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March 2005
IMF Country Report No. 05/89

Albania: 2004 Article IV Consultation, Fifth Review Under the Poverty Reduction and Growth Facility, Request for Extension of the Arrangement, and Financing Assurances Review—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 2004 Article IV consultation with Albania, fifth review under the Poverty Reduction and Growth Facility, request for extension of the arrangement, and financing assurances review, the following documents have been released and are included in this package:

- the staff report for the combined 2004 Article IV consultation, fifth review under the Poverty Reduction and Growth Facility, request for extension of the arrangement, and financing assurances review, prepared by a staff team of the IMF, following discussions that ended on December 16, 2004, 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 February 8, 2005. 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 Notice Information and Press Release, summarizing the views of the Executive Board as expressed during its February 28, 2005, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

- a statement by the Executive Director for Albania.

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

Letter of Intent sent to the IMF by the authorities of Albania*
Memorandum of Economic and Financial Policies by the authorities of Albania*
Selected Issues Paper and Statistical Appendix
Technical Memorandum of Understanding*
Ex Post Assessment of Longer-Term Program Engagement
*May also be 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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INTERNATIONAL MONETARY FUND

ALBANIA

Staff Report for the 2004 Article IV Consultation, Fifth Review Under the Poverty Reduction and Growth Facility, Request for Extension of the Arrangement, and Financing Assurances Review

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

Approved by Ajai Chopra and Donal Donovan

February 8, 2005

- Discussions for the 2004 Article IV consultation, fifth review under the PRGF and financing assurances review were held in Tirana during December 1–16, 2004. The Ex Post Assessment (EPA) report was also discussed with the authorities. The mission met with Prime Minister Nano; Ministers Malaj (Finance), Angjeli (Economy), Doda (Industry and Energy), and Poçi (Transport and Communications); Bank of Albania (BoA) Governor Fullani; parliamentarians; senior officials; academics; and representatives from business sectors, civil society, and the international donor community. The staff team comprised Messrs. Escolano (head), Lazar, Oestreicher (EUR), Dalgic (FAD), Mansilla (PDR), Olters (resident representative), and Ms. Spahia (resident representative's office). Mr. Gola (Executive Director's office) assisted in the discussions.

- The 2002 Article IV consultation was concluded on February 26, 2003. The current arrangement, in an amount equivalent to SDR 28 million (57 percent of quota), was approved on June 21, 2002 (IMF Country Report No. 02/135) and the fourth review was completed on July 14, 2004 (IMF Country Report No. 04/206). An FSAP is planned for early-2005. Albania participates in the GDDS, and a ROSC on data dissemination was prepared in June 2000. A safeguards assessment of the BoA was finalized in June 2002, and a fiscal ROSC in June 2003.

- In the attached Letter of Intent and Supplementary Memorandum of Economic and Financial Policies (MEFP) the authorities request completion of the program and financing assurances reviews; and a five-month extension of the program to November 2005 to allow for the sixth review and associated disbursement to take place within the program period.

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EXECUTIVE SUMMARY

After a slowdown in 2002, Albania's macroeconomic performance has been commendable: growth has been 6 percent in 2003–04 with low inflation, and the lek has appreciated reflecting increasing confidence. The public debt-to-GDP ratio has fallen from nearly 67 percent at end-2001 to about 55 percent at end-2004, and external liabilities, at 17 percent of GDP, are limited. However, despite a narrowing of the external deficit, the trade deficit remains wide and the economy is dependent on transfers from abroad—as a broad-based export-driven expansion has not yet taken root. Thus, improving competitiveness and attracting investment are key priorities. Performance under the program since the fourth review has been good and program conditionality was observed, some with significant margins. The political environment is dominated by the upcoming mid-2005 elections.

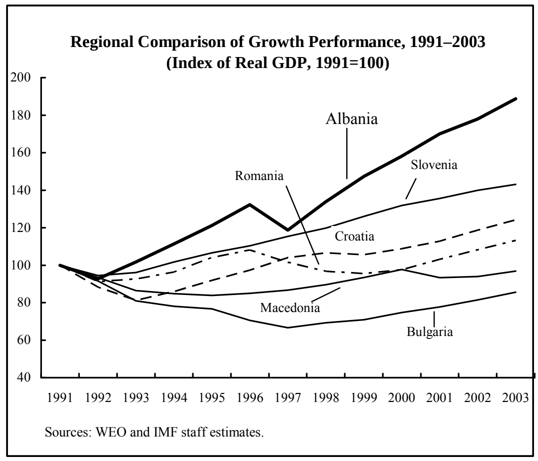
Policy discussions focused on maintaining macroeconomic stability, strengthening the monetary, financial, and budget policy frameworks, and improving the investment climate. The accompanying Ex Post Assessment was also discussed with the authorities.

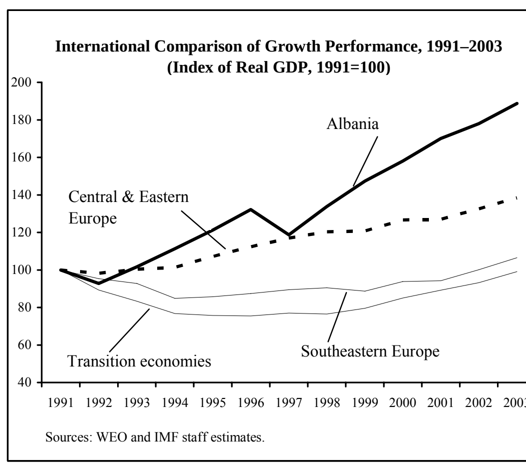
- The outlook is for growth to remain close to its 6 percent trend supported by domestic demand in the near term, and then increasingly by productivity and external trade gains in the medium term. However, maintaining this growth pace will require significant improvements in infrastructure and the business climate, including governance, property rights protection, and the rule of law.
- The newly appointed management of the Bank of Albania (BoA) reiterated the commitment to a strong monetary policy framework based on BoA independence, price and financial stability, and a flexible exchange rate. The monetary stance remains tight, but the current neutral bias is appropriate. In the wake of the large Savings Bank privatization, the financial sector is showing welcome dynamism and the BoA is stepping up prudential vigilance. The upcoming FSAP will contribute to these efforts. Financial intermediation is expanding, helped by the authorities' initiatives to build market infrastructure and curtail the use of cash—including by paying public wages through the banking system. Dollarization hinders the monetary policy transmission mechanism, but does not pose an immediate financial stability threat.
- Staff supported the 2005 budget, which embodies further fiscal and public debt retrenchment. It envisages current spending restraint leading, for the first time, to a current surplus—thus, providing for increased public investment. The budget is premised on a realistic projection of revenue, which should help planning and implementation. Discussions covered policies to improve tax compliance, taxpayer rights, budget process, expenditure management and civil service reform. In this context, the authorities agreed to refrain from across-the-board wage increases in 2005 and will formally eliminate inflation indexation of wages before the 2006 budget.
- Other structural reforms have experienced increased momentum, notably privatization, electricity sector restructuring, and national accounts statistics. But further progress in infrastructure provision, economic statistics, and investment climate is needed. Indicators of absolute poverty have improved reflecting increasing incomes, but targeted social programs need strengthening.

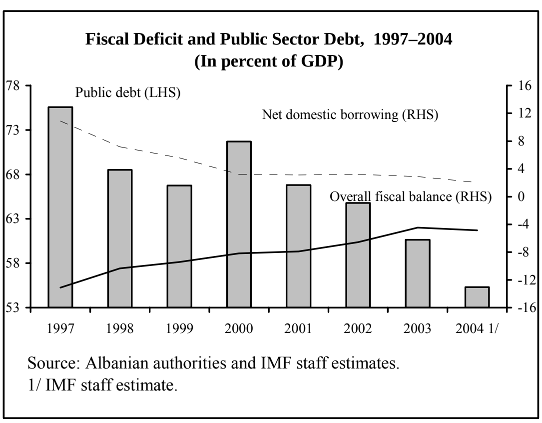
The accompanying supplementary Memorandum of Economic and Financial policies constitutes a strong policy program and staff supports completion of the 2004 Article IV consultation, fifth review of the program, and financing assurances review.

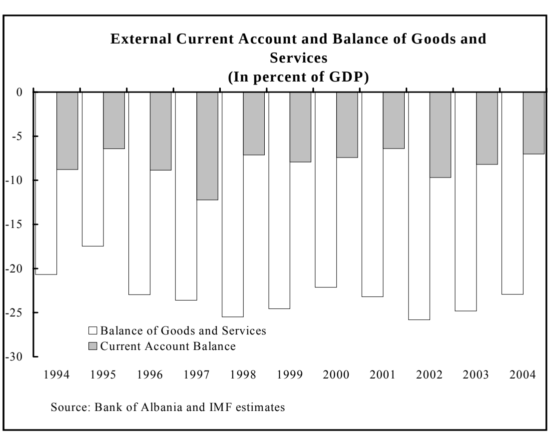
I. Introduction

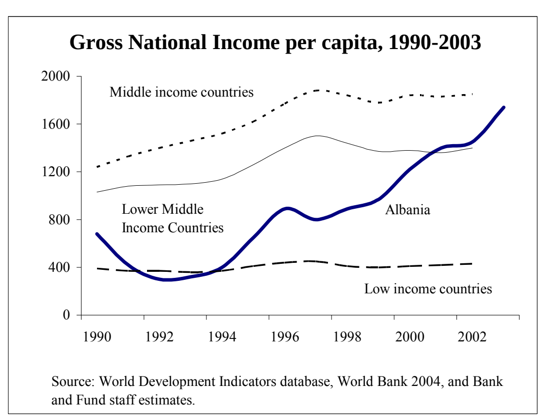
1. **The overall macroeconomic performance of the Albanian economy has been remarkable (Table 1).** After a slowdown in 2002, growth has recovered to about 6 percent; inflation has declined, with the 12-month rate generally remaining within the 2–4 percent target of the Bank of Albania (BoA); the lek has shown an appreciating trend reflecting increased confidence; and the external current account and trade deficits, although still high, have improved. This performance has been supported by sound monetary and financial sector policies, fiscal consolidation, privatization, and structural reforms in selected areas. Public indebtedness has declined steeply, by 9½ percentage points of GDP since end-2002, to 55¼ percent of GDP at end-2004. More broadly, since 1998, output has increased at an average annual rate over 6½ percent and per capita income has











doubled (Figure 1). This has resulted in reductions in absolute poverty (Table 2), although one fourth of the population is still below the poverty line and poverty alleviation remains a key challenge.

2. **The continuation of high growth, however, cannot be taken for granted as a self-sustained, broad-based expansion of tradeable output has not yet taken root**. Expansion of the market economy and an open trade regime have generated large increases in productivity through reallocation of resources since the start of the transition (the private sector now accounts for about ¾ of GDP). However, analyses by Fund and World Bank (WB) staff indicate that this source of total factor productivity (TFP) growth may be waning.[1] In particular, nontradeable sectors have contributed most of the growth. In contrast, the contribution from industry has been modest. Although in 2002–04 the current account deficit narrowed from 10 to 7 percent of GDP reflecting trade gains, it remains high—as does the goods and services trade deficit, which was 23 percent of GDP in 2004 (Table 3). This trade deficit has largely been covered by migrant remittances and other private and official transfers from abroad, buttressing incomes and domestic demand. But remittances and transfers cannot be relied upon to sustain the current fast growth pace for much longer. Indeed, these sources can be expected to decline over time as a share of GDP.

Contributions to economic growth 2003-04 (in percent)

	2003	2004
Agriculture, Hunting and Forestry	**0.8**	**1.0**
Industry	**0.3**	**0.3**
Construction	**0.9**	**0.5**
Trade and services	**3.2**	**3.2**
Transport	**0.9**	**0.9**
GDP at factor cost	**6.0**	**5.9**

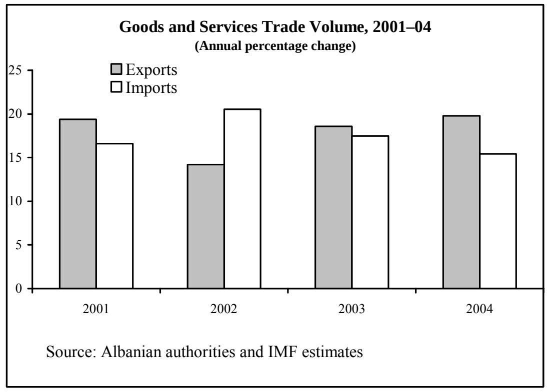
Sources: Albanian authorities and IMF staff estimates.

3. **Therefore, looking towards the future, the challenge will be to foster significant increases in competitiveness and high quality investment.** The recent prosperity of tourism-related activity and selected exports—textile, footwear, and vegetables—may harbinger a new export-based growth phase, but it is still in an early stage. Albania's growth track record and the macroeconomic stability gained in

SE Europe: Foreign Direct Investment
Average 1997-2003

	In US $ millions	In percent of GDP
Albania	114	2.7
o/w related to privatizations	23	0.6
Bosnia and Herzegovina	147	2.8
Croatia	1,129	5.6
Macedonia	137	3.6
Serbia and Montenegro	405	2.6

[1] See associated EPA (www.imf.org). Also, a WB growth accounting exercise indicates that whereas TFP growth explains most of the 1993–2003 increase in productivity, it has decelerated in recent years ("Albania: Sustaining Growth Beyond the Transition," World Bank Country Economic Memorandum, December 2004).



recent years should provide an excellent starting point to attract the strategic domestic and foreign direct investment with the scale, technology and know-how needed to spark a new growth phase based on external competitiveness. But progress in this direction will require substantial improvements in infrastructure, as well as in governance and the institutional investment environment—including in areas beyond traditional economic policies, such as strengthening the rule of law, defining and enforcing property rights, and reforming the court system.

4. **This analysis and policy perspective has been at the core of earlier IMF Board discussions and has been incorporated in the authorities' Poverty Reduction Strategy Papers (PRSPs).**[2] On occasion of the 2002 Article IV consultation, and more recently, at the conclusion of the fourth review, Directors praised the good macroeconomic performance of Albania, fiscal consolidation, adept monetary and prudential policies, and selected structural reforms. Nevertheless, Directors also pointed out that a broad-based export-driven expansion had not yet taken hold and stressed the need to accelerate structural reforms, improve physical and financial infrastructure, and strengthen governance and the rule of law.

II. RECENT DEVELOPMENTS

Albania: 2004 Budget Outturn
(In percent of GDP)

	2004		
	Budget 1/	Program	Estimate
Total Revenue and Grants	25.4	24.8	23.7
Tax Revenue	21.9	21.6	21.3
Non-tax Revenue	2.7	2.3	2.0
Grants	0.8	0.8	0.4
Total Expenditure	31.7	30.9	28.5
Current Expenditure	24.0	23.8	23.4
Capital Expenditure	7.1	6.6	5.2
Overall Balance	-6.3	-6.2	-4.9
Domestic Financing	4.5	4.5	4.1
of which: Domestic Borrowing	2.0	2.0	2.0
Foreign Financing	1.8	1.7	0.8
Current Balance	0.5	0.1	-0.1
Public debt	61.5	58.6	55.3

Sources: Ministry of Finance; and staff estimates.
1/ Incorporates the Supplementary Budget.

5. **Since the fourth review, performance under the program has been good and all program conditionality has been observed.** Quantitative and structural performance criteria for end-September 2004 and the structural performance criterion for end-2004 were all met, some with significant margins (Table 4). Tax collections have met program projections although foreign project-related disbursements and grants continued to underperform. In response, fiscal spending was contained to meet program targets on domestic borrowing—resulting in an overall deficit lower than programmed by

[2] The PRSP is known in Albania as the *National Strategy for Socio-Economic Development* (NSSED). See IMF Country Report No. 04/2004.

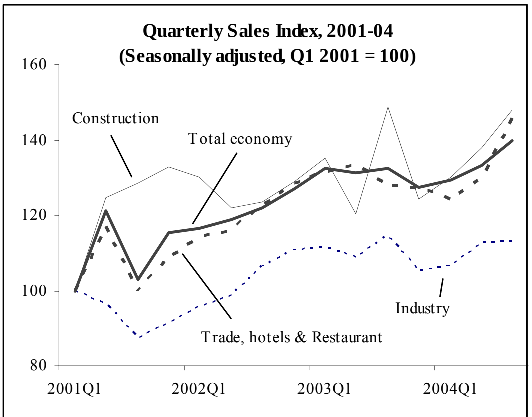
1¼ percentage point of GDP (Tables 5a, 5b, and 6). Monetary conditions have stayed tight and both BoA's net domestic assets and international reserves also overperformed, resulting in a comfortable 4-month reserve import cover (Table 7).

6. **Some structural reforms gained momentum in 2004—notably privatization, financial framework development, electricity sector restructuring, customs modernization, and budget process.** The successful privatization of the large Savings Bank (more than half of banking sector deposits) has revamped banking activity. In addition, notable progress has been made on the privatization of other large public enterprises—i.e., INSIG (insurance), Albtelecom (fixed-line telecom) and ARMO (refinery)—and on implementation of the Power Sector Action Plan (PSAP), allowing the elimination of electricity import subsidies in the 2005 budget. Customs modernization with EU assistance—e.g., deploying the ASYCUDA system in the main custom houses (a program performance criterion)—has tangibly improved efficiency and revenue. The average custom clearing time has been reduced from more than five days in 2003 to below two days, and seizures and cases submitted for prosecution have increased steeply—the latter more than fivefold. Nevertheless, much remains to be done on tax administration, and taxpayer harassment and poor professionalism of some public servants are consistently singled out by private sector bodies as key investment deterrents. The 2005 budget discussion process incorporated substantial advances in transparency, civil society participation, and supporting analyses and information—including much improved revenue forecasts and the simultaneous presentation for parliamentary discussion of the Medium-Term Expenditure Framework (MTEF).[3]

7. **However, progress on wider institutional reforms, mostly beyond the scope of the program, has been protracted and suffered from increasing polarization in the run-up to the mid-2005 general elections.** Multilateral and bilateral donors are providing assistance on a broad range of political and institutional reforms, but progress has been slow. Partly as a result, ongoing negotiations on a Stabilization and Association agreement with the EU have not yet been concluded. In its early-2004 Stabilisation and Association Process report, the European Commission called for greater authorities' commitment in fighting organized crime, human trafficking, money laundering and corruption. Some significant steps, however, have been taken in 2004, including the implementation of asset disclosure requirements for public officials, passage of the property restitution law, and active anti-money laundering collaboration.

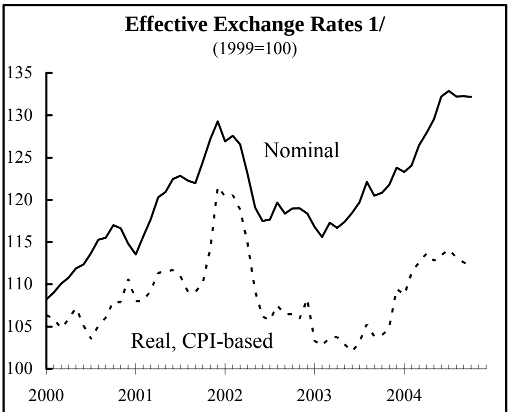
8. **Turning to economic activity, output accelerated during the second half of 2004, after a weak start at the turn of the year, to an annual rate of about 6 percent.** While statistical evidence is scant, it seems that output decelerated substantially by end-2003, partly due to stricter enforcement of urbanistic regulations that dampened construction activity, and to restrained public spending. However, activity picked up in

[3] Known in Albania as the Medium-Term Budget Plan (MTBP).



Sources: INSTAT and IMF staff estimates.

2004Q2 underpinned by favorable weather conditions that boosted agricultural and agro-processing production, and electricity supply aided by sectoral performance improvements. Output accelerated further in the summer supported by a strong tourism season, increased remittances, and public investment. Based on partial indicators of turnover, annual GDP growth in 2004 is estimated at about 6 percent—subject, however, to a wide uncertainty margin.



Sources: Bank of Albania, Ministry of Finance, INSTAT, and Fund staff estimates.
1/ Against the currencies of Albania's major trading partners. A rise in the graph indicates appreciation.

9. **In 2004, the external position strengthened further, exceeding programmed levels, reflecting trade gains and the accounting effect of the lek appreciation**. Indications of strong migrant remittances and tourism earnings; growth in re-export processing activities; and subdued imports due to increased domestic supply of strategic products (electricity, foodstuffs) point to an decline of the current account deficit to 7 percent of GDP in 2004—compared to 8 percent of GDP envisaged in program and to 8¼ percent of GDP in 2003. Reflecting an improved external outturn and firming confidence, the lek has appreciated about 6 percent with respect to the euro during 2004 despite easing domestic interest rates and occasional BoA interventions. In this regard, while Albania’s cost advantage remains wide, competitiveness may be starting to erode.

10. **In collaboration with staff, INSTAT published recently 2001–02 national accounts—incorporated in this paper—resulting in a 7 percent lower nominal GDP level (Box 1).** Beyond this level effect, the revisions do not alter the assessment of the recent past (for which national accounts are not yet available).[4]

[4] To facilitate comparisons, all GDP-share figures (including the program), are presented as ratios to the new GDP in this report.

Box 1. National Accounts Revisions

The first national accounts for Albania, published in 2003, covered the period 1996-2001. In September 2004, INSTAT issued 2002 national accounts and revised 2001 estimates. Figures for periods after 2002 are preliminary estimates or projections agreed with the authorities, but have no national accounts support. The main revisions introduced by the new national accounts estimates are as follows.

- Real GDP growth in 2002 has been corrected downwards reflecting a sharper drop in electricity output and lower growth in industry and services.
- Both 2001 and 2002 GDP deflators are now lower.
- As a result, 2002 nominal GDP is now 7 percent lower than in previous staff reports—a difference carried forward.

Other revisions for years after 2002 reflect estimates of activity in 2004, lek appreciation, and WEO projections, including oil prices.

	2000	2001	2002	2003	2004	2005	2006
Nominal GDP (lek billion)							
Current estimate	531	589	630	695	780	857	939
Previous estimate 1/	531	610	678	746	837	920	1007
Difference (in percent)	0	-3.6	-7.0	-6.9	-6.8	-6.8	-6.8
Real GDP growth (in percent)							
Current estimate	7.3	7.2	3.4	6.0	5.9	6.0	6.0
Previous estimate 1/	7.3	7.6	4.7	6.0	6.2	6.0	6.0
Difference (in percent)	0.0	-0.4	-1.3	0.0	-0.3	0.0	0.0

Sources: INSTAT for 2000-02; staff estimates and projections thereafter.
1/ IMF County Report No. 04/206.

III. Report on the Discussions

11. **Discussions centered on the program objectives of cementing macroeconomic stability, building up solid institutional frameworks for macroeconomic policy implementation, and improving the investment climate.** The authorities see the ongoing expansion in financial intermediation as the cornerstone for expanding private investment and moving economic activity into the formal sector. Thus, nurturing confidence in the monetary policy framework and promoting financial development are key priorities. Given the low level of external debt (17¼ percent of GDP, mainly official assistance), the sustainability of public finances hinges on reducing the domestic borrowing requirement and domestic debt, while the overall deficit is capped by the availability of donors' assistance. Structural reforms on the fiscal area focus on channeling increasing resources to investment in priority areas and improving the quality of fiscal institutions—including by strengthening governance and implementation capacity. Other structural reforms

encompass privatization, sectoral restructuring, and removing barriers to investment—aiming at promoting private sector development and completing the transition to a modern rules-based market economy.

12. **The authorities agreed with the thrust of the staff's analysis and recommendations**. In particular, there was agreement on the importance of medium term-oriented structural reforms within the policy agenda. While there has been progress in this area, stability of purpose and consistent implementation will be essential.

A. Macroeconomic Outlook

13. **The authorities envisaged 6 percent growth in 2005, which underlies budget projections, or possibly even somewhat higher.** Staff concurred that a number of arguments supported this scenario, but with some downward risk. Domestic demand appeared robust and activity was accelerating, further buttressed since the summer by increased public investment and planned privatizations that would attract FDI and support investors' confidence. Banking intermediation and domestic lending was also growing and several banks had started to tap the consumer credit market. The external current account deficit (before official transfers) is projected to remain broadly unchanged as a share of GDP, as export growth is offset by the negative impact of oil price increases and a deceleration of external transfers. On the downside, however, the external environment will probably be less expansionary than in 2004, particularly with a stronger lek, and investment could slow down owing to electoral uncertainties.

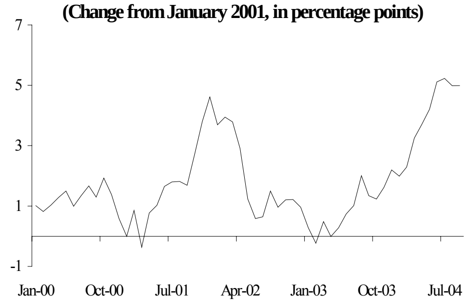
14. **Over the medium term, under the assumption of an improved investment climate, growth can remain close to its historical 6 percent trend**. This expansion, however, is predicated on rising exports and productivity, as structural reforms, improvements in the business climate, financial intermediation, and credit facilitate investment. Reforms to improve the efficiency of tax administration and budget expenditure are envisaged to protect fiscal consolidation gains, while gradually permitting greater expenditure on infrastructure and poverty alleviation. As export earnings and domestic savings expand, the external deficit is projected to resume a downward trend, although possibly remaining around 5–5½ percent of GDP in the medium term owing to capital inflows and associated imports.

15. **The main risks to this scenario stem from possible floundering on structural and institutional reforms.** With low external liabilities, debt sustainability analyses (DSAs) reveal limited vulnerability (Appendix IV). Under the central projection, DSAs point to a steady improvement of the external and public finance positions—a robust outcome under most stress tests. Nevertheless, the DSAs also show that curtailing the trade deficit and sustaining high growth are essential to debt sustainability. Should investment and exports disappoint, output growth could be significantly lower: while imports would also undershot projections to some extent, the bulk of adjustment would need to fall on domestic absorption.

B. Monetary and Financial Sector Policies

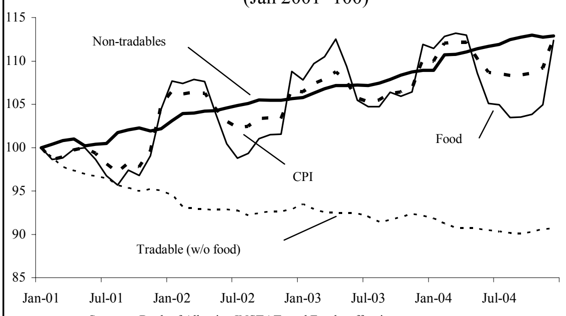
16. **Despite interest rate cuts, the monetary policy stance has remained tight and inflation subdued—against the backdrop of a strengthening banking sector.** The BoA's independence and determination in pursuing its price and financial stability mandates has built credibility on the monetary and financial frameworks, and anchored inflation expectations after the 2002 depreciation and banking stress episode. Although the BoA's policy rate has gradually eased since 2002 by 325 basis points to 5¼ percent, it has remained high—which jointly with the lek appreciation resulted in tight monetary conditions. Price pressures were further muted in 2004 by abundant agricultural supply, with the 12-month rate of inflation closing 2004 at 2.2 percent. Responding to lower perceived risk and interest rate differentials, the composition of broad money has started to shift away from cash towards bank deposits—with the bulk of their growth contributed by lek deposits (Figures 2, 3, Box 2). In the wake of the Savings Bank privatization, the

Albania: Monetary Conditions Index 1/
(Change from January 2001, in percentage points)



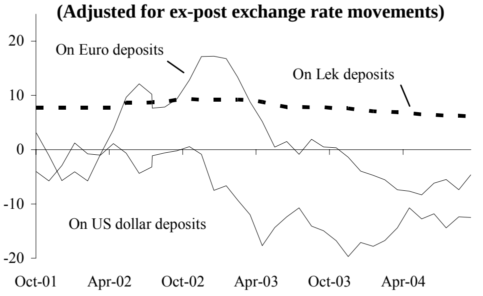
Sources: Bank of Albania; and staff estimates.
1/ Exchange and interest rates weighted equally.

Consumer Price Index and Components
(Jan 2001=100)



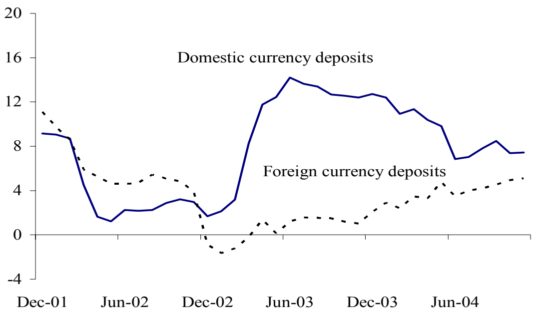
Sources: Bank of Albania, INSTAT, and Fund staff estimates.

Nominal Deposit Rates
(Adjusted for ex-post exchange rate movements)



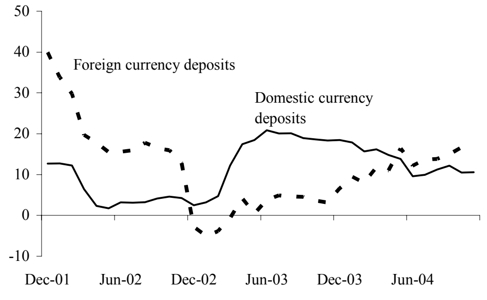
Sources: Bank of Albania and IMF estimates.

Annual Percent Contribution to Deposit Growth



Sources: Bank of Albania and IMF estimates.

Annual Percentage Change in Deposits

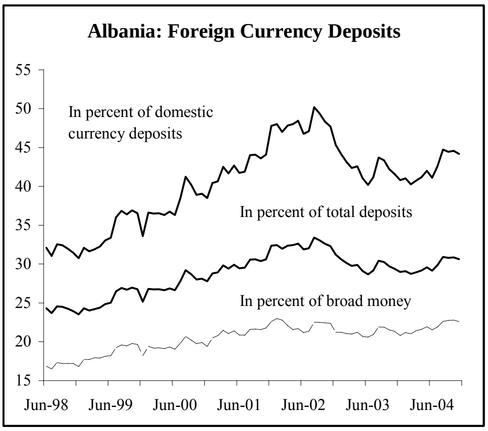


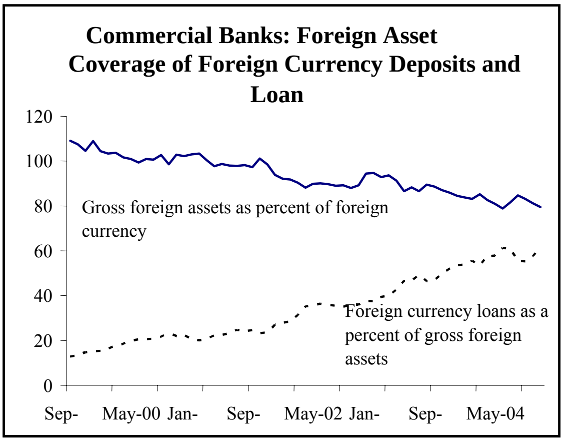
Sources: Bank of Albania and IMF estimates.

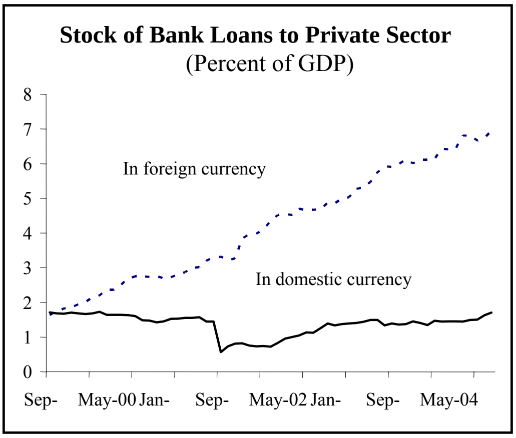
banking sector is now fully under private management, and the BoA is reinforcing the prudential and payment system frameworks with MFD and WB TA, in anticipation of growing credit activity.

Box 2. Dollarization and the Financial System[1]

Following the collapse of the pyramid schemes, dollarization increased. However, even at its peak in late 2002, it remained at relatively moderate levels—below the average for transition countries. Dollarization of deposits has since declined in response to tighter monetary policy. Lending to the private sector, however, still takes place mostly in foreign currency. Potential risks to financial stability are mitigated by limits on banks' open foreign currency positions, strict lending criteria, and large asset positions abroad. Looking forward, banks are expected to continue substituting domestic for foreign assets, and to increase lek-denominated lending.







Sources: Bank of Albania; and IMF staff estimates.

[1] An accompanying Selected Issues paper analyzes dollarization in Albania.

17. **The newly appointed management of the BoA reaffirmed its commitment to price stability, a flexible exchange rate regime, and central bank independence**. Although parliamentary appointment of the new BoA Board and Governor had suffered delays and at times become politicized, the authorities provided assurances of their commitment to BoA independence and a strong monetary policy framework. In this regard, the Treasury's overdraft facility with the BoA (which is seldom used, and always for

liquidity management and not for budget financing) is to be phased out, starting 2005; and government securities have been issued to the BoA to cover the reserve valuation losses stemming from the lek appreciation in accordance with the Central Bank Law (MEFP ¶18). Staff supported BoA's plans to reinforce its analytical and forecasting capabilities. In order to raise the understanding of policy actions by financial market participants and enhance the leading role of the BoA in setting expectations, staff recommended that Board meetings be followed by public statements explaining the Board's policy stance.

18. **There was also agreement that foreign exchange interventions should keep aiming at smoothing out fluctuations, maintaining reserve cover, and facilitating the shift towards lek assets of private sector balance sheets—without any exchange rate target.** There had recently been public calls for the BoA to counteract actively the strength of the lek. However, the authorities consider that, while the lek appreciation has resulted in some temporary loss of competitiveness, monetary policy should stay focused on the inflation target. Moreover, the appreciation with respect to the US dollar is largely explained by the evolution of the euro—which the lek broadly tracked during the second half of 2004.

19. **With inflation subdued and the lek appreciating, the BoA's gradual easing of its policy stance had been appropriate, but there was agreement that a pause was now warranted.** Over 2004, increased lek demand, appreciation, and favorable domestic supply conditions had allowed the interest rate to reach record lows without triggering inflation. At the time of the discussions, however, expectations of price increases around the holidays, agricultural output seasonality, and the possible lagged effect of higher international oil prices argued for a waiting period with neutral bias before any further repo rate move.

20. **The authorities are undertaking reforms to foster financial intermediation, curtail the use of cash in the economy, and strengthen prudential supervision.** Credit to the private sector is still low (8½ percent of GDP in 2004), but it is growing fast at 30 percent annually and the banking sector is showing welcome dynamism and expanding the range of its products. Supporting this process, the BoA successfully introduced a real-time gross settlement system and plans to launch in 2005 a bulk clearing system for small transactions that will facilitate the payment of bills, credit card use, and other services through the banking system. The government is channeling the payment of salaries through banks, rather than using cash—which will improve governance and expenditure management as well as household access to financial services (MEFP ¶16). The authorities are also considering the development of an inter-bank collateralized money market and foreign exchange swaps to foster better liquidity management and mitigate spot market shocks. In staff's view, measures to deepen the T-bill market also warrant consideration—including extending participation to large enterprises and introducing market-making arrangements. With MFD and WB assistance, the authorities are upgrading their prudential monitoring capacity and taking an increasingly proactive approach to supervision. In this vein, the authorities see the 2005 FSAP as an opportunity to assess financial stability issues

and chart future improvements in the monetary framework and supervisory capacity, including in the incipient insurance sector.

Albania: Banking Sector Indicators

	2002	2003	2004 1/
Outstanding Bank Loans by Economic Sector in percent of total			
Trading and maintenance of durables	40.4	34.0	21.9
Processing industry	17.0	17.0	18.2
Real estate	9.1	13.0	15.6
Construction	8.6	10.0	10.2
Hotels and restaurants	6.0	6.0	8.3
Agriculture, hunting and fruit production	0.8	1.0	1.6
Other	18.1	19.0	24.2
Indicators of Banking Sector Soundness			
Regulatory capital as a percent of risk weighted assets	31.6	28.5	25.1
Non performing loans as a percent of total loans	5.6	4.6	4.7
Non performing loans net of provisions as a percent of capital	4.8	3.9	3.4
Non performing loans as a percent of total assets	0.3	0.2	0.2
Return on assets (on an annual basis)	1.2	1.2	1.4
Return on equity (on an annual basis)	19.1	19.5	23.7
Liquid assets to total assets (liquid asset ratio)	77.8	73.6	73.5

Source: Data provided by Bank of Albania.
1/ As at September 2004.

C. Fiscal Policy

21. **The public finances have strengthened substantially over the past few years, but progress on budget process and administration has lagged behind.** The overall deficit improved by about 3 percentage points of GDP in 2002-2004, reflecting expenditure retrenchment. But, although tax collections have increased somewhat, primarily as a result of tax policy measures, tax and customs administrations' capacity remains low. Progress in budget implementation, expenditure planning and control, and investment in priority areas

Albania: Budget Performance
(In percent of GDP)

	2002		2003		2004		2005
	Budget	Actual	Budget	Actual	Budget 1/	Est.	Budget
Total Revenue and Grants	25.7	24.5	26.0	24.0	25.4	23.7	24.1
of which: Tax Revenue	22.0	20.5	22.1	20.9	21.9	21.3	21.3
Total Expenditure	34.6	31.1	32.1	28.5	31.7	28.5	29.0
of which: Current Expenditure	26.3	24.5	24.2	24.1	24.0	23.4	22.7
Overall Balance	-8.8	-6.6	-6.1	-4.4	-6.3	-4.9	-4.9
Domestic Financing	4.3	3.3	3.0	3.0	4.5	4.1	3.3
of which: Domestic Borrowing	2.5	3.2	2.9	2.9	2.0	2.0	2.7
Foreign Financing	4.5	3.3	3.1	1.4	1.8	0.8	1.6
Current Balance	-1.2	-0.7	1.1	-0.5	0.5	-0.1	0.5
Public debt	69.5	64.8	67.1	60.7	61.5	55.3	54.5

Sources: Ministry of Finance; and staff estimates.
1/ Incorporates the Supplementary Budget.

have been undermined by repeated over-optimistic budget revenue projections—resulting in haphazard spending cuts when expected resources failed to materialize.

22. **In 2004, the authorities stayed the course of fiscal consolidation and, after downward adjustments to revenue and expenditure projections during the fourth review, budget implementation has improved.** Through a supplementary budget, the authorities allocated the Savings Bank privatization proceeds to investment and debt reduction in equal parts, which jointly with a limited deficit, lek appreciation, and GDP growth, resulted in a decline of 5½ percentage points in the debt-to-GDP ratio. In 2004, the current budget is estimated to have been in broad balance, for the first time since transition. Thus, budget financing—including borrowing and privatization receipts—funded only investment.

23. **The 2005 budget embodies further reduction of the underlying domestic borrowing and debt, improvements in spending composition, and a realistic revenue projection.** Staff supported the budget submitted to Parliament—including through meetings with legislators. The 2005 budget envisages a reduction in underlying domestic borrowing (i.e., excluding the effects of the Savings Bank privatization) by 0.2 percentages points of GDP to 2.7 percent of GDP. This will help to accommodate the expected expansion of private sector credit without triggering inflation and to maintain the public debt-to-GDP ratio on a downward trend. While increasing somewhat total spending as a share of GDP, it plans a reduction in current outlays—thus, redirecting resources to investment in priority areas and further improving the current balance. Crucially, the expenditure plans are based on a credible revenue forecast, based on past realizations and not on previous over-optimistic budgets that remained under-realized. The budget also envisages the divestment of the remaining minority stakes in banking and other companies. The ongoing privatization of Albtelecom has not been budgeted given uncertainties as to its timing and amount. The authorities, however, reiterated their commitment to continue devoting half of the proceeds of all large privatizations to debt redemption.

24. **While the 2005 fiscal package is a significant first step, substantial additional efforts are needed to modernize and enhance the efficiency of revenue administration (MEFP ¶12).** The authorities plan to expand ASYCUDA to the remaining custom houses and apply risk assessment methods for inspections. Staff argued that, likewise, tax administration reforms should emphasize the implementation of standardized procedures and risk assessment methods, strict application of existing regulations (reforming them if necessary), training and professional qualification of tax officials, fair and professional taxpayer relations, and extensive use of information technology. Staff supported the thrust of the 2005 fiscal package along these lines, including the implementation of many FAD TA recommendations (Box 3). But it argued against some of the measures included in the package: The introduction of a VAT exemption of providers to exporters and filing requirements beyond the monitoring capabilities of the tax administration risk adding opportunities for noncompliance. The authorities agreed to discuss these issues with upcoming FAD TA, supplementing the enacted package as necessary. Also, the authorities

have adopted a plan to clear VAT refund arrears to exporters (0.1 percent of GDP) and implement a quick refund system in 2005.

Box 3. 2005 Fiscal Package

The 2005 fiscal package aims at improving revenue administration. The cost of the package is about 0.3 percent of GDP in 2005. Its main measures are the following.

Reducing administrative complexity and tax evasion:

- subjecting the first sale of residential units to VAT, while exempting rental payments starting in 2006;
- eliminating the requirement for small businesses to renew their registration every year;
- reducing the number of personal income tax brackets to 5 from 7;
- including social security contributions in the base of the personal income tax;
- introducing personal income tax returns.

Bringing tax obligations on businesses closer to the regional average:

- reducing the corporate income tax rate from 25 percent to 23 percent in 2005, and to 20 percent in 2006;
- reducing the small business tax rate on turnover from 4 percent to 3 percent;
- exempting from VAT sub-contractors of re-export companies;
- shortening from 6 to 3 months the obligatory carry-forward period before reimbursement of VAT credit.

Strengthening taxpayers' rights:

- strengthening appeal procedures with clear steps for appeal escalation and time limits for issuing decisions;
- limiting the response period for VAT refund requests (before interest charges apply) to 30 days;
- introducing accrual of interest on overdue tax refunds.

25. **Other structural reforms in the fiscal area also need to be accelerated with a focus on improving the budget process, expenditure management, and civil service and public pay reform (MEFP ¶13).** The mission discussed means to enhance the medium-term orientation of the budget, including by casting it on a rolling multi-year projection. The authorities plan to build up capacity to manage expenditure and monitor investment projects that extend over the medium term, including by introducing information technology and strengthening public procurement and tendering procedures. In this regard, staff expressed concern about the Tirana-Rinas-Durrës railway project which, after receiving the results of the independent feasibility study, the authorities were

considering to undertake. In the authorities' view, the project would have significant spill-over effects on growth. In contrast, WB staff has argued that an alternative focus on improving the road network, including secondary and local roads, would be more consistent with the authorities' NSSED and would represent a better use of limited public funds—EU recommendations on transportation sector strategy also support these relative priorities. The mission stressed that, in any case, the associated budgetary and financial impact would need to be accommodated within the medium-term expenditure envelope and without undermining the declining path of public debt. Regarding wage policy, the authorities intend to refrain from granting automatic across-the-board public pay increases in 2005. Instead, they will use the wage bill expansion appropriated in the budget to implement targeted wage increments in priority sectors and performance incentives associated with the civil service reform. The authorities also intend to formally repeal the automatic indexation of wages prior to the formulation of the 2006 budget.

26. **The mission discussed medium-term plans to maintain the downward course of public debt while making preparations to tap international financial markets as concessional assistance declines (Table 8)**. While aiming for a full mobilization and effective use of domestic budget resources, the authorities are considering how to replace concessional foreign assistance over time in a cost-effective manner and without crowding out domestic investment. In this regard, staff welcomed plans to improve debt management and recommended considering steps to obtain a sovereign credit rating—which would introduce an additional source of policy discipline and facilitate market access for the larger domestic firms. While the authorities agreed on this recommendation, they argued for pacing the access to international capital markets with improvements in the budget framework to ensure the efficient use of the additional resources.

Albania: Medium-Term Fiscal Path

(In percent of GDP)

	2004	2005	2006	2007	2008	2009
Overall balance	-4.9	-4.9	-4.2	-3.9	-3.6	-3.3
Domestic financing	4.1	3.3	3.0	2.7	2.7	2.7
Privatization receipts	2.0	0.6	0.4	0.2	0.2	0.2
Domestic net borrowing	2.0	2.7	2.6	2.5	2.5	2.5
Foreign financing	0.8	1.6	1.1	1.1	0.9	0.6
Public debt	55.3	54.5	54.0	54.0	53.1	52.0
Domestic	38.0	37.3	36.7	36.5	35.9	35.3
External	17.3	17.1	17.2	17.5	17.3	16.8
Debt service to revenue 1/	17.6	17.6	16.7	15.6	16.0	15.9

1/ Revenue excludes grants. Almost none of the domestic debt has a maturity of more than one year.

D. Poverty Alleviation and Other Structural Reforms

27. **Rising incomes have underpinned progress along some basic dimensions of poverty—although poverty remains a key policy priority (Box 4).** Consistent time series data are still wanting but indicators of absolute poverty, such as population with daily expenditure below US$2, and child and maternal mortality appear to have improved (Table 2). Analyses point to the key positive role played by sustained high growth, selected social assistance programs, and non-official safety net arrangements—including migrant remittances and micro-credit networks. The evidence, however, is not all positive, as some social indicators (e.g., educational enrollment) have deteriorated. The authorities are improving social assistance targeting in collaboration with municipal governments and are

Albania: Poverty Indicators 1/

	LCS 1998	LSMS 2002
Percentage of population with consumption below basic requirements	...	25.4
Percentage of population with consumption below minimum calorie requirements	...	4.7
Percentage of population with consumption below 60 percent of median	29.6	13.5
Percentage of population with per capita income below US$2 a day	46.6	10.8
Gini coefficient 2/	0.43	0.28
Percentage of population without running water	...	34
Percentage of population without sanitation in dwelling	...	39
Percentage of population without electricity for over 6 hours/day	...	61
Infant mortality rate (per 1,000 live births) 3/	27.6	22

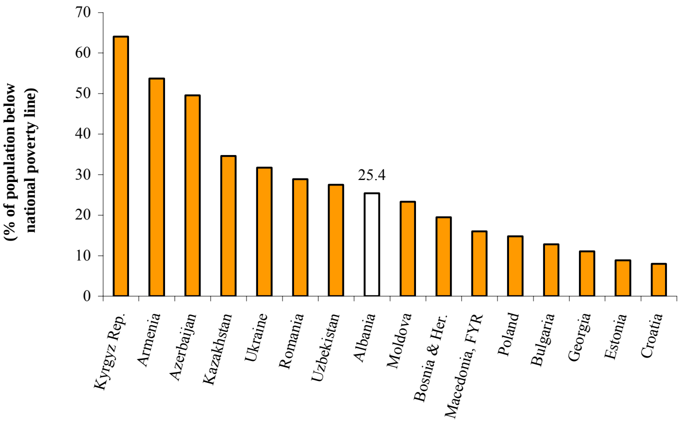
1/ The 1998 Living Condition Survey (LCS) was carried out by INSTAT. The 2002 Living Standards Measurement Survey (LSMS) was carried out by the World Bank. Due to different methodologies, data are not necessarily comparable. 2/ Higher value indicates more inequality. 3/ The source is the World Development Indicators database.

testing a system which requires participation in labor market programs for unemployment benefit eligibility. The authorities have implemented a subsidy to shield low-income households from electricity tariff hikes through direct reduction in their bill. This delivery vehicle has prompted better targeting and budget savings, while helping to forestall opposition to sectoral restructuring plans.

Box 4. Poverty Issues [1]

Despite substantial economic progress, living standards in Albania remain among the lowest in Europe. About one quarter of the population falls below the national absolute poverty line—compared with 19 percent in Bosnia and Herzegovina, 16 percent in FYR of Macedonia and 8 percent in Croatia. Albania also ranks low in terms of the UNDP Human Development Indicator, the UNICEF's report on the State of the World's Children, and progress on Millennium Development Goals.

Figure 3. Transition Economies in Europe and Central Asia: Poverty Rates



Source: World Development Indicators database and Country Poverty Assessment Reports, World Bank.

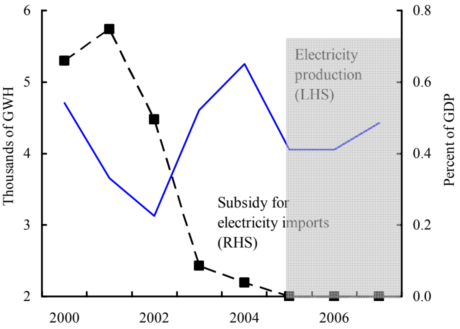
A successful poverty reduction strategy should focus on sustaining growth and reforming basic infrastructure and service provision. In the short-run, some mechanisms have proven particularly effective in alleviating the most severe aspects of poverty among vulnerable groups, including targeted social programs and access to micro-credit.

1/ An accompanying Selected Issues paper surveys the Albanian experience on poverty alleviation.

28. **The authorities' privatization agenda is making substantial progress (MEFP ¶ 19).** As indicated above, after privatizing the Savings Bank and completing the pre-privatization of INSIG with IFC and EBRD participation, the authorities have started the privatization of Albtelecom (abolishing also its international communications monopoly) and ARMO, and the 2005 budget envisages divestment of other public stakes. The authorities intend to follow with privatization or concession of most of the few remaining public companies.

29. **Electricity sector reform has achieved impressive success in 2003–04, but endemic problems in other infrastructure areas remain.** Decisive PSAP implementation with WB assistance and favorable rainfall resulted in a 65 percent increase in electricity production since 2002; collection targets have been met; and a stabilization fund has been set up whereby profits in good pluvial years will finance imports in less favorable times. Continued adherence to the PSAP and steady investment, however, will be needed to avoid a recurrence of energy crises. The inter-enterprise arrears clearing plan has continued on track, aiming for end-2005 completion. However, significant reforms are needed in the water supply sector—the main originator of arrears—and a pilot program has been started with WB assistance.

Electricity Production and Import Subsidy 2000-2007



Source: KESH.
Actuals up to 2003; estimate for 2004; targets thereafter.

Albania: Basic Electricity Indicators 2000-07

	2000	2001	2002	2003	2004 Est 1/	2005	2006 Proj 2/	2007
Domestic Electricity production in GWH (2000=100)	100	78	66	98	112	86	86	94
Supply and use of electricity in percent of demand								
Electricity Demand	100	100	100	100	100	100	100	100
Domestic Production	76	59	50	74	83	61	60	63
Net Imports	16	28	36	15	9	34	33	32
Unsatisfied Demand	7	13	14	11	8	5	7	5
Collection rate (for electricity bills)	62	70	80	85	89	90	92	94
Subsidies for electricity imports (as percent of GDP)	0.7	0.7	0.5	0.1	0.0	0.0	0.0	0.0
Average electricity tariff (in Lek per KWh)	3.41	3.99	5.25	5.95	6.23	7.34	7.99	8.62

1/ Based on November outcomes.
2/ Action Plan for 2005-2007

30. **Reforms in other areas, however, have encountered mixed success.** Business climate indicators remain disappointing. The authorities are planning to update their action plan to remove barriers to investment (including licensing and registration procedures) based on new surveys conducted in recent months (MEFP ¶21). But faster progress will be needed in reforming the judiciary, cadastre, and property rights protection.

Business Climate Indicators (2003)

	Albania	Regional Average	OECD Average
Starting a Business			
Number of procedures	11	10	7
Duration (days)	47	48	30
Cost (% GNI per capita)	65	21.7	10.2
Hiring & Firing Costs			
Flexibility of hiring 1/	33	51	49
Flexibility of firing 1/	15	39	28
Enforcing Contracts			
Number of procedures	37	25	17
Duration (days)	220	344	233
Cost (% GNI per capita)	72.6	27.9	7.1
Procedural Complexity Index (Max=100)	76	56	49
Getting Credit			
Public credit registry index 2/	0	49	58
Private bureau coverage (borrowers per 1000 capita)	0	38.6	443.5
Closing a Business			
Goals of insolvency index 3/	42	51	77
Court powers index 4/	67	57	36

Source: Doing Business, 2003.

1/ Each index assigns values between 0 and 100, with higher values representing more rigid regulations.

2/ The index ranges from 0 to 100, with higher values indicating that the rules are better designed to support credit transactions.

3/ The index ranges from 0 to 100. A higher value indicates a more efficient insolvency system.

4/ Higher values indicate a more court involvement in the process, usually an impediment to resolutions.

31. **Severe statistical deficiencies hamper policy formulation and the mission discussed plans to improve economic statistics (MEFP ¶24).** A statistical law was passed and 1996-2002 national accounts were published in 2004. With STA and other assistance, INSTAT plans to improve availability of economic indicators, including an experimental quarterly GDP (Box 5).

Box 5. Structural Conditionality

In addition to implementing 2005 fiscal package (Box 3, MEFP ¶12), structural conditionality focuses on the following areas, deemed critical to achieving program objectives.

- **Reforms of the tax administration, and the budget and expenditure process:** (i) extend the ASYCUDA system and implement the ASYCUDA risk assessment module in 5 customs houses (¶24;MEFP¶12); (ii) implement a system of rapid VAT refunds, and clear the VAT refunds originated prior to June 2004, preparing quarterly reports (¶24;MEFP¶12); (iii) implement measures to raise efficiency and transparency of expenditure, including formally repeal price indexation of wages (MEFP¶13); (iv) carry out independent feasibility studies for large projects funded by non-concessional borrowing (MEFP¶21); (vi) continue to reschedule the arrears on inoperative payments agreements with official creditors (Article XIV) and conclude this process with official creditors by the end of the program (¶34;MEFP¶23).
- **Financial development and reduction of the use of cash, governance and business climate**: (i) increase the number of public employees paid through the banking system (¶20;MEFP¶16); and, (ii); continue to implement the action plan to remove administrative barriers to investment (¶30;MEFP¶21;NSSED Chapter 7).
- **Quality and coverage of economic statistics** (¶31; MEFP¶24): (i) present to Parliament a 5-year statistical program; (ii) publish the preliminary 2003 national accounts and introduce pilot quarterly GDP estimates; (iv) issue 2004 national accounts.

World Bank Structural Conditionality

Bank's conditionality focuses on implementing the action plan to modernize the electricity sector (¶29;MEFP¶20); governance and institution building sustainable private sector development; human development, and restructuring of key sectors (Appendix II).

E. External Policies

32. **Albania has a floating exchange rate regime and there was agreement that this has served the country well.** The rapid transformation of the economy makes the underlying equilibrium exchange rate level a dynamic parameter subject to wide uncertainty. In this context, a market-determined flexible exchange rate has proven a useful means to forestall misalignments. Moreover, as a small open economy, Albania is buffeted by external, confidence, and domestic supply shocks and the flexibility of the exchange rate remains a necessary buffer to facilitate adjustment. Further, the still significant dollarization levels would undermine achieving durably any exchange rate target in the face of changing fundamentals.

33. **Albania benefits from one of the most open trade regimes among transition countries.** Import tariffs are among the lowest in the region, coupled with very limited nontariff barriers; and several regional free-trade agreements are in effect.[5]

Albania: Import Tariffs, 1996-2004

(In percent)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Average tariffs									
Simple	15.0	13.8	13.6	12.7	10.5	7.9	8.1	7.9	7.3
Weighted	8.5	14.0	...	...	...	7.5	7.9	8.1	8.2
Minimum tariffs	5	5	0	0	0	0	0	0	0
Maximum tariffs	30	30	30	20	18	15	15	15	15
Number of tariff levels	4	4	5	4	4	4	4	4	5

Source: Albanian authorities.

34. **Albania maintains restrictions in accordance with Article XIV in the form of outstanding debit balances from inoperative bilateral payments agreements in former nonconvertible and convertible currencies.** These agreements were in place before Albania became a member of the Fund. As of October 2004, outstanding debit balances were maintained with Algeria, Cuba, the Czech Republic, Greece, Poland, Romania, the Slovak Republic, Vietnam, and Serbia and Montenegro. In 2004, arrears with Hungary were cleared and balances with the Czech and Slovak Republics, and Poland reconciled. An agreement with Romania is planned to be signed in early 2005.

35. **The program for 2005 is fully financed.** The 2005 financing gap (US$ 82 million) is expected to be covered with donors assistance and bilateral arrears rescheduling (Tables 9, 10, 11, and 12).

36. **The authorities are committed to clear all remaining debit balances with official creditors by the end of the program and with private creditors by 2006**. However, incomplete documentation and counterpart delays in some cases have hindered progress. Staff urged the authorities to continue efforts to clear all outstanding arrears. Regarding the financing assurances review, in 2004 arrears with a company based in FYR Macedonia were cleared and negotiations with remaining private creditors continued. No new arrears have been incurred and the existence of the unsettled amounts does not put the recovery of the Fund's credit at risk. Fund's exposure with Albania is very limited (SDR 62 million or 128 percent of its quota) and projected to decrease after 2005. Fund's debt service represents less than 1 percent of exports.

[5] The free trade area comprises Bosnia-Herzegovina, Bulgaria, Croatia, Kosovo, FYR Macedonia, Moldova, Romania, and Serbia and Montenegro.

F. Program Issues

37. **It is proposed that the last disbursement under the arrangement be conditional on the observance of end-March 2005 quantitative performance criteria, end-March and End-June 2005 structural performance criteria, and the completion of the sixth review (Table 13).**

38. **The authorities broadly agreed with the conclusions of the accompanying Ex Post Assessment, and expressed preference for a three-year successor arrangement.** In their view, the Fund had provided valuable input in the design and implementation of structural reforms through appropriately focused conditionality. They stressed the role of Fund conditionality in maintaining reform momentum, including by catalyzing political wills and shoring up consensus. They considered that a three-year successor arrangement would provide medium-term certainty to investors and donors regarding macroeconomic prospects and institutional reform continuity. In this connection, drawings (even if small) provided a significant signal. The authorities and donors envisaged that program conditionality could play a key role in the Stabilization and Association process with the EU. The authorities also indicated interest on wider room within the program to develop stronger ownership.

IV. Staff Appraisal

39. **The macroeconomic performance of the Albanian economy in recent years has been remarkable, but maintaining growth and reducing poverty will require improving external competitiveness and attracting strategic investment.** Growth has recovered to about 6 percent without rekindling inflation, and confidence in the lek and the financial sector has firmed up. This performance owes much to the authorities' perseverance on fiscal consolidation and public debt reduction, sound monetary and financial sector policies, privatization, and restructuring of the strategic energy sector. However, growth has been driven to a large extent by nontradeables, with buoyant domestic demand and incomes supported by migrant remittances and external transfers—while limited progress has been made in reducing trade imbalances. Looking ahead, growth prospects depend crucially on attracting high quality investment and fostering outward-oriented activity.

40. **The outlook is for a continuation of growth at about its 6 percent trend in 2005.** The current demand strength is set to continue into 2005 underpinned by public investment and rising credit to the private sector from its current low level, including consumer credit. However, political uncertainties and a less stimulative external environment pose downward risks—particularly since the real effective appreciation of the lek may have eroded competitiveness in some sectors.

41. **Over the medium term, export-oriented investment and associated productivity is expected to improve gradually the trade balance and increasingly drive growth.** Although external indebtedness is limited, DSAs confirm that external

sustainability hinges on successfully improving competitiveness and maintaining growth. Therefore, it is essential that macroeconomic stability be complemented with improvements in infrastructure and the investment environment. Beyond traditional macroeconomic policy-related structural reforms, a fuller integration of Albania in the regional and world economies will require progress in institutional reforms that promote the establishment and protection of property rights, and complete the transition to a rules-based market economy.

42. **The authorities' determination in building a sound monetary policy framework has been instrumental to macroeconomic stability.** This framework is appropriately based on a clear BoA mandate on price and financial stability; central bank independence; and a flexible exchange rate regime. Its credibility will require that BoA's foreign exchange interventions continue avoiding any explicit or implicit exchange rate target. Plans to introduce a bulk clearing system and a collateralized inter-bank money market are well timed to support financial development with market infrastructure provision—and would be buttressed by measures to deepen the T-bill market and allow trading of foreign exchange swaps. The ongoing expansion of financial intermediation is welcome but will require improvements in supervisory capacity, encompassing the insurance sector. The upcoming FSAP will provide an opportunity to advance in this direction. Payment of government wages through the banking system will be an important catalyst for increased banking intermediation of transactions—reducing the use of cash and opportunities for informality and misgovernance.

43. **The gradual easing of the monetary policy stance since 2002 has been appropriate, but the current pause and neutral bias are warranted.** Whereas there may be further room for easing in 2005 if current trends continue, the policy direction should be reconsidered afresh as more evidence becomes available on seasonal price pressures, fuel price effects, and international conditions.

44. **Much progress has been made in consolidating the public finances and the 2005 budget is a further step in that direction.** The continued reduction in the underlying domestic borrowing requirement and declining profile of public debt are appropriate to crowd in private sector credit and in anticipation of a likely decline of concessional assistance. The budget emphasis in curtailing current spending to a level commensurate with a realistic projection of recurrent revenue—thus devoting borrowing and privatization resources fully to invest—is a substantial step forward in the quality of expenditure and fiscal sustainability. The decision to replace across-the-board wage increases by targeted incentives to improve performance and services in priority areas, and to formally repeal wage indexation before the 2006 budget will further enhance expenditure efficiency. In an election year, the authorities' determination to persevere at fiscal consolidation and improve the budget process is commendable and should cement credibility and investors' confidence.

45. **Progress in capacity building and fiscal institutions reform, however, has been weak and needs to be accelerated.** The 2005 fiscal package and other current initiatives

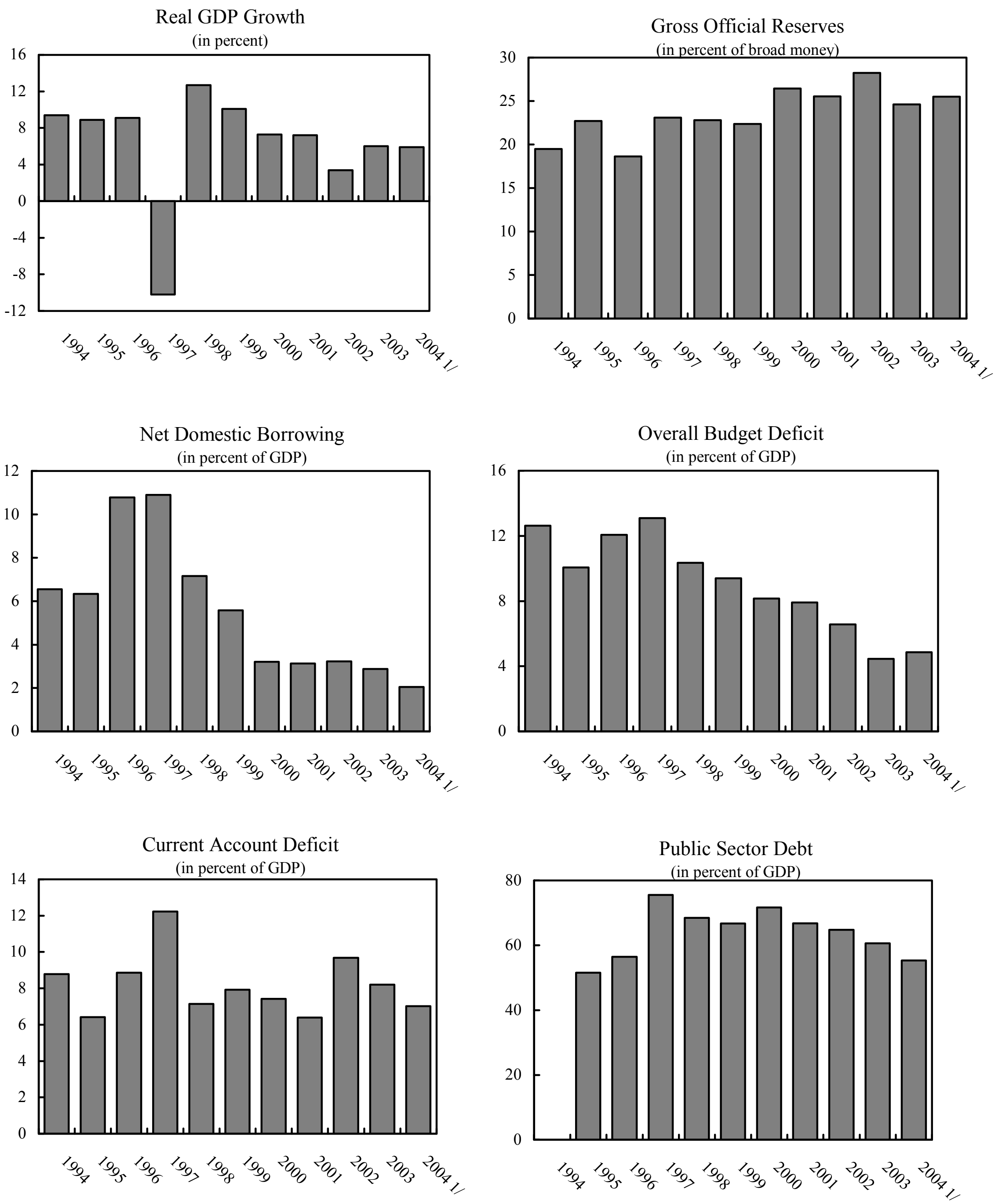
contain many positive elements that, if consistently implemented, could enhance the efficiency of the tax system. The introduction of an effective VAT refund mechanism should be a priority as it would reduce export costs and benefit the investment climate. But broader tax administration reforms are necessary to substantially boost compliance and mobilize budget resources—including standardized procedures, risk analysis-based audit methods, information technology, and human resource rationalization. Likewise, on the spending side, control and tendering procedures; payment, commitment and reporting systems; and treasury and debt management need strengthening.

46. **Privatization and electricity sector reforms have achieved substantial success, but structural and institutional reforms in other areas need to be intensified.** We welcome the start of the privatization process of Albtelecom and ARMO; the decision to sell the minority public stake in banking and telecommunications; and the end of the Albtelecom monopoly on international communications. While vigilance has prevented the emergence of new inter-enterprise arrears, eliminating pressures in this direction will require restructuring of the water provision system and other utilities to ensure their viability. While data provision to the Fund is adequate, plans to expedite and improve the production of economic statistics are welcome and should be considered a priority.

47. **Program implementation has been good and the supplementary MEFP contains a strong policy program to preserve macroeconomic stability and foster growth.** The authorities continued appropriate good-faith efforts to reach agreements with official and private external creditors on remaining arrears. Staff therefore supports the authorities’ request for completion of the fifth review and financing assurances review, and for a 5-month extension of the program to allow for the sixth review and associated disbursement to take place during the program period. It is proposed that Albania be kept on a 24-month Article IV consultation cycle, subject to the provisions of Board decision number 127-94 (02/76).

48. **Given the extensive reform agenda and the authorities’ preference, a successor medium-term arrangement appears appropriate, as discussed in the accompanying EPA.** The nature of the successor arrangement, would depend on Albania’s PRGF eligibility following expiration of the current arrangement.

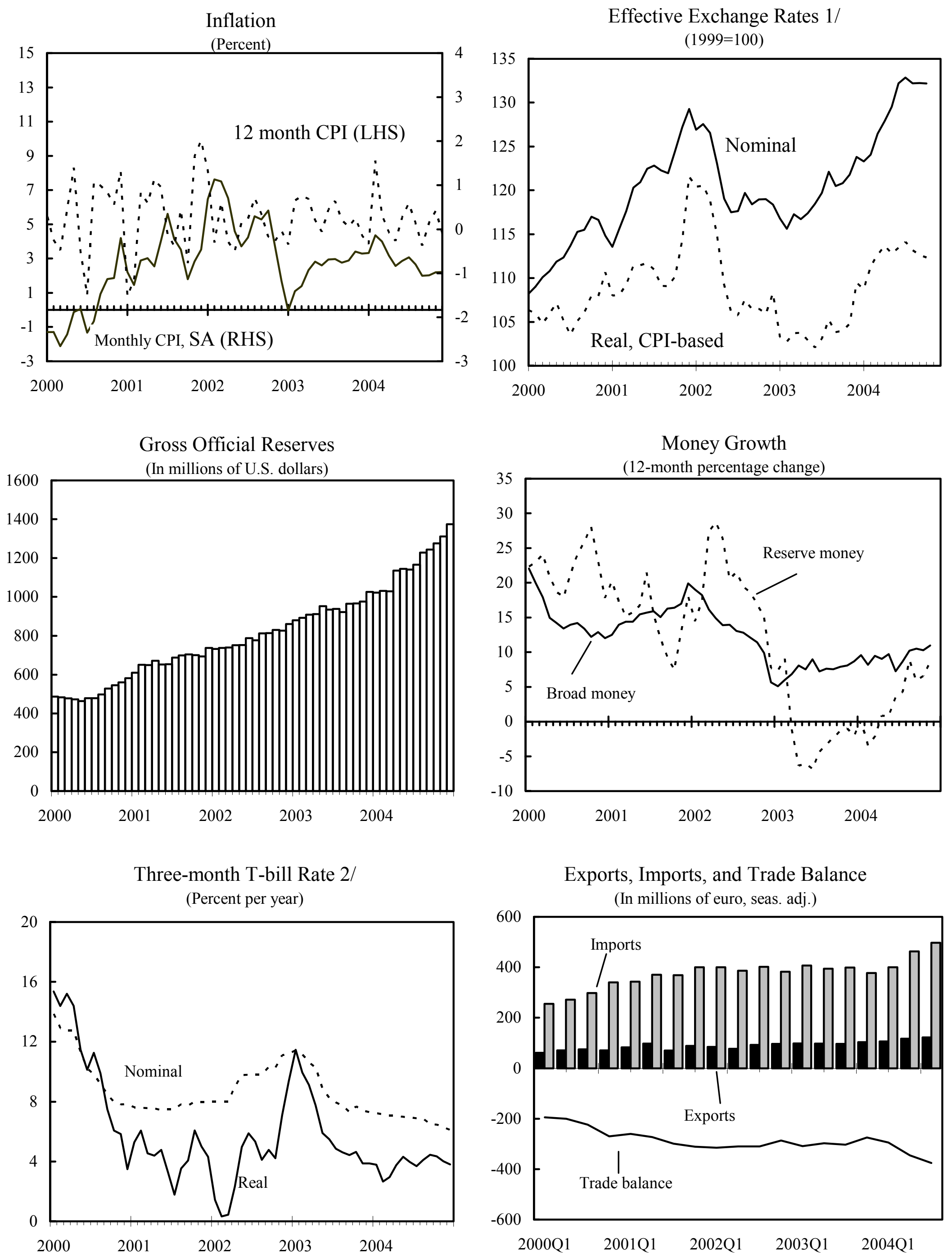
Figure 1. Albania: Economic Developments and Prospects, 1994–2004 1/



Sources: Albanian authorities; and Fund staff estimates.

1/ Data for 2004 are staff estimates.

Figure 2. Albania: Monthly Economic Indicators, 2000-04



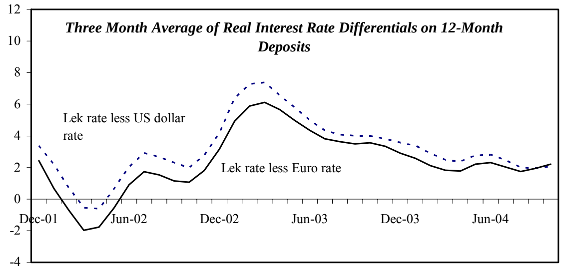
Sources: Bank of Albania, Ministry of Finance, INSTAT, and Fund staff estimates.

1/ Against the currencies of Albania's major trading partners. A rise in the graph indicates appreciation.

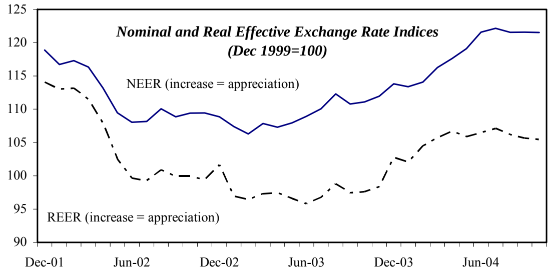
2/ The real rate is derived using annualized seasonally adjusted CPI inflation.

Figure 3. Albania: Monetary Developments

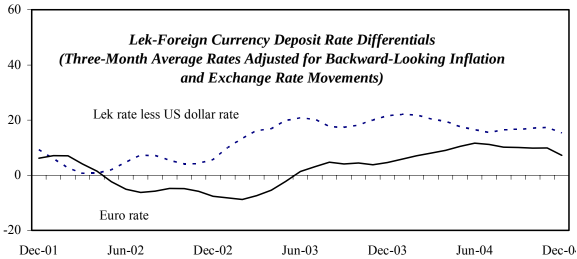
A tight monetary policy raised real yield differentials strongly in favor of domestic assets...



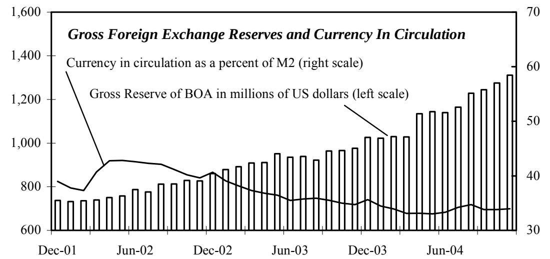
...appreciating the lek in nominal and real terms...



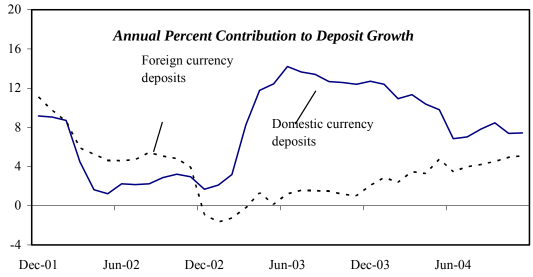
...creating additional incentives to hold domestic rather than foreign assets...



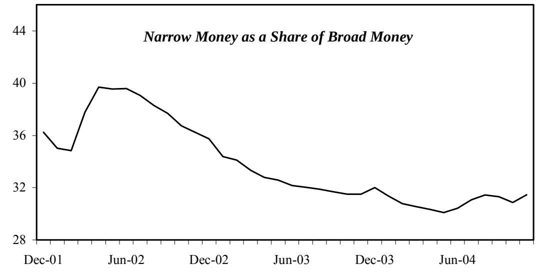
...to which agents responded by reducing cash holdings and selling foreign currency to the central bank...



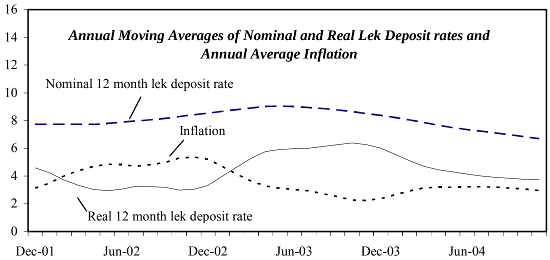
...moving into high-earning lek deposits...



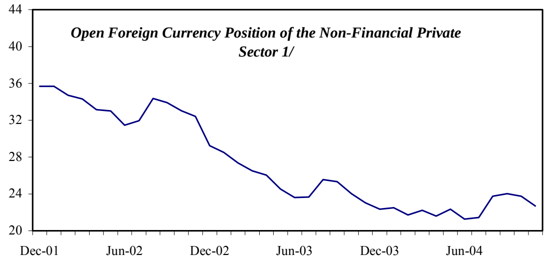
...reducing the share of narrow money in broad money...



...effectively containing inflation...



...and reducing the net foreign asset position of the non-financial private sector.



Sources: Data provided by Bank of Albania and Fund estimates.

1/ Foreign currency deposits less foreign currency loans as a percent of domestic deposits.