Albania: Letter of Intent and Technical Memorandum of Understanding

June 19, 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.
Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

Dear Mr. de Rato:

For over 10 years, IMF assistance has been instrumental in promoting macroeconomic stability and economic growth, as well as improving governance in Albania.

The current Fund-supported program, approved in January 2006, 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 consequently maintain our expectation that our need for the Fund’s resources will end with the expiration of this program in 2009.

On this basis, we request completion of the third review under the three-year Poverty Reduction and Growth Facility arrangement together with concurrent approval of the third review under the three-year Extended Fund Facility arrangement; and also request the fourth disbursement under both these arrangements in a total amount of SDR 2.435 million.

We believe that the policies set forth in the attached Memorandum of Economic and Financial Policies (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/
Sali Berisha
Prime Minister

/s/
Ridvan Bode
Minister of Finance

/s/
Ardian Fullani
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 second half of the 2006-2009 program period, and provides a detailed description of our policy intentions up to the middle of 2008. It is fully consistent with our new National Strategy for Development and Integration (NSDI) for 2007-13—currently in draft form with finalization expected by end-October 2007. The new NSDI is being formulated within the comprehensive Integrated Planning System introduced in 2005 and is benefiting from the ongoing intensive consultation with stakeholders that began in March of this year.

II. ECONOMIC DEVELOPMENTS

2. Macroeconomic developments are unfolding favorably, and broadly as envisioned at the time of the last review. Growth is accelerating and inflation remains low. The energy shortages that became apparent at end-2006 have for now eased, and a broad-based and rapid export recovery and vibrant construction and service sectors are poised to raise growth to 6 percent in 2007. The current account deficit is likely to widen reflecting strong import demand, but inflation is still expected to remain within the Bank of Albania’s (BoA) 3±1 percent target range.

3. However, downside risks—primarily to price stability but also to growth—have increased. Our baseline projections have not changed, but ensuring that macroeconomic objectives remain on track now requires an increasingly cautious and prudent approach to policy formulation.

• The main risk comes from the weakened financial position of our public electricity utility, KESH, where poor collection performance and a sharp increase in the import price of electricity have reduced cash flow and net worth.

• Additional risk may arise from a slight slowdown of domestic revenue collection in early 2007.

• Strong credit growth has the potential to accelerate inflationary pressures, especially if positive expectations of the fiscal outturn are not maintained.

4. We have made considerable progress in structural reform since the time of the last review.

• Tax administration—We prepared and approved 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 continued to prepare and issue quarterly reports on progress made in the actual use of the risk
assessment model of the ASYCUDA system to perform inspections in the customs; and on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (both SB; ongoing). We have already made some progress in reallocating part of the Tax Police Staff (which was reduced from 350 to 262 in 2006) to more productive tax administration activities such as audit and enforcement.

- **We made significant advances in debt management since the time of the last review.** We continued the process of lengthening domestic debt maturity, raising average maturity of government securities held outside the BoA from 284 days at end-2006 to 327 days at end May 2007. To better coordinate cash and debt management functions, we developed weekly cash forecasts on the basis of cash needs of line ministries; and the Ministry of Finance and the Bank of Albania are now holding regular meetings twice a month to coordinate debt management and monetary policy. An independent review of staffing requirements was conducted by the World Bank in the debt management unit (DMU) of the Treasury and Public Debt Management General Directorate (TPDMD), including a review of the conditions necessary to recruit people with the appropriate skills (SB; end-June 2007); and we completed a functional review of public debt management. In accordance with our existing program commitments, we continued to: safeguard the use of nonconcessional project loans by conducting independent feasibility studies for all large projects financed in this manner; provide the Fund with a semestrial listing and status report of all projects being considered for nonconcessional foreign financing; and prepare timely semi-annual reports on the stock of external arrears; (all SB; ongoing).

- **We also made progress in improving our public financial management.** A new organic budget law has been prepared and will be submitted to Parliament soon. This proposed legislation aims to establish a comprehensive budget process, covering both regular budget organizations and special (extrabudgetary) funds, at both the central and local government level, and to strengthen the role of the Medium Term Budget Program (MTBP) in the annual budget preparation process. We also significantly strengthened the capacity of the new public investment unit of the Ministry of Finance to select public investment projects, including by approving procedures for public investment management; and began training line ministries on how to use such procedures, which will include the obligation for line ministries to submit a cost-benefit analysis for their investment projects. Our capacity to execute capital spending is improving—we have introduced and are currently carrying out a mid-year budgetary review of investment projects aimed at redirecting investment allocations to sectors that show higher implementation capacity. We also strengthened coordination between the selection of public investment projects and the Medium Term Budget Program (MTBP), and between the MTBP and the annual budget process by using annual expenditure ceilings for line ministries established under the MTBP as basis for annual budget allocations.
In the financial sector we passed amendments to the civil code to improve the legal framework and process for banks to execute collateral; and made further progress towards the goal of establishing a credit registry in the BoA by end-December 2007 (SB). The development of an electronic delivery-versus-payment (DVP) system for government securities is also proceeding and could also be completed by end-year, resources permitting. We also eliminated the two-day lag previously needed to publish the treasury bill auction results on the Ministry of Finance web site.

With respect to financial sector supervision—Implementation of new BoA prudential regulations to safeguard lending became effecting in December 2006. As at the first test date of March 31, 2007, seven banks were directly impacted by the measures governing credit growth and experienced lower capital adequacy indicators. Should such banks maintain similar credit growth rates, they will have to raise capital shortly in order to comply with minimum level of Capital Adequacy ratio, required by BoA. We continued to improve both our on-site and off-site supervisory capacity, and to improve communications with commercial banks, including through arranging continuous meetings with their management structures, sharing information regarding stress-test analysis, and by maintaining an open dialogue for the discussion and full understanding of changing prudential regulation. Cross-border cooperation in supervision has improved significantly. We have finalized memorandums of understanding (MoUs) with the supervisory authorities in Greece, Bulgaria, FYR of Macedonia, Montenegro, Turkey, and Kosovo. We are exchanging information with these authorities and with some have also organized joint on-site examination and ad-hoc meetings. Although we do not have formal MoUs with Financial Market Authorities in Austria and Banca d’Italia, we are nonetheless cooperating with them through exchanges of information on cross-border banking investments and through joint on-site examinations and ad-hoc meetings. In the nonbank area, our supervisory capacity has increased, but from a low base, while developments in market structure have been rapid. We expect a substantial portion of the insurance industry to soon be under the control of reputable foreign companies—two local companies have already been sold, while finalization of the sale of another two is expected soon.

We took steps to improve our business environment. We reformed the business registration process, set up the National Registration Center which—with assistance from the US Millennium Challenge account—will establish a one-stop shop for business registration by the end of September 2007. We are also intensifying work to reduce barriers in the licensing system and have reduced the legal timeline for business registration from 30 to 8 days—and will reduce it further to one day by September 2007. We moved ahead with our Regulatory Reform Task Force. The institutional framework to monitor these reforms has been set up; and we are moving ahead on steps to develop the regulatory management system, improve the existing legal and regulatory frameworks, and introduce systematic monitoring and evaluation of reforms. Our legal
environment has improved. Parliamentary passage in late 2006 of a new procurement law and a new concessions law will both serve to improve the transparency and competitiveness of the bidding process; while we expect the passage in late 2006 of the law on the business advisory council and the law on chambers of commerce and industry to significantly improve the dialogue between government and the business community. To promote SMEs, we secured additional donor funds for the financing of micro credits and small loans; and we established a small fund to promote further SME development—the Competitiveness Fund is capitalized with about US$250,000 and has a mandate to promote the increased competitiveness of SMEs. We also created the AlbInvest agency to assume responsibility for the implementation of government policies with respect to SMEs, exports, and foreign direct investment.

- **We have taken significant steps to further liberalize trade.** On December 1 2006, Albania implemented the Interim Agreement for Free Trade with the EU. Under this agreement, customs duties for a large range of industrial and consumer products have been eliminated on imports from the EU. Duties on remaining products imported from the EU were reduced by 20 percent on December 2006 and by another 20 percent in January 2007. Duties on agricultural products imported from the EU have also been reduced or eliminated in accordance with the Annexes of the Agreement. As a result, the overall weighted effective tariff rate, based on trade flows, is expected to decline to less than 4 percent in 2007 from above 7 percent in 2005. We expect further reduction in the overall weighted effective tariff rate once a total of four signatories to the Central Europe Free Trade Agreement join us in ratification—which will allow the agreement to enter into force—and from the upcoming free trade agreement with Turkey, which we are in the process of finalizing.

- **Our negotiations for the sale of Albtelecom are expected to be finalized within June 2007.** The winner of the original tender is expected to agree to address all the concerns raised in the independent review of the process and the sale is expected to be concluded within this year. The renegotiation is expected to lead to a number of improvements in the contract, including the buyer meeting the strategic investor criterion.

### III. Strategy, Objectives, and Policies

5. **We remain committed to the medium-term strategy outlined in our previous LOI/MEFP of January 11, 2007.** This strategy is designed to maintain macroeconomic and financial sector stability. At the same time, it addresses the institutional and infrastructure deficiencies—and the resulting lack of nonprice competitiveness—that may hinder the continuation of rapid private sector-led growth.

- **Given the flexibility present in our economy, particularly in the labor market, the proper management of expectations is key to macroeconomic stability.** We will therefore continue our existing policy of limiting unexpected fiscal variability, through
strict adherence to our medium-term fiscal framework. We expect in this way to maintain market confidence, imbue development spending with greater stability and predictability, and further consolidate our fiscal and debt positions. With the fiscal stance largely predetermined, monetary policy will remain our main instrument for dealing with short-term threats to price stability. Our reluctance to employ fiscal policy for countercyclical operations is also related to the lack of timely savings and investment data.

• **This policy framework reflects our belief that a small, but increasingly efficient, government is the most effective means of promoting our economic development.** Reform efforts will therefore be concentrated 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.

• **Financial sector stability will be promoted through a continued refinement of our regulatory and supervisory reforms.** So far in 2007, the tightened supervisory and regulatory regime put in place in January appears to have resulted in higher capitalization of banks and heightened provisioning against risk. However, credit growth remains rapid, as the majority of banks, when faced with a choice of raising provisions or slowing lending, managed to secured additional capital. Further regulatory and supervisory tightening is therefore in order. Strengthening nonbank financial sector supervision is also an important goal which we will pursue vigorously over the program period, with support from the World Bank.

• **Over a longer time horizon, our program will strengthen our institutions, infrastructure, and degree of nonprice competitiveness.** It is designed to encourage a broadening of the export base through wide-ranging reforms to improve the business environment, strengthen governance, and improve the financial sector. 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. Consistent with this, we intend to significantly downsize government involvement in non-core areas, primarily by stepping up the pace of privatization, including in the electricity sector. We are also taking decisive action to improve our infrastructure, particularly in the transportation sector.

A. Macroeconomic Framework

6. **The medium-term macroeconomic framework outlined in our LOI/MEFP of January 11, 2007 remains a realistic goal.**
Economic growth is expected to return to its trend rate of 6 percent in 2007 and beyond, 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.

We expect inflation to remain within the BoA’s target range. Credit growth is now projected to be more rapid than envisaged at the time of the second review. However, when combined with an appropriate monetary policy stance, and supported by a flexible exchange rate regime, we expect it to remain consistent with our price objectives. Ongoing fiscal consolidation—in line with our medium-term framework—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 beginning in 2008 in response to ongoing structural reform and rapidly rising income levels. With capital goods imports for public investment rising rapidly in the near term, there will be an increase in the current account deficit this year. However, we expect this to be temporary and the deficit will begin to narrow again from 2008.

In recognition of rising risk levels, we are taking additional measures—outlined below—to increase the already-significant degree of protection built into this framework.

B. Fiscal Policy

7. We remain committed to the 2007 fiscal targets—including program targets—and priorities outlined at the time of the last review.\(^3\) The 2007 budget, as originally formulated, appropriately and safely balanced the need for ongoing fiscal and debt consolidation with development objectives. With revenues projected to rise as a result of already-observed improvements in tax administration, domestic borrowing of 2½ percent of GDP, and a further decline in debt as a percent of GDP, would both be consistent with increased expenditure on education, health care, and roads. At the same time, the budget was appropriately protected through the use of large budgetary contingencies; by prudent estimates of tax revenue and privatization receipts; and by a policy of not expending the gains from tax administration reforms before their realization. With proven revenue gains allocated almost exclusively to investment and capital maintenance expenditures, full execution would imply that investment spending increases, and that the current surplus remains at a relatively high level.

\(^3\) See MEFP ¶7 in IMF Country Report No. 07/75
8. **We also remain committed to keeping external debt at sustainable levels and to keep the program limit on nonconcessional borrowing unchanged at €680 million.** This is fully consistent with maintaining our transportation strategy unchanged. In this latter regard, we are securing €200-€230mn of external financing for the Rreshen-Kalimash road. However, consistent with our long-standing program agreement, we will reduce our recourse to such borrowing by using half the receipts of any large privatization to reduce our domestic debt stock and the remainder for this road project.

9. **The immediate goal of our policies in the fiscal area is to ensure that the fiscal targets embedded in our 2007 budget and medium-term fiscal framework are preserved in the face of previously-unforeseen risk.** The protections and contingencies built into the budget were adequate for the environment prevalent at the time of approval of the 2007 budget. However, they were calibrated to the risks embodied in the large road investments currently underway, and were not sufficient to cover previously unprogrammed fiscal costs that arose from the deterioration of KESH.

10. **Stabilizing the financial position of KESH is key to containing risks to the budget and maintaining macroeconomic stability.** Poor hydrological conditions are expected to reduce domestic power generation by about 30 percent this year compared to 2006, while import prices for electricity have increased sharply. Despite allowing for limited and well-planned load shedding of power to partly offset the shortfall in production, the cost of necessary electricity imports, which will not exceed 1800 GWhs in 2007, is likely to increase by about 1¼ percentage points of GDP. We are taking actions to reverse the recent deterioration in financial performance of KESH. We have already appointed a new CEO and brought in an Italian management consultancy firm. In consultation with the World Bank, the government has finalized the seventh power sector action plan that includes strong measures to improve efficiency, reduce waste and theft, and raise collection rates through better financial management and technical improvements. Such actions are key to recovery—while collections were effected on only 82.7 percent of the electricity billed to the consumer in 2006, theft and technical loss resulted in this being equivalent to less than 50 percent of the value of the total power supplied to the grid. We will ensure that the past arrears of budgetary and non-budgetary institutions to KESH are fully paid this year and that these institutions henceforth pay power bills in a timely manner. We will also implement an incentives package for key employees in sales and collection to achieve performance targets identified in the action plan. With these and other measures, including taking a stricter position with respect to cutting off service to nonpaying customers, we anticipate that the annual loss rate can be reduced to 35 percent in 2007 (compared to 39.4 percent in 2006). We also expect that the overall collection rate can be raised to 86.8 percent (including collection of arrears from business and household consumers). These improvements are expected to increase revenue collection by about 0.6 percent of GDP. Thus, with strong political support and determined efforts, KESH’s financial performance could be improved relatively quickly. However, despite full implementation of the proposed measures, KESH would nonetheless still
require budgetary support of Lek 5 billion (0.5 percent of GDP) including the above mentioned payments for past arrears in 2007.

11. **Our aim is to make the power utility self-reliant and to ensure a stable supply of electricity in Albania.** In this context, we are committed to the privatization of the distribution arm of KESH as soon as possible, and have already selected IFC as an advisor. We are also committed to eliminating the financial gaps of the power utility in 2008 and beyond, including through higher tariffs, if necessary. We are seeking financing from the World Bank for the technical improvements needed to reduce losses and theft. To ensure a stable supply of electricity we are undertaking a number of initiatives. Construction of a thermal power plant, financed jointly by the World Bank, EIB and EBRD, will start soon and is expected to be completed in 2009.

12. **We consider the enactment of additional revenue measures to be necessary in the latter half of 2007.** Although revenue for 2007 is expected to be in line with budget targets—even at current policies—we believe additional tax policy measures are needed to cover a significant portion of the necessary fiscal support to KESH, while preserving the capacity of the budget to absorb future unforeseen risks. We expect to raise revenue relative to our original budget by an additional 0.3 percentage points of GDP—of which about two thirds from increasing excise tax rates on fuel and alcohol, and the remainder by increasing the rate of the environment tax on cars. We plan to introduce a 10 percent single personal income tax rate from July 1, 2007. We will take appropriate action to ensure that low income taxpayers are protected against reduction of their available income. At the same time, we will compensate local governments for losses incurred due to this policy change.

13. **We are confident that the fiscal measures outlined in this memorandum will be sufficient to fully protect our budget.** We intend to enact them in a supplementary budget before the end of July. However, should additional fiscal risks emerge, we stand ready to take appropriate actions needed, in consultation with the Fund, to fully safeguard the budget outcome and medium-term fiscal framework. In particular, performance against the energy sector action plan, aimed at eliminating the need for budget support for KESH in 2008 and setting it on a more sustainable path, will be essential to safeguard the budget.

14. **Our tax strategy for 2008 will include further changes in income taxes, but we will maintain a single-rate VAT system and will refrain from reducing the existing VAT rate.** In the next budget year, we will align the corporate and personal income tax rates. However, we will design—in consultation with the Fund—and implement compensatory measures to ensure that the change in the corporate income tax rate will not reduce total revenues compared to our medium-term budget framework.

15. **Maintaining momentum on revenue administration reform and consolidating gains made to date constitute a cornerstone of our structural agenda.** Also as a consequence of
improved tax administration, tax revenues have increased from 22 percent of GDP in 2005 to almost 23 percent of GDP in 2006. In the year ahead, we will continue to concentrate our efforts to direct revenue administration resources towards activities with the highest revenue potential. For this purpose, we will remove all inactive taxpayers from the register of active taxpayers maintained by the General Directorate of Taxation (PC; December 15, 2007). This will help collection efficiency and will avoid resource misallocation by ensuring that the tax administration only concentrates its efforts on active businesses. We will also seek to improve administration of social security contributions. For this purpose, we will develop a comprehensive cross agency campaign aimed at improving compliance in relation to social security contributions, including the appointment of a high level and sufficiently-mandated person to co-ordinate and lead the efforts (SB; end-December 2007); this strategy will be instrumental in increasing the number of taxpayers paying social contributions (excluding contributions paid by agricultural workers and voluntary contributors) to 440,000 by end July 2008 (SB). We will also continue our efforts to further strengthen the Large Taxpayer Office by making it a full service office for all large taxpayers in Albania (SB; end-October 2007). Conditional on technical assistance from the Millennium Challenge Account, we will implement a pilot project on electronic filing aimed at reducing face-to-face interactions between taxpayers and tax administration officers, thus reducing opportunities for corruption. We will introduce strong measures to ensure that the practice of VAT refunds is in line with the law; and will continue to improve VAT administration by preparing and providing to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (within one month of the end of each quarter) (SB; ongoing); and prepare and issue quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections in the customs (SB; ongoing).

16. **In debt management, we intend to continue to improve capacity as a matter of priority.** Over the remainder of the year, we will expand and restructure the DMU, including by increasing personnel and elevating the unit into a separate General Directorate for Debt Management. We will also begin to revise the debt management strategy annually, starting from September 2007. We will improve further our IT capacity by establishing an integrated management system for external and domestic debt; and will migrate domestic debt into the computerized system. To safeguard existing gains, we will continue to conduct independent feasibility studies for any large project (as defined in the TMU) financed through non-concessional commercial borrowing; provide a semestrial listing and status report on all projects being considered for nonconcessional foreign financing; and prepare semi-annual reports (within one month of the end of each semester) on the stock of external arrears (all SB; ongoing).

17. **To further reduce debt-related vulnerabilities, we are developing new forms of government securities.** Following the issue of our first foreign currency-denominated treasury bills in December 2006, we are investigating ways and means of tapping the large foreign currency-denominated savings of nonresident Albanians. We anticipate that the improved
maturity structure would reduce rollover risk sufficiently to compensate for the possibility of adverse exchange rate movements.

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

18. **Skillful execution of monetary policy combined with strict adherence to fiscal targets have anchored inflationary expectations at low levels.** Over the last year, the BoA has successfully steered headline inflation back to the midpoint of the target range without causing undue real appreciation or preventing growth from recovering to its potential rate. This significant achievement resulted partly from two policy rate increases—in July and November 2006. However, it was also in large part predicated on the BoA’s past policy success which—along with continued adherence to the medium-term fiscal framework—has anchored inflationary expectations at low levels. Combined with the relatively-mild degree of structural—including wage—rigidity in our economy, this now affords us considerable resilience to unexpected shocks.

19. **This resilience notwithstanding, both our vulnerability to price shocks and risks to the inflation outturn are now on the increase.** These stem not only from the difficult financial situation in KESH, but also from a resurgence in credit growth. Our existing monetary framework is experiencing stress as the asset structure of our financial system tilts increasingly towards private credit. This framework—a reserve money program with quantitative targets set in consultation with the Fund and with changes to the repurchase rate as the main policy instrument—has served us well and will be retained along with the flexible exchange rate. However, we recognize that the underlying transmission mechanism operates primarily by controlling the pass through effect on the lek price of traded goods. Changes in the policy rate appear less effective in mitigating the demand effects of rapid credit creation, and as a result we are increasingly vulnerable to demand shocks emanating from this source.

20. **We will consequently remain vigilant and react quickly to any deterioration in inflationary expectations or excessive increase in the rate of credit growth.** Given the level of risk, and for reasons of caution, we have adopted an upward bias with respect to decisions on moving the policy rate. In these circumstances, we believe full transparency to be the best guarantor of inflationary expectations, and so have clearly communicated to the public our readiness to quickly raise the rate in the event price stability is threatened. Consequently, if risks materialize, additional policy action may be required.

21. **Given limitations in the monetary framework, demand shocks due to credit growth may also require measures aimed at reducing the supply of credit.** The strengthening of banking supervision regulations in January of this year have added to the safety of the loan portfolio and prudential indicators remain highly positive. However, they do not appear to have had the hoped-for dampening effect on credit growth—which remains high. If this growth trend does not soon show signs of reversing itself, and we judge that price and financial sector stability objectives are being compromised, we again stand ready to supplement policy rate increases with additional supply-restricting measures. These could include the imposition of higher
provisioning requirements for foreign currency lending to customers that cannot cover their FC exposure with foreign currency income; and higher reserve requirements for foreign currency deposits. While we would prefer the new measures to be limited to additional strengthening of the prudential and regulatory frameworks, we cannot exclude at this point—as a last resort—the imposition of more direct administrative measures. Regardless of the measures chosen, 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.

22. **We will continue to develop and refine our capacity to oversee the banking system.** The banking system remains solvent, liquid, and profitable, due in large part to the oversight exercised by our banking supervision department, which now operates at a high level of proficiency. We will maintain such capacity by providing regular training opportunities to our staff, continuously assessing the needs for hiring additional qualified staff, and adjusting the department structure should it be necessary.

23. **We will continue to pursue an ambitious structural reform agenda aimed at refining and improving financial sector infrastructure.** We will complete the establishment of a credit bureau within the BoA as planned (SB; end 2007); and a delivery versus payment system (DVP) for government securities shortly thereafter. We expect the DVP system will raise volumes in the secondary market for government debt and foster the development of the interbank market—both of which will improve the efficiency of monetary policy and of the overall intermediation process. 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 have been taken to ensure non-bank participants have access to the government debt market on an equitable basis. In a near-term measure to foster additional competition and efficiency in this market, we will allow nonbank foreign and domestic institutional investors full access to primary auctions—on a competitive basis—for all types of government securities beginning on September 30, 2007 (SB).

24. **We will protect the existing high level of institutional quality in the financial sector.** To preserve the benefits of a completely privately-owned banking system, we will refrain from creating any public financial institution or from taking an equity stake or from issuing any explicit or implicit government guarantee to any financial institution. We will take no legislative or regulatory action that weakens the independence of the BoA, including the Supervisory Board of the BoA’s control over the Bank’s budget and its authority to decide on compensation levels. We are also considering how best to develop and set in place the legal and institutional structures necessary to guarantee the BoA an adequate and prudentially- and operationally-sound level of capital on a sustainable basis; and also how to deal with the other important issues raised by IMF technical assistance. We expect these solutions to build on IMF technical advise and to be completed by end-September 2007.

25. **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 Financial Supervisory Authority (FSA) provides a sound framework for moving forward, significant work will be needed to effect needed institutional changes and to raise the quality of supervision to acceptable standards. At a basic level, the institutional and legal framework underpinning the FSA does not yet provide the agency with sufficient independence of activity or administrative autonomy—including with respect to salary and staffing levels—needed for it to fully carry out its mandate. In conjunction with the World Bank, we intend to correct this situation as a matter of priority and have already begun upgrading our 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 international 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. With respect to leasing companies, those incorporated as subsidiaries of resident commercial banks are currently supervised by BoA. For efficiency reasons, we intend to transfer supervisory authority over the remaining leasing companies—as well as over factoring activity—to the BoA, and will submit the necessary legislative to Parliament by end-October 2007 (SB).

D. Other Structural Reforms

26. **In addition to Albtelecom, we are expecting good progress in privatization of other strategic public enterprises in the remainder of 2007.** The significant interest shown by foreign insurance companies in the Albanian insurance sector makes us fairly certain we will be able to sell INSIG this year or next. In the oil sector, we are in the process of selecting a privatization advisor for ARMO and will prepare a privatization plan once this is done. In line with the decision of the Council of Ministers, ARMO’s refinery unit will be separated from 36 retail trading posts, and the sale of these retail posts will conform with SME privatization procedures. We will also intensify our efforts to divest the assets of the new company Albpetrol-One, which we recently formed by merging Albpetrol and Servcom. We also intend to offload our remaining minority stake in the mobile telephone company AMC in a timely manner.

27. **We are also taking significant actions to improve our business and investment climate in areas outside the IMF-supported program.** We will continue our efforts under the Regulatory Reform Task Force to ease market entry barriers, to make the regulatory environment, more transparent, predictable, and simple; and to ensure a level playing field for local and foreign business. To support the development of SMEs, we will continue to encourage donor support for micro credits, finalize a SME Medium-Term Strategic Program for 2007–09, and carry out the actions necessary to make our new Competitiveness Fund, Export Guarantee Fund, and AlbInvest Agency fully operational and effective.
E. External Arrears

28. **We are continuing to make good faith efforts to conclude the rescheduling of our arrears on inoperative payment agreements.** We have now cleared all official arrears with Poland and Bulgaria; reconciled the amounts owed to Russia, Serbia and Montenegro and Greece and begun negotiating on terms; and are reconciling remaining arrears with Algeria, Cuba, and Vietnam to conclude the clearance process with official creditors. We have cleared arrears with private creditors in Germany, Italy, Kosovo and Turkey and continue to expect that we will eliminate all remaining external arrears with private and official creditors by end-2007. Once all arrears are cleared, we intend to begin discussions with the Fund with a view to accepting Article VIII.

F. Data Issues

29. **We are undertaking a number of surveys to improve the basis for national accounts and other important data.** The household budget survey—covering about 5,600 households at the national level—is currently underway and we expect the field work to be completed by September 2007. The fieldwork for a labor force survey was carried out in May and June, and preliminary results are expected by December 2007. To strengthen short-term economic indicators, we are improving the coverage, timing and quality of our STS business survey.

G. Program Monitoring

30. The fifth disbursement under the PRGF/EFF-supported program will be based on the end-September 2007 quantitative performance criteria (Table 1 and the TMU); the mid-December 2007 structural performance criteria (Table 2 and the TMU); and completion of the fourth review and financing assurances review. The fourth review under the PRGF and EFF arrangements is expected to be completed no later than February 1, 2008. 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.
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<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Est. Prog. (Adj.)</td>
<td>Actual Prog. (Adj.)</td>
<td>Prog.</td>
<td>Prog.</td>
<td>Prog.</td>
</tr>
<tr>
<td>Ceiling on net domestic credit to the government 2/</td>
<td>13 24 26</td>
<td>2 8 8</td>
<td>16</td>
<td>22.0</td>
<td>25.1</td>
</tr>
<tr>
<td>Ceiling on accumulation of net domestic assets of the BOA 3/</td>
<td>-4 10 11 -6 12 12</td>
<td>12</td>
<td>16</td>
<td>16.6</td>
<td>23.5</td>
</tr>
<tr>
<td>Indicative total tax revenue target 4/</td>
<td>197 188 188</td>
<td>48 45 45</td>
<td>97</td>
<td>155.0</td>
<td>221.0</td>
</tr>
<tr>
<td>Floor on accumulation of net international reserves of the BOA 3/</td>
<td>223 96 84 200 71 71 91</td>
<td>-24.9</td>
<td>28.6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(In millions of lek)

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<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Actual Prog. (Adj.)</td>
<td>Prog.</td>
<td>Prog.</td>
<td>Prog.</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>45 70 70 68 180 180</td>
<td>380</td>
<td>380.0</td>
<td>380.0</td>
<td></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 0 0 0 0 0</td>
<td>0.0</td>
<td>0.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceiling on accumulation of new external payments arrears, excluding interest on pre-existing arrears 5/</td>
<td>0 0 0 0 0 0</td>
<td>0.0</td>
<td>0.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(In millions of Euros)

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

<table>
<thead>
<tr>
<th>I. Performance Criteria</th>
<th>Proposed Test Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Remove all inactive taxpayers from the register of active taxpayers maintained by the General Directorate of Taxation</td>
<td>Mid-December, 2007</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>II. Structural Benchmarks</th>
<th></th>
</tr>
</thead>
<tbody>
<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 the TMU)</td>
<td>Ongoing</td>
</tr>
<tr>
<td>financed through non-concessional commercial borrowing;</td>
<td></td>
</tr>
<tr>
<td>(ii) Provide a semestrial listing and status report on all projects being considered for nonconcessional foreign financing.</td>
<td>Ongoing</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 reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (within one month of the end of each quarter).</td>
<td>Ongoing</td>
</tr>
<tr>
<td>4. Prepare and issue quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections in the customs.</td>
<td>Ongoing</td>
</tr>
<tr>
<td>5. Make the Large Taxpayer Office (LTO) a full service office for all large taxpayers in Albania.</td>
<td>End-October 2007</td>
</tr>
<tr>
<td>6. Develop a comprehensive cross agency campaign aimed at improving compliance in relation to social security contributions, including appointing a sufficiently-mandated person to coordinate the efforts.</td>
<td>End-December 2007</td>
</tr>
<tr>
<td>7. Increase the number of taxpayers paying social security contributions (excluding agricultural workers and voluntary contributors) to 440 thousands.</td>
<td>End-July 2008</td>
</tr>
<tr>
<td>C. Strengthen the financial system and improve economic monitoring capability</td>
<td></td>
</tr>
<tr>
<td>8. Prepare semi-annual reports (within one month of the end of each semester) on the stock of external arrears.</td>
<td>Ongoing</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Allow nonbank foreign and domestic institutional investors full access to primary auctions — on a competitive basis—for all government securities.</td>
<td>End-September 2007</td>
</tr>
<tr>
<td>10. Submit the necessary legislation to Parliament for transferring supervisory authority over the remaining leasing companies to the Bank of Albania.</td>
<td>End-October 2007</td>
</tr>
<tr>
<td>11. Complete the establishment of 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 second review under the program (IMF Country Report No. 07/75).
This memorandum defines the quantitative performance criteria, benchmarks and indicative targets established in the Memorandum of Economic and Financial Policies (MEFP) up until end-December 2007; and associated reporting requirements.

A. Net Domestic Credit to the Government

1. For the purposes of the program, the government includes the State Budget, the Social Security Institute (SSI), the Health Insurance Institute (HII), and the accounts of all entities (including special purpose vehicles) that are used to operate or manage public-private partnership (PPP) projects.

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.

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

5 This was equivalent to Lek 12.164 billion at end-December 2006.
(ii) Gross domestic credit in lek and in foreign currency extended to the government excludes (a) the onlending of foreign project loans to all parts of government; and (b) advances on profit transfers by the BoA. The value of the stock of gross domestic credit to government will also exclude the claims held 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 141.5/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 421.7 per ounce).

6 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.

7 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 421.7 per ounce); and (d) then converted to Lek at the program Lek/SDR exchange rate of Lek 141.5/SDR.
(ii) Government financial assets held at the Bank of Albania exclude: (a) foreign currency deposits related to foreign financed projects; and (b) deposits serving as the counterpart for non-standard gold and other precious metals owned by the government.

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

(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 141.5/SDR.

6. Under these definitions, the stock of net domestic credit to the government was Lek 329.5 billion at end-December 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 2006. Under this definition, the level of NDA was Lek 77.1 billion as of end-December 2006. The NDA limits will be cumulative changes from end-December 2006 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 2006, 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 2006 levels and holdings of monetary gold will be valued at SDR 421.7 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$1,493.9 million at end-December 2006.

**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>Date</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-September 2007</td>
<td>Lek 750 mn.</td>
<td>(Of which US$0 mn. in foreign currency);</td>
</tr>
<tr>
<td>End-December 2007</td>
<td>Lek 1,000 mn.</td>
<td>(Of which US$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

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8 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.
half the amount of any excess (shortfall) in the receipt of total privatization proceeds from these assumed values⁹.

12. The ceiling on NCG:

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

- will be adjusted downward by the amount of fiscal expenditure that was authorized by the 2007 budget, but legally expended in the first 14 days of 2008 and legally credited to the 2007 fiscal year.

- will be adjusted upward by the amount of fiscal expenditure that was authorized by the 2006 budget, but legally expended in the first 14 days of 2007 and legally credited to the 2006 fiscal year.

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>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-September 2007</td>
<td>US$10 mn.</td>
</tr>
<tr>
<td>End-December 2007</td>
<td>US$10 mn.</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

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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.
Association of the World Bank Group, and macro-financial assistance from the EU) exceeds these projections.\(^{10}\)

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 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

\(^{10}\) 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.
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 December 31, 2006 and that have not been paid at the time they are due, taking into account the grace periods specified in the contractual agreements. Excluded from the prohibition on the accumulation of new arrears are: (i) arrears arising from interest on the stock of arrears outstanding as of December 31, 2006; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

19. Large projects (as referred to in MEFP paragraphs 4 and 16 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.

20. For the purpose of verifying the observance of the performance criteria "Remove all inactive taxpayers from the register of active taxpayers maintained by the General Directorate of Taxation." (MEFP Table 2), a taxpayer shall be considered inactive when business operations have ceased, except for the following situations:

- When there are outstanding tax liabilities (including penalties) that are considered collectible by the GDT;
- When there are outstanding returns (in situations where it is expected by the GDT that the submission of the returns will produce additional revenue claims);
• When there are unsettled objections or appeals in respect of tax assessments;
• When the GDT has reasonable evidence that the taxpayer is planning to resume business activities in the near future (e.g. within one year).

F. Tax Revenues

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

G. Monitoring and Reporting Requirements

22. 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>
<thead>
<tr>
<th>2. Other central government debt held outside central government (millions of lek)</th>
<th>87,897</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.0</td>
<td>Held by Bank of Albania 3/</td>
</tr>
<tr>
<td>2.0(i)</td>
<td>Other securities 3/</td>
</tr>
<tr>
<td>2.0(ii)</td>
<td>Deposits in lek for projects</td>
</tr>
<tr>
<td>2.0(iii)</td>
<td>In foreign currency at program exchange rates and program price of gold 7/ 8/</td>
</tr>
<tr>
<td>2.0(iii)(i)</td>
<td>In foreign currency evaluated at current exchange rates</td>
</tr>
<tr>
<td>2.0(iii)(ii)</td>
<td>Transferable deposits in foreign currency evaluated at program exchange rate 7/ 8/</td>
</tr>
<tr>
<td>2.0(iii)(iii)</td>
<td>Transferable deposits in foreign currency evaluated at current exchange rate 5/ 6/</td>
</tr>
<tr>
<td>2.0(iii)(iv)</td>
<td>Standard gold deposits of government evaluated at program exchange rate and gold price (Lek mns.) 8/</td>
</tr>
<tr>
<td>2.0(iii)(v)</td>
<td>Number of ounces of gold equivalent</td>
</tr>
<tr>
<td>Plus:</td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Assets of central government (excluding HHI and SSI)</td>
</tr>
<tr>
<td>3.0(i)</td>
<td>Deposits held at Bank of Albania 6/</td>
</tr>
<tr>
<td>3.0(ii)</td>
<td>In domestic currency</td>
</tr>
<tr>
<td>3.0(iii)</td>
<td>Other deposits in domestic currency</td>
</tr>
<tr>
<td>3.0(iv)</td>
<td>In foreign currency evaluated at program exchange rates and program price of gold 7/ 8/</td>
</tr>
<tr>
<td>3.0(iv)(i)</td>
<td>In foreign currency evaluated at current exchange rates</td>
</tr>
<tr>
<td>3.0(iv)(ii)</td>
<td>Transferable deposits in foreign currency evaluated at program exchange rate 7/ 8/</td>
</tr>
<tr>
<td>3.0(iv)(iii)</td>
<td>Transferable deposits in foreign currency evaluated at current exchange rate 5/ 6/</td>
</tr>
<tr>
<td>3.0(iv)(iv)</td>
<td>Standard gold deposits of government at current exchange rate and gold price (Lek mns.) 8/</td>
</tr>
<tr>
<td>3.0(iv)(v)</td>
<td>Number of ounces of gold equivalent</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Deposits of HHI and SSI</td>
</tr>
<tr>
<td>4.0(i)</td>
<td>Short-term direct loans to government 3/</td>
</tr>
<tr>
<td>4.0(ii)</td>
<td>Other securities 4/</td>
</tr>
<tr>
<td>4.0(iii)</td>
<td>Deposits in domestic currency</td>
</tr>
<tr>
<td>4.0(iv)</td>
<td>In foreign currency at program exchange rates and program price of gold 7/ 8/</td>
</tr>
<tr>
<td>4.0(i)(i)</td>
<td>Transferable deposits in foreign currency evaluated at program exchange rate 7/ 8/</td>
</tr>
<tr>
<td>4.0(i)(ii)</td>
<td>Transferable deposits in foreign currency evaluated at current exchange rate 5/ 6/</td>
</tr>
<tr>
<td>4.0(i)(iii)</td>
<td>Standard gold deposits of government evaluated at program exchange rate and gold price (Lek mns.) 8/</td>
</tr>
<tr>
<td>4.0(i)(iv)</td>
<td>Number of ounces of gold equivalent</td>
</tr>
<tr>
<td>Equals gross domestic credit to government:</td>
<td>349,886</td>
</tr>
<tr>
<td>5.</td>
<td>Stock of Net domestic credit to central government (1+2-3-4)</td>
</tr>
<tr>
<td>5.0</td>
<td>Change since December 2006</td>
</tr>
<tr>
<td>6.</td>
<td>Memorandum items:</td>
</tr>
<tr>
<td>6.0(i)</td>
<td>Current exchange rate (Lek/SDR, eop)</td>
</tr>
<tr>
<td>6.0(ii)</td>
<td>Current exchange rate (Lek/US dollar, eop)</td>
</tr>
<tr>
<td>6.0(iii)</td>
<td>Program exchange rate (Lek/SDR, eop)</td>
</tr>
<tr>
<td>6.0(iv)</td>
<td>Program price of gold (SDR per ounce)</td>
</tr>
<tr>
<td>6.0(v)</td>
<td>Market price of gold (SDR per ounce)</td>
</tr>
<tr>
<td>6.0(vi)</td>
<td>Current exchange rate (Lek/US dollar, eop)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>1.</th>
<th>Treasury bills held outside central government</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0(i)</td>
<td>Held by Bank of Albania 1/</td>
</tr>
<tr>
<td>1.0(ii)</td>
<td>Held by deposit money banks 1/</td>
</tr>
<tr>
<td>1.0(iii)</td>
<td>Held by savings and loan institutions 2/</td>
</tr>
<tr>
<td>1.0(iv)</td>
<td>Held by other domestic lenders (excluding holdings of HHI and SSI) 2/</td>
</tr>
</tbody>
</table>

### Notes:

1/ Valued at face value.
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/ Excludes all non-standard gold deposits; and excludes all nongold precious metal deposits of government; and excludes government deposits in foreign currency for projects.
5/ Excludes all non-standard gold deposits; and excludes all nongold precious metal deposits of government; and excludes government deposits in foreign currency for projects.
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