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

January 11, 2007

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, January 11, 2007

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

Dear Mr. de Rato:

For over ten years, the International Monetary Fund has supported our efforts to develop and restructure the Albanian economy, and to achieve and maintain the stable macroeconomic environment needed for rapid growth and improved living standards. This support is ongoing, and our current arrangement with the Fund is on track. All quantitative and structural performance criteria have been observed and economic prospects remain favorable, both from the near- and medium-term perspectives. We therefore maintain the expectation that our need for the Fund’s resources will end with the expiration of the current arrangements.

Since the first review 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 target range, and confidence in the currency and the banking system remains solid. 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.

We therefore request completion of the Second Review under the three-year Poverty Reduction and Growth Facility arrangement together with concurrent approval of the Second Review under the three-year Extended Fund Facility arrangement; and also request the third 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 the end of 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 will prepare a new NSSED—now called the National Strategy for Development and Integration (NSDI)—for 2007-09 by April 2007, formulated within the comprehensive Integrated Planning System introduced in 2005 and taking into account the recommendations of the joint staff assessment of the 2005 progress report.

II. ECONOMIC DEVELOPMENTS

2. Macroeconomic developments proceeded largely as envisioned at the time of the last review.

- Real GDP growth this year is expected to be in line with our previous projection of at least 5 percent. Although activity in construction slowed down—in part owing to a sharp reduction in the number of construction permits and delays in the execution of public investment—a faster-than-anticipated recovery in electricity production and an improvement of exports served as mitigating factors. Trade performance in fact strengthened significantly in 2006, as traditional exports such as footwear recovered and we began exploiting new export opportunities—in particular chrome where exports quadrupled in the first half of 2006 compared with the previous year. Consequently, the weakening of trade performance that began in late 2005—brought on by electricity shortages, rising energy costs, increased competition in export markets, and slower growth in partner countries—was largely reversed during the course of 2006.

- With the recovery of exports, our underlying external balance has improved considerably. The current account deficit is estimated to have narrowed by about 0.6 percentage point to 5.9 percent of GDP in 2006. However, we estimate the underlying trend to be about ½ percentage point of GDP lower, as the structural improvements made to our revenue administrations have also uncovered previously-uncaptured imports of roughly this magnitude.

- Fiscal developments this year were dominated by the success of revenue administrative reforms, which significantly increased our resource envelope. In recognition of the relatively strong demand pressures in the economy we saved ¼ percent of GDP of the revenue gains and allocated the remainder in a supplementary budget—in accordance with our program agreements—between additional investments and tax relief. Combined with half the receipts from the sale of
Italian Albanian Bank (0.1 percentage point of GDP), these revenue gains financed a budgeted increase in infrastructure investment and maintenance expenditures of about 0.8 percentage point of GDP; and a lowering of the employers’ share of the social security tax from 29 percent of wages to 20 percent.

- Inflation exhibited a rising trend in 2006, but remained within the 3±1 percent target range. Price pressures originated with strengthening domestic demand, higher food prices, and an administered increase in the cost of electricity. They were mitigated somewhat, however, by two 25 basis point increases in the policy rate in July and November; by the fiscal correction in the supplementary budget, which reduced the impact of the 2006 fiscal impulse by ¼ percentage point of GDP; and by the tightening of the supervisory and regulatory regime implemented by the BoA that had the effect of both improving banks’ risk profiles and of slowing the rate of private sector credit growth.

3. Significant advances were also made in various areas of structural reform since the time of the last review.

- **Our reform program in revenue administration—developed with the help of IMF TA—is on track.** The role of the Large Taxpayer Office (LTO) was considerably expanded. All large taxpayers are now incorporated into the LTO for assessment and audit purposes; and the assessment and audit of social security taxes have been fully integrated into its operations. The revenue share generated by the LTO is up sharply—about 60 percent at end 2006 instead of the 50 percent targeted at the time of program conception. To further increase the efficiency of tax administration, we completed a feasibility study for merging small branches of the General Taxation Directorate (SB; end October 2006) and intend to move ahead with its implementation. We have requested a follow-up technical assistance mission to chart progress and fine tune recommendations. In addition, we have maintained the impetus to improve VAT administration by clearing all the VAT arrears dating before 2006 and by preparing and providing to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (SB; ongoing). In the customs administration we have introduced the ASYCUDA system and its risk assessment module in 12 custom houses; and have also improved customs performance by preparing and issuing quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections (SB; ongoing).

- **We made some progress in the area of debt management.** We submitted a new public debt law to Parliament defining the objectives and establishing the institutional structures for debt management (SB; end-September 2006); and we completed and published an explicit, time bound, debt-management strategy (PC; end-October 2006). The public debt law was adopted by Parliament at end-December 2006. We
also improved our electronic data management capacity, and made tentative steps
towards increasing the maturity of our domestic debt stock (from 195 days at end-
2005 to 235 days at end-2006) by increasingly issuing multi-year government bonds
for new borrowing and for the rollover of maturing treasury bills, including our first
five-year floating rate bond. We are actively seeking additional technical assistance.
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 the twice yearly listing and
status report of all projects being considered for nonconcessional foreign financing
(SB; ongoing). In addition, we will continue our practice of preparing semi-annual
reports on the stock of external arrears (SB; ongoing).

- **We took steps to significantly strengthen the legal, regulatory, and supervisory
  regimes governing commercial bank activity.** We updated the overall legal
  framework in December 2006 with the passage of a new Banking Law (SB; end-
  March 2007)—prepared with IMF technical assistance—which will come into force
  in June 2007. In addition to strengthening supervision within existing regulations,
  new regulations were introduced to safeguard the banking sector’s health in the face
  of rapid credit growth. These measures focus primarily on improving credit risk
  management—principally by mandating a more complete incorporation of actual
  risks into banks’ pricing decisions—and by instilling greater transparency by insisting
  on a more complete disclosure by banks to their clients of the risks inherent in
  borrowing. It is indicative of the success of these measures that the quarter-on-quarter
  annualized rate of credit creation eased from over 80 percent in mid-2005 to about
  46 percent by end-September 2006, in line with program projections. Draft legislation
  has also been prepared to significantly improve the efficiency and timeliness of the
  execution of collateral. While it was not tabled in time to meet the end-2006
  structural benchmark, the delay will be short as we intend to send it to Parliament by
  end-January 2007.

- **In line with the FSAP recommendations, we unified nonbank financial sector
  supervision within the new Financial Supervisory Authority (FSA).** To promote
  the independence of the new institution, the chairman and supervisory board of the
  new institution were appointed by Parliament, adequate funding has been secured for
  current operations, and technical assistance is being provided by the World Bank.
  Some movement has already been achieved regarding supervision and regulatory
  control over the insurance sector with the submission to Parliament of legislation
  aimed at raising capital requirements to European standards.

---
\(^1\) As defined in the TMU.
We are moving ahead with the sale of our remaining strategic public enterprises. Following the completion of an independent review of the privatization tender for the telecom company (Albtelecom), we reopened negotiations in November with the original investor, and we are optimistic that we can complete the privatization of the company this year. We presented our new electricity strategy to donors in September, and selected the International Finance Corporation (IFC) as our advisor for the privatization of the distribution arm of the power utility KESH, which we have already constituted as a separate company. We have also issued a tender for the privatization of the state-owned insurance company (INSIG). In the banking sector, we sold our minority stake in Italian Albanian Bank to San Paolo-INTESA of Italy, and are proceeding with preparations to sell our remaining equity in the system, which consists of a minority position in one small bank.

Progress in the statistical area was mixed. We made progress in preparing the preliminary national accounts for 2005 and the quarterly GDP estimates for 2005, and completed—albeit with a slight delay—the revision of national accounts for 1997-2004 (SB; end-November 2006). These data will be released in May 2007, in accordance with INSTAT’s official publication calendar. We revised our balance of payments estimates of private transfers (SB; end-2006); and took actions to strengthen the coordination between INSTAT, the Bank of Albania and the Ministry of Finance to expand data sources and improve data sharing between our institutions. We have been working closely with the staff of the IMF’s Statistical department to finalize the recent draft Report on the Observance of Standards and Code (ROSC); and also adopted an action plan to meet the SDDS goals.

III. STRATEGY, OBJECTIVES, AND POLICIES

We remain committed to the medium-term strategy outlined in our previous LOI/MEFP of July 14, 2006. This strategy—predicated on the maintenance of both macroeconomic and financial sector stability—is designed to effectively address the institutional weaknesses and resulting lack of nonprice competitiveness that currently constitute the greatest threat to continued rapid private sector-led growth.

Macroeconomic stability will be anchored through a continued adherence to the existing medium-term fiscal framework—while the BoA will continue to aim at keeping inflation within the 3±1 percent target range. We expect the resulting fiscal stability to engender market confidence, while affording greater stability and predictability to development spending. Our reluctance to employ fiscal policy for countercyclical operations also reflects the lack of timely savings and investment data.

Financial sector stability will be promoted through a continued refinement of our regulatory and supervisory reforms. In the banking sector, though difficult to observe over a short time horizon, we believe the tightened supervisory and regulatory regime
put in place over latter half of 2006 has already resulted in sounder lending practices, as evidenced by the slowing of the rate of credit growth. A clearer picture of the actual situation will emerge over the following months as our enhanced supervisory regime takes hold and improvements in required reporting practices increasingly bear fruit. However, sustained commitment will be necessary to maintain momentum and avoid erosion of gains made to date. Strengthening nonbank financial sector supervision is also an important goal which we will pursue vigorously over the program period.

- Over a longer time horizon, our program addresses institutional weaknesses and nonprice competitiveness, and encourages a broadening of the export base through wide-ranging reforms, including to the 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 with the aim of creating conditions capable of attracting enough foreign and domestic investment to effect a rapid increase of our productive capacity. We also intend to significantly downsize government involvement in non-core areas, primarily by stepping up the pace of privatization, including in the electricity sector. Weak infrastructure is a serious constraint on growth and we are taking decisive action to improve the infrastructure, particularly in the transportation sector.

A. Macroeconomic Framework

5. **The macroeconomic framework outlined in our LOI/MEFP of July 14, 2006 remains realistic.** We expect economic growth to return to its trend rate of 6 percent in 2007, supported by continued strong performance of exports, an acceleration in the growth of services, and by a rise in public investment, including in the road sector. With the level of demand appropriately balanced by monetary policy—aided by lower credit growth and supported by a flexible exchange rate regime—we expect inflation to remain within the target range in 2007. 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 capital goods imports for public investment rising rapidly in 2007 and 2008, there will be a small but manageable increase in the current account deficit next year. However, we expect this to be temporary and the deficit will begin to narrow again from 2008. To secure safe budget execution, 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. Fiscal Policy

6. **Our fiscal strategy is based on the premise that a small, but increasingly efficient, government would be most effective in promoting our economic development.** This strategy—which follows that of the more successful middle-income countries—involves a concentration of reform effort in reducing key vulnerabilities; improving efficiency of core activities; and, wherever possible, offloading noncore functions to the private sector. We anticipate that a successful implementation of our reform program will substantially improve the attractiveness of Albania as a destination for foreign investment.

7. **Our 2007 budget and our medium-term fiscal framework are both fully consistent with this strategy.**

- Net credit to government in 2007 is targeted at 2½ percent of GDP—a ¼ percent of GDP increase over the 2006 outturn due to the one-off nature of the adjustment employed last year to reduce demand pressure—but in line with the original fiscal program and targets so that we maintain the same ongoing trend decline. We have continued our practice of securing safe budget execution and protecting priority expenditure by using realistic revenue projections—which exclude uncertain gains from new tax administration measures—as well as through sizable budget contingencies that will be released after consultation with the Fund if revenues are in line with projections. On the expenditure side, priorities remain education, health care, and roads. With proven revenue gains allocated almost exclusively to investment and capital maintenance expenditures, full execution of budget plans will imply that investment spending increases and that the current surplus, including grants, will remain at the relatively-high level of 2½ percent of GDP. The budget includes no new tax policy measures but—as was the case in 2006—we will introduce such measures in a supplementary budget in mid-2007 if further permanent improvements in revenue collection are attained. Any unanticipated one-off privatization receipts will be allocated in this budget according to our long-established formula—half to investment and the maintenance of existing capital, with the remainder used to retire domestic public debt.

- With our fiscal strategy containing expenditure at the 30 percent of GDP range, and using our existing—conservative—revenue projections, we anticipate a reduction of public debt as a percent of GDP, and a lowering of annual domestic borrowing to 2¼ percent of GDP by 2010. Over this time period, and within the expenditure envelope, a further diversion of resources to capital uses will increase our current surplus (including grants) by ¾ percentage point of GDP. However, with ongoing reform of revenue administration, we consider additional revenue gains likely. After their permanent nature has been demonstrated they will be used to reduce the tax burden, which will further improve our business climate.
8. **Revenue administration reform remains a key component of our program.** In the year ahead, we will concentrate on further strengthening the LTO, including through staff training and better human resource management. With a view to significantly increasing the allocation of skilled human resources to more productive activities (such as audit and enforcement), we will prepare and approve an action plan to review the role of the Tax Police, including a description of the measures that will be taken to implement IMF technical assistance recommendations in this area (PC; end-March 2007). We will also press ahead with efforts to reduce corruption that have been supported by technical assistance from the Millennium Challenge Account in the tax administration and by the European Commission in the customs administration.

9. **Our debt management capacity requires improvement as a matter of priority.** The recent development of an overall strategy and a new public debt law represented important prerequisites. However, more tangible gains are needed if we are to significantly reduce the vulnerability inherent in our present debt structure, where domestic debt equivalent to 38 ½ percent of GDP rolls over every 235 days. Over the next year, we will continue to follow the action plan developed to implement the IMF TA advice, including by:

- Conducting an independent review of staffing requirements in the debt management unit of the Treasury and Public Debt Management Directorate, including a review of the conditions necessary to recruit people with the appropriate skills (SB; end-June 2007);
- Complete a functional review of public debt management and on that basis restructure the Debt Department;
- Further improve our IT capacity by establishing an integrated management system for external and domestic debt; and migrating domestic debt into the computerized system. Automation of the auction process through the utilization of the Reuters system is already being implemented.

10. **We intend to further reduce vulnerabilities by developing new debt instruments.** The narrow range of domestic debt instruments and the large stock of short-maturity lek-denominated public debt leaves us exposed to volatile liquidity movements and shifting market sentiment. Thus, while ensuring that our markets develop at a pace commensurate with our debt management capacity, we need to develop alternate debt instruments and financing options capable of satisfying government borrowing requirements while at the same time insulating us somewhat from adverse short-term disruptions in the market for lek-denominated debt. We have therefore begun investigating ways and means of tapping the large foreign currency-denominated savings of residents. As a first step, we issued our first foreign currency-denominated treasury bills in December 2006. The bills were sold to domestic residents in a competitive auction and fully hedged to protect the treasury from exchange rate risk. Looking ahead, in consultation with the Fund, we intend to explore the
possibility of issuing longer-term foreign currency-denominated domestic debt, where the improved maturity structure would reduce rollover risk sufficiently to compensate for the possibility of adverse exchange rate movements.

11. **Improvements to our government securities markets are also expected to help our debt management capacity.** Over the course of 2007, building on IMF technical assistance, we will complete the development of an electronic delivery-versus-payment system for government securities. Integration of this system with the securities auctions will enable improvements in the debt database, and also allow auctions to take place over a shorter time frame, with agents able to make purchase decisions and receive their securities simultaneously. In addition, we will work to speed up the publication of auction results on the Ministry of Finance web site.

12. **Budget process and financial management.** We will continue to improve the selection of public investment projects, including by strengthening the operations of the public investment unit, which was established within the Ministry of Finance in January 2006. We will also improve our capacity to execute capital spending by introducing a mid-year budgetary review of investment projects, with the aim of redirecting investment allocations to sectors that show higher implementation capacity. We will strengthen coordination between the selection of public investment projects and the Medium Term Budget Program (MTBP), and between the MTBP and the annual budget process. This will include the practice of using annual expenditure ceilings for line ministries established under the MTBP as basis for annual budget allocations. In addition, we will further improve our implementation capacity by increasing the average size of projects in our budget and significantly decreasing their number. A new organic budget law was drafted and sent to international organizations for comments in December 2006, and we intend to submit it to Parliament by March 2007.

C. **Monetary, Exchange Rate, and Financial Sector Policies**

13. **The BoA is being called upon to conduct monetary policy within a difficult and changing environment.** With the fiscal stance determined by the medium-term fiscal framework, monetary policy is shouldering an increased responsibility for price stability. This comes at a time when the existing monetary policy framework is facing new challenges. While this framework has proved effective in the past—and will be retained along with the flexible exchange rate regime—the transmission mechanism operates primarily through controlling the pass through effect on the lek price of traded goods. Over the past year, however, our situation has been one in which a significant portion of the price pressures we experience arise from the rapid growth of credit—over which policy rate changes have less influence. As the acceleration of credit also directly impacts banking

---

2 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.
system soundness, policies to maintain price and financial sector stability have become closely intertwined.

14. **As a consequence, maintaining price and financial sector stability will continue to require that traditional monetary policy instruments be supplemented with prudential and regulatory measures.**

- We stand ready to make appropriate adjustments in the policy rate in response to observed changes in money demand, or to prevent the development of second round effects from the recent increases in food and electricity prices.

- With demand for bank loans relatively interest inelastic, credit growth remains a significant and potentially-volatile component of total demand. Our response over the course of 2006 has been to directly counter this pressure by tightening the regulatory and supervisory framework governing the banking sector, and this has resulted in significant success in lowering banks’ risk profiles and slowing the rate of credit expansion. However, a considerable effort will be required over the next year to safeguard these gains, as international experience has demonstrated a considerable potential for backsliding.

15. **Over the course of 2007, we intend to supplement the measures already taken.** We remain committed to the establishment of a credit bureau within the BoA. In this latter regard, we have completed a detailed action plan for implementation. However, recent Fund-provided technical assistance determined that the magnitude of the legal preparation involved was significantly greater than we had earlier anticipated. In accordance with the TA recommendations, we have postponed the deadline for completion of the credit bureau from end-June 2007 and have set it as a structural benchmark for end-December 2007. We will continue to consult closely with members of the banking community to ensure that they fully understand the actions taken to safeguard the banking system.

16. **In contrast to the situation in the banking sector, nonbank financial sector supervision remains underdeveloped and in need of considerable improvement.** While the unification of the nonbank supervisory agencies under the FSA provides a sound framework for moving forward, significant work will be needed to raise the quality of supervision to acceptable standards. With World Bank assistance, we have begun upgrading capacity. Our immediate priorities are to develop a new supervisory strategy and operating procedures (including operations manuals and basic staffing structures); and to carry out an urgent assessment of the health of insurance sector that will identify the necessary corrective actions. Over the longer term we will review all laws and regulations to bring them up to date with world standards, conduct ongoing staff training, and develop appropriate information technology systems. Until an appropriate legal framework is developed in the private pension industry, and until supervisory capacity improves, we will continue to restrict participation in the pension industry to the three companies already licensed.
17. **Over a near-term horizon, we will examine the issue of which institution would best supervise the leasing sector.** While this sector is still small in Albania, the experience in neighboring countries has shown it is capable both of extremely rapid growth and of circumventing to a large degree the efforts of monetary authorities to control demand forces. In view of the close substitution of some bank loans for lease contracts, we will give serious consideration to moving the supervision of leasing companies back to the BoA.

18. **We will continue to refine and improve financial sector infrastructure and institutions.** The treasury bill window at BoA will be maintained until alternate means of ensuring nonbank access to government securities are in place; and the necessary steps will be taken to ensure non-bank participants have access to the government debt market on an equitable basis. We expect the forthcoming delivery versus payment system to raise volumes in the secondary market for government debt and to foster the development of the interbank market—both developments that will improve the efficiency of monetary policy and of the overall intermediation process. To protect our existing institutional quality, we 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; and will take no legislative or regulatory action that weakens the independence of the BoA, including the Supervisory Board of the BoA’s control over the Bank’s budget and its authority to decide on compensation levels.

**D. Transportation Strategy**

19. **The most important pillar of our NSDI is sustained high economic growth, which requires a sound and solid infrastructure.** Investment in infrastructure, particularly in the transport sector, will also reduce poverty by increasing economic efficiency, lowering costs, and enhancing opportunities for trade, transit traffic and tourism. The recent Stabilization and Association Agreement (SAA) with the EU and our membership in the World Trade Organization (WTO) will open better access to regional and EU markets and provide new opportunities to develop tourism in Albania. However, reaping the benefits from these new opportunities requires a solid road infrastructure. Our National Transport Plan (NTP) therefore includes a number of key projects, both to construct new national roads and to improve the condition of the existing national roads. This will help to secure an Albanian road network that fulfills this purpose and moves us closer towards European Standards.

20. **A critical component of the NTP is a new road corridor between Durres and Morine that connects our main port of Durres with Kosovo and the South Balkans.** The road corridor is divided into three segments. The first section (Milot to Rreshen) will cost about €32 million and we expect it to be mainly financed by the World Bank. The last section (Kalimash to Morine) is expected to cost €38 million and will be fully financed by domestic budgetary resources. The cost of the complex middle section, for which a construction contract has been agreed with a consortium of international companies, is expected to be about €430 million (excluding VAT). The total cost of the project is estimated at about €500
million (about 5½ percent of GDP) over the 2006-09 period. About half of the project cost will be covered by domestic budgetary resources. The domestic component of the financing plan for this project is well within our medium-term budget framework, which provides annual fiscal space of at least 4 percent of GDP for domestically-financed public investment.

21. **However, given other priority investments, our domestic budget resources are not sufficient to fully cover the costs of the Durres-Morine corridor.** Therefore, part of this road will be financed through external loans. We hope to receive strong support and some participation from our international development partners. We are in the process of finalizing a financing agreement for the first section of the corridor with the World Bank ($25 million) and OPEC Fund ($15 million), which is expected to be reached by early 2007. We are also negotiating with the Islamic Development Bank for a loan of $35 million, part of which will be on concessional terms. Nevertheless, we still need to arrange external financing of about €200 million over the next three years for the remainder of the project, most of which will likely be on nonconcessional terms.

22. **We are committed to maintaining external debt at sustainable levels, and we reaffirm our intention to keep the overall cumulative program limit on nonconcessional borrowing unchanged at €680 million.** However, the nature of the Durres-Morine corridor project requires that we seek a re-phasing of these commitments in order to complete the project by mid-2009. Consequently, we are seeking to revise upwards the end-2007 cumulative nonconcessional borrowing limit under the program from the current level of €280 million to €380 million. We will, however, make efforts to reduce our recourse to non-concessional external borrowing if possible—by devoting any additional concessional financing for the transport sector to this project, as well as half of all privatization receipts—and reduce the ceiling for 2007 accordingly.

23. **Inevitably, a large project like Durres-Morine corridor road increases the risk to budget and medium-term fiscal framework.** We will therefore take a number of measures to create a buffer against the potential budgetary risks stemming from this project.

- First, we will increase budget contingencies to about 1 percent of GDP, in line with our organic budget law, starting in 2008 to secure additional resources for this project in case of unanticipated developments.

- Second, this project will be a high priority for additional budgetary resources if our mid-year review of the capital budget (paragraph 12) indicates room for reallocation of funds.

- Third, over the course of this project, the part of the proceeds from any privatization of strategic public enterprises that can be used for investment (one half) will be used to finance this road project and non-concessional external borrowing will be reduced accordingly.
Finally, in case of unanticipated developments that cannot be accommodated by the above described measures, we will reallocate resources from lower priority road projects to this project.

In addition to these buffers, we are establishing, in consultation with the World Bank, an effective monitoring mechanism to minimize cost overruns and delays in implementation.

E. Other Structural Reforms

24. **We are undertaking an important initiative to address informality in the housing sector.** Currently, some 300,000 housing units, accounting for close to 70 percent of all new construction since 1990 and valued at some US$4 billion (about 45 percent of GDP), reside in the extralegal sector. As these buildings are not properly registered, they cannot be sold outside a narrow circle of people or be used as collateral against a formal bank credit. A new legalization law was approved in April 2006 aimed at bringing this wealth into the formal economy where it can better contribute to economic development. A new agency has been set up, and the process of legalization is well advanced—as evidenced by self-declarations which reached some 270,000 buildings between July 15 and November 24.

25. **We will take further actions to ensure a stable supply of electricity and to strengthen the financial performance of KESH.** While favorable conditions for domestic production and large electricity imports helped us meet demand for electricity during most of 2006, our continued dependence on power imports is a concern. In addition to expanding hydro-power capacity, we are, therefore, finalizing a contract for the construction of a thermal power plant, which will be financed largely by the World Bank, the European Bank for Reconstruction and Development and the European Investment Bank. While performance so far is mixed, we will ensure that KESH meets the 2007 objectives with regard to collection rates and electricity losses envisaged in Power Sector Action Plan for 2006-2008. To advance this aim, we used budget funds in 2006 to settle all arrears owed to KESH by public institutions and water supply companies dating back to 2005 and earlier and most of such arrears for 2006. We will make further efforts in 2007 to settle the remaining arrears and ensure that these institutions pay their bills in a timely manner. Moreover, in line with our new energy sector strategy—which aims to increase private sector involvement—we are preparing for the sale of the distribution arm of KESH and have selected the IFC as a privatization advisor.

26. **We are expecting good progress in privatization of other strategic public enterprises in 2007.** In particular, we plan to finalize the negotiations for the sale of Albtelecom by the end of 2007. We also aim to move rapidly towards the privatization of INSIG, ARMO, Albpetrol and Servcom, and Transnafta, and have already merged the latter three enterprises to make them more attractive to strategic investors.
27. We are also taking significant actions to improve our business and investment climate in areas outside the IMF-supported program. In particular, we have established a Regulatory Reform Task Force chaired by the Prime Minister for the formulation and monitoring of regulatory reforms. The Regulatory Reform Action Plan developed by this task force—and endorsed by the Council of Ministers—contains four main pillars: (i) Developing a regulatory management system (institutions and procedures); (ii) Improving the quality of existing regulations (reducing administrative and regulatory barriers); (iii) Improving the quality of new regulation (for example through regulatory impact assessments); and (iv) Establishing a framework for systematic monitoring and evaluation of reforms. The World Bank has approved a $9.3 million credit to support a number of activities under this plan. In addition, Parliament has passed a new procurement law; we have finished drafting a new concession law; and we intend to establish a one-stop shop for business registration and licensing by June 2007. We are also finalizing preparations to introduce the “Albania 1 Euro Initiative”, which is designed to reduce investment barriers caused by the difficulties currently experienced in gaining secure title to land. We envisage this as a temporary measure that will become increasingly unnecessary as land formalization proceeds. The scheme does not involve tax incentives, and so is likely to lead to higher tax revenues once it has the anticipated effect on business and investment activity.

F. External Policies

28. The signing of the Stabilization and Association Agreement with the European Union is a historic milestone. It provides a solid framework to address the many reform challenges on the path to EU accession. Steadfast implementation of the necessary reforms will reap large benefits by strengthening the business environment and generating substantial foreign direct investment.

29. We will retain our liberal trade regime. We have implemented all commitments made to the WTO regarding tariff policies. On a regional level we have concluded free trade agreements with all our regional neighbors—which is significantly boosting our trade with them, albeit from a low level. At the beginning of 2007, we plan to introduce further trade liberalization through the Central Europe Free Trade Agreement.

30. We are continuing to make good faith efforts to conclude the rescheduling of our arrears on inoperative payment agreements. We are engaged in negotiations that aim at concluding the clearance process with official creditors by mid-2007—negotiations with Poland and Bulgaria are successfully concluded and we intend to clear these arrears in the first quarter of 2007. During 2006, we cleared arrears with a number of private creditors in Germany, Italy, and Turkey; and we expect to eliminate all remaining external arrears with private creditors by end-2007. We will continue to 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.
G. Data Issues

31. **We are aware that our revised national accounts estimates rely on very narrow labor input data and lack plausibility.** Improving labor source data will therefore be a matter of priority to ensure the reliability of our national accounts estimates. To that effect, INSTAT will complete a labor force survey by the end of 2007 and finish the household budget survey by October 2007. However, fully revised national accounts using improved labor data might not be ready before mid-2008. Consequently, we will be preparing revised national accounts for 2004 and preliminary national accounts for 2005 based on the methodology used until 2005 to estimate the non-observed economy. We will also prepare revised national accounts estimates based on the labor input methodology using streamlined labor data. Based on the new household survey we will update the weights of the CPI. We will also continue our efforts to produce quarterly GDP estimates. We will strengthen the collaboration of INSTAT and the BOA, with a view to improving the quality of our BOP statistics, notably with regards to data on workers remittances. We will continue to work with the Statistics Department of the IMF to implement the recommendations of the recent ROSC and implement our plan to move towards SDDS status.

H. Program Monitoring

32. The fourth disbursement under the PRGF/EFF-supported program will be based on the end-March 2007 quantitative performance criteria (Table 1 and the TMU); the end-March 2007 structural performance criteria (Table 2 and the TMU); and completion of the third review and financing assurances review. The third review under the PRGF and EFF arrangements is expected to be completed 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.
Table 1. Albania: Quantitative Performance Criteria and Indicative Targets, June 2006-December 2007 1/

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Prog. (Adj.)</td>
<td>Actual</td>
<td>Prog. (Adj.)</td>
<td>Est.</td>
<td>Prog.</td>
<td>Prog.</td>
</tr>
<tr>
<td>Ceiling on net domestic credit to the government 2/</td>
<td>-10</td>
<td>12</td>
<td>12</td>
<td>-10</td>
<td>18</td>
<td>20</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>8.0</td>
<td>16.0</td>
<td>22.0</td>
</tr>
<tr>
<td>Ceiling on accumulation of net domestic assets of the BOA 3/</td>
<td>-13</td>
<td>8</td>
<td>7</td>
<td>-6</td>
<td>6</td>
<td>7</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>11.5</td>
<td>11.9</td>
<td>11.9</td>
</tr>
<tr>
<td>Indicative total tax revenue target 4/</td>
<td>93</td>
<td>87</td>
<td>87</td>
<td>143</td>
<td>134</td>
<td>134</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>45.0</td>
<td>97.0</td>
<td>154.0</td>
</tr>
<tr>
<td>Floor on accumulation of net international reserves of the BOA 3/</td>
<td>140</td>
<td>17</td>
<td>17</td>
<td>125</td>
<td>80</td>
<td>66</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>71.1</td>
<td>90.6</td>
<td>156.6</td>
</tr>
<tr>
<td>Ceiling on contracting or guaranteeing of public and publicly-guaranteed non-concessional external debt with original maturities of more than one year</td>
<td>2</td>
<td>30</td>
<td>30</td>
<td>17</td>
<td>50</td>
<td>50</td>
<td>45</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>180.0</td>
<td>380.0</td>
<td>380.0</td>
</tr>
<tr>
<td>Ceiling on public and publicly-guaranteed external debt with original maturities up to and including 1 year 5/</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Ceiling on accumulation of new external payments arrears, excluding interest on pre-existing arrears 5/</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

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-September 2006 are performance criteria, except where marked. Data for end-March 2007 are proposed performance criteria, except where marked. Data for end-June 2006, end-December 2006, end-June 2007, end-September 2007, and end-December 2007 are indicative targets.

2/ Cumulative change within the calendar year.


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/

<table>
<thead>
<tr>
<th>Performance Criteria</th>
<th>Proposed Test Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Performance Criteria</td>
<td></td>
</tr>
<tr>
<td>1. Prepare and approve by the Minister of Finance an action plan to review the role</td>
<td>End-March 2007</td>
</tr>
<tr>
<td>of the Tax Police, including a description of the measures that will be taken to</td>
<td></td>
</tr>
<tr>
<td>implement IMF technical assistance recommendations in this area (as specified in</td>
<td></td>
</tr>
<tr>
<td>the FAD report &quot;Albania-Challenges to Reforming Tax Administration&quot; of June 2005,</td>
<td></td>
</tr>
<tr>
<td>page. 63)</td>
<td></td>
</tr>
<tr>
<td>II. Structural Benchmarks</td>
<td></td>
</tr>
<tr>
<td>A. Improve public expenditure management</td>
<td></td>
</tr>
<tr>
<td>2. Safeguard the efficient use of nonconcessional foreign project loans:</td>
<td></td>
</tr>
<tr>
<td>(i) Conduct an independent feasibility study for any large project (as defined in</td>
<td>Ongoing</td>
</tr>
<tr>
<td>the TMU) financed through non-concessional commercial borrowing;</td>
<td></td>
</tr>
<tr>
<td>(ii) Provide a semestrial listing and status report on all projects being</td>
<td>Ongoing</td>
</tr>
<tr>
<td>considered for nonconcessional foreign financing.</td>
<td></td>
</tr>
<tr>
<td>B. Reduce fiscal vulnerabilities</td>
<td></td>
</tr>
<tr>
<td>Strengthen tax administration</td>
<td></td>
</tr>
<tr>
<td>3. Improve VAT administration by preparing and providing to the Fund quarterly</td>
<td>Ongoing</td>
</tr>
<tr>
<td>reports on the aggregate amounts of the VAT refunds requested, refunds paid</td>
<td></td>
</tr>
<tr>
<td>and refunds rejected (within one month of the end of each quarter).</td>
<td></td>
</tr>
<tr>
<td>4. Prepare and issue quarterly reports on progress made in the actual use of the</td>
<td>Ongoing</td>
</tr>
<tr>
<td>risk assessment module of the ASYCUDA system to perform inspections in the</td>
<td></td>
</tr>
<tr>
<td>customs.</td>
<td></td>
</tr>
<tr>
<td>Improve debt management capacity</td>
<td></td>
</tr>
<tr>
<td>5. Conduct an independent review of staffing requirements in the debt management</td>
<td>End-June 2007</td>
</tr>
<tr>
<td>unit of the Treasury and Public Debt Management Directorate, including a</td>
<td></td>
</tr>
<tr>
<td>review of the conditions (e.g., competitive salary) necessary to recruit</td>
<td></td>
</tr>
<tr>
<td>people with the appropriate skills.</td>
<td></td>
</tr>
<tr>
<td>6. Prepare semi-annual reports (within one month of the end of each semester) on the</td>
<td>Ongoing</td>
</tr>
<tr>
<td>stock of external arrears.</td>
<td></td>
</tr>
<tr>
<td>C. Strengthen the financial system and improve economic monitoring capability</td>
<td></td>
</tr>
<tr>
<td>7. Establish a credit bureau within the Bank of Albania.</td>
<td>End-December 2007</td>
</tr>
</tbody>
</table>

1/ Text in italics refers to new conditionality not carried over from the first review under the program (IMF Country Report No. 06/286).
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.

A. Net Domestic Credit to the Government

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

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

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

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

---

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

4 This was equivalent to Lek 11.5 billion at end-December 2005 and Lek 12.2 billion at end-September 2006.
stock of gross domestic credit to government will also exclude the claims held 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.

(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.

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

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

(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.

---

5 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.

6 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.
(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.

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

5. 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.

6. Under these definitions, the stock of net domestic credit to the government was Lek 307.9 billion at end-September 2006. The breakdown of the categories of net domestic credit to the government as defined above is given in Attachment Table 1.

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

B. Net Domestic Assets

8. The stock of net domestic assets (NDA) of the Bank of Albania is defined as reserve money—defined as the sum of currency issue (less lek notes and coins held by the Bank of Albania) and commercial bank reserves held at the BoA—less the net international reserves of the Bank of Albania (Section C). For program monitoring purposes, all foreign currency assets and liabilities making up NIR will be valued in local currency at the exchange rates of end-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.

C. Net International Reserves

9. Net international reserves (NIR) are defined as reserve assets minus reserve liabilities of the Bank of Albania. Reserve assets are readily available claims of the Bank of Albania on nonresidents denominated in foreign convertible currencies, and held for the purpose of meeting balance of payments financing needs, intervention in exchange markets, and other purposes. They include Bank of Albania holdings of monetary gold, SDRs, Albania’s reserve position in the IMF, foreign currency cash, 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. 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.

10. 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.

D. Adjusters for NCG, NDA, and NIR

11. The NCG and NDA ceilings and the NIR floor are defined on the assumption that
cumulative privatization proceeds from January 1, 2007 will be as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-March 2007</td>
<td>Lek 250 mn.</td>
<td>(Of which US$0.0 mn. in foreign currency);</td>
</tr>
<tr>
<td>End-June 2007</td>
<td>Lek 500 mn.</td>
<td>(Of which US$0.0 mn. in foreign currency);</td>
</tr>
<tr>
<td>End-September 2007</td>
<td>Lek 750 mn.</td>
<td>(Of which US$0.0 mn. in foreign currency);</td>
</tr>
<tr>
<td>End-December 2007</td>
<td>Lek 1,000 mn.</td>
<td>(Of which US$0.0 mn. in foreign currency).</td>
</tr>
</tbody>
</table>

The NIR floor will be adjusted upward (downward) and the NDA ceiling adjusted downward
(upward) by half of any excess (shortfall) in the receipt of privatization proceeds in foreign
currency from these assumed values. The NCG ceiling will be adjusted downward (upward)
by half the amount of any excess (shortfall) in the receipt of total privatization proceeds from
these assumed values.

12. The 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

---

7 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.

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

13. The ceilings on NCG and NDA, and the floor on NIR are defined based on the assumption that foreign budgetary and/or balance of payments loan financing (excluding IMF financing, project and commodity loans, loans from the International Development Association of the World Bank Group, and macro-financial assistance from the EU) will amount, on a cumulative basis, from January 1, 2007, to:

<table>
<thead>
<tr>
<th></th>
<th>US$0.0 mn.</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-March 2007</td>
<td></td>
</tr>
<tr>
<td>End-June 2007</td>
<td></td>
</tr>
<tr>
<td>End-September 2007</td>
<td></td>
</tr>
<tr>
<td>End-December 2007</td>
<td></td>
</tr>
</tbody>
</table>

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 (excluding IMF financing, project and commodity loans, loans from the International Development Association of the World Bank Group, and macro-financial assistance from the EU) exceeds these projections. The NCG ceiling will be adjusted downward by the amount total foreign loan financing (excluding IMF financing, project and commodity loans, loans from the International Development Association of the World Bank Group, and macro-financial assistance from the EU) exceeds these projections.9

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

E. External Debt and Arrears

15. As set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–00/85) August 24, 2000), the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will 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

9 For the NCG adjuster, the lek equivalent of deviations from the programmed amounts received in foreign currency will be converted to lek at the exchange rates prevailing on the value date of the transaction.
funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

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

17. The limit on 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.

18. 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 September 30, 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 September 30, 2006; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

19. **Large projects** (as referred to in MEFP paragraph 3 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.

**F. Release of Contingencies in the 2007 Fiscal Budget**

20. The first 20 percent of the budget commitments embodied in the 2007 budget that represent contingencies for investment spending will be released after the following conditions are satisfied:

- At end-March 2007, 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;

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

21. The remaining 80 percent of the budget commitments embodied in the 2007 budget that represent contingencies for investment spending, and all the budget commitments embodied in the 2007 budget that represent contingencies for current spending, and all non-allocated contingencies, will be released after the following conditions are satisfied:

- At end-June 2007, 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;

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

**G. Tax Revenues**

22. 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.
H. Monitoring and Reporting Requirements

23. 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 quarter will be supplied within one month of the end of the quarter.
(viii) Information on official grants for projects or budget support purposes.
(ix) Biannual reports on the stock and clearance of outstanding debit balances of inoperative bilateral payment agreements will be supplied within one month of the end of the semester.

(x) Information on expenditure arrears;

(xi) A biannual listing and status report of all projects being considered for nonconcessional foreign financing.

The General Directorate of Customs will supply to the Fund:

(i) Detailed monthly data on customs revenues collected; and
(ii) Quarterly reports on corrective measures taken to deal with problems identified by the internal audit function.
(iii) Quarterly reports on the progress made in the actual use of the ASYCUDA risk-assessment module to perform custom inspections;

The General Directorate of Taxation will supply to the Fund:

(i) Detailed monthly data on tax revenues collected.
(ii) Detailed monthly data on the share of taxes collected by the Large Taxpayer Office (LTO).

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

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

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

(i) The consumer price index (CPI index) at the aggregated level and at the level of each individual item making up the basket.
(ii) The producer price index.
(iii) The construction cost index
(iv) All short term indicators as they become available as defined in INSTAT’s quarterly publication “Conjoncture”.
(v) In addition INSTAT will communicate to the Fund on a regular basis the preliminary estimates for Quarterly GDP. It will also communicate as early as possible the
preliminary estimates for annual GDP disaggregated by 22 sectors and distinguishing between the observed and non-observed economy.
Table 1. Albania: Calculation of Net Domestic Credit to Central Government for Program Monitoring Purposes, September 2006–December 2007
(In millions of lek)

<table>
<thead>
<tr>
<th>Sep-06</th>
<th>Dec-06</th>
<th>Mar-07</th>
<th>Jun-07</th>
<th>Sep-07</th>
<th>Dec-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. (i) Held by Bank of Albania</td>
<td>254,792</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. (ii) Held by deposit money banks</td>
<td>65,533</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. (i) Held by savings and loan institutions</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. (iv) Held by other domestic lenders (excluding holdings of HHI and SSI)</td>
<td>32,406</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| 1. (iv) (i) INSIG | 2,064 | | | | |
| 1. (iv) (ii) Individuals and firms | 30,342 | | | | |
| 1. (iv) (ii) (i) BoA window | 20,313 | | | | |

| 2. Plus: Other central government debt held outside central government (millions of lek) | 69,584 | | | | |
| 2. (i) Held by Bank of Albania | 12,164 | | | | |
| 2. (i) Other securities | 12,164 | | | | |
| 2. (i) Short-term direct loans to government | 0 | | | | |
| 2. (ii) Held by deposit money banks | 57,420 | | | | |
| 2. (ii) Fixed income securities | 57,420 | | | | |
| 2. (ii) Variable income securities | 0 | | | | |
| 2. (iii) Held by savings and loan institutions | 0 | | | | |
| 2. (iv) Held by other domestic lenders | 0 | | | | |

Equals gross domestic credit to government: 324,376

3. Less: Assets of central government (excluding HHI and SSI)

| 3. (i) Deposits held at Bank of Albania | 6,930 | | | | |
| 3. (i) In domestic currency | 4,847 | | | | |
| 3. (i) Deposits in lek for projects | 424 | | | | |
| 3. (i) In foreign currency at program exchange rates and program price of gold | 2,084 | | | | |
| 3. (i) In foreign currency evaluated at current exchange rates | 2,280 | | | | |
| 3. (i) (i) Transferable deposits in foreign currency evaluated at program exchange rate | 107 | | | | |
| 3. (i) (ii) (ii) Standard gold deposits of government evaluated at program exchange rate and gold price | 1,977 | | | | |
| 3. (i) (ii) (ii) (ii) Standard gold deposits of government at current exchange rate and gold price (Lek mns.) | 2,176 | | | | |
| 3. (i) (ii) (ii) Number of ounces of gold equivalent | 37,269 | | | | |
| 3. (ii) Assets held at deposit money banks | 7,221 | | | | |
| 3. (ii) (i) Deposits | 1,408 | | | | |
| 3. (ii) (i) Deposits in domestic currency | 259 | | | | |
| 3. (ii) (i) Other deposits | 259 | | | | |
| 3. (ii) (i) Deposits in foreign currency evaluated at current exchange rates | 259 | | | | |
| 3. (ii) (i) (i) Transferable deposits in foreign currency evaluated at current exchange rates | 1,114 | | | | |
| 3. (ii) (i) (i) (i) Standard gold deposits of government evaluated at program exchange rate and gold price | 1,977 | | | | |
| 3. (ii) (i) (i) (i) (i) Standard gold deposits of government at current exchange rate and gold price (Lek mns.) | 2,176 | | | | |
| 3. (ii) (i) (i) (i) Number of ounces of gold equivalent | 37,269 | | | | |
| 3. (ii) (ii) DMB payables to government | 1,411 | | | | |
| 3. (ii) Ministry of finance short-term lending to commercial banks | 4,402 | | | | |
| 3. (iii) Held in foreign currency evaluated at program exchange rates | 1,149 | | | | |
| 3. (iii) (i) Deposits in foreign currency evaluated at current exchange rates | 2,176 | | | | |
| 3. (iii) (i) (i) Transferable deposits in foreign currency evaluated at current exchange rates | 1,114 | | | | |
| 3. (iii) (i) (i) (i) Other deposits | 0 | | | | |
| 3. (iii) (i) (ii) Ministry of finance short-term lending to commercial banks | 4,402 | | | | |
| 3. (iii) Held at savings and loan institutions | 0 | | | | |

Equals: Stock of Net domestic credit to central government (1+2-3-4) 307,866

5. Change since December 2006

| 5. (i) Current exchange rate (Lek/SDR, eop) | 143.4 | | | | |
| 5. (ii) Current exchange rate (Lek/US dollar, eop) | 97.1 | | | | |
| 5. (iii) Program exchange rate (Lek/SDR, eop) | 147.8 | 147.8 | 147.8 | 147.8 | 147.8 |
| 5. (iv) Program price of gold (price in SDRs dollars per ounce at end-December 2003) | 358.9 | 358.9 | 358.9 | 358.9 | 358.9 |
| 5. (v) Market price of gold (price in US dollars per ounce) | 601.4 | | | | |
| 5. (vi) Current exchange rate (US dollar per SDR, eop) | 1.4764 | | | | |

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