

Ardian Fullani: Bank of Albania – 2006 Annual Report

Address by Mr Ardian Fullani, Governor of the Bank of Albania, at the presentation of the 2006 Annual Report of the Bank of Albania, Tirana, 10 May 2007.

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Honourable Mr. Chairman,

Honourable ladies and gentlemen, members of the Economy and Finance Commission,

It is a special privilege for me to present to you, pursuant to law requirements, the 2006 Annual Report of the Bank of Albania.

This report provides a summary of the Bank of Albania activity in implementing the legal and constitutional obligations. First of all let me focus on the national economy performance, and then on more specific parts related to the institutional responsibilities and direct contributions of the Bank of Albania to subduing inflation, maintaining financial stability, enhancing the financial infrastructure and on our role to European and regional integration.

1. Economic developments over 2006

The country's economic development over 2006 has generally complied with its medium-term development plan. The overall Albanian economy has undergone comparably satisfactory growth rates, due to the private sector's dynamism, macroeconomic stability and the fruits of the so-far structural reforms. The banking system has provided a powerful incentive to economic activity sustainability and to growth of credit to the economy by about ALL 70 billion or above USD 700 million.

Based on available economic indicators, the growth rate is estimated at about 5 percent. This growth has been associated with price stability, reflected in an annual average inflation rate of 2.4 percent. The monetary conditions, characterised by historically low interest rates and exchange rate stability have favoured the rise of investments and consumption in the economy. In particular, they have also been reflected in rapid credit growth, by further sustaining the economy growth. The fiscal developments have taken place within the programmed limits, contributing to further consolidation of public finances and budget deficit control.

However, the realization of capital expenditures requires a larger focus on the programmed level, as concerns the pace these expenditures have been carried out.

The economic growth has been reflected also in the labour market. The number of employed persons in the country has boosted, though it has not yet fully reflected the developments in other sectors of the economy. The country's economic activity extension has been associated with increased foreign trade exchanges. The balance of payments has been closed in positive terms, thus supporting the exchange rate stability.

The quantitative and qualitative indicators of economic performance show a satisfactory growth, based mainly on the activities of services and industrial production. The sales carried out by economic enterprises during the first nine-month period accounted for about 11 percent higher than in 2005. The fact that the first quarter recorded a high annual growth of sales shows that services and production enterprises overcame the problems entailed by power supply constraints at end of 2005. The industry sector, particularly the process industry has recorded positive developments. The country's trade activity continues to ensure the majority of sales, and to record significant annual growth rates.

It is estimated that construction sector has performed almost at the same level with that of the previous year. Direct and indirect indexes of this sector impose the necessity for a

broader attention, particularly to a better allocation of private or public financial resources. Construction developments over the recent years, and particularly the extreme concentration of constructions on certain territories, prove the lack of efficient urban development policies, without guaranteeing long-term sustainability of the branch. Furthermore, construction continues to be dominated by housing buildings, lagging behind other strategic items, such as investments in road infrastructure, in industrial constructions, in land improvement and in agricultural infrastructure, as well as other investments directly related to the standard of living of small urban and rural communities.

Agricultural production during 2006 partly recovered the growth rate decline noticed in 2005. The sector growth projection stands at 2.5 per cent for 2006, higher than the growth of 2005, but lower than the average growth rate noticed over five latest years. Investments in agricultural sector and financing by the banking system will increase in accordance with the potential of this branch, providing that hurdles arising from various structural problems are eliminated.

Agricultural land is not used at maximum, because of external and internal migration and the problems with ownership titles. The relatively underdeveloped rural infrastructure makes more difficult the emerging of products in the market. The parcelling out of agricultural land impedes the effective organisation of production, decreases the profitability and raises the agricultural mechanics utilization cost.

The Bank of Albania deems that energy remains our main challenge in the short-run and in the medium-run.

We have been faced with underlined power supply constraints for about a decade. The current crisis coincidence in time with a global environment that is rather sensitive to this problem has relatively increased the energy import costs, which could be unsustainable in the long run. It has resulted out of Bank of Albania surveys that the negative consequences arising from this situation are numerous and directly related to the economic activity of the productive sector, in both levels, corporate and small and medium sized enterprises. The frequent recurrence of such situation poses the risk that periods of significant power constraints are no longer regarded as accidental shocks, but they are more and more classified as permanent factors that should be factorised in the production cost, and hence should be taken into account in pricing policies and their expectations.

To this end, the Bank of Albania estimates that, starting from 2007, all the respective decision-making stakeholders should apply a new concrete management policy, different from the 15-year practice. An integral part of it should be not only the management of current energy resources, but also concrete steps in the distribution network, as short-term measures to pass to long-term operations, which would imply the establishment of alternative energy sources. The solution of the energy situation at the soonest time possible will provide positive impacts on the Albanian business, the soundness of public finances, the country's sustainable economic development and the macroeconomic stability.

Concluding this part, I would like to point out some other issues, which I think should be encompassed in the priority list of the country's medium-term economic and financial development. The Albanian economy is leaving the status of a transition economy and is approaching to that of a developing economy. This qualitative step requires further deepening of structural reforms, enhancement of effectiveness of development policies and enlargement of the country's absorbing capacities in terms of fostering the Albanian economy competitiveness at regional context and beyond it.

I would highlight the constant trade deficit deepening, as an issue of the present and the future. Even though the current cross-border position of the country is not problematic, being materialised in such indicators as external debt, foreign reserve level or overall balance of payments position, I would point out that the rise of exports is not sufficient, particularly in the context of high reliability of the Albanian economy on remittances. The relatively high current deficit, around 7.6 percent of GDP, is another argument in this regard. The latter one, also in

the presence of a fiscal deficit, increases our economy's exposure and makes necessary the provision of foreign currency inflows of a more steady nature. This would be translated into a need for more qualitative foreign direct investments, which in turn, would contribute to a steady growth of exports.

To this end, taking advantage of the global environment, which is constantly searching for new markets, I would suggest a more qualitative national marketing strategy. This strategy should highlight professionally and contemporarily, all the recent incentives and the multiple opportunities Albania provides. Also, I think it is just the time to integrate even the joint regional projects into our long-term development plans. Road infrastructure, energy, communication, tourism and other areas are still underdeveloped in regional level. Therefore, I assess that regional projects of strategic nature raise the interest of domestic and foreign investors. If taken separately the economies of the region are relatively small, but altogether they form an attractive market, with more investment opportunities.

In recent years, it is noticed that the penetration of foreign investments in our region is relatively small and mainly, it reflects the privatization process of important public properties. The same thing has occurred to the Albanian economy. More concretely, during 2000 – 2006, the overall foreign direct investments, according to the balance of payments statistics, are estimated to about USD 1.45 billion, about 3.5 percent of GDP realised over the same period.

If we would identify the reasons why FDIs inflows are so modest, we might mention the complex problems characterising our region, while different reasons that reduce the absorbing capability of our economy exist even in the national plan.

The Bank of Albania deems that the country's current stage of development creates great possibilities in this regard. The experience of the newly acceded countries has indicated that the signing of the Stabilisation and Association Agreement and the following negotiations have been associated by high FDI inflows. However, we can not assume that this phenomenon will be automatically present even in Albania. Therefore, the Bank of Albania deems that further deepening of structural reforms is necessary and that this process should be followed by improvements in the business climate and by enhancement of the degree of law enforcement.

The last but not the least, I would like to point out that the degree of economic activity coverage with statistics is still low. The monetary policy that we are following is an as much dynamic as visionary process. Besides the existence of efficient markets, it also needs to be supplied with new and methodologically accurate statistics.

Besides our constant efforts and good understanding with INSTAT, we find it necessary to appeal for a greater attention of the whole society and of respective institutions in particular, to increasing statistical information and further consolidating the existing one. It is just the time that all the monitoring, licensing and decision-making institutions, including also the numerous nongovernmental organisations, must feel a great responsibility in this regard. It is just the moment that they develop indirect measuring and estimating approaches for many demographic, economic, social and financial indicators.

Let me now present another important issue in my speech, which has to do with one of the main legal responsibilities of the Bank of Albania, i.e., consumer price stability.

2. Inflation and monetary policy

Consumer goods price inflation over 2006 was generally within the Bank of Albania's targeted range of 2 to 3 percent. Year-end recorded a 2.5 percent annual inflation rate. It was almost similar to the 2005 annual inflation rate of 2.4 percent. Inflationary pressures, though moderate, have been increasing over 2006. The average annual inflation rate amounted to

2.7 percent during the second six-month period of the year, from 2.0 percent it was in the first half of the year.

In general, the annual average inflation steadiness during the recent years, speaks for the inflation rate stability, in spite of the fluctuations in time and size of the factors that have conditioned the consumer price performance. Developments on the demand and supply side of the economy have been balanced, without creating premises for inflationary pressures.

The fiscal policy has observed the programmed indicators on annual basis, stabilizing the impact of the public sector component on the aggregate demand. Also, the monetary policy has controlled liquidity conditions and interest rate developments, and has attended the exchange rate performance, monitoring through them the economic activity financial stimuli. On the other hand, the low inflation rates in the recent years have been reflected in anchoring the inflationary pressures of the economy close to the Bank of Albania's target. The latter might have contributed to constraining the second-round effects that may be caused in the Albanian economy by some supply shocks, such as high oil prices and managed price rises, with which the Albanian economy was faced.

Monetary conditions and monetary policy decisions

Monetary policy decisions on the key interest rate in the economy have been taken on the basis of constantly analysing the current and expected developments of the demand and supply factors springing from internal and external environment. Under the conditions when an enlivening of inflationary pressures was evidenced and in the presence of a number of factors expected to further favour this situation, the Bank of Albania decided on changing its monetary policy stance, at the beginning of the third quarter of 2006. This change occurred after a neutral period that had lasted about one year and a half. The monetary policy change was materialised in raising the key interest rate twice during the second half of 2006. In July and November 2006 the one-week repo rate was lifted respectively by 0.25 percentage point. The maturity in monetary policy decision-making was reflected in the time lag between both tightening movements in the interest rates.

In July-November 2006, many assessments have been made on the degree of banking market response and sensitivity to monetary policy stance on interest rates. The interest rate rise by 0.5 percentage point is estimated to have normalised the annual monetary supply growth rates, fully responding to the public and private sector demand for monetary assets. Monetary policy operations have assisted in stabilizing inflationary pressures of economic agents in the medium run.

Fiscal policy

The Bank of Albania has estimated that during 2006, the fiscal policy provided a satisfactory support to inflation developments. Fiscal indicators were realised in accordance with the budgetary program, preventing premises for inflationary pressure rise in the economy. During the fourth quarter of 2006, a high concentration of budgetary spending was noticed. The budget deficit realization as of year-end, estimated at about 3.2 percent of GDP or 0.7 percentage point less than that of the previous year, has influenced on the contraction of inflationary pressures and control of monetary expansion.

Demand factors

During 2006 domestic demand has significantly sustained the positive economic growth rates. Good performance of the domestic demand has been indicated by a number of economic activity indicators. Hence, the sales index for the first nine-month period of the year recorded an annual growth of 12.4 percent. In particular, the rise of imports of machinery and equipment and the real estate credit growth are indicators of investment expansion in the country. The domestic demand has been increasing also due to rapid growth of lending

activity, which recorded a 57 percent increase in annual terms. Notwithstanding the positive effects of investment expansion, the domestic demand growth exercises pressure on the overall price rise.

In absence of any obvious inflationary pressures on the demand side, it is estimated that the Albanian economy is making use of free capacities without raising the costs and final prices of goods and services. Also, it should be highlighted that part of this domestic demand has been met by rise of imports and trade deficit, thus mitigating the pressure on consumer prices.

Supply factors

Import prices

The Albanian economy is a relatively open economy and therefore, import prices constitute an important element of the country's inflation. Generally speaking, the economic conditions of trade partner countries of Albania have been favourable during this year, easing the control on supply side pressures and enabling the observance of inflation target.

Oil prices

Consumer prices during 2006 were influenced by a stressful situation in the interbank oil price market. The impact of this factor, as concerns the intensity of operation in inflation rate, was not uniform, being higher during the first nine months of the year and recording a decline during the last quarter.

Exchange rate

During 2006 exchange rate developments have dampened inflationary pressures of the supply side. The national currency has been appreciated against the American dollar and has maintained unchanged its position vis-à-vis the euro. The lek's appreciating tendencies, though weakened in the recent months, have led to the decline of import price in domestic currency. In this way, the exchange rate has contributed to containment of the high international oil price effect and to maintaining a low inflation rate.

Agricultural production

Agricultural production is one of the main domestic factors, which condition the consumer price developments. The quantity of domestic agricultural production influences instantly on foodstuff price level. During 2006, the seasonal effect of agricultural production rise appeared later than in the preceding years, leading to foodstuff price decreases only in September and October.

Production prices

During 2006 the production prices continued the downward trend noticed since April 2005. However, the concentration of production price index on the productive sector of industry makes difficult its comparison to consumer price index. Also, the domestic production share is not yet a determinant component of goods supply in the domestic market, thus not affecting the consumer prices.

Wages and unemployment

The good performance of the economic activity during 2006 was also reflected in labour market indicator, and particularly in unemployment rate. New employment possibilities were created, making unemployment rate continue its downward trend observed since more than two years ago. Improvements have also been made in terms of incomes. So, government sector wages, the minimum wage and pensions have increased in accordance with the

budget plan. The so-far inflation performance shows that Albanian economy does not suffer from any significant discrepancy between wage rise and productivity.

Inflationary expectations

The business and public expectations in short- to medium-term have fluctuated around the inflation rates recorded. According to Bank of Albania periodic estimates, the public expectations have converged, mostly around 1-3 percent. In the meantime, the business expectations on price performance have reflected a high volatility. The monetary policy and the consolidation of macroeconomic stability have played an important role in anchoring the expectations of public at large to Bank of Albania's inflation targeted rate.

3. Money supply

During the major part of 2006, monetary indicators have reflected the stabilised demand for monetary assets. The average M3 growth rate resulted to 12 percent. The demand for money of the public sector grew by 3.3 percent during 2006. This relatively low borrowing has balanced the high lending rates of the private sector, positively impacting on the maintaining of monetary stability. In compliance with the trend noticed over the latest years, monetary developments have been characterised by shifting to longer-term monetary assets.

Currency outside banks has followed the general trend of the demand for money. The currency outside banks to M3 stood at 24.2 percent at year-end or 1.7 percentage points less than in the previous year. In nominal terms, the currency outside banks grew by ALL 13.6 billion or 9.1 percent.

The macroeconomic environment during 2006 has been favourable for a steady growth of banking system lek deposits. The positive real interest rates have been associated with further rise of lek deposits. They rose by 38 billion during 2006, satisfying the needs of the economy for ALL 35.9 billion and the needs of the government for credit in ALL.

In 2006 foreign currency deposits rose by about 29.4 percent. The higher growth rate of foreign currency deposits versus the money supply growth rate led the ratio of foreign currency deposits to M3 to about 29 percent. The share of foreign currency deposits to total deposits rose to 38.5 percent, against 35.5 percent in 2005.

4. Demand for money

The increase in the demand for money reached its peak in December, by an annual rise of 16.7 percent. The main contribution to the increased demand for money throughout the year was rendered by credit to the economy. This contribution recorded its maximum in June, being mitigated during the coming months due to growth of public borrowing. Foreign currency position has maintained a relatively steady weight in establishing monetary assets during the year.

Credit to the economy

The banking system developments and the increased role of banks as financial intermediaries, have led to significant expansion of lending activity during the recent years. The loans portfolio amounted to ALL 191.2 billion or 21.3 percent of GDP at end of 2006. The loans portfolio for the economy constituted 31.3 percent of total banking system assets and about 37.4 percent of the banking system deposits.

During 2006, credit to the economy increased by ALL 69.3 billion in absolute terms, compared to ALL 52 billion in 2005. During two latest years, commercial banks have better met the increasing demand for ALL loans, which at end of 2006 constituted 29 percent of the loans portfolio, thus evidencing a moderate extension of its share.

Corporate credit constitutes the main share of banks' portfolio, amounting to 66.5 percent of the total at end 2006. In annual terms, corporate credit increased by 52 percent. The credit distribution structure by use has tended to be more uniform in comparison with the previous year. Most of corporate loans (34.5 percent) have been used for purchasing machinery and equipment, while 23.2 percent of corporate loans portfolio has been used for financing investments in activity area expansion.

In 2006 the household credit was 7 percent of GDP, or 33.5 percent of the total loans portfolio. More than half of loans to households (59.3 percent) have been extended for financing real estate purchases, while the financing of consumer goods purchases has also increased. The ratio of consumer loans to total household portfolio is 27.3 percent, from 20 percent in the previous year. In particular, consumer loans increased obviously during the summer holidays and during the end-year celebrations.

Concerning lending to specific sectors, it should be underlined that trade remains the sector mostly credited by the banking system, by 22.4 percent of the loans portfolio. The growth rate of credit to construction has been inhibited during 2006. This sector presented temporary improvement signs during the summer, then turned back to the downward trend. In the meantime, the low volume of credit to agriculture speaks for constant structural problems that inhibit lending to this sector.

Given the geographical coverage with loans, it is observed that 68 percent of the portfolio is concentrated in Tirana. Durrës and Vlora come afterwards, by respectively 8 and 4 percent of the loans portfolio. This reveals the high economic importance of Tirana, and the need for improving the economic infrastructure in the rest of the country.

Net foreign assets

The foreign currency position of the banking system improved during 2006. Net foreign assets of the banking system amounted to US\$ 2.4 billion at yearend, recording an annual growth of about US\$ 440 million.

Government demand for money

The government account has had an unusual performance during 2006. During the major part of the year, the government demand for money was negative, concentrating the planned domestic borrowing on two last months of the year. The overall deficit financing for 2006 resulted to about ALL 22.6 billion.

5. Financial market and interest rates

Year 2006 was characterised by an increased activity in money and capital market, while the interest rate performance was generally oriented by the Bank of Albania's monetary policy. Under the conditions of excess liquidity, the interest rates had a downward trend during the first half of the year. The interest rates went upward after the tightening signal of monetary conditions in the second half of the year.

The interbank market was more active during 2006, thus ensuring a more efficient way of banks' excess liquidity management. The average daily volume of transactions amounted to ALL 1.6 billion or ALL 0.2 billion more than the previous year average. The interbank market was characterised by narrowing the interest rate spread according to maturities and their positioning close to key interest rate. The average overnight-weekly interest rate spread dropped to 0.7 percentage point in 2006, from 1.6 percentage points in 2005.

In the first half of 2006, there was a constant decline in treasury bills yields and government bonds, due to low government demand for funds. In the second half of 2006, following the Bank of Albania's tightening signals and the increased demand for liquidity in the system,

there was a gradual rise of these yields. The yields increased respectively by 0.83, 0.45 and 0.98 percentage point in comparison with the previous year.

The government bonds issues has increased compared to the previous year, making the banks' portfolio, as the sole participants in this market, increase to ALL 37.0 billion. The share of bonds to total government securities increased 22 percent in 2006 from 12 percent in the previous year. Their maturity structure varies from 2 to 5 years. Five-year bonds were issued for the first time in November of this year, for the amount of ALL 6.3 billion. The demand for them resulted higher than the issued amount.

Lek deposit interest rates went down during the first half of 2006, and up after the tightening monetary policy signals. The interest rates were raised faster for long-term maturities, reflecting the adjustment of their term to long-term government debt rise.

Lek credit interest rates went down for all maturities during 2006. The weighted average interest in December 2006 fell to 12.92 percent, from 13.50 percent it was in the previous year. Though the intermediation cost declined in comparison to the previous year, the spread level is still high. It is influenced by imperfect competition in this market and by higher risk nature of loans extended in ALL.

The interest rates of deposits denominated in lek and euro continued to go up, as a result of monetary policy tightening by the Fed and the European Central Bank during 2006. Simultaneously, the interest rates of loans extended in these currencies went up. The interests of six-month to one-year loans in Euro and six-month loans in USD underwent the highest rise. At end of 2006, the weighted average interests of loans in USD amounted to 9.42 percent and interests of loans in Euro amounted to 8.17 percent, from 8.47 percent and 7.95 percent they were respectively at end of the previous year.

6. Exchange rate

During 2006, the Albanian lek has maintained its appreciating trend against the principal foreign currencies, though at a low intensity. In effective nominal annual terms, the lek has been appreciated on average by 1.1 percent during 2006. During the previous year, this appreciation was 2.8 percent. The lek-foreign currency interest rate spread, though downward during three latest years, continued to be at positive levels.

Economic developments during 2006 have sustained a stable domestic currency. The lek's appreciating pressures have been concentrated mainly on July-August and December. Besides the seasonal entry of foreign currency, which is the main factor of the lek's appreciation over this period, the key interest rate increase has also been reflected in the market. The high foreign currency supply over this period has been absorbed partly by the Bank of Albania's interventions, in respect of the target on the rise of net international reserve and in compliance with the country's overall macroeconomic program.

7. Monetary policy instruments

Fixed-price one-week repurchase agreement is the main instrument employed during 2006. According to the liquidity situation, the Bank of Albania has switched from repurchase agreements to reverse agreements, while the maturity term has changed from weekly to quarterly. This spectre of movements has been imposed by seasonal factors, by the budget behaviour and by the need to reveal certain monetary policy signals.

To meet longer-term needs of the market for liquidity during the four last months of 2006, four Treasury bill outright purchase transactions were carried out, at a total nominal value of ALL 3.2 billion.

During 2006 commercial banks employed the overnight deposit facility for investing their free liquidities with the Bank of Albania, on average at ALL 1.6 billion a day or ALL 0.82 billion more than in 2005.

Overnight credit has been employed only in seven cases, despite the lack of liquidity over the third quarter of the year. For the fourth consecutive year, the final lending facility of the Bank of Albania, i.e., the Lombard loan was not employed at all.

The required reserve instrument was used constantly even during 2006, for withdrawing the banking system liquidity. The monthly pace of ALL required reserve rise during 2006 was on average higher than in 2005, 0.92 percent versus 0.76 percent, reflecting the rise in the respective categories included in the required reserve account.

8. Foreign reserve management

During 2006 the gross foreign reserve, estimated and reported in USD, has been increased by USD 368.06 million, recording the value of USD 1,793.12 million as at end of December.

Out of this growth, about USD 205 million is accumulated from Bank of Albania's interventions in foreign currency. They were intended at meeting the quantitative target for these assets and mitigating the volatility over the peak periods of foreign currency supply. While the exchange rate effect has been positive, at USD 106 million, the rest of the growth has been contributed by receipts from foreign disbursements.

9. Banking system performance

The banking system continued its stable development during 2006. The net banking system result for 2006 stood at a profit of ALL 7.45 billion, about 12.9 percent more than in 2005. Revenues from the principal activity (net income from interest) resulted to 31.2 percent more than in the previous year, reflecting the banking system orientation to activities of higher return and a rise in the overall volume of assets.

At end of 2006, the net income from interests was 92.6 percent of the gross banking system incomes, compared to 84 percent at end of 2005. This indicator has recorded constant growth, particularly over three last years, reflecting the overall net income sustainability for the banking system.

During 2006, the banking system assets grew by All 127.7 billion, or about ALL 57.6 billion more than the growth of assets noted in 2005. The main contribution to the growth of banking system assets was given by large banks, though their share in the market is downward. The estimates show that the lending activity concentration level is lower than that of assets and deposits concentration.

The significant growth of lending has been associated with increased share of non-performing loans portfolio, by about ALL 3.1 billion compared to end of 2005. The loans portfolio quality indicator, expressed as a ratio of nonperforming loans to total loans portfolio in gross terms, is estimated at 3.1 percent as at year-end, against 2.3 percent as at year-end 2005.

The banking system capability of covering loss loans with capital has been downward, but still at good levels. The "non-performing loans to outstanding loans (net)" indicator, which estimates the net size of exposure to credit risk, continues to be at low levels, by 1.4 percent as at year-end 2006.

Compared to year-end 2005, the capital adequacy ratio of the system decreased by 0.5 percentage point down to 18.1 percent at end 2006. The capital adequacy ratio for 2006 continued to maintain the downward trend reflected in the preceding years. Large banks

have recorded a rise of capital adequacy indicator, mainly due to increased regulatory capital at end of the year, by about 62.3 percent.

At end of 2006, the ratio of liquid assets to total assets of the banking system recorded 57.6 percent, compared to 62.6 percent it was at end of December 2005.

During 2006 the banking system underwent important qualitative and quantitative developments. At end of 2006 the Albanian banking sector consisted of 17 banks, of which three are of fully Albanian private equity. At the beginning of 2006 the Union Bank commenced its activity. On May 2006, there was approved the selling of the Italian-Albanian Bank's 80 % stake, which belonged to the Ministry of Finances of the Republic of Albania and to Capitalia S.A., Italy, to the new stockholder SanPaolo IMI S.p.A., Italy. At the same period, there was also approved the 60 percent (plus 2 shares) ownership transfer of the National Commercial Bank's stake from Kent Bank/Bayindir Bank, to the new Turkish institutional stockholder, Çalik-Seker Konsorsiyum Yatirim Anonim.

On August 2006 the ownership transfer of 11.25 percent of the ProCredit Bank's stake, from EBRD to ProCredit Holding AG (existing shareholder) was approved. On October 2006, the 71.97 percent transfer of the stake of Emporiki Bank S.A. of Greece to Credit Agricole S.A., France shareholder was approved. This transfer influenced also the indirect participation of Credit Agricole S.A. to the Emporiki Bank of Albania's equity, to the same extent.

During 2006, the banks' network was extended also by 62 new branches and agencies, in the whole territory of Albania and abroad, having the highest share in Tirana, with the establishment of 30 new branches and agencies. Also, the opening of two branches outside the territory of Albania was approved and the opening of two other new branches is under the process of approval.

10. New activities of the Bank of Albania

Payment system

From the regulatory and operational point of view, the payment system in Albania has already created the physiognomy of a modern system. The number of transactions processed during 2006 has increased by 13 percent, compared to 2005. In the meantime the value of transactions has increased by 21 percent during 2006, amounting to ALL 2,664.43 billion. Compared to 2005, the daily average number of payments (in both systems) has increased from 312, to 352 or 40 more transactions per day. In 2006, a new bank was added to the payment system, leading the number of participants to 17 banks.

On March 2006 the e-payment settlement by VISA cards started. Currently, this scheme counts 6 member banks. The number of cards in circulation has increased by 9 times during 2006, compared to 2004. The addition in cards number counts 127,552 cards compared to 2005, i.e., about 56 percent. Parallel to increased number of cards, the number of ATMs and POSs has also increased, respectively by 130 and 404.

International integration and cooperation

The Bank of Albania's obligations stemming from the SAA relate to the meeting of the economic criteria of Copenhagen, guaranteeing the right of establishment and freedom of services for banks and other communautaire financial services, liberalizing capital movement and current payments between Albania and the EU, and approximating Albanian legislation to that of the *acquis communautaire* in these areas.

One of the most important developments during 2006 regarding the approximation of national legislation to that of the *acquis* was the drafting of the Law "On Banks in the

Republic of Albania". This Law has adopted the largest part of the provisions of the 2000/12/EC Directive, with regards to initiation and continuation of credit institutions activity.

On 8 November, 2006, the European Commission published the Albania 2006 Progress Report. The European Commission evaluated in the report the policy followed by the Bank of Albania in terms of cooperating with international financial institutions and maintaining inflation under control, contributing to keeping a steady macroeconomic environment in the country.

At the same time, the Commission also evaluated the reliable monetary policy followed, highlighting particularly the measures taken by the Bank of Albania in terms of gradually changing its monetary policy strategy towards explicit inflation targeting regime, aiming at enhancing transparency and credibility of its monetary policies.

The report highlighted also the positive developments in the banking sector of the country and assessed the progress achieved regarding the establishment of the loans register, free movement of banking and financial services, freedom of establishment of foreign banks and further liberalization of capital movement.

On 27 January, 2006, the Executive Board of the IMF adopted the three-annual agreement with Albania, at SDR 17.045 million. The main targets of the new program have to do with the maintaining of macroeconomic stability, as a prerequisite for economic growth, and the improvement of financial institutions.

Under Reserves Advisory and Management Program (RAMP), during 2006 the World Bank's group provided consulting and technical assistance to the Bank of Albania for foreign reserve management.

During 2006 the Bank of Albania established constant contacts with the EBRD, mainly in terms of providing information and statistics for the development of the Albanian economy in general and financial sector in particular. The Transition Report 2006 assessed positively the maintaining of inflation within the Bank of Albania's target and the consolidation of the banking system over 2006.

The Bank for International Settlements (BIS) is another institution with which the Bank of Albania kept close contacts during 2006. The BIS has been particularly active in providing technical assistance to the Bank of Albania, through workshops and training courses organised by the Institute of Financial Stability, which promotes the international financial stability through information sharing and cooperation in financial system supervision area.

During 2006 the Bank of Albania enhanced the mutual relations with the central banks of the region and beyond it. Personally, I have paid official visits to many central banks of the region and Europe, discussing about latest developments in the Albanian economy and further extension of mutual cooperation and technical assistance that these banks can provide to the Bank of Albania. In June the Governor of the Bank of Greece, Mr. Nicholas C. Garganas paid a two-day official visit to Albania. It took place in the light of mutual relations between both institutions, laying special emphasis on sharing of information and experience in banking supervision area.

Enhancing relations with central banks of the region reached the peak in the round table of October 2006 held in Tirana, where the governors of the central banks of Rumania, Serbia, Montenegro, Bosnia and Herzegovina and Kosovo discussed about financial stability of the region.

In the framework of the Bank of Albania's objective to benefit from the experience of the central banks of the CEE, recently acceded in the European System of Central Banks (ESCB), during 2006 the cooperation relations with the Central Bank of Poland, National Bank of the Czech Republic and the National Bank of Bulgaria have been intensified.

Currency issuing

The increase of currency in circulation over 2006, by ALL 14, 7 billion is a response to the balanced macroeconomic development of the country. The commercial bank's receivables by the Bank of Albania during 2006 stood at ALL 105 billion, remaining almost at the same level with that of 2005. Concerning cash payments, from Bank of Albania's cash-boxes to commercial banks, the supply was carried out according to their requests, and intending, at the same time, to maintain the currency in circulation structure within the projected limits for year-end 2006.

The velocity of money circulation over 2006, for the shortened cycle of circulation, totalled almost at the same level as in 2005. However, the velocity of circulation underwent changes for certain denominations of banknotes and coins. Hence, a significant increase of velocity of circulation was proved in the 5.000 lekë, 1.000 lekë and 500 lekë denominations, respectively by 13.3 percent, 38.9 percent and 8.3 percent.

Changes in banking legislation

During 2006, further to the signing of the Stabilization and Association Agreement on 12 June, 2006, the banking legislation was amended and improved substantially once the Law "On the Banks in the Republic of Albania", No. 9662 of 18.12.2006 was passed by the Assembly of the Republic of Albania, which shall become effective on 1 June, 2007.

The Law "On the Banks in the Republic of Albania" enables the European Union member states banks and all foreign banks to provide banking services to Albania, through their branches or subsidiaries, without making any distinction in the licensing terms for their branches and subsidiaries and for Albanian banks. Furthermore, in line with the SAA provisions, the adopted law requires their treatment as Albanian banks in every aspect, once they are granted the licence to carry out banking business and financial activity.

The new law provides for clearer rules on management of risk the banks may be faced with while carrying out their activity, in order to guarantee and strengthen the protection of depositors and investors and to maintain banking system stability. Given the current conditions of rapid credit growth in the banking system, the new law treats fully the other types of risks as well, other than that of credit risk, with which banks may be faced, and the permitted exposures of the latter ones when faced with such risks.

The law requires for the first time, inter alia, the establishment and maintaining by the Bank of Albania of the loans register. Under the conditions of a rapid credit growth, the purpose of establishing such a register is to assist banks in making well-informed decisions when extending loans to their clients, as well as to strengthen the Bank of Albania's supervision on the Albanian banking system.

During 2006 the Bank of Albania started examining the prerequisites and implementation conditions over a mid-term period (year 2009), of a new monetary policy regime. In this context, analyses are carried out about the possibilities of improving the legal infrastructure for the creation of such conditions in compliance with international standards in this area. Also, the possibility of improving the organic law of the Bank of Albania has been considered, coinciding with the prediction of its alteration as a mid-term priority of the National Plan for the Implementation of the SAA.

It is forecasted that these alterations will stipulate clearly the competences and procedures for the decision-making process of the Bank of Albania and the transparency of this process, which constitutes also a substantial precondition for the compilation and implementation of an effective monetary policy.

In the framework of the legal reforms undertaken by the Ministry of Justice for the amendment and improvement of the Civil Procedure Code, the Bank of Albania has been

fully committed to cooperating with the banking sector for the completion and accuracy of mandatory execution procedure of executive titles.

The Bank of Albania proposals have aimed at improving the legal base on the application of procedures for the execution of acts that constitute executive titles. The main purpose is to cut the time for the execution of those acts, aiming to increase security in the lending activity, thus reducing the credit risk the banks are faced with.

At end of 2006, the Bank of Albania closely cooperated with the Ministry of Finance in compiling the draft-law "On Preventing Money Laundering and Terrorism Financing". In accordance with the respective European Union directives and other international recommendations, the Bank of Albania, being the supervisory authority of the banking system, regards with priority the legal framework improvement for preventing the use of banking system for laundering money and wealth that derive from criminal activities.

During this year, with the assistance of the World Bank, the drafting and completion of the regulatory framework for foreign reserve management was carried out successfully, reviewing the Bank of Albania's policy on the management of such reserve, the management criteria and terms, as well as the decentralization of decision-making competences during this process.

Internal audit

In 2006, 44 audits and 3 verification procedures were carried out. The inspectors presented 269 findings and 197 recommendations out of these audits, which were carried out at the Bank of Albania and at its five district branches, the Printing House included.

11. Bank of Albania balance sheet

During 2006, the Bank of Albania assets further increased, totalling ALL 255.5 billion, about 14 percent higher than at end 2005.

The constituent groups, both foreign currency and domestic assets, have reflected growth, while the first group occupies about 68 per cent of total assets, the same level as that of the previous year. On the liability side, foreign currency liabilities fell slightly (from 8 to 7 percent of the total) in comparison with the previous year, whereas domestic liabilities increased by 16 percent. Currency in circulation is the indicator that bears the main weight in this growth (about 45 percent of the growth), followed by the "due to the government" item (about 29 percent of the growth) and "due to banks" item (about 26 percent of the growth).

In general, the accounting balance sheet of the Bank of Albania and the income and expenditure statement reflect some basic developments that have occurred in the economy, where the Bank of Albania plays an important role.

The revenues realised during 2006 outstripped the level of the previous year only by about 5 percent. The main impact on this growth was given by income on foreign currency interests (about 20 percent more than in 2005). This reflects the performance of interest rates in foreign exchange markets. This effect absorbs the reduction of "income from ALL interests" item (about 7 percent less than in 2005), which reflects an average interest rate below that of 2005, irrespective of the upward trend at year-end.

On the other hand, interest expenses outstrip the previous year level by about 25 percent, reflecting the positive phenomena of the increased level of deposits and liquidity position in the banking system. Foreign currency interest expenses have been outstripped by 64 percent compared to the previous year, whereas ALL interest expenses have increased by 14 percent. Other (operational and amortization) expenditures are almost at the same level with that of the previous year.

Finally, the almost full compensation between increase of incomes and expenditures makes the net profit of the Bank of Albania for 2006 be in the same level with that of the previous year, at about ALL 5.16 billion (or 99.6 percent of the profit for 2005).

Honourable deputies,

Concluding my speech, I would like to underscore that during 2006 the Bank of Albania included in its agenda all the recommendations given by the Albanian Parliament in its resolution adopted on 25 May, 2006. I would also like to assure you that even in 2007, the same philosophy will characterise our work. Understanding correctly the role and mission of our institution, on behalf of the Supervisory Council of the Bank of Albania, I declare that the Bank of Albania will continue to be an accountable institution, deeply committed to fulfil its obligations vested by the Law and the Constitution.

We have many priorities for 2007, but let me highlight the most important ones:

- Maintaining consumer price stability remains the main legal target of the Bank of Albania. We are confident that the decisions taken in 2006 were appropriate and have served to orient inflationary expectations to the targeted range. Based on our forward-looking philosophy, we will prudentially evaluate all the risk factors, so that we operate on due time and intensity.
- Macroeconomic stability is of primary importance, but definitely the financial stability is also of as much crucial importance. Given the importance and the current level of economic and financial development of the country, this priority assumes extraordinary importance. Furthermore, the rapid credit growth is an argument for more prudence, particularly with regard to its quality. Being fully aware of our role as a decision-making and regulatory institution, we have decided to raise our vigilance in this regard, establishing the Financial Stability Department as a first step.
- Once more, the Bank of Albania emphasises its objective for further consolidation of the banking system. This process, which was present during 2006, should further continue in the current year. Our intention is that the banking system becomes a unity of sound institutions: that are supported by powerful shareholders, experienced in banking industry; that apply best standards of accountability in management; that carry out a balanced activity with well-managed risks; that are able to be faced with and develop under the open market competition provided by an open and integrated market into the international financial market; that support the economic development of the country and that transparently provide efficient and qualitative banking products and services to the public.

I would like to thank the Albanian Parliament once more for the good understanding and constant support it has given to the Bank of Albania.

Thank you for your attention.