Albania and the IMF

Press Release:
IMF Executive Board Completes Fifth Review Under PRGF Arrangement with Albania and Approves US$6.1 Million Disbursement
February 28, 2005

Country's Policy Intentions Documents

Albania: Letter of Intent, Supplementary Memorandum on Economic and Financial Policies, and Technical Memorandum of Understanding

February 3, 2005

Tirana, February 3, 2005

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

Dear Mr. de Rato:

The Poverty Reduction and Growth Facility (PRGF) arrangement, approved in June 2002, has been instrumental in promoting macroeconomic stability and economic growth, and improving governance in Albania.

All quantitative and structural performance criteria under the program have been observed. We request completion of the fifth review as well as the financing assurances review under the arrangement. We also request a five-month extension of the program until November 2005 in order to allow the sixth program review and final disbursement to take place within the program period.

The attached supplementary Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU) describe our economic program for the period ahead. These policies are consistent with our November 2001 National Strategy for Socio-Economic Development (NSSED) and the Annual Progress Reports of May 2003 and May 2004.

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 IMF prior to the adoption of any such measures and of revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultations.

Moreover, after the end of this arrangement and while Albania has outstanding financial obligations to the IMF arising from loan disbursements under this 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 whenever 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/
Fatos Nano	Arben Malaj	Ardian Fullani
Prime Minister	Minister of Finance	Governor, Bank of Albania

Supplementary Memorandum on Economic and Financial Policies (MEFP) for Albania

I. Background

1. **This memorandum reviews the implementation of the PRGF-supported program, updates the macroeconomic framework for 2004–07, and lays out our policies for the remainder of the program period**. It is consistent with the November 2001 National Strategy for Socio-Economic Development (NSSED) and the May 2003 and May 2004 Progress Reports; and supplements the June 2002, January 2003, June 2003, January 2004, and July 2004 MEFPs.

II. Performance under the Program

2. **The Albanian economy continued to register strong, non-inflationary growth in 2004, underpinned by firm macroeconomic policies and ongoing structural reforms**. We estimate output growth at 6 percent in 2004, led by rising retail trade and other services—partially due to higher tourism—and by agricultural and electricity production boosted by favorable weather and sectoral restructuring. Ongoing fiscal consolidation, firm monetary policy, and improved supply of agricultural products held price increases to the lower end of our 2-4 percent target range in the second half of the year. Largely due to trade gains, we now expect a current account deficit of 7 percent of GDP, a full percentage point of GDP lower than our projection at the time of the last review—representing a considerable improvement given the substantial increase in oil import prices.[1] Confidence in the lek has increased further, as the currency component of broad money continued to decline and the exchange rate to appreciate, despite a 50 basis point reduction in the Bank of Albania (BoA) policy rate and the accumulation of an additional US$234 million of reserves in the second half of the year. Some indicators of absolute poverty have improved due to high growth, remittances, selected social assistance programs, and micro credit programs. Real incomes have risen rapidly, and improvements have been registered in such basic indicators as life expectancy, child mortality, maternal health, literacy, and gender equality. However, service provision to the more vulnerable groups in our country, will need to be strengthened.

3. **Despite shortfalls in budgeted resources, we stayed the course of fiscal consolidation, meeting targeted reductions in domestic borrowing through expenditure reduction, substantially outperforming the programmed deficit, and achieving a 5½ percentage point of GDP reduction in public debt—which stood at 55½ percent of GDP at end-2004.** The 2004 outturn for total revenue and grants was 1¾ percentage points of GDP below budget. While tax revenue increased relative to 2003 due to higher receipts from VAT, corporate income tax, excise rate increases, and other revenue-enhancing tax policy measures, it fell somewhat short of budget projections. Nontax revenue and financing sources undershot budgeted levels owing to shortfalls in external grants and reduced central bank profit transfers. The latter resulted from lower interest rates and sterilized intervention. Finally, the envisaged privatization of ARMO had to be postponed and some development loan disbursements failed to materialize.

[1] All figures quoted in percent of GDP, including references to values from our previous MEFPs, use as their base the revised GDP series published by INSTAT in September 2004.

However, we met our domestic borrowing target under the program as we offset these budget resource shortfalls through commensurate measures to reduce expenditure by about 3 percentage points of GDP relative to the budget—mainly on the capital budget but also including savings in personnel and interest costs. Our underlying domestic borrowing requirement declined by 0.2 percentage point of GDP with respect to 2003 and was further reduced by 0.7 percentage point of GDP through the use of half of the Savings Bank privatization proceeds to retire treasury bills, as agreed under the program. Also, the overall deficit was about 1 percentage point of GDP below the programmed level.

4. **Without allowing the mid-2005 elections to distract us from the path of fiscal consolidation, we have adopted a strong 2005 budget consistent with further declines in public debt, domestic borrowing, and current expenditure.** In light of past experience, the budget is based on a realistic projection of revenue, similar to the 2004 revenue outturn. The accompanying fiscal package that implements most FAD technical assistance (TA) recommendations. Representing a significant improvement in transparency and budget process, the budget was sent to Parliament accompanied by a detailed list of investment programs and the updated medium-term budget framework (MTBP[2]), all of which were published along with the fiscal package on our official website prior to the parliamentary debate and discussed widely with stakeholders.

5. **We have improved the performance of the customs administration and are advancing in the reform of other fiscal institutions.** After the deployment of the ASYCUDA system in the Tirana and Durrës customs houses in time for the fourth review of the program, we have continued expanding the coverage of the system. We drastically reduced rotation of personnel, particularly at the managerial level; and stepped up training. As a result, the average customs clearance period has declined from more than 5 days in 2003 to less than 2 days and seizure of smuggled goods and cases submitted to the public prosecutor have increased sharply—the latter by more than 500 percent. Regarding the General Directorate of Taxes (GDT), the improvement in outcomes has been weaker but we have passed several pieces of legislation (mainly as part of the 2005 fiscal package) and approved regulations that will significantly strengthen procedures, including appeals, VAT refunds, and control of the individual income tax. With bilateral TA, we are improving our treasury and debt management systems.

6. **We have continued to direct monetary policy towards maintaining price stability and strengthening the financial sector and its prudential supervisory framework**. In the absence of inflationary pressures, the BoA has continued its easing stance through successive reductions in the repo rate while maintaining tight monetary conditions partly prompted by the strength of the lek. Foreign exchange market interventions have aimed at smoothing exchange rate fluctuations and preserving reserve cover—about 4 months of imports at end-2004. After the privatization of the Savings Bank, the whole commercial banking system is under private management and is showing welcome dynamism. We continued to improve and expand our banking supervisory and AML/CFT capacity, with the help of MFD and World Bank assistance.

[2] The MTBP is the Albanian name for the Medium Term Expenditure Framework.

The inter-bank real-time gross settlement system (AIPS) and its associated intra-day credit facility, introduced in 2004, are functioning well and we have prepared legislation that will establish the evidential value of electronic signatures. We are advancing in our plans to pay government employees through the banking system. We met the end-December 2004 structural performance criterion of paying 10,000 employees through the banking system, and we are fully committed to a rapid expansion of these numbers. We amended the Insurance Law to permit foreign citizens to sit on the boards of Albanian insurance companies—thus, facilitating foreign investment in the industry—and introduced "fit and proper" requirements for vetting managers and board members.

7. **We continued our determined implementation of the privatization agenda and sectoral restructuring, and made progress in other structural reforms.** We concluded the sale of Savings Bank and advanced our privatization program in strategic areas by completing the initial stage in which we solicited internationally expressions of interest in the sale of Albtelekom and ARMO; and abolished Albtelekom's monopoly on international telecommunication connections. We completed the pre-privatization sale of a stake in INSIG to the IFC and EBRD, and with their collaboration are restructuring the company. Results achieved in rationalizing the energy sector under KESH's Action Plan, carried out with World Bank assistance, have been encouraging. Electricity production has increased significantly for the second year in a row, collection rates have improved, and technical losses were reduced, resulting in a financial profit in 2004. This allowed the elimination of the subsidy for electricity imports in the 2005 budget as scheduled under the action plan. We have implemented a subsidy to low-income electricity consumers (incorporated in their electricity bill) to shield them from tariff increases. We made progress in reconciling inter-enterprise arrears—concerned enterprises have signed memorandums of understanding covering arrears incurred in 2002-03, and most of these have already been cleared. We enacted the new law on statistics, published national accounts for 2002, and revised the estimates for previous years, in accordance with the plan drafted with STA TA.

III. Policies and Measures for January-December 2005

A. Overall Strategy

8. **We remain committed to our growth and poverty-reduction strategy.** We will continue to direct monetary and fiscal policy towards ensuring macroeconomic stability. But looking forward, we believe that maintaining the current growth pace will also require attracting high quality domestic and foreign investment to improve productivity and competitiveness. Improving the investment climate is therefore an important precondition that will require not only significant improvements in infrastructure but also our full commitment to entrenching the rule of law, strengthening institutions, and improving governance—including by stepping up our fight against corruption. We expect that ongoing reforms of our revenue and budget institutions will generate the additional resources needed to fund this investment and expand essential poverty-reducing services without rekindling inflation or generating an unsustainable debt profile. Our strategy will require broad-based support and we will continue to deepen our policy dialogue with all stakeholders.

B. Macroeconomic Outlook

9. **Against the background of macroeconomic stability and progress in structural reforms, non-inflationary growth of 6 percent can be sustained—initially by buoyant domestic demand, but then increasingly by gains in productivity and export volumes**. Despite higher-than-envisaged oil prices, the current account is expected to improve slightly in 2005 driven by rising exports, with further improvements over the medium term. We expect public and private domestic savings to increasingly replace foreign savings in financing a rise in investment over the medium term—facilitated by an expansion of financial intermediation.

C. Fiscal Policy

10. **The 2005 budget envisages further reductions in public debt and in the underlying domestic borrowing requirement (before privatization) through substantial savings in current spending—thus buttressing the sustainability of our public finances and allowing the non-inflationary expansion of private sector credit**. Current expenditure is projected to decrease by a further 0.9 percentage points of GDP—mainly as a consequence of reduced subsidies, wage bill, and operational costs—while protecting social expenditures. As a consequence, current revenues will suffice to fund current outlays for the first time since the beginning of the transition process—that is, borrowing and privatization proceeds will be devoted only to investment. We expect our domestic borrowing requirement to be 2.7 percentage points of GDP in 2005, about 0.2 percentage points of GDP lower than domestic borrowing in 2004 before the use of the Savings Bank proceeds to retire debt. Our stock of public debt will decline by a further 0.8 percentage points to 54.5 percent of GDP—17 percentage points down from its level in 2000. The receipts from the privatization of Albtelekom and the sale of the remaining public stake in INSIG have not been included in the budget owing to uncertainty as to their amount and timing. However we intend to privatize these companies as soon as feasible and will allocate the proceeds of their privatization in equal parts to domestic debt redemption and investment in priority areas.

11. **Savings in current expenditure will allow an expansion of infrastructure and poverty-reducing investment, significantly contributing to our growth and poverty reduction efforts**. With the decline in current expenditure broadly matched by an expansion in capital expenditure, we will be able to increase allocations on infrastructure and poverty-alleviating investment by about 0.7 percentage points of GDP relative to 2004. Moreover, as the budget is predicated on prudent revenue projections, we expect to avoid the haphazard end-year expenditure cuts that have characterized budget implementation in the past. This will provide security of funding to our line ministries and lay the foundation for improvements in budget planning and prioritization.

12. We have introduced tax reforms to streamline the tax system and reduce distortions and will press ahead with the reform of the revenue administration.

- **The 2005 fiscal package** eliminated the deduction of social insurance contributions from the base for personal income tax; reduced the number of personal income tax brackets; and subjected to VAT the first sale of residential buildings, effective 2006. To stimulate investment, the fiscal package reduced the corporate income tax rate from 25 to 23 percent in 2005 and to 20 percent in 2006, with the projected 0.15 percent of GDP cost in 2005 offset through savings in other areas. We have introduced individual income tax returns and filing requirements that will be gradually applied to those groups with the highest noncompliance risk. We are eliminating the requirement for small businesses to renew their registration with the GDT every year.

- In the **General Directorate of Customs (GDC)** we will extend the ASYCUDA system to a total of 5 customs houses (PC; end-March 2005), representing more than 75 percent of all customs traffic. We will also implement the ASYCUDA module for risk assessment to trigger inspections in 5 customs houses, including in Tirana and Durrës (PC; end-March 2005), significantly reducing officers' room for discretion. In light of the assessment carried out by the EU Customs Assistance Mission in Albania (CAM-A), we will also develop and issue a new set of instructions to the customs warehouses in order to unify the different procedures currently being applied and to strengthen the existing controls against smuggling and other illegal activities.

- As to the **GDT**, we have introduced accrual of interest on tax refunds overdue more than 60 days; and have reduced from 6 to 3 months the carry forward period before which application for VAT credit refunds can be made. For low-risk exporters we will implement a system of rapid VAT refunds, with audits carried out ex post according to risk assessment methods (PC; end-June 2005). We will also clear in 2005 overdue VAT refunds originated prior to June 2004, estimated at lek 700 million—an amount that has been included in the 2005 budget VAT revenue projection. We will earmark each quarter an amount equal to 1 percent of the VAT collected during the previous quarter for paying overdue VAT refunds until the stock or arrears is eliminated (SB; ongoing). We will provide quarterly reports on this matter (SB; ongoing). Concerning current requests for VAT refunds, we will also provide quarterly reports on the aggregate amount of such refunds requested, refunds paid, and refunds rejected (SB; ongoing) We will advance the process of computerization by implementing the software modules for excises and national taxes in the second and third quarters of 2005 respectively. By the end of 2005, we expect 15 branches to be fully computerized, covering 80 percent of all taxpayers and 95 percent of tax collections. We are in the process of receiving FAD TA on tax administration to update our reform agenda and expand the use of information technology.

13. **We will carry out measures to improve our budget process and raise the efficiency and transparency of expenditure**. We will continue the practice of including a prioritized list of investment projects and the updated MTBP in future budget submissions to Parliament. In 2006, we also plan to include projections of recurrent costs of proposed investment programs as part of the budget documents. We have reduced the maximum allowable transfer between budget appropriations to 5 percent for the 2005 fiscal year. We are working towards a wage structure in the public sector that promotes efficiency and allows the retention of skilled personnel. For 2005, we will discontinue across-the-board public sector wage increases and instead allocate the wage bill increase to raise the pay of workers in education, health and other priority areas, and skilled specialists; and to fund the civil service reform designed with World Bank assistance. We will formally repeal the existing automatic price indexation of wages prior to presentation of the 2006 budget. Over the course of 2005, we will enhance expenditure control and monitoring by

extending the treasury automation system to regional branches and increase the use of the banking system in budgetary transactions.

14. **Our fiscal policies over the medium term will continue consolidating the public finances aiming at offsetting the likely decline in concessional assistance, while undertaking preparations to access international capital markets.** In 2006–07, we intend to reduce domestic borrowing further in order to crowd in private sector credit and maintain the declining trend in public debt. We remain committed to improving revenue mobilization and combating tax noncompliance. In order to keep budget revenue projections prudent and conservative, we have not included revenue gains from tax administration improvements in the 2005 budget. However, we expect these gains to materialize and become sizable over the medium term. In addition, as output grows, we plan to reduce further the current expenditure share of GDP, thus generating a current surplus to fund higher investment in priority areas. Nevertheless, investment projects with high growth impact will continue to exceed domestic resources. Thus, in anticipation of an eventual decline in foreign concessional assistance, we intend to begin preparations to obtain a sovereign credit rating with a view to tap international capital markets. This would also facilitate international financing for domestic private firms.

D. Monetary and Financial Sector Policies

15. **Monetary policy will continue to aim at keeping inflation within the 2–4 percent target band of the BoA, while maintaining an adequate level of reserves**. The repo rate will remain our main policy instrument to ensure adherence to our monetary program. Over the remainder of the program period, we expect a continuation of existing trends: money demand will remain broadly stable as share of GDP; private sector credit will grow rapidly from its low base; and the share of currency in broad money will continue to decline, reflecting rising intermediation and confidence in the banking system. We will maintain a flexible exchange rate regime, with foreign exchange interventions used mainly for smoothing short-term shocks unrelated to fundamentals and for maintaining a level of reserves broadly equivalent to 4 months of imports of goods and services.

16. **We will continue reforms aimed at improving the efficiency, transparency, and volume of banking sector intermediation and financial services**. In this regard, we view the upcoming FSAP exercise as a well-timed means of evaluating progress to date and of refining further our reform agenda.

- **To deepen financial intermediation and combat the informal economy, we will continue to foster the use of the banking system in the regular conduct of business**. We view the payment of public sector salaries through the banking system as a catalyst for this process. We will increase the total number of public employees paid in this manner to 25,000 by end-March 2005 (PC) and to 50,000 by end-June 2005 (PC). In consultation with the industry, we will implement an inter-bank bulk clearing system for small transactions in 2005 to facilitate automated bill payments, wage deposits, and other customer services.

- **Over the course of 2005, we intend to strengthen the market infrastructure and legal framework underpinning our financial system in preparation for the anticipated**

expansion of banking activity. We are considering options to increase the depth of the T-bill market, such as extending participation in the market to large nonfinancial firms and introducing market-making and brokerage arrangements. We are also exploring the feasibility of developing additional financial markets, such as foreign currency swaps and collateralized inter-bank money markets. The banking law, currently in the drafting stage, will introduce greater clarity to the rules and procedures governing the operation of commercial banks—including the powers of the supervisory authority concerning receivership and conservatorship; as well as mandating greater transparency and consumer protection. The Electronic Record Law will establish the evidential value of electronic signatures. A draft of this law has been prepared by the BoA with assistance from the World Bank and passage is expected in 2005.

17. **We recognize that significant improvement in practices, standards, transparency, and the effectiveness of supervision will be required in the insurance sector to ensure its proper development.** As first steps in this process, we have secured resident advisors in the insurance regulatory agency and in INSIG. We anticipate that the upcoming FSAP exercise will also be useful in identifying the broad direction of reform and we will request additional TA as required in order to formulate a comprehensive restructuring plan for this sector.

18. We remain committed to support the integrity of our monetary framework and the independence of the central bank. We will ensure that the BoA retains its policy and operational autonomy, and we will take no legislative or regulatory action that weakens its full control over the bank's budget—including staff compensation levels—currently exercised by the BoA's Supervisory Board. As required by law, and to preserve the integrity and independence of our central bank, the government will issue interest-bearing securities to the BoA in the amount required to cover reserve valuation losses due to the appreciation of the lek. Those corresponding to 2003 valuation losses, amounting to Lek 7.7 billion, have already been issued; while those corresponding to 2004 valuation losses—estimated at Lek 4 billion—will be issued in April 2005 following certification of the 2004 BoA audited accounts. Although drawings under the Treasury's overdraft facility with BoA have been minimal, brief, and unconnected to the financing of the budget, we intend to eliminate the facility gradually, as alternative commercial and market-based options develop and the Treasury's liquidity management capacity improves. Specifically, we intend to reduce the statutory limit for the overdraft facility from its current level of 5 percent of budget revenues to 4.5 percent over the course of 2005 and then by a further 0.5 percent in each successive year.

E. Structural Policies

19. **The privatization agenda for 2005 includes Albtelekom and ARMO, as well as our remaining minority stake in AMC and two commercial banks.** We will strive to privatize other publicly-owned companies such as SERVCOM and Albpetrol as rapidly as feasible. In preparation for the sale of Albtelekom, we will fully regularize the company's outstanding financial obligations to private creditors; and institute reforms to the rural and small operators regime along transparent lines and in accordance with international standards. We will fully support the restructuring of INSIG—currently being carried out in conjunction with its partial pre-privatization to EBRD and IFC—in preparation for its eventual sale. We have started a pilot

project to restructure four water companies, with assistance from the World Bank and other donors, but further actions will be needed ensure the viability of this sector.

20. **We will fully implement our 2005-07 action plan, with World Bank assistance, to modernize KESH and restructure the electricity sector**. We will keep a stabilization fund with KESH's profits in years with pluvial conditions to finance imports in less favorable years, with the funds invested abroad, managed by a well-established international financial firm, and audited regularly.

21. **We intend to implement a number of reforms aimed at enhancing governance, efficiency, and transparency**. We will carry out independent feasibility studies for large projects funded by non-concessional borrowing (SB; ongoing) and subject them to open tenders, except in exceptional circumstances such as in cases of national security. We will continue to provide a quarterly listing and status report on all projects being considered for nonconcessional foreign financing (SB; ongoing). We will continue implementing our action plan for removing barriers to investment, and will carry out a survey to assess its impact and update the plan accordingly. We have implemented the law on asset declaration, and plan to proceed with the conflict of interest legislation. To improve external assistance coordination, we have presented an integrated planning system to the donor community and expect to implement an agreed methodology following a period of dialogue.

F. External Policy

22. **We will retain our liberal trade regime.** We aim at concluding a Stabilization and Association Agreement with the EU and an eventual EU-Albania free trade agreement. On a regional level, we have successfully concluded free trade agreements with Bosnia-Herzegovina, Bulgaria, Croatia, Kosovo, FYR Macedonia, Moldova, Serbia and Montenegro, and Romania. All agreements have been ratified by the respective parliaments and trade volumes are rising rapidly, albeit from a low base—in the first half of 2004 the share of these countries in total trade rose from 2.6 to 8.3 percent.

23. **We made progress in rescheduling our arrears on inoperative payments agreements with official creditors (Article XIV) in 2004 and will continue these efforts in 2005**. The agreement with Hungary has been finalized and was implemented in the first half of 2004. Balances due to the Czech and Slovak Republics, Poland, and Romania have been reconciled. In the latter case, the terms of payment are already negotiated. We expect to conclude agreements with these four countries in the first half of 2005. Although in some of the remaining cases the process has been more protracted than expected, we still strive to conclude this process by the end of the program with official creditors and by end-2006 with private creditors.

G. Data Issues

24. **We are improving the quality and coverage of economic statistics in cooperation with STA and other technical assistance partners.** Building on the new statistical law, we have signed memoranda of understanding for the provision of data between INSTAT and other government institutions. We will present to Parliament our 5-year statistical program (SB; March

2005). We will further improve the scope and collection of data on FDI and remittances and accelerate the production of national accounts. We will publish the preliminary 2003 national accounts by March 2005 (SB) and introduce a pilot project on the preparation of quarterly GDP estimates by June 2005. We plan to issue the 2004 national accounts, based on sampling techniques, by end-2005.

H. Program Monitoring

25. The seventh disbursement under the PRGF-supported program will be based on the end-March 2005 quantitative performance criteria (Table 1 and the TMU); the end–March and end-June 2005 structural performance criteria (Table 2); and completion of the sixth review and the financing assurances review. The sixth review is expected to be completed no later than November 10, 2005. 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. We will provide a new progress report on the NSSED by April 2005, taking into account the recommendations of the joint staff assessment of the 2004 progress report.

Table 1. Albania: Quantitative Performance Criteria and Indicative Targets for 2003–05 1/

	End-Dec. 2003			End-Mar. 2004 2/			End-Jun. 2004			End-Sep. 2004 2/			End-Dec. 2004	End-Mar. 2005 2/	End-Jun. 2005
	Actual	Prog.	Prog. (Adj.)	Actual	Prog.	Prog. (Adj.)	Actual	Prog.	Prog. (Adj.)	Actual	Prog.	Prog. (Adj.)	Prog.	Prog.	
							(In billions of lek)								
Ceiling on net domestic credit to the government 3/	20	21	21	6	6	6	-5	12	1	3	11	13	16	6	12
Ceiling on net domestic assets of the BOA 4/	-19	6	6	-24	-7	-7	-38	-5	-15	-17	2	3	7	-13	-12
Indicative target for revenues collected by Tax Department	57	59	...	...	...	...	...	...	...	...	...	...	...	...	...
Indicative target for revenues collected by Customs Department	54	59	...	...	...	...	...	...	...	...	...	...	...	...	...
Indicative targets for Social Insurance Revenues	29	31	...	...	...	...	...	...	...	...	...	...	...	...	...
Indicative total tax revenue targets, millions of Lek 5/	...	...	...	36	36	36	74	76	76	116	116	116	161	199	244
							(In millions of US dollars)								
Floor for net international reserves of the BOA 4/ 6/	112	21	18	104	57	57	182	71	141	212	71	62	83	240	254
							(In millions of Euros)								
Ceiling on contracting or guaranteeing of public and publicly-guaranteed non-concessional external debt 7/ 8/	19	107	107	19	120	120	46	141	141	46	155	155	171	240	280
of which: 1-5 years	0	0	0	0	0	0	0	0	0	...	0	...	0	0	0
Ceiling on public and publicly-guaranteed external debt with original maturities up to and including 1 year 7/ 8/ 9/	0	0	0	0	0	0	0	0	0	...	0	...	0	0	0
Nonaccumulation of new external payments arrears, excluding interest on pre-existing arrears 7/ 8/ 9/	0	0	0	0	0	0	0	0	0	...	0	...	0	0	0

1/ The performance criteria and indicative targets envisaged under the program, and their adjustors, are defined in the Technical Memorandum of Understanding (TMU). Targets for September 2004 and beyond are defined as cummulative changes from end-2003, except where noted. Targets prior to March 2005 refer to targets set during the fourth and previous reviews.
2/ Data in this column are performance criteria, except for revenue targets. Data in all other columns are indicative targets.
3/ For 2003, 2004, and 2005, data is cumulative within each calendar year.
4/ For end-June 2003 to end-June 2004: cumulative changes as of end-December 2002.
5/ In 2004, the separate indicative revenue targets on tax, customs, and social security revenue used in 2002 and 2003 are replaced by a single aggregate target on 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.
6/ Up to end-June 2004, valued using end-December 2001 exchange rates. After end-June 2004, valued using end-2003 exchange rates.
7/ This performance criterion applies to the contracting or guaranteeing by the central government or the Bank of Albania as specified in the TMU.
8/ Cumulative changes as of end-December 2002.
9/ These performance criteria apply on a continuous basis.

Table 2. Albania: Performance Criteria and Structural Benchmarks under the PRGF Arrangement

	Test-date
A. Proposed Performance Criteria for the Sixth Review	
1. Deployment of the ASYCUDA system in 5 customs houses.	End-March 2005
2. Implement the risk assessment module of the ASYCUDA system in 5 customs houses to perform inspections.	End-March 2005
3. The salaries of 25,000 employees of budgetary institutions to be paid through the banking system.	End-March 2005
4. The salaries of 50,000 employees of budgetary institutions to be paid through the banking system.	End-June 2005
5. Implement a system of quick VAT refunds with audits carried out ex post based on risk assessment selection for qualified taxpayers.	End-June 2005
B. Proposed Structural Benchmarks under the Sixth Review	
1. Presentation to Parliament of 5-year Statistical Program.	End-March 2005
2. Completion of preliminary 2003 national accounts.	End-March 2005
3. Government of Albania's to continue to implement its action plan for removing administrative barriers to investment (NSSED chapter 7, Section on Ministry of the Economy).	Ongoing
4. Prepare quarterly reports (within one month of the end of each quarter) on the stock of external arrears.	Ongoing
5. Clear overdue VAT refunds originated prior to June 2004 by allocating to this end 1 percent of VAT gross revenue on a quarterly basis.	Ongoing
6. Prepare quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected.	Ongoing
7. Safeguard the efficient use of nonconcessional foreign project loans through:	
(i) Conducting an independent feasibility study for any large project (as defined in the TMU) financed through non-concessional borrowing.	Ongoing
(ii) Provide a quarterly listing and status report on all projects being considered for nonconcessional foreign financing.	Ongoing

ALBANIA

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum defines the quantitative benchmarks and performance criteria established in the Memorandum of Economic and Financial Policies (MEFP) for end-June 2004–end-March 2005.

A. Net Domestic Credit to the Central Government

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

2. **Net domestic credit to the central government** (NCG) is defined as gross domestic credit in lek and in foreign currency extended to the central government (as defined above) by the banking system, savings and loan institutions (SLIs), and other domestic lenders;[1] less the sum of central government financial assets held in the banking system and in the SLIs.

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

(i) **Gross domestic credit in lek and in foreign currency extended to the central government includes**: (a) securities (including treasury bills and bonds) issued by the central 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 central government by BoA, DMBs, SLIs, and other domestic lenders; and (c) negative balances in government deposits with BoA, DMBs and SLIs.

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

(iii) The stock of gross domestic credit extended to the central government and held by the BoA and DMBs in the form of treasury bills will be valued at issue price. The stock of gross domestic credit extended to the central government and held by the BoA in the form of other securities and direct loans to government will be valued excluding accrued interest. The stock of

[1] Other domestic lenders comprise both firms (including insurance companies) and households. For small lenders, treasury bill windows are available at the central bank and at selected Albapost offices throughout the country.

gross domestic credit extended to the central government and held by the DMBs in the form of fixed and variable income securities will be valued at face value. The stock of all gross domestic credit extended to the central government and held by SLIs and other domestic lenders will be valued at face value[2].

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

(i) **Central 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 central government. For the purposes of program monitoring, standard gold deposits will be valued at the program price of gold (SDR 280.6 per ounce)[3].

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

(iii) **Central government financial assets held at the DMBs** include: (a) all deposits of central government in domestic and foreign currency; (b) all loans extended by central government to commercial banks; and (c) payable amounts owed by the DMB to central government.

(iv) **Central government financial assets held at the SLIs** include all deposits of central government held at the SLIs.

5. **For the purposes of program monitoring**, central government financial assets in foreign currency will be converted from Lek to SDRs at the end-of period Lek/SDR exchange rate prevailing on the test date; and then converted to Lek at the end-December 2003 Lek/SDR exchange rate of Lek158.1/SDR.

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

[3] The lek value of standard gold deposits will be (a) converted to US dollars using the current end-of-period lek/US dollar exchange rate; (b) then converted to ounces of gold using the current US dollar market price of gold; (c) then converted to SDRs at the program price of gold (SDR 280.6 per ounce); and (d) then converted to Lek at the program Lek/SDR exchange rate of Lek 158.1104/SDR.

6. The breakdown of the categories of net domestic credit to the central 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 from end-December 2004.

B. Net Domestic Assets

8. The stock of **net domestic assets (NDA) of the Bank of Albania** are defined as the difference between 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), with all foreign currency assets and liabilities valued in local currency for program monitoring purposes at an exchange rate at end-December 2003. Under this definition, the level of the NDA was Lek 72 billion as of end-December 2003. The NDA limits will be cumulative changes from end-December 2003 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, and held for the purpose of meeting balance of payments financing needs, intervention in exchange markets, and other purposes. They include Bank of Albania holdings of monetary gold, SDRs, Albania's reserve position in the IMF, foreign currency cash, and deposits abroad. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options). **Reserve liabilities** shall be defined as foreign exchange liabilities to residents and nonresidents of the Bank of Albania, irrespective of their maturity. They include: foreign currency reserves of commercial banks held at the Bank of Albania; all credit outstanding from the IMF; commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies. Excluded from reserve liabilities are the government's foreign currency deposits at the Bank of Albania.[4] Reserve assets and reserve liabilities will both be expressed in U.S. dollars.

10. During this program, for monitoring purposes, the exchange rates of the SDR and non-dollar currencies will be kept at their end-December 2003 levels and holdings of

[4] 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.

monetary gold will be valued at SDR 280.6 per ounce. Excluded from gross international reserves are holdings of nonconvertible currencies, claims on nonresident financial institutions denominated in nonconvertible currencies, and other claims which are not readily available.

D. Adjusters for NCG, NDA, and NIR

11. The NCG and NDA ceilings and the NIR floor are defined on the assumption that total privatization proceeds (privatization proceeds received in foreign currency) will amount, on a cumulative basis, from January 1, 2004, to:

End-March 2005	Lek 15.9 billion, (US$138.5 million).
End-June 2005	Lek 16.0 billion, (US$138.5 million).

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.

12. The ceilings on NCG and NDA, and the floor on NIR are defined based on the assumption that **foreign budgetary and/or balance of payments loan financing** (excluding IMF financing, project and commodity loans, and macro-financial assistance from the EU) will amount, on a cumulative basis, from January 1, 2004, to:

End-March 2005	US$ 19.0 million.
End-June 2005	US$ 29.0 million.

In cases where total foreign loan financing exceeds this projection, the ceilings on NCG to the government and NDA of the Bank of Albania will be adjusted downward, and the floor on NIR will be adjusted upward by the amount of the excess[5].

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

E. External Debt and Arrears

14. 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

[5] For the NCG adjuster, the lek equivalent of deviations from the programmed amounts in terms of dollars is converted at an exchange rate of Lek 106.5 per U.S. dollar**.**

(including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered 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.

15. The limit on medium- and long-term external debt **applies to** the contracting or guaranteeing by the central government or the Bank of Albania, of new nonconcessional external debt with an original maturity of more than one year, **with sub-limits** on external debt with an original maturity of more than one year and up to and including five years. It applies not only to debt as defined in paragraph 14 of this memorandum, but also to commitments contracted or guaranteed for which value has not been received. External debt will be considered to have been contracted at the point the loan agreement or guarantee is ratified by the Albanian parliament. **Excluded** from the limits are refinancing credits and rescheduling operations (including the deferral of interest on commercial debt), credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 35 percent. The grant element is to be calculated using the OECD Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on ten-year averages. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

16. 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 central 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 14 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 U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

17. A continuous performance criterion applies to the non-accumulation of new **external payments arrears** on external debt contracted or guaranteed by the central government or the Bank of Albania. External payment arrears consist of external debt service obligations (principal and interest) falling due after March 31, 2002 and that have not been paid at the time they are due, as 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, 2002; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

18. **Large projects** (as referred to in MEFP paragraph 21 and Table 2) financed by nonconcessional foreign borrowing are defined as those projects involving total nonconcessional foreign borrowing in excess of US$25 million.

F. Tax Revenues

19. 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

Performance under the program will be monitored from information supplied monthly to the Fund by the Bank of Albania, the Ministry of Finance, the General Directorate of Taxation (GTD), the General Directorate of Customs (GDC), and the Ministry of Economy. 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) Net domestic credit to the government (in the form outlined in Appendix Table 1);
(v) The net foreign assets of the Bank of Albania;
(vi) The foreign exchange cashflow of the Bank of Albania, including the level of NIR;
(vii) Daily average exchange rates;
(viii) Trade flows;
(ix) Periodic updates of balance of payments estimates.

The Ministry of Finance will supply to the Fund:

(i) The summary fiscal table, including the overall budget deficit, on a cash basis;
(ii) Issuance of treasury bills by the MOF, including gross value and cash received;
(iii) Privatization receipts;

(iv) Information on the contracting and guaranteeing of new debt;
(v) Information on the stock of short-, medium- and long-term debt;
(vi) Information on all overdue payments on short-, medium- and long-term debt (with assistance from the Bank of Albania).
(vii) Information on the stock of VAT refunds claimed and refunds paid out every month.

The General Directorate of Customs will supply to the Fund:

(i) Detailed monthly data on customs revenues collected; and

(ii) Quarterly reports on corrective measures taken to deal with problems identified by the internal audit function.

The General Directorate of Taxation will supply to the Fund:

(i) Detailed monthly data on tax revenues collected.

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 arrears.

(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.

Table 1. Albania: Calculation of Net Domestic Credit to Central Government for Program Monitoring Purposes, December 2003–March 2005
(In millions of lek)

		Dec-03	Sep-04	Dec-04	Mar-05	Jun-05
1.	**Treasury bills held outside central government**	271,417	277,272	…	…	…
Of which:						
1. (i)	Held by Bank of Albania 1/	70,372	62,935	…	…	…
1. (ii)	Held by deposit money banks 1/	184,203	192,742	…	…	…
1. (iii)	Held by savings and loan institutions 2/	0	0	…	…	…
1. (iv)	Held by other domestic lenders (excluding holdings of HHI and SSI) 2/	16,842	21,594	…	…	…
	Of which:					
1. (iv) (i)	INSIG	1,548	1,535	…	…	…
1. (iv) (ii)	Individuals and firms	15,294	20,059	…	…	…
1. (iv) (ii) (i)	Of which: BoA window	9,528	12,510	…	…	…
Plus:						
2.	**Other central government debt held outside central government (millions of lek)**	6,449	10,974	…	…	…
Of which:						
2. (i)	Held by Bank of Albania 3/	1,449	964	…	…	…
2. (i) (i)	Other securities 3/	1,449	964	…	…	…
2. (i) (ii)	Short-term direct loans to government 3/	0	0	…	…	…
2. (ii)	Held by deposit money banks 4/	5,000	10,010	…	…	…
2. (ii) (i)	Fixed income securities 4/	5,000	10,010	…	…	…
2. (ii) (ii)	Variable income securities 4/	0	0	…	…	…
2. (iii)	Held by savings and loan institutions 5/	0	0	…	…	…
2. (iv)	Held by other domestic lenders 5/	0	0	…	…	…
Equals gross domestic credit to government:		277,866	288,246	…	…	…
Less:						
3.	**Assets of central government (excluding HHI and SSI)**	7,534	13,960	…	…	…
3. (i)	Deposits held at Bank of Albania 6/	4,914	11,541	…	…	…
3. (i) (i)	In domestic currency	3,295	2,962	…	…	…
3. (i) (i) (i)	Transferable deposits in lek	2,902	2,481	…	…	…
3. (i) (i) (ii)	Deposits in lek for projects	393	481	…	…	…
3. (i) (ii)	In foreign currency at program exchange rates and program price of gold 7/ 8/	1,619	8,579	…	…	…
3. (i) (ii) (i)	In foreign currency evaluated at current exchange rates	1,619	8,067	…	…	…
3. (i) (ii) (i) (i)	Transferable deposits in foreign currency evaluated at program exchange rat	0	6,964	…	…	…
3. (i) (ii) (i) (i) (i)	Transferable deposits in foreign currency evaluated at current exchange ra	0	6,547	…	…	…
3. (i) (ii) (i) (ii)	Standard gold deposits of government evaluated at fixed exchange rate and g	1,619	1,615	…	…	…
3. (i) (ii) (i) (ii) (i)	Standard gold deposits of government at current exchange rate and gold p	1,619	1,519	…	…	…
3. (i) (ii) (i) (ii) (i) (i)	Number of ounces of gold equivalent	36,484	36,408	…	…	…
3. (ii)	Assets held at deposit money banks	2,621	2,419	…	…	…
3. (ii) (i)	Deposits 10/	1,757	1,160	…	…	…
3. (ii) (i) (i)	Deposits in domestic currency	91	223	…	…	…
3. (ii) (i) (i) (i)	Transferable deposits in domestic currency	91	223	…	…	…
3. (ii) (i) (i) (ii)	Other deposits in domestic currency	0	0	…	…	…
3. (ii) (i) (ii)	Deposits in foreign currency evaluated at program exchange rates	1,666	937	…	…	…
3. (ii) (i) (ii) (i)	In foreign currency evaluated at current exchange rates 7/	1,666	881	…	…	…
3. (ii) (i) (ii) (i) (i)	Transferable deposits in foreign currency evaluated at current exchange	1,666	881	…	…	…
3. (ii) (i) (ii) (i) (ii)	Other deposits in foreign currency evaluated at current exchange rates	0	0	…	…	…
3. (ii) (ii)	Loans from government to DMBs	500	402	…	…	…
3. (ii) (iii)	DMB payables to government	364	857	…	…	…
3. (iii)	Held at savings and loan institutions 10/	0	0	…	…	…
Less:						
4.	**Deposits of HHI and SSI**	2,230	**2,740**	…	…	…
Equals:						
5.	**Stock of Net domestic credit to central government (1+2-3-4)**	268,102	271,546	…	…	…
5. (i)	Change since December 2003	…	3,444	…	…	…
6.	Memorandum items:					
6. (i)	Current exchange rate (Lek/SDR, eop)	158.1104	148.6618	…	…	…
6. (ii)	Current exchange rate (Lek/US dollar, eop)	106.4	101.2	…	…	…
6. (ii)	Program exchange rate (Lek/SDR, eop) 11/	158.1104	158.1104	…	…	…
6. (iv)	Program price of gold (price in SDRs dollars per ounce as at end-December 2003)	280.6	280.6	…	…	…
6. (v)	Market price of gold (price in US dollars per ounce)	417.0	412.4	…	…	…
6. (vi)	Current exchange rate (US dollar per SDR, eop)	1.4860	1.46899	…	…	…

1/ Evaluated at issue price.
2/ Evaluated at face value (data on treasury bill holdings of SLAs and other domestic lenders are currently available only at face value).
3/ Excludes accrued interest.
4/ Valued at face value (data on fixed and variable income securities held by DMBs are currently available only at face value).
5/ Includes accrued interest.
6/ Includes transferable deposits of government in domestic and foreign currency, lek deposits of central government for projects; and standard gold deposits of government (footnote #8). Excludes all non-standard gold deposits; and excludes all
nongold precious metal deposits of government; and excludes government deposits in foreign currency for projects.
7/ The reported lek value of foreign currency denominated assets of government will be converted to SDRs using the current end-of-period lek/SDR exchange rate; and then converted back to lek using the program Lek/SDR exchange rate of Lek 158.1104/SDR.

8/ Standard gold deposits are usable by government and therefore included in the definition of government assets. The lek value of standard gold deposits will be (a) converted to US dollars using the current end-of-period lek/US dollar exchange rate; (b
9/ Including account set up to hold the Savings Bank privatization revenue (Account No: 11.2.2.1.4)
10/ Includes all deposits of central government.
11/ The program Lek/SDR exchange rate is the value of this rate at end-December 2003 (Lek 158.1104/SDR).