International Monetary Fund

Albania and the IMF

Press Release:
IMF Executive Board Completes First Review Under PRGF Arrangement and First Review Under EFF Arrangement with Albania and Approves US$3.6 Million Disbursement
July 24, 2006

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

July 14, 2006

The following item is a Letter of Intent of the government of Albania, which describes the policies that Albania intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Albania, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Tirana, July 14, 2006

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

Dear Mr. de Rato:

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

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

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

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

Sincerely yours,

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

Memorandum on Economic and Financial Policies (MEFP) for Albania

I. Background

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

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

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

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

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

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

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

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

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

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

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

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

I. Strategy, Objectives and Policies

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

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

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

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

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

A. Macroeconomic Framework

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

B. Monetary, Exchange Rate, and Financial Sector Policies

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

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

- We will raise reserve requirements on foreign currency deposits above 10 percent after evaluating carefully all its implications on the banking sector.

- Regulations on capital adequacy will be amended to allow risk weights up to 150 percent to apply to high risk loans or portions of loans;

- Regulations will be amended to allow for higher provisioning on classified loans;

- Provisions in existing regulations will be employed to impose higher than 12 percent minimum capital adequacy requirements on individual, relatively high-risk, banks;

- BoA will encourage banks to adopt—and impose on banks if necessary—stricter debt service to disposable income ratios and prudent loan-to-value ratios; tighter internal loan classification and provisioning rules; and increased risk premiums in lending spreads to take full account of indirect credit risk from foreign exchange exposure of customers;

- In addition, BoA will devote sufficient resources to decrease the time lag for reporting of monthly bank statistics from 40 to 30 days by end-September 2006; improve coordination and communication with home country supervisors of foreign-owned banks; and increase targeting of supervision activities—including on-site inspections—towards credit-related risks. BoA will also introduce "truth in lending" rules by mid-2007 to disclose annual percentage rates on loans and the risks associated with foreign currency borrowing; and prepare and mandate by end-2006 enhanced reporting rules for commercial banks to allow better monitoring of banking sector developments.

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

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

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

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

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

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

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

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

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

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

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

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

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

C. Fiscal policy

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

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

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

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

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

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

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

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

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

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

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

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

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

- Enacting a new public debt law;

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

20. **There is large scope for increasing the efficiency of spending by improving the budget process and financial management**. The relative isolation of the annual budget process and actual spending decisions from the Medium Term Expenditure Framework (MTEF) and National Strategy for Socio-Economic Development (NSSED) processes is a longstanding problem. Shortcomings also exist in the selection of public investment projects and the monitoring of outcomes. Reforms will aim at identifying measurable objectives in the context of the NSSED, ensuring they are clearly linked to spending requests, strengthening the MTBP and better integrating both the MTBP and NSSED with the budget process. In order to safeguard the use of nonconcessional project loans, we will continue our policy of conducting independent feasibility studies for any large project[1] financed in this manner (SB;ongoing), and will continue to provide to the Fund a biannual listing and status report of all projects being considered for nonconcessional foreign financing (SB;ongoing).We will also strengthen the payment discipline of budgetary units—particularly with respect to the payment of electricity and water bills. Looking ahead, we intend to approve a new organic budget law aimed at enhancing the efficiency of public expenditure management, including by improving budget classification standards and by increasing parliamentary oversight and the accountability of the public administration.

[1] As defined in the TMU.

D. Other Structural Reform

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

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

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

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

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

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

E. External Policies

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

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

F. Data Issues

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

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

G. Program Monitoring

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

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

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

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

2/ Cumulative change within the calendar year.

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

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

5/ Applies on a continuous basis.

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

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

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

ALBANIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

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

H. Net Domestic Credit to the Government

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

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

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

(i) Gross domestic credit in lek and in foreign currency extended to the government includes: (a) securities (including treasury bills and bonds) issued by the government and held by the Bank of Albania (BoA), deposit money banks (DMBs), SLIs, and other domestic lenders; (b) loans and advances extended to the government by BoA, DMBs, SLIs, and other domestic lenders; (c) negative balances in government deposits with BoA, DMBs and SLIs; (d) any securities or debt instrument of any kind issued by government (as defined above) to the Bank of Albania to compensate the Bank of Albania for its net valuation losses on its assets and liabilities in, or denominated in, gold, special drawing rights or foreign currencies, and which the Bank of Albania keeps in its (off-balance sheet) Valuation Reserve Securities Account of the Bank of Albania, as required in Article 64 of the Law on the Bank of Albania (No. 8269, dated December 12, 1997)[3]; and (e) any other form of financial obligation of the government the issuance of which resulted in borrowing funds by the government or a payment for an existing payment obligation of the government.

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

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

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

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

(iii) The stock of gross domestic credit extended to the government and held by the BoA and DMBs in the form of treasury bills will be valued at issue price. The stock of gross domestic credit extended to the government and held by the BoA in the form of other securities and direct loans to government will be valued excluding accrued interest. The stock of gross domestic credit extended to the government and held by the DMBs in the form of variable and fixed income securities (excluding treasury bills) will be valued at face value. The stock of all gross domestic credit extended to the government and held by SLIs and other domestic lenders will be valued at face value[4].

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

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

(i) Government financial assets held at the Bank of Albania include: (a) transferable deposits in domestic and foreign currency; (b) lek deposits held in BoA for projects; and (c) standard gold deposits of the government. For the purposes of program monitoring, standard gold deposits will be valued at the program price of gold (SDR 358.9 per ounce)[5].

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

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

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

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

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

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

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

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

I. Net Domestic Assets

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

J. Net International Reserves

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

interest payments to commercial banks, suppliers, or official export credit agencies. Excluded from reserve liabilities are the government's foreign currency deposits at the Bank of Albania.[6] Reserve assets and reserve liabilities will both be expressed in U.S. dollars. The NIR limits will be cumulative changes from end-December 2005, and will be monitored from data supplied by the Bank of Albania.

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

K. Adjusters for NCG, NDA, and NIR

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

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

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

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

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

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

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

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

The ceilings on NDA of the Bank of Albania will be adjusted downward, and the floor on NIR will be adjusted upward by the amount total foreign loan financing exceeds these projections. The NCG ceiling for end-September 2006 and end-December 2006 will be adjusted downward by the amount total foreign loan financing exceeds these projections. The NCG ceiling for end-March 2007 will be adjusted downward by the amount total foreign loan financing in the first quarter of 2007 exceeds US$2.5 million.[7]

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

L. External Debt and Arrears

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

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

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

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

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

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

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

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

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

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

M. Tax Revenues

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

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

N. Monitoring and Reporting Requirements

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

The Bank of Albania will supply to the Fund:

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

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

The Ministry of Finance will supply to the Fund:

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

The General Directorate of Customs will supply to the Fund:

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

The General Directorate of Taxation will supply to the Fund:

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

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

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

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

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

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

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

1/ Evaluated at issue price.

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

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

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

5/ Includes accrued interest.

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

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

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

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

10/ Includes all deposits of central government.