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

March 14, 2008

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, March 14, 2008

Mr. Dominique Strauss-Kahn  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The current Fund-supported program, approved in January 2006, remains broadly on track, despite some delay in implementing needed increases in electricity tariffs. All quantitative and structural performance criteria have been observed and economic prospects remain favorable, both from the near- and medium-term perspectives. Growth continues to be buoyant, underlying inflation is low, and confidence in the currency and the banking system remains strong. Debt is on a declining and sustainable path. In addition, past and ongoing structural adjustment is now supplying tangible benefits to the economy. We are, consequently, well placed to fully implement the ambitious reform agenda described in the attached Memorandum of Economic and Financial Policies (MEFP).

On this basis, we request completion of the financing assurances review, and completion of both the fourth review under the three-year Poverty Reduction and Growth Facility arrangement and the fourth review under the three-year Extended Fund Facility arrangement. We also request the fifth disbursement and purchase under these arrangements in an aggregate 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/ 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 provides a detailed description of our policy intentions over the final year of the 2006–2009 program period. It is fully consistent with our new National Strategy for Development and Integration (NSDI) for 2007–2013, which was completed in December 2007.

II. ECONOMIC DEVELOPMENTS

2. Macroeconomic events since the last review have been dominated by a regional drought which impacted on the electric utility (KESH) and agricultural production. The resulting supply shocks have created challenges for macroeconomic management and structural policies.

- Domestic hydro-electricity production and small-scale rain-fed farming have been adversely affected. The financial position of KESH deteriorated considerably more than had been anticipated at the time of the third review. Although electricity losses were reduced in line with the World Bank-supported Seventh Power Sector Action Plan, the collection target (excluding collection of arrears from budgetary and nonbudgetary institutions) was not achieved. Effective collections as a share of total power supplied to the grid increased to 52.5 percent, but still remained low by regional standards. Meanwhile, the drought-induced decline in energy production decreased the supply of electricity available to the economy in 2007, while its partial replacement with expensive imports hurt the utility’s cash flow and financial results. Dry conditions also affected agricultural output, which led to pressure on retail food prices, import volumes, and import costs.

- Cost pressures built up. Higher food prices and increased power interruptions fed into 2007 inflation. From August-October, these supply shocks drove headline inflation slightly above the Bank of Albania’s (BoA) 3±1 percent target band. The BoA policy rate was raised by ¼ percent in each of September and November, and this helped to stave off second round effects and to keep inflationary expectations anchored at low levels. Inflation ended the year around the midpoint of the target range.

3. Growth became broader based thus offsetting the drought’s effect. The strong performance of exports and the tourism sector, as well as continued productivity gains in manufacturing, compensated for the slowdown in agriculture and the decline in electricity production, resulting in growth of about 6 percent in 2007. Export growth reflected both the very rapid expansion of new export products such as chromium and oil, and solid performance of traditional exports. Structural reforms have raised productivity in the tradable sector and have strengthened our export capacity. Still, the current account deteriorated to
9½ percent of GDP as a result of higher import spending on electricity, food, and the machinery and equipment needed for the construction of the large road projects.

4. **Despite the drought, the 2007 budget was executed broadly as planned.** Revenue collection was slightly lower compared with the program but still 0.6 percent of GDP higher than in 2006. Improvements in tax administration and tax measures implemented in 2007 helped offset a reduction in custom duties. Personal income tax, VAT and excise tax collection have been particularly strong. However, profit tax and property and local tax collection underperformed, partly reflecting administration problems related to local elections. Additional electricity imports and a delayed tariff adjustment drained KESH’s financial position and required budgetary transfers of Lek 8 billion, of which Lek 3 billion was in the form of a loan to be repaid in 2008. Lower-than-budgeted spending on interest and wages allowed us to keep total current spending in line with the lower revenue, below the program. At the same time the capital budget could not be fully executed reflecting problems with project implementation. We have transferred Lek 0.7 billion to the expropriation fund, to maintain its balance at 0.3 percent of GDP, the same as at the end of 2006. The budget recorded an overall deficit of 3.8 percent of GDP compared with the 3.9 percent envisaged under the program. At the same time, higher-than-projected privatization proceeds reduced net domestic borrowing from 2.3 percent of GDP to 1.7 percent.

5. **Financial conditions have been supportive.** Albania has so far escaped any fallout from unsettled global financial market conditions. The current rate of increase in credit broadly balances the needed to support growth with the need to mitigate risks to financial stability. The latter is also helped by our already strong and growing capacity in banking supervision and the predominant use of credit for investment rather than consumption.

6. **We have also made considerable progress in structural reform since the time of the last review.**

- **Tax administration:** In October, the Large Taxpayer Office (LTO) was transformed into a full service office (SB; end-October 2007) and all large taxpayers now have the possibility of electronic filing and payment. We removed all inactive taxpayers from the tax registry (PC; mid-December 2007). We developed a comprehensive cross-agency campaign aimed at improving compliance in relation to social security contributions (SB; end-December 2007) and a joint working group has been set up with representatives from the Ministry of Finance, General Tax Directorate and Social Insurance Institute. By end-September 2007, all approved VAT refund requests submitted during the first half of the year had been paid and the average delays between submission and payment had been reduced. We provided to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (SB; ongoing). Concerning customs, we provided the Fund with quarterly reports on progress made in the use of the risk assessment module of the ASYCUDA system to perform inspections (SB; ongoing). We are expanding and
upgrading our customs houses and are monitoring the movements of goods between borders and in-land custom houses. Lastly, following the extensive consultations with stakeholders and external experts, we have submitted to parliament a new law on tax procedures which is in line with best international practice.

- **Public expenditure management**: Following extensive consultations with a number of stakeholders, we have submitted the new organic budget law to Parliament. The law provides for the establishment of a more comprehensive budget process, covering both regular budget organizations and special (extrabudgetary) funds at both the central and local government levels. It will strengthen the role of the Medium-Term Budget Program in the annual budget preparation process. The new procurement law allows public institutions to procure for up to seven years, rather than one year, in exceptional cases determined by the characteristics, complexity, and financing of the project or contract. We introduced within–year budgetary reviews of investment projects and developed a register of public investment projects facilitating the redirection of investment allocations to sectors with higher implementation capacity. Finally, as part of the preparation of the 2008 Budget, we have introduced new Public Investment Management Procedures that should help consolidate the public investment portfolio and give priority to larger investments with higher impact.

- **Debt management**: The Debt Management Unit has been upgraded to a General Directorate, with separate front and back offices, and in the next few months we expect to staff the new positions. We continue to extend the maturity of our domestic public debt: the average maturity has increased from 250 days in November 2006 to 409 days in December 2007, significantly reducing rollover risk. In December 2007, for the first time, we successfully issued a 7-year bond. We are also improving IT capacity in debt management by establishing an integrated management system that is already operational for external debt. To safeguard existing gains, we continue to conduct independent feasibility studies for any large project (as defined in the attached Technical Memorandum of Understanding—TMU) financed through nonconcessional commercial borrowing; provide a semi-annual listing and status report on all projects being considered for nonconcessional foreign financing; and prepare semi-annual reports on the stock of external arrears (all SBs; ongoing).

- **Financial markets**: We completed the establishment of a credit bureau within BoA (SB; end-December). In the securities market, foreign and domestic nonbank institutions were given full access to government securities auctions on a competitive basis (SB; end-September); and four domestic banks have been licensed by the Financial Supervisory Authority (FSA) to act as registrars for treasury bonds, allowing them to facilitating purchases and sales for their clients on the primary and secondary markets. FSA’s new online publicly-monitorable system will track sales of securities and aid in expanding volumes on the secondary market. In the insurance sector, the recent entry of three reputable foreign companies, and the subsequent
scope for management improvement, reflect our ongoing efforts to improve regulatory oversight and sector financial health. We improved our supervisory oversight, enforced international standards for capitalization, and set up a new IT system at FSA for reporting sales of automobile third party liability insurance and for administering claims. We also improved the coverage and quality of reinsurance contracts of companies operating in the sector.

- **Financial sector supervision:** We created a new Financial Stability Department (FSD) within the BoA to more pro-actively monitor the entire financial system without detracting from the Banking Supervision Department’s (BSD) concentration on individual bank-specific issues. Our capacity to supervise individual banks and raise the safety of commercial banks’ loan portfolios have also improved. The new regulations introduced in December 2006 in response to the rapid credit growth have been effective in both limiting lending and enforcing capital increases to improve loan safety. Our capacity and expertise in stress testing and off-site bank supervision is also improving, from a relatively high base, and we now conduct a full inspection of every bank at least once a year, while supplementing these with partial, more focused risk-based periodic inspections as needed. We intended to transfer supervisory authority over all leasing companies to the BoA by end-October 2007, the timetable agreed under the program (SB; end-October 2007), but did not achieve this due to problems with multi-agency coordination. However, we will submit the necessary legislation to Parliament by end-April, 2008.

- **Business environment:** The National Registration Center (NRC)—a one stop-shop for business registration—was set up and the legal timeline for business registration has been reduced from 8 days to only 1 day. The cost to register a business has been reduced to 100 lek and other administrative requirements have been streamlined, as necessary. The NRC has been in great demand and we are working to strengthen our capacities both within the NRC and in the regions—we opened windows for business registration in the biggest municipalities in 2007, and will open more in 2008.

- **Statistics:** The field work for the household budget survey—covering about 5,600 households at the national level—was concluded in October 2007. This survey provides for a wider coverage than the previous survey of 2000. We obtained preliminary results for the labor force survey following the completion of fieldwork in June 2007. To strengthen short-term economic indicators, we are improving the coverage, timing and quality of our STS business survey. In December 2007, we revised the products and product weights for the CPI basket based on the 2007 household budget survey, to properly incorporate developments in our economy and consumption patterns.

- **Trade:** In line with the Interim Agreement for Free Trade with the EU we further reduced duties on a range of products, including agricultural products, in January
2008, lowering the overall weighted tariff by over half a percent in 2008. The Central Europe Free Trade Agreement (CEFTA) came into force in July 2007 for 5 CEFTA parties, with full implementation from November 2007. The free trade agreement with Turkey was ratified by the Albanian parliament and is currently being finalized.

- **Privatization**: Albtelecom was privatized for €120 million.

7. **The adoption of the new National Strategy for Development and Integration (NSDI) 2007–2013 was a key milestone.** The new strategy sets our goals of integration into the European and NATO structures, the democratization of society, the consolidation of the rule of law, and for further economic and social development. It is the product of a wide-ranging and in-depth consultation with parliament, civil society, development partners and other interested stakeholders. The NSDI—and the thirty six detailed sector and cross-cutting strategies that underlie it—will from now on form the basis of our medium-term budget planning.

### III. STRATEGY, OBJECTIVES, AND POLICIES

8. **Our medium-term economic strategy aims to deliver continued strong, private sector-led growth.** Macroeconomic and financial sector stability are the essential prerequisites but we also address the institutional and infrastructure deficiencies that could otherwise impede rapid productivity growth. A combination of well-anchored fiscal policy, strong central bank credibility, and low structural—including wage—rigidity in our economy continues to afford us considerable resilience to unexpected shocks.

- **The inherent flexibility of our economy, including on wages, allows us to benefit from ongoing structural changes with a minimum of short-term disruptions.** This flexibility has increased the efficiency of macroeconomic policy transmission. But at the same time, it imposes strict discipline, since such efficiency crucially depends on the maintenance of low inflation expectations—which are themselves closely linked with perceptions of fiscal stability and BoA’s credibility.

- **Continued adherence to our medium-term fiscal framework based on a small, but increasingly efficient model of government remains a cornerstone of our strategy.** This has been effective in maintaining market confidence, imbuing development spending with greater predictability, and consolidating our public finances. Reform efforts will concentrate on reducing vulnerabilities; improving efficiency of core activities; and, wherever possible, offloading noncore functions to the private sector. This will substantially improve the attractiveness of Albania as a destination for foreign investment.

- **Monetary policy will remain our main policy response to short-term threats to price stability.** Strong communication and pro-active interest rate setting have helped us anchor inflation expectations. Still, our present situation—where a fiscal surplus
through most of 2007 has helped offset otherwise strong domestic demand, enabling the BoA to focus on avoiding spill-over effects of cost-push inflationary pressure—has highlighted the potential role for fiscal policy in demand management and countercyclical operations. Greater prioritization of expenditure, a move to a medium-term capital budget, and the availability of short-term demand indicators, including on wages, might provide some scope for assigning fiscal policy a more active demand management role without damaging the fact and perception of fiscal stability. In the year ahead, we intend to explore the scope for fiscal rules that would allow some more room for automatic stabilizers on the revenue side.

- **Financial sector stability will be promoted through further regulatory and supervisory reforms.** Difficulties for creditors in executing collateral remains a concern. And there is a need to further improve international cooperation with the home country supervisors of our major banks. Moreover, despite its moderation in line with projections, credit growth is still high and remains a potential source of risk for macroeconomic and financial sector stability. We will also continue to strengthen nonbank financial sector supervision with support from the World Bank.

- **Restoring the power utility’s finances and privatizing its distribution arm are critical to ensure a stable supply of electricity over the medium term.** We are adopting measures to quickly stabilize KESH’s financial position, which is also important for maintaining fiscal stability. We are progressing with the privatization of the distribution arm of KESH by end-2008 and are undertaking a number of initiatives to increase domestic production and capacity to import electricity.

- **Greatly improving the public transportation infrastructure is another key goal.** With the benefit of foreign finance, we have made significant progress on building the new road corridor between Durres and the Kukes region, and we expect a key part of this corridor—the Rreshen-Kalimash road—to be completed in mid-2009.

A. Macroeconomic Framework

9. **Our underlying medium-term macroeconomic framework remains appropriate, despite the effects of recent supply shocks.**

- With the return of normal rainfall, growth is projected at 6 percent in 2008 and beyond, as recovery in construction and agriculture sectors offset the return of manufacturing growth to normal levels. We expect the current account deficit to improve over the medium term as export growth remains strong, remittances buoyant, and electricity imports decline to more moderate levels.

- Underlying inflation is expected to remain in the BoA’s target range, although electricity tariff increases may push headline inflation temporarily higher. Further
slowing of credit growth should help contain demand pressures, and we expect second round effects to be successfully contained with an appropriate monetary policy stance.

10. **Risks to this framework lie in a possible further deterioration in the energy situation, rekindled credit growth, and adverse global or regional developments.** We have protected the 2008 budget with augmented contingencies, but the risks to growth and macroeconomic stability from continued energy disruptions are less easily mitigated. The potential effect on growth would begin with the direct impact of lower domestic energy production. But the ongoing diversion of budget funds from productive uses to electricity imports, and the effect of energy shortages on our investment climate could also damage our growth potential over the longer term while in the short term negatively impacting growth and likely raising inflation expectations. A renewed acceleration of credit growth would add pressure from the demand side. We will mainly rely on the in-built flexibility of our economy, including the exchange rate, to address slowing market growth abroad or geopolitical or regional risks.

### B. Fiscal Policy

11. **After the acceleration of the road program, we will cap our overall fiscal deficit at no more than 4 percent of GDP.** With this cap serving as an effective fiscal anchor, the increase of our debt burden in 2008 due to the accelerated implementation of the road project will be temporary, and we would expect to regain a downward trajectory beginning in 2009. In this manner, we will finish this nationally-important project quickly, while retaining credible commitment to our fiscal strategy of keeping government small, increasing the share of priority spending, and further reducing public debt. Over the medium term, we expect our debt burden to fall below 50 percent of GDP and, given conservative revenue assumptions, for expenditure to remain in the 30 percent of GDP range. However, in line with longstanding program agreements, receipts from large-scale privatization and currently-unbudgeted gains from tax administration could create one-off departures from these key parameters; in particular, half the revenue of any unbudgeted privatization will be used to reduce domestic debt while half would be expended on well-conceived investment projects.

12. **Containment of fiscal risk is a central component of our strategy.** The principle risks remain the deterioration in the financial position of KESH, the still uncertain cost of the Durres-Kukes road project, and remaining uncertainties relating to revenue collection. We will mitigate these by ensuring that by the time of the next mid-year expenditure review, sufficient allocative flexibility remains so that we can, if necessary, reallocate at least 1½ percent of GDP of expenditure. These reallocations will be made only in consultation with the Fund and in accordance with clear guidelines aimed at minimizing discretion and maximizing transparency. Combined with successful implementation of our reform agenda for KESH, described below, we believe these measures will be sufficient to fully protect the
2008 budget outcome. However, should additional risks emerge, we stand ready, in consultation with the Fund, to take appropriate actions.

13. **The 2008 budget will allow for an acceleration of capital spending, thereby implying a temporary increase in the overall deficit by 1.4 percentage point of GDP to 5.2 percent, financed by faster mobilization of foreign financing.**

- **Tax policy changes will contribute to an increase in tax revenue** to about 24½ percent of GDP in 2008, in spite of the cut in the corporate income tax (CIT) rate from 20 to 10 percent, at an annual cost estimated at 1 percent of GDP. The cost of this cut will be recovered from the full-year impact of the excise and environmental tax measures introduced in mid-2007, the elimination of VAT exemptions for profit generating businesses that were previously considered not-for-profit (such as private schools and medical centers), and from the introduction of reference wages for social security and measures to increase the social security contributions. Following the reduction in the CIT rate, we are not planning any further major tax changes in 2008. However, in line with our obligations resulting from the membership in the World Trade Organization (WTO) and regional commitments, we will continue gradually reducing our external tariffs. We have also closed several loopholes in VAT administration by eliminating the problematic self-invoicing scheme for agro-producers, and by introducing a compensating scheme for farmers who pay VAT on their purchase without being entitled to credit it on their sales. Furthermore, to boost local government revenues, we plan to increase the property tax rate (while leaving municipalities the right to adjust this within a margin of 30 percent), and will transform some national charges into local charges.

- **Budget expenditures will temporarily increase to about Lek 337 billion (31½ percent of GDP).** Current expenditures are projected to increase to some 24 percent of GDP, accommodating wage increases in priority sectors such as health and education. There will be a one-off increase in capital spending from 5.9 percent of GDP to 7.3 percent, reflecting the acceleration of the Rreshen-Kalimash road project, the cost of which is now projected at €530 million, excluding VAT, about €100 million higher than originally estimated. The cost increases are mainly due to changes to the project design and higher cost of inputs, which could yet increase further. While we are currently exploring design changes that could lower budget costs in 2009, we have offset the 2008 budget effects by compensating reductions in other capital spending.

14. **The increased capital spending in 2008 will mainly be reflected in higher imports and a widening of the trade deficit.** We do not expect the incremental spending to add significantly to domestic demand pressures, as wages are unlikely to rise given the still high rate of unemployment in Albania. Moreover, while the budget makes room for all our spending priorities, we do not intend to execute them all, and will in this way hold the fiscal
deficit to 5.2 percent of GDP. Should this target be in jeopardy, we will make offsetting reductions in other expenditure in the context of the midterm budget review. As the increase solely reflects an acceleration of disbursements of foreign financing within the given overall program limit, it will also not adversely impact debt sustainability over the medium term.

15. **Further tax administration improvements are critical to improve the business climate and bring actual collections more in line with potential yield.** We will improve the VAT refund process and continue to provide to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (SB; ongoing). Furthermore, we will introduce by end-April 2008 (SB) a VAT refund system where claims are paid automatically if validity checks are met, as outlined in the IMF TA report on tax administration of October 2007. Following the transformation of the LTO into a full service office for all large taxpayers in Albania, we intend that by the end of June 2008, all education activities, audit, assessment, accounting, enforced collection measures and other administrative actions will be fully conducted by the LTO. We will implement the recommendations of the working group to meet our commitment to increase the number of taxpayers paying social contributions (excluding contributions paid by agricultural workers and voluntary contributors) to 410,000 by end-July 2008 (SB). We will continue expanding and upgrading our customs houses, 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. **We will ensure our external debt position remains sustainable.** We will keep external borrowing within the program’s existing external nonconcessional borrowing ceiling of €680 million. We will use foreign financing of €230 million to finance the Rreshen-Kalimash project in 2008; and will reduce our overall recourse to nonconcessional external borrowing by using half the receipts of any large privatization to finance this project. We will also continue to conduct independent feasibility studies for large projects (as defined in the TMU) financed through nonconcessional commercial borrowing; provide to the Fund a semi–annual listing and status report on all projects being considered for nonconcessional foreign financing; and prepare semi-annual reports on the stock of external arrears (all ongoing SBs). We will also refrain from financing large development projects through state-owned special purpose vehicles (SPVs) until we have developed additional capacity to fully evaluate such schemes.

17. **We will further strengthen our debt management capacity.** We have approved the Public Finance Sector Strategy for 2007–13. We will complete the computerization of debt by including domestic debt and will promptly fill the remaining vacancies in the General Directorate, including that of the General Director. We are also developing new forms of government securities to further reduce debt-related vulnerabilities, and will explore the feasibility of accessing international capital markets. In 2008, we might also consider issuing Albania’s first benchmark Eurobond in international markets, and we are seeking technical
assistance from our US Treasury Adviser and possibly from the IMF or World Bank to assist us in our preparations.

C. Reform of the electricity sector

18. **A sustainable solution to the energy crisis will require stabilizing the financial position of KESH and privatizing the distribution arm of KESH over the next year.** In 2007, we instituted limited load shedding of power to partly offset the shortfall in production; and the new management of KESH took measures to improve efficiency, reduce waste and theft, and raise collection rates, including through a stricter approach to cutting off service to nonpaying customers. Arrears of budgetary and non-budgetary institutions to KESH accumulated up to end-2006 were cleared in August. But notwithstanding our efforts to ensure that these institutions henceforth pay power bills in a timely manner, a new round of arrears had to be cleared by end 2007.

19. **In February 2008, to boost the cash flow of KESH and to begin bringing prices closer to cost-recovery levels, the independent regulator (ERE) approved an about 15 percent increase in electricity tariffs.** Raising tariffs to cost recovery levels and limiting electricity losses are key to reduce the large quasi-fiscal losses of KESH. The increase, which became effective in March 2008, closed some of the gap between local tariffs that had remained unchanged since mid-2006 while international prices of electricity had doubled. At the time of the previous tariff hike in 2006, we instituted a social safety net program targeted to low-income consumers. However, we have experienced administrative problems in disbursing funds under the program. Therefore, we have not increased tariffs for consumption below 300 kWh per month to protect the poorest household consumers until we build capacity for a better targeted safety net program. Given the high demand for electricity in winter, we decided to phase in the move to cost recovery levels by holding the February increase to 15 percent, with another increase to be taken in summer. This phased approach has the added value of allowing us to assess the success of our efforts to raise effective collections and the potential need for electricity imports based on hydrological developments when determining the size of the next adjustment. In any event, we will take measures to reduce the quasi-fiscal losses of KESH to 1.2 percent of GDP (SB; June-15, 2008); and will also raise the effective collection rate in 2008 to 62.5 percent by further limiting losses to 32 percent and boosting collections to 92 percent. In collaboration with the World Bank, work on a new action plan is continuing. These measures are expected to increase KESH’s revenue by about ¾ percent of GDP.

20. **We are also progressing towards privatization of the distribution arm of KESH.** IFC—the privatization advisor to KESH—has helped us set up a program aimed at privatizing by end–2008. We will identify qualified bidders by end-June 2008. In parallel, we are establishing the required regulation and market structure with assistance from USAID. In this regard, we will finalize rules for the electricity market and the methodology for tariff adjustment by end-March 2008. We are aware that the privatization agenda—while
technically feasible within 2008—is subject to complex risks. The Ministry of Economy, Trade, and Energy is carefully monitoring the process to ensure close coordination between KESH, the regulator, IFC, and donors.

21. **We are developing additional sources of electricity supply.** Construction of a thermal power plant, financed jointly by the World Bank, EIB and EBRD, has already started—the plant will increase power supply by 700 GWh a year upon completion in 2009. Awarding the concession contract for the thermal power plant at Fier will further increase power supply. Additionally, with IFC assistance, we have closed the prequalification phase of the Ashta hydro power project, which will be awarded on concession basis through international open tender. We are also progressing with small hydro power concessions. Work on a new transmission line to Montenegro has begun with assistance from KfW which, when completed, will significantly increase our import capacity.

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

22. **We will continue our efforts at anchoring low inflation expectations and remain vigilant and react quickly to any rise in underlying price pressures.** We will continue to proactively use our policy rate if needed to reassure markets and contain any second-round inflation effects. On the demand side, with fiscal policy well-anchored, the principle risk stems from resurging credit growth; while on the supply side, further energy shortages would raise prices as the increasing costs of self-generated electricity are eventually passed on to consumers or if the KESH situation was perceived to undermine successful budget execution.

23. **Open and transparent communication with the market is a key element in our strategy.** We are therefore expanding our outreach and ensuring that price developments and the reasons for our policy measures are clearly conveyed to the market. In this respect, we believe INSTAT's recent decision to develop and publish additional measures of inflation—such as average inflation and core inflation (from which volatile or administrative prices such as food and electricity have been excluded)—will provide us with additional means to illustrate the underlying inflation situation to the market.

24. **Monetary policy will continue to adapt to the changing structure of the financial system.** Our current monetary policy framework—a reserve money program with quantitative targets set in consultation with the Fund and with changes to the repurchase rate as the main policy instrument—has served us well and will be retained along with the flexible exchange rate. Further development of the interbank and secondary markets will help improve the monetary transmission mechanism over the medium term. Pending these improvements, however, over the course of 2008, we will continue to supplement monetary policy measures with regulatory and supervisory measures. This will improve the quality and safety of commercial banks’ growing loan portfolios, while reining in the growth of credit from the supply side. We also stand ready to protect financial stability in case a drastic
increase in collaterizable assets follows the planned large-scale formalization and titling of real estate, which could trigger an unsustainable boost to credit demand.

25. **We attach priority to improving our capacity to oversee and regulate banks.** The banking system remains solvent, liquid and profitable. We are nonetheless vigilant about potential risks. Not only is credit growth still rapid, but the loan portfolio has been built up during a time of unprecedented economic expansion, and has therefore not been tested by adverse economic conditions. Moreover, collateral execution remains difficult, calling into question the effectiveness of a major pillar supposed to safeguard financial stability. Over the course of 2008, we therefore intend, as a matter of priority, to further improve our supervisory capacity by:

- Taking necessary legal and administrative steps to improve the ability of commercial banks to execute collateral.
- Establishing MOUs with the home country supervisors of major banks, including Austria and Italy, for the sharing of information; and promulgating additional measures to improve the execution of collateral.
- Providing regular training opportunities to staff of the BSD, FSD, FSA, and Deposit Insurance Agency, and addressing staffing and any organizational needs.

In order to properly prioritize and augment this considerable agenda, and to ensure its full consistency with international best practice, a Fund technical assistance mission recently visited Tirana to review our existing banking supervision capacity and to assist us in designing future policy and administrative improvements. We intend to utilize the mission’s recommendations as an input to developing a medium-term plan for the further development of our banking and financial sector supervisory capacity.

26. **We will also strengthen incentives for banks to analyze risks.** We might require banks to formally discuss risks, particularly those arising from rapid credit growth and foreign currency lending, in the meetings of their boards of directors, to boost their risk management, or to raise reserve and provisioning requirements for activities with high risk, such as lending in foreign currency to insufficiently-hedged borrowers. Banks’ exposure to the indirect credit risk embodied in unhedged foreign currency lending could be further mitigated by limiting such loans to a specific multiple of capital. We are also considering the introduction of simple rules that would target consumer credit, including credit cards, such as loan to disposable income ratios and transparency and disclosure requirements; the reintroduction of loan to value requirements for all types of loans, including mortgages; and greater monitoring of loan maturity gaps.

27. **Further financial market development is essential to improve the efficiency of monetary policy and financial intermediation.** Our priority is now to develop interbank and secondary markets. To this end, we will develop a delivery versus payment system
(DVP) for government securities, capable not only of simultaneous delivery and settlement for sales, but also for private repurchase operations (SB; end-October 2008), and have requested Fund TA to help design and implement the system. We expect such a system, alongside a reduction in the frequency of primary auctions, to raise volumes in the secondary market for government debt and foster the development of the interbank market. The necessary legislative changes needed to remove obstacles to private party repurchase operations have already been drafted and will be submitted to Parliament. We also expect to fully automate the primary market for government treasury bills and bonds as part of the same IT project, thereby allowing the entire auction process to be completed within a single day compared with three days currently. Nonetheless, the treasury bill window at BoA will be maintained until it is clear that the new system provides a fully acceptable alternative means of ensuring nonbank access to government securities on an equitable basis. Lastly, we will protect progress made to date in privatizing the banking system.

28. **We have taken steps to strengthen the balance sheet of the BoA.** As a prior action for this review, we transferred over 86,000 ounces of gold to BoA in order to ensure a positive level of capital at end-2007. We also increased the permissible level of BoA’s paid in capital from lek 750 million to lek 2,500 million, which removed a legal obstacle that had prevented BoA from using retained earnings to increase its reserve fund. Looking ahead, we will aim to adopt international best accounting practices in the calculation of BoA profits and to make securities to compensate BoA for any unrealized valuation losses fully marketable by end-May 2008. We will take no legislative or regulatory action that weakens the independence of the BoA, including its control over its budget and its authority to decide on compensation levels.

29. **We intend to maintain the pace of reforms in the nonbank financial sector.** In the insurance sector we have an ambitious work program, developed together with the World Bank, which is centered around the introduction of risk-based supervision, as well as implementation at FSA of an IT platform for offsite reporting and internal analytics. In addition, we will review and update all insurance laws and regulations, with an emphasis on the legislation governing motor vehicle third party liability and reinsurance. The legal framework governing the private pension industry is under discussion and will also be reviewed and updated. 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.

**E. Data Issues**

30. **We will continue to improve statistics, particularly the national accounts and short-term economic indicators.** Strengthening the methodology and timeliness and increasing the frequency of national accounts statistics remain a top priority over the short and medium term. We have undertaken a number of surveys to improve the basis for the national accounts and other important data, such as consumer price data. In particular, data
from the national labor force survey of 2007 will enhance the reliability of our national accounts statistics. To strengthen short-term economic indicators, we are improving the coverage, timing and quality of our STS business survey. We will strengthen the collaboration of INSTAT and the BoA to improve the quality of our balance of payments statistics, particularly data on workers remittances and foreign direct investment. We appreciate the extensive technical assistance from the Statistics Department of the IMF and will continue to work with the IMF to implement the recommendations of the 2006 data ROSC, as well as our plan to move towards SDDS status.

F. Other Structural Reforms

31. Privatization of strategic public enterprises will continue in 2008. The significant interest shown by foreign insurance companies in the Albanian insurance sector makes us confident we will be able to sell INSIG this year or next. In the oil sector, we have selected the privatization advisor for ARMO and the international privatization tender is expected to open in spring 2008. We will also intensify our efforts to divest the assets of Albpotrol-One, which we recently formed by merging Albpotrol and Servcom. We also intend to offload our remaining minority stake in the mobile telephone company AMC.

32. We are also making progress in other reforms to improve our business and investment climate. We will continue our efforts in implementing the Regulatory Reform agenda, led by a high level 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, in compliance with the finalized SME Medium-Term Strategic Program for 2007–2009; and carry out the necessary actions to make our new Competitiveness Fund and Export Guarantee Fund fully operational and effective, relying more on the increased capacities of Albinvest. We are also taking measure to improve the commercial court system and we are pursuing land registration, including the legalization of informal housing, in order to enhance contract enforcement and property rights and ensure long-term sustainable development.

G. External Arrears

33. We continue to clear or reschedule our arrears on inoperative payment agreements. Further progress was made in 2007 in clearing or rescheduling arrears to official and private creditors including the rescheduling of arrears to Poland and Bulgaria. However, some negotiations have taken longer than expected. We remain in negotiations with official creditors from Greece, Russia and Serbia and Montenegro, are reconciling terms with Algeria, Cuba and Vietnam, and are negotiating with a number of private companies. The slow pace of negotiations meant that we did not fully clear or reschedule our arrears by the end of 2007. But discussions are in progress, and we aim to conclude them by end-2008.
We will not accumulate new external payments arrears. Once all arrears have been cleared or rescheduled we will begin discussions with the Fund with a view to accepting Article VIII.

H. Program Monitoring

34. The sixth disbursement and purchase under the PRGF/EFF-supported program will be based on the end-March, 2008 quantitative performance criteria (Table 1 and the TMU); and completion of the fifth review and financing assurances review. The fifth review under the PRGF and EFF arrangements is expected to be completed no later than August 1, 2008; and the sixth review no later that February 1, 2009. 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 2008 1/

<table>
<thead>
<tr>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceiling on net domestic credit to the government 2/</td>
<td>1</td>
<td>16</td>
<td>20</td>
<td>-12.4</td>
<td>22.0</td>
<td>32.3</td>
<td>21.4</td>
<td>25.1</td>
<td>26.4</td>
<td>6.3</td>
<td>12.6</td>
<td>18.9</td>
<td>25.2</td>
<td></td>
</tr>
<tr>
<td>Ceiling on accumulation of net domestic assets of the BOA 3/</td>
<td>-9</td>
<td>12</td>
<td>12</td>
<td>-16.8</td>
<td>16.6</td>
<td>10.1</td>
<td>-1.7</td>
<td>-16.8</td>
<td>-16.8</td>
<td>1.7</td>
<td>10.1</td>
<td>6.1</td>
<td>23.4</td>
<td></td>
</tr>
<tr>
<td>Indicative total tax revenue target 4/</td>
<td>100</td>
<td>97</td>
<td>97</td>
<td>156.9</td>
<td>155.0</td>
<td>155.0</td>
<td>221.3</td>
<td>221.0</td>
<td>221.0</td>
<td>51.1</td>
<td>108.6</td>
<td>171.2</td>
<td>244.7</td>
<td></td>
</tr>
<tr>
<td>(In billions of US dollars)</td>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Floor on accumulation of net international reserves of the BOA 3/</td>
<td>232</td>
<td>91</td>
<td>91</td>
<td>165.8</td>
<td>-24.9</td>
<td>50.4</td>
<td>130.5</td>
<td>28.6</td>
<td>103.9</td>
<td>-58.6</td>
<td>-25.2</td>
<td>30.9</td>
<td>92.9</td>
<td></td>
</tr>
<tr>
<td>(In millions of Euros)</td>
<td></td>
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</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>164</td>
<td>380</td>
<td>380</td>
<td>180.0</td>
<td>380.0</td>
<td>380.0</td>
<td>278.0</td>
<td>380.0</td>
<td>380.0</td>
<td>515.0</td>
<td>515.0</td>
<td>650.0</td>
<td>680.0</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</td>
<td>0</td>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td></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>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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<td>0.0</td>
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</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-2007 except where marked. Data for end-March 2008 and end-September 2008 are proposed performance criteria, except where marked. Data for end-June 2008 and end-December 2008 are indicative targets.
2/ Cumulative change within the calendar year.
3/ For end-December 2007 and end-September 2007, cumulative change from end-December 2006. For end-June 2007, cumulative change from end-December 2005.
4/ Indicative target. Defined as all revenues collected by the GDT, GDC, and SSI. Aggregate revenue so defined includes all revenues collected on behalf of local governments, but excludes revenues collected by local governments directly. From September 2007 includes small business tax. Targets defined as cumulative changes within each calendar year.
5/ Applies on a continuous basis.
### Table 2. Proposed Structural Performance Criteria and Benchmarks under the PRGF and EFF Arrangements 1/

<table>
<thead>
<tr>
<th>I. Prior Actions</th>
<th>II. Structural Benchmarks</th>
<th>Proposed Test Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Increase the capital of BoA by transferring to it 86,000 ounces of gold.</td>
<td>A. Reduce fiscal vulnerabilities</td>
<td>End-April 2008</td>
</tr>
<tr>
<td>2. Implement an electricity tariff increase.</td>
<td>3. Take measures to reduce the quasi-fiscal losses of KESH to 1.2 percent of GDP.</td>
<td>End-October 2008</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. Improve VAT administration by preparing and providing to the Fund quarterly reports on the aggregate amounts of the VAT refunds requested, refunds paid and refunds rejected (within one month of the end of each quarter).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5. Prepare and issue quarterly reports on progress made in the actual use of the risk assessment module of the ASYCUDA system to perform inspections in the End-July 2008 Ongoing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6. Introduce modifications into the VAT refund system whereby claims will be paid automatically if validity checks are met (as outlined in the IMF TA report on tax administration of October 2007).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>7. Prepare semi-annual reports (within one month of the end of each semester) on the stock of external arrears.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>8. Increase the number of taxpayers paying social security contributions (excluding agricultural workers and voluntary contributors) to 410 thousands.</td>
</tr>
<tr>
<td></td>
<td>B. Improve public expenditure management</td>
<td>Ongoing</td>
</tr>
<tr>
<td></td>
<td>9. Safeguard the efficient use of nonconcessional foreign project loans:</td>
<td>Ongoing</td>
</tr>
<tr>
<td></td>
<td>(i) Conduct an independent feasibility study for any large project (as defined in the TMU) financed through non-concessional commercial borrowing;</td>
<td>Ongoing</td>
</tr>
<tr>
<td></td>
<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></td>
<td>C. Strengthen the financial system</td>
<td>Ongoing</td>
</tr>
<tr>
<td></td>
<td>10. Complete the delivery vs. payments system for government securities.</td>
<td>End-October 2008</td>
</tr>
</tbody>
</table>

1/ Text in italics refers to new conditionality not carried over from the third review under the program (IMF Country
ALBANIA: TECHNICAL MEMORANDUM OF UNDERSTANDING

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 2008; 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), the Expropriation Fund, local governments, 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;\(^1\) 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)\(^2\); 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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\(^1\) Other domestic lenders comprise firms, nonbank institutions, and households, or any other resident legal or natural person, or institution.

\(^2\) This was equivalent to lek 15.505 billion at end-December 2007.
(ii) Gross domestic credit in lek and in foreign currency extended to the
government excludes advances on profit transfers by the BoA.

(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
plus accrued interest. 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 including 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 issue price plus accrued interest. The stock of all gross domestic
credit extended to the government and held by SLIs and other domestic
lenders will be valued at face value³.

(iv) For the purposes of program monitoring, gross domestic credit to the
government in foreign currency will be converted from lek to Euros at the
end-of period lek/Euro exchange rate prevailing on the test date; and then
converted to lek at the program exchange rate of lek 121.6/Euro.

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 (Euro 569.2 per ounce)⁴.

(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.

³ Under current reporting standards, the stock of all gross domestic credit extended to the government and held
by the SLIs and other domestic lenders is only available at face value.

⁴ The lek value of standard gold deposits will be (a) converted to Euro using the current end-of-period lek/Euro
exchange rate; (b) then converted to ounces of gold using the current Euro market price of gold; (c) then
converted to Euro at the program price of gold (Euro 569.2 per ounce); and (d) then converted to lek at the
program lek/Euro exchange rate of lek 121.6/Euro.
(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 DMBs 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, foreign currency-denominated government financial assets will be converted from their lek value (obtained from the BoA and aggregate DMBs’ balance sheet) to their currency of denomination at the end-of period lek exchange rate for that currency prevailing on the test date; and then converted to lek at the lek exchange rate for that currency prevailing at end-December 2007. Those foreign currency-denominated government financial assets for which the currency of denomination is unknown, will be converted from their lek value (obtained from the BoA and aggregate DMB’s balance sheet) to Euros at the end-of period lek/Euro exchange rate for that currency prevailing on the test date; and then converted to lek at the lek/Euro program exchange rate of lek 121.6/Euro.

6. Under these definitions, the stock of net domestic credit to the government was lek 360.3 billion at end-December 2007. 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 2007. Under this definition, the level of NDA was lek 93.9 billion as of end-December 2007. The NDA limits will be cumulative changes from end-December 2007 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. 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. The government’s foreign currency deposits at the Bank of Albania are excluded from reserve liabilities, with the following exception: those government deposits that arise from the proceeds of the foreign currency-denominated syndicated loan contracted to finance part of the Rreshen-Kalimash road will be included in reserve liabilities. Reserve assets and reserve liabilities will both be expressed in US dollars. The NIR limits will be cumulative changes from end-December 2007, and will be monitored from data supplied by the Bank of Albania.

10. During this program, for monitoring purposes, the bilateral exchange rates between the Euro and non-dollar currencies will be kept at their end-December 2007 levels and holdings of monetary gold will be valued at Euro 596.2 per ounce. Under this definition, the level of NIR was US$1,624.4 million at end-December 2007.

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, 2008 will be as follows:

- End-March 2008 lek 481 mn. (Of which US$0.0 mn. in foreign currency);
- End-June 2008 lek 962 mn. (Of which US$0.0 mn. in foreign currency);
- End-Sept 2008 lek 4,100 mn. (Of which US$12.0 mn. in foreign currency);
- End-Dec 2008 lek 4,100 mn. (Of which US$12.0 mn. in foreign currency).

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

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5 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.
by half the amount of any excess (shortfall) in the receipt of total privatization proceeds from these assumed values.

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 2008 budget, but legally expended in the first 14 days of 2009 and legally credited to the 2008 fiscal year.

- will be adjusted upward 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 upwards by the disbursed amount of the foreign currency-denominated syndicated loan contracted to finance part of the Rreshen-Kalimash road that is sourced through resident banks or other resident lenders. There will be no adjustment to the NCG target for this purpose for disbursements of this loan that are sourced through nonresident lenders.

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, 2008, to:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-March 2008</td>
<td>US$0.0 mn;</td>
</tr>
<tr>
<td>End-June 2008</td>
<td>US$0.0 mn;</td>
</tr>
<tr>
<td>End-Sept 2008</td>
<td>US$0.0 mn;</td>
</tr>
<tr>
<td>End-Dec 2008</td>
<td>US$0.0 mn;</td>
</tr>
</tbody>
</table>

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6 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.
The ceilings on NDA of the Bank of Albania and NCG 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.7

14. The NDA ceilings will also be adjusted to reflect the impact of any change in the required reserve ratio of commercial banks with the Bank of Albania. Should reserve requirements in lek (foreign currency) be changed from the 10 percent on all deposits held in lek (foreign currency), then the NDA ceiling will be adjusted by multiplying the change in the reserve requirement by the programmed deposits for which required reserves are held in lek (foreign currency). The total adjustment to the NDA ceiling will be the sum of the adjustment made for any change in the reserve requirement on lek deposits and the adjustment made for any change in the reserve requirement on foreign currency deposits. Before making any change to the required reserve ratio, the authorities will consult with IMF staff. For the purpose of this adjuster, the programmed level of deposits in lek and foreign currency are defined as follows:

<table>
<thead>
<tr>
<th></th>
<th>In lek (lek bn.)</th>
<th>In foreign currency (lek bn.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-March 2008</td>
<td>350.6</td>
<td>264.5</td>
</tr>
<tr>
<td>End-June 2008</td>
<td>364.5</td>
<td>267.5</td>
</tr>
<tr>
<td>End-September 2008</td>
<td>377.1</td>
<td>294.4</td>
</tr>
<tr>
<td>End-December 2008</td>
<td>372.6</td>
<td>312.6</td>
</tr>
</tbody>
</table>

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

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7 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.
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\(^8\). 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 medium- and long-term external debt as defined in paragraph 16 will be adjusted downwards by the disbursed amount of the foreign currency-denominated syndicated loan contracted to finance part of the Rreshen-Kalimash road that is sourced through resident banks or other resident lenders. There will be no adjustment to the limit on medium- and long-term external debt for this purpose for disbursements of this loan that are sourced through nonresident lenders.

18. 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

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\(^8\) For the purposes of program monitoring, "external" means owed to a non-resident, and includes both foreign currency- and local currency-denominated debt (where debt is defined in paragraph 15 of this memorandum).
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.

19. 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, 2007 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, 2007; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

20. **Large projects** (as referred to in MEFP paragraph 16 and MEFP Table 2) are defined as those projects involving total nonconcessional borrowing in excess of Euro 20 million.

**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).

(xiii) Monthly information regarding the balances held by the Expropriation Fund at BoA disaggregated into foreign currency and domestic currency.
(xiv) Monthly data regarding the currency composition of government deposits at BoA and the aggregated deposit money banks, disaggregated by transferable and other deposits.

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.
(xii) Monthly information regarding the balances held by the Expropriation Fund at deposit money banks and SLAs disaggregated into foreign currency and domestic currency.
(xiii) The amount—and detailed breakdown—of fiscal expenditure that was authorized by the 2008 budget, but legally expended in the first 14 days of 2009 and legally credited to the 2008 fiscal year; and the amount—and detailed breakdown—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.

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.

The Albanian Electricity Corporation KESH will supply to the Fund:

(i) Detailed monthly data on production, imports, and consumption of electricity.
(ii) Detailed monthly data on losses and collection rates.
### Table 1. Albania: Calculation of Net Domestic Credit to Central Government for Program Monitoring Purposes, December 2007–December 2008

(In millions of lek)

<table>
<thead>
<tr>
<th>Dec-07</th>
<th>Mar-08</th>
<th>Jun-08</th>
<th>Sep-08</th>
<th>Dec-08</th>
</tr>
</thead>
</table>

1. Treasury bills held outside central government
   - Of which:
     1. (i) Held by Bank of Albania 1/ 239,825
     1. (ii) Held by deposit money banks 1/ 66,965
     1. (iii) Held by other domestic lenders (excluding holdings of HHI and SSI) 1/ 131,810
     1. (iv) Held by savings and loan institutions 2/ 0
     1. (v) Held by other domestic lenders (excluding holdings of HHI and SSI) 2/ 0
     1. (vi) Held by savings and loan institutions 2/ 0

2. Other central government debt held outside central government (millions of lek)
   - Of which:
     2. (i) Held by Bank of Albania 3/ 137,451
     2. (ii) Held by other domestic lenders (excluding holdings of HHI and SSI) 2/ 0
     2. (iii) Held by savings and loan institutions 2/ 0
     2. (iv) Held by other domestic lenders 5/ 0

3. Assets of central government (excluding HHI and SSI)
   - Of which:
     3. (i) Deposits held at Bank of Albania 6/ 10,253
     3. (ii) In domestic currency 131,810
     3. (iii) Transferable deposits in lek 4,541
     3. (iv) Term deposits of government and deposits in lek for projects 465
     3. (v) Domestic currency portion of Expropriation Fund 2,429
     3. (vi) In foreign currency at program exchange rates and program price of gold 7/ 121,946
     3. (vii) In foreign currency evaluated at current exchange rates 7/ 121,946
     3. (viii) Transferable deposits in foreign currency evaluated at program exchange rate 7/ 3,172
     3. (ix) Transferable deposits in foreign currency evaluated at current exchange rate 7/ 3,172
     3. (x) Foreign currency portion of Expropriation Fund at current exchange rates 0
     3. (xi) Standard gold deposits of government evaluated at program exchange rate and gold price (Lek mns.) 8/ 1,581
     3. (xii) Standard gold deposits of government evaluated at current exchange rate and gold price (Lek mns.) 8/ 1,581
     3. (xiii) Number of ounces of gold equivalent 29,411
     3. (xiv) Deposits held at deposit money banks 3/ 2,112
     3. (xv) Deposits 10/ 1,570
     3. (xvi) In domestic currency 165
     3. (xvii) Transferable deposits in domestic currency 165
     3. (xviii) Other deposits in domestic currency 0
     3. (xix) Deposits in foreign currency evaluated at program exchange rates 1,504
     3. (xx) In foreign currency evaluated at current exchange rates 7/ 1,504
     3. (xxi) Transferable deposits in foreign currency evaluated at current exchange rates 1,504
     3. (xxii) Other deposits in foreign currency evaluated at current exchange rates 0
     3. (xxiii) Ministry of finance short-term lending to commercial banks 129
     3. (xxiv) Held at savings and loan institutions 10/ 0

Less:

4. Deposits of HHI and SSI 6,735

Equals:

5. Stock of Net domestic credit to central government (1+2-3-4) 360,289

6. Memorandum items:

   6. (i) Change since December 2007 360,289

1/ Evaluated at issue price plus accrued interest.
2/ Evaluated at face value (data on treasury bill holdings of SLAs and other domestic lenders are currently available only at face value).
3/ Includes accrued interest.
4/ Valued at issue price plus accrued interest.
5/ Evaluated at face value.
6/ Includes transferable deposits of government in domestic and foreign currency, lek deposits of central government for projects; deposits of the Expropriation Fund; and standard gold deposits of government (footnote # 8). Excludes non-standard gold deposits; excludes all nongold precious metal deposits of government; and excludes government deposits in foreign currency for projects.
7/ Value to be determined using methodology outlined in the TMU.
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 Euro using the current end-of-period lek/Euro exchange rate; (b) then converted to ounces of gold using the current market price of gold; then (c) converted to Euro at the program price of gold of Euro 569.2 per ounce; and then (d) converted to lek at the program Lek/Euro exchange rate of Lek 121.6/Euro.
9/ Including account set up to hold privatization revenue.
10/ Includes all deposits of central government in SLAs.