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Albania: 2008 Article IV Consultation, Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Financing Assurances Review, and Request for Modification of Performance Criteria—Staff Report; 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 2008 Article IV consultation with Albania, fifth review under the three-year arrangement under the Poverty Reduction and Growth Facility, review under the Extended Arrangement, financing assurances review, and request for a modification of performance criteria, the following documents have been released and are included in this package:

- The staff report for the combined 2008 Article IV Consultation, Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Financing Assurances Review, and Request for Modification of performance criteria, prepared by a staff team of the IMF, following discussions that ended on May 13, 2008, 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 11, 2008. 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 Public Information Notice (PIN) and a Press Release, summarizing the views of the Executive Board as expressed during its July 25, 2008, 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*
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 2008 Article IV Consultation, Fifth Review Under the Three-Year Arrangement under the Poverty Reduction and Growth Facility, Review Under Extended Arrangement, Financing Assurances Review, and Request for Modification of Performance Criteria

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

Approved by Poul M. Thomsen and Scott Brown

July 11, 2008

Executive Summary

The expiration of the EFF/PRGF-supported program in January 2009 will cap an impressive period of economic transition. Per capita GDP in U.S. dollar terms more than doubled over the last decade, inflation was brought down to developed-economy levels, social conditions have improved drastically, and Albania is graduating from IDA. This progress was due mainly to prudent macroeconomic and structural policies. The program is broadly on track, despite some renewed slippages in the electricity sector.

These successes notwithstanding, some deep-seated problems remain, notably in the electricity sector and with regard to the business climate, two areas in which reforms have lagged. Moreover, new challenges have appeared on the horizon, and more adversarial politics are in stock ahead of next year's election, while regional risks linger.

In spite of a more difficult external environment, the near-term macroeconomic outlook remains broadly favorable with growth projected at potential, inflation returning to the target band, and continued external stability. The recent widening of the external current account deficit appears due mainly to temporary factors, with continued strong export growth and diversification. Empirical analysis of the real effective exchange rate is subject to a large degree of uncertainty, with a CGER-type methodology resulting in estimates ranging from a 5 percent undervaluation to an overvaluation of up to 25 percent.

Policy discussions took a longer view on the requirements for continued economic success after graduation from the low-income group: securing price stability in the near term; ensuring a continued strong economic outlook by maintaining fast paced productivity growth and low inflation; mitigating risks to domestic and financial stability; anchoring fiscal policy in the cross-currents of potentially conflicting requirements; and bringing electricity sector reforms to a close.

Albania's de facto exchange rate system is an independent float, with occasional intervention**.** Albania maintains exchange restrictions under the transitional arrangements of Article XIV, but maintains no restrictions subject to Fund jurisdiction under Article VIII.

Based on the satisfactory performance and the authorities' commitments, staff recommends completion of the Fifth Review and Financing Assurances Review, and modification of three performance criteria for end-September 2008. All performance criteria were met, and staff considers the end-September 2008 performance criteria to be consistent with program objectives.

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GLOSSARY

ARMO	State-owned oil company
BoA	Bank of Albania
CIRR	Commercial Interest Reference Rate
DMB	Deposit monetary bank
GDC	General Directorate of Customs
GTD	General Directorate of Taxation
INSIG	State-owned insurance company
INSTAT	The state statistical agency
KESH	The state-owned electricity company
LTO	Large taxpayer office
MEFP	Memorandum of Economic and Financial Policies
NSDI	National Strategy for Development and Integration
PPP	Public Private Partnership
SB	Structural benchmark
SLI	Savings and loan institution

Main Sources of Economic Data for Albania

Data in the staff report reflect information received by June 19, 2008 from the following organizations:

Ministry of Finance
http://www.minfin.gov.al/index.php?lang=en&option=com_frontpage&Itemid=1
Bank of Albania
http://www.bankofalbania.org/
Ministry of Economy, Trade, and Energy
http://www.mete.gov.al/index.php?l=e
Albanian Institute of Statistics (INSTAT)
http://www.instat.gov.al/

I. THE CONTEXT

1. **Albania is reaching new milestones in its economic and political development**. Over the last decade and underpinned by Fund programs, per capita GDP in U.S. dollar terms more than doubled and inflation was brought down to developed-economy levels (Table 1). While some of this reflected catch-up gains from the transition from a particular detrimental economic policy regime before the 1990s, the bulk of the progress was due to prudent macroeconomic and structural policies. In recognition of economic and political achievements, a Stabilization and Association Agreement with the EU was signed in 2006, and an invitation to join NATO extended in the spring of 2008.

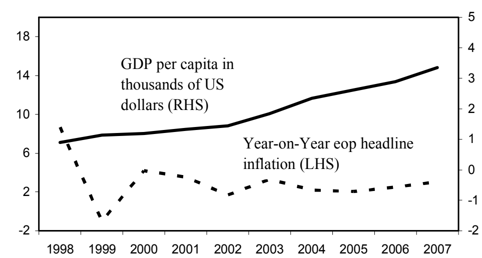
2. **Social conditions have improved drastically and Albania is graduating from IDA**. Rapid growth, price stability, and continued large remittances also significantly improved social conditions and moved the country toward Millennium Development Goals.

Albania: Selected Millennium Development Goals

	1995	2000	2005
Population below 1 US$ a day (percent)	...	2	<2
Population below national poverty line (percent)	30	25	18
Primary completion rate (percent of relevant age group)	94	102	97
Secondary school enrollment (gross, percent)	...	73	78
Ratio of girls to boys in primary and secondary education	...	97	97
Women employed in the nonagricultural sector (percent of nonagricultural employment)	24	29	32
Under-5 mortality rate (per 1,000 births)	34	25	18
Life expectancy at birth (years)	71	73	76
Fixed line and mobile phone subscribers (per 1000 people	13	60	493

Sources: The World Bank and Albanian authorities

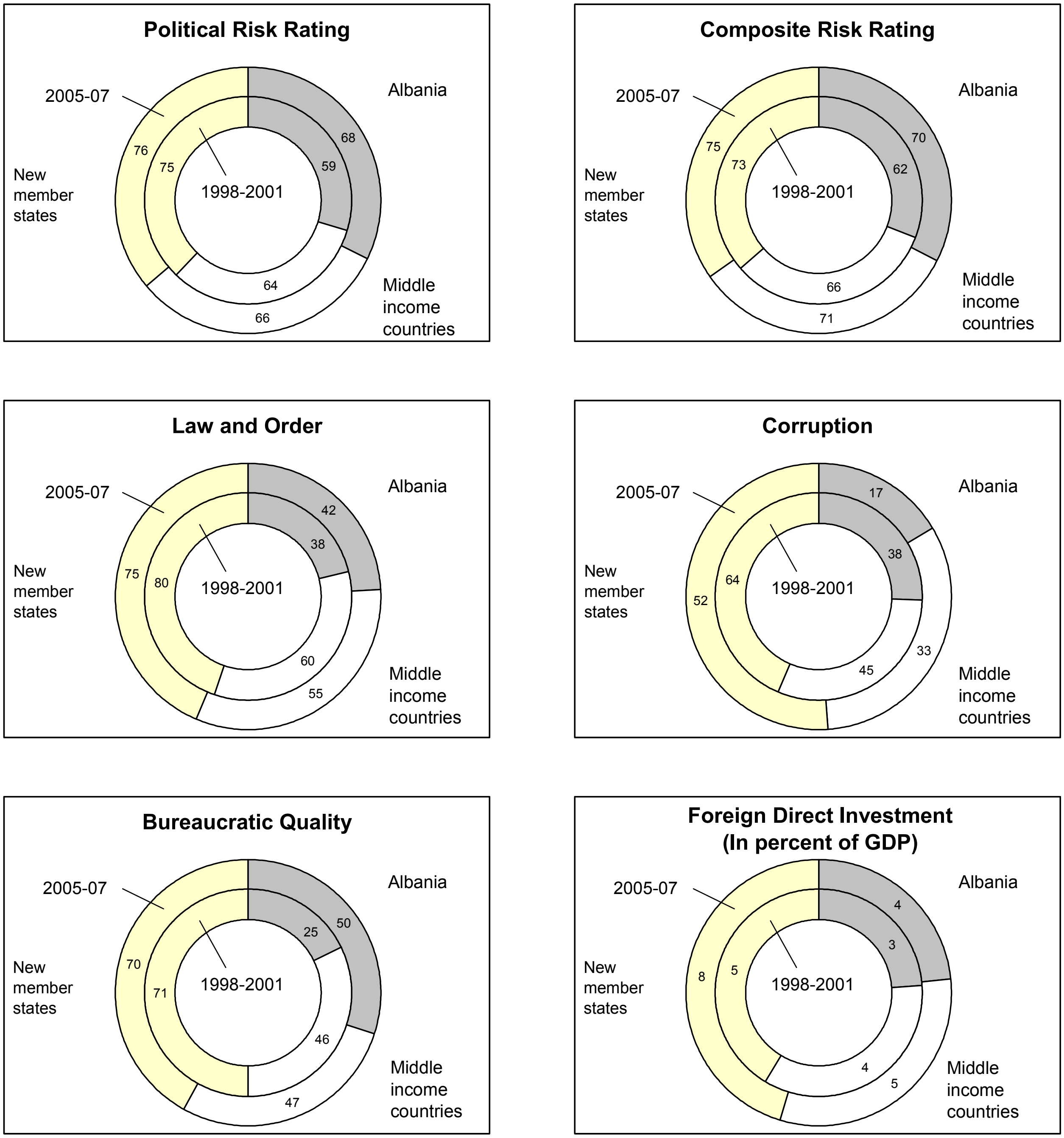
Albania: Per Capita GDP and Headline Year-on-Year Inflation, 1998-2007



Source: Albanian authorities.

3. **These successes notwithstanding, some deep-seated problems remain, new challenges are appearing on the horizon, and more adversarial politics are in store ahead of next year's election, while regional risks linger**. Turning around the loss-making electricity sector and realizing its potential has proved elusive over the entire transition period, despite repeated attempts. Similarly, wide-spread governance concerns remain and the business environment is weak (Figures 1 and 2 and Table 2). Meanwhile, macroeconomic policies cannot rest on past laurels; further fiscal consolidation, advances in fiscal and debt management, and deeper financial markets are required as Albania moves away from concessional finance and starts accessing international markets. After a long and productive relationship with the Fund (Box 1), alternative anchors for policies need to be found. The coming 2009 parliamentary election could make persevering with sound policies harder. Lingering risks to the regional security situation with the potential to trigger economic spillovers, place a premium on protecting macroeconomic and financial stability.

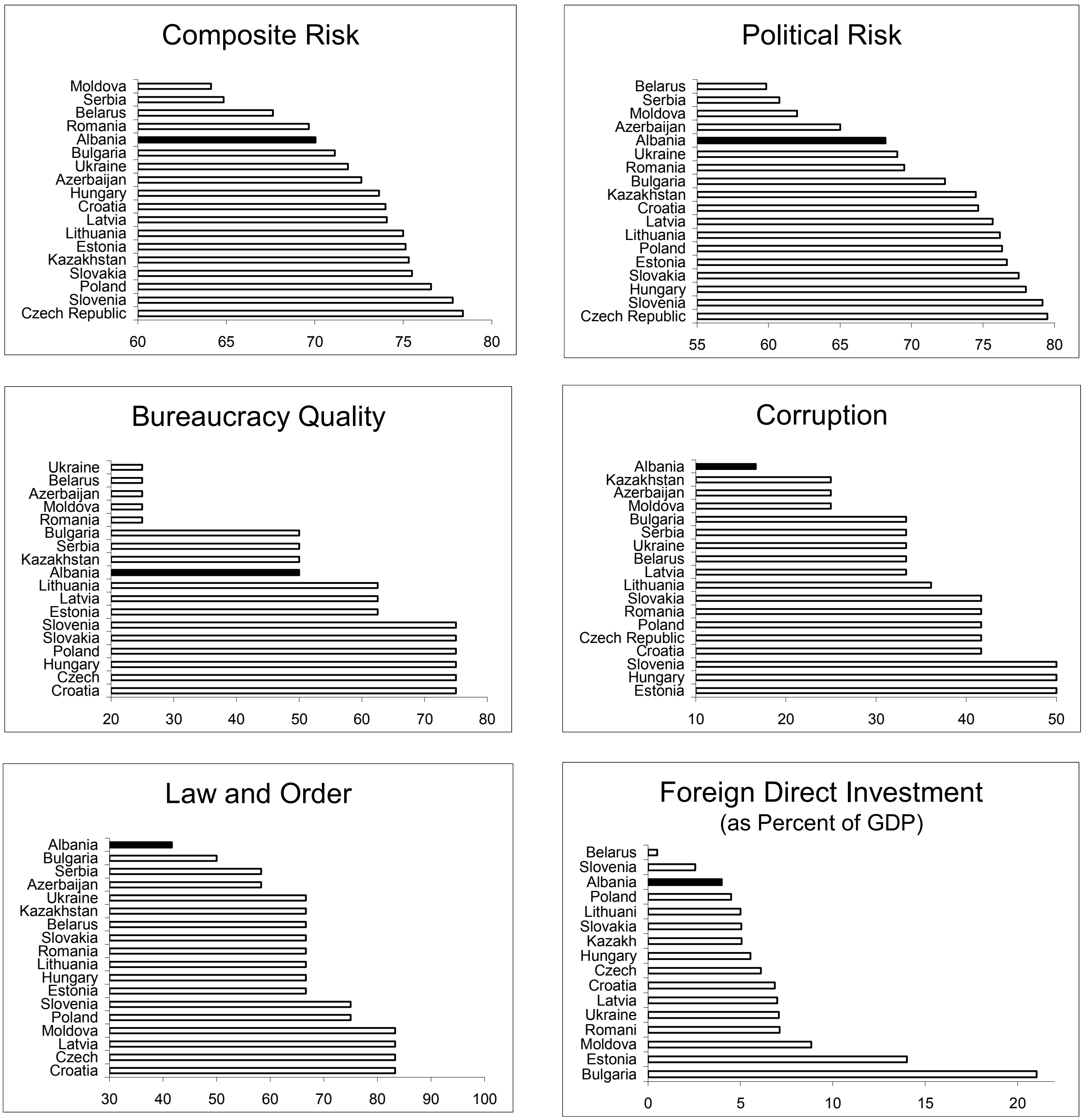
Figure 1. Albania: Business Climate Indicators, 1998-2001 and 2005-07
(In percent of maximum possible score except where indicated, increase implies improvement)



Sources: PRS Group Inc. and Albanian Authorities.

Figure 2. Albania: Comparative Business Climate Indicators, Average 2005–07 1/

(In percent of maximum possible score except where indicated, increase implies improvement)



Sources: PRS Group Inc. and Albanian authorities.

1/ Serbia average 2006–07.

Box 1. Implementation of Past Fund Policy Recommendations

The authorities' responsiveness to Fund advice in earlier Article IV consultations has been good, as reflected in strong program performance and the completion of four reviews under the current arrangement. Macroeconomic policies have been prudent and delivered a strong growth performance. On structural reform, the vulnerabilities that were previously identified in revenue administration, debt management, and banking supervision are being tackled, with progress on tax administration being particularly advanced. However, some key areas for structural reform have lagged behind. The persistently weak financial performance of the electricity sector is a serious macroeconomic concern, and limiting the resulting quasi fiscal costs is subject to program conditionality. Implementation of the reforms to strengthen title registration and enforce contracts has also been slow.

4. **Supported by the authorities' continued commitment, performance under the PRGF/EFF-supported program remains strong**. For the fifth review, all March quantitative performance criteria were met (MEFP Table 1) and structural conditionality appears on track (Table 3) with, however, some stress in the energy sector (see below).

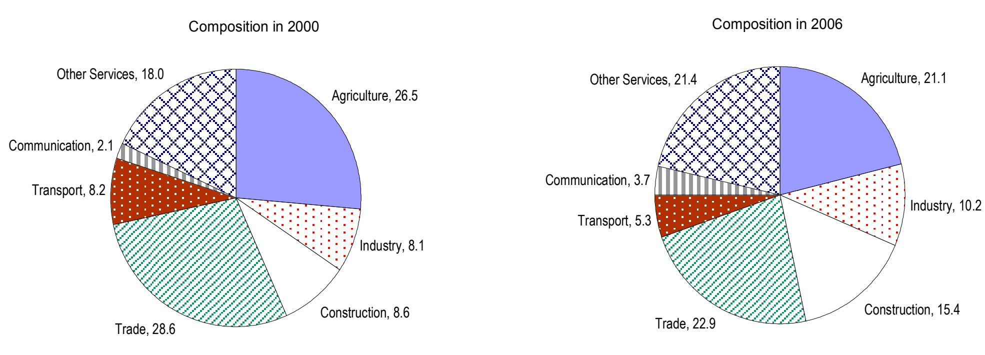
II. Background

A. Recent Economic Performance

5. **Since the last Article IV consultation, macroeconomic performance has remained strong even in trying times**.

- **Notwithstanding a drought, growth remained at potential and became broader based**. Real GDP grew by 6 percent in 2007 and the same rate is projected for the current year. A regional drought in 2007 affected Albania particularly hard because of dependence on hydro-electric power generation and rain-fed farming. But the recovery was rapid as the economy diversified with buoyant construction and trade and the opening of new markets and export activities—e.g., in textiles, footwear and mining (Chart).

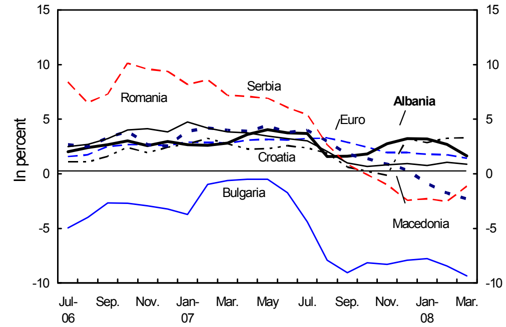
Albania: Changes in Output Composition
(in percent)



Source: Albanian authorities.

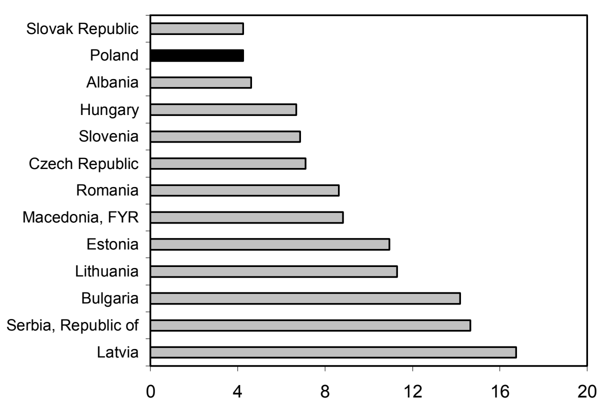
- **Inflation, while episodically above the target range, is among the lowest in the region**. In spite of global food- and commodity price shocks, there were only temporary deviations from the 3±1 percent inflation target, and expectations appear firmly anchored. A cumulative 125 basis points increase in the policy rate since July 2006, has maintained positive real interest rates, buttressed by timely regulatory tightening (Box 2).

Real Policy Interest Rates, 2006-08
(Based on headline inflation, end of period)



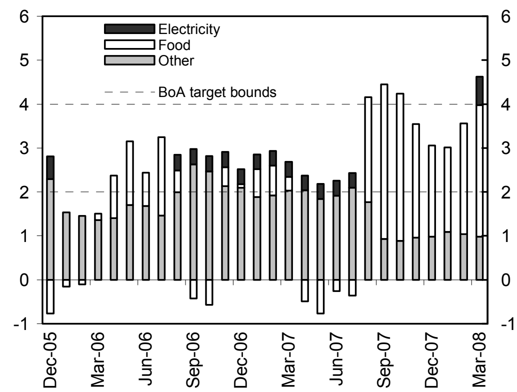
Source: International Finanical Statistics (IFS).

Annual Year-on-Year Inflation, March 2008



Source: IFS.

Albania: Percentage Contribution to Year-on-Year Total Inflation, December 2005-March 2008



Source: Data provided by Albanian authorities.

- **In addition, risks to external and domestic stability have receded somewhat**. Domestic credit growth, though still elevated, has decelerated from past highs. The share of exports of goods and services in GDP has risen in each of the past five years. Albania continues to attract investment in its traditional exports, textiles and footwear. In addition, non-traditional export sectors such as chromium have expanded rapidly and, in the services sector, tourism is registering buoyant growth. As a result, the past heavy concentration of exports to the key Italian and Greek markets has begun to diminish.

6. **These favorable trends are a continuation of more than a decade's rising investment and productivity** (Box 3). Business improvements, labor shedding and inter-industry resource reallocation following the collapse of communism were key, supported by the successful macroeconomic stabilization and market-oriented reforms.

Box 2. Recent Banking Sector Legal and Regulatory Measures

I. **Changes to the legal framework** include enactment of a new banking Law (December 2006) and an Anti-Money Laundering Law (May 2008). Separate legislation has been submitted to Parliament to improve the execution of collateral and establish the legal foundation for private party repurchase operations. In addition, legislation to transfer supervisory authority over leasing companies to the BoA has been approved by the Council of Ministers.

II. **Changes to the regulatory framework**:

1. **Measures aimed at improving credit risk management**. In the event a bank violates twin limits on the rate of credit growth and non-performing loan levels, the BoA may now mandate a bank to: (i) *Strengthen its monitoring processes*, (ii) *Slow its rate of credit provision* by adjusting interest rates and credit growth objectives, by reducing its internal guidelines on the acceptable ratio of credit to collateral and customers' debt service to income; and by suspending promotional advertisements in the media; (iii) *Weight with a 150 percent risk factor*, the greater of the value of credit that exceeds the prudential requirements for single exposures, the value of credit that exceeds the new limits, or the value of nonperforming loans that exceeds the new ceiling; (iv) *Increase capital*, or take other measures to achieve a higher minimum level of capital adequacy ratio; (v) *Initiate cost-cutting measures;* and/or (vi) *Set up an additional reserve fund* from profit within six months. If the BoA judges that the above measures are not producing the correct implementation and compliance by the bank, it now has the authority to suspend all or part of the credit operations of the bank; or introduce credit ceilings for individual banks.

2. **Measures to improving transparency towards clients**, particularly truth in lending.

3. **Measures to strengthen regulations governing lending to related persons**, by reducing the aggregate prudential limit on lending by banks to related persons if the bank is found to have insufficient systems to monitor related persons exposures.

7. **These impressive achievements owe much to sound macroeconomic and structural policies**. Stronger public finances, largely based on major improvements in tax administration, which boosted the ratio of tax revenue to GDP substantially, lowered public debt from 66 percent of GDP in 2001 to 53 percent in 2007 (Table 4). With the budget thus tied down, the Bank of Albania (BoA) was able to sustainably lower inflation. Aside from macroeconomic policies, structural reforms—such as supply-side tax reforms, financial market development, and large scale privatization—provided strong incentives to invest, with financing from persistent large remittances, as well as more traditional FDI (Table 5).

B. Challenges

8. **Notwithstanding this generally strong performance, Albania faces a number of challenges on the way to emerging-market status**.

Box 3. A Decade and a Half of Productivity Growth in Albania

Over 1993-2007, growth in Albania was significantly higher than in other transition economies. The following assesses the performance in growth accounting terms.

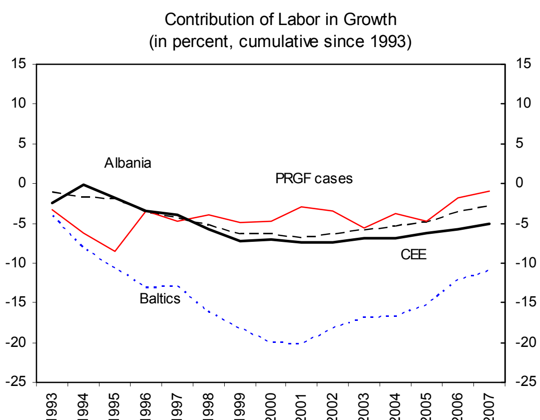
Growth accounting decomposes output growth into the contribution of capital, labor and a residual measure of efficiency gains usually called total factor productivity (TFP). In line with recent studies (e.g., Schadler and others, 2006), the capital and labor shares are assumed to be 0.35 and 0.65, respectively. The analysis suggests that high growth has been driven largely by TFP growth—accounting for over 80 percent of the output growth.

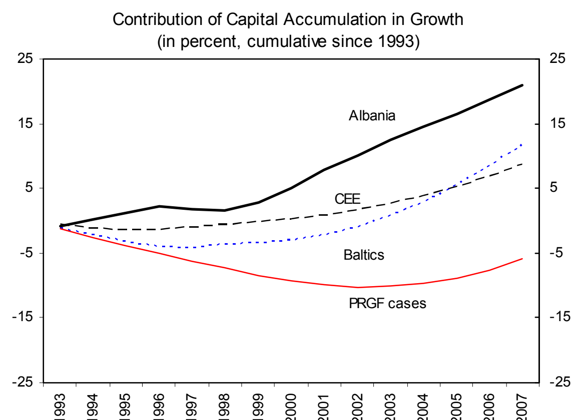
Sources of Growth in Transition Economies, 1993–2007

	Cumulative real growth	Contribution to growth		
		TFP	Capital	Labor
Albania	96.1	80.5	20.9	-5.1
17 transition economies	49.8	49.0	4.8	-4.3
Of which : Baltic States	73.5	73.2	11.7	-11.1
CEE countries	51.3	45.6	8.7	-2.9
PRGF transition economies	37.9	43.0	-5.9	-0.9

Source: Staff calculations.

As in other transition economies, labor was not a major factor for growth, partly because of high labor mobility to advanced economies and hidden labor inputs in the large informal sector. However, a high and growing contribution of capital accumulation sets Albania apart.





Sources: Staff calculations.

Recently, however, Albanian TFP growth is flagging even as it is rising in other transition economies, pointing to the need for further structural reform.

Trends in Total Factor Productivity in Transition Economies, 1993–2007

	In percentage points			
	1993-2007	1993-97	1998-2002	2003-07
Albania	5.4	5.8	7.3	3.1
17 transition economies	3.3	1.3	4.0	4.5
Of which : Baltic States	4.9	3.4	6.0	5.2
CEE countries	3.0	2.8	2.9	3.4
PRGF transition economies	2.9	-1.1	4.0	5.6

Source: Staff calculations.

- **Maintaining price stability in the near term through an appropriate monetary-fiscal policy mix**. Unfavorable global inflation trends are expected to prevail over the near future, while increased food exports will lower domestic supply and likely put pressure on domestic prices over the medium term. These factors could make a return to the inflation target zone harder, all the more so if tight budget policies were to be relaxed.

- **Ensuring a continued strong medium-term outlook by maintaining fast paced productivity growth through an improved business climate**. A key challenge arises from a high degree of labor mobility to more advanced European countries. This sets an effective wage floor, makes labor-intensive growth unlikely, and puts a premium on productivity advances. The business climate, which is particularly weak in the areas of corruption, judiciary, and land titling, constitutes a key impediment.

- **Securing financial and external stability**. In the financial sector, strong credit growth doubled private credit over the last two years to 30 percent of GDP (Table 6). With unsettled international financial market conditions and a predominantly foreign-owned banking system, there is a knife-edge danger of an equally disruptive sudden stop—e.g., if parent banks were to retrench—or a re-acceleration, e.g., if successful land legalization were to increase available collateral. Temporary factors have resulted in recent large current account deficits, underscoring the need to further diversify the export base. Lower external deficits are also needed to improve debt sustainability, especially given the planned shift from concessional to market finance.

- **Anchoring fiscal policy in cross-currents of potentially conflicting requirements**. With the imminent departure from the program's anchor under the Fund-supported program, a framework must be put in place to maintain a fiscal stance conducive to macro stability. This will also be important to ensure that the availability of market finance does not trigger a relaxation in fiscal consolidation efforts, notwithstanding still large infrastructure and social development needs. Redressing the latter is particularly pressing given still weak governance and past problems to spend capital allocations.

- **Bringing electricity sector reforms to a close**. The core of the problem is unpaid electricity usage—the average effective collection rate, at around 50 percent, remains low compared even with the regional average of about 75 percent. Without progress in this area, the financial position of the electricity utility KESH will continue to hemorrhage, electricity supply to the economy remain unreliable, and KESH's privatization be made more difficult.

III. Policy Discussions

9. **Against this background, the Article IV discussions focused on the policy requirements for continued strong growth and macro-financial stability over the medium term**. With the PRGF-EFF arrangement set to expire in January 2009, the Article IV consultation was timely in broadening the horizon from 16 years of Fund programs toward post-program issues, with a focus on the medium-term policies and reforms necessary to sustain high growth and on safeguarding financial stability. These issues were discussed with a wide cross section of society, including through extensive outreach via a high-level conference on opportunities and challenges.[1]

10. **In that context, the Fifth Review discussions covered updates to the Memorandum of Economic and Financial Policies (MEFP)**, importantly pertaining to the mid-year budget review, monetary policy, financial sector stability, measures to boost KESH's financial position, and conditionality for the Sixth Review. The authorities indicated that they wanted to explore possible options for future Fund engagement in the context of the Sixth Review.

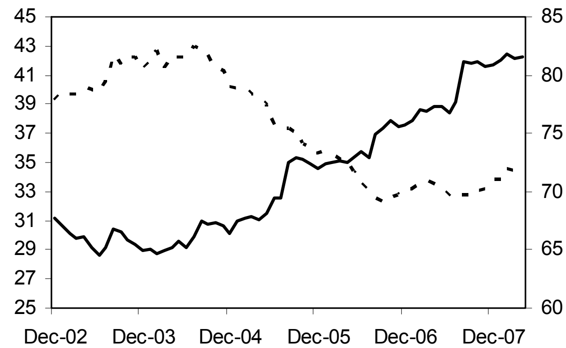
A. Securing Price Stability in the Near Term

11. **In the face of an unfavorable global inflation outlook, there was agreement on the need to stand ready to tighten monetary policy again**. In addition to the recent increase in electricity tariffs, pressures from world food prices will ease only gradually while agricultural market integration would result in a secular trend increase of domestic food prices to international levels. It was agreed that monetary tightening had been essential in achieving low underlying inflation and would again be needed to combat any second round effects or deterioration of inflation expectations (MEFP ¶17). Moreover, as demand pressures could emanate from a re-acceleration of credit growth, the planned regulatory and supervisory measures (see below) provide essential flanking support to monetary policy.

[1] On May 14, 2008, staff and local experts, including high-level officials, discussed appropriate fiscal anchors, debt sustainability and access to capital markets, inflation forecasting, monetary policy, and energy and other reforms to boost growth. Participant conference presentations, including those of staff, and the conference proceedings can be found at http://www.imf.org/external/np/seminars/eng/2008/alb/index.htm .

12. **With the interest rate transmission channel still not fully developed, there was consensus that the monetary policy framework needs to keep abreast of market developments**. The announced inflation target zone coupled to a flexible exchange rate regime has so far successfully anchored expectations. However, the transmission mechanism has important weaknesses and forecast models are still very much work in progress. Generally elevated but variable liquidity conditions, a high degree of euroization, and a relatively interest inelastic credit demand have meant that the transmission of interest rate policy works primarily through the exchange rate. In this context, staff and authorities agreed that strong policy communication accompanying policy rate decisions has been critical in constraining price pressures emanating from a quasi monopolistic retail sector. With greater competition and productivity in that sector, strengthening traditional transmission mechanisms will gain urgency.

Albania: Indicators of Euroization
December 2002-April 2008



Source: Albanian authorities.

13. **Fiscal policy also plays an important role in the authorities' strategy to contain demand pressures**. The budget has accumulated a surplus of some one percent of GDP over the first four months of 2008. It was agreed that over the remainder of 2008, the budget would continue to support efforts to maintain price stability:

- **The 2008 budget mid-year review maintains a neutral fiscal stance from 2007.** The deficit ceiling of 5.2 percent of GDP (MEFP ¶9)—allowing for the very high import content of accelerated capital spending—avoids creating a fiscal impulse in 2008. This is facilitated by buoyant revenue after the adoption of the 10-percent single rate/flat tax (Box 4), which already has permitted the budget to absorb significant cost overruns on the large Rreshen-Kalimash road project as well as compensation payments for the recent catastrophic ammunitions explosion.

- **Planned large wage increases were scaled back sharply** (MEFP ¶9). The mid-year budget keeps wages at originally budgeted levels, thus foregoing earlier plans to effect a large public sector wage increase, which would help prevent a potential wage-price inflation feedback loop.

Box 4. The Albanian Flat Tax Reform in International Perspective

In order to create a friendlier investment climate, make the economy more competitive, encourage the legalization of the shadow economy, and simplify tax collection, the authorities undertook the following tax reforms:

- In August 2007, a 10 percent flat tax on personal income replaced the previous system of five income-dependent rates: 5, 10, 15, 25, and 30 percent, which did not result in a decline in the average PIT rate. Dividends received by individuals remained taxed at 10 percent, and the same rate replaced the small business tax rate of up to 30 percent.

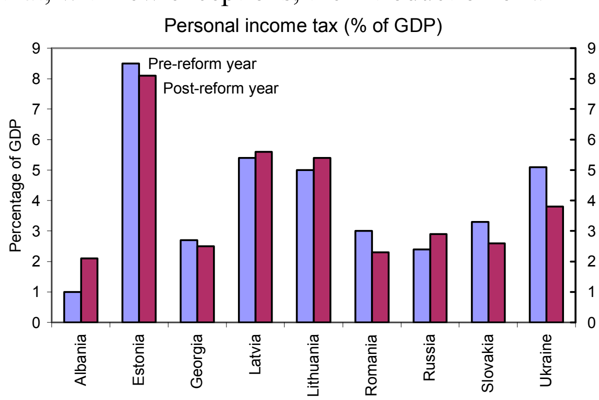
- In January 2008, a 10 percent corporate income tax replaced the 20 percent rate on profits.

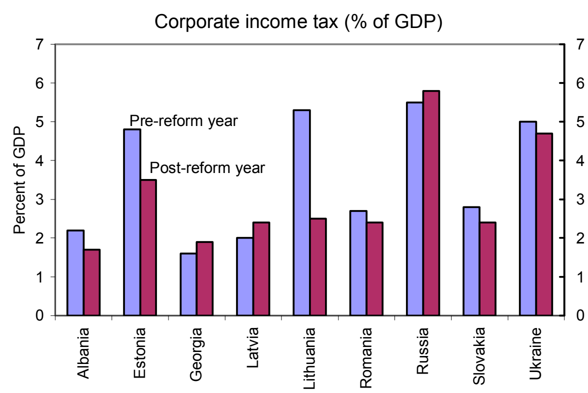
- Income tax rates were thus pegged among the lowest in transition economies.

Simultaneous administrative reforms boosted revenue: the number of workers who pay social insurance contributions (and thus PIT) grew following the authorities' campaign to clamp down on evasion, and the number of CIT payers in the first months of 2008 has increased notably.

While the experience with the new taxes is too short to draw definite conclusions, revenue performance in the January-April 2008 period has been very strong, with cumulative year-on-year growth for the first trimester of almost 40 percent.

How does this compare to other transition economies that introduced a flat tax? Keen et al. (IMF Working Paper 06/218) review the experience with flat tax in eight transition economies and conclude that, with few exceptions, the introduction of a PIT or CIT flat rate was associated with revenue losses.





Sources: Micheal Keen, Yitae Kim and Ricardo Varsano, 2006, "The Flat Tax(es)", Principles and Evidence, IMF Working Paper 06/218; and staff projections.

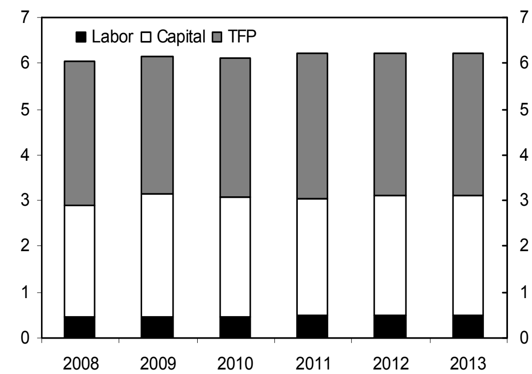
Why is Albania different? While the experience is still very short, a likely reason is that in circumstances of initially very weak tax administration and tax compliance, simplifying the tax system, lowering tax rates, broadening the tax base, and strengthening tax administration, could significantly strengthen revenue collection.

- **Significant contingencies are built in to protect against budget risks**. Such risks remain significant, in particular in the electricity sector—which in 2007 ran quasi-fiscal losses of 2½ percent of GDP, the equivalent of public health spending—while further cost increases for the large road project could be in store. A budget reserve of ¾ percent of GDP for the remaining 6 months of the year—consistent with the program's annual target of 1½ percent—protects the execution of the fiscal program.

B. Ensuring a Continued Strong Economic Outlook

14. **Under sound policies, the medium-term economic outlook remains favorable**. In staff's baseline scenario, growth is projected to remain buoyant at some 6 percent through 2013, supported by capital accumulation and productivity growth. There are pockets of largely untapped productivity gains in the nontradable sector—especially retail and distribution where near-monopolistic price setting seems prevalent—that require a better business environment. In the tradable sectors, tourism has potential, while the topography and climate also imply comparative advantages in hydropower generation and agriculture that remain under-exploited. Appropriate macroeconomic policies and attendant further gains in policy credibility are expected to keep inflation low.

Albania: Percentage Contribution of Factors to Projected Economic Growth, 2008-12



Source: Staff projections

15. **A wavering of policies would be costly and was seen as the main risk to the outlook**. An alternative medium-term scenario was discussed that assumes the maintenance of past policy gains—including macroeconomic stability—but no further improvements in governance and the business climate. This is based on staff analysis which suggests that institutional weaknesses are a major impediment to growth (Box 5 and Figure 3). Without further business friendly reforms, growth would fall progressively below the baseline, while debt sustainability would be imperiled.

16. **The authorities saw more yield from prior reforms in the pipeline and also looked toward a second round of structural reforms to improve the business environment**. In addition to their plans to maintain macroeconomic stability, they viewed an increasingly competitive and foreign-owned banking system, along with recent tax policy reforms, as having drastically improved the environment for investors. Initial feedback from the recently set up one-stop shop for business registration and e-government initiatives had also been positive and the authorities were looking forward to broaden the scope of these initiatives.

Box 5. Model Specification Underlying Alternative Growth Projections

The baseline and alternative medium-term scenarios are underpinned by a growth accounting model relating changes in total factor productivity (TFP) to various measures of institutional improvement, availability of credit and macroeconomic stability. The model was estimated in log differences as an OLS panel regression of 11 countries[1], with the following specification:

$$\mathbf{TFP_t = \beta_0 + \beta_1 CRR_{\,t\text{-}1} + \beta_2\, EBRD_{t\text{-}1} + \beta_3\, PSCLAIMS_{t\text{-}1} + \beta_4 CPIt + \beta_5 TFP_{t\text{-}1} + \varepsilon_t}$$

Where:

CRR	= PRS Group risk indicator;
EBRD	= aggregate EBRD transition indicator;
PSCLAIMS	= Claims on the private sector in percent of GDP;
CPI	= the CPI index;
TFP	= total factor productivity lagged one period (catch up effect).

The rationale for this specification was that the risk variable is a measure of agents' *willingness* to participate in the process of combining labor and capital; and the transition indicator is a measure of their *ability* to participate. The CPI, as a proxy for the degree of macroeconomic stability, and the initial conditions have standard interpretations.

The model differs from the potential growth estimates derived in Box 8 of the IMF Regional Economic Outlook, Europe, April 2008 in several respects: (i) it is estimated using a smaller database limited to transition countries, whereas the REO sample comprises 107 diverse economies and utilizes a dummy variable to account for the effect of transition; (ii) it estimates TFP, rather than real GDP per capita; and (iii) it excludes variables representing education and age dependency rate. The findings are also broadly consistent with IMF Working Paper 07/170, (2007) that shows sound policies (small fiscal deficit and low inflation) and institutional development (low corruption, law and order, bureaucratic quality, etc.) to be associated with higher TFP growth.

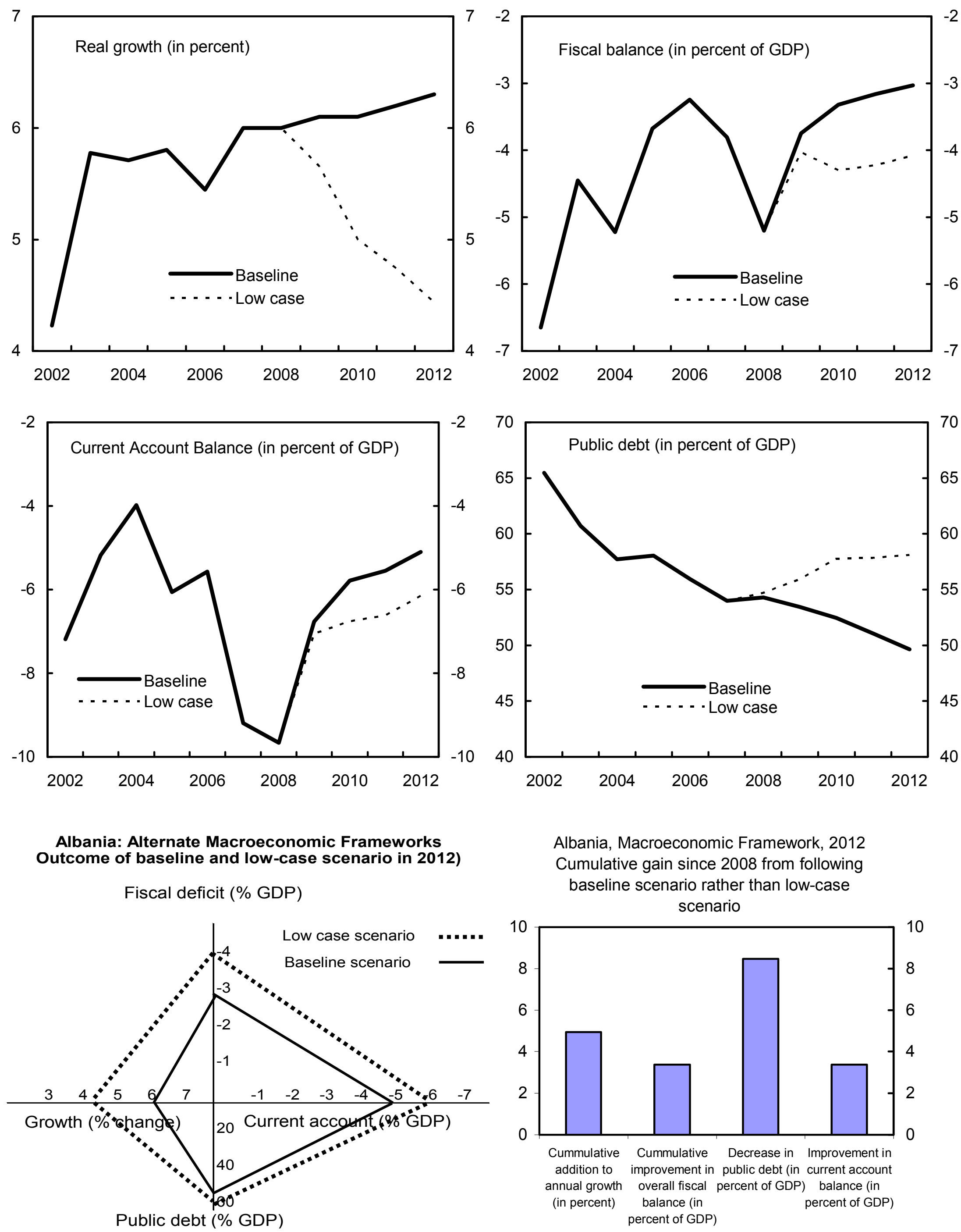
Changes in TFP under alternative scenarios of institutional improvements were then applied to a standard Cobb-Douglas production function to yield baseline and low-case growth outcomes. The simulations imply that institutional factors are important—by 2012, the deterioration in the investment climate embodied in the low-case scenario resulted in a decline in real growth from 6.2 to 4.4 percent.

Albania: Baseline Scenario less Low-Case Scenario

	2008	2009	2010	2011	2012
Growth	0.1	0.7	1.2	1.6	1.8
CRR (Maximum = 100)	0.3	0.7	2.3	5.5	9.9
EBRD1 (Maximum = 4)	0.0	0.1	0.2	0.4	0.5
Percentage change in real capital stock	0.0	0.1	0.2	0.3	0.4

[1] See IMF Country Report No. 06/285 Chapter II for a full description. Countries included comprise Albania, Croatia, Lithuania, Czech Republic, Poland, Estonia, Romania, Hungary, Slovak Republic, Latvia, and Slovenia.

Figure 3. Macroeconomic Framework Scenarios, 2002–12



Sources: Data provided by Albanian authorities; and staff estimates and projections.

17. **Staff observed that reforms to improve the business environment—while essential—require steadfast implementation and need to be tailored to evolving institutions and capacity**. Stepped-up efforts are needed to strengthen institutions and governance. While the authorities have taken actions to lighten the regulatory burden, property rights—importantly those related to land tenure—remain ill defined and contract enforcement is lacking in general, with the judicial system and courts singled out as key impediments. The authorities noted that efforts are underway, with donor support, to redress these shortcomings. Their new anti-corruption strategy focuses on raising public awareness and coordinating efforts across various levels of government. Staff welcomed these steps, but noted that their consistent enforcement across all levels of government required ongoing commitment.

18. **The privatization program is winding down** and the remaining strategic assets, e.g., the large public oil and insurance companies, as well as residual minority shareholdings are likely to be divested over 2008–09. In addition the government aims to privatize the distribution arm of KESH (see below).

19. **Improving statistics is another key element**. In particular, improving the reliability, timeliness and the frequency of national accounts statistics remain a top priority for the authorities. With extensive technical assistance from the Fund, the authorities are improving the methodology and data sources for national accounts and are working toward launching quarterly national accounts—a key requirement for SDDS. However, in general, the progress in improving statistics has been slow and intermittent, partly because of lack of skilled staff and insufficient resources.

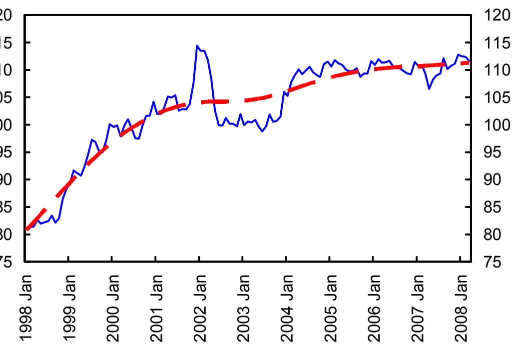
C. Mitigating Risks to Domestic and External Stability

External sustainability and competitiveness

20. While the current deficit has widened temporarily, no major concerns about competitiveness and external stability were raised, and staff and the authorities agreed that the real exchange rate does not appear to be misaligned. Albania has an independently floating exchange rate regime, there are few signs that competitiveness has deteriorated significantly, and domestic monetary and fiscal policies have supported external sustainability.

- **The real exchange rate has been broadly stable**. The BoA only intervenes in the exchange market to smooth seasonal fluctuations or meet foreign reserves targets. The real effective exchange rate has been broadly stable since 2003. The recent depreciation partly reflects the strength of the euro, but is largely the result of a better inflation performance in Albania than in its trading partners.

Albania Real Effective Exchange Rate
1998-2008



Source: Information Notice System.

- **While data limitations prevent an assessment of unit labor costs, the real effective exchange rate does not unduly inhibit export performance**. Growth in the volume of exports of goods and services has been increasingly buoyant (13 and 22 percent in 2006 and 2007, respectively). As a result, export market shares have increased. Also as noted above, while the export base is still narrow, there is evidence of export diversification in terms of both products and markets.

- **The sharp widening of the current account deficit to 9.2 percent of GDP in 2007 mainly reflects temporary factors.** While unwinding, these factors continue to play a role in 2008. In 2007 these included the drought and electricity crisis, and the beginning of the acceleration of infrastructure expenditures; and in 2008 further accelerated capital spending on the Rreshen-Kalimash road project. Excluding temporary and one-off factors, the underlying current account deficit in 2007 was around 6.6 percent of GDP (see text table). Over the medium term, staff expects the current account deficit to narrow to below 5 percent of GDP. As the effect of the adverse terms of trade shock wears off and temporary factors unwind, the current account narrows by just over 3 percentage points of GDP. Moreover, an improved business environment will boost non-price competitiveness, thereby supporting more self-discovery regarding comparative advantage with an attendant broadening of the export base and greater import substitution. However, current account developments in the near future would need to be monitored carefully to ensure that the headline deficit narrows as temporary factors wane.

Adjustments to the Current Account to Construct the 2007 Underlying Current Account

(In percent of GDP)

Current account deficit	9.2
Excluding official transfers	1.0
Effect of electricity crisis	-2.0
Effect of drought	-0.6
Temporary expansion of capital expenditure	-1.0
Underlying Current account deficit	**6.6**

Sources: Albanian Authorities and Fund Staff estimates

- **These findings are broadly consistent with CGER-type analysis**. Using the CGER macroeconomic balance approach, and a recent IMF Working Paper that estimates this approach for new EU member states, staff constructed estimates for the current account norm for Albania (see text table).[1] These estimates are sensitive to the inclusion of FDI in the calculations, vary widely, and result in a range of estimated current account deficit norms of 1.2 to 6.4 percent of GDP—spanning the projected current account—and corresponding exchange rate overvaluations of –5 to 25 percent. As Albania is at an early stage of development and has high investment needs, a current account deficit norm at the higher end of the scale—and including a role for FDI—seems plausible.

Macroeconomic Balance Approach: Calibrations Applied to Albania Based on Projections for 2012

	CGER /1	Working Paper 08/92 /2	
	Pooled Estimation	Pooled full sample	Pooled EUR sample
Fiscal Balance	0.19	0.39	0.23
Old Age Dependency	-0.14	-0.14	-0.04
Population growth	-1.21	-0.79	-0.65
Initial NFA	0.02	0.04	0.02
Oil Balance	0.23	0.15	0.39
Output Growth	-0.21	-0.05	-0.14
Relative Income	0.02	0.03	0.003
FDI	…	-0.31	-0.61
Remittance dummy	…	0.02	…
Albania est. current account norm	-1.94	-3.08	-6.44
Implied overvaluation of the real exchange rate	20.93	14.41	-4.80
Albania est. current account norm alternative IIP /3	-1.24	-1.68	-5.74
Implied overvaluation of the real exchange rate	24.94	22.44	-0.79

Sources: Albanian Authorities and Fund Staff estimates.

1/ See OP 261 Table 1page 5; estimates are relative to trading partners growth.

2/ See IMF Working paper 08/92, "Current Account Developments in New Member States of the European Union: Equilibrium, Excess and EU-Phoria," p. 7, Table 1; and p. 12, Table 4.

3/ The first set of estimates uses the Lane, Milesi-Ferretti estimate of Albania's NFA position WP/06/69. The alternative IIP is more up-to-date and is based on the Albanian authorities current preliminary estimate of the 2007 NFA position.

[1] The macroeconomic framework projects a continuation of established policies and staff used the medium-term projections of the current account as the basis for the underlying current account. This estimate is relatively conservative given projection of a contemporaneous small appreciation of the real effective exchange rate over the forecast horizon.

21. **However, the lek's recent appreciation vis-à-vis the U.S. dollar has triggered domestic concerns**. Exporters questioned whether the monetary policy stance was too tight. The authorities and staff agreed, however, that monetary and fiscal policies have supported external sustainability and that in any event, the real effective exchange rate had remained broadly stable. Greater communication efforts may be needed to explain the impact of bilateral euro/U.S. dollar exchange rate movements.

Debt Sustainability

22. **There was consensus that with public debt still over 50 percent of GDP, a cautious approach to borrowing from the markets is called for**. While the debt sustainability analysis (Appendix I) shows that—based on the adoption of a prudent fiscal rule—debt appears sustainable, the outlook remains vulnerable to shocks, especially given still significant domestic debt rollover risk. In addition, the authorities have taken on a €230 million commercial loan (which is included in the nonconcessional borrowing limit) and are seeking to access international capital markets. While generally supporting the authorities' intention regarding greater integration with global capital markets, staff also noted the added risks in terms of costs and volatility. In this context, targeting a reduction of the debt to GDP ratio below 50 percent of GDP by 2011 (MEFP ¶10) would improve sustainability and also provide a transparent signal to markets about policy intent, especially if implemented through a clear fiscal rule (see below).

23. **The requirements for successful first-time market access featured prominently in the discussions**. It was agreed that strengthening debt management capacity and developing a coherent medium-term debt strategy are key priorities. The authorities pointed to the creation of a General Debt Department, albeit not fully staffed yet, as an important initial step. Staff urged the authorities to move more quickly on filling posts and highlighted the preparatory workload for first time issuance of Eurobonds. In this context, staff noted some common pitfalls for first time issuers—too large an issuance for financing needs (particularly for countries like Albania where capital spending is underexecuted) resulting in high carry costs and causing humps in the repayment profile. Other potential difficulties include high volatility and low liquidity in the secondary market and exchange rate volatility. Given these difficulties, the authorities agreed that they would seek technical assistance to prepare for sovereign issuance.

24. **In domestic currency markets progress has been made on lengthening the maturity of debt, but a further deepening of markets is needed**. The authorities emphasized that the issuance of 5- and 7-year bonds had triggered nonresident interest and significantly raised the average maturity of domestic debt to 424 days at end 2007 (from 195 days in 2005). Nonetheless, rollover risk remains high and a secondary market is needed to further broaden the investor base. Accordingly, the authorities are reducing the frequency of primary auctions (MEFP ¶5). They also noted that over the longer term further lengthening

of maturities and deepening of domestic markets could be achieved but only with the development of pensions and insurance markets.

Financial sector stability

25. **While the banking system appears sound, there was consensus that mitigating risks to financial stability required vigilance on several fronts**. Core indicators suggest that the banking system remains well capitalized, liquid, and profitable (Table 7). Although rapid credit growth has lowered capital adequacy and liquidity ratios, NPLs remain low and stress tests regularly performed by the authorities indicate that the banking sector is resilient to standard exchange rate, interest rate, and credit quality shocks. In addition, the 2005 FSSA gave high marks for the quality of banking supervision in Albania. However, the sector is maturing rapidly, and there was agreement that the authorities needed to scale up their regulatory and supervisory regimes in tandem. The discussion focused on two areas in particular:

- **The recent slowing growth of the banking system balance sheet is welcome, but could also indicate problems**. As credit growth decelerated to under 50 percent, broad money growth has slowed sharply to some 11 percent by end-April 2008 and there was concern that this differential pattern may presage potential pressures on international reserve holdings or the exchange rate. In practice, however, still large NFA holdings by foreign owned commercial banks—levels these banks' management tended to view as undesirably high—may to some extent mitigate these pressures. Still, there was agreement on the importance to fully implement the recent MCM TA recommendations on top of other recent and already planned prudential and regulatory measures. Of particular importance are: improving BoA's cross-border supervisory collaboration with the home-country supervisors of resident foreign banks; speeding up work on contingency planning for crisis management; resolving problems in collateral valuation and execution, loan classification, credit concentration, connected lending, and transparency/truth in lending requirements; and better monitoring and managing of banks' credit risk.

- **Further development of the bank and nonbank financial sector was seen as essential**, in particular development of liquid government securities and inter-bank markets. A key initiative in this regard—being pursued with TA from MCM—is the development of a delivery-versus-payment system for government securities, which will also support private party repurchase operations (MEFP ¶19, SB end-October). To spur interbank market development, staff encouraged the BoA in its dealings with individual banks to avoid simultaneously injecting and draining liquidity through repos and to make full use of the upcoming TA from LEG to improve the legal infrastructure for interbank loan collateralization. Turning to the nonbank financial sector, the authorities continue to work with the World Bank to further develop the insurance and pension sectors, which have potential to provide longer-term funds for investment.

D. Anchoring Fiscal Policy in Cross-Currents of Potentially Conflicting Requirements

26. **The overarching theme of the discussions was how to progress with fiscal consolidation**. The current fiscal anchor—a combined limit on net domestic financing and the stock of nonconcessional debt—will expire with the program and, while having served its purpose well in the past, would need to be updated in any event to reflect the shift toward greater reliance on market finance going forward. The authorities aim to anchor fiscal policy to the objective of bringing public debt to below 50 percent of GDP over the medium term (MEFP ¶10). This would have the twin benefits of allowing for the temporary acceleration in capital spending in 2008 and 09, while providing a clear signal and commitment to debt sustainability to outside observers and markets. It was agreed that a simple and credible fiscal rule would be the best way to implement such an anchor, and several options were discussed. Given the authorities' preference for a small government, their intention to protect recent key tax cuts, and check spending promises ahead of next year's elections, there was some preference for an expenditure-based rule. Staff noted that such a rule would also allow for a greater play of automatic stabilizers compared with a deficit rule, but observed that it would put less emphasis on protecting recent gains in tax administration and the overall fiscal balance. Irrespective of the nature of the rule, staff stressed the need for claw-back mechanisms in case there are upward deviations from the planned debt consolidation path (as was the case, e.g., in Switzerland). It was agreed that these issues would be discussed in greater depth during the Sixth Review.

27. **Within a fiscal consolidation path, discussions focused on how fiscal policy could best address still high development needs**. There was agreement that a stable macroeconomic environment was a sine qua non for sustaining economic development. Beyond its contribution to macro stability, fiscal policy has a role in providing an enabling environment for private-sector led growth, essential public goods and a targeted safety net:

- **With supply-side friendly tax policy reform largely in place, implementation and administrative improvements were seen as key**. The authorities continue improving VAT administration and the large taxpayers office, and are also increasing the number of social security contributors (MEFP ¶11, SB end-July). Further steps are being taken to increase local governments' own revenues. In an environment still characterized by significant evasion, the implementation of the flat-tax coincided with the introduction of a complicated matrix of presumptive and sector- and skill specific reference wages for tax assessment purposes. Apart from the potential threat to wage flexibility, staff noted the scope for abuse by tax administration, and suggested that the complexity be cut to minimize face-to-face interaction between tax administration and payers.

- **Pension reform could offer various benefits, but also risks, and requires careful preparation**. High statutory PAYG social security contribution rates continue to impart a significant tax wedge, which the authorities aim to lower through the introduction of a mandatory funded pillar. In addition, pension funds could supply a stable source of longer term finance. The mission supported these goals, but noted that such a comprehensive reform required time and recommended that the authorities continue to cooperate with the World Bank on the reform's blueprint. In any event, experience elsewhere has shown the potential for significant transition costs that need to be covered within the existing fiscal framework.

- **Given their vision of a small government, the authorities want to arrest the recent growth of current expenditure, focusing instead on efficiency and better targeting**. They saw major scope from better IT, pointing to the recently discovered savings in personnel costs from a comprehensive civil-service employment data base. To improve targeting of scarce resources, it was also agreed to reallocate budget provisions that were previously earmarked for wage increases to a targeted social safety net to compensate for higher food and energy prices (MEFP ¶9).

- **In contrast, capital budget underspending remains a significant concern**. In past years, actual spending lagged well behind budgeted amounts (see table) and was only boosted through late-year reallocations. The authorities pointed to ministries' problems in preparing high-quality project proposals, and to a large number of small projects, as the main culprits. Staff also saw the need to address considerable overbudgeting and improve procurement standards. In response, the authorities have moved to concentrate the capital budget on redressing key transport infrastructure bottlenecks, which—owing to their scale and quality of contractors—can be executed on time. They have also introduced new procedures to improve the quality of submitted projects and consolidate the large number of small projects. Finally, they are stepping up ministries' training to improve their project preparation capacity. While they saw scope in public-private partnerships in the future, the authorities plan to refrain from financing projects through state-owned special purpose vehicles until capacity to fully evaluate such schemes is built. Staff stressed the need for private investors to bear the commercial risks involved to ensure optimal resource and risk allocation.

Albania: Capital Spending as a Percent of Budgeted Amounts, 2003–07

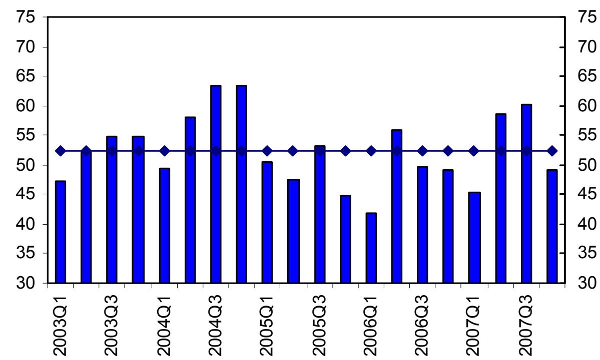
	2003	2004	2005	2006	2007
Capital spending	64	70	76	110	94
Domestic	86	87	87	164	111
External	47	47	62	54	51

Source: Albanian authorities.

E. Bringing Electricity Sector Reform to a Close

28. **Despite a considerable comparative advantage for the production of low-cost hydropower, electricity supply remains unreliable and the sector runs large losses**. The authorities, in consultation with the World Bank, have so far implemented seven action plans, but there is little improvement in effective collection rates. Indeed, unbilled electricity—the core problem underlying KESH's weak financial position—has recently worsened. On average, only half of electricity supplied is paid for. In 2007, the authorities made renewed efforts to lower electricity theft and increase collection rates, including through installing a new KESH management. Initially these efforts produced encouraging outcomes, but the effective collection rate has again dropped below 50 percent over the last six months.

Effective Collection Rates of KESH, Quarterly 2003-07
(In percent of potential)



Source: Albanian authorities.

29. **The litmus test is bringing the financial performance of KESH back into the black.** Following the recent tariff increase, KESH's financial plan allowed for large wage and employment increases and a doubling of investment spending, while electricity imports have run at a level that required KESH to export some of them at a financial loss. While the World Bank and KESH are asking for another increase in electricity tariffs, the authorities considered that the March tariff adjustment had already resulted in significant hardship for vulnerable consumers and had supplied KESH with the financial momentum to effect the programmed halving of KESH's quasi-fiscal losses from 2.4 percent of GDP in 2007 (equivalent to the health budget) to 1.2 percent. Moreover, given slippages early in the year, this would require KESH to begin registering positive cash flows toward the end of the year. Accordingly, the authorities stressed their commitment to several measures to forestall the need for a further tariff increase (Box 6):

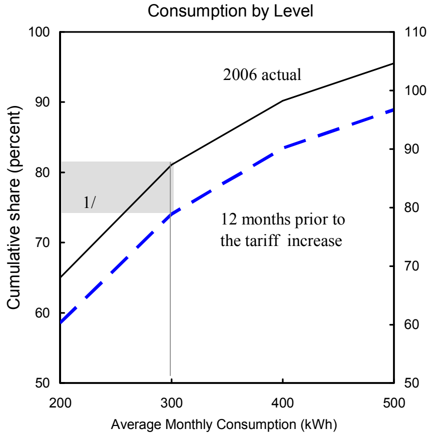
- **Tackling chronic theft is key**. Building on progress made in 2007, further measures are planned to raise collection rates to 90 percent and reduce losses to 32 percent (compared with 81 and 35 percent last year, respectively). Achieving these targets will require determined efforts from KESH management, including cutting off illegal connections and progress will be monitored by a end-October structural benchmark on collection rates (MEFP ¶16).

- **KESH's business plan needs revision**: Limiting personnel cost and imports, and prioritizing investments—the latter also important to not limit the options post-privatization—would be more than sufficient to achieve the goal. The authorities have thus adopted a new Action Plan for KESH containing these measures as a prior action for the Fifth Review.

Box 6. Electricity Sector: Recent Developments and Goals

New electricity tariffs became effective March 2008. Residential tariffs for up to 300 kWh per month consumption remained unchanged, but for consumption in the second block (above 300 kWh) the price increased by 71 percent (to 12 lek per kWh). The overall average tariff thus depends on the share of household consumption in the latter block, which staff puts at 26 percent, thus arriving at an overall average increase of some 20 percent. Of course, the increase in KESH revenue is likely to be less than that for the year as the new tariffs are effective for only 9 months and households adjust their use of electricity.

Cumulative Share of Households' Electricity Consumption by Level



Source: Staff calculation based on authority data.
1/ Shaded area indicates additional consumption in block II.

Electricity Tariffs (Lek per kWh)

	Average tarifffs		Household tariffs		
	Tariffs	% change	Tariffs	% change	Block II share
Average tariffs for 2007	7.09		7.00		
New tariffs effective from March 2008					
KESH estimates	8.28	16.8	7.95	13.6	19.0%
Staff estimates	8.48	19.6	8.30	18.5	26.0%

Source: Staff calculations based on authorities data.
Block II share is percent of households' electricity consumption above 300 kWh.

The authorities have adopted a strategy to halve 2008 quasi-fiscal losses of KESH to the program target. These losses are measured as actual revenue collected at regulated tariffs minus total operating costs, capital depreciation and loan repayments. Losses are caused by setting tariffs below cost recovery prices, excessive electricity losses and a weak collection performance. In 2007, KESH's quasi-fiscal losses rose sharply to 2.4 percent of GDP, partly because of a regional drought that led to a large increase in electricity import costs. Following the March 2008 tariff increase and better rainfalls, and given planned improvements on the collection and loss front, reducing personnel cost and imports and prioritizing investment activities should bring the quasi-fiscal losses of KESH to below 1.2 percent of GDP in 2008.

Estimating Quasi-Fiscal Losses of KESH

	2007	2008 (proj.)
Supply of electricity (GWh)	5727	6504
Billed consumption (GWh)	3641	4249
Transmission losses (percent)	3.7	4.5
Distribution losses (percent)	35.4	32.0
Of which: technical losses	20.0	19.8
Collection rate (percent)	81.3	89.6
Import price (Lek per kWh)	8.8	10.1
Average tariff rate (Lek/kWh)	7.1	8.2
Average operating cost (Lek/kWh)	9.6	8.5
Quasi-fiscal deficit (percent of GDP)	-2.4	-1.2
a) Tariff below cost recovery	-0.9	-0.2
b) Unbilled consumption	-0.9	-0.6
c) Uncollected bills	-0.6	-0.4

Source: Staff calculations based on authorities' data.

30. **There was agreement that a private-sector dominated and diversified electricity sector offered the best chance to make chronic supply and performance problems an aspect of the past**. The authorities plan to lessen dependence on hydropower through rehabilitating an existing thermal power plant and constructing a new one, licensing private independent power producers, and constructing a new transmission line to Montenegro to further integrate Albania's power sector into the liberalized Southeastern European market. To enforce more payment discipline and put the sector on a sounder footing, they also aim to privatize the distribution arm of KESH in 2008. While agreeing with the strategy, the mission noted the tight deadline and pointed out that potential investors will look toward ongoing improvements in the company's finances in line with those targeted under the program as well as to less politicized regulation.

IV. Program and Other Issues

31. **The proposed conditionality for the Sixth Review is consistent with program goals, and the program is fully financed through 2008**. The 2008 financing gap is expected to be closed by arrears rescheduling and Fund financing, and projected future debt service to the Fund is minimal (Tables 8 and 9). Program monitoring for 2008 is described in Tables 1 and 2 of the MEFP and in the Technical Memorandum of Understanding. Modifications are proposed to the end-September 2008 performance criteria: on (i) net international reserves of the BoA to reflect changes in the base period, the temporary widening of the current account, and a change in the currency of calculation from U.S. dollars to euros; (ii) net domestic assets of the BoA due to changes in the base period and lower projected money demand; and (iii) on net domestic credit to government to reflect a higher external financing. It is also proposed to add an end-October structural benchmark for cumulative collection performance by KESH.

32. **The authorities continue making progress in clearing remaining arrears with non-Paris Club Creditors**. Albania maintains restrictions under the transitional arrangements of Article XIV in the form of outstanding debit balances estimated at €35million at end-2007, which are derived from inoperative bilateral payment agreements that were in place before Albania joined the Fund. Most outstanding official external arrears have been reconciled or are in the process of reconciliation and further progress has been made clearing or rescheduling private sector arrears (notably with Swiss private companies). The authorities are aiming to have regularized all outstanding arrears by the end of 2008 (MEFP ¶25).

V. Staff Appraisal

33. **Albania's economic transition and long and productive engagement with the Fund has resulted in impressive gains**. Per capita GDP in U.S. dollar terms more than doubled over the last decade, inflation was brought down to developed-economy levels,

social conditions have drastically improved, and Albania is graduating from IDA. The bulk of the progress was due to prudent macroeconomic and structural policies. Supported by the authorities continued commitment, performance under the PRGF/EFF-supported program generally continues to be strong.

34. **These successes notwithstanding, some deep-seated problems remain, new challenges have appeared on the horizon, and more adversarial politics are in store ahead of next year's election, while regional risks linger**. The reform of the loss-making electricity sector must not falter this time around. Still wide-spread governance concerns must be addressed and the business environment improved. Accessing international markets must not endanger further fiscal consolidation while alternative anchors for policies need to be found after the expiration of the current Fund-supported program. Populist economic policy should be avoided ahead of the 2009 elections, while lingering risks to the regional security situation place a premium on protecting macroeconomic and financial stability.

35. **In the face of an unfavorable global inflation outlook, the monetary authorities need to stand ready to tighten again**. Global and transition forces imply upward pressures on prices in the near- and medium term. The emergence of any second round effects or a deterioration of inflation expectations require a resumption of the tightening cycle. Moreover, regulatory and supervisory measures must provide essential flanking support.

36. **Beyond monetary policy, demand pressures should be contained through fiscal policy**. The 2008 budget mid-year review maintains an appropriately neutral fiscal stance from 2007 with a deficit ceiling of 5.2 percent of GDP. Moreover, now is not the time to implement large wage increases and risk launching a potential wage-price inflation feedback loop.

37. **The medium-term economic outlook remains favorable but a wavering of policies would be costly**. Growth is projected to remain buoyant at some 6 percent through 2013 and appropriate macroeconomic policies and attendant further gains in policy credibility are expected to keep inflation low. However, without further business friendly reforms, growth would fall progressively below the baseline, while debt sustainability would be imperiled. A second round of structural reforms to improve the business environment is thus called for and requires steadfast implementation and tailoring to evolving institutions and capacity.

38. **At present, there are no major concerns about competitiveness and external stability**. The lek is independently floating, the recent widening of the current account deficit is explained by temporary factors, competitiveness is holding up, and macroeconomic policies are generally supportive of external sustainability. It will be important to ensure that monetary, fiscal, and structural policies are used actively to safeguard external and financial

sector stability, particularly in light of the authorities' plans to rely more on international capital markets in the future.

39. **While the banking system appears sound, mitigating risks to financial stability requires vigilance on several fronts**. The recent MCM TA recommendations need to be fully implemented on top of other recent and already planned prudential and regulatory measures. Of particular importance are improving BoA's cross-border supervisory collaboration with the home-country supervisors of resident foreign banks; speeding up work on contingency planning for crisis management; and resolving problems in collateral valuation and execution. Domestic markets need to be deepened to reduce rollover risk and broaden the investor base.

40. **Further fiscal consolidation would best be anchored through a clear and transparent fiscal rule**. Given the authorities' preference for a small government, an expenditure-based fiscal rule could be appropriate provided it maintained claw-back mechanisms in case of upward deviations from the planned debt consolidation path. The Sixth Review will provide an opportunity to discuss the nature of the fiscal anchor after the expiration of the current arrangements.

41. **Within a fiscal consolidation path, fiscal policy can redress still high development needs**. A stable macroeconomic environment is a sine qua non for sustaining economic development. Fiscal policy has a role in providing an enabling environment for private-sector led growth, delivering essential public goods and a targeted safety net while maintaining supply-side friendly tax policies and improving tax administration; arresting the recent growth of current expenditure; cutting back capital overbudgeting; and strengthening implementation capacity.

42. **The public utility's financial performance needs to finally be brought back into the black**. Quasi-fiscal losses amounted to 2.4 percent of GDP in 2007, equivalent to the health budget. Following the recent tariff increase, tackling deep-seated problems is key if another tariff increase is to be avoided: chronic theft must be forcefully dealt with, personnel cost and imports limited, and investment prioritized. Doing so would also facilitate the plan to privatize the distribution arm of KESH in 2008.

43. **The authorities' intention to improving statistics is appropriate**. To maximize the yield of IMF TA, it will be crucial to address the lack of skilled staff and insufficient resources.

44. **Given the strong program performance and the authorities' commitments, staff recommends completion of the Fifth Review under the PRGF/EFF-supported program and the financing assurances review, as well as modification of three performance criteria for end-September 2008.**

45. It is proposed that the next Article IV consultation with Albania remain on a 24-month cycle in line with the provisions of the decision on consultation cycles in program countries.

Table 1. Albania: Basic Indicators and Macroeconomic Framework, 2004–13

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
				(Growth rate in percent)						
Real GDP 1/	5.7	5.8	5.4	6.0	6.1	6.3	6.2	6.2	6.2	6.1
Retail prices (avg.)	2.9	2.4	2.4	2.9	4.0	3.0	2.9	2.9	2.8	2.8
Retail prices (end-period)	2.2	2.0	2.5	3.1	3.9	3.0	3.1	3.1	3.0	2.8
				(In percent of GDP)						
Saving-investment balance 2/										
Foreign savings 3/	4.0	6.1	5.6	9.2	9.8	6.9	6.4	6.0	5.4	5.0
Domestic savings	22.4	22.8	23.6	20.0	21.9	21.8	22.3	22.5	23.4	23.4
Public 4/	-0.3	0.5	1.9	2.2	3.0	2.7	3.3	3.6	4.1	4.4
Private	22.6	22.3	21.7	17.8	18.9	19.1	19.0	18.9	19.4	19.0
Investment	26.3	28.9	29.1	29.2	31.7	28.7	28.7	28.5	28.8	28.4
Public	5.1	4.7	5.6	5.9	8.8	6.0	6.4	6.2	6.5	6.1
Private	21.2	24.2	23.5	23.3	22.9	22.8	22.3	22.3	22.3	22.3
Fiscal sector										
Revenues and grants	24.6	25.0	25.3	25.5	27.7	27.3	28.0	28.5	28.6	28.6
Tax revenue	22.1	22.5	23.0	23.4	25.6	26.0	26.3	26.9	27.2	27.3
Expenditures	29.8	28.7	28.6	29.3	32.9	30.3	30.9	31.0	30.9	30.3
Primary	26.0	25.5	25.8	26.7	29.8	27.3	28.0	28.2	28.2	27.8
Interest	3.8	3.2	2.8	2.6	3.1	3.0	2.9	2.8	2.7	2.6
Overall balance (including grants)	-5.2	-3.7	-3.2	-3.8	-5.2	-3.0	-2.9	-2.4	-2.3	-1.7
Primary balance (including grants)	-1.4	-0.5	-0.4	-1.2	-2.1	-0.1	0.0	0.4	0.4	0.8
Net domestic borrowing	2.3	2.7	2.3	1.7	1.8	1.6	1.3	1.1	1.1	0.9
Privatization receipts	1.9	0.1	0.2	1.7	0.4	0.2	0.3	0.3	0.3	0.1
Foreign financing	1.0	0.8	0.6	0.5	3.0	1.2	1.3	1.0	0.9	0.7
Public Debt	57.7	58.1	55.9	53.1	53.5	52.0	50.4	48.6	46.7	44.7
Domestic	39.3	40.0	39.1	37.6	35.9	34.5	32.9	31.3	29.8	28.4
External (including publicly guaranteed) 5/	18.4	18.0	16.9	15.5	17.6	17.5	17.6	17.3	16.9	16.3
Monetary indicators										
Broad money growth	13.5	13.9	16.3	13.7	10.0	10.0	10.0	10.0	10.0	10.0
Private credit growth	36.9	73.6	57.2	48.2	29.2	18.6	14.6	13.8	12.6	12.6
Velocity	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.2
Interest rate (3-mth T-bills, end-period)	6.2	5.4	6.4	6.3	…	…	…	…	…	…
				(In percent of GDP unless otherwise indicated)						
External sector										
Trade balance (goods and services)	-22.2	-24.5	-24.1	-26.5	-26.8	-23.4	-22.3	-21.6	-20.8	-20.3
Current account balance (including official transfers)	-4.0	-6.1	-5.6	-9.2	-9.8	-6.9	-6.4	-6.0	-5.4	-5.0
Current account balance (excluding official transfers)	-5.7	-7.8	-7.3	-10.2	-10.8	-7.8	-7.1	-6.6	-5.9	-5.5
Official transfers	1.8	1.8	1.7	1.0	1.0	0.9	0.7	0.6	0.5	0.5
Gross international reserves (in millions of Euros)	1,025	1,202	1,359	1,467	1,474	1,537	1,658	1,853	2,085	2,333
(In months of imports of goods and services)	3.9	4.0	3.8	3.7	3.6	3.5	3.4	3.5	3.7	3.8
(Relative to external debt service)	17.6	17.8	11.9	12.1	8.6	7.6	7.2	7.7	8.2	7.8
(In percent of broad money)	25.3	25.7	25.3	23.3	21.7	20.5	20.1	20.4	21.0	21.2
Change in real effective exchange rate (e.o.p., in percent)	5.1	0.3	-0.1	…	…	…	…	…	…	…
Memorandum items										
Nominal GDP (in billions of lek) 1/	751	817	893	974	1072	1172	1280	1396	1521	1654

Social Indicators: GNI per capita, World Bank Atlas Method, US$ (2005): $2,570; **life expectancy at birth** (2005): 75 years; infant mortality rate (2005, per thousand births): 16; population 3.1 million (2005); 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/ GDP data for 2004–05 are from the official national accounts; GDP data for 2007 are staff estimates.

2/ 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.

3/ Negative of current account including official transfers.

4/ Revenue excluding grants less wages, local government expenditure, and opperations and maintenance.

5/ Includes arrears, with the exception of pre-1978 arrears to China, and excludes IMF repurchase obligations.

Table 2. Albania: Comparative Economic and Institutional Performance, 1996–2007[1 2]

	1994–97	1998–2001	2002–04	2005–07
Growth (average GDP growth)				
Albania	**4.3**	**9.3**	**5.2**	**5.5**
Low-income countries	3.4	3.3	4.6	5.7
Middle-income countries	3.1	4.2	5.4	6.4
Average high income countries	4.8	3.7	3.9	4.9
Average all countries	3.7	3.8	4.6	5.7
New member states	2.9	3.7	5.5	6.9
Inflation (average annual percentage change in CPI , eop)				
Albania	**20.3**	**3.8**	**2.4**	**2.5**
Low-income countries	105.9	14.0	11.4	8.2
Middle-income countries	141.0	20.1	8.6	6.8
Average high income countries	13.3	4.9	3.7	4.2
Average all countries	86.7	13.0	7.9	6.4
New member states	45.5	9.4	4.6	5.4
External balance (Current account balance as a percent of GDP)				
Albania	**-5.4**	**-2.1**	**-5.4**	**-6.9**
Low-income countries	-6.1	-5.1	-5.0	-3.3
Middle-income countries	-4.5	-4.6	-3.8	-3.9
Average high income countries	-1.6	-1.1	0.5	1.6
Average all countries	-4.1	-3.6	-2.8	-1.9
New member states	-3.4	-5.5	-6.2	-9.2
Trade openness (Exports plus imports of goods and services as a share of GDP)				
Albania	**44.8**	**54.5**	**66.1**	**73.3**
Low-income countries	68.6	69.9	75.3	81.4
Middle-income countries	87.6	91.1	93.9	99.1
Average high income countries	92.0	99.3	101.5	111.9
Average all countries	82.7	86.8	90.2	97.5
New member states	97.5	108.8	114.6	129.8
Export orientation (Exports of goods and services as a percent of GDP)				
Albania	**10.8**	**16.3**	**20.9**	**24.5**
Low-income countries	28.2	29.0	30.8	33.2
Middle-income countries	39.9	41.4	42.7	45.7
Average high income countries	46.1	50.3	52.7	58.2
Average all countries	38.1	40.2	42.1	45.7
New member states	46.9	51.7	54.5	61.4
FDI (gross, as a share of GDP)				
Albania	**2.8**	**3.0**	**3.6**	**4.0**
Low-income countries	1.9	2.6	3.3	3.8
Middle-income countries	2.9	4.4	5.5	5.4
Average high income countries	3.6	5.9	4.4	5.8
Average all countries	2.8	4.3	4.4	5.0
New member states	3.1	5.3	5.5	7.8
Monetization (Broad money as a percent of GDP)				
Albania	**46.7**	**62.5**	**65.5**	**74.8**
Low-income countries	29.0	32.3	37.0	41.0
Middle-income countries	40.0	42.1	46.4	51.0
Average high income countries	116.9	67.2	72.3	78.2
Average all countries	61.9	47.2	51.9	56.7
New member states	40.0	36.2	40.5	47.2
General government, total expenditure and net lending (in percent of GDP)[3]				
Albania	**30.4**	**33.4**	**29.9**	**29.1**
Low-income countries	25.9	26.7	26.9	27.9
Middle-income countries	27.8	28.0	27.6	28.4
Average high income countries	29.9	29.0	29.1	28.2
Average all countries	27.9	27.9	27.8	28.2
New member states	30.5	28.9	28.2	28.4

Table 2. Albania: Comparative Economic and Institutional Performance, 1996–2007[4 5] (Concluded)

	1994–97	1998–2001	2002–04	2005–07
Gross fixed capital formation (in percent of GDP)				
Albania	**21.9**	**22.3**	**25.2**	**24.8**
Low-income countries	21.0	19.6	21.1	22.7
Middle-income countries	23.1	22.2	23.4	24.8
Average high income countries	24.3	24.6	23.5	25.5
Average all countries	22.8	22.1	22.7	24.3
New member states	21.9	23.7	23.6	26.1
Bureaucratic quality (in percent of maximum possible score)				
Albania	**25.0**	**25.0**	**50.0**	**50.0**
Low-income countries	37.0	33.8	33.5	33.3
Middle-income countries	50.4	46.0	47.0	47.2
Average high income countries	76.4	75.3	74.6	73.9
Average all countries	54.6	51.7	51.7	51.5
New member states	70.3	70.6	71.7	70.0
Corruption (in percent of maximum possible score)				
Albania	**50.0**	**37.5**	**33.3**	**16.7**
Low-income countries	45.0	37.2	31.1	31.1
Middle-income countries	53.8	45.1	34.0	33.1
Average high income countries	67.7	59.0	53.2	54.5
Average all countries	55.5	47.1	39.4	39.6
New member states	75.0	63.5	51.4	51.9
Law and order (in percent of maximum possible score)				
Albania	**66.7**	**37.5**	**33.3**	**41.7**
Low-income countries	55.5	51.8	47.4	49.6
Middle-income countries	65.5	60.3	55.8	54.9
Average high income countries	85.8	79.2	75.7	77.2
Average all countries	68.9	63.8	59.6	60.6
New member states	90.3	79.6	75.8	75.0
Composite risk rating (in percent of maximum possible score)				
Albania	**59.1**	**61.6**	**66.6**	**70.0**
Low-income countries	57.2	59.0	59.9	62.0
Middle-income countries	66.3	66.0	68.6	71.0
Average high income countries	77.8	76.4	78.1	79.1
Average all countries	67.1	67.1	68.9	70.7
New member states	72.9	72.8	75.1	74.7
Political risk rating (in percent of maximum possible score)				
Albania	**65.5**	**58.8**	**66.3**	**68.2**
Low-income countries	57.1	57.0	56.0	56.4
Middle-income countries	65.4	64.3	65.2	66.4
Average high income countries	76.3	76.8	78.0	77.9
Average all countries	66.2	66.0	66.4	66.9
New member states	76.8	75.1	76.2	76.1

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

1/ Excludes Zimbabwe and Liberia.

2/ New member states comprise Latvia, Lithuania, Estonia, Czech Republic, Slovakia, Poland, Hungary, Slovenia, Romania, and Bulgaria.

3/ Central Government for Bolivia, Georgia, Moldova, Mongolia, Uzbekistan, Bulgaria, Ecuador, Turkmenistan, and Romania.

4/ Low income countries defined as countries with average per capita GDP 2004–07 of less than US$2000; Middle income countries defined as countries with average per capita GDP 2003–07 of US$2000 to US$5000; high income countries defined as countries with average per capita GDP 2003–07 greater than US$5,000. Data for all variables was not available for all countries.

5/ New member states comprise Latvia, Lithuania, Estonia, Czech Republic, Slovakia, Poland, Hungary, Slovenia, Romania, and Bulgaria.

Table 3. Status of Structural Benchmarks under the PRGF and EFF Arrangements

	Proposed Test Date	Status as of March 2008
I. Structural Benchmarks		
A. Reduce fiscal vulnerabilities		
1. Take measures to reduce the quasi-fiscal losses of KESH to 1.2 percent of GDP.	Mid-June 2008	Met with delay
2. 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
3. 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	Ongoing	Met
4. Introduce modifications into the VAT refund system whereby claims will be paid automatically if validity checks are met (as outlined in the IMF TA report on tax administration of October 2007).	End-April 2008	Met
5. Prepare semi-annual reports (within one month of the end of each semester) on the stock of external arrears.	Ongoing	Met
B. Improve public expenditure management		
6. 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

Table 4a. Albania: General Government Operations, 2006–13
(In percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
			Projection					
Total revenue and grants	25.3	25.5	27.7	27.3	28.0	28.5	28.6	28.6
Tax revenue	23.0	23.4	25.6	26.0	26.3	26.9	27.2	27.3
VAT	8.3	9.0	9.7	9.7	9.8	10.0	10.1	10.2
Profit tax 1/	2.5	2.2	1.7	1.6	1.5	1.5	1.5	1.5
Excise tax	2.6	3.0	3.5	3.8	3.8	3.9	4.0	4.0
Small business tax	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2
Personal income tax	1.0	1.5	2.1	2.1	2.3	2.4	2.4	2.4
Customs duties	1.6	1.0	0.9	0.5	0.4	0.4	0.4	0.4
Other taxes	1.5	1.5	1.5	1.5	1.6	1.6	1.7	1.8
Property and local taxes	1.0	0.7	1.2	1.4	1.4	1.5	1.5	1.5
Social insurance contributions	4.4	4.3	4.8	5.1	5.3	5.4	5.4	5.4
Non-tax revenue	1.8	1.9	1.7	1.0	1.5	1.4	1.3	1.2
Grants	0.5	0.1	0.4	0.2	0.2	0.2	0.1	0.1
Of which: budget support	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	28.6	29.3	32.9	30.3	30.9	31.0	30.9	30.3
Current expenditure	22.9	23.2	24.2	24.1	24.3	24.5	24.2	23.9
Personnel cost	6.3	6.1	6.3	6.5	6.6	6.5	6.5	6.4
Of which: contingency	…		0.0	0.3	0.3	0.3	0.2	0.2
Interest	2.8	2.6	3.1	3.0	2.9	2.8	2.7	2.6
Of which: Domestic	2.6	2.4	2.7	2.5	2.4	2.3	2.2	2.1
Operations & maintenance	2.9	2.6	2.6	2.7	2.9	3.1	3.1	3.0
Subsidies	0.4	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Social insurance outlays	6.7	7.2	7.5	7.2	7.2	7.2	7.2	7.2
Of which: contingency	…		0.4	…	…	…	…	…
Local government expenditure	2.5	2.2	2.8	2.9	2.9	3.0	3.0	3.0
Social protection transfers	1.2	1.5	1.4	1.5	1.5	1.6	1.5	1.5
Other 2/	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Capital expenditure 3/	5.6	5.9	8.8	5.7	6.1	5.9	6.3	6.0
Domestically financed	4.3	5.0	5.0	4.0	4.2	4.3	4.7	4.6
Of which: contingency	…	0.0	0.5	0.4	0.4	0.4	0.4	0.4
Foreign financed projects	1.4	0.9	3.8	1.7	1.9	1.6	1.5	1.4
Capital transfer to KESH	…	0.6	…	…	…	…	…	…
Lending minus repayment	0.0	0.3	-0.3	0.0	0.0	0.0	0.0	0.0
Reserve and contingency funds 4/	0.0	0.0	0.3	0.6	0.6	0.5	0.5	0.5
Cash balance	-3.2	-3.8	-5.2	-3.0	-2.9	-2.4	-2.3	-1.7
Current balance including grants 5/	2.4	2.3	3.4	2.9	3.5	3.7	4.2	4.5
Financing	3.2	3.8	5.2	3.0	2.9	2.4	2.3	1.7
Domestic	2.6	3.3	2.2	1.8	1.6	1.4	1.4	1.0
Privatization receipts 6/	0.2	1.7	0.4	0.2	0.3	0.3	0.3	0.1
Net borrowing	2.3	1.7	1.8	1.6	1.3	1.1	1.1	0.9
Foreign	0.6	0.5	3.0	1.2	1.3	1.0	0.9	0.7
Memorandum Items:								
Primary balance	-0.4	-1.2	-2.1	-0.1	0.0	0.4	0.4	0.8
Current balance excluding grants	1.9	2.2	3.0	2.7	3.3	3.6	4.1	4.4
Total spending contingencies 4/	…	0.0	0.7	1.3	1.3	1.2	1.1	1.0
Expenditures in priority sectors 7/	9.2	9.4	9.6	10.1	10.1	10.1	10.1	10.1
Public Debt 8/	55.9	53.1	53.5	52.0	50.4	48.6	46.7	44.7
Domestic general government	39.1	37.6	35.9	34.5	32.9	31.3	29.8	28.4
External	16.9	15.5	17.6	17.5	17.6	17.3	16.9	16.3
GDP (in billions of leks)	893	974	1072	1172	1280	1396	1521	1654

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

1/ Includes reduction of CIT rate to 10 percent from 2008.
2/ Includes statistical discrepancy.
3/ Excludes capital transfer to KESH in 2007.
4/ Spending contingencies are reported according to their economic classification at outturn.
5/ Revenue including grants minus current expenditure (including the capital transfer to KESH in 2007).
6/ Includes privatization and decapitalization of Albtelekom in 2007 and projected privatization of INSIG in 2008.
7/ Education, health, and road sectors.
8/ Includes securities issued to the Bank of Albania in 2005 to compensate for its foreign exchange valuation losses.

Table 4b. Albania: General Government Operations, 2006–13
(In billions of leks)

	2006	2007	2008	2009	2010	2011	2012	2013
			Projection					
Total revenue and grants	226.3	248.3	297.4	320.0	358.6	398.3	435.2	473.5
Tax revenue	205.5	228.2	274.4	305.3	337.1	376.1	413.2	451.4
VAT	74.3	87.8	103.9	113.9	125.3	139.2	153.1	168.4
Profit tax 1/	22.3	21.1	17.9	18.9	18.6	20.6	22.5	24.5
Excise tax	23.0	28.7	38.0	44.4	49.3	54.7	60.2	66.2
Small business tax	2.6	2.2	3.0	2.4	2.7	3.2	3.2	3.2
Personal income tax	8.6	14.8	22.3	25.2	28.9	33.1	36.1	39.4
Customs duties	14.0	9.8	9.4	6.1	5.6	6.2	6.4	5.9
Other taxes	13.0	14.5	16.2	17.8	20.4	22.9	26.0	29.2
Property and local taxes	9.3	7.1	12.6	16.4	17.9	21.0	23.0	25.3
Social insurance contributions	39.3	42.0	51.1	60.1	68.4	75.2	82.7	89.3
Non-tax revenue	16.0	18.8	18.4	12.1	19.0	20.0	20.0	20.5
Grants	4.8	1.3	4.6	2.6	2.4	2.2	2.0	1.6
Of which: budget support	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	255.2	285.7	352.9	355.3	395.8	432.3	470.3	502.0
Current expenditure	204.9	225.6	259.2	282.2	310.5	342.7	367.8	395.6
Personnel cost	56.7	59.1	68.0	76.1	83.8	91.3	98.6	106.4
Of which : contingency	…		0.0	3.5	3.5	3.5	3.5	3.5
Interest	25.0	25.6	33.0	34.8	37.0	39.2	40.8	42.2
Of which: domestic	23.0	23.5	28.7	28.9	30.5	32.0	33.0	34.0
Operations & maintenance	25.8	25.2	28.0	32.1	37.4	43.7	46.6	49.7
Subsidies	3.8	3.5	2.3	2.8	2.9	2.9	3.2	3.4
Social insurance outlays	60.0	69.9	80.6	83.9	91.6	100.4	109.2	118.6
Of which: contingency	…		4.6	…	…	…	…	
Local government expenditure	22.7	21.3	29.6	34.1	37.5	42.5	46.3	50.2
Social protection transfers	10.8	14.8	15.4	17.8	19.6	21.9	22.2	24.2
Property compensation	0.0	0.5	0.5	0.6	0.7	0.8	0.8	0.8
Other 2/	0.0	0.0	1.8	0.0	0.0	0.0	0.0	0.0
Capital expenditure 3/	50.4	57.0	94.0	66.6	77.8	82.1	95.1	98.8
Domestically financed	38.2	48.2	53.5	46.4	53.2	59.6	71.7	75.3
Of which: contingency	…	0.0	5.0	5.0	5.0	6.0	6.0	6.0
Foreign financed projects	12.1	8.8	40.6	20.2	24.7	22.5	23.4	23.5
Capital transfer to KESH	…	5.7	…	…	…	…	…	…
Lending minus repayment	0.0	3.0	-3.0	0.0	0.0	0.0	0.0	0.0
Reserve and contingency funds 4/	…	0.0	2.7	6.5	7.5	7.5	7.5	7.5
Cash balance	-28.9	-37.4	-55.5	-35.4	-37.2	-34.0	-35.2	-28.5
Current balance including grants 5/	21.4	22.7	36.9	34.5	44.3	51.9	63.7	74.1
Financing	28.9	37.4	55.5	35.4	37.2	34.0	35.2	28.5
Domestic	23.5	32.1	23.2	21.5	20.1	19.9	21.5	16.5
Privatization receipts 6/	2.0	16.6	4.1	2.4	3.2	3.9	4.4	1.0
Net borrowing	20.7	17.0	19.0	19.1	16.9	16.0	17.0	15.5
Foreign	5.4	5.3	32.4	13.9	17.2	14.1	13.7	12.0
Memorandum Items:								
Primary balance	-3.9	-11.8	-22.5	-0.6	-0.3	5.2	5.7	13.7
Current balance excluding grants	16.6	21.4	32.2	31.9	41.9	49.7	61.6	72.5
Total spending contingencies 4/	…	0.0	7.7	15.0	16.0	17.0	17.0	17.0
Expenditures in priority sectors 7/	81.9	91.5	102.9	118.8	129.7	141.5	154.1	167.6
Public Debt 8/	499.5	517.0	573.3	609.7	645.6	678.2	710.9	739.8
Domestic general government	348.9	366.0	385.0	404.1	420.9	436.9	454.0	469.5
External	150.5	151.0	188.3	205.6	224.7	241.3	256.9	270.4
Direct government external debt	125.1	123.0	156.1	186.0	198.4	209.6	219.0	0.0
Government guaranteed external debt	25.4	28.0	32.1	38.7	42.9	47.3	51.4	0.0

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

1/ Includes reduction of CIT rate to 10 percent from 2008.
2/ Includes statistical discrepancy.
3/ Excludes capital transfer to KESH in 2007.
4/ Spending contingencies are reported according to their economic classification at outturn.
5/ Revenue including grants minus current expenditure (including the capital transfer to KESH in 2007).
6/ Includes privatization and decapitalization of Albtelekom in 2007 and projected privatization of INSIG in 2008.
7/ Education, health, and road sectors.
8/ Includes securities issued to the Bank of Albania in 2005 to compensate for its foreign exchange valuation losses.

Table 5a . Albania: Balance of Payments, 2003–13
(In percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Est.	Projections					
Current account	-5.2	-4.0	-6.1	-5.6	-9.2	-9.8	-6.9	-6.4	-6.0	-5.4	-5.0
Balance of goods and services	-24.7	-22.2	-24.5	-24.1	-26.5	-26.8	-23.4	-22.3	-21.6	-20.8	-20.3
Exports	20.4	21.9	22.7	25.1	27.9	28.2	28.1	28.4	29.0	29.6	30.4
Goods	7.8	8.2	8.0	8.7	10.0	10.0	9.9	10.2	10.6	11.2	11.7
Services	12.6	13.7	14.7	16.5	18.0	18.2	18.2	18.2	18.3	18.5	18.6
Imports	45.1	44.1	47.3	49.3	54.5	55.1	51.5	50.8	50.6	50.4	50.6
Goods	31.1	29.7	30.5	31.9	36.7	36.6	33.6	33.0	32.8	32.7	32.8
Services	14.0	14.4	16.8	17.4	17.8	18.4	18.0	17.8	17.8	17.8	17.9
Income balance	3.0	2.4	2.0	2.8	2.8	2.7	2.4	2.1	1.9	1.7	1.7
Of which : Interest due	0.4	0.3	0.4	0.6	0.6	0.8	0.9	1.0	1.0	1.0	1.0
Private transfers 1/	14.0	14.0	14.7	14.1	13.5	13.3	13.2	13.2	13.2	13.2	13.1
Official transfers	2.6	1.8	1.8	1.7	1.0	1.0	0.9	0.7	0.6	0.5	0.5
Capital account	5.4	5.6	5.0	5.8	9.7	8.7	6.5	6.6	6.8	6.6	6.0
Direct investment	3.1	4.7	3.4	3.6	6.0	3.6	4.3	4.2	4.5	4.8	5.3
Other capital	0.8	-0.2	0.6	1.5	2.8	2.2	1.3	1.4	1.5	0.9	0.2
Private loans (incl.net trade credits)	0.4	1.3	1.0	0.5	0.4	0.5	0.6	0.7	0.8	0.8	0.9
Other financial flows	0.4	-1.5	-0.3	0.9	2.5	1.7	0.7	0.7	0.7	0.2	-0.7
Of which: Change in NFA of DMBs (incr = -) 2/	0.4	-1.5	-0.3	0.1	0.9	1.7	0.7	0.7	0.7	0.2	-0.7
Official medium- and long-term loans (net)	1.5	1.1	1.0	0.7	0.8	2.9	0.9	1.0	0.8	0.8	0.6
New borrowing	2.0	1.7	1.5	1.6	1.6	4.0	2.1	2.2	1.9	1.8	1.7
Multilateral loans	1.5	1.2	1.1	1.1	1.2	1.0	1.3	1.2	1.2	1.2	1.1
World Bank	0.7	0.6	0.5	0.5	0.5	0.4	0.5	0.4	0.4	0.4	0.3
EBRD	0.3	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Other	0.5	0.4	0.4	0.4	0.5	0.4	0.5	0.6	0.6	0.5	0.5
Bilateral loans	0.5	0.5	0.4	0.5	0.4	0.3	0.7	0.6	0.6	0.5	0.4
Commercial debt					0.0	2.6	0.0	0.4	0.1	0.2	0.2
Amortization	-0.5	-0.6	-0.5	-0.9	-0.8	-1.1	-1.1	-1.2	-1.1	-1.0	-1.1
Errors and omissions 3/	0.3	1.4	2.1	2.2	1.3	1.1	1.0	1.0	0.9	0.8	0.7
Net balance	0.5	3.0	1.1	2.4	1.8	0.0	0.6	1.2	1.8	2.0	1.8
Financing requirement	-0.5	-3.0	-1.1	-2.4	-1.8	0.0	-0.6	-1.2	-1.8	-2.0	-1.8
Available financing	-0.5	-3.0	-1.1	-2.6	-1.8	0.0	-0.6	-1.2	-1.8	-2.0	-1.8
Change in net reserves (increase = -) 2/	-0.9	-3.3	-1.1	-2.8	-1.9	-0.1	-0.7	-1.2	-1.8	-2.0	-1.8
BOP support	0.3	0.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Changes in arrears (increase = +) 4/	0.1	-0.2	-0.3	-0.1	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Overdue debt forgiveness	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Rescheduling 4/	0.0	0.2	0.3	0.1	0.0	0.0	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	0.0	0.0
Of which: World Bank including DPL	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Financing gap 5/	0.0	0.0	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Expected EU Macro-Financial Assistance	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Arrears Rescheduling	...	...	0.0	0.0	0.0	0.4	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

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

1/ Bank of Albania data plus IMF estimate (to capture some unrecorded inflows not captured in the BOA estimate).
2/ Net of valuation changes in 2005–07. In projections for 2008–13, valuation effects are assumed to be zero.
3/ Net errors and omissions include unidentified flows of private transfers.
4/ In 2006–2007 assumes rescheduling of stock of outstanding arrears, both with official and private creditors.
5/ The financing gap is expected to be fully covered by arrears rescheduling and prospective privatization receipts.

Table 5b. Albania: Balance of Payments, 2003–13
(In millions of Euros)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Est.			Projections			
Current account	-261	-235	-399	-405	-725	-857	-662	-668	-680	-667	-672
Balance of goods and services	-1,248	-1,307	-1,617	-1,752	-2,091	-2,346	-2,243	-2,339	-2,465	-2,589	-2,746
Exports	1,031	1,293	1,498	1,825	2,202	2,467	2,695	2,974	3,308	3,688	4,114
Goods	396	486	530	631	786	876	951	1,065	1,214	1,388	1,590
Services	635	808	967	1,195	1,415	1,591	1,744	1,910	2,095	2,299	2,525
Imports	2,279	2,600	3,115	3,577	4,293	4,813	4,938	5,313	5,773	6,277	6,860
Goods	1,572	1,752	2,007	2,316	2,890	3,201	3,218	3,451	3,742	4,064	4,440
Services	708	848	1,108	1,261	1,402	1,612	1,721	1,862	2,031	2,213	2,420
Income balance	152	143	132	200	220	239	234	216	212	216	237
Of which: Interest due	21	18	25	42	51	68	84	100	113	124	136
Private transfers 1/	706	826	969	1,024	1,068	1,161	1,265	1,379	1,503	1,639	1,770
Official transfers	129	103	117	123	78	89	83	76	69	68	67
Capital account	274	332	328	420	765	760	623	695	781	815	820
Direct investment	158	277	224	259	477	314	415	440	517	600	711
Other capital	42	-13	41	109	225	192	121	149	168	117	26
Private loans (incl.net trade credits, net)	21	78	63	40	30	46	54	76	90	95	119
Other financial flows	21	-91	-22	69	194	147	67	73	78	22	-92
Of which: Change in NFA of DMBs (incr = -) 2/	21	-91	-22	7	72	147	67	73	78	22	-92
Medium- and long-term loans (net)	75	68	63	53	64	254	88	106	96	99	82
New borrowing	101	100	98	116	124	346	197	227	215	222	236
Multilateral loans	75	72	73	82	94	88	127	131	141	145	155
World Bank	36	37	32	36	39	33	51	40	42	44	45
EBRD	13	13	15	19	14	24	30	30	35	35	45
Other	25	23	25	27	41	31	46	61	64	66	65
Bilateral loans	26	28	26	35	29	29	70	58	64	56	59
Commercial debt					0	230	0	38	10	21	22
Amortization	-25	-33	-35	-63	-60	-93	-109	-121	-120	-123	-154
Errors and omissions 3/	14	80	141	160	103	100	100	100	100	100	100
Net balance	27	177	69	176	143	3	62	127	201	248	247
Financing requirement	-27	-177	-69	-176	-143	-3	-62	-127	-201	-248	-247
Available financing	-27	-177	-69	-178	-145	-3	-60	-126	-200	-247	-246
Change in net reserves (increase = -) 2/	-46	-193	-72	-200	-149	-12	-70	-129	-203	-247	-246
Of which: Change in gross reserves, (increase = -) 2/	10	-191	-77	-197	-108	-7	-63	-121	-195	-240	-240
Use of Fund Resources (net)	1	2	2	-3	-5	-5	-7	-8	-8	-7	-7
Budget support	17	15	3	9	0	0	0	0	0	0	0
Changes in arrears (increase = +) 4/	3	-12	-17	-7	-3	-33	0	0	0	0	0
Overdue debt forgiveness	0	0	0	0	0	0	0	0	0	0	0
Rescheduling 4/	0	12	17	7	0	0	0	0	0	0	0
Identified Financing	0	0	0	13	7	10	10	3	3	0	0
Of which: World Bank including DPL	0	0	0	0	7	10	10	3	3	0	0
Financing gap 5/	0	0	0	0	0	33	0	0	0	0	0
Expected EU Macro-Financial Assistance	...	...	0	0	0	0	0	0	0	0	0
Arrears Rescheduling	...	...	0	0	0	33	0	0	0	0	0
Other	...	...	0	0	0	0	0	0	0	0	0
Memorandum items:											
Gross usable reserves	834	1,025	1,202	1,359	1,467	1,474	1,537	1,658	1,853	2,093	2,333
(months of imports of goods and services)	3.9	3.9	4.0	3.8	3.7	3.6	3.5	3.4	3.5	3.7	3.8
Balance of goods and services (percent of GDP)	-24.7	-22.2	-24.5	-24.1	-26.5	-26.8	-23.4	-22.3	-21.6	-20.8	-20.3
Current account (percent of GDP)	-5.2	-4.0	-6.1	-5.6	-9.2	-9.8	-6.9	-6.4	-6.0	-5.4	-5.0
Debt service (percent of exports of goods and services) 6/	5.0	4.1	3.9	4.7	3.5	5.0	5.5	5.8	5.8	5.7	5.9
Debt service (percent of central government revenues) 6/	4.5	3.9	3.9	5.0	3.8	5.5	5.9	6.3	6.4	6.4	6.8
Total external debt stock (percent of GDP) 7/	21.9	20.8	21.0	19.8	18.0	19.6	19.2	19.1	18.8	18.6	18.2
Volume of Exports of Goods and Services (percent change)	9.5	20.6	5.8	10.8	21.1	12.7	9.7	13.1	13.0	12.7	12.6
Volume of Imports of Goods and Services (percent change)	8.4	10.7	8.4	-1.2	10.6	5.4	6.5	7.5	7.8	7.5	8.0

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

1/ Bank of Albania data plus IMF estimate (to capture some unrecorded inflows not captured in the BOA estimate).
2/ Net of valuation changes in 2005–07. In projections for 2008–13, valuation effects are assumed to be zero.
3/ Net errors and omissions include unidentified flows of private transfers.
4/ In 2006–2008 assumes rescheduling of stock of outstanding arrears, both with official and private creditors.
5/ The financing gap is expected to be fully covered by arrears rescheduling and prospective privatization receipts.
6/ Public and publicly guaranteed debt only.
7/ Public and private external debt, including arrears. Debt stock converted into Lek at the e-o-p exchange rate.

Table 6a. Albania: Monetary Aggregates, 2004–09
(In percent of GDP)

	Actuals				Projections	
	2004	2005	2006	2007	2008	2009
Monetary survey						
Broad money	67.0	70.1	74.6	77.8	77.7	78.2
Currency outside banks	18.4	18.3	18.3	15.9	13.5	11.9
Deposits	48.6	51.8	56.3	61.9	64.2	66.3
Domestic currency deposits	34.0	33.9	35.2	36.1	35.5	35.2
Foreign currency deposits	14.6	17.9	21.2	25.8	28.7	31.1
Net foreign assets	25.1	25.8	26.1	23.8	20.3	18.6
Bank of Albania	15.8	17.0	18.1	17.6	16.2	15.5
Commercial Banks	9.3	8.8	8.1	6.3	4.1	3.1
Net domestic assets	41.9	44.3	48.5	54.0	57.4	59.6
Claims on government (net of deposits)	36.1	33.9	32.2	31.7	29.7	28.3
BOA financing	7.6	7.2	5.2	5.3	4.6	3.4
Other (including T-bills)	28.5	26.7	27.0	26.4	25.1	24.8
Claims on state enterprises and farms	0.0	0.0	0.0	0.4	0.0	0.0
Claims on the private sector 1/	9.5	15.2	21.9	29.8	34.9	37.9
In Leks	2.1	4.1	6.6	8.7	9.7	9.8
In foreign currency	7.5	11.1	15.3	21.1	25.2	28.1
Other items, net	-3.8	-4.8	-5.6	-7.9	-7.3	-6.5
Memorandum items:						
Reserve money (billions of Lek)	23.8	24.3	24.4	23.4	20.9	19.6
M1 (billions of Lek)	22.6	27.4	27.1	24.9	20.3	18.5
M2 (Billions of Lek)	52.4	52.2	53.5	52.0	49.0	47.1

Sources: Bank of Albania; and Fund staff estimates.

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

Table 6b. Albania: Monetary Aggregates, 2004–9

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

	Actuals					Projections			
	2004	2005	2006	2007	2008	2008			2009
	Dec.	Dec.	Dec.	Dec	Mar	Jun.	Sep.	Dec.	Dec.
Monetary survey									
Broad money	503.2	573.0	666.5	757.6	754.4	764.2	802.6	833.4	916.7
Currency outside banks	138.1	149.7	163.3	155.0	146.8	144.7	140.6	144.7	139.8
Deposits	365.1	423.3	503.2	602.7	607.6	619.5	661.9	688.7	776.9
Domestic currency deposits	255.2	276.8	314.1	351.2	351.3	358.5	372.9	380.6	412.3
Foreign currency deposits	110.0	146.6	189.1	251.5	256.3	261.0	289.1	308.1	364.6
Net foreign assets	188.8	210.8	233.2	232.1	216.0	195.1	212.6	217.8	217.6
Bank of Albania	118.6	138.8	161.2	171.0	166.7	160.5	168.6	173.7	181.8
Commercial Banks	70.2	72.0	72.0	61.1	49.3	34.5	44.1	44.2	35.9
Net domestic assets	314.4	362.2	433.2	525.5	538.4	569.1	589.9	615.5	699.1
Claims on government (net of deposits)	271.0	277.0	287.9	308.9	302.2	312.9	315.4	318.9	331.4
BOA financing	57.2	58.6	46.8	52.1	46.5	53.9	53.6	49.6	40.4
Other (including T-bills)	213.7	218.4	241.0	256.8	255.7	259.0	261.8	269.3	291.0
Claims on state enterprises and farms	0.1	0.1	0.2	3.9	4.5	0.0	0.0	0.0	0.0
Claims on the private sector 1/	71.6	124.4	195.5	289.9	311.4	333.7	352.2	374.5	444.2
In Leks	15.6	33.7	59.2	84.8	88.6	97.7	98.6	103.8	114.9
In foreign currency	56.0	90.6	136.4	205.1	222.8	235.9	253.6	270.7	329.4
Other items, net	-28.3	-39.2	-50.3	-77.2	-79.7	-77.4	-77.7	-77.9	-76.6
Memorandum items:									
Reserve money (billions of Lek)	178.6	198.3	217.6	228.2	213.6	218.5	223.0	224.2	229.5
M1 (billions of Lek)	170.1	223.7	242.4	242.7	215.2	214.7	212.0	217.7	216.6
M2 (Billions of Lek)	393.3	426.4	477.4	506.1	498.1	503.2	513.5	525.3	552.1
Annual broad money growth	13.5	13.9	16.3	13.7	11.2	12.6	12.4	10.0	10.0
Annual reserve money growth	11.2	11.0	9.8	4.9	0.1	2.6	3.0	-1.8	2.4
Annual growth in private sector credit	36.9	73.6	57.2	48.2	42.9	40.4	35.8	29.2	18.6
Private sector credit as a percent of GDP	9.5	15.2	21.9	29.8	31.0	32.4	33.5	34.9	37.9
Annual change in credit as a percent of GDP	2.0	5.7	6.7	7.9	7.3	6.8	6.2	5.2	3.0
Annual M2 growth	11.9	8.4	11.9	6.0	4.6	5.8	7.6	3.8	5.1
Velocity (annual GDP/BM)	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Money multiplier (absolute values)	2.8	2.9	3.1	3.3	3.5	3.5	3.6	3.7	4.0
Currency/Broad Money ratio	27.4	26.1	24.5	20.5	19.5	18.9	17.5	17.4	15.3
Currency/M2 ratio	35.1	35.1	34.2	30.6	29.5	28.8	27.4	27.5	25.3
Foreign currency deposits/total deposits	30.1	34.6	37.6	41.7	42.2	42.1	43.7	44.7	46.9
Gross reserves (millions of euros)	1,025	1,202	1,359	1,467	1,421	1,375	1,439	1,474	1,537
Gross reserves (millions of U.S. dollars)	1,374	1,425	1,796	2,138	2,207	2,140	2,242	2,305	2,430
In percent of broad money	25.3	25.7	25.3	23.3	22.9	22.0	21.9	21.7	20.5
US Dollar Exchange Rate (end of period)	92.7	103.4	94.0	82.7	78.3	...	...	...	...
Euro Exchange Rate (end of period)	125.9	122.4	123.6	121.6	123.6	...	...	...	...
3-month T-bill rate (in percent)	6.2	5.4	6.4	6.3	6.3	...	...	...	...
BoA repo rate (in percent)	5.3	5.0	5.5	6.3	6.3	...	...	...	...

Sources: Bank of Albania; and Fund staff estimates.

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

Table 7. Albania: IMF Core Indicators of Financial Soundness, December 2003–December 2007

		Dec-03	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07
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	18.4	18.3	18.1	16.9	16.4	17.5	17.1
(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	17.4	17.2	17.1	15.9	15.4	16.7	16.0
(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	5.7	5.9	5.9	6.4	6.2	6.9	5.8
	Regulatory capital as a percent of total assets	4.7	4.8	5.1	5.3	5.3	5.6	5.9	6.0	6.3	6.2	6.8	6.6	7.3	6.2
	Shareholders' equity as a percent of total assets	5.9	6.1	5.8	6.4	6.6	6.6	6.5	6.7	7.0	6.8	7.0	7.1	7.6	7.6
(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	9.5	7.7	7.2	7.8	8.5	9.0	12.0
	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	8.9	7.2	6.8	7.4	7.9	8.5	11.2
	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	8.1	6.5	6.3	7.1	7.4	8.2	9.1
(v)	Return on equity (ROE) (annual basis)	19.5	21.1	22.1	24.3	24.5	22.2	21.4	18.8	19.2	20.2	20.8	20.0	21.0	20.7
(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	0.1	6.4	5.5	6.9	0.8	7.1	1.8
	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	0.1	6.0	5.2	6.5	0.8	6.7	1.7
	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	0.1	5.4	4.8	6.3	0.7	6.4	1.4
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	60.0	58.7	57.6	55.8	53.6	52.4	49.8
(viii)	Liquid assets as a percent of short-term liabilities	na	na	83.2	109.9	73.5	75.2	75.5	75.6	74.5	69.5	73.2	69.2	71.4	55.6
(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	1.2	1.3	1.4	1.4	1.5	1.6	1.6
(x)	Nonperforming loans (gross) as a percent of total loans	4.6	4.2	3.5	2.4	2.4	2.3	3.0	3.8	3.3	3.1	3.2	3.1	3.4	3.4
(xi)	Sectoral distribution of loans to total loans	na	na	na	na	na	na	na	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	98.5	95.6	92.6	93.0	93.1	94.3	92.7
(xiii)	Noninterest expenses to gross income	57.4	66.2	81.5	75.3	76.7	76.3	71.4	72.9	68.5	65.7	61.1	59.4	58.0	58.5
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	296.6	286.7	265.5	251.2	230.7	227.0	215.5
	Foreign currency-denominated loans to total loans	82.1	80.5	79.9	77.7	77.6	75.5	74.5	72.5	71.1	71.9	72.4	71.1	71.1	72.5
	Foreign currency-denominated liabilities as a percent of total liabilities	35.9	37.0	38.2	39.9	41.5	41.0	41.0	41.6	43.1	44.0	45.2	45.7	46.5	46.9
	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	32.8	34.4	34.6	40.3	40.4	41.6	36.4
	Total loans as a percent of total assets	13.6	16.4	17.6	20.8	22.8	25.7	26.5	28.9	30.4	31.7	33.7	35.9	37.1	39.4
	Total loans as a percent of shareholders' equity	231.2	270.3	302.6	326.5	348.7	387.0	408.7	434.4	432.5	469.5	478.4	504.4	485.7	516.4

Source: Data provided by Bank of Albania.

Table 8. Albania: External Financing Requirement and Sources, 2003–13
(In millions of Euros)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Est.	Projections					
Current account (incl. official transfers)	261	235	399	405	725	857	662	668	680	667	672
Amortization	34	40	43	72	71	103	118	129	128	130	161
Of which : IMF	8	8	7	9	11	10	9	8	8	7	7
Change in gross reserves (increase = +)1/	-10	191	77	197	108	7	63	121	195	240	240
Reduction in arrears	-3	12	17	7	3	33	0	0	0	0	0
Total financing requirement	282	477	536	681	906	1000	843	919	1003	1038	1073
Available financing	282	478	537	679	941	968	844	919	1004	1039	1074
Foreign direct investment	158	277	224	259	477	314	415	440	517	600	711
Other capital	42	-13	41	109	225	192	121	149	168	117	26
Official medium- and long-term loans	101	100	98	116	124	346	197	227	215	222	236
Multilateral (excluding IMF)	75	72	73	82	94	88	127	131	141	145	155
Bilateral	26	28	26	35	29	29	70	58	64	56	59
Commercial						230	0	38	10	21	22
IMF disbursements	10	10	9	6	6	5	3	0	0	0	0
Other 2/	-44	76	144	160	103	100	100	100	100	100	100
Debt rescheduling	0	12	17	7	0	0	0	0	0	0	0
Budget support	17	15	3	9	0	0	0	0	0	0	0
Identified financing	0	0	0	13	7	10	10	3	3	0	0
Of which : WB FSAC/PRSC/EU	...	...	0	13	7	10	10	3	3	0	0
Financing gap	0	0	0	0	0	33	0	0	0	0	0
Expected EU macro-financial assistance	...	...	0	0	0	0	0	0	0	0	0
Debt rescheduling (mostly clearance of bilateral arrears	...	...	0	0	0	33	0	0	0	0	0
Other	...	...	0	0	0	0	0	0	0	0	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 2005–07. In projections for 2008–13, valuation effects are assumed to be zero.

2/ Includes errors and omissions.

Table 9. Albania: Actual and Projected Payments to the Fund, 2003–13
(in millions of SDRs)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					Est.	Projections					
Obligations from existing drawings											
1. Principal											
PRGF repayments	6.8	6.4	6.2	7.6	6.7	9.6	9.1	8.0	7.1	5.8	5.5
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.5	0.9	1.0
2. Charges and Interest 1/											
PRGF Interest	0.3	0.3	0.3	0.4	0.28	0.24	0.19	0.15	0.11	0.08	0.05
GRA	0.0	0.0	0.0	0.00	0.15	0.23	0.24	0.24	0.23	0.20	0.16
Total obligations	7.1	6.7	6.5	8.0	7.1	10.1	9.5	8.4	8.0	7.0	6.7
(percent of quota)	15	14	13	16	15	21	20	17.3	16.4	14.4	13.8
Obligations from prospective drawings											
1. Principal											
Cumulative obligations (existing and prospective)											
1. Principal											
PRGF + EFF repayments	6.8	6.4	6.2	7.6	6.7	9.6	9.1	8.1	7.6	6.7	6.8
2. Charges and Interest 1/											
PRGF Interest	0.3	0.3	0.3	0.4	0.3	0.2	0.2	0.2	0.1	0.1	0.1
GRA	0.0	0.0	0.0	0.0	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Total obligations	7.1	6.7	6.5	8.0	7.2	10.1	9.6	8.6	8.1	7.1	7.1
(Percent of quota)	15	14	13	16	15	21	20	18	17	15	15
Outstanding Fund credit 2/	60.8	62.4	64.3	61.5	57.0	52.3	45.6	37.5	29.9	23.2	16.4
o/w projected under the current arrangements	...	...	...	...	4.9	4.9	2.4	...	...	...	...
Breakdown of Fund credit											
Extended Arrangements				2.4	4.9	7.3	8.5	8.4	7.9	7.0	5.7
PRGF Arrangements	60.8	62.4	64.3	59.1	52.1	45.0	37.1	29.1	22.0	16.2	10.7
Memorandum items:											
Outstanding Fund credit											
In percent of:											
Exports of goods & services	7.0	5.5	5.2	3.8	2.8	2.2	1.8	1.3	0.9	0.6	0.4
GDP	1.4	1.2	1.2	1.0	0.8	0.6	0.5	0.4	0.3	0.2	0.1
Quota	125	128	132	126	117	107	94	77	61	48	34
Total obligations											
In percent of:											
Exports of goods & services	0.9	0.6	0.5	0.5	0.4	0.4	0.4	0.3	0.3	0.2	0.2
GDP	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Fund staff estimates.

1/ Projections are based on current interest rates for PRGF and the EFF.
2/ End of year value.

Appendix I: Public and External Debt Sustainability Analysis (DSA)[1] Update

Over the past five years Albania's debt sustainability has continued to improve—domestic debt maturities have lengthened and the public debt to GDP ratio has remained on a downward path. Nevertheless, it remains relatively high at 54 percent of GDP and domestic debt rollover at 424 days is still short by comparison with other countries. Looking ahead, as long as an adequate fiscal anchor is in place, debt looks set to remain on a sustainable path; it is expected to decline to below 50 percent of GDP by 2011 and, following a one-off increase in 2008, external debt falls back gradually. However, debt remains susceptible to shocks—notably to rollover risk, as well as growth and external shocks. Furthermore, as the authorities seek to access international capital markets, the debt position could change much more rapidly than seen in the past and will be subject to much larger uncertainties. The lower growth scenario—with a lesser reform effort and wavering fiscal discipline—illustrates how easily the relatively benign picture of debt sustainability could be thrown off course.

External and Total Public Debt Sustainability

Despite an increase in 2008, the external debt ratio remains relatively low at 19.7 percent of GDP and is expected to decline over the medium term. The increase in external debt in 2008 is a result of a one-off increase in commercial borrowing to finance a large road project (the Rreshen Kalimash road). The increase remains within the ceiling for nonconcessional borrowing in the IMF program and is not expected to be repeated. The authorities' commitment to reduce total public debt to 50 percent of GDP by the medium term is consistent with a fall back in the external debt ratio beginning in 2009.

The DSA suggests that external debt sustainability will be easily maintained. On current assumptions—which include declining debt concessionality, a gradual slowdown in remittances, and somewhat lower export growth in later years—retaining sustainability looks easily manageable as external debt declines on an NPV basis to below 16 percent of GDP in the medium term (Appendix Table 3). Despite the shift to less concessional debt, the projected public debt service ratio declines from 14 percent of revenues in 2008 to between 8 and 10 percent in the medium term. Over the forecast horizon we assume that FDI gradually becomes more important as a source of financing for investment and the private

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[1] The assumptions underlying the DSA are little changed from the previous assessment: Real GDP growth of around 6 percent, inflation 3 percent and an appreciation of the real effective exchange rate of ¾ percent per year. Export growth at 8-13 percent over the forecast horizon is considerably lower than the historical average of around 30 percent, since this included a period of transition and catch up. FDI is expected to increase gradually over the forecast horizon, reaching 5.3 percent of GDP.

sector increasingly takes on external debt. The probability of a relatively low level of external debt distress is supported by the World Bank's Country Policy and Institutional Assessment (CPIA), which links the quality of a country's policies and institutions to thresholds for debt sustainability. The CPIA classifies Albania as a medium performer—but very close to being upgraded to the high performer level, falling just 0.1 percentage point short. External debt remains well below the indicative sustainability thresholds of NPV of debt to GDP of 40 percent and debt to exports of 150 percent.[2]

The total public debt ratio falls below 50 percent of GDP in 2011 and declines over the forecast horizon such that the debt ratio is close to 32 percent of GDP by 2028 (Appendix Table 1). This is predicated on restraint of public expenditure (kept to below 30 percent of GDP), a further gradual increase in revenue collection, and the fiscal deficit narrowing from 5.2 percent of GDP in 2008 to below 4 percent of GDP beginning in 2009. Looking further ahead the public sector deficit stabilizes at 2.2 percent of GDP from 2013 onward. Under these conditions, total public debt remains on a sustainable downward path, although the public sector debt to GDP ratio remains above the indicative CPIA threshold until 2017. This points to the importance of continued efforts towards debt reduction.

However, public debt remains vulnerable to an export or growth shock, or to a lapse in fiscal policy. While the stress tests show that external debt remains sustainable under a number of standard shocks, it still appears vulnerable to an export shock, which moves the debt to export ratio to above 100 percent (Appendix Table 4 and Appendix Figure 2). Furthermore, the low growth scenario (see paragraph 15) shows how a lower growth path, combined with a lack of fiscal discipline, quickly results in a rising rather than falling path for the public debt to GDP ratio (Appendix Table 2 and Appendix Figure 1).

Moreover, increased commercial borrowing brings new risks—such as higher costs associated with the under-execution of capital spending and sudden reversals in risk appetite. To date, external debt has been largely contracted from bilateral and multilateral institutions and so debt has accumulated only at the pace at which the authorities are able to execute capital spending—foreign-financed capital spending has been very low relative to each year's budget projections. With commercial borrowing, the under-execution of capital spending no longer provides a binding constraint on the accumulation of debt. Instead, debt is contracted at issue and interest costs are incurred regardless of whether the proceeds are spent. As Albania prepares to shift to more commercial financing, the capacity to accurately

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[2] The Country Policy and Institutional Assessment (CPIA) rates countries against a set of 16 criteria grouped in four clusters: (i) economic management; (ii) structural policies; (iii) policies for social inclusion and equity; and (iv) public sector management and institutions. Albania scores relatively highly for economic management and structural policies but has lower scores for policies for social inclusion and public sector management.

project capital spending needs, and to implement capital spending, thus becomes even more important. Moreover, potential exposure to risk appetite reversals heightens the need for a clear and credible fiscal anchor that is communicated effectively to the markets. Finally, debt management capacities need to be strengthened to ensure that the risk and cost trade-offs are adequately analyzed.

Table A.1. Albania: Public Sector Debt Sustainability Framework, Baseline Scenario, 2007-2028

(In percent of GDP, unless otherwise indicated)

	Actual			Estimate	Projections												
	2007	Historical Average 5/	Standard Deviation 5/	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-13 Average	2020	2028	2014-28 Average
Public sector debt 1/	53.1			53.5	52.0	50.4	48.6	46.7	45.2	43.8	42.5	41.4	40.3		37.5	32.8	
o/w foreign-currency denominated	15.5			17.6	17.5	17.6	17.3	16.9	16.6	14.7	13.9	13.0	12.2		10.5	0.0	
Change in public sector debt	-2.9			0.4	-1.5	-1.6	-1.9	-1.8	-1.6	-1.4	-1.3	-1.2	-1.1		-0.8	-0.4	
Identified debt-creating flows	-2.8			0.3	-1.8	-1.7	-2.1	-2.0	-1.7	-2.0	-1.5	-1.4	-1.3		-1.0	0.0	
Primary deficit	1.2	1.6	1.1	2.1	0.1	0.0	-0.4	-0.4	-0.4	-0.3	-0.2	-0.2	-0.1	0.2	0.1	0.3	0.1
Revenue and grants	25.5			27.7	27.3	28.0	28.5	28.6	28.7	28.7	28.7	28.7	28.7		28.7	28.7	
of which: grants	0.1			0.4	0.2	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	26.7			29.8	27.3	28.0	28.2	28.2	28.3	28.4	28.5	28.5	28.6		28.7	29.0	
Automatic debt dynamics	-2.3			-1.4	-1.6	-1.5	-1.4	-1.4	-1.0	-1.5	-1.1	-1.0	-1.0		-0.9	-0.3	
Contribution from interest rate/growth differential	-1.8			-1.2	-1.4	-1.3	-1.3	-1.2	-1.0	-1.0	-1.0	-1.0	-0.9		-0.9	-0.3	
of which: contribution from average real interest rate	1.4			1.8	1.7	1.6	1.7	1.6	1.7	1.6	1.5	1.5	1.4		1.3	1.6	
of which: contribution from real GDP growth	-3.2			-3.0	-3.1	-3.0	-2.9	-2.9	-2.6	-2.6	-2.5	-2.4	-2.3		-2.2	-1.9	
Contribution from real exchange rate depreciation	-0.5			-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.5	-0.1	-0.1	-0.1		...	...	
Other identified debt-creating flows	-1.7			-0.4	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2		-0.1	0.0	
Privatization receipts (negative)	-1.7			-0.4	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2		-0.1	0.0	
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	
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	
Other (specify, e.g. bank recapitalization)	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	-0.1			0.1	0.3	0.2	0.2	0.2	0.1	0.7	0.3	0.2	0.2		0.1	-0.5	
NPV of public sector debt	48.3			49.4	47.7	46.5	45.1	43.8	42.5	42.7	41.9	41.2	40.5		38.0	32.8	
o/w foreign-currency denominated	10.7			13.5	13.2	13.6	13.8	14.0	13.9	13.7	13.3	12.9	12.4		11.0	0.0	
o/w external	10.7			17.6	16.8	16.7	16.2	15.6	15.0	14.8	14.1	13.4	12.7		10.9	10.5	
NPV of contingent liabilities (not included in public sector debt)	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	
Gross financing need 2/	5.0			4.7	4.4	4.1	3.9	3.6	3.5	3.3	3.4	3.5	3.5		3.1	0.0	
NPV of public sector debt-to-revenue and grants ratio (in percent)	189.3			178.0	174.6	166.0	157.9	153.1	148.3	149.0	146.2	143.7	141.4		132.5	114.2	
NPV of public sector debt-to-revenue ratio (in percent)	190.3			180.8	176.1	167.1	158.8	153.9	148.9	149.0	146.2	143.7	141.4		132.5	114.2	
o/w external 3/	42.1			64.4	62.2	59.9	57.2	54.8	52.6	51.5	49.2	46.8	44.4		38.0	36.6	
Debt service-to-revenue and grants ratio (in percent) 4/	12.9			14.0	13.9	13.3	12.8	12.4	12.4	12.6	12.8	12.8	12.5		10.7	8.3	
Debt service-to-revenue ratio (in percent) 4/	13.0			14.2	14.0	13.4	12.9	12.4	12.5	12.6	12.8	12.8	12.5		10.7	8.3	
Primary deficit that stabilizes the debt-to-GDP ratio	4.1			1.7	1.5	1.6	1.5	1.5	1.2	1.1	1.1	1.0	1.0		0.9	0.8	
Key macroeconomic and fiscal assumptions																	
Real GDP growth (in percent)	6.0	6.9	2.6	6.0	6.1	6.1	6.2	6.3	6.0	6.0	6.0	6.0	6.0	6.1	6.0	6.0	6.0
Average nominal interest rate on forex debt (in percent)	2.0	1.6	0.6	4.4	4.6	5.2	5.3	5.3	5.3	5.1	5.4	6.3	6.4	5.0	5.8	0.0	5.6
Average real interest rate on domestic currency debt (in percent)	3.5	7.9	5.2	3.7	3.6	3.5	3.7	3.8	4.2	4.0	3.8	3.3	3.3	3.7	3.6	5.5	3.7
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.0	-4.3	7.5	-1.0	...	...	...	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.9	4.5	3.3	3.8	3.1	2.9	2.7	2.5	2.1	2.4	2.5	2.5	2.5	2.8	2.5	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	9.8	7.6	6.9	18.5	-2.8	8.8	6.7	6.6	6.2	6.3	6.3	6.3	6.2	7.3	6.2	6.1	6.2
Grant element of new external borrowing (in percent)	20.6	2.1	6.5	9.2	21.7	11.7	13.4	12.2	12.2	12.0	11.7	11.7	11.5	13.4	10.9	10.2	...

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

1/ General government debt and publically guaranteed debt.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table A. 2. Albania: Sensitivity Analysis for Key Indicators of Public Debt 2008-2028

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
NPV of Debt-to-GDP Ratio								
Baseline	49	48	46	45	44	43	40	33
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	49	49	49	49	49	49	50	45
A2. Primary balance is unchanged from 2008	49	49	50	51	52	52	57	58
A3. Permanently lower GDP growth 1/	49	48	47	47	46	46	49	61
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2	49	49	49	49	48	48	48	45
B2. Primary balance is at historical average minus one standard deviations in 20	49	50	51	50	48	47	43	34
B3. Combination of B1-B2 using one half standard deviation shocks	49	50	51	49	48	46	43	34
B4. One-time 30 percent real depreciation in 2009	49	53	52	51	50	48	46	37
B5. 10 percent of GDP increase in other debt-creating flows in 2009	49	57	55	53	52	50	46	36
NPV of Debt-to-Revenue Ratio 2/								
Baseline	178	175	166	158	153	148	138	114
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	177	178	173	170	170	169	173	158
A2. Primary balance is unchanged from 2008	177	181	179	178	181	183	199	202
A3. Permanently lower GDP growth 1/	177	176	169	163	161	160	171	213
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2	177	179	176	171	169	166	167	157
B2. Primary balance is at historical average minus one standard deviations in 20	177	183	183	174	168	163	149	119
B3. Combination of B1-B2 using one half standard deviation shocks	177	182	181	172	167	161	148	118
B4. One-time 30 percent real depreciation in 2009	177	196	186	178	173	168	159	128
B5. 10 percent of GDP increase in other debt-creating flows in 2009	177	208	197	187	181	175	159	125
Debt Service-to-Revenue Ratio 2/								
Baseline	14	14	13	13	12	12	11	8
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	14	15	15	15	15	15	15	14
A2. Primary balance is unchanged from 2008	14	15	16	16	16	16	17	19
A3. Permanently lower GDP growth 1/	14	15	14	13	13	13	15	19
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2	14	16	14	14	14	14	14	13
B2. Primary balance is at historical average minus one standard deviations in 20	14	15	16	17	13	13	12	9
B3. Combination of B1-B2 using one half standard deviation shocks	14	15	16	16	13	13	12	9
B4. One-time 30 percent real depreciation in 2009	14	16	15	14	14	14	13	10
B5. 10 percent of GDP increase in other debt-creating flows in 2009	14	15	25	17	14	13	13	10

Sources: Country 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.

Table A.3. Albania: External Debt Sustainability Framework, Baseline Scenario, 2007–28 1/
(In percent of GDP, unless otherwise indicated)

	Actual	Historical Average 6/	Standard Deviation 6/	Projections									
										2007–13			2014–28
	2007			2008	2009	2010	2011	2012	2013	Average	2018	2028	Average
External debt (nominal) 1/	**18.3**			**19.7**	**19.2**	**19.0**	**18.8**	**18.5**	**18.2**		**16.0**	**16.4**	
o/w public and publicly guaranteed (PPG)	16.5			18.2	18.0	17.9	17.5	17.1	16.5		12.4	10.8	
Change in external debt	-1.4			1.4	-0.4	-0.2	-0.2	-0.3	-0.3		-0.4	0.2	
Identified net debt-creating flows	2.6			6.2	2.3	1.8	0.9	0.0	-0.8		-1.3	-1.1	
Non-interest current account deficit	**9.5**	**6.7**	**2.4**	**10.0**	**6.9**	**6.1**	**5.6**	**4.9**	**4.5**		**3.9**	**4.4**	4.2
Deficit in balance of goods and services	26.5			26.8	23.4	22.3	21.6	20.8	20.3		18.4	16.4	
Exports	27.9			28.2	28.1	28.4	29.0	29.6	30.4		30.1	27.8	
Imports	54.5			55.1	51.5	50.8	50.6	50.4	50.6		48.5	44.2	
Net current transfers (negative = inflow)	-13.5	-13.5	1.7	-13.3	-13.2	-13.2	-13.2	-13.2	-13.1		-12.0	-9.8	-11.3
o/w official	-1.0			-1.0	-0.9	-0.7	-0.6	-0.5	-0.5		-0.2	-0.1	
Other current account flows (negative = net inflow)	-3.4			-3.5	-3.3	-3.0	-2.8	-2.7	-2.7		-2.5	-2.2	
Net FDI (negative = inflow)	**-6.0**	**-3.6**	**1.4**	**-3.6**	**-4.3**	**-4.2**	**-4.5**	**-4.8**	**-5.3**		**-5.3**	**-5.6**	-5.4
Endogenous debt dynamics 2/	**-0.9**			**-0.2**	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**0.0**		**0.0**	**0.1**	
Contribution from nominal interest rate	0.6			0.8	0.9	1.0	1.0	1.0	1.0		0.9	1.0	
Contribution from real GDP growth	-1.1			-1.0	-1.1	-1.1	-1.1	-1.1	-1.0		-0.9	-0.9	
Contribution from price and exchange rate changes	-0.5			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**-4.0**			**-4.9**	**-2.8**	**-2.0**	**-1.2**	**-0.3**	**0.5**		**0.9**	**1.3**	
o/w exceptional financing	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	17.7			19.1	18.0	17.8	17.5	17.1	16.8		15.4	15.4	
In percent of exports	63.5			67.5	64.1	62.7	60.5	57.7	55.2		51.1	55.5	
NPV of PPG external debt	**16.0**			**17.6**	**16.9**	**16.7**	**16.2**	**15.6**	**15.0**		**11.7**	**9.8**	
In percent of exports	**57.2**			**62.4**	**59.9**	**58.6**	**56.0**	**52.7**	**49.4**		**38.9**	**35.2**	
In percent of government revenues	**63.0**			**68.0**	**64.1**	**63.2**	**61.5**	**59.2**	**56.7**		**44.4**	**37.0**	
Debt service-to-exports ratio (in percent)	**5.5**			**6.9**	**7.5**	**7.7**	**7.3**	**6.9**	**7.2**		**7.5**	**8.5**	
PPG debt service-to-exports ratio (in percent)	**3.5**			**5.0**	**5.5**	**5.8**	**5.8**	**5.7**	**5.9**		**4.7**	**3.8**	
PPG debt service-to-revenue ratio (in percent)	**3.8**			**5.5**	**5.9**	**6.3**	**6.4**	**6.4**	**6.8**		**5.3**	**4.0**	
Total gross financing need (billions of Euro)	0.4			0.7	0.5	0.5	0.4	0.3	0.2		0.2	0.7	
Non-interest current account deficit that stabilizes debt ratio	11.0			8.7	7.3	6.3	5.8	5.2	4.8		4.3	4.2	
Key macroeconomic assumptions													
Real GDP growth (in percent)	6.0	7.0	2.6	6.1	6.3	6.2	6.2	6.2	6.1	6.2	6.0	6.0	6.0
GDP deflator in Euro terms (change in percent)	2.4	7.8	6.4	4.5	3.2	2.9	2.7	2.6	2.7	3.1	3.0	3.0	3.0
Effective interest rate (percent) 5/	3.5	1.9	0.7	4.7	4.9	5.4	5.7	5.8	5.9	5.4	6.3	6.6	6.7
Growth of exports of G&S (Euro terms, in percent)	20.6	30.1	31.1	12.1	9.2	10.4	11.2	11.5	11.6	11.0	8.5	8.4	8.5
Growth of imports of G&S (Euro terms, in percent)	20.0	20.1	10.4	12.1	2.6	7.6	8.7	8.7	9.3	8.2	8.2	8.2	8.2
Grant element of new public sector borrowing (in percent)	...	...	...	9.2	21.7	11.7	13.4	12.2	12.2	13.4	11.4	10.2	10.6
Aid flows (in billions of Euro) 7/	0.2			0.2	0.2	0.1	0.1	0.1	0.1		0.1	0.3	
o/w Grants	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Concessional loans	0.1			0.1	0.1	0.1	0.1	0.1	0.1		0.1	0.2	
Grant-equivalent financing (in percent of GDP) 8/	...			0.4	0.5	0.3	0.3	0.2	0.2		0.2	0.2	0.2
Grant-equivalent financing (in percent of external financing) 8/	...			9.2	21.7	11.7	13.4	12.2	12.2		11.4	10.2	10.6
Memorandum items:													
Nominal GDP (billions of Euro)	7.9			8.7	9.6	10.5	11.4	12.4	13.6		21.0	50.7	
(NPVt-NPVt-1)/GDPt-1 (in percent)				3.5	0.9	1.4	1.0	0.8	0.7	1.4	0.3	1.3	0.7

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in Euro terms.

3/ 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 cl

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

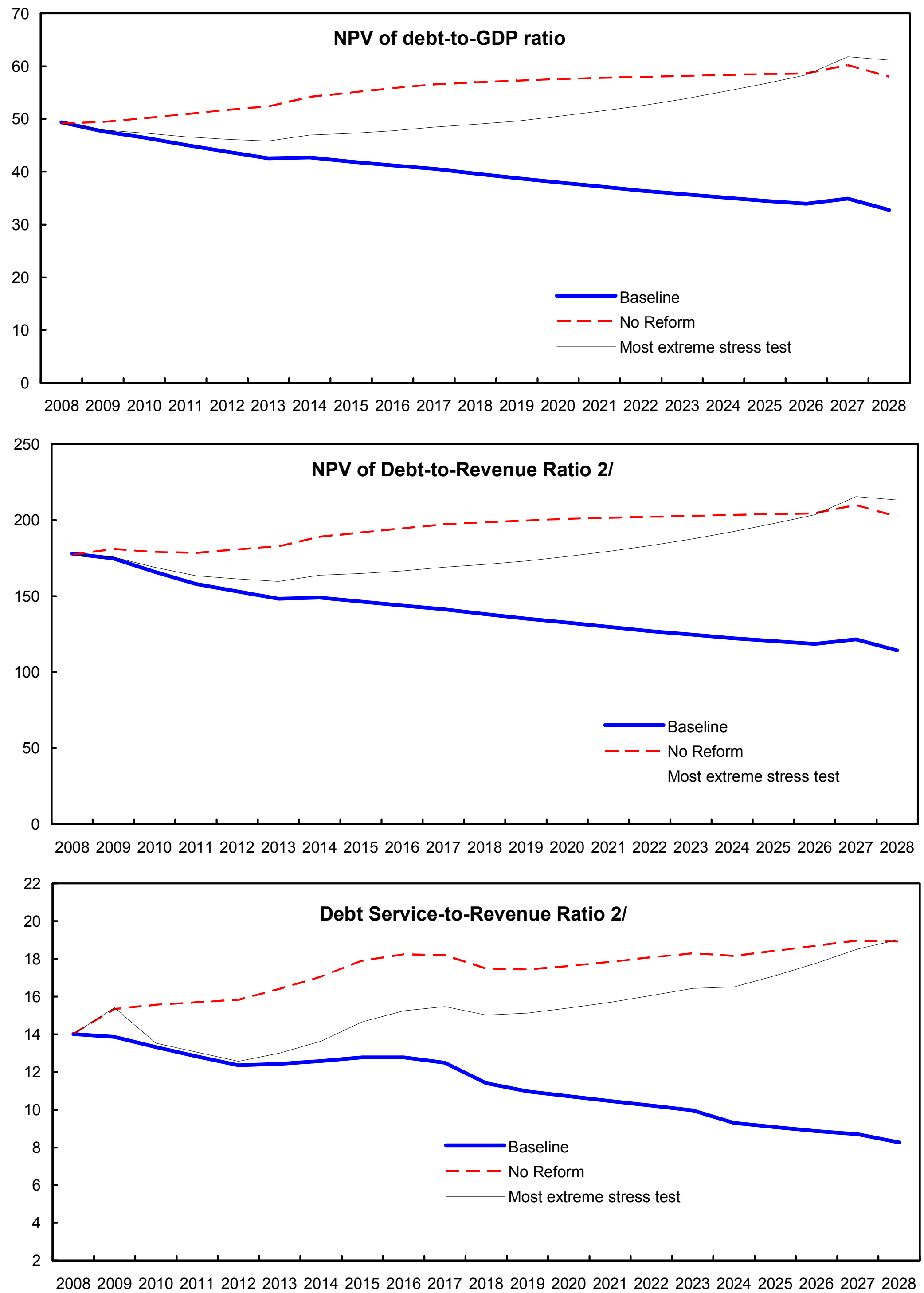
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the NPV of new debt).

Table A.4. Albania: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2008–28
(In percent of GDP)

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
NPV of debt-to-GDP ratio								
Baseline	18	17	17	16	16	15	12	10
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2009–28 1/	18	16	17	17	19	21	27	27
A2. New public sector loans on less favorable terms in 2009–28 2/	18	17	17	17	17	16	14	13
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2009–10	18	17	17	17	16	16	12	10
B2. Export value growth at historical average minus one standard deviation in 2009–10 3/	18	20	25	24	23	22	13	10
B3. Euro GDP deflator at historical average minus one standard deviation in 2009–10	18	17	17	17	16	15	12	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-	18	20	24	23	22	21	13	10
B5. Combination of B1-B4 using one-half standard deviation shocks	18	16	13	13	13	12	11	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	18	24	23	23	22	21	17	14
NPV of debt-to-exports ratio								
Baseline	62	60	59	56	53	49	39	35
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2009–28 1/	62	59	58	60	63	69	91	97
A2. New public sector loans on less favorable terms in 2009–28 2/	62	61	61	59	57	54	46	48
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2009–10	62	60	59	56	53	49	39	35
B2. Export value growth at historical average minus one standard deviation in 2009–10 3/	62	77	107	101	96	88	52	43
B3. Euro GDP deflator at historical average minus one standard deviation in 2009–10	62	60	59	56	53	49	39	35
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-	62	73	83	79	75	68	42	35
B5. Combination of B1-B4 using one-half standard deviation shocks	62	54	44	42	40	38	35	32
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	62	60	59	56	53	49	39	35
NPV of debt-to-revenue ratio								
Baseline	68	64	63	62	59	57	44	37
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2009–28 1/	68	63	63	65	71	79	104	102
A2. New public sector loans on less favorable terms in 2009–28 2/	68	66	66	65	64	62	53	50
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2009–10	68	65	65	64	61	59	46	38
B2. Export value growth at historical average minus one standard deviation in 2009–10 3/	68	74	93	91	87	82	48	37
B3. Euro GDP deflator at historical average minus one standard deviation in 2009–10	68	65	65	64	61	59	46	38
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-	68	78	90	87	84	78	48	37
B5. Combination of B1-B4 using one-half standard deviation shocks	68	60	51	50	48	46	42	36
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	68	90	89	87	83	80	63	52

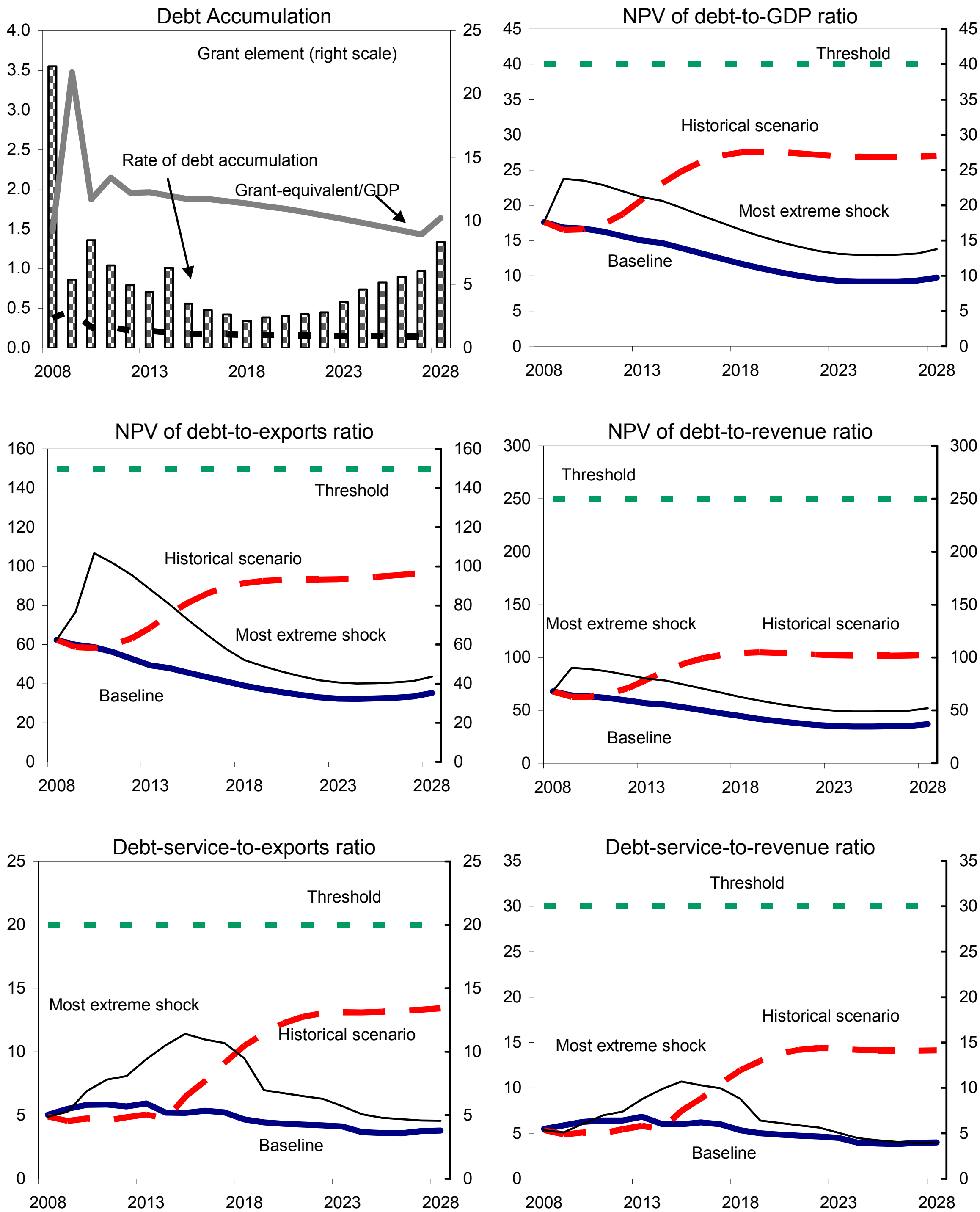
Source: Staff estimates.

Figure A.1. Albania: Indicators of Public Debt Under Alternative Scenarios, 2008-2028 1/



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2018.
2/ Revenue including grants.

Figure A.2. Albania: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2008–28



Sources: Staff projections and simulations.

Appendix II: Fund Relations

As of May 31, 2008

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	51.44	105.62
Reserve position in Fund	3.35	6.89

III. **SDR Department**:

	SDR Million	Percent Allocation
Holdings	8.83	N/A

IV. **Outstanding Purchases and Loans**:

	SDR Million	Percent Quota
Extended Arrangement	6.09	12.50
PRGF Arrangements	50.04	102.75

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	6.09
PRGF	2/01/2006	1/31/2009	8.52	6.09
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		
	2008	2009	2010	2011	2012
Principal	6.31	9.08	8.15	8.15	7.64
Charges/Interest	0.36	0.44	0.39	0.33	0.24
Total	6.67	9.52	8.54	8.48	7.88

VII. **Safeguards Assessments:**

The Bank of Albania (BoA) was subject to a safeguards assessment with respect to current arrangements. The most recent assessment was completed on July 14, 2006 and found that some weaknesses exist in the central bank's safeguards framework. The main vulnerabilities identified by the assessment concern the quality of the external audit, 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. The authorities have already taken steps to improve the external audit process, and staff will monitor their implementation of the remaining recommendations.

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 expect to resolve by end-2008. Albania has not imposed new restrictions under Article VIII. The exchange rate stood at Lek 78.6 per U.S. dollar at end-May, 2008.

IX. **Article IV Consultation:**

The conclusion of the 2006 Article IV consultation and the first review under the PRGF/EFF-supported program took place in July 2006 (IMF Country Report No. 06/286). 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. The extent and focus of Fund TA over the past two years is briefly reviewed below.

Technical assistance from MCM has focused on two main areas: monetary policy and banking supervision. In the monetary policy area, a resident advisor assisted the Bank of Albania during the initial transition to an implicit inflation targeting regime. This was followed by short expert visits that focused on monetary policy decision processes, as well as more technical background work such as modeling and forecasting. The results of the TA have been favorable, with a significant boost in quality of the monetary policy decision-making process, as evidenced, inter alia, by inflation performance as well as research output. In the banking supervision area, following assistance in the implementation of a Supervisory Development Plan through 2005, TA missions have helped the authorities focus on stress testing, rapid credit growth and other emerging issues. A mission in February 2008 focused on assisting the authorities to draw up an action plan for the further development of their banking supervisory practices. Ongoing assistance with the implementation of a credit registry contributed to the successful inauguration of the registry at end-2007. Assistance has also been recently provided to assist in the creation of a delivery-versus-payments system for secondary market sales of government securities.

Recent technical assistance from FAD has concentrated in two main areas: tax administration and debt management. In strengthening tax administration, Fund TA covered improving the large taxpayer operations, review of computerization program, and transfer of responsibility for the collection of social insurance contributions from Social Insurance Institute to the General Department of Taxation. FAD also provided assistance on reform and development of public debt management, including the strategic, legal and institutional framework, development of domestic securities market and the integration of debt and cash management.

Recent technical assistance from LEG included help legislative drafting and supervisory guidance for AML/CFT and banking supervision, and for amendments to the Central Bank Law—and related agency agreements between the Bank of Albania and the Ministry of Finance.

Technical assistance from STA covered national income accounts, balance of payments, consumer price index, and data dissemination. While a previous resident technical expert financed by the Fund helped official statistical agency improve national accounts coverage to informal sector, a new peripatetic technical assistance project has started in February

2008 to increase frequency and enhance accuracy of these accounts. In strengthening balance of payments statistics, Fund TA supported the rapid progress with regard to the accuracy and frequency of data. However, poor source data constitutes a problem in making further progress especially in analyzing current transfers. A Fund mission assisted the authorities in updating the basket of goods used to calculate the CPI index. A data ROSC mission visited Albania in March 2006. While Albania is successfully subscribes to GDDS, the authorities have expressed their intension of subscribing to the SDDS. A recent TA mission has evaluated the requirements for the SDDS and concluded that the main obstacle is the lack of quarterly national accounts data. A recent mission also assisted the authorities in updating and rebasing the consumer price index.

Generally, the authorities welcomed the technical assistance from the Fund and made extensive efforts to adopt the TA recommendations. However, further institutional development is required in virtually every sector.

IX. **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 III: World Bank Relations

Partnership in Albania's Development Strategy

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 69 loans mostly in IDA commitments totaling US$954.1 million, IFC commitments ofUS$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.

The World Bank's Board approved the Country Assistance Strategy (CAS) for Albania for FY06-FY09 in January 2006. The CAS builds on the experience of the World Bank Group (WBG) since the early 1990s (through three CASS).[1] 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).

The government approved the new National Strategy for Development and Integration (in March 2007) and is committed to better address the link between the strategic planning process, the Medium Term Budget Program (MTBP) and the annual budget in the context of newly established Integrated Planning System (IPS). The IPS aims to allow the Government of Albania (GoA) to prioritize its expenditures based on a national strategy that focuses on the European Integration agenda. A government executed multi-donor trust fund (MDTF) has been established with financing from various donors in order to ensure increased and transparent linkage between NSDI objectives and government policy and budget allocations and expenditures

Bank Group Strategy

Reflecting Government priorities, the CAS (2006–09) program seeks to support Albania's efforts in strengthening governance, sustaining a private sector-led growth and improving service delivery. The 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

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

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.

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 is financed by a blend of IDA and IBRD resources, with gradual transition from IDA to IBRD beginning in FY06. Up to 11 IDA/IBRD lending operations are proposed in FY06-FY09, of which three would be a series of programmatic Development Policy Operations (DPO) 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. A project on improving the secondary and local roads is expected to be approved by the Board in June. Another project on the safety of dams is expected to be approved later in 2008. A CAS Progress Report (CAS PR) is expected for presentation to Board in June 2008.

The active World Bank portfolio includes 19 investment projects with a total commitment of $311.5million, of which about $275.3 million remain to be disbursed. The investment side of the Bank's portfolio has performed well. Three projects were approved by the Board in 2006: (i) Albania Avian Flu; (ii) BERIS; and (iii) Education Excellence and Equity Project (June 1). Two new projects have been approved in February 2007, the Transport Project and the Land Administration and Management Project. The first Development Policy Operation (DPO) was approved on March 29, 2007. A new project on Secondary and Local Roads was approved on June 3rd, 2008.

Bank-Fund Collaboration in Specific Areas

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; and (v) an improved policy environment for business.

Public expenditure management: Albania's 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 its support to the GoA through the ongoing Programmatic Public Expenditure and Institutional Review (PEIR) and the Country Fiduciary Assessment Update (CFAU-FY06). These have identified key weaknesses in the PFM system and provide the underlying analysis for defining policy reform conditionality in the Development Policy Operation (DPO) that focus on public investment management.

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.

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 remains in place to allow the Government to move ahead with efforts to (a) strengthen accountability mechanisms for public entities, both Ministries and subordinated agencies, rendering them more efficient; (b) increase competitiveness of the salary structure and the ability of the civil service to attract skilled and competent professionals; and (c) consolidate and deepen the measures aimed at the depoliticization of the civil service, both through improved adherence to the requirements of the Civil Service Law, as well as through a cautious, measured 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 through the DPO continues to engage on civil service reform.

Power sector reform: While the Bank has taken the lead in developing the policy agenda, the sector's fiscal impact has also motivated conditionality in previous IMF-PRGF arrangements. Since mid-2006, KESH's financial situation has deteriorated significantly as a result of the following factors: (a) severe shortage in electricity supply in the region which led to a significant rise in import electricity prices; (b) unfavorable hydrology since late 2006; (c) a suboptimal management of hydro resources in the last quarter of 2006; and (d) poor performance of the utility as indicated by low collection rates and large losses. The hydrology and reservoirs management have improved in 2008. The World Bank believes that the tariff increase effected in March 2008 is delayed and insufficient. This and large unpaid electricity consumption continue to hamper KESH's financial situation, which puts the company's investments as well as operational performance at risk. The Bank had to suspend the preparation of an investment project for KESH's distribution because a satisfactory Action Plan for 2008-2010 is yet to be agreed with KESH and the Government. KESH's financial situation remains precarious and is expected to register significant operating losses in 2008 as well. 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 Generation and Restructuring Project (2004) that will provide new thermal generation capacity (expected to be operation in 2009) 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). The World Bank will present to its board an IDA Credit to address safety issues of the country's Hydroelectric Dams in June 2008.

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 are supporting 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.

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 WBG in conjunction with the IMF are assisting the Government in the completion of the financial sector reform agenda and support the implementation of the recommendations of the 2005 Joint IMF-World Bank Financial Sector Assessment Program (FSAP). The DPO is providing support for policy measures aimed at the (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 ED—compatible legal and institutional framework for accounting and auditing.

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

Improving the business environment. 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 is using a combination of instruments. These include the Business Environment Reform and Institutional Strengthening and the Land Management and Urban Development projects in conjunction with the DPO to support improvements in the business climate, through (i) the adoption and implementation of regulatory governance 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.

Prepared by World Bank staff. Questions may be addressed to Ms. Alia Moubayed at 202-473-0250.

Appendix IV: Statistical Issues

Overall data provided to the Fund are adequate 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.[1] Albania participates in the General Data Dissemination System (GDDS).

A March 2006 data ROSC reassessment 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 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 data ROSC report was published on the IMF's external website in October 2006.

A further review of progress towards SDDS subscription was carried out in October 2007. The mission found that the Bank of Albania (BoA) has started disseminating draft versions of the Advance Release Calendar and the National Summary Data Page, covering data from the Institute of Statistics (INSTAT), the Ministry of Finance (MoF) and the BoA. The mission concluded that Albania would be ready for SDDS subscription within 12 to 18 months, assuming that the current momentum in improving data can be maintained. The main obstacles are in real sector statistics, and the ongoing peripatetic technical assistance project will be important in overcoming them.

The ROSC reassessment mission found 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 adoption of an inflation targeting regime; and (iii) growing national interest in joining the European Union. However, due to severe resource constraints at 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, planned Memoranda of Understandings between INSTAT, the MoF and the BoA should facilitate data sharing and coordination among these agencies.

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[1] This data ROSC was completed before the formal adoption of the Data Quality Assessment Framework.

A. Real Sector

Price statistics

The consumer price index (CPI) is reported regularly for publication in the *International Financial Statistics (IFS)*. In 2001, a revision of CPI weights was initiated by INSTAT based on a new household budget survey; the revised index 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.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 patterns put a priority on new CPI weights. 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 in the CPI as they become significant.

In December 2007, INSTAT has updated the CPI weights using the results of a new national-level HBS conducted during the period October 2006-September 2007. A November 2007 STA mission assisted the authorities in resolving compilation issues for the new CPI.

A monthly producer price index (PPI) has been published quarterly since March 2002. Prices are not collected 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 other available price data.

National accounts

National accounts are compiled from 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. While technical assistance has been provided on methodological procedures, source data still do not provide sufficient information to compile reliable estimates on the nonobserved economy. In November 2005, INSTAT released major revisions of the GDP estimates (for 1996–2003) and updates for 2004, reflecting methodological improvements.

The ROSC reassessment 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.

In November 2004 and March 2005 STA missions assisted the authorities in improving the timeliness of the annual estimates and in developing quarterly national accounts. INSTAT has benefited from technical assistance from 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. In addition, STA is currently providing additional technical assistance through peripatetic missions during 2008–09 for the improvement of the annual accounts and the establishment of a compilation system of quarterly GDP estimates.

The first of these peripatetic missions, conducted in February 2008, concluded that INSTAT was not in a position to compile reliable quarterly estimates of GDP and significant further work is needed to increase the capability of the local staff, who lack experience in interpreting and analyzing economic data. Although some experimental quarterly GDP estimates have been compiled, the second mission undertaken in May 2008 strongly recommended INSTAT management to withhold release of the quarterly figures until compilation attains soundness.

External trade

The compilation and dissemination of foreign trade data has improved in recent years, following disruptions in the late 1990s. One important contributing factor has been the implementation of the Automated System of Customs Data (ASYCUDA) software system, 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

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*). The scope of the general government sector is in line with the *GFSM 1986* and encompasses budgetary central government, (about 1520 individual budget institutions), local government (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 provide the MoF with a mandate to compile and disseminate 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 projects; and (iv) the extrabudgetary funds. External donor financed-projects that do not pass through the treasury system, represent a weakness in source data. Following the ROSC mission's recommendation that MoF accelerate work aimed at formally adopting the *GFSM 2001*-based reporting format and improve source data coverage for external donor-financed projects, the authorities have recently begun reporting quarterly fiscal data for publication in the *International Financial Statistics* using the *GFSM 2001*-based monthly Statement of Sources and Uses of Cash. Albania has submitted fiscal data to the Fund for publication in the *Government Finance Statistics Yearbook* for 2001–06.

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 disseminated 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 contrasts with the *MFSM*'s recommendations of accrual accounting. Another deviation from the *MFSM*'s methodology is that the BoA's and commercial banks' holdings of nontradable long-term securities are recorded at book value.

In January 2005, the BoA began reporting its monetary data to STA using Standardized Report Forms (SRFs). The monetary data in the SRFs format have been published in the quarterly *IFS Supplement* since September 2006. The reporting of monetary data in the SRFs format 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 monetary statistics, the ROSC reassessment mission in 2006 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. The authorities have informed STA of good progress towards implementing the ROSC mission's recommendations, particularly those related to the use of market valuation and improvement of the accuracy of the commercial banks' reporting.

D. Balance of Payments

The data compiled by the BoA are methodologically sound, although some of the estimates, particularly for international transactions 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 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 bank reporting system to verify data from enterprise surveys. It also recommended incorporating the results of the direct investment survey as well as investigating the net errors and omissions observed at the level of individual reporting banks. The February 2006 follow-up mission focused on remittances, goods for processing, services (particularly travel services), official transfers, and direct investment.

To further improve compilation and dissemination of statistics, the ROSC reassessment 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, inspect the financial accounts of firms, and 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.

A September–October 2007 mission reviewed the remittances and travel service estimates and reconciled the financial account and International Investment Position. The mission noted strong progress in adopting earlier recommendations but advised that estimation methods for transactions outside the banking system (mostly remittances and investment transactions by nonresident Albanians) require further improvement.

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 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 would need 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 4, 2008

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological Soundness[7]	Data Quality – Accuracy and Reliability[8]
Exchange Rates	06/04/08	06/04/08	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	04/30/08	05/27/08	M	M	M		
Reserve/Base Money	04/30/08	05/27/08	D and M	D and M	M and M	O, O , O , LO	O, LO, LO, O, O
Broad Money	04/30/08	05/27/08	M	M	M		
Central Bank Balance Sheet	04/30/08	05/27/08	D and M	D and M	M and M		
Consolidated Balance Sheet of the Banking System	04/30/08	05/27/08	M	M	M		
Interest Rates[2]	06/03/08	06/03/08	D	D	D		
Consumer Price Index	April 2008	05/20/08	M	M	M	O, LO, O, LO	LO, LO, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	April 2008	05/12/08	M	M	M	LO, O, O, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	April 2008	05/12/08	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/2007	05/12/08	Q	Q	A		
External Current Account Balance	12/2007	03/03/08	Q	I	I	O, O, O, LO	LNO, O, LO, LO, O
Exports and Imports of Goods and Services	12/2007	03/03/08	M	Q	Q		
GDP/GNP	2006	12/2007	A	A	A	O, LNO, O, LO	LNO, O, LO, LO, O
Gross External Debt	12/2007	5/2008	Q	I	NA		
International Investment position[9]	2007	5/2008	A	A	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).
[7] Reflects the assessment provided in the data ROSC published on October 31, 2006, and based on the findings of the mission that took place March 8-22, 2006, for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 8, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.
[9] Includes external gross financial asset and liability positions vis a vis nonresidents. The IIP is currently being developed by the Albanian authorities and is not yet published. The authorities will publish the data once quality checks have been completed.

ATTACHMENT I

Tirana, July 11, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
700 19th Street NW
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The current Fund-supported program, approved in January 2006, remains broadly on track. All quantitative and structural performance criteria have been observed and economic prospects remain favorable, both from the near- and medium-term perspectives. Growth continues to be buoyant, underlying inflation is low, and confidence in the currency and the banking system remains strong. Debt is on a declining and sustainable path. In addition, past and ongoing structural adjustment is now supplying tangible benefits to the economy. We are, consequently, well placed to fully implement the policies and reform agenda described in the attached Memorandum of Economic and Financial Policies (MEFP). These policies are consistent with our National Strategy for Development and Integration.

On this basis, we request completion of the financing assurances review, and completion of both the fifth review under the three-year Poverty Reduction and Growth Facility arrangement and the fifth review under the three-year Extended Fund Facility arrangement. We also request the sixth disbursement and purchase under these arrangements in an aggregate 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

Attachments: Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Memorandum on Economic and Financial Policies (MEFP) for Albania

I. Background and Economic Developments

1. This memorandum provides a detailed description of our policies over the remainder of the 2006–09 program period. It is fully consistent with our National Strategy for Development and Integration (NSDI), which was approved in February 2008.

2. **Our macroeconomic performance since the previous Article IV consultations has been solid.** We have enjoyed a prolonged period of rapid, non-inflationary growth despite the weather-induced disruptions of 2007. Production is becoming broader based as agriculture recovers from the last year's drought and the supply of electricity improves; and our inflation rate remains among the lowest in the region. Prudent fiscal policy was maintained and the public debt burden has been reduced from 58 percent in 2005 to 53 percent of GDP at end 2007, reflecting fiscal consolidation, rapid economic growth, and the allocation of half the proceeds of large privatizations to debt reduction. In 2008, the strong performance of exports continued, partly reflecting rapid expansion of new export products such as chromium. Still, the current account is likely to deteriorate by ½ percent of GDP as a result of adverse terms of trade, while this year's imports are again temporarily boosted by machinery and equipment needed for the construction of the large road project.

3. **But cost pressures are building**. Despite low underlying demand pressure on prices, higher food and energy prices again drove headline inflation above the BoA's target band in March through May 2008. However, the combination of 5 successive 25 basis points increases in the BoA's policy rate since mid-2006 and regulatory tightening staved off second round effects, leaving inflationary expectations well anchored at low levels.

4. **Tax revenue has over performed budget projections.** Personal income tax, VAT and corporate tax collections have been particularly strong. In response to the introduction of the flat tax and the reference wage, personal income tax collections more than doubled in the first quarter of 2008. Despite the reduction of the corporate tax rate, revenues did not decline as projected, as the number of corporate tax payers increased. At the same time, strong nominal growth, imports, and sales, but also administrative improvements, are boosting VAT.

5. **We have also made progress in structural reform, though this has lagged somewhat our success on the macroeconomic front**. We implemented reforms in tax and customs administration, debt management and the financial system; and improved the statistical and legal frameworks. However, poor payment discipline and attendant losses in the electricity sector continue.

- **Tax administration:** More than half of the eligible taxpayers have already started using the Large Taxpayers Office (LTO). Following our campaign to increase the number of social security contributors, the number of contributors has increased by 30,000 in the first quarter of 2008. We have also moved to pay VAT refund claims automatically if validity checks are met (SB, end-April 2008). Finally, following an intensive debate, Parliament has approved the new tax procedures law.

- **Public expenditure and debt management**: We extended the maturity of domestic public debt to an average 421 days in May 2008, thus reducing rollover risk. The new IT system for conducting primary auctions of government securities has reduced operational risk. We decreased the frequency of 3- and 6-month T-bill auctions to a monthly basis, and started to publish the schedule for issuing government securities to the market for the next quarter, which will stimulate additional use of the interbank money market and the secondary market for government securities. We continue to conduct independent feasibility studies for any large project (as defined in the attached Technical Memorandum of Understanding—TMU) financed through nonconcessional borrowing; provide a semi-annual listing and status of all projects considered for nonconcessional financing; and prepare semi-annual reports on the stock of external arrears (all SBs; ongoing). Parliament adopted the new organic budget law.

- **Financial sector supervision**: The credit registry became fully operational and has been incorporated into our off-site examination procedures. It is used by banks in credit decisions, and by the BoA to improve risk management, assessment, and monitoring of delinquent loan levels. The Council of Ministers has approved legislation to transfer supervisory authority over leasing to the Bank of Albania (BoA) and, in the first quarter of 2008, we introduced additional regulations mandating improvements in banks' internal audit systems and treatment of large exposures.

- **Electricity sector**: The independent regulator (ERE) approved an around 19 percent increase in electricity tariffs, which became effective in March 2008. In the first quarter of 2008, we achieved a steady improvement in electricity losses, which were cut by 5 percentage points to 36.3 percent, but the collection rate declined to 73.7 percent—implying that only 47 percent of all electricity supplied is paid, a level far below that anywhere else in the region.

II. Strategy, Objectives, and Policies

6. **Our medium-term economic strategy aims to maintain macroeconomic stability and deliver continued strong, private sector-driven, growth.** While macroeconomic and financial sector stability are the essential prerequisites, rapid growth will also require significant progress in raising governance, institutions, and infrastructure to norms of advanced middle income countries.

- **Prudent and well-anchored fiscal policy is key to maintaining macroeconomic stability**. Continued adherence to our medium-term fiscal framework based on a small but increasingly efficient government remains the cornerstone of our strategy. To this effect, we are improving the efficiency of core activities and offloading remaining noncore functions to the private sector. Going forward, we will also give fiscal policy a greater role in demand management.

- **Our monetary policy framework will continue to be based on a 3±1 percent inflation target band, supported by a flexible exchange rate.** While changes to the BoA repurchase rate will remain the main policy instrument, given the still underdeveloped transmission mechanism, we will continue to use regulatory measures to support monetary policy objectives and foster financial stability.

- **Improving the business climate and public infrastructure are essential to boost the economy's potential.** Our program addresses deficiencies through a wide range of institutional reforms, including with respect to the commercial court system and real estate title registration. We will continue making good progress on enhancing public infrastructure such as roads and ports. A private-sector dominated and diversified electricity sector is critical to ensure a stable supply of electricity at low cost.

A. Macroeconomic Framework

7. **The medium-term macroeconomic framework envisaged at the start of the year remains appropriate**. Over the medium term, growth is projected to surpass 6 percent, beginning in 2008 as higher supply prices and the return of normal rainfall spur agriculture production and other sectors of the economy benefit from a more stable supply of electricity. Over time, better infrastructure, easing of market entry barriers, more competitive product markets, and governance and administrative reforms will support the needed gains in total factor productivity. Strengthening export growth, buoyant remittances, and declines in electricity and road-related imports will decrease our reliance on foreign savings and allow the current account deficit to return to more moderate and sustainable levels beginning in 2009.

8. **The main risks to this framework arise from the global inflation and growth outlook, fiscal slippages, threats to financial stability, and incomplete reform in the energy sector**. We will therefore retain policy vigilance, including by ensuring a broadly neutral fiscal stance, sufficient budgetary contingencies, proactive financial sector supervision, and tight oversight over energy reform.

B. Fiscal Policy

9. **The 2008 mid-year budget review will contain the deficit at 5.2 percent of GDP.** This level avoids creation of a fiscal stimulus, when account is taken of the high import content of the large road project. We will cover the budget costs of compensation for the Gerdec explosion 0.2–0.3 percent of GDP from budgetary contingencies. To mitigate the social impact of increased foodstuff prices, we will use the wage and pension contingency (4.6 billion lek) to finance targeted subsidies to vulnerable segments of the population. Conversely, to avoid fueling a wage-price inflation spiral, we will hold personnel expenditures, including social insurance contributions, within the originally approved amount of 68 billion lek. We will use the revenue over-performance to pay for the infrastructure projects including recent cost overruns on the Rreshen-Kalimash road—whose total cost, excluding VAT, is now projected to amount to €630 million. We will also maintain a

contingency of ¾ percent of GDP that will allow us to contain further fiscal risks, including those resulting from any further cost overruns on the road and from KESH's financial difficulties. These contingencies would be assessed and reallocated at the next program review. In addition, half the revenue of any unbudgeted privatization will continue to be used to reduce public debt and the other half for expenditure on well-conceived investment projects. Should the fiscal deficit target be in jeopardy, we stand ready, in consultation with the Fund, to take appropriate actions, including offsetting reductions in other expenditure.

10. **To signal our commitment to sound fiscal management, we will continue to reduce public debt, aiming to bring it below 50 percent of GDP over the medium term**. The annual implementation of this target will be carried out either through a cap on the overall fiscal deficit or expenditure consistent with that objective. We will consult with the Fund on the specific form of such rule best suited to Albania's specific circumstances.

11. **While changes in tax policy will be limited, further tax administration effort will be focused primarily on bringing actual collections in line with potential yields.** We will limit changes in tax policy in 2008 to increasing the property tax rate and the royalty tax imposed on extraction of minerals, raising the infrastructure impact tax on newly constructed buildings, further decentralizing certain national fees and charges to local governments, and introducing a new local charge on nonagricultural land. We are on track to increase the number of taxpayers paying social contributions (excluding contributions paid by agricultural workers and voluntary contributors) to 410,000 by the end-July 2008 (SB). We will continue to issue quarterly progress reports on the use of the risk assessment module of the ASYCUDA system to perform inspections in customs (SB; ongoing).

12. **Improving the implementation of capital projects remains a priority of public expenditure management.** Following the introduction of the new public investment management procedures and the new procurement law, we now focus on improving ministries' capacity to implement procedures. With external support, we are accelerating the training of investment officers, and introducing an integrated planning system to allow on-time monitoring of all public investment projects and facilitate any eventual reallocation.

C. Reform of the Electricity Sector

13. **Apart from redressing financial losses in the electricity sector, we will also tackle poor payment discipline and reduce vulnerability to weather shocks**. We expect that privatization of the distribution arm of KESH will enforce more payment discipline and eliminate quasi-fiscal losses emanating from the power sector. We are also taking actions to diversify domestic generation and more fully integrate Albania into the regional power grid.

14. **We are progressing towards privatization**. With assistance from USAID, we established the required market structure and regulations for full vertical unbundling of KESH, and with assistance from the IFC, we have set up a program aimed at privatizing the distribution arm before end–2008. We have finalized the methodology for tariff adjustment and identified qualified bidders in June 2008. We are aware that the privatization agenda—while technically feasible within 2008—is subject to complex risks. The Ministry of

Economy, Trade, and Energy is carefully monitoring the process to ensure close coordination between KESH, the regulator, IFC, and donors.

15. **A number of projects are underway to diversify electricity supply and further integrate into the regional networks.** Construction of a thermal power plant with a total cost of €97 million, financed jointly by the World Bank, EIB and EBRD, has already started. The plant will increase power supply by 700 GWh a year upon completion in mid-2009. A rehabilitation contract for the thermal power plant at Fier is under negotiation and will further increase supply by 800 GWh at completion. Additionally, to increase private sector involvement in generation, we are in the process of concessioning two new large hydro power plants. Work on a new transmission line to Montenegro has begun with assistance from KfW which, when completed in the second half of 2009, will significantly increase cross-border transmission capacity.

16. **Nevertheless, immediate measures to boost KESH's cash flow are important.** In addition to the recent increase in electricity tariffs, we have adopted a new action plan that aims at raising the effective collection rate to 60 percent by further reducing distribution losses to 32 percent and boosting collections to 89.6 percent. With higher technical losses in winter, this is consistent with raising the effective collection rate to 62 percent by end-October (SB). After clearing all past arrears of budgetary and non-budgetary institutions to KESH in 2007, we will ensure that these institutions henceforth pay power bills in a timely manner. KESH is expected to bill eligible customers at the higher regulated rate to recover import cost and the distribution fee. We adopted sufficient measures to reduce the quasi-fiscal losses of KESH to below 1.2 percent of GDP in 2008 (SB; mid-June, 2008). These measures include containing KESH's personnel cost, limiting the electricity imports to 2100 GWh this year and limiting local investment at 2.7 billion lek. If needed, we will take further measures to meet the quasi-fiscal losses target. These short-run improvements in the company's financing should also facilitate the privatization of the distribution arm.

D. Monetary, Exchange Rate, and Financial Sector Policies

17. **In the current less-benign global environment, our primary concern is to keep inflationary expectations anchored at low levels**. We will therefore react quickly to any rise in underlying price pressures that might signal the emergence of second round effects, including by proactively raising our policy rate if needed. We will also intensify our existing policy of maintaining open and transparent communications with the market. With the fiscal stance broadly neutral, a resurgence of credit growth and threats to financial stability remain the principal risks; and we will therefore continue to supplement monetary policy actions with efforts to further tighten the regulatory and supervisory environment to contain credit growth and safeguard the quality of the loan portfolio.

18. **We are pushing ahead with efforts to further strengthen regulation and supervision**. Data indicate that the banking system remains solvent, liquid and profitable, and point to only a slight deterioration in the level of nonperforming loans. We are mindful, however, that this portfolio has never been tested by adverse economic conditions and that its rapid growth can temporarily conceal an underlying deterioration. Also, collateral execution

remains weak, particularly as concerns residential housing which makes up an increasing share of lending. During the remainder of 2008, we will implement the recommendations of the February 2008 IMF technical assistance mission and carry out additional actions to strengthen our capacity to safeguard the financial system. We will:

- Improve the legal and operational framework for executing collateral, including through changes to the Civil Code;

- Further enhance cooperation between BoA and the home country supervisors of resident foreign banks, with an aim to signing formal MOUs; and improve cooperation between the respective domestic financial supervisory authorities and the Ministry of Finance, in particular, to strengthen financial stability and contingency planning for crisis management;

- Enforce better monitoring and managing by banks of the indirect credit risk arising from the extension of foreign currency loans to unhedged borrowers by increasing the level of provisions required for such credit or assigning higher risk weights, setting overall exposure limits to unhedged borrowers at 400 percent of regulatory capital, and mandating that each bank establish a dedicated unit for risk management and economic analysis.

- Increase the transparency of banks towards their customers by mandating clear explanations of the terms and conditions of contracts, including effective interest rates, eliminating misleading marketing practices, and providing a mechanism for dealing with customer complaints. In addition, we will insist on timely disclosure by banks on various aspects of the bank's activities, such as financial performance, strategies and practices of risk administration, risk exposure, organizational structure; and

- Encourage further consolidation of the banking sector and clearly communicate this goal to the market, including by issuing specific provisions governing mergers and acquisitions. In the second half of the year, we will begin revising our regulations governing consumer credit, corporate governance, bank conservatorship and liquidation, and the construction of the capital adequacy ratio.

19. **We will further improve the financial sector architecture**. By end-October we will complete the development of a delivery versus payment (DVP) system for all forms of government securities (SB). As this system will include the capacity to execute private party repurchase agreements, it is expected to improve volumes in the interbank market which, though growing, remain relatively small due in part to perceived credit risk. The purchase and implementation of a fully automated central securities depository IT system is expected to be completed—with IMF assistance—by mid-2009.

20. **We will ensure that the BoA has a sound balance sheet and adequate level of capital.** We will continue to build up the BoA reserve fund to prudent levels, and work towards adopting international best accounting practices in the calculation of BoA profits.

We will make securities issued to compensate BoA for unrealized valuation losses fully marketable by end-September. We will take no legislative or regulatory action that weakens the independence of the BoA, including its control over its budget and its authority to decide on compensation levels.

21. **We will continue reforms in the nonbank financial sector**. We will review and update all insurance laws and regulations by early 2009, with an immediate emphasis on the legislation governing motor vehicle third-party liability and reinsurance. We will consult with the Fund on the tax treatment of private pension funds during the drafting process of a new legal framework governing this industry, and aim to adopt the necessary legislation within 2008. Until the revised legal framework is adopted and supervisory capacity improves, we will continue to follow a prudent approach in the pension industry and restrict participation to the three companies already licensed.

E. External Policies

22. **Prudent external borrowing will remain key to maintaining external debt sustainability.** We are committed to keep external nonconcessional borrowing within the program's cumulative ceiling of €680 million. In 2008, we will use €230 million of foreign bank loans to finance the Rreshen-Kalimash road project. We will continue to conduct independent feasibility studies on all projects being considered for nonconcessional foreign financing, and provide to the Fund a semi-annual listing of projects and progress report on the stock of external arrears (all SBs, ongoing). We will also refrain from financing large development projects through any state-owned special purpose vehicle (SPV) until we have developed additional capacity to fully evaluate such schemes; and will limit the fiscal risks from concessions.

23. **Strengthened debt management capacity is key to proper evaluation and management of the risks of commercial external borrowing.** A new debt strategy is now in place and the debt management Directorate has been reorganized. We will push forward with developing capacity and improving coordination with the medium-term budget. After raising a syndicated commercial loan from a foreign bank, we are considering issuing Albania's first benchmark Eurobond in international capital markets in 2009. We are seeking technical assistance from donors and IMF to ensure that we are adequately prepared to undertake such an operation.

24. **We will further strengthen our liberal trade regime**. The Interim Agreement for Free Trade with the EU and the Central Europe Free Trade Agreement (CEFTA) are promoting the development of regional trade. The free trade agreement with Turkey was ratified by the Albanian parliament and came into force in May 2008. The weighted average tariff rate is expected to decline further to 2.4 percent in 2008.

25. **We continue to make progress on clearing or rescheduling our external arrears.** Outstanding official external arrears have been reconciled with North Korea, Russia, the Bank of Greece, and a consortium of Greek Banks, and are in the process of being reconciled for Vietnam, Algeria and Cuba. We have contacted countries that were part of the former

Yugoslavia (Serbia, Montenegro, FYR Macedonia, Croatia, Bosnia and Herzegovina, and Slovenia) to negotiate terms. We reached agreement with private Swiss companies and two Greek companies to clear arrears in 2008. We are in the process of reconciling outstanding arrears with companies in Austria, Belgium, the U.K., the Netherlands, Sweden India and Denmark. We are working to clear all outstanding external arrears by end 2008 and will not accumulate new external payments arrears. We will continue to provide semi-annual reports to the Fund on the outstanding stock of external arrears within one month of the end of each quarter (SB; ongoing). Once all arrears have been cleared or reschedule we will begin discussions with the Fund with a view to accepting Article VIII.

F. Other Structural Reforms

26. **We are stepping up efforts to implement reforms that are key to improve our business and investment climate**. The National Registration Center (NRC)—a one stop-shop for business registration—has prompted the registration of many more businesses by cutting the legal timeline for registration to only one day and the registration cost to 100 lek. Following this success, we are working to ease the burden of licensing and permits. To support the development of SMEs, we are implementing an action plan prepared based on the approved Strategic Program for 2007–2009. We already made the Competitiveness Fund and Export Guarantee Fund fully operational and effective, and rely more on the increased capacities of Albinvest. We are also taking measures to improve the commercial court system and are pursuing land registration and titling in order to enhance contract enforcement and property rights and ensure long-term sustainable development. To address the regulatory and infrastructure bottlenecks more quickly, we are considering proposals on establishing industrial parks. However, given already low statuary tax rates, we do not envisage any tax incentives for these parks.

27. **Privatization of remaining strategic public assets will continue in 2008**. In June 2008, we approved the sale of 85 percent of the oil refinery ARMO to a US-Swiss consortium which submitted the highest bid for €125 million. Given significant interest shown by foreign insurance companies in Albania, we expect to be able to sell INSIG this year. In addition to the distribution arm of KESH, we will also intensify our efforts to divest the assets of Albpetrol and our minority stake in AMC.

28. **We continue to improve statistics.** Improving the reliability, timeliness and frequency of national accounts statistics remain a top priority. The findings of the household-budget and labor-force surveys—both conducted in 2007—were published in May 2008. We are utilizing these surveys to enhance coverage and reliability of national accounts and short-term statistics. In addition, we will strengthen the collaboration between INSTAT, the BoA and the MoF to improve the quality of economic statistics. We appreciate the extensive technical assistance from the IMF in this area. With IMF assistance, we expect to soon publish our first quarterly national accounts—a key requirement for SDDS. Afterward, we plan to move towards SDDS status. We will ensure that INSTAT has sufficient resources to carry out its mandate.

G. Program Monitoring

29. The seventh disbursement and purchase under the PRGF/EFF-supported program will be based on the end-September, 2008 quantitative performance criteria (Table 1 and the TMU); and completion of the sixth review and financing assurances review. The sixth review under the PRGF and EFF arrangements is expected to be completed no later than February 1, 2009. 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.

Table 1. Albania: Quantitative Performance Criteria and Indicative Targets, March 2008–December 2008 1/

	End-March			End-June			End-September	End-December
	Actual	2008	Prog. (Adj.)	Actual	2008	Prog. (Adj.)	2008	2008
		Prog.			Prog.		Prog.	Prog.
	(In billions of lek)							
Ceiling on net domestic credit to the government 2/	5.1	6.3	23.5	...	12.6	...	14.3	19.0
Ceiling on accumulation of net domestic assets of the BOA 3/	-12.2	1.7	1.7	...	10.1	...	18.8	13.0
Indicative total tax revenue target 4/	71.7	51.1	51.1	...	108.6	...	185.8	261.7
	(In millions of US dollars for March-June; in millions of Euros for September to December)							
Floor on accumulation of net international reserves of the BOA 3/	-29.2	-58.6	-58.6	...	-25.2	...	15.8	57.4
	(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	272.0	515.0	515.0	...	515.0	515.0	650.0	680.0
Ceiling on public and publicly-guaranteed external debt with original maturities up to and including 1 year 5/	0.0	0.0	0.0	...	0.0	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	...	0.0	0.0	0.0	0.0

Source: Calculated from data provided by the Albanian authorities.

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-March 2008 except where marked. Data for end-March 2008 are performance criteria except where marked. Data for end-September 2008 are proposed performance criteria, except where marked. Data for end-June 2008 and end-December 2008 are indicative targets.

2/ Cumulative change within the calendar year.

3/ For end-March 2008 and end-June 2008, cumulative change from end-December 2007.

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. From September 2007 includes small business tax. Targets defined as cumulative changes within each calendar year.

5/ Applies on a continuous basis.

Table 2. Structural Benchmarks under the PRGF and EFF Arrangements

	Proposed Test Date
I. Prior Actions	
1. The Council of Ministers to adopt measures sufficient to reduce the quasi-fiscal losses of KESH to no more than 1.2 percent of GDP in 2008, including by containing personnel costs, limiting electricity imports, and reprioritizing investments.	...
II. Structural Benchmarks	
A. Reduce fiscal vulnerabilities	
2. Raise the effective collection rate on electricity consumption to 62 percent.	*End-October 2008*
3. 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
4. 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	Ongoing
5. Prepare semi-annual reports (within one month of the end of each semester) on the stock of external arrears.	Ongoing
6. Increase the number of taxpayers paying social security contributions (excluding agricultural workers and voluntary contributors) to 410,000.	End-July 2008
B. Improve public expenditure management	
7. 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
C. Strengthen the financial system	
8. Complete the delivery vs. payments system for government securities.	End-October 2008

1/ Text in italics refers to new conditionality not carried over from the fourth review under the program.

ATTACHMENT II

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum defines the quantitative performance criteria, benchmarks and indicative targets established in the Memorandum of Economic and Financial Policies (MEFP) up until end-December 2008; and associated reporting requirements.

A. Net Domestic Credit to the Government

1. For the purposes of the program, the **government** includes the State Budget, the Social Security Institute (SSI), the Health Insurance Institute (HII), the Expropriation Fund, local governments, and the accounts of all entities (including special purpose vehicles) that are used to operate or manage public-private partnership (PPP) projects.

2. **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;[1] less the sum of government financial assets held in the banking system and in the SLIs.

3. 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)[2]; and (e) any other form of financial obligation of the government to domestic lenders, the issuance of which resulted in borrowing funds by the government or a payment for an existing payment obligation of the government.

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

[2] This was equivalent to lek 15.505 billion at end-December 2007.

(ii) Gross domestic credit in lek and in foreign currency extended to the government excludes (i) advances on profit transfers by the BoA; and (ii) the lek 5,908 million temporary security issued by government to BoA on December 31, 2007 and retired on February 27, 2008[3].

(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 plus accrued interest. 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 including 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 issue price plus accrued interest. 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[4].

(iv) For the purposes of program monitoring, gross domestic credit to the government in foreign currency will be converted from lek to euros at the end-of period lek/euro exchange rate prevailing on the test date; and then converted to lek at the program exchange rate of lek 123.6/euro.

4. 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 (€596.2 per ounce)[5].

(ii) Government financial assets held at the Bank of Albania exclude: (a) foreign currency deposits related to foreign financed projects; and (b) deposits serving

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[3] This security was issued to provide bridge recapitalization of BoA until a transfer of gold from government to BoA was finalized on February 27, 2008.

[4] Under current reporting standards, the stock of all gross domestic credit extended to the government and held by the SLIs and other domestic lenders is only available at face value.

[5] The lek value of standard gold deposits will be (a) converted to euros using the current end-of-period lek/euro exchange rate; (b) then converted to ounces of gold using the current euro market price of gold; (c) then converted to euros at the program price of gold (€596.2 per ounce); and (d) then converted to lek at the program lek/euro exchange rate of lek 123.6/euro.

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 DMBs to government.

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

5. For the purposes of program monitoring, foreign currency-denominated government financial assets will be converted from their lek value (obtained from the BoA and aggregate DMBs' balance sheet) to their currency of denomination at the end-of period lek exchange rate for that currency prevailing on the test date; and then converted to lek at the lek exchange rate for that currency prevailing at end-March 2008. Those foreign currency-denominated government financial assets for which the currency of denomination is unknown, will be converted from their lek value (obtained from the BoA and aggregate DMB's balance sheet) to euros at the end-of period lek/euro exchange rate for that currency prevailing on the test date; and then converted to lek at the lek/euro program exchange rate of lek 123.6/euro.

6. Under these definitions, the stock of net domestic credit to the government was lek 361.3 billion at end-December 2007. The breakdown of the categories of net domestic credit to the government as defined above is given in Attachment Table 1.

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

B. Net Domestic Assets

8. 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-March 2008. Under this definition, the level of NDA was lek 74.4 billion as of end-March 2008. The NDA limits will be cumulative changes from end-March 2008 and will be monitored from the accounts of the Bank of Albania.

C. Net International Reserves

9. **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. 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. The government's foreign currency deposits at the Bank of Albania are excluded from reserve liabilities[6], with the following exception: those government deposits that arise from the proceeds of the foreign currency-denominated syndicated loan contracted to finance part of the Rreshen-Kalimash road will be included in reserve liabilities. Reserve assets and reserve liabilities will both be expressed in euros. The NIR limits will be cumulative changes from end-March 2008, and will be monitored from data supplied by the Bank of Albania.

10. During this program, for monitoring purposes, the bilateral exchange rates between the euro and non-dollar currencies will be kept at their end-March 2008 levels and holdings of monetary gold will be valued at €596.2 per ounce. Under this definition, the level of NIR was €1,126.5 million at end-March 2008.

D. Adjusters for NCG, NDA, and NIR

11. The NCG and NDA ceilings and the NIR floor are defined on the assumption that cumulative privatization proceeds from January 1, 2008 will be as follows:

End-Sept 2008	lek 4,100 mn.	(Of which €26.0 mn. in foreign currency);
End-Dec 2008	lek 4,100 mn.	(Of which €26.0 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 will be adjusted downward (upward) by half the amount of any excess (shortfall) in the receipt of total privatization proceeds from these assumed values[7].

[6] 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.

[7] For the NCG adjuster, the lek equivalent of deviations from the programmed amounts received in foreign currency will be converted to lek at the exchange rates prevailing on the value date of the transaction.

12. The ceiling on NCG:

- 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) 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).

- Will be adjusted upward by the increase 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 for the purpose of recapitalizing the Bank of Albania. The transfer of securities to the Bank of Albania will be deemed to be for recapitalization purposes to the extent that the offsetting entry in the Bank of Albania's balance sheet is recorded in the bank's capital account. This adjuster excludes the security referred to in paragraph 3 (ii) (ii).

- Will be adjusted upward by the running down of government financial assets (as defined in paragraph 4) for the purpose of recapitalizing the BoA. As at end-March 2008, the amount of financial government assets (as defined in paragraph 4) expended for this purpose was Lek 2,844 million.

- Will be adjusted upward by the amount of fiscal expenditure that was authorized by the 2007 budget, but legally expended in the first 14 days of 2008 and legally credited to the 2007 fiscal year.

- Will be adjusted downward by the amount of fiscal expenditure that was authorized by the 2008 budget, but legally expended in the first 14 days of 2009 and legally credited to the 2008 fiscal year.

- Will be adjusted upwards by the disbursed amount of the foreign currency-denominated syndicated loan contracted to finance part of the Rreshen-Kalimash road that is sourced through resident banks or other resident lenders. There will be no adjustment to the NCG target for this purpose for disbursements of this loan that are sourced through nonresident lenders.

13. 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, loans from the International Development

Association of the World Bank Group, and macro-financial assistance from the EU) will amount, on a cumulative basis, from January 1, 2008, to:

End-Sept 2008	€0.0 mn;
End-Dec 2008	€0.0 mn.

The ceilings on NDA of the Bank of Albania and NCG will be adjusted downward, and the floor on NIR will be adjusted upward by the amount total foreign loan financing (excluding IMF financing, project and commodity loans, loans from the International Development Association of the World Bank Group, and macro-financial assistance from the EU) exceeds these projections.[8]

14. The NDA ceilings will also be adjusted to reflect the impact of any change in the required reserve ratio of commercial banks with the Bank of Albania. Should reserve requirements in lek (foreign currency) be changed from the 10 percent on all deposits held in lek (foreign currency), then the NDA ceiling will be adjusted by multiplying the change in the reserve requirement by the programmed deposits for which required reserves are held in lek (foreign currency). The total adjustment to the NDA ceiling will be the sum of the adjustment made for any change in the reserve requirement on lek deposits and the adjustment made for any change in the reserve requirement on foreign currency deposits. Before making any change to the required reserve ratio, the authorities will consult with IMF staff. For the purpose of this adjuster, the programmed level of deposits in lek and foreign currency are defined as follows:

	In lek (lek bn.)	In foreign currency (lek bn.)
End-September 2008	372.9	289.1
End-December 2008	380.6	308.1

E. External Debt and Arrears

15. 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

[8] For the NCG adjuster, the lek equivalent of deviations from the programmed amounts received in foreign currency will be converted to lek at the exchange rates prevailing on the value date of the transaction.

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 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.

16. 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[9]. 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.

17. The limit on medium- and long-term external debt as defined in paragraph 16 will be adjusted downwards by the disbursed amount of the foreign currency-denominated syndicated loan contracted to finance part of the Rreshen-Kalimash road that is sourced

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[9] For the purposes of program monitoring, "external" means owed to a non-resident, and includes both foreign currency- and local currency-denominated debt (where debt is defined in paragraph 15 of this memorandum).

through resident banks or other resident lenders. There will be no adjustment to the limit on medium- and long-term external debt for this purpose for disbursements of this loan that are sourced through nonresident lenders.

18. 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.

19. 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, 2008 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, 2007; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

20. **Large projects** (as referred to in MEFP paragraph 5 and MEFP Table 2) are defined as those projects involving total nonconcessional borrowing in excess of €20 million.

F. Tax Revenues

21. 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.

G. Monitoring and Reporting Requirements

22. 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).

(xiii) Monthly information regarding the balances held by the Expropriation Fund at BoA disaggregated into foreign currency and domestic currency.

(xiv) Monthly data regarding the currency composition of government deposits at BoA and the aggregated deposit money banks, disaggregated by transferable and other deposits.

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 quarter will be supplied within one month of the end of the quarter.

(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.

(xii) Monthly information regarding the balances held by the Expropriation Fund at deposit money banks and SLAs disaggregated into foreign currency and domestic currency.

(xiii) The amount—and detailed breakdown—of fiscal expenditure that was authorized by the 2008 budget, but legally expended in the first 14 days of 2009 and legally credited to the 2008 fiscal year; and the amount—and detailed breakdown—of fiscal expenditure that was authorized by the 2007 budget, but legally expended in the first 14 days of 2008 and legally credited to the 2007 fiscal year.

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.

(iii) Quarterly reports on the progress made in the actual use of the ASYCUDA risk-assessment module to perform custom inspections.

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).

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.

The Albanian Electricity Corporation KESH will supply to the Fund:

(i) Detailed monthly data on production, imports, and consumption of electricity.

(ii) Detailed monthly data on losses and collection rates.

Table 1. Albania: Calculation of Net Domestic Credit to Central Government for Program Monitoring Purposes, December 2007–December 2008
(In millions of lek)

		Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
1.	**Treasury bills held outside central government**	239,826				
Of which:						
1. (i)	Held by Bank of Albania 1/	66,956				
1. (ii)	Held by deposit money banks 1/	131,810				
1. (ii) (i)	In domestic currency	131,810				
1. (ii) (ii)	In foreign currency at program exchange rates	0				
1. (ii) (ii) (i)	In foreign currency at current exchange rates	0				
1. (iii)	Held by savings and loan institutions 2/	0				
1. (iv)	Held by other domestic lenders (excluding holdings of HHI and SSI) 2/	41,060				
	Of which:					
1. (iv) (i)	INSIG	1,581				
1. (iv) (ii)	Individuals and firms	39,479				
1. (iv) (ii) (i)	Of which: BoA window	23,756				
Plus:						
2.	**Other central government debt held outside central government (millions of lek)**	138,425				
Of which:						
2. (i)	Held by Bank of Albania 3/	15,505				
2. (i) (i)	Other securities	15,505				
2. (i) (i) (i)	Of which: for BoA valuation losses	15,505				
2. (i) (ii)	Short-term direct loans to government 3/	0				
2. (ii)	Held by deposit money banks 4/	122,920				
2. (ii) (i)	Fixed income securities 4/	122,920				
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:		378,251				
Less:						
3.	**Assets of central government (excluding HHI and SSI)**	11,311				
3. (i)	Deposits held at Bank of Albania 6/	13,398				
3. (i) (i)	In domestic currency	7,435				
3. (i) (i) (i)	Transferable deposits in lek	4,541				
3. (i) (i) (ii)	Term deposits of government and deposits in lek for projects	465				
3. (i) (i) (iii)	Domestic currency portion of Expropriation Fund	2,429				
3. (i) (ii)	In foreign currency at program exchange rates and program price of gold 7/ 8/	5,963				
3. (i) (ii) (i)	In foreign currency evaluated at current exchange rates	5,755				
3. (i) (ii) (i) (i)	Transferable deposits in foreign currency evaluated at program exchange rate 7/ 9/	3,223				
3. (i) (ii) (i) (i) (i)	Transferable and other deposits in foreign currency evaluated at current exchange rate 9/	3,172				
3. (i) (ii) (i) (i) (i) (i)	Of which: Foreign currency portion of Expropriation Fund at current exchange rates	0				
3. (i) (ii) (i) (ii)	Standard gold deposits of government evaluated at program exchange rate and gold price (Lek mns.	2,740				
3. (i) (ii) (i) (ii) (i)	Standard gold deposits of government at current exchange rate and gold price (Lek mns.) 8/	2,584				
3. (ii)	Assets held at deposit money banks	-2,088				
3. (ii) (i)	Deposits 10/	1,695				
3. (ii) (i) (i)	Deposits in domestic currency	165				
3. (ii) (i) (i) (i)	Transferable deposits in domestic currency	165				
3. (ii) (i) (i) (ii)	Other deposits in domestic currency	0				
3. (ii) (i) (ii)	Deposits in foreign currency evaluated at program exchange rates	1,529				
3. (ii) (i) (ii) (i)	In foreign currency evaluated at current exchange rates 7/	1,504				
3. (ii) (i) (ii) (i) (i)	Transferable deposits in foreign currency evaluated at current exchange rates	1,504				
3. (ii) (i) (ii) (i) (ii)	Other deposits in foreign currency evaluated at current exchange rates	0				
3. (ii) (ii)	DMB payables to government	-3,911				
3. (ii) (iii)	Ministry of finance short-term lending to commercial banks	129				
3. (iii)	Held at savings and loan institutions 10/	0				
Less:						
4.	**Deposits of HHI and SSI**	5,675				
Equals:						
5.	**Stock of Net domestic credit to central government (1+2-3-4)**	361,265				
5. (i)	Change since December 2007	...				
6.	**Memorandum items:**					
6. (i)	Current exchange rate (Lek/Euro, eop)	121.6				
6. (ii)	Current exchange rate (Lek/US dollar, eop)	82.7				
6. (vii)	Current exchange rate (US dollar per Euro, eop)	1.458				
6. (iii)	Program exchange rate (Lek/Euro, eop)	123.6				
6. (iv)	Program exchange rate (US$/Euro, eop)	1.552				
6. (v)	Program price of gold (Euros per ounce)	596.2				
6. (vi)	Program price of gold (US dollars per ounce)	925.5				
6. (vii)	Market price of gold (price in Euros per ounce)	571.5				

1/ Evaluated at issue price plus accrued interest. Excludes Lek 5,908 million of securities issued to temporarily recapitalize BoA in advance of gold transfers that was issued on December 31, 2008 and retired on February 27, 2008.
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 accrued interest.
4/ Valued at issue price plus accrued interest.
5/ Evaluated at face value.
6/ Includes transferable deposits of government in domestic and foreign currency, lek deposits of central government for projects; deposits of the Expropriation Fund; and standard gold deposits of government (footnote # 8). Excludes non-standard gold deposits; excludes all nongold precious metal deposits of government; and excludes government deposits in foreign currency for projects.
7/ Value determined using methodology outlined in the TMU.
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 Euro using the current end-of-period lek/Euro exchange rate; (b) then converted to ounces of gold using the current market price of gold; then (c) converted to Euro at the program price of gold of Euro 596.2 per ounce; and then (d) converted to lek at the program Lek/Euro exchange rate of Lek 123.6/Euro.
9/ Including account set up to hold privatization revenue.
10/ Includes all deposits of central government in SLIs.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 08/94
FOR IMMEDIATE RELEASE
July, 29, 2008

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

IMF Executive Board Concludes 2008 Article IV Consultation with Albania

On July, 25, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Albania.[1]

Background

Over the last decade, macroeconomic performance has generally been strong and per capita GDP in US dollar terms more than doubled. A Stabilization and Association Agreement with the EU was signed in 2006, and an invitation to join NATO extended in the spring of 2008. Rapid growth, price stability, and continued large remittances also significantly improved social conditions and moved the country toward Millennium Development Goals. Macroeconomic stability has been maintained and inflation is among the lowest in the region.

Strong fiscal policy, largely based on major improvements in tax administration, lowered public debt from 66 percent of GDP in 2001 to 53 percent in 2007. More recently, tax policy reforms have further boosted revenues—to be allocated in the supplementary budget to investment projects.

With such supportive fiscal policy, the Bank of Albania was able to maintain low inflation, despite a rise in recent months above the 3±1 percent target range, that was driven mainly by higher world food prices. Underlying inflation remains low and, going forward, inflation is projected to

[1] 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.

return into the target band within the year, notwithstanding unfavorable global inflation trends and pressures from the ongoing transition process.

Risks to domestic and external stability have receded somewhat. Domestic credit growth, though still elevated, has decelerated from past highs, and the authorities adapted regulatory and supervisory regimes to keep abreast with the rapidly developing financial system. Exports are growing strongly, though temporary factors have pushed up the current account deficit.

However, progress with structural reform has been uneven. On the one hand, tax reforms, financial market development, and large scale privatization have provided strong incentives for investment. In contrast, turning around the loss-making electricity sector has proved elusive despite repeated attempts. The core of the problem is unpaid electricity usage—the average effective collection rate, at around 50 percent, remains low compared even with the regional average of about 75 percent. Moreover, wide-spread governance concerns and the weak business environment are already factors in the recent slowdown in productivity growth.

Executive Board Assessment

Executive Directors praised the authorities' macroeconomic policy stance that has led to a prolonged period of strong noninflationary growth and sustained improvement in living standards and social conditions, despite a deteriorating external environment. Directors also welcomed the good progress in structural reforms, and encouraged the authorities to undertake early action on the remaining agenda in reforming the electricity sector and in improving the business climate.

Directors concurred that the current stance of monetary policy is appropriate. Given that exogenous shocks implied upward pressure on prices in the near and medium-term—compounding pressures associated with the transition process—Directors noted that monetary conditions might need to be tightened if second-round effects appeared or inflationary expectations deteriorated.

Directors considered external competitiveness to be broadly adequate, and stressed the importance of ensuring that macroeconomic and structural policies continue to safeguard external stability going forward, particularly in light of the authorities' plans to rely more on international capital markets in the future.

Directors encouraged the authorities to set fiscal policy within a transparent medium-term framework. They considered the authorities' goal of reducing debt to 50 percent of GDP by 2011 to be consistent with debt sustainability, macroeconomic stability, and the need to meet Albania's still-considerable development needs. Safeguarding progress made in debt sustainability will require a prudent debt management strategy and a cautious approach to borrowing on international capital markets. Directors welcomed the authorities' intention to limit the 2008 deficit to 5.2 percent of GDP and to adopt an explicit fiscal rule guiding future budgets. They commended the authorities' recent decision to address the welfare effects of rising food prices through targeted subsidies.

Directors regarded continued financial sector development as a prerequisite for maintaining rapid economic growth. The banking system appears sound, and exposure to the current global financial turmoil is slight. Regulatory and supervisory capacity needs to keep pace with the sector's development to mitigate the attendant risks. In this regard, Directors considered that the immediate priority lay in improving cross-border supervisory collaboration, contingency planning, and collateral execution. Directors also saw an important role for regulatory and supervisory measures in supporting monetary policy, given the still undeveloped monetary transmission mechanism and high degree of euroization.

Directors observed that, with efficiency gains from the transition process likely to gradually wane, maintaining strong growth as a middle-income country would increasingly depend on improvements in both institutional quality and infrastructure. This would help to attract foreign direct investment and improve productivity. In this regard, Directors considered that past initiatives, such as the one-stop business licensing procedure, had been effective, and encouraged the authorities to initiate further business-friendly reforms. In addition, they encouraged the authorities to improve governance, strengthen the judicial system, and tackle corruption. Directors noted continuing problems in the electricity sector, and stressed that the authorities would have to follow through with their new action plan for the Albanian Power Corporation (KESH) if another electricity tariff increase in the near future was to be avoided. Progress in this area would facilitate the planned privatization of KESH's distribution company.

Directors welcomed the authorities' intention to improve the reliability and timeliness of statistics. Addressing the lack of skilled staff and insufficient resources in the statistical agency would help maximize the usefulness of Fund technical assistance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Albania: Selected Economic Indicators, 2004-08

	2004	2005	2006	2007 Est.	2008 Proj.
	(Growth rate in percent)				
Real GDP	5.7	5.8	5.4	6.0	6.1
Retail prices (avg.)	2.9	2.4	2.4	2.9	4.0
Retail prices (end-period)	2.2	2.0	2.5	3.1	3.9
	(In percent of GDP)				
Fiscal sector					
Revenues and grants	24.6	25.0	25.3	25.5	27.7
Tax revenue	22.1	22.5	23.0	23.4	25.6
Expenditures	29.8	28.7	28.6	29.3	32.9
Overall balance (including grants)	-5.2	-3.7	-3.2	-3.8	-5.2
Net domestic borrowing	2.3	2.7	2.3	1.7	1.8
Public Debt	57.7	58.1	55.9	53.1	53.5
Domestic	39.3	40.0	39.1	37.6	35.9
External (including publicly guaranteed)	18.4	18.0	16.9	15.5	17.6
Monetary indicators					
Broad money growth	13.5	13.9	16.3	13.7	10.0
Private credit growth	36.9	73.6	57.2	48.2	29.2
Interest rate (3-mth T-bills, end-period)	6.2	5.4	6.4	6.3	…
	(In percent of GDP unless otherwise indicated)				
External sector					
Trade balance (goods and services)	-22.2	-24.5	-24.1	-26.5	-26.8
Current account balance	-4.0	-6.1	-5.6	-9.2	-9.8
Current account balance (in millions of Euros)	-234.6	-399.5	-404.5	-725.0	-857.1
Gross international reserves (in millions of Euros)	1024.9	1201.9	1359.1	1466.8	1474.1
(In months of imports of goods and services)	3.9	4.0	3.8	3.7	3.6
Memorandum items					
Nominal GDP (in billions of lek)	751.0	817.4	893.0	974.0	1072.0
Nominal GDP (in billions of U.S. dollars)	7.3	8.2	9.1	10.8	13.5

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

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 08/184
FOR IMMEDIATE RELEASE
July 28, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes the Fifth Review Under the PRGF and EFF Arrangements with Albania and Approves US$4 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the fifth review of Albania's economic performance and financing assurances under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement and the Extended Fund Facility (EFF) arrangement. The completion of the reviews enables the release of an amount equivalent to SDR 2.4 million (about US$4 million), which will bring the total disbursements to Albania under both arrangements to SDR 14.6 million (about US$23.9 million).

The concurrent three-year arrangements under the PRGF and EFF, amounting to the equivalent of SDR 17 million (about US$27.9 million), were approved effective from February 1, 2006 (see Press Release No. 06/17).

The Executive Board also approved a request for modification of three end-September 2008 performance criteria related to the Bank of Albania's net international reserves and domestic assets, and net domestic credit to government.

Following the Executive Board's discussion of Albania on July 25, 2008, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, stated:

"Albanian economic performance remains strong, despite less benign external conditions. A regional drought in 2007 affected Albania particularly hard, but recovery was rapid as the economy diversified and new export markets were developed. Growth therefore remained buoyant and became broader based, reaching 6 percent last year. Inflation, while episodically above the 3±1 percent target range, remains among the lowest in the region in spite of global food and commodity price shocks. In addition, risks to external and domestic stability have receded somewhat, as domestic credit growth—though still elevated—has decelerated. The share of exports of goods and services in GDP has increased, and Albania continues to attract investment in its traditional exports, textiles, and footwear. Public finances have strengthened, largely due to improved tax administration, allowing public debt to remain on a declining path as a percent of GDP. Firm monetary policy has maintained positive real interest rates.

“Growth is expected to remain at 6 percent in 2008 with inflation just under 4 percent, but risks have increased. Rising global commodity prices, particularly of food, may put pressure on domestic prices in the short term. Over the medium term, investment-driven productivity increases will be needed to maintain the pace of growth and expand the export base. This necessitates improvement in the business climate, particularly in the areas of governance, judiciary, and land titling.

“Regulatory and supervisory capacity need to continue to keep pace with developments in the banking sector. The banking system appears sound with little exposure to current global financial turmoil. Moreover, its rapid development has contributed significantly to economic development. However, in the face of still rapid credit growth, vigilance and regulatory adaptation is required to ensure stability of the financial system. In this regard, the immediate priority lies in improving cross-border supervisory collaboration, contingency planning, and collateral execution.

“The program’s medium-term fiscal framework is consistent with low inflation, debt sustainability, and the authorities’ model of a small, efficient government. This framework is expected to reduce debt to 50 percent of GDP by 2011. Combined with the authorities’ existing strategy of limiting the size of government and outsourcing activities where possible, the resulting medium-term fiscal path is expected to satisfy Albania’s still-considerable development needs, while supporting macroeconomic stability. The authorities appropriately intend to adopt a fiscal rule to anchor this policy direction.

“Despite progress made this year, electricity sector reforms remain unfinished, at considerable economic cost. The core of the problem is unpaid electricity usage—the average effective collection rate, at around 50 percent, remains low compared even with the regional average of about 75 percent. Without progress in this area, the electricity utility will continue to lose cash, risks to the budget will grow, electricity supply to the economy will remain unreliable, and the utility’s privatization will be made more difficult,” Mr. Portugal stated.

Statement by Arrigo Sadun, Executive Director for Albania
and Francesco Spadafora, Senior Advisor to Executive Director
July 25, 2008

On behalf of the Albanian authorities, we thank staff for the well-written and informative report, which is testament to the remarkably close and constructive cooperation with the authorities.

Overview

Sound macroeconomic and structural policies, underpinned by Fund programs, have laid the ground for the impressive progress made by the Albanian economy over the last decade. Per capita GDP growth in U.S. dollar terms has more than doubled and graduation from IDA is forthcoming. Inflation has declined toward the European average and is currently among the lowest in the region. Timely monetary policy tightening, complemented by appropriate regulatory measures, was crucial to reach this positive outcome. While implementing supply-side tax reforms, major improvements in tax administration have contributed to strengthen public finances, boosting the revenue-to-GDP ratio and lowering the public debt.

Growth is projected to remain at a solid 6.0 percent in the current year and, equally importantly, is broader-based, with a pick up in the relative weight of such sectors as construction and manufacturing and upbeat trade following export diversification in both markets and products. Credit growth, identified as a major risk in past reviews, has been somewhat contained, but remains relatively robust.

The real exchange rate does not appear to be misaligned and there are no major concerns about competitiveness and external stability. Most of the widening of the current account deficit in 2007 reflected temporary factors and the gap is expected to decline to below 5 percent of GDP in the medium term as a result of stronger exports, buoyant remittances, and a reduction in electricity and road-related imports.

The authorities are now focusing on the medium-term policies and reforms necessary to sustain growth and ensure financial stability. The persistently strong performance under the PRGF-EFF-supported program confirms their commitment. For the fifth review, all quantitative performance criteria have been met and structural conditionality appears on track.

Against such a positive background, in a context of persistent security-related regional risks, some long-standing problems remain, mainly related to the electricity sector, governance and the business environment.

Fiscal Policy

The authorities' medium-term fiscal framework envisages a small but more efficient government. Fiscal policy has provided a key contribution in maintaining macroeconomic stability and, going forward, should take on a greater role in demand management. In the longer term, further fiscal consolidation will be pursued with a view to fund development projects.

The 2008 budget sets a deficit ceiling of 5.2 percent of GDP that does not generate a fiscal impulse; this gap should decline to 3.0 percent as early as 2009 (as opposed to the projected 3.7 percent at the time of the fourth review).

Following the introduction of a 10 percent flat tax rate for both personal and corporate incomes (respectively in August 2007 and January 2008), personal income tax collections more than doubled in the first quarter of 2008, while the revenues from corporate taxation remained stable due to the broadening of the tax base. Buoyant revenues have allowed the budget to absorb the costs (0.2-0.3 percent of GDP) of compensation for the Gerdec ammunitions explosion. Against such major reforms, the authorities will now concentrate their efforts on bringing actual collections in line with potential yields. In this regard, the objective of increasing the number of social security contributors to 410,000 by end-July 2008 appears on track.

A large wage increase for public sector workers has been scaled back sharply by the mid-year budget review in order to prevent a potential wage-price spiral. Significant contingency reserves of about 1.5 percent of GDP are in place to protect the 2008 budget outcome against the risks arising from quasi-fiscal losses incurred by the electricity company KESH and cost overruns associated with the Rreshen-Kalimas road project.

The authorities stand ready, in consultation with the Fund, to take further actions, including offsetting reductions in other expenditures, should the fiscal deficit target be in jeopardy,

Public debt has been reduced from 58 percent of GDP in 2005 to 53 percent in 2007 and its maturity extended to reduce rollover risk. The authorities aim at reducing the debt-to-GDP ratio to below 50 percent by 2011, in order to mitigate the risks, in terms of costs and volatility, associated with the prospective greater integration with global capital markets. The annual implementation of this target will be carried out either through a cap on the overall fiscal deficit or expenditure consistent with such an objective. In light of the forthcoming expiration of the Fund-supported program in January 2009, the authorities have been discussing with staff how best to replace the current fiscal anchor in order to preserve macroeconomic stability and have expressed a preference for an expenditure-based rule.

Improving the implementation of capital projects remains a priority of public expenditure management. Following the introduction of new public investment management procedures and a new procurement law, the authorities are focusing on strengthening Ministries' capacity to implement such measures.

Monetary and financial sector policies

Following three increases of the policy rate in 2007, the monetary authorities stand ready to further tighten monetary policy in order to avoid second-round effects potentially arising from looming domestic and external inflationary pressures. The former are related to the recent increase in electricity tariffs and, over the medium run, to increased food exports; the latter to the expected pass-through to domestic prices from global inflation trends.

Despite the progress, there remain some upside risks to the rate of credit growth from the potential expansion of available collateral, as a result of the ongoing land legalization. Further regulatory and supervisory measures would complement monetary policy in the event that re-acceleration of credit growth materializes. On the other hand, downside risk to the rate of credit growth may arise from a retrenchment of parent banks in funding their Albanian subsidiaries, in a largely foreign-owned banking system (about 90 percent of total assets in 2007, up from 47 percent in 2003).

The banking system is well-capitalized, liquid and profitable. The authorities intend to safeguard its stability through proactive supervision. However, on account of the system's rapid expansion, they are aware of the need to enhance the regulatory and supervisory regimes in tandem and are benefiting from TA recommendations provided by MCM and LEG.

In particular, the Bank of Albania aims at signing formal Memoranda of Understanding to increase cooperation with the home country supervisors of resident foreign banks. Improvements in the legal and operational framework for executing collateral are also planned, including through changes in the Civil Code.

To improve the effectiveness of monetary policy, as well as to further stimulate the growth of the financial sector, the authorities aim to develop efficient interbank and secondary markets. To this end, a delivery versus payment system for government securities is due for completion by end-October. The development of pensions and insurance markets, supported by the World Bank, would also address the still high rollover risk of domestic debt, although progress has already been made on lengthening its maturity. Moreover, the new IT system for conducting primary auctions of government securities has reduced operational risks.

To prepare the country for the forthcoming graduation from concessional finance, the authorities have been taking steps towards the objective of tapping international capital markets. In order to meet the requirements for a successful first-time market access, a General Debt Department has been created to strengthen debt management capacity. Technical assistance will be sought from donors and the IMF to prepare for Albania's first sovereign issuance of Eurobonds within a coherent medium-term debt strategy.

The electricity sector

In the authorities' view, a privately-dominated and diversified electricity sector is critical to ensure a stable supply of electricity at low cost. Unfortunately, previous attempts to place the electricity sector on a sound footing have not been sufficient to obtain a lasting solution and address the ensuing macroeconomic risks. In fact, chronic power disruptions have taken a toll on inflation, the budget deficit and current account (because of the ensuing need to import more costly energy).

With regard to the fourth review's structural benchmark aimed at reducing the quasi-fiscal losses of KESH to below 1.2 percent of GDP in 2008, a new action plan was adopted as a prior action for the fifth review. This includes such measures as containing KESH's personnel costs, limiting the electricity imports as well as reprioritizing local investments. The authorities stand ready to take further actions to meet the above target, if necessary

Aware of the importance of strengthening KESH's cash flow, in addition to last March's tariff increase, the action plan also aims at raising the effective collection rate from the current 47 percent to 60 percent, consistent with the new structural benchmark of bringing this rate up to 62 percent by end-October. Efforts are under way to ensure that budgetary and non-budgetary institutions, whose arrears have been recently cleared, henceforth pay electric bills on time.

In order to achieve a lasting solution and ensure a stable supply of electricity over the medium term, the authorities, under the advice of the IFC, have set up a program to privatize the distribution arm of KESH by end-2008. To this end, they have finalized the methodology for tariff adjustment and identified qualified bidders in June 2008. Furthermore, with assistance from USAID, they have established the required market structure and regulations for full vertical unbundling of KESH.

The authorities are also involved in a number of projects to diversify electricity supply and further integrate the national grid into the regional network. Construction of a thermal power plant, financed jointly by the World Bank, EIB and EBRD, has already started and should be completed by mid-2009. Additionally, to increase private sector involvement in power generation, they are in the process of concessioning two new large hydro power plants.

Structural issues

The objective of the authorities' medium-term economic strategy is to foster continued strong private sector-led growth.

In a context of successful macroeconomic stabilization, market-oriented reforms have paved the way to rising investment and Albania now sets itself apart in terms of the contribution of capital accumulation to growth. However, total factor productivity, which has provided the largest push to the expansion, shows signs of deceleration. The authorities are aware of the need to avoid complacency and recognize that failure to advance improvements in governance and business climate will negatively affect growth and debt sustainability. A better business environment is also instrumental in addressing quasi-monopolistic price setting in the distribution and retail sectors.

The authorities intend to address the business climate, governance and institutional weaknesses thorough a wide range of reforms. Steps are being taken to improve the legal system and pursue land registration and titling, in order to enhance contract enforcement and property rights. The National Registration Center, a one stop-shop for business registration that cuts time and cost, has proved effective in prompting the registration of more firms. A new anti-corruption strategy is being implemented with donor support. Privatization of the remaining strategic public assets will continue in 2008. While expecting further benefits from prior reforms, the authorities look forward to the adoption of a second round of structural reforms to improve the business climate.

Relationship with the Fund

The authorities look forward to exploring possible options for future Fund engagement in the context of the sixth review.