



# IMF Policy Discussion Paper

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## Stabilization Policies and Structural Reforms in Albania Since 1997— Achievements and Remaining Challenges

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## **IMF Policy Discussion Paper**

European I Department

### **Stabilization Policies and Structural Reforms in Albania Since 1997—Achievements And Remaining Challenges**

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#### **Abstract**

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This paper assesses the effectiveness of stabilization policies and structural reforms in Albania since 1997 and seeks to identify the remaining key challenges in various policy areas. It also draws lessons for other transition economies from the recent Albanian experience. While progress has been made toward macroeconomic stability and the establishment of a modern institutional framework, much remains to be done to enhance the sustainability of the recent favorable macroeconomic performance and reduce unemployment and poverty. Crucial areas of reform are the creation of functioning institutions, notably in the judicial field, and the establishment of a reliable supply of electricity, which has recently become an obstacle for rapid growth.

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## I. INTRODUCTION

This paper assesses the effectiveness of stabilization policies and structural reforms pursued by Albania since 1997 and seeks to identify the remaining key challenges in various policy areas. It also draws lessons for other transition economies from areas of success in the recent Albanian experience. Albania's reform efforts since 1997 have been assisted by the IMF under two consecutive programs: (i) the emergency post-conflict assistance approved in November 1997; and (ii) an ESAF/PRGF arrangement approved in May 1998, which expired in July 2001. In addition, the IMF provided extensive technical assistance in the areas of monetary and fiscal reform and statistics. The paper is divided into five sections. The first section describes briefly macroeconomic developments in Albania before 1997, and then analyzes the main features of the authorities' program of macroeconomic policies in 1997–2001 and their effects on growth, inflation, and the balance of payments. The following sections discuss in detail structural aspects of Albania's fiscal performance, financial markets, and monetary policy, as well as privatization policies. Each section highlights the remaining key challenges in its area. The last section concludes.

## II. MACROECONOMIC POLICIES AND DEVELOPMENTS

### Background

**During 1993–95, Albania's macroeconomic developments were characterized by high growth rates, while inflation fell to single digits and external imbalances were reduced sharply.**<sup>2</sup> This positive macroeconomic performance reflected in large part the

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<sup>2</sup> The quality of available data makes it difficult to be certain of macroeconomic developments in Albania. Nonetheless, Albania's strong growth performance in the early transition years is also suggested by a number of proxy indicators in particular in the

(continued...)

wholesale dismantling of controls, an early privatization of agriculture, retail trade, and small and medium sized enterprises, together with improved financial discipline at the budgetary and state enterprise levels.

**In 1996, however, macroeconomic policies weakened significantly, as the domestically financed deficit increased by over 4 percentage points, to almost 11 percent of GDP, and inflation tripled, to more than 17 percent.** A key factor behind this deterioration was a dramatic decline of revenue collections—primarily due to a virtual collapse in excise revenues, which had previously been boosted by the widespread circumvention of a UN trade embargo against the Federal Republic of Yugoslavia that was lifted at the end of 1995. In addition, expenditure policy was significantly loosened before the May 1996 general parliamentary elections.

**In early 1997, Albania's pyramid schemes collapsed, plunging the country into a deep economic and social crisis.** Rioting, triggered by the collapse of the schemes, intensified into near civil war, with the government losing control over large parts of the country.<sup>3</sup> State institutions ceased to function, and economic activity came to a virtual standstill. Disruptions reduced supply, especially in industry and construction, while the loss

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agricultural area and the services sector. For a more detailed description of the period before 1997, see e.g., *Albania: Recent Economic Developments*. IMF, April 1997.

<sup>3</sup> Pyramid schemes were companies that, by claiming to be engaged in profitable investments, attracted large and increasing volumes of funds from private depositors with promises of dramatically high returns. In reality, however, depositors' funds were largely not used for solid investments, but served either to pay interest on existing deposits or were transferred by the schemes' owners to bank accounts abroad. The pyramid schemes collapsed in early 1997, causing an estimated loss of savings of about \$1 billion. The pyramid scheme crisis has been described in an IMF Working Paper prepared by Chris Jarvis (1999).

of savings in the failed schemes depressed demand. The Lek depreciated by more than 40 percent during the first half of the year 1997, as remittances from abroad declined markedly, foreign aid virtually ceased, and international trade slowed significantly. At end-1997, inflation on a year-on-year basis rose to 42 percent, reflecting the sharp depreciation, the massive supply shocks, and a rapidly rising fiscal deficit caused by a major drop in tax collection. The deficit was largely financed by domestic borrowing, causing domestic debt to rise to unprecedented levels and burdening Albanian state budgets in subsequent years with a significant interest burden.

**The government's efforts to put Albania on a stable path of recovery and reform—supported by the IMF—aimed at macroeconomic stabilization, rebuilding and enhancing institutional and administrative capacity, and restarting structural reforms.**

The main elements of the government's program of macroeconomic stabilization and their effects on growth, inflation, and the balance of payments are described below.

#### **Main features of macroeconomic adjustment since 1997**

**Since 1997, the Bank of Albania (BoA) has adhered to a tight monetary policy,** as evidenced by high real interest rates (Table 1), which stabilized the exchange rate by creating a high demand for Lek assets and facilitated a trend reduction in the velocity of money consistent with lower inflation. A key instrument to ensure positive interest rates in real terms was the minimum deposit rates imposed by the BoA.<sup>4</sup> Furthermore, lending to the non-government sector was severely limited by prudential restrictions on lending by the state-owned banks, which had a large share of nonperforming loans in their portfolio.

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<sup>4</sup> Mandatory minimum deposit rates were first introduced in 1992.

**Only in early 2000 did the BoA gradually loosen monetary policy in response to falling inflation rates and appreciative pressures on the exchange rate.**<sup>5</sup> Interest rates on three-month treasury bills declined rapidly from 14.9 percent in January 2000 to 7.7 percent in October 2001, principally in reaction to interest signals of the BoA, reduced government borrowing, as well as the effect of much larger participation of private banks and nonbank investors in T-bill auctions. Also, deposit and lending rates declined significantly, which began to have a positive impact on lending.

Table 1. Interest Rates, 1996-2001  
(Percent per annum)

	1996	1997	1998	1999	2000	2001 <sup>1</sup>
12-month deposit rate	19.1	27.8	16.5	9.1	7.7	7.7
Real deposit rate	1.7	-14.3	7.8	10.1	3.5	4.2
Average weighted yield of treasury bills						
3 months	14.5	32.4	27.4	14.5	10.7	7.7
6 months	18.4	31.2	28.4	18.6	13.0	9.8
12 months	18.8	32.8	29.3	19.5	14.0	10.5
12-month treasury bill yield in real terms	1.4	-9.3	20.6	20.5	9.8	7.0

<sup>1</sup> September 2001

Source: Bank of Albania.

**Fiscal policy after 1997 struck a balance between the need to contain the budget deficit and the need to finance essential public expenditures.** Gradual fiscal consolidation was evident in the decline of the overall deficit<sup>6</sup> and in particular in the significant reduction in domestic borrowing (Table 2). The latter declined from 10.8 percent of GDP in 1996 to

<sup>5</sup> As inflationary pressures had subsided already in 1999, a loosening of monetary policy might have been appropriate even in the previous year.

<sup>6</sup> The overall deficit includes expenditure financed by grants and concessional lending.

about 3 percent in the years 2000 and 2001. In addition, the primary deficit<sup>7</sup> declined from almost 8 percent of GDP to only 1 percent of GDP in 2001. This reduction in the deficit was made possible primarily by a remarkable revenue effort as well as the deliberate decision by the government to end support to state-owned enterprises in the form of subsidies and soft loans (with the exception of a few companies, like the electricity company KESH) and to embark on a policy of rapid and large-scale privatization. Nonetheless, the overall deficit remained large in light of the need to rebuild basic public services and infrastructure, and reestablish security in the country. This did not, however, lead to high inflation, as these relatively large deficits were financed by a mix of concessional foreign inflows and domestic borrowing at high real interest rates.

Table 2. Deficit Measures, 1996–2001  
(In percent of GDP)

	1996	1997	1998	1999	2000	2001 Projection
Total deficit	12.8	12.9	10.4	11.4	9.1	9.5
Domestic deficit	11.0	11.0	6.4	5.4	4.9	5.5
Excluding privatization revenues	10.8	10.7	6.4	5.2	3.2	3.3
Primary deficit	8.9	7.3	2.6	4.4	3.4	5.0
Excluding foreign-financed projects	7.7	5.1	-0.3	1.1	0.4	1.1

Source: Ministry of Finance.

**Prudent monetary and fiscal policies had a positive impact on the level of remittances transferred by Albanians working abroad and the amount of donor support provided to Albania and helped to stabilize the exchange rate.** Each of these effects contributed to the creation of a high growth—low inflation environment:

<sup>7</sup> Defined as revenue minus expenditure (excluding foreign-financed capital expenditure and interest payments).

- **Substantial remittances fueled strong growth: (Table 3).** After the improvement in public order, remittances quickly recovered to the level before the crisis, which fueled growth—in particular in the services and the construction sectors—and played a crucial role in offsetting the lack of lending from the banking sector. In 2001, officially registered remittances amounted to about 15 percent of GDP, but true figures should be even higher.

Table 3. Remittances by Albanians Living Abroad, 1996–2001  
(In millions of U.S. dollars)

	1996	1997	1998	1999	2000	2001
Remittances from expatriates	499.6	266.9	452.2	368.1	530.8	568.0

Note: 2001 is a projection.

Sources: Bank of Albania; and Fund staff estimates.

- **Donor support, which has averaged some 5 percent of GDP since 1997, played an important role in reducing domestic borrowing and the development of infrastructure necessary to sustain growth.**
- **These greater international capital inflows, as well as currency substitution, motivated by high real domestic currency interest rates resulted in a nominal appreciation of the exchange rate of the Lek relative to the DM.** This was a critical factor in reducing inflation, given that a large share of the consumer price index consists of imported commodities<sup>8</sup> (Table 4).

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<sup>8</sup> See also Haderi (1996).



Table 4. Exchange Rates, 1996–2000  
(Period average)

	1996	1997	1998	1999	2000
Lek/US\$	104.5	148.9	150.6	137.7	143.7
Lek/DM	69.5	85.7	85.7	75.1	67.8

Source: Bank of Albania.

### **Growth, inflation, and the balance of payments since 1997**

**Albania's growth performance since 1997 has been strong, averaging more than 7 percent in real terms (Table 5).** Immediately following the collapse of the pyramid schemes and the ensuing socioeconomic crisis, growth was driven by a rebound in the agricultural sector, but also by the fast resurgence of activities in the construction, transport, and services sectors. In 1998, output increased by 8 percent, fully compensating for the drop in 1997. In 1999, the Kosovo conflict and the refugee crisis somewhat dampened agricultural activity, but the presence of a large numbers of refugees—many of whom could draw on savings—and of international aid organizations provided a positive demand shock, which facilitated continued rapid growth in the transport and services sectors. In 2000 and 2001, agricultural activity picked up and growth in the services, transport, and construction sectors remained strong; but officially recorded industrial growth slowed down, due to the decline in activities of state-owned enterprises. In addition, a worsening electricity crisis began to dampen growth in the private industrial and services sector in 2000 and 2001.

Table 5. Real Growth Rates by Sector, 1996–2001  
(In percent)

	1996	1997	1998	1999	2000	2001	GDP Share in 2001
Total	9.1	-7.0	8.0	7.3	7.8	7.3	100.0
Industry	13.6	-5.6	4.1	6.4	5.0	5.0	11.5
Agriculture	3.0	1.0	5.0	3.7	6.0	4.0	51.0
Construction	18.4	-6.3	21.0	15.0	18.0	17.0	14.8
Transport	-0.9	-20.5	20.0	15.0	15.0	12.0	3.5
Services	20.1	-25.0	10.0	12.0	10.0	9.0	19.2

Source: Ministry of Finance and INSTAT.

**Admittedly, growth estimates are not very reliable, since official national accounts do not exist yet, and the official growth estimates cover only inadequately private and informal sector activity.** Circumstantial evidence, however, indicates that the greater diversification of growth that has taken place since 1998 as a result of the revitalization of the industrial sector and—more recently—increasing agricultural activity is not adequately included in official figures, although it is reflected in a variety of proxy indicators, such as large imports of machinery and equipment, export growth, and the behavior of currency in circulation (Table 6).

Table 6. Imports of Machinery and Equipment, Currency in Circulation,  
and Export Growth, 1996–2001 (1996=100)

	1996	1997	1998	1999	2000	2001 <sup>1</sup>
Imports of machinery and equipment	100	61	66	86	113	145
Currency in circulation	100	147	138	165	202	226
Export growth	100	73	90	120	113	116

1/ January–September 2001 compared with January–September 2000.  
Sources: INSTAT and Bank of Albania.

**Albania's strong growth performance in recent years has also had a positive impact on the unemployment rate, which declined from 18 percent in 1998 to about**

15 percent in June 2001. Although the official data understate the extent of unemployment due to incomplete registration, they provide indications for underlying trends.

**Remarkably, from 1997 to 2001 inflation has been declining almost continuously from a year-on-year increase of about 42 percent in 1997 to 3.5 percent in 2001 (Table 7).** While the consumer price index is based on weights that were established in 1993 and no longer reflects current consumption patterns, a recently constructed new consumer price index based on the 2000 household expenditure survey resulted in even lower inflation rates, as the weight of food prices—which injected a certain degree of volatility into the CPI—was reduced in favor of clothes, housing, and especially services. Overall, Albania has been enjoying relative price stability since 1998.

Table 7. Annual Inflation, 1996–2001 1/  
(In percent)

	1996	1997	1998	1999	2000	2001
Annual inflation (year average)	12.7	32.1	20.9	0.4	0.0	...
Annual inflation (year end)	17.4	42.1	8.7	-1.0	4.2	3.5

1/ Based on 1993 weights.  
Source: INSTAT.

**How exactly can Albania's high growth–low inflation experience be explained, as anti-inflation strategies are typically not consistent with strong growth?** While stabilization policies may be key to reestablishing confidence and, thereby to a recovery of productive capacity, their immediate demand effect tends to be negative. Output of state-owned enterprises indeed declined steadily during 1997–2001, as their access to bank credit was curtailed and subsidies from the state budget were gradually eliminated. Similarly, the retrenchment of public sector employees—from a high exceeding 150,000 in 1997 to

currently about 120,000 employees—put pressure on the labor market. These negative effects were, however, more than offset by the dynamic private sector, which was financed primarily by remittances and in which wages were sufficiently flexible.

**Albania's strong growth performance is also remarkable as it occurred against the backdrop of a relatively strong fiscal consolidation. Is Albania's experience therefore evidence for an expansionary fiscal contraction that has attracted attention in recent years?**<sup>9</sup> The "Expansionary Fiscal Contraction" hypothesis argues that fiscal contractions—in particular those that are attained through retrenchments in expenditures—can lead to growth in consumption, investment and employment through their impact on expectations of future taxation. Albania's fiscal consolidation was driven primarily by revenue increases that resulted from reducing the size of the informal sector, i.e., it reflected the strengthening of state institutions and the rule of law. This political and macroeconomic stabilization was, however, a crucial factor in the resurgence of remittances and of donor support which in turn were instrumental in bringing about high growth. In that sense Albania's experience can be considered a case of expansionary fiscal contraction driven by revenue increases, although the transmission mechanism from these fiscal policies to growth is different from one expected to be seen in more advanced economies.

**Albania's strong growth performance and rapid disinflation went along with a relative strengthening of the balance of payments on account of higher volumes of exports, remittances, and inflows of foreign direct investment.** While partly due to weak domestic production capabilities Albania's current account deficit has been large since the

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<sup>9</sup> See for example Whelan and Hogan (2001) or Barry and Devereux (1995).

beginning of transition, since 1996 it has narrowed by about 2 percentage points of GDP due to stronger exports as well as higher remittances. This development is particularly noteworthy, as the growth in registered imports in recent years reflects to some extent strengthened border controls and less smuggling, so that the real improvement of the current account may exceed the statistically recorded change. Since 1996, exports increased somewhat on account of better performance of reprocessing exports (textiles, shoes) and—most recently—minerals, but at 7.5 percent of GDP Albania's export performance remains extremely low when compared with other transition and developing economies (Table 8).

Table 8. Exports by Groups of Commodities, 1996–2001  
(In million of U.S. dollars)

	1996	1997	1998	1999	2000	2001
Total	229.2	167.2	204.8	274.0	259.0	306.0
Food, beverages, tobacco, and live animals	20.4	21.0	19.9	18.4	17.1	...
Crude materials, except fuel	38.7	31.2	33.8	20.0	22.5	...
Mineral fuels, lubricants, and related materials	9.4	6.2	2.5	7.7	4.9	...
Animal and vegetable oils and fats	5.0	0.0	0.4	0.3	0.0	...
Chemical products	3.2	2.3	1.6	1.9	1.8	...
Manufactured goods	31.6	16.9	25.2	32.9	31.3	...
Machinery and transport equipment	3.9	6.8	5.7	17.3	5.2	...
Miscellaneous manufactured articles	117.0	82.7	115.6	175.6	176.1	...

Source: Bank of Albania.

**The continuous growth of remittances since 1997 (Table 3), interrupted temporarily by the Kosovo crisis, has been a crucial factor in strengthening the balance of payments.** Albania's geographical location as a neighbor of two EU countries (Greece and Italy) and the large wage differential vis-à-vis these countries triggers large-scale emigration of Albanian workers abroad, resulting in high volumes of remittances back to Albania. A precise quantitative estimate of these remittances is difficult, as most transfers are channeled

outside the banking system. In fact, it is very likely that official data substantially underestimate inflows of remittances. Korovilas (1999) concludes that, based on the number of emigrants living abroad and the per capita remittances that they are typically transferring to Albania, remittances could amount to as much as about US\$850 million per year—exceeding the official estimates by about US\$300 million.

**The capital account is dominated by non-debt-creating and concessional financing.** Official transfers, grants, and concessional loans have recently averaged about \$200 million annually, or 5 percent of GDP. Inflows of foreign direct investment have also picked up—amounting to some 3 percent of GDP in 2000—on account of large-scale privatizations and follow-up investments, but also greenfield investments, especially in the oil sector. While the sustainability of these foreign direct investments needs to be confirmed—particularly as many of them are related to privatizations—recent increases represent a notable change from earlier years and could signal the beginning of a period of greater sustainability of growth and of the balance of payments.

**While Albania's macroeconomic performance has been encouraging, its sustainability is far from certain and high growth has so far had little impact on poverty.** Preliminary poverty assessments indicate that as of 2001 about one-third of Albanians live in poverty, while one-fifth live in extreme poverty. Some indicators point to a worsening of poverty trends since the beginning of transition, as income distribution has become more skewed. Albania's balance of payments trends and growth performance continue to be heavily dependent on remittances and official capital inflows, which are potentially volatile and susceptible to political and economic shocks. Moreover, the ongoing electricity crisis dampens prospects for domestic and foreign investment and is the most

important threat to the continuation of high growth. Strengthening the sustainability of Albania's macroeconomic performance and reducing poverty will therefore require an improvement of the business climate to attract far greater levels of foreign and domestic investment, as well as further fiscal revenue mobilization, to reduce dependency on foreign assistance and increasing expenditures in poverty-sensitive areas.

### III. FISCAL DEVELOPMENTS

**One of the major elements of the government's fiscal consolidation efforts—discussed previously—was increased revenue generation.** Albania has shown remarkable results in this area, with tax and customs revenue having increased by about 5 percentage points of GDP since 1996 (Tables 9 and 11). This impressive result was achieved by the VAT reform in October 1997, when the rate was increased from 12.5 percent to 20 percent, and substantial improvements in the efficiency of tax and customs administration. Corruption and smuggling in the customs area have declined significantly, as evidenced by a marked increase in the volume of declared excisable commodities such as petroleum, coffee, cigarettes, alcohol, and beer (Table 10). Other key improvements in the customs administration were the strengthening of the investigative and internal audit functions as well as the swift implementation of disciplinary actions against customs officials found to have acted in violation of the customs code. Also, modern merit-based reward schemes for customs inspectors have been adopted, which helped create an appropriate balance between better control and motivation. An important factor in the improvement of the customs administration was the political will of the government to remove corrupt senior customs officials, often against opposition from vested interests. Nonetheless, anecdotal evidence

suggests that corruption in the customs administration—while reduced—remains endemic and efforts need to continue to effectively tackle it.

Table 9. Import Tax Revenue (VAT, excise, customs duty), 1996–2001

	1996	1997	1998	1999	2000	2001
Import tax revenue (million Lek)	16,187	22,045	36,240	36,052	47,693	51,800
Import tax revenue (million US\$)	154.9	148.0	240.6	261.8	331.9	357.2
Import tax revenue (percent of GDP)	5.8	6.5	7.9	7.1	8.8	8.7

Source: Ministry of Finance.

Table 10. Imports of Excisable Commodities, 1996–2001  
(Volume in tons)

	1996	1997	1998	1999	2000	2001
Coffee	668	95	172	2,354	3,603	....
Cigarettes	942	116	579	2,115	2,267	....
Fuels	80,649	67,618	88,271	172,205	230,289	....
Beer	12,082	4,754	10,865	26,392	32,686	....

Source: Ministry of Finance.

Table 11. Domestic Tax Revenues, 1996–2001

	1996	1997	1998	1999	2000	2001
Domestic tax revenues (million Lek)	14,427	10,773	20,765	28,164	34,786	41,500
Domestic tax revenue (million US\$)	138.1	72.3	137.8	204.5	242.1	286.2
Domestic tax revenue (percent of GDP)	5.1	3.2	4.5	5.6	6.5	7.1

Source : Ministry of Finance.

**Domestic tax revenue improved considerably as a result of an increase in the number of registered taxpayers and the adoption of modern tax legislation, which enhanced the ability of the tax administration to tackle fiscal evasion.** Since 1997, the number of registered small businesses increased from 25,000 to about 40,000, as the tax department made a concerted effort to register traders previously operating in the informal sector. At the same time, the number of registered VAT-payers rose from 7600 to 10,000,



partly on account of the operations of the Large Taxpayer Unit.<sup>10</sup> The Large Taxpayer Unit has recently been strengthened further as a result of the provision of new office space and improvements in the organizational structure.

**Notably, after the VAT reform, tax rates have remained either unchanged or have been cut.** Maximum tariffs were significantly reduced in early 1999 from 30 percent to the current 15 percent, which—together with the full elimination of nontariff barriers—resulted in a substantial improvement in Albania's score on the Fund's index of aggregate trade restrictiveness from 6 at the beginning of 1998 to 1 currently (on a scale from 1 to 10). Moreover, the profit tax rate was reduced from 30 to 25 percent in 2001.

**While revenue increases have been notable, fiscal evasion remains pervasive, particularly in the area of personal income taxes, but also in profit taxes and VAT.** Employees in the private sector often do not pay income tax, as the tax administration lacks appropriate methods to collect these taxes in a systematic way. Furthermore, the lack of modern auditing skills in the tax department permits many businesses to underreport profits and present incorrect invoices. These problems are compounded by corruption and collusion between tax inspectors and companies. As a result, Albania's tax-to-GDP ratio is still among the lowest in Eastern European transition economies with comparable tax rates (Table 12), even after taking into account much lower GDP per capita, which shows that the potential for higher revenue collection remains considerable.

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<sup>10</sup> In interpreting these figures, the simultaneous increase of the threshold for small businesses and the lowering of the VAT threshold that was implemented at the beginning of 2001 needs to be taken into account.

Table 12. Regional Fiscal Indicators

	Tax revenue in percent of GDP1/	VAT Rate	Top Corporate Tax	Top Personal Income Tax
Albania	16	20	25	25
Latvia	32	18	25	25
Estonia	36	18	26	26
Macedonia	24	19	15	35
Moldova	21	20	32	28
Bulgaria	31	22	27	40
Croatia	38	22	35	35
Greece	26	18	40	45
Slovenia	39	20	25	50
Turkey	21	15	27	55

1/ 2000 data based on Fund estimates

Source: PWC, Corporate Taxes 1999-2000, worldwide Summaries and PWC, Individual Taxes 1999-2000, Worldwide Summaries; and Fund staff estimates.

**Further substantial revenue increases will be necessary in order to reduce the still very large overall deficit, and ensure fiscal and debt sustainability, since Albania's debt level—in particular domestic debt—remains relatively high.** Over the next few years privatization receipts are expected to peak and then disappear. Moreover, concessional financing will not be available indefinitely. In this context, in order to keep the debt ratio on a declining path, fiscal discipline will be of key importance. In addition, the authorities will need to be highly selective in attracting loans that are not (or not fully) concessional, in spite of the many remaining infrastructural needs.

**Efforts to increase revenue collection have been accompanied by measures to reduce the size of public administration, with a view to increasing allocations for priority expenditures.** The retrenchment in public administration—already noted above—aimed at streamlining public services while decompressing the wage structure and creating a more competitive civil service. As a result of this policy, the share of the wage bill as a

percentage of total expenditures declined from almost 26 percent in 1997 to below 20 percent in 2001—although average wages in the public sector have risen by almost 40 percent in real terms since 1997, although not yet having recovered their 1996 level.

**The burden of interest payments remains substantial, albeit declining.** As a result of reduced domestic borrowing and a fall in treasury bill rates, the share of interest in total expenditures—which had reached a peak of 25 percent in 1998 due to very high domestic borrowing in the years 1996 and 1997—fell to 16 percent in 2000 and is expected to fall further to 11 percent in 2001, thus reverting back to its 1996 level.

**Reduced shares of interest and wage expenditures, together with significantly strengthened revenue collection, resulted in increased allocations for priority expenditures, such as operations and maintenance, investment in infrastructure, health, and education.** For example, investment expenditures financed by the budget rose from 1.9 percent of GDP in 1997 to 3.4 percent of GDP in 2001 so that several road, as well as water and sanitation projects could be financed directly from the budget. Nonetheless, budgetary spending on infrastructure projects will still have to be increased significantly to reduce Albania's dependency on external assistance and meet its development needs. Another key priority is the increase in allocations on operations and maintenance, which is indispensable in order to ensure the sustainability of already completed infrastructure projects.

**The government has also undertaken important initiatives to improve the efficiency of expenditures in the context of the Medium-Term Expenditure Framework (MTEF) and the Growth and Poverty Reduction Strategy (GPRS).** The MTEF, prepared for the first time in 2000, aims to provide a more strategic focus to the budget process. It

establishes a transparent mechanism for making resource allocations based on strategic priorities determined in a systematic way within the GPRS. Both the MTEF and the GPRS are key initiatives that will in time permit a significantly higher quality of policy and decision making. Nonetheless, expenditure management is still deficient:

- The ability of line ministries to develop and implement comprehensive policy programs remains weak. The MTEF and the GPRS are intended to provide a strategic link to expenditure decisions, but capacity constraints—especially within line ministries—limit the effectiveness of these instruments.
- Monitoring and evaluation of programs and expenditures needs to be strengthened significantly. At present, only input indicators are monitored, while the systematic control of output indicators needs to be developed.

**The Ministry of Finance has also begun to strengthen significantly the control of public expenditure.** Recent audits of expenditure performed by the European Union and other donors suggested a generally positive assessment of the accountability of expenditures. In 2000, a new and much more detailed economic expenditure classification was adopted, which improves fiscal transparency. Nonetheless, much remains to be done:

- The budget is not yet being prepared in accordance with GFS standards.
- The coverage of foreign-financed capital expenditures in the budget remains limited. Grant-financed projects are still largely outside the budget due to some donors' reticence to channel projects through the budget. The accuracy and timeliness of information on other parts of loan-financed projects remain unsatisfactory due to lack of reporting by the Program Implementation Units.

- More systematic control mechanisms—including the strengthening of the internal audit function—need to be adopted to ensure that expenditures are being put to the best use. This is particularly important in the context of the recent drive toward decentralization.

#### IV. FINANCIAL MARKETS AND MONETARY POLICY

**The conduct and the effectiveness of monetary policy has been conditioned by the absence of developed financial markets and prudential and institutional restrictions on lending.** Although the banking sector has been developing rapidly since 1997—as evidenced by the expansion of the branch network and the relatively large ratio of deposits to GDP—the financial system as a whole remains underdeveloped. The credit activity of the Savings Bank is still constrained for prudential reasons, on account of the large share of nonperforming loans in its portfolio.<sup>11</sup> Lending from private banks on the other hand could only partly compensate for this, as these banks are relatively small. Basically, however, lending suffers from structural constraints, such as an ineffective legal framework, borrowers' lack of experience in obtaining and using credit, and the limited branch network. The development of interbank and secondary markets for T-bills has been hampered by the dominance of the Savings Bank, which holds some 80 percent of the market for deposits and T-bills; limited financial sector competition; and poor liquidity management by the banks. Moreover, efforts to re-establish the stock market have been limited and have only recently gained momentum.

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<sup>11</sup> The ban on lending by the NCB was lifted after its privatization in October 2000, but the NCB has only recently and very cautiously resumed its lending.

**Against this background, the BoA conducted a conservative monetary policy that aimed at controlling inflation.** The BoA aims to keep inflation within a 2–4 percent target range, in the context of a flexible exchange rate regime. Initially, the BoA's main instrument of monetary policy was the control of minimum deposit rates, but repurchase agreements and reverse repurchase agreements became gradually more prevalent. In September 2000, the BoA phased out minimum deposit rates and shifted entirely to the use of indirect monetary policy instruments. While the shift to indirect monetary policy instruments is an important step forward, the effectiveness of monetary policy remains constrained, as a result of the lack of efficient financial markets that would allow the transmission of the monetary impulse to the real economy. A key challenge for the BoA in the future will be to develop its framework of monetary policy instruments to respond flexibly to developments in the real economy while at the same time meeting the objective of price stability. This is of particular interest in the context of the development of an inflation-targeting framework the advisability of which will depend on both the development of the financial sector and a better understanding of the transmission mechanism of monetary policy.

**Supervision of the financial sector has substantially improved following the collapse of the pyramid schemes in 1997; rules and regulations are generally in line with international standards and controls are being carried out on a regular basis.** While the banking system can generally be considered sound, the recent diversification of banks' activities and increased lending calls for the further strengthening of supervision techniques and the development of modern risk management skills at the commercial bank level.

**While Albania's financial sector is still underdeveloped, prospects for a further deepening of Albania's financial system are relatively good.** The privatization of the NCB

and the more aggressive behavior of other private commercial banks create better conditions for a strengthening of competition of banks and a less dominant role of the Savings Bank in the future. Steps are being undertaken as well to facilitate the holding of T-bills by households and the development of a stock market. Moreover, the adoption of the Law on Securing Charges and the opening of the registry for movable property in early 2001 are important steps toward improving the legal and institutional framework for lending. The first results of these measures have been evident in 2001, which recorded a substantial expansion of credit.

## V. STRUCTURAL REFORMS

**A key objective of the government's structural reform agenda has been the privatization of strategic and small- and medium-size enterprises, which has proceeded well, although in some cases more slowly than originally anticipated, and has improved prospects for a greater sustainability of growth.**

**Several large privatization projects have recently been completed.** These include the privatization mobile phone company, AMC, and the granting of important concession contracts to foreign investors for the chrome and copper mines in 2001. The sale of the second GSM license was also completed in early 2001 and has already become operational. The privatization or liquidation of all small- and medium-size enterprises was completed by 2001. Some of them, such as the cement factory in Fushe-Kruje or the Superphosphate plant in Lac, were sold to foreign investors. The privatization of the NCB in October 2000 to a consortium consisting of a private bank, IFC, and EBRD created the preconditions for the privatization of the Savings Bank, which is anticipated to be completed in late 2002. There have also been important interests in the oil sector from oil exploration companies. The

privatization of the fixed-line telecommunications company and the remaining elements of the oil firm Albpetrol is expected to be completed in 2002. While these developments are encouraging, the continuation of Albania's reform agenda will crucially depend on progress in a number of structural reform areas.

**The recent energy crises brought to the forefront the fact that further economic progress will be at risk, unless a complete turnaround in energy policy is accomplished.**

In December 2000, a two-year strategy for the electricity sector was adopted that includes specific targets to reduce losses and increase collections, promote the use of alternative sources of energy and modify the tariff structure. The implementation of the strategy has so far been satisfactory, but collections still remain below and losses above acceptable levels. Particular attention will have to be paid to the efficient prosecution of electricity theft, using the amended penal code; to the promotion of alternative sources of energy, including gas and the development and enforcement of building codes; and the improvement of collections from the water supply companies, which are the main creditors of the electricity company KESH. Lastly, the establishment of new energy production facilities needs to be considered carefully and the execution of necessary maintenance work in the electricity network should not be delayed.

**There also needs to be a continued emphasis on public administration reform.**

To further enhance the attractiveness of the civil service, which has been affected by attrition and low motivation, the government will adopt in 2002 a new wage structure for the top civil servants that includes wage increases by up to 100 percent for certain civil servants, although the general wage level was raised in line with nominal GDP growth. Similar reforms—including a wider differentiation of salaries according to job characteristics—are planned for



the education and health areas, where salaries are currently significantly below the average level in the public administration. These measures are part of a broader civil service reform that aims to de-politicize the civil service and includes also the systematic preparation of performance evaluations and job descriptions and the restructuring of ministries. Continued implementation and strengthening of the MTEF process will increase the efficiency of public expenditures and should also serve the government's poverty-reduction objectives.

**The weakness of the public administration is felt particularly in the judicial system which is in large part not functional, causing significant uncertainty about the ability to enforce commercial contracts.** The independence of the courts and prosecution needs to be further strengthened and corrupt officials in the judiciary system removed and punished. Bureaucratic processes to obtain licenses and permits are often nontransparent, and property rights remain very uncertain. These problems have created a difficult environment for foreign and domestic investors and will have to be addressed systematically. Although foreign direct investment flows have recorded significant increases in recent years, investors' assessments of the environment remain largely negative and many initially interested investors have ultimately not realized projects.

**Furthermore, environmental protection is crucial for Albania's long-term prospects for economic development.** Water and air are subject to heavy pollution from industrial enterprises and private households. The pollution of the sea by waste water has severely reduced Albania's tourism potential and the uncontrolled burning of garbage in urban areas poses a significant threat to public health. Albania's forests have been severely diminished as a result of deforestation and erosion. The United Nations Environmental Program has called for the urgent relocation of the population from several areas of Albania

due to immediate and extreme health risks. While the establishment of a Ministry of the Environment and the preparation of selected environmental taxes are positive steps, the adoption of an effective program of environmental protection will require the close involvement of several line ministries.

## VI. CONCLUSIONS

Albania has made significant progress in recent years. What are key lessons from Albania's experience for other countries?

Albania's growth and inflation performance would not have been possible without the authorities' prudent monetary and fiscal policies which were instrumental in attracting increasing levels of remittances and substantial donor support as well as stabilizing the exchange rate. While this demonstrates the importance of sound macroeconomic policies, remittances and donor support also benefited from Albania's geographical position and donors' interest in a stable Albania.

Albania's progress moreover demonstrates the importance of the authorities' clear commitment to the reform agenda, notably in the area of privatization and the fight against corruption in the public administration. Without the willingness to take politically difficult decisions this progress would have been difficult to achieve.

While Albania's macroeconomic performance and progress in the structural reform agenda are encouraging, serious problems remain in many areas. As in other transition economies, most of these problems boil down to issues of governance and capacity building. There is a fundamental need to reinforce existing institutions, so that a state of law can be established that assures the fair and equitable application of the law in all areas. Progress in fiscal sustainability will depend to a large extent on revenue increases, which should be the

result of efforts in fighting corruption and fiscal evasion. The reform of the electricity sector hinges significantly on progress in reducing electricity theft and enforcing the payment of electricity bills, as well as the implementation of building codes that stipulate the use of non-electricity sources of heating. Improving the environment for investment will also require greater reliability of the judicial system as well as the improvement of services for investors through the establishment of an effective Investment Promotion Agency.

In spite of all these difficulties, the progress accomplished since 1997 shows that Albania has good prospects to achieve rapid progress in all these areas.

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