July 2006
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Albania: 2006 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Financing Assurances Review—Staff Report; Staff Supplement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Albania

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2006 Article IV consultation with Albania, first review under the three-year arrangement under the Poverty Reduction and Growth Facility, review under extended arrangement, request for a waiver of nonobservance of a performance criterion, and financing assurances review, the following documents have been released and are included in this package:

- the staff report for the combined 2006 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Financing Assurances Review, prepared by a staff team of the IMF, following discussions that ended on May 11, 2006, with the officials of Albania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 7, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of July 19, 2006 updating information on recent economic developments.
- a Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its July 24, 2006 discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- a statement by the Executive Director for Albania.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Albania*
Memorandum of Economic and Financial Policies by the authorities of Albania*
Selected Issues Paper
Technical Memorandum of Understanding*
*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ALBANIA

Staff Report for the 2006 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Financing Assurances Review

Prepared by the European Department
(In consultation with other departments)

Approved by Ajai Chopra and Scott Brown

July 7, 2006

- Discussions for the 2006 Article IV consultation, first review under the PRGF/EFF-supported program and financing assurances review were held in Tirana during April 26–May 11, 2006. The mission met with Prime Minister Berisha; Ministers Bode (Finance), Ruli (Economy, Trade, and Energy), and Basha (Transportation); Governor Fullani of the Bank of Albania (BoA); parliamentarians; academics; and representatives from business sectors, civil society, and the international donor community. The staff team comprised Messrs. Székely (head), Lazar, Oestreicher (EUR), Ganelli (FAD), Ms. Stuart (PDR), Ms. Westin (resident representative), and Ms. Spahia (resident representative's office). Mr. Chopra (EUR) and Mr. Gola (Executive Director's office) participated in the Article IV consultation discussions. A parallel MFD mission headed by Mr. van der Vossen visited Tirana April 24–May 12, 2006 to provide advice on strengthening prudential regulation and bank supervision.

- The 2004 Article IV consultation was concluded on February 28, 2005. The current arrangements, in an amount equivalent to SDR 17.045 million (35 percent of quota), were approved on January 27, 2006 (IMF Country Report No. 06/54)). Albania participates in the GDDS, and a data ROSC was carried out in March 2006. A safeguards assessment of the BoA was conducted in May 2006 and the report will be completed shortly. A fiscal ROSC was carried out in June 2003.

- In the attached (see supplement) Letter of Intent and Supplementary Memorandum of Economic and Financial Policies (MEFP), the authorities request completion of the first review and financing assurances review; and a waiver for the nonobservance of a performance criterion.

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EXECUTIVE SUMMARY

Albania's macroeconomic performance since the turn of this decade has generally been good. Growth has been rapid and the country is now emerging from the low-income country group. Together with large remittances, the rapid growth has significantly reduced poverty. Debt is declining, and macroeconomic stability has been maintained.

Past accomplishments notwithstanding, macroeconomic stability may be threatened by rapid credit growth and export shocks. Growth is expected to decline to 5 percent this year, and the external current account deficit to widen to 8.1 percent of GDP. Moreover, underlying demand pressures are rising, spurred by rapid private credit growth.

On the structural front, progress with reform has been uneven and the business environment remains relatively uninviting. Despite advances, weak public institutions remain a source of vulnerability. Together with infrastructure deficiencies—including in the electricity sector—these factors constrain medium-term growth capacity. There is no indication of a significant exchange rate misalignment, but the lack of non-price competitiveness hinders investment and exports.

Policy discussions focused on the near-term policy corrections required to maintain macroeconomic stability and on structural reforms needed to promote growth and reduce vulnerabilities over the medium-term.

- To safeguard loan quality, there was agreement on measures to strengthen banking supervision and enhance prudential regulations. Work is also underway to establish a credit bureau and improve the legal framework for collateral execution. These measures are also expected to reduce the rate of credit expansion by increasing effective lending costs.

- As the projected credit growth in 2006 would still generate a small demand impulse, a mid-year fiscal adjustment will be made in the 2006 supplementary budget.

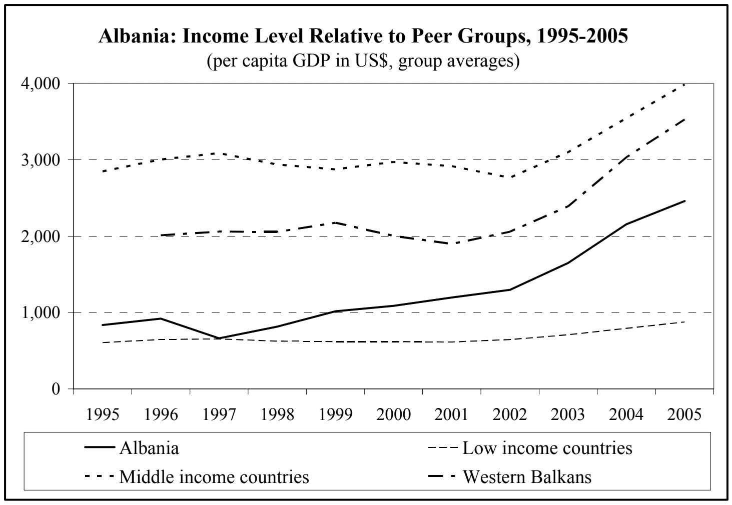
- Staff supported the authorities' strategy of developing a small but efficient government concentrated on its core functions. A rising share of expenditure will be devoted to investment and other priority expenditure. Future gains from tax administration reform will be devoted to tax relief and debt reductions. The planned supplementary budget will allocate expected structural revenue gains in 2006 according to this strategy.

- Growth enhancing institutional reforms should focus on areas where Albania lags its new competitors, such as property rights and contract enforcement, and privatization should be accelerated in non-core areas of government.

The implementation of the PRGF/EFF-supported program has been broadly satisfactory, but the performance criterion on the collection and loss rates of KESH was missed. However, the authorities have taken strong corrective actions. They have adopted a revised strategy for the electricity sector to promote significantly increased private sector involvement, including the privatization of electricity distribution. Moreover, they have secured the technical assistance necessary to move ahead quickly in this area as a prior action for approval of the review. Therefore, staff supports the authorities' request for a waiver for the nonobservance of this performance criterion.

INTRODUCTION

1. **Macroeconomic performance since the beginning of this decade has been strong, and Albania is now emerging from the low-income country group (Table 1).** Per capita GDP in US dollar terms has more than doubled during this period, helped by the successful implementation of PRGF-supported programs. Together with large remittances, the rapid growth has significantly reduced poverty, although further efforts will be needed to achieve some of the Millennium Development Goals (Table 2). Macroeconomic stability has been maintained, evidenced by a narrowing of the external current account deficit, the establishment of price stability, increasing confidence in the currency and the banking system, and rising international reserves.



2. **These positive developments owe much to sound fiscal and monetary policy frameworks**. Fiscal policy has been aimed at containing net domestic borrowing and lowering public debt, which fell from above 67½ percent of GDP in 2001 to below 55½ percent in 2005 (partly helped by debt rescheduling). Fiscal consolidation has supported the monetary policy framework—a reserve money program with the repo rate as the main policy instrument, combined with a de jure and de facto floating exchange rate regime—which strives to keep inflation in a 3±1 percent target range.

3. **However, progress with structural reforms necessary to maintain Albania's high growth potential has been mixed.** As a result, Albania lags behind middle-income countries—its new peer group—with respect to quality of business climate and institutions. The differences are most pronounced in crucial areas such as corruption, rule of law, and infrastructure development (Table 3). The resulting low level of non-price competitiveness deters investment and the expansion of the export base, which is less than half of the typical size for a country at Albania's income level. Moreover, major vulnerabilities remain due to the sizable short-term domestic public debt, a culture of tax evasion, and poorly regulated and supervised nonbank financial institutions. These issues will need to be addressed if Albania is to improve, or even maintain, its position relative to middle-income countries. Political risk, however, appears to be declining following

peaceful elections and transfer of power in 2005, and as the prospect of EU and NATO accession increasingly provides a strong external anchor.

4. **Although the performance criterion for the financial performance of the state-owned electricity company (KESH) was not met, the implementation of the PRGF/EFF-supported program has been otherwise broadly satisfactory.** All other targets of the program were met (Table 4). Revenue administration reforms are progressing well, and an action plan to implement the recommendations of the 2005 Financial System Stability Assessment (FSSA) has been developed.

I. Recent Developments

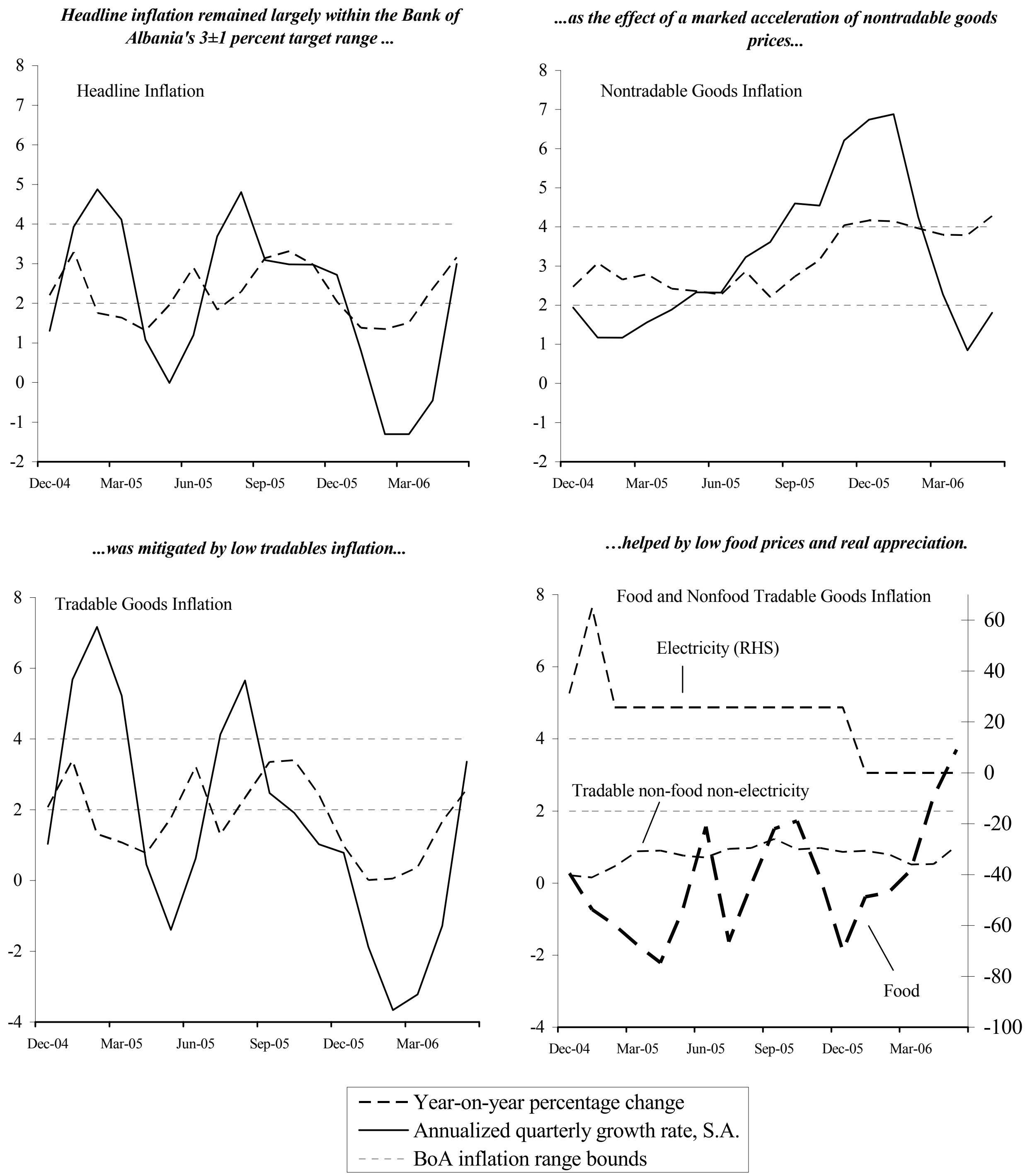
5. **Past accomplishments notwithstanding, recent unfavorable developments pose new challenges.**

- **The external position has deteriorated.** The current account deficit increased to an estimated 7¾ percent of GDP in 2005, up from 5½ percent in 2004 (Tables 5a, 5b). Hit by weakening import demand in Italy, its main trading partner, and by intensifying competition from China in its main product market (textiles), Albania's export growth decelerated in 2005. This, together with strong import demand and higher oil import costs, caused the trade deficit to widen in 2005, a trend that appears to have continued in the first quarter of 2006.

- **Low and relatively stable headline inflation masked a steady pickup in non-tradables inflation (Figure 1).** The latter reached the upper end of the 3±1 inflation target range, indicating emerging capacity constraints in non-tradable sectors. Low food prices and the appreciation of the lek following the elections, however, kept tradables inflation in check.

- **Growth has slowed.** The electricity crisis in October–November 2005 hit the economy hard and, together with major governance problems within KESH, led to a sharp worsening of the company's financial performance (Box 1). Following a boom in 2003–04, economic activity in the construction sector has weakened. These factors, together with a slowdown in exports, led to a decline in growth from 6 percent in 2004 to 5½ percent in 2005. The economy weakened further in the first quarter of 2006, reflecting the emerging capacity constraints in

Figure 1. Albania: Price Developments
December 2004 - May 2006



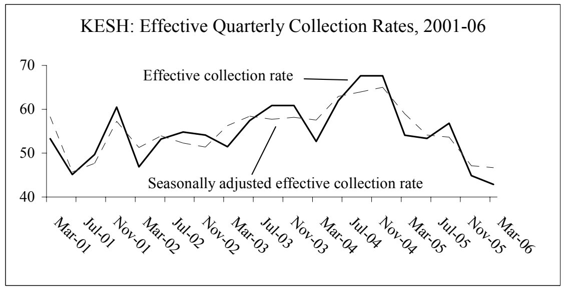
Source: Data provided by INSTAT.

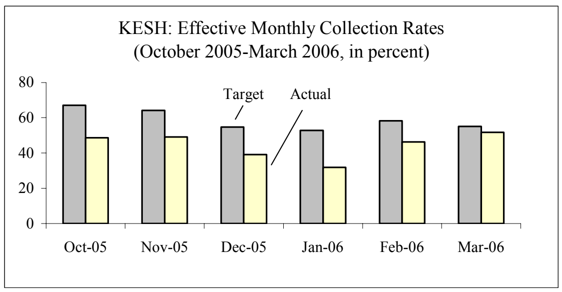
Box 1. Developments in the Power Sector, 2001–06

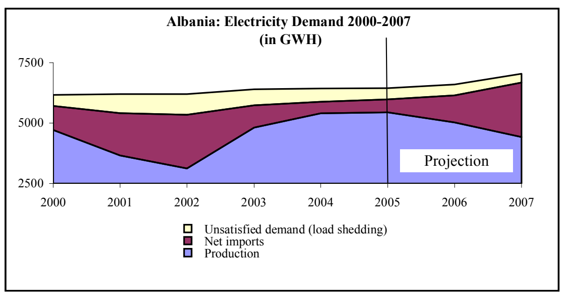
- The dramatic decline in the financial performance of KESH between April 2005 and January 2006 unwound the advances made over the past five years under a World Bank-led power sector program. Collections fell rapidly as technical losses and theft mounted, and KESH proved unable to enforce payment of bills. The deterioration peaked in January 2006, when payment was received on only a third of electricity supplied.

- Beginning in February, the collection and loss performance began to improve, but the program performance criterion was still missed. Moreover, the authorities fear that this improvement is not sustainable without further reform.

- On the supply side, domestic generation and transmission capacities could not catch up with growing electricity demand.







nontradable sectors. Moreover, the largest metallurgy plant in the country ceased operations because of high electricity costs, further deteriorating the trade balance.

6. **On the policy side, the fiscal stance has been restrictive while the monetary policy stance remained broadly neutral.** Under execution of mostly donor-financed capital spending led to a reduction of the overall deficit to 3.6 percent of GDP in 2005, down 1½ percentage points from the previous year (Table 6). Partly as a result of a sizable revenue overperformance, the fiscal contraction was even stronger in the first quarter of 2006: the surplus reached 1¼ percent of annual GDP, up from a deficit of ½ percent of GDP in the same period in 2005. The monetary policy rate has remained unchanged at 5 percent since March 2005 (Table 7).

7. **An ongoing credit boom, however, has led to demand pressures that underlie the high non-tradables inflation and the widening of the current account deficit (Figure 2).** The stock of private credit increased from 9½ percent of GDP at end-2004 to 15 percent of GDP by end-2005, creating a sizable demand impulse. About three-quarters of loans are foreign-currency denominated, going primarily to companies in non-tradable sectors and financing mostly imports.

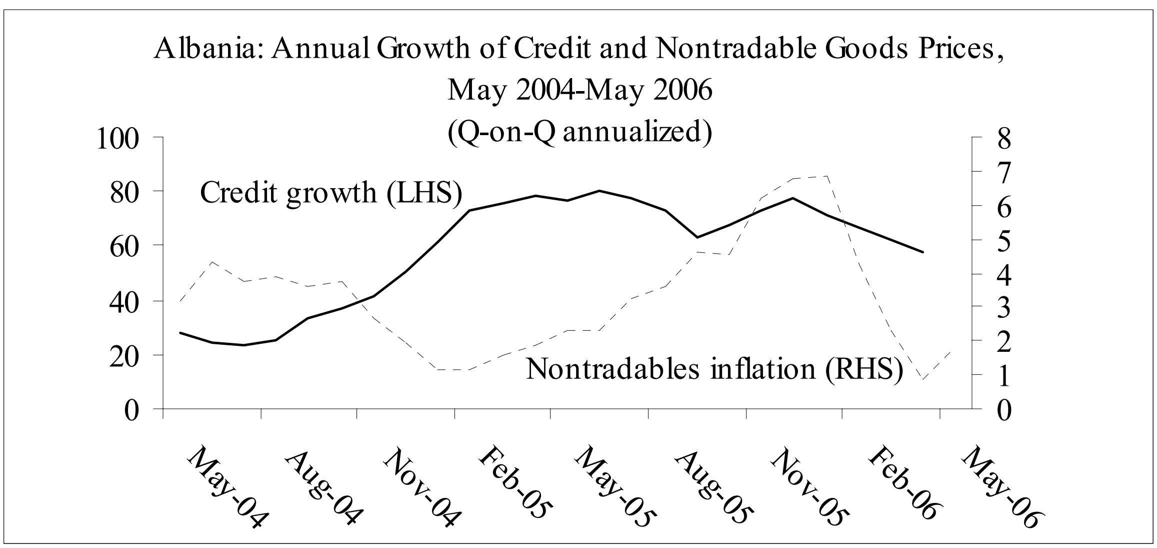
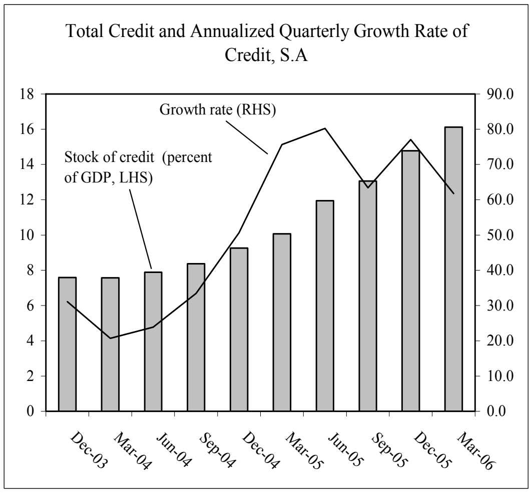
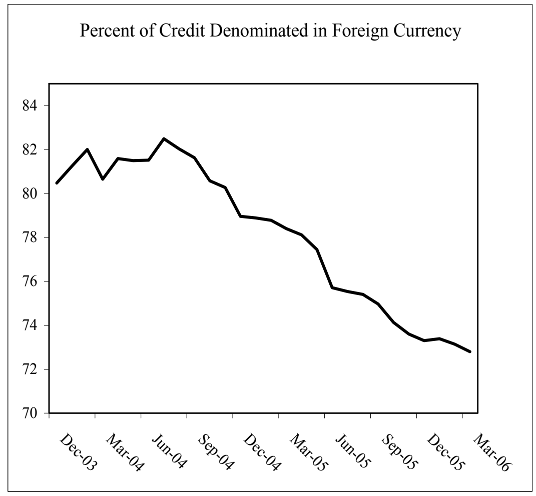


Figure 2. Evolution of Private Sector Credit, December 2003-February 2006

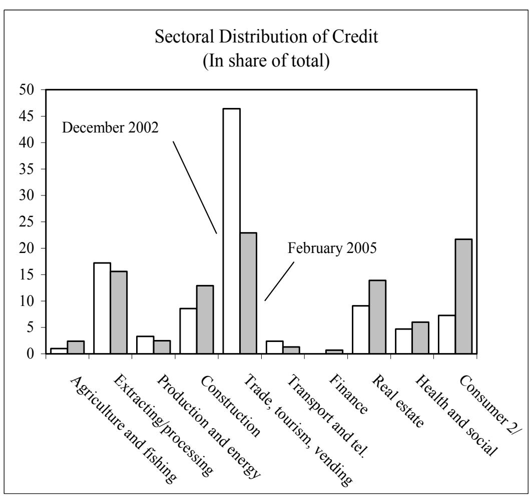
The stock of credit is rising at a sustained and rapid pace…



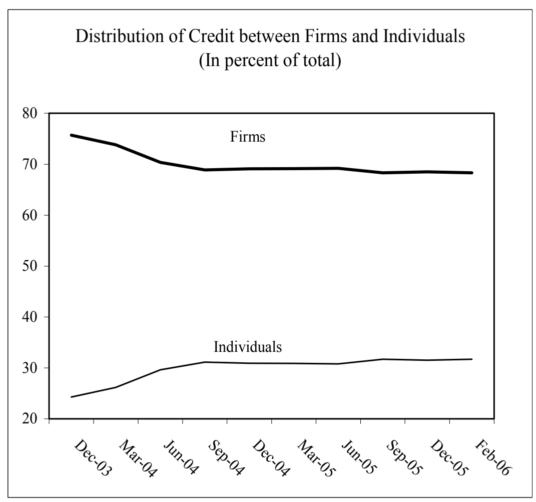
…with an decreasing share denominated in foreign currency.



The majority of borrowing appears to be for productive purposes. Although the share of consumption loans is rising…



...the distribution between business and household borrowing remains relatively constant.

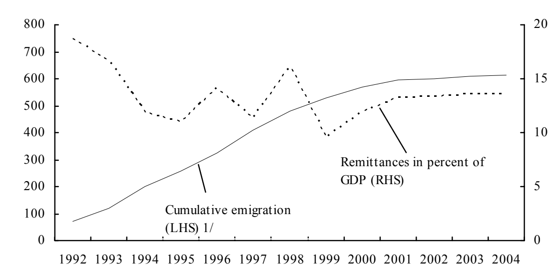


Source: Data provided by Bank of Albania.

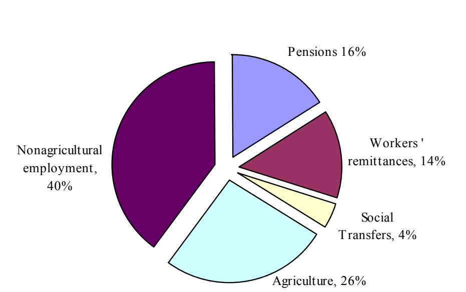
2/ Share of consumer loans in total loans is less precise as for other categories due to reporting irregularities currently being addressed by BoA.

8. **Preliminary analysis of 2005 survey data indicates a further significant decline in poverty**. The absolute poverty rate declined from 25½ percent in 2002 to 18½ percent in 2005 and the extreme poverty rate from 4¾ to 3½ percent. The low degree of inequality (measured by the Gini coefficient) achieved by 2002 was maintained, which helped maximize the positive impact of income growth. Besides

pensions and relatively small but targeted social transfers, large workers' remittances—providing an effective private safety net—played an important role in this regard.[1] An annual report on the implementation of the National Strategy for Social and Economic Development (NSSED, the Albanian poverty reduction strategy) and a joint staff advisory note with the World Bank was prepared in January 2006. A new NSSED will be produced by end-2006.



Sources: Albanian authorities, the International Organization for Migration (IOM), and IMF staff estimates.
1/ Based on a survey by IOM-Tirana.



Source: World Bank based on 2002 LSMS.

Albania: Poverty Indicators 1/

	1998	2002	2005
Absolute poverty rate	...	25.4	18.5
Extreme poverty rate	...	4.7	3.5
Two dollar a day poverty rate 2/	46.6	10.8	7.7
Relative poverty rate 3/	29.6	20.4	21.2
Gini coefficient	0.43	0.28	0.29

1/ Data for 1998 are from the Living Condition Survey (LCS) carried out in 1998 by INSTAT. Data for 2002 and 2005 are from the Living Standards Measurement Surveys (LSMS) carried out by INSTAT with the support of the World Bank. Data from the 2005 LSMS are preliminary. Due to different methodologies, data for 2002-2005 are not necessarily comparable.

2 / Percentage of population with per capita income below 2 US dollars a day.

3/ Percentage of population with consumption below 60 percent of median.

[1] An accompanying SIP presents an analysis of the size and impact of remittances in Albania.

II. Policy Discussions

9. **Discussions focused on the near-term policy corrections required to maintain macroeconomic stability and on structural reforms needed to promote growth and reduce vulnerabilities over the medium-term.** The authorities thought that the Fund's advice had served the country well in the past (Box 2). Looking ahead, their overall strategy for reforms is to concentrate on core functions and shift non-core functions to the private sector. On the fiscal side, this implies a small but efficient government and expenditure reprioritization. The electricity industry is an important non-core area where the authorities aim to promote greater private sector involvement to secure long-term solutions to the sector's severe problems. The key questions for the discussions were:

- How can macroeconomic stability be maintained in the face of strong demand pressures from rapid credit growth?
- What are the critical institutional reforms to maintain high growth?
- What steps are needed to keep government small and increase its efficiency?
- What measures are required to reduce vulnerability in the financial sector and enhance its contribution to growth?
- What are the necessary reforms to attain secure electricity supply over the medium term and to improve KESH's performance in a sustainable manner?

Box 2. The Effectiveness of Fund Surveillance

Overall, the Albanian authorities have a relatively good track record of implementing Fund advice, but reforms have been delayed in some areas:

On fiscal policy, the authorities have implemented recommendations to reduce domestic borrowing; redirect resources from current to capital expenditure; and make full use of contingencies and prepare conservative revenue projections. They have also agreed to delay the 2006 supplementary budget until it could be determined whether gains due to recent tax administration reforms were sustainable.

On structural reform, vulnerabilities were identified in revenue administration, debt management, and banking supervision. The authorities formulated, or are in the process of formulating, action plans to address these vulnerabilities based on Fund technical assistance. Implementation has begun, and is particularly advanced in tax administration. Preparations have also started to develop a credit bureau to help safeguard loan quality. These actions—along with measures to improve expenditure management and to improve the financial performance of KESH—have been supported by program conditionality. Implementation of the reforms to strengthen title registration and enforce contracts has however been slow.

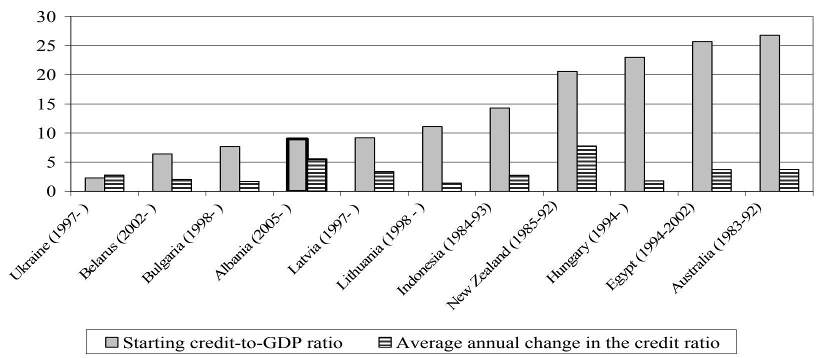
A. Maintaining Macroeconomic Stability in the Face of Strong Credit Demand

10. **There was agreement that growth in 2006 would slow further to about 5 percent, but with upside potential.** A continued slowdown in services and construction—reflecting emerging capacity constraints and less buoyant housing demand from remittances—is the main factor underlying this trend. More secure electricity supply than previously expected has, however, favorably altered the balance of risk. With improved implementation of foreign-financed public investment projects and higher electricity imports, the current account is projected to widen further to over 8 percent of GDP in 2006, despite lower growth.

11. **The authorities concurred that a decisive policy response was needed to rein in underlying inflationary pressures and improve the external position.** The monetary authorities were particularly worried that the expected strong pickup in public expenditure later in the year could raise further non-tradables inflation, which would propel headline inflation outside the 3±1 percent target range. It was agreed that excessive private credit growth was the prime factor responsible for the underlying demand pressures. However, it was also recognized that a healthy level of credit growth was necessary to finance investment that would ease emerging capacity constraints.

12. **There was agreement that private credit growth also needed to be cooled for prudential reasons**. The credit ratio in Albania is lower than in countries with similar income level and the deepening of financial intermediation is an important factor fostering growth. Nonetheless, the current pace of credit expansion entails excessive risks as banks are taking on bigger risks by moving down the credit spectrum. Staff noted that countries with prolonged expansion of private credit that avoided a subsequent banking or currency crisis had experienced, on average, an annual increase of about 4½ percentage points in the private credit ratio— significantly less than the 8½ percentage points the current rate of credit growth would produce in 2006. The authorities suggested that a relatively rapid credit expansion would be appropriate at this juncture because prudential indicators were quite favorable (Table 8) and because some of the apparent increase in lending had previously existed as informal credit. A consensus view emerged that a further increase broadly in line with that experienced in 2005 (5½ percentage

Private Credit Growth during Credit Boom Episodes
(Percentage points)



Source: P. Hilbers et al. (2005) Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies, IMF Working Paper WP/05/151.

points) would still be consistent with maintaining acceptable loan quality—provided it was accompanied by strong prudential and supervisory measures.

13. **The discussions thus turned to the appropriate policy package to curb private credit growth and reduce demand pressure.**

- **It was agreed that implementing decisive prudential and supervisory measures should be the first step (Box 3).** The prudential measures should serve to maintain credit quality and, more broadly, the soundness of the fast developing banking system**.** Together with active communication to promote self-restraint by commercial banks, the monetary authorities hoped that these measures would also slow credit growth by increasing effective lending costs.

- **As the projected credit growth in 2006, after taking these measures, would still generate a small demand impulse, the policy mix has to be tightened.** Staff argued that this should be done on the fiscal side rather than through an interest rate increase. Most loans are foreign currency denominated and hence a rate hike would have limited direct impact on credit growth. As the interest rate channel is weak, a monetary tightening would work primarily through the exchange rate channel which would have the largest and most immediate impact on the tradables sector.[2] It would be preferable to avoid such an impact as Albania is already buffeted by recent export shocks and needs to rein in strong import demand, and also keeping in mind that inflationary pressures are being felt primarily in non-tradables. By contrast, a tighter fiscal stance would weigh less heavily on the tradables sector.

- **On balance, the authorities thus agreed on the desirability of a modest mid-year fiscal correction.** Some ¼ percent of GDP of revenue overperformance will be saved in the supplementary budget (¶26). This, together with saving half the receipts from bank privatization, will reduce net domestic borrowing to 2.3 percent of GDP in 2006, down from the originally budgeted 2.6 percent. With remittances relative to GDP expected to remain unchanged in 2006, this would ensure that no significant additional demand impulse is given to the economy, reducing the need for monetary tightening (MEFP ¶16-17).

- **With these measures, a rate increase may not to be necessary at this stage, but there was agreement that the monetary authorities should stay vigilant.** In particular, the authorities would consider a rate hike if excessively rapid credit expansion continued.

[2] Although international portfolio investment is insignificant, a large stock of foreign currency-denominated assets held by residents makes the exchange rate responsive to interest rate changes.

Box 3. Measures to Strengthen Banking Supervision and Prudential Regulations

Amendments to regulations that will increase the costs of financial intermediation:

- Increasing reserve requirements on foreign-currency deposits (currently at 10 percent).
- Imposing minimum capital adequacy requirements higher than the current 12 percent on high-risk banks identified by the banking supervisor.
- Raising the maximum risk weights applied to high-risk loans above 100 percent—as permitted under Basel II.
- Requiring higher provisioning on classified loans.

Actions to protect loan quality:

- BoA will encourage banks to adopt—and impose on banks if necessary—stricter debt service-to-disposable income ratios and prudent loan-to-value ratios; tighter internal loan classification rules; and increased risk premiums in lending spreads to take full account of indirect credit risk from foreign-exchange exposure of customers.
- BoA will also introduce "truth in lending" rules by mid-2007 to disclose annual percentage rates on loans and the risks associated with foreign-currency borrowing.
- A credit bureau will be established within BoA (*SB; end-June 2007*).
- Legislation will be submitted to Parliament to improve the efficiency and timeliness of collateral execution (*SB; end-December 2006*).

Measures to improve supervisory capacity:

- Decreasing the lag on reporting monthly bank statistics from 40 to 30 days.
- Improving coordination and communication with home country supervisors of foreign-owned banks.
- Increasing targeting of supervision activities—including on-site inspections—towards credit-related risks.
- Preparing and mandate by end-2006 enhanced reporting rules for commercial banks to allow better monitoring of banking sector developments.
- Submitting a new Banking Law to Parliament (*SB; end-March 2007*) to grant BoA the specific legal authority needed to improve and broaden its supervision of commercial banks; and to strengthen legal protection for banking supervisors.

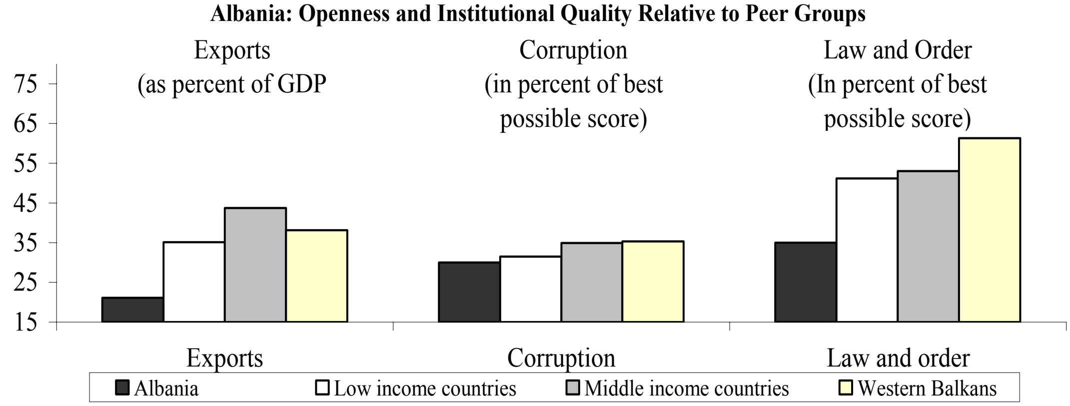
B. Reforms to Generate High Export-Led Growth

14. **There was agreement that institutional weaknesses impede growth and the development of a strong export base (Box 4)**.

- An inefficient government and high compliance costs have led to a large informal sector and a small tax base. Thus, maintaining even a relatively small government requires high tax rates, which create distortions and provide further incentives for business to stay in the informal sector.

- Other characteristics of the business climate also fall short compared to middle-income countries, particularly with respect to rule of law, control of corruption, and bureaucratic quality. Business surveys confirm that the lack of non-price competitiveness—due to poor infrastructure and an unsupportive business environment—is a significant impediment to FDI, domestic investment and export growth. As a result, Albania has a small export base.

Albania: Openness and Institutional Quality Relative to Peer Groups



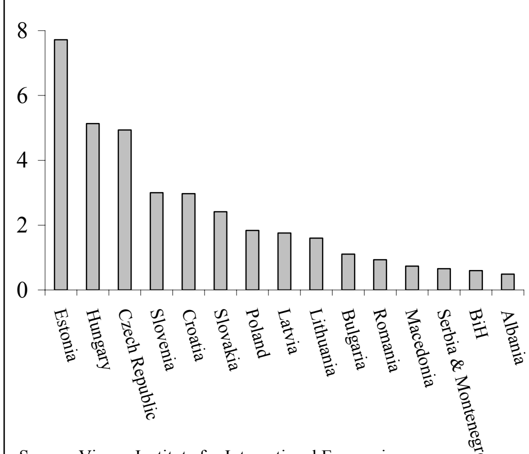
Source: WEO data and PRS Group

Business Climate Indicators (2004)

	Albania	Regional Average	OECD Average
Starting a business			
Number of procedures	11	10	7
Duration (days)	47	48	30
Cost (% GNI per capita)	32	15	8
Hiring and firing costs			
Difficulty of hiring 1/	11	31	26
Difficulty of firing 1/	20	42	27
Rigidity of employment index	30	42	27
Enforcing contracts			
Number of procedures	39	29	19
Duration (days)	390	412	229
Cost (% debt)	29	18	11
Getting credit			
Public credit registry coverage 2/	0	6	76
Private bureau coverage 2/	0	47	577
Closing a business			
Time (years)	4	3.3	1.7
Cost (% of estate)	38	13	7
Recovery rate (cents per $)	25	30	72

Source: World Bank, Doing Business, July 2005.
1/ Each index takes values between 0 and 100, with higher values. representing more rigid regulations.
2/ Borrowers per 1000 adults.

Regional Comparison of Per Capita Stock of Foreign Direct Investment (in thousands of Euros)

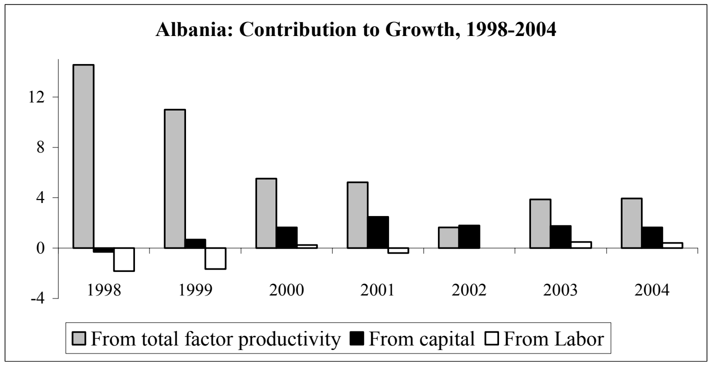


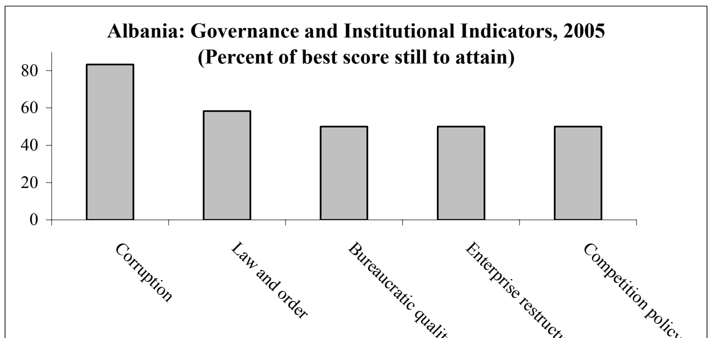
Source: Vienna Institute for International Economic Studies; and staff calculations.

Box 4. Growth and Institutions in Albania

An accompanying SIP presents a growth accounting analysis for Albania and ten Baltic and Central European countries.

- This study finds that total factor productivity (TFP) depends significantly on institutional reforms—particularly those that reduce risk to investors and liberalize markets—as well as on initial conditions, macroeconomic stability, and the level of financial intermediation.
- Increases in TFP explain most of Albania's growth since transition began, but TFP growth has slowed.
- The study identified corruption, law and order, bureaucratic quality, enterprise restructuring, and competition policy as areas that offered the most scope for improving Albania's growth performance.



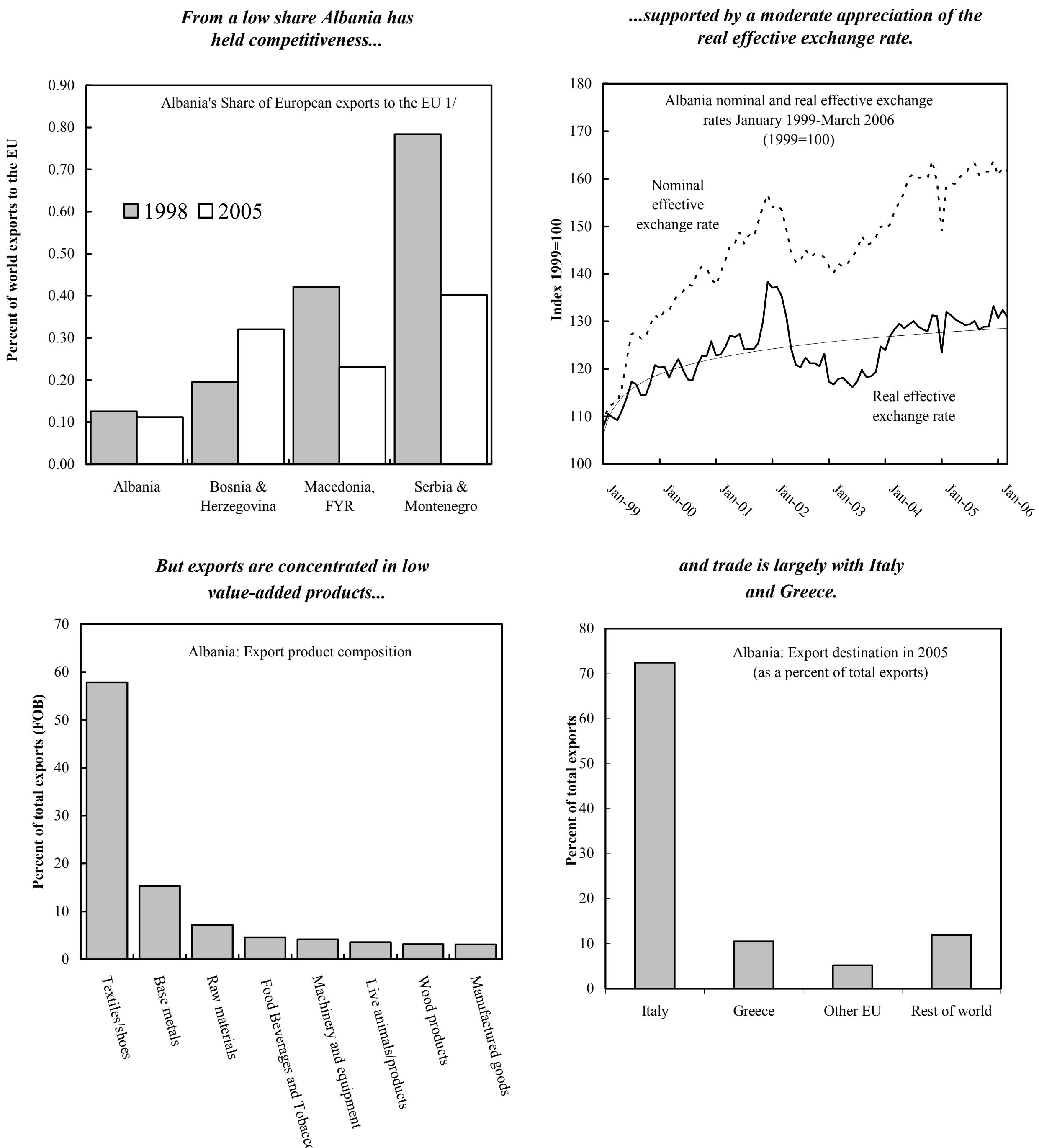


Source: EBRD transition indicators; and PRS Group

15. **Although non-price competitiveness is poor, price competitiveness appears broadly adequate and there is no indication of significant exchange rate misalignment**. While the lack of information on unit labor cost and profitability in tradable sectors prevents a detailed assessment, business leaders confirmed that the exchange rate was not a major factor hindering profitability. Albania's broadly stable market share in the EU over the last seven years also supports this view; and analyses by both staff and the authorities suggest that the extent of REER trend appreciation (about 1½ percent annually) is broadly consistent with rapid productivity growth (Figure 3).

16. **The authorities reiterated their determination to fight corruption and strengthen public institutions** (MEFP ¶14-15). They agreed with staff's assessment that establishing and enforcing property rights and strengthening contract enforcement are key

Figure 3: Albania: Export Performance, 1998-2005



Sources: Direction of Trade Statistics, the Bank of Albania, and Albanina Foreign Trade Report.
1/ Excludes intra-EU trade.

Albania: Macroeconomic Framework 2000-2010

	2000-2005 Average	2006	2007	2008	2009	2010
	(Growth rate in percent)					
Real GDP growth	5.7	5.0	6.0	6.0	6.0	6.0
CPI average growth	2.7	2.2	3.0	3.0	3.0	3.0
	(In percent of GDP)					
Current account deficit 1/	-4.9	-6.6	-5.8	-5.4	-5.2	-4.5
External debt	23.2	17.8	17.8	17.7	17.5	17.0
Investment	24.6	25.6	26.3	27.3	28.0	28.2
Public	5.8	6.2	6.5	6.9	7.0	6.7
Private	18.8	19.4	19.8	20.4	21.0	21.5

1/ Including official transfers.

to promoting the formalization of the economy and attracting more FDI.[3] Regarding property rights, they set priority on significantly improving access to title registration—the lack of which is perhaps the strongest impediment to FDI and also heightens financial sector vulnerabilities because of insufficient loan collateral. Staff urged the authorities to speed up the preparations for their planned land utilization project in cooperation with the World Bank, which would also develop a modern title registration system. Contract enforcement needs to be strengthened by attacking corruption in the court system, by training judges dealing with commercial cases, and by facilitating collateral execution. Staff noted that ongoing revenue administration reforms would make an important contribution in this area.

17. **With ambitious reforms, the high growth of the past decade can continue.** Assuming sustained efforts to improve the business climate and maintain macroeconomic stability, staff projects a return to 6 percent growth in 2007. This will require a gradual increase in domestic investment relative to GDP, which will have to be matched by concomitant increases in domestic savings to maintain safe levels of external current account deficit and foreign debt.

18. **There are significant risks to these projections.** Despite recent improvements, the fragility of the energy sector remains a major risk to growth over the medium term, while the relatively high and short-term domestic public debt and continued rapid private credit growth pose risks to macroeconomic stability. On the external front, staff's debt

[3] An accompanying SIP present staff's analysis in this area.

sustainability analysis shows that on current policies external debt is expected to remain at manageable levels over the medium-term—even as the composition of public debt shifts to less concessional sources and private sector borrowing increases (see Appendix IV). While the debt position is relatively robust, it is vulnerable to shocks to growth and exports in particular. This underscores the need to broaden the export base.

19. **The authorities' strategy for poverty reduction is to maintain high growth and make it more pro-poor by increasing employment.** Reductions in high labor taxes will thus be a crucial part of this strategy. Increasing the share of public expenditure on education, health care and infrastructure investment will also help the poor enter the labor market. Noting that poverty reduction is also essential to improving non-price competitiveness, staff supported the authorities' overall strategy for fighting poverty.

C. The Fiscal Strategy: A Small But Efficient Government

20. **The authorities' fiscal strategy aims to keep government small and increase the share of priority expenditure, while striking a balance between reducing public debt and the tax burden** (MEFP ¶14-15).

- Over the medium term, public expenditure will be capped at about 30 percent of GDP. Within this envelope, growth-enhancing capital spending is planned to increase from 4½ to about 7 percent of GDP by 2010. The share of education and health expenditure will also increase significantly.

- Debt is targeted to decline from 55.3 percent of GDP in 2005 to 51½ percent in 2010 which, according to staff's analysis, is sustainable (Appendix IV). This debt path and the planned increase in capital spending imply a rise in the current surplus from ½ percent to 2¾ percent of GDP during this period. Thus, the improvement in the government's net worth—a more suitable indicator to judge solvency and intergenerational fairness—is likely to be larger than the extent of the reduction in gross public debt. However, as the stress scenarios show, public debt remains vulnerable to adverse shocks to growth.

- Meeting these targets would require revenue to reach about 26½ percent of GDP over the medium term. Future structural gains from revenue administration reforms above this level could be made available for tax relief and a faster reduction of public debt.

Albania: Medium-Term Fiscal Path
(In percent of GDP)

	2004	2005	2006	2007	2008	2009	2010
Overall balance	-5.1	-3.6	-3.8	-3.9	-4.0	-4.0	-3.4
Total revenuee	24.1	24.4	25.5	26.1	26.3	26.4	26.5
Total revenuee (excuding grants)	23.7	23.7	24.8	25.2	25.5	25.6	25.8
Current expenditure	24.0	23.2	22.9	22.9	22.8	22.9	22.7
Capital expenditure	5.0	4.6	6.2	6.5	6.9	7.0	6.7
Current balance 1/	-0.2	0.5	1.9	2.1	2.4	2.5	2.8
Domestic financing	4.2	2.8	2.9	2.7	2.6	2.5	2.5
Privatization receipts	1.9	0.1	0.6	0.2	0.2	0.2	0.2
Domestic net borrowing	2.3	2.7	2.3	2.5	2.4	2.3	2.3
Foreign financing	1.0	0.8	0.9	1.1	1.3	1.4	0.8
Public debt	56.5	55.3	55.2	54.6	53.7	52.7	51.4
Domestic	38.5	37.7	37.4	36.8	36.0	35.3	34.5
External	18.0	17.6	17.8	17.8	17.7	17.5	17.0

1/ Revenue excluding grants minus current expenditure.

21. **Staff noted that the success of the authorities' small-government strategy would depend on improving the quality of public expenditure and reducing non-productive current spending.** This will require continuous efforts to improve expenditure management and medium-term budgeting, also to ensure that increased public investment is matched by sufficient funds for operation and maintenance. The staffing of a public investment department in the Ministry of Finance was an important first step in this regard, as were new requirements issued to line ministries that they only submit public investment proposals that were consistent with the Medium-Term Budget Plan (MTBP). Over time, the full integration of the annual budget with the MTBP and the NSSED will be necessary. The mission considered that, if properly implemented, the proposed framework would help develop public confidence in fiscal policy, as well as prevent politically motivated, ad hoc budgetary initiatives.

22. **The authorities agreed that significant debt management reform was needed to address vulnerabilities resulting from a relatively high level of domestic public debt** (MEFP ¶19). They will formulate a debt management strategy (*PC end-October 2006*); and submit to Parliament a public debt law defining the objectives and the institutional framework for public debt management (*SB; end-September 2006*). Following this, reforms will focus on implementing the authorities' action plan which incorporates the January 2006 FAD mission's recommendations (Table 9). Principle objectives include achieving a significant increase in the average maturity of public debt (currently somewhat over half year), substantially expanding risk management capacity, and acquiring the ability, by the end of the program, to produce independent debt sustainability analysis. Staff welcomed these measures and stressed the need for allocating sufficient resources to build the necessary public debt management capacity.

23. **The authorities' tax reform aims to stimulate growth and help formalize the economy.** Given the central importance of job creation, the highest priority is on labor taxes, particularly on social security contribution which is high compared with countries with similar income levels. Accordingly, the authorities intend to lower the social security contribution rate for employers from 29 to at most 20 percent in the 2006 supplementary budget (MEFP ¶16). Plans for later years envisaged a flat-tax system with a significantly reduced uniform rate.[4] To ensure sustainability of tax reductions, the authorities will evaluate revenue performance every six months in consultation with the Fund before apportioning structural gains from revenue administration reforms to rate cuts.

Social Security Contribution Rates in Selected Middle-Income Countries, 2004 [1/]

	Contribution rate	Per capita GDP in PPP terms [2/]
Albania	**41.9**	**3350**
Algeria	17.0	4984
Bosnia and Herzegovina [3/]	24.0	...
China	27.5	3477
Georgia	33.0	4904
Laos	9.5	...
Macedonia	32.0	...
Moldova [4/]	30.0	2082
Morocco	11.9	3720
Thailand [5/]	6.0	6857
Tunisia [6/]	15.5	6777
Vietnam	15.0	...

1/ Countries with income levels broadly similar to that of Albania.
2/ GDP in purchasing power parity terms in 2000 expressed in 1996 constant US dollars.
3/ As of June 2003, based on net wages.
4/ Contribution rate in industry.
5/ An additional 1 percent is paid by the government.
6/ Excluding certain in-kind payments or reimbursement.

Sources: National authorities, U.S. Social Security Administration, and Penn World Table.

24. **While agreeing with the main goals, staff recommended sequencing tax measures differently and leaving more room for faster debt reduction.** Regarding the planned reduction of social security contribution rates, they urged the authorities to ensure that it was consistent with the findings of the ongoing World Bank fiduciary assessment of the pension system. On other taxes, the mission noted that the 2004 FAD mission found that the basic design of the Albanian tax system was sound and that tax rates were in line with regional levels. Thus, there is no urgent need for reducing other taxes. Staff also noted that while there was some justification for maintaining the same top rate for PIT and CIT, there was no reason to keep this rate equal to the VAT rate. Moreover, given the large share of VAT in total revenue, its wide base and relative efficiency, the mission recommended considering a cut in this tax only in the last phase, if at all. Thus, only PIT and CIT rate cuts should be considered in the second phase following the reduction of labor taxes. More generally, staff emphasized the importance of further simplification of the tax system to reduce compliance cost; and of broadening the tax base to distribute the tax burden more equitably. The authorities agreed with these recommendations. The mission also stressed that, as agreed in the IMF program, if further revenue gains were significant, they should also be used to reduce public debt, as vulnerabilities from relatively high public debt remained substantial.

[4] Currently, the top personal income tax (PIT) rate, the corporate income tax (CIT) rate, and the VAT rate are all at 20 percent.

25. **Revenue administration reforms are so far on track** (MEFP ¶18)**.** Important accomplishments in this area are the incorporation of all large taxpayers into the LTO and a significant increase in the share of taxes collected by this office. As a next step, the authorities will prepare a feasibility study for merging small local tax offices (*SB; end-October 2006*). The authorities have requested a follow-up FAD mission to review progress in reform implementation and to update recommendations. To monitor progress in improving taxpayer services, the authorities will continue to prepare quarterly reports on VAT refunds (*SB; ongoing*); and on the use of the ASYCUDA risk assessment module to perform customs inspections (*SB; ongoing*).

26. **The planned supplementary budget, to be approved in July 2006, is consistent with the new fiscal strategy** (MEFP ¶17). Structural gains from revenue administration reform for this year, estimated at 1–1½ percent of GDP—mostly stemming from enhanced governance in customs and the strengthening of the LTO, improvements that now increasingly appear to be sustainable—will be allocated between additional spending, tax relief, and debt reduction. About 0.6-0.8 percent of GDP will be allocated to high-quality capital spending, primarily road construction. Besides a reduction in the social security contribution rate, planned tax measures, costing about 0.2–0.4 percent of GDP, will include the elimination of custom tariffs on imported machinery, the deferment of VAT on imported equipment, and an increase of tobacco excises to regional levels. The remaining ¼ percent of GDP of gains will be used to retire domestic debt.

D. Development and Stability of the Financial System

27. **Standard financial soundness indicators suggest that the banking sector, fully private and dominantly foreign-owned, is healthy, but close vigilance is warranted.** With assets of 61 percent of GDP, commercial banks dominate the financial system.[5] Though rapid credit growth has somewhat lowered capital adequacy and liquidity ratios, banks appear on the whole to have remained well capitalized, liquid, and profitable (Table 8). The stress tests performed by the FSAP mission in 2005, and those performed by the authorities on a quarterly basis, indicate that the banking sector is resilient to standard exchange rate, interest rate and credit quality shocks, with strong profitability providing a considerable buffer. Earnings are predominantly from interest margins. However, cost efficiency has continued to decline. Moreover, high real lending rates, about 9–13 percent in the past year, reflect major information asymmetries stemming from the lack of a credit bureau and uncertainties surrounding collateral execution.

[5] The collective assets of insurance companies and credit unions are less than 2 percent of GDP.

Albania: Structure of the Banking System, December 2003 and March 2006

	Assets of banking system		Deposits in banking system		Loans to private sector		Net credit to government	
	Dec-03	Mar-06	Dec-03	Mar-06	Dec-03	Mar-06	Dec-03	Mar-06
Percent of total								
All banks (17)	100	100	100	100	100	100	100	100
Foreign-owned (14) 1/	98	92	99	92	97	87	100	96
Domestic-owned (3)	2	8	1	8	3	13	0	4
Largest bank	52	39	58	43	1	12	76	61
Five largest banks	85	77	88	80	61	62	96	89
Percent of GDP								
All banks (17)	55	61	47	52	7	16	29	25
Foreign-owned (14) 1/	54	56	46	47	7	14	29	25
Domestic-owned (3)	1	5	1	4	0	2	0	1
Largest bank	28	24	27	22	0	2	22	15
Five largest banks	46	47	41	41	5	10	27	23

Source: Data provided by Bank of Albania.
1/ Classified according to ownership as at March 2006.

28. **The authorities agreed that the prudential and supervisory measures proposed by the MFD mission would be sufficient at this stage to safeguard loan quality (Box 3).** Nonetheless, they stood willing to take additional actions if necessary. Before starting implementation though, they wanted to discuss the measures recommended by the IMF staff with the commercial banks to secure strong efforts on their part. There was consensus that the present low level of nonperforming loans would likely rise in the months ahead, as some of the loans given out over the past year become impaired. However, the authorities viewed this as a normal development in an environment of rapid credit growth, and did not expect the increase to be large enough to affect the stability of the banking system.

29. **To promote financial market development, the authorities have begun preparations to develop a delivery-versus-payment system for trading government securities** (MEFP ¶12). Regarding the existing elements of the payment system, both the Real-Time Gross Settlements System (AIPS) and Bulk Settlement System (AECH) have facilitated the use of the banking system in economic transactions, and enhanced financial system efficiency and security. The authorities acknowledged that ample banking sector liquidity discouraged the organic growth of inter-bank money markets and secondary markets in government securities. However, they anticipated that the need for these markets would increase in the future because the rise in bank lending would eventually lead to greater liquidity differentiation among banks. They thought that the envisaged delivery-versus-payment system—for which they have already requested Fund technical assistance—would facilitate the emergence of these markets. Staff supported this initiative, noting that such markets would create additional efficiencies and improve both the monetary transmission mechanism and public debt management capacity. To promote organic development, the mission advised the authorities to refrain from entering the inter-bank market when overall banking sector liquidity is sufficient.

30. **Staff supported the authorities' plan to overhaul the currently weak supervision of nonbank financial institutions** (MEFP ¶11)**.** With World Bank assistance, and in line with FSSA advise, a new legal framework has been approved by the government to unify all nonbank supervisory institutions—insurance, private pension funds and securities—within a single agency. The mission urged the authorities to cooperate closely with the World Bank in finalizing and implementing this framework. The new agency should be fully independent—including with respect to its staff compensation levels—and sufficiently funded to enable it to function effectively and to attract and retain qualified staff. It should also have the necessary capacity to cooperate effectively with the BoA. The authorities have temporarily limited participation in the pension fund industry to three firms because of concerns that the governing legal framework is antiquated and doesn't provide adequate guidance for supervision. Staff welcomed this step because of the threat to financial system stability and suggested that the authorities continue to refrain from issuing new licenses until an appropriate legal framework has been developed. It will also be important to strengthen AML/CFT capacities.

31. **In light of worldwide concerns about the possibility of an avian flu pandemic, the authorities plan to improve contingency planning for the financial sector.** Staff encouraged the authorities to accelerate the implementation of the necessary improvements.

E. Achieving Lasting Improvement in the Electricity Sector

32. **The authorities describe the electricity sector as being in permanent crisis and have concluded that the current strategy is not working** (MEFP ¶6)**.** They stressed that the missed performance criterion on KESH's collection and loss performance did not reflect a lack of effort—indeed, their efforts had resulted in significant, though still insufficient improvement since February 2006. The authorities had concluded, however, that the government could not be an effective owner of KESH and, therefore, progress in rehabilitation and improvement was not sustainable over the medium-term. Thus, they intend to develop a new energy sector strategy to promote increased private sector involvement, including the privatization of electricity distribution. After discussions with donors, they plan to finalize the new strategy by end-2006. To facilitate the timely privatization of electricity distribution, the authorities have adopted a new electricity tariff structure that would remove currently existing cross-subsides from business users to households and increase the average tariff to reflect higher import costs.[6] In cooperation with the World Bank, the authorities will expand the existing social transfer scheme administered by KESH to compensate low-income

[6] The independent regulator for the electricity sector approved this proposal, but with a reduction in special tariffs for high-voltage users that would result in a significant revenue loss for KESH. The authorities have appealed this change.

families for the tariff increase. Staff welcomed the shift in the energy sector strategy and urged the authorities to work closely with the World Bank and other development partners in fleshing out the details and preparing for the privatization of electricity distribution. As a prior action for completing the review, the authorities are required to finalize the necessary arrangements to secure technical assistance for these tasks.

33. **Staff also encouraged the authorities to rapidly privatize remaining large state-owned enterprises so as to reduce government involvement in other non-core areas** (MEFP ¶6)**.** The authorities agreed that the companies involved—Albpetrol and ARMO (oil), INSIG (insurance), and Albtelecom (telecom)—should be privatized without first attempting rehabilitation, as this was a task best left to the future owners.

F. Other Issues

34. **Renewed efforts are needed to strengthen official statistics based on the recommendations of the March 2006 data ROSC.** Noting the major weaknesses of the recently revised national accounts, staff recommended revising the methodology and preparing new estimates together with preliminary estimates for 2005 (*SB end-November 2006*). They also identified major methodological problems in the balance of payment statistics related to the way remittances are calculated and recommended preparing revised estimates (*SB end-December 2006*). The mission welcomed the authorities' decision to conduct a labor force survey to provide much-needed employment and wage data.

35. **The authorities have continued to make progress in clearing arrears with non-Paris Club creditors** (MEFP ¶25)**.** Albania maintains restrictions under the transitional arrangements of Article XIV in the form of outstanding debit balances estimated at €65mn at end-2005 which are derived from inoperative bilateral payment agreements that were in place before Albania joined the Fund.[7] Staff has been in an ongoing dialogue with the authorities on the removal of these restrictions in the context of regularization of external arrears. Further progress was made during 2005 with agreements for arrears clearance reached with Romania and the Czech and Slovak Republics for €16.7mn. The authorities have engaged private sector creditors, and reported progress in reconciling outstanding balances with German, Swiss and Turkish creditors. The authorities expect to clear all arrears with official creditors by mid-2007 and with private creditors by end-2007. Albania continues to implement its WTO commitments to reduce tariff barriers.

[7] There are currently outstanding debit balances with Algeria, Cuba, Greece, Poland, Vietnam, and Serbia and Montenegro.

G. Program Issues

36. **The program is fully financed for 2006 (Table 10).**[8] The financing gap is expected to be closed by donor assistance and arrears rescheduling. For 2007, most of the gap financing has been identified. Projected future debt service to the Fund remains minimal (peaking at 0.6 percent of exports) (Tables 11 and 12). Non-concessional borrowing of no more than €70 million (less than 1 percent of GDP) is permitted in 2006, and would be devoted mainly to infrastructure projects, to facilitate Albania's exit from the PRGF facility and IDA.

37. **The proposed structural conditionality includes measures that are necessary to ensure sufficient progress in meeting the goals of the PRGF/EFF-supported program (MEFP Tables 1 and 2).** They are in line with the Fund's policy on streamlining program conditionality. Structural reforms will start in debt management, an area where little progress has been made in the past decade, and will reach an important stage in the financial sector where the establishment of a credit bureau will help reduce vulnerabilities. Tax administration reforms will also progress by preparing the ground for merging small and inefficient local tax offices.

III. Staff Appraisal

38. **Albania's development in recent years has been impressive.** Rapid growth with low inflation, together with large remittances, has raised living standards and significantly reduced poverty. Sound macroeconomic policies and an increasingly competitive banking sector contributed to this success.

39. **The floating exchange rate regime has served Albania well.** A key benefit of the regime has been that it has helped avoid a significant misalignment of the exchange rate. With continued exposure to potentially large idiosyncratic shocks, it will be essential to maintain exchange rate flexibility in the future.

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[8] The Lek 2.1 billion reported by the Albanian authorities for end-March 2005 on net credit to government—which was subject to a performance criterion (PC) in the sixth review under the previous PRGF arrangement—did not include the Lek 7.7 billion worth of government securities that were issued to the BoA on February 1, 2005. These government securities were issued to the BoA in accordance with the central bank law to cover its valuation losses on foreign exchange-denominated assets and liabilities. With these securities included, net credit to the government would have been Lek 9.8 billion compared with the program ceiling of Lek 6.6 billion for this test date, and the end-March PC on net credit to government would have been missed. The information on the issuance of these securities was set out in paragraph 18 of the authorities' MEFP dated February 3, 2005 (circulated to the Executive Board on February 9, 2005). Staff understood that the issuance of these government securities to the BoA was relevant to the end-March PC on net credit to government, and without revision to the PRGF-supported program, the end-March target would not be met. However, staff neglected to include a corresponding adjuster in the program documents. When staff assessed the authorities' observance of this PC and updated the Executive Board on Albania's performance under the program in the context of the sixth review in August 2005, they computed net credit to government as if there had been such an adjuster. Given the above, the nonobservance did not give rise to a noncomplying disbursement because Albania had relied on the staff conclusion that the end-March 2005 PC on net credit to the government had been met.

40. **Notwithstanding these notable achievements, the business environment has remained uninviting and the economy is vulnerable on several fronts.** Weak public institutions, particularly in core areas such as property rights and contract enforcement, and an underdeveloped infrastructure limit Albania's growth potential. Recurring difficulties in the electricity sector have been a particular concern. At the same time, vulnerabilities in debt management and the non-bank financial system may endanger macroeconomic stability. Moreover, the rapid pace of credit expansion creates significant risk in the banking sector and exerts pressure on inflation and the external current account.

41. **Catching up with middle-income countries will require further major structural reforms.** To sustain high growth and create the conditions for a significant expansion of the export sector, it will be essential to strengthen the non-price competitiveness of Albanian producers and remove impediments to FDI and domestic investment. To this end, improving the quality of public institutions and that of the country's infrastructure are key priorities.

42. **As its institutional capacity is limited, the government should concentrate on its core functions.** Growth enhancing institutional reforms should focus on areas where Albania lags its new competitors, such as property rights and contract enforcement. This will require improving access to title registration; attacking corruption, including in the court system; training judges that deal with commercial cases; and making it easier for banks to execute collateral.

43. **The private sector should be encouraged to take the lead in non-core areas.** The authorities' proposed energy sector strategy—which aims to increase private sector involvement, including through the privatization of electricity distribution—is an appropriately ambitious step in this direction. Without this reform, the energy sector is likely to remain a significant risk to growth over the medium term, and also a drain on public finances. The remaining large state-owned enterprises should also be privatized as expeditiously as possible.

44. **The envisaged medium-term strategy of keeping government small and improving the quality of public expenditure is appropriate.** To make this model successful, expenditure needs to be reallocated to priority areas—such as education, health care and public investment—with focus on value for money. This will require strengthening medium-term budgeting to reflect NSSED and integrating these medium-term plans with the annual budget process.

45. **To improve the business environment, tax reforms should aim to eliminate distortions and reduce compliance costs.** Measures should focus on simplifying the tax system, broadening the tax base, and creating a culture of tax compliance. Revenue administration reforms are also essential to reduce fiscal vulnerabilities. Progress made so

far in improving customs administration and strengthening the LTO is encouraging but continued efforts are needed to consolidate these improvements.

46. **If future gains from revenue administration reforms turn out to be significant, a considerable part should be used to reduce public debt more decisively then currently envisaged.** Reductions in the tax rates could promote higher employment and growth, but faster fiscal consolidation would reduce fiscal vulnerabilities and leave a smaller debt burden to future generations. Although the programmed increase of public investment will improve intergenerational fairness and net worth, the planned gradual reduction in gross public debt would still leave public finances vulnerable to shocks. Therefore, in addition to faster debt reduction, the necessary institutional capacity to manage public debt should also be created. To this end, the public debt management reform action plan should be implemented in a timely fashion.

47. **Future tax cuts should be introduced at a measured pace, making certain that revenue gains financing them are sustainable**. The authorities' focus on promoting employment and formalization of the economy is appropriate. In this respect, the planned reduction in high social security contributions rates is a step in the right direction. However, it will be important to ensure that this reduction does not endanger the financial stability of the pension system. The proposed second step—parallel reductions in top personal and corporate income tax rates—may also be appropriate if taken together with sufficient measures to broaden the bases of these taxes. As the VAT rate is in line with regional levels, and in view of its efficiency and wide base, a cut in this important indirect tax should not be contemplated for now.

48. **The supplementary budget for 2006 is consistent with the overall fiscal strategy.** It allocates additional resources to high-quality infrastructure investments while properly balancing the need for tax relief with that for debt reduction. The planned road projects are much needed to improve poor infrastructure. Saving part of the revenue administration gains—rather than spending them all as envisaged at the conception of the program—will provide the necessary support for monetary policy and help reduce public debt faster than previously envisaged. Although it is a small step in absolute terms, it shows the government's willingness to consider the fundamental trade-off between reducing public debt and lowering the tax burden involved in its fiscal strategy.

49. **Albania has a sound and profitable banking system that is developing quickly.** Nonetheless, potential risks arising from rapid credit growth should be carefully monitored and proactively managed. The agreed measures to strengthen banking supervision and enhance prudential regulations—along with the creation of a credit bureau and the improvement of the legal framework for collateral execution—are necessary and will help preserve loan quality. The authorities should take every effort to implement them in a timely fashion and should stand ready to take additional measures if

necessary. The prudential measures should also help contain credit growth at a level that is consistent with macroeconomic stability.

50. **There is an urgent need to strengthen non-bank financial supervision.** The existing supervisory agencies are weak and lack independence, which is a major source of vulnerability. The authorities' plan to create a unified agency is therefore welcome. The authorities should ensure that new agency is independent, sufficiently funded, and has a properly trained and salaried staff to make supervision effective.

51. **Official statistics need to be improved to serve as a reliable basis for policy making and program design.** National accounts and the balance of payments statistics contain significant weaknesses. Moreover, the lack of timely labor market data continues to hinder monetary policy analysis.

52. **Staff supports the authorities' request for a waiver for the non-observance of the performance criterion and recommends completion of the first review of the PRGF/EFF-supported program and the financing assurances review.** The authorities have made continued good faith effort to meet the targets for KESH in the second quarter of 2006. They are committed to cooperate closely with the World Bank in the electricity sector and have taken strong corrective actions in this area to ensure the successful implementation of the IMF program. The authorities have changed their energy sector strategy to promote significantly increased private sector involvement, including the privatization of electricity distribution. They also introduced a new electricity tariff structure to improve KESH's financial performance and facilitate timely privatization. The implementation of the prior action will ensure that they receive the necessary technical assistance to finalize their new strategy and prepare for the privatization of electricity distribution.

53. **It is proposed that the next Article IV consultation with Albania takes place within 24 months subject to the provisions of the decision on consultation cycles in program countries.**

Table 1. Albania: Basic Indicators and Macroeconomic Framework, 2001–10

	2001	2002	2003	2004	2005 IMF Country 1/ Report No. 06/54	2005 Est.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.
					(Growth rate in percent)						
Real GDP 2/	7.0	2.9	5.7	5.9	5.5	5.5	5.0	6.0	6.0	6.0	6.0
Retail prices (avg.)	3.1	5.2	2.3	2.9	2.5	2.4	2.2	3.0	3.0	3.0	3.0
Retail prices (end-period)	3.5	1.7	3.3	2.2	3.0	2.0	3.0	3.0	3.0	3.0	3.0
					(In percent of GDP)						
Saving-investment balance 3/											
Foreign savings 4/	2.8	7.2	5.5	3.8	5.5	6.9	6.6	5.8	5.4	5.2	4.5
Domestic savings	24.8	17.4	17.9	20.0	18.6	16.7	18.9	20.5	21.9	22.8	23.7
Public 5/	-0.6	0.0	-0.1	0.1	1.4	1.2	2.6	3.0	3.2	1.0	1.2
Private	25.4	17.4	18.0	19.9	17.2	15.5	16.3	17.6	18.7	21.8	22.6
Investment	27.6	24.5	23.4	23.8	24.2	23.6	25.6	26.3	27.3	28.0	28.2
Public	7.3	6.7	4.6	5.0	5.2	4.6	6.2	6.5	6.9	7.0	6.7
Private	20.2	17.8	18.8	18.8	19.0	19.0	19.4	19.8	20.4	21.0	21.5
Fiscal sector											
Revenues and grants	23.7	24.7	24.5	24.1	24.6	24.4	25.5	26.1	26.3	26.4	26.5
Tax revenue	19.8	20.6	21.3	21.7	21.7	22.0	23.0	23.4	23.7	23.9	24.1
Of which : social security contributions	3.8	4.1	4.2	4.3	4.3	4.3	4.1	4.2	4.4	4.5	4.5
Expenditures	31.6	31.4	29.0	29.2	28.3	28.0	29.3	30.0	30.2	30.4	29.9
Primary	27.3	27.4	24.6	25.5	25.1	24.9	25.9	26.7	27.0	27.3	26.9
Interest	4.3	4.0	4.4	3.7	3.2	3.1	3.4	3.3	3.2	3.1	3.0
Overall balance (including grants)	-7.9	-6.6	-4.5	-5.1	-3.8	-3.6	-3.8	-3.9	-4.0	-4.0	-3.4
Primary balance (excluding grants)	-4.2	-3.3	-0.5	-1.8	-1.6	-1.2	-1.1	-1.5	-1.5	-1.7	-1.1
Net domestic borrowing	3.1	3.3	2.9	2.3	2.8	2.7	2.3	2.5	2.4	2.3	2.3
Privatization receipts	2.2	0.1	0.1	1.9	0.3	0.1	0.6	0.2	0.2	0.2	0.2
Foreign financing	2.6	3.3	1.5	1.0	0.7	0.8	0.9	1.1	1.3	1.4	0.8
Public Debt	67.6	65.0	61.8	56.5	54.9	55.3	55.2	54.6	53.7	52.7	51.4
Domestic	41.0	41.7	41.1	38.5	38.1	37.7	37.4	36.8	36.0	35.3	34.5
External (including publicly guaranteed) 6/7/	26.6	23.3	20.7	18.0	16.8	17.6	17.8	17.8	17.7	17.5	17.0
Monetary indicators											
Broad money growth	20.2	5.7	8.7	13.5	13.9	13.9	13.5	11.8	12.0	12.1	12.2
Private credit growth	23.4	41.0	31.1	36.9	69.1	73.6	50.9	33.7	26.3	23.0	17.7
Velocity	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.3	1.3	1.3	1.3
Interest rate (3-mth T-bills, end-period)	8.0	11.1	7.3	6.2	5.4	5.4	…	…	…	…	…
					(In percent of GDP unless otherwise indicated)						
External sector											
Trade balance (goods and services)	-22.5	-25.9	-25.1	-21.7	-23.2	-24.1	-24.5	-23.2	-22.3	-21.8	-20.7
Current account balance (excluding official transfers)	-5.8	-10.0	-8.1	-5.5	-7.0	-7.8	-8.1	-7.1	-6.5	-6.2	-5.4
Current account balance (including official transfers)	-2.8	-7.2	-5.5	-3.8	-5.5	-6.9	-6.6	-5.8	-5.4	-5.2	-4.5
Official transfers	3.0	2.8	2.6	1.7	1.5	0.9	1.5	1.3	1.1	1.1	1.0
Gross international reserves (in millions of Euros)	826	845	834	1025	1147	1202	1260	1335	1476	1613	1807
(in months of imports of goods and services)	4.6	4.4	3.9	4.0	4.1	4.2	4.1	4.0	4.1	4.2	4.3
(relative to external debt service)	19.1	13.2	18.8	23.6	19.8	20.5	14.9	13.1	11.0	10.3	10.0
(in percent of broad money)	25.5	28.2	24.6	25.3	24.8	25.7	23.8	22.7	22.6	22.2	22.3
Change in real effective exchange rate (e.o.p., in percent)	9.8	-10.9	1.2	5.1	-1.1	1.5	…	…	…	…	…
Memorandum items											
Nominal GDP (in billions of lek) 2/	587.7	624.7	682.7	766.4	836.8	836.9	899.7	982.2	1075.7	1176.6	1293.1

Social Indicators: GNI per capita, World Bank Atlas Method, US$ (2004): $2,080; **population** 3.2 million (2004); **life expectancy at birth** (2003): 74 years; **infant mortality rate** (2003, per thousand births): 18; **population living below the poverty line** (2005): 18.5; **population without running water inside their dwellings** (2003): 40 percent.

Sources: Albanian authorities; and Fund staff estimates and projections.

1/ Ratios to GDP have been adjusted to reflect revisions to nominal GDP.
2/ GDP data through 2003 are from the official national accounts. Real GDP growth is based on the observed economy only.
3/ The statistical discrepancy contained in the national accounts was allocated to private consumption and investment according to the ratio observed in the national accounts excluding the discrepancy. Unexplained oscillations in this discrepancy introduced additional statistical uncertainty into the historical data.
4/ Negative of current account including official transfers.
5/ Revenue including grants less current expenditure and net lending.
6/ Includes arrears, with the exception of pre-1978 arrears to China .
7/ Excludes IMF repurchase obligations.

Table 2. Albania: Millennium Development Goals

	1990	1995	2001	2002	2003	2004
General Indicators						
Population (million)	3.3	3.2	3.1	3.1	3.1	3.2
GNI per capita, Atlas Method ($)	680	650	1320	1390	1680	2080
Adult literacy rate (% people ages 15 and over)	...	...	98.7	...	...	99.0
Total fertility rate (births per woman)	3.0	2.6	...	2.2	2.2	...
Life expectancy at birth (years)	72.3	71.3	...	74.0	74.3	...
Aid (% of GNI)	0.5	7.3	6.4	6.7	5.8	...
Goal 1. Eradicate extreme poverty and hunger						
Target 1. Halve, between 1990 and 2015, the proportion of people whose income is less that one dollar a day						
1. Population below 1 US$ a day (percent)	...	...	...	2.0	...	...
2. Poverty gap ratio at US$ 1 a day (percent)	...	...	...	0.5	...	...
3. Share of income consumption held by poorest 20 percent (percent)	...	...	...	9.1	...	...
Target 2: Halve, between 1990 and 2015, the proportion of people suffering from hunger						
4. Prevalence of child malnutrition (percent of children under 5)	...	...	...	...	13.6	...
5. Population below minimum level of dietary energy consumption (percent)	...	5.0	...	6.0	...	...
Goal 2. Achieve universal primary education						
Target 3: Ensure that, by 2015, children will be able to complete a full course of primary schooling						
6. Net primary enrollment ratio (percent of relevant age group)	95.1	...	...	...	94.9	...
7. Percentage of cohort reaching grade 5	...	...	...	...	...	...
8. Youth literacy rate (percent ages 15-24)	...	...	99.4	...	...	...
Goal 3. Promote gender equality and empower women						
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education in 2015						
9. Ratio of girls to boys in primary and secondary education (percent)	96.1	...	...	...	99.6	...
10. Ratio of young literate females to males (percent ages 15-24)	...	...	100.1	...	...	...
11. Share of women employed in the nonagricultural sector (percent)	39.6	39.9	41.1	...	40.3	...
12. Proportion of seats held by women in the national parliament (percent)	29.0	...	5.0	6.0	6.0	...
Goal 4. Reduce child mortality						
Target 5: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate						
13. Under-five mortality rate (per 1,000)	45.0	34.0	...	...	21.0	...
14. Infant mortality rate (per 1,000 live births)	37.0	29.0	...	...	18.0	...
15. Immunization against measles (percent of children under 12-months)	88.0	91.0	95.0	96.0	93.0	...
Goal 5. Improve maternal health						
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio						
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	55.0	...	...	...
17. Proportion of births attended by skilled health personnel	...	...	...	...	94.0	...
Goal 6. Combat HIV/AIDS, malaria and other diseases						
Target 7: Halt by 2015, and begin to reverse, the spread of HIV/AIDS						
18. HIV prevalence among females (percent ages 15-24)	...	...	...	...	...	...
19. Contraceptive prevalence rate (percent of women ages 15-49)	...	...	...	...	75.0	...
20. Number of children orphaned by HIV/AIDS	...	...	...	...	...	...

Table 2. Albania: Millennium Development Goals (concluded)

	1990	1995	2001	2002	2003	2004
Target 8: Halt by 2015, and begin to reverse, the incidence of malaria and other major diseases						
21. Prevalence of death associated with malaria	...	...	...	...	...	...
22. Share of population in malaria risk areas using effective prevention treatment	...	...	...	...	...	...
23. Incidence of tuberculosis (per 100,000 people)	26.7	29.0	24.9	23.9	22.9	...
24. Tuberculosis cases detected under DOTS (percent)	...	...	23.2	27.6	29.5	...
Goal 7. Ensure environmental sustainability						
Target 9: Integrate the principles of sustainable development into policies and programs. Reverse the loss of environmental resources.						
25. Forest area (percent of total land area)	39.0	...	...	...	...	...
26. Nationally protected areas (percent of total land area)	...	...	...	...	3.8	...
27. GDP per unit of energy use (PPP $ per kg oil equivalent)	3.2	7.6	7.3	6.9	...	...
28. CO2 emissions (metric tons per capita)	2.2	0.6	0.9	...	...	...
29. Proportion of population using solid fuels	...	...	...	...	...	...
Target 10: Halve by 2015 the proportion of people without access to safe drinking water						
30. Access to improved water source (percent of population)	97.0	...	...	97.0	...	...
Target 11: Achieve by 2020 a significant improvement for at least 100 million slum dwellers						
31. Access to improved sanitation (percent of population)	...	...	...	...	89.0	...
32. Access to secure tenure (percent of population)	...	...	...	...	...	...
Goal 8. Develop a Global Partnership for Development 1/						
Target 16. Develop and implement strategies for productive work for youth						
45. Youth unemployment rate	...	...	...	...	...	...
Target 17: Provide access to affordable essential drugs						
46. Proportion of population with access to affordable drugs	...	...	...	...	...	...
Target 18: Make available new technologies especially information and communications						
47. Fixed line and mobile telephones (per 1,000 people)	12.6	13.4	191.2	347.7	441.0	...
48. Personal computers (per 1,000 people)	...	...	9.7	11.7	11.7	...

Source: World Bank.

1/ Targets 12-15 and indicators 33-44 are excluded because they cannot be measured on a country-specific basis. These are related to market access, and the HIPC initiative.

Table 3. Albania: Comparative Economic and Institutional Performance, 1996-2005 1/ 2/

	1996-2005	1996-2000	2001-05
Macroeconomic indicators			
Growth (average GDP growth)			
Albania	**5.7**	**5.8**	**5.4**
Low-income countries	4.3	3.9	4.7
Middle-income countries	3.6	3.0	4.1
Western Balkans 2/	4.6	4.8	4.3
Inflation (average annual percentage change in CPI , eop)			
Albania	**8.0**	**13.2**	**2.5**
Low-income countries	20.8	29.9	11.7
Middle-income countries	16.9	25.8	7.9
Western Balkans 2/	38.5	67.1	9.9
Monetization (Broad money as a percent of GDP) 2/			
Albania	**60.0**	**58.5**	**66.3**
Low-income countries	35.5	32.6	38.4
Middle-income countries	46.8	44.2	49.4
Western Balkans 2/	36.9	29.6	44.2
General government, total expenditure and net lending (in percent of GDP)			
Albania	**30.9**	**31.9**	**30.0**
Low-income countries	29.1	28.8	29.4
Middle-income countries	30.3	29.7	31.0
Western Balkans 2/	37.2	38.6	35.8
Gross fixed capital formation (in percent of GDP)			
Albania	**22.8**	**19.8**	**25.8**
Low-income countries	20.8	20.3	21.2
Middle-income countries	21.2	21.4	21.0
Western Balkans 2/	20.4	18.9	22.0
Gross public fixed capital formation (in percent of GDP)			
Albania	**5.9**	**6.0**	**5.9**
Low-income countries	7.6	7.5	7.8
Middle-income countries	6.2	6.3	6.1
Western Balkans 2/	5.0	5.1	4.9
Gross public debt (in percent of GDP)			
Albania	**66.3**	**71.6**	**61.1**
Low-income countries	77.4	77.6	77.3
Middle-income countries	49.0	44.4	53.6
Western Balkans 2/	46.0	50.0	42.1
Openness indicators			
External current account balance (in percent of GDP)			
Albania	**-6.0**	**-5.4**	**-7.3**
Low-income countries	-5.4	-6.0	-4.8
Middle-income countries	-2.7	-2.9	-2.4
Western Balkans 2/	-7.4	-5.0	-9.9
Trade openness (Exports plus imports of G&S as a share of GDP)			
Albania	**57.4**	**52.3**	**65.8**
Low-income countries	79.1	75.7	82.4
Middle-income countries	87.4	85.3	89.6
Western Balkans 2/	90.0	85.7	94.4

Continued

Table 3. Albania: Comparative Economic and Institutional Performance, 1996-2005 [1/ 2/] (Concluded)

	1996-2005	1996-2000	2001-05
Openness indicators (continued)			
Export orientation (Exports of G&S as a percent of GDP)			
Albania	**16.9**	**13.9**	**21.1**
Low-income countries	33.4	31.7	35.1
Middle-income countries	42.5	41.3	43.7
Western Balkans 2/	37.8	37.5	38.1
Foreign direct investment (gross, as a share of GDP)			
Albania	**3.1**	**2.4**	**3.8**
Low-income countries	3.2	2.9	3.4
Middle-income countries	3.4	3.4	3.5
Western Balkans 2/	4.1	3.3	4.9
Institutional indicators			
Bureaucratic quality (in percent of maximum possible score)			
Albania	**35.0**	**25.0**	**45.0**
Low-income countries	36.1	36.9	35.3
Middle-income countries	49.3	50.2	48.4
Western Balkans 2/	45.0	41.0	49.0
Corruption (in percent of maximum possible score)			
Albania	**35.0**	**40.0**	**30.0**
Low-income countries	37.1	42.8	31.5
Middle-income countries	42.0	49.0	34.9
Western Balkans 2/	40.1	44.8	35.3
Law and order (in percent of maximum possible score)			
Albania	**40.8**	**46.7**	**35.0**
Low-income countries	54.0	56.9	51.2
Middle-income countries	56.7	60.4	53.0
Western Balkans 2/	64.3	67.3	61.3
Composite risk rating (in percent of maximum possible score)			
Albania	**63.2**	**60.2**	**66.3**
Low-income countries	61.4	60.5	62.3
Middle-income countries	68.0	66.9	69.2
Western Balkans 2/	63.2	59.7	66.6
Political risk rating (in percent of maximum possible score)			
Albania	**63.5**	**61.6**	**65.4**
Low-income countries	58.9	59.4	58.4
Middle-income countries	65.8	65.6	66.1
Western Balkans 2/	65.8	63.8	67.7

Sources: Calculated from data obtained from WEO database and PRS Group Inc.

1/ Low income countries defined as countries with average per capita GDP 2001-05 of less than US$2000; Middle income countries defined as countries with average per capita GDP 2001-05 of US$2000 to US$5000. Data for all variables was not available for all countries.

2/ Western Balkans comprise Romania, Bulgaria, Macedonia, Serbia and Montenegro, Albania, Croatia, and Bosnia and Herzegovina. Data for Bosnia andHerzegovina and Macedonia not available for risk and governance indicators.

Table 4. Status of Performance Criteria and Structural Benchmarks under the PRGF and EFF Arrangements

	Proposed Test Date	Status as of June 12, 2006
I. Performance Criteria		
1. Further extend the use of ASYCUDA systems in customs administration:		
(i) Deploy the ASYCUDA system in 10 customs houses.	End-March 2006	Met
(ii) Implement the risk assessment module of the ASYCUDA system in 10 customs houses to perform inspections.	End-March 2006	Met
2. KESH to meet the targets under the 2006-2008 Power Sector Action Plan for end-March 2006 with regards to collection rates and losses.	End-March 2006	**Not Met**
II. Structural Benchmarks		
A. Improve public expenditure management		
3. Complete a census of the wage bill for all budgetary sector employees.	End-June 2006	...
4. Strengthen public investment programming:		
(i) Establish and staff a public investment program department within the General Directorate of the Ministry of Finance.	End-June 2006	...
(ii) Prepare and issue instructions for submitting public investment proposals consistent with the budget and the Medium-Term Budgetary Plan.	End-June 2006	...
5. Safeguard the efficient use of nonconcessional foreign project loans:		
(i) Conduct an independent feasibility study for any large project (as defined in the TMU) financed through non-concessional commercial borrowing.	Ongoing	Met
(ii) Provide a semestrial listing and status report on all projects being considered for nonconcessional foreign financing.	Ongoing	Met
B. Reduce fiscal vulnerabilities		
Strengthen tax administration		
6. Improve VAT administration by preparing and providing to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (within one month of the end of each quarter).	Ongoing	Met
7. Increase the share of tax revenue collected by the Large Taxpayer's Office to 50 percent of all tax collected by end- June 2006.	End-June 2006	Met
8. Prepare and issue quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections in the customs.	Ongoing	Met
Improve debt management capacity		
9. Develop and discuss with IMF staff an Action Plan for implementing the recommendations of the IMF TA mission on debt management.	End-June 2006	...
10. Prepare biannual reports (within one month of the end of each semester) on the stock of external arrears.	Ongoing	Met
C. Strengthen the financial system and improve economic monitoring capability		
11. Develop and discuss with IMF staff an Action Plan for implementing the recommendations of the Financial Sector Stability Assessment Report.	End-March 2006	Met
12. Strengthen statistical and economic monitoring capacity:		
(i) Prepare advance GDP estimates for the first half of 2005.	End-March 2006	Met
(ii) Prepare and publish preliminary national accounts for 2004.	End-March 2006	Met

Table 5a. Albania: Balance of Payments, 2002–10
(In millions of Euros)

	2002	2003	2004	2005						2006	2007	2008	2009	2010
				2005 Prog.	Q1 Est.	Q2 Est.	Q3 Est.	Q4 Est.	2005 Est.	Projections				
Current account	-468	-402	-331	-473	-66	-117	-78	-264	-525	-594	-563	-566	-585	-560
Balance of goods and services	-1,214	-1,248	-1,307	-1,553	-306	-387	-412	-524	-1,629	-1,794	-1,850	-1,934	-2,047	-2,125
Exports	962	1,031	1,293	1,470	318	381	396	366	1,461	1,640	1,825	2,023	2,250	2,499
Goods	349	396	486	534	122	143	134	132	530	598	682	770	871	984
Services	613	635	808	936	197	237	262	235	930	1,042	1,143	1,253	1,379	1,516
Imports	2,176	2,279	2,600	3,022	624	768	807	890	3,090	3,434	3,674	3,958	4,297	4,624
Goods	1,555	1,572	1,752	2,030	398	507	516	586	2,007	2,285	2,453	2,621	2,806	3,009
Services	622	708	848	992	226	261	291	304	1,083	1,149	1,221	1,337	1,490	1,615
Income balance	134	152	146	133	30	27	39	23	119	130	131	129	130	147
Of which : Interest due	22	21	18	27	4	7	5	9	25	44	55	65	72	80
Private transfers	612	693	830	947	210	243	295	236	984	1,070	1,156	1,239	1,332	1,418
Capital account	481	403	436	405	67	110	10	192	379	604	605	649	677	703
Official transfers	132	129	103	101	16	17	16	13	62	107	101	99	101	102
Direct investment	142	158	277	197	45	50	53	64	212	239	256	295	331	353
Other capital	113	42	-13	58	-18	34	-73	98	41	175	164	187	183	201
Private loans (incl.net trade credits, net)	12	21	78	66	3	43	12	6	63	53	55	58	72	91
Other financial flows	102	21	-91	-8	-21	-9	-85	92	-22	122	110	130	111	110
Of which: Change in NFA of commercial banks (incr = -) 1	102	21	-91	-8	-21	-9	-85	92	-22	122	110	130	98	30
Medium- and long-term loans (net)	95	75	68	49	23	9	15	17	64	82	84	67	62	47
New borrowing	123	101	100	85	30	20	21	31	101	136	146	162	179	190
Multilateral loans	84	75	72	60	19	15	17	26	77	106	107	111	113	112
World Bank	52	36	37	26	9	9	8	6	32	44	32	32	31	26
EBRD	8	13	13	13	3	4	3	7	17	20	26	25	25	27
Other	24	25	23	21	7	1	7	12	27	42	49	54	56	59
Bilateral loans	38	26	28	25	11	5	4	5	25	31	40	51	66	78
Amortization	-28	-25	-33	-36	-6	-11	-7	-14	-37	-54	-63	-95	-117	-143
Errors and omissions	-12	26	73	64	-4	11	45	135	187	57	15	27	20	56
Net balance	1	27	177	-4	-3	4	-23	63	39	67	57	110	111	199
Financing requirement	-1	-27	-177	4	3	-4	23	-63	-39	-67	-57	-110	-111	-199
Available financing	-1	-27	-177	4	4	-3	23	-63	-39	-67	-57	-110	-111	-199
Change in net reserves (increase = -) 1/	-30	-46	-193	-8	4	-3	23	-66	-42	-107	-80	-147	-145	-203
Of which: Change in gross reserves, (increase = -) 1/	-19	10	-191	-13	1	-4	20	-64	-47	-104	-75	-141	-137	-194
Use of Fund Resources (net)	-9	1	2	2	4	-3	3	-2	2	-3	-5	-6	-8	-9
Budget support	30	17	15	0	0	0	0	0	0	14	0	0	0	0
Changes in arrears (increase = +) 2/	-300	2	-12	-17	0	-5	0	-12	-17	-19	-53	0	0	0
Overdue debt forgiveness	225	0	0	0	0	0	0	0	0	0	0	0	0	0
Rescheduling 3/	75	0	12	4	0	5	0	0	5	0	0	0	0	0
Identified Financing	0	0	0	0	0	0	0	0	0	5	8	12	4	4
Of which: IMF PRGF	0	0	0	0	0	0	0	0	0	0	0	0	0	0
WB FSAC/PRSC	0	0	0	0	0	0	0	0	0	5	8	12	4	4
Financing gap	0	0	0	24	0	0	0	15	15	41	68	25	30	0
Expected EU Macro-Financial Assistance	...	...	...	12	0	0	0	3	3	22	0	0	0	0
Arrears Rescheduling	...	...	...	12	0	0	0	12	12	19	53	0	0	0
Other	...	...	...	0	0	0	0	0	0	0	15	25	30	0
Memorandum items:														
Gross usable reserves	845	834	1,025	1,147	1,024	1,071	1,095	1,202	1,202	1,260	1,335	1,476	1,613	1,807
(months of imports of goods and services)	4.4	3.9	4.0	4.1	...	...	...	...	4.2	4.1	4.0	4.1	4.2	4.3
Balance of goods and services (percent of GDP)	-25.9	-25.1	-21.7	-23.2	...	...	...	...	-24.1	-24.5	-23.2	-22.3	-21.8	-20.7
Current account (percent of GDP)	-10.0	-8.1	-5.5	-7.0	...	...	...	...	-7.8	-8.1	-7.1	-6.5	-6.2	-5.4
Debt service (percent of exports of goods and services) 3/	6.3	5.0	4.1	4.2	...	...	...	...	4.2	5.7	5.4	6.3	6.5	6.9
Debt service (percent of central government revenues) 3/	5.5	4.5	3.9	4.2	...	...	...	...	4.1	5.4	5.1	6.1	6.4	6.8
Total external debt stock (percent of GDP) 4/	25.2	22.1	20.4	19.7	...	...	...	...	20.3	20.8	20.7	20.3	19.8	19.3
Volume of Exports of Goods and Services (percent change)	3.9	9.5	20.6	7.2	...	...	...	...	5.6	8.6	13.6	11.9	11.6	11.7
Volume of Imports of Goods and Services (percent change)	11.9	8.4	10.7	8.7	...	...	...	...	8.4	8.0	8.7	8.1	7.8	7.8

Sources: Ministry of Finance; Bank of Albania; donors; and Fund staff estimates and projections.

1/ Net of valuation changes in 2005-2006: In projections for 2007-2010 onwards valuation effects are assumed to be zero.

2/ In 2005-2007 assumes rescheduling of stock of outstanding arrears, both with official and private creditors.

3/ Public and publicly guaranteed debt only.

4/ Public and private external debt, including arrears. Debt stock converted into Lek at the e-o-p exchange rate.

Table 5b . Albania: Balance of Payments, 2002–2010
(In percent of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Projections					
Current account	-10.0	-8.1	-5.5	-7.8	-8.1	-7.1	-6.5	-6.2	-5.4
Balance of goods and services	-25.9	-25.1	-21.7	-24.1	-24.5	-23.2	-22.3	-21.8	-20.7
Exports	20.5	20.8	21.5	21.6	22.4	22.9	23.4	23.9	24.3
Goods	7.4	8.0	8.1	7.9	8.2	8.6	8.9	9.3	9.6
Services	13.1	12.8	13.4	13.8	14.2	14.4	14.5	14.7	14.8
Imports	46.3	45.9	43.2	45.8	46.9	46.1	45.7	45.7	45.0
Goods	33.1	31.6	29.1	29.7	31.2	30.8	30.3	29.8	29.3
Services	13.2	14.2	14.1	16.0	15.7	15.3	15.4	15.8	15.7
Income balance	2.8	3.1	2.4	1.8	1.8	1.7	1.5	1.4	1.4
Of which : Interest due	0.5	0.4	0.3	0.4	0.6	0.7	0.7	0.8	0.8
Private transfers	13.0	14.0	13.8	14.6	14.6	14.5	14.3	14.2	13.8
Capital account	10.2	8.1	7.2	5.6	8.3	7.6	7.5	7.2	6.8
Official transfers	2.8	2.6	1.7	0.9	1.5	1.3	1.1	1.1	1.0
Direct investment	3.0	3.2	4.6	3.1	3.3	3.2	3.4	3.5	3.4
Other capital	2.4	0.8	-0.2	0.6	2.4	2.1	2.2	1.9	2.0
Private loans (incl.net trade credits, net)	0.2	0.4	1.3	0.9	0.7	0.7	0.7	0.8	0.9
Other financial flows	2.2	0.4	-1.5	-0.3	1.7	1.4	1.5	1.2	1.1
Of which: Change in NFA of commercial banks (incr = -) 1/	2.2	0.4	-1.5	-0.3	1.7	1.4	1.5	1.0	0.3
Official medium- and long-term loans (net)	2.0	1.5	1.1	0.9	1.1	1.0	0.8	0.7	0.5
New borrowing	2.6	2.0	1.7	1.5	1.9	1.8	1.9	1.9	1.9
Multilateral loans	1.8	1.5	1.2	1.1	1.4	1.3	1.3	1.2	1.1
World Bank	1.1	0.7	0.6	0.5	0.6	0.4	0.4	0.3	0.3
EBRD	0.2	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Other	0.5	0.5	0.4	0.4	0.6	0.6	0.6	0.6	0.6
Bilateral loans	0.8	0.5	0.5	0.4	0.4	0.5	0.6	0.7	0.8
Amortization	-0.6	-0.5	-0.5	-0.6	-0.7	-0.8	-1.1	-1.2	-1.4
Errors and omissions	-0.3	0.5	1.2	2.8	0.8	0.2	0.3	0.2	0.5
Net balance	0.0	0.6	3.0	0.6	0.9	0.7	1.3	1.2	1.9
Financing requirement	0.0	-0.6	-3.0	-0.6	-0.9	-0.7	-1.3	-1.2	-1.9
Available financing	0.0	-0.6	-3.0	-0.6	-0.9	-0.7	-1.3	-1.2	-1.9
Change in net reserves (increase = -) 1/	-0.6	-0.9	-3.2	-0.6	-1.5	-1.0	-1.7	-1.5	-2.0
BOP support	0.6	0.3	0.3	0.0	0.2	0.0	0.0	0.0	0.0
Changes in arrears (increase = +) 2/	-6.4	0.0	-0.2	-0.2	-0.3	-0.7	0.0	0.0	0.0
Overdue debt forgiveness	4.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Rescheduling 2/	1.6	0.0	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Identified Financing	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0
Of which: IMF PRGF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
WB ESAC/PRSC	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0
Financing gap	0.0	0.0	0.0	0.2	0.6	0.8	0.3	0.3	0.0
Expected EU Macro-Financial Assistance	...	...	...	0.0	0.3	0.0	0.0	0.0	0.0
Arrears Rescheduling	...	...	...	0.2	0.3	0.7	0.0	0.0	0.0
Other	...	...	...	0.0	0.0	0.2	0.3	0.3	0.0

Sources: Ministry of Finance; Bank of Albania; donors; and Fund staff estimates and projections.

1/ Net of valuation changes in 2005-2006: In projections for 2007-2010 onwards valuation effects are assumed to be zero.
2/ In 2005-2007 assumes rescheduling of stock of outstanding arrears, both with official and private creditors.

Table 6a. Albania: General Government Operations, 2003-10
(In percent of GDP)

	2003	2004	2005		2006			2007	2008	2009	2010
			Budget IMF Country Report No. 05/89	Prelimininary	Budget IMF Country Report No. 06/6	Proj.	First Quarter 5/	Proj.			
Total Revenue and Grants	24.5	24.1	24.7	24.4	24.6	25.5	5.9	26.1	26.3	26.4	26.5
Tax Revenue	21.3	21.7	21.8	22.0	21.8	23.0	5.3	23.4	23.7	23.9	24.1
VAT	7.4	7.6	7.6	7.7	7.8	8.4	1.7	8.7	8.7	8.7	8.7
Profit tax	1.9	2.1	1.9	2.3	2.0	2.3	0.7	2.5	2.5	2.7	2.7
Excise tax	1.8	2.1	2.2	2.2	2.2	2.7	0.5	2.7	2.7	2.6	2.6
Small business tax	0.4	0.5	0.5	0.5	0.3	0.3	0.1	0.3	0.3	0.3	0.3
Personal income tax	0.9	0.9	0.9	0.9	0.9	1.0	0.2	1.1	1.2	1.3	1.5
Customs duties	2.0	1.8	1.9	1.6	1.6	1.6	0.4	1.4	1.3	1.1	1.2
Other taxes	1.8	1.6	1.7	1.5	1.6	1.6	0.4	1.7	1.7	1.7	1.7
Property and local taxes	0.7	0.7	0.7	0.9	1.0	1.0	0.3	0.9	0.9	0.9	1.0
Social insurance contributions	4.2	4.3	4.4	4.3	4.4	4.1	1.1	4.2	4.4	4.5	4.5
Non-tax revenue	2.8	2.1	2.1	1.7	1.8	1.8	0.5	1.8	1.7	1.7	1.6
Grants	0.4	0.3	0.8	0.7	1.0	0.7	0.1	0.9	0.8	0.8	0.8
Of which Budget support	0.0	0.0	0.2	0.0	0.2	0.2	…	0.0	0.0	0.0	0.0
Total Expenditure	29.0	29.2	29.7	28.0	28.7	29.3	4.7	30.0	30.2	30.4	29.9
Current Expenditure	24.6	24.0	23.2	23.2	23.0	22.9	4.4	22.9	22.8	22.9	22.7
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	6.5	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
of which contingency	…	…	…	…	0.1	0.1	0.0	…	…	…	…
Interest	4.4	3.7	3.6	3.1	3.4	3.4	0.7	3.3	3.2	3.1	3.0
Of which Domestic	4.1	3.5	3.3	2.9	3.0	3.0	0.7	2.8	2.7	2.5	2.4
Operations & maintenance	3.2	3.1	2.6	2.9	2.4	2.4	0.3	2.4	2.6	2.8	2.8
Subsidies	0.7	0.7	0.3	0.4	0.3	0.3	0.1	0.3	0.2	0.2	0.2
Social insurance outlays	6.6	6.6	6.6	6.7	6.7	6.7	1.5	6.6	6.5	6.4	6.4
Of which contingency	…	…	…	…	0.1	0.1	0.1	…	…	…	
Local government expenditure	2.1	2.1	2.1	2.4	2.4	2.4	0.3	2.6	2.8	3.1	3.2
Social protection transfers	1.3	1.5	1.2	1.2	1.3	1.3	0.2	1.2	1.2	1.2	1.2
Other 1/	-0.3	0.0	…	…	0.0	0.0	0.0	0.0	0.0	0.0	...
Capital Expenditure	4.6	5.0	6.0	4.6	5.3	6.2	0.4	6.5	6.9	7.0	6.7
Domestically financed	2.7	3.6	3.3	2.9	2.8	3.8	0.2	4.0	4.2	4.2	4.5
Of which contingency	…	…	…	…	0.2	0.2	0.2	…	…	…	…
Foreign financed projects	1.9	1.4	2.7	1.7	2.5	2.4	0.1	2.5	2.7	2.8	2.2
Lending minus repayment	-0.2	0.2	0.0	0.2	0.0	0.0	…	0.0	0.0	0.0	0.0
Reserve and contingency funds 2/	...	...	0.4	…	0.3	0.2	…	0.6	0.6	0.5	0.5
Cash Balance	-4.5	-5.1	-5.0	-3.6	-4.1	-3.8	1.1	-3.9	-4.0	-4.0	-3.4
Current Balance 3/	-0.5	-0.2	0.5	0.5	0.5	1.9	0.0	2.1	2.4	2.5	2.8
Financing	4.5	5.1	5.0	3.6	4.1	3.8	0.0	3.9	4.0	4.0	3.4
Domestic	3.1	4.2	3.4	2.8	3.0	2.9	0.0	2.7	2.6	2.5	2.5
Privatization receipts 4/	0.1	1.9	0.6	0.1	0.3	0.6	0.0	0.2	0.2	0.2	0.2
Net borrowing	2.9	2.3	2.8	2.7	2.6	2.3	0.0	2.5	2.4	2.3	2.3
Foreign	1.5	1.0	1.7	0.8	1.1	0.9	0.0	1.1	1.3	1.4	0.8
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:											
Domestically-financed expenditure	26.8	27.5	26.7	25.9	27.1		0.0	27.5	27.5	27.6	
Primary balance	-0.2	-1.4	-1.5	-0.5	-0.7	-0.5	1.9	-0.6	-0.7	-0.9	-0.4
Public Debt (including guarantees)	61.8	56.5	55.8	55.3	55.0	55.2	…	54.6	53.7	52.7	51.4
Domestic general government	41.1	38.5	38.2	37.7	38.1	37.4	…	36.8	36.0	35.3	34.5
External	20.7	18.0	17.5	17.6	16.9	17.8	…	17.8	17.7	17.5	17.0
GDP (in billions of leks)	683	767	837	837	900	900	…	982	1076	1177	1293

Source: Albanian authorities; and Fund staff estimates and projections.

1/ Includes statistical discrepancy.
2/ Spending out of reserve and contingency funds are reported according to their economic classification at outturn.
3/ Revenue excluding grants minus current expenditure.
4/ Includes privatization of Italian-Albanian Bank in 2006.
5/ As a ratio of annual projected GDP.

Table 6b. Albania: General Government Operations, 2003-10

(In billions of leks)

	2003	2004	2005		2006			2007	2008	2009	2010
			Budget IMF Country Report No. 05/89	Preliminінary	Budget IMF Country Report No. 06/6	Baseline Proj.	First quarter	Projection			
Total Revenue and Grants	167.2	184.6	206.5	204.2	221.3	229.1	53.0	256.7	282.5	310.9	343.3
Tax Revenue	145.3	166.0	182.2	183.8	196.2	206.5	47.3	230.3	255.3	281.6	311.9
VAT	50.6	58.2	63.3	64.5	70.0	75.7	15.7	85.2	93.9	102.4	112.7
Profit tax	13.1	16.3	16.0	19.2	18.3	21.0	6.1	24.1	27.4	31.2	34.3
Excise tax	12.3	15.8	18.3	18.5	19.9	24.2	4.6	26.1	28.6	30.8	33.6
Small business tax	2.9	4.1	3.9	3.8	2.4	2.4	0.9	2.8	3.2	3.7	4.2
Personal income tax	6.4	6.9	7.6	7.4	8.3	9.0	1.9	10.8	13.1	15.7	19.0
Customs duties	13.9	13.9	15.6	13.6	14.1	14.4	3.4	14.0	13.5	13.0	14.9
Other taxes	12.5	12.1	14.4	12.7	14.2	14.6	3.2	16.8	18.5	20.2	22.3
Property and local taxes	4.5	5.0	5.8	7.5	8.8	8.8	2.8	8.9	10.0	11.1	12.6
Social insurance contributions	28.6	33.3	36.7	36.2	40.0	36.5	9.5	41.6	47.2	53.4	58.3
Non-tax revenue	19.2	16.0	17.4	14.2	16.5	16.5	4.5	17.5	18.6	19.9	21.3
Grants	2.6	2.6	6.9	6.2	8.6	6.0	1.2	8.8	8.6	9.4	10.0
Of which Budget support	0.2	0.2	1.9	0.4	1.6	1.6	0.0	0.0	0.0	0.0	0.0
Total Expenditure	198.1	223.8	248.7	234.2	258.0	263.4	42.7	294.9	325.1	357.4	386.8
Current Expenditure	167.7	183.8	194.6	194.0	207.2	205.7	39.5	224.6	245.2	269.5	294.0
Personnel cost	44.7	49.0	55.2	53.7	59.9	58.6	12.0	62.9	67.9	73.3	78.2
Social insurance contributions	9.0	9.9	11.7	10.9	11.8	[illegible]	0.0	12.8	13.9	15.1	16.4
of which contingency	…	…	…	…	1.3	1.3	0.0	…	…	…	…
Interest	29.8	28.4	29.9	26.0	30.3	30.2	6.4	32.6	34.5	36.5	38.7
Of which Domestic	28.2	26.7	27.3	24.2	26.6	26.6	6.1	27.8	28.7	29.5	31.6
Operations & maintenance	22.2	24.0	22.0	24.5	21.5	21.3	3.1	23.9	27.5	33.0	36.2
Subsidies	5.1	5.1	2.7	3.7	2.5	2.5	0.5	2.5	2.5	2.5	2.5
Social insurance outlays	44.8	50.2	55.2	55.9	59.9	59.9	13.4	65.0	69.9	74.8	82.3
Of which contingency	…	…	…	…	0.8	0.8	0.8	…	…	…	…
Local government expenditure	14.2	15.9	17.7	20.0	21.2	21.3	2.4	25.4	30.5	36.7	41.0
Social protection transfers	8.8	11.5	10.5	10.2	11.5	11.5	1.6	12.2	12.9	13.7	15.0
Other 1/	-2.0	-0.3	0.0	0.0	0.3	0.3	0.0	0.0	0.0	0.0	...
Capital Expenditure	31.5	38.6	50.5	38.4	47.8	55.7	3.2	64.3	73.9	81.9	86.9
Domestically financed	18.3	27.6	28.0	24.3	25.3	33.8	2.0	39.4	45.2	49.2	58.8
Of which contingency	…	…	…	…	2.0	2.0	2.0	…	…	…	…
Foreign financed projects	13.2	11.0	22.6	14.1	22.5	21.8	1.2	24.9	28.8	32.8	28.0
Lending minus repayment	-1.1	1.4	0.0	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserve and contingency funds 2/	...	...	3.6	…	3.0	2.0	0.0	6.0	6.0	6.0	6.0
Cash Balance	-30.9	-39.2	-42.2	-30.1	-36.6	-34.3	10.3	-38.2	-42.6	-46.6	-43.6
Current Balance 3/	-3.2	-1.9	4.0	4.0	4.5	17.4	-0.4	20.3	25.8	28.9	36.3
Financing	30.9	39.2	42.2	30.1	36.6	34.3	0.0	38.2	42.6	46.6	43.6
Domestic	20.9	31.9	28.3	23.3	26.8	25.8	0.0	27.0	28.5	30.0	32.7
Privatization receipts	0.9	14.4	5.0	0.9	3.0	5.5	0.0	2.0	2.2	2.4	2.3
Net borrowing	20.0	17.6	23.4	22.4	23.8	20.3	0.0	25.0	26.4	27.6	30.4
Foreign	10.0	7.3	13.8	6.8	9.8	8.5	0.0	11.2	14.1	16.6	10.9
Memorandum Items:											
Primary balance	-1.1	-10.8	-12.3	-4.0	-6.3	-4.1	16.7	-5.6	-8.0	-10.0	-4.9
Public Debt (including guarantees)	422.0	433.4	466.9	462.8	494.9	496.4	…	536.3	578.0	620.5	664.9
Domestic general government	280.8	295.2	320.1	315.9	342.4	336.2	…	361.2	387.6	415.2	445.6
External	141.2	138.2	146.8	146.9	152.5	160.3	…	175.1	190.4	205.3	219.3

Sources: Albanian authorities; and Fund staff estimates and projections.

1/ Includes statistical discrepancy.

2/ Spending out of reserve and contingency funds are reported according to their economic classification at outturn.

3/ Revenue excluding grants minus current expenditure.

4/ Includes privatization of Italian-Albanian Bank in 2006.

Table 7: Albania: Monetary Aggregates, 2002–10

(In billions of leks unless otherwise indicated; end-period)

	Actuals								Projections						
	2002	2003	2004	2005				2006				2007	2008	2009	2010
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Dec.	Dec.	Dec.	Dec.
Monetary survey															
Broad money	408.1	443.5	503.2	516.9	537.8	561.9	573.0	575.2	602.1	627.4	650.6	727.7	814.8	913.0	1024.2
Currency outside banks	130.8	125.2	138.1	129.4	135.8	141.5	149.7	137.2	148.1	154.3	166.6	175.4	184.1	187.2	192.3
Deposits	277.4	318.3	365.1	387.5	402.0	420.4	423.3	437.9	454.0	473.0	484.0	552.3	630.6	725.9	831.8
Domestic currency deposits	190.8	226.1	255.2	266.2	271.3	271.9	276.8	284.4	288.7	303.8	313.9	358.4	413.0	477.8	548.3
Foreign currency deposits	86.5	92.2	110.0	121.3	130.6	148.5	146.6	153.5	165.3	169.3	170.1	193.9	217.6	248.1	283.6
Net foreign assets	164.4	161.8	188.8	197.3	199.2	213.8	210.8	214.2	205.1	208.6	203.7	201.5	205.7	213.4	236.5
Bank of Albania	96.9	99.8	118.6	122.2	124.9	128.4	138.8	140.1	137.2	144.0	146.5	157.5	177.6	197.4	224.2
Commercial Banks	67.5	62.0	70.2	75.1	74.3	85.3	72.0	74.2	67.9	64.6	57.2	44.0	28.1	16.0	12.3
Net domestic assets	243.8	281.7	314.4	319.6	338.6	348.1	362.2	360.9	397.0	418.8	446.9	526.2	609.0	699.6	787.7
Claims on government (net of deposits)	245.3	260.1	271.0	269.9	276.4	277.6	277.0	264.7	273.0	282.9	292.8	309.9	327.6	346.2	365.9
BOA financing	71.0	64.6	57.2	56.7	56.0	63.2	58.6	52.4	63.9	73.3	62.9	67.5	63.4	60.6	61.6
Other (including T-bills)	174.3	195.5	213.7	213.2	220.4	214.5	218.4	212.3	209.1	209.6	229.9	242.4	264.1	285.6	304.2
Claims on state enterprises and farms	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on the private sector 1/	39.9	52.3	71.6	81.5	97.8	108.1	124.4	137.4	157.9	169.9	187.7	250.8	316.7	389.6	458.4
In Leks	9.2	10.6	15.6	18.1	24.3	27.6	33.7	37.9	46.2	51.4	61.0	89.6	118.2	151.7	185.0
In foreign currency	30.7	41.7	56.0	63.4	73.6	80.5	90.6	99.5	111.7	118.5	126.7	161.3	198.4	237.9	273.4
Other items, net	-41.5	-30.8	-28.3	-32.0	-35.7	-37.6	-39.2	-41.3	-33.9	-34.0	-33.7	-34.6	-35.2	-36.2	-36.5
Memorandum items:															
Reserve money (billions of Lek)	163.9	160.6	178.6	171.2	180.4	194.1	198.3	186.3	197.7	211.7	217.4	235.9	253.2	270.0	287.6
M1 (billions of Lek)	145.9	142.0	170.1	167.5	173.5	208.9	223.7	213.3	207.6	216.3	227.5	243.1	259.9	271.6	286.3
M2 (Billions of Lek)	321.6	351.3	393.3	395.6	407.1	413.4	426.4	421.6	436.8	458.1	480.5	533.8	597.2	664.9	740.6
Annual broad money growth	5.7	8.7	13.5	14.8	18.8	16.3	13.9	11.3	12.0	11.7	13.5	11.8	12.0	12.1	12.2
Annual reserve money growth	7.7	-2.0	11.2	10.8	14.9	16.6	11.0	8.9	9.6	10.7	10.2	8.5	7.4	6.6	6.5
Annual growth in private sector credit	41.0	31.1	36.9	48.5	68.0	73.2	73.6	68.6	61.4	57.2	50.9	33.7	26.3	23.0	17.7
Annual M2 growth	6.4	9.2	11.9	11.8	14.6	10.8	8.4	6.6	7.3	10.8	12.7	11.1	11.9	11.3	11.4
Velocity (annual GDP/BM)	1.5	1.5	1.5	1.6	1.5	1.5	1.5	1.5	1.4	1.4	1.4	1.3	1.3	1.3	1.3
Money multiplier (absolute values)	2.5	2.8	2.8	3.0	3.0	2.9	2.9	3.1	3.0	3.0	3.0	3.1	3.2	3.4	3.6
Currency/Broad Money ratio	32.0	28.2	27.4	25.0	25.3	25.2	26.1	23.9	24.6	24.6	25.6	24.1	22.6	20.5	18.8
Foreign currency deposits/total deposits	31.2	29.0	30.1	31.3	32.5	35.3	34.6	35.1	36.4	35.8	35.1	35.1	34.5	34.2	34.1
Gross reserves (millions of euros)	845	834	1,025	1,024	1,071	1,114	1,202	1,210	1,194	1,248	1,260	1,335	1,476	1,613	1,807
Gross reserves (millions of U.S. dollars)	860	1,026	1,374	1,351	1,303	1,342	1,425	1,465	1,500	1,569	1,587	1,690	1,878	2,061	2,318
In percent of broad money	28.2	24.6	25.3	25.4	24.9	24.5	25.7	25.8	24.4	24.5	23.8	22.7	22.6	22.2	22.3
US Dollar Exchange Rate (end of period)	133.9	106.4	92.7	97.2	102.7	102.5	103.4	101.5	...	...	...	...	...	...	...
Euro Exchange Rate (end of period)	138.3	133.8	125.9	125.9	123.9	123.3	122.4	122.8	...	...	...	...	...	...	...
3-month T-bill rate (in percent)	11.1	7.3	6.2	5.3	5.0	6.3	5.4	5.2	…	…	…	…	…	…	…
BoA repo rate (in percent)	8.5	6.5	5.3	5.0	5.0	5.0	5.0	5.0	…	…	…	…	…	…	…

Sources: Bank of Albania; and Fund staff estimates.

1/ Excluding credit transferred to the Bank Asset Resolution Trust (BART).

Table 8. Albania: IMF Core Indicators of Financial Soundness, December 2003-March 2006

		Dec-03	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06
I	**Capital-based**							
(i)	Regulatory capital as a percent of risk-weighted assets	28.5	21.6	21.0	19.8	18.3	18.6	19.3
(ii)	Regulatory Tier 1 capital as a percent of risk-weighted assets	29.0	21.5	20.4	19.3	17.9	18.1	18.9
(iii)	Capital as a percent of total assets							
	Regulatory Tier 1 capital as a percent of total assets	4.8	4.8	5.0	5.2	5.1	5.4	5.8
	Regulatory capital as a percent of total assets	4.7	4.8	5.1	5.3	5.3	5.6	5.9
	Shareholders' equity as a percent of total assets	5.9	6.1	5.8	6.4	6.6	6.6	6.5
(iv)	Nonperforming loans net of provisions as a percent of capital							
	Nonperforming loans net of provisions as a percent of regulatory Tier 1 capital	4.8	4.8	4.5	3.0	4.1	4.4	6.2
	Nonperforming loans net of provisions as a percent of regulatory capital	4.9	4.8	4.4	2.9	4.0	4.3	6.1
	Nonperforming loans net of provisions as a percent of shareholders' equity	3.9	3.8	3.9	2.4	3.2	3.6	5.6
(v)	Return on equity (ROE) (annual basis)	19.5	21.1	22.1	24.3	24.5	22.2	21.4
(vi)	Net open position in foreign exchange as a percent of capital							
	Net open position in foreign exchange as a percent of regulatory Tier 1 capital	7.2	7.5	3.6	8.7	7.3	9.5	6.7
	Net open position in foreign exchange as a percent of regulatory capital	7.3	7.4	3.5	8.5	7.1	9.3	6.6
	Net open position in foreign exchange as a percent of shareholders' equity	5.9	5.9	3.1	7.0	5.7	7.8	6.0
II	**Asset-based**							
(vii)	Liquid assets as a percent of total assets (Liquid-asset ratio)	73.6	71.1	70.3	67.1	65.3	62.6	62.1
(viii)	Liquid assets as a percent of short-term liabilities	na	na	83.2	109.9	73.5	75.2	75.5
(ix)	Return on assets (ROA) (net income to average total assets) (annual basis)	1.2	1.3	1.3	1.5	1.5	1.4	1.4
(x)	Nonperforming loans (gross) as a percent of total loans	4.6	4.2	3.5	2.4	2.4	2.3	3.0
(x1)	Sectoral distribution of loans to total loans	na	na	na	na	na	na	na
III	**Income and expense-based**							
(xii)	Interest margin to gross income	89.6	80.3	83.2	80.5	82.0	84.0	93.4
(xiii)	Noninterest expenses to gross income	57.4	66.2	81.5	75.3	76.7	76.3	71.4
IV	**Memorandum items**							
	Other (noncore) indicators:							
	Customer deposits as a percent of total (non-interbank) loans	652.1	535.8	498.3	417.8	384.8	342.5	326.6
	Foreign currency-denominated loans to total loans	82.1	80.5	79.9	77.7	77.6	75.5	74.5
	Foreign currency-denominated liabilities as a percent of total liabilities	35.9	37.0	38.2	39.9	41.5	41.0	41.0
	Other indicators:							
	Risk weighted assets as a percent of total assets	16.7	22.2	24.4	26.8	28.7	30.0	30.8
	Total loans as a percent of total assets	13.6	16.4	17.6	20.8	22.8	25.7	26.5
	Total loans as a percent of shareholders' equity	231.2	270.3	302.6	326.5	348.7	387.0	408.7

Source: Data provided by Bank of Albania.

Table 9. Albania: Structural Reforms in Debt Management

Area	**Activity**	**Proposed Implementation Date**
Developing the strategic framework for debt management	Develop an explicit strategy for debt management and an action plan to guide implementation of the strategy.	Short term
	Adopt a portfolio approach to managing the aggregate debt portfolio.	Long term
	Prepare an annual risk assessment of the guarantee portfolio.	Long term
	Publish data on auction results and debt stock on the MOF website.	Long term
	Examine the feasibility of obtaining an international credit rating.	Long term
Legal and institutional framework for public debt management	Submit to Parliament a public debt law and put in place a timetable to enact proposed new legislation affecting public debt management.	Short term
	Establish a new Debt Management Directorate (DMD) at the same level of the existing Treasury and Public Debt Directorate and appoint a director of the new DMD with financial sector experience.	Medium term
	Develop policies and procedures for debt management within the DMD.	Long term
	Develop an human resources plan consistent with the development of the debt management function.	Long term
Integration of debt and cash management	Immediately discontinue the practice of running the cash balance of the Treasury Single Account (TSA) down to zero at the end of the fiscal year.	Short term
	Develop cash forecasting capacity within the Treasury department.	Medium term
	Amend the procurement law to allow tendering for recurrent items of goods and services for the following year to commence in the previous year.	Medium term
	Introduce a system of commitment controls.	Medium term
	Gradually change T-bill issuance to better reflect government cash flow patterns.	Long term
Development of the domestic government security market	Shorten auction processing time by de-linking of the competitive and non-competitive bidding process.	Short term
	Prepare an analysis on options to replace the BOA window.	Medium term
	Make the allocations between the competitive and non-competitive auction segments more flexible and restrict access to the non-competitive segment to individuals and BOA.	Medium term
	Open up the Treasury bond auctions to a wider audience.	Medium term
	Consider relaxing the prepayment requirement for corporate and institutional investors.	Medium term
	Establish a regular mode of communication with the main participants to discuss issues affecting the government securities market.	Medium term
Money market development	The BoA should assume a leading role in the development of the money market and organize workshops for market participants.	Short term
	Consider excluding interbank transactions from reserve requirements.	Short term
	The BOA should refrain from entering into transactions with individual banks when the system is sufficiently liquid.	Medium term
Investors in the government securities market	Provide a level playing field for non-resident investors and modernize custody and depository systems.	Long term

Table 10. Albania: External Financing Requirement and Sources, 2002–2010
(In millions of Euros)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Est		Projections			
Current account	468	402	331	525	594	563	566	585	560
Amortization	43	34	40	45	63	74	106	127	152
Of which : IMF	15	8	8	7	9	11	11	11	9
Change in gross reserves (increase = +)1/	19	-10	191	47	104	75	141	137	194
Reduction in arrears	300	-2	12	17	19	53	0	0	0
Total financing requirement	830	424	574	634	779	764	813	850	906
Available financing	830	424	574	619	739	696	788	820	906
Official grants	132	129	103	62	107	101	99	101	102
Foreign direct investment	142	158	277	212	239	256	295	331	353
Other capital	113	42	-13	41	175	164	187	183	201
Official medium- and long-term loans	123	101	100	99	136	146	162	179	190
Multilateral (excluding IMF)	84	75	72	75	106	107	111	113	112
Bilateral	38	26	28	25	31	40	51	66	78
IMF disbursements	6	10	10	9	6	6	6	3	0
Other 2/	-14	-32	69	190	57	15	27	20	56
Debt rescheduling	300	0	12	5	0	0	0	0	0
Budget support	30	17	15	0	14	0	0	0	0
Identified financing	0	0	0	0	5	8	12	4	4
Of which : WB FSAC/PRSC	...	...	...	0	5	8	12	4	4
Financing gap	0	0	0	15	41	68	25	30	0
Expected EU macro-financial assistance	...	...	...	3	22	0	0	0	0
Debt rescheduling (mostly clearance of bilateral arrears)	...	...	...	12	19	53	0	0	0
Other	...	...	...	0	0	15	25	30	0

Sources: Ministry of Finance, Bank of Albania, donors, and Fund staff estimates.

1/ The change in gross reserves is net of valuation changes for 2005-2006. In projections for 2007-2010, valuation effects are assumed to be zero.

2/ Includes errors and omissions.

Table 11. Albania: Indicators of Fund Credit, 2000-2006
(SDR Million unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006 Proj.
Outstanding credit							
Stand-by arrangement/ EFF	8.8	4.4	0.0	0.0	0.0	0.0	2.4
PRGF	58.6	61.8	59.6	60.8	62.4	64.3	59.1
Total	67.5	66.3	59.6	60.8	62.4	64.3	61.6
In percent of quota	138.5	136.0	122.4	124.9	128.1	132.0	126.4
In percent of exports (GNFS)	12.7	10.0	8.5	7.3	5.7	5.2	4.4
In percent of public external debt	7.6	6.7	6.9	6.5	6.1	6.1	5.3
Disbursements							
GRA							2.4
PRGF	14.3	9.4	4.0	8.0	8.0	8.0	2.4
In percent of quota	29.3	19.3	8.2	16.4	16.4	16.4	10.0
In percent of exports (GNFS)	2.7	1.4	0.6	1.0	0.7	0.6	0.2
Debt service							
Principal	5.5	10.6	10.6	6.8	6.4	6.2	7.6
Interest and charges	0.7	0.7	0.4	0.3	0.3	0.3	0.4
Total	6.2	11.3	11.0	7.1	6.7	6.5	8.0
In percent of exports (GNFS)	1.2	1.7	1.6	0.9	0.6	0.5	0.6
In percent of public external debt service	29.3	41.6	24.9	17.2	15.2	12.6	10.1
Net Fund Financing	8.0	-1.9	-7.0	0.9	1.3	1.5	-3.1
Memorandum items:							
Exchange rate (Euros per SDR, average)	1.43	1.42	1.37	1.24	1.19	1.19	1.18
Exchange rate (Euros per SDR, e-o-p)	1.44	1.42	1.32	1.19	1.15	1.21	1.17
Quota (in millions of SDRs)	48.7	48.7	48.7	48.7	48.7	48.7	48.7
Exports of GNFS (in millions of Euros)	760	937	962	1031	1293	1461	1640
Public external debt (millions of Euros)	1282	1389	1138	1120	1169	1279	1374
Public external debt service (millions of Euros)	30	39	61	51	53	61	93.7

Sources: Albanian authorities and Fund staff estimates.

Table 12. Albania: Projected Payments to the Fund, 2002-10
(in millions of SDRs)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
					Projections				
Obligations from existing drawings									
1. Principal									
PRGF Repayments	6.2	6.8	6.4	6.2	7.6	9.4	9.6	9.1	8.0
GRA repurchases	4.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
2. Charges and Interest 1/									
PRGF Interest	0.3	0.3	0.3	0.3	0.4	0.27	0.22	0.17	0.12
SDR Net Charges	0.1	0.0	0.0	0.0	0.00	0.06	0.06	0.06	0.06
Total Obligations	11.0	7.1	6.7	6.5	8.0	9.7	9.9	9.3	8.2
(percent of quota)	23	15	14	13	16	20	20	19	16.9
Obligations from prospective drawings									
1. Principal									
PRGF Repayments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Charges and Interest									
PRGF Interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR Net Charges	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.4	0.4
Total Obligations	0.0	0.0	0.0	0.0	0.0	0.1	0.3	0.4	0.4
(percent of quota)	0	0	0	0	0	0	1	1	1
Cumulative obligations (existing and prospective)									
1. Principal									
PRGF +EFF Repayments	10.6	6.8	6.4	6.2	7.6	9.4	9.6	9.1	8.1
2. Charges and Interest 1/									
PRGF Interest	0.3	0.3	0.3	0.3	0.4	0.3	0.3	0.2	0.2
SDR Net Charges	0.1	0.0	0.0	0.0	0.0	0.2	0.3	0.4	0.4
Total Obligations	11.0	7.1	6.7	6.5	8.0	9.9	10.2	9.7	8.6
(percent of quota)	23	15	14	13	16	20	21	20	18
Outstanding Fund credit 2/	59.6	60.8	62.4	64.3	61.6	57.0	52.3	45.6	37.6
Memorandum items:									
Outstanding Fund credit									
In percent of:									
Exports of goods & services	8.2	7.0	5.5	5.3	4.4	3.7	3.0	2.4	1.8
GDP	1.7	1.5	1.2	1.2	1.0	0.8	0.7	0.6	0.4
Quota	122	125	128	132	126	117	107	94	77
Total Obligations									
In percent of:									
Exports of goods & services	1.6	0.9	0.6	0.5	0.6	0.6	0.6	0.5	0.4
GDP	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1

1/ Projections are based on current interest rates for PRGF and the EFF. The current SDR interest rate is assumed for net use of SDRs.
2/ End of year value.

Appendix I: Fund Relations

As of May 31, 2006

I. **Membership Status**: Joined: 10/15/1991; Article XIV

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	48.70	100.00
Fund Holdings of Currency	46.57	95.62
Reserve position in Fund	3.35	6.89

III. **SDR Department**:	SDR Million	Percent Allocation
Holdings	8.96	N/A

IV. **Outstanding Purchases and Loans**:	SDR Million	Percent Quota
Extended Arrangement	1.22	2.50
PRGF arrangements	63.11	129.60

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	2/01/2006	1/31/2009	8.52	1.22
PRGF	2/01/2006	1/31/2009	8.52	1.22
PRGF	6/21/2002	11/20/2005	28.00	28.00

VI. **Projected Payments to the Fund (Expectation Basis)**
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	5.23	9.41	9.62	9.08	8.05
Charges/Interest	0.34	0.33	0.28	0.23	0.18
Total	5.57	9.73	9.90	9.31	8.33

VII. **Safeguards Assessments**:

Under the Fund's safeguards assessment policy, the Bank of Albania (BoA) will be subject to a safeguards assessment with respect to the proposed arrangement, to be completed not later than the first program review. The most recent full safeguards assessment was carried out in connection with the expiring program and was finalized in June 2002. The assessment noted that the BoA has made significant progress in implementing the recommendations of the first safeguards assessment, and that, in general, the BoA has adequate safeguards in place to reduce the risk of misuse and misreporting of Fund resources. Nevertheless, the assessment noted minor weaknesses in the bank's internal auditing, financial reporting, and internal control systems, all of which BoA management agreed to address.

VIII. **Exchange Rate Arrangement**:

On July 1, 1992 the Albanian authorities adopted a floating exchange rate system (an independent float). Under the Fund's de facto exchange rate regime classification, Albania follows an independently floating exchange rate regime—although the monetary authorities occasionally intervene in the foreign exchange market with the objective of smoothing temporary fluctuations. Albania's exchange rate arrangement is free from exchange restrictions and multiple currency practices subject to Fund jurisdiction under Article VIII. However, the country still avails itself of the transitional arrangements under Article XIV and maintains exchange restrictions in the form of outstanding debit balances on inoperative bilateral payment agreements, which were in place before Albania became a Fund member. These relate primarily to debt in nonconvertible and formerly nonconvertible currencies, which the authorities are working to resolve by mid-2007 for official creditors, and by end-2007 for private sector creditors. Albania has not imposed new restrictions under Article VIII. The exchange rate stood at 97.5 lek per U.S. dollar on June 15, 2006.

IX. **Article IV Consultation**:

The conclusion of the 2004 Article IV consultation and the fifth review under the three-year PRGF arrangement took place in February 2005 (IMF Country Report No. 05/89). Albania moved from a 12-month cycle to a 24-month cycle, in line with the decision on consultation cycles approved on July 15, 2002. The last Article XIV Consultation was concluded in December 2005.

X. **FSAP Participation and ROSCs**:

An FSAP was carried out in early 2005. The Financial System Stability Assessment was considered by the Executive Board on August 1, 2005 concurrently with the staff report for the sixth review of the PRGF-supported program and financing assurances review. An action plan for implementing the FSAP recommendations has been prepared in consultation with the IMF and is currently being implemented. A data module ROSC was published on the Fund's website in June 2000. A fiscal ROSC was completed in June 2003. Albania participates in the General Data Dissemination System (GDDS), and a complete set of GDDS metadata for the external, financial, fiscal, and real sectors, as well as for the socio-demographic indicators is posted on the Fund's Dissemination Standards Bulletin Board (http://dsbb.imf.org). A data module ROSC reassessment using the Data Quality Assessment Framework was conducted in March 2006.

XI. **Technical Assistance**:

The Fund, other multilateral organizations and donors have provided extensive assistance for institutional development in Albania. The Fund alone has sent several technical assistance missions to Albania every year since 1991. However, further institutional development is required in virtually every sector.

XII. Resident Representative:

A Fund resident representative has been posted in Tirana since April 1993. Ms. Ann-Margret Westin has filled this position since August 2005.

APPENDIX II: IMF-WORLD BANK RELATIONS

Partnership in Albania's Development Strategy

1. The Republic of Albania has been a member of the World Bank since 1991. Since then, the WBG has provided strong support to Albania, including 60 loans mostly in IDA commitments totaling US$834.8 million, IFC commitments of US$125 million, and MIGA guarantees totaling US$8.6 million. The quality of the active portfolio has continued to improve, with an increasing focus on long-term capacity development and implementation through Government structures.

2. The World Bank's Board discussed a new Country Assistance Strategy (CAS) for Albania for FY06-FY09 in January 2006. The new CAS builds on the experience of the World Bank Group (WBG) since the early 1990s (through three CASs).[9] The CAS presents a program of support which seeks to build on the improved macro-economic management and progress in structural reforms that has occurred since 2002. It aims to support Albania's National Strategy for Social and Economic Development (NSSED) and the European Union (EU) Stabilization and Association process (SAP) with the ultimate objective of EU integration and the attainment of the Millennium Development Goals (MDGs).

3. The NSSED, adopted in 2001, remains the main development strategy that aims to bring Albania's living standards and income levels closer to the levels of its neighboring European countries. It represents Albania's serious effort to use a comprehensive medium-term national development strategy to move from short-term crisis management to creating the conditions that promote long-term growth and poverty reduction. The NSSED has strong government ownership and was prepared through an unprecedented participatory process. It is based on three pillars: (i) improving governance, (ii) promoting private sector development, and (iii) fostering human resources development. The NSSED recognizes that weak governance and institutions are at the root of Albania's developmental problems, and acknowledges that economic growth will be the main instrument to reduce poverty, raise standards of living, and accelerate the attainment of the MDGs. It also contains improved poverty diagnostics and an ambitious plan for monitoring and evaluation. A Joint Staff Advisory Note presented the Staffs assessment of the NSSED implementation as communicated in the Third Annual Progress Report for the NSSED prepared by GoA.
The new government is committed to revise the strategy to better address the link between MTBP and NSSED processes. Based on the Integrated Planning System, the strategic planning methodology has been launched, which sets standards for the formulation, approval, implementation and monitoring of the new national strategy. The new strategy is expected to be approved by end-2006.

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[9] The `Bank' refers to the IBRD and IDA and the 'World Bank Group' generally refer to the Bank, IFC, FIAS and MIGA.

Bank Group Strategy

4. Reflecting Government priorities, the CAS (2006-2009) program seeks to support Albania's efforts in strengthening governance, sustaining a private sector-led growth and improving service delivery**.** The new CAS recognizes that more coherent efforts need to be made to address the challenge of poor governance in Albania, and introduces a 'Governance Filter' compromising of four core principles which will be used to ensure that governance considerations are mainstreamed into all of the Bank's interventions. The CAS program is also more selective, focused on two pillars:

(I) ***Continued Economic Growth through Support to Private Sector Development,*** with expected outcomes including (a) macroeconomic stability; (b) improved business climate through better quality of business regulations and improved public-private sector dialogue; (c) improved public infrastructure; (d) increased operational efficiency of financial institutions; (e) improved functioning of the land market; (f) improved corporate governance; (g) increased transparency and efficiency in the management of public spending and stronger institutions for planning, tendering and providing infrastructure and services; (h) better accountability in public administration; and (i) better management and planning for Albanian coastal resources.

(II) ***Improving Public Service Delivery, particularly in the Social Sectors*****,** with expected outcomes including: (a) improved educational attainment and quality of basic education; (b) improved efficiency and equity of health financing; (c) better quality of health care; (d) improved fiscal sustainability of the social insurance system and increased access to well-targeted, sustainable, and effective assistance; and (e) improved access to safe rural water supply and sanitation.

5. The CAS proposes a lending range of US$ 75 – US$ 196 million, with actual lending to be determined by the pace of reform in key sectors. The proposed lending program would be financed by a blend of IDA and IBRD resources, with gradual transition from IDA to IBRD beginning in FY06. Up to 11 new IDA/IBRD lending operations are proposed in FY06-FY09, of which three would be a series of programmatic Development Policy Loan (DPL) building on the success of the PRSC series in the previous CAS. The CAS employs also targeted program of WBG Analytical and Advisory Activities (AAA) support.

6. The active World Bank portfolio includes 15 investment projects with a total commitment of $245.8 million, of which about $179.1 million remain to be disbursed. The investment side of the Bank's portfolio has performed well, and several new activities are scheduled to be presented to the Board before the end of FY06. Following the Board approval in June 2005 of three new projects : (i) the Natural Resources Development project (June 9); (ii) the Integrated Coastal Zone Management and Clean-Up project (June 21); and, (iii) the new power sector ECSEE-APL2-Albania project (June 28), the World Bank is preparing three operations that have been presented to the Board before the end of June 2006. These include:,a) Education Excellence and Quality and Equity Project , b) Health System Modernization Project**.**

Bank-Fund Collaboration in Specific Areas

7. As in previous periods, the World Bank assistance for structural reform in Albania will continue supporting the IMF's lead role on support for macro-economic policies aimed at facilitating sustainable growth. Continuing collaboration is likely to become even more critical given that most of the outstanding areas for reform remain on the structural side. In areas of direct interest to the IMF, the Bank is engaging in policy dialogue and providing financial and technical assistance to support (i) improved public expenditure management; (ii) public sector reform; (iii) pension, health and social assistance reform; (iv) financial sector reform and development; (v) an improved policy environment for business.

8. **Public expenditure management**: Albania's weak systems of Public Financial Management (PFM) and related fiscal institutions constitute a main risk for macroeconomic stability and high quality fiscal adjustment. Over the past years, the Bank has complemented IMF policy conditionality and technical assistance with a multi-pronged assistance program including lending operations and fiduciary and diagnostic work. Under the new CAS, the Bank will continue taking the lead in this area through the ongoing Programmatic Public Expenditure and Institutional Review and the upcoming Integrated Fiduciary Assessment (CFAA/CPAR-FY06). These will identify key weaknesses in the PFM system and provide the underlying analysis for defining further public expenditure management components and policy reform conditionality in the DPL.

9. To increase the effectiveness of public expenditure and public financial management system, the World Bank will support a number of measures to further improve the strategic allocation of resources mainly through the support to the implementation of the Integrated Planning System (IPS); improving the linkages between recurrent and investment spending and strengthening the rigorous review of public investment projects based on economic and financial criteria.

10. **Public sector reform**: The civil service and broader public sector employment structures require continued engagement and support. The Bank and IMF will need to work closely to ensure that an appropriate framework is in place to allow the Government to move ahead with efforts to a) restructure the government apparatus by reducing the size of government and rendering it more efficient, b) increase competitiveness of the salary structure and the ability of the civil service to attract skilled and competent professionals; and b) consolidate and deepen the measures aimed at the depoliticization of the civil service through the expansion of the Civil Service Law in a manner that is fiscally responsible. As deeper reform of public administration is currently anticipated through the CAS period, the Bank will also look, to use the DPL to continue to engage on civil service reform.

11. **Power sector reform**: The Bank and the Fund confirmed their support to the Government's efforts to overcome the recent crisis and agreed with the authorities that sustained implementation of the agreed measures to improve the performance in the power sector will be indispensable for growth and macroeconomic stability. While the Bank has taken the lead in developing the policy agenda, the sector's fiscal impact has also motivated conditionality in successive Fund arrangements.

12. Conditionality related to improving sector performance, sector restructuring, and strengthening the regulatory and legislative framework is included in successive Bank-financed projects. On-going projects include the Power Sector Rehabilitation and Restructuring Project (2002) that covers rehabilitation of the distribution network in three regions; the Power Sector Generation and Restructuring Project (2004) that will provide new thermal generation capacity and is co-financed by EBRD and EIB; and the ECSEE APL2-Albania Project (2005) that is co-financed by EBRD and will finance the upgrading of the high-voltage transmission substations, thereby facilitating Albania's participation in the Energy Community of South East Europe (ECSEE).

13. **Social Insurance Reforms**: The financial stability of the social insurance system and the coverage and targeting of the social assistance system are key components of medium term fiscal consolidation. Both the Bank and the IMF have focused on pension reform under the PRSC and PRGF programs, including the increase of the retirement age for men and women. The short-term agenda will focus on strengthening the financial sustainability of the existing pension scheme while aiming for a reduction of the overall payroll tax burden in the medium term so as to help improve competitiveness of Albanian labor. The Bank is supporting SII in developing its capacity to model medium- and long-term impacts of policy changes on the fiscal sustainability of the social insurance system and to identify a sustainable path for future reforms to the social insurance system. The Bank and the IMF will support such reforms in a coordinated fashion. They will also work closely to ensure that essential pre-conditions for future structural reforms to the pension system will be put in place, including strengthening of the financial markets as a one of the preconditions for establishment of potential future funded benefits systems.

14. **Financial sector reform and development**. Albania has made significant progress towards the adoption of a market-based economy with the support of the World Bank and the IMF. The Financial Sector Adjustment Credit (FSAC), approved by the Board in June 2002, has helped to advance reforms in the banking sector, including the privatization of the Savings Bank, the development of a deposit insurance system, improvement of the bankruptcy framework and collateral enforcement, strengthening of bank regulation and supervision, and the development of a Real Time Gross Settlement (RTGS) system. The IMF has provided technical assistance to the Bank of Albania by funding a resident adviser to support the implementation of the institutional development program for banking supervision developed by the Bank of Albania with the assistance from the Bank.

15. The WBG in conjunction with the IMF will assist the Government in the completion of the financial sector reform agenda and support the implementation of the recommendations of the recently concluded Joint IMF-World Bank Financial Sector Assessment Program (FSAP). The DPL will support policy measures associated with financial sector development, including (i) adoption of a legal, institutional and supervisory framework enabling sound development of the non-banking financial sector, including the insurance sector; (ii) strengthening insurance supervision and regulation; and (iii) adoption and implementation of an EU-compatible legal and institutional framework for accounting and auditing.

16. This reform agenda will be coordinated closely with European Commission institutions, especially in those elements of the reform agenda, such as accounting and auditing, for which the *acquis communautaire* is relevant.

17. **Improving the business environment.** A weak business environment plagued with considerable administrative barriers, weak governance, corruption, ambiguities in property and land rights, poor quality and high cost of infrastructure and utilities, is undermining future growth prospects and job creation. Improving the business environment will be crucial to overcome high levels of unemployment, attract the badly needed investment flows, and boost exports. Complementing the IMF dialogue on macro-economic stability and its technical and advisory assistance to strengthening tax administration, the Bank will use a combination of instruments, namely the Business Environment Reform and Institutional Strengthening Project and the Land Management and Urban Development project (expected board approval in January 2007) in conjunction with the DPL to support improvements in the business climate, through (i) the adoption and implementation of regulatory governance rules and tools aimed at improving the quality of business-sector related regulations, (ii) establishment and operations of a Secretariat for Regulatory Reforms for the removal of administrative barriers to investment; and (iii) adoption and implementation of a transparent land registration system.

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APPENDIX III: STATISTICAL ISSUES

Data provision is adequate overall for surveillance, although further improvements in some areas are needed. Albania was a pilot country for the data dissemination module of the Report on the Observance of Standards and Codes (ROSC), and a data ROSC was published on the IMF's external website in May 2000.[10] Albania participates in the General Data Dissemination System (GDDS) and metadata for the external, financial, fiscal, and real sectors, as well as socio-demographic indicators were initially posted on the Fund's Dissemination Standards Bulletin Board (DSBB) in May 2000 and last updated in July 2005. Plans for improving data compilation and dissemination across all statistical sectors are also posted on the DSBB. Recently, the authorities expressed an interest in a ROSC data module using the Data Quality Assessment Framework (DQAF) and subscription to the Special Data Dissemination Standard (SDDS). In response, a ROSC data module mission took place during March 8–22, 2006. The mission assessed data quality in six areas of macroeconomic statistics (national accounts, consumer price index, producer price index, government finance, monetary, and balance of payments statistics) based on the DQAF (July 2003), and reassessed Albania's data dissemination practices against the GDDS. At the request of the authorities, the mission also conducted an assessment of dissemination practices against the SDDS and prepared a work program and timetable for meeting the requirements for SDDS subscription.

The mission found that Albania's statistical system has made significant progress in adopting international statistical standards despite acute resource constraints. Official statistical agencies demonstrate strong and sustained commitment to plans and programs to further upgrade statistics in response to greater challenges posed by: i) a rapidly evolving economy; ii) the desire of the Albanian authorities to subscribe to the SDDS; iii) the adoption of an inflation targeting regime; and iv) growing national aspirations to join the European Union. However, due to severe resource constraints at the Institute of Statistics (INSTAT), the improvement in the national accounts has been slower relative to other datasets.

The *Law on Official Statistics* (2004) strengthened the legal framework for INSTAT as an independent agency under the Council of Ministers, and articulated the role of the Statistics Council as INSTAT's governing body. In addition, Memoranda of Understandings between INSTAT and the Ministry of Finance (MoF) and the Bank of Albania (BoA), expected to be signed soon, will facilitate data sharing and coordination among these agencies.

[10] Albania's ROSC (data module) was undertaken before the formal adoption of the Data Quality Assessment Framework.

A. Real Sector

Price statistics

STA has provided considerable technical assistance to Albania on price statistics. Data on consumer price index (CPI) are reported regularly for publication in *International Financial Statistics (IFS)*. In 2001, a revision of CPI weights was initiated by INSTAT based on a new household budget survey and a revised CPI was finalized in February 2002. The compilation of the CPI generally follows international standards, and the estimation of imputed rent within the CPI was improved in 2003. However, given the limited coverage of the 2000 household budget survey (HBS) (only urban areas combined with a rapid change of the structure of the economy and consumption pattern), new CPI weights should be compiled. The recent ROSC mission recommended (i) introduction of checks on the prices reported by enumerators; (ii) replacement of nonrespondents to the HBS with similar households; and (iii) inclusion of new items into the CPI as they become significant.

A monthly producer price index (PPI) has been published quarterly since March 2002. Prices are collected for each month, but only once a quarter, due to financial constraints. The weights were derived from the 1998 annual Structural Business Survey. The ROSC mission recommended (i) monthly publication of the PPI; (ii) replacement of enterprises that go out of business; and (iii) validation of the PPI results against all other available price data.

National accounts

In January 2003, INSTAT published the first official GDP estimates for 1996-2000 and, later that year, preliminary estimates for 2001. Following the first release, revised GDP estimates have been disseminated but not on a regular basis. In November 2005, INSTAT released major revisions of the GDP estimates (for 1996-2003) and updates for 2004, reflecting methodological improvements.

STA missions visited Albania in November 2004 and March 2005 to assist the authorities in improving the timeliness of the annual national accounts data and in developing quarterly national accounts. INSTAT has benefited from technical assistance by the Fund and the European Union (EU), mainly to address weaknesses in methodology, basic data sources, and incomplete coverage of the private sector.

STA concluded a technical assistance project in March 2006 for which the Italian government agreed to commit $500,000 from its sub-account with the IMF over a period of two years. The project was aimed at further improving the national accounts estimates and basic source data. The Italian National Institute of Statistics (Istat) and the National Statistics Office of Finland (Statistics Finland) provided technical assistance to INSTAT following the project contract.

National accounts are compiled from numerous but insufficient source data that are hampered by poor questionnaire design (e.g., Structural Business Survey), limited area coverage (e.g., HBS), and insufficient frequency of surveys. Despite the technical assistance provided on methodological procedures, source data still do not supply sufficient information to compile reliable estimates on the nonobserved economy. The ROSC mission recommended (i) improvement of source data to adequately capture the nonobserved economy; (ii) expansion of the scope of annual national accounts to include the income account, the capital account, and the rest of the world accounts; and (iii) improvement of the timeliness of GDP data (currently 11 months) so as to meet the 9-month recommendation of the GDDS.

INSTAT needs additional staff and financial resources to fully carry out its statistical work program.

External trade

The compilation and dissemination of foreign trade data has improved in recent years, following disruptions in the late 1990s. One important factor is the implementation of the Automated System of Customs Data (ASYCUDA), supported by the EU. Further progress is expected in the area of trade in services as a result of the implementation of surveys.

B. Government Finance

Albanian government finance statistics (GFS) generally follow internationally accepted standards and guidelines on concepts and definitions, scope, classification and sectorization, and basis for recording vis-à-vis the *Government Finance Statistics Manual 1986* (*GFSM 1986*). A formal "migration path" to the *GFSM 2001* has not been articulated, but a series of coordinated technical actions at the MoF—including the design and implementation of an accrual-compatible database infrastructure—are well advanced. The scope of the general government sector is in line with the *GFSM 1986* and encompasses budgetary central government, (representing a total of about 1520 individual budget institutions), local government (representing a total of about 2160 units), and two extrabudgetary funds (the social security fund and the health insurance fund).

The *Organic Budget Law* and the *Guidelines on State Budget Performance* clearly mandate the responsibility of the MoF for compiling and disseminating government finance statistics. The main data sources, which are timely, are reports of i) District Treasury Offices; ii) the Debt Management and Financial Analysis System; iii) project implementation units for foreign financed project; and iv) the extrabudgetary funds. The significant weakness in source data is in the availability of data on certain external donor financed (grants) projects that do not pass through the treasury system. Albania recently submitted fiscal data to the Fund for publication in the *Government Finance Statistics Yearbook*. The authorities have expressed an interest in reporting high-frequency data for publication in the *International Financial Statistics* using the *GFSM 2001*-based monthly Statement of Sources and Uses of Cash.

The ROSC mission recommended that MoF accelerate work aimed at formally adopting the *GFSM 2001*-based reporting format and improve source data coverage for external donor financed projects.

C. Monetary Accounts

The monetary data compilation framework conforms to the methodology recommended in the *Monetary and Financial Statistics Manual (MFSM)*, and data are compiled and reported on a timely basis. The depository corporations survey covers the BoA and all the other deposit-taking institutions (17 commercial banks and 130 savings and loans associations (SLAs)). The accounts of the SLAs, with the exception of loans, are produced on a cash basis, which is not in accordance with the *MFSM*'s recommendations of accrual accounting. The accounts of the BoA and of the commercial banks are produced on an accrual basis. An exception is that their holdings of nontradable long-term securities are recorded at book value.

The authorities revised the accounts of the BoA, commercial banks, and the monetary survey from February 2001 onward to properly record repurchase and reverse repurchase agreements; revised monetary data were first published in the October 2002 issue of *IFS*. The authorities are also making efforts to revise the historical data.

In January 2005, the BoA reported its monetary data to STA using Standardized Report Forms. This will facilitate the implementation of an integrated monetary database to be used for both publication in *IFS* and for operational needs of EUR.

To further improve Albania's monetary statistics, the recent ROSC mission recommended that the BoA (i) apply fully the *MFSM*'s recommendations on market valuation and accrual accounting; (ii) implement measures to improve the accuracy of the banks' reporting; (iii) implement an electronic (online) reporting system for banks and other financial institutions; and (iv) introduce a database driven compilation system for monetary statistics.

D. Balance of Payments

The data compiled by the BoA are methodologically sound, although some of the estimates, particularly for international transactions made outside the banking system need to be refined. The BoA has established data compilation procedures based on the classification system of the fifth edition of the *Balance of Payments Manual*. The BoA reports quarterly data to STA on a regular and timely basis. It has revised the methodology for the measurement of tourism services, principally through surveys of travelers. Problems remain in the areas of service transactions and remittances, and in the monitoring of financial account transactions, foreign assistance (grants from abroad to regional and local governments are underreported), and external debt. These problems could be addressed by strengthening existing data sources and improving estimation methods.

A November 2004 technical assistance mission noted that the coverage and accuracy of the data should be improved through the strengthening of the legal framework and the use of the banks reporting system to verify data from enterprises surveys. It also recommended incorporating the results of the direct investment survey as well as investigation and follow-up of the net errors and omissions observed at the level of individual reporting banks. A follow-up technical assistance mission by STA took place in February 2006. The mission focused on remittances, goods for processing, services (particularly travel services), official transfers, and direct investment.

To further improve compilation and dissemination of balance of payments statistics, the ROSC mission recommended that BoA (i) improve source data to adequately capture remittances; (ii) strengthen its law to provide for the sanctions—including fines—needed to mandate response to surveys by nonbank reporters, to inspect the financial accounts of firms, and to prohibit the provision of individual reporter's data to tax authorities; (iii) require quarterly reporting by significant firms of transactions in direct investment equity, debt, and reinvested earnings; in portfolio equity and debt; and in trade credit; and (iv) introduce a database driven compilation system for balance of payments statistics.

The Albanian authorities have not yet initiated compiling data on foreign currency liquidity in line with the Data Template on International Reserves and Foreign Currency Liquidity (Template). While the definition of data on official reserve assets is, in principle, consistent with that of the Template, the data may not be adequate for monitoring the economy because other foreign currency assets and currency drains are not included. The ROSC mission, in the context of SDDS-related issues, discussed with the authorities the various components of the Template and the data requirements for net predetermined drains and contingent drains.

E. External Debt and Grant Statistics

Good quality external debt statistics for public and publicly-guaranteed debt are compiled by the MoF. The external debt database, developed with technical assistance from UNCTAD, became fully operational in mid-2000. The external debt database ensures timely and accurate reporting of external government debt (including commitments of state-owned enterprises). However, there have been some irregularities in the recording and presentation of old external arrears. The External Debt Committee needs to improve inter-agency coordination to ensure the timely and accurate reporting of the stock of external arrears and changes resulting from rescheduling agreements. The collection of data on external grants is not timely, with lags of several months frequently encountered. In consultation with donors, the authorities are preparing a new framework to improve data collection and reporting, to be led by the MoF.

ALBANIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 12, 2006

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	06/12/06	06/12/06	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/30/06	05/15/06	D	D	M
Reserve/Base Money	04/30/06	05/15/06	M	M	M
Broad Money	04/30/06	06/08/06	M	M	M
Central Bank Balance Sheet	04/30/06	05/15/06	M	M	M
Consolidated Balance Sheet of the Banking System	04/30/06	06/08/06	M	M	M
Interest Rates[2]	06/06/06	06/12/06	W	W	W
Consumer Price Index	06/2006	06//08/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	03/2006	03/2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	12/31/2005	05/08/2006	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	09/ 30/05	11/15/05	Q	Q	A
External Current Account Balance	12/31/05	03/30/06	Q	I	I
Exports and Imports of Goods and Services	12/31/05	03/30/06	M	Q	Q
GDP/GNP	2004	03/2006	A	A	A
Gross External Debt	03/2005	05/2005	Q	I	NA

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

APPENDIX IV: EXTERNAL AND PUBLIC DEBT SUSTAINABILITY ANALYSIS (DSA)

The updated debt sustainability analysis is little changed from that presented in the previous staff report (IMF Country Report No. 06/54)). *Over the past decade Albania's debt sustainability has improved following debt restructuring and as a result of rapid growth and relatively cautious fiscal policies. Looking ahead over the next five years, debt ratios are expected to remain manageable: the public sector debt to GDP ratio falls back a little to 51.4% by 2010 and the external debt to GDP ratio gradually declines to 19.3%. External debt service capacity also improves and the public debt service to revenue ratio declines. Although the stress tests suggest that debt sustainability is comfortably maintained under a range of shocks, Albania looks most vulnerable to shocks to growth and exports. The scale of these shocks is somewhat exaggerated as they are based on historical averages and standard deviations that include the 1997 crisis (when the pyramid schemes collapsed)—but the results are nevertheless indicative of the importance of reforms to improve incentives for investment, non-price competitiveness and to broaden the export base. Overall, the public sector debt ratio is projected to decline over time and looks sustainable in the face of shocks. But the current short duration of domestic debt instruments of only 200 days is a concern which should be addressed as the government strengthens its public debt management in the context of the IMF program.*

External debt sustainability

Outstanding external debt is relatively low at around 20 percent of GDP and external debt ratios are expected to remain easily manageable over the medium term. Looking ahead, the challenge is to maintain external debt sustainability as financing becomes less concessional and the private sector gains increased external market access. On current assumptions—which include declining debt concessionality and lower export growth than during the period after transition—retaining sustainability looks easily manageable as external debt-to GDP ratios (both on NPV and in nominal terms) are expected to remain at just under 20 percent and the external-debt-to-exports ratio (both on NPV and in nominal terms) fall back as the export to GDP ratio improves.[11] At the same time, despite the shift towards less concessional debt, the projected external debt service ratio remains at manageable levels of between 5 and 9 percent. Two further factors lower the risk of debt distress. First, Albania is a net creditor to the world given private sector net assets in excess of public sector net external debt. As the private sector becomes more important for the economy over the forecast period its net indebtedness is expected to turn positive. Second, according to the World Bank's Country Policy and Institutional Assessment,which links the quality of a country's policies and institutions to thresholds for debt sustainability and which

[11] The assumptions underlying the DSA are unchanged from those presented in IMF Country Report No. 06/54: Real GDP growth 6 percent, inflation 3 percent and the real effective exchange rate projected to remain constant. Export growth at 9–11 percent is slower than its historical average of 25 percent. The evolution of domestic public debt is consistent with domestic borrowing targets under the program.

classifies Albania as a medium performer, external debt remains comfortably within the debt sustainability thresholds (of NPV of debt to GDP of 40 percent and debt to exports of 150 percent), although the level of overall public sector debt to GDP is somewhat above the 40 percent.[12]

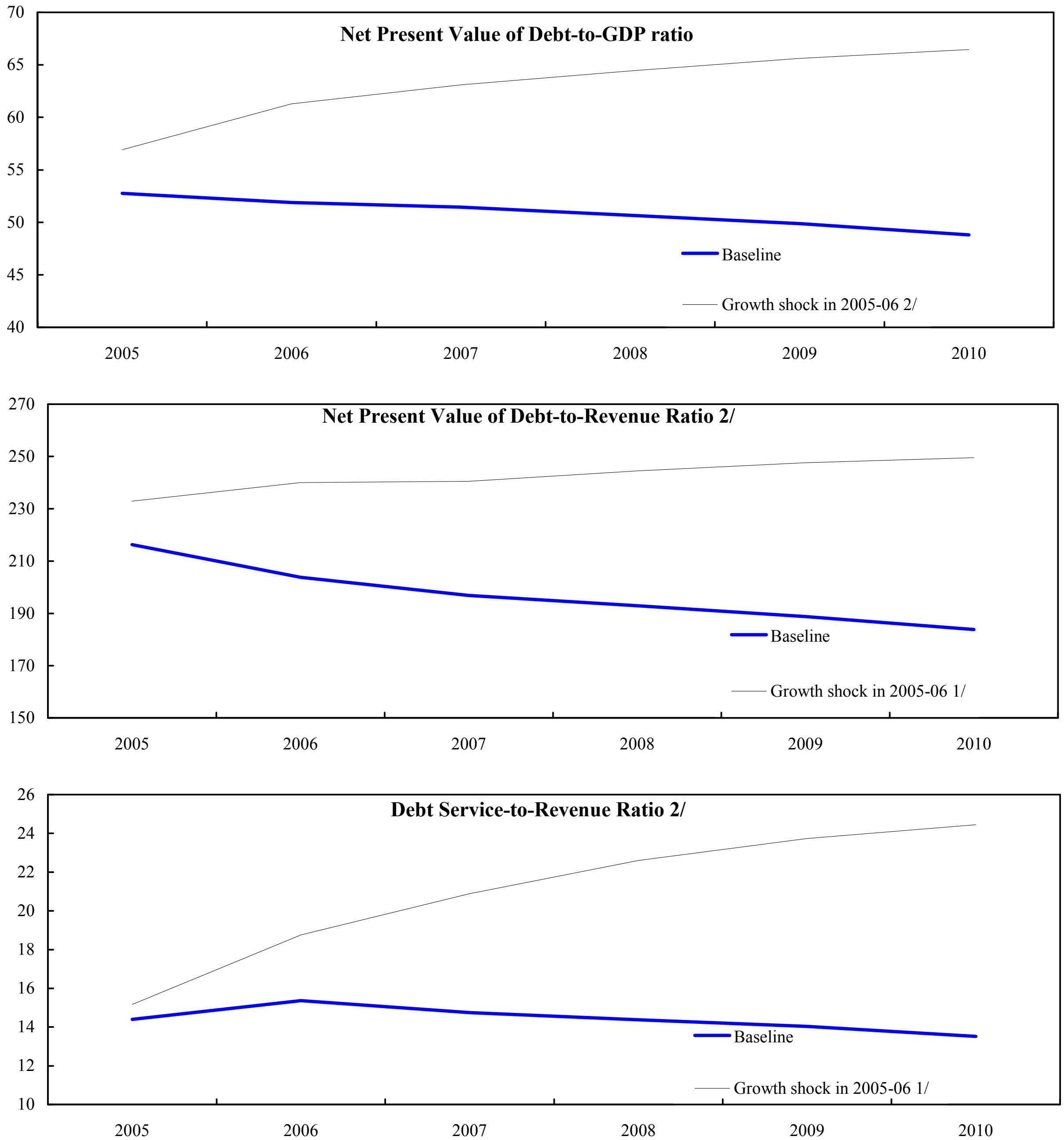
The stress tests show that external debt remains sustainable under a number of standard shocks, but that Albania is vulnerable to shocks to exports and growth. Under the standard simulations, external debt looks particularly vulnerable to an export shock which would cause a fairly severe and relatively long lasting breach of the CPIA debt to exports threshold of 150 percent. However, this reflects the severity of the shock which is based on historical averages and standard deviations that include the economic crisis of 1997 (following the collapse of pyramid schemes). If one looks at shocks based on the averages and variability of exports or GDP over the shorter period of 2000–2005, variability is much lower and the standard shocks are consequently much smaller. Nonetheless, even the smaller shock to exports would still move the debt to exports ratio close to the CPIA threshold. This underscores the importance of reforms designed to remove disincentives to investment, to improve competitiveness and broaden the export base.

Public debt sustainability

The public debt sustainability analysis is also broadly unchanged compared to that contained in (IMF Country Report No. 06/54). In the baseline scenario, public debt is projected to decline to 51.4 percent of GDP at end 2010 (from 55.3 percent of GDP at end 2005). The standard stress tests show that Albania public debt position is relatively resilient to shocks. A real growth shortfall of one standard deviation (compared to historical average) in 2005–2006 is the shock which would have the largest impact, bringing the NPV of the debt-to-GDP ratio to 66 percent in 2010. But again this is a relatively severe shock since it is based on averages and variability that include the 1997 crisis—and again the shock would be much smaller if based on the experience since 2000.

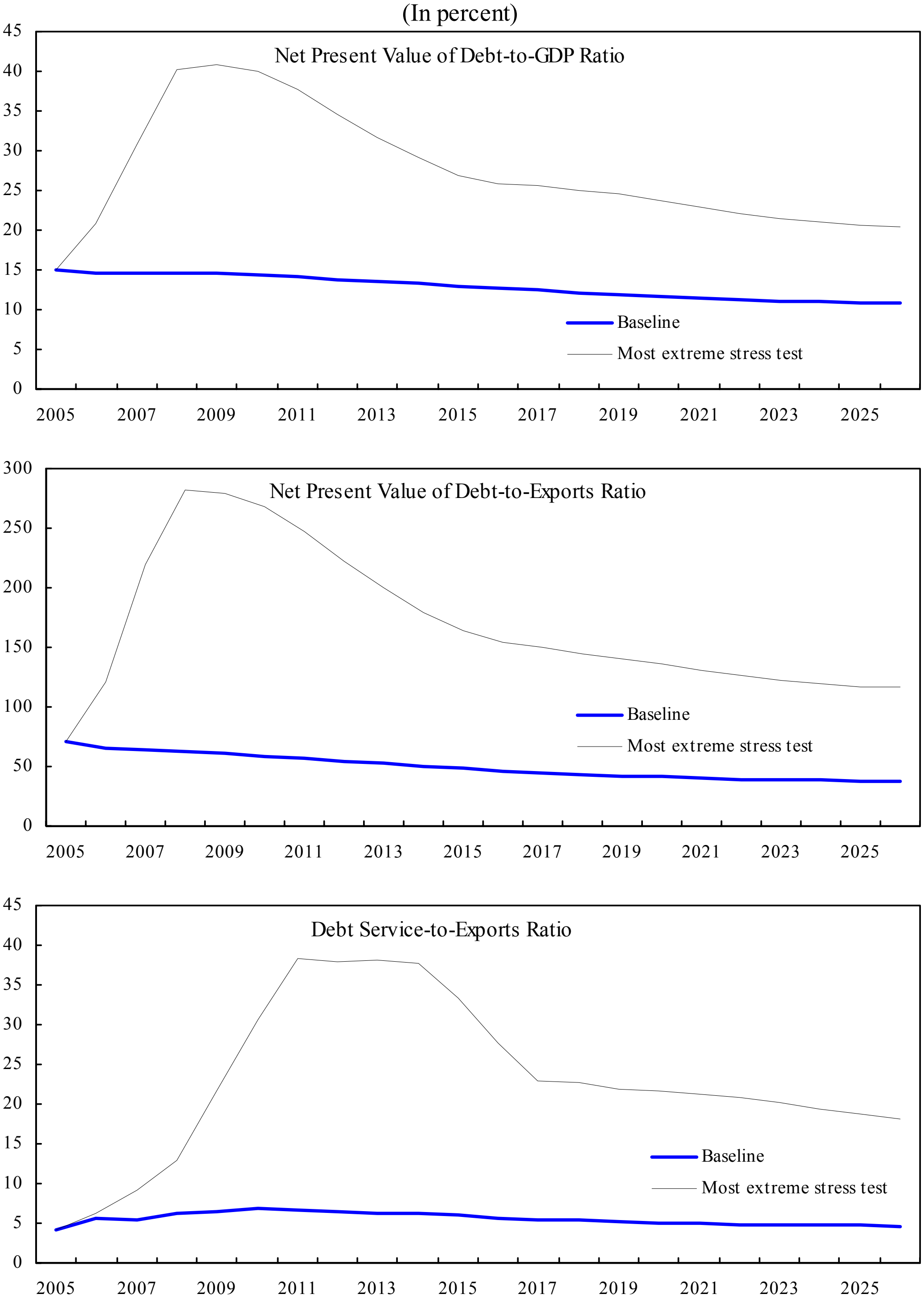
[12] The CPIA index groups 20 indicators into four categories and scores countries against those categories using scores of 1 (low) to 6 (high). The four groupings are economic management, structural policies, social inclusion and equity and public sector management. An overall score of 3.25 to 3.75 gains a medium performer ranking. Albania is classified as a medium performer it scores relatively highly for economic management and structural policies but scores are weaker for public sector management and policies for social inclusion/equality.

Figure 1. Albania: Indicators of Public Debt Under Alternative Scenarios, 2004-2010 1/
(In percent)



Source: Staff projections and simulations.
1/ The stress test that yields highest ratio in 2010: Real GDP growth at one standard deviation below the baseline in 2005 and 2006.
2/ Revenue including grants.

Figure 2. Albania: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005-2026
(In percent)



Source: Staff projections and simulations.

Table 1a. Albania: External Debt Sustainability Framework, Baseline Scenario, 1996-2026 1/
(In percent of GDP, unless otherwise indicated)

	Actual										Projections								
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2009	2010	2015	2020	2024	2025	2026
External debt (nominal) 1/	28.6	40.1	34.3	31.2	31.6	28.5	25.2	22.1	20.3	20.4	20.8	20.7	19.8	19.3	18.6	18.0	18.3	18.5	18.6
o/w public and publicly guaranteed (PPG) 2/	28.6	40.1	34.3	31.2	31.6	28.4	25.2	22.0	19.2	18.7	18.8	18.6	18.0	17.3	15.4	13.6	13.2	13.2	13.1
o/w private	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	1.1	1.7	2.0	2.0	1.9	1.9	3.2	4.4	5.2	5.4	5.5
Change in external debt	-0.9	11.4	-5.7	-3.1	0.4	-3.1	-3.2	-3.1	-1.8	0.0	0.4	-0.1	-0.4	-0.6	0.0	0.0	0.1	0.2	0.1
Identified net debt-creating flows	-1.3	14.5	-6.6	-12.0	-6.5	-6.4	3.5	1.0	-3.0	2.4	3.3	2.2	1.1	0.3	0.7	-0.3	-0.3	-0.3	-0.3
Non-interest current account deficit	7.8	12.8	6.0	1.4	6.3	5.4	9.5	7.7	5.2	7.4	7.5	6.4	5.5	4.7	4.3	3.0	2.8	2.8	2.7
Deficit in balance of goods and services	24.1	26.6	24.6	18.6	21.6	22.5	25.9	25.1	21.7	24.1	24.5	23.2	21.8	20.7	19.2	17.0	16.1	15.9	15.7
Exports	10.7	10.0	10.6	17.3	19.0	20.4	20.5	20.8	21.5	21.6	22.4	22.9	23.9	24.3	26.9	28.5	28.7	28.8	28.8
Imports	34.8	36.6	35.2	35.8	40.6	42.9	46.3	45.9	43.2	45.8	46.9	46.1	45.7	45.0	46.0	45.5	44.8	44.7	44.5
Net current transfers (negative = inflow)	-14.1	-11.4	-16.1	-9.5	-12.1	-13.2	-13.0	-14.0	-13.8	-14.6	-14.6	-14.5	-14.2	-13.8	-12.8	-11.9	-11.3	-11.1	-11.0
Other current account flows (negative = net inflow)	-2.2	-2.3	-2.5	-7.6	-3.2	-4.0	-3.3	-3.5	-2.7	-2.1	-2.4	-2.3	-2.1	-2.2	-2.1	-2.1	-2.0	-2.0	-2.0
Net FDI (negative = inflow)	-3.2	-1.9	-1.6	-1.5	-3.9	-5.0	-3.0	-3.2	-4.6	-3.1	-3.3	-3.2	-3.5	-3.4	-3.0	-2.8	-2.7	-2.7	-2.6
Official tranfers (negative = inflow)	-2.6	-3.5	-3.3	-4.1	-3.0	-3.0	-2.8	-2.6	-1.7	-0.9	-1.5	-1.3	-1.1	-1.0	-0.7	-0.5	-0.3	-0.3	-0.3
Endogenous debt dynamics 3/	-3.3	7.1	-7.7	-7.9	-5.9	-3.8	-0.2	-1.0	-3.6	-1.9	-1.0	-1.0	-0.8	-0.9	-0.6	-0.5	-0.4	-0.4	-0.4
Contribution from nominal interest rate	0.4	0.6	0.6	0.4	0.3	0.3	0.4	0.4	0.3	0.4	0.6	0.7	0.8	0.8	0.8	0.9	1.0	1.0	1.0
Contribution from real GDP growth	-2.3	3.6	-4.0	-2.6	-1.8	-2.0	-0.9	-1.4	-1.1	-1.0	-0.9	-1.1	-1.1	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Contribution from price and exchange rate changes	-1.4	2.9	-4.2	-5.6	-4.3	-2.1	0.3	0.0	-2.8	-1.2	-0.6	-0.5	-0.5	-0.6	-0.3	-0.3	-0.3	-0.3	-0.3
Residual 4/	0.4	-3.0	0.8	8.9	6.9	3.2	-6.7	-4.1	2.9	-1.5	-1.4	-1.0	-0.5	0.1	0.0	0.2	0.4	0.5	0.4
o/w exceptional financing	-0.2	-0.2	-0.2	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net external debt 5/	7.8	13.7	8.8	4.9	2.4	-2.5	-6.7	-5.9	-7.7	-7.5	-4.6	-2.3	-0.1	-1.2	-0.7	-2.4	-3.0	-3.0	-2.8
o/w public sector	19.3	25.8	21.0	17.2	14.9	11.5	6.5	5.6	2.4	1.6	1.6	1.8	0.8	-0.3	-1.3	-4.0	-5.3	-5.4	-5.4
o/w private sector	-11.5	-12.1	-12.2	-12.3	-12.5	-14.0	-13.2	-11.5	-10.0	-9.0	-6.1	-4.1	-0.8	-0.9	0.5	1.6	2.3	2.4	2.6
NPV of external debt 6/	...	...	...	...	...	...	...	...	...	16.7	16.5	16.7	16.5	16.3	16.2	16.1	16.2	16.2	16.3
In percent of exports	...	...	...	...	...	...	...	..	...	78.0	73.7	72.6	68.7	66.7	60.2	56.5	56.4	56.5	56.7
NPV of PPG external debt	...	...	...	...	...	...	...	...	...	15.0	14.5	14.7	14.6	14.3	13.0	11.7	11.0	10.9	10.8
In percent of exports	...	...	...	...	...	...	...	...	...	70.3	64.8	63.8	60.8	58.7	48.3	41.0	38.3	37.8	37.4
Debt service-to-exports ratio (in percent)	8.1	12.8	8.9	4.2	4.0	4.0	6.4	5.2	4.5	4.7	6.5	7.1	8.9	9.3	8.7	8.5	9.1	9.1	9.2
PPG debt service-to-exports ratio (in percent)	8.1	12.8	8.9	4.2	4.0	4.0	6.0	4.9	4.1	4.2	5.7	5.4	6.5	6.9	6.1	5.0	4.8	4.7	4.6
Total gross financing need (billions of Euros)	0.1	0.2	0.1	0.0	0.2	0.1	0.3	0.1	0.2	0.5	0.4	0.4	0.4	0.5	0.7	0.9	1.2	1.3	1.4
Non-interest current account deficit that stabilizes debt ratio	8.7	1.4	11.7	4.5	5.9	8.5	12.7	10.8	7.0	7.4	7.1	6.5	5.9	5.3	4.2	3.0	2.7	2.6	2.6
Key macroeconomic assumptions																			
Real GDP growth (in percent)	9.1	-10.3	12.7	10.1	7.3	7.2	3.4	6.0	5.9	5.5	5.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
GDP deflator in terms of Euros (change in percent)	4.9	-9.1	11.6	19.7	16.1	7.2	-1.2	-0.2	14.3	6.3	3.3	2.7	2.5	3.0	1.9	1.9	1.9	1.9	1.9
Effective interest rate (percent) 6/	1.7	1.7	1.7	1.5	1.2	1.2	1.6	1.8	1.6	2.0	3.1	3.6	4.1	4.3	4.7	5.3	5.7	5.8	5.8
Growth of exports of G&S (in terms of Euros, in percent)	10.3	-23.7	32.8	114.7	37.1	23.3	2.7	7.2	25.4	13.0	12.3	11.3	11.2	11.1	9.9	8.4	8.2	8.2	8.2
Growth of imports of G&S (in terms of Euros, in percent)	29.3	-14.2	20.9	34.1	41.1	21.6	10.3	4.7	14.1	18.8	11.1	7.0	8.6	7.6	8.3	7.6	7.6	7.6	7.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	...	...	...	...	19.4	18.4	15.1	13.3	11.6	8.9	8.7	8.5	8.5	8.5
Memorandum item:																			
Nominal GDP (billions of Euros)	2.4	1.9	2.4	3.2	4.0	4.6	4.7	5.0	6.0	6.7	7.3	8.0	9.4	10.3	15.1	22.2	30.2	32.6	35.2

Averages and Standard Deviations	Historical Average	Standard Deviation	Average 2006-11	Average 2012-26
Real GDP growth (in percent)	5.7	6.2	5.8	6.0
GDP deflator in terms of Euros (change in percent)	7.0	8.8	2.7	1.9
Effective interest rate (percent) 7/	1.6	0.2	3.9	5.2
Growth of exports of G&S (in terms of Euros, in percent)	24.3	36.2	11.2	9.1
Growth of imports of G&S (in terms of Euros, in percent)	18.1	15.7	8.5	7.8
Grant element of new public sector borrowing (in percent)	...	...	13.5	8.7
Non-interest current account deficit	7.0	3.0	5.8	3.5
Net current transfers (negative = inflow)	-13.2	1.8	-14.2	-12.1
Net FDI (negative = inflow)	-3.1	1.2	-3.3	-2.9

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Includes IMF.
3/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in terms of Euros.
4/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
5/ Defined as the stock of debt less international reserves of the banking system. Net debt of the public sector is defined as PPG external debt minus GIR of the Bank of Albania, and net debt of the private sector is estimated as private external debt minus foreign assets of commercial banks.
6/ Assumes that NPV of private sector debt is equivalent to its face value.
7/ Current-year interest payments divided by previous period debt stock.

Table 1b. Albania: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005-26
(In percent)

	Actual	Projections															
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2017	2019	2021	2024	2025	2026
Baseline	15	15	15	15	15	14	14	14	14	13	13	12	12	11	11	11	11
A. Alternative Scenarios																	
A1. Key variables at their historical averages in 2006-26 1/	15	21	22	23	23	24	24	24	24	24	24	26	27	28	29	30	30
A2. New public sector loans on less favorable terms in 2006-26 2/	...	14	14	15	15	15	16	16	16	17	17	17	17	17	18	18	21
B. Bound Tests																	
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	...	17	19	20	20	21	21	20	20	20	19	18	16	15	14	14	13
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	15	21	31	40	41	40	38	35	32	29	27	26	24	23	21	21	20
B3. GDP deflator in Euros at historical average minus one standard deviation in 2006-07	15	17	20	22	24	26	27	28	28	27	26	25	23	22	23	23	24
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	15	21	26	27	27	26	25	24	23	21	20	20	18	17	16	16	15
B5. Combination of B1-B4 using one-half standard deviation shocks	15	20	26	27	26	24	22	20	18	16	15	14	12	10	8	8	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	15	16	24	25	26	26	26	26	26	25	24	23	20	18	16	15	15
Baseline	70	65	64	62	61	59	57	55	52	50	48	45	42	40	38	38	37
A. Alternative Scenarios																	
A1. Key variables at their historical averages in 2004-23 1/	70	99	105	111	115	120	124	128	131	134	141	156	174	197	239	255	271
A2. New public sector loans on less favorable terms in 2004-23 2/	...	65	64	65	65	63	65	65	65	64	64	61	60	61	63	64	75
B. Bound Tests																	
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	...	71	74	76	77	76	75	73	70	67	64	59	52	47	43	43	42
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	...	120	219	281	279	268	248	223	200	180	164	150	141	130	119	117	116
B3. GDP deflator in Euros at historical average minus one standard deviation in 2006-07	70	71	79	87	93	99	102	102	99	95	91	82	73	70	72	74	77
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	70	93	116	117	114	108	101	95	88	82	77	72	64	59	55	55	54
B5. Combination of B1-B4 using one-half standard deviation shocks	70	94	120	122	113	104	92	81	72	64	58	52	44	37	29	28	30
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	70	72	76	79	80	79	78	76	73	69	66	60	51	45	40	39	38
Baseline	4.2	5.7	5.4	6.3	6.5	6.9	6.7	6.5	6.3	6.2	6.1	5.5	5.1	4.9	4.8	4.7	4.6
A. Alternative Scenarios																	
A1. Key variables at their historical averages in 2006-26 1/	4.2	5.8	5.9	6.6	11.2	12.6	14.0	15.1	17.0	18.7	17.9	20.8	24.2	28.3	35.4	38.1	40.7
A2. New public sector loans on less favorable terms in 2006-26 2/	5.0	5.0	4.3	4.5	4.4	4.7	4.7	4.6	4.9	5.1	5.6	5.6	5.9	6.0	6.5	6.7	6.9
B. Bound Tests																	
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	4.2	5.0	4.6	5.2	6.2	7.1	7.7	7.7	8.2	8.5	8.2	7.6	7.4	6.7	5.7	5.5	5.3
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	4.2	6.3	9.1	12.9	21.6	30.7	38.3	38.0	38.1	37.8	33.3	22.9	21.8	21.4	19.4	18.8	18.1
B3. GDP deflator in Euros at historical average minus one standard deviation in 2006-07	4.2	5.0	4.6	5.4	6.7	8.5	10.0	10.9	12.4	13.4	13.5	12.7	11.7	10.7	10.1	10.2	10.5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	4.2	5.0	5.6	7.1	10.6	13.9	14.1	13.9	14.0	14.1	12.1	10.0	9.7	9.0	8.0	7.7	7.5
B5. Combination of B1-B4 using one-half standard deviation shocks	4.2	5.3	6.0	7.5	10.9	13.8	13.9	12.8	12.4	11.6	9.0	6.0	5.5	4.9	3.3	2.9	2.4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	4.2	5.0	4.6	5.3	6.3	7.5	8.1	8.2	8.7	9.1	8.7	8.0	7.6	6.6	5.3	4.9	4.6
Memorandum item:																	
Grant element assumed on residual financing (i.e., financing required above baseline)		0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in terms Euros), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in Euro/local currency rate, such that it never exceeds 100 percent.

Table 2a. Albania: Public Sector Debt Sustainability Framework, Baseline Scenario, 1997-2010
(In percent of GDP, unless otherwise indicated)

	Actual								Historical Average 4/	Standard Deviation 4/	Projections						
	1997	1998	1999	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	2005-10 Average
Public sector debt 1/	75.6	68.5	66.7	72.8	67.6	65.0	61.8	56.5			55.3	55.2	54.6	53.7	52.7	51.4	
o/w foreign-currency denominated	38.1	32.3	29.3	30.2	26.6	23.3	20.7	18.0			17.6	17.8	17.8	17.7	17.5	17.0	
Change in public sector debt	22.1	-7.1	-1.8	6.1	-5.2	-2.5	-3.2	-5.3			-1.2	-0.1	-0.6	-0.9	-1.0	-1.3	
Identified debt-creating flows	23.3	-12.8	-0.9	-1.5	-3.5	6.3	-1.8	-4.6			-1.7	-0.6	-0.8	-0.9	-0.7	-1.4	
Primary deficit	7.3	1.6	1.9	2.4	3.6	2.7	0.2	1.4	2.8	2.2	0.5	0.5	0.6	0.7	0.9	0.4	0.6
Revenue and grants	18.3	24.2	25.5	23.8	23.7	24.7	24.5	24.1			24.4	25.5	26.1	26.3	26.4	26.5	
of which : grants	0.7	1.6	2.8	1.0	0.6	0.7	0.4	0.3			0.7	0.7	0.9	0.8	0.8	0.8	
Primary (noninterest) expenditure	25.5	25.8	27.5	26.1	27.3	27.4	24.6	25.5			24.9	25.9	26.7	27.0	27.3	26.9	
Automatic debt dynamics	16.3	-14.3	-2.6	-2.2	-4.9	3.7	-1.9	-4.1			-2.1	-0.4	-1.2	-1.4	-1.4	-1.6	
Contribution from interest rate/growth differential	7.5	-8.8	-0.6	-0.8	-2.4	0.3	-0.9	-2.4			-1.5	-0.5	-1.1	-1.3	-1.3	-1.4	
of which : contribution from average real interest rate	2.9	4.4	5.6	3.7	2.3	2.3	2.6	1.0			1.4	2.1	2.0	1.8	1.7	1.6	
of which : contribution from real GDP growth	6.1	-8.5	-6.3	-4.5	-4.8	-1.9	-3.5	-3.4			-2.9	-2.6	-3.1	-3.1	-3.0	-3.0	
Contribution from real exchange rate depreciation	8.8	-5.5	-2.0	-1.4	-2.5	3.4	-1.0	-1.7			-0.6	0.1	-0.1	-0.1	-0.1	-0.1	
Other identified debt-creating flows	-0.3	0.0	-0.2	-1.7	-2.2	-0.1	-0.1	-1.9			-0.1	-0.6	-0.2	-0.2	-0.2	-0.2	
Privatization receipts (negative)	-0.3	0.0	-0.2	-1.7	-2.2	-0.1	-0.1	-1.9			-0.1	-0.6	-0.2	-0.2	-0.2	-0.2	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes	-1.2	5.7	-0.9	7.6	-1.7	-8.9	-1.4	-0.7			0.5	0.5	0.3	0.0	-0.2	0.0	
NPV of public sector debt	...	...	...	...	...	...	...	...			52.8	51.9	51.4	50.7	49.9	48.8	
o/w foreign-currency denominated	...	...	...	...	...	...	...	...			15.0	14.5	14.7	14.6	14.6	14.4	
o/w external	...	...	...	...	...	...	...	...			15.0	14.5	14.7	14.6	14.6	14.3	
NPV of contingent liabilities (not included in public sector debt)	...	...	...	...	...	...	...	...			...	...	...	...	...	...	
NPV of public sector debt-to-revenue ratio	...	...	...	...	...	...	...	...			216.2	203.8	196.8	192.9	188.8	183.8	
o/w external	...	...	...	...	...	...	...	...			61.5	57.0	56.1	55.7	55.2	54.0	
Debt service-to-revenue ratio (in percent) 2/ 3/	33.8	37.6	30.1	25.1	18.9	17.7	19.3	17.0			14.4	15.4	14.7	14.4	14.0	13.5	
Primary deficit that stabilizes the debt-to-GDP ratio				-3.7	8.8	5.2	3.4	6.7			1.7	0.6	1.1	1.6	1.8	1.7	
Key macroeconomic and fiscal assumptions																	
Real GDP growth	-10.2	12.7	10.1	7.3	7.0	2.9	5.7	5.9	6.3	6.1	5.5	5.0	6.0	6.0	6.0	6.0	5.8
Average nominal interest rate on forex debt	0.8	0.7	0.4	1.7	0.7	1.5	1.1	1.2	0.9	0.5	1.3	2.8	3.0	3.4	3.7	3.5	2.9
Average real interest rate on domestic currency debt	10.8	13.8	18.0	11.1	7.1	5.8	7.2	3.3	8.6	5.4	4.5	5.7	5.1	4.5	4.3	4.0	4.7
GDP Deflator (percent change)	9.8	13.6	4.5	4.3	3.5	3.3	3.4	6.0	9.9	9.8	3.5	2.4	3.0	3.3	3.2	3.5	3.1
Growth of real primary spending	-2.3	13.8	17.3	2.2	11.6	3.4	-5.0	9.6	4.8	8.7	3.0	9.4	9.2	7.2	7.0	4.8	6.8
Grant element of new external borrowing	...	...	...	...	...	...	...	...	...	...	19.4	18.4	15.1	13.3	13.3	11.6	15.2

Sources: Albania authorities; and Fund staff estimates and projections.
1/ Gross debt of the general government including government guaranteed debt.
2/ Revenues including grants.
3/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
4/ Historical averages and standard deviations are derived over the past 10 years, subject to data availability.

Table 2b. Albania: Sensitivity Analyses for Key Indicators of Public Sector Debt , 2005-2010
(In percent)

	Actual		Projections					
	2003	2004	2005	2006	2007	2008	2009	2010
NPV of Debt-to-GDP Ratio								
Baseline	...	...	53	52	51	51	50	49
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	…	…	55	55	56	57	57	58
A2. Primary balance is unchanged from 2004	…	…	54	54	54	54	53	53
A3. Permanently lower GDP growth 1/	…	…	54	54	55	57	58	59
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2005-2006	…	…	57	61	63	64	66	66
B2. Primary balance is at historical average minus one standard deviations in 2005-2006	…	…	57	60	59	58	57	55
B3. Combination of B1-B2 using one half standard deviation shocks	…	…	57	60	59	58	57	56
B4. One time 30 percent real depreciation in 2005	…	…	58	57	56	55	54	53
B5. 10 percent of GDP increase in other debt-creating flows in 2005	…	…	62	61	60	58	57	56
NPV of Debt-to-Revenue Ratio 2/								
Baseline	…	…	216	204	197	193	189	184
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages		…	223	216	215	217	217	218
A2. Primary balance is unchanged from 2004	…	…	220	210	206	204	201	199
A3. Permanently lower GDP growth 1/	…	…	220	213	212	215	219	223
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2005-2006	…	…	233	240	241	244	248	250
B2. Primary balance is at historical average minus one standard deviations in 2005-2006	…	…	234	236	226	220	215	208
B3. Combination of B1-B2 using one half standard deviation shocks	…	…	234	237	227	221	215	209
B4. One time 30 percent real depreciation in 2005	…	…	240	224	216	211	206	201
B5. 10 percent of GDP increase in other debt-creating flows in 2005	…	…	255	238	228	222	217	210
Debt Service-to-Revenue Ratio 2/								
Baseline	19	17	14	15	15	14	14	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	19	17	14	18	19	20	21	21
A2. Primary balance is unchanged from 2004	19	17	14	17	17	17	17	16
A3. Permanently lower GDP growth 1/	19	17	15	16	17	17	18	19
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2005-2006	19	17	15	19	21	23	24	24
B2. Primary balance is at historical average minus one standard deviations in 2005-2006	19	17	14	21	25	21	19	18
B3. Combination of B1-B2 using one half standard deviation shocks	19	17	15	20	23	20	18	17
B4. One time 30 percent real depreciation in 2005	19	17	15	16	16	16	16	15
B5. 10 percent of GDP increase in other debt-creating flows in 2005	19	17	14	28	24	21	19	18

Sources: Albanian authorities; and Fund staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

Tirana, July 14, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

The approval of our PRGF/EFF-supported program in January 2006 marked the formal continuation of the International Monetary Fund's longstanding assistance to Albania. Over the last decade, the Fund's support has been pivotal to our efforts to achieve and maintain macroeconomic stability and to develop and restructure our economy. In this we have achieved considerable success, and it remains our expectation that our need for the Fund's resources will end with the expiration of the current arrangements.

Since the approval of our latest program, economic developments have proceeded largely as expected and we maintain a firm foundation moving forward. Trend growth is strong, inflation is in the 3±1 percent range, and confidence in the currency and the banking system is on the rise. With significant structural adjustment carried out over the last three years, and with detailed action plans now prepared to implement the FSAP recommendations and to overhaul our debt management capacity, we are well placed to fully implement the ambitious reform agenda described in the attached Memorandum of Economic and Financial Policies (MEFP). These policies are consistent with our November 2001 National Strategy for Socio-Economic Development (NSSED) and the Annual Progress Report of July 2005.

With one exception, all quantitative and structural performance criteria under the program have been observed. We did not manage to achieve the end-March 2006 structural performance criterion stipulating that KESH would meet the collection rate and loss targets under our Power Sector Action Plan. However, we steadily improved our collection and loss performance, and we have taken measures to find a long-term solution to the problems in this sector—including by securing the necessary technical assistance as a prior action for this review. We therefore ask for a waiver for the non-observance of this performance criteria. We request completion of the First Review under the three-year Poverty Reduction and Growth Facility arrangement together with concurrent approval of the First Review under the three-year Extended Fund Facility arrangement; and also request the second disbursement under both these arrangements in a total amount of SDR 2.435 million.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. Albania will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. Following this arrangement, and as long as Albania has outstanding financial obligations to the IMF arising from loan disbursements under the present arrangement, Albania will consult with the IMF from time to time on economic and financial policies, at the initiative of the government or the Bank of Albania, or if the Managing Director of the IMF requests such consultation. These consultations may include correspondence and visits of officials of the IMF to Albania or of representatives of Albania to the IMF. In continuing with our policy of transparency, we consent to the publication of this letter, the attached MEFP, and the accompanying Executive Board documents on the IMF's website.

Sincerely yours,

/s/	/s/	/s/
Sali Berisha	Ridvan Bode	Ardian Fullani
Prime Minister	Minister of Finance	Governor, Bank of Albania

Memorandum on Economic and Financial Policies (MEFP) for Albania

I. Background

1. This memorandum lays out the broad thrust of our policies over the remainder of the 2006-2009 program period, and provides a detailed description of our policy intentions up to mid-2007. It is consistent with the November 2001 National Strategy for Socio-Economic Development (NSSED) and the May 2003, May 2004, and July 2005 NSSED Progress Reports. We have started preparing an updated NSSED for 2007-09, to be completed by end-2006, which will be formulated within the comprehensive Integrated Planning System introduced in 2005.

2. **Our macroeconomic performance during the previous PRGF-supported program was solid.** With the exception of the supply-induced disruptions of 2002, we enjoyed a prolonged period of rapid, non-inflationary growth, within which confidence in the currency, banking system, and viability of our macroeconomic policies demonstratively improved. As risk premiums declined, inflationary expectations were anchored at low levels, allowing the monetary policy stance to gradually relax while reserves increased and the exchange rate maintained a mild trend appreciation. On the fiscal front, current expenditure, the deficit, and domestic borrowing have been curtailed, and the 2005 budget delivered the first surplus on current operations since the beginning of the transition process. The public debt burden has been considerably reduced, reflecting foreign debt restructuring, fiscal consolidation, rapid economic growth, and the allocation of half the proceeds of large privatizations to redeem domestic debt. The debt to GDP ratio declined to an estimated 55¼ percent of GDP at end-2005—a reduction of 10 percentage points since end-2002. We have also made progress in structural reform, though this has lagged somewhat our macroeconomic success. Nonetheless, reforms carried out in our financial system, within our customs administration, and in expenditure management, as well as in the statistical and legal areas have brought us far from our initial position at the beginning of the transition process. However, much remains to be done.

3. **Since program approval in January 2006, macroeconomic stability has been sustained and renewed emphasis given to structural reform, but some underlying developments pose new challenges.**

- We expect a slight slowdown in growth from 5½ percent in 2005 to 5 percent this year. The slowdown in 2005 was due to a severe disruption in electricity supply during the last quarter, and to a weaker trade performance resulting from increased competition in export markets and slower growth in partner countries. Activity in the first quarter of 2006 has been slowed by decelerating activity in services and construction resulting mainly from delays in executing public investment. We expect public investment to rebound, but much of the impulse will likely be felt towards the end of the year. Electricity production has recovered and is likely to remain strong for the rest of the year, but the sector's performance is uncertain and the risk to growth from this source remains significant.

- Based on fiscal revenues in the first half of 2006, as a result of improvements in tax administration—particularly in customs—we expect an overperformance of tax revenue relative to budget projections of 1-1½ percent of GDP. We have allocated most of these gains, along with 0.1 percent of GDP of unbudgeted privatization receipts, in a supplementary budget—primarily for road projects already included in our NSSED and National Road Strategy, and also to reduce the tax wedge on labor and to lower our debt stock at a more rapid pace than envisaged at program conception.

- Year-on-year inflation up to May 2006 was 3.2 percent, near the middle of the 3±1 percent target band of the BoA. However, price performance was uneven: a sustained increase in nontraded goods prices above the target range was balanced by lower tradables prices. Such developments are indicative of rising demand pressures in the economy and hence an increase in vulnerability, as food prices are largely exogenously determined and outside the control of monetary policy. With fiscal policy relatively tight, we believe this demand-pull inflation to be driven primarily by the rapid growth of private sector credit, which rose by 5½ percentage points of GDP in 2005, and continues to increase at a real rate exceeding 64 percent. As a similar rate of expansion in 2006 would imply—in our view—a too rapid increase of 8½ percentage points of GDP, we attach considerable importance to both reducing the rate of increase this year and to strengthening prudential regulations to safeguard loan quality.

- On the external side, rising domestic demand from the credit expansion, combined with higher energy import prices, and increased travel by Albanians abroad, are all contributing factors to a widening of our trade deficit from 21.7 percent of GDP 2004 to 24.1 percent of GDP in 2005. The current account has worsened accordingly.

- We have moved ahead with our program of structural reform. In accordance with our program commitments, we extended the ASYCUDA system—including the risk assessment module—to a total of 11 customs houses (PC; end-March 2006); we improved the functioning of the Large Taxpayer Office (LTO), which now accounts for more than 50 percent of all tax collected (SB; end-June 2006); and carried out a census of the wage bill for all budgetary sector employees (SB;end-June 2006). To improve the quality of public expenditure, we established and staffed a public investment program department within the General Directorate of the Ministry of Finance (SB; end-June 2006); and issued instructions for submitting public investment proposals consistent with the budget and the medium-term budgetary plan (SB; end-June 2006). To improve debt management, we developed and discussed with IMF staff an action plan for implementing the recommendations of the IMF TA mission on debt management (SB; end-June 2006). Similarly, in the financial sector, we developed and discussed with IMF staff an action plan for implementing the recommendations of the Financial Sector Stability Assessment (FSSA) report (SB; end-March 2006). All ongoing structural benchmarks under the program concerned with safeguarding the efficient use of nonconcessional foreign borrowing, strengthening tax administration, and improving debt management capacity were met.

- We have made progress in stabilizing the situation in the electricity sector. Generation has been strong since the beginning of the year due to a combination of good hydrological conditions and prudent management of water resources. The reservoir is full, load shedding has been minimized, and we were able to deposit significant amounts of electricity with our neighbors. By tightening our collection procedures, and vigorously addressing the widespread theft of electricity, we achieved a steady improvement in collections and losses up to June. Nonetheless, the poor performance in January depressed our quarterly average performance and we missed the first quarter targets on collections and losses under the 2006-08 Power Sector Action Plan (PC end-March 2006). However, we have steadily improved our collection and loss performance since January, and are working to find a long-term solution to the problems in this sector. In this regard, as a prior action for completion of this review, we have concluded a contract with [the World Bank] to provide technical assistance to (i) develop and finalize a new energy sector strategy to promote increased private sector involvement, including the privatization of electricity distribution, and (ii) provide on-going resources through mid-2007 to assist with preparing for the privatization of electricity distribution. We are, therefore, requesting a waiver for the non-observance of this performance criteria.

- In the statistical area, we met the requirements of the program, in that we prepared advance GDP estimates for the first half of 2005 and published preliminary national accounts for 2004 (both SB; end-March 2006). However, we are aware that the quality of these estimates requires considerable improvement.

4. **Despite our success to date, much remains to be done.** Maintaining the pace of development as our income level rises will require more than a simple replication of past policies, but will increasingly call for the adoption of the standards of institutional quality, governance, and infrastructure of the more successful middle-income countries. Improvement in these areas are needed to address longstanding deficiencies in our business climate that continue to deny our economy the investment—particularly foreign investment—necessary to boost productivity and export capacity. On the fiscal front, despite improvements, weaknesses in revenue administration and public debt

management still create vulnerability to economic shocks. Moreover, a higher quality of public expenditure is needed to better utilize scarce resources for economic development and poverty reduction. Though relatively more advanced, additional reform and modernization are also needed in the financial sector if it is to develop safely and facilitate economic development to its full potential. In particular, prudential supervision requires further strengthening in light of the rapid growth of credit. Regarding poverty, our preliminary analysis of the 2005 LSMS data points to a significant reduction over the last three years. The absolute poverty rate was reduced to 18½ percent in 2005 from 25½ percent in 2002; and the extreme poverty rate fell to 3½ percent in 2005 compared with 4¾ percent in 2002. Advances are not uniform, however, and some indicators such as enrollment ratios in education require considerable improvement.

IV. STRATEGY, OBJECTIVES AND POLICIES

5. **Our strategy for the next three years will continue to concentrate on maintaining macroeconomic stability, enhancing growth potential, reducing vulnerabilities and strengthening government solvency**. We recognize that success on these fronts will require significant progress in adopting the governance and institutional norms of the more advanced middle income countries.

- A responsible and appropriate fiscal policy is central to maintaining macroeconomic stability. The medium-term path for further fiscal consolidation envisaged at the conception of our program—centered on a steady reduction of domestic borrowing and improvement in the current and primary balances—remains unchanged.

- However, in the immediate term, maintaining macroeconomic stability requires greater focus on the growth rate of private sector credit. Following the advise of an IMF technical assistance mission in May, we have significantly strengthened prudential regulations. We expect this to improve the quality of our loan portfolio, and possibly to have the incidental effect of lowering the rate of credit expansion at the margin. For 2006, in combination with a modest fiscal adjustment, we view a limitation of the annual increase of credit to 6 percentage points of GDP as consistent with easing the rise of nontraded goods prices, arresting the deterioration of the current account, and avoiding unnecessary real appreciation that could hinder export development.

- Over a longer time horizon, our program addresses deficiencies in our business climate through a wide range of institutional reforms, with the aim of creating conditions capable of attracting enough foreign and domestic investment to effect a rapid increase of our productive capacity. Concurrent with this, it addresses existing vulnerabilities through a comprehensive reform of our budget process, financial sector, and debt management capacity. We are also pursuing institutional change outside the program in areas impacting the investment climate, including measures to improve the commercial court system and the process of land title registration.

6. **We also intend to significantly downsize government involvement in non-core areas, primarily by stepping up the pace of privatization**. We are increasingly aware that our electricity sector is in a permanent state of crisis, and that our strategy for rehabilitation and improvement is not working. We have started, with the support of the World Bank, to develop a new energy sector strategy to promote private sector involvement including the privatization of electricity distribution. After discussing it with donors, we will finalize this strategy by end-2006. . A major initiative in this regard, which is already underway, is to unbundle KESH and to privatize the distribution of electricity within two years. We are also moving to quickly privatize the other large entities remaining in government hands. An international tender for the sale of INSIG has been issued. The sale of Albtelecom has been delayed as we investigate alleged irregularities in the previous tender process. However, once the investigation is concluded, we will move ahead quickly with the privatization process. Tenders for Albpetrol and ARMO will also be prepared. Our plan is to sell these latter two companies in their existing condition without first attempting rehabilitation, as we believe this is a task best left to their future owners.

A. Macroeconomic Framework

7. **The macroeconomic framework envisaged at program conception remains valid and realistic**. Real GDP growth is projected to return to its trend rate of 6 percent in 2007 as the electricity situation improves, and productive investment begins to rise in response to improved governance and institutional quality. With demand pressure contained through an appropriate monetary policy stance—aided by reductions in the rate of credit growth through other means and supported by a flexible exchange rate regime—we expect to hold inflation within the target range, while ongoing fiscal consolidation will allow a steady improvement in government solvency. Public savings will increase over the program period as we improve our revenue administration and reduce the share of current expenditure in total spending—including through lower interest costs resulting from better debt management. We also anticipate a rise in private—mainly corporate—savings in response to ongoing structural reform and rapidly rising income levels. With public and private investment also rising, but at a lower pace, the current account will gradually improve and the growth contribution of net exports will rise. In recognition of our continued fiscal vulnerability, we will continue to protect this framework from unforeseen shocks through the use of budgetary contingencies; and also through the use of conservative estimates of absorptive capacity, tax revenue and privatization receipts, and by a policy of not expending the gains from tax administration reforms before their realization.

B. Monetary, Exchange Rate, and Financial Sector Policies

8. **We will continue to direct monetary policy toward maintaining price stability**. The current monetary policy framework—a reserve money program with quantitative targets set in consultation with the Fund and with changes to the repurchase rate as the main policy instrument—has proved effective in the past. It will be retained along with the flexible exchange rate regime. However, while the interest rate channel was previously sufficient to influence the exchange rate and thereby affect the lek price of traded goods, we now face a new situation where price pressures are largely demand driven and arise from the rapid growth of credit. We will maintain market-based monetary policy instruments so long as they remain effective in controlling inflation. However, considering the limited effect of policy rate changes on credit demand, the temporary use of direct instruments for preserving price stability may be also considered as a last resort.

9. **In order to slow credit growth, and prevent a deterioration in loan quality, we will initially strengthen prudential regulations**. Our intention is to implement—after a full discussion with commercial banks—the following measures and regulatory changes over the course of 2006-2007. The measures are aimed at bringing prudential regulations in line with international best practice and strengthening their implementation.

- We will raise reserve requirements on foreign currency deposits above 10 percent after evaluating carefully all its implications on the banking sector.
- Regulations on capital adequacy will be amended to allow risk weights up to 150 percent to apply to high risk loans or portions of loans;
- Regulations will be amended to allow for higher provisioning on classified loans;
- Provisions in existing regulations will be employed to impose higher than 12 percent minimum capital adequacy requirements on individual, relatively high-risk, banks;
- BoA will encourage banks to adopt—and impose on banks if necessary—stricter debt service to disposable income ratios and prudent loan-to-value ratios; tighter internal loan classification and provisioning rules; and increased risk premiums in lending spreads to take full account of indirect credit risk from foreign exchange exposure of customers;
- In addition, BoA will devote sufficient resources to decrease the time lag for reporting of monthly bank statistics from 40 to 30 days by end-September 2006; improve coordination and communication with home country supervisors of foreign-owned banks; and increase targeting of supervision activities—including

on-site inspections—towards credit-related risks. BoA will also introduce "truth in lending" rules by mid-2007 to disclose annual percentage rates on loans and the risks associated with foreign currency borrowing; and prepare and mandate by end-2006 enhanced reporting rules for commercial banks to allow better monitoring of banking sector developments.

If more strict enforcement and interpretation of prudential regulations do not in themselves result in a deceleration of credit growth, we will consider additional fiscal or monetary tightening.

10. **We will press ahead with financial sector reform with the aim of reducing vulnerabilities and creating the financial infrastructure needed to support growth**. Reforms will be guided by our recently-completed action plan for implementing the recommendations of the Financial Sector Stability Assessment (FSSA) report. Key measures with respect to the BoA and the banking sector will include:

- Submission of a new Banking Law to parliament (SB; end-March 2007). Among other provisions, this law will strengthen legal protection for banking supervisors, and grant BoA the specific legal authority needed to improve and broaden its supervision of commercial banks. This will include the authority to: address banking activities carried out by unlicensed agents; make binding qualitative judgments on investments of banks; apply capital requirements and supervise banking groups on a consolidated basis; group together related DMB exposure for enforcement of prudential regulations; and deem a relationship to be connected for the purpose of prudential limits. In addition, the draft law will introduce a formal system of monitoring cross border activity and sharing information with foreign regulators; and mandate bank collection of information needed for supervisory purposes;

- Additional legislation submitted to parliament to improve the efficiency and timeliness of the execution of collateral (SB; end-December 2006);

- Establishing a credit bureau within BoA (SB; end-June 2007);

- Develop rapid response capability in BoA and Deposit Insurance Agency by end-September 2006;

- Continue developing our analytical and forecasting capacity in preparation for an eventual move to formal inflation targeting.

11. **We will move forcefully ahead with measures to strengthen prudential supervision of the nonbank financial sector**. With World Bank assistance, we expect to unify all nonbank supervisory functions—insurance, pension fund and securities—within a single agency. We will ensure that the resulting new agency is fully independent—

including with respect to its staff compensation levels—possessed of an appropriate legal framework, and sufficiently funded to enable it to attract and retain a fully qualified staff. In the insurance sector, we have secured technical assistance to strengthen prudential supervision in the short term. We intend to also request technical assistance to modernize the legal framework for the new private pension industry. In recognition of our international obligations, we will also strengthen our AML/CFT framework, both by bringing the AML Law into full compliance with the FATF Recommendations 2003; and by strengthening the Financial Intelligence Unit.

12. **We attach considerable importance to improving the financial system infrastructure**. The expansion of credit is moving the banking system from a condition of near universal excess liquidity to a more differentiated system. Under these conditions, development of liquid government securities and interbank money and REPO markets would create additional efficiencies and improve both the monetary transmission mechanism and public debt management capacity.

- Experience so far with payments system improvements has been highly positive. Both the Real Time Gross Settlements System (AIPS) and Bulk Settlement System (AECH) are functioning well. These systems have advanced the use of the banking system in economic transactions while enhancing efficiency and security. Over the coming year, we intend to improve their functioning further by monitoring system utilization and collecting and reacting to customer feedback.

- The natural complement of these two systems—a delivery-versus-payment system—will be developed in 2006 to spur the development of the government securities market. The system will be designed so that it can also promote the use and development of the interbank money market by allowing the automated securitization of interbank lending with government securities. To encourage organic growth of the interbank market, the BoA will refrain from transactions with individual banks when there is sufficient aggregate liquidity in the system.

13. **We will maintain the treasury bill window at BoA until alternate means of ensuring nonbank access to government securities are in place**. We have insisted on the use of bank transfers rather than cash for all purchases of securities at the window; and will only redeem securities in cash if they were purchased or rolled over prior to August 2006. With the maximum maturity being 360 days, we will therefore have effectively eliminated the use of cash at the window by August 2007. We will accelerate preparations to divest government's minority interest in the remaining commercial bank; and will refrain from creating any public financial institution or from taking an equity stake or issuing any explicit or implicit government guarantee to any financial institution. We will take no legislative or regulatory action that weakens the independence of the BoA, including the full control over the Bank's budget—including staff compensation levels—currently exercised by the BoA's Supervisory Board.

C. Fiscal policy

14. **As we enter the middle-income group of countries, it will be important to follow our existing fiscal strategy of keeping government small while increasing its efficiency**. Reforms that strengthen our fiscal management will not only improve efficiency, but will also reduce vulnerabilities and reinforce actions taken in other areas to improve the business climate and make Albania a more attractive destination for needed investment. Reducing corruption within fiscal institutions and lowering the cost of compliance will be critical components of this strategy. Our efforts will therefore concentrate on reforming the revenue administrations, improving debt management capacity, and raising the quality and efficiency of expenditure.

15. **The 2006 budget and medium term fiscal framework have been designed to strike a balance between debt reduction and the need for growth enhancing and poverty reducing expenditure**. Over the program period, we expect a further 2 percentage point decline in public debt relative to GDP, and a fall in recourse to domestic financing from 2.7 percent of GDP in 2005 to 2.4 percent in 2008. Total expenditure relative to GDP is programmed to be contained at 30 percent of GDP. Within this envelope, capital spending will increase by 2¼ percentage points of GDP, reflecting our determination to direct expenditure towards more productive uses and to alleviate poverty. We therefore project an improvement in the current balance relative to GDP of about 2 percentage points. These projections are conservative, however, and make no allowance for revenue gains from tax administration measures that the outcome in the first half of 2006 indicate will likely be achieved. Our experience so far with the enhanced use of contingencies in our 2006 budget has been that they are an effective means of mitigating budgetary vulnerabilities. In combination with conservative revenue projections, we intend that they will form an integral characteristic of future budgets.

16. **With the gains from revenue administration expected to be permanent, and with unbudgeted privatization receipts from the sale of Italian Albanian Bank, we will table a supplementary budget in July**. This budget will allocate 0.6-0.8 percent of GDP of additional revenue gains from tax administration and 0.1 percent of GDP of privatization proceeds for infrastructure projects, primarily road construction. The remaining tax administration gains will be used to lower the employers’ share of social security tax from 29 percent of wages to 20 percent (0.2-0.4 percentage points of GDP). We will allocate 0.1 percent of GDP of privatization receipts toward further deficit reduction. In addition, we will allocate 0.2 percent of GDP in contingencies solely to deficit reduction, provided that and to the extent that domestic revenues materialize as budgeted. Our revenue projections, however, are conservative and we feel confident that we will meet our targets. For large privatization receipts, we maintain the same formula developed during the previous program—half the revenues will be used to reduce domestic debt, and half will be spent on well-designed infrastructure projects.

17. **The supplementary budget is consistent with our newly-developed expenditure and tax strategies**. As we expect our tax administration gains to be permanent and to grow over time, a strategy for their division between public investment, tax relief, and debt reduction became necessary, both to increase the efficiency and transparency of the process and to lessen the risk of these gains being allocated in an ad hoc fashion. From 2007 on, in recognition of our still-high public debt burden, we will, in consultation with the Fund, consider applying the formula for large privatizations of allocating half of the proceeds to reduce domestic debt also to gains stemming from over-performance in revenue. The remainder will be split between public investment and tax relief. Given their one-time nature, we will continue to divide privatization receipts equally between debt reduction and public investment. In both cases, public investment projects will be limited to those included in the NSSED. With respect to tax policy, our strategy first aims to minimize tax-induced distortions and promote formalization of the economy. Priority is therefore on further reducing the tax wedge on labor, mainly through cuts in social security taxes, which remain the highest in the region. Next in priority is securing lower rates on personal income tax and corporate profits tax. Adjustments to the VAT would be our last priority, given its relative lack of distortion and its importance to our total revenue collections—and would be undertaken only if it can be done without undermining revenue performance. All tax rate adjustments will be fully costed and designed in consultation with the Fund.

18. **Continued improvement of revenue administration is a key component of our program**. Revenue administration currently lacks prioritization and focuses too much on small taxpayers and comprehensive audits with little revenue potential. An excessive focus on short-term revenue targets also undermines more strategic objectives, such as encouraging self-compliance. Voluntary compliance is also discouraged by limited information on taxpayers' responsibilities and a non-uniform and nontransparent application of existing regulations. Progress on this front is not only essential to increase yields and achieve greater equity and compliance through a widening of the tax net, but is a key institutional reform needed to encourage new investment. Our strategy—based on IMF technical assistance—aims to refocusing resources towards larger taxpayers and reshape the revenue collection agencies into modern organizations relying on self-assessment and voluntary compliance. Key measures include:

- Intensifying staff training, particularly in audit techniques, and achieving full compliance with existing legislation and regulation regarding human resource issues and procedures;

- Merging small branches of the General Directorate of Taxation (GDT) and establishing bigger and more efficient branches. We expect to prepare a feasibility study for this transformation by end-October 2006 (SB);

- Improving the LTO structure and instituting measures to strengthen large taxpayer compliance control. Greater use will be made of risk-assessment software in the selection of audits; while the design of audits will shift from a comprehensive to a more narrow or single-issue focus;

- Improving compliance by (i) more effective implementation of taxpayer registration; (ii) introducing filing and payment obligations; (iii) expanding the computerized information system to include all taxpayers and all types of taxes; and (iv) making better use of information to manage the organization and identify noncompliance; and

- Extending the ASYCUDA computerization system to all remaining customs offices and improving the effective use of the risk selection module. A report on progress in the actual use of the risk module of the ASYCUDA system to perform inspections will be issued on a quarterly basis (SB; ongoing).

In addition, the GDT office structure will be rationalized; the role of the tax police will be reviewed; and better reporting capabilities and practices will be instituted. We will clear all VAT arrears by the end of 2006. To further improve VAT administration, we will prepare and provide quarterly reports to the Fund on the aggregate amounts of VAT refunds requested, paid, and rejected (SB; ongoing). With funding from the US Millennium Challenge Account, we began a new program of carrying out confidential questionnaire-based surveys on corruption in the General Directorate of Customs and the LTO in July 2006, and this initiative will be continued.

19. **Significant reform of debt management is needed to address vulnerabilities resulting from a relatively high level of short-term domestic debt in a market with a limited number of participants**. Reforms will focus on implementing the recommendation of the January 2006 IMF TA mission. Principle objectives include achieving a significant increase in the maturity structure of public debt, improved terms, significantly expanded capacity in analysis and risk management, better management of data, and the ability, by the end of the program period, to independently produce debt sustainability reports. Concrete measures will include:

- Finalizing and publishing a debt management strategy defining the main goals of debt management, the targets for the main characteristics of public debt, including currency composition, average maturity and modified duration, and the main debt instruments; and a time frame for implementing the debt management strategy (PC; end-September 2006);

- Enacting a new public debt law;

- Establishing a new Debt Management Directorate at the same level of the existing Treasury and Public Debt Directorate;
- Developing cash forecasting capacity within the Treasury Department;
- Gradually changing treasury bill issuance to better reflect government cash flow patterns;
- Taking steps to further develop the domestic governments security market, such as opening up the treasury bond auctions to a wider market and relaxing the payment requirements for corporate and institutional investors;
- Providing a level playing field for nonresident investors, and modernizing custody and depository systems;
- Completing the ongoing treasury modernization project; and
- Discontinuing the practice of mandatory closing out of the treasury single account at the end of the fiscal year.

20. **There is large scope for increasing the efficiency of spending by improving the budget process and financial management**. The relative isolation of the annual budget process and actual spending decisions from the Medium Term Expenditure Framework (MTEF) and National Strategy for Socio-Economic Development (NSSED) processes is a longstanding problem. Shortcomings also exist in the selection of public investment projects and the monitoring of outcomes. Reforms will aim at identifying measurable objectives in the context of the NSSED, ensuring they are clearly linked to spending requests, strengthening the MTBP and better integrating both the MTBP and NSSED with the budget process. In order to safeguard the use of nonconcessional project loans, we will continue our policy of conducting independent feasibility studies for any large project[13] financed in this manner (SB;ongoing), and will continue to provide to the Fund a biannual listing and status report of all projects being considered for nonconcessional foreign financing (SB;ongoing).We will also strengthen the payment discipline of budgetary units—particularly with respect to the payment of electricity and water bills. Looking ahead, we intend to approve a new organic budget law aimed at enhancing the efficiency of public expenditure management, including by improving budget classification standards and by increasing parliamentary oversight and the accountability of the public administration.

[13] As defined in the TMU.

D. Other Structural Reform

21. **In addition to our plans to privatize electricity distribution (paragraph 6), we intend to aggressively pursue measures to improve the availability and security of supply and to strengthening the financial position of KESH**.

- We will continue to prudently manage the water resources available to our main hydro-electric plant; and arrange sufficient volumes and stability of imported supply to meet demand for electricity in Albania. In this connection, we have secured sufficient imports of electricity from our neighbors for the third and fourth quarter, which considerably diminishes the risks of disruptions in electricity supply for the rest of the year. In the months ahead we will pursue our efforts to secure additional electricity supply at the lowest possible cost. We have finalized arrangements to construct an additional thermal power plant in Vlore and will continue working with our international partners on programs to strengthen the distribution lines coming from Macedonia and Kosovo.

- We have replaced our two tier pricing structure—which involved cross subsidization of households by business consumers—with a more simple scheme designed to bring electricity prices closer to the international market level while removing the cross-subsidies from business users to households. As a result, the prices paid by business users has been significantly reduced. However, we have appealed the special low tariff for high-voltage users that had been approved by the regulator as it could result in a significant revenue loss for KESH. A necessary aspect of our reform was to significantly raise the price for households consumers. In order to limit the negative social impact this reform will have on lower income households, we have been working with the World Bank to increase the number of households eligible under our social transfer program and redefined the benefit to reflect the new tariffs while keeping the consumption ceiling at its former level.

22. **Given that domestic production has returned to normal, and we will need to import less than previously anticipated, we expect the financial position of KESH to improve**. However, energy prices are high worldwide, and the risk of a further regional price increase is now greater following the closure of a major power plant in Bulgaria. Consequently, the risk of a supply disruption this winter—and an associated rise in import prices—remains . Nonetheless, there will be no return to our previous policy of extending import subsidies to KESH. Instead, should additional funding become necessary, we will direct the company to seek loans from the private banking sector, preferably without a government guarantee. We will, however, provide additional support by ensuring that budgetary and non-budgetary public institutions honor their electricity bills in a timely manner. We will also continue to work with the World Bank and other

donors to restructure the water supply companies and to adjust water tariffs to properly reflect increased operating costs.

23. **We have designed a broad strategy for modernizing our transportation network as part of our recently-adopted National Transportation Plan**. Our strategy concentrates on the development of roads and port facilities—we have identified the Durrës-Kukes-Morine corridor as priority project to develop the northeastern region of Albania, and as a link to neighboring countries. In carrying out this strategy, we will fully respect the non-concessional financing limits agreed under the program.

E. External Policies

24. **We will retain our liberal trade regime**. We have implemented all commitments made to the WTO regarding tariff policies, and are close to concluding a Stabilization and Association Agreement and a free trade agreement with the EU. The technical negotiations with the EU in relation to the free trade agreement are at an advanced stage. On a regional level, we have concluded free trade agreements with regional neighbors, which has significantly boosted our exchange with them, albeit from a low base.

25. **We will continue to make good faith efforts to conclude the rescheduling of our arrears on inoperative payments agreements.** We are engaged in negotiations that aim at concluding the clearance process with official creditors by mid-2007; and with private creditors by end-2007. We will provide semi-annual reports to the Fund on the outstanding stock of external arrears (SB; ongoing) within one month of the end of each quarter.

F. Data Issues

26. **We will expand the coverage and improve the quality of economic statistics over the program period.** We recognize the shortcomings of the recently published national accounts based on the labor input methodology. We will complete the revisions of the national accounts for 1997-2004 and prepare the preliminary national accounts for 2005 (both SB; end-November 2006). We will prepare provisional quarterly GDP estimates up to the first quarter of 2006. We are in broad agreement with the conclusions of the recent ROSC mission, and will adopt a plan to meet the SDDS goals by end-September 2006. We are convinced that in order to bring a durable improvement in national accounts, we need to improve basic data on consumption and employment. To that effect, we are preparing a household budget survey to be conducted in October 2006; and will conduct a labor force survey to be conduced by March 2007. We will publish the results of the Living Standards Measurement Survey (LSMS) before the end of 2006, which will improve our assessment of poverty. We are aware that the assessment of the balance of payments is complicated by measurement issues concerning private transfers and the prevalence of the informal economy. The BoA is working to improve its

methodology in consultation with IMF staff. In this connection, we will prepare revised estimates of private transfers in the balance of payments by end-December 2006 (SB).

G. Program Monitoring

27. The third disbursement under the PRGF/EFF-supported program will be based on the end-September 2006 quantitative performance criteria (Table 1 and the TMU); the end-September 2006 structural performance criteria (Table 2 and the TMU); and completion of the second review and financing assurances review. The second review under the PRGF and EFF arrangements is expected to be completed no later than February 1, 2007; and the third review no later than August 1, 2007. During the program period, Albania will not impose or intensify restrictions on the making of payments and transfers for current international transactions; or introduce multiple currency practices, or conclude bilateral payments agreements inconsistent with Article VIII, or impose or intensify import restrictions for balance of payments reasons. While taking into account the recommendations of the joint staff assessment of the 2005 progress report, we will prepare a new NSSED for the 2007-09 period by end-2006.

Table 1. Albania: Quantitative Performance Criteria and Indicative Targets, March 2006-March 2007 1/

	End-March 2006			End-June 2006	End-September 2006	End-December 2006	End-Marcl 2007
	Actual	Prog.	Prog. (Adj.)	Prog.	Prog.	Prog.	Prog.
				(In billions of lek)			
Ceiling on net domestic credit to the government 2/	-6	7	8	12	18	24	7
Ceiling on accumulation of net domestic assets of the BOA 3/	-20	3	3	8	6	10	11
Indicative total tax revenue target 4/	45	41	41	87	134	188	45
				(In millions of US dollars)			
Floor on accumulation of net international reserves of the BOA 3/	120	22	22	17	80	96	91
				(In millions of euros)			
Ceiling on contracting or guaranteeing of public and publicly-guaranteed non-concessional external debt with original maturities of more than one year	0	15	15	30	50	70	123
Ceiling on public and publicly-guaranteed external debt with original maturities up to and including 1 year 5/	0	0	0	0	0	0	0
Ceiling on accumulation of new external payments arrears, excluding interest on pre-existing arrears 5/	0	0	0	0	0	0	0

1/ The performance criteria and indicative targets outlined in this table, and their adjustors, are defined in the Technical Memorandum of Understanding (TMU). Targets are defined as cumulative changes from end-2005 except where marked. Data for end-March 2006 and end-September 2006 are performance criteria, except where marked. Data for end-June 2006, end-December 2006, and end-March 2007 are indicative targets.

2/ Cumulative change within the calendar year.

3/ For March-June 2006, cumulative change from end-September 2005. For end-September 2006, end-December 2006, and end-March 2007 cumulative change from end-Decembe 2005.

4/ Indicative target. Defined as all revenues collected by the GDT, GDC, and SSI. Aggregate revenue so defined includes all revenues collected on behalf of local governments, but excludes revenues collected by local governments directly. Targets defined as cumulative changes within each calendar year.

5/ Applies on a continuous basis.

Table 2. Proposed Performance Criteria and Structural Benchmarks under the PRGF and EFF Arrangements 1/

	Proposed Test Date
I. Prior Actions	
1. Conclude a contract with a major development institution providing for technical assistance to (i) develop and finalize a new energy sector strategy to promote increased private sector involvement, including the privatization of electricity distribution, and (ii) provide on-going resources through mid-2007 to assist with preparing for the privatization of electricity distribution.	
II. Performance Criteria	
2. Finalize and publish a debt management strategy defining the main goals of debt management, the targets for the main characteristics of public debt, including currency composition, average maturity and modified duration, and the main debt instruments; and a time frame for implementing the debt management strategy.	*End-October 2006*
III. Structural Benchmarks	
A. Improve public expenditure management	
3. Safeguard the efficient use of nonconcessional foreign project loans:	
(i) Conduct an independent feasibility study for any large project (as defined in the TMU) financed through non-concessional commercial borrowing.	Ongoing
(ii) Provide a semestrial listing and status report on all projects being considered for nonconcessional foreign financing.	Ongoing
B. Reduce fiscal vulnerabilities	
Strengthen tax administration	
4. Improve VAT administration by preparing and providing to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (within one month of the end of each quarter).	Ongoing
5. Prepare and issue quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections in the customs.	Ongoing
6. Prepare a feasibility study for merging small branches of the GDT and establishing bigger and more efficient branches.	*End-October 2006*
Improve debt management capacity	
7. Prepare semi-annual reports (within one month of the end of each semester) on the stock of external arrears.	Ongoing
8. Submit to parliament of new public debt law.	*End-September 2006*
C. Strengthen the financial system and improve economic monitoring capability	
9. Submit to parliament of new banking law.	*End-March 2007*
10. Submit to parliament of new legislation improving the efficiency and timeliness of the execution of collateral.	*End-December 2006*
11. Establish a credit bureau within the Bank of Albania.	*End-June 2007*
12. Strengthen statistical and economic monitoring capacity:	
(i) Complete the revision of national accounts for 1997-2004 and prepare preliminary national accounts for 2005.	*End-November 2006*
(ii) Prepare revised estimates of private transfers in the balance of payments.	*End-December 2006*

1/ Text in italics refers to new conditionality not carried over from the original

ALBANIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum defines the quantitative benchmarks and performance criteria established in the Memorandum of Economic and Financial Policies (MEFP) up until end-March 2007; and associated reporting requirements.

H. Net Domestic Credit to the Government

28. For the purposes of the program, the **government** covers the State Budget, the Social Security Institute (SSI), and the Health Insurance Institute (HII).

29. **Net domestic credit to the government** (NCG) is defined as gross domestic credit in lek and in foreign currency extended to the government (as defined above) by the banking system, savings and loan institutions (SLIs), and other domestic lenders;[14] less the sum of government financial assets held in the banking system and in the SLIs.

30. The following definitions apply to **gross domestic credit to the government**:

(i) Gross domestic credit in lek and in foreign currency extended to the government includes: (a) securities (including treasury bills and bonds) issued by the government and held by the Bank of Albania (BoA), deposit money banks (DMBs), SLIs, and other domestic lenders; (b) loans and advances extended to the government by BoA, DMBs, SLIs, and other domestic lenders; (c) negative balances in government deposits with BoA, DMBs and SLIs; (d) any securities or debt instrument of any kind issued by government (as defined above) to the Bank of Albania to compensate the Bank of Albania for its net valuation losses on its assets and liabilities in, or denominated in, gold, special drawing rights or foreign currencies, and which the Bank of Albania keeps in its (off-balance sheet) Valuation Reserve Securities Account of the Bank of Albania, as required in Article 64 of the Law on the Bank of Albania (No. 8269, dated December 12, 1997)[15]; and (e) any other form of financial obligation of the government the issuance of which resulted in borrowing funds by the government or a payment for an existing payment obligation of the government.

(ii) Gross domestic credit in lek and in foreign currency extended to the government excludes (a) the onlending of foreign project loans to all parts of government; and (b) advances on profit transfers by the BoA. The value of the stock of gross domestic credit to government will also exclude the claims held

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[14] Other domestic lenders comprise firms, nonbank institutions, and households, or any other resident legal or natural person, or institution.

[15] This was equivalent to Lek 11.5 billion at end-December 2005.

by the units of government as defined above (in particular, the SSI and the HII).

(iii) The stock of gross domestic credit extended to the government and held by the BoA and DMBs in the form of treasury bills will be valued at issue price. The stock of gross domestic credit extended to the government and held by the BoA in the form of other securities and direct loans to government will be valued excluding accrued interest. The stock of gross domestic credit extended to the government and held by the DMBs in the form of variable and fixed income securities (excluding treasury bills) will be valued at face value. The stock of all gross domestic credit extended to the government and held by SLIs and other domestic lenders will be valued at face value[16].

(iv) For the purposes of program monitoring, gross domestic credit to the government in foreign currency will be converted from Lek to SDRs at the end-of period Lek/SDR exchange rate prevailing on the test date; and then converted to Lek at the program Lek/SDR exchange rate of Lek 147.8/SDR.

31. **The following definitions apply to government financial assets held in the banking system and in the SLIs**:

(i) Government financial assets held at the Bank of Albania include: (a) transferable deposits in domestic and foreign currency; (b) lek deposits held in BoA for projects; and (c) standard gold deposits of the government. For the purposes of program monitoring, standard gold deposits will be valued at the program price of gold (SDR 358.9 per ounce)[17].

(ii) Government financial assets held at the Bank of Albania exclude: (a) foreign currency deposits related to foreign financed projects; and (b) deposits serving as the counterpart for non-standard gold and other precious metals owned by the government.

(iii) Government financial assets held at the DMBs include: (a) all deposits of government in domestic and foreign currency; and (b) payable amounts owed by the DMB to government.

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[16] Under current reporting standards, the following data is only available at face value: (i) the stock of gross domestic credit extended to the government and held by the DMBs in the form of fixed and variable income securities; and (ii) the stock of all gross domestic credit extended to the government and held by the SLIs and other domestic lenders.

[17] The lek value of standard gold deposits will be (a) converted to US dollars using the current end-of-period lek/US dollar exchange rate; (b) then converted to ounces of gold using the current US dollar market price of gold; (c) then converted to SDRs at the program price of gold (SDR 358.9 per ounce); and (d) then converted to Lek at the program Lek/SDR exchange rate of Lek 147.8/SDR.

(iv) Government financial assets held at the SLIs include all deposits of government held at the SLIs.

32. For the purposes of program monitoring, government financial assets in foreign currency will be converted from Lek to SDRs at the end-of period Lek/SDR exchange rate prevailing on the test date; and then converted to Lek at the program Lek/SDR exchange rate of Lek 147.8/SDR.

33. Under these definitions, the stock of net domestic credit to the government was Lek 317.8 billion at end-December 2005. The breakdown of the categories of net domestic credit to the government as defined above is given in Attachment Table 1.

34. The limits on the change in net domestic credit to the government will be cumulative within each calendar year.

I. Net Domestic Assets

35. The stock of **net domestic assets (NDA) of the Bank of Albania** is defined as reserve money—defined as the sum of currency issue (less lek notes and coins held by the Bank of Albania) and commercial bank reserves held at the BoA—less the net international reserves of the Bank of Albania (Section C). For program monitoring purposes, all foreign currency assets and liabilities making up NIR will be valued in local currency at the exchange rates of end-December 2005. Under this definition, the level of NDA was Lek 77.1 billion as of end-December 2005. The NDA limits will be cumulative changes from end-December 2005 and will be monitored from the accounts of the Bank of Albania.

J. Net International Reserves

36. **Net international reserves (NIR)** are defined as reserve assets minus reserve liabilities of the Bank of Albania. **Reserve assets** are readily available claims of the Bank of Albania on nonresidents denominated in foreign convertible currencies, and held for the purpose of meeting balance of payments financing needs, intervention in exchange markets, and other purposes. They include Bank of Albania holdings of monetary gold, SDRs, Albania's reserve position in the IMF, foreign currency cash, securities, and deposits abroad. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options). **Reserve liabilities** shall be defined as foreign exchange liabilities to residents and nonresidents of the Bank of Albania, irrespective of their maturity. They include: foreign currency reserves of commercial banks held at the Bank of Albania; all credit outstanding from the IMF; commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or

interest payments to commercial banks, suppliers, or official export credit agencies. Excluded from reserve liabilities are the government's foreign currency deposits at the Bank of Albania.[18] Reserve assets and reserve liabilities will both be expressed in U.S. dollars. The NIR limits will be cumulative changes from end-December 2005, and will be monitored from data supplied by the Bank of Albania.

37. During this program, for monitoring purposes, the exchange rates of the SDR and non-dollar currencies will be kept at their end-December 2005 levels and holdings of monetary gold will be valued at SDR 358.9 per ounce. Excluded from net international reserves are holdings of nonconvertible currencies, claims on nonresident financial institutions denominated in nonconvertible currencies, and other claims which are not readily available. Under this definition, the level of NIR was US$1,171.7 million at end-December 2005.

K. Adjusters for NCG, NDA, and NIR

38. The NCG and NDA ceilings and the NIR floor are defined on the assumption that total privatization proceeds will amount, on a cumulative basis, from January 1, 2006, to:

End-September 2006	Lek 5,500 mn (Of which: US$45.4 mn. in foreign currency).
End-December 2006	Lek 5,500 mn. (Of which: US$45.4 mn. in foreign currency).
End-March 2007	Lek 6,000 mn. (Of which: US$45.4 mn. in foreign currency);

The NIR floor will be adjusted upward (downward) and the NDA ceiling adjusted downward (upward) by half of any excess (shortfall) in the receipt of privatization proceeds in foreign currency from these assumed values. The NCG ceiling for end-September 2006 and end-December 2006 will be adjusted downward (upward) by half the amount of any excess (shortfall) in the receipt of total privatization proceeds from these assumed values. The NCG ceiling for end-March 2007 will be adjusted downward (upward) by half the amount by which the receipt of total privatization revenue in the first quarter of 2007 exceeds (falls short of) Lek 500 million.

39. The NCG ceiling will be adjusted upward (downward) by the increase (decrease) in debt instruments of any kind (valued at issue price if possible) that the government (as defined above) transfers to the Bank of Albania to compensate the Bank of Albania for its net valuation losses on its assets and liabilities in, or denominated in, gold, special drawing rights or foreign currencies, and which the Bank of Albania keeps in its (off-balance sheet)

[18] This exclusion is justified by current procedures in Albania, whereby the government's foreign currency receipts are deposited in a blocked account at the Bank of Albania and the funds are transferred to the government's lek account before being spent. A change in this procedure, would require revisiting the NIR definition.

Valuation Reserve Securities Account of the Bank of Albania, as required in Article 64 of the Law on the Bank of Albania (No. 8269, dated December 12, 1997).

40. The ceilings on NCG and NDA, and the floor on NIR are defined based on the assumption that foreign budgetary and/or balance of payments loan financing (excluding IMF financing, project and commodity loans, and macro-financial assistance from the EU) will amount, on a cumulative basis, from January 1, 2006, to:

End-September 2006	US$5.8 mn.
End-December 2006	US$5.8 mn.
End-March 2007	US$8.3 mn.

The ceilings on NDA of the Bank of Albania will be adjusted downward, and the floor on NIR will be adjusted upward by the amount total foreign loan financing exceeds these projections. The NCG ceiling for end-September 2006 and end-December 2006 will be adjusted downward by the amount total foreign loan financing exceeds these projections. The NCG ceiling for end-March 2007 will be adjusted downward by the amount total foreign loan financing in the first quarter of 2007 exceeds US$2.5 million.[19]

41. The NDA ceilings will be also adjusted to reflect the impact of any change in the required reserve ratio of commercial banks with the Bank of Albania.

L. External Debt and Arrears

42. As set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–00/85) August 24, 2000), the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered

[19] For the NCG adjuster, the lek equivalent of deviations from the programmed amounts in terms of dollars is converted at an exchange rate of Lek 103.4 per U.S. dollar**.**

or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

43. The limit on medium- and long-term external debt applies to the contracting or guaranteeing by the government or the Bank of Albania, of new nonconcessional external debt with an original maturity of more than one year. It applies not only to debt as defined in paragraph 15 of this memorandum, but also to commitments contracted or guaranteed for which value has not been received. External debt will be considered to have been contracted at the point the loan agreement or guarantee is ratified by the Albanian parliament. Excluded from the limits are refinancing credits and rescheduling operations (including the deferral of interest on commercial debt), credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 35 percent. The grant element is to be calculated using the OECD Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on ten-year averages. Debt falling within the limit shall be valued in euros at the exchange rate prevailing at the time the contract or guarantee becomes effective.

44. The limit on short-term external debt applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the government or the Bank of Albania, with an original maturity of up to and including one year. It applies to debt as defined in paragraph 15 of this memorandum. Excluded from the limit are rescheduling operations (including the deferral of interest on commercial debt) and normal import-related credits. Debt falling within the limit shall be valued in Euros at the exchange rate prevailing at the time the contract or guarantee becomes effective.

45. A continuous performance criterion applies on the accumulation of new external payments arrears on external debt contracted or guaranteed by the government or the Bank of Albania. External payment arrears consist of external debt service obligations (principal and interest) falling due after March 31, 2006 and that have not been paid at the time they are due, taking into account the grace periods specified in the contractual agreements. Excluded from the prohibition on the accumulation of new arrears are: (i) arrears arising from interest on the stock of arrears outstanding as of March 31, 2006; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

46. **Large projects** (as referred to in MEFP paragraph 20 and MEFP Table 2) financed by nonconcessional foreign borrowing are defined as those projects involving total nonconcessional foreign borrowing in excess of Euro 20 million.

47. **The budget commitments related to the contingencies embodied in the 2006 budget** will be released after the following conditions are satisfied:

(i) At end-June 2006, actual revenue collection, defined as all revenues collected by the GDT, GDC and SII (including all revenues collected on behalf of local governments but excluding revenues collected by local governments directly) is in line with the indicative total tax revenue target specified under the program;

(ii) The decision to release the budget commitments related to the contingencies is taken in consultation with the Fund.

M. Tax Revenues

48. Collection of total tax revenue by the Tax and Customs Departments and social insurance contributions will be monitored on the basis of quarterly indicative floors. These indicative floors will include all revenues collected by the GDT, GDC, and SSI (including revenues collected on behalf of local governments), but exclude revenues collected by local governments directly.

49. For the purpose of reporting the share of taxes collected by the Large Taxpayer Office (LTO), the following definition will apply. The share of taxes collected by the LTO will be calculated as the ratio of all taxes collected by the LTO to the total collection of all taxes administered by the GDT (VAT, excises, corporate income taxes, personal income taxes, social security contributions, national taxes, taxes on packages, and gambling taxes). In calculating this ratio, social security contributions paid by budgetary institutions will be excluded from the denominator.

N. Monitoring and Reporting Requirements

50. Performance under the program will be monitored from information supplied to the Fund by the Bank of Albania, the Ministry of Finance, the General Directorate of Taxation (GTD), the General Directorate of Customs (GDC), the Ministry of Economy and INSTAT. This information will include the following, which will be supplied monthly (except where noted) and on a timely basis:

The Bank of Albania will supply to the Fund:

(i) The balance sheets of the Bank of Albania;
(ii) The consolidated accounts of the commercial banks and (separately) the SLIs;
(iii) The monetary survey;

(iv) Banking sector prudential indicators;
(v) Net domestic credit to the government (in the form outlined in Appendix Table 1);
(vi) The net foreign assets of the Bank of Albania and their components;
(vii) Comprehensive information on reserve assets that are pledged, collateralized, or otherwise encumbered.
(viii) The foreign exchange cashflow of the Bank of Albania, including the level of NIR;
(ix) Daily average exchange rates;
(x) Trade flows;
(xi) Periodic updates of balance of payments estimates;
(xii) Detailed information on the stock and flow of any securities or debt instrument of any kind issued by government (as defined above) to the Bank of Albania to compensate the Bank of Albania for its net valuation losses on its assets and liabilities in, or denominated in, gold, special drawing rights or foreign currencies, and which the Bank of Albania keeps in its (off-balance sheet) Valuation Reserve Securities Account of the Bank of Albania, as required in Article 64 of the Law on the Bank of Albania (No. 8269, dated December 12, 1997).

The Ministry of Finance will supply to the Fund:

(i) The summary fiscal table, including the overall budget deficit, on a cash basis;
(ii) Issuance of treasury bills by the MOF, including gross value and cash received;
(iii) Privatization receipts;
(iv) Information on the contracting and guaranteeing of new debt;
(v) Information on the stock of short-, medium- and long-term debt;
(vi) Information on all overdue payments on short-, medium- and long-term debt (with assistance from the Bank of Albania).
(vii) Information on the stock of VAT refunds claimed and refunds paid out every month will be supplied within one month of the end of the reporting period.
(viii) Information on official grants for projects or budget support purposes.
(ix) Biannual reports on the stock and clearance of outstanding debit balances of inoperative bilateral payment agreements will be supplied within one month of the end of the semester.
(x) Information on expenditure arrears;
(xi) A biannual listing and status report of all projects being considered for nonconcessional foreign financing.

The General Directorate of Customs will supply to the Fund:

(i) Detailed monthly data on customs revenues collected; and
(ii) Quarterly reports on corrective measures taken to deal with problems identified by the internal audit function.

The General Directorate of Taxation will supply to the Fund:

(i) Detailed monthly data on tax revenues collected.
(ii) Detailed monthly data on the share of taxes collected by the Large Taxpayer Office (LTO), as defined in paragraph 22 of this Technical Memorandum of Understanding.

The Ministry of Economy will either report quarterly to the Fund or publish quarterly:

(i) All instances of nonpayment on the agreed memorandums of understanding for the repayment of the stock of end-December 2001 inter-enterprise government arrears. It will communicate to the Fund progress in clearing the inter-enterprise government arrears accumulated in the years 2002 to 2005.
(ii) A description of remedial actions undertaken by the ministry in the event of non-payment on the agreed MOUs for the repayment of the stock of end-December 2001 inter-enterprise arrears.

The Albanian Statistical Agency (INSTAT) will supply the Fund:

(i) The consumer price index (CPI index) at the aggregated level and at the level of each individual item making up the basket.
(ii) The producer price index.
(iii) The construction cost index
(iv) All short term indicators as they become available as defined in INSTAT's quarterly publication "Conjoncture".
(v) In addition INSTAT will communicate to the Fund on a regular basis the preliminary estimates for Quarterly GDP. It will also communicate as early as possible the preliminary estimates for annual GDP disaggregated by 22 sectors and distinguishing between the observed and non-observed economy.

Table 1. Albania: Calculation of Net Domestic Credit to Central Government for Program Monitoring Purposes, December 2005–March 2007
(In millions of lek)

		Dec-05	Sep-06	Dec-06	Mar-07
1.	**Treasury bills held outside central government**	276,684			
Of which:					
1. (i)	Held by Bank of Albania 1/	65,934			
1. (ii)	Held by deposit money banks 1/	174,485			
1. (iii)	Held by savings and loan institutions 2/	0			
1. (iv)	Held by other domestic lenders (excluding holdings of HHI and SSI) 2/	36,266			
	Of which:				
1. (iv) (i)	INSIG	1,571			
1. (iv) (ii)	Individuals and firms	34,695			
1. (iv) (ii) (i)	Of which: BoA window	19,942			
Plus:					
2.	**Other central government debt held outside central government (millions of lek)**	50,674			
Of which:					
2. (i)	Held by Bank of Albania 3/	12,464			
2. (i) (i)	Other securities 3/	12,464			
2. (i) (i) (i)	Of which: for BoA valuation losses 3/	11,500			
2. (i) (ii)	Short-term direct loans to government 3/	0			
2. (ii)	Held by deposit money banks 4/	38,210			
2. (ii) (i)	Fixed income securities 4/	38,210			
2. (ii) (ii)	Variable income securities 4/	0			
2. (iii)	Held by savings and loan institutions 5/	0			
2. (iv)	Held by other domestic lenders 5/	0			
Equals gross domestic credit to government:		327,358			
Less:					
3.	**Assets of central government (excluding HHI and SSI)**	7,334			
3. (i)	Deposits held at Bank of Albania 6/	5,917			
3. (i) (i)	In domestic currency	3,417			
3. (i) (i) (i)	Transferable deposits in lek	2,756			
3. (i) (i) (ii)	Deposits in lek for projects	661			
3. (i) (ii)	In foreign currency at program exchange rates and program price of gold 7/ 8/	2,500			
3. (i) (ii) (i)	In foreign currency evaluated at current exchange rates	2,499			
3. (i) (ii) (i) (i)	Transferable deposits in foreign currency evaluated at program exchange rate 7/	520			
3. (i) (ii) (i) (i) (i)	Transferable deposits in foreign currency evaluated at current exchange rate 9/	519			
3. (i) (ii) (i) (ii)	Standard gold deposits of government evaluated at program exchange rate and gold price (Lek mns.) 8/	1,980			
3. (i) (ii) (i) (ii) (i)	Standard gold deposits of government at current exchange rate and gold price (Lek mns.) 8/	1,980			
3. (i) (ii) (i) (ii) (i) (i)	Number of ounces of gold equivalent	37,334			
3. (ii)	Assets held at deposit money banks	1,417			
3. (ii) (i)	Deposits 10/	1,124			
3. (ii) (i) (i)	Deposits in domestic currency	173			
3. (ii) (i) (i) (i)	Transferable deposits in domestic currency	173			
3. (ii) (i) (i) (ii)	Other deposits in domestic currency	0			
3. (ii) (i) (ii)	Deposits in foreign currency evaluated at program exchange rates	951			
3. (ii) (i) (ii) (i)	In foreign currency evaluated at current exchange rates 7/	951			
3. (ii) (i) (ii) (i) (i)	Transferable deposits in foreign currency evaluated at current exchange rates	951			
3. (ii) (i) (ii) (i) (ii)	Other deposits in foreign currency evaluated at current exchange rates	0			
3. (ii) (ii)	DMB payables to government	18			
3. (ii) (iii)	Ministry of finance short-term lending to commercial banks	275			
3. (iii)	Held at savings and loan institutions 10/	0			
Less:					
4.	**Deposits of HHI and SSI**	2,182			
Equals:					
5.	**Stock of Net domestic credit to central government (1+2-3-4)**	317,843			
5. (iii)	Change since December 2005	…			
6.	Memorandum items:				
6. (i)	Current exchange rate (Lek/SDR, eop)	147.8	…	…	…
6. (ii)	Current exchange rate (Lek/US dollar, eop)	103.4	…	…	…
6. (ii)	Program exchange rate (Lek/SDR, eop)	147.8	147.8	147.8	147.8
6. (iv)	Program price of gold (SDRs per ounce)	358.9	358.9	358.9	358.9
6. (v)	Market price of gold (price in US dollars per ounce)	512.8	…	…	…
6. (vi)	Current exchange rate (US dollar per SDR, eop)	1.429	…	…	…

1/ Evaluated at issue price.

2/ Evaluated at face value (data on treasury bill holdings of SLAs and other domestic lenders are currently available only at face value).

3/ Includes Lek 11,500 million of securities issued by government to the Bank of Albania to compensate the Bank of Albania for its net valuation losses in 2003 and 2004. The Bank of Albania keeps these in its (off-balance sheet) Valuation Reserve Securities Account of the Bank of Albania, as required in Article 64 of the Law on the Bank of Albania (No. 8269, dated December 12, 1997). Excludes accrued interest.

4/ Valued at face value (data on fixed and variable income securities held by DMBs are currently available only at face value).

5/ Includes accrued interest.

6/ Includes transferable deposits of government in domestic and foreign currency, lek deposits of central government for projects; and standard gold deposits of government. Excludes all non-standard gold deposits; and excludes all nongold precious metal deposits of government; and excludes government deposits in foreign currency for projects.

7/ The reported lek value of foreign currency denominated assets of government will be converted to SDRs using the current end-of-period lek/SDR exchange rate; and then converted back to lek using the program Lek/SDR exchange rate of Lek 147.8/SDR.

8/ Standard gold deposits are usable by government and therefore included in the definition of government assets. The lek value of standard gold deposits will be (a) converted to US dollars using the current end-of-period lek/US dollar exchange rate; (b) then converted to ounces of gold using the current market price of gold; then (c) converted to SDRs at the program price of gold of SDR 358.9 per ounce; and then (d) converted to lek at the program Lek/SDR exchange rate of Lek 147.8/SDR.

9/ Including account set up to hold the Savings Bank privatization revenue (Account No: 11.2.2.1.4)

10/ Includes all deposits of central government.

INTERNATIONAL MONETARY FUND

ALBANIA

Staff Report for the 2006 Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Financing Assurances Review

Supplementary Information

Prepared by the European Department

Approved by Ajai Chopra and Scott Brown

July 19, 2006

1. **This statement reviews developments in Albania since the preparation of the staff report.** The additional information does not change the thrust of the staff appraisal.

2. **In accordance with the understandings described in the staff report, the authorities have prepared a supplementary budget for 2006.** Because of the strong revenue performance in the first half of 2006, budgeted total revenue has been increased by 0.9 percent of GDP and—contingent on this target being met—domestic financing will be reduced by 0.3 percent of GDP. Additional expenditure is allocated almost entirely to infrastructure investment.

3. **Despite a slowdown in headline inflation, underlying pressures have continued to build.** Headline CPI inflation fell to 2.4 percent (year-on-year) in June mainly due to a base effect as the quarter-on-quarter rate of inflation picked up. Increases in food prices, however, were stronger than previously expected. The recent electricity tariff increases, while on average moderate, will result in a large hike in retail tariffs and a sizable decline in business tariffs due to the elimination of cross-subsidies. The increase in retail tariffs (by about 40 percent) will likely push headline inflation temporarily outside the BoA's 3±1 percent target range in Q3 2006.

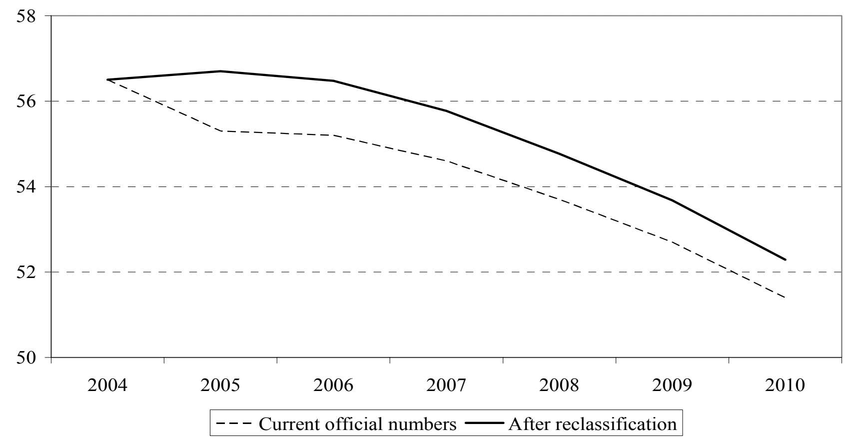
4. **Owing to these underlying pressures and to prevent possible second-round effects from the electricity tariff hike, the BoA raised policy rates by 25 basis points on July 12, 2006.** This increase, the first since April 2002, brings the policy rate to 5¼ percent. If the second-round effects are minimal, headline inflation is expected to return to the middle of the BoA's 3±1 percent target range by late 2007.

5. **The prior action for the completion of the First Review and the end-June structural benchmarks have been implemented (updated Table 4).** The authorities have made the necessary arrangements with USAID and the World Bank to assist them with finalizing their new energy sector strategy and preparing for the privatization of electricity

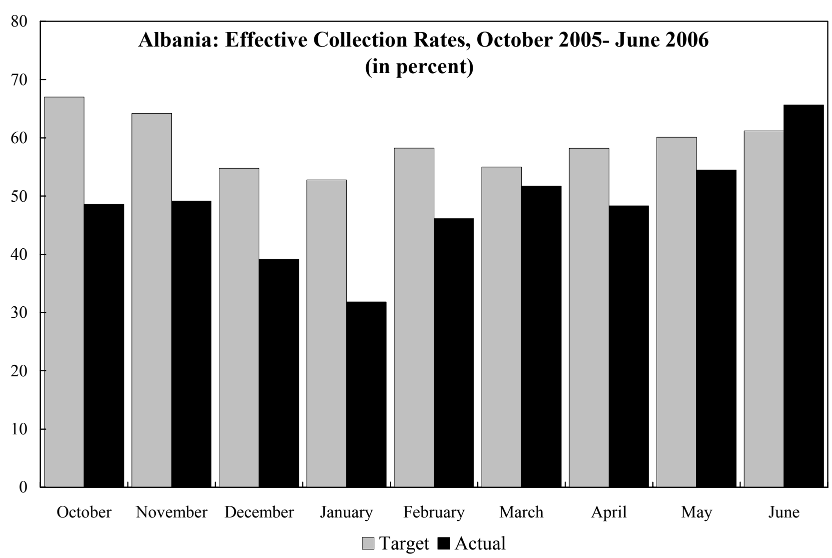
distribution. The remaining four end-June SBs, relating to public expenditure and debt management, were all met on schedule.

6. **Proper accounting for the recapitalization of the BoA will lead to a small upward adjustment in measured public debt.** As discussed in the Staff Report (footnote 8), the government issued securities to the BoA in 2005 to compensate for its foreign exchange valuation losses. These securities have so far been treated and reported as a guarantee in the official statistics on public debt. In addition to the implications for net credit to government discussed in the staff report, our preliminary estimate is that accounting for this item as public debt rather than as a guarantee will result in an increase in public debt from 55.3 to 56.7 percent of GDP in 2005. Projections for 2006–10 will change accordingly.

Albania: Public Debt Relative to GDP
(In percent)



7. **The performance of the electricity company (KESH) has continued to improve, with the effective collection rate running above target in June 2006.** However, as expected, collections remained somewhat below target for Q2 2006 as a whole.



8. **A safeguards assessment for the Bank of Albania, completed on July 14, 2006, found weaknesses in the central bank's safeguards framework.** The main vulnerabilities identified by the assessment concern the quality of the external audit, poor oversight of the external and internal audit functions and the system of internal controls, and certain weaknesses in the controls over the Fund data reporting process. The assessment recommended measures to alleviate these weaknesses and staff will monitor their implementation.

Albania: Status of Performance Criteria and Structural Benchmarks under the PRGF and EFF Arrangements

	Proposed Test Date	Status
I. Performance Criteria		
1. Further extend the use of ASYCUDA systems in customs		
(i) Deploy the ASYCUDA system in 10 customs houses.	End-March 2006	Met
(ii) Implement the risk assessment module of the ASYCUDA system in 10 customs houses to perform inspections.	End-March 2006	Met
2. KESH to meet the targets under the 2006-2008 Power Sector Action Plan for end-March 2006 with regards to collection rates and losses.	End-March 2006	**Not Met**
II. Structural Benchmarks		
A. Improve public expenditure management		
3. Complete a census of the wage bill for all budgetary sector	End-June 2006	Met
4. Strengthen public investment programming:		
(i) Establish and staff a public investment program department within the General Directorate of the Ministry of Finance.	End-June 2006	Met
(ii) Prepare and issue instructions for submitting public investment proposals consistent with the budget and the Medium-Term Budgetary Plan.	End-June 2006	Met
5. Safeguard the efficient use of nonconcessional foreign project loans:		
(i) Conduct an independent feasibility study for any large project (as defined in the TMU) financed through non-concessional commercial borrowing.	Ongoing	Met
(ii) Provide a semestrial listing and status report on all projects being considered for nonconcessional foreign financing.	Ongoing	Met
B. Reduce fiscal vulnerabilities		
Strengthen tax administration		
6. Improve VAT administration by preparing and providing to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (within one month of the end of each quarter).	Ongoing	Met
7. Increase the share of tax revenue collected by the Large Taxpayer's Office to 50 percent of all tax collected by end-June 2006.	End-June 2006	Met
8. Prepare and issue quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections in the customs.	Ongoing	Met
Improve debt management capacity		
9. Develop and discuss with IMF staff an Action Plan for implementing the recommendations of the IMF TA mission on debt management.	End-June 2006	Met
10. Prepare biannual reports (within one month of the end of each semester) on the stock of external arrears.	Ongoing	Met
C. Strengthen the financial system and improve economic monitoring		
11. Develop and discuss with IMF staff an Action Plan for implementing the recommendations of the Financial Sector Stability Assessment Report.	End-March 2006	Met
12. Strengthen statistical and economic monitoring capacity:		
(i) Prepare advance GDP estimates for the first half of 2005.	End-March 2006	Met
(ii) Prepare and publish preliminary national accounts for 2004.	End-March 2006	Met

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 06/80
FOR IMMEDIATE RELEASE
July 26, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Albania

On July 24, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Albania.[20]

Background

Macroeconomic performance since the turn of this decade has generally been strong. Growth has been rapid and Albania is now emerging from the low-income country group. Together with large remittances, the rapid growth has significantly reduced poverty. The absolute poverty rate declined from 25½ percent in 2002 to 18½ percent in 2005 and the extreme poverty rate from 4¾ to 3½ percent. Macroeconomic stability has been maintained—evidenced by low inflation, increasing confidence in the currency and the banking system, and rising international reserves.

Fiscal policy has contained net domestic borrowing and lowered public debt from 67½ percent of GDP in 2001 to 55¼ percent in 2005. More recently, reforms in revenue administration have boosted revenues—which have been allocated in the 2006 supplementary budget between investment spending, tax relief, and continued debt reduction. The absence of fiscal dominance has supported the Bank of Albania's (BoA) monetary policy framework—a reserve money program with the repo rate as the main policy instrument, combined with a floating exchange rate regime.

However, progress with structural reform has been uneven and the business environment remains relatively uninviting. Despite advances, weak public institutions remain a source of vulnerability, particularly in the fiscal and financial areas. Together with infrastructure

[20] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

deficiencies—particularly in the electricity sector—these factors hinder growth and promote corruption and informal activities. While there is no indication of a significant exchange rate misalignment, the resulting lack of non-price competitiveness continues to hinder investment and exports.

Past accomplishments notwithstanding, recent macroeconomic developments pose new challenges:

Credit growth has accelerated markedly. The stock of private sector credit increased from 9 percent of GDP at end-2004 to 17 percent of GDP by April 2006, creating a sizable demand impulse. So far, however, the resulting rise in nontradables prices has been offset by declining traded goods prices, with the result that headline inflation is still low and relatively stable.

The current account deficit increased to an estimated 7¾ percent of GDP in 2005, up from 5½ percent in 2004, as a result of weakening demand in key trading partners and intensified competition in textiles (Albania's main product market). This, together with strong import demand—partly fueled by the credit expansion—and higher oil import costs, caused the trade deficit to widen in 2005, a trend that appears to have continued in the first quarter of 2006.

Growth has slowed. The electricity crisis in October–November 2005 hit the economy hard and economic activity in the construction sector has weakened. Together with a slowdown in exports, these factors led to a slowing of growth from about 6 percent in 2004 to 5½ percent in 2005. The economy weakened further in the first quarter of 2006, reflecting the emerging capacity constraints in non-tradable sectors and the closing of a large metallurgy plant.

Executive Board Assessment

Directors commended the authorities for Albania's good macroeconomic performance in recent years. Strong, noninflationary growth, combined with large and sustained remittance inflows, have raised incomes significantly and lowered poverty. Directors considered that sound macroeconomic policies—including the maintenance of a flexible exchange rate regime—and a more competitive banking system had contributed to this success. In the period ahead, Directors emphasized the need for far-reaching structural reforms to enhance the business climate, secure long-term economic growth, and achieve the Millennium Development Goals.

Directors supported the authorities' fiscal strategy, which aims at maintaining a small government and the privatization of non-core activities. This approach is expected to improve efficiency, conserve scarce resources, and serve more effectively Albania's development needs. However, to be successful, it will require strengthened medium-term budgeting and better integration of the annual budget into the medium-term expenditure framework and the Poverty Reduction Strategy Paper.

Directors commended the authorities for their success in strengthening tax administration, and supported the planned disposition of the resulting revenue gains. However, if the revenue gains continue to exceed expectations, they recommended a more aggressive debt-reduction path than currently envisaged. Directors agreed that any future tax relief should focus first on reducing rates on taxes that most distort the labor market, but stressed that tax relief should be introduced at a measured pace, and only after making certain that other revenue increases that replace the taxes forgone are permanent.

Directors considered that the 2006 supplementary budget is fully consistent with the new fiscal strategy, and properly balances the need for infrastructure investment, tax relief, and debt reduction. The reduced call on domestic borrowing in 2006 will help reduce aggregate demand and provide appropriate support to monetary policy.

Directors commended the BoA for its prudent monetary policy implementation. They welcomed the recent increase in policy interest rates, which should help alleviate underlying price pressures and prevent possible second-round effects of the increase in the electricity tariff. Directors observed that the floating exchange rate regime has served Albania well, and recommended that it be maintained in order to help the economy withstand external shocks.

Directors viewed the recent growth of financial intermediation and increased dynamism of the financial sector as beneficial and necessary for continued rapid economic growth, but noted the attendant risks to macroeconomic and financial stability. In this regard, they commended the authorities for initiating early and proactive measures to strengthen banking and prudential supervision, and urged them to stand ready to take additional measures as warranted.
They recommended that nonbank supervision be strengthened as well. Directors supported the planned creation of a unified supervisory agency for the nonbank financial sector, which should be independent, sufficiently funded, and properly staffed.

Directors supported the authorities' structural reform program, which will help to strengthen institutional quality and infrastructure and underpin growth at higher income levels.
Better governance, the enforcement of property rights, and efforts to root out corruption will help to attract the high-quality private investment that is needed to further develop the export sector and increase the formal sector's share of economic activity. Directors supported the authorities' decision to privatize the distribution arm of the electricity company (KESH), and urged them to proceed in a timely manner with the remaining large-scale privatizations.

Directors encouraged the authorities to work toward eliminating the significant weaknesses that remain in the national accounts and balance of payments statistics.

Albania: Selected Economic Indicators

	2002	2003	2004	2005 Est.	2006 Proj.
	(Percent change)				
Real GDP	2.9	5.7	5.9	5.5	5.0
Retail prices (avg)	5.2	2.3	2.9	2.4	2.2
Retail prices (end-period)	1.7	3.3	2.2	2.0	3.0
	(In percent of GDP)				
Fiscal Sector					
Revenues and grants	24.7	24.5	24.1	24.4	25.5
Expenditures	31.4	29.0	29.2	28.0	29.3
Overall balance	-6.6	-4.5	-5.1	-3.6	-3.8
Net domestic borrowing	3.3	2.9	2.3	2.7	2.3
Public Debt	65.0	61.8	56.5	55.3	55.2
Domestic	41.7	41.1	38.5	37.7	37.4
External	23.3	20.7	18.0	17.6	17.8
Monetary Indicators					
Broad money growth (in percent)	5.7	8.7	13.5	13.9	13.5
Interest rate (3-month T- bills, end period)	11.1	7.3	6.2	5.4	...
	(In percent of GDP unless otherwise indicated)				
External Sector					
Balance of goods and services	-25.9	-25.1	-21.7	-24.1	-24.5
(in millions of euros)	-1214	-1248	-1307	-1629	-1794
Current account balance	-10.0	-8.1	-5.5	-7.8	-8.1
(in millions of euros)	-468	-402	-331	-525	-594
Gross international reserves (in millions of euros)	845	834	1025	1202	1260
(in months of imports of goods and services)	4.4	3.9	4.0	4.2	4.1
Memorandum items					
Nominal GDP (in billions of lek)	624.7	682.7	766.4	836.9	899.7
Nominal GDP (in billions of U.S. dollars)	4.4	5.7	7.5	8.4	9.1

Sources: Albanian authorities and Fund staff estimates and projections.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/164
FOR IMMEDIATE RELEASE
July 24, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under PRGF Arrangement and First Review Under EFF Arrangement with Albania and Approves US$3.6 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Albania's performance and financing assurances under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement and the Extended Fund Facility arrangement (EFF). The completion of the reviews enables the release of an amount equivalent to SDR 2.43 million (about US$3.6 million), which will bring the total disbursement under both arrangements to SDR 4.87 million (about US$7.2 million).

In completing the reviews, the Board approved the authorities' request for a waiver for the nonobservance of the structural performance criterion on the state-owned electricity company KESH meeting the targets under the 2006-2008 Power Sector Action Plan with regards to collection rates and losses.

The concurrent three-year arrangements under the Poverty Reduction and Growth Facility (PRGF) and the Extended Fund Facility (EFF) amounting to the equivalent of SDR 17.045 million (about US$25.2 million) were approved on February 1, 2006 (see Press Release No 06/17).

Following the Executive Board's discussion of Albania, Ms. Anne O. Krueger, First Deputy Managing Director and Acting Chair, stated:

"Albania's macroeconomic performance over the past year has been good, with strong growth, large inward remittances, and a significant reduction in poverty. Debt is declining, and macroeconomic stability has been maintained, with inflation remaining low. Although the current account deficit has deteriorated somewhat, the lek has continued to strengthen, reflecting rising confidence and declining risk premiums.

"The expectation is for growth to moderate slightly in 2006, but to return to a faster pace in 2007 and over the longer term. However, sustaining this pace will require significant reforms to improve infrastructure and institutional quality—including in governance and the rule of law. Such reforms will enable Albania to attract the high-quality investment needed to develop further the export sector, which remains small.

"The current rapid growth of financial intermediation is a positive development, and necessary for sustained high growth. However, the rate of increase must remain consistent with macroeconomic and financial stability, and the program provides for this. Actions will be taken to tighten gradually prudential regulations and enhance banking supervision, to safeguard loan quality. Work is also under way to establish a credit bureau and improve the legal framework for collateral execution. These measures are expected to reduce the rate of credit expansion by increasing effective lending costs.

"The program's fiscal framework and the supplementary budget for 2006 are consistent with the authorities' strategy of developing a small but efficient government concentrated on its core functions. A rising share of expenditure will be devoted to investment and other priority areas, while future gains from tax administration reform will be devoted to tax relief and debt reduction. The supplementary budget allocates projected structural revenue gains according to this strategy.

"Future growth-enhancing institutional reforms will focus on areas directly impacting the business climate, such as property rights and contract enforcement. Privatization is to be accelerated in non-core areas of government, including in the distribution arm of the electricity company (KESH)," Ms. Krueger said.

Statement by Arrigo Sadun, Executive Director for Albania
and Carlo Gola, Senior Advisor to Executive Director
July 24, 2006

On the behalf of the Albanian authorities, we wish to express our appreciation to the staff for a well-written report and a comprehensive set of selected issues papers, which reflect the frank and constructive discussion held in Tirana for the first review under the three-year arrangement under the PRGF and the review of the Extended Arrangement. The implementation of the PRGF/EFF-supported program has been broadly satisfactory. The request for waiver of nonobservance of a performance criterion reflects the still difficult situation in the electricity sector. The authorities recognize that the restructuring of the public-owned company KESH, along the lines established by the Power Sector Action Plan proved more difficult than expected. The new strategy for the electricity sector, already in place, establishes a tariff structure that would remove currently-existing cross-subsidies from business users to households and increase the average tariff to reflect higher import costs.

1. Albanian's macroeconomic performance remains solid

With the exception of the supply-induced disruptions related to the difficulties in the electricity sector, the county has enjoyed a prolonged period of sustained growth. The estimated GDP growth in 2006 remains robust, at 5 percent (against 5.5 percent in 2005), slightly below the average of the last few years. Growth is projected at 6 percent in 2007. The electricity crises in October-November of last year, due to climatic circumstances, a poor distribution network, and mismanagement of the electricity company, created serious power problems and economic costs. In 2005, the slowdown was also affected by the modest export performance (only 5.6 percent in volume in 2005, against more than 11 percent, on average, in the three previous years).

Despite the increase in oil prices, inflation remained subdued. Retail prices increased, on average, by 2.4 percent in 2005. However, year-on-year inflation up to May 2006 was 3.1 percent: a sustained increase in non-traded good prices was balanced by lower tradable prices. The authorities remain vigilant in monitoring the phenomenon. Confidence in the monetary framework has been maintained by a credible monetary policy based on a "soft" inflation targeting.

The external current account deficit remains high and is expected to reach 8 percent of GDP this year (excluding official transfers), despite the strong and consistent inflow of remittances (which are about 15 percent of GDP).

2. The Government is committed to maintaining sound macroeconomic policies

The authorities are determined to preserve the current, prudent macroeconomic policies and further enhance the quality of the budget and the credibility of the monetary framework.

Fiscal Policy

The fiscal stance was restrictive in 2005. The overall deficit was 3.6 percent against 5.1 in 2004, as a result of the policies aimed at improving revenues administration (tax revenue increased by 11 percent) and more stringent criteria for capital expenditure and anti-corruption policies. Such policies create a temporary stagnation of government expenditure for public investment (only 38 billion leks, well below the 50.5 billion projected in the budget). However, the "contingent expenditure" embedded in the Memorandum on Economic and Financial Policies (MEFP) should prevent, in the medium term, undesirable under-expenditure of the capital account. The supplementary budget, to be approved this month, will allocate the relevant "contingent expenditure" in high-quality capital spending, tax relief, and debt reduction. The public debt-to-GDP ratio is steadily declining, although now at a relatively less rapid stance: this year, as in 2005, it should remain at about 55 percent of GDP (it was 61.8 percent only three years ago). The external public debt is steady at about 17 percent of GDP.

Limited technical capacities impeded, so far, the initiation of a comprehensive debt management reform. The authorities recognize that improving budget debt management is crucial, given the very short maturity of the debt (on average about 6.5 months) and the number of participant is limited. By the end-October 2006 the authorities will formulate a debt management strategy and, by end-September, they will present to Parliament a public management law, followed by an action plan, along the lines suggested by staff and with the valuable support of donors.

The authorities reiterate their commitment to preserve the current, sound fiscal policy, reducing gradually but consistently the end-September public debt-to-GDP ratio. They agree with staff that further simplification of the tax system to reduce compliance costs and further broaden the tax base is needed. However, they are convinced that, in the future, there will be room to design a tax regime to stimulate growth and help formalize the economy. In this regard, while sharing the gradualist approach suggested by staff, the authorities see merit in a flat-tax system (with a significantly reduced uniform rate) adopted with success in other countries in the region.

Monetary policy

The authorities are committed to keeping inflation at 3 percent, with a tolerance range of deviation of plus and minus one percent. The current monetary policy framework is based on a reserve money program with quantitative targets and with changes to the repurchase rate as main policy instruments. The flexible exchange rate regime is complemented by limited foreign exchange interventions aimed at maintaining an adequate reserve level and smoothing-out seasonality and short-term shocks. Since the country does not yet have full access to the international capital markets, the phenomenon is mainly related to stock adjustment on the relevant amount of remittances held in foreign currencies. The medium-term goal is to build up (also with the technical help of donors) a monetary framework for a formal inflation target.

In the short term, the main problem is the strong private sector credit growth. Like other countries in the region, this trend is partially related to a convergence problem and to a "catching-up" effect, given the still very low credit-to-GDP ratio (about 17 percent, to be compared with only 9 percent in 2005 and the average of 37 percent of transition countries). More that 73 percent total credit is denominated in foreign currency. The foreign-owned banks (which account for more than 90 percent of the system) seem not to be exposed to exchange rate mismatching since their funding is though domestic deposit denominated in foreign currencies (from remittances). In addition, the banking system is liquid, profitable, and well capitalized, while the non-performing loans are, up to now, very low.

That said, the rapid acceleration of the credit-to GDP ratio is a source of concern. The authorities remain vigilant and will not hesitate to tighten monetary conditions should the economy exhibit preliminary signs of inflationary pressure. However, they also recognize that the effect of monetary policy is limited, since most of the credit is denominated in foreign currencies.

Should the traditional transmission channels fail to succeed (creating incentive to shift from foreign to domestic denominated deposits) the authorities will consider supervisory measures. A few of them would be: increasing reserve requirements on foreign currency deposits above 10 percent; amendments in capital adequacy to allow risk weights up to 150 percent to apply to high risk loans; impose higher that 12 percent minimum capital adequacy requirements. For the moment, the Bank of Albania is encouraging banks, through moral suasion, to adopt stricter debt service-to-disposable income ratios and prudent loan-to-value ratios.

3. Structural reforms

The Albanian economy experienced significantly higher growth than other transition countries, only partially explained by the initial disadvantage. However, in the last few years this differential has been shrinking. As noted by staff, total factor productivity (TFP), which captures the enhancement of organizational and institutional factors, is now growing at a slower pace. To some extent this is a natural phenomenon, as the country is converging toward the peer group. However, it is true that a new wave of reforms is needed to consolidate current results and to boost growth. The attractiveness of foreign direct investment is still low and, in general, the rate of growth of both private and public investments is subdued. It is a source of concern that the investment-to-GDP ratio has steadily declined in the last few years (from 27.6 percent in 2001 to 23.6 percent in 2005). The underperformance of the external sector, and the widening current account deficit, reflects the slowdown in the accumulation of physical capital. It is revealing that, among the interesting comparative indicators produced by staff in table 3 (EBS/06/91, p. 39), one of the most "misaligned" with respect to other Western Balkan countries is the trade openness index (exports plus imports of goods and services as a share of GDP).

The authorities are cognizant that in order to reach the group of middle-income countries a series of challenges still lies ahead. In particular, they need 1) to improve the country's infrastructure by channeling the available resources into productive investments, according to a strict cost/benefit criteria, and prioritizing the allocation of these resources; 2) to enhance institutional reforms and implementation, particularly in the areas of revenue mobilization, contract rights, governance, informal economy, and, in general, business climate; 3) to promote the external sector, not only by developing a more robust manufacturing sector, but also enhancing agriculture and tourism, where the country has considerable potential; and 4) to continue with privatization policies, particularly in the area of public utilities. They are confident that the current three-year arrangement under the PRGF/EFF-supported program will provide not only a valid strategy to re-address the aforementioned problems, but also a successful exit strategy from a Fund-supported program.