers and exporters with regard to the quantity of production and processing of this highly strategically important item. Due to new geopolitical pressures, the risks which affect oil supply in the global markets have augmented in the recent months. The fire on a Turkish section of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which connects Azerbaijan to Turkey, and the Russian-Georgian conflict²⁵ are present conflicts. In their absence, the fall in the prices of crude oil would have been more considerable. At present, OPEC members are producing above assigned quotas which led the oil price to be very close to 100 USD/barrel in the first weeks of September. According to oil market analysts, future OPEC decisions on the oil price and quantity will depend on the geopolitical developments and to the performance of the U.S. economy following the presidential elections.



In January to August 2008, the developments in the international market have been transmitted relatively rapidly to the internal market, hence, intensifying the supply-side inflationary pressures originating from outside our economy. The profile of the annual price rise of oil in the internal market was quite similar to the international one. Characteristic of the domestic market is that starting from end-year 2007 and on, the price rise rates have been markedly more moderated than in the international market. The favourable performance of the exchange rate of the lek vis á vis the U.S. dollar, in particular in the second quarter, has played a significant role in curbing the price rise rates.

Peak price of oil which hit the global market in June 2008 was transmitted to the Albanian market only a month later. The very rapid transmission model of signals coming from the international to the internal market shifted in the months to follow to the moderation of oil price rise rates in Albania. The subsequent performance of the oil price in the internal market will largely depend on the current and future geopolitical developments. Supply-side shocks that may generate from the Russian-Georgian conflict need to be kept under consideration given that these two countries have an overwhelming share in the import of oil²⁶.

Box 2 World Bank recommendations on how to cope with the high food prices crisis

The considerable price rise of foods and fuels, which began in the second half of 2007, continues to keep the international markets under pressure, jeopardizing macroeconomic stability and economic growth in almost all developed and emerging countries.

With respect to the price of foods, the combination of certain factors led to their considerable price rise in the global market, among which:

- The growth of global demand, in particular from countries with high economic growth, such as China, Brazil or India.
- The high price of fuels affected mostly the price rise of raw materials for agriculture, processed food products and the increase of transportation costs.
- The increased bio-fuel production has contributed to the rise in food prices. This factor affected more sharply the U.S market, which is the greatest producer of these products. However, this factor is believed not to have been a determinant in the general price rise of foods.
- Lastly, the low growth rates in the production of these products, in particular of grains, due to the bad weather conditions, were also a specific factor.

This global crisis of food prices hit more severely the net importers agricultural and energy products. Poor people, in particular those living in the urban areas, who spend a considerable share of their income for food, risk to have a lower purchasing power.

Food prices are expected to fall slightly in the short-term period compared with their peak this spring. This is due to the fact that there are still some imbalances between global demand and supply of these products and it will take some time to create necessary stocks for similar emergency situations, mainly in their exporting countries. The prices are expected to fall (in particular grain prices); however, not to be returned to the low levels of some years ago.

Given this situation, many international organizations have recommended the governments some necessary measures to face this critical situation with prices. The World Bank, being one of the main international organizations to recommend policies and ways to overcome this crisis, suggests three possible ways of intervention, adapted according to the economic developments of each country:

“First, the strengthening of social aid to assist directly the most affected groups from the crisis (assistance in income or directly in foods). Although this policy does not jeopardize domestic production, given that it depends on the development of the country applying it, it may be challenging to implement from the administrative point of view and have additional budget costs.

Second, short-term administrative measures (such as the cut of customs tariffs on basic agricultural products). These measures are recommended to be applied only temporarily given that they have high fiscal costs. Along with the strengthening of social aid, they may require the reallocation of budget funds. On the other side, experts do not support measures such as the increase of exports’ tariffs from the biggest producers of base food products, which apart from not affecting the fall in domestic prices they harm severely agricultural production at home.

Third, measures to stimulate the growth of foods supply in the medium-run (the high prices of agricultural products may stimulate their production, hence, contributing to the development of agriculture in the medium-run). This year’s high prices (in particular of grains) can also help to reverse a generally declining trend in government and private investments in agriculture. In 1980, 30 percent of annual World Bank lending went to agricultural projects, but this declined to 12 percent in 2007. This year the expectations for this type of lending show considerable increase compared with the past. The World Bank has committed itself to doubling lending for agriculture in Africa. To this purpose, it is important to expand investments in the watering system and in infrastructure in order to promote increased agricultural productivity”²⁷.

III.1.1.1 Wages

Wages rose in the first quarter of 2008 both in the public and private sector. Average wage in the public sector reached 35,800 leks or 0.4 percent higher compared with the last quarter of 2007 and 12.4 percent higher on annual basis. The administrative measures²⁸ continued to affect the rise in wages²⁹ in the private sector during the first quarter.

Table 11 Annual indicators of employment and wages – annual changes (in percent)

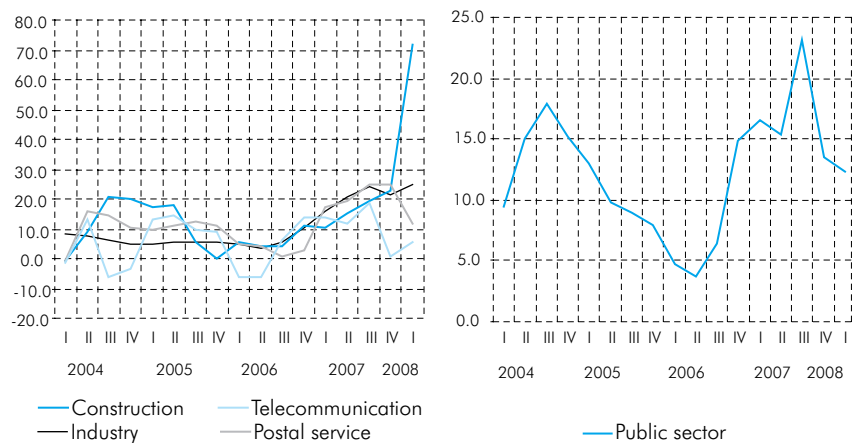
sectors of economy	EMPLOYMENT			WAGE		
	Q1 '07	Q4 '07	Q1 '08	Q1 '07	Q4 '07	Q1 '08
Industry	7.9	3.5	10	16	21.2	24.9
Construction	-1.7	-4.6	30.5	10.2	22.5	71.5
Post	18.1	12.8	7	17.4	25.1	11.9
Telecommunication	9.7	2.1	7.1	13.9	0.7	5.2

Source: INSTAT

In terms of employment and wages indicators, the sector of construction recorded the highest increase during the first quarter, in particular in the area of engineering works³⁰. Industry continued to maintain almost similar increasing rates during the same quarter. The administrative measures taken with regard to the declaration of the number of employees combined with the satisfactory performance of turnover indicator led to the improvement of the annual change of wages in the first quarter in trade activity and postal and telecommunication services.

Minimum monthly base wage rose in the first quarter of 2008 by about 14 percent to 16,000 leks compared with the previous quarter. Unemployment compensation rose in proportion to minimum wage and reached 5,980 leks.

Chart 9 Annual rise rate of wages by sectors of economy

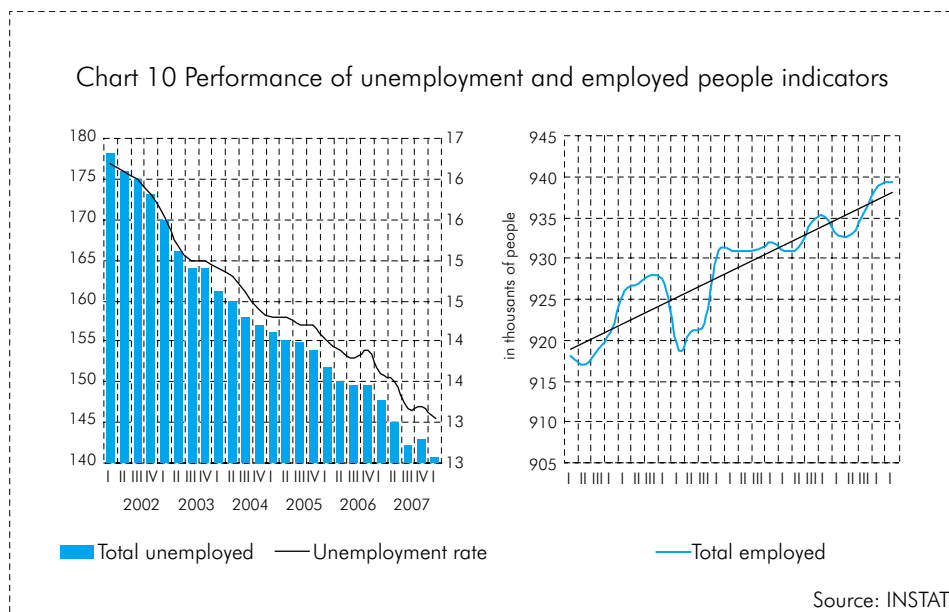


Source: INSTAT

III.1.1.1 Labour market

According to the most recent data, the number of people listed in labour forces totalled 1,080.1 thousand in the first quarter of 2008 or 1,714 people fewer compared with the previous quarter. This fall mainly attributes to the fewer number of jobseekers (about 2,012 people); hence, reflecting a more rapid drop in the number of unemployed people than the increase in the number of employed people.

As of end the first quarter of 2008, the number of employed people totalled 939.3 thousand people. Employment in the private non-agricultural sector increased by about 648 people, while that in the public sector descended by about 350 people. Trade activity, construction and industry sectors provided the main contribution to the increase in the number of employed people in the private sector. The data on employment in the private agricultural sector remain unchanged. Unemployment rate reached 13.04 percent in the first quarter from 13.2 percent in the last quarter of 2007.



In the second quarter of 2008, the number of unemployed people totalled 140 thousand, descending by 0.56 percent compared with the first quarter and by 3.53 percent to the same period the previous year. Relative to the previous quarter, the average number of unemployed people benefiting economic assistance has dropped by about 3.3 percent. In the meantime, the average number of unemployed people benefiting unemployment compensation increased by about 1.9 percent. The number of long-term jobseekers has been falling in the second quarter while the Albanian Employment Office records 2,595 people more than in the first quarter and 631 more than in the same period the previous year. Employment in the public sector continued to fall while quite on the contrary, the private sector recorded an increase in the number of employed people, mainly in industry and construction sectors.

III.1.1.1 Producer price

Producer Price Index maintained in the second quarter of 2008 the same annual growth rate as in the previous two quarters (7.4 percent) and increased by 1.3 percent relative to the first quarter of the present year. It is evident that the increase of inflationary pressures starting from the third quarter of 2007 and on has to certain extent also been driven by the increased producer costs in the Albanian economy.

The high figure of this index in the last two years is a result of temporary imbalances between demand and supply in the Albanian and global market. The needs of some emerging countries, in particular China, India, Brazil etc., for wider use of raw materials, the growth of imports and the speculative environment created as a result of the U.S. dollar depreciation, drove the rise of prices at a global level. The high prices were later transmitted to the prices of imported raw and intermediate materials, which in turn increased the business costs. Given that the Albanian economy develops at relatively high rates and that the same performance will plausibly persist in the future, recurrent supply and demand imbalances are absorbed by business within a short period of time. Consequently, the increase in producer prices does not risk to be fully transmitted to consumer prices – not even in the short term. The latest developments seem to confirm this fact, since consumer prices have been falling starting from July, although producer prices maintained their increasing rates in the second quarter. The rise in these prices does not seem to have dramatically affected the living cost of consumers in comparison to businesses. However, the latter consider them entirely recoverable³¹. On the other side, it is assessed that the share of domestic production is not yet a determining constituent of goods' supply in the internal market and in the sales' price to consumers.

With respect to individual sectors, worth to note is that the prices of processing industry rose further in the second quarter, given that this sector operates mostly with imported raw material. Within this sector, food industry continued to record the highest growth, although the double-digit positive rate is lower compared with previous year when the signs of the prices' crisis in this item were first shown. Industry cost index has increased by an average of 16 percent since the first quarter of 2007. The pass-through of producer price rise in this item was more moderate in consumer prices given that there has been an average increase of 9 percent in the index of 'processed foods' in the CPI basket.

The annual change in the prices of 'extracting industry' recorded declining rates compared with the previous year; however, with no significant impact on total producer prices. Prices in 'production and supply of energy, gas and water' remained almost unchanged compared with the previous quarter, although they recorded considerable fall compared with end-year 2007.

Table 12 Annual change rates of some PPI and CPI components of 'processed foods' (in percent)

	PPI	PPI – Total Processing Industry	PPI – Food Processing Industry	CPI – Processed food products	PPI - Extracting industry
Q1:06/T1:05	0.9	0.7	-0.1	0	7.3
Q2:06/T2:05	-0.1	-0.5	-4.4	0.5	10.8
Q3:06/T3:05	0.4	1.2	-2.1	1.1	8.4
Q4:06/T4:05	-0.7	1.5	1.4	2.4	8.3
Q1:07/T1:06	2.1	14.4	2.5	3.2	8.1
Q2:07/T2:06	3.3	7.3	11.3	2.9	2.8
Q3:07/T3:06	3.6	6.3	14.7	7.3	4.7
Q4:07/T4:06	7.5	10.2	18.6	10.8	4.5
Q1:08/T1:07	7.4	6.8	20.5	11.2	5.6
Q2:08/T2:07	7.4	6.9	14.6	12.9	3.0

Source: INSTAT

III.1.1 Demand

III.3.2.1 Fiscal sector

Budget balance recorded a deficit only in the last month of the first half of 2008. As of end June, fiscal deficit totalled 2.3 billion leks, which is several times lower than the projected deficit of 18 billion leks. Budget revenues have followed a similar tendency with the previous months, exceeding by about 3 percent the level projected for the first half of 2008. Expenditures were carried out at accelerated rates, mainly in the last months of the six-month period, meeting 92 percent of the projected plan for this period.

Table 13 Performance of main fiscal indicators

	FaCt S1 2008 ¹	Plan S1 2008 ¹	Change in percent 2008 ²	Change in percent 2007 ²	July 2008	Annual plan ³
REVENUES	134.99	130.89	16.80	9.61	161.14	303.78
Tax and customs revenues	96.09	89.79	18.32	12.61	113.41	209.71
1.2 Other tax revenues	27.91	31.45	14.8	- 1.69	33.86	66.64
1.3 Non-tax revenues	10.47	7.97	5.42	19.41	13.24	22.76
EXPENDITURES	137.32	148.86	30.30	10.52	166.72	360.21
2.1 Current expenditures	107.79	113.62	14.47	8.15	129.75	257.41
2.1.1 Expenditures on personnel	29.99	30.23	17.20	1.22	35.65	67.96
2.1.2 Expenditures on interests	15.02	15.28	24.61	- 0.89	18.76	32.58
2.1.3 Expenditures on insurance and pensions	35.02	35.32	8.27	15.78	41.80	78.67
2.2 Capital expenditures	28.02	33.36	149.54	35.47	34.74	94.42
FISCAL BALANCE	- 2.33	- 17.97	- 122.86	1.00	- 5.59	- 56.42
3.1 Domestic borrowing	11.52	- 0.22	235.19	- 132.88	8.68	16.96
3.2 Foreign financing	1.13	16.82	283.05	- 69.59	1.75	35.33

Source: Ministry of Finance

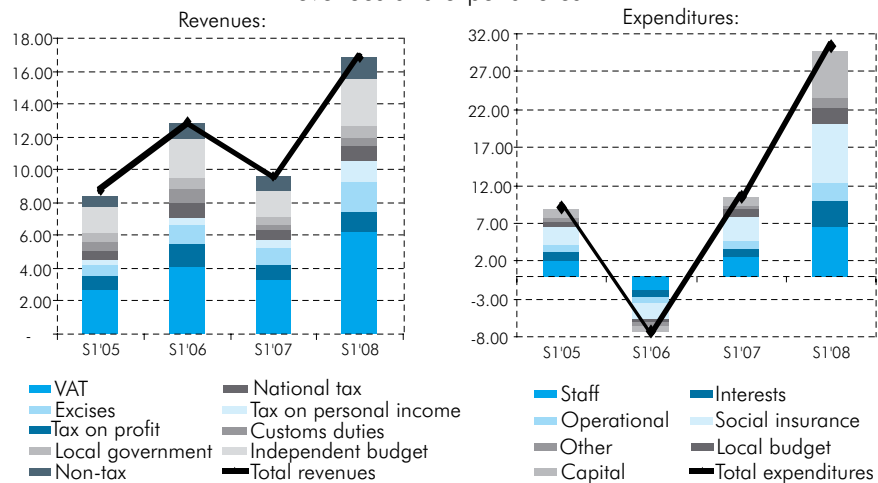
Notes: ¹) Progressive data, in billion leks; ²) Annual change in percent for the first half; ³) Annual plan according to the revised budget in July 2008.

Collected income recorded an annual growth of 17 percent, the highest in the last five years. Income from VAT and personal income tax provided the main contribution to this growth. The ever-considerable contribution of the VAT is explained by the large share of this item in total revenues. It has maintained the same growth rates of the previous years, exceeding at the same time the projected plan for the first half of 2008 by about 8 percent. Starting from the second half of 2007, tax on personal income has increased its share to total revenues. The main factors to have affected the increase of the share are the change in the tax rate of personal income from progressive to simple tax, and the amendments made to the regulatory and legal framework³². Income from tax on profit have exceeded the six-month projection by 40 percent. Despite this positive performance, the annual change rate of this item was about -7 percent as of end the first six months. The main cause is the change in the tax on profit from 20 percent to 10 percent starting from 1 January 2008.

Similarly to revenues, budget expenditures have recorded the highest growth of the last five years with an annual growth of 30 percent. At the same

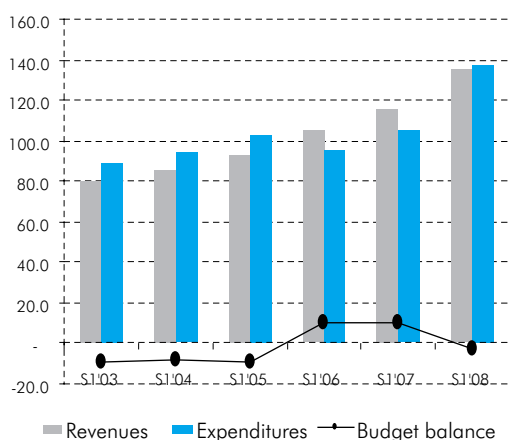
time, expenditures have met 92.3 percent of the plan in the first half of 2008. The annual increase of capital expenditures provided the main contribution to the total increase of expenditures. Worth to note is the fact that long-term expenditures carried out during the first six months have been met by about 84 percent of the plan for this period, while in the previous two years (the first half of the year) the plan was met by around 43-51 percent. The road Durrës-Kukës absorbed about 45 percent of capital expenditures, contributing dramatically to their annual growth by 150 percent. Personnel expenditures have grown by 18 percent in annual terms, which is the highest in the last three years. This growth attributes to the rise in the average monthly wage in the public sector by about 12.4%³³.

Chart 11 Contribution of items to the annual change of budget revenues and expenditures



Source: Ministry of Finance and Bank of Albania estimations

Chart 12 Performance of main fiscal indicators during the first half of 2003-2008



Source: Ministry of Finance

As of end July, revenues and expenditures were met by 161 and 166 billion leks, meeting 53 and 46 percent of the annual plan approved in the revised budget in July the present year.

As of end the first half of 2008, budget balance has had a different performance compared with the previous two years and recorded a deficit of 2.3 billion leks. However, it is reported that it has met only 13 percent of the projection for this period.

As of end July, budget deficit totalled about 5.6 billion leks, deepening by about 3.2 billion leks compared with the previous month.

	S1 2003	S1 2004	S1 2005	S1 2006	S1 2007	S1 2008
BUDGET BALANCE	- 8.82	- 8.45	- 9.47	10.09	10.15	- 2.33
Deficit financing	8.82	8.45	9.47	- 10.09	- 10.15	2.33
Domestic	5.45	6.24	7.35	- 11.06	- 10.44	1.20
Privatization receipts	0.35	4.15	0.62	2.11	0.04	0.40
Domestic borrowing	9.75	5.50	10.48	- 10.45	3.44	11.52
Other	- 4.65	- 3.40	- 3.75	- 2.72	- 1.47	- 9.72
Foreign	3.37	2.21	2.12	0.97	0.29	1.13

Table 14 Budget deficit financing

Source: Ministry of Finance

Domestic borrowing represents the main instrument of budget deficit financing, accounting for 90 percent of total borrowing. Compared with the previous year, the Ministry of Finance reduced the amount of debt in T-bills by about 30 billion leks in the first half of 2008, increasing by about 46 billion leks the debt stock in bonds of different maturity terms. The shift of the amount of debt from short to long maturity terms is in the same line with the Ministry of Finance's policy on public debt management.

Box 3 Supplementary budget and a comparative analysis

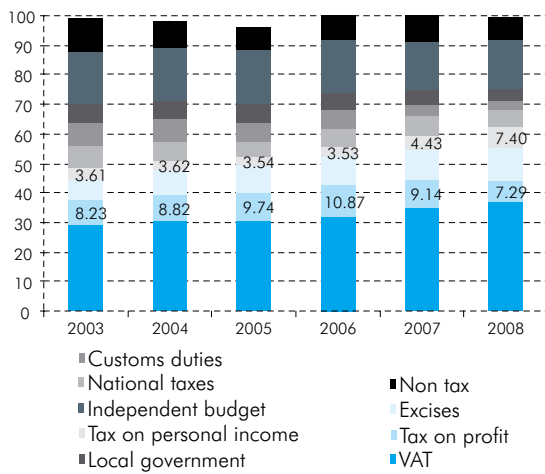
Table 15 Revenues and expenditures according to the early 2008 budget and the revised budget in July 2008

	Initial Budget (1)	Revised Budget (2)	Absolute Change (2-1)
TOTAL REVENUES	283.7	303.8	20.1
Value added tax	99.9	104.9	5.0
Tax on profit	14.4	18.4	4.0
Excises	38.5	37.5	(1.0)
Tax on personal income	16.3	23.3	7.0
National taxes and other	17.2	16.2	(1.0)
Dividend income	0.1	5.0	4.9
Other	1.0	1.7	0.7
TOTAL EXPENDITURES	369.0	360.2	(8.8)
Domestic interests	29.0	28.7	(0.3)
Foreign interests	4.3	3.9	(0.4)
Operational and maintenance expenditures	28.0	28.6	0.6
Subsidies	2.3	2.0	(0.3)
Expenditures on social insurance	76.0	78.7	2.7
Expenditures on local budget	29.6	31.6	2.1
Contingency reserve fund	10.4	9.9	(0.5)
Capital expenditures	105.6	94.4	(11.2)
With domestic funding	38.8	48.8	10.0
With foreign funding	66.7	45.6	(21.2)
BUDGET BALANCE	(85.3)	(56.4)	28.92
Domestic funding	29.4	21.1	(8.32)
Domestic borrowing	25.3	17.0	(8.32)
Foreign funding	55.9	35.3	(20.60)

Source: Ministry of Finance

According to the revised budget for 2008, budget revenues and expenditures are projected to amount to 303.8 and 360.2 billion leks. Revenues are projected to be about 20 billion leks higher and expenditures about 8.8 billion leks lower than the early 2008 projection. Until end 2008, deficit is projected to reduce to 56.4 billion leks or 5.2 percent of the GDP, from 85.3 billion (7.9 percent of the

Chart 13 Individual items by share to total revenues



Source: Ministry of Finance and Bank of Albania estimations

GDP) projected in early 2008. About 35 percent of total additional revenues are projected to be collected from tax on personal income. In the first half of 2008, this sub-item of revenues shared about 7.4 percent of the total, which is two times higher than its average share during the same period the years 2003-2007. About 20 percent or 4 billion leks of total additional revenues are expected to be collected from tax on profit. The share of this item in total revenues reduced by about 2 percentage points in the first half of 2008 compared with the same period the previous year.

The new fiscal package was approved in July 2007. Among others, it envisaged the change in the tax rate of personal income and tax on profit. As of July 2007, personal income tax rate was reduced to 10 percent. The 20 percent corporate tax rate was reduced from 20 to 10 percent in January 2008.

What figures do other countries that have had reforms in flat tax adoption present?

Keen et al. (IMF, 2006) in the working paper "The flat tax(es): Principles and evidence", has analyzed the way and effects of flat tax adoption. The following table lists the countries by order of adoption.

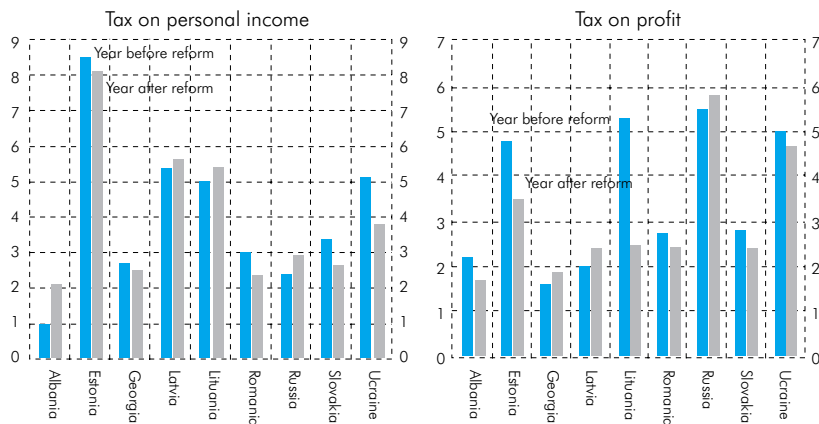
Table 16 Flat tax and tax on profit before and after reform

	Personal income tax rates			Tax on profit	
	Flat tax adopted	After reform	Change in basic allowance	Before reform	After reform
Estonia	1994	26	Modest increase	16-33	26
Lithuania	1994	33	Substantial increase	18-33	29
Latvia	1997	25	Slight reduction	25 and 10	25
Russia	2001	13	Modest increase	12-30	37
Ukraine	2004	13	Increase	10-40	25
Slovak Republic	2004	19	Substantial increase	10-38	19
Georgia	2005	12	Eliminated	12-20	20
Romania	2005	16	Increase	18-40	16
Albania	2007	10	Reduction	20	10

Source: Keen et al, *The flat tax(es): Principles and Evidence*. IMF Working Paper 2006 and Ministry of Finance

The adoption of the flat tax in these countries includes two waves. The first wave is characterized by tax rates set at moderately high levels – at or close to the highest marginal tax prior to the reform. The second wave was marked by tax rates that are closer to the lowest of the pre-reform rates. Except in Russia³⁴, the second wave of low-rate flat tax reforms has been associated with a reduction in revenues from the personal income tax. In the case of Albania, there has been an increase in revenues from personal income tax following the flat tax adoption. Compared with the previous years, revenues from tax on profit expected to accumulate until the end of 2008, are projected to reduce as a share to the GDP.

Chart 14 2008 Revenues from tax on personal income and tax on profit as a share to the GDP before and after reform.

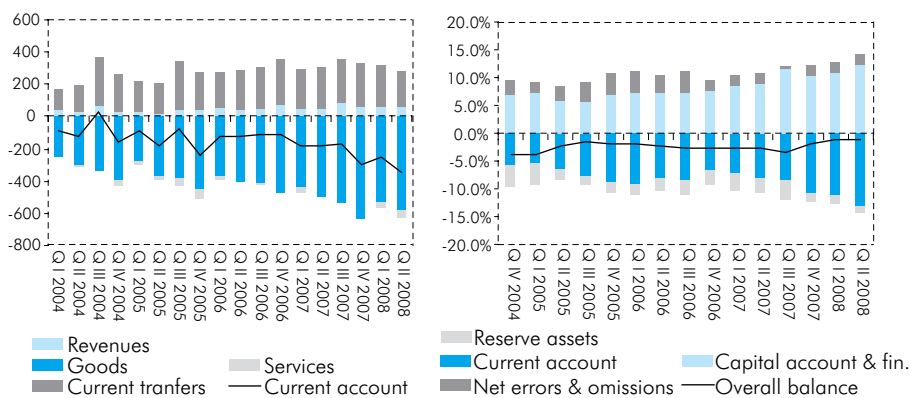


Source: IMF, August 2008³⁵.

III.3.2.2 External sector

Current deficit increased by about 60 percent in annual terms, amounting to 591 million euros and accounting for about 13 percent of the GDP at the end of the first half of 2008. The high trade deficit, the main contributor to the current deficit deepening during this period, was also followed by the deficit on trade in services and the contraction of surplus in net current transfers³⁶.

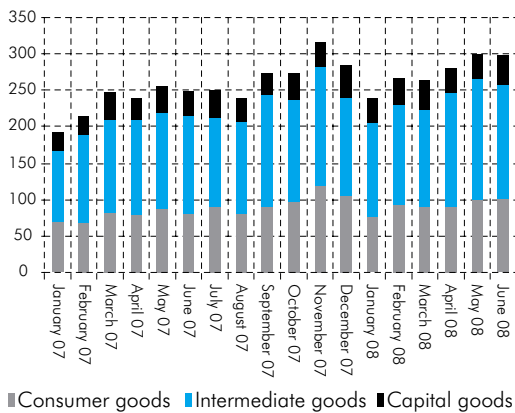
Chart 15 Current account (in million euros) and the balance of payments (as a share to GDP)



Source: Bank of Albania and IMF assessments

The volume of current transactions amounted to 4.2 billion euros, which is 10 percent higher in annual terms. 95 percent of current expenditures were used for the import of goods and services, while 60 percent of current revenues stems from the export of goods and services. The rest is obtained from current

Chart 16 Imports by purpose of use
(in million euros)



Source: Bank of Albania

transfers (30 percent) and income (10 percent). Deficit on trade in goods deepened by 17 percent in annual terms, accounting for about 28 percent of the GDP. Imports and exports of goods recorded an annual growth of 18 and 19 percent, respectively. Imports' coverage rate from exports was estimated at about 30 percent. In terms of imports by purpose of use, it is noted that imports for consumption purposes have been reducing relative to total imports, although they have grown by 17 percent in annual terms. The import of 'capital goods' has grown by 18 percent and does not present any changes in terms of share. Imports for 'intermediate consumption' recorded the highest annual growth rate (18.3 percent) and the largest share to total imports (53.4 percent).

Total exports are mainly represented by the exports of textiles and footwear (45 percent); however, their share has been decreasing³⁷. Around 38 percent of total exports is shared by the exports of 'construction materials and metals' (22 percent) and 'minerals, fuels and energy' (16 percent). As of end period, the balance of services recorded a deficit of about 83 million euros, while the income balance ended in a surplus of 129.3 million euros. Services account is dominated by travel services, mainly personal ones, while 'other services' covered about 93 percent of deficit in services. Income from tourism have grown by 20 percent in annual terms, owing to the increase in the number of non-resident travellers. Net current transfers continue to record positive values, although at a downward tendency. Represented mainly by workers' remittances, net current transfers finance about 42 percent of trade deficit in goods and amount to about 470 million euros. Their share to the GDP is about 12 percent. During the period January to June 2008, the net flow in capital and financial account was about 500 million euros. Around 31 million euros have entered in the form of capital transfers and 435 million euros in the form of residents' financial liabilities. The net flow of this account funds about 85 percent of current deficit. The substantial increase of residents' financial liabilities attributes to the increase of foreign direct investments and borrowing from abroad which amounted to around 227 and 145 million euros. External debt has increased by about 41 million euros. As of end the first half of 2008, Albania's foreign reserve amounted to about 1.42 billion euros which are sufficient to cover 3.7 months of imports of goods and services.

III.3.2.3 Public expectations of inflation

Public expectations of inflation have been higher in the last 18 months compared with the previous periods. Despite the upward tendency, they have converged close to 3 percent, attesting to their relatively satisfactory anchoring around the Bank of Albania quantitative inflation target of 3 percent \pm 1 percentage point. Evidences from the periodical survey conducted by the Bank of Albania indicate that the different market economic agents are

ever-increasingly becoming aware and rational in providing opinions and assessments on the future and possible developments in consumer and producer prices in the medium-run. The expectations formation process implies the combination of information on past and future events in consumer prices and the domestic and foreign economy and on the central bank inflation target. Each information has a specific share when analyzing the expectations. The Bank's monetary policy target is that the public forms the expectations based mostly on the future economic events and on the medium-term quantitative inflation target.

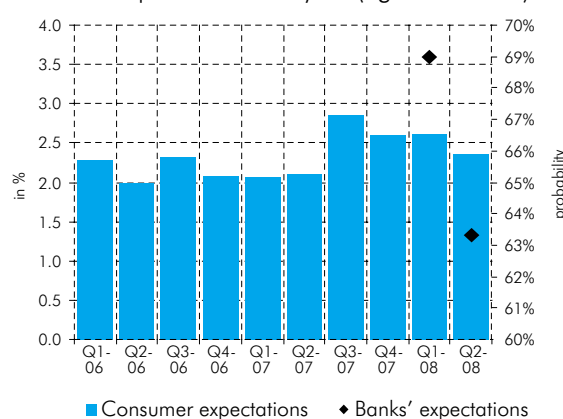
Box 4 Market agents' expectations of inflation – evidences from surveys

During the last years, the measures of different market agents' expectations of the change rate in the general level of prices have played a role in the Bank of Albania decision-making process, given that its main objective is to achieve and maintain price stability. This box aims to present the inflations expectations of consumers, businesses and commercial banks' experts.

Medium-term expectations. The measures of expectations in the long-term period are useful to measure the market agents' confidence in the Bank's announced target. During 2008, medium-term expectations have increased compared with the previous year, although they appear to be more contained or optimistic than short-term expectations. Consumer expectations of inflation over the next 12 months, after peaking in the third quarter of 2007 (2.9 percent), moved below but however close to the 3 percent in the first two surveys conducted in 2008. The latest data of 'Monthly banks' survey' indicate that the expectations of commercial banks' experts of inflation over the next 12 months have registered a slight downward tendency during the last three months after having increased in February 2008. According to banks, however, there is a 64 percent probability that annual inflation marks above 3 percent after a year.

Short-term expectations. Inflation expectations in the short-term period are considered as indicators of short-term pressures on the level of consumer prices. Unlike long-term expectations, short-term expectations of commercial banks' experts have been aggravating during the first nine months of 2008. In their anticipations of the change of prices in the short-term period – annual inflation after a month – banks tend to be more pessimistic compared with long-term expectation. According to banks, there is a 42 percent probability that inflation jumps the upper tolerance band of 2-4 percent. Consumers on the other hand expect a more optimistic situation. According to Consumer Sentiment Survey, during the first half of 2008, consumers anticipated inflation to decrease in the next 3 months. On the other side, business expectations of producer prices for the next quarter have remained at high levels since 2007, signalling the presence of upward supply-side pressures.

Chart 17 Performance of consumer expectations of inflation after a year (left-hand axis) and the probability that banks expect inflation to mark above 3 percent after a year (right-hand axis)



Source: Consumer Sentiment Survey and Monthly Banks' Survey

III.3.2.4 Monetary policy

The main objective of the Bank of Albania monetary policy³⁸ for 2008 remained the achievement and maintenance of price stability, translated into an annual inflation rate of consumer prices equal to 3 percent. The tolerance bands around this central value are 2 and 4 percent. In order to achieve this objective, the Bank of Albania collects and uses all the possible economic and financial information that serves to the decision-making process. In addition, it implements some key features of the inflation targeting regime. Repurchase agreement rate, which is set by the Bank of Albanian Supervisory Council every end of the month, is the main monetary policy instrument.

The key interest rate was 6.25 percent in the beginning of the year 2008. This rate was kept unchanged until August. During 2007, this rates rose three times by 25 basis points each. The three consecutive raises aimed to contain the credit growth rates, which during that period accounted for above 8 percent of the GDP, and to anchor the expectations around the 3 percent target. The raise of the key interest rate has also affected the increase of the real interest rate of lek denominated deposits. The maintenance of positive spreads between the deposits' real interest rates in lek and in foreign currency aimed to push the demand for money in lek in the form of deposits. The decisions on tightening the monetary policy by 75 basis points were expected to provide their effect during a time frame of 12 to 24 months. As expected, there was a slowdown in the growth rates of credit to economy in the first half of 2008 both to M3 aggregate and to the GDP.

The macroeconomic environment of the first half of the present year was very dissimilar to that of the previous year. Global and Albanian CPI inflation began to respond markedly to supply-side shocks and to the increased producer prices. The high annual inflation rates registered in the first two quarters were generated as a result of the rapid increase of food prices (in particular of processed foods), oil price rise and the increase of energy tariffs at end March. The shortages in the supply of energy at home – in particular during winter – have also exerted pressure on the increase of producer price, which pushed a considerable number of producers to increase the prices of goods and services. Even under the conditions of supply-side shocks, the Bank of Albania has monitored closely the demand-side developments and has assessed periodically the need of monetary policy intervention to manage money supply in economy. According to the Bank of Albania projections made in mid-2007, annual inflation rate was expected to return to the targeted band of 2-4 percent around the end of the first half of 2008, as a result of the absence of other strong supply-side shocks. In assessing and weighing the risk factors have been considered past and expected developments in the main goods' prices in the international market, exchange rate performance, meeting rates of budget plan, the possible deterioration of energy, credit growth rates and the performance of public, business and bank's short-term and long-term expectations of inflation. While the supply-side pressures persisted and their impact was assessed as being long-lasting, the other factors mentioned above have generally helped lower or contain the increase of inflation. In

more concrete terms, the fiscal stimulus has almost been inconsiderable during the first half of 2008, the appreciation of the lek against the euro and the U.S. dollar has amortized the impact of imported inflation increase, inflation expectations have not jumped markedly from the target and the growth rates of credit have been declining. The combination of monetary policy tightening with the relaxation of external pressures and the statistical effect of the termination of annual price rise of bread and grains starting from the second quarter of 2008 have caused the annual inflation rate to return to the targeted band of 2-4 percent. In addition, in August inflation fell to below the 3 percent target of the Bank of Albania. In the second half of 2008 and on, the monetary policy will monitor closely the internal and external macroeconomic developments and make a periodical assessment of the shifts in the balance of risks, which may jeopardize the price stability objective.

BoA supervisory council meeting date	interest rate	change
4 April 2007	5.50	---
2 May 2007	5.50	---
6 June 2007	5.50	---
27 June 2007	5.75	+ 0.25
19 July 2007	5.75	---
29 August 2007	5.75	---
26 September 2007	6.00	+ 0.25
31 October 2007	6.00	---
27 November 2007	6.25	+ 0.25
27 December 2007	6.25	---
30 January 2008	6.25	---
27 February 2008	6.25	---
26 March 2008	6.25	---
30 April 2008	6.25	---
27 May 2008	6.25	---
25 June 2008	6.25	---
30 July 2008	6.25	---
29 August 2008	6.25	---

Table 17 Monetary policy meeting dates and decisions during 2007 and 2008 (as of August 2008)

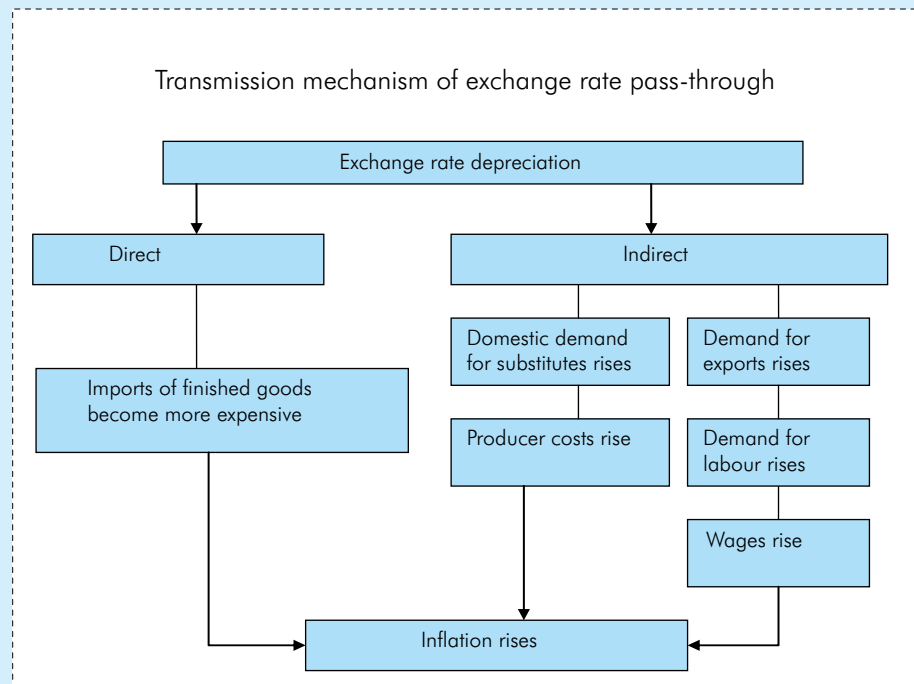
Source: Bank of Albania

Box 5 Exchange rate pass-through to consumer prices

In a small open economy such as Albania, the exchange rate has a considerable impact on the economic activity. The expression 'exchange rate pass-through' is generally used to refer to the effect of exchange rate changes on one of the following: import and export prices, consumer prices, investments and trade volumes. The primary focus of this box is on the effects of exchange rate changes on consumer prices, that is, the extent to which exchange rate changes alter relative prices. This interest stems from the fact that changes in the exchange rate pass-through to consumer prices are integral to the design of monetary and exchange rate policies.

Exchange rate changes affect inflation measured by the consumer price index through some channels (chart 1). They affect inflation directly on prices of imported final goods, and indirectly through prices of imported intermediate goods which affect

final prices of goods and services produced in the country. Exchange rate changes may also affect labour cost, affecting inflation through wage/inflation spiral.



Exchange rate pass-through to consumer prices may be complete or partial. The pass-through is complete when a one percent depreciation in the exchange rate leads to a 1 percent price rise. In case the price rise is less than 1 percent, the pass-through is defined as partial.

Empirical studies³⁹ have found some main factors that influence the degree of exchange rate pass-through to an economy: (i) openness and size of the economy. The degree of pass-through will decrease the more open the economy is. (ii) Relative elasticities of demand and supply⁴⁰ for traded goods. For exports, the degree of pass-through will increase the greater the elasticity of demand and the smaller the elasticity of supply. (iii) Macroeconomic conditions and the microeconomic environment. These studies conclude that the degree of exchange rate pass-through is higher in emerging than in developed economies.

Exchange rate and inflation in Albania

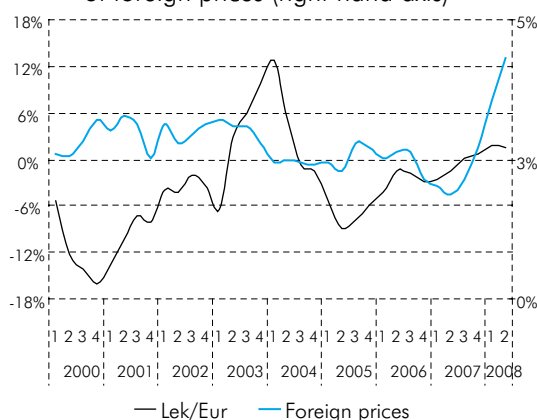
Albania implements a floating exchange rate regime which is determined by the supply and demand in the foreign exchange market. Foreign exchange market interventions aim to avoid strong and speculative short-term fluctuations and to create the foreign reserve. Exchange rate developments have an overwhelming impact on the CPI inflation. According to the survey conducted by the INSTAT in 2004, about 50 percent of the consumer basket is shared by imported consumer goods. Albania's main trading partners are EU countries. Italy and Greece share about 80 percent of our imports. These developments and the empirical results⁴¹ provide evidence that the role of the U.S. dollar in the Albanian economy has weakened in favour to the euro.

In addition to the price rise abroad, the depreciation periods of the lek against the euro (Q1 1999-Q1 2002 and Q4 2003-Q1 2006) were followed by the negative contribution of imported inflation to total inflation rate in Albania. The high global price rise during fall 2007 (galloping price rise in foods and energy) and the slight appreciation of the euro against the lek during this period has translated into positive increasing rates of imported inflation. The latter has contributed by 2.1 percentage points to the average inflation of 3.8 percent during Q3 2007 – Q2 2008.

Conclusions of the studies on transmission mechanism of exchange rate pass-through

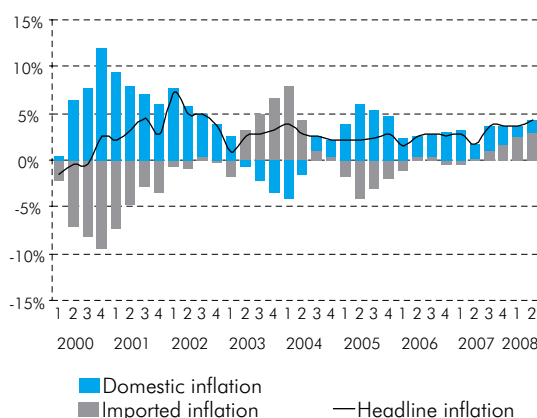
The latest empirical studies⁴² on the exchange rate pass-through to consumer prices in Albania indicate that it is almost complete, however falling. The pass-through of a shock to the exchange rate reaches 42 percent in the first four months after this shock. The transmission is complete within the year. The shocks on the exchange rate explain about 24.5 percent of the consumer price fluctuations. However, the pass-through intensity depends on the period under analysis. Results show that the exchange rate pass-through to consumer prices reduces during periods with low and stable inflation. Developments in the market structures, the lek stability, the inflationary environment and the confidence in the Bank of Albania, in particular after the inflation target has been made public, seem to be good 'justifiers' of a low exchange rate pass-through to consumer prices after 2000. These outcomes are in line with the findings of similar studies on countries that have been through such changes. However, these conclusions may not be confirmed during periods of high inflation and volatile exchange rates.

Chart 18 Annual changes of lek/euro exchange rate* (left-hand axis) and of foreign prices (right-hand axis)



Source: Bank of Albania
Notes: (*) The exchange rate affects with a time lag of 3-4 quarters; (-) appreciation (+) depreciation

Chart 19 Contribution of imported inflation and domestic inflation to the annual headline inflation rate (in percentage points)



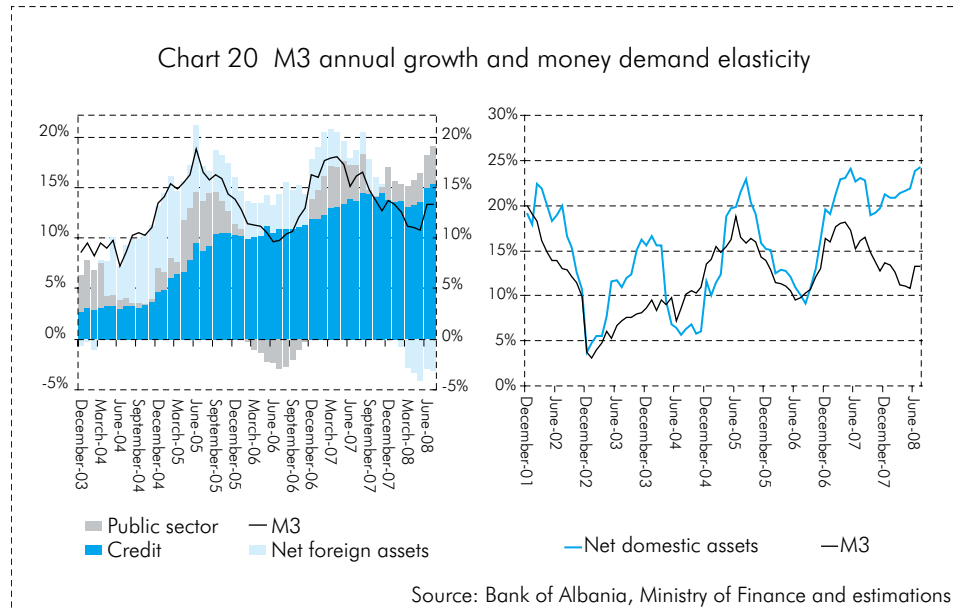
Source: INSTAT and Bank of Albania estimations

III.1 MONETARY DEVELOPMENTS

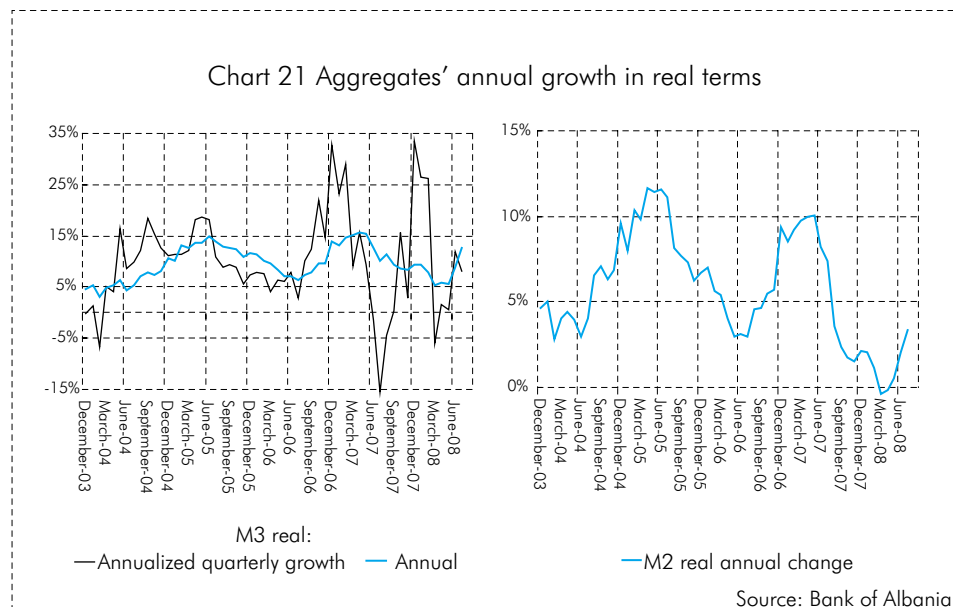
III.1.1 Monetary aggregates

Demand for money in economy has grown during 2008 at a stable rate by about 12 percent in annual terms⁴³. Money flows have been mainly created in the form of credit to economy. Annual flow of credit to the private sector dominates the money growth by about 15 percentage points in terms of M3. On the other hand, annual credit to the public sector has contributed by only about 2.5 percentage points to the M3 annual growth. In total, demand for net domestic assets has grown at more rapid rates to broad money stock. The reduction of net flow of the system's foreign currency assets has amortized the pressures in terms of further growth of money supply. The more accelerated

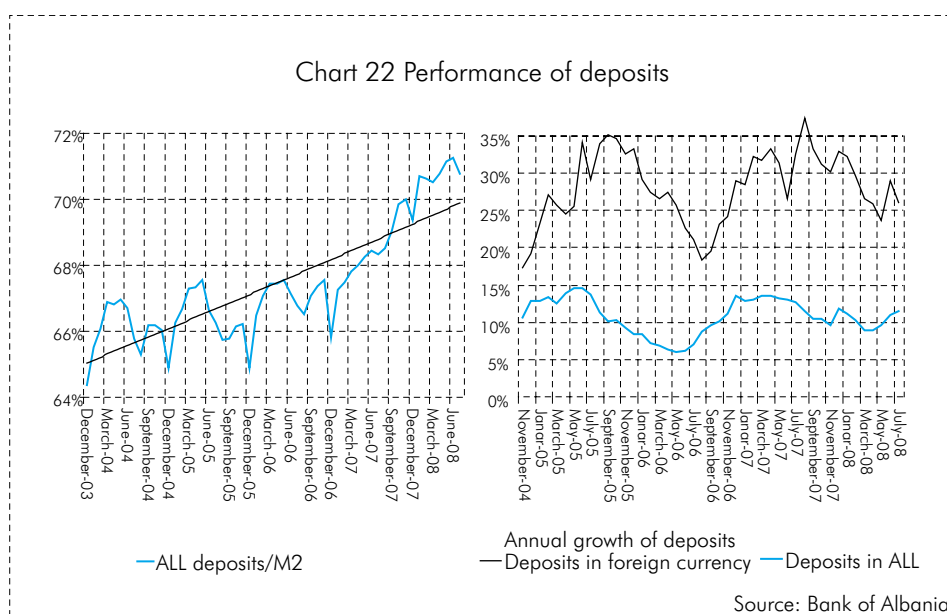
credit rate in June and July was followed by the annual growth of the M3 to 13.3 percent in July.



In real terms, money growth has been increasing during June-July. In the first half of 2008, real growth of M2 and M3 aggregates was 1 and 7 percent, respectively, in annual terms. The upward tendency of real M3 during the recent months to 12 percent moves around the average of this indicator in the last years. At the same time, money base has maintained its downward tendency which was shown during 2007. In annual nominal terms, it has grown by an average of 2.6 percent, while it has reduced by an average of 1.7 percent in real terms. In June to July, the annual rate of money base has reflected the growing demand for currency in circulation. In nominal terms, annual growth rate for July reached 5 percent, while in real terms it stood at 3.6 percent. This tendency was reflected in the more rapid growth of currency outside banks and in the foreign reserve accumulation in terms of assets.

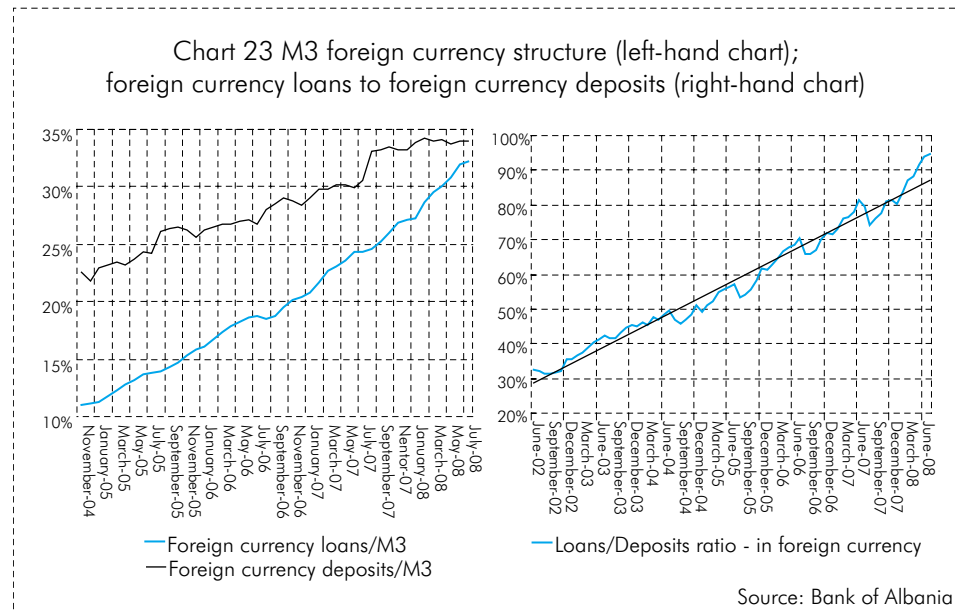


The more moderate growth of the liquid component, currency outside banks, than the monetary aggregates was reflected in the higher growth rate of deposits in the banking system. During the first half of 2008, annual growth of total deposits was about 17 percent. In monthly terms, deposits recorded higher growth in June and July. Average annual rate of deposits denominated in lek and in foreign currency was 10 and 28 percent. During the last two months, their time structure shifted to time deposits, being mainly reflected in the growth of household time deposits. Given the growth of demand for domestic monetary assets, annual ALL deposits' rate increased to about 11.2 percent in July. The ratio of ALL deposits to M2 was above 71 percent compared with the average ratio of 69 percent in 2007.



Foreign currency inflows in the form of workers' remittances have affected the foreign currency structure of M3. The more accelerated growth rates of foreign currency-denominated deposits than ALL deposits continue to affect M3 foreign currency structure. In more concrete terms, the share of foreign currency deposits to M3 results stable at 34 percent during 2008, compared with the share of 33.2 percent at end 2007. The shift of broad money to foreign currency-denominated deposits was followed by the drop in the ratio of M2 to M3 to 66 percent from the average of 69 percent in 2007.

The shift of the M3 to the foreign currency component was also affected by the creation of money in the form of credit to economy and by its foreign currency composition. Hence, the increase of the intermediation through the channelling of the system's net foreign assets to foreign currency lending has led to a more accelerated creation rate of foreign currency. In July, the ratio of foreign currency loans to foreign currency deposits increased to 95 percent from 82 percent at end 2007. Being in line with the upward tendency of this ratio, the share of foreign currency loans to M3 has increased to 32 percent from 27 percent as of end the last year.



Foreign currency inflows and the prudent operational policy have allowed the increase of the Bank of Albania net foreign reserve during 2008. In order to meet its operational objectives, the Bank of Albania has met the liquidity needs in economy given the seasonal growing demand and has managed to balance the foreign currency structure of money base in economy in line with its objectives. In August, net foreign reserve amounted to 1,219 million euros, compared with the objective of 1,143 million euros in September. The increase of the reserve has maintained the net domestic assets at low levels.

Table 18 Meeting of quantitative objectives⁴⁴

	March 2008	June 2008	July 2008	August 2008	September 2008
Net International Reserve of the Bank of Albania (in million euros)					
Objective	1,088	1,122	1,129	1,136	1,143
Current	1,127	1,137	1,163	1,219	--
Difference (C-Obj)	39	15	34	83	--
Net Domestic Assets of the Bank of Albania (in billion leks)					
Objective	88	96	95	94	93
Current	74	81	82	76	--
Difference (C-Obj)	-13.8	-15.7	-13.2	-18.1	--
Net Domestic Credit to the Government (in billion leks)					
Objective	383	389	--	--	--
Current	360	376	--	--	--
Difference (C-Obj)	-22.6	-13.1	--	--	--

Source: Bank of Albania

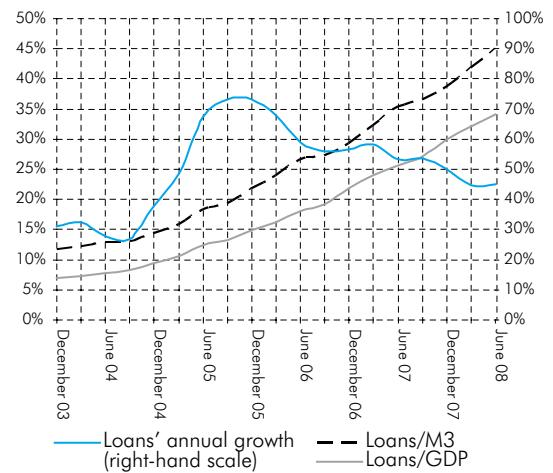
III.1.1 Credit to economy

During the first seven months of 2008, credit to economy continued to grow at an average annual rate of 45.5 percent, accounting for 34 percent of the GDP and 45.3 percent to M3 broad money. Credit growth rates have by and large followed the downward tendency of the last two years, except for June and July when the growth rates were higher than in the previous months.

This performance owes to the higher monthly lending, mainly to businesses, during June. In addition, monthly lending returned to the average annual level of about 8 billion leks in July.

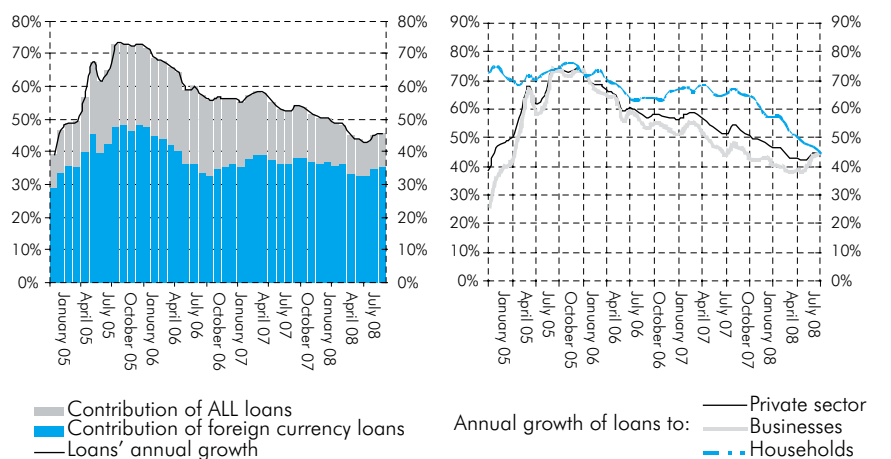
The foreign structure of credit has maintained the same tendency as in the previous year, being characterized by the moderate growth of the share of credit in foreign currency, both for business and household credit. At average levels, during the first seven months of 2008, credit denominated in foreign currency shared about 72 percent of loan portfolio or about 2 percentage points more than the average for 2007. This performance owes to higher growth rates of foreign currency lending compared to ALL lending which averaged 49 and 37 percent.

Chart 24 Performance of loan portfolio



Source: Bank of Albania

Chart 25 Performance of loan portfolio by foreign currency and borrowers



Source: Bank of Albania

Credit to the private sector recorded an average annual growth of 40.6 percent in the first seven months of 2008. Business credit provided the main contribution. Worth to note is that this type of credit has in the last months provided greater contribution than household credit. Trade, construction and industry absorb about 77 percent of business credit. Most of the credit is used by businesses to cover their liquidity needs (48 percent) and to finance investments in real estates (22 percent).

In annual terms, household credit grew by 51 percent at average in January to July 2008. The growth of this type of credit has been following a downward tendency to 44.3 percent in July from 57.5 percent as of end 2007. This considerable slowdown attributes to a large extent to the decline of consumer loans. On the other side, real estates loans, which account for about 66

percent of household loans' portfolio, maintain high growth rates, providing the highest contribution to the growth of this portfolio. The high and stable rates of real estates loans to households and the growth of business loans have increased the share of this type of loan to 12.5 percent to the GDP which is 2 percentage points more than as of end 2007.

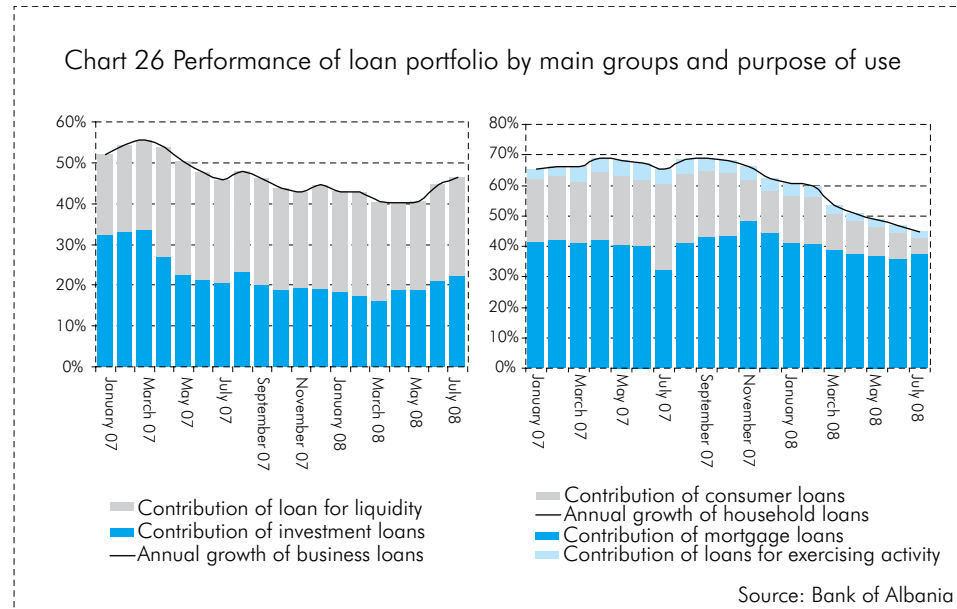


Table 19 Indicators of loan portfolio

		Average annual growth for the quarter (in percent)				
		Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007
Loan portfolio (in billions of lek), July 2008	351	44.0	47.1	50.7	53.4	55.5
Composition of loan portfolio in percent (July 2008)						
Business loans	64.7	41.8	42.7	43.7	46.6	50.6
-working capital (+overdraft)	30.8	48.6	58.3	58.0	61.8	64.2
-investments	33.9	36.1	30.2	33.2	36.2	40.9
Household loans	35.3	48.7	58.0	65.5	67.5	68.2
-consumer	8.7	36.2	57.7	61.5	106.7	100.9
-real estates	23.2	60.4	64.8	76.8	62.4	66.3

Source: Bank of Albania

Box 6 Survey results of lending activity during the first half of 2008

According to the survey on lending activity during the first half of 2008, banks report the further tightening of loan standards compared with the second half of 2007, both to businesses and households. Banks have been more prudent in lending to large businesses and to consumers than to lending to small businesses and mortgage-related loans.

The factors with the highest contribution to the tightening of lending standards to businesses have been: the Bank of Albania decisions; the specific issues of the sector the business operates in and the expected macroeconomic situation. The main

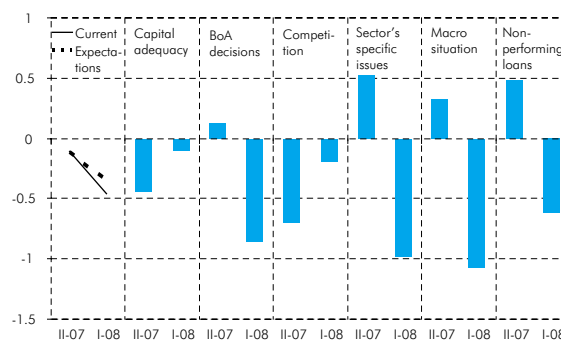
factors to have contributed to the tightening of lending standards to households in the first half of 2008 were the financial situation of households and the performance of non-performing loans.

With respect to banks standards in lending to businesses, banks have strengthened the standards applied on loans through the increase of the margin for risk-bearing loans and the increase of the collateral as a ratio to the amount of loan. With respect to banks standards in lending to households, their tightening policy was mainly applied through the increase of the margin for higher-risk loans. The margin for average loans has slightly reduced, hence allowing the implementation of a looser lending policy.

The business and household demand for loans has been assessed as positive in the first half of 2008, although there is a downward tendency compared with the second half of 2007. Business demand is expected to remain positive in the second half of the present years, while household demand is anticipated not to show considerable changes compared with its level of the first half.

With regard to foreign currency lending, the main factor to have fuelled the business demand was the interest rate spread. In addition, banks consider the low awareness on the future economic developments (such as the changes in the exchange rate or interest rate) as another important factor with a positive contribution to the growth of demand for foreign currency lending. With respect to the factors that have fuelled the household demand for foreign currency lending, they are the prices of goods which are expressed in foreign currency and the interest rate spread.

Chart 27 Changes in the lending standards applied in business loans and the influence of different factors (net balance*), in percent



Source: Bank of Albania

* A positive balance implies the relaxation of standards or that the factor has influenced on the relaxation of lending standards. A negative balance implies the tightening of lending standards or that the factor has influenced on the tightening of lending standards.

Chart 28 Changes in the lending standards applied in household loans for houses and consumption and the influence of different factors (net balance*), in percent



Source: Bank of Albania

* See note 1

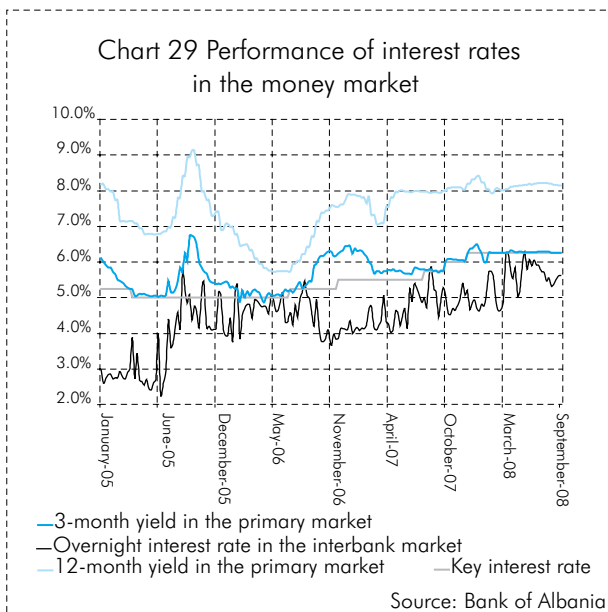
III.1 MARKETS AND INTEREST RATES

Key interest rate increased three times in the second half of 2007 (a cumulative change of 75 basis points) in response to the expectations for the increase of inflationary pressures in economy. Consequently, the interest rates in the markets increased during 2008 relative to the previous year. Interest rates in the money market have shown steady volatilities given the expectations for the maintenance of an unchanged key interest rate. The spread between the interest rates of deposits and loans denominated in lek and in euro has narrowed following the introduction of attractive summer offers for the collection of deposits. In addition, the average interest rates for the lek-denominated loans have shown a downward tendency starting from early 2008.

III.1.1 Money market

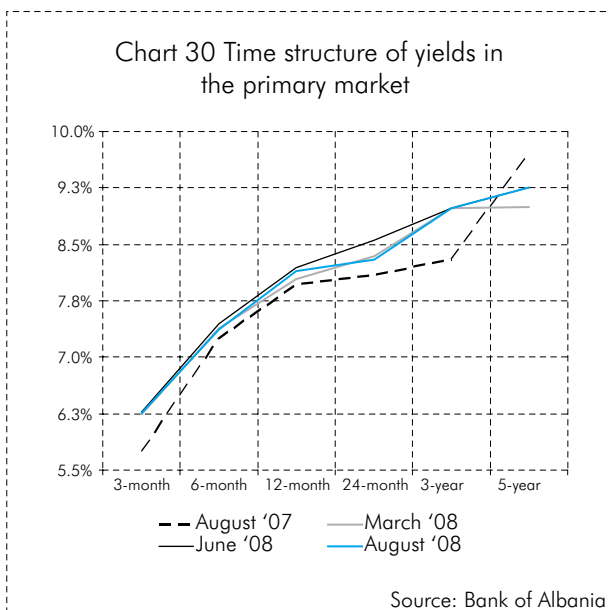
The interest rates in the money market have increased during the present year in line with the monetary policy orientation. Compared with the previous year, overnight interest rate in the interbank market has increased in average terms by 80 basis points to 5.60 percent, while the 12-month yield has risen by 27 basis points to 8.14 percent.

The oscillations of interest rates in the interbank market relate to the change of liquidity conditions in the market and to its asymmetrical distribution. The amount of liquidity shrank over the second quarter, leading to the increase of overnight interest rates and to their shift close to the key interest rate.



Average overnight interest rate increased to about 6.00 percent in the second quarter from 5.20 percent in the previous one. Weekly interest rate stood at 6.17 percent or 0.31 percentage points higher. During this period, the Bank of Albania has conducted open market operations by injecting funds through reverse repurchase agreements of one-week maturity term. The majority of funds were concentrated in a limited number of banks which have met the market's needs, which in turn have led to oscillations in the interest rate. Transactions were mainly of overnight maturity term and their average volume grew compared to the first quarter. Average daily volume of lending recorded a total of 1.6 billion leks, while average weekly volume reduced by about 0.2 billion, showing a similar performance with the previous quarter.

The beginning of the third quarter was followed by the improvement of the liquidity situation and a more balanced distribution which was reflected in the downward performance of overnight interest rates to 5.6 percent as of end August.

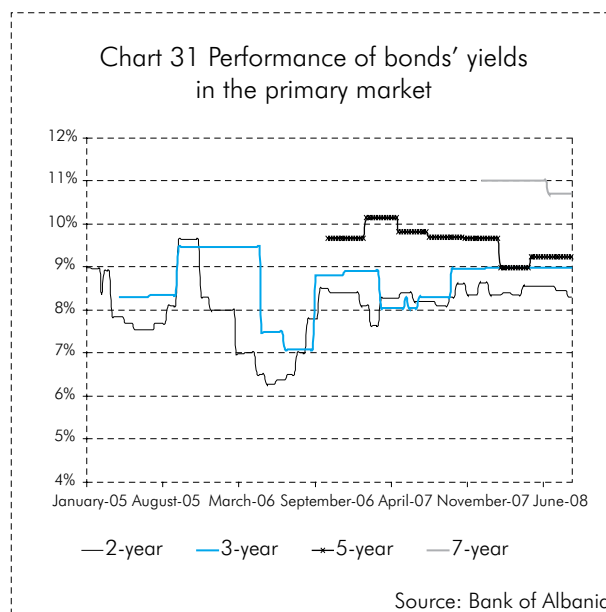


The primary market has shown low fluctuations of the yields during 2008. They have gradually transmitted the tightening of monetary conditions signalled in the second half of 2007, while the spread between the maturity terms has narrowed. Relative to the previous year when the key interest rate rose by 50 basis points, as of end August 3-month and 12-month yields increased by 51 and 0.18 percentage points, respectively.

While the yields maintained an upward tendency in the first two quarters of the present year, they dropped in the third quarter following the creation of larger excesses of liquidity in the market. In the

beginning of September, the 12-month yield was 8.02 percentage points, falling by 0.19 percentage points from its peak of 8.21 percent at end-June.

Long-term yields in the bonds' market show a narrowing tendency of the spreads between maturity terms in the last two years. In average terms, 2-year bonds, which are of higher frequency (monthly), have increased slightly during 2008, while other maturity terms' yields have been falling. As of end August, 2-year bonds' yield marked 8.3 percent or 0.06 percentage points higher than last year's average, while 5-year bonds' yield fell to 9.06 percent or 0.76 percentage points lower. The banking system's portfolio continues to shift to instruments of maturity term longer than one year⁴⁵, which has moderately affected the fall of bonds' yields and the consolidation of this market. Market participation has been high and the volume of issued bonds is increasing, reflecting the upward tendency of debt financing through long-term instrument. For the first time in November 2007 were issued bonds of 7-year maturity term. In the auction of June 2008, their yield was 10.71 percent or 0.29 percentage points lower. The secondary market remains almost inactive with a limited number of transactions and volumes. The trading of securities in this market would otherwise provide valuable information on the behaviour of participants and their expectations of financial and economic indicators.

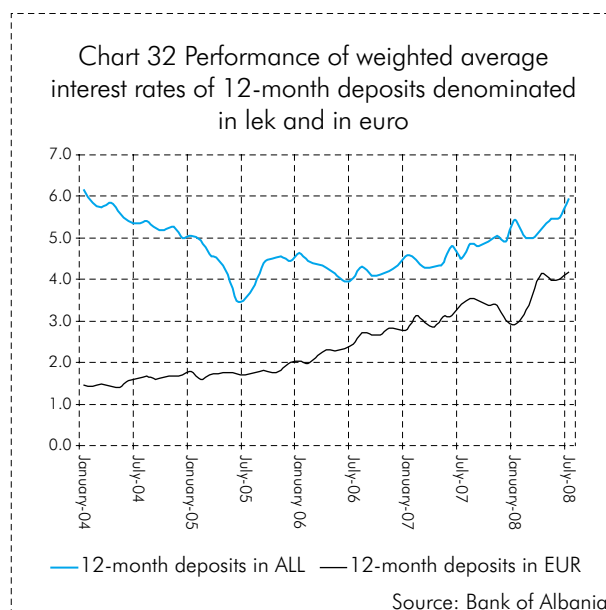


III.1.1.1 Performance of deposits' interest rates

Weighted average interest rate of deposits denominated in lek increased to 5.94 percent in July, up by 1.43 percentage points to the previous year and 0.95 percentage points to the previous quarter. The increase has persisted, except for in February and March when the offers made by the banking system in the end of 2007 were concluded.

With respect to maturity terms, worth to note is that the weighted interest rate for 12-month deposits recorded the highest increase by 1.12 percentage points to 7.72 percent. This considerable increase owes to the aggressive marketing strategy applied by the banking system to collect deposits through the application of promotional products during summer.

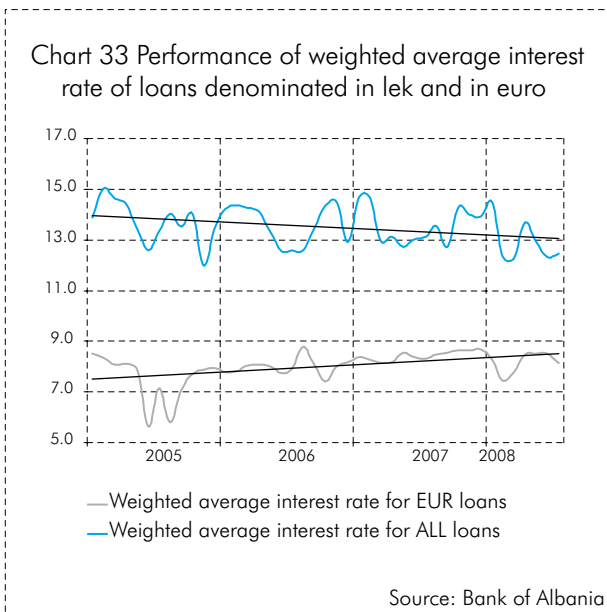
The interest rates of euro-denominated time deposits have generally had an upward tendency. The aggressive marketing strategies have been also applied for foreign currency-denominated deposits



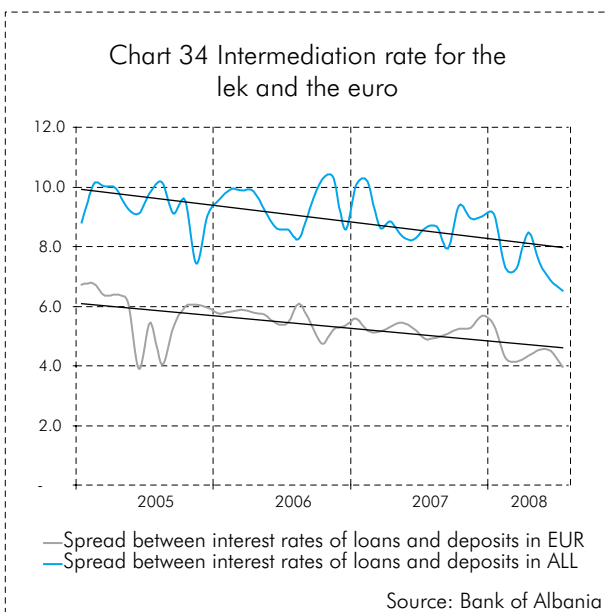
of long maturity term. Average interest rate of 12-month deposits reached 5.36 percent in July from 4.74 percent in June, hence increasing by 0.62 percentage points. The spread between lek and euro 12-month deposits increased significantly in July from 1.81 to 2.36 percentage points, affecting positively competition for lek deposits and perhaps having some influence on the exchange rate.

III.1.1.1 Performance of loans' interest rates

The downward tendency of interest rates of new loans in lek shown in the beginning of 2008 persisted in the following months as well. Demand for lek-denominated loans continued to be high in particular in the beginning of summer. Weighted average interest rate of lek-denominated loans was 12.46 percent in July from 12.93 percent in March and 12.32 percent in June. The loans extended have been mainly used to fund the short-term needs of businesses for working capital, consumption and the purchase of real estates. The overwhelming enhancement of competition, the banks' eagerness to gain their market shares, the more conservatory policies in terms of foreign currency lending have affected the drop in the banks' margins for lek-denominated loans. The average spread of the interest rates of new loans and T-bills has shown a distinct downward tendency in the first half of 2008 to an average of 4.79 percentage points, which is 0.92 percentage points lower than in the same period the previous year.



The interest rates of foreign currency-denominated loans have performed in line with the developments in the global markets, observing the changes in LIBOR and EURIBOR. In July, the interest rate for euro-denominated loans was 8.15 percent, which is 0.35 percentage points lower than in June 2008. As in deposits, this fall mainly reflects the aggressive marketing policies of banks during this month. The demand for euro-denominated loans remained high for all purposes of use, in particular for real estates, hence keeping the spreads low and competition between banks high.



Intermediation rate in the banking system has dropped in average terms. With respect to the lek, it is noted that the spread between the weighted average interest rate of deposits and loans denominated in lek dropped to 7.56 percent in the first seven months from 9 percent the same period the previous year. In addition, average intermediation rate for the euro

has dropped by 0.82 percentage points compared to the first half of 2007, to 4.44 percent.

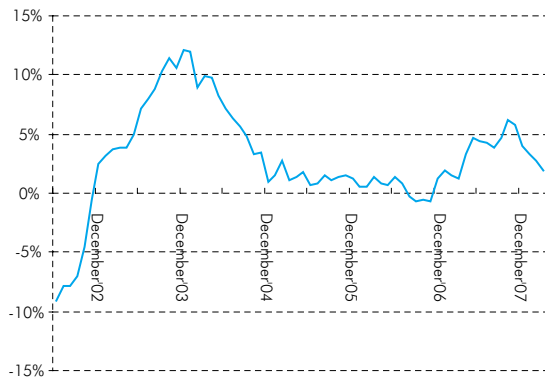
III.1.1.1 Exchange rate

The appreciating tendency of the lek against the main currencies in the first two quarters of 2008 persisted in the third quarter, although at more moderate rates. In annual nominal effective terms, the lek has appreciated against the main currencies, the euro and the U.S. dollar by an average of 2.63 percentage points during this quarter – relatively higher than 1.58 percent the same period the previous year. In annual terms, the nominal exchange rate of the lek against the euro and the U.S. dollar has appreciated by an average of 0.75 and 9 percent, respectively.

The performance of the exchange rate has been affected by the behaviour of the main currencies – euro and U.S. dollar – in the international market and by the seasonal behaviour during summer. In the beginning of the third quarter, the EUR/USD exchange rate showed high volatilities in the international markets. The depreciating tendency of the U.S. dollar shown in the last three quarters (Q4 2007-Q2 2008) was also maintained in the beginning of the third quarter. The U.S. dollar depreciation against the euro has mainly reflected the uncertainty in finding a solution to the credit crisis and the non-satisfactory performance of the U.S. economy. On the other side, the figures published recently in the Euro area have indicated some deterioration of the economic situation even after the tightening of the monetary policy by the ECB in the beginning of July (raise of the key interest rate by 0.25 percentage points).

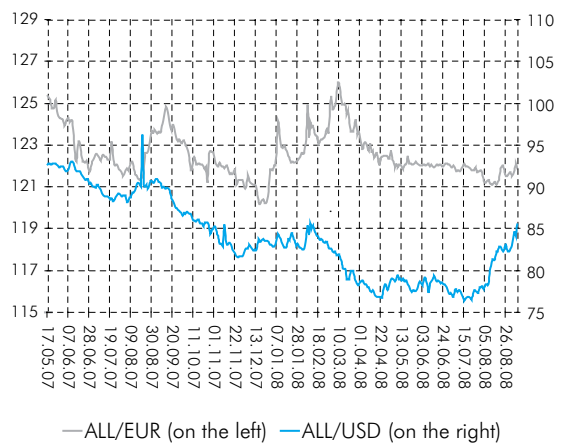
As of end this quarter, the U.S. dollar has gained considerable ground against the euro being exchanged at the highest rates since the early 2008 (1.39 EUR/USD), however, not exceeding the rates of the same period last year (1.42 EUR/USD at end September 2007). The fact that the other economies, and the European economy in particular, are being affected by the current economic crisis, support the appreciating behaviour of the U.S. dollar; however with not long-term effects if we consider the latest turbulences in the U.S. financial market.

Chart 35 Annual changes of the lek in nominal effective terms (NEER⁴⁶).



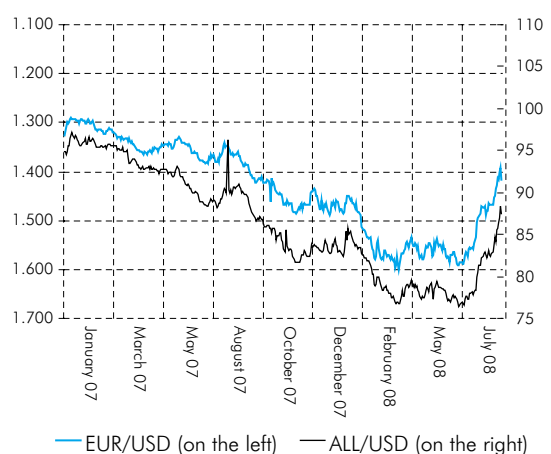
Source: Bank of Albania

Chart 36 Daily performance of ALL/EUR and ALL/USD exchange rate



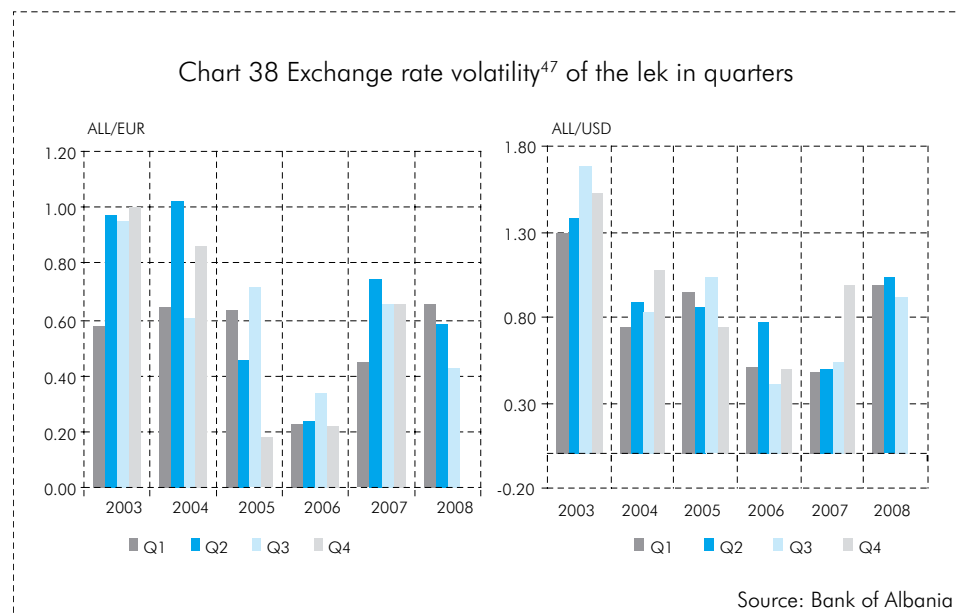
Source: Bank of Albania

Chart 37 Daily performance of EUR/USD and ALL/USD



Source: Bank of Albania

In the Albanian market, the lek has appreciated against the euro by 0.41 percentage points and has depreciated against the U.S. dollar by 4 percentage points relative to the second quarter of 2008. The appreciation of the lek against the euro owes to the seasonal effect characterizing this period of the year. However, this effect has been somehow more moderate due to the active presence of market agents which has offset the demand/supply ratio. The quarterly dynamics of the lek performance in relation to the euro is presented stable during this period, with lower volatilities compared with the first two quarters of 2008 and the same period the previous year. On the other side, the depreciation of the lek against the U.S. dollar reflects the developments of this currency in the international markets. The correlated performance between the U.S. dollar and the lek over the last years may constitute a characteristic of the period to follow. As of end period, the lek exchanged against euro and the U.S dollar at 123.33 ALL/EUR and 78.20 ALL/USD, respectively.



Box 7 Understanding Monetary Conditions Index – The Albanian approach

Monetary Conditions Index (MCI) has become widely known during the last years as a way to interpret the monetary policy orientation and its impact on the economy. The central Bank of Canada was the first institution to use this index in the early 90s. Later, the central banks of Sweden and Norway began to use this index as a tool to interpret the changes in monetary policy. (Freedman (1994); Hansson and Lindberg (1994)).

Nowadays, central banks are ever-increasingly using the term 'monetary conditions' to evaluate the monetary policy settings. The monetary conditions represent the combined effect of interest rates and the exchange rates on the economy. These are the key variables through which monetary policy can affect economic activity,

which in turn influences inflation. In a period of easy monetary conditions, monetary policy has been set in way as to support economic growth. If, conversely, monetary policy suppresses growth, we speak of a period of tight monetary conditions. Finally, in the case of neutral monetary policy settings, the monetary conditions are also termed neutral.

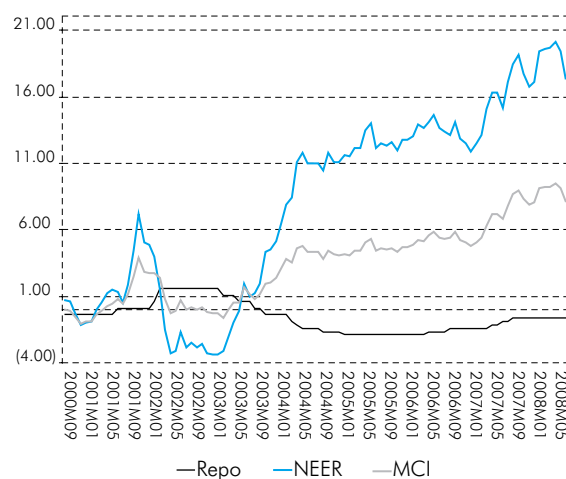
The components of the monetary conditions do not necessarily affect the economy in the same direction. The interest rate component may, for instance, be evaluated as relaxed and the exchange rate component as tight, or vice versa. The interest rate plays the primary role in determining the monetary conditions. The exchange rate, - along with numerous other effects, - adjusts to interest rates: low interest rates in a given period tend to lead to disinterest in the domestic currency and a weaker exchange rate, whereas high interest rates have the opposite effect.

The selection of this index's components has aroused long debates over the years and has been influenced by different economic points of view. According to the Banque de France (1996) the use of short-term nominal rates in calculating the MCI in the short-term may be considered as a good approach of the real MCI. However, in the long-term, the variables need to be expressed in real terms in order to avoid their effect on inflation. In the same line, the Czech National Bank supports the fact that the interest rate component of the monetary conditions is made up not of short-term interest rates, which are subject to direct control by the central banks, but of long-term interest rates. Most firms, households and other economic agents work with long-term interest rates (one-year or longer) when making decisions about their level of consumption and investment. High interest rates generally increase the attractiveness of deferring consumption and investment and of depositing any free funds in the interim on an account to increase their value. This leads to weaker domestic demand, slower economic growth and a fall in inflation. By contrast, if interest rates are low it is generally better to realise one's consumption and investment plans now, be it using one's own money or borrowed funds. The result is upward pressure on economic growth and inflation.

The exchange rate component of the monetary conditions is represented by the relative price of domestic and foreign goods and services. Appreciation of the real exchange rate, i.e. an increase thereof, naturally leads to a shift in interest from domestic to foreign supply. The result is a decrease in domestic economic growth and downward pressure on prices of domestic goods. Depreciation of the exchange rate has the opposite effects.

Based on this concept and considering the particularity of the economic and financial structure, the use of the key interest rate and the nominal exchange rate lead to a better approach of the MCI in the case of Albania⁴⁸. The MCI is a weighted average of changes in the key interest rate and the nominal effective exchange rate (NEER) of the lek against the respective values of these two indicators in a base period. In the case of Albania, the ratio of the MCI is 1.82:1. Interpreting it, it implies that the effect on the aggregate demand of an appreciation of the NEER to 1.82 percent would be offset by a drop in the key interest rate by 1 percentage point. Worth to note is that an increase of the MCI would be viewed as a sign of monetary policy tightening at home, but not as the monetary policy stance.

Chart 39 MCI and its components' performance



Source: Bank of Albania

The slight upward tendency of the MCI, shown since the second half of 2007, relates to the change of the key interest rate in economy during this period, which has reinforced the effect of the lek appreciation on these indicators. During the year 2008, the key interest rate has remained unchanged, while the lek has appreciated. The developments in the exchange rate in the recent months have reflected a slight slowdown of the appreciation rates of the lek against the foreign currencies. Despite this development, the information provided by the MCI indicates that the monetary conditions have continued to affect the relaxation of aggregate demand in economy.

ENDNOTES

¹ Preliminary data indicate a growth of 3.3% in the second quarter relative to the first quarter of 2008. Compared with the previous quarter, GDP growth in the first quarter was 0.9%.

² As a result of the more rapid rise of wages than the growth of productivity.

³ ECB, *Statistics Pocket Book*, 2008.

⁴ Adjusted to exclude the seasonal effect.

⁵ The data have been made available by the Ministry of Agriculture, Food and Consumer Protection. This is the first time for this institution to publish data on the first half of 2008, given that they have only been published in annual terms.

⁶ The exports and imports of agricultural and agro-industrial production during the first half of 2007 amounted to about 3.55 and 24.4 billion leks, respectively.

⁷ The data have been made available by the Ministry of Agriculture, Food and Consumer Protection. They are expressed only in percentage and not in value. The data on the first half of 2007 are not available.

⁸ Figures on the agricultural production for the period January to June 2008 are available only for these products.

⁹ According to IMF data, the price index of food and oil in August increased at lower growth rates in annual terms (29 and 63%, respectively). In the meantime, in monthly terms they have decreased by 7 and 14%.

¹⁰ Prices mainly increased in 'Fats and oils' (average annual growth in 17%), 'Milk, cheese and eggs' (8%) and particularly in 'bread and grains' (30%).

¹¹ In Greece, annual inflation rates of 'Foods and alcoholic beverages' were 5.3 and 4.5% in July and August.

¹² Included in 'servicing personal transportation vehicles'.

¹³ Agflation is a term used during the last decade to describe the inflation originating from the rise in food and grain prices. In global markets, the extent of this phenomenon becomes international. In addition, agflation affects the price rise in agro-industry products or processed foods, given that food and grains are used in this industry as raw materials.

¹⁴ Excluding Romania (60 percent) and Slovenia (35 percent).

¹⁵ A measure of core inflation which excludes permanently certain items that face volatile price movements, administered prices, etc.

¹⁶ Rise of bread and grains prices.

¹⁷ Long-term period refers to the time period from January 1999 to August 2008.

¹⁸ This measures are also known as 'net inflation'.

¹⁹ Starting from June 2008.

²⁰ According to (BoA) Balance of Payments statistics, during the first half of 2008, food products and fuels shared about 30% of Albanian imports' volume, which is close to the share for 2007 (27%).

²¹ IMF, *World Economic Outlook –UPDATE* (an update of the key WEO projections) - July 2008.

²² The annual changes of the series in the database in <http://www.imf.org/external/np/res/commo/externaldata.csv> have been calculated, since the latter have been transformed into figures of quarterly frequency.

²³ In March 2008 was recorded the highest annual rise (121%) for the period January 1980 to March 2008.

²⁴ In April to August 2008, this sub-group marked an average annual inflation rate of about 18%.

²⁵ The oil resource in the Caspian Sea (Azerbaijan) is one of the few new and important resources of global oil supply from non-OPEC countries. Oil and pipeline-related (BTC) issues and those which relate to the Georgian-Russian conflict (in the Georgian part of the Black Sea where the port of Supsa is situated) have severely hindered the oil and gas transportation from the Caspian Sea to Georgia.

²⁶ According to ACIT 2007, the Russian Federation and Georgia are ranked the third and the sixth in the list of countries importing the commodity group, wherein oil takes part.

²⁷ Source: 'Rising food prices: Policy options and World Bank response', World Bank.

²⁸ The measures relate to the declaration of the number of employed people and their income.

The application of the Council of Ministers' decision No. 285, dated 4 May 2007 'On the establishment of the referring monthly wage, for the effect of calculating the social and health insurance contributions and the tax on personal income according to the nomenclature of economic activity for private sector employees who carry out qualified or non-qualified work and for their managing and technical-economic personnel' by the private enterprises.

²⁹ According to INSTAT, wages refer to the wage fund paid to all employees during the reference period. During the first quarter of 2008, INSTAT updated the methodology on the calculation of short-term economic indicators.

³⁰ Engineering works involve the construction of roads and highways. The quarterly increase attributes to the works for the construction of Durrës-Kukës-Morinë road.

³¹ According to periodical surveys of the Bank of Albania with businesses.

³² Decision of the Council of Ministers, No. 285, dated 4 May 2007 'On the establishment of the referring monthly wage, for the effect of calculating the social and health insurance contributions and the tax on personal income' and the Law 9844, dated 17 December 2007, on some amendments and changes to the Law 'On tax on income'.

³³ This figure refers to the first quarter of 2008.

³⁴ In Russia, there is little evidence that the strong revenue performance after the reform was due to the flat tax itself; rather it appears to have reflected wider macroeconomic recovery.

³⁵ IMF, Country Report no. 08/267, August 2008.

³⁶ Deficit on trade in services amounted to 83 million euros, while the surplus in net current transfers account amounted to 467 million euros, about 6 percent lower in annual terms.

³⁷ The share of this item has dropped by about 6 percent over the period January to June 2008 compared with the same period the previous year.

³⁸ See: Monetary Policy Document for 2008, www.bankofalbania.org

³⁹ Ball, Laurence, 2006, 'Has globalization changed inflation?' NBER Working Paper 12687

Ca' Zorzi M, Hahn E, Sánchez M, 2007, 'Exchange rate pass-through in emerging markets', ECB Working Paper 739

Daniels Joseph, 2008, 'Exchange-rate pass through, openness, inflation, and the sacrifice ratio'

⁴⁰ C. Kent (1995), 'Exchange Rate Pass-through: Testing the Small Country Assumption for Australia', *Econometrics Paper*.

⁴¹ Peeters, M, 2005, 'What about monetary transmission in Albania? Is the exchange rate pass-through (still) the main channel?'

⁴² Tanku A, Vika I, Gjermani M, 2007, 'The role of exchange rate in an IT framework, what do we do?'

Istrefi K, Semi V (2007), 'Përçimi i kursit të këmbimit në Shqipëri: evidencë nga modelet me vektorë autoregresivë (VAR)'.

⁴³ The data on monetary indicators are based on 'Monetary Statistics' standard. This standard differs slightly from the International Financial Statistics standard in classifying deposits in M3 broad money. However, the differences between the two standards do not affect the thorough assessment of monetary indicators for monetary policy purposes. For more information, please refer to the monetary statistics methodology published in www.bankofalbania.org.

⁴⁴ The meeting of quantitative objectives is an obligation of the Bank of Albania in view of observing the EFF/PRGF arrangement with the IMF and the Albanian authorities.

⁴⁵ The share of bonds' portfolio has increased to 38 percent in August from 33 percent in end 2007.

⁴⁶ 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). A positive change of the NEER implies the appreciation of the lek.

⁴⁷ Measured as quarterly average of exchange rate volatility. The latter is measured as the standard deviation indicator.

⁴⁸ M. Tase, (2006), 'Matja e Indeksit të Kushteve Monetare/Financiare për Shqipërinë'.

SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI

at the Forum with the financial system players, which focused on supervision and financial stability, and the functioning of money and financial market
Tirana International Hotel, 3 April 2008

Good morning,

Dear bankers, dear participants,

This is a big and remarkable day for all of us. Today's meeting, although pre-announced, coincides with an event of special importance. The invitation to the NATO is a privilege which brings trust, certification and safety for new investments in Albania.

At the same time and above all, it bears the responsibility for achieving the standards and actualizing the structural reform. Today's invitation to the NATO is a guarantee for the further integration into the European family.

In its recent endeavours to enhance the financial market efficiency and to guarantee the banking system stability, the Bank of Albania introduces today a new initiative, which will have at its core the establishment of a periodic communication channel between the central bank and the banking system. Indeed, our communication with the banking system has been constant and at all levels, and we have discussed a wide variety of topics and issues and the perspective related with the banking activity in Albania.

I would like to highlight that the novelty in this new initiative relates with the necessity to have a permanent and well-structured dialogue, both in terms of content and time factor. In more concrete terms, this will be a periodic forum which will have at its centre the analytical discussion of many questions and challenges we should together address in the proper way and time.

The financial market is an argument we have been mentioning a lot recently. In many of my public speeches, in the Supervisory Council statements, in the reports and papers of the Bank of Albania, in many of the formal and informal contact of the Bank of Albania with groups of banks or particular banks, special emphasis has been placed on different elements which influence on the financial market deepening and expansion. The same may be said for the system's financial stability as well.

However, I think that the novelty of this forum stands in the fact that within the bankers' house we will diagnose and identify together the right therapy to guarantee a safe future. Moreover, the period between the two meetings will correspond with a constant dialog at experts' levels in order to increase the level of assimilation of duties and conclusions to be concluded in each forum.

This is the reason why I publicly invite you to be active, forward-looking, and come with concrete future-oriented proposals. The Bank of Albania rightly understands that like any private business the banking community business aims at maximizing its profit.

However, I would like to re-highlight the fact that the following are the same crucial:

- The constant improvement of bank's governance;
- The introduction of new products;
- The functioning of the interbank market;
- The increase of funds circulation through the system;
- The building of full technological capacities;
- The absorption of skilful human capacities;
- The recognition of and protection from the various risks;
- The increase of ALL denominated lending;
- The strengthening of internal control; and
- The publication of the results of your activity.

I do not hesitate to repeat once again that the banking system stability and the financial market stability are crucial for the Bank of Albania. In this context, I invite you to consider these two priorities of the Bank of Albania as the main priorities of your activity.

During 2007 the Albanian economy has generally had positive developments. The stable economic growth was in line with the objectives of consumer price stability and budget deficit. The lek, our national currency, was stable.

Year 2007 was a good one for the banking system as well. The banking system's net result for 2007 is reported about 42 per cent more than in 2006. The banking system's assets increased by ALL 118.6 billion or 19 per cent higher than as of end 2006. The banking system's outstanding loans grew by ALL 94.5 billion or 47.7 per cent higher than the end 2006.

The banks have increased the electronic products provided to their clients. There are now 11 banks in the Albanian banking system that use the transactions electronically. Worth mentioning is also the expansion of internet banking in three other banks in the system. Another testimony of the enhancement of banking competition and the increase in the volume of financial transactions through the banks is the expansion of the banking network with new branches and agencies. During 2007, the number of branches and agencies within the territory of the Republic of Albania increased by 103, out of which 43 were opened in Tirana.

For the first time during 2007 were evidenced modern elements of the banking system consolidation through the merger of two banks.

Another important achievement relates with the establishment of the Credit Register which is considered as an important element for guaranteeing the banking system stability.

However, I would like to emphasize that year 2007 and the first months of 2008 correspond with a relatively complex situation in terms of global developments. We are currently being faced with high price rises of raw materials and foodstuffs, in addition to a high and increasing demand of developing economies. The financial markets continue to reflect the negative effects of the credit crisis generated by the US economy. In contrast with the initial assessments, it seems that its spreading is larger, contaminating a considerable number of large financial institutions. The central banks have been constantly injecting liquidity, while the Federal Reserve has aggressively dropped the key interest rate in order to avoid the recession of the economy.

Due to some factors which relate to the development characteristics of the financial activity within the country, the difficult situation in the international markets is not expected to have a real and considerable effect on the domestic financial markets. However, the situation in the international financial markets remains unstable and its impact over the domestic financial market might change. Therefore, it is crucial for these developments to be monitored and analyzed carefully by the financial institutions and the regulatory authorities in the country.

The prolongation and the possible aggravation of the situation in the international financial markets may have a reduced influence on the Albanian financial market in some respects as follows:

- The increase of the risk related with the rapid lending, in particular in foreign currency, as a result of the increased volatility of the exchange rate and the frequent change of interest rates.
- The increased exposure of the financial system to sectors of economy that are negatively affected by the slowdown of regional and global economy.
- The combination of difficulties in the international financial markets with the unfavourable dynamics of global energy prices and prices of foodstuffs' raw materials.

Dear participants,

The issues I have mentioned so far come naturally to help me to dwell on issues related with financial stability, and then with the financial market efficiency.

I think it would not be a novelty to repeat what I have been constantly saying: "The main objective of the Bank of Albania is consumer price stability". However, I think that monetary policy and financial stability are inseparably related to each other. It is difficult for me to establish which weighs more nowadays. However, I am convinced that any investment made today to guarantee the financial stability will turn into greater efficiency of monetary policy.

I will try to refer to the main issues I would like to have your attention on:

CREDIT TO ECONOMY

Lending in foreign currency is now a sensible reality. Consumer loan is lent in foreign currency as well. Financing the consumption of households in foreign currency is like selling foodstuffs without an expiry date. Based on the observations of our experts it seems that banks are running to gain their market share and very often, they do not pay the right attention to the quality. The data confirm our concern for the increase of non-performing loans. In gross terms, the indicator of non-performing loans to total loans' portfolio was 3.6 per cent as of end January 2008. Lek interest rates remain high. Referring to credit of up to one year maturity, according to the data for January 2008, there is a difference of 7.3 per cent to the ALL denominated deposits rate of the same maturity term. While the same indicator for the foreign currency is 4%. We are currently witnesses of a very aggressive marketing strategy for credit products in foreign currency, while with the exception of a single case, it is totally inexistent for ALL denominated credit.

I may continue and mention other observations of this kind. From the various meetings we have had with the representatives of the banking system, I have more or less been acknowledged of the reasons that according to you explain this situation. I would like to highlight that among them there are objective reasons I agree with, but I have to disagree and comment on many issues and express the objection of the Bank of Albania to some of them.

From our viewpoint, we believe that you are still underestimating the exchange rate risk. Despite the perception of the public for a cheaper foreign currency credit I think that it is dangerous for the same philosophy to be part of you; especially when gaining market share becomes a prevailing philosophy. We believe that you are currently spreading the risk to individuals and creating moral hazard issues.

Taking this opportunity I would like to ask you the following questions: How is it possible that consumer loans are extended in foreign currency? How is it possible that mortgage loans are extended in foreign currency? Do you know that most employed people have their income denominated in ALL? Which bank has measured the exposure to this risk? Have you ever taken any measures to be protected against this risk?

I hope you will address these issues in your discussions since I believe time is ripe for us to dwell on these issues and avoid fictional statements.

In light of these developments, the Bank of Albania has prepared a package of regulative amendments which interweaves administrative measures with prudence and supervision examination measures. Without dwelling on their details I would like to bring into your attention the fact that the changes in the regulation "On credit risk management", in the cases when the client is not

protected against the exchange rate risk, will include the following obligations for the banks:

- The establishment of reserve funds for credit losses;
- The increase of the capital when the limit set to foreign currency exposure is not observed.

RISK MANAGEMENT

The factors I have decided to discuss with you today are related to each other. In my speech I raised our concern for a specific risk; however there is a second risk which relates to risk in general, to the exposure of your business to various risks. Allow me to remind you that you manage the Albanians' savings and as such the exposure does not only affect your capital but also the individuals'.

For this reason I require your utmost commitment to seriously assess this issue. I think that the banking system should invest more in human resources and in the adequate infrastructure to know and rightly manage the activity risks. I would like to make clear that the application of the abovementioned will be monitored rigorously and it will become part of the assessment of each bank's activity.

MANAGEMENT AND INTERNAL CONTROL

Good governance is the basis for the stable development of one business and its financial position. It certainly requires people with a high level of integrity and professionalism. To this purpose, we expect your institutions to be more sensitive in this context, in particular in terms of the quality of human resources involved in the decision-making process and risk management. Hence I require you to apply the right motivation in order to provide qualified staff, by establishing the conviction that only those who deserve it will be provided with career and social compensation.

In several cases we have observed the *de facto* concentration of decision-making in only a few hands, causing the institution dependence to be concentrated in only a few people. To this purpose I think that you should review all the internal procedures you base your day-to-day activity on.

The Bank of Albania has drafted a new regulation "On some basic criteria for the governance of banks and branches of foreign banks and their administrators". This regulation establishes the duties and responsibilities of the governing structure of banking institutions. These structures are responsible for and guarantee the safe and sound functioning of the institutions they manage. This regulation has considered the best international standards and practices of the Basel Committee and the European Union.

From the conceptual viewpoint, this regulation has expanded and it includes:

- The rules and criteria for an effective governance;
- The requirements related to reputation, qualification and experience;
- The evaluation criteria for the approval of administrators;
- The terms which cause their dismissal;
- The responsibilities of the governing council and the management;
- The criteria for the efficiency of the governing council activity;
- The risk management policies and procedures.

Governance-related issues will be considered with priority by the Bank of Albania during the periodical assessments made to your activity.

The strengthening of structures which control and guarantee the functioning in line with the rules of these procedures should be seen with priority by the banking system. I refer to internal control which should have a more active role. It should be active, responsible and cover every aspect of the bank in order to prevent the development of undesired phenomena.

Lately, the Supervisory Council of the Bank of Albania has approved the regulation "On the internal control system in banks and branches of foreign banks". This regulation considers the internal control in banks as a crucial part of banks' governance. The regulation stipulates the criteria for the organization of internal control aiming at providing an independent, unbiased and responsible functioning.

PUBLIC TRANSPARENCY

Good governance implies increased transparency with the clients and the market. Is the Albanian banking system as transparent as we wished it were?

The issue of transparency has been present a lot in my last speeches. I have to admit that there is progress; however, a lot needs to be done. Placing myself in the shoes of an individual who would like to use banking products or services I raise the following questions: How easy is it for me to be oriented properly and quickly to the best option? How easy is it for me as a depositor to know about the bank's financial situation? Which banks offers the cheapest commissions? Where can I find the information which tells me how much my bank has grown during the period? Do I have to wait for another year to learn something or I can find the information I need more frequently?

Are you sure your clients understand that many of your offers now are only with temporary benefits and that at a later time their terms will change?

I do not want to dwell on the details; however, allow me to remind you that after the US credit crisis another simple reason is being displayed: although somewhere in the contracts the banks signed with the individuals there was a specific part which focused on the credit terms, most of them were not aware of this information.

With this I imply that there is no need to make transparency for the sake of transparency. I think we will be more protected if we address the abovementioned issues. If a client knows the ultimate consequence of foreign currency denominated credit when his/her income is in lek, he/she will surely hesitate. If a client knows the terms and penalties well, again he/she will hesitate.

However, being the Governor of the central bank, I take this opportunity to state that the Bank of Albania will encourage the banking system to face the market directly. Before I move to another issue I conclude by stressing once more: Transparency at any cost.

Allow me to say once again that the Bank of Albania will require from the governing structures of banks in general to prudently monitor the market developments, strengthen the control systems in their institutions, take measures for the proper diversification of financial sources and the directions of their investment, continuously develop a well-capitalized activity and monitor its risks. The Bank of Albania will strengthen the measures in order to enrich and implement the regulatory framework in terms of improving the risk assessment systems in commercial banks and it will co-operate with the Financial Supervision Authority in order to encourage the complete implementation of these principles in the rest of the financial market.

Dear bankers,

The commitment of the Bank of Albania in developing the money market will be concrete in terms of the operational, regulatory and supervisory framework.

In terms of operational implementation of monetary policy the Bank of Albania commitment will be reflected in the orientation of monetary operations towards the establishment of a proper and adequate liquidity structure which will vitalize the interbank market activity.

The structural excess of liquidity which has characterized the banking system has been followed by a passive behaviour of banks while numerous experiences show a proportional relation between a structural absence of liquidity and the development of interbank market. Despite this goal, I would like to stress that at no case it will compromise the main objective: implement the monetary policy.

To this purpose I require the orientation of operations to a structural liquidity deficit to be viewed as profitable for your institution. The use of this opportunity from the people you need to train and motivate will bring the development of the money market, which in the final analysis will result profitable for you and to the benefit of a more efficient monetary policy transmission.

Providing you with full transparency and theoretical and practical assistance with respect to these operations, I would once more clarify three basic aspects of our work:

- First, the monetary policy is and will be signalled through the decision of the Supervisory Council of the Bank of Albania on the key interest rate.
- Second, the main instrument for the implementation of monetary policy is and will remain the repurchase agreement of one-week maturity.
- Third, the use of instruments of longer maturity term or the type of auction do not bear any kind of monetary policy signal, despite for the fact that they are operational techniques for a more effective implementation of money market interventions.

In order to provide you with more grounds in terms of managing the liquidity and on the other hand, to encourage your active positioning in the money market we are working on extending the use of the required reserve. It will be your professional ability that will transform this facility from one possibility to meet the unexpected demands for liquidity into a concrete option to be positioned in the market based on the well-based expectations.

All these measures have one thing in common: the development of money interbank market. They would not be efficient without your commitment.

In order to avoid any subjective excuse allow me to bring into your attention the draft-law on repurchase agreements through the banks in the system drafted by the Bank of Albania. Currently, this draft-law is in process of approval. The approval of this law requires greater commitment in using this new instrument. In this context we require from you to start the preparations for implementing this law because the excuses will not be welcome. The repo market in the Euro area is the largest interbank market sharing 35 per cent of total trading. Banks, which own the largest part of the Albanian banking system, are part of this market and as such we believe they will be willing and interested in providing assistance for trading through repurchase agreements in the domestic market as well. The market participants should contribute to building a developed and efficient financial market because in this way they increase the chances for determining the price of their products accurately.

I hope this forum will be productive and interactive. I tried to raise some topics and issues which I think we should be faced with considering that our role is concrete and real.

I would like to assure you that the Bank of Albania will be fully committed to taking the proper measures for encouraging, improving and enhancing the market and the financial intermediation instruments.

This forum confirms the role of the Bank of Albania and the banking system as two crucial factors in the development of economy in general and the financial system in particular.

Fortunately when each financial institution follows the motives and is cautious for its financial stability, it guarantees long-term prosperity for the entire system, high efficiency of economic policies' transmission in general and of monetary policy in particular. Therefore, I invite you to follow these

incentives in order to achieve your objectives and at the same time to provide a more qualitative service to the public.

Despite the challenges the public authorities and different economic agents will be faced with the Bank of Albania believes that the accomplishment of the approved policies and the flexibility of the economy will lead to the achievement of a stable economic growth during 2008. The financial system and the banking sector in particular will be playing an active role in the financial intermediation and in supporting the country's economic development, by preserving the stability and the sound financial performance.

SPEECH OF THE GOVERNOR OF THE BANK OF ALBANIA, MR. ARDIAN FULLANI

At the Joint Press Conference of the Ministry of Finance, the Bank of Albania and the IMF at the Conclusion of the Article IV Consultation and the PRGF-EFF Review Mission to Albania

13 May 2008

During the last two weeks, the Bank of Albania has been part of negotiations that the Albanian authorities have had with the IMF Mission in the context of reviewing Albania's agreement with the IMF. Discussions have been focussed on the assessment of conditions and some focal issues exhibited recently in the Albanian economy.

I take this opportunity to highlight that we by and large share the same assessment with regard to the previous period, the causes and the shift of risks in the near future.

With respect to the overall macroeconomic situation, the Bank of Albania states that the Albanian economy continues to enjoy a sound and stable balance. According to preliminary assessments, GDP is expected to grow in line with its growth in 2007. What is of interest is the response of agricultural production, in particular in the context of various stimuli yielded by the increased agricultural products' prices.

Relative to the second half the previous year, the cessation of massive and long shortages in the energy supply has provided a positive contribution to the production and consumption process. However, as in the past, energy remains a sensitive concern constituting one of the main risks to the Albanian economic activity.

External environment pressures on the Albanian economy, mainly exhibited in the continuous rise of food, raw material and oil prices, persisted in the first four months of 2008.

As of end April 2008, annual inflation marked 4.4 percent, exceeding the upper tolerance band of 3 +/-1 targeted by the Bank of Albania by about 0.4 percentage points. This figure reflects the contribution of processed foods and the price rise of energy in March the present year. The last tariff increase of energy has contributed by 0.7 percentage points.

Based on the short-term forecasts, inflation will continue to fluctuate around the current levels in the months to follow and mark a little below the upper tolerance band targeted by the Bank of Albania as of end 2008. Fiscal developments over the first months of 2008 attest to a satisfactory performance of collection of budget revenues.

The deepening of current account deficit is another aspect that requires special attention. Previous year data seem to confirm this concern. Albania's

trade activity with the rest of the world in the early months of 2008 attest to stable exports' rate, which is however insufficient to offset the effect of added imports.

With respect to future developments, the Bank of Albania assesses that the supply-side pressures are still upward dominating the demand-side ones.

The most recent developments in the international markets and the future prospects provide evidence for new developments in this context. The prices of food, raw material and oil and its by-products in particular, are recording peak rates in the international market.

In addition, there are some demand-side risks which mostly relate to the rapid growth of credit to economy. Special attention needs also to be paid to the possible measures that the authorities may take to reduce the price rise effect of foods. In this context, the Bank of Albania deems as necessary the adoption of measures that allow the direct funding of needy people, which implies the set up of certain public schemes or programs to support the poorest part of the population. Any other measures of the kind of subsidies or raise in wages need to be well-analyzed in order to avoid any second round effects or the triggering of a new inflationary cycle (where prices raise wages and wages raise prices).

Particular attention has been also paid to the inflationary expectations, which until now have been well anchored around the Bank of Albania target. The further orientation of these expectations represents a real challenge, which interweaves the combination of a number of measures. Among them, the constant communication of this challenge, the explanation of the entire inflation process and the role of monetary policy are the most important. The Bank of Albania will continue to make public the balance of risks in economy, being willing to respond proactively under the given circumstances and conditions.

Being the country's monetary authority, the Bank of Albania is entirely committed to take the proper decisions, based on the actual developments and at the same time assessing the possible materialization of expected events.

Our main objective remains the long-term anchoring of inflationary expectations around the target and the stability of the banking system's financial stability.

SPEECH OF THE FIRST DEPUTY GOVERNOR OF THE BANK OF ALBANIA, MR. FATOS IBRAHIMI

At the forum "Banking and financial activities in Albania and South-East
Europe"

"Sheraton" Hotel, 16 May 2008

*Honourable Minister,
Dear participants,*

It is a great pleasure for me to participate in this promoting and important forum and present an overview of the main developments of the Albanian banking system, being one of the sectors with the most impressive performance and with positive contribution to the stable economic growth for several years and to the macroeconomic stability at home.

Similarly to other South-East European countries, the financial activity in Albania has been characterized by overwhelming and major developments the recent years.

One of the key features is that the financial activity in Albania is dominated by the banking activity, while non-banking activities remain very limited. As of end 2007, total assets of the banking system accounted for about 96.8 percent of total assets of the financial system. Non-banking system's assets accounted for only 3.2%. These figures bring forth the need to reform the non-bank financial system and allow supervision according to its best practices. The establishment of the Albanian Financial Supervisory Authority in 2006 served to this purpose. The development of non-bank financial intermediaries and capital markets would provide alternative funding ways and would positively enhance efficiency and competition in the financial system.

Banking intermediation in Albania has experienced considerable growth in the recent years although lower than in the Euro area countries. As a share to GDP, total banking system's assets were 76, 69 and 60 percent as of end 2007, 2006 and 2005, respectively, which is close to the average of South-East European countries but far from the Euro area, which averages 240 percent. The increase of financial intermediation is also shown in the greater variety of financial products, greater geographical coverage and more rapid growth of credit.

The rapid growth of credit constitutes a very important and sensitive issue to the banking system. It is for this reason that I would like to dwell longer on this issue and explain some of the factors that have fuelled this rapid growth in the last four or five years, its implications for the economic growth in general and the financial system's stability in particular.

Outstanding loans have shown high annual growth rates in Albania: 48, 55 and 82 percent in 2007, 2006 and 2005, respectively. With these figures,

Albania has been considered as one of the countries with the highest credit growth in the last three years. However, in 2006 and 2007 outstanding loans as a share to GDP were 22 and 30 percent lower than in the Euro area. The study of the Deutsche Bank research team 'Banking in Southeast Europe' assesses among others the optimal equilibrium level of credit to the private sector as a share to GDP for some regional countries in case there was a convergence with the Euro area. According to this study, this level should have been about twice as high the current level for Albania.

The rapid growth of credit is on one hand considered a required convergence process which helps economic growth sustained by the domestic demand and by the fact that it is measured over a very low initial base. On the other hand, it is commented as a risky phenomenon to price stability through the influence on aggregate demand and to the financial stability, given the unstable prices in different assets. In many countries, the rapid growth of credit was followed by the asset-price bubbles – in real estates prices for instance -, which later burst and impacted negatively on the value of collateral and the quality of credit issued. The freshest case of the consequences of this phenomenon is the U.S. sub-prime market crisis, which continues to affect negatively and contaminate other countries as well. Being displayed as a liquidity crisis with direct impact on the capital markets and followed by the food crisis and the rapid rise of oil price, this crisis has raised many questions related to the development perspectives of the global economy. The Bank of Albania considers the current difficult situation the international financial markets are going through as a new risk to the Albanian financial system. However, for as long as it does not develop into a global financial crisis with consequences on the real global and in particular on the European economy, its impact on the domestic market will be relatively insignificant. This conclusion is drawn given the relatively low development of the domestic financial market and the absence of sophisticated products such as derivative instruments which are not part of our banks' portfolio. In addition, the Albanian financial institutions have relatively low needs in terms of being funded by the international market, given that they have adequate funding resources.

In light of these developments, the Bank of Albania has paid special attention to monitoring the credit portfolio quality. Consequently, the ratio of non-performing loans to total (gross) outstanding loans has shown low levels although there is an upward tendency (3.4, 3.1 and 2.3 percent in 2007, 2006 and 2005, respectively). The latest measures taken relate to the entry into force of the new banking law in June 2007, the approval of new regulations and the amendment to the existing ones, which place their emphasis on a more effective supervision in line with the EU directives and the Basle Committee principles. In addition, the Credit Registry has started to operate at the Bank of Albania since January 2008 which will help deepen the analysis and decrease banks' credit risk.

With respect to loan structure, it has undergone several changes in the recent years in terms of sector of economy, maturity and currency. Worth to note is that despite the changes, some features prevail for quite a long time

in the Albanian banking system. Notwithstanding the positive developments in term of growth of credit to households, banks continue to be inclined to lending to business. As of end 2007, outstanding loans extended to business accounted for about 63 percent of total loans. Trade, processing industry and construction are the most credited sectors, while credit to one of the most important sectors - agriculture -, remains limited. Lending in foreign currency is another characteristic of Southeast European countries and Albania. Although the share of loans denominated in lek has grown in the recent years, it remains low. In terms of maturity, there has been a shift to mid-term and long-term loans, as a result of the growth of demand for these types of loans and the greater variety of products offered by banks.

Demand for the purchase and construction of houses (in particular in the cities where there is a higher concentration of the population) has been ever-increasingly growing, being followed with the growth of demand for real estate loans. This product is now being considered as one of the types of loans of great interest to banks and customers. Its share has been increasing, accounting in the first quarter of 2008 for about 24 percent of total loan portfolio of the Albanian banking system. Worth to note, however, is that while Central and Eastern European countries reach double-digit figures of the ratio of real estate loans to the GDP, the regional countries – including Albania – record very low levels. In Albania, this figure is estimated at nearly 7 percent, which is comparable to other South-East European countries.

Another feature of the Albanian banking system and of the majority of South-East European countries is the high intermediation cost, which has been constantly increasing, although the growth rate has slowed down. This high margin attributes to the increase of banks' investments in higher-risk assets and to the shift of deposits' structure to foreign currency ones with lower interest rates. According to an IMF study, these high intermediation costs impede the economic development of the region and show lack of efficiency. The change of business environment through institutional reforms, the enhancement of competition between banks and the development of the non-bank sector would be necessary steps for the enhancement of efficiency and the decrease of financial intermediation costs.

The increasing role and interest of large financial groups in entering the Albanian and the South-East European banking system is a positive tendency. Currently, in the Albanian banking market are operating Austrian (Raiffeisen Bank), Italian (San Paolo Imi), French (Société Générale), Turkish, Greek, Bulgarian and Arab banking groups. Foreign investments are considered as crucial for emerging countries given their positive contribution to the macroeconomic, technological and institutional situation of recipient countries. The vast experience over the last decades indicates that the financial FDIs improve the Albanian financial system's soundness through the better management of portfolio risk and the more efficient allocation of credit funds. In addition, the introduction of technological novelties from the financial FDIs affects the enhancement of competition and efficiency in the banking system, by increasing the number of their products and services. In

addition to these positive effects, the presence of foreign banks improves the institutional framework by pushing the application of international accounting reporting and control standards which helps the commercial banks and the Central Bank's decision-making process.

The early presence of foreign banks in the Albanian banking system has helped to establish a stable banking system. Despite the shocks of 1997 or the panic crisis in 2002, in no case was the system's performance a source of crisis or instability.

However, the economic benefits from the presence of foreign banks are not yet in desired levels. They still lag behind in terms of increase of information quality both to the public at large and the Central Bank, decrease of intermediation cost, further improvement of risk management and the uniformity of accounting financial reporting systems.

The international financial institutions, namely the IMF, World Bank, European Bank for Reconstruction and Development, European Investment Bank etc., have played a key role in providing assistance and promoting the financial system, intermediating in funding and investments in view of sustaining economic growth and stability of current account.

Today's topic provides us with a good opportunity to briefly comment on the banking system's safety and risks. Capital adequacy indicator was 17.1, 18.1 and 18.6% in 2007, 2006 and 2005, respectively, which is above the required regulatory level of 12 percent. Despite the long history of this indicator's decrease, the decrease rate in the last three rates has been lower than in the previous years. In addition, the Albanian banking system enjoys good profitability indicators. In 2007, 2006 and 2005, return on average assets was 1.57, 1.36 and 1.4 percent, respectively, while the return on capital was 20.74, 20.17 and 22.24 percent.

On the other side, there are certain risks which need to be handled with vigilance. The rapid growth of credit needs to be monitored carefully in terms of quality. This is one of the present focuses of the Bank of Albania. In addition, there is another risk – the exchange rate risk. 72.5 percent of outstanding loans is in foreign currency, while the private sector and households' income is mainly in lek. Consequently, a possible depreciation of the lek, pushed by the need to reduce the trade deficit, would have a negative impact on the creditworthiness of foreign currency borrowers and on the quality of loans denominated in foreign currency. Finally, the unfavourable dynamics in the prices of energy resources, raw materials and foods adds the inflationary pressures and may affect the financial system as a result of the tightening of internal or external monetary and financial conditions.

Concluding, I would add that as a result of the undertaken reforms, the Albanian banking system – being the most dynamic part of the financial system – has marked constant progress over the recent years. This progress owes to the clear vision and the maturity shown by the Albanian authorities

while reforming the banking system, to the efficient co-operation with the international financial institutions (IMF and World Bank) in drafting the medium-term strategies for developing this sector further, and to the numerous challenges it has been faced with in the last years.

Thank you.

PAPERS PUBLISHED IN THE ECONOMIC BULLETINS OF 2008*

A DISCIPLINED APPROACH TO PORTFOLIO MANAGEMENT AND TRADING

March 2008

Rezart Molla

This paper aims to give a short description of the trading process in general and the steps through which a disciplined trader and/or portfolio manager should go in particular. Its content comes on the top of a previous document which was a feedback for the internship the author attended in the World Bank Treasury in Washington D.C. during the months of October 2007 on reserve management. The back-bone of the approach is the one World Bank currently uses, therefore the author fully recognizes the authorship of the World Bank staff on the core concepts behind this paper. However, the three-year experience the author has had as a portfolio manager at the Bank of Albania surely helps in providing a meaningful description.

The document is titled T.R.A.D.E.M.A.P, where every character stands for the first letter of each of the stages of portfolio management process from inception to execution and the follow-through. The paper describes the following stages:

(1) T-Theme, (2) R-Review, (3) A-Assess, (4) D-Decision, (5) E-Execution, (6) M-Monitoring, (7) A-Adjust, (8) P-Performance.

After going through the eight stages of portfolio management process, the author concludes that this process involves strong human emotions and that market gyrations can cause similar and almost one to one gyrations to these feelings which might have consequences on portfolio's performance.

* Opinions expressed in these papers are those of the authors and do not necessarily reflect the official opinion of the Bank of Albania.

PAPERS

INDEX OF FOREIGN PRICES / UNIT VALUES OF ALBANIAN IMPORTS*

INTRODUCTION

Economic data and statistics are a key element for successful economic analysis and economic policy formulation, by both the public and the private sector. Actually, economic data and statistics fulfill all the requirements to be considered a public good. Unfortunately, the state of economic data and statistics in Albania is not very satisfactory at the moment. Recognizing the importance of the economic data and statistics, the Bank of Albania has taken concrete steps in the improvement of the construction, reliability, availability and dissemination of such data.

In this respect, the Index of Foreign Unit Values/prices of Imports marks yet another effort by the Bank of Albania to contribute to the improvement of the economic data and statistics. The original index is focused on capturing only the movements of the prices of the Albanian imports in the markets where they are imported from, but not the effect of the exchange rate. This would allow the effects that import price movements in the foreign markets and exchange rate movements have on different macroeconomic indicators of interest, as for instance on inflation rate, to be analyzed and quantified separately. The importance of the index at hand for Albania is quite high, taking into consideration the fact the Albania is a small open economy.

Obviously, calculating a sort of weighted-average of the CPI's movements in the main countries from where Albania imports – weighted by the share of imports from each of these countries – can also serve as a proxy for the purpose at hand. However, such a proxy can be quite vague and largely unrepresentative of the movements of the prices of the Albanian imports in the foreign countries. Other attempts to construct more representative proxy indices can potentially satisfy the cost/benefit criteria.

The paper is organized in the following sections. Section 2 offers a brief discussion of index number theory and of the main issues related to price indices. Section 3 presents an approach based on the indices of export unit values/export prices of the main countries from where Albania imports. Because of data availability reasons, the indices of export unit values are used for some of the foreign countries and the indices of export prices are used for other foreign countries. The advantages and disadvantages of this approach are obviously elaborated. Finally, section 4 offers a brief conclusion.

GENERAL DISCUSSION OF PRICE INDICES

Purpose of Price Indices

A price index intends to serve as a single aggregated measure of all the individual relative changes in the prices of a domain set of commodities. The necessity of a price index results from the fact that prices of many individual commodities change at different rates and that it is obviously not feasible to analyze all of these individual price changes separately. Thus, price indices are constructed by taking a weighted-average of the different rates of the individual price changes, in order to obtain a single measure. In general, price indices take a base value of 100 in the base period, whereas the values in the other periods represent a weighted-average of the individual price changes relative to the base period, multiplied by 100¹.

Although, the majority of price indices are constructed to capture relative changes in price with respect to different periods of time, it is also possible to construct price indices that capture relative changes in prices with respect to different regions/markets at the same time. The three most widely used price indices are the Consumer Price Index, the Producer Price Index, and the Export and Import Price Indices. However, many more price indices are constructed for different purposes and focus on different sets of commodities or transactions.

Price Index Formulas

The construction of a price index is characterized by a number of difficulties and requires dealing with different issues, the most relevant of which I will try to discuss along the coming paragraphs in this section. However, it seems quite convenient to mention at the very beginning that the main two questions that need to be answered while constructing a price index are:

- 1) Which commodities' or transactions' prices should be included in the domain set of the price index, - meaning what should be the representative basket?
- 2) Which index formula or technique should be used to aggregate all the individual price changes into a single measure?

Theoretically, the answers to these two questions depend largely on the precise focus of the index and on the desired economic and statistical properties. Quite importantly, in practice the answers to both questions depend on the availability of price and quantity data, as well as their method of collection. However, first let us briefly look at some of the main price index formulas. Please, be aware that there exist too many price index formulas, but considering the scope of this discussion paper only the main ones are discussed here.

The first attempts at constructing price indices date back to very early times and different studies seem to mention different such attempts. However, it is

generally agreed that the first sophisticated and detailed attempt has been undertaken by Lowe (1823). The Lowe price index formula is based on a fixed quantity vector q_i (q_1, q_2, \dots, q_n) that basically serves for assigning the weights. The functional form of the Lowe price index is the following:

$$P_{t,0} = \frac{\sum_{i=1}^n p_i^t \cdot q_i}{\sum_{i=1}^n p_i^0 \cdot q_i} \cdot 100; \text{ where } q_i \text{ is the fixed quantity vector and } p_i^t \text{ is the price vector at time } t.$$

Furthermore, if the fixed quantity vector q_i is determined from the base period (meaning, q_i^0), then the index becomes a Laspeyres price index - P_L . Instead, if the fixed quantity vector q_i is determined from the current period (meaning, q_i^t), then the index becomes a Paasche price index - P_p . From the theoretical point of view, these two price indices seem to be equivalent and as good as each other. However, the results obtained from these two price indices, - the Laspeyres and the Paasche -, can be considerably different in reality. This has led economists and statisticians to explore the causes of such a discrepancy between these two indices and to propose different solutions.

The literature on index number theory recognizes that if individual prices exhibit *smooth monotonic trends* and rational substitution reactions occur, then the Laspeyres price index can be proved to be higher than the Paasche price index. This is attributed to the substitution bias, which is explained in Box 1 because of its importance to index number theory. Instead, if individual prices do not reveal monotonic trends, but bounce up and down continuously, then the differences between the Laspeyres and Paasche price indices are quite difficult to explain. In any case, it is obvious that the final price index results are affected a lot by the choice of the weights and the way the quantity vectors enter the price index formula or technique.

Economists and statisticians have proposed three main ways to deal with the discrepancy between the Laspeyres and Paasche price indices:

- By treating the Laspeyres and Paasche indices in a symmetrical manner;
- By treating the quantity vectors of the two periods – that of the base period and that of the current period – in a symmetrical manner;
- By chaining the Laspeyres and Paasche indices.

Box 1 – The Substitution Bias

The substitution bias results from the fact that rational buyers tend to substitute away from commodities that become more expensive. Even if we assume that all commodities become more expensive but not at the same rate, then rational buyers eventually substitute away from those commodities that become more expensive at a

higher rate. Actually, short-term fluctuations and oscillations in prices do not provoke "true" substitution reactions by rational buyers, since prices turn back to their origin after a short time, - it might be even before buyers have had time to decide about and engage in substitution reactions. Instead, long-term monotonic trends in prices can provoke "true" substitution reactions, since in this case rational buyers do have a strong basis to become convinced about their substitution reactions. This is why, monotonic trends in prices constitute a very crucial condition and assumption.

Let's turn back to the effect of substitution on the Laspeyres and Paasche price indices. Obviously, from the rational buyers' point of view, the Laspeyres price index that is based on base-period quantities, might overstate/understate the true increase/decrease in the prices of the commodities purchased by them, since after a certain time they should have substituted away from commodities that became relatively more expensive and at a higher rate. On the other hand, the Paasche price index, which is based on the current-period quantities, might understate/overstate the true increase/decrease in the prices of the commodities purchased by the rational buyers.

The first way consists in other index formulas, which are constructed as averages of the Laspeyres and Paasche price indices. The second way also consists in other index formulas, which after all have the functional form of a Lowe price index, but the final quantity vector is a form of average of the base and current period's quantities. The main formulas are described immediately below. Instead, the third way consists in a different technique and it is explained in a different sub-section. Chaining can be applied to the Laspeyres and Paasche formulas as well as to all these other formulas. However, the consequences of chaining are stronger when applied to Laspeyres and Paasche indices. Instead, the consequences of chaining are in general reduced quite significantly when applied to these other formulas.

Edgeworth and Marshall have proposed that the final quantity vector (q_i) should be set equal to the arithmetic average of the base-period and current-period quantity vectors, resulting in the following formula.

$$P_{t,0} = \frac{\sum_{i=1}^n p_i^t ((q_i^0 + q_i^t)/2)}{\sum_{i=1}^n p_i^0 ((q_i^0 + q_i^t)/2)} \cdot 100$$

Walsh, instead, has proposed that the final quantity vector (q_i) should be set equal to the geometric average of the base-period and current period quantity vectors, resulting in the following formula.

$$P_{t,0} = \frac{\sum_{i=1}^n p_i^t \sqrt{q_i^0 \cdot q_i^t}}{\sum_{i=1}^n p_i^0 \sqrt{q_i^0 \cdot q_i^t}} \cdot 100$$

Sidgwick (1883) and Bowley (1901) have proposed the use of the arithmetic average of the Laspeyres and Paasche indices.

$$P = 1/2P_L + 1/2P_P$$

Instead, the well-known economist Irving Fisher has proposed the use of the geometric average of the Laspyeres and Paasche indices.

$$P_F = (P_L * P_p)^{1/2}$$

Another index is the Tornqvist index, whose formula is:

$$P_{t,0} = \prod_{i=1}^n (p_i^t / p_i^0)^s \cdot 100 ; \text{ where } s = 0.5 \left(p_i^t q_i^t / \sum_{i=1}^n p_i^t q_i^t \right) + 0.5 \left(p_i^0 q_i^0 / \sum_{i=1}^n p_i^0 q_i^0 \right)$$

The theory of index numbers recognizes many more index formulas, however, only the most relevant ones are mentioned here.

The Axiomatic Approach to Index Number Theory

Obviously, choosing one best index formula is not straight-forward at all. From the theoretical point of view, choosing the best index depends on the desired economic and statistical properties. However, from the practical point of view it is certainly limited by the availability of the data and from a cost-benefit perspective, which is why two main approaches are proposed in this discussion paper. In any case, economists and statisticians have tried to develop criteria for selecting superior index formulas. One of the most reputable approaches for identifying superior index formulas and comparing different index formulas is the axiomatic approach.

The axiomatic approach consists of a number of axioms that have been suggested by statisticians and economists as required properties for superior index formulas. In other words, according to the axiomatic approach, index formulas should satisfy a number of properties by fulfilling a number of axioms in order to be classified as superior. These axioms have been developed, through time, based on the properties possessed by the price index P_t/P_0 for a single commodity. Please, find a brief explanation for the individual axioms in Appendix 1.

The literature on index number theory does not strictly agree on the appropriateness and necessity of different axioms². However, the axiomatic approach seems to be overall successful in identifying the main properties that an index formula should possess, in identifying the main pitfalls of different index formulas, and in identifying superior indices. The Fisher index seems to be the most outstanding one.

Appendix 1 on the Axiomatic approach and the following discussions are mainly based on Chapters 15 and 16 of the IWGPS' draft of Export and Import Price Index Manual.³ In addition, the (non)fulfillment of the axioms by the different price index formulas has been checked by the author of this discussion paper, based on a simple hypothetical "2 commodities and 2 periods" simulation. The Fisher price index is the only index that satisfies all the axioms presented in Appendix 1. The Walsh price index, together with the respective Walsh quantity index, fails axiom 14- the "Value" Product. Despite this, the Walsh index is still considered as a superlative index in the literature on index number theory.

The Laspeyres and Paasche price indices fail axioms 9- the Symmetry of Quantity Weights and 10- the Time Reversal. Axioms 9 and 10 are considered as very important because they imply that the index is not affected by the choice of the base period. Intuitively, if two periods are compared, the index should not depend on which one is chosen as the base period. Therefore, failing to satisfy axioms 9 and 10 is seen as a potential limitation of the Laspeyres and Paasche indices. In addition, the Laspeyres and Paasche price indices, together with their respective Laspeyres and Paasche quantity indices, fail axiom 14- the "Value" Product. It is important and interesting to know that axiom 14 is satisfied by a Laspeyres price index multiplied by a Paasche quantity index, or the other way around - by a Paasche price index multiplied by a Laspeyres quantity index.

The Sidgwick-Bowley price index also fails axioms 10- the Time Reversal and 14- the "Value" Product. Instead, the Edgeworth-Marshall price index fails axioms 7- Invariance to Proportional Changes in Current Quantities and 8- Invariance to Proportional Changes in Base Quantities, as well as axiom 14- the "Value" Product. Then, the Tornqvist price index fails axioms: 6- the Fixed Basket or Constant Quantity, 9- the Symmetry of Quantity Weights, 12- Monotonicity in Current Prices, 13- Monotonicity in Base Prices, 14- the "Value" Product. Overall, the Fisher index seems to be rated as the best one, followed by the Walsh index.

Rebasing and Chaining

An important issue mentioned in the literature on index number theory is whether weights should remain fixed or should be up-dated, and if yes, then how frequently. This is a concern because the relevant goods and their respective share in the representative basket can change over time. Thus, it becomes necessary to up-date the representative basket. In this respect, the two most relevant and important biases are: 1) the substitution bias and, 2) the new goods bias.

The substitution bias is explained in Box 1. Instead, the new goods bias, as its name implies, results from the fact that as time passes new products are developed and some of the old products become obsolete. Apparently, the base-period quantity vector might lose its relevance in the coming periods, especially after a relatively long time has elapsed. At the same time, the current-period quantity vector also might not be representative of the early periods.

Up-dating the weights has been naturally proposed as a solution to the two biases mentioned above. If weights are up-dated only once a certain number of periods have elapsed, then it is generally known as rebasing. Instead, if weights are up-dated for every consecutive time period, then it is known as chaining. Basically, rebasing or chaining is done by using the index value for the last period with the old weights as the base value for the coming periods with the new weights. From a practical point of view, these techniques makes it easier to introduce new products and dismiss obsolete ones in due time. In

addition, these techniques allow accounting for the substitution from some products to others.

The literature on index number theory suggests that chaining is especially useful when the structure of the representative basket is more similar between two adjacent periods than between distant periods. Under this condition, the index for distant time periods can be calculated by cumulating through consecutive bilateral indices for adjacent periods, during which time the representative basket has not changed significantly.

For instance, chaining might not bring any gains when the individual prices in the representative basket bounce continuously in an irregular manner, without exhibiting a general trend. Under these circumstances, the quantities and the structure of the representative basket are not necessarily more similar between two adjacent periods than between distant periods. As a consequence, chaining might make the index drift away from the true index. Instead, rebasing from time to time is seen as a better approach.

On the other hand, chaining is highly recommended when individual prices display *smooth monotonic trends* and substitution reactions take place. Under these circumstances, the quantities and the structure of the representative basket is expected to change smoothly over time. Therefore, accuracy can be gained by calculating the index for distant periods, characterized by huge differences in the representative basket, by cumulating consecutive bilateral indices of adjacent periods, with much smaller differences in the representative basket. In this case, chaining can reduce the spread between the Laspeyres and Paasche indices caused by the substitution bias.

A chain index takes the following form. Let us assume that $P(p_1, p_2, q_1, q_2)$ is the value of the bilateral price index from period 1 to period 2, using any formula. In the same way, $P(p_2, p_3, q_2, q_3)$ is the value of the bilateral price index from period 2 to period 3. Below are presented the values of the price index for the first three periods under both the fixed-weight approach and the chain approach.

fixed weight $\rightarrow 100; P(p_1, p_2, q_1, q_2)*100; P(p_1, p_3, q_1, q_3)*100;$
 chain $\rightarrow 100; P(p_1, p_2, q_1, q_2)*100 ; P(p_1, p_2, q_1, q_2) * P(p_2, p_3, q_2, q_3)*100;$

For example, a chained Laspeyres price index has the following functional form:

$$P_{t,0} = \frac{\sum p^1 q^0}{\sum p^0 q^0} \times \frac{\sum p^2 q^1}{\sum p^1 q^1} \times \dots \times \frac{\sum p^t q^{t-1}}{\sum p^{t-1} q^{t-1}} \times 100$$

Instead, a chained Fisher price index has the following form:

$$P_{t,0} = \sqrt{\frac{\sum p_1 \cdot q_0}{\sum p_0 \cdot q_0} \cdot \frac{\sum p_1 \cdot q_1}{\sum p_0 \cdot q_1}} \times \dots \times \sqrt{\frac{\sum p_n \cdot q_{n-1}}{\sum p_{n-1} \cdot q_{n-1}} \cdot \frac{\sum p_n \cdot q_n}{\sum p_{n-1} \cdot q_n}} \times \dots \times \sqrt{\frac{\sum p_t \cdot q_{t-1}}{\sum p_{t-1} \cdot q_{t-1}} \cdot \frac{\sum p_t \cdot q_t}{\sum p_{t-1} \cdot q_t}} \cdot 100$$

Obviously, the positive contribution of chaining is realized when it effectively yields weights that are much more in line and representative of the share of their respective commodities during both periods under comparison, in an evenhanded manner. From this point of view, the positive contribution of chaining is higher when applied to Laspeyres and Paasche indices, since these indices do not treat themselves the share of the commodities during both periods in an evenhanded manner. Instead, the positive contribution of chaining is severely diminished when applied to other index formulas, which to a certain extent achieve themselves an evenhanded treatment of the share of the commodities during both periods.

Likewise, even the risk of having a chained index drift away from the true index is higher when applied to Laspeyres and Paasche indices than when applied to a Fisher or Walsh Index. The justification mostly mentioned in the literature on index number theory relates to the fact that Laspeyres and Paasche indices do not satisfy the time reversal test and do not return to unity, whereas the Fisher and Walsh indices do satisfy this important test.

In order to discuss the impact of chaining on different price formulas a separate test is employed – the circulatory test. The circulatory test can be expressed in the following way: $P(p_1, p_3, q_1, q_3) = P(p_1, p_2, q_1, q_2) \times P(p_2, p_3, q_2, q_3)$. If an index formula satisfies the circulatory test, then it will yield identical results no matter if it is chained or not. According to the literature on index number theory, none of the index formulas discussed in this discussion paper satisfies the circulatory test. However, it is important to know that indices such as Fisher or Walsh do approximate the circulatory test substantially, which is not the case with the Laspeyres and Paasche indices.

“However, it is of some interest to find index number formulas that satisfy the circularity test to some degree of *approximation*, since the use of such an index number formula will lead to measures of aggregate price change that are more or less the same whether we use the chain or fixed-base systems. Irving Fisher (1922, p. 284) found that deviations from circularity using his data set and the Fisher ideal price index *PF* were quite small. This relatively high degree of correspondence between fixed-base and chain indices has been found to hold for other symmetrically weighted formulas like the Walsh index *PW*.”⁴

The excerpt above from Chapter 15 – Index Number Theory of the IWGPS’ draft of Export and Import Price Index Manual conveys the idea that chaining does not make a significant difference when applied to indices such as Fisher or Walsh. The literature on index number theory reports chained Laspeyres/Paasche indices to be considerably lower/higher than their respective direct Laspeyres/Paasche indices. Instead, it is reported that the chained Fisher index and the direct Fisher index correspond and converge to a high degree.

In practice, chaining or frequent rebasing are difficult to achieve because statistical agencies base their indices on broad surveys, which either are very expensive to conduct or take a lot of time. This is why the most widely used

formula is that of a Laspyeres price index with weights up-dated every five years.

Treatment of Seasonality

Seasonality is another issue that causes huge difficulties in constructing price indices. It is important to distinguish between two types of seasonality; 1) strong seasonality refers to the case when a product appears and disappears completely during certain periods of the year; and 2) weak seasonality refers to the case when the price and quantity of a product exhibit regular fluctuations during certain periods of the year, but the product does not disappear completely. The strong seasonality is the most problematic one because it is impossible to calculate the index value for a product during a period -t, if the product is missing during that period and no price quotation is available.

Obviously, the frequency of the index is an important determinant of the degree of seasonality in the index. For instance, it is quite impossible to satisfactorily reduce the seasonality in a monthly index, whereas seasonality does not constitute a concern for yearly indices. The following three approaches/measures of dealing with seasonality in *monthly* indices will be discussed in the coming paragraphs.

1. Excluding Seasonal Products from the Representative Basket;
2. Annual Basis Weights and Carry-forward of Unavailable Prices;
3. Maximum Month-to-Month Overlap Representative Baskets.

Excluding seasonal products from the representative basket is a measurement that is widely advocated by economists and statisticians, especially due to the justification that the purpose of price indices is to capture the overall trend in the movement of prices. This approach of excluding seasonal products can be extended to strong seasonal products and weak seasonal products. However, in practice it might turn out to be difficult and arbitrary to identify commodities that exhibit seasonality, although those commodities that are subject to strong seasonality or a large degree of weak seasonality can be identified more easily.

The next approach determines the weights based on an annual basis, which aims at smoothing out the effect of seasonality on the weights. The more frequently the annual weights are up-dated, -let's say every year-, the better it is. Obviously, the weights will be fixed for all the months during the coming year, which basically means that a rebased Lowe index formula is applied. However, troubles can arise whenever any commodity, to which an annual weight has been assigned, disappears during a certain period. As a consequence, the price for that period is not available, which is why it should either be carried-forward from previous periods or should be imputed. In turn, carrying-forward or imputing prices can hamper a lot the accuracy of the index.

The approach of "Maximum Month-to-Month Overlap Representative Baskets" aims at calculating the price index between any two months by

including in the representative basket the maximum number of commodities/ transactions that exist in both months. The question that arises is: should the base month be fixed (fixed base index) or should the base month and the current month be adjacent to each other (chained index)? The answer depends mainly on the fact whether the number of seasonal products that overlap is higher between any two adjacent months or between a fixed base month and any other current month. Obviously, it is not possible to give a precise answer to this question, although the general assumption is that it is more likely that the number of products that overlap will be higher between any two adjacent months. In any case, it is crucial to be aware that this approach simply makes possible the calculation of monthly indices, despite the strong seasonality of some of the commodities. However, it does not necessarily reduce the degree of seasonality and does not tackle weak seasonality.

Other Issues of Relevance for Index Number Theory

It is important to be aware that constructing an index involves many other issues.

For instance, the frequency of the index constitutes another important aspect, as it has already been mentioned above. However, this discussion paper is limited to considering only a monthly index because of the present need at the Bank of Albania to have a larger number of observations for the purpose of different econometric models.

The data used in constructing price indices and their properties constitute a very essential aspect for the final index as well. In most of the cases, the data are obtained either from large surveys and observations or from administrative sources. When data are direct observations or gathered from surveys, the resulting indices are generally known as price indices. Instead, when data are obtained from customs authorities, the resulting indices are generally known as unit value indices. The explanation for this has to do with the fact that customs report value and volume figures, which are divided to obtain unit value figures. Each one of the above-mentioned two practices has its advantages and disadvantages. Sampling procedures, especially when data are obtained from surveys, constitute the major focus of the discussions.

THE APPROACH BASED ON THE INDICES OF EXPORT UNIT VALUES/ PRICES OF THE MAIN COUNTRIES FROM WHERE ALBANIA IMPORTS

This section aims at explaining the approach based on the indices of export unit values/prices of the main countries from where Albania imports. This approach is based on the assumption that the exports of the main countries from where Albania imports can be considered as the imports of Albania. As a consequence, the indices of export unit values/prices of these countries can be aggregated into an index of foreign unit values/prices of Albanian imports.

However, there is still a huge risk that the representative baskets that are used for constructing the indices of export unit values/prices of the main

countries from where Albania imports can be quite different from a truly representative basket of Albanian imports from those countries. Still, they are assumed to be less different than, for instance, the representative baskets used to construct the WPIs or CPIs of the main countries from where Albania imports. This is the initial motive why the export unit value/price indices are considered in this discussion paper, rather than the WPIs or CPIs of the countries from where Albania imports. However, certain disadvantages of the export unit value/price indices that are identified in the coming paragraphs might be considered as adequate for abandoning them and turning to the WPIs or CPIs.

The indices of export unit value/prices for the foreign countries are all expressed both in Euro and in USD. Respectively, the index of foreign unit values/prices of Albanian imports is also calculated both in Euro and USD. The expression of the index in foreign currencies guarantees that the pure effect of the exchange rate between the Albanian Lek and foreign currencies is avoided. Expressing in Euro is suggested as a much better choice based on the fact that the majority of Albanian imports are purchased in Euro.

The data, the methodology and the advantages and disadvantages of this approach are examined in the coming paragraphs.

The Data

The data include: 1) the monthly indices of export unit values/prices for the main countries from where Albania imports, and 2) the monthly values of Albanian import flows according to the foreign countries from where they are imported.

The indices of export unit values/prices for the foreign countries are obtained from the International Financial Statistics (IFS), compiled and published by the IMF. However, the indices are characterized by the following main disadvantages:

- 1) They are Laspeyres indices, which as argued before can be considerably upward biased due to the substitution bias and do not satisfy important axioms, such as axiom 10 - the Time Reversal, etc.
- 2) They are published at irregular lags of approximately 4-6 months and in some cases, previously published figures are revised.
- 3) The indices for some countries are unit value indices, whereas for other countries they are price indices. The aggregation of such indices of different types into a single index for Albania might have various implications and not be very advisable.

However, the above-mentioned pitfalls and constraints should be accepted due to the lack of other data.

The values of Albanian import flows according to the foreign countries from where they are imported are obtained from the statistical series at the

website of the Bank of Albania and are expressed in USD. They are used to determine the weight that should be assigned to each one of these countries, as explained in the next sub-section.

The Methodology

The indices of export unit values/prices of the *main* countries from where Albania imports are considered as “elementary indices” that should be aggregated into a final index of foreign unit values/prices of Albanian imports. Obviously, the weighting technique and the applied price index formula are of essential importance. Fundamentally, the weight assigned to a main country from where Albania imports - in other words, the weight assigned to the “elementary index” coming from this main country of importation - should reflect the share of import quantity from this foreign country to the total import quantity from all the foreign countries that fulfill the classification of main countries from where Albania imports, - which enter the index.

Obviously, it is first of all necessary to develop a framework for identifying foreign countries that can be classified as *main* countries from where Albania imports. The proposed framework suggests that an up-date of the classification should be done every 3 years and it should be based on the following criteria:

- 1) The share of total value of imports from one country to the total value of all imports, for the last 3 years prior to the data of re-classification, should be at least 5%.
- 2) If the sum of the shares of all the countries that fulfill the criterion 1 is less than 60%, then next-coming countries should also enter the classification of main countries from where Albania imports, until the sum of the shares of them all reaches 60%.

The proposed criteria are largely arbitrary. In any case, the 3 year period for re-classification is proposed as an in-between solution to: 1) on one hand, not ending up in a classification that is out-dated for a long time, and 2) on the other hand, smoothing out seasonalities and major events during one specific year. The 5% and 60% thresholds explained above are proposed as an in-between solution to on one hand, 1) identifying the main countries from where Albania imports and whose individual shocks in the respective export unit value/prices might reasonably shock foreign unit values/prices of Albanian imports, 2) keeping a minimum level of representation of the countries from where Albania imports the most, and 3) on the other hand, facing the lack of export unit value/price indices for other foreign countries from where Albania has imported less during the entire period taken into consideration so far, 1993-2006.

Please, be aware that the framework presented above serves only for identifying the main countries from where Albania imports and the respective “elementary indices”, which are up-dated every 3 years. It does not determine or affect the way these “elementary indices” are weighted or aggregated,

which is explained below. Please, refer to Appendix 2 for the detailed results obtained by using the above-mentioned framework.

Instead, the weights are based on proxies of series of volumes of Albanian imports according to foreign countries, which are expressed in base-year prices. To be more precise, the series of values of Albanian imports have a quantity effect as well as a price effect incorporated within them. For the purpose of our index, it is necessary to eliminate the price effect, because the weights in a price index should be determined only by the quantities. Otherwise, the index will be biased because the price effect will be double counted – once directly from the “elementary indices” and once from the weights. In order to eliminate the price effect, the series of the values of Albanian import flows are divided (deflated) by the respective export unit value/price indices, according to the main country of importation that they represent. The resulting series can be considered as proxies of series of volumes of Albanian imports expressed in base year prices and the weights are based on these resulting series.

The formula used is that of a chained-Fisher. Please, refer to section 2 on a general discussion of price indices and index number theory for a better explanation of the chained-Fisher index. According to the discussion in section 2, the Fisher formula turns out to be the best one, which is why its usage is advocated here. Instead, the choice between chaining or not is more vague and of little importance, knowing that the Fisher formula is chosen. For convenience, the chained-Fisher formula is presented again:

$$P_{t,0} = \sqrt{\frac{\sum p_1 \cdot q_0}{\sum p_0 \cdot q_0} \cdot \frac{\sum p_1 \cdot q_1}{\sum p_0 \cdot q_1}} \times \dots \times \sqrt{\frac{\sum p_n \cdot q_{n-1}}{\sum p_{n-1} \cdot q_{n-1}} \cdot \frac{\sum p_n \cdot q_n}{\sum p_{n-1} \cdot q_n}} \times \dots \times \sqrt{\frac{\sum p_t \cdot q_{t-1}}{\sum p_{t-1} \cdot q_{t-1}} \cdot \frac{\sum p_t \cdot q_t}{\sum p_{t-1} \cdot q_t}} \cdot 100$$

The base month for the index in USD is January 1993, whereas the base month for the index in Euro is January 1999. Please, find the chart of the two indices in Appendix 3.

The Advantages and Disadvantages

The aim of this subsection is to summarize the main advantages and disadvantages of this approach. The main advantage of this approach is that it results in an index that is straightforward to maintain, unless the IMF ceases publishing the export unit value/prices index of any one of the major countries from where Albania imports.

On the other hand, this approach features the following main disadvantages:

The index for the future months can be calculated only after a lag of 4-6 months, because IFS’s export unit value/price indices are published approximately after 4-6 months.

The representative basket used for calculating the export unit value/price index of a foreign country might differ a lot from the true representative basket of Albanian imports from this country.

The differences in transportation and insurance costs with respect to different foreign countries are ignored by this approach.

CONCLUSIONS

The scope of this discussion paper is to propose an approach for an index of Foreign Unit Values/Prices of Albanian Imports. The original index focuses on the prices of Albanian imports in the markets from where they are imported. This excludes the effect of the exchange rate and allows the impact of these two effects on different macroeconomic indicators of interest to be analyzed and quantified separately. The discussion paper offers also a brief review of index number theory, which unveils important aspects that need to be kept in mind by economists and policymakers while performing economic analysis and recommending or implementing economic policies. The proposed approach is based on this review of index number theory.

The most important conclusions from the general discussion on price index theory are:

- 1) The Laspeyres indices, which are widely used by statistical agencies – for instance, even for the Albanian CPI, exhibit an upward bias that results from their inability to account for the substitution bias;
- 2) According to the axiomatic approach, the Fisher index formula emerges as the best formula;
- 3) Chaining is advocated as useful if prices reveal smooth monotonic trends, but chaining can cause a drift in the index if prices bounce up and down in a continuous and irregular manner;
- 4) The positive as well as negative effects of chaining are “felt” more when it is applied to Laspeyres and Paasche formulas, instead the effects of chaining do not seem to be that relevant when it is applied to the Fisher formula; etc.

The approach for constructing the Index of Foreign Unit Values/Prices of Albanian Imports is based on the IFS’s publications of the export unit value/price indices for the main countries from where Albania imports. The approach results in an index that is straight-forward to maintain and requires less effort. However, the approach is based on an “effective” representative basket that might be quite different from a true representative basket of Albanian imports and future values can be calculated only after approximately 4-6 months.

APPENDIX 1 – AXIOMATIC APPROACH

Axiom 1 – Positivity

The positivity test, $P(p^0, p^t, q^0, q^t) > 0$, says that any index value should be positive, which is straight forward.

Axiom 2 – Identity or Constant Prices

The identity test, $P(p, p, q^0, q^t) = 100$, says that if all the individual prices are equal between the two periods, then the price index value should be equal to 100, no matter how quantities change.

Axiom 3 – Proportionality

The Proportionality test, $P(p, C \times p, q^0, q^t) = 100 \times C$, says that if all the individual prices increase by the same rate $-C$ between the two periods, then the price index value should be equal to $100 \times C$, no matter how the quantities change.

Axiom 4 – Proportionality in Current Prices

The proportionality in current prices test, $P(p^0, C \times p^t, q^0, q^t) = C \times P(p^0, p^t, q^0, q^t)$, says that if all the individual prices in period t are multiplied by the same positive constant $-C$, then the new price index value should be C times the old price index value.

Axiom 5 – Inverse Proportionality in Base Period Prices

The test for inverse proportionality in base period prices, $P(C \times p^0, p^t, q^0, q^t) = 1/C \times P(p^0, p^t, q^0, q^t)$, says that if all the individual prices in period 0 are multiplied by the same positive constant $-C$, then the new price index value should be $1/C$ time the old price index value.

Axiom 6 – Fixed Basket or Constant Quantity

The fixed basket test, $P(p^0, p^t, q, q) = \frac{\sum p^t q_i}{\sum p^0 q_i}$, says that if the quantities are constant between the two periods, then the price index should be equal to the ratio of the revenue in the current period to the revenue in the base period.

Axiom 7 – Invariance to Proportional Changes in Current Quantities.

The test for invariance to proportional changes in current quantities, $P(p^0, p^t, q^0, C \times q^t) = P(p^0, p^t, q^0, q^t)$, says that if all the quantities in period $-t$ are multiplied by the same constant $-C$, then the old price index value and the new price index value should be the same.

Axiom 8 – Invariance to Proportional Changes in Base Quantities

The test for invariance to proportional changes in current quantities, $P(p^0, p^t, C \times q^0, q^t) = P(p^0, p^t, q^0, q^t)$, says that if all the quantities in the base period -0 are multiplied by the same constant $-C$, then the old price index value and the new price index value should be the same.

Axiom 9 – Symmetry of Quantity Weights

The test for the symmetry of quantity weights, $P(p^0, p^t, q^0, q^t) = P(p^0, p^t, q^t, q^0)$

q^0), says that the quantity vectors of the two periods should be treated in an evenhanded manner.

Together, axioms 7 and 8 imply that all the individual prices should be weighted according to the relative share of their respective commodities in the representative basket. As a consequence, equally proportional changes in the quantities of all the commodities, either in the base year or in the current year, should not affect the price index value since such changes do not affect the relative share of the commodities. Instead, axiom 9 implies that both quantity vectors, - that of the base period and that of the current period -, should be equally important and have the same say in determining the relative share of the commodities.

Axiom 10 – Time Reversal

The test for time reversal, $P(p^0, p^1, q^0, q^1) = 1 / P(p^1, p^0, q^1, q^0)$, says that if the price and quantity data for the two periods are interchanged, then the new price index should equal the reciprocal of the old price index.

Axiom 11 – Mean Value for Price

The test for mean value for prices, $\text{Min}_i (p_i^1/p_i^0) < P(p^0, p^1, q^0, q^1) < \text{Max}_i (p_i^1/p_i^0)$, says that the price index value should lie between the minimum and maximum individual price ratio, as it is supposed to be a sort of weighted-average of the individual price ratios.

Axiom 12 – Monotonicity in Current Prices

The test for the monotonicity in current prices says that the price index value should increase, if it is recalculated assuming an increase in anyone of the current prices.

If we assume $p_i^1 < p_i^2$ for only one current price observation -i and all the other price and quantity observations remain the same, then $P(p^0, p^1, q^0, q^1) < P(p^0, p^2, q^0, q^1)$.

Axiom 13 – Monotonicity in Base Prices

The test for the monotonicity in the base prices says that the price index value should decrease, if it is recalculated assuming an increase in anyone of the base prices.

If we assume $p_i^0 < p_i^1$ for only one base price observation -i and all the other price and quantity observations remain the same, then $P(p^0, p^1, q^0, q^1) > P(p^1, p^1, q^0, q^1)$.

Axiom 14 – “Value” Product

Changes in the value of a set of commodities/transactions can be caused by a change in the prices, a change in the quantities, or both. The aim of economists and statisticians is to construct indices that separate the price effect and the quantity effect from each other. Due to this reasoning, another very important property for index formulas has been developed. Actually, every price index $P(p^0, p^1, q^0, q^1)$ should have a corresponding quantity index

$Q(p^0, p^t, q^0, q^t)$, such that the product of these two indices should be equal to the value ratio, between any two periods. This is known as the “value” product test:

$$V^t/V^0 = P(p^0, p^t, q^0, q^t) \times Q(p^0, p^t, q^0, q^t).$$

As a consequence, once a price index and the value ratio V^t/V^0 are available, then the corresponding quantity index should be determined as a function of the two, or the other way around. According to the axiomatic approach, the resulting quantity vector also should desirably possess the characteristics described through the axioms. For instance, likewise the last two monotonicity tests, two other monotonicity tests can be developed, for current quantities and base quantities.

APPENDIX 2 – THE MAIN COUNTRIES FROM WHERE ALBANIA IMPORTS

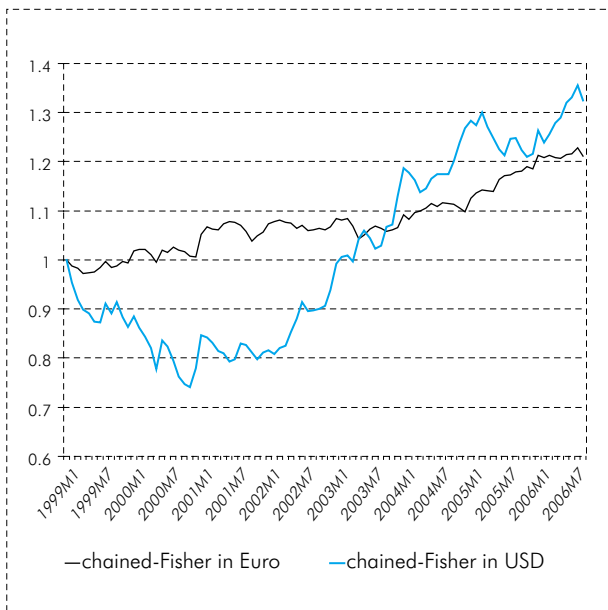
The identification of the main countries from where Albania imports is done based on the framework proposed in section 3. The classification is up-dated every 3 years. More precisely, the entire period starting from January 1993 is divided into 3-year periods as follows: 1) 1993-1995; 2) 1996-1998; 3) 1999-2001; 4) 2002-2004; 5) 2005-.

The table below presents the shares of the value of imports from one country to the total value of all imports from all the countries, for all the 3-year periods. The shares for the period 2005-, are based on the two years available so far – 2005 and 2006-, and should be re-estimated at the end of 2007.

1993-1995		1996-1998		1999-2001		2002-2004		2005-	
Italy	35.27%	Italy	43.05%	Italy	35.56%	Italy	33.59%	Italy	28.68%
Greece	22.51%	Greece	24.78%	Greece	28.25%	Greece	21.46%	Greece	16.17%
Germany	7.61%	Germany	4.72%	Turkey	5.73%	Turkey	6.72%	Turkey	7.52%
Bulgaria	7.30%			Germany	5.06%	Germany	5.60%	China	6.32%
								Germany	5.53%
Total		Total		Total		Total		Total	
All	72.69%	All	72.55%	All	74.60%	All	70.37%	All	64.22%
Available	65.39%	Available	72.55%	Available	74.60%	Available	70.37%	Available	64.22%

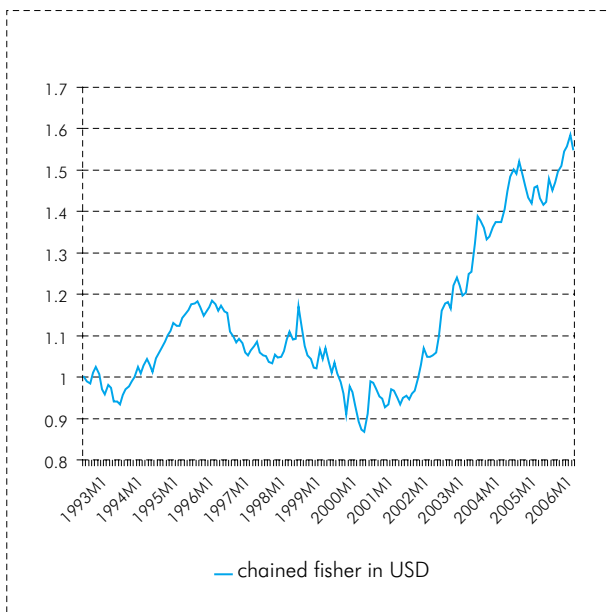
* Bulgaria (1993-1995) emerges as a main country from where Albania imports, but the lack of export unit value/price indices for it makes it impossible to be represented in the final index of unit values/prices of Albanian imports. Instead, Germany (1996-1998) does not strictly emerge as main country of importation, but since it emerges in all other periods, it was decided to keep it. Moreover, please, remember that results during one 3-year period are used to determine whose foreign countries' export unit value/price indices will enter the final index during the coming 3-year period. For instance, the results presented in the table above for the period 2002-2004 are used to determine whose foreign countries' export unit value/price indices will enter in the calculation of the final index for the period 2005-2007. An exception relates to the final index in USD during the period 1993-1995, which uses the same period's results because of the lack of data for the prior periods.

APPENDIX 3 – CHARTS



The graphs portrayed below are the charts of the Indices of Foreign Unit Value/Prices of Albanian Imports, constructed according to the second approach presented in this discussion paper – the approach based on the export unit value/prices of the main countries from where Albania imports.

The first chart presents chained-Fisher indices in Euro and USD, starting in January 1999, when Euro was introduced for the first time. The second chart presents the chained-Fisher index expressed in USD, starting from January 1993. The first chart allows the two indices, expressed in different currencies, to be compared. According to the first chart, three main periods can be identified: from 1999 to late 2001, when the index in USD tends down and further below from the index in Euro; from late 2001 to mid 2003, when the index in USD starts moving up and towards the index in Euro; from mid 2003 and on, when the index in USD takes over the index in Euro. The three phases reflect the developments of the Euro/USD exchange rate.



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Note: The members of the technical expert group are: Kim Zieschang (IMF), Thomas Alexander (IMF), William Alterman (U.S. Bureau of Labor Statistics), Paul Armknecht (IMF), Pam Davies (United Kingdom Office for National Statistics), Erwin Diewert (University of British Columbia), Jemma Dridi (IMF), Robert Feenstra (University of California Davis), Maria Mantcheva (IMF), Keith Woolford (Australian Bureau of Statistics).

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ENDNOTES

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¹ Please, be aware that a value of 100 in the base year, instead of a value of 1, is assumed in the entire discussion paper and is represented in all the formulas.

² The aim of Appendix 1 on the Axiomatic Approach is to explain only the most important and widely accepted axioms.

³ The draft of Export and Import Price Index Manual has been supervised by the Technical Expert Group on Export and Import Price Index (TEG-XMPI), under the auspices of the Inter-secretariat Working Group on Price Statistics, which is a joint initiative of IMF, World Bank, OECD, ILO, etc.

⁴ Source: The draft of Export and Import Price Manual, Chapter 15- Basic Index Number Theory, pg 41-42; by the Technical Expert Group on Export and Import Price Index (TEG-XMPI), under the auspices of the Inter-secretariat Working Group on Price Statistics; July 2003.

BANK OF ALBANIA NEWS OVER APRIL-JUNE 2008

On 3 April 2008, the Bank of Albania organized at Tirana International Hotel a forum entitled "Supervision, financial stability and the functioning of money and financial market". Present in this roundtable forum were the main financial system's players and representatives of 16 commercial banks operating in Albania. This activity represents another effort of the Bank of Albania to promote constant communication with the financial system in general and the banking system in particular. In addition, it has already become a tradition which aims at improving the financial market and boosting the country's economic development.

"Supervision, Financial Stability and the Functioning of Money and Financial Market". Bank of Albania Forum with the Financial System Players

In his speech, the Governor of the Bank of Albania, Mr. Ardian Fullani, raised a number of issues, namely the need to establish a periodic communication channel between the central bank and the financial system's players; the Bank of Albania's concern on the constant extension of loans in foreign currency for most consumer and mortgage loans; the banking system's transparency to the public; the constant improvement of banks' governance; the well-functioning of the interbank market; the increase of funds' circulation through the system; the strengthening of internal control at commercial banks and the disclosure of the banking activity results.

Governor Fullani also introduced a package of rules that the Bank of Albania has drafted in order to enhance prudence in terms of the banking system's stability. More concretely, the package aims at better disciplining the banking system in terms of assessing credit-related risks; imposing penalties for banks in case the share of non-performing loans increases, encouraging lending in lek and enhancing transparency and clarifying the customers for any products or services.

On 25 April 2008, the final phase of the competition "The Real Value of Money" that the Bank of Albania ran for high school students of the capital city, took place in the Black Box theatre of the Arts Academy in Tirana. The academic year 2007- 2008 was the first year for the central bank to organize this competition, being also the first of its kind in the country. It was held in two phases, the eliminatory phase and the final one, which were attended by nearly 600 spectators. The final phase, which was won by "Qemal Stafa" high school, was aired on the Albanian Public Television.

Competition "The Real Value of Money" for Academic Year 2007-2008 Finalizes

The central theme of the competition related to the main function of the central bank – preserving price stability through the formulation and implementation of monetary policy. "The Real Value of Money" resembles a classical competition,

where teams of three students each compete against one another and respond to a number of questions to the jury panel. The jury is composed of five members and headed by the Governor of the Bank of Albania.

The eliminatory phase took place in the Bank of Albania hall on 2 and 4 April. The 20 participant teams competed against one another divided into groups of 5 for about 90 minutes. They answered to a number of questions, including elaborative questions, quizzes, missing terms completion equations, exercises, charts interpretation and concluding with a question that each team prepared for the other competing teams. The team representing "Qemal Stafa" public high school had a better performance regarding their knowledge on the study material, analytical skills, presentation skills and team-work performance. The second runner-up was the team from "Sami Frashëri" public high school, followed by the third runner-up, "Besnik Sykja" public high school.

This competition is part of the comprehensive educational programme "The Central Bank in Everyday Life", which aims at establishing a real economic and financial culture targeting various age-groups through the organization of educational activities. Although "The Real Value of Money" began as a competition for high schools in Tirana, it will also be held for other cities in Albania, hence, turning it into a nationwide educational programme.

Meetings of the Governor of the Bank of Albania, Mr. Ardian Fullani, during the Spring Meetings of the World Bank Group and the International Monetary Fund

On 12-16 April 2008, a delegation of the Bank of Albania, headed by Mr. Ardian Fullani, the Governor of the Bank of Albania as well as the Governor of Albania to the International Monetary Fund (IMF), participated in the Spring Meetings of the World Bank Group (WB) and the International Monetary Fund (IMF) and in the Executive Forum on Central Bank Reserves Management organized by the World Bank Treasury Department.

During his stay in Washington D.C., the Governor of the Bank of Albania together with the Minister of Finance, Mr. Ridvan Bode, had meetings with senior IMF and WB representatives.

In his meetings with senior IMF officials, in addition to the annual discussions on the latest global, regional and Albanian economic and financial developments, Mr. Fullani provided a long description of the developments in the financial and banking market and dwelt on issues related to financial stability, money market and the work done by the Bank of Albania to develop this market.

IMF representatives expressed their support to the measures undertaken by the Bank of Albania. In particular they appraised the achievement of the central bank in terms of anchoring the inflationary expectations. In addition, IMF representatives showed their willingness to support the Bank of Albania with technical assistance programmes and so on.

In the meetings with high level representatives of the WB, Mr. Fullani presented the macroeconomic, financial and banking developments in

Albania and the central bank's objectives to keep inflation under control and safeguard financial stability.

As in the previous meetings, special attention was paid to the developments in the energy sector and the urgent need to carry out structural reforms in this sector.

During his stay in Washington D.C., Mr. Fullani also attended the Executive Forum on Central Bank Reserves Management organized by the World Bank Treasury Department. The main topics that were dealt with in this forum related to the decision-making framework, assets and foreign reserve investment policies, investment operations, risk management, strategic allocation of assets as well as issues related to the diversification of foreign reserve assets.

On 30 April 2008, the Governor of the Bank of Albania, Mr. Ardian Fullani, met with representatives of non-profitable organizations and institutions specialized in education and social issues.

*"There is always more to learn about money"
Meeting of the Governor of the Bank of Albania, Mr. Ardian Fullani, with representatives of non-profitable organizations and institutions specialized in education and social issues*

This meeting marked the beginning of the Governor's meetings with representatives of different social audiences. They will aim at having open discussions between Mr. Fullani and the participants and co-operating on issues related to economic and financial education of the institutions and organizations they represent.

The main topics of this first meeting held at the Bank of Albania hall were the introduction of the educational brochure "Shape your future – plan your finances" and the educational programme for the social workers which will focus on central banking, trade and other similar issues of interest to the public at large.

"Shape your future – plan your finances" intends to help the public at large organize the financial aspect of everyone's everyday life, better manage personal finances as well as providing orientations towards the most adequate ways of how to increase savings and earnings. This brochure meets the demand for financial and banking knowledge of some social groups: those living alone who want to manage their money properly; housewives who manage their families' income; people who work and want to manage their savings rightly; and people who are preparing for retirement.

The educational programme for social workers is another activity the Bank of Albania will organize every year and it will be dedicated to students who have just graduated from social sciences. It will be held four times a year and will deal with issues related to the central bank, its role in the general development of the economy and in everyone's everyday life. Through these people and because of their professions, the Bank of Albania aims at reaching to the public at large, or better say to all those who for different purposes are in contact with representatives of the above organizations and institutions.

Activities of this kind, which dedicate to the public education on issues related to the central bank and the economic and financial education, are part of the educational programme "The Central Bank in Everyday Life" of the Bank of Albania. The latter is a comprehensive programme which targets different groups of people.

"The Central Bank in Everyday Life". Visit of the Governor of the Bank of Albania, Mr. Ardian Fullani, to "Ali Demi" high school in Vlora

On 13 June 2008, the Governor of the Bank of Albania, Mr. Ardian Fullani, met with students and professors of high schools in Vlora district to launch the educational programme "The Central Bank in Everyday Life". In the context of this programme, the Bank of Albania has organized in Tirana for two years in a row (2007-2008) different educational activities, which include training seminars for high school professors of economics and journalists covering economic issues, meetings with high school students of Tirana, educational brochures on important arguments of the central bank and central banking, meetings and lectures of the Governor with Tirana students and professors, etc.

The meeting was held in the premises of Ali Demi high school and was attended by about 150 students, professors and representatives of the Educational Directory of Vlora District.

Like in Tirana, the educational programme for Vlora district will begin this summer with the organization of training seminars for professors teaching economics in high schools. The second step will be the competition "The Real Value of Money" for academic year 2008-2009.

In the speech held on this occasion, Mr. Fullani explained to the audience the importance of establishing a real economic and financial culture which would assist everyone's wellbeing and would ensure the progress of the Albanian economy in general. The Bank of Albania ambitions in the area of education were another topic in Mr. Fullani's speech. The Governor pointed out that education is a matter to everyone and that the Bank of Albania aims at converting the information and literature on this area accessible to and understandable by the public at large.

Mr. Fullani also introduced the audience to the ways the Bank of Albania tries to transmit the work and the economic and financial education to the young public in an entertaining way.

In conclusion, the Governor answered to students' questions on the communication means with the public, on specific issues of central and commercial banking, on the Bank of Albania webpage, on the global financial crisis etc.

After the meeting, the students filled in the questionnaires which were prepared to identify their interest in and knowledge of the Bank of Albania and its educational activities.

On 5 May 2008, a delegation from the Central Banking Authority of Kosovo (CBAK) headed by Mr. Hashim Rexhepi, Managing Director, paid an official visit to the Bank of Albania. This was Mr. Rexhepi's first visit to the Bank of Albania as Managing Director of the CBAK. The delegation met with the Governor of the Bank of Albania, Mr. Ardian Fullani, and the First Deputy Governor, Mr. Fatos Ibrahim.

Meeting of the Governor of the Bank of Albania with Central Banking Authority of Kosovo Delegation

Mr. Fullani expressed his appraisals for the remarkable administrative capacities of the CBAK, which will enable the complete transformation of this institution into a central bank. The governor highlighted that the Bank of Albania remains willing to provide all the support and expertise to the CBAK and expressed his full conviction that the further strengthening of technical co-operation will be beneficial to both institutions.

On his behalf, Mr. Rexhepi presented the CBAK's work in setting up the necessary legal and operational framework in view of preparing for the transformation of the CBAK into a central bank following the entry into force of the Constitution of the Republic of Kosovo on 15 June 2008. Mr. Rexhepi highlighted that the CBAK's governing structure remains aware of the extremely important role of the central bank in the economic development of Kosovo and the challenges ahead. In addition, Mr. Rexhepi gave his full support in intensifying the bilateral co-operation further.

Part of the delegation was also Mr. Gazmend Luboteni, Chairman of the CBAK Governing Board. Mr. Luboteni said that the strengthening of technical co-operation in banking supervision, human resources and the Bank of Albania support with technical expertise are crucial to the CBAK and in particular to the future Central Bank of the Republic of Kosovo.

Mr. Luboteni also asked for the Bank of Albania support with respect to the involvement of the CBAK in the international cooperation network between central banks.

The meeting continued with discussions and exchange of opinions related to the functioning of respective financial systems in general and the banking ones in particular, with special focus on the prudent supervision of the financial market's players and on the safeguard of financial stability in both countries.

On 5 and 6 May 2008, the Bank of Albania organized the closing ceremony of the annual training seminars round that the central bank holds for professors in Tirana. These two-day seminars, part of the educational programme "The Central Bank in Everyday Life", are held four times throughout the academic year and they aim at deepening and enriching the professors' knowledge on central banking, the Bank of Albania and its role in the Albanian economy. Specialists and heads of Bank of Albania departments make presentations and hold discussions with professors on these topics and others as requested.

Training Seminars Round for High School Professors, Academic Year 2007-2008

Through these seminars, the Bank of Albania has established interactive educational relationships with the professors, who can convey the activity and message of the Bank of Albania to the young people, to their students, relatives, friends and colleagues better than anyone else. As said by the Governor of the Bank of Albania, Mr. Ardian Fullani, during the certificate distribution ceremony for the training seminar round for academic year 2007-2008 "...The Bank of Albania believes that economics and finance, just like anything else, needs to be learnt! School is obviously the best place to learn and you are the professors."

During the last two academic years, over 65 high school professors of economics in Tirana have shown great interest while attending the two training seminar rounds organized by the Bank of Albania for their further qualification. In addition, certificates have been distributed to participant professors at the end of the seminar.

For the academic year 2008-2009, the training seminars for high school professors will be also organized in Vlora and Shkodra.

*Visit of Riksbank's
Delegation from Sweden to
the Bank of Albania*

On 12-17 May 2008, two experts from Riksbank, Sweden visited the Bank of Albania and held training sessions with Monetary Policy and Research Departments' specialists.

The purpose of this training seminar was to introduce the specialists from the two departments to the modern methods of inflation forecasting, more specifically to the models used by the Riksbank, and to the macroeconomic models of developed countries' central banks.

During the two-day training seminar, the focus was on the inflation forecasting models and the MEAM (macroeconomic model) used by the Bank of Albania. After a short presentation of the models and the decision-making process at the Bank of Albania, open discussions were held in two separated groups according to the respective departments.

Worth to note is the fact that these models use almost every available data on the Albanian economy and their use helps the decision-making process at the Bank of Albania.

*Memorandum of
Understanding between the
Bank of Albania and the
Institute of Statistics*

On 13 May 2008, the Governor of the Bank of Albania, Mr. Ardian Fullani, and the General Director of the Institute of Statistics (INSTAT), Ms. Ines Nurja, signed a Memorandum of Understanding (MoU) between the Bank of Albania and INSTAT.

Through this MoU, the Bank of Albania will increase the number of statistical products obtained from the INSTAT in the context of making assessments of the new stage of economic development the country is entering. In addition, the implementation of this MoU will enable the INSTAT to enrich further the

statistical data spectrum with data from the financial and external sector which are produced by the Bank of Albania.

The accurate observance of the MoU requirements makes a good basis for meeting a number of obligations the Albanian statistics have in order to comply with the international standards. The MoU establishes concrete responsibilities for accurately meeting the requirements set by the IMF Special Data Dissemination Standard Project, which will enable the inclusion of Albania into the international financial markets from the statistics viewpoint. In addition, the observance of these standards and of other requirements provided for in the existing programmes of statistics development in the Albanian statistical institutions provide contemporary basis for our statistics to meet the European standards.

Organizing meetings in almost all high schools in Tirana is one of the activities of the Bank of Albania educational programme "The Central Bank in Everyday Life". In these meetings, heads and specialists of the Bank of Albania have discussions on its function, the banking system and the management of personal finances.

Meetings in High Schools of Tirana for Academic Year 2007-2008 Finalize

The meetings for the academic year 2007-2008 were finalized at "Myslym Keta" high school on 13 May 2008. During the entire academic year have been held meetings in 13 high schools in Tirana and the Bank of Albania representatives have held discussions with around 500 third grade students. 400 questionnaires have been filled in by students and professors, which reflect their opinions regarding the main aspects of the educational programme for the academic year.

The Bank of Albania plans to extend these meetings to other cities as well. For academic year 2008-2009, meetings in high schools will be organized in Vlora and in Shkodra.

The 19th Meeting of the Central Bank Governors' Club of the Central Asia, Black Sea Region and Balkan Countries was held on 23-24 May 2008 in Tirana, under the auspices of Mr. Ardian Fullani, Governor of the Bank of Albania as well as Deputy Chairman of this Club for the time period 2007-2008.

19th Meeting of the Central Bank Governors' Club of the Central Asia, Black Sea Region and Balkan Countries

The governors of the central banks of Bosnia – Herzegovina, Greece, Kazakhstan, Macedonia, Montenegro, Russia, as well as the Governor of the National Bank of Serbia, who currently serves as the Chairman of the Club, participated in this meeting.

The meeting was also attended by the Vice-Governor of the National Bank of Moldova, the Deputy Governor of the National Bank of Romania, the Deputy Governor of the National Bank of the Republic of Macedonia as well as by representatives from the central banks of Azerbaijan, the Kyrgyz Republic, Bulgaria and Israel.

Mr. Lucas Papademos, Vice - President of European Central Bank, greeted the Tirana meeting and held a speech on the ways to cope with the financial market turmoil, focusing on the restoring of confidence and the strengthening of financial market resilience. The meeting continued with the speeches delivered by Mr. Athanasios Orphanides, Governor of the Central Bank of Cyprus, who presented the Cypriot experience concerning accession to the European Union and the Eurozone, as well as with the presentation of Mr. Mario I. Blejer, Former Governor of the Central Bank of Argentina, who focused on the main challenges that central banks in emerging markets currently face. The concluding session of the meeting continued with the presentations delivered by the representatives of the participating central banks on the economic developments in the respective countries, with a special focus on the performance of their financial systems in general and of their banking systems in particular, as well as on the activity of central banks in these countries.

The Governors' Club, established in 1998, represents a forum of central banks, which aims at strengthening the relations between the central banks of the region, to promote the cooperation on monetary, financial and banking issues as well as to encourage the exchange of national experiences in an open and direct environment. The Bank of Albania is a member of this Club ever since its establishment.

*Bank of Albania Seminar
with Social Workers in
Tirana*

For the first time this year, the Bank of Albania held a training seminar with students who had just graduated from social science. This training seminar is held one week a year and presently, it focuses on topics related to the central bank and to the economic and financial education. Given the fact that it is challenging for the Bank of Albania to contact the public at large directly, the assistance provided by the social workers in transmitting the information is very useful. The latter's profession allows them to have frequent contacts with different parts of the population.

The training seminar for year 2008 closed with a ceremony of certificates distribution by the Governor of the Bank of Albania, Mr. Ardian Fullani, to around 60 participants on 16 June 2008 at Tirana International Hotel. Starting from this month, almost all participants in the training seminar were enrolled in the electronic list of people who receive the Bank of Albania publications.

*Implementing the
International Accounting
Standards IAS/IFRS*

On 18-20 June 2008 at Tirana International Hotel, the Bank of Albania in co-operation with the FSVC organized the seminar titled "Implementing the International Accounting Standards IAS/IFRS". This seminar was held following the two-day consultations of the working group with the experts. The discussions had at their focus the influence of the standards implementation on the commercial banks' financial statements.

In addition, this seminar dealt with other topics of special importance, such as the establishment of gradual steps in implementing IAS 39 "Recognition and measurement of financial assets and liabilities" or the methodology applied

by banks to create reserve funds for covering the credit losses according to the IFRS. The latter is considered as crucial given the impact that these funds have on the banks' financial result.

The conversion from applying the national to international standards represents a challenge both to commercial banks, which had to report this change starting from the early months of the present year, and to the Supervision Department examiners.

Starting from January 2007, Research Department at the Bank of Albania *Friday Seminar* has been holding "The Friday Seminar". This seminar invites all the Bank of Albania employees, researchers from academic sphere and other financial, research and scientific institutions to present and discuss their theoretical and empirical research work.

Central banks' economists are ever-increasingly being faced with analyses requirements from policy makers, the financial and the banking market and the public at large. Their analyses also assist in meeting the central banks' main objective – maintaining price and financial stability. In addition, economic analyses are the backbone of modern central banking policy-making and they play a key role in informing the market and the public and in the expectations' formation. The production of analyses on national and international economic variables and the relations between the two in the proper time and in an understandable way are crucial to monetary policy credibility and independence. Moreover, the ability to understand and model the behaviour of financial markets and their agents allows the central bank to identify the risks which may affect the economy, rate them according to the level of risk and probability and advise the policymakers to pursue more adequate policies to remove or mitigate these risks.

The Friday Seminar provides a good opportunity to strengthen and facilitate the communication between the Bank of Albania, the universities and other research and scientific institutions which analyze the economic developments in Albania, as well as assist in transmitting the expertise from the researchers to the decision-makers.

This seminar is held every two weeks at the Bank of Albania premises and closes for two months in July and August. The duration of each session is 60-90 minutes and each author is given around 30-40 minutes to present the paper. The remaining time is used to make questions and comments on the presented paper.

So far have been presented 26 papers from 27 people, who are mainly employees from different Bank of Albania departments – mostly the Research and Monetary Policy Departments.

LEGAL EVENTS OVER APRIL-JUNE 2008

BANKING SUPERVISION

On 9 April 2008, the Supervisory Council of the Bank of Albania approved upon Decision No. 28 the revocation of the licence of Tirana Branch of First Investment Bank, Tirana. The licence of Tirana Branch of First Investment Bank, Tirana, was revoked following its voluntarily liquidation.

On 30 April 2008, the Supervisory Council of the Bank of Albania approved upon Decision No. 31 the Regulation "On risk management from banks' large exposures". The purpose of this regulation is to establish the rules and criteria for calculating, supervising and reporting the bank's large exposures to a person/customer or group of people/customers related between them or the bank, in order to manage the risk stemming from the concentrated exposure to them.

INFORMATION TECHNOLOGY

On 9 April 2008, the Supervisory Council of the Bank of Albania approved upon Decision No. 29 the Regulation "On the organization and functioning of the Information Technology Strategy Committee". According to this regulation, the purpose of the Information Technology Strategy Committee is to formulate and propose for approval from the Supervisory Council development strategies of information technology at the Bank of Albania, as well as to advise the governing structures at the Bank on issues related to information technology.

MONETARY POLICY

On 27 May 2008, the Supervisory Council of the Bank of Albania approved upon Decision No. 34 the opinion of the Bank of Albania "On the situation of the Albanian economy for the first quarter of 2008". After analyzing the economic and financial situation, the Supervisory Council of the Bank of Albania decided to keep the key interest rate unchanged at 6.25 percent.

PAYMENT SYSTEMS

On 11 June 2008, the Supervisory Council of the Bank of Albania approved upon Decision No. 38 the Document "Supervision policy of payment and settlement systems". Payment and settlement systems enable the settlement of parties' obligations as a result of financial transactions carried between them

in economy. The supervision of these systems will aim at: the preservation of systems' safety through the identification and taking of measures to avoid the drawbacks; the maintenance of a satisfactory efficiency in the payment systems, promoting the automation in using and processing payment instruments, the inter-operationality and the co-functioning with other systems; the full transparency of the operational rules and the acknowledgement of users' rights and obligations; the setting out of minimal standards for the instruments and payment services provided, aiming at high security and wider use.

ECONOMIC POLICY

On 14 April 2008, the Parliament of the Republic of Albania approved the Law No. 9901 "On merchants and commercial companies". This law regulates the merchant's status, the establishment, management, reorganization and liquidation of commercial companies, the rights and obligations of founders, partners and shareholders. According to this law, commercial companies are collective companies, commandite companies, limited liability companies and shareholder companies.

On 17 April 2008, the Parliament of the Republic of Albania approved the Law No. 9902 "On consumer protection". The purpose of this law is to protect the interest of consumers in the market and to set out the rules and the establishment of respective institutions to protect their rights. According to this law, consumers will be considered all people who buy or use goods or services to satisfy personal needs and not for purposes related to trade activity or exercise of profession.

On 24 April 2008, the Parliament of the Republic of Albania ratified upon Law No. 9905 "The loan agreement between the Republic of Albania, Alpha Bank, A.E., National Bank of Greece, S.A., as regulators and Alpha Bank, A.E., London branch, as agent, for the loan of 230 million euros to finance the project for Rrëshen – Kalimash road".

On 5 May 2008, the Parliament of the Republic of Albania ratified upon Law No. 9910 "The loan agreement between the Council of Ministers, as representative of the Republic of Albania, and the Council of Europe Development Bank to finance the programme "Community works, third phase"". According to this agreement, the Council of Europe Development Bank extends a loan of 10 million euros for the partial financing of the above project. This project covers the social infrastructures which relate to the modernization of rural areas, health, education, environment protection and those projected to improve the living conditions in the urban areas.

On 13 May 2008, the Ministry of Finance approved the Instruction No. 17 "On value added tax". This instruction removes the procedure of monthly submission of book entries, reconfirming as a legal obligation their accurate and regular keeping from the company, and being based on the principle of self-declaration and structural tax control.

On 19 May 2008, the Parliament of the Republic of Albania approved the Law No. 9917 "On the prevention of money laundering and terrorism financing". The purpose of this law is to prevent the laundering of money and products stemming from criminal acts, as well as the terrorism financing. It sets out the preventing measures which need to be undertaken by the financial and non-financial institutions to prevent the harmful use of these entities in money laundering or terrorism financing activities.

On 19 May 2008, the Parliament of the Republic of Albania approved the Law No. 9920 "On tax procedures in the Republic of Albania". This law regulates the procedures for managing tax obligations in the Republic of Albania. Its provisions apply to all types of taxes and tax obligations, except for cases when it is provided differently by other laws.

On 26 May 2008, the Parliament of the Republic of Albania ratified upon Law No. 9921 "The loan agreement between the Republic of Albania, represented by the Council of Ministers and the Kuwait Fund for Arab Economic Development, for the financing of the project "Durrësi crossover and Vlora road node"". The purpose of this project is to enhance the economic and social development of central and eastern Albania and provide a flowing road traffic in the road segment Durrës-Vora and Durrës-Morinë. This project is expected to be finalized in 2010.

On 17 June 2008, the Social Assistance Commission approved upon Decision No. 26, the Instruction "On state aid in the form of compensation of services of general economic interest". The purpose of this instruction is to establish the terms and criteria upon which the state aid for services of general economic interest will be granted. In economic terms, these services relate closely with the obligation to provide public services to certain categories of people (sick people or people living in natural disaster areas), but also to the entire population (education, culture and health-related services).

On 18 June 2008, the Council of Ministers approved the Decision No. 856 "On the raise of pensions". Upon this decision, the Council of Ministers decided to raise by 10 percent the full, partial and early retirement pensions, special merits and service seniority pensions, handicapped and household pensions pursuant to the Law No. 7703, dated 11 May 1993 "On social insurance in the Republic of Albania", and to raise by 15 percent the full, partial and seniority pensions, handicapped and household pensions pursuant to the Law No. 4976, dated 29 June 1972 "On pensions of agricultural cooperatives members in the People's Republic of Albania".

On 26 June 2008, the Parliament of the Republic of Albania approved upon Decision No. 9936, the Law "On budget system management in the Republic of Albania". This law regulates the budget system in the Republic of Albania, the structure, principles and the basis of budget process, intergovernmental financial relationships and the responsibilities for implementing the budget legislation in general. Some of the novelties are as follows: a better relation between the budget and the policies through the institutionalization of medium-

term budget programme; a clear division of the responsibilities of participants in the management process of public expenditures, aiming at dividing the policy-making functions of the minister from the management function and the implementation functions of employees; the data entry of the financial and public internal control system; the reflection of developments in the statistical international standards and public accounting, etc.

On 26 June 2008, the Parliament of the Republic of Albania ratified upon Decision No. 9941 "The contribution agreement between the Council of Ministers of the Republic of Albania and Al-Diwan Al-Emir of Kuwait State for the funding of "Refurbishment of Scanderbeg Square" and restoration of Ethem Beu mosque in Tirana"". According to this agreement, His Highness the Amir Sheikh Sabah Al-Ahmad Al-Jaber Al-Sabah, the Amir of the State of Kuwait provides a financial support of 5 million euros for this project.

BANK OF ALBANIA MANAGEMENT, 30 JUNE 2008

SUPERVISORY COUNCIL

ARDIAN FULLANI	Chairman
FATOS IBRAHIMI	Vice Chairman
TEFTA ÇUÇI	Member
LIMOS MALAJ	Member
KSENOFON KRISAFI	Member
ADRIAN CIVICI	Member
ARJAN KADAREJA	Member
HALIT XHAFA	Member
BENET BECI	Member

GOVERNOR

ARDIAN FULLANI

GOVERNOR'S OFFICE

GENC MAMANI

DEPUTY GOVERNORS

FATOS IBRAHIMI *First Deputy Governor*

GENERAL INSPECTOR

TEUTA BALETA

DEPARTMENTS AND OTHER UNITS

HUMAN RESOURCES DEPARTMENT	Dashmir Halilaj
MONETARY POLICY DEPARTMENT	Gramoz Kolasi
RESEARCH DEPARTMENT	Altin Tanku
MONETARY OPERATIONS DEPARTMENT	Marian Gjermeni
SUPERVISION DEPARTMENT	Indrit Banka
FINANCIAL STABILITY DEPARTMENT	Klodion Shehu
INFORMATION TECHNOLOGY DEPARTMENT	Xhilda Kanini Deliana
STATISTICS DEPARTMENT	Kliti Ceca
ISSUE DEPARTMENT	Valer Miho
ACCOUNTING AND FINANCE DEPARTMENT	Artan Toro
PAYMENT SYSTEMS DEPARTMENT	Marseda Dumani
LEGAL DEPARTMENT	Toni Gogu
AUDIT DEPARTMENT	Teuta Baleta
FOREIGN RELATIONS, EUROPEAN INTEGRATION AND COMMUNICATION DEPARTMENT	Ina Kraja
ADMINISTRATION DEPARTMENT	Agron Skënderaga
SECURITY AND PROTECTION DEPARTMENT	-
PRINTING HOUSE	Alfons Theka

BRANCHES

SHKODRA	Ermira Istrefi
ELBASANI	Valentina Dedja
GJIROKASTRA	Anila Thomaj
KORÇA	Liljana Zjarri
LUSHNJA	Shpresa Meço

LIST OF ALL ENTITIES LICENSED BY THE BANK OF ALBANIA*

BANKS AND BRANCHES OF FOREIGN BANKS

1. RAIFFEISEN BANK (JOINT-STOCK COMPANY)

Licence No. 2/1998, dated 11.01.1999

Approved by the Supervisory Council Decision of the Bank of Albania No. 163, dated 11.12.1998.

Certificate No. 2 "On Deposit Insurance".

Director: Oliver WHITTLE

Address: Bulevardi "Bajram Curri", European Trade Center, Tirana, Albania

Tel.: 222 66 99, 222 45 40, 222 26 69, 222 54 16

Fax.: 227 55 99, 222 35 87, 222 36 95, 222 40 51

2. UNITED BANK OF ALBANIA (JOINT-STOCK COMPANY)

Licence No. 3/1998, dated 11.01.1999

Approved by the Supervisory Council Decision of the Bank of Albania No. 165, dated 11.12.1998.

Certificate No. 3 "On Deposit Insurance".

Director: Abdul Waheed ALAVI

Address: Bulevardi "Dëshmorët e Kombit", Nr. 8, Tirana, Albania

Tel.: 222 84 60, 222 38 73, 222 74 08

Fax: 222 84 60, 222 83 87

3. ITALIAN BANK OF DEVELOPMENT (BANCA ITALIANA DI SVILUPPO)

Licence No. 5/1998, dated 11.01.1999

Approved by the Supervisory Council Decision of the Bank of Albania No. 164, dated 11.12.1998. Certificate No. 4 "On Deposit Insurance".

Director: Libero CATALANO

Address: Bulevardi "Dëshmorët e Kombit", Ndërtesa Kullat Binjake, Tirana

Tel.: 228 03 51 / 2 / 3 / 4 / 5

Fax: 228 03 56

4. NATIONAL COMMERCIAL BANK (JOINT-STOCK COMPANY)

Licence No. 6/1998, dated 11.01.1999

Approved by the Supervisory Council Decision of the Bank of Albania No. 162, dated 11.01.1999.

Certificate No. 5 "On Deposit Insurance".

Director: Seyhan PENCAPLIGIL

Address: Bulevardi "Zhan D'Ark", Tirana, Albania

Tel.: 225 09 55

Fax.: 225 09 56

5. TIRANA BANK (JOINT-STOCK COMPANY)

Licence No. 07, dated 12.09.1996

Approved by the Supervisory Council Decision of the Bank of Albania No. 9, dated 12.09.1996.

Certificate No. 6 "On Deposit Insurance".

Director: Bedri ÇOLLAKU

Address: Rruga "Dëshmorët e 4 Shkurtit", Tirana, Albania

Tel.: 226 96 16/7/8; 223 34 41/42/43/44/45/46/47

Fax.: 223 34 17

* As of June 30, 2008.

6. NATIONAL BANK OF GREECE (JOINT-STOCK COMPANY) – TIRANA BRANCH
Licence No. 08, dated 25.11.1996

Approved by the Supervisory Council Decision of the Bank of Albania No. 4, dated 14.03.1996.

Certificate No. 7 "On Deposit Insurance".

Director: Ioannis LEIVADITIS
Address: Rruga "Durrësit", Godina Comfort, Tirana, Albania
Tel.: 227 48 02; 227 48 22
Fax.: 223 36 13

7. INTERNATIONAL COMMERCIAL BANK (JOINT-STOCK COMPANY)

Licence No.09, dated 20.02.1997

Approved by the Supervisory Council Decision of the Bank of Albania No. 9, dated 30.04.1996.

Certificate No. 8 "On Deposit Insurance".

Director: Mahendra Sing RAWAT
Address: Qendra e Biznesit, Rruga "Murat Toptani", Tirana, Albania
Tel.: 225 43 72 / 225 62 54
Fax.: 225 43 68

8. ALPHA BANK (JOINT-STOCK COMPANY) – ALBANIA

Licence No.10, dated 07.01.1998

Approved by the Supervisory Council Decision of the Bank of Albania No. 01/03/96, dated 27.12.1997.

Certificate No. 9 "On Deposit Insurance".

Director: Andreas GALATOULAS
Address: Bulevardi "Zogu I", Nr.47, Tirana, Albania
Tel.: 223 35 32; 223 33 59; 234 04 76/77
Fax.: 223 21 02

9. AMERICAN BANK OF ALBANIA (JOINT-STOCK COMPANY)

Licence No.11, dated 10.08.1998

Approved by the Supervisory Council Decision of the Bank of Albania No. 105, dated 10.08.1998.

Certificate No. 10 "On Deposit Insurance".

Director: Lorenzo RONCARI
Address: Rruga "Ismail Qemali", Nr. 27, P.O. Box 8319, Tirana, Albania
Tel.: 224 87 53/4/5/6
Fax.: 224 87 62

10. PROCREDIT BANK (JOINT-STOCK COMPANY)

Licence No. 12, dated 15.03.1999

Approved by the Supervisory Council Decision of the Bank of Albania No. 22, dated 03.03.1999.

Certificate No. 11 "On Deposit Insurance".

Deputy Director: Anila DENAJ
Address: Rruga "Sami Frashëri", Tirana e Re, P.O. Box. 2395, Tirana, Albania
Tel.: 227 12 72/3/4/5
Fax.: 227 12 76

11. EMPORIKI BANK OF ALBANIA (JOINT-STOCK COMPANY)

Licence No. 14, dated 28.10.1999

Approved by the Supervisory Council Decision of the Bank of Albania No.105, dated 19.10.1999.

Certificate No. 13 "On Deposit Insurance".

Director: George CARACOSTAS
Address: Rruga "Kavajës", Tirana Tower, Tirana, Albania
Tel.: 225 87 55/ 56/ 57/ 58/ 59/ 60
Fax.: 225 87 52

12. CREDIT BANK OF ALBANIA (JOINT-STOCK COMPANY)

Licence No. 15, dated 28.08.2002

Approved by the Supervisory Council Decision of the Bank of Albania No. 66, dated 28.08.2002.

Certificate No. 14 "On Deposit Insurance".

Director: Kamal Abdel MONEIM

Address: Rruga "Perlat Rexhepi", Al-Kharafi Group Administration Building,
Kati 1&2" Tirana, Albania

Tel.: 227 21 68, 227 21 62

Fax.: 227 21 62

13. CREDINS BANK (JOINT-STOCK COMPANY)

Licence No. 16, dated 31.03.2003

Approved by the Supervisory Council Decision of the Bank of Albania No. 22, dated 26.03.2003.

Certificate No.15 "On Deposit Insurance".

Director: Artan SANTO

Address: Rruga "Ismail Qemali", Nr. 21, Tirana, Albania

Tel.: 222 29 16, 223 40 96

Fax.: 222 29 16

14. POPULAR BANK (JOINT-STOCK COMPANY)

Licence No. 17, dated 16.02.2004

Approved by the Supervisory Council Decision of the Bank of Albania No. 06, dated 11.02.2004.

Certificate No.16 "On Deposit Insurance".

Director: Henri Maus de ROLLEY

Address: Bulevardi "Dëshmorët e Kombit", Ndërtesa Kullat Binjake, Kulla 1,
Kati 9, Tirana, Albania

Tel.: 227 27 88 / 89 / 90 / 91

Fax.: 227 27 81; 228 04 41

15. UNION BANK (JOINT-STOCK COMPANY)

Licence No. 18, dated 09.01.2006

Approved by the Supervisory Council Decision of the Bank of Albania No. 101, dated 28.12.2005.

Certificate No.17 "On Deposit Insurance".

Director: Gazmend KADRIU

Address: Bulevardi "Zogu I", Pallati 13-katësh, përballë Stacionit të Trenit,
Tirana, Albania

Tel: 225 06 53; 225 80 81

Fax.: 225 06 54; 227 28 80

16. FIRST INVESTMENT BANK (JOINT-STOCK COMPANY)

Licence No. 13, dated 16.04.1999

Approved by the Supervisory Council Decision of the Bank of Albania No. 35, dated 27.06.2007.

Certificate No. 12 "On Deposit Insurance", dated 18.07.2007.

Director: Bozhidar TODOROV

Address: Bulevardi "Dëshmorët e Kombit", Kullat Binjake, Kulla 2, Kati 14,
Tirana, Albania

Tel.: 225 64 23/4; 228 02 10

Fax.: 225 64 22

*In addition to banks and branches of foreign banks, the Bank of Albania has as of 30 June 2008 licensed the following entities**:*

NO.	ENTITIES
6	NON-BANK INSTITUTIONS
152	FOREIGN EXCHANGE BUREAUS
2	UNIONS OF SAVINGS AND CREDIT ASSOCIATIONS
133	SAVINGS AND CREDIT ASSOCIATIONS
1	REPRESENTATIVE OFFICES OF FOREIGN BANKS

**The full list of these entities may be found in section "Banking Supervision" of the official website of the Bank of Albania www.bankofalbania.org